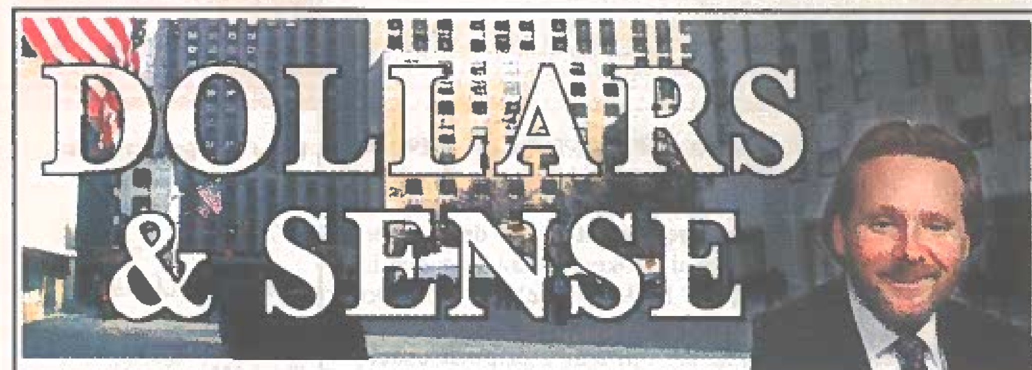

with Bob Knakal

How fast will interest rates increase?

Q: Most economists project that interest rates will not rise until sometime next year as our economy struggles to recover. Do you agree with this position and, if rates do rise more quickly, what will the implications be for the commercial real estate capital markets?

A: This is a great question. You are correct that the consensus among economists is that interest rates wont increase in 2011 and that it will be sometime in early 2012 when we will see the first rate increases.

I don't agree with this assessment for a number of reasons. There are a number of factors which indicate that interest rates will increase sooner than expected and the ramifications for the commercial real estate capital markets are significant.

These factors include inflation, global events, Federal Reserve policy, money supply and municipal deficits.

For a couple of years now, many economists have forecasted that the risk of deflation was higher than the risk of inflation and that inflationary pressures should not impact the markets in the short term.

It is true that core inflation has been within the Fed's comfort zone of 1 percent to 2 percent. However, this modest level of core inflation has been held in check mainly be reductions in home values.

The apparent double dip in the national housing market has exerted significant downward pressure on the core measure. Without this occurrence, it would be a different story. Moreover, food and energy prices are increasing at a rapid rate.

We are seeing food prices escalate globally and the unrest in the Middle East, along with other factors, is exerting upward pressure on energy prices.

As of the writing of this column, crude prices are approaching $90 per barrel. Food and energy prices are stripped out of core inflation data.

To the extent we have increases in inflation above the 2 percent threshold, interest rates will rise.

With regard to global implications, it appears that the European Central Bank has established a bailout fund that is completely inadequate given the economic problems and needs that exist, particularly in Portugal, Italy, Ireland, Greece and Spain.

To the extent that these funds fall short, there could be significant implications on global financial markets and ours would not be immune to this.

Disruptions like that could exert upward pressure on rates necessary to attract buyers to the bond markets.

Recent Fed monetary policy has been such that interest rates must inevitably rise. In 2009, the money supply was doubled and something like that has to have an impact on inflationary pressures.

Additionally, the Fed's balance sheet has tripled within the past couple of years and the Fed has only four ways to exit the market.

They can stop buying assets (the last three treasury auctions, a two-year, a five-year and a ten-year, would have produced dismal results if it wasn't for the Fed buying most of the bonds), sell the assets they have purchased, raise the Federal Funds Rate or drain excess bank reserves from the system.

Any of these will raise interest rates. Ironically, the recent implementation of QE2 was intended to keep long term interest rates low and the 10-year treasury has increased over 100 basis points since that time, the opposite result of the program's intention.

Many suspect that this occurred due to concerns about the inflationary pressures created by this additional printing of money.

Lastly, deficits, debt levels and pensions combine to form what could be a devastating formula for municipal debt ratings.

While some analysts have projected tens of billions of dollars in municipal defaults, expectations are that things will not get nearly so bad.

However, even if actual defaults don't materialize in a meaningful way, $130 billion in projected state budget deficits and federal debt approaching 100 percent of gross domestic product, have left investors nervous which is exerting upward pressure on interest rates.

The implications for commercial real estate, in the event interest rates rise significantly, are as follows: as interest rates rise, mortgage lending rates will rise and as mortgage rates rise, capitalization rates will rise.

As cap rates rise, property values fall. Naturally, we all hope that rates stay low for an extended period of time but there is a good case to be made for rates rising sooner than expected.