Real Estate: What does Big Money want? Answer: 7%+

H&R Real Estate Investment Trust (REIT) update – NBF

NBF's link to this weeks H&R REIT update makes for heavy wading through industry speak. H&R has been 'deleveraging' selling assets to pay down debt. The seller is a sophisticated real estate property manager whose mandate is income generation – not build/flip. The buyers are equally sophisticated equity managers also seeking yield/long term appreciation. I hope to focus client attention on the 'implied yield' of these deals, being the net rent after expenses compared to cost of the purchase to the buyer expressed as a % rate. Think rate of interest on a bond.

The deals are for are rent-producing properties that tend to produce stable(ish) cash flows. These kinds of assets are popular with pension funds and income-oriented institutional investors. An agreed-deal implied yield reflects the saw-off between the seller (lower yield = higher price) and the buyer (higher yield = lower price). The deal rates tell us much about the rate of return Big Money is demanding from real estate rents. Most of the deals are priced at 7-8% yields.

This means for each $100,000 in price the buyer expects to receive $7,000 to $8,000 in net rent. Putting this into the Duncan context, I featured a house recently sold down the road from our place, for $940,000. At 8% 'yield' if the new owner was a landlord they would expect to rent the place for $75,200 per year or $6,260 per month. At 7% yield the anticipate rent would be $65,800 annual/$5,483 per month.

I've checked with my rental property-owning clients. Most own single family or small multi-family properties (duplexes, townhouses, 4-room buildings). Typically, they've owned these properties for years. The net-rent has gone up from their original purchase, but the property prices have increased at a much faster rate.

They are not unhappy but also shake their heads on market values. None said their net rent is anywhere close to 7% of the current market value. *"I couldn't do it again at these prices vs. rents"* was a common reply.

Why is Big Money pricing at much higher yields? The correct question is *"Why is small-potatoes money pricing at much lower yields?"* paying so much more? The answer is "*Because they can*". Occupant home buyers will pay as much as they can afford, being a combination of their net disposable income and cost of borrowing. Disposable Income is the net result of gross employment income less taxes and cost of living. The lower borrowing rates fall vs. income, the more debt per paycheck can be taken on by the buyers and the higher the price the seller can demand.

- If there is a growing group of house buyers and if their incomes rise dramatically, taxes are static and inflation is low while borrowing costs don't change, they can borrow a lot more. Sellers will be able to achieve much higher prices.
- If buyers' disposable incomes are flat, taxes and inflation are flat and rates fall, they can borrow more. Prices will rise.
- If disposable income is reduced by taxes, inflation rises but interest rates fall, buyers may be able to sustain the same monthly borrowing. Prices can hold.
- If income is flat, taxes rise, inflation picks up and borrowing costs rise…well, you get the idea.

We have an extreme example house price sensitivity to disposable income with house prices in Fort MacMurray, Alberta, during the oil boom and bust.

That's for owner/occupants. What about landlords?

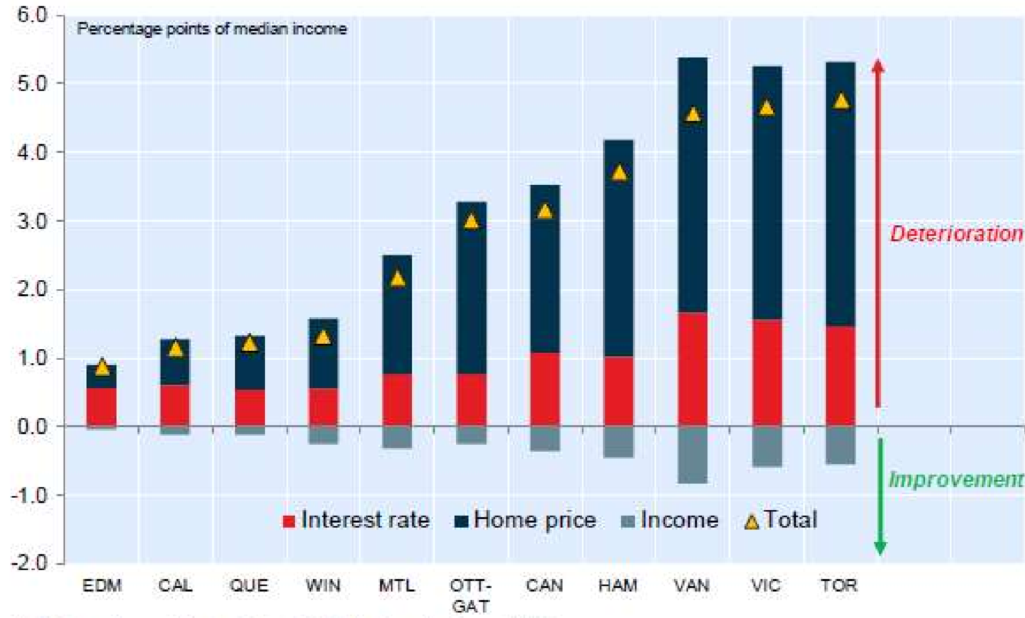
The lower rates go, the lower the rent can be accepted vs. price. More precisely the higher the price can be for the same rent and still cover mortgage payments. As prices are set by the highest bidder, if 10 bidders show up, the one with the highest price wins, setting the price expectation for the next sale. If rental income investors won't buy, a live-in occupant will, pushing up small property prices. Big Money has a lot more options. Small scale property investors should pay attention.

