



Economic and Real Estate trends and outlook

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Economic and real estate overview



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US economic conditions and outlook



EY

Building a better
working world

US economy by the numbers

3.4%

April US unemployment rate

- ▶ Down from 3.5% in March
- ▶ Appears to signal that labor markets remain tight
- ▶ Wages up 4.4% (y/y) in April, below 5.0% March inflation rate

1.1%

Real growth during the first quarter of 2023

- ▶ Growth led by strong consumer spending
- ▶ Slowdown in business investment and decline in housing investment

0.1%

Monthly increase in the March Consumer Price Index (CPI)

- ▶ Down from the 0.4% increase in February
- ▶ The March CPI was up 5.0% from a year ago and core-CPI, which excludes volatile energy and food prices, was up 5.6% from a year ago

253k job gain

For the overall economy in April

- ▶ Above the 165k increase in March
- ▶ March job openings fell from their level in February
- ▶ Weekly new UI claims have been gradually rising and are now close to pre-pandemic levels

~1.0%

Growth expected in the United States for 2023

- ▶ Weakening growth and recession-like conditions in many 2023 forecasts
- ▶ Recent bank failures concerning, labor markets tight, inflation elevated

25 bp

Increase in the federal funds target rate at the May 2-3 Federal Open Market Committee (FOMC) meeting

- ▶ Federal Reserve needs to weigh the countervailing pressures of bank failures, inflation, and tight labor markets in deciding the future path of interest rates
- ▶ Market expectations are for the Federal Reserve to begin lowering rates in Fall 2023

Economic risks/uncertainties: inflation, weakening growth, tight labor market, uncertain path for interest rates

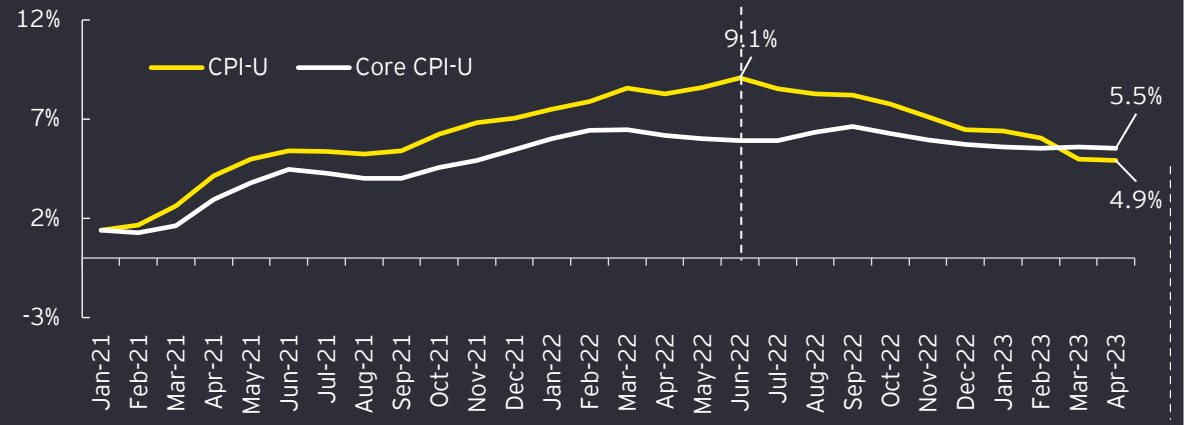
Inflation



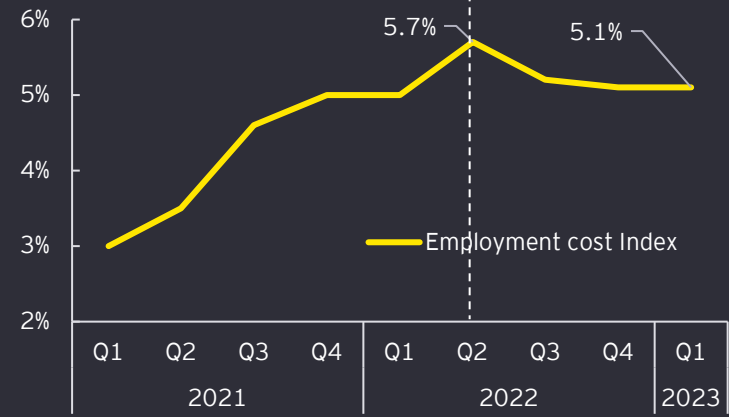
April CPI report suggests inflation continues to cool but it remains elevated

- ▶ US consumer prices increased by 0.4% in April and by 4.9% over the past 12 months.
- ▶ The core inflation rate, which excludes volatile energy and food prices, increased by 0.4% in April and 5.5% over the past 12 months.
- ▶ The March PCE price index, the Fed's preferred metric, rose by 0.1% and by 4.2% over the past 12 months.
- ▶ Wage costs decreased slightly; real wages falling.

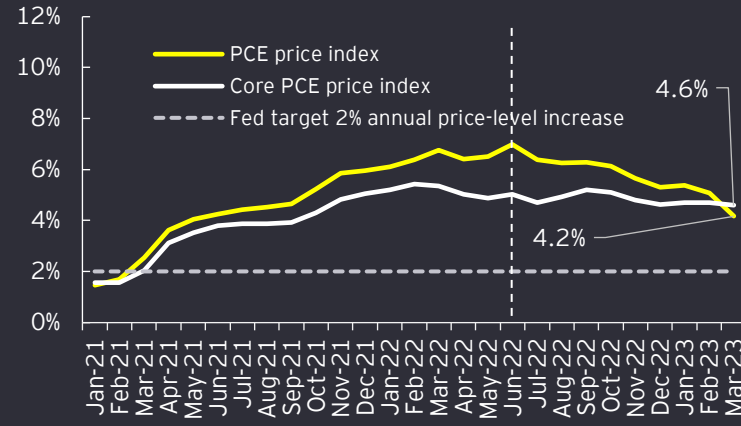
YoY change in CPI-U and Core CPI-U



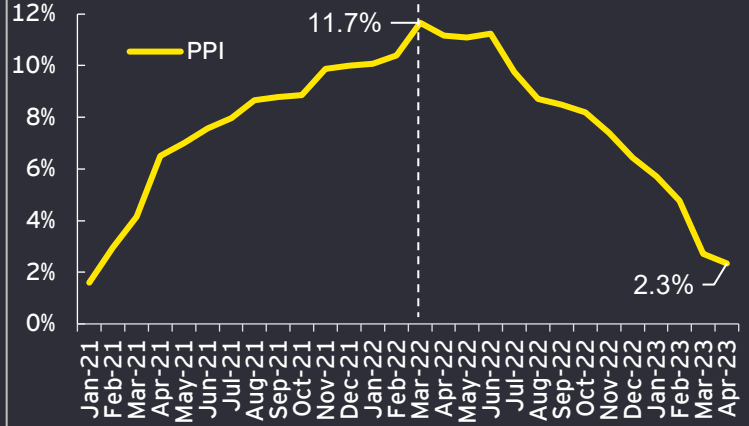
YoY change in Employment Cost Index: Wages and Salaries: Private Industry Workers



YoY change in Personal Consumption Expenditure Price Index



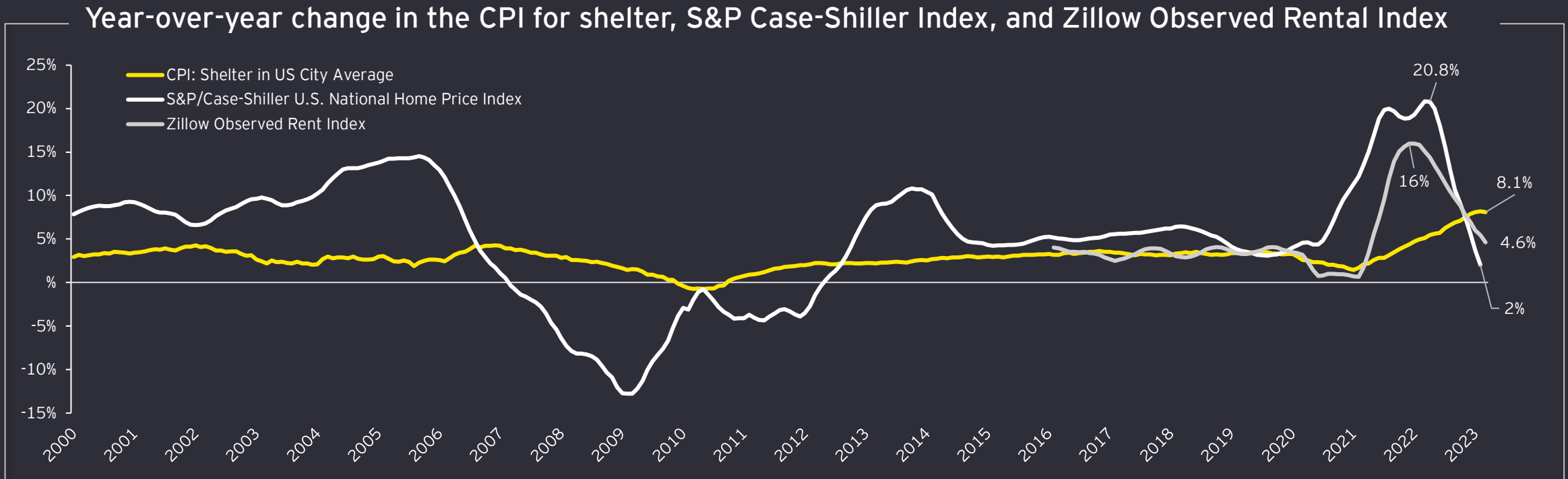
YoY change in Producer Price Index for final demand



Note: CPI, PPI and ECI are not seasonally adjusted. PCE is seasonally adjusted. Next PCE release May 26, next CPI release June 13, next PPI release June 14, and next ECI release July 28.
Source: US Bureau of Labor Statistics; Bureau of Economic Analysis.

Official inflation measures lag changes in housing and rental prices

- ▶ The CPI measures of shelter tend to lag other measures of housing/rent indices.
- ▶ Research from the [Federal Reserve Bank of Boston](#) says that the CPI for shelter will remain elevated through 2023 even if housing price measures fall.
- ▶ The President's [Council of Economic Advisers](#) says that *declines* in housing and rental prices will not appear in the standard inflation measures until later in 2023.



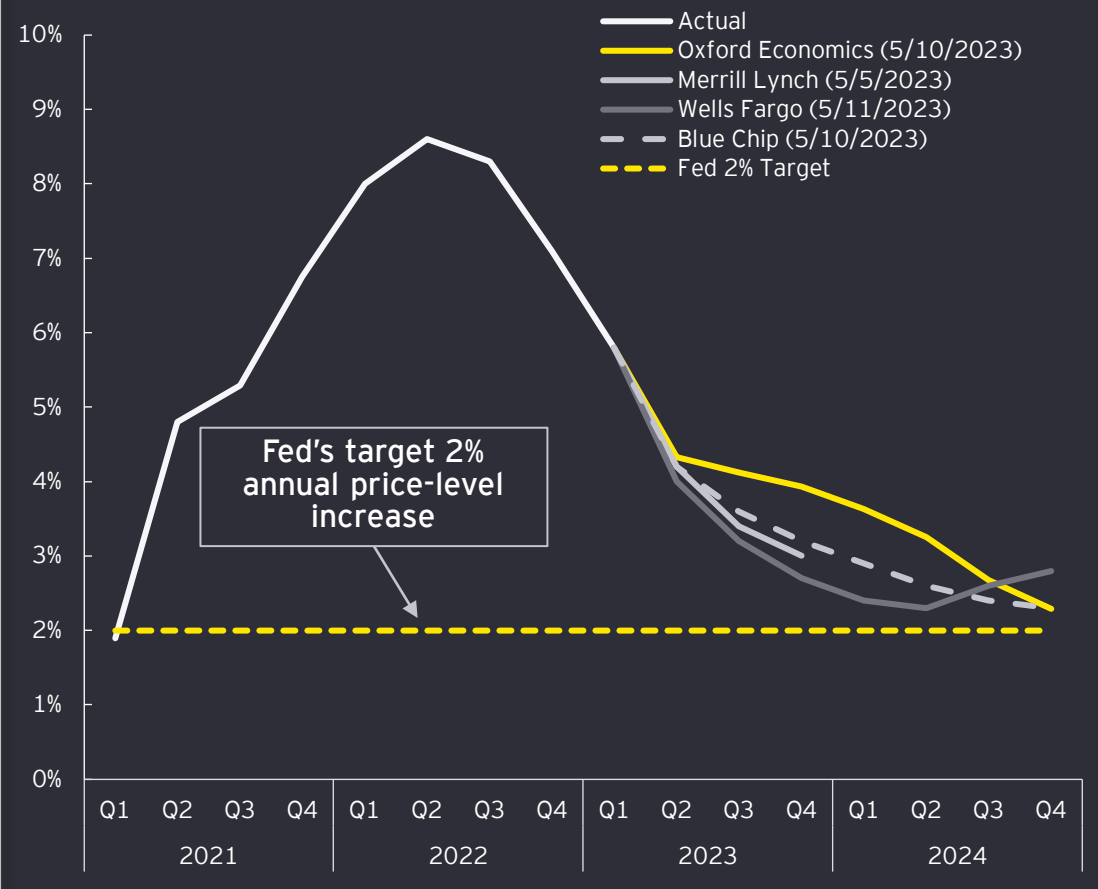
Note: Not seasonally adjusted.

