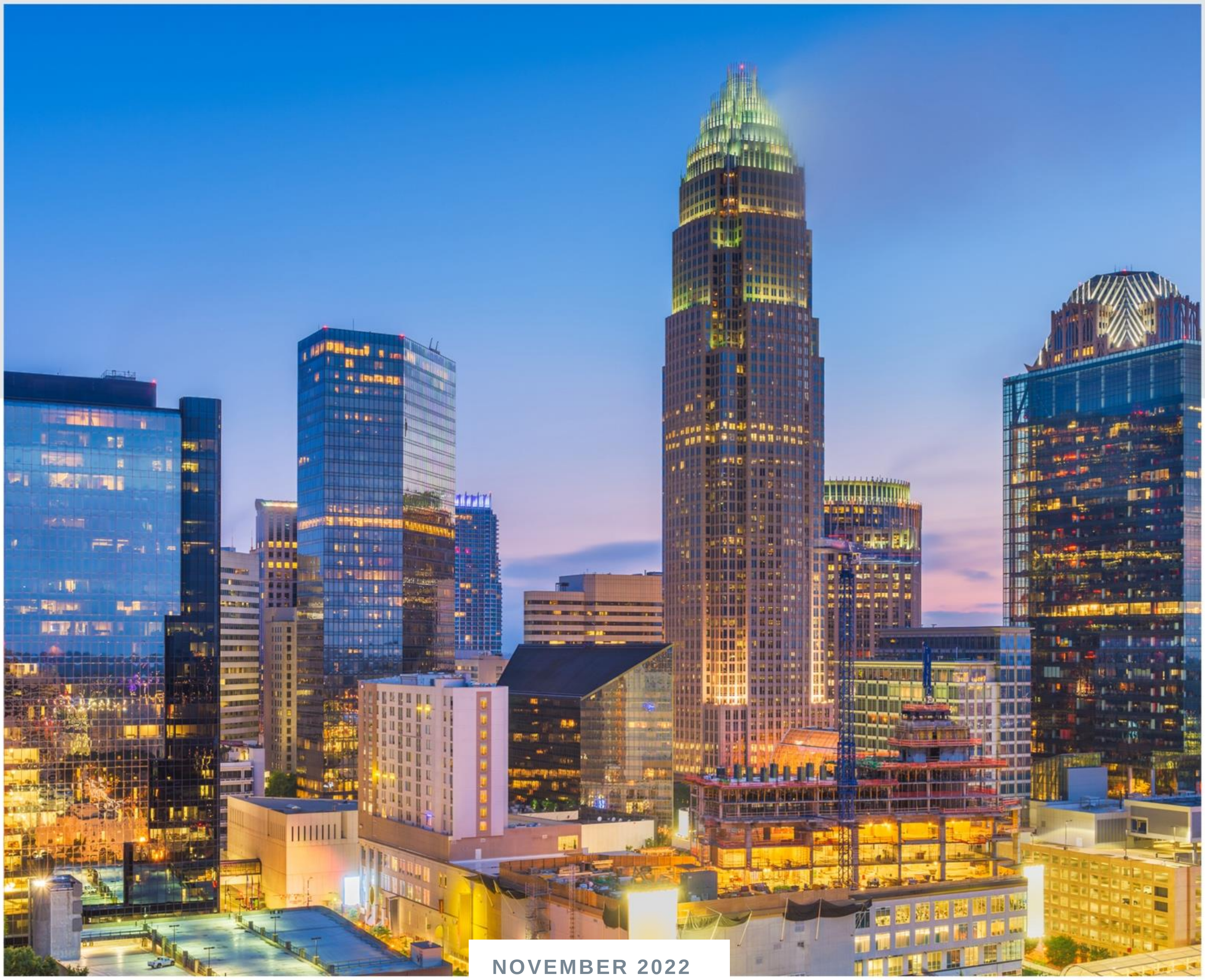
A Bumpy Path Ahead for U.S. Real Estate

U.S. Real Estate Research Quarterly



NOVEMBER 2022

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Executive Summary

ECONOMY

- September's CPI data highlighted the need for the Fed to remain vigilant over restoring price stability. Core YoY inflation accelerated to a 40+ year high of 6.6%.
- The current health of underlying economic fundamentals is one of the reasons behind the speed and intensity of Fed rate hikes. There are indications that monetary policy is slowing the economy.
- The U.S. economy is not yet in recession with third quarter GDP growing at a 2.6% annualized, seasonally-adjusted rate. Investors are bracing themselves for a downturn as the risk of recession over the next year rises.
- Robust underlying economic fundamentals means property performance could weather a mild downturn without falling to perilous depths.

