Real Estate Values Are Made in the Money Market

by James E. Gibbons, C.R.E.

Over a great many years, real estate appraisers have employed the "Three Approach" procedure, looking at value from the viewpoints of cost, market activities, and income attributes. At various times, any one of these yardsticks may be more useful or persuasive than the other two; but if it was necessary to select the one most extensively employed, the nod would go to the market data procedure. It always seemed prudent to look to the latest and most relevant market transactions, seeking in them the clues to and evidences of value. There can be no doubt that such efforts will always be an important part of an appraisal, but recent economic and monetary trends point to a need to shift major emphasis to income or money conditions. This position is strongly supported when one studies the concept of value and considers the nature of a real estate investment.

A widely held view today is that value is best described as the present worth of future benefits of ownership. It is a function of futures and the benefits, both income and proceeds of sale, are generally expressed in dollars. Valuation is, therefore, a projection of such benefits and their discounting to express present worth or value. Obviously, key considerations are selection and application of discounting rates.

Consider then the nature of a realty investment. It is not land, bricks, and mortar; rather, it is the capital invested to secure the enjoyment of the benefits accruing to the property rights involved. In a single word, the investment is capital.

Traditionally, two types of funds have been used to purchase real estate, namely, a substantial amount of debt capital provided by a lending institution, and a smaller amount of risk money from the investor. Of course, there have been occasions where the investments have consisted entirely of one or the other of these types of capital. In any event, the realty investment is clearly a money situation. Therefore, the price and availability of this commodity will influence and regulate the value of the situation.

Consider some features of the commodity money. Like all others, its pricing is influenced by laws of supply and demand. In periods of excess supply and

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slack demand, the price is low, whereas, in periods of limited supply and heavy demand, the price is high. It would appear, therefore, that money does not differ greatly from other economic commodities. Its price, however, is generally not expressed in dollars and cents, but as a rate of interest to be paid for the use of the funds. A most significant difference between money and other commodities is found in the supply side of the pricing formula. While demand for funds is a product of natural economic forces, supply of money is a mechanically regulated element. It follows, therefore, that whoever manages supply can regulate general interest rates (prices) which, in turn, set the discounting rates used in valuing real estate. Because of this process, it is valid to assert that realty values are made in the money market, not in the real estate market.

CREDIT REGULATION

It is interesting to examine the monetary supply regulation devices that exist in today's economy. Since 1913 when Congress created it, the Federal Reserve System has had the mission of managing money and credit with a view to promoting orderly growth of the national economy. In order to discharge this duty, the Fed has been given a group of credit regulation tools.

Reserve Requirement

First, there is the Reserve requirement. As a requirement for membership in the System, the nation's banks must agree to keep varying amounts of their deposits frozen in accounts at the Federal Reserve banks, thereby eliminating these funds from availability for loans. The magnitude of this requirement can be changed from time to time; and by such changes, the volume of money and credit is expanded or contracted. If the Fed wishes to restrict money supply, they can increase the deposit reserve obligation. On the other hand, should monetary ease be the objective they can lower the limitation. Over recent years, demand deposit funds have carried an approximate 15% requirement, and time funds have been frozen to the extent of 3% to 5%.

Fed Discount Rate

A second credit regulation tool is the Fed discount rate. One of the great privileges of membership in the Reserve System is the right of member banks to borrow from Fed. This ability makes it possible for them to secure funds and accommodate their customers during periods of great demand. It is clear, therefore, that this privilege is a means of expanding monetary supply, and a limitation on the privilege is a restrictive factor. The cost to member banks acquiring funds is an interest item which is called the Fed Reserve discount rate. If it is very cheap to borrow, member banks will be encouraged to acquire funds and make them available to customers. On the other hand, if it is expensive there will be a disinclination to use the device. The regulation of the discount rate is quite obviously an effective credit management tool.

A further word should be said about member bank borrowings from the Fed. Even though membership in the System purportedly makes this privilege available, the actual operation of the arrangement involves very significant limitations and restrictions. Fed is not always willing to extend credit, particularly when the System feels that it is not in the best interests of the U.S. economy. When that is the case, it is said that the "discount window is closed."

