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As Interest Rates Rise, Where Do Valuations and Transaction Volumes Go?

Years of warnings that rising Treasury rates would depress commercial real estate prices—during an extended period when rates stayed low and acquisition yields fell to record lows—has given the concept a "boy who cried wolf" quality.

Those warnings, however, will be tested now that the 10-year Treasury seems poised to continue its growth of the past 18 months and volatility has roiled the bond and equity markets. No longer can the market rely on the unusually large premium between Treasury rates and cap rates to buffer the impact of higher interest rates and the likely increase in mortgage coupons.

The recent increase in Treasury rates has not yet caused much change to property values. A compression of debt spreads has kept mortgage rates from keeping pace with the rise in Treasury rates, while equity return expectations have also contracted due to higher debt costs and stagnant property yields.

Looking ahead, we foresee interest rates will continue to climb, with modest impact on borrowing costs due to tighter debt spreads, strong property fundamentals and continued robust capital flows into the sector. We also expect a shift in capital from core to secondary and tertiary markets as investors seek higher yields in light of the increasing costs to borrow.