Roller coaster cap rates - by John Rynne

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Very early in the first quarter of 2024, I projected that the trend of 10 year treasuries and cap rates would decrease because inflation had been substantially decreased. However, early in the second quarter inflation reared it's ugly head again. Cap rates inched up very slowly. During the third quarter cap rates slowly decreased again. This roller coaster is continuing during the beginning of the fourth quarter because cap rates are inching up slightly again. However, the trend is still below what it was in the fourth quarter of 2023. The problem is massive government spending which is continuing. As an example, the 2024 fiscal year U.S. federal budget deficit is over $1.8 trillion and growing. The interest on the debt has increased to almost $1.2 trillion which is a record. This debt service exceeds the defense budget by 41%. The defense budget was $850 billion.

There are two ways to control inflation;

A) Fiscal policy and

B) Monetary policy.

Right now fiscal policy is the culprit because of massive government spending. Most government bureaucracies are not conducive to efficiency. Given the inefficiency of the government, it is preferable to reduce taxes on businesses and individuals which eliminates the government as the middleman. When the government doesn't use tax cuts and uses spending as a solution, there are too many dollars chasing limited supply. The proper way to reduce inflation is supply side economics which allows the resources of the private sector to increase the supply of goods and services. If demand remains stable, this will decrease inflation. The monetary policy is to have the Federal Reserve increase interest rates directly or indirectly by selling off government paper. This floods the market which puts upward pressure on interest rates. At the end of the first quarter 10-year treasuries were at 4.33%. At the end of the second quarter 10-year treasuries were at 4.48%. At the end of the third quarter (September 30th) they were 3.81%. However, this represented an increase from September 16th to 3.63%. Furthermore, the trends are up with 4.08% on October 11th and October 28th at 4.25%. So the treasury rate trends are escalating which puts upward pressure on cap rates for the upcoming fourth quarter.

The office sector in the Rynne, Murphy & Associates, Inc. (RMA) rate survey include: small, class A, class A/R, class B and class C. This survey applies to Upstate New York and northwest and west central New England. The range of overall capitalization rates for small office for the third quarter range had an average rate of 8.5%. The class A office third quarter cap rate was 7.5%. The class A/R office average cap rate was 8.25%. The class B office average cap rates for the third quarter was 10.25%. The class C office average cap rate was 12.25%.

The retail sector of the RMA survey has three sections which include: regional, community and neighborhood properties. The range of cap rates for regional retail properties for the third quarter average was 12.25%. This is skewed higher because of the continued high risk of regional malls. The non-mall properties which are considered regional will have average cap rates nearer to the community retail properties. The third quarter community retail average cap rate was 9%. The neighborhood retail average cap rate for the third quarter was 8.75%.

The industrial sector of the RMA survey has four sections which include: heavy, older, light industrial and R & D. The heavy industrial sector cap rate average was 11.75% for the third quarter. The older industrial segment average cap rate for the third quarter was 11.25%. The light industrial average cap rate was 8.50%. The R & D average cap rate for the third quarter was 8.5%.

The apartment section part of the RMA survey has five segments which include: urban small multifamily, urban apartment project, suburban multifamily, suburban apartment project, and new apartment projects. The urban small multifamily average cap rate for the third quarter was 7.5%. The urban apartment project average cap rate was 8%. The suburban multifamily (10 units or less) average cap rate was 6.5%. The suburban apartment projects had an average cap rate for the third quarter at 6.75%. New apartment project average cap rates for the third quarter were 6.25%.

In summary, the trend of the 10 year treasuries and cap rates will continue to be a roller coaster for the remainder of the fourth quarter in 2024. Finally, go to www.rynnemurphy.com for the entire RMA third quarter rate survey.

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