BARINGS

U.S. Real Estate

QUARTERLY RESEARCH

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U.S. Real Estate

Executive Summary

ECONOMY

- The U.S. economy bounced back strongly in Q3 from the unprecedented collapse in Q2 caused by the pandemic and containment measures designed to "flatten the curve."
- The V-shaped recovery will likely give way to a slower but still-positive growth trajectory that will feature elevated unemployment rates for the next couple of years.
- Despite Congress' failure to agree on a new stimulus package, massive fiscal and monetary support is still working its way through the economy and financial markets globally.
- Still, the near-term path for the economy and real estate markets is highly dependent on further progress toward a medical solution to COVID and the degree of any further lockdown restrictions.
- With Congress unable to agree on a new stimulus package and new COVID cases reaching all-time highs, the near-term risks remain tilted to the downside.

PROPERTY MARKETS

- Property market fundamentals continue to deteriorate across most sectors and markets as tenant demand remains weak and the supply pipeline continues to deliver new product.
- Apartment occupancies have slipped and concessions have increased as new supply continues to come online, but the impact varies widely, with urban high-rise product hit hardest.
- Industrial property continues to outperform the other major sectors across all metrics, but new completions in Q3 outpaced absorption for a seventh consecutive quarter—a trend that will likely continue through 2022 at least.
- Office market fundamentals in Q3 continued to deteriorate at an accelerating pace. The more than 50 msf of negative net absorption over the past two quarters (per CBRE-EA) already exceeds the total recorded during the GFC, and sublease space has increased sharply.
- Retail rent collections are improving as many retail businesses remain open—some at limited capacity, such as restaurants, gyms and hair salons—and foot traffic slowly returns.
- The U.S. hotel market continues to struggle most from the travel restrictions and social distancing requirements meant to contain the COVID outbreak.

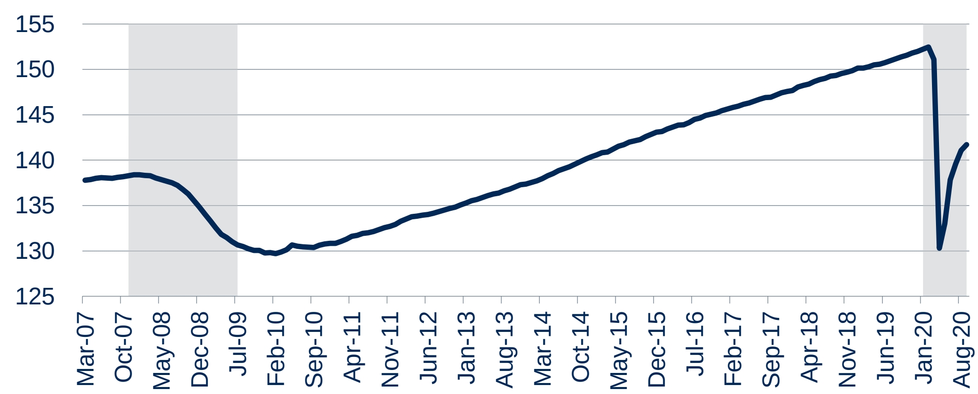
Economic Outlook

After suffering an unprecedented collapse in the second quarter, the U.S. economy bounced back sharply in the third quarter as businesses came back online and people did their best to resume daily activities in a world altered by the global pandemic. The economy added more than 11 million jobs from May through September, and consumers, who comprise about 70% of the U.S. economy, made up for time lost during the lockdowns. Through September, retail sales were more than 5% above their year-ago levels and at an all-time high. The composition of spending since the pandemic hit has clearly changed. Spending since March reflects both the still-real health risks of the virus—such as less spending on things that involve crowds or in-person interaction—and new priorities, which include more spending on essentials, homes and home improvement-related goods. But the rebound has been impressive, particularly when contrasted with the 30-month lag it took for retail sales to return to their prior peak following the Global Financial Crisis (GFC).

