

Real Estate Outlook

US – Edition 1, 2020



Widespread stability.



Expansion growth supports real estate demand.

Tiffany Gherlone
Head of Real Estate Research
and Strategy – US



US property sector performance continues to diverge. Economic growth provides a sound backdrop for positive real estate demand but is no longer accelerating. Low interest rates indicate that spreads remain attractive relative to recent years.

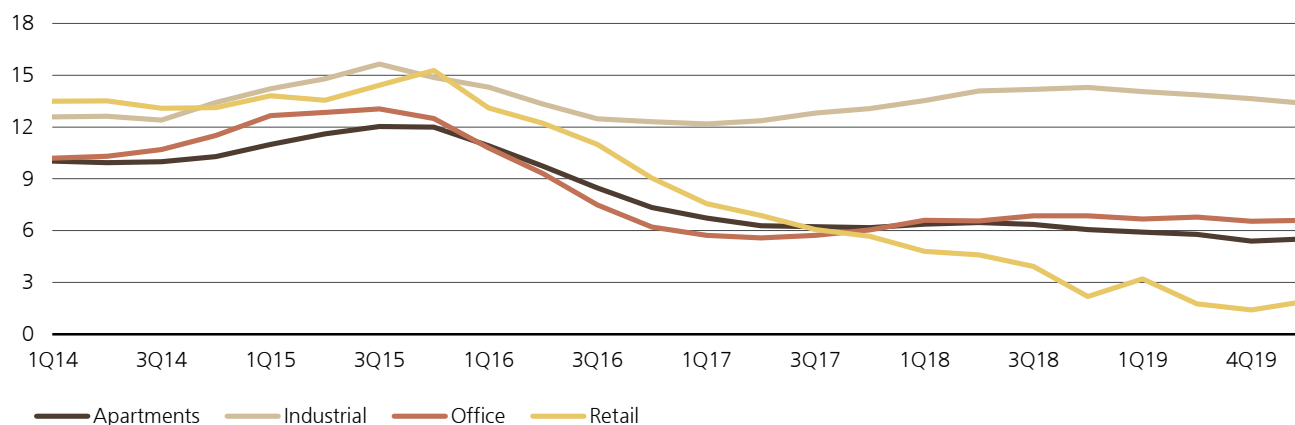
Real estate fundamentals

Private commercial real estate continues to produce steady returns in-line with long-term expectations, even though there are big differences across property types (see Figure 1). The income side of the equation is positive and expectations are for continued growth, although this is likely to be at a diminished rate. It is the valuations and capital expenditures that have changed. Appreciation ranges from high in the industrial sector to negative in the retail sector.

The risk premium available in US real estate has increased. The US Federal Reserve has left rates flat since the last decrease in October 2019. For US commercial and multi-family real estate, lower interest rates mean the spread available in the sector widened marginally where they had been low. Cap rates moved sideways or slightly downward in all but the retail sector, where cap rates increased.

Demand for space is supported by moderating economic expansion and a strong labor market, while supply growth must be monitored closely. Supply eased in the office sector and is low in retail. For apartments and industrial, development is elevated, but currently, new construction levels are meeting strong demand, resulting in relatively stable occupancy rates and positive rent growth.

Figure 1: US real estate returns across property types (Annualized, rolling four-quarter total return, %)

