Economic Update

SVN | Research

AUGUST 11, 2022

1. INFLATION

- The Consumer Price Index (CPI) rose by 8.5% year-over-year through July, but remained flat from the month before, according to the Bureau of Labor Statistics. It was the first time that inflation hadn't increased on a month-over-month basis since May 2020.
- A 7.7% decline in gasoline prices in July helped alleviate pressure on the broader index, while an increase in food and shelter offset some of that movement. Food costs rose by 1.1%, the seventh consecutive monthly increase of 90 bps or more.
- Other declines were seen in airline fares, used cars and trucks, communication, and apparel.
- Core CPI, which removes food and energy prices from the calculation, rose 30 basis points, the smallest increase in four months. Core CPI is up 5.9% year-over-year.

2. INFLATION REDUCTION ACT IMPACT ON CRE

- On August 7th, the US Senate passed the "Inflation Reduction Act" bill, which now goes to the House of Representatives, and is widely expected to pass before being sent to the President's desk.
- While the bill primarily focuses on climate and health care policy changes, it also effectively closes the door on this congress' attempt to boost Affordable Housing programs or amend how some real estate gains are taxed.
- A proposal by the White House to change the tax treatment of carried interests, often used by real estate developers to reduce capital gains tax liability, was removed in the 11th hour to gain the support of Senator Kristen Sinema (D-AZ), whose vote was needed for the party-line bill to pass. The National Association of Realtors and other industry trade groups opposed the proposed change.
- While maintaining the status quo for carried interest should stave off any direct negative impact on Commercial Real Estate investments, the final bill did not include an expansion of the Affordable Housing programs or incentives generally championed by the industry as a way to boost housing supply.

3. STAGFLATION RISK TO CRE

- In a recent analysis of factors that could affect CRE valuations, Fitch Ratings finds that the combination of inflation and weak economic growth could soften tenant demand and cause upward pressure on cap rates, potentially resulting in a decline in net operating income.
- The analysis, which looked at the historical relationship between interest rates and NOI, found that during a period of rising long-term interest rates, property-level cash flows tend to keep pace or grow faster than cap rates. Still, a period of stagflation, which implies that we are in both a rising cost and falling growth environment, may result in prolonged elevated cap rates, likely softening CRE values.

SVN COMMERCIAL REAL ESTATE ADVISORS
svn.com
185 Devonshire St, M102
Boston, MA 02110

- The analysis notes, however, that the historical link between cap rates and the yield on the 10-year Treasury has weakened since the 1980s, making the circumstance of rising cap rates in our current tightening environment less certain. Still, evidence of upward pressure on some sector cap rates has surfaced since the Fed began hiking interest rates in the spring.

4. SURGING RETAIL INVENTORIES

- A recent market analysis by Prologis projects that an additional 800 million square feet of warehouse space may be needed to handle excess inventories taken on by retailers in recent months.
- According to a Wall Street Journal summary of the report, many large retailers, including Walmart, Bed Bath & Beyond, and Best Buy, have reported dealing with unexpected inventory increases as consumers move away from goods spending due to inflation. Meanwhile, supply chain bottlenecks continue to force retailers to stretch out buying cycles, incentivizing them to stock shelves earlier in the season than they would have previously, further increasing industrial space demand.
- Demand so far is growing the most among discount retailers and liquidators. Still, some observers caution against being too bullish. Many retailers are also cutting prices and canceling orders to cope with the excess, a signal that higher demand for space may be unaffordable for some.

5. JOBS REPORT

- The US economy added 528,000 jobs in July while the unemployment rate ticked down to 3.5%, according to the Bureau of Labor Statistics.
- This month's jobs report far exceeded most economists' expectations, with widespread gains led by leisure and hospitality, professional and business services, and healthcare. Both employment levels and the unemployment rate have returned to February 2020 levels, recovering all jobs lost during the COVID-19 pandemic.
- Nonfarm employment has increased by 22 million jobs since reaching a pandemic low in April 2020, with private sector employment 629,000 jobs above its February 2020 level.
- Despite leading job gain metrics for much of the pandemic recovery, leisure and hospitality employment remains 1.2 million below its February 2020 level. Meanwhile, professional and business services employment is 989,000 jobs above its February 2020 level, and retail trade is 208,000 above its February 2020 level. Construction employment is 82,000 jobs above its February 2020 level, and manufacturing is 41,000 jobs above its February 2020 level.

6. LAW FIRM LEASING ACTIVITY

- According to Savills' latest quarterly report on law firm activity, leasing activity among law firms ticked

up by more than 43% in Q2 2020, a turnaround from COVID-era lows reached in Q2 2021.
- Data shows that 1.6 million square feet of office space were leased to law firms in Q2, returning leasing volume to the quarterly average seen over the past four years.
- Seven of the ten largest leases completed so far in 2022 were in the most recent quarter and exceeded 100,000 square feet. 63% of activity year-to-date, measured by square footage, has been relocations.
- The report suggests that there is evidence that flexible in-office work schedules represent a long-term shift, with firms moving away from dedicated office space but towards denser, shared use and collaboration spaces.

