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LGIM America

Real Estate Pulse

Standing on Solid Ground

Q1 2024

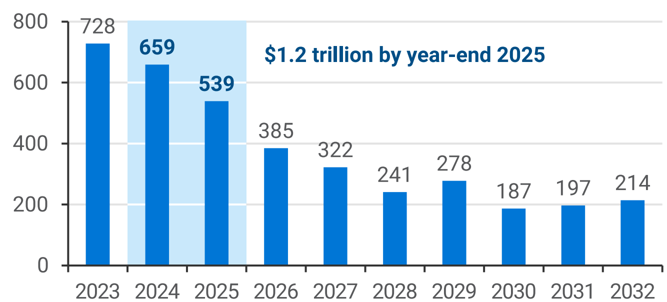
Executive summary

Investment performance results for US commercial real estate for year-end 2023 were released recently by the National Council of Real Estate Investment Fiduciaries (NCREIF). The NCREIF National Property Index contains $848 billion in US property, including apartment, industrial, office, and retail, owned by institutional investors. The index is a widely used benchmark for US institutionally owned property investment performance and, as such, it is widely monitored.

- US commercial property investment total return performance was negative through all four quarters of 2023.
- Higher interest rates stressed property values and constrained refinancing property debt and financing property purchases.
- Excess supply of apartments and industrial space in some metros stressed rent growth; office remains unsettled.
- But, surprisingly strong economic growth in 2023 sustained NOI growth for all four property type sectors.
- Positive economic growth and interest rate cuts in 2024 are positive for CRE but further value decline is possible.

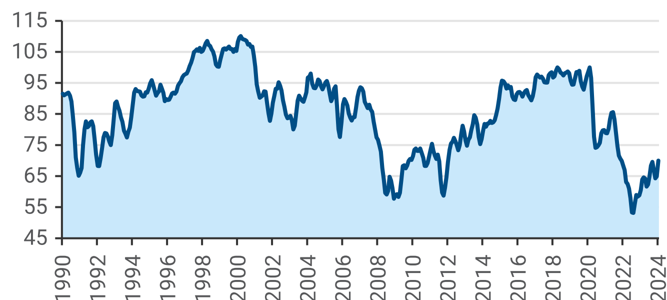
Fourth quarter property performance capped a year of pervasive pressure in response to the interest rate tightening that began in early 2022. The Federal Reserve enacted 525 basis points in tightening between March 2022 and July 2023. Commercial real estate investment performance remained positive through most of 2022 as it typically lags macro-economic developments. The first crack occurred in the fourth quarter of 2022 with a negative 3.5% total return. The fourth quarter of 2023 produced the fifth consecutive negative quarter bringing 2023 full year total return to a negative 7.9%.

Figure 1 – Total commercial mortgages maturing ($ billions)



Source: Wall of Maturities, CRED IQ. Data as of December 2023.

Figure 2 – Index of consumer sentiment



Source: University of Michigan, Survey of Consumers. Data as of February 2024.

The data monitored in this report offer insights into prospects for CRE investment performance in the quarters ahead.

- Total return is likely to endure a few more negative quarters ahead as property transactions increase with buyers and sells finally coming together.
- Expectations for an improvement in the pace of transactions are grounded in the gap between recent transactions reported by Real Capital Analytics and the property index calculated by Green Street using more expansive and more timely data. The gap will likely close as buyers and sellers accept the reality of lower property values.
- Lower property values have resulted from the interaction of higher interest rates and constrained availability of debt along with a buildup in supply in apartment and industrial sectors. Office sector work-from-home upheaval is a further complication. With the construction pipeline diminishing, apartment and industrial sectors will move toward equilibrium as 2024 progresses. Office space resolution will take longer as in-the-office attendance protocols are established and as obsolete stock is weeded out.
- Interest rate cuts are widely expected, and long-term Treasury yields are down from their highs, but difficulties in refinancing maturing debt will remain. We note that the huge volume of debt that matured last year, as shown in the Figure 1, was not catastrophic. Maturity extensions and rescue capital have kept a lid on delinquencies and debt funds are accumulating capital to deploy this year. With the expectation of ongoing economic growth and lower interest rates in the offing, this year's maturities may also be digested if all goes well.
- Finally, the macro-economy is on positive footing. Fears of recession have evaporated. Consumer spending is holding up with support from an ongoing strong job market and strong growth in real disposable income over the second half of 2023. Consumer sentiment, as shown in Figure 2, has rebounded sharply to a level last seen prior to the GFC; perhaps consumers are (at last) in a better mood.

