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2023 2Q
US REAL ESTATE MARKET REPORT

CREATING WINNING CONNECTIONS FOR INVESTORS

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What is the forecast for the US economy?

The economy will display a variety of outcomes in 2023. Even though the pace has slowed, this was anticipated, given the surprisingly high growth rate in the previous year. Most of this delay can be attributed to policy. The Fed raised rates, and fiscal policy is tightening to lower the high inflation. The economy is beginning this new secular era, which recalibrates the economic ingredients for the US moving forward. Even though there will undoubtedly be a slowdown or adjustment in the economy, many experts believe a recession will be avoided.

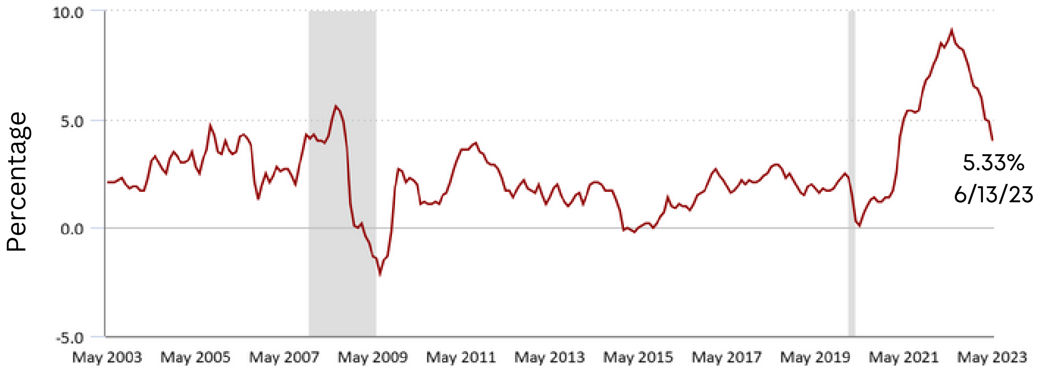
There are indications that inflation has peaked.

Inflation continues to be the driving issue for the US economy. Fortunately, we are already seeing indicators that inflation has peaked. The headline consumer price index (CPI) peaked in June 2022 and has since decelerated. In recent months, the core CPI has decreased.

The global supply chain, which has been considerably disrupted in recent years, is still recovering and improving in 2023. This will assist in relieving supply-side inflationary pressures.

Demand-side pressures also show signs of stabilizing. While consumer spending has remained resilient, demand-side pressures on inflation should ease in 2023. Wage growth is slowing, and fiscal stimulus from the last few years continues to fade. Consumer's excess savings has burned off under higher prices and spending. Consequently, we anticipate a more pronounced slowdown in inflation during 2023, likely heading toward the 4% range later this year. Even so, inflation will stay above the Fed’s target yearly target. We envisage additional slowing in inflation in 2024 and 2025, but it remains to be seen if inflation will reach the 2% target.

12 Month Percentage Change
US Core CPI Price Index YoY



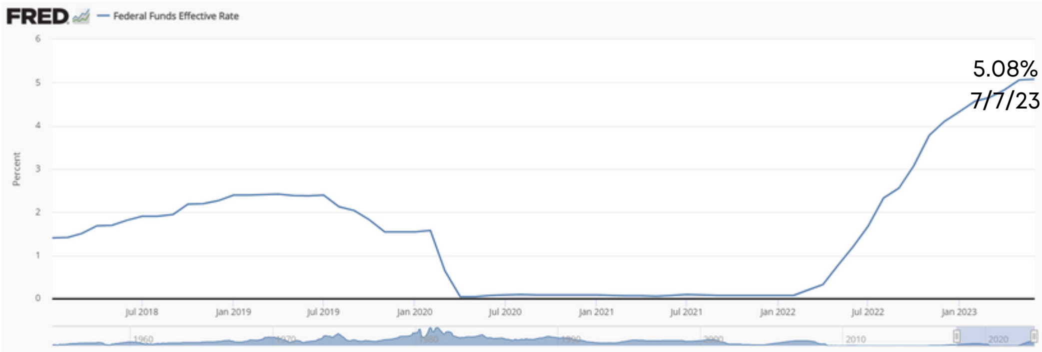
Source: Bureau of Labor Statistics
Core CPI = CPI - energy + food