In this way, it is not just the pricing that limits credit expansion but non-availability of funds, as well.

Open Market Committee

A third credit management tool is operation of the Open Market Committee. This is probably the most intensely used, and certainly the most potent of Fed's arsenal of weapons. The Committee is composed of the president of the New York Federal Reserve Bank, a few fixed members, and a group of rotating members. This body buys and sells U.S. government securities in the open market. By so doing, they exert a powerful influence on interest rates. In fact, by reason of their operations being conducted on a daily basis, they can maintain short-term money rates at target levels selected by the Committee. Without going deeply into the mechanics of operations, the impact of a purchase of securities by the Open Market Committee is to infuse into the general money market an amount of credit equal to approximately six times the amount of the purchase. On the other hand, a sale by the System results in withdrawal from supply of money and credit of an amount equal to approximately six times the sale. When one considers that on a daily basis the transactions of the Committee run in hundreds of millions of dollars, it is apparent that the supply side of the money market is in reality manipulated by the Fed. In this connection, it should be noted that the Fed has the duty to use these great influences in a manner likely to promote orderly growth in the U.S. economy. Whether over the years of their operations they have, in fact, moved effectively toward this goal is a matter for debate; and there are as many who will vote "no," as those who will vote "yes."

FED FUNDS RATE

Since real estate valuation is a discounting procedure, and its key is the selection of a discounting rate, the issue of money rates is a central consideration. Federal Reserve operations impact most directly and immediately on the so-called "Federal Funds Rate." This rate is the amount banks pay each other for short-term loans made back and forth to enable the institutions to meet their deposit reserve requirements. If a bank is falling short of the amount necessary to be kept in its reserve account, it will, on its own or through a broker, canvas the banking system to find another member bank that has excess reserves. The needy bank will borrow on a short-term basis from the surplus bank, and the rate paid is called the Fed Funds Rate. It is obvious that if through Open Market Committee operations the Reserve is infusing large amounts of excess reserves throughout the monetary market, the price for Fed Funds, or the Fed Funds Rate, will be quite low. On the other hand, if reserves are tight the rate will go up. This Fed Funds Rate is a key consideration because it is directly influenced by the Open Market Committee operations. It is also important because it is a foundational type rate, representing top quality credit and the shortest loan term. From such a base, poorer credit risks are assigned increments of additional rates, thus forming composite rates from the Fed Funds level. The amount banks must pay customers for longer term deposits in the Certificate of Deposit market will generally be something in excess of the Fed Funds Rate. Similar adjustments will appear throughout the whole array of credits, such as commercial paper, U.S. Treasury bills, U.S.

agencies, U.S. bonds, municipal securities, corporate borrowings, and so forth. Through a process of risk rating, each of these is assigned some level above or below the key Fed Funds Rate. Through this process, it can be seen that, as the Fed Rate fluctuates, there are sympathetic adjustments throughout the entire credit market. Of course, where longer term credits are involved, daily movements in the Fed Rate will not produce instantaneous and precisely duplicate changes throughout the bond markets. It is clear, however, that the changing trends, policies, and views of the Federal Reserve System will and do limit both the availability and price of money.

ECONOMIC RECAP

So much for the mechanics of the market; and, of course, it should be emphasized that this discourse is intended to illuminate only the highest spots in the very complicated terrain of credit operations. Of more importance to the real estate counselor, appraiser, or investor should be a review of recent economic experience in order to judge the validity of the assertion that realty values are made in the money market. During the late 1960s, as a result of pursuing the Viet Nam War in an expansive economic climate, the government operated on large deficit budgets which resulted in accelerated rates of inflation. As the decade of the 1970s arrived, the Federal Reserve was most concerned, and remains so, about the damaging effects of continued inflation. The number of dollars in circulation proliferated throughout the world, and there were serious doubts about the continued durability of this currency's value.

