Real Estate

The Fed shows its talons

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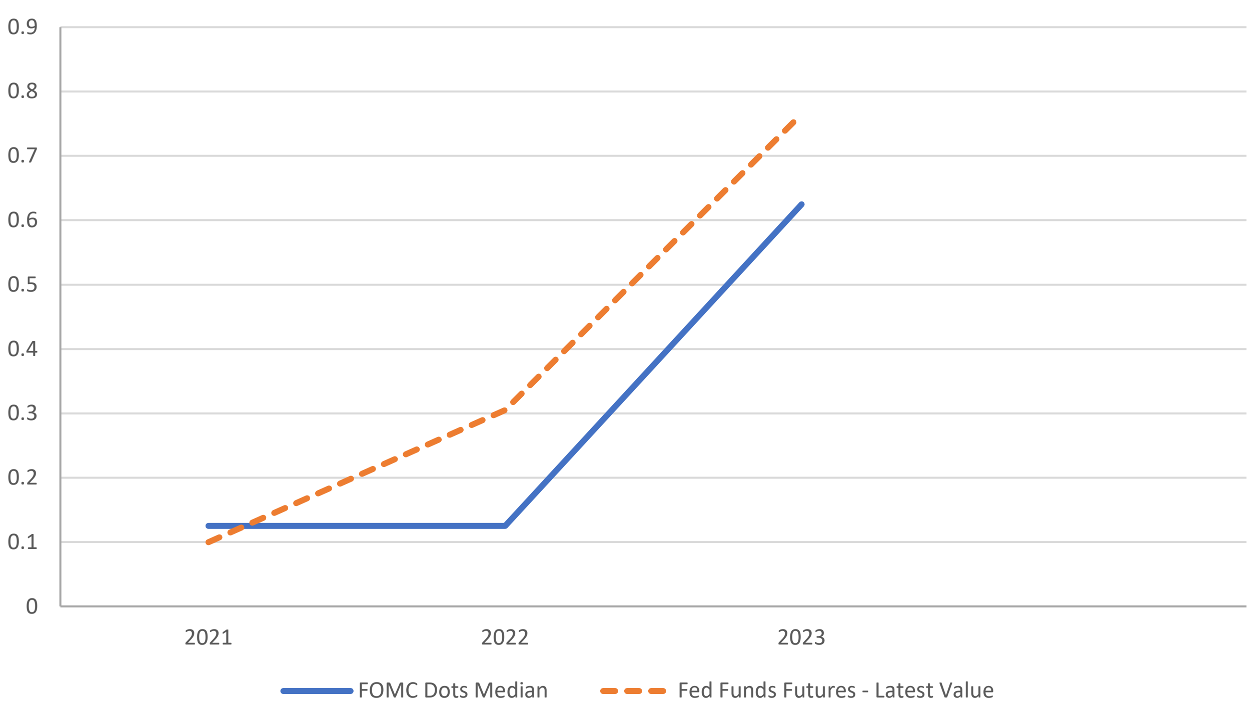
At its meeting last week, the Federal Open Market Committee (FOMC) delivered some hawkish language to the markets indicating a shifting mindset within the central bank. The biggest change was in the Federal Reserve's (Fed) forecast "dot plot" of short-term interest rate expectations.

The median forecast increased to two rate hikes in 2023 versus none in the last March meeting. Market reaction has been confused with risk assets under pressure at the thought of accelerated rate hikes somewhat offset by the Fed's reassurances on looking through the current elevated level of inflation.

Exhibit 1: FOMC Expected Fed Funds vs. Forward Fed Funds

FOMC as of June 16, 2021, with Forward as of June 17, 2021



Source: Federal Reserve, Bloomberg, Principal Real Estate Investors Research, June 2021

Why did the FOMC change its language?

In short, the Fed raised its expectations on growth and signaled its confidence that inflation pressures remain transitionary.

- The median real GDP growth forecast for the U.S. economy in 2021 increased by 0.5% to 7% while staying broadly unchanged for 2022 and 2023.
- The summary of economic projections (SEP) also raised the median projection for core PCE to 3% from 2.2% for 2021 as well as slight overshoot of the 2% Fed target for 2022. While the FOMC signaled that it believes the sharp increase in inflation will be transitionary, it noted the need to be "humble" in an "extraordinarily unusual time".

What are some of the implications for commercial real estate?

- A pull ahead in the hiking cycle reflects the Fed's growing confidence in the economic recovery. With 2021 likely to be the strongest year of growth since 1984 in the U.S., investors should view the Fed's signal as generally positive for real estate since tenant demand historically lags improvements in the labor market and the broader economy.
- While short-term interest rates are where the Fed can most obviously exert influence, investors should watch the slope of the yield curve carefully for potential implications on growth and inflation. Were the yield curve to steepen (it has flattened since the FOMC meeting), listed REITs may experience volatility and downward price pressure if 10-year yields were to rise in a consistent manner.
- A hiking cycle if accompanied by positive growth and inflation expectations should also be positive for real estate credit markets. CMBS bonds could benefit from a flattening in the credit curve, particularly in those tranches with exposure to property types perceived to be most vulnerable to cyclical risk (CBD offices and hotels for example).
- Private market lenders particularly with floating rate strategies may finally begin to see some benefits from a steeper short-term curve. Provided NOI growth keeps pace or exceeds inflation, subordinate and mezzanine lenders should benefit from a step up in interest rate expectations.
- Private equity real estate investors should continue to benefit from structural shifts to the economy that were catalyzed by the pandemic (logistics, data centers for example). A constructive growth outlook should support recovery in the most deeply impacted, pro-cyclical industries (leisure, travel and hospitality) opening opportunities in adjacent property types such as hotel and selective retail. Risks to build to core and re-positioning strategies should also decrease on the heels of the expected economic strength.

Risk Considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk**.**

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