

UNITED STATES

Key Themes

- November Election: What Changes for Real Estate in a Policy U-Turn?
- Does Retail Still Offer Value if Consumers Pull Back?

November Election: What Changes for Real Estate in a Policy U-Turn?

With labor markets still tight, and after a wild three years whipsawing real estate values, policy changes might be the difference between a delayed real estate recovery and an accelerated one.

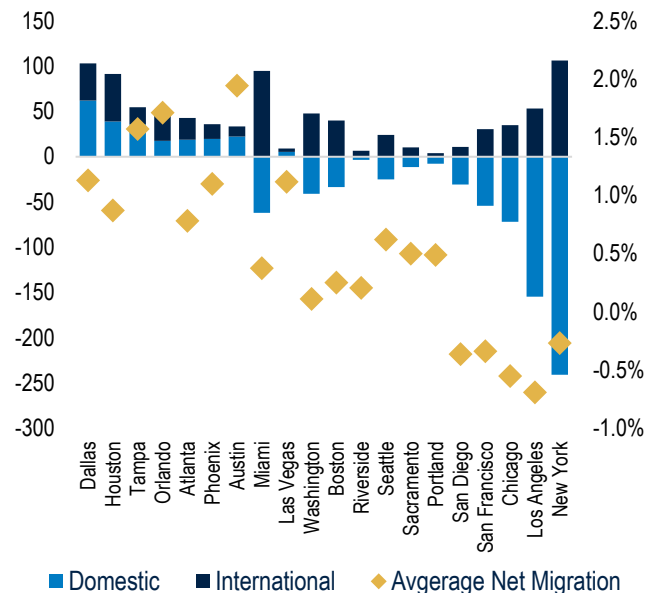
We modeled two potential outcomes: status quo, defined as a Democratic president and a closely divided Congress; and a Republican sweep in which both the executive and legislative branches are fully controlled by a new nominee. We focused on three policy areas where there are likely to be substantial differences in the latter scenario:

- **Less migration**, with reduced legal immigration and less unauthorized immigration;
- **More restrictive trade policies**, which would be more restrictive in a Republican sweep due to new high tariffs; and,
- **Lower personal and corporate taxes**, which would stimulate higher nominal economic growth but also higher Treasury rates.

Less migration would pressure labor costs up, given today’s tight labor markets. This would be felt unevenly across the U.S., as shown in **Exhibit 1**, with metros on the right particularly exposed to wage cost pressures.

Exhibit 1: Rents Need Another Year to Catch Up With Incomes

Total Migration in 2023 (ths.) vs Avg. 10-Yr Net Migration (% of population)



Sources: Bureau of Labor Statistics, PGIM Real Estate. As of August 2024.

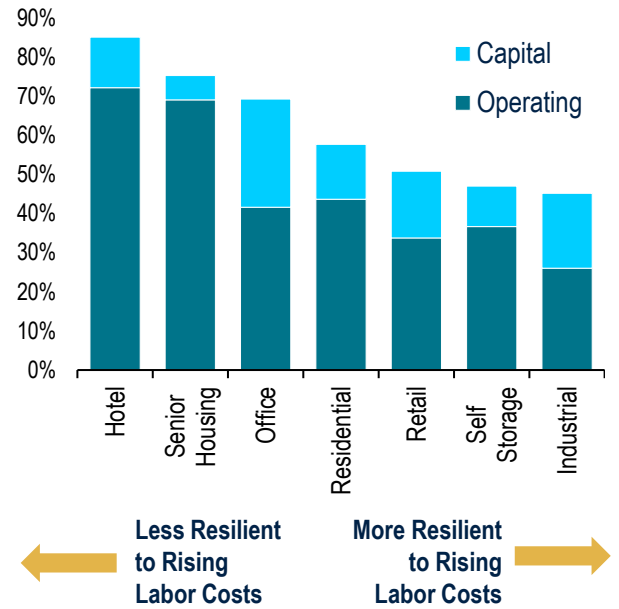
Higher labor costs would also disproportionately hit sectors with high operating expenses, as shown in **Exhibit 2**. Retail, storage and industrial are best positioned to weather another round of wage increases.

