SVN RESEARCH®

SVN INTERNATIONAL CORP.

Special Report

ROLLING TO A STOP—HOW RECESSIONARY FORCES IMPACT CRE DEAL VOLUME

Overview

Historically, seasonality has been a predictable characteristic of commercial real estate (CRE) transaction volume, which typically peaks in the fourth quarter of each year before normalizing again to start the next. However, heading into the Q4 2022, the US economy is sending mixed signals about its health.

This year's transaction cycle could face resistance from two interrelated headwinds: Quantitative Tightening (QT) by the Fed and a potential US recession.

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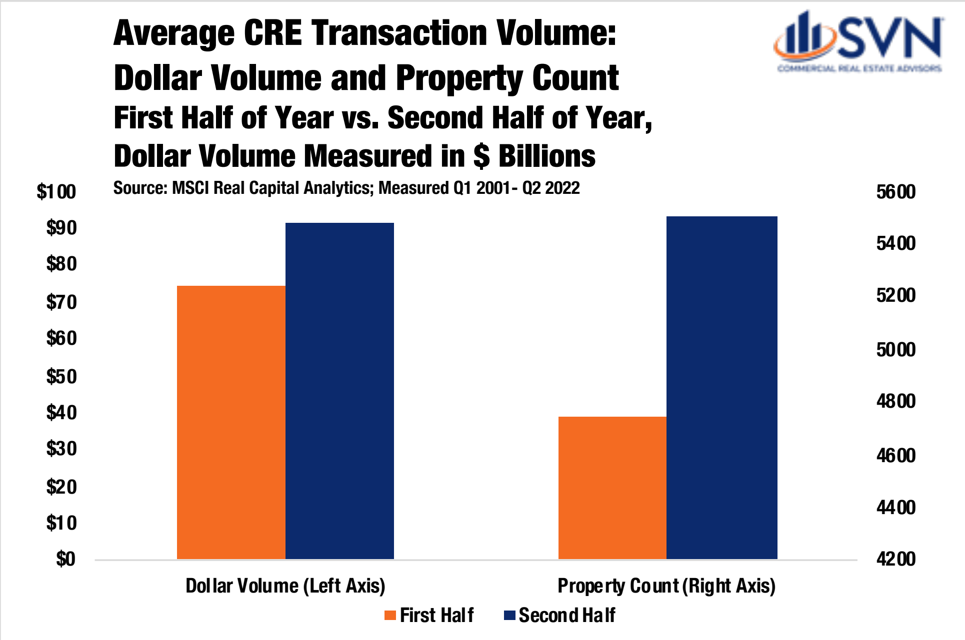
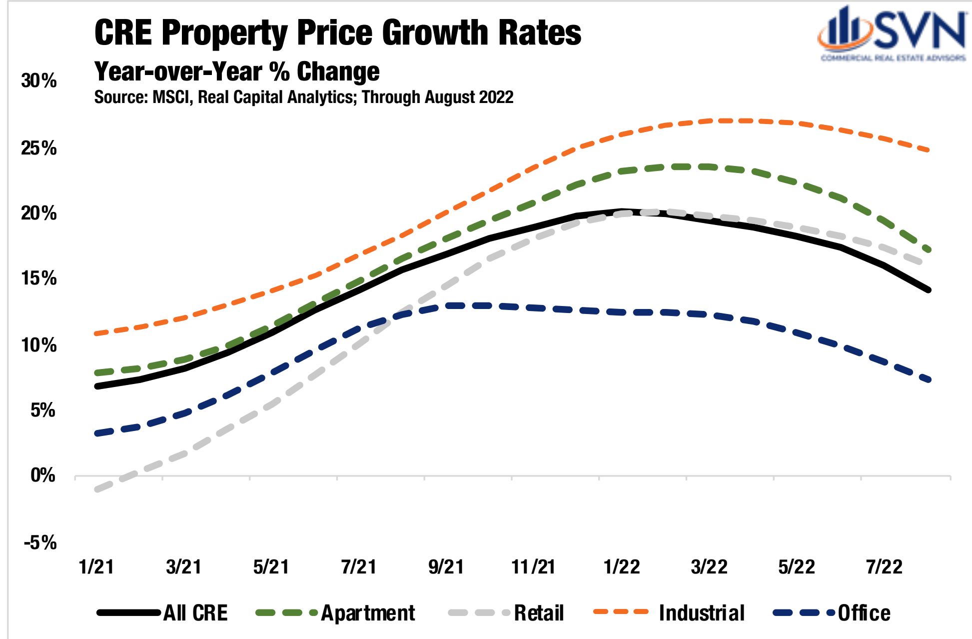
Fourth Quarter Comebacks

Since MSCI Real Capital Analytics (RCA) began tracking Commercial Real Estate volume in 2001, transaction volume, on average, has performed better during the second half of the year compared to the first, both in terms of dollars and total properties. Historically, total sales are on average 19% higher during Q3 and Q4 compared to the first two quarters, while there is a 16% increase in total properties trading hands.

