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The Fed, Interest Rates And The Good News For Commercial Real Estate

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The Federal Reserve has kept interest rates low to support economic recovery.

Official Federal Reserve Photo

The Federal Open Market Committee [left interest rates unchanged](#) at its April 27-28 policy meeting, and reaffirmed its commitment to keep rates low until the economy has recovered more fully from the pandemic. Rates are at historical lows, however, and will certainly move higher as

the economy gets back to pre-pandemic levels of activity. Some observers have expressed concern about the impact of higher rates on commercial and residential real estate markets. Most of the evidence, however, suggests that the rate environment will remain favorable for real estate.

Most people are familiar with the effects that interest rates have on housing markets. Lower rates on home mortgages reduce the financing cost of a home purchase, and often spur home buying, new construction, and increases in house prices. We are currently [in the middle of a housing boom](#), fueled in large part by current low mortgage rates. Of course, this process can work the same way in reverse, and higher mortgage rates generally slow home buying and cool the housing market.

The same forces are at work in commercial real estate, as properties are frequently financed with commercial mortgages. As a result, commercial real estate markets are often considered one of the sectors of the economy most exposed to interest rates. The current risks are not large compared to previous periods, though, as in many property sectors debt loads are more moderate than in the past.

The two biggest factors for the outlook for long-term interest rates (which have the most direct impact on commercial real estate markets) are economic growth and the likelihood that such growth will lift inflation higher. Economic activity is expected to rebound over the spring and summer as the vaccine rollout helps slow the spread of Covid-19, allowing businesses and consumers to begin getting back to pre-pandemic normal. Many economists [expect the economy to grow at a 6% or faster](#) annual rate over the remainder of this year. To the extent that faster growth generates higher inflation, it also generates higher business activity and demand for commercial space, higher occupancy rates, higher earnings for commercial real estate, and higher property valuations. These higher earnings generally offset any drag from rising interest rates during periods when growth accelerates.

Inflation is indeed likely to move higher as growth accelerates. Concerns about inflation risks first began to surface as Congress debated the \$1.9 trillion fiscal stimulus package in February. Former Treasury Secretary Lawrence Summers [warned](#) that the magnitude of this stimulus could push the economy beyond its potential, fueling inflation pressures.

Financial markets have responded to this stronger growth environment, and long-term interest rates have already begun moving higher. The yield on the 10-year Treasury note rose from just above 1% in late January to 1.75% at the end of March.

Commercial real estate is likely to be resilient, however, for a whole host of reasons, including macroeconomic factors, economic policies, and financial conditions within commercial real estate markets. Let's take a look at the most important factors.

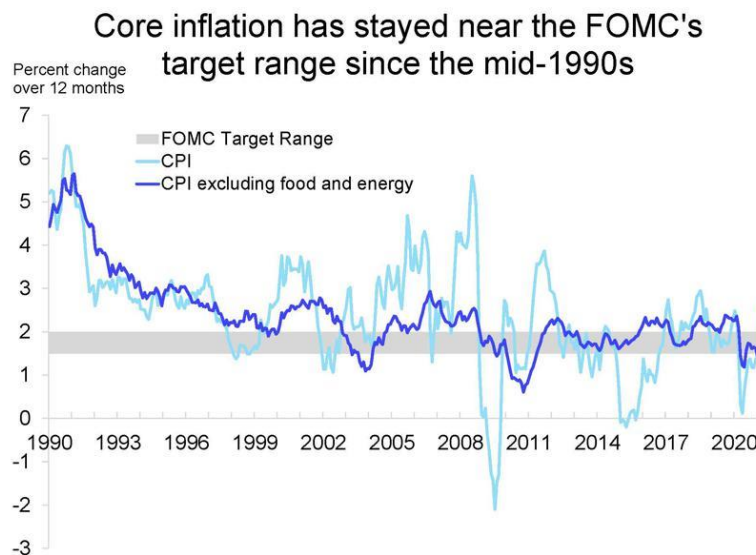
We are in a low-inflation, low-yield, low-interest rate world

This isn't *That '70s Show* or even that sixties show when it comes to inflation risks. There is by no means a consensus that the coming pickup in growth will push inflation too high; in fact, many economists (including me) expect inflation to remain moderate. There are cyclical, structural and policy reasons why the inflation outlook is benign:

Cyclical factors will be transitory

Inflation will move higher over the next 12 months due to base effects. This is because comparisons for price changes versus year-ago will be looking back to the first few months of the pandemic, when prices were temporarily depressed by unusual weakness during the shutdowns. This will give an artificial boost to the reported 12-month inflation rate, but this higher reported inflation rate is not the start of an inflationary spiral.

More important for the medium-term outlook, the overheating of the 1960s and 1970s resulted from years and years where the economy was pushed above potential GDP—the economy's “speed limit.” Joseph Gagnon at Peterson Institute for International Economics has [pointed out](#) that the fiscal boost from spending on the Vietnam War was long lasting, stretching out for many years, while many parts of the current fiscal stimulus are a temporary response to the current economic crisis. As these components of the stimulus fade in the years ahead, so will inflation pressures.



Core inflation has not moved far outside the Fed's 1-1/2% to 2% target for the past 25 years.

BLS, Federal Reserve, Haver Analytics, Nareit.

