ISA by LaSalle | Insights Strategy Analysis

North America
Outlook 2024

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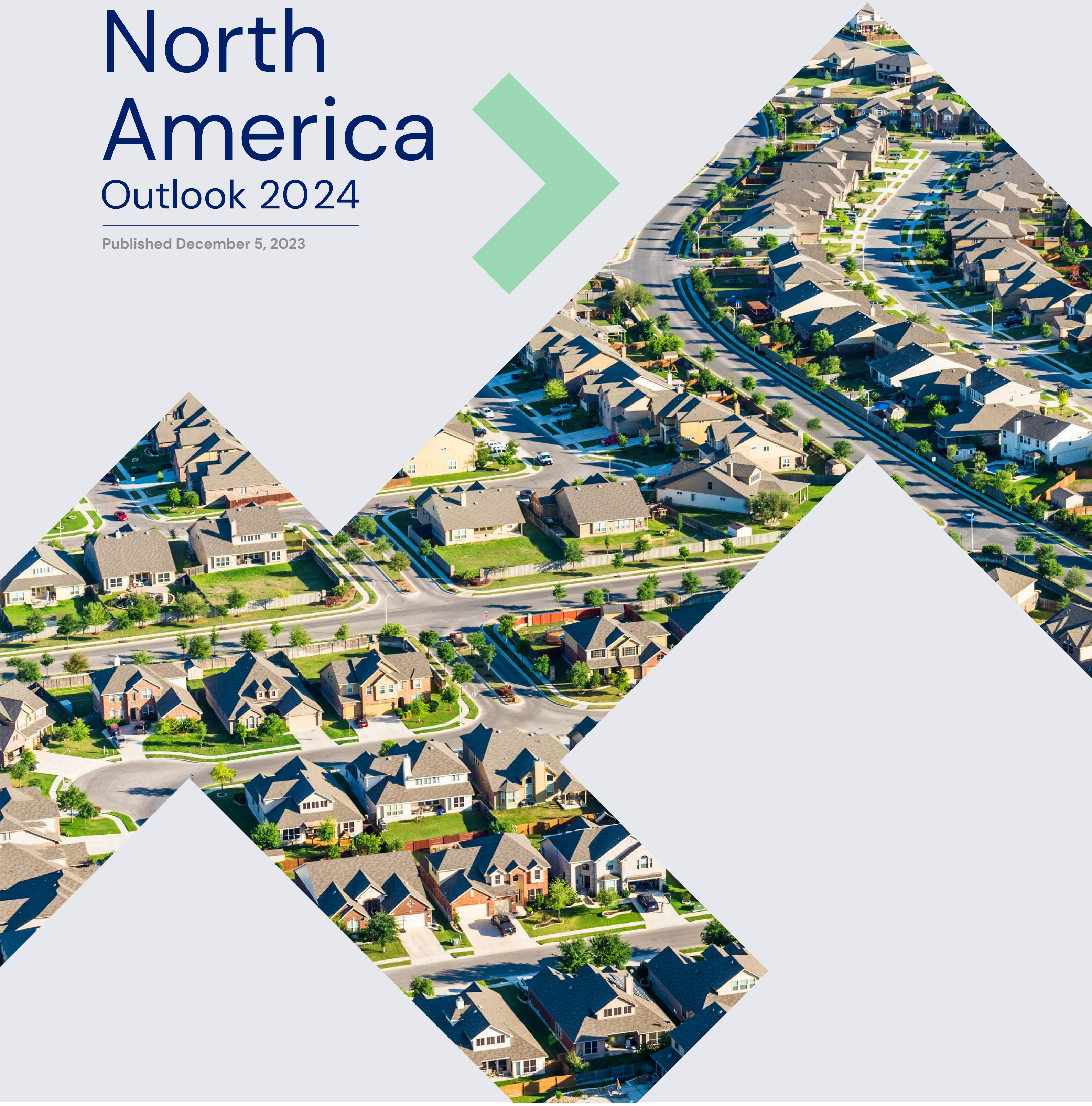

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Healing gradually

EXECUTIVE SUMMARY

In the North America chapter of *ISA Outlook 2024*, we discuss how our key global themes apply in the context of the United States and Canada. Property markets in both countries spent much if not most of 2023 wondering when the US and Canada would hit their peak rates. At the time of writing, the answer to that question remains uncertain.

We begin by discussing how this search for peak interest rates has had on the North American real estate markets, namely how the battle against inflation has meant cooling conditions for some sectors. However, there is enough variation within sectors that opportunities are emerging with high-quality assets. Variation also exists between the two countries, for example in the residential sector, where population growth in Canada has translated into persistent undersupply. The chapter concludes with investment strategies for the coming year based on three broad themes where we see growing potential.

Approaching the close of 2023, the US and Canadian real estate markets are still adapting to significant macroeconomic changes, with the prospect of further adjustment and potential stresses in 2024. Based on our observations and analysis, we do not expect a rapid recovery. In our view, it will not be until the second half of 2024 at the earliest that we see signs of an inflection point.

The *ISA Outlook* global chapter frames the macroeconomic backdrop, with the headlines of "Searching for peak rates," "No map to a hard or soft landing," and "Cooler conditions" all relevant to our view of conditions in North American markets.

LASALLE GLOBAL THEMES FOR 2024

Our *ISA Outlook 2024* global chapter focuses on five themes for the year ahead. Look for these icons throughout this chapter whenever we tie back our observations for Europe to these global themes.

- Searching for peak rates
- Solving the capital stack equation
- Coming off the boil
- Beyond "bifurcation"
- The changing definition of quality and core

IN HINDSIGHT

Looking back on key calls from last year's *ISA Outlook* North America chapter

As in our *ISA Outlook* global chapter, the "In hindsight" sidebars in this chapter look back on key North American calls from the prior year's edition, assessing the accuracy of our predictions.

