February 2, 2022

REAL ESTATE

Real Estate Investment Strategy Quarterly

Our Outlook and Forecasts for 2022

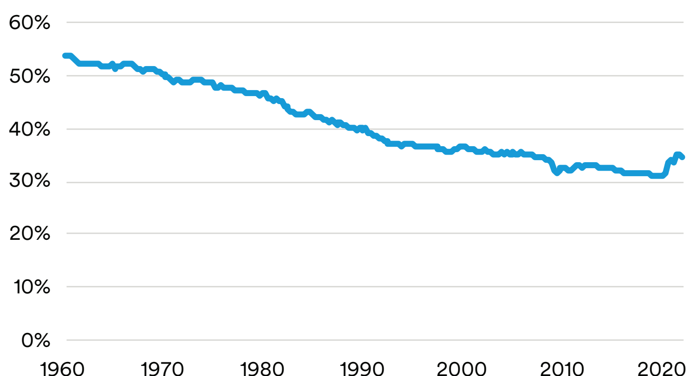
- We expect commercial real estate values to rise 11% in 2022, as measured by the NCREIF Market Value Index.
- Inflation is likely to remain above the Fed's 2% target in 2022. Apartment and hotel assets may capture inflationary impact on rents more quickly than the other core property types, but also may be more exposed to rising operating expenses.
- Given the unique nature of the 2020 recession and 2021 recovery, we believe the economy may be closer to a mid-cycle than early recovery period, and that interest rates could therefore hit their cyclical peak in 2022.
- Investor competition is particularly strong today for certain markets and property types, potentially creating attractive investment opportunities in some of the out of favor market segments.

MetLife Investment Management

2022 Outlook

We believe the four most important economic drivers for real estate in 2022 will be government responses to COVID-19 variants, labor force participation, supply chain disruptions, and inflation.

Exhibit 1: Share of Consumer Spending on Goods



Sources: MIM, BEA. January 2022.

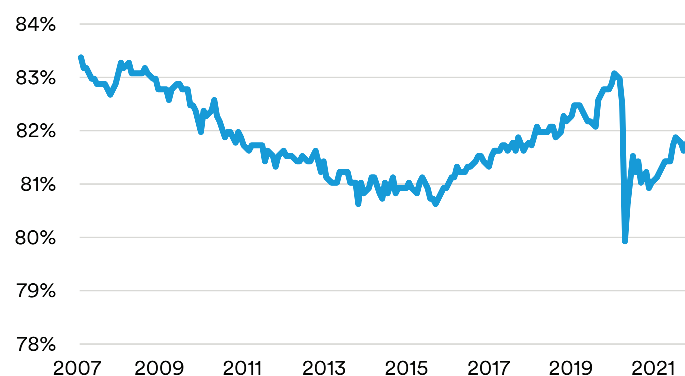
The Omicron and Delta variants have been reminders that a full resolution of COVID may or may not be in sight, and uncertainty regarding the future impact of COVID on the economy and real estate markets persists. On the bright side, we now have a much clearer roadmap for pandemics than was the case in 2019. Hotels, and specifically full service hotels catering to business or group travel, have the highest risk from future COVID variants. This is followed by the office and retail sectors, while the warehouse and residential sectors were generally unaffected or even benefited from responses to the pandemic.

Supply chain disruptions and labor shortages are two residual hangovers from the early months of COVID that have yet to resolve. In terms of supply chain disruptions, the production and movement of goods stalled during the pandemic, and subsequent COVID waves have made it difficult to get global supply chains fully back online. Additionally, a shift in consumer spending towards goods, and away from services, has further complicated the issue (Exhibit 1).

Labor market conditions, as measured by the unemployment rate, are now more akin to a mid- or late-cycle period than the start of a recovery. The unemployment rate sits at 3.9%, and there is now less than one unemployed person available per every job opening.[1] Our outlook for the unemployment rate, as well as other economic and real estate market indicators, is summarized in exhibit 7.

