

AEW RESEARCH

U.S. Economic & Property Market Perspective

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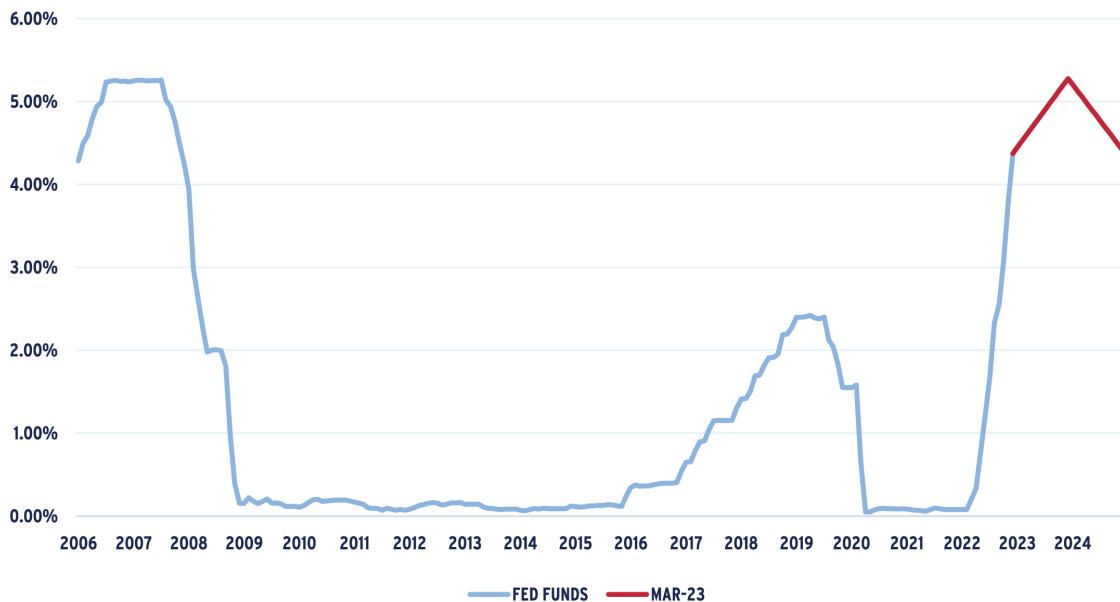
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U.S. Economic and Property Market Outlook

The first quarter saw the continuation of two interrelated trends, tightening credit conditions and slowing economic growth. With respect to the former, the Federal Reserve twice increased the overnight lending rate by twenty-five basis points during the quarter bringing the effective Fed Funds rate to 4.83% at the end of March, almost five hundred basis points above the year-prior level and the largest 12-month increase in the benchmark rate since 1982.

For the latter, annualized first-quarter real GDP growth, while positive, slowed from the fourth-quarter mark of 2.6% to just 1.1%. Despite this, labor market indicators, albeit lagging, remain strong with continued historically low unemployment with moderate but elevated levels of new unemployment insurance claims. With the Federal Reserve poised to “stay the course” on continued tightening of credit conditions, we expect aggregate growth to continue to slow through the rest of this year and into 2024 with continued elevated near-term recession risks.

FIGURE 1
FEDERAL OPEN MARKET COMMITTEE (FOMC) FORWARD GUIDANCE ON PATH OF POLICY RATE

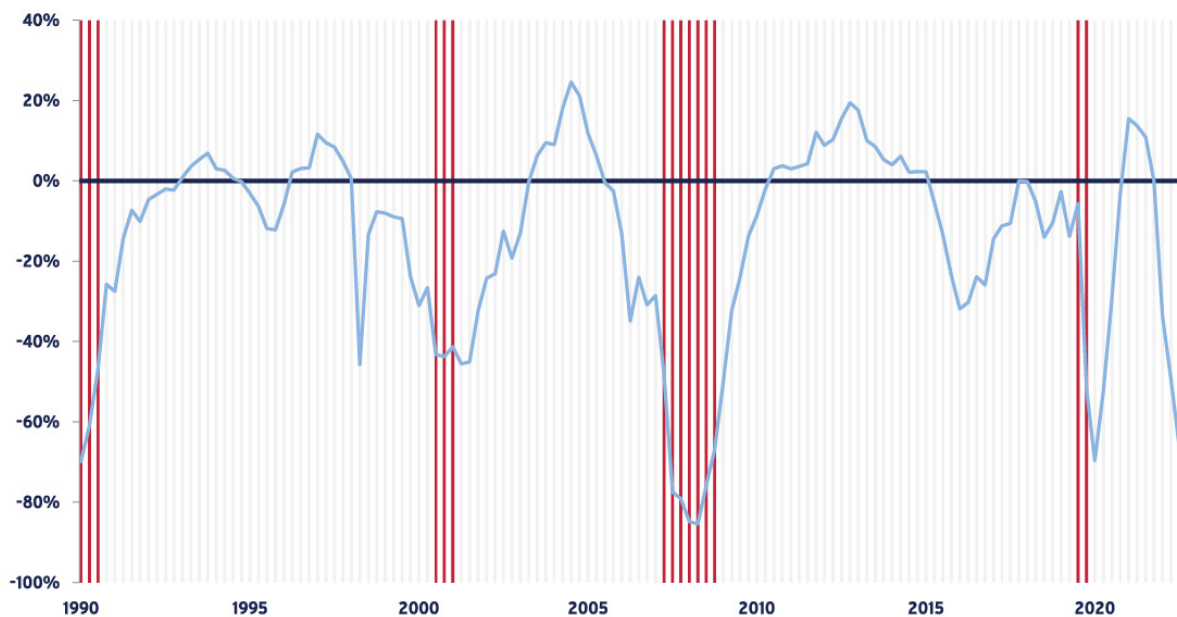


Source: Federal Reserve

The most critical issue facing the broader economy, the financial system as a whole and commercial property specifically remains the notable change in the yield environment over the past 12 months and the various knock-on effects associated with this change. The most immediate of these related effects so far has been the rapid deterioration in bank balance sheets, particularly among smaller regional banks not fully enveloped by the post-GFC regulatory regime. Indeed, the first quarter ended with bank failures at Silicon Valley Bank (SVB) and Signature Bank as balance sheet worries triggered classic panic-driven bank runs on deposits, which were unfortunately greatly accelerated by the newfound speed of deposit withdrawal in the digital age.

