CUSHMAN & WAKEFIELD

CHIEF ECONOMIST'S PERSPECTIVE: THE TIDE IS TURNING FOR CRE

DECEMBER 2024

Key Takeaways

- The U.S. economy is growing robustly. It's time to retire the recession predictions; the economic fundamentals remain strong going into 2025.
- After two years of adjustments and declines, commercial real estate (CRE) is generally fairly priced again. Pick your number: expected returns vs. corporate bonds, cap rates vs. treasuries, debt spreads—they all signal that CRE pricing is nearing or back to equilibrium across most product types.
- For CRE, the worst of the supply-demand imbalance is behind us. An inflection point is nearing, even for office, which is undersupplying the product occupiers want the most.
- President-elect Trump's policies will create a mix of positives and negatives for the market, and it's too soon to know what the net effect will be. However, property performed well under his last administration when similar policy initiatives were in play.
- There are downside risks to the outlook, but that is always the case. Prospects are good that the tide is finally turning for the CRE sector.

The U.S. economy is in the sweet spot

The U.S. economy is in the sweet spot, growing robustly while inflation is working its way back to the Fed's 2% target. Real GDP is on track to grow by 2.7% in 2024, and the second half of the year was every bit as strong as the first. Real-time GDP trackers estimate growth will come in above 3% for Q4, driven largely by the unflappable U.S. consumer who is benefiting enormously from stock and housing market wealth effects, let alone a resilient labor market and more than decent real wage growth. The labor markets are cooling off though, by the Fed's design. As the final data rolls in, we expect job growth to be north of 2.5 million in 2024, on top of the 3.5 million it created in the prior year. The unemployment rate is hovering near 4%, a level that is widely believed to be consistent with full employment. And it has been below 4.5% for 38 straight months, which is only bested by the mid-1960s expansion historically. The supply side of the economy is once again firing on all cylinders and productivity is up, which is enabling strong growth without reigniting inflationary pressures. The personal consumption expenditures (PCE) index, the Fed's preferred measure of inflation, was down to 2.3% year-over-year (YOY) in October. Excluding the shelter component, which most agree has been distorting the inflation picture, the PCE has been below the Fed's target rate of 2% for over a year. Inflation has largely been tamed at this point, and barring a major setback, the Fed will continue cutting rates, albeit gradually.

U.S. Strong Fundamentals Going into 2025

	Q1 2024	Q2 2024	Q3 2024	Q4 2024E
Real GDP	1.6	3	2.8	2.6
Job Growth	771	577	420	433
Unemployment	3.8	4	4.2	4.2
PCE Deflator, Y/Y %	2.7	2.6	2.3	2.5
Wage Growth, Y/Y %	4.3	4.2	3.9	3.6
Retail Sales, Y/Y %	2	2.4	2.3	2.7
Oil Prices (WTI)	$78	$82	$76	$71
10-yr Treasury Yield	4.2	4.4	4	4.2

Source: Various Sources, E = Estimate

The U.S. economy has been consistently good for so long that it has driven recession odds down to sleepy normal levels. The 12-month recession probability is now at 15%, roughly consistent with the historical average. This is an astonishing improvement, considering we started the year at a 40% probability.

Corporate profits remain healthy—growing in the high single-digits YOY throughout 2024. With businesses this profitable, it's difficult to see massive layoffs occurring anytime soon. Corporate profits typically must decline for three to four straight quarters YOY before we see significant job losses. As we head into 2025, the underpinnings of the U.S. economy remain as strong as ever.

Property sector gaining momentum

Demand for property remains mixed, but is generally healthy overall. Demand for data centers, apartments, experiential retail and high-quality office is better than just healthy—it's thriving. Meanwhile, as expected, demand for industrial space tapered off, following the unprecedented surge experienced prior to 2024. Still, the U.S. industrial sector is projected to absorb north of 100 million square feet (msf) in 2024, and this will pick up in 2025 as space needs grow in conjunction with e-commerce and increased consumer consumption. The rest of the office sector outside of the high-quality echelon, remains challenged. But with new supply constrained and return-to-office gradually trending higher, demand is beginning to trickle down to the next best thing. On a risk-adjusted basis, well-located Class A office will emerge as one of the stronger opportunities in CRE over the next few years. The capital markets remained subdued for most of 2024, but green shoots are emerging as we head into 2025. REIT prices are up 30-50% from a year ago, debt costs have improved by 100-125 basis points (bps), CMBS issuance is up well over 150% from a year ago, and most importantly, real estate is generally looking fairly priced again.

