Real Estate Outlook

US – Edition 2, 2022

Increasing crosscurrents.

UBS

UBS Asset Management

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US outlook

A strong economy facing headwinds.

Growing economic uncertainty based on weaker consumer sentiment and inflation concerns increases the importance of focusing on durable income growth across real estate sectors, metros, and product types. Continued strong industrial and apartment return performance is anticipated, but at a lower margin than 2021, given interest rate pressures. We expect a deteriorating performance for office and a gradual strengthening in retail performance through 2022.

Market overview and outlook

The difference one quarter can make.

Commercial real estate

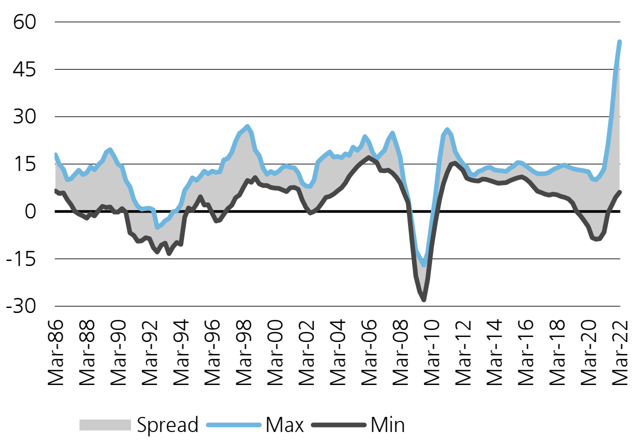
Our first edition of the 2022 Real Estate Outlook saw few signs of the economy slowing. Corporate earnings were healthy, employment was reaching pre-pandemic levels, reasonable wage growth was present, and the supply chain issues were largely unwinding. In one quarter, commodity and energy prices spiked due to the Ukraine war, the geo-political framework is being questioned as it relates to powerful trade blocs and national security, and now the prospect of a *soft-landing* seems unlikely without the right amount of fiscal planning and support. As other asset classes experienced losses year-to-date, the first quarter commercial real estate data came in strong, bringing the one-year total return to 28.5% – the highest on record for the NFI-ODCE.

In this new era of macro volatility, public markets can warrant concern as a useful leading indicator but can also give false signals based on short-term volatility. Fundamentals, in general, for real estate are still strong as of the writing of this piece (May 2022), but the growing disconnect between public and private market values has inspired added caution. Dispersion among the traditional sector total returns are at the highest levels since the inception of the NPI (four times the average spread of 10%) driven primarily by the industrial sector.

Private real estate has been able to absorb the shock to the risk premium spreads caused by the Fed's hastened plans of tightening. Sectors with relatively strong growth prospects, such as industrial and apartments, trade at a third of their 15-year average spread to treasury, 93 and 88bps respectively (see Figure 1). The other sectors are at roughly half of the 15-year average spread (below 200bps) except for non-mall retail (227bps). In some cases, depending on the metro and product type, cap rates are now lower than secured debt costs (see Figure 2) which means positive gearing will rely on growing the income.

Growing economic uncertainty, based on weaker consumer sentiment and inflation concerns, increases the importance of focusing on durable income growth in sectors, metros, and product types.

Figure 1: Sector dispersion – total return (%YoY)



Source: NCREIF as of March 2022. Past performance is not a guarantee for future results.

According to Real Capital Analytics, transaction volume in 1Q22 was USD 170 billion (including entity transactions), which represents a 56% increase in volume from 1Q21. Apartment trades still represent the largest block of volume at USD 63 billion, but the highest growth was exhibited by the retail sector. Retail transaction volume grew by 102% year-over-year. However, rising rates will undoubtedly temper the outsized growth in overall transaction volume going forward. The trailing twelve-month total volume of USD 913 billion as of 1Q22 may well be the peak in transactions for some time.

Figure 2: Initial yield by asset class and real estate sector

Asset class or real estate sector	Initial yield (%)
Non-mall retail	5.2
Baa Corporate Bond	5.2
S&P 500	4.9
Suburban office	4.8
Mall	4.6
All property	4.2
CBD office	4.1
Industrial	3.9
Apartments	3.8
10-year US Treasury	2.9

Source: NCREIF, Moodys, multpl.com (S&P 500 initial yield is inverse of TTM PE Ratio). Past performance is not a guarantee for future results.

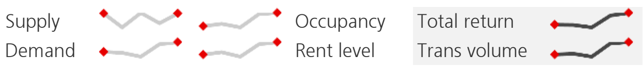
Primary sector review

Figure 3: Sector forecast

%	Rent Growth					Cap Rates					Total Returns				
	2019	2020	2021	2022 forecast	3-yr forecast	2019	2020	2021	2022 forecast	3-yr forecast	2019	2020	2021	2022 forecast	3-yr forecast
Apartment	2.8	(1.1)	13.7	8.0	4.8	4.2	3.5	3.6	3.6	3.6	5.5	1.8	19.9	12.0	8.4
Industrial	2.4	3.3	6.8	6.0	4.5	4.4	4.2	3.2	3.1	3.1	13.4	11.8	43.3	15.7	10.4
Office	2.6	(0.6)	0.1	0.2	0.4	4.1	4.2	4.1	4.1	4.1	6.6	1.6	6.1	4.3	4.8
Retail	1.1	1.2	1.7	2.7	2.2	4.6	4.1	4.8	4.9	4.9	1.9	(7.5)	4.2	4.6	5.4

Source: REPM forecast model as of February 2022. Past / expected performance is not a guarantee for future results.