While the unemployment rate is near a historically low level, that figure does not account for individuals who have, for one reason or another, left the labor force. The labor force participation rate has yet to recover pre-COVID levels, and there are nearly 4 million fewer employed workers than there were prior to the pandemic (Exhibit 2).[2]

Exhibit 2: Labor Force Participation Rate (Prime Age Workers)



Sources: MIM, FRED. January 2022.
Prime age defined as 25-54.

It is not immediately clear why workers are remaining on the sidelines. Six months ago, we believed government subsidies to the unemployed may have played a bigger role, but as those subsidies have gone away, and labor force participation has remained low, the picture is less clear. Regardless, even if the participation rate were to begin sharply rising in 2022, the unemployment rate and job openings rate is strong enough that we would still expect tight labor market conditions. As a result, we expect wage growth to remain high, which could contribute to more persistent inflation.

We are expecting inflation to moderate from the 2021 peak of 7.0%[3], but to remain elevated near 3% by year-end 2022. Beyond 2022, our base case view is not that inflation will run significantly above 2% for a prolonged period, but we acknowledge that the chance it does has grown. How should investors think about navigating a potentially higher inflationary environment in the near-to-medium term?

Inflation Impacts Across the Real Estate Sector

As we pointed out in *Two Steps Forward, One Step Back*, real estate investors generally have less to worry about during a bout of higher inflation than investors in other sectors. We also mentioned that an increase in the outlook for inflation would lead us to increase our expectations for real estate returns.

Over the long term, meaning at least seven years, we believe all the core property types are approximately equally well hedged against inflation. That being said, there are considerations across markets and property types that may cause inflation to not be realized equally in the short term. Specifically, we believe apartments and hotels are more sensitive to short-term inflation impacts, both in terms of revenue and expenses.

In terms of revenue, apartments and hotels have shorter lease terms – one day for hotels, and one year for apartments, shorter than the 5+ year leases that are typical in other property types. As such, individual apartments and hotel assets can more immediately capture rising market rents in a higher inflationary environment.

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In terms of expense growth, apartments and hotels also have relatively high operating expense ratios compared to the other core property types, and unlike retail, office, and industrial assets, owners of apartments and hotels are generally responsible for paying operating expenses (many industrial, office, and retail leases make expenses like property taxes the responsibility of the tenant, for instance).

Due to the fundamentals supporting the economy today, we believe the ability of apartments and hotels to quickly capture rising market rents will more than offset the negative impacts of rising operating expenses. However, we believe that the real estate investment industry has a long-held practice of underwriting a fixed rate of operating expense growth, regardless of shifts in the macroeconomic picture. This could lead to misallocations of capital and incorrect estimates of returns, to both the upside and the downside.

Underwriting a fixed rate of expense growth has been industry standard for several decades, but we believe the current environment requires deviation from that approach. More careful underwriting of expense growth could offer buyers (and sellers) of commercial real estate both tactical pricing opportunities and risk mitigation strategies in 2022.

For Class A apartment and hotel assets (both full service and limited service hotels), payroll and other labor-related costs account for a significant share of operating expenses. In our view, markets with an unemployment rate below its historical average (where availability of labor is lower, and thus wage growth may be higher) could see operating expenses run higher than the 3% level that many market participates and appraisers are underwriting today.

Examples of apartment and hotel markets where underwriting 4% or 5% operating expense growth in 2022 may be appropriate include Atlanta, Charlotte, and Portland. On the contrary, market participants in metros with a higher unemployment rate may be overly conservative in underwriting that level of expense growth in the near term. In markets such as Los Angeles, New York, and Houston, 3% or even 2.5% expense growth may be appropriate.

Capital Markets Outlook

We believe that capital market conditions will be especially sensitive to Fed Chair Powell's comments on inflation during 2022. The Fed has taken a more hawkish stance on inflation in recent months, retiring the word "transitory" and acknowledging it has become more widespread outside of base effects and supply chain issues.

