Question of the Month: 2022 a year to remember and recession concerns heading into 2023 - How will federal reserve policies drive the outcome? - by DiGeronimo

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As we end 2022 inflation reached its highest levels since the early 1980s. As a result, elevated inflation, supply chain disruptions, and higher interest rates have contributed to the global downturn. Recessions prompted by excesses of prior uninterrupted periods were evident over the last decade.

2022 witnessed seven Fed rate hikes targeting the rate to 4.25% to 4.50%, the highest level in 15 years in contrast to the 2021 rate of 0.25%. Additional Fed rate hikes are expected in 2023 with

several forecasts exceeding 5.50%. These rate hikes have resulted in a prime rate of 7.5%, the highest since 2007 vs. 3.50% as of March 2022 which will impact consumer credit and existing home equity lines. As a result, home sales declined for the first time since 2012 with a forecast of 15%-20% if a prolonged recession prevails. Adding to housing costs are the rising costs of labor, insurance and utilities which have also impacted the investment sales market of rental properties especially rent regulated product.

The stock markets wrapped up the worst year since 2008 with the Dow down 9.5%, the S&P500 down 20% and NASDAQ down 35%. A combination of higher costs of capital and borrowing, prevailing inflation over 8.0% and earning reports declines all contributed to this downturn, especially overleveraged companies with negative cash flows. Adding to this trend is the Crypto hacking of 2022 which resulted in reported losses over $3 billion with total U.S. data breaches exceeding $9.4 billion. Therefore, a closer watch of the stock market may be a more realistic indication of a near-term recession along with Fed policies.

Higher interest rates will affect the resizing of existing commercial loans as they mature and may result in distress debt, substandard loans, and increased reserve requirements. The spread between commercial real estate loans funded over the last several years at 3.00% -3.75% vs. rates now exceeding 6.0% will impact debt yields, capitalization rates, and debt coverage ratios potentially contributing to negative amortization. A creative approach to refinancing will be necessary and may lend itself to a floating rate structure. The 5 and 10-year treasury spreads will be the primary benchmark for repricing and financial balance sheets are favorable with increased reserves resulting from the last recession.

The Inflation Reduction Act (IRA) will have a positive impact on commercial real estate with sizeable tax deductions and credits to subsidize energy efficient buildings and renewable energy generators. These credits will allow property owners and developers to claim notable tax deductions. ESG Criteria and ESG Scoring will become the industry standard for both real estate and companies as well as lending underwriting mandates. Each factor – Environment, Social, and Governance will be ESG rated and scored. ESG scoring normally follows a 100-point scale and evaluates a company’s or industry’s ESG performance over time and in relation to their peers. Real time data will be the driving generator for these
ratings using AI/ML/NLP for ESG insights.

Another emerging trend is the cannabis growth and expansion and its benefit to various real estate sectors. Currently 18 states have legalized cannabis for recreation and 37 states for medical use. Sales topped $33 billion in 2022 and is one of the fastest growing industries.

So where is 2023 headed if inflation persists and higher interest rates prevail along with additional Fed rate hikes and quantitative tightening – how does the economy land; hard, soft, stagflation or return to above average growth? Moreover, are the Fed’s 2% inflation and 4.5% unemployment targets in 2023 achievable or unrealistic to achieve over the near term without alternative catalysts or conversely continue to mandate policies that will drive the economy into a recession?

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