TA REALTY

2024 Q1 MARKET COMMENTARY

ECONOMIC OVERVIEW[1]

The U.S. economy maintained its momentum in the first quarter, albeit at a more moderate pace compared to the robust growth seen in the second half of 2023. U.S. gross domestic product ("GDP") growth slowed to an annualized rate of 1.6% during this period. This deceleration in growth can largely be attributed to the volatility in international trade activity and a slowdown in inventory growth. However, the underlying indicators revealed a stronger picture, with business investment experiencing a notable increase. Business investment in manufacturing benefited from 2022 legislation, including the CHIPS & Science Act and the Inflation Reduction Act, which has boosted construction of electronic vehicles and semiconductor plants. This gradual moderation in the pace of the U.S. economy's expansion adds to the possibility of a soft-landing scenario, wherein inflation edges closer to the Federal Reserve's (the "Fed") 2% target without triggering a recession or significant job losses.

U.S. consumers continued to show resilience in the face of the Fed's monetary policy tightening campaign that began in March 2022. Consumer spending increased 2.5% in the quarter, down from a 3.3% gain in the fourth quarter. Consumers spent more on entertainment and other in-person activities and spending on services increased at a 4.0% annualized growth rate, its highest quarterly level since the third quarter of 2021. Spending on goods declined 0.4%, due in large part to a decline in big-ticket purchases that are more sensitive to higher borrowing costs. In a positive sign for the single-family housing market, residential investment surged 13.9%, its largest increase since the fourth quarter of 2020.

The labor market also showed remarkable strength in the first quarter with an average of 276,000 jobs created per month. First quarter job gains were above the 2023 monthly average of 251,000 jobs added and well-ahead of pre-pandemic (2015-2019) norms. March saw a particularly robust performance and marked a 10-month high in job gains. The sustained strength in hiring has kept the unemployment rate below 4.0% for over two years — a first in over 50 years. An uptick in the labor force participation rate supported businesses' ability to expand while at the same time reducing upward pressure on wages. Average hourly earnings rose a healthy 4.1% over the year, outpacing inflation. The continued growth in real wages, coupled with strong household balance sheets, suggests that consumers will continue to spend at a healthy rate. However, households dipped further into savings and the personal saving rate dipped to 3.6% in March, the lowest since October 2022 — likely due to the cumulative wealth effect of wage growth and low unemployment.

Inflation has fallen rapidly over the past year but that downward trend stalled in the first quarter. The Fed's preferred inflation gauge, the core personal-consumption expenditures ("PCE") price index (which excludes the more volatile food and energy sectors) ticked up slightly from the start of the year. At a 2.7% annualized pace in March, the rate of inflation was 200 basis points ("bps") below first quarter 2023 and 400 bps below the peak reached in June of 2022. Although inflation is near the Federal Reserve's 2% target, this stickiness will keep the Fed cautious before making its first rate cut of the cycle. Inflation is expected to fall gradually but hold near 2.4% in the latter half of 2024.

Uncertainty and volatility surrounding Fed policy and the path of interest rates continued to be a central theme at the start of 2024. After keeping rates on hold at its March meeting, the Fed pointed toward the likelihood of rate cuts commencing mid-2024. However, the more recent inflation data has not been supportive of those expectations. The central bank has not hiked since July 2023, holding the benchmark federal-funds rate in a targeted range between 5.25% to 5.5%, the highest in 22 years. In April, Fed Chairman Jerome Powell noted that that the Fed is prepared to leave interest rates at this level until it sees clear signs that disinflation is back on track. The U.S. 10-year Treasury rate fluctuated from 3.8% at the start of the year to 4.4% near the end of the quarter. With two rate cuts expected for the Fed's policy rate by year's end, the 10-year Treasury rate is expected to settle near 4.0% at the end of 2024 and near 3.8% in 2025.

