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Better Faster Decisions

Economic and CRE Update

Emerging Clarity?

- Thomas P. LaSalvia PhD – Director of Economic Research

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Web: https://cre.moodysanalytics.com/insights/

- January 2023

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- Economic Trends & Forecasts

Is the Economy Expanding???

Yes

RGDP: Q4 = 2.9% annualized & 2022 = 2.1%

- Above US "potential" of ~ 1.9%
- Consumer spending and Business Investment are Stronger than the decline in residential investment

So Far….

Is a Recession Coming???

We will get to that….. But first….

What Actually Defines a Recession???

NBER definition of a recession: a ***significant*** decline in economic activity that is ***spread across*** the economy and that ***lasts more than a few months***.

How will we know we are in a recession???

Not GDP, but …   Labor, Labor, Labor (Sahm rule)

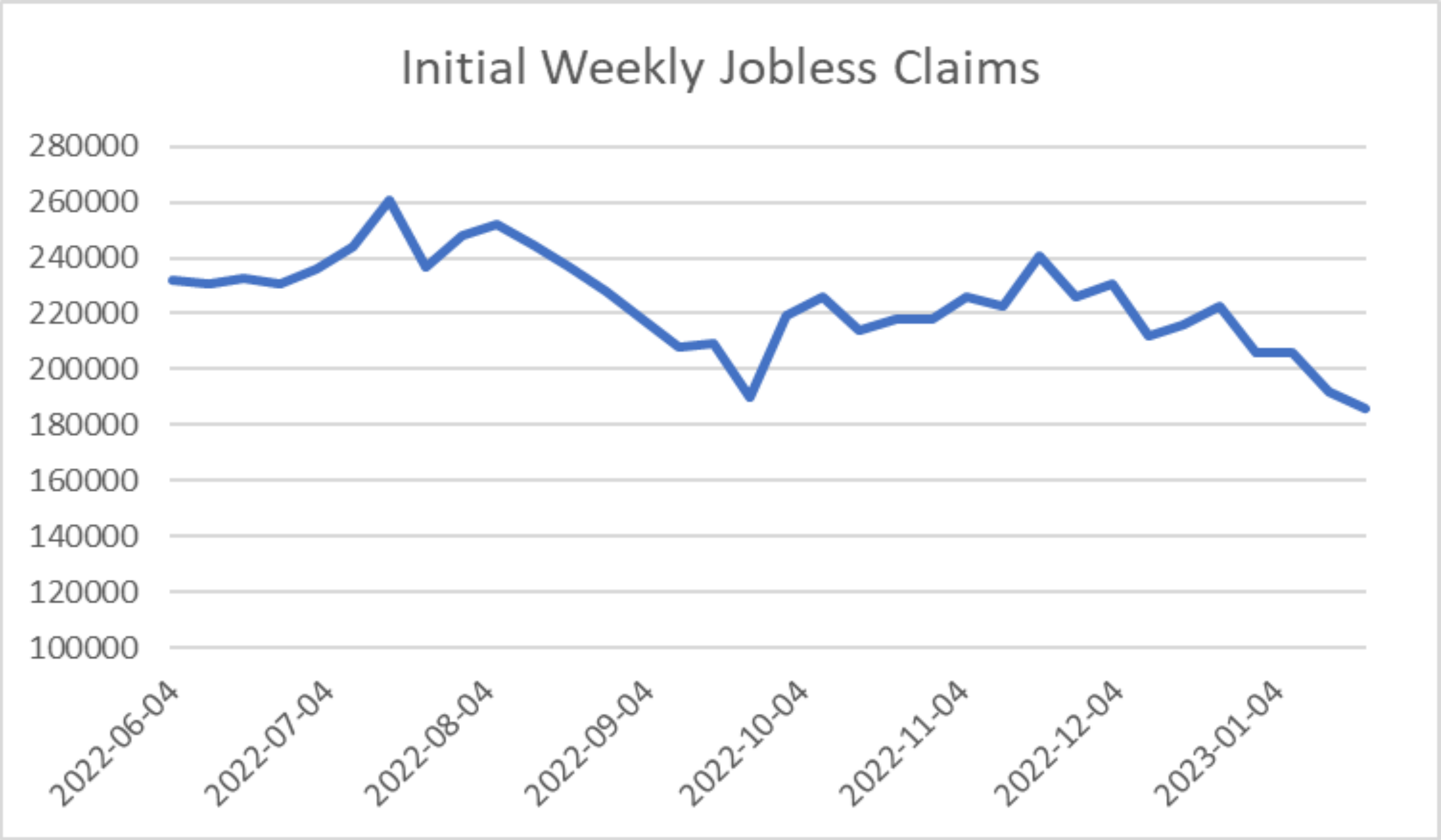
Year-over-year change in the unemployment rate, %

Not even close

Sources: BLS, Moody's Analytics

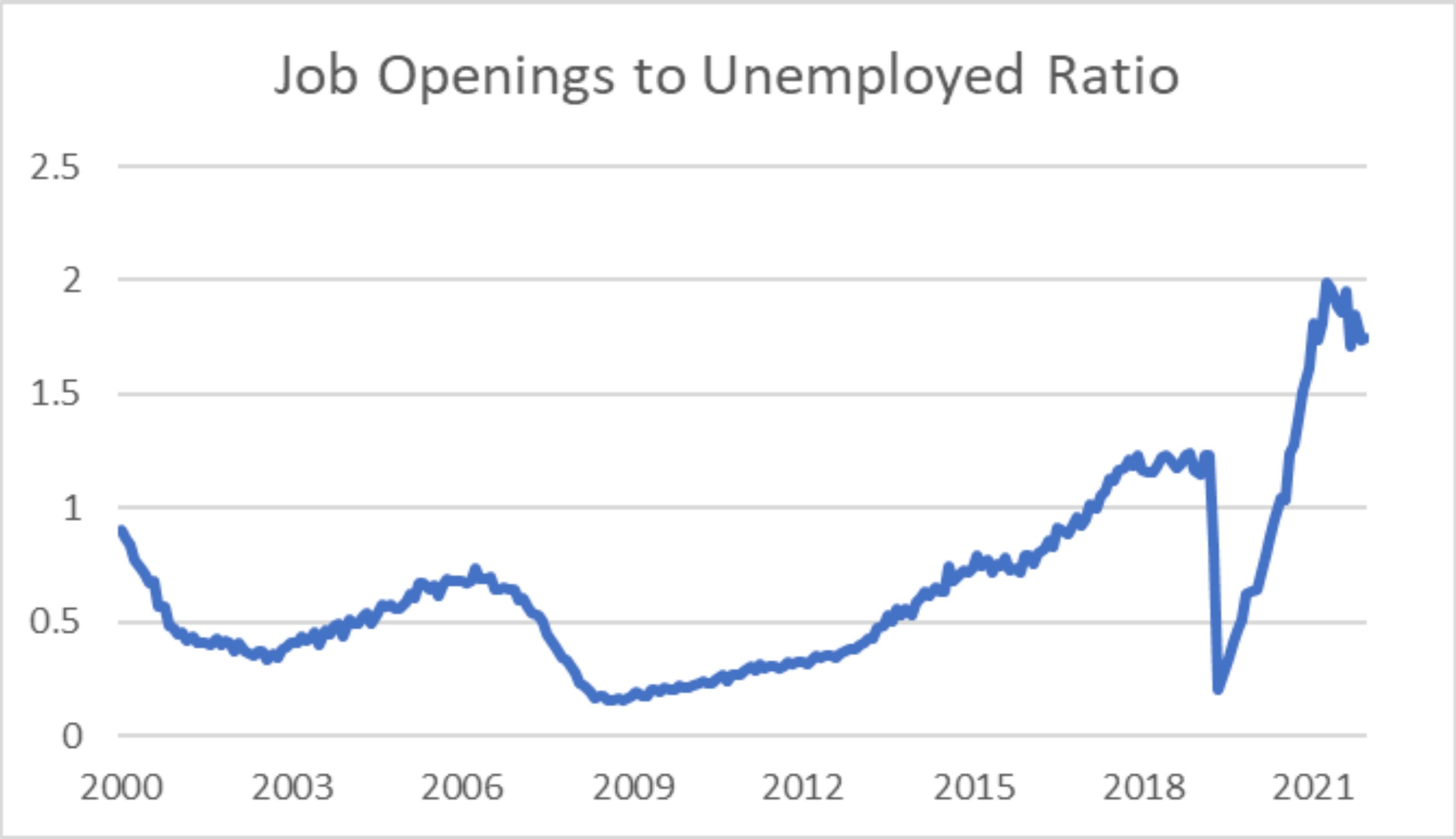
So then, what about tech layoffs???

Concerning, but a bit sensationalized



Is there any more evidence???

Why Yes…



Wisconsin:

- 261k openings

  + 35k openings in Dec

- 99k Unemployed
- Ratio of 2.6!!!!

- A Labor Supply concern?
  - Not Participation rate
    - 64%
  - Pop skews older than avg
  - Domestic outmigration 4 of last 6 years, but… maybe turning the corner

Isn't this Bad for Inflation???

Unfortunately, Yes

2% will be tricky: Inflation is like???

Easy to get out

Difficult and messy to get back in

Inflation is caused by???

$\underbrace{\text{Too much money}}_{\text{Demand}}$ chasing $\underbrace{\text{too few goods}}_{\text{Supply}}$

Demand

- Employment and Income
- Expectations*

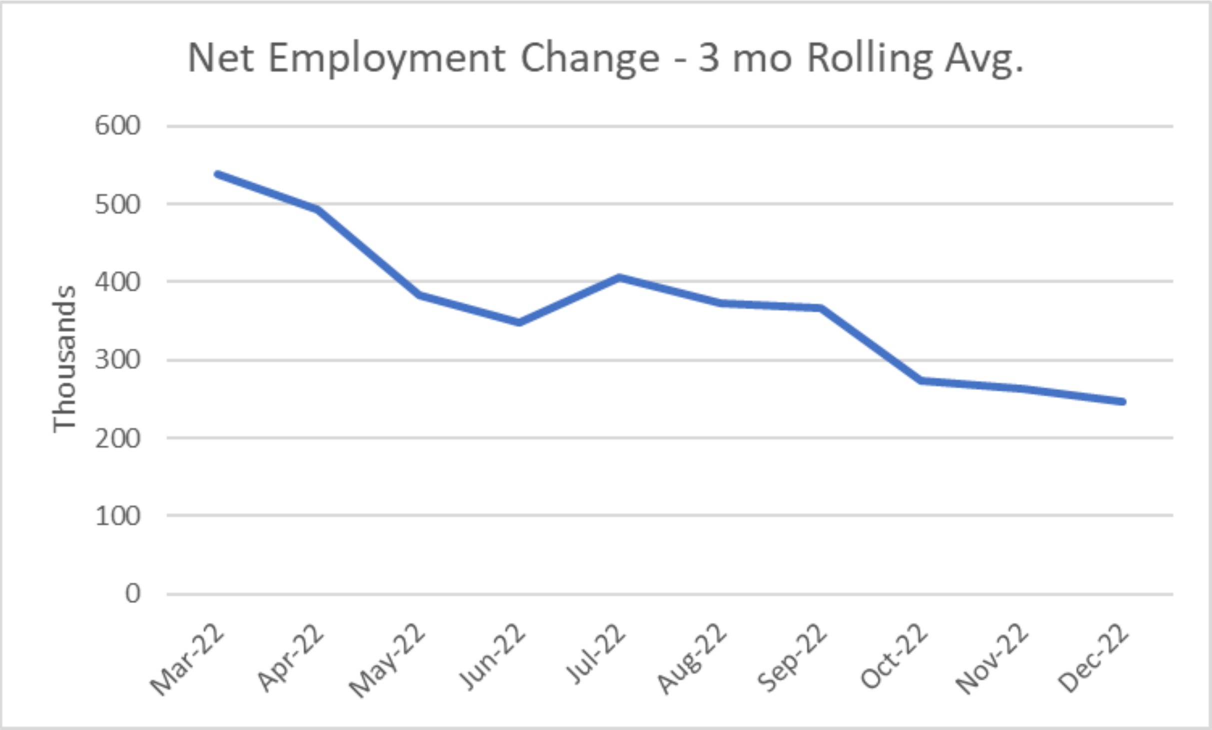
Supply

- Supply Chain
- Energy
- Labor Costs
- Productivity

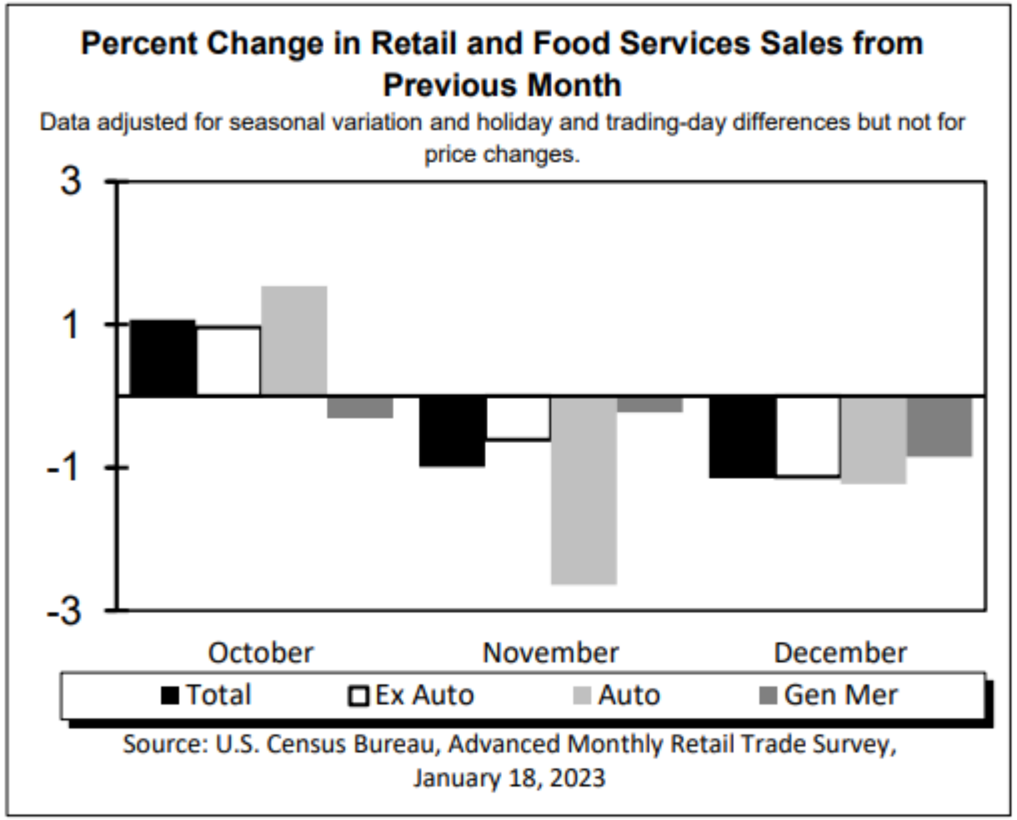
When is a bad thing a good thing???

