Will a Bear Market Bring Commercial Real Estate Out of Its Cave?

By Emily Gallagher

Unless you're tiptoeing back into society from an off-the-grid retreat, hearing that the economy has tumbled into a bear market isn't breaking news. Wall Street hung its head on June 13th after the S&P 500 closed more than 20 percent beneath the high it reached in early January. Unlike a bull market, which typically lasts around 32 months, bear markets only average about 11. Bear markets tend to be short-lived, but thanks to an international supply chain crisis, an ongoing war in Europe, ballooning inflation rates, and a recession expected any minute now, this particular downturn is attracting extra attention.

Real estate has generally been considered a safe investment for these down market periods. Properties are hard, tangible assets that can generate income, and property values are less volatile than stocks. But investors generally rethink their portfolios in times of economic crises. As we enter phase two of the bear market (when stock prices fall and trading activity slows as investors decide to shift gears), there are some things to consider when it comes to bearing the brunt, so to speak, of the economic stressors to come.

The good, the FED, and the ugly

Market watchers have put up a wide range of potential explanations for the onset of a bear market. They include the pandemic, drastic changes in consumer habits because of the pandemic, geopolitical unpredictability, a lack of energy security because of that geopolitical unpredictability, and, oh yeah, an increase in prices and a fall in the purchasing value of money.

In his July 5th commentary, Howard Silverblatt, Senior Index Analyst, Product Management for S&P Dow Jones Indices, put the bulk of the blame of the market's plunge on inflation. "Inflation is being placed squarely as the fall guy for the market declines," he wrote. "As the market's 'expert' historians cite the [Federal Reserve's] 'excess' stimulus programs as the reason for the 40-year high inflation rate."

Indeed, the Fed received criticism for not taming inflation quickly enough, even though they only have the very crude lever of increasing interest rates to pull. But if this bear market is primarily caused by inflation, brighter times could be ahead. Kiplinger's latest inflation forecast revealed that the inflation rate is likely to remain within the 9 percent range for the rest of this year before falling to 3 percent sometime in 2023. Hopefully that estimate stays accurate. As of this month, inflation has already stretched to 9.1 percent.

Overall, inflation is expected to finally begin its decline sometime within the next three months, and that's the good news (especially for anyone trying to buy office furniture right now, good grief). The not-so-good news is the ongoing expansion of pricing pressures. The tight labor market has pushed up the price of hiring in many industries which creates a very real possibility of another wave of inflationary price increases, especially if the Fed's actions fail to slow the job market as they hope.

We're not only in a bear market, we're in a state of fiscal shock, so the Fed is urged to go big to get inflation (and thus the economy) in order. However, the key strategy to do that is to tighten the amount of money in circulation by raising interest rates. Raising interest rates makes borrowing more expensive, which (hopefully) lowers inflation by slowing the economy. Less people borrow money to establish businesses or buy homes when interest rates rise. Theoretically, prices will decrease when demand for properties, workers, and other goods and services declines. But hiking interest rates can negatively impact commercial real estate transactions. So if that's the case, how should real estate players handle this period of market volatility?

Invest all odds

John Mazurek, Executive Manager of Sales at Douglas Elliman Real Estate, noted that in the last 20 bear markets since the '50's, only twice have real estate values gone down in value. Even after the last big one in 2008, prices in the majority of the country have surpassed 2006/2007 levels by a large margin. Because of that, in times when stocks lose their value, investors might be tempted to pull their money out of the market and turn to real estate as a stable alternative.

But not all real estate is an equal investment opportunity in a down market "I wouldn't be looking at office buildings myself unless they were in areas where converting them to a different use was a tangible possibility," he said. "I love the idea of turning vacant office buildings into urban indoor farms, but that's a long way off I think. But if you have a stomach for multi-family or warehouses, I'd put attention there." Mazurek told me that people need a place to live, and as more UPS, FEDEX and Amazon trucks clog the streets, distribution and warehousing space is becoming harder to come by, especially in already dense cities.

That said, now may not be the best time to sell off any assets either. "Except in cases of 1031 exchanges, I wouldn't be looking to sell any commercial property investments," said Mazurek. Where are you going to park your money in a bear market that's as stable long-term as real estate?"

Kevin Shtofman, Chief Operating Officer at NavigatorCRE, a platform that helps commercial real estate customers integrate and visualize all types of data, is seeing the upside to the market's downside. For Shtofman, the possible impending downturn is what keeps most players in real estate so excited, there's always opportunities around the corner. "There have always been periods of massive uncertainty and those are usually the moments of excitement because real estate companies aren't operating on sheer comfort," he said. "They're forced to innovate."

Shtofman said that each market cycle will create opportunities in each property type. Case in point: logistics. "I haven't seen anyone be excited about industrial logistics and warehousing in my lifetime. Until two years ago. And now all of the sudden it's like the hottest asset class ever. So, any time an asset class is down and out, I always think OK, just wait a bit because it's going to become exciting again."

But all that excitement aside, Shtofman thinks that the combination of increased interest rates and fairly suppressed supply, especially in the multifamily sector, is going to create a pretty big chasm between deals that are successful and deals that fail. "I've never seen a negative leverage environment until now," he said. "Those deals are going through because investors are hoping that they can rapidly increase the rates which they charge rents to justify the cost of that deal but I think some of those deals are going to blow up in their face."

Despite the bleak cacophony of bad news whirling around in the echo chamber, bear markets can be beneficial, if not essential, for the long-term health of commercial real estate. Many investors, large and small, lye in waiting for a down market in order to leverage capital. Down markets can often mean high deal volumes and short-term appreciation attractive to even the most impatient of capital. Those investors who have the fortitude and self-control to keep investing during bear markets will be rewarded with greater profits during bull markets. No one likes to see an economic pullback, but in this instance, it might be necessary to fight the inflationary boogyman that threatens to bring the economy to a standstill.