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2024 Real Estate Outlook

Investment Research

Hear From Our Experts 

For Professional and Institutional Investors only. All investments involve risk, including possible loss of capital.

EXECUTIVE SUMMARY

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Real estate is adjusting to elevated interest rates, with expectations of buyers and owners still far apart. We estimate those expectations will not converge until property values fall another 10%.

Nevertheless, property incomes remain resilient. U.S. rent growth will decelerate, but generally remain positive, as newly built properties deliver and demand moderates.

The best opportunities are concentrated in credit and REIT markets. As property values reprice and transactions markets thaw, multifamily and niche residential, and Mexico industrial, are first on our shopping list.

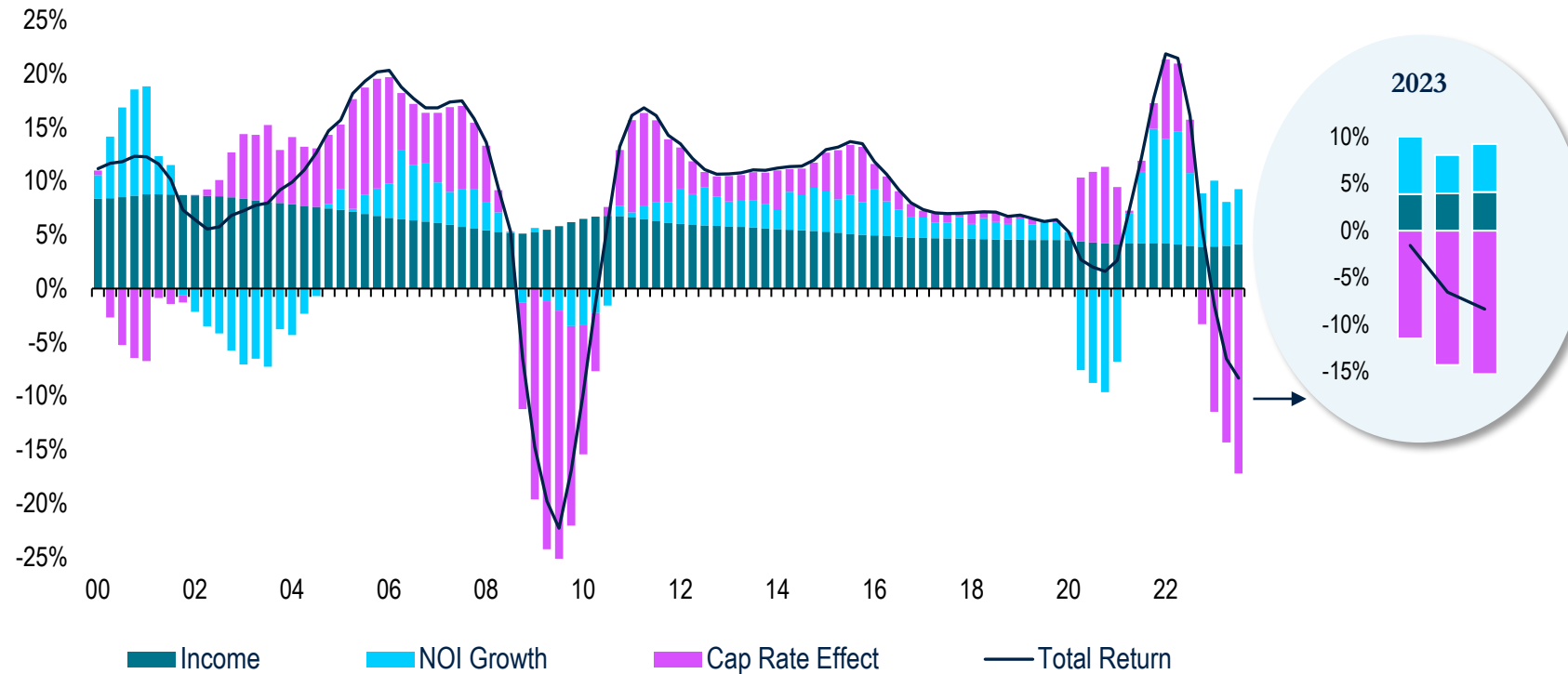
MARKET OUTLOOK

A slowing economy combined with elevated interest rates will cause property financing to remain scarce, extending the slide in property values and activity through 2024.



Real Estate Is Still Repricing to Higher Interest Rates...

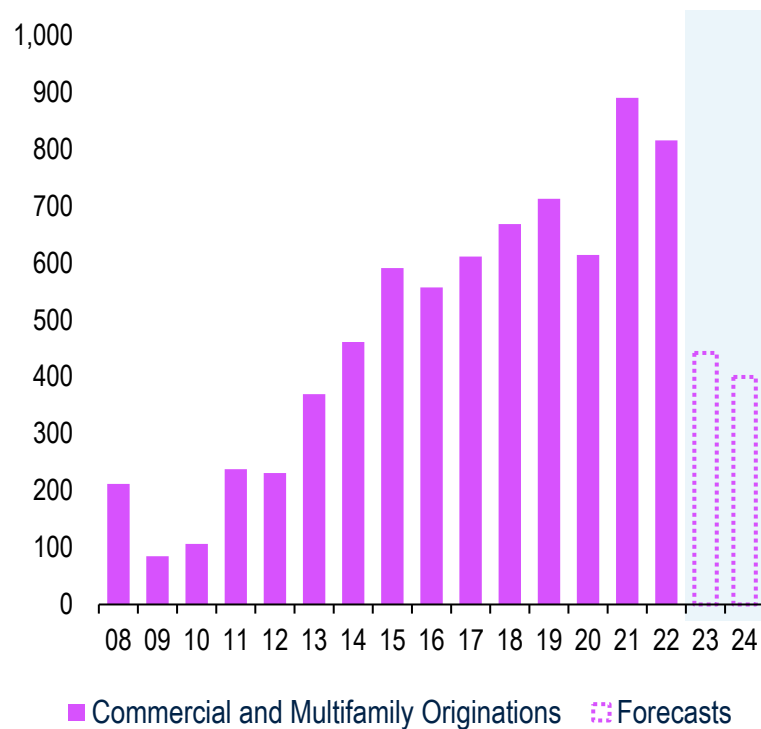
Unleveraged Real Estate Returns (Trailing 4 Quarter %)



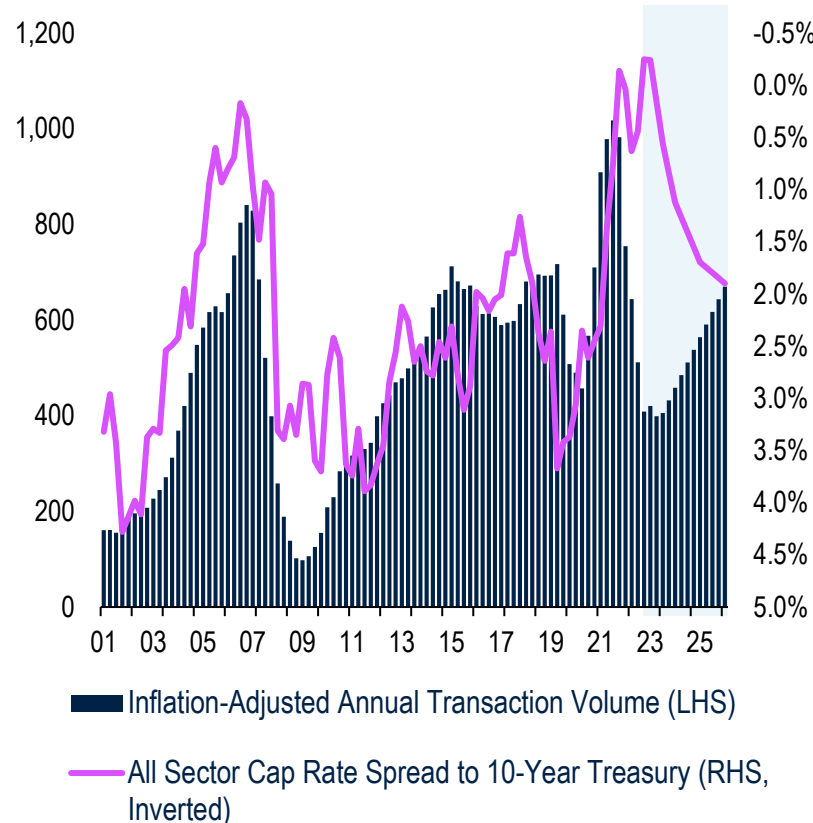
Private U.S. real estate values fell by 8.1% in the first three quarters of 2023. Economic growth surprised to the upside, keeping net operating income (NOI) growth positive, but real estate cap rates have been pressured higher by the rapid rise in interest rates.

