

U.S. Real Estate: A Modest Start to the Recovery

The first major real estate downturn since the GFC is almost over. Demand is rebounding modestly across most of the U.S. real estate market while supply continues to pull back. This backdrop is presenting select opportunities in the asset class—but near-term risks remain.

RESEARCH QUARTERLY



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Executive Summary

ECONOMY

- With a soft-landing materializing, a 50 bps rate cut in September signaled an end to an aggressive Fed hiking campaign.
- Despite tighter financial conditions, the demand backdrop remains supportive, although pockets of weakness are percolating.
- Near-term risks are front and center of investor minds—from political uncertainty to inflationary pressures and implications for the rate outlook.

PROPERTY MARKETS

- Transaction activity and valuation trends are bottoming as investors price in elevated base rates and risk premiums for the long-term relative to the pre-2022 era of unsustainably loose monetary policy.
- Demand is rebounding modestly across most of the major property types while supply activity continues to pull back, resulting in stabilizing vacancy rates.
- Financing is more available, but leverage is still not wildly accretive.

Economic Outlook

On September 18, the U.S. Federal Reserve (Fed) marked an end to its most recent rate hiking cycle with a “jumbo” cut of 50 basis points (bps). Public equity markets responded emphatically with the Russell 2000 up by 7.7% over the last three weeks of the month.¹ Movements in real estate pricing were more subdued, however, even though investors also anticipated the end of the property market downturn. The NFI-ODCE index, based on appraised values, depreciated by 0.8% over the third quarter but is down 11.0% over the past year.² Most investors expect core prices to stabilize within one to two quarters. Uncertainty still characterizes the near-term political and economic outlook. A very contentious election season and tight presidential race have voters as well as investors on edge. Additionally, recent employment, GDP, and inflation data suggest that price pressures may not be fully contained as economic activity remains resilient.

Broader economic trends are playing out in property fundamentals. From 2022 to 2023, tighter financial conditions weighed on both demand and new supply growth. Vacancies rose, especially for the industrial and multifamily sectors, as softening demand was exacerbated by robust additions to stock.³ The “soft landing” has played out according to script as a tight labor market has helped the cycle transition to slower growth while preventing the collapse of absorption as values corrected. The past two years have marked the most significant correction in property values since the GFC, yet the lack of a recession certainly mitigated a deeper downturn.

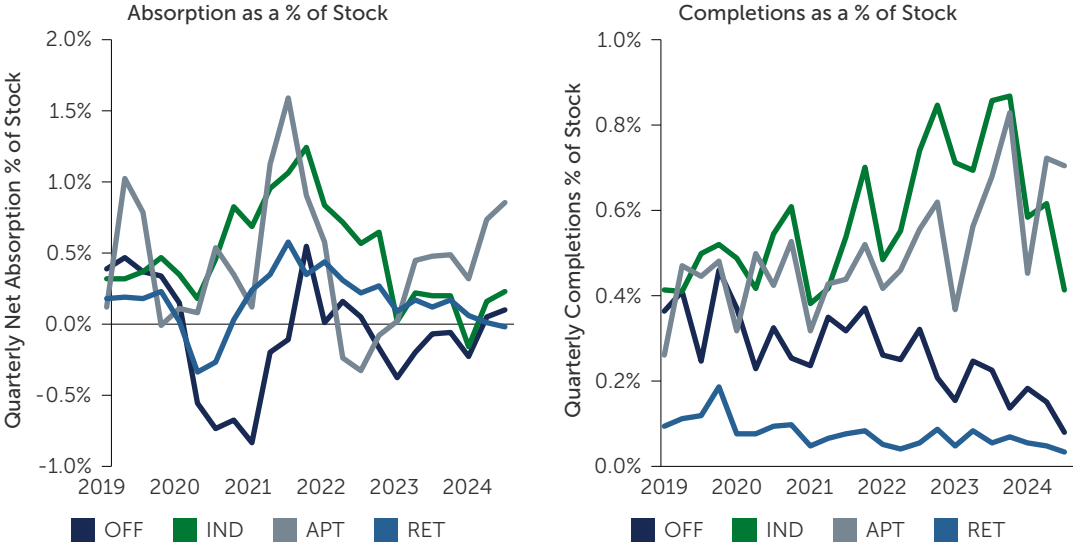
It will take more than a singular, hefty interest rate cut to drive a recovery in values. This time around, absent the trillions in public stimulus injected into the financial system during the COVID-19 pandemic, the post-2022 recovery is slated to be slower and more modest than the post-lockdown frenzy of 2021. With the regional banking sector hamstrung, financing costs remain elevated, especially relative to the pre-2022 era when the policy rate was kept at near zero for far too long. Even as the recovery gains momentum, distress continues to build as lenders and borrowers have more clarity around pricing and may have already exhausted loan extension options.

