

REAL ESTATE

Fall 2021 Real Estate Outlook:

# Two Steps Forward, One Step Back

- The growth trajectory of the U.S. economy exceeds its pre-COVID path, and we continue to believe real estate investors should consider modestly higher risk/return strategies.
- We believe the commercial real estate sector is uniquely suited to benefit from current monetary policy, which may allow for higher inflation.
- Out of favor property types including retail, office, and hotel may offer attractive relative value today, and should not be ignored by investors seeking a diversified portfolio.

## Introduction

We believe the U.S. economy is on a strong growth path, with GDP on track to exceed its pre-COVID trajectory. Specifically, had the COVID-19 pandemic never occurred, the Congressional Budget Office estimated in 2019 that 2021 U.S. GDP would have been \$19.9 trillion<sup>1</sup>, but today we expect the year to finish at \$20.0 trillion. If realized, this will be the first post-WW2 economic recovery where the size of the economy grows above the pre-recessionary trend in the year following the end of the recession. While the late summer and early fall months

have continued to exemplify strong economic growth, they also brought risks, with rapid spread of the highly contagious COVID Delta variant, as well as some concern regarding the prospects of economic turmoil faced by several major Chinese property developers. Nonetheless, we remain positive on the economic outlook, and forecast 5.5% GDP growth for 2021. As a result, when considered alongside our analysis of current market pricing that we will outline later in the report, we believe real estate offers attractive relative value, and that investors may benefit from higher risk, and modestly higher yielding real estate investments.

## Made-for-CRE Monetary Policy

Although some segments of commercial real estate were squarely in the crosshairs of the COVID-19 impact, we believe the sector may be uniquely suited for current economic conditions. Namely, the economy is in a not-often-seen position where inflation is increasing while interest rates and yields across investment sectors have remained low.

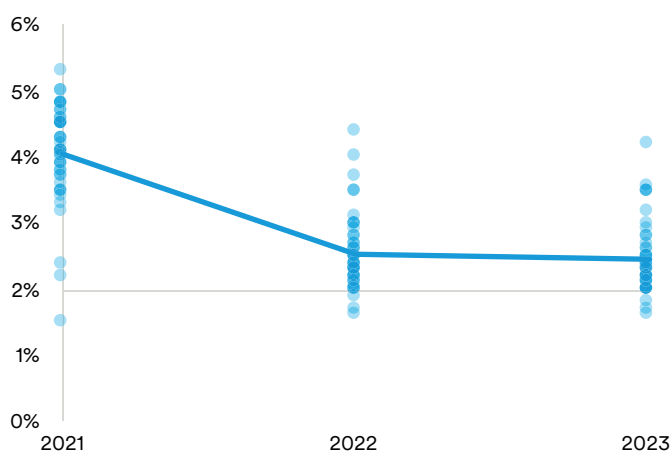
Real estate prices have historically benefitted from both low interest rates and rising inflation. Usually, these two conditions do not occur at the same time.

We believe the fact that this is occurring simultaneously today exemplifies the Fed's 2020 updated policy guidance allowing inflation to exceed their 2% target (even when the economy is in a rapid growth mode). The Fed itself is forecasting above 2% inflation all the way through its forecast horizon (2024), and as evidenced in exhibit 1, expectations among market participants appear to be anchored in that range. Although our base case view is not that inflation will run significantly above the 2% target, the possibility of a bout of sustained 3% or higher inflation has grown.

As exhibit 2 shows, periods of higher inflation have often been positively correlated with higher real estate returns<sup>2</sup>. "Modeled returns" are simply comprised of the real estate sector's average cap rate, plus average annual inflation as measured by the consumer price index. As is depicted, the relationship is not perfect, especially during the 2000-2010 decade when two recessions occurred, but we feel it may be a reasonable indicator of unlevered private real estate returns nonetheless.