Macro economy

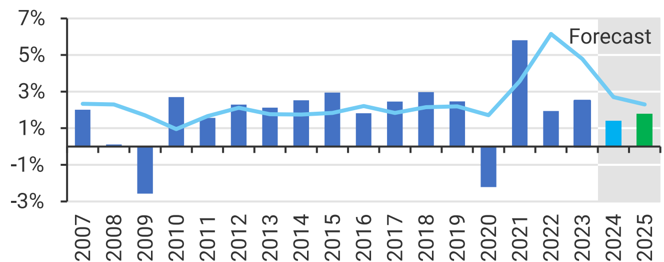
Real GDP growth surged in Q4 2023 bringing the full year growth rate to 2.5%. Consumer spending continued driving growth propelled by a solid uptick in real disposable personal income. Investment spending slowed after posting a 10% growth rate in Q3 2023 but contributed positively to growth in all its subcomponents.[1]

The strong growth performance supports the declaration of a soft-landing success for the Federal Reserve's inflation fighting interest rate tightening. While some forecasters are holding onto expectations for one or two negative quarters in 2024, maybe even a mild recession, the consensus is positive. This is demonstrated in the December projections from the survey of Federal Reserve Board members and Fed Bank presidents. It shows a 1.4% expected real GDP growth in 2024 and 1.8% in 2025. None of the 19 individual forecasters expect a negative GDP growth for either 2024 or 2025.[1]

Most expect interest rate loosening this year. The fed funds consensus shows a 4.6% average fed funds rate for 2024 and 3.6% for 2025 down from the current 5.4%. Rate cut expectations assume that inflation stabilizes near or below the Fed's 2% goal.[2] It hit that target in fourth-quarter data but policymakers need a longer period of confirmation before easing becomes palatable.

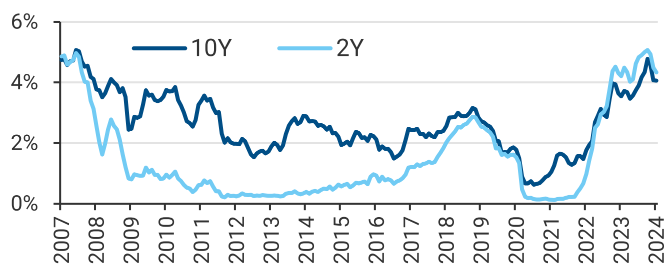
In the meantime, financial markets are letting go of inflation fears as shown in the decline in the 10-year Treasury yield from its recent 4.98% high in October. The yield curve remains inverted but the conventional wisdom that interprets inversion as a predictor of recession has been distorted by the COVID recovery's peculiarities.

Figure 3 – Annual US real GDP and core CPI



Source: St. Louis FRED. Data as of Q4 2023. Federal Reserve Projection Materials, December 13, 2023.

Figure 4 – US 10-year and 2-year Treasuries (monthly yield)



Source: University of Michigan, Survey of Consumers. Data as of February 2024.

For consumers, employment growth continues at a pleasing pace with no material pressure on wage inflation. This is likely reflecting job creation in lower-paying job categories especially in health care which are still recovering from COVID disruption. Higher prices are still troubling to consumers especially gyrating gasoline prices, rent and out-of-reach home ownership. But consumer expectations for inflation ahead are back to their pre-COVID range according to the University of Michigan Survey of Consumers.

