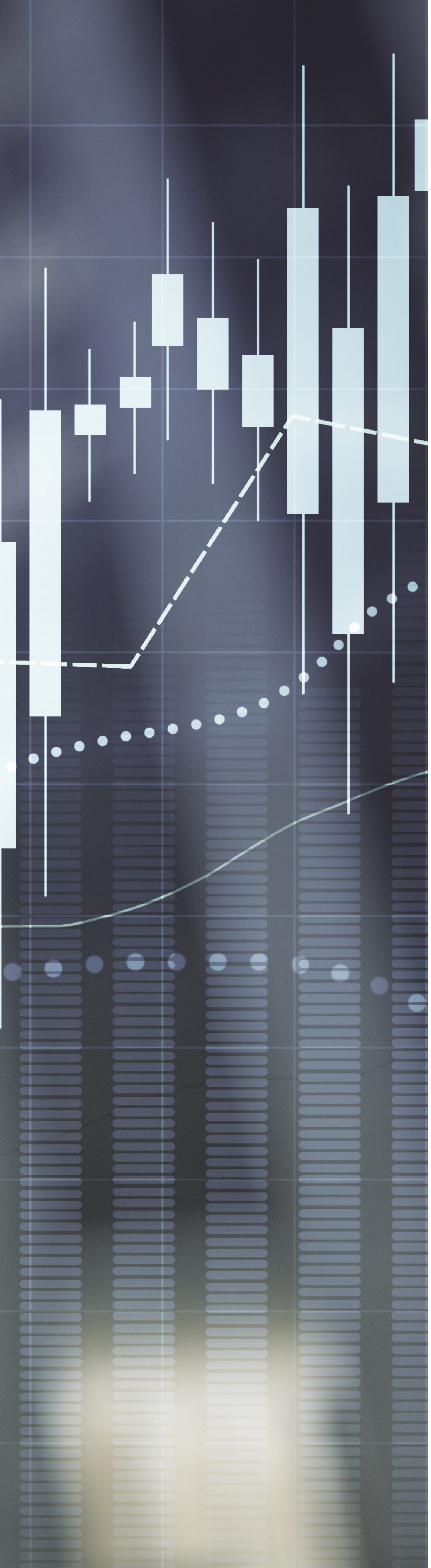

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# THE ADVISORY

## RCLCO Real Estate Sentiment Increases Slightly, Risk of an Impending Recession Remains

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# RCLCO Real Estate Sentiment Increases Slightly, Risk of an Impending Recession Remains

RCLCO's Sentiment Survey has tracked real estate market conditions in the U.S. for over 10 years. Events of the last three years have generated unprecedented volatility in the index – with significant swings in sentiment (both positive and negative) with COVID-19 and the initial recovery, followed by inflation and rising interest rates. The RCLCO current sentiment index had dropped to a new low of 8.3 at Year End 2022, and has recovered somewhat to 19.0 at Mid-Year 2023, yet still remains in the recessionary zone.

