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News & Information

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With Interest Rates and Risk Rising, Cap Rates May Be Next In Line

According to a recent report by Moody's Analytics, the rest of 2022 might be the start of an economic rough patch as increasing risk factors boost market volatility. Moody's states that economic risks and tightening monetary policy could translate into higher cap rates all the way into 2023.

Cap Rate Forecasts

The report also points out, however, that all is not equal in commercial real estate (CRE) markets, with sectors like hospitality, office and retail already showing signs of an increase in cap rates in response to rising interest rates. Multifamily and industrial cap rates have meanwhile remained steady in the face of uncertainty.

Worth noting is that the existing low cap rates seen in multifamily mean that an overall rise in cap rates will likely cause an increase for the sector. Put another way: "…sectors that have been transacting at very low cap rates have little place to go but up."

Is a Bump Up Inevitable?

Earlier this year, the National Association of Realtors (NAR) predicted only a modest rise in cap rates in 2022, counterbalanced by upward pressure in CRE prices. NAR notes that sales price growth has been on the up, especially for the industrial and multifamily sectors.

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Moody's Head of CRE Economic Analysis, Kevin Fagan, adds:

"There are strong opinions in the market both ways, that cap rates will go up significantly with rising rates, and others saying that cap rates will go down, and demand and expectations of rent growth will compress risk premiums."

In a May 2022 interview with Wealth Management, Fagan added that the biggest headwinds currently facing US CRE are a combination of inflation, lower consumer expenditure and the risk of a recession.

Moody's adds that, given the current economic climate, the chances of 2022 being a recession year have risen to 33%, while 2023 faces an "uncomfortable 50% probability" of a recession setting in.

Taking the Long View

Though these predictions certainly add some uncertainty in the coming year, worth bearing in mind is that the outcome of the current volatility is far from set in stone. The way these factors play out in the CRE market remains to be seen.

For now, Moody's takeaway prediction is that we should "expect to see more volatility in transaction and capital markets before we record pronounced effects on rents and vacancies."