Invesco

Off the Floor in ’24

Why we expect 2024 to be an attractive entry point for new real estate investments

Mike Sobolik, CFA®, CRE®
Managing Director
Regional Investment Strategist, North America
Invesco Real Estate

February 2024
invesco.com

We believe that the US real estate market is poised to start its price recovery sometime in the second half of 2024. This paper looks at two drivers for this recovery, the capital markets and real estate fundamentals.

1. **In capital markets,** we expect projected reductions of the fed funds rate[1] to flow to real estate debt costs. We believe lower borrowing costs should in turn reduce upward pressure on cap rates[2], and an eventual lift in cap rates should drive higher real estate prices.

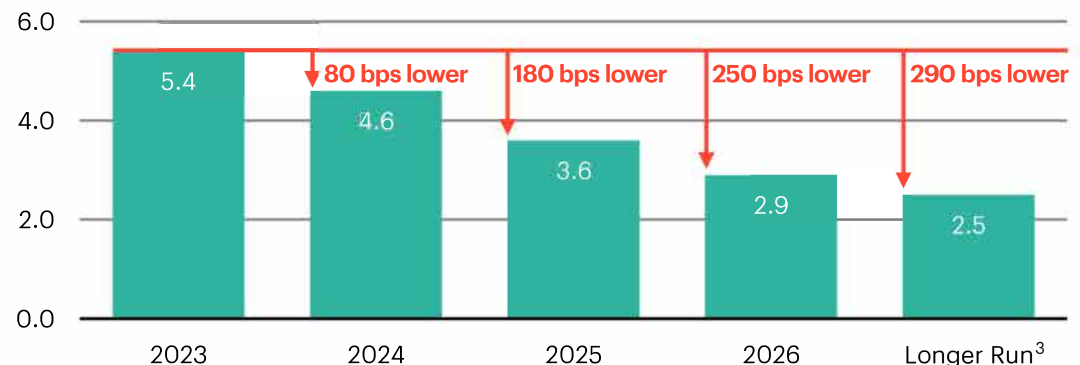
2. **In real estate leasing markets,** we anticipate that a strengthening of tenant confidence, supported by lower borrowing costs and ongoing economic growth, will eventually coincide with a sharp reduction of new supply deliveries, caused by the recently sharp pullback of construction financing. We expect the timing of these trends to eventually converge and drive rent growth.

This paper summarizes the historic relationships between these factors, and why we remain confident that similar patterns will apply in the near term.

A drop in policy interest rates should start a chain reaction to benefit real estate.
The December meeting of the Federal Open Market Committee (FOMC) sent the message that real estate investors have been waiting for: Confidence in inflation reduction is solidifying, monetary tightening is nearing an end, and the fed funds rate is guided to be cut three times in 2024 and several more times into 2027 (see Figure 1). The recent January meeting reinforced that sentiment.

Figure 1: A drop in policy interest rates should start a chain reaction
We believe a lower fed funds rate should lead to lower real estate debt costs and cap rates

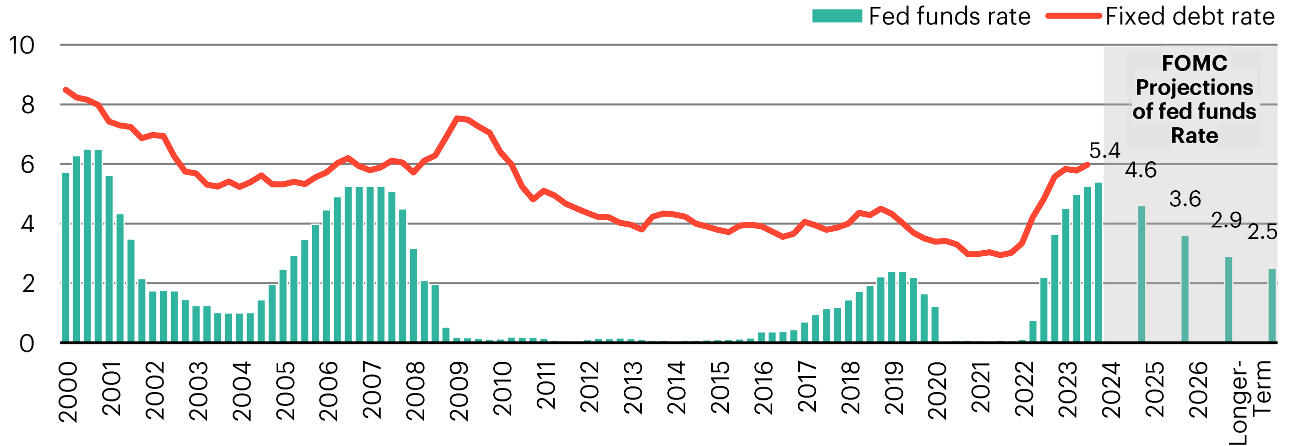
FOMC median projections of the fed funds rate at year-end



