How did past interest rate cuts affect commercial property? Check out these six charts.

Federal Reserve’s half-point cut starts the clock on improving market conditions

By Mark Heschmeyer and Parker Leipzig

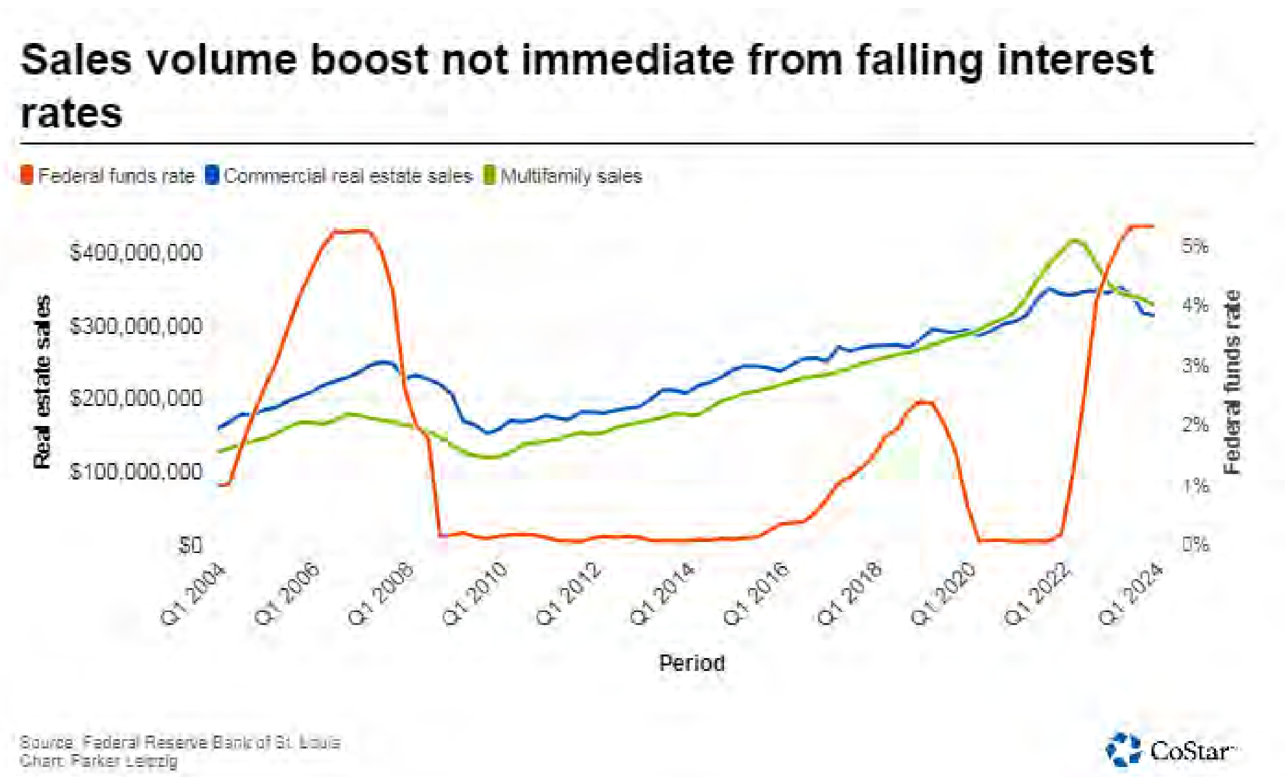
In this century, it has taken anywhere from 1 1/2 to 3 1/2 years for commercial property sales volume and prices to begin increasing following interest rate cuts.

The way it all plays out, after the Federal Reserve's announced half-percentage-point cut in the past week, will depend on how far the central bank keeps trimming rates to get them closer to what the U.S. economy experienced over the past 14 years, according to industry professionals.