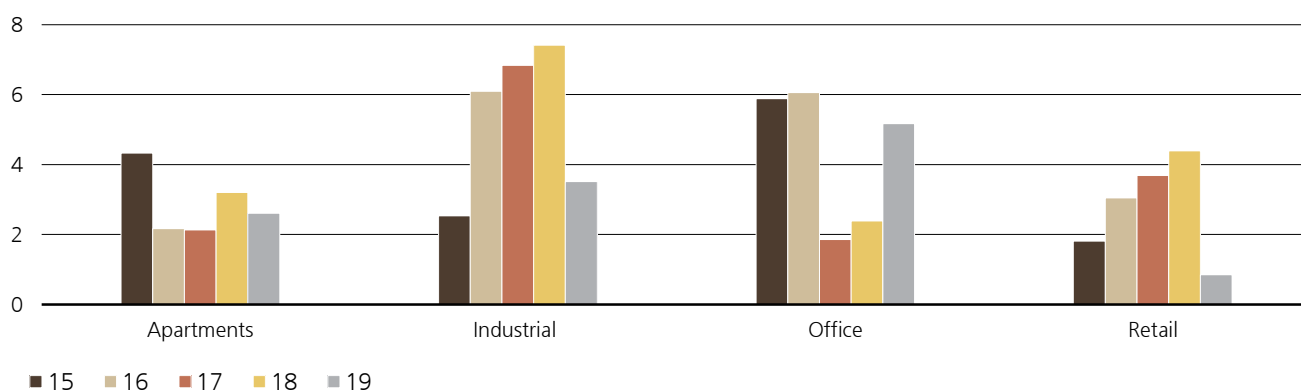


Source: NCREIF Property Index, 4Q19

We can further break out real estate revenue into occupancy and rents. Occupancy rates are high relative to the past 10 years and despite supply growth pressure, only industrial saw a net decline in occupancy over the past year as demand met or exceeded completions.

Rental growth is the driving force behind income gains (see Figure 2). However, the supply level is forcing landlords to compete for occupancy, reining in rental growth. Economic conditions create some optimism that growth will continue to reflect positive, if less enthusiastic, momentum for the US.

Figure 2: Property sector rent growth (% YoY)



Source: CBRE-Econometric Advisors, 4Q19. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Apartments

Strong demand has sustained high apartment occupancy (between 95% and 96%) despite near constant development. Rental growth is positive at 2.6% for the year, softening as landlords compete for tenants.

In 2020, new unit construction is expected to be double the 20-year average nationally, and persistent levels of multi-family permit approvals could sustain elevated development for another two years. Figure 3 shows supply as a percentage of existing inventory. In particular, new construction is a declining share of the market on an annual basis although total units constructed per annum remains nearly unchanged.

US home ownership was 64.6% by the end of 2019, representing an imperceptible increase. Persistent labor market growth and household formation offset higher home ownership levels, supporting demand for rentals.

Industrial

The pace of industrial completions remains elevated as shown in Figure 3. The slight slowing between 2018 and 2019 is likely down to the natural ebb and flow of individual markets, with 2020 expected to deliver more space than 2018.

By the end of 2019, industrial occupancy dipped as developers and investors remained keen on the sector, but potential tenants now have more options than ever. In addition, increased asset options have softened rental growth – the healthy 3.5% growth of 2019 is below the five-year average of 5.2%. Despite high demand, rising completions add increasing risk to the outlook.

Our expectations for industrial remain strong, but the persistent low cap rate carries some future uncertainty. It remains a good time to sell marginal assets to improve the quality of portfolios, as increasing supply introduces more moderate expectations.

Office

Office returns are in line with apartments; however, capital expenditure requirements have increased in the office sector, resulting in thinner cash yields.

2019 new office deliveries were an echo of 2018 (see Figure 3). Office rental gains outperformed inflation with Downtown's 8.0% annual growth. This (unsustainable) growth spurt far exceeded Suburban office's decelerating 1.6% rental growth.

The average office occupancy increased 30 basis points from one year ago, continuing a decade-long trend of tightening. The gap between Downtown office vacancy at 10.3% and Suburban vacancy at 13.1% remains wide, even as both tighten.

Retail

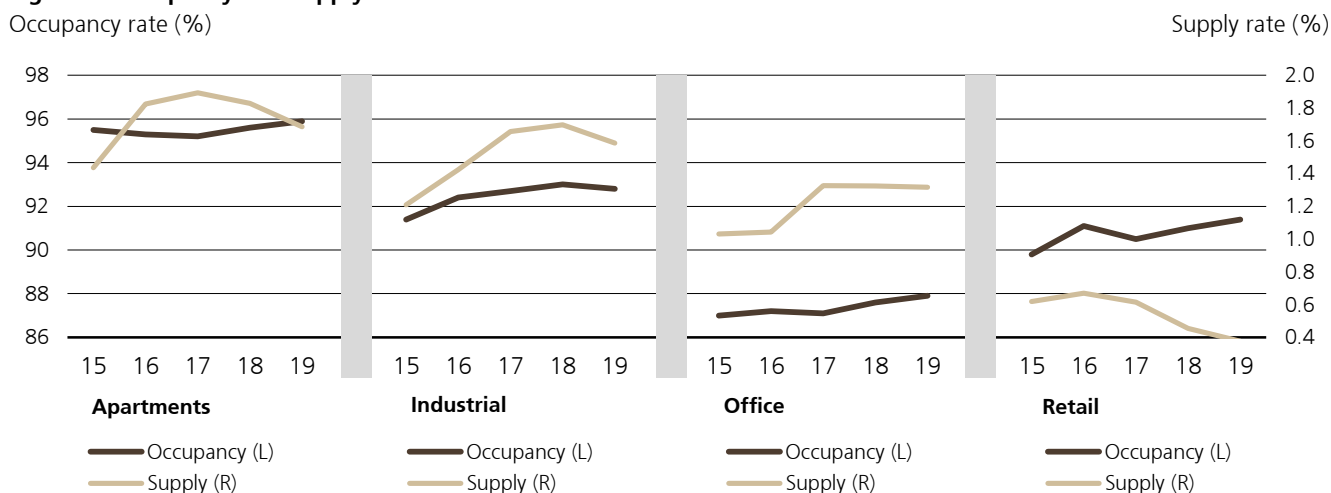
Consumer preferences are changing and landlords are tasked with identifying the prototypical new retailer. Apparel-based retailers, which have largely occupied traditional malls, are now living the consequences of inflexibility.

