U.S. commercial real estate: Q2 2018 review and outlook

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Introduction

The broad theme across U.S. macroeconomic data over the course of the second quarter was “more.” Some of it, such as increased retail sales, business spending, housing construction activity, and employment, was welcome: At the time of this writing, real GDP has so far clocked in at a robust 4.2% SAAR.¹²

Some of it, however, was less welcome: Inflation accelerated, oil prices rose, and a stronger U.S. dollar adversely affected the emerging markets.² These changes occurred against a backdrop of another, greater uncertainty: U.S. trade policy. The U.S. administration has followed through on its escalating tariff threats, which have been countered with similar levies on U.S. exports by China and others. While the tangible impact on GDP data has been minimal so far, sector-specific risks are increasing, and the higher degree of uncertainty could ultimately be reflected in more modest business investment than expected.

The United States will likely continue to print solid growth over the course of the year, but we believe that Q2 will come to be seen as an inflection point. Aside from the standard quarter-to-quarter volatility (Q1 tends to be weak, followed by a subsequent rebound in Q2),³ there are various factors that at the margin are likely to be moderating influences on the economy. Mortgage rates are up 14% year over year (YoY) and have contributed to slowing residential real estate activity, which is important because of its potentially detrimental impact on consumer spending. Combined with higher gas prices, this could be enough to erode at least part of the benefits expected as a result of the tax bill. In addition to policy uncertainty, corporate credit spreads have widened, which could, in turn, have a modifying influence on industrial production.

Somewhat more positively, the combination of peak base effects and a stronger U.S. dollar suggests that inflation could moderate over the second half of the year, which would be supportive of the U.S. Federal Reserve’s (Fed’s) current trajectory of gradual interest-rate increases. Our longer-term outlook is broadly unchanged, with calls for moderation beyond 2018. While our 2018 GDP estimate is a robust 2.8% YoY due to the U.S. tax bill and other fiscal measures, we expect that the United States will hit peak growth this year and decelerate from there over our five-year forecast period, with modest (albeit slightly higher) inflation persisting over that period as the Fed continues to tighten.

Mortgage rates are weighing on housing activity, 2012–2018

Source: Bloomberg, Manulife Asset Management, as of March 31, 2018.

¹ Seasonally adjusted annual rate (SAAR). ² Bloomberg, as of August 31, 2018. ³ “Why is the economy always so weak in the first quarter? Nobody really knows,” cnbc.com, April 22, 2015.
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Investment markets

Following a modest drop in activities after the peak levels of 2015, total transactions have remained relatively flat compared with last year, but were edging upward in the first half of 2018, which saw an increase of 4% YoY. U.S. economic fundamentals and strength of currency remain attractive characteristics for foreign investors, who increased activity by 27% YoY in the first half of the year. Institutional and private investors also increased their activities, while listed real estate investment trusts suffered a sharp decline.

Trends across property types and markets remained distinctly different in the first half of 2018. Strong fundamentals and robust income growth continued to attract investors to industrial and multi-residential markets, increasing volume by 26% and 8% YoY, respectively. The retail market, challenged by e-commerce competition and chronic oversupply, remained a drag on activities. Retail transactions grew by 1%, including the estimated US$8.1 billion Unibail acquisition of Westfield. Excluding entity level acquisitions, retail volumes contracted by 10% YoY. The office market also experienced a decline of 13% YoY, primarily driven by decreased activity in major central business district office markets.

Asset pricing trends mirrored transaction activities during the first half of 2018. The average transaction cap rate for industrial and apartment contracted by 32 and 11 basis points (bps), respectively, while office and retail cap rates remained relatively flat.

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4 CoStar, as of June 30, 2018. Market fundamental statistics, including vacancy, absorption, completion, under construction, and rent growth.

5 Buyer caution beneath the equilibrium, rcanalytics.com, July 19, 2018.
Office markets

The U.S. office market remains well balanced despite increased supply in recent quarters. With net completions of 15 million square feet (SF) and net absorption of 14 million SF in Q2, the national vacancy remained unchanged, at 10%.