Typically, commercial properties are bought or financed with loans set to mature in 10 years. Loans originated in 2014 through the second quarter of 2022 were financed while the borrowing rate was less than 2.5%, about half the current rate.

“Rate changes will probably be modest and are unlikely to return commercial interest rates to pre-pandemic levels anytime soon,” according to an analysis by S&P Global. “As of Aug. 19, the average interest rate on commercial real estate loans originated in 2024 was 6.2%, whereas the rate on those maturing was 4.3%, a jump of nearly 200 basis points.”

Here's a look at six charts that tell the story of commercial real estate's recent past when interest rates were high:



Quarterly commercial real estate sales volume peaked this century in the fourth quarter of 2021 when the federal funds rate was at 0.08%, according to Fed data. In 2022, the Fed began its steady push to raise the rate to help bring down rapidly rising inflation. Quarterly multifamily sales volume peaked just as that process began.

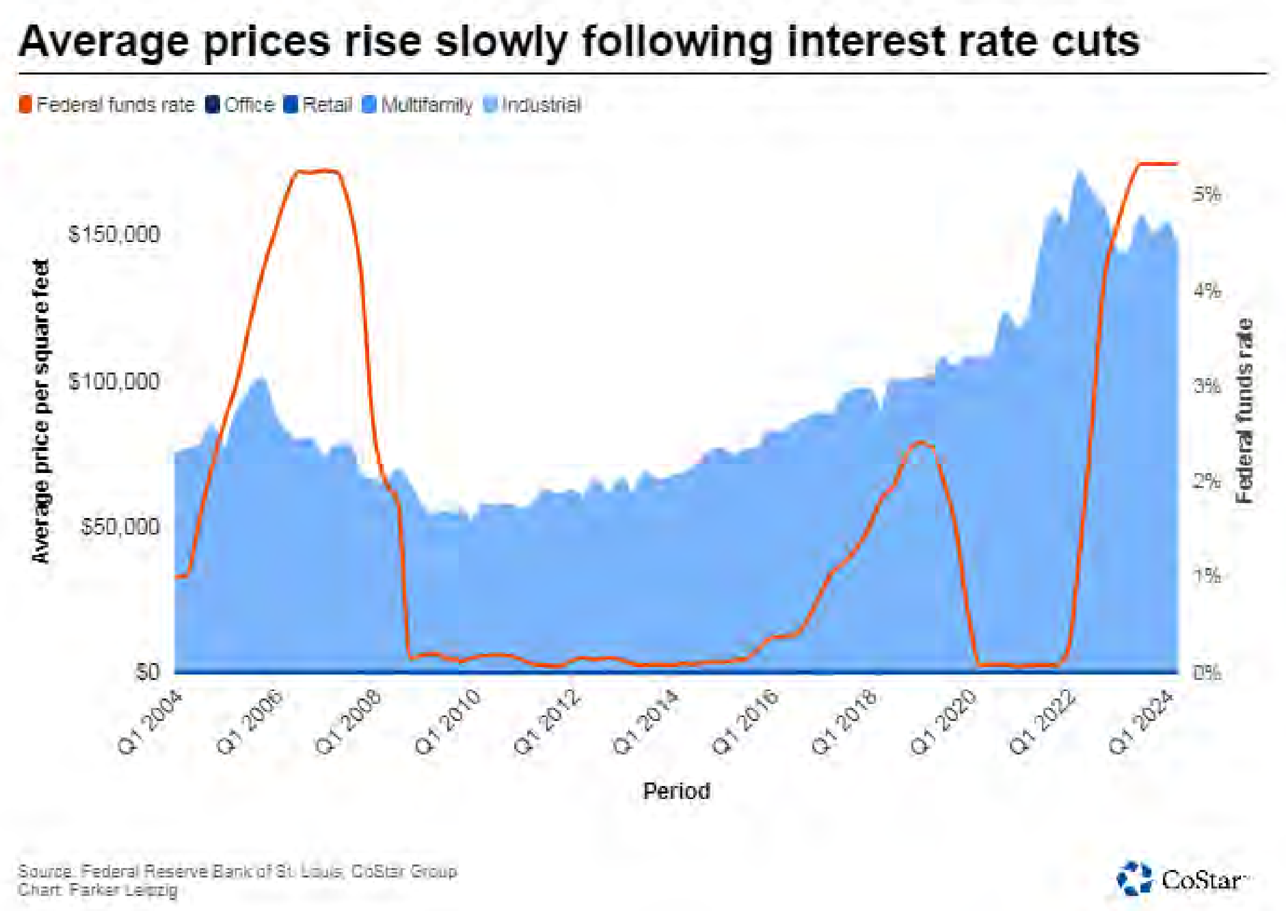
Historically, sales have climbed quarterly as long as the federal funds rate has been 2.6% or less.

