

ECONOMIC AND COMMERCIAL REAL ESTATE OUTLOOK: BRACING FOR UNCERTAIN TIMES AUGUST 2022

EXECUTIVE SUMMARY:

- The global economy faces material headwinds heading into the second half of 2022 from ongoing conflict in Ukraine, stubbornly disrupted supply chains, and central banks tightening monetary policy swiftly to try control very high inflation levels. This central bank pivot comes at a dangerous time for growth, as consumer sentiment wanes, brewing a potentially dangerous cocktail.
- The U.S. economy has been on the forefront of these headwinds, but weak growth and conflict in Ukraine has more directly impacted the European Union in recent months. Both major economies could enter recession in the next 12 months.
- Though not all recessions have an indelible impact on commercial real estate markets, investors should anticipate some decline in capital values.
- Under a slower growth/recessionary scenario, investment performance will vary widely across property sectors. We view sectors that have better long-term structural drivers as more durable during a downturn, while more cyclical sectors (office, retail and hotel) will likely see broader declines in fundamentals potentially allowing price discovery and opening investment opportunities that have been generally scarce.

Global economic outlook now fraught with risks

The global economy is rapidly approaching a crossroad as it confronts fast growing consumer prices, weaker fiscal support and the ongoing impact of geopolitical conflict that is disrupting global trade already challenged by dislocated supply chains. In the U.S., the Federal Reserve has pivoted hard to remove record level monetary accommodation and tighten financial conditions.

The European Central Bank is mulling tighter monetary policy though it faces the more immediate challenge of record-high energy prices which may make it harder to increase interest rates.

Both economies are poised to see a deterioration in key indicators (exhibit 1) which has sent a chill air to traditional risk assets that have suffered their worst year-to-date performance in decades.

Commercial real estate has not escaped the deterioration in sentiment with public quadrants experiencing double-digit decline in performance (-20%, -10% for REITs and CMBS A 2.0 respectively) year-to-date. Private real estate index values have yet to see a draw-down in capital values given the scarcity of transactions. That said, we are starting to see signs of weakness and repricing in transaction markets as inflation, interest rates and uncertainty filter through to the private real estate sales market.

In this paper we discuss changes to our baseline outlook given persistently high inflation and a more hawkish central bank policy regime which have greatly increased the probability of recession and the likely impact on property sectors in both Europe and the U.S.

EXHIBIT 1: Outlook on key indicators is weakening

	U.S.	Eurozone	UK	
Outlook				Risks of recession are uncomfortably high, and we expect the U.S. and European economies to fall into some sort of recession over the next 12 months.
Inflation				Inflation remains ingrained in the economic outlook. Energy and supply chain related issues continue to fuel inflation. Demand-side U.S. inflation may take longer to cool than supply-push price rises in Europe.
Policy				Monetary policy has shifted dramatically in the past months. Policy risks remain elevated given the reactionary framework.
Consumers				Retail spending remains healthy but is at risk to turn over as discretionary income comes under pressure from higher inflation.
Businesses				Corporate balance sheets are currently healthy, but profit margins have been squeezed by, higher costs, and labor shortages.
Labor Market				Markets remain resilient, but U.S. layoffs may be increasing. Labor market structure in Europe will likely help mitigate layoffs during a downturn in economic growth.

Baseline: Talking ourselves into a recession

United States

Although GDP growth has weakened considerably during the first half of 2022, it has been largely attributable to the effects of a widening trade deficit, inventories, and a reduction in government consumption. Payrolls continue to grow at a solid pace; job openings are outstripping unemployed individuals by nearly two to one; the financial system is well capitalized; and corporate balance sheets are in good shape. These are hardly signs of an economy on the verge of recession.

Yet, rising policy rates, high-levels of inflation—particularly gasoline prices, which have proved a catalyst for every U.S. recession since the 1970s, are beginning to weigh on both consumer balance sheets and sentiment. Higher policy and treasury yields are also starting to weigh on housing affordability. Taken together, these factors have elevated the risk of recession to uncomfortable levels.

