QUARTERLY INSIGHTS | INVESTMENT RESEARCH

UNITED STATES

Key Themes

- Shifting Apartment Winds – What's the Outlook for Relative Market Performance?
- What Industrial Markets Might See the Biggest Slowdown in an Economic Downturn?

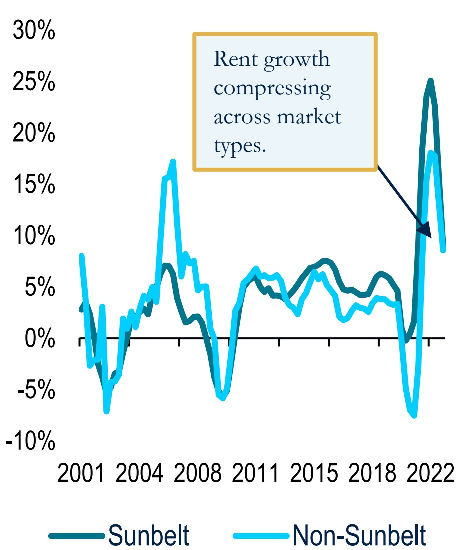
Shifting Apartment Winds – What's the Outlook for Relative Market Performance?

Rental housing faces headwinds this year and into 2024 both from outsized supply growth and weak demand drivers. Rental growth in metros located across the southern United States (Sunbelt[1]) has been higher than non-Sunbelt markets since 2013. However, we expect a temporary shift, with rents and occupancies softening the most in the Sunbelt.

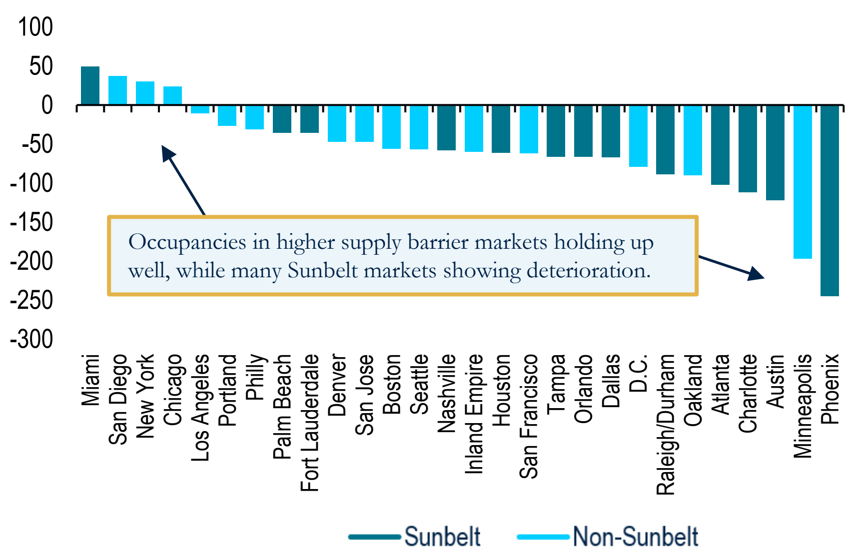
As shown in **Exhibit 1**, Sunbelt market occupancies are now farther below pre-pandemic levels than are occupancies elsewhere. Rental growth is converging across Sunbelt and non-Sunbelt markets.

Exhibit 1: Relative Market Performance Shifting

Annual Rent Growth



Multifamily Occupancy Change, 4Q22-4Q19 (Basis Points)



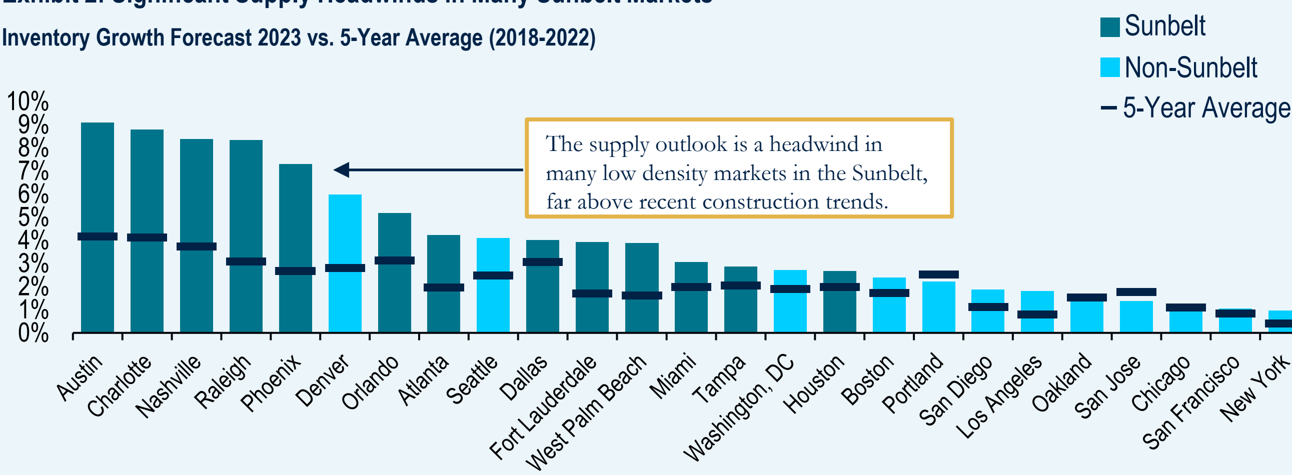
Sources: RealPage, PGIM Real Estate. As of February 2023.