Retail development has stalled during this transitional phase. Over the past decade completions averaged 0.5% per annum, well below the 2.4% annual growth seen in each of the prior two decades.

Mall/lifestyle center and Power Center availability have been flat for three quarters at 5.4% and 7.0%, respectively. At 8.6%, availability in the smaller-format, Neighborhood, Community & Strip (NCS) sub-sector is down 40 bps since the end of 2018.

During 2019, cap rates increased for mall and non-mall retail. Upward pressure may remain on US retail cap rates in 2020.

Figure 3: Occupancy and supply trends



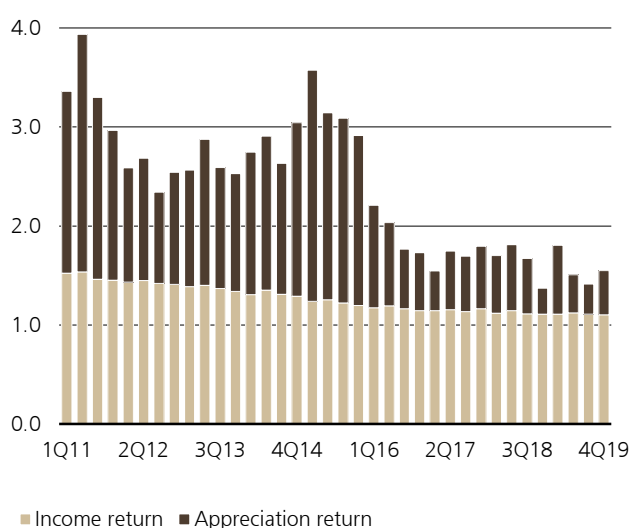
Source: CBRE Econometric Advisors, 4Q19. Note: Supply is shown as a completion rate (ie. completions as a percentage of existing inventory).

Capital markets

NPI total returns have been slowly decreasing since early 2018 (see Figure 15). When taken sector by sector solid income and modest appreciation have kept apartment, industrial and office returns fairly stable (as shown in Figure 12). Retail returns have declined noticeably, pulled down by multiple quarters of depreciation.

Figure 4: US property returns

(%)



Source: NCREIF Property Index, 4Q19

Modest yields and positive property-level fundamentals continue to fuel investor demand for private real estate debt strategies. The spread between property yields and the cost of debt decompressed somewhat in 2019. However, banks must contend with a flat yield curve. When both short and long-term rates are nearly the same, it becomes difficult to pay depositors a market rate while charging a competitive interest rate on loans. On the whole, US debt markets can be described as operational but not excessive, which encourages development but not an abundance of supply.

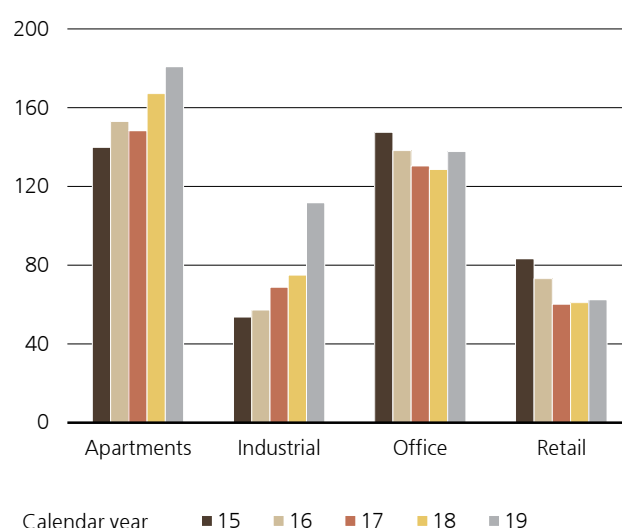
With little movement in cap rates, the downward move in Treasury rates widened the spread available on stabilized US real estate (see Figure 6). While the real estate spread is no longer compressing, the higher-risk premium seems warranted as uncertainty around future economic growth has also increased.

