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Fed Continues to Ease Back on Rate Increases to Assess Cumulative Impact

Softening economic data warrants less-assertive rate increase. The Federal Reserve has extended its tightening cycle into 2023 by raising the federal funds rate to a lower bound of 4.50 percent. The 25-basis-point increase is nevertheless the smallest hike since March of last year, reflecting both easing inflation pressure and diminishing economic growth. Headline CPI actually dipped 0.1 percent on a monthly basis in December, for a year-over-year change of 6.5 percent. The 14-month low in consumer price escalation was joined by a dampened 2.1 percent improvement in U.S. real GDP for the year. Both data points align with the Fed's goals of tempering economic growth in order to provide price stability. To grant time to assess, the central bank will likely take a more gradual path to rate hikes going forward.

Measured adjustment lessens uncertainty. Last year's rapid series of interest rate increases, the fastest since the early 1980s, has notably hindered commercial real estate transactions. While last year started out strong, when interest rates were lower, trading velocity steadily slowed through the back half of 2022. Sales activity could improve going forward, however, if the Federal Reserve were to provide more stability on interest rates. The moderate 25-basis-point hike this month is a step in this direction. More consistent debt costs would help lenders and borrowers better determine valuations and help trades move forward.

Smaller rate hikes would bode well for the multifamily sector. One of the property types most impacted by tightening Fed policy has been multifamily. A doubling in the average sale price over the past decade has compressed cap rates to a point where the mean first-year yield on recent transactions is not much above the current federal funds rate. This unfavorable margin coincides with a correction in rental demand, following an absorption surge in 2021. A persistent housing shortage nevertheless positions apartments as a growing part of the nation's housing continuum, keeping investors focused on the asset class. Less upward velocity from an interest rate standpoint would go a long way toward allowing trades to move forward, even at higher debt costs.

Inflation and GDP Insights

Moderating inflation still above target. While price increases entered a deceleration trend in late 2022, much of that was due to falling fuel costs. Excluding the more volatile energy category along with food, the core CPI measure increased 5.7 percent in 2022, down only modestly from a September 2022 peak pace of 6.7 percent. Paired with a slower correction in core inflation is a stubbornly tight labor market, with unemployment falling to a 53-year low of 3.4 percent in January. While the labor market is softening in certain fields, the Fed anticipates unemployment gains will be necessary before it ceases rate hikes.

GDP trends signal softer macroeconomic trajectory. While the economy grew in 2022, it was by a smaller margin than the year before. Recent data reveals a downturn in exports, consumer spending and certain investments since the third quarter, reflecting the impacts of a stronger dollar, elevated inflation and higher debt costs on overall activity. If GDP were to decline in the opening period of 2023, it could send a strong signal to the Fed to further slow its pace of tightening.

4.50%

Lower Bound of
Federal Funds Target

2.1%

U.S. GDP Growth
in 2022

GDP & Core Inflation Both Trending Down

