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Special Commentary — September 25, 2024

# Is the Tide Turning for Commercial Real Estate?

## Easier Monetary Policy Lays the Foundation for Recovery

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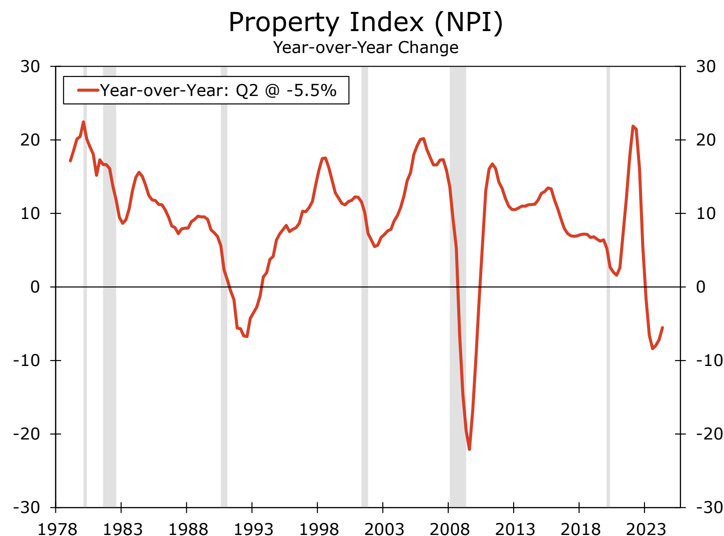
## Summary

### The Fed Plants the Seeds for a CRE Recovery

The Federal Reserve's 50 bps cut at the September FOMC meeting marks the beginning of the end of the worst CRE downturn since the Global Financial Crisis. Given inflation appears contained and strains are emerging in the labor market, we expect the Fed to follow with a string of rate cuts through the summer of 2025 in order to keep the economic expansion intact.

Lower interest rates are not a magic bullet, but less restrictive monetary policy lays the groundwork for a commercial real estate recovery. Decreased long-term interest rates appear to be easing upward pressure on cap rates and slowing declines in property valuations. Meanwhile, increased expectations for an economic soft-landing look to be giving capital the green-light to move off the sidelines. There's no shortage of obstacles ahead, especially when it comes to the office market. That said, reduced interest rates should prevent distress from spreading and shorten the hurdles coming down the road.



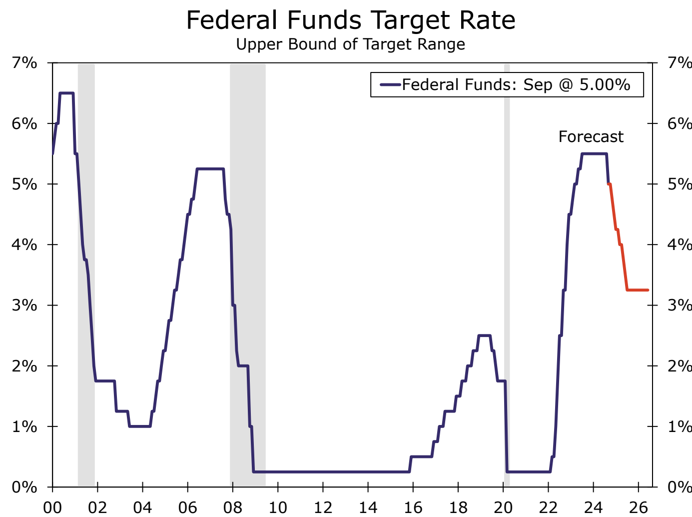
Source: NCREIF and Wells Fargo Economics

All estimates/forecasts are as of 9/25/2024 unless otherwise stated. 9/25/2024 6:00:44 EDT. **This report is available on Bloomberg WFRE**