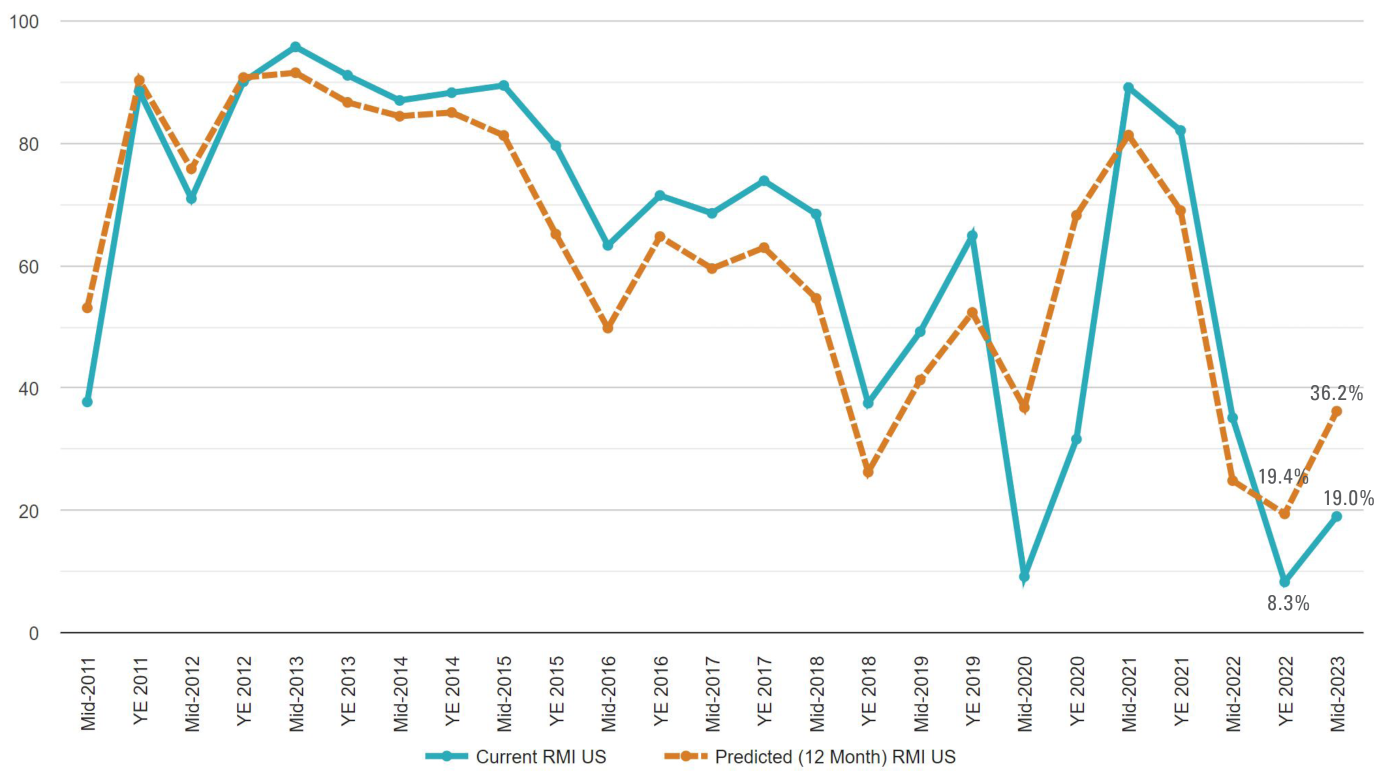
## Key Takeaways From the Survey

- The RCLCO Current Real Estate Market Sentiment Index (RMI)[1], which measures sentiment on a 100-point scale, has increased 10.7 points over the past six months ending at 19.0 at Mid-Year 2023. The index has improved somewhat from Year End, but remains decidedly in the zone indicating **challenging market conditions – an RMI <40 is typically consistent with a period of real estate market distress/recession**
- Respondents predict that the real estate market will be improving, yet will remain in distress mode over the next six to 12 months – the Future RMI is predicted to increase 17.2 points to 36.2 over the next 12 months.
- **Survey respondents predict that a national economic recession is imminent: the vast majority (84%) believe that there will be a recession in the next two years**; a significant share (47%) believe it will occur within the next 12 months, nearly a third (29%) believe we are already in one, and the remaining (8%) predict it will occur 13-24 months from now.
- One potential silver lining is that the majority of respondents anticipate that the looming recession will likely be of shallow to moderate depth (0% to -2% GDP).
- **For most respondents, the for-sale housing sector has clearly moved into downturn** mode in response to waning demand as a result of rising interest rates – but there is some optimism that the worst is behind us as interest rates have stabilized. **Most report that rental housing has moved past the cyclical peak and has entered the early downturn stage.** However, most predict that housing (both for-sale and rental) will again be in expansionary mode within the next six to 12 months.
- Beyond housing, looking ahead over the next 12 months, survey respondents expect **most of the real estate sectors to be in some stage of downturn**, though some niche sectors such as self-storage, seniors housing, grocery/necessity retail, and hospitality are anticipated to have more resilience.
- In another potential sign of optimism, **approximately half of respondents (47%) predict that inflation will begin to decrease**, while only 23% anticipate that it will increase – this compares with 66% who predicted an increase one year ago.
- Overall respondents predicted that both **capital flows to real estate and homeownership rates would fall in the coming year**
- Not surprisingly, **office was anticipated to top the list with the largest weighted peak-to-trough value decline (16.3%) across asset types**, with 40% of respondents predicting the decline would be larger than 20%. Other land uses were predicted to decline 4% to 8% on average.

## Better, But Still Not Good...

The RMI index has had a series of dramatic peaks and valleys during the Covid-19 Pandemic, War in Ukraine, and the Fed's recent interest rate hikes. RCLCO's RMI Index in 2021 was exceptionally optimistic reaching a high of 89.1, reflecting an initial wave of confidence in what has been a recovery characterized by fluctuating conditions. Sentiment took a pronounced dive to 8.5 at Year End 2022 – comparable to the Mid-2020 low of 9.2 when the Nation was reeling from the first wave of the Covid-19 pandemic. Recent sentiment has rebounded slightly to 19.0, but remains at a level of market stress. **The Fed's interest rate increases have slowed inflation, but the real estate market is still impacted by higher mortgage rates and with the increased costs of construction financing and reduced debt availability.** While there have been recent signs that inflation is moderating, survey respondents overwhelmingly indicated that we are in a period of economic distress and that a recession remains imminent.

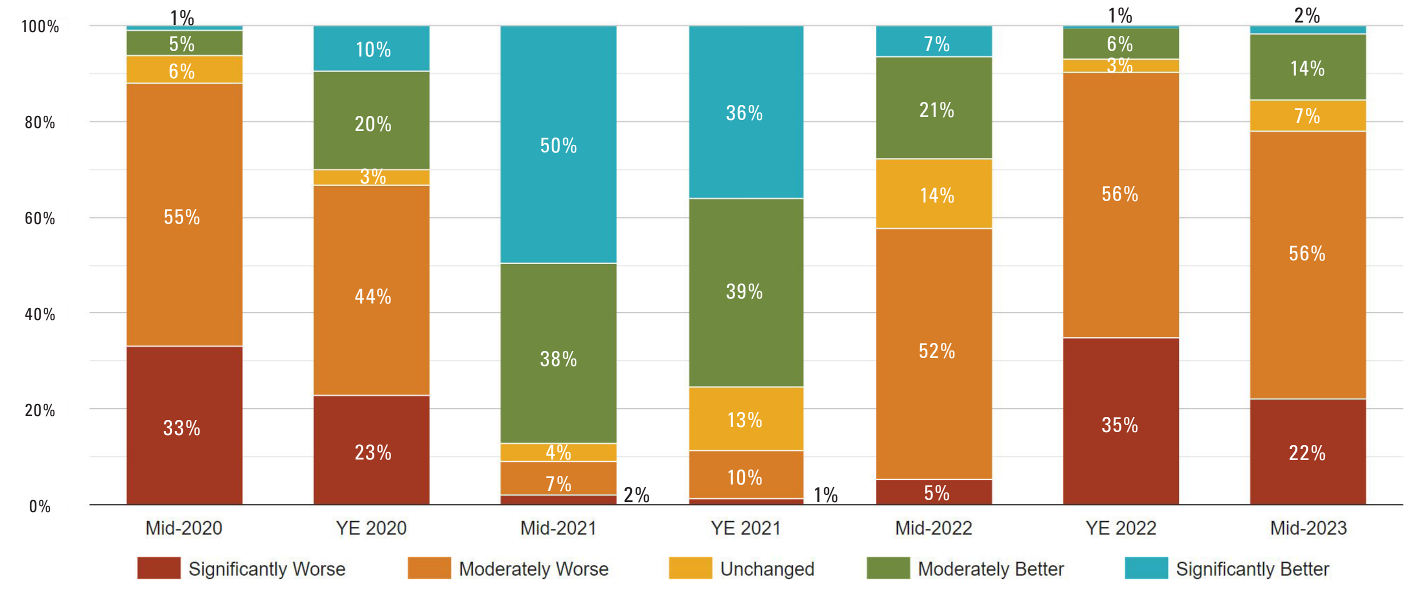
**RCLCO National Real Estate Market Index**




*Source: RCLCO*

The current index at 19.0 puts the market firmly below 30 and at a level that is typically coincident with periods of economic distress or recession. Looking forward, respondents predict that the index will increase by 17.2 points over the next 12 months to 36.2, inching out of the distress/recession zone

