Marcus & Millichap

Special Report

10-Year Treasury Rate

April 2018

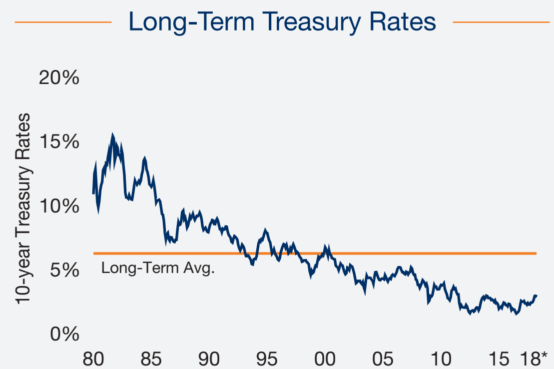
10-Year Treasury Breaks 3 Percent; Higher Rates a Positive Sign for Commercial Real Estate?

Rising interest rates spark fear from investors but reflect persistently strong economic growth that underpins commercial real estate performance. The 10-year Treasury rate inched past 3 percent for the first time since late 2013 following the "taper tantrum." Though many investors fear the rising rates will erode their investment yields, they must consider the strength and durability of the current economic cycle and how it will continue to support commercial real estate performance. First-quarter job creation outpaced the growth rate of the past three years, while unemployment has been restrained to exceptionally low levels. Additionally, over 6 million jobs remain available, highlighting the tight labor market and the skills gap facing employers. Healthy economic momentum has driven both consumer and business confidence to extraordinarily high levels, with consumer optimism nearing an 18-year high in April. Rising confidence trends reinforce indications that consumption and business spending will rise this year, boding well for housing and all types of commercial real estate space.

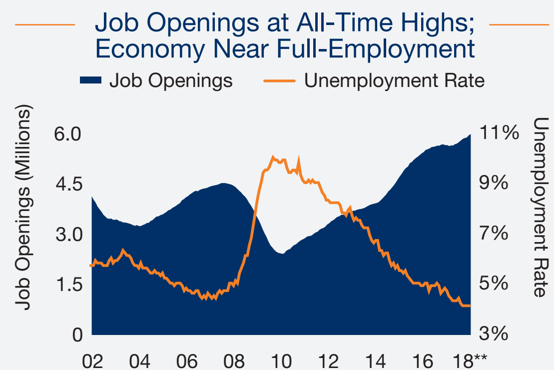
Sub-3 percent 10-year Treasury rates were an anomaly; Fed carefully considers rate increases. From a long-term perspective, the 10-year Treasury has averaged 6.2 percent, and until the post-recession era, it had never been below 3 percent for a prolonged period. In the midst of the Great Recession, the Fed put strong downward pressure on interest rates to spark economic growth, lowering the Fed funds rate to near zero and launching a series of quantitative easing efforts. Rates have remained low since then, but the accelerating economy has prompted the Federal Reserve to hedge against the potential of economic overheat by raising the Fed funds rate and reducing their balance sheet. It is likely the Fed will maintain a cautious approach so it does not inadvertently cause the economy to stall, but it has indicated that it may raise rates three or four times in 2018. Even with the increases, interest rates remain very low by historical standards and should not be a major barrier for real estate investors.

A rapid interest rate increase could create turbulence for commercial real estate transactions. Rising interest rates will lift the cost of capital for borrowers, modestly eroding margins and forcing buyers to re-underwrite acquisitions. Though competition among lenders may prompt some to narrow their spreads, absorbing a portion of the cost increases, a very rapid rise in rates could create a short-term stall in transactions. This reflects a widening expectation gap between buyers and sellers as buyers reevaluate their margins and sellers continue to seek premium pricing. Eighteen months ago, when interest rates escalated 85 basis points in a month, numerous transactions faced renegotiation, delaying closings.