As always, there are downside risks to the outlook—with potential missteps in monetary policy and Trump policies at the top of the list. However, when are risks ever absent from an outlook? Property performed well during Trump's first go. Prospects are good that it will do so again.

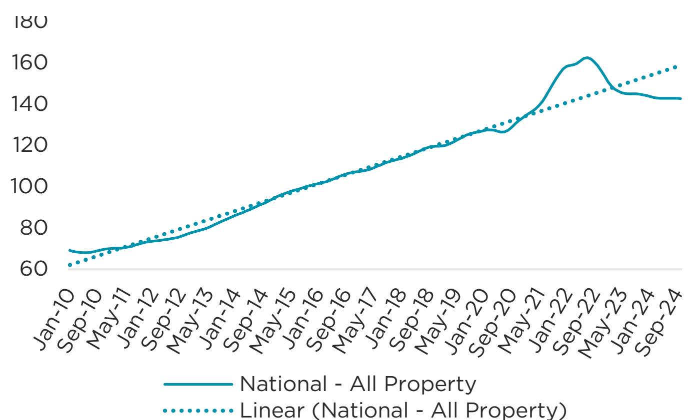
CRE is *generally* fairly priced again

Pricing in the CRE sector became overheated during the pandemic. After nearly a year of sheltering in place, investors emerged with unprecedented pent-up demand, driving up asset values at a breakneck pace fueled by record-low interest rates and an avalanche of fiscal stimulus. Between December 2020 and mid-2022, the MSCI Real Capital Analytics national commercial property price index (CPPI) soared by 22%, translating to a compound annual growth rate of 12.6% per year. The historical average for property appreciation is roughly 4% per year, so this surge coming out of the pandemic was more than triple the norm. Price gains in the industry's darlings, multifamily and industrial, were even more staggering, growing by 35% during the post-pandemic period. For context, during the real estate boom years leading up to the GFC (Great Financial Crisis), property values rose by only 17% during the strongest 18-month stretch—and we know this ultimately resulted in a massive price correction in the years that followed. Clearly a pricing bubble had formed in the CRE sector during the pandemic, and it needed to burst.

In March 2022, the Fed began hiking policy rates, which marked the commencement of the CRE price correction cycle. Initially, the impact was gradual—property values even continued to rise in the first six months following the rate increases. But eventually the higher rate environment began to take its toll, historically cheap credit stopped flowing for leverage-intensive sectors, forcing adjustments in prices, valuations and yields to align with the new, normalized rate paradigm.

CRE Prices have corrected

Commercial Property Price Index (CPPI)



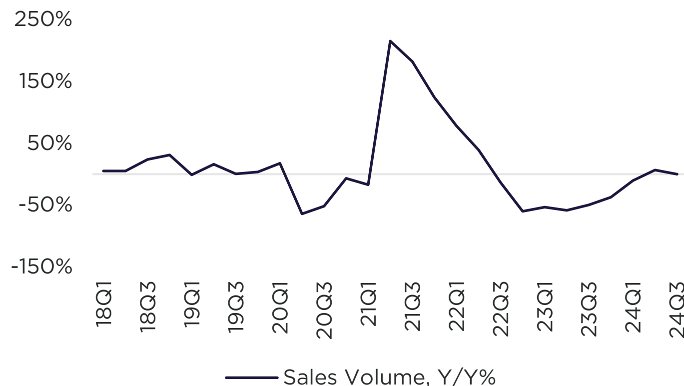
Source: MSCI RCA, Cushman & Wakefield Research

After two years of a meaningful price correction, property values are generally fairly priced again. The national CPPI index is down 12% since peaking in mid-2022. This correction brings the index back in line with pre-pandemic trend growth. Given the hybrid work impact, CBD-office pricing has experienced the largest

pricing correction with values plunging by 50%. This hefty price correction is drawing investors back in. Sales volumes of CBD office is up 28% YOY in 2024 through three quarters.

Other metrics corroborate that property pricing is back to equilibrium again. Typically, there is a 150 bps spread between expected unlevered returns for CRE and the returns from investment-grade (Baa) corporate bonds. This means investors require an additional 1.5% total return to invest in a relatively less liquid real estate asset versus a perceptively safer and more liquid corporate bond. As of December 2024, unlevered expected returns are hovering around 7.5%, compared to corporate bond yields which are hovering in the mid-to-high 5% range, right in the strike zone of yields that are commensurate with drawing healthy investor interest. The industry "go to" method for assessing whether property is fairly valued or not is to look at the spread between cap rates and treasuries. Here too, spreads are normalizing across most sectors. Historically, transaction-based cap rate spreads over Treasuries range between 300 and 400 bps, depending on the sector. Today, cap rates for office and retail are trending in the 350 bps range, and spreads for industrial and multifamily have also begun to normalize into relative yield and spread territory that will fuel greater investor interest, helping to grease the wheels of liquidity ahead.

