U.S. Property Fundamentals Steady Amid Heightened Uncertainty

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Executive Summary

ECONOMY

- U.S. real estate fundamentals remained buoyant over the second quarter even as the uncertain economic backdrop continued to deteriorate.
- The struggle of central banks, including the Fed, to contain accelerating inflation is now the focus of monetary policy.
- The probability of recession is the highest it has been since March 2020. Real GDP declined by 0.9% at a seasonally adjusted annual rate marking consecutive quarters of contraction over the first half of 2022.
- Despite the rise in debt costs and the implications for levered property values, secular demand trends remain drivers of value creation over the long term.

PROPERTY MARKET

- Second quarter property sales volume rose by 17% over the prior year. Though bid-ask spreads have widened between buyers and sellers, there is still meaningful transactional liquidity.
- Private property prices gained 18.5% YoY as of June—but the exceptional annual appreciation trend reflects more the investor confidence of the second half of last year than current sentiment, which is markedly less optimistic.
- Given the upward pressure on property cap rates exerted by tightening monetary policy, uncertainty around pricing will persist, which could affect transaction volumes in coming months.

Economic Outlook

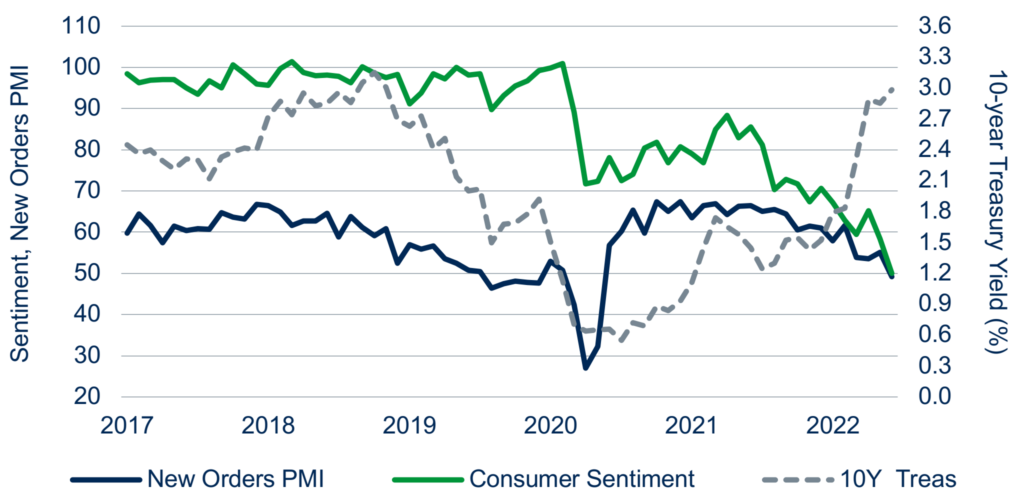
U.S. real estate fundamentals remained buoyant over the second quarter even as the uncertain economic backdrop continued to deteriorate. The struggle of central banks, including the U.S. Federal Reserve (Fed), to contain accelerating inflation is now the focus of monetary policy. A key contributor to the inflationary environment has been the robust labor market, but elsewhere indictors point to slowing economic activity.

Activity is also likely to continue to fall going forward because demand needs to be further curbed to combat inflation. While property performance has historically benefitted from moderately high periods of inflation, downward pressure on demand from tighter financial conditions will arguably be the more important factor for real estate investors and operators in coming months—possibly more than any inflationary lift.

With rising prices pressuring household and firm spending, consumer and business sentiment have fallen to their lowest levels in more than a decade, underscoring the urgency of restoring price stability. The Institute of Supply Management Purchasing Managers Index (ISM PMI) remained expansionary but the new orders component contracted, which suggests further deceleration to come. The probability of recession is the highest it has been since March 2020, but given that unemployment remained unchanged at 3.6% over the quarter, the economy seems adequately positioned to weather a slowdown. Real GDP declined by 0.9% at a seasonally adjusted annual rate marking consecutive quarters of contraction over the first half of 2022.

Despite the rise in debt costs and the implications for levered property values, secular demand trends including the expansion of e-commerce capacity, deteriorating housing affordability, hybrid work, and the migration of businesses and households to Sun Belt metros are still intact—and they remain drivers of value creation over the long term.

