BARINGS

U.S. Property Market Recovery Powers On

U.S. Real Estate Research Quarterly

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Executive Summary

ECONOMY

- Real GDP is expected to grow by a robust 3.2% in 2022, down from 2021's exceptional annual pace of 5.7%, driven by the post-lockdown re-opening.
- Despite inflationary pressures and geopolitical tensions, consumer and business spending and the labor market are healthy and should continue to support economic and occupier demand growth.
- With CPI inflation accelerating to its fastest rate in more than 40 years, the Fed is intent on restoring price stability through aggressive monetary policy. Investors are concerned the Fed will overcorrect and halt the economic expansion.
- The invasion of Ukraine is exerting pressure on energy prices and impacting sentiment. Headwinds to growth are likely to persist over the near-term.

PROPERTY MARKET

- The U.S. property market has continued to recover even as volatility, driven by geopolitics and the ongoing impacts of the pandemic, continues to reverberate through global supply chains.
- Occupier demand improved across major property types over the first quarter as pandemic-related restrictions loosened across the U.S. Additional COVID variants could slow but are unlikely to disrupt economic activity as profoundly as the first coronavirus outbreak.
- Capital markets activity remained robust following a record 2021 for transaction activity. Aggregate deal volume totaled $171 billion in the first quarter, 56% above the same period last year.
- Price appreciation remains well above average with the national Real Capital Analytics Commercial Property Price Index gaining 17.4% YoY.

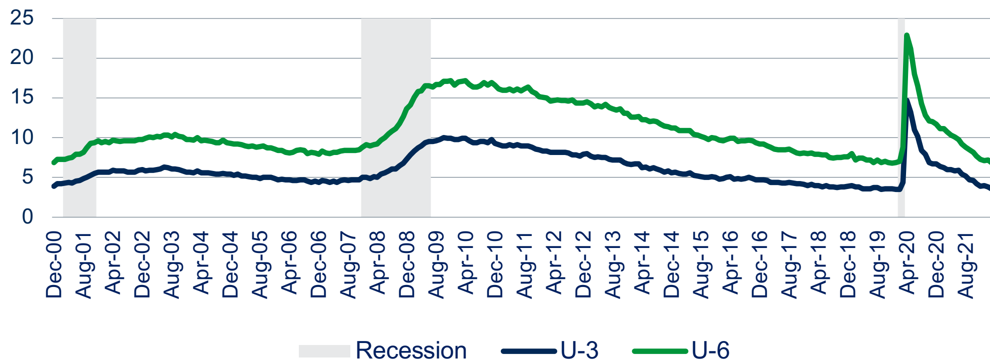
Economic Outlook

U.S. real GDP growth is expected to moderate to 3.2% this year following a 5.7% increase in 2020—the fastest rate in 36 years. Consumer spending and the labor market recovery have been resilient and should continue to support the economic expansion and concurrent recovery in tenant demand. 431,000 jobs were added in March, and the unemployment rate is now only 10 basis points (bps) above its pre-pandemic low. U.S. employers could add around four million jobs in 2022, which would likely push unemployment down even further.

Encouraged by the healthy macroeconomic backdrop, the U.S. Federal Reserve (Fed) is intent on curbing inflation with aggressive monetary tightening. Feds futures suggest a high probability of more than one 50 bps rate hike over the next 12 months. On the consumption front, the Conference Board's consumer sentiment index rose in March, led by the present conditions component. The expectations component, however, remains weighed down by the uncertainty caused by Russia's invasion of Ukraine, which is manifesting most saliently in the form of higher energy and commodity prices. The tight labor market is spurring above-average wage growth that mitigates some of the effect of rising energy prices.

Firms are benefitting from the lifting of pandemic-era restrictions. Slowly but steadily, more are returning to the office. Despite a rise in infections due to the Omicron variant, vaccinations and anti-viral treatments have prevented a commensurate rise in deaths due to COVID. Nevertheless, the pandemic is still a critical factor in the trajectory of the U.S. and global economic recovery. The renewed lockdowns by China's government as part of its "Zero-COVID" policy have continued to disrupt global supply chains. Apartment and industrial fundamentals carried their unprecedented positive momentum into the first quarter, but lagging property sectors including hotel, office, and retail saw substantive improvement as well. Headwinds to economic growth are building, but the U.S. commercial property market continues to power on for now.

