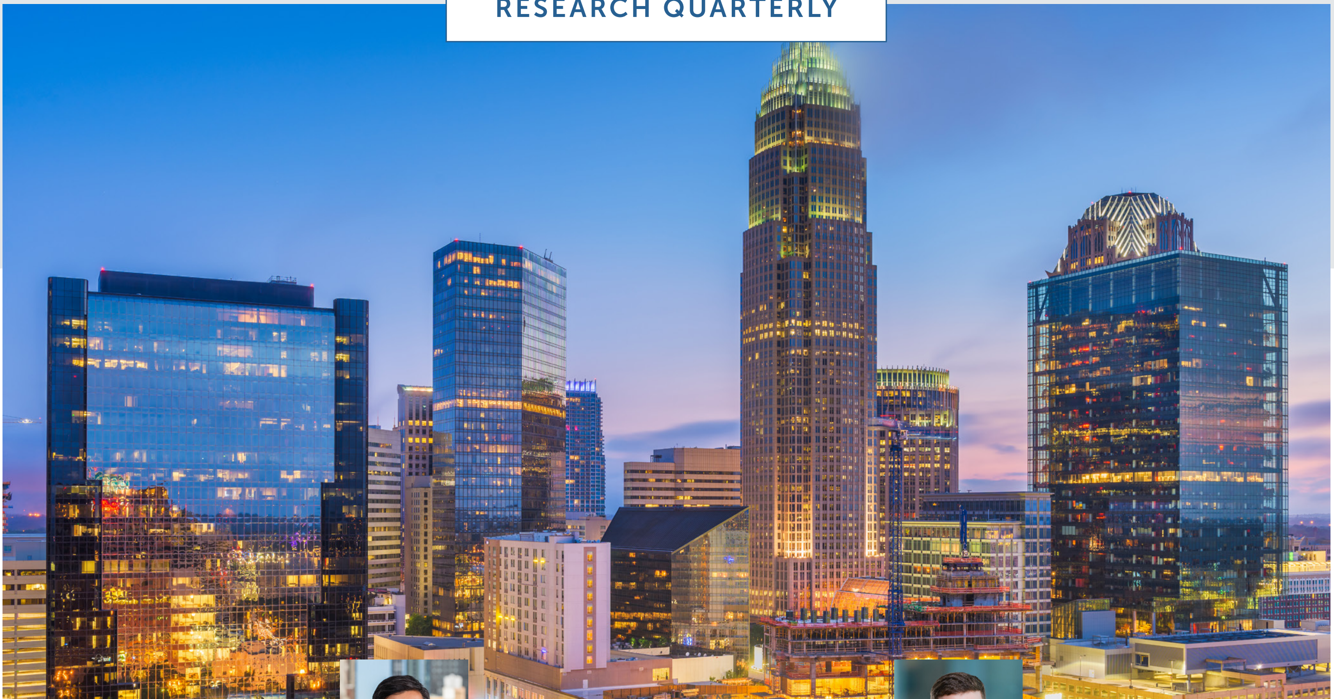
BARINGS

REAL ESTATE

U.S. Real Estate: The Real Estate Recovery Meets the Disruptor-in-Chief

The real estate recovery continues to gain ground, but at this moment the new U.S. President—and the potential impact his policy agenda could have on property fundamentals and values—is top of mind.

RESEARCH QUARTERLY



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Executive Summary

ECONOMY

- While the estimate of real GDP growth in the fourth quarter declined from the third quarter, the deceleration seemed to be more around near-term business uncertainty and inventory management while consumer spending stayed buoyant. Consensus forecasts for 2025 real GDP growth have risen steadily from 1.7% to 2.1%.
- The unemployment rate is expected to stay close to its recent run rate and likely to stay tight if mass deportations further constrain labor availability. Markets generally expect the President's policy stances will be inflationary, particularly the recent tariff announcements.
- Volatility in credit markets reminds us that caution especially in the face of resurgent investor "animal spirits" is necessary. Policy reform, even those instituted through "emergency executive powers", faces significant political, judicial and bureaucratic friction.

