Aberdeen Standard Investments

North America Real Estate Market Outlook

Q3 2020

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Executive summary

- The US economy is rebounding strongly. But reduced lockdown measures have contributed to a sharp rise in Covid-19 cases in several states, which threatens the recovery.
- There are signs of weakening fundamentals across property sectors, but temporary and permanent store closures have led to a severe impact on the retail segment.
- Investment activity has plummeted in recent months due to a considerable tightening in lending standards, increased investor caution, and quarantine measures that have limited travel and due diligence.
- Property returns are projected to experience significant losses over the next year due to declining values across property types.
- Retail losses will likely be the most severe among the four major property types, while industrials are expected to continue to outperform.

Economic outlook

- While the US labour market is far from fixed, the speed of recovery over the past two months has been impressive.
- However, this pick-up in activity has come at a cost. The US is experiencing an alarming surge in Covid-19 infections, which are concentrated in the south and west. This has forced some policymakers in these areas to reverse course on reopening and consider renewed local lockdowns.
- Elevated community infection levels across a broader range of states and a continued rise in new cases could trigger a much wider swathe of rollbacks and lockdowns. This would severely derail the US recovery and deliver a staggered—or W-shaped—recovery profile for the US economy as a whole.
- Aberdeen Standard Investments Research Institute (ASIRI) expects the Fed to announce state-based forward guidance in September, with a commitment to allow inflation to overshoot its target. This would help bed-in the credibility of its policy review should it, as we expect, recommend a shift to a policy framework that formally commits the Fed to make up past inflation misses.
- Latin American countries continue to suffer from severe rates of Covid-19 infections. Brazil's size means that it has garnered most attention as a global hotspot. Only Chile and Peru have had success in flattening their new infection curves, partly on account of better testing regimes.

Occupier trends

- The retail sector continues to experience the brunt of the fallout of the economic downturn. Retail sales rebounded strongly but remain depressed. Non-store retail boomed to its highest level on record (since 1992). This led to a steep loss of in-store retail sales per square foot, which has contributed to rental losses in recent months. The decline in retail rents is expected to accelerate as the list of retail bankruptcies and store closures mount. A recovery is expected, but it's likely that discretionary goods sales will continue to lag as consumers remain cautious and are hit by reduced incomes.
- While rent collections have remained high, apartment fundamentals have weakened in recent months. Vacancy rates have been on the rise and rents falling throughout much of the year, which is contrary to seasonal trends when leasing is strongest in the spring. The biggest impact has been on urban mid- and high-rise products, given the strong supply growth. Suburban, garden-style assets have proven more resilient.
- Office rental growth continued in the second quarter, but vacancy rates ticked higher as leasing activity has slowed. Companies are holding off on expansion plans and dealing with remote workers, furloughed employees, and even permanent office-using layoffs. This has led to a surge in sub-let space and a significant rise in the availability rate. Annual net absorption for class B office properties turned negative this quarter for the first time since the global financial crisis. We expect class A assets to outperform in the near term as tenants take advantage of softening rents and newer properties may be more able to meet new safety and cleanliness guidelines.
- Industrials have continued to post solid rental growth, outperforming all other sectors. Vacancy rates and availabilities have risen in recent quarters due to weakening leasing activity. Ecommerce leasing activity has remained fairly strong, but struggling retailers and economic uncertainty have restrained expansion plans. However, construction starts have slowed considerably as a few major market players, such as Prologis, have halted new speculative development projects. This should support fundamentals in the medium term.

Investment trends

- Investment activity has fallen sharply since the start of the crisis. Total sales volume during March-May 2020 declined by 50% versus the same period in 2019, according to Real Capital Analytics data. The largest declines were in sectors in which fundamentals have been most affected by the crisis, including retail, lodging, and senior housing.

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- Private market pricing is unclear due to lack of liquidity, but Green Street estimates all property pricing declined by 10% year-on-year as at June. The worst declines are estimated for malls (-33%), lodging (-25%), strip retail (-15%), and student housing (-12%). However, most residential sectors have proven to be more resilient, with manufactured housing posting gains (+8%) and apartments (-4%) falling more modestly. Pricing for industrials was up (+%6) over the past year, but the sector posted losses over the previous three months.

