Commercial Real Estate Debt

End of the Road for Growth

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Investors face headwinds as market forces conspire to end the property price appreciation trend.

Commercial real estate prices now stand 26 percent above their prior peak in 2007, but rising interest rates, increasing operating costs, and less robust revenue growth may slow the pace of growth in both prices and net operating income (NOI). For the past six years, the spread between the 10-year Treasury yield and cap rates has provided attractive returns to investors, but since the third quarter of 2016, Treasury rates have risen while cap rates have declined (see chart, top right). This has squeezed investors as the cost of debt has increased due to rising rates, but their return over the 10-year Treasury has compressed. In addition, decelerating growth in NOI in all property types other than industrial over the last two years indicates that we may be at a tipping point in values. Investors are adjusting their risk/return objectives by increasing cap rates on new purchases. Evidence of this can be found in quarterly cap rates, which dipped slightly at the end of the first half of 2018 (see chart, bottom right).

Adding to these concerns, especially for new construction and typical tenant improvement projects, is the rising cost of steel, wood, and aluminum due to ongoing trade disputes with China and Canada. Owners will try to pass on these higher prices to tenants, but nevertheless they will likely see their returns negatively affected. Increased construction costs and higher debt costs could also stifle new development projects over the next two years, which would contribute to the slowdown in the economy that our Macroeconomic and Investment Research Group expects to occur in 2020.

Capital supply has remained well above demand, and we do not see that changing for the remainder of the year. We anticipate a strong fourth quarter for originations for banks, life companies, and Agency lenders. With the recent rise in short-term rates, we see value in five- to seven-year terms in both floating and fixed-rate products. While the bridge market is dominated by private lenders, we are finding conservative borrowers with reasonable debt requests who are willing to pay a yield premium for prepayment flexibility and future proceeds at a fixed interest rate.

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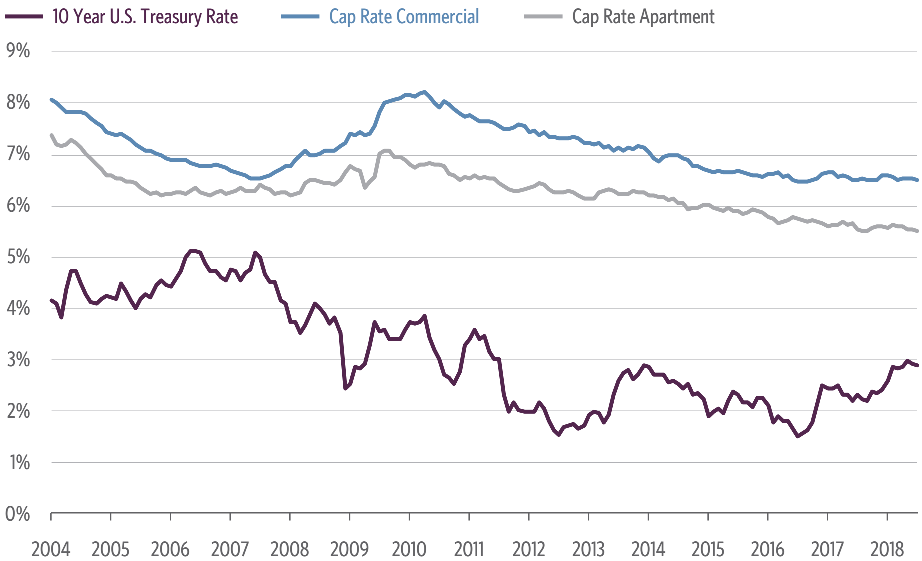
Cap Rates Declined Even as Treasury Yields Rose

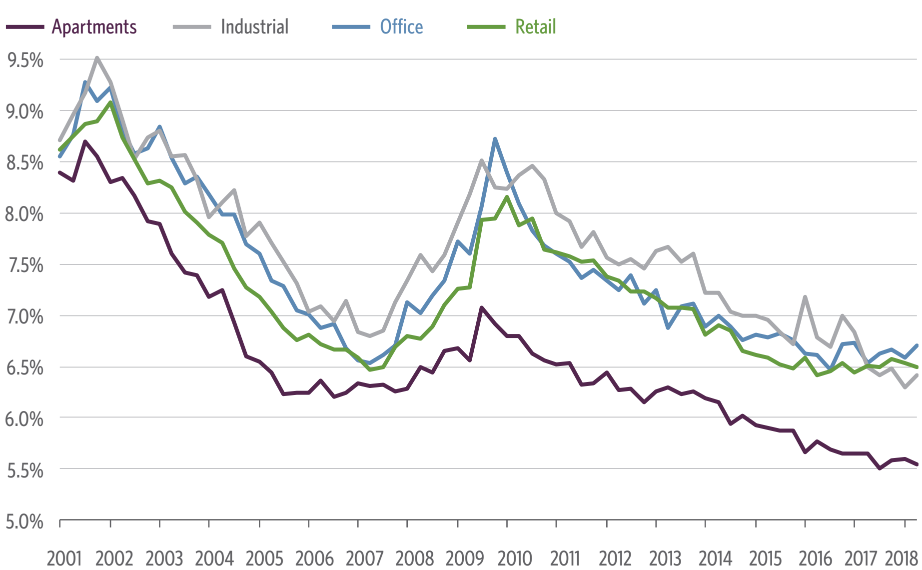


Source: Real Capital Analytics, Federal Reserve, Guggenheim Investments. Data as of 9.30.2018.

For the past six years, the spread between the 10-year Treasury yield and CRE cap rates has provided attractive returns to investors, but since the third quarter of 2016, value has diminished as the spread has narrowed.

Investors Increased Cap Rates on New Purchases

Quarterly Cap Rates by Property Type



Source: Real Capital Analytics, Federal Reserve, Guggenheim Investments. Data as of 6.30.2018.

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