

## Fed Rate Hikes Typically Compress Cap Rate Spreads. Should Investors Be Worried?

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The first of several expected increases in interest rates announced Wednesday by the Federal Reserve is an important step in controlling inflation, which has persisted well above the central bank's target of 2%, leading the consumer price index to hit its highest reading in 40 years.

For commercial real estate investors, though, those rising rates can become a point of serious concern if they coincide with a narrowing of spreads between interest rates and capitalization rates.

Cap rate spreads represent the opportunity cost of investing in commercial real estate. As spreads narrow, investors tend to be compensated less relative to what may be considered safer assets such as treasury bonds.

Indeed, there can be a negative relationship between increases in the so-called Fed funds rate and cap rate movement. For every 100 basis point increase in the Fed funds rate in a year, there is roughly a 12 basis point decline in cap rates on average.



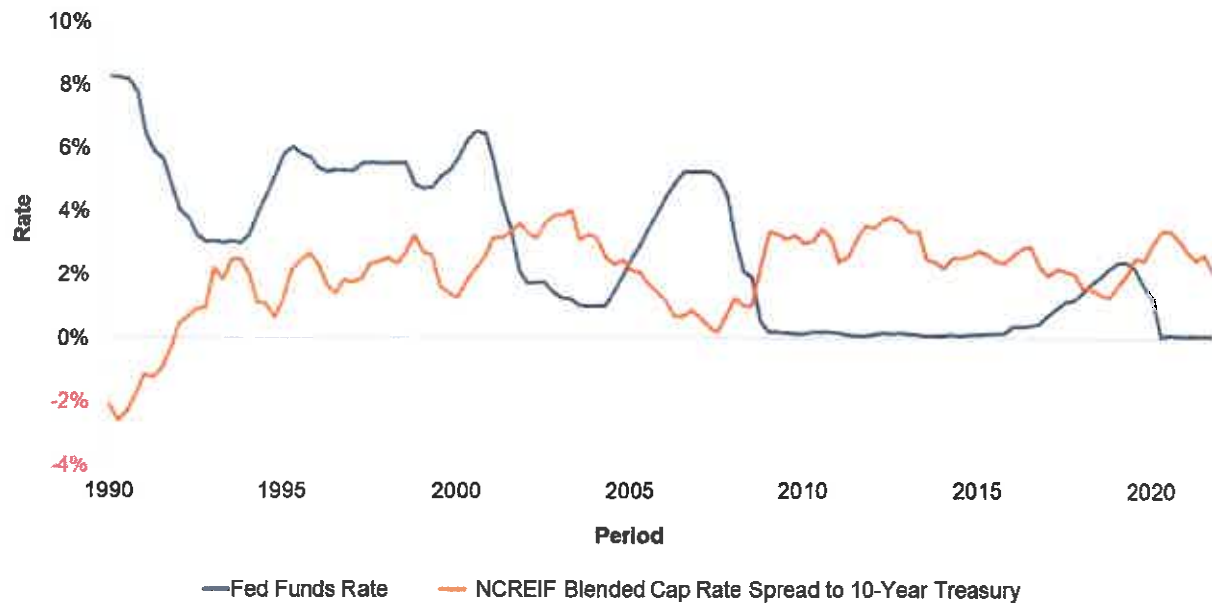
### Powell Pulls the Trigger as Fed Pivots From Accommodative Policy to Tightening

However, this does not necessarily suggest higher short-term interest rates are the sole reason cap rates might compress. The Fed typically raises rates during periods of strong economic growth, which is also when real estate fundamentals in the form of demand and value growth are strong. As a result, spread compression from declining cap rates in a healthy economic environment is typically considered "good compression" because it is largely driven by increasing values.

Yields on 10-year Treasuries represent the other half of the spread, and unlike cap rates, they will typically increase when the Fed raises rates. However, any increase in the 10-year Treasury yield because of a Fed funds rate increase is not a one-to-one relationship. Inflation expectations, U.S. fiscal policy, projected economic performance and expected Fed policy also can cause the 10-year Treasury yield to shift in other ways.

