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# Can commercial real estate stand continued lower rates?

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It seems counter-intuitive in real estate to wish for higher interest rates. But, when it comes to artificially low rates, do we want to risk another manipulated market bubble?

Quantitative easing, or QE3, has been recently announced, because Chairman Bernanke and the Federal Reserve Board have decided that, while U.S. Gross Domestic Product (GDP) has been growing at about 1Â½ to 2%, it is not adequate to reduce unemployment. This growth rate will only provide enough jobs for new people entering the market.

As I wrote in a recent article, the Feds create QE by keeping interest rates low, by buying U.S. Treasuries. At this point, it is said that the Fed financed 75% of the U.S. deficit and thus, the Fed is predominantly supporting new U.S government debt. The Federal Reserve now owns one in six dollars of national debt, the largest percentage of GDP in history.

What is the impact to us? The Feds zero low interest rate policy has created or sustained a cycle in which yield hungry investors drive up prices of traditional commercial property investments. With institutions, banks, and individuals barely able to earn 2% on 10-year treasuries, everybody is looking for higher yield. Thus, all of a sudden, 4 to 5% yields on real estate look like a deal. For the most part, the commercial real estate that warrants these purchases has been that of the highest quality, lowest risk. However, as those products disappear, investors will be moving into riskier second tier property. Investors will begin to forget that there really is risk in real estate.

Most agree that quantitative easing worked best in the beginning, when an emergency influx of funds in the marketplace replaced a locked up banking system. At this point however, QE has moved interest rates perhaps too low, and investors are becoming wary about future impact. By way of example, traditional companies, large and small, are waiting on the sidelines before they hire new people, or make new investments. According to a recent Wall St Journal article, "employers have added just 36.7 million s/f since they began expanding office space in 1st qtr. 2011...., well shy of the 141 million that business shed between 2008 and 2010." Those business leaders are smart and won't be pushed into a bubble.

Not so clear with real estate investors. Low interest rates have an immediate and compelling impact on real estate. As rates get lower, as we said, demand for real estate increases and prices increase. If there is no real change in unemployment, and business leaders are holding back with investment, it is unlikely that new office space will be easily absorbed.

What to watch for: several bad things could happen. First, and most obvious, rates will eventually reset to higher levels, creating trouble for commercial real estate debt that is short term. This has already happened in some areas. Second, if prices continue to rise without underlying business occupancy, it will allow some spectacular sales in trophy real estate, but will leave a second tier of building far behind. Third, it is a self-fulfilling prophecy, as rates continue to be artificially low, and prices continue to increase, that real estate investors who are not in the market will jump in so as not to miss the run-up.

The Fed is in unprecedented waters. The amount of debt it is funding is one thing; the burden of interest payments is another. If interest rates go up, the burden of financing the debt will explode. Commercial real estate could be on a parallel track. Next time you read that mortgage loans fell into an all-time low, before running out and borrowing to buy that property which value seems to be increasing, think again about the longer term ramifications.

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