The near-term path for the economy and real estate markets is still highly dependent on further progress toward a medical solution to COVID and the degree of any further lockdown restrictions. Under even the "best case" scenario, the V-shaped recovery will give way to a slower growth trajectory that will likely feature elevated unemployment rates for the next couple of years. However, as long as the economy continues to add jobs and consumers keep spending—even at a slower pace—the recovery should continue and become self-sustaining. Even with the expiration of the government stimulus programs in the U.S., massive fiscal and monetary support is still working its way through the economy and financial markets globally.

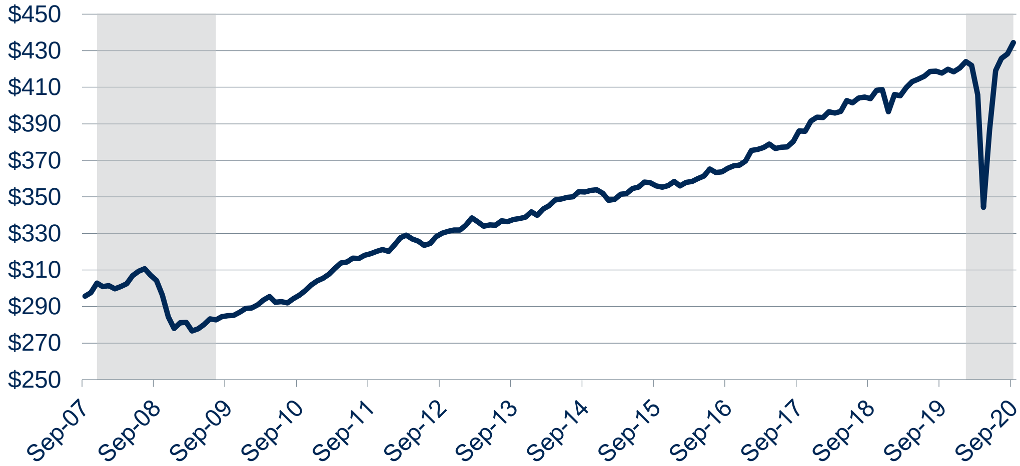
For now, however, with Congress unable to agree on a new stimulus package and new COVID cases reaching all-time highs, the near-term risks remain tilted to the downside. A new stimulus package would provide a bridge between now and a medical solution and a boost to consumer confidence. It's not clear whether Congress can agree on something before year-end, but it seems reasonable to expect that a new stimulus package will be a priority when the next session convenes in January; and by then we will also know the outcome of the election and possibly have more visibility on a vaccine or treatment. As a result, our base case assumes the recovery stays on track, decelerating from the sharp bounce in the third quarter to above-trend growth in 2021.

FIGURE 1: U.S. LABOR MARKET IS RECOVERING BUT HAS FAR TO GO



Source: Moody's Analytics (Bureau of Labor Statistics, millions). As of September 2020.

FIGURE 2: CORE RETAIL SALES HAVE RECOVERED TO PRE-COVID LEVELS (US$ BIL SA)



Source: Moody's Analytics (U.S. Census Bureau). As of September 2020.