A simple correlation shows the weak relationship between the Fed funds rate and 10-year Treasury movement. For commercial real estate owners, compression in the spreads as a result of an increase in the 10-Year rate is considered "bad compression," where values don't need to rise for asset yields to look less attractive compared to more liquid, income-producing assets like bonds.

## Spreads Typically Decline When Fed Raises Rates



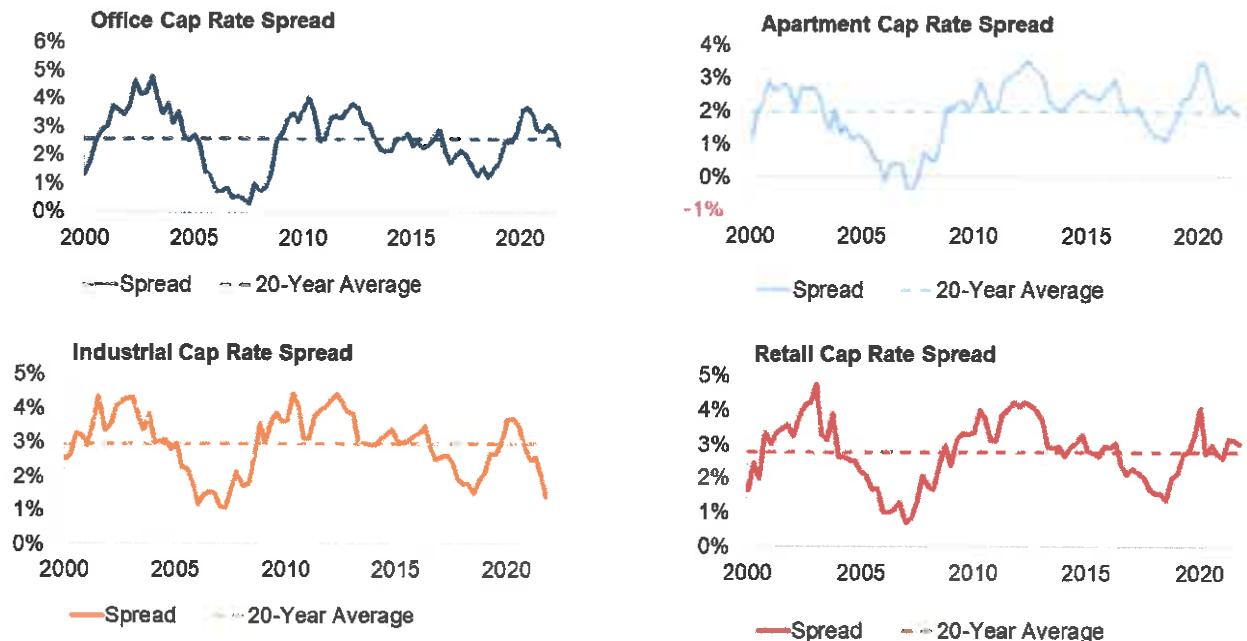
Sources: NCREIF, Federal Reserve Bank of St. Louis, CoStar Advisory Services; Fourth Quarter 2021



The trend suggests that on average for every 100 basis point increase in the Fed funds rate in a given year, there is a roughly 40 basis point decrease in the spread over the same time. Since 1990, in the 17 quarters when the Fed funds rate increased by 100 basis points over the previous year, the cap rate spread increased only four times.

The implication from the simple relationship is that, in a year when the Fed is expected to raise interest rates as much as 200 basis points, cap rate spreads are going to compress. Among property types, outside of industrial where values have been sharply bid up by investors, there is room for compression with cap rate spreads near their 20-year average.

## Excluding Industrial, Cap Rate Spreads Are Fairly Average



Sources: NCREIF, CoStar Advisory Services; Fourth Quarter 2021  
Note: Cap rate spreads use 10-year Treasury bond yields.

