Real Estate Outlook

US – Edition 1, 2022

Forging ahead.

UBS

UBS Asset Management

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US outlook

Grab the skis: powder day!

Anticipated economic slowdown is driven by diminishing fiscal stimulus, the spread of the Omicron variant, and expected hikes in the Fed funds rate. Despite these headwinds, lessening supply chain disruptions, and continued recovery of employment are expected to support growth this year. At the market level, we anticipate strong industrial and apartments returns but modest performance for office and retail as we move further into 2022.

Market overview and outlook

Windblown clearings and drifts.

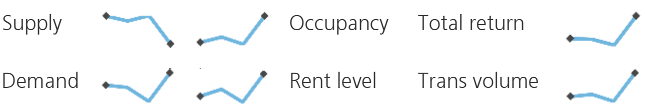
The NCREIF-ODCE Fund Index saw a positive total return of 7.97% for the quarter which was the highest quarterly total return on record. In addition, the index saw a 22.17% total return for the year ending 4Q21, which was the highest annual return since 1980. With the exception of hotels, all sectors experienced positive quarterly returns in 4Q21. This was largely driven by record setting industrial appreciation returns.

Multifamily and industrial continue to post outsized returns relative to the other sectors. However, fundamentals within the strip-center component of retail surprisingly showed modest improvements during the fourth quarter. In December 2021, Green Street reported no alterations to previously published positive year-end public strip-center REITs NOI/FFO guidance. Office demand continues to be focused on a flight-to-quality. Now two years in, remote and hybrid working feels like the norm, subsequently tenant firms may be assessing their culture and redesigning physical space requirements.

Transaction volume in 4Q21 alone stood at USD 313 billion (including entity transactions), equal to 79% of the full year 2020 volume, driven by apartment trades. The price per square foot/unit, in sectors except retail, is the highest since Real Capital Analytics records began in 2001. Investors are taking advantage of increased market liquidity to update portfolio positioning.

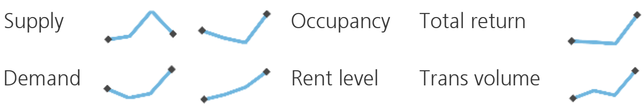
The primary property sectors all saw total returns on an annual basis accelerate over the quarter. Industrial returns accelerated to nearly four times that of one year ago. Office returns remain 100 bps below the pre-pandemic average. Retail returns were positive for the second consecutive quarter. Apartment returns accelerated to the highest level since 2011.

Apartments



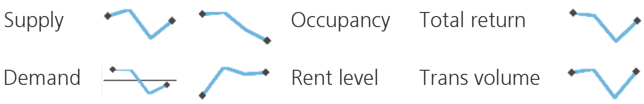
As the sparklines above indicate, the pace of apartment supply growth is well below that of 2018 and 2019, while the pace of demand has accelerated. As a consequence, occupancy and rent growth have gained strength. Apartment returns delivered an annual total return of 19.9% in 2021 – the highest since 2005. Additionally, the 2021 apartment transaction volume (including entity sales) reached a record high not only in dollar value, USD 335 billion, but also in number of properties transacted which was over 12,000.

Industrial



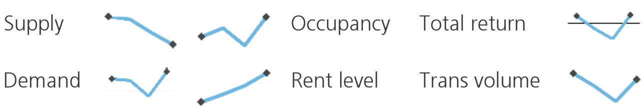
The industrial sector saw an unprecedented 43% annual total return. This proved out expectations that supply chain disruptions and logistics challenges would be no match for sustained customer demand. Persistent demand has been more than a match for near constant completions and occupancy continues to rise. The sparkline table above illustrates that 2020 ultimately had minimum impact on this rising sector. Growth trends established in 2018 and 2019 have sustained, and in some cases accelerated during 2021.

Office



Office sector fundamentals are struggling for consistent and sustainable strength. Although office rents have not experienced a substantial drop, the downward pressure is evident. The office sector is pushing hard for growth and recovery, but has only managed to match 2019 returns and transaction volumes. An accelerating price per square foot for CBD properties has suppressed overall subsector trades.

Retail



Demand experienced a rebound in 2021, while the pace of supply continued to diminish; driving a sharp rise in both occupancy and rent growth. The sparklines above show total return and transaction volume are little changed from 2018 and 2019. However, sector fundamentals have seen growth in line with pre-pandemic trends.

Sparklines: Data shown are year-end 2018 through 2021. Horizontal axis only shown if there are negative datapoints.
Supply, demand, occupancy, rent: CBRE-EA as of December 2021
Transaction volume: Real Capital Analytics as of December 2021
Total Return: NCREIF as of December 2021. Data show unlevered NCREIF Property Index total returns filtered for only ODCE managers. Past / expected performance is not indicative of future results.

