Bell Bank

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Commercial Real Estate Insights

How the Economic Outlook Impacts Commercial Real Estate in 2023

Commercial real estate has been on the frontlines of the market and economic shocks of the past few years. From rising interest rates and inflation to hybrid work models and the economic slowdown, countless trends have forced many companies to reevaluate their CRE plans and financing needs. This landscape presents both difficulties and opportunities for CRE leaders looking across 2023 and beyond. Below, we explore the impact of these macroeconomic challenges and how CRE leaders can best position for growth in the years ahead.

While CRE has always been economically sensitive, the industry has been on a rollercoaster ride since 2020. The economic shutdown due to the pandemic created significant uncertainty for commercial real estate demand and vacancy rates across sectors, especially in office and brick-and-mortar retail. The economic recovery that followed from mid-2020 to late 2021 led to a turnaround in industrial, ecommerce and multifamily activity, driving demand for manufacturing space, warehouses and housing units. However, this also spurred inflation, which pushed interest rates higher, tightened financial conditions and slowed the economy. Today's challenges are a result of these factors.

In many ways, the Midwest has fared better than the rest of the country over this period. Unemployment remains extremely low in the region, industrial activity is generally robust, and inflation has fallen faster than in many other parts of the country.

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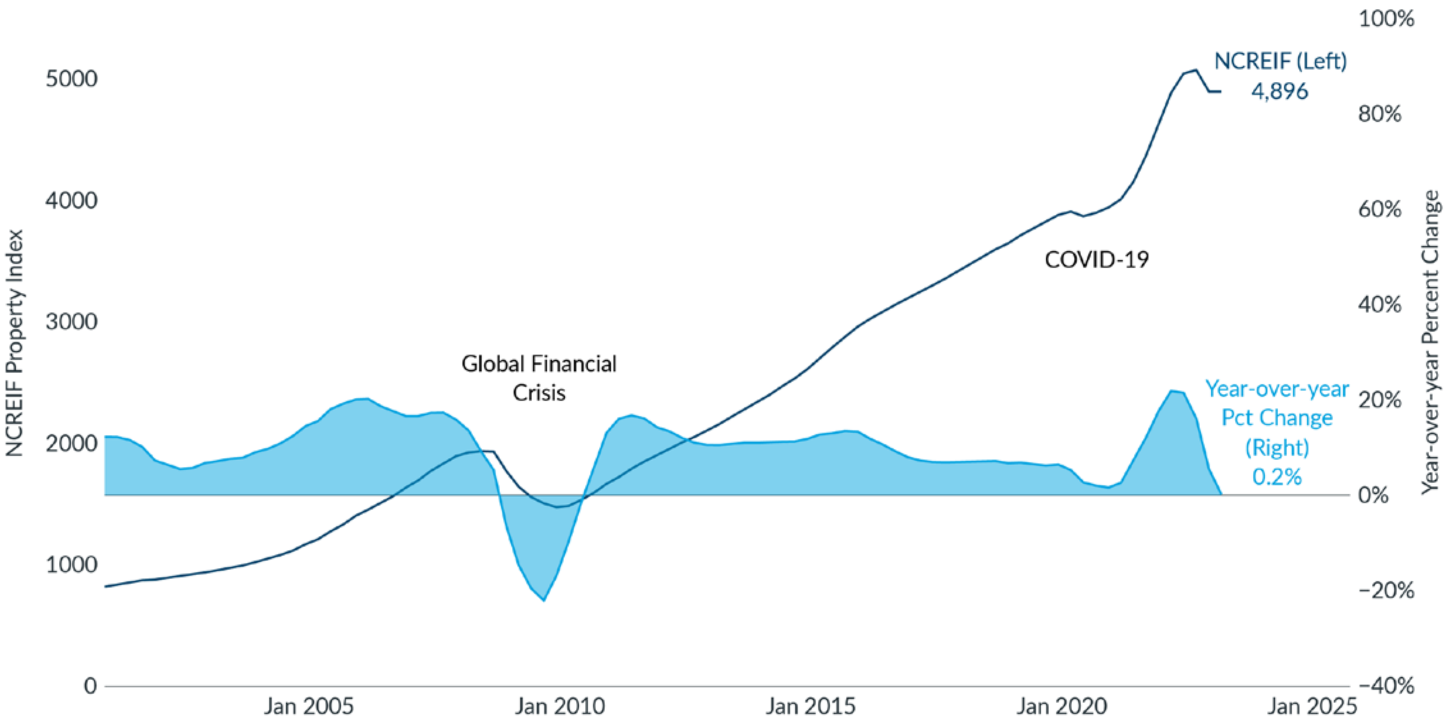
NCREIF National Property Index

