TA Realty

The road ahead: Investing in a challenging environment

Resilient sectors and new frontiers

What economic factors and trends are influencing the real estate sector?

The United States is facing a unique and complex macro environment. The combination of elevated inflation and the aggressive pace of monetary tightening, along with the ongoing impact of the war in Ukraine, is expected to cause the economy to enter a mild recession in 2023.

Depending on how quickly inflation responds to the Federal Reserve's tightening, several possible economic scenarios could play out over the next one to two years. Oxford Economics' baseline forecast for U.S. employment growth is generally positive, with the expected unemployment rate rising to 4.6 percent in 2024. Under this scenario, significant job loss is not expected over the next two years, which should bode well for real estate fundamentals. If the U.S. economy falls into a more severe recession, however, we might see more substantial job loss, hurting consumer spending and lowering real estate rent growth. Irrespectively, as the economy slows and the labor market softens, the United States should experience lower inflation, which could prompt the Fed to moderate and conclude its rate increases in 2023.

Despite these headwinds and a more challenging global economic climate, there are still significant positive tailwinds that make the U.S. macro backdrop less uncertain. Important strengths underpin the U.S. economy, such as the steady labor market, solid consumption patterns, relatively healthy household and corporate balance sheets, and a banking system with much lower leverage than before the global financial crisis. These strengths should continue to support demand for the U.S. real estate market, and the anticipated slowdown is not expected to repeat the severity of the GFC.

How have these trends affected property fundamentals and tenants?

Although a few pockets of weakness have emerged in response to the softening economic environment, favorable property fundamentals continued for most commercial real estate sectors through the end of 2022. For example, the U.S. industrial sector fundamentals began 2023 strong. According to CoStar, as of December 2022, the overall industrial vacancy rate hit near-record lows of 4.0 percent in the fourth quarter – 50 basis points lower than the fourth quarter of 2021. Among major port markets in California, Florida and New Jersey, vacancy rates are near 2.0 percent. The industrial market is signaling a trajectory of slower growth in 2023 but appears to be well positioned to withstand economic headwinds.

The U.S. multifamily sector also performed well through 2022, although the tight market conditions following the pandemic-related spikes in demand that characterized 2021 have eased. Forecasts anticipate the national vacancy rate will remain close to long-term averages this year, but supply may outpace demand in some construction-heavy markets. The multifamily sector is expected to finish 2023 on solid footing, even as fundamentals are evolving toward more sustainable, balanced levels. In the near term, the slowing economic conditions may temper renter demand, but tight market conditions may sustain rents above historical averages due to the strong labor market and the rising cost of homeownership.

The office market is facing a series of headwinds from the lingering return to office following the COVID-19 pandemic to the potential impact of slowing economic activity. Despite softness in overall demand, appetite for high-quality space is propelling top-of-market rents in many geographies. This dichotomy is of little surprise as many firms remain committed to flexibility and hybrid schedules and, therefore, opt for smaller, higher-quality office spaces designed to entice employees into the office. Overall market vacancy reached 12.5 percent, according to reports from CoStar as of December 2022. New supply continues to add to the existing space overhang, but construction starts have fallen nearly 40 percent from 2019 peak levels. The pace of deliveries is anticipated to slow significantly toward the end of 2023. A more uncertain economic outlook may further slow the U.S. office market, and the increase in available space, both existing and forthcoming in the near term, points to downside risk.

Heading into 2023, the U.S. retail sector continued to expand. After falling sharply during the depths of the pandemic, retail leasing activity bounced back in 2022, and U.S. retailers opened more stores than they initially closed – a first in many years. Leasing activity has been driven by demand for smaller spaces, and the strongest rent gains have been in neighborhood centers anchored by necessity-based retailers. The retail sector recovery has also been aided by a limited amount of construction activity. While a slowing economy may weigh on consumer spending in 2023, this will likely translate into choppier growth across retail segments rather than a broad-based downturn.

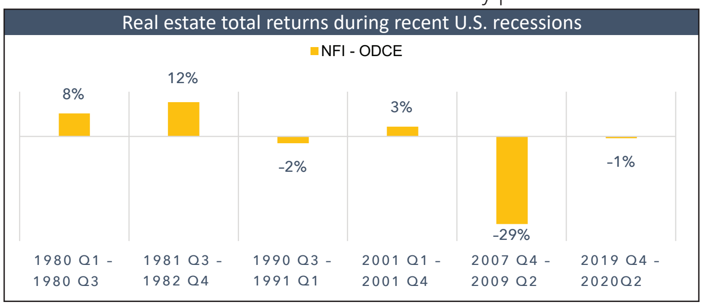
With higher interest rates, what is the status of pricing on the U.S. commercial real estate sector?

