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Inflation fighting: Impacts on real estate? - Daniel Calano

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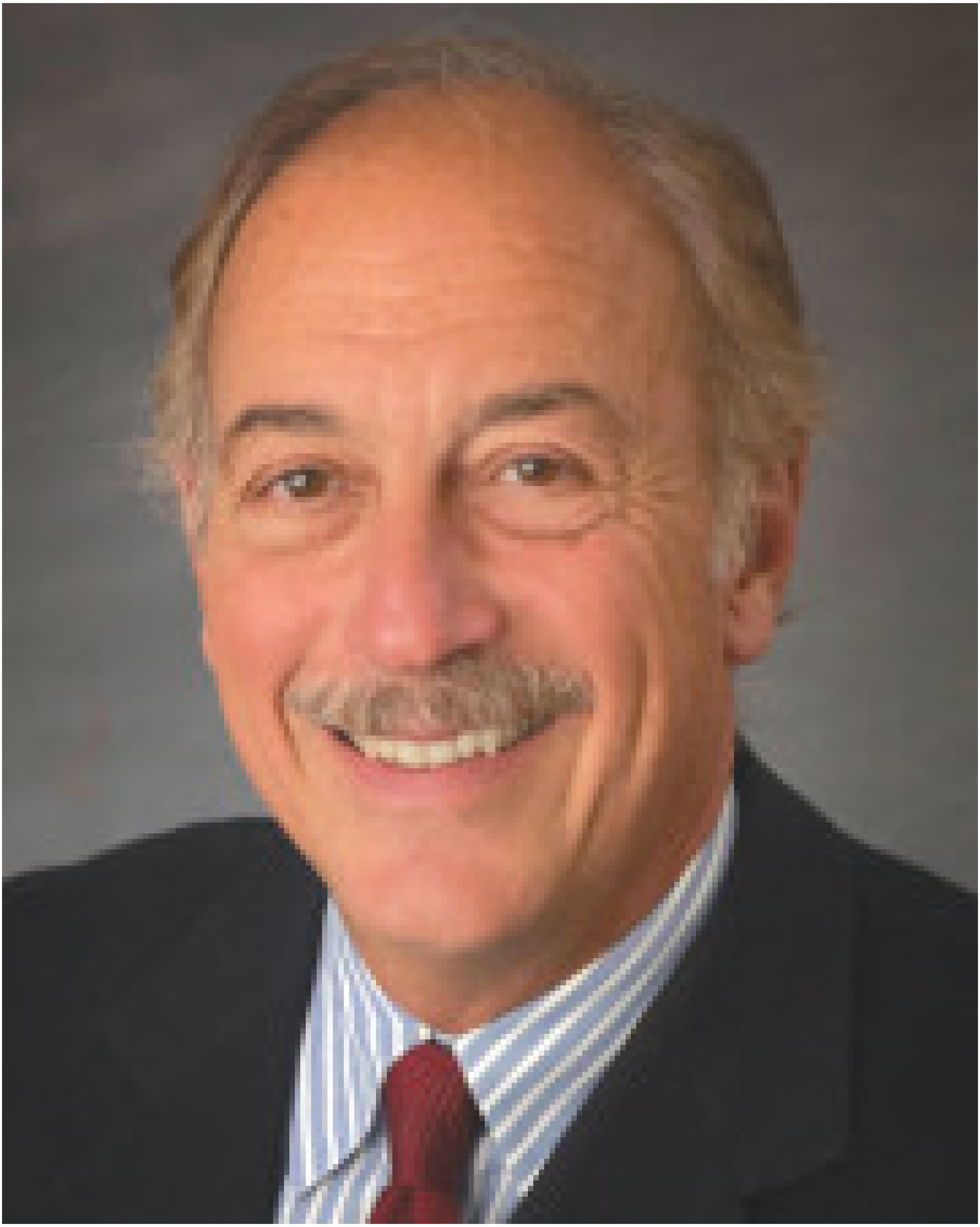

Daniel Calano

Interest rates are finally increasing. Red hot inflation, now at overall 8-10%, is in the Federal Reserve Bank's cross-hairs. The Fed increased the short term borrowing rate by .5% in May, with expectations for another raise in June and July. Before the actual May increase, and based only on the expectation, mortgage rates increased to over 5%, 43% higher than the previous year according to Redfin. All real estate will be impacted to some degree, but how serious will it be? Well, it's complicated, and sometimes seemingly counter-productive. Think see-saw as you read.

First, a quick reminder that the Fed theoretically can only move short-term rates, and thus not long-term real estate borrowing rates. That said, the short and long-term rates do tend to move in lockstep. Thus, with the Fed's commitment to increase the short rate, we can expect and already see further increases in the long-term rate.

The Fed is pursuing this aggressively, due to an extremely fast rise in inflation. Many criticized the Fed chair for acting too slowly, and worse, for thinking that inflation was transitory. That notion has been dispelled, and thus higher interest rates are here to reduce the amount and pace of inflation. But we argue growth is good! They say yes, but only up to the point where inflation erodes the benefits of growth. There is also the risk that the Fed will be too aggressive, and rather than slow growth, it could force a recession. It is a very difficult balance, and a "soft landing" may be impossible.

The impact on real estate is not only about more expensive monthly mortgage payments. This is inevitable. Home purchases demonstrate the impact most vividly. Estimates range, but mortgage brokers find that a 1% increase in mortgage rates will reduce purchasing power by 12 to 15%. On the other hand, with inflation lowered, the cost of labor and materials theoretically will be reduced, potentially balancing some of the increased borrowing costs. We'll see.

While housing has the most obvious and visible impacts, commercial real estate will also be impacted. Increased borrowing rates will apply to larger real estate projects as well. As importantly, more equity participation may be required within the capital stack, as lenders look for more security against increased costs of debt. On the tenant side, slowing the economy may also hurt business's capacity to pay higher rents, thus reducing operating income and ultimately building value, also increasing lender perceived risk.

Finally, equity in the form of private and/or institutional wealth has been, and will probably continue, to be diminished in a slowing economy. Many assets, currently in stocks for example, have easily dropped by 25%, and most likely more, measured year-over-year. As lenders may require more equity or security, investors may simply be unable to participate as much.

Now you get the seesaw metaphor: one end is up while the other is down. While some Fed actions are helpful to real estate, some unintended consequences will be detrimental.

Regardless, slowing inflation is underway. Housing contracts and purchases have already slowed, according to the National Association of Realtors. Companies like Amazon that have over-hired are now laying off thousands, sub-letting millions of s/f. Commercial offices are already less fully occupied due to the work at home hybrid. Consumer confidence and spending has already shown signs of pullback. The Fed is doing its job. At this point we can only hope the results provide a good balance between slightly slower growth and substantially slower inflation. Stay tuned.

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