

## Federal Reserve to Embark on Normalization; Balance Sheet Reductions to Influence Commercial Real Estate

**Balance sheet normalization likely to begin.** Following the rounds of quantitative easing that pushed the Federal Reserve's balance sheet to \$4.5 trillion, the Federal Reserve has outlined plans to reduce the size of its holdings. This will accelerate its effort to move toward more normalized monetary policy following nearly a decade of easing. Although the Federal Reserve has raised short-term interest rates four times since the financial crisis took them to zero, the balance sheet has remained consistently near \$4.5 trillion as interest and proceeds from investments have been rolled over into new securities. However, that process is about to change, with members outlining plans to allow \$6 billion of Treasury securities and \$4 billion in mortgage-backed securities to roll off the balance sheet per month to move toward normalization. The Fed plans to gradually increase the amount allowed to mature to \$30 billion in Treasuries and \$20 billion in mortgage-backed assets as the process moves forward. The winddown is expected to transpire at a cautious pace over several years, with a primary focus on market stability.

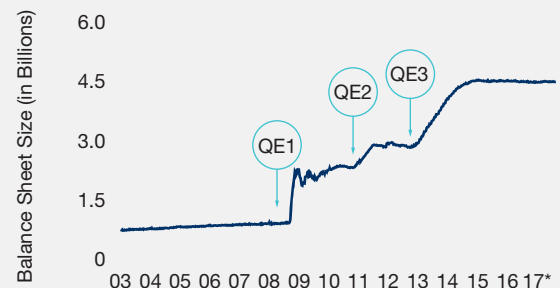
**Fed normalization to place upward pressure on longer-term interest rates.** A winddown of acquisitions by the Fed, one of the largest buyers of long-term debt, will exert upward pressure on long-term rates. Additionally, market liquidity could decline for other asset classes as participants adjust to the resulting rise in risk-free rates. This process could slow demand for bonds originating from weaker capital structures as capital markets adjust to reduced liquidity. However, interest rates remain historically low, encouraging market participants to purchase higher-yielding assets to achieve targeted rates of return. This will partially counterbalance upward pressure on interest rates. Additionally, investment flows from foreign markets to the United States in search of higher yields and safe-haven assets could restrain the pace of rate increases. As a result, upward pressure on yields will at least be partially offset by foreign and domestic buyers who favor the safety of U.S. Treasuries, particularly given the positive yield premium when compared with similar offerings overseas.

**Rising cost of capital could weigh on investor activity.** The majority of commercial real estate investors expect a modest increase in interest rates over the course of the year, pushing up the cost of capital. While commercial real estate fundamentals remain strong, rising costs associated with debt financing will tighten the spread between cap rates and lending benchmarks. This environment could weigh on transaction activity as investors evaluate their yield options. Cap rates have remained relatively stable over the last year, but upward movement in Treasury rates has amplified the expectation gap between buyers and sellers. Some anticipate short-run declines in the Treasury yields, reiterating that the untested moves by the Fed could increase rate volatility.

### Quantitative Easing

- **QE1:** Beginning in November 2008, the Federal Reserve began the purchase of \$750 billion of mortgage-backed securities and \$300 billion of Treasuries. It sought to maintain orderly markets and asset valuations during the height of the financial crisis.
- **QE2:** Fulfilling its role as the buyer of last resort, the Federal Reserve followed the first round of quantitative easing with QE2 in November 2010, purchasing \$600 billion of long-term Treasuries in an effort to lower the cost of borrowing across debt markets.
- **Operation Twist:** Beginning in September 2011, the Federal Reserve announced Operation Twist. This endeavour involved selling short-term Treasuries to buy longer-term Treasuries, while keeping the balance sheet the same rather than creating new holdings. The policy extended through the end of 2012.
- **QE3:** The Federal Reserve in 2012 announced QE3, a plan that involved the purchase of \$85 billion per month at its height, comprising \$45 billion in long-term Treasuries and \$40 billion of mortgage-backed securities. It provided additional stimulus to the recovery. The program ran until December 2013.

