2024 Mid-Year Outlook

– Phil McAlister, Head of Research

As we reach the second half of 2024, the economy has been showing signs consistent with the concepts expressed in our "Five Themes Defining the 2024 Macroeconomic Outlook."

Q2 Gross Domestic Product (GDP) increased to just under 3 percent,[1] mainly driven by a rebound in productivity. Now signs are pointing to a slowing in economic activity as we continue to return to a low growth, low inflation environment, similar to the 2009-2019 era. A slowdown in both the employment market and on the ISM manufacturing index may likely contribute to weaker growth, with the New York Fed Nowcast, as of July 2024, at 2 percent for the second quarter.[2] Inflation continues to cool, with the Consumer Price Index (CPI) coming in at 3 percent in June, falling from 3.3 percent in May 2024. By excluding shelter (a component that lags actual shelter costs by 12 months), CPI is below 2 percent, settling in at 1.81 percent in June.[3]

Current data continues to support our outlook for low inflation and steadily falling interest rates at both the short end (the part of the curve that ranges from 0 to 1 year) and the long end (yields that are 10 years or greater) of the yield curve. This economic backdrop may bode well for commercial real estate values as borrowing costs drop and fundamentals remain strong in many sectors. However, should the slow growth tip into more severe recessionary territory, we would expect increasing cap rates and weakening net operating income (NOI) to outweigh the effects of lower interest rates in the short term. Long-term real GDP growth remains consistent with our initial projection of 0.5-1.8 percent annually, on average, through 2032. This growth remains steady but below post-WWII averages due to demographic and debt challenges. We believe this to be a reasonable range given the potential for employment and productivity growth going forward. Factors like increased immigration of employees and enhancements to productivity via AI or other technological advancements could cause this range to increase significantly.

[1] Federal Reserve Bank of St. Louis; Real Gross Domestic Product; https://fred.stlouisfed.org/series/A191RL1Q225SBEA, retrieved July 2024.
[2] Federal Reserve Bank of New York; New York Fed Staff Nowcast, July 26, 2024; https://www.newyorkfed.org/research/policy/nowcast#/nowcast/quarter/2024:Q
[3] U.S. Bureau of Labor Statistics. Consumer Price Index News Release. July 2024; https://www.bls.gov/news.release/cpi.htm

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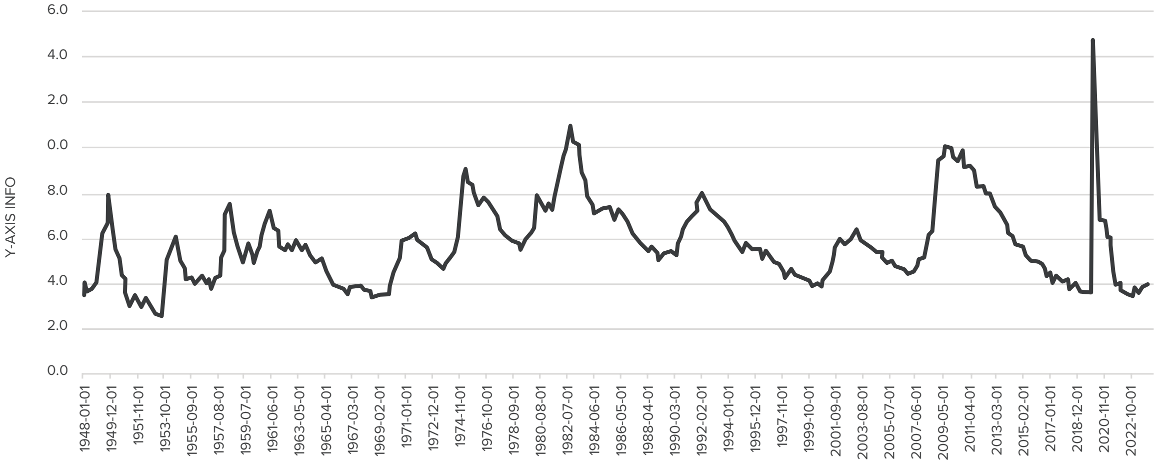
Key Takeaways

