Housing as an Inflation Hedge?

Managing debt and protecting assets in a shifting economy.

By Patrick S. Duffy

Given the size of the federal bailouts to prevent the U.S. economy from lurching into a full-blown Depression and a federal deficit that will rise to about 13 percent of GDP during the current fiscal year, the chorus of voices concerned with runaway inflation just down the road grows larger every day. So is that a good or bad thing for the housing market? It's actually both.

Writing in an August op-ed piece for The New York Times, investment sage Warren Buffett, CEO of Berkshire Hathaway, argues that although he supported the financial intervention engineered by the federal government to prevent an economic collapse, the side effects from trillions of dollars sloshing around — and still largely protected in the coffers of risk-averse banks — will soon need to be monitored closely.

To be sure, finding buyers for U.S. government debt is a complicated process in the best of times. Assuming that both foreigners and citizens continue to funnel all of their extra cash into Treasury bills, that still leaves another $900 billion needed to underwrite the $1.8 trillion in debt being issued this year alone — $900 billion of which will most likely fall out of Washington's money tree at the Federal Reserve.

With legislators not about to incur the wrath of voters already frustrated with lower home values and retirement accounts, it's unlikely they'll be serious about raising taxes or cutting spending to fill the void. Instead, they have a third option which requires no official vote, nor can it be easily used against them at election time: let inflation take care of it!

The problem is that inflation is a double-edged sword which can slowly yet deliberately eat away at the wealth of its citizens, especially if that wealth is directly tied to the value of the U.S. dollar. Yet for owners of "real" assets, such as commodities, gold, and real estate, inflation can both boost the value of the asset while chipping away at the fixed-rate debt used to finance it.

In the case of real estate, the inflation hedge is really more about the type of debt used — preferably a long-term mortgage with a fixed interest rate — than anything else. But add in the impact of rising prices on rents, and suddenly investing in real estate for passive income and enjoying the various tax write-offs becomes a tried-and-true method (and one used extensively in the 1970s) to build wealth while paying off debt that becomes worth less and less each day.

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Of course to address rising inflation, the Federal Reserve will eventually have little choice but to hike interest rates, which could counteract the advantage of real estate's strength as an inflation hedge. Moreover, the housing inflation of the 1970s was made possible with concurrent increases in wages; given a global economy which has kept a tight lid on wage income, it's also possible that we'll see higher prices for oil, food and commodities as home prices continue to stagnate.

For now, the best advice for households is to conduct their own financial analyses and determine how to defend their assets in an inflationary environment while also looking out for advantageous investments, such as selling off bonds and converting variable-rate loans such as those used for credit cards, cars and home equity lines into fixed-rate alternatives.

For those with extra cash to spare, investing in exchange-traded funds specializing in gold and commodities (although more volatile) can be more profitable than the type of Treasury Inflation-Protected Securities, which simply keep investors above water.

However, one group of potential homebuyers who might benefit the most from rising inflation are the baby boomers, who will start retiring en masse just as interest rates on their CDs and savings accounts begin to rise. Add in the fact that Social Security payments are adjusted for inflation, and they might even forget that the actual dollars they've saved for a lifetime are worth just a bit less each day. And that's where the "retirement home as inflation hedge" discussion could very well have the most merit.

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Fast Facts

- **Unless Congress raises taxes or cuts benefits, inflation is just around the corner.**
- **Real estate can be a solid inflation hedge when wage inflation is also present.**
- **If rents for housing rise, income property serviced with fixed-rate debt can be a great inflation hedge.**
- **All households should conduct their own financial analyses to protect their assets in an inflationary environment.**