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INSIGHT FROM INVESTMENT MANAGEMENT

The U.S. Federal Reserve is about to Raise Rates: Keep Calm

Higher Rates are a Good Thing

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PROPRIETARY RESEARCH

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With widespread inflation persisting in many western economies, the United States, United Kingdom and to a lesser degree, the Eurozone are moving up the curve of hawkish monetary policy.[1] Emerging from the pandemic-induced lockdowns, the initial burst of inflation was largely driven by so-called base effects as prices were being compared to artificially low prices in 2020 due to the dramatic disruption of aggregate demand. However, persistent rises in the price of energy and continued supply shortages in many industries have made inflation stickier than initially expected. In addition, in many economies, particularly in Europe, inflation will be further exacerbated by the crisis in Ukraine. As a result, the Federal Reserve is widely expected to begin a rate tightening cycle starting upon the conclusion of their two-day meeting on March 16th.

Lessons Learned

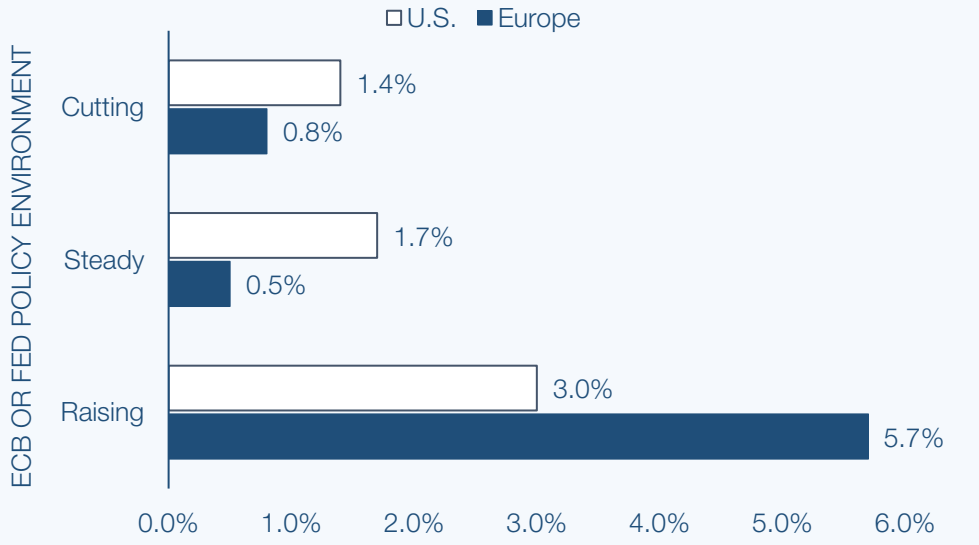
With hikes on the horizon, we looked back at past periods of tightening cycles by the Federal Reserve ("The Fed") and European Central Bank (“ECB”) to better understand what these potential rate moves may mean for commercial real estate fundamentals and capital markets. In addition to examining real estate performance during tightening cycles, we also compared this performance to periods when the central banks were cutting rates as well as to periods when they were holding rates steady. One of the first things that became apparent is that both the Fed and the ECB tend to monkey with interest rates more often than not. Since 1990, the Fed has been cutting rates 25% of the time and raising them just a bit more frequently at 27% of the time. There were times within each of those periods where the Fed paused with its cuts or hikes, but those times were just that: pauses, rather than changes in policy. Only 48% of the time has the Fed truly held rates steady. And in Europe, the ECB has held rates steady just 51% of the time since they started setting rates in 1999. Whether the Fed or the ECB are raising or hiking, not to mention other financial market maneuvers such as quantitative easing, active monetary policy via rate adjustments have been fairly par for the course.

Given that rate hikes typically occur during periods of economic strength, it’s not surprising that average historical rent growth has been much stronger when the two central banks have been raising rates. **Exhibit 1** summarizes average rent growth in U.S. and European real estate markets across more than 40,000 market observations during periods when policy rates have been cut, raised, or held steady.