More restrictive trade policies would also have geographically disparate impacts. As shown in **Exhibit 3**, an increase in tariffs would weigh most on trade-dependent economies on the left-hand side of the chart. The outlook is particularly uncertain for smaller East Coast ports like Savannah, Charleston and Norfolk, which are major gateways for autos and other goods manufactured in Europe.

By contrast, markets such as Laredo, El Paso and Detroit on the Mexico and Canada borders would be insulated from tariffs if those countries continue to be exempt due to the free trade agreement in place at least through 2026.

Exhibit 2: Low Opex Sectors Are Most Defensive

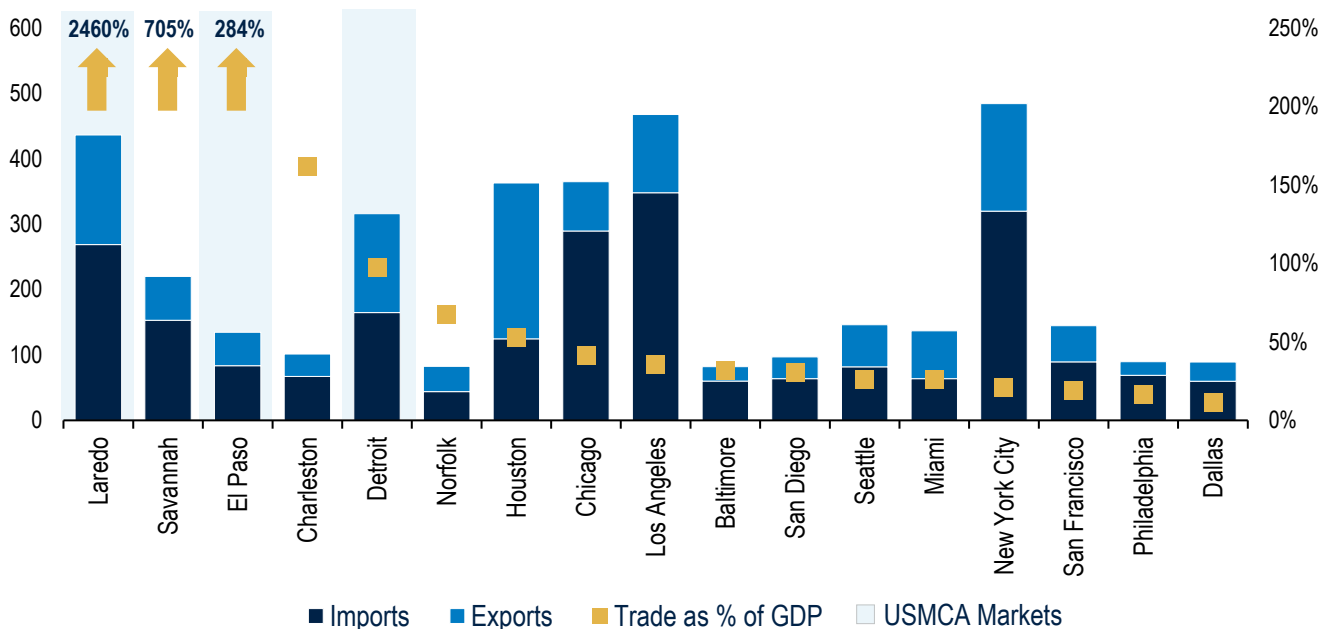
Expenses as a Percent of Revenue (20-year Average)



Sources: NCREIF, PGIM Real Estate. As of August 2024.

Exhibit 3: Tariffs Will Weigh on East and West Coast Transit Hubs

Trade Activity by District (US\$ Billions)



Sources: U.S. Census, Oxford Economics, PGIM Real Estate. As of August 2024.

