# 4 quadrant report

## Monthly insight into U.S. commercial real estate opportunities

**March 2021**

## Top U.S. economic issues:

- Virus spread moderation and fiscal policy/stimulus drive 2021 growth expectations higher
- Inflation in intermediate goods and inflation expectations gain momentum
- Real rates are rising, and the yield curve is bear steepening – a headwind despite good earnings
- Fed expected to be "reactive" so a period of volatility may lie ahead
- On watch for wider credit spreads and pressure on equity multiples

## Implications for U.S. commercial property:

- Price movements across quadrants appear reasonable given the upgraded economic/jobs outlook
- Risk premia (average) appear tight relative to real estate fundamentals (below average)
- Equity relative value: REITs for office and select retail; neutral for industrial and multifamily
- Upgrading private equity development and subordinate debt given shorter duration and high margins
- Period of volatility near-term may offer an opportunity to fine tune portfolio positions

## The 4 quadrants:

| | |
|---|---|
| Private Equity | Private Debt |
| Public Equity | Public Debt |

## In this summary:



## Total return (risk-adjusted):

| Rank | Attractiveness ranking[1] | Change from prior month |
|---|---|---|
| 1 | Subordinate/bridge debt | Upgraded |
| | Private equity—niche development/re-development | Upgraded |
| 2 | AAA CMBS/cash equivalents | Downgraded |
| | Select CMBS (BBB+ composite) | No change |
| | Public (U.S) REITs | No change |
| | Select Long duration mortgages and sale leaseback bonds—high quality | Downgraded |
| | Emerging opportunistic investments in debt & equity | Potential upgrade |
| | Private equity—levered core* | No change |

*Industrial, suburban multi-family and niche segments are more attractive

[1]Using Base Case economic forecast and total return estimates over a two to three-year time horizon plus some tactical near-term considerations

# U.S. economy:

Prospects for accelerated vaccine dosing along with potential for additional stimulus continued to drive positive sentiment in growth expectations in the U.S. while Europe prepares for a technical recession. A bifurcated recovery remains in place as weakness in job growth, sentiment and personal spending is offset by policy, benign financial conditions, improving corporate profits and sustained strength in manufacturing and housing. Attention has been pivoting towards fiscal policy since the start of the year, and odds are on the rise for a healthy stimulus in March followed by infrastructure initiatives. This in turn has stirred debate as to the appropriate level of stimulus needed amid rising concerns regarding inflation risks, although the Fed expects price pressures to be transitory given labor slack. Modest steepening of the yield curve and a stable U.S. dollar are constructive, but a volatile dollar accompanied by a disorderly steepening of the yield curve would suggest otherwise.

The near-term U.S. growth outlook has been volatile as the more aggressive growth expectations of 5%+ on a sequential basis were tempered briefly, but steadying at 3% to 4%+ annualized. The Atlanta Fed GDP estimate for first quarter growth dropped from 6% to 4.5% before surging to 9.6%. On balance, the decline in COVID spread and higher odds of a $1.9 trillion stimulus package passing in March boosted investor confidence and raised growth expectation in the following quarters to 5%+ and to ~5% for the full year, completing the recovery process and confirming that a "V" shaped recovery has indeed unfolded.

In Europe the pace of recovery is not yet in sync, and the timing for full recovery to pre-COVID levels is not likely until 2022. The EU is expected to deliver two consecutive quarters, 4Q 2020 and 1Q 2021, of economic contraction, resulting in a "double dip", but likely to rebound thereafter although 2021 growth may be modest at less than 4%. The UK contracted nearly 10% in 2020 (but grew at 1% during 4Q 2020) and is not expected to complete its round trip full recovery anytime soon. Lifting of some virus containment measures is expected to boost Japan's growth in 4Q 2020 as well, but it may slip back into contraction territory as virus containment efforts were reinstated in January. The global growth vector itself is "bifurcated" with China's economy at the top, potentially 10% larger by year end compared to pre-COVID levels.