## How Would You Rate National Real Estate Market Conditions Today Compared with One Year Ago?

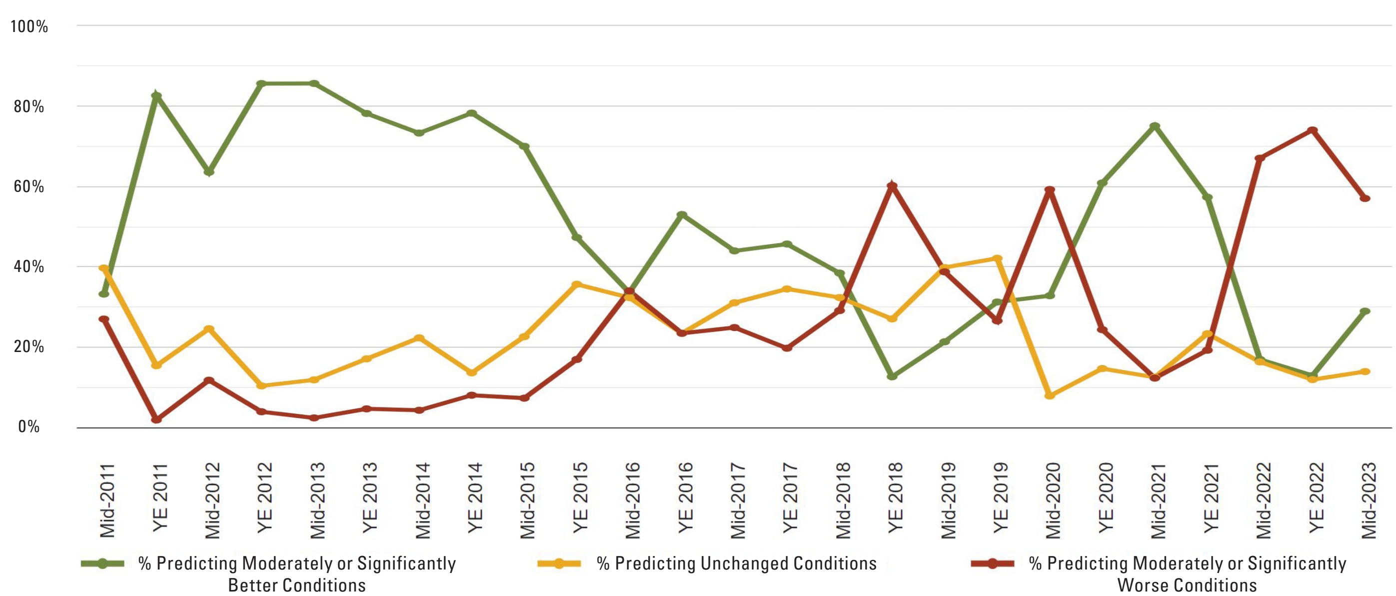



*Source: RCLCO*

Sentiment has seen dramatic peaks and valleys over the past three and a half years. At Mid-Year 2023, there remained consensus among respondents, with a majority (78%) indicating that national real estate conditions were moderately or significantly worse when compared with one year ago. The majority of those respondents felt that real estate market conditions are moderately worse than last year. This signals that while 2021 showed a rapid and strong recovery, that it may have been short-lived as 2022 and 2023 brought a more prolonged period of negative sentiment.

» The outlook for the upcoming year predicts a continued decline. Just over half (57%) of respondents predicted that national real estate market conditions would continue to get "moderately" or "significantly" worse in the next year. Nearly one third (29%) of survey respondents felt conditions would be improving.

## 12-Month U.S. Real Estate Market Predictions Over Time

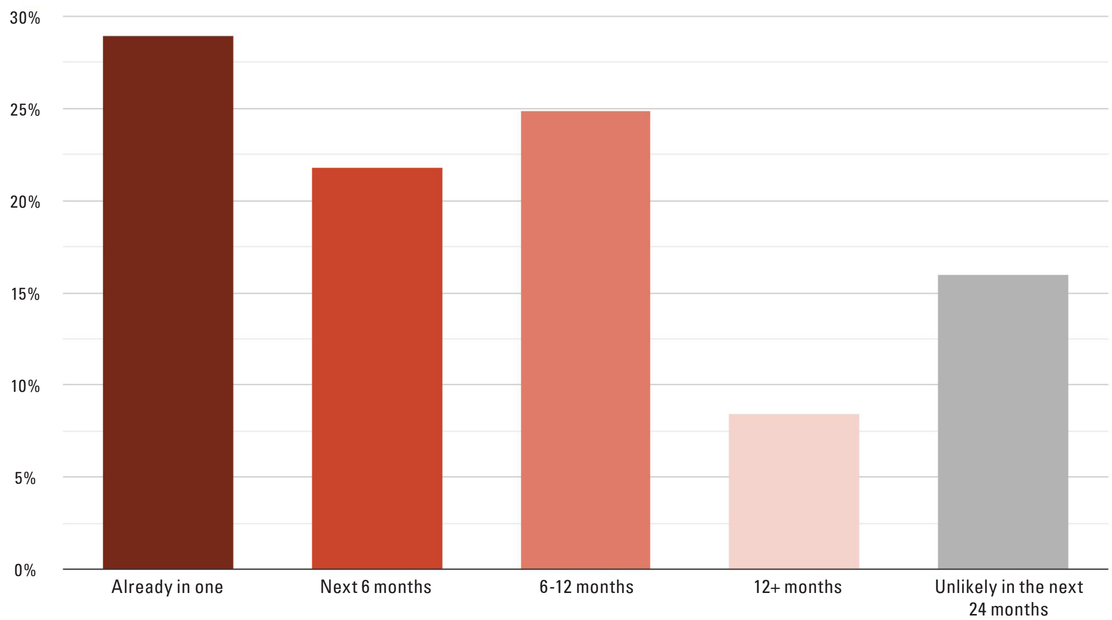



*Source: RCLCO*

## Recession Forecast

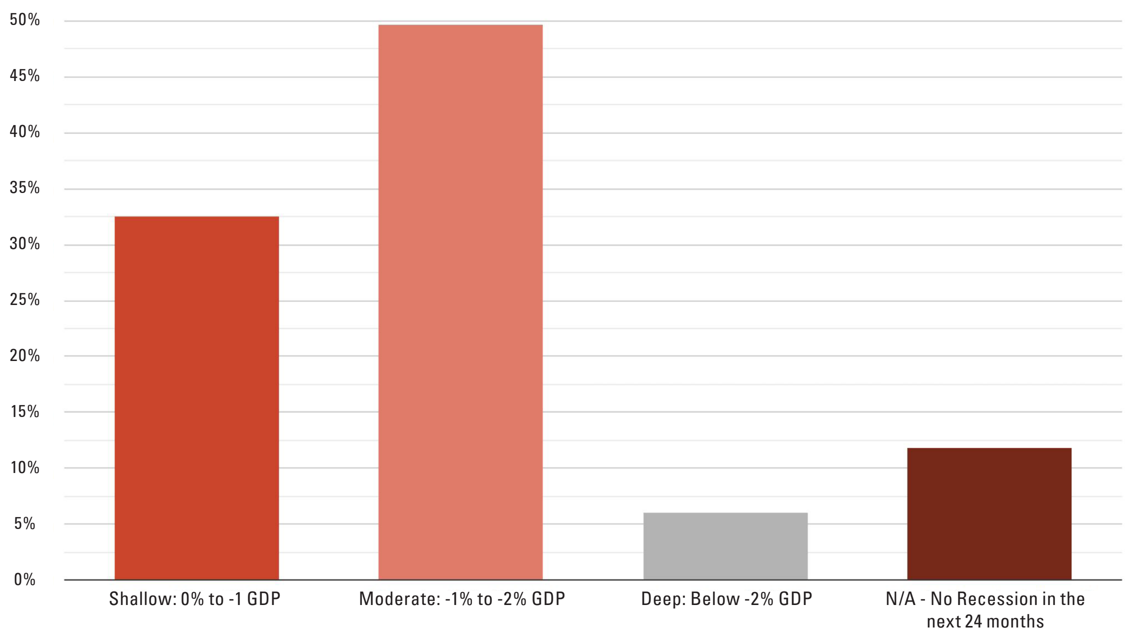
A majority (84%) of respondents feel that a recession will occur at some point in the next two years, and nearly half (47%) believe that this recession will occur within the next 12 months. This is in-line with RCLCO's house view that the economy is likely to enter a recession in the second half of 2023. Regarding the severity of the recession, half (50%) believe it will be moderate in depth (-1 to -2% GDP), while encouragingly another 33% believe it will be shallow (0% to -1% GDP).

