REAL ESTATE

U.S. Real Estate Market Outlook

Lifting Fog

January 31, 2024

Executive Summary

- We believe private commercial real estate prices may be near or past the trough, following the October trough in the public REIT sector.
- We believe all property types will benefit from a moderating construction pipeline in the coming years, though office and some pockets of multifamily will work through vacancy challenges in 2024.
- Real estate cap rates / required returns are stabilizing (and possibly modestly declining), while real estate fundamentals are moderating. As such, the start of the next cycle could be less "V-shaped" than a traditional real estate recovery in our view.

MetLife Investment Management

A Clearer (and Possibly Brighter) Economic Outlook

At the start of 2023, economists believed there was a 63% probability that a recession would occur during the year (many estimated that the U.S. was already in a recession).[i] The path of inflation was uncertain, as was the impact of higher interest rates on consumers and U.S. businesses. The war in Ukraine was also relatively new, causing heightened geopolitical uncertainty and energy market volatility, further pressuring economic growth.

Today, progress on inflation and the associated monetary policy implications point towards a clearer, if not improving, economic outlook for 2024, relative to where we sat at the start of 2023.

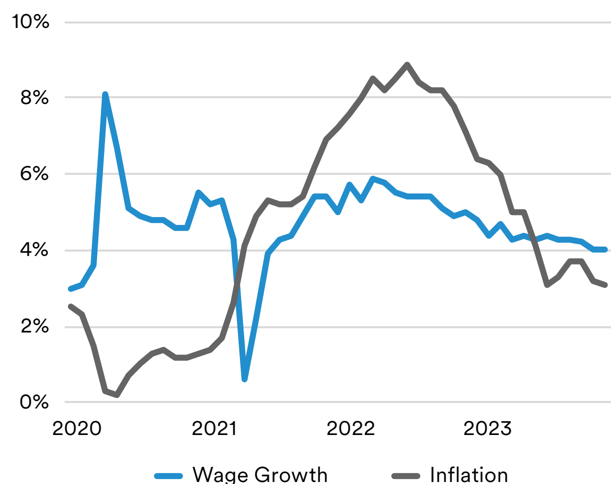
The most recent Consumer Price Index (CPI) showed prices grew at just 3.4% year-over-year, down from a peak of 8.9%.[ii] Core Personal Consumption Expenditures (the Fed's preferred inflation metric) registered 0.7% annualized growth in November, well below the 2% target.[iii]

A positive consequence of the Fed's rate hiking campaign is the policy "space" afforded to the Fed to fight a recession should one occur this coming year. The Fed now has the power to lower interest rates to stoke economic growth if necessary and has signaled a shift away from combatting inflation towards a focus on preserving labor market stability. In the last FOMC meeting, the Fed hinted at 3 rate cuts in their forward guidance for 2024.

Along with progress on inflation, consumer health is stabilizing. This is partially due to the Fed's own comments on supporting labor market conditions. Additionally, consumers are once again experiencing positive real wage growth (exhibit 1), a condition that could support stable labor markets and economic growth next year.

Accumulated savings and healthy household balance sheets helped bridge consumers through the high-inflation and high-interest rate period of 2021-2023. While pandemic-era accumulated savings have been mostly spent down, positive real wage growth should step in and act as a buffer against potential economic shocks this coming year.

Exhibit 1 | Inflation vs. Wage Growth



Source: MIM, BLS. January 2024.