Bps: Basis Points[4]
Sources: Invesco Real Estate, utilizing data from the Federal Open Market Committee’s (FOMC) December 13, 2023 median projection of the fed funds rate. Past performance is not a guarantee of future results. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations.

Lower policy rates give scope to lower real estate debt costs. Lower policy rates are the necessary catalyst for a reduction of interest rates more broadly, including real estate debt costs. The historical relationship between policy rates and debt costs has been well-established (see Figure 2): Real estate debt costs are priced at a spread[5] above certain base interest rates, including the fed funds rate, and the spread varies over time. When policy rates escalate and the spread to real estate debt costs narrows, that narrowing eventually compels real estate debt costs to rise to maintain a premium over base policy rates. And when policy rates are reduced, pressure on debt costs are reduced, eventually leaving room for debt costs to fall, which ultimately affects real estate cap rates.

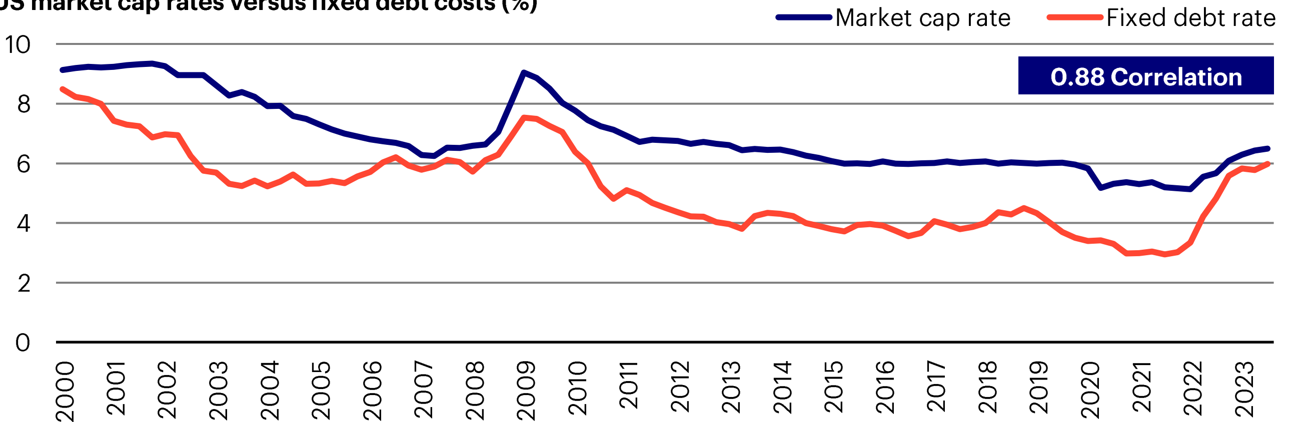
Figure 2: Lower policy rates give scope for lower real estate debt costs
When the fed funds rate falls, real estate debt costs have room to fall



Sources: Invesco Real Estate, utilizing data from the American Council of Life Insurers and Moody's Analytics (historical data as of January 2024), and the Federal Open Market Committee's (FOMC) December 13, 2023 median fed funds rate projection. Past performance is not a guarantee of future results. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations.

Lower real estate debt costs should relieve pressure on cap rates. Reductions in real estate debt costs have historically led to lower cap rates and price growth. Because commercial real estate investing often involves the use of financing, real estate debt costs historically have been closely related to real estate cap rates, which is the relationship between a property's net operating income divided by the property's purchase price. The correlation[6] between market cap rates[7] and fixed debt costs[8] since the start of 2000 has been very strong at a 0.88 correlation (see Figure 3). Based on the historical strength of this relationship and on the highly integrated use of financing in commercial real estate investing, a decline of debt costs is highly likely to result in a decline in cap rates, which typically reflects rising prices.

