

INTEREST RATES: WHAT GOES UP MUST COME DOWN

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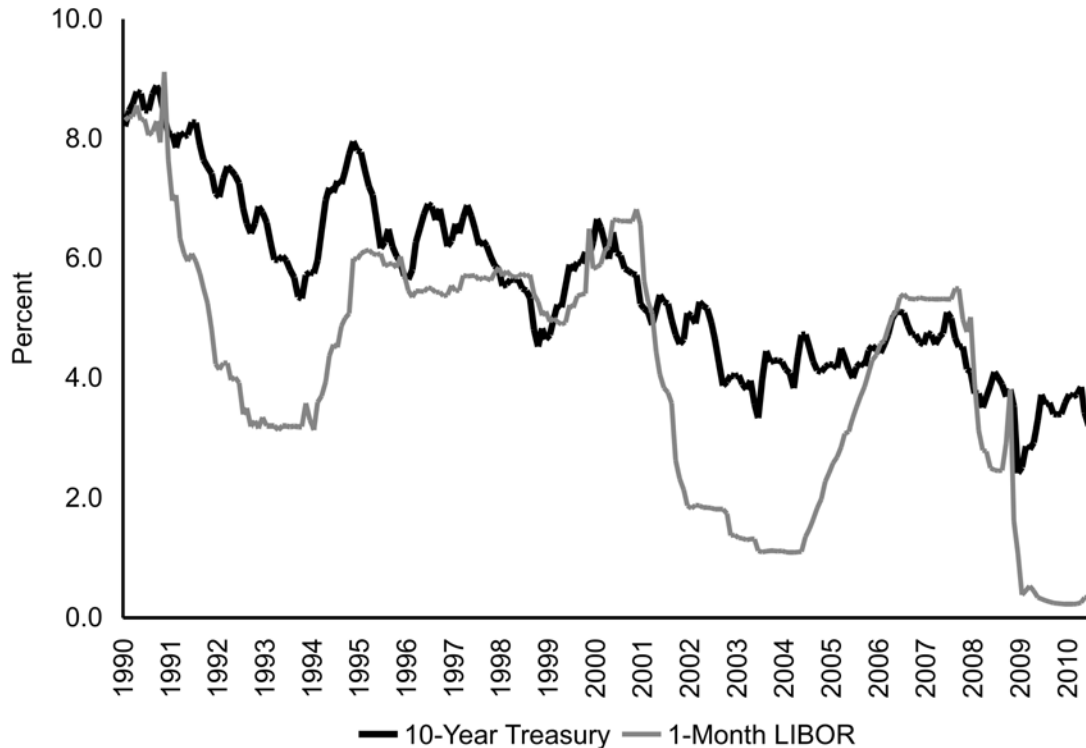
Melvin Mark Capital Group, LLC

What an interesting time to be asked to write something about interest rates! Our practice emphasis is commercial real estate capital markets (also known as finance and investment). I will use this opportunity to discuss rates in that context. I will also attempt prediction as to future rates. However, with comfort, it would be difficult to do worse than recent consensus.

“Interest rates” mean different things to different market participants. In addition the market is faced with many different interest rates: LIBOR, SWAPs, prime, SFR mortgages, Treasuries, Fed funds, bond rates, and so on.

My comments will focus on those facets of the interest rate universe that impacts commercial real estate the most: the 10-year Treasury in particular, but also cap rates, the yield curve, LIBOR, and risk spreads. The U.S. Treasury bond rate is the standard for risk free, fixed income investing. Treasuries are viewed by many as a barometer of market sentiment, anticipating both central banker behavior and global economic trends; the forecast is worrisome. Treasuries span durations ranging from from 3 months to 30 years. At the start of the year there was strong consensus of rising rates on Treasuries over the second half of 2010. When the investment world becomes unpleasant or uncertain, as has happened several times this year, investors move toward what they expect to be safer investments. This “flight to quality” drives bond yields lower and bond prices higher. We have now had a series of runs taking the yield on the 10-year Treasury from more than 4 percent to less than 3 percent This is in contrast to earlier forecasts that predicted increasing yields. The

market has set and reset record lows for 2-year Treasuries and have seen decades-long lows for 5- and 10-year Treasuries.



