August 30, 2021

U.S. commercial real estate Q2 review and outlook

Our U.S. commercial real estate outlook reveals the latest across the markets for investment, office, industrial, and multiresidential properties. Learn more.

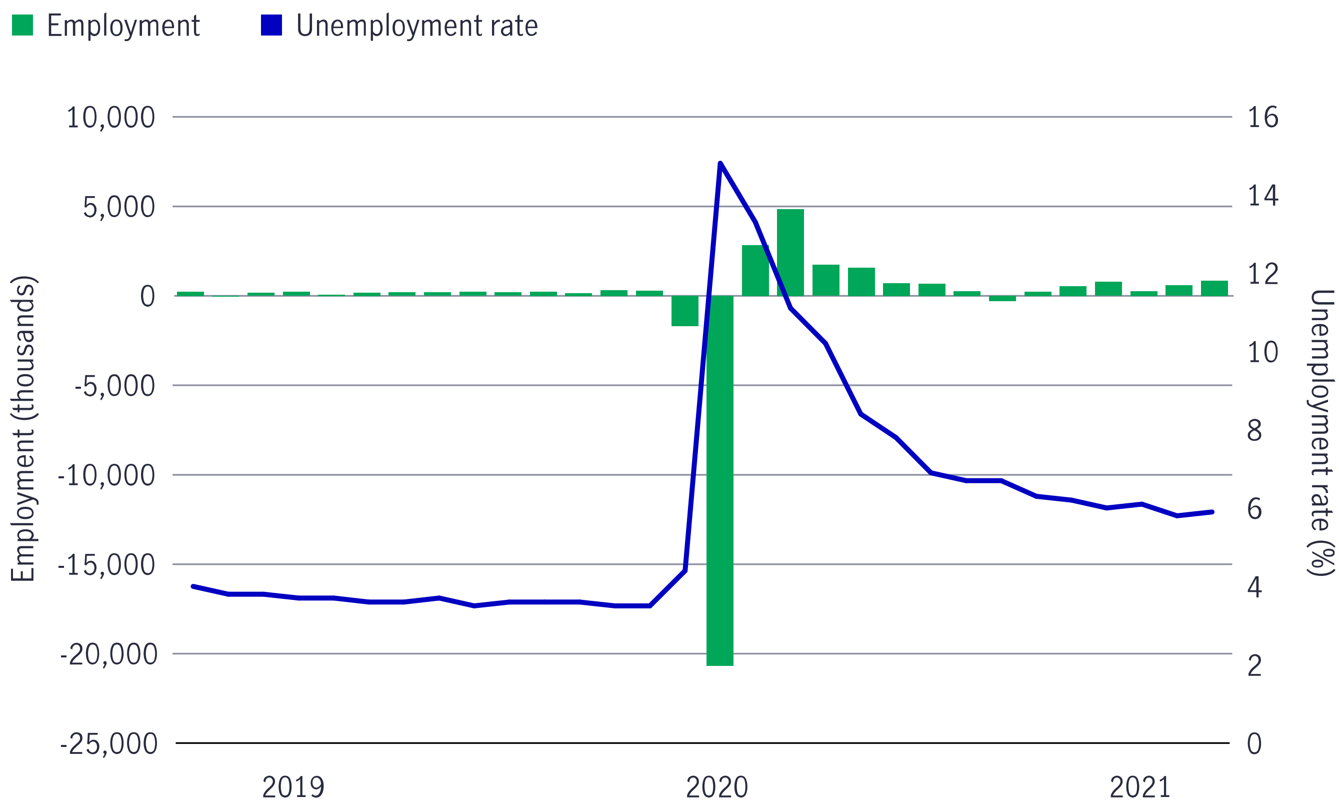
U.S. economy—real estate is positioned to catch the postpandemic wave

With the first six months of 2021 now past, almost 350 million COVID-19 vaccines have been administered in the United States, along with 3.5 billion doses administered globally. Currently, with the uncertainty emerging around the Delta variant, we know this isn't the end of the crisis—or even the beginning of the end—but perhaps it's the end of the beginning. Now that the global macro environment seems to be reaching its final stages, it leaves us wondering, what comes next?

So far, we've seen central banks in developed countries either signal or implement a tighter monetary policy, and while the United States has yet to make an official decision, it's expected to follow suit in the coming months. Assuming evidence of positive economic data, the tightening could come in the form of tapered quantitative easing, or, in real terms, a reduction in government bond purchases. Signs of an improving economy include lower inflationary pressure, strong job gains ahead of the expiry of enhanced unemployment benefits, and moderation of production and consumption measures. U.S. Federal Reserve Chair Jerome Powell has indicated that these events would have to occur "well before" considering raising interest rates.

The pandemic engendered a wave of fiscal stimulus as a transitioning U.S. federal government sought to curb the impact of a significant decline in economic activity and widespread job losses across many sectors of the economy. Riding the tailwinds of increased fiscal spending, along with high household savings rates and pent-up consumer demand, economic growth should be ongoing through 2021 and into 2022.

Monthly employment change and unemployment rate



Source: U.S. Bureau of Economic Analysis, Manulife Investment Management, as of June 2021.

