BARINGS

U.S. Real Estate: Patience, Vigilance Needed

U.S. Real Estate Research Quarterly

FEBRUARY 2023

23-2705284

Executive Summary

ECONOMY

- U.S. property fundamentals are softening as rising interest rates weigh on the broader economy and financial markets.
- Inflation has trended positively over the past two quarters, leading to increased optimism that the Fed will be able to bring inflation under control.
- Consensus expectations are currently for a mild recession—if one at all—to transpire in the later part of this year or early 2024.

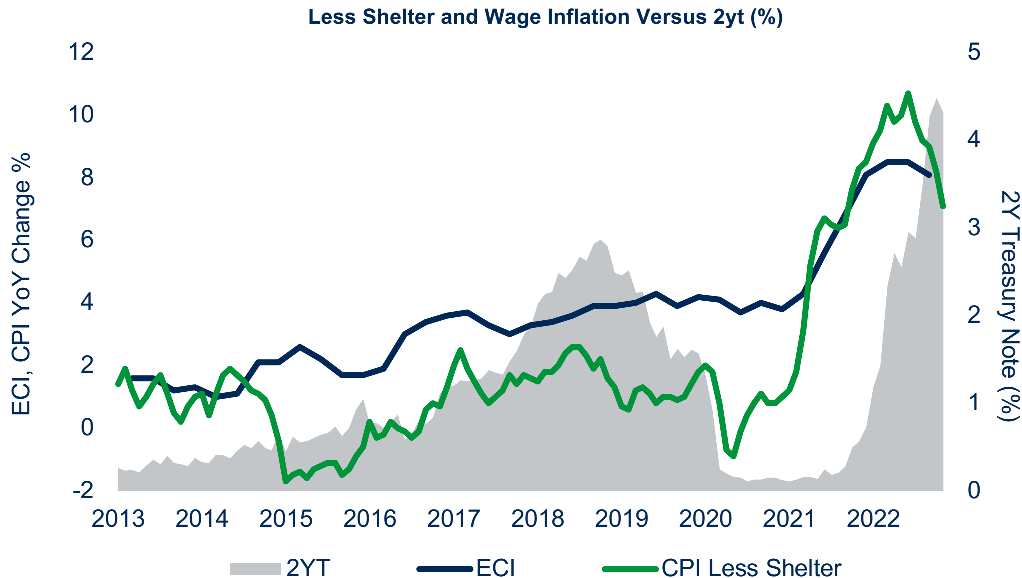
PROPERTY MARKET

- Transaction activity totaling $138 billion over the fourth quarter of 2022 was 62% lower than the same quarter the year prior, reflecting the decline in sales volume but also the magnitude (and exuberance) of 2021's fourth quarter activity.
- All major property types transaction activity was down by more than 50% year-over-year. Leading the decline relative to a year ago was apartment (-69%), followed by office (-65%), then by industrial (-58%) and retail (-57%).
- Lower transactional liquidity and higher interest rates have impacted property prices. Composite public REIT share prices have fallen by 27% since the beginning of 2022.

Economic Outlook

U.S. property fundamentals are softening as rising interest rates weigh on the broader economy and financial markets. Inflation has trended positively over the past two quarters, leading to increased optimism that the U.S. Federal Reserve (Fed) will be able to bring inflation under control. Monetary tightening is slowing down economic activity, but with unemployment at 3.5%, the labor market is historically low and, consequently, supportive of wage growth. We believe it is wise to take the Fed at its word that it will continue to keep monetary policy tight until inflation in all its forms is decisively lower. This time around the probability is low that we will see anything resembling the stimulus-driven "re-opening" surge the U.S. experienced as COVID-related lockdowns were lifted.

