Principal
Asset Management[SM]

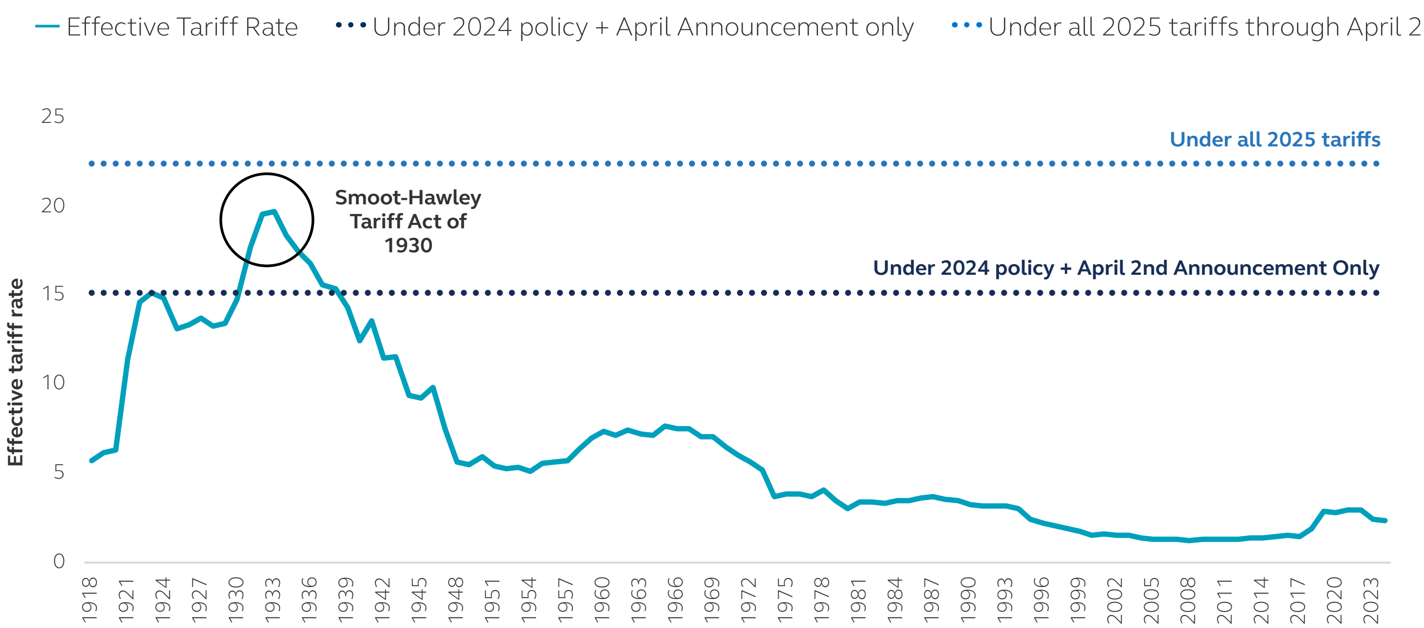
PRINCIPAL REAL ESTATE

Commercial real estate and the tariff test: How will the asset class respond

The announcement of the Trump administration's tariff hikes on April 2nd roiled global asset markets and created a sense of agita among investors, including and especially those focused on real estate. Under the current play, including all 2025 tariffs, the effective average custom duty paid on imported goods would increase 22.4%; surpassing the Smooth-Hawley tariffs in 1930. Since 2022, real estate assets have experienced a corrective environment driven primarily by high inflation and rising interest rates. Entering 2025, underlying asset values had experienced a correction of roughly 20% despite a lack of macroeconomic distress, which has historically been highly correlated with shifts in pricing cycles. While net operating income (NOI) growth remains largely positive and supportive of a recovery in values, the tariffs create a specter of another shock for a sector waiting for a sustained recovery to take hold.

US average effective tariff rate since 1918

Customs duty revenue as a percent of goods imports



Source: Historical Statistics of the United States Ea424-434, Monthly Treasury Statement, Bureau of Economic Analysis, The Budget Lab analysis.

In this bulletin, we discuss four potential macroeconomic scenarios and their impact on the real estate cycle over the next 12 months. In addition, we also discuss the potential impacts of renewed tariffs and a potential trade war across the primary asset markets, including private debt and equity, public markets, and infrastructure. As the policy environment is moving both quickly and unpredictably, we envision periodic updates to both our scenarios and viewpoints on the market. This bulletin builds upon our high level views that we expressed on our latest insights report titled Resilience and risk: Navigating CRE valuations in an unprecedented tariff-laden environment.

