TOWNSEND GROUP

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Townsend Perspectives

Navigating the Real Estate Market Amid Changing Interest Rates

Executive Summary

As interest rates start their downward trajectory, many investors are wondering about the impact on property values and market dynamics. Will the rates go back down to the sub-1% levels or are they expected to remain higher? How will the interest rate levels impact the real estate values? Townsend's analysis indicates that the rates will come down but remain higher than what our economy experienced in the decade leading up to the covid crisis. While the higher interest rates can pressure real estate values downward, the expected future growth and the overall strength of the US economy suggest that values might be bottoming out. Additionally, the limited new supply due to high interest rates and scarce debt capital further supports property values by creating a demand-supply imbalance that drives up rents.

Introduction

The US commercial real estate market benefited from one of the longest periods of low interest rates starting from the end of the Great Financial Crisis (2008-2010) through 2021. The low-interest rate environment helped heal the financial damage following the GFC while increasing demand for risk assets, including property.

When the pandemic hit in 2020, economic growth came to a standstill worldwide. To lower the risk of a sharp recession, both the Trump and Biden administrations delivered unprecedented fiscal packages. The combination of expansionary government spending and emerging pandemic-induced global supply bottlenecks led to rising pricing pressures. At first, the sharp acceleration in inflation was viewed as "transitory" by the Fed. The persistence in inflation finally forced the Fed's hand. In March 2022, the Fed made its first interest-rate hike since 2018, raising rates from 0% to 0.25%. By July of 2023, the Fed made its final hike, having raised the Fed Funds Rate (FFR) to 5.25% to 5.50%. This was a pretty remarkable increase in interest rates in a span of less than two years.

The reversal in the path of interest rates altered the commercial real estate (CRE) landscape significantly. Higher financing costs brought transaction activity to a standstill. The uncertainty around interest rates and the impact to the domestic economy effectively halted CRE deals. It was harder to underwrite acquisitions and development projects. In the private markets, given the inherent appraisal lag, CRE cap rate movements did not track those of interest rates. This lack of visibility on pricing and cap rates increased risks facing property investors. Refinancing property debt, in particular, became challenging with the office sector most distressed.

Higher interest rates have stymied refinancing activity. But developers have also had a harder time financing new construction as lenders, regional banks in particular, pulled back on any leverage. Transaction activity has also been constrained by the limited availability of capital.

In the last FOMC meeting, the Fed Funds Rate was cut by an unusually large 50 basis points to 4.75% to 5.00%. This larger than normal cut was characterized by Chair Powell as a "recalibration" to support the labor market from any downward risks. This recent pivot to easing follows that of other developed markets, most notably that of the EU.

In this paper, we take more a detailed look at interest rates, their term structure and their influence on commercial real estate capitalization rates historically. We look at the current state of the property market, comparing public and private pricing. In order to assess the likely path of CRE cap rates, we provide an outlook for the US economy, which ultimately determines CRE fundamentals. Next, we provide a base case for short-term and long-term interest rates given the latest move by the Fed. We conclude with key implications for property investors going forward.

