Private Markets

August 2024

# U.S. Real Estate Outlook: Gaining momentum

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# U.S. Real Estate Market Insights

BlackRock Real Estate Research & Strategy

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## Key highlights

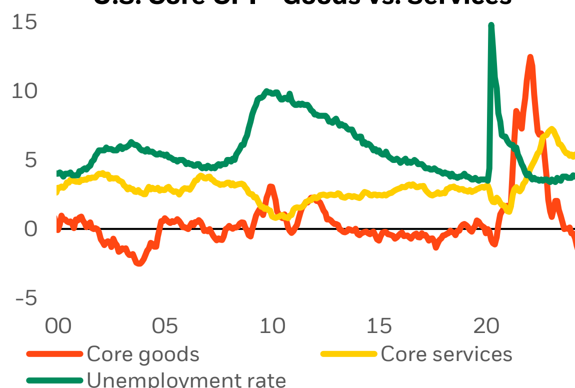
- Real estate fundamentals will likely remain stable over the next few quarters, while a projected decline in interest rates is bringing investors back to the market.
- As of Aug 2024, the Fed has signaled the possibility of rate cuts later in the year, which is supportive for real estate investment activity.
- There has been elevated levels of completions of multifamily and industrial, but there has been very few new starts and thus deliveries will likely materially decline starting mid-2025.
- Investors currently have the advantage of acquiring at prices below replacement cost as well as at meaningful discounts to peak pricing. However, the investment environment will likely be more volatile going forward, and investors would benefit from aligning with long-tern structural trends

## Gaining momentum

The US real estate market is showing signs of stability and recovery. Fundamentals will likely remain stable during the next few quarters, and an uptick in transaction activity in the second quarter of 2024 and projected decline in interest rates appear to be bringing investors back to the market.

There are many signs that point to a strengthening capital market. Transaction volume was USD $92.8 billion for 2Q'24, which is a 14% increase from the previous quarter and a small 2% decline from the same period last year, according to data from MSCI. Opportunities for investors to buy assets below their replacement costs remain and a clearer picture of interest rate trends is bringing buyers and sellers back to the market. Recent earnings results from brokerages signal a recovery in revenues, driven by improved leasing activity, a nascent signal of improving momentum in the real estate industry. Moderating inflation is providing some breathing room to the Federal Reserve, which hinted in mid-June 2024 that it will probably maintain the current rates, with a chance of a rate reduction later in the year. As of early August, market expectations suggest fewer than two rate cuts for the remainder of 2024, and the markets are pricing in a total of five rate cuts through 2025. However, real estate investors should brace for potentially higher rate volatility in line with a new investment climate characterized by a volatile macroeconomic environment.

**U.S. Core CPI - Goods vs. Services**




Source: Bureau of Labor Statistics, LSEG DataStream, BlackRock Investment Institute, as of May 31, 2024

Economic growth remains generally resilient with US real GDP growing at an annualized rate of 2.8% in 2Q'24 (source: U.S. Department of Commerce). The job market is steady despite some layoff activity, indicating a tight and dynamic labor market. The unemployment rate has inched up higher but remains low at 4.3% in July 2024. Job openings remain high at 8.1 million in May 2024, albeit 33.6% lower than the peak of 12.2 million two years ago in March 2022 (source: U.S. Bureau of Labor Statistics).

Real estate fundamentals are largely stable thanks to the strength of the U.S. economy. NOI growth was 3.7% year-over-year as of June 30, 2024 (source: NCREIF), driven by industrial performance at 8.7% YoY. The industrial property type is still benefiting from meaningful mark-to-market in rental rates due to strong rent growth achieved over the past few years. Leases are still 28% below market on average according to Altus Group as of June 30, 2024. Supply is a risk for both industrial and multifamily sectors in 2024 although the rate of deliveries is projected to drop off sharply starting mid-2025. Office sector fundamentals are an exception to the broad sector trend. Existing tenants are paying even if their employees are not using the space, but demand is and will likely continue to be weak over the medium term.

Anecdotally, investment activity is improving, and lenders have started to come back to the market to take advantage of high-quality collateral at attractive all-in yields.