As CRE investment intensified to new highs in 2021, so too did it's end of year uptick. Three of the four major food-groups of CRE achieved record-high transaction volume in dollar terms during Q4 2021. Office, the only of the four to that did not reach a new record, still experienced its best performing quarter since Q2 2007.

While history suggests that CRE should have the wind at its back entering Q4, weather predictions have been a dicey undertaking in recent years. Recession signals are escalating, with modest warning signs already flashing in the latest real estate data. During August, US commercial property transactions continued to climb, but at the slowest rate so far this year.





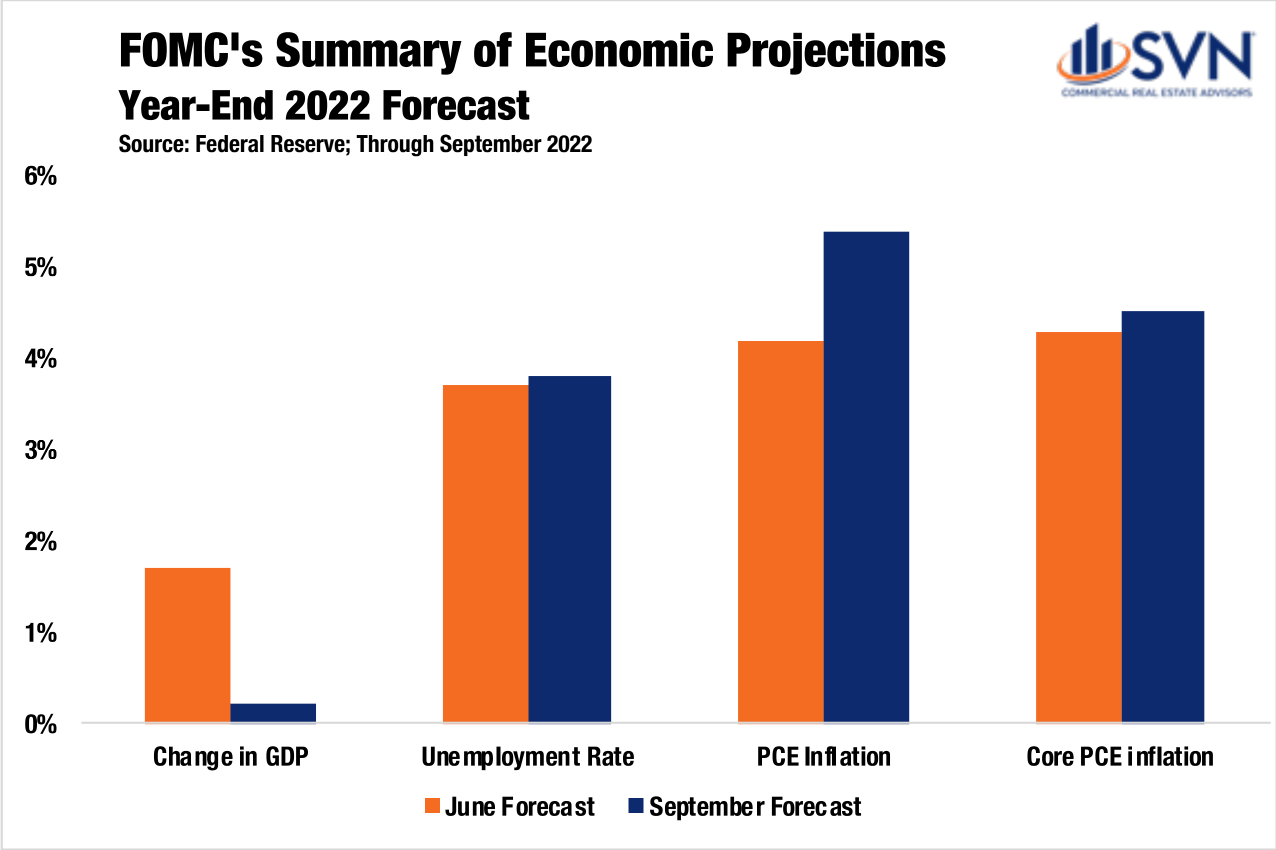
The average price increase across the major property types slowed to 14.0% year-over-year in August, 260 basis points lower than July as investors continue to digest the impact of higher rates.

Further, while transaction volume from a dollar volume standpoint has sat close to all-time highs for much of 2022, less properties are changing hands, indicating that price-growth is currently being driven more by supply shortages rather than a demand-spike.

A Cloudy Forecast

As the Federal Reserve began its rate-hikes in March in a bid to tame US inflation, many wondered whether a monetary soft landing was possible, where rates are raised just enough to calm prices but not throw the economy into recession. More than a half-year into QT, the US inflation rate remains north of 8% year-over-year, and policymakers have been forced to intensify their efforts — conducting three consecutive 75 basis point increases through September.

Reacting to moves by the Fed, as well escalating global uncertainty stemming from the War in Ukraine and various fiscal conundrums — recession risks have begun to ratchet up in recent weeks. Utilizing a model based on Treasury yields, national financial conditions, and leading economic indicators, the Conference board recently raised its probability of recession to 96% heading into Q4. Markets are increasingly fearing the likelihood that a hard landing will be needed to calm overheating prices, and policymakers appears to agree.



