BARINGS

U.S. Real Estate: Ready, Set... Go?

U.S. Real Estate Research Quarterly

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Executive Summary

ECONOMY

- Recent data continues to support the “soft landing” narrative that once elicited skepticism. CPI inflation excluding food and energy grew by 3.3% year-over-year in June, the slowest pace of inflation since May 2021.
- The initial estimate of second quarter 2024 real GDP SAAR growth was reported at 2.8%—higher than the 1.4% rate of the first quarter. The underlying strength of the economy serves as a reminder not to take anything for granted regarding monetary policy.
- The fight against inflation is far from finished, not only because certain components of the price basket remain elevated, but because the potential policy implications of Trump’s vocal endorsement of tariffs, immigration restrictions, and corporate and household tax cuts are also likely to spur additional inflation if fully realized.

PROPERTY MARKET

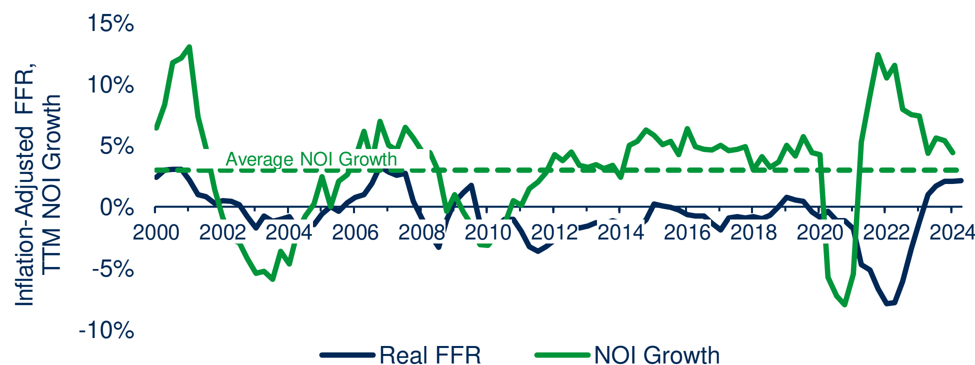
- Preliminary transaction activity data shows that year-over-year sales volume has declined for eight consecutive quarters matching the period during and following the GFC. However, the cumulative decline of 44%, when considering the NFI-ODCE after the GFC, was far deeper than the more recent decline of 23% from the peak.
- As investors contemplate the price correction, the length of the current downturn, and the prospect of lower borrowing costs, many are positioning themselves to deploy capital.
- Distress levels continue to climb even as a recovery approaches. MSCI RCA estimated that cumulative real estate debt distress across major property types reached $94 billion as of the second quarter of this year. Office comprised the largest share of outstanding distress at $41 billion, however, distress is pending across other property sectors.

Economic Outlook

Recent events around the U.S. presidential election cast the second quarter of 2024 in a new light. The debate performance that led to President Biden dropping out of the 2024 race and the assassination attempt on former President Trump's life now bring into sharp relief the risks to the global macroeconomy and commercial real estate market from the upcoming presidential election. Monetary policy does appear to be helping tame price pressures with concerns rising that overly tight financial conditions could tip a slowing—though resilient—economy into recession, rather than a soft landing. Yet, the fight against inflation is far from finished, not only because certain components of the price basket remain elevated, but because the potential policy implications of Trump's vocal endorsement of tariffs, immigration restrictions, and corporate and household tax cuts are also likely to spur additional inflation if fully realized. While it appears increasingly likely that the "data dependent" U.S. Federal Reserve (Fed) will cut rates, bringing some relief to stressed borrowers, the uncertainty surrounding the medium-term outlook for commercial real estate has hardly diminished.

Preliminary transaction activity data shows that year-over-year sales volume has declined for eight consecutive quarters matching the period during and following the global financial crisis (GFC). However, the cumulative decline of 44%, when considering the NFI-ODCE after the GFC, was far deeper than the more recent decline of 23% from the peak.[1] As investors contemplate the price correction, the length of the current downturn, and the prospect of lower borrowing costs, many are positioning themselves to deploy capital. Real estate fundamentals have been resilient even during this period of Fed tightening. As the inflation-adjusted Fed funds rate has risen to its highest level since 2008, net operating income growth has slowed from its post-pandemic surge of 12.4% down to 4.4%—which is still above the historical average of 3%.[2]

FIGURE 1: INFLATION-ADJUSTED FEDERAL FUNDS RATE, CORE NOI GROWTH



Source: Federal Reserve; NCREIF. As of June 28, 2024.