A softening labor market is a good thing right now

- Reduce demand (spending)



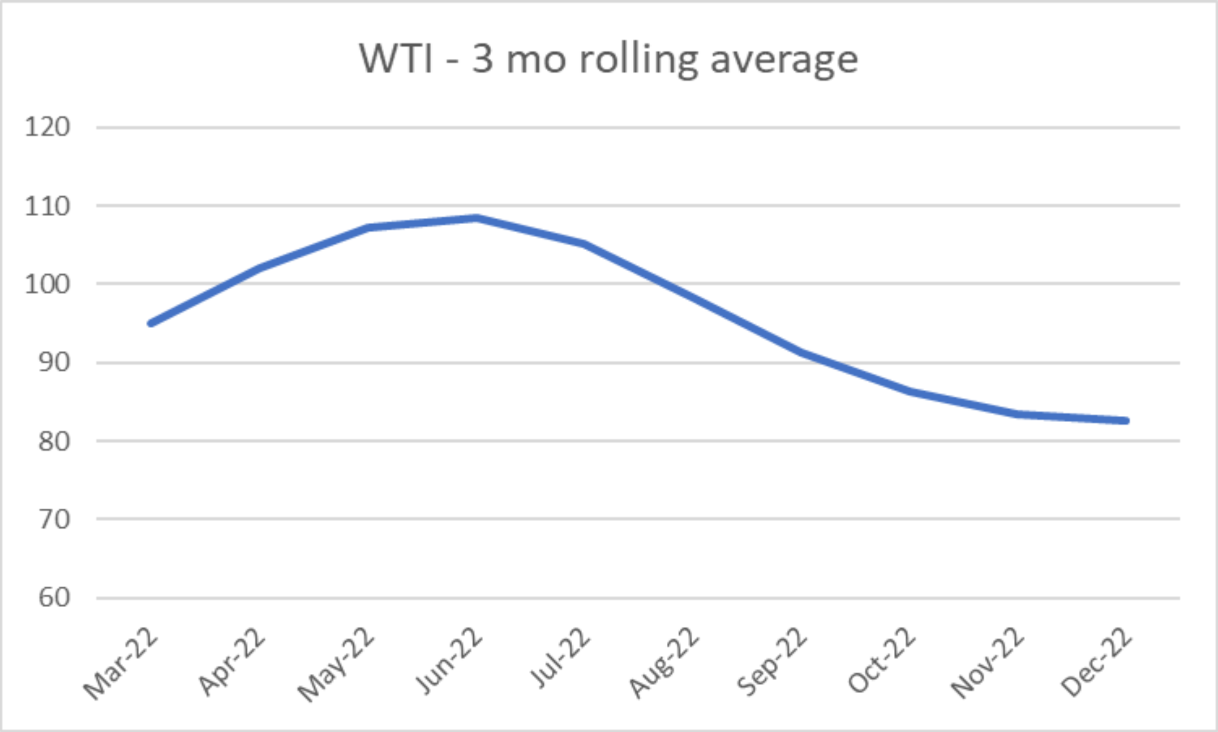
Source: Moody's Analytics, BLS, US Census

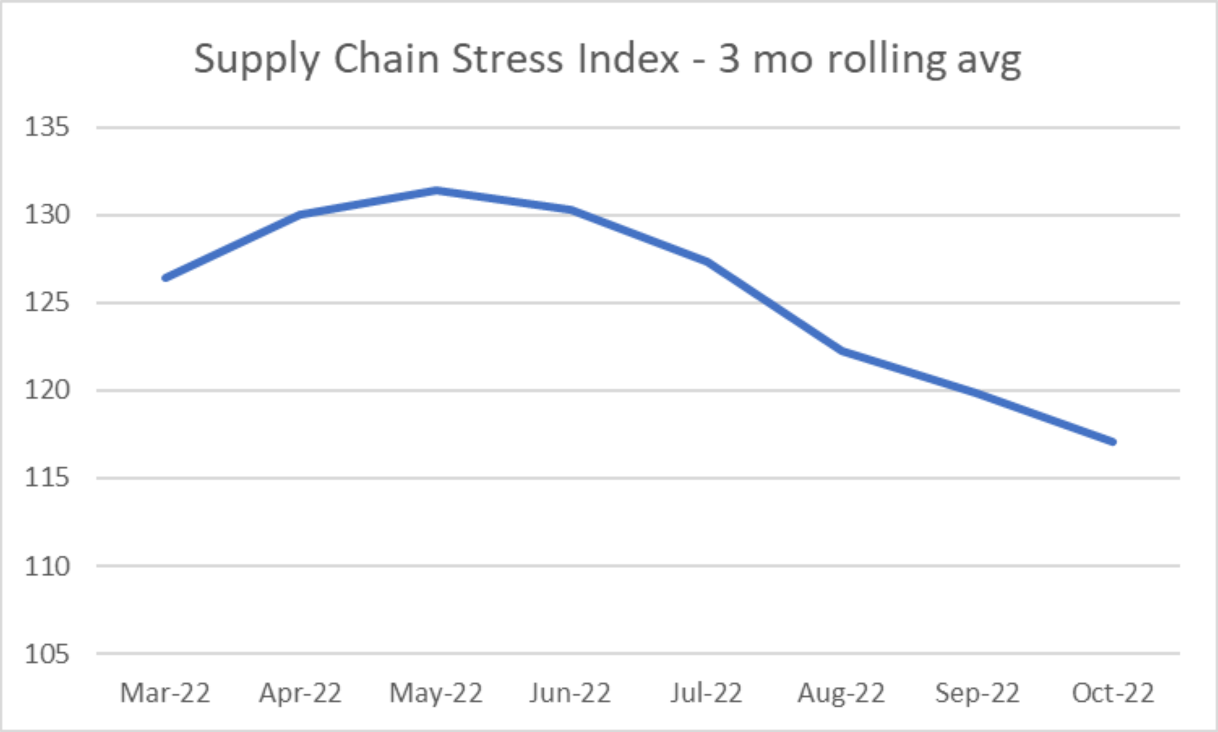


When is a good thing a good thing???

Lower Oil Prices, Less Supply Chain Issues

- Increase Supply – lower production and shipping costs



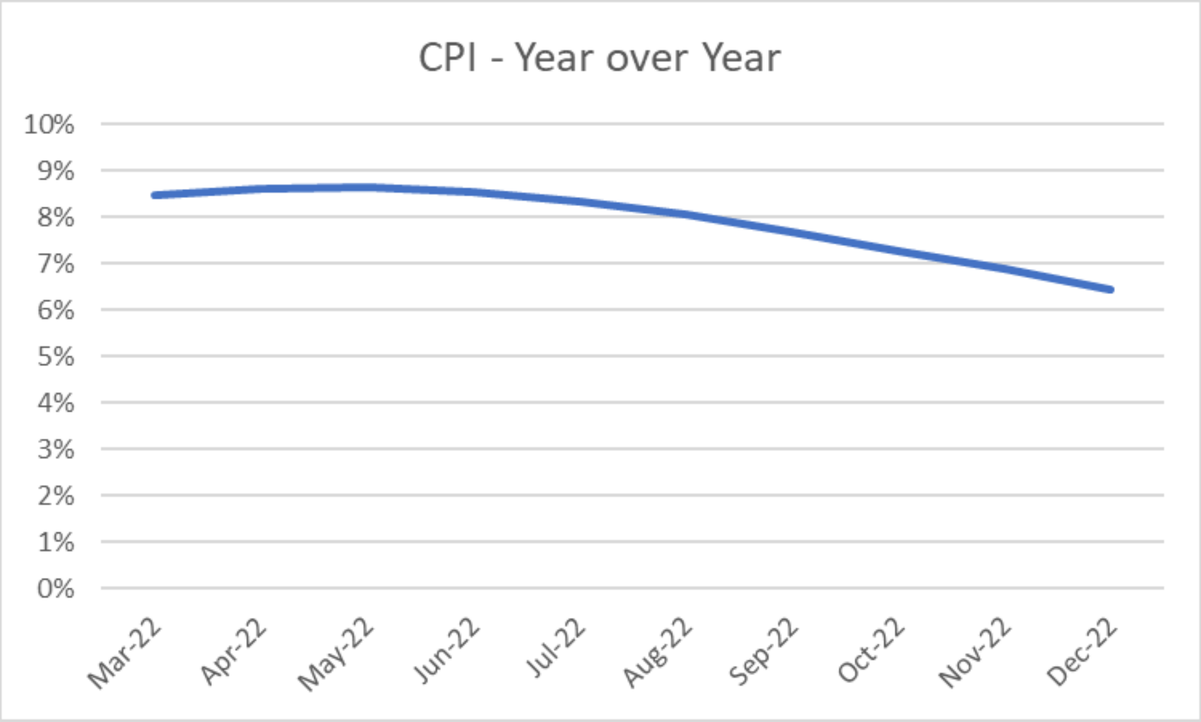


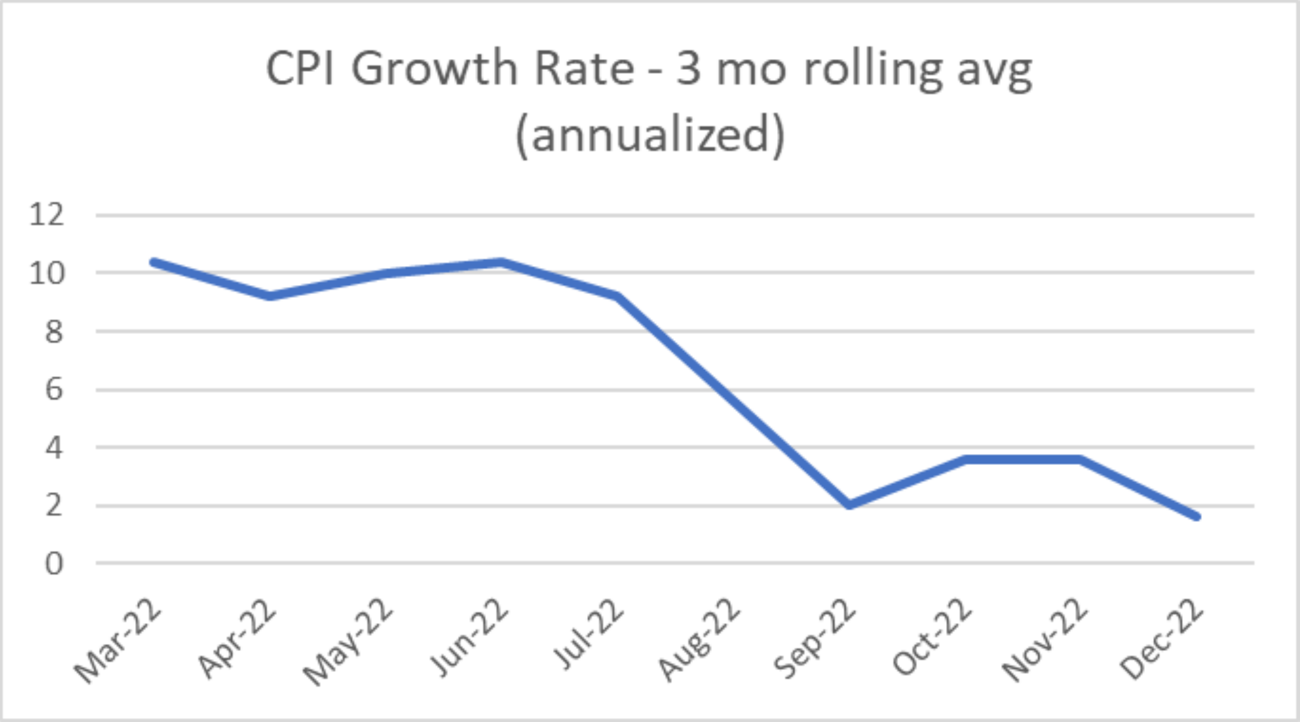
Source: Moody's Analytics

So, we are on the right track???

It depends on how you look at it.

- Year over year vs. monthly annualized





Source: Moody's Analytics, BLS

What do the next 6 to 12 months look like???

- ➢Fed raised rates 50 bps on December 15
- ➢Fed will likely raise rates 25 bps tomorrow
- ➢Fed will likely raise rates 0 to 25 bps on Mar 16, then <u>Hold</u>

<u>If supply side keeps improving</u>

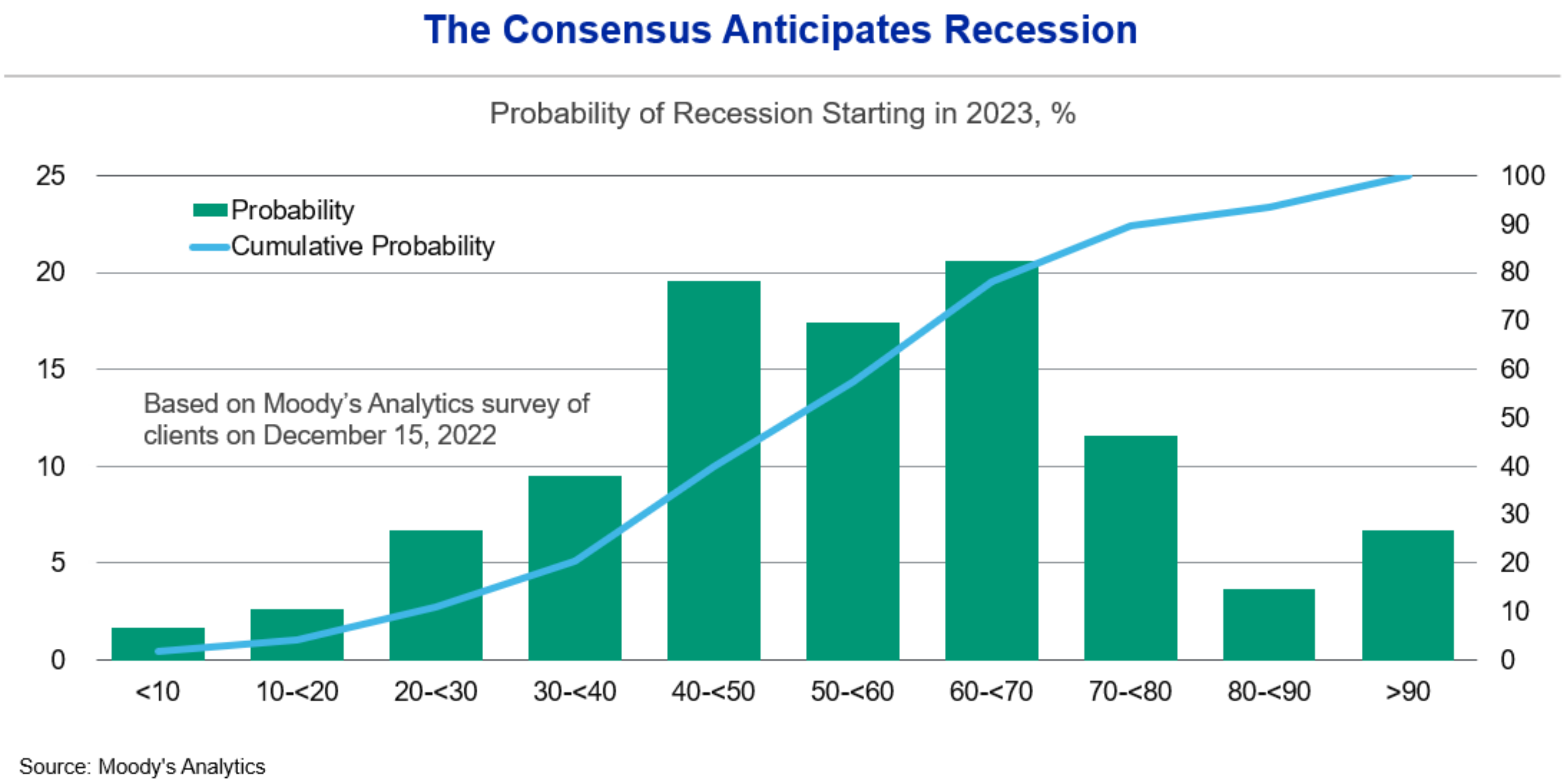
- CPI (y/y) < 5% by April `23
- Avoid a deep recession or maybe any recession at all
- Fed pivots end of year?

<u>If supply side stumbles (already is?)</u>

(Labor Strike, Russia/Ukraine, Consumers)

- CPI (y/y) ~ 6.5% by April `23
- Fed will resume increases
- Recession becomes quite likely

Probability of a Recession?



If optimistic outcome, is all well???

