

Will Higher Interest Rates End the Current, Hot Real Estate Market?

by John V. Kamin



The Federal Reserve met and raised the Federal Funds Rate up $\frac{1}{4}$ percent. **FORECAST:** It is likely the FOMC Committee at the Central Bank will keep raising interest rates to head off hidden powerful inflation as best they can, one of the few tools Feds have left. They may raise (Federal Funds) interest rates to double or triple current levels over the next 2 or 3 years. Interest rates have not been raised by FOMC for 4 years. Now they're starting to pump rates up. The Big Question? Will higher-priced mortgages and tougher qualifying kill the property markets?

PREDICTION: I think higher rates will affect some demand on housing markets, particularly where first-time buyers (who could qualify under super-low held-down interest rates) now find it harder to qualify for a new loan based upon their income. But first-timers are only a small-to-modest portion of the housing marketplace. Rising ARM payment push-ups may hobble present new-house owners.

FORECAST: Apartment buildings, 4-plexes, small commercial buildings, housing a CPA, LLB or DDS practice may also be affected - but probably not much.

Example: If you are paying super-high rents for your medical practice now, and discover a "good buy" on a small commercial building with a couple of extra spaces for cash flow, I don't think you'll care much whether you're paying 6% or 8% interest on your mortgage. You won't be worried about a few percent upswing in the Federal Funds Rate as dictated by the FOMC Central Bank. On the other hand, if mortgage rates on small commercial and small apartment buildings head up to 9% to 12% on new commercial mortgages, boosted rates could affect the commercial markets. Why?

INCOME STREAM (RENT CASH FLOW) PRICE BASING

Fourplexes, (apartment buildings) and small commercial buildings often sell not only based upon their location, but mostly upon a multiple of their income stream - their net profit on gross rental cash flow after expenses are deducted. Therefore, since mortgage interest expense is likely to go up, net profits are going to go down. That means prices could be somewhat vulnerable on overpriced apartment buildings, commercial buildings and the like.

Either rents must be raised so rental income stream rises to offset rising mortgage expense, or prices will have to notch lower.

Speculators and prospective buyers are very good at "running the numbers". Yes, it is true that some property buyers in Orange County are buying buildings now with negative cash flow (probably a disaster-in-the-making, in my opinion). If the real estate market does turn down for cash-flow income buildings and small commercial buildings, if sales slow, then prices might come down, unless rents can be raised.

Sometimes rents cannot be raised easily (due to long-term leases, difficulty in finding new tenants, other problems, such as changing areas, downgraded neighborhoods, difficulty in getting new loans and tougher qualifying).

FACT OF LIFE: Most property sales in the USA are resold based upon borrowed money, financing, and its cost. When the financing cost changes, the entire structure changes, and entire sales deals will change on individual properties. Add to that a potential downcycle or other outside factors such as unpredictable weather (earthquake/tornado factors), higher income taxes proposed by new political candidates and rising property taxes! All affect the net income stream.

COMPETITIVE RETURNS ELSEWHERE?

Another factor: The people who buy these buildings, speculators and prospective property buyers when they see rising interest rates on CDs or other alternatives, may pull out of the

property-buying market. What if prospective retirees can put their money out to work at interest and earn 6% or more positive cash flow without risk on FDIC insured CDs? That certainly seems (to them) a high yielding alternative (compared to paying too much for an income stream Orange County apartment building with negative cash flow)! Watch for it.

FORECAST: The property market will continue changing, albeit slowly - although it's still hot. New factors are entering the calculations.

Our current Forecaster advice still stands: "Sell your worst properties now, keep the best. Sell those problem properties, unload the junk, in today's hot-hot-hot real estate market. Once the property cycle changes, you may find it hard to get qualified buyers, or get prospects out to consider your building! Negotiating will get tougher as will financing!

INFLATION ALERT

Are you seeing evidence of price hikes sprinkled throughout the economy, of substantially higher inflation? Our research is encountering these red flags more frequently.

(E.G. Parking meters in front of the Forecaster building now charge double the amount of money for the same time, a 100% fee hike. That's not 2% inflation that analysts tell you is "No problem".)

Another sign. The nearby dry cleaner recently raised his price 25% on shirts and pants. That's not 2% or 3% inflation.

FORECAST: Merchants who now feel they have pricing power will raise prices not the amount of inflation that the government calculates, but instead will raise double-digits, sometimes even triple-digits (as the parking meters did)!

The new holiday catalogs that will clog your mailbox over the next 3 months will have substantial price hikes! Not 2% either!

Therefore, if there is something you buy regularly that is non-perishable, negotiate your best deal and get your quantity discounts, but get the job done.

PREDICTION: There will be even greater signs of double-digit and triple-digit price hikes in the months to come, substantially higher inflation!

John Kamin is a Consulting Economist and publisher of The Forecaster, 19623 Ventura Blvd., Tarzana, CA 91356, (818) 345-4421. \$180 per year. For more money making ideas, order his latest book Active Money Strategies & Hidden Wealth Builder Secrets For Young Adults: What They Were Afraid To Teach You In School, If They Ever Knew! \$20 + \$4 s & h and \$1.65 tax. 95 pages.

Forecaster Money-Letter publishes confidential reports about the future to benefit you, and makes decisions easier. It helps you profit, sidestep losses, enhance lifestyle and creates financial independence. Send for a 10 issue trial. \$120 value. . . only \$59 when you mention the AOA. Mail your check to: Forecaster, 19623 Ventura Blvd., Tarzana, CA 91356; or if you wish immediate shipment, phone (818) 345-4421 and put it on your credit card.