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Higher Cap Rates, Lower Property Values Not a Foregone Outcome from Interest Rate Hike

Rate Rise Driven by Growing Economy, Strong Real Estate Demand

By **Mark Heschmeyer** March 15, 2017

With the quarter-point interest rate hike a done deal as of today, the Federal Reserve is signaling that the US economy is another step closer to full health after its slow recovery from the depths of the Great Recession.

In addition, today's rate increase is not expected to be the last we see this year. Many observers are expecting at least two more quarter-point raises before the end of 2017.

Rising interest rates particularly impact the real estate sector, from home buyers to REIT investors.

And many investors believe higher interest rates automatically translate into higher capitalization rates and lower property values. But new research from TH Real Estate, a division of pension fund investment manager TIAA Global Asset Management, calls into question a direct link between the two.

In fact, the report finds that rising interest rates have not automatically resulted in lower real estate values or total returns as many investors assume.

In analyzing earlier periods of rising treasury yields, the TH Real Estate report found a very low correlation between higher interest rates and lower real estate values, to the point that it contends no relationship could be found.

For instance, between the first quarter of 2003 and the second quarter of 2006, when yields rose from just under 4% to just under 5%, total returns averaged 15.4%, including 7.8% capital appreciation, according to TH Real Estate.

In a similar period several years earlier, between fourth quarter 1998 and first quarter 2001, yields rose from 4.66% to 6.47%, and total returns averaged 11.7%, including 3.1% capital appreciation.

"Interest rates and capitalization rates are believed to move in lockstep, with higher interest rates quickly translating into higher capitalization rates and lower property values," said Tom Park, TH Real Estate, Strategy & Research for North America. “That is not necessarily the case. If interest rates are rising because of stronger economic growth, as is currently the case, real estate demand will also likely be growing.”

Also, if interest rates increase gradually, and remain at, or below, long-term averages as many economists expect, real estate would likely be well positioned to benefit in such an environment, Park added.

TH’s report acknowledges that the relationship between interest rates and property values is complex, and property values reflect many other variables, including prospects for economic growth and real estate fundamentals, such as NOI growth.

Meanwhile, TH is projecting total returns for real estate to decline in 2017 and 2018, with lower capital appreciation due to surge in property values since 2009, and the late stage of the current real estate cycle.

"Political change, rising interest rates, and elevated valuations are just some of the headwinds we see facing the real estate industry in 2017," said Chris McGibbon, TH Real Estate, head of Americas. "Hopefully, interest rates will increase gradually, providing the market with time to adapt."

Real estate's sensitivity to interest rate movements will be tempered by NOI growth from stronger tenant demand and continued favorable supply/demand fundamentals," added McGibbon.