U.S. Macro Outlook: An Uncomfortable Soft Landing

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Key Takeaways

Economy
Slowing growth and a break in shelter inflation's stickiness will pave the way for the Fed to pivot in the fall.

Capital markets
Acceptance of higher-for-longer is permeating the market, leading to more price discovery and more optimism around activity moving forward.

Industrial
Even with rent growth decelerating, strong fundamentals and an ongoing adjustments to higher rent levels among existing leases will keep this sector favored in an income-focused era.

Multifamily
The supply wave gets the attention, but the strength of demand should be equally acknowledged, given that it is offsetting the impacts of development on vacancy, which is now nearing its peak.

Office
Still challenged by the adjustment to hybrid work, the office sector at large remains soft. But not all markets or product are created equal: the market is trifurcated and becoming more so.

Retail
The lack of supply is the story here for a sector that has a 40-year low vacancy rate, hovering at 5.4%. Store openings will exceed store closings this year, helping keep the market anchored at tight levels.

Lodging
While pent-up demand for travel continues to buttress spending on lodging, cost effective and luxury options are likely to remain more insulated given inflation's impact on middle- and lower-income households.

Alternatives
Secular demand drivers continue to favor most alternatives, especially those with residential underpinnings and data centers.

C&W Baseline U.S. Economic Outlook: The Fed is Data Dependent, And So Are We

What We Are Seeing

- Cracks are forming beneath the surface. Credit card and auto loans delinquency rates are rising. Leading labore market indicators are signaling a slowdown and consumer confidence is subdued.

- Some sectors have been or are in contraction mode. Housing, manufacturing, and the transportation sectors have been anemic, if not recessionary, over the past 18 months. Job growth is concentrated in lagging sectors like government, education and healthcare.
- The rising burden of interest costs is significant, with lower-income consumers showing the greatest signs of strain. Some are insulated—namely homeowners with no mortgage or a locked-in low mortgage rate—which will continue to buoy consumer demand.
- Resilience is predicated on an avoidance of mass layoffs even as firms see profit margins come under pressure amid more price sensitivity of consumers, less excess savings, slowing credit growth and high (although slowing) inflation and wage growth.

Outlook

- Sticky inflation will continue to weigh on the Fed's decision-making in 2024. Housing inflation should recede more meaningfully in the second half of the year, paving the way for the Fed to begin cutting rates in the fall.
- The 10-year Treasury rate will be range-bound between 4% and 4.5% in 2024, and then in the 3.8% to 4.2% range thereafter.
- Generally, the economy and labor markets will moderate further in the coming quarters, with real GDP and job growth slowing meaningfully for the remainder of the year. From there, as rate cuts take effect, we expect momentum to build throughout 2025. Real GDP will grow in the 1% range at the start of 2025 but will end the year in the 2.5% range—good enough for the economy to create another one million jobs.

Capital Markets: It's Not Illiquidity, It's Pricing

Economic Drivers

- The Fed is expected to cut interest rates as inflation moderates, which should happen more meaningfully as shelter inflation decelerates. We have two 25 basis points (bps) cuts penciled in for 2024, followed by four next year and four in 2026.
- An acceptance of a higher-for-longer environment has permeated the market, leading to renewed optimism that transaction velocity will pick up sequentially this year. This has been corroborated by an improvement in CMBS originations, which are up 155% year-to-date through April versus the same period last year.
- At the long end, the 10-year rate is expected to hover near 4% over the medium term. Credit spreads across asset types (corporate bonds, CRE, etc.) should avoid a rapid expansion given economic resilience. They are historically tight, however, at present and will trend slightly wider as growth slows and becomes more uneven.

Outlook

- Investors will remain income-focused for the foreseeable future as existing debt slowly reprices into the higher rate environment. Fortunately for most asset classes, the NOI outlook is decent if

not robust, growing by 1.5% to 2% this year and next (in a diversified portfolio) before accelerating to the 4.5% to 7.5% range in the following years.

- Despite the fact that some measured cap rates will march upwards as credit spreads normalize off higher base rates, we forecast that total (unlevered) returns will once again reach double-digits and high-single-digits in 2026 and beyond.
- Buyers and sellers are growing increasingly more open to act, though both sides remain cautious and selective in the near term. Debt maturities and other liquidity-based needs (including redemptions/withdrawals) should continue to motivate sellers to meet the market, thereby improving price discovery for the marketplace more broadly.
- The long-awaited distress wave will continue to disappoint opportunistic capital sitting anxiously on the sidelines, as the process unfolds at a slow, sequential, and often boring pace. IN Q1 2024, only 3.9% of total sales were distressed and many delinquency rates remain low or are holding steady. This is obviously not true for office where expected distress is greatest—as well as for regional malls and hotels.

