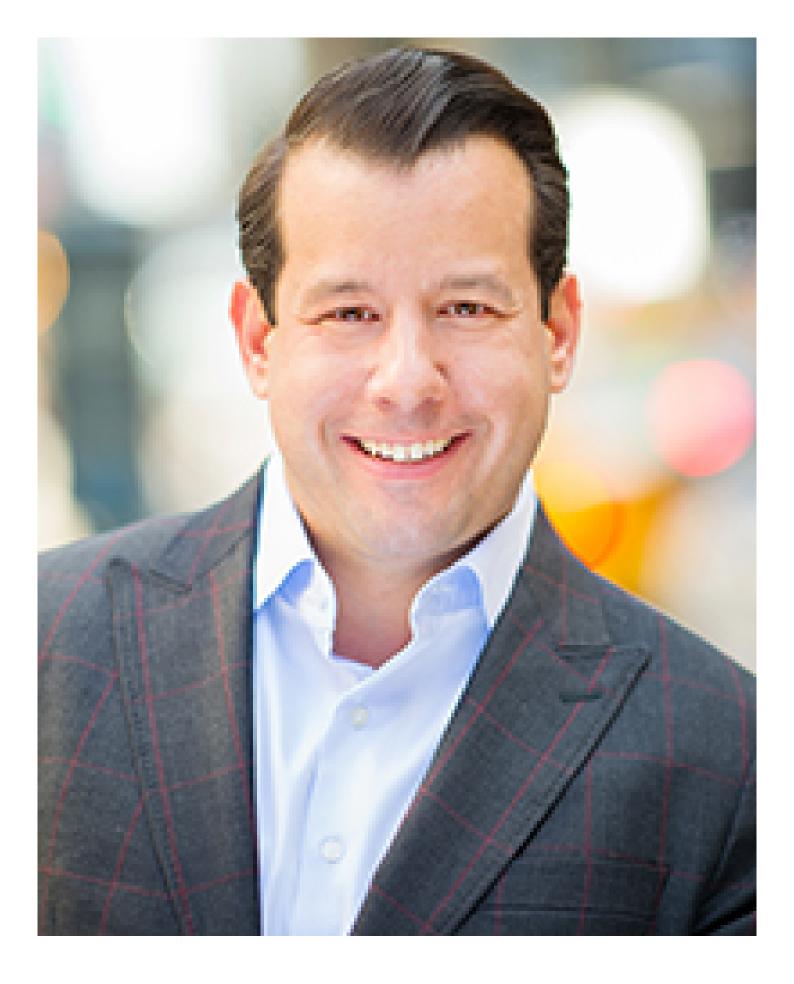


Quantitative tightening's anticipated effect on commercial real estate capital markets - by Michael Zysman

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To shore up financial markets during the COVID-19 pandemic, the Federal Reserve took the approach of lowering the Federal Funds rate effectively to 0% in April of 2020 and start an asset

purchase program. This asset buying increased the Federal Reserve's holdings of marketable securities from approximately \$4.2 trillion dollars in February of 2020 to approximately \$8.965 trillion in April of 2022, a 114% increase. A side effect of an extended period of asset purchases and low interest rates is increased inflation. As a result, inflation increased to an annualized rate of 8.5% as of March 2022. Now that many of the COVID-19 pandemic restrictions have been reduced and high inflation is pushing our economy towards a recession, the Federal Reserve has committed to taking swift action to control inflation by tapering its balance sheet and increasing interest rates.

The success of the Federal Reserve's policies during the COVID-19 pandemic is evidenced by the US economy's quick but sustained recovery from the immediate financial shock caused by COVID-19 restrictions. When the pandemic began, the unemployment rate in the US hit 14.8% in April 2020, and sectors such as leisure and hospitality had an unemployment rate of 39.3%. The Federal Reserve's emergency measures helped stabilize employment by lowering the unemployment rate to 5.4% as of July 2021, and it has since decreased to 3.6% as of April 2022. From February 10, 2020 to March 16, 2020, the S&P 500 dropped from 3,380 to 2,305, a decrease of 31.8%. It then rose to a high of 4,766 by December 27, 2021, an increase of 107% when compared to its pandemic low. It can be argued that the S&P would have gone down further, GDP would have been slower to recover, and unemployment would still be high if the Federal Reserve did not take these emergency measures.

When the Federal Reserve lowered interest rates and started buying financial assets at an unprecedented pace, it created an artificially high availability of capital. This allowed for corporations, asset investors and homeowners to refinance their debt with low long-term interest rates and/or obtain cash outs due to increases in asset values. Other COVID-19 era government programs helped artificially increase the amount of capital in the system as well. Much of these increases in capital were used to acquire goods, services, and make capital improvements at a rate that exceeded pre-pandemic demand levels. This dynamic, coupled with supply chain irregularities has led to excess inflation.

In addition, the excessive availability of cheap capital for an extended period has made many investors numb to risk taking. Increased risk taking without proper credit oversight or discipline can lead to a misallocation of capital, which is how asset bubbles are formed. As the Federal Reserve takes swift action, it should help reallocate our country's financial resources from having the primary objective of saving our economy at all costs from the economic devastation of the pandemic, to adding the necessary supply to meet the population's demand in a post-pandemic world.

In December 2021 at the Federal Open Market Committee meeting, Federal Reserve Chairman Jerome Powell indicated that the Federal Reserve will likely stop adding assets to its balance sheet by the end of March 2022. The Fed's balance sheet peaked on April 13, 2022 with a balance of \$8.965 trillion and has decreased to \$8.94 trillion as of May 4, 2022. After the initial \$3 trillion of Federal Reserve asset purchases that occurred between February and June 2020, they steadily continued buying \$120 billion a month of assets. Now that the \$120 billion a month of Federal Reserve asset buying is presumably over, coupled with anticipated asset sales from the Federal Reserve's balance sheet and increased interest rates, we should expect private capital to flood the

market due to higher returns that a higher risk-free rate should make available to them.

This higher interest rate environment should create a great opportunity to invest in real estate. The period of opportunity might be small if the Federal Reserve is able to quickly lower inflation to its target. Then we will likely re-emerge into a relatively low interest rate and high growth environment. Regardless of how well the Federal Reserve manages inflation, it will take a while for the supply of quality housing to catch up with demand. Due to this dynamic alone, our industry should hopefully continue to see outsized returns for properties that are moderately leveraged and are of high asset quality.

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