I must clarify the above is oriented towards rental income investors. For individual home-owners, over a long period of time when finally sold, home ownership often results in getting one's purchase and occupancy costs back after inflation (not after-tax). The resulting lump of money means they lived in the house 'for free' with a big payout at the end. That's useful in retirement planning. This does not equal a great investment return.

https://nbf.bluematrix.com/sellside/EmailDocViewer?encrypt=c60ccdab-6bef-467c-835e-20f378d4ecb9&mime=pdf&co=nbf&id=steven.hilberry@nbc.ca&source=mail

Where are Canadian house prices vs incomes? How is affordability?

'Housing affordability worsens by the most in 27 years in Q2 2021' – NBF Economics



(see PDF for the full report)

Having established affordability is already low, prices are determined by borrowing power and borrowing power is impacted by interest rates, what drives interest rates?

Back to the future: Inflation?

All the above has me fretting about inflation in recent commentaries. I've pointed to potential pressures from rising wages, both due to pandemic reverb and demographics (Boomers retiring/Millennials arriving). I've noted that the COVID-19 induced recession job losses were concentrated in the low-wage sectors, while other sectors saw an increase in wages. This combined with lack of spending, a decline in financing costs and generous govt checks means consumers have money to spend. Wages are the largest component of inflation indices.

'How best to gauge underlying pay pressure' Global Economics Update – Capital Economics – August 4, 2021

Capital Economics out of London, UK walks us through the nuance of the COVID-19 job losses and rebound. Chart 1 (upper left) shows Leisure and Hospitality represented close to 1 in 2 out of all jobs lost while representing 16% of all jobs and an even lower portion of wage income. Chart 3 tells us wages & salaries per-employee have on average increased in the US and Canada (we're lagging) by 10%+ since 2018.

Chart 1: Leisure & Hospitality Share of Job Losses in H1 2020 & of Pre-virus Private Non-Farm Employment (%)

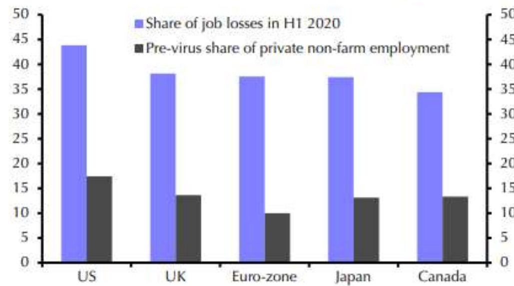


Chart 2: Relative Median Pay of Job Role Vs. Change in Employment Share in Australia (Q4 2019 – Q2 2020)

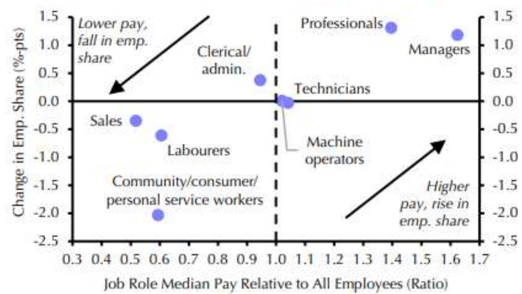


Chart 3: Wages & Salaries Per Employee (Q4 2019 = 100)

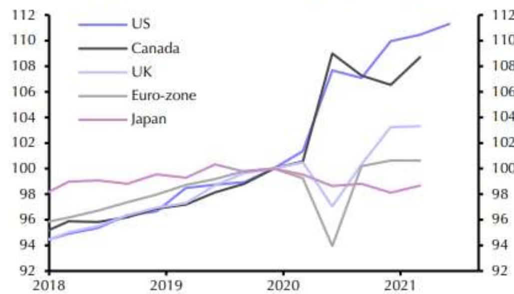
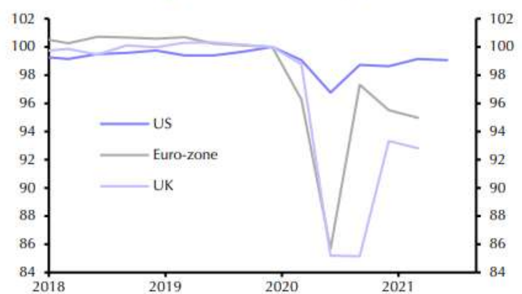


Chart 4: Average Hours Worked (Q4 2019 = 100)



Sources: Refinitiv, Capital Economics

(see PDF attached for full report)

What's the problem with inflation?