Despite the more recent failure of First Republic Bank, the policy response by the FDIC, Treasury and the Fed appears to have stemmed broad investor and depositor bank anxiety for the time being. Against this backdrop, commercial property markets continue to experience limited liquidity in the absence of an active lending market with bank willingness to lend on commercial property approaching levels comparable to the first months of the pandemic and headed to levels not seen since the financial crisis.

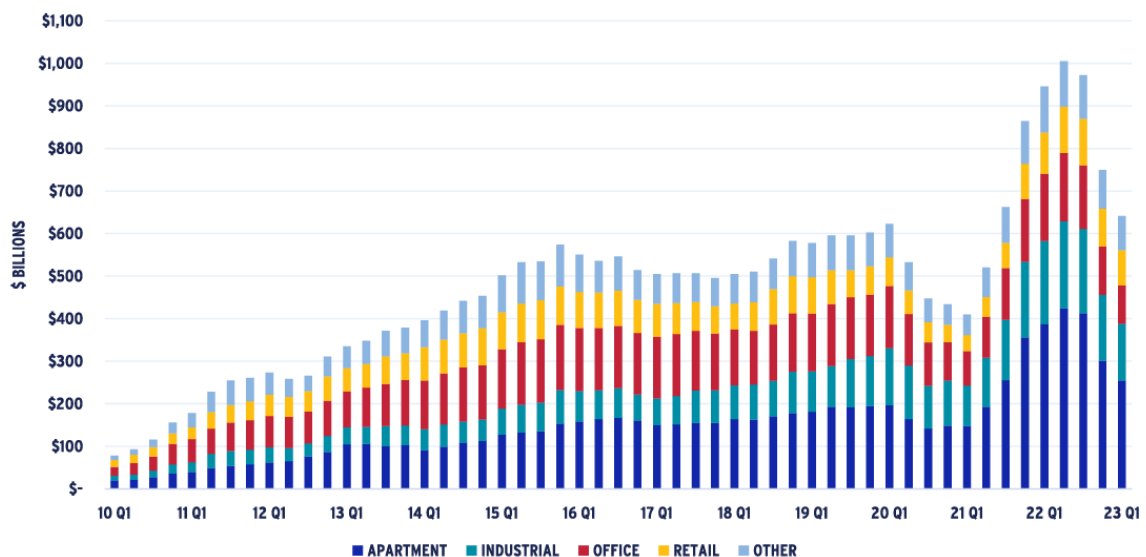
FIGURE 2
NET SHARE OF BANKS INCREASING LENDING TO COMMERCIAL PROPERTY AND PAST RECESSIONS



Source: Federal Reserve, Survey of Senior Loan Officers

Not surprisingly, restrained credit availability has led directly to reduced transaction volume/liquidity, particularly relative to the strong transaction pacing of 2021 and the first half of 2022. This slowdown began around the middle of 2022, accelerated through year-end, and has continued through the first quarter of 2023.

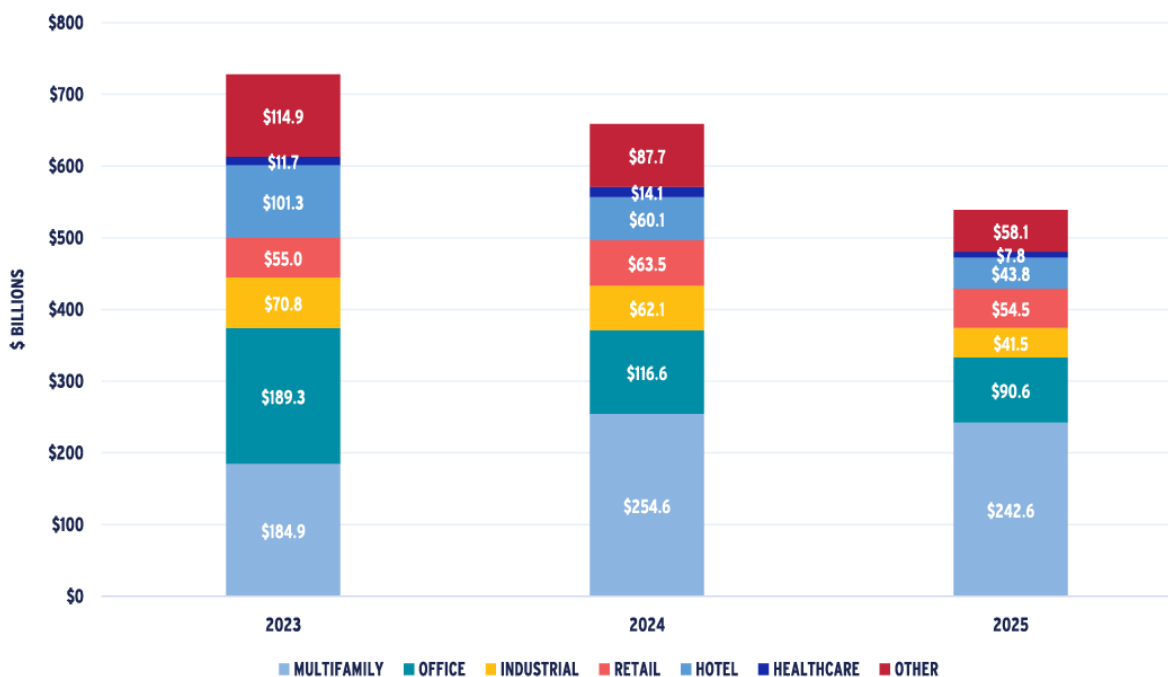
FIGURE 3
TRAILING FOUR-QUARTER COMMERCIAL PROPERTY TRANSACTION VOLUME BY PROPERTY TYPE