The rate was above 5% from the third quarter of 2006 through the second quarter of 2007. It was in the third quarter of 2007 that sales volumes started falling. They did not start rising again until the first quarter of 2010 — after 10 full quarters of falling sales.

The federal funds rate again exceeded 5% in the second quarter of 2023 and held there until now. If the pattern of 2006 to 2007 is any indicator, it would not be until the end of 2025 or the start of 2026 that sales would begin increasing.

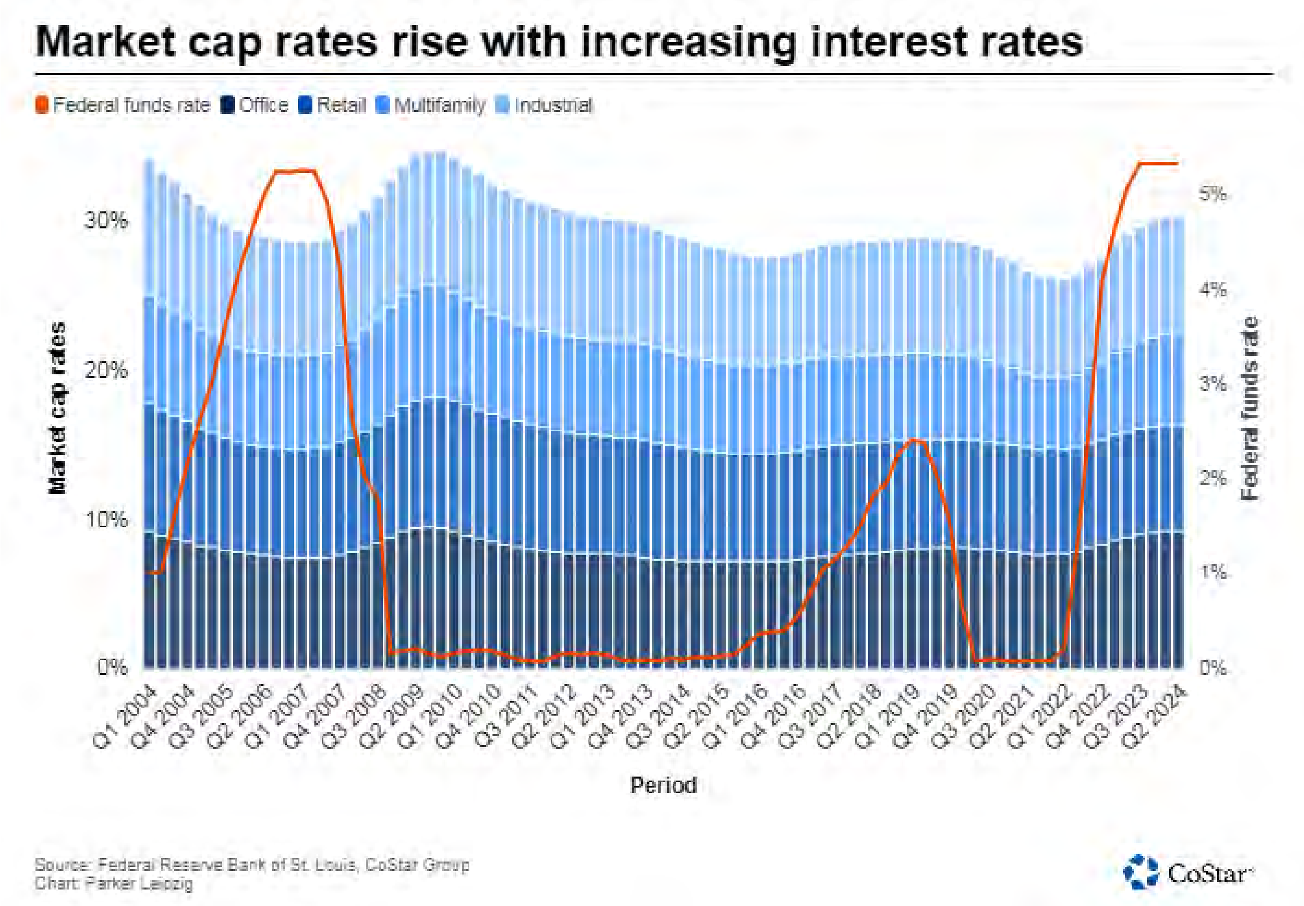
The high interest rates since 2022 have been a contributing factor to investors holding off selling, buying or refinancing properties in the hope of lower rates, according to the Mortgage Bankers Association. With rates now being lowered, many of those players are more likely to act.

