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*Research*

# It's the economy, stupid!

## Current real estate valuations are being stretched by a precipitous rise in interest rates, but the economy has an equally important role in what follows

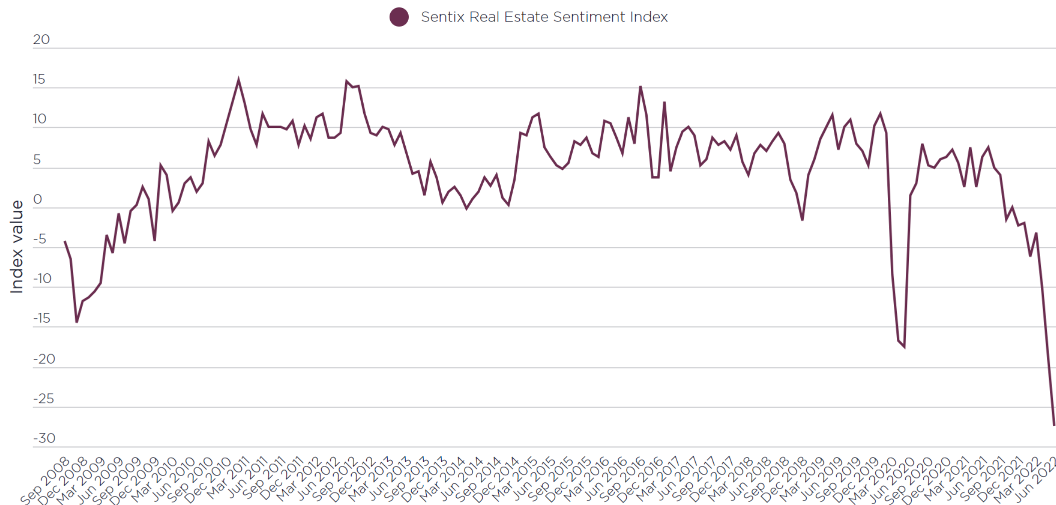
After the storm...comes another storm. It certainly feels that way for the global economy at the moment. First we had an inflation shock, underpinned by a mismatch in the pace of the post-pandemic recovery in global demand and supply, and subsequently reinforced by surging commodity prices after Russia invaded Ukraine. Then we experienced an interest rate shock, as global central banks belatedly hiked rates in response to pervasive inflationary pressures, leading to a sharp tightening in global financial conditions.

Now, the realisation that the economy cannot easily withstand the combination of higher inflation and higher interest rates has prompted increased concerns of a growth shock, with the probability of recession rising. The combination of all three factors represents a perfect storm for commercial real estate, so it's no surprise that sentiment amongst investors has dampened in recent months.

In times of heightened volatility, investors in private markets typically adopt a 'wait and see' approach. Timing is always crucial when buying real estate, but even more so during periods of flux.

This is evident in the data for commercial real estate; figures from MSCI Real Capital Analytics suggest the volume of transactions globally declined by more than 25% year-on-year in the second quarter of this year. Given that a typical transaction can take many months to complete, these figures almost certainly overestimate the amount of liquidity around ready to meet vendor's aspirations for new assets coming to market. With less transactions, there is less visibility on the value of existing assets (which are often benchmarked on other transactions using a 'mark to market' approach), potentially reinforcing the downward spiral.

**Sentiment amongst global real estate investors has dampened in recent months**




***Source:*** *Savills Research using Macrobond data.*

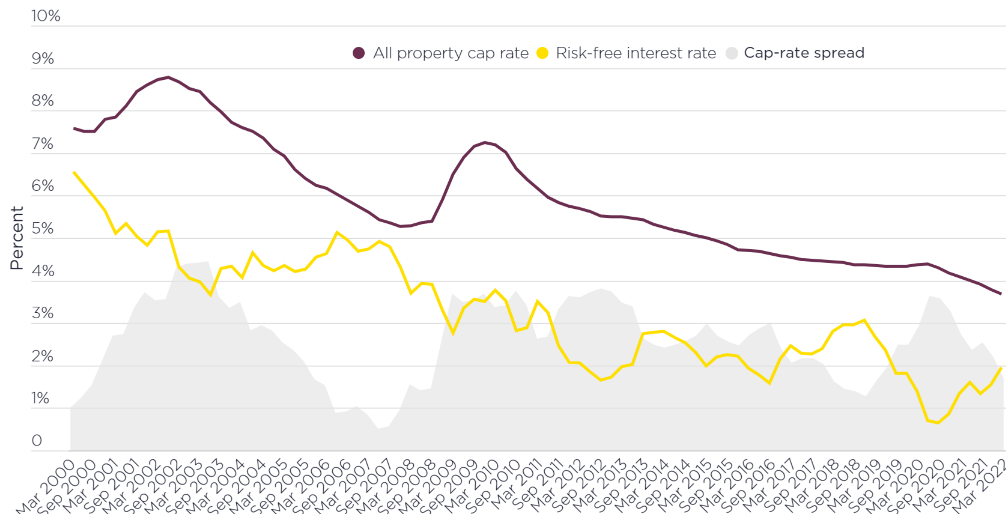
Commercial property prices are typically expressed using the capitalisation rate (cap rate). Without muddying the water, the cap rate is the ratio of annual income received (i.e., rent) to the value of the asset itself, expressed as a percentage. It is broadly comparable to the yield on a fixed income product, such as a government bond, or the price-to-earnings ratio of equities. Over the long term, cap rates broadly track changes in interest rates, reflecting the influence of the prevailing cost of debt.