- Right / Mostly right
- Remains to be seen
- Not right / Not quite right

The search for peak rates is negatively impacting liquidity

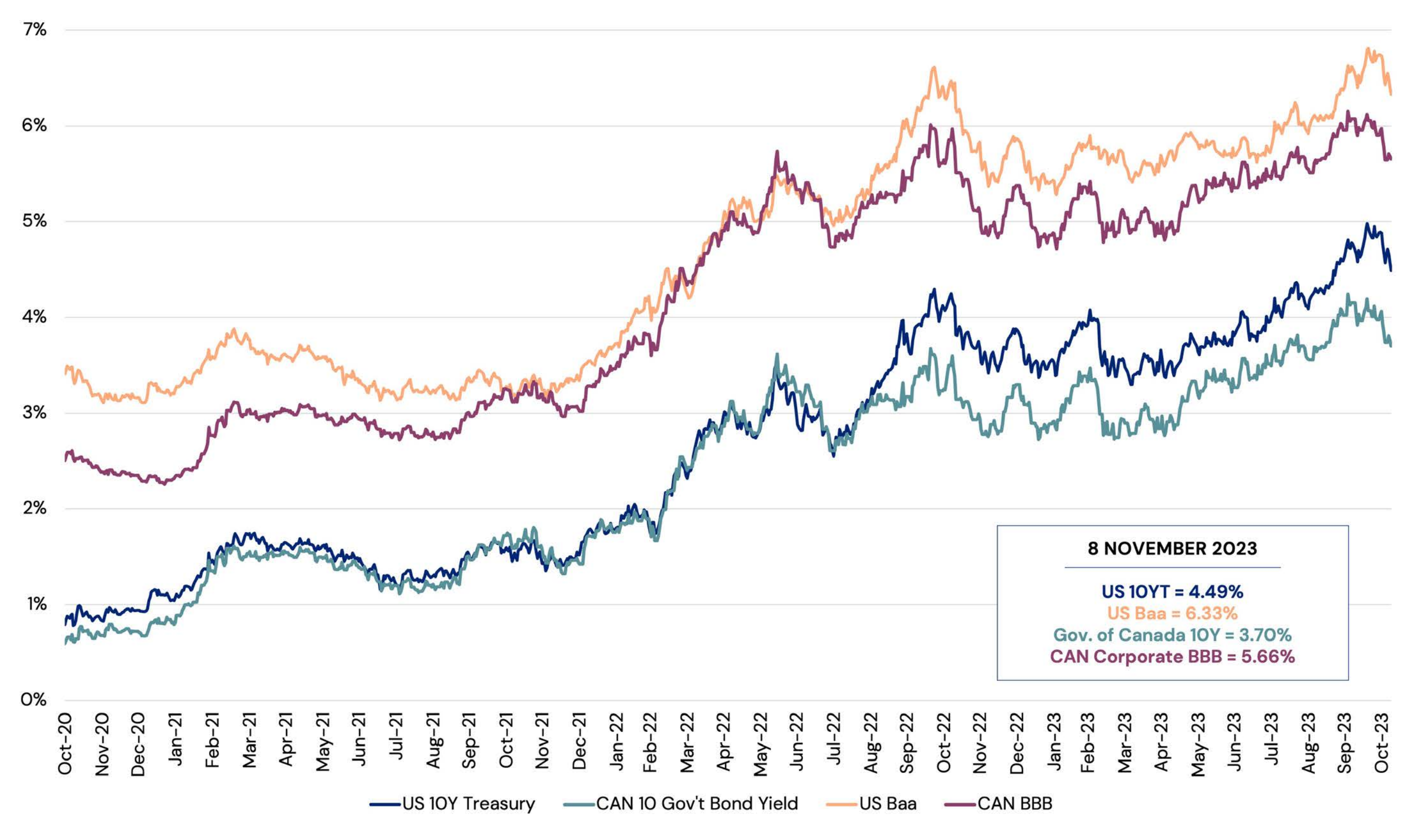
The negative impacts of higher interest rates on real estate values dominated other macroeconomic dynamics in the second half of 2023. The trend of higher long-term interest rates (shown in Figure NA-a) continues to put downward pressure on real estate values across all property types in the US and Canada.

In some market segments, income growth is providing a degree of insulation, but even in the strongest sectors, that only partially offsets the downward pressure on values. And the "higher for longer" narrative taking hold during Q3 2023 in the US is leading to a somewhat larger impact of higher rates in the US than in Canada.[1]

As always, the direction of interest rates is uncertain and extremely difficult to predict, so we choose not to base investment strategies on views of future interest rates. The more pertinent question is to what extent real estate pricing has digested the impact of higher rates. We observe in our market activity that this varies across markets based on levels of liquidity. The most transacted sector is US apartments, followed by US industrial.[2] These sectors provide more data points that help guide other buyers and sellers on market pricing in a dynamic environment. In contrast, office transaction volume is so thin that both buyers and sellers (along with lenders) have little market information to support valuation calls. In this case, limited trading breeds a more challenging transaction environment.

1 "Higher for longer" is more prominent in the US because, as discussed later, economic growth in the US has been more resilient through 2023.
2 Source: RCA – see chart NA-d for detail.

NA-a Long-term interest rates trend higher in 2023



Source: Bank of Canada, Bloomberg, Economy.com. Data through November 8, 2023.
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue.

No map to a soft or hard landing

While interest rates have been the dominant macroeconomic driver in the past two years, economic growth challenges could be more of a headline story in 2024 (see Figure NA-b). Currently US growth is still strong, but concerns about a potential recession remain front and center.[3]

In Canada, signs of a recession were clear at the beginning of 2023; the country indeed entered what has so far been a mild, shallow recession in Q2 2023.[4] While both the US and Canadian central banks paused interest rate increases at their most recent meetings, both indicated that inflationary risks remain elevated, and there could be further increases. However, with Oxford Economics forecasting slower economic growth in the US and muted growth in Canada into 2024, we expect central banks to shift their focus to stimulating growth. But that dynamic will take several quarters to play out, and in the interim, there could be negative impacts on real estate fundamentals from slowing growth.

