



The long and winding road of cap rates - by John Rynne

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John Rynne

In 1970 the Beatles released their last album together; "Let It Be". On that album was a classic song; "The Long and Winding Road". This memorable song also was released as a single and became the Beatles' 20th number one single. Shortly after, the Beatles broke-up. While thinking about overall capitalization rates which I do very often, this song came to mind. In a way "The Long and Winding Road" describes the journey of overall capitalization rates over the past 50 years. The 10-year treasuries at the time were 350 basis points over the current 2023 treasuries. In the early 1970's, my recollection was many cap rates at least in upstate New York, centered around 10%. This changed dramatically in the 1980's because of the Economic Recovery Tax Act of 1981 (ERTA 1981) which gave real estate some massive benefits in regards to accelerated depreciation, tax credits, etc. In conjunction with that, interest rates decreased massively after 1981 which resulted in some of the lowest cap rates in decades until 40 years later. Cap rates were in the general vicinity of 8-9% or 100-200 basis points lower than the 1970's.

The low 1980's cap rates escalated later in that decade because of the Tax Reform Act of 1986 (TRA-1986) which moderated substantially some of the benefits of ERTA-1981. Interest rates also started to escalate in the late 1980's. In the early 1990's interest rates began to fall significantly which was good for the residential market. However, because of the hangover from the "savings and loan" debacle of the late 1980's and early 1990's there was a substantial lending slow down for non-residential and large residential development loans due to perceived oversupply. Every lender had intense scrutiny of their portfolios by government agencies like the Resolute Trust Corporation (RTC), FDIC, etc whose actions put a damper on commercial property lending until late in the 1990's. At that point, Federal Reserve actions put downward pressure on interest rates which resulted in lower cap rates. As an example, average Class A office overall cap rates trended from 9.5% to 8.9%.

After Y2K in 2000 and the 911 tragedy, interest rates decreased substantially due to actions of the Federal Reserve. Also, during George W. Bush's administration there were tax cuts, tax credits, etc. which helped lower cap rates. Of course, at the end of his administration, the near collapse of our banking system due to the massive default of the high risk residential securities loan packages occurred. This resulted in one of the deepest recessions in American history which increased cap rates substantially due to the withdrawal of lending sources. However, during President Obama's administration Federal Reserve policy produced a low-interest atmosphere which extended throughout the Trump administration and the first 1.5 years of the Biden administration. These were some of the lowest interest rates in modern history. Because of high inflation due to President Biden's policies and lingering COVID effects, the Federal Reserve actions increased mortgage rates by almost 300-350 basis points. However, overall cap rates on this long and winding road increased at a much lower level. The current 10-year treasuries are at almost 50-75 basis points higher than the end of the first quarter of 2023 but the increase to overall cap rates is much lower. This is

consistent with long-term history. There have been big swings in the 10-year treasuries by as much as 1,100 basis points in the last 50 years. Yet cap rate swings over that same period are only a fraction of that.

The 2nd quarter 2023 Rynne, Murphy & Associates Inc. (RMA) rate survey stated the average Class A Office overall cap rate was 7.75%. In the 4th quarter of 2021 before the big increase in interest rates, the overall cap rate was 7%. This represents a 75 basis point increase. During that same time period there was a 224 basis point increase in the 10-year treasury which translates to 33.48% ($75/224$) relationship between overall cap rates and the 10-year treasuries. This is much less than a one-to-one ratio. This is further borne out by comparing the average Class A overall cap rate in May, 1994 (9.5%) to the second quarter of 2023 (7.75%) which is a 175 basis point difference. At the same time the 10-year treasuries were 7.09% and 3.69% respectively or a 333 basis point difference. The ratio being 52.55%; well below a one to one ratio. In summary, "The Long And Winding Road" of overall cap rates does not have many sharp turns. Check out the 2nd Quarter, 2023 RMA Rate Survey at rynnemurphy.com which covers most of Upstate New York & Western/Central New England.

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