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Real Estate

# 4 quadrant report

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

**April 2021**

### Top U.S. economic issues:

- Weather and supply chain-related weaknesses noted, but employment surged
- Passage of COVID-19 stimulus appears to have had positive ripple effects globally
- Fed upgrades 2021 growth forecast, but forecast suggests limited carryover into 2022
- Inflation overshoot expected to be transitory, but markets are pricing for earlier policy rate liftoff
- Possibly in early stages of price discovery/market tolerance for higher yields

### Implications for U.S. commercial property:

- Equities relative strength—an indication growth is offsetting yields
- Modest divergence noted in public quadrants—REITs bullish but CMBS more cautious
- CMBS/mortgage spreads tighten and may weigh on conduit pipeline development
- Equities relative value: Neutral as REITs and private equity implied cap rates are in sync
- Yields—path of least resistance is higher; public quadrants price action will be instructive

### 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 | No change |
| | Private equity - niche development/re-development | Potential Upgrade |
| 2 | AAA CMBS/cash equivalents | No change/ potential downgrade |
| | Select CMBS (BBB+ composite) | Developing |
| | Intermediate term mortgages/high quality | Developing |
| | Public (U.S) REITs | Developing |
| | Emerging opportunities | Developing |
| | Private equity - levered core | Developing |

[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:

The passage of the $1.9 trillion COVID-19 stimulus plan, combined with an accelerated vaccination timetable and Fed signals for ongoing accommodation, began to ripple across a broad economic spectrum. U.S. and global growth outlooks were revised up, along with inflation expectations, which translated into further steepening of the yield curve. The Fed views these developments as reasonable given the more upbeat economic outlook and expects near-term price pressures to be transient. Incoming data was mixed with weather-influenced weakness in retail sales and housing and with supply chain issues weighing on auto production/manufacturing. However, strong job gains and the leading index of economic growth suggest a positive growth trajectory in the coming months. Fed forecasts indicate stimulus primarily boosting 2021 growth; if so, given potential for higher inflation and yields amid a “stand-still” Fed, markets may be entering a period of price discovery. Rising infections, renewed lockdowns in Europe and select U.S. metros all pose some concern.

2021 growth prospects for the U.S. were upgraded following the passage of a $1.9 trillion stimulus and rising reopening optimism as President Biden raised his vaccination goal to 200 million in the first 100 days of his presidency. This was further supported by a pick-up in air travel, easing of dining restrictions in various states, tentative plans to reopen schools for in-person learning in the fall and expectations for monthly job growth of ~300,000 for the balance of this year. 2021 growth for U.S. moved up to the 5.5% [consensus] to 6.5% [OECD] range with growth expected to accelerate in the coming months; Atlanta Fed estimate of 1Q 2021 GDP growth rose to 6% despite weather related weakness. Also, the savings rate is expected to rise dramatically following the receipt of stimulus checks and may stay elevated through year end, offering the potential to boost consumption-driven growth in 2022.

The spillover from U.S. stimulus had a positive impact on global growth expectations. OECD upped its global growth forecast to 5.6% from 4.2%],rising above pre-pandemic levels by mid-2021. Also, growth revisions were positive across major economies such as the EU [up 0.3%], UK [up 0.9%], despite near-term weakness in the EU/UK. But the pace of recovery is still quite varied across major economies—U.S. and China leading but dispersion noted among EU nations, with UK/Germany forecast tempered by renewed lockdowns in response to virus mutations.

Central banks were cautiously optimistic about growth prospects as well but refrained from signaling any material changes in policy. Further, although noting the recent surge in yields, there appears to be limited interest in reacting to it yet. Although ECB indicated its willingness to step up bond purchases, there was no change to the size of PEPP [€1.85 trillion] nor the duration of its program through March 2022, and change in bond purchases was expected through internal market consensus and not necessarily market-driven. The Bank of England was not alarmed by the rise in yields either, and the Bank of Japan was considering widening the trading band for its bonds.

The Fed’s sentiments were similar, reinforcing the view that rise in yields was mostly constructive and, more importantly, that the forecasted overshoot in inflation metrics in the coming months is likely to be transitory. Also, interestingly, although it upgraded the U.S. growth forecast for 2021 from 4.2% to 6.5%, it barely budged for 2022—ticked up to 3.3% from 3.2% and lowered the 2023 forecast—suggesting the impact of the stimulus may be short lived with minimal multiplier effects longer term. Also, despite strength in its employment forecast [full employment by late 2022], its inflation forecasts hovered just around 2% over the next 24 to 36 months. As such, given the inflation averaging framework, the Fed appears content allowing market forces to work through a price discovery process with its long-term policy rate projection of 2.5% as a soft ceiling on yields.

