SPECIAL REPORT

Interest Rate Outlook

IPA | INSTITUTIONAL PROPERTY ADVISORS

MAY 2025

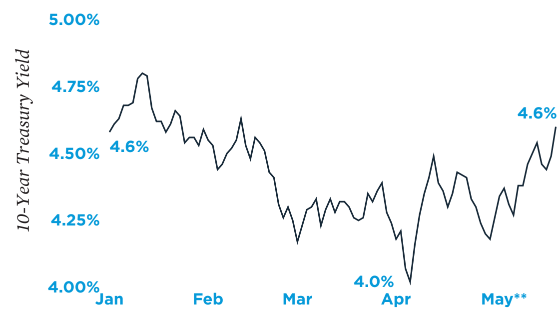
Potential Interest Rate Rise Prompts Investors to Recalibrate Strategies

Deficit surge and policy uncertainty amplify upward rate trajectory. Interest rate risk remains tilted to the upside as investors contend with a convergence of structural and policy-driven pressures. Chief among them are rising fiscal deficits and elevated uncertainty around U.S. trade policy. The Congressional Budget Office already projects the deficit to total $21 trillion over 2025—2034. If every temporary tax cut in the House bill is kept on the books, BudgetLab estimates the deficit would rise by another $5 trillion, pushing the 10-year total to about $26 trillion. While tariff revenue could shave roughly $2.5 trillion off this amount, the trajectory will still require a substantial increase in new Treasury issuance. At the same time, tariff-driven shifts in trade policy have added volatility to global supply chains and raised concerns about inflationary pressures. Combined, these dynamics elevate the likelihood of higher long-term interest rates, as investors demand higher yields for fiscal and policy uncertainty.

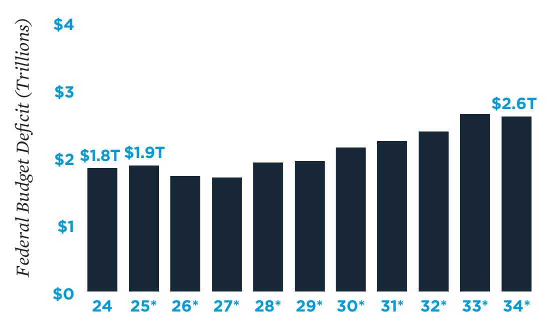
Reduced buyer participation complicates Treasury funding. The expanding federal deficit will necessitate increased Treasury issuance at a time when key buyers have pulled back, which could lower treasury prices and push yields higher. As of midyear, the Treasury Department had issued roughly $550 billion in new debt, with another $1.4 trillion expected by year-end. Yet the Federal Reserve continues to shrink its balance sheet, letting about $5 billion in Treasuries to roll off monthly. Meanwhile, major foreign holders — particularly China and Japan — have cut their exposure. China's holdings have declined from $1.3 trillion in 2013 to $765 billion as of April 2025. Japan's position has fallen by more than $200 billion since 2021. The scaled-back purchasing from traditional Treasury buyers raises concerns about the capacity to absorb the forthcoming supply. Moody's recent downgrade of U.S. credit may further hinder foreign capital flows, exacerbating an imbalance between rising supply and weakened demand that is likely to place upward pressure on the yield curve.

Inflation risk caps potential for a rate cut. Fueling the possibility of higher interest rates is the uncertain inflation outlook, which will be made worse if tariffs on imports begin to lift consumer prices. If inflation expectations start to rise, the Federal Reserve may be less inclined to cut interest rates, especially in the absence of clear weakening in the labor market. While futures markets keep pricing in rate cuts later this year, policymakers are likely to stay focused on persistent inflation risk if employment conditions hold steady. Even if the Fed begins easing, changes to the overnight rate do not directly pass through to longer-term yields. Amid broad-based uncertainty and growing structural imbalances, longer-term interest rates are expected to remain elevated, though the path of rates is still susceptible to policy shifts and investor sentiment.