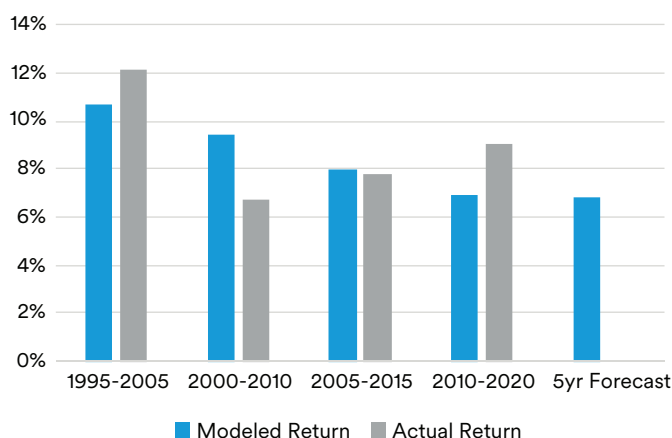
To apply this methodology to the outlook, we combine expectations for cap rates

**Exhibit 1 | Consensus Inflation Forecast - Range and Midpoint**



Sources: MIM, WSJ. July 2021.

**Exhibit 2 | Modeled Return versus Actual Return**



Sources: MIM, NCREIF, Moody's. August 2021.

Actual Return represents NCREIF average annual total rate of return. Forecast represents MIM projection of NCREIF unlevered total rate of return (TROR). See endnote 4.

and interest rates through 2025. As we outlined in our Summer 2021 report *Open for Business*, we expect average real estate cap rates to remain in the low 4% range in the near and medium term. Additionally, forecasts suggest inflation could average 2.7% through 2025.<sup>3</sup> Adding these figures together suggests that unlevered returns could average 6.7% per year from 2021-2025, as measured by the NCREIF Property Index, an industry benchmark.<sup>4</sup>

Investors concerned that inflation could exceed the current market expectations can take some comfort in this relationship, as an increase in the outlook for inflation would lead us to increase our outlook for NCREIF total returns.

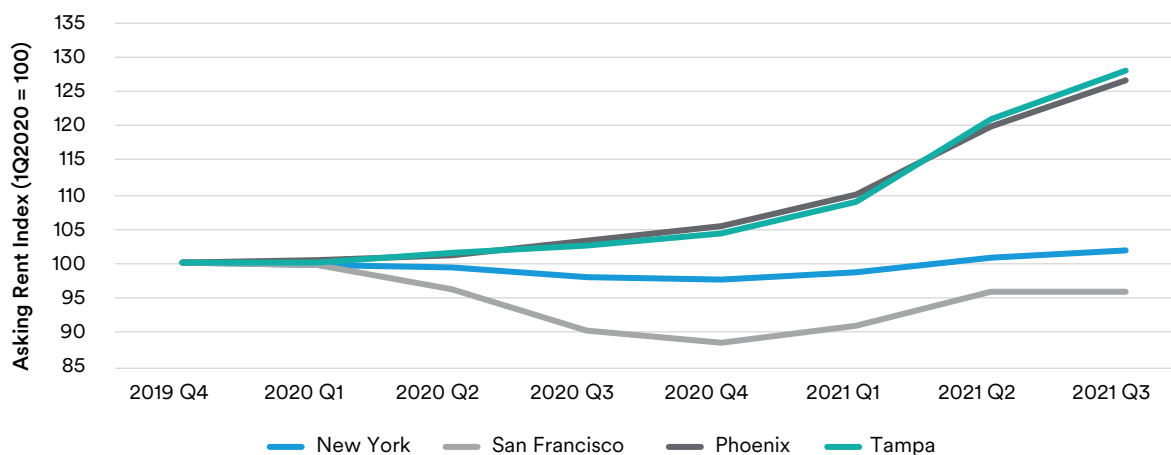
Overall, this cap rate and inflation forecast is an admittedly simple way to consider real estate returns, one that has been somewhat imprecise in the past, and will undoubtedly not be perfect in the future. We nonetheless think it is worth consideration given a shifting inflation outlook. One additional use for this framework is to consider the modeled returns as a spread to current corporate bond yields, which we believe can indicate both if the real estate sector offers attractive relative value, and if it's worth increasing or decreasing the risk profile of real estate investments. From 2000-2020 the historical average spread between unlevered real estate returns and Baa corporate bond yields was 3.5%. Using the 6.7% modeled return outlined above, and a 2.2% average Baa bond yield, the spread would be 4.5%, above the 3.5% long term average.<sup>5</sup>

## Property Market Conditions

### Apartment

The apartment sector was strikingly resilient during the COVID-19 pandemic, and current quarter results indicate continued strength in demand for almost all geographies and formats. A tight for-sale housing market has further supported demand for apartments, with 385 of the 390 U.S. metropolitan areas reporting positive rent growth as of the most recent readings.<sup>6</sup> Even the hardest hit submarkets in dense metropolitan areas like New York and San Francisco are now realizing rent growth rates of 3% or higher.<sup>7</sup>

**Exhibit 3 | Divergent Apartment Performance Across Markets**



Sources: MIM, CoStar. October 2021.



