U.S. Real Estate: Parsing a Different Kind of Downturn

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Executive Summary

ECONOMY

- Following the bank failures, concerns about contagion risk spiked. While fears have eased slightly since mid-March, financial system stability risk remains elevated.
- The U.S. economy could slow substantially in the second half of the year, driven by the depletion of savings buffers, the tightening of credit conditions, the cooling of consumption, and firms' margin pressures.
- Inflation will trend down, but the path will be bumpy, and will likely require additional Fed rate hikes this spring. Any recession—this year or next—is expected to be short and shallow.

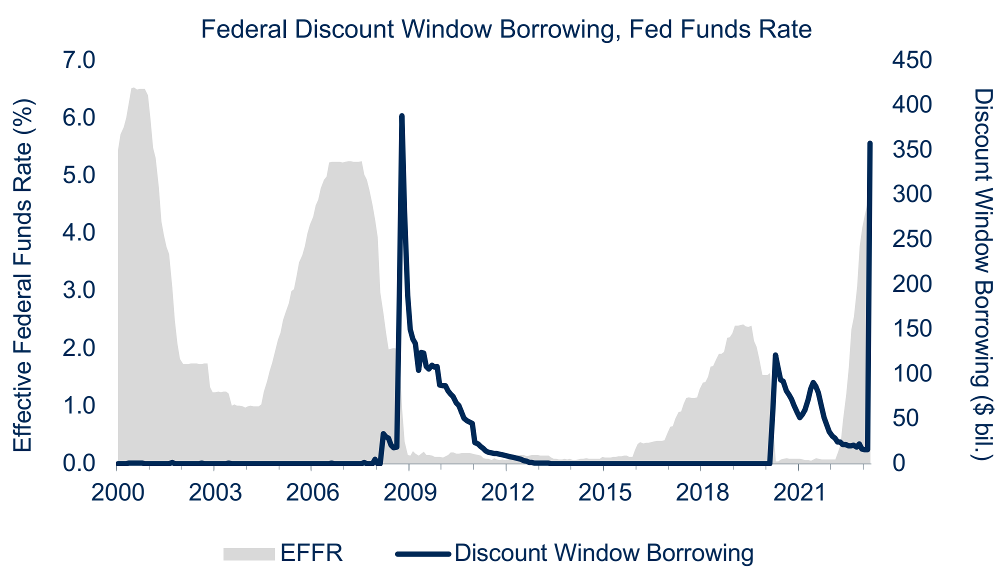
PROPERTY MARKET

- The prospect of a mild recession is unlikely to mitigate the ongoing and substantial correction to U.S. property values—especially for the office property sector, which posted its biggest decline in demand since the midst of the pandemic.
- Some real estate investors are already adjusting their expectations around higher base rates and real estate risk premiums. Implied public REIT cap rates, which react more quickly to inflection points in financial markets, have jumped to their highest level in over a decade.
- Transaction activity totaled $85 billion in the first quarter of 2023, 56% below the same quarter the year prior—the weakest first quarter level since 2013. Sales are likely to remain subdued as lenders and sponsors work through existing loans, some of which are distressed.

Economic Outlook

One year after the U.S. Federal Reserve (Fed) began to tighten monetary policy, economic activity and inflation appear to be slowing across a broad range of "hard" data metrics including continuing unemployment claims and first quarter real GDP, which came in at a meager 1.1% SAAR. The pace of commercial rent increases is also decelerating, a trend the Fed is watching closely. The U.S. economy and consumer households, however, have far from capitulated. One of the defining moments of the first quarter was the failure of two regional banks in rapid succession: Silicon Valley Bank and Signature Bank. The bank failures shook investor confidence and prompted the installation of emergency liquidity measures from the public sector. Concerns about contagion risk spiked, and while fears have eased slightly since mid-March, financial system stability risk remains elevated and certain banks are at high risk of failure.

