REAL ESTATE

Real Estate Market Outlook

Are We There Yet? The Road to Recovery for CRE

May 30, 2024

Executive Summary

- The U.S. 10 year is likely locked into a tight range for the remainder of 2024.
- Real estate prices appear to be past the trough, and most assets can no longer be acquired at prices from late 2023.
- Office vacancies are rising, but inventory reduction and declining sublease availabilities suggest it will peak in coming quarters.
- Infill warehouses, net lease retail, and seniors housing offer the best opportunities today, in our view.

MetLife Investment Management

Kicking the Rate Hike Can?

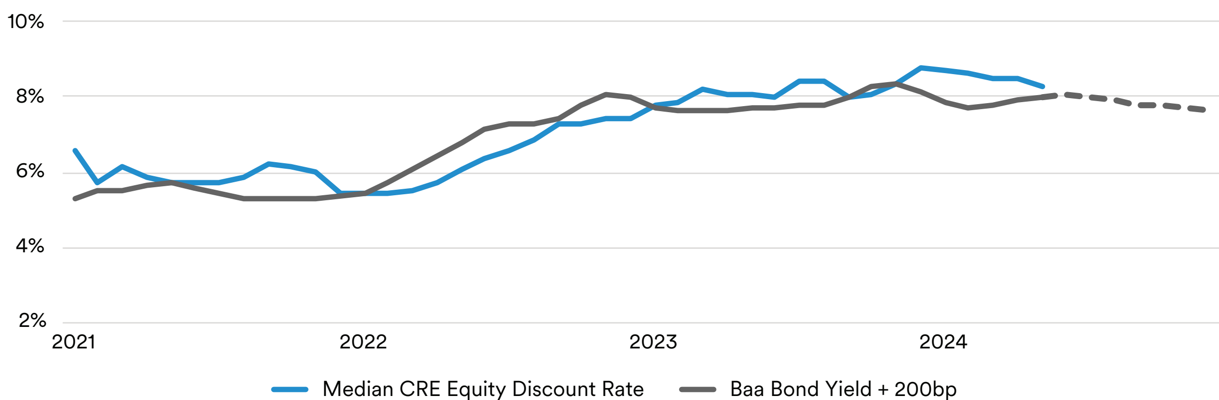
Stickier than expected inflation and robust economic activity have delayed and diminished expectations for rate cuts in 2024. Markets are now pricing only 25 basis points of cuts for later in the year, down from the 150-200 bps in cuts that were priced in at the end of 2023.[1] While economic data have been stronger than expected, persistent restrictive monetary policy could negatively impact the broader economy and remains a downside risk.

We believe that 25 basis points of cuts in the second half of this year is a reasonable base assumption and expect the U.S. Treasury 10 year—currently trading near 4.4%—will be locked in a tight range for the duration of 2024, hovering near 4.5%.

In our 2024 outlook published last quarter we were asking if spot market prices were at or past the trough. We have now seen enough transactions to conclude that commercial real estate prices are past the trough.

In addition to direct observation of transaction prices, our relative value benchmark (exhibit 1) also suggests that prices should be rising. The benchmark compares proprietary tracking of current CRE market pricing collected from MIM's acquisitions teams to Baa bond yields + 200 basis points.

Exhibit 1 | Real Estate Discount Rate vs. Baa + 200 BPS



Sources: MIM Discount Rates, Oxford Baa, three month trailing average. May 2024.

This dataset represents a 3-month trailing average through May and is generally capturing the recent increase in treasuries. There appears to be sufficient cushion between spot yields for equity real estate and bond yields to absorb the re-pricing of rate cuts without causing further deterioration in property values. In fact, this dataset suggests property prices may have even slightly over-corrected at the start of this year.

Although this dataset is not perfect, it serves as a valuable tool among many in MIM's toolbox for evaluating real estate capital market conditions. We believe it is a helpful "north star" in a market where transaction volume, and thus transparency, is low. Based on this analysis, we would begin to re-think our call for the trough in real estate prices if the 10-year treasury rises above 5.0% and remains in that range for at least one quarter. The most likely scenario for an upside surprise in rates would be resurgent inflation, represented by several consecutive months of PCE inflation exceeding 5% on an annualized basis.