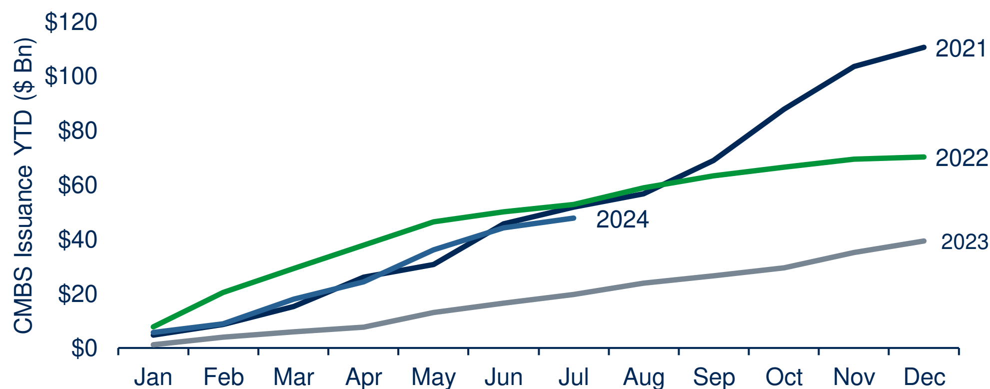
Recent data continues to support the "soft landing" narrative that once elicited skepticism. CPI inflation excluding food and energy grew by 3.3% year-over-year in June, the slowest pace of inflation since May 2021.[3] One of the causal factors behind persistently elevated inflation has been shelter, which has seen cost trends slow over the past two years. Unemployment also

[1] Source: NCREIF. As of March 31, 2024.
[2] Source: NCREIF. As of March 31, 2024.
[3] Source: BLS. As of June 30, 2024.

rose above 4% in June, the first time since November 2021.[4] Manufacturing PMI was contractionary (below 50) through the entire second quarter.[5] The initial estimate of second quarter 2024 real GDP SAAR growth was reported at 2.8%—higher than the 1.4% rate of the first quarter—driven by consumption.[6] The underlying strength of the economy serves as a reminder not to take anything for granted regarding monetary policy.

On the lending side, borrower green shoots have appeared for CMBS and some insurance company lenders. Overall commercial mortgage originations volumes were flat in the first quarter of 2024 compared to a year prior, but the whole of 2023 was down 47% from 2022 with banks and debt funds pulling back more than other lender types.[7] CMBS and life company originations were up by 93% and 35%, respectively, while banks, debt funds, and government-sponsored enterprises were still down relative to the first quarter of 2023. An uptick in originations activity is signaling a return of debt capital liquidity for now.

FIGURE 2: CMBS ISSUANCE



Source: Green Street. As of June 28, 2024.

The impact of base rates on cap rates continues to play out, but upward pressure has eased. In October 2023, the 10-year Treasury yield reached its highest level in 16 years, almost touching 5.0% before falling to 3.9% by year end.[8] By the end of June, the 10-year yield had risen by 40 basis points (bps) to 4.3%. Composite implied public real estate investment trust (REIT) cap rates peaked at 6.6% in October of last year before settling close to 6% through the first half of 2024.[9] Even considering the rise in cap rates, real estate risk premiums are still compressed relative to their historical average. In a scenario where uncertainty remains elevated, higher risk premiums coupled with elevated base rates would likely mean further price depreciation.

Distress levels continue to climb even as a recovery approaches. MSCI RCA estimated that cumulative real estate debt distress across major property types reached $94 billion as of the second quarter of this year. Office comprised the largest share of outstanding distress at $41 billion, however, distress is pending across other property sectors. Potential distress has reached $202 billion, and the apartment sector is still the most sizeable portion constituting $57 billion.

