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2Q2024 U.S. CRE Outlook

Highlights

- Market fundamentals firm
- Equity capital markets stabilizing
- Debt capital markets exhibit nuance
- Investment strategy offers options
- Key risks remain exogenous

With one quarter in the books, the narrative for the US commercial real estate (CRE) market remains largely unchanged. The economy continues to expand, supporting generally healthy space market fundamentals, which are maintaining their general trajectory, both overall and within each property type. But the capital markets remain largely stymied by relatively high interest rates. Consequently, many in the CRE market are growing increasingly frustrated with the Fed and monetary policy. Despite these challenges, the balance of risks still skews positive for CRE over the next 12-18 months. We remain broadly positive on the outlook and continue to foresee better overall performance for CRE over the balance of the year. But what does that look like and how can investors best position themselves for this future?

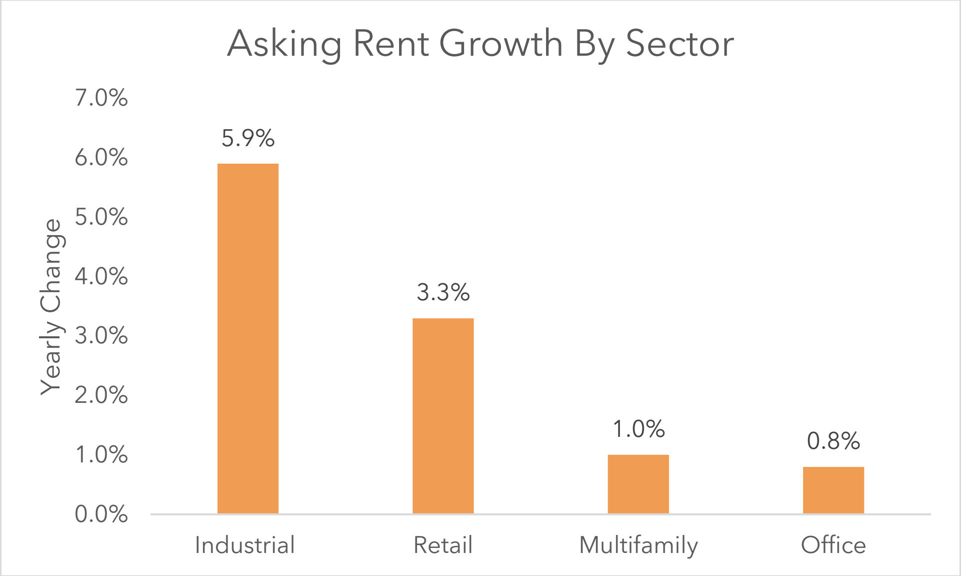
Market Fundamentals

Industrial remains the darling of CRE and now stakes a claim as the bellwether property sector, a title formerly held by office. Because of this, many look to industrial as a gauge for the overall health of the CRE market. Though normalizing, industrial still looks broadly favorable. During the first quarter the national vacancy rate increased by 50 basis points (bps) to 6.2%[i]. That marks the 7th consecutive quarter of increase, up 240 bps since reaching its historical low in the second quarter of 2022[ii]. Consequently, asking rent growth continues to slow, hitting 5.9% yearly, but it remains the strongest of the major property sectors, well above inflation[iii]. Major markets across the country are generally following the same pattern, with some local variation. The sector has come under pressure from new supply growth which is exceeding net absorption. While we project excess supply and vacancy rate increases roughly through year end, we maintain a positive outlook for industrial over the five-year forecast period and do not foresee industrial relinquishing its crown as the strongest property sector.

Retail continued its strong performance during the first quarter. While the national vacancy rate increased by a slight 10 bps, retail's 4.1% is hovering just above its historical low and surpasses the vacancy rates of all other major property sectors by an average of 513 bps[iv]. Although asking rent growth has slowed a bit, down to 3.3% yearly, it remains strong by historical standards[v]. The combination of low vacancy and healthy rent growth are quietly producing strong performance from the sector. While this is not uniform across subtypes, it marks a dramatic reversal of fortune for the sector since the 2008-2009 global financial crisis (GFC) when many left the retail sector for dead. Consumption remains the dominant force driving the US economy and retail centers – which offer both goods and services – remain the dominant avenue of access for consumers. Of course, due to stark differences among subtypes, retail remains the property sector driven most by micro factors within a property's trade area. That offers widespread opportunity to selectively target individual investments to meet specific risk-return characteristics. Our outlook remains positive: while we foresee relatively little upward pressure on vacancy rates over the forecast horizon, the sector will struggle to maintain the outsized rent growth of the last few years.