> “Fed forecasts indicate stimulus primarily boosting 2021 growth—if so, given potential for higher inflation and yields amid a “stand-still” Fed, markets may be entering a period of price discovery.”

Inflation watch: Although inflation metrics still remain modest, a sharp move higher appears increasingly likely as headline CPI may rise from 1.7% now to ~4% by May/June — a portion of which is likely to be transitory, while secular forces such as de-globalization [supply chain appears fragile with a contentious U.S./China trade negotiations] and a policy driven weaker U.S. dollar have the potential to sustain price pressures [5-year/5-year breakeven is at 2.2%, a 52-week high]. All of this is beginning to get noticed, with emerging consensus among economists of a rate hike in 2023 further supported by Fed Fund futures pricing for one hike before March 2023. However, although volatile, high yield bonds have continued to outperform investment grade bonds - an indication that investors expect higher growth to offset higher inflation/yields - but a quality bias was evident when 10-year yields approached 1.75%, a level that may be of interest near-term. As such, conditions are in place to test the Fed’s tolerance for an overshoot and, given the reactive backdrop of an untethered long yield, risks tighter financial conditions that may weigh on valuations.

On balance, an adjustment process may be unfolding as risk assets fully price for higher growth, inflation and, in turn, higher yields. Under the Base Case [early phases of an expansion cycle], price discovery that may be underway should offer more durable valuations; however, the depth and duration of this phase could be characterized by bouts of volatility that could be disruptive and weigh on consumer, business and investor confidence. Given the spread between Treasury yields and nominal growth expectations, bond market volatility is likely to be elevated, although the potential for bearish investor positioning suggests a rally in bonds [lower yields] remains an ongoing possibility. Regardless, in the absence of Fed intervention, the trend in yields remains to the upside while lower yields are more likely in response to market volatility/desire for safety.

### A summary of recent fundamental data:

- Labor market: March non-farm payroll gain easily exceeded expectations at 916,000 and prior period revisions were positive; gains were broad-based indicating strong momentum. The unemployment rate declined to 6%, the participation rate ticked up and hours worked rose to 34.9—all in all a very impressive report. Job openings [JOLTS] rose to a 12-month high of 6.9 million and a survey of small businesses noted that nearly 40% of respondents cited job openings as being hard to fill, so wage pressures may be building up as well. Initial claims remain elevated at ~700,000, but the 4-week average is drifting down and the number collecting some form of unemployment benefit held above 18 million, reflecting substantial slack but should resolve lower soon given the hiring trends.
- Retail sales slipped in February but were mostly offset by upward prior period revisions. Headline sales were down 3% and declined 3.3% ex-auto and fuel but were offset by positive prior period revisions to +7.6% and +8.5% respectively, up from +5.3% and +6.1%. As such, the weakness appears to be an adjustment for the strong January readings that were boosted by $600 stimulus checks; so, given passage of the new stimulus bill, consumption is expected to accelerate in the coming months. Weakness was broad-based and weather may have been a factor as well—sales declined for autos, electronics, furniture, building materials, sporting goods, department stores, online merchants, and health/personal items. However, the control group that factors into GDP calculations rose 0.3% and the prior period gain was revised up to 8.7%, supporting upward revisions for 1Q GDP growth.
- Industrial production and manufacturing activity softened in February as supply shortages, weather and shipping delays were influencing factors but expected to be transient. Industrial production declined 2.2%, manufacturing was down 3.1% [estimated at -0.5% if weather effects are excluded] and capacity utilization dropped to 73.8%.Utilities rose 7.4% after a surge in demand for heating, but auto production declined 8.3% [semi-conductor shortage was cited] and chemical plant production was down 7.1% [shut down along the gulf coast]. Oil and gas drilling rose 6.4%—a trend worth noting given the uptrend in oil prices.
- Durable goods orders declined 1.1%, ex- transports orders were down by 0.9% and, within transport autos dropped but aircraft orders rose. Core capital goods orders and shipments dropped 0.8% and 1% respectively, indicating business equipment investment may have slipped in the first quarter.
- Housing: Activity weakened, driven by weather and low inventory, although underlying demand and construction backlogs offer a more constructive backdrop. However, rising construction costs, healthy increases in sale prices and rising mortgage costs are potential headwinds. Starts declined 10.3% [single family -8.5%, multifamily -15%] and permits slipped 10.8%. Existing home sales—a key driver of economic activity—dropped 6.6% as available inventory dipped to one million, roughly two months' supply, and new home sales fell sharply as well [-18%].

