2023 Q3 MARKET COMMENTARY

ECONOMIC OVERVIEW[1]

The U.S. economy continued to show remarkable resilience in the face of higher interest rates and tightening credit conditions. U.S. gross domestic product ("GDP") rose at a seasonally adjusted 4.9% annualized rate in the third quarter, marking the strongest pace of economic growth since the end of 2021 and more than double the estimated long-term potential growth rate of roughly 1.8%. The sharp increase in economic gains raises the prospect of a longer post-pandemic expansion despite the aggressive pace of monetary tightening and adds to the potential for a soft landing — in which inflation returns close to the Federal Reserve's 2% target without a recession or significant job loss.

The U.S. consumer, alongside increased inventories, and government spending drove overall growth in the third quarter. Consumer spending grew at a 4.0% annualized pace, the fastest rate of expansion since the 2021 pandemic recovery. This growth was broad-based and split nearly evenly between goods and services, with the two measures up 4.8% and 3.6%, respectively. A buildup in inventories also supported the quarter's economic expansion. Following a slow first half of the year, inventory investment accelerated notably in the third quarter, returning to levels last seen during the post-pandemic inventory restocking efforts. Meanwhile, government spending increased at a 4.6% annual rate, due to healthy gains in both defense and nondefense outlays. Business investment in manufacturing structures benefited from 2022 legislation, including the CHIPS & Science Act and the Inflation Reduction Act, which has boosted construction of electronic vehicles and semiconductor plants.

The labor market continued to show a strong trajectory. By many measures, the labor market has grown stronger over the course of the year. Employers added 336,000 jobs in September, well above both the pre-pandemic average and the average 278,000 jobs per month added during the first half of the year. The unemployment rate remained near historic lows at 3.8%. Prime-age worker employment (25 - 54) reached the highest rate in more than 20 years — underscoring the resilience of the economy. However, declines in real disposable personal income indicate that last quarter's spending increases were due in part to the continued drawdown of pandemic-related excess savings. The personal saving rate fell to 3.8% in the third quarter, compared to 5.2% in the second quarter — an indication that consumer spending may soften in the near term.

Despite the stronger than expected economic growth, inflation has eased sharply from its peak in June 2022. The Federal Reserve's ("Fed's") preferred inflation gauge, the core personal-consumption expenditures ("PCE") price index, which excludes the more volatile food and energy sectors, slowed in September to 3.7% year-over-year, but remains well above the central bank's 2% inflation target. Core inflation is projected to remain elevated at or near this level through the end of this year before returning to long-term trends by the end of 2024.

The jump in third quarter GDP gains came even as the Fed signaled that it may keep interest rates higher for longer to ensure inflation will slow and maintain acceptable levels. At the Federal Reserve Open Markets Committee meeting in July, the central bank announced its 11th rate hike since March 2022 and raised its benchmark interest rate by 25 basis points ("bps") to a target range of 5.25% - 5.5%, the highest level in two decades, and noted that it will continue to reduce the size of its balance sheet by $95 billion per month. The Fed held rates steady at their meeting in September and indicated it is near the end of its rate hiking cycle but may pause at peak rates for some time taking into consideration the lagged impact of tightening monetary policy on the economy. The federal funds rate is expected to remain at, or near, current levels through mid-2024.

Concerns that monetary policy could remain tight for a longer duration combined with stronger economic growth expectations have significantly impacted long-term interest rates. The 10-year benchmark yield on U.S. Treasury bonds, which settled near 3.75% at the end of the second quarter, climbed over 100 bps during the third quarter and touched near 5% in early October — a 16-year high. The rapid upward movement in these long-term bonds, which serve as a benchmark for borrowing costs throughout the economy, contributed to financial tightness in the economy and has potentially delayed the recovery of the capital markets. If the Fed has reached the end of its monetary tightening cycle, the 10-year Treasury rate is expected to fall to roughly 3.5% by the end of 2024 and settle near 3.0% by 2027.

Overall, the strength seen in the third quarter means the U.S. economy is nearing the end of 2023 with much more momentum than forecasts anticipated. While a year-end recession now appears unlikely, an expected slowdown in economic growth along with the tightening of financial conditions suggests more weakness is likely to show up in the first half of 2024. The impact of more restrictive lending standards and the rise in bond yields, which is filtering through to broader borrowing costs, will likely weigh heavily on U.S. real estate investment into early 2024. Risks to the economic outlook remain but the outlook for property markets is positive amidst strong consumer fundamentals and corporate profitability.

REAL ESTATE FUNDAMENTALS[2]

U.S. property fundamentals continue to moderate toward a long-term equilibrium after years of pandemic-induced volatility. With the exception of the office sector, property market fundamentals have proven to be resilient even as inflation and rising interest rates weighed on segments of the economy and financial markets in the third quarter of 2023.

