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PRINCIPAL REAL ESTATE

What's after "higher for longer?"

A reversion to the mean is supportive of real estate credit

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AT-A-GLANCE

In this paper we explore whether interest rates are likely to stay higher for longer or revert to the mean—and the impact it could have on real estate credit returns.

- Between Q4 2008 and Q4 2021, the standard benchmark interest rate averaged 0.5%. Rates have never been lower than during that period.
- SOFR began rising at the beginning of 2022 and reached a 23-year high of 5.32% in Q4 2023. This is a period some call "higher for longer."
- Considering the longer historical time period (1987 to present), when the standard benchmark interest rate averaged 3.24%, the most recent SOFR and SOFR forward curve look more like a reversion to the mean.[1]
- The forward curve suggests the 1M Term SOFR rate will settle in the 3% range, which is good for real estate credit investors.

[1] Data is current as of the time of this writing, September 24, 2024.

Where are interest rates headed? "Higher for longer" appears to be behind us, and the market is projecting a reversion to the mean—not a return to the near zero interest rate environment. While no one can predict the future, we believe that any of the likely interest rate scenarios bode well for investors.

"Higher for longer" has been the mantra in investment circles since Q4 2023, when the Secured Overnight Financing Rate (SOFR) reached a 23-year high. Taking into account only the period since 2009, higher for longer does seem like an accurate characterization of the recent interest rate environment. Looking forward, "higher for longer" will only persist if inflation reports occur that are a surprise to the upside.

The market is now pricing in a soft landing as the highest probability outcome, with a mild recession remaining a decent possibility. The Federal Reserve has started cutting rates, and the forward curve has SOFR settling around the long-term (1987 to present) standard benchmark interest rate average of 3.24%. If that's correct, a reversion to the mean is a more accurate characterization of the rate outlook. This scenario, however, still presents opportunities for investors—higher returns than Q4 2008-Q4 2021, when SOFR averaged 0.5%. Other ancillary benefits for mean reversion include better loan metrics at origination, such as debt service coverage. Transactions should likely uptick as well as equity investors test the market and become more confident in their underwriting.

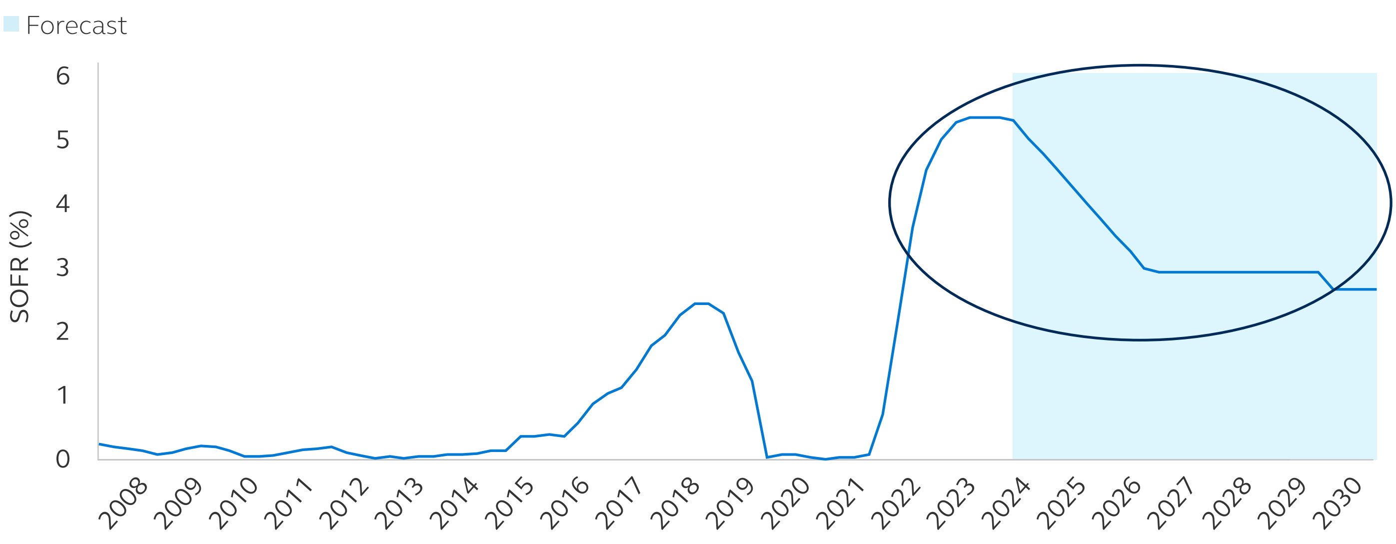
While the SOFR forward curve loses reliability beyond six to 12 months out, it is the accepted benchmark to give us a sense of where interest rates are headed. Acknowledging there are many market forces that affect SOFR, at the time of this writing (September 24, 2024), this is what we're seeing in the market.