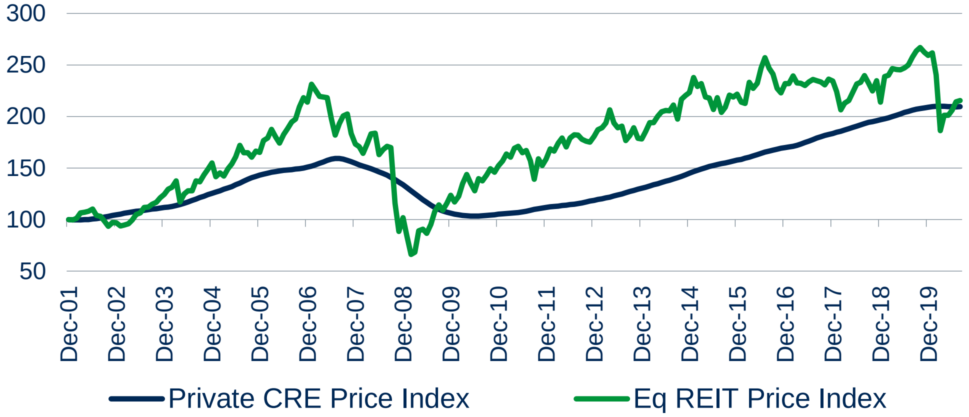
Capital Markets

Efforts by the Federal Reserve (Fed) and other central banks around the world continue to support liquidity and confidence in the global financial markets, keeping credit flowing and interest rates extremely low. The Fed made clear its intention to keep monetary policy loose for as long as necessary, announcing a new policy framework that includes allowing inflation to run a little "hotter" than the Fed might have tolerated in the past. As a result, the odds of a rate hike before the end of 2022 are almost nil, which will keep the short end of the curve well anchored until inflation revives.

The public real estate markets continue to differentiate between the "winners" and "losers" in a COVID world. U.S. REITs that own data centers and warehouses delivered double-digit total returns through the third quarter, but performance across most sectors remains deeply in the red, with hotel and mall REIT share prices down more than 50% year-to-date. It remains to be seen how the gap between the public and private markets will close. The private market always lags, but with limited price discovery, it's difficult to assess how pricing has changed since February. According to Real Capital Analytics (RCA), transaction prices have held up so far, and in the apartment and industrial sectors, average prices are up more than 7% year-on-year. But the sample size of transactions is limited and likely has a positive selection bias. Transaction activity in September picked up, but monthly volume is still at depressed levels last seen in 2012 as the markets were recovering from the GFC.

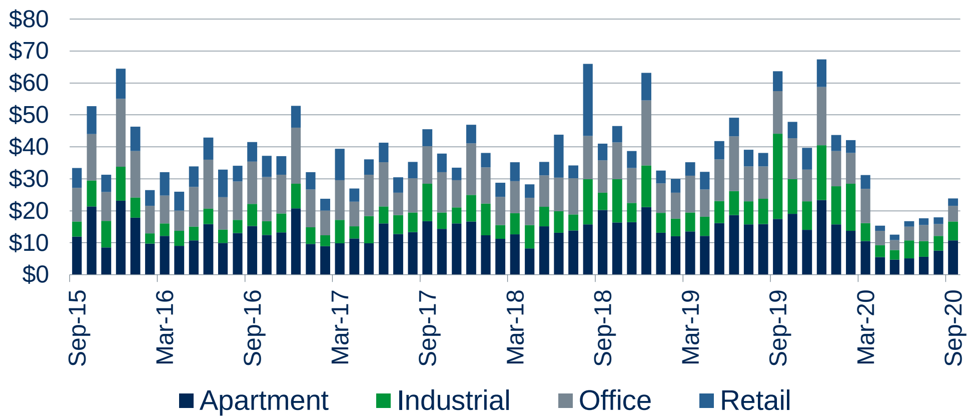
Valuations have started to adjust to the deteriorating fundamentals and more challenged near-term outlook. Preliminary quarterly appreciation returns in Q3 for the NCREIF ODCE index, a benchmark for institutional "core" open-end property funds, declined for a third consecutive quarter. The -47 basis points (bps) fall in Q3 leaves capital values for the index down by about 3% year-to-date, but that undoubtedly masks a wide range in performance by sector and at the asset level. Absent a surge in distress or a material downgrade to the macro outlook, however, low bond yields and strong investor demand for secure cash yield should insulate valuations from falling income to some extent; but the risks in the near term remain to the downside, especially in the office and retail sectors.