In the U.S. odds are fiscal policy can easily fill the output gap but also ignite price pressures—already evident in intermediate goods [PPI], commodities [China] and construction labor costs [commercial construction]. The $1.9 trillion stimulus appears high, compared to the $1 trillion output gap, while a $2 trillion infrastructure plan may pressure labor costs in various segments even as sentiment remains strong to support dislocated sectors, such as retail, lodging, tourism and airlines. In other words, output could easily exceed pre-COVID levels even though a material portion of the labor market faces a multi-year recovery timetable, increasing the risk of higher labor costs.

That would be a set up for inflationary pressures to percolate further and, given a reactive Fed, risk of a disorderly rise in yields cannot be dismissed. But the path may not be a "straight line" as such bear steepening and higher real rates will likely weigh on asset valuations and push a desire for safety into Treasury bonds. When the Fed does choose to intervene, it may well set the stage for a challenge to policy efficacy. A stable U.S. dollar could be constructive for policy efficacy, but a weaker U.S. dollar (inflationary) or, to a lesser extent, a crowding out effect (demand for dollars) may be problematic for the Fed. For now, if fiscal policy, including infrastructure, is adopted, a bear steepening of the yield curve appears likely and that may in turn demand a policy response from the Fed.

"Modest steepening of the yield curve and a stable U.S. dollar are constructive, but a volatile dollar accompanied by a disorderly steepening of the yield curve would suggest otherwise."

**Inflation watch:** Traditional metrics remain manageable, but intermediate goods and market based forward looking data point to upside risks. The CPI ranged from 1.4% to 1.6% on a YOY basis for headline and core respectively, but core PCE is expected to drift up to 1.7% and surpass 2% in the coming months as PPI was stronger than expectations (with core PPI jumping up to 2% YOY from 1.1% last month). Also, inflation expectations are rising sharply. The 2-year breakeven is 2.6%+ (highest in nearly a decade), University of Michigan inflation expectations over the next year rose to 3.3%, NFIB survey participants expected higher selling prices, Bloomberg's commodity index is 10%+ higher than pre-COVID with WTI oil well above pre-COVID levels amid evidence of rising shipping (Baltic Index) and food costs. Further, the 5-year/5-year forward swaps reached 2.2%, in aggregate suggesting the potential for a modest surge in inflation near term and the ability to hold at/above Fed targets longer term. 10-year Treasury yields broke through 1.5% with momentum and upside potential from this level over the next 12 months ranging from 30+ bps (pre-COVID levels) to 100+ bps (historical levels).

Capital markets' sentiment is constructive, and price movements reflected expectations for the cyclical upturn to gain strength. Sectors sensitive to economic growth were again strong performers, led by small caps, energy, industrials and financials (as a steeper yield curve is typically a positive). Defensive sectors such as staples and utilities underperformed. On a cautionary note, weakness was noted in consumer cyclicals (slipped) and high yield debt (flat) but followed strong performances in recent months. Earnings multiples at over 22X are pricing for a robust, cyclical upturn in earnings and appear reasonably well supported by the steeper yield curve, signaling strength in real and nominal growth, but may come under pressure if the steepening is sustained. As noted herein, in the absence of policy intervention, there is substantial headroom for yields to move higher.

### A summary of recent fundamental data:

- The labor market has been trending softer over the last few months, reasonable given the limited reopening of hard-hit sectors, but with the potential for renewed strength as virus effects moderate. On a cautionary note, initial unemployment claims remain elevated with a 4-week average of 807,000, and total number receiving some form of unemployment benefit, including pandemic benefits, is hovering near 19 million. On the other hand, job openings (per JOLTS) rose and the work week expanded to 35, suggesting extended hours and potential for wage gains. Job growth expectations have turned more upbeat relative to weaker trends and business sentiment and are now calling for monthly gains to average 300,000 to 500,000 over the next 18+ months accompanied by a pick-up in the participation rate; as a result, pre-COVID levels for aggregate employment may be reached by year end 2022.