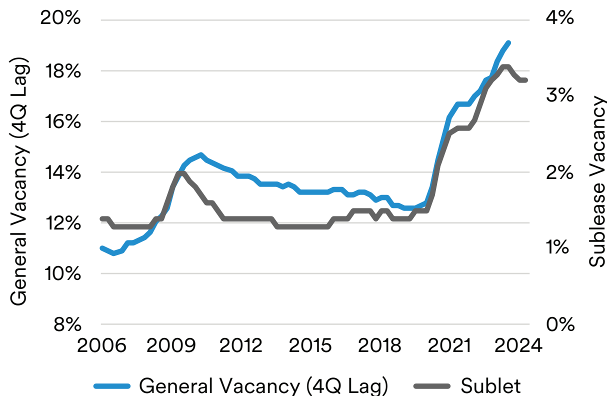
Real Estate Fundamentals on Stable Footing

Similar to the broader economy, trends in real estate fundamentals are generally positive. Possibly the most noteworthy trend since the start of 2024 has been some early bright spots for the office sector.

In our view, office sublease availability is an important leading indicator for general office vacancy trends. In exhibit 2, we observe that sublease vacancy leads general vacancy by roughly four quarters. At the start of this year, office sublease vacancy declined for the first time since the start of the pandemic.

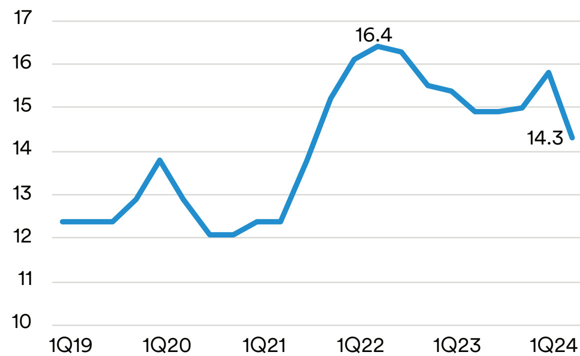
This data warrants some "taking with a grain of salt". Anecdotally, we have also observed a handful of firms removing sublease space from the market that they have been unable to lease, which would explain the reduction in sublease availability (a false positive). This dataset though has been an important and reliable indicator over the last 20 years, and one worth monitoring.

Exhibit 2 | Sublease Vac. Leads General Vac. by 4QTRS



Sources: MIM, CoStar. 2Q2024.

Exhibit 3 | Months to Lease Office Space



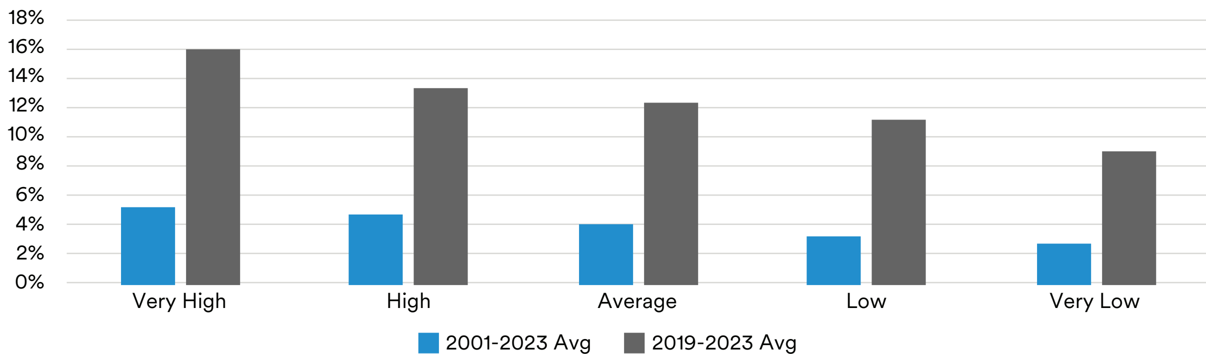
Sources: MIM, CoStar. 2Q2024.

In addition to improving office sublease vacancy, the amount of time vacant office space is sitting on the market has begun to decline (exhibit 3). Taken together, we believe these trends imply that office vacancy will rise from 19.0% to 20.0% by the end of 2024, before beginning to decline next year.[2]

As we pointed out last quarter, the industrial and multifamily sectors are generally healthy, but are facing some pockets of supply risk. In the multifamily sector, markets like Austin, Nashville, and Charlotte will likely underperform this year as elevated deliveries dampen rent growth. At the same time markets with less favorable demographics like Chicago, New York, and Orange County are not facing supply pressures, and investors are benefiting from high occupancy levels and stronger rental growth.

