US Commercial Real Estate Outlook: Looking Beyond 2024

August 2024
invesco.com

Mike Sobolik, CFA®, CRE®
Managing Director
Regional Investment Strategist,
North America
Invesco Real Estate

The final lap of the annual real estate race in the US starts just after Labor Day. Until recently, transaction volumes were expected to end 2024 at a slow jog due to the lingering drag of higher interest rates. But mounting evidence of easing inflation and economic conditions has provoked sharp declines of US Treasury yields and has elevated expectations of imminent fed fund rate[1] cuts. This shift is driving confidence that transaction activity could re-accelerate either late this year or in early 2025, and that the start of a new real estate value cycle is close at hand.

But the new real estate value cycle is expected to experience less benefit from cap rate[2] compression compared to previous recoveries. Near-term economic growth is expected to ease, and current pricing largely reflects different sector expectations for income growth and liquidity. This accentuates the need for property income growth and reliance on secular demand drivers that can mitigate an easing of the economic cycle. It also elevates the need to seek differentiated performance through market selection, because of the large historical gap between top- and bottom-performing markets.

As the November US presidential election rapidly approaches, policy differences between the primary candidates will undoubtedly provoke speculation about which set of policies is best for real estate. But the current trajectory of inflation, economic growth, interest rates, and real estate conditions provides more actionable information for investment decisions.

Here are five key takeaways from our outlook.

1. Macro environment: Income growth is critical

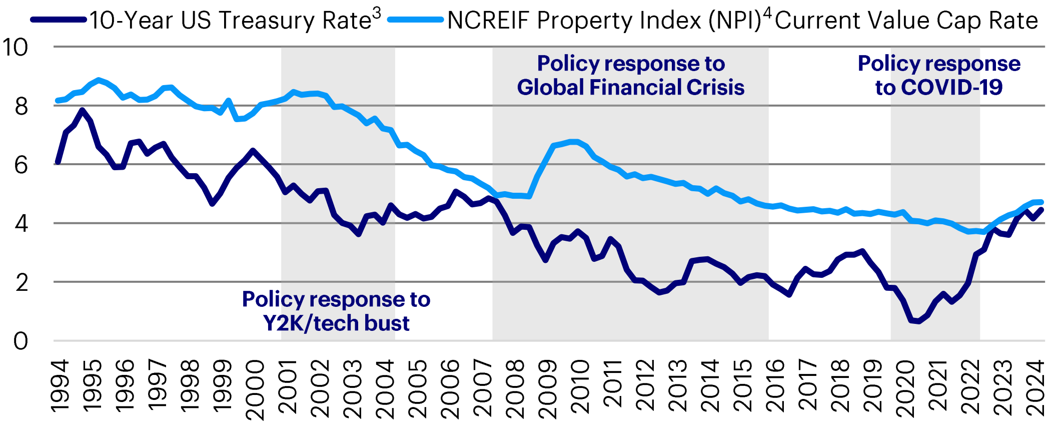
We expect at least three factors to shape returns:

Capital markets: Don't expect cap rate compression to save the day.
Since the early 1980s, declining interest rates have led to declining commercial real estate (CRE) cap rates and helped drive CRE value growth. But going forward, we expect declining interest rates to exert less influence on CRE cap rates.

Monetary policy loosening and interest rate declines were essential to boosting liquidity in past economic downturns. During the three most recent downturns – the early-2000s tech bust, the late-2000s Global Financial Crisis (GFC), and the 2020 COVID-19 pandemic – the 10-year US Treasury yield fell from highs in the 6%-8% range (mid-1990s) to below 1% (2020). In turn, CRE cap rates fell from an average range of 8%-9% (mid-1990s) to below 4% (2022). This allowed cap rates to maintain a sizeable spread above the 10-year US Treasury rate for most years (see chart below).

Base rates are unlikely to fall to previous lows, likely limiting how much cap rates may fall

US Treasury rates versus institutional real estate cap rates per quarter (%)



Source: Sources: Invesco Real Estate, utilizing data from the US Department of Treasury, Moody's Analytics, and NCREIF Property Index (NPI) as of June 30, 2024. Full period of shown begins January 1, 1994 and ends June 30, 2024.
An investment cannot be made directly in an index. Past performance is not indicative of future results. NCREIF data reflects the returns of a blended portfolio of institutional quality real estate and does not reflect the use of leverage or the impact of management and advisory fees.