...Scarce Debt Is Suppressing Transaction Volumes...

Commercial and Multifamily Mortgage Debt Originations (\$ Billions)



Transaction Volume (\$ Billions) vs. Yield Spread to Treasury (Inverted, Basis Points)



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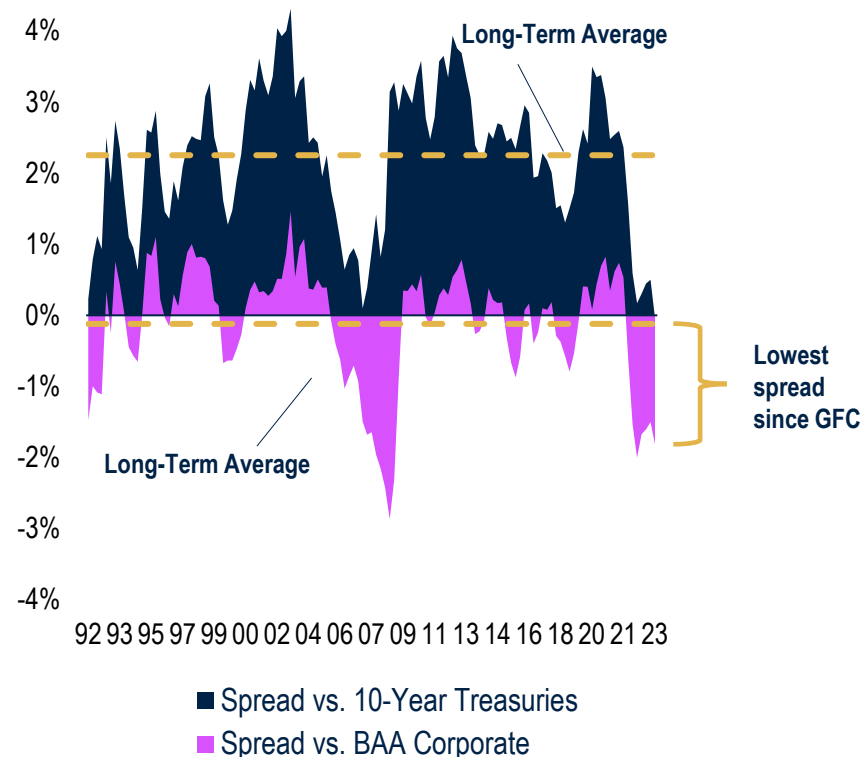
Real estate debt originations have further declines ahead, due to rising lender caution and greater regulatory scrutiny after multiple banks failed in the spring.

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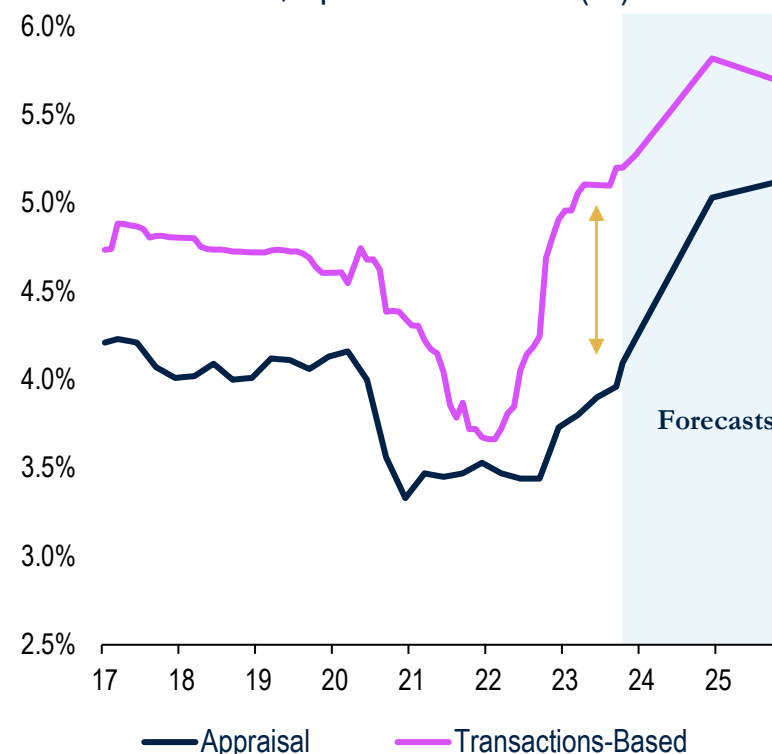
Scarce debt and price declines are contributing to slowing transaction volume. The 60% inflation-adjusted volume decline is the most severe since the Global Financial Crisis (GFC).

...And the Appraisal vs. Market Gap Is Still Wide

Appraisal Cap Rate Spreads (%)



Core Fund Appraisal Cap Rates vs. Transaction-Based Estimates, Apartment Sector (%)



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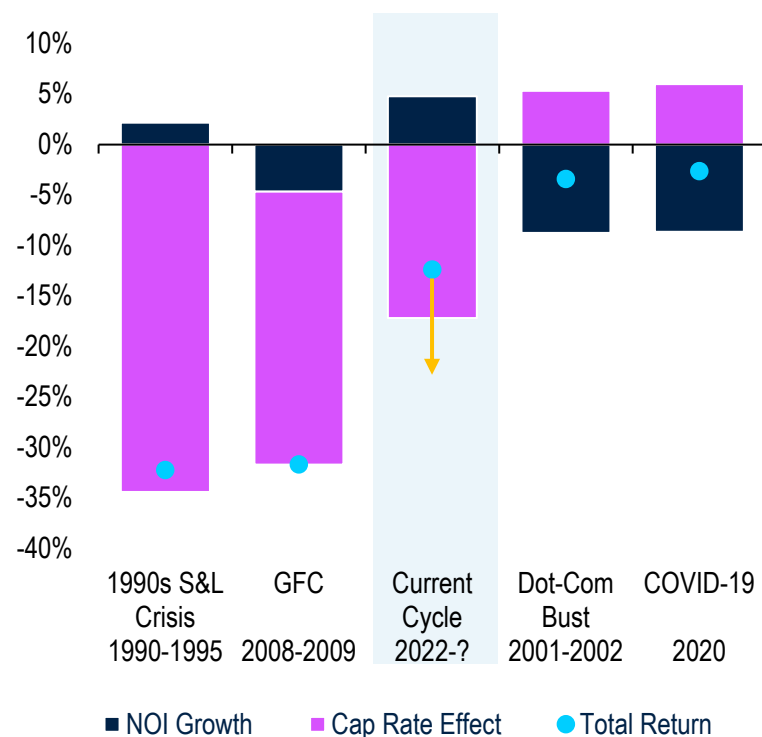
Private real estate appraisal cap rates are too low. The spread between private appraisal cap rates and the risk-free rate collapsed by 50 basis points in 3Q 2023, as U.S. Treasury yields soared. Real estate is expensive versus corporate debt too.