In such a situation, the Fed consciously embarked upon a program of restrictive credit intended to slow down the economic tempo and ease inflationary pressures. By 1973, the Fed's program had gathered momentum, and we witnessed an unparalleled climb in interest rate levels. Commercial banks' prime lending rates went from approximately 5% to 12% and remained at such levels well into 1974. It should also be noted that during the latter part of said period and as a result of political pressures, the prime rate was held constant. Commercial paper rates, which were free of political influence, soared into the 14% to 15% area. High quality corporate bond issues rose to the 9-10% level and, in many instances, even higher.

During this period of restrictive credit and high interest rates, there was little or no long-term debt capital available. Money managers found conditions changing so rapidly that they were reluctant to do anything but place their funds in the shortest term situations so that they could be rolled over at the increasing interest rates that were constantly emerging. This phenomenon is of tremendous significance to the field of real estate, where investments are of a long-term nature and where, for many years, the key part of the investment was long-term debt capital, otherwise known as mortgage money. Venture capital, or equity money, became extremely scarce because the managers of these funds were also reluctant to take a position involving intermediate to long-term commitments. Conditions were changing so rapidly that investors' anticipations of further rate changes kept everyone on the fence, and available capital went only into high quality short-term debt situations.

Consider the impact of these credit conditions on real estate investments. In the construction area it became the rule that building funds had to be borrowed on the basis of floating rates. A construction loan would be pegged at 4% or 5% above commercial banks' prime rate or commercial paper rate, whichever was the greater. With the prime rate moving in a very short period of time from 5% to 12%, and the commercial paper rate moving from 5% to 14% or 15%, the cost of construction money escalated from about 9% to close to 20%. The cost of such funds is a critical element in the so-called cost approach to value. Costs are both direct and indirect, and the construction loan interest is one of the largest indirect elements. With such a serious price distortion, there was no way a construction project could have been rationally budgeted. In just about every instance, these ventures ran out of funds and fell into foreclosure. But above all, their costs had escalated beyond any previously anticipated level.

COMPONENT PRICE LEVELS

Of equal importance in the cost approach to value are the price levels of the components that go into the makeup of building ventures. Each element of a building is manufactured by an organization that operates its affairs by using some equity money and a significant amount of borrowed funds. As interest rates escalated, manufacturers passed such additional costs through to customers by pricing their products at higher levels. In this matter, builders were forced to stand not only increased direct interest costs, but higher prices for all the materials utilized in their ventures.

In the situations where real estate developers were fortunate enough to have completed the construction phase of their investments and were facing the problem of marketing their products, the monetary problem became equally difficult. If a project was of the rental variety, the owner would have to establish rents that would be sufficient to pay all operating expenses (including the huge increases generated by the energy crisis and real estate taxes) and the very steep requirements for mortgage money (if any at all was available) and show something beyond that as a return on equity capital invested. Looking at the operating expense elements and considering mortgage constants in the 12% to 14% range, it was clear that rents had to be raised to levels far beyond the ability of the market to pay. In other words, in these real estate ventures value was destroyed and there was no economic feasibility.

From the viewpoint of a market data approach to value, how does one identify and measure a market when market activity is stifled and killed by oppressive money costs? If the project was a sales venture, such as a condominium apartment, the same general maladies existed. Either there was no mortgage money available to the prospective purchasers of apartments or, if there was mortgage money available, the terms were exceptionally onerous. Mortgages would be quoted at low ratios of loan to value, high interest rates, short amortization terms, and, generally, some substantial fees to the lender. Only a very few purchasers could stand these conditions. Market activity halted and it has only recently shown signs of a broad-based recovery.

IMPACT OF DISINTERMEDIATION

While discoursing on mortgage funds, it would be well to touch on another money market factor which proved to have a powerful influence on real estate markets. This is the activity which has acquired the very fancy label of "disintermediation." In simplest terms, this was the withdrawal, by savers, of funds from thrift institutions (paying relatively low interest rates) for the purpose of investing them in short-term money market instruments (where rates had escalated to 10, 11 and 12%). This activity sharply curtailed the availability of long-term mortgage funds which had traditionally been supplied by the thrift industry and life insurance companies.