Not a Deposit | Not FDIC Insured | Not Guaranteed by the Bank | May Lose Value | Not Insured by any Federal Government Agency

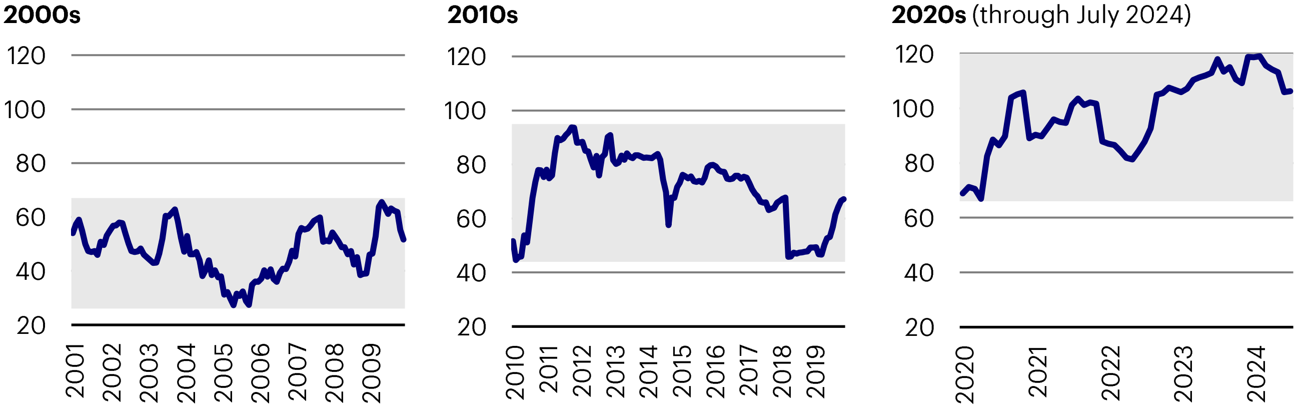
Going forward, however, we expect cap rate compression will play a lesser role for real estate value growth. Over the past year, 10-year US Treasury yields have ranged from the high-3%s to near 5%, compared with average CRE valuation cap rates of 4.7% in Q2-2024. This means that the spread between cap rates and Treasury rates has either been thin relative to history or inverted, implying that either interest rates need to fall or CRE cap rates need to rise to restore an appropriate risk premium to real estate values. And 10-year Treasury yields are not likely to be sustained longer term at the sub-3% levels that followed the Global Financial Crisis or the sub-1% levels that immediately followed the onset of COVID-19. Together, these metrics indicate that cap rate compression will likely play a muted role in the recovery of CRE values over the next few years. That means that future property value growth will need to be found in property income growth.

Economic conditions: Rate cuts foretell slower growth.
The need for strong property income growth coincides with slowing economic conditions. Highly anticipated action by the Federal Open Market Committee to reduce the fed funds rate suggests two things: First, inflation is potentially easing enough to cut interest rates. But second, the current pace of growth may not be sustainable if interest rates are overly restrictive. This means that property income will need more than typical cyclical drivers to accelerate growth. Stronger growth will likely come from secular demand drivers, such as shifting demographics and advancing technologies.

Sector pricing: Differences have rarely been wider.
Since the 2022 start of interest rate escalation, cap rates among the various property sectors have widened from each other. It's seen in the standard deviation[5] of average property sector cap rates. Today's deviation is close to the 30-year highs in 2023 and earlier this year (see chart below). Sector differences in expected growth and liquidity appear to be priced into the market already. Said differently, sectors with higher expected income growth (e.g., industrial, single-family rentals) or greater financing liquidity (e.g., apartments, single-family rentals) are priced at much lower cap rates compared to sectors with lower expected income growth (e.g., medical office, shopping centers) or higher perceived risk (e.g., traditional office), making the search for property income growth more challenging.

Sector pricing has become more differentiated

Standard deviation of US property sector cap rates per month (basis points)[6]



2000s

2010s

2020s (through July 2024)

Source: Invesco Real Estate, utilizing data from Green Street. Sectors represented include apartments, data centers, industrial, manufactured housing, medical office, traditional office, self-storage, single-family rentals, strip retail, senior housing, and student housing, Fullest sector representation starts in 2010. Full period of shown begins January 1, 2001 and ends July 19, 2024.

2. Property income: Where to find growth

Differences between property sector characteristics and geographic drivers are the key places to find better relative income growth opportunities.

By property sector

Our outlook for property sector income growth is based on each sector's exposure to long-term secular demand drivers, sensitivity to the economic cycle, and exposure to new supply. Let's look at what's happening with each.