While the supply pipeline will certainly ramp up in the coming years to meet surging demand, labor and materials costs and availability are significantly crimping supply growth. Looking forward, we expect tight vacancy conditions across many markets to continue to translate into healthy multifamily net operating income growth in both the near and medium term.

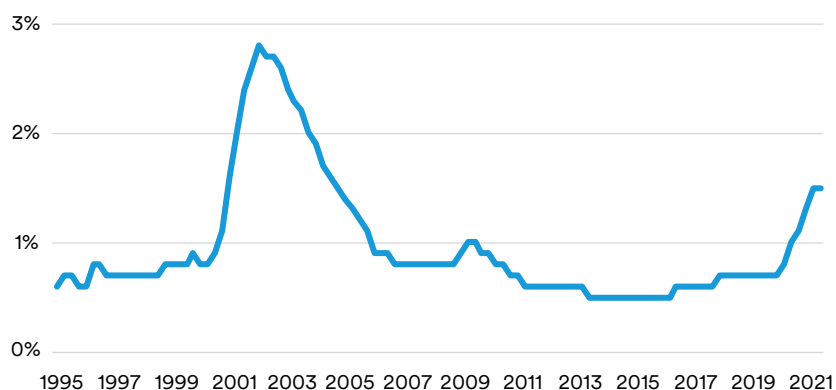
Perhaps counterintuitively, we are carefully monitoring markets like Phoenix and Tampa that experienced strong rent growth during the pandemic, but where we feel some investors are potentially underwriting overly aggressive 5% or greater annual rent growth through the mid-2020s. We believe these markets could be at risk of tightening relationships between rents and household incomes, and a rising construction pipeline, both of which could slow rental growth rates.



## Office

Uncertainty persists in the office sector, especially considering the effects of the Delta variant which has caused many firms to again delay return-to-office plans. Despite the worsening COVID situation over the summer, we believe leasing decisions in recent months point toward continued expectations for an eventual return to office. The sublease vacancy rate probably best illustrates this as it was rising rapidly over the past year but has more recently shown signs of leveling off (see exhibit 4).

### Exhibit 4 | Sublease Vacancy Peaking



Sources: MIM, CoStar.



Although the sublease vacancy rate is higher than in the years following the Global Financial Crisis, it is lower than what occurred during the fallout from the 2001 dot.com bust. We believe that the sublease vacancy rate is a reliable leading indicator of office fundamentals, and in both prior downturns, general vacancy peaked roughly 6 quarters after sublease vacancy leveled off. As a result, we believe that office fundamentals as measured by vacancy and effective rent growth will both begin recovering in mid-2022.

Transaction volume remains thin in the office sector, but we continue to believe tactical pricing opportunities are available, particularly in markets with both durable long term demand drivers, and high levels of remote working adoption during the pandemic that is contributing to short-term investor fear. San Francisco, Austin, and Seattle all meet these criteria, with Austin office assets experiencing high vacancy increases over the last year as a result of remote working, while also realizing growth in population and company relocations.

## **Industrial**

E-commerce driven demand for industrial real estate was further reinforced during the second quarter, when the National Council of Real Estate Investment Fiduciaries reported an eye-popping 8.9% unlevered **quarterly** return for the sector. This is the best quarterly return for any property type since the first quarter of 1980, when the office sector posted a quarterly return of 10.1% (a time at which annual inflation was running at a hefty 15%).<sup>8</sup>



We believe commonalities among top performing markets are access to labor pools for the transportation & warehouse industry, access to a variety of distribution channels such as ports or intermodal links, and accelerating e-commerce penetration.

