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LGIM America

# Real Estate Pulse

## On the Upswing, Despite Wobbles

Q3 2024

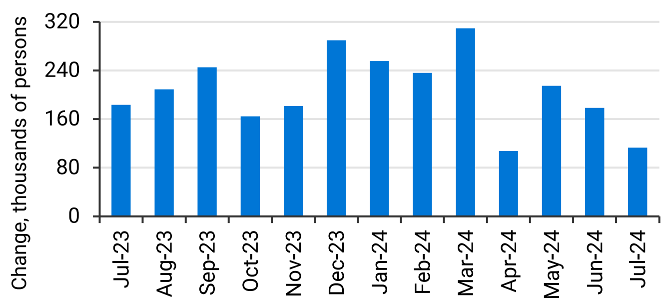
## Executive summary

Identifying the bottom or near-bottom of the property pricing cycle and acting on it is the holy grail sought by commercial real estate investors. Second quarter data for the US NCREIF National Property Index is feeding hope that a bottom is in sight. Such hope is supported by transaction volumes and valuation data along with an ongoing positive macro-economic backdrop. At the same time, the overhang of distressed property debt remains threatening.

Total return performance reported for the NCREIF-NPI was much improved for Q2 2024 but still negative. One-year total return at -5.3% compares favorably with the -6.9% one-year total return for the four quarters ending March 2024.[1] Improvement in the capital appreciation component accounted for the better results along with a slight increase in the income component. All four of the primary property sectors (Industrial, Office, Residential and Retail) showed improvement in the second quarter. These metrics refer to the new "Expanded NPI" which includes roughly 8% more value associated with specialty property types such as self-storage that were not included in "Classic NPI". The improved readings for Q2 2024 vs the prior quarter are similar for both the new expanded and the smaller classic data sets.

The prospects for stabilizing property value are reinforced by differences in valuation timing and methodologies. The NCREIF Capital Appreciation Index uses appraised values that incorporate consideration of sales prices of comparable properties. This methodology is backward looking by design. In contrast, real estate research firm Green Street bases

**Figure 1 – All employees, total nonfarm**




Source: US Bureau of Labor Statistics. Data as of July 2024.

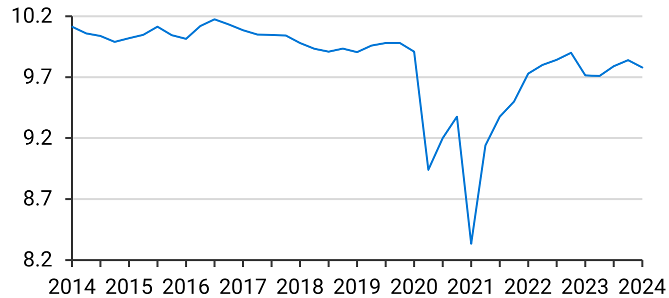
its Commercial Property Price Index on consideration of forward-looking information including the movement in REIT stock prices and earnings reports. Their July report shows no negative value changes across sectors and increases in value for the apartment, core and all property metrics.[2]

Improvements are also apparent in the availability of financing as spreads have stabilized. Green Street reports that CMBS issuance for the year through mid-July is more than double the flow for the same period in 2023.

The macro-economic backdrop for CRE performance continues to provide solid support despite the weakening in the pace of job creation. July's employment report showing 114,000 new jobs is a let-down from stronger additions in May and June.[3] The disappointment is compounded by the uptick in the unemployment rate to 4.3% from 4.1% in June.[3] The Federal Reserve's decision to maintain the current high funds rate unchanged adds to angst; the Fed is now seen as "behind the curve." Forecasters are expecting a solid 50 basis points rate cut from the Fed in September as a catch-up.

