Real Estate Outlook

US – Edition 4, 2021

Harvesting growth.

UBS

UBS Asset Management

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US outlook

Frosty nights and sunny days.

US GDP has exceeded pre-pandemic levels, although cooling somewhat during third quarter. Continued healthy growth is anticipated into the new year. The apartment and industrial sectors continue to outperform and the retail sector is on the mend. However, office sector performance is causing concern.

Market overview and outlook

Autumn's harvest bears fruit.

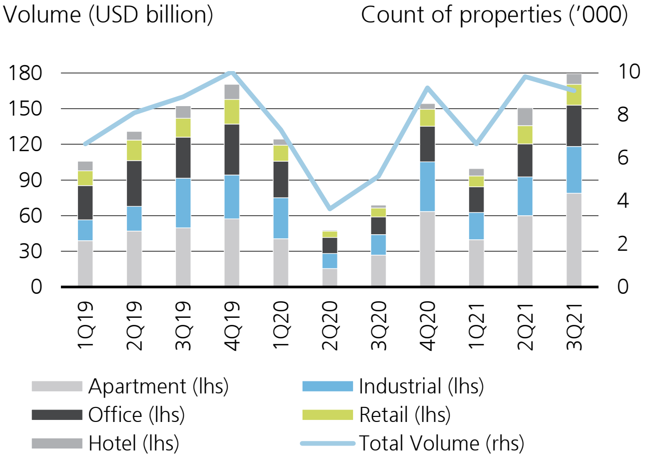
The NCREIF-ODCE Fund Index saw a positive total return of 6.6% for the quarter – the highest quarterly total return on record – and 14.6% for the year ending 3Q21. With the exception of hotels, all sectors experienced positive quarterly returns in 3Q21. This was largely driven by record industrial appreciation returns.

Multifamily and industrial continue to post outsized returns relative to the other sectors. However, fundamentals within the strip-center component of retail seem to have bottomed out as demand for restaurants and health/fitness services has increased. Green Street reported positive revisions to year-end public strip-center REITs NOI/FFO guidance. Office demand continues to be in question and may push more investors to price a premium on higher quality (i.e., newer product) and well-located assets in a *flight-to-quality* movement.

The primary property sectors all saw total returns on an annual basis accelerate over the quarter (see Figure 2). Industrial returns continue to exceed the other sectors, accelerating to nearly triple that of one year ago. Office returns have maintained modest improvement. Retail returns turned positive for the first time since 2Q19. Apartment returns accelerated to the highest level since 2016. At the market level we forecast a strong growth pace for industrial and apartment returns, but modest performance for office and retail for 2021 overall.

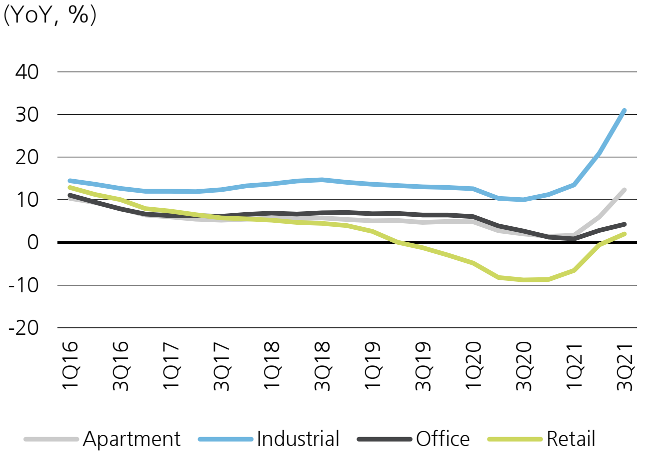
Apartments: Demand set new records in 3Q21, pushing vacancy down to 2.9% and rent growth up to 6.2% QoQ, according to CBRE-EA. We expect the pace of construction to accelerate in the coming quarters, normalizing vacancy rates and rent growth.

Figure 1: Transaction activity



Source: Real Capital Analytics as of September 2021, totals include entity sales and are not adjusted for seasonality.

Figure 2: Total returns at property level for ODCE funds



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

Transaction volume in 3Q21 (measured in USD) exceeded that of both the third and fourth quarters of 2019, driven by apartment trades. A modest decrease in the number of properties traded overall indicates a general rise in pricing (see Figure 1). Investors are taking advantage of increased market liquidity to update portfolio positioning.

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.

Industrial: Rolling annual completions remain near 2% of stock, yet availability continues to decline. Rent growth remains strong, at 4.4% in the year ending 3Q21, according to CBRE-EA.