NCREIF Property Index and year-over-year percent changes



Latest data point is Mar 31, 2023
Sources: Clearnomics, NCREIF

Some of this can be attributed to industry concentration. According to a recent Bureau of Labor Statistics report, the concentration of manufacturing in the Midwest has grown significantly since 1990. This bucks the trend of declining manufacturing across the rest of the country and has driven CRE demand. There has also been a meaningful increase in manufacturing employment in the Midwest following the Great Recession, a reversal of previous trends.

Although manufacturing represents only one CRE sector, its positive impact on the Midwest can be seen in the NCREIF's industrial property index's performance. This index gained 14.6% in 2022, well above the broader CRE market's increase of 5.5%.

Financing Risk

Perhaps the biggest issue facing CRE is rising interest rates. The tightening of financial conditions is by design as the Federal Reserve attempts to fight inflation by slowing the economy. Over the past year, the Fed has raised the federal funds rate nine times, from a lower bound of zero percent to 4.75%. This pace of rate hikes is second only to the cycle of the late 1970s and early 1980s when the Fed was also battling inflation.

However, the Fed has slowed their pace of rate hikes from 75 basis points to 50 basis points and now 25 basis point hikes. While highly uncertain, current Fed projections are for interest rates to increase once more and remain high for the remainder of the year.

Fluctuating and high interest rates have resulted in higher financing costs, which have had a blunt impact across the CRE landscape, just as they have across many industries. Higher interest rates and uncertainty naturally mean higher hurdle rates are required by developers and investors, and may lead to greater scrutiny of cap rates for new projects.

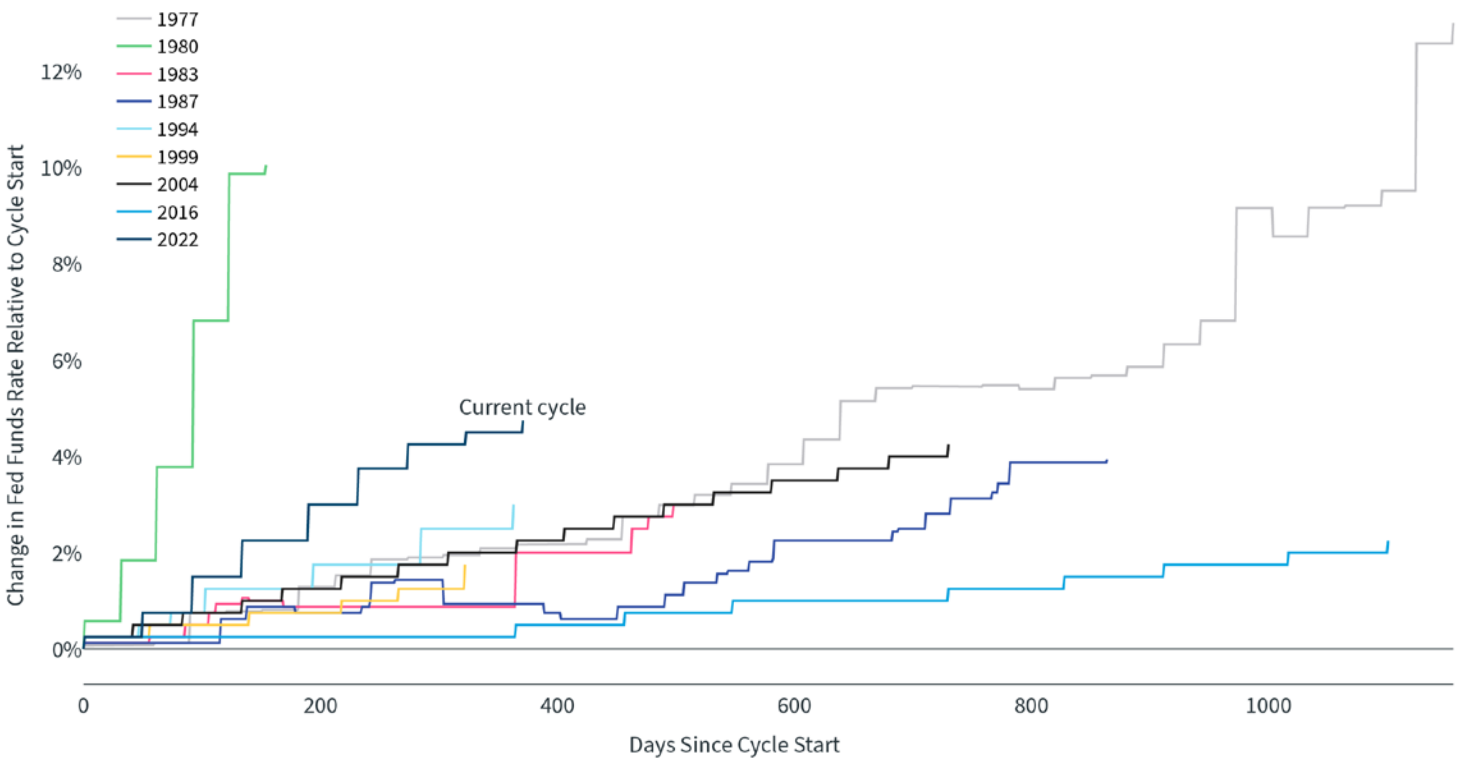
However, there are signs that this could be plateauing with recent inflation data decelerating. The Consumer Price Index, for instance, slowed to a year-over-year rate of 5.0% in March, compared to a peak of 9.1% the previous June.

