AEW RESEARCH

U.S. Economic & Property Market Perspective

Q2 2023

AEW

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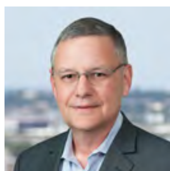

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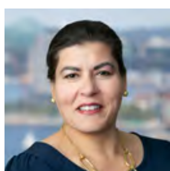

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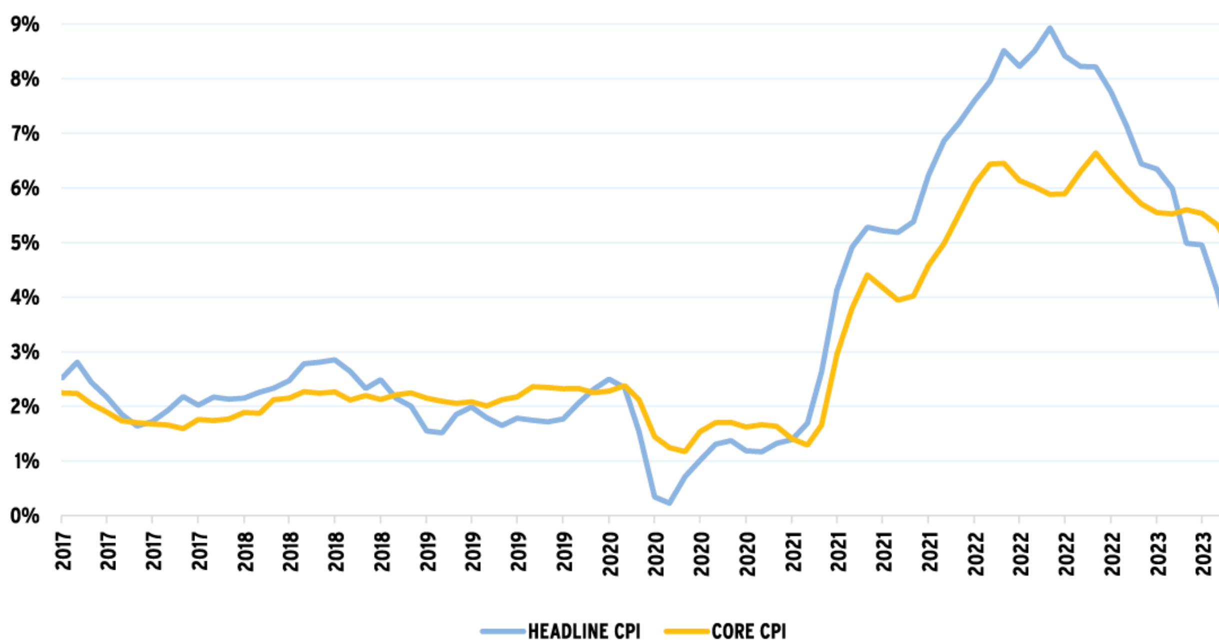
It Ain't Over 'Til It's Over

- Yogi Berra

The combination of continued moderation in inflation and higher than expected second-quarter real GDP growth has buoyed both investor and consumer sentiment with growing expectations that the Federal Reserve may be approaching the end of the credit tightening cycle and the U.S. economy may avoid recession and achieve a so-called "soft landing."

With respect to inflation, the widely watched "headline" consumer price index (CPI) showed a year-over-year increase of slightly more than 3% in June compared with a near 9% increase in June 2022. While it is too early to declare the period of excess inflation fully contained, the data are clearly moving in the right direction. The Fed may want to see various measures of inflation move to or below the policy target of 2% and remain there for some time before they begin to reverse course. On this point, it is worth noting that the same recent inflation report also shows a more modest improvement in core inflation (excluding food and energy prices) with year-over-year growth of nearly 5%, well above the Fed's longer-term target.

FIGURE 1: MODERATING INFLATION

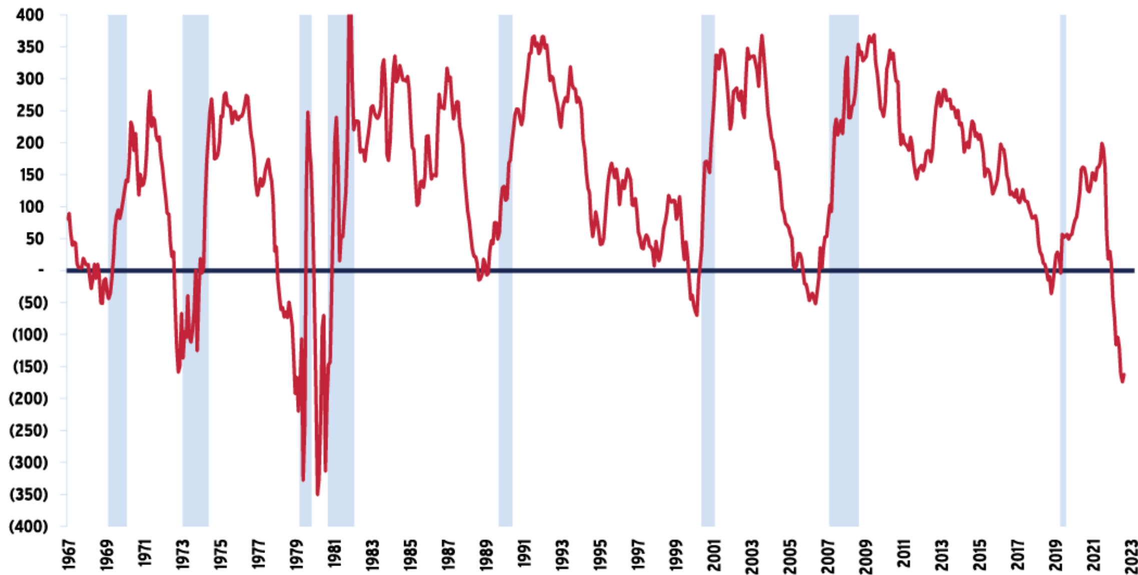


Source: Bureau of Labor Statistics (BLS)

With respect to growth, an economic soft landing is conceptually possible following a period of Fed tightening but history offers few examples of this outcome. Positive GDP growth during any one quarter also does not preclude recession. Consider, for example, annualized real GDP growth of 2.4% during the fourth quarter of 2007, the very quarter that the National Bureau of Economic Research (NBER) believes the Global Financial Crisis (GFC) recession began. Interestingly, 2.4%, is the exact same annualized growth rate reported for the second quarter of 2023.

