House View:
Real Estate Outlook

U.S.

Q2 2023

CBRE Investment Management

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House View: Real Estate Outlook U.S.

Introduction

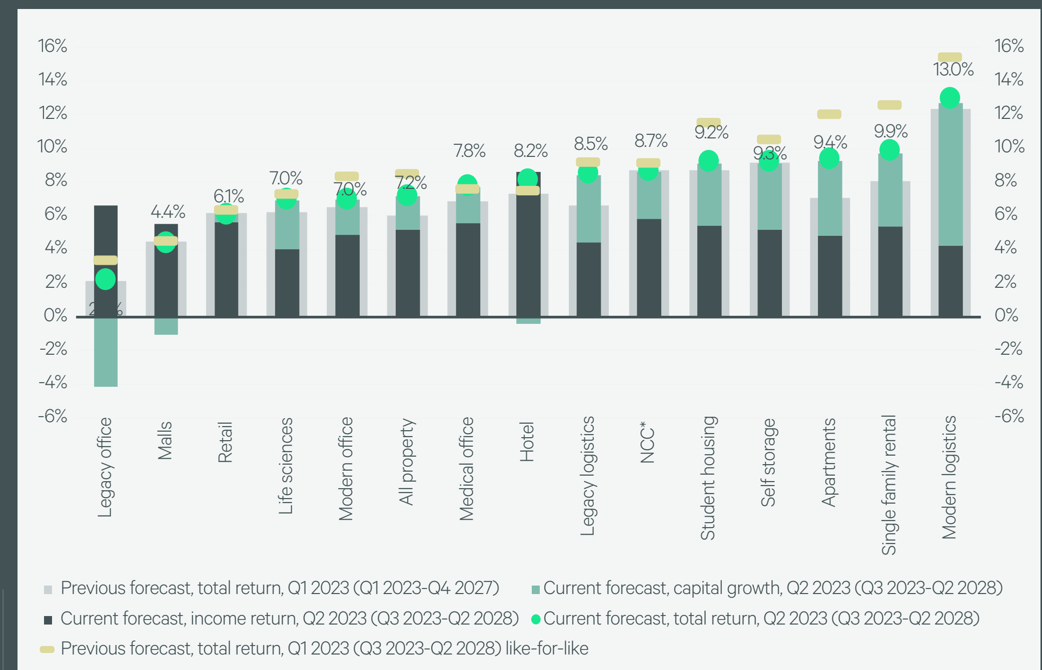
Q2 2023

We have upgraded our five-year average annual total return forecast for core, unlevered U.S. all property to 7.2% (**Figure 1**) from 6.0% previously. This is better than our last forecast due to the passage of time that has shifted some of the forecast value losses into the past. On a like-for-like basis for the time period though, this represents a slight downgrade from our forecast three months ago since our macro outlook suggests a tougher time ahead—most especially in the near term. The U.S. now has higher all property returns than the other regions, but we are cautious with a lower-than-desirable conviction around the U.S. macro outlook.

As of the time of writing (one day after Fed Chairman Powell's announcement of a pause on rate hikes but suggestions of further tightening ahead and a longer wait for the first rate cut), we remain cautious on downside risk. But we still have conviction on continuing to actively invest into generally strong occupier fundamentals (with some notable exceptions), assisted by a pricing correction, which is now deeper and broader than at any point since the Global Financial Crisis (GFC).

Given ongoing uncertainty on the macro outlook, we emphasize the importance of thematic investment around demographic trends and technological change, and redouble our conviction around the modern logistics and residential sectors. Looking through the nearterm volatility, we are confident that investing in a back-to-basics approach and seeking secure income streams from real estate will lead to long-term value creation as well. We also appreciate, however, that this moment in time offers a rare opportunity to acquire generational assets at reset bases that have the potential to deliver superior value gains as markets normalize.