- After a strong first quarter driven by a rebound in productivity, economic growth is showing signs of slowing, consistent with our long-term outlook. Q2 real GDP is trending toward 2% in the New York Fed GDP Nowcast.
- The disinflationary trend continues as CPI fell below 3% for June, and CPI was below 2% in June excluding the lagging shelter component. We see the inflationary impulse in the rearview mirror as the long-term fundamentals continue to take over, indicating a low inflation environment.
- Rising unemployment, slowing inflation, and slowing GDP growth are likely to influence the yield curve lower as the Fed contemplates cutting rates. A 10-year Treasury yield in the mid to high 4% range is considered the top end of the range, and revisiting rates in the 2% range is plausible over the longer term if recession and/or deflation come to pass.
- Real estate returns are down moderately over the past 4 quarters with the steepest losses in the office sector. Student housing and hotels are bucking the trend and showing gains over that period. With interest rates stabilizing and set to head lower, and solid fundamentals in many markets, this decline may be poised to turn around if a recession is avoided.
- There has been significant over-building in some real estate sectors and markets, which we believe will lead to additional pressure on rents over the next 18-24 months. However, with nothing new entering the construction pipeline, markets with continued strong demand may see strong rent growth in 2026 and beyond as demand begins to outweigh supply again. Student housing and senior housing both have an interesting combination of low new supply and the potential for strong demand in the right markets.

Employment

Unemployment rates have trended upward slowly and moderately from the post-pandemic low of 3.4 percent, now reaching 4.1 percent.[4] While the current unemployment rate is considered low by historical standards, this overarching trend may be more important than the level, indicating that more Americans are unable to find a job relative to recent months. The following chart shows that when the unemployment rate begins to rise after cycle lows, a recession generally follows. Given the unprecedented changes facing the employment market in this post-pandemic world, we are open to the idea that this rise in unemployment could be a normalization rather than an indication of a looming recession. Nevertheless, we believe unemployment is worthy of watching closely.

Unemployment Rate[4]

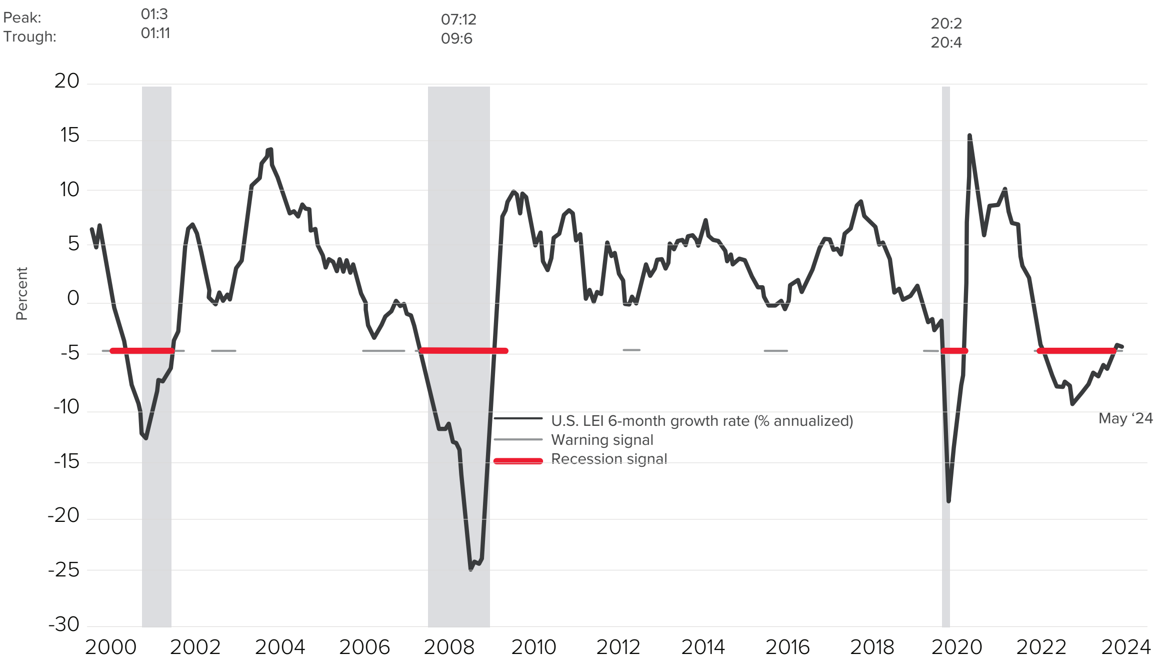


[4] U.S. Bureau of Labor Statistics, Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UNRATE, July 5, 2024.