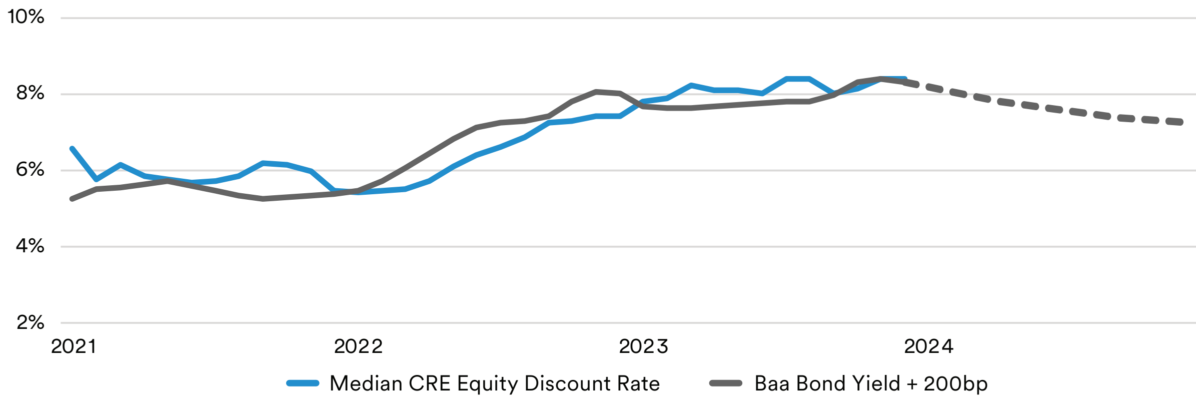
For 2024, we welcome a clearer and potentially brighter outlook for the economy and commercial real estate relative to where we sat this time last year. We expect the 10-year treasury rate to remain near 4.0% and expect modest cooling in the labor market throughout the year.

Values Stabilizing

We believe private commercial real estate prices may be near or past the trough and expect the benchmark NCREIF property index to report a roughly 20% value decline from the 2022 Q2 peak. Three factors that lead us to this conclusion include our proprietary relative value benchmark, active bidding/selling in the market today, and improvements in the public REIT market.

First, our oft-cited relative value benchmark that compares under-negotiation real estate discount rates to Baa yields + 200 bps shows that real estate is offering fair relative value (exhibit 2), meaning discount rates, or required returns, do not have to adjust in response to the returns offered by other investment sectors. Additionally, the rate outlook implies that corporate bond yields, and thus real estate required returns, could decline further in 2024[iv], putting upward pressure on real estate prices.

Exhibit 2 | Private Commercial Real Estate IRR vs. Baa+200bps



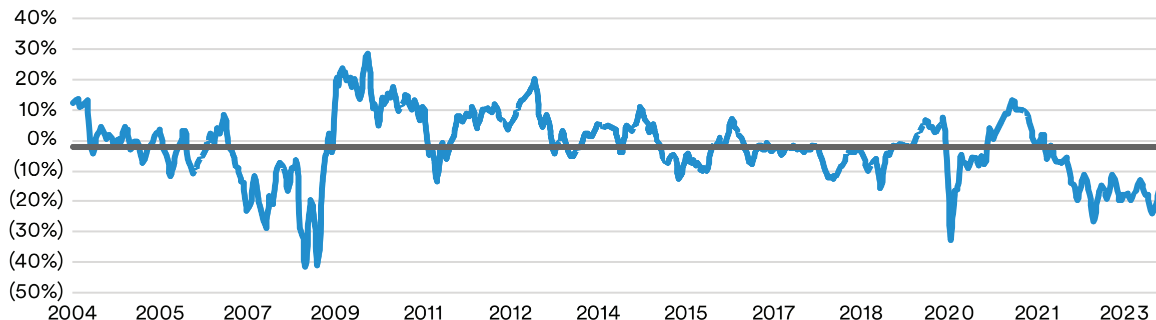
Source: MIM, GreenStreet, Oxford Economics. January 2024.