Industrial: Lower Gear As Expected

Economic Drivers

- U.S. manufacturing activity—despite some pockets of reshoring—has been subdued as evidenced by the ISM Manufacturing Index, which has been in contractionary territory for 18 of the last 19 months. Employment in manufacturing has gone sideways over this timeframe as well.
- A slowly improving global growth picture, however, is likely to lead to a rise in manufacturing activity, exports and trade—which will all benefit industrial CRE heading into 2025.
- E-commerce continues to gain market share in consumers' wallets, and a resilient job market coupled with real income growth should lead to steady consumption, particularly of nondurable goods.

Outlook

- While e-commerce continues to increase as a percent of retail sales, some of the pull-forward effect—firms building out sooner and faster during the pandemic—will weigh on the demand outlook for 2024 and the first half of 2025.
- Absorption is expected to hit a trough of just over 100 msf in 2024 before roughly doubling in 2025. We expect a return to a more normal demand run rate in 2026.
- New supply will be a key factor driving vacancy in 2024 as another 381 msf delivers throughout the market this year. The pipeline is dropping off significantly and we forecast only 160 msf will be delivered in 2025. From there, lower interest rates and improving fundamentals will help drive a new construction cycle.
- The imbalance in supply and demand seems starker than it is—vacancy is expected to peak in early 2025 at 6.7% before starting to compress back toward 5% by the end of our five-year

forecast horizon. For context, this is consistent with the lowest vacancies recorded in prior cycles, meaning that this cycle is fundamentally different.

- Rent growth is moderating on par with expectations after having grown by 54% since Q4 2019. We believe rent growth will come in at 3% in 2024 and 2% in 2025 before picking back up to the mid-single digits.

Multifamily: Resilient Demand Tempers Supply Impact

Economic Drivers

- Steady job growth, strong immigration and healthy household formation are underpinning strong demand for apartment units thus far in 2024.
- The 30-yr fixed mortgage rate has been hovering in the 6.5-7% range for most of 2024, up from the 3-4% range prior to the Fed's rate hikes. This increase, along with rising single-family home prices, is making home buying unaffordable for many, boosting demand for multifamily housing. The 30-yr fixed rate mortgage is expected to remain above 6% through the end of 2025.
- Healthy household formation is expected over the next two years, averaging over 1 million new households annually. This, coupled with a lack of affordable housing, should sustain apartment demand in the forecast horizon.

Outlook

- The multifamily vacancy rate has risen from a low of 5.1% in mid-2021 to its current rate of 8.7% as of Q1 2024. Our baseline forecast calls for vacancy to peak at the end of this year at 8.9%, before adjusting lower to 8.3% in 2025 and 7.3% in 2026.
- The pipeline is thinning out due to market conditions and challenging financing conditions. Multifamily permits as of the first quarter 2024 are down 38% from their peak, which will help vacancy tighten on the other side of the supply wave. Forecasted deliveries total 400,000 this year, but that total will be roughly halved in 2025.
- While it will take several quarters for these new units to be leased, demand is clearly on a solid trajectory as evidenced by the first quarter, where the 85,900 units absorbed was the strongest in two-and-a-half years and the second highest first quarter total on record. Demand is expected to average 292,000 units per year in 2024-2025, slightly stronger than the 2017-2019 average.
- Property owners have been generally prioritizing occupancy over rental increases, leading to decelerating rent growth over the last year. National rent growth is expected to bottom at 1.2% in 2024, before reaccelerating to 2.7% next year and 5.1% in 2026.

Office: The Devil Is In The Details

Economic Drivers

- Office attendance peaks at 60-70% on Tuesdays, Wednesdays, and Thursdays, setting a baseline for the minimum office space needed.

- U.S. office-using job growth has slowed dramatically, with 134,000 net new office jobs created in 2023, down from 1.1 million in 2022. The broader job market slowdown will temper growth, with an expected increase to just 210,000 this year before rising to 315,000 in 2025.
- Long-term, office employment is projected to rise from 35 million to 38 million by decade's end. Job growth is expected to counterbalance the work-from-home trend starting late-2025. After six years of declines, office space net absorption will become positive in 2026.