Leading Indicators

The Conference Board publishes a leading index comprised of 10 components that have historically led economic activity by around seven months. This index turned negative in 2022 as the spike in GDP growth reverted to normal. However, after reaching levels typically associated with recession, and despite remaining negative, the index has been steadily improving, sitting slightly above the -4.4 percent that has been associated with an oncoming recession in the past.[5] Should this trend continue, this may indicate the potential for a soft landing scenario for the U.S economy.

Lagging Economic Index Year-Over-Year Growth Rate[5]



Note: Shaded areas represent recessions as determined by the NBER Business Cycle Dating Committee

Source: The Conference Board

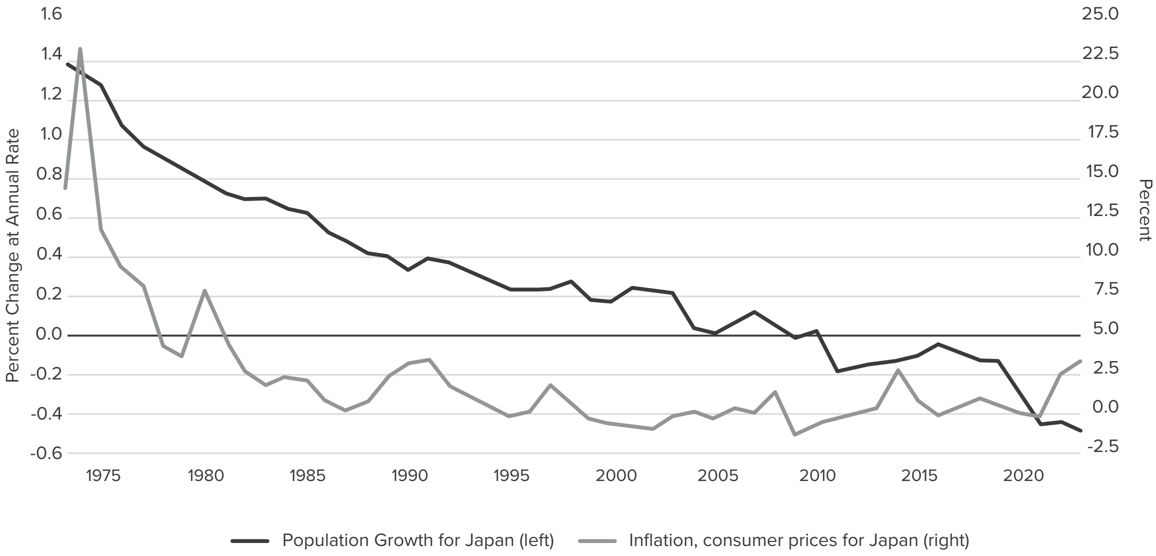
Inflation

CPI continues its steady march lower and registered the first reading below 3 percent since April of 2021. The shelter component of CPI lags actual shelter costs by about 12 months. Removing shelter, CPI is below the 2 percent: right where we expect inflation to settle in over the long-term.[6]

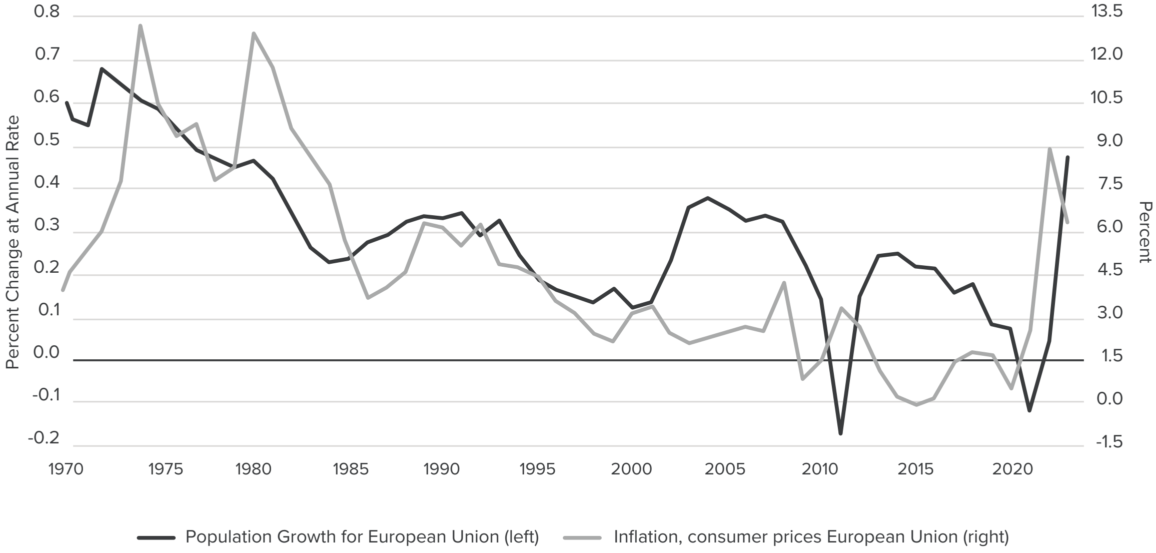
History shows that developed economies with aging, low-growth populations and high debt loads tend to experience low inflation environments, as seen by the European Union and Japan. We believe the U.S. will not experience declines as severe as our global counterparts. But while our population growth continues to slow and the economy ages, we expect to return to similar inflation levels seen from 2010-2019, averaging 1.8 percent annually.[6]