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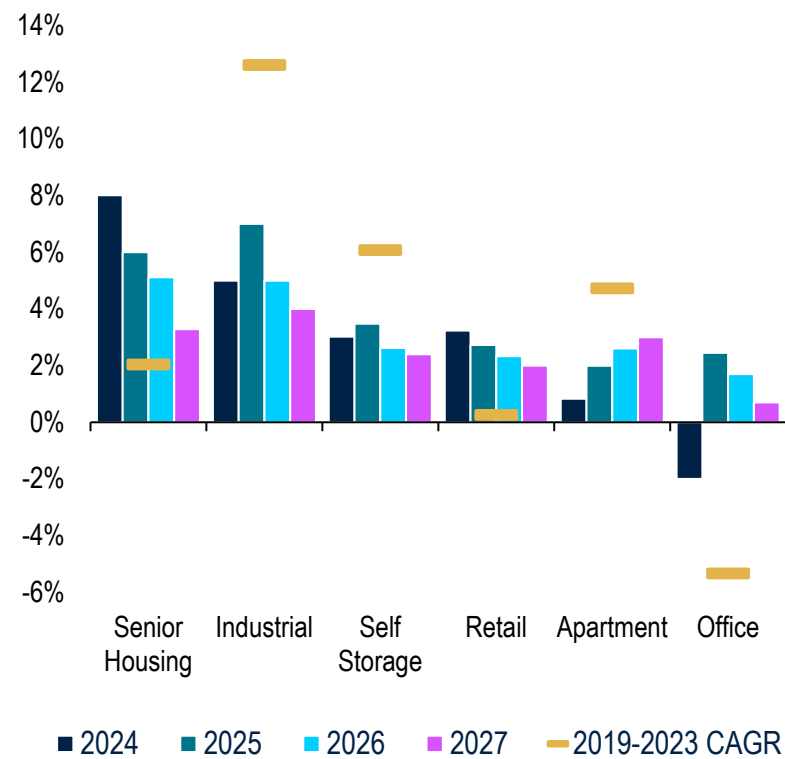
A bid-ask standoff persists, with no end yet in sight. For example, the spread between core apartment appraisal cap rates and estimated transaction Class A apartment cap rates has nearly doubled from its 2017-2020 average.

This Time Is Different: Resilient Income, Repriced...

Value Corrections (%)



Forecasted Change in Property Market Revenue* (% p.a.)



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Value declines so far this cycle are mostly due to the higher risk-free rate, plus lower (but positive) expected future income growth. In comparison with most real estate downturns, positive NOI is partially offsetting the negative impact of higher cap rates.

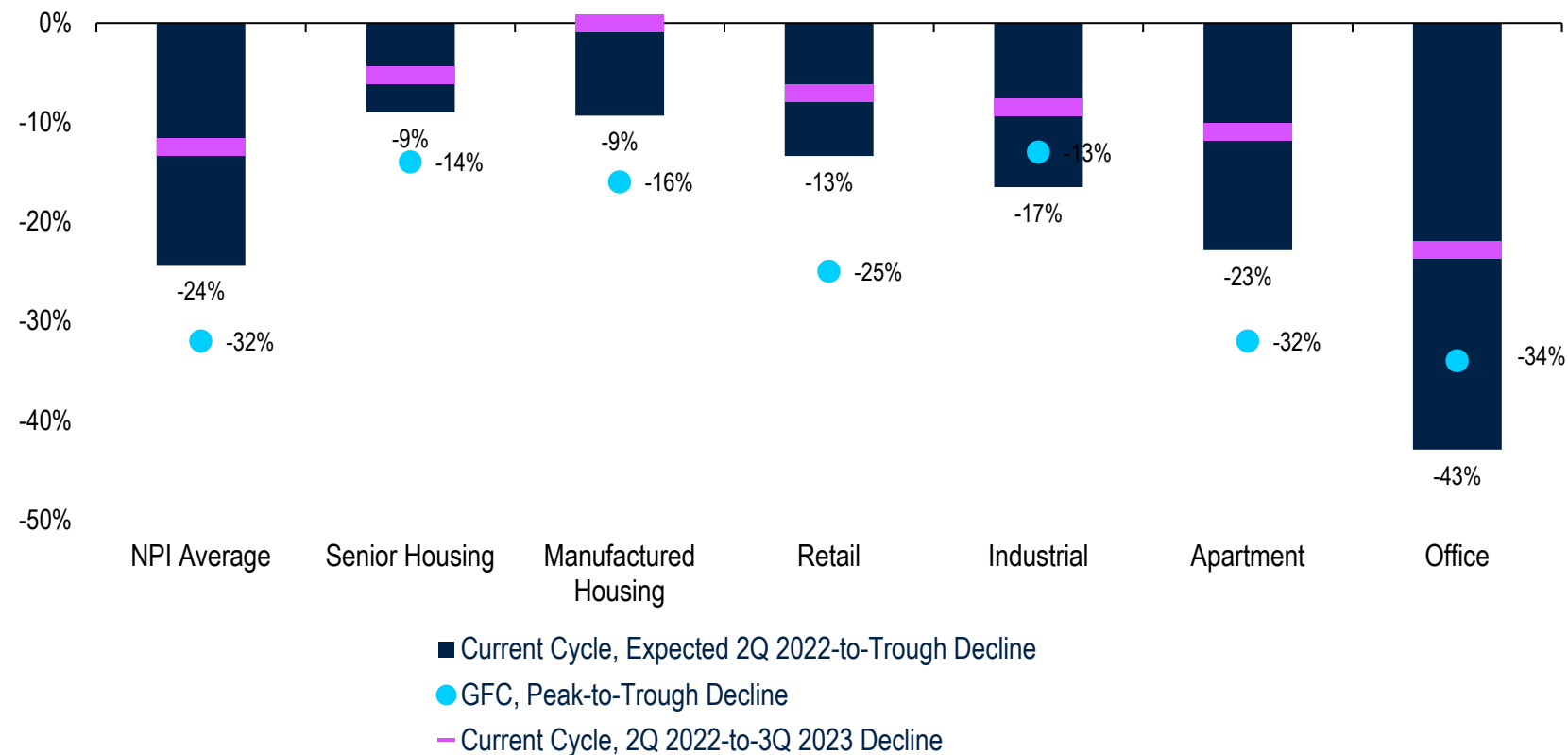
RIGHT

We forecast positive revenue growth across all sectors over the next four years. Look for deceleration in industrial, storage and apartments, and improving income growth in the senior housing, retail and office sectors.

*Note: Market revenue is a combined measure of rent and occupancy.
Sources: Green Street Advisors, NCREIF, PGIM Real Estate. As of November 2023.

