

Economic Update



JUNE 28, 2024

1. BANK STRESS TESTS

- According to the Federal Reserve, all 31 “systemically important financial institutions” (SIFIs) passed their annual stress tests. These tests evaluate the ability of large US banks to absorb hypothetical losses while maintaining more than their minimum required capital levels.
- The stress tests evaluated banks under a scenario where the unemployment rate surges to 10%, commercial real estate values fall by 40%, and housing prices fall by 36%. The results showed that large banks would take roughly \$685 billion in aggregated hypothetical losses, but each would remain solvent.
- Following the recent failures of several mid-sized US banks, which, as a segment of the market, hold a disproportionate share of CRE on their balance sheets, the hypothetical resilience of banks shown during the stress tests is a welcomed sign. However, the stress tests evaluate only large and systemically important banks, leaving the conditions of regional banks in such potential scenarios relatively unknown.

2. COMMERCIAL PROPERTY PRICES

- According to the MSCI-RCA commercial property price index (CPPI), US commercial sector prices declined at an annual pace in May that was roughly similar to the rate seen in April.
- Prices fell 2.3% year-over-year through May and are down 0.2% from April.
- The industrial sector again arose as the only property type with an annual or monthly increase during the month, climbing 0.9% month-over-month from April and 8.7% over the past 12 months.
- Apartment sector prices fell by 0.1% month-over-month and by 8.9% year-over-year in May.
- The annual decline in retail prices eased for the 10th consecutive month but fell by 1.8% year-over-year through May. Retail prices are down 0.2% from April.
- Suburban Office properties reversed a monthly uptick in prices during April to post a 0.4% decline in May. Suburban office prices are down by 10.9% over the past twelve months. Meanwhile, CBD office prices continue to fall more steeply than their suburban counterparts, falling 1.4% from April and down by 30.8% year-over-year.

3. FLIGHT TO QUALITY IN OFFICE

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- A recent Globe Street article points to a trend of flight to quality in the office sector, showing the nuances in office market activity despite recent struggles.
- Top tier office buildings maintain robust fundamentals. Rent premiums in prime office spaces sit at 84% while vacancy rates are down to 14.8%, 4.5% lower than the rest of the office market. Moreover, the sector's performance gap has widened significantly from the 1.9% registered in 2018.
- Further, office market troubles have shrunk the sector's construction pipeline, allowing more room for rent increases in prime space as they absorb remaining demand.
- The study notes that such prime spaces account for just 2% of US office buildings and that 60% of them were constructed in the past decade.

4. OFFICE MATURITIES TICK-UP

- According to recent data from Moody's, a staggering \$2.24 billion across 23 CMBS office loans reached fully extended maturity in May.
- The 23 loans represent 54% of all maturities year-to-date. Moreover, loan size appears to play an essential role in determining payoff success. In both 2023 and 2024, smaller loans have paid off at a higher rate than larger ones.
- Year to date, Office loan payoffs at maturity remain the lowest across all property types. 92.4% and 91.9% of Industrial and Multifamily loans at maturity have been paid off, respectively. When excluding malls, retail has seen a 78.0% payoff rate, but this falls to 53.9% when including mall loans. Meanwhile, 43.5% of Hotel loans are paid off through the end of May. The Office payoff rate sits at 36.0%.
- Looking ahead, the balance of office loans maturing over the next 12 months totals \$19.1 billion, 70% of which, according to Moody's, have performance characteristics that indicate that they will face difficulties in refinancing.

5. BGO CRE OUTLOOK

- A recent Q2 2024 CRE outlook by BGO shows that market fundamentals remain firm, capital markets are stabilizing, and most emerging risks remain exogenous.

