Economic Update

SVN | Research

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1. INTEREST RATE OUTLOOK

- Despite the Federal Reserve's decision to hold rates constant at their June meeting, current market forecasts project an 81.8% chance that the FOMC will move forward with a 25-basis point hike in July, according to the Chicago Mercantile Exchange's Fed Watch Tool.
- In June, officials placed their year-plus hiking cycle on pause in an effort to evaluate the success of their tightening effort thus far. Earlier in the month, national employment data registered stronger than expected, while annualized inflation continued to trend downwards.
- With recession concerns still pertinent, the Fed opted to pause and digest incoming data. At the same time, some officials have signaled a preference for further rate hikes to anchor longer-term inflation expectations. Notwithstanding recent deceleration, Real PCE, the Fed's preferred inflation gauge, remains well above the central bank's 2.0% target.
- In recent days, Fed Chair Jerome Powell indicated that "there's more restriction coming," acknowledging that despite the committee's decision to pause last month, he and other members "expect the moderate pace of interest rate decisions to continue." While not outright saying that they expect rate hikes to continue, the statement signals the Fed won't hesitate to move forward with a hike if the data warrants it.

2. HOME PRICES

- Home prices fell annually for the first time since April 2012, declining 1.7% year-over-year in April, according to the S&P/Core Logic Case-Shiller Home Price Index.
- Market forecasts for the Case-Shiller projected a 2.6% annual decline during the month. Despite the steepest annual drop in over a decade, monthly data suggest that home value declines may have hit a cyclical nadir in recent months, as home prices were up 1.27% from March. Between June 2022 and January 2023, home prices fell in each month before turning positive again in February.
- Seattle and San Francisco continue to experience deep year-over-year declines, while several other markets, including Miami, Chicago, Atlanta, and Charlotte, are experiencing modest single-digit growth.
- The southeast continues to be the strongest region for home price growth, averaging 3.6% year-over-year. The west remains the weakest, falling -6.9% over the past 12 months.

3. INDEPENDENT LANDLORD RENTAL PERFORMANCE

- The on-time payment rate in independently operated rental units declined for the third consecutive month in June, falling to 82.5%. Despite the recent retreat in on-time rates, compared to one year ago, the on-time payment rate remains up by 118 basis points compared to a year earlier.
- These data underscore how the rental housing sector has fended off widespread distress while headwinds mount elsewhere in the market. According to MSCI Real Capital Analytics, through May 2023, apartment

prices are down 13.8% from their 2022 peak. Additionally, borrowing terms remain stringent as banking sector volatility and high-interest rates impact the attainability and feasibility of debt financing.
- Nevertheless, the continued performance of rental units amid a still resilient labor market is allowing independent operating landlords to withstand the economic malaise. As units maintain their monthly rental payments, the cash flow ecosystem between tenants, operators, and lenders stays intact.
- The June 2023 forecast full payment rate is 91.6% — just 44 bps below its post-covid peak.

4. REGULATORS SOUND THE ALARM ON CRE

- In recent weeks, US regulators have asked major lenders to work with credit-worthy borrowers facing stress in the commercial real estate market.
- The statement arrived from the Federal Reserve, the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency, and the National Credit Union Administration, who urged them to work “prudently and constructively” with good clients.
- The outreach comes amid rising concerns about the stability of commercial real estate as lending standards tighten and property values absorb a testing demand outlook.

5. SELLOFF IN CRE STOCKS MAY PRESENT OPPORTUNITIES

- Portfolio manager Jeffrey Kolitch of Baron Funds, a publicly traded fund that manages close to $1.5 in real estate assets, recently expressed his belief that recent stock selloffs in the sector present investors a “gift,” proving some an opportunity to acquire high-quality companies at “attractive” prices.
- At a recent talk, Koltich expressed his disagreement that we are on the cusp of a CRE crisis and his belief that setup for real estate in public markets is bullish. He emphasized the flurry of headwinds that the industry has faced in recent years, including the pandemic and generational shifts in consumer preferences, and how the industry has proven to remain innovative and efficient in the face of them.
- Further, he believes the rising fears surrounding the industry have caused stocks in the sector to fall steeper relative to the broader market, presenting attractive pricing to looking for upside in the public markets.