Figure 1: Total return by sector and breakdown
% year-over-year average



* NCC signifies neighborhood and community centers
All property figures include office, life sciences, medical office, malls, NCC, logistics, apartments, student housing and single-family rental, weighted by current NPI weights. It excludes hotels and self storage as these sectors have no weight in NPI.
Source: CBRE Investment Management, forecasts as of Q2 2023.
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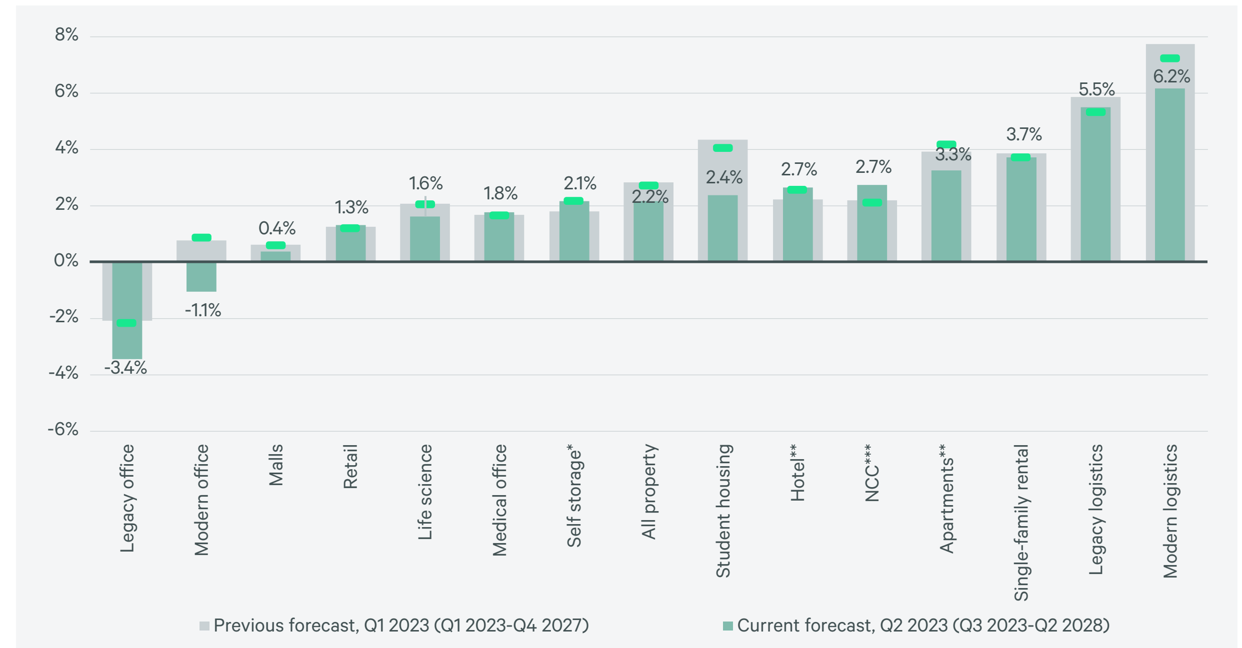
Slower near-term rent growth, improving in the medium term

We have revised down our five-year asking rent growth forecasts in most sectors given our forecasts of a more severe credit crunch and weaker growth in the near-term. (**Figure 2**). Even for legacy office, where our forecasts have for some time been suggesting a challenged performance ahead, we have downgraded the sector yet further with deeper rent losses over the five-year outlook. Although modern office fares better than the legacy segment, it too now sees rent losses on average. And in the niche office segments, we remain positive on life sciences long-term but the sector faces near-term challenges from heavy supply and restrained funding. Medical office rent growth forecasts remain steady given America's demographic outlook and limited supply. The extraordinary rent growth delivered in recent years in logistics segments and most residential formats is now decelerating back to more normal levels. Hotels and neighborhood and community center (NCC) retail have seen their rent growth prospects upgraded as fundamentals continue to improve and recent trends have exceeded expectations.