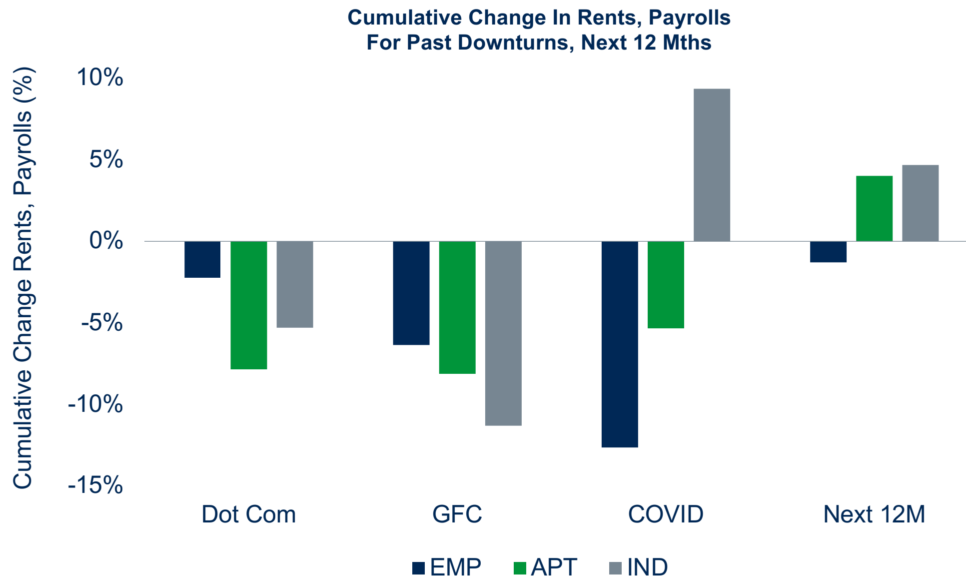
FIGURE 1: STILL MORE WORK TO BE DONE BEFORE INFLATION IS TAMED



Source: Conference Board; Bureau of Labor Statistics; U.S. Federal Reserve. As of December 31, 2022.

Historically, soft landings have been elusive for the U.S. central bank, which has had a poor track record of avoiding recessions following tightening cycles. However, consensus expectations are currently for a mild recession—if one at all—to transpire in the later part of this year or early 2024. Excepting office, property fundamentals should remain relatively buoyant through 2023. Forecasted rent trends for industrial and apartment point to growth, something that has not happened in the last four real estate downturns. Rents for all property types fell deeply in past recessions. This provides some comfort that when interest rates normalize and transactional liquidity returns, well-leased, well-maintained, and well-located properties will have likely held their values relative to those that were not. Until then, patience and diligence, especially in regard to asset management, are the order of the day.

FIGURE 2: PROPERTY FUNDAMENTALS EXPECTED TO BE RESILIENT



Source: U.S. Federal Reserve. As of December 31, 2022.

There remain meaningful differences between property performance by type. The office and apartment sectors experienced negative absorption over the quarter while the industrial and retail sectors registered their strongest rent growth quarters in more than 20 years. For apartment renters, 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) much of the excess savings accumulated during the pandemic and the use of revolving credit is ticking up.

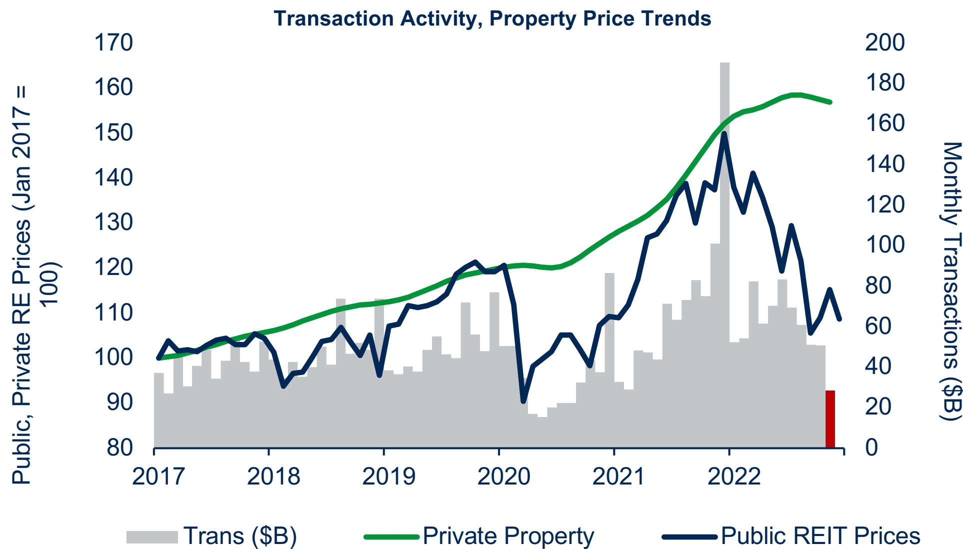
Meanwhile, industrial demand has continued to surprise even the most skeptical, registering a year of double-digit rent growth and record low vacancies even in the face of robust construction activity. Despite the rise in debt costs and the implications for levered property values, positive secular demand trends including the expansion of e-commerce capacity, deteriorating housing affordability, and the migration of businesses and households to Sun Belt metros are still intact and remain the drivers of value creation over the long term.

