BARINGS

Spring is Here

U.S. Real Estate Research Quarterly

MAY 2021

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Executive Summary

ECONOMY

- With the vaccination campaign making steady progress, we believe the near-term outlook for the U.S. economy is as bright as it's been in three decades.
- Hiring and spending both rebounded in March amid easing restrictions on activity and travel—and as the fiscal stimulus approved in December made its way into the economy.
- With additional fiscal support signed into law in March and ongoing massive monetary stimulus, job growth and consumption are poised to accelerate over the coming months.
- COVID remains a risk, however, and U.S. bond yields have increased meaningfully since the year began, partly due to growing concerns about inflation.

PROPERTY MARKETS

- As expected, the winter surge in COVID cases and restrictions on mobility contributed to a steep fall in transaction volume in Q1 after a flurry of activity to close out 2020.
- The apartment market continues to struggle to digest a steady flow of new supply, but apartment fundamentals should improve in the second half of this year, especially in denser urban markets that are currently out of favor, in our view.
- The industrial sector continued on its torrid pace in Q1 fueled by strong demand from occupiers and investors, along with abundant and cheap financing.
- Office market fundamentals continued to deteriorate at an alarming pace in Q1, but we believe demand should stabilize in the second half of 2021, setting the stage for a pickup in leasing activity in 2022, and perhaps sooner in some markets.
- Neighborhood and community centers exhibited some resilience in the first quarter with the availability rate declining quarter-over-quarter for the first time since Q4 2019.
- With consumer sentiment rebounding from the lows recorded over the winter, and many households sitting on excess savings accumulated during the pandemic, we think hotel room demand should see a nice pent-up demand-driven bounce over the summer months.

Economic Outlook

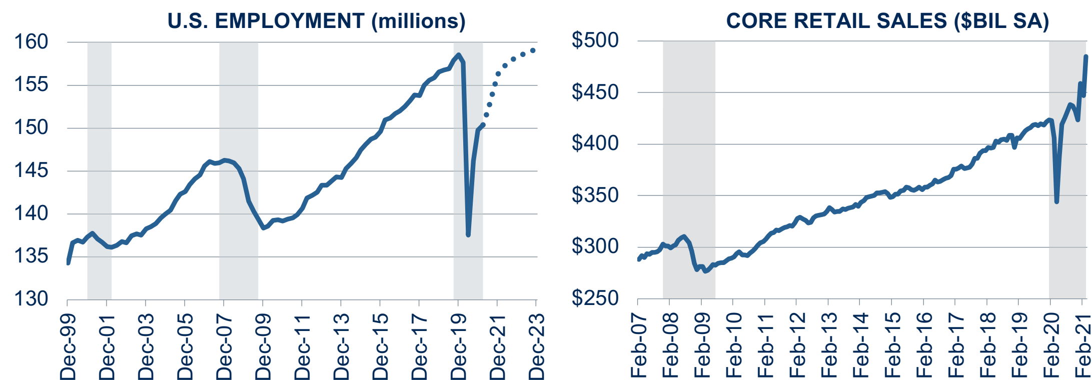
As we expected at the start of this year, the U.S. economy weathered the winter surge in COVID cases and the tightened restrictions on activity, and is now primed to rebound strongly over the balance of 2021 and into next year. Employment growth suffered a brief setback in December and posted only tepid gains in January, which contributed to the pullback in consumer spending in February. However, hiring and spending both rebounded in March, with employers adding more than 900k jobs and nominal retail sales jumping 8.4% month-over-month to an all-time high that is nearly 15% above its pre-COVID levels.

Spring is here, and with the vaccination campaign making steady progress, we believe the near-term outlook for the U.S. economy is as bright as it's been in three decades. More than 40% of the U.S. population has already received at least one dose, and the vaccination pace increasingly is being determined by demand rather than supply or the availability of appointments. According to Bloomberg, the current pace puts the U.S. on track to have 75% of the population fully vaccinated before the end of the summer, paving the way for schools to resume in-person instruction in the fall and for working parents to return to the workplace.