Q2 market review and Q3 outlook

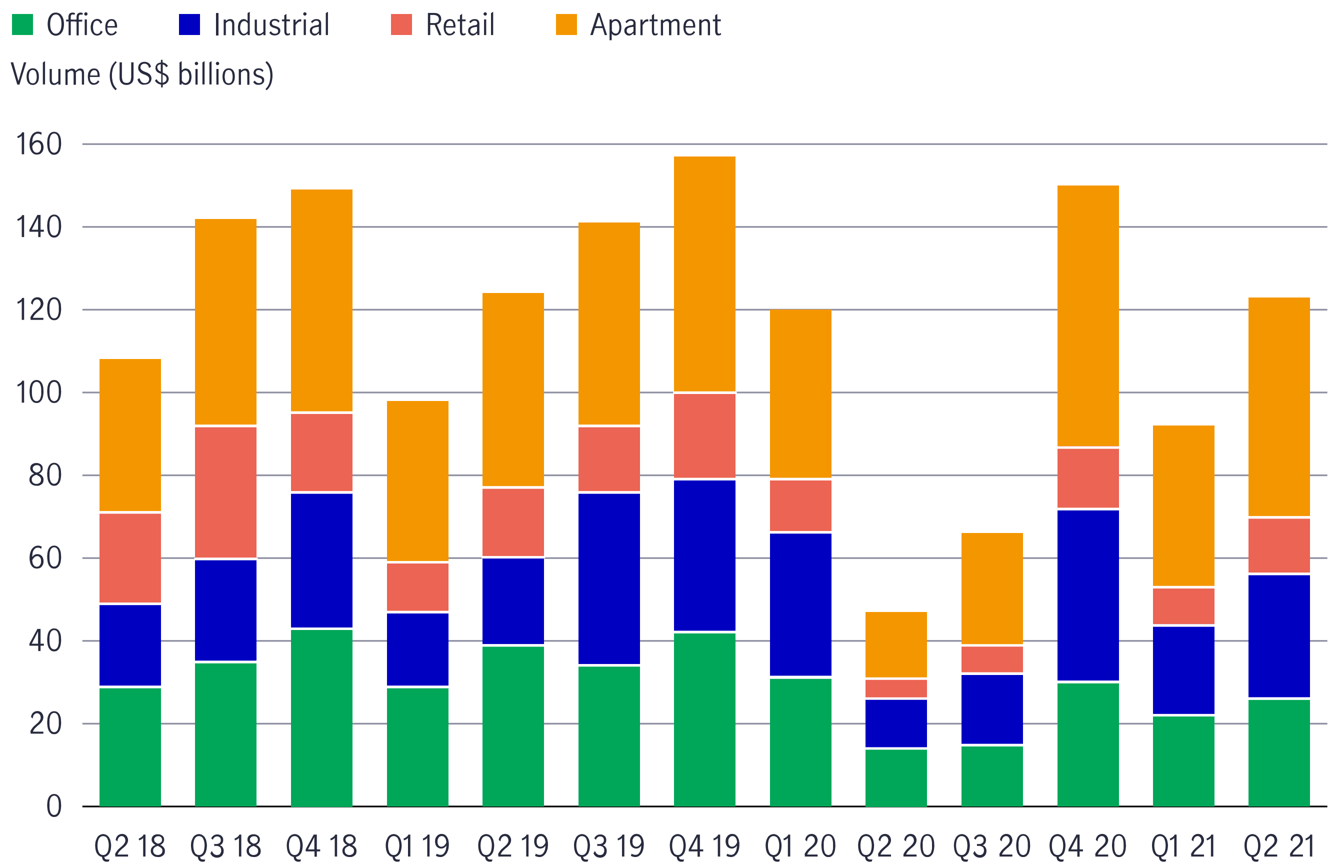
Investment markets

The COVID-19 crisis froze commercial real estate investment markets in the second and third quarters of 2020, which started to thaw in the fourth quarter as demand for multifamily and industrial properties started to heat up. Now with over twelve months of postpandemic data, we're seeing encouraging signs, although with one caveat: Base year impacts continue to warp the true nature of the market. Preliminary data from Real Capital Analytics (RCA) shows that most property types are experiencing high year-over-year (YoY) growth, which is likely due to lack of demand one year ago rather than high demand today. Between 2015 and 2019, typical transaction volumes for all property types in each second quarter averaged US$127.2 billion. With sales reaching US$144.7 billion in Q2 2021, we're surpassing prepandemic averages by about 14%.[1]

Transaction volumes for office, retail, and hospitality took a hit at the start of the pandemic. Fundamental concerns about postpandemic demand restrained investors, and even industrial and multifamily were held in check by delays in processing transactions and the inability to view properties in person. The RCA Commercial Property Price Indices (CPPI) aim to measure the capital appreciation component of total return to more accurately quantify price movements using a verified repeat sales methodology, which should reduce the impact of base year effects caused by the pandemic. Data for Q2 2021 shows that multifamily pricing has improved the most, with its RCA CPPI YoY growth pegged at 12.0%, while industrial wasn't far behind, coming in at 9.8%. Surprisingly, prices for office properties increased 6.0%, but with divided results, as suburban office grew 7.7% while Central Business District office fell 2.4%.[1]

Clearly, the pandemic has caused much uncertainty among investors, and misguided analysis may unwittingly lead some to compare this crisis against our most recent global upheaval, the Great Financial Crisis. In the years following that event, well-capitalized investors took advantage of opportunities where distressed properties carried too much debt and, as a result, they were able to realize immense gains. This time around, property owners were well funded prepandemic, and rather than overindebtedness precipitating the downturn, it was demand shock that pulled the rug from under commercial property markets. This fundamental difference in market conditions should help carry property markets forward as we emerge from the pandemic-induced slump; as inflationary fears have begun to rise, an increased allocation to commercial real estate may prove invaluable for those most committed to preserving capital.