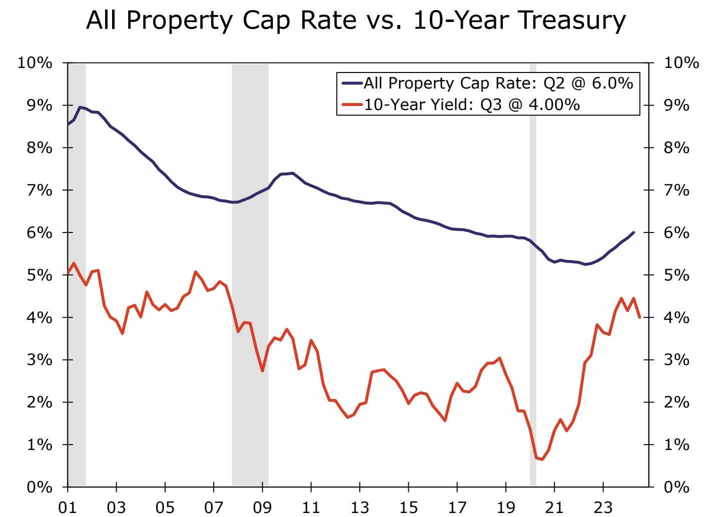
## The Federal Reserve Has Started to Ease Monetary Policy

Trees don't grow to the sky and falling acorns eventually hit the ground. Conditions in the CRE market have deteriorated significantly since early 2022 when the Federal Reserve began raising the federal funds target rate in order to bring down inflation. The increase in interest rates resulted in a sizable drop in transactions, higher cap rates, lower property values and a pull-back in lending. Although supply and demand fundamentals have been more resilient to the effects of tighter monetary policy, occupancy generally has shifted lower amid a post-pandemic surge of new construction completions, resulting in sharply higher vacancy rates and slower rent growth for many property types.

The good news is that a monetary easing cycle is upon us. The Federal Reserve reduced the federal funds target rate by 50 bps at the September FOMC meeting and strongly hinted that additional cuts are coming soon. Although several measures of inflation generally are still slightly above the Federal Reserve's 2% target, underlying price pressures appear well contained and the path back to target looks to be in reach. Meanwhile, labor market conditions have softened. The unemployment rate stood at 4.2% in August, up from 3.7% in January. The uptick in the unemployment rate demands that the Fed shift its attention to the employment side of the mandate. Although economic growth remains solidly intact, with real GDP expected to expand more than 2% in Q3, the Fed will need to shift monetary policy toward a neutral stance in order to prevent a recession and sharp deterioration in the labor market. As such, we look for the FOMC to follow up September's 50 bps cut with a string of reductions amounting to 175 bps of additional cuts by the summer of 2025.



Source: Federal Reserve Board and Wells Fargo Economics



Source: CoStar Inc. and Wells Fargo Economics

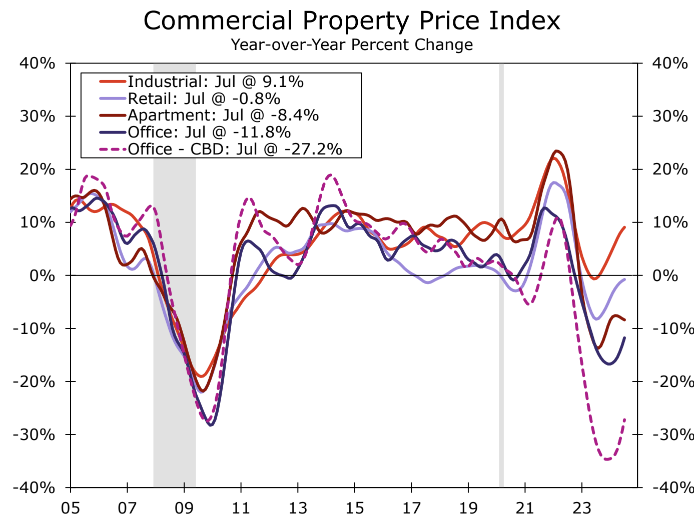
## Every Little BPS Helps

Lower interest rates on the horizon lay the groundwork for a commercial real estate recovery. Alongside expectations for Fed easing, the 10-year Treasury yield has trended lower in recent months, declining from this year's peak of 4.70% in April to 3.73% in September (as of this writing). We expect the 10-year yield to remain below 4% and to move slightly lower to an average of 3.40% in Q4-2025. Given the reduction in rates recently, it is not entirely surprising to see some stabilization when it comes to cap rates, which were either unchanged or slightly lower across property types in Q2-2024. Cap rates are not driven entirely by interest rate changes. CRE capital flows, investor risk preferences, local market conditions and property-specific supply and demand dynamics all play a role. That said, the cost of capital is the keystone for many of these drivers and a down-step in interest rates should help alleviate upward pressure on cap rates moving forward