...And Sector Differences Are Wider Than the GFC

Expected Peak-to-Trough Value Change, by Property Sector (%)

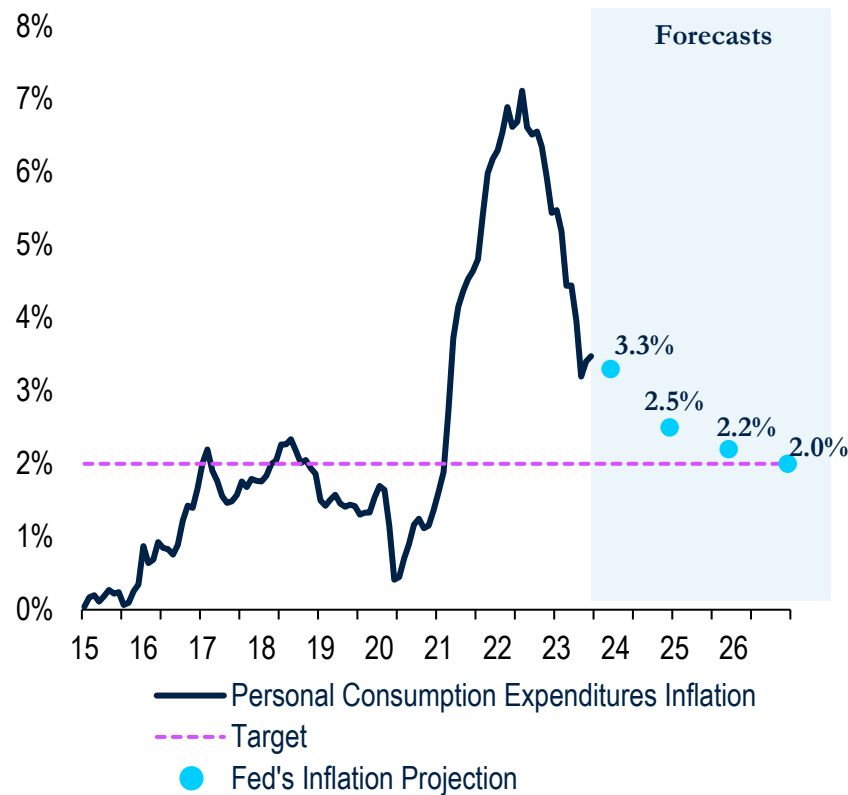


Values still have ~10% to fall. As usual in a real estate downturn, office will be the most impacted sector. Necessity-based real estate (defensive retail, senior housing and manufactured housing) should emerge comparatively better off.

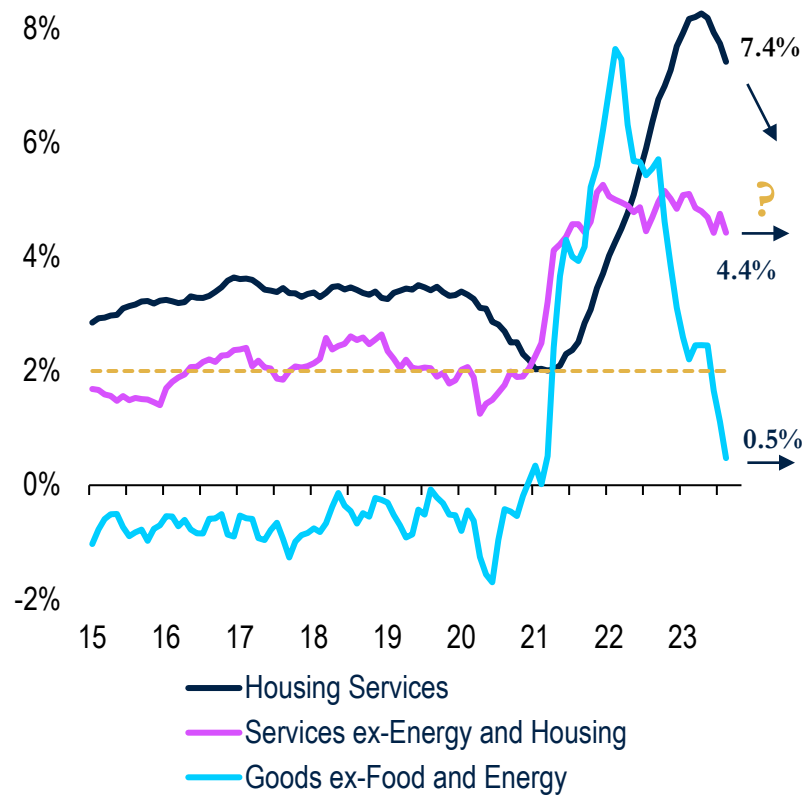
As compared with the GFC, we anticipate lower average value losses in this cycle. Office is the most notable outlier.

Real Estate Price Declines Depend on Inflation Trajectory...

Inflation (% p.a.)



Personal Consumption Expenditures (% p.a.)



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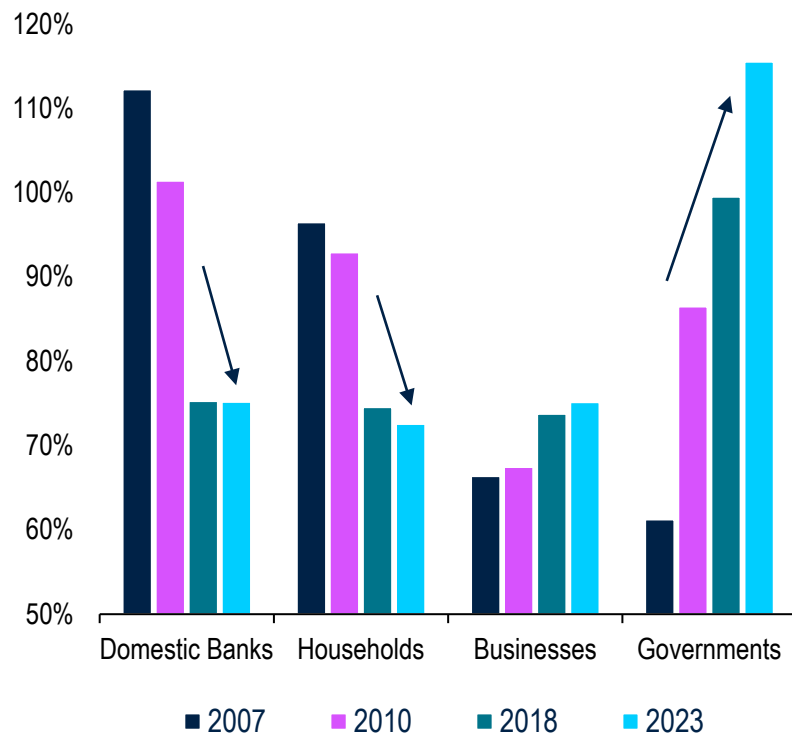
U.S. economic growth surprised to the upside in 2023, keeping labor markets resilient while inflation trended down. But U.S. monetary policy remains focused on achieving the Fed's 2.0% inflation target.

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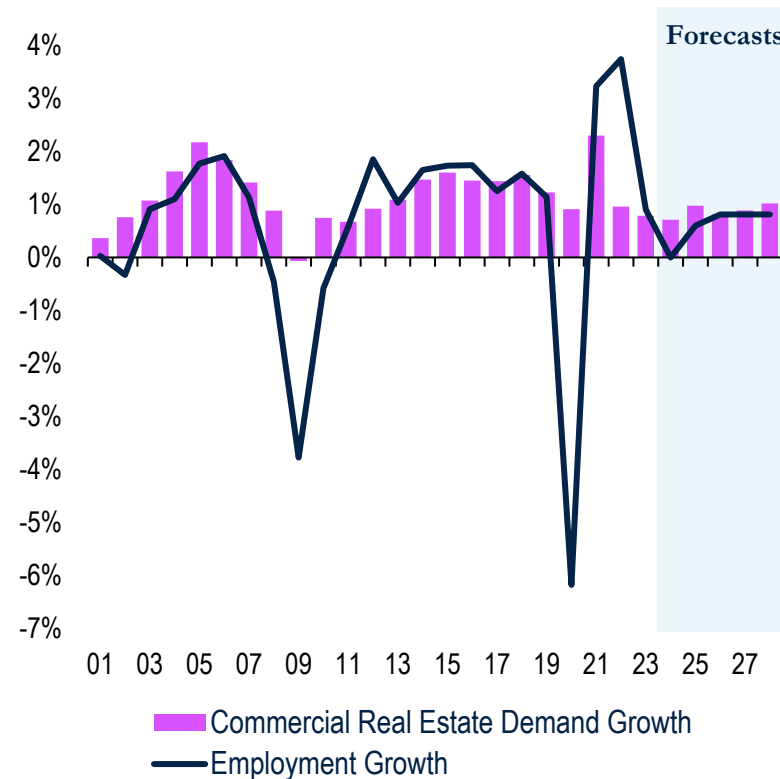
Breaking PCE inflation into three core categories helps illuminate the challenges ahead. Shelter inflation has peaked and is trending down – although higher mortgage rates exacerbate shelter inflation pressures. And services inflation is stubbornly high.

