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Interest rate outlook and its property yield implications

By Zoltan Moricz, Brent McGregor, Shang Du, John Holmes - March 2024

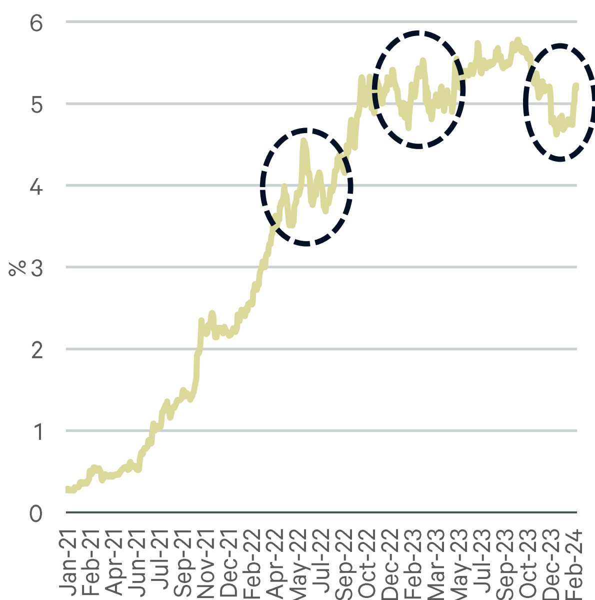
Recent months saw good progress in the price discovery journey, which indicates that market (if not valuation) yields are near their cyclical peak. This report looks at prospects for yield movements in the context of expected interest rate changes and their historic margins to property yields.

Interest rates showed volatility in the past two years with wild swings as they responded to changing expectations (see Figure 1). Most recently, markets got ahead of themselves with the substantial late 2023 interest rate declines that reversed just as sharply since early this year as stronger than anticipated non tradeable inflation and employment data delayed the expected commencement of OCR cuts, with some predictions that the RBNZ may raise further in the short term. At the same time, focusing on the bigger cyclical picture shown in Figure 2, the next major step for interest rates will most likely be down despite the short term volatility in the overall inflation cycle.

New Zealand Interest Rate Moves Since 2023 Market Peak

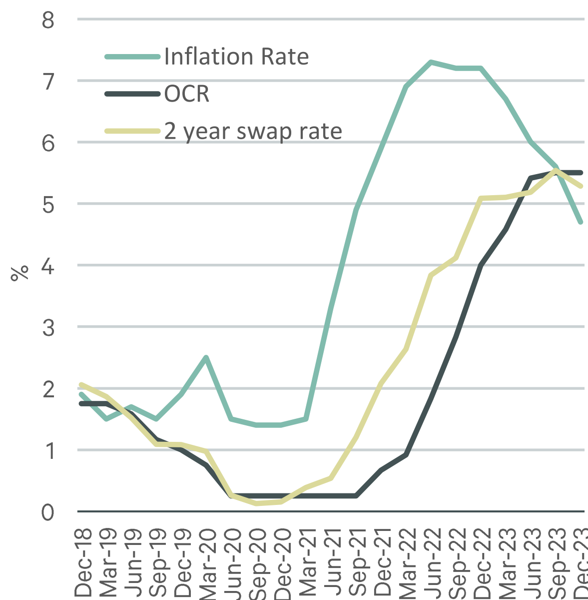
10 yr Bonds	- 75 bps
2 yr Swaps	- 65 bps

FIGURE 1: New Zealand 2 Year Swap Rates



Source: Reserve Bank of New Zealand

FIGURE 2: New Zealand Interest Rates and Inflation



Source: Reserve Bank of New Zealand

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Current expectations show the market led fall in interest rates taking a breather before resuming their declines as OCR cut expectations become more entrenched and their timing more imminent. Assuming OCR cuts start before the end of 2024, current forecasts show steady declines in interest rates through to late 2025.

Figures 3 and 4 indicate the forecast interest rate track from now to December 2025 and place it into the context of longer-term historic interest rate trends as well as Prime commercial and industrial property yields. . In Figure 4, we also provided an estimate for the cost of debt based on the 2 year swap rate plus a 225 basis point lending margin. Figure 4 illustrates large variations in the gap between property yields, bond rates and the cost of debt during the past 30 years.