FIGURE 1: MONETARY TIGHTENING SLOWS DEMAND, WEIGHS ON SENTIMENT



Source: U.S. Federal Reserve, ISM, University of Michigan. As of June 30, 2022.

Capital Markets

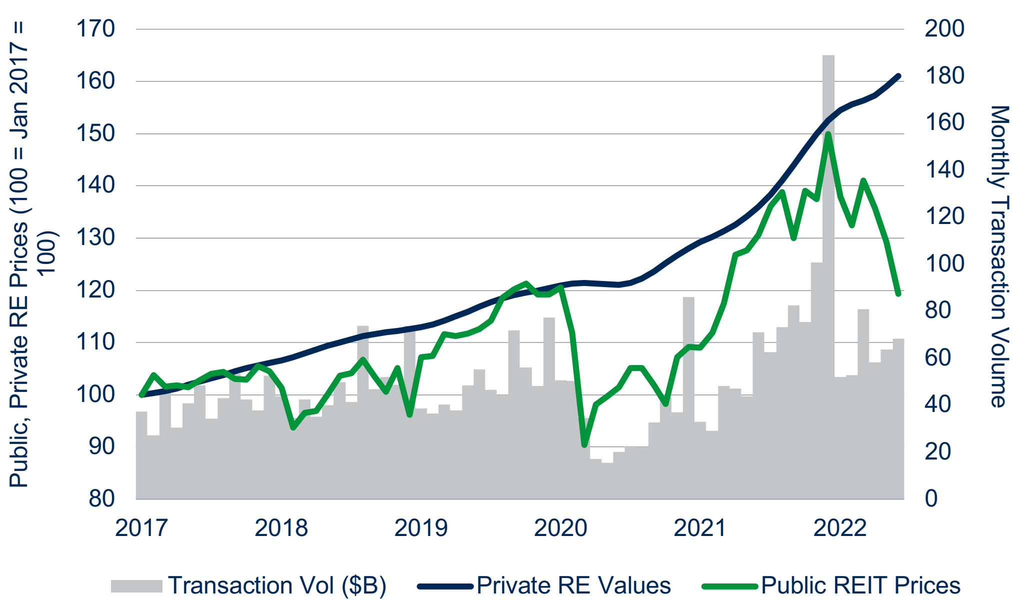
Second quarter capital markets activity grew 17% over the prior year, indicating that despite a widening bid-ask spread and higher volatility, transactional liquidity is still present. The $190 billion in aggregate sales during the second quarter is a tick up from $171 billion in the first quarter, but it nonetheless pales when compared to the $365 billion of sales activity over the fourth quarter of 2021.

The two property types that registered the largest jump in transactions year-over-year were retail (46%) and apartment (42%), followed by industrial (8%). Office and hotel aggregate sales fell by 9% and 37%, respectively. Given the upward pressure on property cap rates exerted by tightening monetary policy, pricing is uncertain, suggesting that sales volume could fall further in coming months—especially as signs of a cyclical slowdown become more pervasive.

Led by industrial and apartment, private property prices, as measured by the Real Capital Analytics (RCA) Commercial Property Price Index (CPPI), gained 18.5% year-over-year (YoY) as of June 2022. But the CPPI rose by 3.0% over the second quarter—suggesting that the exceptional annual appreciation trend reflects more the investor confidence of the second half of last year than current sentiment, which is markedly less optimistic. Public REITs declined by 8.7% YoY as of the end of June and 15.4% over the second quarter.

The higher cost of debt is one factor as spiking prices have compelled the Fed to raise the overnight bank borrowing rate to its highest level since 2005 as implied by the futures market. Base interest rates have risen wholesale. In mid-June, the market yield on the 10-year Treasury note touched 3.5%, its highest level since 2011.

FIGURE 2: TRANSACTION VOLUME, PUBLIC REIT PRICES DOWN SINCE START OF 2022



Source: Bloomberg, RCA. As of June 30, 2022.