[1] The trajectory in Asia does not appear to be so aggressive in that regard. While smaller export-driven economies with open capital accounts will necessarily tighten in response to US rate hikes (e.g. Singapore and South Korea), both Japan and China, who together make up almost 70% of nominal GDP for the region, are maintaining easy monetary policy. Japan has seen slight increases in inflation, but not anywhere high enough to result in a shift to a more hawkish monetary stance; quite the opposite as the central bank is keeping rates steady, and the government announced a new fiscal stimulus package near the end of 2021. To counter the impact to its own domestic weakness, China is cutting loan rates, and encouraging local governments to issue more special bonds in a concerted effort to spur credit growth, prop up home-buying, and expand infrastructure investment. So, while rates may rise in other smaller economies, rate hikes should be moderate in most, and pose relatively lower risk to economic growth.

Exhibit 1

Average Rent Growth During Various Central Bank Policy Environments



Sources: Federal Reserve; European Central Bank; Hines Research; as of 1990-2021Q4 for U.S. markets; as of 1999-2021Q4 for European Markets; CoStar; Property Market Analysis (PMA)

> **Whether the Fed or the ECB are raising or hiking... active monetary policy via rate adjustments have been fairly par for the course.**

In addition to stronger average rent growth, almost 90% of the U.S. market observations during periods when the Fed was raising rates exhibited positive annual rent growth while 70% of European observations enjoyed positive rent growth during tightening cycles. In contrast, rents fell in nearly one-third of the U.S. observations during periods when the Fed was cutting rates, while they fell in 45% of the European data points when the ECB was loosening policy. Rent growth in the commercial sectors (office, retail, and industrial) has been particularly sensitive to the rate cycles but less than 9% of the observations in the apartment sector showed rent declines when the fed was raising rates. That compares to almost 16% of apartment observations when the Fed is cutting. Given a choice between operating real estate during a rising or falling policy rate environment, it is clear that fundamentals have historically been much stronger when central banks have enough confidence in the economy to increase rates.

Of course, hiking or cutting cycles can be somewhat extended and there are differences in the shape of future rent growth depending on whether you are looking at the data following the first or last move of a change in monetary policy. In the U.S. data we examined, the average loosening cycle has lasted 16 months while the average tightening cycle has lasted 20 months. **Exhibit 2** illustrates the average U.S. rent growth over the following five years after the first or last rate change in a Fed policy cycle. The European data exhibited similar patterns.

Exhibit 2

The Shape of Future Rent at the Start or End of Active Fed Policy Environments

Sources: Federal Reserve; Hines Research; as of 1990-2021Q4; CoStar

Historically, rent growth has been strongest in the early years following the initial rate hike in a tightening cycle...

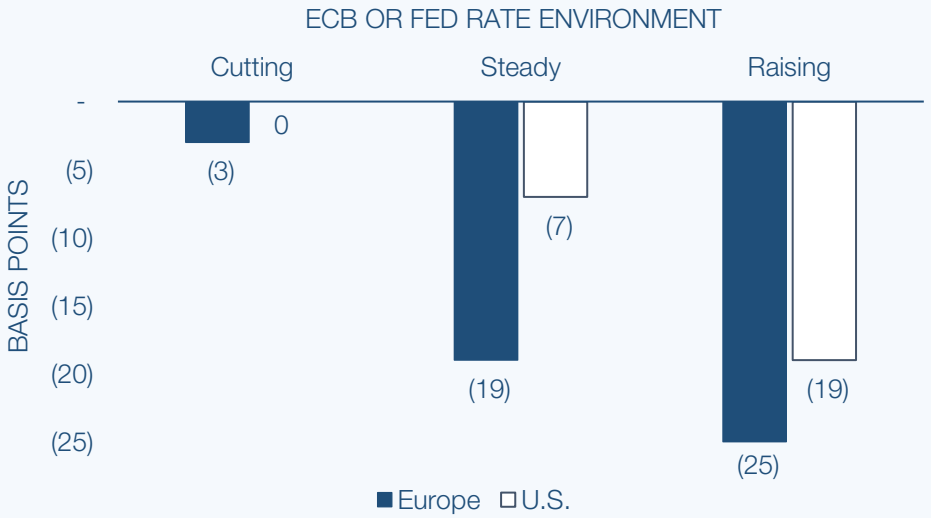
Historically, rent growth has been strongest in the early years following the initial rate hike in a tightening cycle, with a gradual slowing occurring in years three through five. Following the last rate hike in historical tightening cycles, rent growth has been strong in the following year but it has dropped off quickly in year two and has remained under 2% through year five. Conversely, following the first rate cut in a loosening cycle, rent growth has historically weakened over the following three years given the weaker economic environment before picking up in year four and continuing to improve in year five. Following the end of a loosening cycle, rent growth has historically been weak in the first year but has steadily improved in years two through five.

