Principal Asset Management℠

Principal Real Estate

2024 Mid-Year Real Estate Outlook

Waiting for clarity

JULY 2024

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The capital market waiting game

Bulls and bears both had ample evidence to support their cases coming into 2024. Although inflation has yet to relent to a level that the central banks are comfortable enough to normalize policy interest rates, the global economy has remained remarkably resilient thanks to strong hiring and consumer spending. At this point, the balance can be viewed as tenuous and a push in either direction can be the difference between sticking the landing to a sustained expansion or ending up in a recession.

Policy missteps are not the only points of concern this year. Geopolitical risks remain as elevated as ever in shaping the global economic outlook. The war in Ukraine, renewed tension and conflict in the Middle East, a full slate of global elections, and advances in Artificial Intelligence (AI) all have far reaching impacts that can make their way into supply chains, the health of the consumer, and by extension, commercial real estate markets.

With this backdrop in mind, in this edition of our ***Mid-Year Real Estate Outlook***, we discuss the macroeconomic drivers and risks that we are keeping an eye on and which commercial property sectors we believe have the highest conviction outlook. Understanding the systemic risks and global exposure to unprecedented change is imperative for investors as we head into the back half of 2024.

Principal Asset Management℠

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ECONOMIC OUTLOOK

Steady but slower

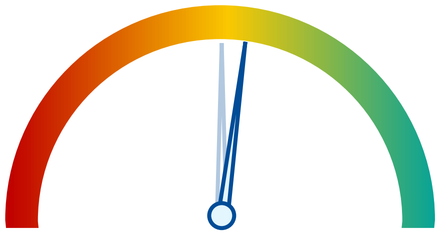
The economic outlook has improved since entering 2024. While risks remain elevated, strong global labor markets and resilient consumer spending have supported a stronger than anticipated expansion.

Real estate investors entered 2024 with a sense of renewed optimism, but the tone has shifted. Stickier than anticipated inflation has pushed potential rate cuts later into the year. To that end, we anticipate slower but stable growth over the next twelve months.

Growth prospects across regions have begun to converge

Economic outlook for 2024 – 2025

January '24 vs July '24

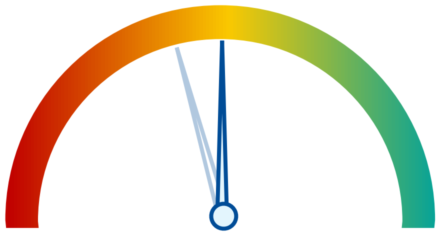


UNITED STATES

Moderating

The U.S. is set to maintain a solid growth trajectory over the next twelve months, ahead of previous expectations.

However, as household savings retrace toward trend levels and corporate debt maturities roll over, the impact of higher interest rates may finally feed through, prompting a downward shift in trend growth and a healthy rebalancing of the labor market.

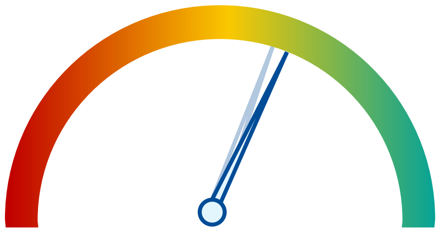


EUROPE

Stabilizing

The European economy is on the path to recovery after a period of stagnation. Its growth prospects have improved since the start of the year, although remaining mild, especially in Germany.

Consumer confidence has returned to its pre-Ukraine war level as disinflationary pressure and moderating interest rates continue to revive real income and investment.



ASIA PACIFIC

Constructive

Growth prospects for Asia Pacific remain broadly positive and have improved slightly, amid resilient domestic demand and stronger exports.

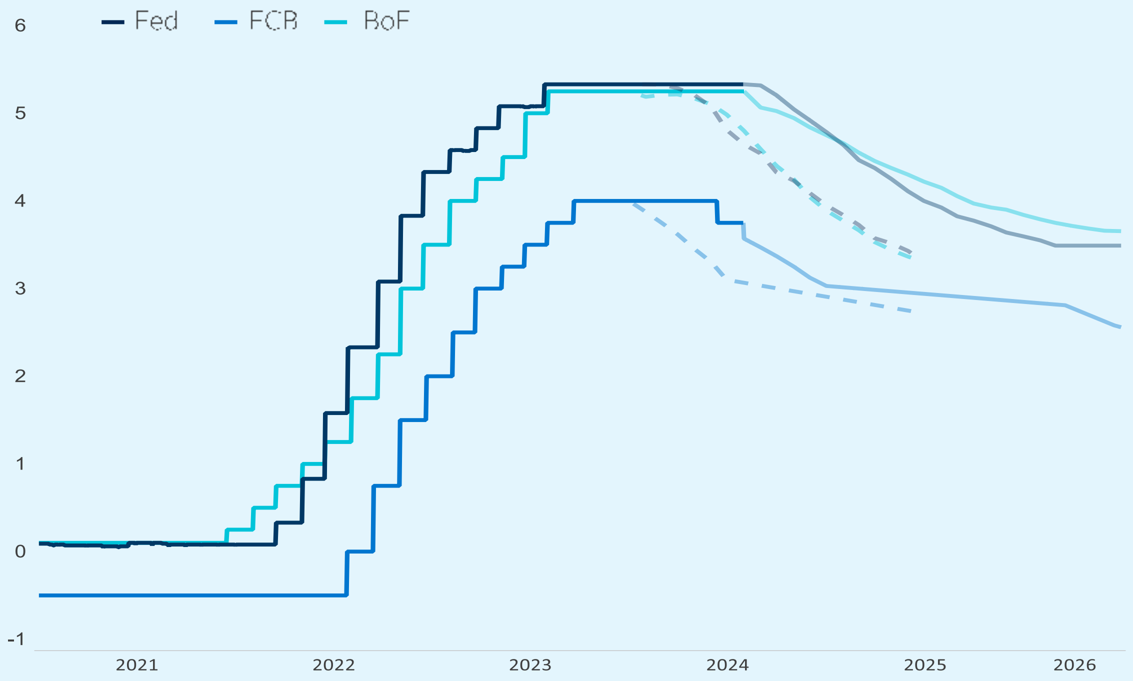
The Chinese economy, however, continues to struggle. Policymakers have ramped up stimulus by lowering borrowing costs and extending subsidies to boost Electric Vehicle sales.

All eyes are on the Fed as they navigate a challenging landscape

- 2024 began with optimism that the Federal Reserve (Fed) would swiftly begin cutting rates, but that has proven to not be the case. We now forecast only two rate cuts this year; the first in September and one in December.
- The economy is continuing to walk a tightrope between elevated inflation and an expanding labor market. Consequently, the Fed is struggling to maintain its dual mandate of full employment and price stability. At some point its fight against inflation may begin to push unemployment upward.
- We anticipate we are on the cusp of a global easing cycle. Central banks across the world are eager and waiting to start cutting rates in response to the slower economic growth that they are experiencing.
- For investors, after rate cuts begin during the second half of the year, we expect an increased appetite for risk.
- In China, stimulus measures are underway to reinvigorate the country's primary storage of wealth – the property market. We anticipate a slow recovery with stable growth and weak-to-moderate investor interest in 2024.
- Our economic growth outlook suggests slower growth, which drives lower inflation and, in turn, allows central banks to normalize interest rates starting later this year. In the unlikely event that economic growth continues above trend or accelerates, it could cause central banks to increase rates, resulting in a hard landing under our downside scenario.

Base rate expectations

Percentage. Forecasts based on Fed funds, Euribor, and Sonia futures in Jan 2024 and July 2024



Fed – Federal Reserve, ECB – European Central Bank, BoE – Bank of England

Source: Federal Reserve, ECB, BoE, CME, Eurex Exchange, ICE, Macrobond, Principal Real Estate, July 2024.

GEOPOLITICS

The global economy is in flux as political tensions escalate

- With the war in Ukraine raging for more than two years and heightened tension around the world, the global economy remains exposed to downside tail risks. Compounding effects of unforeseen geopolitical reverberations have the potential to disrupt major economies that have been balancing on a razor's edge. If these risks find a way to disrupt markets, the path to a soft landing may be compromised.
- For example, an energy price spike driven by a disruption in supply due to a Middle East event would have a significant impact on the economic outlook. Such a scenario would increase consumer prices globally through a spike in commodity and energy prices. While the outcome is not in our baseline forecast, the risk is of interest to the bond market and real estate investors should be aware of the potential impacts as well.

Potential risks and their impact

Source: Moody's Analytics, Principal Real Estate, July 2024

ELECTIONS

The world is watching as the U.S. prepares for a new president

- One of the key events taking place in 2024 is, of course, the U.S. Presidential election. The Republican Party has officially nominated former President Donald Trump, but at the time of writing, the Democrats are still finalizing their nominee. Kamala Harris has obtained the support of enough delegates to secure the nomination at their convention. She has also received the endorsements of several leaders including President Biden and former President Barack Obama.
- Both Trump and Harris have experience in the White House and thus have had ample opportunity to showcase their platforms for the 2024 election.
- While it takes more than the President to shape an economy, both platforms will have direct impacts on financial markets.