PROPERTY MARKETS

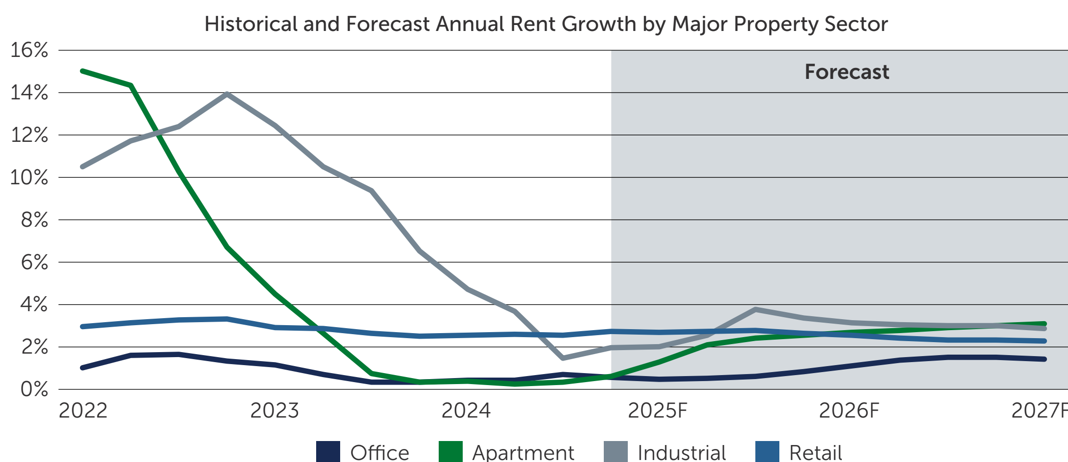
- Despite the Trump administration's aggressive rhetoric around immigration and tariffs, transaction activity continues to increase while values continue to stabilize—both hallmarks of a real estate recovery.
- Cap rates across all major property types have risen markedly since the Fed began raising interest rates, reflecting expectations around a secular shift in base rates (i.e., higher-for-longer) although the cap rate risk premium is compressed relative to historical averages, similar to other risk assets.
- Given the combination of tenant demand driven by solid corporate and household balance sheets and muted development activity, there is strong potential for property performance to top the current modest forecasts over the near term.

Economic Outlook

The return of Donald Trump to the White House and the potential implications for the global economy and financial markets were the near-singular focus of the investment community toward the end of 2024. A recovery in commercial real estate (CRE) had been building even before the presidential election. Despite the Trump administration's aggressive rhetoric around immigration and tariffs, transaction activity continues to increase while values continue to stabilize—both hallmarks of a real estate recovery. Markets generally expect the President's policy stances will be inflationary, particularly the recently announced tariffs and threats of additional trade levies. From the middle of September 2024 to the middle of January 2025, the yield on the 10-year Treasury has moved from 3.7% to 4.7% as expectations around policy rate cuts have been pulled back.[1] Another hallmark of recent real estate recoveries is easing monetary conditions, but mass deportations and tariff concerns have complicated the job of the U.S. Federal Reserve (Fed).

Property fundamentals continue to adjust to the post-pandemic "new normal"—one in which interest rates and inflation, but also spending are higher-for-longer. For the apartment and industrial sectors, vacancies have moved off record lows toward their 20-year averages.[2] Rent growth is moderating after whipsawing from mid-teens to flat (even slightly negative) to historical averages **(Figure 1)**. For retail, vacancy continues to fall to record low levels based upon favorable demand and supply fundamentals.[3] For office, the new normal is still taking shape as vacancy, inclusive of Class A properties, remains near 19% and has been for the past three quarters.[3] Generally, oversupply has been the primary culprit where real estate fundamentals have been soft in recent quarters, but the elevation in financing costs over the past two years has now culled development pipelines—which is likely paving the way for rent and occupancy growth.