7. CAP RATES

- Cap rates on office properties ticked up slightly in Q2 2022, rising ten basis points to 6.3%, according to data from MSCI Real Capital Analytics. Office cap rates remain close to historical lows met in the previous three quarters. A 10 bps rise in CBD and Suburban cap rates in Q2 led to the overall increase. Meanwhile, cap rate compression in Suburban offices has driven much of the reduction in the broader sector over the past year.
- Industrial assets saw cap rates rise on average by 20 bps to 5.7% in Q2, led by a rise in Warehouse cap rates, while Flex spaces compressed by 60 bps.
- Retail cap rates were unchanged quarter-over-quarter, remaining at 6.3%. Over the past decade, retail cap rates have steadily compressed, though at an increasingly slower pace in recent years.
- Apartment cap rates continue to post all-time lows, dropping 20 bps to 4.5% in Q2 and down by a half-percentage point year-over-year.

8. INVESTMENT VOLUMES

- Quarterly transaction volumes averaged across all commercial real estate property types rose in Q2 2022 to $190 billion, up by $5 billion from the previous quarter, and up 17% year-over-year. Transaction volume year-to-date is roughly 38% above the total volume registered in 2021.
- On a year-over-year basis, Apartment and Retail transactions represent the bulk of the increase in activity. Retail led all sectors with a 46% year-over-year increase in transaction volume; however, current growth in retail activity is dwarfed compared to the triple-digit increases seen throughout the early parts of the pandemic recovery. Still, on a quarter-over-quarter basis, Retail transactions ticked up marginally. Meanwhile, Apartment transactions rose by $18 billion in Q2 2022 and are up 42% year-over-year.
- Industrial volume rose 8% year-over-year through Q2 2022 but declined by roughly $4 billion quarter-over-quarter. The annual increase in volume was pushed by a rise in warehouse demand, while flex space transactions remained unchanged.

SVN COMMERCIAL REAL ESTATE ADVISORS
svn.com
185 Devonshire St, M102
Boston, MA 02110

- Office transaction volume fell by $8 Billion from the previous quarter and is down by -9% year-over-year.

9. LOAN MATURITIES

- A recent report by Moody's Analytics investigates how rising interest rates create refinancing challenges for CMBS loans approaching maturity. The analysis finds that there has been an increase in loans past their maturity dates but have not yet paid off, as lending headwinds impact performance.
- Comparing 2012 vintage CMBS loans, many of which are maturing this year, to 2011 vintage loans that matured last year, Moody's analysis finds that, on average, the 2012 batch has performed better. However, they note that a higher amount of outstanding 2012 vintage loans are due in the latter half of 2022. As rising interest rates cause additional pressure on refinancing activity in the coming months, non-performance among 2012 vintage loans could increase.
- Additionally, the report finds that higher LTVs and the resulting decrease in reappraisal activity appear less prevalent among Hospitality and Multifamily loans than in others. The findings are consistent with space and capital market trends, apartment rent growth, household formation, and income fundamentals.

10. ADAPTIVE REUSE ON THE RISE

- A recent article by Multi-Housing News details how Adaptive Reuse projects are on the rise across the US, mainly targeting under-occupied office properties and the industry's challenges.
- In addition to the opportunities presented by falling urban office demand and rising urban apartment demand, financing options, including Low-Income Housing Tax Credits (LIHTC), Historic Tax Credits, and other federal programs, are helping incentivize adaptive rescue efforts.
- Challenges include building, mechanical, and electrical system conditions and weatherproofing. Additionally, inspecting environmentally hazardous materials and removing costs can present unpredictable obstacles.
- Interestingly, some architects believe that older, pre-1950s office buildings may be better suited for conversions than those built in the latter decades of the 20th century due to more nuanced attention to detail on interior design features. Building shape matters, too, with some suggesting that narrower buildings have easier access to outside light and air often desired by apartment tenants.

svn.com
185 Devonshire St, M102
Boston, MA 02110

Economic Update

SVN | Research

SUMMARY OF SOURCES

- (1) https://www.bea.gov/news/2022/gross-domestic-product-second-quarter-2022-advance-estimate
- (2) https://s3.documentcloud.org/documents/22122291/summary_of_the_energy_security_and_climate_change_investments_in_the_inflation_reduction_act_of_2022.pdf
- (3) https://www.fitchratings.com/research/corporate-finance/us-commercial-real-estate-values-threatened-by-rising-rates-stagflation-risk-sluggish-noi-will-likely-harm-values-10-08-2022
- (4) https://www.wsj.com/articles/retailers-seeking-more-warehouse-space-to-stow-excess-inventory-11659460929
- (5) https://www.bls.gov/news.release/empsit.nr0.htm
- (6) https://www.savills.us/research_articles/256536/331757-0/savills-u.s.-law-firm-activity-report-q2-2022
- (9) https://cre.moodysanalytics.com/insights/cre-trends/loans-reaching-maturity-without-paying-off-more-trouble-ahead/?cid=YJZ7YNGSROZ5414
- (10) https://www.multihousingnews.com/why-multifamily-adaptive-reuse-is-on-the-rise/

SVN COMMERCIAL REAL ESTATE ADVISORS
svn.com
185 Devonshire St, M102
Boston, MA 02110