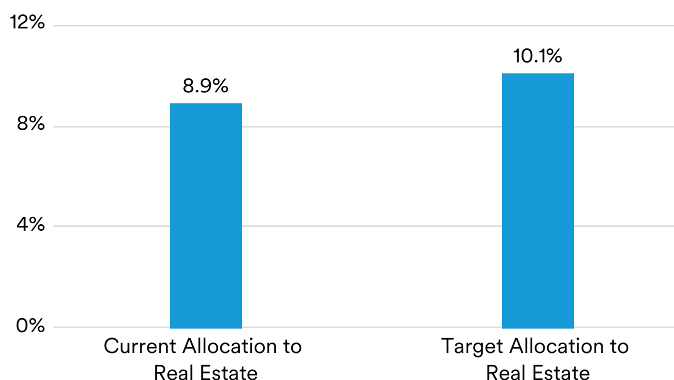
We expect the Fed to complete the wind down of its asset purchase program by mid-2022 and are anticipating two, 25-bp hikes to the policy rate. We acknowledge there is upside risk to the forecast for two rate hikes this year, but also believe lingering COVID-related economic uncertainty could lead the Fed to raise rates slower than the market consensus view of three to four rate hikes.

Despite our expectation for two rate hikes, we are not expecting a significant change in the 10-year Treasury rate during the year. We believe the 10-year rate will end 2022 at 2.0%, not far off from where it is today.[4] The reason for that is due in part to the rapid nature

of the COVID downturn and equally rapid recovery. With the labor market now near "full employment," we may be closer to a mid-cycle environment, which has historically been when long rates remain stable, and the yield curve begins to flatten. As such, the 10-year Treasury rate may be near a cyclical peak. This has implications for real estate investment strategies.

For one, although we are still recommending a "risk on" stance for real estate investments (which we outlined in greater detail in *Two Steps Forward, One Step Back*), we expect cap rates to compress from 3.9% in 2021 to 3.8% (as measured by NCREIF) during 2022.[5] If that occurs, and if rates rise as we expect, then we may change to a neutral risk recommendation during the year. In the meantime, we believe investors still can find attractive investment opportunities with reasonably conservative underwriting.

Exhibit 3: Current and Target Allocations to CRE



Sources: PREA Investor Intentions Survey. January 2022.
Based on global investment managers/strategies.

As mentioned above, higher inflation is generally positive for real estate income growth, and we believe many market participants have not yet recognized the accelerating inflation in their rent growth forecasts. Additionally, if the risks of COVID continue to dissipate, and as the current cycle matures, risk premiums should compress across all asset classes, including commercial real estate.

In part due to this cap rate compression, we expect commercial real estate prices to increase by 11% in 2022, well above the 4.0% annual average from 2000-2021, but below the record-breaking 14% growth in 2021 (all figures as measured by NCREIF Market Value Index).[6]

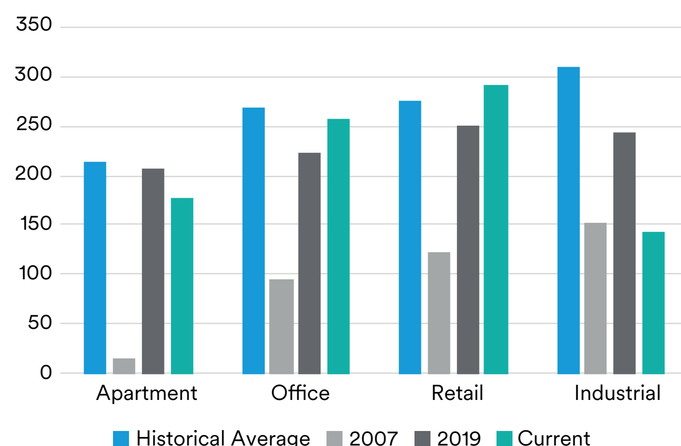
In terms of transaction activity, 2021 volume was a banner year, with volume 34% above 2019 levels.[7] Given the positive outlook for commercial real estate performance, and the fact that many institutional investors remain under-allocated to the asset class (Exhibit 3), we expect 2022 volume to exceed the 2021 level by around 10%.

