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LGIM America

Real Estate Pulse

US CRE Producing Positive Returns

Q4 2024

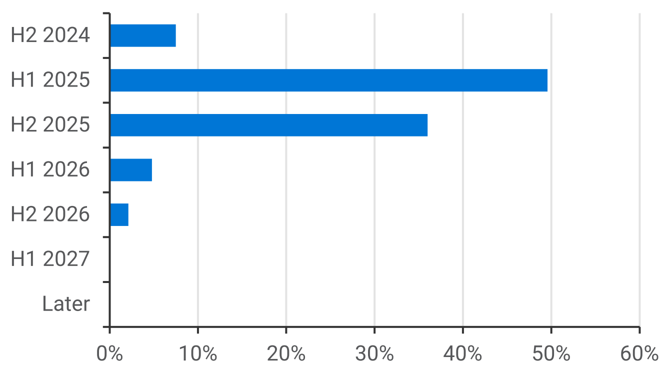
Executive summary

Investment performance for US Commercial Real Estate (CRE) improved solidly in Q3 2024 according to updated NCREIF data. Total return for all properties on a cumulative basis was positive (0.83%) for the first time since mid-2022. Third quarter results showed shrinking negative capital appreciation compensated by ongoing solid income return. Among the eight sectors now contained in the Expanded National Property Index (NPI), only two report negative capital appreciation, office (-2.37%) and seniors housing (-0.44%). With the latter representing less than 2% of the index properties, the office sector is essentially alone in producing the quarter's negative capital appreciation return for the NPI. The strongest positive impact on appreciation was delivered by the retail sector followed by the small hotel, self-storage, and "other." Retail properties comprise 13% of the index while the latter three together comprise just under 5%.[1]

The combination of ongoing solid economic growth, moderating inflation and the first interest rate cut of the cycle largely explain the improvement in CRE performance. Signals of a cycle bottom have been emerging since the beginning of 2024. More recently, roughly half of investors polled by CBRE are expecting a big improvement in transactions during the first half of 2025.[2]

This expectation follows from the upticks in transactions of individual properties reported by Real Capital Analytics (RCA) for the second and third quarters of 2024. The first quarter appears to have been the cycle trough. At the same time, RCA reported a minor -0.6% decline in its price index during the third quarter, perhaps indicative of the price haggling behind transactions.[3] Nonetheless, property pricing seems to be stabilizing both in RCA data and in Green Street metrics which show a trough in pricing earlier this year.

Figure 1 – Timing in which respondents believe transactions will begin to come back in a serious way



Source: CBRE, US Cap Rate Survey. Data as of August 2024.

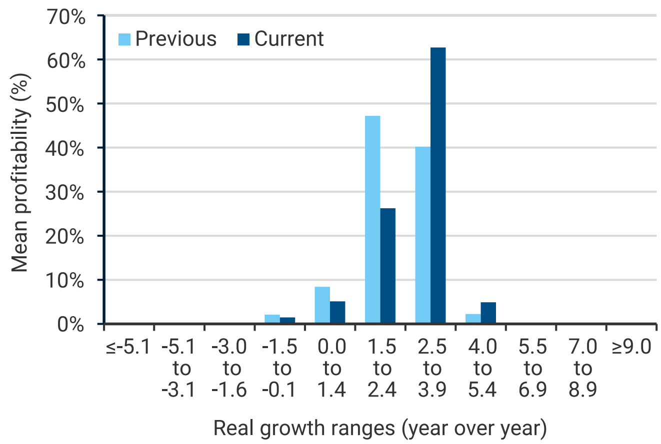
Financing availability has been improving as well with the strongest CMBS issuance in two years accompanied by narrowing spreads. Bank lending for commercial real estate has also been loosening up as shown in the sharp reduction in banks reporting tightening in lending standards versus a year ago. Bank holdings of commercial real estate loans are up from a year ago as well despite some ups and downs over the year. At the same time, the flow of mortgages into distress slowed in the third quarter to the smallest volume since Q4 2022 according to the RCA Distress Tracker.

Unexpectedly strong GDP growth during the first three quarters of 2024 provided a solid foundation for the improvements in commercial real estate. Forecasters had been expecting tepid economic growth for 2024 as shown in the 1.7% median real GDP forecast reported in the Q4 2023 Philadelphia Fed's Survey of Professional Forecasters. The most recent survey shows a 2.7% median while 60% of forecasters see growth possibly as high as 3.9%. The stronger growth this year has been accompanied by headline CPI in line with the 2.5% expected in last year's report.

