Economic Update

SVN | Research

MAY 31, 2024

1. CRE LOAN MODIFICATIONS RISE AMID HIGH-RATE ENVIRONMENT

- According to a new report by Trepp, CMBS loan modifications rose dramatically in 2023 as a significant swell of loans are set to mature in the coming quarters.
- Modification volumes peaked mid-year 2023, climbing to $3.9 billion during the third quarter, almost nine times higher than levels one year before.
- Perhaps unsurprisingly, Office loans have received the largest volume of new modifications recently, making up roughly 42% ($4.2 billion) of all modifications made during 2023. Retail was the second largest, with $2.6 billion in loans modified.
- The jump in loan modifications within the CMBS universe signals how the broader Commercial Real Estate financing system is beginning to tackle the looming challenge of new financing needs amid lower property values and higher interest rates.
- Instead of refinancing old loans, borrowers are increasingly seeking extensions or amendments to current loan terms. These can sometimes involve the borrower committing new capital in the form of paying down debt, investing in renovations, or making other tenant improvements.

2. AI FUELS DATA CENTER BOOM

- A recent report by Baystreet estimates that Data Center investments have surged by more than 200% since 2016. The traditionally more niche asset class is expected to expand by another 89% between now and the end of 2028 as AI propels the property type to new heights.
- Several tech companies and firms that have been early to invest in generative AI have sat at the forefront of the recent trend. Big names such as Amazon, Applied Digital Corporation, and Avant Technologies, among others, signal that they expect to expand their AI infrastructure further as demand continues to boom.
- The intersection of AI and Commercial Real estate reveals recent activity by industry lenders and could signal broader trends in real estate finance. For example, Equinix, Inc., another large player in the digital infrastructure space, has recently launched a $600 million joint venture with PGIM Real Estate to help develop and operate a new Data Center in Silicon Valley.

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- As more traditional CRE lenders, such as mid-sized regional banks, pull back from real estate investments due to the interest rate climate, alternative lenders like PGIM are stepping into the vacuum. As an emerging and less matured asset class, data center investment activity by traditional alternative lenders will be an interesting indicator to watch.

3. HOME PRICES IN TOP METROS HIT RECORD

- According to the latest data from S&P/CoreLogic, home prices in the top 20 major US metros climbed to their highest level on record in March.
- The S&P CoreLogic Case-Shiller 20-city house price index rose 0.3% monthly and 7.4% year-over-year in March, the latest month of available data.
- After eight consecutive months of price deceleration that partly overlayed three months of price declines, national home prices tracked by the Case-Shiller Index reaccelerated in the three months ending in March.
- Housing prices in major markets continue to face upward pressure from falling inventories, which is further exacerbated by the start of the Spring homebuying season.
- In recent weeks, pressure on inventories has eased slightly. According to the National Association of Realtors, housing inventory totaled 1.21 million units at the end of April, 9% above March's level and up 16.3% from the same time last year. Still, as pricing trends show, this pace has not kept up with demand.

4. COMMERCIAL REAL ESTATE PRICES

- According to the MSCI-RCA commercial property price index (CPPI), the pace of decline in US commercial sector prices slowed for the ninth straight month in April.
- Prices fell 2.2% year-over-year through April and just 0.1% from March.
- The industrial sector again arose as the only property type with an annual increase during the month, climbing 0.6% month-over-month from March, its 12th consecutive monthly increase. Industrial prices are up 6.0% over the past 12 months.
- The annual pace of decline for Apartment sector prices has slowed in each of the last eight months,

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with prices charting a 6.9% year-over-year decrease in April. Monthly, Apartment sector prices are down 0.3%,

- Retail sector prices also improved. The sector's annual price decline eased for the ninth consecutive month to 2.6% year-over-year in April. However, relative to March, sector prices are down.
- Suburban Office properties experienced a slight monthly uptick, rising 0.5% month over month. Annually, CBD office prices continue to fall more steeply than their suburban counterparts, falling 33.9% year over year compared to just 7.8%.

5. LUXURY RETAIL EXPANDS

- According to new reporting by Globe St that analyzes trends in New York and major European markets, leading luxury retailers are snapping up store space/
- High-end retailers are increasingly opting to purchase prime units in major cities across the globe instead of leasing as they take advantage of discounted property prices.
- According to Bernstein Research, European luxury brands have paid upwards of $9 billion since the beginning of 2023 to buy prime space in the world's top shopping locations, such as New York and Paris.
- Some brands have indicated that they continue to bet on consumers' spending resilience, which is expected to experience its fourth consecutive annual increase in 2024.