Theme	Trend	Sectors affected
Long-term secular drivers	Robust growth of 75+ age population	Sectors for seniors (medical office, life science, senior housing)
	Strong growth of late-30s to early-40s	Sectors for transitional households (single-family rentals, manufactured housing)
	Advances in technology	Drives growth for industrial, life science, and data centers; hinders growth for senior housing (tech allows seniors to age in place)
Economic cycle sensitivity	Acyclical sectors	Medical office and student housing
	Traditionally cyclical sectors benefiting currently from low vacancy and supply	Single-family rentals, manufactured housing, strip retail, and data centers
	Traditionally cyclical sectors impaired currently by high vacancy and supply	Industrial, life science
New supply exposure	Sectors with high current supply deliveries	Industrial, apartments, self-storage, life science
	Outlook after 2024?	High interest rates have sharply curbed new construction starts. Deliveries in these sectors should abate sharply in 2025 and 2026.

Based on these drivers, we expect some sectors to deliver stronger property income growth over the next one-to-two years and others to deliver strong growth over a longer time horizon:

- **Near-term growth sectors:** Data centers, single-family rentals, manufactured housing. Moderate growth is expected from open-air retail, medical office, and student housing.
- **Long-term growth sectors:** Data centers, single-family rentals, manufactured housing are expected to lead over the long term, too, along with industrial.

Missing in the above list of strong income growth sectors is apartments. Near-term income growth is expected to be hindered by high supply deliveries and potential move-outs of tenants to homeownership as mortgage rates moderate. Long-term growth is expected to be tempered by weak population growth in the sector's primary renter cohort, 25-34 year-olds. We believe that these trends will generate average rates of income growth relative to other sectors. That said, rental growth variance within the apartment sector can be considerable.

By geography

Tenant demand is driven by both sector-specific factors and common factors. Here are some of the common factors driving tenant demand:

- **Highly concentrated by region.** Regional growth has clearly favored the Southeast, Southwest, and select Mountain region markets over locations in the Midwest and Northeast, which are largely projected to lose population. These trends are expected to continue, which means most of the growth-oriented real estate investment opportunities will emerge in the Southeast, Southwest, and Mountain regions.

- **One wild card – California.** While California has experienced net outmigration post-COVID-19, its history of massive growth during technology expansions suggests that it could re-emerge as a growth leader. Also, growth could result from favorable shifts in local policies about housing, taxation, and business friendliness.

- **Greater gains around large metro perimeters and smaller metros.** Several secular trends are expected to drive outsized growth to the far suburbs of large metro areas (1 million and higher population) and to smaller metro areas (250,000 to 1 million). Aging and the need for proximate medical services, hybrid and remote work, and expanding needs for affordable housing are key drivers.

3. Why differentiation matters

Relative performance across real estate portfolios is driven by sector exposures, market and location exposures, and asset characteristics.

Sector

Sector-level themes tend to reflect long-term secular drivers that boost demand over-and-above normal cyclical growth. For example, relative performance over the past decade has been defined largely by whether a portfolio held an overweight or underweight exposure to the burgeoning industrial sector. Secular trends go through roughly four performance stages.

1. **Emergence:** Tenant demand undergoes outsized growth and returns surge**.**
2. **Recognition:** Investors pay up to gain exposure to the growth trend and developers accelerate construction activity to meet higher levels of demand.
3. **Deceleration:** The tenant demand trend starts to moderate, but market pricing hasn't adjusted to moderated growth.
4. **Normalization:** The secular driver has run its course and related real estate demand reverts to a normalized long-term growth rate.

