The Net Takeaways

August 2019

What does a sub-2.0% Treasury mean for the net lease market?

Dear Clients –

As summer draws to a close across America, investors begin to prepare for "Deal Making Season," the annual window between Labor Day and Thanksgiving where more than 40.0% of the net lease market's annual volume is put under contract for purchase.

Certainly as we approach the Season this year, the marketplace is facing a unique convergence of events. They include:

Geopolitical global instability

- The China Trade War and—to a lesser extent—the simmering tensions in the Gulf with Iran have inflamed investors' concerns about meaningful risks on the economic landscape.

Sustained positive economic indicators

- Unemployment continues to hum along at historically low levels.
- GDP continues to display solid quarterly growth with virtually no drop off yet demonstrated.

Recessionary concerns

- The net takeaway for investors is marked trepidation about what 2020 has in store for the U.S. economy and real estate markets.
- The jury still very much remains "out" regarding the consensus for what the economy will bring over the next 12 months, and investors are considering how best to position themselves for the market conditions.
- The Dow & NASDAQ have shown incredible volatility in recent weeks, with wild fluctuations reflective of the uncertainty in the broader marketplace.

All of these dynamics have culminated in a precipitous drop of the 10-year Treasury from its highs near 3.25% last December to as low as 1.50% in recent weeks. So they key question is: **What does a sub-2.0% Treasury mean for the net lease marketplace?**

Our opinion is as follows:

Keeping the lid on cap rate expansion

- We are all too often asked by clients something along the following lines: "The 10-year is below 2.0%, how much better is my sale cap rate today?"
- The truth is cap rates were in real expansion mode in Q3/Q4 2018, and the substantive move downwards in interest rates has helped stem that trend over the last 6 months.
- *Had interest rates remained at December 2018 levels, we project that cap rates would be at least 25bps, if not 50bps, higher today than what we are seeing.*

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Mildly concerning for the economic outlook

- More than anything else, the downward move in interest rates is demonstrating an increasing fear of recessionary risk going into 2020.
- We believe net lease buyers are becoming increasing "picky" about deals with an eye to these 2020 risks. Buyers are still very active, they just seem to be more sensitive to potential problems ahead.

More of a cold than the flu

- The good news is that there seems to be a working consensus among most economists that any pullback in 2020 and beyond is likely to be more of the mild version of a recession, rather than a sustained deep event similar to 2008-2010.

Cheap financing

- The upshot here (of course) is that 10-year fixed financing on net lease properties can be secured in the 4.0% range or lower.
- With 30-year amortizations, this would translate a loan constant of 5.72%, which means that the marketplace is ripe with significant positive leverage acquisition opportunities, even on investment-grade, long-term product.

Final takeaways

- Despite growing recessionary concerns in the marketplace, we believe investors will be quite active in Q3/Q4 2019, and the year will finish on a strong, solid note.
- We do advise clients to look at marketplace conditions with a cautious eye and temper their expectations about timing and terms. In a fluid marketplace, we recommend leaning more on certainty and carefully assessing risk factors.
- We welcome the opportunity to discuss with you in further detail and look forward to working with you in 2019! Wishing you a great Labor Day holiday with friends & family!

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