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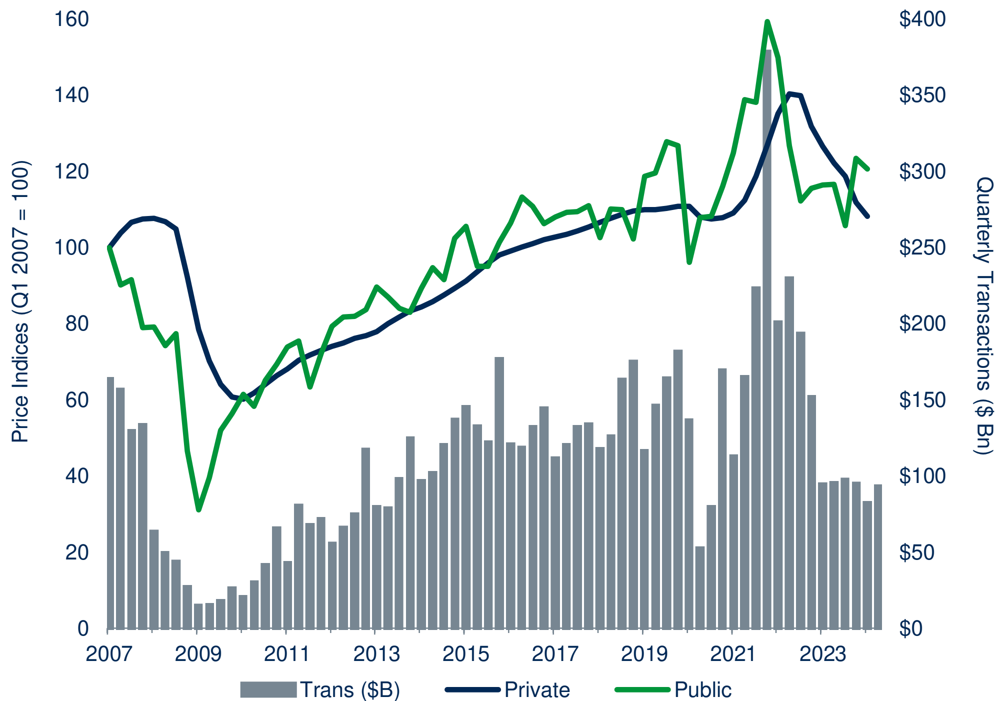
[4] Source: BLS. As of June 30, 2024.
[5] Source: ISM. As of June 30, 2024.
[6] Source: BEA. As of June 30, 2024.
[7] Source: MBA. As of March 31, 2024.
[8] Source: Bloomberg. As of June 30, 2024.
[9] Source: Green Street. As of June 30, 2024.

Capital Markets

Transaction activity totaled $93 billion in the second quarter of 2024, a 2% decline year-over-year versus a decline of 59% in the second quarter of 2023 (Figure 3). Apartment and hotel sales activity rose over the last year by 20% and 4%, respectively. Offices were down by 20%, retail by 10%, and industrial by 17%.[10] From the fourth quarter of 2021 to the second quarter of 2024, quarterly transaction activity has fallen by 75%. This marks the eighth consecutive quarter of declining sales volume, matching the GFC in terms of duration.

Composite public REIT share prices are 23% below their prior peak with significant variation by property type. A proxy for the NFI-ODCE fund index value has fallen by 22.9% from the peak, but the pace of capital value declines slowed over the quarter relative to the prior quarter.

FIGURE 3: QUARTERLY TRANSACTION ACTIVITY, PUBLIC & PRIVATE RE PRICE TRENDS



Source: Bloomberg; MSCI RCA; NFI ODCE. As of June 28, 2024.

[10] Source: Bloomberg; MSCI RCA; NFI ODCE. As of June 28, 2024.