Outlook

- Although office jobs will continue to grow, office demand is still adjusting to hybrid work. We believe we are further along in that process beyond what weighted average lease terms (WALTs) imply, as about half the space on the sublease market has an underlying expiration date in 2028 or beyond. Occupiers have pulled forward future downsizing.
- The rationalization of office space usage is ongoing in 2024, and consistent with our prior outlook. This means that net absorption is going to be negative this year (-63 msf) and next year (-7 msf). We expect demand to average 20-25 msf per year as we go into the second half of the decade.
- Vacancy is expected to peak at 21.6% in the second half of next year—when the pipeline will be further tapering off and demand will be stabilizing.
- Trifurcation remains a key theme. There are bright spots in the office sector, including that 30% of Class A buildings have essentially no vacancy and another 20% have sub-15% vacancy. The bottom 10% account for over 730 basis points (bps) of current vacancy, reflecting a growing weight that these highly challenged and likely obsolete buildings have on headline statistics.

Retail: Steady As She Goes

Economic Drivers

- The U.S. consumer continues to spend thanks to a favorable job market and increases in real incomes. Real personal consumption expenditures increased at a healthy 2.5% rate in the first quarter, even as inflation reaccelerated.
- While overall spending remains solid, consumers continue to shift their budgets, resulting in disparate outcomes by sector. Furniture, electronics and appliances, and home improvement categories are generally seeing declining retail sales compared to 2023, while restaurants, e-commerce and mass merchandisers outperform—in both real and nominal terms.
- Consumers continue to dip into savings and credit to finance spending. The personal savings rate averaged 3.6% in the first quarter, roughly half the 6.2% average from 2015-2019. Additionally, the share of delinquent credit card accounts is at a 13-year high, as primarily lower-income households remain under financial pressure.

Outlook

- The retail sector will continue to be resilient amid steady demand and limited new supply, even as consumer spending throttles back. The national vacancy rate for open-air shopping centers is

currently at an all-time low of 5.3% and is forecast to tick up a marginal 40 basis points (bps) over the next two years.

- Demand for retail space remains robust, in part because of a strong pipeline of store openings by large retailers. Thus far in 2024, there are roughly 850 more store openings planned than closures.
- Tenant mix continues to diversify as well, limiting the downside risk of sector-specific weakness. Beyond traditional retailers, consumer service providers—including restaurants, education/healthcare, beauty and wellness—are leasing more space in retail centers. Consumers will continue to rotate back to service-oriented spending that has lagged post-pandemic, benefiting retail centers featuring these offerings.
- The lack of new supply is a key aspect of the outlook. With less than 12 million square feet of retail space under construction and over 4.3 billion square feet of inventory, high-quality retail locations will remain scarce. New supply is not expected to ramp up to its 2010-2019 average until 2027, at the earliest.
- Owners of well-located shopping centers will continue to have leverage to raise rents given the demand and supply dynamics, although rent growth is poised to slow over the next several years. After peaking at 5.0% in 2022, rent growth will average 2.9% from 2024-2026.

Lodging: Post-Pandemic Paradigm Shifts Operators' Strategies

Economic Drivers

- After averaging 3.9% annual growth leading into the pandemic, spending on accommodations dropped severely during the pandemic and recovered at the end of 2023. We expect demand to soften to 1.1% during 2024 before returning to trend in 2025 and 2026.
- Similarly, we expect hospitality employment to remain flat for 2024 and revert to trend over the next two years.
- Consumer spending continues to favor services including travel and leisure; real PCE growth on sporting events, museums and theaters has outpaced overall PCE each quarter since mid-2021.
- Given pressures on discretionary spending, we expect travelers will generally opt for more affordable tiers of lodging, benefitting occupancy and revenue growth in economy and midscale product. Luxury hotels will continue to have a slower recovery.

Outlook

- Despite challenges to consumer discretionary income, the post-pandemic recovery of the lodging sector continues to remain resilient. The TSA has reported that checkpoint volumes at end-of-year (EOY) 2023 exceeded 2019 levels by 1.6%.
- Due to the hybrid work paradigm, business travel has dipped noticeably, resulting in reduced lodging activity during weekdays in many business-oriented hotels. To better meet the growing concentration of the market on luxury travel, hospitality operators are planning changes in

marketing and design strategies, including reevaluating amenity offerings and selecting sites in travel-destination markets.