Performance and risk outlook

- The residential sector should continue to offer relative stability. Rent collections remain in line with last year's levels and weaker economic conditions will likely restrain home ownership. But properties in lease-up concentrated in urban mid- and high-rise product along with student living assets are vulnerable.
- The office sector has held up well thus far in the crisis, but is expected to experience significant weakness. The segment continued to post solid rental growth, but availability is on the rise as sub-let space has surged. Lower-quality assets are expected to continue to underperform. Increased adoption of flexible working arrangements is a longer-term risk for the sector.
- The retail sector will likely experience substantial losses and performance will continue to lag over the longer term. Performance in centres that are focused on consumer staples will continue to outperform, while discretionary retailers will suffer—weighing on near-term mall prospects. Ecommerce remains a long-term headwind.
- The industrial sector will likely remain an outperformer. Rental losses are expected as leasing activity decelerates. However, a slowdown in construction starts could help to stabilise fundamentals over the next year. Ecommerce will continue to fuel demand, while shifts in inventory practices and 'near shoring' could provide a long-term lift for the sector.

Investment themes

- The industrial sector remains favoured by investors. This pandemic has fuelled a more aggressive adoption of ecommerce and the crisis could encourage distributors to maintain higher inventory levels, which will support the demand for warehouses. The continued rise in online grocery sales will buoy demand for cold-storage facilities. Bulk distribution facilities offer better income prospects in the near term, but weaker performance in light industrial properties may support higher-yielding opportunities in the medium term.
- Within the residential sector, suburban garden-style apartments should benefit from low supply levels and favourable demographic trends. Given virus-exposure concerns, there is a preference for less densely populated areas and more space at relative affordable rates. This is expected to accelerate these demand trends and support niche sectors, such as single-family housing rentals and manufactured housing. A potential price correction in urban, mid- and high-rise assets may lead to cyclical investment prospects.
- The office sector should offer cyclical opportunities as it tends to see outsized losses during economic downturns. Tightening lending markets and a suspension in investor activity are expected to weigh significantly on values. This may allow investors with available capital to take advantage of pricing discounts for value-add and select core assets. Higher-grade assets are likely to outperform in the near term driven by stronger demand.
- Retail investment choices should be sharply focused on tenant quality. Properties anchored by retailers of consumer staples, such as groceries and certain general merchandiser brands, will likely continue to outperform. However, risk is growing even in these relative safe havens as ecommerce is penetrating food-related sectors. Centres focused on apparel and other discretionary goods, such as malls, will struggle in the near term. The severe pressure placed on retail landlords should lead to distressed or deeply discounted opportunities.

Chart 1: Americas Q3 2020 - Real estate short-term performance signals

	Performance Signals	Current Signal	Outlook	Comment
Macro	Economic fundamentals		→	Recent jobs reports indicate a turning point in the labor market but the unemployment rate remains near a post-war high and significant economic risks remains.
	Margin over bonds		→	Margins to 10-year government and BBB corporate bonds attractive but cap rates likely to expand further in the near term.
	Monetary policy		→	Remains expansionary, with policy rates near zero and aggressive asset purchases. The Fed is also moving forward on its business lending program.
Real Estate	Supply		→	Projects are moving forward with some delay, which will hinder near-term fundamentals, but starts have slowed.
	Flows of capital		↘	Deal flow fell in recent months and will remain subdued from weaker income prospects and travel restrictions.
	Lending		→	Lending standards have tightened considerably due to increased risk and pricing uncertainty.
	Fund flows		↘	US core fund redemption queues have climbed and available capital will likely remain on the sidelines.
	360° view		→	REIT returns positive in Q2, but are down YTD and private real estate returns will likely continue to weaken.

Sources: NCREIF, Yahoo Finance, RCA, Nareit, CoStar Group, CBRE, MBA, IPE Real Assets, Aberdeen Standard Investments, June 2020.

Key	Performance Signal:	Trend:	
	Supportive	→	Stable
	Neutral	↗	Upward trend
	Unsupportive	↘	Downward trend

The value of investments and the income from them can go down as well as up and your investor may get back less than the amount invested. Real estate is a relatively illiquid asset class, the valuation of which is a matter of opinion. There is no recognised market for real estate and there can be delays in realising the value of real estate assets.

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