


TOP TEN ISSUES AFFECTING REAL ESTATE®

The Counselors of Real Estate®




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The Counselors of Real Estate® and its 1,000 credentialed real estate advisors have identified the current and emerging issues expected to have the most significant impact on all sectors of real estate. The **Top Ten Issues Affecting Real Estate®** are determined through broad membership polling, discussion, and debate. Now in its 12th year, this signature thought leadership initiative is an invaluable resource to clients of Counselors worldwide and to the real estate industry in general.

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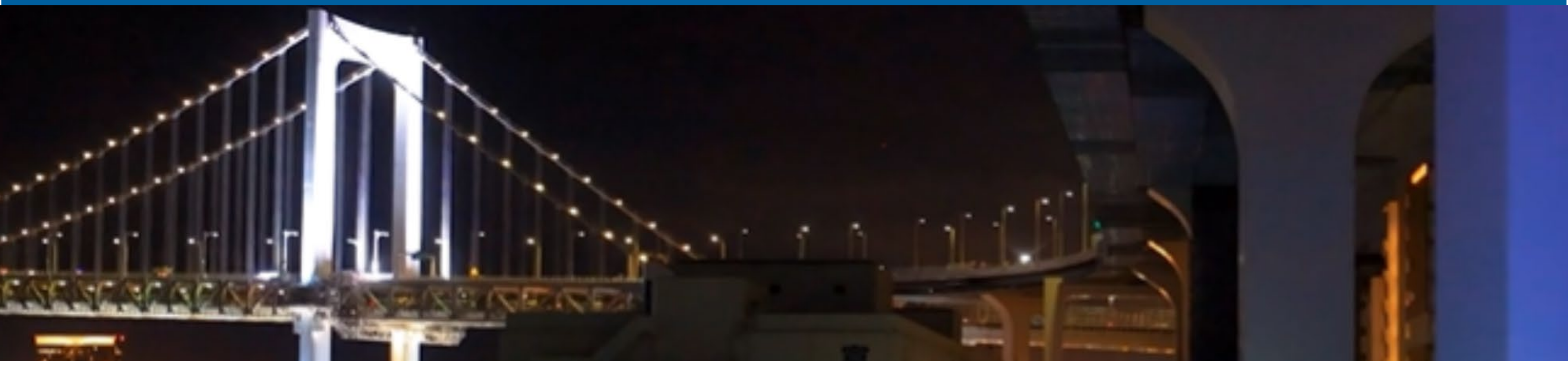
A Fork in the Road, Traversing Both Paths:

Finding "a Third Way" to Advance America's Infrastructure



10. London Bridge is Falling Down

A Fork in the Road, Traversing Both Paths: Finding "a Third Way" to Advance America's Infrastructure

Subject Matter Expert: Korin Crawford, CRE®

The problems – and staggering costs to repair and upgrade – America's aging infrastructure are well documented. The topic of infrastructure tends to start with the American Society of Civil Engineers (ASCE), which has been handing out sub-par grades in the C and D range for the past 20 years (with an overall grade of a C- in its most recent 2021 report card).

Inspired from the great public works projects of the 1900s that solidified the U.S. as a global 20th century economic leader, the tremendous need for new and improved infrastructure is now being met with what could be once in a generation legislation that is allocating substantial funding towards infrastructure spending as part of the $1.2 trillion Bipartisan Infrastructure Law and $783 billion within the Inflation Reduction Act. The funding is a significant accomplishment that will bring needed improvements and create jobs. At the same time, it puts the country at a critical fork in the road. The country is legislatively committed to investing in major infrastructure projects and money is starting to flow, yet it is unclear if things will play out with careful thinking – and perhaps rethinking – about what types of infrastructure are truly needed to sustain U.S. prosperity throughout the 21st century.

A Fork in the Road

Will investment be made with a backward look and traditional view of infrastructure, with spending on megaprojects, such as highways, bridges, and pipelines? Or will investment focus on forward-looking infrastructure needed to support new technologies, changing societal needs, and volatile environmental conditions?

One could argue that the Bipartisan Infrastructure Law is largely doubling down on existing infrastructure, shoring up its gaps and addressing deferred maintenance – a strategy better suited for the 20th century and perhaps primarily a jobs creation bill facilitated by infrastructure spending. If the view is on better preparing the country for what it needs to be a leader in the 21st century, does the Inflation Reduction Act provide enough of a pivot toward the energy transition and climate resilience?