Industrial has not been immune from elevated supply growth. In the first quarter of 2024, industrial vacancy rose 70 basis points to 7.8%.[3] While this vacancy level remains below the historical average, performance divergences across markets have emerged, and are very much a function of supply barriers (exhibit 4).

Exhibit 4 | Industrial Rent Growth by Construction Barrier Grade

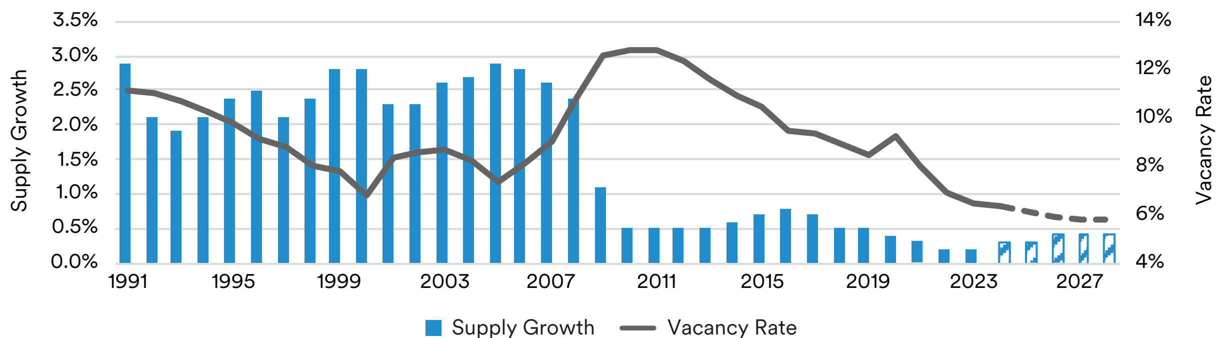


Sources: MIM, Green Street. Effective rent growth. Data as of April 2024.

Markets like New York, Ft. Lauderdale, and Orange County, which have physical or legislative barriers to new supply, have been outperforming and we expect that to remain the case. We also believe that thesis extends down to the submarket or micro-market level, and as a result, believe investors should focus on infill industrial facilities that support last mile distribution strategies or are in ports with supply barriers.

Retail investment remains a bright spot but may still not be receiving the credit it deserves. Retail vacancies, with the exception of the still-recovering mall subsector, are at the lowest level on record, yet developers remain unwilling to respond by delivering product into the historically tight market (exhibit 5). As a result, the outlook for retail income growth is the best it has been in many years, and we think this is particularly true for high-quality centers catering to experience-based tenants.[4]

Exhibit 5 | Limited Supply Growth Supporting Retail Fundamentals



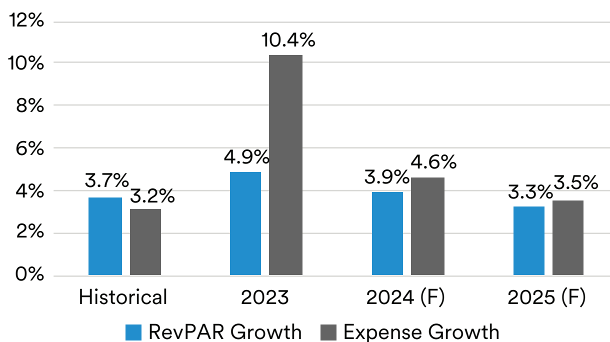
Sources: MIM, CBRE-EA. 1Q2024.

Lastly among the major property types, hotel demand is healthy, but expense growth remains a challenge. Expense growth significantly outstripped RevPAR in 2023, and while it has begun to moderate, may not be fully back in line with RevPAR growth until 2025 or 2026 (exhibit 6). As a result, we continue to recommend limited-service hotels over full-service hotels due to more favorable operating expense ratios that are less susceptible to rising operating expenses.

On the demand side, a healthy economy, strong consumer spending, and stable business optimism are being reflected in the hotel sector's performance, but of equal importance in our view is the continued incremental demand being driven by the digital nomad trend.

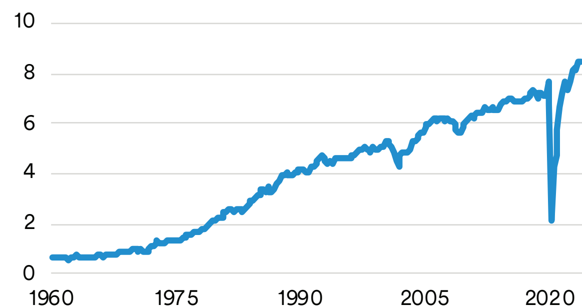
The average number of room-night stays per working-age U.S. resident rose from around 2 nights per year in the 1970's, to around 7 nights per year prior to COVID, and now sits at around 8 nights per year as of the end of 2023 (exhibit 7). We expect roughly 3.9% RevPAR growth this year.[5]

Exhibit 6 | Expenses Still Outpacing RevPAR



Sources: MIM, GreenStreet, CoStar, NCREIF. Data queried May 2024.

