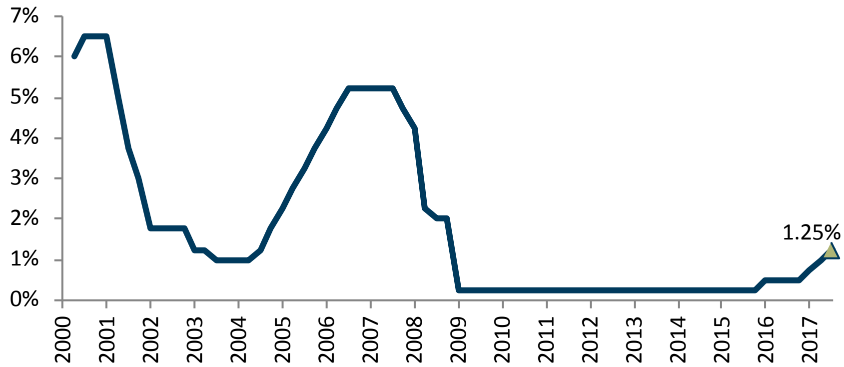
Prashant Tewari
Principal

Impact of Rising Interest Rate Environment on Real Estate Values

Overview

Given that the Fed has started to raise rates, property investors are concerned about the impact on cap rates and ultimately real estate values. Some believe that higher rates will lead to lower valuations, while others believe that an improving economy and rising inflation are beneficial to the asset class. A more thorough analysis of periods of rising interest rates, however, points to three factors that need to be considered to determine how real estate will perform.

Exhibit A: Fed Funds Target Rate (Upper Bound)

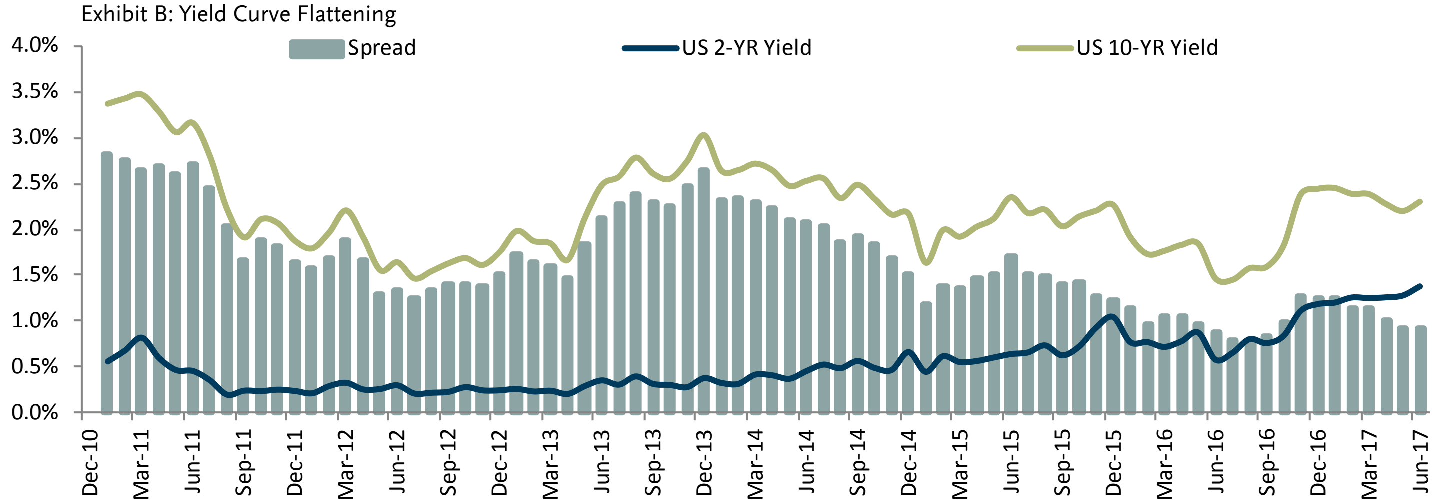


Source: Bloomberg

Long-term vs. Short-term Bond Yields

With a new Republican administration in office, inflation expectations upwardly adjusted post-election, on the premise of impending pro-growth fiscal policies and, as a result, higher GDP growth. As of July 2017, little has been accomplished politically in the way of actual legislation to spur growth; enthusiasm has waned, resulting in a flattening of the yield curve. Additionally, the structural challenges the U.S. and many developed nations face, including lower population and productivity growth rates, cannot simply be solved with legislation. In our view, the flattening of the yield curve (Exhibit B) is a direct result of the potential for short-term, pro-growth fiscal policy challenged by the current longer-term structural issues. Additionally, technological innovation and labor-replacing automation have lowered long-term inflation expectations; which has anchored longer-term nominal interest rates.

Exhibit B: Yield Curve Flattening



Source: Bloomberg

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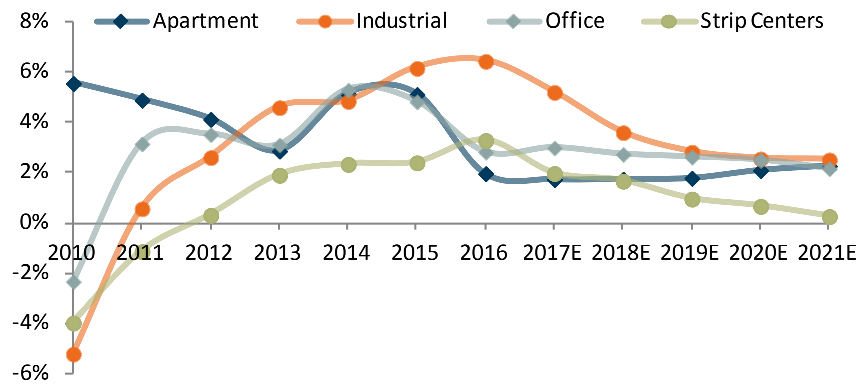
Rental Growth Upcycle