## U.S. commercial real estate:

The set up remains unchanged. Higher economic/employment growth, higher inflation/expectations and, in turn, potential for higher yields suggest a period of price discovery lies ahead. On balance, equities strengthened relative to debt, a constructive development indicating stronger growth has been able to offset the effects of rising yields so far. However, wider CMBS spreads have the potential to ripple through the mortgage market and translate into higher cost of debt capital that may ultimately weigh on equities' performance. Private and public equity quadrants are in sync, which indicates further strength in REITs—so that the sector trades at a premium to NAV—should be observed going forward, but CMBS is signaling the potential for weaker collateral values, a divergence worth monitoring. Further upgrades in earnings/real estate fundamental outlook may be needed to maintain the positive trend; if so, office and retail sectors may need to be key drivers.

**Fundamentals and price discovery process update:** Based on year end 2020 inputs, 2021 rent growth is expected to be negative for all sectors ex-industrial, and only industrial looks materially stronger relative to earlier expectations while office has slipped. Further it suggests that recovery in real estate fundamentals [rents, operating income] may be complete in aggregate in 2023 but with retail and office still lagging. This is in line with full recovery in job growth by year end 2022, although some acceleration in rents is possible given rising inflation expectations, but it may be back-ended given modest demand for new construction in the interim.

From a price discovery perspective, a review of the public quadrants is instructive. REIT earnings are expected to be soft in 2021 but gaining momentum next year; however AFFO multiples appear elevated at over 22X, which translates into equity risk premia [AFFO yield less 10-year Treasury] of 270 to 280 bps compared to long term average of 270 to 300 bps. In other words, risk premia is already at the lower end despite a two-year recovery phase ahead and so vulnerable to near-term fundamental weakness, especially if yields continue to climb higher. Such weakness appears to be priced into CMBS where spreads in BBB- tranche widened 40 bps and, combined with 30 bps higher yields, nominal yields climbed 70 bps and traded in line with corporate BB—i.e. slipped a notch relatively indicating some additional downside risks to collateral values.

Also, private and public equity quadrants appear to be mostly synchronized with REITs trading near 100% NAV and all core sectors fully aligned from a relative value perspective. Implied cap rates across core sectors are roughly 4%+ [multifamily and industrial], 5.5% to 6% for office and ~6% for broader retail and so neutral to accessing equity exposure through public or private quadrants. Under an up-trending scenario, REITS typically trade at a modest premium over NAV and, if so given the momentum observed in private equity [RCA, CPPI], higher REIT prices should be expected.

From a fixed income quadrant perspective, nominal yields are rising, and conditions are emerging for a sticky conduit market. CMBS spreads have widened as have excess spreads over corporate bond spreads, while mortgage spreads have been mostly stable with a tighter bias [excess spreads slipped] setting the stage for some repricing in the conduit market and in turn higher cost of debt capital. Nominal yields for REIT debt are 2.75%+ for 10-year term with the potential to move higher. If so, REITs, by design a levered exposure, appear vulnerable.

> "Further upgrades in earnings/real estate fundamental outlook may be needed to maintain the recent trend—if so, office and retail sectors may need to be key drivers."

**The price discovery process may be in its early stages:** On balance, the current "price equilibrium" across the quadrants is fairly fluid and the next "break", perhaps in REIT prices, may have some significance. Given the current outlook for growth and inflation, yields are likely to be volatile with an upward bias and, in turn, likely to weigh on spreads. Under these conditions, additional upgrades to real estate fundamentals may be needed to maintain the upbeat trend. In this regard, office and retail seem to have the most potential with retail more directly benefiting from stimulus/higher savings, while office may indirectly benefit from virus containment and the reopening of service sectors. Regardless, 10-year Treasury yields in excess of 2% near-term is likely to pressure prices across the quadrants and 1.75% may be a level of interest near-term, a level above which a quality bias may emerge.

