Time to Pay Attention to the Yield Curve?

Inversion Implications and Strategies for CRE

JUNE 2019

Executive Summary

- When the yield curve[1] inverted briefly in March and April this year, we were relatively unconcerned, as they were not persistent inversions. The inversion since May, however, has persisted and continues into June, warranting another look at this metric which is widely tracked in the financial markets.

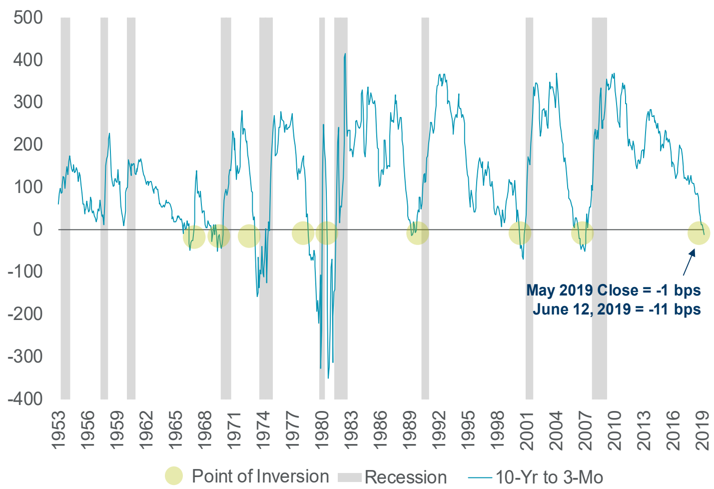
- There is no recession today; nor is one likely to arrive any time soon. In fact, we expect the expansion to continue and become the longest in history. GDP growth is expected to end the year at 2%-to-2.5%, and we anticipate commercial real estate market performance will remain strong.

- Yield curve inversions do not *cause* recessions. But they have been good—although not infallible—*predictors* of recessions, with a lead time of anywhere between five and 18 months. The economic and financial data bear watching.

- In the event of increased downside risks, we expect the Fed to respond swiftly with interest rate cuts, among other measures, to prevent any material deterioration in the economy. In addition, CRE fundamentals in most markets are in good shape.

- While there are some arguments to support the "this time is different" narrative, current conditions do offer CRE participants opportunities to re-engineer their portfolios:
  - *Refinancing strong assets:* switching out of shorter-term debt and locking in more longer-term debt at lower rates.

YIELD CURVE: 10-YEAR TO 3-MONTH SPREAD



Source: Federal Reserve, Cushman & Wakefield Research

- *Plan for income, but not for further material capital appreciation:* opportunity to move up the capital stack, from equity to debt positions

- *Diversification is key:* both in terms of product type (multifamily and industrial) and geography (larger, more diverse markets)

- *Back to basics:* markets with strong underlying demographics, strong industries such as technology, and sectors supported by robust supply/demand dynamics (life sciences and healthcare)

[1] Spread between the 3-month Treasury bill and the 10-year Treasury note

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Last month the monthly yield curve spread in U.S. Treasury markets turned negative for the first time this cycle. Some economic indicators, including the initial weekly unemployment claims and the unemployment rate, continue to point to strong growth; others—the purchasing managers' index and capital investment—are softening.

What is the yield curve? The yield curve represents the risk associated with lending over time. Simply put, long-term interest rates are typically higher than short-term rates because there is a higher risk associated with longer term loans. One measure of the yield curve is the difference between the 3-month Treasury bill and the 10-year Treasury note, although there are several other commonly used short-term rates.

Historically a reliable (but not infallible) predictor of recessions: In 1965, the 3-month to 10-year yield curve spread turned negative, but it was a false alarm. Since then, the yield curve has inverted seven times and every time a recession has followed. This track record in "predicting recessions" is second to none.