By September, the 2024 macro-economic performance to date provided just enough moderation in inflation to allow the Federal Reserve to cut the federal funds rate by 50 basis points in September and another 25 basis points in November. The rate cuts doused fear that the Fed would keep rates too high for too long and jeopardize growth prospects. Another cut in December may be in the offing especially given the very small employment increase posted for October.

Altogether, US commercial real estate investors have a solid basis for expecting a cycle upturn in 2025. Conventional wisdom views the REIT market as a harbinger of the path of private property performance. If so, it is reinforcing the view that the cycle has turned upward. The FTSE Equity REIT total return index is up 24% since its September 2023 cycle low.

Figure 2 – Mean probabilities for real GDP growth in 2024



Source: Federal Reserve Bank of Philadelphia, Quarterly Survey of Professional Forecasters. Data as of November 2024.

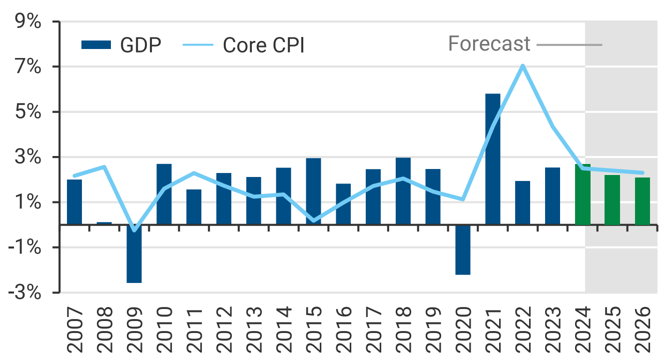
Macro economy – Looking ahead

Forecasters continue to expect trend-like US economic growth in 2025 with real GDP growth hovering around 2.0% with upside and downside probabilities roughly balanced. The weakening from 2024 may be indicative of a re-establishment of economic equilibrium after the COVID disruptions. In particular, the labor market appears to be at a cyclical peak with the labor force participation rate for prime age population (25-to-54 years of age) at 83.9%, the highest since early 2000.[4] Labor force growth is now serving as a constraint on economic growth and prospects have been muted as baby boomers retire and immigration flows remain uncertain.

In the quarters ahead, consumer spending growth is likely to slow following the strong growth in Q3 2024. Gains in spending on durable goods in the third quarter may have been prompted by the prospect of lower interest rates. But with consumer debt payment burdens now back to near the pre-COVID level and delinquency rates on credit card and auto loans rising, it is likely that consumers will slow down. Slower employment growth will constrain consumer spending gains as well.

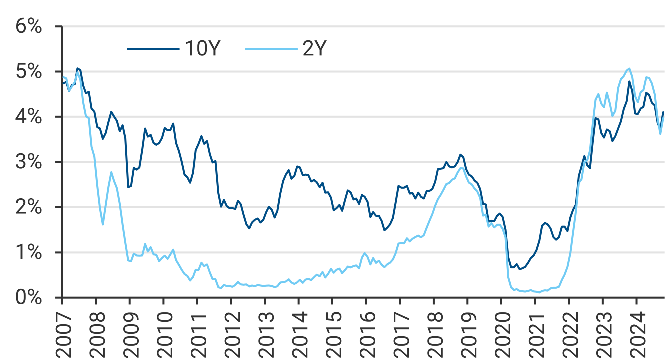
Residential construction could provide some fuel for GDP growth next year. Hope for lower interest rates prompted a bounce in residential in early 2024 but declines followed in subsequent quarters. Housing demand for single-family homes remains solid even with mortgage rates up from September. The SF construction shortfall following the GFC

Figure 3 – Annual US real GDP and core CPI



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

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



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

has not yet been fully reversed. Multi-family construction has been stronger with some metros experiencing excess supply. New multi-family projects are unlikely to drive economic growth in 2025 as the pipeline of under-construction activity has yet to empty.

Inflation remains well-behaved approaching the Federal Reserve's 2+/-% target range. Prospects for ongoing modest inflation are supported by the moderate pace of wage gains despite the tightness in the labor market. Well-behaved inflation prompted the 25 basis points interest rate cut in November. Combining it with the 50 basis points rate cut in September brings the federal funds rate 75 basis points below its cycle high. Financial markets have looked kindly on the rate cuts as shown in the reversal in the yield curve inversion that prevailed from July 2022 to September 2024. The market is finally accepting a soft landing reality.

With this said, 2025 prospects for the US economy will be influenced by the return of Donald Trump to the White House together with Republican control of both houses of Congress. Concrete changes in policy will probably take some time but reactions in financial markets might be already evident in the uptick in the 10-year Treasury yield since September.

