3Q2024 U.S. CRE Outlook

Highlights

- Market fundamentals remain healthy
- Equity capital markets show slight improvement
- Debt capital markets starting to rebound
- Great Resynchronization is coming
- Risks shouldn't stop the CRE recovery

In the third quarter of 2024, the US commercial real estate (CRE) market sits poised for significant, positive change. Over the last couple of years, the CRE capital markets and space market fundamentals have operated in distinct cycles, out of synch with each other. The rapid increase in interest rates since 2022 hampered CRE capital markets and consequently investment performance. Yet, despite those rate increases the economy remained robust, expanding, avoiding a recession, and supporting space market fundamentals. But after roughly two years, the beginning of the long-awaited "great resynchronization" – when market fundamentals and capital markets reconnect – seems imminent due to the upcoming shift in monetary policy. The economy should remain resilient, getting a boost from declining interest rates and supporting a positive outlook for fundamentals and income returns. But the real action, and change, should come from the capital markets. As the Fed starts cutting rates, stabilization should become acceleration, boosting many metrics including appreciation returns. With both income and appreciation returns back in positive territory, the CRE market will resynchronize for the first time since the second quarter of 2022. That won't occur immediately, but signs are already emerging of this shift. The outlook for the CRE market is turning increasingly positive, the great resynchronization is coming, and shrewd investors are already noticing.

Market Fundamentals

Industrial is still undergoing a period of transition after inordinate strength during the pandemic. The market remains in an excess supply situation with net completions continuing to exceed net absorption. That pushed the national vacancy rate up to 6.5% and caused quarterly asking rent growth to effectively stall during the second quarter[i]. Some expansion in the national vacancy rate seemed inevitable after it hit a record low in 2022[ii]. But this adjustment is occurring quickly, causing a notable downshift in 5-year backward-looking asking rent growth (the cumulative change in asking rents over the last 5-year interval).

Short-Term Outlook: The sector should still undergo further pressure, with excess supply continuing and the national vacancy rate increasing. Five-year backward-looking rent growth should slow further but remain the strongest of the major property types for the next couple of years due to prior high growth in asking rents.
Longer-Term Outlook: Vacancy rate increase should flip to vacancy rate compression. Five-year backward-looking rent growth should reaccelerate and challenge multifamily as the best performer among major property types. But it should remain below the lofty record heights achieved during the previous cycle, which seem highly unlikely to get repeated anytime soon.

Multifamily seems like an apparent paradox. Housing remains chronically and acutely undersupplied in the US. But high construction volumes for multifamily in some key markets, particularly in the south, are putting upward pressure on vacancy. At the same time, the tighter markets are increasingly becoming unaffordable, also pressuring vacancy. The national vacancy rate increased by 10 basis points (bps) during the second quarter to 7.9%[iii]. Asking rents over the last two quarters contracted and 5-year backward-looking rent growth has slowed over the last couple of years[iv]. A wide divergence remains between the oversupplied markets in the south and the supply-constrained coastal markets[v].

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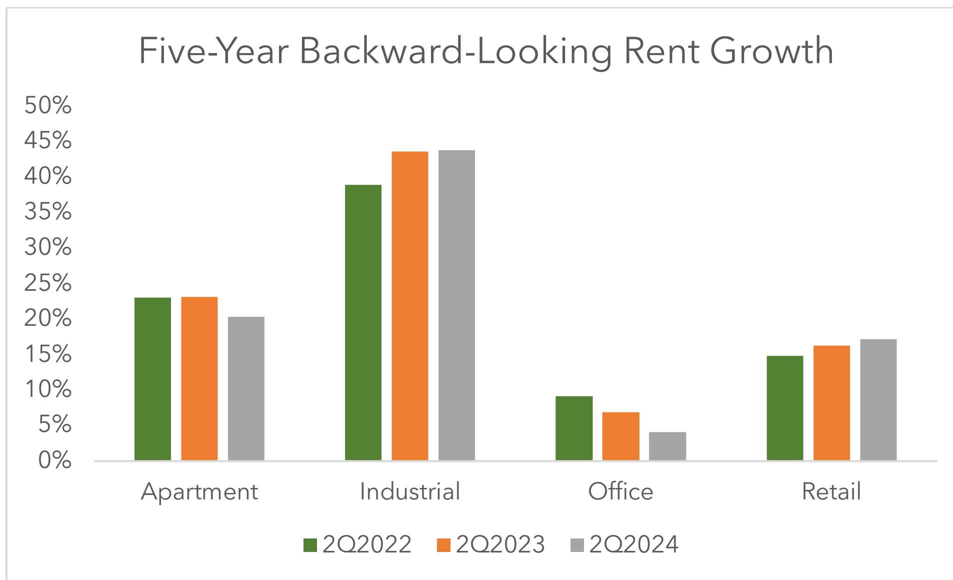
Short-Term Outlook: The national vacancy rate is beginning to stabilize and should stop rising as supply growth slows. Five-year backward-looking rent growth looks set to accelerate notably.
Longer-Term Outlook: Limited supply growth should return while demand remains strong, pushing vacancy rates downward across the country. Five-year backward-looking rent growth should further accelerate and make multifamily the best performer among major property types.