[5] https://www.conference-board.org/topics/us-leading-indicators
[6] U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPIAUCSL, July 11, 2024.

Japan's Population Growth & Inflation[7]



European Union's Population Growth & Inflation[8]



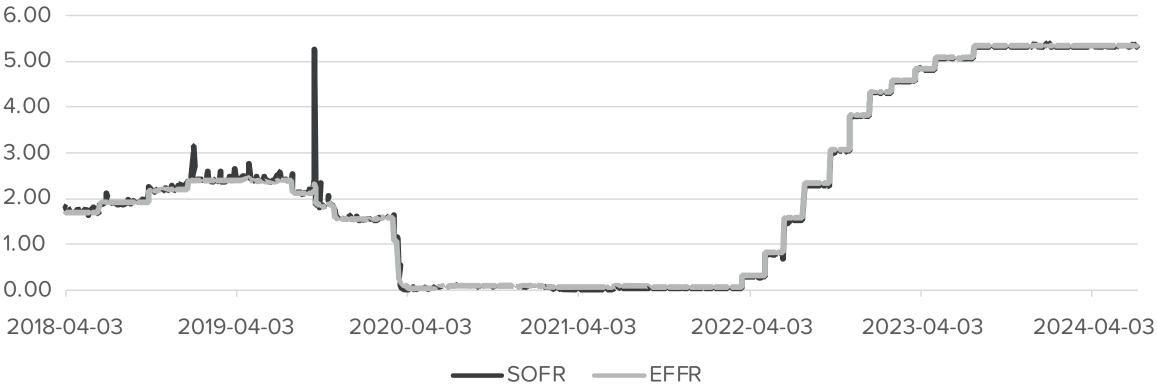
[7] World Bank, Population Growth for Japan [SPPOPGROWJPN], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SPPOPGROWJPN, July 11, 2024. World Bank, Inflation, consumer prices for Japan [FPCPITOTLZGJPN], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FPCPITOTLZGJPN, July 11, 2024.
[8] World Bank, Population Growth for the European Union [SPPOPGROWEUU], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SPPOPGROWEUU, July 11, 2024.; World Bank, Inflation, consumer prices for the European Union [FPCPITOTLZGEUU], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FPCPITOTLZGEUU, July 11, 2024.

Interest Rates

As economic growth remains tepid and the specter of inflation continues to wane, interest rates at the long-end of the yield curve, defined by the 10-year Treasury rate, have steadily declined from its October 2023 high of 4.99 percent to 4.18 percent in July 2024.[9] This has happened despite the Federal Reserve (the Fed) maintaining the effective Federal Funds Rate at 5.33 percent as of August of 2023.[10]

As a refresher, many real estate investors use short-term, floating-rate debt to finance acquisitions and development and will typically have their interest rate based on the Secured Overnight Financing Rate (SOFR) rate. SOFR generally moves in near-perfect lockstep with Fed policy.[11]

Fed Funds and SOFR Rate[11]



Therefore, we don't expect to see major differences in borrowing costs at the short-end of the yield curve for variable rate loans until the Fed begins to cut rates again in 2024. The broader market generally expects gradual rate cuts from the Fed as 2024 rolls on, with the forward SOFR curve declining from 5.3 percent currently to approximately 3.55 percent by the end of 2026. With inflation continuing to moderate and unemployment increasing, our view is generally align with the data outlined above. The only caveat would be if the economy deteriorates more than expected, we would anticipate the Fed cutting rates much more drastically.