FIGURE 1: FED TIGHTENING STRESSES THE BANKING SECTOR



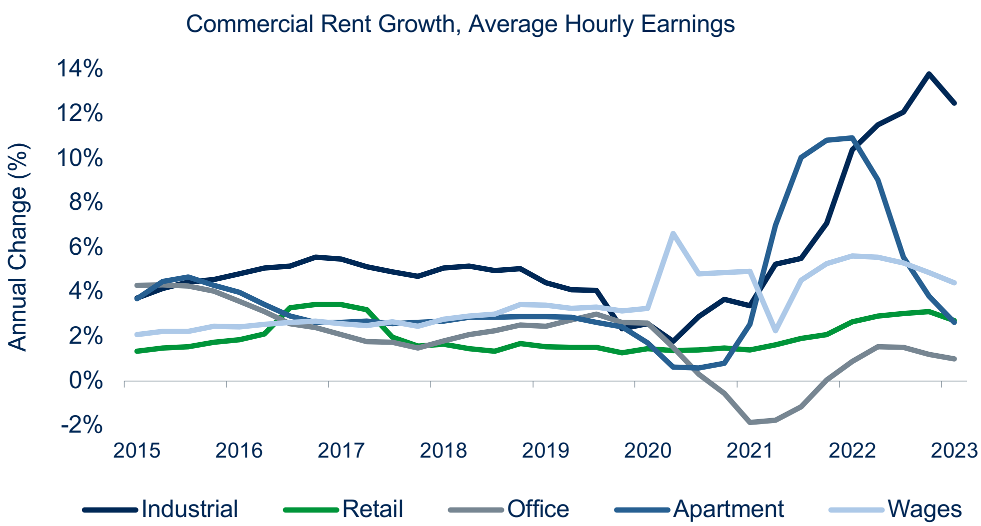
Source: U.S. Federal Reserve. As of March 31, 2023.

As the Barings Investment Institute recently noted, the U.S. economy may be poised to slow substantially in the second half of the year, driven by the depletion of savings buffers, the tightening of credit conditions, the cooling of consumption, and firms' margin pressures. Inflation will trend down, but the path will be bumpy, and will likely require additional Fed rate hikes this spring. Firms will respond to slower growth and higher funding costs by some increase in layoffs. Yet, a shortage of workers exacerbated by an ageing population point to a limited rise in unemployment. Many firms did not find enough workers to meet demand in the last three years. Any recession—this year or next—is expected to be short and shallow.

The prospect of a mild recession, however, is unlikely to mitigate the ongoing and substantial correction to property values—especially for the office sector, which posted its biggest decline in demand since the midst of the pandemic. The past four quarters have dispelled the notion that interest rates can remain low indefinitely without creating highly problematic distortions in asset values. A preponderance of data reflecting slowing wage and goods inflation suggests that the Fed should be near the end of its tightening campaign. However, even after inflation is subdued, there is a growing consensus among market participants that it would be imprudent to return to the post-GFC era of "zero policy rates."

Some real estate investors are already adjusting their expectations around higher base rates and real estate risk premiums. Implied public REIT cap rates, which react more quickly to inflection points in financial markets, have jumped to their highest level in over a decade. Loan costs have risen, and many real estate lenders of scale are monitoring or restructuring mortgages—a significant portion of which were made before 2022. It is unlikely that debt capital providers would roll back loan costs even once the Fed stops hiking. Borrower distress, magnified by expectations of softer tenant demand in the near-term, is likely to continue to rise into 2024. However, both the abundance of investor capital on the "sidelines" combined with a minimal impact to fundamentals, especially around the industrial and multifamily sectors, should serve as backstops to property values.