In the short term however, this relationship is less obvious. In the UK for example, the correlation coefficient between the all property cap rate and the 10 year government bond yield (the 'risk-free interest rate'), going back to 1988, is around 0.4 to 0.5, suggesting a reasonable amount of co-movement between the two. However, the correlation coefficient falls sharply, and even turns slightly negative, when considering a rolling 1, 3, or even 5-year average. This is indicative of the presence of a shorter-term investment cycle, driven by factors other than interest rates.

In order to explore some of the drivers of this investment cycle, we subtract the risk-free interest rate from the all property cap rate, and explore the relationship between the residual ('cap-rate spread') and a variety of economic and financial market indicators. Our analysis identifies seven key indicators that exhibit a strong correlation with this cap-rate spread. While we use US data, the conclusions have a wider application (see methodology for details).

First, we include variables related to the strength of the real economy: GDP growth, the unemployment rate, and capacity utilisation in the industrial sector. These variables underpin a key component of the valuation narrative: occupier demand. Occupiers require more space to expand during periods of strong economic growth, which given inelastic supply, puts upward pressure on rents. The correlation with GDP growth was strongest with a 12 month lag. Logically this makes sense; the real estate sector is slow moving and often lags the business cycle (the unemployment rate is in and of itself a lagging economic indicator).

**US cap rates have fallen in line with the risk-free interest rate**




***Source:*** *Savills Research using MSCI Real Capital Analytics and Macrobond data.*
***Note:*** *The risk-free interest rate is taken to be the 10-year US Treasury yield.*

The remaining four indicators – credit growth, equity markets, corporate bond spreads, and consumer confidence – capture other factors that would be expected to drive valuations; credit conditions and sentiment. The majority of commercial real estate transactions are financed with some component of debt, usually in a bid to boost returns by leveraging the difference between interest rates and yields. Credit conditions, which encapsulate trends in both supply and demand for debt, will therefore impact transaction volumes. This is captured explicitly through data on the growth in credit to the economy, but also implicitly through equity markets and the spread of corporate bonds to US treasuries (both variables, which are lagged by 12 months, will proxy the willingness of lenders to extend credit). These latter two indicators also reflect trends in investor preferences towards riskier assets, which in addition to consumer confidence, capture the wider sentiment based drivers of valuations. See charts on following page.

Using our set of seven indicators, the final step is to draw some conclusions on the direction of travel for valuations. If just reviewing interest rates, the outlook appears bleak. Bond yields are high in comparison with the period following the global financial crisis; a rapid tightening in monetary policy in the US has underpinned an increase in Treasury yields of around 150bps in the last 12 months alone.

But in the wider context, our economic and financial market indicators suggest a more mixed outlook. While investor sentiment and attitudes towards risky assets have deteriorated sharply, given the rapid rise in interest rates, the labour market is very strong, and economic activity has held up reasonably well despite the many headwinds. This is consistent with the recent strength in occupier demand seen across many markets in the first half of 2022.

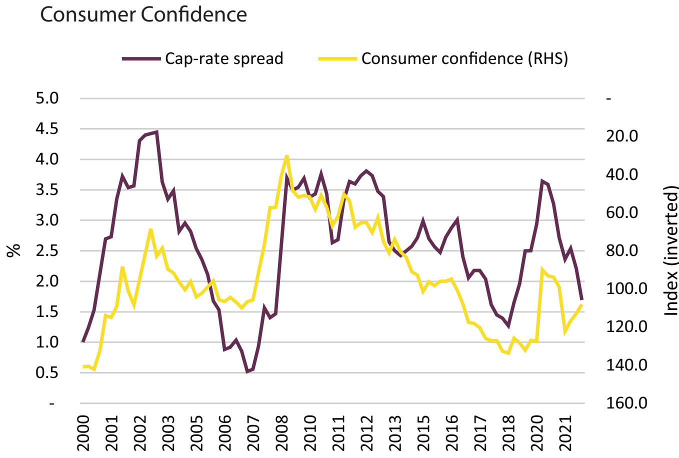
Looking ahead, the economic outlook is deteriorating however. According to their latest projections, the IMF forecast US economic growth to slow to 1.0% in 2023 and 1.2% in 2024 (down from 2.3% in 2022), with the unemployment rate expected to rise to 5.2% by 2024. But if central banks achieve the holy grail of bringing inflation down and achieving a soft landing, our cyclical drivers of valuations could yet offset some of the negative impulse of higher interest rates. ‘The economy, stupid’ was a phrase coined by Bill Clinton’s strategists, to emphasise the importance of his economic agenda to campaigners ahead of the 1992 presidential elections. Commercial property investors would be wise to adopt a similar philosophy.