It's been so long since inflation has been a thing, many consumers, homeowners (and voters) have never experienced it.

Here's a handy inflation explainer oriented towards Econ 101 college students.

'The Confusion of Inflation' Khan Academy

https://www.khanacademy.org/economics-finance-domain/macroeconomics/macro-economic-indicators-and-the-business-cycle/macro-price-indices-and-inflation/a/the-confusion-over-inflation-cnx

Inflation drives interest rates on Govt bonds. Governments must ASK for the money from the bond market – (Hello! Canada are you listening?). Govt bond interest rates then affect consumer borrowing power. Rates up = borrowing power down. So…are the current interest rates on Govt bonds in line with the trend in inflation? The 'natural rate' of interest is the 'real rate' (nominal yield less inflation) one would expect given the economy at full capacity.

Answer: From 2010 onwards? No.

The following chart is for the US.

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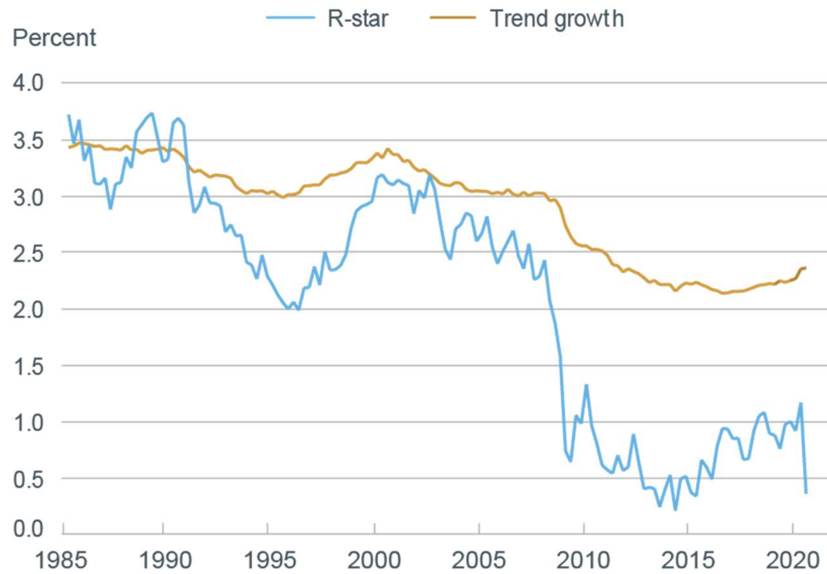
What is the 'natural rate of interest'? – New York Fed Nov 30/2020)



Source: Laubach and Williams (2003).
Note: We plot estimates of the natural rate of interest (r-star) along with those for the trend growth rate of the U.S. economy, a source of change driving r-star.

https://www.newyorkfed.org/research/policy/rstar

Since 2010, real rates have been well below the economic growth trend (above chart, 2010 onwards: blue line is well below tan line). Using this tool as a rate direction predictor was problematic, or at least REALLY early. Productivity increases may explain part of this difference.

The above is for US inflation/rates. What about Canada and how did/does that rate trend compare to inflation and Canadian property prices?

Chart #1: Canadian inflation has been declining since the 80's.

