Bifurcation and more: the year ahead for real estate

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The past year has been marked by volatility and uncertainty in capital markets. But at least so far many, if not most, real estate occupier markets have proven resilient. But this dynamic is at a critical juncture. With 2024 around the corner, there is no better time to take stock of the key themes that tie together global markets and shape our outlook for the coming year.

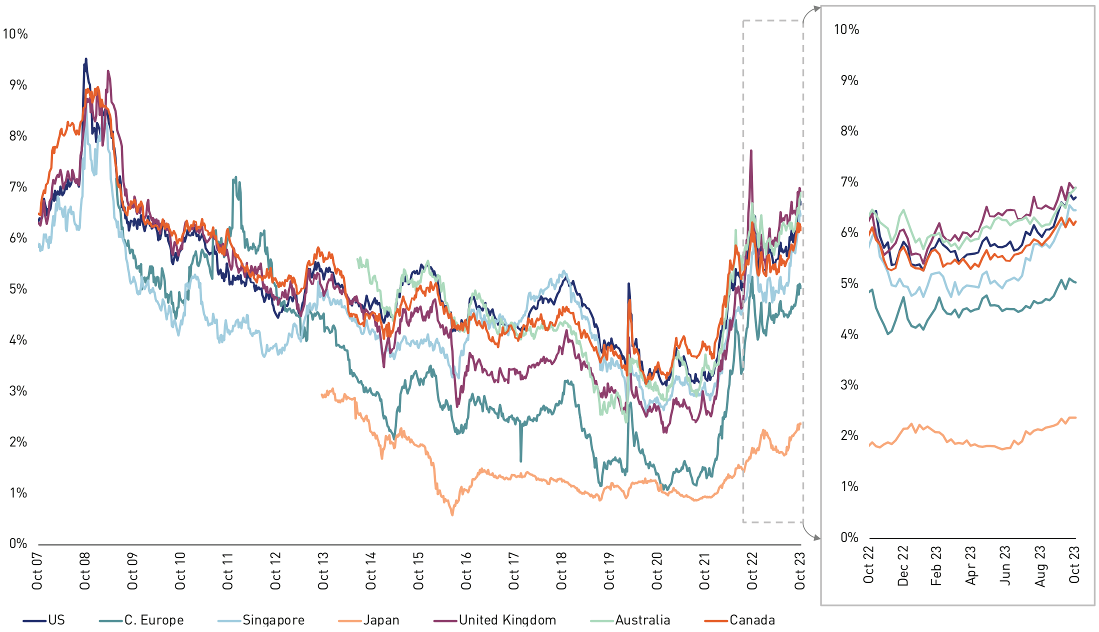
1. Searching for peak rates

The macro context for real estate remains unsettled. Earlier in 2023, rates exhibited high volatility, but little overall trend. They moved mostly sideways or only gradually upward. This was enabled by cooling inflation and expectations that central banks were reaching the end of their tightening cycles. But more recently there has been a renewed surge in interest rates in several key markets. Corporate bond yields, which we use as a building block for our pricing models, have taken a clear turn upwards, reaching or surpassing levels last seen in late 2022 (see chart 1).

The recent upward trend in interest rates could prove short-lived. But history suggests that whenever there is a big increase in rates, there is an increased risk that "something breaks"—whether that be a financial institution, a part of the capital markets or the like. Also, extended periods of yield curve inversion, as we have seen in 2023, tend to presage economic downturns; if a recession does arrive, it would only add to the challenges we have faced so far. Both factors should raise the alert level for the global economy in 2024.

That said, real-time evidence[1] does not point to an imminent global recession, especially given strength of the US economy. Labor markets have been surprisingly resilient and forecasts of economic growth in key global economies have mostly been revised upward for 2023, as a potential slowdown is pushed into 2024. Nevertheless, it is important to recognize the inherent localness of real estate; avoiding a global recession, while welcome, would not mean that every major economy avoids a meaningful contraction in economic activity.

Chart 1: Nominal corporate bond yields



Source: LaSalle Global Solutions, Bloomberg data through October 31, 2023. The bond indices above are based on Moody's Baa US bonds with terms of 20 to 30 years. In other countries, comparables are used of similar credit quality and term. Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

Fortunately, inflation is already cooling across advanced economies, especially in the US, Canada and the eurozone. But inflation is moderating slowly and remains meaningfully above central bank targets. It is still far from clear that a so-called "soft landing" can be achieved.

At LaSalle, we aim to be "macro aware", but we are not macroeconomists. Our recommendation is to largely be a "taker" of bond market signals, reflecting them in valuation models but focusing on insight within real estate to find the best relative value.

