In spite of strong CRE market, does trouble lie ahead?

Expert Opinion

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Investment in Washington real estate is about choices — choices not only of a broad range of property types, but also, and probably most importantly, choices as to the timing of investment in real estate.

Nationally, most studies rank the D.C. area as the No. 1 real estate market for investment. Even international investors recently selected Washington the top investment market in the world, ahead of London, New York and Paris.

To the naked eye, there appears to be an endless stream of real estate products with many drivers — improved services and infrastructure, population growth, the empty-nester phenomenon and urbanization trends, to name a few.

On the other side of the ledger, low-cost money is creating an artificial demand soon to be rocked by the inevitable end to historically low interest rates.

But what does this all mean?

Pragmatic investors look for returns. Money is cheap and the region's economic health is attracting unprecedented inflows of capital. As remarkable as this real estate cycle appears to be, there are signs of trouble ahead. As some observers manage to put a positive spin on D.C.'s real estate economy, it simply doesn't add up to a continuation of, "Let the good times roll."

It is known that economic cycles are natural in our economic system. So just where does the market stand in terms of the traditional seven-year cycle? One would presume we are at the "peak" of this cycle. This knowledge notwithstanding, the cyclical nature of capitalism is being ignored by the real estate industry. Why? Perhaps another case of irrational exuberance at work.

Case in point: Few Washington residents are unfamiliar with the skyrocketing prices of real estate in the metro area, and especially in the District.

As well, one has to take a deeper look at the dynamics of wholesale (unimproved) prices vis-à-vis retail (end-user) prices to better understand rising prices and the dangers that lie ahead in this residential real estate house of cards.

Anyone who has purchased a residential property in the last few years is all too familiar with the multiple bid phenomenon, escalation clauses and feeding frenzies that occur when newly improved or new condos and single family homes go to market. This dynamic is the result of basic supply and demand and the distorting effect of speculative investment behavior.

Money looking for high returns ends up driving price increases as would-be, part-time developers and investors with access to easy cash rush to cash in on the upward trend. It's not hard to see the aforementioned irrational exuberance at work in Washington's real estate industry. The creation of a distorted and unsustainable market condition pegged to low interest rates is setting us up for a collapse, unless of course, we listen to our own advice.

Is another "soft landing" the answer?

More than likely, the fate of real estate lies in the hands of the Federal Reserve. Having gone through a similar bubble-like experience, tinkering with rates will probably be more subtle. Gradual increases in interest rates will send the right signal to the speculative buyers advising them to look elsewhere for "junk" type returns, thus creating the necessary adjustment in the market. Once the dust settles and a somewhat predictable 10 percent downward adjustment takes place, investment will continue to fuel the local economy as one thing is certain: Government growth is a staple of the Washington economy.

Now if the solution were this simple for rest of the sector.

Massive building, even without the effect of lower interest rates, can produce yet another undesirable effect: overbuilding.

We need not look far to see the effects of rapid job creation. Across the Potomac, Northern Virginia has been living through growing pains since the mid '90s when the tech boom was in full swing. Shortsighted planning has put Fairfax County in a logjam. Ironically, some of the District's growth is attributable to overcongestion in Virginia as commuters are faced with a tough choice between urban living and living in traffic congestion.

It would appear that D.C.'s mayor and the planning office have developed contingency plans for the expected, and desired, population growth in the District. From the tax incentives to promote the East End as a viable living destination, to the planning and development of the Anacostia Waterfront, the city's government seems to be firing on all cylinders with an effective focus on planned growth.

Part of intelligent planning includes the incorporation of the historical preservation process into the permitting process. As more areas of the city become protected by Historic District designations, the beautiful character of the city is being preserved while having a balancing effect on overbuilding.

New jobs require the creation of new communities, not just new real estate. Embedded in the city's historic architecture, the "hometown" feel is promoting a healthy balance between growth and community development. Only time will tell if the District has discovered a way to become livable as compared to suburban life. The District's success or failure will come down to good local government and responsible development in the years ahead.

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