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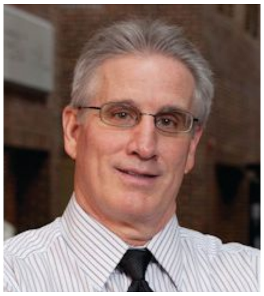
Remaking the Suburbs

Economist's View

What Happened to Inflation?

By Dr. Peter Linneman



We have been warning our readers of an impending inflation spike since the summer of 2009, but the consumer price index has yet to show any significant increases. Inflation is caused by excessive amounts of money chasing limited goods and services. Yet as the Fed has increased the monetary base by 279 percent since the end of August 2008 and M1 and M2 have grown by 81.4 percent and 38.4 percent, respectively, over this period, consumer prices have risen by just 1.5 to 3 percent per annum.

These muted consumer price increases seem to refute the traditional model of excessive money creating inflation, an incongruity that has been a puzzle to us and many other observers. After all, if the Fed can create infinite amounts of money without causing inflation, get on with it!

Reflecting on the absence of consumer inflation in the presence of substantial amounts of money, we have revisited the basic question of what is meant by "prices." Since economists assume that money impacts asset and consumer prices roughly proportionately and consumer prices are far better measured than asset prices, it is best to focus inflation discussions solely on consumer prices. This is behind assertions by Mr. Greenspan and Mr. Bernanke (and almost all economists) that they track consumer, rather than asset, pricing when monitoring inflation. They (and heretofore we) remained untroubled by the massive inflation in the prices of homes, stocks, gold, government bonds, et cetera, comfortable in the belief that modest consumer price inflation meant inflation was under control.

In reviewing the literature on money's transmission into the economy, it would seem the money enters neutrally and each economic player receives their pro rata share (relative to their economic size) of any newly created money. If this occurs, it seems reasonable to assume that each individual chases goods, services and assets in rough proportion to their initial demand for these items, resulting in roughly proportional increases in all prices. In such a world, consumer price inflation makes sense as a proxy for the inflation of all prices. Such a view of neutral monetary injection was probably realistic when the Fed injected money through many thousands of small, local depository banks.

Over the past 40 years, the U.S. banking industry has morphed into a highly concentrated system where banks both lend globally and conduct investment activities. As a result of this industrial transformation, money enters the economy through

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Market View: Single-Family Rentals

Shakeout and Shift Among Investors

By James Breitenstein

A year ago, there were at least a dozen active buyers in the institutional single-family rental space, all touting investment strategies in the $100 million-and-above stratosphere. Now there are just a few. What's going on?

Investors entered this business to make money as either a short-term opportunity or a buy-and-hold investment. The investors that viewed this solely as a short-term trade typically have yield requirements of 20 percent or more in internal rate of return. With appreciation, these expectations have likely been realized. Once these investors' initial capital was deployed, the question became, "Can it be done again?" Firms like Och-Ziff Capital Management Group L.L.C. apparently have concluded that it can't; the company exited the market in 2012. We

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a few large and very specialized money center banks in a highly non-neutral manner. If money center banks receive all of the monetary injections (which is close to true over the past five years) and these banks lend only to traders in U.S. government debt, U.S. government bond prices would be bid up while bread prices would be little affected. Since today's money center banks are disproportionately focused on asset lending and trading, one should expect the price inflation for assets in these niches to far exceed consumer price inflation. Thus, consumer price inflation remains low even as asset prices experience substantial inflation due to excessive money, making consumer price inflation no longer a useful proxy for the economy's inflation.

Commercial real estate price inflation has generally not occurred, as banks have reduced their lending to commercial real estate by $300 billion over the past five years. The current inflation has distorted capital allocations and has transferred staggering amounts of wealth from lenders (primarily U.S. retirees and foreign sovereigns) to high-grade borrowers (particularly the U.S. government). This inflation tax has allowed the U.S. to maintain unsustainable budget deficits without the need to raise taxes or cut spending, as the newly created money has financed the revenue shortfalls.

But the current inflation will end badly once the Fed finally raises rates. We already had a hint of the recessionary response associated with the shock of declining asset prices when Bernanke muttered something indecipherable about tapering. The longer the Fed waits to raise rates, the deeper the next recession will be. CPE

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expect similar investors to shortly take their profits and exit, as well.

Buy-and-hold investors initially bought homes at cap rates of 10 percent and above, and have captured significant price appreciation. The challenge now is that as more investors came into the market and institutional investors chose newer homes to buy, cap rates declined to more of the 4 to 6 percent range. Investors such as Oak Tree Capital and Carrington Mortgage Services got to the party relatively late in 2012 and caught some price appreciation but were unhappy with the ongoing returns. They recently announced they are going to exit.

Meanwhile, other large investors have been sidelined as they work to digest their recent purchases. As large investors raced to capture market share and appreciation, many of their homes were left vacant on the theory that with rapid appreciation even empty homes are yielding 10 percent or more. Unfortunately, GAAP accounting does not allow investors to recognize appreciation and limits capitalization of start-up expenses. This makes the numbers look bad even if they have performed well on balance. These investors' capital sources are taking a wait-and-see approach. In general, they want to see the empty homes leased and stable returns created before providing more funding.

The ongoing challenge will be to buy "institutional"-quality homes at good cap rates. In order to attract institutional capital, nearly all large investors purchased mostly newer homes near good schools and in nice neighborhoods. While this may ultimately provide long-term appreciation and reduced expenses, the short-term effects are lower current yields.

One strategy is to buy non-performing notes rather than actual homes. The theory is that you can get additional supply of homes and higher returns through the workout process. It remains to be seen if this holds true for investors, as pools of non-performing notes tend to include a wide variety of home locations and varying quality.

Some large investors are buying older homes in less desirable areas on the theory that they can achieve higher yields. It is difficult to accurately predict expenses with such homes, but correctly managed, they can produce the intended results.

Another emerging strategy among surviving large investors is to build their own inventory of homes. Landsmith, for example, delivered more than 1,000 "build-to-rent" homes to institutional investors in 2013. The challenge for investors pursuing build-to-rent is to understand the single-family land development, construction and rental businesses.

We expect to see continued consolidation in the single-family rental business. Those with access to low-cost capital, who can buy higher-yielding properties and have efficient property management, will be the winners. CPE

—James Breitenstein is CEO of Landsmith L.P. Look for his regular insights on CPE's experts' blog, **From the Inside.**