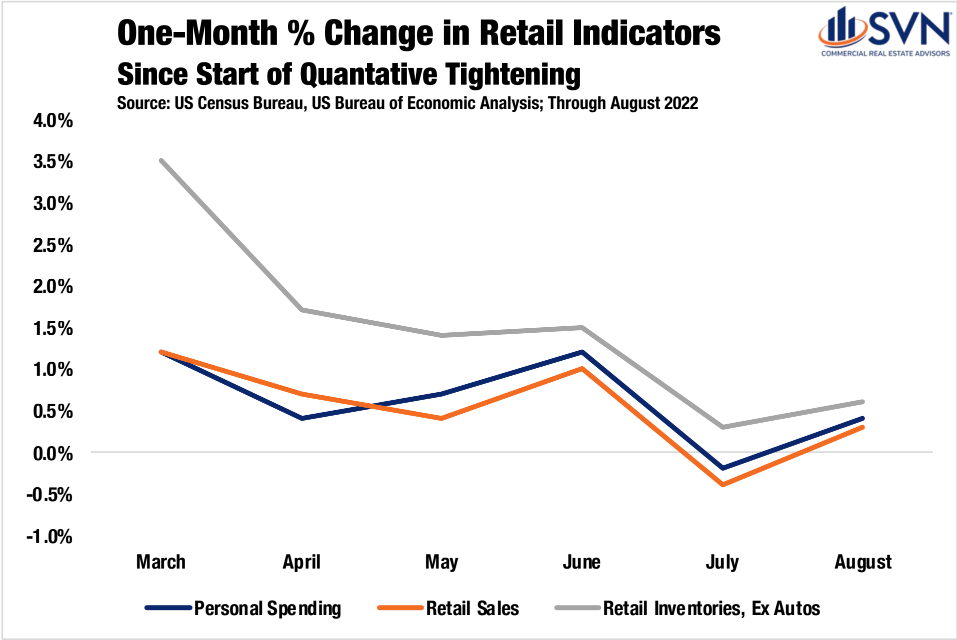
In their latest Summary of Economic Projections released in September, the FOMC forecasts for growth, inflation, and unemployment were all revised in the wrong direction. The average forecast for the annual change in GDP through Q4 2022 fell to 0.2%, a drop from the 1.7% growth forecast at their June meeting. The Fed also projects that, because of higher rates and slowing growth, the unemployment rate will rise modestly by year's end, while core inflation is expected to remain above the FOMC's 2.0% target as we turn the page to 2023.

CRE, A Fortress?

While Quantitative Tightening's adverse effects are visible across rate-sensitive industries, concurrently, real estate market fundamentals continue to fortify CRE's relative stability. For example, despite a modest slowdown, prices in the Industrial sector posted a far-from-pedestrian 24.7% year-over-year increase in August, supported by large inventories, and continued spending on goods. Apartment properties, which similarly experienced price deceleration in recent months, remain up 17.1% annually and will continue to largely reflect the effects of strong housing demand amid constrained supply.

The Retail and Office sectors are also being supported by a resilient US economy. Despite two consecutive declines in annual GDP to start the year (an unofficial marker of a recession), a combination of steady job growth, low unemployment, and robust consumer spending hasn't resembled a typical recession. So far, this year's decline in output reflects a pullback in private and residential investment and government spending, while inflation-adjusted consumer spending remains positive, averaging 1.9% year-over-year during the first half of 2022. Personal spending continued to rise in August (+0.4%), beating most market forecast despite declines in energy spending amid falling gasoline prices. Meanwhile, retail sales climbed 0.2% between July and August, inventories ticked up, and the recent start to the school year helped push office occupancy levels to a new post-pandemic high.

Future rate-hikes could begin to dampen demand if inflation continues to force the Fed's hand, further pushing down on



price growth. On the other hand, supply and labor issues continues to make new construction projects challenging, which in turn, is providing a floor for property prices. According to July data from the Jobs, Opening, and Labor Turnover Survey (JOTLS), there are currently 375,000 construction job openings through July 2022, up 22k and 28k from the prior month and the same point last year, respectively. Unemployment claims also recently fell below 200,000 per week, which is supporting prices through both limited labor supply and durable incomes.

The Q3 Real Estate Roundtable Sentiment Index showed continued optimism regarding the underlying fundamentals of real estate, despite some caution about inflation and rising rates in the short term. Other longer-term trends developing in real estate also remain at play. Remote-work continues to play a significant role in driving local housing demand— accounting for more than half of all price increases between November 2019 and November 2021, according to recent research by the San Francisco Fed. The work-from-home renaissance appears to be here to stay and will remain an anchor of some of the best markets for Apartment investment. Additionally, the pandemic-era shift in goods consumption appears to have a degree of permanence, which combined with the upcoming holiday shopping season should provide some support to Industrial and Retail in Q4. Meanwhile, a takeoff in Life Sciences is driving new opportunities for the Office sector.

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