Our internal view has evolved in recent weeks such that we feel a recession is more likely than not over the next 12 months. Consumer spending is generally healthy but showing signs of strain under higher prices and increased uncertainty—in real terms retail spending growth is negative. Corporations have seen their profit margins come under pressure and there are nascent reports of layoffs in the technology, retail, and banking industries.

We expect the ensuing recession to be moderate, imagining a retracing of the unemployment rate from its current full-employment level of 3.5% to roughly 5%. This would imply a peak to trough drawdown in payroll employment of between two to three million—significant enough to have reverberations across the economy. Energy markets already in the early stages of a correction would see price pressures ease. Interest rates would remain higher than what we have been accustomed to over the past decade, but inflation, in the absence of a material recession, would likely decline at a slow pace towards the Fed's target rate of 2% owing to continued supply chain issues. The Fed would have little option but to start cutting its policy rate once it believes it has achieved a reasonable trade-off between inflation and growth, which remains a wild card in terms of timing.

Europe

The ECB faces a difficult task in reversing decade-long easy monetary policy without tipping the economy into recession. The endeavor is made more challenging by two additional risks, namely a possible debt and energy crises.

Due to the imperfect nature of the monetary union, rising interest rates may reverberate with different intensity across the member states, widening the borrowing cost spreads for those countries with higher debt levels. To contain unwarranted divergence, the ECB is devising a new anti-fragmentation tool, details of which will be announced by the end of July. Any assessment of the feasibility and efficacy of this tool must wait until then.

The second risk refers to the geographical proximity to the conflict in Ukraine and to the dependency on energy imports from Russia. Gas prices in the eurozone reached an all-time high in June amid Russia's unilateral decision to reduce supplies. This contributed to driving annual inflation to double-digit levels in nearly half of the states comprising the monetary union. The combination of soaring prices and tightening monetary policy has led to a squeeze in real household disposable income and a sharp drop in consumer confidence across the continent. So far, consumer spending has held on, buffered by savings accumulated during the pandemic, strong labor market and governments' temporary relief measures. However, the first signs of weakening demand have started to emerge, as retail sales stagnated in the European Union in May versus the previous month and declined outright in the UK.

Assuming the relationships with Russia will remain tense, the energy deficit is only set to increase, especially during the winter months when demand reaches its peak. Since the Ukraine invasion last February, Europe has reduced Russian gas supplies from 40% to 20% of total imports. However, the International Energy Agency has warned the continent to prepare for the likelihood of a complete cut-off, which may tip Europe into a more severe recession compared to the U.S. Under this scenario, the ECB estimated the Euro area's economy will shrink by -1.7% in 2023.

Economic impact on commercial real estate

The impact of our slower growth/recessionary scenario will differ across property types. Elevated valuations remain well supported by property fundamentals in both the U.S. and Europe with the notable exception of office (in the U.S.) where utilization rates remain depressed. Retail too will encounter weakness, particularly in the larger shopping center (regional mall) format. A downturn in economic activity at this stage in the cycle would likely result in both a retracing of cap rates and declines in asset values. Some declines in value would be offset by income returns, but only for those property types which we view as most resilient from a both cyclical and structural perspective.

The impact of the moderate recession, which is now our baseline scenario, will also vary by geography. As we have already stated, we feel that the impact of a global slowdown in growth is likely to impact Europe disproportionately due to its exposure to Russian commodities. As a result, private equity property values could face a correction of between 10% to 15% in the next 12 to 18 months in Europe. In the U.S. while energy prices are less threatening, the surge in interest rates is a much bigger problem than Europe. Thus, in the base case of a moderate recession, we will not be surprised to see the NCREIF NPI index witness capital depreciation in the neighborhood of 5% to 15%, over a similar timeframe of 12 to 18 months. Sector specific impacts will also vary widely depending on each property type's sensitivity to cyclical shifts as well as underlying demand and capital market positioning.