Not quite

- Positive but Slow GDP growth 0-1.5% (“slowcession”)
- Unemployment rate slightly increases to 4 – 4.5%

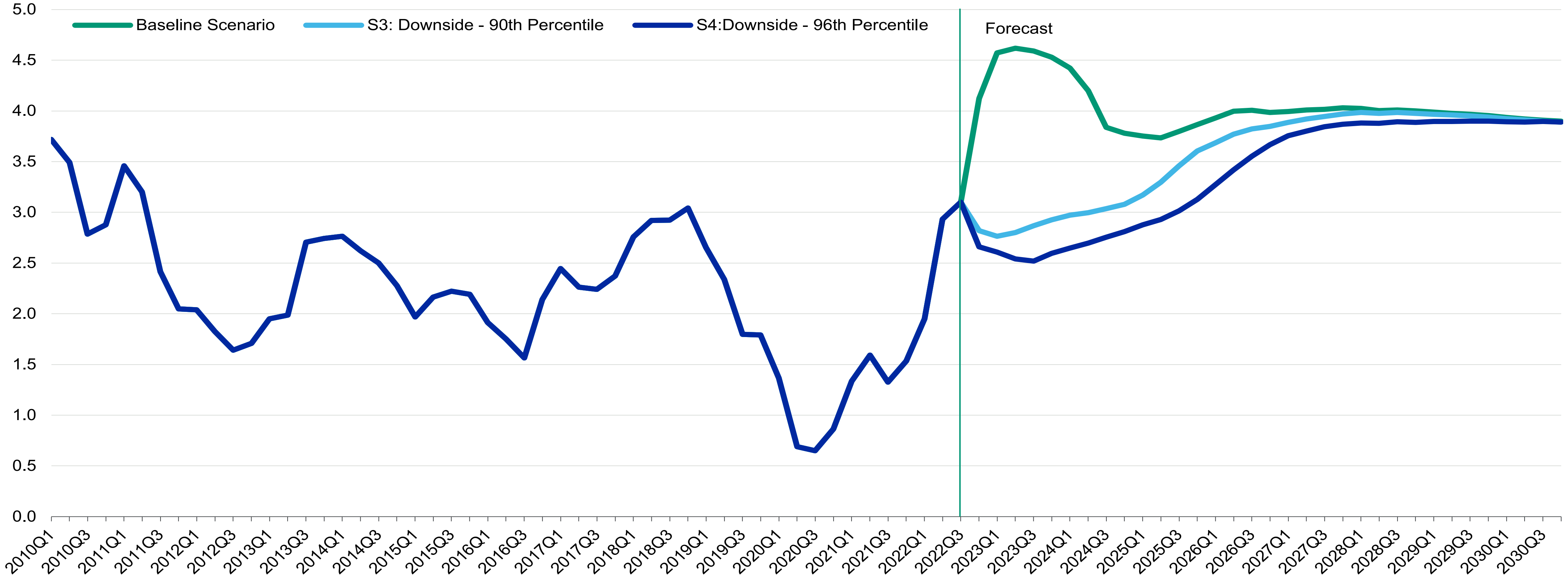
If pessimistic outcome, is all hell???

Not quite – this is not 2008

- Negative GDP growth 1 - 2%
- Unemployment rate increases to 6 - 7%

What about Interest Rates? (UST 10 yr)

Regardless, look at where we end up…



Source: Moody's Analytics

Why is all of this important for CRE???

High interest rates – increased financing costs

- Slows development
- Dampens transactions
- Decreases value appreciation, causes value declines
- Difficultly refinancing

Recession – decreases business and consumer activity

- Slows household formation – hurts MF (Class A first, then BC)
- Affects tenants ability to pay current rent and their desire to expand - across all sectors

Biggest Fear? Both Stick Around (Stagflation)

- geopolitical issues hurt supply (inflation), while consumers extend too much (credit defaults)

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- CRE Trends and Forecasts

Sort of…

It is the *location of labor* that matters

So, it is now - Labor, Labor, Labor

*and water, but so far no one really seems to care

What does this mean for Local Markets???

Keep Labor Happy and Keep it Coming

Winners from this pandemic period of migration will be those that can provide:

- quality and **cost-effective housing**
- quality and a variety of infrastructure
- quality education and a diversity of skill (and people)

Is housing cost-effective (affordable)???

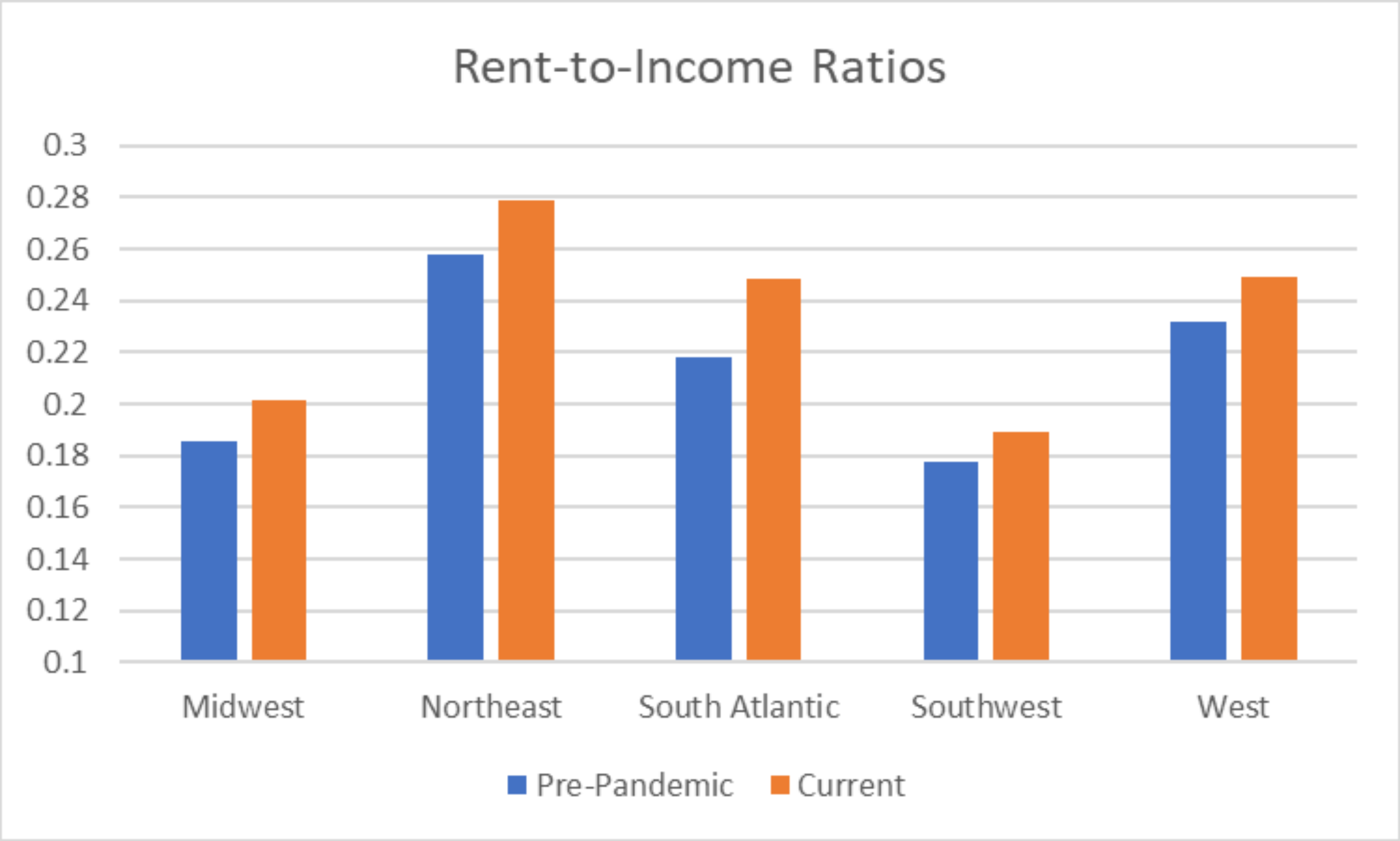
Less so everywhere, but it still depends….

Milwaukee = .22

Madison = .20

Minneapolis = .20

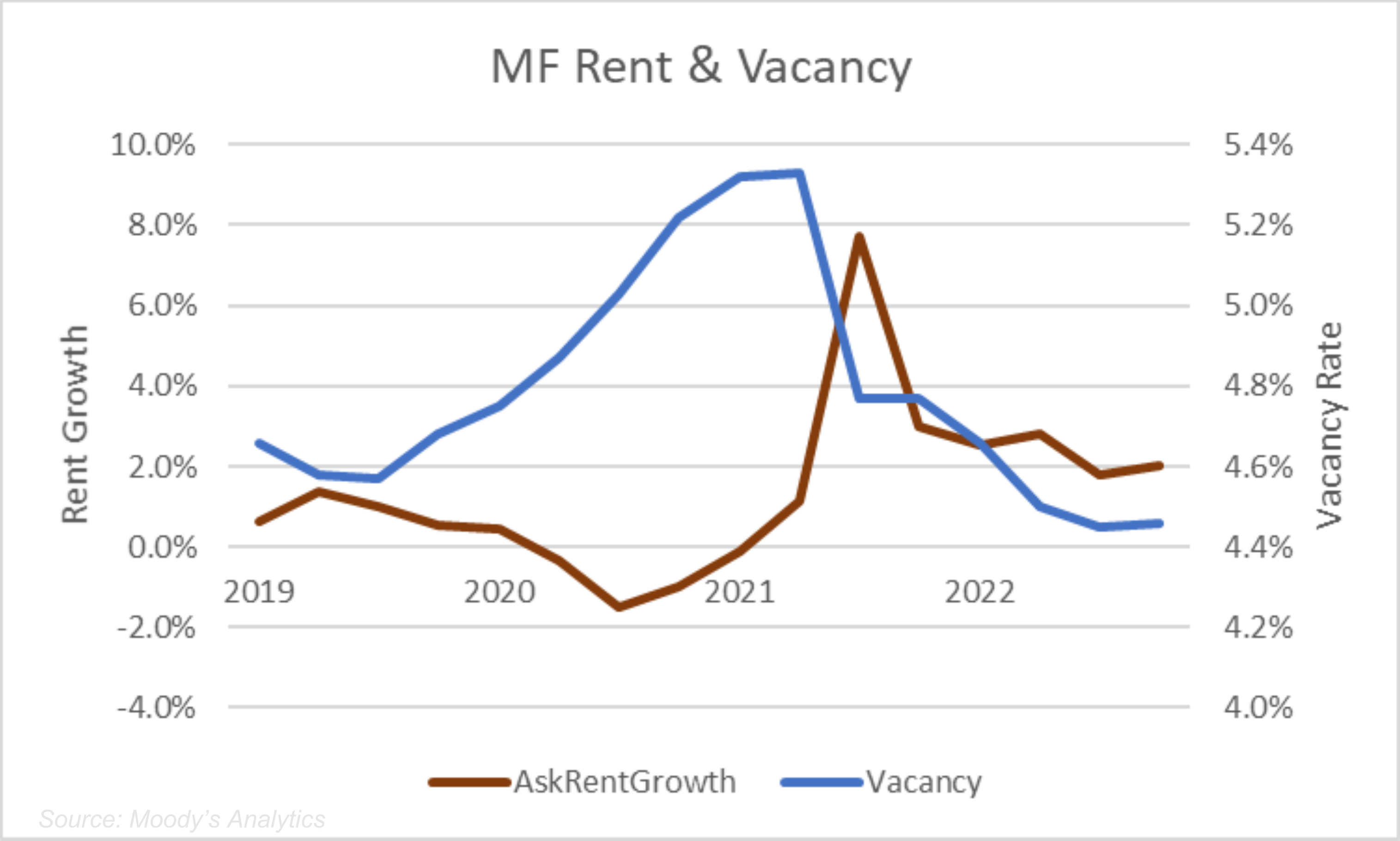
Chicago = .26



Source: Moody's Analytics

How is this affecting Multifamily rent growth???

Deceleration has commenced, but decline unlikely….



- Negative relationship holds
  - Vac down & Rent up
- **A sub 5% vacancy rate is typically related to positive rent growth**
  - Regardless of vac trajectory

Is there variation between metros???

Yes, and a shift is underway…

Many Pandemic "Darlings" are realizing rent reversals or a major deceleration

***Housing affordability is key to sustained growth**

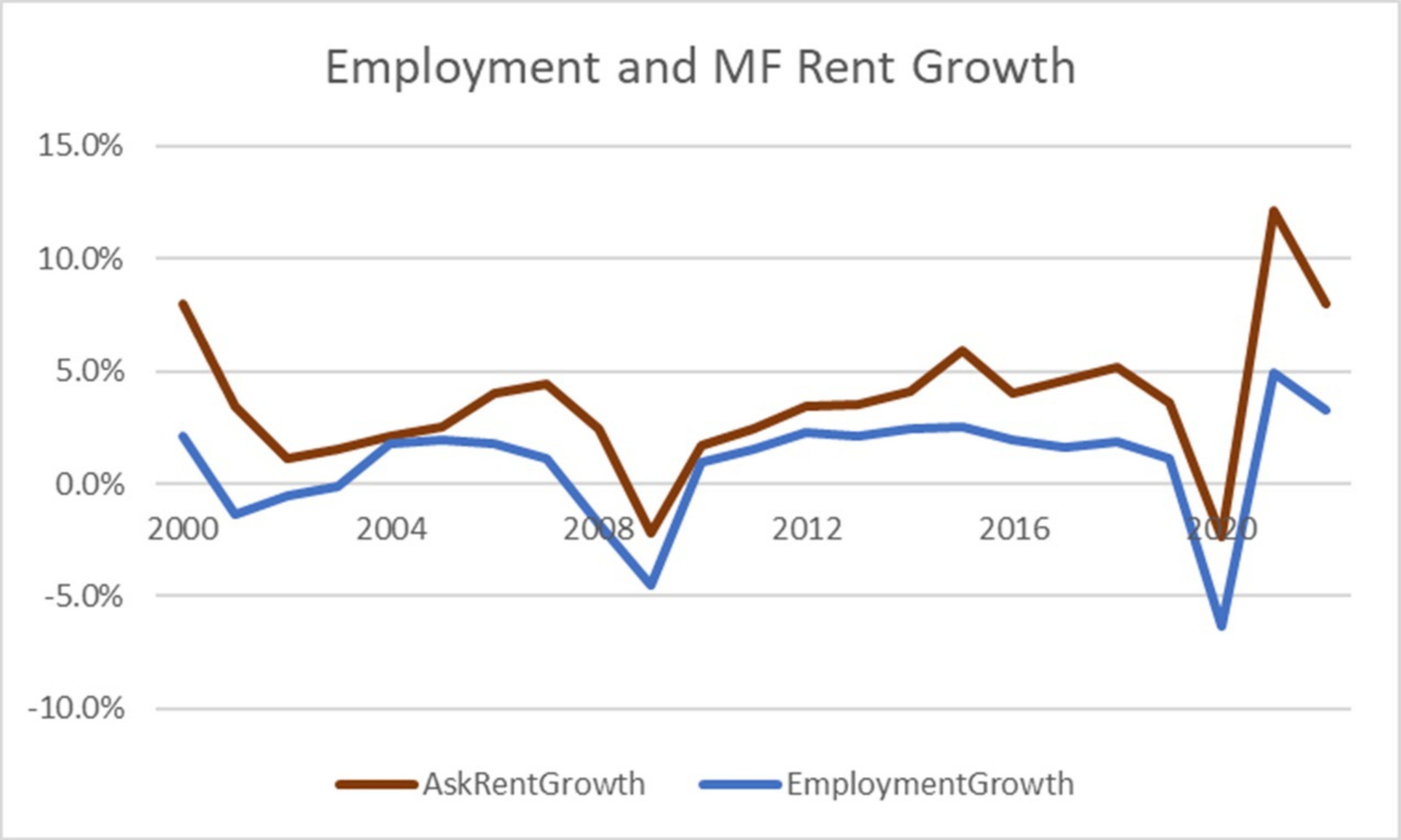
- Milwaukee ~ 17%
- Madison ~ 15%
- Minneapolis ~ 10%
- Chicago ~18%
- US ~ 18%

Notable Metros (Q3 Asking Rent Growth)				
Below Average Rent Growth			Above Average Rent Growth	
Fort Worth	-0.30%		Boston	4.50%
Tampa	-0.30%		Seattle	4.30%
Jacksonville	-0.20%		Cinncinati	4%
San Antonio	0.10%		Philadelphia	3.80%
Salt Lake	0.20%		Nashville	3.70%
Palm Beach	0.30%		St. Louis	3.60%
Charlotte	0.40%		Omaha	3.40%
Miami	0.50%		Indianapolis	3.20%
Orlando	0.60%		Knoxville	3.20%
Las Vegas	0.90%		New York	3.20%
Raleigh	1.10%		Cleveland	3.10%
Phoenix	1.50%		Columbus	3%