Although there is a dispersion in performance across metropolitan areas, with markets like San Bernardino posting a nearly 16% total return during the quarter, even the bottom performing markets did well. The laggards included markets like Kansas City and Minneapolis, which realized quarterly returns in the 3-5% range.<sup>9</sup> We believe commonalities among top performing markets are access to labor pools for the transportation & warehouse industry, access to a variety of distribution channels such as ports or intermodal links, and accelerating e-commerce penetration among consumers in the market. Examples of top performing industrial markets over the past year include Northern New Jersey, San Bernardino, and Reno.

Going forward, submarket dynamics might be more important than the broader metro-level picture because of the increased push among e-commerce firms for faster delivery speeds. At the submarket level, we expect infill / last-mile industrial rent growth to outpace the broader sector until “click-to-door” delivery speeds average about four hours, which we believe is at least three years in the future.

At the asset level, a recent trend has been an increased demand among users for excess trailer parking, potentially to support more quickly scaling up or down operations. We are placing increased emphasis in searching for assets that fit this criterion.

## Retail

Similar to the broader economy, brick and mortar retail may be benefitting from government stimulus that has boosted consumer balance sheets. Additionally, pent up demand and a rising savings rate during 2020 has contributed to increased spending in 2021.

We estimate that spending in brick and mortar stores is now well above its pre-COVID trajectory, a statistic that may be under-appreciated by those issuing the most dire predictions for the retail sector (exhibit 5).

Looking forward, we are monitoring one new short-term trend, and two new longer-term trends. In the short term, we are concerned that new COVID variants and associated supply chain disruptions will negatively impact both consumer spending and retailers' cost of goods during the remainder of the year and into 2022. In the longer term, we believe that the rate of e-commerce adoption was so strong during 2020, that it could slow over the next several years. In other words, the brick and mortar disruption that was set to happen over the next 5 years may have already occurred, creating potential opportunities in a sector that is not viewed favorably by most investors. Lastly, demographic shifts pushing aging millennials to suburban submarkets could boost the performance of some retail formats, especially those offering experiential elements.

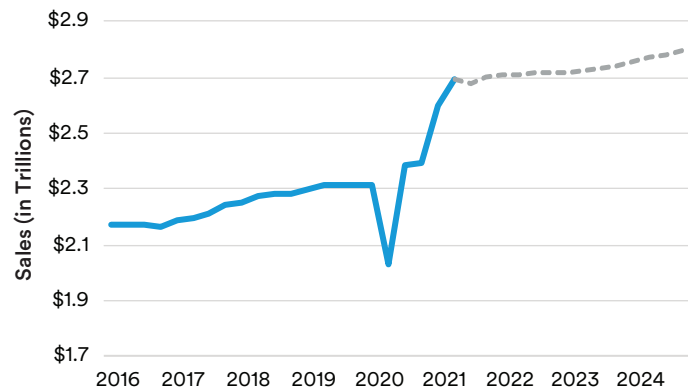
Overall, we remain selective in, but not afraid of, the retail sector. Even though there are some positive trends that may occur in the longer term, we only have a medium level conviction in them. Additionally, even though the number of institutional investors has thinned, REITs remain active, making tactical/pricing opportunities challenging (but not impossible) to find.

## Hotel

In our recent report [A Stigmatized Sector: Our Outlook for U.S. Hotel Investments](#), we noted that equity markets had yet to thaw, but debt markets were active. Today, it appears as though equity transaction activity is accelerating more rapidly. The hotel sector remains a bifurcated property type, with leisure and limited service hotels experiencing RevPAR above 2019 levels, while business and large convention hotels have yet to recover<sup>10</sup>, and this is being reflected in transaction data.

While we believe both segments of the hotel sector offer debt and equity investors attractive relative value today, we believe the dearth of investor interest in business and convention hotels makes this segment worth additional consideration, especially for investment managers with

**Exhibit 5 | Brick & Mortar Retail Sales**



Sources: MIM, Moody's. 3Q2021.





specialized capability and experience investing in and managing hotels. We believe the recovery timeline outlined in exhibit 6 (and described in more detail in the MIM report *A Stigmatized Sector*) offers a conservative approach to underwriting risks in the sector. Based on the underwriting forecasts that we believe it implies, as well as the pricing of recent hotel trades, we believe the hotel sector offers some of the most attractive risk-adjusted returns available in the market today.