1. Source: Bloomberg. As of September 30, 2024.

2. Source: NCREIF. As of September 30, 2024.

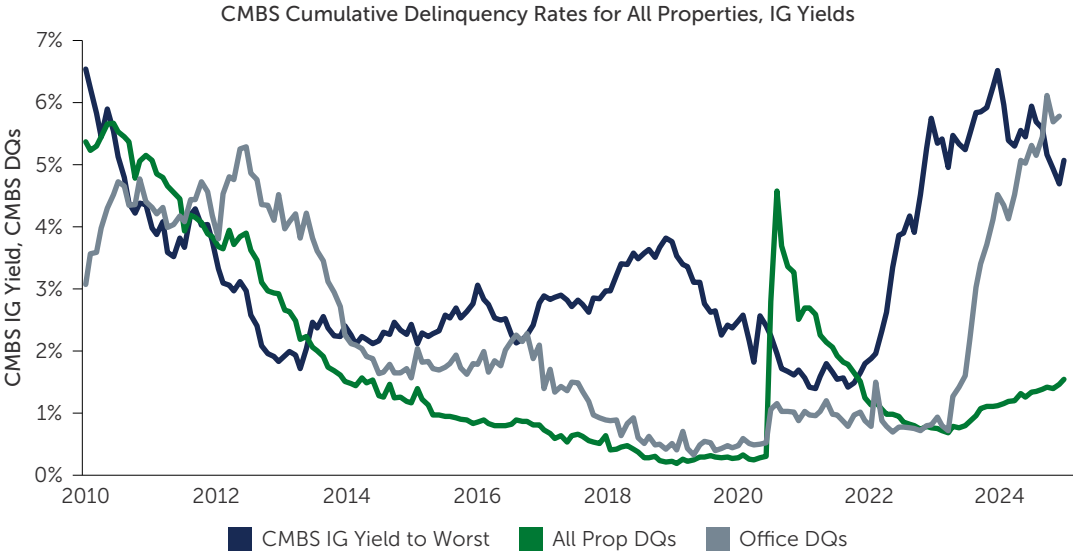
3. Source: CoStar; CBRE EA. As of September 30, 2024.

Figure 1: Demand Begins to Rebound While Supply Recedes



Source: CBRE-EA. As of September 30, 2024.

