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## Markets Should Prepare for Higher Inflation, Interest Rates

By ,

Commodity prices have been surging in recent months. In 2010, the global Commodity Price Index for fuel (energy) climbed 21%, for food 27% and for industrial inputs, including raw materials and metal, a whopping 31%. Yet headline inflation and core prices, excluding food and energy in the United States, have been tame, up just 1.1% and 0.8%, respectively. And in November the Fed was worried about *deflation*. So, where does the disconnect lie?

The answer has at least five major components: flat wages, falling to flat cost of housing, low velocity of capital, the relationship of the dollar to other currencies, and the globalization of manufacturing and its impact on pricing power. Thus far, trends in these areas have greatly offset the strong increases in commodity prices. Two of the most important drivers of inflation in the United States are the cost of housing and wages, both of which have declined or remained stagnant. The housing component is calculated by estimating an owner's cost of renting his/her house, which has been particularly weak compared to apartment rents. In the past six months, the U.S. dollar has climbed by 14% over the Euro, reducing the domestic impact of recent global commodity price increases. In the past 12 months, productivity per hour worked among U.S. employees increased by 2.5%, enabling firms to produce more without having to hire and keeping wage pressure low due to the high unemployment rate. Year-over-year growth in total compensation costs, which includes wages and benefits, has been tepid, up a mere 1.9%. Furthermore, companies have found that they cannot increase prices, with wage growth so low and unemployment so high. Intense competition on finished goods is also keeping a lid on pricing thanks to globalization of manufacturing. Another major factor is the low velocity of capital despite massive liquidity infusion around the world and low interest rates. Weak demand for consumer and business loans has prevented inflationary pressure so far in the recovery.

With these variables in the global marketplace, what is the outlook? Given the current resistance in the economy to price increases, we would not be surprised to see commodity prices, which are always volatile, flattening or correcting downward in some sub-sectors. The biggest vulnerability is supply shock, a risk that could send commodity prices even higher and threaten corporate profits and the economic recovery. Beyond 2011, there will be upward pressure on inflation for several reasons. There is a limit as to how much the U.S. dollar and productivity can rise, and we appear to be approaching that limit. Wage and benefit costs will climb significantly once again when unemployment drops below 8%, expected by mid 2013. Commercial rents are near bottom, and will be climbing in 2012 and 2013. Apartment rents are already rising, and the monthly cost of home ownership will also climb once prices stabilize and/or grow again, and mortgage rates increase. The calculation for housing costs within the inflation index can turn up sharply once the reading on owners' cost to rent their home starts to climb. Improved hiring, business and consumer confidence will result in more borrowing demand, higher velocity of capital and more pricing power in 2012.

Inflation should remain tame in 2011, increasing only 1.5% to 2.5% due to the aforementioned factors, leaving the Fed flexibility and time to remain accommodating. However, starting in 2012, we expect to see inflation rise to the 3% range. This is the stage at which the Fed's ability to mop up excess liquidity to prevent a run-up on inflation without killing the expansion will be tested.

And what does this mean for real estate investments? We will likely have another nine or so months of relatively low interest rates. However, starting toward the end of 2011 or in early 2012, interest rates appear likely to climb as inflation expectations pick up speed, demand for loans increases, and QE2 sunsets. Rents and real estate prices appear likely to start increasing significantly in 2012 and accelerating into 2013. This will be driven by an inflating dollar, probable strong growth in user and investor demand, and a dearth of construction completions projected for 2012 and early 2013. All of these factors suggest that an exceptional window of opportunity currently exists for real estate investors.

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