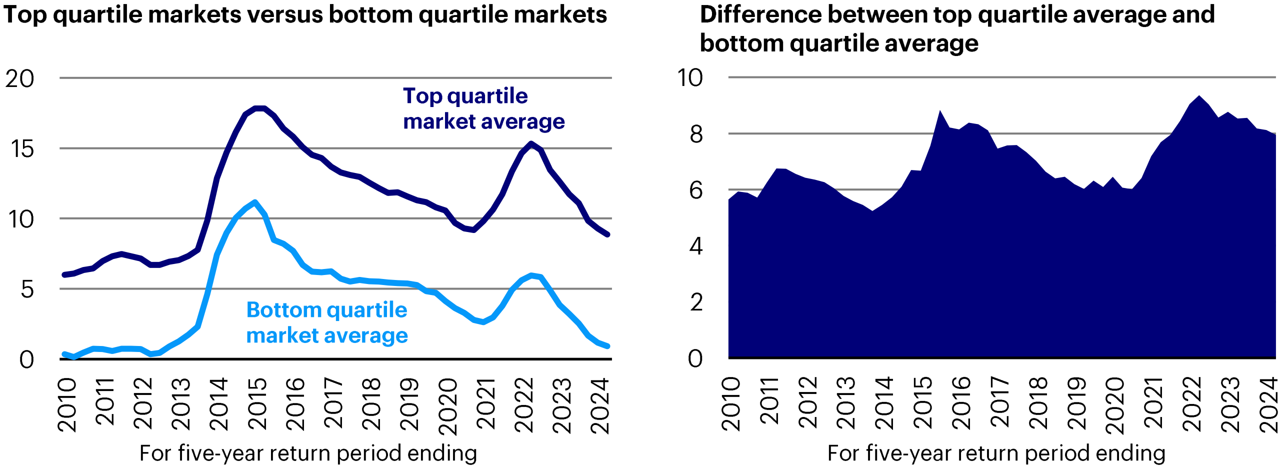
When we assess where the secular demand drivers are for industrial (or any other sector) along these four stages, we can't assume that the coming decade will be like the last one. These trends are dynamic, and we will update our views as we anticipate shifts.

Market

Differences in market-level performance within each sector can be significant. Take the example of apartments. The difference between five-year rolling returns for top-quartile performing markets versus bottom-quartile has consistently ranged from 5% to more than 8%. (See chart below) Individual markets move in and out of the top-quartile and bottom-quartile positions due to the ebb and flow of changes in market prices, changes in supply levels, operating expenses, and capital expenditures. While the composition of markets in the top and bottom positions can change over time, the consistent performance gap between the best and worst markets within a property type is a big reason why market differentiation matters.

Market selection matters: Dispersion of US apartment market return

Annual five-year rolling total return for apartments (%)



Top quartile markets versus bottom quartile markets

Difference between top quartile average and bottom quartile average

Sources: Invesco Real Estate, utilizing data from NCREIF as of June 30, 2024. Full period of shown begins January 1, 2010 and ends June 30, 2024. Past performance does not guarantee future results.

4. Investment strategy: Where to find better relative value

Relative performance across real estate portfolios is driven by sector exposures, market and location exposures, and asset characteristics.

Buy versus build

Commercial real estate prices and construction costs have moved in opposite directions since the start of COVID-19. From Q1-2020 to Q1-2024, average prices fell by 9%[7] while average construction costs rose by 33%.[8] The price of recently delivered product today broadly provides better relative value than building from scratch.

Equity versus debt

Expected real estate unlevered equity returns in early August 2024 of 7.1%[9] exceeded fixed debt costs of 6.1%[10]. This 100-basis point difference is wider than a year ago[11] yet slimmer than historical norms[12] which more fully reflect the risk differences between equity and debt. That's why we believe real estate debt at present offers better relative value. Once base rates and CRE debt rates start to fall, however, we expect that the equity-versus-debt comparison will move along a spectrum. That should improve the attractiveness of CRE equity opportunities while still offering higher debt yields than the 2010's cycle, but lower than recent peaks.

5. Public policy: Local policies impact CRE more directly than national ones

The historical relationship between the party occupying the White House and real estate investment returns has been weak. Not because policies don't matter, but because election-year policies can turn out differently than expected once in office for at least three reasons:

- **Short-term election cycles:** Parties rarely hold the presidency and Congress long enough to fully implement their policies.
- **Intentions versus reality:** Election-year policy positions are rarely implemented as fully intended because of the bipartisan vetting process for new legislation.
- **Lag times with implementation and impact:** Once approved, policies take time to implement, and impacts on consumer and business behaviors take time to unfold.

While we're comparing the policies of the two primary presidential election candidates for potential investment impacts, we believe that state and local policies are far more impactful on real estate. That's where differences in property taxes, insurance, landlord and tenant protections, zoning and permitting, and other issues more directly affect real estate performance.

Conclusion: The need for property income growth

We believe strong property income growth will be needed to drive better relative returns into the new real estate value cycle. That's because the power of cap rate compression experienced in previous recoveries is expected to be tempered in the next cycle. Income growth faces near-term challenges because US economic growth is expected to ease and current pricing largely reflects different sector expectations for income growth and liquidity. This accentuates the need for reliance on secular drivers that can mitigate an easing of the economic cycle. It also elevates the need to seek differentiated performance through market selection, because of the historical gap between top- and bottom-performing markets. We currently see better relative value in purchasing existing buildings instead of new development. We expect that the current risk-adjusted advantage of CRE debt over equity will even-out as interest rates are reduced. While we're focused on the potential impacts of the US presidential election, we believe that differences in state and local policies impact real estate investment more directly.

