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MAY 2022

Fed Hikes Rate as Expected; Real Estate Sustains Strong Fundamentals

Fed continues along established stratagem to combat inflation. On May 4 the Federal Reserve raised the Federal Funds rate by 50 basis points in the second of seven planned rate hikes for the year. Now at a target range between 0.75 percent and 1.00 percent, the effective overnight lending rate is expected to climb to the 2 percent to 3 percent zone before the start of 2023 if the Fed continues with this strategy. Numerous forces continue to put upward pressure on inflation. Global supply chains remain disrupted, with significant production shutdowns in China. Labor shortages persist, with only about half as many people looking for work as jobs open, placing upward pressure on wages. The Fed's actions are a step forward relieving these pressures by raising borrowing costs.

Factors placing pressure on cap rates. Initial yields on commercial real estate compressed substantially over the past decade as investment demand increased. Further cap rate compression is less likely, given tightening monetary policy; however, property yields will likely not adjust in tandem with interest rates. Strong underlying property fundamentals and expectations for above average rent growth will likely keep the attention of many investors, slowing any upward movement. A persistent housing shortage reflects a robust need for dwellings of all kinds, while rescinded health restrictions have lifted foot traffic for retailers and hotels. Supply chain disruptions also continue to underscore the critical roles of many industrial facilities.

Strategies adjust as margins narrow. Contracting margins between cap rates and financing costs may push some investors to recalibrate strategies or widen criteria. One place investors may look to is tertiary metros, where space demand in many markets is supported by favorable demographic projections. Last year marked an inflection point, with the population of people ages 35 to 54 beginning to expand, ending more than a decade of contraction. This age range often correlates with notable gains to income and household sizes, reinforcing a pandemic-era shift to smaller metros that are more accommodating to single-family home ownership. Local commercial properties stand to benefit from this shift.

Additional Trends:

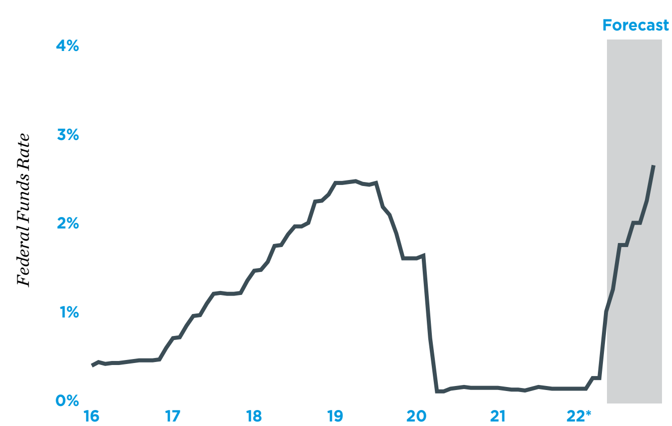
Fed reiterates quantitative tightening plans. In order to combat the economic costs of the health crisis, the Fed more than doubled its balance sheet between March 2020 and April 2022. To address this, the Federal Open Market Committee (FOMC) intends to begin reducing the central bank's holdings in June by allowing assets to mature and fall off its balance sheet. By September, the FOMC aims to reduce the Fed's assets by up to $95 billion per month. This quantitative tightening process will place additional upward pressure on long-term interest rates.

Lending rates already responding to Fed statements. By early May, the average rate for a 30-year mortgage had climbed to about 5.3 percent, up over 200 basis points from the beginning of this year. Despite a shortfall of listings relative to buyer demand, higher borrowing costs for prospective homeowners may begin to weigh on price growth in the near future. This could help relieve some of the constraints on household formation. Affecting markets more generally, the 10-year Treasury yield is also at its highest level since late 2018.

50 *Basis Point Increase in the Federal Funds Rate Target Range*

$95B *Estimated Pace of Balance Sheet Run Off by Late 2022*

Fed Continues on Aggressive Rate Hike Schedule



** Historical values through April*
Sources: IPA Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Federal Reserve; Moody's Analytics; U.S. Census Bureau