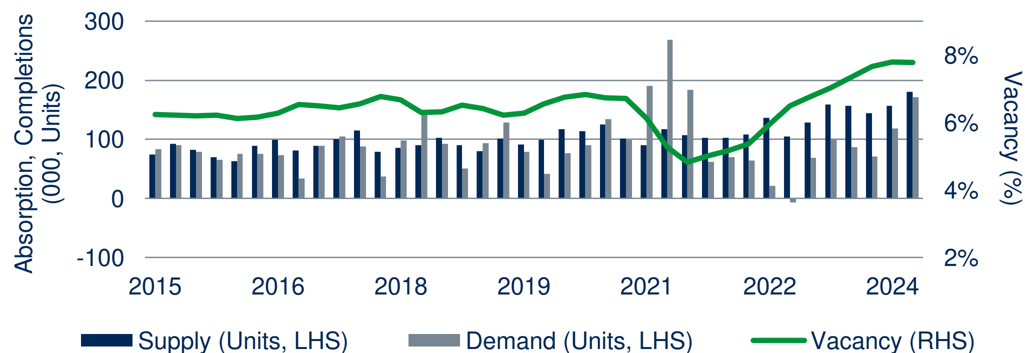
Property Markets

APARTMENT

In the second quarter of 2024, apartment vacancy rates were unchanged quarter-over-quarter at 7.8% despite heavy new supply as demand accelerated, supporting 1.0% year-over-year asking rent growth.[11] Tenant leasing activity reached its highest level since 2021, supported by a strong, though slowing, labor market. However, supply-demand dynamics differ by product type. For example, 4- and 5-star multifamily properties have a 10.9% vacancy rate compared to 7.0% for 3-star buildings that are more affordable. Occupancy rates are also higher for supply constrained markets (such as New York, Washington, and Boston) compared to growth areas (such as Austin, Atlanta, Houston, and other Sunbelt markets). The weaker fundamentals in these markets, along with higher interest rates, are apparent in credit indicators as properties in such areas have higher loan modification rates. In addition, it appears higher risk and leverage sponsors have experienced increased stress as multifamily CMBS 30+ days delinquency rates reached 2.36% in June 2024, compared to 1.59% the same time a year ago.[12]

The apartment sector's new supply pipeline has slowed, which is supportive of improved fundamentals. Challenges from higher interest rates and softness in certain markets represent potential opportunities, particularly given long-term sector strengths.[13] For example, household formation has outpaced overall housing inventory growth since the GFC while the share of individuals renting has increased following a peak in 2004. Barings estimates this has resulted in an additional 11.9 million renter households, along with general population growth. This incremental source of demand is projected to be durable given homeownership affordability issues from higher house prices and mortgage rates. According to the Mortgage Bankers Association (MBA), the national median payment for home purchase applicants was $2,219 in June compared to $1,320 in April 2021. The rate-lock effect has provided an additional headwind to for-sale inventory as many families have stayed in their current home for longer than expected as nearly 80% of outstanding mortgages are 5% or lower.[14]

FIGURE 4: VACANCY RATES UNCHANGED WITH STRONG DEMAND DESPITE NEW SUPPLY



Source: CoStar. As of June 30, 2024.

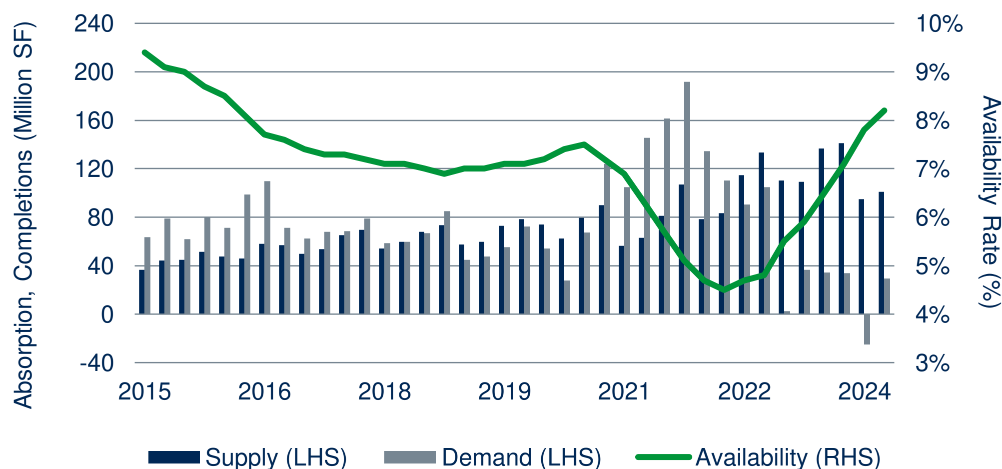
[11] Source: CoStar. As of June 30, 2024
[12] Source: Trepp. As of June 30, 2024.
[13] Source: CoStar. As of June 30, 2024. Deliveries are forecast to decline by 35% in the second half of 2024.
[14] Source: Redfin. As of May 31, 2024.