Structural changes to the economy affect price dynamics

During the [Great Inflation of the 1960s and 1970s](#), the economy was heavily reliant on manufacturing and energy-intensive businesses. These types of production processes were more prone to bottlenecks that pass along price pressures, including energy costs, than today's information economy. In fact, the concept of "capacity" is poorly defined for, say, software engineers compared to auto assembly lines. In addition, economic activity in those days was much more heavily regulated, which limited its ability to respond to shortages in a way to head off price changes. And finally, the role of price expectations, and the inclusion of cost-of-living clauses in many employment and commercial contracts, helped perpetuate inflation pressures in the 1960s and 1970s in a way that is not widespread today.

Monetary policy is more proactive

The Fed is already discussing how it plans to respond as the economy firms. This is a sharp contrast to the 1960s and 1970s, when the Fed waited until inflation rates had already moved significantly higher before they began raising interest rates. As my grandmother used to say, a stitch in time saves nine.

Commercial real estate entered with pandemic without the imbalances of decades past

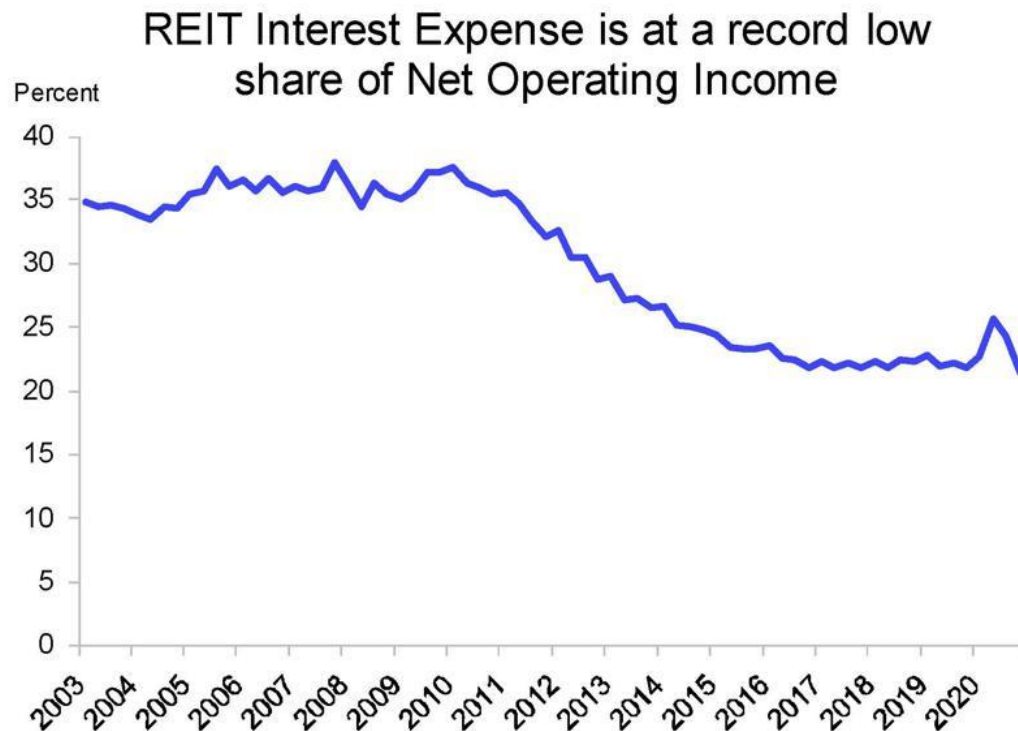
Commercial real estate markets in the past had been vulnerable to three types of imbalances: overbuilding, overheating, and over-indebtedness. None of these three factors was a major risk on a national basis, fortunately, when the pandemic hit. This more stable footing for the sector has helped commercial real estate be resilient through the crisis and provides conditions more conducive to recovery ahead.

New construction was moderate prior to the pandemic, especially in office and retail property markets. Completions of office buildings in the twelve months prior to the pandemic represented just 0.7% of the existing stock, according to data from CoStar, well below the 1.5% at the onset of the 2008 financial crisis, or the 2.5% new supply during the 2001 Dot.com recession. New construction of retail properties was almost nonexistent, at 0.4% of existing properties. Vacancy rates are rising and rents have been weak or falling due to cuts in demand for commercial space, but the impact nevertheless is smaller than it would have been with a heavy construction pipeline. The low levels of supply will be important for the recovery ahead.

In addition, prices did not have much speculative froth. Capitalization rates are low pretty much across the board, but interest rates are low, too. The spread between cap rates and Treasury yields—which is the return investors receive to compensate for holding real estate—have remained comfortably wide. This will help cushion commercial real estate prices from moderate increases in interest rates.

Finally, debt burdens did not appear excessive prior to the pandemic. There have been delinquencies and defaults among businesses that saw cash flows disappear during the shutdowns, but there have also been surprises at how resilient many property owners have been

to these stresses. A more cautious approach to debt underwriting after the financial crisis of 2008-2009 helped avoid repeating some of the mistakes of the past.



Decreases in leverage ratios and declines in interest rates have pushed REIT interest expenses to ... [+]

Nareit T-Tracker.

REITs provide a window into an important part of the commercial real estate universe. As publicly listed companies, REITs have a degree of transparency into financial conditions that is lacking among private real estate investors. REIT balance sheets are robust, having lowered their leverage over the past decade from a high of 58.2% debt-to-book asset ratio in 2008, according to the [Nareit T-Tracker](#), to less than 50% today (full disclosure: I am senior economist at Nareit and created and maintain the T-Tracker database). Together with low interest rates this has resulted in interest payments at a record low share of net operating income (NOI). REITs, and much of the rest of the commercial real estate sector, are well prepared for moderate increases in interest rates.