**When Will the Next U.S. Recession Occur?**




*Source: RCLCO*

**What Do You Believe the Depth of Recession Will Be?**

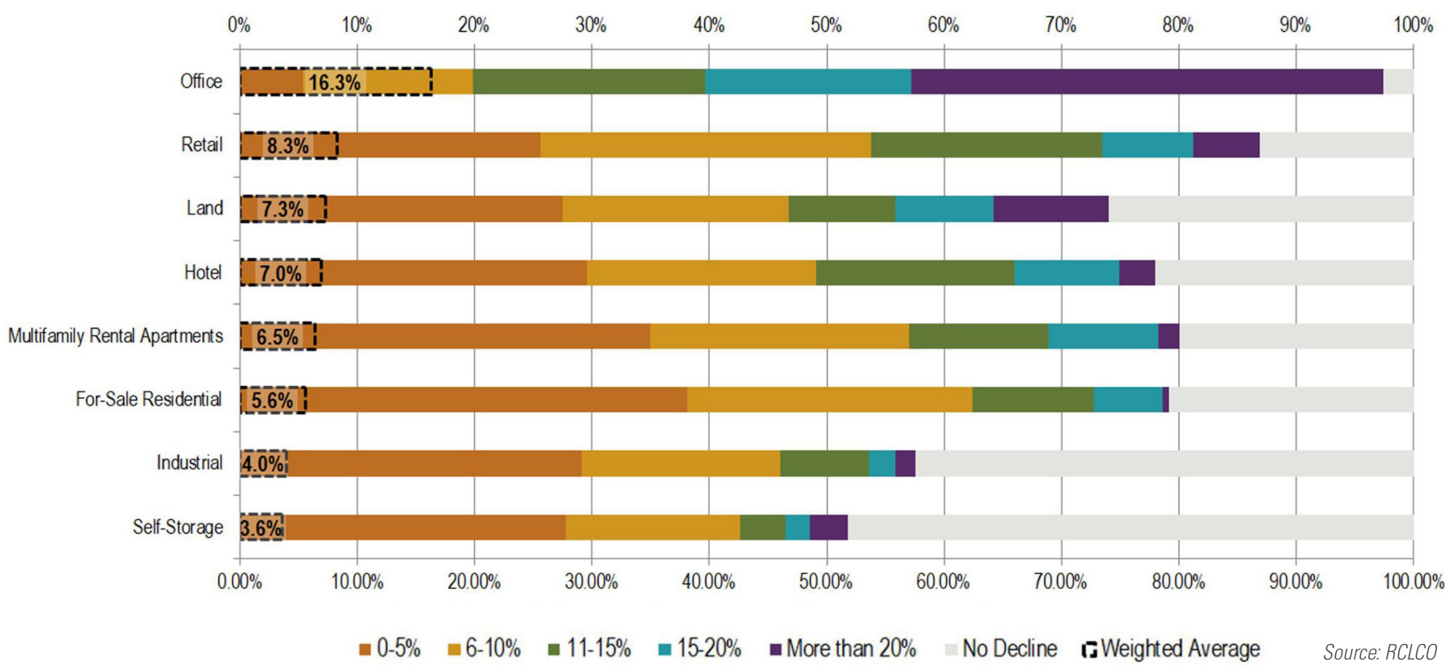



*Source: RCLCO*

## Peak-to-Trough Asset Value Declines

Real estate values have been impacted by current market conditions, and for the wild card question we asked respondents to estimate the peak-to-trough decline of each asset type. Office was the sector that respondents felt would decline in value the most, with over 40% believing office values will end up at 20% below peak, and with a weighted average drop of -16.3%. Retail was second at -8.3% average decline, followed by land (-7.3%) and hotel (-7.0%).