Figure 2: Financing Costs Remain Elevated



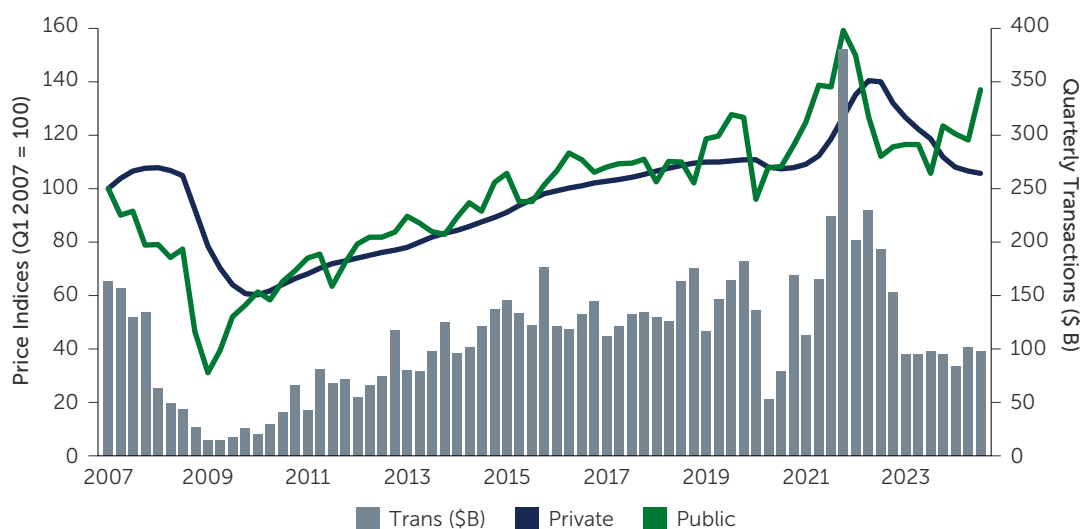
Source: Bloomberg. As of September 2024.

Capital Markets

After seven consecutive quarters of year-over-year declines, transaction activity is finally stabilizing. Sales levels across all property types for the third quarter of 2024 exhibited no change from a year ago. Transactions for 2024 year-to-date were only 1% below 2023 over the same period (Figure 3). As of the third quarter, office property sales rose by 13% over the last year and apartment sales were up 9%, while industrial and retail levels were down by 2% and 27%, respectively.⁴ Cap rates across all major property types have risen markedly since the pandemic, reflecting expectations around a secular shift in base rates (i.e., higher-for-longer) combined with expanded risk premiums.⁵ Given increased visibility around valuation trends, slightly more favorable debt terms, and elevated levels of dry powder, the bid-ask spread between arms-length buyers and sellers has narrowed.⁶ Concurrently, distress is also driving sales activity, albeit at significant discounts to peak valuations as sellers capitulate and/or lenders move to foreclose.

Share values of public REITs are 30% above the third quarter of 2023, the most recent price trough. The REIT composite spiked by 16% over the third quarter, led by the office sector (28%), self-storage (22%), and retail (17%), while industrial and apartment sectors gained 12% and 10%, respectively.⁷ As has been the case with past cycles, public REITs are much quicker to rebound than private real estate over the sector cycle.

Figure 3: Transaction Activity, CRE Price Trends



Source: Bloomberg; NCREIF; RCA. As of September 30, 2024.

4. Source: MSCI RCA. As of September 30, 2024.
 5. Source: MSCI RCA. As of September 30, 2024.
 6. Source: MSCI RCA. As of September 30, 2024.
 7. Source: NAREIT. As of September 30, 2024.

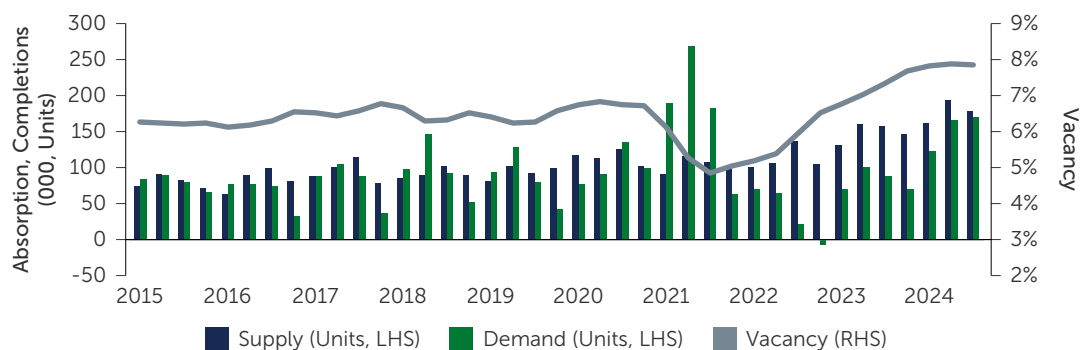
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APARTMENT SECTOR