Multifamily surrendered its title as the darling of CRE to industrial during the latter stages of the prior business cycle. Multifamily had been on a strong run since the GFC and some slowdown proved inevitable. But one should not read too much into that. The national vacancy rate increased by 20 bps during the first quarter and has risen by 300 bps since reaching its historical low during the third quarter of 2021[vi].But relative to industrial, the vacancy rate increase is taking on a very different form. The industrial vacancy rate increase is occurring on a widespread basis, including in some of the tightest markets (historically). But in multifamily, the vacancy rate increase is largely stemming from high-growth markets in the southern parts of the country where developers got overexcited about migration flows[vii]. The tight coastal markets have only experienced marginal upward pressure on their vacancy rates. On a more heartening note, national asking rent growth appears to have stabilized during the quarter[viii]. Quarterly rent increased for the first time since the second quarter of 2023 and yearly rent growth now appears to have bottomed during the third quarter of last year[ix]. We maintain a positive outlook for multifamily over our forecast horizon – vacancy rates should stabilize toward the end of this year before beginning another down cycle while rent growth should slowly reaccelerate.

Office remains the most challenged of the major property types. The national vacancy rate reached a new record high during the first quarter while asking rent growth remains roughly flat as the market seeks more clarity on the utilization of office space over the medium to long term[x]. Vacancy rate increases are occurring on a widespread basis, even in the stalwart institutional markets, typically located on the coasts[xi]. Gradually, the market is adjusting to excess supply, particularly of older obsolete space. That inventory adjustment process will likely unfold over a number of years. But as is often the case, it appears as if CRE market participants have overreacted to office's plight. While we don't expect the fortunes of office to swing wildly back toward pre-pandemic norms, the market is not completely imploding either. And moving forward, a number of individual office markets will almost surely outperform many markets in other property types. However, the margin of error in market selection has become miniscule and investors need to avoid making a mistake because of what could become incalculable downside risk to choosing poorly.



Sources: CoStar, BGO Economics and Research

Finally, emerging sectors are increasingly playing a more important role in investment portfolios. **Cold storage** boasts strong performance in market fundamentals as an integral part of the global food supply chain, especially as its inventory ages. **Data centers** also offer strong fundamentals as a critical component of the digital infrastructure. The quantification of the economy and associated analysis of the resultant data has increased demand for storage and brute-force mathematics capabilities that only modern data centers offer. **Build-to-rent communities (BTRC)** are thriving during a severe housing shortage and offering opportunities to invest in single-family dwellings at scale. BTRC represents entire communities of single-unit rentals in one professionally managed and highly amenitized community. Fundamentals are preforming well as demand for housing inexorably increases and supply growth badly lags.

Capital Markets

CRE capital markets showed additional signs of stabilizing during the first quarter. Total transaction volume remained effectively flat for the fifth consecutive quarter, even as the composition by property type changes marginally from quarter to quarter as investors evaluate the relative merits of each sector[xii]. Meanwhile, cap rates continued to tick higher, but increasingly it appears as if the worst of cap rate increases have passed, even if some properties have not yet gotten fully marked down[xiii].

