FED POLICY WILL DEPEND ON THE STRENGTH OF THE ECONOMY

WEEKLY ECONOMIC UPDATE

A Cushman & Wakefield Research Publication

SEPTEMBER 23, 2014

RATE INCREASES ARE COMING – IT'S ONLY A QUESTION OF WHEN

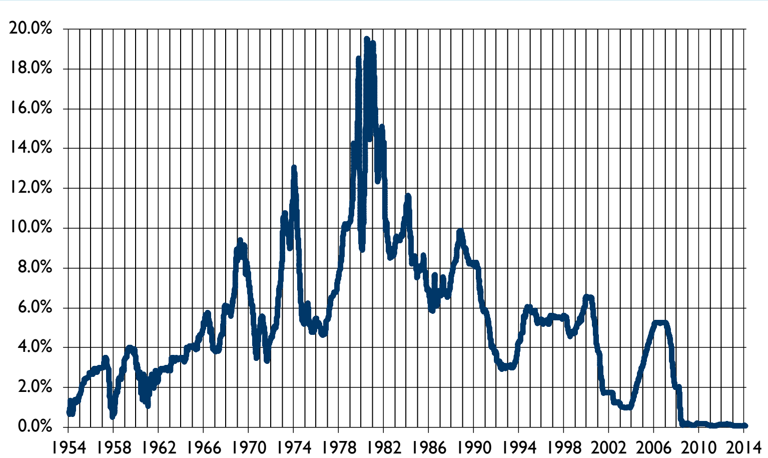
- We are nearing the end of the longest period of easy money in U.S. history. The return to a more normal interest rate regime may begin as early as Spring 2015. When it does, there may be some bumps in the road for the U.S. economy and the commercial real estate sector.
- After the Federal Open Market Committee (FOMC) announced no change in its gradual approach to monetary policy, interest rates will likely remain in a holding pattern over the balance of the year.
- Next year, interest rates are expected to increase and the rise could be substantial, depending on the performance of the economy.

In September 2008, as the U.S. financial system was close to collapse, the Federal Reserve began what would end up being the most extraordinary series of actions to stimulate economic activity in its history. Between September and December 2008, the FOMC lowered the federal funds rate (the rate at which banks lend money to each other) from 2.0% to between 0.0% and 0.25%. The fed funds rate has been held at this level ever since – as low as it has ever been – now close to six years. The Fed also engaged in a series of policy actions to keep long-term interest rates low, including large-scale purchases of Treasury notes and bonds along with asset-backed securities.

The policy has worked, although perhaps not as quickly or effectively as Fed policy makers had anticipated. Gradually, the economy has recovered and is now healthy enough that the FOMC has begun to wind down the massive stimulus. Starting in late 2013, the FOMC began to gradually reduce the amount of additional long-term notes and bonds the central bank was purchasing each month and by October those incremental purchases will be stopped.

The next phase in the return to a more normal monetary policy environment will be when the Fed begins to increase the federal funds rate. The current expectation among market participants is that the first increase in short-term interest rates since 2006 will take place in Spring 2015. But when and how that change will take place will depend on how the economy performs.

Federal Funds Rate



Source: Federal Reserve Board.

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10-Year Treasury Note Rate
(Percent)

Source: Federal Reserve Board

If we are correct and the economy has accelerated to a stronger growth trend, job growth is likely to accelerate and the Fed may be forced to shift to raising interest rates sooner and faster than most market participants currently anticipate.

The Fed has a dual mandate to hold down inflation and support employment growth. These can at times be conflicting goals, but not in today's economy. Inflation is very low and shows no signs of heating up any time soon. Last week, the Labor Department reported that the Consumer Price Index increased 1.7% in August from a year ago. With inflation this low, the Fed can continue to focus its efforts on stimulating growth. But, as we have noted over the past few months, the pace of economic growth has accelerated and the Fed now faces the possibility that strong growth will create conditions that will lead to more inflation in the future. Fed Chairman Yellen has indicated that the FOMC will monitor a range of economic indicators with a focus on labor markets because the Fed views tighter labor markets and the rising costs that occur when companies have difficulty finding employees as a key driver of inflation. Thus, the timing of the shift to higher interest rates and how fast those rates increase will also depend on the pace of increases in employment and wage statistics.

Currently, wage growth is moderate and job growth in August was slower than expected. But these trends can change quickly. If we are correct and the economy has accelerated to a stronger growth trend, job growth is likely to accelerate and the Fed may be forced to shift to raising interest rates sooner and faster than most market participants currently anticipate.

The possibility that interest rates may rise sooner than currently anticipated has implications for bond markets and for commercial real estate. If we look back at spring 2013, we can see what might happen if there is an unexpected shift in Fed policy. In May 2013, then Fed Chairman Bernanke hinted that the Fed may begin to reduce the amount of bonds it was purchasing. This hint of a change had a dramatic effect on the 10-year Treasury note. The yield jumped from 1.6% in May to nearly 3.0% just four months later. This near doubling of long-term rates shows how important it is for the Fed to communicate its intentions. It also indicates that when bond market participants are anticipating a certain course of action, an unexpected change can lead to rapid changes in interest rates in the market.

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RESEARCH REPORT
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Sudden shifts in interest rates can have a significant impact on commercial real estate markets. In the current economic environment, the most likely interest rate surprise would be one that pushes rates higher and faster than currently anticipated. That would raise the cost of funds for purchasers and owners of real estate as well as impact their operations and plans.

Conclusions. We are at an inflection point in the conduct of monetary policy in the U.S. The Fed is about to shift to a regime of raising interest rates for the first time since 2006. If the shift takes place sooner than generally expected and if it is not well communicated to financial markets, there could be a sharp reaction in financial markets with higher rates sooner than expected. This could have a negative impact on commercial real estate markets, especially when it first occurs.

Keep in mind, the reason interest rates are expected to increase is that the economy is performing better. This healthy economic climate is supportive of commercial real estate markets as it means that demand for space is likely to be strong.

Overall, we expect interest rates to increase in the coming year, and the rise could be substantial if the economy strengthens further. The key to the speed and magnitude of interest rate increases will be the economic statistics as they are released. Over the next several months, it will be more important than ever to carefully monitor the economic data released by the government and the private sector.

[The Fed is about to shift to a regime of raising interest rates for the first time since 2006.]

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