...And Waning Fiscal Stimulus Raises Recession Risk

Debt Outstanding, as a Share of GDP (%)



Employment and Tenant Demand Growth (% p.a.)



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Higher interest costs and waning fiscal stimulus both pose economic risks to the downside. Households and banks have broadly deleveraged, but the federal government has levered up by more than 50 percentage points of U.S. GDP since 2007.

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Our base case calls for decelerating real estate demand and job growth in 2024, both slowing to well below trend as higher interest rate pressures ripple through the economy.

INVESTMENT THEMES

Debt returns are attractive in today's market.

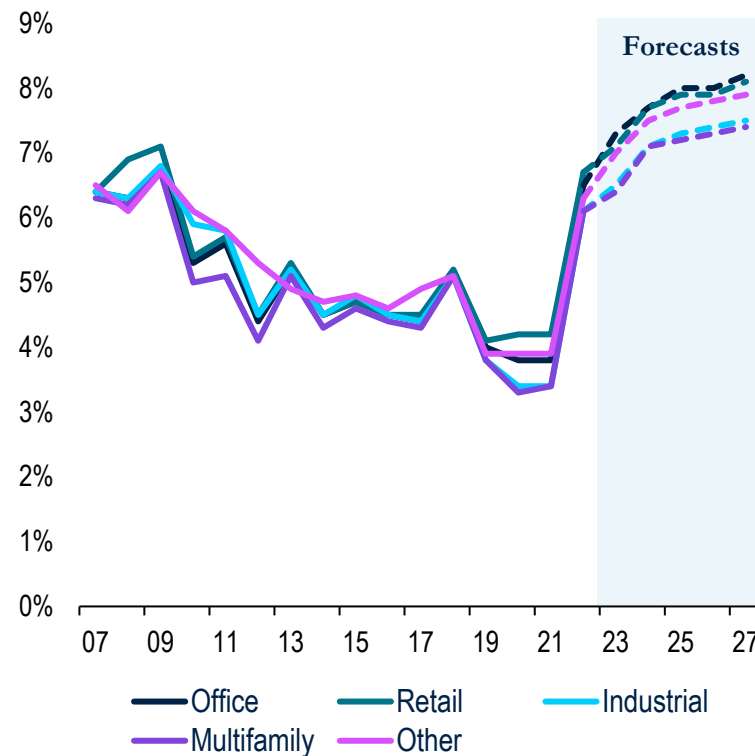
Select situations to invest at lower prices may emerge, beginning with REITs at an impressive discount. As the year progresses, expect defensive and needs-based opportunities to stay in favor.



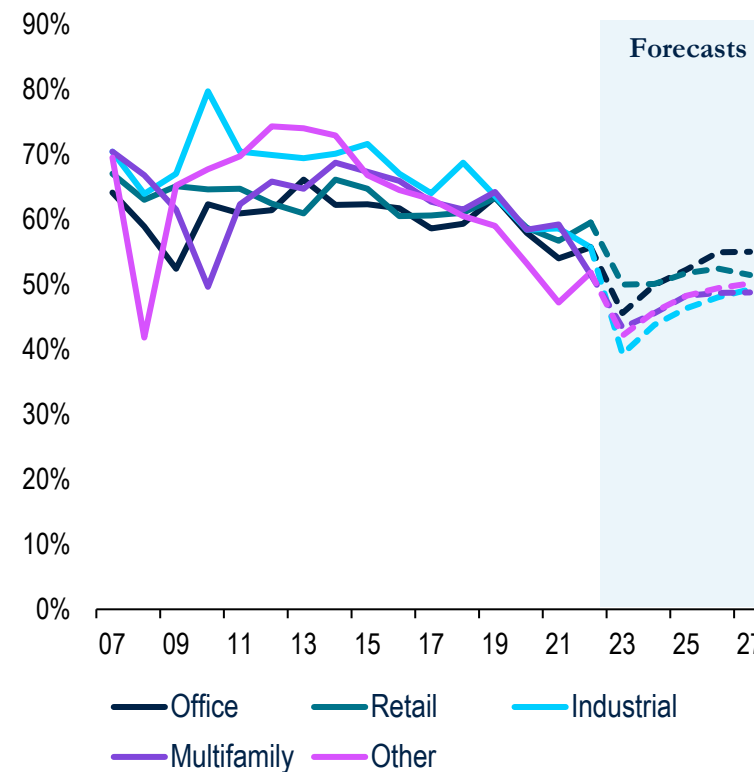
INVESTMENT THEMES

Core Debt: Strong Risk-Adjusted Returns...

Higher Debt Coupons as All-in Real Estate Debt Costs Rise Alongside Increasing Reference Rates¹



Restricted Leverage on New Issue Loans Due to Increased Focus on Debt Serviceability²



¹ All-in fixed rate senior debt costs for loans of mixed terms.

² LTV on new issue fixed rate senior loans constrained by 1.5x ICR.

Sources: Bloomberg, Chatham Financial, Giliberto-Levy, CREFC, ACLI, RCA, Cushman & Wakefield, PGIM Real Estate. As of November 2023.

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After real estate borrowing costs have risen more than 300 basis points due to higher base rates, we believe core lending will offer the most attractive risk-adjusted return in years.

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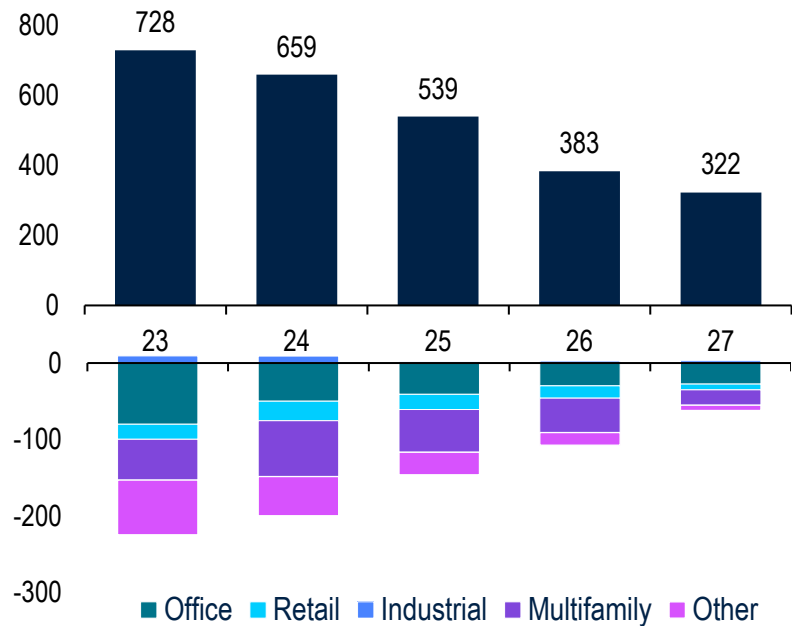
Further protecting lenders, loan terms are among the most conservative in decades. Demand from borrowers will be high due to refinancing needs, even if transaction activity remains muted.

