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## **The changing environment: inflation, rates, geo-politics - by Bill Pastuszek**

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The year 2022 has greeted us with plenty of uncertainty. At the end of the first quarter, most projections are now subject to review and possible resetting.

Let's review some of the pertinent issues—good and bad—that will have to be considered in comprehending the behavior of the varied real estate markets we work in.

**Geo-Political.** Seemingly out of nowhere, we now have an invasion of a sovereign nation underway. As a general and specific condition of uncertainty, there is no clear path to understanding its effect on real estate. Much like COVID-19, it will add another layer of uncertainty. It's really too soon to know what the long- and short-term effect on real estate markets and investor behaviors will be.

**Inflation.** Inflation may not be the enemy of commercial real estate. Some asset classes—such as lodging, self-storage, and multi-family—can reset rental rates relatively quickly to respond to inflation. However, consumers in markets such as lodging also have the ability to not buy when rates get too pricey and high energy costs begin to make travel expensive enough to become discretionary. Apartments, on the other hand, tend to be more inflation resistant.

Apartments are a favorite among investors and will likely continue to be that way. Boston continues to generate new apartment product and there is always ongoing concern that the market is becoming over built. On the other hand, the supply is replacing much older stock and making up for years of little additions to the stock. And, in a market where there is a severe shortfall of detached housing to meet demand, condominiums represent the viable alternative and the demand generated continues to drive multi-family development.

What effects do inflation have on the bottom line of income-producing properties? On the revenue side, landlords can raise rents where possible, adjust reimbursements, and apply escalators where possible. Managing vacancy becomes an issue where tenants are also being affected by inflation. (At some point and in some markets, raising rents may have the opposite effect, i.e., of driving tenants to seek cheaper space.) On the expense side, some costs can be controlled, while others are at the mercy of market forces. At the level of NOI, how to convert income into value gets built into investor expectations regarding various risk points. It's a complex relationship of number of moving parts. There's no easy answer to be found.

Projecting revenue and expense, however, needs to build in the effects of increasing costs into forecasts. Property-specific historical data, comparable market data, and the expectations of market participants in terms of energy, labor, and other operating costs and rents have to be considered more carefully now than ever.

**The Fed and Interest Rates.** During the height of the pandemic, rates were lowered to near zero, and the government massively bought back debt. To combat inflation, both of these activities are being reversed: money will now cost more. The cost of debt is an important factor in real estate. How does that affect various property classes based on cash flow characteristics?

Residential Markets. The 1-4 family housing market are first to be affected by looming rate hikes; consumer housing activity is exquisitely sensitive to interest rate fluctuations. The sector that gets hit first is the refinance market. Purchase activity is less sensitive, to a point. Last year in Massachusetts, MLS data showed the number of units up 10% in 2021 over previous years, with decreased marketing times, and very strong price appreciation (15-20%). Will these metrics continue to be sustainable under conditions of heightened uncertainty, continued affordability disconnects, and higher debt costs?

Interest Rates. How far do interest rates need to move up before commercial markets begin to be impacted? Economists, investors, lenders and appraisers can build models to simulate the effects of high interest rates and inflation but market activity ultimately will be the final arbiter.

Just like markets reacting to COVID surprised many, this situation may also yield some unanticipated results. Real estate is long-term and making too much of the short-term may underestimate the ability of markets to adjust.

Final Thoughts. There is no certainty except that we can always expect the unexpected. The war in Ukraine will continue to have global consequences we cannot fully anticipate but will require adjustment in an environment that is far more dangerously uncertain than at the beginning of this year.

The Ukrainian nation has been independent for over a generation, gaining its independence after many years of Soviet rule, and before that, being handed back and forth between German, Polish, and Russian rule. The citizens of Ukraine do not deserve what is going on there now. Please keep Ukraine in your thoughts and prayers and, if you can, find a way to help those who are enduring this lethal invasion.

(Author's Note: My parents both came from Ukraine.)

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