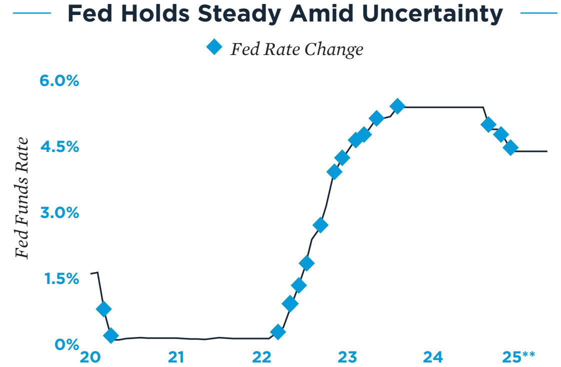
U.S. 10-Year Yield Movement in 2025



U.S. Deficit Expected To Increase



Fed Holds Steady Amid Uncertainty



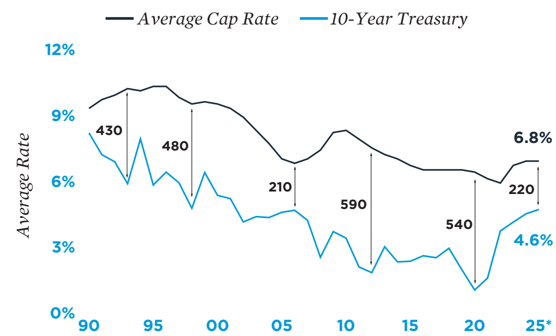
* Forecast
**Through May 20

Compressed Spreads Support Divestment; Elevated Rates Accelerate Strategic Buying

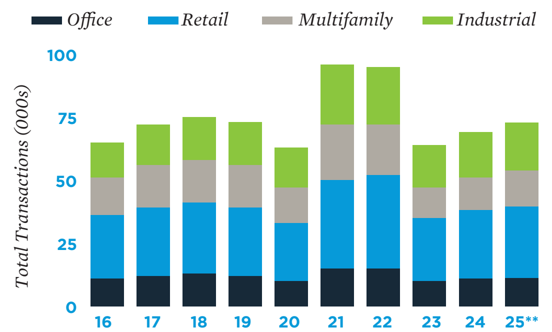
Tight spread aids dispositions. During a period of rising interest rates, sellers may face a narrowing window of opportunity. The 10-year Treasury yield has held between 4 percent and 5 percent so far this year, but a move above 5 percent would further elevate borrowing costs and strain financing conditions. This dynamic may push cap rates higher, placing downward pressure on asset valuations. Though the relationship between interest rates and cap rates is not perfectly correlated, the broader trend often results in repricing — especially for older assets with weaker cash flows or more limited upside. For owners considering selling, acting sooner may mitigate the risk of market softening. Doing this will also allow them to lock in pricing before buyers reprice risk. The spread between cap rates and the 10-year Treasury remains historically tight, enabling sellers to exit while buyers continue to underwrite deals at relatively aggressive valuations. The longer rates remain elevated — or move higher — the more likely it is that buyer pools will thin or demand greater discounts.

Investors lock in debt as development pipeline thins. Against a backdrop of higher interest rates, buyers may benefit from locking in financing now rather than waiting for price adjustments that may not fully materialize. Many investors have already delayed acquisitions for the better part of two years. Continued hesitation could mean missing opportunities to acquire well-located properties that have strong upside potential. With elevated rates likely to persist, buyers may focus on deal structure and value creation — whether through asset repositioning, operational improvements or targeted leasing strategies. Generating returns through active management will likely be essential. At the same time, a pullback in construction is expected to help property fundamentals improve over the coming years, creating a favorable backdrop for investors with long-term investment horizons. As development slows across most property types, many markets are better positioned to deliver strong performance. Assets with secular demand tailwinds, such as industrial and multifamily, may stand out. Acquiring properties ahead of a broader recovery could position investors for sustained income growth and value appreciation potential as market conditions strengthen.

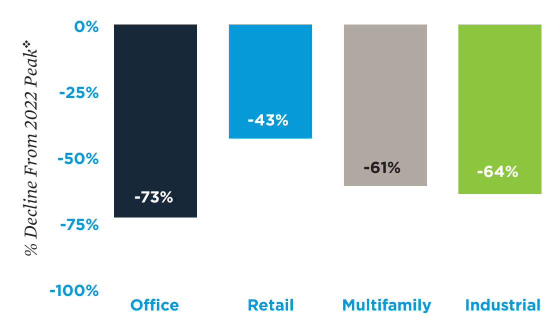
Average Cap Rate vs. Treasury



Total Transaction Trends



Construction Starts Decline From Peak



*Through May 21
**Trailing 12-month transactions as of Q1 2025
❖Trailing 12-month construction starts as of Q1 2025

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