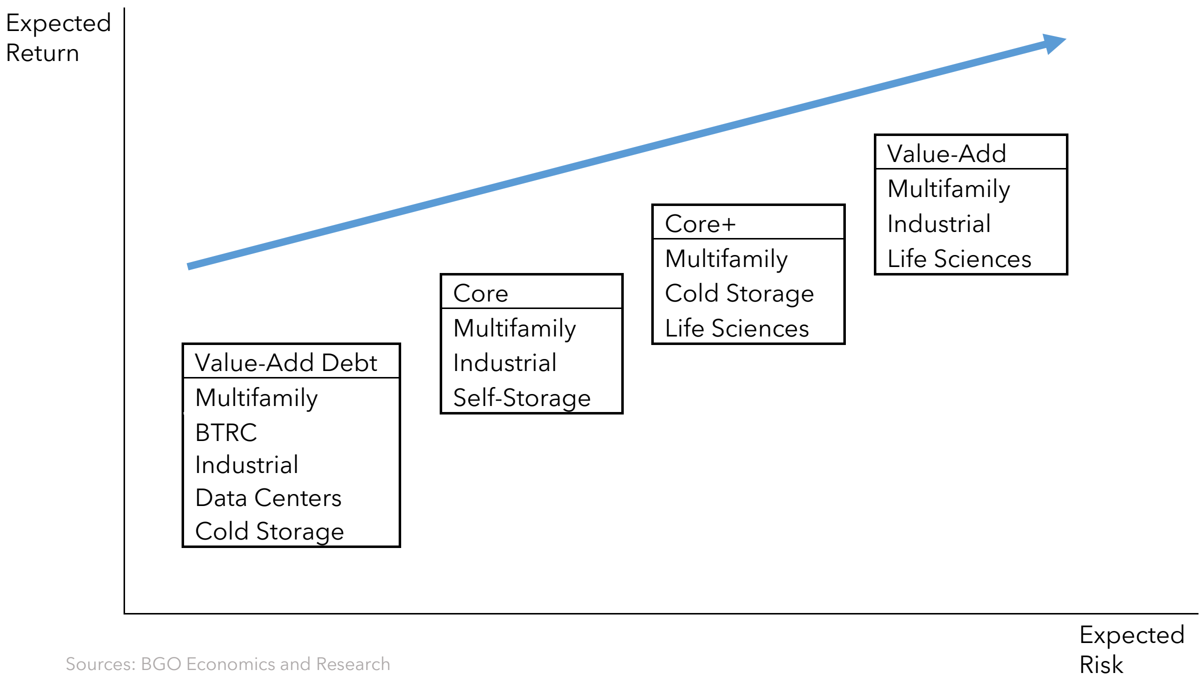
With fundamentals holding up relatively well, income returns have maintained consistency over the last couple of years[xiv]. The main drag on total returns, appreciation returns, remain negative but increasingly reflect a phenomenon that we have highlighted in the past[xv]. Historically, once the Fed stops raising rates, total returns revert back into positive territory relatively quickly as appreciation returns become less negative at first, and then turn positive. We see something similar unfolding this cycle. In the first quarter, industrial and retail total returns have already swung positive while apartment total return notably improved even as it remained negative[xvi]. Office will remain the outlier among the major property sectors until the market obtains greater clarity on the sector's future prospects. And higher frequency measures of return, such as monthly measures, are tentatively showing that the overall CRE total return is reverting to positive territory in the second quarter[xvii].

CRE credit markets remain largely shut down due to elevated interest rates, but performance largely reflects the performance of fundamentals, indicating opportunities for lenders still willing to issue loans. Although overall delinquency rates (as measured by the CMBS market) have risen to roughly 5%, performance by property type over the last year varies widely[xviii]. The increase in delinquency rate over the last year was predominantly driven by office and lodging[xix]. Industrial and multifamily experienced only slight increases while the retail delinquency rate actually declined[xx]. Over time, we expect this pattern to roughly persist, even as overall performance should improve as interest rates ultimately decline. But lower rates will likely not become a panacea for struggling property types and individual loans and further distress lies ahead, even if the bloodletting many expected does not materialize, similar to past cycles.

Strategy Implications

While many market participants tend to view the merits of each property type on a stand-alone basis, that proves rather limiting. By combining the outlooks for market fundamentals and capital markets with portfolio risk-return profiles we can create more nuanced view of investment strategy. To do this, we have produced the BGO Preference Vector, which combines the overall investment outlook for property types and investment risk profiles. The vector shows the preferred investment options across the risk-return spectrum. This unique moment in time, when the Fed has not yet cut rates, but appears set to do so over the next 6-12 months, offers opportunities across the risk spectrum, including for strategies that many deemed unpalatable in recent periods. As income returns continue to hold steady and appreciation returns shift from negative to positive, virtually all investment strategies could capitalize on such a unique phase of the CRE cycle. But each particular strategy should focus on the most attractive components of the overall market. As they do, they will position themselves best to generate attractive absolute and risk-adjusted returns within their respective categories.

Investment Strategy Vector - Preferred Property Types By Strategy



Sources: BGO Economics and Research

Risks And Closing Thoughts

At this juncture, the main risk to the CRE investment market remains exogenous, namely monetary policy. Endogenous risks remain limited. Market fundamentals are faring well amidst ongoing demand and subdued construction activity. Valuations have already gotten marked down considerably from cycle highs and are nearing, if not actually at, bottom. That offers better opportunities for appreciation returns over the medium term. Increased transaction volume and liquidity should help facilitate such returns. And debt markets, limited by the interest rate environment of the last two years, should thaw, and become more active. But the key to all of this remains monetary policy. Until the Fed begins cutting rates, the CRE market will only make incremental progress. We foresee monetary policy turning sooner than later, but not just yet.

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[i] www.costar.com
[ii] Ibid.
[iii] Ibid.
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