AEW RESEARCH

U.S. Economic & Property Market Perspective

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AEW

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2022 Cold War 2.0

"Cry 'Havoc!' and Let Slip the Dogs of War"

-Julius Caesar Act 3, Scene 1

Dr. King's observation that the moral arc of the universe is long but bends towards justice has been tested many times since first shared[1] and Russia's invasion of Ukraine once again elongates this arc. In the near-term, the economic and political outlook will undoubtably be negatively impacted. Food and energy prices are and will be higher and the specter of global food insecurity becomes more likely each day Ukraine is unable to plant its spring crop. Uncertainty and volatility, the bane of investors everywhere, are and will be elevated for quite some time to come. The post-Cold War, rules-based liberal democratic order that so many of us take as certain is diminished and the previously near-ubiquitous free movement of people, goods, capital and, most importantly, ideas that most of us have enjoyed has been degraded.

The rapidity of this change is both jarring and profound, particularly for anyone who did not live through the earlier Cold War period of near continuous proxy war (but rarely direct conflict) between the Soviet Union and its client states and the United States and its democratic allies. Conflicts can, of course, be resolved, and treaties can be negotiated. Life can return to a degree of normality, but it would be a new normal debased by the havoc let loose by Russia and the suffering and loss endured in Ukraine and beyond. Memories are long and grievances fester. Forgiveness is fleeting and reparations, if any, seldom suffice.

Even before the possibility of a land war in Europe emerged, 2022 was going to be a year of significant change and transition. The global pandemic has been evolving towards rolling regionalized endemic for some time and this is the year of broad public acceptance of learning to live with COVID without draconian activity restrictions. Similarly, this is the year where extraordinary fiscal and monetary policy support designed to offset the pernicious negative impacts of COVID-19 was set to recede.

Against this backdrop, and now shrouded by the fog of war, conventional macroeconomic forecasting is difficult at best. Growth this year is certain to be slower than it would have been, and the risk of recession is undoubtably greater in turn. Elevated inflation, particularly those aspects of inflation directly related to pandemic-induced supply disruptions will persist longer than they might have, especially food and energy price inflation now impacted directly by the war. All this compounds the policy dilemma facing the Federal Reserve and other central banks around the globe – how quickly to normalize borrowing rates and balance sheets without tipping economies into recessions and how best to do this amidst the uncertainty and volatility of war.

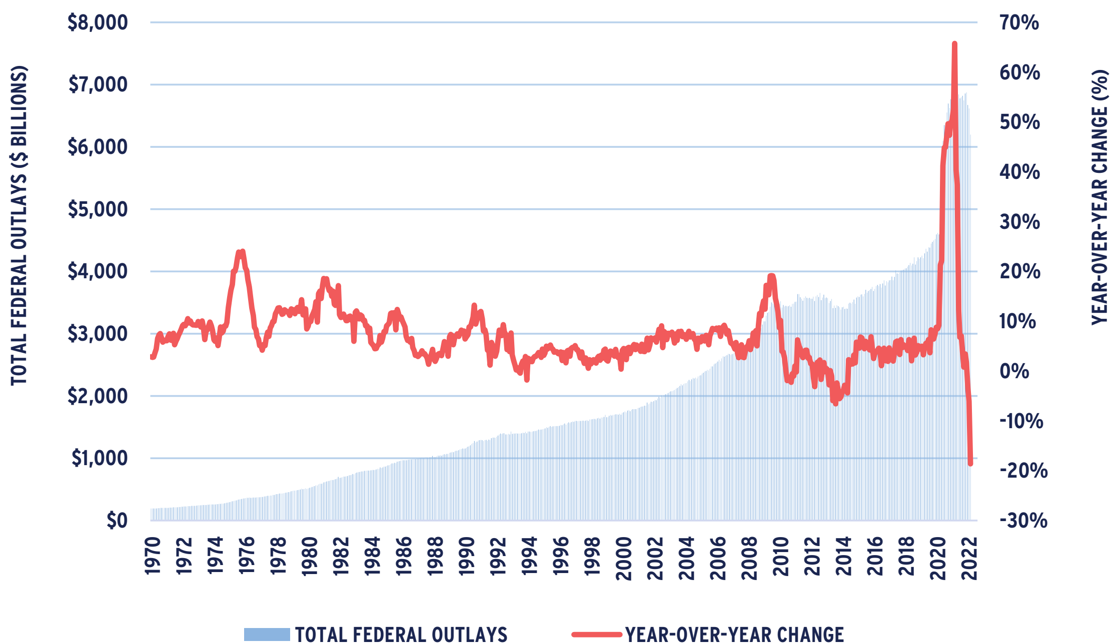
[1]Dr. Martin Luther King Jr., "Remaining Awake Through a Great Revolution." Speech given at the National Cathedral, March 31, 1968.1

U.S. Economy

Following the staggering economic contraction of 2020, the sharpest since the 1930s, the U.S. economy, bolstered by unprecedented fiscal and monetary policy support, roared back during 2021, recording the fastest year-over-year growth in real GDP since 1950 and the largest single-year job increase/recovery ever. For the year, real GDP grew 5.5% (Q4/Q4), the fastest growth rate since 1984 and total employment increased/recovered by 6.5 million jobs, the largest one-year increase since World War II. Growth did slow sharply during the first quarter of this year, in part as a result of significant growth in imports in response to supply chain challenges and inventory drawdown during 2021[2].

Leaving aside the first quarter GDP report, rapid economic recovery has been driven by unprecedented levels of direct government spending, transfer payments to individuals, families and businesses, amplified, of course, by unbridled money creation by the Federal Reserve and other central banks and, with respect to the fiscal portion of this recovery elixir, a reversal is already well underway. Total federal government outlays reached a rolling 12-month all-time peak of $7.6 trillion in March 2021 and has since declined by nearly 20%. For perspective, prior to the pandemic, 12-month aggregate federal government spending was approximately $4.5 trillion.

FIGURE 1
TOTAL FEDERAL GOVERNMENT OUTLAYS OVER THE PRIOR 12 MONTHS



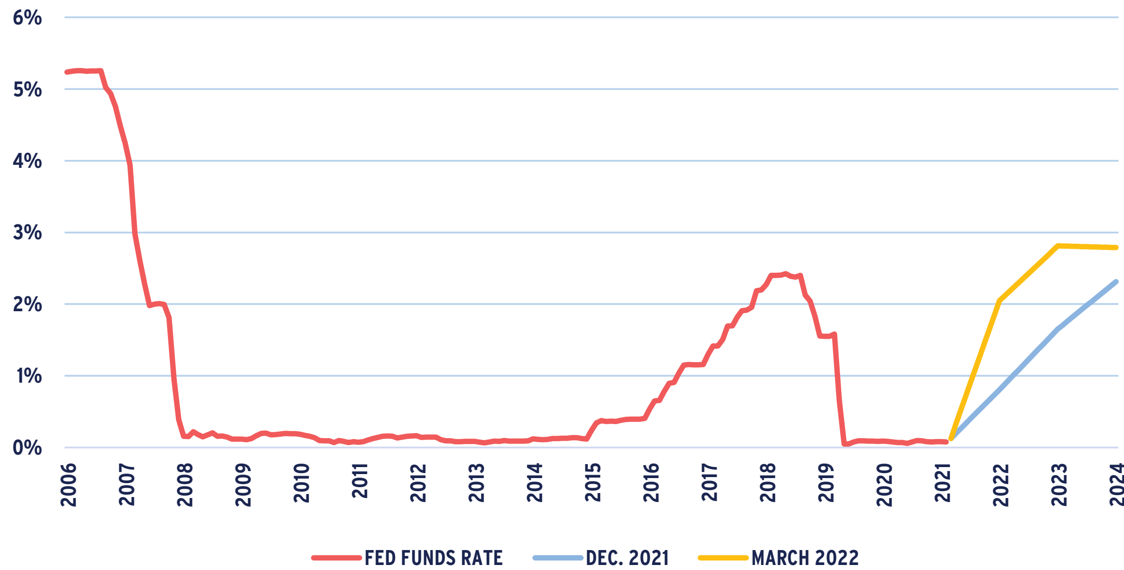
Source: Bureau of Economic Analysis

In March, the Federal Open Market Committee (FOMC) revealed an accelerated expected pacing of future short-term interest rates as compared with their December 2021 assessment. The Fed's current so-called "Dot Plot," the path of future rate increases shows the Fed's overnight borrowing rate (Fed Funds), moving up