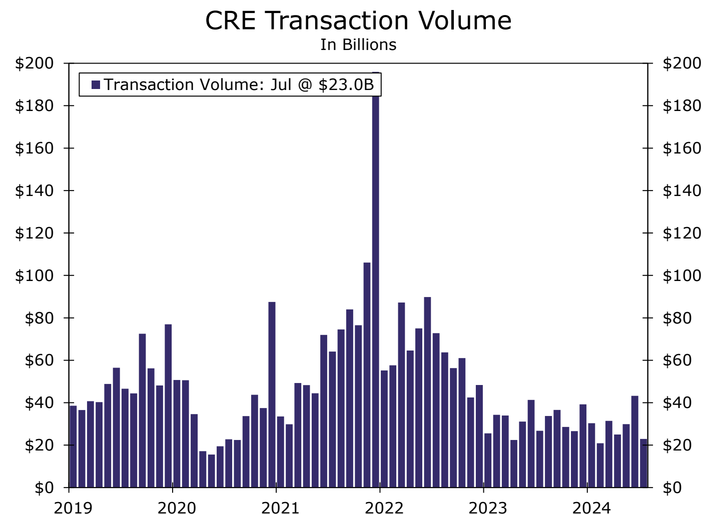
The easing in cap rates has occurred alongside firming property valuations. As we show in the chart at the top of the report, the NCREIF Property Index declined 5.5% in the Q2-2024, marking the slowest annual decline since Q1-2023. Other private valuation measures, such as MSCI's All-Property Price index, show a similar trend. What's more, several publicly traded REIT valuations have also rebounded after moving lower over the course of the past several years. For example, the MSCI US REIT Index has climbed steadily since the Spring and recently reached its highest level since early 2022. There

is still a wide variation by market and within the different property types, with private industrial property valuations rising a little over 9% over the past year and Central Business District office prices plummeting by over 27%. That noted, property valuations do appear to be steadying, which suggests a bottom may have already been established for most property classes.

One caveat to the recent stabilization in valuations is that price discovery is still limited by depressed transaction volumes. Sales volumes were down 5% on a year-to-date basis as of July and are still running about 34% below the same period in 2019. As monetary policy becomes less restrictive, lower financing costs should induce a pick-up in transactions and bring additional clarity to the current state of property values. Thus, there is still some downside risk for properties, such as office, where transactions have been especially scarce and distress is mounting.