[1] For the following analysis, Sunbelt markets considered include Atlanta, Austin, Charlotte, Dallas, Fort Lauderdale, Houston, Miami, Nashville, Orlando, Raleigh, Tampa and West Palm Beach.

At the same time, developers have responded to the double-digit rent growth in the last couple of years. Construction activity is much higher in many Sunbelt markets and set to outpace new demand to a greater degree than elsewhere. Prime examples of this include Austin, Charlotte, Nashville, Phoenix and Raleigh, which face potential supply growth this year of more than double the average of the past five years, as shown in **Exhibit 2**.

Exhibit 2: Significant Supply Headwinds in Many Sunbelt Markets

Inventory Growth Forecast 2023 vs. 5-Year Average (2018-2022)

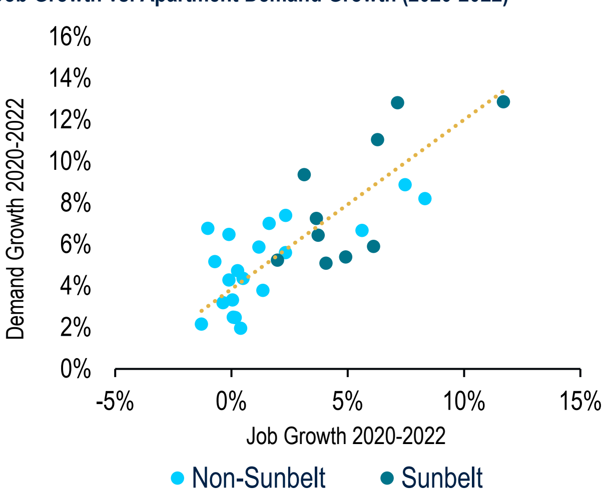


Sources: RealPage, PGIM Real Estate. As of February 2023.

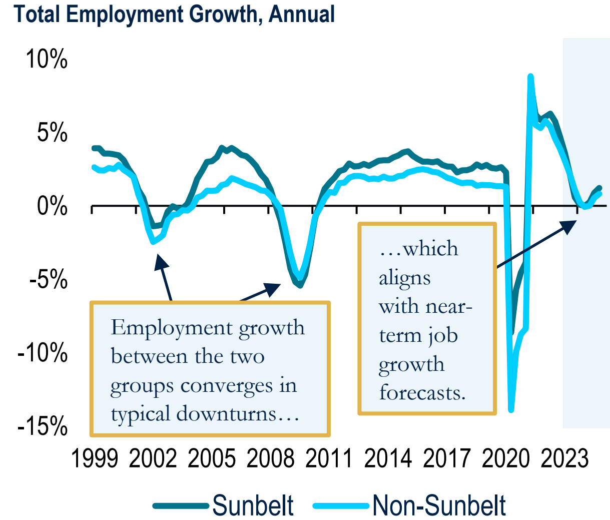
Supply growth is typically higher in these metros since demand growth, driven by employment, is also stronger. Despite significant volatility in both apartment demand and employment growth over the last few years, the link between the two across markets remains strong, as shown in **Exhibit 3**. However, near-term employment forecasts suggest that construction at its current scale is excessive because job growth in the Sunbelt markets will decelerate over the next year and match that of non-Sunbelt markets, as shown in **Exhibit 3**.

Exhibit 3: Job Growth Set to Slow Across Metros

Job Growth vs. Apartment Demand Growth (2020-2022)



Total Employment Growth, Annual



Sources: Oxford Economics, PGIM Real Estate. As of February 2023.

