An Industry On The Ropes: CRE Hopes A Rate Cut Will Get It Back On Its Feet

By Matt Wasielewski and Ryan Wangman

The left jab was the onset of the coronavirus pandemic, ushering in a prolonged era of empty office chairs, shuttered businesses and hollowed-out landmarks of commerce, entertainment and public life.

Then came the right hook. Just as the commercial real estate industry stumbled to its feet, a fast and furious barrage of rate hikes entered the fray, knocking the wind out of a sector pumped up by the frenetic free-money party that gobbled up assets when debt was cheap.

Now, a battered and bruised group of CRE fighters is attempting to weave underneath the knockout punch, hoping a new cycle of rate cuts might rescue it from the ropes.

“Real estate has been taking punches from all sides for the last few years, and this is the first time they're getting any sort of relief,” said Derek Tang, an economist at LHMeyer. “It's not relief that will wipe the slate clean, but it will help a little bit. And maybe this is what the industry needs.”

The long-awaited moment is nearly here, and many in CRE are banking on the Federal Reserve’s first cut in years to unlock a shift in investors’ mindsets and open the door to a flood of new deals.

Pessimists say it won’t be enough to boost a sagging industry facing existential questions about how we work, shop and travel.

But nearly a dozen economists and finance insiders who spoke to Bisnow said the Federal Reserve’s upcoming decision is less about the cut and more about the pivot.

At the conclusion of the Federal Open Market Committee's highly anticipated meeting Tuesday and Wednesday, the Fed is overwhelmingly expected to begin cutting rates after years of restrictive monetary policy.

“The time has come for policy to adjust,” Federal Reserve Chair Jerome Powell said late last month. “The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook and the balance of risks.”

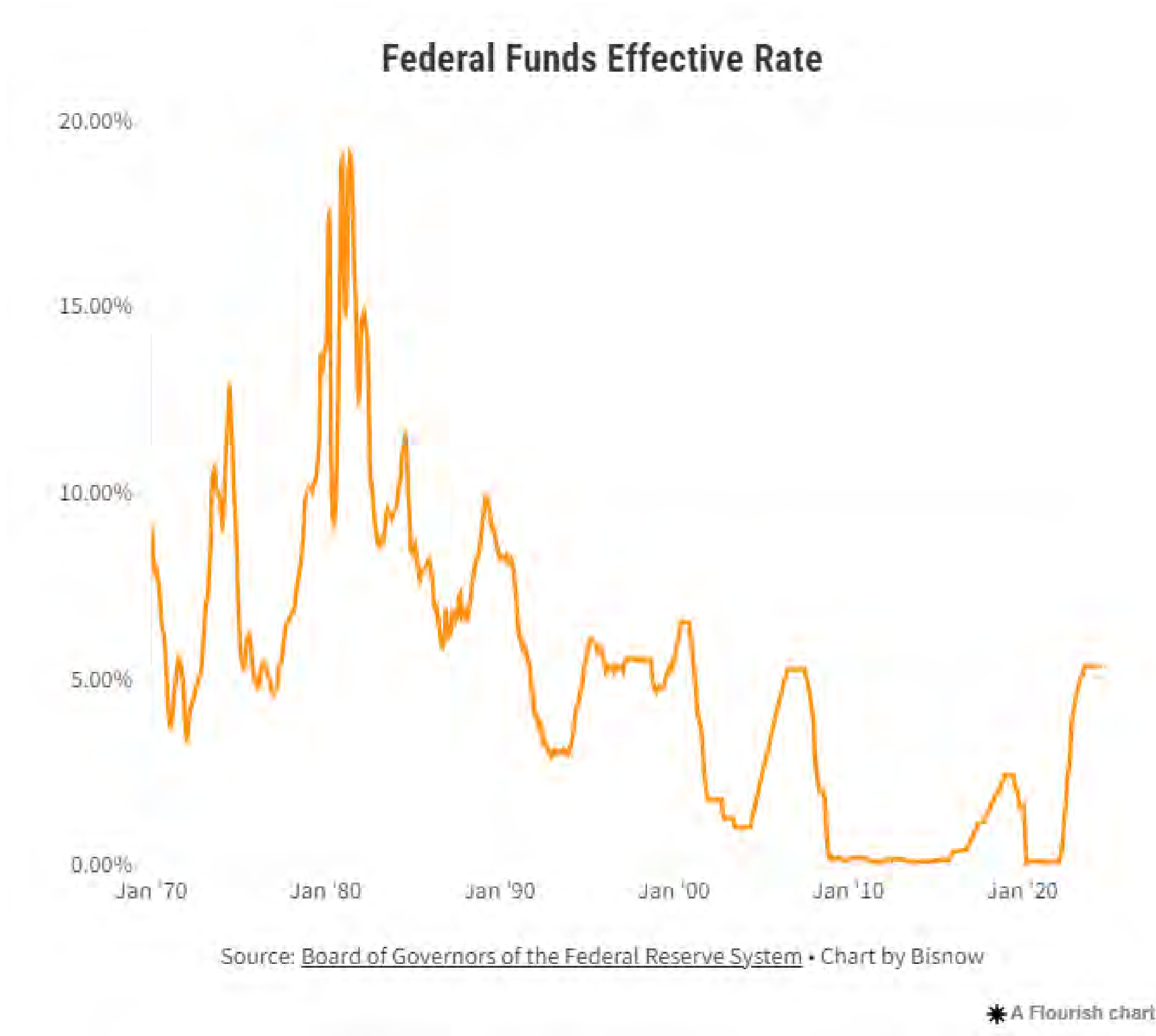
Only time will tell if CRE is saved by the bell.

