September 27, 2022

REAL ESTATE

Fall 2022 Real Estate Outlook

Key Takeaways:

- Inflation remains high, interest rates are rising, and geopolitical risks have worsened, but consumers are well positioned, and job growth is strong.
- We estimate discount rates across property types rose by around 50 basis points (bps) between May and September of 2022. Taken alone, this change in discount rates would imply a roughly 10% decline in real estate prices compared to just a few months ago; however, there are several mitigating factors that point to a milder impact on prices.
- Few cracks are evident in the apartment, industrial, and hotel sectors.
- We believe retail offers tactical pricing opportunities and a brightening fundamentals outlook.
- The office sector remains challenged, but painting office with a broad brush could lead to both elevated risks and missed opportunities.

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Uncertainties Abound

The economy was mixed over the summer with GDP contracting for a second consecutive quarter while labor markets continued to exhibit strong growth. The risks that we outlined in our Spring 2022 Outlook have become more acute, in our view, with both rising inflation and rising interest rates contributing to a decline in consumer confidence.

In terms of monetary policy, the Fed continues to chart an aggressive path of interest rate increases. Though we believe year-over-year inflation has peaked and will fall back to around 3% by the end of 2023, the impacts on global capital markets, including on commercial real estate liquidity, have been swift. The effects of rising interest rates are also beginning to show in consumer segments, such as the housing market and automobile sales, as borrowing costs have risen.

With regard to energy and food costs, a near-term resolution to the Russia-Ukraine crisis does not appear likely, and access to commodities has become a key component of Russia's economic war. Russia has indefinitely suspended natural gas flows via the critical Nord Stream pipeline, which could severely impact economic growth in Europe, especially during the upcoming cooler months when home heating costs typically rise. Similarly, ports in the Black Sea for grain exports have become bargaining chips in the conflict and could lead to further instability in food prices.

A risk we are increasingly monitoring is the effects of slowing growth in China. China's stringent Zero COVID-19 policy remains in place. The property sector, which accounts for around 25% of the Chinese economy[1], has slowed, and the Chinese government has been reluctant to implement accommodative monetary policy. Each of these factors could impact growth abroad, including in the U.S.

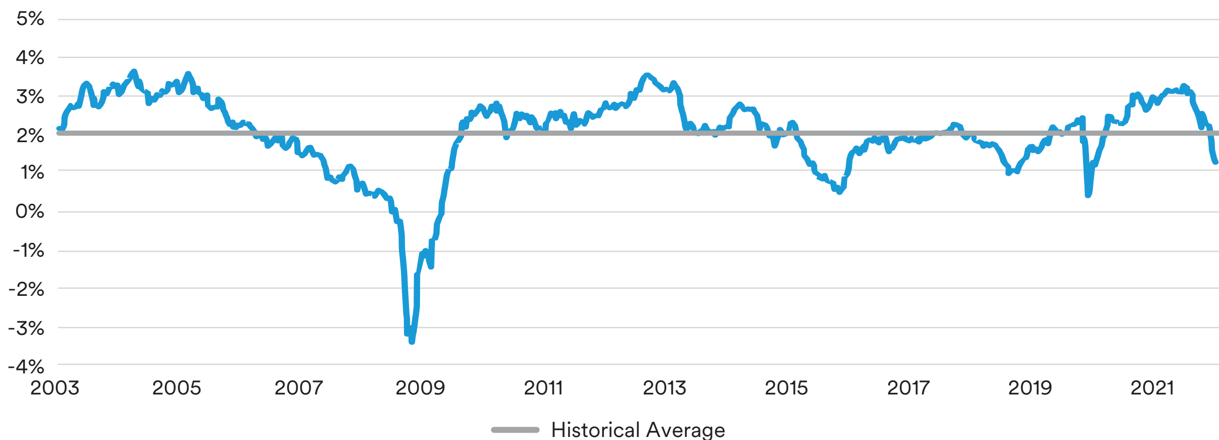
Economic and geopolitical turbulence have caused a sharp decline in consumer confidence since our last report. However, set against the backdrop of sub-4% unemployment, rising wages, and elevated savings, neither the murky economic picture nor the outlook for real estate investment performance is obviously positive or negative. We expect continued but moderating economic growth in the U.S., with positive GDP growth in the second half of 2022 and slowing but positive growth in 2023.