Strategy viewpoint

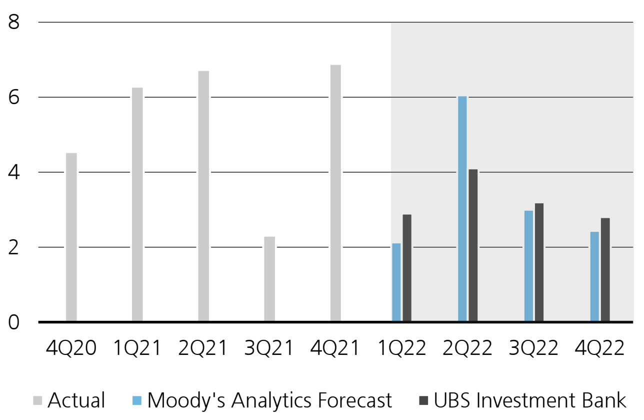
Avalanche threats recede.

The US economy ended the year on a strong note, fueled by consumer spending and business investment in inventory restocking. GDP expanded at a 6.9% annualized rate in 4Q21, following a moderate 2.3% pace in 3Q21 (see Figure 1).

Economic growth accelerated in the fourth quarter despite negative effects from the early stages of the Omicron variant. Over the full year of 2021, the US economy expanded 5.7%, marking its fastest pace since 1984.

With the US labor market on track to full recovery, the Fed has shifted its attention to combating inflation which continues to persist well above the 2% target. The Fed has signaled three 25 basis point interest rate hikes in 2022. However, the market is betting on more hikes this year. The impact of higher interest rates on commercial real estate will vary across sectors. All else equal, higher interest rates will impact values, as the cost of borrowing becomes more expensive. However, we believe that strong demand for space and higher rents will offset higher interest rates in certain sectors (i.e. industrial, multifamily).

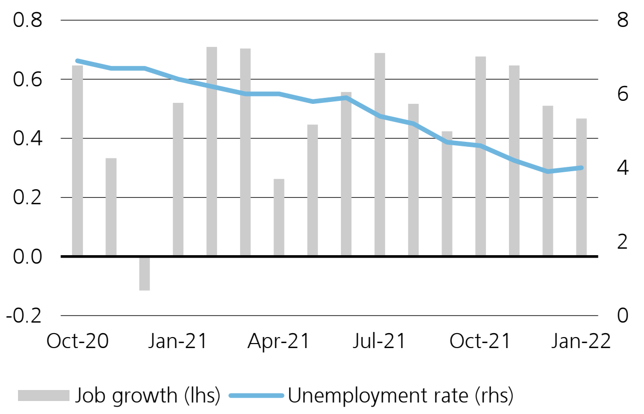
Figure 1: GDP quarterly annualized forecast (%)



Source: Actual Moody's Analytics, as of 27 January 2022; Moody's Analytics forecast, as of 10 January 2022; UBS Investment Bank forecast, as of 28 January 2022. Shaded area indicates forecast data.

Figure 2: Monthly job growth

Jobs (millions) Unemployment rate (%)



Source: Moody's Analytics, as of 4 February 2022

UBS Investment Bank forecast US GDP growth to deliver solid above-trend growth in 2022, albeit at a more moderate pace than in 2021. The expected slowdown is being driven by diminishing fiscal stimulus, the spread of the Omicron variant, and expected hikes in the Fed funds rate. Despite these headwinds, lessening supply chain disruptions, and continued recovery of employment are expected to support growth this year.

January's jobs report posted an increase of 467,000 employed and significant revisions for November and December by a combined 709,000 jobs to much higher levels of 647,000 and 510,000 respectively (see Figure 2). The monthly unemployment edged up 10bps to 4.0% in January, 40bps above the December 2019 rate. As of January 2022, the labor force participation rate remains 120bps below the February 2020 peak with nearly 2.2 million fewer jobs than at the end of 2019.

The abnormally high returns experienced in the industrial and apartment sectors may drive the bulls and bears further from each other. The confirmation of the structural changes in demand across the two sectors will continue to be tailwinds. But the question remains: *at what price?*

The contrarian views are now creeping into the market, as sectors that have long been out of favor are now showing signs of stability, with some green shoots showing relatively robust spreads in pricing. We expect marginal moves in capital seeking risk-adjusted total returns within the core sectors (e.g., tiers of metros and sub-property types) more than across sectors. However, the next two quarters will be an important barometer of the fundamental direction for the retail and office sectors.

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