Source: Federal Reserve System; wsjprimerate.us

Figure 3.1 Interest rates on 10-year Treasury and 1-month LIBOR, monthly, 1990–2010

As the standard for risk free returns, Treasuries are commonly used to benchmark pricing for mortgage loans or bonds. Typically, these instruments add a risk spread or premium to the quoted benchmark. Top rated bond risk, for corporate or mortgage backed instruments, termed “AAA,” is defined as best quality or “*nearly* risk free.” Commercial mortgage-backed securities, or CMBS, typically are separated into series of tranches from rated from lower risk (e.g., AAA) to higher risk (e.g., B). The blended pricing from all the tranches drives the loan pricing and the profitability on securitization and sale.

At the height of the capital markets surge approximately three years ago, the AAA CMBS tranche priced at 25 basis points over Treasuries with the same maturity. A basis point is 0.01 percent, so 25 basis points is the same as 0.25 percent. At the peak of the correction following the bubble two years ago, AAA spreads were as high 1000 bps (i.e., 10 percentage points) higher than Treasuries and there were few if any takers. In fact, CMBS took a two year hiatus. Life insurance companies, traditional source of long term fixed rate mortgage financing, have returned cautiously. More recently, the best pricing on high quality properties has improved to 200 basis points over Treasuries, down from twice that 18 months

ago Even so, these more favorable rates are seen only on “least risky” assets with leverage levels of 55–60 percent.

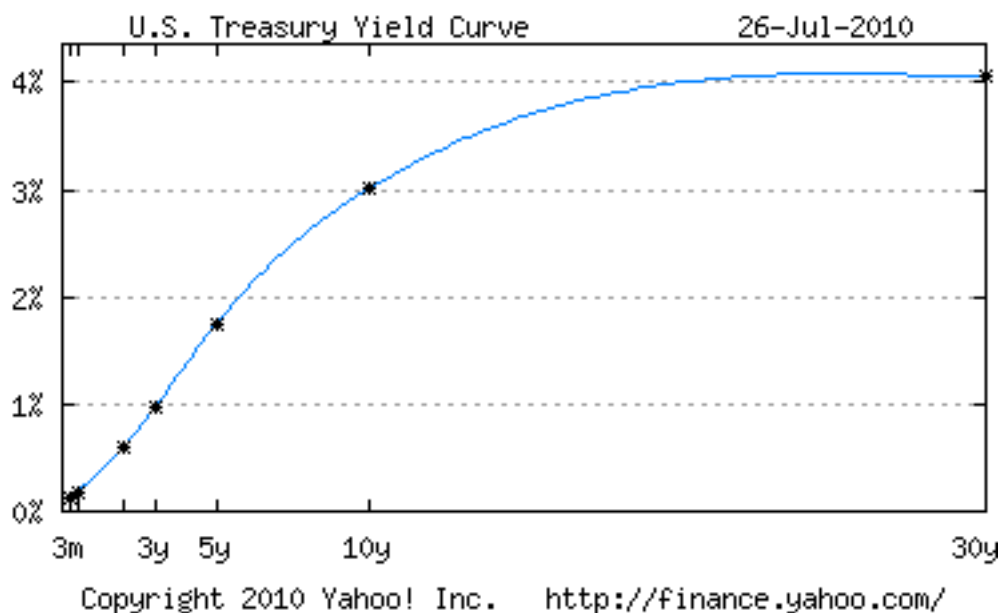


Figure 3.2 U.S. Treasury bond yield curve, 2010

The “yield curve” describes the difference in yields among bonds with shorter maturities and those with longer maturities. The yield on a 30 year U.S. Treasury typically is higher than the yield on a 1 year U.S. Treasury. The higher yield reflects a number of factors, such as inflation uncertainty, that make holding a long-term security riskier than holding a short-term security. Currently, shorter maturity Treasuries are at record lows and they the yield curve is historically steep. Other short term rates are facing near-record lows. For example, the Fed Funds rate is 0.25 percent, money market rates are between 0.10 percent and 0.20 percent, and 1-month LIBOR stands at 0.33 percent, all at or near all-time lows.