FIGURE 1: ROBUST LABOR MARKET RECOVERY DESPITE RISING INTEREST RATES AND ACCELERATING INFLATION



Source: U.S. Bureau of Labor Statistics (BLS); Moody's Economy.com; Barings Real Estate Research. As of March 31, 2022.

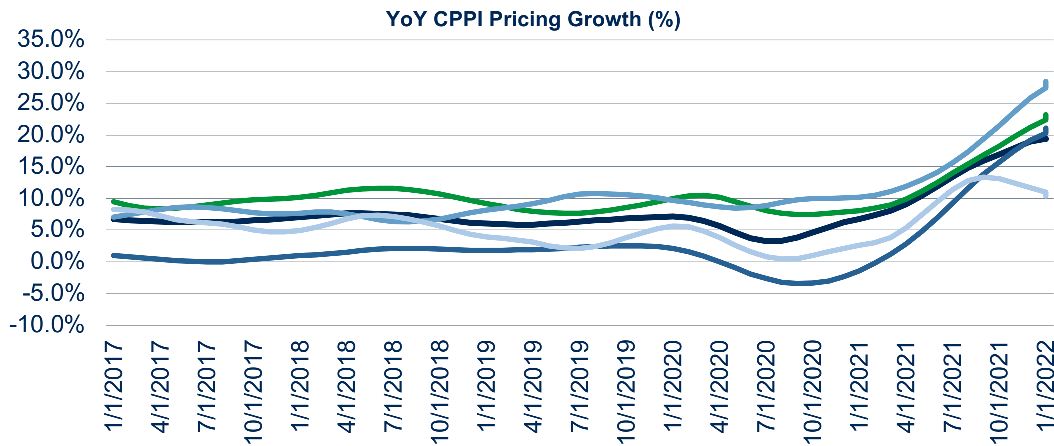
Capital Markets

Capital markets activity remained robust following a healthy close to 2021 with aggregate deal volume totaling $171 billion[1] for the first quarter, 56% above Q1 2021. Apartment volume totaled $63.0 billion followed by office at $35.1 billion, industrial at $33.9 billion, retail at $18.6 billion, and hotel at $11.0 billion. All property sectors saw volume increases of greater than 50% over Q1 2021 with retail volume increasing by 102%—more than any other sector.

Pricing continues to trend impressively with the national Real Capital Analytics (RCA) Commercial Property Price Index (CPPI) gaining 17.4% over March 2021. Industrial led with year-over-year (YoY) price appreciation of 30.1%, followed by apartments with 22.4%. Office trailed the other sectors but still posted an above-average 10.3% increase. In terms of cap rate spreads, the 80 bps jump in the 10-year Treasury yield during the first quarter has compressed the property risk premium for real estate below its historical average, even as institutional real estate cap rates remained stable.

Over the near term, we expect that institutional investor capital appetite, combined with ample fund dry powder, should backstop current asset values and buttress transactional liquidity. Macroeconomic volatility may give investors pause over the coming quarters, but the private real estate asset class remains highly attractive to most institutional investors.

FIGURE 2: CAPITAL MARKETS REMAIN ROBUST IN 2022



Source: RCA; FRED; Barings Real Estate Research. As of March 31, 2022.

[1] Inclusive of development sites, seniors housing.