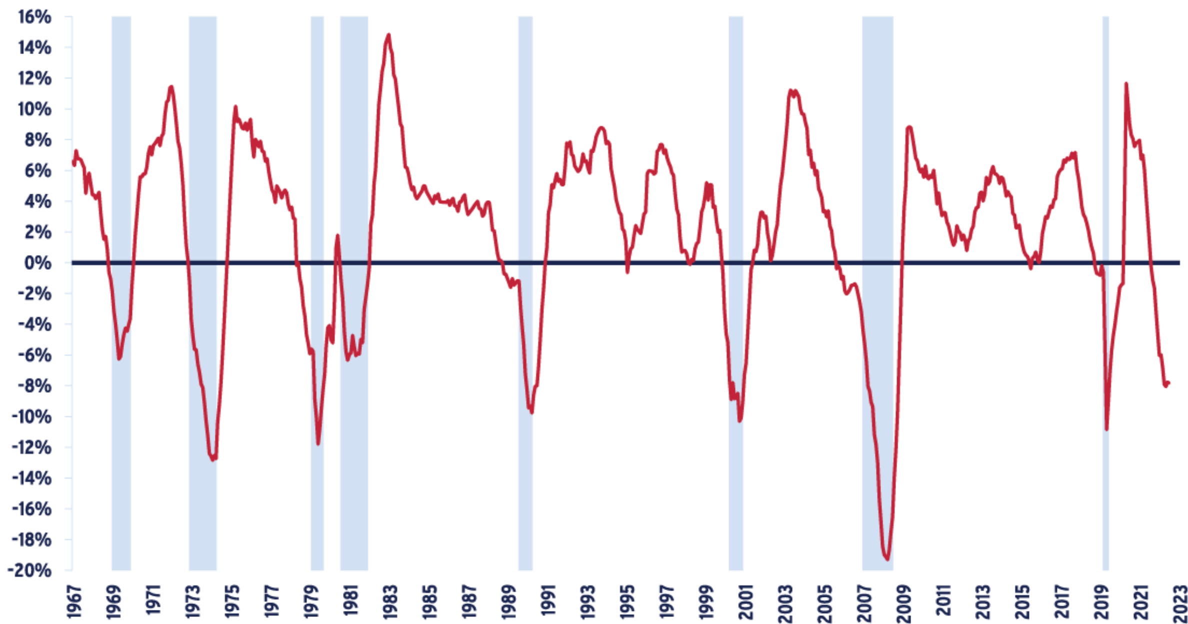
This observation in no way suggests that the U.S. economy is poised to tip over into recession in the coming months but numerous indicators that have been highly predictive of past contractions such as the spread between short-term and longer-term interest rates (yield curve) and the growth in various leading economic indicators have heightened recession concerns for some time.

FIGURE 2: DIFFERENCE BETWEEN 10-YEAR TREASURY YIELD AND 3-MONTH T-BILL YIELD (BP) AND PAST RECESSIONS



Sources: Federal Reserve, NBER

FIGURE 3: YEAR-OVER-YEAR GROWTH IN LEADING INDICATORS COMPOSITE INDEX AND PAST RECESSIONS



Sources: The Conference Board, NBER

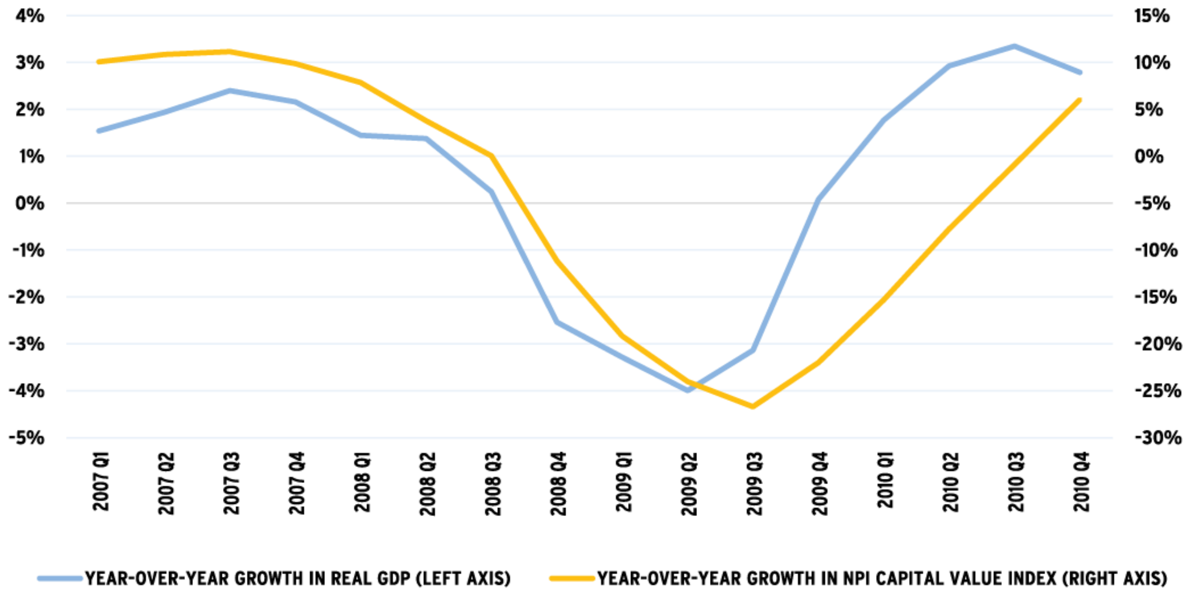
Recessions are not preordained economic events and there is always the possibility that this time will be different, but we are mindful of Sir John's sage adage that these are often dangerous words.

"The investor who says, 'This time is different,' when in fact it's virtually a repeat of an earlier situation, has uttered among the four most costly words in the annals of investing."[1]

Of course, what is happening in the U.S. economy and property markets today is very different than the earlier GFC period and investors may be correct in expecting a different outcome. In the earlier period, the economy contracted sharply during 2008 and into the first half of 2009, and property values quickly followed suit as property operating conditions deteriorated. Today, recession, if there is to be one, has not yet presented itself.

[1]John Templeton. 16 Rules for investment Success. 1933.