Higher for longer?

SOFR reached a high point of 5.32% in Q4 2023. This comes on the heels of a 13-year period (Q4 2008-Q4 2021) often referred to as "lower for longer," during which SOFR averaged 0.5%.

Looking between now and 2030, the SOFR forward curve is expected to settle around 3%. That is lower than 2023-2024 but still significantly higher than the Q1 2019 peak of 2.43% and the Q4 2008-Q4 2021 average of 0.5%. Based on the Q4 2008-Q4 2021 period in isolation (see Exhibit 1), "higher for longer" may be an accurate characterization of the interest rate environment for the foreseeable future, when compared to the most recent credit cycle.

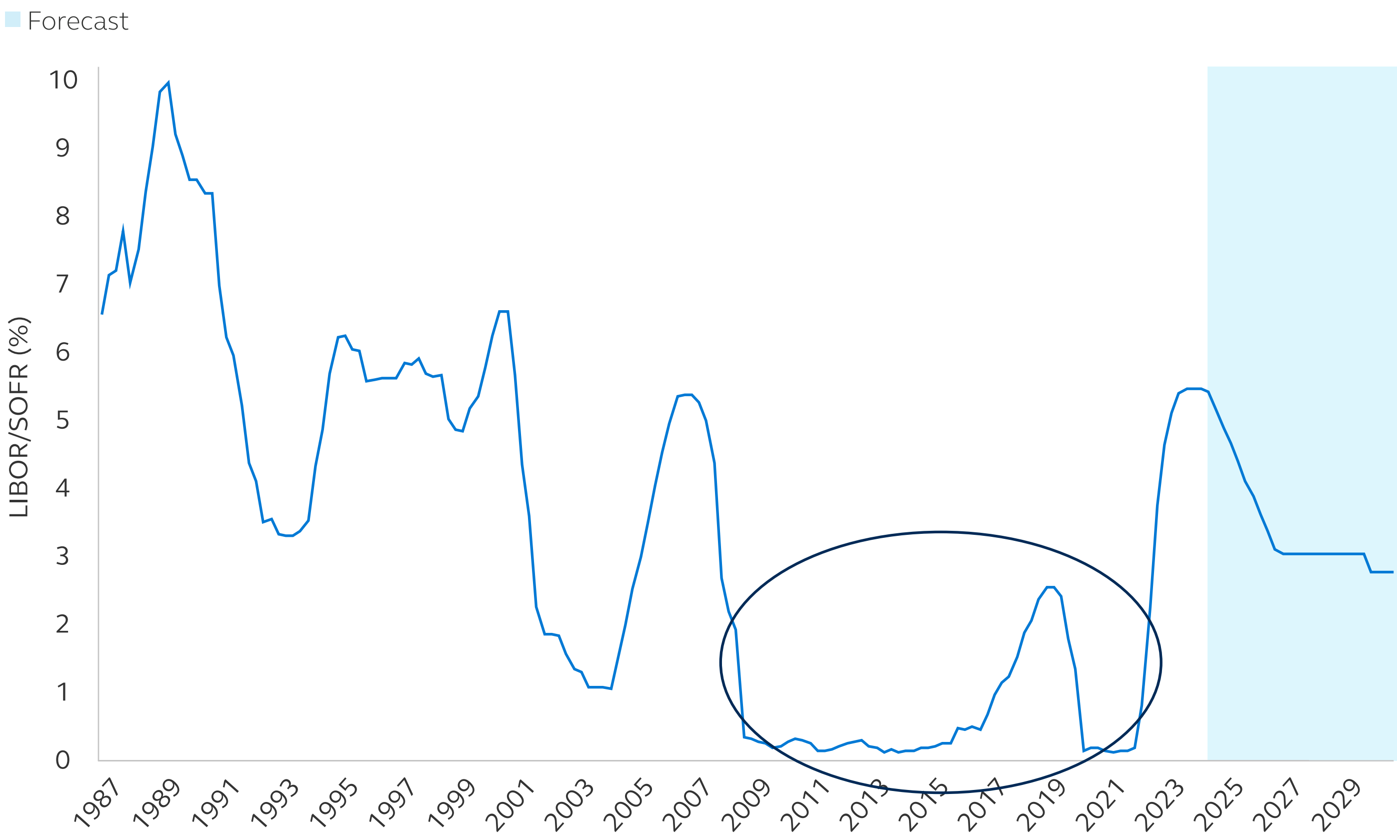
EXHIBIT 1: Plotting SOFR from Q4 2008 makes the recent period look "higher for longer"