**How Far Do You Think That Real Estate Values Will Decline Peak-to-Trough in the Current Cycle?**

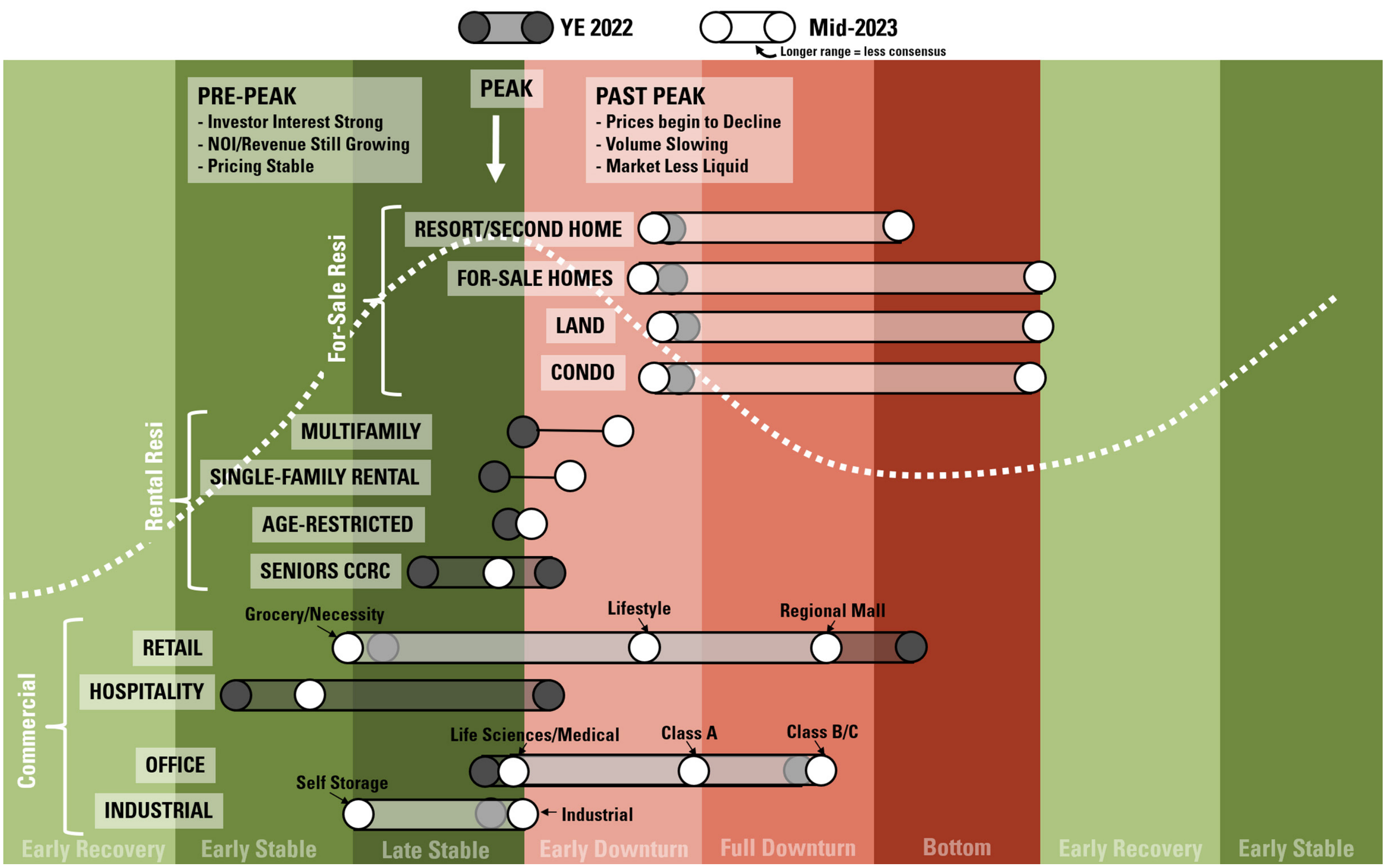



*Source: RCLCO*

## Operating in the Red

At Mid-Year 2023, we are continuing to experience stress and corrections in the residential real estate sectors. As we did last time, we reflect the range of responses (when there is less consensus) in the chart below – the longer the bar, the larger the variation in responses. Commercial uses have more variation due to the fact that they contain more subsectors of varying performance than the residential groupings, and we have begun to add that detail into the chart for the first type this round. Sentiment around the for-sale residential sectors was relatively mixed, with some respondents feeling it is well into downturn or bottom, while others feel conditions have improved since year end. Rental residential has moved past peak generally, though subsectors such as age restricted or seniors housing may still be in stable phases. Hospitality and industrial appear to have remained in the expansionary phases, while retail and office show more variation as certain subsectors outperform others in these groupings.

**Cycle Stage Movement over Past Six Months**




*Source: RCLCO*

- Residential for-sale uses including **resort/second home, for-sale homes, land**, and **condo** have mixed sentiment, ranging from downturn to those who feel conditions are improving somewhat. Elevated mortgage rates continue to impact pricing potential and the overall volume of sales.
- Rental residential uses including **multifamily apartment, age-restricted** rentals and **single-family rental** are moving into early downturn. Seniors CCRC remains in late stable phase as demographic headwinds bolsters the sector.

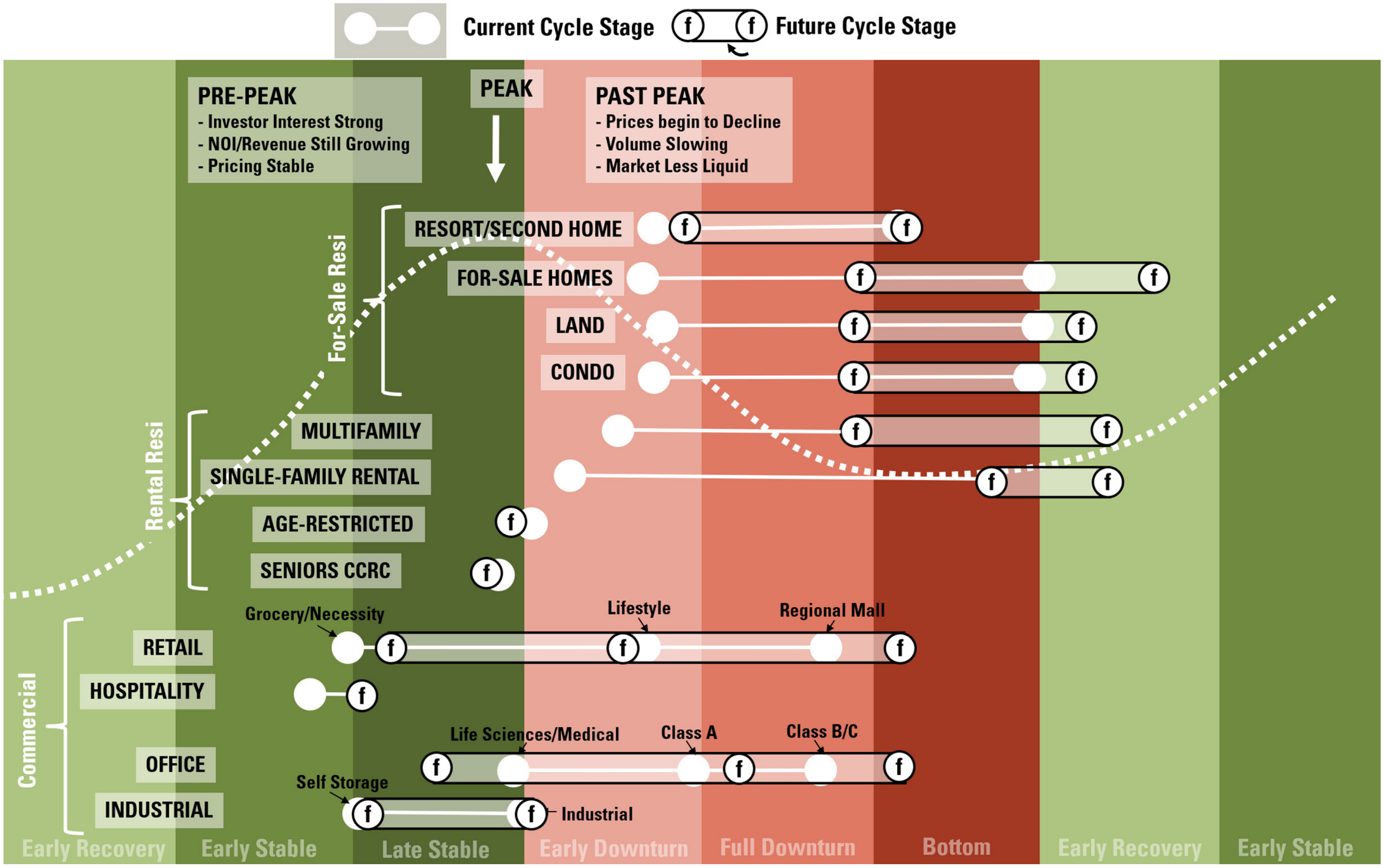
» **Retail** sentiment varies by subsector. **Grocery/Necessity** retail sectors performed the highest, with the majority feeling these were in early or late stable phases. **Lifestyle** uses had moderate performance though many felt the sector was moving into early downturn. There was consensus that **Regional malls** have moved into downturn, though we know that Class A centers have outperformed their Class B peers.

» **Hospitality** continued to remain in stable phases, as much of travel has returned to pre-pandemic levels.

» **Office** also had a mix of opinions depending on the subsector. **Life sciences/medical** are in late stable phases with strong overall sentiment. Class A office has moved into downturn, while class B/C is approaching full downturn/bottom; Class A continues to outperform due to the "flight-to-quality" tendencies seen in this sector.

» The **industrial** sector shows signs of moving towards peak, while **self storage** remains solidly in the stable phases

## Many Land Uses Predicted to Move into Downturn in Next 12 Months, Some Possibly Emerging




*Source: RCLCO*

Looking forward, many of the residential and commercial sectors are predicted to remain or move into downturn stages, consistent with the consensus that a recession is likely in the next 12 months. The outlook for some commercial sectors remain relatively positive: grocery-anchored retail, storage and data centers, life sciences and medical office, and the hotel industry.