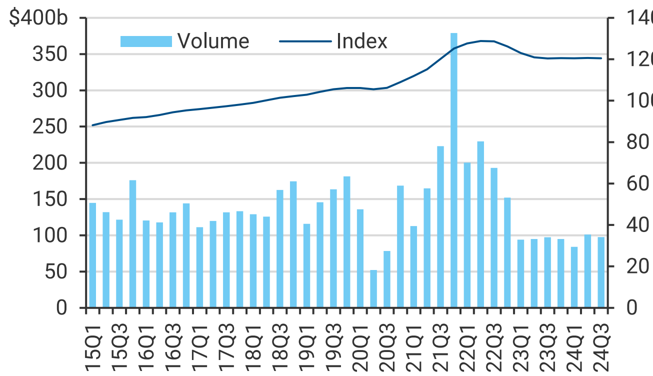
Transactions pick up

After seven quarters of shrinkage, property transactions improved during the second and third quarters of 2024. However, volumes remain well below the pre-COVID pace recorded in 2019. Both individual property and portfolio volumes improved after the first quarter indicative of the uptick in investor optimism. Most notable volume improvements occurred in the office and apartment sectors. CBD office transactions account for the entirety of the office improvement with an astounding 79% year-over-year volume improvement.[5] The breadth of the gain reflects the year ago (Q3 2023) level at a deep trough in activity. Suburban office transactions improved in Q1 2024 but meandered down in the subsequent two quarters. The improvement in apartment transactions was concentrated in the mid/high-rise segment with a less robust improvement in garden apartments.

Industrial sector transactions weakened somewhat over the second and third quarters, but the warehouse segment separately improved slightly in the third quarter. The weakening in industrial is attributable to individual property transactions as portfolio entity sales volume improved in both the second and third quarters. Investment in the industrial sector is clouded by excess supply in some metros. But, the secular expansion in the sector as COVID accelerated online shopping and encouraged higher inventories of essential goods appears to have further to go. The macro-economic inventory-to-sales ratio is still below its pre-COVID level.

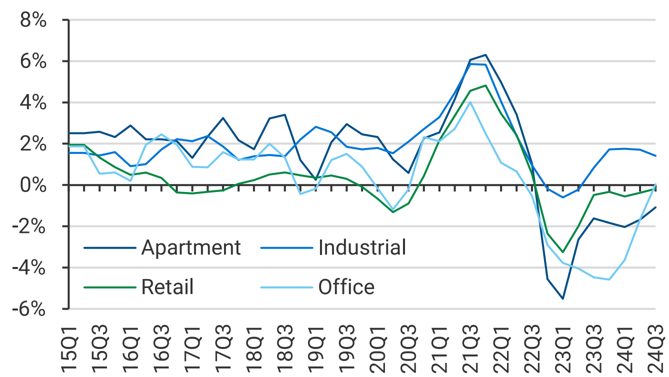
Using transactions data, RCA reports that property prices slipped -0.6% in the third quarter. Separately, office pricing improved 0.2% and industrial pricing strengthened 1.3%. Remaining sector showed minor declines, -1.0% for apartments and -0.2% for retail.[5] Minor ups and downs in pricing are expected during the early stage of a cycle turnaround as buyers and sellers make serious effort to close deals.

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.

Green Street's index of prices is less dependent on transactions data as it includes their extensive analysis of REIT performance. Their core price index reached bottom in March 2024 and is now 4% higher. The Green Street index shows a -21% overall decline in core sector prices from their peak in 2022 with the office sector down the most severely at -37%.[6]

Property fundamental performance mostly positive

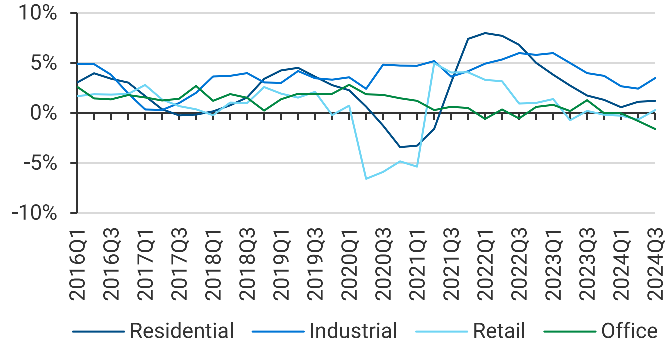
The income generated primarily from property rents is best examined in data for net operating income (NOI). The NCREIF "income return" component is not a measure of income flow but rather the ratio of income flow to property value. As such, it is essentially a capitalization rate that uses updated property value. The terminology is deceptive in that it can lead some observers to conclude mistakenly that property provides very steady income flows. Figure 7 shows clearly the error in that conclusion. NOI is cyclical; it varies with occupancy, rent growth, and the term of leases along with property expenses.