Quarterly transaction volumes

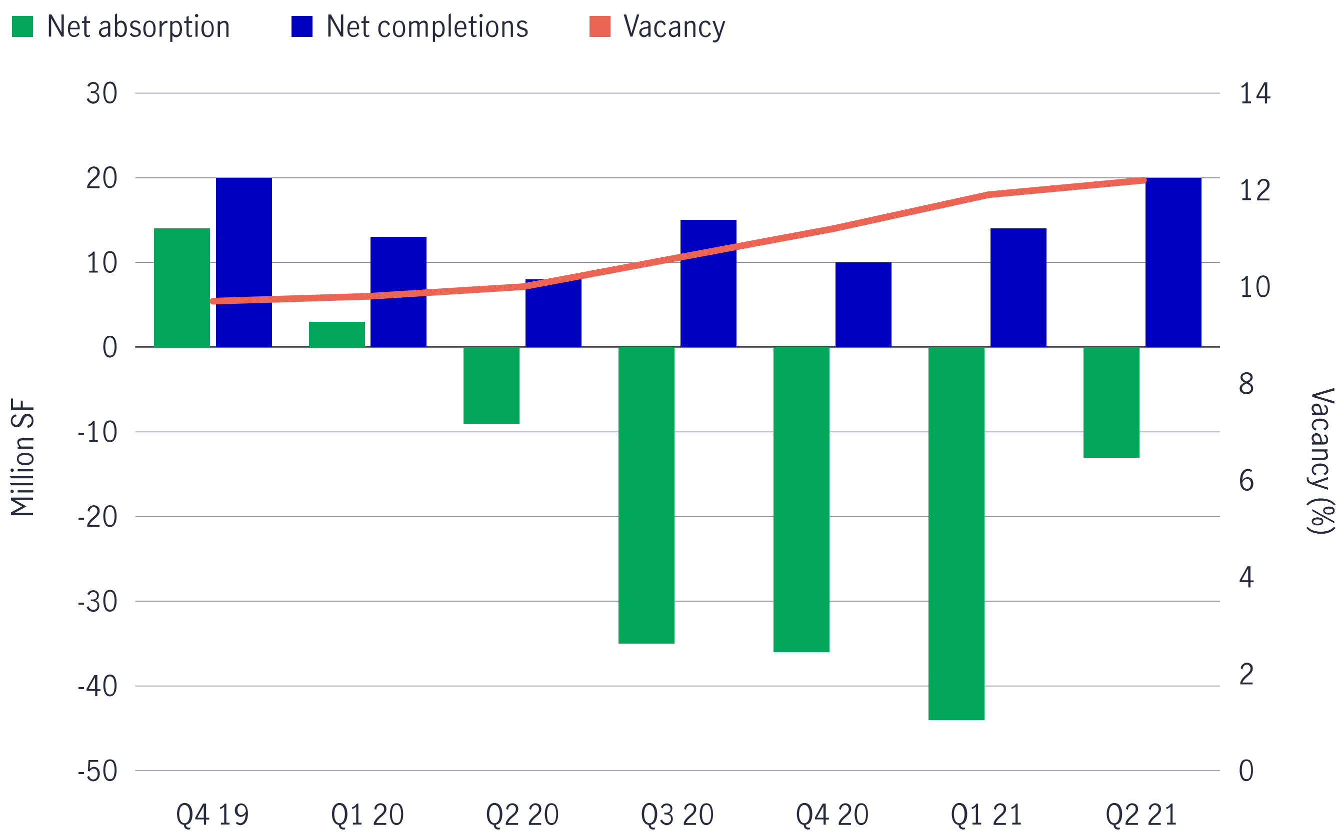


Source: Real Capital Analytics, as of Q2 2021.

Office markets

After finding themselves off-balance early in the pandemic, office markets are starting to find firmer ground as we go forward. Employment in key office-reliant sectors is improving, with professional and business services growing by 72,000 jobs in June, sitting only 2.9% below prepandemic highs.[2]

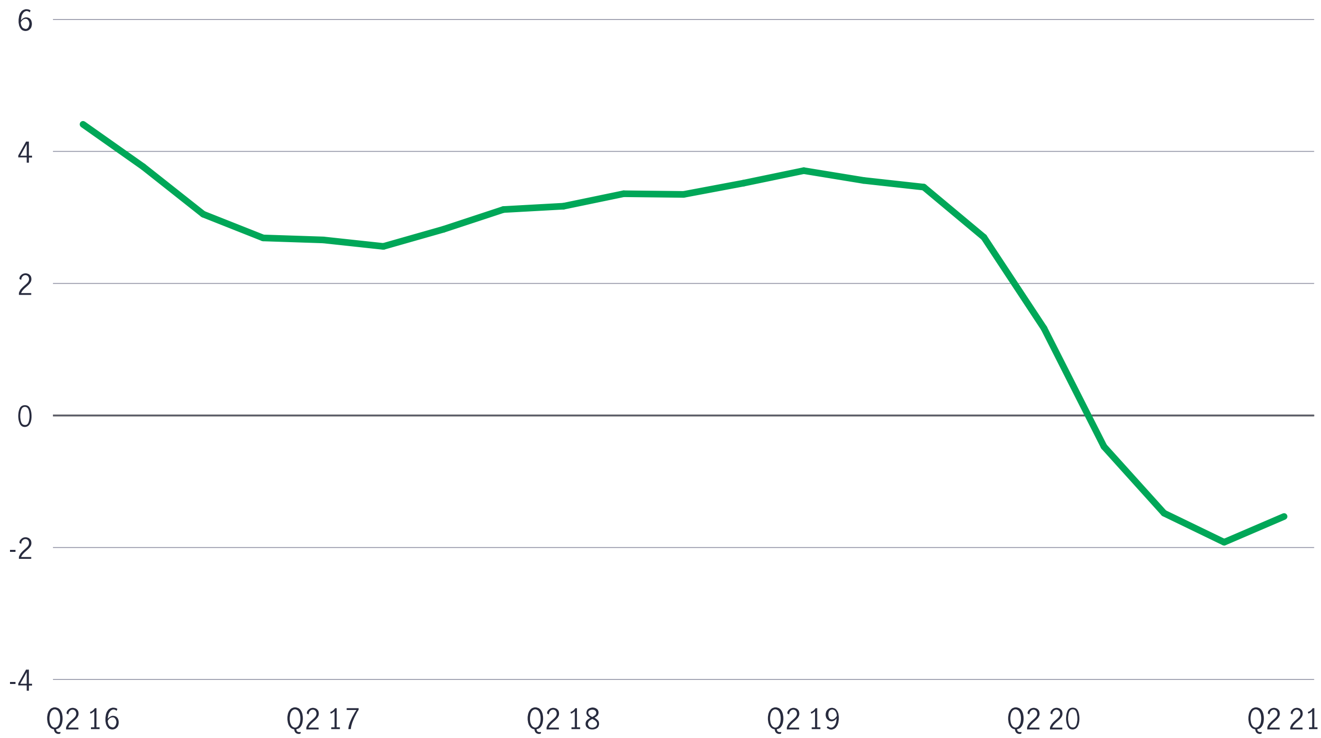
Office supply/demand fundamentals



Source: CoStar, as of Q2 2021.

