RESEARCH BRIEF

Marcus & Millichap

FINANCIAL MARKETS

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Structural Inflation Drivers Prompt Rate Hike; Real Estate Capital Markets Responding

Federal Reserve enacts fifth rate hike of the year. Following accelerated core CPI inflation and ongoing above-average hiring last month, the Federal Reserve raised the overnight lending rate 75 basis points at its September meeting. This is the third consecutive rate hike of this magnitude, extending the target range of the federal funds rate above 3 percent. September also marked an increase in the level of Fed balance sheet reductions, to an estimated $95 billion per month. These quantitative tightening measures are applying substantial upward pressure to interest rates, with the aim that greater borrowing costs will help bring commercial and consumer demand back in line with supply, and temper the current elevated inflation environment.

Structural obstacles to curbing inflation keep Fed on watch. While lower gas prices led to slightly cooler headline inflation in August, prices are climbing in many other areas, including medical care and housing. Beyond those systemic challenges, supply chain disruptions are keeping transportation costs for goods historically elevated, while a labor shortage is applying upward wage pressure across a range of industries, ultimately raising the costs of final goods and services. These dilemmas are not quickly solved, and will continue to fan inflation in the near term. As such, Chairman Jerome Powell has reiterated the Fed's intent to further increase interest rates this year. Two additional rate hikes of at least 50 basis points are likely, which would extend the federal funds target range above 4 percent before the start of 2023.

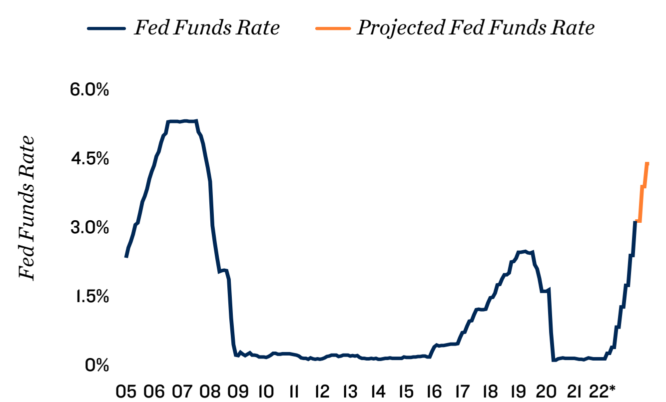
Investment continuing amid disruptions. While capital is available, higher borrowing costs add disruption to the commercial real estate lending and investment markets. Amid higher interest rates, lenders have widened spreads and tightened underwriting criteria. These additional hurdles are extending the trading process, but underlying investment demand is strong across most property types. Improving fundamentals and favorable long-term outlooks are encouraging investment across several asset classes, especially as equity markets remain in flux. Transaction activity was at an above average pace through midyear, but rising interest rates have begun to weigh on investor sentiment.

As monetary policy tightens, range of properties in solid position. Through midyear, operating fundamentals across several property types were continuing along positive trajectories. Multifamily effective rents have generally kept ahead of inflation, while the U.S. retail vacancy rate returned to the pre-pandemic mark in June. Industrial operations, meanwhile, are the tightest in decades, although record new supply could add to availability in the short term. Moving through the third quarter into the final period of the year, the combined impact of higher prices and interest rates on the finances of households and business may begin to curb the trajectories of some sectors.

Fed to keep careful eye on the labor market. How hiring responds to higher interest rates will play a key role in the central bank's policies moving forward. The below-average 3.7 percent unemployment rate in August is not sustainable over a long term, and the Fed intends to bring labor demand and supply into better alignment by allowing joblessness to moderately rise. Plans could change if conditions sharply deteriorate.

6.3% *Core CPI Inflation in August 2022*	3.0% *Federal Funds Target Rate Lower Bound*

Fed Funds Rate Set to Eclipse 4% by 2023



** Historical data through Sept. 21; projected rate assumes two hikes of 75 bps and 50 bps.*
Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Federal Reserve; RealPage, Inc; U.S. Census Bureau

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