Source: US Bureau of Labor Statistics, S&P Dow Jones Indices, and Zillow.

Forecasts expect inflation to moderate, but likely elevated through at least 2023

Short-term US CPI, YoY % change

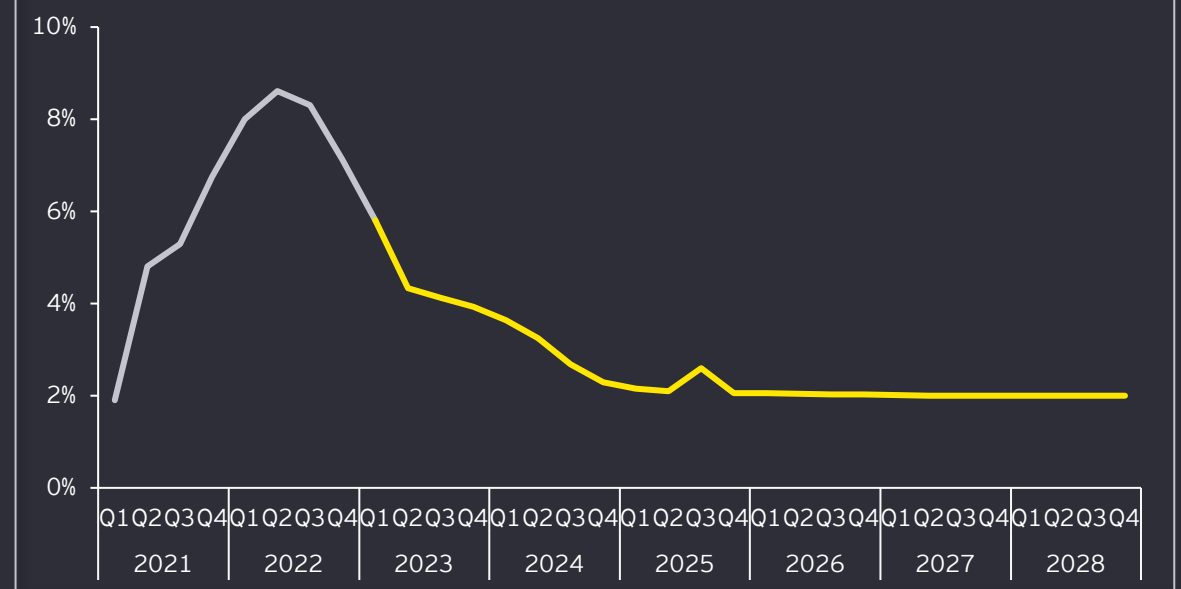
(2021 Q1-2024 Q4; seasonally adjusted)



Fed's target 2% annual price-level increase

Long-term US CPI forecast, YoY % change

(2021 Q1-2028 Q4)



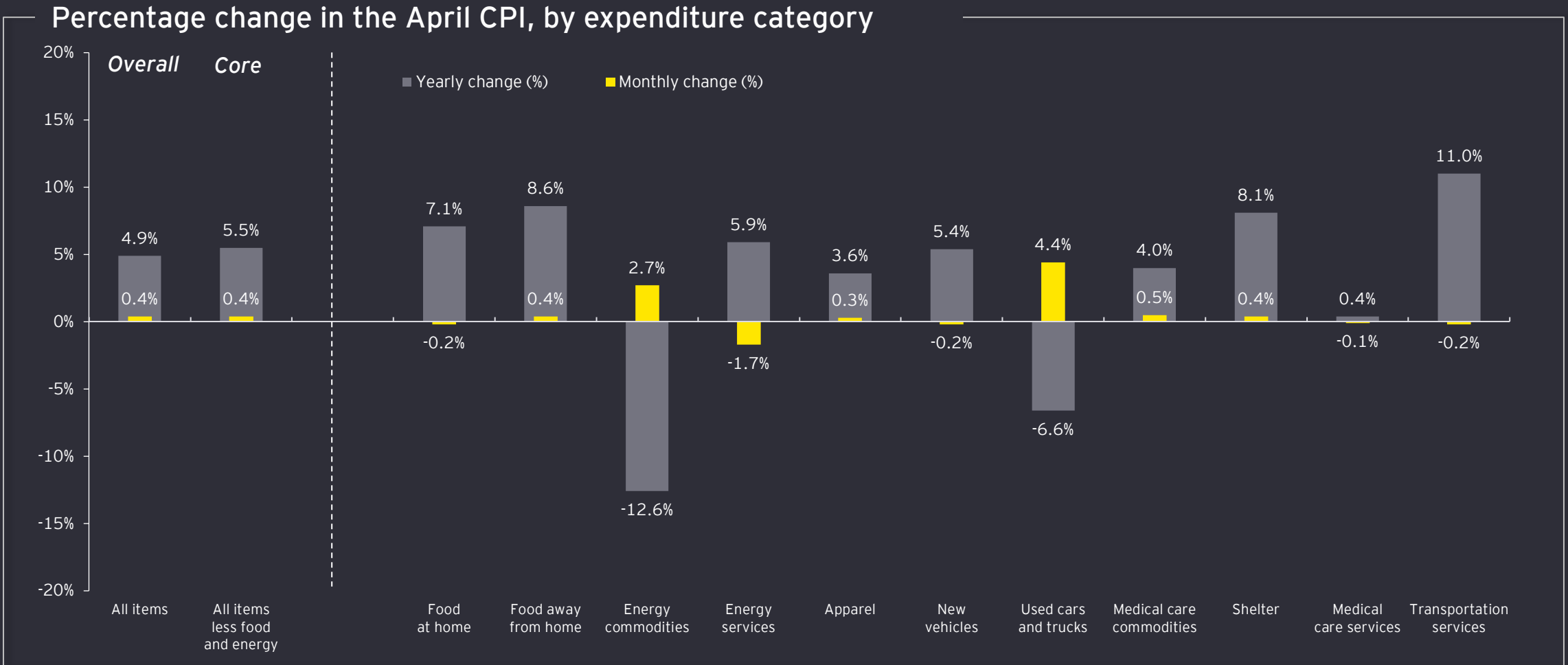
Source: Oxford Economics, May 10, 2023.

- ▶ While the decline in the inflation rate is generally forecast to continue, inflation remains elevated and the decline has been more gradual over the past several months than previously forecast.
- ▶ Inflation is generally expected to remain well above the Federal Reserve's 2% target into 2024.
- ▶ **A soft landing is still possible but there continues to be significant risk of recession in 2023.**

Note: Forecasts are only shown starting 2023 Q2 onwards. All values up until 2023 Q1 are actual estimates from BLS.

Source: EY Analysis, Oxford Economics, Wells Fargo Economic Outlook, Merrill Lynch Capital Market Outlook, Blue Chip Economic Indicators (Vol. 48, No. 5, May 10, 2023).

Components of April CPI increase



Note: Seasonally adjusted. Next update June 13.
 Source: US Bureau of Labor Statistics.

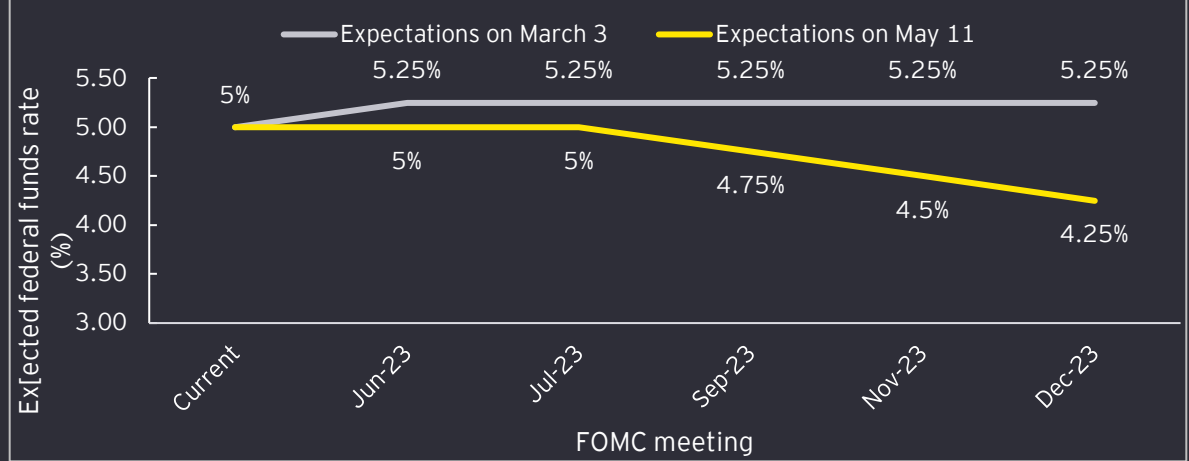
Interest rates



Federal Open Market Committee (FOMC)/monetary policy

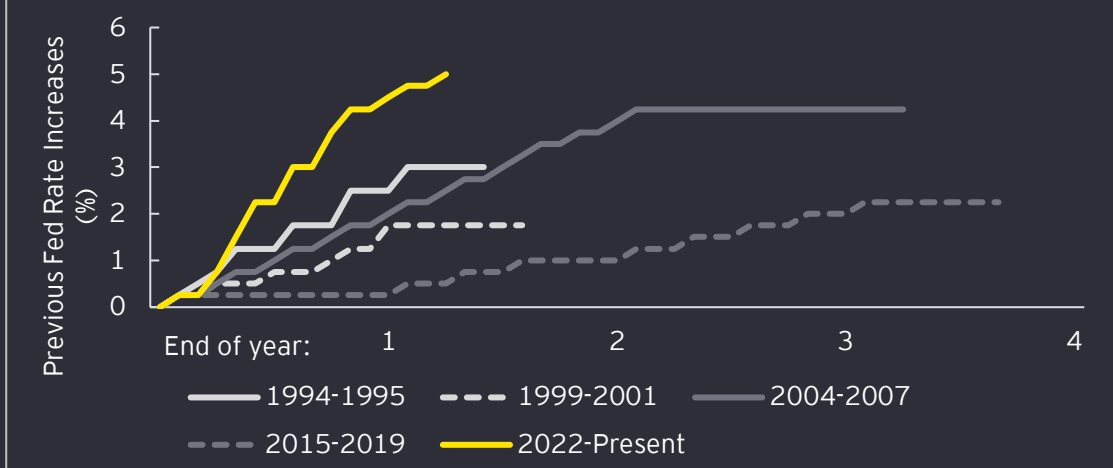
- ▶ The 25-basis point increase in the federal funds target rate in May expected to be the last, at least for now.
- ▶ Market expectations are for the FOMC to begin to lower the target rate in September.
- ▶ FOMC [meeting minutes](#) revealed that Federal Reserve staff projected a mild recession in 2023.

Expected federal funds rate over 2023



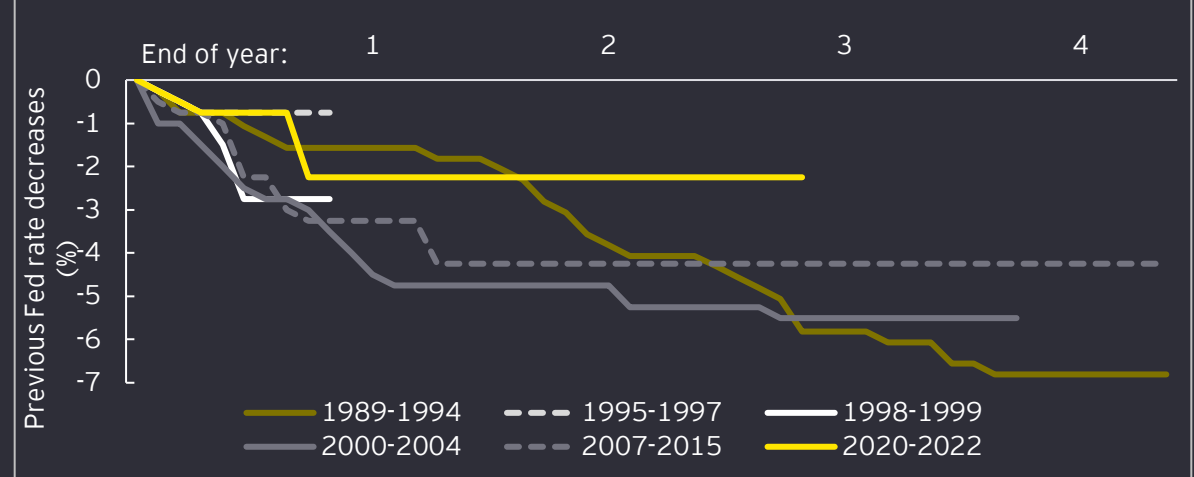
Source: Chicago Mercantile Exchange FedWatch Tool as March 3, 2023 and May 11, 2023.

