2024 Q2 MARKET COMMENTARY

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ECONOMIC OVERVIEW [1]

The U.S. economy showed its strength in the first half of 2024. U.S. real gross domestic product ("GDP") grew at a 2.8% annualized pace in the second quarter, double the 1.4% pace during the first quarter and well-above the estimated potential growth rate of roughly 2.0%. Consumer spending, which accounts for more than two-thirds of the economy, was a key driver of growth. U.S. households picked up spending at a 2.3% annualized rate in the second quarter, after slowing to a 1.5% pace in the beginning of the year. Spending on both services and goods saw solid increases for the quarter. In addition, business investment posted double-digit growth as firms purchased new equipment and restocked inventories. U.S. companies also upped investment in intellectual property, such as artificial intelligence, which bodes well for future productivity growth. The U.S. economy's steady pace of growth adds to the possibility that the Federal Reserve's ("Fed") efforts to return inflation to the 2% target without triggering a recession will be successful.

Signs of softening in the labor market offered further evidence that the economy is on a path toward a soft-landing. 180,000 jobs per month were added in the second quarter, well below the 2023 monthly average of 251,000 jobs added but in line with pre-pandemic (2015-2019) norms. The U.S. economy has now added jobs for 42 consecutive months, one of the longest periods of job base expansion on record dating back to 1939. The sustained strength in hiring kept the unemployment rate low at 4.1%, near 50-year lows, but nearly half a point higher than at the start of the year. An uptick in the labor force participation rate supported businesses' ability to expand while at the same time reducing upward pressure on wages. Overall wage growth slowed but continued to surpass rising prices; average hourly earnings were up 3.9% year-over-year.

The growth in real wages, coupled with strong household balance sheets, suggests that consumers will continue to spend at a healthy rate. However, there are signs of weakness for U.S. households. The personal saving rate dipped to 3.5% in June, the lowest since October 2022. After a period of high inflation, some households are trading down and seeking cheaper alternatives, as evident in earnings reports from major retailers and manufacturers.

Inflation has fallen rapidly over the past year and that trend accelerated through the second quarter. The Fed's preferred inflation gauge, the core personal-consumption expenditures price ("PCE") index (which excludes the more volatile food and energy sectors) ticked down slowly from the start of the year. At a 2.6% annualized pace in June, the rate of inflation was 400 basis points ("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 and hold near 2.4% at the end of 2024.

The path of Federal Reserve policy and interest rates continued to be a central theme through mid-2024. After hiking its policy rate by over 500 basis points since March of 2022, the Fed has held its benchmark overnight interest rate steady in the 5.25%-5.50% range since July of 2023, the highest in 22 years. In June, Fed Chairman Jerome Powell noted the progress in cooling inflation, pointed toward the likelihood of a single interest rate cut later this year and projected four rate cuts in 2025. The U.S. 10-year Treasury rate fluctuated from 3.8% at the start of the year to 4.3% near the end of the quarter. With one rate cut expected for the Fed's policy rate by year's end, the 10-year Treasury rate is expected to settle near 4.1% at the end of 2024 and near 3.8% in 2025.

The U.S. economy is heading toward the end of 2024 with solid momentum supported by resilient consumer spending and a steady labor market. Interest rates are expected to come down gradually from their two decade high and signs of stability should grow as the year progresses. However, risks to the economic outlook remain including the lagged impact of tightening monetary policy and growing geopolitical concerns. In addition, the outcome of November's U.S. Presidential election could sway the economy's trajectory by introducing yet another layer of uncertainty. A potentially weaker economy may weigh on the property fundamentals through 2024 but the outlook for the U.S. real estate market is positive amidst strong household balance sheets and corporate profitability.

REAL ESTATE FUNDAMENTALS [2]

At the midpoint of 2024, U.S. real estate fundamentals are healthy overall but there are signs of deceleration in some sectors, especially the office sector. High construction costs, softer fundamentals and tighter financial conditions have prompted a dramatic pullback in permitting and new construction starts across sectors, which should help set up a potential fundamental recovery in 2025.

Industrial

The U.S. industrial market remained strong in the second quarter but demand for space has downshifted since the beginning of the year as tenants focused on controlling costs weighed on the pace of leasing. The vacancy rate rose to mid-6% while annual rent growth decelerated to a healthy 4%. This slowdown can be attributed to increased competition from new supply in some markets combined with weak, but improved, demand. Net absorption tripled from the first quarter to 30 million square feet (“msf”), but this marked the lowest second-quarter tally since 2012. This weakness can also be attributed to 12-year lows in single-family home sales, which led many tenants involved with adjacent industries, like furniture sales and building materials, to close large distribution centers.