The second signal we looked at is observations from transactions currently in the market (including MIM's own experience and discussions with peers and brokers). For example, in early November 2023, MIM completed an initial underwriting of a core stabilized property that produced an internal rate of return (with moderate leverage) of 8.9%. The underwriting assumed a mortgage coupon of 6.6%.[v]

The underwriting completed in late December revealed that due to the improved rate environment, the actual mortgage rate that would be applied to the property was 6.0%, improving the levered IRR by 40 bps (assuming the same acquisition price as the original underwriting). MIM could have paid a 5% higher price for the property and achieved the same IRR as the original underwriting.[vi]

The final signal is the relationship between REIT stock prices and underlying net asset values (NAV). REITs have been trading at a discount to NAV since November 2021, making it difficult to raise new equity for acquisitions (exhibit 3).[vii]

Exhibit 3 | Historical REIT NAV Premium / Discount



Source: MIM, GreenStreet. January 2024.

The REIT price-to-NAV relationship has steadily improved over the past 3 months, and REITs are now trading close to parity with underlying Net Asset Values (NAVs). This is allowing many REIT managers to consider new acquisitions, and could draw institutional capital back into the market, helping both transaction activity and values to stabilize.[viii]

"Calling the bottom" can be a difficult endeavor. While there are many factors to consider, the three that give us the greatest pause include:

1. **Office sector uncertainty.** As we will discuss later, we expect a continued deterioration in office fundamentals during 2024. It is unlikely that office values will reach a bottom until return to office (RTO) stabilizes and office occupancy finds a floor.
2. **Multifamily maturities.** We estimate that 30% of the multifamily investable universe changed hands at peak valuations and peak underwriting assumptions during 2021-2022, and that most of the financing was based on a variable interest rate. Lenders' willingness to work with multifamily borrowers in 2024 could determine if a large number of multifamily properties come to market at distressed prices, which adds downside risk to our forecast.
3. **Economic conditions:** A more significant labor market deterioration than we are currently expecting could cause real estate demand, and values, to decline further.

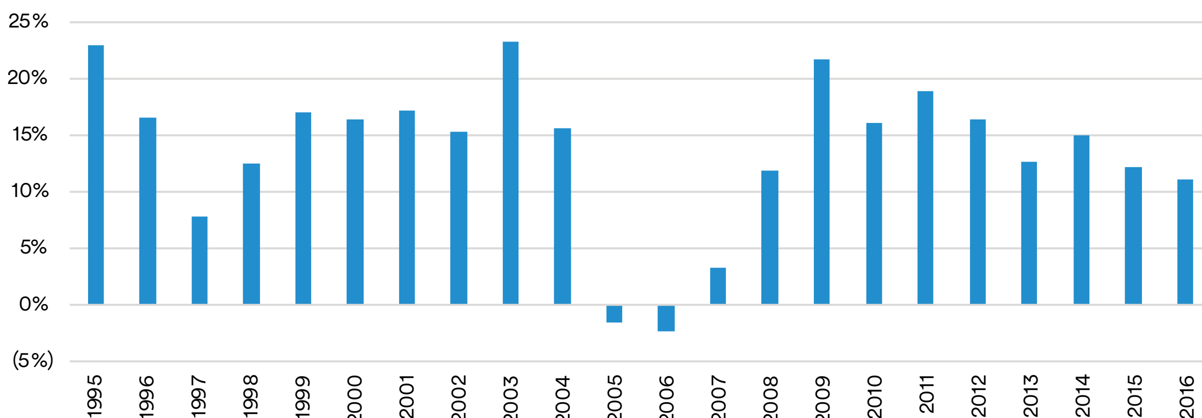
Timing the Cycle?

Recoveries after the past several real estate downturns have been characterized by *both* a recovery in capital markets factors (with cap rates declining) *and* a rebound in real estate fundamentals (with vacancies declining and rent growth accelerating).

In the current market, we believe real estate cap rates / required returns are stabilizing (and possibly modestly declining), while real estate fundamentals are moderating. The lack of improving fundamentals implies that this recovery could be less "V-shaped" than a traditional real estate recovery.

Entry point is particularly important for higher volatility strategies, like value-add or opportunistic / development funds. We observe fund vintages from the end of a cycle typically underperform, and fund vintages from the beginning of a new cycle typically outperform (exhibit 4).