Uncertainty with the Fed Rate Continues to Weigh on Markets

With inflation at four-decade highs, the Fed made significant efforts to curb inflation in 2022. After starting the year with increasing rates at 25 bps, the Fed a series of increases of 50 basis points (bps). In March, the Fed raised rates by 75 bps, bringing the target Fed Funds rate to 5.08%.

Before easing these rate hikes, the Fed will require unambiguous evidence that inflation is on track. Most forecasts call for one or two rate increases in the second half of 2023, with rates not stabilizing until early 2024. Fed Fund Rates are projected to decrease in the latter half of 2024 to the mid-4 percent level, and long-term projections show future reductions into 2025.

Even though there are some early signs that inflation is starting to ease, the core metrics driving inflation remain stubbornly high, which will continue to force the Fed to put downward pressure on markets until they see signs of easing in these core inflation gauges.



Government policy set to turn even tighter in 2023

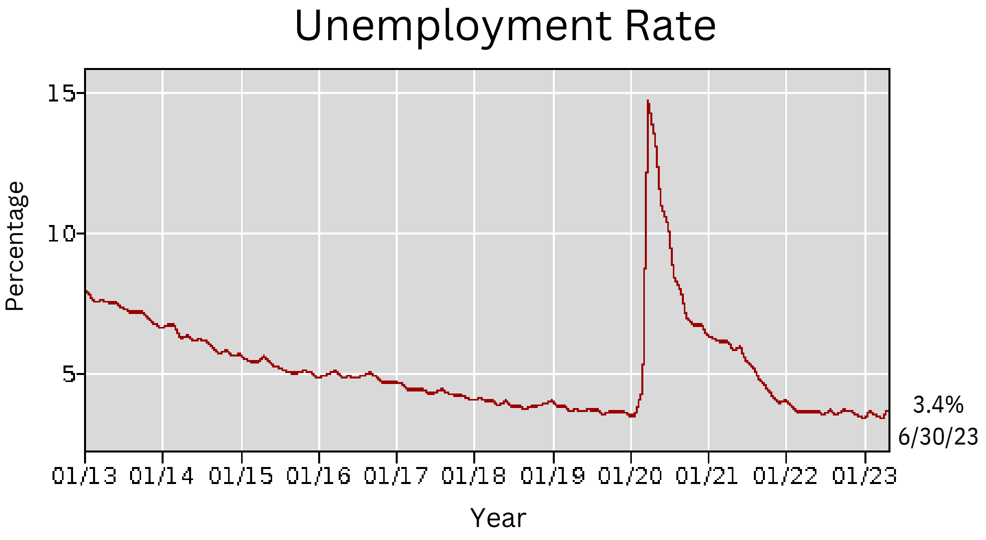
After a period of incredibly stimulative fiscal policy, with trillions in government spending, the situation seems likely to shift in 2023. The appetite for stimulative fiscal policy diminished in 2022 across the political spectrum, with high inflation prevailing. With the Republicans retaking control of the House of Representatives, government spending is expected to become more contentious and challenging. Practically, for the first time in decades, the U.S. economy should head into a period of slowing without the benefit of fiscal stimulus to help soften the blow.

Any meaningful government safety net will not likely support slowing growth. Yet this also means that some government spending supporting demand-side inflation will wane in 2023. Together with higher interest rates, overall government policy seems set to be even tighter in 2023. While some government spending, such as infrastructure, will occur over the next decade, the prospect of purely stimulative fiscal measures appears low in the near to medium term.

