Economic Update

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1. FED INTEREST RATE DECISION

- On June 14th, The Federal Reserve announced a pause in interest-rate increases as it assesses the effects of its tightening efforts on the economy, holding the target federal funds rate at 5.0-5.25% while signaling the likelihood of further rate hikes this year.
- The decision was unanimous and followed ten consecutive rate-hikes dating back 15 months to March 2022 as the central bank attempted to get spiraling inflation under control.
- May's Consumer Price Index (CPI) report showed falling headline inflation numbers, with prices climbing just 0.1% month-over-month and 4.0% year-over-year, its smallest annual increase in over two years. Futures markets were forecasting a rate pause before the release of CPI data, but May's numbers likely reinforced the Fed's decision.
- The Fed's Summary of Economic Projections reveals that despite the pause, policymakers have pushed their expectations of the terminal interest rate further out, with the median forecast projecting a 5.6% federal funds rate by the end of 2023.
- Markets climbed on the news and largely shrugged off worries over future increases while fed futures continue to project a rate-cut later this year. Market reactions signal that investors aren't entirely convinced of the Fed's hawkish stance and that the Fed funds rate may have peaked. Officials have said they will wait about six weeks to see the impact of policy moves and remain data-dependent in their decision-making.

2. CPI INFLATION

- The Consumer Price Index CPI) rose just 0.1% month-over-month in May and climbed 4.0% over the previous 12 months, according to the latest release from the Bureau of Labor Statistics (BLS). May's increase was the slowest annual increase in inflation since May 2021.
- Excluding food and energy, inflation was up 0.4% on the month and 5.3% year-over-year. Core and headline inflation numbers have steadily diverged, with core data remaining elevated. This is partially due to falling energy prices, which saw a 3.6% decline in May, causing headline CPI to fall faster than core. Shelter prices remained the largest contributor to price gains in May despite a gradual fall in home prices over the past several months.
- Real wages also improved for the average worker as hourly wages adjusted for inflation rose 0.2% on the month.

3. MAY JOBS REPORT

- The US added 339,000 new jobs in May while the unemployment rate rose by 0.3% percentage points to 3.7%, according to the Bureau of Labor Statistics.

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- Job growth continues to hold firm despite fears about higher interest rates, slowing spending and investment, and recent layoffs in the tech industry. Professional and business services added more than 64,000 payrolls in May, while government employment increased by 56,000 jobs, followed by healthcare with a 52,000-job gain. Leisure and hospitality, construction, transportation, and warehouse also posted notable payroll growth during the month.
- However, recent waves of layoffs are reflected in the uptick in unemployment, which over the past several months has continued to hover above the 3.4% nadir that it hit in January 2023. The labor force participation rate remains little changed at 62.6%.

4. INDEPENDENT LANDLORD RENTAL PERFORMANCE

- On-time rental payments in units operated by independent landlords dipped slightly in May, declining 108 basis points to 82.1%, according to the latest Independent Landlord Rental Performance Report by Chandan Economics/RentRedi.
- Despite the decline, the on-time payment rate remains relatively robust and is up by 190 basis points compared to a year ago. However, at the same time, the on-time rate has now fallen by more than 100 bps in consecutive months— which could potentially lead to distress if the trend continues.
- As of May 15th, 1.2% of units had paid rent late, and 16.6% had yet to complete full payments. Chandan Economics projects that the late-payment rate for May will increase to 9.5% in the coming months, while the unpaid rate is expected to decline to 8.4%.
- Still, the forecast full-payment rate, which include received on-time and late payments plus anticipated late payments in upcoming months, is falling. The expected full-payment rate for May is just 91.6%— the lowest mark in eight months. These data indicate a potential worsening situation with late payments, suggesting a challenging outlook for rental affordability.

5. Q1 2023 SFR TRENDS

- SFR continues to perform well compared to other commercial property types despite challenges from rising interest rates and lower home prices, according to the findings from Arbor Realty Trust's Q1 2023 Single Family Rental Investment Trends Report.
- The average SFR Occupancy rate was 94.4% in Q1 2023, with rent growth showing volatility but sustained gains in lease renewal rent growth. On-time rental payments in SFR properties remain healthy, while long-term fundamentals have maintained its favorable investment outlook.
- SFR cap rates increased during the quarter, rising to 5.9%, reflecting both a rise in the SFR risk premium and a stabilization in home prices.
- CMBS issuance did decline in the sector, reflecting a broader market decline, while debt yields rose,

signaling caution from lenders in an uncertain housing market. Still, construction trends remain relatively robust in the sector. In the past year, SFR/Build-to-Rent accounted for a record high of 6.9% of new single-family construction.
- Southeastern Sun Belt states, in particular, show high demand for SFR properties, with lower average land prices contributing to their attractiveness.