Figure 2: Market rent growth

% year-over-year average



These figures relate to asking rents unless indicated differently:
* M-Rev PAF change per Green Street Advisors.
** Average daily room rate ("ADR")
*** NCC denotes neighborhood and community centers
All Property figures include office, life science, medical office, malls, NCC, logistics, apartments, student housing and single-family rental, weighted by current NPI weights..
It excludes hotels and self storage as these sectors have no weight in NPI
Source: CBRE Investment Management, forecasts as of Q2 2023.
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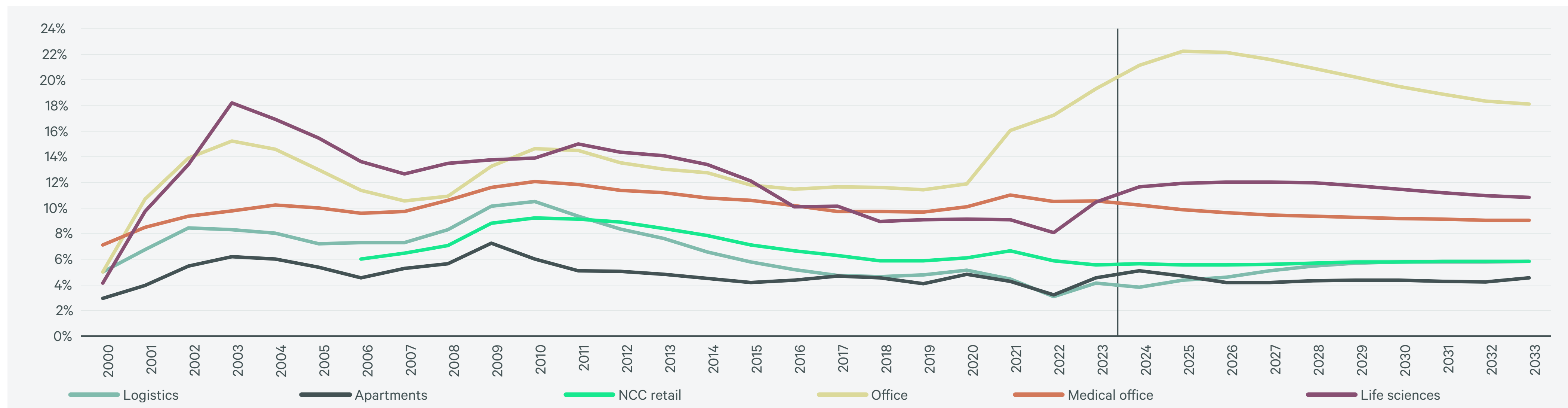
The best and worst times for vacancy

In the face of over 500 basis points of policy rate tightening at the fastest pace since the early 1980s, the U.S. economy has been showing remarkable resilience, especially in the labor market. While technology companies and local and regional banks have announced job cuts, the bigger issue is, in fact, ongoing labor shortages across a wide range of occupations and industries. The U.S. Bureau of Labor Statistics reported (May 31, 2023) that job openings edged up to 10.1 million as of the end of April, with over half those openings found in just three industries: retail trade; healthcare and social assistance; and transportation, warehousing and utilities. Structurally, we continue to believe that the shortage of labor should encourage tenants and their real estate managers to urgently think through how technology may be more rapidly adopted in these fields.

For the majority of property types, the strong labor market is translating into decent space demand, keeping vacancy rates well below long-term averages and close to record lows in some markets. **Figure 3** shows national-level sectoral vacancy rates historically, currently and in our long-range forecast. Office is expected to endure its worst of times, with vacancy expected to surpass 20% by next year and potentially top 22% by 2025. This would be a worse situation than the GFC, the 2002 “tech wreck” or the early 1990s. Shopping malls (not graphed) also have current vacancy rates at their highest point in decades. Life sciences vacancy has risen sharply over the past two quarters but remains well below historical highs. For most of the other sectors, vacancy rates are not far from all-time lows.

