



FINANCIAL ADVISORY

Why to Buy When Interest Rates are High

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A real estate management company recently sent a newsletter to their clients advising them to avoid doing 1031 Exchanges upon sale, and to hold onto their cash in expectation of “good deals ahead when interest rates drop.” First, I can’t believe they are advising their friends to guarantee themselves up to 30% losses by paying unnecessary taxes. Next, as I’ve detailed in previous articles, after a 30% loss, an investor needs a 45% increase immediately to break even! (and nobody invests with a goal of breaking even.) If a potential price drop is in the future, it’s hard to believe the deals will be that good. Lastly, I think substantial evidence points towards lower interest rates meaning higher real estate prices.

The property value boom between 2008 and 2022, fueled by continuously sub-6% mortgage rates, is a good example of what lower interest rates will do. Economically, this makes sense: if a buyer can afford to borrow more, then he can afford to pay more and sellers can ask for more.

WHAT IS THE MARKET GOING TO DO?

This is a question I get a lot. My answer depends on what market you are talking about. It’s important to point out that all real estate isn’t the same – single family residences, multifamily investment properties, retail strip centers, single-tenant NNN leased retail, hotels and office all have different demand drivers and economic forces acting upon them. For example, when the government shut the economy down in 2020, hotel values plummeted while single tenant NNN spaces leased to “necessity retailers” stayed open and skyrocketed in value as investor dollars chased stability. Apartment values in growing

metropolitan areas rose as renters moved to more open economies in search of work. Sub-3% interest rates caused the value of single-family residences to reach new heights.

SHORT TERM REAL ESTATE MARKET OUTLOOK NOT AS IMPORTANT

“What will the real estate market do in the next two years?” I suggest that, since investment real estate is an asset usually held for longer terms, this question isn’t as important as many think it is. If we are buying cash flowing investment real estate today and holding it for the next 10 to 20 years, our chief concern should be what the value will be 1 or 2 decades from now – not 24 months from now.

INFLUENCE OF INTEREST RATES ON VALUE

Remember that interest rates are controlled by the US Government’s Federal Reserve. Interest rates will be set higher to curb inflation when needed and lowered to encourage economic growth. The Fed will therefore want to drop interest rates as soon as possible and keep them as low as they can.

I think it is reasonable to assume that the Fed would like to see interest rates in the 5% or lower range again over the next several years. If we agree that an interest rate decline in the future can lead to rising prices, a buyer today can take advantage of lower prices and simply refinance his debt in the future when interest rates drop and values climb.

HOW HAVE RISING RATES AFFECTED VALUES?

While interest rates have more than doubled since December of 2021, prices have continued to rise. Economics tells us this is because demand is higher

FINANCIAL ADVISORY

than supply – high demand for a product can lead to higher prices. (Think about gasoline.) A 30-year \$1 million loan at 3% has a monthly mortgage payment of \$4,216 compared to \$6,653 at 7%. Even with monthly payments that are as much as 57%, (as in our 7% loan example), higher today; prices are still higher than last year. This tells me that today's buyers are expecting interest rates to drop as well. Investors today are buying at 7% with a plan to refinance once rates decline to the 5% range.

IF YOU THINK RATES WILL COME DOWN IN THE FUTURE, YOU SHOULD BUY TODAY

That “save your money until interest rates drop” advice that inspired this month's article has it backwards. If you think interest rates will drop in

the future – and evidence indicates that you aren't alone in this belief – then you will want to buy today. That way, you can start collecting in-come and depreciation benefits today. If rates drop and cause values to rise, you can then refinance to potentially create more cash flow for yourself rather than buying at those higher prices. Investors may be able to take advantage of higher values to do cash out re-finances, and then use the proceeds to buy more real estate – putting themselves well ahead of those who waited for rates to drop. If you have any questions, my toll-free office number is (877) 313-1868.

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\$200,000+ equity required.

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