FIGURE 2: LABOR MARKET, MUCH OF TENANT DEMAND HAS BEEN RESILIENT



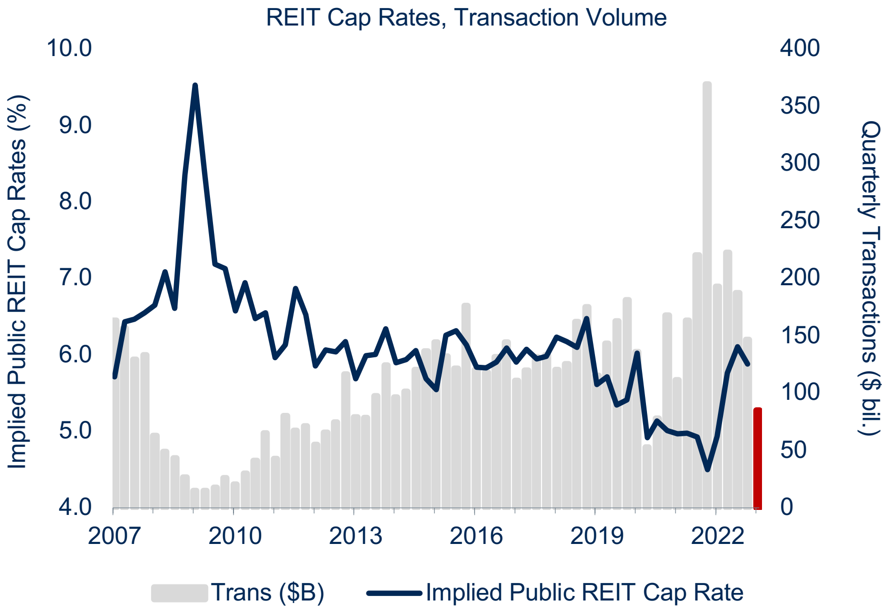
Source: BoL, CBRE-EA. As of Q1 2023.

Property performance continues to be differentiated by sector. For renter households, the post-pandemic surge in rates has been painful especially when combined with the decades-high increase in consumer prices. Lower and middle-income renters are spending (or have spent) the excess savings accumulated during the pandemic and the use of revolving credit is ticking up. Industrial demand has continued to surprise even the most skeptical, registering a year of double-digit rent growth and near record low vacancies even in the face of robust construction activity. Despite the rise in debt costs and downward pressure on property values, positive secular demand trends including the expansion of e-commerce capacity, deteriorating homeownership affordability, and the migration of businesses and households to high-growth metros are still intact and drivers of value creation over the long term.

Capital Markets

Transaction activity totaled $85 billion in the first quarter of 2023, 56% below the same quarter the year prior—the weakest first quarter level since 2013 (Figure 3). Sales are likely to remain subdued as lenders and sponsors work through existing loans, some of which are distressed. While distressed sales are still a small portion of overall transaction activity, consensus expectations are that they will rise in coming quarters.

FIGURE 3: TRANSACTIONS HAVE FALLEN BACK TO PANDEMIC LEVELS



Source: Bloomberg, Real Capital Analytics. As of March 31, 2023.

All major property type transaction activity, except for retail, was down by more than 50% year-over-year. Leading the decline relative to a year ago was office (-68%), followed by apartment (-64%), industrial (-55%) and retail (-27%).[1]

Lower transactional liquidity and higher interest rates have impacted property prices. Composite public REIT share prices have fallen by approximately 24% since the beginning of 2022. Private property prices have only recently started to move lower with the Real Capital Analytics (RCA) Commercial Property Price Index (CPPI) 7.8% off its recent peak.

[1] Source: Bloomberg, Real Capital Analytics. As of March 31, 2023.