INVESTMENT THEMES

Non-Core Debt: ...Paired With Distressed Buying and Lending Opportunities

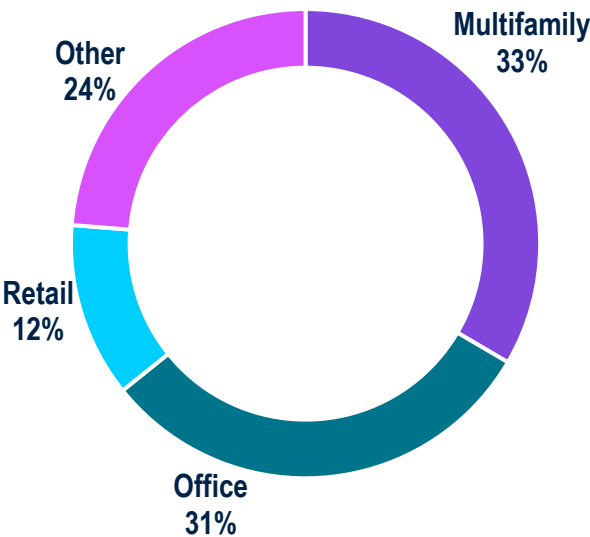
Lower Leverage Offered for Upcoming Loan Maturities, Leading to a Wider Funding Gap

Loan Maturities (\$ Billions)



Funding Gap (\$ Billions)

It's Not Just Office. Multifamily Has the Biggest Funding Gap



Sources: Mortgage Bankers Association, Bloomberg, Chatham Financial, Giliberto-Levy, CREFC, ACLI, RCA, Cushman & Wakefield, PGIM Real Estate. As of November 2023.

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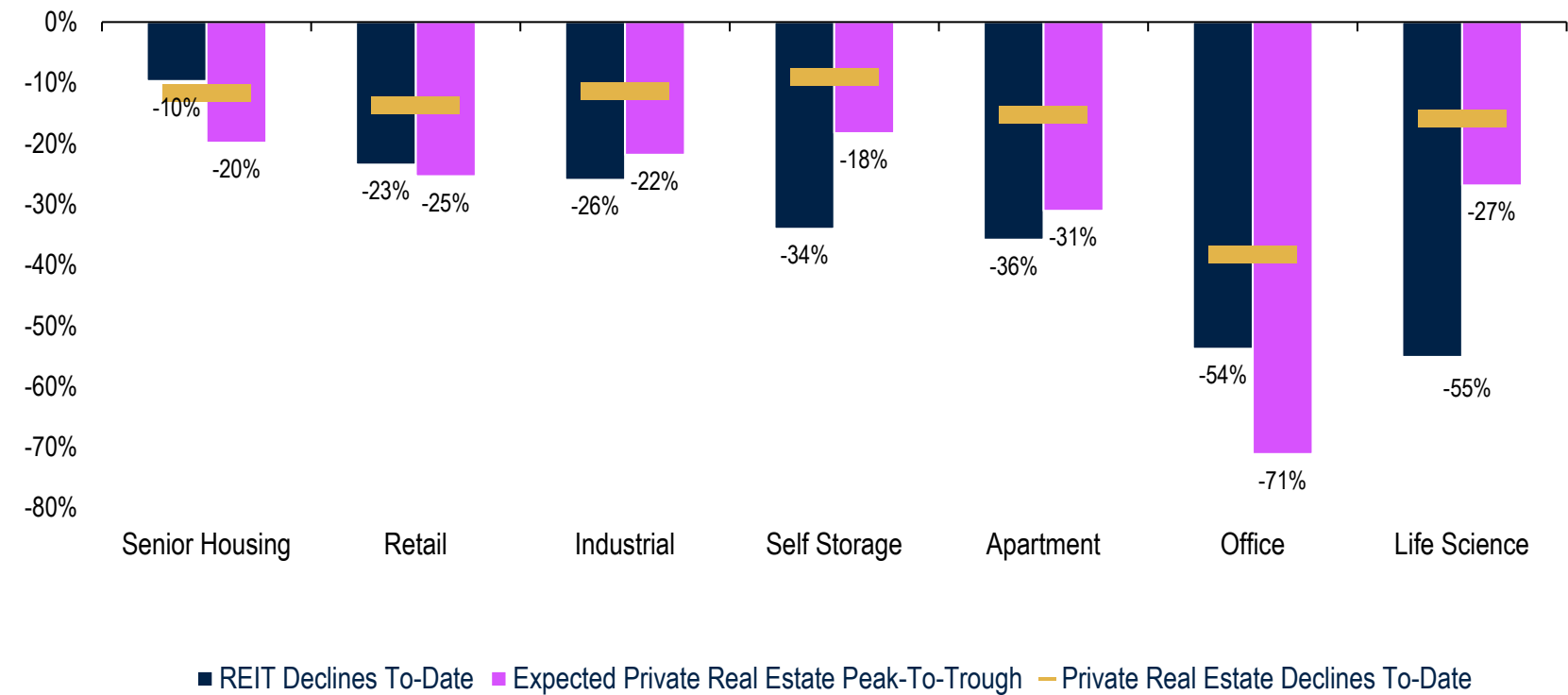
More than \$1 trillion in commercial real estate loans is coming due over 2024 and 2025, which we estimate will leave a refinancing gap of more than \$300 billion.

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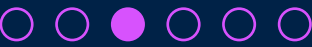
New-vintage multifamily properties and older assets in appealing locations will be part of this mix, along with distressed office, retail and lodging collateral.

Public Equities: Share Prices Already Reflect Future Value Losses

Leveraged Private vs. Public Real Estate Price Declines



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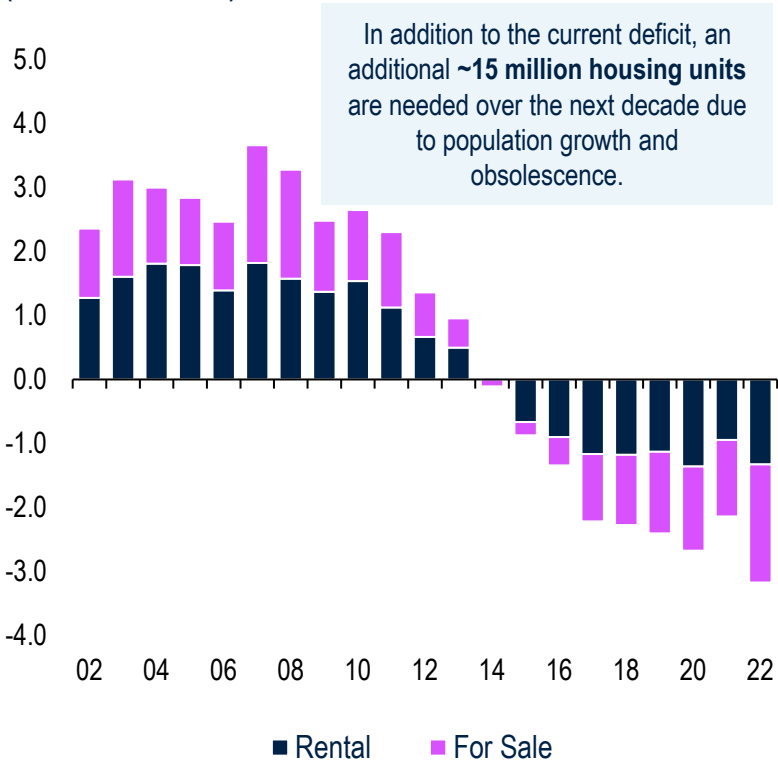


Core sector REIT prices largely already incorporate our expected full-cycle, leveraged value corrections, and some are priced for recession already. With high-quality real estate portfolios and full liquidity on demand, public REITs offer an attractive entry point today.