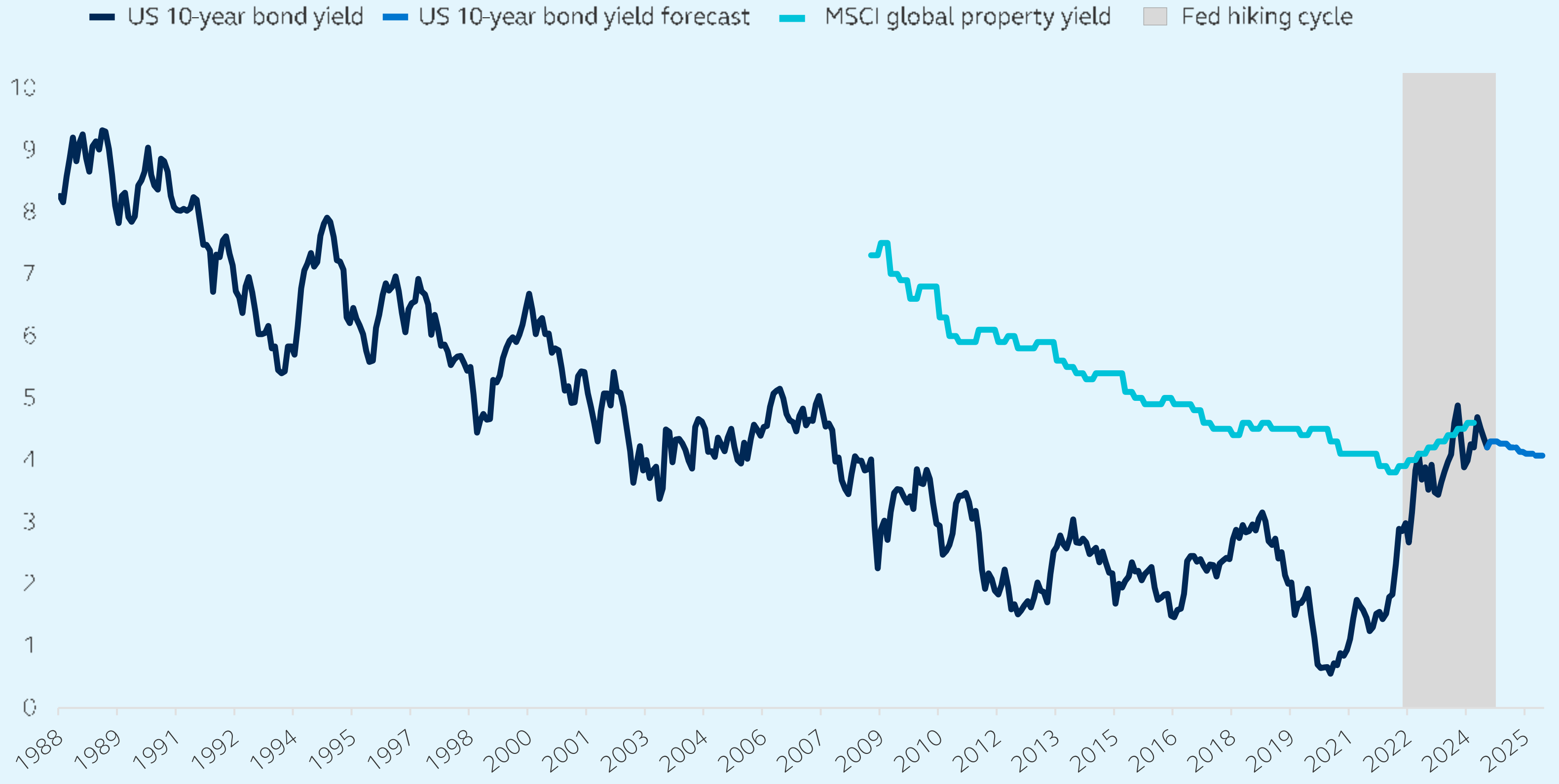
DEMOCRAT		REPUBLICAN
Focus on sustainable trade practices (ESG), support for domestic manufacturing and supply chains—execution mixed	**Trade policy**	Double down on 'America First Agenda', imposing a 10% tariff on imports—a potential headwind for trade-related industries
Higher stimulus spending, higher taxes	**Fiscal policy**	Lower fiscal spending, lower taxes
No change	**Monetary policy**	No change
Higher taxes on top of income distribution; roll back 2018 Trump tax cuts to corporations and wealthy individuals	**Taxes**	Make permanent temporary tax cuts set to expire in 2025, which will focus on top end of income distribution
More accommodating to immigration, particularly for asylum seekers	**Immigration**	Increased enforcement on non-documented entry. More restrictions on asylum
More cooperative approach with allies; maintain tariffs on China with a focus on strategic competition	**Foreign policy**	Unilateral approach, less support for NATO, continued decoupling with China
Increased spending on more progressive programs; fiscal support for domestic manufacturing; higher taxes; wider deficit	**Federal budget**	Focus on reduction in spending. Will try to cut entitlements; lower taxes; wider deficit
	IMPACT	
Evolves on its own—better supported by immigration policy	**Job market**	Evolves on its own—less supported by immigration policy
Potential for increased trade with strategic partners, shift in imports from China in favor of Mexico and Canada	**Trade**	Tariffs and trade war continue; potential reduction in imports
Near-term moderate; potential for higher structural inflation	**Economic growth**	Near-term potential for favorable growth; longer-term growth slower
Lack of holistic approach to policy making has potential for misallocation of capital	**Capital markets**	Inconsistent messaging could drive market volatility higher
Near-term, stickier inflation and higher interest rates may push yields on commercial real estate higher. More accommodating immigration is positive for real estate demand	**Commercial real estate**	Near-term, more focused on capital markets through lower interest rates. Immigration policy is a negative for growth

REAL ESTATE

Real estate recovery will be gradual and uneven

Interest rate and property yield

Percentage



Our commercial real estate outlook for the remainder of the year is centered around three key pillars:

1. We believe 2024 will be a year of transition, albeit later in the year than initially anticipated. Valuations have nearly bottomed and central banks are close to a pivot.
2. The recovery will be gradual rather than steep, and will start at the turn of the year, between Q4 2024 and Q1 2025.
3. The recovery will be income-driven and uneven, which means there will be divergence among sectors, with winners and losers.

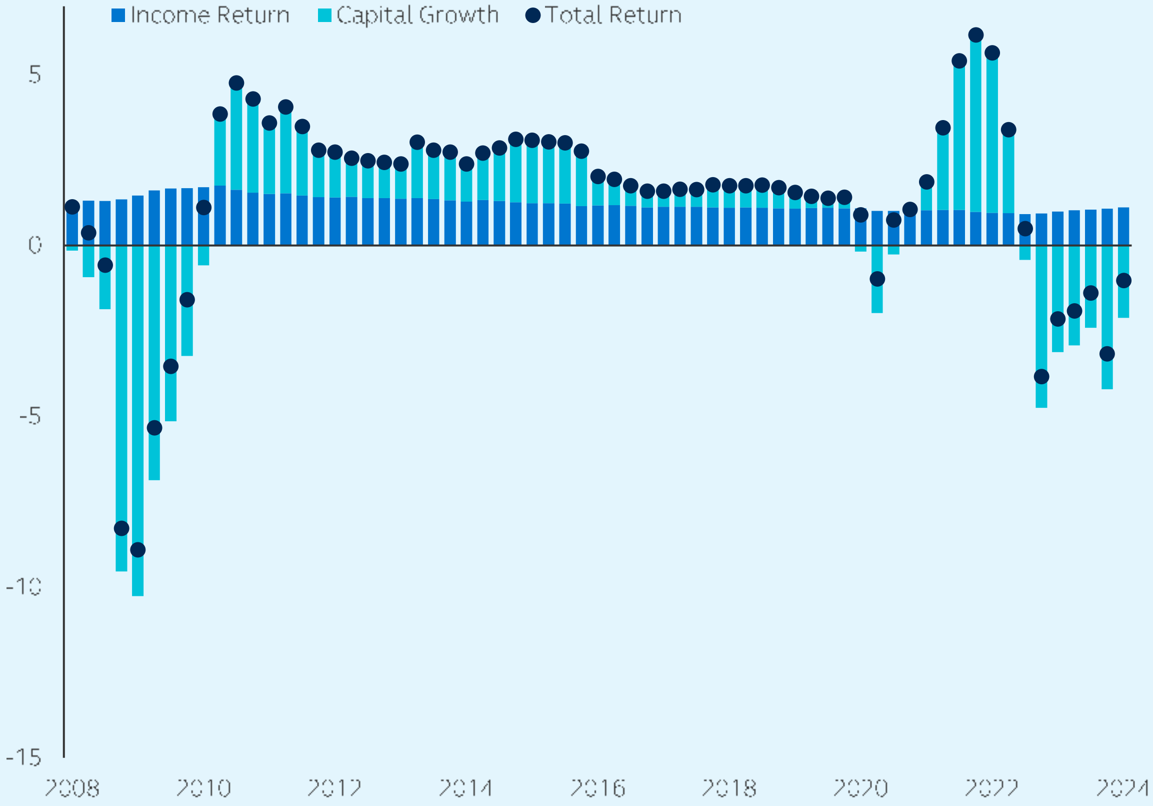
Source: MSCI, Moody's Analytics, Macrobond, Principal Real Estate, Q1 2024

REAL ESTATE

Property returns improving, although still negative in the U.S.