Office: Total vacancy continues to rise, reaching 16.8% in 3Q21. Development has not slowed and asking rent declines are forecast to continue through mid-2023.

Retail: The most vulnerable businesses are those unable to adapt to online or app-based strategies. Neighborhood & community center availability is down by 50bps for the quarter to 8.3% as of 3Q21 according to CBRE-EA, while rent growth remains positive.

Strategy viewpoint

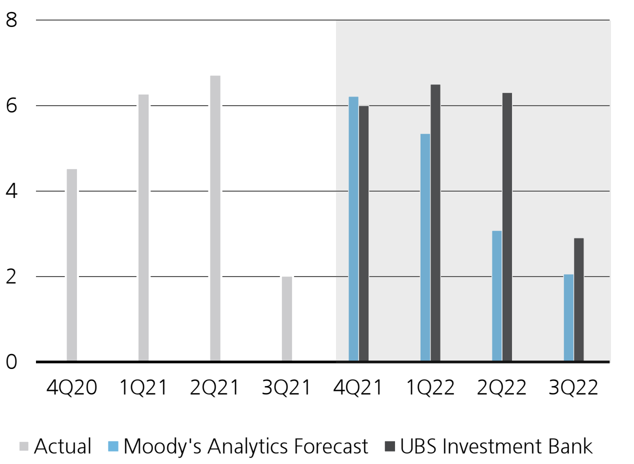
Cold winds, slow growth.

The US economy saw strong recovery growth throughout the first half of the year, exceeding the pre-pandemic GDP level by 2Q21. GDP growth in 3Q21 fell short of forecasts, reaching 2.0% annualized but is expected to pick back up at year-end (see Figure 3).

Effects of COVID-19 are continuing to moderate since a peak of US hospitalizations was reached in early September as new approvals for vaccinations for 5-11 year olds (9% of the population) were approved by the FDA on 29 October 2021. Seven-day moving average levels of booster shots surpassed first and second dose vaccine administration, and are expected to continue to outpace them.

UBS Investment Bank is projecting US GDP growth to deliver strong above-trend growth over the next few years driven by accommodative monetary policy, continued recovery in employment, healthy household balance sheets with pent-up savings, and further fiscal stimulus (see Figure 3). The October jobs report posted an increase of 531,000 in employment and strong revisions for August and September to much higher levels (483,000 and 312,000, respectively).

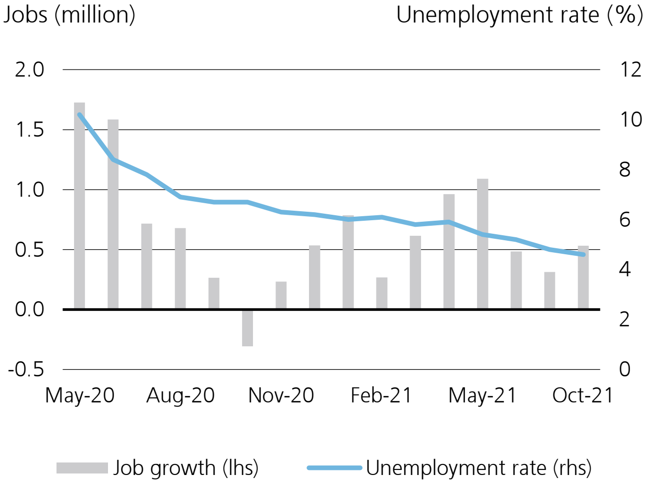
Figure 3: GDP quarterly annualized forecast (%)



Source: Actual from Moody's Analytics, 28 October 2021; Moody's Analytics forecast, 11 October 2021; UBS Investment Bank forecast, 8 October 2021. Shaded area indicates forecast data.

The monthly unemployment rate declined to 4.6% in October (see Figure 4), after holding steady near 6% throughout the first half of the year. As of 3Q21, the labor force participation rate remained 160bps below the 4Q19 peak; with more than four million fewer jobs than at the end of 2019.

Figure 4: Monthly job growth and unemployment rate



Source: Moody's Analytics, 5 November 2021

The US is experiencing faster job growth and more fiscal stimulus is being considered via the Infrastructure Investment and Jobs Act and the Build Back Better program. The market is still pricing a Fed driven interest rate hike in 3Q22 at the earliest.

The Fed continues to label the current inflationary environment as transitory, but may reassess if 4Q21 levels are above expectations. We continue to believe any surprise inflation that is more than transitory will affect capex heavy real estate sectors/sub-segments that do not have clear 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 premiums compensate adequately for the risk.

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