How To Buy Your First Rental Property in 2023

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Real estate investors have been spoiled for the last few years, enjoying the artificially low interest rates created by the government's reaction to the COVID pandemic. As the world (and interest rates) return to normal, what worked in 2021 and 2022 will not work in 2023. In this article I'll discuss three changes you need to be aware of before you "pull the trigger" this year and buy your first investment property. They are:

1. Inflation
2. Mortgage Rates
3. Fear of Recession

INFLATION

One thing that's changed the investing landscape from last year is an increase in inflation, from 2.0% to 8.0% or higher by some estimates.

Inflation is very positive for real estate, as we saw in the inflationary 1970s when real estate was one of the best-performing asset classes. Inflation benefits real estate in these ways:

- Rents go up faster over time
- Property values go up faster over time
- Inflation erodes the real cost of your debt as you pay off your mortgage in inflated dollars

Over time, inflation transfers wealth from savers (who lend money) to borrowers (who borrow money to invest in appreciating assets like real estate). You want to be on the right side of that transfer!

While the Fed's been raising interest rates to bring inflation back to its target of 2.0%, many economists believe that the era of 2.0% inflation is over for good.

Here's why: The main reason inflation has been so low for the last 20 years is because of globalization i.e., having most manufacturing done offshore in places with low production costs, like China. But as we saw during the Covid pandemic, that efficiency came at a price: lack of resilience. The United States realized it was completely dependent on China to produce antibiotics, personal protective equipment, and many other basic necessities.

Today, policy makers and business leaders realize that dependable supply chains are more important than cheap supply chains. This is resulting in a "reshoring" of basic manufacturing back to the United States, which will in turn result in higher overall prices. (See the footnotes at the end of this article for examples.) Built-in inflation is now structural (not transitory), and we can expect inflation in the 3-4% range as the new normal going forward.

That's good news, as a 3-4% inflation range is a potential "sweet spot" for real estate investors looking to buy their first rental property this year (and also experienced investors looking to grow their portfolios). This range high enough to cause rents and property values to go up (all the while eroding the real cost of your mortgage), but not so high that the Fed will feel compelled to make draconian interest rate hikes.

INTEREST RATES

Perhaps the biggest change to the real estate investing landscape from the last few years has been the increase in mortgage rates. At their lowest point, mortgage rates were at a 50-year historic low of 3.0% but are now back to a more normal 6.0%.

This, too, affects real estate investors wanting to know how to buy a rental property in several ways:

- Less cash flow due to increased borrowing costs. A home that cash flowed $400 per month at 3.0% interest might cash flow only $100 at 6.0% interest. In high-priced markets, or with new construction homes, the cash flow might even turn negative.
- Less inventory available for purchase, as homeowners with 3.0% mortgages don't want to sell their existing home to buy a new one with a 6.0% mortgage.
- Higher rates means you can afford less house, unless home prices drop enough to compensate.

Though these are all negatives, the way you work around higher rates is by financing your investment property with an Adjustable-Rate Mortgage (ARM) at a lower interest rate. You might even get some seller incentives, such as the seller paying points on your behalf to get you a lower rate.

Compare the two financing options below, for the same property:

Denison TX Single Family Home
3 Bedroom / 2 Bath / 1 Car Garage / 1,264 sq feet

New Construction	30-Year Fixed @ 6.875%	7/1 ARM/ 2 Points / 5.75%
Purchase Price	225,000	225,000
Down Payment (25%)	56,250	56,250
Closing Costs	10,125	10,125
Total Cash Invested	***66,375***	***66,375***
Rent	1,790	1,790
Mortgage Payment	**1,108**	**985**
Property Taxes	367	367
Insurance	74	74
Property Management (6.5%)	116	116
Total Expenses	***1,665***	***1,524***
Monthly Cash Flow	125	248
Annual Cash Flow	***1,500***	***2,976***
Cash-on-Cash Return	***2.3%***	***4.5%***

As you can see, using an ARM gets your mortgage rate down by over a full percentage point, and in year one almost doubles your annual cash flow and cash-on-cash returns! Since rents go up over time, the cash flow only increases from that point on. This additional cash flow provides a better financial cushion and gives you, the investor, a greater margin of safety.

Of course, if rates decline in the future, you can always refinance with a 30-year fixed loan at the new, lower rate. But the days of 3.0% interest rates are likely over – that has happened only once in the last 50 years – and if you for wait those rates to return before investing, you many never buy a property.

FEAR OF RECESSION

The final thing we investors should keep in mind as we enter 2023 is the widespread fear of a recession occurring later this year. If that happens, here are some pitfalls you should know about before investing:

- Certain markets will be hit harder than others. You'll want to be cautious about investing in single-industry cities like Detroit (which is heavily dependent on the auto industry) or Las Vegas (which is heavily dependent on tourism). Markets such as these will be more impacted from an economic downturn than metros with diverse economies.
- Certain assets will be hit harder than others. An Airbnb vacation rental may do well in good times, but in lean times the first thing consumers cut back on is discretionary spending, like $250/night vacation rentals.
- Your tenants may lose their jobs and will no longer be able to pay rent, causing a temporary loss of cash flow while you find a replacement tenant. Cash is always king, but especially so during a recession. Investing in high-cash flow properties is safer than properties with lower cash flow and potential appreciation.

HOW TO BUY YOUR FIRST RENTAL PROPERTY IN 2023: A PLAYBOOK

So, putting all this together, what's your best strategy for buying your first rental property in 2023?

Markets

- Avoid markets heavily dependent on one industry and focus on markets with diverse, stable economies.
- Lean toward markets that have higher cash flow over markets that merely break-even and which may or may not appreciate in the future.
- Metros near military bases (e.g., Warner-Robins GA, near Robins Air Force Base) are virtually recession-proof, as the military is not affected by recessions.

Property Types

- Focus on bread-and-butter properties that have universal rental demand, such as a median-priced, 3-bedroom, 2-bath home in an "A" or "B" neighborhood. Universal demand means "shorter vacancies".
- Be careful about out-of-the-mainstream properties like vacation rentals, luxury timeshares and McMansions.
- Consider multi-families like duplexes and fourplexes, as they cash flow better per-invested-dollar than single-family homes within a given market.

Financing

- Be open to Adjustable-Rate Mortgages (ARMs) and other financing options like buying down points that increase your cash flow and margin of safety.

Minimize Your Risk

You can avoid the inevitable rookie mistakes of buying your first rental property by working with an established property provider that has already done the heavy lifting for you: Identified good markets, vetted good home builders and turnkey providers, and built a complete ecosystem of quality property managers, lenders, insurance agents and others.

There is no need for you to do this alone when you can invest with an experienced team that will guide you through the entire process.

To engage with a leader in this field, take advantage of a free real estate investment strategy session by becoming a member of RealWealth. You can speak with an investment counselor who is a seasoned investor and can help you get started.

Avoid Analysis Paralysis

Above all, there is also no need to spend lots of time and money on expensive "boot camps" and courses. There's an entire industry built around making you feel you're not ready and need to take more training. You should put your money into properties, not real estate boot camps.

RealWealth has a library of 900+ free, educational webinars and articles that cover any questions you may have, with new webinars each week. We also offer free property tours in various markets where you can see available properties and talk to fellow investors who have bought in those markets.

Your goal should be to buy your first property this year. Avoid analysis paralysis and get on the scoreboard in 2023! Click the orange "Join for Free" button in the main menu to get started today.