Perhaps the framing of the infrastructure debate (vis-a-vis backwards versus forward looking) needs to evolve. Ultimately, the solution may be a both, and approached and framed as "gritty, committed and nimble progress" versus "sweeping change in one fell swoop." This approach warrants shoring up our gaps while looking at innovation and alternatives that address the new infrastructure imperatives that have emerged.

Finding a Third Way

From this viewpoint, both pieces of legislation are sorely needed while also acknowledging that much more must be done (e.g., many argue that both the BIL and IRA are “drops in the bucket” compared to the long-term spending needs). Gritty incremental progress comes in the form of the Debt Ceiling bill that contains “permitting reform” for energy infrastructure projects to help accelerate the development of large-scale transmission projects. Comprehensive permitting reform was previously (and continues to be in some cases unaddressed in the Debt Ceiling provisions) an enormous missing link to getting significant infrastructure built across multiple state lines and local government jurisdictions. Instead of choosing and going down one clear path, we're cobbling together a new path by "clearing the brush" in the wilderness that will be an ongoing heavy lift with lots of fits, starts, and pitfalls.

The Inflation Reduction Act is a game changer with regards to the types of investments it is targeting, including emerging technologies and new and more resilient energy, waste, and water solutions. One opportunity ahead is to reimagine infrastructure the same way we are reimagining how we are delivering products and services to people in the future, which includes shifting from a model of mass distribution to more localized distribution. Do we spend $5 billion to upgrade one regional power plant, or do you spend that $5 billion to build 20 smaller-scale decentralized power facilities? Those smaller facilities could be customized to generate power from alternative sources, whether it is solar, wind or waste to energy, as well as change the way power is delivered.

Is there a third option to advance America’s infrastructure? The “Genius of the AND” is a concept developed in the book *Built to Last* by Jim Collins. Builders of greatness reject the "Tyranny of the OR" and embrace the "Genius of the AND" by courageously traversing seemingly contradictory and/or incompatible extremes.

Preparing the country’s infrastructure for the future is going to be a heavy lift even with the help of federal funding. People also need to shift their thinking about infrastructure spending as only the responsibility of the federal government. These two key pieces of legislation could be a catalyst and call to action for local government, cities and counties, private corporations, non-profits, foundations and other associations to work together. A combination of these actors can participate at the local level to take leadership in thinking about infrastructure that will be needed to support the American population and economy over the next 25, 50 and 75 years.

9. The Price is…Wrong?

Do Markets Need a Pricing Reset for Values to Normalize?

Subject Matter Expert: Del Kendall, CRE®

Basic math tells us that if the cost of capital increases, cap rates and property values should decrease. However, the pricing reset the market has been waiting for has been slow to materialize given the freeze in the transaction market with few reliable comps.

The reality is that CRE markets have hit peak prices for the cycle and are starting to decline due to higher interest rates, and in some sectors, slower growth. The big question is where those prices are going to settle out, and there are several factors that are slowing that price discovery. A key hurdle is that buyers and sellers are still in a stand-off. Sellers are holding out for values at or close to what was achievable prior to the interest rate explosion. Meanwhile, buyers believe values are much lower based on higher capital costs.

Although there is some acceptance that prices have dropped, there is less willingness to take those write-downs in values. Owners are opting to hold rather than sell in what could be a trough of the market. So, there is a bit of a Catch 22 and a big barrier to assessing true values. The combination of motivated sellers and limited sales transactions is setting the "market price" at an artificially low level. Something needs to give in order to close the gap between buyers and sellers and stimulate transaction activity. Either prices need to drop, interest rates need to drop, or perhaps it is a combination of the two.

Reading the tea leaves

The main bellwether for asset repricing is interest rates and capital costs. The 10-year has increased 200+ basis points from 1.6% in January 2022 to 3.8% as of mid-June, while the 1-month SOFR rate has jumped 500+ basis points to hover above 5%. Lender spreads also have widened. Owners are looking for clues in how higher capital costs are impacting prices in the public REIT market. According to the Green Street CPPI, property values have dropped 14% YOY as of May, with the office sector taking the biggest hit at -26%. A 14% drop in REIT prices is not entirely proportional to private sector prices. However, public REITs might be a good indicator on general trends in how property values are trending.

Sentiment remains decidedly mixed on whether interest rates will drop, remain where they are, or potentially even move higher over the next 12 months. If interest rates don't move lower, it doesn't bode well for creating a thaw in the transaction market. Sellers are going to need to be the ones to blink first and recognize that they need to lower their pricing expectations. Rent growth in some sectors, such as industrial and multifamily, are helping to offset the higher interest rates. Multifamily values have dropped about 8 to 10% and industrial even less, whereas office has experienced more significant drops in value of 20-30%.