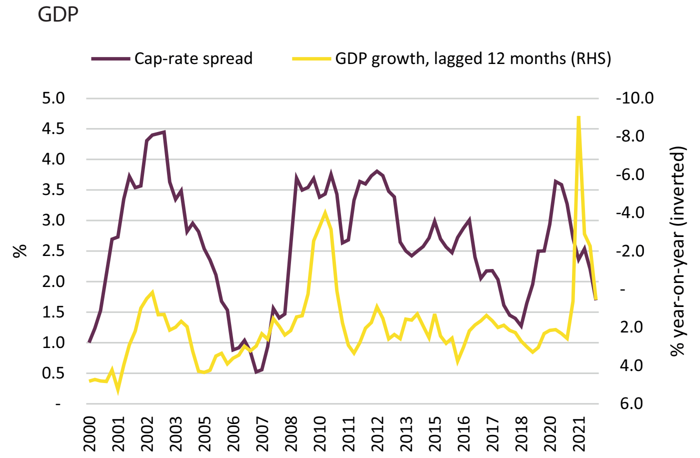
**Impact of key economic indicators on US cap rates**

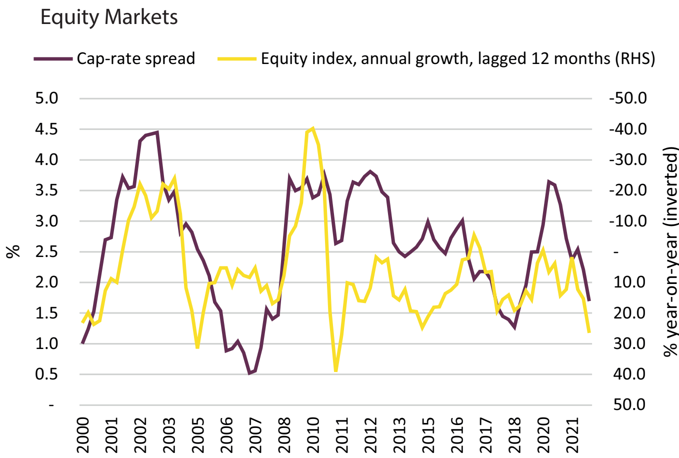
| | Impact on cap rate direction of travel |
|---|---|
| Interest rates, 10 year treasury yield | |
| Capacity utilisation, industrial sector | |
| Unemployment rate, 16 years and over | |
| Gross Domestic Product, annual growth, lagged 12 months | |
| Credit growth, nonfinancial sector | |
| Consumer confidence, Conference board, Index | |
| BBB corporate bond spreads relative to US Treasury yield, lagged 12 months | |
| Equity index, S&P 500, annual growth, lagged 12 months | |

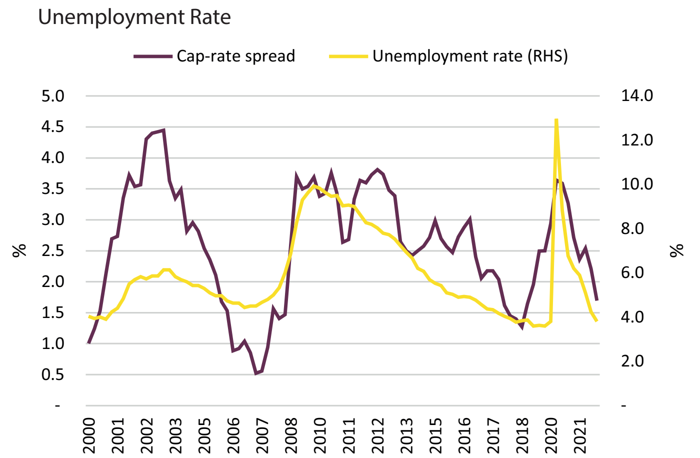
***Source:*** *Savills Research using MSCI and Macrobond data.*
***Note:*** *Shading represents the performance of recent data relative to the historical average, using Z-scores, from green (positive) to red (negative).*