While the successful vaccine rollout has accelerated the timeline for the recovery in the economy and, therefore, the property markets, the outlook is not without risks. COVID remains the biggest threat in the near term and potentially longer if variants of the virus and/or the uneven pace of vaccinations delay a full re-opening of the global economy. But this is not the only concern clouding the outlook. Total employment also remains well below pre-COVID levels; and, more recently, bond yields in the U.S. have moved higher amid improving expectations for growth and, potentially, growing concerns about inflation and super-sized public sector deficits extending well into the future.

We are keeping a close eye on these and other risks. However, our base case for the real estate recovery has not changed since the year began. Assuming the expected sharp bounce in the economy and hiring materializes, which we believe is well underway, commercial property demand will follow, albeit with a lag. The recovery will be uneven across and within markets and sectors, but broadly speaking we expect transaction activity will accelerate and occupier demand will stabilize in 2021. Leasing activity may take longer to regain momentum, but should pick up in the second half of 2021 and next year as employment closes in on its pre-pandemic peak, in our opinion.

FIGURE 1: HIRING AND SPENDING ACCELERATED IN MARCH



Source: Oxford Economics, Moody's Analytics, Barings Real Estate Research.

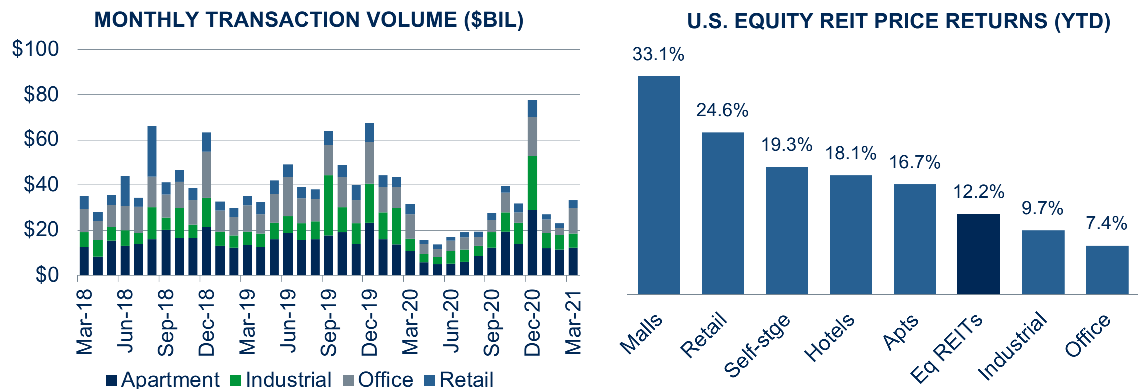
Capital Markets

Predictably, the winter surge in COVID cases and restrictions on mobility contributed to a steep fall in transaction volume in Q1 after a flurry of activity to close out 2020 pushed December volume to its highest level in the 20-year history of the Real Capital Analytics (RCA) data series. According to RCA, U.S. transaction activity totaled a little less than $97 billion in the first three months of this year, 28% below the volume in Q1 last year, but nearly 30% higher than the $76 billion recorded in Q3 2020. Anecdotal reports of increased tours by potential buyers and of more sellers willing to test investor demand should translate into more deal activity and price discovery in the months ahead, especially with the volume of equity and debt capital that is sitting on the sidelines.

Despite the recent slump in transactions, capital remains readily available for almost anything in the industrial and multi-family sectors, where the weight of capital continues to put downward pressure on cap rates and loan spreads, and, more broadly, for almost any asset that offers durable, stable cash flows. As the path to a post-COVID world becomes clearer, we expect investors and lenders will expand their strike zones to include a broader range of assets and markets, similar to the change in sentiment seen in the REIT market since last November, when REIT shares rallied on encouraging news about vaccines. REITs are usually a decent directional indicator at inflection points in the cycle; but they have been an even better indicator of investor sentiment regarding changing risk profiles across different property sectors. Although some sectors of the REIT market remain well below pre-pandemic levels, as the chart below makes clear, the hardest hit sectors have outperformed this year. However, office REITs have continued to lag, which likely reflects the heightened uncertainty around future demand and use.