**Strategy considerations:** The attractiveness rankings remain unchanged as we await further signals from the public markets—the expectation is for a period of relative weakness in the public quadrants, so the outlook is more fluid. On a constructive note, on watch for [a] continued strength in REITs and at sustained modest premium to NAV; [b] pick up in transaction activity offering further conviction regarding price discovery; and [c] stable to relative strength in CMBS spreads over corporate bond spreads to reconcile the divergence with REITs. If such conditions are met, investors are likely expressing higher conviction that real estate fundamentals may be upgraded. Office, especially CBD, and retail [power centers and neighborhood centers/shop space rents] exposures may be worthy of additional consideration. For now, this would be a modest upside scenario.

Other themes of interest in early stages include (i) tactical exposure to the recovery in energy markets—drilling activity is still depressed but may be starting to turn around; and (ii) strategic exposure to broad continuum of housing sector since it is likely underserved on many fronts: demographics [seniors/millennials household formation], limited supply excluding upscale product leaving price sensitive segments/bottom three quartiles with fewer options and/or less discretionary income. A review of how these segments are positioned within respective cycles may be in order, and it may be of interest as a partial hedge to working from home initiatives as many residences are not set up to easily accommodate a permanent office at home.

# Additional commentary on the 4 quadrants

## Private equity

Broad-based strength was evident as private markets caught up with REITs roughly on par with NAV; however, transaction volume was down ~60% [RCA] - a sign that price discovery has been limited. CPPI has been expressing a bullish trend over the last several months, and over the one and three month periods all segments ex-CBD office posted positive price appreciation, although as noted herein a pick-up in traction volume would offer higher conviction of such a broad-based recovery. Within core sectors, CBD office and select retail [the expected laggards going forward] may have the potential to get a boost from such broad-based recovery. Industrial and multifamily have been consistent top performers, but suburban office is gaining some traction as well.

## Public equity (U.S. REITs)

REITs exhibited an upward bias as upbeat expectations for earnings, especially in 2022, were modestly offset by rising cost of debt/higher yields. At their recent central tendency [MSCI 1,210 to 1,220] REITs are still trading at an implied cap rate of 4.5% on a trailing basis and at par to modest discount to NAV for core sectors. Equity risk premium [AFFO yield spread over 10-year UST] approached the tighter end of historic average of 270 to 300 bps and suggest further tick up in Treasury yields near-term may weigh on share prices. Annual total return potential slipped to 2% to 5%+ [three-year average trend] with the higher end in line with 10-year Treasury yield contained below 2.5% over that time frame.

## Private debt

Spreads were modestly volatile in response to the steepening yield curve, typical response lags and corporate spreads volatility but appear to be settling down with a tighter/quality bias [excess spreads tightened higher up in credit]. The shape of the credit curve was mostly unchanged but appears vulnerable to a pick-up in Treasury volatility, which in turn could drive corporate spreads wider. Excess spreads tightened but still reasonably attractive across the curve ranging from 60 bps (AA rated credits) to 140bps (BBB) range, for 10-year tenor and ~80bps for 5-year, "A" credit quality. CMBS/ mortgage differentials deteriorated which may weigh on conduit pipeline development/profit potential; and, if such condition persists, mortgage spreads may widen.

## Public debt (CMBS)

The credit curve modesty bear steepened with down in credit/BBB tranche widening 40 bps and priced in line with BB- corporate bonds, reasonably aligned with the view that higher yields may be starting to weigh on collateral values. Spreads were more bearish relative to corporate bond spreads where spreads have been volatile. As such, the spread tightening cycle may be at risk of turning around if bond market volatility ticks up. Excess spreads over corporate bonds widened by 5 to 35 bps and remain attractive across the curve. A quality bias appears prudent near term given the potential for further volatility in bond markets. The opportunity set [target 200 bps excess spread for 5-year duration/BBB+ to A-quality] has the potential to deliver 3% to 4% yield to maturity, but lower total returns near term is possible given the expectation for higher nominal yields.

