2023 Q4 MARKET COMMENTARY

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ECONOMIC OVERVIEW [1]

The U.S. economy defied expectations of a recession and ended 2023 with robust growth. The year was capped by a fourth quarter in which the economy grew at a 3.3% annualized pace, — a slowdown from the summer's 4.9% pace but still a healthy rate. For perspective, U.S. gross domestic product ("GDP") grew at an average rate of 2.4% per annum during the last economic expansion (2010 - 2019). 2023's robust economic gains raise the prospect of a longer post-pandemic expansion despite the aggressive pace of monetary tightening cycle and adds to the potential for a soft landing — in which inflation returns close to the Federal Reserve's (the "Fed") 2% target without a recession or significant job loss.

GDP growth was well-balanced, fueled by consumer spending, business investment and government expenditures. Consumer spending, which makes up nearly two-thirds of the U.S. economy, grew at a strong rate of 2.8% in the fourth quarter with an increase in both goods and services spending. Government spending was up 3.3% on an annualized basis. Business investment rose 2.1% and was another significant factor for the robust quarter with notable spending on structures. 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. Meanwhile, growth in exports surged, outpacing the growth in imports by nearly 3:1.

In another sign of consumer strength, American shoppers spent strongly during the 2023 holiday season. U.S. retail sales rose 5.6% in December from a year earlier. Consumer sentiment at the beginning of 2024 jumped to its highest reading since July 2021, according to the University of Michigan. However, declines in real disposable personal income indicate that last year's spending increases were due in part to the continued drawdown of pandemic-related excess savings. Personal savings declined further in the fourth quarter and the savings rate slipped to 4% — an indication consumer spending may soften in the near-term.

The labor market was also a consistent strong point for the U.S. economy in 2023. Over the fourth quarter, employers added an average of 165,000 jobs per month, down from the average 278,000 jobs per month added during the first half of the year but well above both the pre-pandemic (2015-2019) averages. The unemployment rate held near historic lows at 3.7% and layoffs remain near record lows. For 2023 as a whole, the labor force participation rate rose, and with a 2% rise in the labor force 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.

The Fed's progress in stemming inflation became evident toward the end of 2023. The Fed's preferred inflation gauge, the core personal-consumption expenditures ("PCE") price index, which excludes the more volatile food and energy sectors, fell to a 2.9% annualized pace in December, 200 basis points ("bps") below the start of the year and the lowest level since March 2021. With the rapid downward trajectory toward year end, core inflation is projected to return to long-term trends and reach the central bank's 2% inflation target by the end of 2024.

Uncertainty and volatility surrounding Fed policy and the path of interest rates was a central theme in 2023 but slowing inflation prompted the Fed to suggest a pivot by year-end. Fed policymakers continued their tightening agenda through July, raising short-term rates an additional 100 bps atop the 425 bps of rate hikes that occurred in 2022, the most aggressive cycle of hikes in four decades. In December, the Fed held its benchmark federal-funds rate steady at between 5.25% - 5.5%, a 22-year high, but also indicated plans for as many as three rate cuts in 2024. Central bank policymakers projected a policy rate of 4.6% by year's end. The U.S. 10-year Treasury rate fluctuated from 3.8% at the start of the year to as high as 5.0% in October and ended the year nearly on par with where it started. With the Fed indicating it has reached the end of the monetary tightening cycle, the 10-year Treasury rate is expected to hold steady at 3.8% through 2024 and settle near 3.6% by 2025.

The U.S. economy began 2024 with strong momentum with inflation easing and employment holding strong. However, risks to the economic outlook remain including the lagged impact and unequal pressure across sectors 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. While a recession now appears unlikely, the economy is expected to slow in the first half of 2024. A weaker economy will likely weigh on the property markets into early 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 consumer fundamentals and corporate profitability.