On a quarter-over-quarter basis, the apartment vacancy rate was unchanged at 7.9% in the third quarter as new supply declined while demand increased, with 1.1% year-over-year growth in asking rent.⁸ Tenant leasing activity reached its highest level since 2021 with a notable improvement for four- and five-star properties. However, vacancy for higher priced buildings—which experienced elevated deliveries in recent years—remained well above the overall market at 11.2% and compares to 7.0% for lower-cost, three-star units. There are also differences by geography as occupancy and rent growth are generally stronger in Midwest and Northeast markets (such as Boston, New York, Washington, and Chicago), where there is lower new supply, compared to Southern markets (such as Austin, Nashville, Atlanta, and Phoenix). Despite pockets of weakness, positive developments including slower new-supply rates and resilient tenant demand contributed to modestly improved credit performance for higher-risk multifamily loans. For example, CRE collateralized loan obligation (CLO) multifamily loan 30+ day delinquency rates declined 20 bps quarter-over-quarter to 13.7%—but remained well above 4.7% for the same time a year ago with higher interest rates weighing on borrowers as well.⁹

Interest rates have declined but mortgage rates remain elevated near 6.5% as of mid-October, while the Mortgage Bankers Association’s (MBA) home purchase mortgage index was relatively unchanged compared to the same time a year ago when mortgages were about 7.8%. The combination of still-high mortgage rates and record-high home prices pose significant barriers to homeownership. For example, while the median mortgage payment slipped to \$2,057 in August from \$2,140 in July, both were well above the median mortgage payment of \$1,320 in April 2021.¹⁰ Meanwhile, other costs—such as insurance and property taxes—have also increased. These homeownership headwinds create additional structural long-term demand for rental properties that extends beyond traditional multifamily buildings.

Figure 4: Apartment Vacancy Rates Unchanged on Stronger Demand, Slowing Supply



Source: CoStar. As of September 30, 2024.

8. Source: CoStar. As of September 30, 2024.

9. Source: CRED iQ. As of September 30, 2024. Includes specially serviced loans.

10. Source: Mortgage Bankers Association. As of August 31, 2024.

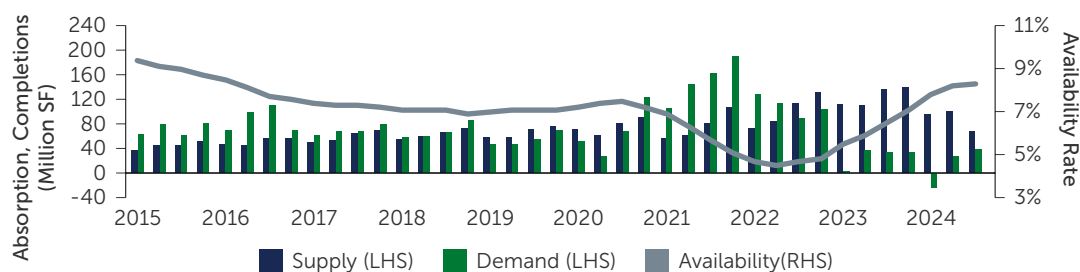
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INDUSTRIAL SECTOR

The industrial availability rate rose in the third quarter but at a slower rate, up 10 bps quarter-over-quarter to 8.3%.¹¹ Although new supply continued to outpace demand, newly delivered space declined to its lowest level since 2021. Net absorption was positive and improved during the quarter at 39 million SF but remained below its long-term average of 50 million SF—while companies continued to add sublease space to the market in part due to corporate logistic consolidation strategies. Weakness in national goods production is translating to softer tenant demand especially in the West, where markets including the Inland Empire, Los Angeles and Oakland/East Bay recorded over 1.5 million SF of negative net absorption during the quarter. The South reported the strongest tenant demand, but the region’s strong economic and demographic performance attracted elevated new supply, leading to availability rates roughly 80 bps above the national average.¹² The sector’s softer fundamentals caused asking rent growth to slow, which decelerated to 1.6% year-over-year in the quarter compared to 3.9% in the prior quarter. Supply is expected to outpace demand in the near-term, but the spread has narrowed significantly with the construction pipeline at the lowest level since 2018.

