RESEARCH BRIEF

Marcus & Millichap

FINANCIAL MARKETS **AUGUST 2019**

Yield-Curve Inversion Reiterates Stability Of Commercial Real Estate

Brief yield-curve inversion sparks volatility. The short-lived inversion of the 10-year and two-year Treasury yield curve sparked significant financial market volatility as the closely monitored sign of an impending recession delivered a warning alert. Despite efforts by the Federal Reserve and generally strong economic metrics, including steady job creation, low inflation, above-average retail sales growth and elevated small-business confidence, financial markets remain concerned about ongoing trade disputes with China. The flight to safety sparked by the uncertainty has pushed the 10-year Treasury rate to the 1.5 percent range, within 20 basis points of the record low set in July 2016. The convergence of these factors has delivered a unique window of opportunity for commercial real estate investors.

Financial market volatility reemphasizes security of real estate. The recent financial market swings reiterate both the stability of commercial real estate and the attractive yields offered by the sector. In addition, the exceptionally low interest rates currently available provide a strong levered yield premium, with the average combined commercial real estate cap rate of 6.3 percent exceeding the 10-year Treasury by 480 basis points, one of the widest margins this cycle. While this has the potential to attract additional capital to the sector, it also offers current investors an opportune time to reevaluate their existing portfolios. With risks of an impending recession elevated, real estate owners may consider more defensive asset allocations favoring single-tenant net-leased assets with a strong credit backing as well as sectors that generally fare well during weaker economic periods such as healthcare-related real estate. Diversification across markets with different economic drivers and across property types will also become increasingly important as the next economic cycle plays out. The window of opportunity could close quickly, however, as a resolution to the trade war could rapidly erase much of the uncertainty and spark a brisk rise in interest rates.

Developing Trends

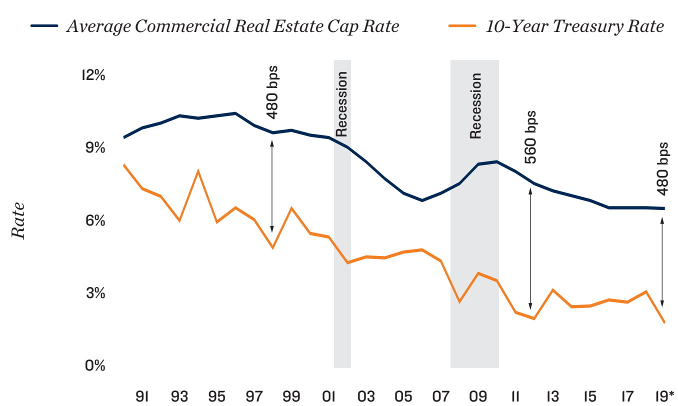
Job creation maintains steady pace. The U.S. is on pace to hire 2 million new employees in 2019, sustaining unemployment in the upper-3 percent range as job openings still outnumber people seeking work by 20 percent. Sustained job creation remains a primary driver of domestic growth and real estate demand.

Spending picks back up as consumers stay optimistic. Core retail sales growth rose 4.2 percent year over year in July, after posting 3.8 percent gains three of the past four months. Elevated consumer confidence and solid wage growth continue to support spending, putting consumption above historical averages.

Stable economy keeps income levels on the rise. Disposable income remains at an all-time high on an inflation-adjusted basis, reaching $45,600 per capita in June. Year-over-year growth has remained in the mid- to high-2 percent range throughout 2019, reiterating the underlying strength of the economy.

6.3% *Average CRE Cap Rate*	1.54% *10-Year Treasury Rate*

Yield Spread Widening



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* Through Aug 16

Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; Federal Reserve Bank