FIGURE 3: PUBLIC REAL ESTATE PRICES HAVE FALLEN SHARPLY IN 2020 (YE 2001 = 100)



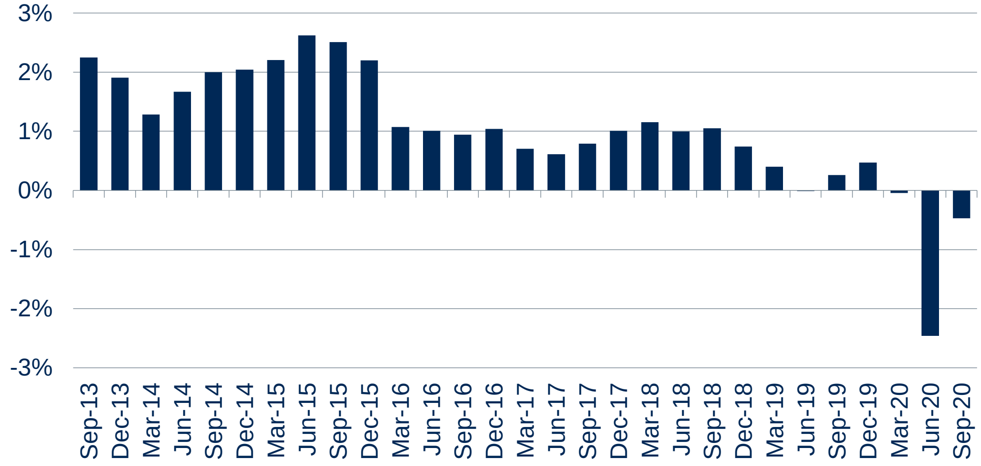
Sources: Real Capital Analytics, NAREIT, NCREIF, Barings Real Estate Research.

FIGURE 4: TRANSACTION VOLUMES REMAIN DEPRESSED (US$ BIL)



Sources: Real Capital Analytics, NAREIT, NCREIF, Barings Real Estate Research.

FIGURE 5: NFI-ODCE QUARTERLY APPRECIATION RETURNS TURNED NEGATIVE IN Q1



Sources: Real Capital Analytics, NAREIT, NCREIF, Barings Real Estate Research.

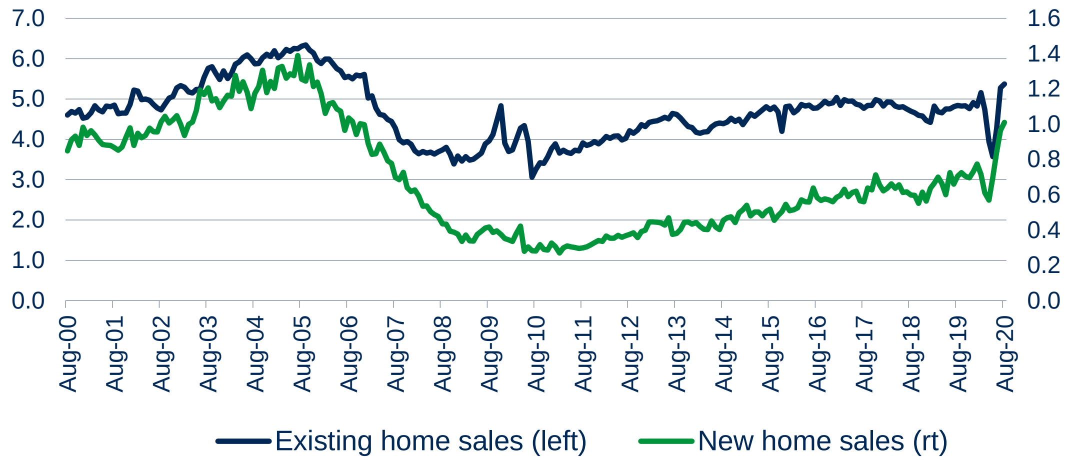
Property Markets

APARTMENT

The apartment market has held up relatively well since the pandemic brought life to a standstill. Rent collections across Barings' portfolios remain around 95%, but occupancies have dipped slightly and concessions in most markets are on the rise as newly delivered projects compete aggressively to lease up. The apartment vacancy rate in Q3 increased 80 bps year-on-year, but it remains low at 4.4% and is well below the GFC peak, when vacancy reached 7.3%. Mid- and high-rise urban apartment properties have taken a bigger hit from the pandemic and are underperforming garden-style product in lower-density suburban markets, but this is not a new trend.

