Real Estate Outlook

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The storm is passing.

UBS

UBS Asset Management

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US outlook

Closer to calm.

US economic recovery is pushing through the lingering headwinds of virus variants and sluggish job growth. A year of pent-up demand is powering progress in necessity-driven asset classes.

Market overview and outlook

Rediscovering sea-legs.

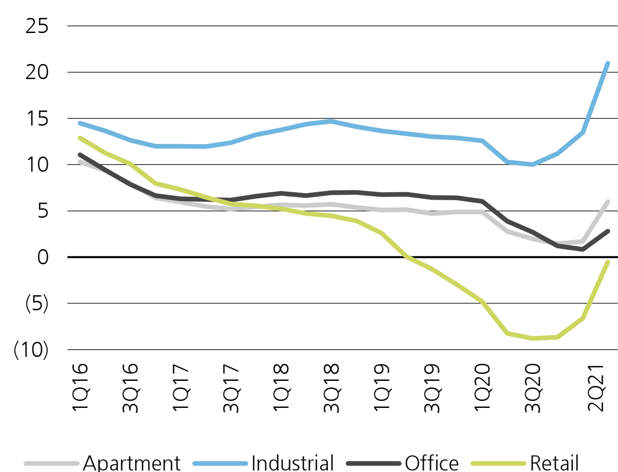
The NCREIF-ODCE Fund Index showed income return offsetting capital depreciation in private commercial real estate resulting in a positive total return of 3.93% for the second quarter – the highest quarterly total return since 2015 – and 8.02% for the year ending 2Q21.

A year of pent-up demand is affecting multifamily and industrial the most (tailwinds are expected to outpace the headwinds). Office and retail continue to have hardships but more dynamic sub-segments of these property types such as life-science, medical office, and grocer/cloud-kitchen trends in retail, have upside surprise factors.

Fourth quarter 2020 showed a fairly normal surge in transaction activity. 2Q21 volume was in line with 2Q19. Increased transaction volume should give investors more clarity and confidence in values as 2021 progresses.

Interest rates remain low and support increasing transactions. Spreads available in private real estate remain near long-term averages. Borrowers have options as lenders become more competitive, especially for high-quality credit, long-term leases, multifamily and industrial properties.

Figure 1: ODCE returns by sector (Four-quarter rolling returns, %)



Source: NCREIF as of June 2021. Data show unlevered NCREIF Property Index total returns filtered for only ODCE managers. Past performance is not an indication of future results.

Most sectors saw notable acceleration in total returns over the quarter. However, retail continued to post negative returns, albeit at a diminishing pace (see Figure 1). Industrial returns continue to exceed the other sectors. Office returns finally turned upward increasing over the previous quarter for the first time in more than two years. Apartment returns accelerated to the highest level since 2016, potentially heralding a rapid recovery. At the market level, we forecast a recovery growth pace for industrial and apartment returns but modest performance for office and retail during 2021.

Apartments – Apartment fundamentals are beginning to stabilize and are likely to see occupancy and rent values recover fully during 3Q21. According to CBRE-EA average apartment rents increased by 3.5% QoQ in 2Q21; sufficient for a YoY growth rate of 0.4%. Vacancy declined by 60bps in the year ending 2Q21 to 4.0%, and is the lowest it's been since the end of 2019.

Industrial – Many consumers have become accustomed to the convenience of online shopping. Industrial remains the sector with the strongest fundamentals. Despite a nearly 2% increase in national inventory, according to CBRE-EA 2Q21 industrial availability was 6.4%, down by 40bps from 2Q20. YoY rent growth accelerated to 5.0% in the year ending 2Q21.

Office – Total office vacancy continues to rise rapidly, and reached 16.5% in 2Q21 (350bps over 2Q20) according to CBRE-EA. Development has not slowed, with over 45 million sqft of new supply delivered over the past year into a market with diminishing demand. Over the past year, downtown vacancy has risen to 15.8%, 440bps above one year ago; while suburban vacancy, at 16.8%, is 290bps above last year. Asking rent declines are expected to continue through mid-2022.

Retail – The full impact for traditional brick and mortar stores and restaurants remains to be seen. The most vulnerable appear to be businesses unable to adapt to online or app-based strategies. Neighborhood & Community Center availability is down by 20bps to 8.8% in the year ending 2Q21 according to CBRE-EA, but we expect rent growth to be moderately positive by year end 2021.