But it is not a driver or trigger for recessions. An inverted yield curve does not *cause* a recession. It might, if it persists, reduce credit availability in the economy as lenders hold back. But an inversion by itself is unlikely to trigger a recession. A recession usually occurs because of excesses in the economy that need to be corrected (e.g., the housing bubble in 2005-2007). Such corrections are usually spurred by an event or shock of some kind such as surging oil prices (1973), excessive Federal Reserve tightening (1981) or war (1991).

What's the lead time? The time between when the yield curve inverts and when a recession begins varies widely and depends not only on the rate but also the frequency of the data. When looking at *daily* data for the 10-year and the 3-month Treasury yields, the time frame varies from just under one year to three and a half years; the average lead time is two years. The recent inversions in March and April this year were daily inversions and so gave us little cause for concern.

However, when an inverted yield curve lasts a month—that is, when we look at monthly data—the lead time can be as short as five months or as long as 18 months. The average lead time is 11 months.

This is not by any means an exact science. The yield curve moves up and down every day, sometimes from negative to positive territory from one day to the next. So the direction of the latest inversion could well change tomorrow.

Prior to the previous three recessions, the yield curve turned negative, then went back into positive territory before the recession began. While there is no rule of thumb, the longer the inversion persists, the more likely a downturn will follow.

Is this time Different? Maybe, maybe not. As with many predictive indicators, there is a tendency to rationalize the current situation. For example, when the yield curve turned negative in mid-2006, it was rationalized on the basis that we were in a new paradigm with low inflation that caused long-term rates to remain low despite a strong economy. We all know how that ended.
Most arguments today revolve around the fact that the 10-year Treasury rate may be held artificially low by central bank policies around the world. These policies have the net effect of putting downward pressure on long-term yields. Most estimates suggest the Fed's actions are depressing 10-year U.S. yields by roughly 75 to 100 bps. Other factors, such as a flight to quality in financial markets (e.g., U.S. bonds) due to trade disputes and slowing global growth may also account for a lower 10-year Treasury yield.

The next recession is not likely to be as bad as the last one. There will be another downturn in the future, but it will not be like the Great Recession for several reasons. Debt levels are reduced/contained in the U.S. financial sector (although non-financial corporate leverage may be a growing risk), and we have not seen excessive supply or wage growth that would need to be rectified. Household and bank balance sheets are much healthier than they were in the mid-2000s. Finally, the Fed is better prepared; it now has a more diverse toolkit to respond to a slowdown (although theoretically there is less fiscal capacity). Certainly CRE fundamentals are in much better shape than they were in 2007.

RESTRUCTURING AND REBALANCING STRATEGIES FOR CRE.

Notwithstanding any recessionary concerns, an inverted yield curve does present some opportunities including:

- *Refinancing strong assets:* While long-term rates have retreated, short-term rates have remained flat. Owners wanting to refinance to benefit from new low rates can do so, switching out of shorter-term debt and locking in more longer-term debt at lower rates.

- *Plan for income, but not for capital appreciation:* At this point, any further capital gains from CRE would be a bonus. There is also an opportunity to move up the capital stack, from equity to debt positions. In general, have an eye for defensive plays.

- *Modest, short-lived corrections in asset pricing:* A short, shallow recession combined with a strong monetary reaction suggests pricing corrections that could present buying opportunities in an environment with record levels of capital allocated to CRE but with few buying opportunities.

- *Diversification is key:* Aim for a healthy mix both in terms of product type and geography. Multifamily and industrial, for instance, continue to benefit from long-term structural shifts. Within markets, larger ones with more diversified economies and tenant bases tend to be better able to withstand downturns.

- *Back to basics:* Markets with strong underlying demographics, strong industries (such as technology) and sectors supported by robust supply/demand dynamics (such as those underpinned by life sciences and healthcare) are less sensitive to the business cycle. For instance, life sciences and healthcare are both experiencing healthy secular growth due to a combination of rapid technological change and an aging population.

- *Opportunities for strong tenants:* Tenants who are in a sound financial position can take advantage of any downturn to improve the quality of their space and/or lower their rent.

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