Source: ICE Benchmark Administration Limited (IBA); Moody's Analytics, Q2 2024

The picture looks different, though, if we take a longer historical view of rates (see Exhibit 2). Considering the 37 years since the inception of the London Interbank Offered Rate (LIBOR), the "lower for longer" Q4 2008-Q4 2021 period is the anomaly; rates have never been lower than during that period. In this context, both the recent high and forward curve are consistent with long-term historical rates—not "higher for longer."[2]

EXHIBIT 2: Plotting rates since 1987 reveals Q4 2008-Q4 2021 was the anomaly



Source: ICE Benchmark Administration Limited (IBA); Moody's Analytics, Q2 2024

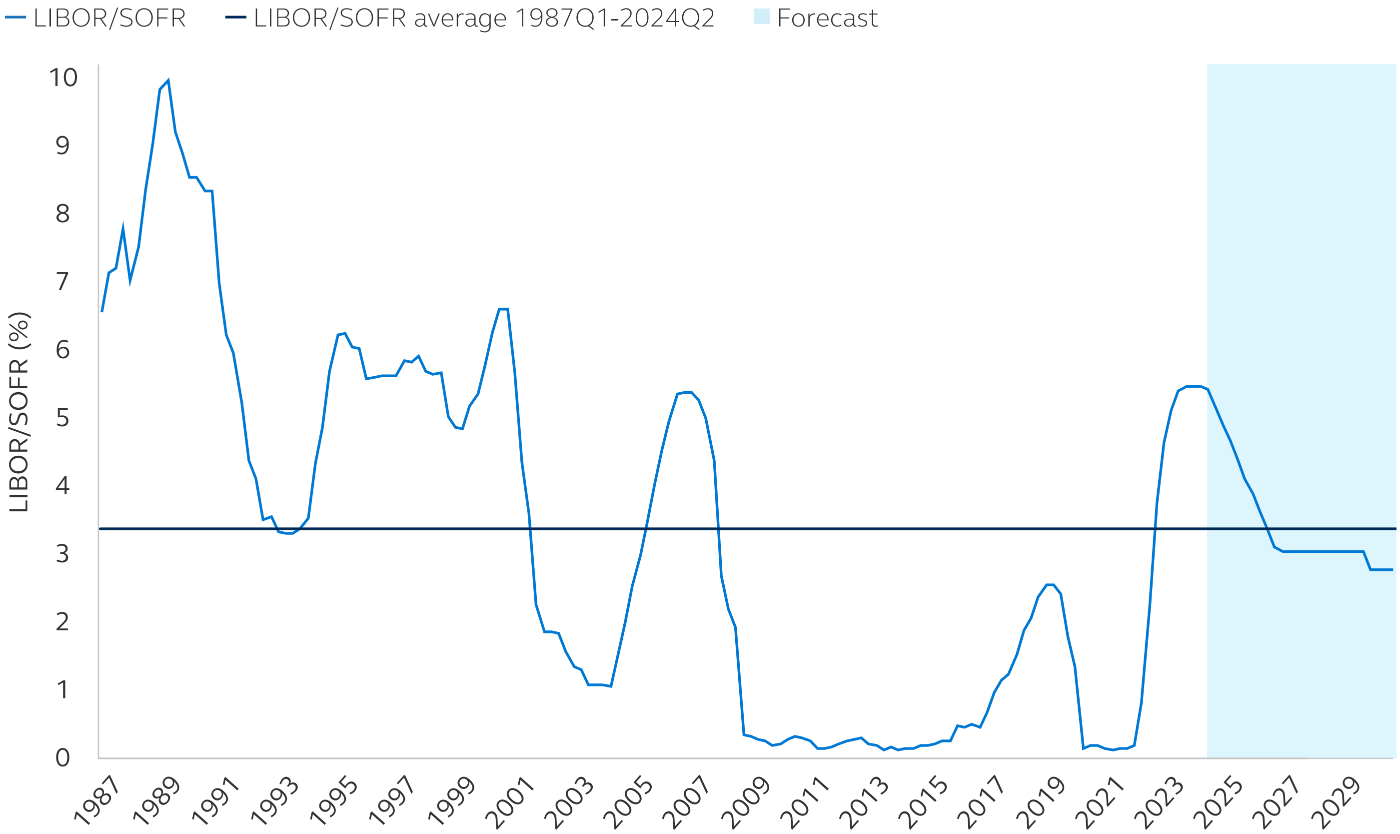
Reversion to the mean?