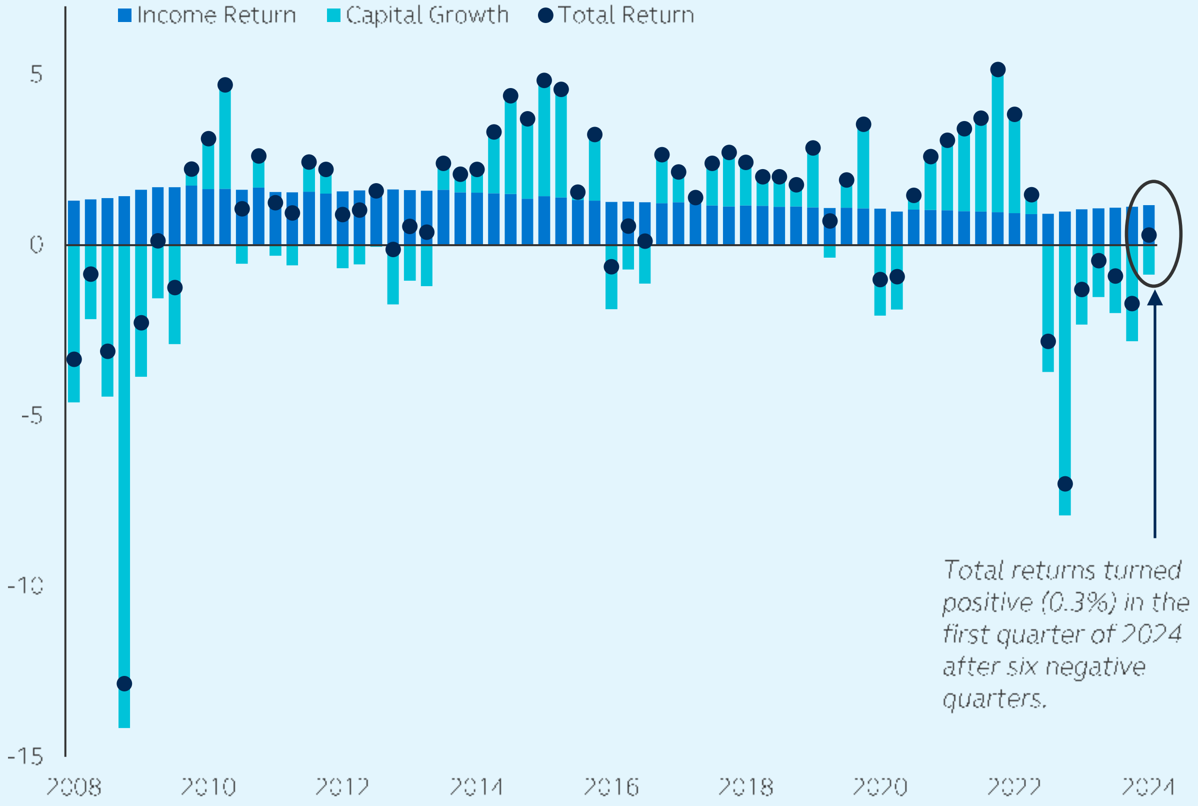
U.S. property total returns

Percentage change, quarterly, year on year, USD$, 1Q 2008 to 1Q 2024



European property total returns

Percentage change, quarterly, year on year, €, 1Q 2008 to 1Q 2024



Source: MSCI, Principal Real Estate, Q1 2024

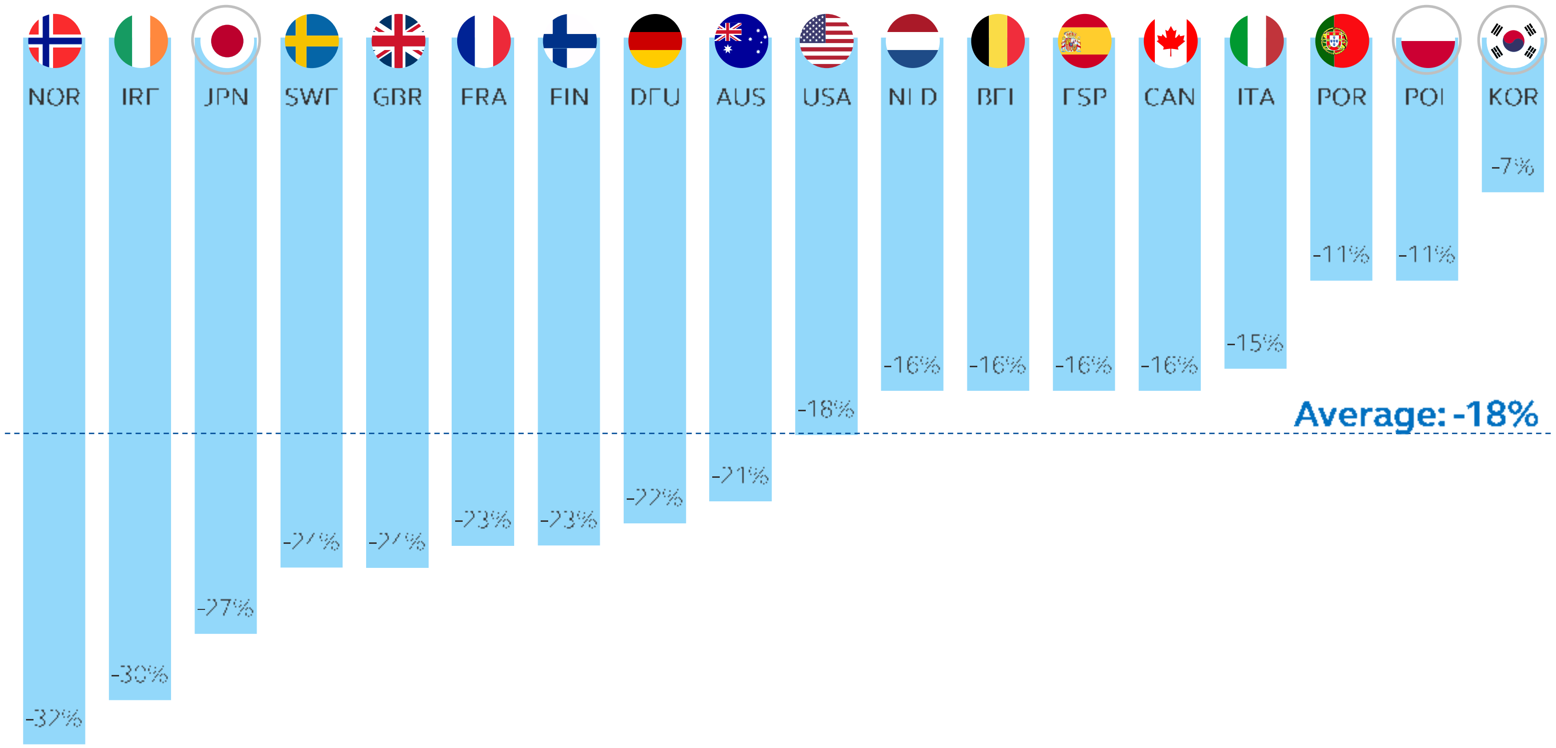
Valuations to reach equilibrium by year's end

Markets offer unique opportunities after two years of re-pricing

- European countries are further along in the recovery process in the commercial real estate market compared to the U.S.
- We suspect European real estate prices are closer to the end of their correction and offer an interesting entry point for long-term investors today given current discounts.
- Conversely, we expect further downward price adjustments for private equity real estate that will adversely impact some U.S. markets and sectors in 2024 before a more robust recovery in 2025.

Value change since post-pandemic peak[1]

Percentage change, MSCI Global Property Index, Q1 2024, USD



[1]The value change from the post-COVID peak to the latest available data (Q1 2024) is based on MSCI Global Property Index and it is impacted by differences in sector weightings across countries.
Source: MSCI, Principal Real Estate, Q1 2024.

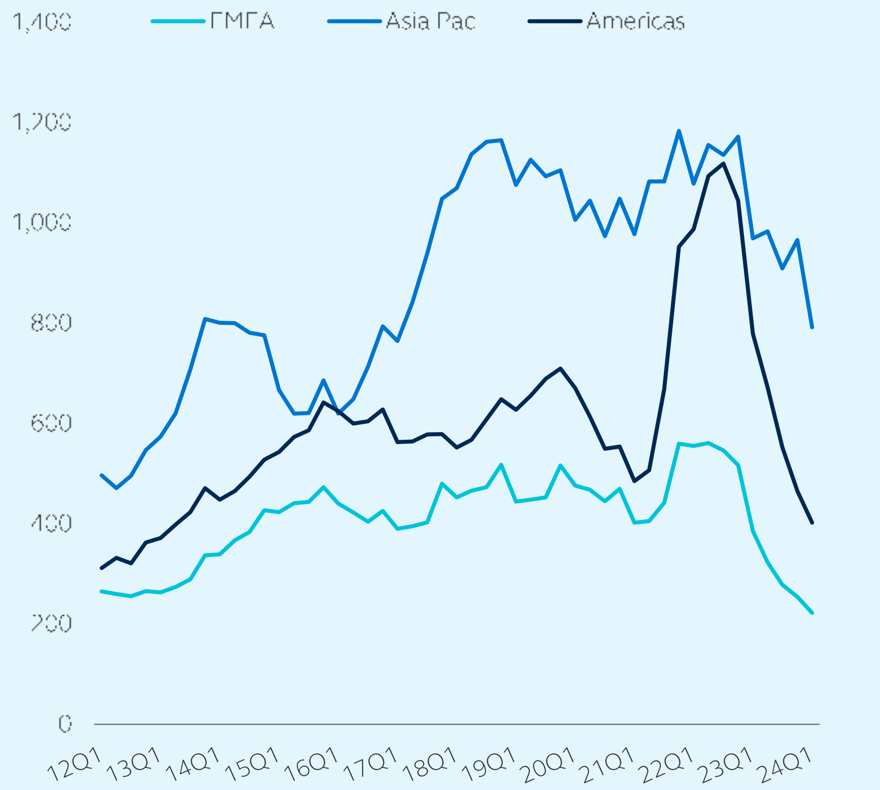
Capital markets liquidity remains low, deals are still scarce

Global deal volume declined again in 1Q 2024, falling by 18% year-on-year, and down to the lowest level in more than a decade.

Although valuations have corrected on average by 18% globally since the previous peak, the price gap between buyers and sellers remains wide, preventing liquidity to return to the market and deal flow to resume. Preliminary data for 2Q 2024 shows no difference.