Capital Markets

Transaction activity totaling $138 billion over the fourth quarter of 2022 was 62% lower than the same quarter the year prior, reflecting the decline in sales volume but also the magnitude (and exuberance) of 2021's fourth quarter activity. 2022's fourth quarter sales volume was the lowest since the fourth quarter of 2017. Sales are likely to remain muted until the interest rate outlook improves. Distress sales were still a very small portion of overall transaction activity, comprising 1% of total 2022 volume.

All major property types transaction activity was down by more than 50% year-over-year. Leading the decline relative to a year ago was apartment (-69%), followed by office (-65%), then by industrial (-58%) and retail (-57%). Lower transactional liquidity and higher interest rates have impacted property prices. Composite public REIT share prices have fallen by 27% 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) and is only 3.2% off its recent peak as of December.

FIGURE 3: TRANSACTIONS HAVE FALLEN BACK TO PANDEMIC LOWS



Source: Bloomberg, Federal Reserve, NAREIT, NCREIF. As of December 31, 2022.

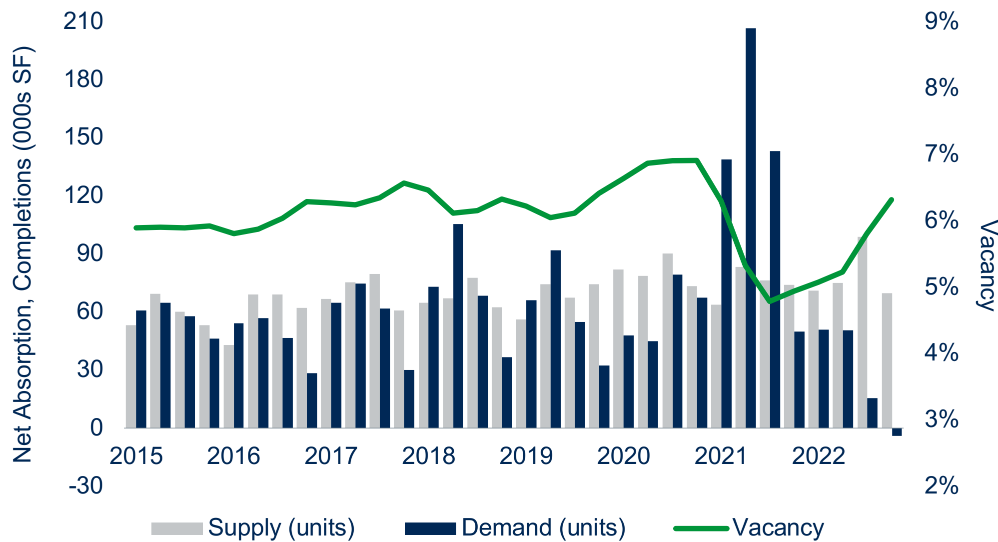
Property Markets

APARTMENT

National apartment vacancy in the fourth quarter rose to 6.3%, its highest in eight quarters. Rent growth is decelerating and rose 3.4% annually during the quarter. A year prior, apartment rents grew by a record 11.1%—though this was clearly unsustainable. Deliveries of new apartment units also accelerated, especially across the Sun Belt metros, and coupled with slowing demand over the past couple of quarters have caused vacancy to edge up. Many metros that led rent growth coming out of the pandemic have ceded their ranking to others, including those in the historically slower-growth Midwest.

Over the longer term, the performance of Sun Belt apartments that have benefitted from secular demographic trends should exceed the rest of the nation. The rise in mortgage rates has slowed previously red-hot home price appreciation but it has also exacerbated housing affordability, which is now at its lowest level since 2006. That leaves many prospective homebuyers with little option other than to keep renting.

