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Question of the month: How do you maneuver uncertainty in today’s economy? - by Alan Doyle

February 10, 2023 - Front Section

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Fighting Inflation

The Federal Reserve’s attempts to control a 9.0% annual inflation rate in March of 2022 led to seven successive rate increases by year-end. While effective, the Fed’s rate increases could prove to be more of a sledgehammer than a scalpel in cooling off the economy and combating inflation. If the Fed raises rates too slowly inflation could continue to rage on; too fast and the Fed will likely push the economy into a recession with millions of Americans losing their jobs.

Corporate giants such as Goldman Sachs, Morgan Stanley, CNN, PepsiCo, Amazon, Meta, Twitter and Microsoft have recently announced significant lay-offs. Also, The WSJ also reported that the nation's four largest banks collectively set aside $2.8 billion in loan loss reserves in the 4th quarter of 2022.

Many economists believe that the Fed will continue to push up short-term rates in the first two quarters of 2023 to north of 5.0%. When and at what interest rate level will the Fed back off further rate hikes and what's the tipping point where we slide into a recession? If so, will it be deep or short-lived?

The Big Mortgage Slowdown

The commercial mortgage market kicked off 2022 in top gear with record low interest rate indices (1.63% 10 Year Treasury). According to Trepp data, CRE mortgages increased by $474.2 billion in 2022s 3rd quarter, up 9.3% from the previous year to total $5.52 trillion.

By December 2022, originations had lost momentum and spreads began to widen while key lending indices, such as the 10-year Treasury, peaked in October at 4.25% before retreating to 3.88% by the end of the year. A 225-bps change!

Because of the frenetic pace of lending in the first 2–3 quarters last year, many lenders had already met their goals and were comfortable stepping back and taking a wait and see approach in the 4th quarter.

Widening Loan Spreads

Similarly, loan spreads widened on construction, mini-perm, and long-term non-recourse commercial mortgages by the 4th quarter 2022. Starting 2022 at an average spread of +/-150 bps, spreads quickly widened to between 215–225 bps by year's end. Lenders began the year with interest-only periods of between 5–10 years (on low leveraged transactions) which was pared down to 2–3 years by mid-year before completely evaporating by year end.

Institutional Property Returns Down after a Record Year

Perhaps the best indicator of commercial property returns is the NCREIF Open-End Diversified Core Equity (ODCE) Index which measures the economic returns of $350 billion in institutional quality, office, industrial, retail, multifamily, and hotel properties. In the 4th quarter of 2021, the ODCE index recorded a record 5.12% appreciation return, the highest quarterly appreciation since the 1978 start of the index. By contrast, ODCE's 4th quarter 2022 appreciation return went negative at -5.75% which caused institutional investors to line up and withdraw an estimated $20 billion from core real estate funds.

The View from Here

Through a series of rate hikes the Fed has already experienced success in reducing inflation from its peak of 9.1% last year. However, the current 6.5% inflation rate is still well above the Fed's target of 2%–3%, which will necessitate additional Fed interest rate hikes in the first half of this year. Economists are divided on whether the Fed has already increased rates too fast and too high.

Well margined deals will continue to be awarded with the best terms and pricing, while high leverage loans transitioning to a higher interest rate environment may require an infusion of equity capital to meet more challenging debt coverage standards.

Capitalization rates are predominantly derived by the weighted cost of debt and equity capital, as we remember from Appraisal 101. Because year end 2022 mortgage rates increased by 225 bps from January last year, and since mortgage financing typically accounts for +/-70% of the capital stack, the impact on capitalization rates is expected to be +/-120 bps from earlier last year. This equates to an average loss in value of roughly 12%–15% from earlier last year.

While the financing market volume is projected to be +10% lower than last year, with $450 billion in loans maturing this year and $486 billion in 2024 and a multitude of new projects moving forward, lenders are expected to remain active in 2023.

Despite the inherent volatility in the CRE capital marketplace, lending this year is projected to remain strong, albeit at lower levels than the past few of years. With offices in Rhode Island, Connecticut and New York, Larew Doyle & Associate's team of experienced professionals will continue to guide our valued clients through 2023s challenges and ensure that they continue to benefit from competitively priced mortgage financing that best fits their investment objectives.

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