Property valuations clearly face some risk if interest rates continue to drift higher and erode spreads between property and bond yields. Historically, the relationship between cap rates and interest rates has been complicated, but the context and catalysts for rising rates matters. To the extent inflation concerns and/or stronger growth is driving interest rates higher, real estate cash flows should continue to find favor with investors seeking stable cash yields and positive real returns.

FIGURE 2: IMPROVING SENTIMENT LIKELY TO DRIVE TRANSACTIONS HIGHER



Source: Real Capital Analytics, NAREIT, Barings Real Estate Research. Monthly transaction volume as of March 2021. U.S. equity REIT price returns as of April 16, 2021.

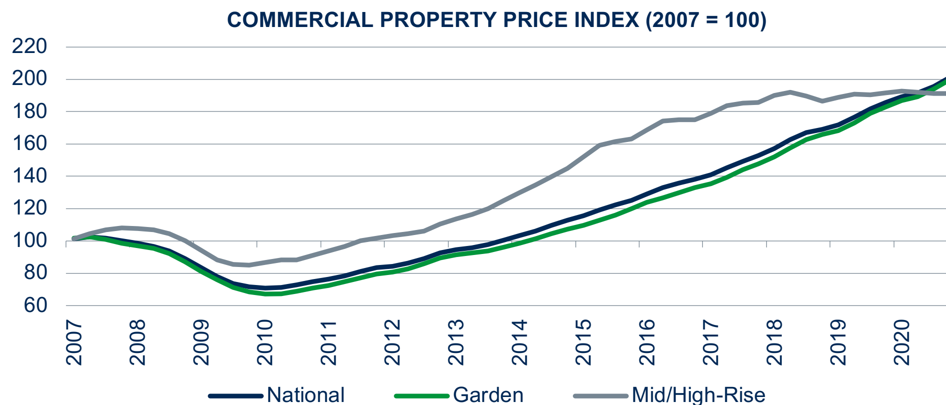
Property Markets

APARTMENTS

The U.S. apartment market continues to struggle to digest a steady flow of new supply, which shows few signs of slowing. According to CBRE-EA, the average apartment vacancy rate increased another 50 basis points (bps) year-over-year (YoY) to 4.7% in Q1, despite healthy absorption during what is typically the slowest leasing season. Consistent with recent trends, market performance varied widely across markets. Notably, all six “gateway” markets reported an increase in vacancy, with San Francisco, New York and Washington, DC reporting some of the sharpest increases. At the other end of the spectrum, several smaller, less dense metros, such as Atlanta, Riverside and Las Vegas, reported material improvements YoY in vacancy. Additionally, in a continuation of the trend we observed pre-COVID, average transaction prices of garden-style and low-rise properties in suburban submarkets outperformed mid- and high-rise assets in urban submarkets.

Looking forward, we expect apartment fundamentals will improve in the second half of this year supported by a strong rebound in economic activity and broad-based vaccine availability. As noted, payroll employment surged by more than 900k in March, and most economists, including Federal Reserve (Fed) Chairman Powell, expect job gains will accelerate further and remain elevated this year as the economy comes fully back online. With robust job growth and good progress on vaccinations making it possible for workers to return to the office in the fall, we expect apartment fundamentals to improve, especially in denser urban markets that are currently out of favor. Meanwhile, structural tailwinds, such as a shortage of single-family homes and constrained mortgage availability, remain supportive of apartment demand over the long run.