## Economic Indicator Predictions for the Next Year

The Federal Reserve's actions have begun to cool inflation, though there is still relative consensus (which is echoed by statements by Chairman Powell) that interest rates will continue to rise moderately over the next 6-12 months. Respondents to the RCLCO survey also weighed in on interest rates, as well as real estate factors such as cap rates, capital flows, homeownership and construction costs. For many of the factors at mid-year, there was a shifting of opinions from Year End, but less consensus on all the metrics overall.

» One third (35%) of respondents said that interest rates will increase at a moderate pace, while only 2% predicted significant increases. This is down significantly from the total of 66% who predicted increases at year end.

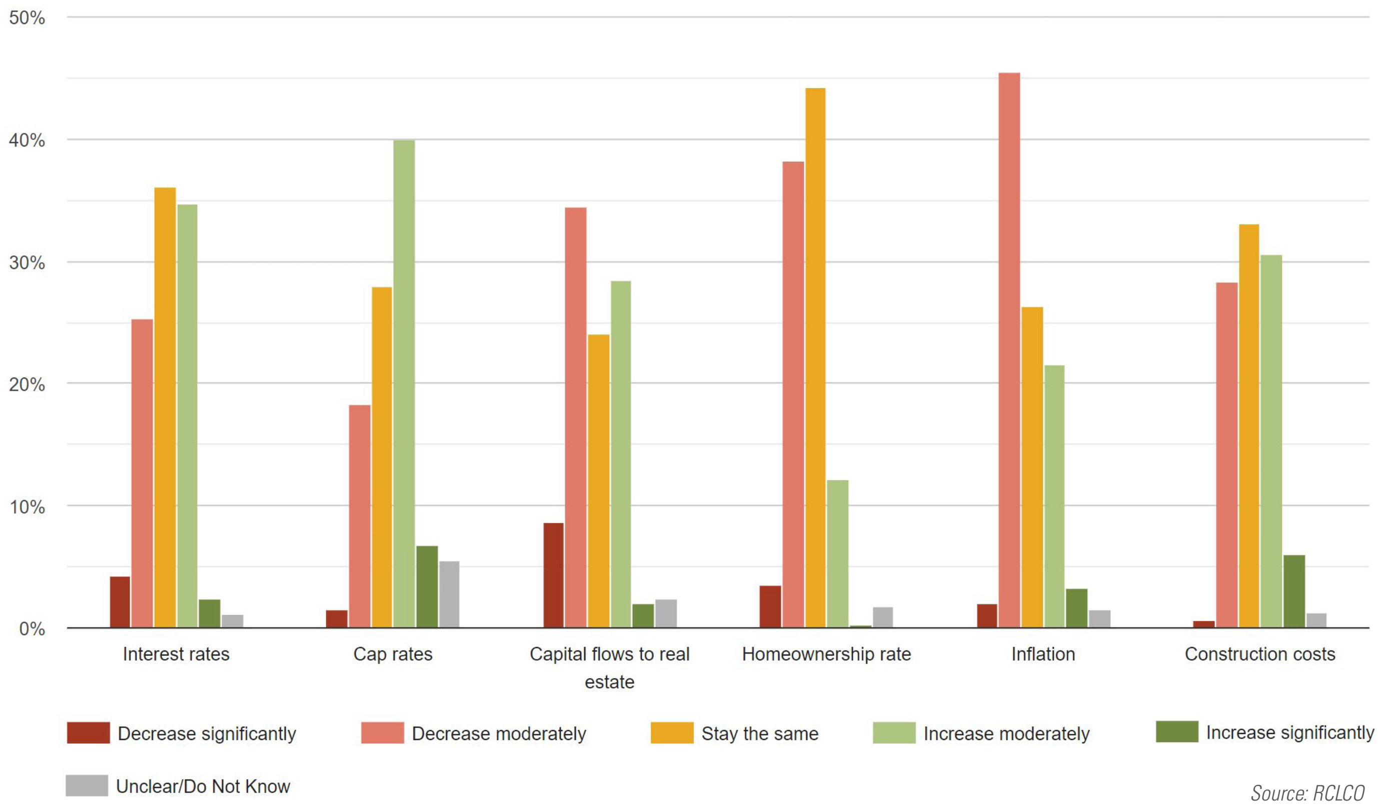
» Cap rate forecasts closely follow interest rate expectations. 40% predicted a moderate increase.

» Inflation had some of the highest consensus of all the metrics this survey round. The largest share (45%) believe that inflation will decrease moderately, 22% believe it will increase moderately, and 16% feel it will remain the same.

» There are mixed options relating to capital flows to real estate, with slightly more feeling there will be a decline. Construction costs also had relatively mixed views between prices declining, remaining constant, or increasing.

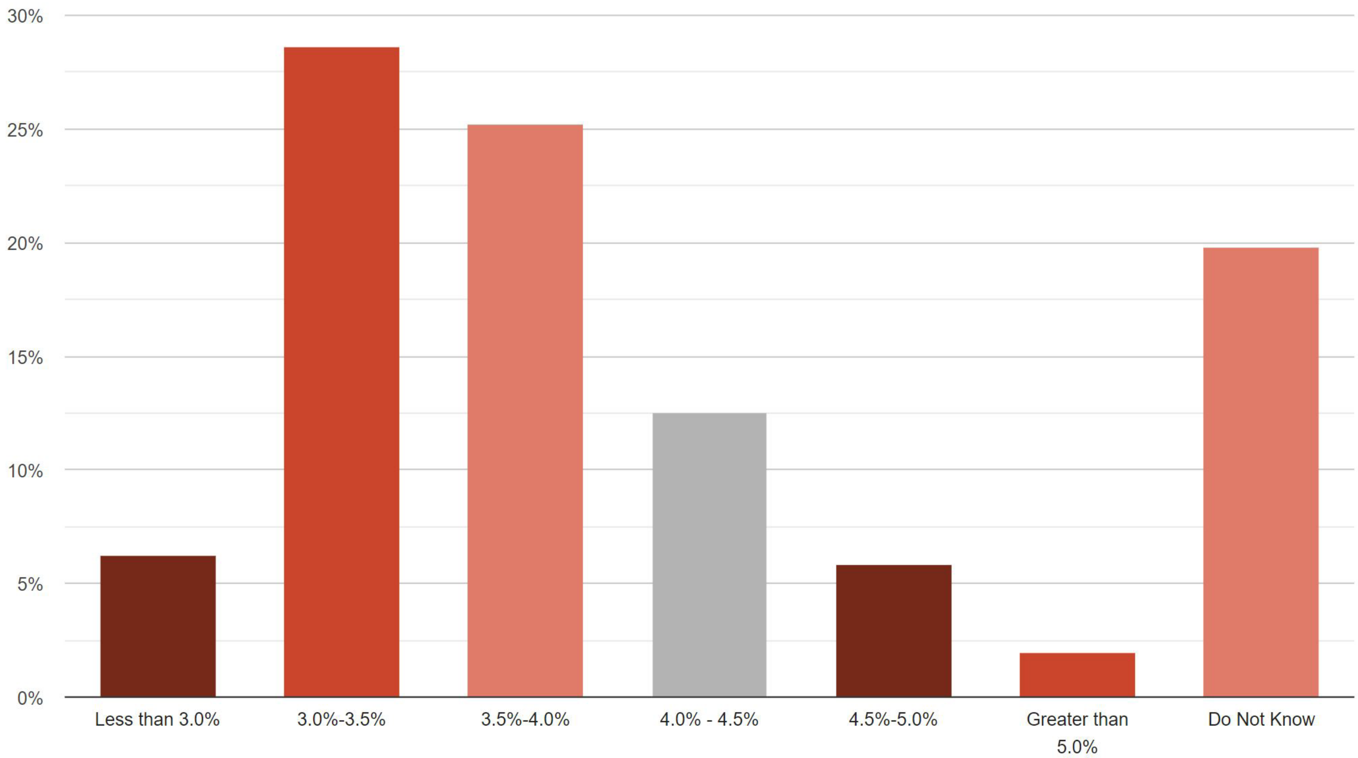
» A majority (82%) of respondents believe that the homeownership rate either stay the same or fall, as rising interest rates and low inventory continue to constrain the for-sale housing market.