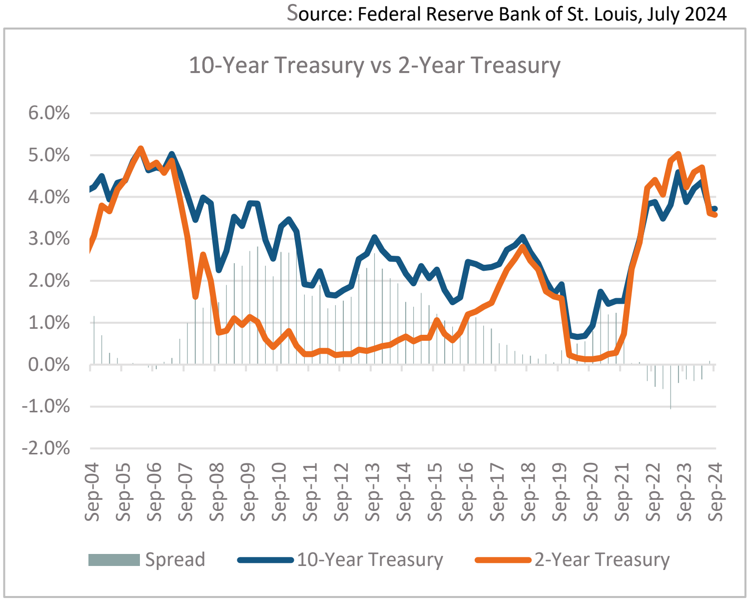
The Term Structure of Interest Rates

Property investors need to discern among the multitude of interest rates they face, since not all have the same significance to CRE decisions. Interest rates on government-issued bonds have different maturity schedules. This is the "term structure" which refers to the relationship between interest rates or bond yields at different maturities. When graphed, the term structure of interest rates is referred to as the yield curve. The yield curve has been an important indicator of the state of the economy. Essentially, the term structure reflects the expectations of market participants about future changes in interest rates and the strength of economic growth going forward.

Normally, yields increase in line with maturity. The longer you are willing to hold a government bond, the more you should be rewarded with a higher yield. This gives rise to an upward-sloping yield curve. One commonly used yield curve metric compares yields on 2-year and 10-year treasury debt. Up until a month ago, this spread was inverted, with short-term yields greater than long-term yields as illustrated in the accompanying graph. This implied that investors thought the economy would slow in the longer-run. Inverted yield curves have long been a harbinger of recessions. This time around, however, no US recession has materialized in part because of strong household balance sheets through 2023. US households were able to build savings during the pandemic years. More recently, a strong labor market is contributed to steady wage gains which is supporting consumption. The latest retail sales number came in far above consensus, underscoring the strength of the US consumer.

With the recent Fed interest rate cut and softer inflation readings, the yield curve has "un-inverted". The yield on the 10-year treasury is greater than the 2-year. The shape of the yield curve supports a "soft-landing" scenario for the US economy.

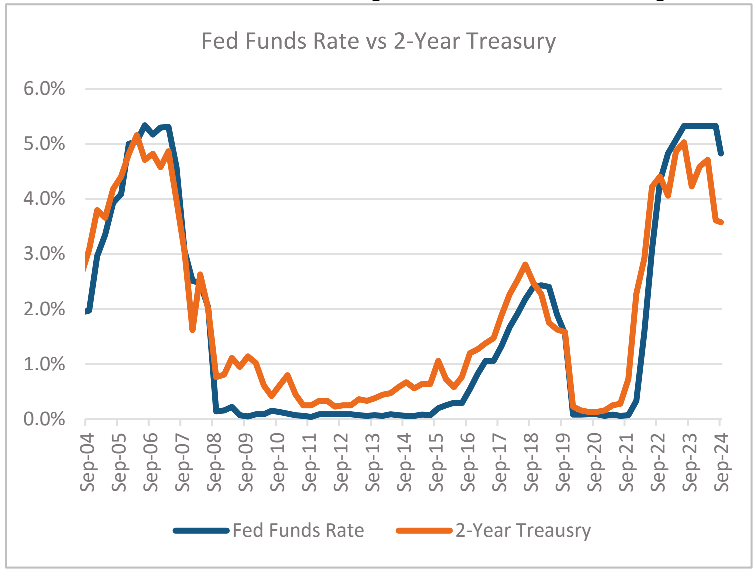
Source: Federal Reserve Bank of St. Louis, July 2024



Both short-term and long-term interest rates are important to property investors. Short-term rates are more aligned with the FFR and influence financing costs for CRE as well as refinancing and development projects in the near-term. Short-term yields also determine floating-rate debt that is used tactically by property investors in their near-term leverage strategies.

As illustrated in the accompanying graph, the 2-year yield moves pretty much in lock-step with movements in the FFR, the Fed's key monetary policy tool. The FFR reflects the rate banks charge on overnight loans to other banks. The Fed has direct control over the FFR and through it can impact market interest rates to a certain extent. The impact of the Fed's rate hikes and cuts are mostly felt at the short-end of the yield curve.

The drivers of the 10-year yield are more elusive and harder to forecast. Longer-term rates are more significant to CRE investors. The 10-year yield directly impacts financing costs for CRE acquisitions, including permanent financing, refinancing, and development projects. Long-term yields also impact the pricing of commercial real estate mortgages. Commercial real estate investors invest in long-duration fixed assets. The 10-year treasury yield better matches long-duration hold period returns. For many CRE investors, the 10-year yield has evolved into a common reference point as well.