In addition to slower industrial delivery rates, the sector’s long-term structural demand drivers remain intact as companies emphasize supply chain resiliency given geopolitical risks, labor disputes, climate, and other factors. Increased per capita consumption, population growth, and continued e-commerce adoption remain significant sources of demand as well. For example, e-commerce sales increased 7.1% year-over-year in September compared to the 2.8% increase in retail sales, excluding gas stations, based on Census Bureau data. Within e-commerce, demand for high-speed delivery has increased significantly. As an indicator, Amazon same-day and overnight deliveries were up roughly 70% year-over-year.¹³ These evolving consumer preferences have impacts on various segments of the sector with speed-to-customer as an example of increased demand for infill industrial space in densely populated areas.

Figure 5: Availability Increased but at a Slowing Rate on Lower Deliveries



Source: CBRE EA. As of September 30, 2024.

11. Source: CBRE EA. As of September 30, 2024.

12. Source: Cushman & Wakefield. As of September 30, 2024.

13. Source: Amazon 2023 Letter to Shareholders. As of April 11, 2024.

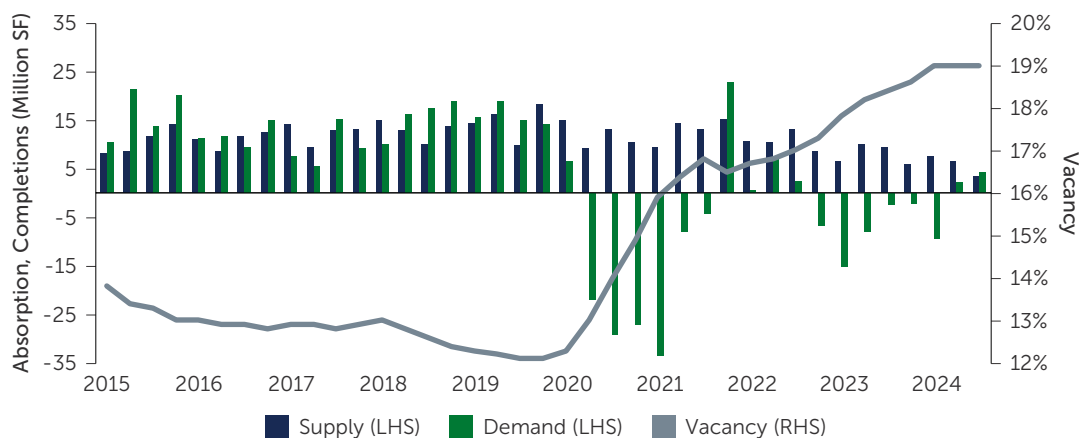
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OFFICE SECTOR

Office vacancy rates were unchanged quarter-over-quarter at 19.0% in the third quarter of 2024 with modest positive net absorption (**Figure 6**). New supply fell to 3.5 million SF compared to the 12.7 million SF long-term quarterly average.¹⁴ Although the sector remains challenged, there are other encouraging signs that stabilization is nearing. These include relatively unchanged sublease inventory, lower tenant downsizing rates, and increased leasing activity at roughly 19% of pre-pandemic levels.¹⁵ However, rents were relatively unchanged quarter-over-quarter while concessions continued to grow and are elevated. For example, new leases over the past 12 months had about \$100 per SF in tenant improvement allowances and roughly 10 months of free rent for a 10-year term.¹⁶

The highly competitive office leasing environment places increased emphasis on building quality and location. According to Avison Young data, class A+ office buildings have an availability rate nearly 790 bps lower than class A space, while 39 out of 53 markets covered by JLL have lower vacancy rates in properties built since 2015 than older product. In addition, micro locations with differentiated offerings—such as connectivity, live-work-play dynamics, or innovation—are performing strong in otherwise challenged metro areas. For example, the availability rate in San Francisco’s Jackson Square submarket has declined roughly 580 bps since 2021 (compared to a 790 bps increase for the overall San Francisco market), supported by start-up companies and venture capital firms in the area, strong transit access, and popular nearby restaurants.¹⁷ Other examples of outperforming submarkets in challenged metros include San Jose’s West San Jose, New York’s Grand Central, and Austin’s West Central submarkets.

