Real Estate Outlook

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US property sector performance continues to diverge

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US property sector performance continues to diverge. Economic growth provides a sound backdrop for demand but is no longer accelerating. Falling interest rates combined with little movement in the market cap rate mean the risk premium on US real estate has increased.

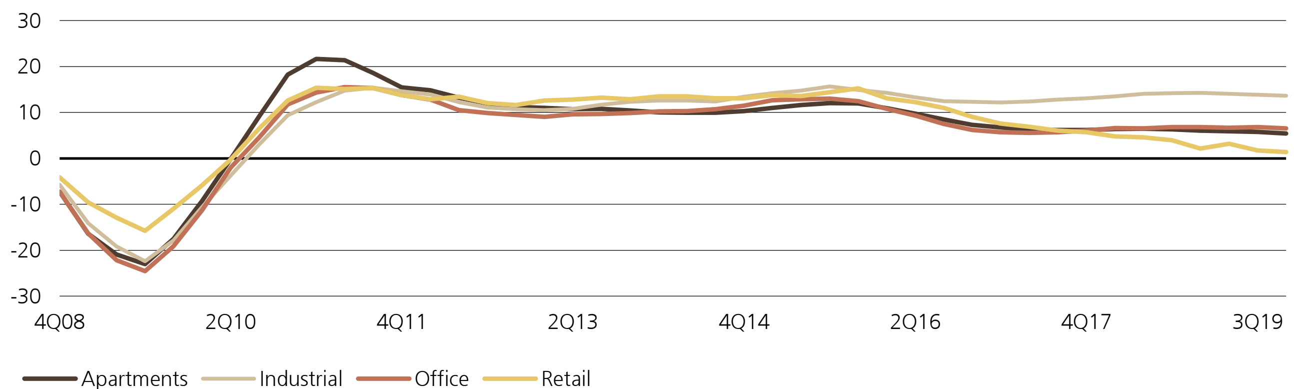
Real estate fundamentals

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. Expectations are for continued growth, albeit 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. After four short-term rate hikes in 2018, the US Federal Reserve lowered rates for the first time in more than a decade in July, and then again in September and October. For US commercial and multi-family real estate, lower interest rates mean the spread available in the sector widened slightly. Spreads 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 economic expansion and a strong labor market, although supply growth must be monitored closely. Supply eased in the office sector and is low in retail. Development is elevated for apartments and industrial, 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, %)

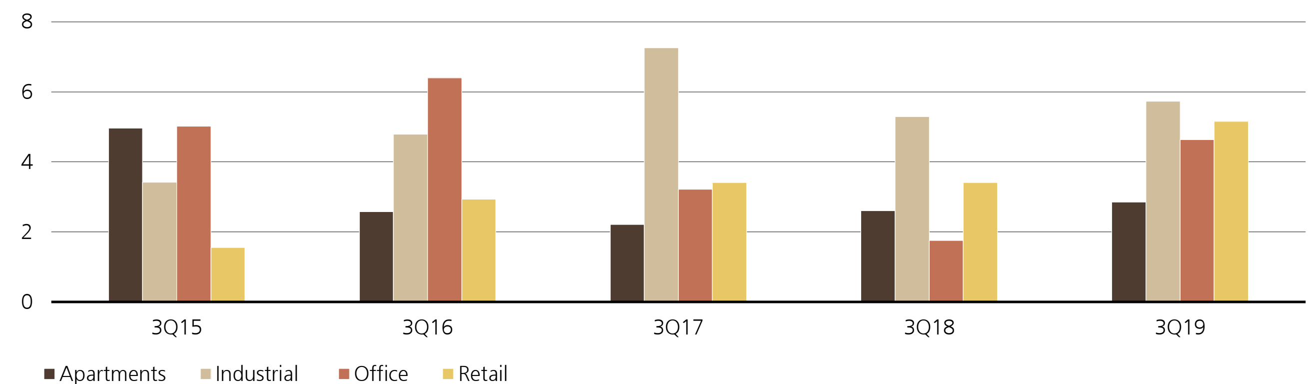


Source: NCREIF Property Index, 3Q19

We can further break out real estate revenue into occupancy and rents. Occupancy rates are high relative to the past 10 years and occupancy faces a small degree of downward pressure with supply growth matching or exceeding demand.

As there is little room to increase occupancy, rent growth is the driving force behind income gains (see Figure 2). Economic conditions create some optimism that growth will continue to reflect positive momentum for the US.