2. Solving the capital stack equation

"The math of higher interest rates", which we wrote about last year, underlies the repricing of real estate that we have seen, and we believe that this gives rise to challenges and opportunities. One obvious challenge is that equity flows have fallen back sharply. This is because the math of higher rates affects investors differently. The flow through of higher rates hits would-be levered buyers first as they borrow at today's cost of debt. Sellers, by contrast, are much slower to catch up. They might have fixed debt arrangements with medium-to-long-term duration that may lead them to wait and hope that they will be able to fetch a selling price closer to their book value at some point in the future.

A standoff between buyers and sellers with an obvious bid-ask spread is evident in the investment volume data through to the first half of 2023. On a positive note, the volume of capital waiting on the sidelines means transaction activity could recover once that bid-ask spread narrows. Preqin estimates that over US $400 billion are earmarked for private market real estate investments, down only 10% on the end of 2022 figure, a much shallower decline than in investment volumes overall.

But real estate debt has become both costlier and less available, suggesting that this volume of dry powder might be less effective than it could have otherwise been. The higher cost and reduced availability of real estate debt in part reflects higher real risk-free rates, as driven by bond market movements. But it also reflects the fact that 2023 was a turbulent year for banks, with the notable failures of Silicon Valley Bank, Signature Bank and First Republic bank and the merger of Credit Suisse and UBS. Thankfully, since these events, market perception of bank failure risk has fallen, as suggested by bank CDS spreads.

That said, traditional bank lenders are only one slice of the real estate debt pie. They account for roughly 40% of lending to income-producing real estate in the US, while the same figure in the UK stands higher at over 50%. In the EEA and Australia, it is close to 80%.[2] The implication is that a bout of renewed stress in the banking sector could still create risks to the orderly flow of capital to real estate, but there is ample room for non-bank private lenders to help plug some gaps, providing them with interesting opportunities.

3. Hot sectors are coming off the boil

One encouraging factor is that we still observe solid occupational fundamentals in many key market segments. But we also seeing a real cooling in sectors that had been riding high, especially logistics, rental housing and life sciences real estate. For example, logistics rent growth shows a marked slowing from peak levels across the globe, though it remains very strong compared to history. Aggregate data show cooling has happened across North America, Europe and Asia Pacific, though there are exceptions at the country and market level.[3]

Part of the cooling trend is just down to macroeconomic slowing; but is also due to ripple effects originating from the pandemic shock. COVID lockdowns triggered waves of disruption, adjustment and—eventually—normalization. This has happened to both demand and supply. On the demand side, logistics is case in point. The sudden shift of retail demand to online drove a frenzy of logistics leasing that went a little too far, and we see pullback in demand today. We have seen similar demand normalization in other sectors, such as rental housing, resort hotels, and life sciences.[4]

On the supply side, there is clearly post-pandemic lumpiness in supply. Key sectors, especially logistics and apartments, are seeing temporary spikes in deliveries in many key markets. Delays due to lockdowns and supply chain issues are one part of the supply spike story, as are cheap development finance and low exit yield assumptions in 2021, which temporarily allowed more development projects to "pencil" out as profitable.

In our view, the pattern of cooling absolute growth in the strongest market segments does not really alter the relativities between sectors. Our most favored sectors are still well positioned on a relative basis. One way to assess the "tightness" of a market is to compare current and long-term average vacancy as markets with tighter vacancy than normal tend to see growing rents (see chart 2). If we break these down by sector, we see that logistics markets are the tightest, living and residential market segments are broadly balanced, while offices show a really wide dispersion, with the loosest office markets being those in the US. While our favored sectors of logistics and residential remain strong, the cooling of their hot fundamentals is a reminder that trees do not grow to the sky. Predicting that frothy growth around peaks will just continue forever can be a recipe for overpaying.

4. Beyond bifurcation

Understanding high-level dynamics across geographies and sectors can go some way to helping craft investment strategy. However, at a bird's eye view it can be easy to forget the reality that no two properties are identical; making sense of differences and the likely performance differentials arising from them is just as important.

When reading descriptions of the current state of the market fundamentals the word "bifurcation" seems to appear more and more often, describing performance gaps opening between winning and losing assets. In last year's ISA Outlook we pushed investors to look "beyond the sector chasm" and consider widening gaps within sectors. However, in our latest ISA Outlook we invite investors to look beyond the oversimplification that the term "bifurcation" implies. Outcomes do not stand on one side of a divide or another. In the real world, the dispersion exists on a spectrum with a very wide array of possibilities.

Assets can experience performance differentials along a number of dimensions, often simultaneously. For example, sustainability credentials—like green certifications and buildings' alignment with net zero carbon pathways—can be a major differentiator for assets. In our recently published ISA Focus report on the "Value of Green", we assessed a large number of empirical studies estimating the impact of green features on rents and values.

In addition to green considerations, asset-level experiential factors are another key divide. For example, successful offices can be thought of as sharing features that make bearing the cost of commuting—in terms of financial cost, time and discomfort—worthwhile. Key differentiators include things like a wide range of flexible working areas, wellness features, as well as vibrant and socially focused amenities.