Source: MSCI Real Capital Analytics and Wells Fargo Economics

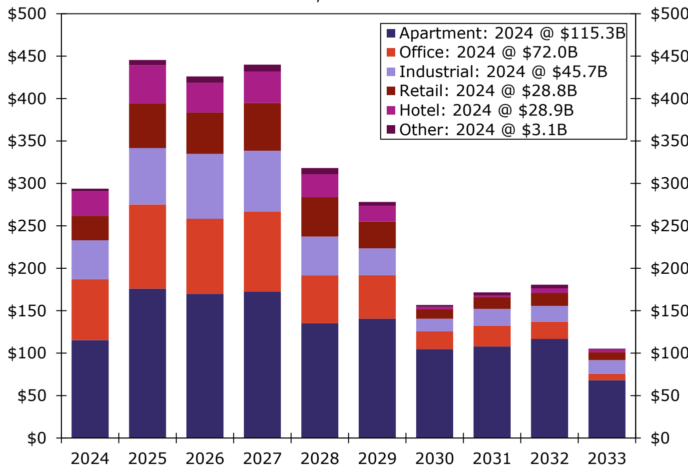



Source: MSCI Real Capital Analytics and Wells Fargo Economics

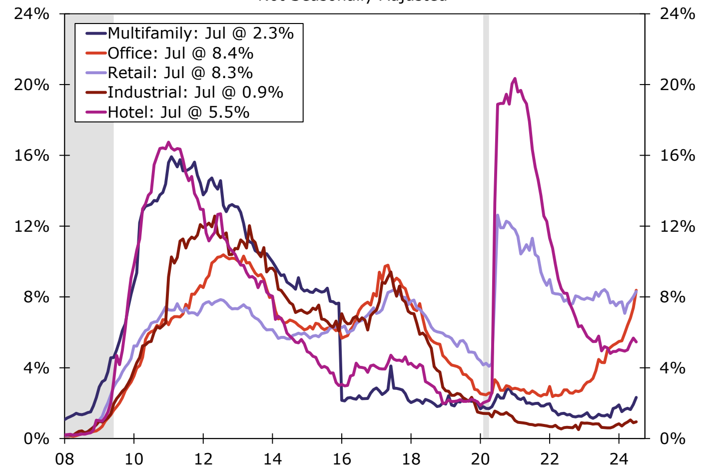
## Fed Cuts Provide a Ladder to Help Clear the Debt Maturity Wall

A looming debt maturity wall and potential increase in distressed sales could also bring additional downward pressure on property values. Close to $1.9 trillion of CRE debt is scheduled to mature by the end of 2026, up markedly from the levels registered in recent years. Although higher cap rates, lower valuations and relatively tight credit markets will certainly be a challenge for borrowers who will need to refinance in the near term, many lenders have been amenable to “amend and extend” troubled loans, effectively pushing out debt maturities to a later date when the capital market environment is more conducive to refinancing. The result has been a relatively low level of distressed sales so far. According to Real Capital Analytics, the share of distressed sales rose to about 3% so far in 2024, up slightly from 2% in 2023 as a whole, yet far away from the 17% averaged in 2010 after the global financial crisis.

To be clear, the “refinancing gap” is likely to exert further near-term stress as the amount of maturing debt in need of refinancing exceeds available capital. Office debt, in particular, is likely to experience additional strain as more leases roll over and the market resets further to reflect increased supply, lower demand and reduced rents. The office commercial mortgage-backed security (CMBS) delinquency rate rose to 8.3% in July, up from the pre-pandemic low of 2.7%. For historical context, the office CMBS delinquency rate peaked at 10.4% in 2013 the aftermath of the Great Recession. Outside of office, however, fundamentals appear far more constructive in the multifamily, retail, industrial and hotel markets, and delinquency rates generally have not climbed to the same extent.