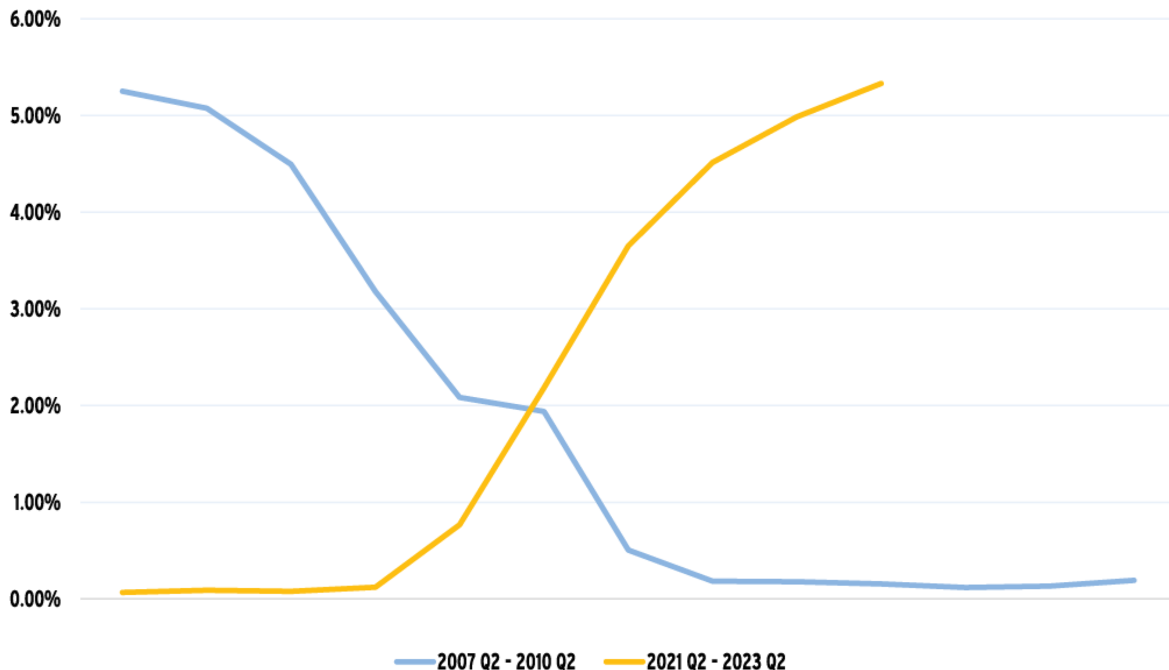
FIGURE 4: GDP GROWTH AND PROPERTY VALUE DECLINES DURING THE GFC



Sources: Bureau of Economic Analysis, NCREIF

More significantly, the yield environment and the Fed's intervention in the economy during the current period and the GFC are also quite different. During the GFC (and beyond), the Federal Reserve was aggressively loosening credit conditions and injecting liquidity into asset markets around the globe. Today, in response to elevated inflation, likely directly related to similar stimulative monetary policy during the pandemic, the Fed is aggressively tightening credit conditions and draining excess liquidity from the financial system.

FIGURE 5: FED FUNDS RATE DURING GFC PERIOD AND TODAY



Source: Federal Reserve

Differences aside, the Fed is near the end of this period of raising rates. At their June meeting, Federal Open Market Committee (FOMC) members collectively indicated that they expect the overnight lending rate to peak slightly above 5.5% later this year, not far above the current effective rate of approximately 5.3%. Perhaps more significantly, the FOMC also expects the Fed funds rate to remain well above 4% through 2024.

Longer term, sometime after 2025, the FOMC expects the policy rate to revert to what they refer to as the "neutral rate," the level that they believe is neither stimulative nor restrictive to economic growth. Currently, the neutral rate is estimated to be approximately 2.5% to 3%, or roughly 1% above the Fed's longer-term inflation target. For investors, the neutral policy rate is important as many other interest rates and, more significantly, asset yields are inherently linked to this rate. In a recent Bloomberg editorial, Bill Dudley, the former president of the Federal Reserve Bank of New York and vice chair of the FOMC explained what the eventual return to the neutral rate would mean:

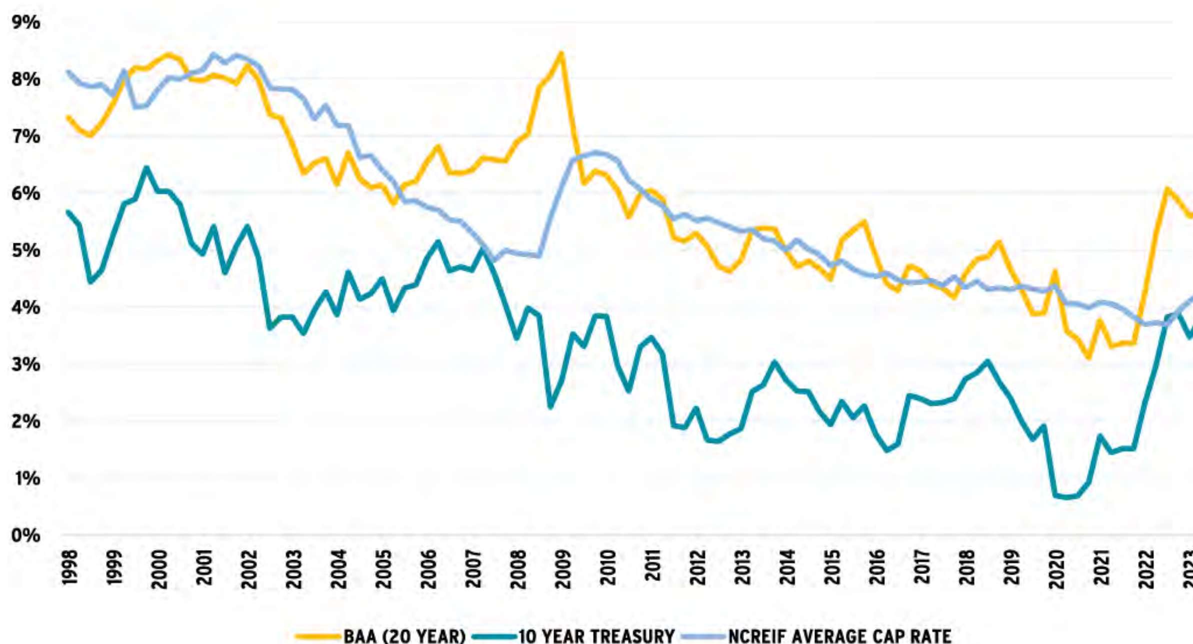
"How high, then, might Treasury yields go? Let's put together the pieces. Suppose the Fed's short-term interest-rate target, adjusted for inflation, averages about 1% over the next decade. Inflation averages 2.5%, and the bond risk premium is one percentage point. In sum, this suggests a 10-year Treasury note yield of 4.5%. And that's a conservative estimate." While somewhat higher than current bond market pricing and the experience of most of the post-GFC period, Dudley's shorthand forecast for the 10-year Treasury yield is consistent with the pre-GFC yield environment and represents the average Treasury yield between 2000 and 2007 prior to the implementation of extraordinary monetary policies such as zero interest rate policy (ZIRP) and yield curve controls such as quantitative easing (QE) during the financial crisis and beyond.

