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Interest Rates: Where are we heading?

November 07, 2013 - Front Section

The Counselors of Real Estate recently completed their annual conference in San Francisco. This conference brings together real estate experts from all over the world resulting in a broad set of perspectives. The increasing velocity of capital flows beyond local borders prompted considerable discussion about domestic interest rates and where they are headed. These discussions were particularly focused on the current level of interest rates which is clearly being artificially held low by actions of the Fed.

The issue of low interest rates and capitalization rate risks has been identified as a #1 hot topic for real estate investment. As noted in their top 10 real estate issues published earlier this year, the counselors note that the Fed has signaled that interest rates will remain through 2014. If we look at history, low interest rates have propelled capital to leave bank accounts in search of higher returns at higher level of risk. This has clearly taken place and some believe that this may be creating an asset bubble. Real estate has benefited primarily because most real estate investments employ lots of debt.

Capitalization rates are at historic lows and they are especially low in global gateway markets such as Boston. There is significant and heated competition for class A core assets. There is some concern that this undersupply in the face of this enthusiastic demand has driven prices to unsustainable levels - another sign of a bubble. This situation bears close monitoring if we begin to see decompression of capitalization rates.

To date, the Fed has been successful in maintaining this level of interest rates. There is, however, inherent risk in equity investments that are made based upon the assumption that these artificially low interest rates will continue for an extended period. Experts conclude that the current level of interest rates is likely between 1.5% and 3% below "natural rate levels."

Counselors note that key implications of interest and capitalization rate risks are that investors should be locking in low interest rate debt at current levels, reconsidering strategies predicated on significant price appreciation and focusing on meeting tenant needs and operating their properties more efficiently. In the long run, real estate values are sustained by good quality management, attention to basics and meeting tenant needs. Artificially low interest rates are a danger on the horizon if the Fed is not successful in slowly allowing rates to reach normal levels.

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