Source: Federal Reserve Bank of St. Louis, July 2024

While the 2-year yield is more or less determined by movements in the FFR, the yield on the 10-year treasury has numerous drivers. This makes forecasting longer-term interest rates more challenging.

Drivers of longer-term interest rates include but are not limited to:

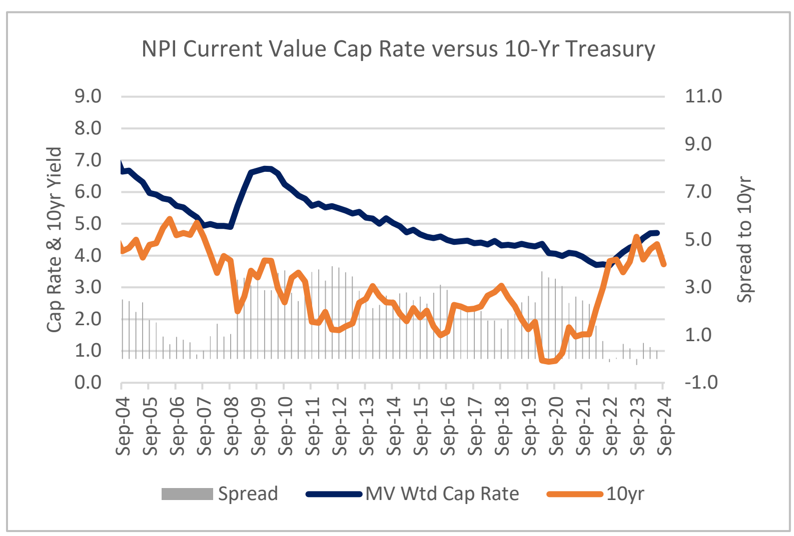
- Future inflation expectations
- Future growth expectations
- Future interest-rate expectations
- Uncertainty
- Demand for safe-haven assets
- Demographics

Interest Rates and Cap Rates

The characteristics of CRE assets make them highly leverageable. CRE assets are highly-capital intensive and big-ticket items. Core assets have the benefit of a secured stream of regular cash flows.

In the majority of CRE transactions, leverage is an integral part of strategy. As such, interest rates of different maturities are important variables in any commercial real estate transaction, whether acquisition financing, development, or construction loans.

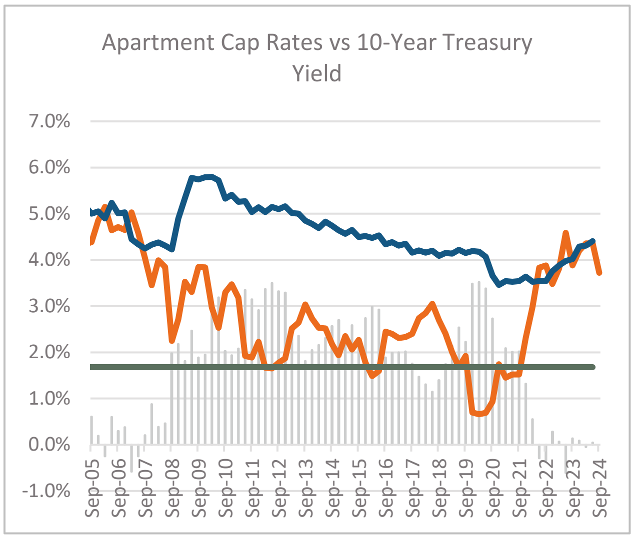
Higher interest rates have increased financing costs. The recent failures of a number of regional banks have also tightened lending standards. Regulators are monitoring the quality of loans closely. Refinancing property at such higher interest rates has become cost prohibitive, leading to some distressed sales, especially within the beleaguered office sector. Not surprisingly, property cap rates have