Capital Markets Impact on Real Estate

The outlook for real estate fundamentals (rents and vacancy) is mostly unchanged since our last market update, but capital market conditions have started to shift during the summer months. Three factors that are impacting real estate prices today are [1] higher interest rates and risk spreads, which impact levered real estate returns and thus the prices investors are willing to pay [2] public stock and bond market valuations have declined, and the so-called "denominator effect" (when investors become over-allocated to a sector because values of other similar sectors have declined) is causing institutional investors to reconsider allocations to real estate, and [3] relative value of real estate compared to similar institutional investment classes like corporate bonds remains positive but compressed as bond yields rose (exhibit 1).

As a result, investors are now demanding a higher rate of return for new commercial real estate investments. We estimate discount rates across property types rose by around 50 bps between May and September of 2022. Taken alone, this change in discount rates would imply a roughly 10% decline in real estate prices compared to just a few months ago; however, there are several mitigating factors that point to a milder impact on prices.

Exhibit 1 | Real Estate Yield Spread to Corporate Bonds through May 2022



Sources: MIM, FRED, NCREIF, Moody's, Green Street.

The first is the acceleration of inflation in the past several months. In our view, construction is the primary transmission mechanism between inflation and real estate performance. Inflated costs of labor and materials are thinning development yields, making many construction projects unprofitable and preventing new construction starts. As the rate of project-starts continues to slow, we believe this could contribute to rent and occupancy growth across all property types later in the 2020s. Additionally, higher inflation in the past few months has caused an even wider gap between in-place rents and market rents, supporting property values as leases expire and roll to market.

Second, investors have employed a more disciplined approach to leverage this cycle, which is preventing distress and forced sales. Investors may require a higher discount rate today, but few owners are motivated to sell, especially given healthy property-income growth. This is leading to a wide bid-ask spread and a decline in transaction volume in recent months.

Taking the rise in discount rates and inflation/leverage mitigants together, we expect commercial real estate values to fall between 0% and 5% during the second half of the year, as measured by the NCREIF Property Index. If true, this would leave commercial real estate prices up by about 5% during calendar year 2022, after increasing 13.5% in 2021. Both years exceeded the historical average annual price increase of 4.0%.[2]

From a longer-term perspective, we believe current discount rates are cyclically elevated and don't represent a "new normal." The 10-year Treasury/risk-free rate is moderately above our estimated long-term equilibrium level of 2.75%, and risk spreads remain wide given recession fears. Following this period of market turbulence, we expect discount rates to settle about 25 bps above early 2022 levels. However, the risk that discount rates remain elevated for a prolonged or uncertain period is real and is a reason to exercise discipline when pricing new investments.

Steady Outlook for Apartment, Industrial, and Hotels

Few cracks are evident in the apartment, industrial, and hotel sectors. Apartment rents have increased roughly 6% in the first half of the year.[3] In addition to healthy job growth, apartment demand has been further bolstered by the higher cost of homeownership. We estimate for-sale homes have become about 50% more expensive since last December due to rising home prices and mortgage rates.[4]

Recent announcements from Amazon about subleasing space has caused concern that industrial demand could slow. While Amazon is a dominant user of industrial space, we estimate it only accounted for approximately 10% of new leasing activity in 2021. Similar to the apartment sector, industrial vacancies remain near historical lows, and we expect continued healthy income growth in the industrial sector.