Figure 6: Office Remains Challenged but Encouraging Signs from Unchanged Vacancy



Source: CBRE EA. As of September 30, 2024.

14. Source: CBRE EA. As of September 30, 2024.

15. Source: JLL; Avison Young. As of September 30, 2024.

16. Source: JLL. As of September 30, 2024.

17. Source: CoStar; Bloomberg; City of San Francisco. As of September 30, 2024.

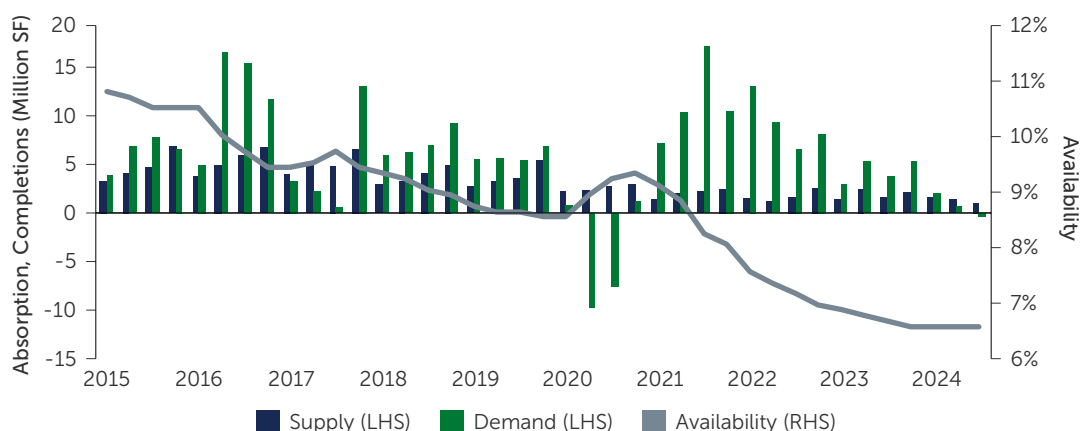
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RETAIL SECTOR

The neighborhood and community shopping center (N&CS) sector remained historically tight in the third quarter of 2024 with availability at a record low of 6.5% for the fourth consecutive quarter, supporting 2.6% year-over-year rent growth.¹⁸ The South has the highest regional occupancy rates, but the market is generally strong across the U.S. Occupier demand has softened—but newly available space from retailer bankruptcies such as Big Lots and closed pharmaceutical stores like Walgreens are likely to be absorbed in a modest amount of time given the limited availability of high-quality space in strong locations. For example, new completions reached an all-time low of 1.1 million SF during the third quarter while overall N&CS market inventory stood at 3.0 billion SF.¹⁹

The resilient economy supported consumer spending through the third quarter with retail sales, excluding gas stations, up 2.8% year-over-year, which topped economists’ expectations in September.²⁰ Consumer spending was supported by job growth, with 254,000 jobs added in September, while the unemployment rate was well below the long-term average at 4.1% and average hourly earnings increased 4.0% year-over-year. There are strains for certain households as 14.2% of consumers expect to miss a debt payment over the next three months—the fourth consecutive month of increases and the highest level since the pandemic. On balance, however, consumers remain strong and are supported by higher financial asset values.²¹ That said, N&CS is positioned well to meet a range of potential economic outcomes given the sector’s diverse and necessity-based offerings, along with limited new supply.

Figure 7: Availability Rates are at Record Lows on Muted New Supply



Source: CBRE EA. As of September 30, 2024.