REAL ESTATE FUNDAMENTALS [2]

U.S. real estate fundamentals decelerated in 2023 as the market moved toward a long-term equilibrium after years of pandemic-induced volatility. With the exception of the office sector, property fundamentals remained healthy in the fourth quarter of 2023, even as inflation and elevated interest rates weighed on segments of the economy and financial markets.

Industrial

After two years of unprecedented growth, the U.S. industrial market experienced a deceleration in 2023. Key fundamentals remained strong even as elevated levels of new supply coincided with slower demand. The national vacancy rate ticked up moderately to 6%, in line with pre-pandemic averages. A total of 520 million square feet ("msf") of new space was added during 2023, a 30% jump above 2022 and a record high, but was met with a notable deceleration in demand. Net absorption during the second half of 2023 was the weakest combined third and fourth quarter total recorded since 2010 as some retailers paused inventory accumulation out of caution over the economic outlook. Occupancy gains were tempered across many markets, though Los Angeles and the Inland Empire saw a significant decline due in large part to threats of a strike by West Coast dockworkers. The recent contract agreement should stabilize demand in these markets along the diversion of trade through the drought-stricken Panama Canal. Meanwhile the uptick in U.S. imports is expected to benefit major port markets.

With a significant drop in new supply under construction, industrial inventory is expected to grow by a more manageable 2.3% through the end of 2024. Most markets appear to be relatively insulated from risks of oversupply due to healthy levels of pre-leasing (40%) and persistent shortages of in-fill distribution space. The uptick in available space toward the end of 2023 was primarily concentrated in properties larger than 500,000 square feet.

Annual rent growth continued to be strong at 7%. While below the peak of 12% reached in mid-2022, rent growth ended the year 200 bps above pre-pandemic averages. As the market continues to moderate from the record fundamentals of 2022, further rent growth deceleration is expected. That trend is expected to reverse course in late 2024 when new supply is expected to decline sharply due to the significant pullback in construction. Construction starts have fallen by nearly 70% from last year as tight financing conditions curtailed new development.

While the industrial market slowed in the second half of the year, early signs of a stabilization and eventual recovery in tenant demand have emerged. The year-end uptick in consumer goods and imports sets the stage for industrial space needs to pick up in early 2024. Increased investment in U.S. manufacturing 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 was characterized by a rebound in rental demand in 2023 along with an unprecedented wave of new supply. A solid 320,000 units were absorbed during the year including the second highest fourth quarter for demand on record; a remarkable increase compared to the weakness seen at the end of 2022 when renter household formation slowed in response to peak levels of inflation. However, the resurgence in demand coincided with a record level of new supply; 574,000 units were delivered in 2023.

Supply-side pressures put downward pressure on rent growth which decelerated to 1% year-over-year and pushed vacancy above 7%, slightly above pre-pandemic levels. With over 950,000 units under construction, new deliveries are expected to remain elevated for several quarters and vacancy rates may continue to rise, albeit likely at a slower pace. Demand is projected to continue to improve but is expected to fall short of the pace of new supply and a continued moderate softening in rent growth is forecasted in most markets in 2024. However, new deliveries are expected to drop by nearly 20% in 2024 as rising construction costs and limited construction financing have significantly slowed construction starts. Thus, after the pipeline underway is completed, a more moderate delivery pace should allow for a relatively quick recovery.

With fewer supply additions, Midwestern and traditional gateway markets have emerged as winners in terms of rent growth and lower vacancy levels. In contrast, Sun Belt markets have seen outsized demand since the onset of the pandemic in 2020, but recent fundamentals have been tested by new supply. Ultimately, these markets are expected to continue to benefit from attractive demand drivers and are likely well-positioned in the long-term.