Source: RCA/MSCI

Lower transaction volume brings with it reduced pricing conviction and significant bid-ask spreads across all property sectors but is typically most acute in property sectors with the greatest near-term cash flow uncertainty. Today, this uncertainty is most associated with office properties struggling to adapt to the new post-pandemic, hybrid/remote work environment. The problems facing office property operating fundamentals and values are likely to get worse over the next few years as two forces potentially interact: a possible near-term recession and a significant volume of office property loans maturing through the remainder of this year and 2024. Broadly, there are approximately \$2 trillion of U.S. commercial property loans maturing over the next three years, with office property loans accounting for approximately \$400 billion of the total. Currently, most office property loans are difficult or impossible to refinance and few will be able to refinance with loan proceeds sufficient to retire the existing debt balance as tighter underwriting (lower loan-to-value ratios, higher debt yield requirements) combine with great valuation uncertainty to necessitate full or partial pay down of existing loans. Compounding the problems for current office owners is the similar conundrum surrounding tenant leasing decisions requiring significant capital expenditure (leasing costs, tenant improvement allowances, free rent). In both cases, current owners will be carefully evaluating their true equity position in highly challenged assets.

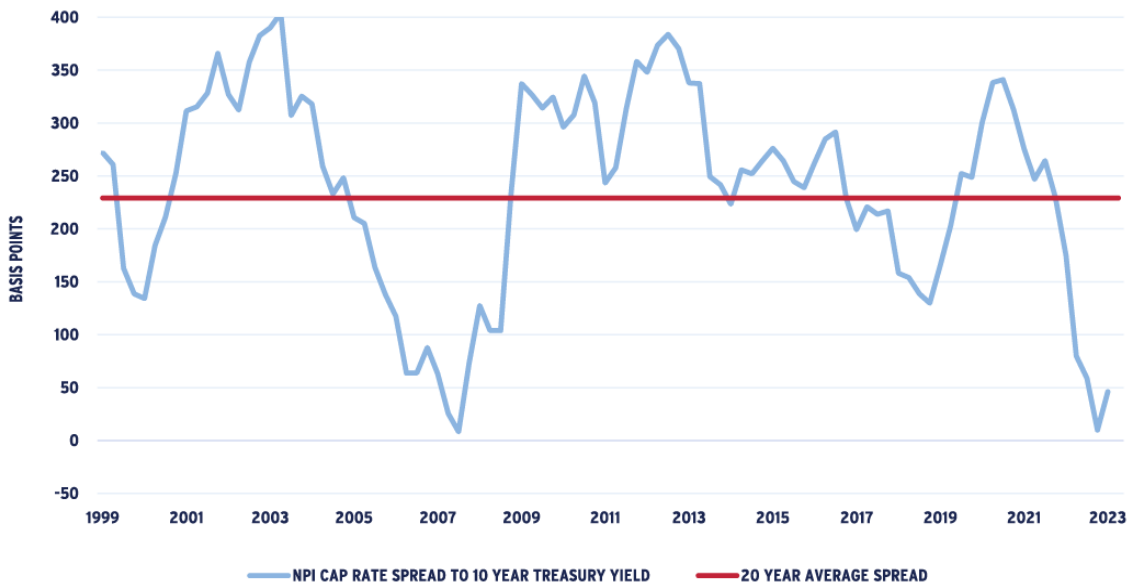
FIGURE 4
EXPECTED COMMERCIAL PROPERTY LOAN MATURITIES BY PROPERTY TYPE



Source: Mortgage Bankers Association (MBA)

Finally, the NCREIF Property Index posted the third consecutive quarter of capital value decline during the first quarter, bringing the total capital value decline for the index to -7.5%. As of Q1, the average appraisal value capitalization rate for the index stood at 4.1%, a modest but still positive spread to Treasury bond yields of approximately 3.5%. As illustrated in Figure 5, there is no specific long-term stable yield spread that investors have demanded from property pricing. Over the past twenty years, this relationship has ranged from near zero to as high as four hundred basis points with an average of approximately 220 basis point. Obviously, this spread can change as bond yields vary as well as property pricing. Today, investors across asset classes seem to be expecting a return to a lower yield environment predicated by a so-called policy pivot by the Federal Reserve in response to slowing economic growth and inflation expectations. While possible, we continue to prepare for a longer period of higher yields than what most investors have become conditioned to over the past fifteen years (post-GFC) but lower than most periods that preceded the financial crisis. In this scenario, the re-pricing of U.S. commercial property is likely to continue over the remainder of this year and into the first part of 2024.

FIGURE 5
NCREIF PROPERTY INDEX AVERAGE CAP RATE AS SPREAD TO TREASURY BOND YIELD



Source: NCREIF, Federal Reserve

Conclusion

Periodic asset valuation cycles are an expected aspect of long-term investing, particularly following significant political or economic dislocations. The Federal Reserve policy response to unacceptably high inflation is such a dislocation. Property is priced in the context of all other asset classes and valuations cannot be unaffected during a period where the cost of capital has changed significantly. Property markets will, in time, find their footing and move forward in step with operating fundamentals (rent, occupancy, NOI) and yet to be determined pricing metrics (cap rates, discounts rates). History suggests investors should expect a period of outsized positive returns following revaluations. Table 1 attempts to illustrate this by showing the five-year total return for the ODCE Index following each of the last three market troughs. Additionally, we show the return for each five-year future period from one and two quarters before and after each trough to make the simple point that long-term investors do not need to exactly identify market bottoms to participate in the next valuation up cycle.