- Sentiment was mixed. The NFIB small business optimism index declined, but NAHB [home builders] market index ticked up even though rising construction costs and declining affordability weighed on expectations. From a consumer perspective, the University of Michigan Index declined sharply, and the Bloomberg Consumer Comfort index has been range-bound, but the Conference Board Index gained (although expectations dipped).

- Retail sales surged in January following a weak holiday season, bolstered by some easing of restrictions and stimulus ($900 billion/$600 checks) approved near year end; seasonal adjustments were a factor as the typical drop in January was less than normal but followed a weak holiday season. Nevertheless, it was a positive coming into the new year and likely translated into an upgrade of economic growth in the coming quarters. Headline sales were up 5.3% and +6.1% ex auto and fuel, while the control group which factors into GDP calculations rose 6%; however, prior period revisions were negative for all metrics. The strongest segments included online stores [+11%], restaurants and bars [+6.9%], furniture stores, electronics and appliances [10+%].

- Lean inventory and steady demand continued to power the industrial sector. For January, headline production was up 0.9%, while manufacturing activity rose 1% and in aggregate Fed's measure of activity was just 2% short of pre-COVID levels. The recovery in factory output was broad based across consumer goods, business equipment, construction materials as well as non-durables, but auto production was impacted by shortage of semi-conductors. Utility output was down 1.2%, but mining was up 2.3% and drilling activity rose 11.3%—an encouraging sign for energy sensitive markets even though drilling activity remains 50% below last year's levels. Business investment remains strong with core durable goods orders rising 1.4% and core capital goods shipments up 2.1%.

- Housing: Starts declined 5% (single family -12%, multifamily +17%), but permits rose 10.4% with single family up +3.8% and multifamily surging +27.2%; declining affordability was cited as potentially weighing on growth. Nevertheless, existing home sales, a key driver of economic activity, rose 0.6%—an encouraging sign as a decline was expected—as did new home sales, but pending sales declined. Still, rising rates, declining affordability, possible plateauing of sentiment, and weakening profile of homebuilder shares suggest a slowdown in activity may lie ahead.

## U.S. commercial real estate:

Pricing across the quadrants appears reasonable given the economic outlook. Sector recovery seems to be modestly broadening given strength in REIT earnings, tighter spreads across fixed income segments and positive appreciation in private equity indices. However, the recent run up in Treasury yields is approaching levels where it may be a headwind despite the upbeat economic backdrop which, in turn, has tightened the band of risk adjusted returns across strategies of interest. As such, a more volatile phase may lie ahead near term. Selectively adding exposure within certain economically sensitive segments is appealing, and weakness in prices/valuations near term may be an opportunity to fine tune portfolio positioning. Policy efficacy is likely to be tested and may impact the return potential across the quadrants over the intermediate to longer term.

**Price movement across the quadrants appears reasonable on a fundamental basis:** REIT earnings are ahead of expectations, and share prices were higher across all REIT segments over the last few weeks—suggestive of a broader recovery. Credit spreads tightened across CMBS, REIT debt and mortgages but are arguably at "fair levels" relative to real estate fundamentals (down in credit CMBS priced for ~10% peak-to-trough decline in private equity) while maintaining attractive spreads relative to corporate bonds (policy influenced) across the credit curve with excess spread of 70 bps to 150+ bps which appears well supported on an absolute and relative basis. Private equity is exhibiting signs of a bottoming process in aggregate as the more upbeat topline (positive appreciation) is still offset by wide divergences in performance across property sectors.

An upgraded economic outlook has led to more aggressive revisions to job growth (300,000 to 500,000 monthly) to achieve full employment by year end 2022. If so, there is potential for upward revisions to real estate fundamentals in terms of occupancy, rent growth, net operating income trajectory. For now, real estate outlook reflects a more tempered recovery given [a] cyclical and secular headwinds for office and retail; [b] moderating rent growth for industrial (expected but not yet evident); [c] dispersion of performance across multi-family (suburban over urban); and [d] lodging/tourism recovery still shackled by lingering virus mitigation efforts—translating into a broad based recovery in net operating income across all sectors possibly by mid to late 2023.