Source: Moody's Analytics

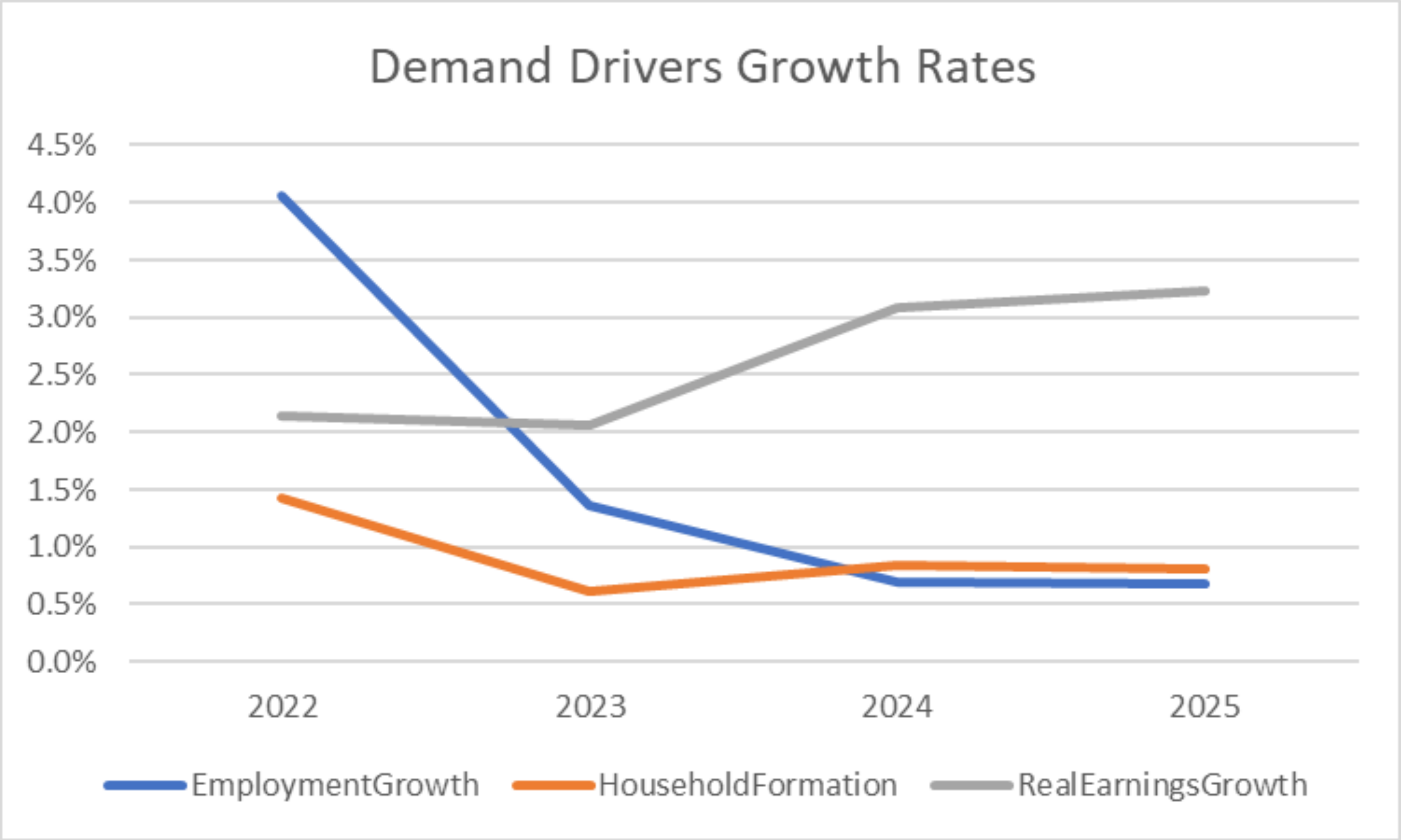
What will it take for Multifamily to suffer???

Labor, Labor, Labor



Source: Moody's Analytics

Will the Labor market suffer???
A bit….

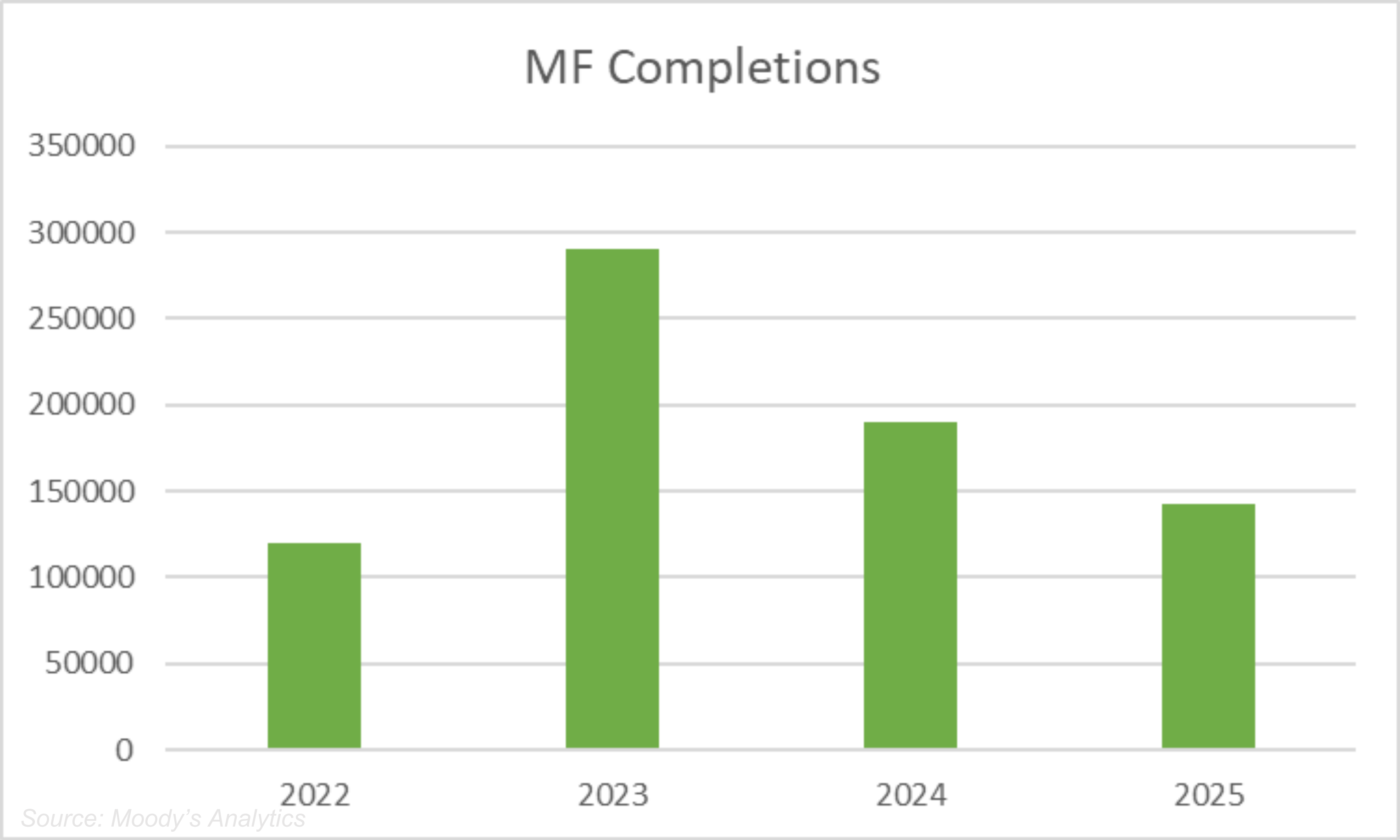


- Employment Growth Falls
- Household Formation Falls
- Real Earnings Falls then recovers

- **None of these go negative**

Source: Moody's Analytics

Anything Else???
Yes, Oversupply

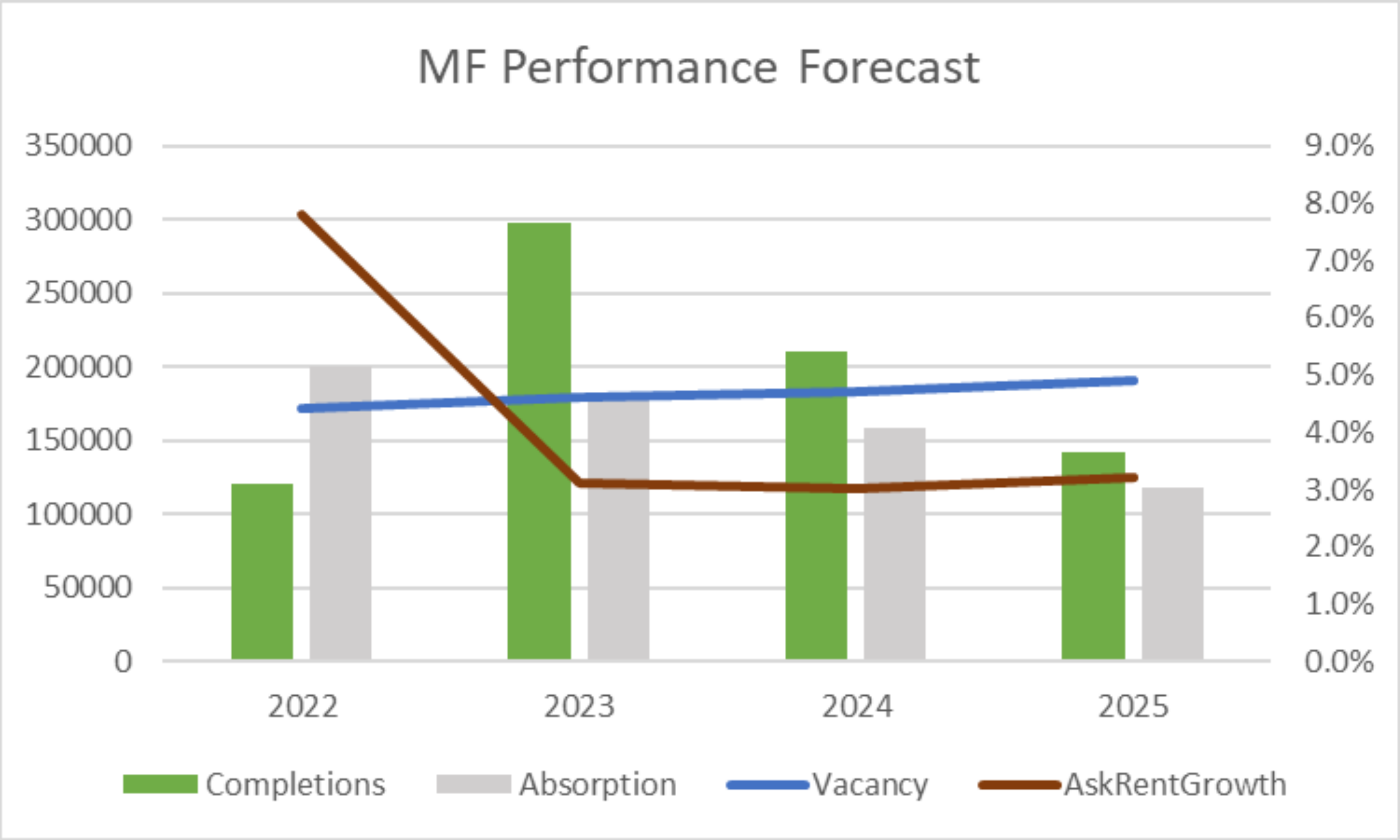


The pipeline is large but…

- ➢ It is mostly due to lower than average deliveries in 2022
  - Labor, materials, uncertainty, financing cost
- ➢ The two year avg. ('22-'23) will be fairly average

Softening Demand and Average(ish) Supply = ???

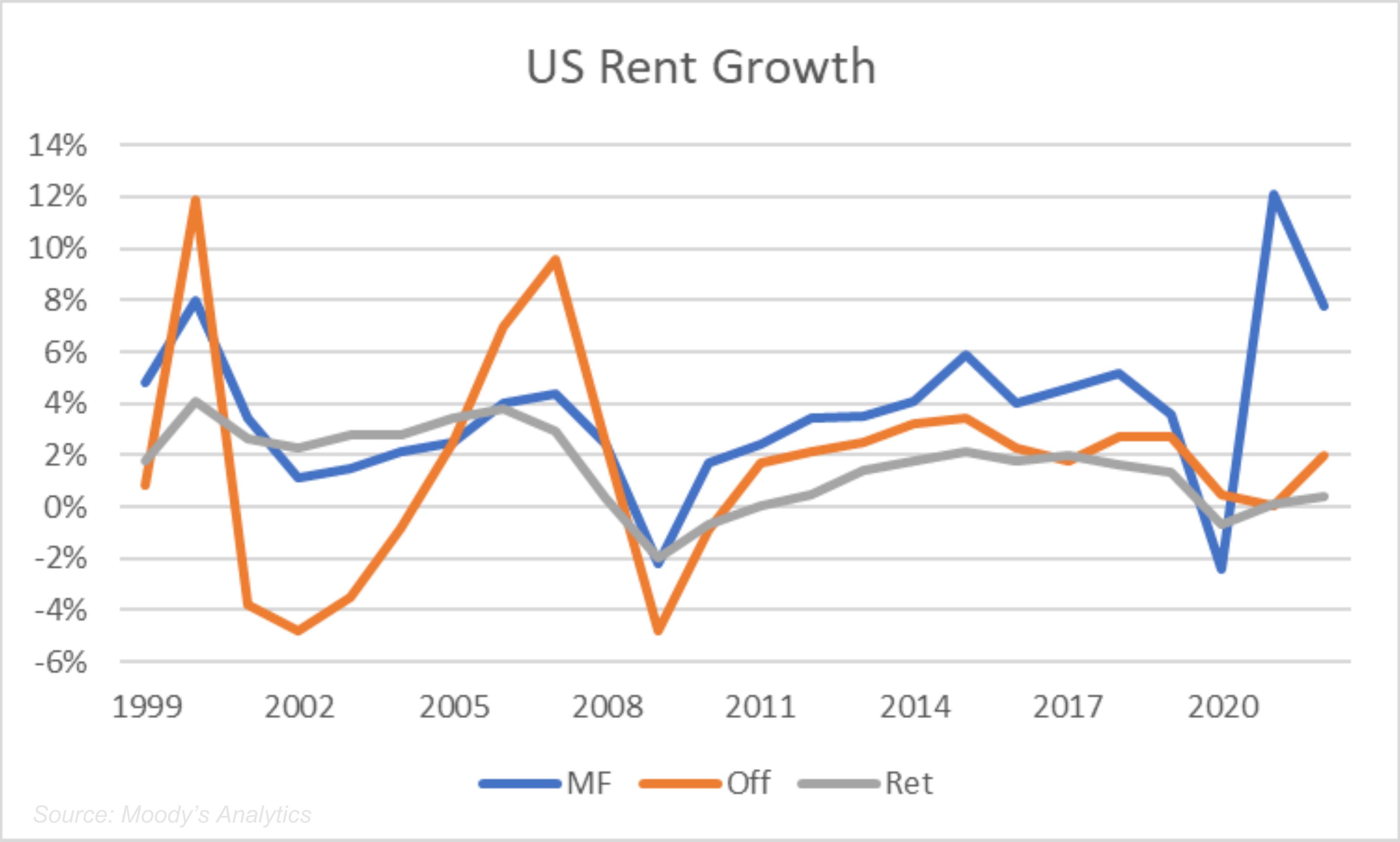
Deceleration, not decline…..