The near-term outlook for the apartment sector remains modest due to ongoing mobility challenges posed by COVID, relatively weak household formation, continued robust supply and rising homeownership. The supply pipeline was expected to peak in 2019, but that was pushed into 2020 as projects were delayed, and with no slowdown in permitting activity, it will likely remain at elevated levels in many markets. Supply poses a bigger risk for higher rent, Class A apartments, which are also facing more competition from a surge in home sales.

FIGURE 6: U.S. HOUSING MARKET HAS AWAKENED



Sources: Moody's Analytics (National Association of Realtors (NAR), Census Bureau), Barings Real Estate Research.

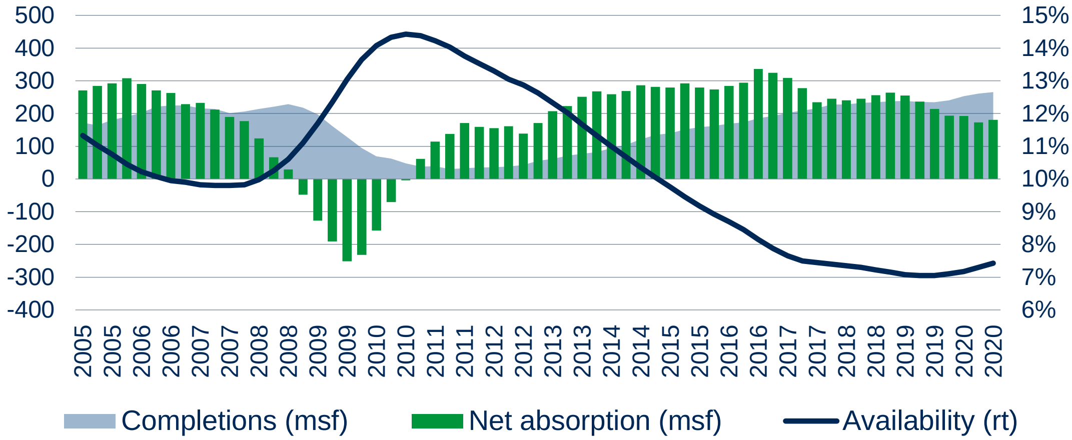
Despite the near-term challenges, the long-term case for investing in the apartment sector remains compelling as structural demand tailwinds remain in place. The U.S. faces a persistent housing shortage, mortgage credit availability remains constrained, and single-family home prices remain out of reach for many households, all of which should continue to drive tenant demand for apartments.

INDUSTRIAL

Industrial property continues to outperform the other major sectors across all metrics. Net absorption rebounded in Q3 to 57 million square feet (msf) driven by strong demand in the warehouse sub-sector that came in slightly above year-ago levels. New completions in Q3 outpaced absorption for a seventh consecutive quarter, a trend that will likely continue through 2022 at least. Although the average availability rate has increased ~50 bps year-on-year, it remains near two-decade lows and is well below the GFC peak. Several macro indicators point to a continued recovery including the ISM manufacturing index, recent vehicle sales and the overall level of merchandise imports, which should boost warehouse space demand over the near term.

Year-to-date through the third quarter, nearly 40% of the 63 markets covered nationally by CBRE-EA reported either a decline or no change in their availability rates. Houston and San Jose reported the steepest increases nationwide, while national distribution nodes such as New York and Dallas reported declines.