Figure 2: Property sector rent growth (year-over-year change %)



Source: CBRE-Econometric Advisors, 3Q19. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Apartments
Our expectation for the US apartment sector is one of sustained performance. Supply and demand are balanced, resulting in positive and sustainable rent growth. Returns are income-driven with near-inflationary appreciation.

US homeownership was relatively flat near 64.8% in September 2019, representing an anticipated pause in a trend of increasing homeownership. Persistent labor market growth and consistent household formation help offset higher homeownership, supporting demand for multifamily rentals.

Apartment vacancy experienced a typical seasonal rise in the first quarter of 2019, but a surge in demand brought third quarter vacancy down by 100 bps to 3.6% (see Figure 3). New construction is expected to increase through the middle of 2020. Year-over-year rent growth has remained near 3% of the last four quarters.

Industrial
Demand for industrial assets remains high, as this sector generates impressive double-digit returns. We expect 2019 to be another good year for industrial, but the low cap rate carries some future uncertainty. It is a good time to sell marginal assets, increasing the quality of portfolios, as increasing supply introduces more moderate expectations.

Growth in net rents remains strong. In the year ended 3Q19, industrial rents grew by 5.7%, remaining above the five-year average of 5.3% per annum. Despite moderate easing during the first half of 2019, the pace of completions remains elevated (see Figure 3). Forecasts expect rising completions over the coming year.

Industrial availability was 7.2% in September 2019, and although nearly as low as it has been since 2000, 3Q19 availability has risen by 20 bps from 4Q18. Even as demand remains high, rising completions add increasing risk to the outlook.

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

New office deliveries decelerated slightly over the past year (see Figure 3). Exhibiting characteristic volatility, office rent gains outperformed inflation with Downtown's 8.3% annual growth. This unsustainable growth spurt far exceeded Suburban office's "steady as she goes" 2.2% rent growth.

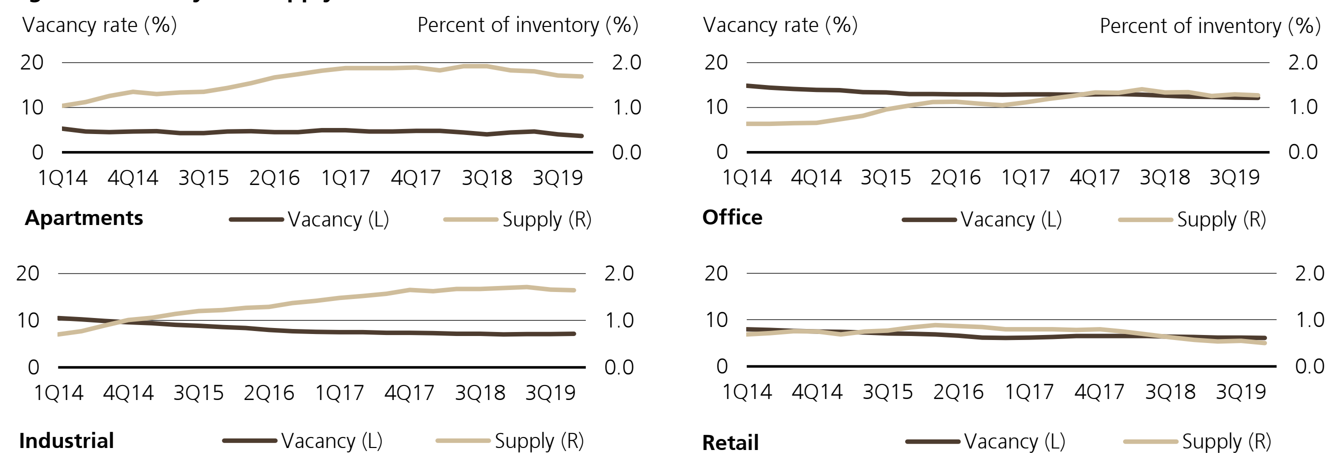
Average office vacancy decreased 50 basis points from one year ago. The gap between Downtown office vacancy at 10.2% and Suburban vacancy at 13.1% remains wide. Downtown deliveries were modest in the third quarter but are expected to pick up through 2020, while Suburban completions have remained steady over the year.

Retail
Capital requirements increased in the US retail sector, implying that the long-anticipated transition to mixed use centers is underway. Consumers are doing well; therefore, increased disposable income and low unemployment should support retail sales in 2019. However, performance of the sector is likely to vary as the retail sector transitions to less apparel-based formats.