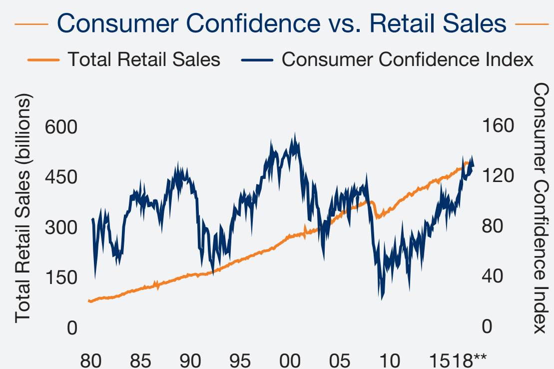
Long-Term Treasury Rates



Job Openings at All-Time Highs; Economy Near Full-Employment



Consumer Confidence vs. Retail Sales



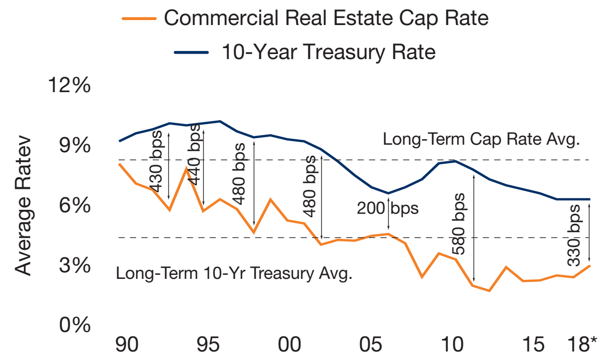
* Through April 27
** Through March

Sources: Marcus & Millichap Research Services; U.S Census

Real Estate Yields Comparatively Strong

Recent financial market volatility reiterates the benefits of steady commercial real estate performance and the compelling yields offered by the sector. Compounding the benefit, tax reform has introduced favorable treatments for commercial real estate investment. Although many investors believe that cap rates rise in tandem with interest rates, this has not historically been the case. The flow of capital to the sector, comparative yields from other investment options and the longer-term outlook for properties can also affect the trend. Although interest rates have more than doubled since the summer of 2016, average cap rates have generally held steady. Considering the prospects for economic growth in 2018, upward pressure on cap rates for well-performing assets in metros with favorable employment and demographic trends will likely be limited. Still, buyers remain sensitive to yields and the return profile of their acquisitions, so properties with highly aggressive pricing could quickly be bypassed by prospective investors.

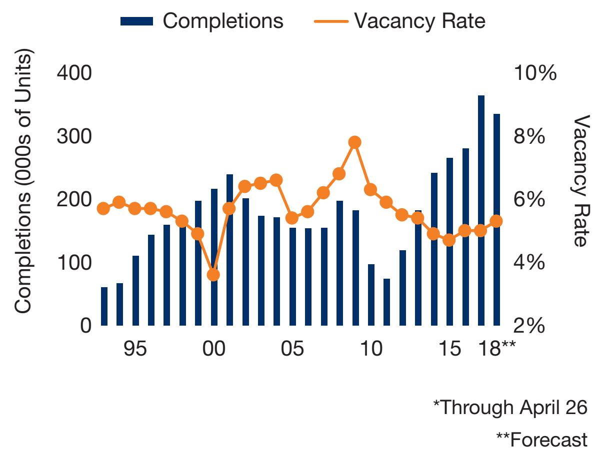
Cap Rates vs. 10-Year Treasury



Strong Economy Benefits Apartments

The accelerating economy could boost household formation, particularly as more young adults begin to move out on their own. Since the Great Recession, young adults have increasingly stayed at home with their parents rather than moving out into independent households. That trend recently shifted as the tight employment market has created a wide range of job opportunities, causing the number of 18-to-34-year-olds living with their parents to decline. The majority of these households will choose to rent apartments, supporting absorption in the already tight market. Nationwide, vacancy rates have maintained an equilibrium in the 5 percent range even though construction has been at record levels, with 365,000 new units added last year. Class C apartments in particular have been in demand, with vacancy rates near 4.5 percent. Demand for apartments will be further sustained by rising mortgage rates, which will increase monthly payments on purchased homes, and the new tax rules that reduce economic incentives that previously benefited homeowners.

National Apartment Vacancy vs. Construction



*Through April 26

**Forecast

Yields by Property Type*

	Tier 1	Tier 2	Tier 3	National Avg.
Alternative Yields	**2.8% (10-year Treasury)**	**3.8% (AA Corporate Bonds)**	**4.6% (Baa Corporate Bonds)**	
Apartments	4.1%	5.4%	7.0%	5.2%
Retail-ST	5.0%	6.0%	6.9%	6.0%
Self-Storage	5.8%	6.6%	7.7%	6.6%
Manufactured Housing	6.3%	7.0%	8.1%	7.0%
Seniors Housing	6.1%	7.0%	8.0%	7.0%
Office	5.8%	7.0%	7.8%	7.0%
Industrial	6.0%	7.1%	8.6%	7.0%
Retail-MT	5.6%	7.2%	8.0%	7.1%
Hospitality	6.7%	8.6%	9.3%	8.8%

* As of April 6, 2018

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Price: $500

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Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Federal Reserve; Moody's Analytics; Real Capital Analytics; RealPage, Inc.; U.S. Bureau of Labor Statistics; U.S. Census; The Conference Board