The shift in sentiment follows buoyant spirits through the end of the second quarter. The quarter's GDP report showed strengthening to a 3.0% rate of growth from the weaker 1.4% in the first quarter.[4] Consumer spending strengthened markedly and investment in equipment soared. Real disposable personal income continued to grow bolstering expectations for ongoing consumer strength over the remainder of the year. Consumers do have some room for further borrowing to buoy spending as shown in the Figure 2; household debt payments as a percent of disposable income are levelling out below the pre-COVID trend. However, consumer credit delinquency rates have been increasing and are now in line with pre-covid readings suggesting that credit-propelled spending growth is probably unlikely. Together, these metrics support expectations for ongoing modest economic growth to drive recovery in commercial real estate performance.

**Figure 2 – Household debt service payments as percent of disposable income**




Source: Board of Governors of the Federal Reserve System (US). Data as of July 2024.

## Macro economy

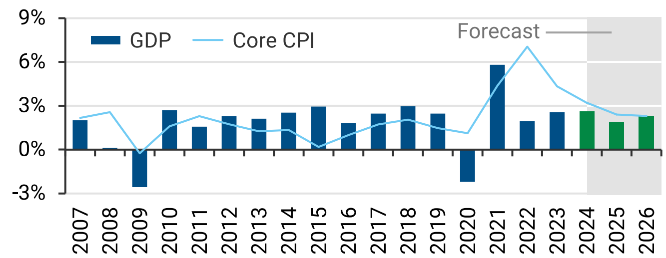
Looking ahead, forecasters remain optimistic despite the disappointing July employment report. The Federal Reserve Bank of Philadelphia Third Quarter 2024 Survey of Professional Forecasters released in early August, shows a minor increase in the 2024 real GDP growth forecast to 2.6% from 2.5% in the prior quarter's survey. 2025 expectations are unchanged at 1.9% growth strengthening to 2.3% in 2026.[5] Probability of negative annual GDP over the 2024-2026 period remains very low at under 10% for each of the three years, unchanged from the earlier quarter probabilities. However, the probability of a negative quarter sometime in 2025 has increased probably reflecting fear that interest rates are staying too high for too long.

Expected unemployment rates have notched up with the 2024 forecast at 4.1% from 3.9% in the prior quarter. 2025 is now at 4.3% and 2026 at 4.2% up from 4.1% for both in the prior quarter. These changes are noteworthy but not material. Similarly, forecasts for core CPI are a notch lower at 3.2% in 2024, 2.4% in 2025 and 2.3% in 2026.[3] Together, unemployment and core CPI forecasts demonstrate confidence that monetary policy is accomplishing its dual goal of maintaining full employment and acceptable inflation even with the latter a bit about the 2% guideline.

Financial markets are affirming these expectations as seen through the downdraft in the 10-year Treasury yield to below 4% and holding in August. Residential mortgage rates have declined as well showing a roughly 50 basis points drop since early July. The cycle high in mortgage rates was posted in October 2023 at 7.8%; the current 6.5% is a big improvement that has not yet boosted home sales.[6]

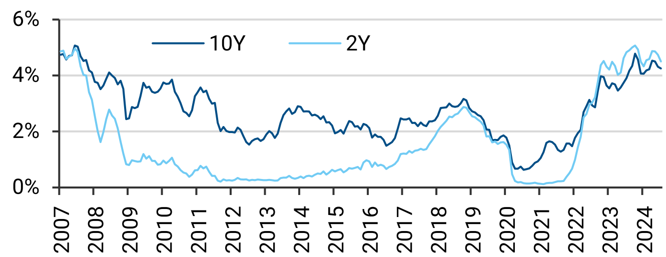
Despite pervasive expectations of a Fed rate cut in July, policymakers declined to make that move. The policy statement again cited their appetite for more assurance

**Figure 3 – Annual US real GDP and core CPI**




Source: Federal Reserve Bank of Philadelphia, Third Quarter 2024 Survey of Professional Forecasters.

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




Source: St. Louis FRED. Data as of August 2024.

that inflation has been tamed. The Fed's hesitancy leaves market participants confident that the next meeting will bring a catch-up 50 basis poins cut. July's modest inflation report reinforces this expectation. However, with a presidential election coming in November, the Fed will likely be charged with behaving politically no matter what rate action emerges.