Like the apartment and industrial sectors, U.S. hotels are performing well. We attribute this to a combination of healthy consumer balance sheets as well as a hybrid, work-driven increase in leisure travel demand that we projected in our March 2021 report, A Stigmatized Sector – Out Outlook for U.S. Hotels. Hotel occupancies have fully recovered to 2019 levels, and revenue per available room (RevPAR) during the summer months was 11.2% above the same period in 2019.[5]

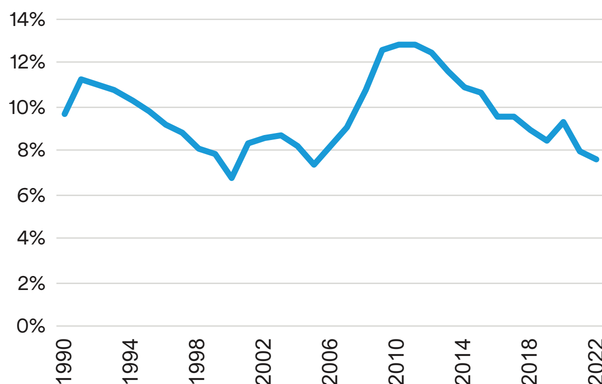
Retail Rally

Perhaps the most underappreciated trend in property market conditions, and the biggest surprise to us over the last three months, is the improvement in retail fundamentals. Neighborhood and strip center vacancies are at the lowest level in 20 years (exhibit 2). Malls, which have been the most negatively impacted by the rise in e-commerce, have finally reversed a decade-long rise in vacancy rates.[6]

> Despite evidence of improvement, retail (especially non-grocery retail) remains heavily stigmatized by most institutional investors.

As shown in exhibit 3, we estimate retail mortgages are pricing at the widest level relative to other core property types in history. Grocery anchored retail is one exception to this favorable pricing trend, which leads us to favor non-grocery-anchored assets. Although grocery-anchored centers have historically offered more stability, we believe they are often being priced too aggressively, especially in the face of the quickly growing e-grocery sector.

Exhibit 2 | Retail Strip Center Vacancy



Sources: MIM, CBRE-EA. September 2022.

Exhibit 3 | Retail Mortgage Spread Premium to Other Core Property Types

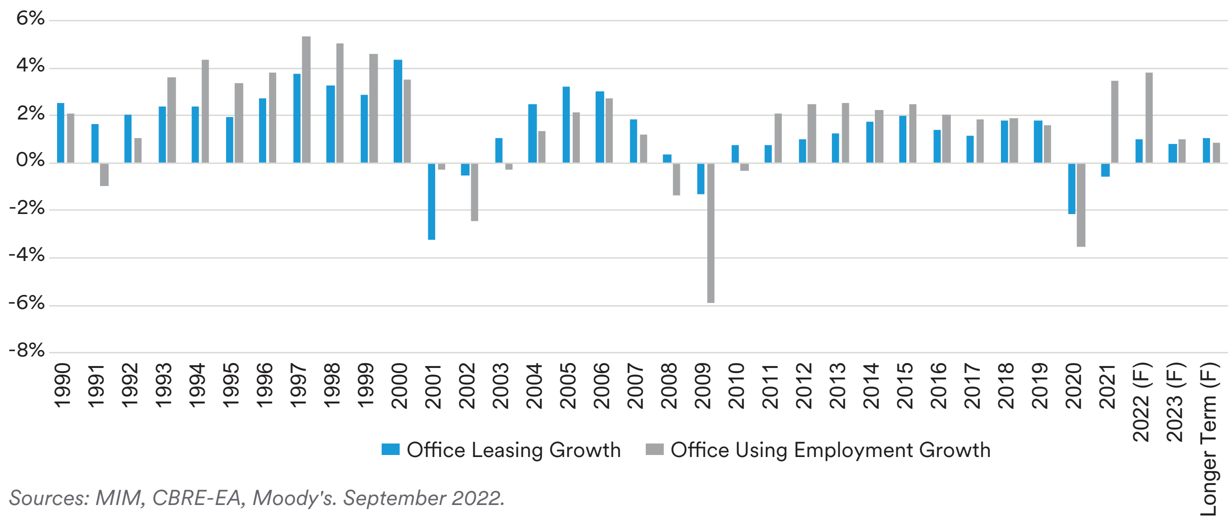
Sources: MIM, ACLI. September 2022.

Office Outlook

Forecasting office demand used to be a straightforward exercise. There has been a consistent relationship between employment growth in office-using job categories and office leasing activity. Pandemic-era remote work, however, broke that relationship (exhibit 4).