[2] The preliminary estimates of 2022 Q1 GDP growth was -1.4% (annualized)

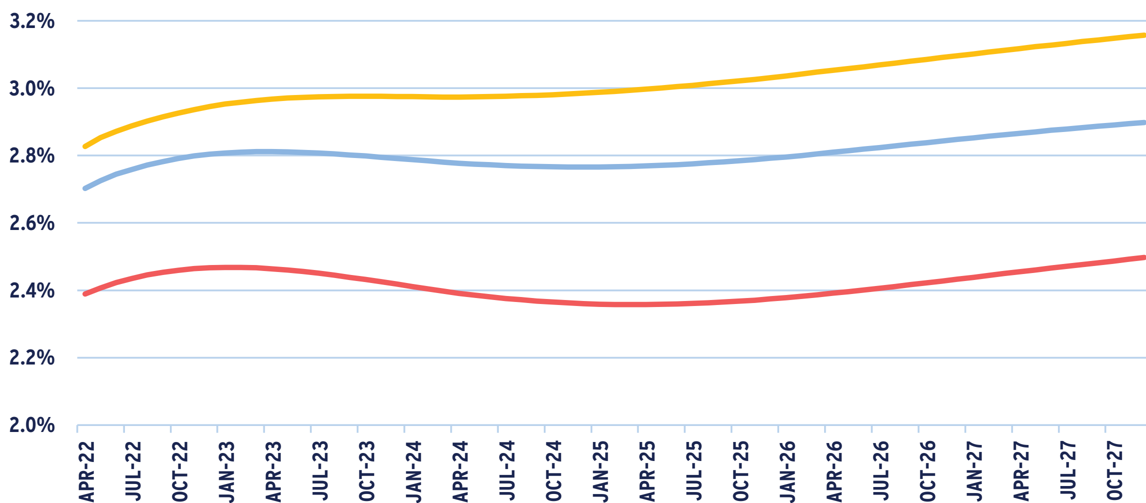
quickly over the balance of this year, reaching 2% by year-end and moving slightly above the previously targeted terminal rate of 2.5%. Bond investors have reacted to the revised guidance by quickly moving long rates back to pre-pandemic levels with the 10-year Treasury yield hovering nearing 3%. More importantly, the market's implied forward yield now suggests benchmark Treasury yields remaining above 3% for the foreseeable future, an increase of approximately 50 basis points over just a few weeks.

FIGURE 2
FEDERAL RESERVE SHORT-TERM INTEREST RATE GUIDANCE



Source: Federal Reserve

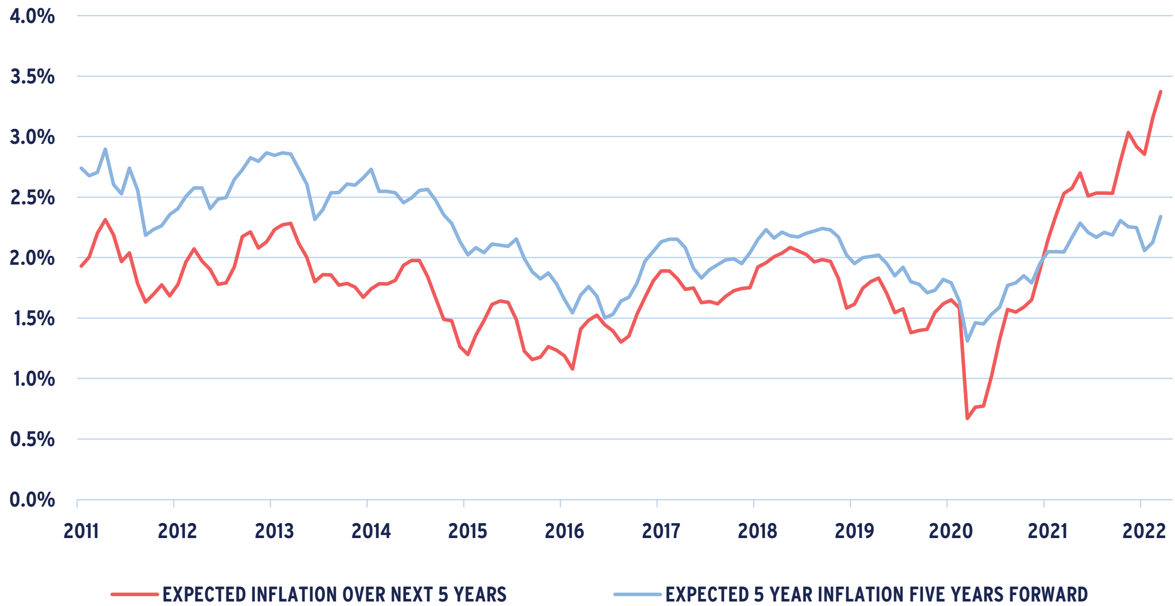
FIGURE 3
EXPECTED FUTURE INTEREST RATES



Source: Chatham Financial

Bond investors also appear to remain convinced that elevated inflation is likely a near-term, not long-lasting, condition but their faith is weakening. Current pricing suggests investors collectively expect average annual inflation over the next five years of approximately 3.5%, a sharp departure from the 2% or less inflation expectation over most of the past decade. Current pricing also reveals that this higher expected inflation is largely frontloaded into 2022 and 2023 with expectations reverting to current Fed policy target inflation of slightly more than 2% over the following five years, consistent with earlier Fed guidance of targeting inflation of 2% over an entire business cycle.