Figure 1: Property Fundamentals Adjust to New Normal



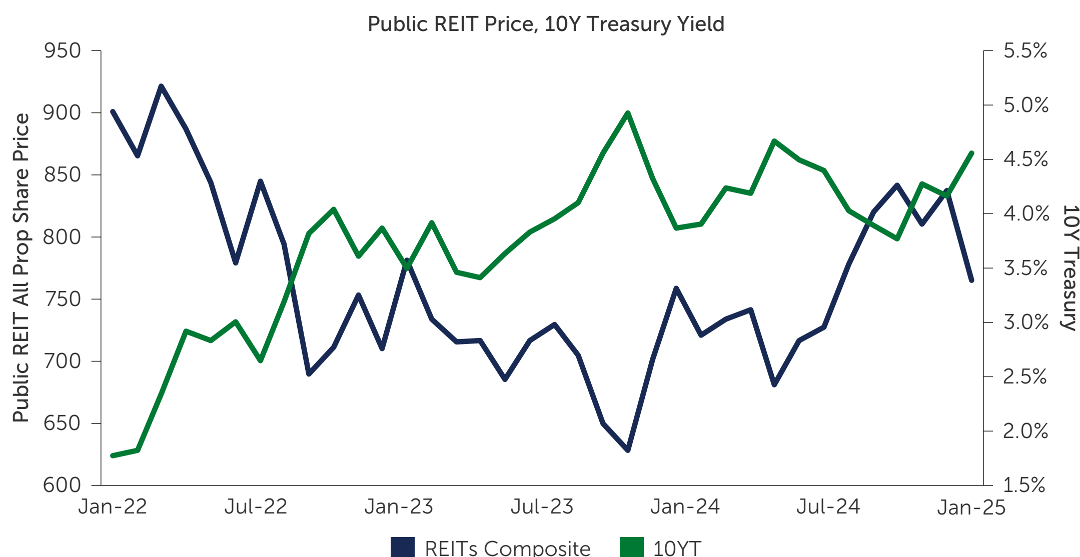
Source: CBRE-EA. As of December 31, 2024.

1. Source: CME Group. As of January 30, 2025.
2. Source: CBRE-EA; CoStar. As of December 31, 2024.
3. Source: CBRE-EA. As of December 31, 2024.

The expectations around property performance could be understated considering the optimism surrounding Trump's campaign assurances of lower taxes and less regulation. Consensus forecasts for 2025 real GDP growth have risen steadily from 1.7% to 2.1%.[4] While the estimate of real GDP growth (SAAR) in the fourth quarter declined to 2.3% from 3.1% in the third quarter, the deceleration seemed to be more around near-term business uncertainty and inventory levels as consumer spending stayed buoyant.[5] The unemployment rate is expected to stay close to its recent run rate of approximately 4% and likely to stay tight if mass deportations further constrain labor availability.[6] Given the combination of tenant demand driven by corporate and household balance sheets and muted development activity, there is strong potential for property performance to top the current modest forecasts over the near-term.

Yet volatility in credit markets reminds us that caution especially in the face of resurgent investor "animal spirits" is necessary. Policy reform, even those instituted through "emergency executive powers", faces significant political, judicial, and bureaucratic friction. Meanwhile, underlying price pressures persist even before the potential inflationary burden of the Trump administration's policy agenda. The public REIT share price composite, which has been a useful leading indicator for private real estate price trends, rose by 15.8% in the third quarter of 2024, but then fell by 9.1% in the fourth quarter as investors tried to sort through the positive and negative impacts of the new administration's policy agenda **(Figure 2)**.

Figure 2: Public Equity and Credit Markets are Choppy



Source: Bloomberg. As of December 31, 2024.