IN HINDSIGHT

Rate-induced US recession

"Although a recession in the US and Canada in 2023 is our base case, the North American economy remains surprisingly strong. The lagged impact from tighter financial conditions appears to finally be feeding through, with preliminary signs that inflation is cooling. But many uncertainties remain." (ISA Outlook 2023 page 46)

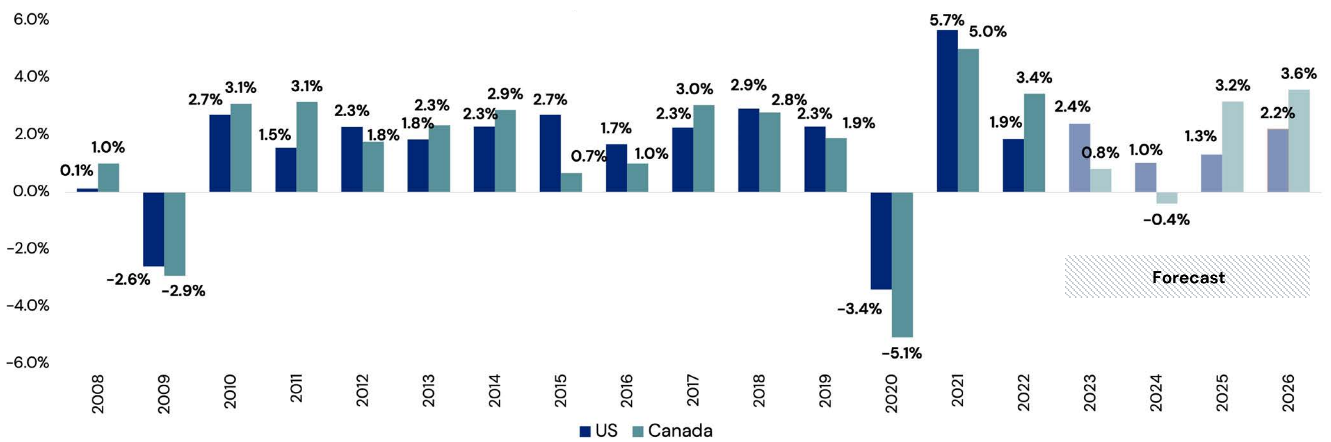
The US seems to have avoided a recession in 2023 as the strong fundamentals at the start of the year carried through. Inflation has continued to cool through 2023.

That said, we believe an economic slowdown will not severely impact real estate demand. It is broadly our view that secular forces will remain more important than cyclical dynamics for real estate demand, both positively and negatively; this is explored on a sector-by-sector basis below. There are also longer-term dynamics that we expect will enable the North American economies to get back on track quickly and mitigate the long-term impact a near-term recession could have on real estate demand.

3 Source: Oxford Economics
4 Canadian real GDP fell at a 0.2% annual rate in Q2 2023, following a 2.6% gain in Q1, according to Statistics Canada.

NA-b Weak growth in 2024 followed by recovery

Real annual GDP, US and Canada – 2008-2026



Source: US Bureau of Economic Analysis, Statistics Canada, Oxford Economics. LaSalle. Data and forecast most recent as of November 2023.
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

Cooler conditions

The link between growth and interest rates is inflation. As illustrated in Figure NA-c inflation is down in 2023, but not to the extent the Federal Reserve and Bank of Canada are aiming for, and more inflation heat could return from increases in oil prices.

Our view is inflation will remain contained, which is consistent with the pricing of inflation-protected bonds. The shelter component of inflation has been a major recent contributor to inflation and is worth watching; while historically strong population growth is exceeding new supply and boosting apartment rents in Canada, we expect US housing cost inflation to slow meaningfully.