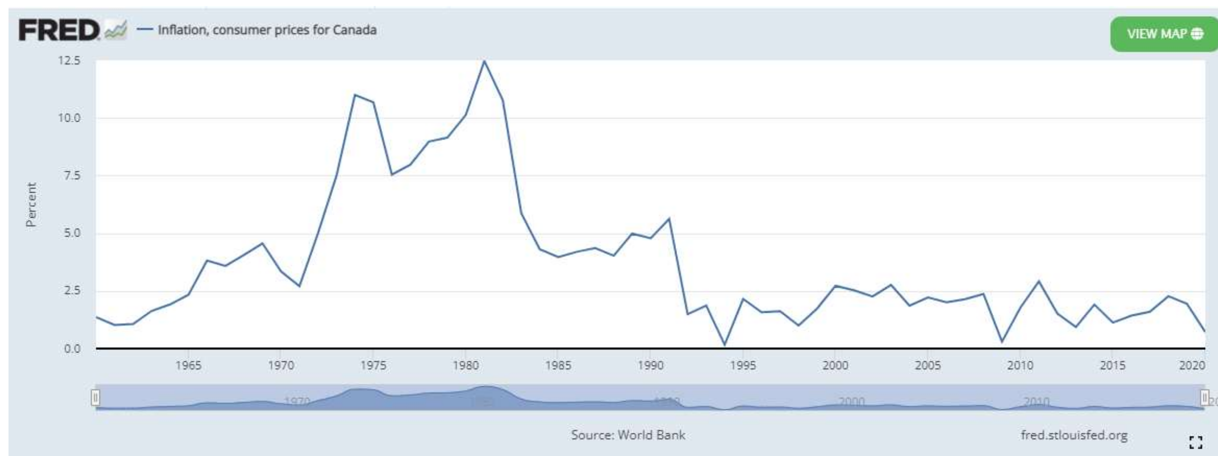


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Chart #2: Canadian interest rates have followed suit

Chart #3: Canadian consumer Debt to GDP (2005-2020) has risen as Canadian debt service cost have fallen. The debt servicing costs as a precent of earnings has not risen…yet.

Chart #4 Canadian House price 1965-2020 (2010=100**):** Why the debt bulge? Yup. Houses.

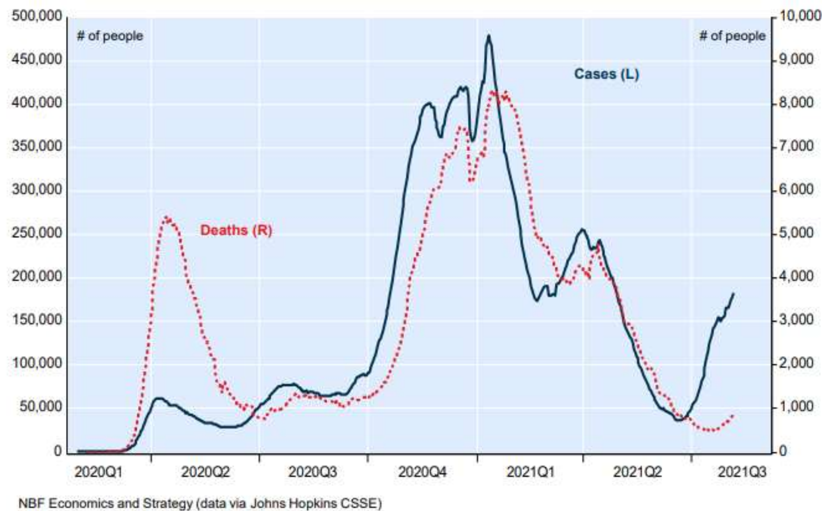
It's all good. Until it isn't.

Chart #1 says from 1965 to 1981 inflation went up. Chart #2 says from 1965 to 1981 interest rates went up. Chart #4 says from 1965 to 1982 house prices largely remained unchanged flatlining from 1975 to 1982 then declining sharply, into a bottom around 1985. That 1981-85 decline was the long-cycle wave result of the 1981 peak. Note the smaller run-up in interest rates from 1986 to 1990. House prices then went through a long flat spell again. When inflation rises, borrowing costs rise. There is an argument for property that it's inflation resistant. That hasn't been the case. When inflation increases, rates go up, borrowing costs rise and house prices don't. House price reaction to interest rates is long-cycle. It's a long, slow painful burn not a short-sharp OUCH, one and done. It's not rocket-science.

As a side bar, I was speaking with a construction contractor this week. He says they can't get anyone to work, and his suppliers are having the same problem. He blames it on CERB payments. He thinks workers like receiving the checks and will probably vote accordingly. His guess is we'll see a Liberal majority result from a Canadian Federal election this fall.

CONCLUSION: If the population expands, the economy expands, after-tax disposable incomes per buyer rise, debt service cost and inflation doesn't eat up too much of it, house prices can and will increase. House buyers tend to be at the middle to upper income-tax brackets. Lately new buyers have had to be in the very highest brackets. The tax part of the equation is already a problem. With debts ballooning, Governments are not going to reduce taxes. If inflation remains dormant and rates follow, we could be okay. Not great buy okay. I worry about the very worst of all combinations being stagnant incomes, rising taxes, rising inflation paired with rising interest rates. Stagflation. Hopefully not like 1981 anytime soon.