The difference between 2021 leasing demand and the trend depicted in exhibit 1 suggests that remote working caused a 4.0% rise in office vacancy, or 150 million square feet from the roughly 4 billion square feet of professionally managed U.S. office space. In other words, if not for remote working, we estimate that 12.8% of office space would be vacant (in line with the pre-COVID-19 level and the historical average), rather than the current elevated vacancy level of 16.8%.[7]

Exhibit 4 | Office Leasing vs. Employment Growth



Sources: MIM, CBRE-EA, Moody's. September 2022.

While remote working was to blame for rising office vacancy in the last two years, we believe demographics will dictate the pace of the office sector's recovery in 2023 and beyond, as well as the types of office assets that we believe will outperform.

Office Space in the War for Talent

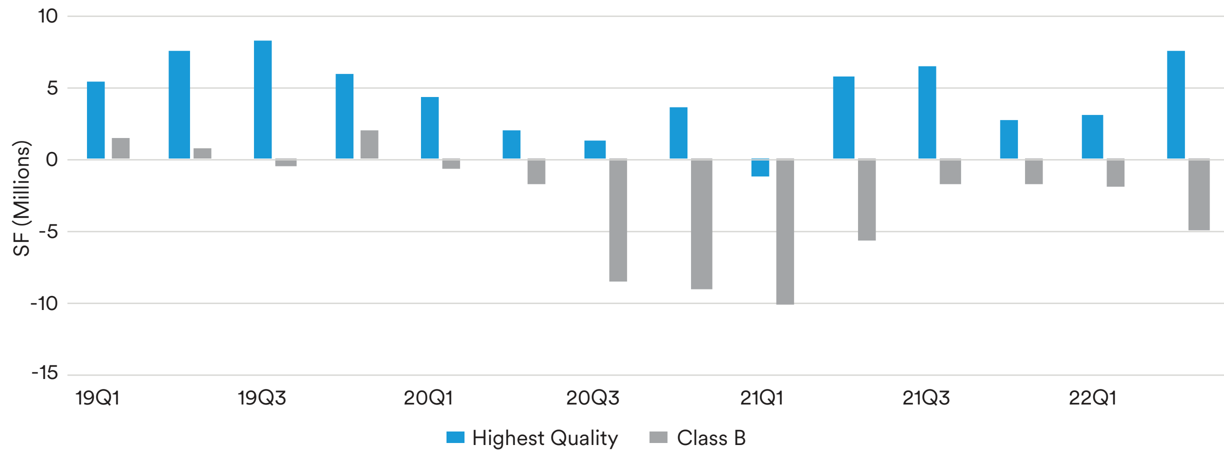
Many economists were surprised by how quickly the unemployment rate recovered in 2021 and 2022. Government stimulus was certainly a factor, but we believe the demographic picture today versus the last recession was also important and is potentially not being sufficiently considered by the market.

As the economy recovered from the 2008 Global Financial Crisis, millennials were entering the work force en masse, and only the relatively small silent generation was reaching retirement age, creating a glut of workers. Today, conditions couldn't be more different. Millions of baby boomers are retiring each year, and only the relatively small Generation Z is entering the workforce. We therefore believe that the 2020s could exhibit persistently tight labor markets, and the so called "jobless recovery" of 2009-2015 is unlikely to happen again following potential recessions that could occur during this decade.

This dynamic should create winners and losers within the office sector. Specifically, we believe highly amenitized space will become an increasingly critical tool for employers seeking to attract and retain talent, which could drive an accelerated recovery for the most desirable office assets (typically classified as "class A" or "creative" office space). Examples include facilities with full-service (and free) dining options, gyms, high-quality air filtration, outdoor amenity space, natural light from floor-to-ceiling windows, and high (12+ foot) ceilings with limited or widely spaced columns. The premium for assets with more submarket amenities such as walkable restaurants and access to main roads and public transportation is also likely to grow in value. The trend of class A+ outperformance is already evident in leasing data (exhibit 5).