IN HINDSIGHT

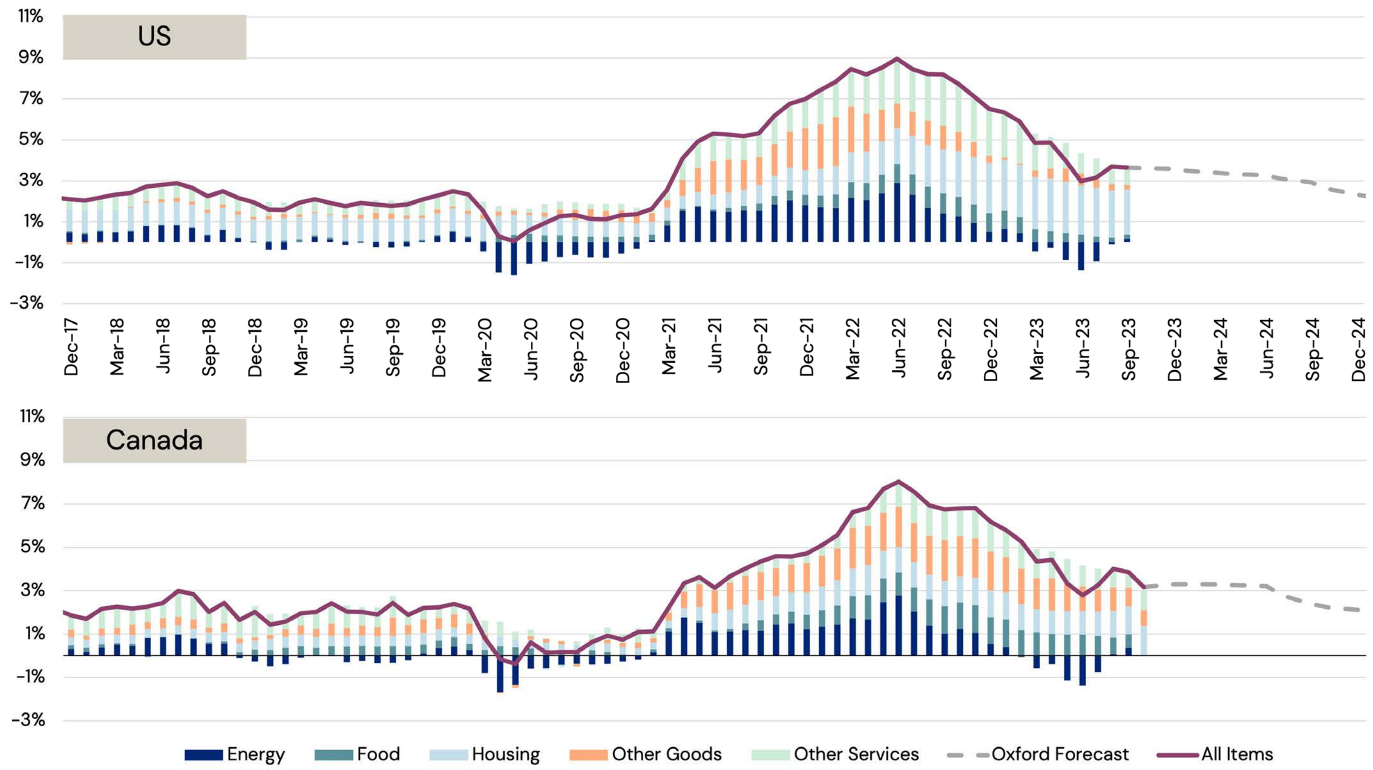
Real estate pricing correction

"Real estate pricing in North America will adjust to higher interest rates at varying speeds across sectors depending on the level of liquidity, strength of the ties to the fixed income/equities markets and the motivation of sellers. For core real estate investors, a long-term view on interest rates is as important as the near-term trajectory of central bank policy rates."
(ISA Outlook 2023 page 55)

This is playing out as expected, but unfortunately the process is still underway. Consistent with expectations, it was the increase in long-term rates in the second half of 2023 rather than the expected increases in short-term rates at the start of the year that had a greater impact on the real estate capital markets.

NA-c Downward inflation trend expected to continue

Contributors to Consumer Price Index (CPI) inflation
Percentage point contribution by major category



Source: Bank of Canada, Bloomberg, Economy.com. Data through November 8, 2023.
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Real estate capital markets

North American real estate capital markets were directly impacted by increasing interest rates, with debt costs up, transaction volumes below typical levels (as shown in Figure NA-d) and prices down.[5] This creates a mix of challenges and opportunities driven by an investor's situation.

We expect 2024 to look a lot like 2023 at the start, but as the year progresses, there could be shifts that drive increasing transaction volume. If interest rates come down or even just stabilize, in our view that should enable a gradual increase in transaction volumes.

Thus far in this downturn, there has been limited motivation to sell. That could change due to several factors including the need to deliver liquidity in open-end funds or to generate cash for refinancing in closed-end funds. Traditional office is the most stressed market segment, and a stand-off between borrowers and lenders limits distressed transaction volume. However, we think this is likely to come to an end at some point because offices require a large amount of ongoing capital investment. It will be in lenders' interest to adopt structures that preserve value by finding sources for that capex; we think this will lead to more distressed office asset sales.

In 2024, the pressure to transact could also hit US multi-family properties that were acquired in late 2021 and early 2022 at peak pricing and financed with high levels of floating rate debt. These properties could be in a position where they need capital to refinance or extend loans. In contrast to office, these apartment lenders might be more ready to push for a quick resolution as property values are likely to remain above the debt balance. The logical outcome is either outright sales or recapitalization opportunities.

Higher interest rates are also driving capital flows to real estate lending. The analysis shown in Figure NA-e indicates the current premium for core equity investment relative to real estate lending is less than in normal market conditions. Our view is that now is an attractive time to create a real estate debt allocation in the context of a diversified real estate portfolio. The current opportunity might prove fleeting, but the ability to act quickly to get capital placed in the lending market is appealing. However, a major caveat is that downside operating risks need to be carefully underwritten. Office debt is both expensive and hard to find given that the risks associated with office extend even into more senior portions of the capital stack.

IN HINDSIGHT

Denominator effects dominate

"Denominator effects and higher borrowing costs will keep a meaningful fraction of core and higher return buyers on the sidelines, especially at the start of 2023. For well-capitalized buyers, this creates opportunities to deploy capital in a less competitive market and will allow investors to add strategic targets to diversified portfolios." (ISA Outlook 2023 page 55)

This has been true, but has extended past the first part of 2023.