FIGURE 3: New Zealand Interest Rate Forecasts

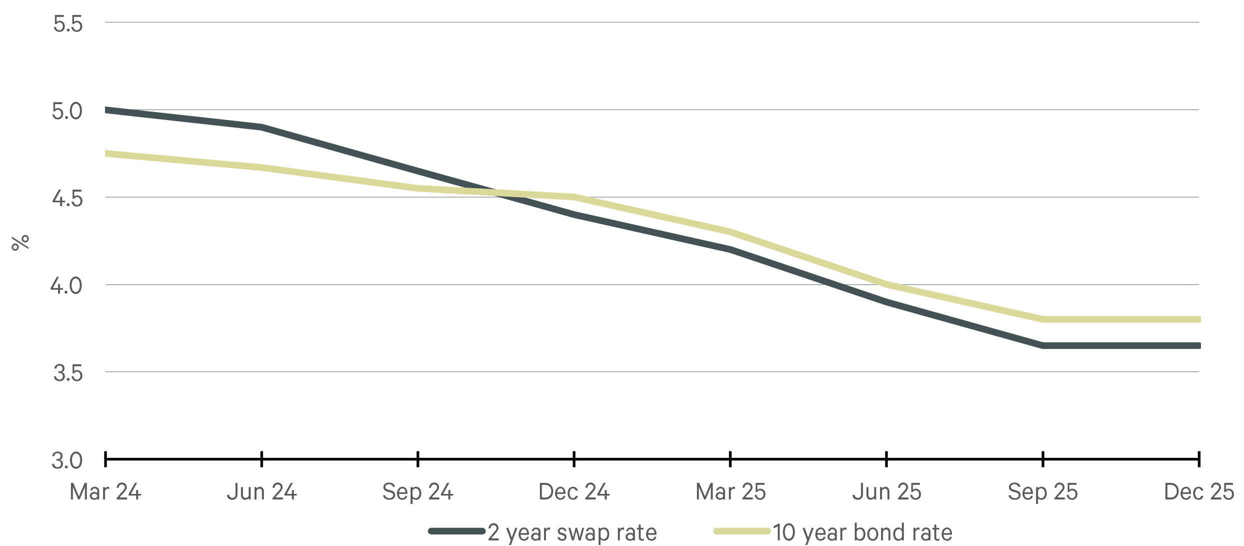
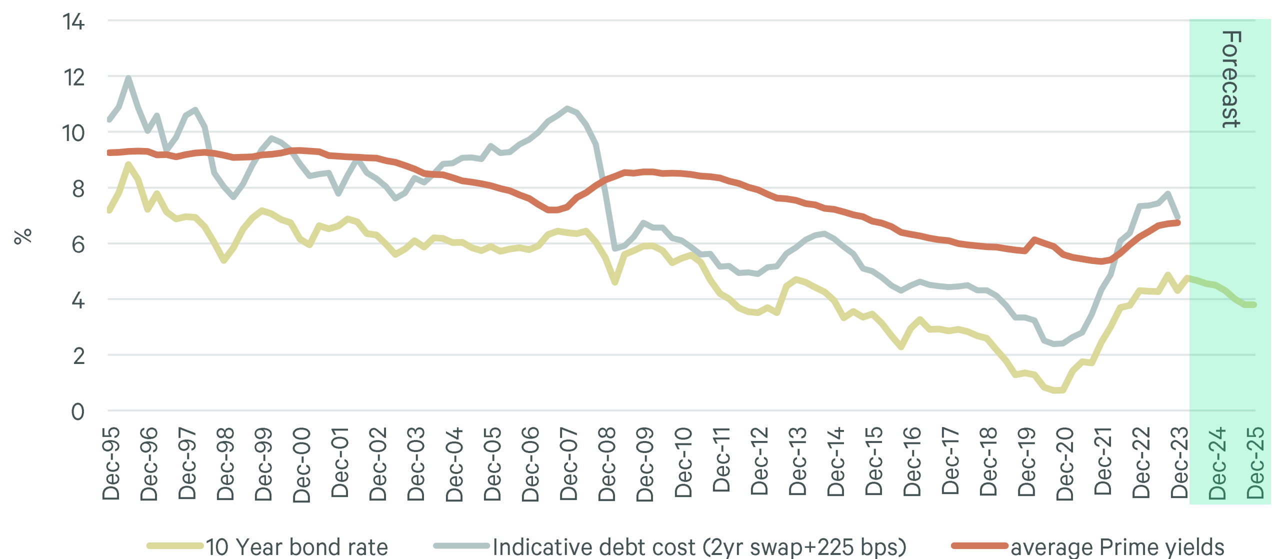


FIGURE 4: New Zealand Historic and Forecast interest Rates vs Prime Yields



Source: : RBNZ for historic and average of economist's forecasts

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Historic Yield Margins to Interest Rates

Figure 5 focuses on the gap between property yields and interest rates and illustrates the historic variations in the margin between yields, debt costs and 10-year bond rates. It shows significant margin fluctuation over the past thirty years, reflecting changing mixes of monetary and property market conditions that sometimes reinforced each other and sometimes showed discord.

