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Real Estate Pulse

A Positive Cycle Takes Hold

Q1 2025

Executive summary

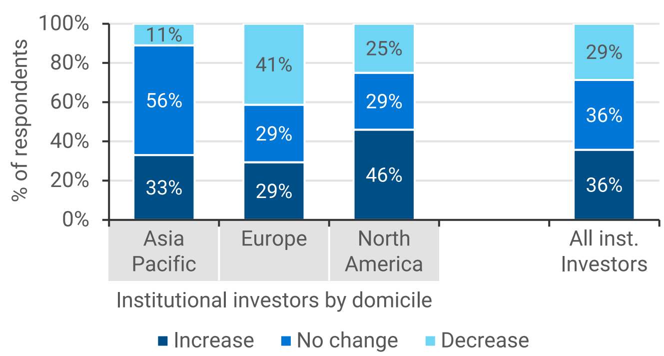
Performance results for US Commercial Real Estate (CRE) in the final quarter of 2024 confirm a cycle inflection to positive returns in the second half of the year. The NCREIF Expanded National Property Index posted positive total returns in both the third and fourth quarters of 2024 after negatives starting in the fourth quarter 2022. Over the four quarters of 2024, total return amounted to 0.6% with capital appreciation at -4.0% offset by income return. The erosion of capital diminished over the course of the year from -1.40% in the first quarter to -0.24% in the fourth quarter.[1]

Except for office, the primary property sectors posted positive capital appreciation for both the third and fourth quarters with minor full year capital declines of -1.4% for industrial, -2.9% for residential and -0.2% for retail. The progression to positive capital appreciation over the second half of the year affirms the cycle inflection. For office, the improvement in the cycle was not enough to counter the sector's structural challenges which pushed down capital value -12.6% for the full year on top of the -23.8% decline in 2023, and -7.4% in 2022.[2]

The cycle turnaround is bolstering the appetite of institutional CRE investors with 36% of respondents to the 2025 PREA Investment Intentions Survey reporting plans to increase real estate allocations over the next two years. The 2024 Survey reported a weaker 25% of respondents with such intentions. North America domiciled investors are particularly enthusiastic with 46% reporting plans to increase allocations versus 26% reporting such plans last year.

Improved CRE credit availability focused on commercial mortgage-backed (CMBS) securitizations and private equity debt funds also helped turn the cycle to positive. CMBS issuance was almost three times the 2023 pace at $17.8 billion and not far from the $18.8 billion average over the 2015-2019 pre-COVID years. For the larger universe that includes all commercial and multifamily mortgages, the Mortgage Bankers Association reported that originations from the fourth quarter of 2024 were 84% higher than originations in the fourth quarter of 2023 and up 30% from the third quarter of 2024.[3]

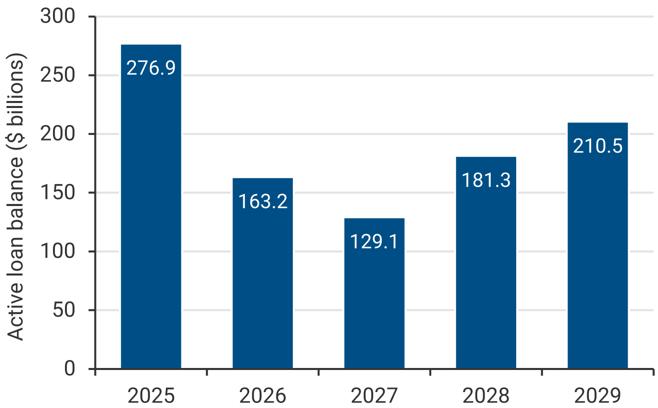
Figure 1 – Expected change in real estate allocation over the next two years



Source: 2025 Investment Intentions Survey, PREA. Data as of January 2025.

The cycle turn, improving investor sentiment and CRE credit availability should help to ease the threat of the 2025 commercial mortgage "wall of maturities." In 2024, resolutions mushroomed with CRED-iQ reporting that loan modifications, also called "extend and pretend," for securitized commercial mortgages spiked to an all-time high for the year.[4] This sets the stage for coping with this year's huge wall of maturities as well.

Figure 2 – $961.1 billion of securitized universe maturing over the next five years



Source: Cred-iQ, Maturity Outlook. Data as of January 31, 2025.

