Cap rates or quack rates? - by John Rynne

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John Rynne

If it looks like a duck and quacks like a duck, it might be a duck; quack, quack!!! As interest rates have escalated in all sectors over the past three quarters so have overall capitalization rates. The 10-year treasuries have escalated 146% from 1.63% to 4.01%. At that time 1-year treasuries were at 0.40% which was significantly less than the rate for the 10-year treasuries. This was one indication that the economy was healthy. However, the most recent treasuries show an inverted yield curve with the 1-year treasuries more than the 10-year treasuries (4.50% versus 4.01%).. Historically, the inverted yield curve is an indication of a recession. Another indicator of a recession is negative Gross Domestic Product (GDP) trend in two consecutive quarters. Many economists agree if it looks like recession; it's a recession; quack, quack!!! Besides, the 7% U-6 unemployment level is at a much higher rate than what is being reported in the media. The U-6 unemployment level considers the official unemployment rolls, those who are underemployed, those who have given up and those who have dropped out of the labor force.

We just came out of the lowest interest rate periods in modern United States history. This low interest rate period lasted for the last decade which was almost unprecedented. It actually started in the aftermath of 9/11; over 21-years ago. But the massive low interest rates began after the financial collapse in 2008 and 2009. The Federal Reserve artificially kept interest rates low through the early part of 2022. They were able to accomplish this through quantitative easing in which they put into their balance sheet trillions of dollars of treasuries. This stabilized the demand for these financial instruments. Also, the Congress, the Obama, Trump and Biden administration ran up the huge deficits which has contributed to the current approximately $31 trillion national debt. Of course there was a need for higher spending during these time periods to deal with the 2008 economic and the 2020 COVID debacles. This high amount of debt along with the higher interest rates could increase interest on the debt at by 300% over the next few years. This has the potential to create interest on the debt to over $1 trillion and rising annually. All this has an upward effect on overall capitalization rates (cap rates).

There is a significant dampening on the effect of the higher rates on cap rates. As an example mortgage rates have increased by 250-300 basis point since late last year. This same basis point increase does not apply to cap rates. One of the reasons is the mortgage constant basis point difference is less. If there is a difference of 250 basis points in the interest rates the basis point difference in the annual constant is less; closer to 170 or a discounted effect of 32%. This assumes an amortization period of 20 years. There are other factors that reduce the effect of escalating interest rates on cap rates. High inflation naturally will increase material costs, labor costs and even soft costs. Tenants directly or indirectly will be paying higher rents for build outs and raw space. Also, tenants will be less apt to purchase their own space because of the higher interest rates. In addition, because of the higher interest rates developers will be less apt to hire general contractors for the construction phases and become "do it your-selfers" because of tightening margins. Because of the decrease in stock market returns, real estate investors will reduce their expectations regarding cash on cash and yield returns. There are a growing number of real estate investors who have the philosophy of long-term ownership. These investors are willing to take lower cash on cash returns. In an escalating mortgage interest rate market other investors also reduce their expectations on cash on cash and yield returns.

Finally, because of the vibrant economy which was pre-COVID, many real estate investors, especially institutional ones accumulated large cash positions. That sector of real estate investor is not concerned with mortgage terms because their purchases are all cash. Check our web site at www.rynnemurphy.com for the 3rd quarter cap rates and other rates. Keep in mind that the 4th quarter cap rates will probably escalate when we update the chart in January. In summary, now that we know what the definition of a duck is; we know that we're in a recession with high inflation; quack, quack!! To combat that; get used to much higher interest rates and higher cap rates for the foreseeable future. Can you say quack Rates?

John Rynne, MAI, SRA, is president and owner of Rynne, Murphy & Associates, Inc., Rochester, N.Y.