Figure 3: National vacancy rates by sector



Source: CoStar and CBRE Investment Management forecasts as of Q2 2023.
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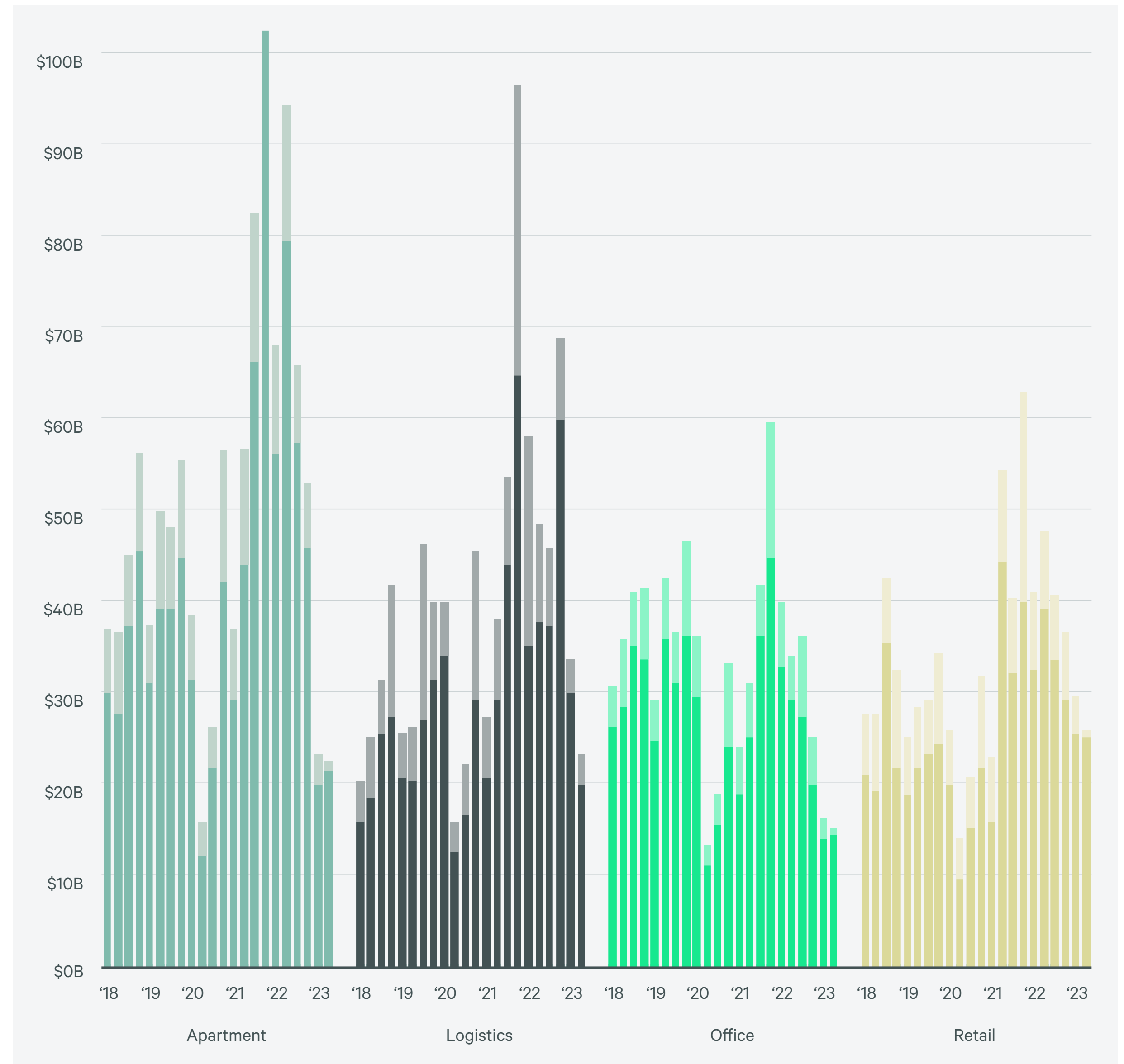
Highly illiquid capital markets

Transaction volumes are one of the best indicators of the uncertainty pervading the market (**Figure 4**). The decrease is made more dramatic by the record-high transaction volumes in certain quarters of late 2021 and early 2022 for apartments and logistics. Quarter-to-date indicators suggest Q2 may be as similarly slow as Q1. Appraisers may well complain about a lack of transactional evidence by which to make their valuations but the volume of trade in U.S. real estate in recent quarters is still moderate by longer-term historical levels.

All-in debt costs have risen by 550-650 basis points in June 2023 compared to February 2022. The four important sources of real estate financing in the U.S., the life companies, banks, debt funds and agencies, were described as active to voracious at the start of 2022 in their lending approach but are now best characterized as cautious, selective and relationship driven. We also have evidence of substantial quantities of dry powder on the sidelines. Preqin data indicates over $227 billion of dry powder targeting North American real estate was tallied for Q1, more than all other regions combined and only slightly down from the $245 billion of dry powder recorded at the market's peak in December 2021.

Figure 4: Quarterly transaction volume by property type



Source: CoStar, as of July 6, 2023. Colored columns indicate transaction volume entered by CoStar research by the end of each quarter (for like-like comparison to history). Gray bars indicated deals entered after the end of each quarter. Note that the logistics total for 2022 Q4 includes ProLogis' $23b acquisition of Duke. 2021 Q4 apartment transaction volume topped $140b; scale is shortened for clarity.
For illustrative purposes only. Current market conditions differ from prior market conditions; including during prior periods of stress and dislocation. There can be no assurance any prior trends will continue.