Sales Volumes Inflecting



Source: Real Capital Analytics, Cushman & Wakefield Research

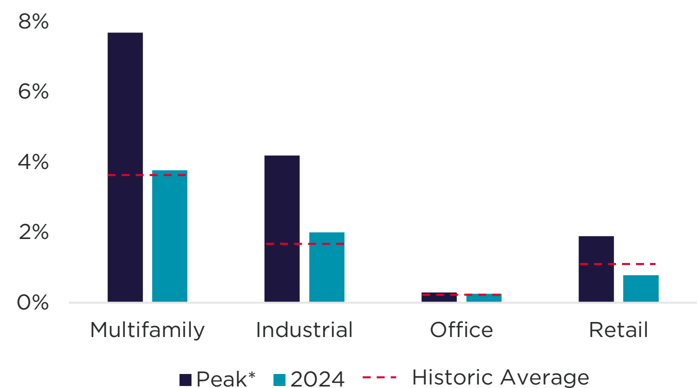
Prevailing price adjustments are doing the trick, and the period of pronounced gridlock appears to be behind us. After plunging 50% YOY in 2023, CRE transaction volumes have stabilized in 2024 and are beginning to trend higher heading into 2025. Transaction-based property values have also largely stabilized and are beginning to tick higher as of the third quarter. Market conditions are increasingly favorable for both equity and debt. The substantial pool of dry powder remains intact, the denominator effect has reversed, suggesting that investors are largely underweighted on property, and debt costs are coming down. Together, these factors point to a meaningful uptick in transaction activity, particularly now that we've seen the required pricing corrections to bring valuations back into balance.

CRE supply-demand coming into better balance

As the economy continues to expand, and the construction pipeline eases from prior years, vacancy has likely peaked in 2024 and will begin trending lower next year. Here are a few thoughts on specific sectors going into 2025.

New Supply Wave Winding Down

U/C as % of Existing Stock



*Source: Cushman & Wakefield Research, *Peak = peak construction year post pandemic*

Industrial: After two years of outsized construction activity—double the norm—activity is tapering off, down 50% from peak levels. Vacancy, which is at 6.4% as of Q3 2024, is forecast to stabilize in 2025 and erode from there. The key engines that will continue to drive demand for industrial space remain

intact. E-commerce growth will continue, consumer spending for goods will grow over time consistent with population growth, and the push for more domestic manufacturing and onshoring will continue. Given these strong engines, the industrial sector overbuilt briefly, but it could be underbuilt by 2026.

Multifamily: Demand remains robust, with 400,000 units absorbed through three quarters of 2024—the second strongest year on record after 2021. Demographic drivers, including growth in the prime rental cohort (ages 20–34) and persistent affordability challenges in the single-family housing market, will continue to underpin demand. The new supply side of the equation presents a greater challenge for multifamily. As we flip to 2025, there are still north of 609,000 new units under construction. Although this is down 36% from the peak, this level is still about 25% higher than the norm. Multifamily likely has a couple years of new supply to work through. Then again, if the absorption levels observed in 2024 hold going forward, vacancy will be nearing equilibrium by the end 2025, and stronger rent growth will quickly follow. Early signs indicate that rent growth likely bottomed in 2024 for most markets and upward pressure is already mounting.

Office: The office market is still grappling with hybrid work's transformative impact. Vacancy rates hit a record 21% in 2024 as businesses continued to shed space. Yet, green shoots are beginning to emerge. Corporate return-to-office policies are gaining traction, with many firms mandating three or more in-office days weekly. The rate at which sublease space is getting added to the market has also come to a standstill in 2024, indicating that businesses are at, or nearing, the point where their office footprint largely matches their workplace strategy. Over time, these trends should stabilize demand for well-located, high-quality office space. Net absorption will remain negative for one more year in 2025. After that, demand for office space will turn positive as job growth begins to more than offset the hybrid drag on demand. It will continue to be story of haves and have nots, but better days lie ahead for office.

Retail: Retail has been quietly thriving, although the weight of inflation on consumers has dampened demand and created divergences between concepts and brands. Although consumers have a strong footing heading into 2025, several headwinds (bankruptcies, discount/dollar stores struggling with sales) will cause demand to be restrained in 2025, with 2026 picking up amid lower interest rates and a better position for lower income households. Given that there is effectively no new construction, occupancy rates still reached 95% in Q3 2024, a 15-year high, where we expect them to hover heading forward. Given the limited options retail brands will face in the space market, rent growth of 3-4% YOY in 2025 should still be expected.

