Monitoring the market, making the right decision at the right time - by Thomas Sweeney

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When you are sick your body fights infection by stimulating your immune system via a fever. Similarly, to the body's response to sickness, the commercial real estate market likely will worsen over the next 12 months before leveling out. This will be concentrated on the volatility of the office market as vacancies increase due to office users continuing to downsize. This trend ripples into the retail areas that rely on office buildings being fully occupied.

The surge in interest rates by the central bank is the fever, causing significant disruption to the economy. Financial institutions are tightening lending to preserve capital and strengthen balance sheets. Moreover, loans for office properties are approaching their maturity dates. Tenants have drastically reduced their square footage resulting in the devaluation of office buildings, that in combination with higher interest rates could be catastrophic.

“CPI rose by 3% from one year ago, which is much lower than the 8–9% hikes of last summer and is the slowest gain in over 2 years,” said Lawrence Yun, NAR chief economist on July 12th. “The Fed misjudged the early strength of inflation, which got out of control. Now it could misjudge on the economic front. Monetary policy works with a long lag time. The Fed appears too focused on the lagging economic indicators of jobs rather than early indicators like future inflation and commercial leasing activity; they should look ahead and stop raising interest rates,” said Yun.

In the office market, the fall out of the new dynamic continues. “High office vacancy rates in markets nationwide mask the fact that a disproportionate amount of empty office space is concentrated in a relatively small percentage of buildings,” according to a report by JLL. “Specifically, 60% of vacancy is concentrated in 10% of office buildings, and over 90% of vacancy is concentrated in 30% of office buildings.” Office vacancy rates in downtown Providence and Rhode Island have been stable in recent months, as folks try to bring back office workers with varying degrees of success. We anticipate some increases in vacancies as companies fine tune their plans to bring the workers back, while not pushing them to the extent where they consider other options. A corollary of the ongoing flux is the impact hybrid work arrangements has had on the sales at businesses that rely on office workers, as well as other related businesses, such as parking lots. These businesses which were used to the five day a week work week are now adapting to the three day in office work week, with pre-pandemic numbers being seen Tuesday through Thursday.

The industrial market continues to be robust. From a sale point of view, inventory is very limited and if a property is brought to market, marketing time is usually very short as long as the seller does not have unrealistic expectations. Industrial leasing, while always a competitive market in Rhode Island, faces the same challenge with a continuing lack of inventory. Vacancy rates are very low and good space is being occupied quickly. For example, West Davisville in Quonset continues to be 100% occupied, with any turnover space being occupied at or before the space is vacated.

The combination of financing tightening, rate hikes, and the high cost of construction have limited some new space from coming to the market. The spaces that have, asking rents at levels rarely seen in this market, but if a company has a requirement they have to make decisions if it is worth to build or lease.

Investing and lending has been more stringent, but we are hopeful for the fever to break in Q4 of 2023 or Q1 of 2024. Office will continue to flux and those that maintain well kept, highly efficient, and tech-adapt spaces will feel less of this impact. Retail will to continue walk the tightrope of efficient operation & availability, while we are seeing the fever in the industrial market already starting to break. “There’s a general fear that the cure could be worse than the disease,” said Bruce Van Saun, CEO and chairman of the Providence-based Citizens Financial Group Inc. Another interest rate hike by the Federal Reserve could affect discretionary spending. As we conduct business in the coming months, we need to continuously monitor the market and make the best decisions at the right time.

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