Source: MSCI Real Capital Analytics and Wells Fargo Economics

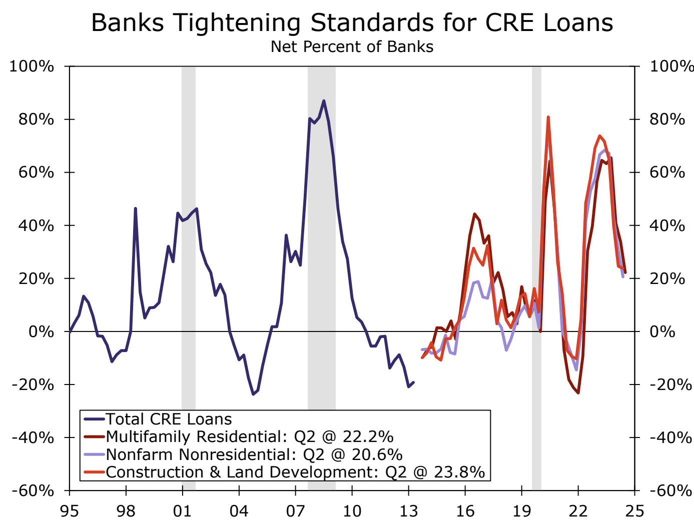


Source: Moody's Analytics and Wells Fargo Economics

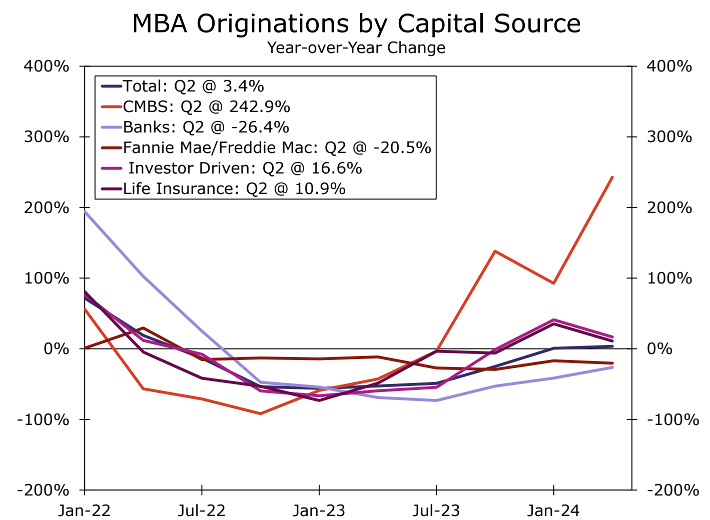
## Capital Flows Begin to Percolate

Additional monetary policy easing won't be a cure-all, but lower interest rates should help limit distress in the years ahead. Lower financing costs should help borrowers with floating-rate debt better cover interest expenses. Importantly, reduced rates should also foster an improved lending backdrop and strengthen capital flows, which remain thin as a result of economic uncertainty and restrictive monetary policy. As displayed below (chart), banks have significantly tightened lending standards on CRE underwriting since 2022. Banks are still being prudent, but have become less guarded recently, with the net share of banks tightening lending standard falling to the lowest reading since Q2-2022. Banks are a critical source of capital for CRE borrowers, representing about 50% of commercial and multifamily mortgage debt outstanding.

They are not the only option, however. Life insurance companies, government sponsored entities (GSE's), CMBS and other investor groups also comprise significant shares of debt outstanding. Like banks, most capital sources have tightened lending substantially over the past several years. Yet, recent months have brought an increase in origination activity, which suggests capital is starting to move off the sidelines. MBA's Origination Volume Index showed that commercial and multifamily mortgage loan originations improved 27% in Q2, a 3% year-to-year gain. Although originations activity is still running slow, especially at banks, CMBS lending has risen significantly over the past year. Originations from life insurance companies and investor-driven lenders have also picked up notably. In terms of property types, hotel, industrial and healthcare originations drove the overall annual gain, while office, multifamily and retail originations remained down significantly. All told, capital flows look to be percolating, a trend which appears likely to continue if the Federal Reserve further reduces interest rates in the year ahead.




