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Inflation is here, finally. Why do we care? - by Daniel Calano

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For those of you who were around in real estate a couple of decades ago, you know we were sure inflation would come, and interest rates would increase. The truth is...it never happened, except for a few blips. I, for one, gave advice or made decisions based upon an inevitable increase in interest rates. So, we've said it before, but finally it is really here...like 7-8% here. At first, some called it transitory, but it now sure looks more sticky, particularly in labor. What does it mean to us and how should we change our behavior in anticipation?

As you are probably aware, inflation is here because the Federal Reserve Bank has been buying US bonds, thus lowering interest rates, while also providing easy access and almost free money due to Covid. The Federal Reserve mission is to keep unemployment low and keep inflation at a moderate level. It has been successful in lowering unemployment but in the process, the economy has fired up to a point which is potentially unmanageable. Critics say the Fed should have stopped buying bonds months ago (ie., taper) and should have started raising the short term interbank lending interest rate .

We as consumers have seen the prices of daily needs, food, fuel, services all increasing at a scary fast pace. As real estate people, we have seen it in building materials and labor. Clearly, materials costs have been further impacted by supply chain issues, thus creating a perfect storm of constrained supply with increased demand from a strong economy, quickly leading to increases in price.

How does it impact us? Plenty! As stated, prices are high, sometimes out of reach. Consider housing where some builders and developers, because of costs, have begun to pull back or delay, thus ironically, decreasing supply and further exacerbating pricing. As homebuyers are priced out of the market, people have to rent. Rental costs are up, 15 to 25%, year over year, depending on location, because it is more affordable shelter. However, at high levels of inflation, there is a limit to what people can pay, thus causing some pain, or worse, suffering. Also, with this growth in inflation, consumer confidence has dropped by 15 to 20% in the last couple of months, thus potentially decreasing future spending.

As rates go up on the short end, controlled by the Fed, it is not necessarily true that the long end will follow. While the sequence occurs often, the Fed cannot directly increase long-term rates. For real estate, that clearly can be a good thing if buyers and developers can count on modest increases on 5 to 10 year loans, i.e. those typically required for real estate development and construction. That said, there is correlation often, and it is unlikely that long-term rates would not change to the higher over time.

The other issue for real estate entrepreneurs, of course, is the correlation between interest rates, cap rates, and discount rates. To simplify, they usually go higher or lower together, and higher discount rates and cap rates 10 years out mean lower prices paid for real estate. Good for buyers, but not so much for providers.

No one knows yet what the Fed will do including, probably, the Fed itself. They will be data dependent, acting within the context of the economy at various periods. If they don't do enough, inflation can increase dangerously. At this point there is huge uncertainty, but it is anticipated that there will be at least four or more rate increases within the year. It has to be a perfect balance between too little, thus not lowering inflation, or too much, thus putting the economy into potential recession.

Essentially there are two potential outcomes:

1. Moderate rate hikes combined with bond taper, hopefully keeping inflation at 2-4%;
2. Increase rates too much or too fast potentially constraining the economy, moving towards recession.

It is a balancing act that many economic policymakers are understandably nervous about. For us, it is more uncertainty in the process of supplying real estate that is already complicated enough. There will be impacts, for sure, but let's be patient and watchful. This will take a year or more to shake out.

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