While "lower for longer" (Q4 2008-Q4 2021) was the lowest rate period ever observed, "higher for longer" is not higher than pre-2009 historic rates (see Exhibit 3). In fact, rates have been significantly higher than the most recent peak of 5.32%. The all-time high, in Q2 1989, was 9.75%. To quote one of the long-tenured portfolio managers on the Principal Real Estate private debt team, Scott Smith, who has been investing in debt since 1982, "The first deal I ever did was a 14% coupon with a participation."

In this historical context, rather than "higher for longer," the most recent SOFR and SOFR forward curve look more consistent with pre-2009 historical rates—suggesting, perhaps, that "reversion to the mean" is a more accurate characterization of the interest rate environment for the foreseeable future. From 1987 through Q2 2024, the long-term standard benchmark interest rate average was 3.24%. A SOFR forecast of 3%, then, is about the long-term average.

[2] LIBOR was the standard benchmark interest rate for many years but was discontinued in June 2023 and replaced by SOFR. For the calculations in this paper, we use LIBOR from Q1 1987 through Q4 1997 and SOFR thereafter.

EXHIBIT 3: Plotting the long-term benchmark interest rate average reveals a reversion to the mean



LIBOR was the standard benchmark interest rate for many years but was discontinued in June 2023 and replaced by SOFR. Here we use LIBOR from Q1 1987 through Q4 1997 and SOFR thereafter.