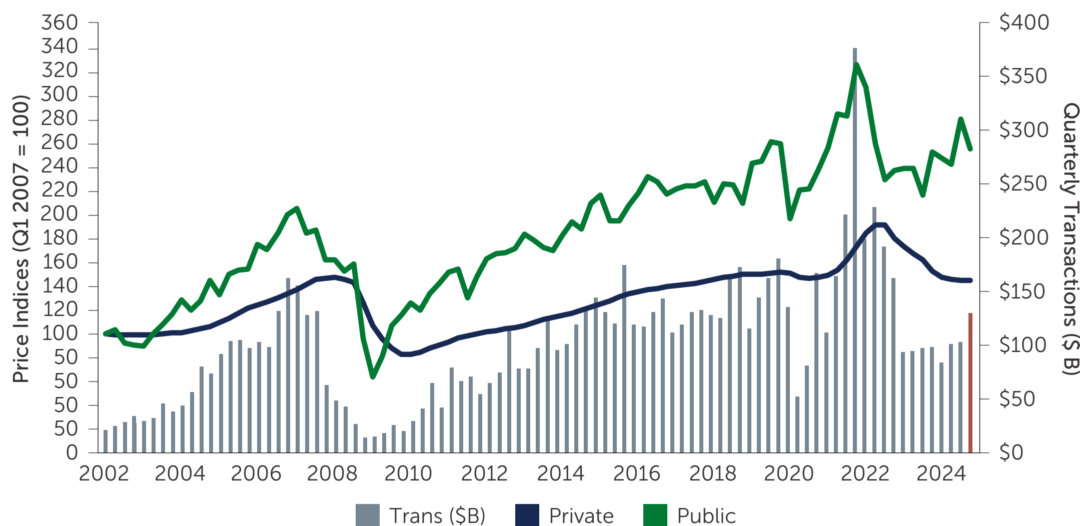
4. Source: Bloomberg. As of January 30, 2025.
5. Source: BEA. As of December 31, 2024.
6. Source: BLS. As of December 31, 2024.

Capital Markets

Quarterly transaction activity for the fourth quarter rose by 32% to $131 billion over the prior year for major property types **(Figure 3)**. The quarter marked the strongest year-over-year increase in sales volume since the first half of 2022, and the third consecutive quarter of volume growth. Over the whole of 2024, transaction activity increased by 9% over 2023, which was marked the lowest level of aggregate CRE sales since 2015. Total volume in 2023 was $53 billion lower than in 2020, the year of the COVID-19 pandemic. All property types except hotel rose year-over-year during the quarter.[7] Apartment and industrial sales were up by 64% and 33%. Office rose by an impressive 36% while retail center sales were up by 8%. Hotel transactions fell by 28%.

Cap rates across all major property types have risen markedly since the Fed began raising interest rates, reflecting expectations around a secular shift in base rates (i.e., higher-for-longer) although the cap rate risk premium is compressed relative to historical averages.[7] 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. Concurrently, distress is also driving transaction activity, albeit at significant discounts to peak valuations as sellers capitulate and/or lenders move to foreclose.

Figure 3: Transaction Activity, CRE Price Trends



Source: Bloomberg, NCREIF, RCA. As of December 31, 2024.