An analysis of prices yields similar conclusions. Annual price growth in U.S. markets has averaged 5.8% during periods when the Fed is raising rates versus just 1.1% when the Fed is cutting and 2.8% in steady rate environments. In European markets, price growth has been even more sensitive, averaging more than 10% per year during periods when the ECB is raising rates, 4.7% when rates are being held steady, and just 1.8% when the central bank is easing monetary policy.[2]

Stronger rent growth during tightening cycles as shown earlier has contributed to the more robust price performance but as is shown in **Exhibit 3**, cap rates have compressed more during tightening cycles than they have when rates are being cut as the capital markets take note of the improved prospects for NOI growth. If we use longer-dated bonds in the analysis, cap rates have also compressed more during periods when 10-year sovereign bonds have been rising than when they have been falling. Declines in cap rates generally dominate the real estate data over the past 30 years, but when 10-year treasuries have risen in the prior year, U.S. cap rates have declined an average of 15 basis points versus a decline of just five basis points when treasuries have fallen. In Europe, cap rates have fallen an average of 18 basis points during periods when 10-year sovereign bonds have risen versus 13 basis points when they have fallen.

Exhibit 3

Average Cap Rate Changes in Various Central Bank Policy Environments



Sources: Federal Reserve; European Central Bank; Hines Research; as of 1990-2021Q4 for U.S. markets; as of 1999-2021Q4 for European Markets

…cap rates have also compressed more during periods when 10-year sovereign bonds have been rising than when they have been falling.

[2] Sources: Federal Reserve; Hines Research; as of 1990-2021Q4

Key Takeaways: Keep Calm

Don't fight the Fed is an old investment axiom but we shouldn't fear central bank tightening either. Central banks don't hike rates in a vacuum and though higher interest rates can slow the economy over the longer-term, the fact that the central banks are getting more hawkish is generally indicative of a strong economic environment. Today's economy is quite robust with low unemployment, an abundance of job openings, strong balance sheets, and rising incomes. Inflation is quite elevated but indicative of equally strong demand amidst disrupted supply chains. Geopolitical issues may keep the ECB on the sidelines in the near term a potential Fed move would clearly signal the economic strength that is driving rents higher in a growing number of U.S. markets.

There are many things to worry about, including the length and severity of Ukraine's crisis, but rising short-term rates have historically coincided with much stronger real estate performance, so don't put the Fed's nascent tightening cycle high on your list of worries. It's not on mine.

About the author and Hines' Proprietary Research team

Joshua Scoville, Senior Managing Director – Research, reports to Hines' Chief Investment Officer and works closely with the firm's Chief Risk Officer and Strategy Group. Josh Scoville and his team are responsible for constructing the Hines macroeconomic view and outlook for commercial real estate market fundamentals and pricing; and with assisting with the development of investment strategies for the firm's investment programs and funds.

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