RESEARCH BRIEF

Marcus & Millichap

FINANCIAL MARKETS: FEDERAL RESERVE MEETING

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Softer Rate Hike Outlook Potentially Clears Some Hurdles for Investors

Banking shock prompts Fed to take a more measured approach. At its March 22 meeting, the Federal Open Market Committee raised the federal funds rate for the ninth time in 12 months. The 25-basis-point hike matches the margin from February and lifts the lending rate's lower bound to 4.75 percent. The FOMC cited still-too-high inflation and a persistently tight labor market as reasons for necessitating the increase, which is nevertheless below what was anticipated by the market just a few weeks prior. The recent seizures of Silicon Valley Bank and Signature Bank, while due to unique challenges and quickly contained by regulators, have prompted more caution around the banking sector. The resulting tightening to credit conditions is likely to complement the Federal Reserve's goal of reducing inflation and softening employment, allowing for a smaller policy rate adjustment.

Further rate hikes less likely. The combined 50-basis-point lift so far this year marks a much more deliberate pace from 2022, when the overnight lending rate was hiked by more than four times that amount in a similar span of time. Moving forward, the Fed is likely to be just as measured, if not more so. In order to take time to assess the full impact of the recent banking shock, the FOMC has walked back previous language indicating ongoing rate hikes and has instead advised that some policy firming may be necessary. A more stable federal funds rate will go a long way to aid commercial real estate lending, allowing capital providers to more readily set terms and determine valuations.

Clearer near-term rate picture to help investment landscape. A more consistent federal funds rate would give financiers and borrowers more time to agree on terms. While the bank closures will likely spur lender caution over the short-term, tightening underwriting, recent downward pressure on the 10-year Treasury together with reduced rate uncertainty could deliver modestly lower interest rates to commercial real estate borrowers. A net increase to capital costs over the past year will nevertheless require investors to take on less leverage going forward, but for well-performing properties, asset demand should supersede those concerns. Most property sectors are in strong long-term positions, even if some asset classes like downtown offices face headwinds.

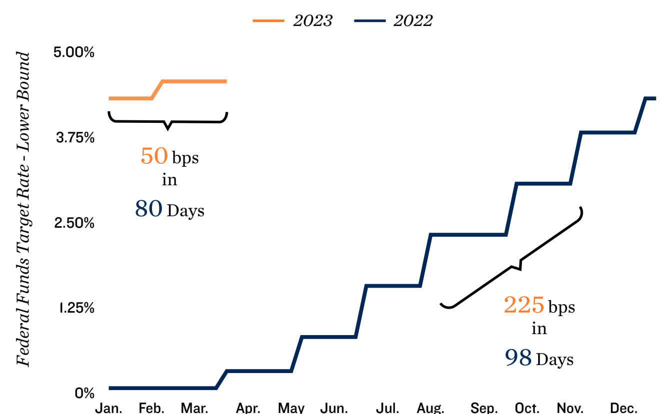
Wave of distress still unlikely. The rapid rise of interest rates over the past year underscore concerns about distress among properties with upcoming debt maturities. Current distress is low, at about 1 percent of recent sales, well below the 20 percent peak following the Global Financial Crisis. Whether this trend will pick up going forward largely depends on property performance. Owners holding onto well-performing properties are unlikely to enter a distressed sale purely because of higher capital costs from refinancing. The situation could be different for under-performing assets, which may be more prevalent among urban-core office towers and outdated retail floor plans.

Commercial real estate not a risk factor for banks. Concern of commercial property distress extending to the banking sector is also unlikely. Chairman Powell stated that banks holding concentrations of CRE debt are not comparable to SVB. Much of the debt maturing in 2023 is backed by CMBS, while more bank debt is maturing after 2024 when the interest rate environment could look very different.

4.75% *Lower Bound of Federal Funds Target*

50 *Basis-Point Increase in the Federal Funds Rate Year-to-Date*

Fed Takes Markedly Slower Pace to Rate Hikes in 2023



Sources: Marcus & Millichap Research Services; Bureau of Economic Analysis; Bureau of Labor Statistics; CoStar Group, Inc.; Federal Reserve; Real Capital Analytics; RealPage, Inc.; U.S. Census Bureau