We believe it is likely that the 10-year Treasury will have a generally downward bias from here, given that the long-end of the yield curve can and will react more quickly to changes in growth and inflation. Currently the 10-year Treasury has steadily dropped from its October high of 4.99 percent to the 4.18 percent July 19, 2024.[9]

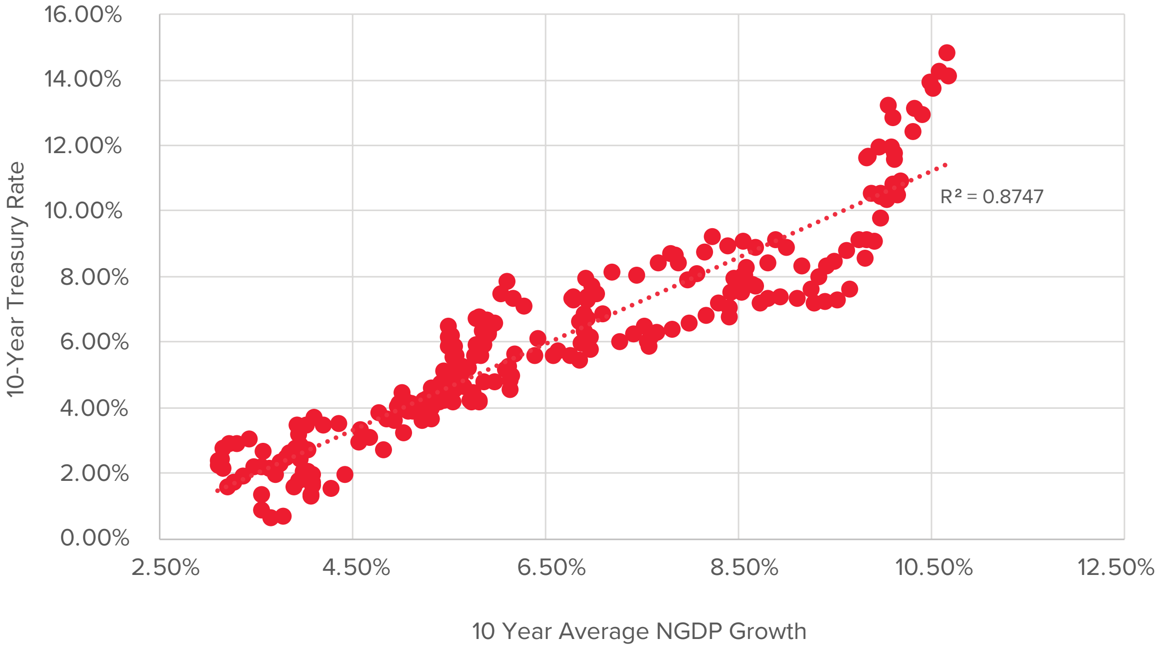
As we detailed in the 2024 themes, and demonstrate in the chart below, the 10-year Treasury rate is strongly tied to the 10-year average nominal GDP growth (NGDP), which measures the economic production at current market prices.

[9] U.S. Department of the Treasury. Daily Treasure Par Yield Curve Rates: 2023 and 2024 Reports.

[10] Federal Reserve Bank of St. Louis; Federal Funds Effective Rate, retrieved from FRED, https://fred.stlouisfed.org/series/FEDFUNDS, June 2024.

[11] Federal Reserve Bank of New York, Secured Overnight Financing Rate [SOFR], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SOFR, July 11, 2024., Federal Reserve Bank of New York, Effective Federal Funds Rate [EFFR], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/EFFR, July 11, 2024.

10-Year Treasury Relationship to NGDP[12]



Assuming muted real GDP, which measures economic production using constant prices, growth and moderating inflation, we believe it is reasonable to expect nominal GDP growth to range between 4.5-5.0 percent over the long-term, with weaker quarters coming in well below that going forward. Based on the historical relationship shown above, this would imply the top end of the range for the 10-year Treasury to be somewhere around 5.0 percent. At the low end, it would be plausible to see the 10-year Treasury return to 2.0 percent or below if recessionary conditions emerge and inflation drops below 2.0 percent.