COVID-19 Daily Monitor – National Bank Aug 6, 2021

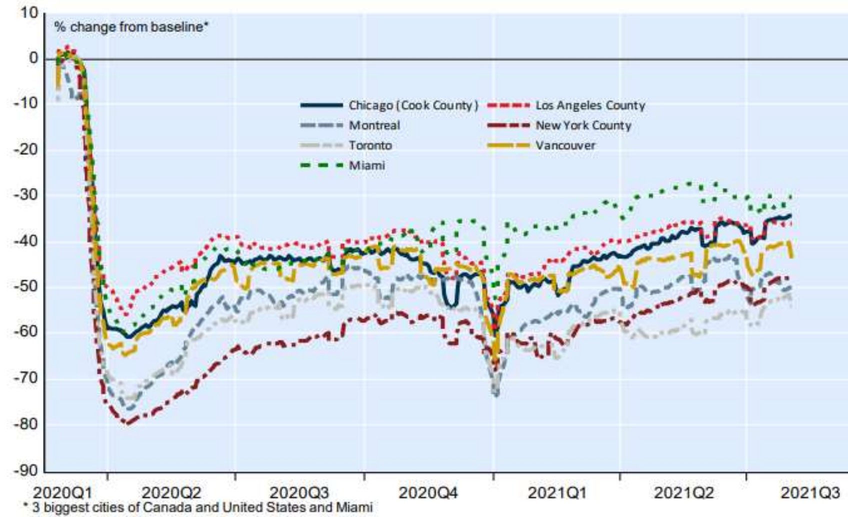


Investors have valid concerns over the spread of the COVID-19 Delta variant. Here in BC cases have increased. Happily, serious illness and hospitalizations are not tracking the same trajectory. Developed countries (where the money is) with their higher vaccination rates appear likely to avoid the most impacts. BC saw 49 per million this week. Florida shows 736 per mill.

There is good news on the expanding economy portion of the above house price equation. The bad news is we're not back to normal. The good news (for the stock market) is we're not back to normal. IE there's still a LOT of upside

18. Canada and United States*: Back to normal index (2)

Google mobility data for transit and workplaces, workdays only, 5-day mov. average



* 3 biggest cities of Canada and United States and Miami

**The baseline is the median value of the corresponding day of the week during the 5 week period from January 3 to February 6 2020

NBF Economics and Strategy (data via Google)

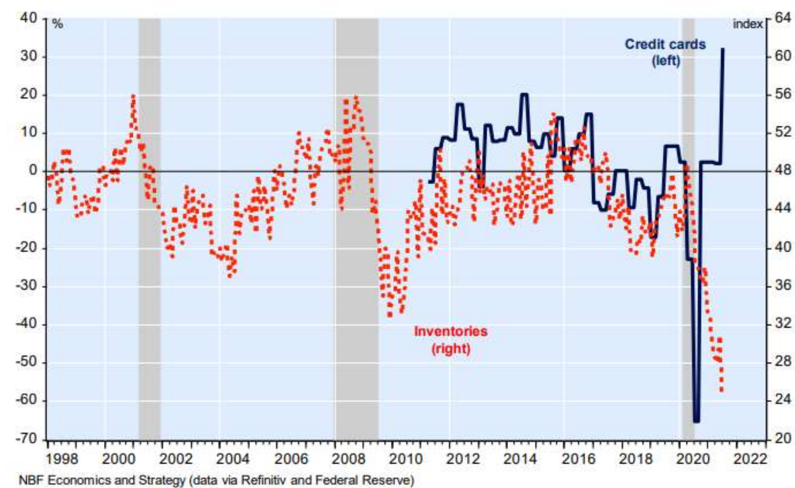
We're watching this one closely. See the full report.

https://nbf.bluematrix.com/sellside/EmailDocViewer?encrypt=d829599f-ca6a-4f85-99c9-a7ea5596bb87&mime=pdf&co=nbf&id=steven.hilberry@nbc.ca&source=mail

NBF Hotcharts – Aug 2, 2021

U.S.: Depleted inventories and consumers willing to spend

ISM customers' inventory index and share of senior loan officers reporting higher demand for credit card loans



We think the economy will overcome these worries. On balance we remain cautiously optimistic. Our horns are pulled in modestly but we're still bullish.

FIRE, Financial Independence | Retire Early

This week Anna looks at this radical savings method. Is it worth it?

Watch Anna's latest video here

https://www.youtube.com/watch?v=0fN7nC9ZAP0

Steve & Anna Hilberry

FOR THE RECORD Aug 6, 2021

DOW INDUSTRIALS:	35,182
S&P 500:	4,432
S&P/TSX COMP:	20458
WTI:	$68.08
LOONIE IN $USD:	$0.7958 $US

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