Below is a scenario analysis based on the key factors that drive commercial real estate (CRE) valuations:

SCENARIO 1: Tariffs induce a mild recession

CRE prices are rising at an annual pace of roughly 5%, driven by a sharper decline in interest rates than the slowdown in NOI growth. Lending standards remain stable, and CRE is increasingly viewed as a relatively safe haven, attracting stronger investor demand. This sentiment is supported by recent market dynamics: real rates have fallen nearly 45 basis points year-to-date, listed REITs are outperforming the broader equity market, and credit spreads have widened only modestly. While this outcome may seem optimistic, it mirrors conditions from the early 2000s, when CRE values continued to climb despite a broader market downturn.

SCENARIO 2: Tariffs result in a "no-landing" environment

We envision an environment in which CRE delivers annualized returns between 7% and 10%, as investors gain greater confidence in both the economic outlook and asset pricing. In this scenario, the 10-year Treasury yield holds above 4%—remaining within an equilibrium range—while inflation stays persistently elevated, just above 3%. The broader economy remains supportive, with constrained unemployment levels helping to sustain demand-side drivers of NOI growth, effectively offsetting the impact of higher inflation and interest rates. This outlook reinforces CRE's role as an inflation hedge and evokes the "old normal" of the pre-Global Financial Crisis (GFC) era (1994–2003), when returns were fundamentally driven and property values appreciated steadily, even in the face of macroeconomic challenges.

SCENARIO 3: Tariffs trigger stagflation

Stagflation evokes memories of surging prices and the severe recession of the early 1980s. In a worst-case scenario, the Misery Index—which combines the unemployment and annual inflation rates—spikes, and the economy descends into disarray. If such conditions were to materialize, CRE prices could decline by 10% or more, as persistent inflation, rising interest rates, and stalled economic growth converge. This trifecta—elevated financing costs, tighter lending standards, and weakening NOI growth—would place significant downward pressure on valuations. The environment would resemble the conditions of 2022 and early 2023, when listed REITs sharply underperformed, offering an early warning sign for private market declines.

SCENARIO 4: Tariffs lead to a hard landing

In this scenario, we envision a more traditional recessionary outcome: consumer sentiment weakens, and higher prices lead to a pullback in discretionary spending. Corporations respond by trimming payrolls to protect shrinking profit margins, setting off a negative feedback loop. The extent of CRE value declines would depend largely on the speed and effectiveness of the policy response. However, in this case, inflation moderates more quickly, allowing interest rates to ease. As a result, CRE valuations would likely decline no more than 5% overall, though performance would vary significantly by sector. We expect CRE to outperform other risk assets on a relative basis, as some downside has already been priced in. Cyclical sectors may experience steeper value declines due to weaker NOI and tighter credit, while sectors supported by secular demand tailwinds are likely to hold up better. A K-shaped recovery is atypical in CRE, but it appears increasingly plausible under this scenario.

Private equity and sector specific implications

Private equity CRE may be the canary in the coal mine when it comes to gauging the impact of new tariffs and the potential for a broader trade war. While tariffs themselves are unlikely to directly affect day-to-day commercial property operations, their secondary effects—on interest rates, inflation, and consumer or business spending—could prove significant, particularly at a time when valuations appear to have reached their cyclical bottom.

Despite the range of outcomes discussed above, our cautiously optimistic view is that the economy will avoid both a hard landing and stagflation, instead achieving a slower, but sustained, pace of growth in 2025. Our base case assumes a soft-landing scenario, with GDP growth in the 1.5%–2% range over the next 12 months. The implications for private equity will vary widely by property sector.

Sectors with the greatest exposure to global trade and consumer demand—namely industrial and retail—are most at risk. Industrial warehouses are on the front lines of shifting tariff policies, given their heavy reliance on imports, particularly through major port markets. While West Coast ports remain the most exposed, East Coast hubs like New York/New Jersey are also key entry points for Chinese goods. Leasing activity has recently picked up, particularly among e-commerce and 3PL operators, but a pullback in consumer spending could present renewed headwinds.