Strain on maturing debt

Repricing of assets has big implications for the transaction market and also underwriting on loan refinancing with a staggering $1.5 trillion of U.S. CRE debt coming for repayment before the end of 2025. This is a story that the real estate industry has seen play out in the past, most recently with the mountain of maturities looming over the market in 2015, 2016 and 2017 when post-Great Financial Crisis capital markets were still constrained. That crisis never materialized because lenders were able to kick the can down the road and pretend and extend.

A key difference back then is that while rates were low, capital wasn't available. Now capital is available, but rates are significantly higher. That scenario creates a few potential problems. Is it feasible for borrowers to refinance at higher rates? How much equity will borrowers have to bring to the table with loan economics and valuations that are now very different? Will those refinancing challenges force lenders holding the debt – largely banks – to mark to market, which will have a cascading impact on CRE and financial markets? These are all weighty questions that will continue to play out in the second half of 2023 and into 2024.

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8. Alexa, Where's My Stuff?

Supply Chain, Logistics and U.S. Onshoring

Subject Matter Expert: KC Conway, CRE®

Container ships that stacked up outside of the California coastline during the pandemic galvanized action to build more resilient, efficient supply chains, which for many, was already underway.

Companies are remaking supply chains from one that was anchored on the West Coast with goods that moved through the L.A. and Long Beach ports and were dispersed East-West through Chicago to the East Coast. New supply chains are moving North-South. The seeds of that shift were planted a decade ago with the expansion of the Panama Canal, and that transformation really took root and blossomed due to the supply chain disruption that occurred during COVID. A decade ago, about 60-65% of all containerized goods were flowing through the West Coast ports of L.A. and Long Beach with 30 to 35% coming from the East Coast and Gulf Coast ports. Now that flow of goods has flipped the other way with 65% of containers are coming through the East Coast and Gulf Coast ports.

The East Coast and Gulf Coast ports can move containerized goods through their ports inland and reach 70% of the country's population at twice the speed that West Coast ports can and at half the cost. In fact, New York surpassed L.A. and Long Beach as the busiest container port in 2022. Charleston has been recognized as the fastest growing port in the country, and Savannah is on track to be the busiest container port by 2025. The Port of Mobile is another up-and-comer thanks to $300 million in federal money that is funding a major overhaul of the port. There also is redundancy with ports in Houston, Freeport and the Everglades.

The Golden Triangle

The heart of America's logistics infrastructure lies in the Golden Triangle. The Golden Triangle is the interior of the country that runs from the Great Lakes at the tip down through Texas on one side of the triangle and down to the mid-Atlantic on the other side. Five of the country's Class I railroads run through the center of this region and connect to a redundant network of ports, and it also is where all of the rail consolidation is occurring. For example, Canadian Pacific recently merged with Kansas City Southern to create the first Class I railroad running from Canada through the U.S. into Mexico.

The remaking of supply chains coincides with a reshoring boom of manufacturing, and much of that growth is again focusing on the interior and southern states. Over half of the U.S. GDP is produced in this Golden Triangle region. Mapping the FedEx, Amazon and Walmart e-commerce fulfillment locations in the country shows a heavy concentration of locations from the East Coast into the Mississippi Valley area with very little on the West Coast. A majority of the new plant announcements made recently also are situated in that Golden Triangle in cities such as Memphis, Wichita and Huntsville. The key drivers behind that are affordability, access to workforce and the logistics infrastructure – rail, roads and ports.

Winners and losers

The Golden Triangle is where companies are locating because they desperately need that infrastructure for their supply chains. Those cities that are going to benefit from that shift are those that are connected to a port by rail. Cities that don't have the logistics infrastructure and don't have that connectivity don't have a chance of being part of this new e-commerce economy.

Another byproduct of those shifting supply chains is that the value of the real estate going forward is going to be less about whether it's located in a big urban CBD primary market versus where it has value in terms of logistics, infrastructure, workforce or the quality of the building. What used to be a discount for a secondary market or suburban market is going away, and the discount is likely to shift to the big urban cities.

7. Real Estate Armageddon

Economy, Interest Rates and Inflation

Subject Matter Expert: Hugh Kelly, Ph.D., CRE®

The recent era of “free money” ended abruptly following a blistering pace of Fed rate hikes. The federal funds rate is now at its highest level since 2007, and owners, investors and developers across the commercial real estate market are feeling the effects of higher capital costs.