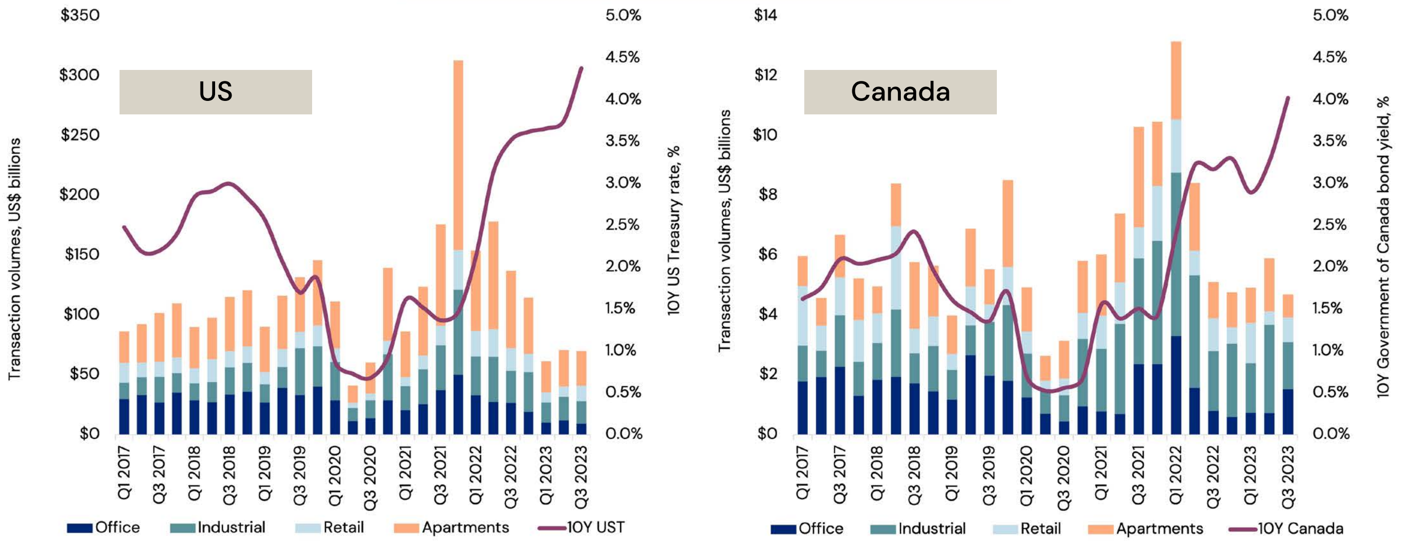
5 Source: Green Street Advisors

NA-d Transaction volumes stabilize at lower levels

Transaction volumes

Trailing year transaction volume as percent of 10-year average

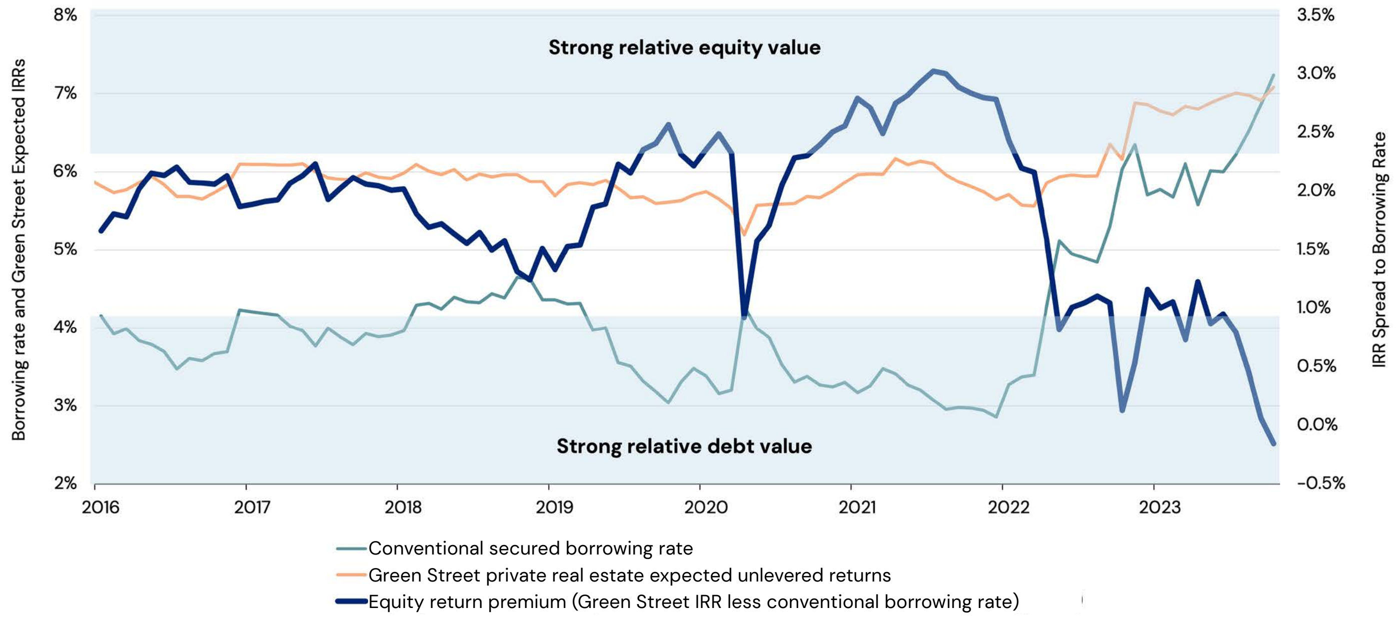
	US	Canada
Retail	73%	55%
Office	41%	58%
Industrial	106%	134%
Apartment	76%	84%
Total	72%	84%



Source: RCA. Note: Closed transactions; excludes privatizations, hotels, senior housing, and development sites. Excludes transactions with a gross value of less than US $5 million. Data through September 2023. Most recent as of November 6, 2023.
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue.

NA-e Real estate lending screens as solid value

Real estate debt and equity pricing comparison



Source: LaSalle Investment Management.; Green Street Data as of November 16, 2023;
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

Occupier market fundamentals

Residential

In 2023, the US apartment market definitely came off the boil after strong demand pulled back unexpectedly in 2022, despite a healthy economy. Many Sunbelt metros that performed the best previously have seen the sharpest reversal of momentum.[6] In 2024, we expect steady demand, helped by affordability challenges in the for-sale housing market. Still, we expect to see elevated deliveries of projects started when market conditions are stronger. Thus, parts of the US residential market are expected to see fundamentals weaken further, leading to rent declines. Other segments (i.e., sub-types, markets or submarkets) are not seeing as much competitive new supply and thus are well-positioned. In the longer term, we expect US residential demand to recover. And with higher costs, higher interest rates and lower stabilized property values, the economics of development have become much less attractive, leading to more limited starts (as shown in Figure NA-f). This limited new supply from 2025 onward is expected to drive a strong rent recovery.

6 Source: RealPage

IN HINDSIGHT

A slowdown in rent growth

"Weaker demand and still-elevated new supply will shift vacancy rates up in 2023 and lead to a slowdown, but not stagnation, in rent growth. And metros with more new supply will see a greater slowdown and even some rent declines. In 2024, we expect a swift recovery as lower levels of new supply and recovering demand enable declines in vacancy." (ISA Outlook 2023 page 52)

2023 has largely played out as expected, but with a potential recession still to come and the wave of new supply still looming, we no longer expect that swift recovery to come in 2024.

With supply a key factor in the near-term outlook, we expect to see more variation in market, submarket and asset-specific performance variation than in recent years. Some US apartment markets and submarkets, along with scattered-site single-family homes for rent, are positioned to outperform as they have less new competitive supply coming. While the long-term outlook is solid, we could see some short-term stresses that depress pricing, as weak fundamentals pair with maturity-driven capital needs (as noted above). This may create an opportunity for those with capital to deploy, but a challenge for those who need to sell.

The Canadian apartment market is markedly different from the US. Canada's persistent supply-demand imbalance is expected to continue. This is fueled by record immigration-driven population growth over the past two years, which is expected to continue in 2024.[7] While purpose-built apartment supply has been rising sharply, it is not keeping pace with population growth. As a result, Canadian apartment vacancy hit a 21-year low in 2023 and is expected to fall further as new projects are delayed due to higher interest rates and high construction costs.

