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The year ahead: What's 2023 going to look like? - by William Pastuszek

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For most real estate professionals, including lenders and appraisers, 2022 was a transitional year. For the most part, gone is the “blue skies forever” thought processes. Instead, endless optimism is being replaced with a good deal more balance and perspective. With respect to economic behavior as it relates to real estate and valuation, the post-COVID era continues to challenge and surprise.

Nearly everyone spends some time staring at the ceiling trying to understand how the following factors relate to real estate investing, valuation, and management.

Inflation. Probably not going away soon. So we may have to live with it for now. Not a lot to be done as a practical matter except to suffer and endure high interest rates and high prices. COVID disturbed supply chains and the normal flow of goods. Russia’s invasion destabilized energy markets. Central banks responded by raising interest rates to squeeze out inflationary pressures with a consequent effect on markets all over. There’s a growing consensus that the upward interest rate stair stepper is far from over. More interest rate increases will be needed before inflation gets tamed. Going back to the late 1970s and early 1980s - the Volcker Fed Era - the prime rate was 8% in January 1978 and peaked at 20% in April 1980. This translates into a 150% increase over +/-27 months. Compare this to the present situation. The prime rate was 3.5% in April 2022 and was 7.5% in December of 2022. The rate more than doubled in less than a year. The Fed continues to face an unappetizing task of taming inflation while trying to manage to not create a severe recession. On the other hand, the Fed may not have to do too much more in terms of recession management. Events may have taken care of that task.

Economic Growth. Economic growth is not going to be strong, and the best hope is that it doesn’t turn negative. Equity and bond markets are probably not going to become less volatile. Is the job market going to hold up? Many yearn for the days of pre-COVID low growth, low inflation modes.

Housing Markets. The imminent crash of the housing market may be somewhat overstated. Fast growth areas are seeing price erosion. Markets like Boston seem to be doing not that badly. In the case of Boston, demand comes from many sources, and, even though new construction demand has languished, these markets are not oversupplied. While volumes are down, in the Northeast they are holding their own. Let’s see what 2023 brings. Lenders are still lending and there is demand for loans, even at what seem to be usurious rates. The availability and cost of money drive real estate markets. It’s all about “what monthly payment can I qualify for?,” that have driven price in many markets rather than “is the price I am paying supportable in the marketplace?” Higher rates create some discipline in markets.

Residential Rents. Multifamily rents show signs of settling down but housing affordability will continue to be low point in the cycle. And, buying a house or a condo may not be something that the post Great Real Recession generation is particularly interested in.

Commercial Markets. All the uncertainty has created a greater amount of introspection and more careful due diligence in commercial markets. Even industrial and multi-family are now fair game for the media looking for content that spells the end of the upcycle for these property classes. As leases come up for renewal and tenants now can act on the experience of the last several years in terms of space flexibility and alternatives to the traditional office models, the reality of the effects of COVID will hit home. Expect to see more hesitancy on the investment grade side of CRE. On the other hand, non-investment grade markets, especially in mature markets like Boston, expect to see investor appetite continuing for Main St. properties. Lenders will continue to be aggressive in their interest in good deals and strong borrowers. Expect to see a lot more focus on the ability to repay, rather than asset appreciation or reliance on future cash flow increases.

What About 2022? For various reasons, 2022 deserves to be put in the archive as a year of mostly unpleasant change. Will 2023 be more of the same, or, worse? Probably no one thinks it will be better.

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