

2008 Inflation: Impact on Commercial Real Estate Investments

According to [US Bureau of Labor Statistics](#), the US consumer price index for all urban consumers (CPI-U) in May 2008 was 4.2% higher than in May 2007 (refer to the article "[Indexes Investors Should Know](#)" for more info about CPI). In previous years, the increases were somewhat mild: 2.8% in 2007, 3.2% in 2006, 2.8% in 2005, 2.6% in 2004, 2.3% in 2003, 1.6% in 2002, and 2.8% in 2001. The average increase for the first 5 months of 2008 has been 4.06%. 4.2% increase in the CPI-U means it now costs 4.2% more to buy the same thing compared to a year ago. Another way to look at this is the same one dollar bill is now worth 4.2% less compared to a year ago. This is expected as rising fuel prices have driven significant increases in the cost of food and other basic goods and services. There is evidence that the inflation is expected to rise in foreseeable future. J.P. Morgan economist Michael Feroli predicts the consumer price index will be up 5.1% in August 2008, the biggest year-over-year increase since 1991.

If you borrow to finance your real estate purchase, inflation is good for you from a real estate investment viewpoint. The same loan you borrow is actually worth 4.2% less compared to a year ago due to inflation. When the cap rate is higher than the interest rate, you get double benefits. You make a profit on the loan you borrow and also earn a 4.2% "bonus" because the loan is worth 4.2% less compared to a year ago. So it is a good idea to maximize leverage during the period of high inflation.

If you are a landlord of commercial properties then long term leases with fixed rent increases, e.g. 20 years NNN lease with 2% annual rent increase will not be in your favor. The 2% rent increase is less than the inflation so your rent is actually less next year. Shorter leases, e.g. 3 to 5 years will give you an opportunity to increase to higher market rent when the tenants sign new leases or exercise the options. Higher rents in turn will have positive impact on the value of your properties when it's time to sell.