Retail remains the tightest of the major property sectors. It boasts a national vacancy rate of just 4.1%, largely unchanged over the last year[vi]. Asking rent growth is slowing and 5-year backward looking rent growth has stalled in recent quarters. But that's not a function of market deterioration so much as the ongoing challenge of pushing record-high rents even higher[vii]. Through mid-year, consumer spending remains healthy, widely supporting most retail subtypes. Some weak points, such as inferior malls, remain, but they represent the exception not the rule.

Short-Term Outlook: The national vacancy rate should remain relatively stable, with slight upward pressure as demand for space cools slightly. Five-year backward-looking rent growth should slowly reaccelerate after a period of stagnation.
Longer-Term Outlook: Vacancy rate increases should be limited with demand for space supported by a consumer-driven economy and supply growth remaining in check. Five-year backward-looking rent growth should continue to accelerate, reaching the highest levels in at least the last few business cycles.

Office still sits in a holding pattern as the market continues to adjust to the changes in space use that are ongoing. Once again, the national vacancy rate reached a new record high during the second quarter of 13.8% while asking rent growth remains barely positive[viii]. Five-year backward-looking rent growth continues to slow, reaching its lowest rate in about a decade. With the market so in flux, performance remains heavily dependent upon the individual building – almost all markets continue to face systematic pressures.

Short-Term Outlook: The national vacancy rate should continue to tick higher, although the rate of increase should be limited. Five-year backward-looking rent growth should further decelerate.
Longer-Term Outlook: Our forecast horizon is not infinite, but into the latter half of this decade office should continue to face significant headwinds. The national vacancy rate will continue to increase until supply right-sizes with demand. Consequently, 5-year backward-looking rent growth will struggle to find a bottom and will reach tepid growth rates unseen since the initial stages of the GFC recovery.



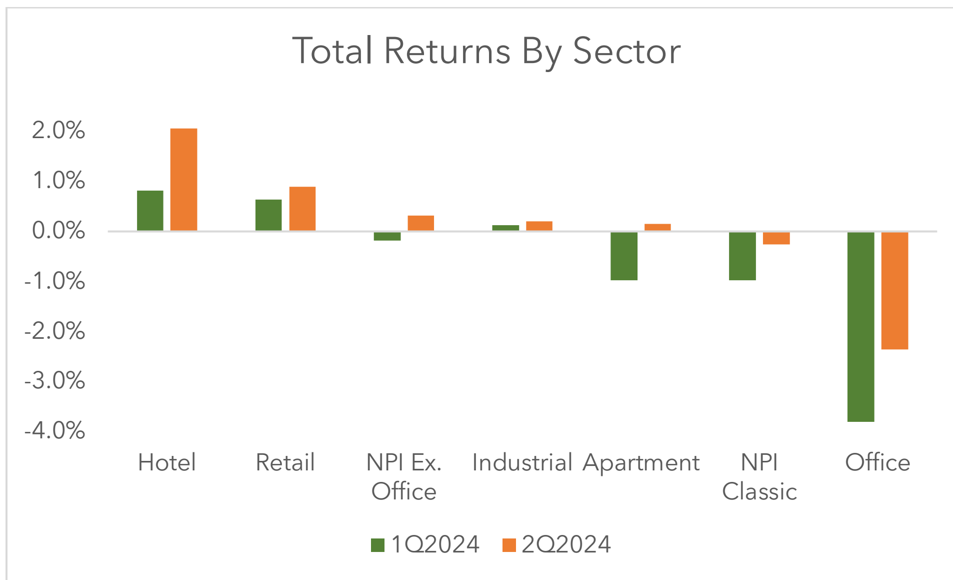
Sources: CoStar, BGO Economics and Research

Capital Markets

CRE Equity markets are already showing tentative signs of improvement through the middle of the year. Midyear 2024 volume is trailing midyear 2023 volume. But that predominantly stems from one property type, industrial, which has seen investors sour on it as fundamentals have worsened in recent quarters[ix]. Meanwhile, cap rates across property types have recently shown signs of stabilization, if not recent declines[x]. The resilient economy and space market fundamentals continued to support income returns, which increased slightly for the seventh consecutive quarter[xi]. And although appreciation returns remained negative, they posted their best result since they fell into negative territory during the third quarter of 2022[xii]. While that kept total returns negative, that stemmed exclusively from the office sector. Excluding office, total returns were positive. That fulfilled a projection we made over a year ago – that once the Fed stopped raising rates, CRE returns would quickly revert back into positive territory[xiii].