Retail has been one of the strongest performers in private equity post-pandemic, with leading brick-and-mortar operators proactively managing inventories ahead of potential tariff-related disruptions. However, should consumer sentiment erode further under a prolonged trade conflict, retail margins could come under pressure and performance may become more uneven.

On the other hand, the residential-for-rent sector appears better positioned to weather the storm. Demand across most multifamily subsectors has remained robust—if not accelerated—over the past year, as elevated mortgage rates continue to hamper affordability in the for-sale market. Any slowdown in new development, whether due to rising material costs (e.g., lumber tariffs) or tighter labor availability tied to immigration policies, will constrain supply and support rent growth. While these dynamics pose challenges for developers, they enhance the investment case for stabilized multifamily assets and justify an overweight position in the current environment.

Importantly, all of these sector-level insights are predicated on the economy avoiding a hard landing. If that assumption fails, the potential for a broader repricing in private equity real estate rises significantly. The severity of any correction would depend on the depth and duration of the downturn. That said, many owners and operators have entered this cycle with healthier balance sheets, offering some insulation relative to past downturns.

Ultimately, navigating tariff-driven crosscurrents in private equity CRE will demand sharp attention to both asset-level fundamentals and evolving macroeconomic signals.

CMBS

Prior to the implementation of Trump's tariffs, the economy was already showing signs of slowing. In hindsight, it's likely that the trade policy announcements meaningfully accelerated this deceleration. Regardless, they have undoubtedly amplified uncertainty for both consumers and businesses, with many unknowns still surrounding the ultimate impact.

In early January, CMBS spreads were already softening from their three-year tights. The official tariff announcements contributed to this trend, widening Conduit AAA spreads by 20 basis points and Conduit BBB spread by 200 basis points.Since the initial announcements, spreads have partially retraced with better CMBS market trading transparency on optimism that constructive negotiations will prevail. As of April 25, 2025, AAA Conduits appear slightly cheap relative to investment-grade (IG) corporate bonds, with IG spreads only 3 basis points wider than CMBS AAA. Over the past decade, AAA Super Senior CMBS has typically priced 24 basis points inside IG corporate spreads.

The relationship for Conduit BBBs is even more notable, offering 164 basis points of excess spread compared to high-yield (HY) corporate bonds. Historically, BBB Conduits have averaged 31 basis points of excess spread versus HY corporates. However, in periods of extreme market stress—such as during COVID-19 or the Regional Banking Crisis—Conduit BBBs have significantly dislocated, with a three-year average excess spread of 230 basis points and a peak of 476 basis points.

While the recent volatility is not driven by a deterioration in CRE fundamentals (although it's possible they are pressured for some property types as discussed throughout this report), it's important to remember how sensitive CMBS BBB spreads are to broader market risk.

Against a backdrop of a slowing economy and heightened market volatility, we recommend a focus on higher-quality, recent-vintage positions with strong coupons. Carry income can help cushion potential spread widening in AAAs, which are likely to hold up better than BBBs in the event of further market correction.

Private debt

Private debt investors began the year with cautious optimism, as that interest rate stability would provide clarity on pricing across both private equity and debt markets. However, the prospect of a trade war—sparked by rising tariffs—had led to repricing for new debt becoming more frequent, as fast-moving markets make it difficult for investment sales participants to set and manage expectations. Life company spreads have widened by 15 to 25 basis points on average, with some participants quoting as much as 30 basis points higher.

Still, the market remains open. Conservative loan-to-values on property prices that have already reset ~20% protect against further declines in unlevered property valuations. At the same time yields are attractive given higher risk-free rates and widening credit spreads.

While delinquency rates and debt distress is likely to rise over the course of the year, that's associated with legacy origination and may present an opportunity to fill potential gaps in new originations. Indeed, there is ample opportunity given $1tn of loans maturing in 2025, of which 50% are held on bank balance sheets and nearly $2.5tn by the end of 2028. This may help to mitigate the impact on loan origination volumes if transaction volumes decline.

Rising construction costs present a double-edged sword. While they have materially slowed permitting and new development—contributing to greater stability in the physical asset market—they also reduce opportunities for construction lending and may drive up insurance premiums, prompting further underwriting adjustments.