Borrowers holding short-term debt are taking the brunt of the impact. The SOFR benchmark rate has climbed from 0.5% in March 2022 to 5.30% as of early September, while the 10-year treasury is hovering around 4.2%. Higher interest rates coupled with tighter liquidity in the wake of major bank failures have taken a toll on the real estate transaction market, with sales activity that has dropped sharply and buyers and sellers both trying to come to terms with a reset on property values.

Is the Fed choking the economy and tipping the market towards a real estate Armageddon? The outlook may not be as dire as it seems.

Cooling economy, hot employment

Given the severity of the pandemic disruption, it is hard to say that the economy is gasping for air in 2023. In the second quarter, real GDP increased 2.1% year-over-year. Although growth is slow, it also is mixed. Personal consumption expenditures, adjusted for inflation, were up 2.3% year-over-year, while expenditures on services were up 3.0%. Investment, which is especially interest-rate sensitive, is where we see significant drag at -8.2%. But, even here, the data is mixed with intellectual property output up 6.4%, while residential fixed investment has taken a severe hit, dropping 19% since the Fed started to raise rates.

Because real estate is so focused on the ramifying effects of the housing economy, it is not a surprise to feel that we are choking on Fed policy. But that’s simply myopia on the part of industry. It’s important to remember the Fed’s dual mandate: price stability and full employment. On the jobs side, it’s tough to see Fed policy as derailing the economy. With a 3.8% unemployment rate (as of August 2023) and monthly gains over the past 12 months averaging 334,000 new jobs, the labor market is still running hot.

The inflation seesaw

On the inflation front, there is no denying that the Fed missed the boat on price dislocation as the pandemic swept across the economy. In a very basic sense, there are two key forces affecting inflation: cost-push pressures and demand-pull pressures. The pandemic-era inflation had both forces building in a serious way. Supply-chain disruptions and the resulting shortages created a classic squeeze on prices affecting everything from food and energy to technology.

On the cost-push side of inflation, the Fed is primarily reactive, and its policies are naturally marginal and lagging. Where the Fed has come in for greater criticism is in reining in demand-pull inflation. Loose monetary policy has been cited by those for whom Milton Friedman's dictum about "too much money chasing too few goods" represents the other side of the story of price inflation.

Who's to blame? Look in the mirror

The Fed pursued a policy of near-zero-bound interest rates following the Great Recession and Global Financial Crisis, making "cheap money" available across the economy. Meanwhile, the nation's money supply (M2) grew on average 6.2% annually between 2000 and 2020. In the pandemic, massive fiscal stimulus accelerated monetary growth. It's clear that the Fed is putting on the brakes, both in reversing its QE program and in its FOMC interest rate moves.

Opinions are mixed on the Real Estate Armageddon effect. Rising interest rates and the uncertainty higher costs are creating on property values is shaking up both commercial and residential real estate markets and creating a drag on transaction activity. Higher capital costs coupled with tighter bank lending also is concerning for borrowers with a staggering $1.5 trillion of U.S. CRE debt maturing before the end of 2025. Although concerns about impending "urban doom" may be overblown, we are still in the throes of the late COVID era and the disruption on major urban economies has not yet run its course.

While it's always tempting to second-guess public officials and organizations, the real estate and financial industries need to look in the mirror, too. How is it that banks, whose primary business involves the management of interest rate risk, found themselves unprepared for the consequences of Fed tightening, its squeeze on spreads, and the potential for disintermediation by depositors? Likewise, how is it that commercial real estate investors accepted cap rate compression to the point where risk premiums virtually disappeared? In many ways, we once again find ourselves with Pogo's confession: "We have met the enemy and he is us."

6. Population Shock Migration's Impact on Real Estate

Subject Matter Expert: KC Conway, CRE®

People were packing up and moving to new cities and states well before anyone had even heard of COVID-19. Although that great migration shift has been fueled by the pandemic and remote work, the fundamental driver behind that shift is simple affordability.

As the West Coast and Northeast became exorbitantly expensive for housing and cost of living, people started to look at alternatives. The rise of remote work has accelerated that migration with people who now have greater flexibility to work from anywhere. They can choose to live in a lower cost city such as a Tucson or Greenville – and still get a San Francisco or New York paycheck. Another key driver is change in behavior. People used to get a job first and decide where they want to live second. Now that has reversed with younger workers now choosing where to live first and then finding a job.

Jobs shift to low-cost states

The U-Haul Growth Index provides insights into where people are moving. The states that top the list are Texas, Florida and South Carolina, with cities attracting the most inflows including the likes of Ocala, Florida, Auburn, Alabama, Surprise, Arizona, Madison, Wisconsin, and Myrtle Beach, South Carolina. Cities benefiting from that growth have three key ingredients: 1) affordability, 2) good airports and 3) housing.