Exhibit 4 | IRR by Vintage Year (U.S. Real Estate Funds)



Source: MIM, Preqin. January 2024.

If the recovery is not V-shaped, we believe high-volatility strategies may not experience the usual benefits associated with the beginning of a new cycle. As such, we think investors may want to consider maintaining a mid-cycle approach to exposure weights across debt, core/core+, value-add, and development/opportunistic strategies, though this would not be a standard playbook in a typical recovery.

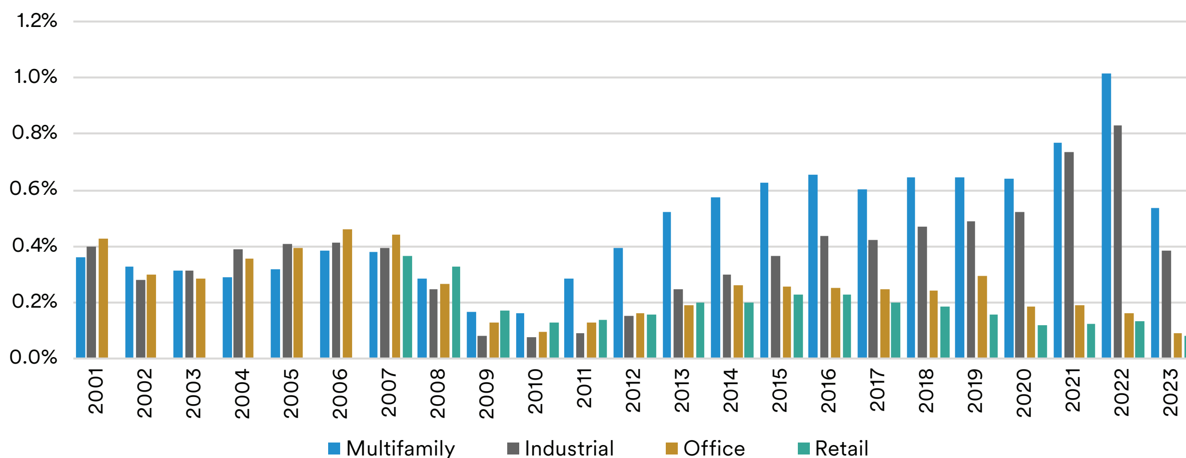
Exceptions to this could include tactical strategies offered by the current cycle, such as high-yield debt or preferred equity investments targeting funding gaps in the capital stack, or opportunistic strategies that capitalize on distressed office pricing.

Cooling Construction...

Capital market conditions are the driving force behind today's shifting commercial real estate cycle, but we believe property fundamentals will increasingly come into focus as the fog lifts on pricing.

Higher inflation and higher interest rates have had a chilling effect on construction activity. This is a common theme across all property types (exhibit 5).

Exhibit 5 | Starts as % of Total Inventory



Source: MIM, CoStar. 4Q 2023.

The downshift in construction activity is more significant than the declines that occurred following the global financial crisis and is happening at a time when vacancies for most property types (outside of office) are generally healthy.