Pace of rate increases until next rate cut



Source: Federal Reserve.

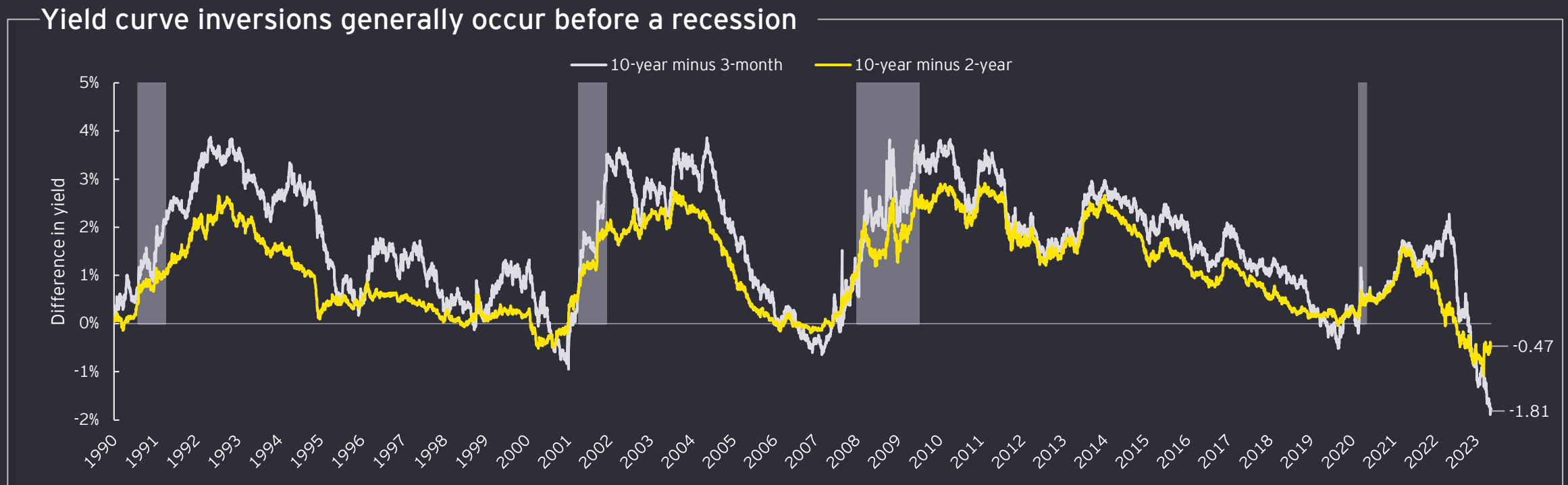
Pace of rate decreases until next rate increase



Source: Federal Reserve.

Inverted yield curve – suggests a recession is on the horizon ...

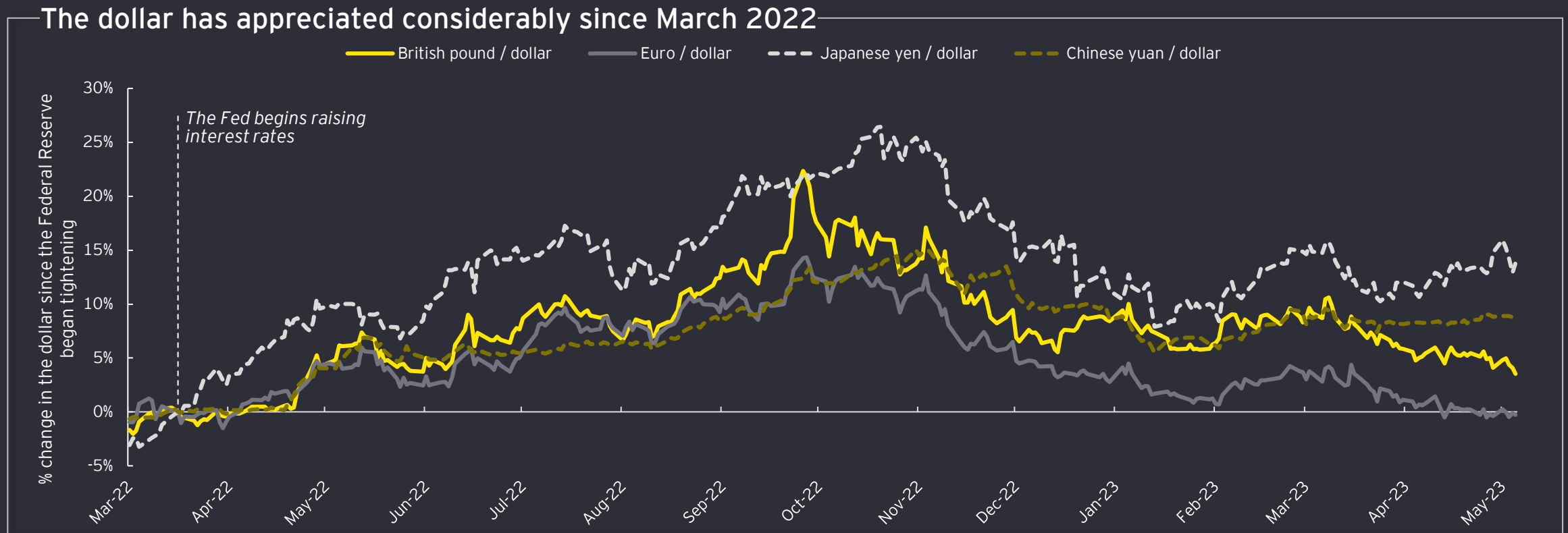
- ▶ Yield curve inversions are viewed as recession indicators and have occurred prior to every recession since at least 1990.
- ▶ The yield curve is the difference between US Treasury securities of different maturities, and an “inversion” is when short-term rates exceed long-term rates.
- ▶ The difference between the interest rate for 10-year and 2-year Treasury securities inverted on July 6.
- ▶ The difference between the 10-year and 3-month Treasury securities has been inverted since October 25.



Source: Federal Reserve and Treasury data (through May 10, 2023).

The dollar's value initially strengthened following the Federal Reserve's interest rate hikes, then declined, and now perhaps moving "sideways"

- ▶ Globally, central banks have reacted to both inflation and the dollar's appreciation by raising interest rates, and the Bank of Japan is performing foreign-exchange operations for the first time in decades to defend the value of the yen.
- ▶ Many worry that a round of global monetary tightening could push economies into a recession.

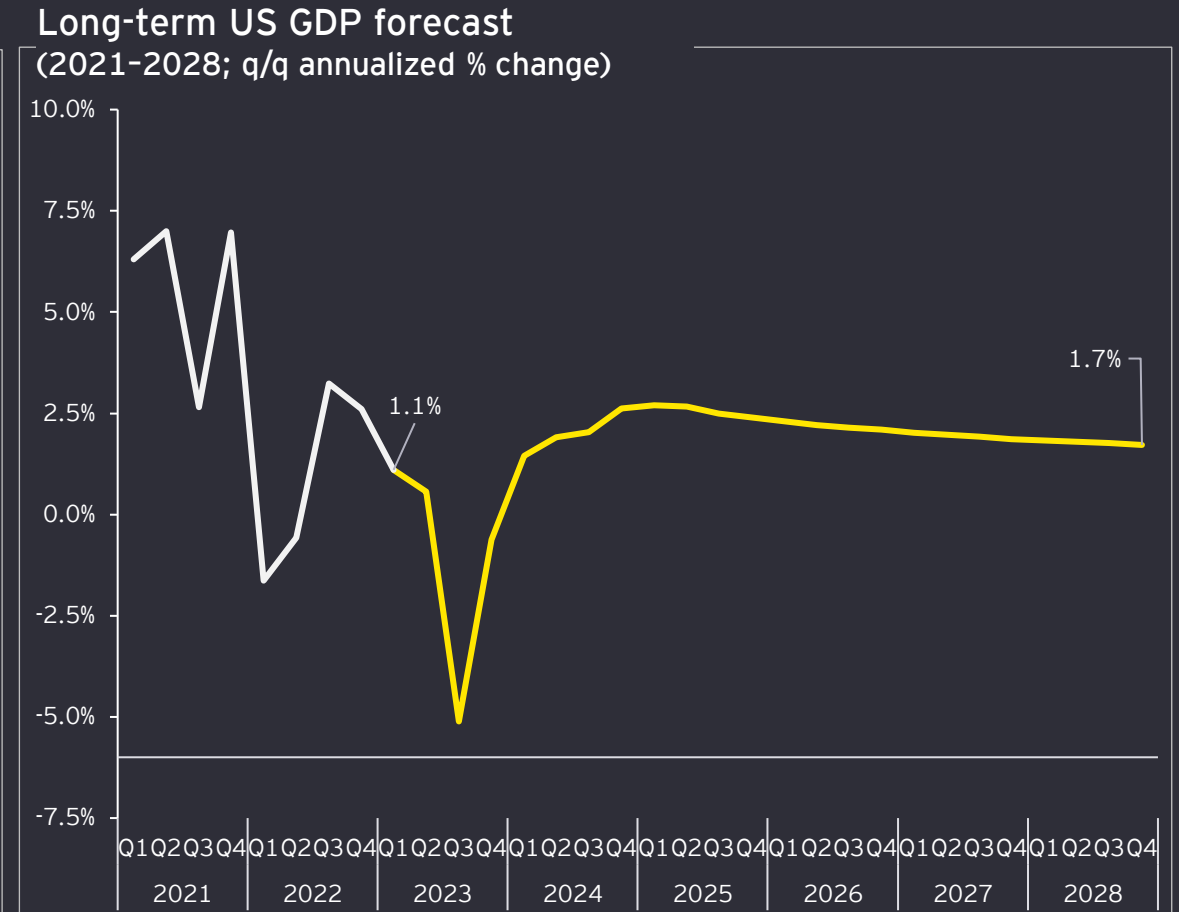
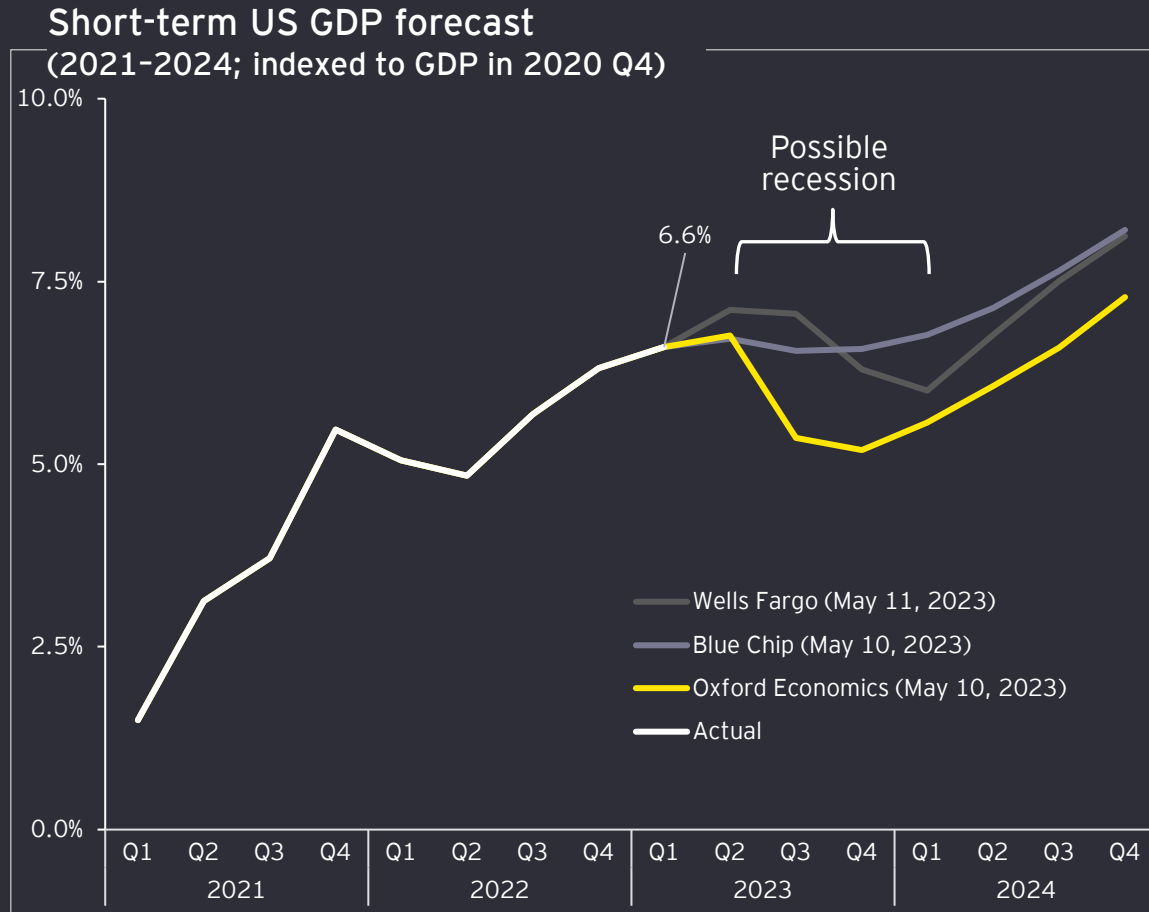


Source: Federal Reserve (through May 5, 2023).