TABLE 1
ODCE FUNDS GO-FORWARD FIVE YEAR ANNUALIZED TOTAL RETURN FOLLOWING MARKET TROUGHS

EARLY 1990'S		5-YEAR RETURN
	1995 Q2	11.9%
	1995 Q3	12.3%
TROUGH	1995 Q4	13.0%
	1996 Q1	13.0%
	1996 Q2	12.7%
TECH CRASH		5-YEAR RETURN
	2002 Q1	12.7%
	2002 Q2	13.5%
TROUGH	2002 Q3	14.0%
	2002 Q4	14.0%
	2003 Q3	12.5%
FINANCIAL CRISIS		5-YEAR RETURN
	2009 Q3	11.3%
	2009 Q4	12.9%
TROUGH	2010 Q1	13.4%
	2010 Q2	13.3%
	2010 Q3	12.9%

Source: NCREIF

Office

Challenges facing the office sector weighed more heavily on performance in the first quarter as both perception and reality collided making for what will likely be another tough year. Lenders and equity providers have shifted towards a much more defensive stance and are looking to reduce overall exposure to the sector in the face of an already difficult capital markets environment as fundamentals soften. The sector faces some of the stiffest headwinds regarding future values as acceptance of the hybrid work model becomes more entrenched in employee and employer expectations, which has structural implications for future demand as companies reevaluate the type, location, configuration and aggregate need for space. Employers also recognize that near-term growth dynamics are not what they once were with layoff announcements becoming more prevalent, especially among but not limited to tech-oriented firms. Whether the cause was aggressive competition for talent, aggressive growth expectations, space utilizations shifts or other factors, the net impact on office has been less demand for new space and a consolidation or downsizing of existing space from tenants.

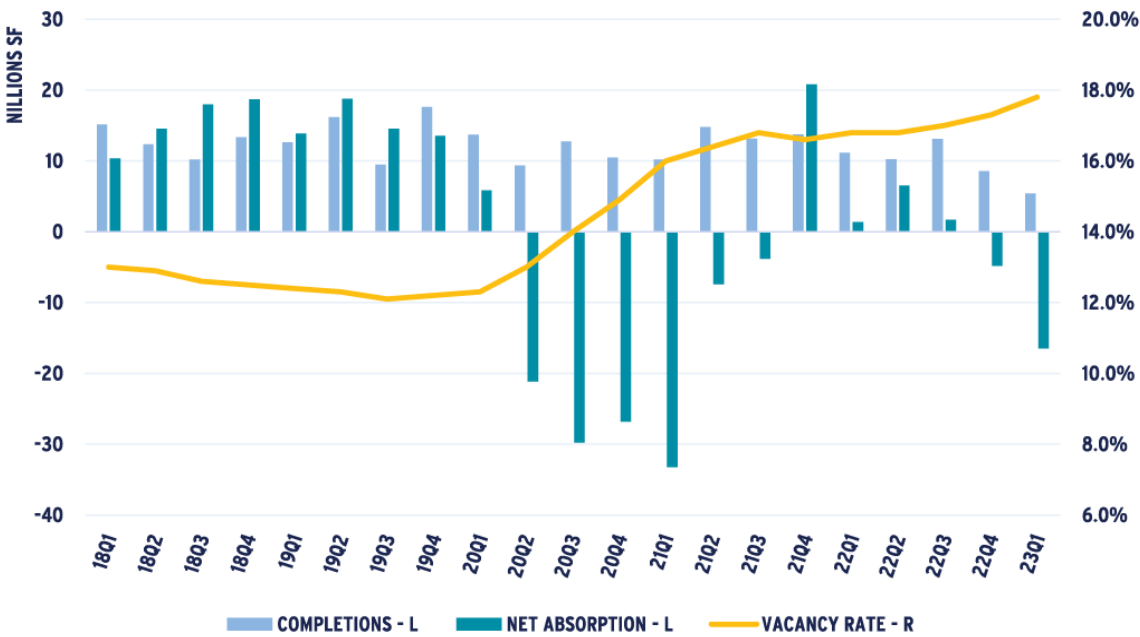
Leasing volume (new and renewals) took a step down in the first quarter tracking roughly 40% below pre-COVID levels and about 20%-25% behind the pace seen last year. Brokers continued to report fewer tenants in the market with added pressures coming from the sublease market. San Francisco and Seattle remained the most notable negative outliers while Boston was an outperformer given its life science exposure, although not immune. As a result, net absorption of space fell by 16.5 msf in the first quarter following a negative fourth quarter (-4.8 msf) across the sum of markets tracked by CBRE. In aggregate, the market has yet to find its footing.

Office vacancies climbed 50 bps to 17.5% for the quarter and 550 basis points (bps) since the pandemic began, continuing the pattern of rising rates. Sublease space accounted for 250 bps of the vacancy totals. The downtown markets have fared worse with vacancies up over 750 basis points over the past three years to 18.1% in Q1, eclipsing suburban rates that have risen to 17.7% after climbing 750 bps from 10.6% over the past 3 years. Low space utilization related to the remote working dynamic remains a persistent issue although calls to bring employees back into the office more consistently have been louder to start the year. Vacancy issues have not been limited to the major gateway markets. The largest increases in vacancy over the quarter were seen in Salt Lake City (250 bps), Charlotte (210 bps), Orange County (180 bps), Raleigh (170 bps) and Austin (170 bps), with Raleigh at 13.8% the only market with vacancies below the national average. New supply has been a factor in pushing vacancy rates higher in select markets but not to the degree of previous cycles. Austin, Seattle, Boston, San Jose, Nashville and Miami have at least 5% of inventory still under construction, which may pose more of a problem going forward. That said, over the near term, challenged financing conditions will make it difficult to add to these totals.