7. Source: MSCI RCA. As of December 31, 2024.

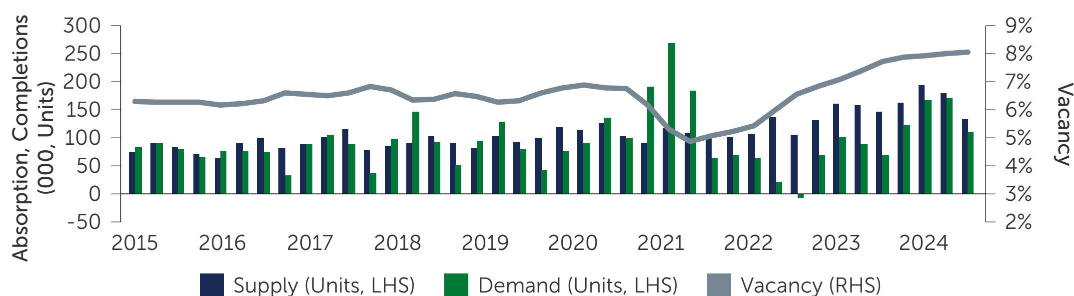
Occupier Markets

APARTMENT SECTOR

The apartment vacancy rate was relatively unchanged quarter-over-quarter at 8.0% in the fourth quarter of 2024 as resilient leasing activity curbed availability following record high new construction during the year.[8] For example, the difference between new deliveries and tenant demand narrowed to 22,000 units—the lowest level in three years. The higher quality apartment segment has softer fundamentals but improved quarter-over-quarter with vacancy rates down 20 basis points (bps) to 11.3% for 4- and 5-star properties as demand outpaced supply **(Figure 4)**. This was supported by favorable labor markets with the unemployment rate at 4.1% as of December 2024 while higher-wage industries—such as professional and business services, financial activities, and information industries—added 51,000 jobs in the month.[9] Although multifamily deliveries remained above their long-term average—particularly in the Southern region—higher interest rates are taming new projects as starts were down nearly 60% from their cycle peak.[10] The rate environment has weighed on credit performance as well. For example, CMBS multifamily loan 30+ day delinquency rates rose 125 bps quarter-over-quarter to 4.58%, often due to debt service coverage ratio issues, while the special servicing rate increased 265 bps to 8.72% over the same period.[11]

Higher rates pose challenges for segments of the market, but increased mortgage costs also provide structurally higher renter demand from a demographic perspective. Homeownership rates declined from 66.0% in 2022 to 65.6% in 2024 as mortgage rates hovered around 7% and home prices reached record levels.[12] For example, the median mortgage payment was $2,133 in November compared to $1,595 for housing rent and a mortgage payment of $1,320 in April 2021.[13] First time homebuyer data well illustrates affordability issues as the median age increased to nearly 38 years old in 2024 compared to about 31 years old pre-pandemic, effectively adding seven more years of renter demand based on NAR data.

Figure 4: Apartment Vacancy Rates Crest on Slower Supply and Resilient Demand



Source: CoStar. As of December 31, 2024.

8. Source: CoStar. As of September 30, 2024.
9. Source: BLS. As of December 31, 2024.
10. Source: Census Bureau. As of November 2024.
11. Source: Trepp. As of December 31, 2024.
12. Source: S&P Dow Jones; Census Bureau. As of October 31, 2024.
13. Source: Rent.com. Mortgage Bankers Association. As of November 30, 2024.

