Marcus & Millichap Capital Corporation

Special Report

Fourth Quarter 2018

Federal Reserve

Fed Raises Rates, Tapping Brakes on Robust Economy; International Capital Keeps Downward Pressure on 10-Year

Federal Reserve raises overnight interest rate, signals another hike in December. Following the conclusion of its September meeting, the Federal Reserve raised the federal funds rate by 25 basis points to 2 percent. Citing persistent levels of inflation, burgeoning acceleration in wages and exceptionally low unemployment, the Fed also outlined plans for an additional rate increase in December. Rising wage pressure, underpinned by a domestic labor market with more positions available than unemployed workers, as well as looser fiscal policy have underpinned more robust economic growth in recent months. Combined with the recent tariffs placed on numerous Chinese imports, which should filter into corporate and consumer prices over the next several weeks, sustained upward momentum on inflationary pressure seems likely. As a result, the Fed is likely to take a more determined approach toward tighter monetary policy than it has shown in the past.

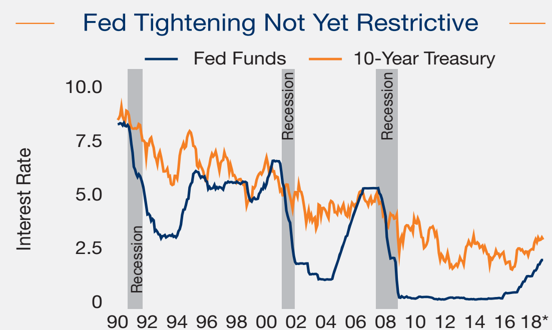
Economic data upbeat, furthering Fed argument for future policy action. A string of robust economic reports are underpinning optimism for future growth. Average hourly earnings increased 2.9 percent in August, the fastest rate of improvement since June 2009. Rapid growth in wages has quickly translated into more vigorous consumer spending, with core retail sales vaulting 5.9 percent higher over the past year ending in August. The upbeat numbers have spread beyond the consumer space, with small-business optimism reaching the highest level since 1983, bolstering the Federal Reserve's assessment that additional rate hikes through the remainder of 2018 and into early next year remain warranted. Shorter-term interest rates, such as the two-year Treasury, largely mirror the Fed's assessment of domestic economic strength, surpassing 2.8 percent in recent days.

Yield curve flattening as 10-year Treasury remains range bound; rising risk of inversion. While shorter-term interest rates have risen in lockstep with Fed policy, longer-term yields have trended upward in a more measured manner. Loose monetary policy and low interest rates in Europe and Japan have encouraged international investors to purchase U.S. Treasurys in order to capture a yield premium of more than 200 basis points. This activity has slowed the upward trend in long-term U.S. interest rates. These capital flows have the potential to invert the yield curve, where short-term rates rise above long-term rates. Yield curve inversions have preceded every recession for the past 50 years, and an inversion now could weaken consumer and business confidence sufficiently to slow consumption and investment. However, regulatory changes and the aftereffects of quantitative easing have prompted many economists to question the continued validity of yield curve inversions as a signal of an impending recession.

Executive Summary

- **Fed increases rates at September meeting:** The Fed concluded its two-day September meeting by lifting overnight rates to the 2.0 to 2.25 percent range. Commentary from Chairman Powell raises the likelihood of an additional increase in December, along with more hikes in 2019.
- **Domestic economy supports tighter Fed policy:** A string of exceptional economic readings over the past month, including 4.2 percent GDP growth in the second quarter, underscore the robust economy. Barring an unexpected setback, the Fed will likely continue on its stated plans for rate increases.
- **European quantitative easing may hamper the Fed's plans:** Despite a robust domestic economy, long-term rates have remained mostly range bound near 3 percent as international central banks have kept their interest rates low. Future rate increases from the Fed could invert the yield curve, dampening confidence and consumer spending.
- **Shrinking yield spread and tighter underwriting complicate lending:** While rising interest rates have reduced the gap between borrowing costs and cap rates, buyers remain active — for now. Abundant financing is available, but lenders are becoming more conservative, requiring investors to undertake more specialized financing solutions in order to meet their return objectives.