Part of the demand pressure on shorter term Treasury rates has resulted from the capital accumulation following the subprime liquidity crisis. Once the capital markets began to return, those with access to capital took advantage. Banks and life insurance companies currently hold close to double their historical levels of liquidity. Real estate investment trusts (REITs) and opportunistic funds have accumulated war chests. Public companies in every sector have taken advantage of recovering bonds markets to build historically high levels of cash. That massing of liquidity competes for safe, short term yields, while awaiting productive deployment.

The market seems primed for activity once a catalyst gets it started. Mortgages or mortgage bonds represent one of several fixed income alternatives available to investors. Current rate levels are very attractive from a borrowers perspective, while at the same time,

lenders find mortgage spreads relatively attractive both historically and compared to alternative fixed income investments.

Many commercial loans, however, include payment protection. Prepayment protection is typically provided in the form of prohibition, yield maintenance or defeasance. Yield maintenance calculates a “make whole” prepayment penalty while defeasance provides for preservation of scheduled payments from replacement bond collateral. The steep yield curve makes either very expensive from a borrowers perspective: borrowers must give up substantial cash up-front to obtain the savings from lower interest rates. As a result, early refinance has become very challenging, frustrating borrowers and lenders alike.

A “cap rate” is the ratio between the net operating income (NOI) produced by an asset and its capital cost (the original price paid to acquire the asset). Cap rates had compressed or tightened to historic lows at the peak of the capital markets surge in 2007. A dramatic reduction of (nearly 90 percent) in commercial real estate sales volume since that peak, however, makes market cap rate data scarce. At the market peak, cap rates were tightly grouped without much differentiation between markets, asset types or relative quality. Today, there is drastic differentiation, with bottom tier assets drawing little market interest except from all-cash opportunists.

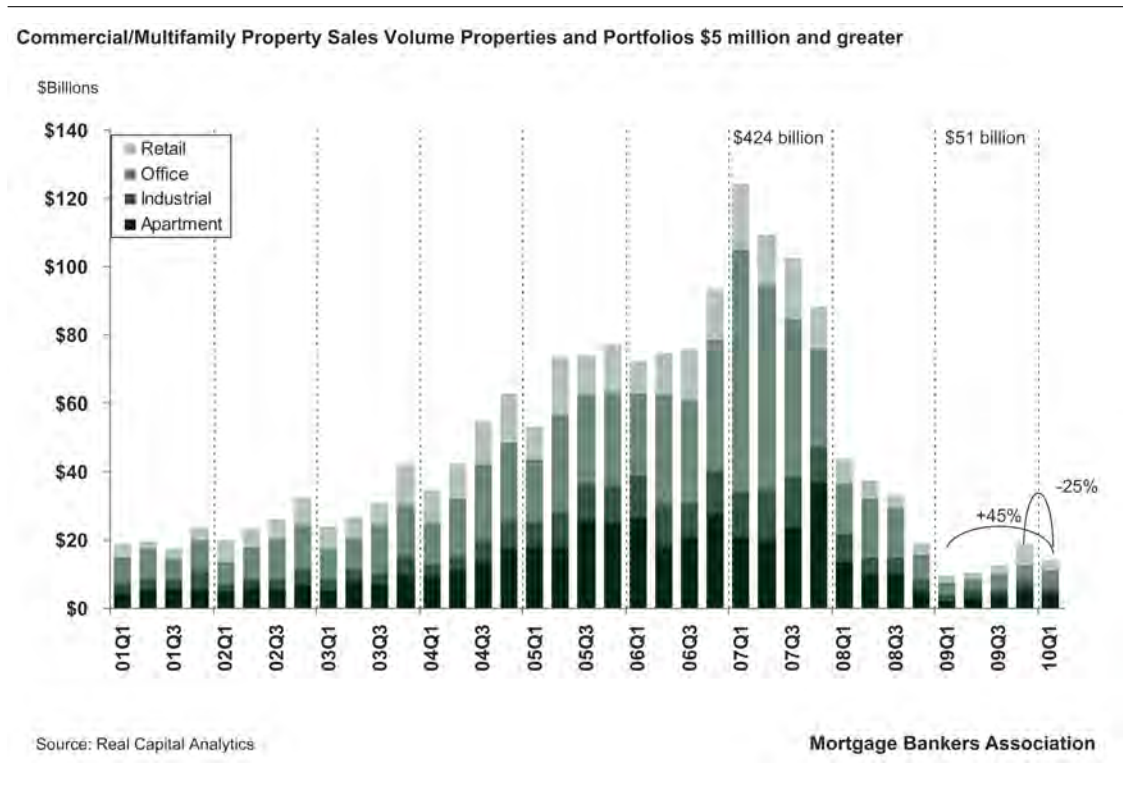


Figure 3.3 Small transaction volume means a lack of meaningful comparable cap rate data

