Economic Update

SVN | Research

MARCH 29, 2024

1. INDUSTRIAL'S LARGEST OPERATORS EXPAND

- According to an article by Commercial Observer, Industrial real estate heavyweights Prologis and Link Logistics are leading an ongoing expansion in warehouse use despite recent reports of a post-COVID-boom slow in demand.
- Industrial real estate demand has softened in recent months but has retracted from record double-digit growth experienced in 2022 and early 2023. E-commerce's share of retail sales remains in a new post-pandemic paradigm, and while near-term growth may slow, operators with ample liquidity and a long-term eye remain active in the current environment.
- The CEOs of both companies indicated that they expect to add similar or higher leasing volume in 2024 compared to last year. Link Logistics added 86 million square feet of leased space in 2023, including 23 million in the fourth quarter. Prologis is looking to add up to $3.5 billion in new development in 2023 and expects occupancy levels to remain at or above 96%.

2. HOMEBUILDER SENTIMENT RISES

- Based on data from the NAHB/Wells Fargo Housing Market Index, homebuilder sentiment about housing market sales conditions rose to its highest level in eight months.
- The index measuring views of current sales conditions rose four points to 56. Conditions have steadily rebounded since reaching a recent nadir of 24 in November 2023. Index measures above 50 indicate positive sentiment.
- Expected sales conditions over the next six months also increased, climbing two points to 62. Prospective buyers' traffic rose similarly two points to 34.
- NAHB economist Robert Dietz mentions that as potential rate cuts stimulate demand, rising material prices, particularly lumber, will impact homebuilder activity. Rising activity could also impact logistics and warehouse inventories as market intermediaries ramp up to meet demand.

3. MIXED-USE PROPERTIES

- As trouble in the Office sector causes some investors to consider repositioning their portfolios, mixedused projects are emerging as a prospective choice for developers.

- Mixed-use projects bring together office, retail, and residential spaces and offer a medium for reimaging at-risk sub-sectors like indoor shopping malls and CBD office spaces.
- Jamestown, a real estate developer, has utilized the mixed-use approach to implement ambitious projects that accommodate varied local market environments, such as in Atlanta, Brooklyn, and Raleigh.
- Mixed-use projects also offer developers a way to test the success of newer and emerging product types such as advanced manufacturing, life sciences, flex-living, and health and wellness alongside more tried and tested concepts such as traditional residential and retail space.

4. COASTAL PROPERTY VALUES DEFY CLIMATE RISKS

- Despite risks from sea-level rise and storms, US coastal communities remain a hotspot for growth as high-income residents continue to purchase in and populate these areas.
- Coastal property values continue to climb, with both market and policy forces appearing to be at play. A recent study by Nature found that a combination of stable property values for investment, tax advantages for high-income owners, and subsidies for coastal management activities such as beach nourishment have dampened the effect of sea-level rise on coastal property values.
- Still, the report cautions that such effects are likely temporary and that policy components, such as subsidies and tax advantages, distort the price signals that typically reflect longer-term risks.

5. COMMERCIAL PROPERTY PRICES

- According to the MSCI-RCA commercial property price index (CPPI), the decline in US commercial sector prices slowed further in February, declining just 4.0% year-over-year.
- Price declines in CRE have been consistent over the past year and a half, but in February, they fell at their slowest pace of annual decline since 2022 and dropped just 0.3% month over month.
- The industrial sector again emerged as the only property type with an annual increase, growing by 1.9% year over year and 0.2% month over month.
- Apartment sector prices declined 8.9 % year-over-year but extended a six-month-long moderation in

annual price declines for multifamily properties. Still, apartment prices posted the largest month-over-month decline across all sectors, falling 0.1%.

- Retail sector prices were flat month-over-month, but annual returns fell by 2.5%. Notably, annual price declines in the sector have softened from the double-digit declines seen during the third quarter of 2023.
- Suburban office prices fell 11.6% year over year and 0.4% month over month. Meanwhile, CBD office valuations fell 29.9% annually and 1.3% monthly. The differing magnitudes of devaluation largely reflect each subtype's sensitivity to remote work. The negative demand shock appears most intense in dense, high-price office markets.

