SVN INTERNATIONAL CORP.

Emerging Trend Report

PULLING THE PUNCH BOWL: NAVIGATING CRE IN A TIGHTENING MONETARY ENVIRONMENT

Pulling The Punch Bowl

As the US began to recover from the depths of the COVID-19 recession in 2020, a debate took place over whether the nation would experience a sustained period of high inflation. Many predicted a transitory price spike as fiscal stimulus made its way through the economy, boosting demand while global supply chains were still thawing. However, two years later, severe supply chain imbalances persist, worsened partly by geopolitical tensions, and transitory has become just another internet meme.

In response, the FOMC—the Federal Reserve's rate-setting body— has voted to increase the Federal Funds rate at its last three meetings and has amplified the increases by 25 bps each time. After a new generational-high inflation reading in June, some Federal Reserve officials are even mulling a full-percentage point increase at their next meeting. Policymakers now face the task of trying to tackle high inflation without sacking economic growth in the process.

Historically, Commercial Real Estate (CRE) has been uniquely positioned to absorb both inflation and monetary tightening effects. In this piece, the SVN® Research team explores the latest forecasts for inflation and interest-rate policy in 2022 while detailing how CRE investments are better suited against high-risk environments than most.

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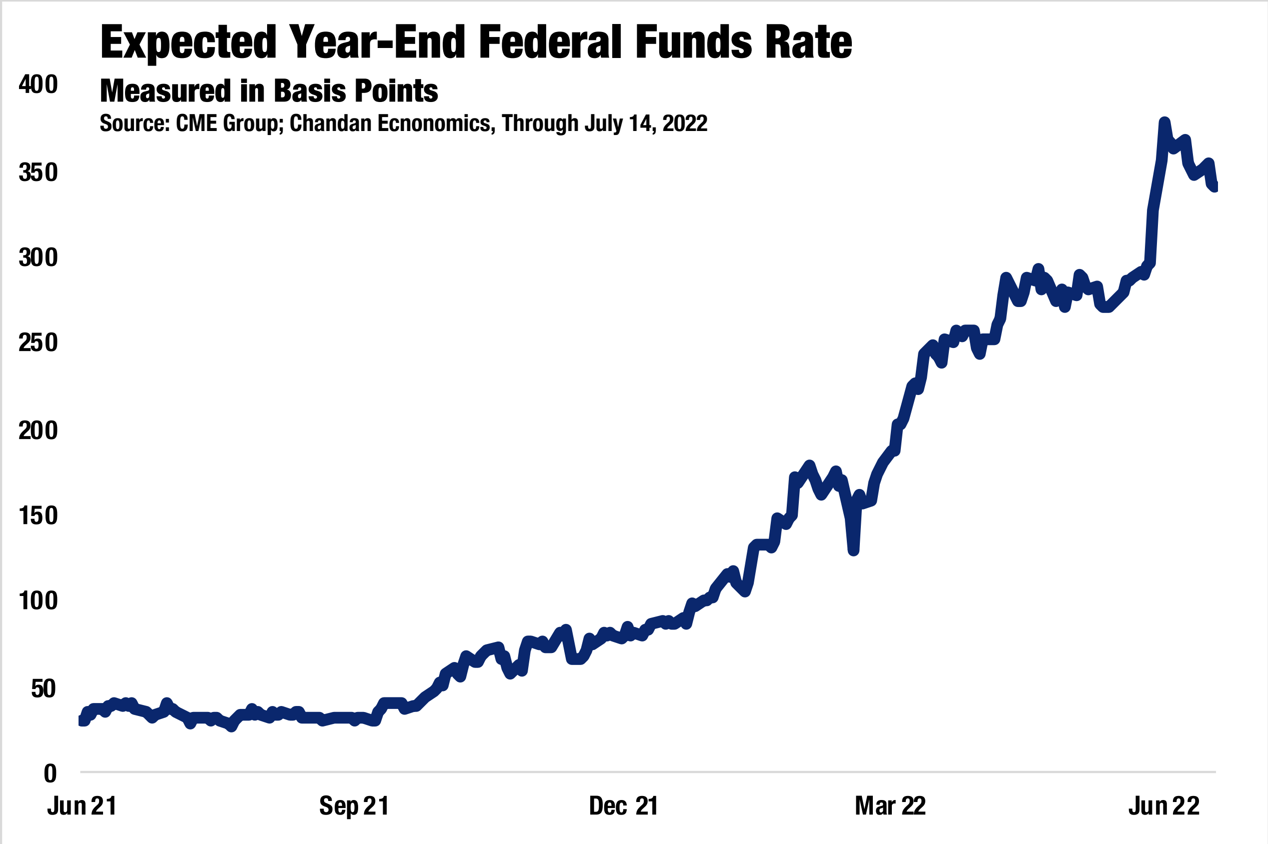
Watching With Interest