While property market fundamentals have largely remained stable, the rising cost of capital resulting from tighter monetary policy, along with broader economic and geopolitical uncertainty, has caused some dislocation across the real estate markets. At the end of 2022, transaction volumes were down significantly, with a lack of clarity on current property values, and greater uncertainty of future property values and the impact higher interest rates will ultimately have on cap rates. Ten-year financing costs rose approximately 200 basis points in 2022. Higher financing costs, along with tighter lending standards, have added upward pressure on cap rates, causing both buyers and sellers to reassess asset values.

This period of price discovery is likely to continue to have a material, yet varied, impact on the U.S. real estate market, but attractive entry points could emerge. Volatile conditions and secular forces will create winners and losers, and market dislocations should present attractive buying opportunities. The durable nature of real estate cash flows, and the diversification and potential inflation-hedging properties real estate offers, position the asset class well, even in this period of global volatility. The U.S. economy is facing unprecedented risks. Yet, long-term U.S. real estate return expectations remain healthy.

How has real estate performed in previous down cycles?

Historically, average annual real estate total returns have tended to be higher in stronger economic climates. Looking at historical real estate performance during recent U.S. recessions, however, an economic downturn does not always equate to negative real estate performance. The chart below shows cumulative total returns for the National Council of Real Estate Investment Fiduciaries ODCE index during U.S. recessions. Across the last six recessions, the NCREIF ODCE posted an average cumulative total return of –1.6 percent, but real estate posted positive cumulative total returns for three of the last six recessions, with only the 2008–2009 recession showing a significant drop in performance. Notably, superior returns in real estate tend to follow recessionary periods.



Source: NCREIF

What markets will be most resilient in the current environment?

Real estate continues to offer long-term thematic tailwinds that may limit the impact in some sectors. For example, the multifamily and industrial markets continue to benefit from positive, structural and secular demand dynamics.

Multiple tailwinds, including the need for "safety stock" to avoid the supply-chain disruptions, growing U.S. manufacturing and the continued development of modern ecommerce infrastructure are expected to continue to drive growth within key logistics markets. Prime markets with large consumption bases and/or near integral ports of entry where industrial-zoned land has become scarce continue to experience the sharpest imbalances of supply and demand. The long-term investment outlook for the industrial market appears to be positive, and seaport cities and major logistics hubs are expected to remain the strongest performers.

Multifamily performance is expected to benefit from reduced single-family home demand caused by higher mortgage rates and the chronic undersupply of housing in the United States, overall. Multifamily trends that were under way pre-COVID will continue in the coming years. Specifically, Sun Belt states, low-cost metros, select suburban submarkets and garden-style formats have all shown the strongest recent performance. Multifamily is expected to weather the economic storm relatively well in the short term, and apartments should continue to produce solid returns over the long term.

Retail may feel the effects if consumers retrench, but the lack of new construction during the past 10 years means vacancies are unlikely to surge. While ecommerce and shifting consumer preferences are creating challenges for traditional retail, alternative retail, such as grocery-anchored retail centers, provide opportunity. Healthy fundamentals in the necessity-based retail subsectors and demand for institutional-quality retail assets may lessen the impact of the rising cost of capital.

A recovery in the office market is likely a longer-term proposition, as office-using tenants reassess their space needs in this new hybrid work environment. Overall, while the office market continues to experience weak demand, a scarcity of supply for the highest-quality space appears to be emerging and may present unique opportunities for investment.

What types of acquisitions do you think will be attractive in the coming years, and why?

2023 should bring opportunities to the real estate market not only for the traditional sectors but also in niche property types. Growth has been strong in many of these smaller sectors, and several are set to benefit from demographic or secular trends. For example, the growth story for data centers is impressive. Data center net absorption has tripled since the first half of 2021, according to CBRE.[1]

In 2022, NCREIF rolled out a series of new subtype definitions and clarifications that will likely spur the growth of investment into nontraditional property types. While these niche asset classes are often very small, the NCREIF data will begin to provide a benchmark to evaluate performance. For example, NCREIF's new residential property type includes four subtypes: apartment, student housing, single-family rentals and manufactured housing. While the apartment subtype makes up nearly 95 percent of the residential property market value, according to the preliminary second quarter 2022 data, over time the smaller residential subtypes will grow and begin to provide transparency to these niche sectors.

Ultimately, the growth and assimilation of nontraditional property types will likely be a material benefit to the real estate market, attracting additional capital and enhancing investment opportunities.

Notes: [1] CBRE, *North America Data Center Trends H1 2022,* September 2022

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