The rent premium between class "A" and class "B" office space was approximately 45% in 2019, as tracked by VTS. It has since increased to slightly above 50%, and we expect the premium to grow to 60% by the end of the 2020s.[8] As of this writing, we do not believe investors are placing a significant enough discount on class B or C office space, and not enough of a premium on class A and creative office space.

Exhibit 5 | Office Leasing by Class



Sources: MIM, CoStar. 3Q2022.
Highest Quality represents CoStar properties designated as Class A and 5 Stars.

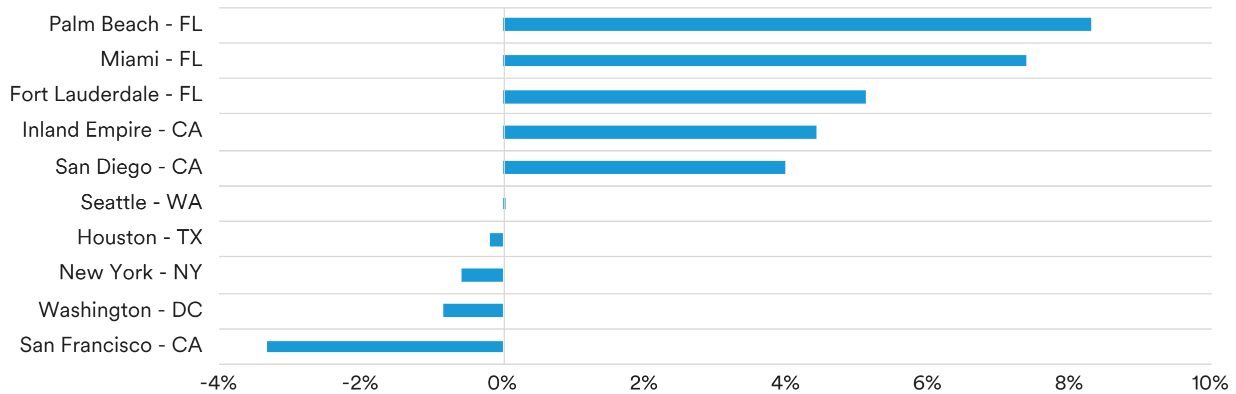
Office Market Targeting

Thus far, the ranking of markets with better or worse leasing demand has been playing out as we expected at the onset of the pandemic. Markets that are performing well have had a combination of high population growth, more limited risk from remote working (as we outlined in our December 2020 report, The Pandemic Pitfall), and a manageable amount of construction activity (exhibit 6).

Looking forward, we believe that several markets experiencing some of the most severe, near-term challenges have the best long-term office-demand drivers and could offer pricing opportunities in the current market. This includes stigmatized markets like San Francisco, as well as a handful of modestly better-performing markets like Seattle and Denver, all of which have aggregated the talent that supports rapidly growing industries.

At the submarket level, we believe firms will continue to choose locations that provide the best access to the largest number of highly productive employees and neighborhood amenities. This generally points to Central Business Districts, as opposed to suburban office locations. Hybrid working arrangements, such as three days in the office instead of five, also modestly reduce the appeal of suburban locations, in our view.

Exhibit 6 | Top and Bottom Office Markets (RevPAF, 3Q21-3Q22)



Sources: MIM, CoStar. 3Q2022.
Revenue Per Available Foot (RevPAF) equals the product of occuapncy and rent.

Conclusion

We believe real estate fundamentals remain strong. Inflation has run above expectations, which has generally benefited property-income growth across most asset classes. Additionally, the labor market remains healthy with labor force participation continuing to recover, job openings remaining elevated, and an average of 438,000 jobs having been added per month thus far in 2022.

Across property types, we maintain our positive outlook for the industrial sector and most residential formats. We believe retail offers tactical pricing opportunities and a brightening fundamentals outlook. The office sector remains challenged but painting office with a broad brush could lead to both elevated risks and missed opportunities.

Endnotes

[1] Moody's
[2] NCRIEF, September 2022.
[3] CoStar, September 2022.
[4] MIM, Moody's. September 2022.
[5] CoStar, September 2022.
[6] CoStar, September 2022.
[7] CBRE-EA, 2Q2022.
[8] MIM, VTS. August 2022.

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