FIGURE 6: 10-YEAR TREASURY YIELD FORWARD CURVE

Sources: Chatham Financial, Federal Reserve

If it is then reasonable to expect the Treasury bond yield to remain near 4% or perhaps slightly higher, what does that imply for property pricing over the next several years? Today, despite four consecutive quarterly declines in capital values as measured by the NCREIF Property Index (NPI), an aggregate decline of slightly more than 10%, average property yields on existing property investments largely remain lower than what would be suggested by the current yields on Treasury and corporate bonds, with the NPI average property cap rate of 4.25% as of the end of second quarter.

FIGURE 7: AVERAGE PROPERTY YIELD (CAP RATE) VS BAA CORPORATE BOND YIELD AND 10 YEAR TREASURY YIELD



Sources: Federal Reserve, NCREIF, Moody's

Property yields can rise for two very different reasons: growing property income or falling property values (or some combination of the two). Absent a return of extraordinary monetary policies that push all yields lower, property pricing is expected to stabilize at yields consistent with the broader interest rate environment and overall investment performance will be more closely related to property market fundamentals and growth in property income (NOI). Currently, property market operating fundamentals outside of the office sector remain generally positive but softening with vacancies rates rising from historically low levels in most apartment and industrial markets.

As we observed last quarter, the problems facing office property operating fundamentals and values are likely to get worse over the next few years, particularly if the economy does slow significantly or contract. Currently, most office property loans are difficult or impossible to refinance and few will be able to be refinanced 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 similar investment decisions related to tenant leasing requiring significant capital expenditure (leasing costs, tenant improvement allowances, free rent, etc.).

Conclusion

Reflecting more favorable recent data on economic growth and inflation, investors are increasingly focusing on the expected end of Federal Reserve credit tightening and some form of a "soft landing" for the economy whereby growth slows enough to forestall re-accelerating price inflation but does not contract significantly. While we share the expectation that Fed is approaching their terminal rate and are unlikely to significantly tighten credit further, we remain focused on previously dependable historical indicators that suggest recession risks remain elevated over the next 12-18 months. We also continue to believe that direct property investment, as measured by the NCREIF Property Index (NPI) has not yet fully re-priced to reflect the current yield and growth environment, an environment that seems likely to last longer than what might have been expected as recently as last summer. As such, we expect additional property value adjustments in the NPI through the remainder of 2023, setting the stage for an attractive, higher initial yield property investment market for 2024 and beyond.

Property Sector Updates

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Office

The office market has yet to find its footing in what will likely be an extended adjustment period for fundamentals and values. The dynamics have not changed materially from what we outlined last quarter with investor sentiment solidly in the pessimistic camp. Lenders and equity providers have taken a much more defensive stance as they look to reduce overall exposure in the face of an already difficult capital markets environment as tenant needs for space wane. 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. A full understanding of where these dynamics will settle remains elusive although employers are moving toward more structured return-to-work policies than was the case earlier in the spring. Regardless, the impact on values is playing out much quicker in the public markets, while the private equity market has been much slower to adjust. The low velocity of transactions has muddied the water, but the wide bid-ask spreads and lack of debt financing suggest where the puck is likely headed over the near term. Current estimates of office value loss on the private side relative to previous peaks range as high as 40% with additional risk to the downside being noted. Through Q2 2023, the NCREIF capital appreciation index reflected an aggregate decline of 18.8% from previous highs with the second quarter accounting for 700 bps of the decline.

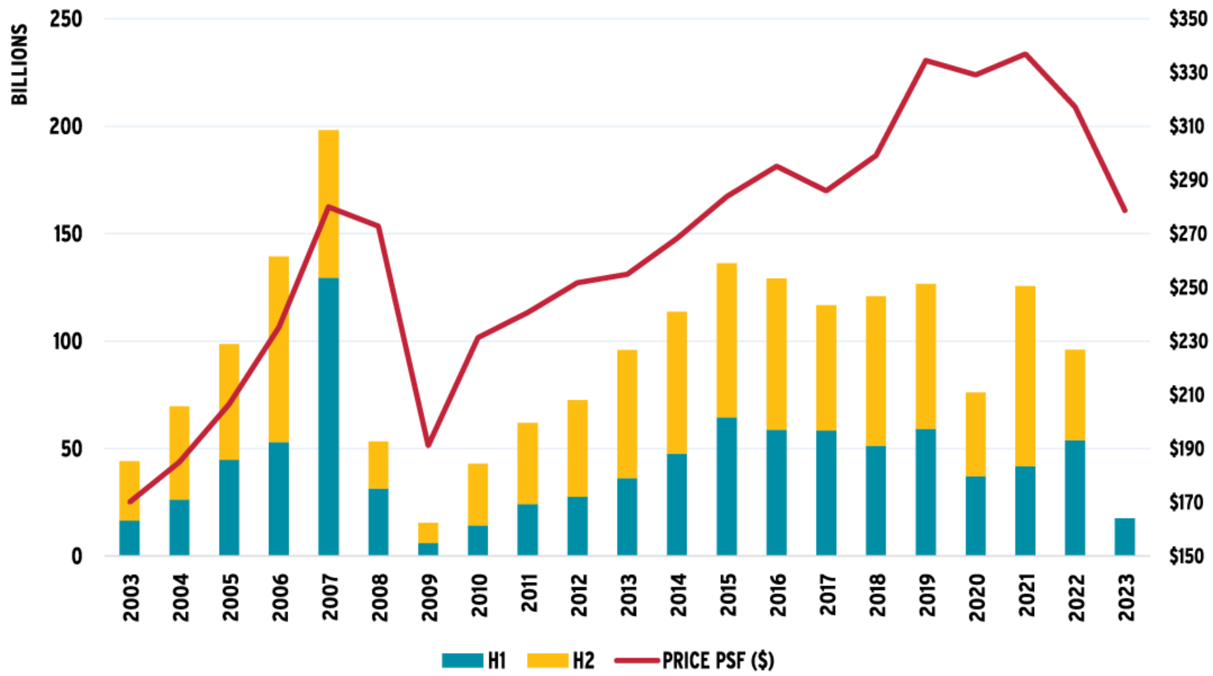
Leasing volume (new and renewal) remained sluggish in the second quarter of 2023, tracking roughly 40% below pre-COVID levels and about 20%-25% behind the pace seen last year. Brokers continued to report fewer tenants in the market, with added pressures coming from consolidations and higher levels of sublease space. Demand remains skewed toward quality space with the advantage clearly in the hands of tenants as robust TI packages and other incentives are used to win deals. That said, gross asking rents have remained essentially flat in aggregate through 2023 according to CoStar and CBRE-EA. Outliers on the downside remain the Bay Area and Greater Los Angeles as well as Austin as it deals with a robust supply pipeline and rising subleases. Outliers on the upside are more limited with the Florida markets generally outperforming.