### Federal Reserve Lays Out Steps to Reduce Balance Sheet



\* Through second quarter  
Sources: Marcus & Millichap Research Services;  
CoStar Group, Inc.; Real Capital Analytics

## Interest Rate Spreads Remain Positive; Yield Curve Points to Continued Growth

The yield spread between long- and short-term Treasury rates is closely monitored as a sign of an impending recession. When the yield on short-term rates exceeds the yield on long-term rates, the yield curve turns negative. For every recession since the 1970s, the spread has gone negative at least 12 months before the onset of a recession in the business cycle. This poses a challenge for the Federal Reserve as it attempts to lift the overnight rate. The Fed has raised its rates four times within the last 18 months, applying upward pressure on short-term rates. Since the Fed started raising rates in December 2015, the two-year Treasury has risen by roughly 40 basis points. Meanwhile, the 10-year Treasury rates have essentially remained flat. As a result, the yield spread has tightened from 135 basis points to 85 basis points. One of the strategies the Fed is using to push long-term rates upward is shrinking its balance sheet. By reducing its acquisitions of bonds and mortgages, 10-year Treasury rates should drift upward, thereby expanding the spread between short- and long-term rates. Naturally, there are numerous forces such as the flow of international capital that could still hold long-term rates down, but the move by the Fed is a logical step toward normalizing monetary policy while reducing the potential of creating an inverted yield curve.

**U.S. 10-Year Treasury still offers yield premium to foreign capital.** Due to continued stimulus in Japan and Europe, which is holding down foreign Treasury rates, U.S. Treasuries offer much higher yields to investors. This yield premium is encouraging capital flow into the United States from foreign pension plans and insurance companies. Additionally, due to the dollar's role as the world's reserve currency, numerous foreign central banks and commercial banks must hold Treasuries to maintain capital and liquidity needs. As a result, considerable support remains for U.S. Treasuries, which are widely considered the safest sovereign debt instrument in the world.

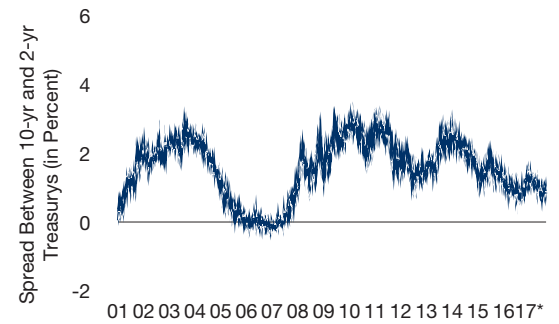
## Global 10-Year Government Bond Yields

Country	10-Year Bond Yield	S & P Rating
Switzerland	-0.20%	AAA
Japan	0.02%	A+
Germany	0.37%	AAA
France	0.68%	AA
United Kingdom	1.06%	AA
United States	2.17%	AA+
China	3.67%	AA-
Russia	7.80%	BB+

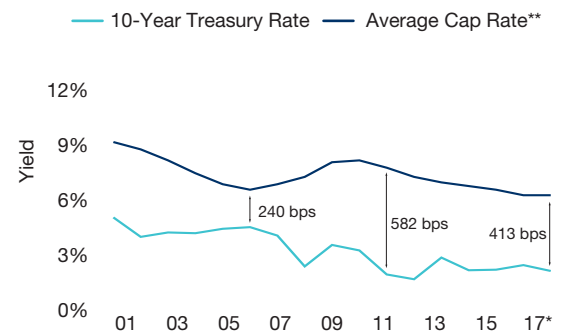
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Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Federal Reserve; Moody's Analytics; Real Capital Analytics; Standard & Poor's; U.S. Bureau of Labor Statistics.

### Lending Spreads Remain Positive



### CRE Yield Still Supportive of Acquisitions



\* Through August 25, 2017

\*\* Estimate; Includes apartment, retail, office, industrial and hotel properties \$2.5 million and greater

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Price: \$500

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