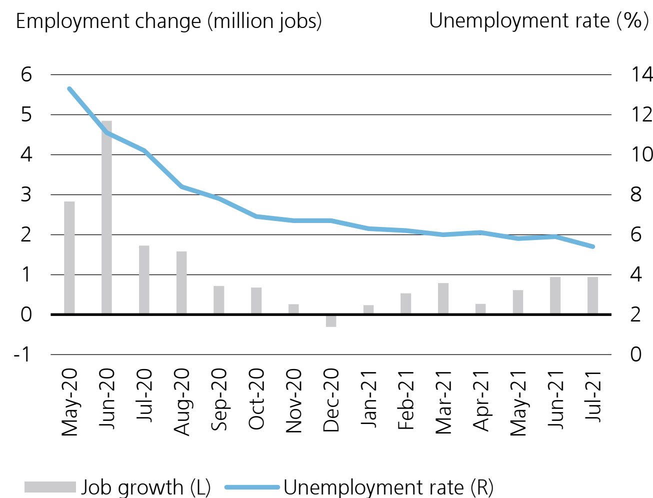
Strategy viewpoint

Strong sailing, expect headwinds.

The US economy began to recover during 1H21, bolstered by additional stimulus and legislation designed to seed expansion. Preliminary data indicates that 2Q21 GDP has exceeded the pre-pandemic level, with steady growth anticipated for 2H21. Variant virus strains and the below-expectation rate of adult vaccinations have led to confused messaging and sporadic reinstatement of masking requirements posing a risk to continued growth.

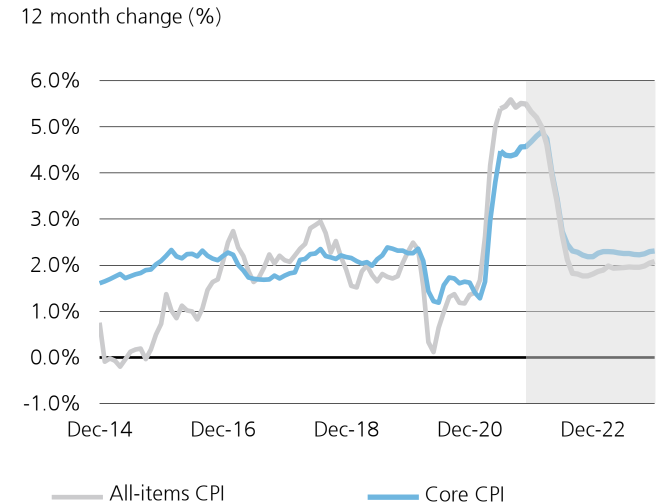
The 10-year US Treasury rate declined by 50bps from the start of 2Q21 to the writing of this piece (6 August 2021). The Federal Reserve continues to focus on payrolls and is putting little weight on the increase of COVID-19 Delta infections, given the increase in vaccinations leading to lower death rates. If payrolls continue to improve, the decision to reduce the Fed bond buying program is likely to come later this year.

Figure 2: Monthly job growth



Source: Moody's Analytics, as of 6 August 2021

Figure 3: Inflation forecast



Source: BLS; UBS, as of 3 August 2021. Shaded area indicates forecast.

Although employment gains have been strong in recent months, the overall number of jobs is still below pre-pandemic levels. Along with push back on low wages, there remains a higher exposure risk associated with customer and food service jobs. The monthly unemployment rate declined to 5.4% in July, after holding steady near 6% for six months (see Figure 2). Average hourly earnings increased by a solid 0.4% MoM. While childcare concerns have kept many from seeking employment, the general return to in-person schooling this fall and the expiration of the federal USD 300 unemployment bonus, should drive increased employment.

Rebuilding confidence in the economy will be a long process given the recent uptick in COVID-19 Delta variant cases. The UBS Knowledge Network expects that the peak of this new COVID-19 wave could be seen by early September 2021.

UBS is forecasting inflation to remain at elevated levels, above 4.5% (12-month rolling) until early spring of 2022, but then slowing in the second half of the year (see Figure 3). Any surprise inflation that is more than transitory will affect capex heavy real estate sectors/sub-segments that do not have clear increased demand drivers (i.e., traditional office and malls).

Investor confidence remains higher in the industrial and apartments sectors, given the persistent, necessity-driven tenant demand. In retail, office and hotels, constrained transactions, and higher capex burdens make it difficult to assess whether current risk premiums compensate adequately for the risk. We expect industrial and apartments to continue to outperform retail and office in 2021.

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