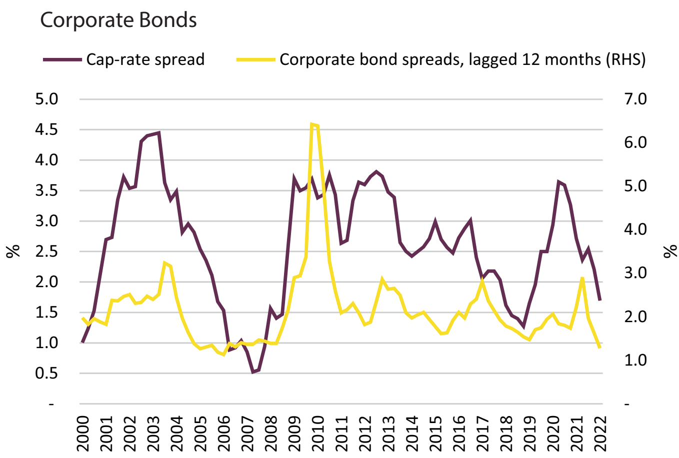
## US cap-rate spread and selected economic/financial indicators

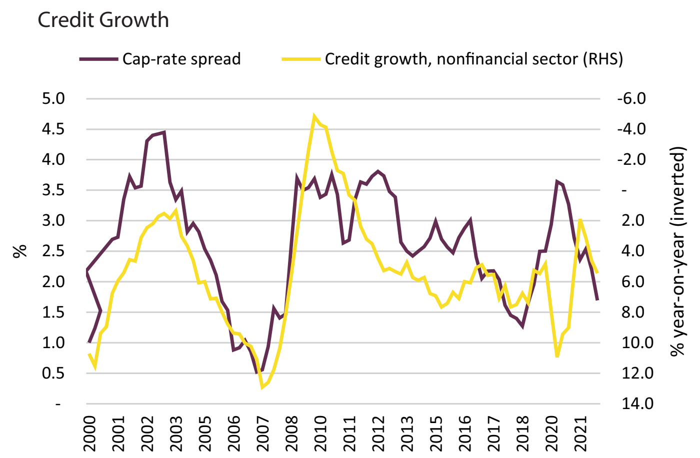


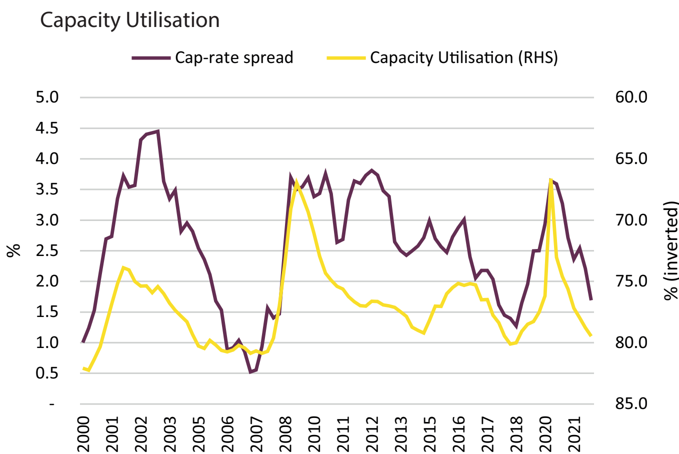



## Methodology

Capitalisation rates (cap rates) are often modelled as a combination of three distinct components:

- The 'risk-free interest rate,' typically benchmarked using the yield on a 10-year government bond, representing the minimum expected return for investors, or the opportunity cost to investing in real estate;
- A risk premium, to compensate investors for the additional risk of buying an illiquid asset (sometimes referred to as an 'illiquidity premium'); and
- Expectations of income growth in the future, which is inversely related to the cap rate, as stronger future rental growth would boost capital values now and therefore lead to cap rate compression.

$$\text{Cap rate} = i + rp - y$$

**Where i = risk-free interest rate, rp = risk premium, and y = expected income growth**

There is an argument that the risk premium has fallen over time, particularly during the period following the post global financial crisis, as commercial real estate as an asset class has permeated through more traditional investment philosophies. But if we assume that this is not the case, by subtracting the risk-free interest rate from the cap rate, we can isolate the impact of other drivers on property valuations i.e., the variation in the spread between the cap rate and the risk-free rate (the 'cap-rate spread'), which assuming a fixed risk premium, is driven by expectations of future income growth.

This was done by reviewing both contemporaneous and lagged correlations between the cap-rate spread and a range of economic and financial market indicators. We use the US market for this analysis given it is the largest and most liquid real estate market, and given the plethora of publicly available economic data. Final indicators were selected based on their high correlation with the cap-rate spread (with correlation coefficients ranging from 0.5 to 0.8), as well as the logic behind their inclusion in the analysis.

**Research**

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