The availability and cost of debt affects the price buyers are able or willing to pay for commercial real estate assets. Easy access to historically aggressively sized and priced

debt at the peak of capital markets surge influenced valuations three years ago, as have the ebbs and flows since. The gradual return of debt availability over the past two years has supported a return of valuation growth, although this has been mostly true of top tier assets and multi-family which enjoy more favorable access to debt. After peaking in 2007, valuations fell by as much as 40 percent or more depending on asset particulars, and have recovered modestly this year. Now, values have reset on average to where they were in 2000.

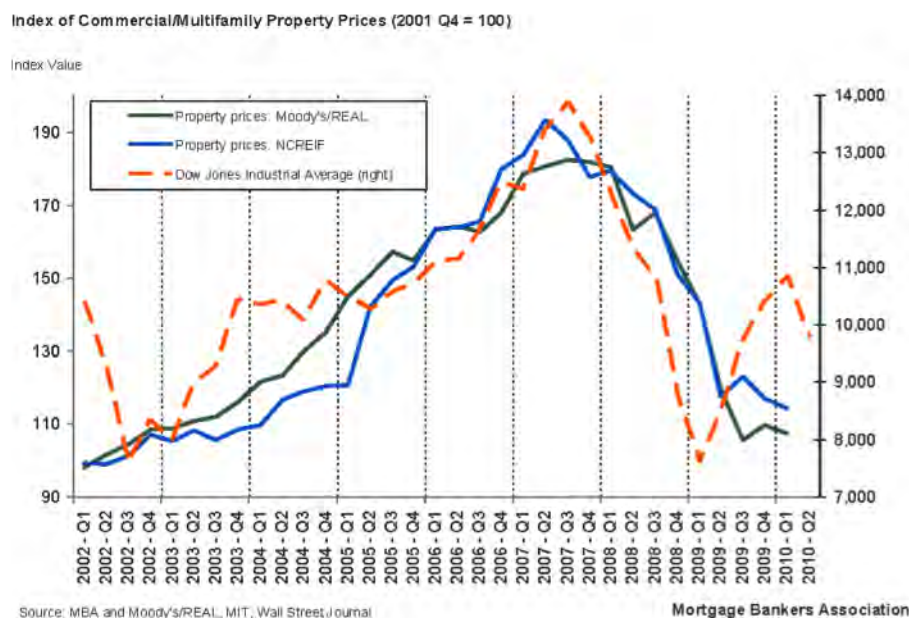


Figure 3.4 The rise and reset of property prices and other equity investments

Positive leverage depends on the relationship between the cap rate and the cost of debt, either enhancing or diminishing the investment return. With cap rates having reset to historical or higher levels and debt pricing at or near historical lows, positive leverage has been restored at least with regard to top tier assets. However, earlier this year we shared forecast concerns about the risk of rising Treasuries becoming an issue for owners who had not yet refinanced. We now expect a more gradual upward shift, delayed until the year's end or early next year. Offsetting global pressures should cause this to be a more subdued and extended recovery cycle.

We are seeing the best mortgage pricing currently at 5 percent or less for 10 year borrowing, and 4 percent for 5 year borrowing. This results from accommodative central banker policy and something of a "perfect storm" of too much capacity competing for too few transactions. When the market begins to find supply/demand equilibrium, we may see rates moving back toward more normal favorable levels into next year, with 10-year loans in the 5.5 percent to 6.5 percent range and 5-year loans approaching 5 percent. Beyond that we see the 10 year Treasuries working back toward a more low/normal 5 percent to 6 percent range, with credit spreads settling back to a 175–225 basis point range, for "all in" pricing

in the mid 6 percent to mid 7 percent range. Those who are in a position to transact over the next year and a half will be pleased that they did. ■

John M. Petersen is president of Melvin Mark Capital Group, LLC, a mortgage banking company that focus on arranging capital and financial solutions for regional owners, buyers and developers of commercial real estate.