Property Markets

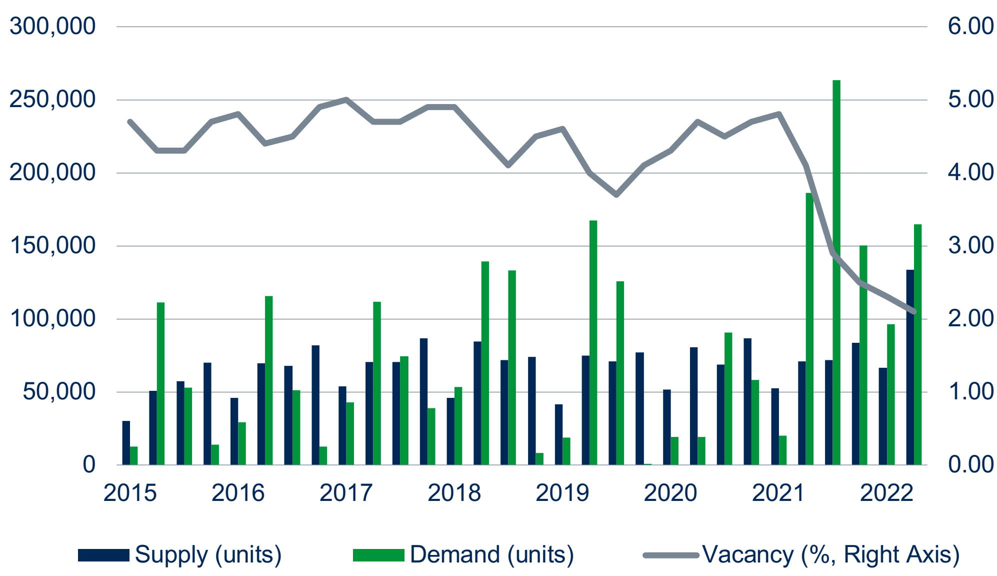
APARTMENT

National apartment vacancy in the second quarter fell to 3.1% YoY, but rose 80 basis points (bps) from its first quarter level. National vacancy averaged 5.1% over the past 15 years according to CBRE-EA. The apartment market is still historically tight. Typically, the second quarter sees a jump in net absorption due to seasonality, but demand came in uncharacteristically weak, possibly reflecting the squeeze that decades-high inflation is putting on household spending.

With rent growth still in the mid-teens YoY, the supply pipeline will likely remain robust despite higher material and labor costs. As CPI inflation slows, rent growth should decelerate also, but is expected to trend above its historical average if a recession is avoided.

The performance of Sun Belt apartment market fundamentals, which have benefitted from secular demand tailwinds well before the pandemic, continue to outperform the rest of the country. Nationally, housing affordability has worsened with the 30-year fixed mortgage rate rising to its highest level in more than a decade, while home price appreciation has average approximately 20% YoY over the past. Prospective home buyers now face high mortgage rates in addition to record home prices.

FIGURE 3: FOLLOWING POST-COVID DEMAND SURGE, APARTMENT VACANCY DECLINES TO RECORD LEVEL



Source: CBRE-EA. As of Q2 2022.