People aren't the only ones relocating. Businesses also are moving out of high-cost states, highly regulated states in favor of locations across the Sun Belt and interior of the country. Companies are looking for locations that have the workforce and the logistics infrastructure – rail, interstates and access to ports. For example, a new report from Argonne with the Department of Energy mapping where all the new EV battery plants are being built or have been built in the last three years shows a concentration from the Great Lakes all the way south to Alabama, Tennessee, Georgia and Texas down into Mexico.

Spotlight shines on suburbs and secondaries

The movement of people and businesses is creating some clear winners and losers. The big urban areas with density and lack of affordability are seeing outflows, and that trend is not likely to reverse. The punctuation mark on the downside of that population trend is clearly San Francisco. Office vacancies and valuations have both dropped sharply. Office buildings that were transacting at between $200 million and $300 million are now going back to the lender, in some cases at less than half of what they traded for just a few years ago. Other likely big losers in the Great Migration are the seven states served by the Colorado River impacted by drought, with new restrictions on water usage that are likely to impede future growth.

The bottom line is that the population dynamics across the country are changing. The U.S. is becoming less CBD concentric and more suburban or secondary market concentric. And it's not a fad tied to remote work that is likely to swing back the other way. It's a deeper trend that is rooted in affordability. Employers are drawn to those cities where they can find the workforce and the logistics infrastructure to support their business. And that shift has significant implications for the real estate industry in terms of growth opportunities, as well as the challenges ahead for property valuations, surplus space and obsolescence created in areas where populations are declining.

5. Where Have All the Workers Gone? The Labor Shortage

Subject Matter Expert: Kathleen Rose, CRE®

Everyone, everywhere, in nearly every sector is reporting that it is difficult to find skilled, willing and able workers. Layering on top of the worker shortage are a series of trends that are changing requirements for both workers and employers.

Despite some signs of softening in the wake of Fed rate hikes, the labor market remains incredibly strong. The monthly Job Openings and Labor Turnover Survey (JOLTS) report consistently shows more job openings than there are available workers. As of August, there were approximately 1.8 available jobs for every unemployed person, with the unemployment rate remaining low at 3.8%. The biggest factor contributing to the labor shortage is the aging population of baby boomers that are moving out of the workforce. That labor shortage was accelerated during the pandemic with more people who left the workforce with the Great Resignation.

Employers are struggling to not only find workers to fill jobs, but also keep up with a dynamic labor market that is moving at a fast pace. Over the last five years, the American workforce has not stayed static. Data from the National Occupational Employment and Wage Estimates put out by the U.S. Bureau of Labor Statistics (BLS) tracks the fluctuations in the labor market[i]. In 2022, the U.S. population stood at 333 million. Of that, roughly 60% were employed in various jobs, positions, and sectors in the U.S. economy.

The labor market has and will continue to shift, and the change is accelerating faster than the data can keep up. The dislocation in the workforce goes beyond just demographics to include changes in technology, migration trends and changes in worker behavior.

Game changing trends

The pandemic was a game changer. At its peak, 62% of all office workers were working remotely, which introduced new virtual ways of working. Many of those workers are continuing to demand more remote work options. They like the convenience and flexibility, not to mention saving time and cost on a tedious commute. The office has relocated to the home or apartment, and the downtown office markets have been pummeled by this dynamic.

Technology also is changing work beyond just the traditional office worker. For example, telemedicine allows virtual visits with doctors and other health professionals. Self-service kiosks are reducing the need for workers in the hospitality and service industries, while automation and robotics are replacing human capital in assembly, warehouse and distribution facilities. Looking at what's ahead, AI is the big elephant in the room, and it is not yet clear how AI and machine learning might impact how work is done, job growth or declines across different industries and skills that will be needed in the future workforce.

Jobs follow the people

Although the job market has been holding up under economic pressure, the bank failures that occurred early in 2023 are a warning sign that the Fed was slow to react to inflation and then perhaps overcorrected with its rapid interest rate increases. The question now is whether the U.S. will experience a soft landing or a hard recessionary landing. Labor markets often lag, and layoff announcements have started to emerge across many sectors, particularly tech. The labor market has significant downstream implications for real estate. Pure and simple, jobs drive demand for real estate, and populations also shift to where jobs are located.

