

Northern Colorado BUSINESS REPORT

Aug. 28-Sept. 10, 2009
Vol. 14, No. 25
www.ncbr.com

Only sluggish money too much money in system

Deflation bigger real estate threat than dreaded inflation

"A thing long expected takes the form of the unexpected when at last it comes."

— Mark Twain

Hardly a day goes by when I don't pick up a paper or watch the news and hear another journalist or economic prognosticator ratcheting on about the looming threat of inflation. I half expect to see people lined up outside the local Home Depot, clamoring for their wheelbarrows to carry their unwanted cash to the bank, much like the days of the Weimar Republic in Germany in the 1920s.

But as we are reminded by Mark Twain, the expected does not always occur. So let me offer a possible alternative in the form of inflation's ugly cousin — deflation — and how that might affect commercial real estate in the not-so-distant future.

As those who followed the late economist Milton Friedman will attest, inflation is and always will be a monetary phenomenon: Too much money chasing too few goods, causing a general rise in the level of prices of goods and services.

The key word here is chasing. In real estate this means higher cost for material and labor which translates into higher building costs and ultimately higher rents. To combat inflation, central banks fight back with higher interest rates equating to higher borrowing cost to builders and owners.

The most frequent cause of inflation is

the soaring deficit our government is running and the resulting massive expansion of the money supply. Under normal times this certainly would sound the inflation alarm, but in a period of de-leveraging like the one we are in today, the velocity of money is much more important than the amount of money. Too much money is just too much money when it is not moving through the system.

Consider the Japanese economy, where the mounting debt is equal to 170 percent of GDP, the largest among developed nations and almost twice that of the United States. They have been battling deflation for decades with interest rates near zero. Their stimulus efforts went to prop up "zombie banks" and did not allow the market to establish a clearing price for the collateralized assets. The net effect has been a prolonged period of reduced demand and lower prices for most assets — including real estate.

Back in the States, where our stimulus is not getting outside the banks to allow for new loans that fuel demand, it is unlikely that the velocity of domestic funds will increase anytime soon.

Changed spending habits fuel deflation

Consider the current U.S. economy where consumer spending accounts for nearly two-thirds of our economic output. With real wages in decline, excess capacity



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in the labor market, a contraction of available credit to consumers and a potential secular shift in spending habits among consumers — the savings rate for U.S. households has risen from nothing to more than 5 percent of income in a short period of time — it is doubtful that we will be able to rely on the Jones' consumption patterns to stoke the economic engine sufficiently to produce inflation. When a cyclical recovery does occur, it is likely to be sluggish for quite some time.

So that's why deflation, rather than inflation, might be the peril we need to be watching for. How will that affect commercial real estate in the near future?

We have already seen a general decline in rents across all commercial property types by as much as 50 percent in some sectors. The cost of building continues to decline, although at a much more subdued rate, but without available credit, it is improbable that there will be enough demand to spur new development. Although the economy is stabilizing, there is unlikely to be a sustainable force of consumption to maintain historical growth rates.

With adversity comes opportunity. Investors who have over-leveraged will discover that risk does not pay during deflationary periods and cash becomes king. Opportunities will continue to arise as the calamity unravels and a new generation of capital flows into the market. This, of course, will take years to play out and good sound counsel will again be at a premium.

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