### Exhibit 6 | Forecasts of Hotel Demand by Source

	2022	2023-2024	2025+
Leisure	Above pre-covid demand	Modestly above pre-covid demand	Modestly above pre-covid demand
Business Transient	Modestly above pre-covid demand	Modestly below pre-covid demand	Modestly below pre-covid demand
Group	Below pre-covid demand	Modestly below pre-covid demand	Modestly above pre-covid demand
International	Modestly below pre-covid demand	Pre-covid demand	Modestly above pre-covid demand

■ Above pre-covid demand   
 ■ Modestly above pre-covid demand   
 ■ Pre-covid demand   
 ■ Modestly below pre-covid demand   
 ■ Below pre-covid demand

Source: MIM

### Conclusion

The recovery from the COVID-19 crisis is progressing, but not necessarily in a straight line. Despite some of the setbacks from the summer, our outlook for the economy and commercial real estate is optimistic. We continue to believe now is a time to target modestly higher risk real estate investments.

As a point of context, in our spring 2016 Investment Strategy Quarterly, we wrote “The U.S. real estate market is likely entering the later stage of its cycle. A reduction in risk taking and heightened investment selectivity is recommended.” At the time, we adopted a posture of sharpening our investment criterion while making investments across the capital stack that we felt would perform well through the ups and downs of a cycle. We transitioned back to widening our scope, risk tolerance, and yield targets for real estate investments in late 2020, shortly after COVID-19 vaccine trials were successful, believing the pool of attractive investment opportunities had increased. Given the strong economic conditions, favorable spreads to other asset classes, and favorable positioning relative to recent changes in monetary policy, we continue to believe real estate offers attractive opportunities, including in the higher risk space.

Across property types, apartments and industrial assets are performing well, and we think price increases are generally justified by the solid fundamentals. Out of favor sectors like retail, office, and hotels can provide higher risk, and higher yielding, opportunities, and should not be ignored by investors seeking a diversified portfolio.

## Endnotes

- <sup>1</sup> 2019 CBO estimate.
- <sup>2</sup> Discussion of real estate returns represents gross unlevered returns as measured by NCREIF. Gross returns will be reduced by costs and expenses, including management fees, and do not reflect, even on a hypothetical basis, net returns resulting from the reduction of these costs and expenses.
- <sup>3</sup> Moody's Analytics, 3Q21.
- <sup>4</sup> The index returns shown herein are for illustrative purposes only, and do not reflect actual historical trading results for any product or investment strategy, and are not a guarantee of future performance. Hypothetical results are subject to various modeling assumptions, statistical variances and interpretational differences. No representations are made as to the reasonableness of the assumptions used and any change in these assumptions would have a material impact on the hypothetical performance results portrayed. Hypothetical results have other limitations including: they do not reflect actual trading and therefore don't reflect the impact that actual market conditions may have had on the investment manager's decision making process; regulatory or tax rules that may have existed during the periods modeled; and it also does not take into account an investor's ability to withstand losses in a down market and assumes the strategy was continuously invested throughout the periods modeled. There is no guarantee that any actual product or strategy that followed any of the hypothetical portfolios modeled herein would have had similar performance. A decision to invest in an investment strategy should not be based off of hypothetical or simulated performance.
- <sup>5</sup> Moody's Intermediate-Term Bond Yield Average: Corporate - Rated Baa - Bonds with Seven-year Average Maturities, NCREIF, 3Q21.
- <sup>6</sup> CoStar, 3Q21.
- <sup>7</sup> CoStar, MIM, 3Q21.
- <sup>8</sup> NCREIF, Moody's, 3Q21.
- <sup>9</sup> Ibid.
- <sup>10</sup> CoStar/STR, 3Q21.

## MetLife Investment Management Real Estate Research and Strategy



### **WILLIAM PATTISON**

*Head of Real Estate Research & Strategy*

William Pattison is the head of the real estate research & strategy team within the risk, research & analytics group of MetLife Investment Management (MIM). He is responsible for research and strategy development in support of MIM's real estate equity and debt platforms. In this role, he works closely with MIM's real estate regional offices and portfolio managers to craft the strategic house view, drive thought leadership initiatives, project capital market trends, and develop investment strategies that seek to maximize returns while minimizing market, rate, and liquidity risks. As a member of the Investment Committee, William is responsible for reviewing and voting on all U.S. real estate acquisitions. Prior to joining MetLife in 2015, he worked for ten years in the real estate group at Aegon Real Assets. William is a graduate of Iowa State University, where he earned his Bachelor of Science degree in economics.