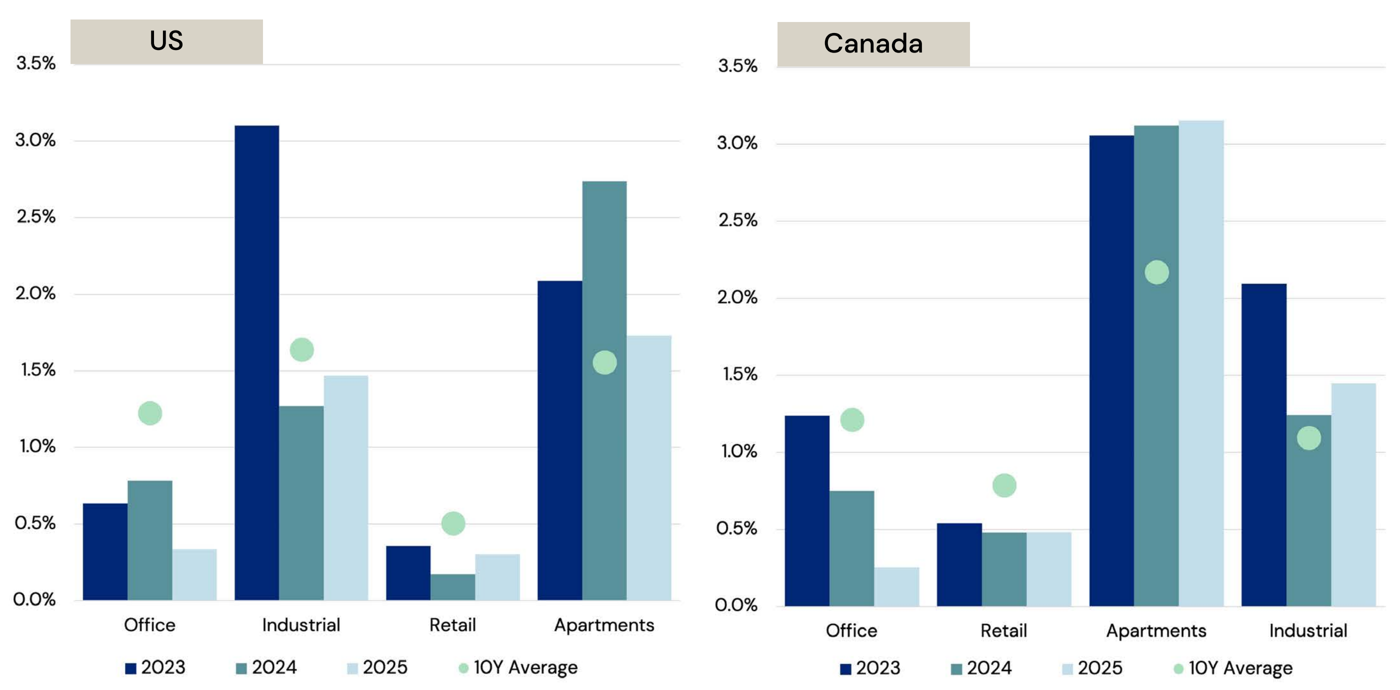
7 Source: Statistics Canada and Immigration, Refugees and Citizenship Canada.
8 Source: Based on our observations of market activity

Industrial

The super-heated North American industrial markets are also coming off the boil from peak performance levels. The strongest performing metro areas from the last several years provide the clearest evidence that "trees do not grow to the sky." But while some residential markets could be going from the burner to the freezer, industrial markets are generally moving from a rolling boil to a soft simmer.

North American industrial markets generally remain tight, with availability rates well below long-term averages (see Figure NA-g). However, slowing economies, elevated new supply and excess leasing in 2021-22 will cause fundamentals to soften in many markets. This impact is already seen with rent growth slowing and even turning negative on a quarter-over-quarter basis in some markets.[8] In 2024, we expect rent declines in some of the industrial markets that experienced the greatest gains during the post-pandemic period. This will come as tenants regain leverage and landlords are willing to sign leases below peak levels, but still above even their wildest expectations from a few years ago. Looking ahead to 2025, we expect a