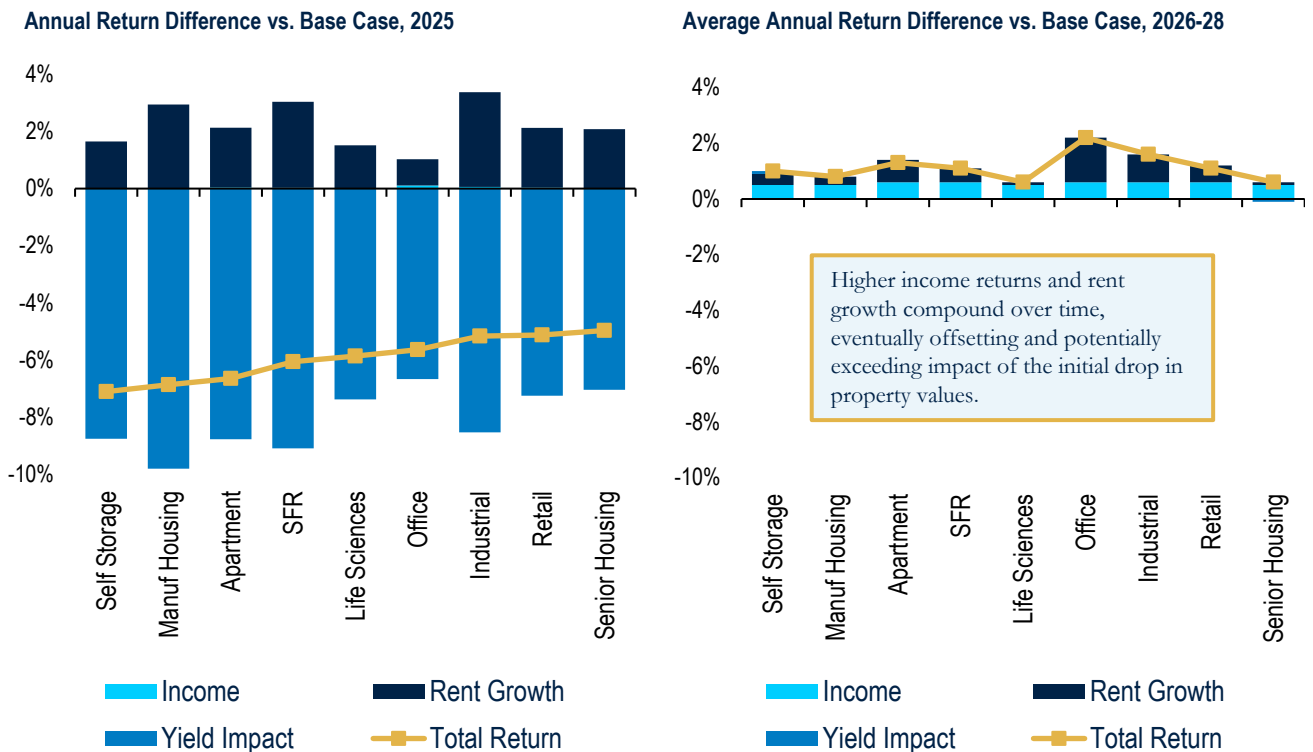
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Finally, lower taxes would be a boost to economic growth, but unless offset by deep spending cuts (not proposed by either party as part of their 2024 platform) would cause the fiscal outlook to deteriorate and long-term bond yields to stay high for longer.

We estimate the impact of a 100 basis point increase in 10-year Treasury rates in **Exhibit 4**. The first order effect, shown on the left-hand chart, would be another leg down in property values, to re-establish real estate’s risk premium. That impact would be highest for property types with the lowest cap rates, such as self storage and manufactured housing.

However, the second order effect would be positive via higher income returns and, for most property types, rent growth due to less construction as financing becomes more expensive and slightly better tenant demand growth. The scale of this chart is deceptive: the positive effects compound, and would eventually offset the initial property value decline.

Exhibit 4: If Interest Rates Rise, Another Round of Valuation Losses Counterbalanced by Higher Returns



Sources: Federal Reserve Board, Oxford Economics, RealPage, Moody’s, American Community Survey, PGIM Real Estate. As of August 2024.

Does Retail Still Offer Value if Consumers Pull Back?