The rise in vacancy is being felt across the country, as 42 of the 50 largest office markets registered elevated vacancy during the second quarter, which is nonetheless a slight improvement over last quarter, when 48 of 50 markets saw increases. Notable quarter-over-quarter decreases were recorded in Salt Lake City (–81 basis points (bps)), the Inland Empire (–37bps), Northern New Jersey (–9bps), and San Diego (–7bps). Early perceived beneficiaries of positive pandemic-related demographic flows, Charlotte and Denver, registered the biggest hikes quarter over quarter, bumping up 125bps and 91bps, respectively. Major tech-driven markets San Jose and San Francisco continued downward, at –91bps and –85bps, respectively.[3]

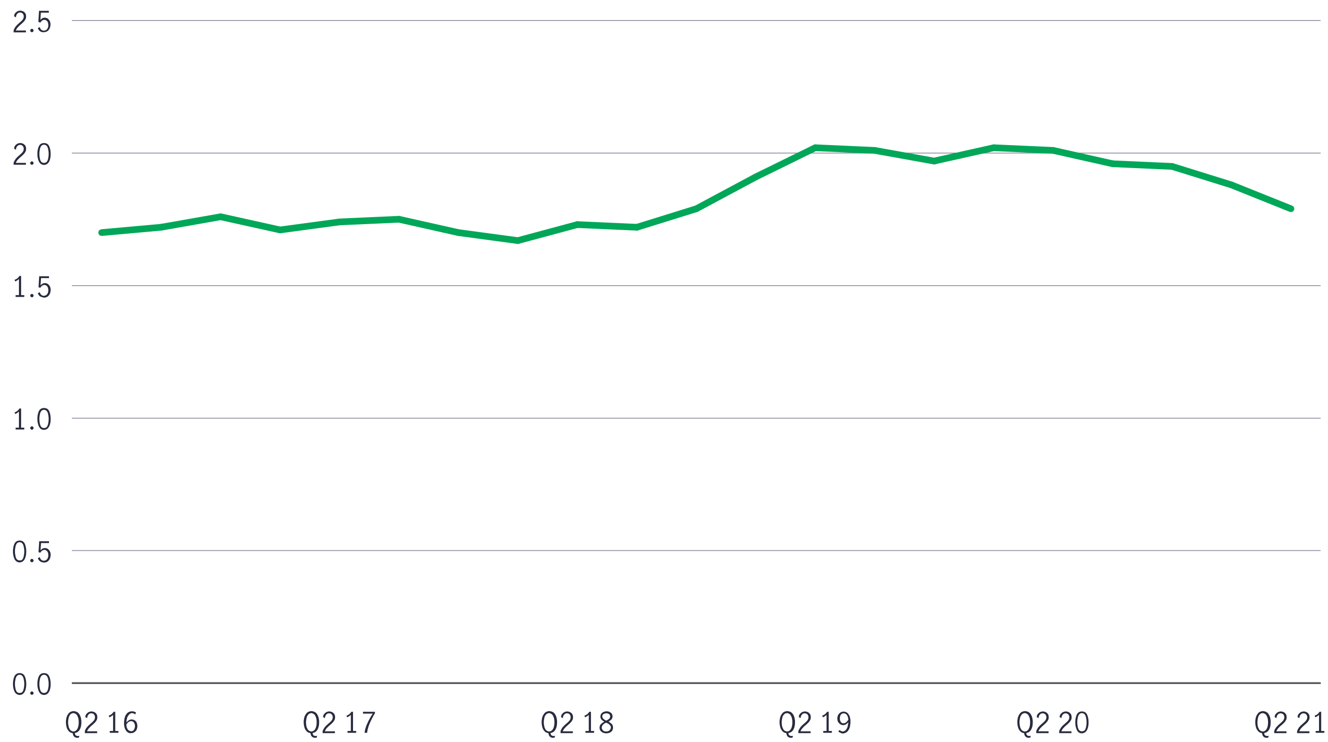
Office rent growth (%)



Source: CoStar, as of Q2 2021.

Leasing activity is starting to show a glimmer of hope as many major markets experienced big boosts in demand. High-profile quarter-over-quarter increases were reported in New York City (1.9 million square feet (SF), up 27%), Philadelphia (1.8 million SF, up 125%), Boston (1.3 million SF, up 48%), and Washington, DC (1.1 million SF, up 28%).[3] One unexpected factor in this uptick in activity is that a greater proportion of leasing appears to be happening in smaller office formats: In the second quarter, only 12.3% of new leases was for office space greater than 100,000 SF. Historically, leases larger than 100,000 SF represented about 22% of total leasing volume, which indicates that many larger companies are delaying office real estate decisions as they weigh return-to-office options in a postpandemic world.

Office under construction as % of stock



Source: CoStar, as of Q2 2021.