Source: Federal Reserve Board and Wells Fargo Economics



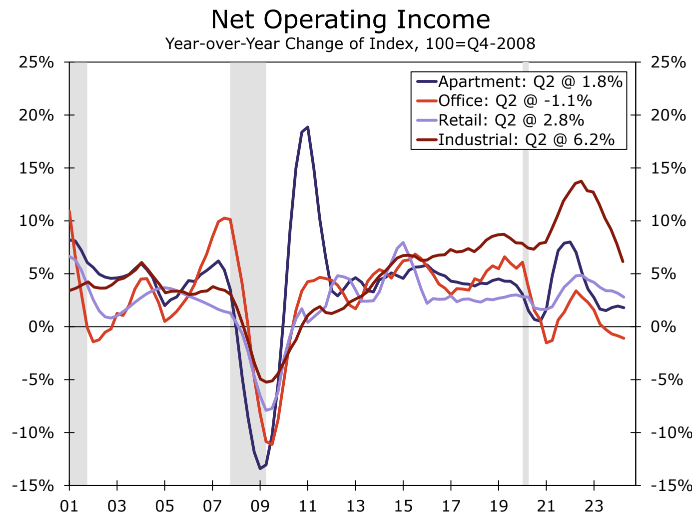

Source: MBA and Wells Fargo Economics

## Approaching a New Equilibrium

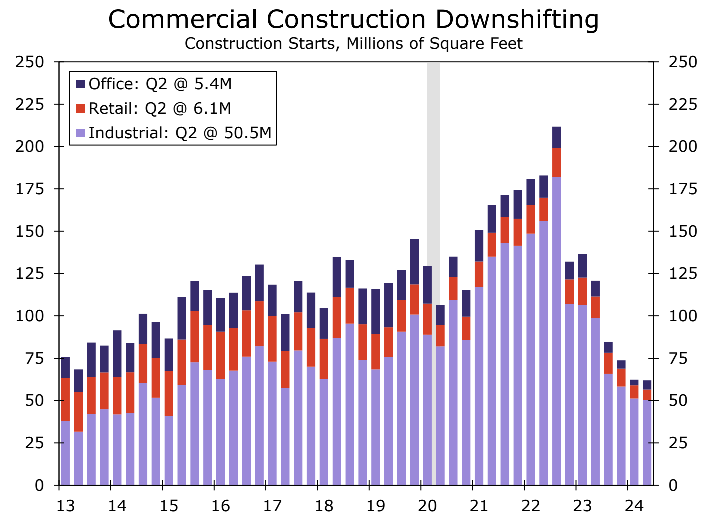
Less restrictive monetary policy should also bolster CRE fundamentals. The U.S. economic expansion remains intact, in large part due to the resilient pace of consumer spending. Sturdy economic growth is one reason why net absorption for most major property types has remained positive despite a challenging capital markets backdrop. We expect the Fed rate cutting cycle to keep the economic expansion alive and eventually bring about a stronger pace of real GDP growth. Consequently, demand for CRE should also grow stronger in the years ahead. For example, decreased financing costs should foster a stronger pace of income growth and give some relief to households dealing with higher debt costs. As such, demand for consumer-related CRE segments, such as retail, industrial and hotel, should benefit. Lower interest rates will likely prevent further deterioration in the labor market, which should support multifamily demand and help stave off even more drastic declines in office net absorption.

Of course, the challenges afflicting the office market will not be resolved by less restrictive monetary policy. That noted, more accessible credit for developers and lower financing costs for conversions and tenant improvements should ultimately separate the wheat from the chaff and clear the way for a new equilibrium. Elsewhere, the restrictive monetary policy put in place over the past few years should help bring balance to the segments dealing with an influx of new supply. Currently, there are still a considerable amount of industrial, multifamily and hotel projects under construction that are expected to deliver over the next year or so. In the near-term, an influx of new supply appears likely to apply upward pressure on vacancy rates.

That noted, the boost in demand from lower financing costs could help demand rise closer to supply and prevent vacancy rates from climbing significantly higher in the near-term, supporting rents and the income-producing potential of properties. As we show below (chart), net operating income has been remarkably resilient this cycle. Looking further ahead, new construction starts have downshifted dramatically. A thin project pipeline means the script may soon flip, with demand potentially running ahead of new supply after the wave of projects are completed. Easier monetary policy will likely encourage new development, but interest rates are not expected to fall back to the lows experienced after the pandemic and CRE construction will likely remain conservative as a result.




Source: CoStar Inc. and Wells Fargo Economics




Source: CoStar Inc. and Wells Fargo Economics

In summary, the Federal Reserve's 50 bps cut at the September FOMC meeting should mark the beginning of the end of the worst CRE downturn since the Global Financial Crisis. Lower interest rates are not a magic bullet, but less restrictive monetary policy lays the groundwork for a commercial real estate recovery. A decrease in long-term interest rates appear to be easing upward pressure on cap rates and slowing declines in property valuations.

Meanwhile, increased expectations for an economic soft-landing look to be giving capital the green-light to move off the sidelines. There's no shortage of obstacles ahead, especially when it comes to the office market. That said, stress should be fairly contained so long as interest rates move lower and other property class fundamentals continue to hold up. Challenges are certain to remain, but those hurdles should be more easily cleared in the years ahead if the Federal Reserve continues to ease monetary policy and the economic expansion remains intact as we currently anticipate. All told, it has been a tumultuous few years, but the tide finally appears to be turning for commercial real estate.

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