PROPERTY MARKET

- Third quarter transaction activity totaled $172 billion across major property types, a decline of 21% over the prior year, reflecting elevated uncertainty in the macroeconomy.
- Apartment, industrial, and retail sales activity declined 17%, 18%, and 9%, respectively, while hotel and office registered transaction volume declines of 21% and 33%, respectively.
- The rapid climb in base rates as exemplified by the 10-year Treasury yield has been the driving force behind the rise in real estate debt costs, which are at their highest in over a decade.
- Real estate investors should take comfort that as we may be transitioning to a "higher-for-longer" interest rate environment, real estate performance remains still correlated with secular demand tailwinds that were active well before the pandemic.

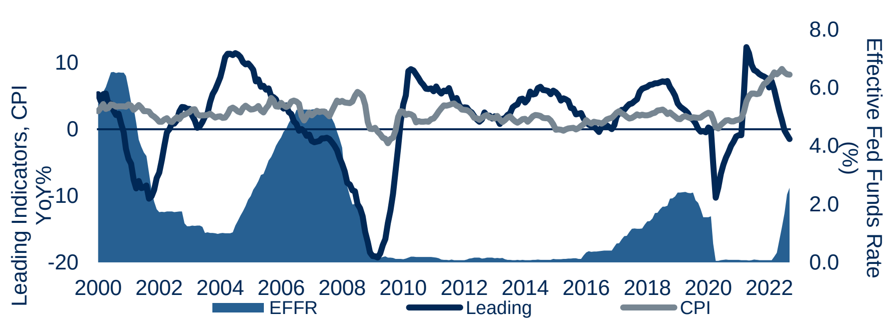
Economic Outlook

Components of economic activity and consumer price inflation are slowing in response to tighter monetary conditions. The problem, however, is that they are not slowing quickly enough to avoid broad price impacts on risk assets—including private commercial real estate. September's CPI data highlighted the need for the U.S. Federal Reserve (Fed) to remain vigilant over restoring price stability. Core year-over-year (YoY) inflation accelerated to a 40+ year high of 6.6%. The central bank likely will have to raise the Federal funds rate to between 4.5% and 5.0%—the highest level since 2007—putting tremendous additional strain on public markets, which have already taken a beating year-to-date (YTD).

The current health of underlying economic fundamentals is one of the reasons behind the speed and intensity of Fed rate hikes. Unemployment began 2022 at 4.0% and has now declined to 3.5%. Initial jobless claims average 207K for September versus its pre-pandemic 5-year average of 244K. Contrary to precedent, it is the unyielding labor market that is pressuring capital markets. Yet there are signs that monetary policy is slowing the economy. As of September, the Conference Board's Index of Leading Indicators has declined YoY for three consecutive months, which can be a precursor to a recession. Additionally, one of the early causes of surging goods prices was COVID-related supply chain backlogs—but some backlogs are easing as evinced by the rapid decline in some Trans-Pacific container shipping costs.

For the office sector, net absorption around the third quarter was flat. The long-expected post-pandemic recovery in office demand has fallen far short of expectations. Space demand continues to decouple from underlying fundamentals. Leased space is nearly 2.7% lower than prior to the pandemic while traditional office-using employment is 3.9% higher. The secular downshift in demand is only beginning to be priced into asset values. Outside of office, property fundamentals have softened, but pockets of resilience remain. Vacancy ticked up across all property types. Nominal rent trends have historically benefitted from moderately high periods of inflation. However, in the current inflationary environment, the resultant expansion in base rates and risk premiums are proving more consequential than any inflationary lift to revenues. The economy is not yet in recession with third quarter GDP growing at a 2.6% annualized, seasonally-adjusted rate, but owners and investors are preparing as the risk of recession over the next year is rising. Given how robust underlying economic fundamentals currently are, property performance could weather a mild downturn without falling to perilous depths, but the near-term outlook has dimmed.