- Slight Vacancy Increases
- Rent Growth Slows to just below long run average
- **We are monitoring very, very carefully….**

Source: Moody's Analytics

Tom, why do you talk about MF so much???
High Correlation across property type…



National and Metro Level

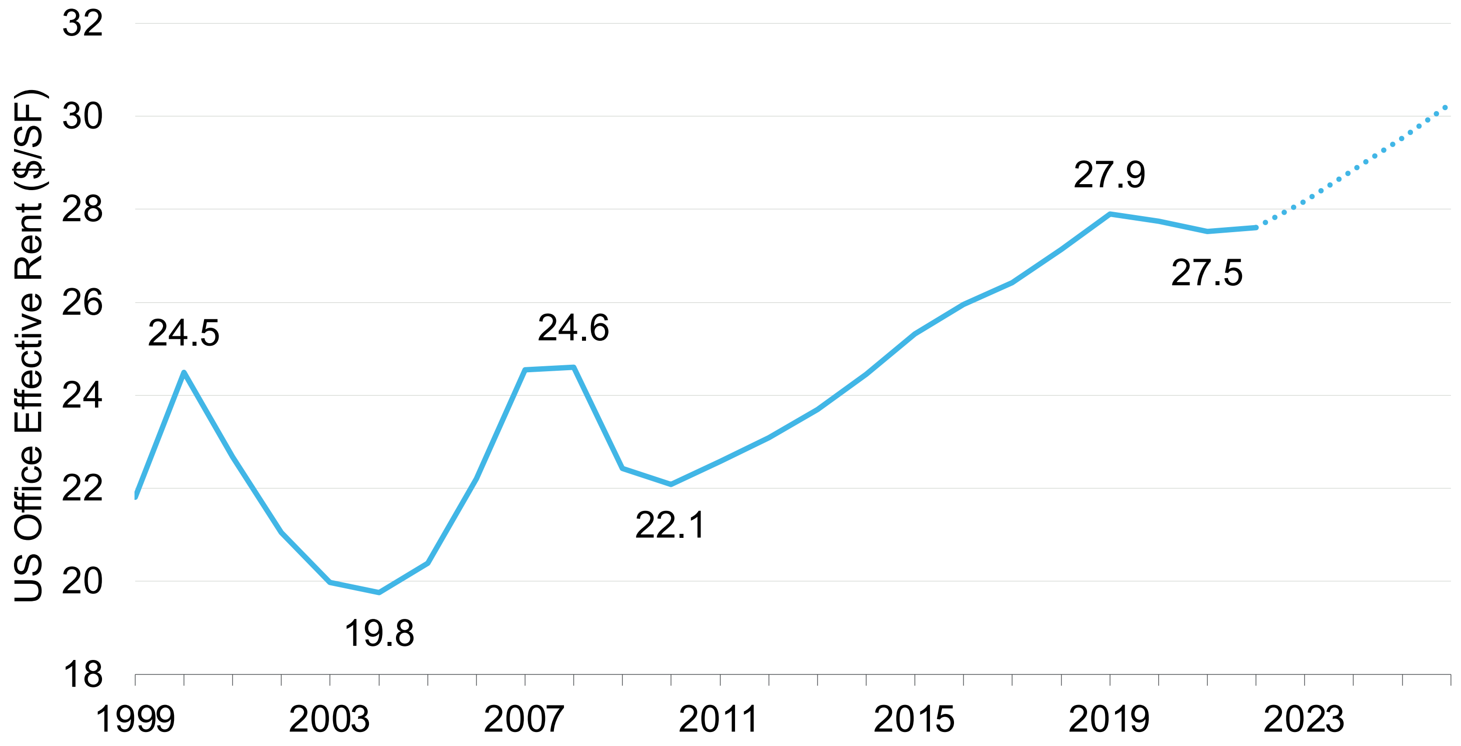
- Same Peaks and Troughs
- Office is much more variable

Will the Relationship weaken?

- Remote work…

How Bad are things in the Office Sector???

Not that Bad, Yet….

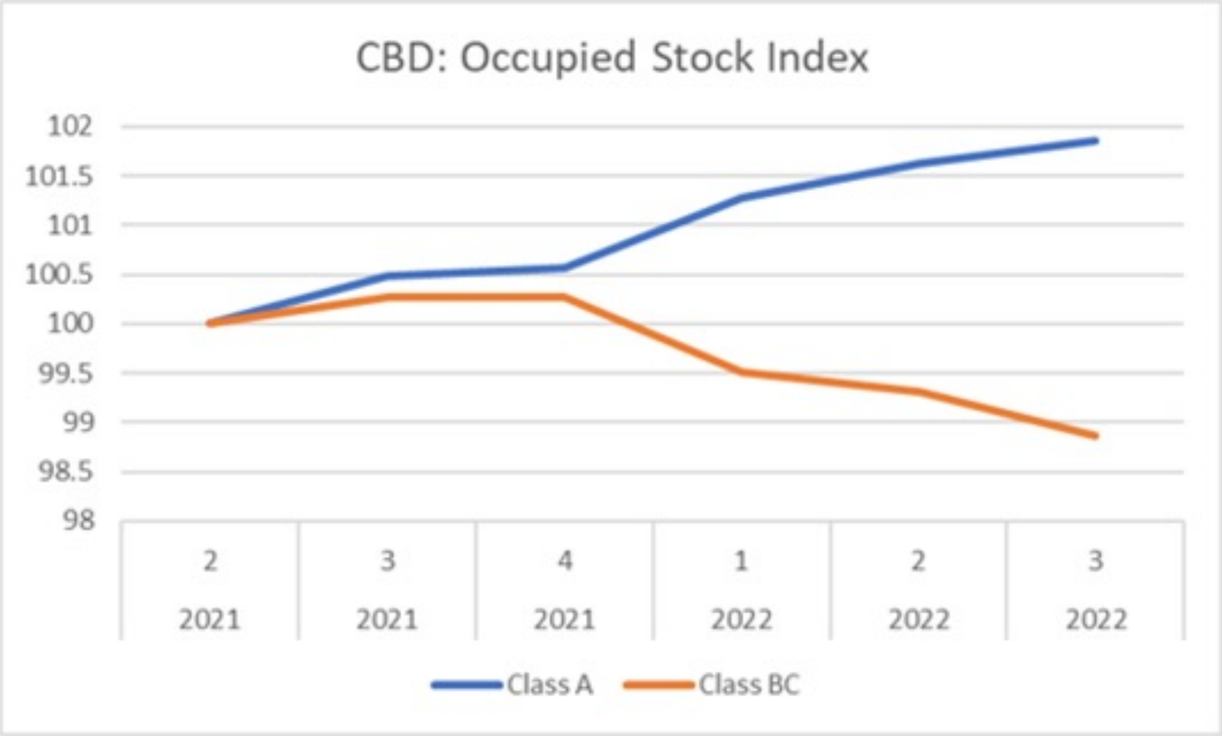


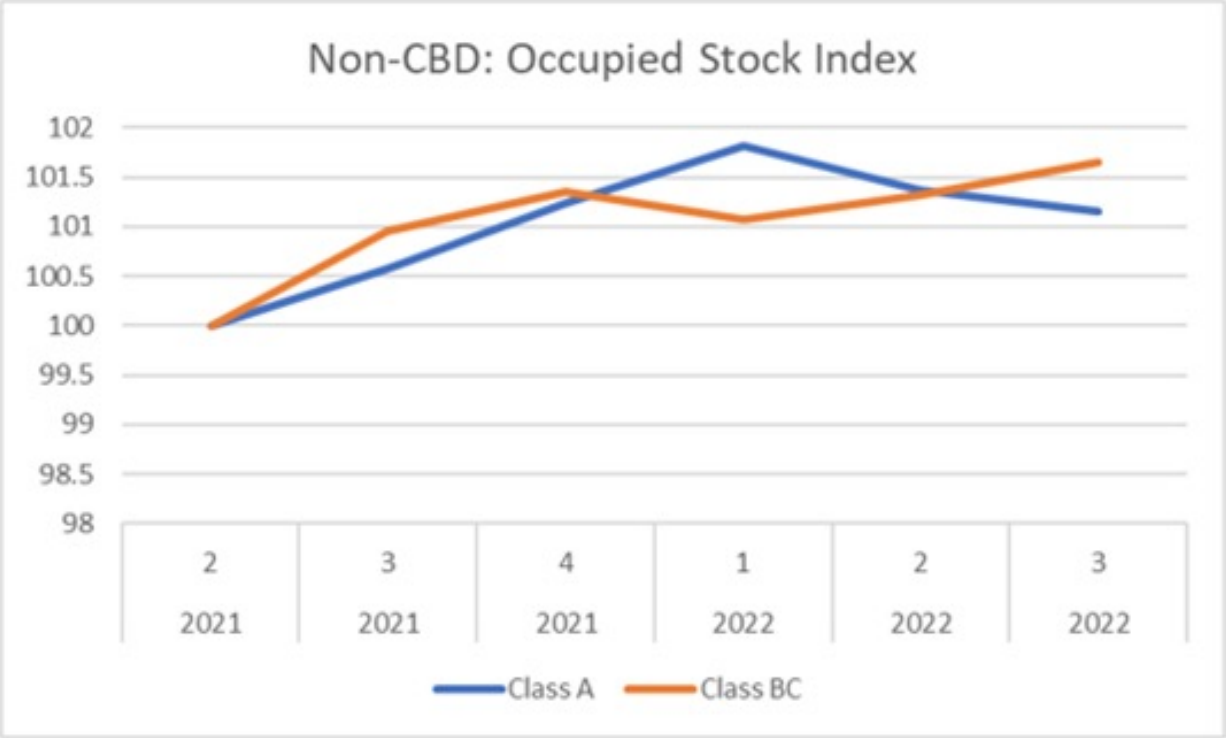
Source: Moody's Analytics REIS

- Much more **benign downturn** than previous times.
- **Five-to-ten-year trial-and-error process** regarding remote work policies
- **The Debate:**
  - ➢Recession – good, bad?

Is “Flight to Quality” a real phenomenon???

Yes, certainly for Central Business Districts

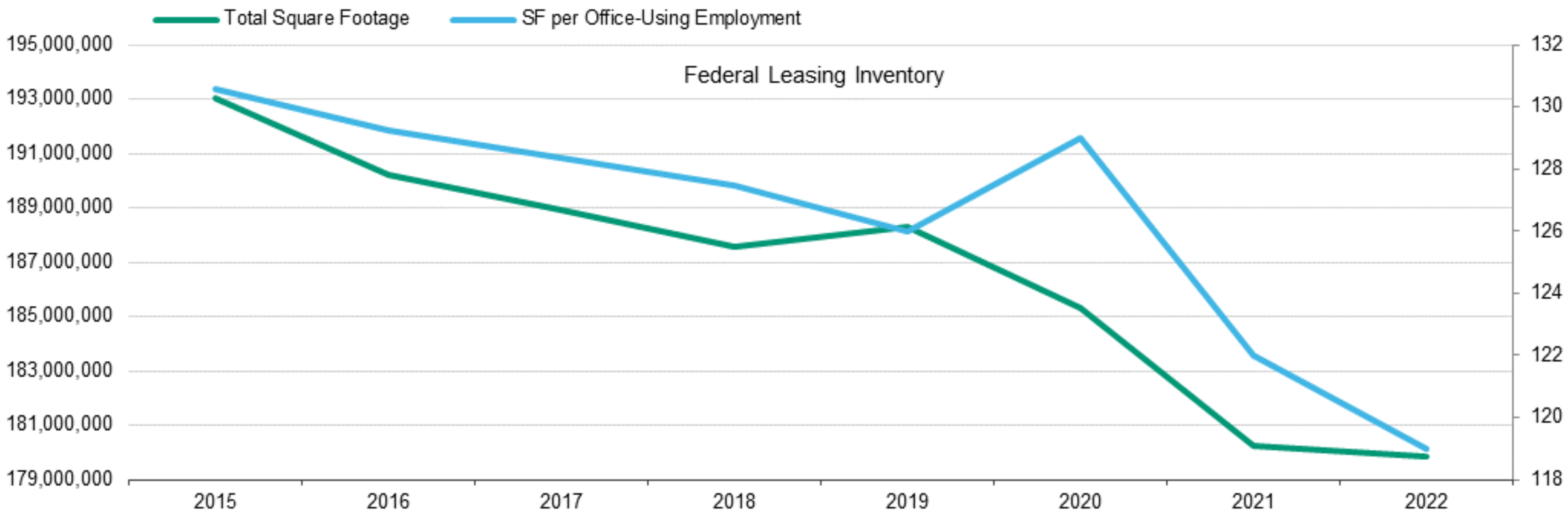




Source: Moody’s Analytics

Evidence of lease reduction???

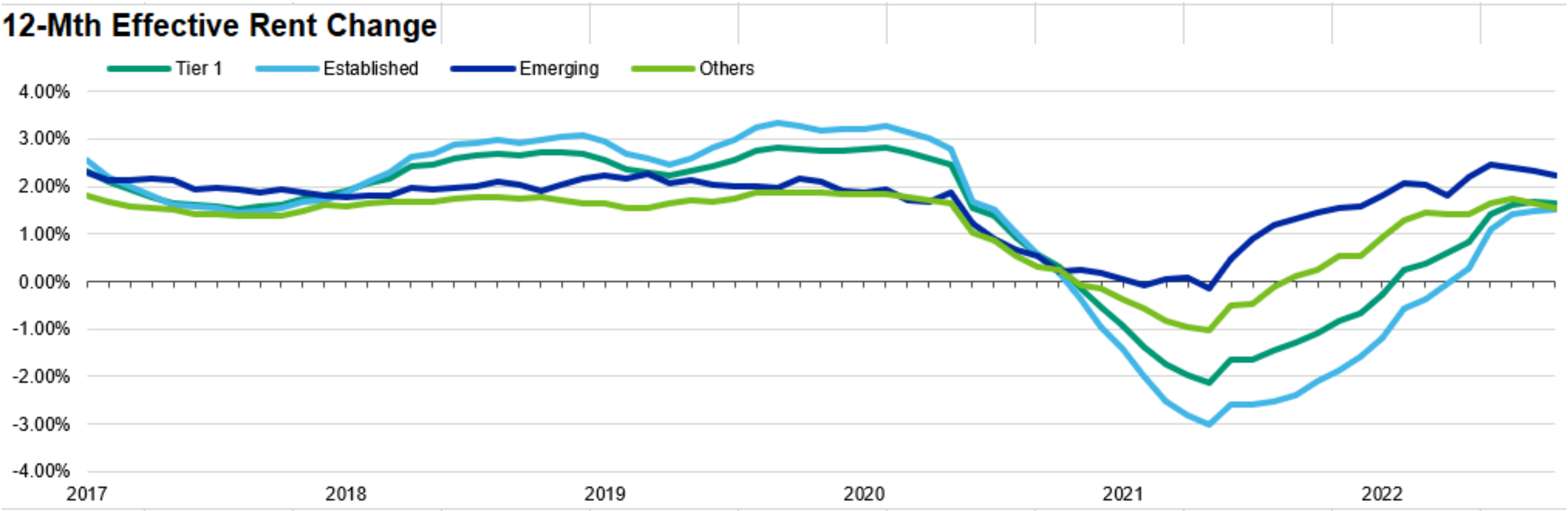
Yes, the federal gov't has been doing for it a while



Source: Moody's Analytics

How much does Tech matter???

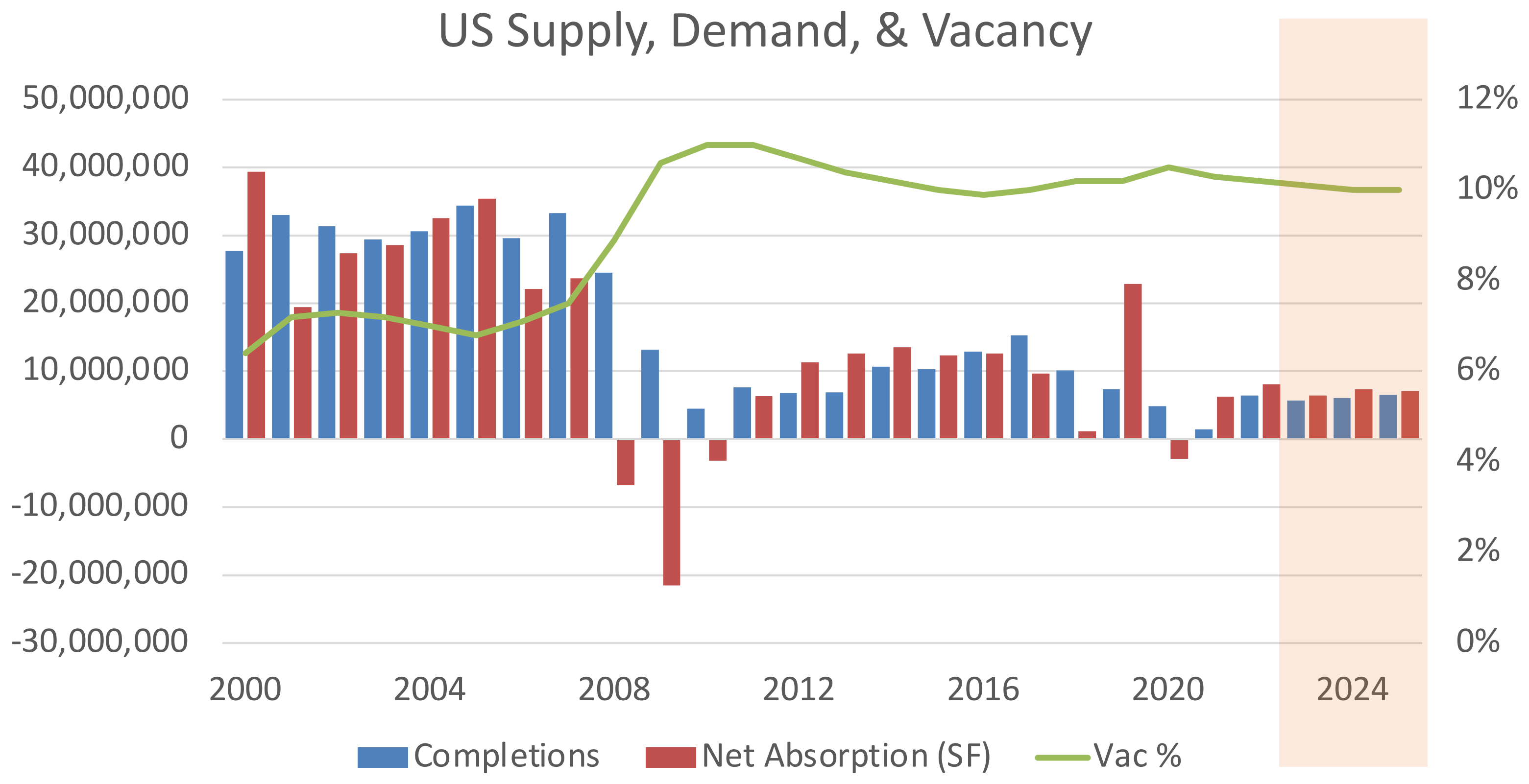
Quite a bit, especially if you are emerging tech



Source: Moody's Analytics

Did the Apocalypse Occur for Retail???