### **REGINALD ROSS**

*Associate Director*

Reginald Ross is an Associate Director in the Risk, Research, and Analytics Division of MetLife Investment Management (MIM). He is responsible for market forecasts, client engagement, investment committee participation. Reginald has over 16 years of experience in CRE financial and econometric modeling. He joined MetLife in 2019. Prior to joining MetLife, Reginald was a Director at JLL focusing on redevelopment finance and advisory. He began his career in investment banking at Wolfensohn & Co and UBS. Reginald earned a Bachelor's degree in Economics from Morehouse College and an MBA from the Wharton School of Business at the University of Pennsylvania.



### **MICHAEL STEINBERG**

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<sup>2</sup> As of June 30, 2021. At estimated fair value. Represents the value of all commercial mortgage loans and real estate equity managed by MIM, presented on the basis of gross market value (inclusive of encumbering debt). At estimated fair value. Includes MetLife general account and separate account assets and unaffiliated/third party assets.

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## **Appendix**

This appendix contains details for the preceding charts and provides additional information for greater accessibility.

### **Consensus Inflation Forecast - Range and Midpoint**

**Note:**

- All values are approximate
- Sources: MIM, WSJ. July 2021

<b>Year</b>	<b>Midpoint</b>	<b>Range</b>
2021	4.1%	1.6% to 5.4%. Most readings are approximately in the range 3.2% to 5.0%.
2022	2.5%	1.7% to 4.4%. Most readings are approximately in the range 1.9% to 3.2%
2023	2.4%	1.6% to 4.3%. Most readings are approximately in the range 1.7% to 3.0%.

### **Modeled Return versus Actual Return**

**Note:**

- All values are approximate
- Sources: MIM, NCREIF, Moody's. August 2021
- Actual Return represents NCREIF average annual total rate of return.
- Forecast represents MIM projection of NCREIF unlevered total rate of return (TROR). See endnote 4.

<b>Year Range</b>	<b>Modeled Return</b>	<b>Actual Return</b>
1995-2005	10.8%	12.2%
2000-2010	9.5%	6.7%
2005-2015	8.0%	7.8%
2010-2020	6.9%	9.0%
5yr Forecast	6.8%	n/a



### Divergant Apartment Performance Across Markets

**Note:**

- All values are approximate
- Sources: MIM, CoStar. October 2021
- Asking Rent Index is 100 for Q1 2020
- The New York line varies little.
- The San Francisco line dips down to 89 in 2020 Q4 and then rises back up to 95 in 2021 Q2.
- The Phoenix and Tampa lines track each other closely, rising gradually through 2020 Q4 and then rising more rapidly afterwards.

Year and Quarter	New York	San Francisco	Phoenix	Tampa
2019 Q4	100	100	100	100
2020 Q1	100	100	100	100
2020 Q2	99	97	102	102
2020 Q3	98	91	104	104
2020 Q4	98	89	105	105
2021 Q1	99	90	110	110
2021 Q2	101	95	120	120
2021 Q3	102	95	126	127

### **Sublease Vacancy Peaking**

**Note:**

- All values are approximate
- Sources: MIM, CoStar

<b>Year</b>	<b>Percent Vacancy</b>
1995	0.7%
1997	0.7%
1999	0.8%
2001	2.0%
2003	2.4%
2005	1.4%
2007	0.8%
2009	1.0%
2011	0.6%
2013	0.6%
2015	0.5%
2017	0.6%
2019	0.7%
2021	1.5%

### **Brick & Mortar Retail Sales**

**Note:**

- All values are approximate
- Sources: MIM, MIM, Moody's. 3Q2021.

<b>Year</b>	<b>Sales (in Trillions)</b>
2016	2.17
2017	2.18
2018	2.28
2019	2.30
2020	2.17
2021	2.67
2022	2.71
2023	2.72
2024	2.78