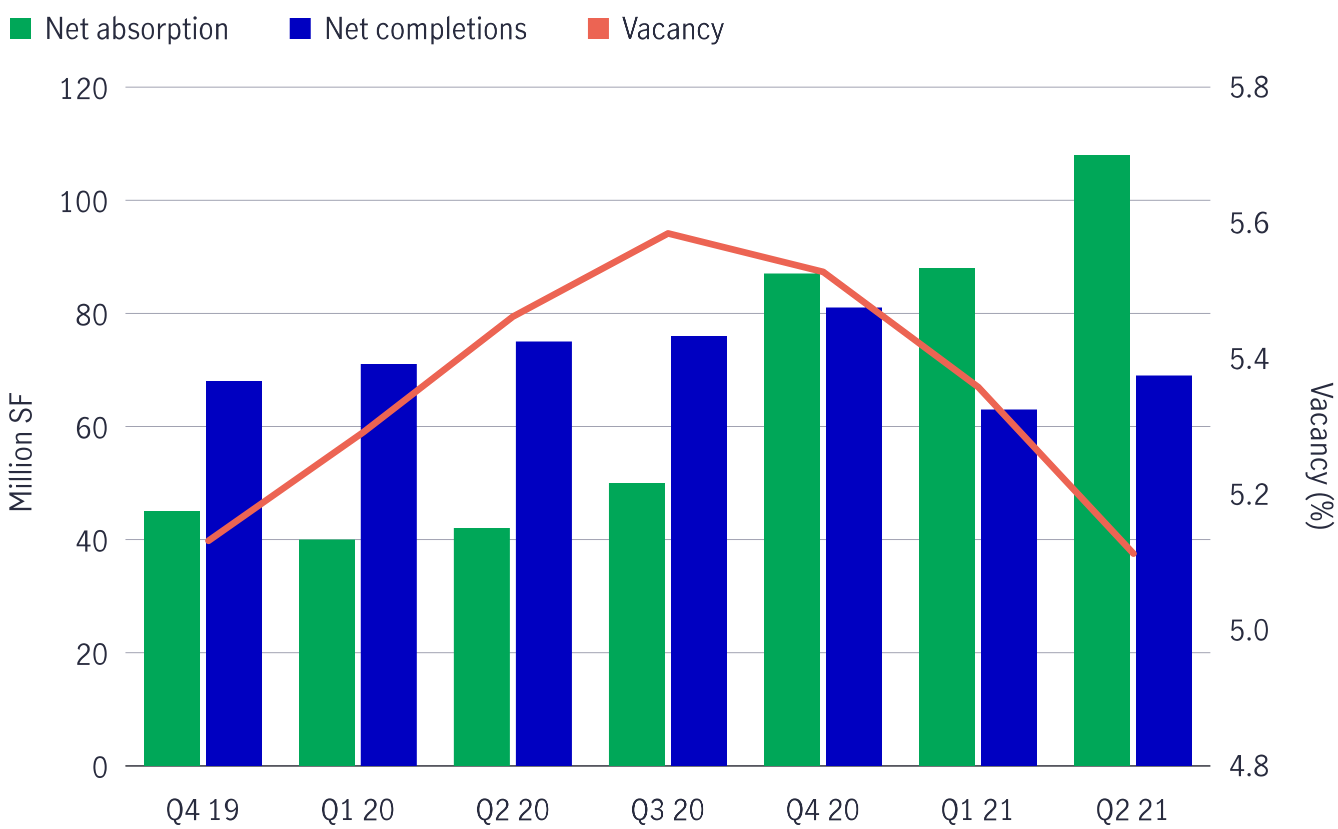
A recent CBRE report that polled corporate real estate decision makers helped to clarify occupier intentions for returning to the office. The report highlights that 85% of responding companies expect at least an equal mix of time in and out of the office, with smaller companies (<100 employees) more likely to prefer working in office. Most small companies indicated they'd likely increase or not change their office presence, whereas large companies (>10,000 employees) said they'd moderately reduce office space. Across the spectrum, most respondents reported that they anticipate the usual level of activity to resume in either the third or fourth quarter of 2021 and that capital expenses will likely increase to incorporate more collaborative workspaces, enhanced video conferencing, and improved air ventilation/quality.[4]

Industrial markets

Industrial real estate demand has been on the rise—from both investors and occupiers—since the pandemic threw a wrench into the global economic engine in March 2020. Yet as hot as the sector may be, it hasn't been without its headwinds. Finding enough skilled labor has been a struggle as enhanced government benefits, childcare challenges, and fear of contracting the coronavirus have kept some from returning to the labor pool. These factors, combined with a surge in leisure and hospitality employment as a result of easing pandemic-related restrictions, have had the knock-on effect of reducing the availability of labor.

Preliminary data nationwide shows vacancy declining for the third consecutive quarter, falling 25bps to 5.1% between the first and second quarters. Although secondary markets have seen the biggest drop in vacancy, notable quarterly decreases in primary markets include the Inland Empire (–53bps), Atlanta (–52bps), and Chicago (–45bps). YoY, primary markets experiencing the biggest decrease include Atlanta (–185bps), Phoenix (–101bps), and San Diego (–101bps).[3]