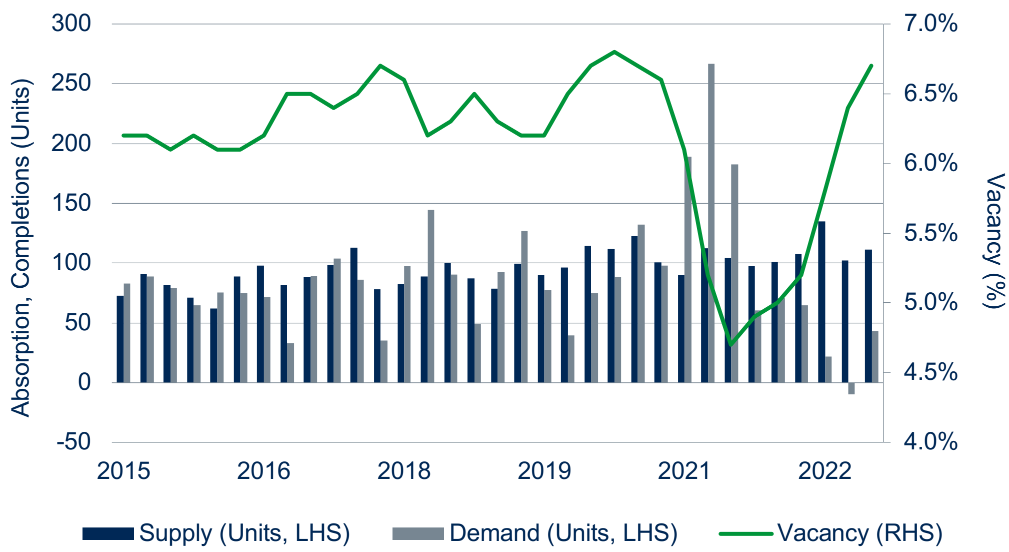
Property Markets

APARTMENT

U.S. apartment supply continued to outpace demand, which caused vacancy rates to climb to 6.7% as of the first quarter of this year (Figure 4). New construction has been concentrated in the higher-end property segment which reported higher vacancy rates during the quarter. The mid-priced property segment also experienced rising vacancy rates, but the increase was primarily attributable to the impacts of higher inflation on consumer finances, unaffordable rent increases, and economic uncertainty, which caused some renters to return to their parents' home or find a roommate. These headwinds caused multifamily year-over-year rent growth to decelerate from 3.8% in the fourth quarter of 2022 to 2.1% in the first quarter of this year, and compares to an unsustainably high 10.9% rate in the first quarter of 2022.[2]

Over the long term, the multifamily sector is expected to benefit from its status as a core necessity, structural housing shortages, and higher building costs and mortgage rates which make homeownership less affordable. However, oversupply will continue to be a challenge for the market in the near term. As an example, there were approximately one million units under construction in the first quarter, and new supply is expected to reach a 40-year high in 2023. In addition, renters are sensitive to changes in the economic environment and labor markets and there is Federal and local government support for policies to address housing affordability, which may encourage additional supply or increase regulations.

FIGURE 4: OVER SUPPLY AND AFFORDABILITY ISSUES CAUSE VACANCY RATES TO RISE



Source: CBRE EA. As of March 31, 2023.

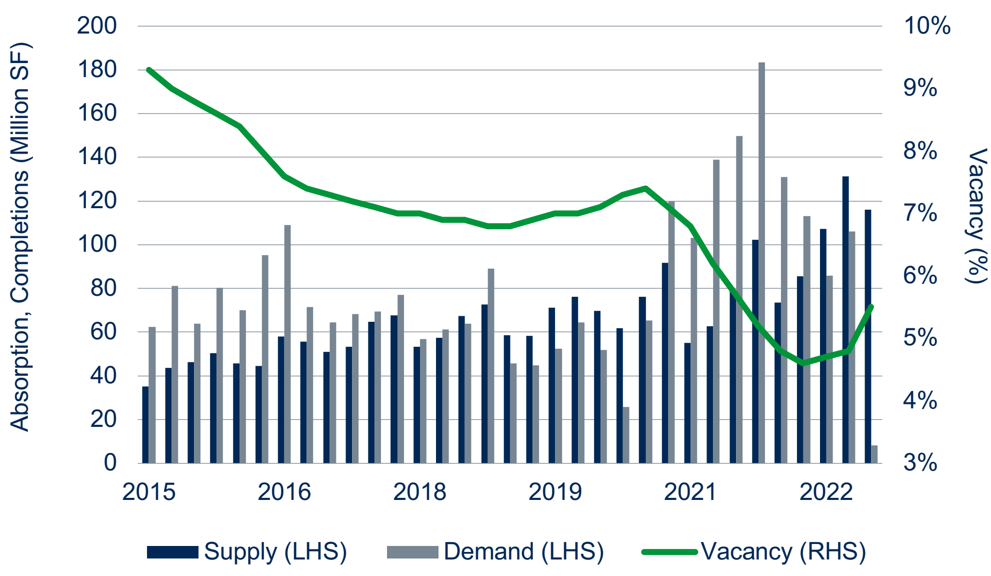
[2] Source: CBRE EA. As of March 31, 2023.