FIGURE 4: SOFTENING RENTER DEMAND PUSHES UP VACANCY



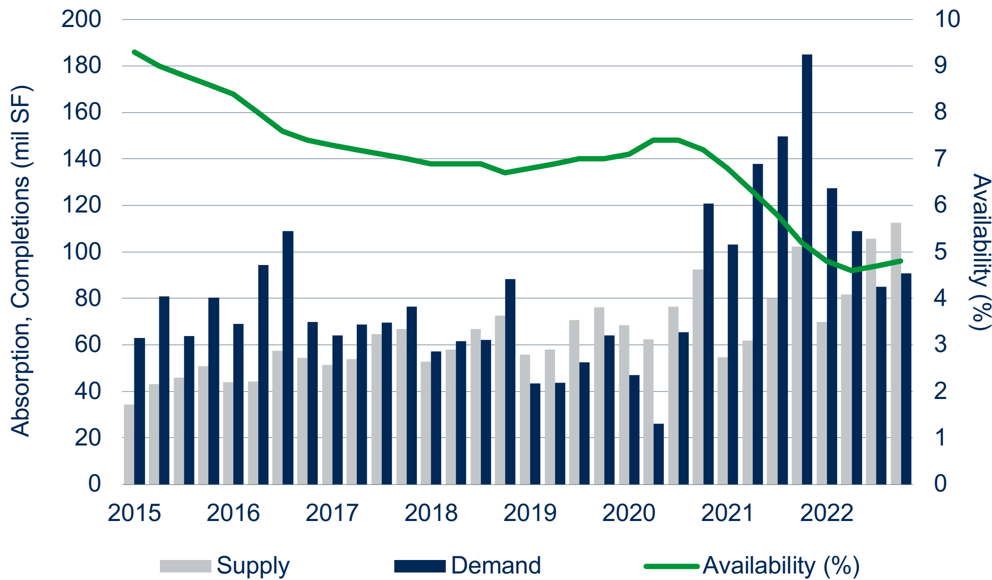
Source: Costar. As of December 31, 2022.

INDUSTRIAL

The national industrial sector availability rate edged up 10 basis points (bps) to 4.8% in the fourth quarter. New supply marginally outpaced demand. However, the pace of rent growth accelerated to 13.8%, its fastest pace on record. Warehouse tenant demand has been resilient even amid increasing macroeconomic headwinds. The 10 major industrial metros with the fastest rent growth all saw rates rising by more than 19% over the year prior.

Consumption trends as well as longer-term tailwinds supported by e-commerce and functional obsolescence remain intact, which reinforce both the space and capital markets outlook for the industrial property type. The pervasiveness of these trends has led to robust demand growth outside of the largest metros especially in secondary coastal and inland port markets.

FIGURE 5: HISTORIC INDUSTRIAL DEMAND KEEPS AVAILABILITY LOW



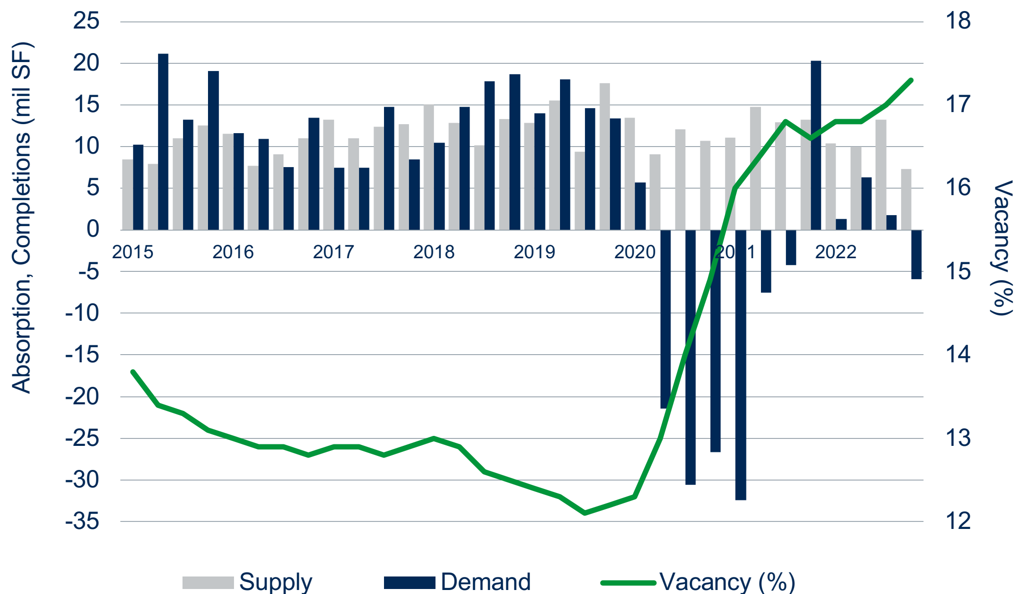
Source: CBRE-EA. As of December 31, 2022.

OFFICE

After four consecutive quarters of positive net absorption following the post-pandemic return-to-office, national office demand is once again in retreat. Net absorption turned negative again and vacancy rose to 17.3%, its highest since 1993. While more and more firms are solidifying their back-to-office policies, a tight labor market favors employees—the majority of whom still prefer hybrid work to being either at-home or in the office full-time. Office-using employment is 4% higher than it was pre-COVID, but actual physical occupancy of office space is still half of what it was prior to the pandemic almost 24 months ago, suggesting that property fundamentals are becoming untethered from traditional macroeconomic demand drivers.