What can go wrong? Lagged negative impact from the runup in interest rates might still emerge. Shocks are always lurking, but current geo-political turmoil is especially troubling in a US presidential election year

Muted transaction volumes

The positive macro-economic environment is not yet boosting commercial property transactions as shown in Figure 5. Transactions in the fourth quarter were down sharply from year ago across all four property sectors.

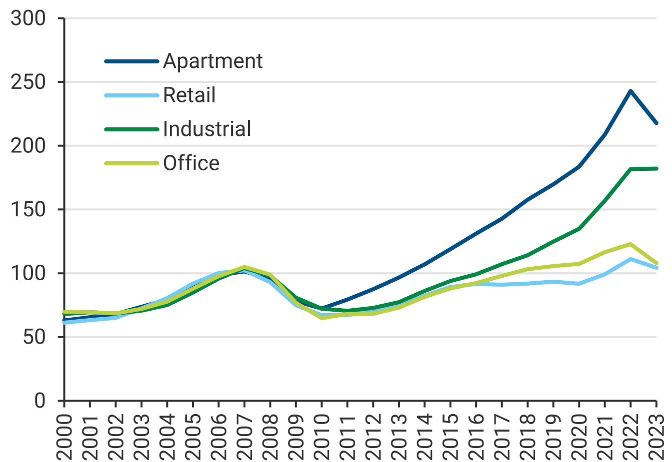
While transactions are typically a lagging indicator, expectations of interest rate cuts this year should be a tonic especially because institutional investors cite interest rates as their most important concern. Accordingly, almost half of US domiciled institutional investors expect to increase their allocation to US property over the next two years. (Note, PREA, 2024 Investment Intentions Survey).

Buyers and sellers need to find agreement before the pace of transactions can improve. Buyers have been hoarding cash waiting for distress opportunities as suggested by the huge flow of maturing mortgages. The paucity of transactions shows they are still waiting. Without a flood of distress opportunities, property value decay observed in transactions has been muted compared with value calculations gathered from the public markets.

Drawing from transactions data, RCA reports that property values in the four major sectors are down 11% from their July 2022 high. Green Street calculates a 24% decline using data that includes public market pricing. The gap is indicative of the ongoing bid-ask spread that is stalling transactions. Perhaps motivated institutional investors will loosen the logjam this year in anticipation of lower interest rates ahead. If so, dealmaking will likely recognize further decline in property values beyond the 11% already posted.

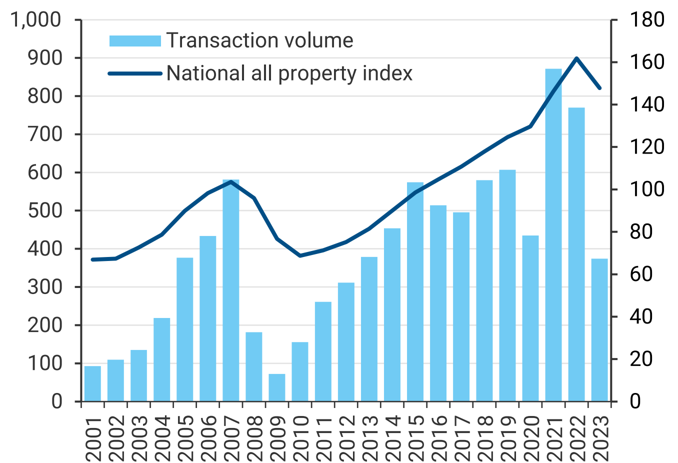
Investor appetite is further confirmed by the narrowing in bond spreads which serves as a market-updated gauge of investors' risk posture. Spreads for both high-yield BB and low investment grade BBB corporates have narrowed to pre-COVID levels.