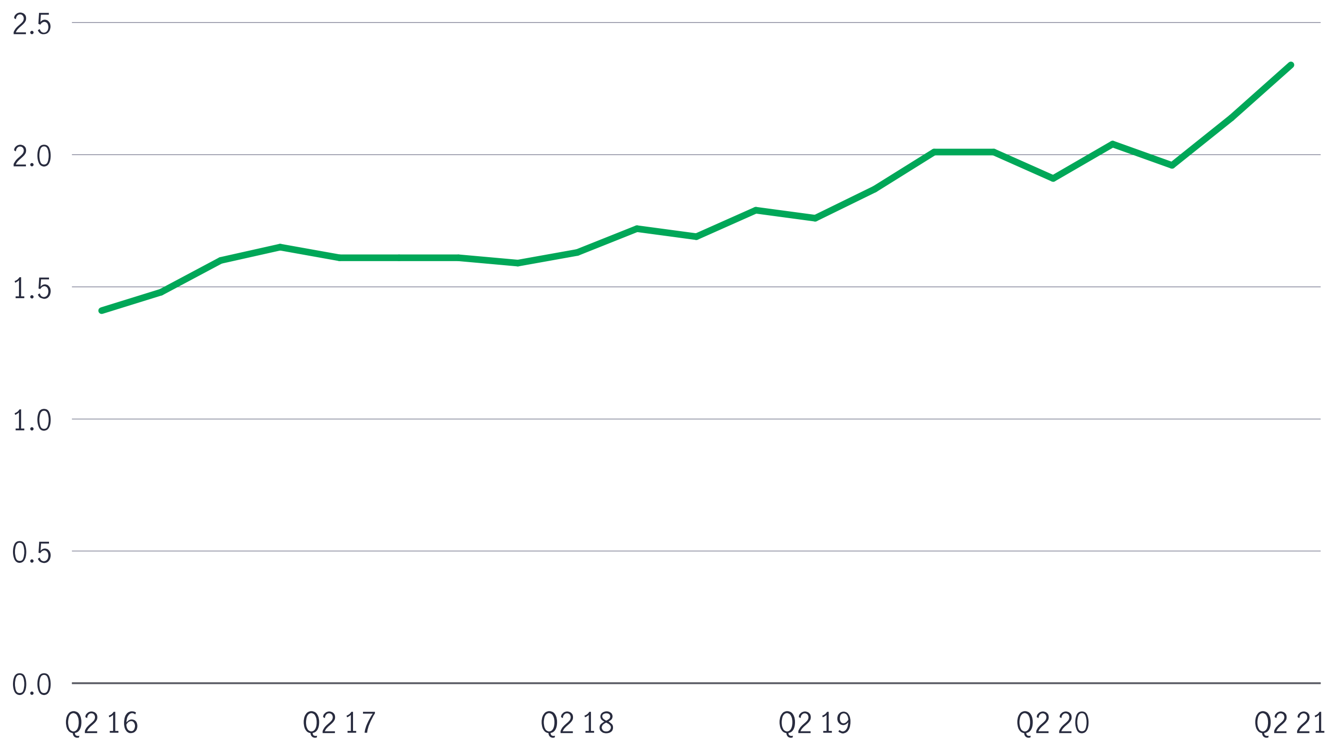
Industrial supply/demand fundamentals



Source: CoStar, as of Q2 2021.

On the demand side, industrial net absorption has surpassed record highs on both an absolute and percentage basis, reaching an astounding 108.8 million SF—0.63% of total inventory. The uptick is being felt in almost all major markets, with 46 of the 50 biggest industrial markets experiencing positive net absorption over the quarter. Top markets include the Inland Empire (10.1 million SF), Chicago (9.5 million SF), and Dallas-Fort Worth (9.5 million SF), which together made up 26.6% of total quarterly net absorption.[3] Even with a historically high 2.3% of inventory under construction, demand is far outpacing supply, inferring this imbalance will likely continue to propel industrial values for the foreseeable future.

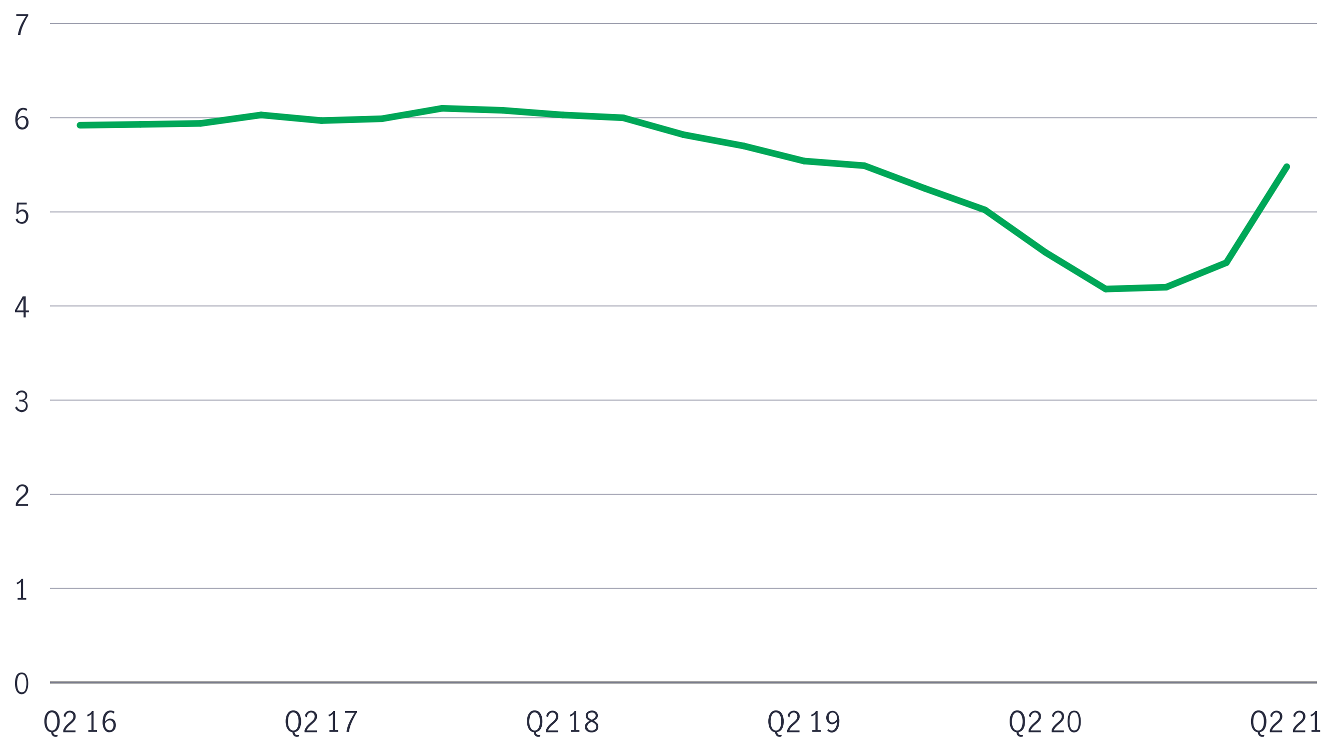
Industrial under construction as % of stock



Source: CoStar, as of Q2 2021.

More recently, the outstanding performance of industrial real estate has started to beg the question, how sustainable is this rate of growth? A closer look at the relevant macro and micro economic factors reveals a healthy picture, auguring well for the future. First, rock-bottom interest rates are likely to remain low and have fueled the availability of capital, which has led to more money than properties to purchase in the market. Second, recent supply chain disruptions combined with a sharper focus on the environmental impact of global logistics have amplified interest in onshoring and reshoring—a major boon to secondary markets and generating an even bigger premium for properties near dense urban metros. And finally, overall real estate costs represent only a fraction of total operational expenses for most occupants of industrial real estate, so even a moderate increase in the proportionate share of costs would likely go unchallenged, as more pressing concerns such as rising labor and energy prices take priority for most tenants.

Industrial rent growth (%)



Source: CoStar, as of Q2 2021.