FIGURE 4
EXPECTED INFLATION

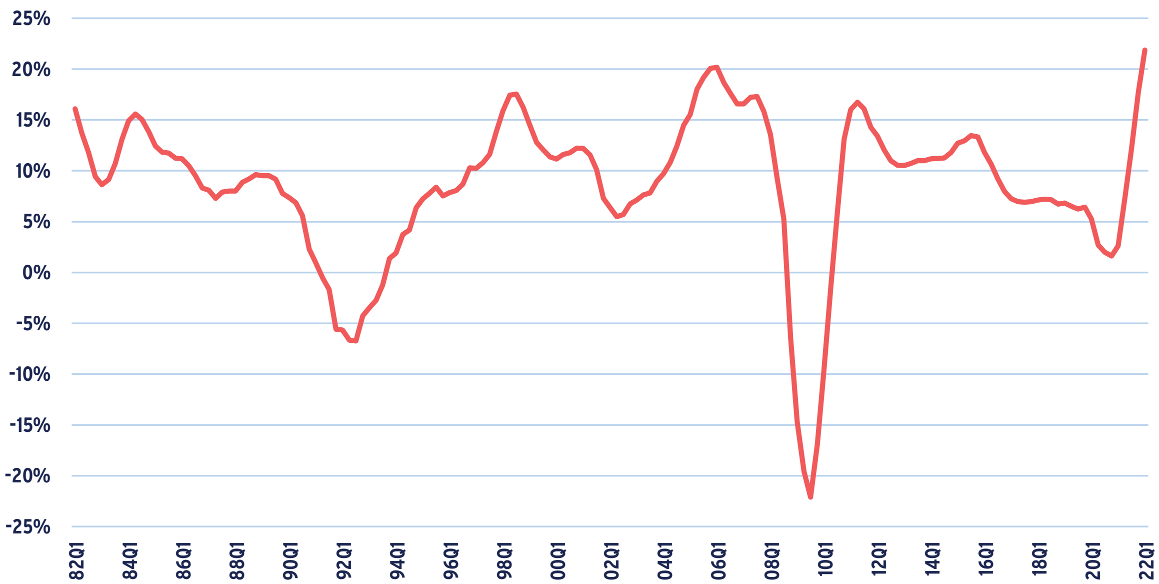


Source: Federal Reserve

U.S. Commercial Property

Led by unprecedented capital appreciation in the industrial property sector and, to a lesser extent, apartments, U.S. commercial property, as measured by the NCREIF Property Index (NPI) posted the greatest four-quarter total return of the past 40 years as of 2022 Q1. Indeed, the average institutionally owned industrial property recorded a four-quarter increase in value of more than 46%, the largest four-quarter gain of any property sector in any four-quarter period since the inception of the index in 1978 and more than twice as large as the next greatest increase of any property sector over any four-quarter period. To this point, the average apartment property recorded four-quarter capital appreciation of nearly 20% over the same period, again larger than any other four-quarter movement in any property sector prior to the past year.

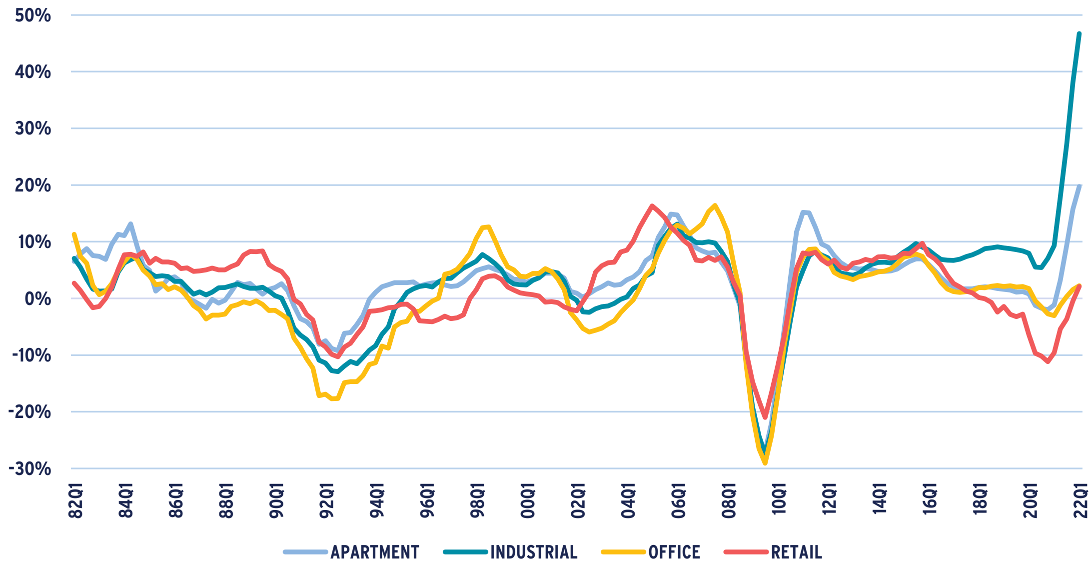
FIGURE 5
NCREIF PROPERTY INDEX (NPI) FOUR-QUARTER TOTAL RETURN



Source: NCREIF

In the case of industrial property, strong NOI growth over the prior four quarters was dwarfed by the impact of compressing capitalization rates. For the four quarters ending 2022 Q1, 100 basis points of compression in the average industrial cap rate accounted for three fourths of the outsized appreciation while average NOI growth of more than 12% accounted for roughly one quarter. In contrast, the four-quarter appreciation in apartment properties was driven by NOI growth alone as average appraisal cap rates remained roughly constant over the period.

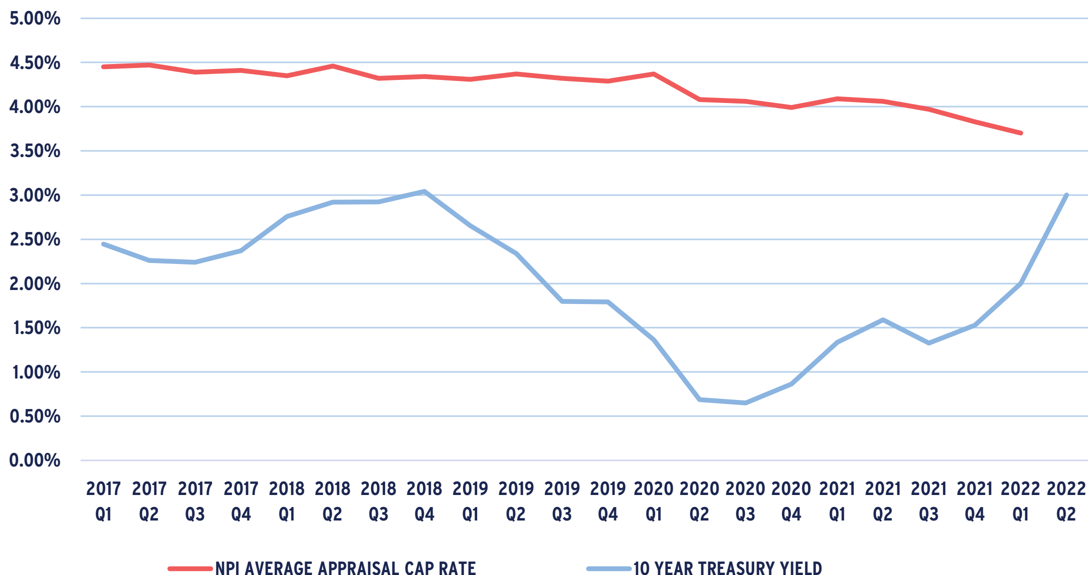
FIGURE 6
NCREIF PROPERTY INDEX (NPI) FOUR-QUARTER TOTAL RETURN BY PROPERTY TYPE



Source: NCREIF

Outsized investment performance, while always welcome, typically brings with it heightened investor go-forward concern. With the changes in the broader capital markets described earlier, the obvious question facing property investors today is how much and how quickly are property pricing metrics likely to change? While the second quarter is yet to be fully written, it is likely that Treasury yields will end up near or above 3%, roughly in-line with pre-pandemic levels, while average property yields (cap rates) are approximately 50 basis points below pre-pandemic levels. Assuming investors require comparable yield-spread going forward as compared to the period leading up to the pandemic, this suggests that property yields will eventually need to rise. Property yield expansion can, of course, happen in different ways -- values can decline relative to property net operating income (NOI), NOI can grow relative to values or some combination of the two. In many cases (not all), we find property market fundamentals (supply, demand, vacancy, etc.) to be highly supportive of continued robust NOI growth, but we also fully acknowledge the heightened recession risks that could disrupt these fundamentals.

