Where do U.S. property values go from here?

May 2022

This is the first in a two-part series that provides an in-depth perspective on how the shifting economic outlook and interest rate environment will impact the future trajectory of property values. In this first part, we review the historical relationship between the economy, inflation, interest rates and commercial real estate price movements. The second part will take the learnings from part one and analyze them through the lens of the current environment and then model property values over a five-year forecast horizon under different economic scenarios.

Introduction

The macroeconomic environment is becoming increasingly complex for real estate investors to navigate. On the one hand, the economic data still points to fundamental strength. In fact, there remains a myriad of positives: consumer spending remains resilient despite inflation, household balance sheets are in excellent shape, excess savings support continued spending for many households, there is tremendous job growth, job openings are elevated pointing to future job gains, wages are growing (albeit not outpacing inflation for many groups) and corporate profits remain robust. Probably most notable is that consumers are quitting their jobs at the highest rate since the inception of such data tracking, which started in the early 2000s. If there were fears about the economy's prospects or a cooling in the labor market, it's likely this metric would not be sitting at a record high. In terms of the property sector, the current snapshot in time indicates similar momentum: leasing fundamentals are strong in most sectors and improving in others, NOI growth is healthy and growing, sales volume hit a record high in Q1 2022 (for a first quarter), and dry-powder metrics targeting property remain at near-record levels.

On the other hand, there is no shortage of downside risks accumulating in 2022. The war in Ukraine, persistent labor shortages, supply chain issues, and COVID-19 outbreaks in China and its associated lockdowns are all dynamics which are amplifying inflationary pressures in the U.S. and abroad. Combined with changes in inflation readings particularly since the Delta wave, this has prompted the Federal Reserve's Federal Open Market Committee (FOMC) to tighten monetary policy more aggressively. At the May FOMC meeting, the Fed voted to raise the federal funds rate by 50 basis points (bps), and they signaled that more rate hikes are coming, including additional 50-bps hikes. The Fed also announced in May that it will move forward with quantitative tightening (i.e., it will begin to reduce its holdings of Treasury securities and mortgage-backed securities starting on June 1). Long-term interest rates have already moved sharply higher, with the 10-year Treasury yield currently hovering at 3% as of this writing—doubling what it was at the beginning of the year.

While there are strong arguments that we are entering, if not uncharted waters, then ones that we have not visited in some time, **it is important to ask what history tells us about the relationships between inflation, interest rates and property market performance.**

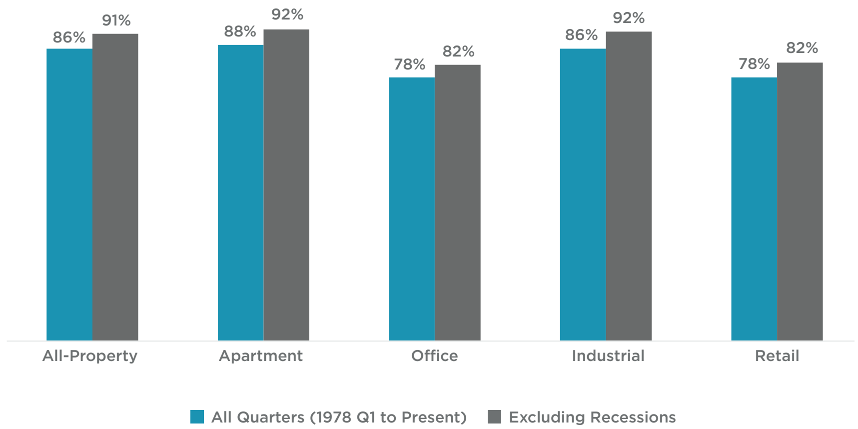
Relationship Between Inflation & Property

- **U.S. property returns have consistently outpaced inflation historically.** Indeed, in analyzing NCREIF property price data, we found that property returns have outpaced CPI inflation in 34 out of the last 41 years; the only time property returns did not outperform inflation was during recessions. On average, unlevered property returns exceed inflation by 5-6% per annum.