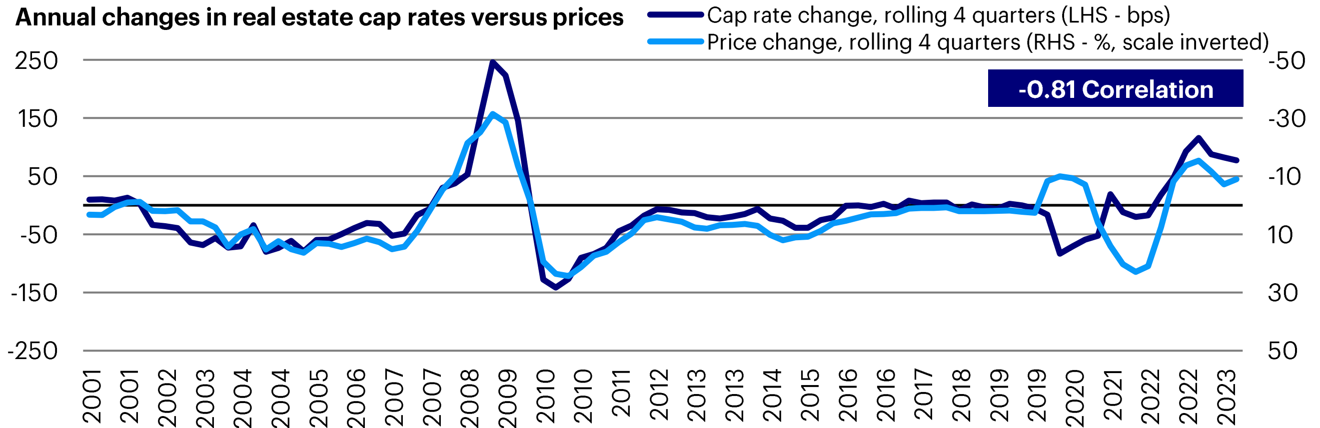
Figure 3: Lower real estate debt costs should relieve pressure on cap rates
Historically, falling debt costs have coincided with or been followed by falling cap rates and rising prices



Sources: Invesco Real Estate, utilizing data from Green Street (market cap rates) and the American Council of Life Insurers (fixed rate debt costs as of January 2024. Data cover the time period from January 1, 2000 to September 30, 2023.

A drop in cap rates typically reflects rising prices. The historical relationship between year-over-year changes in cap rates and real estate prices has been very strong; a reduction in cap rates and a rise in prices typically go hand-in-hand, and vice versa, for a structural reason: Real estate price is part of the cap rate equation (i.e., net operating income divided by price). From the start of 2000 to the end of 2023, the correlation between the annual movement of cap rates versus prices has been -0.81, indicating a very strong inverse relationship (see Figure 4 – note that the right-hand scale for pricing is inverted to show the relationship with cap rates more clearly). So historically, falling policy rates led to falling debt costs, falling debt costs led to falling cap rates, and falling cap rates led to rising prices. Looking forward, we expect this chain reaction to unfold over the next several months.

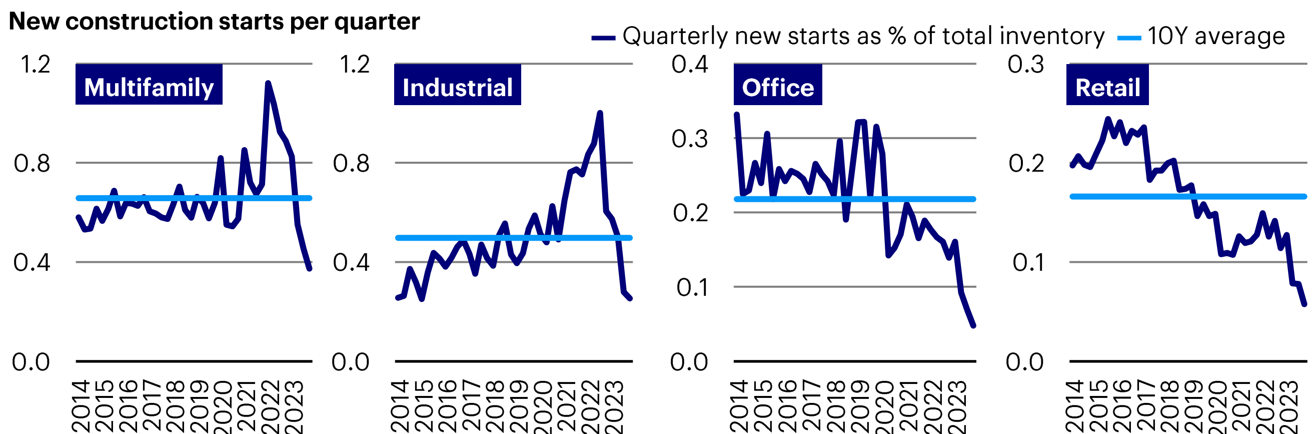
Figure 4: A drop in cap rates typically reflects rising prices
Real estate cap rates and prices are inversely related and strongly correlated