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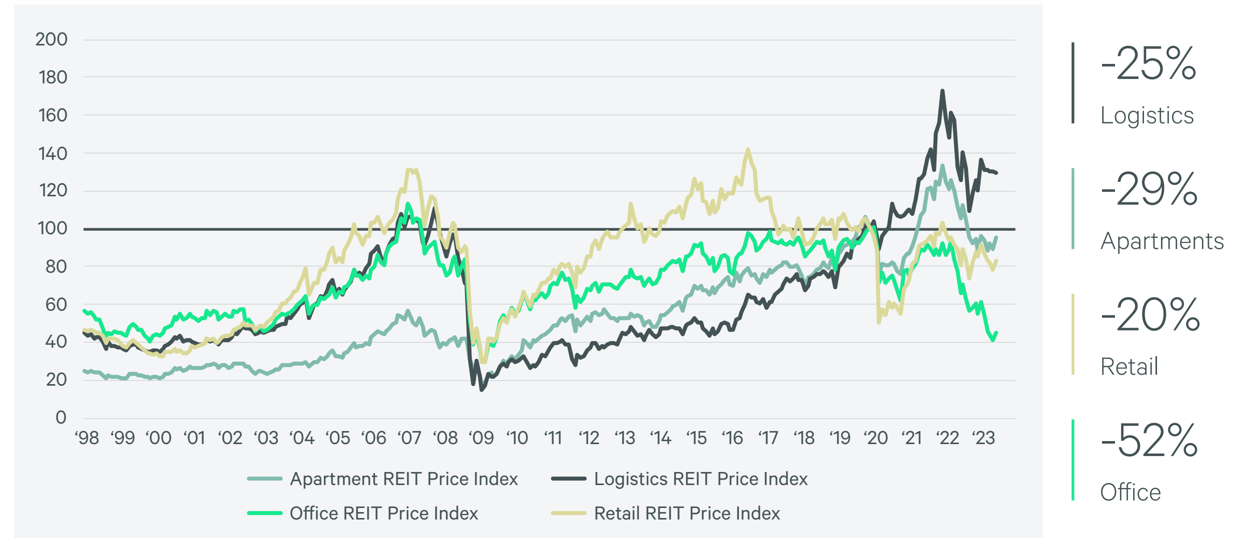
As goes listed...

The listed REIT market serves as a harbinger of where broader values may be headed. As of the end of Q1 2023, REIT pricing was down notably, with office down 53% for that period. But the higher inflation and interest rate environment and other macro uncertainties have seen the other three sectors slip by approximately 20%-30% for that period as well, as shown in **Figure 5**. By the end of May 2023, the discount to NAV for US REITs was approaching 25%.

Unlisted NCREIF capital values, however, have thus far posted relatively minor write-downs in value (**Figure 6**). One of the biggest questions on our minds is the extent to which mounting debt maturities, foreclosures, and real estate owned sales may lead to a massive basis reset as was seen in the early 1990s or the GFC, or whether owners may manage a slower, more gradual and less severe reset this time. This is an especially relevant question for the office sector, currently beset by the worst fundamentals and the greatest uncertainty over future income streams and hence pricing.

Figure 5: U.S. REIT price indices (December 31, 2019=100)

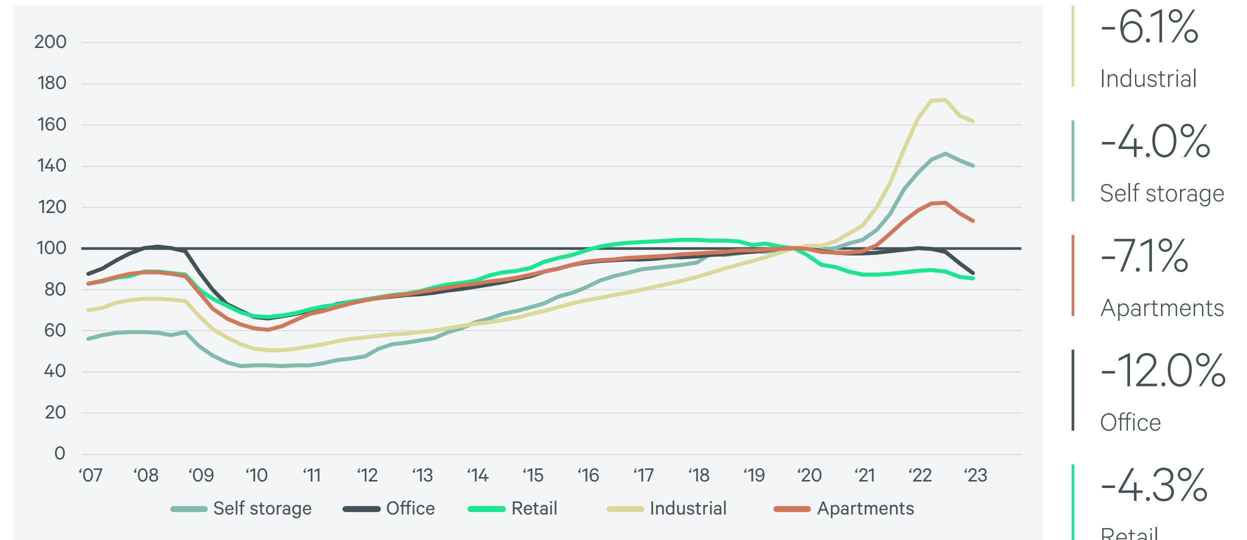
Labels show change from 2021 peak to end April 2023



Source: NAREIT, through June 2023.