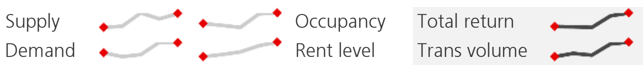
Apartments



As the sparklines above indicate, the pace of apartment supply growth is in line with that of 2018, while the pace of demand has accelerated. As a consequence, occupancy and rent growth have gained strength. Our forecast model anticipates rent growth to average 4.8% over the next three years (see Figure 3); steady performance just above the long-term average.

The apartment sector delivered an annual total return of 19.9% in the year ending 1Q22 – the highest since 1980. Transaction volume is typically down in the first quarter, as such 1Q22 transaction volume was about 60% below the record setting 4Q21 volume; the per unit price has risen sharply since mid-2020.

Industrial



The industrial sector saw an unprecedented 51.9% annual total return in 1Q22, proving out expectations that supply chain disruptions and logistics challenges would be no match for sustained customer demand. Persistent demand has been more than a match for near constant completions and occupancy continues to rise.

Our forecast model supports continued above average rent growth (see Figure 3), the three-year forecast averaging 4.5% annually. The sparkline table above illustrates that 2020 ultimately had minimum impact on this rising sector. Growth trends established in 2018 and 2019 have sustained, and in some cases accelerated, into first quarter 2022.

Office

Office sector fundamentals are struggling for consistent and sustainable strength. Although office asking rents have not experienced a prolonged drop, neither has the sector seen clear upward momentum (see Figure 3). Our forecast model calculates near zero-average rent growth over the next three years. The office sector is pushing hard for growth and recovery, but has only managed to match 2019 returns.

The pace of 1Q22 office transactions stands at half that seen in 4Q21. However, the sector price per square foot was held steady by a balance between the decline in CBD values and the rise in suburban values. We expect structural vacancy to be higher and capital expenditures to continue to grow as landlords compete for a shrinking office-using workforce that will require higher standards of sustainability and quality of occupants' health.

Retail

Demand experienced a rebound in 2021, while the pace of supply continued to diminish, driving a sharp rise in both occupancy and rent growth. Our forecast model (see Figure 3) anticipates retail rent growth annual average of 2.2% over the next three years; a healthy pace, above the 1.4% 10-year average.

The sparklines above show total return improving as the negative quarterly returns in 2020 fall from the one-year calculation, with 4.2% annual return in 1Q22. Transaction volume has recovered to the 2018 level with an incremental increase to the per square foot average price.

Sparklines: Data shown is year-end 2018 through 2021, and year-over-year 1Q22. Horizontal axis only shown if there are negative datapoints. Supply, demand, occupancy, rent: CBRE-EA as of March 2022
Transaction volume: Real Capital Analytics as of March 2022
Total Return: NCREIF as of March 2022. Data show unlevered NCREIF Property Index total returns. Past / expected performance is not indicative of future results.

Selected niche sectors

Self-Storage

Self-storage fundamentals remain strong. The sector continues to benefit from pandemic-related demand drivers, such as remote workers becoming first-time storage users and looking to create space for their home offices. Occupancy rates are near record highs, at 96% as of 4Q21.

New deliveries slowed in 2021 due to delays from labor shortages and increasing construction costs. A moderate supply pipeline is expected to continue through 2022 due to further delays. Tight market conditions coupled with a postponed construction pipeline accelerated same-store NOI growth, which grew 17% in 2021.

The near-term outlook for the sector is strong given positive tailwinds from relocation and working from home, but some moderation in the outer years is expected as supply ramps up again.

Cold storage

The cold storage sector faces long-term tailwinds amid near-term headwinds. The COVID-19 pandemic spurred a change in consumer behavior towards online grocery consumption.

Although e-commerce sales as a share class of total retail sales moderated between 2020 and 2021 from 13.6-13.2%, grocery online penetration captured more market share, expanding from 8.7-9.6% within the same period. Over the long term, we expect increasing grocery online penetration to drive additional demand for cold storage.

Despite this long-term trend, the sector faces existing challenges from reduced food production volumes, which has dragged occupancy levels, and increased power and labor costs, which are eating into margins. Landlords will benefit from triple-net lease structures to reduce inflationary risk.

Senior housing

Senior housing market fundamentals are recovering from pandemic disruptions. According to NIC MAP, occupancy rates in primary markets improved to 80.6% in 1Q22, a 20bps increase from a quarter ago, and a 250bps jump from a pandemic-low in 2Q21.

Rents have also accelerated, growing 3.3% over the trailing year. The sector faces strong tailwinds from the aging baby-boomers. Over the next 10 years, robust population growth among the 80-plus cohort is expected to drive significant demand for senior housing and the pace of development will need to ramp up to meet this demand.