INDUSTRIAL

U.S. industrial sector availability rates increased 70 basis points (bps) quarter-over-quarter to 5.5% in the first quarter (Figure 5). The higher availability rate is primarily attributed to increased supply as the market digests record-level deliveries, which totaled 440 million SF over the past 12 months. The new supply contributed to slower year-over-year rent growth, which decelerated from an all-time high of 13.8% in the fourth quarter of 2022 to 12.5% in the first quarter of 2023.[3] However, rent growth remains exceptionally strong from a historical perspective. According to Cushman & Wakefield data, the Northeast and West regions recorded the strongest rent growth from a location perspective. There are also signs that demand has declined from retailers and wholesalers due to the economic outlook, though absorption remained positive in the first quarter.

Although availability rates increased, the sector's long-term strengths remain intact due to structural changes such as e-commerce adoption, transition from just-in-time to just-in-case inventory management, and increased near-shoring and reshoring of supply chains. These dynamics, along with strong inflation-adjusted rent growth, support the positive outlook for the market.

FIGURE 5: INDUSTRIAL AVAILABILITY RATE INCREASED, LONG-TERM STRENGTHS REMAIN INTACT



Source: CBRE-EA. As of March 31, 2023.

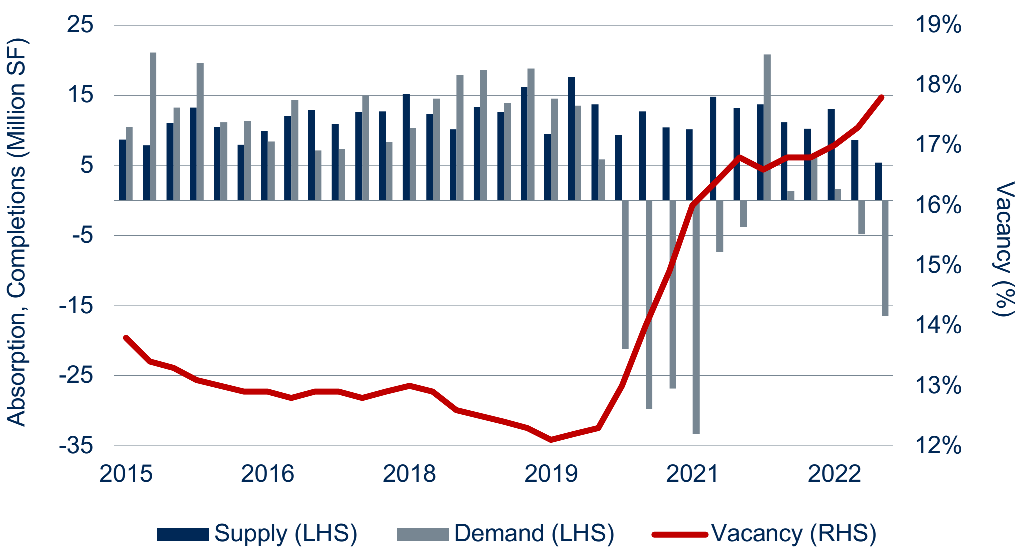
[3] Source: CBRE-EA. As of March 31, 2023.

