What does the new normal mean for real estate?

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Navigating the “New Normal”

• We expect global growth to be slower this decade than in past decades, weighing on US growth.
• Meanwhile, higher inflation will keep interest rates above the lows seen in the 2010s.
• This means after a strong run, real estate cap rates have to rise, causing prices to fall.
• The new normal of how we work (and live) will drive further weakness / offset the weakness in specific sectors.
US Headline Inflation (% y/y)

Sources: Refinitiv, Capital Economics
US Interest Rates (%)

Sources: Refinitiv, Capital Economics
Office real estate crash will be so sharp and deep that Capital Economics thinks office values are unlikely to recover by 2040.

Now, the research firm suggests that the -35% plunge in office values we’re forecasting by mid-2025 is unlikely to be recovered even by decades, economist says.
Indexed Capital Values (Peak = 100)

Sources: MSCI, Capital Economics
Office Occupier Markets Struggling

- Office utilization is still only around 50% of pre-pandemic levels.

- Negative absorption has pushed the vacancy rate around 5%-pts higher. Sublease availability points to this growing.

- But asking rents holding up; trophy buildings hitting new highs.

- Incentives have ballooned, meaning net effectives are much lower and bigger discounts to come.
Average Office Rents

Sources: CBRE, Capital Economics
Net Effective Taking Rents (Index, Q1 2020 = 100)

Source: Capital Economics
Office Capital Markets Drying Up

• Financial conditions have tightened considerably, especially for offices – investors talk of an office sector “credit crunch”.

• Valuations against other asset classes look fair. But they are not telling the full story.

• Office investment volumes have fallen off a cliff, with little prospect of a recovery this year.
CE Financial Conditions Indices

Source: Capital Economics

GFC spike in composite indicator caused by banking

Latest spike in composite indicator more driven by debt cost
How Bad Could It Get?

- CMBS distress is growing. The office delinquency rate could hit 10% this year.
- Investors returning unviable assets to lenders.
- Cap rates have increased, but REITs point to another 100 bps. We also expect to see another 100 bps rise in NOI yields.
- Valuation indices down 15% so far, but examples of struggling assets in worst-hit markets trading at 60%-75% markdowns.
Office CMBS Delinquency and Special Servicing Rates (%)

Source: Trepp
Office Cap Rates (%)

Office Gross Yield

Office REITs Implied Cap Rate (Adv. 3 Qtrs)

Sources: MSCI, NAREIT, Capital Economics
Putting the National Office Outlook in Context

• The metro-level outlook varies due to a range of factors, including commute times, industry sector shares and rent levels.

• The outlook for offices is much worse than the other sectors, with distress much more likely. But other sectors are not without risk.

• We expect retail to outperform on both a 3-and-5-year basis. The longer-term prospects for multifamily and industrial also look good.

• The hit to office values will be much larger in the US than in Europe, with differing office utilization rates driving this divergence.
Office Capital Value Forecasts, 2023-25 (%, Cumulative)

Source: Capital Economics
Implied LTVs by Origination Year (%)
2022 Peak to Trough Capital Values (% Cumulative)

Sources: MSCI, Capital Economics
Forecast Total Returns (% p.a.)

Source: Capital Economics
Office Capital Values Relative to All-Property (Q4 2019 = 100)

Source: MSCI, Capital Economics
Key Takeaways

- The “new normal” will be negative for real estate values in the short-term but will support decent income returns further ahead.

- Offices will be the clear loser, especially in metros with a high share of tech, long and expensive commutes and expensive housing.

- Southern metros will continue to benefit from migration patterns, although the rate of growth of recent years will not continue.
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