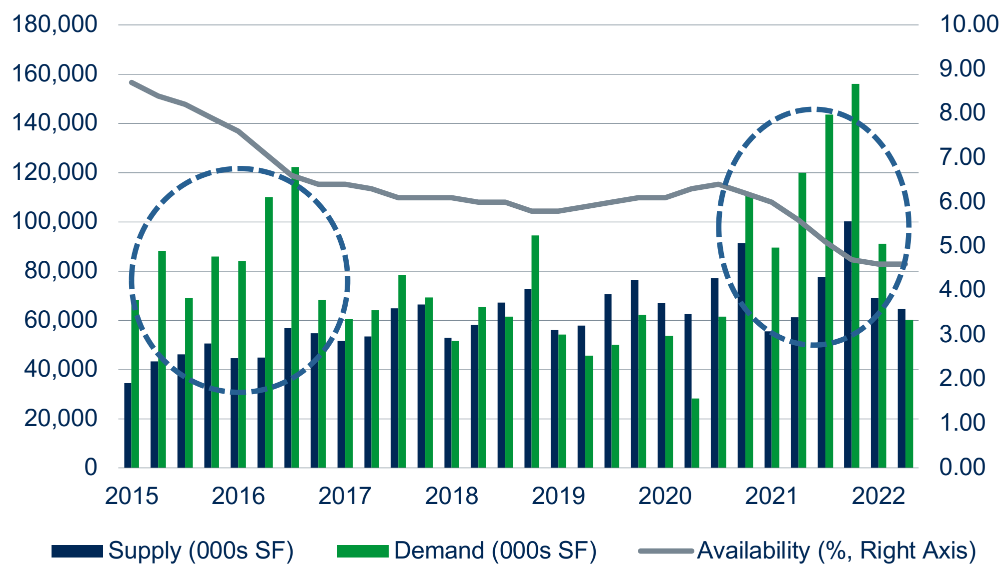
INDUSTRIAL

National industrial availability remained unchanged over the second quarter at 4.6%, 100 bps lower than it was a year ago. Net absorption retreated to 60.2 million sf from 91.0 million sf in the first quarter. The combination of slowing economic activity, tight availability, and record industrial rents contributed to the lowest level of quarterly demand in two years. While availability is still at record lows across most markets, nearly half of the major metros tracked by CBRE-EA posted an increase in availability over the second quarter reflecting sensitivity to the business cycle.

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 also slowed over the second quarter as construction timelines were impacted by the availability of certain building materials. Asking rents rose by 12.0% YoY as of the second quarter, setting another high watermark for rent growth.

FIGURE 4: SUSTAINED PERIODS OF ABOVE-AVERAGE DEMAND PUSH INDUSTRIAL AVAILABILITY TO A RECORD LOW



Source: CBRE-EA. As of Q2 2022.

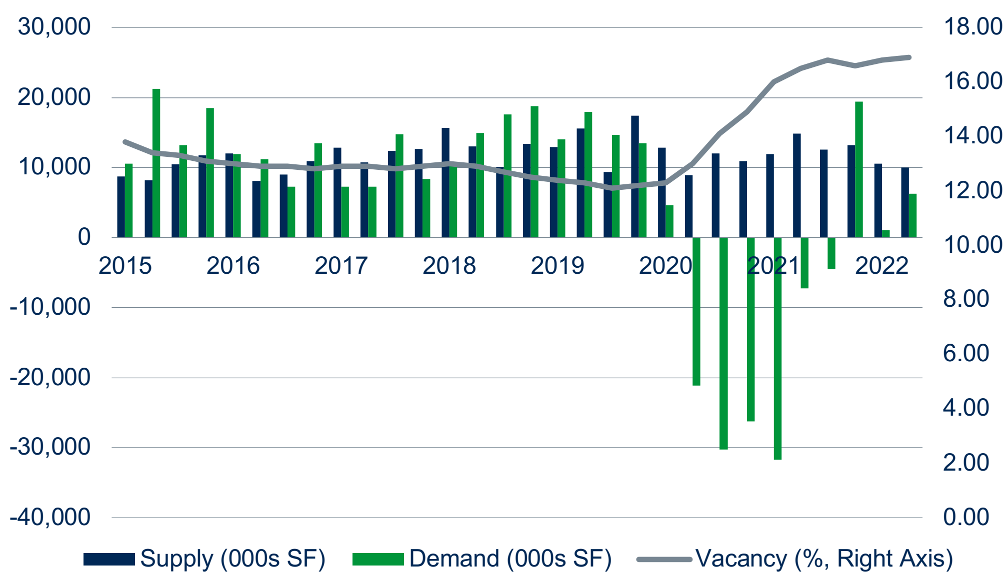
OFFICE

National office vacancy rose by 10 bps over the second quarter to 16.9%—its highest level since 2003. While employees are returning to the office, remote work continues to weigh on leasing. Many firms are still reassessing their future space needs. U.S. office-using payrolls stand 1.9 million above their pre-COVID level, equating to an increase of 5.7%, but the historical connection between office jobs and office demand has been altered by hybrid work.

Net absorption was positive over the quarter, but nearly 10 million sf was also delivered, exacerbating an already uncertain outlook for fundamentals. Elevated new supply will likely keep vacancy from retreating quickly over coming months. Still, office vacancy should stabilize and set the stage for a stronger recovery next year provided that we do not see significant job losses due to a recession.