6. FED INTEREST RATE DECISION

- The Federal Reserve held interest rates steady at its March policy meeting, in line with market expectations that policymakers would continue its wait-and-see approach for the time being.
- Both the Fed and fed futures markets, as indicated by the Chicago Mercantile Exchange's Fed Watch Tool, kept consistent their projections of three rate cuts by the end of 2024.
- Inflation has come down consistently over the past year, but resilient labor market and consumer spending dynamics have kept price pressures salient and inflation expectations elevated.
- In his post-meeting statement, Fed Chair Jerome Powell stated that the committee is prepared to maintain current interest levels for longer if needed to re-anchor price stability and expectations.

7. CORPORATE TO CRE DEBT SPREAD HITS 24-YEAR HIGH

- Based on data from MSCI, a snapshot of US capital markets shows that the spread between corporate versus commercial real estate debt rates has risen to a high of at least 24 years.
- Dating back to 2000, mortgage rates were consistently low relative to the cost of corporate debt except for during the worst parts of the Great Financial Crisis (GFC), according to the MSCI analysis.
- The rising relative cost of CRE debt indicates that investors are recalibrating the sector's risk profile relative to other investments. Higher interest rates impact investor returns, with investment funds feeling the pinch recently, according to the report.

8. CRE TOP RISK, SAYS UBS

- UBS recently flagged a potential commercial real estate downturn as a "top and emerging risk" that it's preparing for in 2024. It cited higher borrowing costs and slumping demand as potential headwinds in its outlook.
- In its annual 2023 report, UBS noted that "adverse effects on valuations from higher interest rates" and a "structural decline in demand for office and retail" could trigger impacts on the bank, given its exposure to the sector.
- UBS's citing of CRE risks does not suggest a significant CRE downturn. Still, it indicates how shifting supply and demand dynamics may affect the balance sheets of financial firms invested in at-risk assets. The broader CRE market remains a story of diverging sector-level performance and varied metro-area trends.

9. CONTEXTUALIZING CRE RISKS TO BANKS

- According to a recent report by Cohen and Steers, CRE risks to the banking system are spread across large, mid, and small-sized institutions, significantly mitigating potential risks to the financial system.
- The top 25 largest US banks by total assets hold 13% of all commercial real estate mortgages but have just 4% of their total assets exposed to the sector.
- Regional and community (mid-sized) banks are more exposed relative to the market as they hold roughly 30% of all CRE mortgages and, on average, have a 20% balance sheet exposure.
- Banks outside of the top 100 account for roughly 15-20% of all CRE mortgages, but exposure is spread across more than 4,500 institutions nationally.
- Further, their debt service coverage ratios indicate that loan term default risks and low and underwritten values on existing loans are low, as property values have risen over the past ten years.

10. NAR SETTLEMENT

- A recent landmark settlement between the National Association of Realtors and consumer advocates

svn.com
185 Devonshire St, M102
Boston, MA 02110

reforms how brokers can charge commissions on home sales, eliminating the standard 5-6% fees charged to sellers to have their homes posted on Multiple Listing Services (MLS).

- If approved, the settlement would open MLS sites to negotiated pricing, and changes to the brokerage fee structure would take effect within months of approval. A hearing on whether to approve the deal is set to take place in the next few weeks.
- Advocates of changes to the system point out that the settlement could increase price transparency and competition in the home-selling industry.

Economic Update

SVN | Research

SUMMARY OF SOURCES

- (1) https://commercialobserver.com/2024/03/industrial-real-estate-more-inventory-2024/
- (2) https://www.nahb.org/news-and-economics/housing-economics/indices/housing-market-index
- (3) https://www.globest.com/2024/03/27/mixed-use-much-more-than-office-retail-residential/
- (4) https://www.nature.com/articles/s41467-024-46548-6
- (5) https://www.msci.com/our-solutions/real-assets/real-capital-analytics
- (6) https://www.federalreserve.gov/newsevents/pressreleases/monetary20240320a.htm
- (7) https://www.globest.com/2024/03/27/spread-between-corporate-debt-and-cre-mortgages-hits-24-year-high/
- (8) https://www.reuters.com/markets/europe/ubs-flags-commercial-real-estate-downturn-top-risk-2024-03-28/
- (9) https://www.cohenandsteers.com/insights/the-commercial-real-estate-debt-market-separating-fact-from-fiction/
- (10) https://www.nbcnews.com/business/consumer/realtor-settlement-affects-homebuyers-sellers-how-explainer-rcna144650

svn.com
185 Devonshire St, M102
Boston, MA 02110