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RESEARCH NEWSLETTER

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Rising Rates and Commercial Real Estate: A Glass Half Full or Half Empty?

The brief period following the Presidential election has been the best of times for equities and the worst of times for fixed income. The Dow Jones Industrial Average has risen more than 12% above its pre-election level, at one point increasing from 18,260 the day before the election to more than 20,620 as of mid February.

Conversely, yields on 10-year U.S. Treasury rate increased more than 40%, at one point moving from 1.83% the day before the Presidential election to a high of 2.60% afterward.

	DAY BEFORE ELECTION	POST ELECTION HIGH	2/16/17
DJIA	18,260	20,101	20,620
10 YEAR TREASURIES	1.83%	2.60%	2.44%

Source: Federal Reserve Bank of St. Louis, Yahoo Finance

While these two benchmarks went in different directions subsequent to the election, both are being driven by market expectations of significantly rising rates and expectations of expansionary fiscal, regulatory, and trade policies. But is this scenario a certainty, and, if so, how should commercial real estate investors react?

Great Expectations, Great Uncertainty

As we wrote in our research piece, "Will 1600 Pennsylvania Avenue Return to Economic Relevance, or Is It Merely Rhetoric", a robust economic expansion is not a current certainty. There are many steps between here and the booming economy necessary to generate the earnings growth and rapidly rising rates that seem to be baked into current market pricing. First, we have little but speculation regarding the new administration's proposed fiscal initiatives. Second, while the President does have a majority in both chambers of Congress, he may not have many powerful allies within his own party -- he will have to contend with a staunch group of deficit hawks who are unnerved by the prospects of yawning deficits over the next ten years. It remains to be seen whether Congressional Republicans will wholeheartedly sign off on both a substantial increase in government spending and a reduction in taxes.

While fiscal policy remains an uncertainty, what is becoming increasingly certain is the President's willingness to aggressively engage the world, especially Mexico and China, in trade policy disputes. The potential impact of this stance should not be taken lightly, as it can have material implications for economic growth, trade, and inflation. Net exports reduced 4Q16 GDP by 170 basis points.

Absent this headwind, GDP would have grown 3.6% instead of the less than robust 1.9%. Given the Administration's desire for more restrictive policies the potential magnitude of trade's near-term negative impact on GDP should give equity markets pause. Reduced trade and falling imports would place upward pressure on inflation, and the economic implications of this are very different from inflation resulting from robust economic activity, employment, and wage growth. Rising costs of goods without commensurate increases in wages and employment impairs consumer

purchasing power and places downward pressure on personal consumption, the largest component of GDP. Thus, even if the President proposes and Congress approves an increase in federal spending and tax cuts, economic growth could be somewhat offset by a combination of reduced export activity and rising costs.

Fed Governors Face Interest Rate Governors

Even if the market's belief that the President will implement a expansionary fiscal policy while not following through on his aggressive trade rhetoric becomes reality, there are factors limiting future movements in interest rates.

- First, the dollar is already ascending on the mere prospects of an expanding economy, so much so that the President attempted to "tweet" it down while the Treasury Secretary nominee voiced concern that an excessively strong dollar could hurt economic growth. A rising dollar could lead to the Federal Reserve being more sensitive to the impact its interest rate policies may have on the dollar and exports.

- Second, global growth trends in Europe, Japan, and China are very different than in the U.S., resulting in different monetary policy outlooks. With one-third of the world's GDP already operating under negative rates, aggressive monetary policy by foreign central banks would only further strengthen the dollar.

- Third, U.S. government and corporate debt levels are high and rapidly rising rates would compound the economic drag of U.S. debt levels, while corporate profits would come under pressure from increased financing costs. Additionally, rapidly rising rates could create refinancing issues for corporations.

- Fourth, rapidly rising rates could create financial instability in emerging markets through negative impacts on capital flows.

- Fifth, the already depreciating Chinese yuan would face additional downward pressure, forcing it to liquidate more Treasuries, and in turn, reducing demand for Treasuries and placing upward pressure on rates.

- Last, if protectionist trade policies are implemented, it would exacerbate the negative effects of a rising dollar on exports limiting Fed action further.

Absent a spike in inflation, these factors collectively will likely result in a manageable increase in rates. This contrasts with the exponential rise in rates that some feared based on the initial increase in rates after the Presidential election. This is not to say that Treasury rates couldn't increase in the event of passage of a highly expansionary fiscal policy, but there will be limits to the subsequent path of rates. This conclusion is based on the assumption that inflation will continue to increase at a manageable pace. If inflation spikes in response to highly expansionary fiscal policy, the Fed would be compelled to react quickly, at which point the major macroeconomic concern wouldn't be rising rates, but rather the possibility of a Fed induced recession. In that scenario, equities would go from today's darlings to tomorrow's discarded.