FIGURE 1: MONETARY TIGHTENING SLOWING ECONOMIC ACTIVITY, INFLATION PEAKING



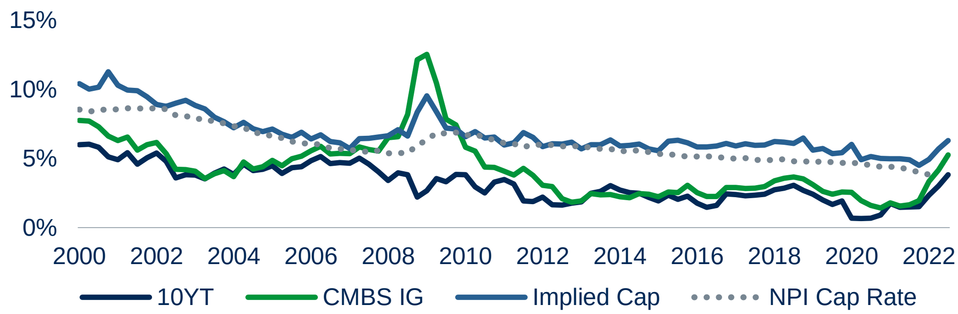
Source: Conference Board; Bureau of Labor Statistics; U.S. Federal Reserve. As of September 30, 2022.

Capital Markets

Third quarter transaction activity totaled $172 billion across major property types, a decline of 21% over the prior year, reflecting the challenging environment. The higher cost of debt has sapped transactional liquidity and led to incidences of “negative leverage”, where financing costs exceed that of unlevered equity. Some buyers are closing without debt capital in the hopes of financing when there is less market turbulence. Real Capital Analytics also reported that apartment, industrial, and retail sales activity declined 17%, 18%, and 9%, respectively, while hotel and office registered transaction volume declines of 21% and 33%, respectively.

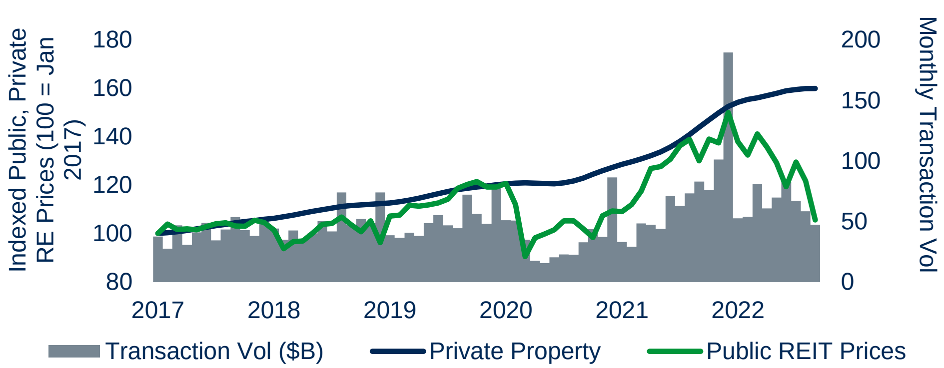
The RCA Commercial Property Price Index (CPPI) gained 11.1% YoY as of June 2022. The CPPI rose by 0.7% over the quarter, its slowest quarterly pace of appreciation since Q2 2020. The difference between public and private real estate price indices performance widened further over the third quarter with composite REIT prices down 29.6% YTD versus the CPPI, which is up 3.7% YTD. The rapid climb in base rates as exemplified by the 10-year Treasury yield has been the driving force behind the rise in real estate debt costs, which are now generally their highest in over a decade. Public REIT implied cap rates are accommodating the shift in interest rates and borrowing costs, but appraisal-based cap rates as represented by the NCREIF have yet to adjust meaningfully.

FIGURE 2: RISING BASE RATES, BORROWING COSTS SUGGEST CORE CAP RATES WILL EXPAND



Source: Bloomberg; Federal Reserve; NAREIT; NCREIF. As of September 30, 2022.

FIGURE 3: TRANSACTION ACTIVITY, PUBLIC REIT PRICES DOWN YTD



Source: Bloomberg; Real Capital Analytics. As of September 30, 2022.