- **CRE is thought to provide an effective hedge against inflation risk.** Certain property types have relatively short leases that constantly rollover (e.g., multifamily, self-storage) so rents associated with those leases are better able to capture real-time changes in price pressure, such that NOI keeps pace and often grows faster than inflation. Other sectors (e.g., office, industrial and retail) contain longer leases (typically five to seven years) that are structured to include annual rent increases which help protect property owners from future inflation risk. If escalation clauses are explicitly linked to indices of inflation (versus a static step-up rate), then such leases represent the best form of protection.

- Because returns have often outpaced inflation and by a significant margin, **investors gravitate to property during periods of elevated inflation.** Indeed, in analyzing 20 years of historical data from Real Capital Analytics—granted, this was generally a low inflationary period—it shows that sales volume either remained resilient or *increased* during years where inflation accelerated. In 2021, the most recent example, CPI inflation increased by 4.7% in 2021 (7% YOY in Q4 2021), which played a role in driving more investment into property resulting in sales volume setting a record high the same year. Incidentally, activity was highest in multifamily (with short-term leases) and industrial (where investors are favoring shorter duration leases over longer in order to mark rents to market more frequently).

Share of Periods in Which Quarterly NCREIF Total Returns Exceeded Inflation



Source: NCREIF, Bureau of Labor Statistics, NBER, Cushman & Wakefield Research

Change in CRE Sales Volume under Different Inflation Regimes: 2000 to Present

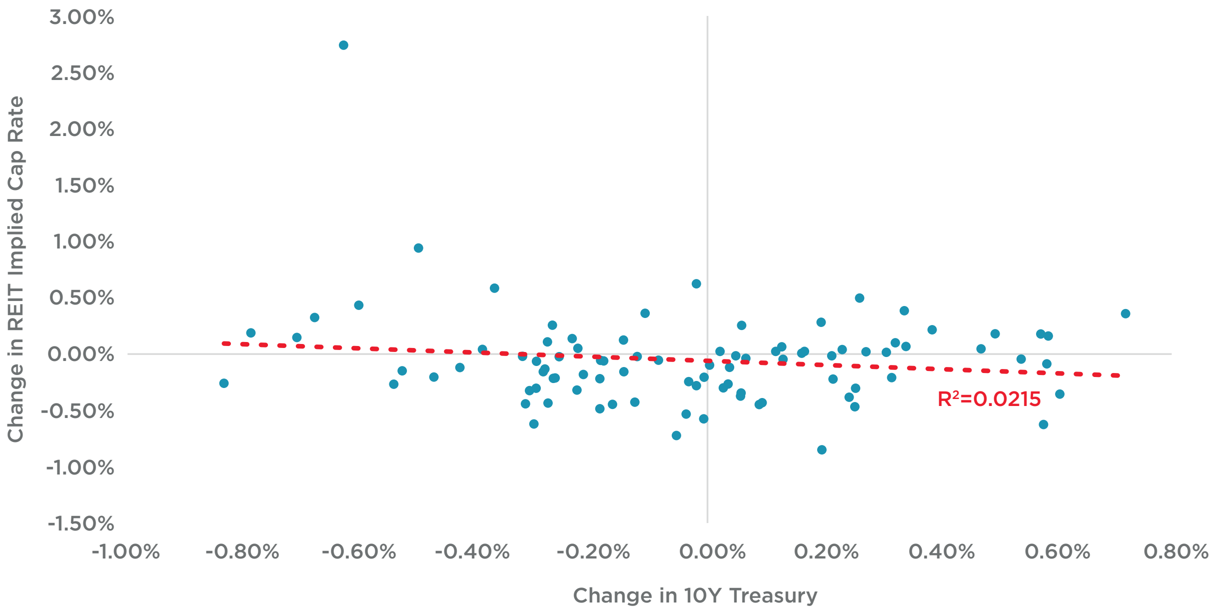
Source: NBER, RCA, Bureau of Economic Analysis, Cushman & Wakefield Research
Note: “Low inflation” means under 1.5%, “Sweet Spot” means 1.5% to 2.5% and High Inflation means over 2.5%.