The solidly optimistic tone of economic forecasts stands in contrast to the surge in stock market volatility in August. It bears remembering that the stock market is not a predictor of GDP growth. It also bears noting that the uptick in volatility follows a largely calm and positive year for stock investors.

# Transactions and pricing stabilizing

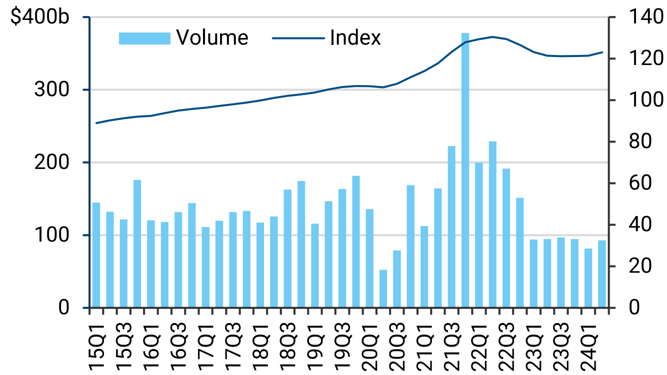
Second quarter property transactions show a small uptick in single asset sales from the first quarter albeit still 9% below the prior year. Portfolio sales jumped sharply with Blackstone's acquisition of the AIR apartment REIT. Total transactions inched up but remained 2% below Q2 2023.[7] Is this a sign of a cycle bottom in transactions? Are buyers and sellers beginning to come together?

Sector details offer some food for thought. Second quarter industrial sales were down 17% from last year perhaps indicating a cooling in an otherwise hot sector. Similarly retail property sales were down 10% from last year, again indicating a pullback in a favored sector. But the 20% decline in office sales cannot be regarded as a pause in healthy trading but rather as a continuation in pervasive office sector restructuring. At the same time, the 20% higher apartment transactions may be a sign of increasing willingness of buyers to make deals as excess apartment supply is absorbed.[7]

Transaction prices in the second quarter reflected in the RCA CPPI support these interpretations. Industrial and retail property prices were up over the quarter while office prices continued to weaken without bringing a turnaround to office transactions. Apartment prices were down 1.8% for the quarter and 7.5% for the year, perhaps helping to narrow the gap between sellers and buyers.[7] Geographically, West Coast markets enjoyed growth in transactions versus the rest of the US.

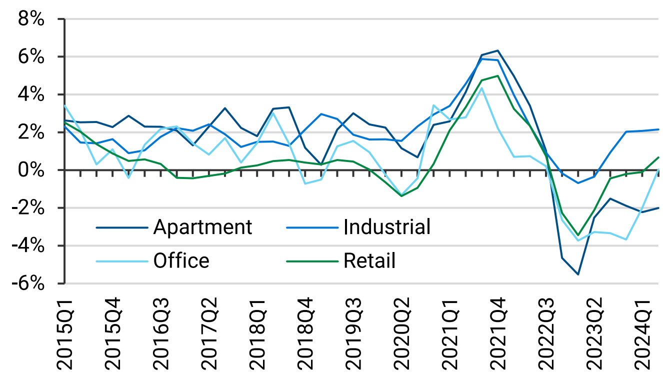
Green Street's Forwarding Look Price Index shows no change for July in the overall index nor in any of its sector components. While stabilizing property prices are good news, the shadow of distressed commercial mortgage debt remains. RCA estimates $94 billion in current distress of which $11 billion was added in the second quarter.[7] So far, maturity extensions are keeping a lid on further price deterioration, but the distress remains.

**Figure 5 – Transaction volume (quarterly, $b)**




Source: Real Capital Analytics. Data as of August 2024.

**Figure 6 – RCA CPPI (% change quarter-over-quarter)**




Source: Real Capital Analytics. Data as of August 2024.

