with Bob Knakal

Inverse relationship

Q. Most people expect that rental rates for commercial and retail space will increase over the next year. Does this mean that property values will continue to increase with these rental rate increases?

A. A good argument could be made that even with revenue increases we could see property values fall within the next year or two.

While this is counter intuitive, it is important to keep in mind that macroeconomic and political forces can affect our real estate market as much as underlying fundamentals might.

It is certainly likely that values will rise in New York City but this is not guaranteed. From a monetary policy perspective, the Fed has continued to buy Treasuries at a furious pace.

Over the past three years, the Fed has purchased approximately 70 percent of all Treasuries sold in the U.S. in an attempt to keep the long end of the yield curve low.

This strategy was implemented to help the ailing housing market and to stimulate the broader economy. Unfortunately, this strategy cannot continue indefinitely.

At some point the Fed will either stop buying or will start selling all of the assets they have purchased (the Fed balance sheet has nearly quadrupled since QE began) which will exert upward pressure on interest rates.

Additionally, should they continue to print money, this will create inflationary pressures which will also push interest rates higher.

We know, from nearly three decades of analysis, that interest rates and cap rates are highly correlated.

To the extent that interest rates increase, we will see corresponding increases in capitalization rates.

Moreover, given the political implications of budget deficits, and the fact that we are seeing very little political will or courage among elected officials to tangibly deal with the deficit conditions that most budgets are in, we will see continued upward pressure on real estate taxes. They have been, and are likely to continue, rising at a faster rate than revenue will.

We have seen this very demonstrably in the multifamily sector. Revenue over the past 2 to 3 years is up 15 to 20 percent; however, net operating incomes are essentially flat. This is due to the fact that real estate taxes have continued to increase at a tremendous rate and is eating up all of the recent revenue increases.

Fast forward to a couple of years from now, during which time, market rental rates may have increased significantly.

Due but due to the unabated need to increase real estate taxes (and other mandated expenses like water & sewer) to meet budget deficits, bottom line net operating incomes could remain flat.

To the extent they, do and cap rates rise due to interest rate increases, we can actually have values that are lower, even while we have had increases in rental rates and top line revenue.

> *"Even with revenue increases we could see property values fall within the next year or two."*