FIGURE 7: INDUSTRIAL AND WAREHOUSE DEMAND REBOUND IN Q3



Sources: CBRE-EA (trailing 4Q moving average, Q3 2020), Barings Real Estate Research.

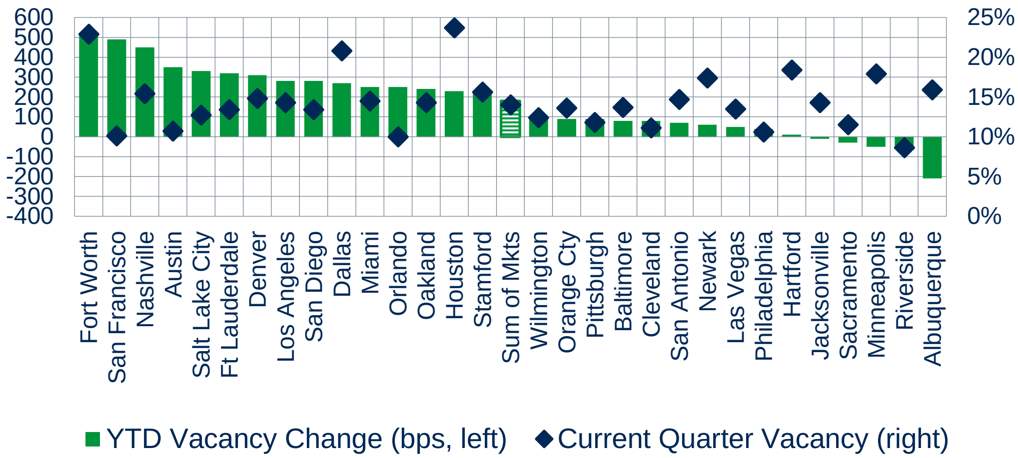
The outlook for industrial property and modern warehouse space in particular remains overwhelmingly positive. E-commerce sales as a share of total retail sales increased in Q2 by 440 bps to 14.8%, and the continued growth trend in online shopping should provide a further boost to industrial demand over the near to medium term. Increased adoption of online shopping will also have long-term implications for retailers (e.g., higher inventory-to-sales ratios) and retail supply chains. Industrial pricing leaves little margin for safety, however. Average transaction prices have continued to move higher and cap rates lower as investors compete for assets to increase allocations. Healthy income growth means that core returns for industrial assets in the NCREIF Property Index should continue to outperform other major sectors, but with cap rates at record lows, appreciation gains will become more challenging going forward.

OFFICE

The biggest questions about the longer-term impacts of COVID in commercial real estate continue to swirl around the office sector. For now, most offices that would be occupied by workers who can work from home remain empty and leasing activity remains on hold. As a result, office market fundamentals in the third quarter continued to deteriorate at an accelerating pace. Office vacancy increased by 100 bps in the quarter to 14.0%, adding to the 70 bps expansion in the prior quarter, but space available for sublease has also jumped. Few markets have been spared, with 55 out of the 63 markets in CBRE-EA’s coverage universe reporting rising vacancy in the third quarter. The average vacancy rate in downtown markets again rose at a moderately faster rate than in suburban markets, climbing 120 bps during the quarter versus an increase of 90 bps in the suburbs.

Markets experiencing large increases in vacancy and sublease space include many tech markets such as San Francisco, San Jose, Oakland, Portland, Seattle, Denver, Raleigh and New York. Active supply pipelines in many of these markets have exacerbated the deterioration in fundamentals from the pause in leasing, and will continue to drive vacancy rates higher in the near term. However, even with the significant softening, tech markets continued to record the nation’s lowest vacancy rates including San Francisco (10.1%) and Austin (10.7%).

FIGURE 8: IMPACT ON OFFICE MARKETS VARIES WIDELY



Sources: CBRE-EA (Q3 2020), Barings Real Estate Research.