The US economy and financial market conditions supported the 2024 CRE cycle upturn. Real GDP growth of 2.8% for 2024 bested expectations while holding to the Federal Reserve's 2.8% reading on its preferred inflation metric. That metric, for personal consumption inflation excluding food and energy, peaked at a 6.1% rate in the first quarter of 2022 and prompted the Fed's forceful 525 bps increase in the federal funds rate. In 2024, anticipating an easing in interest rate policy, the 10-year Treasury yield edged downward from its 4.95% cycle peak posted in October 2023 to a low of 3.63% in September 2024. Over the remainder of the year, the yield trended higher reaching 4.79% in late December.[4]

While the interest rate drop from the cycle high was certainly positive for CRE, the subsequent uptick in the fourth quarter is unlikely to have affected fourth quarter CRE transactions and pricing. Closing CRE transactions is a time-consuming process suggesting that late-year closings were negotiated before the upward shift in interest rates. 2025 transactions will reflect that interest rate uptick and forthcoming changes as well. Interest rate movements ahead are uncertain but the late-year escalation is holding.

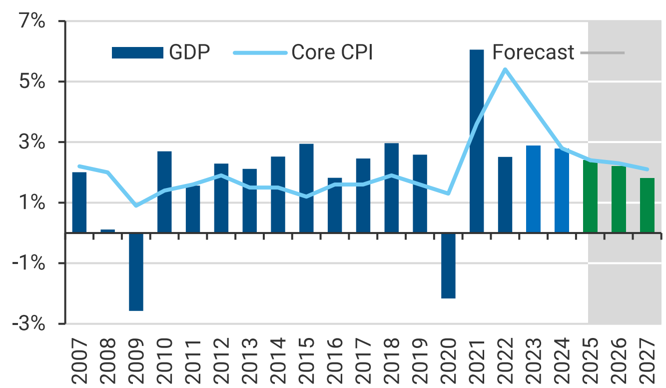
Macro economy

Forecasters are digesting uncertainty along with financial markets. The first quarter 2025 "Survey of Professional Forecasters" conducted by the Philadelphia Federal Reserve shows a weakening in economic growth expected for 2025 to 2.4% and 2.2% in 2026. The fourth quarter 2024 results are a foundation for such expectations. Real GDP for the quarter posted a 2.3% rate of growth, down significantly from the 3% growth rates for the second and third quarters. Altogether, annual average 2024 growth was an impressive 2.8%.[5] Consumption spending held up well in the fourth quarter, but private investment spending contracted following six positive quarters. That contraction, along with January's mediocre employment growth report, support expectations for weaker economic growth ahead.

Higher inflation is also anticipated. While the median projections for core PCE inflation only inched up to 2.4% in 2025 and 2.3% in 2026 from 2.2% and 2.1%, respectively, in the fourth quarter survey, the probability of higher inflation increased noticeably. The survey offers no indication that the boost in inflation expectations is related to Trump-2 policies. Nor does it provide explanation for the steep decline in projected monthly payroll employment growth from 145,000 per month in 2025 to 113,500 per month in 2026. It is worth noting here that the January 2025 BLS employment report shows that the foreign-born labor force filled 1.9 million of the 2.7 million increase in 2024 household employment.[6]

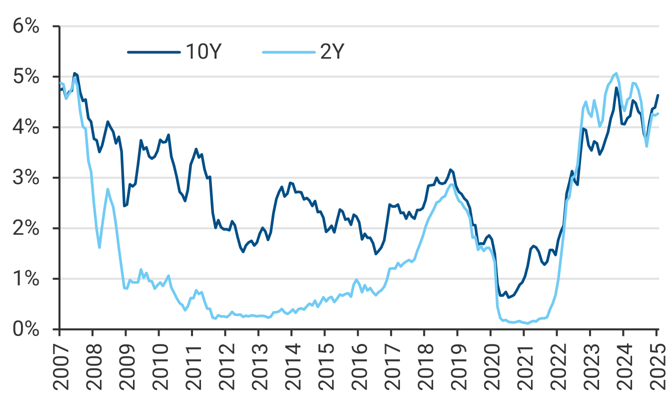
Analysts are grappling with the potential impact of various tariff and immigration scenarios, but it is too soon to deem any scenario as most probable. Regarding immigration, it is

Figure 3 – US real GDP and core PCE (annual)



Source: Federal Reserve Bank of Philadelphia, First Quarter 2025 Survey of Professional Forecasters.