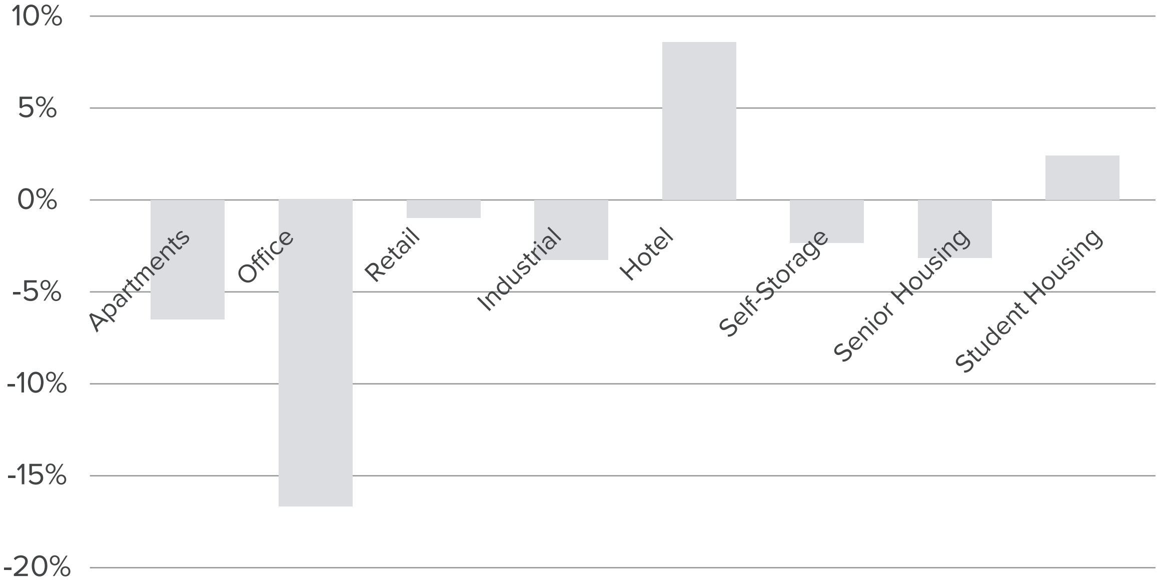
Presented with this backdrop, we may allow for periods of higher than trending NGDP growth and spikes in the 10-year Treasury. But when the 10-year is in the mid-4 percent or higher range, we believe the probability skews toward lower rates given the long-run dynamics at play.

Real Estate

Commercial real estate was strained in the first half of 2024 as higher interest rates and rising cap rates, the ratio between the net operating income (NOI) produced by an asset and its market value, took a toll on valuations and transaction volumes. Unlike the last down real estate cycle, we are observing strong fundamentals even within assets that have become distressed, as these assets are generally struggling due to investment structure. Owners who bought assets with high leverage at very low rates, using either variable rates or short maturities, are now seeing their borrowing costs skyrocket. This distress, along with higher cap rates and lower prices, may provide a buying opportunity for those with a long-time horizon, who employ long-term, fixed-rate debt or no leverage at all as some owners are being forced to sell amid these unfavorable conditions.

Annual returns over the last four quarters ending Q1 2024 across several property types have struggled, with the exception of hotels and student housing – both saw positive returns during that same time period.[13] The weakness in returns can be attributed in large part to rising cap rates as interest rates have risen.

Returns – Last 4 Quarters Ending Q1 2024[13]



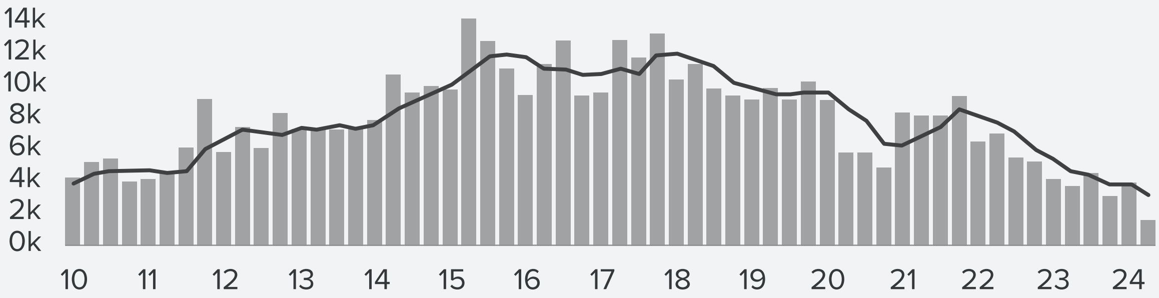
Additionally, high construction costs and interest rates, along with higher projected cap rates, have created an environment where the number of new projects entering the construction pipeline is significantly tightened. Therefore, as the market absorbs the assets set to come online in 2024 and 2025 that were started during the boom, we expect to see a shortage of competition in the following years. We believe this limited supply will lead to stronger rent growth in markets where demand for certain property types remains high. Investors that have a long-term outlook and are not beholden to a short-term return on investment can find themselves in a great position to acquire assets at lower valuations over the next 12-18 months, with strong future rent growth in 2026 and beyond.