18. Source: CBRE EA. As of September 30, 2024.

19. Source: CBRE EA. As of September 30, 2024.

20. Source: Bureau of Labor Statistics; Census. As of September 30, 2024.

21. Source: Federal Reserve Bank of New York. As of September 30, 2024.

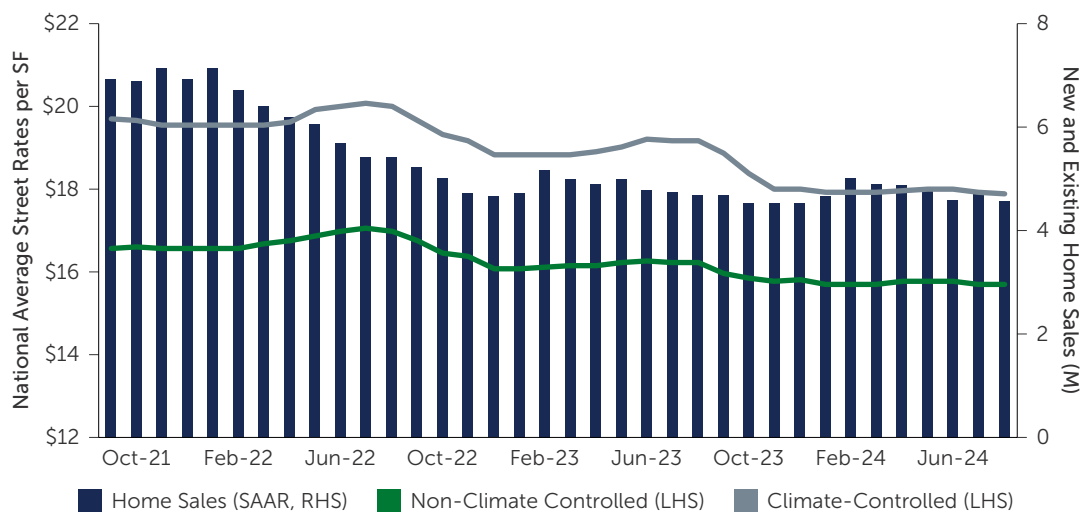
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SELF-STORAGE SECTOR

On a quarter-over-quarter basis, self-storage rental rates were relatively unchanged in the third quarter as the market continues to absorb heavy new supply while net new customer demand has been slow, in part due to weak home sales.²² This has weighed on move-in rents, which were down 12% year-over-year in August, yet somewhat of an improvement from a 15% decline in recent months.²³ However, other key performance indicators—such as existing customer rate increases and occupancy—have been steadier. The softer market conditions, along with elevated interest rates, have slowed development activity, but deliveries continue while construction completions are expected to decline 9.4% year-over-year in full-year 2024.²⁴

Market participants are encouraged by the prospect of lower interest rates given the housing market’s impact on self-storage demand. Although mortgage costs remain elevated, rates declined to 6.5% in mid-October which improves homeownership affordability, though significant headwinds remain. However, self-storage has other demand drivers such as today’s smaller home and apartment sizes relative to the past. For example, the size of the median U.S. new single-family home was 2,104 SF in June compared to 2,465 SF the same time 10 years ago.²⁵ Smaller housing units are expected to increase the need for extra space, particularly with the prevalence of work-from-home.

Figure 8: Self Storage Street Rates Seek to Stabilize from Pandemic Era Highs



Source: Yardi Matrix. As of August 31, 2024.

22. Source: Yardi Matrix; NAR; Census Bureau. As of August 31, 2024.
 23. Source: Green Street. As of September 10, 2024.
 24. Source: Yardi Matrix. As of August 31, 2024.
 25. Source: Census Bureau. As of June 2024.

About the Team

BRE's research team efforts are led by Dags Chen in the U.S. and Paul Stewart in Europe. The research team is structured by sector and geographic expertise. The team's diverse backgrounds include appraisal, legal, technological and academic applications across multiple asset-classes, across buy and sell-side shops in markets around the globe. The real estate research team is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.



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