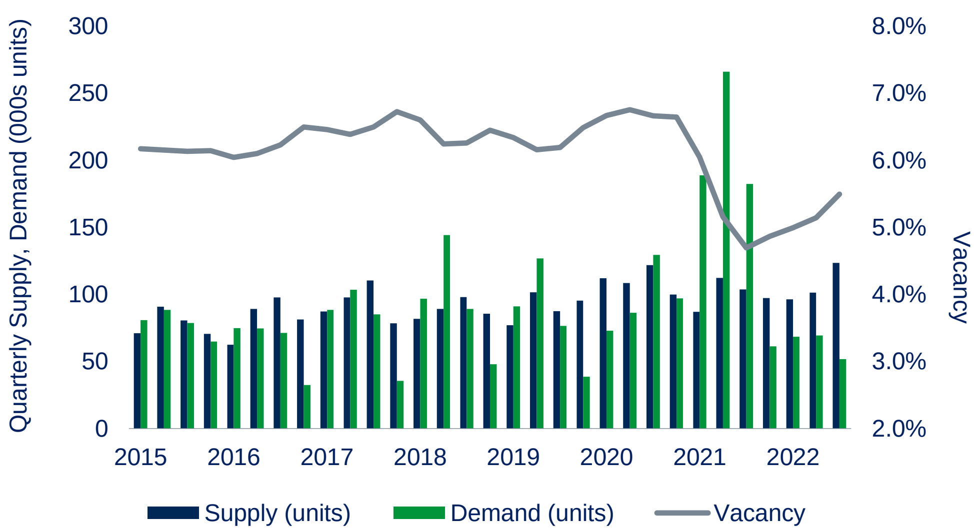
Property Markets

APARTMENT

National apartment vacancy in the third quarter climbed to 5.5%, increasing 40 basis points (bps) over the quarter and 80 bps YoY. Vacancy is still below its 10-year average but climbing quickly. Third quarter demand came in uncharacteristically weak as the unprecedented surge in rent growth coming out of the pandemic is weighing on consumer balance sheets. Shelter inflation, inclusive of both rental and own housing costs, is one of the main reasons that CPI inflation has remained persistently elevated.

Rent growth is decelerating from its 2021 double-digit pace as asking rents climbed 5.7% over last year. Supply activity is helping to moderate the pace of rent growth, which is still well above the historical average. Quarterly deliveries hit their highest on record in the third quarter. Sun Belt apartment metro fundamentals, which have benefitted from secular demand tailwinds well before the pandemic, continue to outperform the rest of the country. They also have some of the most aggressive supply pipelines. Nationally, housing affordability has worsened with the 30-year fixed mortgage rate rising to 6.9% as of September—its highest level since March 2002. Home price appreciation is decelerating, rising 13% over the prior year as of August, after peaking at 21% YoY in March. Home buyers now face high mortgage rates in addition to record home prices.

FIGURE 4: POST-PANDEMIC APARTMENT DEMAND SURGE COOLING



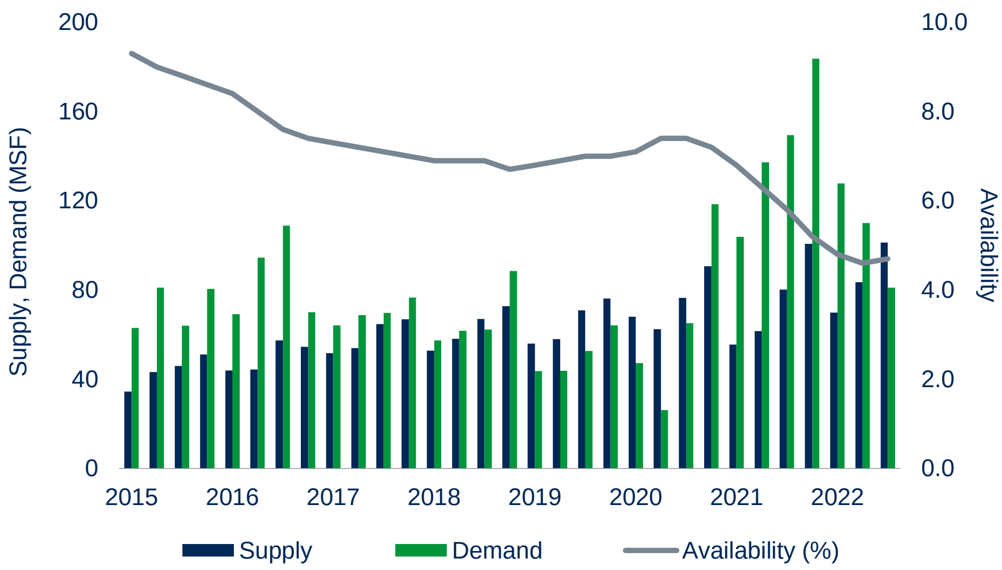
Source: Costar. As of Q3 2022.

