

# Seven Reasons Why Real Estate Prices Will Hold Up for Now

*But Five More Reasons Why You Should  
Sit Up Straight and Pay Close Attention*

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**A**s Rosanne Rosannadanna was fond of saying, “It’s always something.” This is why, as an economist, I find commercial real estate so fascinating—that and the personalities of those who buy, sell, build, and finance the stuff. The “something” right now is how commercial real estate prices, which one can safely characterize as frothy, will react to upticks in inflation and short-term interest rates.

This is a critical and confusing question, as much of our conventional wisdom is based on the following two “facts”: (1) Commercial real estate is an inflation hedge, and (2) supply (as opposed to demand) is the wildcard in space markets. Based on recent experience, we can toss those two pieces of conventional wisdom out the window. Commercial real estate has done just fine, thank you very much, in a non-inflationary environment. This would suggest that real estate is more of a stagnation hedge than an inflation hedge. Furthermore, as we all know, the recent weakness in fundamentals has been driven by demand—not supply. Supply has been extremely well behaved in aggregate for the last decade, even as funds have flowed at high rates from old and new capital sources. Toss in capital market integration—a butterfly flaps its wings in Russia and U.S. real estate debt markets come to a screeching halt—and you have a recipe for bewilderment.



Consequently, we cannot fall back on the conventional logic that inflation chokes off supply and is bad for “paper assets” like equities, thereby causing real estate price increases. This time around moderate inflation could very well mean a healthier macroeconomy, a stronger equities market, and higher-cost mortgage debt—probably not a good-news scenario for real estate prices.

Where do the industry gurus come out on this subject? In the articles that follow, our property sector experts are remarkably uniform in their assessments. Upticks in inflation and short rates will likely cause cap rates to increase a bit, a negative effect that will be more or less offset by better fundamentals and therefore higher cash flows. The net expected effect? Prices will hold firm in the short run and even increase in certain sectors such as hotel and industrial.

I generally agree with our experts’ assessments but with some slight differences. In the immediate term, I expect cap rates to decrease somewhat below their already aggressive levels, causing prices to continue their march upward. Then, perhaps six months from now, I am hopeful that reality sets in and there is a correction—a controlled burn, if you will—in commercial real estate markets as investors take stock of what has gone on in the past few years. However, I am far from confident that sanity will prevail, as the psychology of disappointment and desperation hangs over the market like a bad dose of Prozac. Thus, I have some serious concerns about the medium term. The stars are aligning for a real-life boom and bust in commercial real estate—an out-of-control wildfire, if you will—that threatens the long-run health of the market.

Thus, with the usual economist’s “on the one hand, but on the other hand ...” approach to things, I will now provide you with seven reasons why commercial real estate prices will hold for now, followed by five reasons why you should sit up straight and pay close attention to the market. I guess if you want to pin me down, and because seven positives are more than five negatives, I am neutral to slightly bullish on the sector for now—very much in the camp of our expert prognosticators.

### Seven Reasons Why It’s Going to Be All Right (for Now)

**Reason #1—A Fed Tilt Toward Tightening Is Already Priced Into Long Rates:** When the Federal Reserve raised short-term rates in late June, the ten-year Treasury yield actually fell. Since then, long-term rates have held steady. Why? The bond market had expected the possibility of steeper rate increases as a signal of wider-spread impending inflation. A quarter-point increase had been fully priced and actually calmed folks down. The result? Fixed-rate mortgage debt remains reasonably priced. In fact, when since 1985 has it been a better time to be a borrower, with low rates, slim spreads, and high loan-to-value (LTV) ratios? I don’t see this changing in the immediate term.

**Reason #2—The Budget Deficit Is Not a Problem—Yet:** Yes, OK, we are running a deficit again. In fact, at close to \$500 billion, it’s bigger than any in history. But as a percentage of GDP (3 percent) the deficit is not out of line with historic norms. The general consensus is that (i) bond markets can handle a deficit of this magnitude without much trouble, and (ii) increases in interest rates will in all likelihood be because the economy is firming up, not because of 1970s-style stagflation. This in turn suggests improving real estate fundamentals with moderate increases in interest rates and inflation—all in all, not too bad for real estate investors.

**Reason #3—Globalization and the Inflow of Capital from Abroad:** Although globalization certainly has its critics, the good news is that economic development and open trade have really helped keep the lid on inflation. Moreover, the United States continues to attract capital from abroad. Why? Although we are the world’s 800-pound economic gorilla, we continue to be productive, innovative, flexible, and stable. We look especially vibrant when compared to Western Europe. This means we can continue to fund our imports and deficits without too much pain.

**Reason #4—Uncertainty Overhang in the Equities Market:** The broader equities market has been in a funk. Corporate profits are up and governance is better. However, price-earnings (P/E) ratios have fallen and the market is basically going sideways. An exercise in water torture, really. Why? A whole lot of uncertainty originating from three major sources: commodities prices, terrorism, and politics. What will happen to oil and other commodity prices? How significant is the terrorism threat? Who will win the election? Those questions have created much angst, to be sure—bad news for equities, which in turn is not bad news for real estate.

**Reason #5—The Supply Side Has Been Well Behaved:** Remember supply ...? We used to obsess on it and with good reason. It has blown us out of the water more than once, and the pain it caused in the early 1990s still resonates. However, with localized exceptions, supply is well-behaved today and looks good going forward. This is largely because fundamentals have been soft. Everything could change in a heartbeat, though, if net operating incomes begin to surge and capital keeps flowing to commercial real estate.

