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Adapting to change - by Bill Pastuszek

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As the warmth and hopeful prospects of the holidays and the New Year are in the rear view mirrors, the hard work starts in trying to understand what the year portends. Now two months into 2023, there are high points and there are pain points to be discussed.

The inflationary environment is probably not going away soon, nor is the concern about recession. Both of these concepts have been known for a while. It is also known that the Fed will do what it will, based on its parsing of the economy. So the economy will have to adjust to its actions. Market participants have managed to adjust to its effects reasonably quickly, which may allow a somewhat graceful exit once rates reach a peak and the economy reacts in a way that won't require additional increases.

Of course, events beyond anyone's control may have unanticipated effects and some unpredictable events have landed us here. In any event, not a lot to be done as a practical matter except to adapt and endure a period of unpleasantness in terms of inflation and high interest rates. At this point, if there is a recession, adaptation will occur and rethinking of some of the bad habits developed during the easy money, low interest rate era will be a necessary survival skill.

Some history. In the Volcker Fed Era of late 1970s and early 1980s—the prime rate was 8% in January 1978 and peaked at 20% in April 1980. This represents a 150% increase in a little over two years. Presently, the prime rate was 3.5% in April 2022 and was 7.5% in December 2022. The rate more than doubled in less than a year.

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. Retail sales and the job market seem to be holding up rather well. U.S. Gross Domestic Product (GDP) increased by 2.1% in 2022, down from 2021's 5.9% expansion. This reflected the economy's return to a more normal pace of growth after the pandemic-induced dislocations in the two years prior. Positive 2022 contributions came from consumer spending, exports, private inventory investment, and nonresidential fixed investment while decreases were reported in residential fixed investment and federal government spending. Imports increased.

Housing markets—whether sales or rentals—are clearly adjusting to a lowered appetite for housing in the face of higher interest rates. The demise of housing markets may be somewhat overstated, or, maybe generalization should be avoided in these sectors. There is concerns of price erosion in high-growth areas. A market like Boston seems to be adapting by generating demand from many sources, and, even with slower absorption of new construction, the region's markets currently are not oversupplied. Volumes in the Northeast are certainly down which creates problems for allied economic sectors. (Housing has a multiplier effect for construction trades, home goods, etc.) A return to the easy money, over asking times is unlikely soon. Markets find ways to adapt.

Let's consider commercial real estate (CRE). Uncertainty has created a greater amount of introspection and more careful due diligence in commercial markets. One analyst characterizes

capital as having its “pencils down,” and, as a result, wide bid-ask gaps abound. Sales volumes are declining with pricing pressures more evident: even industrial and multi-family markets are experiencing far less frothiness.

As one leading brokerage notes: “Today’s market conditions are abnormal. ... [F]undamentals are generally sound, if not improving, in most asset classes.” Investors crave interest rate and economic/political stability and prefer to sit on the sidelines, watchful for opportunistic buys.

For cap rates, if spreads from BBB bond and 10-year Treasury rates continued to be viewed as benchmarks, cap rates are overdue to rise. But it may be a while before transaction data appears to show incontrovertible evidence. However, higher cap rates are on the minds of many.

Consider office. Where the pandemic seemed to point to the end of retail and lodging as we know it, both classes have managed to refocus and recalibrate. Both classes in general will swing with the economy. Retail has taken so many hits over the past decade and the sector has managed to adapt to a series of “new realities.” Volatility will continue as a substantial factor. Lodging has always had to deal with economic cyclicalities; the pandemic tightened up focus on operational efficiencies.

Office is not a favored class and currently is most problematic. Fundamentals in this class are challenged. (Much of the change is due to the stalling in return to office with consequent growth of work at home.) Wholesale drops in rental rates are not pervasive, but concessions have increased as has subleasing availability. Take up of space has decelerated. Sales prices have been affected negatively and are likely to continue this trend. Suburban sectors appear to be faring better than CBD assets. Office space conversions—residential, life sciences—may help ease pressure in the office sector.

As leases face renewal and tenants can act on lessons learned about space flexibility and alternatives to traditional office models, the reality of the effects of COVID will hit home.

The bright spot is that CRE will continue to be a viable investment venue, being the least uncertain of investment classes. For all sectors, the focus will be on adaptation. Owners, brokers, investors, lenders, and appraisers will need to meaningfully adjust to a changed reality. Again.

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