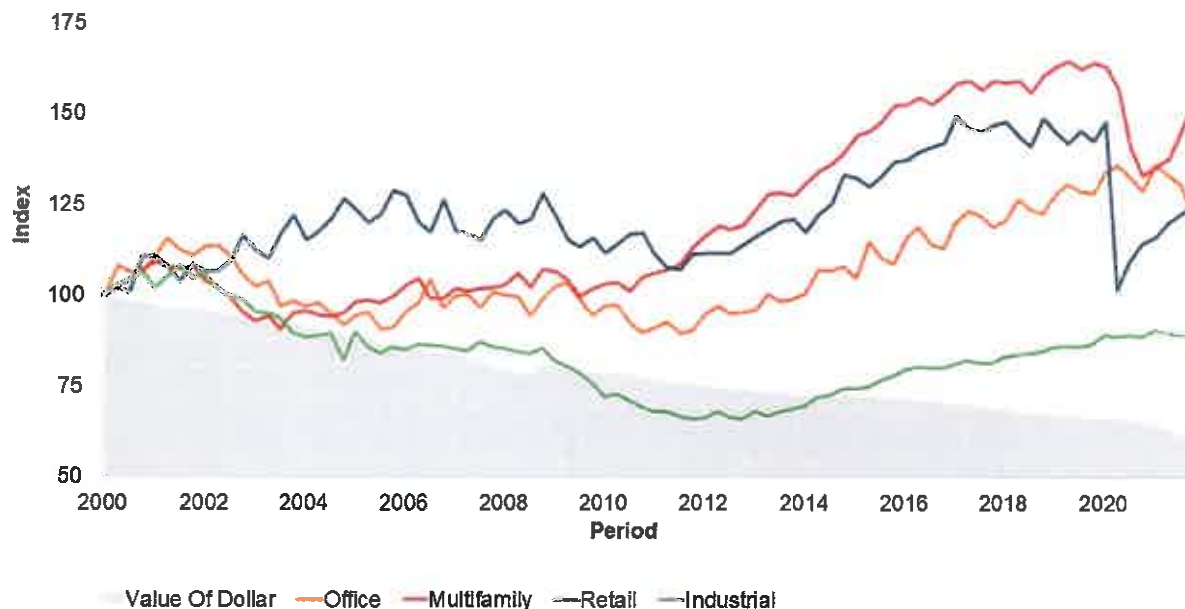


There are two caveats with the above analysis, however. First and foremost, this is based on a historical view and every economic cycle is its own special case. The current situation is that both cap rates and interest rates are low. The only other time the Fed has lifted off from near-zero rates, the pace of rate increases was slower than that expected today, and inflation was not threatening to hit double digits.

This presents a mixed "bad news-good news" situation for commercial real estate investors. It will be increasingly difficult for cap rates to decline much further given how low they currently are. Commercial real estate values would have to increase exponentially at the same net operating income for cap rates to decline, so there is less room for "good compression." Investors should therefore expect relatively little cap rate decline going forward.

The other caveat with the analysis is that flat or even increasing cap rates do not always equate to declining returns, especially in an inflationary environment. Commercial real estate has been shown to be a good inflation hedge as it can maintain, or more commonly grow, real income return in response to rising prices, whereas most bonds depreciate over time.

## Real Net Operating Income Typically Holds or Gains Value as Dollar Value Declines



Sources: NCREIF, CoStar Advisory Services; Fourth Quarter 2021  
\*Baseline is 100 in the first quarter of 2000.



Lease escalations and renewals provide the opportunity for owners to maintain real income returns while bond values typically depreciate, creating a strong argument for real estate even as cap rate spreads compress. Real estate income in the form of rent can adjust to inflation, where a standard treasury bond cannot, making commercial real estate relatively more valuable in an inflationary environment and justifying a narrower cap rate spread. An extreme example of this is where spreads invert in the face of rising inflation expectations, and while that isn't necessarily the base case, it is not out of the realm of possibility.

While a controlled inflation environment is still beneficial to commercial real estate in the long run, rising interest rates do create a drag on demand in the economy and will likely weigh on leveraged investors, many of whom have gotten use to an easy money environment, putting stress on debt-laden businesses.

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