With COVID cases on the rise again just as the flu season gets underway, office demand is likely to remain fragile until an effective treatment or vaccine becomes widely available. According to various surveys of office tenants, the majority of respondents are putting their expansion or relocation plans on hold until the outlook becomes clearer. The longer-term impact from the pandemic experience and accelerated adoption of remote working and meeting capabilities remains very much an open question, but whatever the outcome, the changes are likely to be at the margin rather than binary. Greater flexibility for workers seems like a sure thing, but that does not mean the office or face-to-face interaction is going away. Rather, the space where it takes place in the future will likely become more important as a place for innovation, collaboration, culture, training and mentoring.

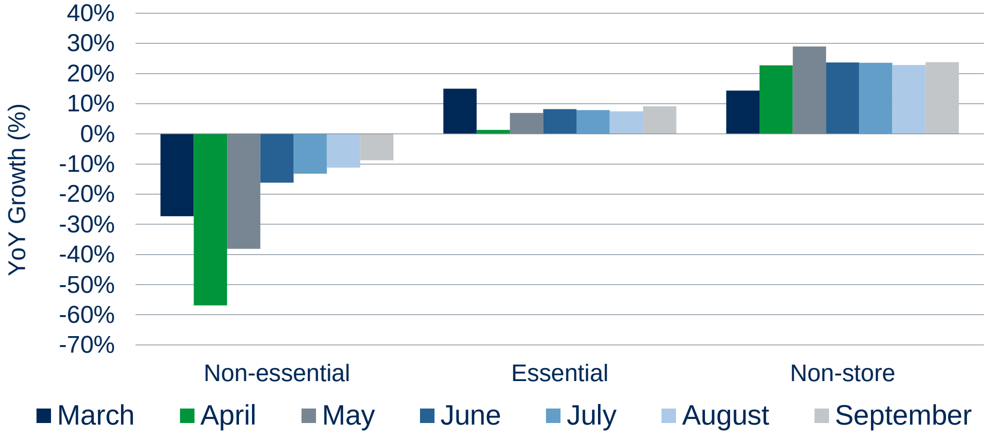
RETAIL

While the pandemic, heightened tensions from a contentious presidential election and social unrest continue to weigh on sentiment, consumers are spending again and providing critical support to the economy. Core retail sales are now back above their pre-pandemic levels, but many discretionary/non-essential retail categories remain in the red. With COVID cases in many parts of the U.S. still elevated and rising, consumers continue to focus their spending on essential goods and online shopping. However, they have also increased spending on home improvement goods as much of the activity remains close to home.

Rent collections are improving as many retail businesses remain open—some at limited capacity, such as restaurants, gyms and hair salons—and foot traffic slowly returns. That said, rent collections nationally are still well below where they were last year, and leasing activity is severely depressed. According to CBRE-EA, neighborhood, community and strip centers reported a further 40 bps increase in availability in Q3 to 9.4%, about 70 bps higher than at the same time last year.

Even with a rise in new COVID cases, we expect that consumers will continue to rely primarily on local grocery-anchored centers for daily necessities. While some smaller in-line stores are at risk due to forced closures or limited reopening, other retailers have adjusted their business models to offer online purchasing with store pick-up or perhaps to use stores for online fulfillment centers. We expect online shopping will continue to gain market share, but we believe omni-channel retailing with local fulfillment through retail centers will remain an important part of retailers' strategies. As a result, well-located neighborhood and community centers should continue to draw foot traffic and generate sales.