Property Markets

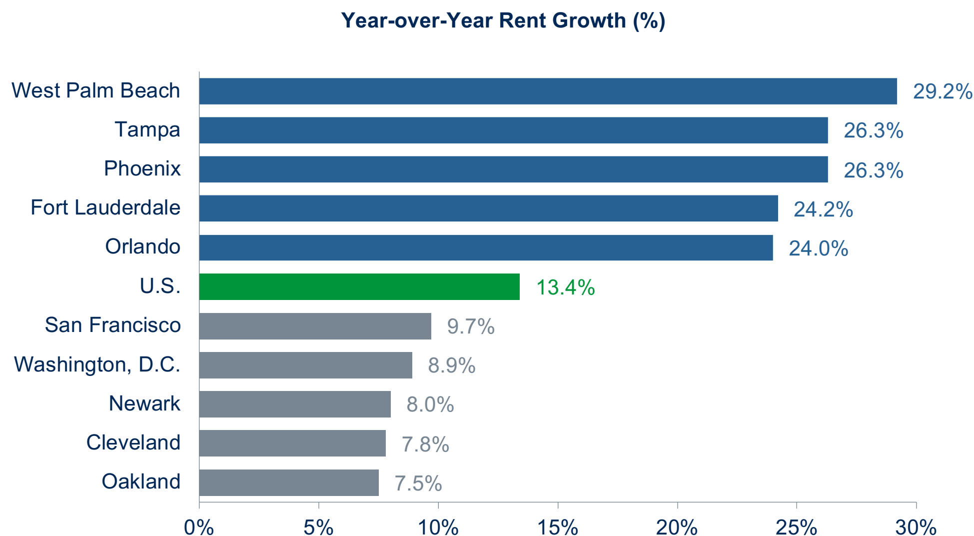
APARTMENT

Apartment vacancy in the first quarter continued to decline, falling 230 bps YoY to an estimated 2.5%, one of the lowest rates on record, according to CBRE-EA. As occupancy soars to a historically elevated rate, effective rents continue to expand beyond pre-COVID levels in the U.S. Concessions, as a percent of asking rents, are slowly burning off but remain above the 5-year average. While demand growth has continued to keep ahead of new deliveries, a robust supply pipeline likely means that rent growth, though expected to remain above average, will moderate from the historic, double-digit growth recorded last year.

The performance of Sun Belt apartment market fundamentals, which have benefitted from secular demand tailwinds well before the pandemic, continue to outperform. West Palm Beach, Tampa, Phoenix, Fort Lauderdale, and Orlando have seen rents grow by 24% or more over the past year. These metro areas have seen in-migration accelerate since the start of the pandemic. Meanwhile, San Francisco, Washington D.C., Newark, Cleveland, and Oakland have lagged, hurt by outmigration exacerbated by COVID.

As it relates to supply, the pipeline remains very active and shows few signs of slowing. Nationally, multi-family permitting on a trailing 12-month basis is up 32% YoY and is currently at an all-time high. Headwinds in the form of raw material and labor constraints may impact construction timing—although there is abundant debt financing for development projects.

FIGURE 3: EXCEPTIONAL APARTMENT RENT GROWTH LED BY SUN BELT METROS



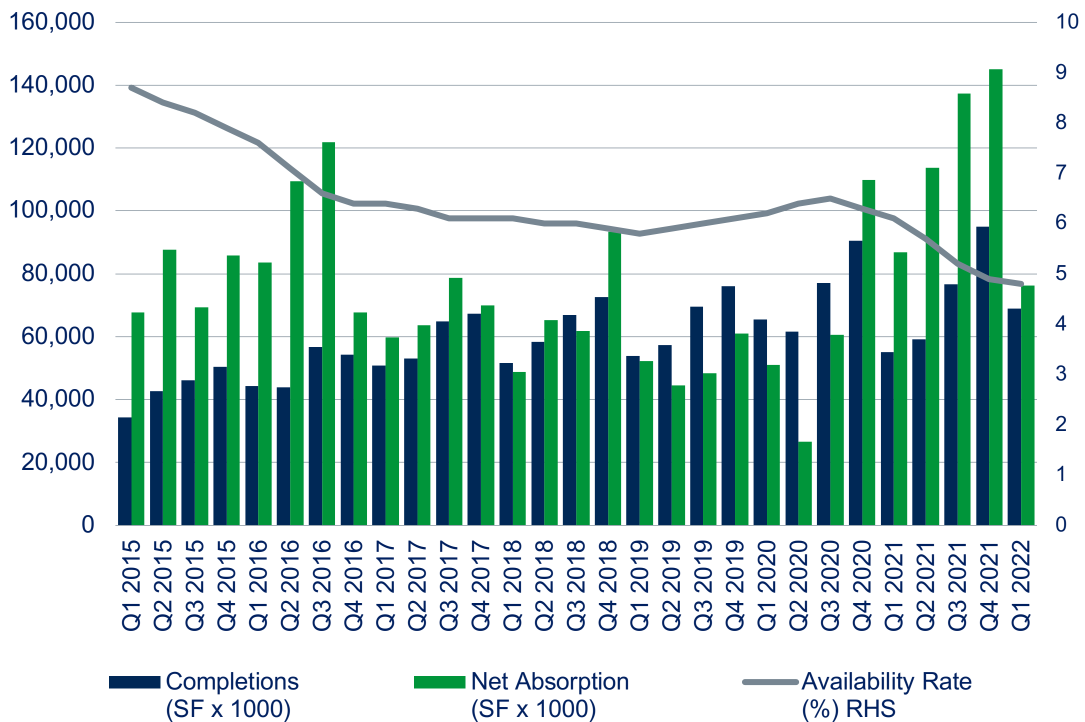
Sources: RealPage; Barings Real Estate Research. As of Q4 2021.