6. MEASURING UP OFFICE DEVALUATIONS

- A recent CRE Moody’s Analytics analysis explored some of the worst-case scenarios for the office sector by setting out to answer the question: what does it take to see a peak-to-trough Office value decline of 40%?
- The analysis notes that a 40% peak-to-trough decline would require current levels of distress to worsen

and sustain. Between Q1 2022 and Q1 2023, office property values have declined nationally by an average of 12.7%. Prices would need to fall by another 31.3% from current levels to reach the 40% aggregate devaluation threshold.

- According to the authors' calculations, to see office valuations drop by another 31.3% nationally, it would require that occupancy rates fall by an average of 3.8% from current levels and an NOI drop-off of 24.5% from current levels.
- The analysis notes that while the above scenario will likely play out in some properties, "the chances we see broad office declines at this level is on the tail end of the distribution of possibilities, as opposed to the expected case."

7. RENTS DECLINE

- According to Realtor, May rents on 0–2-bedroom apartments fell -0.5% year-over-year through May, marking the first decline since they began tracking the segment in 2020, signaling a potential shift in the market cycle.
- Smaller units saw rents increase over the year, with studio apartments up 2.0% in the past 12 months and one bedroom up by 0.4%. The retreat in rents was driven by two-bedroom units, which have declined by 0.5% year-over-year.
- The median asking rent in the 50 largest US metros rose by $3 from April but is down $38 from its July 2022 peak.
- Rents in the West are falling steeply, down -3.0% year-over-year, while markets in the South have seen an average decline of -0.7%. Rents in the Midwest continue to climb but are slowing, rising 4.5% in the past 12 months.

8. THE FIVE TIGHTEST RENTAL MARKETS IN THE US

- According to recent research from Chandan Economics and Arbor Realty Trust, the five tightest rental housing markets in the US today are Cape Coral, Louisville, Boston, Knoxville, and Worcester. The scoring matrix relied on two factors: rent growth and occupancy.
- Cape Coral, FL, which had the country's most intense rent growth pressures through April, has seen its profile rise as a retiree destination. Meanwhile, Louisville and Knoxville have gained in recent years as their combinations of urbanized downtowns and housing affordability have attracted new residents.
- In Massachusetts, Boston's market tightness appears primarily due to supply-side factors, including the market response to the municipal government's push to implement rent control. At the same time, Worcester is gaining from demand-side factors as its downtown revival attracts residents away from Boston.

9. MIXED USE MALLS

- Some developers are turning to a mixed-use approach to salvage the value of struggling big-box retail space, specifically by combining a variety of smaller retail tenants with residential properties mixed in.
- For instance, many investors owning property at former Sears locations are now converting them into experimental "live, work, and play" environments, reflecting a trend to revitalize malls and adapt to changing consumer preferences.
- Sears, a retailer with a formerly sizeable national footprint, has just 12 department stores remaining nationwide following a Chapter 11 bankruptcy filing and the effects of the pandemic's "retail apocalypse." During the proliferation of malls in the 1960s, Sears positioned its auto center adjacent to mall parking lots where their department stores were typically located.
- As a result, properties that formerly housed these connected retail sites are in a unique position to accommodate such a mixed-use approach and may serve as a template for investors looking to implement such a strategy. The new strategy focuses on residential, retail, and other amenities.

10. NET LEASE INVESTING

- For net lease investors, the recent pause in rate-hikes may signal an easing of cap rate expansion, but the likelihood of additional rate increases in the coming months means that investors should brace for further cap rate increases before normalizing in 2024.
- Even if the Fed's tightening cycle halts and rates remain neutral for the foreseeable future, lending conditions and risk appetites will likely remain restrictive in the near term.
- Those with cash-on-hand, who can secure long-term lease deals with creditworthy tenants—alongside the proper due diligence processes to execute those deals—should be able to proceed with investment plans despite the lending pullback.
- However, smaller deals will have an advantage in this environment, as larger players with more significant targets may be forced to stay in wait-and-see mode until demand unsticks.

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SUMMARY OF SOURCES

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