Katten Speaks with Cushman & Wakefield's James Bohnaker on Commercial Real Estate Outlook

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Katten and Cushman & Wakefield recently co-hosted the 16th Annual Outlook on the Commercial Real Estate Market in Charlotte, North Carolina. James Bohnaker, senior economist with Cushman & Wakefield's Global Think Tank, delivered a keynote speech that placed a spotlight on the country's economic outlook and how various forces are affecting the commercial real estate market, both at the national level and on the ground in North Carolina.

Daniel Huffenus, Katten Real Estate partner and event moderator, and Real Estate partner Barrett Mallos followed up with Mr. Bohnaker after the event to ask some questions about the future of the economy and commercial real estate markets. The below Q&A highlights some of Mr. Bohnaker's thoughts on what lies ahead.

Economic Forces

Recession, the dreaded "R" word, has been floating around for a while and consumer confidence is down. What is driving the negative economic outlook?

One word: inflation. We are seeing higher prices for food, gas and other products, with inflation reaching its highest level since the 1980s in 2022. Consumers and businesses experience this on a daily basis and expect inflation to remain higher for longer. The reality is that inflation, while still uncomfortably high, has moderated in the last few months, while economic growth picked up in the second half of the year despite subdued confidence. Moreover, the labor market has been incredibly resilient as hiring continues at an above average rate. So there are both positives and negatives when surveying the economy as a whole.

It seems the risk of recession could be growing amid falling confidence and the Federal Reserve's effort to fight inflation with aggressive interest rate hikes. Are you seeing specific warning signs that a recession could be on the horizon?

One indicator of a potential recession is the bond market and past recession trends. The current relationship between long-term treasury bonds and short-term treasury bonds has inverted from what it normally is, as typically the long-term yields are higher. This is an interesting indicator because the curve has inverted roughly 12 months before each of the last seven recessions.

By contrast, in the current labor market, we are seeing near record lows in unemployment and fairly strong job growth. And despite some high-profile layoffs, it is a tight market with job openings far exceeding the supply of available workers. However, while there have been isolated layoffs on a national scale, that could change in 2023. It is important to maintain a watchful eye on the labor market going forward – as an indicator of whether we are in a recession, and more importantly, how severe it will be.

The stock market could also provide signs of a potential economic downturn. As companies struggle with falling earnings and share prices, they will face increasing pressure from shareholders to cut costs. How do companies cut costs? They lay off employees, cut back on building projects and invest less. Those actions will have a real impact, and we're just starting to see that spill into the real economy.

Multifamily Sector

What does the economic landscape, including the Federal Reserve's battle to bring inflation under control, mean for the commercial real estate market?

As we know, the housing market hit a strong stride a couple years ago with low mortgage rates, but it has seen the wind taken out of its sails with dramatic increases in rates. As the Federal Reserve raised interest rates at a record pace over the past year, mortgage rates likewise increased and monthly mortgage payments skyrocketed. Mortgage rates were as low as 3 percent a couple years ago, whereas the current average rate is a little over 6 percent. Many prospective buyers have been sidelined by the prospect of nearly doubling their mortgage rates. This is a tailwind for the multifamily market. A lot of people who were thinking of buying in 2023 will not have that option and will shift to renting, which in turn will boost the multifamily sector based on that substitution effect.

That being said, home prices are expected to decline across the country. The Charlotte market likely will experience a larger drop in home prices despite limited supply, as they increased in Charlotte even more than they did nationally several years ago. In 2021, the city's home prices increased by approximately 21 to 22 percent. Looking ahead to 2023 and 2024, we are expecting a slightly larger decline in Charlotte, but only on the magnitude of about 6 to 7 percent. That would not be a housing bubble or collapse in the local market, but rather a correction. Despite moderating prices, homebuying is expected to remain costly relative to renting for the next couple years, which will be beneficial for multifamily demand.

The multifamily sector has been strong in both Charlotte and Raleigh. What are key drivers behind this growth, and will the two cities continue to see robust multifamily demand?

Net migration to North Carolina has been very strong. When it comes to projections of average population growth from 2020 to 2030, Charlotte and Raleigh rank among the fastest growing metros in the country. Lower cost of living, great job prospects and better climate conditions are just a few of the factors attracting people to the two cities, particularly people from higher cost metros such as Chicago and New York. This will be another tailwind for multifamily in North Carolina's local markets, not just over the next few years but also over the long term.

Charlotte and Raleigh have seen a significant uptick in the number of new multifamily construction projects. Is this uptick affecting rent growth and vacancy rates, and how will this affect the multifamily market in the coming year?

The multifamily market has a positive outlook. The units under construction make up a significant percentage of multifamily inventory in both Charlotte and Raleigh, which will be a headwind for multifamily in the near term. This likely will drive up vacancy rates, albeit from very low levels. Rent growth, however, is expected to continue in Charlotte and Raleigh. But unlike the past few years, when the rates of rent growth ranged from 15 to 20 percent, the rent growth will become more sustainable and fall in the lower single-digits.

Manufacturers and large companies will continue coming into the region, and the local job markets will continue to grow. This will keep the market demand for multifamily in a good place. And even if there is a recession – with the most likely scenario being a mild recession – the multifamily sector across the nation has proven resilient in prior recessions. So, the multifamily industry in Charlotte and Raleigh likely will be in good shape, relatively speaking to other property types.

Office Sector

Office markets have been cooling off over the last few years with a move to work-from-home and hybrid work structures, leaving less demand for office space. However, many companies are moving their workforce back into the office. Has this shift led to stronger office markets?

While you might think that moving back into the office has created more demand for office space, the transition is not as quick as flipping on a light switch. Many employees have resisted returning to the workplace, and employers have been hesitant to enforce mandates on being in the office. This has made the office sector weaker than industrial and retail sectors. Office markets might just need time to heal, but it's uncertain whether they will fully bounce back.

That said, we are seeing a clear flight to quality in the office market, as absorption of space in newly constructed, highly amenitized buildings has been positive since the onset of the pandemic. These assets will continue to outperform as the broader market recalibrates to the new reality of hybrid work.

From an investment perspective in the commercial real estate market, how does the office sector compare to other sectors?

When you look at the share of transaction volume by property type in 2022, office space was down by 25 percent from the 2017-2019 average, whereas apartment and industrial saw an increase of 58 percent and 52 percent, respectively. Even hotels and retail space have seen a resurgence, with people wanting to get back out and resume their normal activities. At the same time, it is still being determined how the market will play out with a potential recession and minimal data regarding the impact of higher rates. However, once the Federal Reserve pivots and capital is unleashed, there will be countless opportunities because there is still strong demand for commercial real estate as an investment type. The best suggestion is to have a playbook for managing various scenarios and identifying opportunities.

Final Thoughts

While there is a looming risk of recession and headwinds are expected, the outlook for commercial real estate markets is generally optimistic. The economic landscape will present some challenges and there will be new variables to consider. And as always, some property sectors will remain investment darlings while other sectors will generate less interest. But moving ahead, the commercial real estate space is expected to remain resilient during these uncertain times and will be ripe with opportunities.

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