- Performance across specific markets has varied greatly. Sunbelt markets have performed strongly while some coastal markets have been slower to recover. Overall, RevPAR growth has been stagnant, as room rates have increased but occupancy is no longer rising and operating costs have grown.
- Going forward, we can expect performance to remain steady in this 'new normal,' with a delivery pipeline over the next several years limited largely to luxury assets in Sunbelt markets. As conditions improve in downtown core markets in other asset categories during the longer term, expect hotel assets in these submarkets to directly draft off this recovery.

Alternatives: Residential Niche Plays Remain Attractive

Build-to-Rent (BTR)

- In the 2020s, the U.S. population of 40-49-year-olds will grow by more than 10%, the fastest of any age group outside of 65+. Given affordability challenges in the single-family market, this demographic will likely rent at an outsized pace, gravitating toward BTR product.
- BTR product has outperformed at both a national level, as well as within our third-party management portfolio across demand levels, trade outs, delinquency and more.
- Only a small fraction of the multifamily market at present, BTR is poised to become more institutional, but likely requires more development to cement that path. Thus, it may see outsized construction activity—potentially leading to uneven performance over the next few years.

Student Housing

- A steadily growing population of university-aged students offers relatively more surety in outlook. Forecasts suggest that the total number of students will approach 20 million by the end of the decade.
- Student housing assets have outperformed the broader multifamily market over the past few years, thanks to a development pipeline that has all but shut down in the wake of the pandemic. As a result, occupancies improved and rent growth should outperform the broader multifamily sector through 2025-2026.
- Larger schools, especially top-tier state institutions with more stable demand pools, are likely to garner the majority of the activity and growth over the next few years.

Senior Housing

- The fastest-growing age cohort in population is those over the age of 75, which is expected to increase by over 50% in the next 12 years. This demographic shift will provide substantial demand for senior living over the next 10-20 years.

- With the pandemic in the rearview mirror, occupancies have recovered and so too has rent growth. To meet this growing demand, we estimate the need for an additional 35,000 units of new supply per year through 2045, well ahead of the current pace of roughly 25,000 units.
- In the years ahead, we expect renewed interest from investors across the sub-sectors (i.e., independent living, assisted living, and memory care) as construction will race to keep up with growing demand.

Alternatives: Demographics, R&D And Technology Drive Secular Demand

Life Sciences

- An aging global population requires more medicines, providing a secular demand driver for life sciences real estate.
- Sensitivity to interest rates and funding markets has led to a near-term slowdown in demand. Net absorption was negative in 2023 for the first time this decade.
- Not all of the market correction is demand-led. The overall vacancy rate increased to 17.2% in Q1 2024 from 15.0% in Q4 2023 as nearly 12 million square feet (msf) of new space delivered in 2023, representing 5.7 % of inventory.
- Vacancy is expected to increase further this year with another 16 msf of space delivering, or 7.6% of inventory. The incoming construction pipeline has slowed down, indicating that the number of completions in 2025-26 will decrease significantly and allow vacancy to stabilize.

Healthcare/Medical Office

- Driven by similar demographic trends as those affecting senior housing and life sciences, an aging population and rising healthcare spending has spurred continued growth.
- After working through operating budget challenges in 2023, many healthcare systems have looked to control labor costs and are actively evaluating conversion of administrative office space into direct healthcare uses. This conversion strategy has addressed both the rising hybrid and remote work prevalence of health system back-office talent, as well as controlling capital costs for expanding clinical space.
- Healthcare asset performance continues to remain strong, with average national occupancy at 91.5% and rent growth continuing to range from 2.5% to 3.5% in many markets.

Data Centers

- The growth of major cloud computing platforms and the emergent surge of AI interest continue to be the primary drivers of growth in the data center sector. While its rate of growth decelerated in 2023, cloud revenue growth is now back up to an estimated 20% year-over-year (YOY) in Q2 2024.
- Almost all major markets continue to remain at record low vacancy levels between <1% - 5%. Lease rates remain elevated as the market remains highly competitive for large capacity leases, driving preleasing rates of 70%+.

- Despite the challenges of power availability in many markets, the North American data center market pipeline continues to grow. With a development pipeline of 24GW, the region's total capacity is poised to grow 2.5x over the next several years.

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