Coming Out Of The Cave

CRE has been hooked on low rates for nearly a decade and a half. In the wake of the Global Financial Crisis, the Fed set its discount rate below 1% for seven years, from December 2008 to

December 2015. Even as monetary policy gradually grew more restrictive, the discount rate topped out at 3% in December 2018 before ticking down slightly.

The current high-rate environment is uncharted territory for many younger decision-makers, said Adam David Lynd, president and CEO of Texas-based The Lynd Group.



“We've had a 20-year bull market almost,” Lynd said. “Most of the people in charge of things have never seen a downturn.”

While some would argue CRE has been in a recession for some time, the Fed is attempting to stave off a wider crisis by loosening its grip on monetary policy. Rate cuts are likely to provide an ideal window for new transaction activity, according to Maverick Hotels and Restaurants CEO Bob Habeeb, who believes now is the time to start shopping new deals.

By the time the construction or build-out of his next project begins, Habeeb expects the lending environment to be much more forgiving, with several smaller interest rate cuts compounding to bring down borrowing costs.

The initial cut will tell the industry that the worst is behind it.

"It's that first signal that things are starting to improve," he said. "I think people are very reluctant to come out of their caves while there's still a chance that things are going to stay the same or get worse."

Rates aren't likely to come down as fast as they went up during this cycle, but the pivot from the Fed should bring clarity to the market, said Liz Holland, CEO of Chicago-based Abbell Associates.

"There's something to be said for knowing that this is as bad as it's going to be," Holland said.

Those speaking to Bisnow all said it was nearly certain that the Fed would cut rates when it meets this week. It's the size and reasons for the cut that are up for debate.

The latest unemployment numbers show signs of a cooling job market, but the figures remain well within the parameters of what is considered a strong economy. Inflation is inching closer to the Fed's preferred 2% target each month, and GDP was a strong 2.8% last quarter, according to Ermengarde Jabir, Moody's director of economic research.

"If we look at the numbers, the high-level economic indicators, in a vacuum, there's no indication of the need for a rate cut," Jabir said. "But we don't exist in a vacuum."

'Little Glimmers Of Sun'

The early days of the pandemic spelled disaster for CRE. Commercial buildings emptied out as people hunkered down at home to protect themselves from the deadly virus. Nationwide office visits fell 82% in the second quarter of 2020, retail foot traffic saw a 45% drop-off in April, and hotels posted an abysmal 44% occupancy rate on the year.

The Fed acted quickly to stabilize the economy, holding an emergency meeting in March where it cut rates effectively to zero. The move kicked off a bonanza of asset trades and construction loans financed at rock-bottom rates.

In 2022, the Fed aggressively flipped the script to combat rampant inflation, raising its policy rate at 10 consecutive meetings until it finally settled at a discount rate of 5.5%, the highest in more than 20 years. The central bank was on red alert after its preferred inflation indicator, the personal consumption expenditures index, began skyrocketing that year and hit 7.1% in June, the top rate in more than four decades and well above the Fed's 2% target.

The central bank has held its elevated discount rate for more than a year, leaving CRE struggling to adjust to a higher-for-longer capital environment.

The Federal Reserve's mandate is to balance employment and price stability, but it is perhaps equally concerned with maintaining calm in the broader capital markets — or at least not adding

to any turbulence.

Since Powell signaled a cut was coming, investors have spent the better part of the last month prognosticating over whether they would receive a 25-basis-point or 50-bps reprieve.

“There's little glimmers of sun peeking out behind the clouds, and that's really important because, come next year, I think you'll really see a lot more activity come to the market,” said James Bohnaker, senior economist at Cushman & Wakefield.

It will take time for the benchmark rate cuts to trickle through the broader capital markets, and Bohnaker doesn’t see the likely nominal initial cut as being impactful enough to open the floodgates of sidelined capital.