Investor sentiment remained negative in early 2023 with an expectation of deteriorating office values and uncertainty surrounding where cap rates will settle. Banks and other lenders are increasing loan-loss reserves and the CMBS market has seen the volume of loans in special servicing notch higher albeit from low levels. NCREIF reported an office capital value decline of 5.2% in the first quarter and 12.7% for the one year. Correspondingly, financing has become scarce and/or expensive with transaction volume dipping to one-third the pre-COVID pace. For those needing to sell assets, seller financing is noted more often as a consideration for generating liquidity.

Overall, the office dynamics remain challenging with few signs emerging that suggest any settling out in the capital markets or fundamentals to date. At some point the falling knife will stick in the floor, but it will take time to fully play out as firms assess the impact of the shifting work model on productivity, profitability and the ability to retain talent. Demand remains skewed toward quality space with advantage clearly in the hands of tenants as robust TI packages and other incentives are used to win deals.

OFFICE MARKET FUNDAMENTALS



Source: CBRE-EA

OFFICE	
Vacancy Rate	17.5%
12-Month Historical Trend	
Vacancy Change	↑
Rent	↔
Absorption	↓
Completions	↓
Cap Rates	↑
Transaction Volume	↓

Apartment

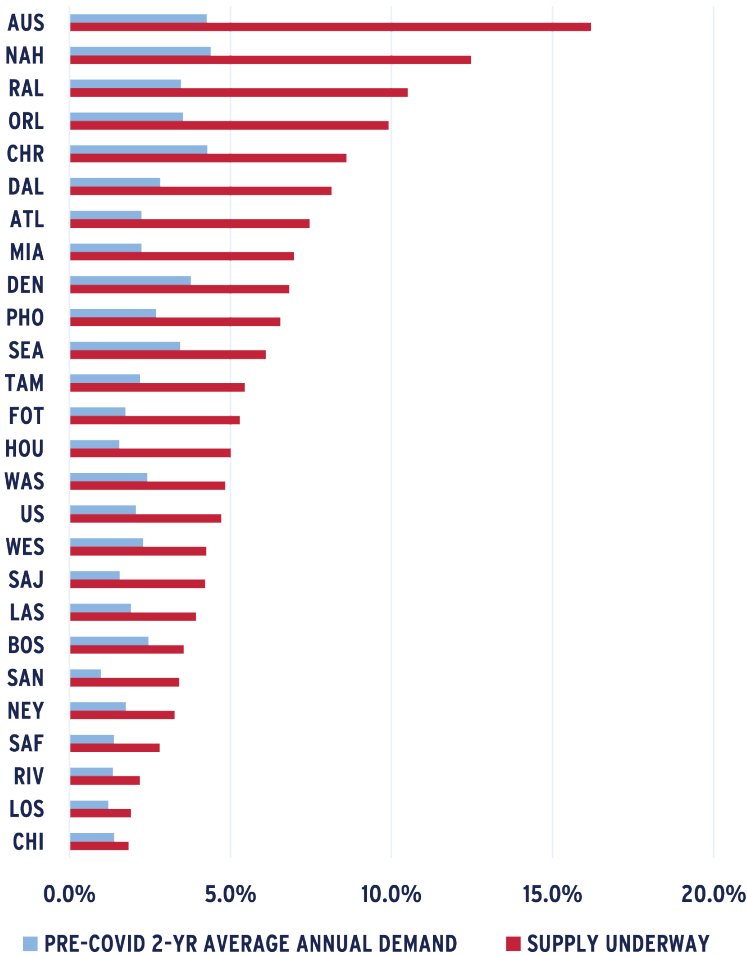
The apartment market continued to soften in the first three months of the year. Vacancies edged up to 4.9%, a 30 basis points (bps) increase quarter over quarter (QOQ) and a 250-bps year-over-year (YOY) gain. By market, only three, Madison (1.5%), New York (2.9%) and Providence (1.5%), now have vacancies below 3% versus 58 markets one year ago. Instead, 41 markets now have vacancies over 5% with the southeast and southwest markets generally reporting the highest vacancies. Among more major metro areas, Houston (7.2%), Fort Worth (6.9%), Las Vegas (6.8%), Phoenix and Atlanta (6.6%), Austin (6.4%) and Dallas (6.3%) reported the highest vacancies.

Overall, the post-COVID bounce back has been fully eroded and vacancies now match the pandemic high. Further, the moderation in fundamentals was pervasive with all but three markets reporting flat or increasing vacancies QOQ and all 69 markets tracked by CBRE-EA reporting a YOY increase in vacancies. Markets that bucked the QOQ trend included Honolulu (-60 bps), Fort Lauderdale (-10 bps), San Jose (-10 bps) while San Francisco, Long Island, Hartford and Richmond all reported flat vacancies QOQ. Meanwhile, the QOQ upward movement in vacancies ranged from a low of 10 bps in Chicago, Corpus Christi, Louisville, Madison, Phoenix, Providence and Ventura to a high of 110 bps in Oklahoma City. On a YOY basis, Tucson, Memphis, San Antonio, Greensboro and Fort Worth all reported a 400+ bps increase in vacancies, while Madison (40 bps) and Honolulu (40 bps) were the only two markets to report a YOY vacancy increase of less than 100 bps. Of note, however, New York, San Francisco and San Jose, laggards in the post-COVID recovery, saw vacancies increase by only 110 to 140 bps, the smallest increases among large markets and considerably less than the increase nationally.

