PGIM REAL ESTATE

CAPITALIZING ON AN EXPECTED PICKUP IN RENTAL GROWTH

That forecasters have revised down the risks of recession – particularly for the United States – and that talk of a so-called soft landing is being heard more often is very much a surprise. For real estate, this speaks to an investment outlook that is better than expected with opportunities to capitalize on an expected pickup in rental growth.

Nonetheless, risks do remain as the outlook is weaker than expected. Jobs growth forecasts remain weak while interest rates are set to remain higher than the past few years. Faced with such uncertainty, investors would be forgiven if they remained focused on sectors that, to date, have offered resilient income streams – income that holds up better than the economic backdrop. For most that means continuing to invest heavily into both logistics and multifamily sectors – those sectors that continue to demonstrate a resilience in values that resonates with previous downturns (Exhibit 1).

The problem for investors, however, is that when a real estate recovery kicks in, these sectors at large do not outperform to the upside. Their resilience is more about lower cyclical volatility, both on the downside and upside of a real estate cycle.

This is where geography matters.

Cities' Reliance on Job Growth Signals Resiliency

That the macroeconomic backdrop to a world of rising interest rates has demonstrated economic resilience is not a surprise when looking at the role jobs growth plays in driving economic activity over time. Economies are typically less cyclical when the economic growth story is driven more by jobs than by productivity.

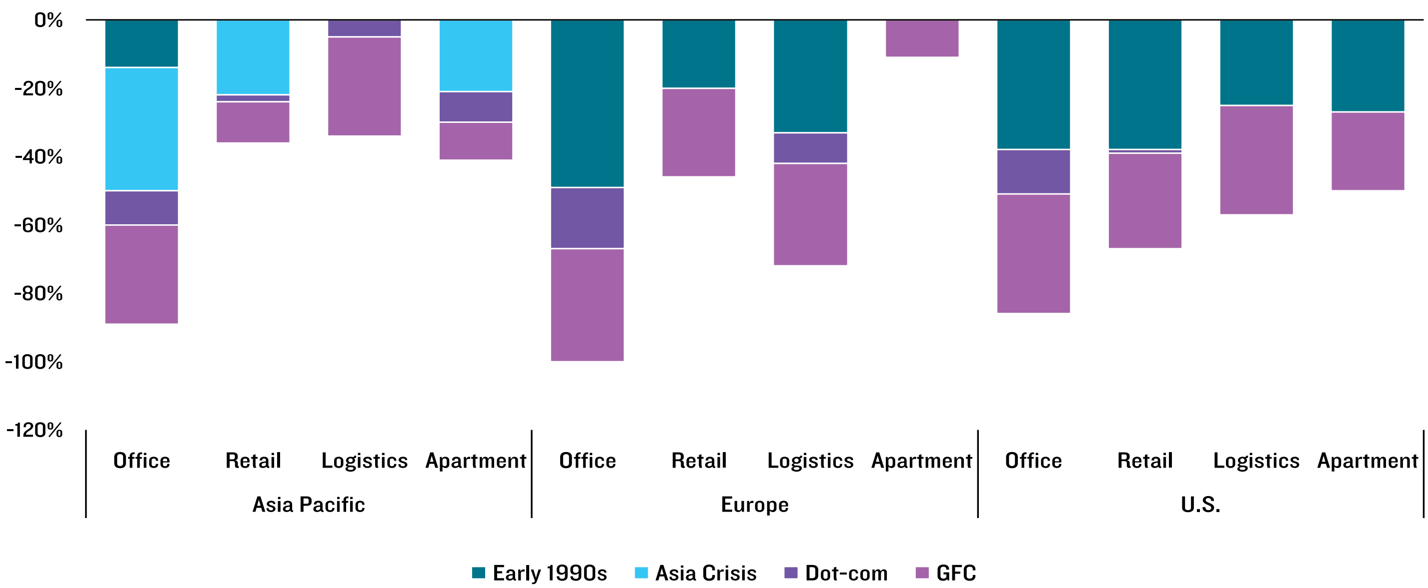
For example, in Exhibit 2 we look at a selection of U.S. cities and analyze how city economies have performed relative to the broader U.S. economy during downturns and in recovery.

In particular, by subtracting each city's GDP growth from the national average in years of national negative growth and the immediate year after, we build up an average score that tells us which U.S. cities perform better (are more resilient) or worse (are less resilient) than the national economy.

What we find is cities in which most economic growth is due to job growth (as opposed to productivity growth) perform relatively better – are more resilient to the national economic cycle – than cities more dependent on productivity growth. In other words, we find that the more a city's economy depends on jobs, the more resilient it is. We see this connection between jobs growth forecasts and resiliency playing out around the world.

Exhibit 1: Sector Focus Is Not a New Story

Peak-to-Trough Prime Real Estate Nominal Capital Values, Main Sectors, During Previous Downturns



Sources: CoStar, PMA, Cushman & Wakefield, JLL, CBRE, PGIM Real Estate. As of December 2023.

Exhibit 2: The Economic Resilience* and Employment Share of Real GDP Growth

(Various U.S. Cities, 1991-1992, 2001-2003, 2009-2011, 2020-2021, (%))

*Note: Calculated as the average of city real GDP growth relative to national GDP growth when national GDP growth was negative and the first year of positive growth. Negative values mean weaker than the U.S. national.

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

The Intersection of Cities and Sectors in Uncovering Opportunities

What this means for investors is that while the sector play continues to make sense – protecting investors on the downside – it also works by investing in cities that are not only dependent on jobs growth but also have a stronger jobs growth outlook – promising upside growth.

So far so good. For major cities around the world, this resilience story leads to compelling investment opportunities in markets such as San Francisco and Dallas in the United States, Amsterdam, Stockholm and London in Europe, Sydney and Melbourne in Australia and possibly Tokyo in Japan, where strong jobs growth forecasts sit alongside very much job-driven city economies.

Jobs growth alone, however, is not the entire story. Investors still need to account for supply. While there are pockets of relatively high development, such as logistics in greater Tokyo and greater Seoul or multifamily across the U.S. sunbelt, don't forget about supply pressures in the office market given the shift to remote work; supply pipelines remain below averages set over the last cycle. That bodes well for rental growth, even if jobs growth comes in weaker than expected.

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