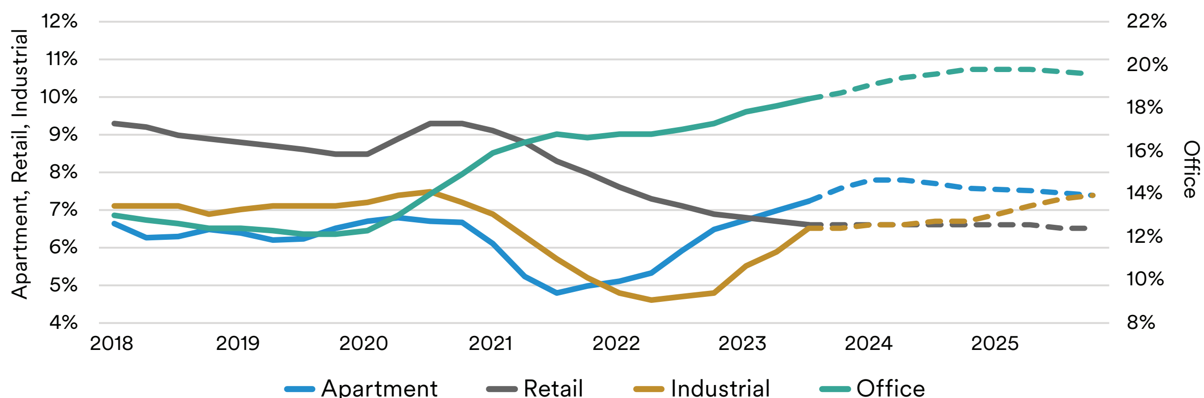
Many market participants underwrite inflationary 2-3% rent growth in outer years of their forecast period, however this sharp reversal in project starts could lead to supply shortages later in the decade, meaning inflationary rent growth assumptions for the late 2020's may be overly conservative. Even in the case of the office sector, we think this supply dynamic may cause the office vacancy rate to return to its pre-pandemic norm faster than many expect.

...and Varying Vacancy

While new construction starts are cooling, the elevated pipeline from 2021-2023 could contribute to a divergent vacancy picture across property types in 2024.

Somewhat counterintuitively, the retail sector appears the least likely to see vacancies rise this year. Vacancies are now at an all-time low, thanks to a combination of healthy consumers and limited new construction (see constructions stats above). At the other end of the spectrum is the office sector. While office construction began declining following the onset of COVID, demand growth remains negative as [1] office users continue to re-think space utilization needs and [2] last year's murky economic outlook further dampened office demand. The office vacancy rate currently sits at 18.6%[ix], and we expect it to rise an additional 100-150 bps in 2024 before leveling off in 2025.

Exhibit 6 | Vacancy Rate



Source: MIM, CBRE-EA, CoStar. 4Q 2023.

The industrial sector is at a moderate risk of rising vacancies given the large supply pipeline and normalization in demand following years of record growth. However, the industrial vacancy rate at 7.1% is still well below the historical average of 9.4%.[x] If the vacancy rate rises to 7.5% this year (our base case forecast), the industrial sector could still be considered under-supplied, and will likely continue to generate healthy rent growth (but perhaps not the double-digit annual rent growth we observed in the last several years).

The multifamily sector has become increasingly divergent due to a concentration of high construction activity in a number of growing sunbelt markets. Markets like Nashville, Austin, Charlotte, and Atlanta could see 2024 vacancy well-exceed their respective markets' historical average, and we expect several of these markets to realize negative rent growth. Combining this effect with still-elevated expense growth, we would not be surprised to observe several over-supplied markets experience net operating income declines of 5-10%.

Exhibit 7 | Apartment Performance Varies by MSA

	2024 Year-end Vacancy (F)	2024 Vacancy vs. Historical Avg.
Nashville	11.9%	4.7%
Austin	12.5%	4.3%
Charlotte	11.4%	3.4%
Atlanta	11.8%	3.0%
Orlando	10.3%	2.1%
Phoenix	10.7%	2.1%
East Bay	6.6%	1.5%
Portland	7.1%	1.5%
Denver	8.6%	1.5%
Fort Lauderdale	7.6%	1.3%
Sacramento	6.8%	1.3%
Minneapolis	7.0%	1.3%
West Palm Beach	8.9%	1.3%
Riverside	6.7%	1.1%
Houston	10.6%	1.1%
Tampa	8.3%	1.0%
Dallas	9.5%	0.9%
Washington, DC	7.4%	0.8%
San Francisco	6.3%	0.8%
Miami	6.0%	0.7%
United States	7.4%	0.7%
Northern NJ	5.3%	0.7%
Baltimore	6.8%	0.6%
Seattle	6.7%	0.6%
Philadelphia	6.8%	0.6%
Los Angeles	4.7%	0.2%
Boston	5.4%	0.2%
San Jose	5.1%	-0.1%
San Diego	4.2%	-0.3%
Orange County	4.1%	-0.4%
New York	2.6%	-0.5%
Chicago	5.7%	-1.1%

Sources: MIM, CoStar. 4Q2023.