No – Retail has bounced back and has a future



Source: Moody's Analytics CRE

Combination of:

- Limited supply growth
- Better than expected Net Absorption
- Better outcomes in growing metros

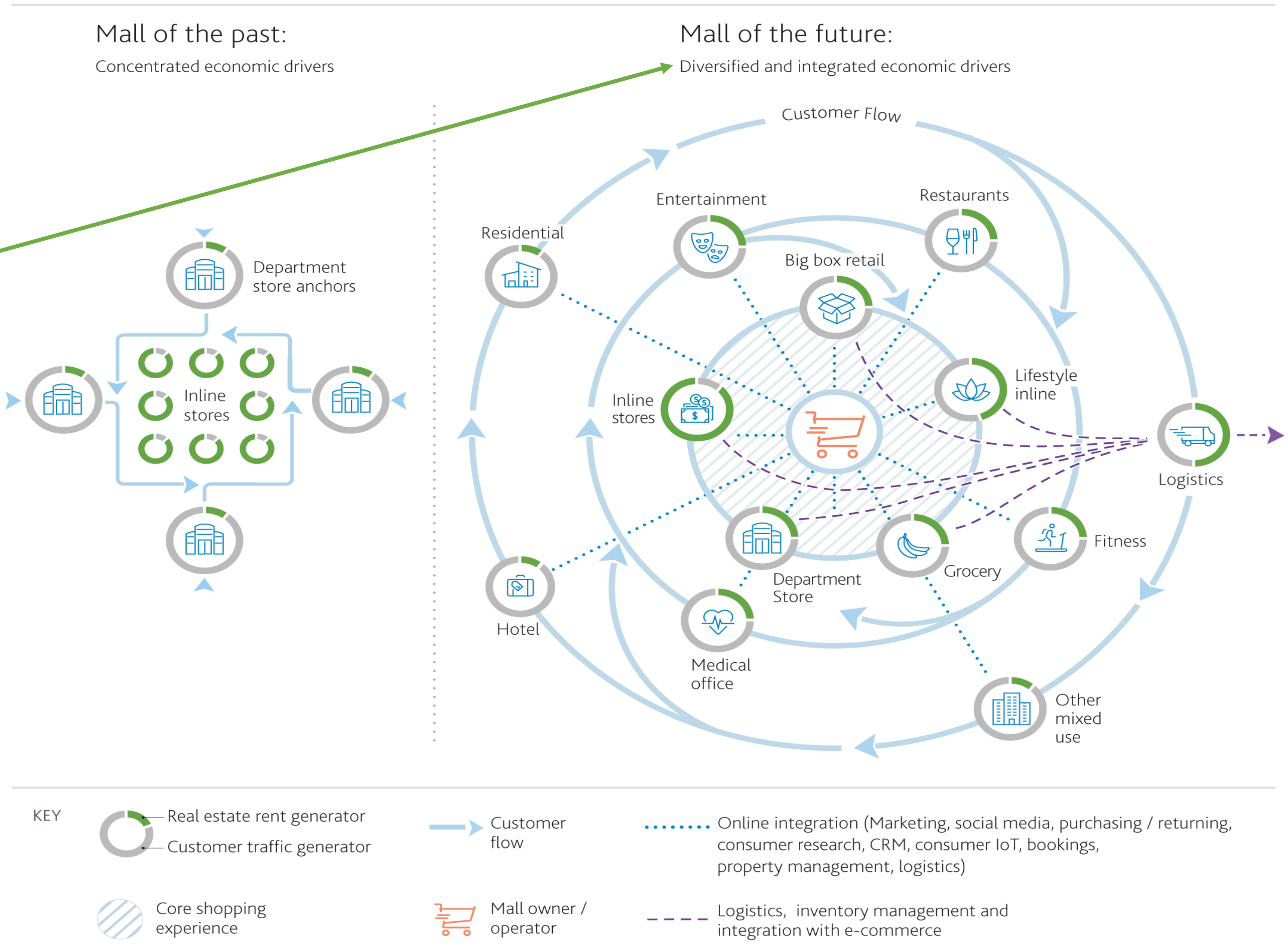
Watching for…

- Development and Repurposing towards **Lifestyle Centers**

Retail's New Trend?

Tremendous Mixed-Use/Lifestyle Activity

- Repurposing now has a model
- New Construction
  - 1/3 of >3K planned or proposed projects are Lifestyle or Mixed-Use



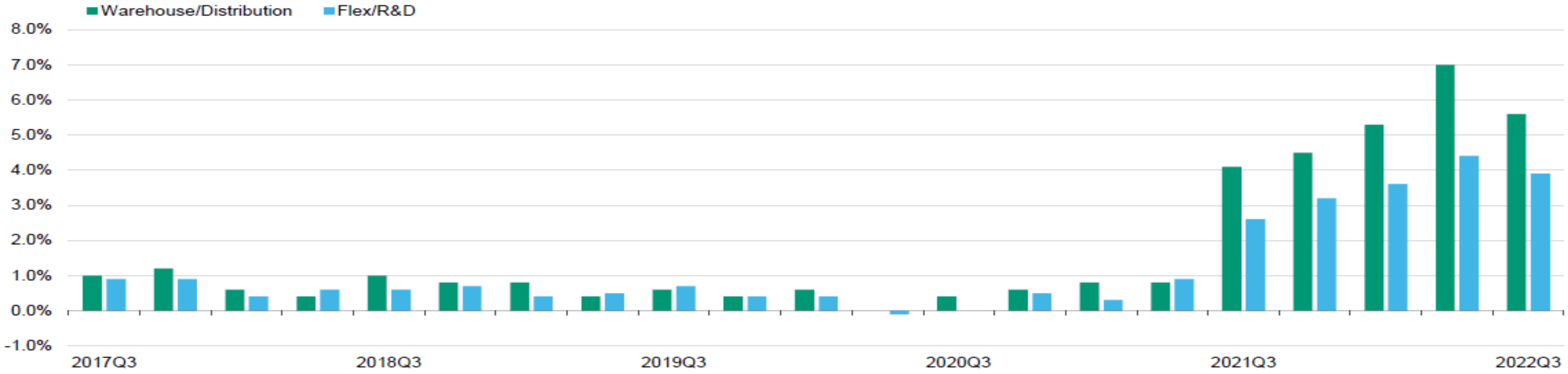
Source: Moody's Analytics CRE

Has Industrial Begun to Slow???

Not really, but we do expect some evolutionary pains along the way

Remember Labor, Labor, Labor

- Let's add Population, Population, Population
- And Infrastructure, Infrastructure, Infrastructure
- And Critical Mass (advanced manufacturing is a big deal)



Source: Moody's Analytics REIS

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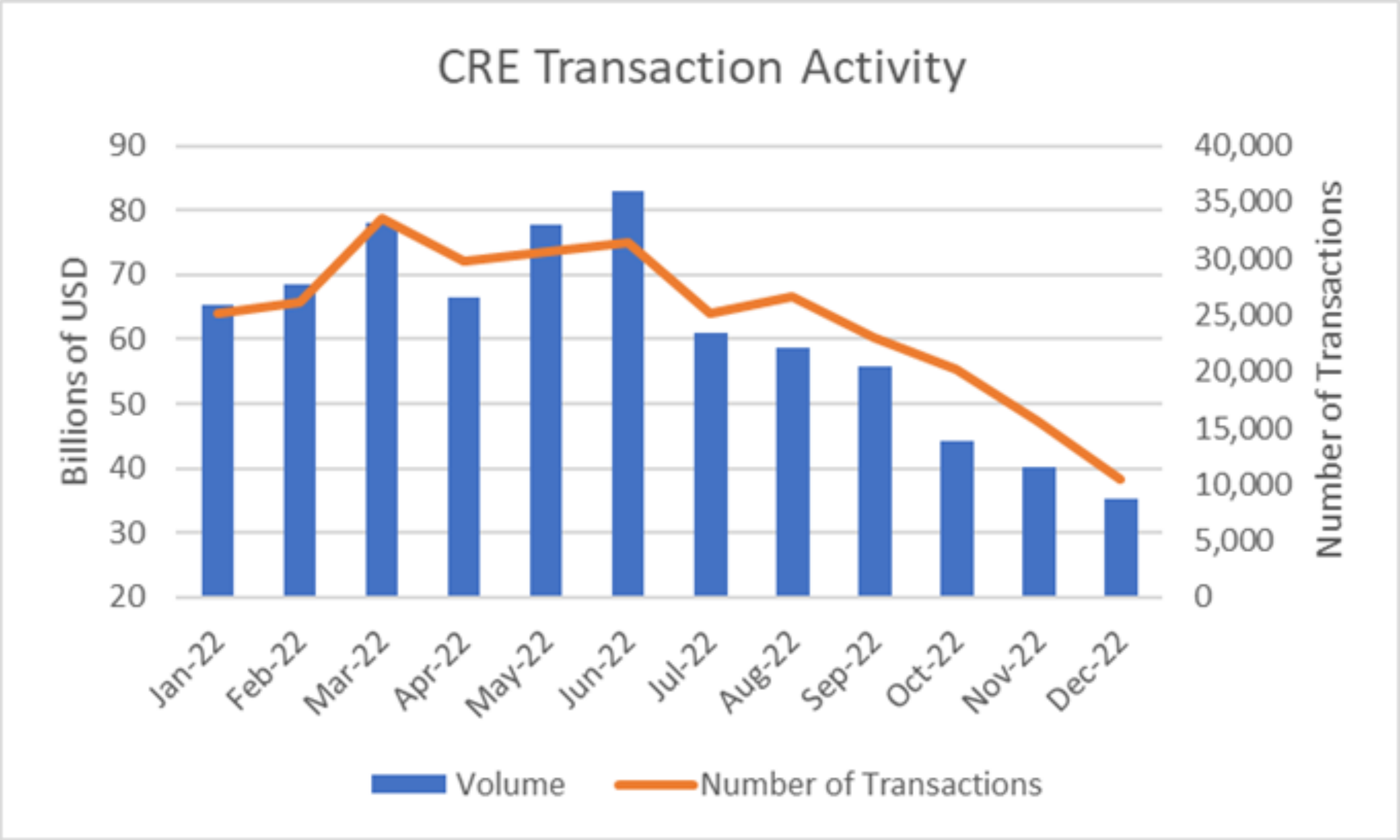
- CRE Capital Markets

How are Capital Markets handling all of this???

Transaction volume is declining

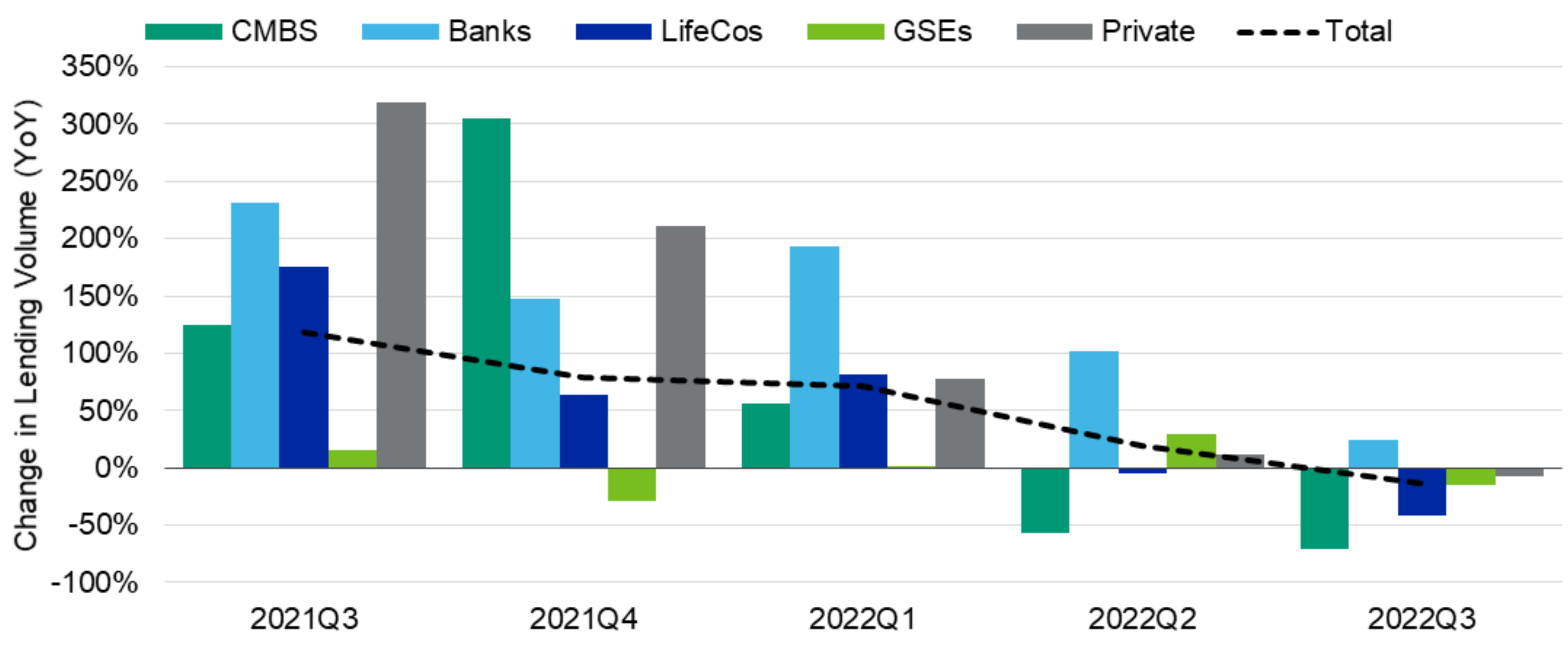


Source: Moody's Analytics CRE

*Q4 data is still preliminary and likely to be revised up slightly

How are Capital Markets handling all of this???