The U.S. economy began 2024 with solid momentum supported by robust consumer spending and a strong labor market. However, risks to the economic outlook remain including the lagged impact and unequal pressure of tightening monetary policy. Further, growing geopolitical concerns and the outcome of November's U.S. Presidential election could sway the economy's trajectory by introducing yet another layer of uncertainty. A weaker economy may weigh on the property markets through 2024. But interest rates are expected to come down gradually from their two-decade high and signs of stability should emerge as the year progresses. The outlook for the U.S. real estate market is positive amidst strong household balance sheets and corporate profitability.

REAL ESTATE FUNDAMENTALS[2]

U.S. real estate fundamentals decelerated in the first quarter of 2024 as the market moved toward a long-term equilibrium after years of pandemic-induced volatility. Except for the office sector, property fundamentals remained healthy, even as supply and demand dynamics weighed on segments of the market.

Industrial

The U.S. industrial market continued to downshift in the first quarter of 2024. Key fundamentals remained strong even as elevated levels of new supply coincided with slower demand. The national vacancy rate ticked up moderately to 6% but remained 100 bps below long-term averages. Annual rent growth continued to decelerate but was a healthy 6% in the first quarter — in line with the average from 2017 through 2019. This slowdown can be attributed to increased competition from new supply in some markets, combined with a notable deceleration in demand.

Demand continued to fall from 2022 peaks and registered the lowest first-quarter net absorption since 2012 as tenants remained focused on controlling costs, which weighed on decision making and the pace of leasing. This weakness was also due in part to 12-year lows in single-family home sales, which led many tenants involved with adjacent industries, such as furniture sales and building materials, to close large distribution centers.

There are signs that the industrial market is nearing the end of a historic development wave. After a record-setting 520 million square feet (“msf”) delivered in 2023, the 335 msf expected to deliver this year is a nearly 40% drop. Construction starts have fallen nearly 80% below the peak reached in late 2022 as tight financing conditions curtailed new development. Deliveries are expected to hit a 10-year low by the second half of 2025 and this lack of new product should result in upward pressure on rents. This may happen more quickly in some markets than others. Key markets in South Florida, for example, have begun to emerge from this transition and are among the tightest in the nation.

While the industrial market continued to normalize in the first quarter, there is strength in the underlying fundamentals. Early signs of stabilization and an eventual recovery in tenant demand have emerged. Inflation has fallen and consumer spending on goods has begun to re-accelerate from the lows of Spring 2023. Container traffic through the ports of Los Angeles and Long Beach began to bounce back following ratification of a six-year labor agreement by dockworkers in September. Increased investment in U.S. manufacturing from the 2022 passage of the CHIPS and Science Act and the Inflation Reduction Act is likely to be a boon nationally while near-shoring supply chains are likely to be drivers of demand, especially in key Sun Belt markets. These trends, combined with ongoing supply chain risks and rising transportation costs (that require industrial occupiers to prioritize locations) are expected to continue to drive demand for warehouse space, particularly in prime markets with large consumption bases and near integral ports of entry.

Multifamily

The U.S. multifamily market’s performance in the first quarter was defined by a supply/demand imbalance but a surge in demand suggests this period of decline may be ending. Following a strong rebound in the second half of 2023, first quarter absorption of 104,000 unit was a jump of 60% above the first quarter of 2023 and the highest level seen since 2021. However, new supply outpaced demand with 153,000 units delivered in the quarter and the vacancy rate ticked up 15 bps to 8%. In contrast to the rent growth pullback of 2021 and 2022, the deceleration of rent growth appears to be stabilizing. Annual rents grew 1% in the first quarter — on par with growth seen at the end of 2023.

The multifamily market is poised to improve in 2024 with an anticipated slowdown in new completions for the year. 495,000 units are expected to be delivered this year, a 15% pullback from the record supply posted in 2023. This shift could help mitigate some of the recent oversupply issues, particularly in the Sun Belt regions, where heavy construction activity since 2021 post-pandemic has led to increased vacancy rates and suppressed rent growth. In contrast, markets with more controlled development, such as those in the Midwest and Northeast, may continue to see more stable or even increasing rents due to better supply-demand alignment.