FIGURE 7
AVERAGE NPI APPRAISAL CAP RATE AND 10-YEAR TREASURY YIELD



Source: NCREIF, Moody's Analytics

Recession risks aside, the differences in property sector and market performance that have widened over the past two years seem likely to remain widened for some time. Demand for all forms of storage and distribution logistics has increased significantly and the market struggles to meet this demand; vacancy rates are extremely low, and rents are rising at levels not previously seen in many locations. Housing costs (rents and prices) have soared as individuals and families have reassessed their location and tenure preferences and have moved accordingly. Local housing markets absorbing this diaspora are facing pressures previously not thought possible; again, with vacancy rates descending towards zero and rents escalating far beyond pre-pandemic peaks. Office tenants, normalized to two years of remote working, are returning but not fully and at greatly varying degrees depending on job function, industry and location. Retail centers, impacted to varying degrees by mandated or self-imposed consumer limitations are reviving but, again, at widely varying pacing.

Office

Office market vacancies inched higher in the first quarter after ending 2021 on a more positive note, but overall conditions remained sanguine. While every effort is being made to put the pandemic behind us, Omicron's impact and the evolution of new variants has weighed on employers' ability to implement return-to-work policies that will ultimately shape longer-term space needs. Office utilization (physical occupancy) ended the quarter at about 40% of pre-COVID levels, roughly where it stood at the end 2021. Indications and expectations are that utilization will rise more consistently going forward although it will likely vary widely by industry and market. The legal industry is already running at close to 70% physical occupancy, while the tech sectors have been lagging the aggregate. Tight labor markets are also likely playing a role in the narrative. Employees are pushing for more remote or flexible schedules while employers are becoming more accepting after what has been a two-year test run. All told, a more ubiquitous hybrid (remote/in-person) working model is evolving and resulting in lower office space needs per employee.

The velocity of leasing improved significantly through 2021 to about 80% of 2019 levels but dipped to ~70% in Q1 suggesting the recovery will have its bumps along the way. Sublease space is elevated and has not come down, pushing vacancies and availability rates higher in the first quarter after a pause last quarter. Office vacancies rose 20 basis points (bps) to 16.8% as new supply offset a small increase in net absorption (1.6 msf) in Q1 according to CBRE-EA. It remains to be seen if the increase in vacancies reflects an easing in return-to-work timeframes or something more structural. It's likely been a combination of both. Regardless, recent occupier surveys indicate more firms are anticipating a reduction in space needs per employee despite countervailing shifts in space use (e.g. away from densification and toward collaboration). Green Street estimates office demand will be 15% lower as a result with downside risk to that estimate. Sublease space was up again in the first quarter and the rise in sublease space suggests the process of reducing space has already begun with some companies deciding to downsize or move to a virtual environment. More broadly, office tenants appear to be taking a measured approach to making significant changes to their space needs at this juncture as the return-to-work dynamics continue to evolve. According to the brokerage houses, many companies have been extending leases short term (1-2 years) to put off the space needs decision. For those making a more definitive decision, the dynamics appear to be more skewed to reducing space in a renewal or move.

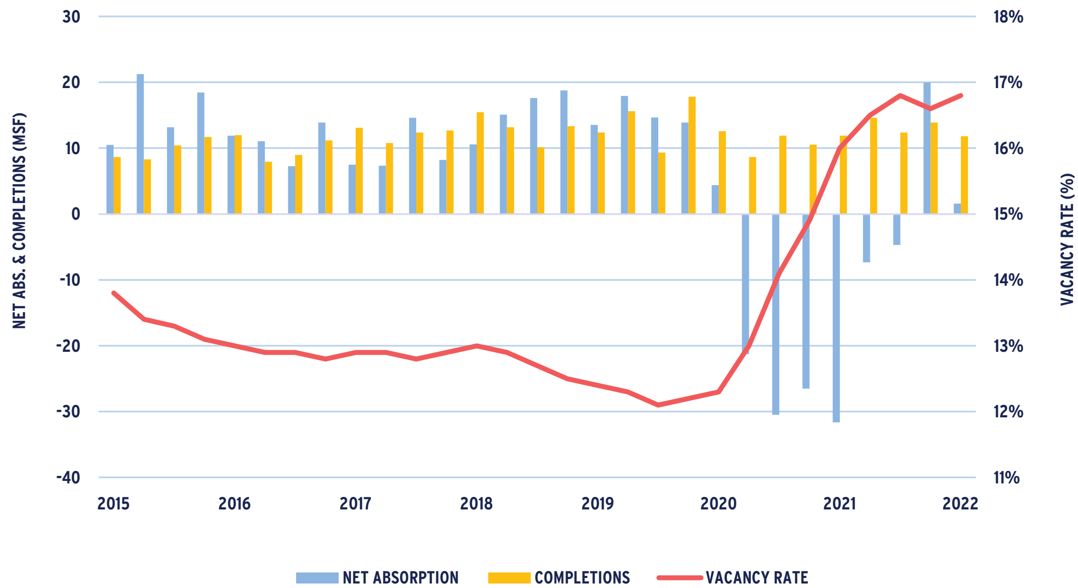
As noted last quarter, an encouraging sign is the relative strength of the underlying office employment picture. Traditional office-using jobs were expanding faster than overall employment prior to the pandemic and have been less impacted given the ability to work from home. As of March, traditional office-using jobs were 2.4% above the February 2020 peak while total employment remains ~1.0% below. The correlation between office-related employment and space demand is clearly shifting in real time as many employers integrate some form of hybrid work model adding uncertainty to the pace of office space demand growth longer term. The impact of these dynamics will likely become clearer as leases roll over the next few years.

At the metro level, office dynamics have varied but a few overriding trends have evolved. Downtown and suburban vacancies have converged with CBDs rising more dramatically over the past year although suburban markets have not been net beneficiaries. The sunbelt markets fared better despite new supply with all Florida markets seeing 40-90 bps vacancy declines along with Austin (-50), Charlotte (-40) and Nashville (-40). Other notable vacancy declines were Boston (-50) and San Diego (-20), both benefiting from strong life science demand, as well as Denver (-70). The bigger challenges were felt in the Gateway markets with Chicago (+70), San Francisco (+60), NYC (+60), Washington (+40) and LA (+30) all registering higher vacancies. Other notable increases were San Jose (+140) and Salt Lake City (+350) where declines in net absorption were compounded by new supply. In aggregate roughly one-third of the markets tracked by CBRE showed vacancy declines.

Overall, AEW Research reaffirms its belief that many companies will embrace a more fully integrated hybrid work model that will translate into a reduction in aggregate demand. That said, it will take time to play out as firms assess the impact of the shifting work model on productivity, profitability and the ability to retain talent. We are seeing this

translate into a skewed demand for quality space and location premiums that often show up at this point in the cycle along with other dynamics outside of the pandemic like ESG. Commodity and Class B office space will likely be more challenged. We are just now seeing employees physically returning to work and it will be interesting to see the dynamic unfold over the next couple of quarters.

OFFICE MARKET FUNDAMENTALS: VACANCY INCREASES MODERATE



Source: CBRE-EA

OFFICE	
Vacancy Rate	16.8%
12-Month Historical Trend	
Vacancy Change	↑
Rent	↓
Absorption	↑
Completions	↔
Cap Rates	↓
Transaction Volume	↑

Source: CBRE-EA, RCA and NCREIF.