Mall/lifestyle center availability bounced between 4.9% and 5.7% over the past six quarters, while power center availability has been flat at 7.0% for three quarters. Mall/lifestyle and power center asking rent growth are volatile, with little consistency from one quarter to the next.

At 8.7%, availability in Neighborhood, Community & Strip (NCS) retail is down 80 bps since the end of 2017 (see Figure 3). In the year ending third quarter 2019, NCS rents grew at a pace of 4.1%, more than double the pace of inflation.

Figure 3: Vacancy and supply trends



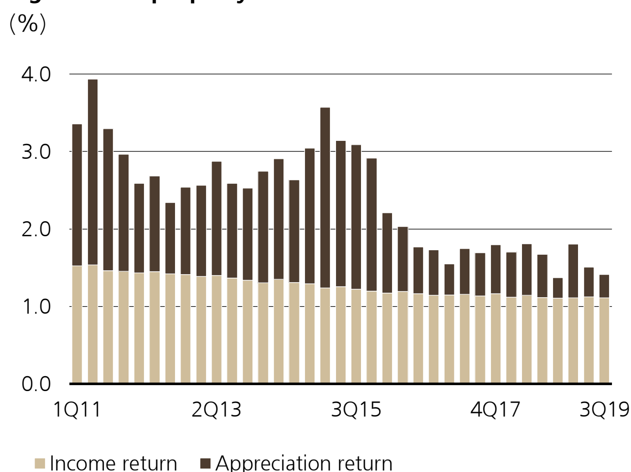
Source: CBRE Econometric Advisors, 3Q19. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory).

Capital markets

In 2019, we anticipate positive unlevered property returns driven by growth in income with moderation in appreciation, relative to recent years. In the third quarter of 2019, appreciation returns slipped below that of the previous two quarters, softening the NCREIF Property Index gain to 1.4% (see Figure 4).

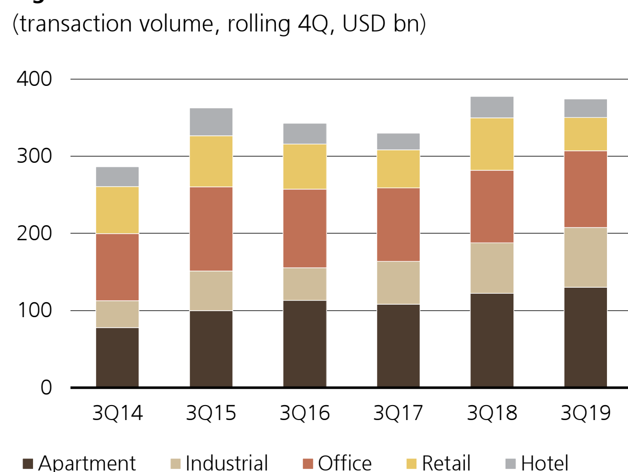
Total US commercial real estate sales volume was USD 499 billion in the 12 months ended 30 September 2019, up slightly compared to the prior 12-month period. During the three quarters of 2019, the volume of hotel, office, and retail properties sales remained consistent with the previous two years. However, apartment sales volume has maintained a rising trend and industrial sales volume increased over the prior year (see Figure 5).

Figure 4: US property returns
(%)



Source: NCREIF Property Index, 3Q19

Figure 5: US transactions
(transaction volume, rolling 4Q, USD bn)



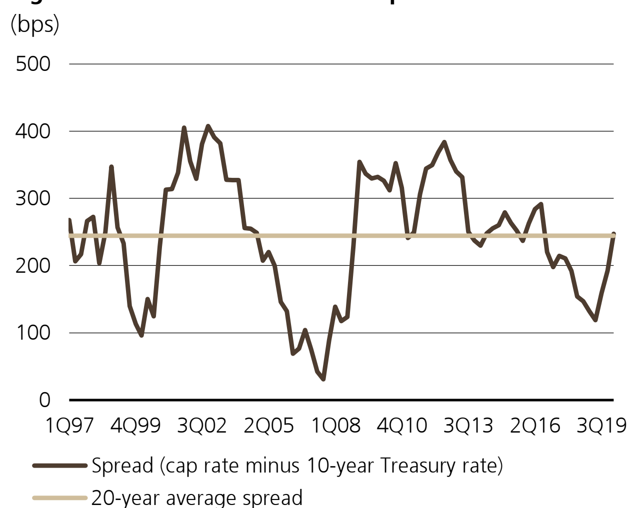
Source: Real Capital Analytics, 3Q19

In today's low interest rate, low cap rate environment, real estate debt capital is inexpensive and generally available. However, debt is not as free-flowing as it was during the lead-in to the last downturn. 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 also increased.