Source: ICE Benchmark Administration Limited (IBA); Moody's Analytics, Q2 2024

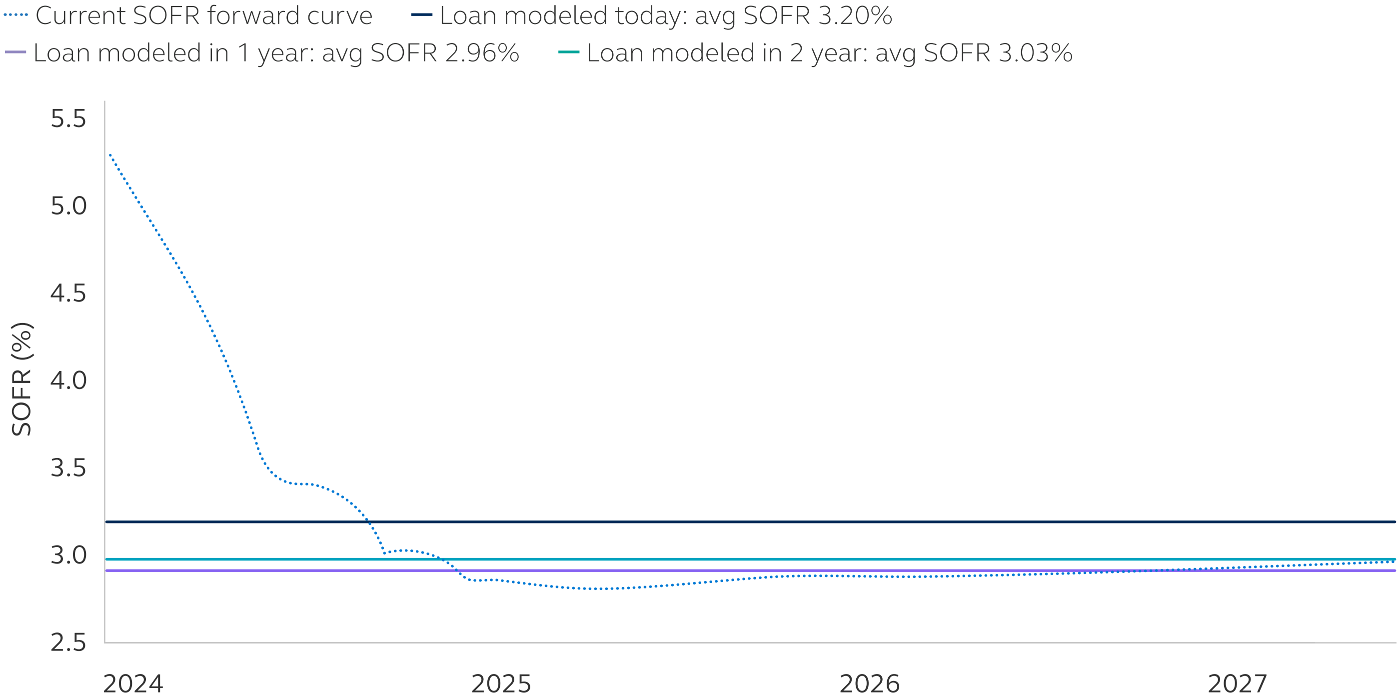
What's ahead for commercial real estate credit

If today's SOFR forward curve is directionally accurate, interest rates are set to decline over the next two years to about 3%. Considering the current SOFR around 5%, that seems like a significant drop in the market (200 basis points). But the actual impact on loans made today, or even a year or two from now, will likely be minimal, because when a loan is modeled, the modeling accounts for the forward curve, already impounding the assumed rate cuts.

Consider a typical high-yield debt investment: a three-year floating rate loan with two extensions. If the loan were modeled today based on the current SOFR forward curve, the average SOFR over the life of the loan (36 months) is 3.20%. If the loan were made one year from now, average SOFR over the life of the loan would be 2.97% (23 basis points lower); it would be 3.03% (17 basis points lower) if the loan were made two years from now.

In other words, over the life of the loan, a SOFR decline to 3% will have a smaller impact on returns than would be expected from a major cut in the market (see Exhibit 4).

EXHIBIT 4: The impact on returns of a SOFR decline to 3% is relatively modest



Source: ICE Benchmark Administration Limited (IBA); Moody's Analytics, Q2 2024

Of course, the actual outcomes will be contingent on the market environment. As noted earlier, the SOFR forward curve is typically not accurate over longer term horizons and spreads will play a role in where total returns ultimately land.

Opportunity for attractive returns from real estate credit

If the current SOFR forward curve is accurate and interest rates revert over the next two years to their long-term mean, it is not likely to have a major impact on investor returns for the next several years. We feel the real estate credit opportunity will persist into the next several years and that investors should have confidence in real estate credit for some time to come.

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