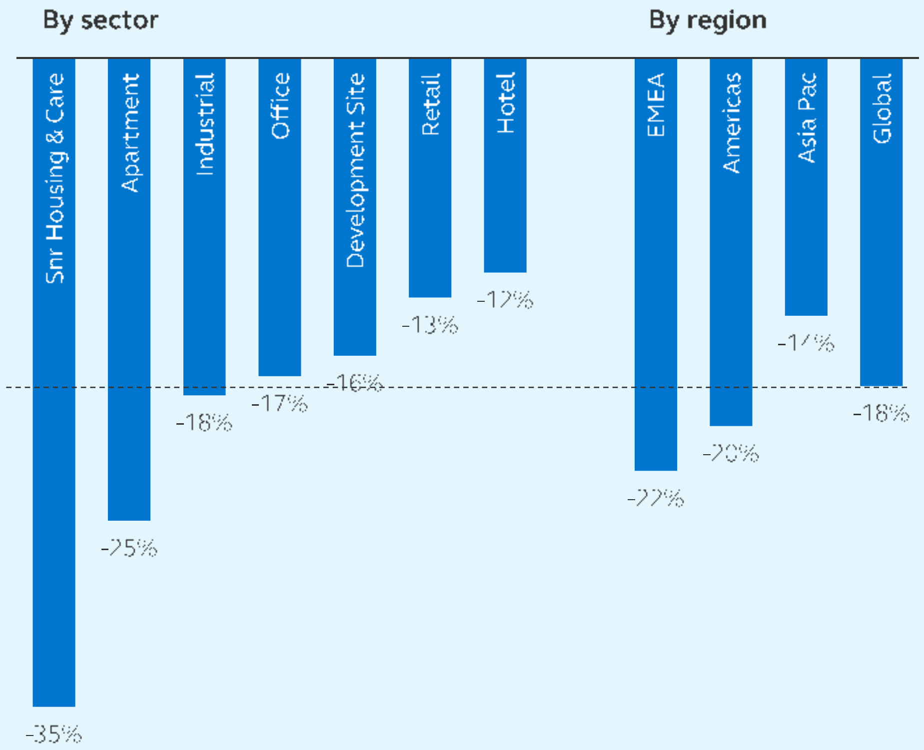
Global real estate transaction volume

Rolling four quarters volume, US $bn



Transaction volume change by sector and region

Percentage change, US $bn, Q 2024 vs. 1Q 2023



Source: RCA, Principal Real Estate, Q1 2024

Focus on top performing sectors

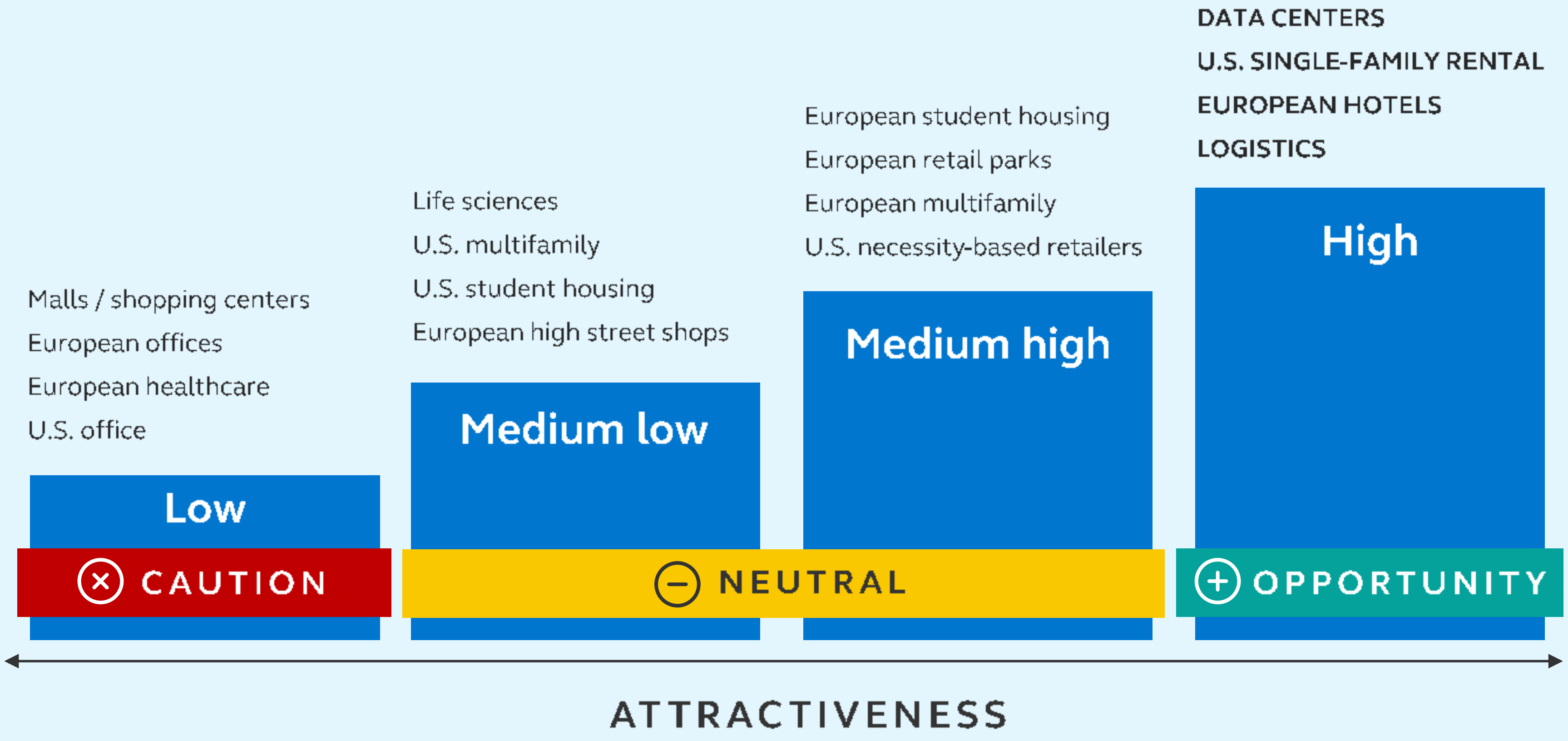
Maintain focus on fundamentals to identify sectors with positive outlook

We believe investors should be focused on identifying resilient property sectors that have structural demand drivers that we expect will propel growth going forward. By focusing on the needs of the consumer and the adoption of technology that will define the next era of innovation, we are optimistic that these property sectors will be attractive additions to real estate portfolios.

A lot of ink has been devoted to articles commenting on corrections in the office sector. While we acknowledge a bottom is coming, we do not believe we have seen the full impact of this correction yet. As a result, we have office, and some other property types, in our lowest tier of sectors in 2024. We remain most optimistic about sectors driven by strong structural and demographic growth drivers, such as data centers, U.S. single-family rentals, European hotels, and logistics.

Property sector fundamentals tracker

Based on rental growth outlook, occupancy level, value trends, supply demand imbalance

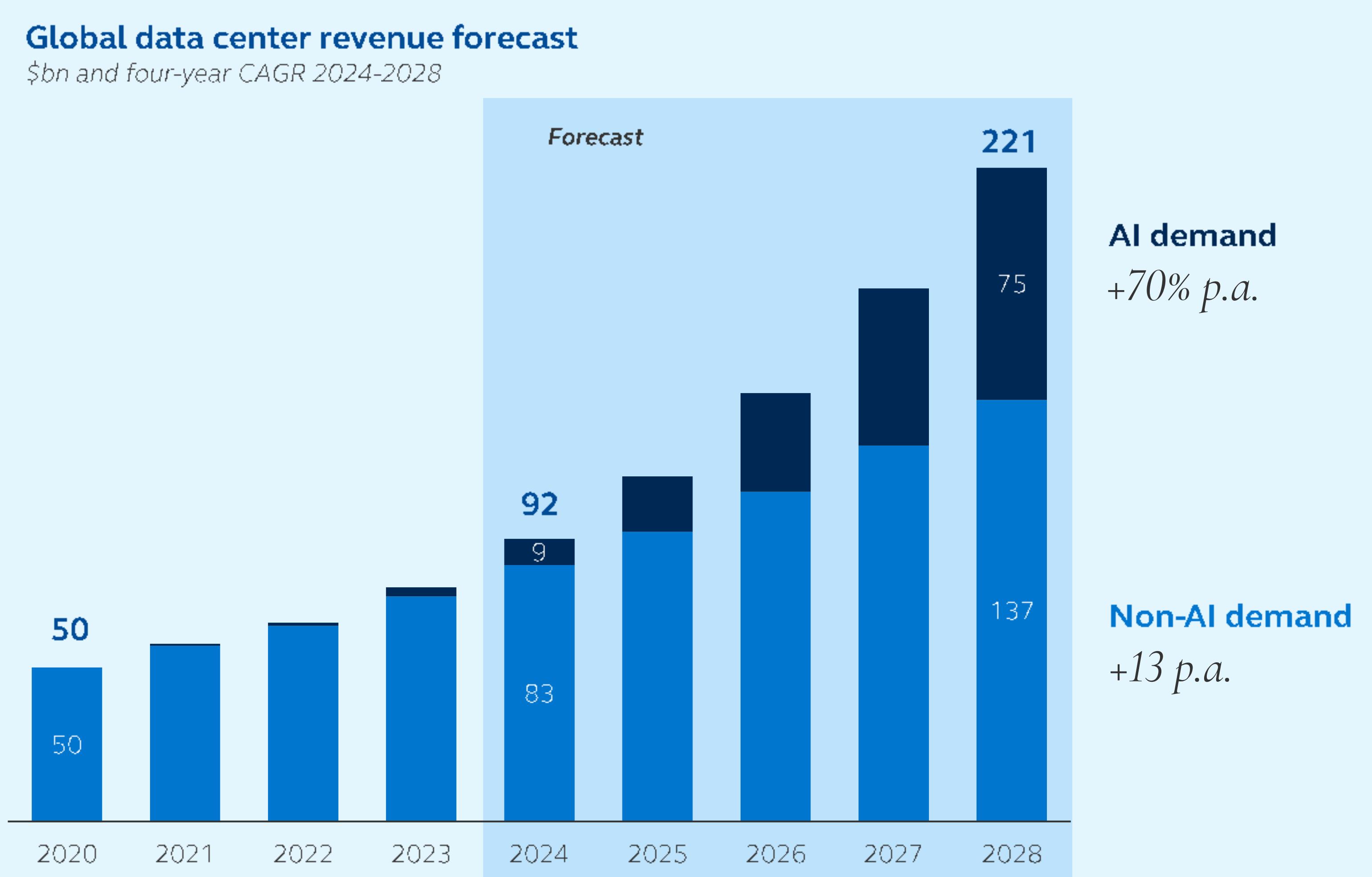


Source: Principal Real Estate, July 2024. The recommendations above reflect our views on relative opportunities over a 12-month horizon. It is not intended to be, nor should it be relied upon in any way as a forecast or guarantee of future events regarding particular investments or the markets in general.