The persistence of above-target inflation over the past several quarters forced the Fed's once reluctant hand into action as it attempts to keep a handle on price stability. Through June 15th, the FOMC has conducted three consecutive rate increases. First, a widely anticipated quarter-percent hike in March, followed by a half-percent increase in May, and a three-quarter-percent rise in June.

The most recent increase is the committee's most aggressive action to tighten credit conditions since the early 1990s.

A key question moving forward is how long and aggressive Fed tightening will go? Of course, this squarely depends on the path of inflation, and so far, price pressures have shrugged off the Fed's actions. In June, the Consumer Price Index (CPI) registered an 9.1% year-over-year increase, the fastest increase since 1981. Prices of food and gas, while typically removed from monetary policy considerations, continue to exert immense pressure on American wallets. Both have been exacerbated by Russia's invasion of Ukraine and the ensuing Western economic sanctions.

Future markets have been swift to price in these developments, predicting a steep path for interest rates. According to the Chicago Mercantile Exchange's Fed Watch Tool—which tracks the market's anticipated path of the Fed Funds— the consensus expects several more rate hikes this year, with the year-end Federal Funds rate landing at 350-375 bps.



In the weeks since the FOMC's initial hike, future market sentiment has grown even more hawkish, primarily in response to incoming economic data that they believe will force the Fed's hand into an increasingly aggressive stance. The US economy continues to exhibit strong job growth, adding 372,000 payrolls in June, while consumer spending is up 9.2% from one year ago despite a decade-low in consumer confidence.