NA-f Supply to slow due to capital market shifts



Sources: CBRE Canada, CBRE-EA, CMHC, LaSalle. Data to Q1 2023 for office and industrial, year-end 2022 for retail and apartments. US data to Q3 2023
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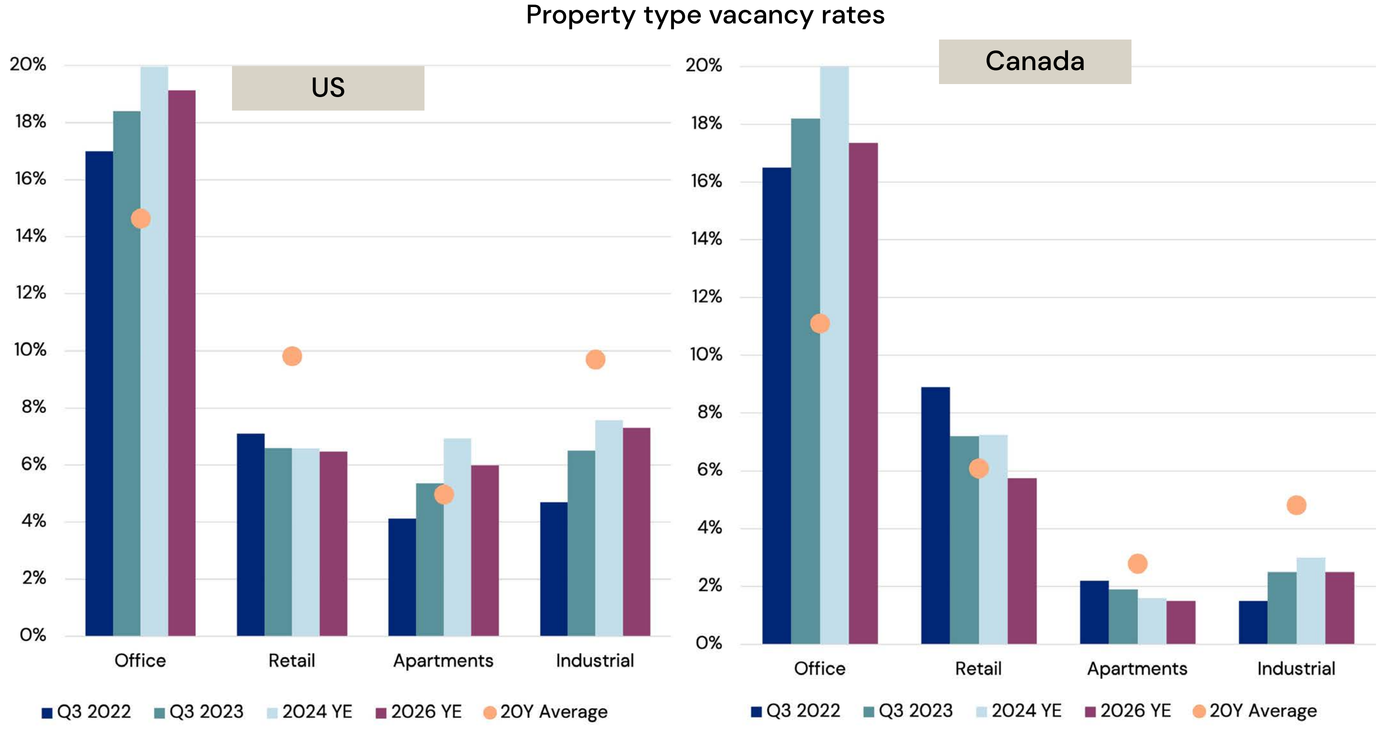
NA-g Property type vacancy shows great variation



Source: Realpage (US Apartments), CBRE EA (US and Canada Industrial and Office), CoStar (US Open-Air Retail), MSCI (Canada Retail) and CMHC (Canada Apartments). Data to Q3 2023, forecast as of Q2 and Q3 2023 - latest available as of November 2023.
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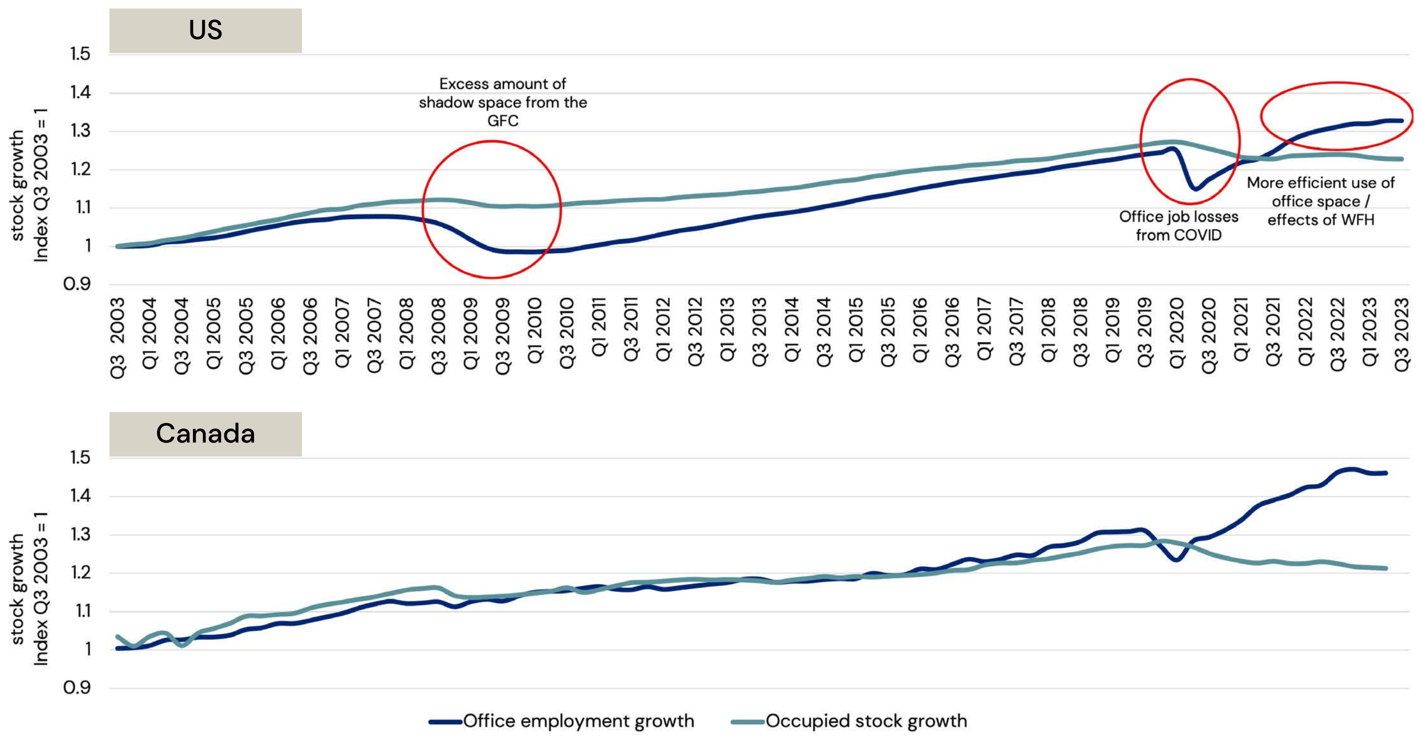
NA-h Property type vacancy shows great variation

Change in office employment and occupied stock through cycles, 2003-2023



Office occupancy is implied based on leased space (inventory - vacancy rate). Office-using employment is sum of NAICS sectors: Finance, insurance, real estate and leasing, Professional, scientific and technical services; Business, building & other support services; Information, culture and recreation; Public administration.
Source: CBRE Canada, Statistics Canada (Labour Force Survey), LaSalle. Data to October 2023. Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue.

shift again as limited new supply meets recovering demand. This should allow industrial markets to tighten quickly and power to shift back to landlords.