OPPORTUNITY

DATA CENTERS

Data center demand poised for a new wave of growth, driven by AI



- Globally, fundamentals are strong, rental growth is in the double digits, and vacancy rates are trending to record lows.
- Historically, demand has been driven by streaming services and the migration of enterprise servers to the cloud. Demand from this segment is expected to grow by 13% annually.
- The recent boom in AI has generated an additional layer of demand, which is expected to grow even faster—by 70% per year. Hyperscalers are investing so much capital in this space that by 2027 it is expected that generative AI is set to consume three-quarters of global data center capacity.
- What makes this sector even more attractive is its high barriers to entry as the electricity required for new facilities is simply unavailable. The grids do not have enough capacity to accommodate all the demands. Securing new power is very difficult, with waiting lists that go up to two years in core markets.

Source: Cushman & Wakefield Research, Structure Research, Principal Real Estate, May 2024

OPPORTUNITY

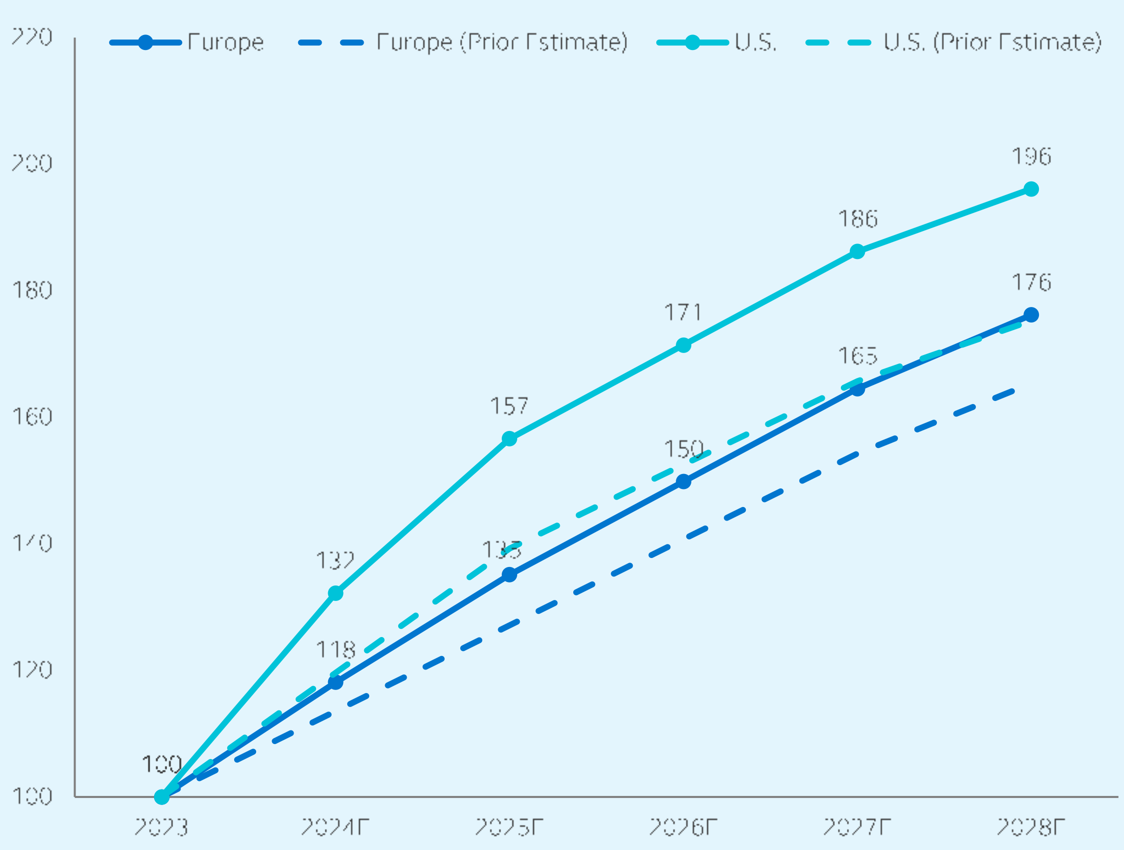
DATA CENTERS

Supply growth expands due to insatiable demand

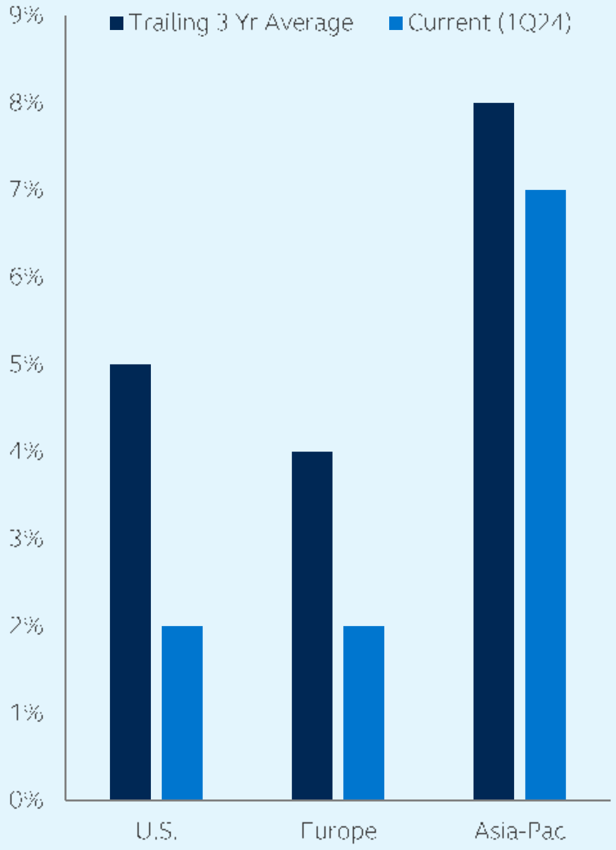
- Supply drivers in Western economies have driven market growth estimates higher than originally anticipated.
- Markets in the Asia-Pacific have yet to absorb existing supply, but trends in other regions point to potential opportunities for investors to enter.
- We believe that the data center markets in the U.S. and Europe will maintain strong fundamentals as a resilient property type within the digital era.

Data center supply forecast

Index, 2023 = 100



Data center vacancy rates



 Source: Green Street, DataCenter Hawk, Principal Real Estate, Q1 2024.

