The Fed’s Decision: Implications for Commercial Real Estate

December 2015

Today Federal Reserve Board Chairwoman Janet Yellen announced that the Federal Open Market Committee (FOMC) voted to raise the federal funds rate for the first time in almost 10 years. This initial rate hike is largely symbolic and the action is just the first step in what will likely be a very lengthy process of monetary policy normalization. It reflects the growing consensus that the economic foundation propelling the current expansion is solid. More importantly, it also signals that the FOMC believes the labor market is close enough to—or already at—full employment. Despite core inflation1 hovering below the 2% target typically associated with price stability, the major impetus for the decision today was the rebound in several job market indicators.

After its mid-September meeting, the FOMC commented that the combination of a slowdown in August job creation and job openings, a deceleration in wage growth and impending difficulty in industrial production was sufficient to make the Fed pause. Downward pressure on inflation from low oil prices, volatility in global financial markets due to China’s currency devaluation and the relative strength of the U.S. dollar heightened the downside risk to U.S. economic growth. At the FOMC’s October meeting, with one additional month of lackluster job gains, there was no evidence to determine if the late summer slowdown really was over or not.

Indeed, much of the slowdown in job gains appears to have been temporary. In October and November, more than 500,000 net new nonfarm jobs were created; more than one-quarter of them were in office-using sectors. In November, the unemployment rate stood at 5%—a rate that most economists, including us, believe is consistent with full employment—while the underemployment rate remained elevated at 9.9%. Some analysts point to underemployment as evidence of continued slack in the labor market. That is true to a certain extent, but it does not necessarily preclude the FOMC from beginning normalization. In fact, there have been times when the FOMC has voted to raise the federal funds rate despite an underemployment rate of over 11.5% and relatively

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### Past Monetary Policy Tightening Cycles

<table>
<thead>
<tr>
<th>Year</th>
<th>Unemployment Rate (U3)</th>
<th>Underemployment Rate (U6)</th>
<th>12 Month Prior Decline in U3 (bps)</th>
<th>12 Month Prior Decline in U6 (bps)</th>
<th>Core PCE1 (at Time of Rate Hike)</th>
<th>Core PCE1 (12 Months Prior to Rate Hike)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mid 1988</td>
<td>5.5%</td>
<td>9.8%</td>
<td>800</td>
<td>1,085</td>
<td>4.9%</td>
<td>4.1%</td>
</tr>
<tr>
<td>Early 1994</td>
<td>6.6%</td>
<td>11.5%</td>
<td>567</td>
<td>733</td>
<td>1.8%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Mid 1999</td>
<td>4.3%</td>
<td>7.5%</td>
<td>133</td>
<td>433</td>
<td>1.3%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Mid 2004</td>
<td>5.6%</td>
<td>9.6%</td>
<td>533</td>
<td>633</td>
<td>2.5%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Late 2015</td>
<td>5.0%</td>
<td>9.9%</td>
<td>700</td>
<td>1,517</td>
<td>0.7%</td>
<td>1.2%</td>
</tr>
</tbody>
</table>


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1Core PCE is the name for inflation in personal consumption expenditures, less food and energy. This is the Fed’s preferred measure of inflation.
tame inflation. It is also worth noting that wage growth, as measured by the Employment Cost Index, reaccelerated in the third quarter. The deceleration in wage growth observed in the second quarter was one of the key reasons the Fed cited for not raising rates in September. Wage growth is back on track—trending over 2%—and robust job openings indicate wage growth will continue to push upwards. These developments helped support the Fed’s decision to raise rates today.

It is important to keep perspective on today’s move. After years of a near-zero interest rate policy, a 25-basis-point increase is not very significant by itself. What matters more is the path from here forward. Monetary policy, via the federal funds rate, will remain extraordinarily accommodative in the near term. Current market conditions suggest inflation will remain below 2% for the next ten years, implying that the upward pressure on longer term bonds will be muted. Finally, what impacts commercial real estate most is not the federal funds target rate or even the 10-year rate, but rather the combined forces of economic growth and job creation. Those factors more directly power a building’s pro forma (i.e., lower vacancy, higher rents, higher NOI). Indeed, there is a much stronger correlation between GDP growth and NCREIF unlevered returns than that between the federal funds rate and unlevered returns. Economic growth is a far greater influence on property values.

Like every other asset class, the commercial real estate sector has benefitted from the Fed’s massive injection of liquidity into the economy over the past seven years. Prices have generally recovered; indeed, for some property types and local markets prices now exceed pre-recession peaks. As the FOMC moves to normalize interest rates, there is some concern that rising rates will reduce investor demand for commercial real estate as lower risk investments (e.g., treasury bonds) begin to look more attractive. However, there are reasons to expect that commercial real estate prices and returns will continue to be attractive even in a rising interest rate environment.

- The Fed’s policy moves, while important, are not the sole driver of long-term interest rates. Inflation, a major driver of longer-term yields, is expected to remain low over the next 10 years. That, combined with what will eventually be a slow unwinding of the Fed’s balance sheet, will keep downward pressure on the 10-year Treasury note.

- Improving economic conditions helped drive the Fed’s decisions. The FOMC is raising interest rates in part because labor markets are strong. Since the end of 2013 nonfarm payrolls have increased by slightly more than 5.5 million jobs. It is likely that 2014 and 2015 will be the strongest back-to-back job growth years since 1998 and 1999. This job growth is a major factor driving improving leasing market fundamentals across the U.S. As space is being absorbed, vacancy is...
falling and rents are rising across property types and geographies. In the third quarter of 2015 the national office vacancy rate fell to its lowest level in seven years (14.2%).

- Against the background of weakness in the global economy, the U.S. continues to stand out as the safest of safe havens and is attracting massive capital flows from around the world. With many countries central banks (Eurozone, China, Japan, India) still implementing aggressive monetary policies, some of the newly printed capital will gravitate to the U.S. and continue to support real estate pricing.

Historically, a rising federal funds rate has coincided with tightening commercial real estate markets and rising prices. The last two tightening cycles have been accompanied by rising office occupancy rates. From 1993 to 2000 the federal funds rate rose from 3.0% to 6.5%. Office occupancy during that period jumped from 79.6% to 90.9%. Similarly, from 2003 to 2007 the federal funds rate rose from 1.0% to 4.25% and office occupancy increased from 80.5% to 87.1%.

Typically when the Fed begins raising rates, the clock for when to expect the next economic downturn to occur is started. Post-World War II, nine of the last 14 recessions have occurred during a time when the Fed was tightening monetary policy. The time between when the Fed first begins to tighten policy to when a recession occurs is typically two to three years. However, the Fed’s current mantra is that this tightening cycle will be more gradual than normal. Other factors—monetary stimulus still occurring in other economies, the slow and evolving nature of this recovery in general—do suggest there is a fair amount of runway left in the current expansion. We would anticipate that office occupancy and values will continue to increase for the majority of building assets over the coming year even in an environment with higher interest rates.

In general, the Fed’s decision today is not something that the commercial real estate industry should fear. To a degree, it is something that should be celebrated.

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