Relationship Between Interest Rates & Property

- Changes in either the federal funds rate or the 10-year Treasury have had no consistent association with changes in cap rates. They are, in fact, uncorrelated at face value. In other words, **why Treasury rates move matters for what happens to cap rates, not the movement alone.**

- Interest rates and the cost of capital are a factor in determining the future trajectory of property values, but they are just one of many factors (such as GDP/NOI growth, weight of capital, policy risk, geographical risk). Moreover, we have found that if the economy is growing, cap rates have tended to decrease with the rate of cap rate compression proportional to how far cap rate spreads are above or below their long-term average. In other words, in general, as long **as the economy is growing, then yields have tended to be stable or more often falling** (implying that property values can and often do rise in a climbing interest rate environment). **There are reasons to believe that this historical pattern may not be applicable (or as applicable) today**. For one, earlier periods benefit from a long-term downward trend in interest rates whereas that trend now appears to have bottomed or even reversed. Second, rates often rise in concert with an improving growth environment and declining risk aversion. The opposite is true today. Part two will explore these implications in detail.

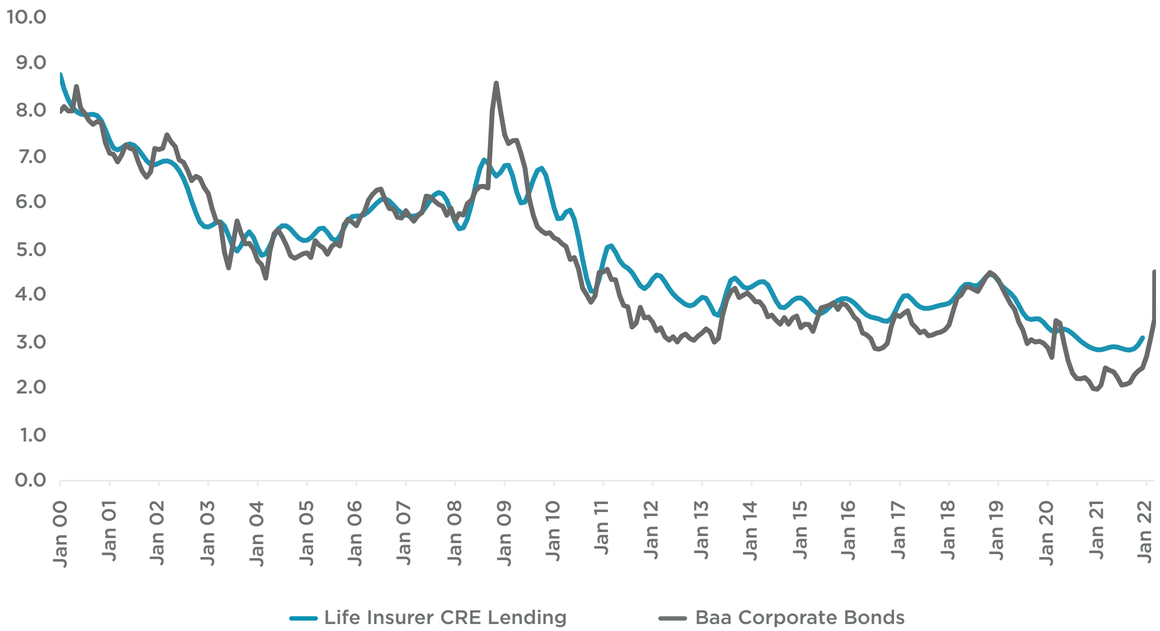
Change in Cap Rates vs. Change in 10-year Treasury: Q1 2000 to Q4 2021



Source: Green Street, Federal Reserve, Cushman & Wakefield Research

- **Upward forces on cap rates have increased markedly in the last few months.** The cost of low leverage, fixed-rate CRE debt has tracked Baa bonds closely historically (within 15 to 20 bps), and they are again today. Trepp's balance sheet lender survey indicates that low leverage fixed financing costs have risen from 3.2% at the beginning of the year to 4.7% today. Accordingly, **cap rate spreads have narrowed sharply or even turned negative, especially for the most sought-after assets, multifamily and industrial.**