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Despite this short-term, cyclical mismatch between supply and demand, the sharp pullback in debt availability will curtail multifamily supply deliveries beyond 2024, as developers find it more costly to finance projects. At that point, apartment leasing will benefit from an improved economy at the same time supply recedes. In this environment, Sunbelt apartment market performance will once again benefit from continued strong job growth.

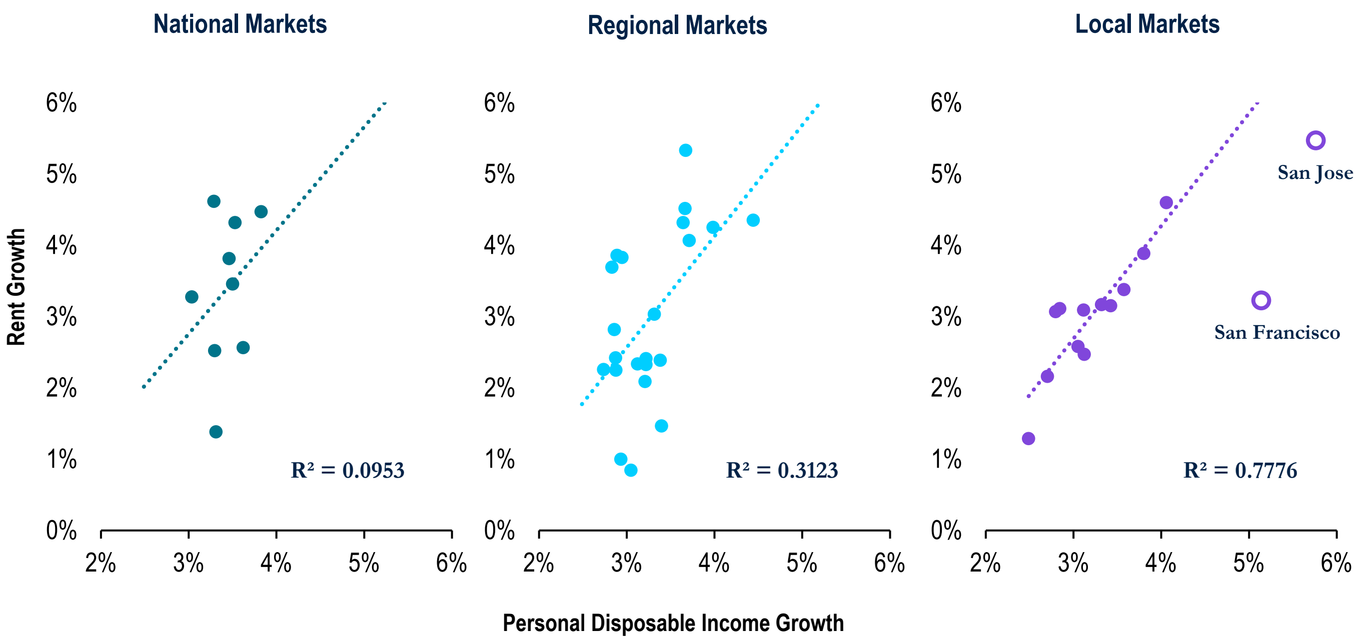
What Industrial Markets Might See the Biggest Slowdown in an Economic Downturn?

Economic headwinds have mounted over the past year, and while we believe the Industrial sector will remain resilient, it will not be immune. Should the U.S. enter a recession, markets that are not solely reliant on local economic activity will prove more resilient.

Knowing an industrial market's scope of distribution, where inventory is shipped to and from, can provide insight into the strengths and vulnerabilities of a market. Based on this, markets can be grouped into three categories: national, regional and local[2]. National markets, such as Los Angeles, New York and Chicago, have the widest scope, distributing goods to all corners of the country. On the opposite side of the spectrum are local markets, such as Austin, Boston and San Francisco, which serve the immediate metro area. In the middle are regional markets, like Baltimore, Miami and Philadelphia, serving various metropolitan areas in their respective regions.

Exhibit 4: Influence of Local Economy Differs by Market Type

Industrial Rent Growth Versus Disposable Income Per Capita Growth (2006-2021)



National Markets: Atlanta, Chicago, Columbus, OH, Dallas, Indianapolis, Inland Empire, LA/Orange County, New York, St. Louis.

Regional Markets: Washington/Baltimore, Charlotte, Cincinnati, Cleveland, Denver, Detroit, Harrisburg, Houston, Jacksonville, Kansas City, Lehigh Valley, Miami, Ft Lauderdale, Milwaukee, Minneapolis, Nashville, NNJ, Oakland, Philadelphia, Phoenix, Portland, Seattle.