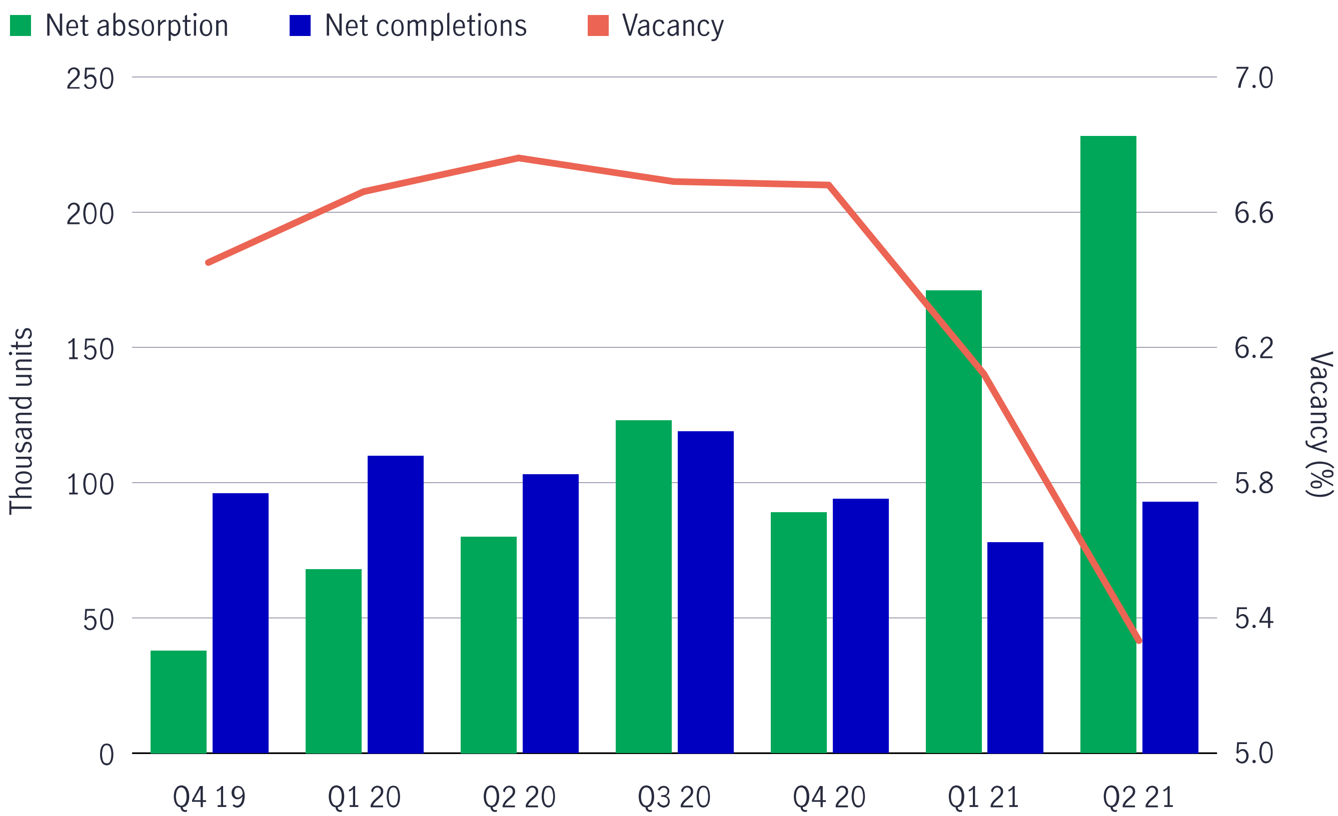
Multifamily markets

Multifamily markets have maintained resilience throughout the pandemic, as rentals in urban markets fell somewhat out of favor and shifting demographics brought an influx of renters to suburban markets. Looking ahead, surging employment should boost rentals across all markets as pandemic-related government support begins to unwind.

While no firm date has been set, the Biden administration has hinted that the temporary boost in unemployment benefits would likely end by September. In addition, the federal moratorium on evictions is set to expire in October, and with an estimated

US$35 billion[5] owed in back rent, states and local governments will have to act fast to distribute the nearly US$47 billion that the Biden administration has designated for rent relief.