Figure 5 – RCA CPPI – annual

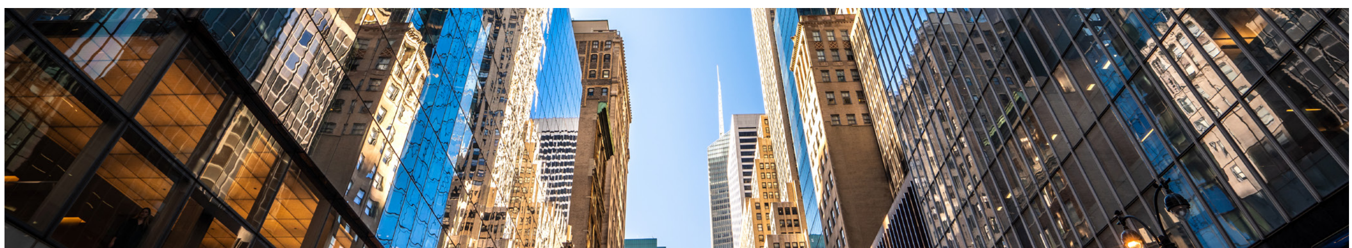


Source: Real Capital Analytics (December 2023)

Figure 6 – Transaction volume – annual ($b)



Source: Real Capital Analytics (December 2023)



Declining returns

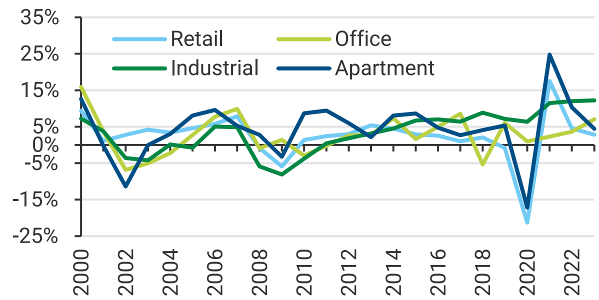
Fourth-quarter 2023 NCREIF-NPI total return performance incorporates ongoing decay in the capital appreciation component across property sectors as shown in Figure 7. Retail sector total return was least affected with full year performance at a barely negative -0.9%. Industrial ended the year with a -4.1%, followed by apartment at -7.3% and office at -17.6%.[3]

The negative total returns for 2023 are pervasive across sector subtypes, regions and metro areas with the South somewhat less negative than other regions. The relative strength in the South is focused on retail properties and industrial properties in the Southeast.

Despite negative total returns, property market fundamentals reported in the Q4 2023 NCREIF National Property Index show that net operating income continues to grow across all four major property sectors. This result reaffirms that pressures on US commercial real estate are more about financing than property fundamentals. Note too the impact of COVID on apartment and retail NOI growth; it produced a strong decline in 2020 and a strong recovery in 2021-2022. Office was less affected by COVID due to long-term leases while industrial was bolstered by the explosion in on-line shopping.

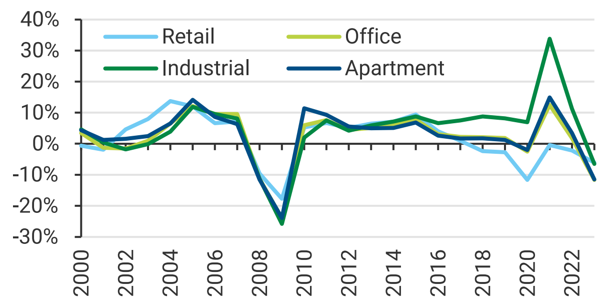
2023's superb economic growth supported NOI growth and expectations for ongoing macro-economic support this year are a positive. Even the office sector will benefit despite turnover risk as leases turn to lower rents, and obsolescence risk as the least desirable office properties are weeded out of institutional quality stock.

Figure 7 – NCREIF-NPI NOI growth



Source: NCREIF. Data as of December 2023.

Figure 8 – NCREIF-NPI capital return



Source: NCREIF. Data as of December 2023.