**However, capital markets are a potential headwind:** Given the current set up, good news for the economy will likely translate into a much steeper yield curve, and in this regard real estate pricing appears vulnerable. For REITs equity risk premia (AFFO spread over 10-year yield) of ~290 bps is within the normal range of 275 to 300 bps, as is private equity risk premia (trailing NPI income of 4.2% is a spread of 270 bps over 10-year Treasury). So, risk premia are tight relative to the current real estate recovery phase and capital markets pricing, implying the 10-year Treasury could be 30 bps to 100+ bps higher. So, in most cases, despite the upbeat sentiment for job growth, rent growth is unlikely to fully offset such capital market pressures; however, higher inflation/construction costs, combined with higher yield, can drive out higher asking rents for new projects, thereby offering more headroom for rent growth.

Given a reactive Fed, long yields are likely to be untethered near term, and so a period of price volatility appears likely. If so, it may offer an opportune time to recalibrate policy efficacy, and in turn reposition portfolios by taking selective risks in segments with higher degree of sensitivity to an economic rebound as well as offering attractive margins. Downside risks remain given valuation sensitivity to policy efficacy (i.e., ability of Fed to monetize debt in an environment of rising price pressures).

> "Selectively adding exposure within certain economically sensitive segments is appealing, and weakness in prices/valuations near term may be an opportunity to fine tune portfolio positioning"

**Public versus private equity--relative value observations:** Given the recent price moves in both public and private equity quadrants, relative values have shifted. Multi-family and industrial pricing is neutral across these segments (exposure either through public or private equity yields comparable return potential at the asset level), but public equity exposures for office and retail appears modestly more attractive relative to private equity.

**Strategy considerations:** Higher yields/secular risks and improving economic/job growth are likely offsetting, driving a convergence of risk adjusted returns across strategies of interest. Wider risk premia for retail and lodging are positives but offset by [i] expectations for lingering risks (re-opening time table, e-commerce et al, tempered earnings/outlook from Marriott and WalMart); [ii] expectations for office sector earnings appear upbeat relative to rent growth which is forecast to decline in 2021; and [iii] tight risk premia in aggregate. A steeper yield curve continues to suggest shorter duration as strategies search for a healthy combination of [a] modest duration; [b] relatively wide risk premia; and [c] pockets of potential mispricing within each segment.

**Given the more constructive economic/job growth outlook, development deserves an upgrade although mostly limited to industrial, multi-family and certain niches such as data centers. A steep mortgage credit curve, especially approaching high yield, is supportive of subordinate debt strategies. A more balanced risk/reward outlook drives a neutral positioning for CMBS (down from a potential upgrade).**

For now, rankings are positioned for yield induced volatility which could offer an opportunity to fine tune exposures and add exposures to economically sensitive segments at more attractive price levels. Durations can be trimmed through any period of weakness since it may be accompanied by a flatter yield curve. Cash remains on watch for further downgrade and is primarily a hedge for potentially weaker performance of risk assets near term.

# Additional commentary on the 4 quadrants

## Private equity

Strength in industrial and garden multifamily has masked weakness in office and retail—sectors that are expected to weigh on benchmark index performance in 2021. Nevertheless, pockets of secular strength in industrial/e-commerce and multi-family/household formation, including niche sectors such as data centers/data storage needs, appear increasingly better positioned given upbeat expectations for economic growth which materially lowers the odds of new supply being delivered into a weak economic environment. Selective development is increasingly more attractive in these segments, although exit cap rate assumptions may need to be fine-tuned. Further, recent strength in oil prices suggests that energy markets are worthy of additional consideration.

## Public equity (U.S. REITs)

REITs pushed higher as good earnings and low cost of debt capital offset higher Treasury yields. At current levels (MSCI 1,180 to 1,200) core sectors are trading at an implied cap rate of 4.5% on a trailing basis and ~5% discount to NAV. Equity risk premium (AFFO spread over 10-year UST) is within historic average of 270 to 300 bps and suggests a Treasury yield of 1.5% may be a key threshold above which share prices may be pressured in the near term. Return potential remains highly variable and sensitive to the trajectory of long-term Treasury yields, with annual total return potential of 2% to 8% (3-year average).