The CMBS market improved during the first half of 2024, with $66.8 billion in volume priced through June 2024, up 57% year-over-year (source: BlackRock Aladdin). Institutional investors are starting to move from the sidelines and bringing more properties to market and some are eager to deploy dry powder. However, conditions are still tight with high interest rates and lenders remain selective. Real estate investors today have the advantage of acquiring assets at significant discounts to peak pricing and replacement costs.

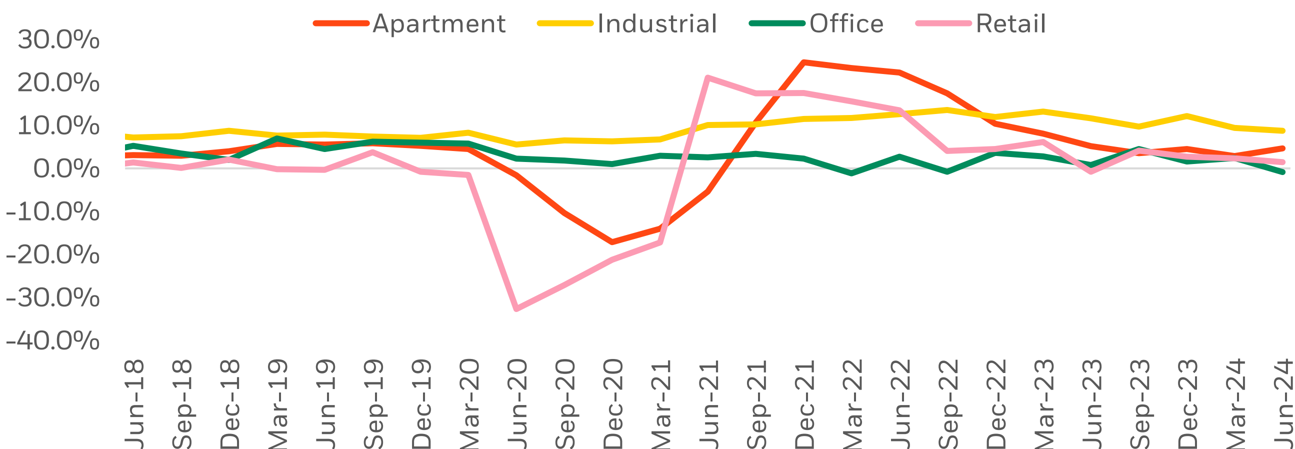
**Property fundamentals**

Real estate fundamentals are generally steady and consistent with what was experienced in 2023. Rent growth has softened recently, even in the industrial and apartment sectors due to record levels of supply. Vacancy edged up due to new supply recently, but strong demand prevented rents from falling dramatically year-over-year. The rate of completions is already declining for industrial and is expected to drop off for apartments starting in mid-2025. The high cost of capital and elevated construction costs are preventing many newly planned projects from starting, supply will likely be muted thereafter. Demand remains resilient for both property types, driven by strong demographic trends and the rewiring of supply chains.

By sector, we favor industrial, necessity retail and apartments for any incremental investment today. The office sector is still facing many headwinds and investors would need to factor in

**A moderation in fundamentals**

NOI growth by property type




Source: NCREIF, as of June 30, 2024.

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large amounts of incremental capital expenditures in the face of declining demand. Therefore, most investors would benefit from paring down allocations to this sector.

**Apartment** fundamentals have been resilient, thanks to the tight labor market and good economic growth. As of Q2 2024, apartment occupancy rate was 94.2%, down 48 bps year-over-year and 120 bps below the 10-year average, and effective rent growth was flat again at 0.2% year-over-year. Demand was strong during Q2'24, with net absorption at 390,000 units over the past 12 months. However, supply has been outpacing demand. More than half a million new units were delivered over the past 12 months, the highest since 1986. Indeed, high supply caused many major markets to face weak rent pressures, such as Austin at –7.4% (source: RealPage). The rate of supply is expected to decline sharply from mid-2025, setting up the sector well then. We are most constructive on high net migration markets such as Dallas, Phoenix, and Miami, as well as established metros with good barriers to entry such as Boston and San Diego.