2. Price per square foot or unit



The average property price per square foot or unit fell to its lowest point four to five years after the last time the federal funds rate topped higher than 5%, according to CoStar data. It also took that long for the price to start rising as the Fed started lowering the rate.

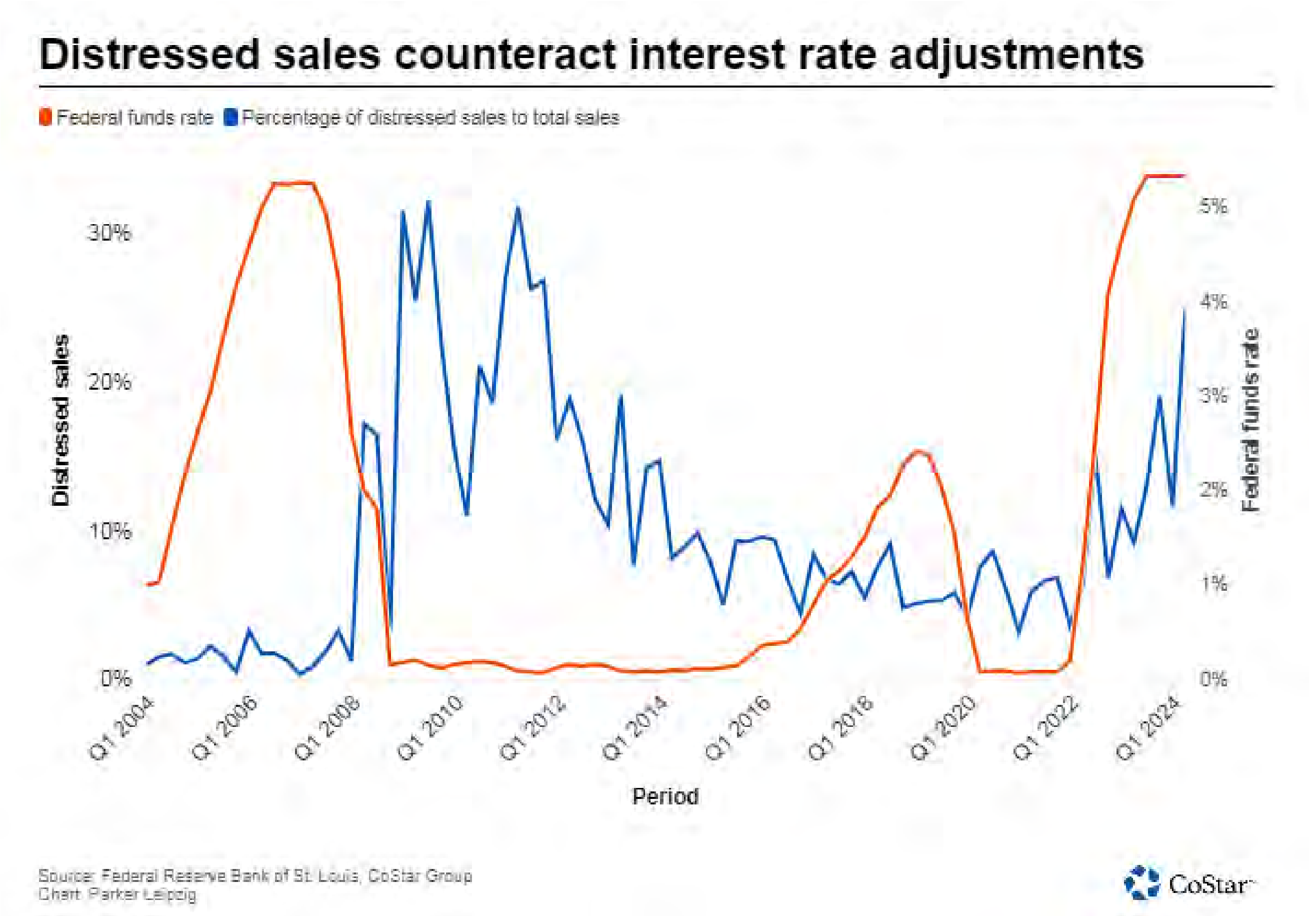
3. Capitalization rates



In the past, market capitalization rates started moving up five quarters from when the federal funds rate moved higher than 5%, according to CoStar data. These projected yields continued that climb for about two years after the rate started being lowered.

This real estate valuation metric estimates a property's potential return on investment, with a lower cap rate generally better because it indicates a less risky and more valuable property. A higher cap rate means a higher return, but the investment is also riskier.

