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Rate Hikes One of Many Factors Affecting Our Economy

Commentary by
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The Federal Reserve's decision to raise its benchmark interest rate by a quarter-percentage point to between 0.50 of a percent and 0.75 of a percent will not by itself affect the South Florida economy.


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The rise in rates has been forecast for months, and frankly any commercial project where a small increase in rates would cause a project to be materially less successful should not be built, purchased or financed in the first place. That being said, the Fed's decision is just one of many indicators that we are heading toward a higher interest-rate environment which, when coupled with other factors that are a near-certainty under a Trump presidency, will negatively affect South Florida real estate.

First, the modest increase by the Fed is not as relevant as the concurrent statement by the Fed that it may continue to raise interest rates throughout 2017, raising the possibility that the benchmark rate will break above the psychologically important 1 percent. The Fed is sending a clear signal that it wants to reduce borrowing and the level of risk in the real estate market. This will accelerate the pullback already underway by many South Florida banks, which view the pricing of South Florida real estate to be too high or certain real estate sectors to be oversaturated.

Even before the rise in interest rates, most South Florida real estate lenders had already decided to stop lending to new residential condominium projects. The rise in interest rates, which impacts both the cost of construction lending and the appetite of unit purchasers who require financing, may shut this lending sector down altogether for projects that are not yet out of the ground.

The risk is that this trend could now spread to other sectors including but not limited to hospitality as lenders come to terms with the Fed's message. Higher interest rates and lower risk profile could also lead to decisions by lenders to require additional collateral, full recourse guaranties, higher debt service coverage ratios and a host of other factors that may limit choices available to developers requiring loans in the South Florida market.

In addition, the tax cuts and fiscal spending promised by President-elect Donald Trump — both expected to boost growth and inflation — are already rippling through the bond market. There has been a dramatic sell-off of bonds due to investor concern about returns and a corresponding hike in U.S. Treasury bond yields. This has resulted in a very fast and large increase in the cost of borrowing from many of the South Florida banks that price their interest rates to the Treasury indexes. Further increases may follow as Trump puts these promises into action.

This upward interest-rate environment will most likely cause buyers to demand higher cap rates, which will probably slow down what has been a dramatic run-up in the price of many classes of South Florida real estate.

It is also worth noting that the timing of the rate increase coincides with the maturity date of many CMBS-backed loans, and there may be fewer avenues available for these heavily leveraged deals to be refinanced. There are already vulture funds being formed to step into this area to take advantage of borrowers with limited or no options. This industry could become more prominent as interest rates rise and institutional lenders step back.

Foreign Factors

Of course, there are numerous other factors that will affect South Florida real estate. The upward strength of the dollar against the currencies of South American countries and Europe as well as possible changes to immigration policy could negatively impact the South Florida real estate market in a far more dramatic way than upward interest-rate pressure. Many experts believe that U.S. policy will accelerate a further decrease in overseas currency valuation.

Accordingly, there will be less disposable income for travelers to spend and less money available for real estate investment. The slowdown in residential condo sales already reflects this trend, which may now spread to both the hospitality and retail classes of real estate.

In sum, the South Florida real estate market has benefited greatly from a variety of factors that has changed our landscape. While interest rates remain extremely low by historical standards, there is both a real and perceived impact to interest-rate increases that inevitably affect investment and lending decisions, particularly if exacerbated by the proposed policies of the Trump presidency.

There are ebbs and flows in every real estate cycle, and the two- to three-year window that many South Florida developers saw as remaining in the current cycle may be coming to an end sooner than anticipated.

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