Exhibit 7 | Average Room Night Stays per Year per Capita



Sources: MIM estimate based on data from BEA, Oxford Economics, and CBRE-EA. Data queried May 2024.

Property Type Recommendations

In MIM's quarterly real estate market updates, we frequently review our property type overweight/underweight guidance. In the past, this has been based on a Delphi survey of MIM's seven regional acquisitions teams located across major U.S. markets, to assess current spot market yields for stabilized properties across all the core and alternative property types. We then apply risk adjustments based on forecasted supply/demand conditions, historical investment performance volatility, operating expense loads, and average CapEx needs to estimate the risk-adjusted returns being offered in the market. In the table below, this is referred to as MIM's "internal" score.

More recently, this analysis has been expanded to include an "external" score, which is primarily based on public market REIT pricing. We have begun integrating data on REIT pricing, price-to-NAV ratios, and near-term income growth outlook as reported by REITs in their forward guidance. As a measure of how the market is pricing volatility for the various property types, we also capture options-implied volatility for each REIT. The various REITs are then categorized by property type.

The data show some differences between how public markets rank relative value across property types, and what we aggregate and forecast based on our internal/direct portfolio data. Generally, we believe infill warehouses, net-lease retail, and seniors housing offer the best relative value today. Full-service hotels, office, and grocery-anchored retail fall towards the bottom of the list and receive underweight recommendations.

Sector	Internal Rank	External Rank	Composite Rank	Strategy
Infill Warehouses	1	4	1	Overweight
Retail-Net Lease	6	2	2	Overweight
Seniors Housing (IL)	2	7	3	Overweight
Manufactured Housing	5	5	4	Overweight
Retail-Mall	14	1	5	Overweight
Cold Storage	4	8	6	Neutral+
Data Centers	11	6	7	Neutral+
Limited-Service Hotels	3	17	8	Neutral+
Moderate Income Housing	7	11	9	Neutral
Regional Warehouses	15	3	10	Neutral
Medical Office	10	9	11	Neutral
Retail-Strip/Neighborhood	8	12	12	Neutral
55+ Housing	9	15	13	Neutral
Single-Family Rentals	13	13	14	Neutral-
Self Storage	20	10	15	Neutral-
Student Housing	12	19	16	Neutral-
Traditional Apartment	17	14	17	Underweight
Life Science	16	16	18	Underweight
Full-Service Hotels	18	21	19	Underweight
Office (Excludes Life Science/Medical)	19	20	20	Underweight
Retail- Grocery Anchored	21	18	21	Underweight

Source: MIM. Based on a May 2024 Delphi consensus survey of MIM's acquisitions staff for current market pricing, aggregated portfolio information, and ratios from vendors including CoStar and Green Street. External sources include REIT and market information from MIM vendors including CBRE-EA, CoStar, and Green Street.

Importantly, this analysis is an unconstrained view that does not consider critical factors like debt availability, portfolio diversification, liquidity, operational challenges or economies of scale, MSA exposures (i.e., Life Science may only be available in several markets), or higher yielding strategies such as value-add or new development, etc.

Conclusion

The commercial real estate sector is at an inflection point. Property prices declined precipitously over the past two years and are beginning to find their footing. However, the recovery cycle may not be immediate and may not occur in a straight line.

For the remainder of the year, we are focused on how capital market conditions evolve, relying on our analysis of real estate equity yields and bond prices as a guidepost. Property fundamentals are stable, and we welcome glimmers of light in the office sector. Market selection will remain particularly important in the multifamily and industrial sectors this year, where a handful of markets are facing supply challenges.

The economic outlook remains positive, and we believe that the resilience of the U.S. consumer will enable the U.S. economy and many real estate sectors to successfully overcome the challenges of the year ahead.

Endnotes

1. CME Group. May 2024.
2. MIM, CoStar. May 2024.
3. CBRE-EA. 1Q2024.
4. Ibid.
5. MIM, CoStar. May 2024.

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