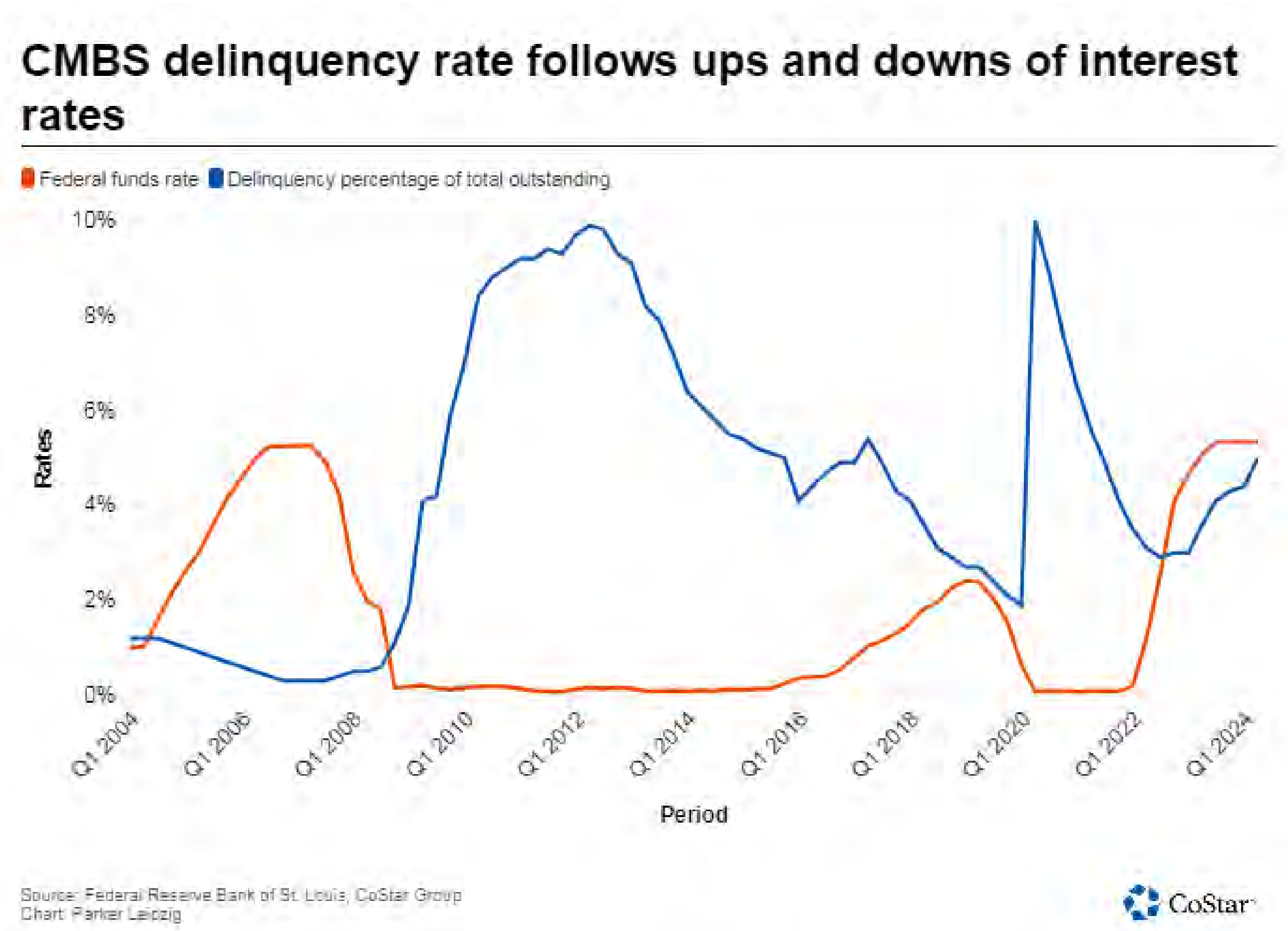
4. Distressed sales



The percentage of all sales classified as distressed started rapidly accelerating within about three years of the federal funds rate moving higher than 2.5%, and that phase has lasted for about three years, CoStar data shows.

The coronavirus pandemic started a quicker rapid rise in distressed sales with a spike occurring just two years later and is now at its highest point since the third quarter of 2011.