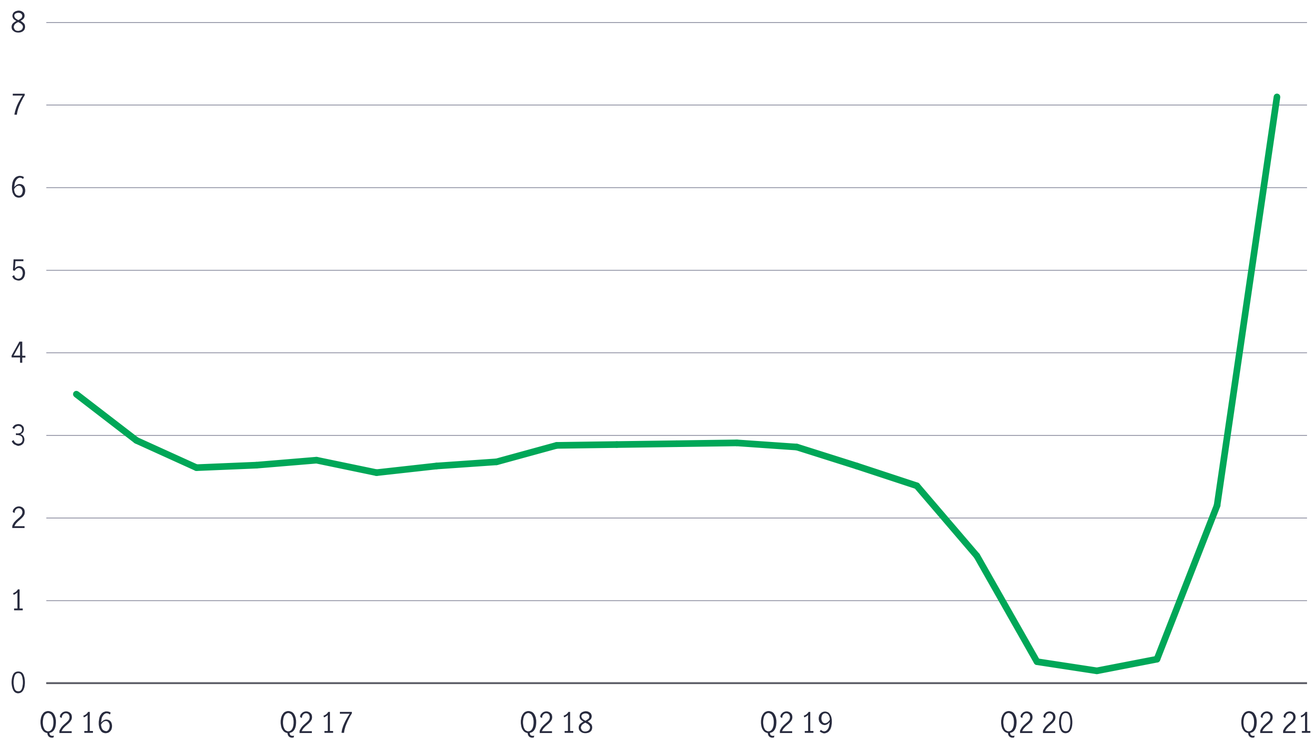
Multifamily supply/demand fundamentals



Source: CoStar, as of Q2 2021.

Q2 2021 data from RCA shows that pricing on multifamily investment has scored a new record on two key metrics: Nationally, the average price per unit reached US$190,000 and cap rates fell 9bps, to a new low of 4.9%.[6]

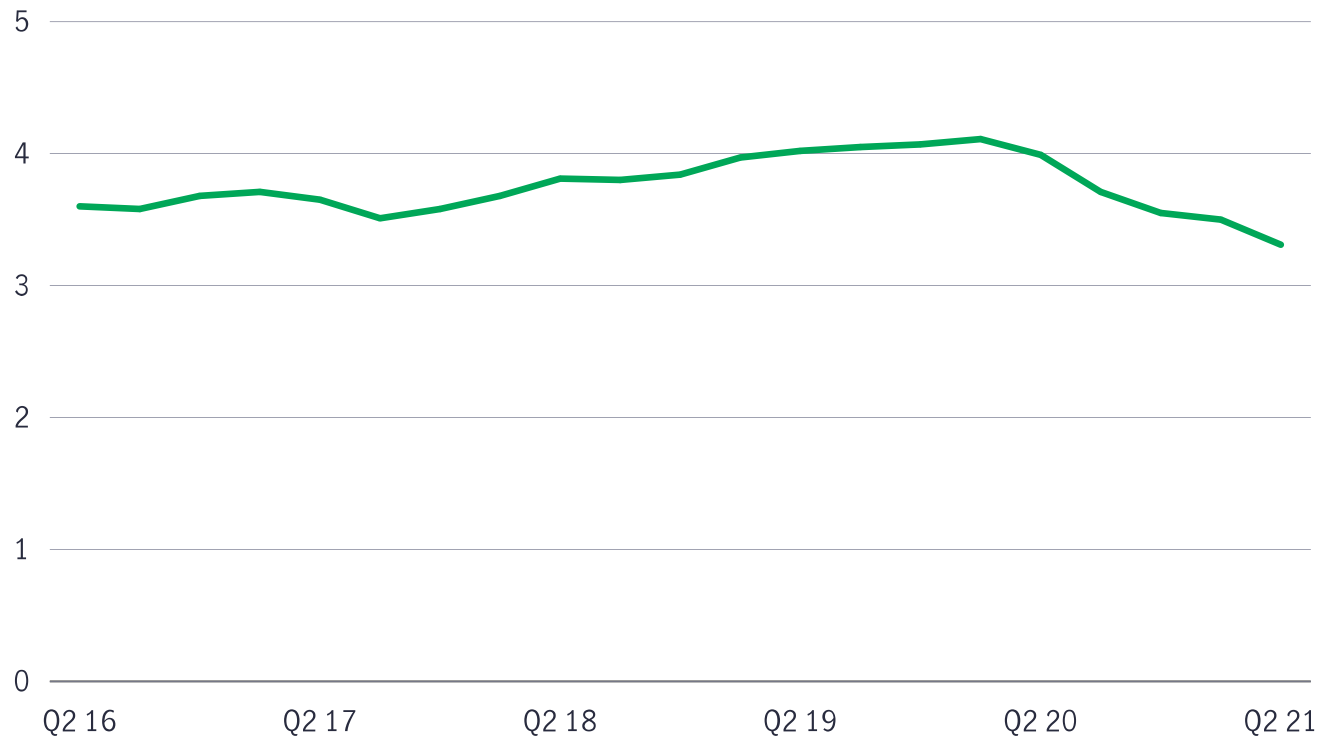
Multifamily rent growth (%)



Source: CoStar, as of Q2 2021.

The much-publicized demographic shift that took place across the country during the pandemic is starting to manifest in rental data. All of the top 10 markets for YoY growth in asking rent are located in the Sun Belt, and 7 of 10 are in Florida. Looking ahead, the most sizable markets by inventory are still leading the charge on the construction front, suggesting that developers have faith that an interest in dense major markets will return. In fact, the anxiety over a lasting urban exodus may have been overblown from the start: A review of vacancy rates in the 20 largest markets by inventory shows that 17 of the 20 have experienced vacancy rate declines since Q1 2020. Trends indicate that rather than an exodus, the current situation might be better described as an urban reshuffle. Two of the steepest downturns in vacancy since Q1 2020 took place in Orange County (–309bps) and Baltimore (–271bps), which are located within commuting distance of massive rental markets Los Angeles and Washington, DC, respectively.[3] Renters are signaling that they still want to live near dense urban metros, but they place less of a premium on smaller-format units in the downtown core. And as companies start to unveil their return-to-office plans, it's expected that many renters will return to the downtown core, as even occasional commuting could take the luster off suburban living. When tenants do return, major office-driven markets could face a sudden revival in demand as people fear missing out on a good deal.

Multifamily under construction as % of stock



Source: CoStar, as of Q2 2021.

1 Real Capital Analytics Capital Trends, Q2 2021. **2** U.S. Bureau of Labor Statistics, as of June 2021. **3** CoStar, as of June 2021. **4** "CBRE Occupier Sentiment Survey," CBRE, Q2 2021. **5** Research Institute for Housing America, as of May 2021. **6** Real Capital Analytics, Q2 2021.

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