What is a challenge on the liability side of company balance sheets may be a benefit on the asset side as interest rates remain elevated. CRE companies should consider strategies for achieving higher yields as they manage their cash. Ideally, using treasury services allows companies to take advantage of attractive cash yields that can fuel cash flow and support strategic initiatives.

For CRE companies with robust balance sheets and, perhaps more importantly, strong banking relationships, the ability to finance projects at attractive rates can be a competitive advantage as the economy stabilizes and business conditions improve.

Fed Funds rate across history

Increase in target range lower limit or effective rate since 1977



Sources: Clearnomics, Federal Reserve

Recession Risk

At a national level, while there are clear signs that the broader economy is slowing, it's not yet certain whether there will be a recession. Additionally, this outlook differs across sectors, and any economic slowdown would have a mixed effect on each sector.

Over the past year, the industrial sector within CRE has outperformed as industrial capacity has remained relatively flat and utilization has expanded. As a result, vacancy rates are the second lowest among any CRE sector at 4.6%, according to the National Association of Realtors. In contrast, the office space sector lagged but is now showing signs of stabilization after the dramatic decline and partial rebound in office use in 2020 and 2021. Hotel and retail CRE have seen strong rebounds in recent months as consumer spending has been robust, although there are early signs of slowing as the economy decelerates. Multifamily housing CRE has struggled as interest rates increased over the past year.

Moving forward, economic uncertainty and high interest rates will continue to be a headwind for the CRE industry broadly. Office space, hotel, and retail space may be particularly affected by expectations for a mild recession. As consumer and business confidence falls, spending will likely be limited as consumers and businesses look for areas to cut costs.

However, there are still bright spots across the economy and the CRE industry. Supply chains have improved for many goods that were in high demand during and immediately after the pandemic. Improving supply chains have decreased the prices of lumber, computer chips, used and new cars, and many more inputs to production. Many businesses have encouraged workers to return to the office, and consumer spending has also held up despite high inflation. These bright spots may lead to opportunities across office and industrial CRE sectors. While it is not clear precisely how an economic slowdown may impact the CRE industry, it is important to remain flexible and reevaluate strategic plans to best take advantage of evolving conditions.

Opportunities for CRE Leaders

Navigating the commercial real estate market will continue to be challenging as the Fed fights inflation, the economy remains uncertain, and long-term trends such as hybrid work evolve. However, these trends also create opportunities for CRE leaders with longer time horizons. Those who can access financing via strong banking relationships, and take advantage of attractive deposit and treasury management services as rates remain high, will likely be better positioned when the economy does recover once again.

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