[12] Data retrieved from Federal Reserve Bank of St. Louis; Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis, Percent, Quarterly, Not Seasonally Adjusted; Gross Domestic Product, Percent Change from Year Ago, Quarterly, Seasonally Adjusted Annual Rate.
[13] NCREIF Expanded NPI Return Index Data Retrieved from subscription website 7/11/2024

Sector Spotlight – Senior Housing

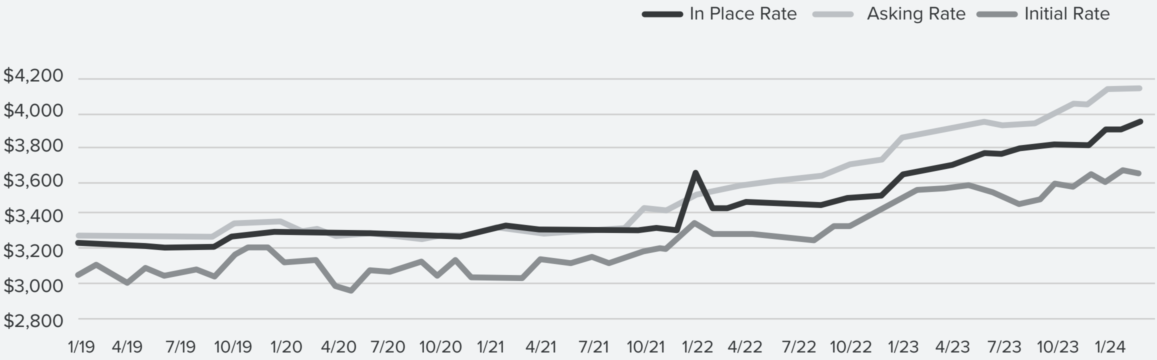
The lack of new supply in senior housing is particularly acute, with the construction of only 14,500 senior housing units started in 2023. This marks the lowest level of starts since the fallout from the great financial crisis of 2009-2010.[14]

Construction Starts & 4 Quarter Moving Avg.[14]



The lack of new supply comes as the U.S. population continues to age. The U.S. Census Bureau projects the population of Americans 65 and older to increase by 31 percent from 2022 to 2035, representing 18 million more seniors. The 85 and older cohort will increase by 4.7 million people or 72 percent.[15] In fact, in a 2019 paper, NIC estimated that about 95,000 units per year would be needed between 2025 and 2030. After 2030, the shortage may become more severe as the oldest baby boomers reach their mid-80s, the prime age group requiring senior housing.[16] This dynamic is already resulting in higher rates in the senior independent living space, which is anticipated to remain without a major boom in new construction.[17]

Rate Trends[17]



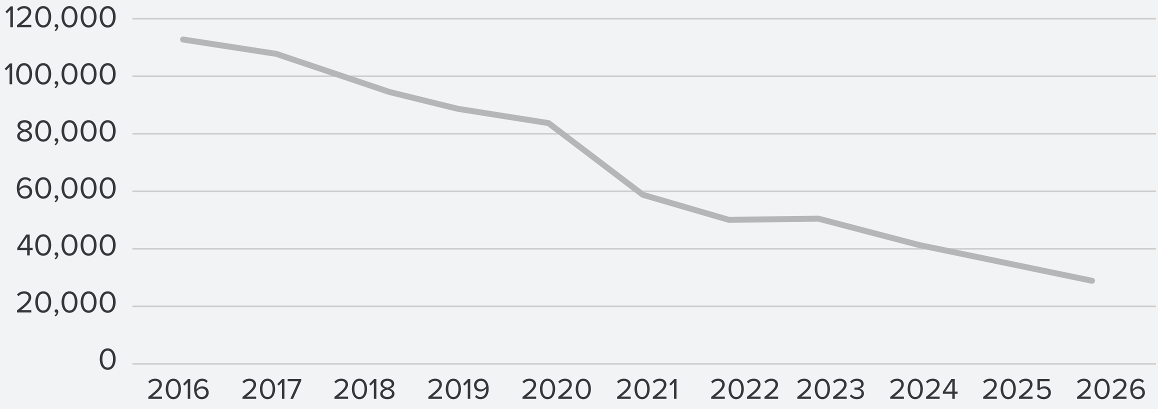
The demand for senior housing will be driven by life events and therefore less impacted by any future economic challenges. We believe this characteristic, alongside a supply/demand imbalance, makes senior housing an interesting sector to watch in the coming years.