FIGURE 3: GARDEN-STYLE OUTPERFORMANCE CONTINUES



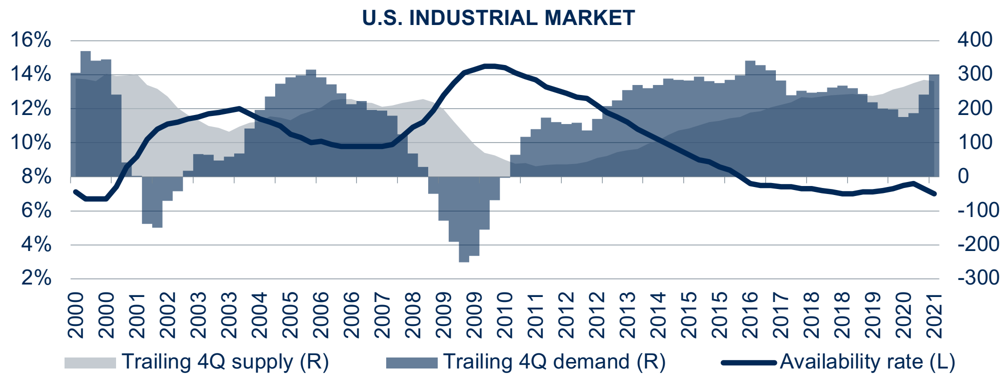
Source: BRE Research, Real Capital Analytics. As of March 2021.

INDUSTRIAL

The industrial sector continued on its torrid pace in Q1 2021 fueled by strong demand from occupiers, investors and abundant cheap financing. The availability rate for industrial space inched down 30 bps YoY to 7.0%, according to CBRE-EA, on par with the cyclical low of the previous expansion. Quarterly net absorption, which came in at a 20-year high in Q4 2020,

remained strong. The 99+ million square feet (msf) of net absorption in Q1 was the second highest quarterly total since 2016 and kept upward pressure on rents despite an active development pipeline. New deliveries are forecast to remain robust through 2021, but surging materials costs and limited availability of steel in particular are creating challenges for developers and threaten to erode economics on new projects until supply catches up with demand.

FIGURE 4: INDUSTRIAL FUNDAMENTALS REMAIN TIGHT



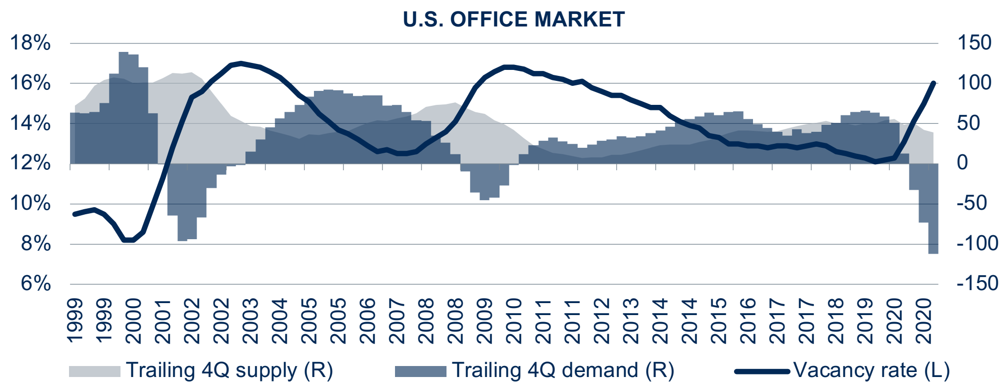
Source: BRE Research, CBRE-EA. As of March 2021.

Unsurprisingly, with improving fundamentals and ample liquidity, pricing for industrial assets continues to tighten as cap rates for stabilized properties grind lower. According to RCA, average industrial prices through March climbed 9.1% YoY, outpacing all other property types as well as the national all-property index. Competition for deals has pushed investors to broaden their geographic focus to secondary and tertiary markets, often following in the footsteps of Amazon and other e-commerce users as they build out their distribution platforms and seek to establish last-mile facilities beyond the largest cities. While the structural tailwinds of e-commerce will continue to drive demand for modern warehouse and industrial assets and a rapidly improving economic outlook will support both consumption and trade activity in the near term, industrial pricing leaves little margin of safety, especially if rent growth disappoints high expectations.