New renter demand may struggle to keep pace with supply in select markets near-term. Nonetheless, 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 office sector struggled for a fourth straight year in 2023 due to subdued demand and headwinds associated with the impact of remote and flexible work. Many of the largest tenants downsized their office footprints with a focus on efficient space utilization. In 2023, new leasing volume ended 15% below 2019 levels. Leasing activity has been largely concentrated in first-generation space, which has maintained a relatively strong level of demand even as overall absorption has trended negative. Office tenants gave back 65 msf in 2023, bringing cumulative net move-outs to over 180 msf since the beginning of 2020 and the onset of the pandemic. This is nearly four times the occupancy losses recorded during the GFC. In addition, available sublease space rose to over 200 msf, significantly above the peak achieved during the GFC.

The office vacancy rate climbed to 14%, reflecting the excess supply and reduced demand in the market. An additional 50 msf of supply is set to be delivered by the end of 2024, further exacerbating the existing space overhang. 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 and 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 rent growth. With construction starts falling to a 13-year low at 31 msf in 2023, 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 2023 thanks to steady demand from a diverse array of sectors, a significant pullback in store closures, and minimal new supply. U.S. retail property fundamentals remain tight and demand improved throughout the year led by the general retail and neighborhood center segments, which account for the majority of leasing activity over the year. Notably, the vacancy rate hit a 13-year low of 4%, highlighting the resilience of the sector. In the past 12 months, just over 40 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.

Competition for the limited available space drove annual rent growth to nearly 4%, below the record highs seen in late 2022 but above the pre-pandemic average of below 3%. 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 economic 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]

2023 was a challenging year for capital markets activity as high interest rates and tighter lending conditions weighed on real estate investment activity. The fourth quarter was the weakest quarter of the year with transaction volume totaling $89.5 billion, a 41% decrease from the fourth quarter of 2022. Transaction volume for the calendar year 2023 was down 51% from 2022, but only down 32% when compared to the years leading up to the pandemic. This highlights the extreme highs that were reached in the market in 2022 due to ultra-low rates and pent-up demand from the pandemic.

According to the MSCI CPPI National All-Property Index ("CPPI"), the pace of price declines has been decelerating in recent months. Overall prices held relatively steady in the third and fourth quarters. The CPPI ended the year down just 6% year-over-year, a significant improvement from the 10% decline seen in the third quarter. The slowing pace of deceleration may indicate the market is reaching an equilibrium in which transactions may begin again. Market activity, although limited, suggests that capitalization rates ("cap rates") have risen roughly 30 - 40 bps across multifamily, industrial, and retail properties and 70 bps among office properties since the first quarter. However, additional pricing adjustments may be needed for some segments of the market to ignite deal activity, especially in the beleaguered office market.

The industrial sector was an outperformer among the main property types with slight growth in property prices for the year as pricing increased 0.5% year-over-year. Overall industrial deal volume for 2023 was $89.2 billion. This represents a 44% decrease from 2022 but a 4% increase when compared to average deal volume from prior to the pandemic. Industrial cap rates expanded 60 bps in 2023 when compared to 2022. 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 continued to garner the largest share of transactions among the main property types ending the year with $118.9 billion in total transaction volume. This represents a 61% decrease in volume year-over-year, but just a 30% decrease in volume when compared to the pre-pandemic averages. Pricing remained relatively steady in the second half of the year but ultimately decreased 8% year-over-year. Cap rates expanded 20 bps from the third to fourth quarter in 2023 and expanded 60 bps year-over-year. Garden apartment transactions made up the majority of transaction volume for 2023 though cap rates expanded similarly, about 50 bps, for both garden and mid/high rise apartments. Pricing declined about 13% year-over-year for both types of assets. As some high-growth Sun Belt markets face supply-side headwinds, 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.

The office sector registered the largest monthly and annual price declines of the property types due to challenges with tenant demand and a contraction of deal activity. Office transactions made up the smallest share of volume for 2023 at $51.9 billion. This marks a 56% year-over-year decline and is 66% below the average fourth quarter pace set over the years 2015 to 2019. Though volume and pricing were down for the year, the fourth quarter slowed the pace of decline in terms of volume and pricing per square foot. The sector was led by suburban office transactions which accounted for more than 74% of volume for the year. CBD office prices fell 29% from a year ago and suburban office prices dropped 13%. The office sector remains challenged, and credit remains extremely limited. Further deterioration in office prices is expected with an estimated $400 billion in office property loans maturing over the next three years.