At the same time, pressure on capital appreciation will likely continue as buyers and sellers catch up with market realities.

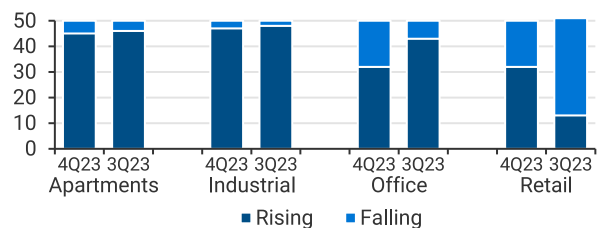
Market fundamentals

Some green shoots emerged in Q4 2023 in metro area vacancy and rent growth data. Vacancy rates rose in the majority of the top 50 metros for all property sectors but in markedly fewer office markets compared with the third quarter. Rent growth picked up despite rising vacancy rates for all sectors except retail. The pickup in rent growth will bolster NOI growth in 2024.

The improvement in rent growth among apartment markets is noteworthy. It points to progress absorbing excess supply and amplifies the very slight decline in the number of metros reporting rising apartment vacancy rates. Retail sector data are also noteworthy with more metros reporting higher vacancy rates and falling rents in 4Q versus 3Q. This easing reflects the tamer growth in retail sales over latter half of 2023 as the COVID recovery matured.

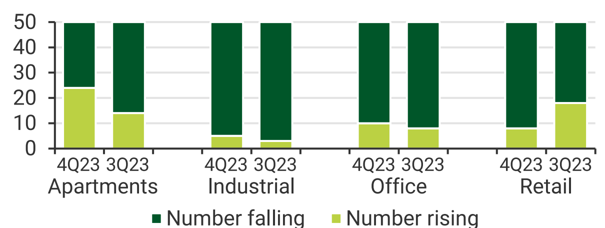
If macro-economic growth expectations for 2024 materialize along with interest rate cuts, US commercial real estate investment performance should reach a cycle bottom. Ongoing economic growth in 2025 will help to turn property total return performance back to positive especially as the new construction pipeline winds down.

Figure 9 – Vacancy rate changes (top 50 metros)



Source: CoStar, Q4 2023 vs Q3 2023.

Figure 10 – YoY rent growth changes (top 50 metros)



Source: CoStar, Q4 2023 vs Q3 2023.

