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## **The faces of uncertainty - by Bill Pastuszek**

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Appraisers, and pretty much everyone else on the planet, face conditions of unparalleled uncertainty heading into the second half of the second decade of a relatively young century.

Uncertainty, as we know, is anathema to investors. Investment decisions are predicated on the reasonable probability that an investment will perform as forecast, even if within a range. However, economic and social forces don't always exert their influence rationally or with any predictability. That's where measuring risk becomes important to understand what happens if forecasts don't materialize as modeled.

Although beset with headwinds, commercial real estate (CRE) continues to attract investment interest. But the market sectors operate under different dynamics. For all sectors, the focus will be on adaptation. Owners, brokers, investors, lenders, and appraisers will continue to meaningfully adjust to change. Again.

Change is a constant. Markets are influenced by events outside of their control. The only option is to react to change. Many individual decisions, made somewhat independently and based on individual needs and goals, make up a market.

Looking at some of the forecasts gives us some direction in terms of understanding the psychology of the CRE markets. A few examples follow.

In terms of lodging, prognosticators trend positive. However, there are concerns about ADR growth.

The office market, according to CoStar, indicates that demand for office space turned meaningfully positive at the end of 2024 for the first time since 2021. The U.S. office market shows historically low supply of completions that is expected to last for years. Office-to-residential conversions are taking place. Then there are the central business districts (CBD) locations, which markets may have a greater challenge to figure out. But no one is forecasting an immediate recovery.

Housing prices continue to ascend, but there are signs that the supply/demand imbalances may be easing. Maybe the best that can be said is that absent dramatic changes in mortgage rates, prices will level off and inventories will increase. The need for new housing, whether 1-4 unit or multi-family housing, is hamstrung by continued high rates and high material and labor costs.

Of some concern is the consumer. A CoStar article notes: "Retail sales in January fell by the largest margin in nearly two years, and consumer sentiment in February dropped to its lowest level since November 2023. Worries over tariffs and continued inflation were primary drivers in the drop. However, rising consumer debt delinquencies show some segments of the population are increasingly strained by challenging economic conditions.

Interest rates – specifically the 10-Year Treasury – need to move down further but may not in the light of persistent inflation. The Fed Funds Rate, which is the rate the Fed can control, doesn't really

have much effect on the 10-year rate, which is the rate that influences long-term instruments, such as mortgages.

Markets as a whole tend to be adaptable. Real estate tends to be slower moving than other investment classes and lacks the transparency shown in other investment classes. Thus, the impacts of external events and their influence on real estate performance may not be immediately apparent.

In the case of the COVID investment runup, the decisions made in a low interest rate and strongly competitive investor environment are coming to fruition. Some of the decisions were good, others not so good. In the office environment, external events – the work at home movement – have created difficulties.

Prevailing conditions are unsettling, unnerving, and stressful. Uncertainty is ever present: recently, it seems to come in waves, in unexpected ways. Learning to live with uncertainty and realize its unpredictability may be the best way to counter its effects in effective and timely ways.

While investors abhor uncertainty, the ability to adapt – and adapt rapidly by evaluating risk - is key going forward. And the ability may have to become nimbler as uncertainty persists. As analysts of market behavior, we have to be cognizant of its effects on markets and be able to quantify risk in evaluating those behaviors.

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