Retail has endured six years of bankruptcies, a pandemic, and continued erosion of in-store sales from e-commerce. Nevertheless, retail returns were high than any other major sector over the past year. We think retail is well positioned to weather its next challenge: consumer fatigue.

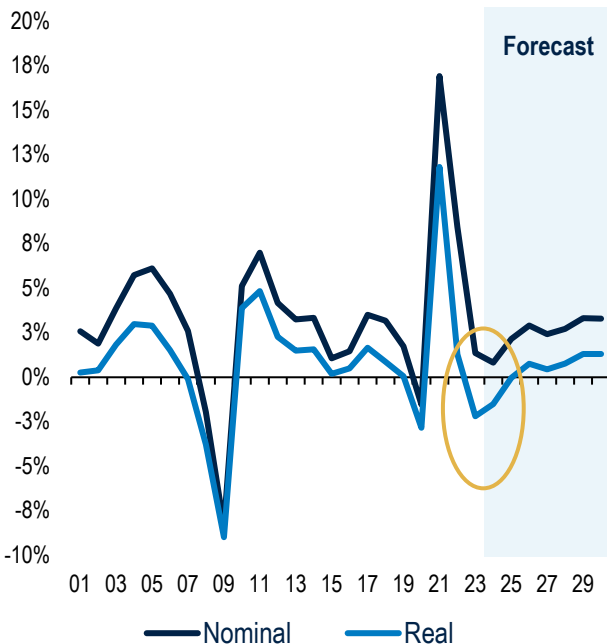
The topline in-store shopping data, shown on the left chart in **Exhibit 5**, are sobering. On a nominal basis retail sales are positive. However, factoring in inflation, annual retail sales are down by nearly as much as they were in 2020. After cleaning out the stores in 2022, it's not surprising consumers are taking a breather.

Some context is in order. First, in-store sales are not the only metric retailers look at. Some retail stores function as showrooms to drive online sales, with branding as much or more important than in-store sales.

Second, as shown in the right chart, consumers are not done buying everyday items like groceries or eating out. Retail sales are down because people aren't buying many houses, leading to weakness in the home improvement and furniture categories. That will persist at least as long as mortgage rates remain high, and perhaps longer if economic growth slows.

Exhibit 5: In-Store Retail Sales Are Squeezed by Sluggish Homebuying

In-Store Retail Sales (Annual Change)

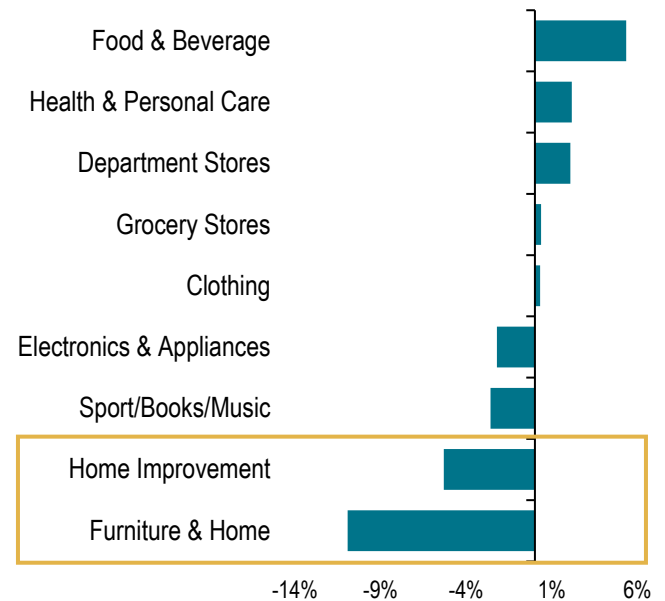


*Note: Q1 2024 vs Q1 2023.

Sources: Moody's Analytics, PGIM Real Estate. As of August 2024.