Defined Terms and Notes

1. The Federal funds (fed funds) rate is the rate at which depository institutions lend to each other. An investment cannot be made directly into an index.
2. Capitalization rates (cap rates) is the quotient of a property's net operating income divided by the property's estimate value.
3. 10-year US Treasury rate is the rate paid by the US government as interest for borrowing money by selling a US Treasury bond with a 10-year maturity.
4. NCREIF Property Index (NPI) is the broadest measure of private real estate index returns. The NPI is published by the National Council of Real Estate Investment Fiduciaries and is a quarterly, composite total return (based on appraisal values) for private commercial real estate properties held for investment purposes including fund expenses but excluding leverage and management and advisory fees. All properties in the NPI have been acquired, at least in part, on behalf of tax-exempt institutional investors and held in a fiduciary environment. NCREIF data reflects the returns of a blended portfolio of institutional quality real estate and does not reflect the use of leverage or the impact of management and advisory fees.
5. Standard deviation is a statistic that measures the dispersion of a dataset relative to its mean.
6. Basis point (bps) is a unit that is equal to one one-hundredth of a percent.
7. Based on the percent value change of the Green Street Commercial Property Price Index, equal-weighted, from March 1, 2020 to April 1, 2024. Green Street's Commercial Property Price Index (CPPI) is used as the proxy for commercial real estate pricing.
8. Based on the percent value change of the Engineering News Record (ENR) Building Cost Index published by McGraw-Hill, from Q1-2020 to Q1-2024. The Engineering News Record (ENR) Building Cost Index is calculated from wage rates and materials prices for the U.S. and each of the 20 metro areas reported. It applies to general construction cost. The dataset includes 20 metro areas in the United States.
9. Based on internal rate of return expectations by Green Street on August 1, 2024 for the equal-weight return average for apartments, industrial, office, and strip retail. Past performance is not a guarantee of future results. Internal rate of return IRR is a metric used in financial analysis to estimate the profitability of potential investments.
10. Based on the Green Street equal-weighted average secured fixed rate debt yield for apartments, industrial, office, and retail on August 9, 2024. Past performance is not a guarantee of future results.
11. Based on data from Green Street for expected real estate equity returns minus and secured fixed rate debt as described in notes 9 and 10 above. The average spread in August 2023 equaled 50 basis points (6.9% expected equity return on August 1, 2023 minus August 2023 secured fixed rate debt average of 6.4%). Past performance is not a guarantee of future results.
12. Based on data from Green Street as described in the previous note. The spread between expected equity real estate returns and secured fixed rate real estate debt in the pre-pandemic years from 2016 to 2019 averaged 189 basis points and ranged from 131 to 253 basis points. Past performance is not a guarantee of future results.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Property and land can be difficult to sell, so investors may not be able to sell such investments when they want to. The value of property is generally a matter of an independent valuer's opinion and may not be realised.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest.

Generally, real estate assets are illiquid in nature. Although certain kinds of investments are expected to generate current income, the return of capital and the realization of gains, if any, from an investment will often occur upon the partial or complete disposition of such investment.

Investing in real estate typically involves a moderate to high degree of risk. The possibility of partial or total loss of capital will exist.

Important information

This paper contains general information only and does not take into account individual objectives, taxation position or financial needs. Nor does this constitute a recommendation of the suitability of any investment strategy for a particular investor. Neither Invesco Ltd. nor any of its member companies guarantee the return of capital, distribution of income or the performance of any fund or strategy. This paper is not an invitation to subscribe for shares in a fund nor is it to be construed as an offer to buy or sell any financial instruments. As with all investments, there are associated inherent risks. This paper is by way of information only. This paper has been prepared only for those persons to whom Invesco has provided it. It should not be relied upon by anyone else and you may only reproduce, circulate and use this document (or any part of it) with the consent of Invesco. Asset management services are provided by Invesco in accordance with appropriate local legislation and regulations.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions if they are uncertain whether an investment is suitable for them.

Data as of June 30, 2024, unless otherwise stated.

Where individuals or the business have expressed opinions, they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice.

Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations.

Invesco Distributors, Inc. is the US distributor for Invesco's retail products and private placement, and is an indirect, wholly owned subsidiary of Invesco Ltd.