BPS: Basis Points; LHS: Left hand side; RHS: Right hand side
Sources: Invesco Real Estate, utilizing equal-weighted figures for both cap rates and the Commercial Property Price Index from Green Street as of February 2024. Data cover the time period from January 1, 2000 to December 31, 2023. Past performance does not guarantee future results.

A plunge in new starts makes room for rent growth once leasing improves. Slower leasing velocity through much of 2023 largely reflected tenants' caution in a higher interest rate environment. While office buildings and malls continue to face long-term structural demand pressures, the leasing pace in other property types is expected to accelerate as interest rates ease and confidence in sustained economic growth recovers. Ideally, the recovery of leasing demand will coincide with the expected decline of new supply deliveries later this year and into early 2025. New construction financing has stalled for over a year due to higher interest rates, leading to a rapid reduction of new construction starts[9] from the end of 2022 to the present (see Figure 5). Given that new projects typically require one to two years to complete, a dearth of new starts in 2023 means that new deliveries will likely shrink in 2024 and into 2025. Once leasing demand eventually picks up, a lack of new supply should provide room for rents to grow. And growing rents would provide confirmation to investors that a new growth cycle had indeed commenced, which would potentially attract capital and drive real estate prices higher.

Figure 5: A plunge in new starts makes room for rent growth once leasing improves
Recent reductions of new starts mean deliveries will shrink later this year



Sources: Invesco Real Estate, utilizing data from CoStar as of February 2024.
Data cover the past 10 years of available data from January 1, 2014 to December 31, 2023

Risks to the outlook. Just as the shift in Federal Reserve (Fed) policy could be the primary catalyst for real estate price recovery, factors that could redirect that policy shift is where to look for key risks. The most obvious factor to consider is that inflation could unexpectedly escalate again and cause the Fed to delay the loosening of monetary policy. Indeed, the US government's upward revision of 2023 job growth released in January invites questions about the potential for wage expansion to fuel inflation. Consequently, keeping interest rates higher for longer would delay the reduction of real estate debt costs and hence delay the easing of cap rates and growth of real estate prices, and even perhaps cause cap rates to rise further and prices to fall further. Furthermore, sustained higher interest rates would likely cause tenants to persist in their caution and delay leasing decisions. Our expectation of real estate prices finding a trough in the second half of 2024 is contingent on confidence expressed by the Fed that inflation is on a path toward normalization. And assuming the Fed does reduce policy rates this year as expected, the time required to ultimately affect cap rates potentially could stretch into 2025.

Conclusion

The Fed sent a clear message about inflation and monetary policy in December, and they reinforced that message in January. We expect that a shift in Fed policy will start a chain reaction that will lead to lower real estate debt costs and cap rates, and hence a rise in real estate prices sometime in the second half of 2024. And while risks to this outlook must be considered, we believe that real estate investors are poised to act on a growing conviction of rate reduction.