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Nominal Retail Sales (Annual Change, 1Q 2023 – 1Q 2024)*

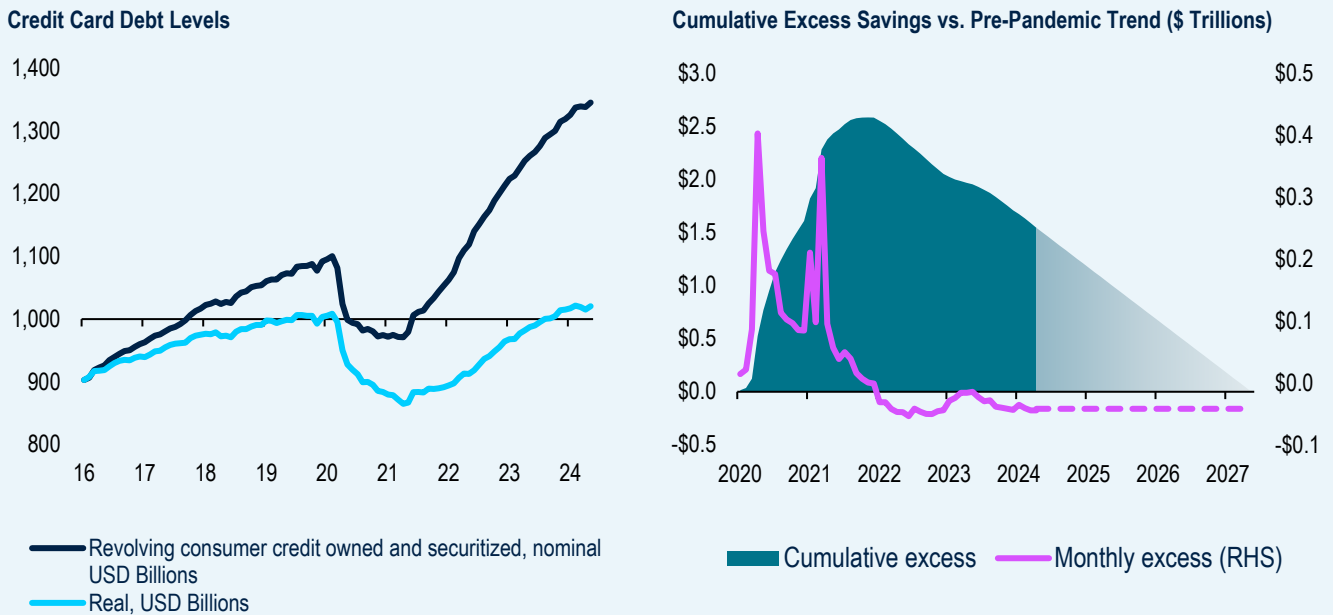


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Credit and Credit and savings data also indicate that consumers are cutting back because they want to, not because they must. While nominal credit card debt is growing at its pre-COVID pace, as shown on the left chart in **Exhibit 6**, on a real (inflation-adjusted) basis it has only recently surpassed its early-2020 peak. More recently, real credit card debt has leveled off, suggesting consumers are holding back.

Households also have ample savings, after pocketing much of the stimulus payments in 2020 and 2021, as shown in the right chart. After peaking at an “excess” savings (the difference between savings rates prior to 2020 and actual savings) of \$2.5 trillion, consumers have been spending down this excess savings since mid-2022. However, we estimate consumers still have more than half of this savings available to them, ready for when they want to spend again.

Exhibit 6: Consumers Can Keep Spending...If They Want To



Sources: Federal Reserve Board of St. Louis, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, PGIM Real Estate. As of August 2024. Forecasts are not guaranteed and may not be a reliable indicator of future results.

Exhibit 7: Strip Center Occupancies Are High



Finally, necessity retail property markets have not been in such good shape in decades. While malls and street retail remain weak, as shown in Exhibit 7, strip (neighborhood) center occupancies are now above 93%. Even within that segment there is a distinction. Centers without a grocer average 91% occupancy, and those with one are now 95% full.

While the near-term outlook for consumption is less positive than it has been for the past few years, the retail sector enters this environment in a position of strength.

*Note: Retail: Street data in NCREIF only goes back to 1995. Sources: NCREIF, PGIM Real Estate. As of August 2024.

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