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## **Interest rates - Not so fast! - by William Pastuszek**

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Long awaited, the Federal Reserve dropped the “benchmark” federal funds rate to the 4.75 to 5% range, a 50 basis point drop. The statement from the Fed’s rate-setting committee noted the decrease was made “in light of the progress on inflation and the balance of risks.” The rate had been in the 5.25 to 5.5% range since July 2023. FRED (St. Louis Fed) reports the September Fed Funds rate at 4.83% after the rate cut having reached a high of 5.33% earlier this year.

FRED shows 30 year fixed mortgage rates at 6.12% down from a recent high of 7.2%. Good news for the home mortgage market. Lower rates will make buying homes more affordable. Will housing prices be further buoyed by lower rates? Will more homes come onto the market as homeowners see opportunities to move, finally?

Homebuilders should begin to see relief in their carrying costs for new construction and make projects more feasible. Hopefully, buyers will be more willing to pay the price for new housing.

To be sure, it doesn’t look as if 3% rates are in the offing very soon. A rough unweighted 10 year average 30 year fixed interest rate is +-4.8%, according to FRED data.

The prime rate is down from 8.5 to 8%. (I am dating myself but the prime rate used to be the rate everyone looked at, along with the Dow Jones Industrial Average. And the Wall Street Journal in paper arrived every morning...)

Much commercial real estate is tied to the 10 year Treasury. FRED reports that the rate is currently in the upper 3% range. The peak rate, earlier in 2024, was 4.7%. CMBS participants report that conditions have eased.

So, rates are down. What implications does this have for the current state of commercial real estate?

CRE markets have been dismal over the past two years. Higher interest rates and inflation are only part of the problem. For buyers and owners who took on debt in the frothy era of COVID, purchases at peak prices based on aggressive assumptions about occupancy and rent levels, the agony is not over. CRE is slow moving and with leases turning over and with no predictions of runaway rent growth as a consequence of lower rates, owners and lenders are still faced with challenges. Certainly, lower rates will ease the pain but not cure the underlying causes completely.

On the other hand, for investors who have been on the sidelines and who have been waiting for a turnaround, this cut may represent an inflection point. High quality assets may have greater attractiveness and possibly less of a bid-ask spread. Bid-ask is often mentioned as representing the reluctance (or inability) of sellers to temper expectations to connect with buyer motivations.

For the various sectors, one report noted that office pricing is still in the phase of discovery. Here's an asset class that was strongly affected by the COVID era of work from home and which is still trying to recover from the changed expectations of tenants and buyers. Retail has been "constrained" and is likely to remain so. Industrial reached a peak but remains a source of CRE strength. Multi-family has had some ups and downs but remains a stable class in many, but not all, markets. Lodging has rebounded gloriously and is always privy to the ups and downs of travel. Net lease and self-storage have faded somewhat like the leaves of late fall but are still objects of investor desire.

If rates fall further, investors will expect better returns on investment with lower costs of capital. Lenders will be able to extend better terms and feel better about their credits. A 50 basis point drop isn't going to turn markets around overnight but the Fed's action signals that the era of really high rates may be coming to an end. There are plenty of other areas of uncertainty which could create instability going forward that might act as a brake to further cuts.

While the interest rate drop is a positive short-term sign, its implications, longer term, are yet to be understood. And different market sectors will react to this change in market conditions differently so while herd instinct is in play, care should be taken in making broad generalizations about commercial real estate markets. The problems are not solved just yet!

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