

Inflation Valuation

If it kicks in, so what? ... So this!

One of the questions on many minds today is whether inflation will hit in a meaningful way and, if so, what the impact will be on commercial real estate. If we do experience above-trend inflation, the impact on our real estate market will be significant.

Inflationary pressures have been relatively controlled recently as headline inflation (as opposed to core inflation, which excludes food and energy prices) has been below the upper end of the Federal Reserve's comfort zone of 1 to 2 percent. During this recession, we have experienced massive asset price deflation as we have seen dramatic reductions in value. Overall, consumer-goods pricing has been fairly stable primarily because the velocity of money has dramatically decreased.

Within a recent nine-month period, the Fed committed to a doubling of the U.S. money supply, an increase greater than the aggregate increases in our nation's money supply over the past 50 years. As a result, inflation has remained steady despite significant asset price deflation. Absent this massive monetary expansion, we would



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have witnessed an enormous deflation, due to the decline in velocity as Americans held on to their quarters so tightly you could hear the eagles screaming.

Capricious and irrational government policy under both the Bush and Obama administrations created tremendous uncertainty, resulting in massive fear in the hearts of people. This resulted in cash being the only safe haven for investment dollars.

Americans liquidated investments in stocks, bonds and hedge funds and put their cash in banks (several different banks, even after the F.D.I.C. insurance threshold was increased from \$100,000 to \$250,000), money market accounts, Treasuries and even under the mattress as the soundness of our financial system was in question. This dynamic became so pronounced that, at one point, Treasuries were paying negative interest rates. This was reminiscent of the 1800s, when citizens paid the local bank to hold their gold in the bank's vault.

Asset values were crushed by the flight to cash in the face of arbitrary government deci-

sion making. It drove investors out of the market, causing excess volatility and abnormal levels of illiquidity.

The Dow is once again approaching the 10,000 threshold. Over the last two earnings periods, corporate profits have exceeded expectations, driving the equities markets higher. However, these profits were achieved with significantly lower revenues. As revenues fall, the only way to achieve profitability is by increasing productivity and slashing overhead.

American companies have responded by greatly reducing labor costs, and workers (those who still have jobs) have become more efficient, as productivity has increased by about 6 percent. These labor cost reductions are tangibly seen in our unemployment rate, which currently stands at 9.7 percent. Corporate performance is likely to be challenged again without real growth in the economy, because companies cannot continually cut overhead in order to achieve profits. These dynamics have placed deflationary pressures on the costs of goods and services. The question is, will this deflationary pressure be a short-term dynamic, or will it be sustained? Because the government's presses have been working overtime printing greenbacks, the commonly accepted rule of thumb is that above-trend inflation must kick in at some point given the dramatic increase in money supply. (Money-printing rampages are almost always completely about a deep lack of spending restraint by governments.)

In an inflationary environment, there is a flight to hard assets, and commercial real estate is a quintessentially great hard asset. As inflation becomes tangible, the Fed's response will be to tighten monetary policy by increasing interest rates.

How will commercial real estate perform if inflation spikes? The answer is dependent upon how severe the inflation spike is. If higher inflation is limited to 100 to 200 basis points, and lasts for a relatively short period of time, the impact on cash flow and value should be minor. However, it could crush highly leveraged, floating-rate borrowers who are barely above water today. If the inflationary surge is greater, it will favor property types with short-term leases, like hotels and multifamily properties, where owners have the ability to increase revenue. It will also favor properties with long-term, fixed-rate debt, as borrowers will be able to pay their relatively low debt service payments with a debased currency.

The brunt of the inflationary punch will be felt by owners who mismatched long-term leased properties with highly leveraged short-term debt, as their incomes will not increase despite rising inflation, even as their debt service soars.

During the mid-1980s, we saw a significant period of negative leverage as credit flowed and the multifamily market was going through a co-op-conversion phase. After the savings-and-loan crisis of the early 1990s, we went through a period with very disciplined underwriting and investing and saw positive leverage throughout the balance of the decade.

When easily available credit returned and the condominium-conversion craze kicked in, in the mid-2000s, we once again saw a period of negative leverage.

As we emerge from the present credit crisis, we anticipate another period of positive leverage, which means that if interest rates increase from their present levels substantially, due to Fed policy changes to combat inflation, we could see mortgage rates hit 7 to 9 percent. If this is the case, double-digit capitalization rates would likely follow.

Inflation may not be a given. According to Goldman Sachs research released last week, there is a growing school of thought that we may not be looking at a pending inflationary environment because of the change in savings-rate patterns among U.S. residents.

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In 2006, we had a negative 4 percent savings rate in this country. You might ask how the savings rate could be negative; the answer is that Americans were spending more than the amount of their disposable income by virtue of credit-card expenditures and massive home-equity withdrawal. Today, the savings rate is approximately 6 percent. If we consider that the U.S. has about a \$13 trillion economy and that 70 percent of our GDP is due to consumer spending, this 10 percent swing in the savings rate has extracted \$1 trillion from our annual GDP.

A large percentage of these trillion dollars has flowed into Treasury bonds. As the demand for Treasuries increases, the price goes up, and as the price of a bond goes up, the yield goes down, exerting downward pressure on interest rates. This will create a flattening of the yield curve (two-year T bill rate vs. 10-year T bill rate); and this will cause market dynamics that lead to a non-inflationary or modestly inflationary period.

For those real estate investors who believe inflation is headed toward us, the way to take advantage of it would be to acquire assets during a non-inflationary period, locking in today's low interest rates on a long-term basis to ride out the inflation. No one knows whether we will be hit with above-trend inflation, but whether it occurs and the extent to which it occurs could have a profound effect on the future of our commercial real estate market.

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