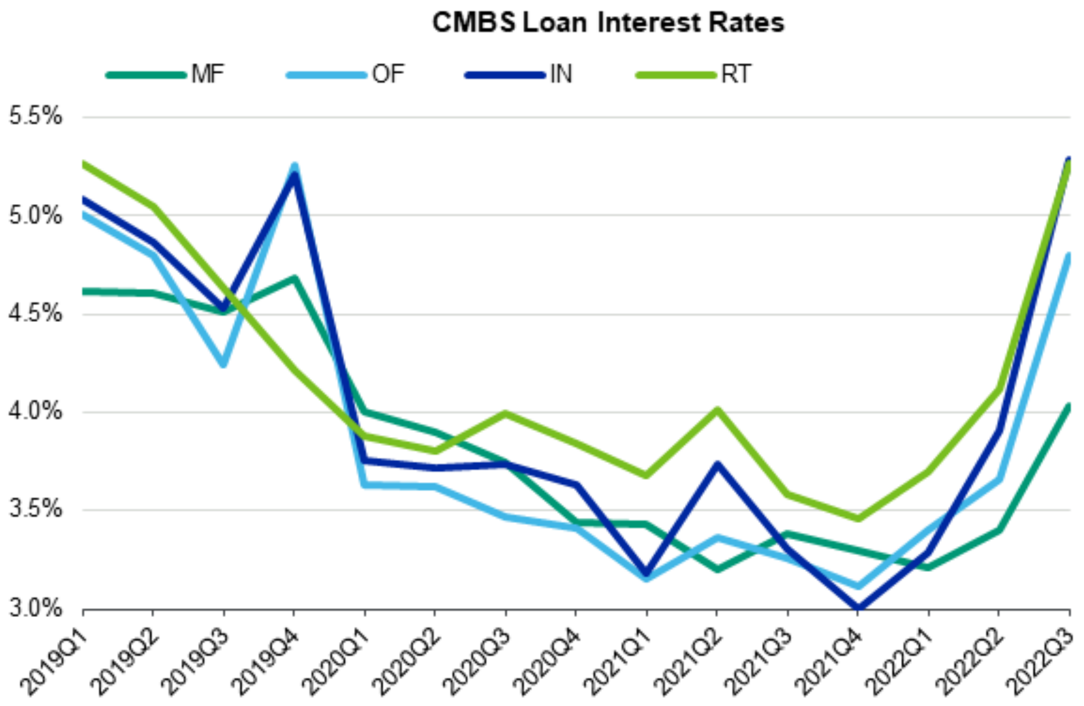
Lending slowing, nearly across the board

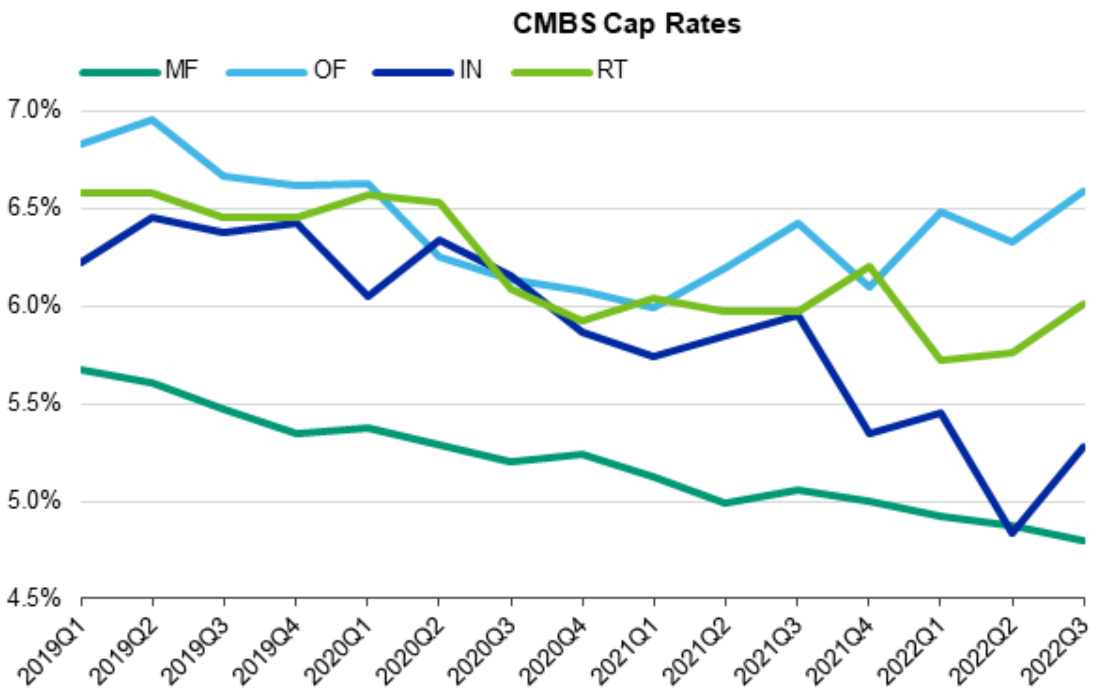


Sources: Mortgage Bankers Association, Moody's Analytics CRE

What about trades that are being financed???

Higher rates and increasing cap rates…..

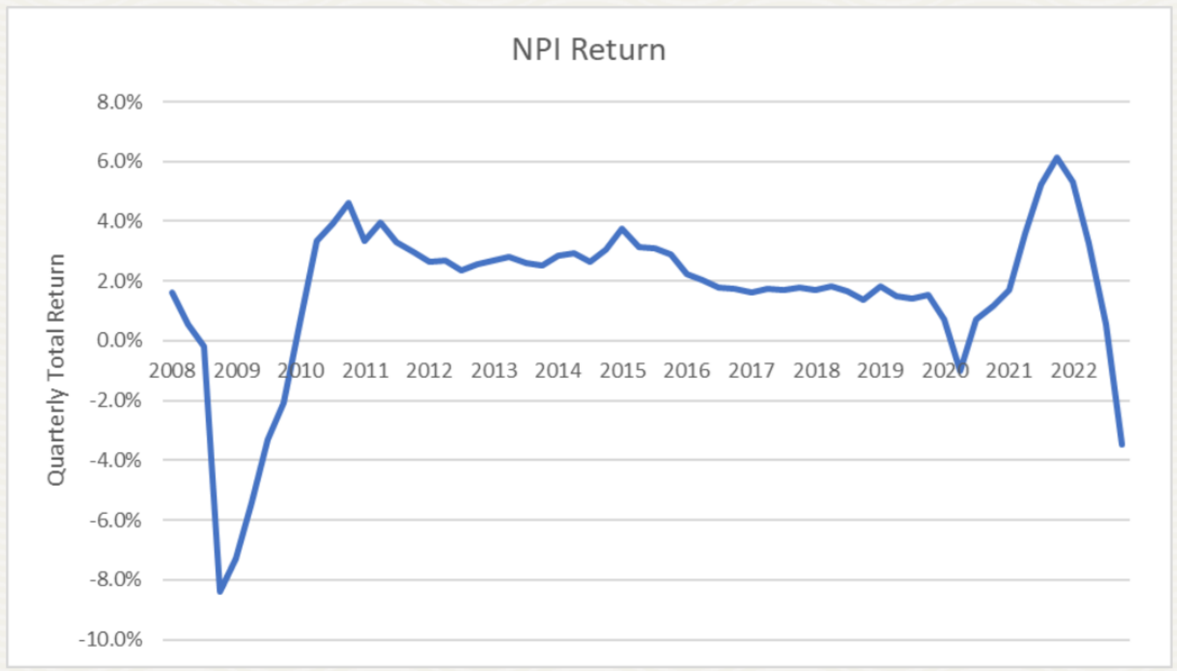


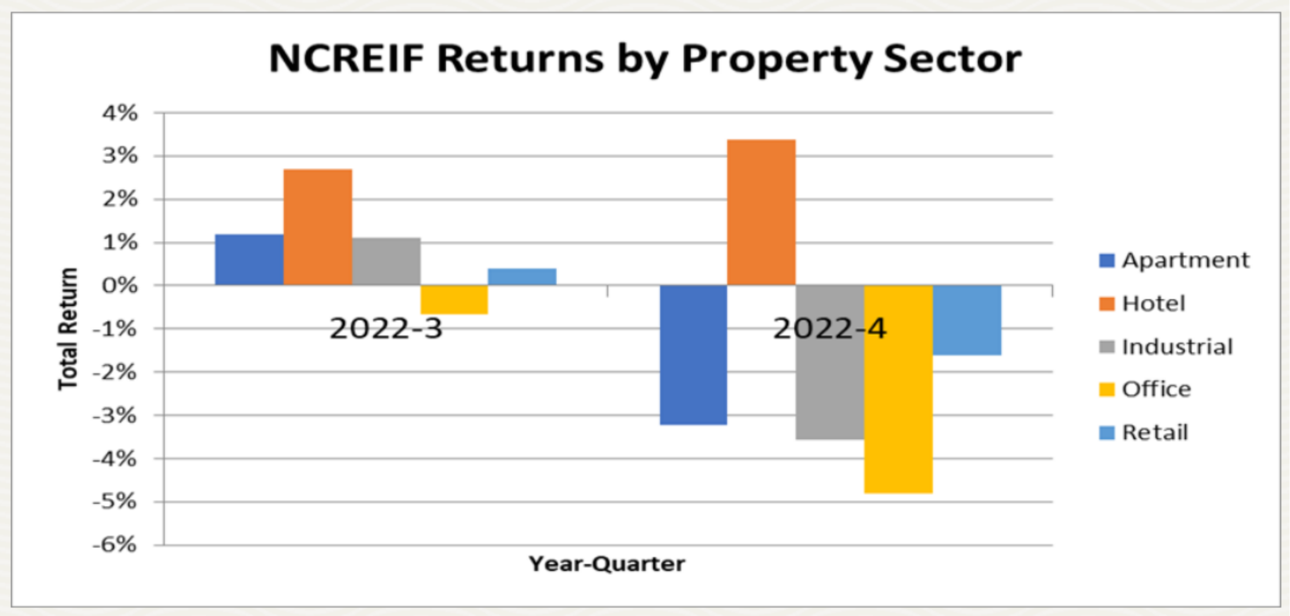


Sources: Moody's Analytics CMBS, Moody's Analytics CRE

Have Property Values Declined???

Yes, in fact, this just in….

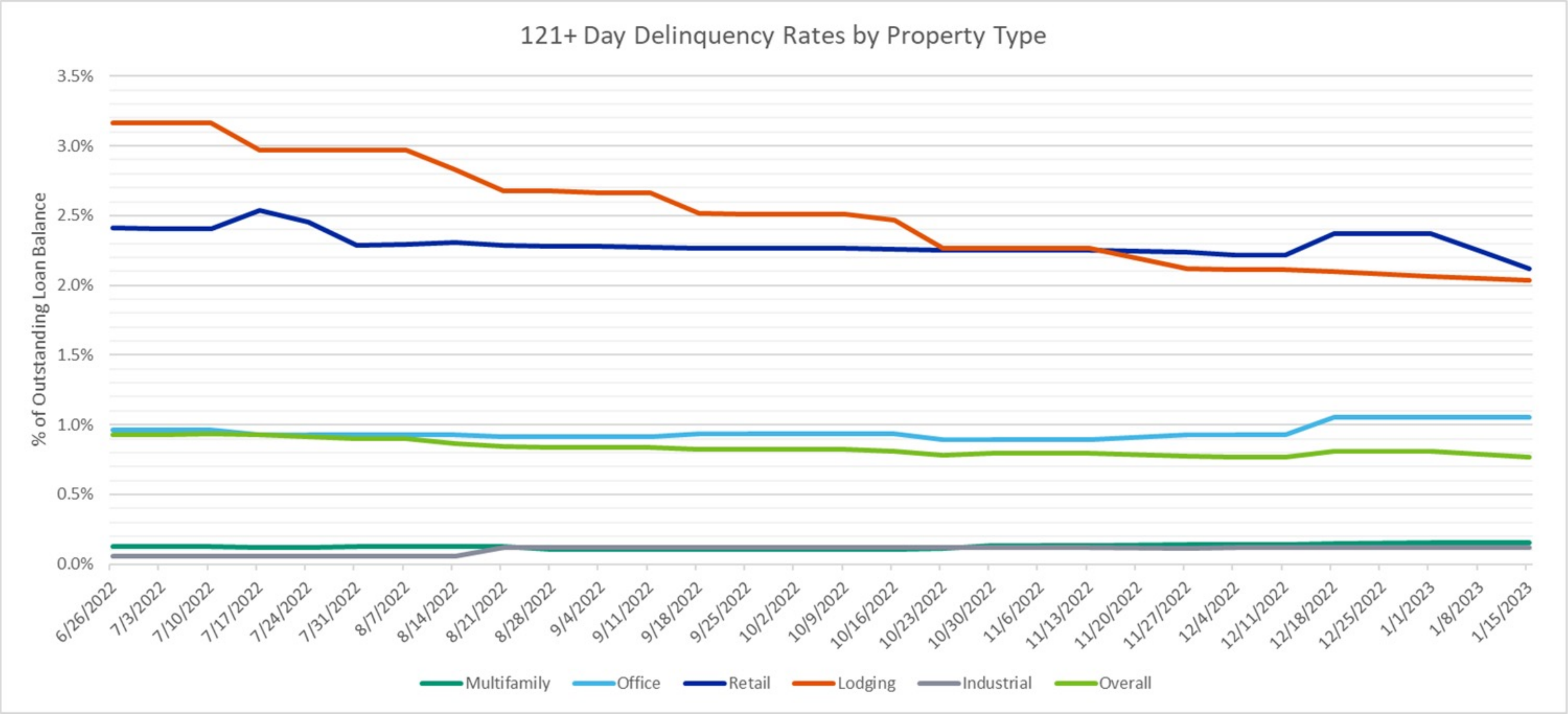




Sources: Moody's Analytics CMBS, Moody's Analytics CRE

Any sign of delinquency/defaults?

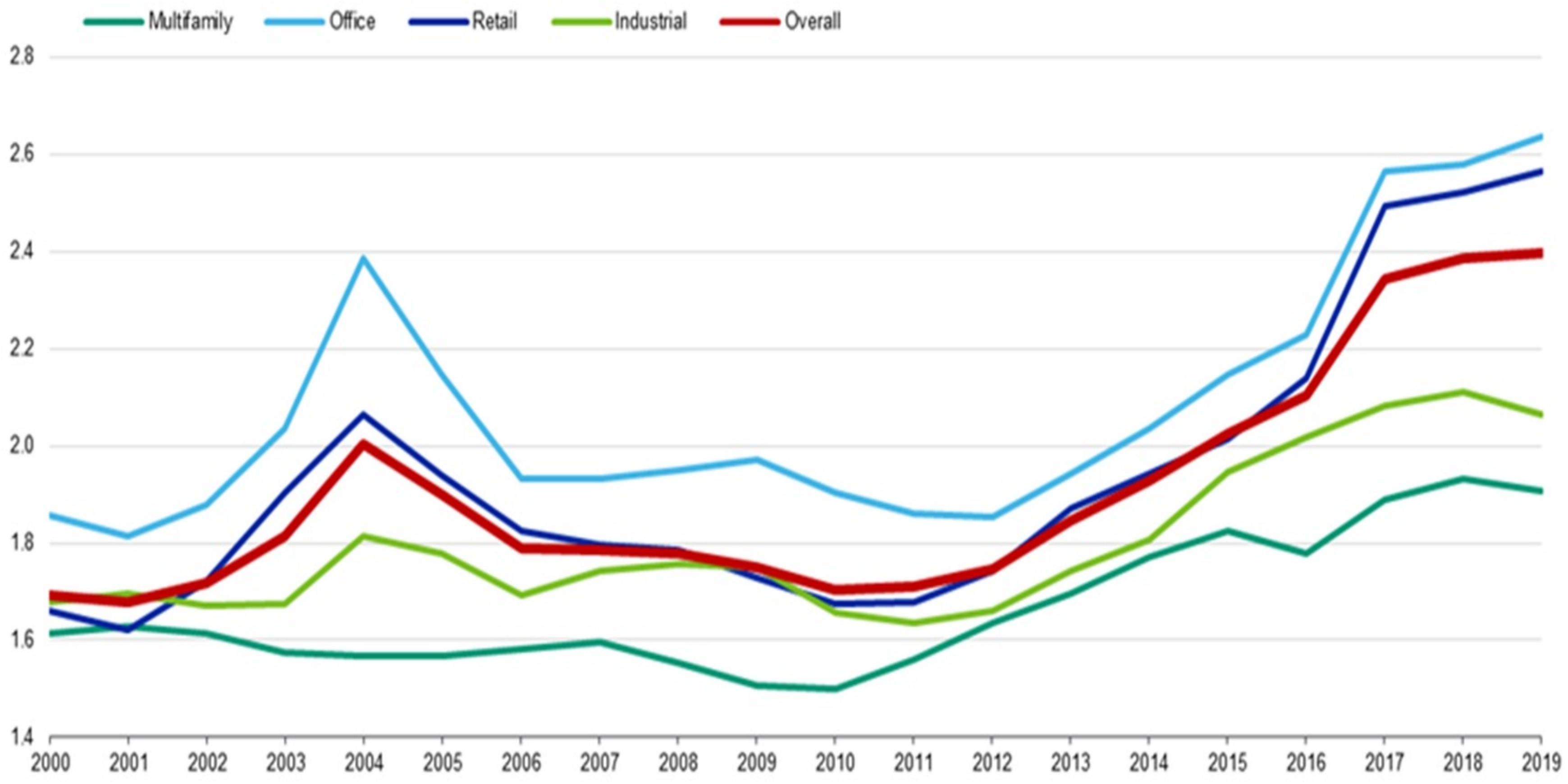
Not really…



Sources: Moody's Analytics

Why not???