FIGURE 9: NON-STORE AND ESSENTIALS DRIVE TOTAL RETAIL SALES

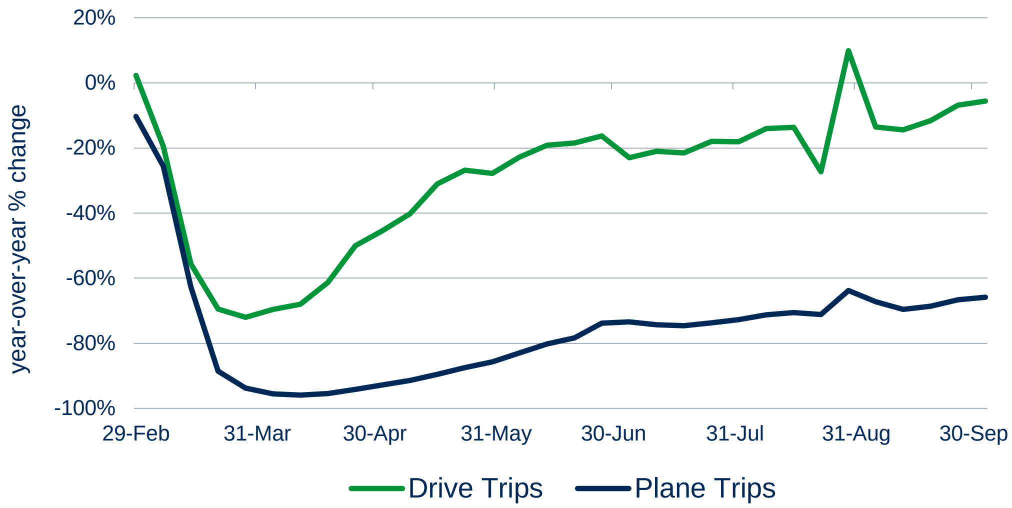


Source: U.S. Census Bureau (Q3 2020), Barings Real Estate Research.

HOTEL

The U.S. hotel market continues to struggle most from the travel restrictions and social distancing requirements meant to contain the outbreak. Travel has rebounded only gradually since the onset of COVID, with almost all of the improvement in the drive-to leisure segment of the market, where alternative offerings from Airbnb and others have been surprisingly competitive. Rising COVID cases in late summer in states that managed to avoid the initial outbreak in the spring helped dash hopes for a broader rebound as lockdown restrictions were lifted. Air travel remains severely depressed and corporate travel and industry conferences are on hold.

FIGURE 10: DRIVING TRAVEL PICKS UP, FLYING REMAINS SEVERLY DEPRESSED



Sources: CBRE Hotels, Arrivalist, TSA, Barings Real Estate Research.

The near-term outlook for hotels will remain challenging at least until COVID is no longer a threat and people feel comfortable traveling again for business and pleasure. Unsurprisingly, equity and debt capital for hotels remains very scarce, and distress is building as borrowers reach the end of lenders' forbearance periods. For investors with an appetite for higher risk and tolerance for negative cash flows for some period until demand stabilizes, the next few quarters should provide attractive opportunities to acquire or recapitalize good quality assets at significant discounts to replacement cost.

SUMMARY

With winter approaching in the northern hemisphere and no medical solution yet for COVID, real estate market fundamentals in most property sectors and markets will deteriorate in the near term, putting downward pressure on rents and values. However, as some of the uncertainty that is clouding the outlook today gives way to more clarity in the New Year, and as the development pipeline empties, real estate demand will stabilize. The recovery will likely be uneven, with sectors and markets that rely heavily on travel, tourism and leisure lagging, and other market segments potentially facing new, longer-term challenges due to changes accelerated or amplified by the pandemic. But in a slow growth, aging world, investor demand for secure stable yields that may offer some protection against inflation should continue to support valuations for assets and strategies that are positioned to benefit from the structural trends—namely, demographics and technology—that drove performance in the last cycle.

About the Team

Barings Real Estate's research team is highly integrated throughout the investment process, and is structured by sector and geographic expertise. The team's diverse background includes appraisal, legal, technological and academic applications, across multiple asset-classes, across buy and sell-side shops in markets around the globe. The real estate research team is complemented by an analytics function within Barings, enhancing the team's ability to collect, augment and analyze data to inform better decision making.

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