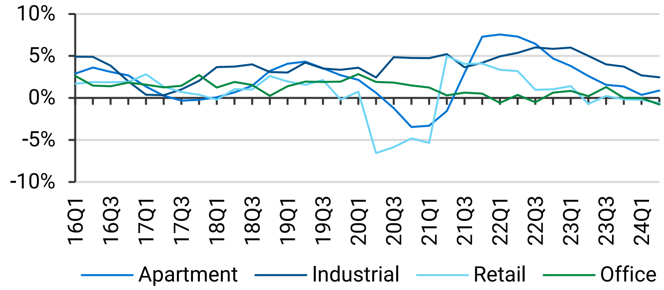
# Property investment returns stabilizing

The improvement in NCREIF-NPI total returns noted earlier were supported by the positive changes in apartment and industrial sector net operating income shown in Figure 7 with small negatives in office and retail sectors. Net operating income for all sectors adjusts to rent changes as leases turn over. Apartment leases have the shortest duration, typically one or two years, leaving apartments most vulnerable to NOI volatility. The slight uptick in apartment NOI suggests that the process of digesting excess supply and its downward pressure in rents may be nearing an end. This is reinforced by Figure 10 showing fewer metros experiencing apartment rent declines during Q2 versus Q1. Industrial sector NOI appears to be stabilizing though longer leases prolong the digestion of lower rents. Office and retail sector NOI continue in the negative range with office distress and long lease terms likely to keep it there indefinitely.

Capital appreciation for the sectors shown in Figure 8 illustrates a path approaching stable value for apartment, industrial and retail sectors. The office sector remains in negative territory. It bears repeating that these metrics are drawn from appraised values which reflect sales of comparable properties. Even with the small uptick in transactions in Q2, the weak flow of property transactions provides sparse data on comparable sales for appraisers.

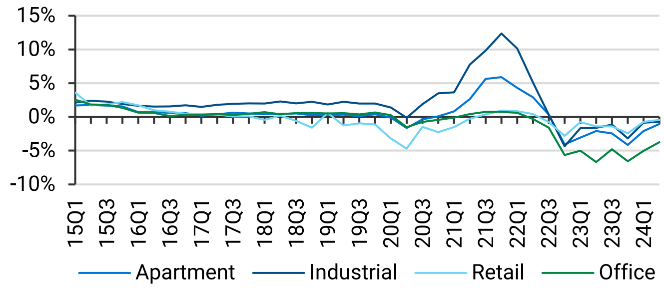
The flow of transactions will improve with lower interest rates particularly as investors suspect a cycle bottom in values as suggested by Green Street. Institutional investors responding to PREA's 2024 Investor Intentions Survey cited interest rates as having most influence on their investment intentions.

**Figure 7 – Expanded NCREIF-NPI NOI growth (rolling four-quater average)**




Source: NCREIF. Data as of August 2024.

**Figure 8 – NCREIF-NPI capital return**




Source: NCREIF. Data as of August 2024.

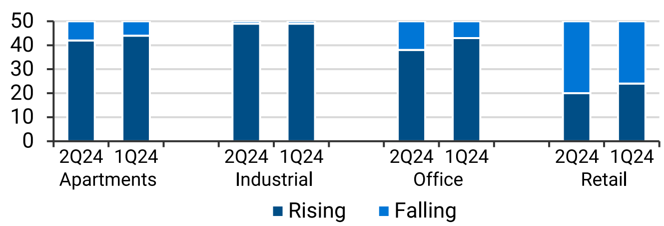
Most importantly, 85% of respondents cited intentions to deploy capital in 2024.[8] With sparse transactions in the first half of the year, interest rate cuts afoot, and suggestion of bottoming values, it is possible that investment activity will pick up noticeably over the quarters ahead.

# Market fundamentals showing minor improvement in momentum

Figures 9 and 10 are designed to portray momentum in metro area markets as defined by changes in vacancy rates and rents by property sector. Second quarter data show fewer metros reporting rising apartment, office and retail vacancy rates compared with the first quarter. However, industrial vacancy rates continued to tick up for almost all fifty top metros. At the same time, most metros reported an absence of rent growth. The combination of vacancy rate improvements with stable-to-declining rent is a signal that markets are struggling toward equilibrium.

