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The State of Real Estate

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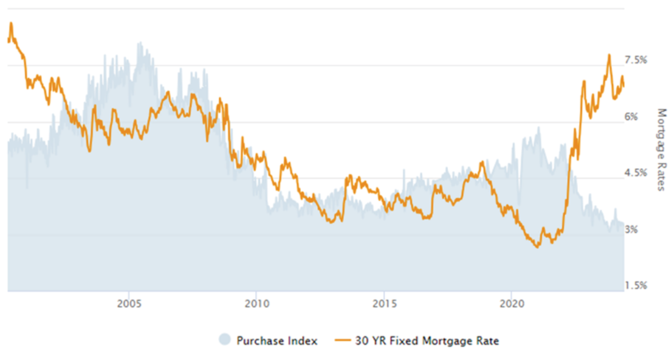
Real estate prices and rents are top of mind these days. From the long-anticipated Commercial Real Estate (CRE) problems to the resiliency of the housing market, there is much newsworthy material. It is no surprise that interest rates have had a major impact on real estate markets, especially since the start of the 2020 pandemic. This is because income-producing real estate is an alternative to bond interest for investors and because properties are often financed with debt that may or may not be at a fixed rate. So, the impact of higher interest rates has varied in magnitude within residential and CRE markets.

For the residential housing market, the Federal Reserve's (Fed) aggressive mortgage and bond buying effort in 2020 resulted in the lowest mortgage rates and largest refinance boom in history. Many homeowners took advantage of this, as evidenced by the fact that home purchase activity hit a post Great Financial Crisis high in 2021. As fiscal and monetary stimulus stoked inflation, the Fed rushed to reverse the stimulative impact of their actions in 2022 by raising interest rates at a record pace. These efforts, which were intended to bring inflation down, have crushed home purchase and refinance activity. Currently, only 2% of borrowers have mortgages that could be refinanced today. Most expected that home prices would fall as mortgage rates increased and demand ebbed.

Purchase Index vs. 30-Year Fixed Mortgage Rate



Source: Mortgage News Daily – Housing Data – Mortgage Applications (Data through 5/30/2024)

However, the Fed's actions created a "lock-in effect," as homeowners are choosing not to move because they have record low mortgage interest rates in place. This has put pressure on the available supply of pre-existing homes for sale, leading to a boom in new home sales. Today, homebuilders have little competition from existing home sellers and are trading at all-time highs. Somewhat surprising is that home prices have not been impacted by higher interest rates thus far and, in fact, are increasing. We estimate that the shortage of inventory, buoyant stock market, and low unemployment are more than offsetting the higher mortgage rate impact on housing prices today.

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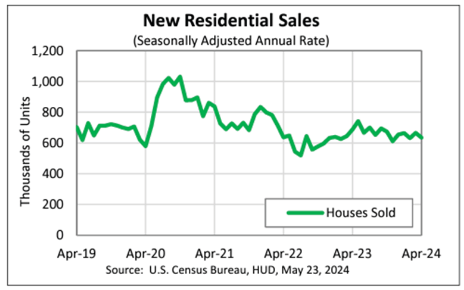
Home Price Index

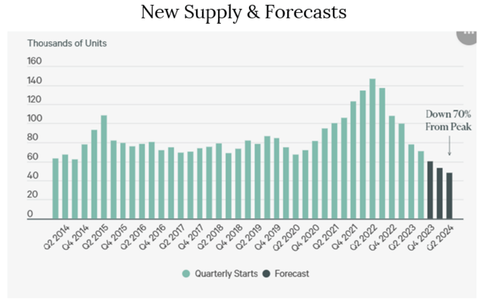
Source: Federal Reserve Bank of St. Louis (Data through 1/27/2024)



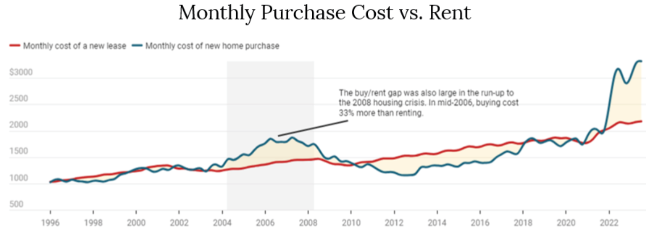
Contrary to the mixed picture for housing, CRE markets have been negatively impacted by interest rates, with each property sector having its own story. This is due to interest rates and secular trends that were in place prior to the pandemic, coupled with new trends emerging post pandemic. Some context on each segment is below.

Multifamily: The apartment market saw a rental rate and construction boom during the pandemic as low rates and the demand for housing incentivized developers to build new units. As interest rates have increased, the new supply outlook continues to decline. We believe this property sector has fundamental tailwinds due to the aforementioned “lock-in effect” of residential housing limiting the supply of existing home sales. We remain optimistic on this sector as apartment REITs maintain 95% occupancy on average and continue to increase renewal rental rates at mid-single digits.