Short-Term Outlook: With the Fed poised to start cutting rates, investment volumes and valuations should slowly increase, while cap rates should compress more meaningfully as sentiment among investors shifts. Total returns should gradually improve with both the short and long ends of the yield curve shifting downward.

Longer-Term Outlook: A repeat of previous cycles, or at least something similar, looks increasingly likely. Investment volumes should revert back to normalized levels, valuations should sustain more consistent upward pressure, and cap rates and cap rate spreads should compress. Total returns should accelerate and potentially reach their highest sustained returns since before the GFC.



Sources: NCREIF, BGO Economics and Research

CRE credit markets are also showing signs of healing. During the second quarter commercial mortgage originations increased 27% versus the first quarter and 3% versus last year[xiv]. Volumes should increase further as the Fed begins to cut rates. The cost of debt should decline along with the broader interest rate environment. Into the third quarter, overall delinquency rates (as measured by the CMBS market) continued to tick up, approaching 5.5%, and up by roughly 120bps over the last year[xv]. Office and multifamily are now driving the majority of that change[xvi].

Short-Term Outlook: Debt origination volume should slowly increase while the cost of borrowing should slowly decrease. The market should remain a bit tentative initially as the Fed starts cutting. Loan performance will remain largely determined by the property type. Office will continue to face structural challenges while multifamily grapples with variable-rate debt that repriced as interest rates increased.

Longer-Term Outlook: Markets should strongly benefit from the coming change in monetary policy. The increase in origination volumes should accelerate, the cost of debt should fall further, and overall loan performance should improve. Lower interest rates should not prove a panacea to all loans, particularly those used to purchase assets at record-high prices. And structural problems with office should persist for the foreseeable future, imperiling many loans backing office properties. But the credit markets should look much improved with greater debt availability and liquidity.

Strategy Implications

In only one prior period during the recorded history of the CRE market has a desynchronization occurred. During the early 2000s in the wake of the dot-com bubble bursting, market fundamentals struggled for about four years. But concurrently the Fed was cutting rates to stabilize the economy. And many investors who had soured on equities during the dot-com

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meltdown trained their sights on CRE, spurred on by relatively low valuations and relatively cheap and plentiful debt. That combination kept the CRE capital markets in fine health despite challenges in the space markets. Yet by the middle of that decade, the economic recovery had taken hold, market fundamentals improved, and the CRE market resynchronized, with both sides of the market faring well. Total returns surged, posting their best result in decades.

This cycle looks like the reverse of that one, with fundamentals faring well while capital markets struggle. Yet, we see no reason why this version of resynchronization should prove dramatically different from the last. With income returns gradually improving and appreciation returns set to accelerate notably, the outlook for CRE investment looks the brightest it has been in years. The Great Resynchronization should benefit strategies across public and private markets, property types and geographies, the capital stack, and the risk-return spectrum. The high tide will not raise all ships and lower interest rates cannot fix inferior assets or solve structural problems. But market is poised to shift in a positive direction.

Risks And Closing Thoughts

The main risk to this positive outlook remains the Fed. If it hasn't held rates too high for too long, which doesn't appear to be the case, then our outlook has a high probability of occurring. The main endogenous concern, high construction volumes in a couple of property sectors, is already abating. And those sectors – namely industrial and multifamily – should swing back to excess demand, declining vacancy rates, and healthier rent growth over the next 6 to 12 months. Idiosyncratic shocks can always occur, especially in a world of heightened geopolitical risk. But even if the economy takes a hit from once-high rates or some kind of exogenous shock occurs, the shift in the CRE capital markets should almost certainly more than offset any such disruption and keep positive returns on course over any reasonable horizon.

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Ryan Severino, CFA
Managing Director, Chief Economist & Head of Research
BGO
ryan.severino@bgo.com

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[i] www.costar.com
[ii] Ibid.
[iii] Ibid.
[iv] Ibid.
[v] Ibid.
[vi] Ibid.
[vii] Ibid.

[viii] Ibid.
[ix] www.costar.com
[x] Ibid.
[xi] www.ncrief.org
[xii] Ibid.
[xiii] www.greenstreet.com
[xiv] www.mba.org
[xv] www.trepp.com
[xvi] Ibid.