Life sciences

The life science sector is quickly gaining ground as an attractive alternative to conventional office. The sector's physical space is a key component to research and development (R&D) operations, making life science resistant to work-from-home headwinds.

Additionally, increasing venture capital funding towards R&D within the biotechnology and pharmaceutical industries is driving strong sector fundamentals. Vacancy rates dropped 30bps to 5.3% in 1Q22, and high barriers to entry within key cluster markets (i.e. Boston, San Francisco) will further contribute to tight market conditions.

Strategy viewpoint

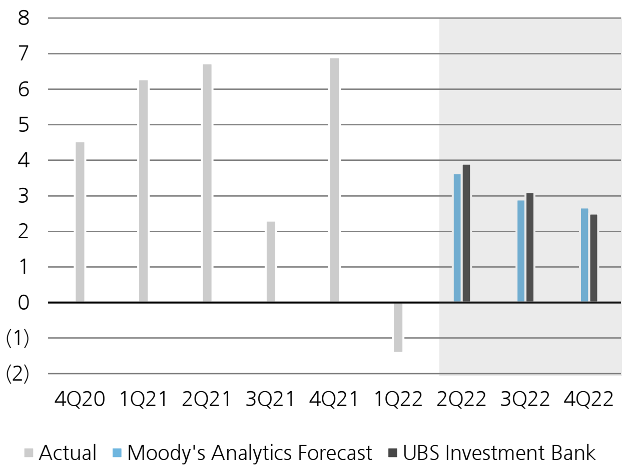
Uncertainty looms.

Economic viewpoint

The US economy contracted in the first quarter, as a widened trade deficit and slowdown in inventory investment weighed on output. GDP shrank at a 1.4% annualized rate in 1Q22 (see Figure 4), a sudden turnaround from a 6.9% expansion in 4Q21. The first quarter posted the weakest GDP growth since the pandemic-induced recession in 2Q20. The increased trade deficit masked the acceleration in consumer and business spending. Domestic demand remained strong despite soaring prices.

At the market level, we anticipate continued strong performance for industrial and apartment returns, but at a lower margin than 2021, given interest rate pressures. We expect deteriorating performance for office and a slow strengthening in performance, albeit from a low base, in retail through 2022.

Figure 4: Real GDP quarterly annualized forecast (%)

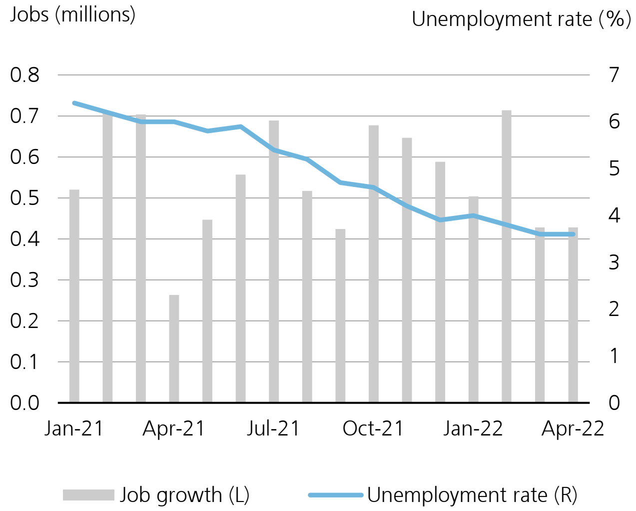


Source: Actual Moody's Analytics as of 28 April 2022; Moody's Analytics forecast as of 9 May 2022; UBS Investment Bank forecast as of 29 April 2022. Shaded area indicates forecast data.

UBS Global Banking Research expects US real GDP growth to rebound in 2022, finishing the year off at a solid annual pace of 2.0%. The expectation of a rapid rebound in the second quarter is being driven by strong momentum from private domestic demand, a shift in consumer spending towards services, and a continued strong labor market.

April's jobs report posted an increase of 428,000 employed and moderate revisions for February and March by a combined 39,000 jobs to 714,000 and 428,000, respectively (see Figure 5). The monthly unemployment rate held steady at 3.6% in April, matching December 2019's rate. As of April 2022, the labor force participation rate remains 120bps below the February 2020 peak, with 475,000 fewer jobs than at the end of 2019.

Figure 5: Monthly job growth



Source: Moody's Analytics as of 6 May 2022

Despite a positive base case scenario, talks of a recession are sweeping the market as uncertainties surrounding the effects of a higher policy rate loom. With prices continuing to soar, the Fed has signaled plans for multiple rate hikes this year. In an attempt to combat inflation, the Fed runs the risk of overcorrecting and sparking a recession. The Fed also faces the challenge of tackling elevated prices amid the Ukraine War, which is an external factor that is driving up food and oil prices.

If the Fed is unable to slow inflation, the US economy could enter stagflation – a period of simultaneously stagnant economic growth and high inflation. Even with these uncertainties, UBS Global Banking Research's leading predictor model signals that there is currently a low (30%) chance of a recession within the next year.

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