# How Will Rising Interest Rates and Economic Uncertainty Impact Real Estate Industry in 2024?

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Katten and Cushman & Wakefield have partnered to provide commercial real estate thought leaders with an opportunity to network and examine current factors impacting the industry during a January 25 event in Charlotte. Real Estate Partner Barrett Mallos, alongside Katten's Managing Partner in Charlotte and event host Karen Nelson, debriefed keynote speaker David Smith, the global head of Occupier Insights at Cushman & Wakefield, after the event concluded. What follows are their insights on how interest rates, economic uncertainty, job growth and even artificial intelligence will affect the commercial real estate industry in 2024.

While much has changed since David Smith last headlined the event in 2020, one constant has been uncertain economic conditions despite low unemployment rates and increased consumer spending.

## Clarifying Mixed Signals from the Economy

**We are hearing a lot of talk about a soft landing out there. Is that too optimistic? Are we in a recession or not?**

We are still anticipating a recession in 2024, but we expect it to be moderate, with a GDP decline of about 30 basis points. The economy is expected to recover by 1.1 percent in 2025 and then grow by 2.5 percent in 2026. Unfortunately, we may lose around 1.8 million jobs overall, with a little less than a quarter of those jobs using office space. However, if we can navigate the next 12-18 months, we will see a return to normalcy. It's important to remain cautiously optimistic about the next 12-48 months and not be too pessimistic or hopeful about the very near future.

**Then why does it feel like the economy is still doing well?**

There are a lot of reasons to believe that the economy is healthy. The unemployment rate is still sub 4 percent, which is historically very strong. Job openings continue to be high, and wage growth has been outpacing inflation over the last 12 months. Consumers are confident, and they continue to spend. The GDP number for 2023 was just 2.5 percent, most of that driven by consumer spending and consumer confidence. All these factors continue to point to strength in the economy, but there are a number of leading indicators that also show weaknesses.

**What are the signs that normally indicate an oncoming recession or downturn?**

The yield curve inverted more than 18 months ago, and it typically takes 12-24 months before a recession occurs. The current lack of a recession does not guarantee that there won't be one in the future. A decrease in temporary employment is likely a precursor to a drop in full-time employment. And it is likely that all of the impacts of increased interest rates have not yet worked their way through the system.

**How do you expect rate cuts to play out in 2024, and will they be enough? Is the initial rate cut the one that gives us some momentum to start moving forward because the clock is now ticking, or is it better to wait for three or four rate cuts to come and not rush back into this?**

Inflation remains above the Fed's target, and getting from where we are today to the long-term goal is not guaranteed. Rate cuts are likely to occur later this year, but they may not be as soon as the market is banking on. Additionally, they will be slow and stepwise, taking time to impact credit markets. More than the rate cuts providing momentum, clarity is what the market is looking for. Stability and credit liquidity will beget increased capital markets and leasing activity.

## Multifamily Construction Outpaces Demand

**How did the pandemic migration from city apartment dwellings impact household composition and multifamily unit demand? How has that demand evolved during the pandemic recovery?**

During early 2021, the pandemic led to a decrease in household growth as many people moved out of apartments in urban areas and back to their parent's homes. However, in recent times, there has been a significant increase in household growth, leading to historically high absorption and a decline in vacancy rates. Due to the high cost of owning a home and inflation, there has been a continuing demand for multifamily housing options. Vacancy in the CBD is now below suburban multifamily, showing that people do want to live in urban corridors.

**What is the main factor impacting the multifamily housing market in 2024?**

The main challenge facing the multifamily housing market is that 2023 demand was back to normal, but construction levels of new multifamily housing continue to outpace demand, which has begun to drive down rent growth and push up vacancy rates.

## Retail Space Unencumbered by Supply Challenges

**How has e-commerce shaped the recovery of the retail and industrial space?**

During the early months of the pandemic, many people stopped shopping in stores and going out, leading to a decrease in demand for retail stores. However, online shopping and e-commerce saw a significant increase in demand. As a result, there were many store closures and negative net absorption in 2020. Fortunately, the retail industry bounced back quickly. In the last two years, we have seen a net increase of 2,600 new stores across the United States, even with the closure of some big-name retailers. In fact, many of those closures were quickly filled by other big box stores.

In industrial, the impact of the pandemic increased demand very quickly and saw a huge rise in e-commerce with record-setting absorption numbers. Vacancy went down but has started to tick back up and will continue to do so over the next year by maybe another 90 basis points. However, it is not going to go up very high; it is still sub-6 percent right now. Leasing activity for warehouse space has come down from recent peaks but is in line with long-term norms. Also, the elevated construction pipeline has begun to come down which will alleviate supply-side pressures.

## Office Space Demand Likely to Recover in 2025

**What is the dynamic between office space demand as more remote workers return to the office? Why have improving employment numbers not led to fewer office space vacancies?**

While overall employment has been pretty strong, office-using employment has been flat for the second half of 2023. Office space has seen over 200 MSF (thousand square feet) of negative net absorption since the beginning of 2020 — that is more than double the two previous recessions. However, we may be past "peak remote" if we pay attention to what companies are saying and doing. Among companies that have changed their workplace policies, almost all of them have shifted toward more in-office work, not less.

Industrial and warehouse employment have also been negative for the second half of 2023, while retail employment has remained flat. With all the major food groups of commercial real estate in decline for the last six months, a lot of the growth in jobs that we have seen have been from the second half of 2023 were from areas that had not fully recovered from the recession in 2020 such as health care, education, government and construction.

**Artificial intelligence is all the buzz. There will be a few great companies who just crush it in this space, and there will be others who do not succeed. How do you see that impacting the real estate industry, both in the short term and the long term?**

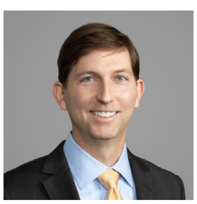
While artificial intelligence is going to replace some jobs, it will likely create many more jobs than it takes away. AI is going to create more housing, more offices, and all the things that come along with that population growth — it is just going to take some time to get there.

## Final Thoughts

There is currently a lot of uncertainty in the commercial real estate market, but as interest rates stabilize and capital market activity increases, we should gain more clarity as we move through 2024. Unfortunately, we expect that there will be a moderate recession and negative absorption in the office market in 2024. However, we are optimistic that in 2025, we will be able to bring back all the jobs that were lost this year and that the GDP will recover from this year's losses. At some point, there will be a reset with the flight to quality, and the vacancies during a recession will create space for other companies to move in. The biggest challenge for economic development is when a company wants to come to an area, but there is no available space.

### CONTACT

For more information, please contact your Katten attorney or one of the following Real Estate attorneys:

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