INDUSTRIAL

Macroeconomic factors including manufacturing and global trade conditions supporting the industrial sector remain stable albeit with inflationary pressures and supply chain issues posing some headwinds at the margin. Consumption trends as well as longer-term tailwinds supported by e-commerce and functional obsolescence remain intact, which reinforce both the space and capital markets outlook for the industrial property-type.

The national industrial sector availability rate decreased an additional 10 bps quarter-over-quarter in Q1 2022 to 4.8%, a new all-time low. However, both the pace of net absorption as well as completions retracted slightly from the prior quarters' fervid pace. Although supply is likely to ramp up, headwinds in the form of continued supply chain blockages and resource shortages will likely moderate supply in the near term. All major national distribution nodes reported a YoY decline in their availability rates.

FIGURE 4: FUNDAMENTALS REMAIN FAVORABLE FOR THE INDUSTRIAL SECTOR



Sources: CBRE-EA; Barings Real Estate Research. As of Q1 2022.

OFFICE

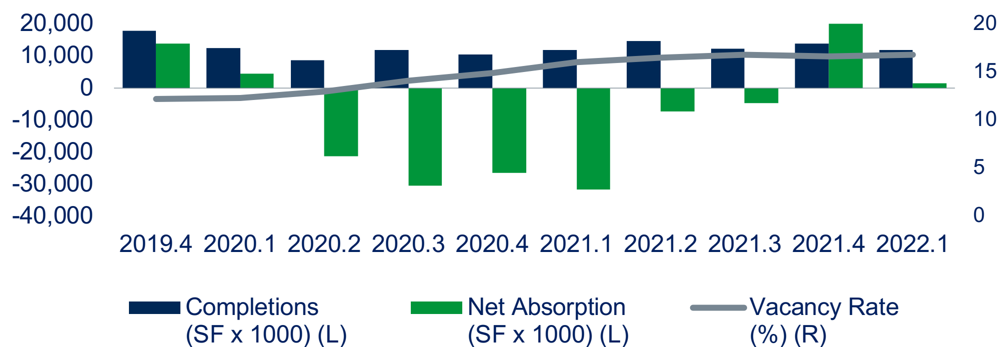
Office net absorption in the first quarter slowed sharply from a heathy pace recorded in the prior quarter, but remained in positive territory. This is not a surprise given that the Omicron variant surge during the winter months caused a plunge in physical office occupancy. With physical occupancy rebounding and more and more firms planning a full return to the office, office demand is likely to pick up. The labor market is supportive as well with financial employment fully recovered nationally and professional/business service jobs nearly 3% above the pre-pandemic peak. However, elevated new supply will keep vacancy from retreating quickly in 2022. We continue to believe that the nation's office sector will stabilize this year, setting the stage for a stronger recovery next year.

Overall office vacancy increased by 20 bps to 16.8% during the first quarter as new supply delivered into a soft market. Downtown vacancy was up 40 bps to 16.8% while suburban vacancy increased by a smaller 10 bps to 16.9%. Performance varied greatly by market during the quarter due to diverging local supply and demand dynamics. About half of the 64 markets tracked by CBRE-EA reported positive net absorption, led by Boston, Houston, Austin and Denver. Markets experiencing marked improvement also include Charlotte, Nashville and South Florida metros. New York City, which is lagging in return to the office, continues to report sizable negative net absorption.