Defined Terms and Notes

1. The Federal funds rate is the rate at which depository institutions lend to each other.
2. Capitalization rates (cap rates) is the quotient of a property's net operating income divided by the property's estimate value.
3. The median forecast for the longer-run Fed Funds rate by the Federal Open Market Committee (FOMC) is represents each committee participant's assessment where the rate "would be expected to converge, over time, under appropriate monetary policy and in the absence of further shocks to the economy". (Source: FOMC Summary of Economic Projections, December 13, 2023). The St. Louis Fed defines the FOMC "longer run" projections as follows: "The longer-run projections are the rates of growth, inflation, unemployment, and federal funds rate to which a policymaker expects the economy to converge over time in the absence of further shocks and under appropriate monetary policy. Because appropriate monetary policy, by definition, is aimed at achieving the Federal Reserve's dual mandate of maximum employment and price stability in the longer run, policymakers' longer-run projections for economic growth and unemployment may be interpreted, respectively, as estimates of the economy's longer-run potential growth rate and the longer-run normal rate of unemployment; similarly, the longer-run projection of inflation is the rate of inflation which the FOMC judges to be most consistent with its dual mandate in the longer-term." Per the December 13, 2023 FOMC projections, their "longer run" projections start after December 31, 2026.
4. Basis Point (bps) is a unit that is equal to one one-hundredth of a percent.
5. Spread is the difference between two financial rates. This paper includes discussion about the difference, or spread, between fixed debt costs (fixed debt rate) and the fed funds rate. American Council of Life Insurers (ACLI) is used as the proxy for fixed debt rates.
6. Correlation indicates the degree to which two investments have historically moved in the same direction and magnitude.
7. Green Street's Commercial Property Price Index (CPPI) is used as the proxy for commercial real estate pricing. Data for the series starts in Q1-2000 (beginning January 1, 2000).
8. Data from the American Council of Life Insurers (ACLI) is used as the proxy for fixed debt rates. At the time of this writing, ACLI debt rate data were available through Q3-2023, that is, through September 30, 2023.
9. A construction start is the physical commencement of new construction activity, which is usually represented by "breaking ground" to prepare the land for work on a building's foundation. Construction starts are one measure of construction volume, and therefore tends to be measured in terms of physical space, e.g., square footage for commercial buildings or number of units for residential buildings.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Property and land can be difficult to sell, so investors may not be able to sell such investments when they want to. The value of property is generally a matter of an independent valuer's opinion and may not be realised.

These materials may contain statements that are not purely historical in nature but are "forward-looking statements." These include, among other things, projections, forecasts, estimates of income, yield or return or future performance targets. These forward-looking statements are based upon certain assumptions, some of which are described herein. Actual events are difficult to predict and may substantially differ from those assumed. All forward-looking statements included herein are based on information available on the date hereof and Invesco assumes no duty to update any forward-looking statement. Accordingly, there can be no assurance that estimated returns or projections can be realized, that forward-looking statements will materialize or that actual returns or results will not be materially lower than those presented. The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

Generally, real estate assets are illiquid in nature. Although certain kinds of investments are expected to generate current income, the return of capital and the realization of gains, if any, from an investment will often occur upon the partial or complete disposition of such investment.

Investing in real estate typically involves a moderate to high degree of risk. The possibility of partial or total loss of capital will exist.

Important information

This document is intended only for Professional Investors in Hong Kong, for Institutional Investors and/or Accredited Investors in Singapore, for certain specific sovereign wealth funds and/or Qualified Domestic Institutional Investors approved by local regulators only in the People's Republic of China, for certain specific Qualified Institutions and/or Sophisticated Investors only in Taiwan, for Qualified Professional Investors in Korea, for certain specific institutional investors in Brunei, for Qualified Institutional Investors and/or certain specific institutional investors in Thailand, for certain specific institutional investors in Malaysia upon request, for certain specific institutional investors in Indonesia and for qualified buyers in Philippines for informational purposes only. This document is not an offering of a financial product and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any unauthorized person is prohibited.

This document may contain statements that are not purely historical in nature but are "forward-looking statements," which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.

This document is issued in the following countries:

- in Hong Kong by Invesco Hong Kong Limited景順投資管理有限公司, 45/F, Jardine House, 1 Connaught Place, Central, Hong Kong.
- in Singapore by Invesco Asset Management Singapore Ltd, 9 Raffles Place,
#18-01 Republic Plaza, Singapore 048619.
- in Taiwan by Invesco Taiwan Limited, 22F, No.1, Songzhi Road, Taipei 11047, Taiwan (0800-045-066). **Invesco Taiwan Limited is operated and managed independently.**