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** | • Recent momentum has been upbeat with broadening price recovery<br>• Transactions down ~60%, an indication price moves are still not fully confirmed<br>• At 100% NAV, public markets are supportive<br>• Potential for a steeper yield curve remains a key risk | • Upside earnings momentum needs more support from retail and office<br>• Niche, industrial and select multi-family development attractive given upgraded economic outlook<br>• Sectors with secular drivers are better positioned longer term--data centers, logistics and workforce housing<br>• Active participation across the housing/shelter continuum is worthy of further investigation |
| **Public equity** (U.S. REITs) | • Upgraded economic/job growth offset higher yields/cost of debt to support share prices<br>• Evidence of broad-based recovery as most segments delivered share price gains<br>• Trading roughly at par with NAV and so appears to be at a key juncture | • "Central tendency" of total return profile slipped and remains sensitive to rate policy/yield trajectory<br>• Fundamental expectation for 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 were relatively unchanged but with a tighter bias<br>• Credit curve remains steep approaching HY territory<br>• Excess spreads are reasonably attractive but expressing a tighter bias | • 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>• Conduit pipeline profitability appears modest and if sustained could ripple into wider spreads and higher cost of debt |
| **Public debt** (CMBS) | • Spreads widened across the curve and a modest bear steepening was evident<br>• BBBs are trading like BB- corporates, signaling downside risks to collateral may be rising<br>• BBB+ composite [target credit quality] return potential moderated further | • Lodging and retail segments offer wide spreads but offset by lingering risks/re-opening timetable<br>• Selectively adding risk [BBB/BB 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** | YTM/Total return (TR) potential is likely in the 6% to 9% range as credit curve remains steep. Potential to selectively add retail and lodging may be emerging but still limited transaction activity. | Steeper yield curve may expand the opportunity set given conservative underwriting for senior mortgages and modest equity TR. Core equity risk with core-plus to value-add equity return potential. |
| **Private equity— niche development/ re- development** (tie w/ subordinate debt) | Risk of delivering product in a weak environment has declined. Likely limited to Industrial, multifamily and certain niches, such as data centers. Targeting mid-teen, levered returns. | Potential upgrade. 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+50 bps (5 -year term). Lowering duration and TR potential to 1%+. Looking to exit during any pullback in yields if economic outlook is unchanged. | Highly collateralized investments and modest carry increasingly less attractive given the upgraded economic outlook but holding given the potential for price discovery |
| **Select CMBS (BBB+ centric) composite** (tie w/ REITs) | YTM of 3% to 4%+ and cautious regarding TR near term as spread compression may be complete and yields are on the rise. | Developing. Bottoming process is likely to offer a better entry opportunity. Core to sub-core equity risk with sub-core to core equity return potential. |
| **Intermediate term mortgages/ high quality** (tie w/ REITs) | High quality mortgages offer 60 to 140 bps excess spread over comparable bonds. YTM of 2.5% to 3%+. Attractive for ALM investors. | Developing. Excess spreads compressed in some segments and Treasury yields/CMBS spread differentials may push yields higher. Sub-core equity risk, sub-core equity return potential. |
| **U.S. REITs** | TR potential slips to 2% to 5%+ over a 3-year time frame. Longer duration increases sensitivity to trajectory of long-term yields. Upside if yields are contained and/or earnings outlook is upgraded. | Developing. Near term risks skewed to the downside. Core plus equity risk with sub-core to core equity return potential. |
| **Emerging opportunities** (tie w/ REITs) | Limited price correction other than select segments [lodging and retail] dampens opportunistic return potential. Continued bear steepening of the yield curve could expand the opportunity set. | Developing/tempering expectations. Retail, lodging and office are under watch. Seek value-add equity risk with value-add to opportunistic equity return potential. |
| **Private equity (levered core)** (tie w/ REITs) | Downtrend potential is moderating given recent momentum and the potential to outperform REITs near term. Office remains a focus sector. | Developing. Lower volatility may give the edge over REITs near term. 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 third virus surge in EU and in some U.S. regions threatens the upgraded outlook
2. President Biden's plans for additional stimulus may further boost inflation expectations and yields
3. A reactive Fed increases the risk of a disorderly rise in Treasury yields
4. Stagflation risks may be rising if real wage growth/consumption is weighed down by price pressures
5. Removal of 13(3) programs pressure weaker credits if economy weakens or yields rise too fast
6. Job losses in retail/hospitality sectors become permanent, leading to broader weakness in office/FIRE sectors
7. Simmering geopolitical tensions [China, N. Korea, Iran] could further weigh on the recovery


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