New Supply & Forecasts



Monthly Purchase Cost vs. Rent

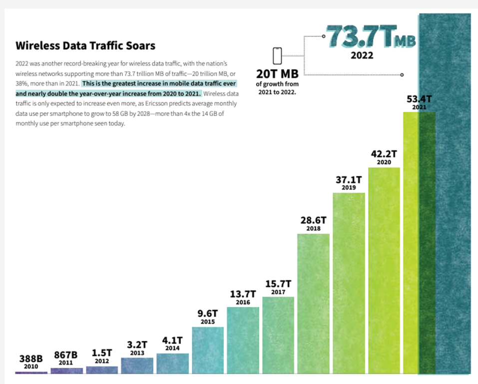


Industrial: E-commerce has been around for over a decade, but its acceleration during Covid has been a boon for industrial warehouses. Unprecedented rental rate growth and occupancy also brought about a wave of new supply that is being absorbed today. We remain bullish this sector as the e-commerce secular trend continues.

E-Commerce Retail Sales as a Percent of Total Sales

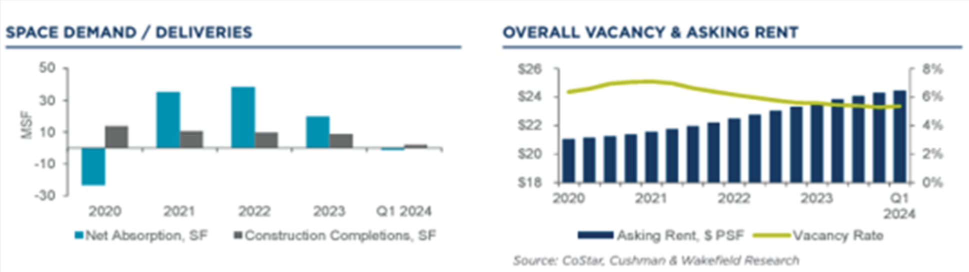
Source: Federal Reserve Bank of St. Louis (Data through 12/31/2023)

Communications - Cell Towers: Your cell phone only works because of the vast cell tower network in the U.S. and globally. These high-margin towers are truly mission-critical, and the data traffic continues to explode higher, which benefits these valuable networks of cell towers. In addition, 5G technology requires new equipment to be attached to these towers resulting in higher revenues. Given the sector's long-duration lease structures, it has been negatively impacted by higher interest rates. However, this mission-critical asset class remains a great source of yield and secular growth, which is unusual in REITs. As a result, we remain optimistic.

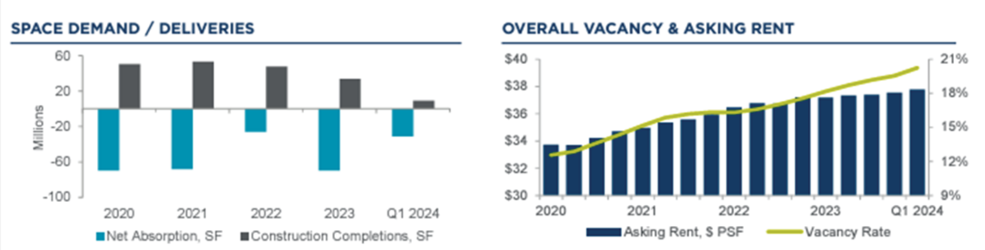


Communications - Data Centers: The AI revolution will be housed within massive data centers funded by the mega cap companies of our generation. Private equity firms and American Tower saw this trend early and have taken all of the small cap data center REITs private in just the last five years. Only three public players remain, Equinix, Digital Realty, and DigitalBridge. The outlook for the sector remains positive, but valuations reflect a lot of AI enthusiasm today, making us cautious.

Retail: Shopping centers also received a post-Covid boost as consumer balance sheets have rarely looked better. This has resulted in record low shopping center vacancy and robust rental rate growth. In addition, given the oversupply of retail space coming to this decade, developers have shied away from retail construction, opting for industrial and multifamily. As a result, fundamentals have rarely been better for the sector, absent enclosed shopping malls which are in secular decline.



Office: The pandemic's biggest loser continues to be office real estate. Work-from-home trends and cost cutting during and post-pandemic made reducing office space an easy decision for CEOs. Record vacancies result in high concessions to get new tenants interested. This makes leasing economics very punitive. In addition, foreclosure sales across the country continue, which further depresses valuation and creates financing risks. Simply put, we fear a lost decade for this property type and are avoiding it.



In summary, the state of real estate is a mixed picture today, with certain property types performing well and others struggling. Supply/demand trends and interest rates are having disproportionate impacts on various categories of real estate, and public market prices of REITs are well off their highs. We will seek to take advantage of this where appropriate with the intention of gaining exposure to attractive total investment returns and rising dividends.