For the retail sector, resilient consumer spending and limited space availability for in-demand locations supported investment activity. Retail property sales dropped 38% year-over-year for a total 2023 transaction volume of $57.3 billion. This represents a 26% decline in volume from the annual average achieved in the years prior to the pandemic. 2023 also represents the first time since 2017 that retail transaction volume outpaced the office sector. Retail CPPI declined just 5.5% year-over-year and cap rates expanded 50 bps. This relatively minimal expansion has been driven, in part, by strong levels of income growth. 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, welllocated retail – especially grocery-anchored – is expected to out-perform the rest of the sector.

In the fourth quarter of 2023, NCREIF Property Index ("NPI") total returns saw a fifth consecutive quarter of negative returns driven by declining appreciation returns. U.S. real estate posted a rolling 12-month total return of (7.9)% driven by an (11.8)% appreciation return and a relatively strong 4.3% income return. 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. Total returns for the fourth quarter dipped (3.0)% driven by a 200 bps

quarter-over-quarter decline in appreciation for an appreciation return of (4.1)% while the quarterly income held steady for the fourth consecutive quarter at 1.1%.

For the third quarter in a row, all four asset classes posted a negative total return. At (1.1)%, retail returns were again the best performer resulting in a rolling 12-month return of (0.9)%. The industrial sector was the next best performer posting a total return of (2.3)% for the fourth quarter and (4.1)% for the last 12 months driven by an annual appreciation return of (7.4)%. Multifamily total returns were down 160 bps quarter-over-quarter to (3.0)%. 12-month total returns for multifamily were the second lowest behind office at (7.3)%. After a brief third quarter improvement, office returns declined again in the fourth quarter for a total return of (5.4)%. Value declines were driven by the fifth consecutive quarter of cap rate expansion with appraisal cap rates ending the fourth quarter at 4.6%, 20 bps higher than the third quarter. Net operating income ("NOI") growth expanded to 2.1% in the fourth quarter further underlining the health of operating fundamentals among most real estate sectors. Value declines so far in this cycle have been due in large part to the market's adjustment to higher interest rates. In contrast to previous real estate downturns, positive NOI growth has partially offset the negative impact of higher cap rates.[4]

Outlook

The 2024 outlook for the U.S. real estate market is one of opportunity amid challenges. The U.S. economy is expected to experience a period of slower growth in early 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 market is through the worst part of an adjustment to higher interest rates. The Fed has indicated that it has reached the end of the rate hiking cycle and the real estate market may be approaching levels that reflect the market is near a bottom. 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.

With the Fed's anticipated pivot to rate cuts, 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. The bifurcation across property sectors and markets is expected to be more pronounced as improvements continue.

Looking through the near-term volatility, secure income streams from real estate will lead to long-term value creation and 2024 may bring opportunity 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 are often generated in the aftermath of markets like we are experiencing today.

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SOURCES

[1]Source: U.S. Bureau of Economic Analysis, Gross Domestic Product, Consumer Spending, Fourth Quarter 2023, Advance Estimate; U.S. Department of Commerce, Congressional Budget Office, February 2023; U.S. Bureau of Economic Analysis, U.S. Personal Income and Outlays, Private Investment, Personal Consumption Expenditures, December 2023; U.S. Bureau of Labor Statistics, Employment Situation, December 2023; U.S. Bureau of Economic Analysis, December 2023; Board of Governors of the Federal Reserve System, Daily, December 2023
[2]Source: CoStar, Fourth Quarter 2023, Property Market Fundamentals Statistics
[3]Source: MSCI CPPI, Hedonic Series Cap Rates, Fourth Quarter 2023, Capital Markets Statistics
[4]Source: National Association of Commercial Real Estate Investment Fiduciaries NPI, Fourth Quarter 2023