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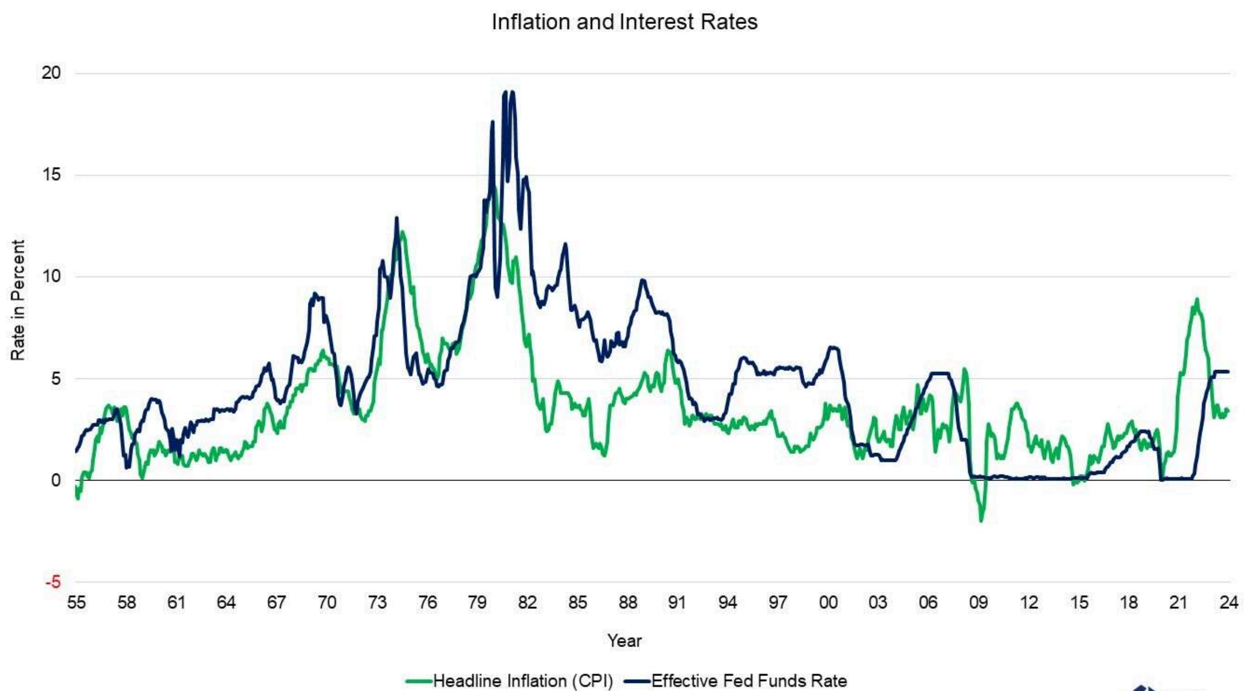
Inflation Delays the Much-Anticipated Bottom for Property Values

Elevated Treasury Yields Prove Dilutive to Asset Values, Driving Up Capitalization Rates



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Global bond yields, commodities and reflating home prices all point to a persistent, if not rising, headline inflation rate in the months ahead.

This shift to a 'higher-for-longer' inflationary period poses further challenges for commercial real estate owners looking to secure financing under increasingly adverse

conditions resulting from the persistent issue of sticky inflation, higher bond yields and their lagged effect on higher capitalization rates.

The inflationary periods in the late 1960s and 1970s posed similar challenges to investors, driven by a combination of external oil supply shocks, wage-price spirals, supply-side constraints and global trade disruptions. While a repeat of the economic conditions from those two decades is considered unlikely in the present context, those historical events continue to influence current policymakers who aim to prevent or stem a rapid increase in today's headline inflation rate.

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The dilemma faced by the Federal Reserve is fairly well understood: If it cuts interest rates too quickly, it risks reigniting the inflationary pressures it has painstakingly worked to control. Conversely, if the Fed delays rate cuts, that will postpone or prevent the economy from achieving a soft landing, and prolong financial difficulties for rate-sensitive sectors including commercial real estate.

Despite individual preferences that emphasize the superiority of various inflation measures, it's important to remember that headline inflation bottomed out at 3% in June 2023, triggering hopes that the Fed would be persuaded to lower rates. Since then, inflation has remained elevated for 10 consecutive months, hitting 3.4% in April 2024.

Rate Cut Expectations Pushed Further Out

Federal Reserve Chair Jerome Powell noted in a recent press conference that readings on inflation have come in above expectations. Powell said, "It is likely that gaining such greater confidence [that inflation is moving sustainably toward 2%] will take longer than previously expected."

Furthermore, Vice Chairman Philip Jefferson is currently guiding expectations around "It [being] appropriate that we maintain the policy rate in restrictive territory," as he

stated in a recent speech in Cleveland, until it has further evidence that inflation will return to its 2 percent target.

Over the past year, the prevailing market belief has been that interest rate cuts would lower the cost of short-term debt and increase loan-to-value ratios. As inflation fell, long-term interest rates would decrease, and commercial real estate owners would be able to obtain better financing options and recoup recent value losses.

What's more, commercial tenants would benefit from improved access to capital markets, obtaining favorable debt for business expansion, and leasing more space. This would also lift asset values by growing net operating incomes.

So far, this first domino, interest rate cuts, has yet to fall. Instead, the Federal Reserve has signaled that short-term interest rates may be higher for longer. According to the Federal Reserve's official guide on monetary policy, "The Federal Open Market Committee's (FOMC) primary means of adjusting the stance of monetary policy is by changing its target for the federal funds rate" (Federal Reserve Board, "Monetary Policy: What Are Its Goals? How Does It Work?").

The guide on monetary policy also notes that "Revisions to the expectations of households and businesses regarding the likely course of short-term interest rates can affect the level of longer-term interest rates. Fed communications about the likely course of short-term interest rates and the associated economic outlook, as well as changes in the FOMC's current target for the federal funds rate, can help guide those expectations."

Per the CME FedWatch Tool, the Fed Funds futures market indicates shifting rate cut expectations in tandem with such statements by Fed officials. As recently as February, the market was pricing in a 99% probability of a rate cut by this May. At the time of this writing, expectations have now shifted to an 72% probability by September.

Effect of Elevated Borrowing Costs

There's a long way to go between May and September and a lot can change during that time. Until then, we can consider the Federal Reserve's observations that by setting its policy rate and then guiding its narrative around the future path of short-term interest rates, long-term interest rates can be indirectly affected.

In a recent article titled "The role of cap rates in real estate," JPMorgan Chase noted, "Rising interest rates increase the cost of capital, so fluctuations in the interest rate environment can contribute to rising cap rates."

"Since cap rates are a measure of [yield] on an asset," notes Xander Snyder with First American Title, for potential buyers to obtain "higher 'risk-free' rates mean sellers will need to reduce their price expectations or increase cash flow, if that's an option, to entice buyers seeking competitive yields, which should also push up cap rates."

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Essentially as Snyder states, owners of commercial properties with fixed income in place, increasing cap rates will continue to diminish the value of that property.

Until vacancy begins to fall and income growth returns through tenant expansions and higher rents, elevated borrowing costs should continue to pin cap rates to an uncomfortably high level.