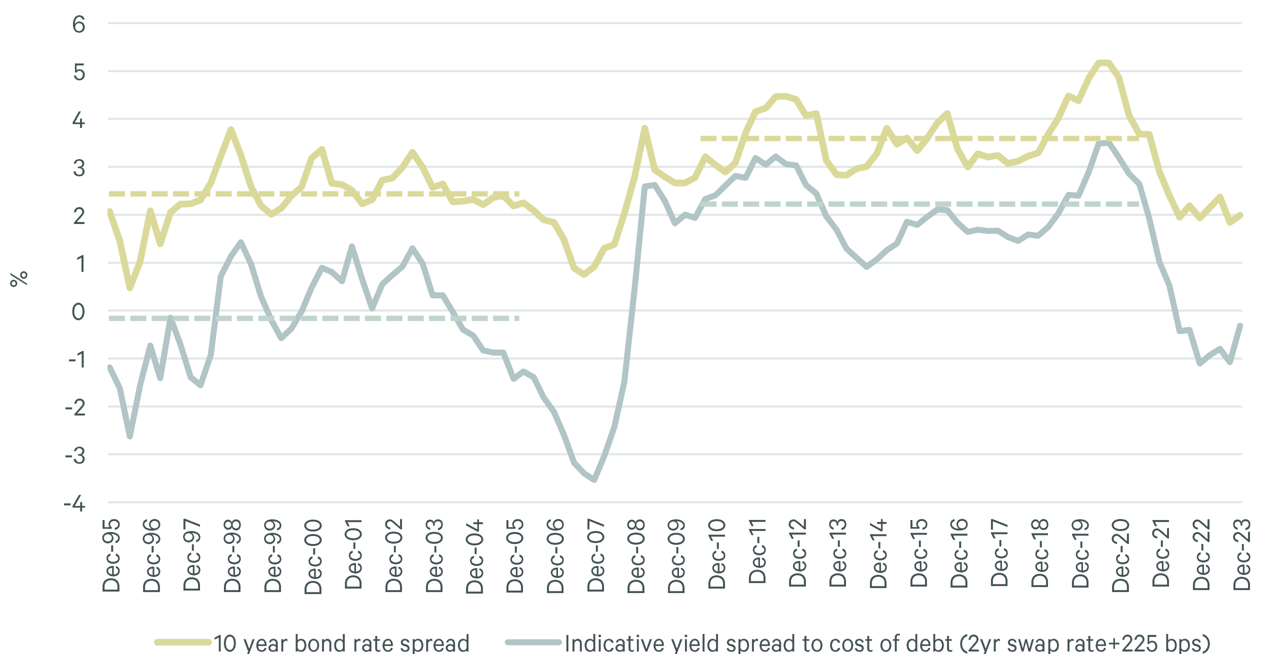
In the mid to late 1990s, for instance, yields were broadly stable and did not respond to substantial falls in interest rates, causing margins to move from 100-200 bps in 1995 to nearly 400 bps in 1998. During the heat of the pre-GFC market, yields were firming when interest rates, especially at the shorter end of the curve, were increasing significantly. This resulted in negative margins relative to 2-year swap rates for the duration of 2007, with the cost of debt tracking significantly above yields, not preventing continued steep yield firming that year.

The property market's response to the steep interest rate rises of the past two years has been more rational, with yields moving out by an average of 140 bps since March 2022. However, with swap and bond rates increasing by 400+bps since market lows, margins have still compressed significantly relative to the prevailing trends of the past decade.

Beyond these cyclical margin fluctuations, two broader, possibly more structural, trends are evident that can be seen as the pre-GFC and post-GFC eras. Pre-GFC era, average yield-to-interest rate margins were significantly lower than post-GFC. Between 2011 and 2021, despite their significant reduction, property yields didn't close the historically large gap to swap and bond rates that opened up during the GFC.

We don't have a conclusive answer as to why this large gap was maintained post-GFC, but it likely revolves around a combination of factors, including generally more cautious investor attitudes in the aftermath of the GFC, lesser reliance on high rent growth expectations to drive future total returns due to a generally more pessimistic attitude regarding economic growth prospects compared to pre-GFC, more conservative lending practices, higher post debt net return expectations, and possibly also a psychological aspect that resisted a more sudden and substantial downward shift of yields that could have been facilitated by lower interest rates in the mid-2010s.