The pervasiveness of difficult conditions in the money market is fascinating to contemplate. When one complains about the high level of real estate taxes, he normally thinks of the cost of building and operating schools, sewer systems, water supply, and so forth. It is true that these constitute major increments of the tax package, but not far behind is the interest rate cost to municipalities of the funds borrowed for these projects. Witnessing the surge upward in municipal bond rates, it was clear that local governments were being compelled to pay very high rates for the funds they needed for projects of necessity. High interest costs are passed through to the citizenry as increased real estate taxes. The escalating tax item thus destroys the bottom line of rental real estate and at the same time pushes the cost of home ownership beyond the market's ability to pay.

When one also considers the increased costs stemming from the energy crisis, he naturally thinks of the huge increase in oil prices forced on the world by the Middle East oil-producing nations. Not far behind in importance, however, is the fact that utility companies had to acquire from the money market the funds they needed for their necessary operations. These companies had to face substantial increases in money costs which in turn were passed on to the customer in the form of higher utility prices. Again, an adverse impact on real estate bottom-line earnings occurred and more value was destroyed.

In recent months, Fed has pursued a substantially easier monetary policy, and the price of short-term funds has declined. As a result, there has been an inflow of money to the thrift industry which in the past always signaled a new wave of building operations and mortgage activity. To date, the recovery of the housing industry developed slowly. It is interesting to speculate about the causes of this situation. Probably, "the once burned—twice shy" attitude is holding back builders and mortgage lenders. There is still a very large overhang of real estate disaster situations remaining from the 1973-75 period. They will have to be absorbed before large new efforts will start in the housing construction market.

The price of long-term capital and equity funds has been slow to yield to recent downward trends in short-term interest rates. In the back of the minds of money managers, there must be a fear of returning to the restrictive credit conditions of 1973-75, causing a reluctance to drop prices. These people seem to be trying to avoid the roller coaster effects experienced in short-term money markets.

VALUE DESTRUCTION

Perhaps the most damaging aspect of recent monetary policy has been the destruction of values and economic feasibility throughout the real estate investment field. The very serious increases in construction costs, operating expenses, real estate taxes and mortgage money rates have occurred without corresponding increases in the market's ability to pay. These factors all contribute to the reduction, if not total elimination of any net earnings from many real estate ventures. In the appraisers' eyes, therefore, is the unhappy prospect of newly-constructed projects that are not worth the cost needed to create them. This has its most serious implications throughout the housing field. Younger people in the family formation phase of their lives are now confronted with a median home price of $42,000 or $43,000. By most rules of thumb, this would mean a monthly housing cost of about $450. A quick glance at earnings statistics throughout the nation will reveal that the people who most need housing are economically eliminated from the market. This is not a happy or healthy condition for the real estate industry or, more particularly, for the country.

Value is best described as being the present worth of future benefits, and valuation is the discounting procedure employed to calculate such worth. In this article, the impact of monetary conditions on many economic elements related to real estate has been indicated. Two major trends emerge. The increased construction, operating, and monetary cost levels generated by a restrictive monetary policy have destroyed net earnings, or what we have described as the future benefits of ownership. The remains of these benefits, if any, must be discounted at rates which in a historical perspective are startlingly high. The appraiser's so called capitalization rate is nothing but a weighted average of the cost of mortgage money and equity funds.

The purpose of this article has been to indicate that the cost or rates of these types of capital stems from money market operations which, in turn, are manifestations of the economic thinking and regulation of the Federal Reserve System. Throughout a large segment of the economy, the laws of supply and demand represent the results of free market activity. But with the supply of money we have a somewhat different situation. It seems clear, therefore, that the obligation of real estate valuators and counselors is to be thoroughly aware and informed on monetary conditions. It has been said that the real estate counselor is an economic generalist, and this is just one more demonstration of the accuracy of such a statement. Since real estate values are made in the money market, real estate people must now be money market students.