Much has been discussed about hefty deliveries of new product leading to the weakening of fundamentals; however, supply is not the only issue plaguing the market today. Indeed, as we mentioned last quarter, demand was negative on an annual basis in 2022, the first time this has occurred since the GFC, and the softness in demand has continued into 2023. Demand was only modestly negative in the quarter on a national level with roughly 2,000 units being returned to the market; however, over half of the markets tracked by CBRE-EA reported flat or negative demand in the quarter. Moreover, on a rolling four-quarter basis, demand was negative in 51 of 69 markets. Overall, the current economic uncertainty, along with a rapid increase in rents is forcing renters to double up or leave the market. According to the Pew Research Center, half of adults between the ages of 18 and 29 were living with one or both of their parents in mid-2022; this is down from the COVID peak of 52% but is still well above the 44% and 38% reported in 2010 and 2000, respectively. Given the recent apartment market performance, however, the percentage of young adults living with a parent is likely trending higher again.

At the same time demand has trended down, supply has accelerated. Over 340,000 units were completed in 2022, a record high. Deliveries were modest in the first quarter with roughly 60,000 units being added to the market; however, this is the calm before the storm as there are over 800,000 units currently under construction. The 2023 completion total is expected to top 2022's record-high with 550,000 units projected to be completed, an increase in inventory of 3.3% or double the 10-year historical average. The greatest supply risk is in the Sunbelt, where Austin (16.2%), Nashville (12.5%), Salt Lake City (12.2%), Raleigh (10.5%) and Jacksonville (10.2%) all have double-digit pipelines as a share of inventory underway; Orlando, Charlotte, Dallas, Atlanta, San Antonio and Miami are not far behind with between 7% and 9% of inventory underway. Under normal circumstances, the pipeline in these markets would generally total between 1.8 and 3 years of supply (this excludes outliers like Austin, San Antonio and Salt Lake City where years of supply are between 3.8 and 5 years), a relatively balanced pipeline as it would be completed in 2 to 3 years given delivery date projections between 2023 and 2025. With the current uptick in vacancies, softening demand and overall economic uncertainty, the years of supply across these markets could increase significantly.

SUPPLY AND DEMAND BY MARKET (REPRESENTED AS A SHARE OF INVENTORY)



Source: CBRE-EA as of 2023 Q1

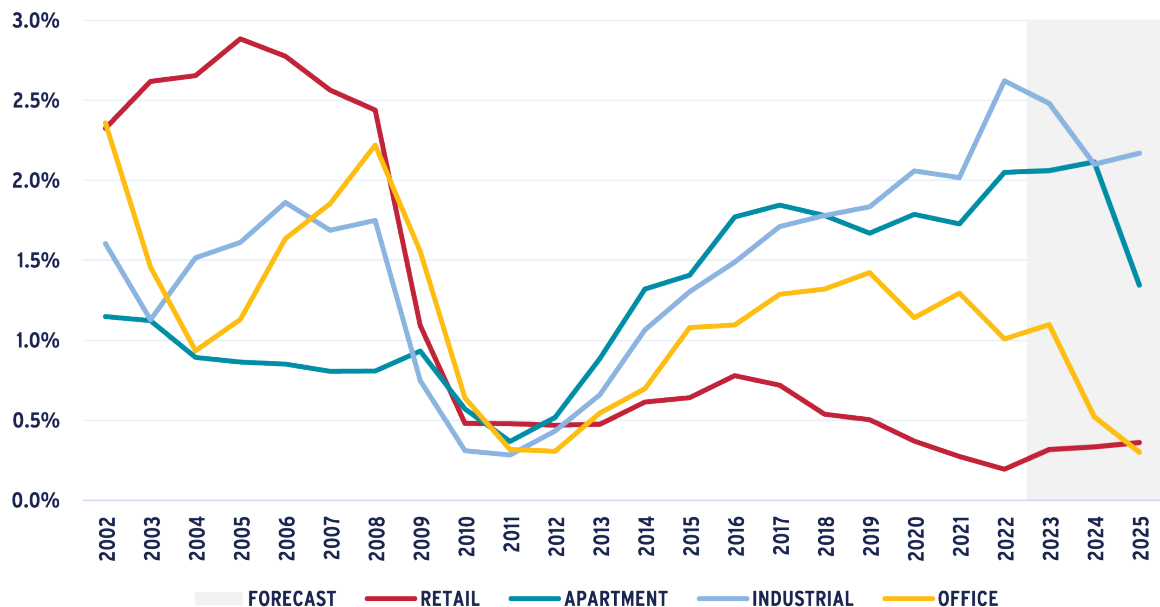
With the shifting market conditions, rent growth projections have been adjusted downward but not negative, yet. The higher end of the market is at greater risk of a rollback in rents as supply is concentrated in this segment of the market. However, the potential for a correction in rents will hinge on the spring/early summer leasing season. Currently, AEW’s 2023 rent growth forecast ranges from a low of only 0.5% to a high of 3%; this is down from a low of 3% a year ago to a higher end of 6+% in New York and the Northern California markets where a more substantial recovery was expected. Growth expectations for 2024 and 2025 have also been tempered with more normalized growth expected in 2026 and beyond once the current supply is absorbed.