A healthy labor market should enable the economy to weather the slowdown

The economy is headed into 2023 with a tight labor market. Demand for workers continues to exceed supply. Slowing net job gains averaged roughly 375 000 in 2022. Yet, a tight labor market represents both positives and negatives. On the negative side of the ledger, the Fed will continue to see excess demand contribute to demand-side inflation. Wages grew by around 5% on a year-over-year basis for most of 2022. Coupled with such substantial job gains, this helped consumers to continue spending, supporting inflation to an extent.

On the positive side, a healthy labor market should enable the economy to weather any slowdown relatively well. While we expect job and wage growth to slow, and we should see some upward pressure on the unemployment rate (which still hovers at a half-century low), we do not foresee the kind of massive deterioration experienced during the last two recessions. Any job losses should resemble a typical post-war downturn in the low millions. This should help to limit the severity and duration of any downturn.



Source: Bureau of Labor Statistics

What is the outlook for the U.S. Real Estate Markets?

The office sector remains under pressure with tenants looking to reduce footprints and improve efficiency.

High-quality space will outperform as the flight to quality continues, with high rents and low vacancy rates for best-in-class assets. However, second-generation space will need help to backfill, with an increase in demolitions and/or conversions. Sublease space remains at an all-time high, but not all tenants will find those options desirable. Landlords will grapple with rising costs of capital and deal costs, making some segments of the market uncompetitive and requiring financial restructuring. Tenants possess strong leverage in today's market, but quality space options will quickly diminish as new speculative groundbreakings are delayed. The vacancy will be concentrated in inferior, second-generation spaces, limiting future options for tenants that prefer high-quality space if they don't act quickly.

The industrial market will sustain its strong position in 2023

Widespread demand, led by logistics firms and retailers, has pushed vacancies to record lows. Such low vacancy has driven asking rental growth to a record pace. While rent growth in 2023 should slow from 2022's scorching pace, it will stay elevated. With such strong demand, new properties are getting larger to capitalize on market strength. Roughly 20% of projects under construction are larger than 500,000 square feet compared to approximately 5% of existing inventory.

Consequently, construction activity will remain elevated but should moderate over the next few years. New deliveries will relieve markets with vacancy rates of less than 1%, although such tightness will continue to push many tenants to those secondary markets with greater availability. Existing sites will also see continued demand growth, especially those with smaller square footage footprints, as the trend in new construction to go big will price out a significant portion of the smaller tenants which make up a considerable portion of the market share in this sector.

Retail continues to perform well overall despite the challenges consumers face

The retail sector has recovered faster than many anticipated and enters 2023 in a position of strength. Retailer bankruptcies and store closures have decreased. Consumers have returned to spending in physical locations, including bars and restaurants - which will benefit centers boasting such offerings. However, performance should continue to be uneven. Foot traffic at suburban shopping centers has returned to 2019 levels. But foot traffic at urban centers remains well below 2019 levels. The continued exodus of consumers from urban core submarkets will put downward pressure on retailers that are often paying inflated rates for what was previously considered prime retail locations and will increase the trend of retail relocations to suburban markets in the short and medium term, in search of a more stable customer base and more affordable lease rates.

The multifamily market will face more significant headwinds in 2023

The rental sector continues to benefit from the ongoing housing shortage in the United States. Outsized demand pushed down vacancy rates and drove robust rent growth. But toward the end of 2022, demand declined despite ongoing job creation and healthy consumer balance sheets. Many young adults (between 18 and 29), including college graduates, who likely would have rented apartments, have moved back in with their parents. In 2022 nearly half of all young adults lived at home, a proportion unseen since the Great Depression. Why? The likely culprit is uncertainty surrounding the economic outlook and labor market, especially in a period with high rents. This is somewhat offset by the fact that single-family home prices have not decreased significantly as initially forecasted, even in the face of doubling of interest rates in the last 24 months, which has led to demand for rental units to remain steady as many individuals and families do not have the available capital to invest in a single-family home at this time. The easing of supply chain pressures should lead to an increase in single-family home starts.