While growth markets are outperforming, several coastal and gateway markets like Chicago, New York, and Orange County are experiencing stable vacancies and rent growth, which should persist into 2024 given limited supply pipelines in these markets.

In general, we would characterize real estate fundamentals for 2024 as a stable outlook with some pockets of risk, not dissimilar from performance in 2023.

Alternative Property Type Update

We frequently survey MIM's regional acquisitions teams to assess current spot market yields for stabilized properties across all the core and alternative property types. We then apply risk adjustments based on forecasted supply/demand conditions, historical investment performance volatility, operating expense loads and average CapEx needs to estimate the risk-adjusted returns being offered in the market. The exhibit below highlights the property types with the best to worst risk-adjusted returns, and corresponding overweight/underweight recommendation.

This analysis suggests the most favorable opportunities in the current market exist in infill warehouses, cold storage, limited service hotels, and net-lease retail. Residential alternatives like seniors housing, manufactured housing, and moderate income housing also receive favorable scores.

Importantly, this analysis is an unconstrained view that does not consider critical factors like debt availability, portfolio diversification, liquidity, operational challenges, MSA exposures (i.e., Life Science may only be available in several markets), or higher yielding strategies such as value-add or new development, etc.

Exhibit 8 | Property Type Overweight/Underweight Guidance

Sector	Strategy
Infill Warehouses	Overweight
Seniors Housing (IL)	Overweight
Limited-Service Hotels	Overweight
Cold Storage	Overweight
Manufactured Housing	Overweight
Retail-Net Lease	Neutral+
Moderate Income Housing	Neutral+
Retail- Strip/Neighborhood	Neutral+
Single-Family Rentals	Neutral
Regional Warehouses	Neutral
Medical Office	Neutral
55+ Housing	Neutral
Full-Service Hotels	Neutral
Data Centers	Neutral-
Life Science	Neutral-
Traditional Apartment	Neutral-
Retail-Mall	Underweight
Office (Excludes Life Science/Medical)	Underweight
Student Housing	Underweight
Retail- Grocery Anchored	Underweight
Self Storage	Underweight

Conclusion

We believe 2024 will be a year of lifting fog for commercial real estate. While that will be a welcome development from the obscurity of 2023, fog can lift to reveal the challenges on the road ahead. This is especially true when considering the potentially new normal pricing regime.

Still, we think the clarity offered by the coming year will be a step in the right direction of healing real estate capital markets. We expect transaction activity to begin recovering during the year as buyers and sellers agree on the outlook for interest rates and thus real estate values. The recovery may feel more like a mid-cycle period than a typical real estate recovery.

We believe a moderating construction pipeline will benefit all property types, though office and some pockets of multifamily will work through vacancy challenges this year. Alternative property types are becoming more mainstream staples of institutional investment portfolios, and we expect that trend to continue this year. Opportunities in infill industrial, residential alternatives, cold storage, limited-service hotels, and net-lease retail are high on our list, offering an attractive combination of fundamentals and pricing.

Although many macroeconomic factors remain unresolved, we believe that the resilience of the U.S. consumer will enable the U.S. economy and real estate sector to successfully overcome the challenges of the year ahead.

Endnotes

[i] WSJ Economic Forecast Survey. January 2023.
[ii] BLS. January 2024.
[iii] BEA. January 2024.
[iv] Oxford Economics. January 2024.
[v] MIM. November 2023.
[vi] MIM. December 2023.
[vii] GreenStreet. January 2024.
[viii] Ibid.
[ix] CBRE-EA. 4Q2023.
[x] Ibid.

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