6. OFFICE EXPOSURE RISK

- Commercial Edge's May 2024 national office report details the risk several markets could be exposed to concerning Office sector distress.
- Analyzing debt service coverage ratios (DSCRs), which measure net operating income against current debt obligations, the report notes that only five of the 91 markets in focus had DSCRs below 1.0, a level that the researchers associate with high risk.
- Lenders often require a DSCR of 1.25 to consider a business to have sufficient net operating income to repay a loan. The report found that only a handful of markets are presently exposed to widespread risks.

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7. CONSUMER CONFIDENCE REBOUNDS

- According to the latest release, the Conference Board's Consumer Confidence Index rose in May following three consecutive monthly decreases.
- US consumers showed an unexpected surge in optimism over the past month as the labor market outlook improved. Still, inflation concerns persist, and as a result, households continue, on average, to expect higher interest rates over the next year.
- The survey's underlying data suggested a more mixed outlook. The share of consumers who expect a recession over the next 12 months increased on a month-over-month basis. Conversely, consumers remain relatively upbeat about the stock market.
- In a potential foreshadowing of how May's mixed report could translate into consumer spending trends, the share of respondents indicating that they plan to buy a major household appliance also ticked up from April.

8. FEDERAL DEBT WORRIES

- As the US national debt approaches $35 trillion, there are increasing concerns about the nation's fiscal health.
- Since the onset of the COVID-19 pandemic in March 2020, the federal government has added about $11 trillion in debt. While US economic growth and the dollar's position as a global reserve currency have often placed deficit reduction on the back burner of fiscal priorities for both political parties, recent debt growth is again raising some alarms.
- The four-year uptick is largely due to a massive expansion of government spending, namely the pandemic-era stimulus packages in 2020 and 2021, followed by the 2022 Bipartisan Infrastructure and Inflation Reduction Acts.
- Increasing deficits have also been exacerbated by previous reductions in tax revenues, including the 2017 Tax Cuts and Jobs Act, and the increasing strain from rising interest rates, which increase the government's debt liability.

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- The Congressional Budget Office (CBO) estimates that the public's debt-to-GDP ratio, which currently stands at 99%, will rise to 116% over the next decade, which would become its largest proportion in history.
- The CBO projects a $1.6 trillion deficit for 2024 that will increase to $2.6 trillion by 2034 if current fiscal revenues and spending levels continue on trend. Many economists note that the US has historically only experienced such deficit-to-GDP levels during wartime or severe downturns. Such levels could place the US government in a position of fiscal vulnerability during a downturn.

9. FOMC MEETING MINUTES

- According to the meeting minutes from the FOMC's April 30th- May 1st policy meeting, while policymakers continue to expect inflation to remain on its trend towards 2% over the medium term, most believe that recent data has necessitated a more cautious approach.
- The minutes point to an increasing sentiment among officials that the disinflation processes will likely take longer than previously thought. Some members also indicated a willingness to raise rates further if inflation pressures mount.
- As inflation data trended in an unfavorable direction over the first quarter of 2024, officials have grown notably more cautious in their statements on the future path of rate policy but have mostly refrained from overly hawkish sentiments that would indicate a return to rate hikes.
- So far, FOMC officials have responded to this year's inflation risks by leaving their benchmark Federal Funds Rate unchanged at recent meetings. However, they have left the door open to rate cuts later in the year if underlying economic data improves.

10. INTEREST RATE OUTLOOK

- According to the Chicago Mercantile Exchange's Fed Watch Tool, the average futures market forecasts for the Federal Funds Rate at the end of 2024 have recently shifted to reflect only one quarter-percentage point cut.
- Futures markets place a 42.1% chance that the Fed funds rate will finish the year 25 bps down from its current level. The shift is a significant recalibration from earlier this year when futures markets projected

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at least three quarter-point cuts in 2024.

- Higher than expected inflation pressures to start 2024 have resurfaced futures markets' hawkish sentiments, aided by recent Fed commentary suggesting a longer path ahead toward a pivot.

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SUMMARY OF SOURCES

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