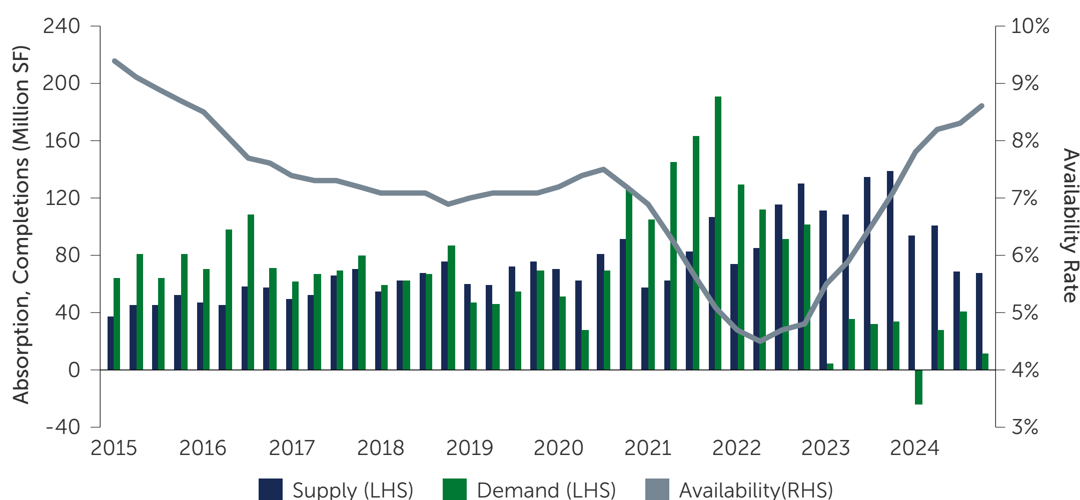
Occupier Markets

INDUSTRIAL SECTOR

The industrial availability rate increased 30 bps quarter-over-quarter to 8.6% in the fourth quarter of 2024 largely due to new deliveries, which were only 35% pre-leased (the second lowest for newly completed properties since 2010).[14] Net absorption was mildly positive with tenant demand concentrated in newer vintage properties. Buildings delivered pre-2000 experienced more than 100 million SF of negative absorption in 2024 compared to over 200 million SF of positive absorption for buildings construction after 2022.[15] Although new supply remained elevated from a pre-pandemic perspective and continued to weigh on fundamentals, completions have declined by 51% from the cycle peak and new starts are expected to fall further given the recent wave of new inventory and still-elevated interest rates.[15]

The macroeconomic backdrop is positive for industrial demand as the Fed projects GDP to increase 2.1% in full year 2025—but uncertainty around trade policies caused some companies to pause leasing decisions during the second half of 2024. Trump's recent tariff announcements and subsequent pauses may cause continued headwinds to leasing activity as businesses seek clarity for supply chain planning. However, generally strong corporate and household financial conditions, along with secular trends (such as supply chain resilience and increased e-commerce adoption), are key durable long-term positive demand drivers for the sector.

Figure 5: Availability Increases on Slower Demand, Supply Peaked but Unchanged QOQ



Source: CBRE EA. As of December 31, 2024.

14. Source: CBRE EA. As of December 31, 2024.
15. Source: CBRE. As of December 31, 2024.

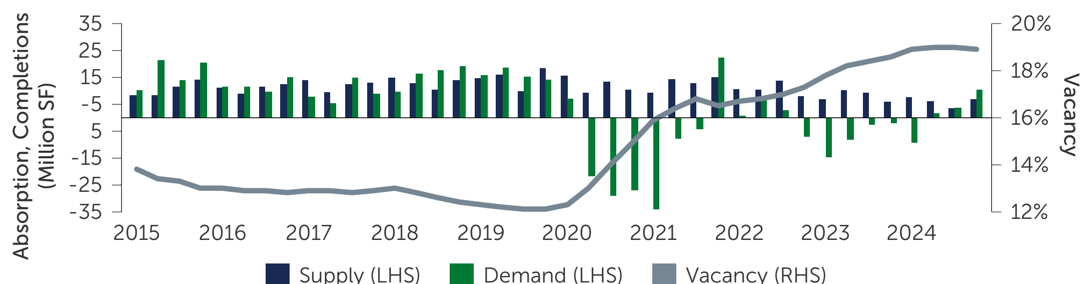
Occupier Markets

OFFICE SECTOR

Office vacancy rates declined 10 bps quarter-over-quarter to 18.9% in the fourth quarter of 2024, marking a third consecutive quarter of positive net absorption.[16] Demand appears to be stabilizing with leasing in the most recent quarter representing 92% of typical pre-pandemic averages, supported by an increased return-to-office push by employers **(Figure 6)**. Hybrid work is here to stay, but a Fortune 100 company survey indicates a 3.4 day in-office requirement with 21% implementing "full in office" mandates as of the fourth quarter of 2024 compared to just 2% in the first quarter of 2021. Other positive developments for the sector include lower sublease space additions (down 26% year-over-year) and lower downsizing rates (major tenants reduced space by 8% in 2024 compared to 12% in 2023).[17] However, it remains a competitive environment for landlords to sign leases as the spread between asking and effective rents is approximately 23% with nine months of free rent. New supply remained modest as still-elevated interest rates, lower capital flows, and post-pandemic work arrangements have diminished construction activity. For example, construction starts totalled 2.2 million SF in the fourth quarter compared to a quarterly average of 18 million SF since 2005, while office inventory removals totalled approximately 6 million SF in the fourth quarter.[18]