Figure 7 shows that residential and retail sector NOI growth rates plummeted during the COVID recession and then recovered very quickly. Both sectors delivered positive NOI growth during Q3 2024. In contrast, the industrial sector delivered strong positive NOI growth throughout the COVID years and continues to do so. The sector benefited especially from the surge in on-line shopping during COVID and anticipation of a secular increase in inventories of essential products. The latter stems from the infamous shortage of toilet paper and hospital gowns during the COVID emergency.

Finally, office sector NOI growth remained positive during the COVID recession reflecting the long terms typical of office leases. The negative impact of COVID on the office sector is evident in occupancy rates and sub-leasing activity that continue to show distress. Office NOI growth slipped into negative territory this year and will probably remain there for quite some time. The distress is largely a secular phenomenon reflecting the impact of hybrid work on office occupancy. Some observers expect the current three-days-in-the-office average to continue while others focus on increasing employer demands to come back full time.

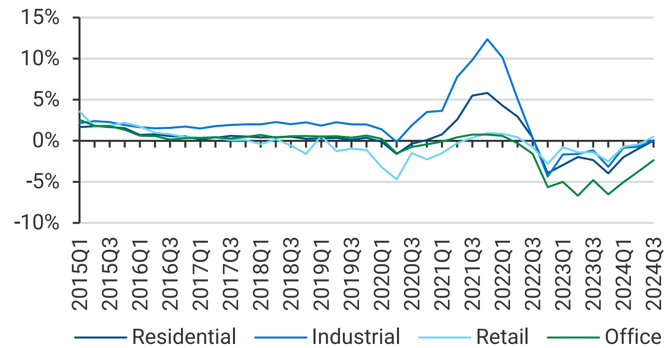
NCREIF capital appreciation reached positive territory in Q3 2024 for all the major sectors except office and the small seniors housing sector. The office -2.37% decline was large enough to keep the overall NCREIF capital appreciation component slightly negative at -0.37%.[7] The lower interest rates stemming from the Fed's September rate cut may have helped to boost capital return; expectations of rate cuts were probably important as well. The largely positive NOI growth rates since 2022 versus the negative capital appreciation demonstrates that property pricing was more important for property investment performance than fundamentals. The latter depend very much on disciplined supply, disciplined lending, and solid macroeconomic growth.

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



Source: NCREIF. Data as of November 2024.

Figure 8 – NCREIF-NPI capital return



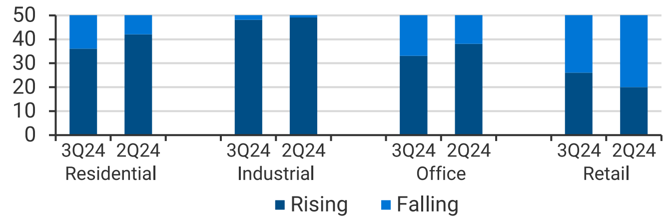
Source: NCREIF. Data as of November 2024.

Market fundamentals showing ongoing improvement in momentum in Q3 2024

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. Third quarter data show fewer metros reporting rising apartment, industrial and office vacancy rates compared with the second quarter. However, industrial vacancy rates continued to tick up for almost all fifty top metros albeit slightly fewer versus the second quarter. At the same time, most metros reported improvements in rent growth during the third quarter again with only a few metros showing rent growth in the industrial sector. The combination of vacancy rate and rent growth improvements is a signal that the top metro markets are now in recovery.

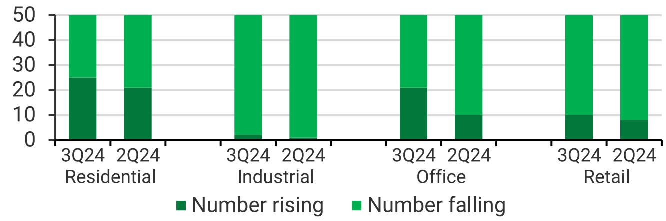
The positive macro-economic environment with ongoing employment growth and two interest rate cuts has already been contributing to this equilibrating process. The stage is set for ongoing recovery in 2025… all else equal.

Figure 9 – Vacancy rate changes (top 50 metros)



Source: CoStar, Q3 2024 vs Q2 2024.

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



Source: CoStar, Q3 2024 vs Q2 2024.

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.

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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. CBRE, US Cap Rate Survey. Data as of August 2024.
3. US Bureau of Labor Statistics.
4. St. Louis FRED..
5. Real Capital Analytics.
6. Green Street's Forwarding Look Price Index.
7. NCREIF.

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