

## Upclose with Economy.com's Mark Zandi

Midway through 2006, it's good to survey the economic landscape and measure the barriers that could impede our progress, and the path ahead is remarkably smooth. Sure, there are concerns--inflation is a constant threat, and both interest and cap rates have bottomed out. But as Mark Zandi, chief economist for Moody's Economy.com indicates, not only are the threats to economic stability minor, any current blips on the radar screen can only solidify real estate's position as a mainline investment vehicle. In a recent exclusive interview, he explained:

**GlobeSt.com:** Let's start with the micro and end with the macro. What's your sense of the cap-rate picture for the foreseeable future?

**Zandi:** Cap rates will rise, but modestly. We're not going back anywhere close to the cap rates that prevailed prior to the past few years, but they'll rise from these very unusually low levels. The spreads off of treasuries will remain narrow, but with treasury yields rising, cap rates will also rise.

**GlobeSt.com:** How much of a change do you expect?

**Zandi:** Broadly, you can expect a 25- or 50-basis-point increase over the next year. But capital flows will remain very strong, and that's reason for optimism. Commercial real estate remains a very attractive alternative for institutional investors, and that impetus for investment remains firmly in place. You might see interest rates rise about 50 basis points, so spreads will remain narrow. They may even tighten up a bit.

**GlobeSt.com:** So, no fears?

**Zandi:** Not in commercial real estate, because fundamentals are good. It might vary a bit by market and property type, but the supply side has been constrained, and while that's starting to change, absorption should keep vacancy rates low and we should see solid rent growth. As long as the fundamentals remain good, and I think they will, nothing untoward will happen. That doesn't mean there won't be corrections in financial markets, but those corrections are going to be much more pronounced in other places.

**GlobeSt.com:** Why did you qualify your fears?

**Zandi:** There's a reasonable risk that we'll see some kind of financial event in the next six to 12 months as interest rates rise. But in the minds of investors that might solidify real estate as a good, solid alternative investment.

**GlobeSt.com:** Inflation drums are beating. No worries?

**Zandi:** It's still low by historical standards although it will rise a bit more through the remainder of the year. The Federal Reserve will head off any significant acceleration and inflation. The economy's growth is already slowing in response, and by this time next year, inflation will have stabilized and will be back in the targets the policy makers have set for it.

***GlobeSt.com: So cautious optimism all the way around?***

***Zandi:*** The economy is fundamentally sound, and commercial real estate is well poised. So, it's a time to be optimistic, despite the financial event I mentioned. To some degree that will be therapeutic, since it reintroduces a more reasonable pricing of risk. Investors are still not pricing risk very well.

***GlobeSt.com: Are you talking about real estate investors?***

***Zandi:*** Well, real estate investors as well. That's why cap rates will rise, but more so in other markets--particularly fixed-income markets . . . residential mortgage-backed securities come to mind, but equity markets as well.

***GlobeSt.com: Anything else that concerns you?***

***Zandi:*** A few things. Energy prices are a threat. If they spike higher, that could undermine the economy; it could certainly undermine performance. The economy has done a good job of digesting the higher prices so far, but the reasons for that are fading and another run up in prices will be pretty hard for it to bear. And the risk of that is significant in the current environment, and that's the most significant near-term risk. The potential that inflation and interest rates go higher than I'm anticipating is clearly a threat. We can certainly underestimate the inflationary pressures that are developing, and if interest rates have to go higher, that will raise the risks too.

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By [John Salustri](#)

June 30, 2006