We believe that property types that adhere to our DIGITAL¹ drivers are better positioned at least on a relative basis. Exhibit 2 below outlines the magnitude of both the fundamental and capital market impact of a moderate recession on each sector. The residential sector in both the U.S. and Europe is likely the most resilient, especially given its non-discretionary nature. In the U.S. there is an acute shortage of housing across much of the income spectrum, particularly single-family units to middle- and lower-income housing, because of the lack of development for much of the decade following the global financial crisis. Though the problem is less acute in most European markets, supply remains tight and should help mitigate both demand fallout and NOI declines that would drive values lower.

EXHIBIT 2: Property types most influenced by DIGITAL should be more resilient²

SECTOR		U.S.			EUROPE			
		Market Fundamentals	Capital Markets	Total Return Impact	Market Fundamentals	Capital Markets	Total Return Impact	
Industrial		Positive	Positive	Positive	Positive	Negative	Negative	
	Office	CBD	Negative	Negative	Negative	Positive	Negative	Positive
		Suburban	Negative	Negative	Negative	Negative	Negative	Negative
Medical		Positive	Positive	Positive	Positive	Positive	Positive	
Retail	Convenience	Positive	Positive	Positive	Positive	Positive	Positive	
	N&C Centers	Positive	Positive	Positive	Positive	Positive	Positive	
	Power Centers	Negative	Negative	Negative	Negative	Negative	Negative	
	Malls	Negative	Negative	Negative	Negative	Negative	Negative	
Residential	Suburban Apartment	Positive	Positive	Positive	Positive	Positive	Positive	
	Urban Apartment	Positive	Positive	Positive	Positive	Positive	Positive	
	Single Family	Positive	Positive	Positive	Positive	Negative	Positive	
Alternatives	Data Centers	Positive	Positive	Positive	Positive	Positive	Positive	
	Hotel	Positive	Negative	Negative	Positive	Negative	Negative	
	Life Sciences	Positive	Positive	Positive	Positive	Positive	Positive	
	Student Housing	Positive	Positive	Positive	Positive	Positive	Positive	
	Senior/Care Living	Positive	Positive	Positive	Positive	Positive	Positive	

¹DIGITAL: Demographics, Infrastructure, Globalization, Innovation & Technology

²Color indicates relative outlook

Source: Principal Real Estate

Shorter residential lease terms will allow for tenants to regain a modicum of pricing power should the recession prove more persistent than our current base case imagines. Though industrial has continued to outperform all other sectors, the nature of the downturn and a turnover in e-commerce spending relative to brick and mortar sales (in the U.S. in particular), have highlighted its vulnerability. Amazon, which had been a catalyst for outsized net absorption of space since 2019, has also announced it will be releasing space to the sublet market, indicating that it had overestimated its space needs.

Though it is unlikely to signal a broader drawdown given the demand for space along supply-chains, it could signal a level-shift in demand, which would be exacerbated by recession. A retracing of consumer spending would of course create problems for warehouse landlords and impact overall sector performance in both the U.S. and Europe—particularly as it relates to e-commerce. Our base case for recession, however, is far from the experience following the housing collapse in 2008, which saw consumer demand decline so far that the U.S. experienced a brief period of deflation for the first time since the 1950s. Record low vacancy rates in both regions will also provide support to industrial landlords, although weakness in core values will not be unexpected if tenant demand softens.

Among the remaining primary core real estate sectors, we feel there will be more room for adjustment, particularly in weaker subsectors. The secular decline in office demand in the U.S. has been well documented over the past 24 months. And, while occupancy and utilization trends in European office markets have outperformed their U.S. peers, a drawdown in services employment would likely create a darker scenario for landlords and investors in which vacancy rates linger higher than their equilibrium levels. We would expect some outperformance within the sector, however, from the traditional offices in core locations and, with ESG designations, medical and the life sciences sectors, which to date have outperformed. These sectors will remain in demand from a structural perspective and likely continue to outperform the broader office property indices over the next 12 to 24 months.