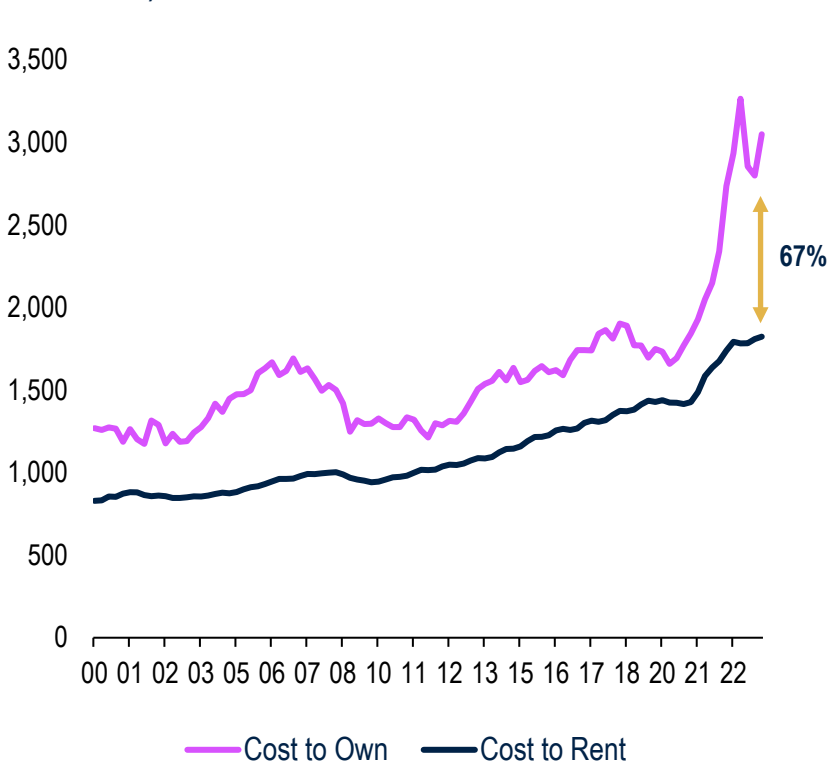
Leveraged private real estate value estimates are calculated at REITs' leverage ratios by sector as of end-2021 and an assumed debt cost of 4%. Sources: NAREIT, Green Street Advisors, NCREIF, PGIM Real Estate. As of November 2023.

Residential: Undersupply and Expensive For-Sale Housing Support Rentals

Estimated Surplus / Deficit in Housing Stock (Units, Millions)



Cost to Buy Versus Cost to Rent (Monthly Payment in Dollars)



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The U.S. has underbuilt housing for nearly a decade, while household formation has surged and millennials age into a preference for single-family and suburban homes.

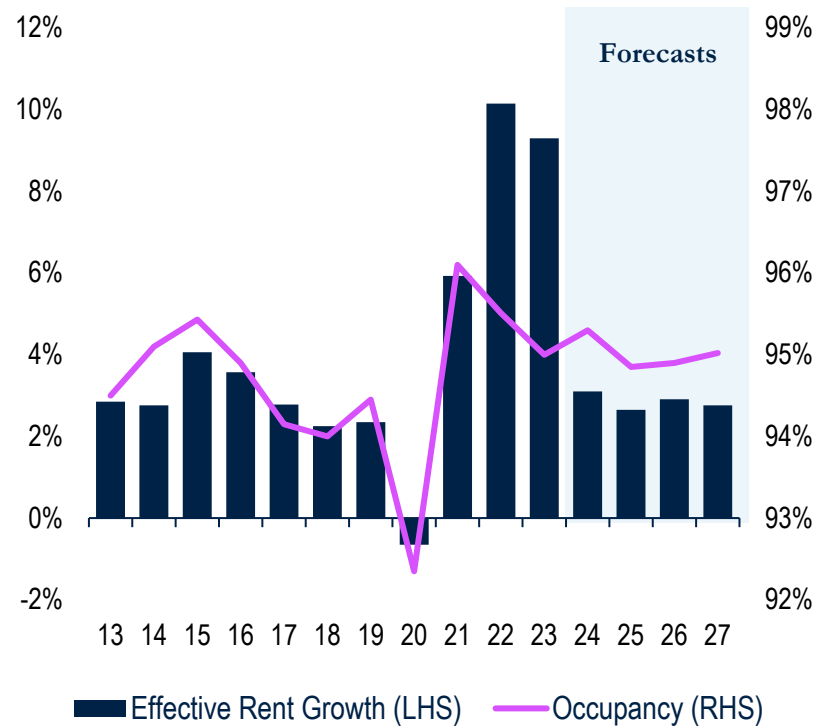
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Rapid house price increases plus the recent rapid runup in mortgage rates makes renting a compelling option.

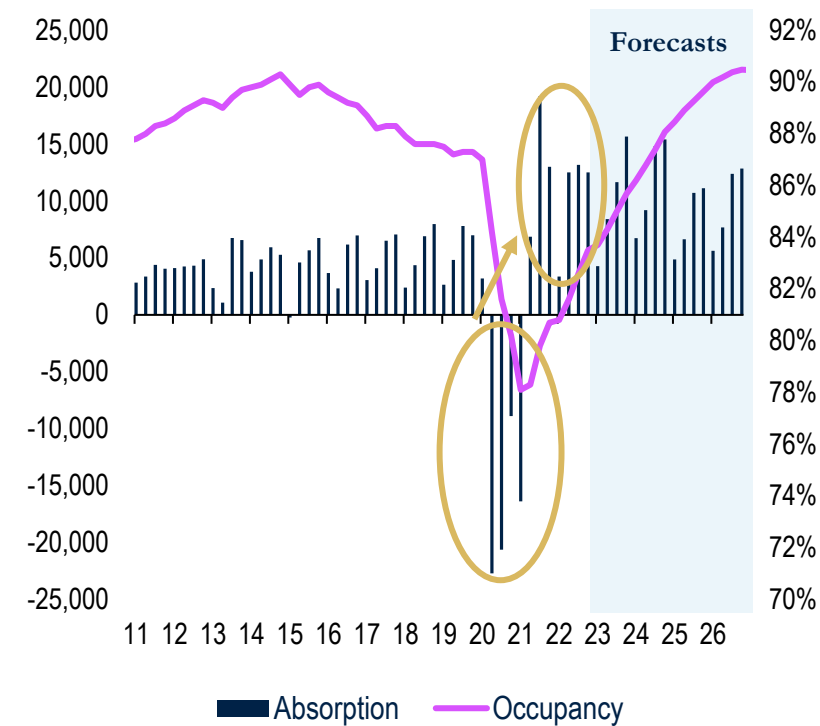
INVESTMENT THEMES

Student Housing and Senior Housing: Cyclical and Structural Support

Student Housing Effective Rent Growth and Occupancy*



Senior Housing Quarterly Absorption and Occupancy (%)



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The post-pandemic rebound in student housing demand leaves the sector with healthy occupancy, setting the stage for continued rent growth.

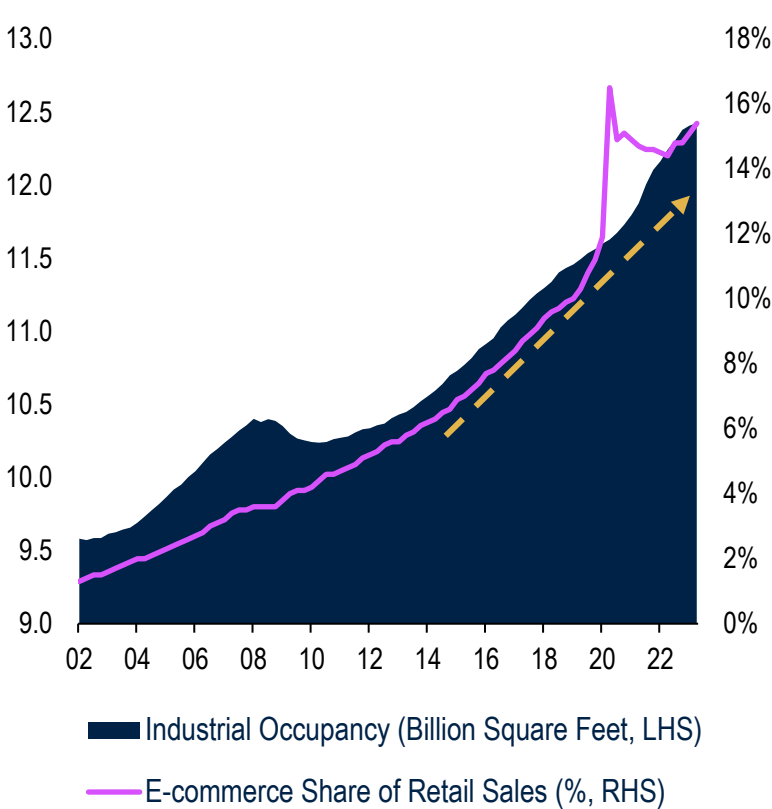
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The cyclical rebound in senior housing continues, with occupancies now nearing pre-pandemic norms and net absorption running at about double the average of the last decade. We expect occupancies to fully recover by 2025.

