Since the onset of COVID-19, we have provided timely updates on the pandemic; however, given the strong progress of the U.S. vaccination program, many investors are now turning their attention to the future and focusing on a resumption of business as usual. While the markets will likely remain dynamic in their evolution around the pandemic, the following includes several of the issues we have contemplated recently that relate to the path ahead:

How are the supply chain challenges affecting the U.S. economy?

Supply chain disruptions continue to put upward pressure on prices in the United States. The most widely known gauge of U.S. inflation, the Consumer Price Index, remained at elevated levels through the end of August – rising 5.3% from the year prior. The recent spike in inflation has been a product of shortages in the supply of goods and labor running headlong with a recovery in demand. Supply chains have been negatively impacted by a myriad of factors since the onset of COVID-19, including production facility shutdowns, scarcity of raw materials for use in finished goods, shipping delays, and even extreme weather events.[1] While shortages are occurring in a wide range of goods and services, the semiconductor industry has remained in the headlines given its importance in the manufacturing of most consumer goods (e.g. motor vehicles, laptops, televisions) around the globe. On that front, many leading tech-sector CEOs are communicating that it will still take time before the situation normalizes, although things are improving.

What are the potential changes to capital gains and/or carried interest taxation?

Last week, the House Democrats introduced a flurry of tax hikes on corporations and individuals in an attempt to fund the roughly $3.5 trillion budget resolution. The new proposal features maximum corporate and individual tax rates of 26.5% and 39.6%, respectively. Further, the plan calls for a capital gains tax of 25% and a 3% surcharge on individual income over $5 million. As of this week, the proposal asks for investment funds to hold assets to five years, versus three years, to qualify for the carried interest tax break. The Democrat's plan proposes to use the new tax revenue to fund expanded childcare, paid leave, pre-K education, community college, public health insurance plans, household tax credits, and green energy, amongst other initiatives.[2] Early indications show resistance within the Democratic caucus that may result in a watered down plan for an amount well below $3.5 trillion, but House leaders are set to vote on the new tax and spending package before October 1st.[3]

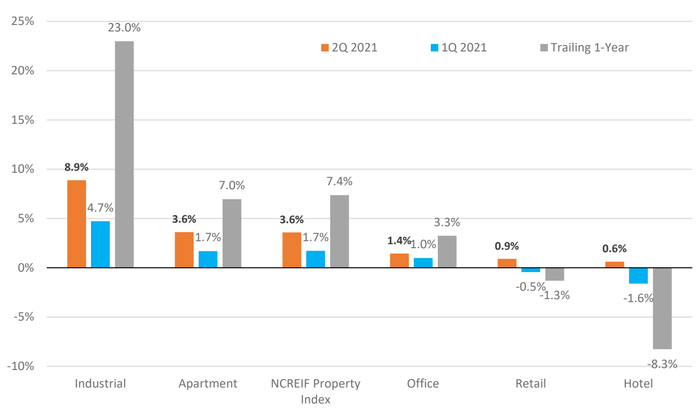
What is included in the proposed Infrastructure Investment and Jobs Act?

In early-August, the $1 trillion infrastructure package received bipartisan approval by the Senate. The bill is aimed at rebuilding the nation's aging roads, bridges, and railways as well as funding broadband and climate control measures.[4] Currently it awaits a key vote in the House of Representatives. If it passes in the House and is then signed into law by President Biden, the bill provides a rubberstamp to spending on existing federal programs, in addition to $550 billion to upgrade the nation's deteriorating transportation-related infrastructure and water, electric, and broadband utilities. From here, the proposal faces a perilous path in the House, but Speaker Pelosi has decided that the bill will not come to the floor until after the $3.5 trillion dollar budget reconciliation is signed into law. If passed, the Act would represent the most spending by the federal government on infrastructure in more than a decade.[5] According to analysis by The Wharton School at the University of Pennsylvania, GDP growth would remain unchanged in the intermediate- and long-term due to higher levels of deficit financing and its effects on reducing private capital investment.[6]

How have commercial real estate prices and transaction activity behaved so far this year?