There are signs that the industrial market has moved past the historic development wave. After a record-setting 540 msf of space delivered in 2023, the 350 msf expected to be delivered in 2024 is a nearly 40% drop. Construction starts have fallen by more than 30% as compared to the three years prior to the pandemic (2017-2019) and deliveries are expected to hit a 10-year low by the second half of 2025. The shortage of new product is expected to put downward pressure on vacancy in early 2025, with varying impacts across markets. Key submarkets in South Florida, for example, have already begun to emerge from this transition.

The industrial market continued to normalize in the second quarter, but there was strength in the underlying fundamentals. Signs of recovery in tenant demand have emerged. Consumer spending on goods re-accelerated from Spring 2023 lows. Cargo volumes through the port of Los Angeles increased 18% year-over-year in the first five months of 2024, which should bolster the need for industrial space in Los Angeles and the nearby Inland Empire markets. 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 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 saw a sharp rise in demand alongside unprecedented levels of new supply in the second quarter. Following a robust first quarter, net absorption nearly doubled in the second quarter and reached 170,000 units. Buoyed by a strong labor market and income growth, new demand for the first half of 2024 was up 70% when compared to the first half of 2023. Remarkably, supply still slightly outpaced demand with a record-setting 186,000 units delivered in the second quarter. As supply and demand metrics grew close to equilibrium, the national vacancy rate held steady quarter-over-quarter at 8%. Annual asking rent growth has held steady at near 1% since mid-2023. Markets delivering high levels of new supply, such as Austin and Phoenix, lagged in rent growth.

The second quarter marked the end of the cyclical peak in deliveries and the number of units under construction fell dramatically. 400,000 units are projected to be delivered by mid-2025, a 40% pullback from the last four quarters’ record supply. This should help mitigate some of the recent oversupply issues, particularly in the Sun Belt regions, where heavy construction activity since 2022 increased vacancy rates and suppressed rent growth. In contrast, markets with more controlled development, such as in the Midwest and Northeast, may continue to see stable or increasing rents due to better supply-demand alignment.

Overall, the U.S. multifamily market's performance suggests that the market is nearing stabilization, particularly if the trend of strong absorption continues. The pullback in new construction and the narrowing of the supply-demand gap have set the stage for rent growth to accelerate in the third quarter. Near-term single-family housing affordability issues — exacerbated by rising mortgage rates — may help insulate multifamily demand from a slowing economy. Long-term multifamily fundamentals should remain healthy, supported by a broad undersupply of housing that has persisted since the Global Financial Crisis (“GFC”). The outlook for multifamily real estate remains positive with potential for sustained growth.

Office

The U.S. office market continued to face significant challenges due to changes in workplace dynamics post-pandemic, but there were potential signs of stabilization in the second quarter. Tenant demand for the high-quality buildings pushed net absorption up 2 msf in the second quarter, breaking a two-year streak of occupancy declines. Further, space available for sublease has plateaued since the beginning of the year. However, nearly 6 msf of new supply were delivered. With added competition from the 200 msf of sublease available, the vacancy rate reached a record 14%. Since 2020, the office market has recorded 200 msf of negative absorption, a scale of occupancy loss nearly four times the losses recorded during the GFC.

High availability continued to pressure office rents. Rent growth 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. 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. Construction starts are expected to fall below 12 msf in 2024 and limited deliveries in 2025 and 2026 should lead to further outperformance in the premium office space segment.

With nearly 40% 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. Following this adjustment, the relationship between job growth and demand for office space is to likely reestablish itself, and the office sector may begin to recover.

Retail

The U.S. retail market remained tight in the second quarter, as limited new deliveries and steady demand kept space available for lease at near record lows of 4%. In the past 12 months, just over 60 msf of retail space was delivered, 40% below the 10-year average. Construction activity was primarily concentrated in 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 20-year lows over the past year. 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 office workers continued to reprice downward.

The U.S. retail market has continued to show resilience and adaptability, and fundamentals are expected to remain balanced for the foreseeable future. Limited available space and a further pullback in new deliveries are expected to offset a potential minor slowdown in consumption.

CAPITAL MARKETS [3,4]

U.S. capital markets began to show signs of improvement in the second quarter. Investment activity and pricing both broke a streak of declines as debt market conditions improved, showing better pricing and liquidity with evidence of spread compression. U.S. sales volume totaled $93 billion for the quarter, down just 2% year-over-year and the slowest decline seen since the onset of capital markets uncertainty in the second half of 2022. Second quarter volume still represented a 38% decrease when compared to the average second quarters from 2015 to 2019 but was a 14% increase in volume over the first quarter of 2024.

Price discovery continued in select markets but stabilized overall. According to the MSCI Commercial Property Price Indexes National All-Property Index (“CPPI”), property pricing held steady year-over-year and was up 1.2% over the end of the first quarter — an indication that real estate prices overall may have reached a floor. Even with limited transaction activity and segments of the market still in a phase of price discovery, capitalization rate (“cap rate”) increases moderated and most sectors showed little or no change from the beginning of the year.