That said, there is no obvious distress in the market that might put stronger upward pressure on cap rates. Income is growing and potential sellers can afford to be patient. In addition, debt is available and capital expenditures are increasing.

Total US commercial real estate sales volume was USD 525 billion in the 2019 calendar year, excluding entity level deals, up by 12% from 2018 and 13% above the previous peak volume in 2015. During 2019, all four major sectors saw an increase in sales volume over each of the prior two years (see Figure 16). Industrial saw the greatest increase, with total transaction volume in 2019 reaching half again of the 2018 volume.

Figure 5: US transactions

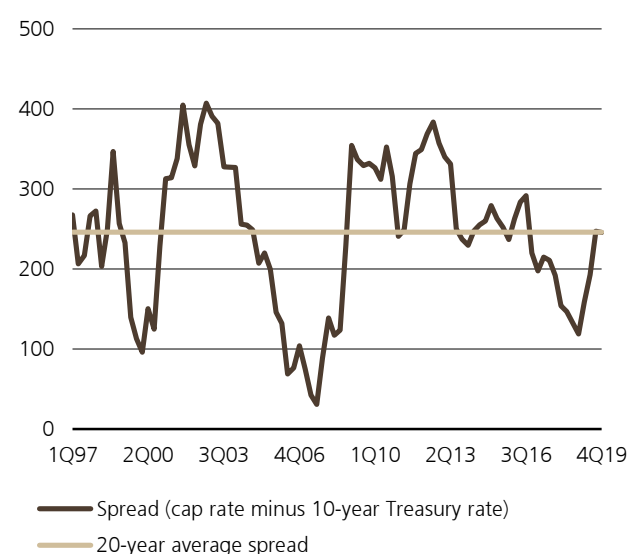
(Transaction volume, USD billions)



Source: Real Capital Analytics, 4Q19. Ex-entity transactions over USD 2.5m

Figure 6: Commercial real estate spread

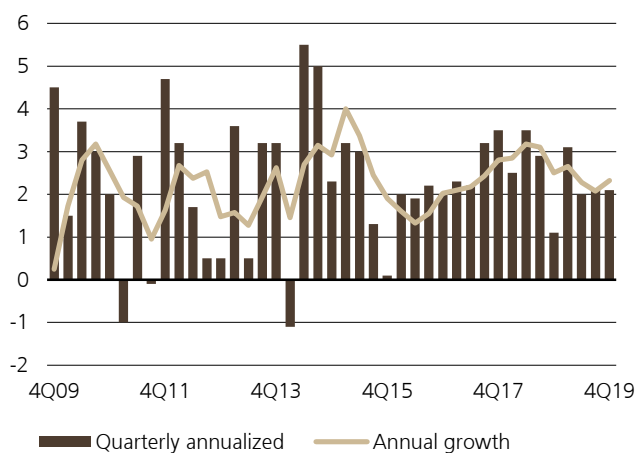
(bps)



Sources: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 4Q19

Unlike recovery and expansion periods of the past, the level of output did not spike and fall to a long-term level. Rather, real GDP growth gradually rose to 4% and has fluctuated between 1% and 3% since (see Figure 7). Thus, the long period of growth may continue. Common recession culprits, such as imbalanced business inventories, reduced housing development and reduced borrowing levels are in balance. However, there are mounting pressures on other recession indicators, including flat corporate profits and yield-curve inversion that could interfere with growth from time to time.

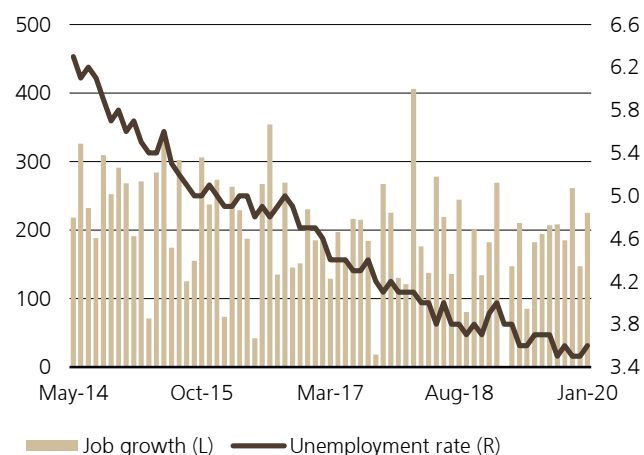
Figure 7: US real GDP growth
(Real GDP growth, %)



Source: Moody's Analytics, 4Q19

Employment growth will almost certainly continue to slow over 2020. With unemployment below 4% (see Figure 8), it seems implausible that employment can continue to grow at a rate above that of the labor pool. We expect some wage increases but not at the level that the unemployment rate might imply.