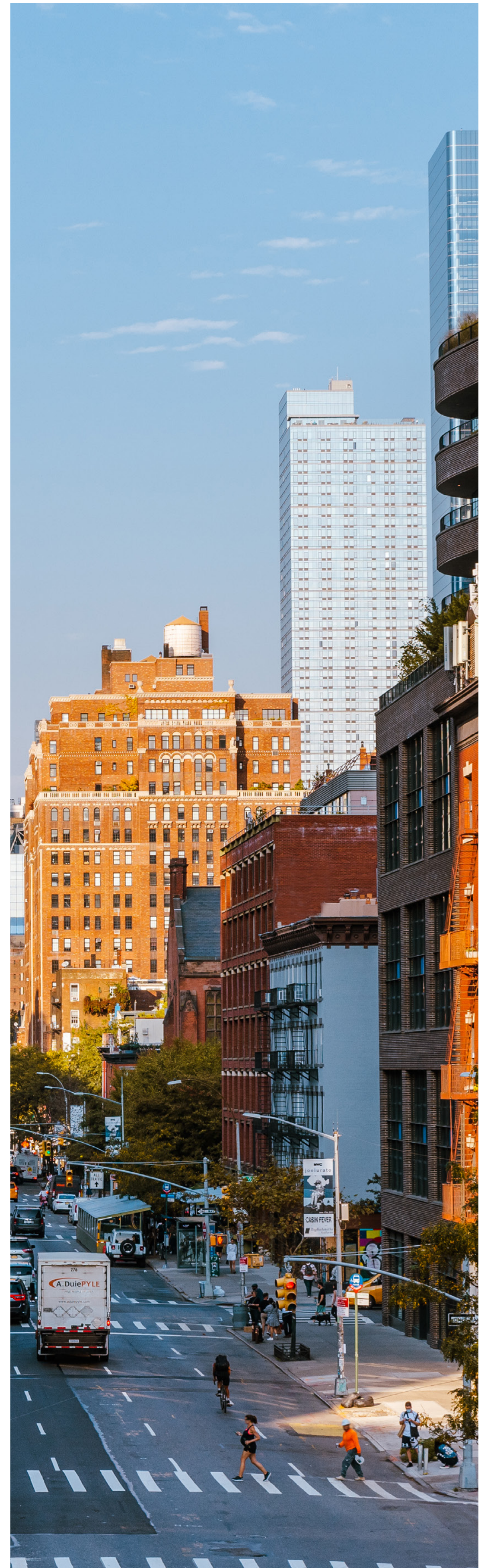
Our assessment process

Analysis of real estate investment prospects commonly starts with a review of recent and expected macroeconomic performance. That starting point reflects the importance of the macroeconomy as a driver of the supply and demand forces that determine property investment performance. The macroeconomic environment influences those drivers and propels a national real estate cycle. That cycle is the dominant influence on performance with property sector and local geographic influences following in importance. At the same time, the idiosyncratic characteristics of specific properties and their specific locations combine with the national cycle feeding each property's bottom line. These diverse influences encourage investors to evaluate both the "top-down" macro environment and the "bottom-up" characteristics of each individual investment under consideration.

Economic growth affects property sectors through varying channels. For apartments, demand drivers include employment and income growth that enable maturing young people to form households along with the absolute number of that population cohort. Interest rates are also important as they influence the cost of buying a home versus renting. Stronger economic growth fuels both employment and income growth. Employment and income growth along with population growth also influence prospects for the retail sector. But growth that is too strong can promote inflation leading to rising interest rates which put a lid on growth.

The industrial sector depends on the widest definition of GDP including the international trade sector. Industrial space demand reflects the flow of goods through the domestic economy. Industrial space demand is very responsive to the macroeconomy in part because the sector can build new space quickly when compared with other types of structures. This responsiveness contrasts sharply with office space where construction lags dampen responsiveness to the macroeconomy.

But, at the same time, there are structural forces of various strengths affecting each sector. For apartments, the strongest is the ongoing shortfall in the supply of housing due to weak construction following the 2008 recession. For industrial, the adjustment to more online shopping and demand for faster delivery is an ongoing tailwind. For office, work-from-home appetite is still uncertain and space obsolescence is a mounting concern. Finally, the retail sector is enjoying a tailwind from disparate population growth contributing demand for space in growing localities while the headwind of excess space in declining areas and shrinking venues is ongoing.



Martha Peyton
Research Consultant to LGIM America

Martha Peyton is a Research Consultant to LGIM America's Real Estate Equity team. In this role, she is responsible for US economic and property market research, which is a foundation for the team's investment strategy.

Between 2018 and mid-2023, she was Managing Director of Applied Research for Aegon Real Assets US, primarily responsible for the development and application of research to real asset strategies. Between 1993 and 2016, Martha was Managing Director, Head of Real Estate and Global Real Assets Research for TIAA-Nuveen. While at TIAA, she built and oversaw the research function for the commercial mortgage loan and real estate businesses. This included managing research staff, setting the research agenda, conducting ongoing monitoring and analysis of the investment environment and asset class performance and authoring white papers and research publications.

Martha earned her BA, MA and PhD in Economics from Fordham University. She is a Counselor of Real Estate (CRE) and is President of the Real Estate Research Institute.

1. Source: St. Louis FRED.
2. Source: University of Michigan, Survey of Consumers. Data as of February 2024.
3. Source: NCREIF. Data as of December 2023.

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