US and global economies



US GDP forecasts indicate weakening economic growth and possible recession risk, especially in the later half of 2023

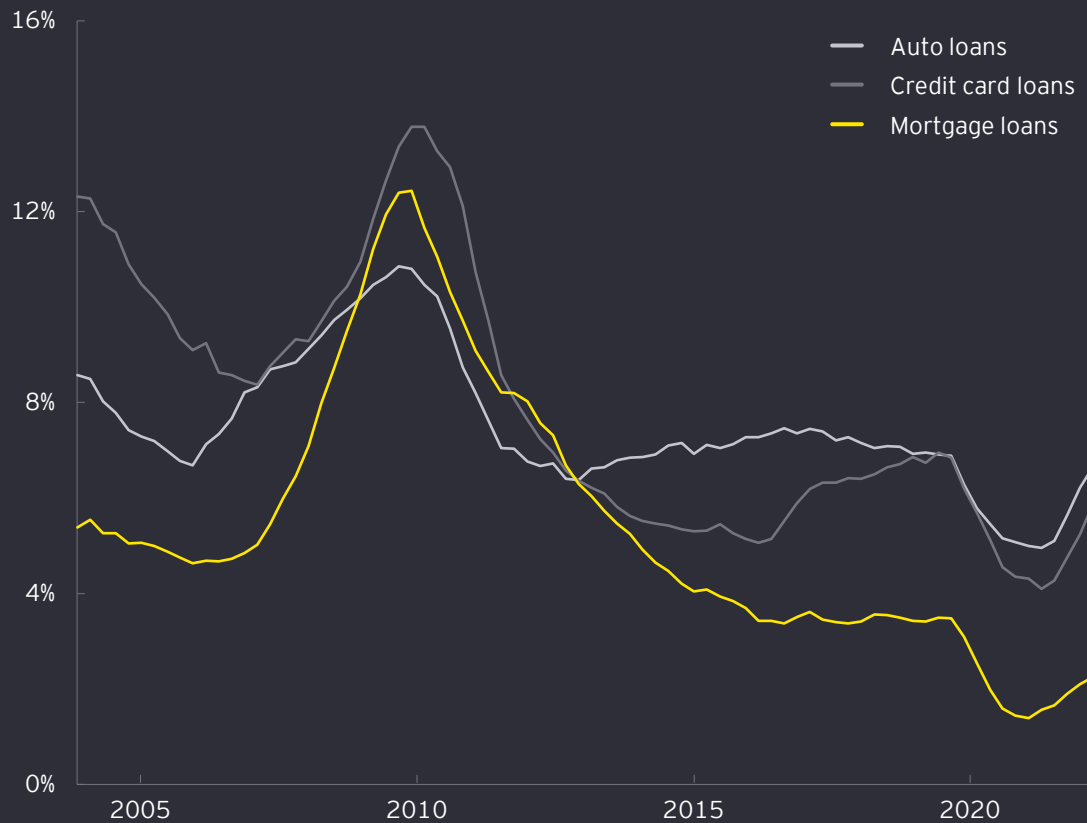


Note: Short-term GDP values represent change from 2020 Q4. Forecasts are only shown starting 2023 Q2 onwards. All values up until 2023 Q1 are actual estimates from BEA.
Source: EY Analysis, Oxford Economics, Wells Fargo Economic Outlook, *Blue Chip Economic Indicators* (Vol. 48, No. 5, May 10, 2023).

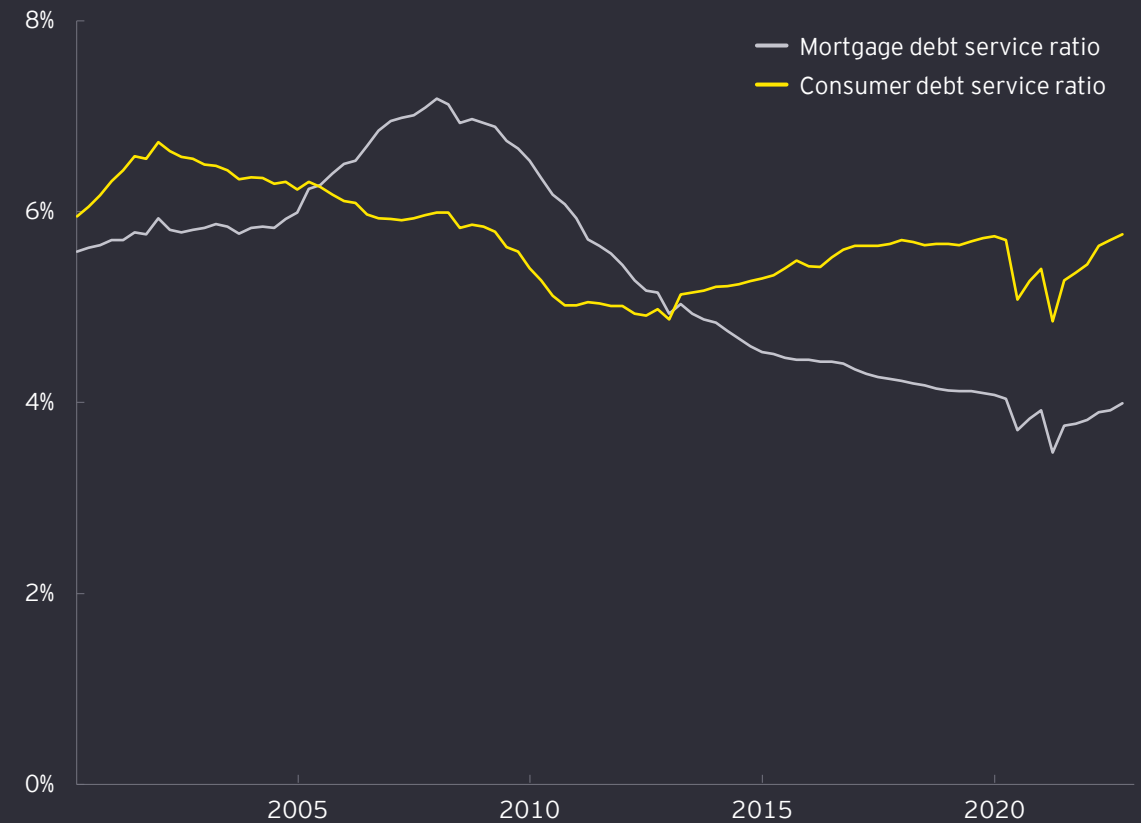
Note: Long-term GDP values show q/q annualized % change.
Source: Oxford Economics, May 10, 2023.

While consumer leverage and delinquency rates are not immediately concerning, the rise of new delinquencies and increase in debt-servicing cost are troublesome

US % of balances newly delinquent (30 days)
2003-22



US household debt service ratio
2000-22

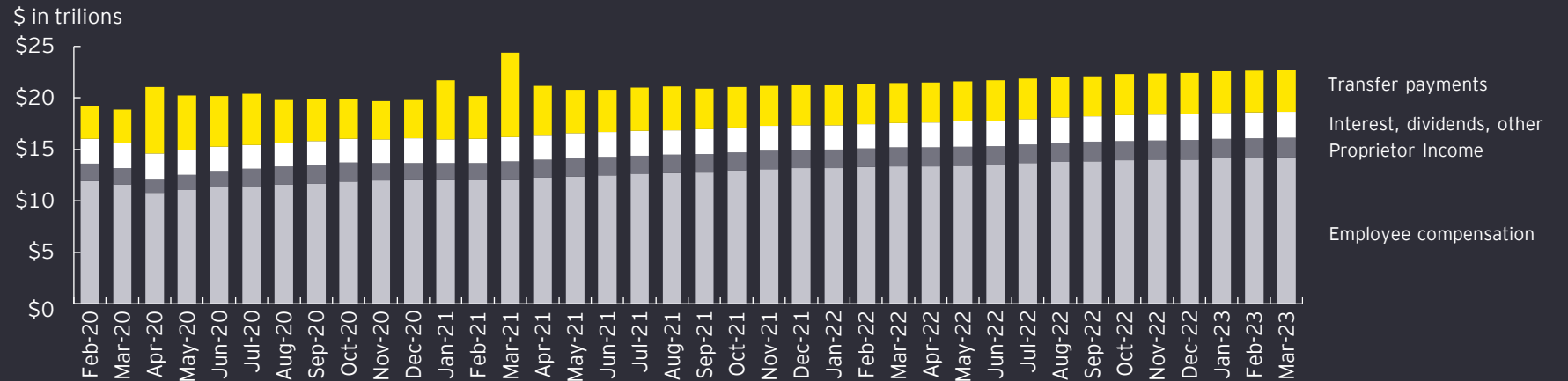


Source: Federal Reserve; New York Fed; EY-Parthenon analysis

US personal income and consumer spending increased in March

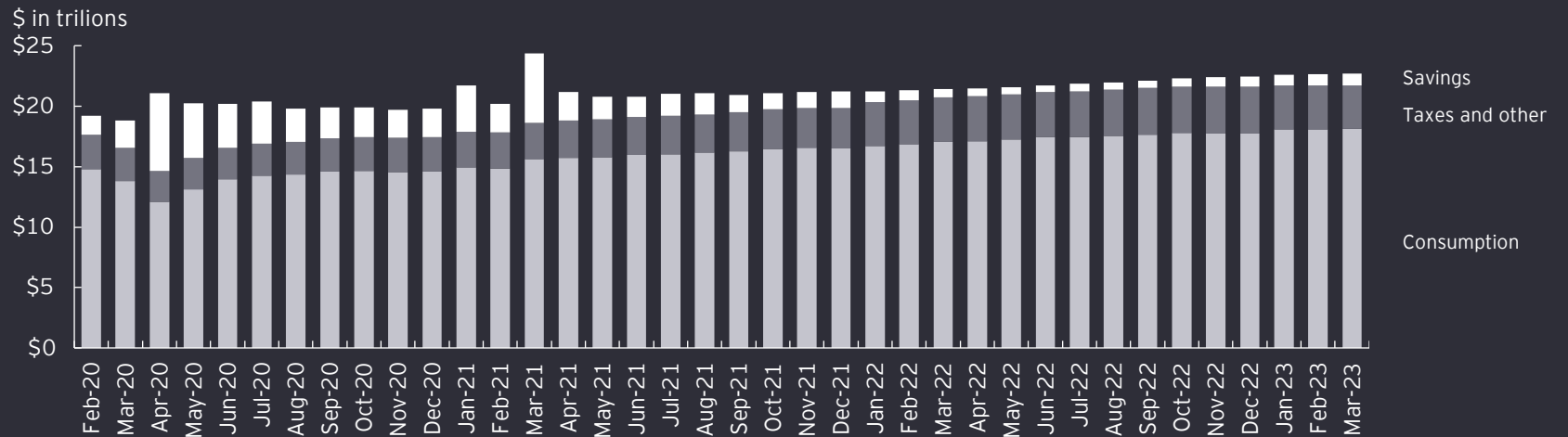
Personal income by source (annualized)

- ▶ Personal income rose 0.3% in March following a 0.3% increase in February.
- ▶ Employee compensation rose 0.3% in March following a 0.3% increase in February.



Personal consumption, savings and other outlays (annualized)

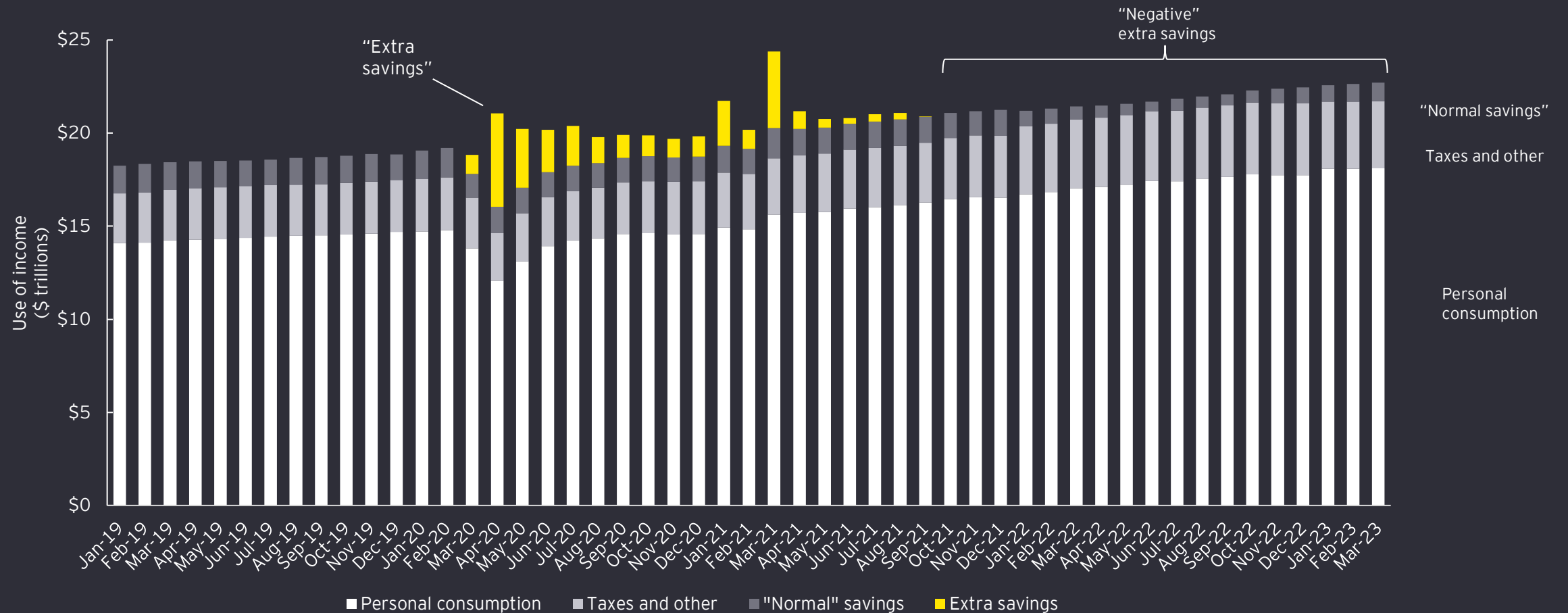
- ▶ Most of the increase in personal consumption during the first quarter occurred in January.
- ▶ Spending on both, goods and services increased in March.