It will, however, boost spirits.

“It's always more psychological. That goes without saying,” Holland said. “It's psychological for the lenders, it's psychological for the borrowers, it's psychological for the [yield curve] spreads, because that's really where you borrow off of anyway.”

The sentiment-driven side of the market has become all the more impactful in an environment where price discovery is difficult and the economic future uncertain. The macroeconomic numbers don’t paint a clear picture, but investors generally agree that interest rates have peaked. As a result, some are waiting for the cuts to manifest before they close deals.

“The actual quarter of a tick or half a tick that they're going to come down isn't going to be as meaningful as the perception that we're coming off the high,” Habeeb said. “If people believe that we're now in an environment that's going to progressively get better for the rates, then you'll start to see activity again.”

Confidence that a rate cut is coming has been so strong that it is already appearing in deal underwriting.

Peter Merrigan, CEO of Boston-based Taurus Investment Holdings, said his firm started receiving unsolicited offers in July for multifamily assets. The sales and financing terms shifted in real time as data like a weak jobs report came in and signaled the economy was at an inflection point where the Fed was likely to act.

“The pricing on those, that interest changed right away, almost as an instant reaction to the data that came out late in July,” Merrigan said. “It probably tightened on the cap rate side by about 50 basis points almost overnight.”

While preemptive rate cuts from lenders may be welcomed by a landlord facing a debt maturity deadline, they also could blunt the impact when the Fed does move.

Some economists and investors argue that a 50-basis-point cut is more likely given that a small cut

has already been priced into many deals. At the same time, another cohort of market watchers worries a significant initial cut would send the wrong message to the market that a recession is on the horizon, potentially spooking investors.

“The most important thing is signaling what lies ahead,” Bohnaker said. “One of the signals — if they go 50 basis points or more — could lead everyone to get overly optimistic.”

That could lead investors to expect future rate cuts to be similarly sized, he said.

“I don't think that's really what the Fed wants to signal,” he said.

The New Reality

There is a natural tension between the desire for rate cuts and the macroeconomic factors that would drive those cuts, like higher unemployment, fewer new jobs and shrinking consumer spending.

The relative strength of today’s economy is far from settled as Powell continues to chart a course for a so-called “soft landing.”

“The Fed is really set on trying to avoid a recession, which is really what's important for real estate,” LHMeyer’s Tang said. “You've got the rate side of things, which affects the valuations, but real estate is a real asset, it's physical space, and the economic value of it depends on the actual fundamental economic uses of it.”

The cumulative effect of multiple nominal cuts would bring down lending costs but, by their very nature, would also signal an economic slowdown amid the backdrop of looming questions about the future of office use and the staying power of the American mall.

“As interest rates come down, a lot of real estate assets might start to look more attractive,” Tang said. “But we also have to remember, one of the reasons why interest rates are coming down is also because the labor market is weakening. So if people are getting less work or they're getting paid less, that's not necessarily good news for real estate.”

Trying to discern Fed tea leaves is more art than science, but residential real estate lenders are already cutting rates ahead of what they expect to be a series of cuts from the Fed, according to Leo Pareja, CEO of the digital brokerage eXp Realty.

“I'm actually worried that if we don't get 50 basis points, rates are actually going to bump up a little bit,” Pareja said.

Like in the commercial sector, Pareja said he doesn’t expect the shift in either direction to be meaningful enough to get buyers off the sidelines.

Homeowners, like commercial landlords, are playing the long game.

Whether the U.S. sticks the soft landing or heads for a recession will remain a pressure point as policymakers chart the muddy seas created by a record period of low interest rates.

A gradual decline of benchmark rates to a lower but not insignificant level is where investors eventually expect to land.

“I don't think we're waking up and it's 2006 again,” said Ryan Shear, managing partner of U.S. developer Property Markets Group. “I think there’s a new reality we’re all adjusting to here.”

That will funnel investments toward top-tier developers with a long track record and national footprint, Shear said, likening the bifurcation to the separation between the strong performance of trophy office towers and the trials and tribulations of most other office buildings.

Those controlling some of the trillions of dollars in dry powder are also likely to start actively looking for deals. As the Fed signals the start of monetary easing, some funds that have been waiting for distressed assets or rock-bottom pricing will fear they are missing the market, Shear said.

Apartment projects, whose underwriting is especially susceptible to debt costs, could be the earliest beneficiaries of falling rates. But Shear expects a lot of the new debt to go to developers that have spent the last two years working with lenders to kick the can on a debt maturity.

Even then, rates will come down, but not to the near-zero numbers that dominated the last decade and a half.

“There's going to be more options than there are today, but I don't know that everybody's going to love the options in front of them,” Shear said.