Capital market trends have been positive in the office sector. Both suburban and CBD markets experienced a strong pickup in deal volume, but the CBD market continues to see sales significantly below pre-pandemic levels. Capital market dynamics indicate that investors have returned to the office sector but are selective.

With COVID cases subsiding and return to the office picking up pace, 2022 will turn out to be a transition year for the nation's office market. Hybrid workplace is expected to become a key factor reshaping the sector post-pandemic. Moreover, the escalating war for talent as unemployment for people with a bachelor's degree or higher plummeted to just 2% will likely compel companies to rethink their office space need in order to attract and retain employees. Given these dynamic forces behind future office demand, a rigorously selective framework is required to approach office investing after COVID.

FIGURE 5: OFFICE SECTOR FUNDAMENTALS CONTINUE THEIR RECOVERY



Sources: CBRE-EA; Barings Real Estate Research. As of Q1 2022.

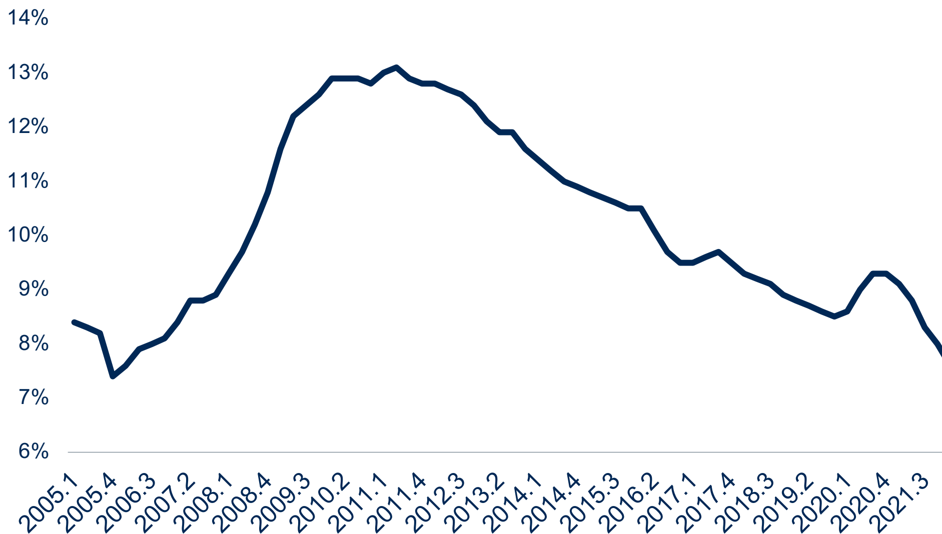
RETAIL

Neighborhood and community centers began the year with availability down 40 bps quarter-over-quarter, according to CBRE-EA; the availability rate, which is currently 7.6%, remains historically low. The consistent quarterly decreases in availability point to the resiliency of these types of centers, even as consumers shift some of their spending habits, i.e. to more omni-channel shopping. All fund markets reported a decrease in their availability rate.

Retail sales growth has moderated from its unsustainable pace in 2021, which was driven partly by "revenge spending." 3-month trailing retail sales growth excluding autos averaged 14.6% YoY. Sales were bolstered by segments with the highest share of sales growth including department stores and non-store retailers. Omni-channel shopping is likely here to stay, even as consumers shift to more services spending, and therefore local fulfillment through retail centers will likely remain an important part of retailers' strategies going forward.

Consumers should continue to divert more of their spending on entertainment and services but higher inflation may mean more spending on essentials as prices remain elevated in the short term. This should result in continued sales at neighborhood and community centers, supporting the ongoing recovery. In our view, neighborhood and community centers, with their resilient tenant mix and open air design, in strong population growth markets—such as in the Sun Belt—are well-positioned to withstand and thrive in a post-pandemic retail environment.

FIGURE 6: RETAIL SECTOR AVAILABILITY NEAR PRE-CRISIS LOWS



Source: U.S. Census Bureau; Barings Real Estate Research. As of March 31, 2022.