Overall, the U.S. multifamily market's performance in the first quarter of 2024 reflects ongoing adjustments as the sector seeks equilibrium between supply and demand. While rent growth remains subdued, the pullback in new construction projections for the remainder of the year suggests potential for market stabilization and recovery, particularly if the trend of strong absorption continues. Near-term, multifamily fundamentals should remain healthy, supported by a strong job market and a broad undersupply of housing that has persisted since the Global Financial Crisis (“GFC”). In addition, single-family housing affordability issues — exacerbated by rising mortgage rates — will likely help insulate multifamily demand from a slowing economy. Despite challenges, the long-term outlook for multifamily real estate remains positive with potential for sustained growth.

Office

The U.S. office market continued to face significant challenges in the first quarter of 2024 with a persistent decline in demand contributing to the historically high vacancy rate of 14%. Since the onset of the pandemic in 2020, the office market has experienced over 200 msf of negative absorption, a scale of occupancy loss nearly four times the losses recorded during the GFC. This decline reflects changes in workplace dynamics post-pandemic, including reduced office attendance, which have prompted many of the largest tenants to downsize their office footprints with a focus on efficient space utilization. In addition, the increased availability of sublease space, which currently stands at 203 msf, has added to upward pressure on vacancies in many primary markets.

High availability continued to exert downward pressure on market rents. Rent growth has failed to keep pace with inflation and has remained nearly flat since 2019. Meanwhile concessions are at a record high. To attract tenants, landlords have had to offer incentives, including free rent and tenant improvement allowances, which can often equate to 40% - 50% of the value of the lease. Notably, exceptions to this challenging market environment exist in select buildings that are highly amenitized and in prime locations. These premium properties have managed to maintain positive effective rent growth. With construction starts expected to fall below 12 msf in 2024, limited deliveries in 2025 and 2026 should lead to further outperformance in the premium office space segment.

With nearly half of pre-pandemic leases yet to expire, the outlook for 2024 is a continued rise in vacancy. But, by the end of 2025, most firms are expected to have completed their downsizing as it relates to hybrid and remote work, allowing for the relationship between job growth and demand for office space to likely reestablish itself, and the office sector may begin to register positive absorption.

Retail

The U.S. retail market maintained its strength through the first quarter of 2024 thanks to limited store closures, minimal new supply and steady demand from a diverse array of sectors including an increase from the food and beverage and experiential sectors. Notably, the vacancy rate has maintained a historic low of 4% since late 2022, highlighting the resilience of the sector. In the past 12 months, just over 62 msf of retail space was delivered, 40% below the 10-year average. Construction activity was primarily concentrated in single-tenant build-to-suit projects, grocery-anchored centers, and smaller spaces within mixed-use developments. The majority of the 50 msf of retail space under construction has been pre-leased and construction starts declined to 15-year lows over the past year. Over 155 msf of space has been demolished over the past five years, the vast majority of which was attached to, or within, underperforming malls.

Competition for the limited available space drove annual rent growth to 3%, below the record highs seen in late 2022 but in-line with pre-pandemic averages. Sun Belt markets, which have benefited from an influx of population and increased buying power, outperformed while urban locations in larger gateway cities with heavy reliance on daytime office workers continued to reprice downward.

Despite forecasts suggesting a minor slowdown in consumption, retail fundamentals are expected to remain balanced for the foreseeable future. The limited availability of space and a further pullback in new deliveries are expected to offset a minor pullback in demand formation. The U.S. retail market continues to show resilience and adaptability, even in the face of economic challenges.

CAPITAL MARKETS[3]

Deal volume was still depressed in the first quarter of 2024 following a challenging year for capital markets as high interest rates and tighter lending conditions weighed on real estate investment activity. Sales volume dropped for the seventh consecutive quarter and totaled $79 billion, representing a 45% drop from the first quarters of 2017 through 2019 but just 19% less than the first quarter of 2023.