Industrial

The U.S. industrial market saw another strong quarter despite some challenges. Key fundamentals remained healthy even as elevated levels of new supply coincided with slower demand. The national vacancy rate ticked up moderately to 5%, in line with pre-pandemic (2015 - 2019) third quarter averages. A total of 132 million square feet (“msf”) of new space was added during the third quarter, a three-decade high, but was met with a notable deceleration in demand. Net absorption in the third quarter fell to 33 msf for the quarter, a 10-year low, as some retailers paused inventory accumulation out of caution over the economic outlook. Occupancy gains were tempered across many major markets though Los Angeles and the Inland Empire saw a significant decline due in large part to a slowdown in U.S. imports and the diversion of trade with China through the Panama Canal, which has simultaneously benefitted several East Coast port markets.

With 515 msf of new supply under construction, industrial inventory is expected to grow by 3% through the end of 2023. Most markets appear to be relatively insulated from risks of oversupply due to healthy levels of pre-leasing (40%) and persistent shortages in distribution space exacerbated by the Covid-19 pandemic. The uptick in available space in the third quarter was primarily concentrated in properties larger than 500,000 square feet.

Annual rent growth continued to be strong at 8% but slowed in the third quarter. While below the peak of 12% reached in mid-2022, rent growth for the quarter was 300 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 60% from last year as tight financing conditions curtailed new development.

Many structural trends point to continued strength for the U.S. industrial market. 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 continued its path toward normalization with a third consecutive quarter of significant improvements in demand. An impressive 116,000 units were absorbed during the quarter, marking the highest quarter of absorption in two years and a remarkable five-fold increase compared to the same period in 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; 147,000 units were delivered in the third quarter.

Supply-side pressures put downward pressure on rent growth which decelerated to 1% year-over-year and pushed vacancy above 7% and above pre-pandemic levels. With over 900,000 units under construction as of the third quarter, new deliveries are expected to remain elevated for several quarters and vacancy rates may continue to rise, albeit 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 market continued to reflect the fundamental changes brought about by the COVID-19 pandemic's impact on remote and flexible work. Occupied space per worker has settled 8% below the levels observed in 2019 and the average lease size in the third quarter was 20% below the pre-pandemic average. Many of the largest tenants have downsized their office footprints, indicating a more permanent shift towards more remote and flexible work arrangements. Various sources, including transit ridership and Kastle Systems daily attendance data, suggest that office attendance has held steady for the last 12 months at 50% - 60% below pre-pandemic levels, signifying stagnant demand for traditional office space.

The third quarter marks the sixth consecutive quarter of negative absorption, bringing the total for 2023 to a staggering 58 msf decline in leased office space. Total occupancy reached its lowest level since 2017, despite an 11% increase in employment in office-using sectors during the same period. Over 1,100 msf, or 17% of total office inventory, was available at the end of the third quarter. This availability includes 215 msf of sublease space, significantly exceeding the peak achieved during the GFC.

The vacancy rate climbed to 13%, reflecting the excess supply and reduced demand in the office market. An additional 45 msf of supply is set to be delivered by the end of the first quarter 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 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. However, the broader office sector is struggling to adapt to the new hybrid work environment, and the road to recovery appears to be a longer-term proposition.

Retail

The U.S. retail market maintained its strength through first three quarters of 2023 thanks to steady demand from a diverse array of sectors, a significant pullback in store closures, and minimal new supply. The third quarter marked the eleventh consecutive quarter of positive net absorption. Notably, the vacancy rate hit a 13-year low of 4%, highlighting the resilience of the retail sector. In the past 12 months, just under 50 msf of retail space was delivered, 35% 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 60 msf of retail space under construction has been pre-leased and construction starts declined 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 well 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]