**What Do You Expect to Happen with the Following Economic Indicators Over the Next 6 to 12 Months Nationally?**




*Source: RCLCO*

**Because it has a big impact on real estate valuation and debt costs, where do you think the 10-year treasury will be 24 months from now?**



## RCLCO POV

The current RCLCO Base Case (~65% probability) is the U.S. GDP growth will be close to zero (0-1%) with the likelihood of a mild recession sometime in the next 12 months. Lower, but still above trend, inflation, high interest rates, and weaker global growth will negatively impact the US economy. Real estate will not escape the negative impacts of the looming recession, and while there will be some buying opportunities, RCLCO does not expect widespread distress.

### ECONOMIC CONDITIONS

Despite relatively strong labor markets and moderating energy prices and inflation, the potential of continuing Fed action later this year is likely to put downward pressure on demand in the near term. This together with weaker global growth will negatively impact the US economy, and to lead to a mild recession in the near-term. US GDP growth will be close to zero (0-1%) in 2023. Depending on inflation and geopolitics, trend (2-3%) growth will likely resume in 2025. Job growth will moderate to 1.0-1.5 million (annual) in 2023 and could turn negative for part of 2024.

The 10-Year US Treasury has moderated since peaking above 4.0% in Q4 2022, but stands at 3.7% as of the publication of this advisory. With possible further Fed action later this year, we would expect the UST rate to remain elevated in the 3.5-4.0% range before rates start coming down again later in 2024. Real estate capital markets will remain cautious for the balance of 2023, although wholesale selling is not likely. Transactions should pick up in 2024 once prices reset at 10-20% below peak values, which is relatively in-line with sentiment survey predictions.

### REAL ESTATE OPPORTUNITIES

High borrowing costs and a likely recession will put stress on leveraged owners over the next year or so. At some point, re-financing and interest cap costs will precipitate transactions (sales and re-capitalizations) most likely in 2024. Unlike in past recessions, the Fed is unlikely to lower short term rates in the near term. RCLCO recommends focusing on property types and regions that should have strong demand over next 3-5 years:

» **Rental Housing** – Demographics and high borrowing costs will keep multifamily and single-family rental demand high, although supply is ramping up and rent/price increases are moderating. Elevated vacancy rates and potential job losses in a recession could cause softness in some markets.

» **Industrial** – Demand should stay strong as e-commerce continues to expand and re- and near-shoring accelerate.

» **Niche Sectors** – Health care (medical office, life sciences, senior housing), data centers, and self storage out-perform in recessions and have strong long-term demand drivers

**Caution is recommended for office and discretionary retail**, as ongoing structural shifts are creating greater risk. Deep discounts in some cases will create some opportunistic buying/redevelopment opportunities.

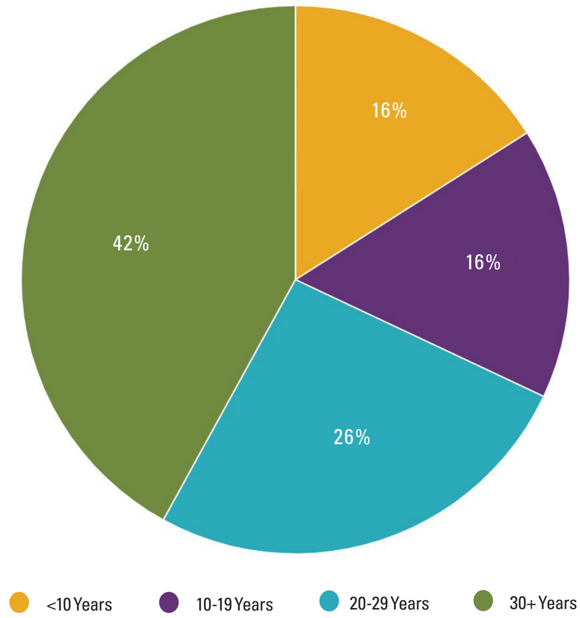
Job growth in gateway markets is forecasted to rebound, although **Sunbelt markets will continue to outperform**.

RCLCO recommends a cautious investment approach for the balance of 2023, as values are likely to remain in flux. Values for many sectors will likely fall below replacement cost, creating buying opportunities, although some office and retail properties may have limited future usefulness. Strong fundamentals and long-term growth factors support selective development and refurbishment of rental residential, industrial, and some niche property types (hotel, senior housing, medical real estate, self-storage). Widespread distress selling is unlikely, except for office and non-dominant regional malls.

## Who Took the Survey?

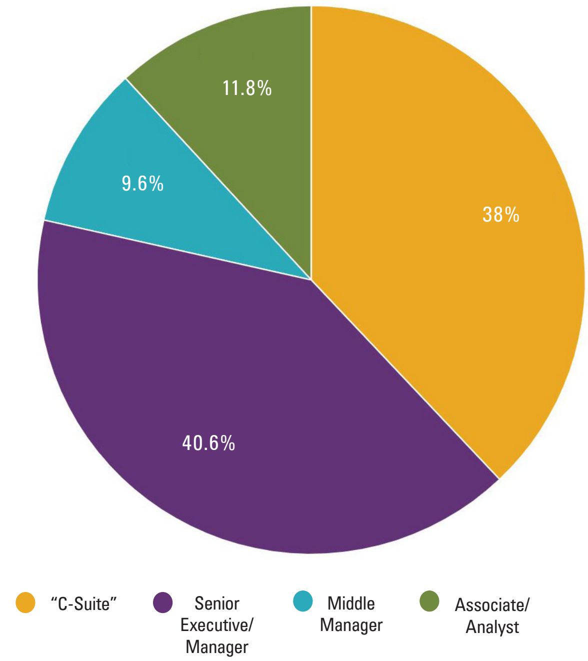
RCLCO's Real Estate Market Sentiment Survey tracks the sentiments of a highly experienced pool of real estate professionals from across the country and the industry. A majority (68%) of respondents have worked in the real estate industry for 20 years or more, with an average respondent tenure of approximately 25 years, and 79% of respondents are C-suite or senior executives in their organizations.