Apartment

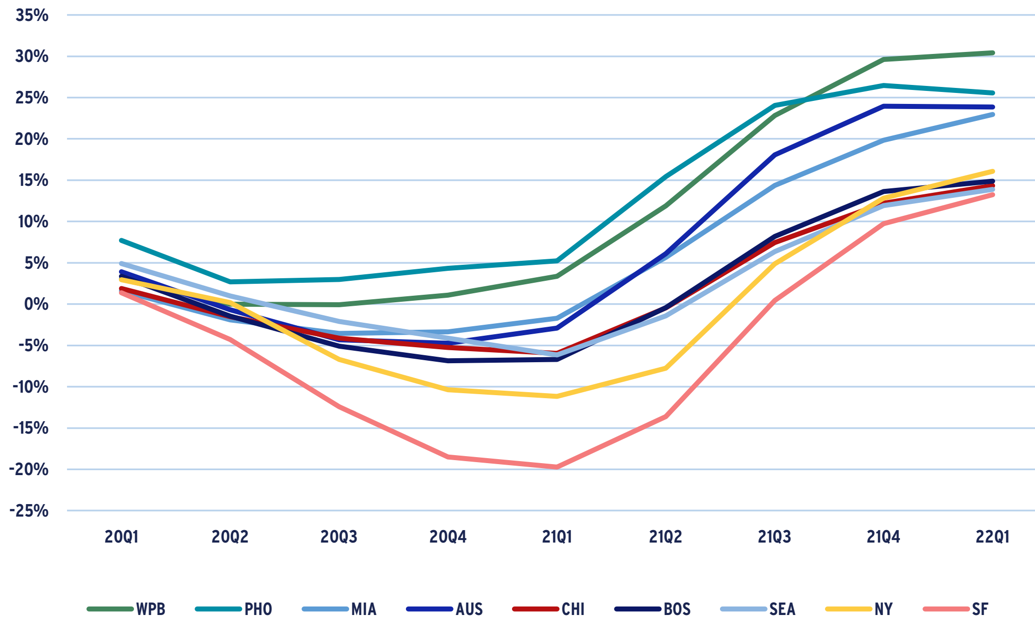
The apartment market has more than fully recovered with another stellar performance in 2022 Q1. Per preliminary data from CBRE-EA, vacancies dropped to a record low of 2.3% in the quarter, down 20 basis points (bps) quarter-over-quarter (QOQ) and 150 bps year-over-year (YOY). The strong quarterly performance was driven by the net absorption of nearly 96,500 units; this was nearly 3x the average first-quarter demand over the previous five years. Meanwhile, roughly 66,400 units were completed in the quarter, roughly in line with the quarterly average over the previous five years, but approximately 35% above the typical Q1 deliveries. Still, supply has been stable over the previous five years, with the four-quarter completion rate ranging from 1.7% to 1.9% and averaging 1.8%; demand has eclipsed this, with net absorption as a share of inventory averaging 2.0%. Not surprisingly, given the strong 2022 Q1 performance, effective rent advanced 15.5% YOY, a record increase.

Regionally, the number of markets reporting vacancies less than 2% increased to 17, up from 13 markets in 2021 Q4. Meanwhile, an additional 42 markets reported vacancies between 2.1% and 3.0%, up from 26 markets last quarter. Overall, 30 markets reported historically low or near historically low vacancies (within 30 bps) in the quarter. Of note has been New York's late but rapid recovery. In 2022 Q1, vacancies improved to 1.5%, down 50 bps QOQ and 340 bps YOY. Putting New York's recovery in further perspective, pre-pandemic, New York had the lowest vacancy rate in the nation at 2.4% (2020 Q1); with the onset of the pandemic, vacancies rose to 4.6% (2021 Q2). The increase in vacancies had the market dropping from the lowest vacancy rate in the nation to the 29th lowest rate in the nation (or the 21st highest rate). While other markets began their recovery in mid-2021, the New York recovery was delayed. By 2021 Q2 and 2021 Q3, vacancies in New York were the 15th highest in the nation at 4.3% and 3.1%, respectively. While people may be reluctant to return to the office, they are very clearly returning to urban markets. The recovery in New York has been echoed in Houston, San Francisco, Miami, Dallas and San Jose, which have reported some of the largest contractions in vacancies post-pandemic.

The rapid recovery over the previous two quarters has prompted the start of a recovery in rents. On a YOY-basis, rents in New York advanced 16.1%, the largest annual rent gain ever reported in the market and outpacing the 15.5% gain nationally. Further, rents in the city surpassed their pre-pandemic level in 2021 Q4 and are 3.1% above the 2020 Q1 pre-pandemic level. Likewise, Houston, San Francisco, Dallas and San Jose all reported strong double-digit rent growth, ranging from 13.3% to 14.3%. More specifically, urban core submarkets in Boston, San Francisco, Austin, Washington, DC, and Seattle have reported some of the largest rebounds in effective rents, ranging from over 40% in the Intown Boston submarket to 30% in Downtown Seattle. While the urban market recovery and rent growth has been impressive, the sunbelt region has been a clear winner from a broad-market perspective. Rent growth in many sunbelt markets ranged from 20%-30% YOY in 2022 Q1 and this was a clear acceleration from just six months ago. West Palm Beach led the way with rent growth of 30.4%, while Tampa, Orlando, Fort Lauderdale, and Phoenix had rent growth between 25% and 30%; Austin, Las Vegas, Miami, Raleigh, Nashville, Salt Lake City and Atlanta had rent growth between 20% and 25%.

Going forward, demographics remain overwhelmingly supportive of apartment demand. Young adults, who returned home to their parents in record numbers during the pandemic, have begun to reverse course and once again establish their own households. Some estimates portend that this will ultimately yield 750,000 new households or the equivalent of 2.5 years of supply. Further, rising mortgage interest rates will work to delay homeownership in the near-term. Thus, we expect rent growth will be strong and above trend growth again in 2022. Urban core markets, which lagged in recovery, will continue to catch up to other markets. We continue to project effective rent growth between 8%-10% in San Francisco, New York, Oakland, San Jose, Boston and Seattle and effective rent growth above 6% in Los Angeles, Chicago and Washington, DC. Growth in the Southeast and Southwest will moderate from a breakneck-pace of 20%+ in 2021 to 5%-7% in 2022. Midwest markets like Cincinnati, Cleveland, Columbus, St. Louis and Indianapolis will underperform relative to other markets; however, with expected rent growth between 3% and 4%, these markets will still be above trend. Overall, the above-average near-term growth in all markets is further supported by the strong home price appreciation recently. Apartment rent growth tends to follow home price appreciation by 12-18 months.

YEAR-OVER-YEAR EFFECTIVE RENT GROWTH FOR SELECT MARKETS



Source: CBRE-EA

APARTMENT	
Vacancy Rate	2.3%
12-Month Historical Trend	
Vacancy Change	↓
Rent	↑
Absorption	↑
Completions	↔
Cap Rates	↔
Transaction Volume	↑

Source: CBRE-EA, RCA and NCREIF.