Local Markets: Austin, Boston, Las Vegas, Norfolk, Oklahoma City, Orlando, West Palm Beach, Raleigh-Durham, Richmond, Sacramento, Salt Lake City, San Antonio, San Francisco, San Jose.

Sources: CoStar, PGIM Real Estate. As of February 2023.

[2] CoStar, "Industrial Big Book," September 2018: Page 62.

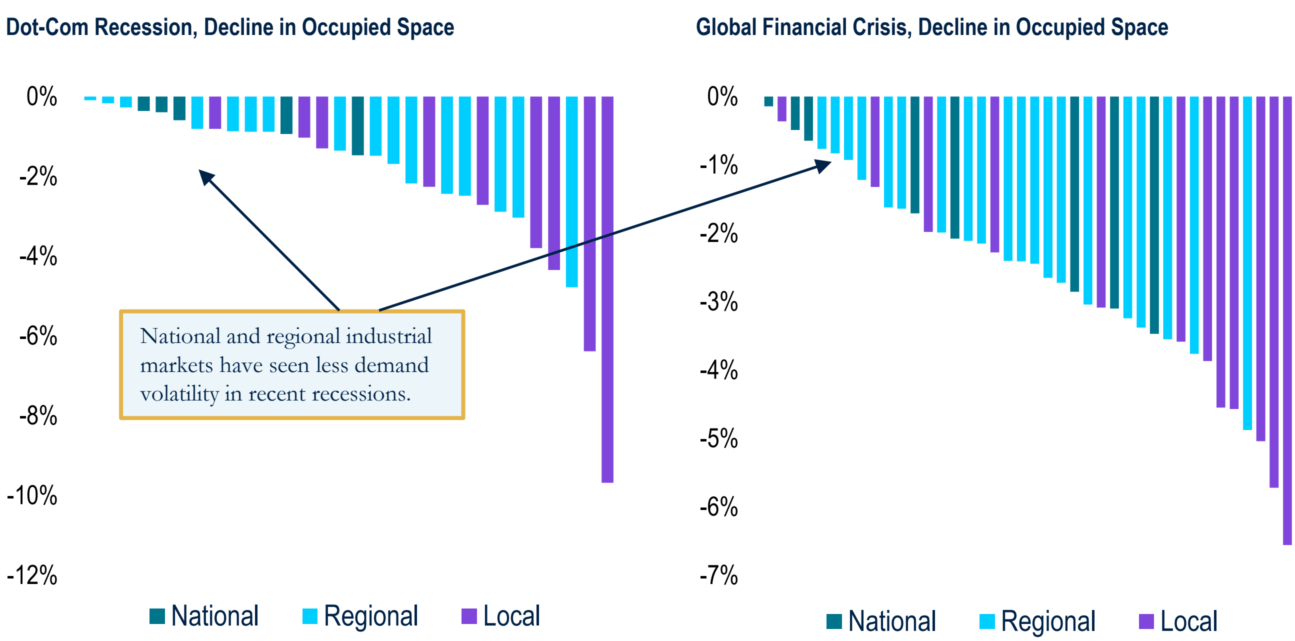
As show in **Exhibit 4**, the correlation between growth in local personal income and industrial rent growth in a market increases from national, to regional and then local. As expected, the more local a market's scope of distribution, the more a market is tied to the local economy. That makes local industrial rent growth highly sensitive to changes in local economic growth.

National and regional markets benefit from serving a wide geographic area and generally play a critical role in many companies' supply chains. By contrast, as shown in **Exhibit 5**, over the past two decades local markets were typically the hardest hit during recessions as measured by declines in occupied space. Similarly, cap rates in local industrial markets historically move up more than the average metro during recessions.

In a downturn, national and regional industrial markets are usually more resilient than local markets, benefiting from diversification of demand sources and preventing sharp declines. Furthermore, it is possible facilities in these metros can be used as storage for excess inventory, ready to be shipped whenever and wherever consumer spending picks back up.

As a result, as we head into a likely U.S. recession, we continue to favor some of the largest regional and national markets, particularly those with high supply barriers such as Los Angeles, New York and Miami. The combination of limited supply pressures and a cushion provided by their importance to supply chains will drive strong relative performance.

Exhibit 5: Local Industrial Demand More at Risk in a Downturn



Sources: CoStar, PGIM Real Estate. As of February 2023.

Contacts

Dr. Peter Hayes
Managing Director
Global Head of Investment Research
peter.hayes@pgim.com

Dean Joseph Deonaldo
Senior Associate
Americas Investment Research
dean.joseph.deonaldo@pgim.com

Bradley Doremus, CFA
Vice President
Americas Investment Research
bradley.doremus@pgim.com

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Important information *(continued)*

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