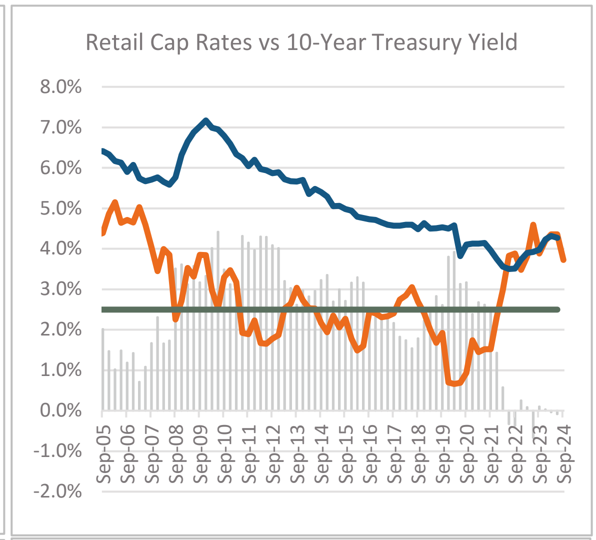


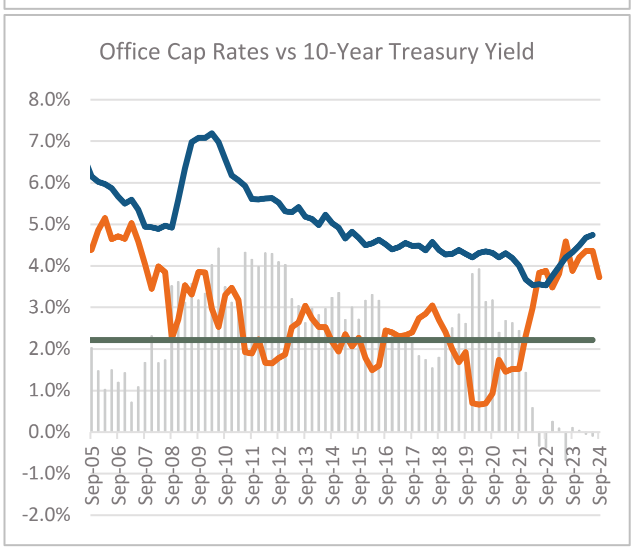
Source: NCREIF, June 2024, Federal Reserve Bank of St. Louis, July 2024 expanded. The accompanying chart illustrates the cap-rate to 10-year spread.

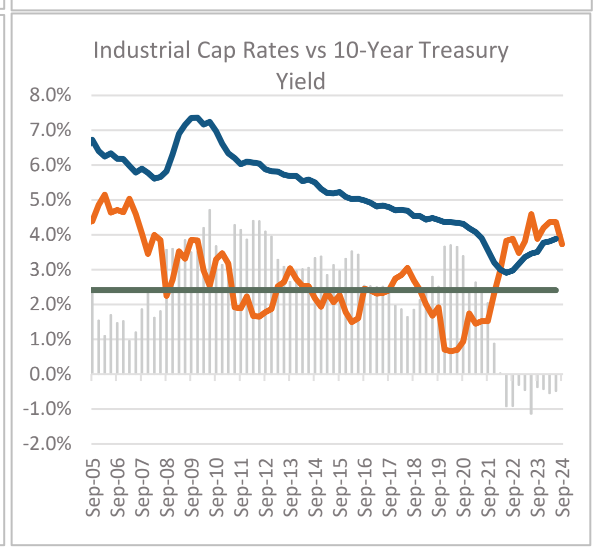
Private market cap rates as proxied by the NPI current value cap rate have expanded but not as much as would have been expected given the increase in interest rates. The cap rate to 10-year yield spread has averaged 213 basis points historically. This implies that cap rate expansion will continue should the spread revert back around its mean. The recent cut in the FFR has lowered both short-term and long-term interest rates. This should limit any further cap rate expansion.

Cap rate to 10-year yield spreads for the four main property sectors are presented below. Cap rates for each of the four main sectors: apartment, industrial, office and retail are graphed relative to the 10-year yield. Average historical spreads are also graphed as a horizontal line. Property cap rates have not increased in line with interest rate movements. In each case, the spreads have actually narrowed.









10-Year Yield
Cap Rate
Spread

Source: NCREIF, June 2024, Federal Reserve Bank of St. Louis, July 2024

These narrowed spreads do not necessarily mean that cap rates will rise to restore long-term averages. Historical relationships can also be restored through income growth (particularly for industrial properties) and through future declines in the 10-year treasury yield. While the relationship between cap rates and 10-year yields is a useful guidepost, the two do not move in lockstep.

With recent declines in interest rates and with forecast income growth for real estate, we see a path for spreads to return to a normal range – even if they remain below their long-term averages. This dynamic suggests diminishing downward pressure on values.

