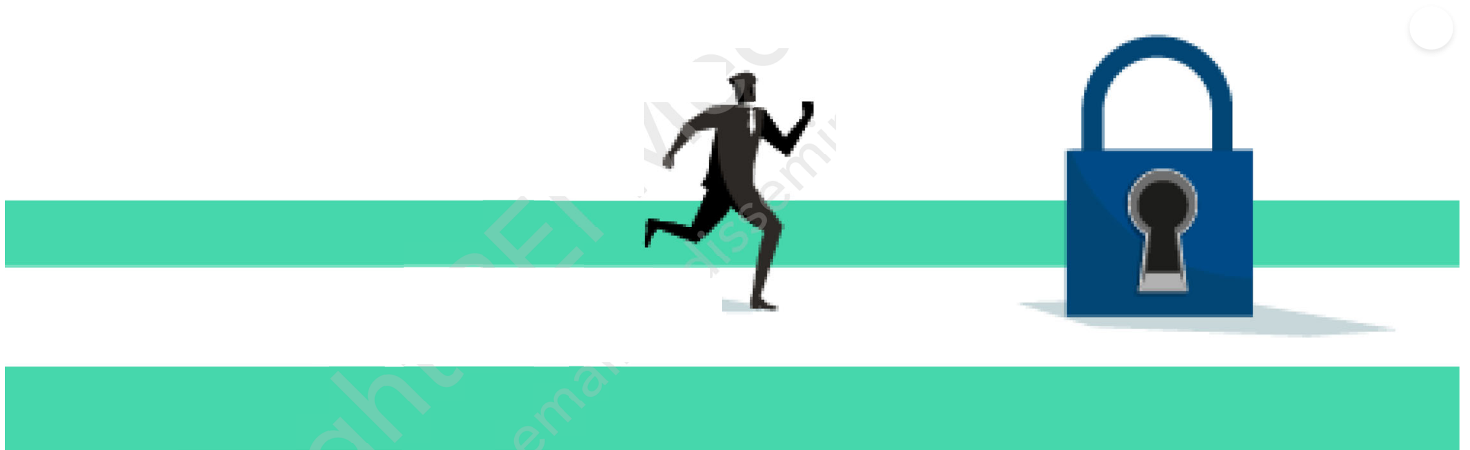
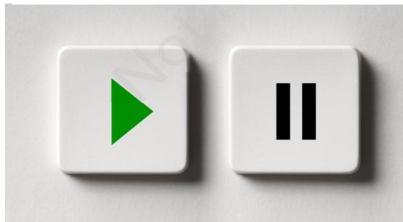
News & Analysis

Analysis: Federal Reserve keeps rates stable, but no near-term end seen to market stasis

Transaction volumes will stay subdued until bank lending standards begin to ease.

Samantha Rowan - 5 hours ago





The Federal Reserve opted to keep the federal funds rate range stable at 5.25-5.5 percent at its September meeting, but market participants do not believe the move will lead to a near-term increase in transaction volume in the commercial real estate debt and equity markets.

The September 20 meeting came amid cautious hope of an indication that the US central bank is at or near the end of its current cycle of rate increases, said Ran Eliasaf, founder and managing partner of New York-based real estate credit platform Northwind Group.

"It also feels like we're closer to the end of rate increases. The real question is how long will rates stay at this level?" he said. In Eliasaf's view, rates will be higher for longer and the market will have to keep adjusting to that reality. "We have to remember that today's rates are really the normal rates, not the extremely low ones we have seen."

Regardless of the Federal Reserve's decision to keep rates stable, transaction volume is not likely to return to previous levels given the higher interest rate environment, said Bryan Kenny, president and principal at Los Angeles-based manager Bandon Capital Advisors.

"While cap rates are increasing, all-in rates on debt still result in negative leverage which is not attractive to most buyers," Kenny added.

This sentiment is reflected in mid-year data from New York-based data provider MSCI, which found that year-over-year transaction volume was down 63 percent – and attributed the drop almost entirely to higher interest rate levels, which were making debt difficult to obtain and keeping a gap between buyer and seller expectations.

The consensus among market participants prior to Wednesday's meeting was that the Federal Reserve would opt to keep rates stable. Still, the US central bank is adamant about its goal of bringing inflation down to 2 percent and the outlook is for the potential of at least one more rate hike, Kenny said.