INDUSTRIAL

The industrial availability rate rose 40 bps quarter-over-quarter to 8.2% in the second quarter of 2024 as the sector normalizes post-pandemic (Figure 5). The rate of availability increases slowed from an average of 60 bps over the previous three quarters as leasing improved. However, new supply remained well above demand with 83% of new space delivered without a lease in-place year-to-date.[15] Similar to the apartment sector, markets in the South have experienced higher vacancy rates given more elevated speculative construction. The West has also softened as tenants consolidated operations and reduced real estate space while the Midwest and Northeast markets have experienced lower vacancy. The sector's weaker fundamentals have resulted in slower rent growth though rates continued to rise well above other core property types at 4.0% year-over-year in the second quarter.[16] Although new supply is expected to outpace tenant demand in the near-term, the spread is expected to narrow. In addition, the construction pipeline fell to a four year low in the second quarter, and there are positive signs from leading indicators such as increased business inventory levels and e-commerce sales.[17]

Despite the industrial market's slowdown, the sector benefits from secular demand drivers such as continued e-commerce adoption, which requires more space than brick-and-mortar retail due to factors such as higher product variety, individual business-to-consumer shipping, and a heightened need for reverse logistics for returns. In addition, population growth—albeit at a slowing rate—represents an increased number of individual consumers who are spending greater amounts on an inflation-adjusted per capita basis.[18] Although circumstances vary by household, increased consumption is supported by higher per person net worth, which reached a record high of nearly $450,000 in the first quarter of 2024.[19]

FIGURE 5: INDUSTRIAL AVAILABILITY CONTINUED TO INCREASE ON NEW SUPPLY



Source: CBRE-EA. As of June 30, 2024.

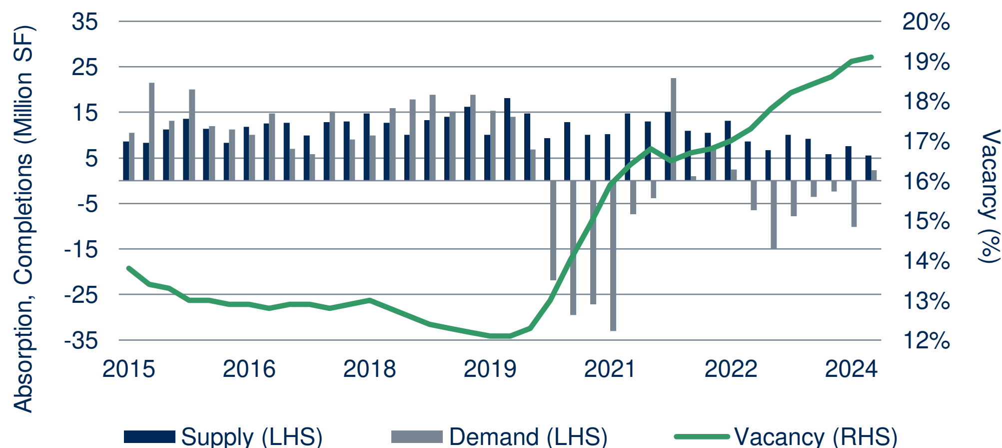
[15] Source: C&W. As of June 30, 2024.
[16] Source: CBRE-EA. As of June 30, 2024.
[17] Source: Census Bureau. As of May 31, 2024, and June 30, 2024.
[18] Source: Oxford Economics; BEA. As of March 31, 2024.
[19] Source: Census Bureau; Federal Reserve. As of March 31, 2024.

OFFICE

Office vacancy rates increased 10 bps quarter-over-quarter to 19.1% in the second quarter of 2024, with higher rates in downtown (19.6%) compared to suburban (18.7%) areas (Figure 6). San Francisco has the highest vacancy rate (25.2%), while 17 out of 63 markets tracked by CBRE EA have rates above 20% (including Portland, Dallas, and Houston). Although the sector is likely to further weaken, there are signs of nearing stabilization as the rate of vacancy increases has decelerated, active tenant space requirements has trended upward, and overall availability—including sublease space—was relatively unchanged quarter-over-quarter. For example, office leasing activity increased 38% quarter-over-quarter in the second quarter, but remained nearly 25% below the pre-pandemic average as the sector adjusts to the post-pandemic environment.[20] The market remains highly competitive for new tenants as landlords are offering an average of $26 in concessions—such as free rent and tenant improvement allowances—for every $100 per square foot leased, up 8.9% from 2023.[21] In addition, occupiers are placing added focus on property owners' financial health to be able to fund tenant improvements, which favors well-capitalized landlords and sponsors.