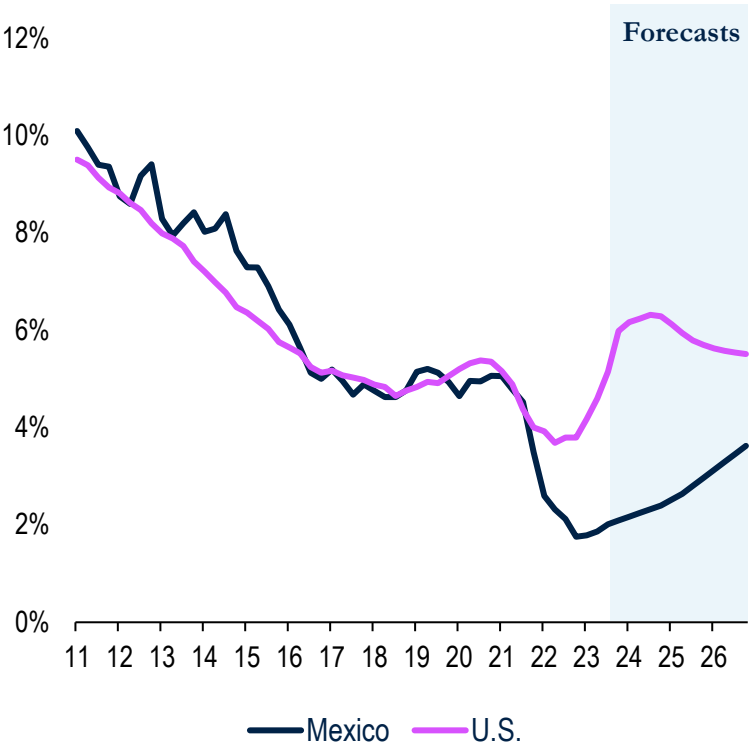
*Note: Represents RealPage's Top 175 universities.
Sources: RealPage, NIC, Green Street, PGIM Real Estate. As of November 2023.

U.S. and Mexico Logistics: Now a Cross-Border Strategy

U.S. Industrial Demand (Billion Square Feet) and U.S. E-commerce Market Share (%)



Mexico and U.S. Industrial Vacancy



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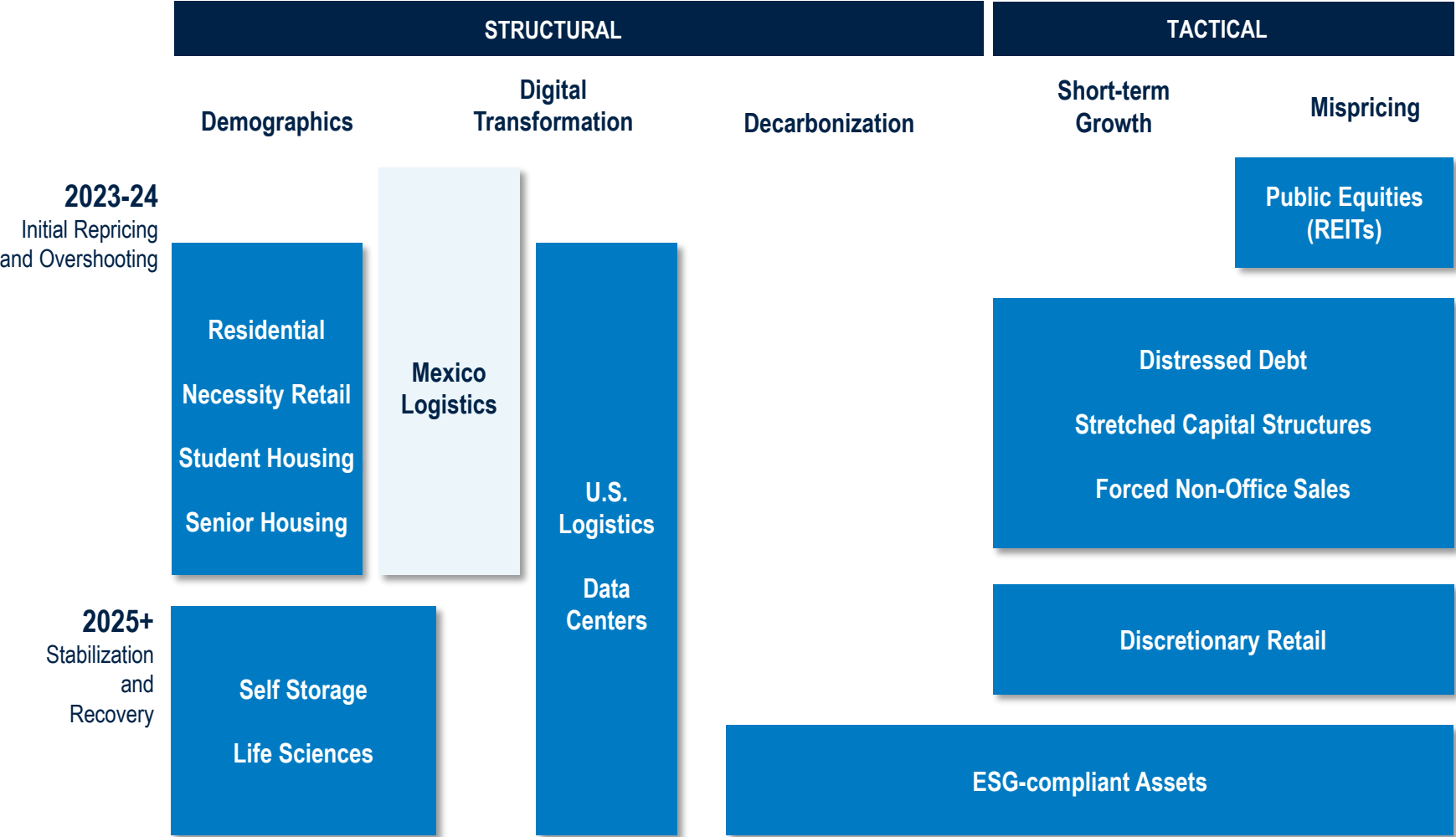
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E-commerce penetration is re-accelerating after a brief pullback post-2020. We believe well-located and smaller properties, best-suited for last-mile delivery, will continue to outperform.

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Industrial vacancy in Mexico remains below 2% even as vacancies rise to pre-COVID-19 levels in the United States. The USMCA and nearshoring trends are continuing to create demand for Mexican industrial.

Dynamic Opportunity Set



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Our global investment convictions are built upon structural growth of digitalization, demographics, and decarbonization themes which drive long-term secular shifts in occupier demand across real estate sectors and geographies.

Core lending at attractive attachment points, REITs pricing at compelling discounts to NAV, and logistics investments capitalizing on U.S. – Mexico nearshoring trends are our preferred tactical opportunities today.

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