Retailers would also fall in the unfavored category, though it remains a highly bifurcated sector and investment performance will vary significantly. Brick and mortar sales growth has been impressive since 2021—partially fueled by fiscal stimulus and pent-up consumer demand—and store openings have outpaced closings over the past 18 months. The retail recovery has largely focused on convenience-based retail formats such as grocers, value-oriented retailers in community centers, as well as retail warehouses.

Over the next 12 months, these sectors should hold up well on a relative basis though rising cap rates should imply at least moderate value declines. The most impacted sector under our new base case will be larger mall and shopping center formats and those with a focus on discretionary spending and higher price points such as regional and super regional malls in the U.S., and High Street retailers (particularly focused on CBD locations) in both Europe and the U.S. The dislocation in the cyclical property types will challenge landlords and open up the pathway to price discovery, thereby also creating investment opportunities that have been hitherto absent from the transaction market.

Among the alternative sectors not already addressed, data centers should hold up both on an absolute and relative basis. Supply and demand fundamentals remain in balance and despite capital market disruptions strong rent and NOI growth will provide a bond-like coupon for investors.

It is imaginable that demand for data centers continues to improve through the recession due to both structural and cyclical drivers. Cost cutting among major corporates for example could shift demand further from pricey CBD offices toward work from home arrangements, which could potentially increase demand for data services.

Investment strategy implications

In this challenging environment where should investors look to preserve capital and seek relative value? At a base level, we expect cost of capital to increase and financial conditions to tighten. For real estate, we would expect capitalization rates to push up more as investors seek higher risk premia in an environment of slow growth/recession. As such, we prefer debt over core equity given the potential write down in equity values and the possible preservation to cash flows provided by subordination.

From a sector selection perspective, we are biased towards segments that are non-discretionary—food (grocery anchored centers, discounters, retail warehouses), shelter, and structurally driven property types (data centers, medical offices, senior/care living). For markets, we continue to tilt towards our DIGITAL¹ markets which have key structural elements that should weather a recession, though asset selection is going to become even more paramount. In the past 12 months, transaction activity has been mostly focused around the most favored property types (mostly structurally resilient). We expect the transaction market to broaden out as debt markets become less forgiving and force more assets towards price discovery. We are therefore also going to be on the look out for interesting dislocation opportunities once price discovery becomes more widespread, particularly within the more cyclical property types.

EXHIBIT 3: Investment strategy implications

Negative ■ ■ ■ Positive

SECTOR	OUTLOOK		RECOMMENDATION
	Tactical	Strategic	
Industrial	■	■	Coming to end of business cycle boom and potential for oversupply. Values nearing peak
Office	CBD ■	■	Very selective, focus on tech markets. European office outlook is more constructive
	Suburban ■	■	Focus on markets with research universities and tech employment growth
	Medical ■	■	Demographics will support longer-term demand
Retail	Convenience ■	■	Solid drivers, but demand is putting some pressure on pricing. Difficult for e-commerce to disrupt
	N&C Centers ■	■	E-commerce resistant (particularly with stronger grocer presence) and allows a value-oriented element
	Power Centers ■	■	Focus on centers with value and home improvement elements. Pricing is favorable but not great
	Malls ■	■	Low conviction on strategic outlook, short-term debt strategies at the right basis
Residential	Suburban Apartment ■	■	Focus on renters by necessity (earning 80-120% of median income) in markets with high barriers to entry
	Urban Apartment ■	■	Focus on high-cost/high-tech metros where single-family housing less affordable
	Single Family ■	■	Takes advantage of wealth/generational gap and need for space
Alternatives	Data Centers ■	■	Strong outlook but may behave more like a bond longer-term
	Hotel ■	■	Tactical opportunity as pandemic fades
	Life Sciences ■	■	Pricing may be an issue in the near-term, but remains a long-term strategic opportunity
	Student Housing ■	■	Not a high level of conviction, case by case basis...currently too much construction
	Senior/Care Living ■	■	Look for a boom in the next 10-15 years, but in the U.S. the sector is prone to over-supply

¹DIGITAL: Demographics, Infrastructure, Globalization, Innovation & Technology
Source: Principal Real Estate

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