The sector has long-term challenges but the combination of modestly improving fundamentals, the effects of higher interest rates on debt, and upcoming loan maturities create potential compelling entry opportunities. According to the MBA, office debt set to come due from 2024 through 2026 totalled approximately $380 billion while loan originations for the sector were down nearly 75% compared to 2019 levels as of the third quarter 2024. In addition, office loan 30+ day delinquency rates—measured by the CMBS market—reached a record high of 11.1% in December.[19] However, all distress is not equal in a highly differentiated post-pandemic office market that favors micro locations with dynamism and offerings such as connectivity, live-work-play dynamics and innovation.

Figure 6: Office Vacancy Declined 10 bps as Absorption Reached Highest Level in Three Years



Source: CBRE EA. As of December 31, 2024.

16. Source: CBRE EA; JLL. As of December 31, 2024.
17. Source: JLL. As of December 31, 2024. The average tenant 25,000 SF+ facing expiration over the past 12 months reduced space by 8%.
18. Source: CBRE EA. As of December 31, 2024.
19. Source: Trepp. As of December 31, 2024.

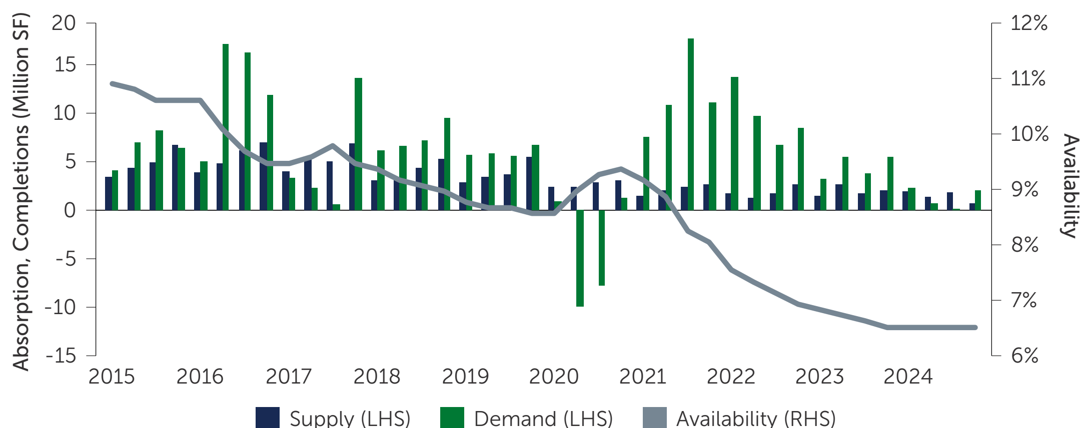
Occupier Markets

RETAIL SECTOR

The neighborhood and community shopping center (N&CS) sector remained historically tight with availability at a still-record low of 6.5% for the fifth straight quarter in the fourth quarter of 2024, as rents increased 2.5% year-over-year **(Figure 7)**. Demand improved quarter-over-quarter as retailers have generally absorbed newly available space following bankruptcies and pharmaceutical and wellness store closures, particularly tenants in the food services, discount, experiential, and healthcare industries. High-quality available space remains scarce as nearly 40% of vacancy is considered 1- and -2 stars while roughly 60% is in areas with below-average household incomes, suggesting less discretionary consumer spending.[20] From a supply standpoint, completions fell to a new low of 702,000 SF nationally which represents 0.02% of total inventory and compares to a historical quarterly average of 0.23% since 2005.