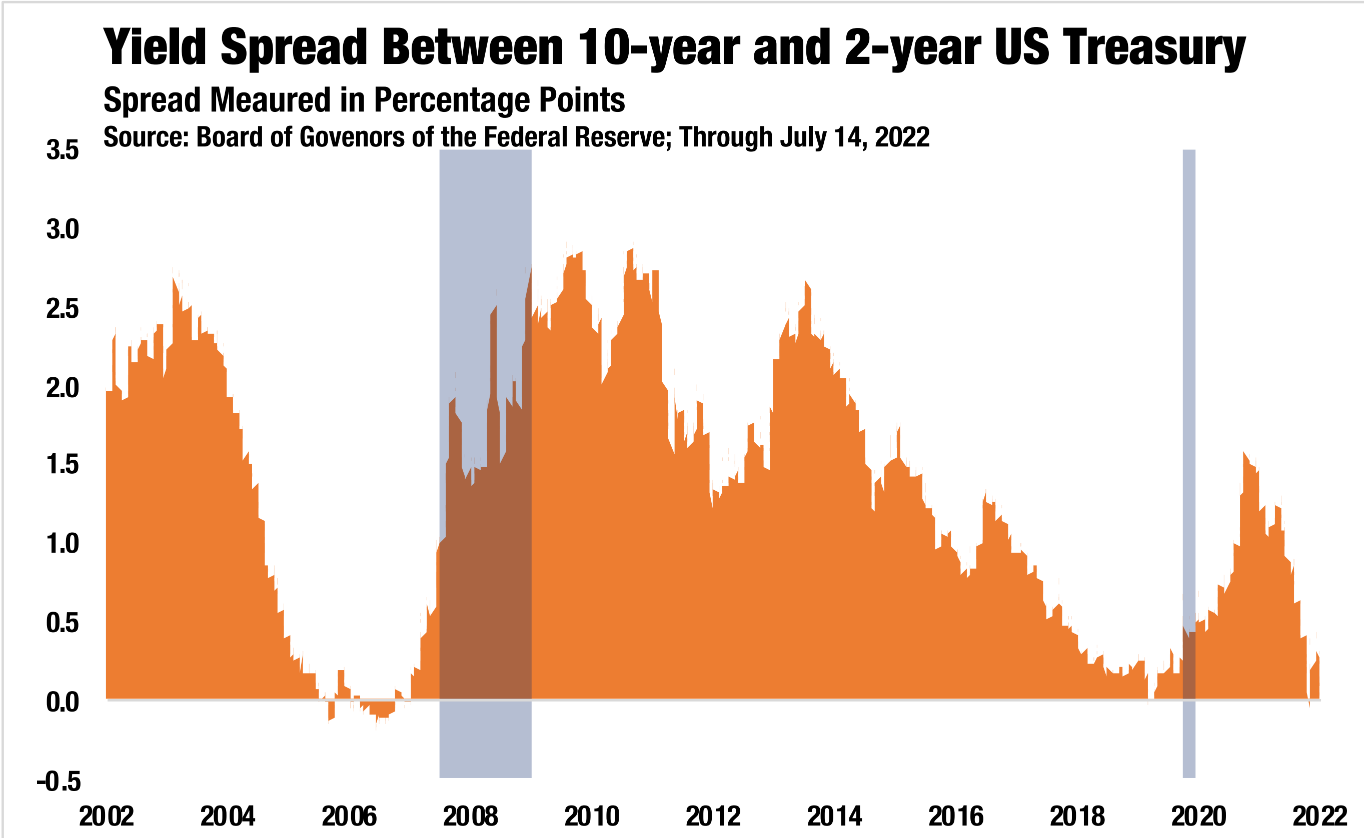
Markets are betting that this mix of economic conditions will likely keep policymakers' foot on the pedal in the near term barring a directional shift in inflation-related indicators—and so far, they've been correct. In his recent Senate testimony following the FOMC's three-quarter-percent point hike in June, Fed Chair Jerome Powell reaffirmed the Fed's commitment to price stability, staying that they "can't fail," and his confidence that "ongoing rate increases will be appropriate."

Steady Landing

A separate but growing concern facing the US economy is that increases in borrowing costs may dampen demand to the point where it tips the US economy into a recession. In an ideal world, the Fed is eyeing a “soft-landing” as they look to raise interest rates fast enough to defend the dollar against an extended period of above-target inflation while leaving room for growth. Soft landings aren’t easy, though, and the Fed’s urgency increases the risk of a policy-triggered recession.

Markets are increasingly pricing-in higher probabilities of a recession over the next year. According to the latest Bloomberg monthly survey of economists, experts now see a 30% probability of a recession in the US within the next 12 months. Other warning signals are beginning to flash as well. In June, S&P Global’s flash US Composite PMI Output Index, a measure of current manufacturing and service sector conditions, fell to its slowest pace in five months. Similarly, June data revealed that consumer confidence collapsed to its lowest level in more than a year.

Treasury markets have ebbed on the question— in April, the measure inverted for the first time since 2019, an often-reliable signal of an upcoming US recession. A second inversion occurred on July 8th.