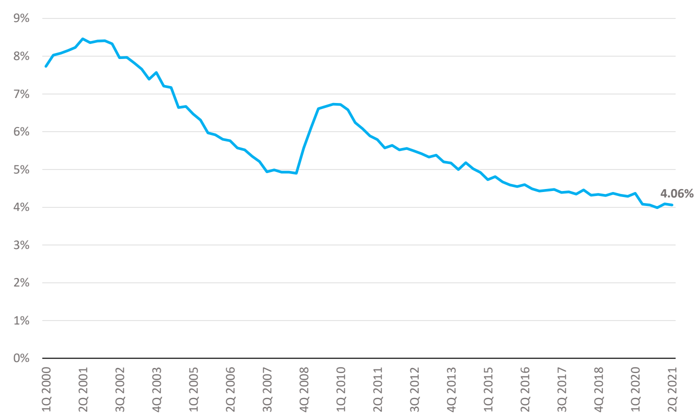
The NCREIF Property Index (NPI) gained 3.6% during the second quarter of 2021 and advanced 7.4% over the trailing 12-months. While all property sectors posted positive returns for the quarter, industrial rose 8.9% from the prior quarter, setting a new quarterly performance record for the property type (see Exhibit 1). Industrial's strong performance was driven by solid capital value growth and subsequently pushed prices up to levels now exceeding their pre-pandemic peak, with the sector gaining 23% over the past year.[7] Overall, the NPI's income return edged up during the quarter on continued improvement in rent collections.

Exhibit 1: Private Real Estate Total Return Performance



Source: NCREIF

Exhibit 2: NCREIF Appraisal Based Cap Rates



Source: NCREIF

Core cap rates fell to an average of 4.06% in the second quarter of 2021, a noteworthy 23 basis points below the pre-pandemic record lows at the end of 2019 (see Exhibit 2).[8] Capital flows have improved substantially since the depths of 2020, with transaction activity increasing 74% from a year ago. Investment volumes thus far in 2021 continue to favor the industrial and multi-family sectors, with the latter representing over one-third of aggregate transaction value on a year-to-date basis.[9] Interestingly, the office sector witnessed a renewed level of sales volume in August. Investors remain focused on suburban located assets versus CBD offices in light of the rise in the Delta variant; however, owners and buyers are beginning to make price concessions on both sides.

Notable Property Sector Updates

Industrial: As mentioned above, the industrial sector continues its strong pace of outperformance in 2021. Transaction activity in the sector has been red-hot, with total volume and portfolio sales increasing by 107% and 338% on a year-over-year basis, respectively. Yields were pushed even lower, with NCREIF reporting the lowest average cap rate for industrial properties on record at 3.89%. This comes on the heels of strong public and private institutional capital flows since the third quarter of 2020 from both U.S and international investors.

Multifamily: Within the multi-family sector, as people have migrated back to the largest coastal markets, those looking for apartments have found rent concessions are quickly being eliminated as strengthening rental prices follow suit. New York City leasing activity has seen a substantial increase through the summer months, driven by renewed demand from recent college graduates and young professionals. For instance, the number of available units declined 38% in June from the month prior and overall inventory has been more than halved since the start of the year, according to Miller Samuel Inc. and Douglas Elliman.

Office: Last week, Google announced that it will be purchasing a new Manhattan office building for $2.1 billion, signaling resilient demand from the tech giants for office space despite many of these companies having embraced a hybrid working model. The deal represents the highest sale price for a single U.S. office building since the start of the pandemic. Throughout the pandemic, technology companies have been using the large cash positions on their balance sheets to take advantage of the decline in office building asset values.[10]

Retail: While headwinds continue to test retail on a secular level, the pandemic has produced varying results for the different pockets within the sector. Deal activity was robust for grocery-anchored shopping centers, up 219% from a year ago.[11] Other types of retail saw a steep decline in transactions, particularly malls and lifestyle centers, as the pandemic has only accelerated the velocity of E-Commerce's cannibalization of most other retail typesets. That said, retail is performing better than expected at this stage of the recovery in aggregate.

Concluding Thoughts

The pace of capital investment in real estate continues to achieve new heights. With many traditional investment securities providing low yields relative to historical levels, commercial real estate remains a strong candidate for re-allocations in many institutional portfolios. So far in 2021, capital flows have pushed sectors with the best long-term prospects to record levels, such as industrial and multi-family. These sectors represent two of our strongest opportunities, to which we have committed billions of dollars in new investment since the start of the COVID-19 pandemic. We believe the long-term opportunity in commercial real estate remains extremely compelling and our focus is on sharp execution around enduring secular trends combined with a highly selective and pragmatic approach.

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Disclosures