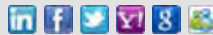


# Avison Young: Property Prices and Interest Rates – What's the Correlation?

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Insightful Unique Not For Me

By Amy Erixon

During the last cycle it became conventional wisdom that capitalization rate spreads to bond yields had become a reliable factor in predicting the behavior of property values.

Over the decade prior to the recent market turmoil, both indicators trended generally downward. Late in the cycle spreads closed dramatically, widening again during the recent period of highly stimulative interest rates.

So we learned that at least in the short run, property valuations are affected by many other capital markets variables.

The **chart on this page, illustrated with US data**, shows that over the long run the spread to bonds has not been a strong indicator of short or long term property valuations. During some periods they not even positively correlated (such as in periods characterized by high inflation, 1984-1992). In fact, what the data shows is that over time cap rates for property tend to remain within in a tight range between 7 and 9 percent, begging the question - now that we are back into a more normalized range - what does the future hold?

Property buyers still look for stabilized real estate investments to produce total returns (income plus appreciation) around 7-8 percent after taking into account capital expenses, management fees, positive (or negative) leverage and market volatility. Increasing use of leverage on property as nominal interest rates declined played a role in creating a pricing bubble and subsequent property market dislocation We saw this play out in both residential and commercial property markets in the US and UK among other locations.

There is a broadly held view that interest rates and property prices are inversely correlated, meaning rising rates will have an adverse impact on property values. In the housing market there is a direct relationship between affordability and interest rates due to the high levels of leverage used by most buyers. But the commercial property market includes high, low and moderate leverage buyers and is less sensitive to interest rate changes.

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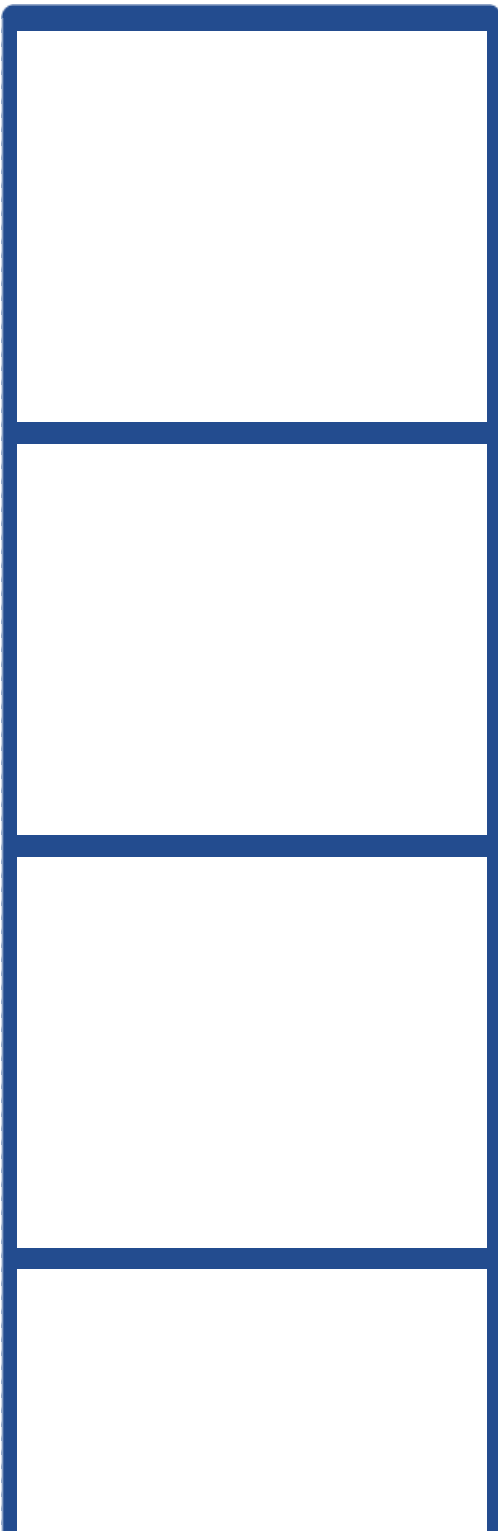
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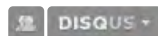
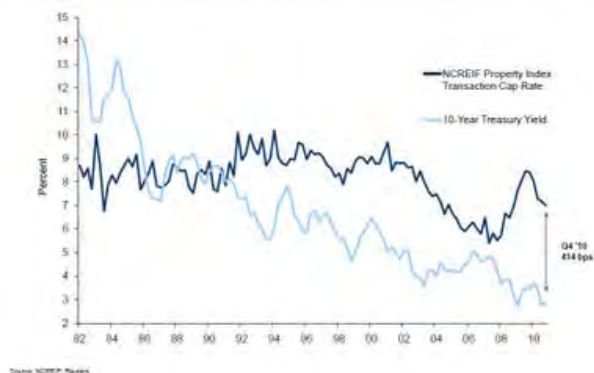
In today's world interest rate trends tell us more about who is the most aggressive buyer of property, (leveraged or unleveraged buyers) than the nominal market price or rate of change. During early stock market recovery periods, the REITs are aggressive property buyers. During periods of very low interest rates, private high leverage buyers have an advantage. During periods of rising interest rates and anticipated near term inflation, long term buyers and institutions that normally hold significant long bond positions dominate the purchaser population.

#### So what does the data tell us?

First, anticipate a lag at the very least in any correlation of property values to bond yields. Spreads have widened to unusually large levels and cap rates are falling strongly as all types of investors are returning to property holdings from other sectors deemed to be topping out. Second, the advertised benefits of holding real estate in a multi-asset portfolio are not only to provide enhanced return over bonds, but also to provide capital growth which is not closely correlated with the stock market; specifically growth which serves as a medium to long term hedge against inflation.

**Amy Erixon** joined **Avison Young** in August of 2010 to develop the company's cross-border investment activities. Prior to joining Avison Young, Ms Erixon was Chief Executive Officer of IGRI, a privately held Canadian investment and development company, which she joined in 2005. While at IGRI she grew third party assets under management to \$800 million and oversaw completion of in excess of \$1 billion of investments and development. Prior to IGRI she spent 12 years at LaSalle Investment Management where she served as International Director, founded and led the firm's Canadian and Mexican operations and led development and hotel investment activities.

U.S. Commercial Real Estate Spreads Remain Wide



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