In the public real estate markets, yield expectations have also re-priced faster than the private markets. From Q1 2021 to Q1 2024, cap rate expansion across the four primary sectors has been much quicker for REITs than what is observed in private markets. This suggest that there are still gaps between private and public real estate valuations. Recent interest rate moves, however, should narrow this gap between the private and public sector.

Outside of the office sector, it is our view that cap rates have approached a peak (with values approaching a bottom). Any movement in cap rates going forward is determined by the outlook for interest rates and US economic fundamentals. In the next section, we focus on the business cycle and the outlook for the US economy. From that we provide a base case interest rate forecast.

THE OUTLOOK FOR THE US ECONOMY AND INTEREST RATES

Despite sharply higher interest rates and tightening financial conditions, the US economy continues to surprise on the upside. Second quarter GDP rose 3.0% supported by strong consumer spending and better-than-expected exports. Retail sales have been solid. Industrial production has recovered as well indicating strong economic momentum heading into the third quarter. Forecast highlights are presented below.

US Economic Growth Outlook

Real GDP (% over year ago)			Real GDP (% over previous period SAAR)					
2023	2024	2025	1Q24	2Q24	3Q24	4Q24	1Q25	2Q25
2.5	2.5	1.7	1.4	3.0	1.5	1.0	1.8	1.8

Source: JP Morgan, September 2024

The US labor market, though, is showing signs of stress. In August, job growth gains totaled 142,000, far below expectations. Job growth figures for the prior two months (June and July) were downwardly revised as well. But most significantly, the Bureau of Labor Statistics updated its 12-month forecast for job gains. It indicated an 818,000 downward revision to jobs gained for the past 12 months through March. This also signals weakening in the US labor market.

With fading fiscal support and tighter financial conditions, the US economy is expected to slow going forward. Our expectation is that growth is normalizing and we can still avert a recession. Household balance sheets are strong, supporting the soft-landing scenario.

There has been steady progress on inflation as well. Inflation came down from a high of 9% back in June of 2023 to levels more in line with the Fed’s target. August inflation as measured by the CPI came in at 2.9%. The Fed cut the FFR 50 bps in response to the weakening labor market and inflation rates coming in closer to its target range.

US Consumer Price Outlook

Consumer Prices (% over year ago)			
4Q23	2Q24	4Q24	2Q25
3.2	3.2	2.3	1.7

Source: JP Morgan, September, 2024

There is now more conviction surrounding interest rates cuts. FFR futures imply at least two 25 basis point cuts for the balance of the year. This would take down the FFR to 4.25%-4.5%. As of today, additional cuts are expected in 2025 with the FFR reaching 3.00% by year end 2025.

Fed Watch

Current FFR (% pa)	Forecast FFR (% pa)				
	Sept 2024	Dec 2024	March 2025	June 2025	Sep 2025
5.50	5.00	4.25	3.75	3.25	3.00

Source: JP Morgan, September 2024

The decline in the FFR will drive down short-term interest rates. This should benefit near-term CRE financing conditions. Longer-term rates have followed suit as well. With the softening in the labor market, 10-year yields have declined sharply in recent days. As of September 26, 2024, the 10-year yield was 3.792%, its lowest rate since December. In the near-term, 10-year yields are under pressure. As the economy slows, the 10-year yield is expected to fall further. But we do not expect the 10-year yield to go back to the very low rates observed after the GFC. There are numerous factors that will support higher for longer interest rates in this cycle. We have identified a number of key variables that will determine the path of longer-term yields in the table below. Explanations follow.

Structural Forces Driving Long Term Interest Rates

	Future Effect
Fiscal Deficits and Government Debt	Higher Rates
Climate Investment and Decarbonization	Higher Rates
Demographics	Higher Rates
Economic Growth	Lower Rates
Deglobalization	Higher Rates
Trump Presidency	Higher Rates
Harris Presidency	Higher Rates

Source: Townsend, September 2024

Fiscal Deficits: For a very long time, running fiscal deficits and carrying high debt burdens were fairly benign. That is because interest rates were very low, letting the public sector carry high levels of debt with virtually no cost. During the pandemic, governments globally and the US in particular, carried out large fiscal stimulatory policies that added to the public debt burden. In order for the public sector to carry this debt going forward, it needs to issue more bonds. In order to make these bonds more attractive, prices will have to come down. Bond prices and interest rates move in the opposite direction. Interest rates will rise. Going forward, any new debt issuance will be saddled with higher interest rates.

