Inflation Surprise Means More Pressure Ahead For Commercial Real Estate

September 13, 2022 | Jarred Schenke, Bisnow Atlanta (https://www.bisnow.com/author/jarred-schenke-5711) (mailto:jarred@bisnow.com)

U.S. inflation stubbornly rose again last month — even as energy costs dropped — all but ensuring that the Federal Reserve Board will raise its benchmark interest rate by 0.75% at its meeting later this month.

The Fed has already raised rates by 2% this year, but inflation has yet to come down: The overall consumer price index (https://www.bisnow.com/tags/consumer-price-index) rose by 8.1% year-over-year in August and by 0.1% over July, the U.S. Bureau of Labor Statistics reported (https://www.bls.gov/news.release/cpi.nr0.htm) Tuesday. The prospect of further monetary tightening could have more profound effects on the commercial real estate sector than the last round of hikes, experts told *Bisnow* Tuesday.

“Yes, this inflation report was a surprise. The increase of 75, maybe even 100 basis points, at the next meeting and then another 50 or 75 at year's end is not completely out of the realm of what's being expected,” Moody's (https://www.bisnow.com/tags/moodys) Senior Economist and Director of Economic Research Thomas LaSalvia (https://www.bisnow.com/tags/thomas-lasalvia) said. “For certain assets, weaker assets, ones where debt yield is already low and [landlords are] trying to refinance, this doesn't play out very well for those.”

The CPI report raised alarm on Wall Street, as economists were expecting inflation to start coming down. It kicked off the worst day on the stock market since 2020, with the S&P cratering by more than 4% (https://www.cnbc.com/2022/09/12/stock-futures-are-higher-as-wall-street-awaits-key-inflation-report-.html) at the close of trading.

Market watchers say investors have already priced (https://www.bloomberg.com/news/articles/2022-09-07/fed-traders-steer-toward-a-75-basis-point-september-rate-hike) in a 75-point hike when the Fed meets on Sept. 20-21, and the August CPI report only adds weight to expectations that the Fed could raise interest rates further (https://www.bloomberg.com/news/articles/2022-09-13/fed-swaps-show-75bp-hike-for-september-fully-priced-after-cpi) this year.

While gasoline prices declined by more than 10%, the prices for shelter, food, medical care, new vehicles, household furnishings and education kept rising. Stripping out food and energy, the CPI rose 0.6% in August, a larger increase than in July, when it clocked in at 0.3%.

“We continue to look for the Fed to raise rates another large 75bps on September 21, followed by an additional 75bps of rate hikes by year-end,” Kathy Bostjancic (https://www.bisnow.com/tags/kathy-bostjancic), the chief U.S. financial economist for Oxford Economics (https://www.bisnow.com/tags/oxford-economics), wrote in a newsletter Tuesday. “However, if inflation remains very rapid, it raises the risk of the Fed doing more tightening.”

Interest rates have a direct effect on the costs real estate owners pay to acquire or build new commercial properties. The Fed's actions so far have begun to cool lending markets, and more hikes could further reduce the number of loans banks hand out.

Commercial and multifamily lending is expected to fall to $733B this year, an 18% drop from 2021, according to the Mortgage Bankers Association (https://www.mba.org/news-and-research/newsroom/news/2022/07/19/higher-rates-economic-uncertainty-to-slow-commercial-multifamily-lending-in-the-second-half-of-2022)'s projections.

“If you're in real estate, you are in recession. It's just a matter of time when it goes to financing, refinancing, restructuring. It's going to show up,” said Rajeev Dhawan (https://www.bisnow.com/tags/rajeev-dhawan), the director of Georgia State University's Economic Forecasting Center (https://www.bisnow.com/tags/georgia-state-universitys-economic-forecasting-center). “The cost of doing business is going to be much higher.”

Inflation's impact on real estate goes beyond the Fed's moves to cool it. Energy costs — which have fallen but are expected to rise again (https://www.politico.com/newsletters/weekly-new-york-new-jersey-energy/2022/09/12/high-energy-prices-ahead-00056069) as the Russia-Ukraine War drags on — labor costs and materials costs have squeezed margins for both construction and operations.

“For property owners, it means all the expenses they face … continue to rise,” said Jamie Woodwell (https://www.bisnow.com/tags/jamie-woodwell), the vice president of commercial real estate research at MBA. “That can put a crimp on their operations and often leaves them to pass that on to the tenants. This reinforces some of the challenges that developers face with increased borrowing costs coming right in tandem with the rise in inflation.”

Industrial demand could slacken as consumers slow down on buying — the fewer goods purchased, the fewer warehouses retailers will need, Dhawan said.

Owners of industrial and multifamily assets still have some runway to pass off increased costs to their customers in the form of rent hikes — but not much, LaSalvia said. The market could see a wave of refinancing as borrowers look to lock in rates before further hikes, but that could also produce a ripple of distress, he added.

“Certainly the darlings of real estate, industrial and multifamily, they're going to have to see a little less activity,” he said. “This could lead to more distressed loans, more issues in the CMBS universe in terms of delinquencies because there could be more issues in refinancing that."

The asset class that appears most vulnerable to an interest rate spike-fueled recession, however, is office.

"Really, office remains the laggard," Woodwell said. "That really stems from a real uncertainty about the office and what the future may hold for that. It remains the property type that people have questions about. Investors and lenders are working to try and get their heads around it."

At a *Bisnow* event about the Atlanta office market Tuesday morning, industry experts said inflation is impacting office owners disproportionately.

"In the industrial arena, we're able to push rents and we're able to counteract that. But on the office side, while rents are not decreasing, they're not going up at a pace that keeps up with inflation," said Brian Granath, a partner with Atlanta-based industrial and office investor OA Development (https://www.bisnow.com/tags/oa-development). "We're the one industry that does not have the pricing power during an inflationary period, the office market."

Offices are vulnerable to any impending recession, but as hybrid work has forced a rethink of the buildings' intrinsic value, they are particularly at risk. The persistently tight labor market could wind up being a factor working against landlords, Moody's LaSalvia said.

"One reason why labor is holding up so well is companies are unwilling to get rid of talent," he said. “Which means they might look for other ways to lower costs in a slowing economic environment, which might mean real estate.”

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