OFFICE

Against a backdrop of prolonged closures of office buildings across the nation, office vacancy increased by another 100 bps during Q1 2021 to 16.0%, according to CBRE-EA. The speed of the deterioration in office fundamentals has been remarkable, especially considering that office employment in the finance and tech sectors has held up relatively well and is expected to rebound quickly as the economy reopens. Negative net absorption since Q1 last year already exceeds the total during the Global Financial Crisis by a factor of two, and is now roughly on par with the severe office downturn during the tech wreck in the early 2000s. As a result, vacancy has climbed by 370 bps over the past four quarters. Expensive coastal markets continue to face the biggest challenges. In San Francisco and Seattle, among the hardest hit in this cohort, vacancy increased 240 bps and 230 bps, respectively, in the most recent quarter alone. Some dynamic inland markets, such as Austin, Atlanta, Charlotte and Raleigh, also posted vacancy increases of more than 100 bps.

FIGURE 5: SWIFT AND SHARP CORRECTION IN OFFICE FUNDAMENTALS



Source: BRE Research, CBRE-EA. As of March 2021.

With the vaccination campaign well underway, we expect demand will stabilize in the second half of the year, setting the stage for a pickup in leasing activity in 2022, perhaps sooner in some markets. However, rising new supply combined with more than a year of almost no leasing will continue to put downward pressure on office rents and occupancies in the near term. Markets with the highest levels of new supply underway include New York, Boston, Austin, Seattle and Washington, DC. Although asking rents have been sticky so far, property owners are likely to feel compelled to lower rents to compete for tenants once the leasing market thaws, especially in markets where vacancy rates have expanded the most.

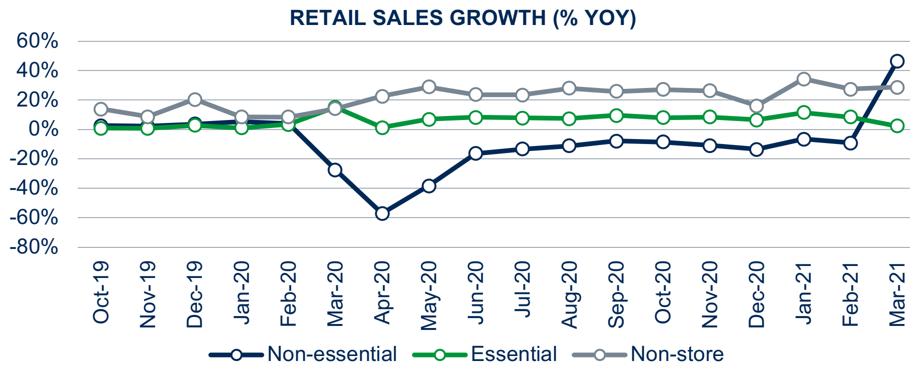
RETAIL

Neighborhood and community centers exhibited some resilience in the first quarter. For the first time since Q4 2019, the availability rate declined quarter-over-quarter, according to CBRE-EA. While availability is still elevated compared to one year ago, the recent decline for this segment of the retail market speaks to consumer shopping behavior over the past year. The recovery is likely to be uneven over the next few quarters, as vaccinations continue and consumers settle into a “new, new normal.” But neighborhood and community centers have positioned themselves as relative “winners” in this bifurcated retail downturn and look likely to outperform in the recovery and thereafter.

Fiscal support has been a crucial lifeline for the economy over the past year. Consumers used at least some of their extra spending power at local neighborhood and community centers, stocking up on daily necessities and home improvement items. That spending has bolstered leasing activity in recent months which, despite being below pre-pandemic levels, has improved, particularly among those retailers targeted by consumers—namely discounters, general merchandisers, pharmacies, home improvement retailers and grocers.

As the economy reopens, we expect that pent-up demand will drive consumers to their local retail centers. Entrenched shopping behavior will remain as consumers utilize the omni-channel methods they became accustomed to during the pandemic. However, as the latest retail sales data suggests, spending patterns already are shifting from “essentials,” which captured a disproportionate share of consumption during the pandemic, to discretionary goods and services, including restaurants. Both trends point to a recovery in foot traffic and sales at neighborhood and community centers in the near term, and, longer term, to a role for well-located centers as local fulfillment points in retailers’ omni-channel retail strategies.