Tenant demand for the highest quality properties remains strong. For example, total availability rates for Class A+ properties are 750 bps lower than the overall office average.[22] However, leasing activity in this segment has been tempered by limited supply, which is expected to persist given tepid new office development as groundbreakings recently fell to an all-time low.[23] Outside of asset quality, proximity to major transit stations has impacted supply-demand as well. In New York City, buildings within a 10-minute walk from Penn/Moynihan Station and Grand Central Station have an average vacancy rate of 13.9%. This compares to a 22.4% rate for office buildings in the Financial District, which is far south of the city's major transit stations.[24]

FIGURE 6: OFFICE VACANCY RATES INCREASED, BUT AT A SLOWER RATE



Source: CBRE-EA. As of June 30, 2024.

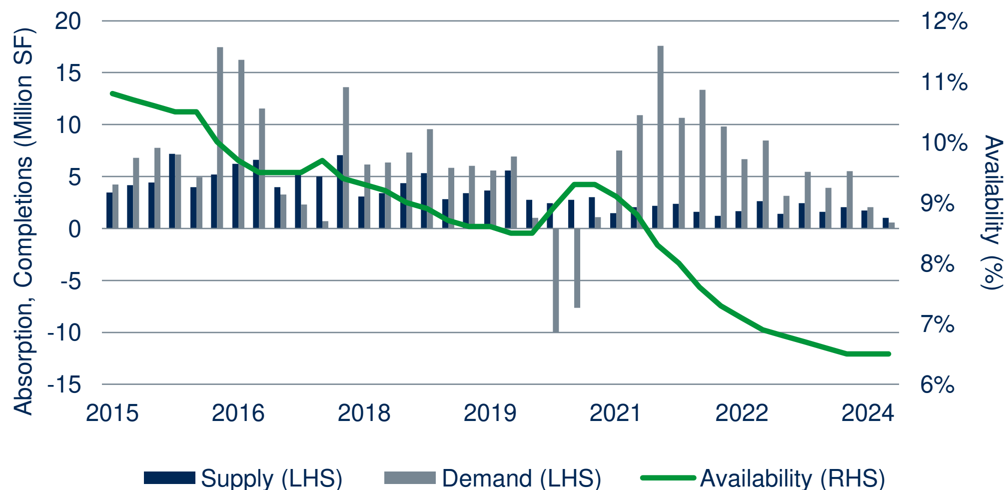
[20] Source: Avison Young. As of June 30, 2024.
[21] Based on BOS, CHI, NYC, SF and DC. Source: Avison Young. As of June 30, 2024.
[22] Based on BOS, CHI, LA, NYC, SF and DC. Source: C&W. As of June 30, 2024
[23] Source: JLL. As of March 31, 2024.
[24] Source: CBRE EA. As of June 28, 2024.

RETAIL

The neighborhood and community shopping center (N&CS) sector remained steady in the second quarter as vacancy rates were unchanged at a record low of 6.5%, while rents increased 2.5% year-over-year (Figure 7). Retailers have slowed expansion plans due to rising costs of rent, fit-out construction, operations, security, and insurance based on a recent survey.[25] In addition, leasing activity was constrained by limited availability as the second quarter marked the lowest level of new completions since at least 2005 when the data series began. The South region recorded the strongest absorption and 42% of all leasing in the quarter while Nashville, Raleigh-Durham, Miami, and Charlotte had the lowest vacancy rates in the U.S. The Northeast and Midwest regions' vacancy rates were relatively unchanged while the West modestly increased and recorded negative net absorption for the second consecutive quarter.[26]

Consumer spending remained resilient through the second quarter. Retail sales excluding motor vehicles and parts increased 0.4% month-over-month in June, which was above consensus economist projections.[27] Households have benefited from increased real incomes and solid, though cooling, employment gains. For example, private hourly earnings increased 3.9% year-over-year in June and 206,000 jobs were added, while the unemployment rate edged up to 4.1%.[28] Strong spending by affluent consumers—supported by higher financial asset values—has carried personal consumption based on Comerica and Bank of America analysis. Lower- and moderate-income consumers, however, have exhausted pandemic-era savings although a tight labor market helps buoy their necessity spending. There are a range of potential future economic scenarios which the N&CS is well-positioned to meet given the sector's diverse and necessity-based offerings.