Industrial

In the first quarter of 2022, the industrial property sector continued to set new record lows for availability as a result of robust demand for the sector that has eclipsed solid levels of new supply. The national average availability rate stood at 4.8%, down 10 basis points (bps) from the prior quarter and down 130 bps from the prior year. This pushed availability to a new historical low for the fourth consecutive quarter. The national availability rate stands 450 bps below the quarterly historical average of 9.3% (tracked since 1989 Q1). This quarter, 76.3 million square feet (msf) were absorbed, outpacing the healthy completions of 69.0 msf. New supply was down by 27% this quarter compared with the previous quarter, which had reported the highest quarterly completions in over two decades with 94.9 msf delivered (a record since the 104.6 msf delivered in 2000 Q4). With declining availability, a reduced level of completions, and significant demand, rising rents have followed. In 2022 Q1, the CBRE-EA rent index reached a record high of $8.99, up 10.0% year over year (YOY).

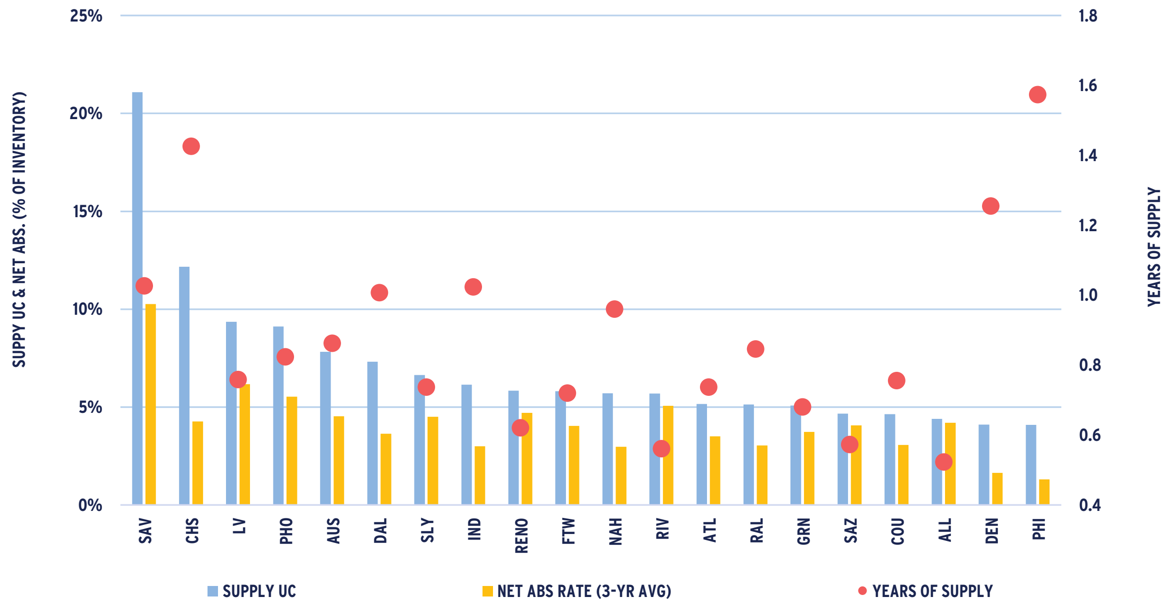
When narrowing in on the individual markets, national trends played out in a majority of the metros this quarter as the availability rates of most markets maintained their record lows or even saw decreases. Of the 69 major industrial markets tracked by CBRE-EA, 36 markets reported availability decreases from the prior quarter, while four markets maintained their fourth-quarter availability. Of the set that had decreasing availability, the average improvement reported was -50 bps. Some of the industrial markets that reported the largest decreases in availability from the prior quarter were Columbus (-140 bps), Charleston (-130 bps), Wilmington (-130 bps), Hartford (-110 bps), El Paso (-100 bps), and San Jose (-100 bps). Some of the markets reporting the tightest 2022 Q1 availability include Riverside (1.6%), Albuquerque (2.0%), Salt Lake City (2.0%), Los Angeles (2.1%), Charleston (2.2%), Columbus (2.3%) and Las Vegas (2.3%).

Additionally, supply pipelines, while active, have been unable to provide enough supply to meet robust demand. In the 37 markets that reported demand outpacing supply, the gap between demand and supply averaged 1.0 msf, with the largest gap being Columbus where net absorption exceeded supply by 4.2 msf. Demand has been broad-based with e-commerce, brick-and-mortar retailers and third-party logistics providers taking up space in the quarter.

Going forward, Amazon has announced it would slow its pace of leasing, driven in part by labor shortages, in 2022. That said, some of the reduced demand from Amazon will likely be offset by the shift towards just-in-case inventory management from just-in-time inventory management and reshoring of manufacturing activity; both of these changes have been anticipated and anecdotal information from the market suggests demand is already responding as a result of these factors.

Meanwhile, on the supply side, increasing inflation, shortages of labor and materials and rising debt costs will likely temper construction activity. Further, based on supply currently underway by market, there are very few markets with more than one and a half years of supply underway, based on the average demand over the past three years. Markets with the greatest supply underway as a share of inventory include Savannah (21.1%), Charleston (12.2%), Las Vegas (9.4%), Phoenix (9.1%) Austin (7.8%), Dallas (7.3%) and Salt Lake City (6.6%) and Indianapolis (6.1%). While the Savannah, Charleston, Las Vegas and Phoenix shares of construction underway are staggering, demand has been equally strong over the previous three years. Indeed, Savannah has absorbed 10.3% of stock per year on average, while Charleston, Las Vegas and Phoenix have averaged demand of 4.3%, 6.2% and 5.3%, respectively. The new supply underway is expected to be delivered over the next two years, assuming the demand pace remains similar to the past three years, the aforementioned markets have between 0.76 and 1.43 years of supply. With still-favorable supply and demand fundamentals expected, industrial will continue to outperform all other property sectors with robust near-term rent growth.

INDUSTRIAL SUPPLY REMAINS LOW BASED ON RECENT DEMAND TRENDS



SOURCE: CBRE-EA, AEW RESEARCH

INDUSTRIAL	
Availability Rate	4.8%
12-Month Historical Trend	
Availability Change	↓
Rent	↑
Absorption	↑
Completions	↔
Cap Rates	↓
Transaction Volume	↑

Source: CBRE-EA, RCA and NCREIF.

Retail

The retail sector has continued to see progress towards recovery, but trends are specific to each retail subtype. Per CBRE-EA, in the first quarter of 2021, total retail had an availability rate of 5.3%, down 40 basis points (bps) from the prior quarter and down 120 bps year over year (YOY). Net absorption of 32.2 million square feet (msf) outpaced limited completions of 5.3 msf. Completions have slowed to a crawl, reaching the second-lowest quarter in national retail's history in terms of deliveries, just after the 5.3 msf completed in the first quarter of last year. Over the last two years, quarterly deliveries averaged just 7.9 msf; this is a sharp departure from the historical average of 20.1 msf. Per CoStar, 80% of deliveries this quarter were pre-leased, as developers have prioritized built-to-suit projects or smaller spaces in mixed-use developments. Even with decreasing deliveries, 2022 Q1 leasing activity of 63 msf is nearly recovered to the 67 msf of quarterly leasing activity recorded in 2019, another indicator of rebounding retail health.

