Americas

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As 2023 began, we were keenly interested in a number of macroeconomic indicators, including U.S. employment trends, discretionary spending, real estate transaction volume, and lending activity. As the end of the year approaches, using only the most recent data for the first two indicators puts the U.S. economy in good health. Unemployment dropped from 4.2% in Q4 2021 to 3.6% one year later – as of October it stands at 3.9%[1] – about where it was pre-pandemic when the economy was booming. Consumption in 2023 far outpaced many forecasts, increasing 2.4%[2] through October. So, the U.S. consumer hasn't been having many concerns with employment or spending, and the economy itself has arguably been among the strongest performers in the developed world. The story is different in Canada – even though it borders the U.S. and should benefit from its proximity, the country has already slipped into a "technical" recession.[3] And according to Oxford Economics, Canadian GDP will likely contract by 0.4% in 2024, with the unemployment rate rising to 7.2% by the end of the second quarter.

Signs of moderation in the U.S. are starting to show – job growth is slowing, unemployment has crept up, and credit card debt is up, suggesting a segment of consumers may have exhausted their pandemic-related savings. This fiscal stimulus party (totaling about $5 trillion just in the U.S.[4]) had to end eventually, but the economic soothsayers continue to discount the odds of a recession[5] in the next 12 months. While the economy continues to chug along, both transaction volume and lending indicators (critically important from a real estate perspective) remain problematic.

The total value[6] of U.S. real estate transactions fell 53% during the 12 months ended September 30, 2023. We view falling transaction activity as a sign that sellers are not yet willing to accept lower valuations, and while the year-to-year result is bleak, there are signs of a turnaround. Office, Industrial, and Retail volumes all increased in the third quarter, and Apartment volumes rose in the second quarter and are up nearly 8% from the first quarter low. It's a similar Q3 volume rebound story in Europe and Asia, possibly showing that transaction volume may have or is near to bottoming globally.

[1] Bureau of Labor Statistics, The Employment Situation – October 2023, November 3, 2023
[2] Council of Economic Advisors, As the U.S. Consumer Goes, So Goes the U.S. Economy, October 20, 2023
[3] Oxford Economics, Shallow Recession Now Underway Expected to Deepen, Tony Stillo, November 14, 2023
[4] New York Times, Where $5 Trillion in Pandemic Stimulus Money Went, Alicia Parlapiano, Deborah Solomon, Madeleine Ngo, Stacey Cowley, March 11, 2022
[5] Goldman Sachs, Goldman Sachs Cuts U.S. Recession Odds to 15% as Economic Optimism Grows, Matt Egan, September 5, 2023

Hines Research has developed a metric comparing trailing annual sales as a percentage of the NCREIF Property Index – when trailing annual sales exceed the 3-year average, this has typically signaled a turnaround. In Q3, this figure fell to 4.5%, well below the 6.1% 3-year average calculated by Hines Research.[6] There was also a 100+ basis point difference between appraised capitalization rates and transaction cap rates across major U.S. sectors during the third quarter, perhaps reflecting continued reluctance on the part of sellers to sell. Canada has an additional problem related to residential housing. Home prices never took that post-GFC breather one might have expected – per the Canadian Real Estate Association, prices have been heading up almost uninterrupted for decades. Unlike elsewhere, Canadian mortgages generally have a fixed term of five years or less, which will mean payment shock for homeowners as rates reset.

Back testing by Hines Research[7] also shows a clear relationship between the direction of U.S. lending standards and real estate performance as measured by Federal Reserve lending surveys. The third quarter survey shows that U.S. lending remains very restrictive, with nearly two-thirds of banks tightening their lending standards across the three real estate categories surveyed by the Fed. This is the fourth consecutive quarter of 60%+ readings – a streak that has only happened one other time since 1990 (six consecutive 60%+ quarters during the Global Financial Crisis). We will continue to watch these important metrics for additional signs of a turnaround.

