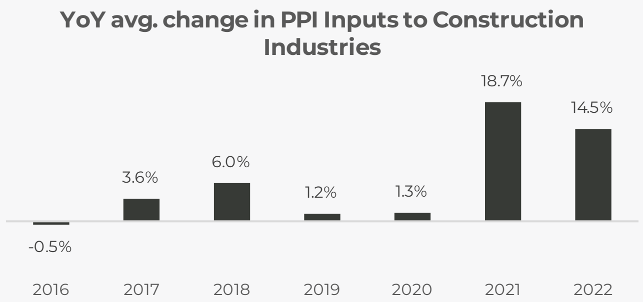
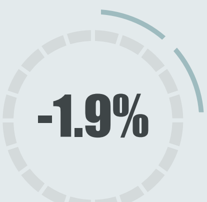
An Artificially Good Year Ahead

Navigating the Real Estate Landscape in 2024: A Tapestry of Resilience, Rate Hikes and Lumbering Expectations

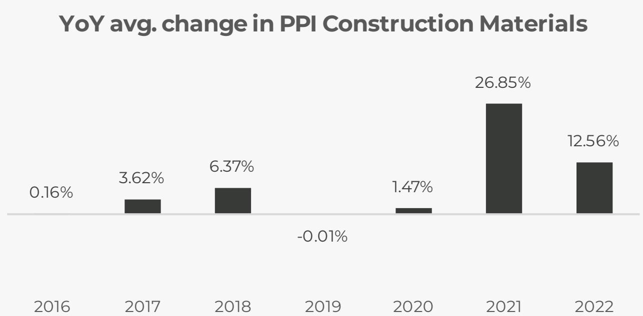
January 4, 2024

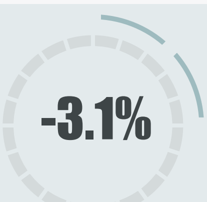
How would you characterize and summarize the key events and takeaways of 2023?





Year to date (Jan-Nov) avg. % change in PPI: Inputs to Construction Industries from 2022 to 2023





Year to date (Jan-Nov) avg. % change in PPI: Construction Materials from 2022 to 2023

(Source: U.S. Bureau of Labor Statistics)

Fed up

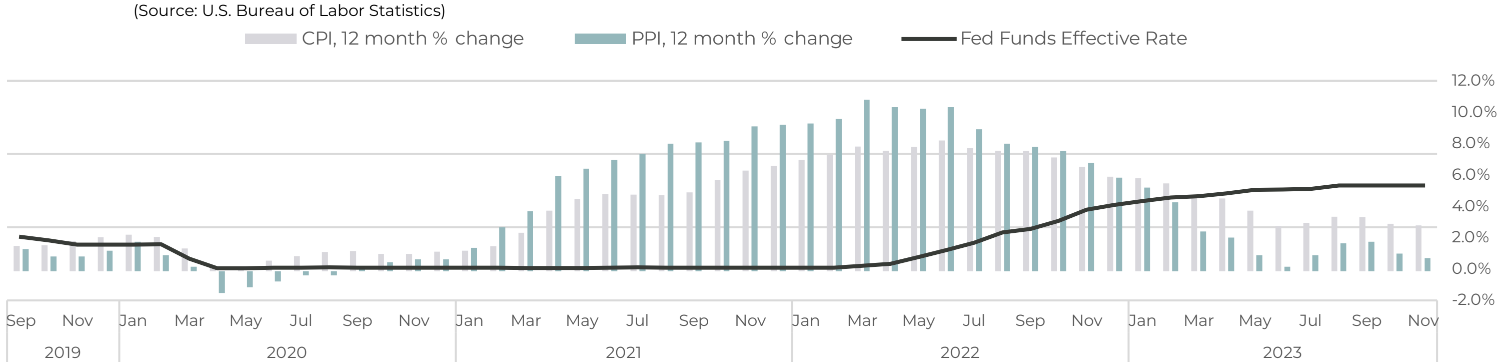
The aftermath of the pandemic has presented the industry with challenges characterized by erratic fluctuations in material costs, elevated borrowing expenses and brewing geopolitical tensions. These have been extensively discussed, revolving supply chain disruptions, shortages, economic sanctions, and their cascading effects. Couple that with lockup induced day drinking and television programming about home improvement (not a good mix).

At the outset of the pandemic, the Federal Reserve (Fed) hastily dropped the fed funds target rate to near zero. Seductively low mortgage rates fueled a frenzy of homebuying and renovations. Increased demand for building materials collided with supply bottlenecks during 2020. Prices grew out of control. Inflation in quickly rose above historical averages with year-over-year increases of 18.7% and 14.5% in goods and services to construction industries[1] in 2021 and 2022, according to the U.S. Bureau of Labor Statistics (BLS). Specifically, year-over-year inflation in construction materials[2] dwarfed historical averages by a wide margin —26.9% in 2021 and 12.6% in 2022.

