US Commercial Real Estate Outlook

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- **We have a constructive view on the US economy with growth remaining strong, inflation moderating further, and interest rates coming down over the next year.**
- **Commercial Real Estate (CRE) prices have bottomed out in the US and the price declines have moderated across all segments; the industrials sector leads while office is recovering.**
- **Falling interest rates and slowing distress growth should help the CRE sector; policies under Trump 2.0 present both opportunities and risks, making diversification more important.**
- **Considering risks, a sudden spike in UST yields could damage the sentiment for the sector while sustained higher levels of yields could negatively impact the activity.**

US Macro: Growth, inflation, and monetary policy

On growth, soft-landing – defined as the slowdown in GDP growth to or below trend without slipping into a recession – is our base-case. A hard landing is an outright recession (NBER style in the US), and a no landing is an acceleration of growth from this point. As the subjective base-case with 50% probability, we think the global economy, led by the US, is on track for a soft landing. Hard landing is the downside risk scenario (with 15% subjective probability), and the no landing scenario represents the upside risk scenario (with a subjective probability of 35%). We note that the probability of the upside risk scenario materializing has increased since the end of summer.

On inflation, in absence of details on which set of policies the US administration will deliver and the sequence of those, we continue to assume that the inflation will trend towards the central bank's target over the next 12 months. Inflation is likely to be stable in the near-term, but upside risks come from some of the reflationary and inflationary policies under the new administration. In the long-term inflation could turn more volatile.

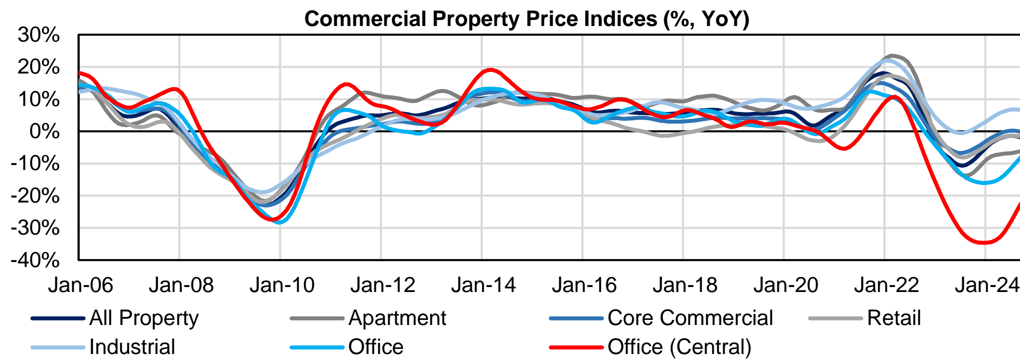
On monetary policy, we continue to think that the Federal reserve will remain on its path of calibrated policy normalization. We continue to expect that the Fed will lower its interest rates to reach our estimated neutral rate of 3% by end-2025 or early-2026. This line of thought is out-of-consensus now given that most market participants think that under Trump 2.0 the Fed will not be able to deliver rate cuts as previously projected. While some of the policies proposed by Trump are indeed inflationary, they also come with some balancing forces, especially those that Fed needs to care about. For instance, higher budget deficits mean higher debt. To that extent, higher interest rates put pressure on debt servicing costs bringing in questions of debt sustainability. As such, looking through the potentially volatile inflation outlook, it is reasonable to expect that productivity growth will offset rise in inflation.

For more on our medium-term outlook, see Q4'24 Outlook: Playing twister, October 2024, and for impact of Trump's re-election, see Trump 2.0 implications: it's all about timing and sequence, November 07 2024.

US Commercial Real Estate sector

- **Performances:** Commercial property price declines have moderated across all segments in the US (exhibit 1). The industrial sector property prices increased over the past year (as we expected in our note US Industrial Real Estate Outlook, April 23 2024) while the office sector price falls have abated. Sharp fall in the property prices seen between 2022 and early 2024 appears largely done.
- **Interest rates:** High borrowing costs have been the key headwind for real estate investors. The rate on newly originated commercial mortgages has risen sharply between September 2021 and October 2023 but moderated slightly recently. This elevated rates of the recent years have influenced the borrowing and refinancing activities, which in turn reduced transaction demand. We think a fall in interest rates is likely to help with the improvement in the real estate sector's demand outlook. For instance, from an investment perspective, lower interest rates typically lead to higher valuation multiples. However, mortgage rates are more closely tied to the 10Y rates than the short-term rates (exhibit 2). Here, apart from the actual policy rate, demand and supply of treasuries is also likely to influence the 10Y rates. Therefore, there is a scenario (which we define as the risk scenario) where the long-end rate remains elevated due to term premium. Under this scenario, a further moderation in mortgage rates might be delayed.

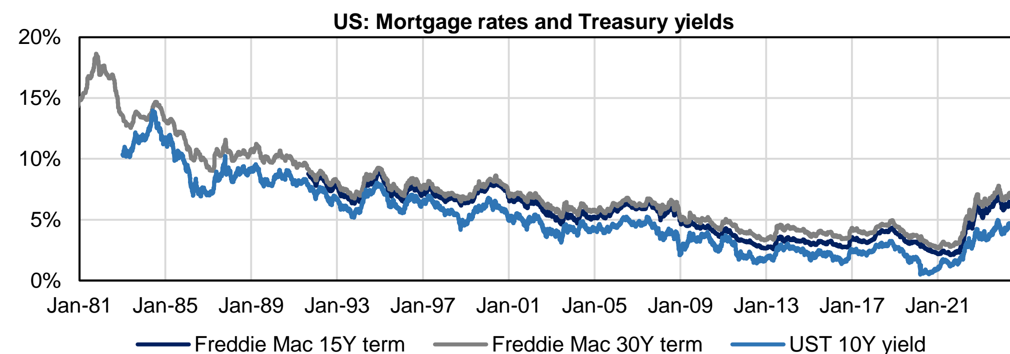
Exhibit 1: CRE price declines have moderated across all segments



Source: Real Capital Analytics, LSEG Workspace, and ADCB Asset Management

- **Distress growth has slowed:** The value of distress, which is calculated as the total of assets that are financially troubled and those that are taken back by lenders reached USD103bn by end of Q3'24 (for comparison, after the Global financial crisis of 2007/08, total distress reached USD200bn in mid-2010). The growth in distressed assets during Q3'24 came at the slowest pace since Q4'22. Growth in newly distressed assets has fallen consistently over the past four quarters while the worked-out portion increased.
- **Trump 2.0:** While the second term of Trump administration is likely to create volatility (this is of course relevant for all asset classes beyond CRE), benefits of a deregulated environment and tax-friendly incentives should not be ignored. Tariffs could impact construction costs, and immigration policies could tighten labour markets implying higher costs for the real estate construction which could result in reduced supply to the market. Uncertainties around policies and their implications for various sectors of the US economy call for a diversified exposure to the commercial real estate asset class. Long-term investors might also benefit from reduced realized volatility by staying invested in some of the private real estate investments.
- **Risks:** A sudden spike in UST yields (caused by debt sustainability concerns or reflationary policies from the new US administration) could damage the sentiment for the sector while sustained higher levels of yields could negatively impact the activity. Higher inflation caused by Trump policies is a double-edged sword: on the one hand it helps demand for real assets (including real estate) but on the other hand it causes interest rates to stay higher for longer.

Exhibit 2: US Mortgage rates closely track yields on 10Y USTs



Source: Freddie Mac, LSEG Workspace, and ADCB Asset Management

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