INVESTMENT IMPACTS

As noted, the U.S. economy is among the performance leaders across the globe. The gross domestic product read for the third quarter blew by estimates, up 4.9% annualized. Growth in other countries in the Americas is also accelerating – Oxford Economics recently raised its Q3 GDP forecasts for Brazil and Mexico. In part because these central banks raised rates early and often, their monetary policy is now leaning toward easing, with predictable results. The U.S. Federal Reserve has communicated at least a sustained pause is warranted to allow rate hikes to work through the economy, and this has contributed to a "split personality" between capital markets and fundamentals. Equity exchanges like the Dow and S&P 500 are posting gains year-to-date while economic metrics look strong, but other measures (home sales, real estate indexes, etc.) are signaling problems.

In Latin America, industrial real estate is demonstrating remarkable resilience. The combination of low vacancies, rent growth, and growing demand paints a promising picture for long-term investors.[8] In markets like Brazil, Chile, and Mexico, demand is perhaps most concentrated in high-quality, modern warehouses catering to e-commerce and industrial output. Office in the region, however, is experiencing some strong headwinds. Hybrid work, high inflation, slowing tenant demand, and other factors make for investment challenges in the short-term. The residential outlook in the region is mixed – rents are up strongly, but optimism is tempered by high interest rates and escalating construction costs. The regional trend towards larger, modern living spaces does remain a significant demand driver for high-quality apartments. We believe longer-term, Latin American residential may present an intriguing opportunity for patient investors.

[6] MSCI Real Capital Analytics, Hines Research as of Q323

[7] Back-tested results are calculated by retroactive application of strategy-based model constructed using historical data based on assumptions integral to the model which may or may not be testable and do not include adjustment for fees. The results reflect performance of a strategy not historically offered to investors and do not represent actual returns to any investor. Actual results may differ materially from back-tested results and are subject to losses. Back-tested results do not guarantee future performance. Model assumptions are subject to continuous updating.

[8] MSCI Real Capital Analytics, Hines Research as of Q323

Among the three major regions, one could argue that the U.S. is experiencing the most traditional cycling of fundamentals. For years, apartment construction boomed in the sunbelt in response to growing demand, but this now is undergoing a correction in vacancies, demand, and rent levels. This process has progressed to the point where apartments are showing signs of recovery in demand growth, and in fact, more than half the markets covered by Hines are posting positive year-over-year rent growth. The Industrial sector seems to be exhibiting a softening in its fundamentals – possibly portending a slowdown among the larger sized (one million SF and up) facilities. Smaller projects, particularly those catering to e-commerce, are holding up better.

This is an unusual correction for real estate, due partly to the absence of a "normal" recession (at least so far). The broad deceleration that one would expect is playing out in a much gentler fashion. One profound example is how prices are down substantially, but rents continue to increase year-over-year. Some U.S. appraised values are marking to market at a much slower pace than during the last (2008-2010) correction. Appraised values by less conservative managers may not be capturing the level of current opportunities, as many properties are changing hands below their appraisals. More visibility on market-clearing prices will develop – it has begun as there are signs suggesting the correction is finding a bottom. Hines Research forecasts that the total amount of distressed sales will increase next year and peak in 2025. We believe savvy investors should be ready to strike during this period as financing liquidity slowly improves.

CONCLUSION

The investment signals we were following in 2023 are providing a mixed message. Most economies (the U.S., Latin America, and parts of South America) in the region are generally doing well by traditional measures, but real estate is experiencing a cyclical reset. The U.S. recovery is lagging Europe and Asia, but seems to be showing signs of life, with transaction volumes possibly on the rise and bank lending standards ready to relax. In Canada, we expect some pain as the economy continues to contract and high mortgage rates take a toll on consumers. The U.S. Fed seems content to let its long series of rate increases soak in throughout the economy, which may facilitate the acceleration of the current reset. Signs of life in certain sectors and regions, combined with projected distressed sales peaking in 2025, might be a call to action for long-term investors with capital.

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