Office vacancies climbed 40 bps to 18.2% in the second quarter from a revised 17.8% last quarter, continuing the pattern of rising rates according to CBRE-EA. Sublease space accounted for 260 bps of the vacancy totals with availability rates now sitting just shy of 25%. National net absorption was negative through the first half of 2023, falling ~23 msf after a hiatus in 2022 and matching the decline for all of 2021. Completions were a contributing factor to higher vacancies, especially in the downtown areas as new buildings delivered with availability. The remaining pipeline of projects under construction is low relative to historical standards at ~80 msf but will remain a factor in select markets. It is difficult to see more than just a select few projects breaking ground over the near term given the current environment.

Investor sentiment remained negative midway through 2023 with an expectation of deteriorating office values and uncertainty surrounding where cap rates will settle out. Banks and other lenders are increasing loan-loss reserves and the CMBS market has seen loans in special servicing notch higher albeit from low levels. Correspondingly, financing has become scarce and prohibitively expensive with transaction volume dipping to one-third the pre-COVID pace. For those needing to sell assets, seller financing has become the best path for generating liquidity.

Overall, the office dynamics remain challenging with few signs suggesting any settling out in the capital markets or fundamentals. Owners, investors, and lenders are facing increasingly difficult decisions about what to do as loans mature or major leases come due. Each likely requires material new capital contributions from ownership. For borrowers, the most likely lender on an existing investment is the current lender. With most lenders focused on reducing overall exposure to the office sector, it makes for some difficult discussions. At some point the falling knife will stick in the floor (on values), but it will take time to fully play out.

FIGURE 8: OFFICE MARKET TRANSACTION VOLUME AND PRICING



Source: MSCI/RCA as of Q2 2023

OFFICE	
VACANCY RATE	17.3%
12-MONTH HISTORICAL TREND	
VACANCY CHANGE	↑
RENT	↔
ABSORPTION	↓
COMPLETIONS	↓
CAP RATES	↑
TRANSACTION VOLUME	↓

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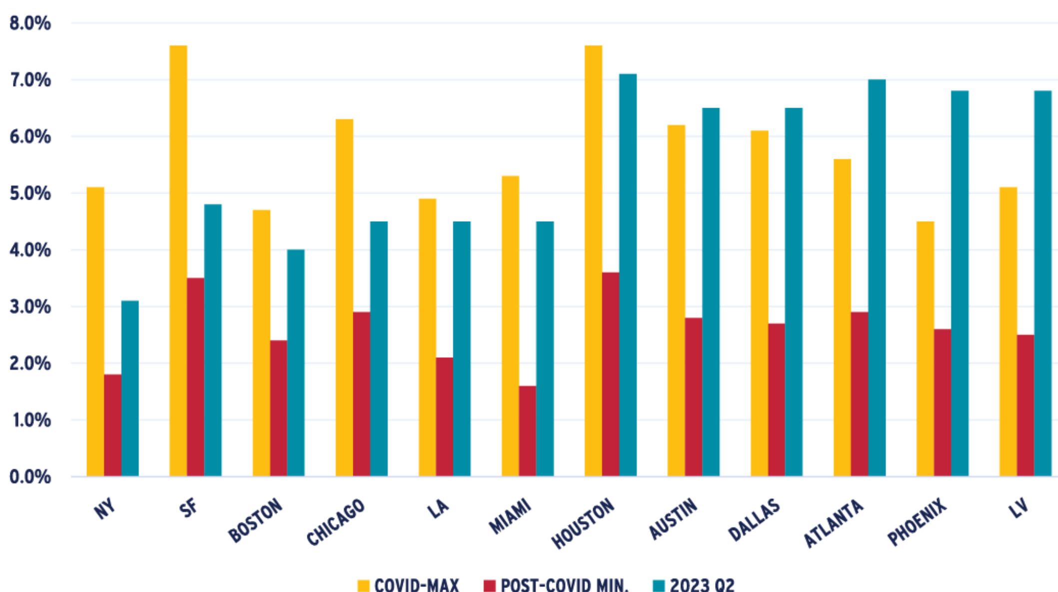
Apartment

Apartment market conditions remained tepid in the second quarter of the year. Vacancies continued to trend higher, increasing 10 basis points (bps) to 5.0%, marking the first time since early 2017 that vacancies have reached 5.0%. Vacancies are now nearly double their post-COVID low of 2.4% and are up 190 bps from one year ago. Further, vacancies are 130 bps above the pre-COVID low. The quarterly uptick in vacancy was the result of both hefty deliveries and modest, but improved, demand. Nearly 91,500 units were completed in the quarter, roughly 30,000 more than the previous quarter and 41% above the average quarterly deliveries in the five years leading up to the pandemic. Moreover, on a rolling four-quarter basis, roughly 351,500 units were completed, a record high. At the same time, demand, after being roughly flat in 2023 Q1 and negative from 2022 Q2 through 2022 Q4, turned positive with nearly 70,200 units being absorbed on a net basis. While this is welcome news for apartment owners and landlords, demand remained well short of typical second-quarter trends. Indeed, demand in the quarter was off historical trends by roughly 45% with second-quarter net absorption averaging 128,000 units per second quarter in the five years leading up to the pandemic.