**Industrial** fundamentals have softened but remain resilient. Rent growth was 4.9% in Q1'24, much lower than the peak market growth rate of 13.9% in 2022 (source: CBRE-EA). Occupancy declined 320 bps from the peak in mid-2022 at 95.4% to 92.2% in Q1'24. The rate of deliveries likely peaked in 2023 at 3.2% of inventory and will likely decline to an average of 2% of inventory annually for the next few years. The markets with high expected supply (as percentage of inventory) over the next three years are Austin, Las Vegas, Charleston, and Phoenix. Many industrial assets still have leases significantly below market rates given the immense rent growth over the past few years. Releasing and marking to market these rent rates, will likely drive NOI growth going forward. We are most constructive on markets with good barriers to entry and favorable growth, such as Boston, Fort Lauderdale, Los Angeles, and Miami.

**Retail** is appealing for stable income growth and wider entry cap rates; we see the best supply and demand dynamics in necessity retail centers. Fundamentals are solid, yields are attractive, cash flows are stable, and supply is muted, which all points to good risk-adjusted returns for the property type. According to CBRE-EA, retail occupancy has been steadily increasing nationwide, reaching 93.5% as of Q1'24, up 30 bps year-over-year, and rent growth has been steady at 2.5% year-over-year. Necessity retail centers in attractive catchment areas with good median household incomes and population density can act as a portfolio diversifier.

**Office** fundamentals will likely be challenged going forward with tepid demand, rising vacancy and weak rent growth. Lack of capital markets support has pointed to sharp valuation corrections. Indeed, anecdotal transaction activity show that some office buildings are expected to be valued at double digit cap rates and at valuations below $200 per square foot. Nationwide occupancy has sharply declined to 81% as of Q1'24, a decline of 230 bps over the past two years and rent growth has been very muted at only 0.3% year-over-year (source: CBRE-EA). We expect the office sector to continue to shrink and its share as a percent of the overall institutional real estate universe will likely continue to decline.

## Capital markets

After a period of instability, the real estate capital market appears to be finding its footing. The NCREIF Property Index shows a 18.5% decrease in values peak-to-current in Q2 2024, and the transaction market has seen even greater adjustments. The latter half of 2023 experienced stringent credit conditions, with lenders being particularly choosy. Nonetheless, early indicators of improved financing availability are emerging, as evidenced by CMBS issuance volume. Volumes YTD are up almost 3x compared to the same period last year. Despite this, the increased cost of capital persists which acts as friction for deal activity, compelling many in the market to seek higher returns.

Although lenders are more active so far this year, transaction volume started at a slow pace in 2024. Total volume was at $174.7B during the first half

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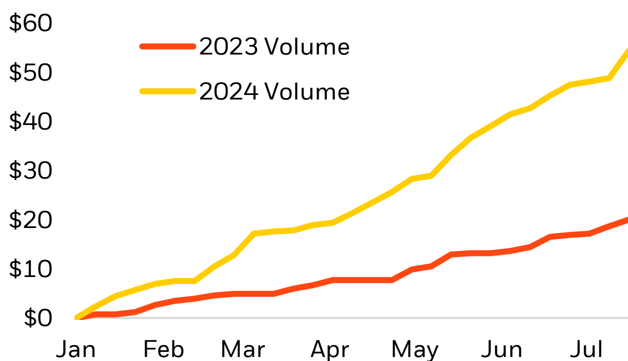
down 7% year-over-year (source: MSCI). Apartments continued to be the most favored by investors, with $60.3B transacted during the quarter, roughly flat year-over-year. Industrial won second place with $37.5B transacted, but still down 17% year-over-year. Interestingly, office and retail volumes were similar at $26B. While office deal volumes were very low, the 1H'24 volume was up 3% year-over-year. Active groups continue to be private buyers or family offices who can transact with limited or low leverage and typically target smaller transaction sizes of less than $100M. However, we have seen institutional investors start coming back to the market based on anecdotal observations of our investment pipeline. We expect transaction volumes to meaningfully recover during the second half of 2024.

