EYEING RETURNS

WORDS **OLIVER SALMON**

Interest rate rises may be nearing their peak, but where they settle will have long-term implications for real estate investors across the world

Most major economies, with the exception of China and Japan, have seen interest rates rise sharply over the past 18 months after more than a decade of being at rock bottom. This has had a knock-on effect on the pricing of many financial assets, including commercial real estate.

This current cycle of monetary tightening and interest rate rises appears to becoming to an end. However, the question now for property investors isn't how high interest rates may go in the short term, but where rates will settle in the longer term.

Risk-free returns and the cap rate

The pricing of many financial assets is underpinned by the notional "risk-free" rate of return that investors would get if they held long-term government bonds. These are deemed risk-free because most governments won't default on this debt, so investors can be confident of getting the promised return. There is clearly more risk investing in other assets, such as commercial property, which means investors will want a higher return to compensate them for the risk they are taking. As interest rates increase and government bond yields rise with them, riskier assets can begin to look less attractive to investors.

Commercial property prices are typically expressed in terms of a capitalisation rate, or cap rate – the net income divided by the market value of the asset. The historical correlation between interest rates and this cap rate has focused real estate investors' minds. They are keeping a keen eye on the potential future direction of interest rates as an indication of expected yields on property holdings.

Where next for interest rates?

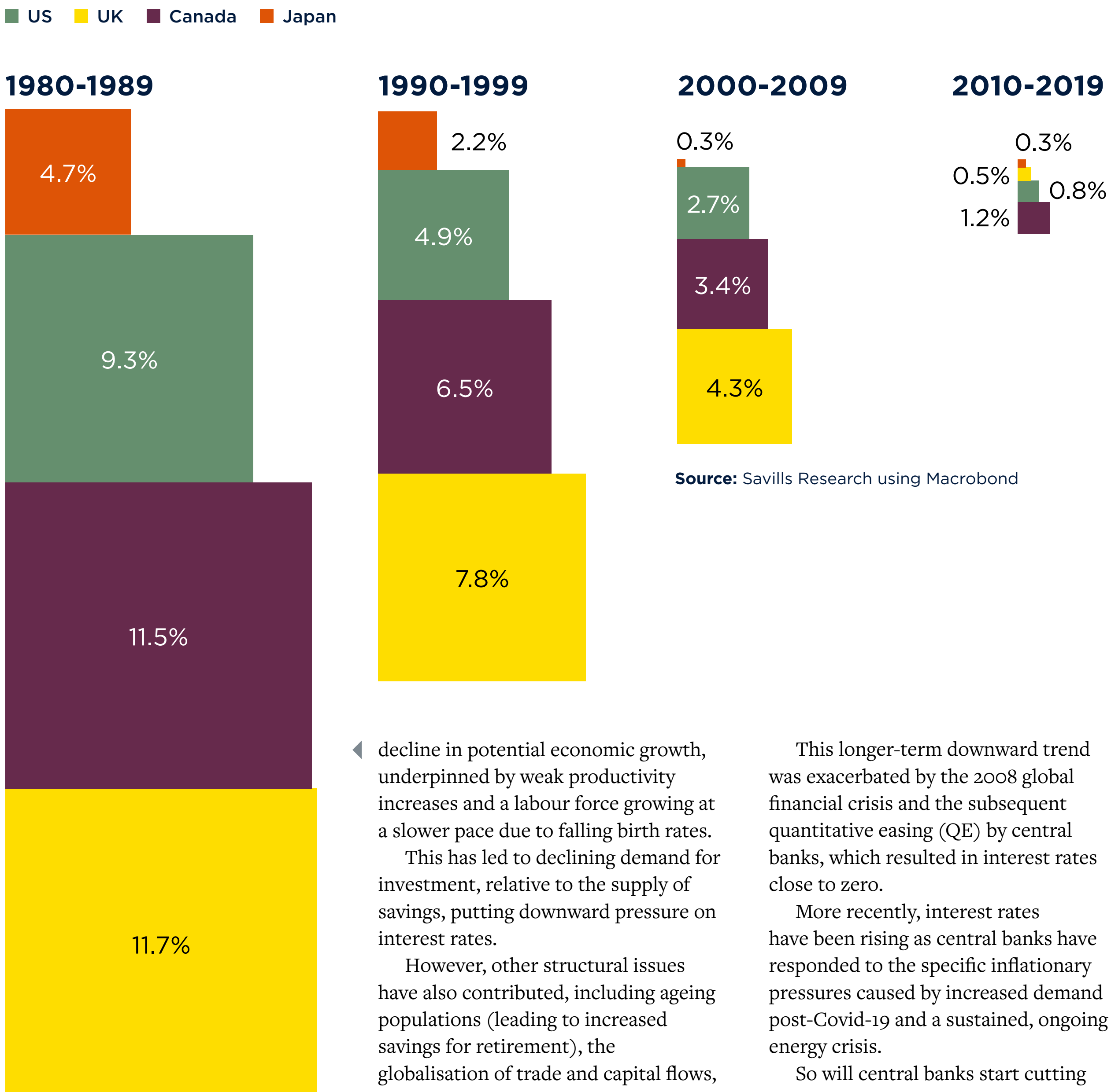
In the past four decades, interest rates across advanced economies have been trending lower, as the graph overleaf shows.