In response to stubborn price growth, the Fed began raising interest rates in March 2022. By July 2023, the Fed's Federal Open Market Committee (FOMC) had implemented 11 rate hikes: effectively elevating the fed funds target rate by 525 basis points**. The swiftest tightening cycle in four decades!** Higher interest rates and more stringent lending criteria weighed heavily on construction starts and investments in commercial real estate. The value of construction starts shrunk by 4.2% in 2023 (YTD-November) compared to the same period last year according to ConstructConnect[3].

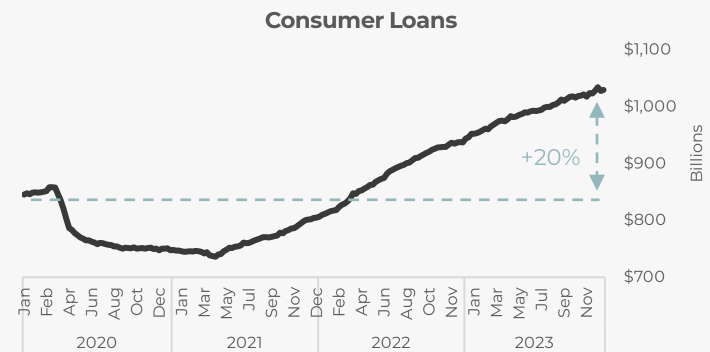
Throughout 2023, the combination of contracted spending and improved supply chains yielded deflationary trends in construction commodities. Volatile swings subsided and cost of materials began to normalize, (though still above pre-pandemic levels). Average year to date (Jan-Nov.2023) percent change in PPI (Produce Price Index) for construction material decreased by 3.1%, compared to the same period last year.

(Source: U.S. Bureau of Labor Statistics)



How did predictions at the beginning of 2023 pan out? What surprised you most in 2023?

(Source: U.S. Bureau of Economic Analysis)



(Source: Board of Governors of the Federal Reserve System)

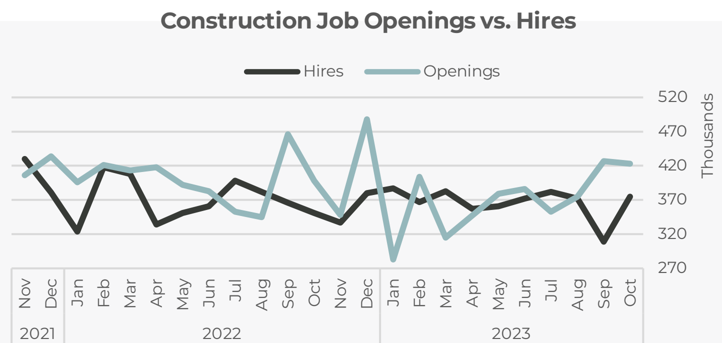
"Resilience"

Expectations about a rate cut happening sometime in the second half of 2023 did not materialize. The Fed's FOMC raised rates (for the last time this year) in July and from their most recent meeting in December they're projecting 3 rate cuts in 2024. Treasury yields started going down mid Q4.2023. That bodes well for commercial real estate. It could ease access to capital.

Around this time last year, it was widely perceived that the U.S. economy was going to slip into a recession in 2023. Contrary to these expectations, the U.S. economy displayed resilience, in the wake of elevated interest rates and mounting geopolitical tensions. The U.S. Bureau of Economic Analysis, in its third estimate, reported a 4.9% annualized growth of real GDP in Q3-2023 (revised downward from 5.2%) which represents the most robust reading since Q4-2021. Notably, this growth rate stands at 2x the level observed in the initial two quarters of the year.

Yet, this information offers limited insights into future economic growth as we head into 2024. Early economic indicators from Q4-2023 are hinting at decelerated momentum. Household and government spending is slated to retract in the wake of escalating debt and the rising cost associated with servicing that debt.

What is your take on current labor shortages?



(Source: U.S. Bureau of Labor Statistics)

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Staying higher for longer

The maxim, demography is destiny, holds here. The challenges associated with a shortage of skilled labor and a declining labor force participation rate are exacerbated by long-term demographic trends. Declining birth rates in the U.S., dating back to the 1970s, and the accelerated retirement of baby boomers during the pandemic have contributed to structural issues in the availability of skilled labor.

Also, a decline in workforce participation[4] triggers fierce competition among industries vying for a limited labor pool. To attract and retain skilled labor, businesses offer competitive salaries and benefits. **BLS data reveals that average construction hourly earnings increased by 4.9% to $37.18 in November 2023** compared to the previous year and surged by 18.4% since the onset of pandemic lockdowns.

While material costs are beginning to show signs of stabilization, the main driver of the current inflation in construction costs is the upward trend in wages where the demand for labor is outpacing supply. If there's anything staying higher for longer, it's construction labor wages.

We talk a lot of about aggressively high interest rates – do you see that letting up anytime soon?

Yes

Financial markets are transitioning in the wake of decelerating inflation and rising likelihood of rate cuts. Treasury bond yields have been declining since November. The consensus is that we're at peak rates for this tightening cycle. December's FOMC meeting echoed dovish sentiments and pointed at three 25 basis point cuts next year. Last CPI reading in December was 3.1%. Fed's target is around 2%. Anticipating the first rate cut in the second half of 2024.

Any big predictions for 2024, specifically in Q1?