FIGURE 6: CONSUMER SPENDING PATTERNS CHANGED IN MARCH



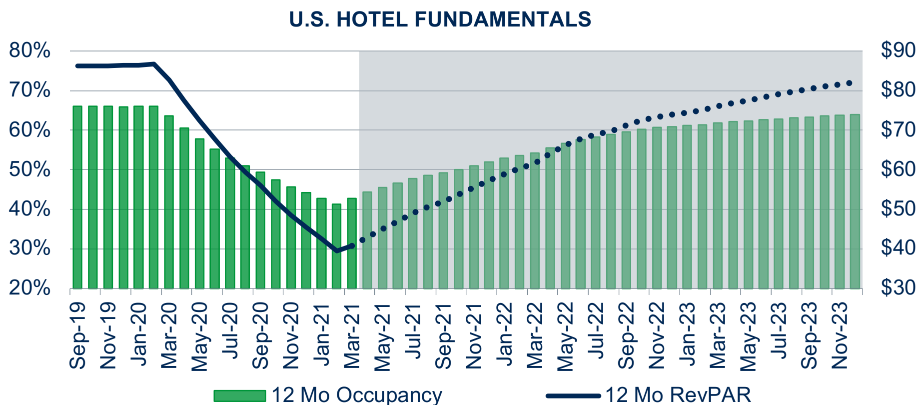
Source: BRE Research, U.S. Census Bureau. As of March 2021.

HOTELS

No sector has been more eagerly anticipating the vaccine rollout—and the unleashing of pent-up demand—than lodging. The hotel industry came into 2020 with occupancies and revenue per available room (RevPAR) at or near historic highs after a full decade of steadily improving fundamentals. The pandemic definitively answered the questions that were already casting a shadow over the industry pre-pandemic about when and how the unprecedented expansion would end. While the swift and painful ending to the last cycle will leave scars, a new cycle is already underway.

With a growing share of the U.S. population vaccinated, or soon-to-be, and restrictions easing on domestic travel and public gatherings, room demand has picked up to its highest level since the start of the pandemic. Leisure travelers continue to account for most of the demand, and continue to favor resort and drive-to destinations over urban hotels. With consumer sentiment rebounding from the lows recorded over the winter and many households sitting on excess savings accumulated during the pandemic, the odds of a nice pent-up demand-driven bounce over the summer months clearly have increased. However, the recovery in corporate demand likely will lag the leisure recovery until workers return to the office and companies lift restrictions on travel. Likewise, group demand looks unlikely to improve much this year, but advance bookings for next year and 2023 have started to improve.

FIGURE 7: HOTEL OCCUPANCY AND REVPAR TICKED UP IN MARCH



Source: BRE Research, Smith Travel Research. As of March 2021.

SUMMARY

While we are not surprised by the strong performance year-to-date in the U.S. economy, it looks increasingly likely that we may have underestimated the speed and magnitude of the rebound in activity over the balance of this year. The outlook is not without risks, of course. COVID tops the list of worries, and clearly will be with us for a while—potentially a long while. The recent increase in U.S. bond yields also poses some risk for capital-intensive sectors of the economy like commercial real estate, but the Fed will lean hard against rate increases, and history argues strongly against fighting the central bank.

We have not revised our base case expectations for U.S. commercial real estate, and we recognize the near-term path is uncertain and headwinds remain, especially in the office sector. However, the risks now appear more skewed to the upside as far as the pace of recovery in both occupier demand and the investment markets. With the depressed transaction activity in 2020 and substantial pools of equity and debt capital looking to deploy, we expect transaction volume will accelerate meaningfully in Q2 and through year-end. Leasing may take a bit longer to regain momentum, particularly in the office sector where the demand recovery in many markets is probably more of a 2022 story, but activity clearly is picking up as tenants prepare for a post-COVID world. So, while we may still have far to go, we have come a long way. Spring is here, summer is coming.

About the Team

BRE's research team efforts are led by Philip Conner 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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