Despite economic uncertainty and inflationary pressures, consumers continued to spend at a solid pace with retail sales, excluding gas stations, up 3.4% year-over-year in November with record level holiday sales.[21] Household purchasing power has been driven by a resilient labor market with a 4.1% unemployment rate and 256,000 jobs added in December, along with elevated asset values such as stocks and real estate.[22] However, segments of consumer credit have weakened—particularly for lower income and younger demographics—with blended credit card, auto, and other non-mortgage loan delinquency rates at their highest since 2012 excluding the pandemic period.[23] Nonetheless, the sector's favorable fundamentals and often non-discretionary offerings well position N&CS to a range of household financial conditions and economic scenarios.

Figure 7: N&CS Retail at Record Lows for Availability and New Supply



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

20. Source. CoStar. As of December 31, 2024.
21. Source: Census Bureau. As of November 30, 2024.
22. Sources: BLS; Federal Reserve. As of December 31, 2024.
23. Sources: Federal Reserve Bank of New York; Equifax. As of September 30, 2024. Excludes student loans.

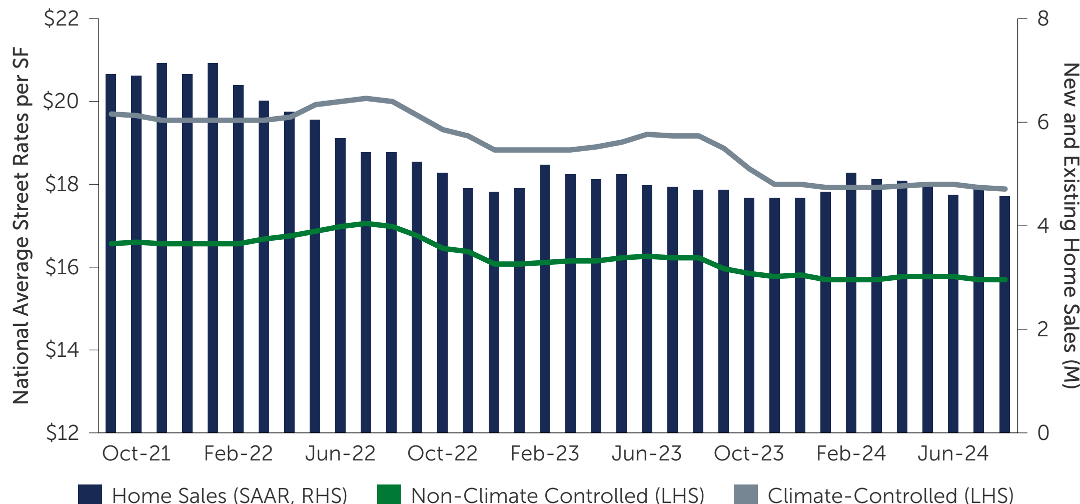
Occupier Markets

SELF-STORAGE SECTOR

Self-storage vacancy increased to an estimated 10% in the fourth quarter of 2024 given continued supply pressures with 65 million SF completed during the year (though lower than 70 to 80 million SF per year from 2018 to 2020).[24] New deliveries have dragged down market rents as owners have lowered pricing to drive move-ins while in-place rates have been relatively unchanged and stable.[25] The weaker fundamentals and higher borrowing and building costs cooled development activity, but deliveries for this lower barrier-to-entry sector continues with projects under construction only down 40 bps year-over-year and equal to 3.2% of existing inventory.[26]

Self-storage has been constrained by a key source of tenant demand as the housing market has slowed given elevated rates—for instance, the 30-year mortgage rate is around 7%. This has slowed home sales activity which contributed to lower mobility—which North American Van Lines estimated declined 8% year-over-year in 2024. However, long-term demand trends for the self-storage continued to be underpinned by household balance sheets and consumer spending noted previously.

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



Source: Yardi Matrix. As of November 30, 2024.

24. Source: Marcus & Millichap. As of September 30, 2024.
25. Source: Yardi Matrix, KBMC Self-Storage Investor Forum. As of January 9, 2025
26. Source: Yardi Matrix. As of December 31, 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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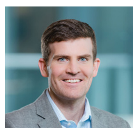

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