Note: In current dollars. Next update on May 26.
Source: US Bureau of Economic Analysis.

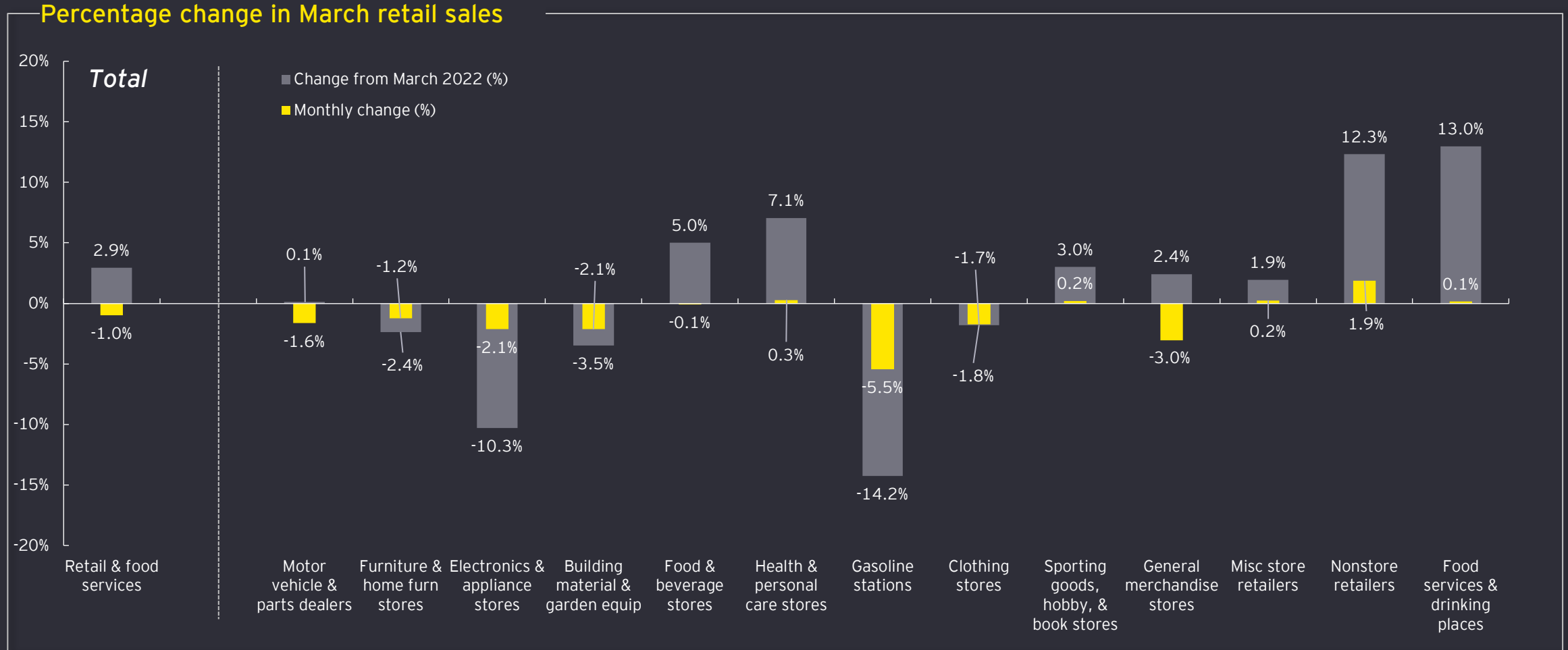
Accumulated savings during pandemic unwinding

- Americans accumulated an extra \$2.5 trillion in savings during the pandemic, but now down to \$0.8 trillion, suggesting almost two-thirds of the pandemic-related savings has unwound.



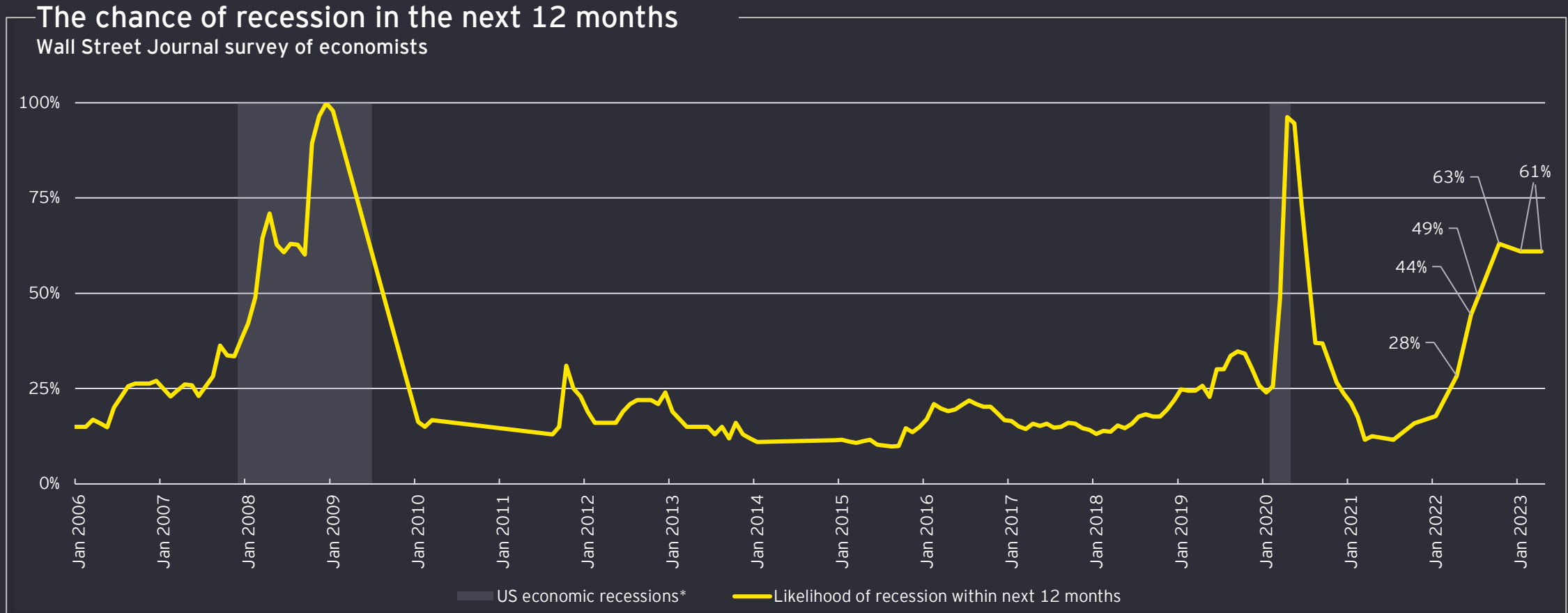
Note: In current dollars. Next update on May 26.
 Source: Bureau of Economic Analysis (BEA) data and EY analysis.

Retail sales fell by 1.0% in March (2.9% above March 2022)



Note: Adjusted for seasonal variation and holiday and trading-day differences, but not for price changes. Based on change in nominal dollars (i.e., not adjusted for inflation). Next update on May 16.
Source: US Census Bureau.

Likelihood of a US recession within next 12 months at 61%



Source: Wall Street Journal survey of economists, National Bureau of Economic Research (NBER).

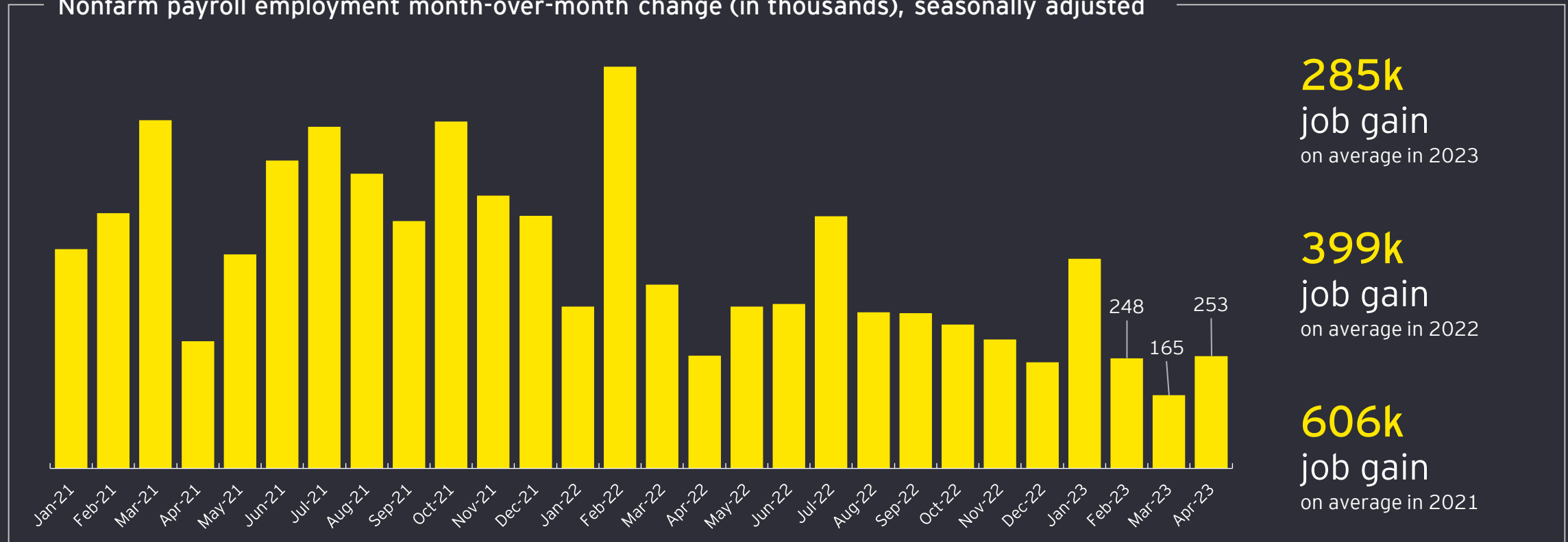


Labor markets

Overall US employment situation

- ▶ In April 2023, 253k jobs were added following gains of 165k in March and 248k in February.
- ▶ Total employment is 3.3m above pre-pandemic level.

Nonfarm payroll employment month-over-month change (in thousands), seasonally adjusted



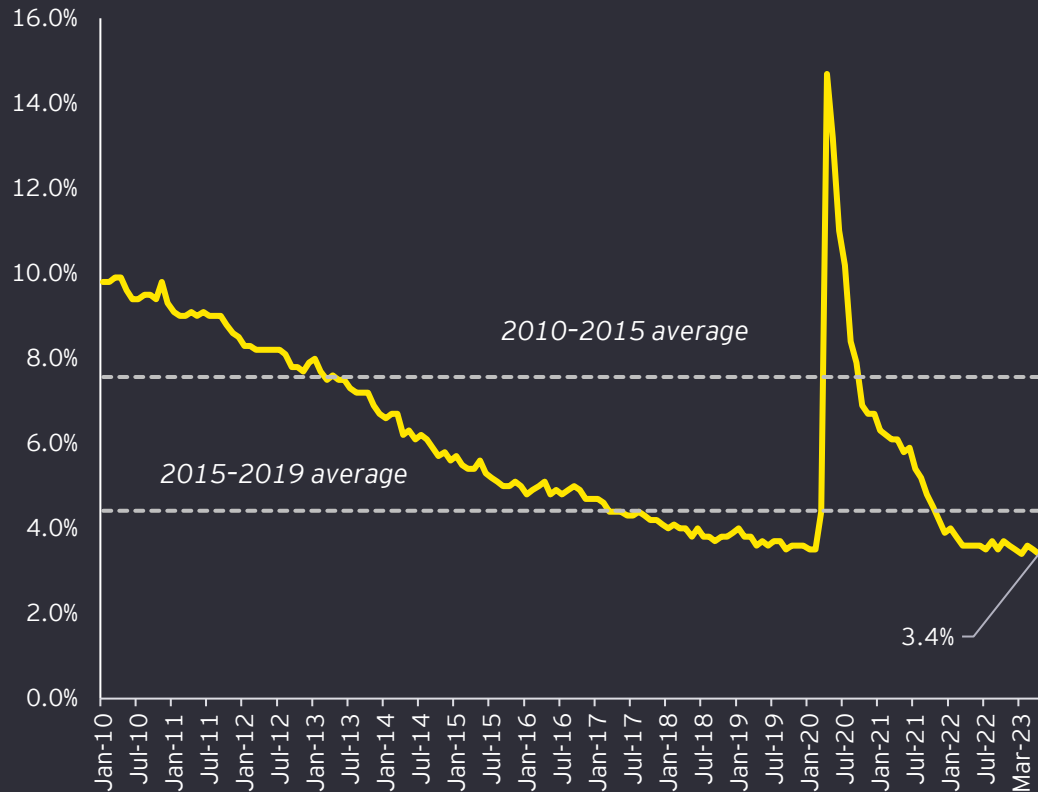
Note: Next update on June 2.