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



Source: St. Louis FRED. Data as of February 2025.

important to note that the "Demographic Outlook" released by the Congressional Budget Office (CBO) in January assumes immigration of 2.0 million persons in 2025 and 1.5 million in 2026.[6] These assumptions contribute to CBO's forecasted 2.2% average real GDP growth for 2025 through 2029.[7] Without that immigration inflow, labor force and employment growth will likely be constrained thereby constraining economic growth potential as well.

While it may be premature to construct explicit macro-economic assumptions around potential changes in policies, the uptick in interest rates over the latter part of 2024 may serve as a metric of political uncertainty; as such, it is factored into economic projections. The residential sector is most vulnerable to elevated interest rates. On average, residential borrowers paid 80 basis points more for home financing at the end of 2024 versus the September low which followed the Fed's shift to easing.

The yield curve returned to a positive slope with the September Fed easing shown by the 10-year Treasury yield moving above the 2-year Treasury yield. This affirmed that financial markets were letting go of fear that the Fed's hesitancy in easing would lead to recession. That fear had prevailed earlier in 2024. Looking ahead financial markets are focusing on inflation prospects, further Fed easing, and pervasive political uncertainty.

While the Federal Reserve's December 2024 economic projections show two 25 basis points cuts expected for 2025, the path and impact of the new Trump administration's policies will play a role in the Fed's decisions and in financial market reactions.

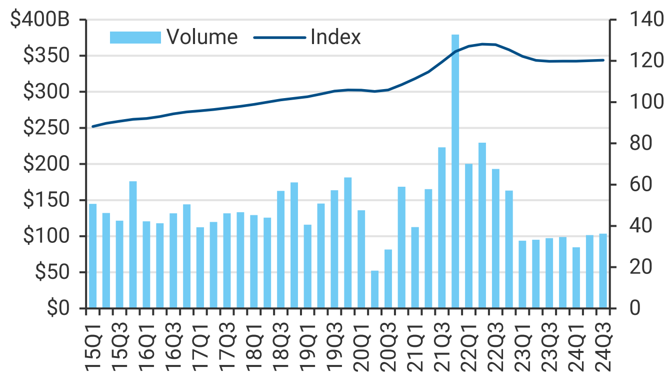
CRE Transactions and pricing

The volume of CRE transactions continued to inch up in the fourth quarter of 2024 following advances in the two prior quarters. Volume for the quarter was 32% above the fourth quarter of 2023, bringing the full year 2024 volume to 9% above 2023. Apartment transactions posted the strongest gains, up 64% year-over-year for the quarter and 22% for the year. Office followed, up 36% for the quarter and 20% for the year with industrial next at 33% for the quarter and 5% for the year. Retail transactions trailed with only an 8% gain for the quarter and a 7% drop for the year. The intensified volume of transactions was focused more on single-property transactions, up 33% for the quarter and 7% for the year compared with portfolio entity transactions, up 26% for the quarter and 17% for the year.[8]

The surge in fourth quarter transactions for apartment and industrial properties is not surprising because those sectors have been viewed most optimistically by investors for quite some time. The fourth quarter timing suggests that investors were viewing pricing more favorably as the year progressed perhaps validated by the September turn to interest rate easing. The improvement in office sector volume is more puzzling in light of the ongoing challenges facing the sector. Perhaps news of increasing employer demands that workers return to the office are putting a floor under office occupancy. Perhaps the strength in demand for the highest quality office space is helping investors to gauge relative value more comfortably. For the retail sector, the minor improvement in volume for the fourth quarter and minor decline for the year are not surprising. The sector has been least roiled by post-COVID gyrations in supply and demand.

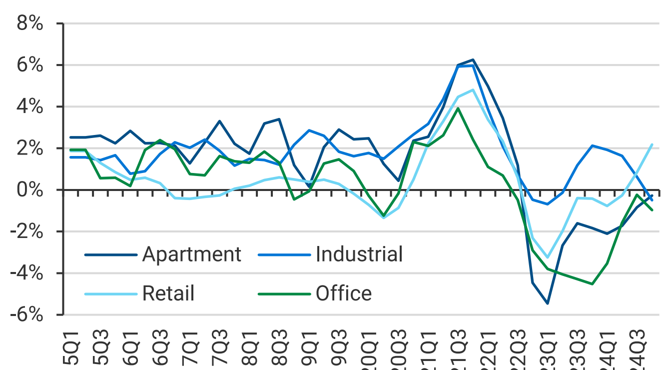
Property pricing improved slightly over 2024 according to the MSCI-Real Capital Analytics Commercial Property Price Indexes shown in Figure 6. For the year, commercial property prices inched up 0.2% while apartment pricing declined -4.2%. Retail property showed the strongest 2024 increase at 3.2% followed by industrial at 2.7%. During the fourth quarter, retail's strength continued as shown in its 2.7% quarterly

Figure 5 – Transaction volume (quarterly, $b)



Source: Real Capital Analytics. Data as of February 2025. Index = RCA CPPI Core Commercial Index.