Employers are following the people and paying close attention to migration shifts. Traditionally, older generations set up their lives around where their job was located. Younger generations, including Gen X, Y and Z, are now taking a different approach. They're reversing the order, choosing their lifestyle and where they want to live first and the job second. Younger workers also have a different mindset as it relates to remote work and contract work versus full-time employment. They tend to be more entrepreneurial, and they might work two or three jobs. So, in addition to tracking the availability of labor, employers need to consider the shifts in attitudes, behavior and skillsets that are reshaping the workforce.

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[i]https://www.bls.gov/oes/current/oes_nat.htm

4. AI – How Intelligent Is It?

Subject Matter Expert: Timothy H. Savage, Ph.D. CRE®

Artificial intelligence awakens. The genie is out of the bottle on AI. You can now ask a bot a question, and it can quickly mine massive amounts of data on the internet to provide a substantive answer. That genie isn't going back in the bottle. The key issues now are what is the function and purpose of AI for the real estate industry?

This powerful new technology comes at a time when there is an incredible need to measure things accurately. Access to real-time data is more and more critical to investors in a dynamic market as they decide what properties they want to acquire, exit or hold. There is this notion that the real estate industry is slow to adapt to technology. However, with innovation moving at a fast clip, industry participants no longer have the luxury of time to "wait and see" how things play out. They need to act quickly and embrace AI as we continue to integrate alternative data into industry analytics.

The AI Lifecycle

The early days of AI – AI 1.0 – started back in the 1980s with collecting data, such as on rents, vacancies, operating income and ultimately cap rates. Groups such as NCREIF came up with standardized data sets to compare NOIs that helped to measure performance, both relative and absolute. AI 2.0 was the work that Bill Wheaton and Ray Torto did in collecting a time series of data on rents and vacancies and then forecasting using traditional time series methods, and the work that Bob White did in collecting and forecasting transactional cap rates.

Where we are now with AI 3.0 is integrating new and alternative forms of data and new forecasting techniques. AI 3.0 involves an entirely different framework for thinking about data in commercial real estate. One, it involves thinking about probabilistic modeling (in a Bayesian sense), and two, causation (in a Judea Pearl sense). Will a tenant renew in year three, four or five? We want to be able to predict with great accuracy what the most probable outcome is likely to be.

We have embraced a new wave of thinking about things probabilistically. That empowers end users to run different models and simulate possible outcomes, all in relation to their risk-return profile. However, in this AI 3.0 we're still in the process of merging in massive databases into one clean data source that includes alternative data sets, such as sentiment data collected from a chatbot to more traditional rent and vacancy data that the industry is accustomed to using.

Embracing change

Everyone likes to talk about ChatGPT, and ChatGPT has brought mass attention to AI 3.0

and generative AI – the ability to scrape large amounts of data and restructure it to give rise to answers that look as if a human wrote them. However, the big innovations in commercial real estate will come, not from ChatGPT, but from the large number of PropTech start-ups that are reimagining the idea of data collection. They're incorporating mind-boggling amounts of data, and they're adopting probabilistic frameworks to think about the future.

It's an exciting time to be in 3.0 because we are starting to get data that is more accurate, granular and timely, and we can combine that big data or alternative data with new ways of forecasting. The nature of 3.0 is that those firms that embrace it will be better positioned for success, while the firms that don't or are slow to move beyond their 2.0 practices will be disrupted.

3. There's No Place Like Home
The Global Housing Shortage

Subject Matter Expert: Paula Munger, CRE®

People need to live somewhere. It's a basic necessity, and frankly, a simple concept that drives significant investment into all types of for-sale and for-rent residential real estate. Solving the nation's housing shortage is not so simple.

The U.S. continues to face an overwhelming housing shortage that has resulted from decades of underbuilding. Research studies reinforce the point that the U.S. has a lot of catching up to do in order to address the housing shortage and bridge the gap that exists between supply and demand.

The National Apartment Association (NAA) and the National Multifamily Housing Council (NMHC) estimate that the U.S. needs to build 4.3 million more apartments by 2035 to meet the demand for rental housing.

Other research, including a study conducted by Rosen Consulting on behalf of the National Association of Realtors, found a cumulative housing shortage of 5.5 million units between 2001-2020 due to chronic underbuilding. The supply-demand gap could be as high as 6.8 million when accounting for the cumulative effect of properties removed from the market.

Multifamily: Closing the gap
Closing the gap in the multifamily market may not be as daunting as it sounds. The 4.3 million shortfall equates to a more manageable annual volume of roughly 309,000 units per year. The issue is that progress will be bumpy. Robust development that resulted in more than 700,000 units over the past two years, according to the U.S. Census, is likely to slow in the near term due to higher costs and tighter lending.