Source: US Bureau of Labor Statistics (Establishment data), EY analysis.

Top-line metrics of labor market suggest tightness

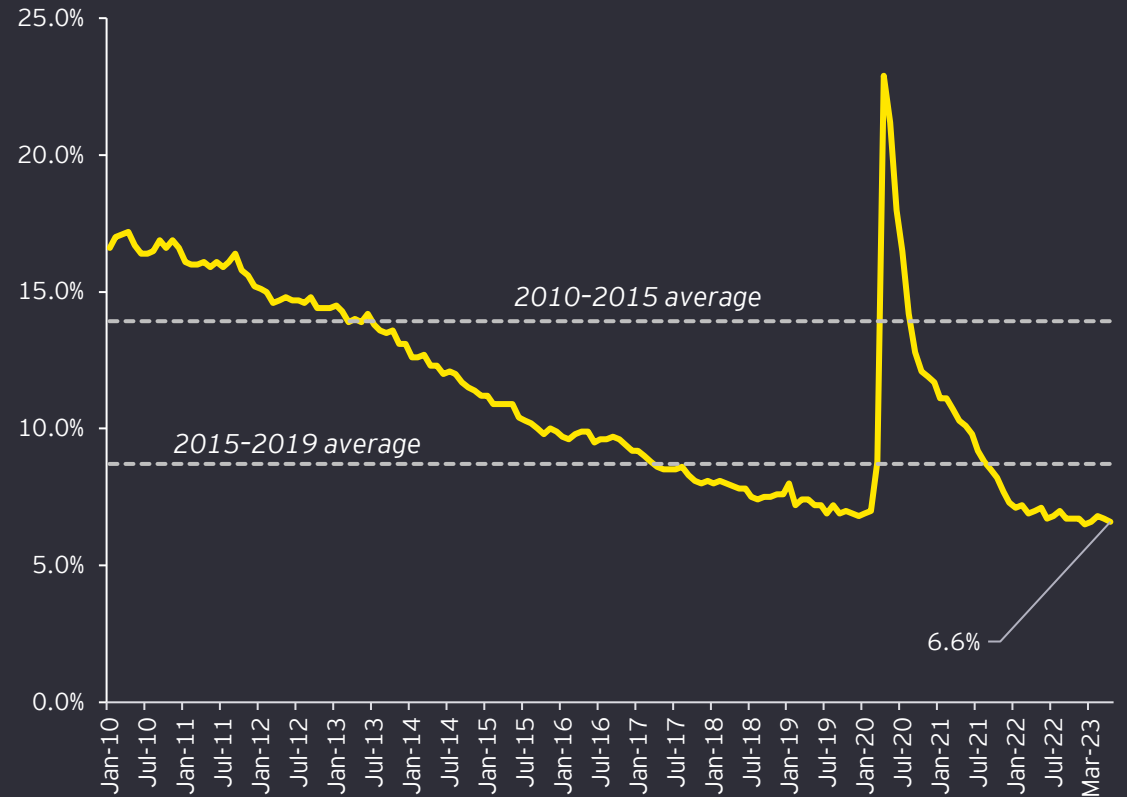
US unemployment rate

3.3m more workers are employed than in February 2020.



Underemployment rate (U6)

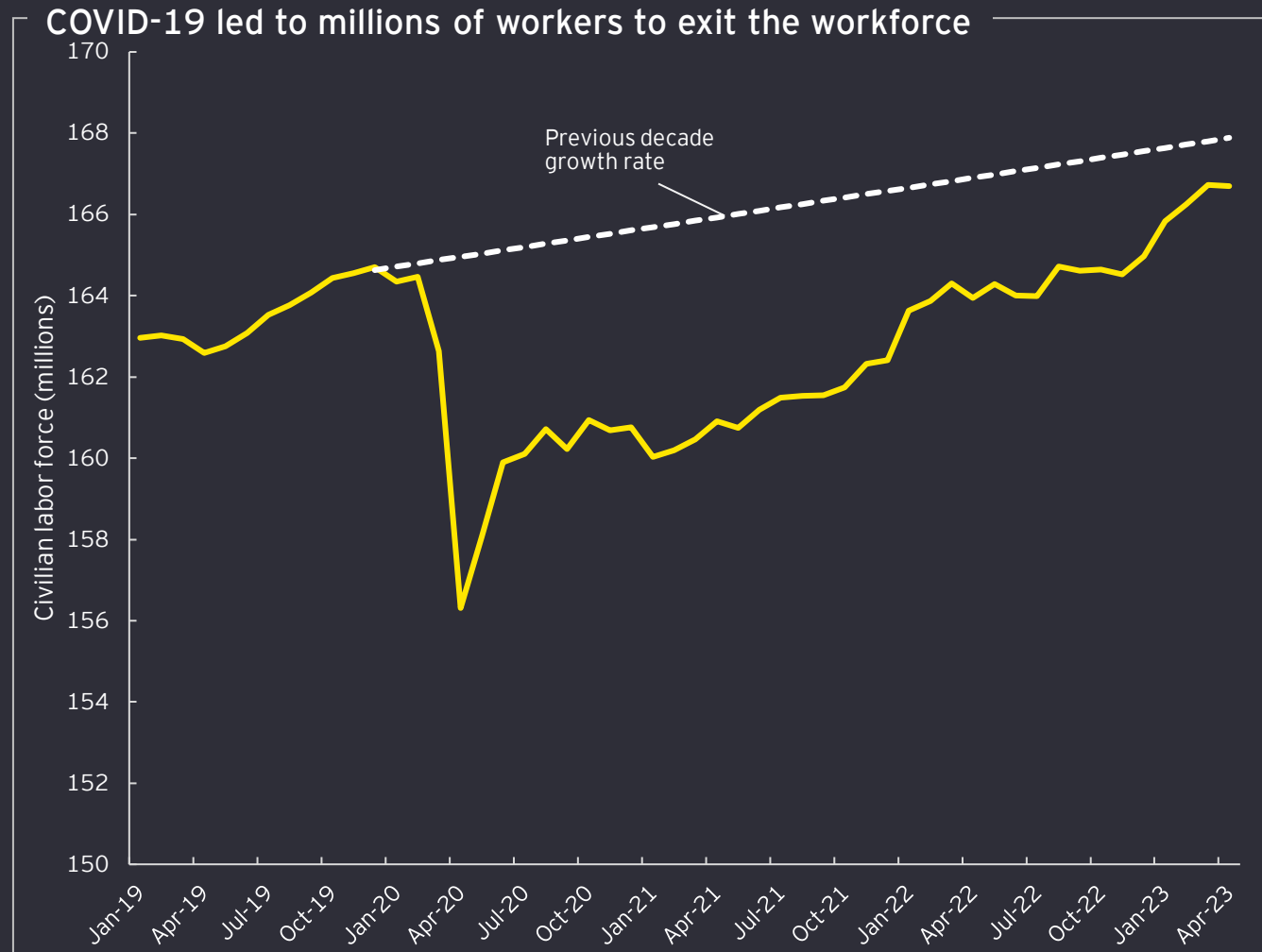
The underemployment rate is 0.4% below the rate in February 2020 (and below the 8.7% average from 2015 through 2019).



Note: Next update on June 2.

Source: US Bureau of Labor Statistics, EY analysis.

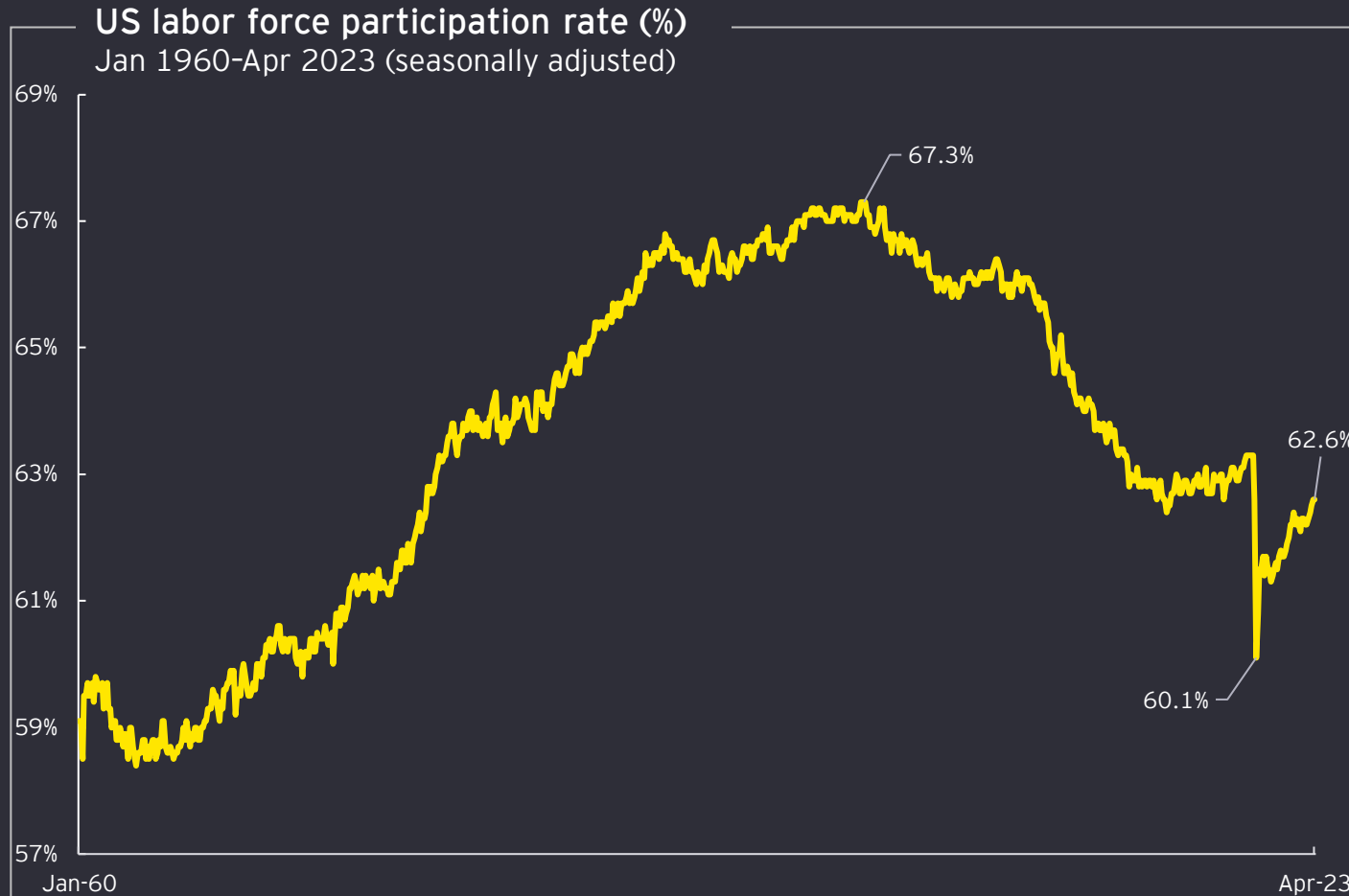
Large employment gap (relative to trend) putting significant pressure on labor markets and the economy



Note: Next update on June 2.
Source: Department of Labor; EY analysis.

- ▶ In April 2023, the labor force had **1.2 million fewer** workers than had it continued to grow at trend.
- ▶ Federal Reserve Bank of St Louis [research](#) indicates excess retirements drove the labor force down by 2.4 million as of August 2021. New [data](#) from Indeed suggests this could be reversing as “unretirements” increase.
- ▶ Federal Reserve Board of Governors [research](#) indicates caregiving responsibilities and concerns reduced the labor force by almost half a percent in 2021.
- ▶ UC Davis [research](#) suggests immigration restrictions led to a shortfall of 2 million more workers than previous trends indicate.
- ▶ Many economists question whether the labor force will return to its previous levels/trend.