Figure 8: US job growth and unemployment rate
(Change in employment, thousands of jobs)



Source: Moody's Analytics, January 2019

Strategy viewpoint

Investors should take some comfort from the generally positive fundamentals real estate offers. Rents are growing and occupancy rates are stable across all sectors. Income-driven real estate investment options continue to be attractive. Stabilized, lower-risk real estate provides a steady stream of income. Taking more risk and changing the real estate through renovation or smart development continues to find tenants in the aggregate.

Apartment cap rates are low, and the capital expenditures required to run apartments are below the three commercial sectors. The low capex requirement means this sector is poised to deliver competitive risk-adjusted cash flow. There is just one thing slowing this sector down – supply. We expect some apartment markets to be a bit sluggish when they would otherwise be healthy and strong. Investors should be cautious when underwriting in markets where supply is still increasing, while looking for markets where supply has ramped up in recent years and has now settled down.

Office capex spending hit new highs in the US office market and current returns are second only to those of industrial. Fundamentally, the office market outlook is modest but positive. Hiring employees becomes more difficult when unemployment is low. Employee compensation is increasing at a time when GDP growth is decelerating, which may limit the upside for office rental growth. We expect the sector's historical volatility to resume in outer years, which reduces long-term risk-adjusted performance expectations relative to other less capital-intensive property types.

Industrial rent growth continues at an impressive clip. Both debt and equity capital remains hungry for industrial exposure. Quality should outperform quantity over the long run. Industrial cap rates are low relative to history and the sector should perform well again in 2020. We continue to advocate for industrial investors to take advantage of the low cap rates and sell marginal assets to increase the quality of their long-term portfolios.

Retail cap rates increased in 2019 as a result of uncertainty and reduced income expectations. Most shopping centers remain well occupied and retail sales are growing. Yet, retailers face stress as the need to invest for the future meets diminished capital market interest today. To attract workers in a low unemployment environment, retail wages should continue to increase. Well-located, local shopping centers should continue to offer the most attractive stabilized yield.

Our research team

Adeline CHAN
Christopher DEBERRY
Nicola FRANCESCHINI
Zachary GAUGE
Tiffany GHERLONE
Samantha HARTWELL
Gunnar HERM
Fergus HICKS
Brice HOFFER
Amy HOLMES
William HUGHES
Sean RYMELL
Shaowei TOH

For more information please contact

UBS Asset Management

Real Estate & Private Markets (REPM)
Research & Strategy

Tiffany Gherlone
+1-860-616 9059
tiffany.gherlone@ubs.com



Follow us on LinkedIn

To visit our research platform, [scan me!](#)



www.ubs.com/repm-research

This publication is not to be construed as a solicitation of an offer to buy or sell any securities or other financial instruments relating to UBS Asset Management Switzerland AG or its affiliates in Switzerland, the United States or any other jurisdiction. UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any errors or omissions. All such information and opinions are subject to change without notice. Please note that past performance is not a guide to the future. With investment in real estate/infrastructure/private equity (via direct investment, closed- or open-end funds) the underlying assets are illiquid, and valuation is a matter of judgment by a valuer. The value of investments and the income from them may go down as well as up and investors may not get back the original amount invested. Any market or investment views expressed are not intended to be investment research. **The document has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.** The information contained in this document does not constitute a distribution, nor should it be considered a recommendation to purchase or sell any particular security or fund. A number of the comments in this document are considered forward-looking statements. Actual future results, however, may vary materially. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class, markets generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund. Source for all data/charts, if not stated otherwise: UBS Asset Management, Real Estate & Private Markets. The views expressed are as of February 2020 and are a general guide to the views of UBS Asset Management, Real Estate & Private Markets. All information as at February 2020 unless stated otherwise. Published February 2020. **Approved for global use.**

© UBS 2020 The key symbol and UBS are among the registered and unregistered trademarks of UBS. Other marks may be trademarks of their respective owners. All rights reserved.