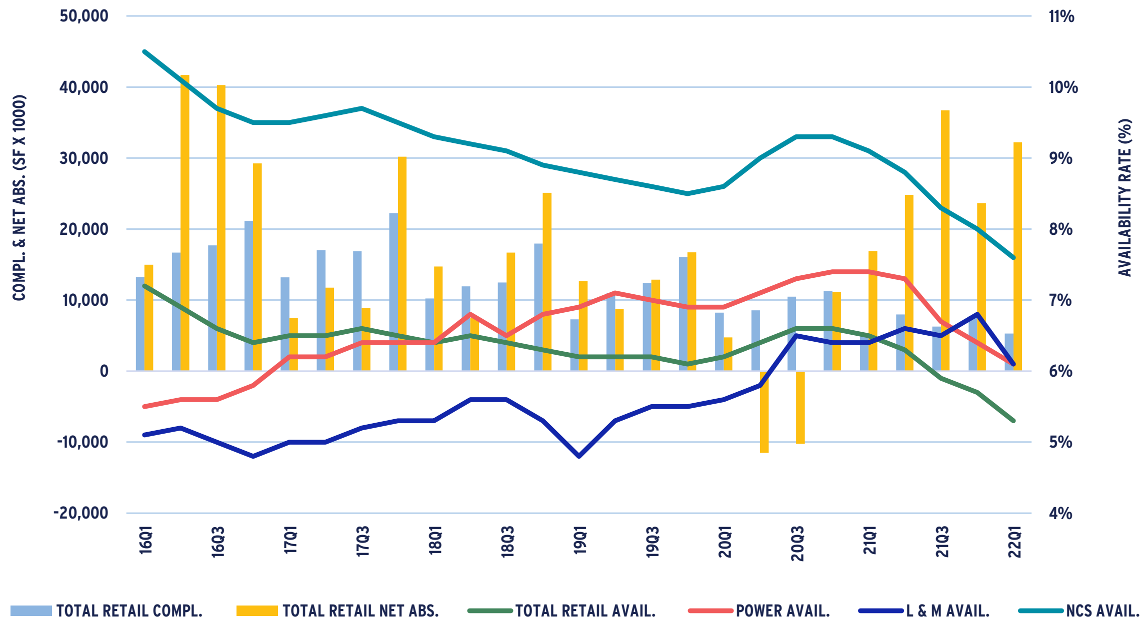
When narrowing in on the higher-performing neighborhood and community shopping centers (NCSC) subtype, the 2022 Q1 availability rate stands at 7.6%, down 40 bps on the quarter and down 150 bps YOY. Availability is at the second-lowest point in NCSC history, since it stood at 7.4% in 2004 Q4. The NCSC segment of the market has been resilient and has recovered from the effects of the pandemic; the current availability rate stands below the 8.6% reported in 2020 Q1. Rents are at a record high, with EA asking rents at $21.37/sf, up 2.2% YOY. Of the 64 markets tracked by CBRE-EA, 60 markets saw availability hold steady or decrease year to date, with that subset of 60 markets reporting an average decrease of 50 bps in availability. Some of the top improvements were seen in Albuquerque (-160 bps), Memphis (-140 bps), Northern New Jersey (-110 bps) and Austin (-100 bps). The four markets that saw NCSC availability increase this quarter were Louisville (10 bps), Orange County (30 bps), San Jose (30 bps) and Honolulu (70 bps). Tightening in availability rates comes as foot traffic has rebounded. Per Green Street, foot traffic at NCSC properties is now back to levels seen in 2019, supporting both sales and demand.

The Power Center subtype has also seen strong performance, with a 2022 Q1 availability rate of 6.1%, down 30 bps on the quarter and down 130 bps YOY. This is the lowest availability rate seen in over five years. Again, as seen in NCSC subtype, Power Center rents are currently at a record high, with EA asking rents of $24.79/sf, up 1.4% YOY. Year to date, 50 markets saw availability of their Power Centers hold steady or decrease, with an average decrease of 60 bps in availability. Jacksonville (-360 bps), San Francisco (-250 bps) and Portland (-210 bps) reported the most significant tightening in availability. Some of the largest availability increases were in Columbus (110 bps) and West Palm Beach (100 bps).

Unexpectedly, the more challenged Lifestyle & Mall (L&M) subtype saw improving availability in the first quarter. Availability, which peaked at a record high of 6.8% in 2021 Q4, declined to 6.1% in 2022 Q1, down 70 bps quarter over quarter and 30 bps YOY. Moreover, the 5.8 msf of net absorption reported in 2022 Q1 was the highest level of demand for the subtype in over a decade, since 7.3 msf were absorbed in 2005 Q4. This quarter's net absorption more than reversed the negative annual demand reported in both 2020 (-3.4 msf) and 2021 (-929,000 sf). Still, despite the good news, the L&M segment of the retail sector remains the most challenged with foot traffic for the subtype lagging. Per Green Street, mall foot traffic remains down roughly 10% from pre-pandemic levels, partially resulting from slowed international tourism and concerns about virus spread due to the Omicron variant. Given the still soft conditions, the 2022 Q1 EA asking rent of $33.97/sf remains below the peak rent of $34.41 seen in 2019 Q1.

The improvements to total retail are benefits of a recovering national economy. As of March 2022, the national unemployment rate was 3.6%, essentially recovered to the pre-pandemic levels. Pent-up demand has supported retail sales and consumer spending into this year but shrinking consumer confidence and rising inflation may curb these trends moving forward. While disposable income had been up due to pandemic-related government transfers, higher prices, particularly for gas, may reverse this. On the positive side, per Morning Consult, e-commerce has seen some stabilization after the increases spurred during the pandemic. There were limited changes in frequency of online shopping from April 2021 to January 2022, hinting at a current plateau. Going forward, the biggest concerns for the retail sector remain competition from e-commerce as well as new threats to consumer spending.

RETAIL MARKET FUNDAMENTALS



Source: CBRE-EA

RETAIL	N&C SHOPPING CENTERS	LIFESTYLE & MALL	POWER CENTER
Availability Rate	7.6%	6.1%	6.1%
12-Month Historical Trend			
Availability Change	↓	↓	↓
Rent	↑	↔	↑
Absorption	↑	↑	↑
Completions	↓	↓	↔
Cap Rates	↔	↔	↑
Transaction Volume	↑	↑	↑

Source: CBRE-EA, RCA and NCREIF.

Capital Markets

Transaction volume remained strong in the first quarter of 2022, with $170.8 billion in properties changing hands. Total volume increased 56% on a year-over-year (YOY) basis and was 37% higher than the first-quarter average from 2018 to 2020. Apartment transaction volume accounted for 37%, or $63.0 billion, of total volume. The share of volume was flat YOY, but overall dollar volume was up 56.4%. Both office and industrial accounted for roughly 20% of all transactions, office trades were up nearly 60% YOY while industrial volume was up 50%. The largest increase in sales volume, however, was in the retail sector. Roughly $18.6 billion in properties changed hands, up 102% YOY and the share of trades increased to 11%, up from 8% in 2021 Q1. Of note, the 2022 Q1 retail transaction volume exceeded the average first-quarter volume over the previous three years by 37% and outpaced the five-year average by 17%. Hotel activity also significantly recovered with sales volume increasing 71% over the year, jumping to nearly $11 billion. The only laggards were the seniors housing and health care sectors, where volume dropped 48% YOY to $2.1 billion. The seniors transaction volume was the lowest since 2020 Q2 and was half the typical first-quarter volume.