FIGURE 5: Average Prime Property Yield Margins to Interest Rates



Source: RBNZ, CBRE

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Implications of historic margins and the interest rate outlook for property yields

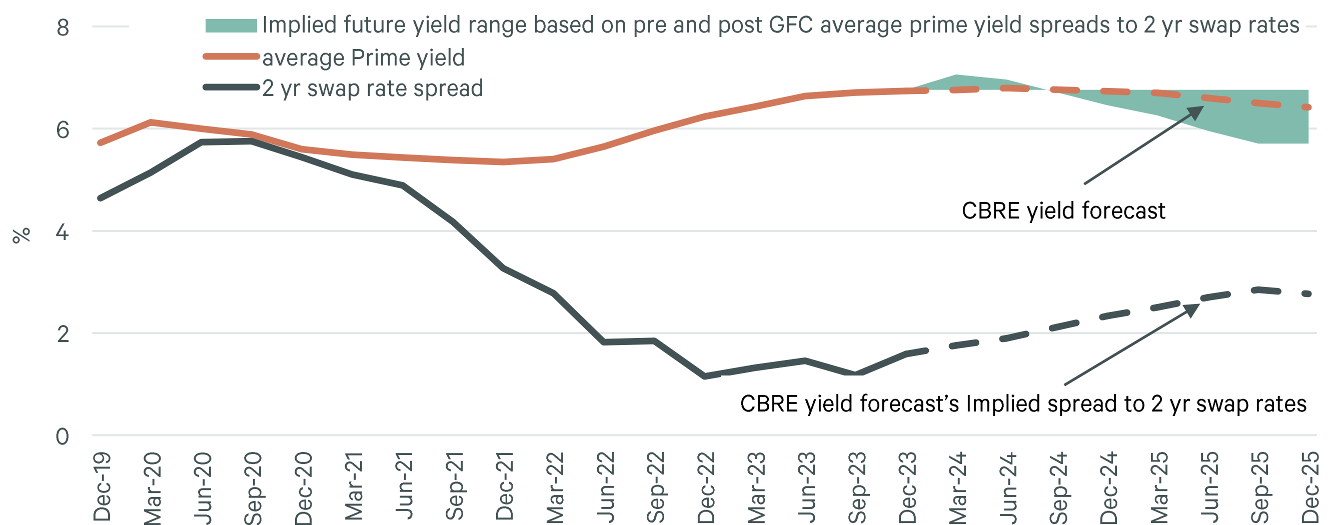
The elevated yield to interest rate spreads created a large cushion when interest rates started to increase in late 2021, and interest rate rises have not translated to a one-for-one increase in yields. Instead, margins compressed back towards pre-GFC norms. The current (March 2024) average Prime property yield to 2 year swap rate and bond rate margins are within 30-40 bps of the pre-GFC average. Recent months saw progress in price discovery, with more investment deals providing clearer market price indicators. On balance, these pointed to continued upward pressure on yields; however, in CBRE Research's opinion, the increases in the last two quarters were the smallest since the easing cycle commenced in early 2022, and we believe that the market is close to the top of the current cap rate cycle.

Yield Spread to 10 yr Bonds	
Current (March '24)	200 bps
Pre GFC average	240 bps
Post GFC average	365 bps

Yield Spread to 2 yr Swap Rate	
Current (March '24)	175 bps
Pre GFC average	205 bps
Post GFC average	440 bps

So, how will the outlook for interest over the next two years translate to property yields? Will falling interest rates translate to falling yields, or will this be a chance for the market to rebuild yield to interest rate margins closer to post-GFC norms, implying limited yield movement? We feel that the cost of debt has been a more significant influence on yields in the past two years than the risk-free rate and, combining the forecast 2 year swap rates with pre and post-GFC risk premiums, Figure 6 shows the range of implied future property yield outcomes from no change, as spreads are rebuilt towards the post-GFC average of 440bps, to yields matching their pre-GFC spread of 205 bps and following interest rates down. The latter scenario would result in yields firming c.100 bps between mid 2024 and late 2025. This is unlikely, and our current forecasts indicate yields remaining close to current levels until late 2024 and then declining moderately once economic conditions turn more positive and interest rate falls are entrenched. This scenario leads to average (across office, industrial, and retail centres) Prime yields falling from their cyclical peak of 6.80% in mid-2024 to 6.40% in December 2025. It also implies the yield to 2 year swap rate spread expanding from the current 175 bps to c280 bps, higher than the pre GFC average but materially below post GFC.

FIGURE 6: Average Prime Property Yield and 2 year Swap Rate Spread Outlook



Source: RBNZ, average of economist's interest rate forecasts, CBRE

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