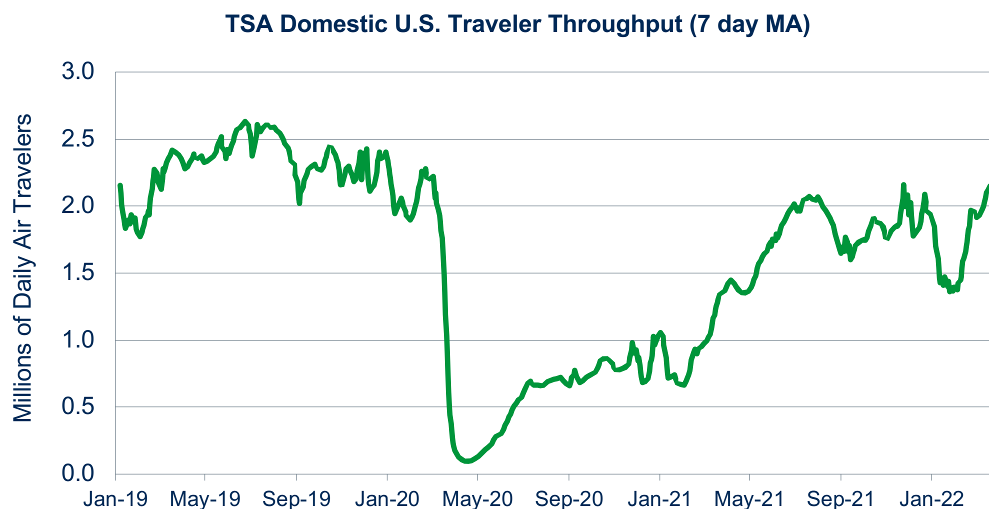
HOTEL

Hotel demand continued to recover through the first quarter led by a surge in leisure travel as pandemic restrictions have lifted. Occupancy rose to 56.9% in March from 36.3% a year prior, while RevPAR more than doubled to $102 from $47 a year earlier.[2] However, both RevPAR and occupancy are still below their pre-lockdown levels by 10.7% and by 1,200 bps, respectively. Unlike prior hotel downturns, room rates are 5.1% above their prior peak helped by an acceleration in CPI inflation that sent ADR 35% above its March 2021 level.

The performance of hotel metros in the post-pandemic recovery has been uneven with leisure-dominant markets including Miami, Tampa, Phoenix, Oahu, and Orlando posting the highest occupancies and markets that are more dependent upon corporate demand are lagging. Business travel is reviving with many companies focused on getting workers back to the office. Daily domestic passenger count is only 5% less than its February 2020 peak. Going forward, we believe this bodes well for the recovery of the upper-upscale segment of the hotel market, which is more weighted to business travel.

International arrivals will continue to be the slowest traveler demographic to rebound as international restrictions and varying vaccination rates across the world create headwinds. As with most things in the post-COVID economy, meeting increased demand will come with challenges for hotel operators, particularly as it relates to labor. Employment in the leisure and hospitality sector plunged by 8.2 million jobs at the start of the pandemic, and while the sector has since added back 6.7 million jobs, anecdotal reports suggest hotel operators face a difficult road ahead—as well as higher costs—in luring workers back.

FIGURE 7: AIR TRAVEL RECOVERY CONTINUES



Source: TSA; Barings Real Estate Research. As of March 2022.

[2] All hotel figures reported are a 12-month moving average unless indicated otherwise.

SUMMARY

Though economic growth faces increasing headwinds from geopolitical tensions and broad-based, intensifying inflation, the commercial property market remains underpinned by healthy macroeconomic fundamentals. As of the first quarter of 2022, investors remain committed to deploying capital within the real estate asset class, although many are keenly aware of the risks the industry faces with rising interest rates. The pandemic has left a deep mark on commercial real estate that will become more apparent with time. Aggregate tenant demand is growing but in many instances the recovery has been bifurcated and differentiated, depending upon property type and geography.

About the Team

BRE's research team efforts are led by Dags Chen in the U.S. and Paul Stewart in Europe. The research team is structured by sector and geographic expertise. The team's diverse backgrounds include appraisal, legal, technological and academic applications across multiple asset-classes, across buy and sell-side shops in markets around the globe. The real estate research team is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.

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