Office

North American office market conditions range from awful to apocalyptic for investors. Across the US and Canada, the sustained acceptance of working from home continues to weigh on occupier demand as illustrated by the decline in occupied space shown in Figure NA-h. Tenants still communicate a desire to bring employees back to the office, but progress toward that goal remains incomplete. Office buildings that can help employers achieve this goal of bringing employees back to the office (owing to their location, amenities or quality of the space) are positioned to see stronger demand, consistent with the global theme of **bifurcation** by quality. But we believe the structural weakness of the office market will weigh on all assets to some degree. As rents in the best buildings are stable or growing while others are falling, the potential profit from closing that gap will lead to investments that will increase the stock of buildings competing for the best tenants. The flip side is that some tenants will be tempted into lower-quality space just by the significant cost savings that can be achieved.

Beyond demand, another challenge for the office market is heightened investor recognition of the amount of capital required to sustain revenue in a market where tenants have numerous options. This is especially acute in the US, where some leases are barely generating positive cash flow on a net economic basis. Canada is somewhat better positioned, as tenant expectations and the structure of leases that pass a portion of capital expenditures to tenants provide owners a cash flow boost.

While the office outlook today is grim, we believe office demand will recover at some point. And we could see offices trade at sufficiently deep discounts to create attractive opportunities. We expect some investors could earn exceptionally high returns from office acquisitions in the coming year, but that will depend on a combination of good asset strategy and luck with tenants. For those with an appetite for risk, that possibility might be hard to ignore, but on average we still do not see current pricing yet at a point that generates an appropriate risk-adjusted return.

IN HINDSIGHT

North American office market conditions range...

"Office investments in the US will face significant challenges in 2023 as lenders and core buyers view the sector as particularly risky. Highly leveraged buyers with loans coming due – and in many cases their lenders – will face hard choices on how to proceed. In the US, transaction activity could become dominated by distressed sales later in 2023. In Canada, distressed sales will be less likely given the higher concentration of institutional ownership in the office market, much of which is unlevered." (ISA Outlook 2023 page 55)

Nothing good has helped the US office market in 2023, but distressed sales have been surprisingly limited. The hard choices for leveraged owners and lenders are still to be made, so this prediction is pushed out to 2024 at the earliest.

Retail

While the retail sector overall still faces challenges and there is risk from a potential economic slowdown, North American shopping centers align with the beyond bifurcation global theme. On the positive side, competitive new supply is not an issue. On the demand side, we observe that investors have more confidence in which sub-types and specific properties are positioned to succeed. This creates an opportunity for investors to identify properties benefiting from durable long-term retailer demand, and they can achieve return premiums when this more positive outlook is not yet reflected in pricing. Sub-sector themes can be identified in some cases, such as the positive reception of US grocery-anchored retail properties from investors. Still, this is often about picking the best-positioned assets, even when there are challenges for the sector overall. But unlike office, we think there is a greater ability to see which assets will be winners based on the challenges experienced over the past decade.

9 See LaSalle's ISA Portfolio View
10 Source: JLL

Specialty sectors

The US offers investors the broadest and deepest menu of alternative sector options of any market around the world.[9] As more of these specialty sectors mature and get on the radar screen of core investors, it is increasingly important to focus on the risk-return profile of each sector individually. As we do that work, we continue to see strength in segments we have recommended for years, including medical office and self-storage. Life sciences is facing a wave of new supply[10] and a period of weaker-than-average demand that will weigh on the sector. Opportunities are emerging from sub-sectors of the major property types, such as single-family homes for rent and industrial outdoor storage (IOS). In the Canadian market, strong recent and forecast population growth supports self-storage, student housing and data centers as particularly attractive sectors. Among the range of options, it is easier to say what we like than what we don't like, but we note that sometimes we are silent on sectors where we do not have high enough conviction in our views rather than a negative conviction.

Brampton Industrial, Ontario, Canada

Themes and strategies

We identify three broad strategic themes in common among our recommended strategies:

1. Finding supply gaps

With the strongest property types facing near-term stress from new supply, investors who can identify properties insulated from that in the next year should do well. Looking beyond that, it is about finding opportunities for quick recoveries that are not yet priced into the market.

2. Solving capital stacks

Higher interest rates and, in some cases, challenged operations will create stress that can sometimes create opportunities to solve creatively. These opportunities could be working with office lenders, over-leveraged apartment owners or helping core funds meet elevated redemptions. Those who can understand sellers' needs might find superior returns or access to transactions that are generally unavailable through a traditional sale process.

3. Emerging property types

The need for core portfolios to find assets to replace the historic heavy weight to office assets will become more real when capital starts to flow back to real estate. When this occurs, we believe the choice of options will be more diverse than ever, and a new wave of what we have labeled "going mainstream" will occur. This should create a new pool of buyers with a lower cost of capital than those that have played in the past in some of these emerging sectors.

LOOKING AHEAD

- **A meaningful recovery in transaction volume is not likely to occur in the first half of 2024. But activity may pick up in the second half as pressure to transact mounts, and there is potential for the interest rate environment to become more favorable. That said, interest rates are notoriously difficult to forecast, so investors should not rely upon a decline in rates.**
- **Interest rates will continue to be more important to real estate performance than economic growth. If the economy slows and interest rates fall, it will be a net positive for existing real estate portfolios while "higher for longer" will be a net negative for the performance of those portfolios if sustained through 2024.**
- **Supply will weigh on real estate fundamentals in 2024. Vacancy will likely climb, and rents should fall nationally for US apartments and in several industrial markets. However, a period of limited supply after 2024 will enable a full recovery for many market segments.**
- **Office investment will be a high-risk, high-reward endeavor in the coming year. In time, some of these investments are likely to prove very successful, but overall pricing has not yet fallen enough to reward office investors on a broad basis.**
- **A low-cost basis per square foot will be a common and justified rationale for investment. Opportunities to acquire below replacement cost will be plentiful, but replacement cost can be a moving target based on land values, construction costs and financing costs.**

Molly Brook on Belmont, North Haledon, New Jersey

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