Despite an improved economic backdrop, high interest rates and tighter lending conditions weighed on real estate investment activity in the third quarter. Transaction volume across all sectors came to $89 billion, down 53% from the third quarter last year and 37% lower than the average achieved in the third quarter of the years leading up to the COVID-19 pandemic (2015 - 2019). Distressed sales were in line with long-term historic levels at 2% of total sales in the quarter. Overall, 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 MSCI CPPI National All-Property Index stayed relatively flat across the third quarter, down (9%) year-over-year compared to (10%) last quarter. Cap rates showed little change from the prior quarter across all property types. Market activity, although limited, suggests that cap rates have risen roughly 50 - 70 bps across the four major property types over the year. 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 pricing relatively flat, down 1% year-over-year. Deal volume reached $41 billion, down 40% year-over-year, but just 12% below the average from third quarters of the years prior to the pandemic (2015 - 2019). Industrial cap rates held steady near 6% in the third quarter, up 60 bps from a year earlier. Transactions offering near-term lease rollover with mark-to-market opportunities continue to be in high demand from a deep investor base. With vacancy rates near historic lows 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, despite a notable decline in activity relative to a year ago. Total sales volume of $30 billion represents a 62% drop in volume year-over-year. Prices have declined 13% since late 2022 but held relatively stable over the quarter. Cap rates remained flat quarter-over-quarter at mid-5% representing a 60-bps expansion from a year ago but are in line with those from 2019. Prices fell further for high-rise assets. This segment of the market saw prices fall 14% versus the 12% year-over-year decline for garden apartments. This stability in the cap rate environment may be a signal that the multifamily market is moving toward historic pricing trends. As certain markets grapple with a supply influx, 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 third quarter of 2023 brought office deal volume to near-record lows and ranked as the lowest amount of activity among the four sectors. Transaction volume was down 65% year-over-year. The sector was led by the suburban office segment which accounted for more than 80% of office transaction volume for the quarter. Office transactions in central business district locations totaled $1.8 billion, comparable to volumes seen in the wake of the GFC in 2009 and 2010. 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.

Retail sales volume represented the only quarter-over-quarter increase among property types, growing from $11 billion to $15 billion in sales in the third quarter. Transaction volume in the retail sector outpaced the office sector for the first time due in large part to several large mergers but was 31% below last year’s level. Retail cap rates stayed flat over the quarter but have expanded by 50 bps year-over-year to nearly 7%. This relatively low expansion has been driven, in part, by strong levels of income growth. Grocery-anchored retail posted the shallowest price decline, falling less than 3% over the year. If the economy slows as the retail sector continues to evolve to meet changing consumer preferences, a rising pace of distressed property sales in some segments of the retail sector will likely aid the price discovery process.

NCREIF Property Index (“NPI”) total returns saw another quarter of negative returns driven by declining appreciation returns. U.S. real estate posted a rolling 12-month total return of (8.4)% driven by a (12.1)% appreciation return but balanced by a relatively strong 4.1% 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 third quarter of (1.4)% were negative yet again but improved quarter-over-quarter. The income return for the quarter moved up to 1.1%, appreciation returns were (2.4)% but improved more than 50 bps in the quarter. For the second quarter in a row, all four asset classes posted a negative total return. At (0.1)%, retail total returns were the best performer, resulting in a rolling 12-month return of (1.4)%. The industrial sector was the next best performer and posted a (0.3)% return for the quarter and (5.3)% for the last 12 months, driven by an annual appreciation return of (8.5)%. The multifamily asset class was the only one whose returns did not improve quarter-over-quarter, albeit by a minimal amount, total third quarter returns for multifamily properties were (1.4)% bringing the 12-month total return to (7.6)%. Total office returns improved by over 200 bps from (5.8)% in the second quarter to (3.7)%. Unsurprisingly, office properties presented the lowest 12-month returns at (17.1)% with a (21.1)% appreciation return. Value declines were driven by the fourth consecutive quarter of cap rate expansion with appraisal cap rates ending the third quarter at 4.4%, 65 bps higher than the cyclical low point in the third quarter 2022. With structural factors weighing on certain sectors and metros combined with the uncertainty of higher interest rates and slower economic growth, returns may continue to moderate in the next quarter.[4]

Outlook

The global economy has proven more robust than anticipated coming into the year, but the second half of 2023 may still be challenging for many sectors of the U.S. economy including the real estate market. Consensus expectations are that the U.S. will experience a period of slower economic growth later this year which may soften real estate property fundamentals in the near-term. Segments of the beleaguered office sector are expected to see the most impact.

The Fed has indicated that it is near the end of the tightening cycle and U.S. treasury rates appear to be settling into a longer-term trend, which may set the real estate capital markets up for a rebound later this year. While valuations vary by property type, the real estate market may be approaching levels that reflect the market is nearing a bottom. Near-term attractive entry points may begin to emerge. Volatile conditions and secular forces create winners and losers, and market dislocations should present attractive buying opportunities ahead of the broader economic recovery forecasted in 2024.

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SOURCES

[1]Source: U.S. Bureau of Economic Analysis, Gross Domestic Product, Consumer Spending, Third 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, September 2023; U.S. Bureau of Labor Statistics, Employment Situation, September 2023; U.S. Bureau of Economic Analysis, September 2023; Board of Governors of the Federal Reserve System, Daily, October 2023
[2]Source: CoStar, Third Quarter 2023, Property Market Fundamentals Statistics
[3]Source: MSCI CPPI, Hedonic Series Cap Rates, Third Quarter 2023, Capital Markets Statistics
[4]Source: National Association of Commercial Real Estate Investment Fiduciaries NPI, Third Quarter 2023