Recent employment data is indicative of healthy economic expansion and supportive of demand for office space. Total nonfarm employment increased by 1.3 million in the first half of 2018, an increase of 17% YoY. With job openings standing at a record high of 6.7 million, employment growth is expected to remain robust in the medium term. With the unemployment rate for educated labor at a near historic low of 2% and baby boomers starting to exit the workforce, the availability of educated labor will likely be the major limiting factor over the next decade. Naturally, markets with higher growth in the working-age educated population are likely to attract employers and experience stronger demand fundamentals. Furthermore, as labor markets tighten, we feel the quality of office space will become an increasingly important factor for attracting and retaining talent. Accordingly, we would expect top quality assets in the right locations to capture a disproportionately high share of demand.

Average rent growth has continued to decline since its peak in 2015, but there’s significant divergence among markets. Average rent growth was at 2.3% for the 12 months ended Q2 2018, but the top five markets—Raleigh, North Carolina; San Jose, California; Charlotte, North Carolina; Seattle, Washington; and Sacramento, California—recorded rent growth of more than 5.0%.

Construction activity appears to have peaked in 2017, and with rent growth, inflation, and interest-rate trends not supportive of increased activity, we expect new construction to continue to trend down. New York, Washington, Dallas, San Francisco, and Chicago are the top five markets with the most construction.

Industrial markets\(^9\)

Demand for industrial space continues to outpace overall economic growth as logistic infrastructures adapt to the requirements of e-commerce. Industrial net absorption of 51 million SF against net completion of 47 million SF in Q2 2018 helped push vacancies to 4.8%, their lowest level in 35 years. Historically, industrial market demand has grown in sync with overall economic growth; in years, however, demand has accelerated to 1.3 x GDP.\(^9\) This additional demand is primarily attributed to the needs of e-commerce for large regional and superregional warehouses and small last-mile fulfillment centers. These unexpectedly high demand fundamentals, paired with the slow supply response seen earlier in the cycle, has pushed average rent growth to a historically high rate of almost 6.0% in recent quarters.

The strength of the industrial market’s fundamentals and its income growth story have also resulted in a robust pickup in investment activities, increasing by 17.0% YoY and reaching a record high of US$18.2 billion in Q2 2018. Prices for industrial assets also continue to break historic levels, with average cap rates for industrial deals reaching 6.3% in Q2 2018. At the extreme, some properties occupied by Amazon have traded at cap rates as low as 4.5%.

With peak pricing, construction activity has recently increased and is reaching levels not seen since 2000. As a result, the increased supply is expected to surpass demand in 2019 for bulk regional products in many markets and help decelerate rent growth to long-term averages.
Multiresidential markets

The multifamily sector continues to appeal to institutional investors. U.S. demographic trends, such as steady household formation, a decreasing home ownership rate, and baby boomers reaching retirement age, are all supportive of healthy demand growth.

Despite an increase in supply in recent years, U.S. markets overall remain undersupplied. With net absorption of 96,000 units and net completion of 44,000 units, average vacancy rates reached 5.9% in Q2 2018.

The recent wave of supply has been concentrated on high-end properties located in core urban locations, more than half of which require an income in excess of US$100,000. The characteristics of this new supply are not reflective of average U.S. market demand and have resulted in pockets of oversupply. The vacancy rate of the top 10% of high-rent properties has surged from 6% in 2013 to 13% more recently. On the other hand, this concentrated supply offers investment opportunities in the remainder of the market that continues to be undersupplied.

The overall strength of fundamentals is also evidenced in rent growth, which continues to trend upward. Average rent growth was at 3% for the 12 months ended June 30, 2018.

Investment demand for multiresidential has led all other sectors since the peak of activity seen in 2015. Multiresidential transaction volume topped all asset types at US$34 billion, up by 6% YoY in Q2 2018. However, cap rates have remained relatively unchanged YoY, at 5.7% and 4.9% for garden and mid/high-rise apartments, respectively.
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