**Reason #6—Momentum in Funds Flow:** Did I say that capital is flowing to commercial real estate? Oh—my—God (intonation like that of my 16-year-old daughter), it’s really a bit frightening. Capital is flowing from everywhere: from other countries, mom-and-pop as well as sophisticated retail investors, the commercial mortgage-backed securities (CMBS) market, pension funds. Much of this capital, especially the institutional capital, has significant momentum. Absolute return and real cash flow are highly valued today, as investors are starved for yield. Underfunded pension liabilities are a particular concern for

some institutional investors, resulting in a move up the risk curve. Allocations of more than 10 percent to commercial real estate? Considered reckless yesterday, they are becoming the norm today. Leverage? Almost unheard of yesterday, it's commonplace today. The result: No way around it—cap rate compression will continue in the immediate term.

**Reason #7—Capital Market Integration and Improved Risk Management:** I've been arguing for years that cap rate compression was coming to commercial real estate. It came in the form of higher P/E ratios to the broader equities market in the 1990s; so why not real estate? Actually, there are very good financial economic reasons for lower long-run cap rates (and they are not just related to lower interest rates). First, capital market integration has resulted in real sustained discipline, which investors have finally bought into. Discipline implies less boom and bust and therefore a lower risk premium. Second, we are now more than two generations removed from the traumatic effects of the Great Depression, with vast numbers of baby boomers headed for retirement. Translation: Less risk aversion and therefore a tolerance for lower returns (backed by real cash flow). Third, investment and hedging opportunities continue to expand through globalization and financial innovation. This implies better risk sharing and risk management, and therefore increased tolerance for "alternative" investment risks such as commercial real estate. The downside of course is that everything is increasingly interconnected, so when that butterfly flaps its wings again ...

#### Five Reasons to Sit Up Straight and Pay Close Attention

OK, a close read of the above suggests ambivalence and a slight bit of waffling. It's true, I admit it, but there are so many mixed signals in the economy that it's hard to be sure. The overall tone was positive, however. Now, let's examine the negatives. Because we have some control over our own sector, I will specifically focus on the commercial real estate market in the vain hope that people will pay attention and engage in behavior modification.

**Reason #1—Private Equity REITs:** Private equity REITs are growing like topsy, largely by attracting unsophisticated (aka dumb) retail money. They are taking huge up-front fees and moving up the risk curve to generate promised returns. A syndication-like structure, no investor control, a pyramiding investment approach ... it's beginning to look a lot like 1985.

**Preview of Reasons #2, #3, and #4:** While many of you obsess over market fundamentals, I obsess over debt markets. This is in part because the debt markets have been a huge source of discipline in commercial real estate over the past decade. And I don't like what I see. The next three items deal specifically with what is happening in commercial real estate debt markets.

**Reason #2—Mortgage Loan Underwriting Standards Have Softened Considerably:** It's a bit shocking—yes, shocking—how much mortgage underwriting standards have softened in the last year or so. LTVs are up considerably with fewer questions asked, and spreads continue to compress. A great time to be a borrower, but at what longer-term cost?

**Reason #3—The Rating Agencies Have Wimped Out:** That's a bit harsh, but hear me out. Subordination levels on CMBS are controlled, or at least influenced, by the rating agencies. Since the early 1990s the rating agencies have taken a relatively conservative approach to rating CMBS. Higher subordination levels mean more credit-risk protection for security holders and, all else equal, higher risk-adjusted returns. Investment banks have recently argued that default rates on CMBS are significantly lower than similarly rated corporate debt—in effect, that CMBS tranches should contain more risk. The rating agencies have bought into the argument, and subordination levels have declined significantly. The implication? Lower mortgage rates for borrowers (required yields have declined as well on CMBS) and greater risk to the system as a whole.

**Reason #4—New Entry Into the B-Piece CMBS Market:** A wonderful source of discipline (at least since late 1998) in commercial real estate has been the B-piece CMBS market. Because there had been only a small number of players, B-piece buyers had been able to exert big-time discipline by kicking out risky loans and otherwise pounding on conduit lenders to behave properly. Now it's the revenge of the conduit lender, as new aggressive B-piece buyers have entered the market. When combined with reasons #2 and #3 above, this new mortgage market dynamic makes me jumpy.

**Reason #5—The Psychology of Disappointment and Desperation:** Allow me to tell you a short story. Not so long ago, commercial real estate pros surveyed the market and shook their heads. Bad fundamentals together with rising prices set off alarm bells. "I remember the 1980s and early 1990s," they said, "and I vow not to repeat it." They held their ground on cap rates and lost deal after deal. It was disappointing, especially when due-diligence costs could not be recouped and cap rates continued their downward trend. Then pressure mounted to do deals as capital flowed in—have to deploy the capital for yield-hungry investors—lost a few more deals—desperation sets in—then analysis fatigue hits as the numbers didn't seem to matter anymore. The eyes glaze over and you say, what the hell, everyone else is doing it, I'd better do it too. ...

That's it, my best shot at the "something" in "it's always something." To conclude, my read is that a moderate uptick in inflation and interest rates is not bad news for commercial real estate. The bad news is that eroding discipline within the sector has taken on a life of its own. I trust you will enjoy the thoughtful and informed essays that follow. ■