5. Commercial mortgage delinquencies

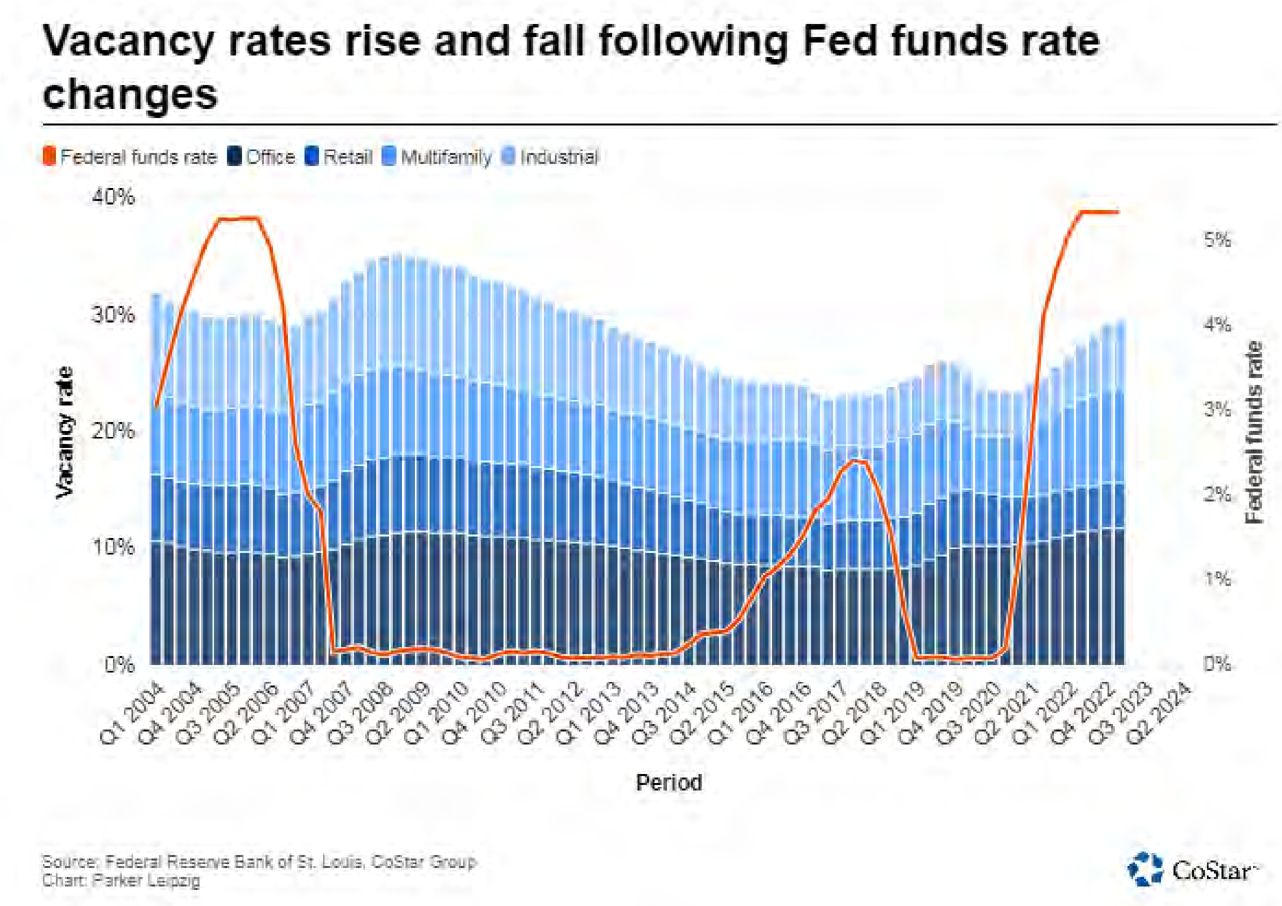


Commercial mortgage-backed securities data shows how borrowing rates have affected commercial property loan delinquencies over the century. The percentage of delinquent CMBS loans started climbing just two quarters after the federal funds rate hit 5.25% in the second quarter of 2006, according to CoStar Risk Analytics data. It took six years before the delinquency rate peaked.

CMBS loan delinquencies started their most recent ascent one year after the Fed began boosting the borrowing rate in the first quarter of 2022.

This time, the CMBS delinquency rate rise may not be as prolonged as from 2006 to 2012. Bond rating firm Fitch Ratings is forecasting that the delinquency rate will continue rising through 2025. However, it could eventually surpass its last peak of 9.9%.

6. Vacancy rates



The federal funds rate's last previous peak of 5.26% occurred in the first quarter of 2007, according to Fed data. Property vacancy rates for office, industrial and retail properties peaked from 3 to 3 1/2 years later, CoStar data shows. The same is true for when vacancy rates started falling as the federal funds rate started being lowered.

However, the office vacancy rate has responded much more quickly to the federal funds rate movement since the first quarter of 2020 as the pandemic took hold. The federal funds rate dropped to 0.08% in the second quarter of 2020. The office vacancy rate, which had been rising, leveled off a year later. It started rising again within six months of the first increase in the federal funds rate in the first quarter of 2022.