Figure 6: Value index by property type (Q4 2019=100)

Labels show cumulative decline from COVID-era peak

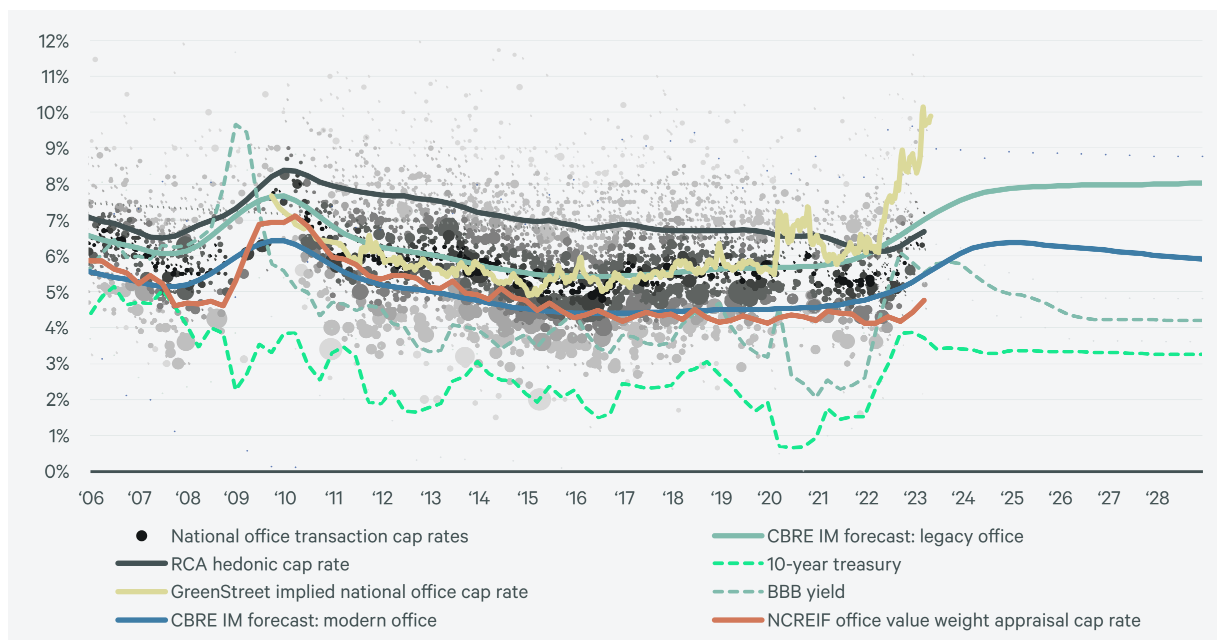


Source: NCREIF, as of Q1 2023.

As goes Listed...