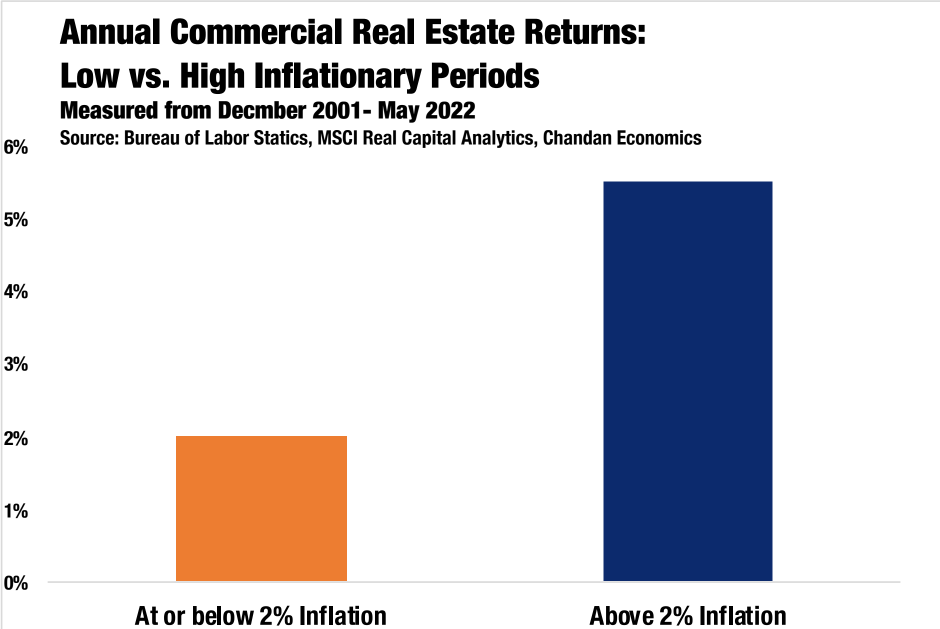
The fallout of the Russia-Ukraine War introduces an additional, double-edged risk into the picture. Elevated energy prices don't only contribute to inflation but can be a significant barrier to growth, as credit conditions elsewhere tighten simultaneously.

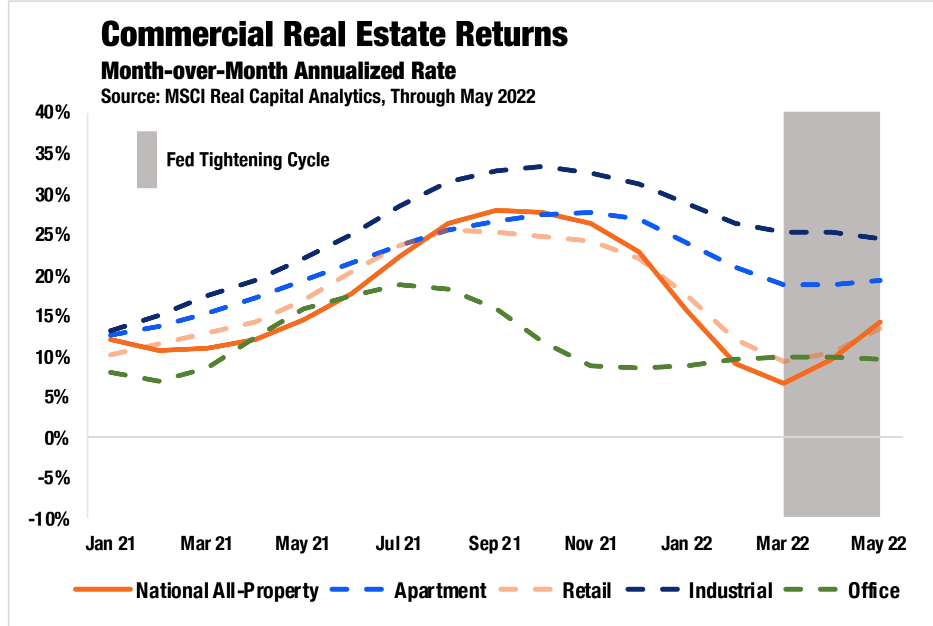
According to the BLS, energy prices are up 41.6% over the last 12 months through June. Much distress followed a ratcheting-up of Western sanctions on Russian oil exports, making predicting our inflation peak even more complicated. However, in recent weeks, prices at the pump have fallen, elevating hopes of a peak in price movements.