## Private debt

Spreads tightened modestly (5+ bps) and appear to have mostly caught up with gains in corporate bonds over the last few months. The shape of the credit curve was unchanged and remains steep, approaching high yield segments and offering attractive relative value for subordinate debt. However, the strong rally in corporate high yield may come under some pressure if the yield curve steepens further as pricing power may not be sufficient to offset higher yields which may, in turn, weigh on excess spreads—now ranging from 65 bps for AA rated credits to 140 bps for BBB credits for 10-year tenor and ~90 bps for 5-year, "A" credit quality. CMBS/mortgage differentials remain supportive, but conduit pricing is increasingly more sensitive to corporate bond spread/pricing trends.

## Public debt (CMBS)

The credit curve flattened further but the pace may be moderating as corporate bond spreads could be pressured by rising yields. CMBS has been more fully participating in the strong rally in bond markets as stabilization in collateral values is factored in. Per Trepp, special servicing rates (ex-lodging) declined to 9.7%, and the delinquency rate slipped to 7.6%. Spreads tightened ~10 bps in the BBB- tranche, bringing it in line with BB/BB- corporates which appears in sync with the anticipated drawdown in asset values, and AAA spreads were flat. Spread compression appears substantially complete and some profit taking appears prudent. The opportunity set [5+ year duration/BBB+ quality] return potential of 3% to 6% moderated, and risks are skewed to the downside near term.

Given our views on the factors influencing the commercial property markets, the following is a summary of the current conditions and investment themes for the four U.S. commercial real estate quadrants.

| | Current conditions | Investment themes |
|---|---|---|
| **Private equity** | • An extended bottoming process appears underway given the divergence in performance across sectors<br>• Transaction trends are still lackluster<br>• Maintaining further downside risks to asset values at 5%+ (driven by office & retail)<br>• Potential for a steeper yield curve is likely to weigh on appreciation potential | • Value/price sensitive households/ corporations is an emerging theme longer term<br>• Sectors with secular drivers are better positioned longer term—data centers, logistics and workforce housing<br>• "Suburban over Urban" theme continues to work well for office and multifamily<br>• Niche and industrial development are attractive given the upgraded economic outlook |
| **Public equity** (U.S. REITs) | • A good earnings season and low cost of debt capital offset higher Treasury yields<br>• Some evidence of broad-based recovery as most segments delivered share price gains<br>• Trading at a modest discount to NAV for core sectors, so not confirming a sustainable trend yet | • "Central tendency" of return profile is reasonable but sensitive to policy efficacy<br>• Fundamental expectation for a weaker office sector is a lingering concern that may exacerbate downside risks<br>• A corrective phase in response to higher yields may offer an attractive entry point |
| **Private debt** | • Spreads tightened, but the credit curve remains steep approaching HY territory<br>• Spreads remain attractive across the credit curve with liquidity spread premium likely priced in | • Subordinate debt: spreads pressured near term, but a steeper yield curve may expand the opportunity set<br>• Senior mortgages are very appealing for ALM investors<br>• High quality, long duration—modestly interesting on a tactical basis, but policy driven lower yields should be viewed as an attractive exit opportunity |
| **Public debt** (CMBS) | • Rally in equity sensitive BBB tranche flattens curve, but increasingly more sensitive to corporate bond trends<br>• BBBs are trading like BB-/BB corporates, signaling downside risks to collateral are reasonably priced in<br>• BBB+ composite total return potential moderated—less attractive | • Lodging and retail segments offer wide spreads but offset by lingering risks/re-opening timetable<br>• Selectively adding risk, such as BBB bonds, has the potential to be accretive under constructive outcomes<br>• Office risk needs to be monitored and priced for in portfolio construction |

