Cap rates: Tip of the iceberg? - by John Rynne

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In the February edition of the NYREJ, I reported, “A Look Forward To More Normalcy In 2022.” In that article, 10-year treasuries were at 1.93% which was an increase of 33% more than in November, 2021. As of April 26th the 10-year treasury was at 2.77%, a 44% increase over what I reported on this past February. As you know, 10-year treasuries are one the top indicators in pricing amortizing mortgage loans. The sudden rise in rates is due to the Federal Reserve (The Fed) to combat the high annualized inflation rates approaching 9%. which is caused mainly by fiscal and other policies of Congress and the executive branch. The wholesale inflation index is near 11% and the producer inflation index is approaching 13%.

When I became an appraiser in the early 1970’s mortgage rates were 8-10% based upon 10-year treasuries that were over 7%. Over the past 15 years we have seen the some of the lowest rates in modern times. Over the past five years, the rates have been even lower. Last year there were residential mortgage rates below 3%. Recently these same rates are approaching 5%. The recent sudden rate increase have surprised even the most seasoned mortgage brokers because the mortgage rates were so low for such a long period of time. Of course this has some upward pressure on overall capitalization rates.

The Fed uses monetary policy to:

A) Stimulate the economy and

B) Slow down inflation.

In general, they create an atmosphere of easy money when stimulating the economy. One of the tools is quantitative easing in which The Fed buys up United States treasuries and other notes in order to keep the rates low. In order to increase rates during times of inflation The Fed stops using quantitative easing and sells off the notes from their balance sheet. When rates on government notes are increased this reduces inflation but creates a burden on the Treasury of the United States because the higher interest rates increase the amount of debt service. As an example, if United States debt is at a level of $30 trillion, a 1% interest rate increase on a $30 trillion debt can add over $300 billion to the annual deficit and subsequently to the national debt which compounds each year. Some would categorize it as a type of Ponzi scheme in which monies from these parties eventually indirectly winds in or out of the pockets of The Fed andthe federal government. It’s similar to an a non arms length lease or sale of real estate. Real estate appraisers typically are cynics of non arms length leases or sales as not being reliable and not market value. There are exceptions but appraisers are ingrained with this cynicism throughout their appraisal training and education.

Technically the Federal Reserve is not part of the federal government. It technically is an independent private bank, but it really has common threads with the federal government. To draw a parallel in real estate terms and practice, many types of properties have a business operation renting space in a building on a land parcel. This type of arrangement has two parties: Real estate holding corporations (landlord) and the business operation (tenant). The business operation pays rent to the real estate holding corporation. This is especially used for hotels, nursing homes, and one tenant occupied properties. A majority of these arrangements are arms length where the owner of the real estate holding corporation has no direct ownership interest in the business operation. However, many are not arms length. There are many situations where a developer may have a niche of finding multiple sites for a large chain of fast food restaurants, pharmacies, convenience gas stores, sleep bed retailers, etc where technically there is no common ownership but much familiarity and synergy. The Fed and the federal government have an indirect similarity to that example.

In the relationship between the Fed and the federal government, some negative consequences result such as the 50% increase in the national debt over the past six years and the 300% increase over the past 22 years. The national debt is now over $30 trillion with unfunded liabilities of over $160 trillion. This is not the tip of the iceberg, but the bulk of the iceberg. The tip of the iceberg is the unstable interest rate market which is created by the cozy relationship between The Fed and the federal government. This tip of the iceberg effect creates fluctuating cap rates.

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