"That hasn't happened yet, even after a steady series of rate hikes," Kenny said. "It seems likely that Federal Reserve will assess the next two months of data in November before making any additional changes. Higher oil prices in the past month do not make the Fed's task any easier as this is obviously inflationary yet also could dampen economic growth."

Changing investor behavior

Lauren Gerdes, a senior analyst at New York-based tax consultancy RSM US, said an understanding that rates will be higher for longer means the firm's commercial real estate clients are broadly expecting to see the current stasis in transaction activity continue in the coming months. This leads managers to change the structures through which they are investing.

"Our client base and investors, instead of chasing short-term appreciation, are now looking at the longer-term and thinking more about cashflow," Gerdes said. "This is leading more firms to consider open-ended fund structures, which allow managers to align their strategy with their investors need for long-term, strong cash flow from assets."

Scott Helberg, a senior tax adviser for RSM, said the firm is seeing more managers consider open-ended debt funds.

"As more existing deals are seeing their loans mature, there are opportunities out there to backfill deals with new debt. While the closed-ended fund has typically been the way, I think the next step is more of a long-term, evergreen investment opportunity," Helberg said. "With open-ended funds, you're not locked into an investment based on the life of your fund and you have more flexibility to roll with the market."

Hiring snapshot

Kent Elliott, principal of San Francisco-based RETS Associates, said the executive search firm has observed that hiring has ebbed and flowed within the commercial real estate sector almost in lock step with the market.

"While 2020 was a year in which not a lot happened, January 2021 to May of 2022 was a bull market for hiring in commercial real estate. I have not seen that type of voracious appetite for more than 20 years," Elliott said. "But since May 2022, hiring has been up and down, with a trend line of up. There are still soft spots, especially on acquisitions and for financial analyst roles."

Because the major firms are off of their transaction volumes in a way that tracks a broader market drop in transaction volume, these companies are trying to reduce their burn rate until rates are more stable, Elliott said.

"The consensus prior to the Federal Reserve meeting was that there was no rate increase that was going to happen. There may be one more raise that will happen later this year," Elliott said. "The SOFR forward curve was supposed to drop in May or June of next year and rates were expected to go down, but now that is being projected for next September. The concept is higher for longer."

Sustained elevation for now

John Beuerlein, executive vice-president and chief economist at Minneapolis-based Pohlad Investment Management, believes volumes will stay subdued until bank lending standards begin to ease. This typically occurs about the same time that the Federal Reserve commences a rate easing cycle, he added.

"The Fed will continue to be vigilant for any rekindling of core inflation pressures and will not begin monetary easing until they are very confident that inflation is moving sustainably down to their 2 percent goal," Beuerlein said.

"The combined impacts of tighter lending standards at banks, an inverted yield curve, and the outflow of deposits from banks has turned the credit cycle so that both the supply of credit and the demand for credit are contracting. This is not a good mix

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for a credit-driven economy and will slow down or push out the initiation of prospective commercial developments."

At this point, the markets are expecting to see an initial cut in the federal funds rates in mid-2024, either at the June 12 or July 31 meeting of the Federal Open Markets Committee. "I think there is a chance that economic data will be weak enough in the interim that the first rate cut could occur as early as the May 1, 2024 meeting," Beuerlein added.

Beuerlein cautioned, however, that while it is easy to assume that once the Federal Reserve starts to lower rates, transaction activity will rebound.

"History over the last 40 years shows that recessions only officially begin after the initial decline of interest rates. Assuming we do have some level of economic recession as a result of the most aggressive monetary tightening cycle of the past 40 years, this suggests that a meaningful increase in transaction volumes won't occur until late 2025, at the earliest," Beuerlein said. "While volumes may start increasing at that time, I expect the recovery of values, particularly office values, to take much longer."

Bandon's Kenny believes unless the economy enters a recession that warrants action from the Federal Reserve, it could be several months before rates start to fall.

"Some experts believe that we may see lower rates in 2024 since it is an election year, but unless economic growth declines, a decrease in interest rates is not likely. There has also been some speculative discussion about the Fed's inflation target changing from 2 percent to 3 percent or even 4 percent if we continue to see heightened inflation. This remains to be seen," Kenny said.

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