# Real estate attractiveness ranking/risks

| Segment | Opportunity* | Comments |
| --- | --- | --- |
| **Subordinate debt** | Total return (TR) potential is likely in the 6% to 9% range as credit curve remains steep. Potential to selectively add retail, lodging and participating construction loans but still limited transaction activity. | Upgraded. Steeper yield curve may expand the opportunity set given conservative underwriting for senior mortgages as bottoming process is still incomplete. Core equity risk with core-plus to value-add equity return potential. |
| **Private equity—niche development/ re- development** (tie w/ subordinate debt) | Lower risk of delivering product in a weak environment. Likely limited to industrial, multi-family and certain niche, such as data centers. Targeting mid-teens levered returns. | Upgraded. Value-add to opportunistic risk with opportunistic return potential. Exit cap rates need to be fine-tuned. |
| **New issuance AAA CMBS (cash equivalent)** (tie w/ REITs) | CMBS 2.0 AAA bonds at T+60 bps (5 to 10-year term). Lowering duration and TR potential to 1% to 2%+. Looking to exit during any pullback in yields if economic outlook is unchanged. | Downgraded/potential for further downgrade. Highly collateralized investments and modest carry increasingly less attractive given the upgraded economic outlook. |
| **Select CMBS (BBB+ centric) composite** (tie w/ REITs) | TR potential is 3% to 6% but cautious near term as spread compression may be complete and Treasury yields are rising. Bottoming process in collateral is likely to offer an opportunity to accumulate at attractive spreads. | No change—revising potential upgrade to neutral based on valuation. Core risk with core equity return potential. |
| **U.S. REITs** | TR potential suggests a wide range of potential outcomes of 2% to 8%+ over a 3-year time frame; a constructive "central tendency" but longer duration increases sensitivity to trajectory of long-term yields. | No change. Near term volatility may be elevated with risks still modestly skewed to the downside. Core plus equity risk with sub-core to core-plus or value-add equity return potential. |
| **Longer duration mortgages secured by high quality leases** (tie w/ REITs) | Mortgages secured by IG credit leases can offer 70 to 100+ bps excess spread potential over comparable bonds. Attractive for ALM investors and a steeper yield curve may be an attractive tactical buying opportunity if a policy response is expected. | Downgraded. Prepared to exit if the yield curve flattens in response to weakness demanding a policy response. TR potential of 4% to 6%+ but risks skewed to the downside. Sub-core equity risk, core equity return potential. |
| **Emerging opportunistic investments in debt & equity** (tie w/ REITs) | Expecting a fragile capital stack to become more fully defined by mid-2021. Continued bear steepening of the yield curve may be the catalyst. | Potential upgrade. Preparing to fine tune. Retail, lodging and office are under watch. Seek core to value-add equity risk with value-add to opportunistic equity return potential. |
| **Private equity (levered core)** (tie w/ REITs) | Downtrend over the next 1 to 2 quarters, targeting negative total returns. Near term downside to capital values is around 5%+ but with the potential to be more modest. Office remains a focus sector. | No change. The bottoming process still appears incomplete. REITs offer better relative value in aggregate. Assets with long leases sensitive to a steeper yield curve. Market selection and thematic investing remain attractive. |

*The examples shown above are presented for discussion/demonstration purposes only and are not a projection of results for any investor. The actual results may differ materially from that depicted above based on numerous factors, including market changes. Attractiveness rankings use Base Case economic forecast and total return estimates over a two to three-year time horizon with some near-term tactical considerations.

## Risks

1. A reactive Fed increases the risk of a disorderly rise in Treasury yields
2. Potential reset in asset values weighs on investor and consumer sentiment, driving weaker investment & consumption
3. Virus mutations and delays in vaccination trajectory threaten to derail the fragile global recovery underway
4. President Biden's policy proposals may be considered too aggressive; amendments could delay/stall execution
5. Accelerating deficits and inflation averaging policy weigh on long-term yields, limiting policy flexibility and efficacy
6. Stagflation risks may be rising if real wage growth/consumption is weighed down by price pressures
7. Removal of 13(3) programs pressure weaker credits if economy weakens or yields rise too fast
8. Job losses in retail/hospitality sectors become permanent, leading to broader weakness in office/FIRE sectors
9. Simmering geopolitical tensions in China, N. Korea and Iran could further weigh on the recovery