### Improving financing activity

CMBS issuance volume

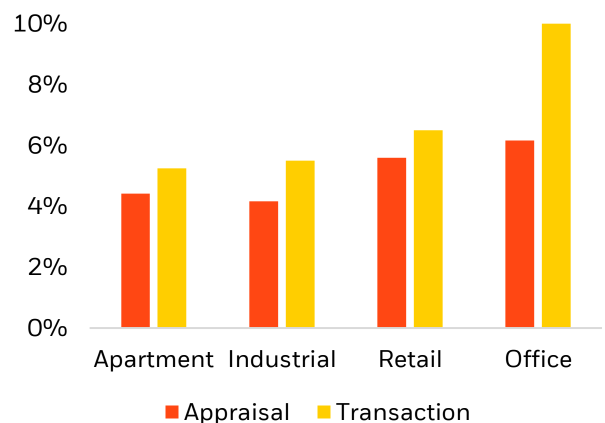



Source: Green Street Advisors, as of July 26, 2024

Good quality assets with solid cash flows are still sought after, but prices have adjusted by 15-20% or more relative to peak values based on cap rate movements. In many instances, properties can be acquired at below replacement cost. Appraisal values have been correcting and will likely continue to decline further, but the transactions market has likely reached a bottom.

Distress in the market is quite low, although should increase modestly, especially as landlords with maturing high-leverage loans fail to find refinancing. The value of distressed properties increased by $10.6B during the second quarter to $94.2B as of Q2 2024, according to MSCI. Office continues to be the leading distressed property type at 43.6% of outstanding distress. We expect distress to remain relatively low this cycle, but the market will see an increase in the near term as debt maturities come due and refinancing needs arise. We do not expect a repeat of the Great Financial Crisis as underwriting standards generally improved post-GFC with lower LTVs and higher DSCRs. Some lenders will offer extensions and in other situations investors will contribute additional equity, either directly or through a recapitalization. Owners can also sell their properties as there is dry powder waiting on the sidelines (~$400B according to Preqin), especially those with good fundamentals. Borrowers unable to complete either of these options will face foreclosure, and we will likely see more of that from office landlords especially.

### Appraisal and transaction cap rates




Source: BlackRock and NCREIF, as of June 30, 2024. Appraisal cap rates from the NCREIF Property Index (NPI)

## Portfolio Strategy

We believe investors should prioritize quality for the medium term, holding properties that can benefit from both short-term and long-term trends. Based on that, we recommend an overweight to industrial and apartments because of the high demand for both sectors. Investors should also overweight necessity retail because of the wider initial cap rates, low supply, and stable demand characteristics. Although growth is not expected to be as strong, returns should be stable with the

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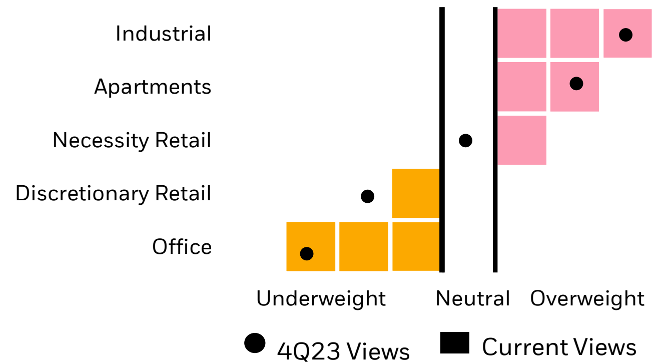
possibility of upside. Lower-quality shopping centers have been declining in the investment universe over the past few years, enhancing the performance of the sector overall. The outlook for discretionary retail is not as appealing although it did start adjusting almost a decade ago and therefore is facing less revaluation risk.

Office has faced valuation corrections of 33.3% peak-to-current so far according to the NCREIF Property Index, much more than the 18.4% value decline of the overall index. Upcoming debt maturities over the next two years will likely be the catalyst for larger market movements across the sector as transactions occur.

Investors have the pricing advantage with the ability to purchase good quality assets at below replacement costs and at wider cap rates compared to a few years ago. Many investors can deploy a tactical strategy to take advantage of tighter credit conditions and sponsors facing liquidity issues due to refinancing needs. Investors can seek to marry this tactical strategy with long-term underlying trends such as aging demographics, net migration favoring the South and secondary metros in the West and the rewiring of supply chains.

**Strategic allocation views**

3Yr asset allocation views




Source: BlackRock as of July 2024. Notes: The chart shows our asset views for the next three years.

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As of August 2024, subject to change.

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