At present, domestic capital flows into private real estate debt remain strong. However, the credit curve has steepened, and foreign capital inflows appear to be waning. Lender appetite is solid for low-risk, high-quality core commercial mortgage loans, as investors continue to seek safe-haven assets. Debt is still available for "stretch senior," bridge, and construction loans, though the market has yet to fully settle on post-"Liberation Day" pricing—particularly for higher-risk positions.

REITs

We think REITs are relatively well positioned versus the broader equity markets for five primary reasons.

First, earnings are relatively insulated from the direct impacts of tariffs and other trump policies while they have strong balance sheets with LTVs of approximately 30%.

Second, they are likely to be favored by investors in a defensive market rotation given their durable income profile. This is already occurring as real estate is the 4th best of the elven S&P 500 sectors in 2025 YTD and, REITs are outperforming the S&P 500 by approximately +500 bp and +900 bp versus the NASDAQ so far in 2025.

Third, REIT valuations relative to equities has grown historically cheap as interest rates rose in recent years and the market favored the growth of the so called Mag 7. We believe that REITs are an important diversifier in portfolios as the serve as a counterbalance against other stocks with greater economic sensitivity and, over the longer term, they behave more like private real estate.

Fourth, real yields importantly drive pricing for property and REIT stock prices. Lower or stable long term real yields ahead would help drive REIT market outperformance.

Finally, global REITs provide investors with a hedge against a potential de-risking of America by foreign investors and a U.S. economic recession. Bottom line, we believe listed REITs have an important home in both stock and private real estate portfolios given a combination of their valuations as well as their diversifying benefits.

Infrastructure

As with all sectors, infrastructure assets ultimately depend on both domestic and global supply chains, which could be disrupted by shifting tariff policies. We expect this to be a key consideration across public and private markets. However, the inherently long-term and stable nature of infrastructure investments positions the asset class as relatively defensive and well-suited to withstand such potential headwinds.

The Trump administration's evolving stance on renewable energy has introduced uncertainty that may dampen greenfield development activity in the U.S. Nevertheless, existing assets—particularly those already generating revenue—are unlikely to see a material impact in terms of profitability, M&A, or refinancing activity. Public market sentiment toward U.S. renewables remains low, which could create entry points in listed infrastructure should policy direction become clearer later in 2025.

Broader energy transition projects funded in part by the Inflation Reduction Act (IRA) still enjoy some level of bipartisan support. However, if the IRA is amended or repealed, it could slow private capital deployment in new development across the energy transition spectrum. That said, many developers have built healthy stockpiles and secured pre-qualifications that will support the immediate pipeline of late-stage projects.

Meanwhile, growing focus on energy security and rising power demand are likely to drive increased private sector capital expenditures in oil and gas infrastructure. This includes investment in production, natural gas generation, and LNG import/export facilities—especially if federal permitting becomes more efficient.

In Europe, the response to a potential second Trump term has been marked by efforts to increase strategic and economic autonomy. Some countries are following Germany's lead in pursuing more aggressive fiscal expansion—at least part of which is likely to flow into infrastructure spending. These shifts may also enhance the investment environment for private infrastructure through regulatory or policy support.

Should tariff policies result in meaningful changes to global supply chains or the geographic distribution of manufacturing, operators in logistics infrastructure—such as ports and freight rail—are likely to experience changes in volume and product mix.

While infrastructure tends to be relatively insulated from inflation compared to other asset classes, M&A activity could be affected by shifts in interest rates, given the leverage typically used in both greenfield and brownfield projects. Higher rates may also weigh on listed infrastructure valuations. However, in a downside economic scenario shaped by administration-driven policy shifts, infrastructure fundamentals are likely to remain resilient—and infrastructure stocks could outperform broader equity markets.

Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. Real estate investment options, such as real estate investment trusts (REITs) and commercial mortgage backed securities (CMBS), are subject to risks associated with credit, liquidity, interest rate fluctuation, adverse general and local economic conditions, and decreases in real estate values and occupancy rates. Commercial Mortgage Backed Securities carry greater risk compared to other securities in times of market stress. Investments in private debt, including leveraged loans, middle market loans, and mezzanine debt, second liens, are subject to various risk factors, including credit risk, liquidity risk and interest rate risk. Infrastructure companies may be subject to a variety of factors that may adversely affect their business, including high interest costs, high leverage, regulation costs, economic slowdown, surplus capacity, increased competition, lack of fuel availability, and energy conservation policies.

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