Suburban vacancy edged 10 bps down to 16.8% over the quarter while downtown vacancy rose another 20 bps to 17.0%—its highest level since 1993. The escalating war for talent, as unemployment for people with a bachelor's degree or higher plummeted to just 2%, will likely compel companies to rethink their office space needs and amenities in order to attract and retain employees. In particular, new-build, "next-generation" office buildings in highly amenitized neighborhoods with a highly educated workforce and concentration of STEM employment are outperforming conventional office properties.

FIGURE 5: OFFICE VACANCY CONTINUES TO RISE AS SUPPLY REMAINS ACTIVE AMID SLOW DEMAND RECOVERY



Source: CBRE-EA. As of Q2 2022.

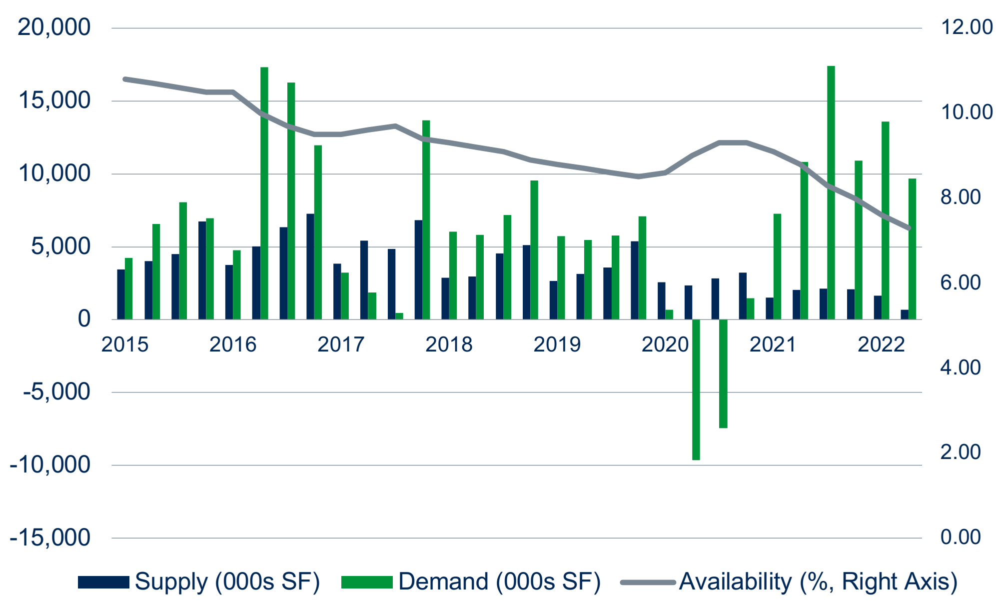
RETAIL

Neighborhood and community centers saw availability decline over the second quarter to 7.3%, the lowest level in more than 15 years according to CBRE-EA. 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 seven quarters.

Consumer spending as of June as measured by core retail sales, which exclude food, energy, autos, and gas, rose by 6.6% YoY. While that is lower than the average spending growth over 2021, June core retail sales growth was still well above the pre-pandemic average of 4.0%.

At the same time, household balance sheets have been bolstered by pandemic-related stimulus measures and because the lockdowns themselves constrained spending. In our view, neighborhood and community centers—with their resilient tenant mix and open air design—in a strong population growth market, are well-positioned to withstand and thrive in the post-pandemic retail environment.

FIGURE 6: SHOPPING CENTER AVAILABILITY AT RECORD LOW AS DEMAND OUTPACES SUPPLY FOLLOWING LOCKDOWNS



Source: CBRE-EA. As of Q2 2022.

SUMMARY

Tighter monetary conditions are weighing on economic growth and inflation—or at least some components of inflation. Public financial markets, including REITs, have weathered a pullback due to the rising risk of recession and debt costs. The Fed's prioritization of price stability is likely to continue over the near term, even as a downturn looms.

Real estate fundamentals have been stable over the second quarter, but should the U.S. enter into recession, lower demand will likely impact occupancy and rent growth. The near-term outlook is sobering relative to the euphoria of the second half of last year—but even amid elevated uncertainty, opportunities are presenting themselves across the asset class. Secular demand trends fueling value creation at the property level are still intact. Cap rates are expanding, and while investors are rightfully more cautious, their longer-term convictions have not necessarily changed.

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.

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