Roughly 61% of the 69 markets tracked by CBRE-EA reported an uptick in vacancy in the quarter, while 7% reported flat vacancies and 31% reported a decline in vacancies. Generally, smaller tertiary markets (i.e. Birmingham, El Paso, Providence, Lexington, Corpus Christi, etc.) reported an improvement in vacancy while the bulk of primary (Miami, Los Angeles, New York, Atlanta, etc.) and secondary markets (Greenville, San Antonio, Colorado Springs, Sacramento, etc.) reported an increase in vacancy. On a year-over-year (YOY) basis, all markets reported an increase in vacancy, ranging from 50 bps (Honolulu) to 380 bps (Memphis). Overall, the breakdown in vacancy increases yielded 61% of markets with a 200+ bp rise in vacancy, 31% posting an increase between 100 bps and 190 bps and only 7% of markets showing a gain of less than 100 bps. Relative to the post-COVID low, 83% of markets reported a 200+ bp increase in vacancy, 16% reported a gain between 100 and 190 bps and only one market (Madison, WI) registered a pickup in vacancy of less than 100 bps. One notable trend that has remained unchanged from recent quarters is the sizeable increase in vacancies among Sunbelt markets due to hefty supply additions; Atlanta, Southeast Florida, Salt Lake City, Austin, Raleigh, Phoenix, Las Vegas and Charlotte all have reported substantial upticks in vacancies. Overall, the increase from the post-COVID lows has been particularly high in all the aforementioned markets, ranging from 320 to 430 bps, well above the national increase of 260 bps and particularly high relative to San Francisco, San Jose, New York, Chicago and Boston where vacancies are up 130 to 160 bps from their post-pandemic low.

FIGURE 9: COMPARATIVE VACANCY CHANGES FOR SELECT MARKETS



Source: CBRE-EA

In terms of supply, over the previous four quarters the completion rate (four-quarter completions relative to stock) has totaled 6.7% in Salt Lake City, the second-highest rate in the nation behind Colorado Springs (7.3%). Nashville, Orlando, Charlotte, and Austin followed Salt Lake City with completions rates ranging from 5.4% to 6.1%. Next tier markets in terms of supply gains were Phoenix, Raleigh, Southeast Florida and Atlanta with four-quarter completions as a share of stock between 2.2% and 3.6%. The major gateway markets with the smallest increases in vacancy noted above all had completion rates between 0.8% and 1.7%.

Demand in the Sunbelt, like the national trend, moderated in the last three quarters but has remained positive on a rolling four-quarter basis. That said, the mismatch in supply and demand has brought about the expansion in vacancies. Putting this into perspective, Austin's demand rate of 2.4% is above the U.S. average but is well below both the completion rate of 5.4% and the pre-pandemic demand average of 4.1% from 2015-2019. Similarly, Phoenix's absorption rate stood at 0.8%, well below the market's completion rate and roughly one-third the market's pre-pandemic demand average.

Going forward, construction activity will remain elevated through 2024 and 2025. Again, the bulk of the pipeline exists in Sunbelt markets. With better economic news as of late and higher interest rates, which will likely hinder homeownership opportunities among younger professionals, the demand outlook is slightly more positive than the previous quarter. Vacancies are still expected to increase modestly through the remainder of 2023 before stabilizing and ultimately improving in late 2024 or early 2025. Rent growth, as a result, will be more muted near term, particularly among newer properties, before picking up in 2025 and beyond.

The change in the interest rate environment and fundamentals is beginning to flow through valuations. NCREIF transaction cap rates have edged higher for four consecutive quarters with the value-weighted cap rate moving from roughly 3.5% in 2021 Q4 to 5.1% in 2023 Q2. Appraisal cap rates have also moved, but at a much slower pace, increasing from 3.5% in mid-2022 to roughly 4.0% in 2023 Q2. Meanwhile, the NCREIF capital value index has declined by 8.9% since peaking in 2022 Q3 and the one-year total return was a -5.1%. We expect valuations will continue to come down as the market adjusts to the current environment; the adjustments to valuations we are seeing today are in line with prior cycles as the private market usually takes six to eight quarters to fully adjust valuations. Thus, we expect valuations and returns will remain negative for the next couple of quarters before recovering in step with the expected improvement in fundamentals.

MULTIFAMILY

VACANCY RATE	5.0%
12-MONTH HISTORICAL TREND	
VACANCY CHANGE	↑
RENT	↑
ABSORPTION	↑
COMPLETIONS	↑
CAP RATES	↑
TRANSACTION VOLUME	↓

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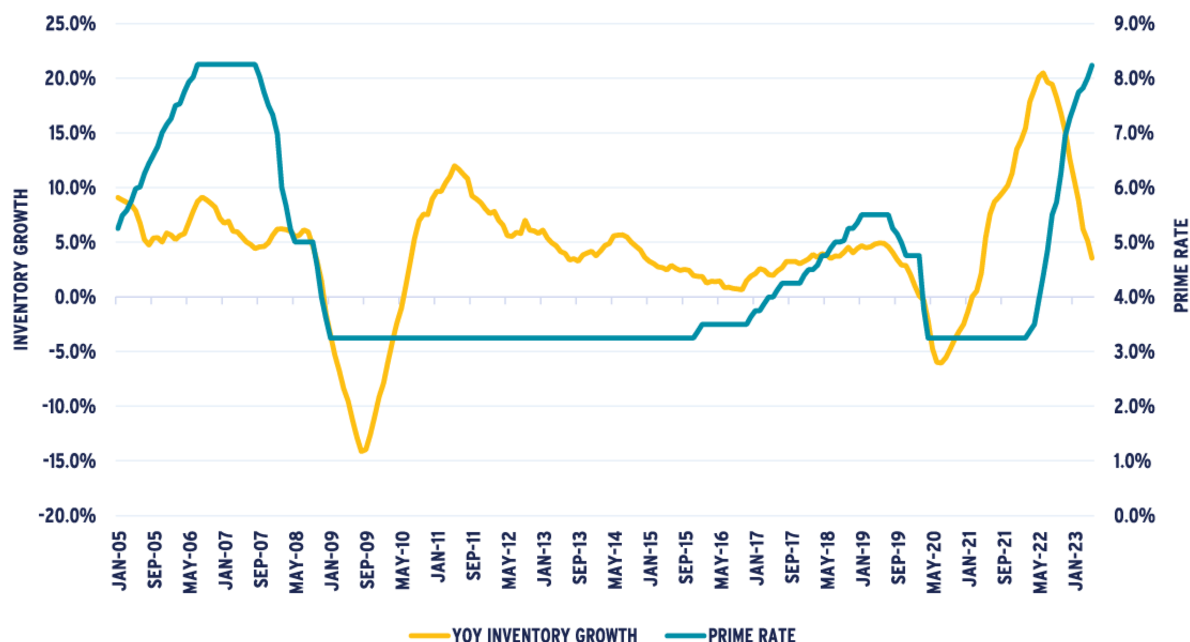
Industrial