FIGURE 7: N&CS AVAILABILITY RATE AT A RECORD LOW, LIMITED INVENTORY



Source: Barings, CBRE-EA. As of June 30, 2024.

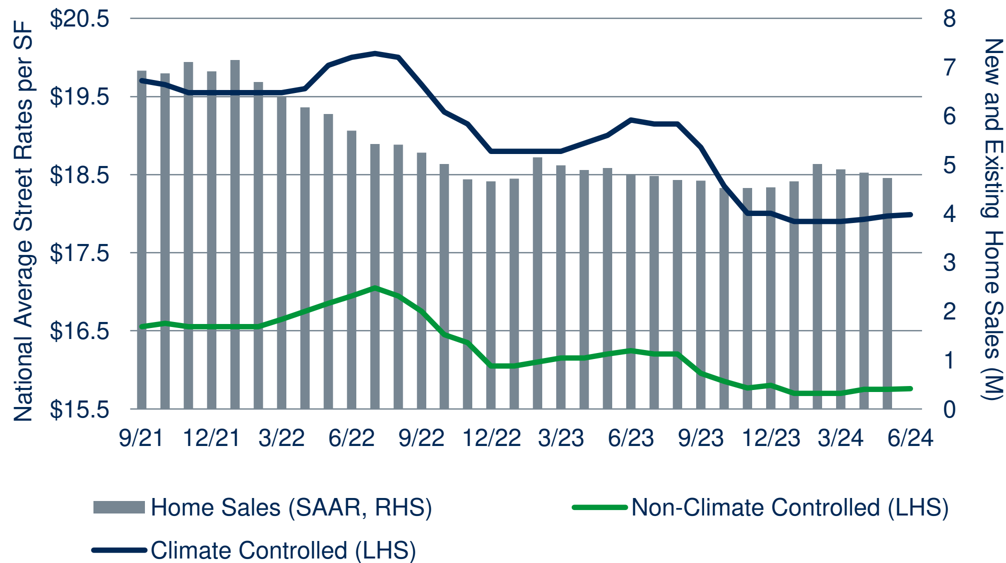
[25] Source: Cushman & Wakefield survey. As of June 30, 2024.
[26] Source: Barings; CBRE-EA. As of June 30, 2024.
[27] Source: Census Bureau; Reuters. As of June 30, 2024, and July 16, 2024.
[28] Source. Bureau of Labor Statistics. As of June 30, 2024.

SELF-STORAGE

Self-storage rental rates were relatively unchanged quarter-over-quarter and remain well below their July 2022 peak given that a key source of demand—home sales—has declined (Figure 8). New supply has slowed but has not significantly declined and remained at 3.6% of total inventory as of June 2024. However, 88 of 3,307 construction projects tracked by Yardi Matrix were abandoned in the early stages of development due to issues such as softer fundamentals, higher interest rates, and increased building costs.

Household mobility is expected to have a meaningful impact on the sector and should be a primary focus for market selection given individual moving patterns are associated with self-storage demand. This favors geographies with a higher share of renter households—who tend to move more frequently than homeowners given home sales remain low—and there is evidence of this in rent growth. For example, Boston, New York, Austin, and DC reported the strongest positive rent growth in June and all have a lower share of homeowners compared to other metro areas.[29]

FIGURE 8: SELF-STORAGE RENTS REMAIN RELATIVELY RANGE BOUND, WELL OFF PEAK



Source: NAR; Yardi Matrix, Federal Reserve. As of May 31 and June 30, 2024.

[29] Source: NAR; Yardi Matrix. As of June 30, 2024.

CONCLUSION

We are near or at the end of a protracted real estate downturn. Investors contemplating the current macro environment—with the combination of reduced values, resilient fundamentals, and the prospect of lower financing costs—are likely to see reasons to deploy capital. The backdrop, however, is one of uncertainty considering that the causal factors of inflation have not been fully tamed and the outcome of the highly divisive U.S. presidential election could further stoke inflationary fires. In our view, opportunities are present and becoming more plentiful, but they should be assessed through a lens of caution and experience.

About the Team

BRE's research team efforts are led by Dags Chen in the U.S. and Paul Stewart in Europe. The research team is structured by sector and geographic expertise. The team's diverse backgrounds include appraisal, legal, technological and academic applications across multiple asset-classes, across buy and sell-side shops in markets around the globe. The real estate research team is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.

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