Evidence of that slowing construction activity is already materializing with a near record high gap between the multifamily permits that were authorized and actual construction starts. That tells us a few things. In the beginning, there were supply chain issues, high inflation and material shortages that created delays. Now that the market is seeing improvement in supply chain and inflation, developers are dealing with higher interest rates and higher construction costs that are making it more difficult to secure financing along with general economic uncertainty that is causing some developers to push the pause button.

Hurdles to homeownership
The single-family home market is battling higher costs and limited supply of inventory that has been especially difficult for first-time homebuyers. There is approximately only a 2.9 months supply of homes on the market based on the current sale rate, according to the

National Association of Realtors. The imbalance between supply and demand has contributed to a huge run-up in home prices in recent years, although pricing has started to stabilize, and even decline in some markets.

Part of the problem is that there isn't a lot of turnover in existing homes. People who may want to relocate are reluctant to give up the low mortgage rate they have today in exchange for a significantly higher rate. According to the National Association of Home Builders, approximately 33% of homes listed for sale are new homes. In comparison, between 2000 and 2019, it was 12.7 percent. That figure highlights the market shift towards new construction. However, it is becoming more difficult – and costly – to build new housing for a multitude of reasons, including regulations and fees.

Bumpy near term outlook

Challenges in the for-sale market will continue to drive demand for all types of rental housing, including the growing single-family rental and built-to-rent markets. More and more millennials are getting married and starting families, which typically triggers the move to a home. However, the cost gap between owning and renting a home is the highest it's been since 2006. On average, owning a home costs $1,176 more per month than renting from a professionally managed apartment complex, according to the NMHC.

Despite the for-sale housing shortage, multifamily owners are likely to face a bumpy outlook in the near term. The recent surge in new supply is creating some softening in fundamentals as markets absorb the new supply. On top of that there are near-term headwinds for demand with slower economic growth. Capital and operating costs are higher and housing providers need to adjust to higher financing rates and uncontrollable operating costs (such as insurance and property tax) and what that means for their bottom lines.

If there is a recession, it is likely to be mild and short-lived. Upticks in immigration and natural population growth, the resilient labor market, as well as continued Gen Z household formation will also provide some tailwinds for apartment demand on the other side of a downturn. Over the longer term, access to housing, and especially affordable housing, has huge implications for real estate investors, economic growth, healthy communities, and of course, the people who do need to live somewhere.

2. Do I Have to Go to the Office? Occupiers, Obsolescence and Devaluation

Subject Matter Expert: Maureen Ehrenberg, CRE®

The future of what hybrid work looks like is still playing out with themes of flexibility, agility, productivity and space reduction. What is clear is that the pandemic created permanent shifts in where work is done that is taking a toll on both the office sector and central business districts.

At the peak of the pandemic, 62% of all office workers were working remotely. That percentage has flipped back the other way. According to WFH Research, 58% of workers are now fully back in the office, while 29% are working hybrid schedules and 13% are fully work-from-home. In addition, 28% of all U.S. workdays, on average, are spent working from home. As the future of hybrid work continues to unfold, the near-term focus is centering on calibrating hybrid schedules and setting new expectations for work that needs to be done in person.

How many days are people in the office? There is still some push-pull between employers and employees on the required number of days in person. Where that lands is going to depend on a variety of factors, including the company culture, the location of the office, the business and the type of work that is being done. Employers also are setting expectations around the type of work that needs to be done in the office, such as team meetings, training and key project work.

Destination worthy locations

Employers recognize that they need to pull people back to the office, which is creating a bigger battle cry for offices to be "destination worthy". That shift is generating some exciting new properties, such as the new JP Morgan Chase Tower in New York City and Google's new Bay View headquarters in California. These highly experiential properties allow people to do different types of work throughout the building, as well as being net zero carbon, more automated and digital. Employers also are curating spaces with amenities that employees consider worth the commute to come to the office.

According to BOMA International, property managers are having to change the way they work with tenants to facilitate those destination worthy environments, such as coordinating activities on higher occupancy days. If a major occupier is bringing tenants back to the office three days a week, the management, for example, can arrange special events to coincide with those days, such as bringing in food trucks, hosting an art exhibit creating patios and outdoor seating,

Battling obsolete office space

The discussion of WFH is not just about a job, but it is increasingly tied to where people want to live. Population shifts have resulted in a resurgence in suburban living and demand for suburban office properties. Combined, the shift to hybrid work and migration trends away from urban CBDs is contributing to a surplus of vacant office space, and ultimately, a growing inventory of obsolete office space. Those buildings in the line of fire that are likely to be most impacted are older B and C properties in CBDs, particularly those in poor locations and those that face costly capital projects for repositioning and decarbonization requirements.

