How Unemployment and Inflation Could Affect Commercial Real Estate Values

The most common question I am asked these days is, **"When will the good times return to the commercial real estate market?"** That question is impossible to answer with accuracy as we are in unprecedented times with unprecedented government intervention and an unprecedented global recession. **Below is a scenario that I think could be possible and may even be probable based upon what we are presently seeing in the market.**

I have read many reports recently stating that "experts" are seeing a turnaround in several segments of both the commercial and residential real estate markets. Intuitively, it is difficult to put any credence in these reports due to one very important fact. **There is no other metric that is more closely tied to the fundamentals of real estate than employment and there is no indication that we are close to seeing a peak in unemployment.** We are presently at a rate of 9.4% nationally and economists' estimates have risen from a peak of 9%-10% to as much as 11% before the trend reverses. The implication for real estate value is acute.

This article, and all other Commentaries by Bob Knakal, can be found on The Massey Knakal Reel – a blog for breaking sales, listing and neighborhood real estate news – at www.masseyknakal.com/blog

As unemployment rises, people who have either lost their job or fear losing their job do not move to a larger rental apartment and do not move from a rental unit to purchase a residence whether it is a single family home, co-operative apartment or a condominium. As unemployment rises, companies do not increase their need for office space and may shed excess space adding to the vacancy and availability rates. **It is easy to see how the fundamentals of real estate are most stressed when unemployment reaches its peak.**

The most optimistic economists predict that the economy will begin to turn during the third quarter of 2009 (the most pessimistic see the turnaround sometime during the first half of 2010). Unfortunately for the real estate market, **unemployment is a lagging indicator and it is likely that unemployment will peak three to six months after the economy turns.** That would place the peak at the end of 2009 or the beginning of 2010 in the best case scenario. This is the point at which the fundamentals of our market will be suffering the most and this is the point at which value will hit a bottom.

The question then becomes, when will value start to climb? In order to answer that, we must consider the potential impact of inflation. Will we have above trend inflation? It is hard to imagine that inflation will not be well above trend as the amount of government spending we have seen, coupled with the overtime the printing presses at the Treasury have been putting in, is creating a very likely potential for excessive inflation.

If this inflation kicks in, what are the ramifications for real estate values? There are two impacts, one positive and one negative. **In an inflationary environment, a flight to hard assets is prudent as cash in the bank loses purchasing**

During Mr. Knakal's almost 25-year career, he has sold over 1,000 buildings having an aggregate market value of over $5.8 Billion. He was the top salesman, with partner Paul Massey, at Coldwell Banker Commercial (now CB Richard Ellis) in New York in 1986, 1987, and 1988 prior to forming Massey Knakal. In 1990, he was awarded Crain's New York Business "40 Under 40" awarded annually to 40 business people under forty years of age for outstanding achievement in the New York business community. In 2001, Mr. Knakal was named one of "The Top Dealmakers" by Real Estate New York Magazine. He has twice been the recipient of the Robert T. Lawrence Award in the Real Estate Board of New York's Most Ingenious Deal of the Year Contest. First in 2002, for the assemblage of the easterly blockfront of Second Avenue between 54th and 55th Streets. Then again in 2004 for the sale of the historic Gotham Book Mart at 41 West 47th Street. In 2009, Real Estate Forum Magazine named Mr. Knakal one of the Top 10 Real Estate Investment Sales Brokers in the United States.

Please give a call if you have questions about your property or the market in general.

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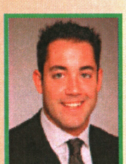

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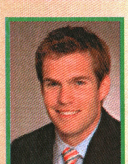

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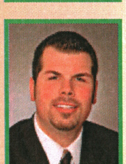

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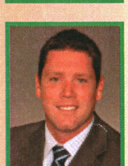

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power each day. Commercial real estate is a great hard asset to own so demand for the asset class should increase. **But with inflation comes intervention from the Fed in the form of increasing interest rates.** The Fed's comfort zone on inflation has been in the 1%-2% range on an annual basis so anything over this range will prompt the Fed to tighten monetary policy, i.e., raise interest rates. Currently in the 6% range, mortgage rates could climb to 8%-9%

If interest rates rise, mortgage rates are likely to rise. **Given economic conditions, we are likely to see an extended period of positive leverage again as we did throughout most of the 1990s after the S&L crisis of the early 1990s left lenders underwriting in a very disciplined manner for the balance of the decade as the "sting" of the crisis was still fresh in their memories.** If we see positive leverage, we could see cap rates rise into the high single digits to low double digits range. This dynamic will have a negative impact on real estate values.

Rising interest rates will be only one of a two part wallop to the market. The other is the impact of a deleveraging process which will play out over a multiyear period as it is based as much on mortgage maturity as a deterioration in fundamentals.

After value hits its low point, it is likely that value will simply bounce along this bottom for a period of years as the dynamics mentioned above play out and distressed sellers consistently add to the available supply of properties for sale. It might be 2012 or 2013 before any meaningful appreciation is seen in the market. If this happens, why should an investor buy now not waiting for value to clearly hit a bottom? There is a good reason.

Calling an absolute bottom of a cycle is nearly impossible and if you want to buy a hard asset as an inflation hedge, you want to buy that asset at a time before interest rates start to meaningfully rise. **Buying an investment property today will give the investor the ability to lock in fixed rate financing at today's low rates.** The asset will have steady debt service payments while inflation increases rents and the value of the asset over time.

This is only one of a number of scenarios that might play out in the coming years. No one knows for sure what will happen but if I was a betting man, my bet would be on the analysis presented above.

Bob

For weekly observations on the New York City Investment Market, please visit Robert Knakal's blog, **StreetWise** – a joint initiative of Massey Knakal and GlobeSt.com – at **www.knakalstreetwise.wordpress.com**