Climate Investment and Decarbonization: At the very basic level, such strategies impose a tax on fossil fuels. This increases the price of energy, acting similar to a negative oil supply shock. This raises inflation and drives up interest rates. Some observers have referred to decarbonization as "greenflation" with its impact on bonds very similar to that of inflation.

Demographics: Interest rates are the price that makes savings equal investments. When savings is greater than investments, interest rates fall. Weakening demographics in the West, the US included, lower the savings rate. Older people move from their savings stage to their spending stage of their lifecycle. This lowers savings to below investment, leading to higher interest rates.

Economic Growth: It is expected that US growth should slow over the next few years. This is due to a combination of tightening financial conditions, an expected slowdown in consumer spending, fading fiscal support, lower global trade and slower labor force growth. Slower economic growth leads to lower interest rates, all else equal.

Deglobalization: A decline in free trade should lower the cost advantage benefits of free trade. On-shoring trends and higher tariffs increase prices of imports, leading to overall increases in prices. Deglobalization acts like a price hike, leading to higher interest rates.

Trump Presidency: Trump supports a tax-cut heavy economic agenda which is highly stimulative for the US economy. The bond market is likely to struggle to absorb the supply of new debt a Trump Treasury would need to issue, partly to offset loss in revenue from such tax cuts. With a Trump presidency, the spreads between short-term and long-term treasury yields have to widen. Under this scenario, bond traders would expect lower interest rates in the near-term as the Fed adjusts to a cooling economy, but higher nominal growth and inflation in the long-run. Why? Trump plans to extend his 2017 tax cuts which expire in part in 2025. This is a $4.6 trillion loss in revenue over the next 10 years. Trump has also proposed a 10% increase in tariffs on all US imports and a 50% to 60% increase on Chinese imports. These policies are highly inflationary.

Harris Presidency: Harris has been defending Biden's economic policies which have increased the fiscal deficit and have added to inflationary pressures. For example, Harris has continued to defend Biden's policies including the Inflation Reduction Act's subsidies for EVs and green energy projects. She recently suggested financial support for first-time home-buyers and "price-controls" on grocery items to prevent price-gouging. The latter policy may actually lead to shortages and higher effective prices. She has also called for the construction of 3 million new starter homes with incentives to both developers and first-time homebuyers.

Implications for Commercial Real Estate

We expect the slowdown in the US economy, weakness in the labor market, and softening inflation to lead to further declines in interest rates. The whole yield curve will shift inwards and all rates with different maturities will decline. We also expect that short-term interest rates that are more closely aligned with the FFR will fall by a greater degree than longer-term interest rates. This will increasingly steepen the yield curve as short-term rates decline faster than long-term rates. Long-term yields will fall but are not expected to go back to the levels seen after the GFC. Longer-term yields will remain higher than what may be currently expected by the market given structural forces identified above. What are the implications for CRE investors?

- **Interest Rates:** The Fed is lowering interest rates as both inflation and the economy slow. With falling interest rates, further cap rate expansion should be limited. In the near term, our view is that both short-term and long-term interest will fall. CRE investors should take advantage of lower rates in the near-term for any refinancing needs. Over the longer-term, however, the 10-year yield is not expected to fall to the previous decade lows. There are endemic structural variables that will keep a floor under longer-term interest rates. Property return expectations should be brought in line with a higher interest rate environment over the long run.

- **Fundamentals:** Real estate deals should not only be dependent on positive leverage but underlying fundamentals. The supply and demand balance and geographic location should be key to any real estate acquisition decision. Property portfolios should be skewed to sectors that have lower vacancy and better growth prospects. Positive leverage should not be the dominant factor in decision making.

- **Phase of CRE Cycle:** The US CRE sector may be entering the final stages of the downturn as banks/other lenders seize control of distressed assets. There is now increased visibility on pricing. According to MSCI, during Q2 2024, the portfolio of foreclosed assets (office, apartment, and other) totaled $20.5 billion. This is 15% over Q1 2024 and the highest quarterly figure since 2015. Office, especially obsolete product, remains the most troubled sector, both due to higher financing costs and the entrenched "work-from-home" trend. 2024 may be a good vintage year to acquire deeply discounted CRE assets.

- **Strategy:** We expect there is still some distress in the office market, especially older product. The soft-landing scenario, however, will support fundamentals in the other core property sectors going forward.

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