It has never been more important for owners and occupiers to be in lockstep with one another. Tenants are looking hard at their occupancy and utilization of space, their rent costs, carbon footprint and their strategy for return to office. Owners need to get as close as possible to those tenants and have conversations to figure out – together – how they can work together to help pull people back to the office. If a tenant is going to be giving up space or subletting, owners need to know that sooner rather than later. Owners also need to know their local market better than anyone else. Who is in the market? Where are shifts happening in the market? What steps can be taken to strengthen relationships with existing tenants?

Tactically, owners need to act. Now is not the time to sit back and wait and see how hybrid work trends play out. If that property doesn’t check the box in some critical way – location, access, convenience, tenant amenities, or even an amazing view – those owners need to start thinking about alternative strategies. There is a great opportunity for reuse of obsolete office buildings with conversions to residential, seniors housing, healthcare or hotels. However, such conversions are challenging for a variety of reasons ranging from cost to zoning, and cities need to be proactive and work with owners on new solutions particularly in large cities where other factors are also impacting building occupancy and a decline in RTO.

1. What's This World Coming To? Political Unrest & Global Economic Health

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Volatility, uncertainty and economic risk
In a market where there is no shortage of geopolitical, economic and real estate market risks, there is some definite reshuffling of issues that are top of mind in 2023 and heading into 2024.

Turn the clock back a year, and the big geopolitical focus was on Russia's invasion of Ukraine and how it might affect global gas prices, commodities and inflation. Fed rate hikes were just starting to materialize with the full weight of the aggressive rate-hiking cycle that was not yet being felt in the commercial real estate market. Fast forward to today, and different risks have moved to the forefront. Although geopolitical risks haven't disappeared, the focus is closer to home with turbulence in the economy, capital markets and the office market.

One thing that hasn't changed is that we still have mixed macroeconomic signals in the economy, which contributes to an overarching uncertainty on where things are headed. In the U.S., we continue to have a substantially inverted yield curve and slowing GDP growth, but labor markets remain incredibly resilient. Moreover, yield curves are inverting in Europe. What has shifted hugely is the nature of the risk in the system. Yes, there are still ongoing concerns on the geopolitical front in Russia, as well as China. But we live in a world of much tighter monetary policy, and the state of capital markets is creating a strong undertow to both the economy.

New risks rise to the top
One or two risks in the market are worrisome. In the current market, there is a lengthy list with inflation, high interest rates, bank stress and tightening liquidity, among others. Any one of those risks could cascade into other parts of the market and tip the economy into recession. Another overarching risk is the overall level of uncertainty fueled by secular changes that are moving rapidly, whether you are talking about the impact of AI, migration trends, hybrid work or the reconfiguring of supply chains.

On the heels of major bank failures, there is concern about weakness in the banking sector that could be compounded by CRE loan defaults. Loan delinquencies are now higher than they were at the start of the pandemic, and the expectation is that there are more defaults coming, especially in the office sector. Banks hold a lot of those loans on their balance sheets, and the effects of that bad debt are going to ripple through the broader market.

Over the last year, the Fed has engaged in the tightest cycle of raising rates that we've seen in decades. In July 2022, the Fed Funds Effective Rate stood at about 160 bps and, as of this writing, stands at 500 bps. Higher interest rates have real implications, both for the broader economy and commercial real estate as the price of debt dramatically affects pricing and adversely affects investment. Another byproduct of those rate increases is an inverted yield curve, with the 10-year treasury roughly 150 basis points below the 3-month US treasury. Capital costs are creating significant refi risk with an estimated $1.5 trillion in commercial and multifamily debt set to mature before the end of 2025.

Caution ahead

Those risks don't necessarily mean the sky is falling. However, it is critical to face the realities of the risks that are now prevalent in the market as real estate industry participants navigate key decisions and evaluate strategies. People need to stay focused and pay attention to the things that are going to affect their particular segment of the industry, whether they are a lender, a developer, a distressed buyer or institutional investor.

One of the key fundamentals to real estate is location, location, location, and location is more important than ever. We're in a period of extreme risks that will create variance in returns. Market participants will need to be much more micro focused, because market conditions, as well as other factors such as the regulatory and tax landscape vary from market to market. Depending on where you sit in this market, the next year could be extraordinarily difficult, or you could have tremendous opportunities.

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