While we have a positive view on overall capital market conditions, fundamentals and pricing across property types are worth additional consideration.

Current Pricing and Outlook by Property Type

COVID-19 caused some of the most divergent performance between markets and property types since commercial real estate tracking and benchmarking records began in the 1970s. As a result, investors have repriced both risk and the outlook for rent growth. This has driven cap rates to the lowest levels ever recorded for a number of property types. The 8 trillion-dollar question then becomes, are all these cap rates justified, or are we entering a period of irrational exuberance?

Exhibit 4: Cap Rate Spread to 10-yr Treasury



Sources: MIM, NCREIF. January 2022.

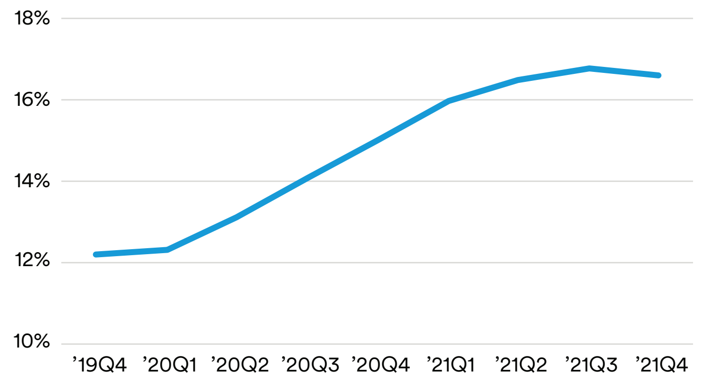
Before 2021, investors in the apartment sector were not used to seeing cap rates led by the number "3". This has caused consternation among industry participants that values could be negatively impacted in a rising interest rate environment. An evaluation of historical cap rate spreads, however, presents a somewhat different picture.

Exhibit 4 shows historical apartment cap rates spreads to the 10-year Treasury. The data indicates that apartment cap rate spreads are only modestly below their historical average, even though the outlook for apartment rent growth is more favorable than what could be characterized as "normal conditions." We believe that apartment cap rates as measured by NCREIF could fall from 3.7% as of 4Q 2021 to around 3.4% by year-end 2022, even as interest rates modestly rise.[8]

Although we expect rent growth to be strong over the next several years, in recent months we have observed participants in some markets underwriting higher apartment rent growth through entire 10-year holding periods. This is most prevalent in a few U.S. Sunbelt markets such as Nashville, Tampa, and Phoenix, where these forecasts have driven cap rates to close to 100 bps below the market's historical average.[9] Although this 100-bps spread still represents "fair pricing," given how strong we think rent growth will be in the near term, we think some of these investors may be disappointed by their underwriting later in the decade. Additionally, any further spread compression in these high-growth markets could cause us to be increasingly selective and risk-averse when considering new investments.

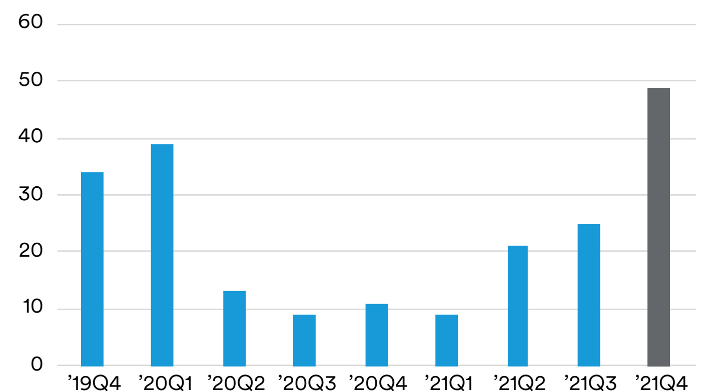
Unlike the other major property types, industrial cap rate spreads are now well below their historical average. This is unsurprising given the fact that the sector is still benefiting from an e-commerce related secular shift, and virtually all U.S. geographies are experiencing positive rent growth despite high levels of new construction. In our view, industrial demand growth as a result of e-commerce is still several years away from a steady state. We believe this helps alleviate uncertainty around the outlook for market rent growth and helps justify a tighter cap rate spread.