OFFICE

U.S. office vacancy rates increased 50 bps quarter-over-quarter to 17.8% in the first quarter, the highest level since the second quarter of 1993 (Figure 6). The upward trend was broad-based as 47 of 64 markets covered by CBRE EA experienced higher vacancy rates during the quarter. Although new office supply has decreased, tenant demand remains tepid as companies adjust their real estate needs to the post-pandemic work environment and have been cautious on leasing decisions given the macro environment. Although the overall office sector is challenged, there has been a flight-to-quality which has benefitted newer trophy properties while older commodity buildings face obsolescence risks. As an example, properties delivered since 2015 have recorded 103 million SF in positive absorption since the start of the pandemic, compared to -311 million SF for buildings built before 2015, based on JLL data.

There are signs that the trend toward remote and hybrid work is peaking. As examples, the share of job postings for hybrid or fully remote work has leveled off at approximately 10% since October 2021 and office utilization rates have oscillated around 50% since January 2023.[4] Many companies recognize that having some in-office presence can increase productivity, innovation, and collaboration especially as the economy weakens.

FIGURE 6: OFFICE VACANCY RATES HAVE YET TO PEAK



Source: CBRE-EA. As of March 31, 2023.

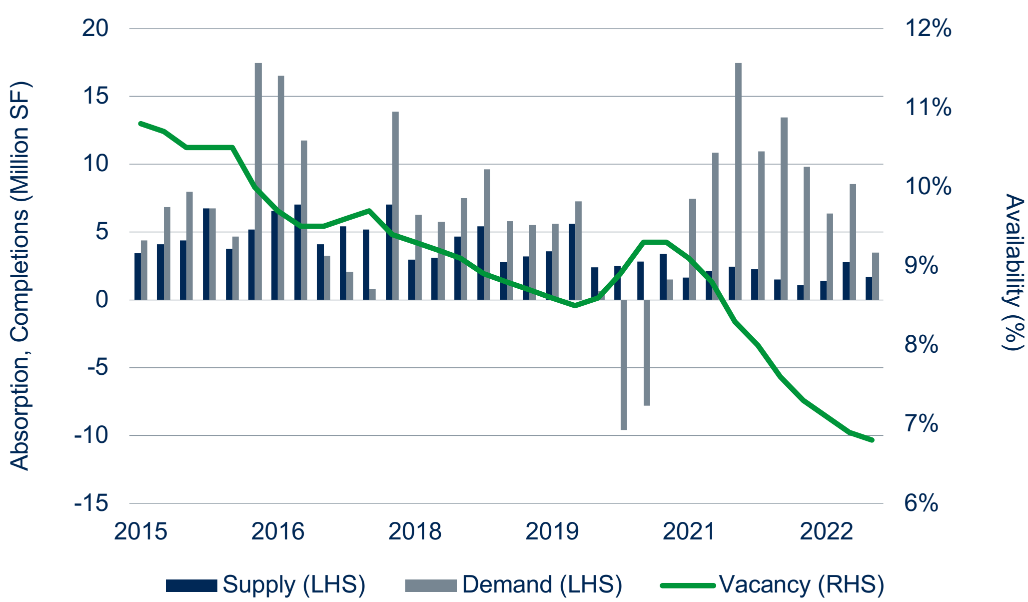
[4] Source: CBRE-EA. As of March 31, 2023.