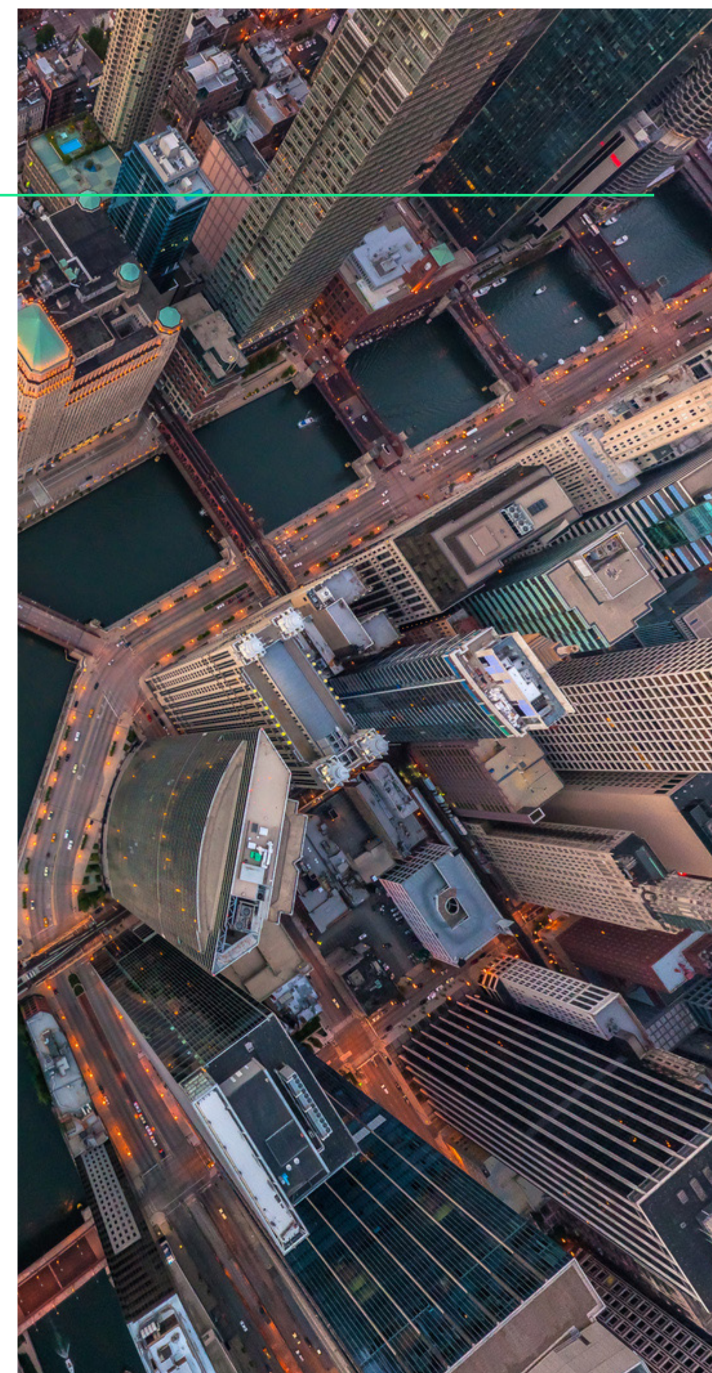
We also note an historically wide gulf between several cap rate indices (**Figure 7**) and above all, for the office sector. With the NCREIF cap rate at the end of Q1 at just 4.75%, yet an implied listed office cap rate (from Greenstreet) hovering in the 9%-10% range, a considerable amount of price discovery needs to play out in this sector. Either NCREIF valuations have a lot of catching up to do and we see those appraised values continue to fall in the quarters (and years) ahead, or the listed markets have well overshot. We think some of both will occur, for as also seen on the chart, our forecasts of modern and legacy office segments fall between those two extremes.

Figure 7: U.S. office cap rates with 10-year treasury and BBB corporate bond yields



Sources: CoStar (transaction cap rates). Cap rates are sized according to transaction price and shaded by distance from trailing 180-day average to indicate trend. Note that not every transaction reports a cap rate, and thus this graphic is not necessarily a comprehensive portrayal of transaction activity. As of May 25, 2023. Implied cap rates from REITs per Green Street Advisors. Real Capital Analytics (RCA) hedonic cap rate as of May 25, 2023. Interest rate data from Federal Reserve and CBRE IM forecast. NCREIF data as of Q1 2023.
10-year treasury yield and BBB corporate yield from Oxford Economics (CBRE Investment Management forecast).

Forecast per CBRE Investment Management's Q2 2023 House View. Forecasts are preliminary and subject to change. For illustrative purposes only. Current market conditions differ from prior market conditions, including during prior periods of stress and dislocation. There can be no assurance any prior trends will continue.