"Wood" you look at this?

Anticipating lumber prices to modestly rise throughout 2024, primarily fueled by a resurgence in the demand for new homes. However, growth in housing construction activity and the subsequent demand for lumber hinge significantly on broader economic factors due to this segment's sensitivity to mortgage rates. Also, Q1 is a seasonal buying period because that's when orders at mills ramp up in anticipation of the looming building cycle that kicks off in spring.

Seeking greener pastures

Funding from public and private sector is at a carbon crossroad that aims to incentivize passive design principles and finance LEED-certified assets. Earlier this year the Department of Housing and Urban Development (HUD) introduced guidelines for its Green and Resilient Retrofit Program (GRRP), allocating $4.8 billion to retrofit and decarbonize buildings. A theme that will continue to shape construction and the CRE industry is sustainability and access to capital that promotes ESG objectives.

The tsunami of climate change awareness has birthed a breed of investors that are keen on eco-conscious investments. A flurry of financial products was synthesized to cater to a growing demand to decarbonize the global economy. One burgeoning source is green bonds. **These bonds are structured and issued specifically to fund projects with positive climate impacts, corporate sustainability, and other ESG mandates.**

According to data compiled by S&P Global Market Intelligence, the U.S. REIT (real estate investment trust) industry experienced a green bond boom, with total gross proceeds soaring from $2.25 billion in 2018 to a record high of nearly $12 billion in 2021, constituting 15.5% of total REIT bond proceeds. However, this was tempered in 2023, as green bonds' share of total U.S. REIT bond issuance significantly scaled back due elevated interest rates which raise an issuer's cost of capital and generally dampen debt market activity. In the coming years, with the transition of financial markets from a high to low interest rate environment, there is potential for an increase in the issuance of green bonds to finance eco-sustainable projects.

Cash is king

Multifamily. The outlook is mixed for 2024, with challenges in rent growth and vacancy rates but opportunities in affordable housing. The multifamily market is expected to face headwinds from anemic rent growth (compared to the previous two years) and elevated vacancy rates while the market absorbs new supply deliveries in 2024. Despite these (transitory) challenges, the current landscape presents opportunities for investment growth in affordable housing due to zoning amendments calling for higher residential density and more efficient land use.

Industrial, Infrastructure, and Data Centers. Construction in this sector is poised for expansion in 2024, fueled by Federal funds from the Infrastructure and Investment Jobs Act (IIJA) and the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act. In October 2023, the U.S. Department of Transportation allocated $61 billion for investments in heavy civil projects in 2024. Capex to modernize critical infrastructure and re-shoring manufacturing will require more construction of freight hubs and warehouses. Fueling growth in the data center market is increased demand for AI computing and opportunities to retrofit existing facilities.

Office. Older urban office properties lacking modern amenities face further value erosion in 2024, serving as a sobering reminder to owners that action for underperforming assets is needed. Pervasive hybrid work arrangements are pushing vacancy rates higher, reducing rents, and contributing to negative operating income. However, these challenges unveil opportunities to acquire discounted assets for adaptive re-use, such as conversion to residential or life science

The 2024 outlook for the commercial real estate market reveals distinct trends and challenges across various segments. Capital availability and cost of capital will continue to weigh on investor appetite, however opportunities ahead as inflation in construction materials and borrowing costs subside in the second half of 2024. Till then, cash is king and investors with strong balance sheets are poised to capitalize on bargain prices.

What are big things that are happening in the construction industry right now?

I'll be back

Despite its reputation for lagging behind other industries, the construction industry has progressively embraced digital technologies as a means to optimize operational processes. The recent surge in applications of generative artificial intelligence presents a unique opportunity to realize and capitalize on efficiencies in project design, schedules, controls, and safety. But harnessing the right technology to boost productivity is a significant undertaking. Successful adoption requires careful curation of practical uses cases and professionalization of employees. To leverage the potential of AI and gain a competitive edge, it is vital to determine the most suitable use cases and cross-train employees in various functions. Creating versatile and efficient teams is essential for extracting business value from AI implementation. For smaller firms contending with diminishing backlogs, adopting AI to support lean team structures isn't just a matter of staying competitive; it's necessary for survival.

(1) Source: U.S. Bureau of Labor Statistics. Producer Price Index by Commodity: Inputs to Industries: Net Inputs to Construction Industries, Excluding Capital Investment, Labor, and Imports. Not Seasonally Adjusted. Measured on a year-to-year % change by averaging 12-month indices.

(2) Source: U.S. Bureau of Labor Statistics. Producer Price Index by Commodity: Special Indexes: Construction Materials Not Seasonally Adjusted. Measured on a year-to-year % change by averaging 12-month indices.

(3) Measured on a year-to-date basis, Jan-Nov.2023 vs Jan-Nov.2022: residential -20.9%, non-residential building +2.1%, heavy engineering/civil (airport, bridges, power infrastructure, roads etc.) +15.5%

(4) Source: U.S. Bureau of Labor Statistics. Labor Force Participation Rate 62.8% (Nov.2023) down from 66.1% (Nov.2003). Seasonally Adjusted.