Bonds: The Building Blocks *of Commercial Real Estate*

Bonds are a vital component of the commercial real estate lending market. They set the limit on what banks and lenders charge for commercial real estate loans. More specifically, the 10-year Treasury note is one of the major bonds that affects mortgage rates. It is also the benchmark for commercial and residential real estate loans. The 10-year Treasury note also sets the tone for how the real estate market performs and where it's headed.

Let's start with the basics, what is a bond? A bond is a form of a debt. They are loans that are made by the investor to an entity such as a corporation, a city or the government. When the investor makes the loan to the entity, that entity agrees to pay regular interest payments on that note, with the principal due at maturity. The riskier the entity, junk bonds for example, the higher the interest rate payment. Whereas the lower the risk, government bonds for example, the lower the interest rate payment. These bonds are then bought and sold on the secondary market, setting the yields most many are used to seeing change on a daily basis.

The yields for treasuries are determined by the market forces of supply and demand. The fixed face value and interest rate is set when the bonds are initially sold at auction. When demand is high for a particular bond, the bond will go to the highest bidder at a price above the face value. When this happens, the yield is lowered because the government will only pay back the face value of the bond, plus the stated interest rate. If demand is low for particular bond, the bond will sell for less than the face value, which will increase the yield. This is the reason that yields are always moving in the opposite direction of the bond prices.

Most commercial real estate loans are priced around one bond in particular, the 10-year Treasury note. The 10-year Treasury note is a bond auctioned by the United States Government and backed by the United States Government. This bond sets the standard for determining loan prices. Because this bond is backed by the United States, the government ensures that the bond will not default unless the government defaults on its obligations. Since there is very little risk of a government default, the note has a very low risk associated with it, meaning the interest rate the note produces is very low. The 10-year Treasury note is a safe investment for most investors compared to riskier bonds like corporate or junk bonds that have lower credit ratings with higher risk.

There are many reasons and factors that play into how mortgage rates are set, but the 10-year Treasury note is said to be the best indicator.

- For one, although most mortgages have 25 to 30 year amortization schedules, most are paid off within 10 years, so the 10-year Treasury note is a great bellwether to measure interest rate changes within that 10-year period.
- Second, since the 10-year Treasury note is backed by the US Government, it sets the lower limit on one of the lowest risk investments an investor can make. A lender can use this lower limit to set the baseline, and add to it any risk premium associated with the loan, and any additional returns the lender would like to see.
- Finally, the mortgage rate movements are tied to the 10-year Treasury because of the mortgage-backed securities market. This market buys and sells "packages" of securitized mortgages, most of these packages are government-backed (Fannie Mae, Freddie Mac, Ginnie Mae). Since these securities are government-backed, the quality level puts them in direct competition with Treasury bonds for investor money. So when the 10-year Treasury rate rises, mortgage rates will also rise to keep the mortgage-backed securities competitive with these Treasury bonds. When the 10-year Treasury falls, mortgage interest rates also fall.

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$2.1B IN REVENUE

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Below is a snapshot of how the 10-year Treasury has trended over the past 10 years, compared to a 30-year conventional mortgage. In the past decade, the average 30-year mortgage has been approximately 1.72% higher than the 10-year Treasury rate. Although there have been some larger volatile swings on separate occasions, this average has held constant over for the most part.

The commercial real estate investment market closely monitors the 10-year Treasury, as the rise and fall will affect the interest rates of loans that borrowers use for commercial real estate property. These interest rates are vital to a borrower's pro-forma analysis, setting the expectations of what yield a borrower expects to receive on their overall investment. As mortgage rates rise, lending costs increase, lowering the potential internal rate of return of a commercial investment. Conversely, as the 10-year Treasury falls, and lending costs become cheaper, the yield on income producing properties can become more attractive.

Bonds are a vital component of the commercial real estate market, and Colliers | Ohio will continue to monitor these trends, providing our clients with the most up-to-date information needed for their commercial real estate decisions.

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