MULTIFAMILY	
Vacancy Rate	4.9%
12-Month Historical Trend	
Vacancy Change	↑
Rent	↑
Absorption	↓
Completions	↑
Cap Rates	↑
Transaction Volume	↓

Retail

Among the four core property types, the retail sector reported the best quarterly performance in terms of market fundamentals. Total retail availability declined to a new record low of 4.8% in 2023 Q1, down 10 basis points (bps) from the previous quarter and 50 bps year over year (YOY). Overall, availability has improved by 180 bps from a COVID high of 6.6% and is now less than half the GFC high of 9.9%. Demand remained positive in the quarter but moderated to 8.6 million square feet (msf) from 15.2 msf in 2022 Q4. The slowdown in leasing, however, is tied to the very tight fundamentals and a lack of available space at the most desirable centers. Supply too moderated in the quarter with only 5.1 msf being added to the market, the lowest quarterly completions ever reported by CBRE-EA. Further, unlike other property types, the pipeline of properties under construction is minimal (35.5 msf or 0.4% of inventory) and substantially pre-leased (71%).

RETAIL SUPPLY REMAINS IN CHECK RELATIVE TO OTHER PROPERTY SECTORS (COMPLETIONS AS A SHARE OF INVENTORY)



Source: CBRE-EA as of 2023 Q1

By property subtype, the neighborhood and community shopping center segment (NCSC) of the market, which is the largest subtype tracked by CBRE-EA at roughly 3 billion square feet, is the best performing market post-COVID. Availability at 6.8% is a new record low and is down 10 bps quarter over quarter (QOQ), 80 bps YOY and 250 bps relative the COVID high. Further, since the post-COVID recovery began in late 2020, roughly 90 msf has been leased on net, an absorption rate of 3.0%. Overall, the annualized post-COVID absorption rate has been the strongest since 2016. At the same time, less than 1.7 msf was completed in the quarter while only 7 msf has been completed over the past four quarters. As a share of inventory, the supply increase over the past four quarters has tallied a mere 0.2%, matching the past four quarters at the lowest increase ever reported.

After the NCSC segment of the market, the second strongest subtype was once again the power center (PC) segment of the market. Availability improved to 5.2%, down 10 bps QOQ, 90 bps YOY and 220 bps from a COVID high of 7.4%. Like the NCSC segment of the market, demand moderated but remained positive and outpaced new supply by roughly 4x in the quarter and the year. Roughly 600,000 sf was absorbed in the quarter and 6.5 msf over the past four quarters, far outpacing new supply of 143,000 sf and 1.3 msf over the same period.

Finally, the lifestyle and mall (L&M) segment of the market has continued its slow and steady recovery. Availability improved to 6.0%, flat QOQ but down 10 bps YOY and 50 bps from the COVID high. The L&M segment of the market will continue to have a tepid recovery, however, as consumer preferences for open-air centers, the L&M tenant mix, stubbornly high inflation and a switch to more service-based spending prevents a more robust recovery. The L&M segment of the market, with its higher percentage of apparel and department store tenants, is feeling the adverse effects of inflation as consumers switch from discretionary spending (apparel) to necessity-based spending (grocery and pharmacy). Additionally, higher inflation is also pushing more consumers to off-priced apparel stores which are traditionally in the NCSC and PC segments of the market. That said, the worst has likely passed for this L&M segment of the market in terms of fundamentals; additionally, values appear to be stabilizing and even improved slightly in the quarter. Indeed, Green Street's Mall and Outlet Commercial Property Price Index is up 3% over the past three months due to 4Q22 NOI growth and cap rates are down roughly 100 bps for malls graded A- and below in January 2023.

Going forward, the bankruptcy of Bed Bath & Beyond and the subsequent closing of its remaining 480 stores (includes BuyBuy Baby subsidiary) poses a risk for both the PC and NCSC segment of the market as the majority of the retailers' stores were in both categories. Per CoStar, roughly 165 stores are in NCSCs and 200 are in PCs while the remaining are either in malls, lifestyle centers or stand-alone stores. While this seems like a significant exposure, the retailer occupies only 26 msf of space or 0.3% of retail space nationally. Moreover, it is expected that demand for the space will be strong. Indeed, most of the leases held by Bed Bath & Beyond are in well-located centers that are in demand by expanding retailers. Further, landlords recapturing these spaces will likely release them at higher rents. Potential tenants include fitness centers and grocery stores that can take the entirety of the average 25,000 to 35,000 sf typically occupied by Bed Bath & Beyond. Overall, the retail sector is well poised headed into the anticipated slower economic environment. Further, the sector has already repriced with an average NCREIF cap rate of 5.3% in 2023 Q1 versus the 3.7%, 3.9% and 5.1% reported in the industrial, apartment and office sectors, respectively.

RETAIL	N&C SHOPPING CENTER	LIFESTYLE & MALL	POWER CENTER
Availability Rate	6.8%	6.0%	5.2%
12-Month Historical Trend			
Availability Change	↓	↓	↓
Rent	↑	↓	↔
Absorption	↓	↓	↓
Completions	↓	↓	↓
Cap Rates	↔	↑	↑
Transaction Volume	↓	↓	↓