The industrial market continued to moderate in the second quarter of the year. Availability in the sector increased for the fourth consecutive quarter, edging up 40 basis points (bps) to 5.8%. Overall, availability is now 120 bps above its mid-2022 low of 4.6%. Demand was roughly 4x the first-quarter tally but at roughly 32 million square feet (msf) demand was underwhelming and was roughly half the pre-pandemic five-year quarterly average (2015-2019). At the same time, supply remained elevated with just under 100 msf being completed in the quarter, well above the pre-COVID five-year historical average of 57 msf. Overall, the increase in supply has been driven by a surge in industrial property value over the last few years, which pushed values per square foot well above replacement cost; this, combined with cheap debt prior to the Fed's tightening, made development economically feasible and beneficial for developers and investors. This phenomenon has essentially come to an end, however, with the rise in interest rates and change in values. That said, a significant pipeline of properties underway still exists. Despite the continued uptick in availability, rent growth remained strong at 10.5% on a year-over-year basis (YOY), marking the sixth consecutive quarter of double-digit YOY gains.

Quarter over quarter (QOQ), only 19 markets reported flat or declining availability, while 56 markets reported an uptick in availability. Markets reporting the greatest increase in availability include Savannah (220 bps), Memphis (180 bps), Austin (170 bps), Fort Worth (150 bps), Indianapolis (140 bps), South Central PA (140 bps) and Salt Lake City (120 bps). The increase in availability in Savannah, Austin and Indianapolis is primarily the result of new supply while Fort Worth, Memphis, Salt Lake City and South Central PA were impacted by weak demand. Indeed, Memphis posted the largest drop in demand with net absorption totaling a negative 4.1 msf, surpassing Riverside's 4.0 msf of negative absorption. The uptick in availability in Riverside (80 bps) was significantly less than Memphis, however, as the Riverside market is 2.5x the size of Memphis. That said, since bottoming out post-COVID, Riverside has seen the largest run up in availability at 450 bps and, at 6.0%, availability is 20 bps above the 10-year historical average. Austin (2023 Q2 = 8.9%, 30 bps above average), Denver (8.2%, 100 bps), Indianapolis (7.5%, 70 bps), San Francisco (9.1%, 300 bps), and Seattle (6.7%, 80 bps) are the only other markets with availability above the long-term average. Instead, 69 markets still reported availability below average ranging from 30 bps below average to 560 bps below average. Generally, smaller secondary and tertiary markets are reporting the largest gap between the historical average and current availability rate. Among primary/gateway markets, Atlanta, Chicago, Miami and Northern NJ have availability still well below average ranging from 170 bps to 300 bps below average while the spread in Dallas, Los Angeles, and Orange County is more muted at 30 to 40 bps.

As noted above, the shift in fundamentals as of late is due to both moderating demand and continued construction. The slowdown in demand is being driven by both reduced imports and slower inventory accumulation. Per the Journal of Commerce, total monthly imports have posted double-digits declines on a YOY-basis since November 2022. Further, according to projections from NRF/Hackett Associates Global Port Tracker forecast, US imports through the end of 2023 will remain below year-ago levels as consumers grapple with the impact of still relatively high inflation, lower tax refunds and higher borrowing costs. Meanwhile, with respect to inventories, the supply-chain disruptions of the pandemic forced a surge in inventories coming out of the pandemic, with YOY inventory growth of 10%-20% monthly from late 2021 through January-2023. Inventory growth, however, peaked in mid-2022 and has been slowing since, dropping to single-digit territory in February and to only 3.6% in May. The slowdown in inventory accumulation is due to both higher interest rates and a more cautious stance among retailers with respect to the economic outlook. The 500+ bps increase in interest rates by the Fed has led to higher costs for businesses that finance their inventories. Indeed, the prime rate, the rate offered to businesses with exceptional creditworthiness, has risen to 8.25%, the highest rate since just before the Great Financial Crisis. Meanwhile, costs for businesses deemed less creditworthy are above the 8.25% prime rate.

FIGURE 10: INVENTORY GROWTH & BUSINESS BORROWING COSTS



Source: U.S. Census Bureau, U.S. Board of Governors of the Federal Reserve System

Given expectations for further slowing of imports and weaker inventory accumulation, demand will likely remain more modest in the coming quarters; however, this will likely be more of a return to normal levels relative to the post-pandemic surge. On the supply side, while construction activity slowed slightly in the second quarter, we believe this is likely a temporary reprieve as there is more than 416 msf underway with completion expected by year end. Thereafter, supply will slow substantially as there is only 125 msf underway for delivery after year end. Further, additional near-term groundbreakings should be modest given the current interest rate environment, the adjustment in values that is still expected and the moderation in fundamentals. Thus, availability will likely nudge higher in the near term. Importantly, while availability is likely to increase, it is still expected to remain relatively low and below historical averages in most markets. Thus, rent growth will remain positive, but will likely return to single-digit territory soon. Growth will remain above average (3.0%) in nearly all markets through 2026. Rent growth will likely normalize in 2027 and beyond; however, the 5-to-10-year outlook is still for average annual growth above 3.0% given the stronger near-term growth anticipated.

INDUSTRIAL	
AVAILABILITY RATE	5.8%
12-MONTH HISTORICAL TREND	
AVAILABILITY CHANGE	↑
RENT	↑
ABSORPTION	↓
COMPLETIONS	↑
CAP RATES	↑
TRANSACTION VOLUME	↓

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Retail

Retail market fundamentals remained strong in the second quarter of 2023. Total retail availability dipped to a new record low of 4.8%, down 10 basis points (bps) from 2023 Q1 and 20 bps year over year (YOY). Overall, since availability peaked in mid-2020, availability has improved by 280 bps; putting the market's performance in further perspective, availability is well below the long-term historical quarterly average of 7.4% (2005-2022). Currently, the total retail and industrial sectors are the only two major property types with availability below their long-term averages.