Industrial pricing saw the strongest growth among sectors in the second quarter with an 8% increase year-over-year. Industrial transaction volume totaled $20 billion, a 17% decrease from a year prior, but 10% higher than the average second quarter volume from 2015 to 2019. Investors continued to be drawn to the stable income producing qualities of industrial assets and transactions offering near-term lease rollover with mark-to-market opportunities remain in demand from a deep investor base.

The multifamily sector led transaction volume among the main property types with $38 billion in sales in the second quarter, a 20% year-over-year increase. However, this growth was due largely to Blackstone's $10 billion acquisition of AIR Communities. Excluding this transaction, volume fell 14% from mid-2023 but still increased 34% over the first quarter. Pricing fell 7.5% year-over-year, but the pace of decline has slowed with some markets improving. Despite supply-side challenges in high-growth Sun Belt markets, demographic trends, high single-family home costs, and the U.S. housing shortage are expected to sustain investment in the sector long-term.

The office sector continued to weaken in terms of volume and pricing in the second quarter. At only $11 billion, transaction volume was in line with 2010 in the wake of the GFC. However, the pace of decline slowed with a 20% decrease in volume year-over-year, moderating from the 55%-65% drops seen in 2022 and 2023. Office pricing fell by 12% year-over-year, weighed down by buildings located in central business districts ("CBD"). In the second quarter, CBD office pricing was down 25% year-over-year while suburban office pricing saw a more moderate decline of 8%. The office sector remains challenged while credit is extremely limited for investment. As the office market moves through this period of pricing adjustment there may be strategic opportunities for office deals.

The retail sector showed signs of stabilization. For the second quarter in a row, transaction volume declined 10% year-over-year – a slower rate of decline as compared to the end of 2023. After industrial, retail was the only other sector to post positive year-over-year pricing growth. While modest, at less than 1% this uptick may mark an end to the period of decline for the sector. 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 the highest returns in the second quarter since the period of decline began in the fourth quarter of 2022. However, this quarter marked a seventh consecutive quarter of negative returns, driven by declining appreciation returns. U.S. real estate posted a quarterly total return of (0.3)% driven by a (1.4)% appreciation return, but was over 70 bps improvement from first quarter total returns. Income returns continued to be steady and posted a 1.8% return for the second quarter. 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 (5.5)% with a (9.8)% appreciation return and 4.6% income return.

Another data point that may suggest real estate pricing has reached a cyclical low in the U.S.; all asset types but office posted a positive return for the second quarter. Retail returns were strongest totaling 0.9% with a (0.4)% appreciation return and 1.3% income return. Industrial returns were the next strongest at 0.2% total return; (0.8)% appreciation, and 1.0% income returns. The multifamily sector posted a positive return for the first time since the third quarter of 2022 with a 0.2% total return; (1.0)% appreciation return and 1.1% income return. Office continued to post the lowest returns though still improved from last quarter with (2.4)% total return; (3.9)% appreciation, and 1.5% income return. As operating fundamentals remain relatively steady across sectors except office, net operating income ("NOI") was flat quarter-over-quarter but has grown by 2.6% year-over-year. As a note, NCREIF released an expanded NPI for the second time this year which includes senior housing and self-storage assets in addition to the classic NPI property types. The return for expanded NPI in the second quarter of 2024 was (0.2)%.

Outlook

Midway through 2024, the U.S. real estate market appears to be at a turning point with several key indicators of liquidity and fundamentals suggesting the market is moving past the trough. The cost of capital has begun to decline and the Fed has indicated that it will pivot to rate cuts toward year-end. As a lower and more stable interest rate environment takes hold it should set the foundation for a new cycle of increasing values in real estate.

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. Wide differences in fundamental outlooks within real estate subsectors suggests market, submarket, and asset selection will be crucial for driving outsized performance.

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, through March 31, 2024, TA Realty has acquired, invested and/or managed approximately $42 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, Second Quarter 2024, Advance Estimate; U.S. Department of Commerce, Congressional Budget Office, June 2024; U.S. Bureau of Economic Analysis, U.S. Personal Income and Outlays, Personal Consumption Expenditures, June 2024; U.S. Bureau of Labor Statistics, Employment Situation, June 2024; U.S. Bureau of Economic Analysis, June 2024; Board of Governors of the Federal Reserve System, June 2024
[2] Source: CoStar, Second Quarter 2024, Property Market Fundamentals Statistics
[3] Source: MSCI CPPI, Hedonic Series Cap Rates, Second Quarter 2024, Capital Markets Statistics
[4] Source: National Association of Commercial Real Estate Investment Fiduciaries, NCREIF NPI, Second Quarter 2024