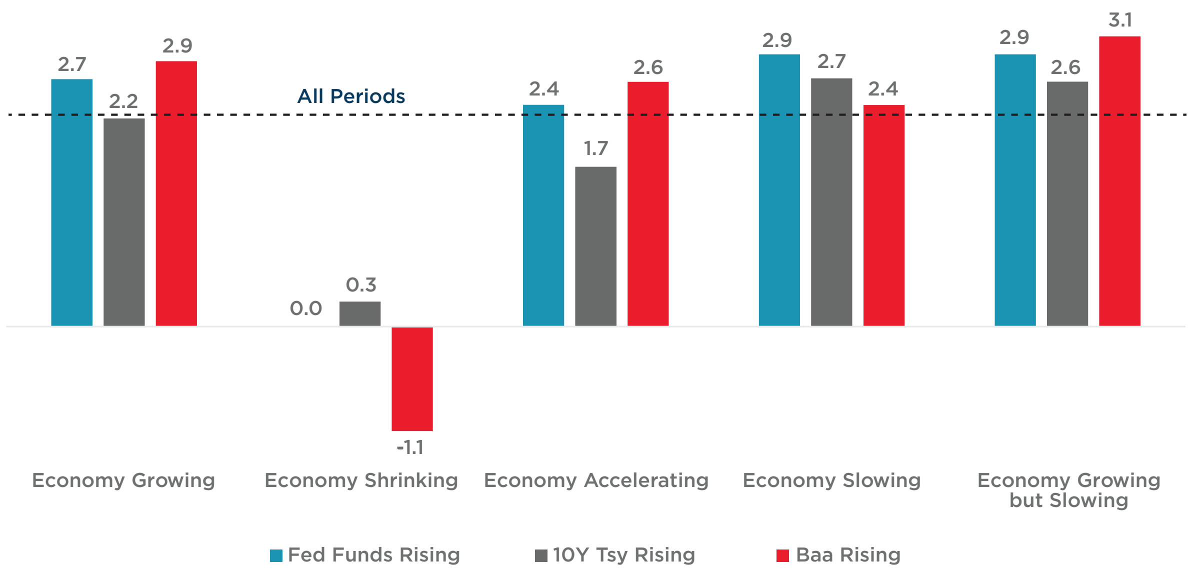
Baa Corporate Bond Yield vs. Commercial Mortgage Yield (%)



Source: ACLI, Moody's, Cushman & Wakefield Research

- Looking past cap rates to total returns, **CRE investments have tended to deliver above average total returns despite rising interest rates across a range of instruments and growth scenarios.** Surprisingly, average returns have been better in periods in which the economy was growing but slowing. To a degree, this resembles today's environment.

Average Quarterly NCREIF NPI Total Return Since Q1 1990



Source: Bureau of Economic Analysis, Federal Reserve, Moody's, NCREIF, Cushman & Wakefield Research

In summary, history suggests that **CRE markets have been largely resilient to higher inflation** and rising rate environments as long as the economy keeps growing. **That said, we are in unprecedented times.** CPI inflation is currently running at 8.2% YOY—a 40-year high. There are increasing signs that the recent move up in interest rates (143 bps year-to-date) in combination with heightened market uncertainty is placing upward pressure on cap rates. REIT implied cap rates have already increased materially. At the same time, many economic fundamentals remain strong and investors have accumulated enormous amounts of capital to deploy into CRE—that genie isn't going back in the lamp. Strong headwinds continue to collide with strong tailwinds, creating many different scenarios, some more likely than others. The one certainty is that these opposing forces have created choppier and murkier market conditions. **Investors need to aggressively challenge their assumptions when making buy and sell decisions in this market.** Usually, investors have done well to focus cash flow growth in periods of volatility, but even this path has become treacherous with the fastest growing sectors also the most exposed to rate risk. Which force wins out will vary from asset to asset as usual but will also be contingent on the path of macro environment over the next several years.

Stay tuned for part two of this series in which we will explore property values under different economic scenarios.

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