INDUSTRIAL

National industrial availability edged up to 4.7% but remains 110 bps below its Q3 2021 level. Demand lagged supply for the first time in seven quarters, although the anecdotal evidence points to elevated tenant demand. Some major industrial tenants and investors are guiding more cautiously over the near term. Except during the pandemic, the industrial property sector has typically been sensitive to economic cycles and should be susceptible to retreating demand if a recession materializes.

Global manufacturing and trade circumstances that have supported warehouse demand remain intact. While the pace of consumption has been slowed by high inflation, aggregate household and business spending reinforces both the space and capital markets outlook for the industrial property type. Industrial deliveries climbed over the third quarter as supply chain congestion eased, but additional headwinds to supply growth will come from the cooling economy. Asking rents rose by 12.1% YoY in the third quarter, setting another record quarter of rent growth.

FIGURE 5: INDUSTRIAL AVAILABILITY TICKED UP BUT REMAINS HISTORICALLY TIGHT



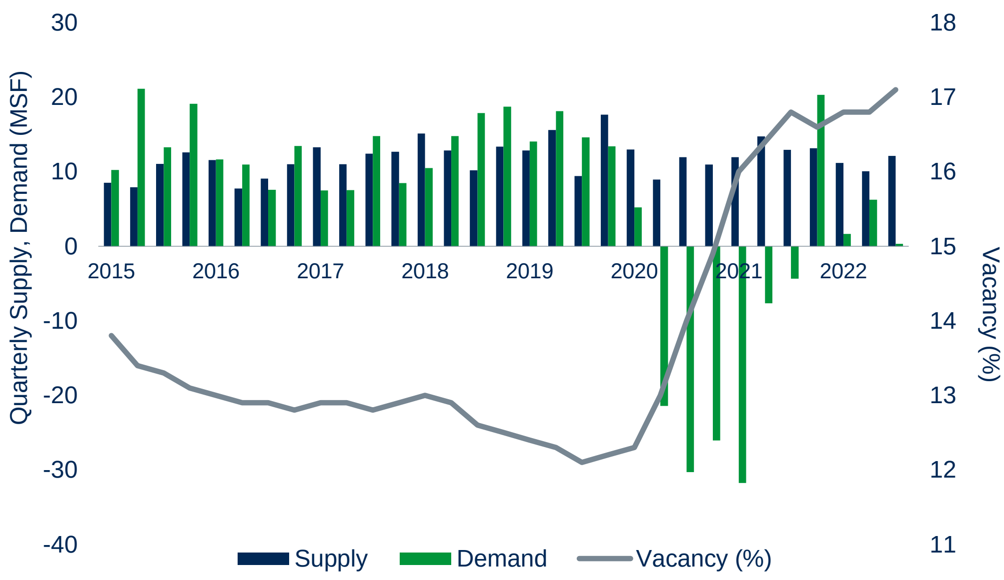
Source: CBRE-EA. As of Q3 2022.

OFFICE

National office vacancy climbed to 17.1%—its highest level since the third quarter of 1993. Over the past 10 quarters, the amount of multi-tenant space that has been given back (i.e. negative net absorption) totals 93 million SF, the worst episode of demand destruction since the 2001 dot-com bust. Sublease vacancy, an indicator of office shadow supply, peaked in early 2002 signaling an impending recovery for the market. Today, sublease vacancy continues to climb with little indication of slowing. Shadow supply, which refers to space that is leased or owned by unoccupied, looms large, meaning that vacancy is significantly understated.

Third quarter net absorption was marginally positive. Meanwhile, completions added another 12.1 MSF to aggregate inventory over the quarter, well above the 10.1 MSF 10-year historical average. Both suburban and CBD vacancy rose over the quarter to their highest since 2013 and 1993, respectively. The escalating war for talent, as unemployment for people with a bachelor's degree or higher is only 1.8%, will likely compel companies to rethink their office space needs and amenities in order to attract and retain employees. New-build, "next-generation" office buildings in highly amenitized neighborhoods with a highly educated workforce and concentration of STEM employment should continue to outperform commodity office properties.