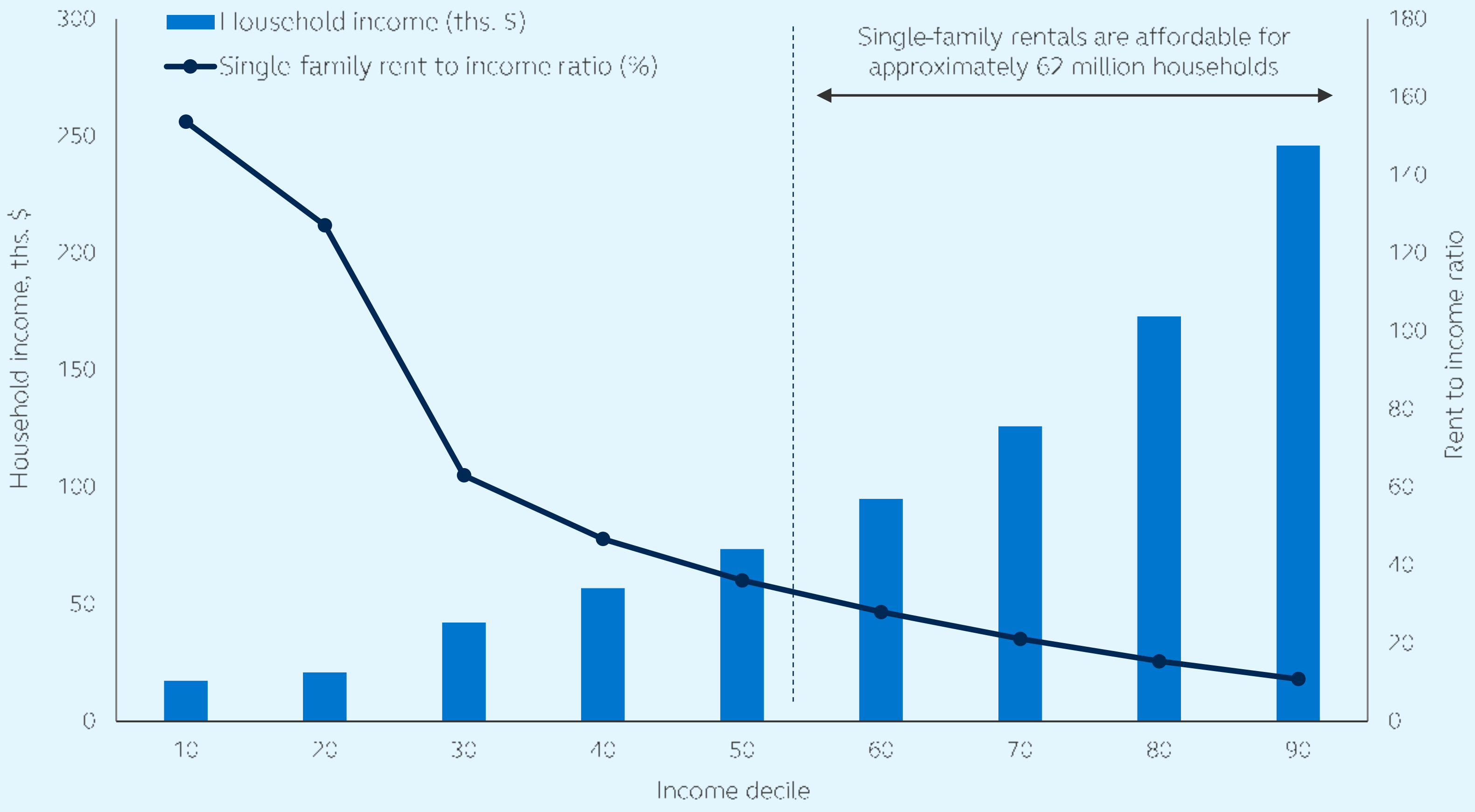
OPPORTUNITY

U.S. SINGLE-FAMILY RENTAL

Single-family rentals have a broad demand base…

- Affordability in the U.S. single-family for-purchase market remains at a record low. Following the COVID-19 pandemic, low interest rates and a lack of single-family development caused a spike in home prices, exacerbating an already emerging problem.
- One potential solution to the issue is single-family rental housing, which offers would-be first-time home buyers—or renters by choice—an affordable option to rent larger homes to meet their growing needs.
- The rental rate for single-family rentals is also attractive and allows landlords to target households with incomes of $88,650 and higher. While this figure is above the national median income, it is well within the means of nearly 45% of the income distribution in the U.S., or approximately 62 million households

Household income and single-family affordability



Source: CBRE-EA, John Burns Consulting, IPUMS ACS (1-Year Sample), University of Minnesota, www.ipums.org, Principal Real Estate, Q4 2023.

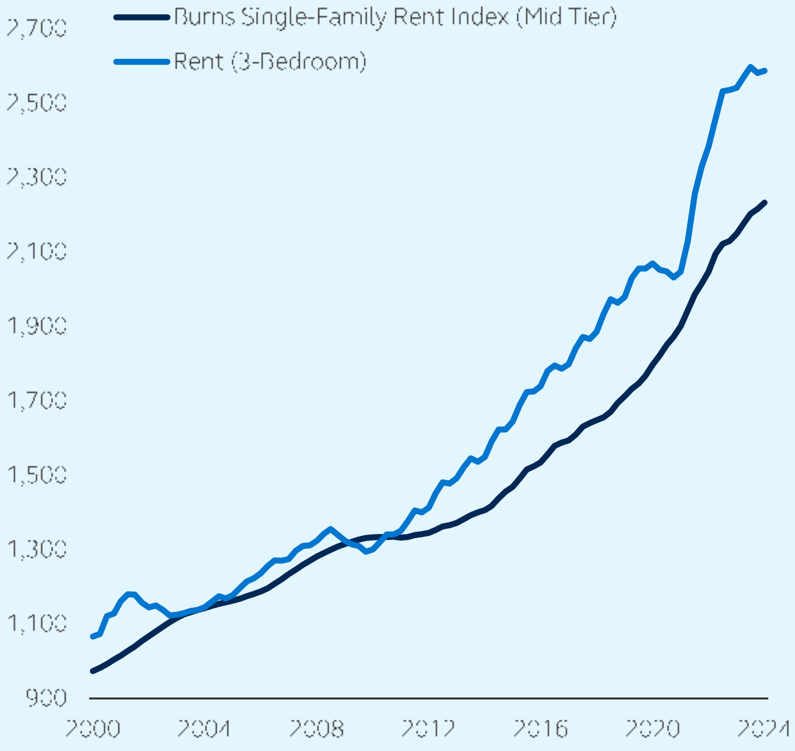
OPPORTUNITY

U.S. SINGLE-FAMILY RENTAL

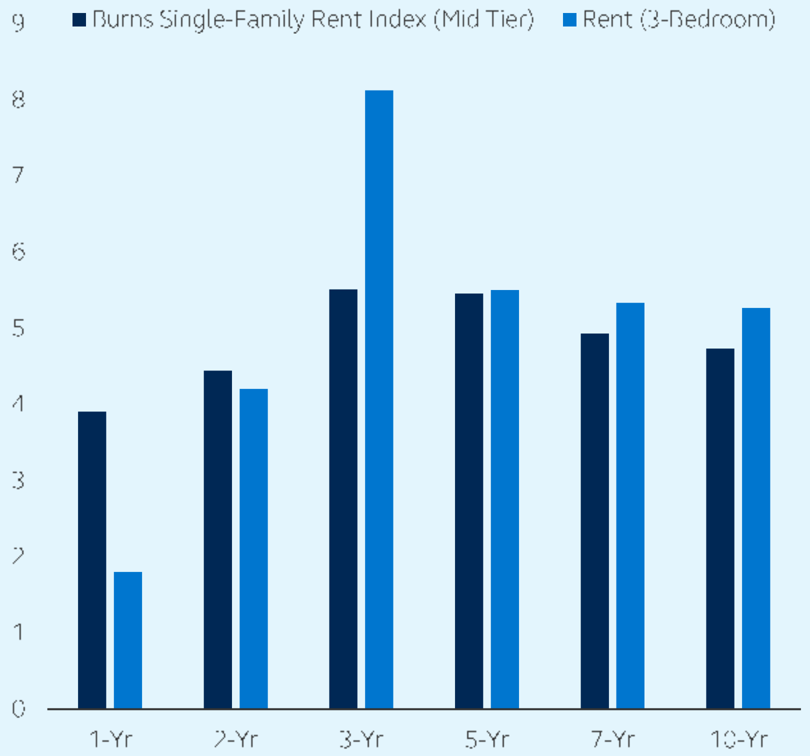
…and offer an attractive price point to traditional apartments

- Comparing rental trends from John Burns Consulting and CBRE, we show that mid-tier single-family rentals offer a significant discount to a comparable traditional three-bedroom rental unit. A mid-tier single-family unit rents for $2,216 per month compared with $2,579 for a three-bedroom apartment.
- While the single-family sector is relatively new to investors, it has a long history within the U.S. rental market dating back decades. Its performance is also impressive as it has shown the ability to generate both attractive and consistent rental and income returns for investors, much like other residential subsectors of commercial real estate.