Exhibit 5: Office Vacancy Rate



Sources: MIM, CBRE-EA. January 2022.

Exhibit 6: Number of Markets With Vacancy Declines



Sources: MIM, CBRE-EA. January 2022.

To put a number to it, we believe industrial assets would still be fairly-priced if cap rate spreads compress by an additional 30-40 bps. As such, we expect industrial cap rates as measured by NCREIF to fall from 3.3% as of 4Q 2021 to 3.0% by year-end 2022.[10]

Uncertainty persists in the office and retail sectors. Despite wide cap rate spreads for these property types, we are not expecting significant cap rate compression in 2022. Due largely to companies embracing remote working, our view for the office sector remains that vacancy will not peak until mid-2022. As of this writing, preliminary data from CBRE-EA shows stronger-than-expected office leasing during 4Q 2021 (Exhibit 5), suggesting upside risk to our forecast.[11]

Moving to the last of the major property types, hotels are currently offering returns akin to the highest risk sectors such as super regional malls, but with a risk profile more akin to the apartment or industrial sectors, in our view. That is because we believe current market underwriting suggests a recovery to pre-COVID hotel RevPAR by 2024 or 2025, whereas we expect the recovery to largely occur by the end of this year. The most significant downside risk to the hotel sector is a new COVID variant that causes the types of lockdowns that were experienced in early 2020. However, restrictive lockdowns seem less likely with each successive COVID wave.

Lastly, we expect alternative property types to receive more attention from institutional investors during 2022. We expect to see the most growth in single family rentals, life science, and net lease retail assets. Investor interest may also grow in cellular towers, cold storage, manufactured housing, and seniors housing.

Conclusion

The outlook for the U.S. economy and commercial real estate markets is positive, despite the risks that have arisen in recent weeks. We believe the commercial real estate sector continues to offer investors an effective inflation hedge, with the apartment sector potentially the most well-suited for this role. While cap rates in some market and property type combinations have raised caution flags as of late, MIM's analysis suggests that overall market conditions remain favorable for investment. Cap rates have tightened, but in general, we believe real estate remains fairly priced. Exhibit 7 contains our primary forecasts for the year.

Exhibit 7: Forecast Summary

	2021	2022 Projection
GDP Growth	5.5%	3.8%
CPI	7.1%	2.7%
Unemployment Rate	3.9%	3.9%
10yr Treasury Rate	1.5%	2.0%
NCREIF Market Value Index	14%	11%
Apartment Cap Rate	3.7%	3.4%
Industrial Cap Rate	3.3%	3.0%
Office Cap Rate	4.3%	4.3%
Retail Cap Rate	4.9%	4.9%
Transaction Volume	$808B	$890B

Sources: MIM, NCREIF, Census, Moody's, RCA, BEA

Endnotes

1. BLS. January 2022.
2. Ibid.
3. Ibid.
4. Bloomberg. January 2022.
5. MIM forecast of NCREIF cap rate level. January 2022.
6. Ibid.
7. RCA. January 2022.
8. MIM forecast of NCREIF cap rate level. January 2022.
9. MIM, NCREIF, Green Street Advisors. January 2022.
10. MIM forecast of NCREIF cap rate level. January 2022.
11. CBRE-EA. 4Q2021.

MetLife Investment Management Real Estate Research and Strategy

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[2] As of September 30, 2021. At estimated fair value. Represents the value of all commercial mortgage loans and real estate equity managed by MIM, presented on the basis of gross market value (inclusive of encumbering debt).

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