**Years of Experience in Real Estate**

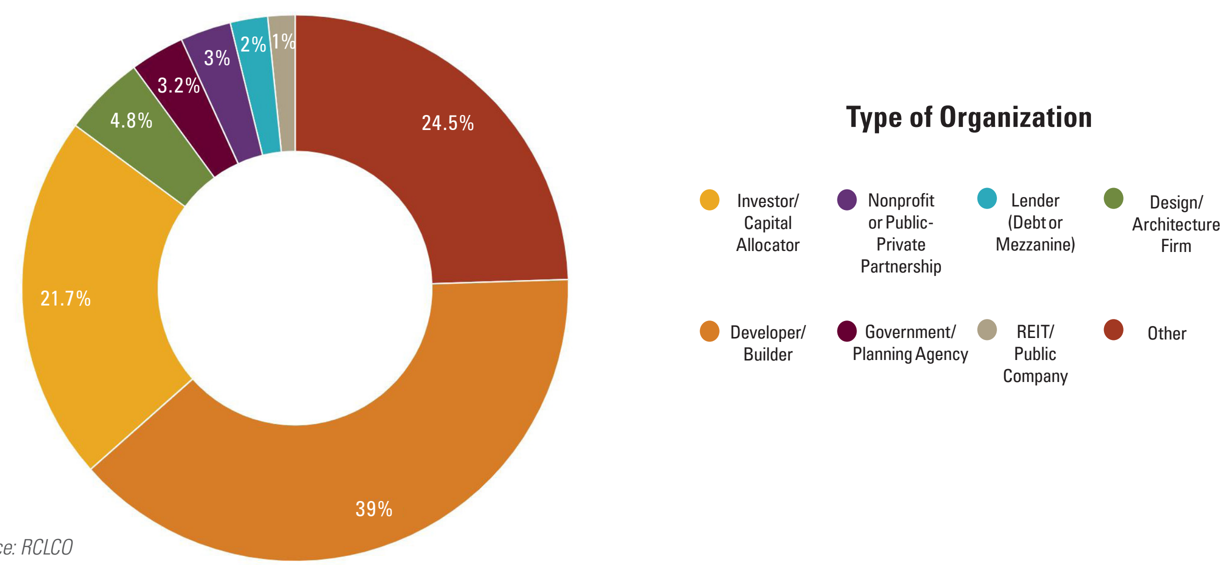



*Source: RCLCO*

**Position in Organization**

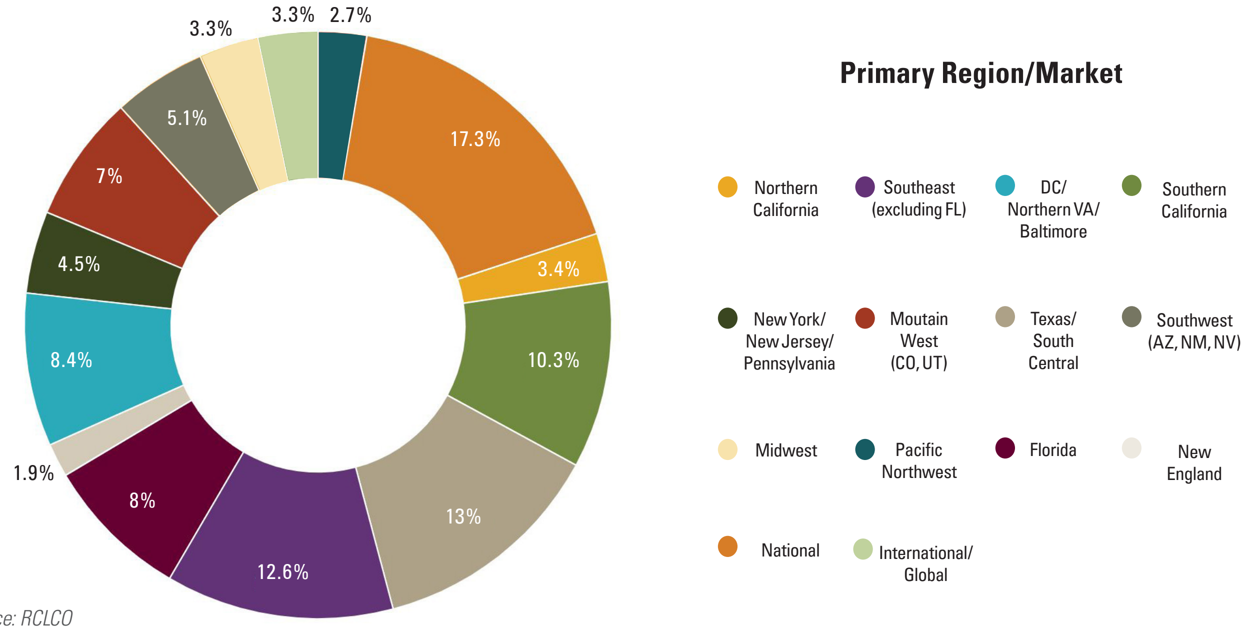



Developers and builders comprise the largest share of respondents, at 39% of the sample. Another 22% are investors or capital allocators, followed by 5% in design or architecture firms. The remaining 34% of respondents come from a variety of other types of organizations within the real estate industry and public sector.




*Source: RCLCO*

The respondent mix is representative of the U.S. as a whole; however, it is weighted towards those who report working primarily in coastal and Sunbelt markets. This respondent mix reflects markets where there has been significant development activity in this cycle.




*Source: RCLCO*

References

[1] The Real Estate Market Index (RMI) is based on a semiannual survey of real estate market participants and is designed to take the pulse of real estate market conditions from the perspective of real estate industry participants. The survey asks respondents to rate real estate market conditions at the present time compared with one year earlier (Current RMI), and expectations over the next 12 months (Future RMI). The RMI is a diffusion index calculated for each series by applying the formula "(Improving – Declining + 100)/2." The indices are not seasonally adjusted. Based on this calculation, the RMI can range between 0 and 100. RMI values in the 60 to 70+ range are indicative of very good market conditions. Values below 30 are typically coincident with periods of economic and real estate market stress/recession.

*Disclaimer: Reasonable efforts have been made to ensure that the data contained in this Advisory reflect accurate and timely information, and the data is believed to be reliable and comprehensive. The Advisory is based on estimates, assumptions, and other information developed by RCLCO from its independent research effort and general knowledge of the industry. This Advisory contains opinions that represent our view of reasonable expectations at this particular time, but our opinions are not offered as predictions or assurances that particular events will occur.*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