

Letters to Mycroft #45: Forecast: 25 Years of Higher Interest Rates by Klarise Yahya

To My Dear Nephew, Mycroft:

“What if interest rates continue to go up?” Dromedary asked. “What will happen to me?”

Mitochondria put her tea cup back on its saucer. “Well, rates do move in long cycles, don't they? A couple of months ago there was an article in Forbes about interest rates. I think it was written by that fellow who does the highly respected Grant's Interest Rate Observer. He wrote that interest rates tend to move in twenty or 30 year cycles. This last cycle ran from the early 1980's until this year. Rates dropped from the high teens to the low single digits, didn't they?”

“So, if Mr. Grant is correct – and he incorporated data from over 150 years of interest rate cycles – we can anticipate interest rates rising over the next generation. There will obviously be significant short-term fluctuations, but my guess is that, overall, rates will rise pretty smoothly. That permits businesses to adjust.”

“It's so stupid to let rates go up like that! Rising rates just hurt everybody!” Dromedary interjected.

“Henry Hazlitt, who wrote that splendid little book Economics in One Lesson, might have something to say about that. Do you remember the story about the street thug who cast a brick through the bakery's window? The crowd gathered to mourn the loss of the window. Eventually someone in the crowd pointed out that at least the glazier would get some business out of the vandalism. Then another person observed that the baker's \$250 loss was the glazier's \$250 gain, and concluded that the destruction of property resulted in no net loss to the community.

“The fact is that everybody can see that before the vandalism, the baker had \$250 and a functional shop window. Afterwards, the baker had a (new) functional shop window and the glazier had the \$250. No net loss to the community. And, for most folks, analysis stops right there. They see no further than the obvious.

“What they didn't see is that the baker intended to buy a new suit with the \$250. If the vandalism had not occurred, the baker would still have his (old) functional shop window, plus a new suit, and the tailor would have \$250. The mob doesn't see this, because it's not immediately apparent.

“There are two lessons here. The obvious one is that destruction of property never results in a net gain to the community. The other lesson is that while an investor observes what the mob sees, she doesn't necessarily invest that way. For profitable investments, an investor must always look beyond the immediate.

“Clearly, higher interest rates will make mortgages more expensive. What does that mean for us? It means that we should immediately refinance and lock in the highest fixed-rate period we can. If we can pull out some cash, so much the better.

“It means that property values will probably trend downwards. We can expect single family homes and condos to drop the most, simply because higher interest rates will reduce the amount a prospective buyer can borrow. That, in itself, tends to depress prices.

“And prices on investment properties will probably soften. After all, higher interest rates will decrease the mortgage that the building's income can service. Right now, in many places, we're seeing listings that require 40% - 60% down just to debt-service – and that's with current low rates!

“As rates go up, an investor may be faced with the possibility of investing her money into an apartment building giving a cash flow of less than 2% even after a huge down payment, with no reasonable expectation of the building increasing in value. Alternatively, she could buy risk-free U.S. Treasury bonds yielding 9% and never have to deal with the problems that come with owning apartments.

“Under those conditions, it would be real hard to convince an investor that her money was better placed at the 2% level, wouldn't it? With less demand, one can expect the value of the investments to decline. This is not rocket science. Similarly, it is reasonable to suppose that fewer new apartment buildings will be built, simply because higher loan costs make the marginal buildings uneconomical, so we can expect some reduced competition for our units.

“And higher interest rates probably mean that fewer tenants will be moving to their own homes. So higher quality tenants – those that may have bought a home under more favorable interest rates – will more likely stay.

"We've covered a few of the possibilities. When considered as a whole, what do they mean? Overall, we can expect rising interest rates to reduce sales prices on our buildings while putting upward pressure on rents. Cash flows increase. When the total yield to the owner returns to competitiveness with alternative investments, apartment buildings will once again begin to appreciate.

"What should we do? I would keep good, well-located buildings with favorable loans and agreeable cash flows. I would expect cash flows to increase over time, even if building values trend downwards.

"I would sell marginal buildings and park the money somewhere safe. Eventually, you will probably be able to pick up one or more splendid buildings for prices that seem outrageously low from today's prospective".

"You mean that you expect a building that someone bought for \$1,000,000 to be worth only \$700,000 five or ten years later?" Dromedary asked, her eyes wide.

"Investment values are not measured by prices. They are measured by yield. Hypothetically, presume that a building today is purchased for \$700,000. It requires a 50% down payment and generates a cash flow of \$6,600 a year. That's 1.8% on the down payment.

"As we've discussed, over time higher interest rates produce upward pressure on rents. Eventually the building is sold for \$1,000,000. The buyer only has to put 25% down and receives \$18,000 a year cash flow. That's over 7% cash-on-cash.

"Which is the better purchase? Higher interest rates mean there will be more competition for the investor's dollar. Even if the \$700,000 purchaser makes money, she will probably have to offer the next buyer a better deal than she got. And that, I think, is where higher interest rates will take us."

Cordially, Aunt Klarise

Klarise Yahya is a Commercial Loan Broker. If you are thinking of refinancing or purchasing five units or more, Klarise Yahya can help. Find out how much you can borrow! For a complimentary mortgage analysis, please call her at (818) 500-9966.