Single-family and apartment rents
Monthly, USD$/unit



Single-family and apartment rent growth
Average annual percentage change



Source: CBRE-EA, John Burns Consulting, Principal Real Estate, Q1 2024

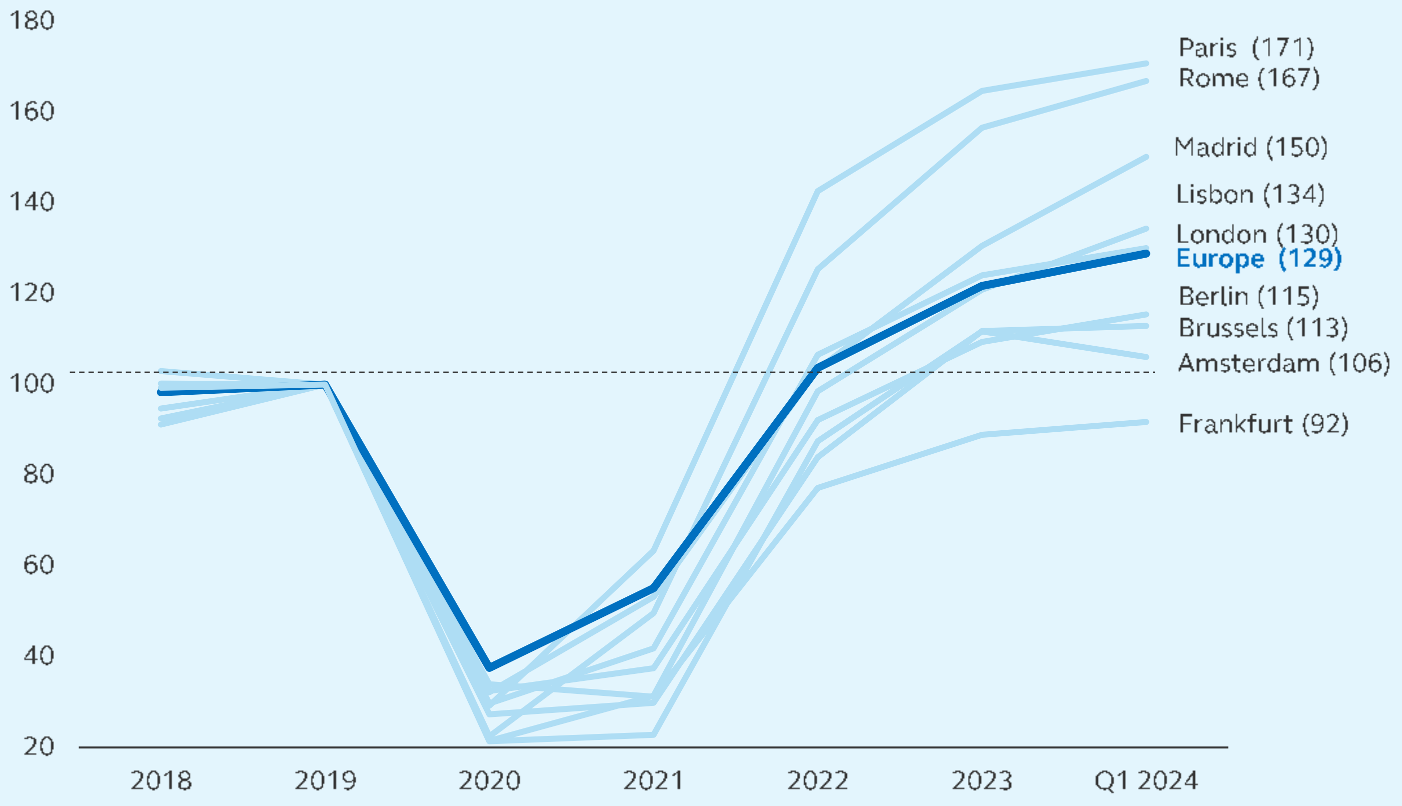
⊕ OPPORTUNITY

EUROPEAN HOTELS

Europe's hospitality sector has experienced an exceptional recovery

Hotel recovery in selected European key markets

RevPAR growth index, 2019 = 100

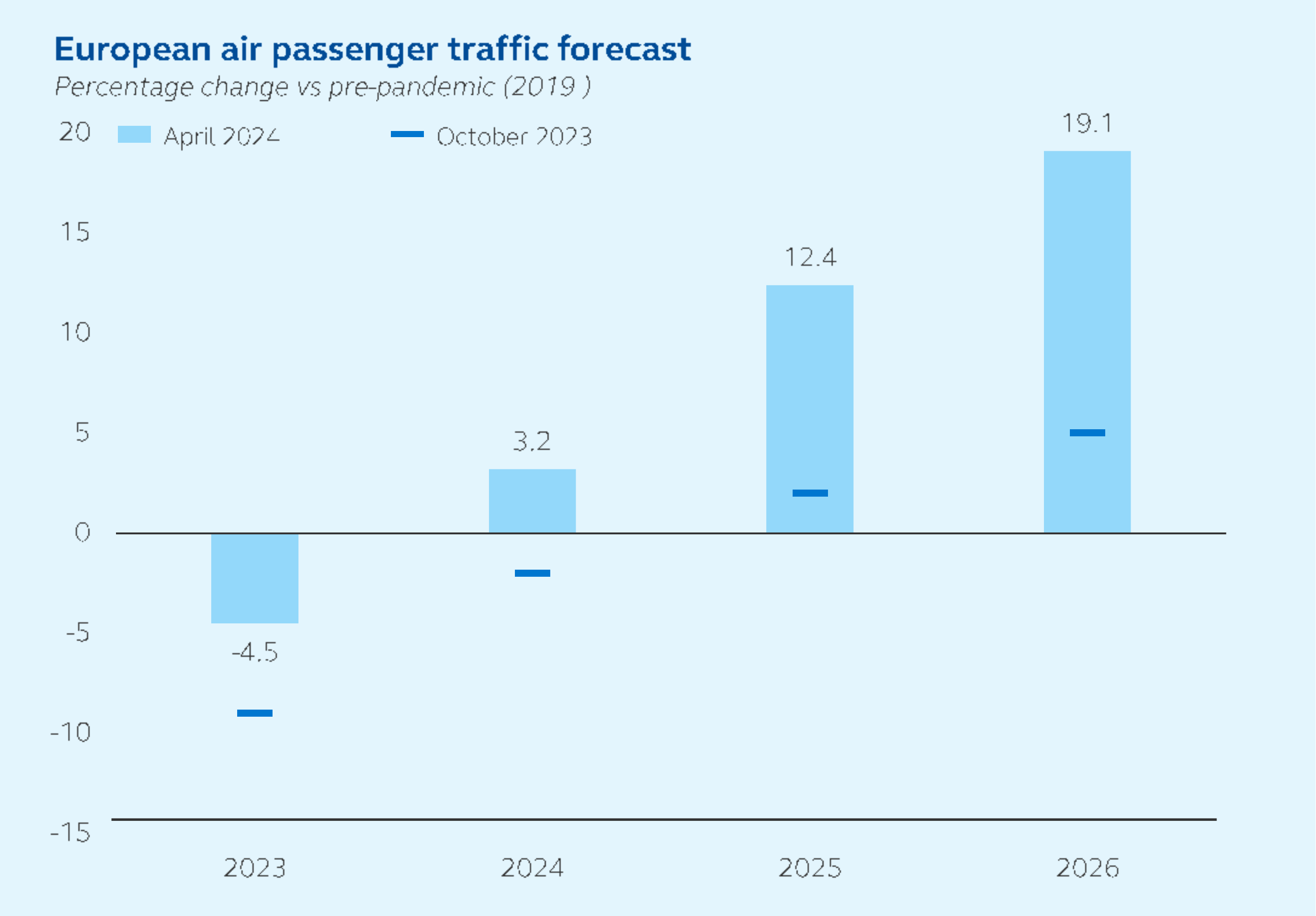


- Recovery in hotel trading has been exceptional, surpassing 2019 levels (a previous peak), in almost all markets.
- Europe, as a whole, is up +29% VS. 2019.
- Southern European cities and leisure destinations were the fastest to recover.
- Although business travel has improved, business reliant destinations continue to lag, whilst those with a strong mix of both leisure and business continue to outperform.
- However, not all hotel types were able to benefit from the sector's recovery. Several small, independent family-owned hotels are in a difficult financial situation.

Source: STR, Principal Real Estate, May 2024. Includes accommodation and food service activities

EUROPEAN HOTELS

The outlook for the European hotel sector looks positive



- We believe that the year ahead offers a unique opportunity to acquire undervalued and underinvested assets and reposition these ahead of the new cycle.
- The sector went through a long period of stress, first due to COVID-19, and then to inflation and high borrowing costs. The consequences of this challenging environment has been more severe in Europe where approximately 70% of hotels belong to small independent owner-occupiers, with weaker balance sheets, less sophisticated management, and lower online brand presence.
- As a result, we anticipate that many undervalued assets, that historically have not traded, will come to market. Acquiring and unlocking the full potential of some of these assets represents an attractive opportunity, especially considering tourism projections are very promising.

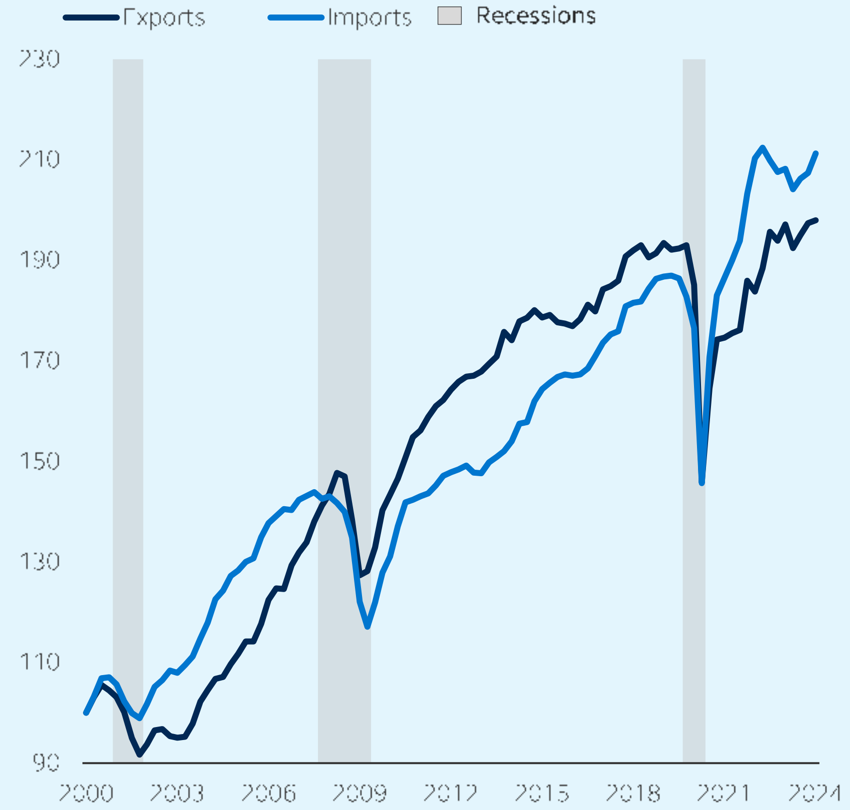
 Source: Airports Council International, Principal Real Estate, May 2024