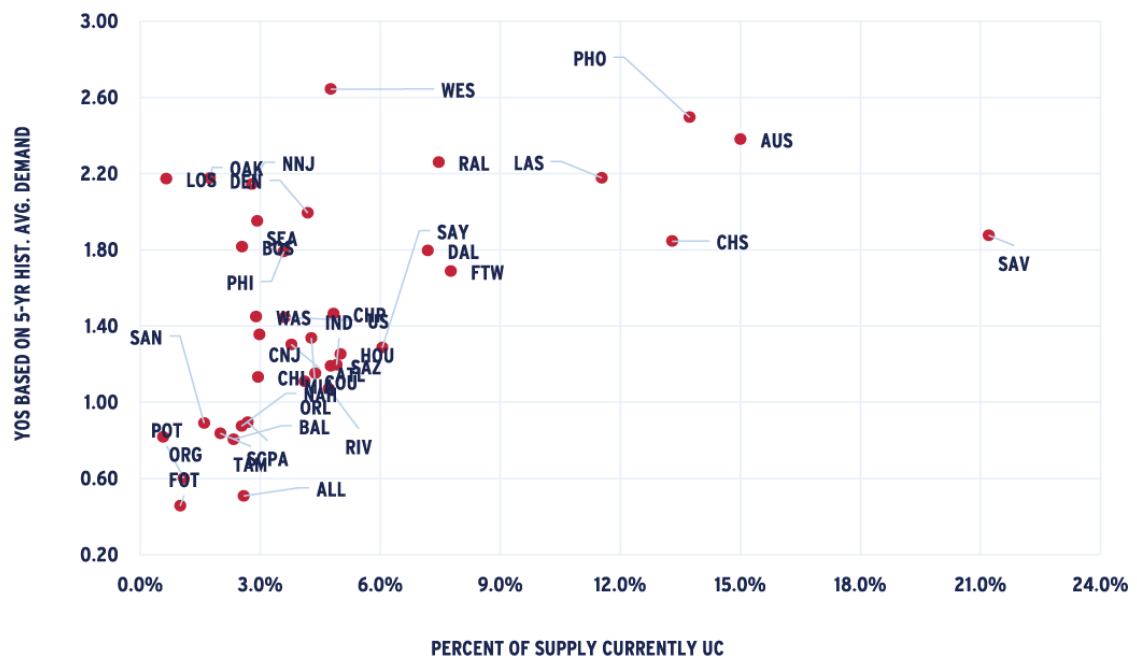
Source: CBRE-EA, NCREIF and RCA, as of Q4 2022

Industrial

In 2023 Q1, U.S. industrial availability increased to 5.5%, up 70 basis points (bps) from 2022 Q4 and 80 bps from the 2022 Q2 post-COVID low. The increase in availability quarter over quarter was broad-based with only 7 of CBRE-EA's top 51 markets bucking this trend. Both weak demand and continued construction led to the uptick in availability. Indeed, in 2023 Q1, net absorption totaled less than 8.5 million square feet (msf), the weakest quarterly demand since early 2010. On a rolling 4-quarter basis, roughly 313 msf was absorbed, in line with the 10-year historical average (319 msf) but a continued moderation from a high of over 600 msf in 2022 Q1. On the supply side, over 550 msf has been completed since 2022 Q1. The pipeline remains healthy with 566 msf (3.6% of inventory) underway. Based on the 2-year and 5-year average historical demand this equates to between 1 and 1.5 years of supply, respectively.

By market, the bulk have roughly two years of supply or less underway. However, there are several sunbelt markets with a notable pipeline underway that could yield a sizeable increase in availability if demand falters. Savannah (21.2%), Austin (15.0%), Charleston (13.3%), Phoenix (13.7%) and Las Vegas (11.5%) all have over 10% of supply currently underway. Per CoStar, nationally roughly 30% of space currently under construction is pre-leased, while the pre-leased percentage ranges from a low of 22% in Charleston to a high of 35% in Las Vegas among the aforementioned markets. That said, Phoenix has by far the largest available pipeline among markets with double-digit space underway as a share of inventory at over 41 million square feet (msf); this is more than double Savannah's 18 msf and four times the Austin, Charleston and Las Vegas available pipelines, which range from 10 to 11 msf.

THE SUPPLY RISK IS GREATEST IN THE SUNBELT



Source: CBRE-EA as of 2023 Q1

On the demand side, 25 of the nation's 51 largest markets reported negative net absorption in 2023 Q1, including the gateway markets of Los Angeles (-8.9 msf), Northern New Jersey (-2.4 msf), Riverside (-1.0 msf) and Miami (-630,000 sf). This, along with completions in the quarter, pushed availability up in Los Angeles by 110 bps, 70 bps in Northern New Jersey, 240 bps in Riverside and 60 bps in Miami. Overall, Riverside reported the largest increase in availability in the quarter (240 bps to 5.6%), followed by Dallas (190 bps to 7.1%), St. Louis (180 bps to 7.7%), Columbus (150 bps, 5.7%) and Indianapolis (150 bps, 5.7%). On the other end of the spectrum, Tucson, Minneapolis, Stamford, Chicago, Phoenix, Detroit and Westchester reported improving availability in the quarter.

Despite the uptick in availability across many markets, 47 of the nation’s 51 largest markets continue to have an availability rate below the 10-year historical average while all 51 markets have a current availability rate below the 20-year average. Moreover, 21 markets have an availability rate below 5%. Among major gateway markets, Miami reported the lowest availability rate of only 3.6%, followed by Orange County (3.8%) and Los Angeles (4.1%). Smaller, secondary markets leading the way in availability include Minneapolis (3.4%), Salt Lake City (3.5%), Portland (3.6%) and Las Vegas (3.7%).

While the pause in demand in the first quarter is concerning, fundamentals remain exceptionally tight, as we have highlighted above, and are in favor in landlords. Given the still strong market conditions, near-term rent growth should remain healthy. Markets with the greatest supply or slightly higher availability, like Austin, Raleigh and Houston, should range from 4% to 5%, while larger gateway markets with tight fundamentals, like Miami, Los Angeles and Northern New Jersey, are expected to have double-digit rent growth. Longer term, in 2025 and beyond, we expect rent growth to trend toward the long-term average of 3.0%.

INDUSTRIAL	
Availability Rate	5.5%
12-Month Historical Trend	
Availability Change	↑
Rent	↑
Absorption	↓
Completions	↑
Cap Rates	↑
Transaction Volume	↓