Declining labor force participation rate detracts from economic growth



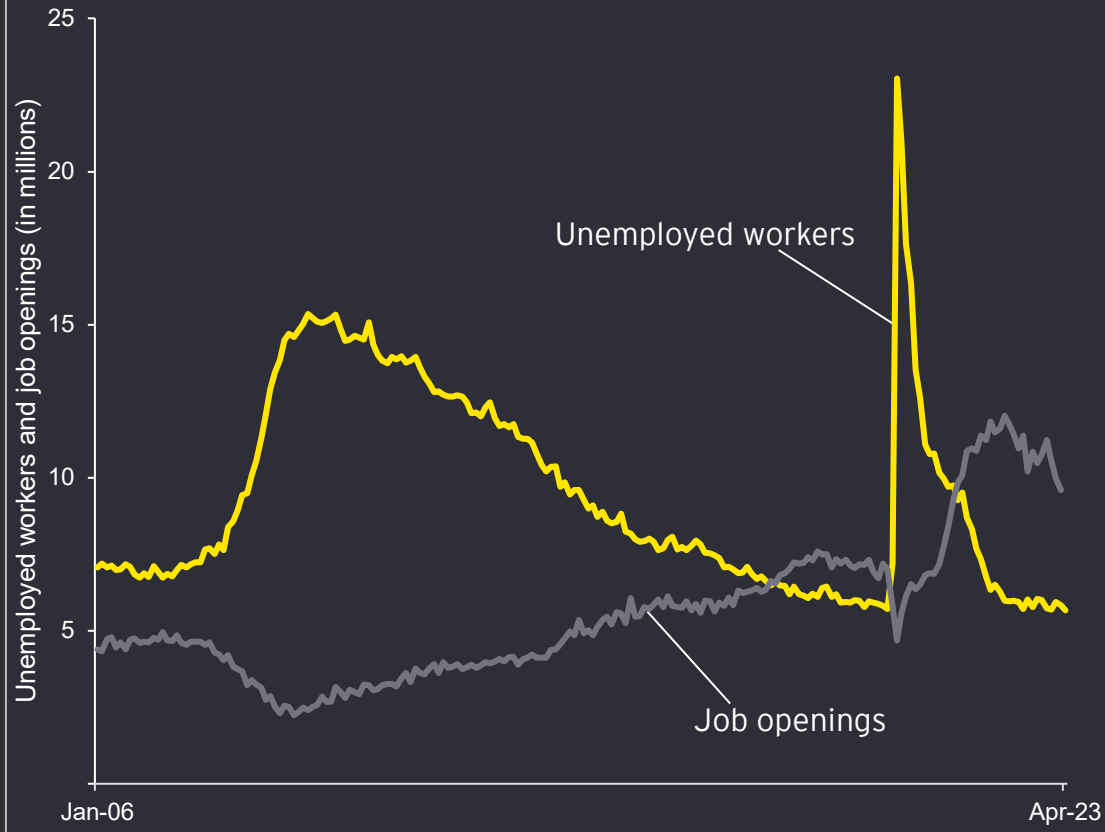
Note: Next update on June 2.
Source: US Bureau of Labor Statistics.

- ▶ The increase in female labor force participation is credited with helping lift economic growth in the several decades preceding the 1990s.
- ▶ Declines in the labor force due to the aging of the US population has been a significant drag on economic growth in the United States and other developed economies.
- ▶ The Congressional Budget Office has lowered its estimates of longer-term economic growth by roughly 1 percentage point due to the aging of the US population.

Job openings fell slightly in March and remain below their March 2022 peak

Job openings vs. unemployed workers

Job openings are near record levels and exceed the number of unemployed workers.



Note: Job openings data is available through March 2023; next Job openings release May 31; next unemployment release June 2.
Source: US Bureau of Labor Statistics.

Unemployed workers per job opening

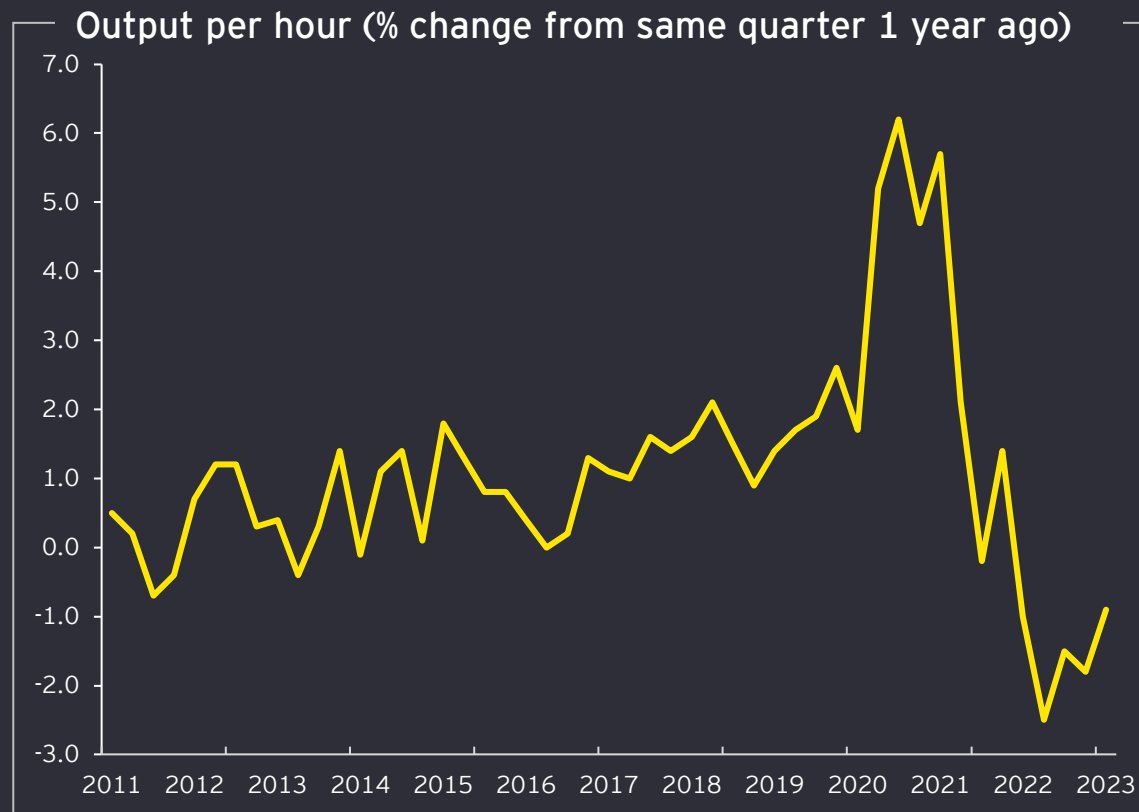
In March 2023, all industries except construction and mining had more job openings than unemployed.



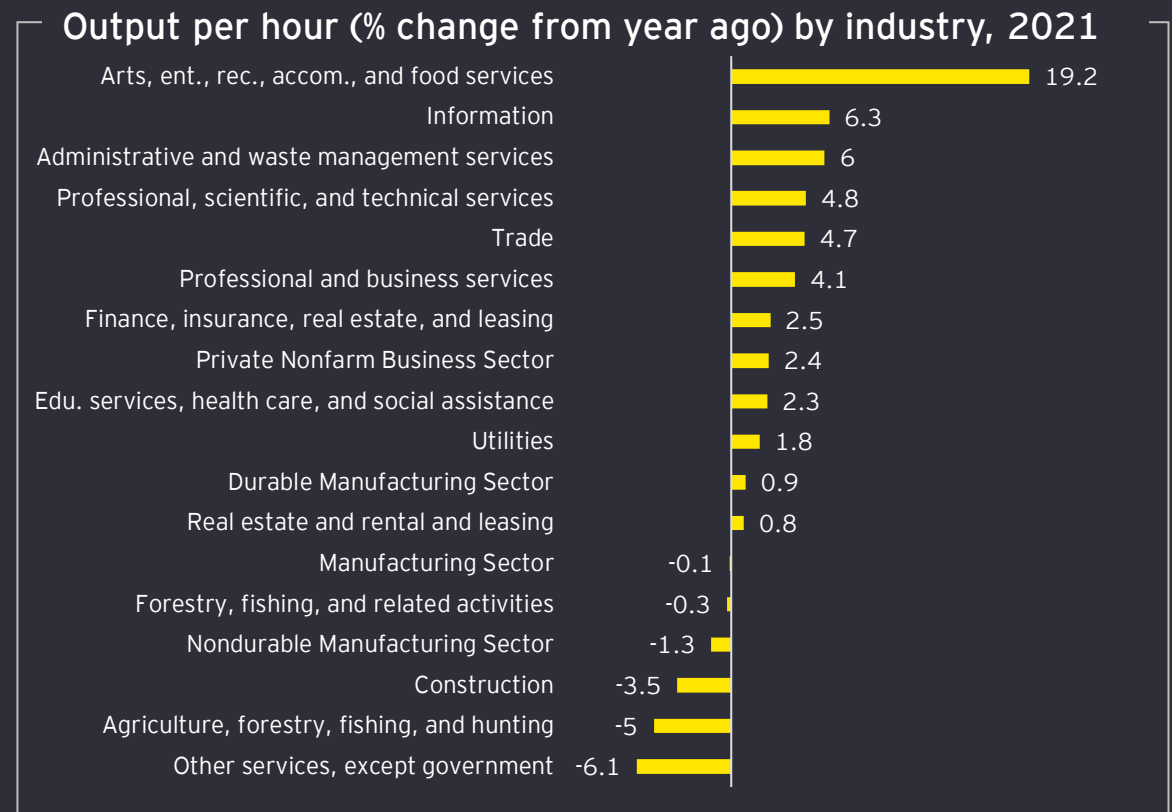
Note: Unemployment and job openings by industry are not seasonally adjusted due to limitations in data availability. The overall ratio is based on seasonally adjusted data.
Source: US Bureau of Labor Statistics.

Declining labor productivity a significant concern going forward

- ▶ In 2022, growth in labor productivity dropped for four consecutive quarters.
- ▶ Economist Jason Furman: “these declines are larger than the largest two-quarter declines since the data began to be collected in 1947—with the official estimate nearly twice as large as the largest previous decline” and “looking forward, the evolution of productivity ... will be one of the most important factors in the economic recovery.”



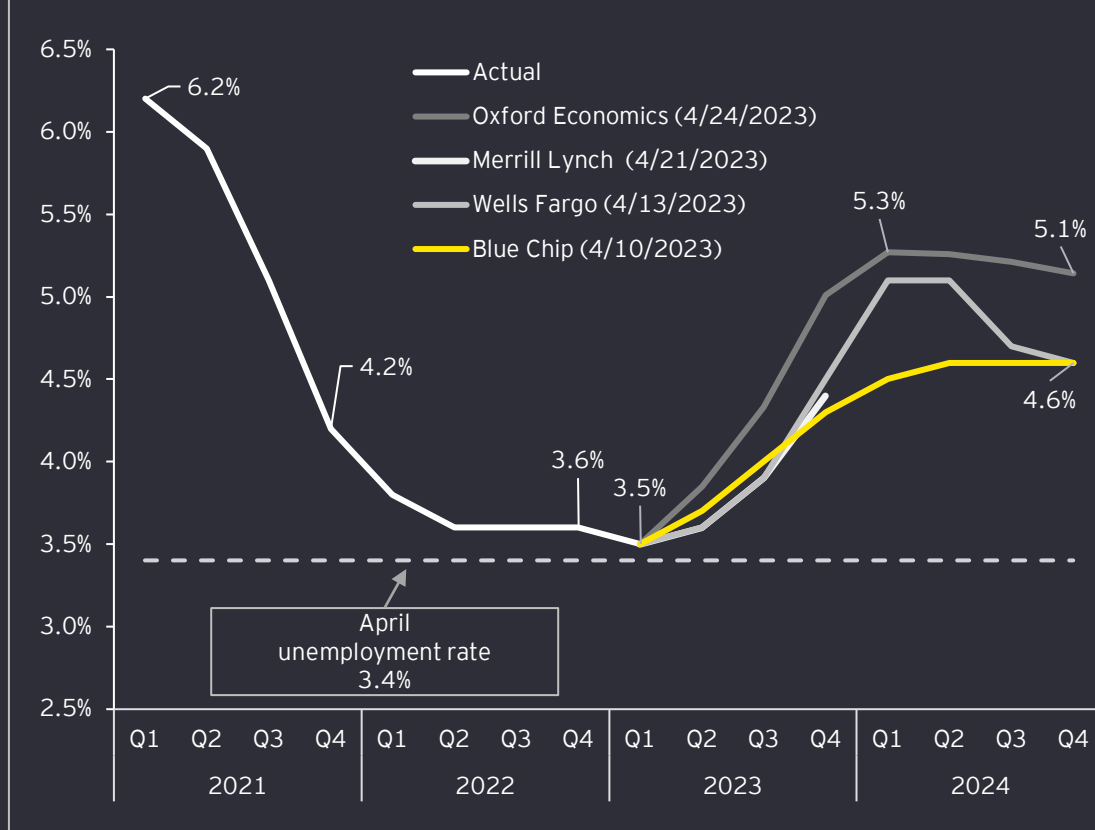
Note: Not seasonally adjusted. Next update June 2.
Source: US Bureau of Labor Statistics.