These reductions have been driven by a

SHUTTERSTOCK

...IN AN UNCERTAIN INTEREST RATE ENVIRONMENT

CENTRAL BANK AVERAGE POLICY RATES



Source: Savills Research using Macrobond

decline in potential economic growth, underpinned by weak productivity increases and a labour force growing at a slower pace due to falling birth rates.

This has led to declining demand for investment, relative to the supply of savings, putting downward pressure on interest rates.

However, other structural issues have also contributed, including ageing populations (leading to increased savings for retirement), the globalisation of trade and capital flows, and the transition to service-based economies that are less capital-intensive than goods-based economies.

This longer-term downward trend was exacerbated by the 2008 global financial crisis and the subsequent quantitative easing (QE) by central banks, which resulted in interest rates close to zero.

More recently, interest rates have been rising as central banks have responded to the specific inflationary pressures caused by increased demand post-Covid-19 and a sustained, ongoing energy crisis.

So will central banks start cutting rates sooner rather than later? Or will rates need to stay higher? Here is a summary of the main arguments.

IN THE PAST FOUR DECADES, INTEREST RATES ACROSS ADVANCED ECONOMIES HAVE BEEN TRENDING LOWER

Arguments for lower interest rates

- A continued shrinking in the labour force, coupled with weak productivity growth.
- No significant change to supply issues around savings, given an ageing global population, rising household incomes (particularly in emerging markets) and diminishing risk appetite.

Arguments for higher rates

- Stronger productivity growth emerging from greater use of technology. This could lead to increased demand for investment.
- The transition to net zero. Addressing climate change will require significant new investment.
- Higher public debt. This implies an increase in demand for capital from governments that want to spend more.
- QE is now unwinding, and many households and private businesses are in a much healthier financial position now than they were back in 2008, which could support future demand.

Secular stagnation

Looking at these arguments, we believe that demographic change is likely to be the most dominant factor, suggesting a lower "neutral" interest rate and return to a period of "secular stagnation". However, some arguments for higher rates hold water. The end of QE and the transition towards net zero are likely to act as counterweights, for example, meaning the neutral rate is not as low as it has been for much of the past decade.

However, this return to the "normal" is unlikely to happen quickly. While there are some positive signs that inflation has peaked, central banks continue to err on the side of caution with concerns about a return to the "Great Inflation" of the 1970s.

Normally, it can take up to two years for the full effects of a change in monetary policy rates to feed through to economic growth. But there is an argument that the economy is less interest rate sensitive than it was in the past, with far more borrowed on fixed-rate mortgages and loans, for example. As a result, we expect a very gradual transition.

What does this mean for property investors?

Cap rates have to a degree mirrored the rise in interest rates over the past 18 months.

But this move has been relatively small in comparison and has made most commercial property a less attractive asset class for investors, relative to risk-free assets like government bonds.

In the short term, the longer interest rates remain above the neutral rate, the more likely it is that property yields will continue to rise. But if rates come down relatively quickly, prices may stabilise.

In the longer term, a permanently higher interest rate will force many investors to deleverage. There has been a lot of talk about refinancing risk in commercial property following the sharp rise in interest rates over the past 18 months. In practice, the level of distress that some anticipated hasn't yet materialised.

Instead, many investors can temporarily withstand high interest rates, either because they were already on a fixed deal or because lenders anticipating a return of the low-rate environment have found creative solutions to avoid short-term defaults.

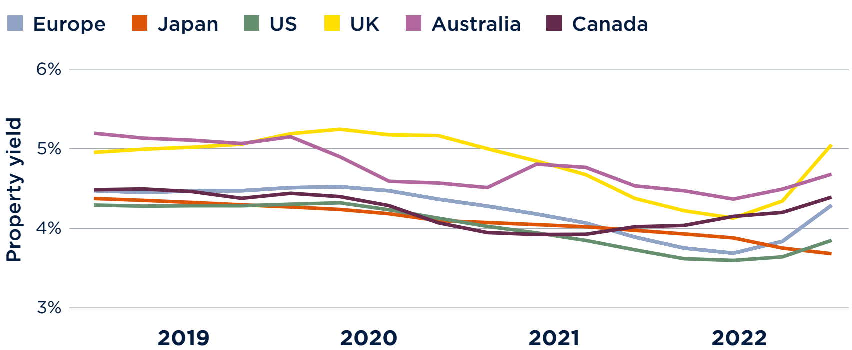
But if rates now settle at a much higher level than we've seen for the past decade, debt servicing costs will remain permanently high. This will mean higher refinancing costs, or selling unprofitable buildings, potentially at discounts.

A return to a low interest rate environment, even if it is not as low as before the Covid-19 pandemic, will alleviate some of these concerns. But investors may need to revise their expectations on the returns available through commercial real estate nevertheless, as there is an expectation that risk premiums are likely to be lower in the future than over the past decade.

Real estate has become a more "vanilla" asset class: institutions are allocating more money to it and there is more liquidity/transparency in trading. Therefore, investors will need to generate income growth to counter low-entry yields and tight risk premiums.

In turn, strong income growth is going to be more difficult in a low-growth secular stagnation scenario. ■

PROPERTY YIELDS IN DIFFERENT COUNTRIES AND REGIONS



Source: Savills Research using MSCI