However, the pace of price declines continued to slow in the first quarter according to the MSCI Commercial Property Price Indexes National All-Property Index (“CPPI”). After a 6% year-over-year decline in the fourth quarter of 2023, prices were only down 3% in the first quarter of 2024. This marks the slowest pace of decline in pricing since the fourth quarter of 2022. This moderation in price declines may be an indication that real estate prices are reaching a floor. Though transaction activity is limited, it appears price declines continue to be driven by capitalization rate (“cap rate”) expansion. Cap rates have expanded roughly 50 - 80 bps across asset types year-over-year. Despite another quarter of slow transaction volume and price declines, some asset classes showed signs of strengthening in the first quarter.

The industrial sector showed the most pricing growth among the main property sectors with a 6% growth in CPPI year-over-year. Transaction volume in the first quarter of 2024 for industrial properties totaled $17 billion. While this represents a 20% decrease year-over-year, total industrial volume is in line when compared to average first quarter volume seen in 2017 through 2019. Industrial cap rates have expanded 80 bps since the first quarter of 2023. Transactions offering near-term lease rollover with mark-to-market opportunities continued to be in demand from a deep investor base. With low vacancy rates in many key markets, the long-term investment outlook for the industrial market is positive and seaport cities and major logistics hubs are expected to remain the strongest performers.

The multifamily sector once again garnered the largest share of transaction volume among the main property types with a total of $21 billion in sales volume. This represents a 25% decrease in volume year-over-year. Pricing was also down for the sector with the CPPI 8% less than a year prior. Though the multifamily market is still in decline as of the first quarter of 2024, the pace of these declines has slowed from one quarter ago. While some high-growth Sun Belt markets face supply-side headwinds near-term, demographic tailwinds alongside the high cost of single-family homes and the U.S. housing shortage are expected to keep investment focused on the sector in the long run.

Surprisingly, the office sector was the only of the main property sectors to record a year-over-year increase in transaction volume in the first quarter of 2024. With volume totaling $16 billion, this was a 27% increase in volume when compared to one year ago and is likely due to a one-time, entity-level transaction. When compared to an average of the first quarters of the years 2017-2019, volume was down nearly 96% in the first quarter of 2024. Price declines in the office sector are being driven primarily by office buildings in central business districts (“CBD”). In the first quarter of 2024, CBD office pricing was down by nearly 50% year-over-year. Suburban offices, by comparison, were down only 12%. The office sector remains challenged, and credit remains extremely limited for investments. Further deterioration in office prices is expected with more than an estimated $200 billion in office property loans maturing in 2024.

The retail sector showed signs in the first quarter of 2024 that its period of decline may be coming to an end. The $15.5 billion in transaction volume for the quarter represents a 14% decline from a year prior. But when compared to the first quarter average of transaction volumes from 2017 through 2019, the first quarter of 2024 slightly outperformed. Pricing held relatively steady for the sector year-over-year with a 1.2% decline recorded for the first quarter. Cap rates ticked up 70 bps from one year ago. The retail sector saw disruption and distress long before the COVID-19 pandemic, and the first quarter of 2024 might be an indicator that the sector is reaching a period of recovery. The retail sector’s supply and demand dynamics and evolving rental profile position it well for long-term attractive returns and opportunities for growth. High-quality, well-located retail — especially grocery-anchored — is expected to outperform the rest of the sector.

The NCREIF Property Index (“NPI”) marked a sixth consecutive quarter of negative returns, driven by declining appreciation returns. However, this quarter marked the highest returns from the NPI since this period of decline began in the fourth quarter of 2022. U.S. real estate posted a quarterly total return of (0.98)% driven by an (2.14)% appreciation return — an improvement of nearly 200 bps when compared to the fourth quarter of 2023 — and relatively strong and steady income return of 1.16%. This supports the consensus that while the capital markets are still working through the impacts of higher interest rates and general uncertainty, underlying real estate fundamentals have remained relatively resilient. Rolling twelve month returns for U.S. real estate totaled (7.16)% with a (11.23)% appreciation return and income return of 4.45%.