With a possible recession on the horizon, the path to recovery for the nation's office sector looks tenuous over the near term. Both CBD and suburban vacancy rose again. CBD vacancy rose to 17.6%, its highest in three decades, while suburban vacancy rose to 17.2%, its highest in a decade. However, STEM offices properties continue to outperform the rest of the market with tighter vacancies and persistently higher rental rates.

FIGURE 6: OFFICE VACANCY REACHES 30-YEAR HIGH AS DEMAND FALLS AGAIN



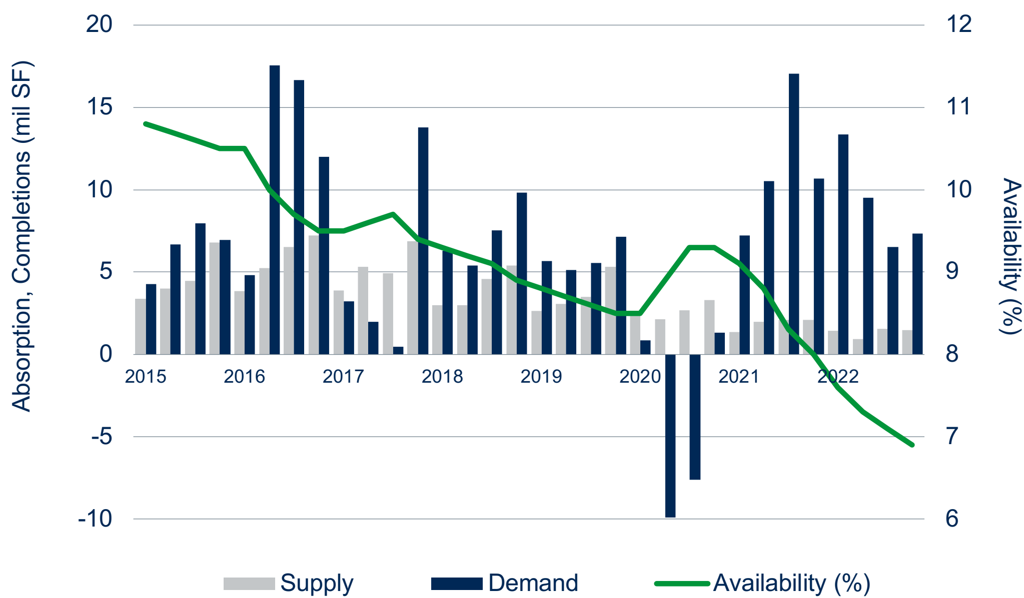
Source: CBRE-EA. As of December 31, 2022.

RETAIL

Neighborhood and community centers posted an availability rate of 6.9% in the fourth quarter following 10 quarters of consecutive declines. The availability rate is the lowest on record while rent growth accelerated to 3.0%, its fastest pace since 2017. The consistent quarterly decreases in availability point to the resiliency of these types of centers, even as consumption shifts to a combination of in-store and online.

Retail sales growth continues to moderate as household cash reserves are being spent down and consumers are starting to use more revolving credit. Three-month trailing retail sales growth, excluding autos and gasoline, averaged 7.1% year-over-year, still above its 10-year average of 5.7%. Sales were bolstered by segments with the highest share of sales growth including department stores and non-store retailers. Omni-channel shopping is likely here to stay, even as consumers shift to more services spending. As a result, local fulfillment through retail centers will likely remain an important part of retailers' strategies going forward.

FIGURE 7: SHOPPING CENTER SECTOR SEEING RECORD LOW AVAILABILITY



Source: CBRE-EA. As of December 31, 2022.

SUMMARY

The resiliency of the labor market, tenant firms, and upper to middle income consumer households has been a contrast to the turbulence of real estate capital markets. As borrowing costs ratcheted up in 2022, public REIT share prices declined. Relative to public real estate, most unlevered property price indices are only beginning to turn.

Unlike past downturns, buoyant fundamentals could keep rent growth positive for industrial, apartment, and certain niche sectors. Shopping center availability is at its tightest in more than a decade. Additionally, higher construction costs and greater near-term uncertainty are weighing on supply activity, allowing owners to retain pricing power. If a soft landing continues to play out in 2023, then transactional liquidity could return sooner than market participants expect—possibly circumventing a substantial property price correction.

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

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