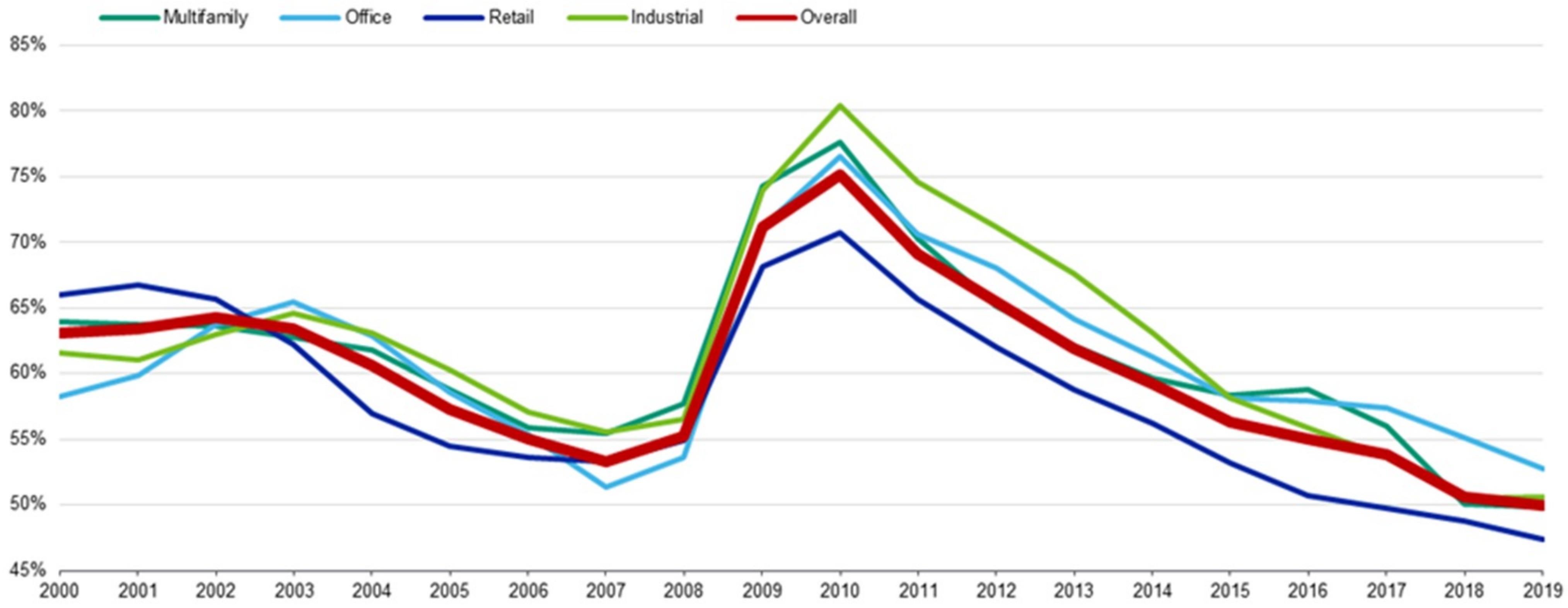
Lenders were very well behaved…(DSCR)



Sources: Moody's Analytics CRE, Moody's Analytics CMBS

Why not???

Lenders were very well behaved…(LTV)



Sources: Moody's Analytics CRE, Moody's Analytics CMBS

Key Takeaways

Bifurcation of Space and Capital Markets

» Space Market (rent and occupancy) performance will remain strong

– If the labor market holds-up we expect all sectors to grow at near LR avg.

– Office is the wildcard – evolution is here, bumps for the next few yrs.

» Capital Market will remain a bit subdued

– Clarity is Key - Listen for Powell's statement and Q&A M

– Plenty of Capital for this income producing market, but it needs confidence in a timeline

Better Faster Decisions

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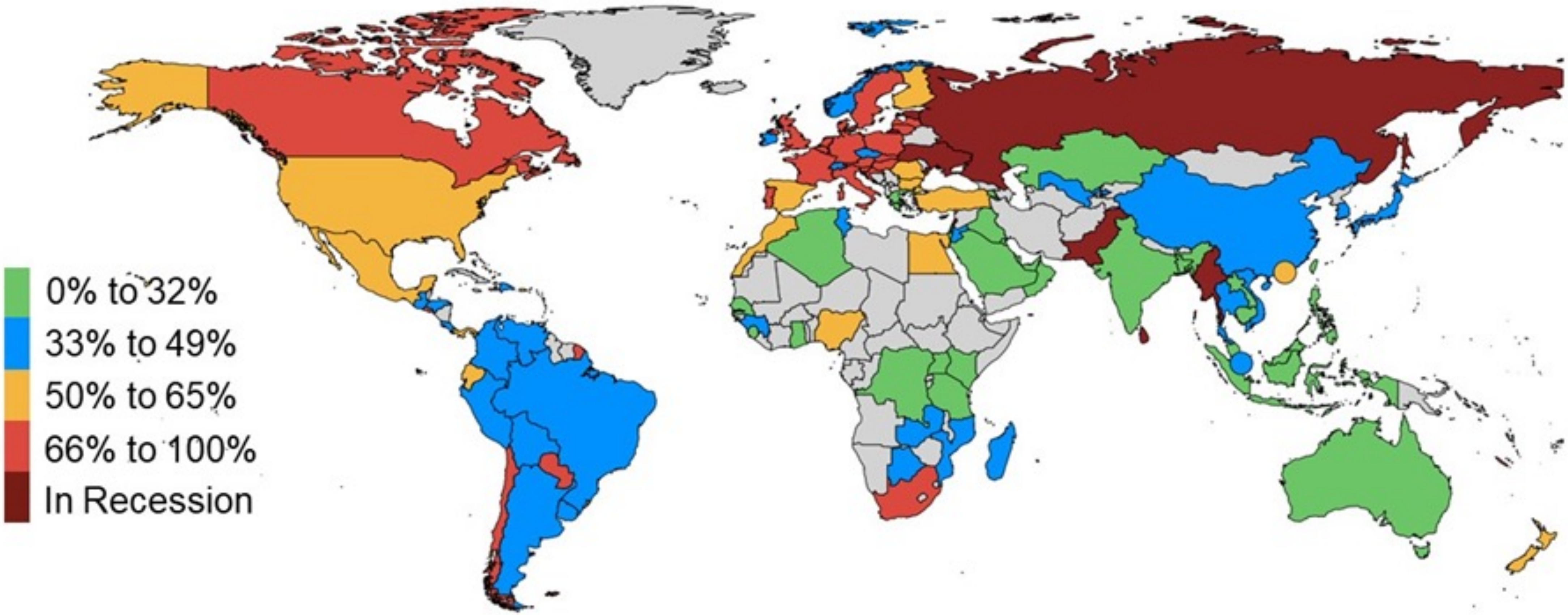
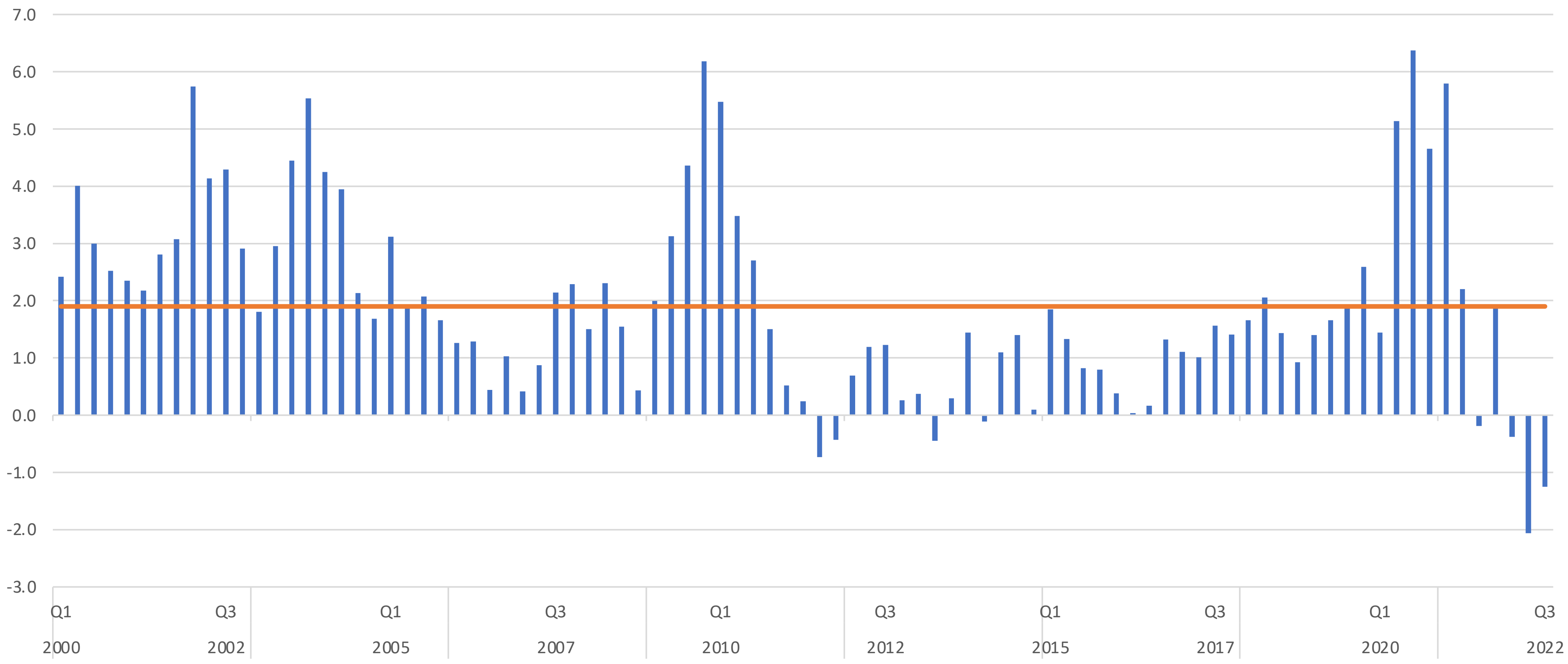
Will we be in a recession any time soon?



Source: Moody's Analytics

What about productivity?

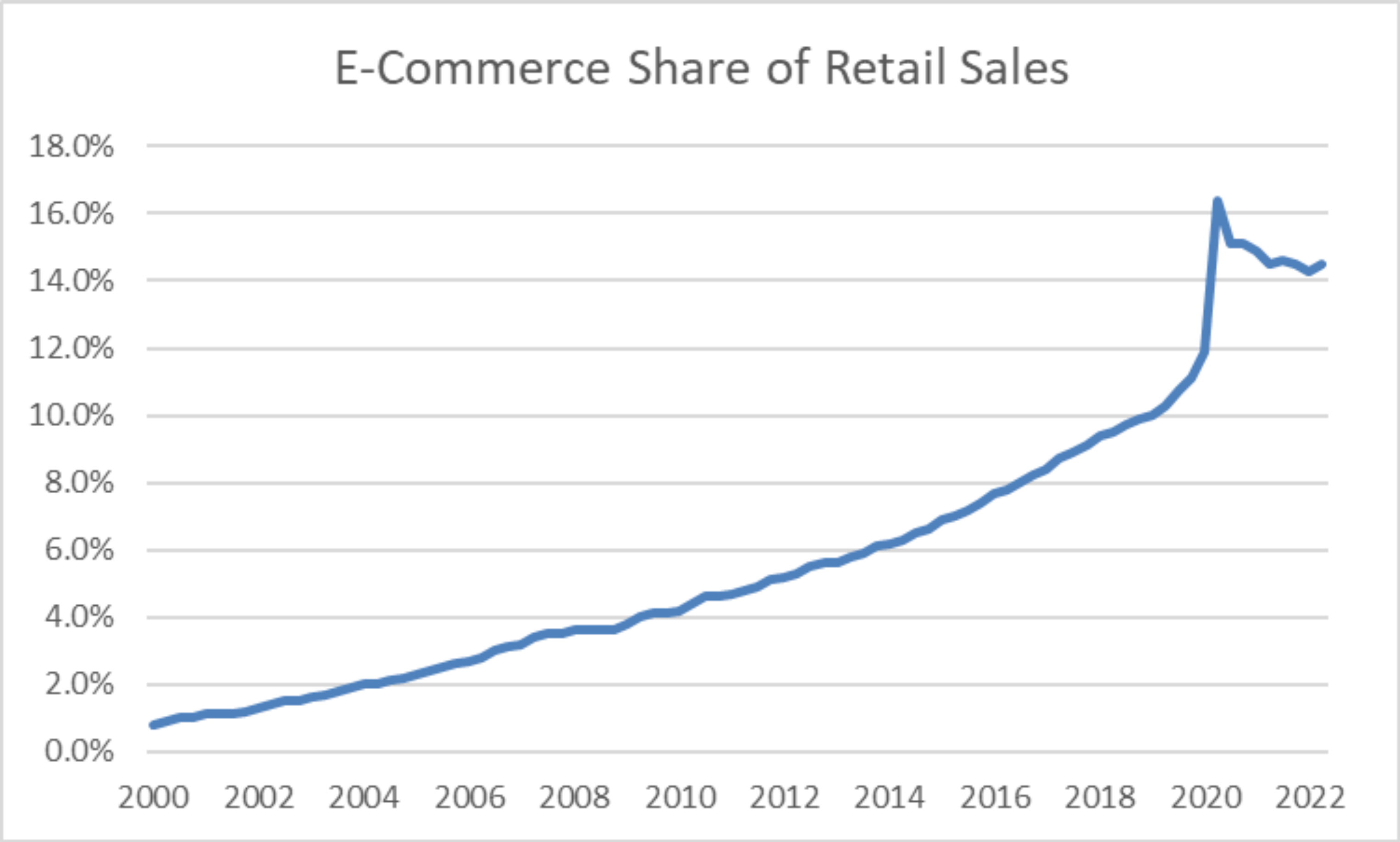
Very ugly, but why?



Source: Bureau of Labor Statistics

Is e-commerce taking over?

Little by little, but pandemic didn't change the path



Source: US Census

Anything Else Worth Watching???

The US Consumer is resilient

- Retail spending trend turned positive in October & Thanksgiving weekend foreshadowing a strong holiday

How? Debt has Soared and Delinquencies are rising

- Credit Card
- Mortgage

Household Debt and Credit Developments as of Q3 2022

CATEGORY	QUARTERLY CHANGE * (BILLIONS $)	ANNUAL CHANGE** (BILLIONS $)	TOTAL AS OF Q3 2022 (TRILLIONS $)
MORTGAGE DEBT	(+) $282	(+) $997	$11.67
HOME EQUITY LINE OF CREDIT	(+) $3	(+) $5	$0.32
STUDENT DEBT	(-) $15	(-) $10	$1.57
AUTO DEBT	(+) $22	(+) $81	$1.52
CREDIT CARD DEBT	(+) $38	(+) $121	$0.93
OTHER	(+) $21	(+) $68	$0.49
TOTAL DEBT	(+) $351	(+) $1262	$16.51

Flow into Serious Delinquency (90 days or more delinquent)

CATEGORY [1]	Q3 2021	Q3 2022
MORTGAGE DEBT	0.27%	0.50%
HOME EQUITY LINE OF CREDIT	0.25%	0.51%
STUDENT LOAN DEBT	1.08%	1.04%
AUTO LOAN DEBT	1.57%	2.02%
CREDIT CARD DEBT	3.24%	3.69%
OTHER	2.84%	3.55%
ALL	0.70%	0.94%

Source: NY Federal Reserve Bank

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