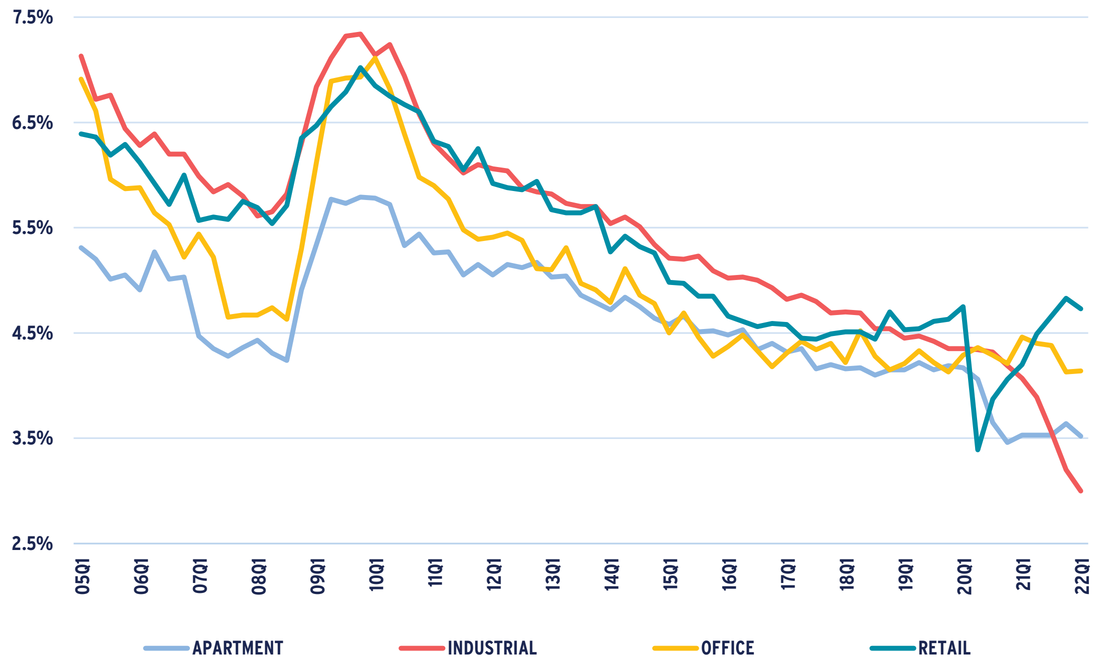
With strong transaction volume, real estate prices continued to climb on a year-over-year basis, increasing 17.4% in March as measured by Real Capital Analytics repeat sales index (CPPI). However, the increase in interest rates has had an impact on the market. Indeed, with the 10-year Treasury rate increasing nearly 50 basis points over the course of the month, anecdotal reports of properties being re-traded due to the rise in interest rates and the corresponding change in lenders' term sheets have begun to emerge. As such, it is not surprising that on a month-over-month basis, the CPPI fell 0.4%, the first monthly decline since mid-2020, during the height of the pandemic. Retail and suburban office were, however, the only property sectors reporting a monthly decline in pricing, dropping 0.7% and 0.2%, respectively. The softness in both sectors is likely due to the more moderate rent growth expectations for these sectors, a factor that could weaken values in a rising cap rate environment.

As referenced earlier, the NCREIF property index one-year return surged to 21.9%, the highest return ever reported since NCREIF began publishing their data in 1978. The industrial and apartment sectors outperformed once again. The one-year industrial return was a staggering 51.9%, led by appreciation of 46.7% and an income return of 3.9%. The industrial appreciation and total return set yet another record in the quarter. Likewise, the one-year apartment return was also record-breaking in the quarter, totaling 24.1%, driven by appreciation of 19.8%. Retail and office returns were also quite healthy, albeit significantly below the performance of the industrial and apartment sectors. The one-year total retail return was 7.1% with capital appreciation of 2.1%, positive for the first time since the pandemic began. The one-year retail income return accelerated to 4.9%, up from 4.7% in the previous quarter and only 3.9% in 2021 Q1. Finally, the office total return also accelerated to 6.8%, up from 6.1% in the previous quarter and only 1.3% a year earlier. The uptick in the total return was driven by a corresponding uptick in appreciation to 2.3% versus 1.6% in the previous quarter and depreciation of 3.0% a year earlier.

The investment market, despite some price adjustments associated with interest rate concerns, remains competitive and, as such, cap rates declined or were flat across all property sectors on a quarterly basis. The greatest quarterly compression occurred in the industrial sector where the market value-weighted cap rate declined to 3.0%, down from 3.2% in 2021 Q4. Apartments followed with cap rates declining 10 basis points (bps) on the quarter to 3.5% but generally flat over the past four quarters. Retail cap rate movement matched the apartment sector on the quarter, dropping to 4.7% from 4.8% in 2021 Q4 while office cap rates were flat on the quarter, remaining at 4.1%. On a year-over-year basis, retail cap rates are up 50 bps while office cap rates are down 40 bps.

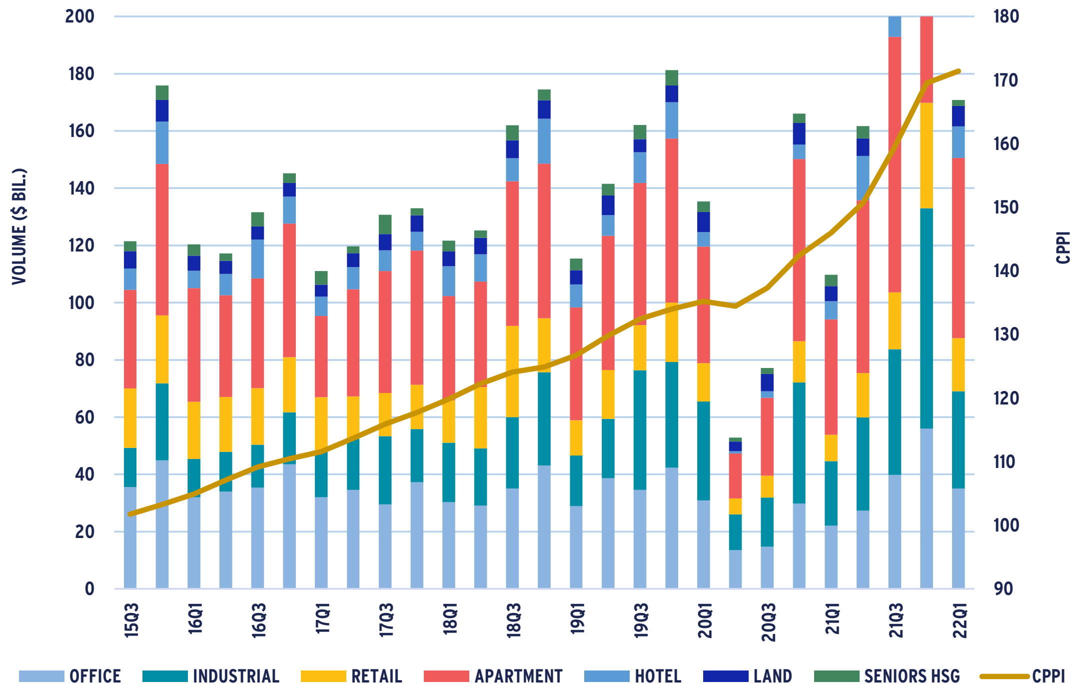
No doubt, the world has changed considerably since the beginning of the year. Inflation is higher and more persistent than expected, interest rates have moved quickly in response and the war in Ukraine has increased the risks to the previously upbeat outlook. Despite this, property markets remain very strong and, barring a significant recession, the outlook for fundamentals remains healthy. In an investment environment with greater risk, investors often seek dollar-denominated real assets and we expect dollars to continue to flow to U.S. property. At the same time, all investors are likely revisiting their underwriting assumptions across all asset classes.

NCREIF CAP RATES BY PROPERTY TYPE (MARKET VALUE BASIS)



Source: NCREIF

TRANSACTION VOLUME AND PRICING



Source: Real Capital Analytics