Fed Tightening Not Yet Restrictive



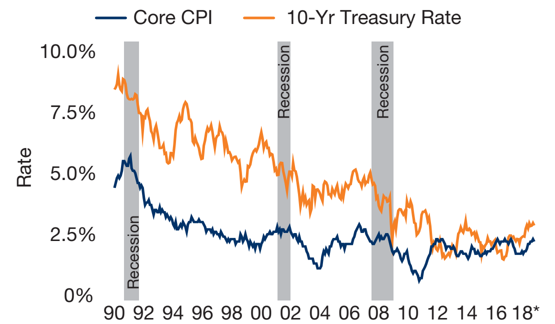
* Through September 26
Sources: Marcus & Millichap Research Services; Federal Reserve

Rising Lending Costs Compressing Yield Spread; Investors Actively Deploying Capital

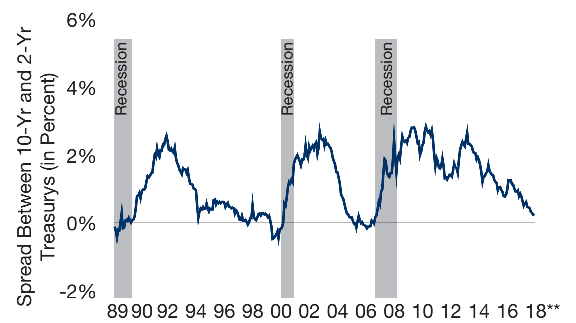
The compression of the spread between long-term interest rates and cap rates for commercial real estate has been an ongoing process since interest rates bottomed in 2016. As a result, the overall cost of capital has been on an upward trajectory, even as capital sources and available lenders remain abundant. Spread compression, however, has caused lenders to become more conservative in their underwriting process, pulling back on their willingness to lend based on pro forma rents. This has required investors to execute on their strategies prior to acquiring long-term financing at their desired leverage ratios, typically through the use of mezzanine financing to upgrade assets and prove their viability at increased valuations. In some instances, buyers have reduced their use of leverage to keep internal rates of return attractive, often using more intricate solutions such as bridge financing.

- **Positive capital flow remains; limited signs of overdevelopment.** Although cap rates have compressed considerably over the course of the past decade, buyers remain highly acquisitive. Additionally, development has lagged past cycles considerably, reducing the impact of new supply on existing assets for the vast majority of markets and property types.
- **Yield spread could tighten further.** Historically, there has been little correlation between cap rates and Treasurys, as each is influenced by unique capital flows. However, increases in borrowing costs will tighten the yield spread, potentially reducing buyer willingness to meet asking prices, even as positive operating dynamics remain in place. This could widen an expectation gap, especially if rates increase significantly in a short period of time.
- **Potential rapid interest rate rise poses downside risk.** While capital sources remain plentiful, a quick upward surge in interest rates has the potential to reduce market liquidity as lenders adjust to higher funding costs. Considering that interest rates have moved rapidly higher in both late 2016 and early 2018, borrowers will likely benefit by taking a cautious approach and locking in advantageous financing quickly.

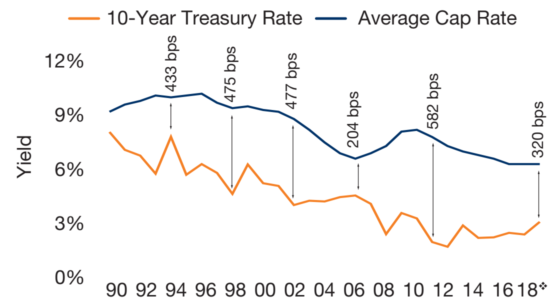
Rising Inflation Underpins Rate Increase



Lending Spreads Approach Inversion



CRE Yields Supportive of Acquisitions



Note: Sales $1M and above

* Through August
** Through September 26
❖ Through 2Q18

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Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Federal Reserve; Moody's Analytics; Real Capital Analytics; Standard & Poor's; U.S. Bureau of Labor Statistics.