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- As expected, Industrial maintains the strongest fundamentals across all of CRE, but some normalization and buildup of excess supply is expected in the coming months.
- On Retail, BGO maintains a positive outlook as low vacancies and healthy rent growth continues to keep the sector strong by historical standards.
- Multifamily has experienced a slowdown from its post-pandemic boom, with vacancies climbing in some of the markets that had the highest during the boom. BGO sees the vacancy rate stabilizing toward the end of the year before a potential down cycle in 2025, while rent growth is expected to gradually reaccelerate.
- Capital markets appear to be stabilizing, though transaction volume continues to be effectively flat. Delinquencies are increasing, and BGO sees this pattern continuing despite the likelihood of improved overall performance on the horizon.
- The report noted that monetary policy remains the primary risk to CRE and that, despite solid fundamentals, CRE markets will be beholden to the future path of interest rates.

6. ZOOMING IN ON HOUSING AFFORDABILITY

- Recent research from Zillow shows that a median-income household would need to put down 35.4% of their income to afford payments on a typical US home.
- The article highlights, for example, that a median-income household in Seattle making \$116k would need to save 10% of their annual salary for 24 years to build up the savings that are typically expected for prospective homebuyers.
- Staggeringly, in 2023, 43% of home buyers used a gift from family or friends to help with their down payment.
- Affordability issues became increasingly salient as housing prices boomed during the pandemic years. Still, public policy responses have been slow to address them and are driven mainly by state and local initiatives. The US Department of Treasury recently outlined a new fund to provide an additional \$100 million over the next three years to support the financing of affordable housing, while advocates are eyeing a White House budget proposal that would include mortgage relief credit for middle-class first-

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time homebuyers.

7. NAHB HOUSING MARKET INDEX

- According to the National Association of Home Builders' Housing Market Index (HMI), each of the index's components (current sales conditions, expected sales conditions, and traffic of potential homebuyers) fell in June from the previous month.
- The index, which evaluates homebuilder sentiment for the single-family home market, shows that builder confidence has stalled as interest rates have remained higher for longer than much of the market anticipated.
- Notably, this month's survey shows that 29% of builders cut home prices in the past 30 days to boost sales, the highest share since January.
- May was the first month since December where each component of the HMI was in contraction.

8. RETAIL SALES

- According to the latest data from the Census Bureau, US Retail and food services sales (seasonally adjusted) rose by 0.1% in May from the previous month and 2.3% from one year ago.
- Overall, while positive, these data came in weaker than expected, with the Dow Jones consensus estimate forecasting a 0.2% increase during the month.
- Zeroing in on retail trade, sales were up 0.2% from April and 2.0% from May 2023. Over the past year, non-store retailers have seen an increase in sales of 6.8%, while food services and drinking places have increased by 3.8% over the same period.
- Following the report's release, the likelihood of a Fed rate cut in 2024 climbed higher as measured by Fed funds futures markets.

9. CONSUMER CONFIDENCE

- Consumer confidence, as measured by The Conference Board, fell slightly in June but remained within its relative range over the past two years.

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- Notably, the two subcomponents of the index, one measuring the present situation and one measuring future expectations, diverged in the latest reading. The Present Situation index rose during the month while short-term expectations fell. However, the expectations index metric has sat within the recession threshold for the last five months, which has failed to align with reality.
- Peeling one layer deeper, consumers expressed an overall increase in confidence in labor market conditions within both the present situation and expectations index. In contrast, their views on income and business conditions fell in both components.
- The report also noted that the decline in confidence was primarily driven by consumers aged 35-54, while the cohorts above and below this age group saw a boost in confidence.

10. RISING COSTS IN THE MULTIFAMILY SECTOR

- A recent study by the Joint Center for Housing Studies at Harvard University shows that rising insurance premiums were the main cause of higher operating costs in the Multifamily sector heading into this year.
- Citing data from RealPage, the report detailed that through January 2024, insurance premiums in the sector rose 27.7% year over year and were a significant contributor to the 7.1% increase in total operating expenses over the same period.
- Within the nation's top 50 metros, per-unit insurance costs have more than doubled since the start of the pandemic. Further, NOI growth slowed to just 2.8% in Q1 2024 compared to 24.8% at the end of 2021.
- The rising costs can increase the risk of multifamily loan delinquencies. However, the report notes that delinquencies in the CMBS market remain well below their GFC comparisons and just slightly above their pre-pandemic average.

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SUMMARY OF SOURCES

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