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



Source: Real Capital Analytics. Data as of February 2025.

increase while industrial edged down -0.8% for the quarter. Office property prices declined -5.3% for 2024 with declines persisting through December -0.5% decline.[8]

Ups and downs in pricing are not surprising at this point in the CRE cycle. As investors become more open to negotiating opportunities and owners become more open to accepting market realities, transactions pricing will gyrate. Green Street's Commercial Property Price Index incorporates REIT data as well as transactions pricing; their index was up more strongly for 2024 at 6% for the four core property sectors.

Property performance in positive territory

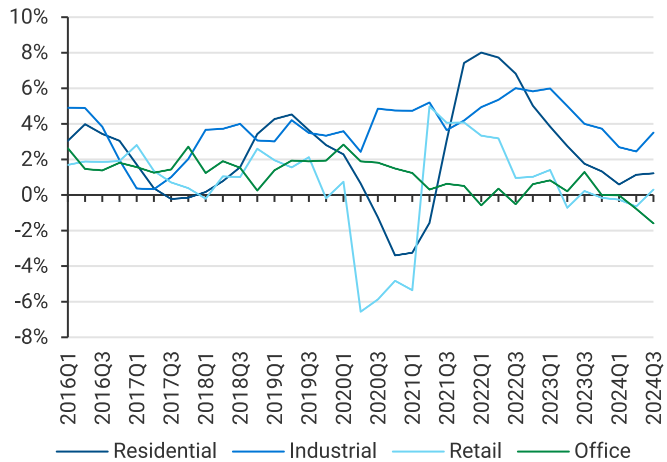
As noted earlier, NCREIF NPI total return rebounded to positive territory for the third and fourth quarters of 2024 and boosted full year 2024 total return to a positive 0.6% as well.[9] Figures 7 and 8 examine NPI property performance in more detail.

Four quarter net operating income (NOI) growth is a telling measure of fundamental property performance. As shown in Figure 7, industrial property has been the star performer even with the weakening in NOI growth in 2023 and into 2024. The uptick in the most recent four quarter data incorporates re-leasing expiring long-term leases at elevated rents along with the absorption of supply additions. Residential NOI growth has also evidently bottomed and is showing some pickup. Unlike industrial, residential leases are generally short-term allowing for quicker catch-up to market rents. Retail property NOI growth has shown only a minor pick-up; it remains weak albeit positive. Office remains the weakling with explicitly negative NOI growth for 2024. For office, expiring long-term leases are turning into lower market rents.

The upticks in industrial, residential, and retail sector NOI growth affirm the turn in the US CRE cycle. Both industrial and residential sectors produced hearty construction pipelines in response to the COVID-related zero interest rate policy along with that period's boost in demand for warehouse space and apartment rentals. Over-supply in some metros depressed rent growth feeding into the downturns in NOI growth in 2023 and into 2024. At the same time, the tighter interest rate environment and the burden of excess supply is curtailing new construction and helping to define the bottom in NOI growth as occurring the latter part of 2024. The office sector did not experience the same cyclical forces; office was dominated by a downshift in demand as work-from-home during COVID led to hybrid work protocols in the years since. With office staff no longer in buildings all week, the need for space has declined. Employers are increasingly requiring more time in the office, but a new equilibrium has not yet emerged.