Constraints in the capital markets and the failure of many developers has muted new supply post-GFC and improved the fundamental health of the U.S. real estate market. Consequently, vacancy levels have declined and NOI has grown as the market has absorbed the supply overhang left over from the run up to the GFC. However, while we have recently voiced concerns over growing supply in key markets (e.g. Class A apartments in New York and San Francisco), and certain overplayed investment thematics, we recognize new construction in the broader national market has been subdued compared to historic levels. In the upside scenario and as a direct result of healthy real estate fundamentals—where inflationary pressures and GDP growth increase—it is expected NOI growth will drift off of improving economic fundamentals and, at the very least, will offset the impact of a rising discount rate in a higher interest rate environment. Key to a successful real estate strategy, however, is picking the markets where NOI is most likely to offset higher cap rates.

Exhibit C: NOI Growth by Sector

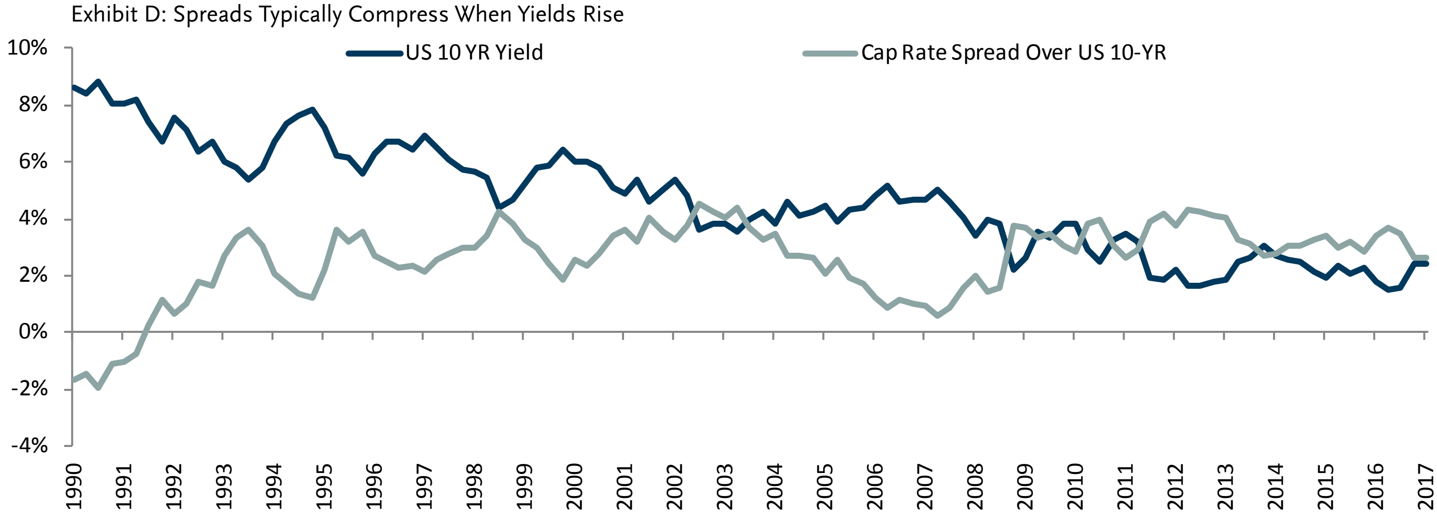


Source: Green Street

Spreads Compress When Rates Rise

Cap rate spread premiums to bond yields have typically compressed in the short-term when nominal yields have increased. Cap rates exhibit "stickiness" in the short-term, but over the long-term, cap rates tend to move in a similar direction to interest rates. This stickiness tends to smooth volatility in real estate pricing and lower short-term correlations between interest rates and bond yields. In addition, while short-term inflationary expectations may increase, structural changes in the economy would need to occur for long-term inflationary expectations to shift substantially upward (higher population growth, GDP-to-Debt ratio, and/or productivity growth).

Exhibit D: Spreads Typically Compress When Yields Rise



Source: Bloomberg, NCREIF

Conclusion

The notion that bond yields and cap rates are inseparably intertwined is an oversimplification, although they are positively correlated over the long-term. Real structural impediments to achieving the historic norm of 3% GDP growth exist and, going forward, will likely keep the long end of the yield curve subdued. In addition, the two most probable scenarios going forward consist of either 1) higher GDP growth and higher inflation, which will likely result in some cap rate expansion but be offset by NOI growth, or 2) lower GDP growth and sustained low rates, which will likely result in relatively stable real estate valuation cap rates. Both scenarios seem even more palatable when considering the broader investable universe, given lower yields in the bond market, which have no way of offsetting rising rates other than reinvestment of the coupon, and equities which are trading at historic P/E ratios. Real estate cap rates are fairly valued on a relative basis compared to nominal yields and fundamentals, including supply growth and financial leverage, are much healthier than during the run up to the GFC. In the upside scenario, we believe office and industrial assets will benefit from tailwinds such as record corporate earnings, e-commerce growth, and tightening labor markets; and should be well positioned to convert momentum in the economy to NOI growth. In the downside scenario, real estate values should remain relatively stable given sustained low rates, and owners should be well-positioned to benefit from the resilient cash flows core real estate has displayed in the past.