How these quality gaps should inform investment strategy hinges on how the dispersion is priced. Is the winning side of a bifurcated sector strong enough and priced appropriately to generate a suitable risk-adjusted return? How do the best segments of challenged sectors compare to the range of other investment alternatives? Is the value gap between winning and losing assets bridgeable through refurbishment and repositioning, and if so, does bridging that gap generate an appropriate risk-adjusted return? Tackling these questions is essential if investors are to go beyond the simple observation that bifurcation is occurring.

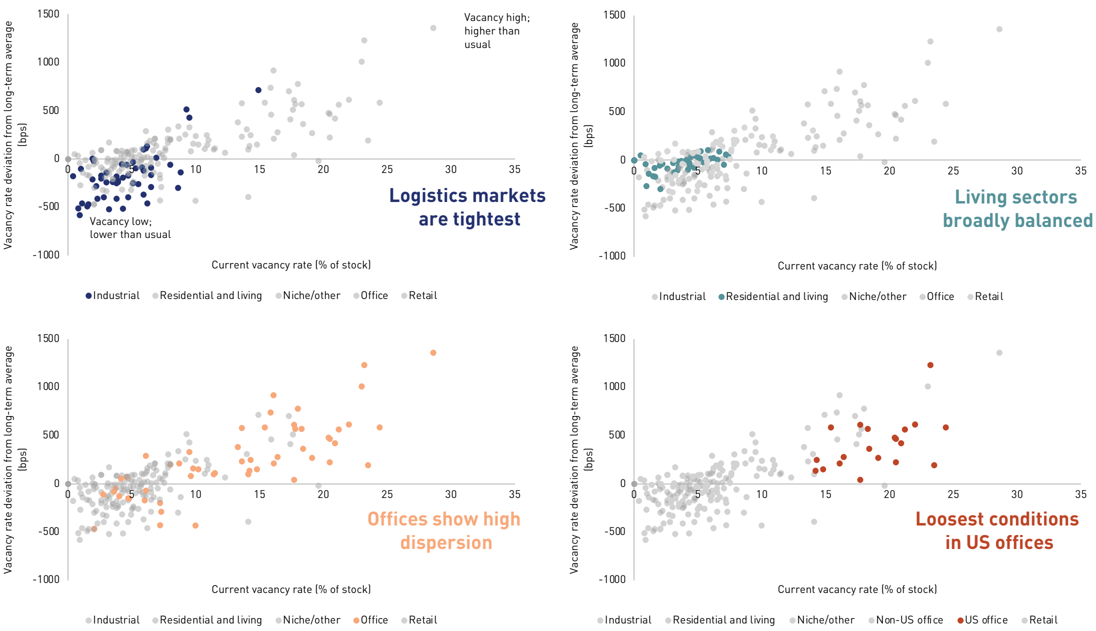
Boiling it down

Despite a year of volatility, our investment recommendations have changed only subtly since last year. We remain drawn to the long-term growth potential of logistics and residential, and their various adjacent sub-sectors. Office and retail sectors are by no means uninvestable, but investment prospects are highly variable by market and sub-type, and vulnerable to divides by factors like property quality. We continue to be advocates for investing in the most dynamically repriced segments of the market such as listed equity and debt, and in structured investments with debt-like structures that allow the bridging of bid-ask spreads. And we remain cautious on office markets in North America, as well as commodity office in Europe.

We recommend patient and flexible deployment of capital, given that situational opportunities may arise from dislocation within capital stacks. However, over-caution can come to at the cost of missed opportunities. Prospects for interest rates, economic growth and real estate fundamentals are all uncertain. But history has shown that the best vintages tend to be those immediately following periods of disruption. For a deeper dive into these themes and the regional nuance behind them, read our full ISA Outlook 2024 at lasalle.com/Outlook2024 or on the IPE Reference Hub.

Chart 2: Global vacancy rates by property type

Offices in the US stand out with highest absolute and relative vacancy



The current vacancy rate refers to the latest available data point for each location and these dates range between Q1 and Q3 of 2023. Similarly, the measurement period of the long-term average will depend on data availability but represents the longest period available for each series.
Sources: JLL, CBRE-EA, CBRE, Real Page, MSCI, NCREIF, Canada Mortgage and Housing Corporation, ARES, Ichigo Real Estate Service, company reports and LaSalle Research and Strategy as of October 2023. Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

FOOTNOTES

1 Based on LaSalle analysis of various economic data points, mostly national sources and publications of our economic analysis providers, principally Oxford Economics and Capital Economics.
2 Federal Reserve Flow of Funds, Bank of England, Refinitiv, Bayes Business School, European Banking Authority, European Insurance and Occupational Pensions Authority, Real Estate Capital, LaSalle (June 2023), Australian Prudential Regulation Authority, CLI Group Research (August 2023).
3 LaSalle analysis of JLL, CBRE-EA, Real Page, and Green Street Advisors data as of November 2023.
4 JLL as of November 2023

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