Commercial Real Estate: Fish or Foul?

So how should investors view the prospects for commercial real estate in the current environment? While retail investors are borderline giddy regarding the prospects for equities and downright dour regarding the prospects for fixed income, opinions on commercial real estate are only cautiously optimistic and mixed, with some fearing a bond-like reaction to changes in short-term rates. We think it is a mistake to lump commercial real estate into the same bucket as fixed income.

Commercial real estate is a hybrid offering characteristics found in both equities and fixed income. Like fixed income, it provides a higher current income than equities.

However, commercial real estate income is dynamic and generally growing over time. This is an important distinction that alone should separate the outlook for real estate from the market's dour prospects for fixed income. How significant is the difference? In periods of rising interest rates from 2002 through 2016, while fixed income levels were just that, fixed, real estate income grew 3.7% annually on average, providing a significant tailwind to both income returns and valuations. Why is this? An expanding economy results in increased demand for office space, warehouses, shopping center locations, and housing. In the property sectors and markets where manageable construction activity is occurring, landlords have the ability to adjust rents upward, having a positive effect on income.

Real estate values can also benefit from an expanding economy. As real estate income levels increase, this exerts upward pressure on real estate values, reflecting real estate's equity-like component, where valuations benefit from expanding economic growth similar to stocks reacting to expanding earnings.

Commercial Real Estate Performance During Periods of Rising Rates

What does history tell us? Employment growth during periods of rising rates on average was more than two-and-a half times the rate seen during periods when rates were not rising. Growth in GDP, especially its business investment component, was significantly greater during periods of rising rates. Growth in business investment during periods of rising rates was more than twice that of growth during periods when rates were stable or falling. As the economy grows, higher employment requires additional workspace, provided by office buildings, higher consumption drives demand for retail, and higher levels of business investment result in an increasing need for warehouse space to store the goods being produced and consumed.

Q3 1993- Q3 2016	RISING	NON-RISING	RISING VS. NON
Average Quarterly Job Growth (ths.)	720	270	2.6
Quarterly GPD Growth (%)	3.0	2.4	1.3
Quarterly Consumption Growth (%)	3.4	2.7	1.3
Quarterly Business Investment Growth (%)	6.8	3.3	2.1

Source: Bureau of Labor Statistics, Bureau of Economic Analysis

Not surprisingly, robust employment growth and business investment during periods of rising rates results in greater real estate income growth during periods of rising rates than periods of non-increasing rates. As shown in the table below, net operating income growth during periods of rising rates was more than three-and-a-half times greater than during period when rates were not increasing. Investors seem to be underestimating the positive effects an expanding economy has on demand for real estate space and the resulting real estate income growth.

Q2 2002- Q3 2016	RISING RATES	NON-INCREASING
ODCE YOY NOI Growth	3.7%	1.1%

Source: NCREIF

That's the income side of the return equation. Regarding the appreciation component of real estate return, data related to average quarterly appreciation during different interest rate regimes in the table below show that appreciation rates during periods of increasing interest rates outpaced value increases during periods of non-rising rates.

Q2 2002-Q3 2016	RISING RATES	NON-INCREASING
Average Quarterly Appreciation Returns	2.1%	0.4%

Source: NCREIF

This may appear counterintuitive, but considering the significantly higher NOI growth during periods of rising rates, higher appreciation during periods of rising rates becomes reasonable.

Where does this leave total returns during period of rising rates versus periods of non-rising rates? Given superior NOI growth and appreciation returns, it should not be surprising that average returns during periods of rising rates were greater than returns during periods of non-rising rates.

Q2 2002-Q3 2016	RISING RATES	NON-INCREASING
Average Quarterly Total Returns	3.4%	1.8%

Source: NCREIF

Glass Half Full or Half Empty?

Some investors mistakenly lump the prospects for commercial real estate during a rising rate environment in with expectations for fixed income investments, ignoring the fact that real estate income is dynamic and has historically grown more on average during periods of rising rates than during times of flat or declining rates. Still others believe only equities will benefit in an expansionary economic environment underestimating the capacity for commercial real estate to capitalize on economic growth and the resulting increase in demand for office space, warehouses and shopping center locations. While some may take the view that rising rates would only portend negative consequences for commercial real estate, we believe the outlook for commercial real estate in a moderately rising rate environment is more akin to a glass half full than half empty.

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