That said, there is no obvious distress in the market that might place 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.

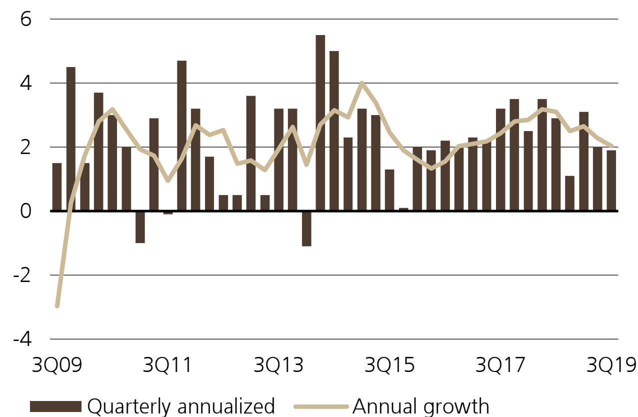
Figure 6: Commercial real estate spread
(bps)



Sources: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 3Q19

Delving deeper into the fundamentals, a growing economy and tight labor market should continue to generate demand for real estate which supports income growth. After the first three quarters of 2019, economic growth remains positive, although notably slower than during the first half of 2018. In 3Q19, GDP growth was 1.9%, which is near the long-term trend (see Figure 7).

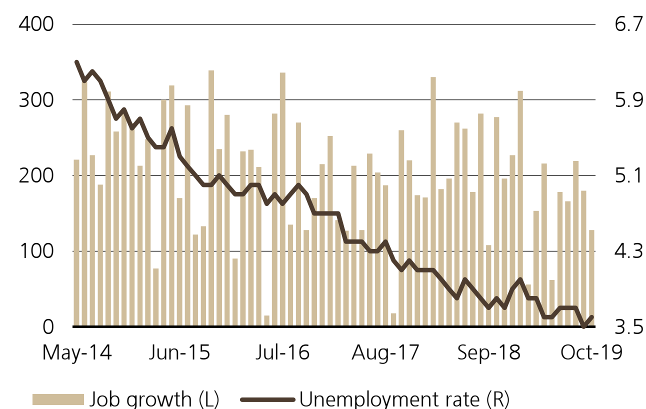
Figure 7: US real GDP growth
(real GDP growth, %)



Source: Moody's Analytics, 3Q19

Expectations continue to be for a strong, but slowing, labor market and modest inflation in 2019. US consumer price inflation slowed to 1.7% in the year ending 30 June 2019. At 3.6% as of October 2019, the national unemployment rate is near its lowest point since 1969. A tight labor market makes it tougher to fill open positions but bodes well for continued upward pressure on wage inflation. The tight labor market is one reason that wage growth is expected to support consumer spending in the US. Average monthly job gains softened further in the third quarter of 2019, averaging 167,000 per month since January. Monthly additions continue to be lumpy (see Figure 8).

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



Source: Moody's Analytics, October 2019

Strategy viewpoint

Uncertainty has increased around appreciation in US real estate. Falling interest rates eased upward pressure on cap rates, but the risk premium increased. Fundamental strength in the US economy acts as a stabilizing factor by supporting income growth at the property level. A tight labor market and optimistic confidence measures reinforce our expectations for relatively good occupancy rates and continued rent growth in the US real estate sector.

Beginning in early 2016, US real estate entered a widely-anticipated period of income-driven performance. On the whole, US properties are appreciating at about the pace of inflation. Appreciation relates back to the positive rent growth generated by properties, as opposed to the out-sized influence of capital flows the US experienced in 2014 and 2015.

Income-generated performance is consistent with a long-term expectation for private commercial real estate investments. Looking more closely at the drivers of income, rent growth is the true powerhouse behind the gains. Property-level income growth should outpace today's modest inflation even as the pace of growth moderated in recent years.

Even though 2018's rising interest rate environment reversed and long-term interest rates fell during 2019, uncertainty remains and the increased risk premium appears warranted.

Capital investment into stabilized assets is increasing, an expected outcome in a long expansion. Debt and equity capital is seeking growth strategies, and existing assets are under pressure to compete with new construction. Investors should pay careful attention to the risk-return expectations for incremental capital.

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