Another data point that may suggest real estate pricing has reached a cyclical low in the U.S.; two of the four main asset classes posted positive total returns for the first quarter of 2024. Retail returns were strongest totaling 0.64% with a (0.74)% appreciation return and 1.38% income return. Industrial returns were the next strongest at 0.13% total for the quarter, with (0.83)% owed to appreciation and 0.96% from income returns. Multifamily returns were still negative in the first quarter, though still the highest returns in six quarters at (0.97)% total driven by (2.04)% appreciation return and 1.07% income return. Expectedly, office returns remained the lowest in the first quarter with a total return of (3.80)% driven by a (5.24)% appreciation return and a 1.44% income return. Value declines continue to be driven by cap rate expansion. Appraisal based cap rates expanded 70 bps in the first quarter from the last quarter of 2023. Surprisingly, net operating income ("NOI") shrank by about 5% quarter-over-quarter but remained almost flat when compared to one year ago. Given the relative health of real estate operating fundamentals, and solid income returns across sectors, this decrease in NOI is likely a temporary phenomenon. As a note, NCREIF released an expanded NPI for the first time this quarter which includes senior housing and self-storage assets in addition to the classic NPI set (office, multifamily, retail, industrial, hotel). The return for expanded NPI in the first quarter of 2024 was (0.92)%.[4]

Outlook

2024 should be a turning point for U.S. commercial property markets. A gradual easing of inflationary pressures alongside healthy consumer spending and employment growth should help to ease the market through the final leg of the post-COVID adjustment. The U.S. economy is expected to experience a period of slower growth through 2024 which may soften real estate property fundamentals in the near-term. Yet, recent sale trends and a moderation of some price declines suggest that the real estate market is through the worst part of an adjustment to higher interest rates and may be approaching levels that reflect the market is near a bottom.

The Fed has indicated that it has reached the end of the rate hiking cycle and with an anticipated pivot to rate cuts toward year-end, short-term and long-term rates should fall. As a lower, or at least more stable and predictable, interest rate environment takes hold, real estate performance should again be driven by its strong operating performance and not negative valuation metrics.

While the market faces the prospect of further adjustment and potential stresses, the extreme post-pandemic highs and lows should moderate and offer more predictable outcomes, supporting an expected increase in investment activity in the second half of the year and a more robust recovery in 2025. The bifurcation across property sectors and markets is expected to be more pronounced as improvements continue.

Looking through the near-term challenges, secure income streams from real estate will likely lead to long-term value creation and 2024 may bring opportunities to acquire generational assets at reset bases that have the potential to deliver superior value gains as markets normalize. History has shown that the best vintage returns have often generated in the aftermath of markets like we are experiencing today.

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Founded in 1982, TA Realty is an experienced and established real estate investment management firm. The Firm is headquartered in Boston, Massachusetts, with additional offices in Newport Beach, California, Dallas, Texas and San Francisco, California. Since its inception, as of June 30, 2023, TA Realty has acquired, invested and/or managed approximately $40 billion of real estate assets through core, core plus and value-add strategies and customized separate/advisory accounts. TA Realty's investment philosophy focuses on creating diversified real estate portfolios that aim to generate strong cash flow, receive intensive asset management, and seek to achieve long-term value creation. For four decades, TA Realty has maintained this philosophy through multiple real estate and economic cycles, a strength recognized by pension funds, endowments, foundations, and high-net-worth individuals. For more information, please visit **www.tarealty.com.**

SOURCES

[1]Source: U.S. Bureau of Economic Analysis, Gross Domestic Product, Consumer Spending, First Quarter 2024, Advance Estimate; U.S. Department of Commerce, Congressional Budget Office, April 2024; U.S. Bureau of Economic Analysis, U.S. Personal Income and Outlays, Private Investment, Personal Consumption Expenditures, March 2024; U.S. Bureau of Labor Statistics, Employment Situation, March 2024; U.S. Bureau of Economic Analysis, March 2024; Board of Governors of the Federal Reserve System, Daily, March 2024
[2]Source: CoStar, First Quarter 2024, Property Market Fundamentals Statistics
[3]Source: MSCI CPPI, Hedonic Series Cap Rates, First Quarter 2024, Capital Markets Statistics
[4]Source: National Association of Commercial Real Estate Investment Fiduciaries, NCREIF NPI, First Quarter 2024