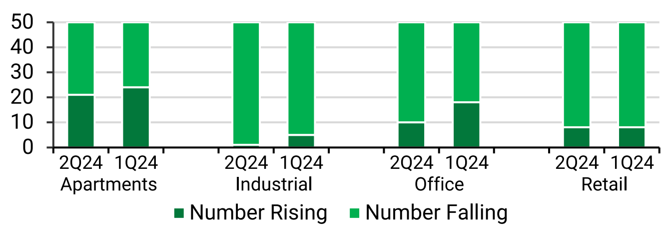
The positive macro-economic environment with ongoing employment growth is contributing to this equilibrating process. Projected interest rate cuts will help to accelerate the process.

**Figure 9 – Vacancy rate changes (top 50 metros)**




Source: CoStar, Q2 2024 vs Q1 2023.

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




Source: CoStar, Q2 2024 vs Q1 2023.

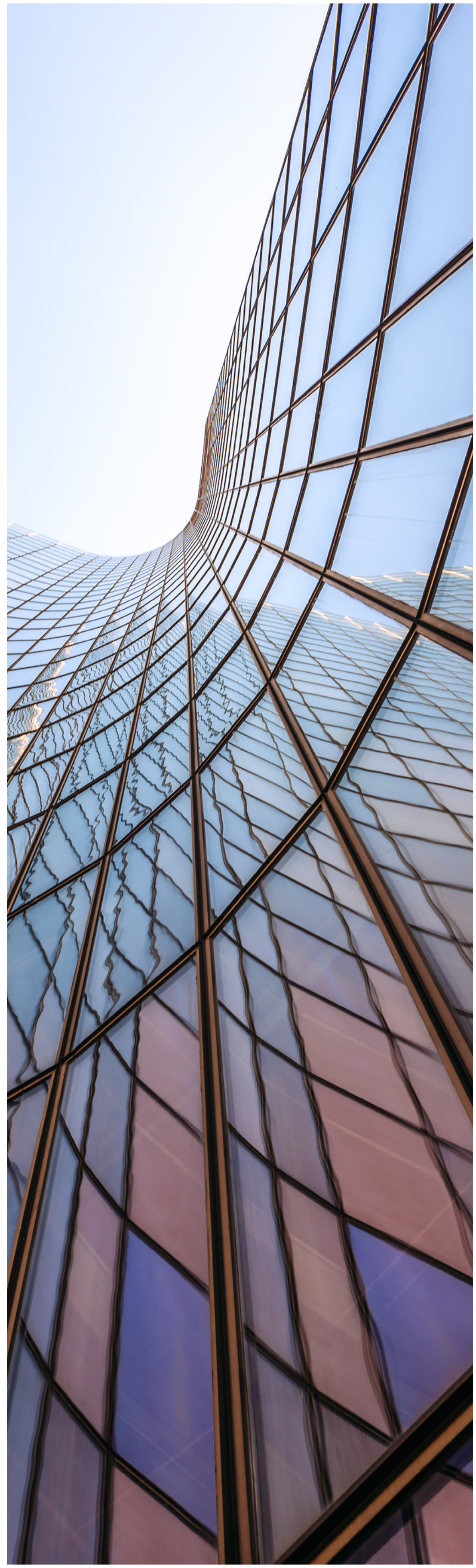
## Our assessment process

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 a Fellow and past President of the Real Estate Research Institute.

1. NCREIF Property Index (NPI).
2. Green Street July Report.
3. US Bureau of Labor Statistics.
4. US Bureau of Economic Analysis (BEA).
5. The Philadelphia Federal Reserve Third Quarter Survey.
6. Bankrate.
7. Real Capital Analytics.
8. PREA, 2024 Investment Intentions Survey, pages 7 and 21.

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