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Interest Rates and Real Estate

Interest rates have a profound effect on the value of real estate. But it would be wrong to think it is consistent factor throughout the asset class. Rising interest rates do not necessarily affect all real estate values in the same way. For example, highly indebted property is more at risk than low levered assets; residential is more at risk than commercial property; development is more at risk than investment; and short income investment is more at risk than long income investment.

In other words, the more value associated with capital value and less with income the more sensitive will be the overall value to movements in the cost of capital (i.e. interest rates). But there are wrinkles even in this generalisation. In decreasing order of importance, they are: the extent to which interest rate rises restricts general economic activity can have an exogenous effect on property as an asset class, a central bank's rate setting has is not always related to the availability of credit for property transactions, the rate set might not be passed on to property borrowers in full in a timely manner by banking institutions that can borrow from the central bank.

The last ten years has seen a breakdown in assumed correlations most people have worked with all their working lives. The wholesale implosion of the global capital market makers, followed – in the main – by the absorption of their debts onto government balance sheets around the world as well as counter-veiling government activities to promote fiscal stimulus (principally interest rate reductions and quantitative easing). No one is quite sure how this will end – policymakers will wish for a smooth transition but cataclysmic brick wall is another mooted by market participants. Supporting policymakers in their hope are their own innovations to date in using new fiscal policy tools. Supporting cataclysmic brick wallers in their analysis is the fact that there is no public appetite for overt assistance to the capital markets, and nothing like this has ever been tried / unwound before.

The UK has just raised its base rates by 25 basis points to a total of 50 basis points (it was only ever lowered to this particular level as an act of support for the British economy after the Brexit vote). But whilst the correlation between asset values and interest rates can't be refuted most institutions have lowered their exposure to real estate, meaning that leverage in the industry is much lower than at any time since the 2007/2008 global financial market turbulence. Any small rise has less of an effect that it would without these fundamental changes. This means that the Bank of England's 0.25% is well within the range of ordinary day-to-day real estate activity and investment.

The surprising thing is that although the consensus is that rates of the West will rise (and has been for the last ten years) the Fed declined to raise interest rates at its last session and economists are seeing weaknesses throughout the economies of the West that would be exposed by rapid interest rate rises and with no inflationary pressure throughout the West (except the UK where devaluation of the pound is seen as a transitory phenomenon). Maybe correlations are being remade.

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