CRE Tries to Understand When—Or If—Long-Term Inflation Will Set in

The tricky part is understanding how inflation affects real estate.

By **Erik Sherman** | August 13, 2021

There's an inflation tug-of-war happening. On one side, the Federal Reserve, Biden administration, and others say that a current inflation spike is temporary and pricing in many categories will return relatively soon to normal.

On the other side, there is a separate group of economists and experts who are sure that higher inflation is here to stay because of ongoing historically low interest rates and massive amounts of federal stimulus funds.

Don't expect more uniformity in commercial real estate. There are opinions on both sides of the fence. The difference is some specific factors—and professional interest—that make the discussions more nuanced and closer to the bone.

Randy Hubschmidt, managing partner at Fortis Family Office, tends to agree with the Fed and administration that things are transitory. He doesn't even like the term "inflation."

"The July CPI data bear this out as 14% of the core CPI has an inflation rate over 20% but the other 86% is experiencing an inflation rate of just over 1%," Hubschmidt tells GlobeSt.com. "Excluding automobiles, the core was up .2% from June to July and this is the smallest increase since February."

Hubschmidt says that price increases have been the result of pandemic-based supply chain disruptions. The **up** (https://www.globest.com/2021/05/25/behind-the-surge-in-lumber-prices/) and **down** (https://www.globest.com/2021/08/11/lumber-costs-continue-to-fall-but-pricing-remains-uncertain/) movements in commodity prices like lumber have been well noticed industry examples.

"Additionally, there are longer term issues at play that are deflationary; productivity gains due to technological innovation, lower population growth due to lower birth rates and tightening immigration policies, potentially higher taxes to pay for the increasing federal debt, among others," he adds.

David Pascale, senior vice president at George Smith Partners agrees that supply chain problems were an issue. Also, price drops in 2020 made rebounding prices look higher because of the comparison to depressed levels.

"The data over next 6 months will be critical to determining if inflation is a long-term issue," Pascale tells GlobeSt.com. But he also points out that real estate is "highly sensitive to interest rates."

"For example, treasury rates determine the cost of capital for about $40 billion of fixed rate commercial loans each month," Pascale says. "Treasury rates fluctuate daily; it's a fluid market. If bond investors believe persistent inflation is here, they will sell treasuries and rates will increase immediately. Cap rates, asset prices and values will all be affected." And that could happen in a matter of weeks.

Then there are those who say that long-term inflation is already here.

“Inflation has already persisted and embarrassed the Federal Reserve system,” says Fergus Hodgson, director at Econ Americas. “The notion that this inflationary period is only transitory is fading fast, especially since the Fed is way outside its stated mandate and with little ability to turn it around. Further, the immense fiscal deficits at the federal level are feeding the problem and ensuring its continuance.”

So, either inflation will go away—or it’s here to stay, at least for a while. For industry pros, the question is what to do.

“Inflation historically has raised the high-water mark for real estate values,” Jahn Brodwin, senior managing director of the NYC real estate solutions practice of FTI Consulting, tells GlobeSt.com. “It may be time to lock in long-term low interest rates and let inflation subsidize the repayment. Time for landlords to think about shorter-term leasing to allow for more frequent rental resets.”

“It will clearly impact cap rates in the future as borrowing will get more expensive,” warns Allen Wilen, national director of the financial advisory services group of Eisner Advisory Group. “As long as there is lots of liquidity in the market it will not impact deal flow dramatically in the short term.” In the longer term, the future belongs to Fed policy and the “implications of the infrastructure bill on future construction costs,” as greater demand pushes up prices and the effective rate of inflation in CRE.