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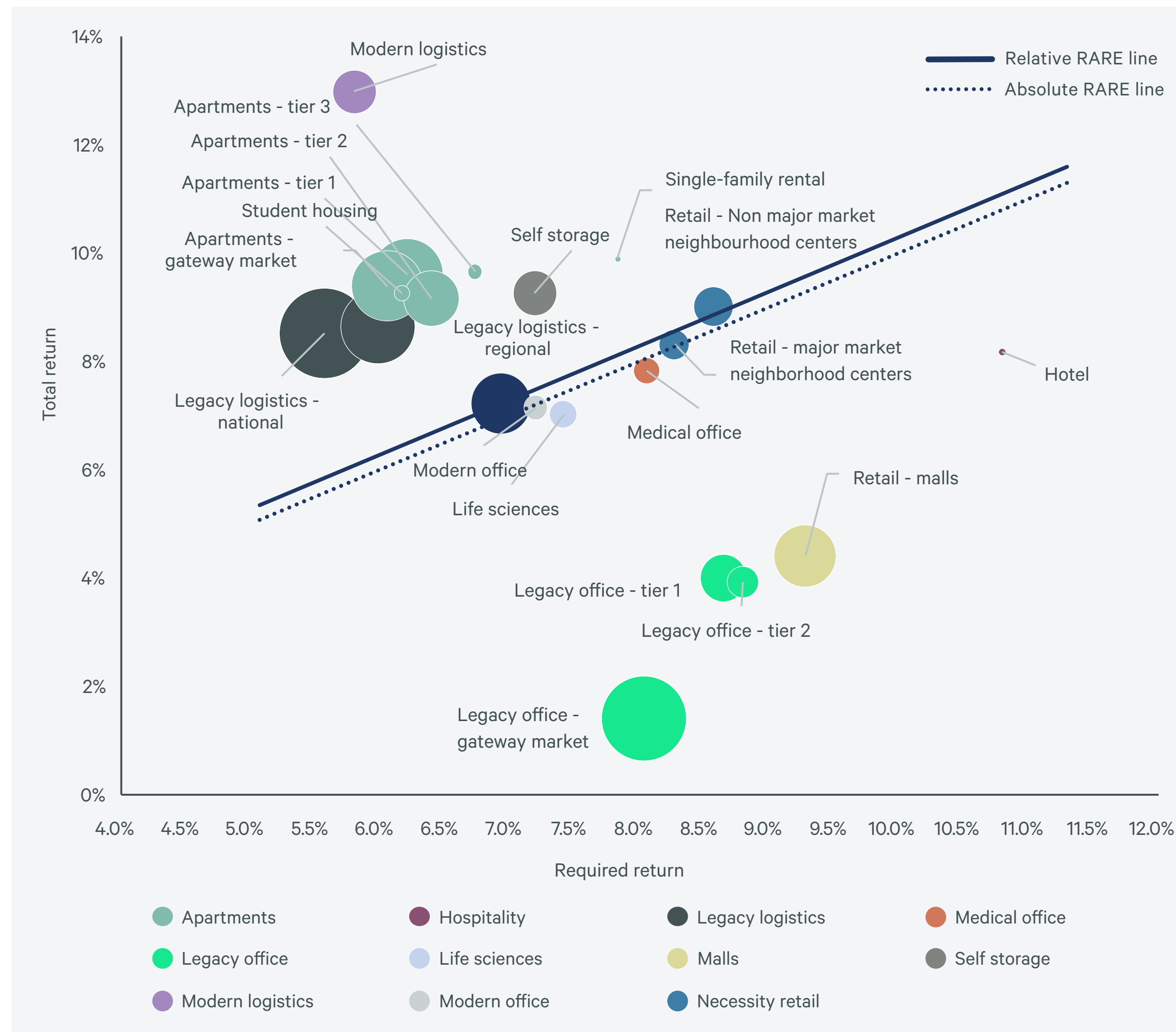
What it all means

For several years, we have overweighted our U.S. portfolio for logistics, residential and next-generation property types. Attribution analysis suggests this has served well both during the pandemic period but also in the tightening cycle of the past 18 months which is still upon us. Even though the inflation and interest rate environment going forward will likely be quite different from the decade leading up to the pandemic, our required return analysis (**Figure 8**) guides us to continue in this way. With the repricing window now open after a decade of near constant cap rate compression, acquiring good-quality assets in those sectors at attractive pricing by exploiting capital market dislocation will be a main focus. Refinancing distress and forced sales from core funds with redemption queues may be among the best sources of such opportunities in our preferred sectors.

Figure 8: Required return & total return for all U.S. sectors

(Q3 2023-Q2 2028, year-over-year average)



Note:
1. Total return figures reflect unlevered property returns of a passive fully invested portfolio before fees and taxes. The return is the five-year average per annum for the period Q3 2023-Q2 2028. Assumptions are generalized to provide a consistent market outlook and asset-specific strategies have not been taken into account.
2. Absolute RARE line: Markets above the line are expected to generate returns higher than their required return.
3. Relative RARE line: During late cycle phases, markets may not achieve required returns given high pricing. The relative analysis takes the average gap between required and forecasted return (the benchmark bubble) as a given for all markets when setting the hurdle (the benchmark line). Hence, markets above the line are expected to perform relatively better than markets below the line.
Source: CBRE Investment Management, forecasts as of Q2 2023.
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