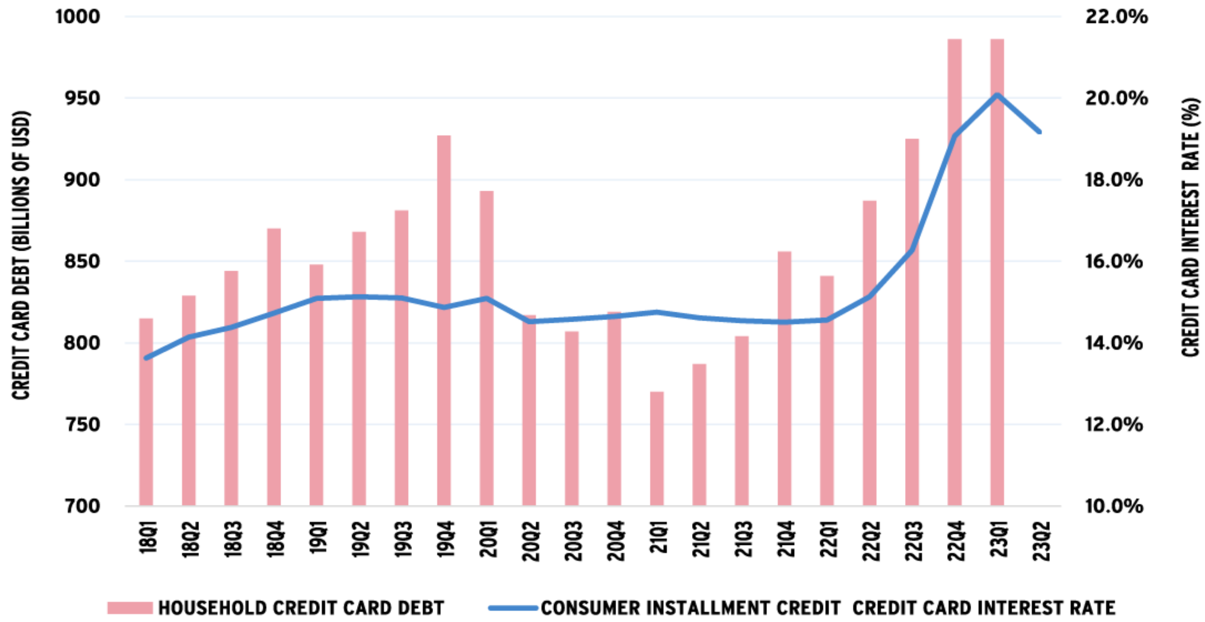
Within the retail sector, the neighborhood and community center (NCSC) and power center (PC) segments of the market continue to post availability rates below their long-term averages. In the NCSC segment of the market, availability dropped to 6.7% in the quarter, down 10 bps quarter over quarter (QOQ) and 30 bps YOY; availability in the subtype is now nearly 340 bps below the long-term average. Moreover, availability is 260 bps below the COVID high and is nearly half the post-GFC high of 13.1% (2011 Q2). Within the PC segment of the market, availability increased modestly in the quarter, edging up 10 bps to 5.3%, but declined YOY (-30 bps) and availability remains exceptionally low at roughly 120 bps below the long-term average. The L&M segment of the market, which has continued to struggle, reported availability of 6.2% in the quarter, up 20 bps QOQ and roughly 120 bps above the long-term average. That said, the L&M segment of the market appears to be stabilizing, with availability remaining flat on a YOY basis and fluctuating within the narrow band between of 5.9% and 6.2% for the last six quarters.

Demand for retail space was positive in aggregate; however, the NCSC was the sole contributor to positive demand. Demand for PC and L&M space was slightly negative and was likely tied to the closure of Bed, Bath and Beyond. With limited availability, we fully expect the former Bed, Bath and Beyond space will be absorbed in short order. Meanwhile, there has been positive leasing among a broad array of retail categories and among all space sizes, although activity has been greatest in the spaces under 3,000 square feet. Per CoStar, fast casual restaurants and cellular retailers have driven small-space leasing, with Starbucks, Crumbl Cookies, Yum Brands (KFC, Pizza Hut, Taco Bell and The Habit Burger Grill), Restaurant Brands International (BK, Tim Hortons, Popeyes, and Firehouse Subs), T-Mobile, and AT&T all signing leases in the smaller square-footage category. Within the medium to larger-sized space category, Dollar Tree, Dollar General (including their new pOpshelf concept), TJ Maxx and Burlington have continued to sign leases while fitness, entertainment or experiential concepts have been taking space in the over 10,000 sf category. Not surprisingly, given still-high inflation, higher interest rates and a more cautious consumer, growth has been concentrated among tenants offering a lower price point to consumers.

Indeed, retail sales and food service growth started moderating at the end of 2022. Retail sales advanced only 1.5% YOY in 2023 Q2 versus 4.9% in 2023 Q1 and 7.0% in 2022 Q4. Growth is expected to remain moderate through 2024 Q1, ranging from 1.0% to 1.5% each quarter on a YOY basis. Putting this in perspective this is down from the average annual growth of 4.0% in the three years leading up to COVID. Sales growth is expected to accelerate again in 2024 Q2 and beyond, reaching more normalized YOY growth in 2025. Meanwhile, retail sales excluding autos and food services are expected to slow to just under 1% in 2023 Q3, a decline of 0.1% in 2023 Q2 and 2023 Q3 on a YOY basis. The weakest sectors are projected to be furniture, building suppliers, jewelry, electronics and clothing. Grocery is expected to continue to grow in each quarter with the exception of 2023 Q4 when sales are projected to be flat YOY.

Part of the slowdown in sales growth is likely tied to the state of consumers' balance sheets. While many consumers have the advantage of low mortgage rates locked in, variable rate loans, i.e. credit cards and home equity loan rates, have soared and monthly payments are likely cutting into spending. Indeed, household credit card debt has reached a record high both in aggregate and on a per-household basis. At the same time debt has been expanding, the average consumer installment credit card interest rate has increased from under 15% in 2021 to roughly 20% in the first half of 2023. Given the outlook for retail sales and the current state of consumer balance, we expect L&M performance, relative to NCSC and PC performance, will remain more moderate. Instead, properties with tenant concentrations in food, necessity and off-priced goods in open-air formats are expected to outperform in the near term.

FIGURE 11: THE IMPROVEMENT IN CONSUMER BALANCE SHEETS DURING COVID HAS EVAPORATED AT THE SAME TIME CREDIT CARD INTEREST RATES HAVE SOARED



Source: U.S. Board of Governors of the Federal Reserve System (FRB)

RETAIL	N&C SHOPPING CENTER	LIFESTYLE & MALL	POWER CENTER
AVAILABILITY RATE	6.7%	6.2%	5.3%
12-MONTH HISTORICAL TREND			
AVAILABILITY CHANGE	↓	↔	↓
RENT	↑	↓	↔
ABSORPTION	↑	↓	↓
COMPLETIONS	↓	↓	↓
CAP RATES	↑	↑	↑
TRANSACTION VOLUME	↓	↓	↓