FIGURE 6: Q3 FLAT NET ABSORPTION PUSHED OFFICE VACANCY TO ITS HIGHEST IN ALMOST FOUR DECADES



Source: CBRE-EA. As of Q3 2022.

LAB AND LIFE-SCIENCES

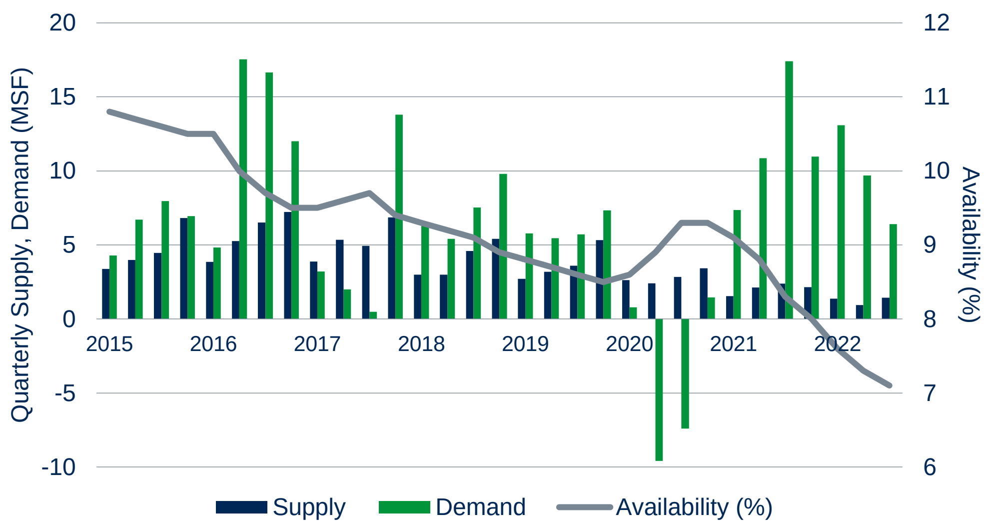
While the lab and life sciences sector is not immune to the ongoing capital market turmoil, it is demonstrating resiliency. Vacancy tightened another 10 bps to 5.2% across the top 12 life sciences markets tracked by CBRE, owing to demand from large pharmaceutical companies. The supply pipeline remains active with total lab space under construction up two million square feet quarter-over-quarter to 31.3 million square feet. Venture capital flows into biotech and pharmaceuticals and biotechnology have slowed from their record 2021 pace, but remain above pre-pandemic levels.

RETAIL

Neighborhood and community centers saw availability decline over the third quarter to 7.1%, hitting another record low. Availability declined from 8.3% last year and 7.3% over the quarter. The Darwinian environment of retail real estate over the past decade forced tenants and owners to adapt as e-commerce and the pandemic changed consumer behavior and expectations. As a result, the sector's prospects have improved significantly as demonstrated by an average availability rate that has consistently tightened over the past eight quarters.

Retail sales excluding autos and gasoline grew by 7.5% over last year as of September 2022. While that is lower than average spending growth over 2021, September core retail sales growth was still well above the pre-pandemic historical average of 4.0%. Neighborhood and community centers—with a resilient tenant mix and open air design—located in strong population growth markets should continue to be defensive across economic cycles.

FIGURE 7: SHOPPING CENTER AVAILABILITY AT RECORD LOW AS DEMAND OUTPACES SUPPLY



Source: CBRE-EA. As of Q3 2022.

SUMMARY

As the risk of recession increases, aggregate U.S. property sector fundamentals are in a position of relative health, with the exception of the office sector. The Fed is determined to restore price stability, and market participants are no longer doubting its resolve. Financial markets are straining as a result of elevated volatility and uncertainty. Underlying economic fundamentals, including the labor market, have been resilient, and real estate owners and investors should take comfort that as we may be transitioning to a “higher-for-longer” interest rate environment, real estate property and investment performance are still correlated with secular demand tailwinds that were in place long before the pandemic.

About the Team

BRE’s research team efforts are led by Dags Chen in the U.S. and Paul Stewart in Europe. The research team is structured by sector and geographic expertise. The team’s diverse backgrounds include 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 enhancing the team’s ability to collect, augment and analyze data to inform better decision making.

Dags Chen, CFA

Head of U.S. Real Estate Research & Strategy

Ryan Ma, CFA

Managing Director, Research

Important Information