Time to normalise?

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Interest rates on their own are not likely to cause a correction in the commercial property market, suggests Tarrant Parsons

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Following nearly a decade in which any build-up in momentum had flattered to deceive, global economic growth finally began to pick up more convincingly around the middle of 2016. Impetus appears to be increasing further in 2018, prompting another round of upgrades to the IMF?s key macro forecasts. World economic activity is now projected to rise by around 4% both this year and next, and if this were to prove to be the case, it would mark the strongest expansion in 7 years.

In this context, however, it is widely anticipated that monetary policy across major developed economies is close to a turning point. According to OECD estimates, five of the G7 nations already have unemployment rates comfortably below levels at which inflation should begin to accelerate. Policymakers will of course have their own estimates, but capacity constraints are becoming more prominent in many localities.

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Even so, there is only limited evidence as yet that wage growth is gaining the traction that would drive inflation higher on a sustainable basis, despite the ongoing tightening of labour market slack. Furthermore, many of the world?s longer-term structural deflationary forces are still firmly in place, including changing demographics, shifting consumer habits, more liberalised labour markets and automation of jobs.

Notwithstanding these, there has across advanced economies been a noticeable change in the tone of central bank communication, signalling an increasing appetite to normalise monetary policy, or at least scale back stimulus, while the global economy is enjoying a cyclical upswing. The challenge is deciding how best to do so while balancing competing pressures to avoid disruption. This will require particularly careful judgement, given the financial vulnerabilities associated with the sharp rise in asset prices seen over recent years.

Real-estate view

Real Capital Analytics data shows that property values in London, Paris and the largest German cities have appreciated by 80%, 56% and 47%, respectively, since 2011. At the same time, across the major US markets average commercial property prices have increased by 55%, while investment yields have sunk to record lows. The main channels through which ultra-loose monetary policy ? quantitative easing in particular ? have functioned, by pushing investors to seek higher-yielding assets, has clearly been beneficial to global investment inflows into commercial real estate.

On the face of it, then, the process of monetary authorities withdrawing or scaling back this stimulus, especially when the world?s largest central banks are working in unison, poses perhaps the most substantial near-term market risk. In other words, a sustained rise in bond yields across the globe, brought about by a shift in policy ? and driven by higher medium-term inflation expectations ? is likely to place downward pressure on property valuations.

This is because, in theory, if risk premiums and rental growth expectations remain unaltered, then an increase in the risk-free rate of return should lead to an upward adjustment in what is perceived as a fair-value yield on property investments. Generally speaking, a rise in policy rates could make developing new projects more expensive, or accessing finance more difficult. All of this would be at least somewhat detrimental to capital inflows for commercial real estate.

Rising occupier demand, falling vacancy rates and stronger rental growth prospects will likely play a pivotal role in sustaining investor demand

In practice however, the relationship between bond yields and property yields is not so direct. For a start, the extent to which higher interest rates are consistent with strengthening economic performance reflects improving occupier fundamentals. Rising occupier demand, falling vacancy rates and stronger rental growth prospects will likely play a pivotal role in sustaining investor demand.

Furthermore, even after the recent uptick in bond yields ? most noticeably in the USA ? the current yield gap, or spread, with commercial property is still elevated by historical standards. This implies there is further room for compression before the relative attractiveness of commercial real-estate returns become notably impaired on this metric.

The upshot is, while economic growth retains solid momentum, it is unlikely that rising interest rates will provide the catalyst for a meaningful correction in the commercial property market. Tighter monetary policy may cool investment somewhat from already very strong levels, but markets in many parts of the world at least look well placed to absorb incremental rate increases, so long as income fundamentals remain favourable.

Further down the line, either a recession or a material slowdown in economic activity presents a much larger threat, and this may well be induced eventually by a tightening in financing terms. But, for now, strengthening projections for the global economy over the next year or two should be viewed as a positive for commercial property, even if it means interest rates become somewhat less supportive.

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Further information

- Related competencies include: Corporate finance
- This feature was taken from the RICS Property journal (May/June 2018)