OPPORTUNITY

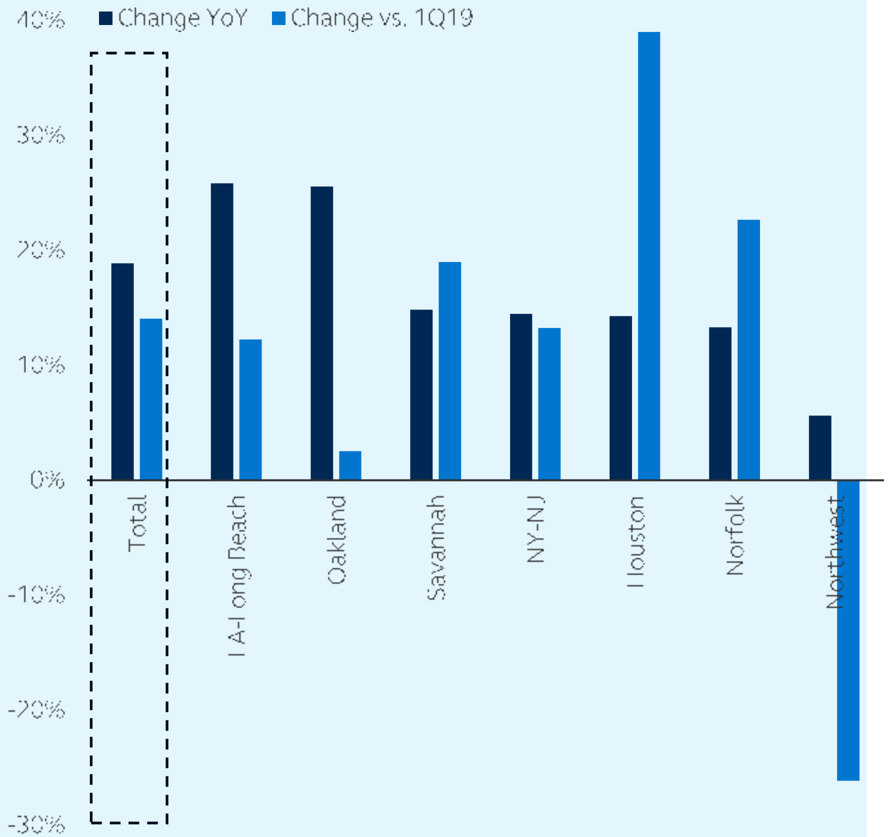
U.S. LOGISTICS

Changes in trade routes and supply chain is creating demand for new hubs

Real imports and exports,
Index, 2000=100



1Q24 Import TEU volumes by major seaport



- The industrial sector is facing cyclical headwinds as demand re-adjusts from a post-pandemic surge and a surfeit of new supply has pushed availability rates higher.
- Despite near-term challenges, we believe the sector is poised to be a top performer for long-term investors.
- Global trade has experienced a resurgence and a shift in trade patterns away from China will continue to bolster the demand for new warehouse space over the next several years.
- We believe that 2024 and 2025 will offer an appealing entry point for investors due to attractive valuations. However, additional tariffs or disruptions to international trade is worth monitoring.

Source: Moody's Analytics, Green Street, NBER, Port Disclosure, Principal Real Estate, Q1 2024

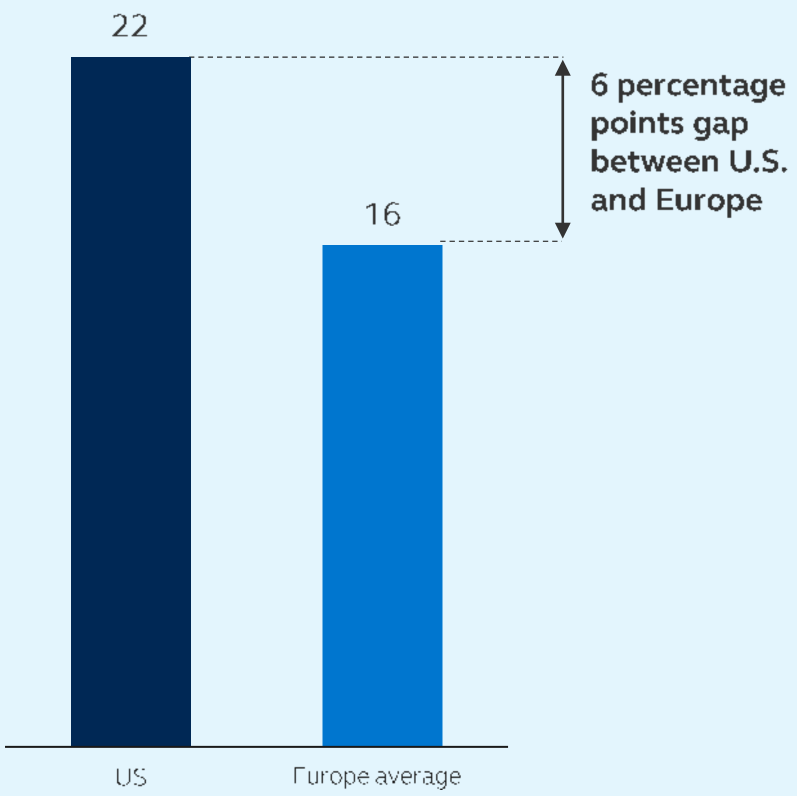
OPPORTUNITY

EUROPEAN LOGISTICS

Relatively low e-commerce penetration still offers opportunities

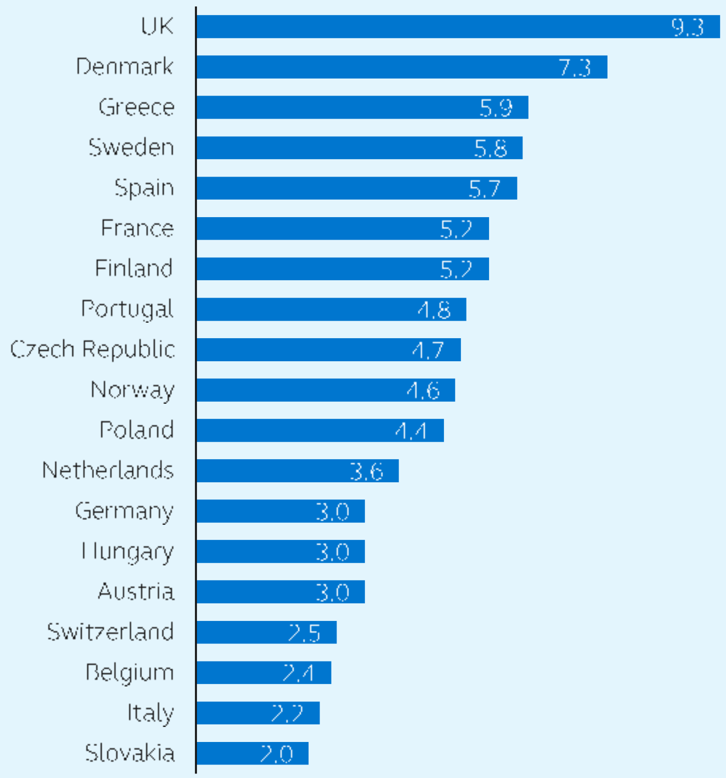
E-commerce penetration[1]

Percentage of total retail sales, 2023



E-commerce as share of GDP

Percentage, e-commerce spending in 2023



- In Europe, relatively low e-commerce penetration still offers many opportunities for the logistics sector to grow. As illustrated in the chart on the left, the share of e-commerce in Europe is much lower than in the U.S., and within Europe there are countries, such as Italy, where the share is even lower—close to 10%, or around 2% of total country GDP (chart on the right).
- Additionally, most warehouses in Europe are more than 20 years old, unable to fulfill modern operational requirements. Rapid advancements in AI and warehouse robotics will accelerate the shift toward newer buildings, which will likely become taller, smaller, and closer to end customers.
- In the longer-term, we expect tightening sustainability regulations will make it increasingly difficult to execute greenfield development projects, putting a cap on new supply.

[1] E-commerce penetration figures were calculated after subtracting from total retail sales those segments that don't typically sell online, such as restaurants, bars, automobile dealers, gas stations, fuel dealers.

Source: U.S. Department of Commerce, Digital Commerce 360, Knight Frank, PPRO Group, Principal Real Estate, Q4 2023

Waiting for clarity

1 A waiting game

While we anticipated 2024 to be a year of transition, investors have been playing a waiting game as central banks continue their battle with price stability, which has extended uncertainty around pricing in private real estate markets.

We continue to believe that a new cycle is forming, and that 2024 and 2025 will offer investors an attractive entry point into private markets. A mature valuation cycle is nearing its end, and a resilient economy continues to support strong demand across most sectors today.

2 Our long-term conviction for structurally-resilient property sectors is unchanged heading into the second half of 2024

Residential, hotel, data center, and logistics sectors will remain underserved in the current growth and demographic environments and have outperformed other sectors this year.

3 Focus on quality and sector selection

We continue to suggest that investors focus on quality and sector selection as keys to effective strategy in 2024, as values begin to stabilize and the path to the recovery comes into view.

"We continue to believe that a new cycle is forming, and that 2024 and 2025 will offer investors an attractive entry point into private markets."

Source: Principal Real Estate, July 2024

About Principal Real Estate

Access the full spectrum of today's commercial real estate investment opportunities.

Principal Real Estate is the dedicated real estate investment group within Principal Asset Management.

We have a 360° view of real estate, with capabilities that span the spectrum of public and private equity and debt investments. We seek to maximize opportunities and find the best relative value on behalf of our clients using our specialized market knowledge, dedicated and experienced teams around the globe, and extensive connections across all four real estate quadrants.

- Top 10 global manager of real estate[1]
- $97.7 billion in real estate assets under management[2]
- Over 60 years of real estate investment experience[3]
- More than $124 billion in real estate debt and equity transactions over the past decade[4]
- Recognized globally as a leader in sustainable investing[5]

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See important information for footnote references

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Important information

[1] Managers ranked by total worldwide real estate assets (net of leverage, including contributions committed or received, but not yet invested; REOCs are included with equity; REIT securities are excluded), as of 30 June 2023. “The Largest Real Estate Investment Managers,” Pensions & Investments, 9 October 2023

[2] As of 30 June 2024. Includes clients of, and assets managed by, Principal Real Estate Europe Limited and its affiliates. Does not include assets that are managed by Principal International and Retirement and Income Solutions divisions of Principal. Due to rounding, figures shown may not add to the total.

[3] Experience includes investment activities beginning in the real estate investment area of Principal Life Insurance Company and continuing through the firm to present.

[4] As of 31 December 2023. Excludes public REIT transaction volume.

[5] As recognized by Global Real Estate Sustainability Benchmark (GRESB) assessment 4-Star rating (2023) as of October 2023. Data as of 31 December 2022. 4-star rating reflects top 40% worldwide performance. In order to receive a ranking, the firm paid GRESB an application fee to be evaluated and rights to use the rating. Principal Real Estate recognized as ENERGY STAR Partner of the Year 2016-2024, Sustained Excellence Award 2018-2024. The U.S. Environmental Protection Agency (EPA) annually honors organizations that have made outstanding contributions to protecting the environment through energy efficiency, April 2024.

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