[14] NICMAP Vision Construction Monitor Q2 2024
[15] https://www.census.gov/data/tables/2023/demo/popproj/2023-summary-tables.html
[16] "Looking into the Future: How Much Seniors Housing Will Be Needed?" – NIC White Paper 2019
[17] NICMAP Vision Seniors Housing Actual Rates Report 1Q2024

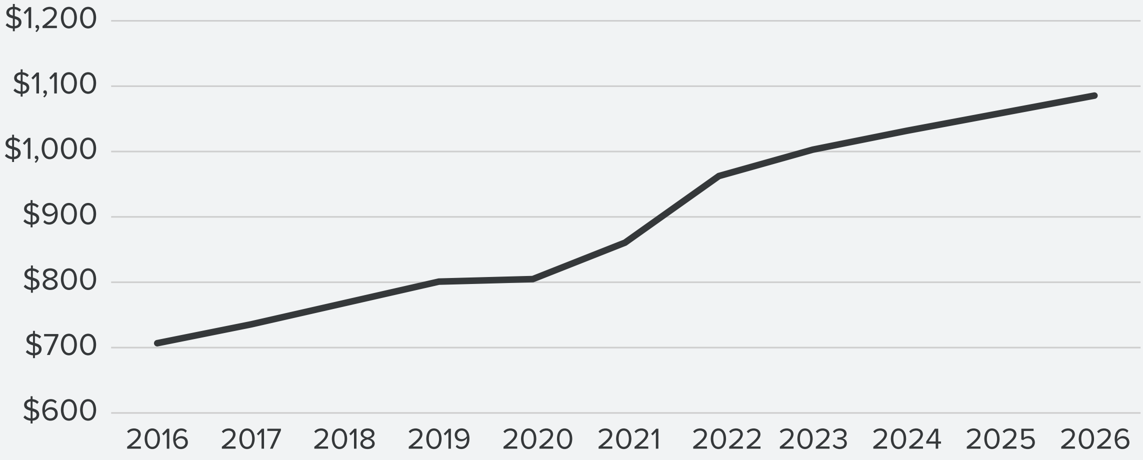
Sector Spotlight – Student Housing

Student housing has many unique real estate characteristics, some of which mimic that of senior housing. Most notably, student housing demand is driven by life events versus economic growth, allowing for the sector to demonstrate resilience in the face of economic headwinds. The National Center of Education Statistics projects that between fall 2021 and fall 2031, total undergraduate enrollment will increase by 9 percent, to 16.8 million students.[18] While enrollment rates are steadily climbing, student housing itself is experiencing a stable decline of new projects entering the construction pipeline through 2026. We believe the decline in new construction, increasing enrollments and other factors may lead to significant rent growth in many markets.[19]

Student Housing Construction[19]



Effective Rent per Bed[19]



[18] National Center for Education Statistics. Undergraduate Enrollment. May 2023.

[19] Real Page Market Analytics, retrieved from website 7/11/24

The Bottom Line

As we enter the second half of 2024, we believe the prevailing themes will be stagnant economic growth, a continued inflation deceleration, and a growing potential for interest rate cuts. Although whether the economy will enter a recession is still unclear, leading indicators, while declining, are doing so at a slower pace that no longer suggest imminent recession. This may be offset by the rising unemployment rate and continued slowdown in the ISM manufacturing index. Ultimately, the short-term economic outlook remains muddied by these factors. The truly unprecedented economic conditions seen throughout the pandemic and recovery make historical comparisons difficult.

And while this type of economic environment may continue to strain various asset classes, we believe the outlook for commercial real estate remains strong over the long-term (barring any drastic changes in the markets), with construction starts down significantly across all sectors, easing interest rates and demand in top markets remaining stable. More specifically, we believe operators using moderate to no leverage with a long-term focus may outperform over the long haul by taking advantage of the potential buying opportunity presented by currently depressed valuations against strong long-term fundamentals.

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