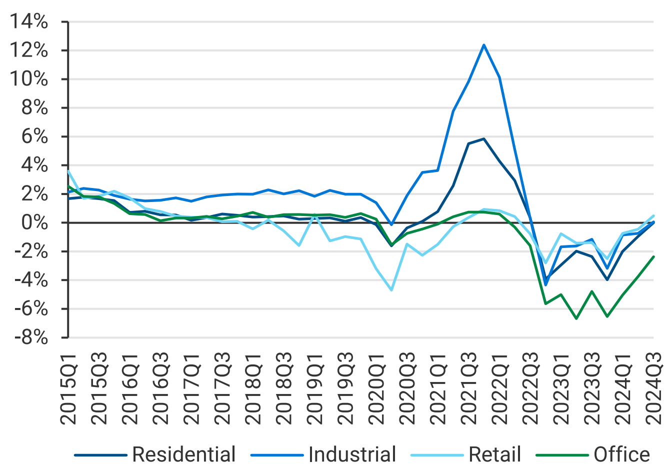
The capital appreciation chart tells the story of pricing property rather than fundamental supply-demand factors. Figure 8 clearly shows that industrial, residential and retail space experienced similar negative capital appreciation as interest rates tightened in 2022, albeit from different heights. Office is again the outlier as its structural problems depressed capital values more severely than occurred for the other sectors. Nonetheless, all four sectors show a reversal in recent quarters again confirming that the cycle has turned.

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



Source: NCREIF. Data as of February 2025.

Figure 8 – NCREIF-NPI capital return



Source: NCREIF. Data as of February 2025.

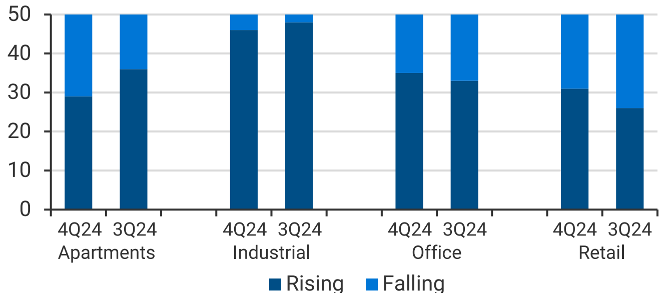
Negative metro market vacancy and rent changes still dominate

Figures 9 and 10 are designed to portray momentum in the top 50 metro area markets as defined by changes in vacancy rates and rents by property sector.

While macro performance indicators for CRE signal a turn to a positive cycle, metro market performance continues to vary widely both within and across sectors. For the top 50 metro areas, apartment vacancy rates improved in 21 of the 50 between the third and fourth quarters of 2024.[10] Office and retail vacancy rates improved in fewer metros while only two of the 50 metros saw improving industrial vacancy rates. The majority of the 50 metros also saw falling rents year-over-year in the fourth quarters. In general, these readings were roughly in line with year-over-year changes in the third quarter.

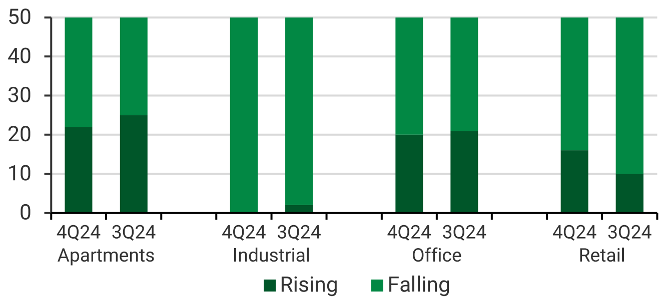
The disparities in vacancy rate and rent changes among the top 50 metros demonstrates that metro market selection continues to matter even as the overall CRE cycle turns to positive. Some metros continue to grapple with vacancy and rent pressures associated with lingering excess supply in some sectors. Excess construction was not problematic in the retail sector requiring that vacancy and rent changes be interpreted rather as local economy ups and downs. Office sector changes are also different indicating that some metros are showing signs of improvement in an otherwise problematic sector.

Figure 9 – Vacancy rate changes (top 50 metros)



Source: CoStar, Q4 2024 vs Q3 2024.

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



Source: CoStar, Q4 2024 vs Q3 2024.

Our assesment 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.

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Martha Peyton is a Research Consultant to the firm'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, Martha 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 a Fellow and past president of the Real Estate Research Institute.

1. NCREIF Property Index (NPI).
2. NCREIF.
3. Commercial/Multifamily Borrowing Up in the Fourth Quarter of 2024 | MBA.
4. Maturity Wall Grows with $440 Billion Coming Due Over the Next Two Years | CRED iQ Blog.
5. Federal Reserve Bank of Philadelphia, Fourth Quarter 2024 Survey of Professional Forecasters.
6. CBO, The Demographic Outlook, January 13, 2025.
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8. Real Capital Analytics. Data as of February 2025.
9. NCREIF.
10. CoStar

Disclosures

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