We've been here before

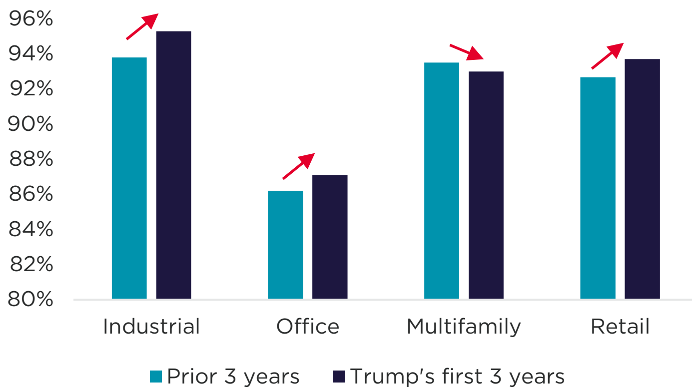
President-elect Trump's second term throws a potential wild card into the outlook. The upcoming policy changes encompass a wide range of macroeconomic influences, including regulatory conditions, fiscal policies such as taxation and government spending, trade policies, and immigration policies. Some of these will have a more immediate impact (for example on the financial markets), but others have a more lagged impact on the economy and financial markets and are therefore more likely to influence leasing fundamentals and the capital markets down the road. To read more, see [Trump 2.0 & Implications for Property.] Although many of the changes to policy could be significant, they also have the potential to exert offsetting forces to economic growth and inflation. At this stage, our baseline assumes that the expected changes in policy will not significantly alter the trajectory of the economy or the property sectors' performance in 2025. Of course, like all forecasters, we will be monitoring the situation carefully and updating our outlook as policy changes unfold.

Despite the uncertainty, we've been here before. Many of the policies that the Trump administration is pursuing in his second term—such as restrictive immigration, tariffs, tax cuts—mirror the same policies that were pursued during his first term and, despite the whipsaw in policy, the U.S. property sector performed well. During Trump's first term (excluding the pandemic year), the industrial sector absorbed 843 msf of space—one of the strongest stretches on record prior to the pandemic-fueled boom years. Industrial occupancy climbed to a near-record high at the time, over 95%. The office sector absorbed 130 msf of space—on par with historical averages—and occupancy hovered in the 87% range. The multifamily

sector boom, which started before Trump, continued unabated. The U.S. economy absorbed 836,000 apartment units in the first three years of Trump's first term versus the 666,000 in the three years prior. The capital markets also did well under Trump. Sales volumes reached a pre-pandemic record high in 2019, and property values grew by a healthy 18%.

Property Performed Well Under Trump

Average Occupancy Before & During Trump's First Term



Source: Cushman & Wakefield Research

Of course, the past is not always prologue. The degree to which the economy, inflation and the financial markets are impacted depends entirely on the scope of policies adopted, their timing, magnitude and detail. We know that Trump and his advisors intend to make sweeping changes to certain policies and that he is coming in more seasoned than he did in 2016. However, Trump has shown a willingness to shift his stance based on the reactions of investors and financial markets, which led to a milder version of the polices espoused on the campaign trail the first time around. Time will tell, but if history is any guide, the property sector will still be able to navigate the policy changes that lie ahead.

The tide is turning for CRE

Unlike the last two years, we enter 2025 with more confidence and optimism for the property sector's outlook. Consider the state of the property sector just 12-18 months ago: in mid-2023, core inflation was running in the 5% range, interest rates were highly restrictive, and the yield curve was deeply inverted, with the 10-year Treasury yield approaching 5%. Recession fears abounded, there was tremendous uncertainty about the Fed, and discussion about rate cuts were nonexistent. At the same time, relatively under-appreciated tech job losses combined with the hybrid dynamic were still ripping through the office sector, putting millions of square feet of empty sublease space back on the market.

Fast forward to 2025, and the landscape has shifted significantly. The Fed is cutting rates, the 10-year Treasury yield is hovering in the 4% range, and the yield curve is flattening, on track to un-invert this year. The cost of debt is coming down as a broader suit of lenders reengages with the market. Sellers are gradually capitulating which is leading to more transactions and price discovery, and dry powder is starting to move off the sidelines eyeing this period as an attractive entry point.

After two years of challenges and headwinds, the tide is finally turning.

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ABOUT CUSHMAN & WAKEFIELD

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