Our Future Hangs in the Balance Sheet

Despite the gloomy introduction to this analysis, real estate property has long served as a hedge against dollar inflation. In contrast, Commercial Real Estate has outperformed equity markets since the tightening cycle began. Comparing year-over-year CPI inflation against MSCI RCA's Commercial Property Price Index (CPPI) dating back to December 2001—the earliest date of comparable data— real estate values have not only consistently outpaced inflation but did so twice as fast when CPI was above 2% annually compared to when CPI was at or below 2% annually. In the 116 months where inflation was at or below the Fed's 2% annual inflation target during the observed period, commercial real estate prices grew by an average of 3.04% year-over-year. In the 128 months where inflation was above 2% annually, commercial real estate prices rose by 6.24% year-over-year.

Through our latest battle with inflation, both CRE and broader equity markets initially performed strongly, but when tested by COVID uncertainty and then the Fed's tightening cycle, CRE has proven to be the more stable asset. When consumer prices began to climb to overheated levels in early 2021, the economy saw a strong performance, and annualized monthly returns for the S&P 500 outpaced commercial real estate price growth. However, as the Omicron wave roiled stock markets in the fall of 2021, CRE's stability held strong.





Further, while the S&P 500 has collapsed under the uncertainties of 2022, CRE as a whole— driven by longer-term supply and demand fundamentals— continues to experience similar growth levels to early 2021. According to MSCI Real Capital Analytics National All-Property Index, through May 2022, CRE prices are up 4.4% from where they finished in 2021 and 18.6% year-over-year. Comparatively, through May 2022, the S&P 500 had fallen by 13.3% from the start of the year and 1.7% year-over-year.

Across CRE and at the sub-sector level, there are signs that pricing momentum has slowed— at least compared to the lofty highs of the past year. If prices grew as quickly as they did between April and May for an entire year, annual CRE price growth would total 14.3%. Industrial and Apartment continue to lead the way for the CRE sub-sectors, with annualized monthly growth rates currently sitting at 24.4% and 19.2% through May, respectively. Retail and Office follow next, with growth rates at 13.3% and 9.6%, respectively. Notably, while these growth rate totals are below their recent peaks, the compass continues to point north— an accolade that is increasingly rare in most financial sectors thus far in 2022.

Forward Guidance

While we expect growth to fall from the highs observed in the market over the previous two years, few predict a significant breakdown. During a recent forum with members, National Association of Realtors (NAR) director Lawrence Yun pointed to land development as a growing opportunity in the coming years as the nation continues to try and address a significant housing shortage.

Further, Yun pointed out that Industrial and Retail assets continue to see high demand from inventory buildup and post-pandemic food traffic. On Office, while admitting that the sector faces unique challenges from the structural shift in remote work, NAR points out that they've seen "improvement in some midsize markets as companies seek more affordable office locations away from major US cities."

During most periods of economic uncertainty, good opportunities will present themselves, but a diligent understanding of today's challenges is critical in enabling the best strategies. The Commercial Real Estate industry is uniquely prepared for our current environment due to excess demand causing much of our economic headaches rather than sluggish growth. While The Federal Reserve's policy actions seek to calm some of this demand deliberately, its intent to stop at some level that is consistent with inflation-stable economic growth implies that there is some room for the most prudent investments.

About SVN®

SVN International Corp. (SVNIC), a full-service commercial real estate franchisor of the SVN® brand, is one of the industry's most recognized names based on the annual Lipsey Top Brand Survey. With over 200 office locations serving 500+ markets, SVN® provides sales, leasing, corporate services, and property management services to clients across the globe. SVN Advisors also represent clients in auction services, corporate real estate, distressed properties, golf & resort, hospitality, industrial, investment services, land, medical, multifamily, office, retail, self-storag,e and single tenant investments. All SVN offices are independently owned and operated. For more information, visit www.svn.com.

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