RETAIL

Demand continued to outpace supply for neighborhood and community centers (N&CS), which posted their lowest availability rate on record at 6.8% during the first quarter (Figure 7). However, demand has decelerated given limited available retail space in strong performing locations, along with a more difficult tenant operating environment, labor supply issues, and uncertainty surrounding future consumer spending. Softer tenant demand contributed to lower rent growth as rents increased 2.7% year-over-year in the first quarter compared to 3.1% in the fourth quarter of 2022.[5]

The N&CS sector has demonstrated resilience and an ability to adapt to e-commerce with in-store pick-up and omni-channel options for consumers. In addition, the property market has benefitted from solid consumer spending, which has been supported by a strong labor market and excess household savings built-up through the pandemic. Although consumers have spent-down a significant portion of their savings, Bank of America data suggest consumers in aggregate still have higher than pre-pandemic savings and checking account balances across all household income cohorts. Nevertheless, there are signs of weaker consumer financial conditions with higher consumer credit card utilization rates, a cooling labor market, slowing economy, and low consumer sentiment.

FIGURE 7: NEIGHBORHOOD AND SHOPPING CENTERS POST RECORD LOW AVAILABILITY



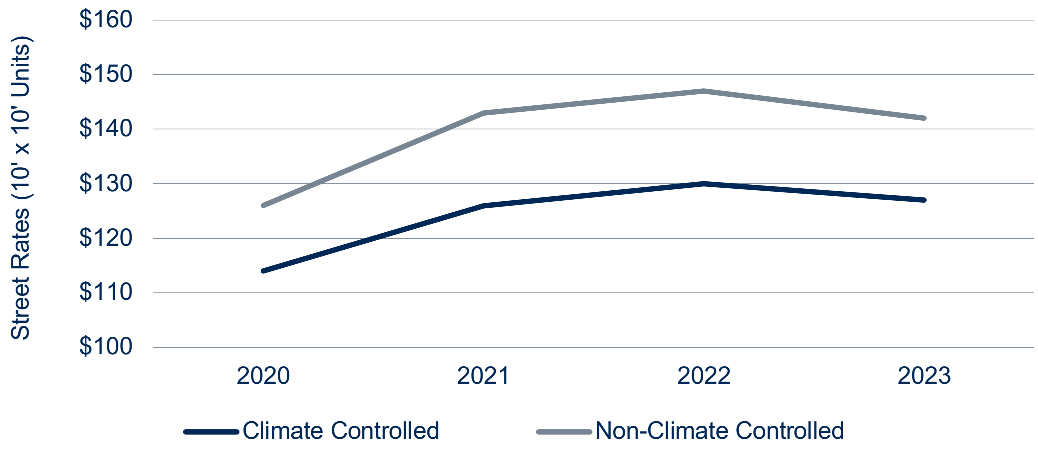
Source: CBRE-EA. As of March 31, 2023.

[5] Source: CBRE-EA. As of March 31, 2023.

SELF-STORAGE

The self-storage sector performed well throughout the pandemic, though rental rates have normalized and vacancy rates increased due to softer demand as COVID-19 tailwinds have cooled and individuals' purchasing power has declined. According to Yardi Matrix data, rental rates have been strongest in Sun Belt metros with solid multifamily rent and population growth, but low new storage supply pipelines. The broader U.S. market is likely to benefit from lower new supply as construction activity is expected to decline given higher construction costs and tighter financial conditions. Transitional life events, such as a growing retirement age demographic, are also anticipated to provide long-term support to the sector.

FIGURE 8: SELF-STORAGE RATES MODERATE BUT REMAIN WELL-ABOVE PRE-COVID LEVELS



Source: Yardi Matrix. As of March 31, 2023 (estimates).

SUMMARY

The U.S. commercial real estate market downturn is proving painful. Property prices are suffering their steepest decline in more than a decade while transactional liquidity has fallen back to pandemic lows. However, unlike prior downturns, underlying fundamentals are still relatively robust and likely to either mitigate a steep demand decline and/or backstop the current price correction—especially for favored property types and geographies. Office has been the exception, and the property sector faces significant stress that will materialize in coming quarters. Recent shocks to the banking system have darkened investor sentiment, but at the same time, a theme that is common to every downcycle is that opportunities emerge in moments of crisis.

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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