6. TROUBLE BREWING IN CRE

- Warnings have been growing in volume about potential trouble brewing in CRE, much of which has focused on the estimated $270 billion in CRE loans coming due this year. Tightening lending conditions, increased funding costs, and compressed margins are creating a perfect storm for banks and increasing default risks for CRE loans.
- Office space faces challenges due to low occupancy rates resulting from the remote work boom, dampening rental growth. Office property valuations are under pressure from underperformance and interest rates reaching generational highs; refinancing those loans may prove difficult.
- Still, historically real estate has been seen as an effective hedge against inflation, and some investors are looking beyond the short-term volatility. Adaptive Reuse, which looks to convert older office buildings into multifamily units, has gained steam recently as a potential solution to office over-supply. Still, several challenges exist both from a financing and construction standpoint.
- Though banks nationwide are bracing for a potential CRE storm, some markets are more at risk than others. Markets with high pre-pandemic office supply, such as New York, San Francisco, and Chicago, are more exposed to the potential glut than other metros. Further, a recent wave of tech layoffs has made more tech-heavy cities more susceptible to slowing office demand. Local labor market trends will continue to be an essential barometer of the office market's future in these metros.

7. A LONG VIEW OF THE OFFICE MARKET

- As concerns about the state of CRE grow, some investors are instead taking a long and nuanced view of the future of the office market.
- One key factor that will impact office valuations is property age. In addition to the location of an office property and the effect of local economic forces, how old an asset is will also significantly impact its value in the case of a bear market.
- Older properties will suffer more due to competition from higher-quality properties. Newer offices that cannot attract tenant demand are also better positioned for adaptive reuse projects, where conversions can be more cost-effective.
- There is also the expectation that some office activity will return two to four years from now. Business

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travel has started to recover from the depths of COVID, and remote work is creating a new quasi-tourist/remote worker class in several highly amentized cities. While tenants in 2026 may be less interested in old-cubical-style designs left on the market, office properties that blend productivity and hospitality can capture new demand.

8. SELF-STORAGE: A CRE BRIGHT SPOT?

- With home prices and mortgage rates too high for many American families, the self-storage market has seen an uptick in space demand as several households downsize or look for space for new consumer items that their current residence can't accommodate.
- Analyzing self-storage REIT performance, shares have averaged a return of 7.27% this year, outperforming the REIT average.
- According to data from Hoya Capital, while the sector has seen some softening from 2021 highs in occupancy and rents, they remain above pre-pandemic levels and are less exposed to potential overvalue issues than the broader CRE market.
- Funds from operation (FFO) for the Storage REIT sector is on pace for double-digit performance in 2023, following a 3.0% gain in Q1 2023.

9. DELOITTE'S Q2 2023 US ECONOMIC FORECAST

- In Deloitte's latest US economy forecast, new projections arrive for the path of consumer spending, housing affordability, and business investment for the remainder of 2023.
- On consumer spending, forecasts zero in on the US savings rate. During the pandemic, many households saved significantly more than anticipated, but savings rates began to shrink as a post-pandemic activity wave met higher consumer prices.
- Deloitte projects two potential paths for consumer spending for the remainder of this year: cautious spending as consumers prioritize savings or a continued spending boom driven by summer travel and services.
- In housing, the forecast expects the decline in construction activity to continue in 2023, with a modest bounce back to begin 2024.
- Business investment is expected to become more selective. Investment in non-residential structures could slow. Investment in equipment and software has slowed from the pandemic-era boom. Still, it may continue to grow modestly as companies struggle with labor costs and competition and look for ways to become more capital efficient.

10. RETAIL SALES

- US retail sales unexpectedly rose in May, climbing 0.3% month-over-month following a 0.4% monthly increase in April. Economists had forecasted a 0.1% decline in May.
- Consumer spending appears to be resilient despite the pressure of higher prices and rising interest rates. The largest increases in sales were seen in building materials and gardening equipment (+2.2%), motor vehicles and parts (+1.4%), food services and drinking places (+0.4%), general merchandising stores (+0.4%) and furniture stores (+0.4%).
- Sales were flat at health, personal care, and clothing stores and fell 2.6% at gas stations.
- Core-retail sales, which exclude automobiles, gas stations, building materials, and food services, rose 0.2% month-over-month, following a 0.6% monthly gain in April.

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SUMMARY OF SOURCES

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