Reading the tea leaves - What’s doing now, what may be ahead... - by Bill Pastuszek

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It's been an eventful year …some good, some bad, events, and a lot that are hard to figure. Here is assembled information to aid in understanding commercial real estate markets in the context of the broader economy.

The yield on the 10-year Treasury note rose to 4.84% recently. It was reported that a solid retail report and positive industrial production data lifted 10-year yields by 0.13 percentage points, which represents a good-sized Treasury market jump. Is this important to commercial real estate?

That 10-year Treasury represents essentially what financial markets would charge the U.S. government to borrow money for 10 years; this indicator is foundational for most other borrowing activity. Thus, many assets, ranging from corporate bonds to 30-year home mortgages, base their rates on this benchmark yield.

Higher rates are going to be with us for a while. What does this mean for commercial real estate markets? Rising yield rates in the past six months are a clear reflection of the market believing in a higher interest rate environment but also that that the U.S. economy possesses great momentum. So, is a recession imminent? There doesn't appear to be many signs that that one is expected soon. Consumers are not overly optimistic and housing activity is way off but prices are holding steady mostly. Independent of recession concerns, there are commercial market concerns, both broad and specific.

The Fed Reserve surveys senior banking officers from time to time. The most recent survey tells us "For CRE loans, major net shares of banks reported that lending standards were on the tighter ends of their historical ranges for all loan categories." These include "construction and land development loans and nonfarm nonresidential loans," with multifamily property loans "near the midpoint of their ranges." Cited reasons include "a less favorable or more uncertain economic outlook, an expected deterioration in collateral values, and an expected deterioration in credit quality of CRE and other loans." There was "an expected reduction in risk tolerance, an expected deterioration in their liquidity position, increased concerns about funding costs and deposit outflows." There were also concerns about regulatory changes. GlobeSt.com reports "Distress has been the buzzy question making the rounds of commercial real estate for more than a year now. When will it really start?" It was reported that the "balance of distress in the U.S. commercial real estate market climbed for a fifth consecutive quarter." Levels of financially troubled and bank-owned assets are similar to 2013 levels, where the results of the "fallout" from the Great Recession were working through property markets." However, current distress levels are less than half than reached during that time.

CoStar CRSI notes the following: "Apart from the COVID-era, July 2023 transaction counts were lower than any month since February 2013." Investment grade transaction volume was down nearly 20%; general commercial segments were down 40%.

Pricing is down but not as much as might be expected. Withdrawn listings are up 10+%. The lack of transactions is a cause for concern because without transaction activity it is obviously more difficult to draw credible conclusions.

Note that the CoStar indices are constructed using a repeat sales methodology, widely considered the most accurate measure of price changes for real estate. This methodology measures the movement in the prices of commercial properties by collecting data on actual transaction prices. When a property is sold more than once, a sales pair is created.

The CoStar index lists Boston as a prime market in three of four property categories.

A major investor survey notes that for the second quarter 2023, average cap rates increased in most markets surveyed. An average change of 24-basis-points took place for all surveyed markets. All markets were reported to have higher cap rates than a year ago with an average increase of more than 70 basis points. Obviously, some asset classes are experiencing greater changes than others but there is an obvious upward trend. The question is how high will rates go?

Summary. Certainly, CRE markets are highly segmented and specific sectors operate within their own orbits, which may be distinctly different from the orbits of other sectors. Consider the office sector orbit and compare and contrast it to the industrial movements, for example. Retail markets are going well but there is some concern about net lease sectors. There are some concerning trends in drugstore and bank leasing markets. Multi-family remains an area of strong investor interest but there are oversupplied markets that are behaving less briskly.

There are a lot of conflicting concerns and trends out there. This is a time to watch market sectors closely and analyze carefully the often limited data out there.

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