Note: Seasonally adjusted. Next update June 2.
Source: US Bureau of Labor Statistics.

US unemployment forecasts have the unemployment rate rising through 2023, perhaps to above 5% by early 2024

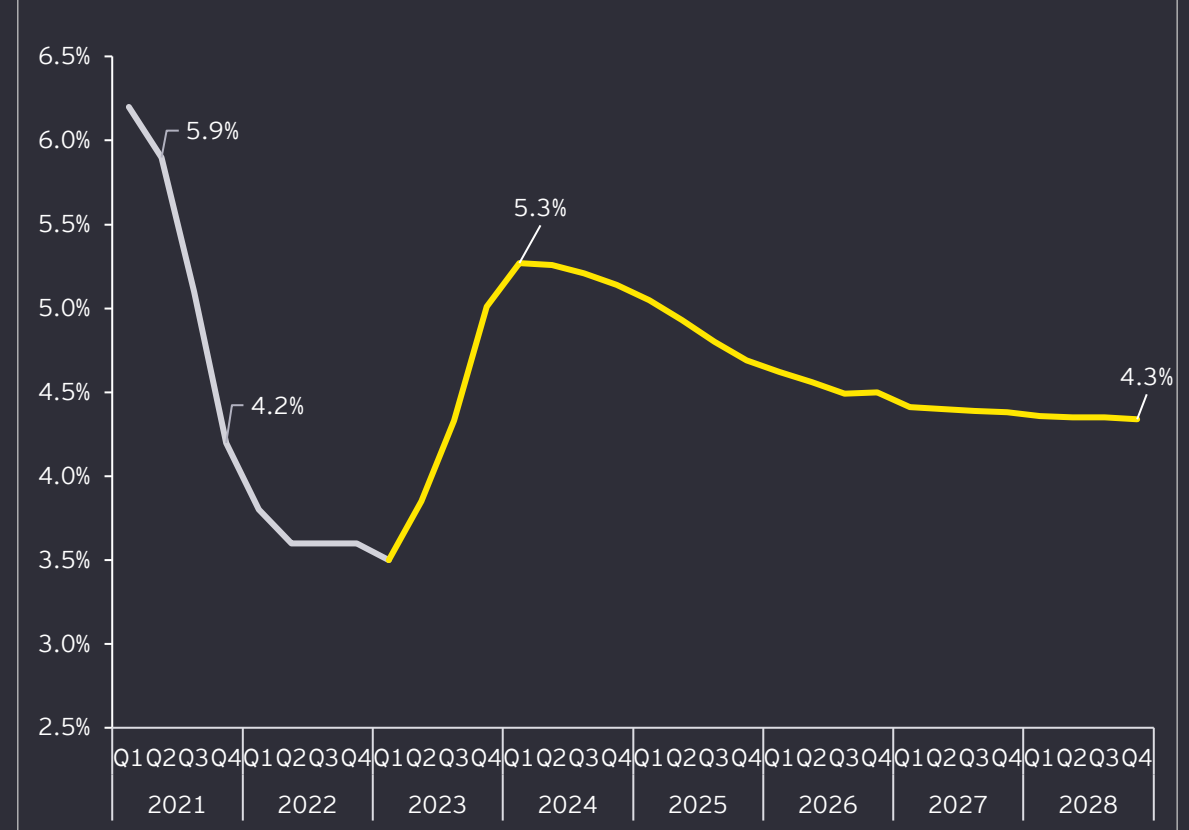
Short-term US unemployment rate forecast (2021-2024)



Note: Actual unemployment rate for each quarter is calculated as the average of the unemployment rate in the months in each quarter.

Source: EY Analysis, Oxford Economics; Capital Market Outlook Merrill Lynch; Wells Fargo US Monthly Economic Outlook; Blue Chip Financial Forecasts, Vol. 48, No. 4, April 10, 2023.

Long-term US unemployment rate forecast (2021-2028)



Note: Actual unemployment rate for each quarter is calculated as the average of the unemployment rate in the months in each quarter.

Source: Oxford Economics, April 24, 2023.



Real Estate outlook



EY

Building a better
working world

Trouble has been brewing in the commercial real estate sector

What is next?

Market trends

475 bps

Increase in fed funds rate since March 2022¹

26.4%

Decline in valuations (CPPI) within the office REIT sector valuation since 2021²

7.25%

Increase in national office building operating expenses since 2021³

\$1.2tn

Of loans maturing in 2023 and 2024⁴

52%

more office loans by volume in special servicing since 2021⁵

44%

more office loans by volume, in delinquency since 2021⁵

Sources:

1 Federal Reserve Bank of St. Louis

2 Green Street

3 Realty Rates, Nationwide CBD Office Buildings

4 RCA and Newmark Research

5 TREPP

CRE Headlines

The office buildings that form the bedrock of big cities could be worth \$500 billion less because of work from home

-Forbes

Commercial Real Estate Sector Faces Risk as Financial Conditions Tighten

-IMF Blog

Banks Boost Reserves for Commercial Real Estate in Case Recession Hits

-CoStar

Distress in Office Market Spreads to High-End Buildings

-Wall Street Journal

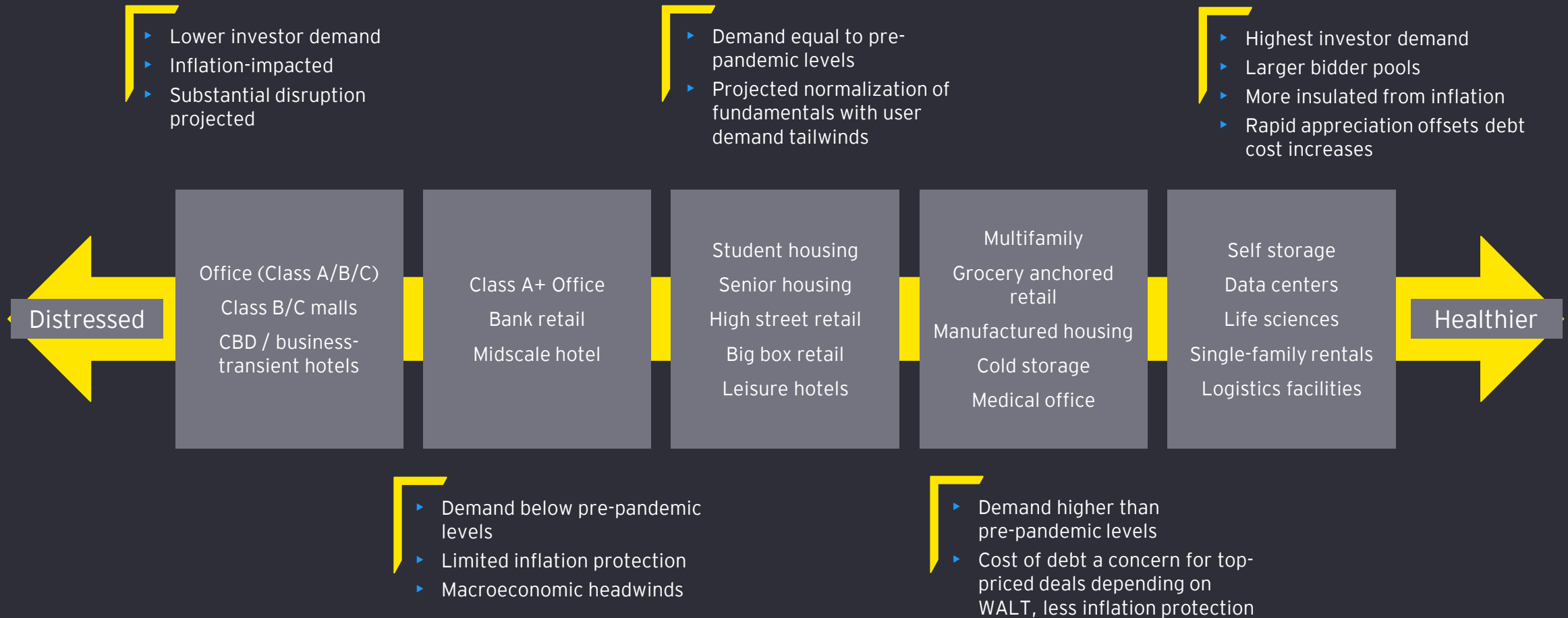
Brookfield's Downtown Los Angeles Office REIT Defaults on Office Tower Loans

-CoStar

Pimco Is Saddled With a \$1.7 Billion Default in Office-Market Meltdown

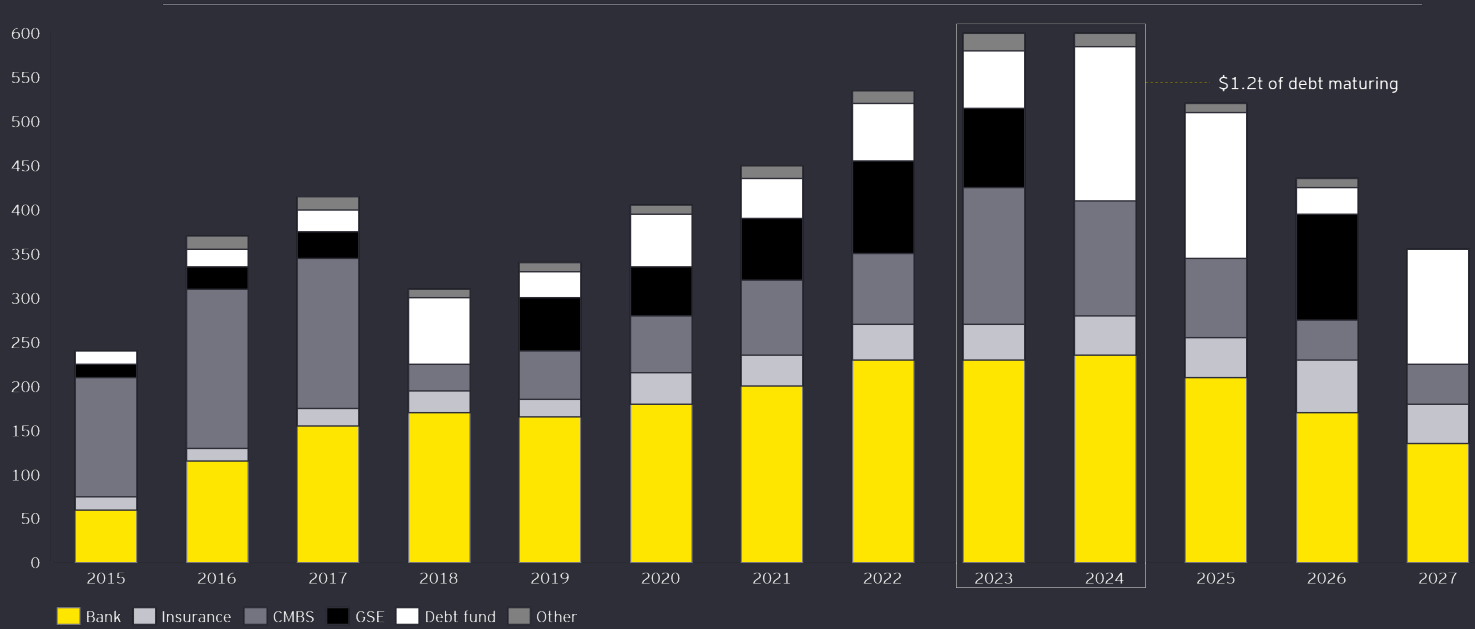
- Wall Street Journal

Exposure to macroeconomic influences will produce uneven impacts across real estate asset classes and quality types

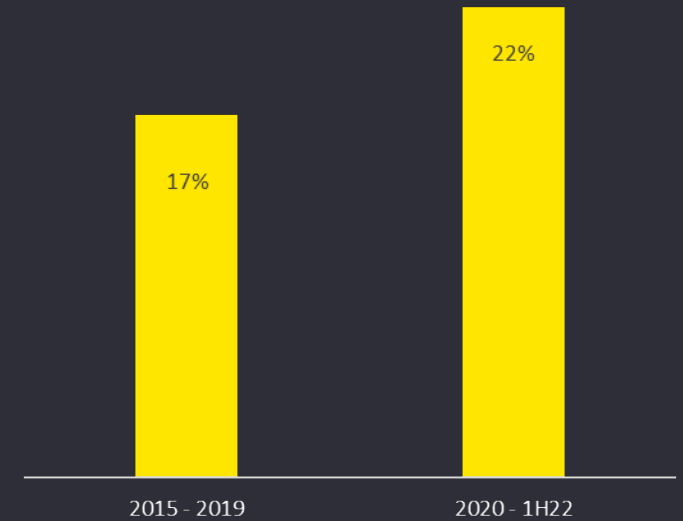


Record volumes of debt are maturing in 2023-2024

US commercial mortgage maturities by original loan term (\$b)



Share of CRE lending attributed to local and regional banks



Source: JLL Research, Real Capital Analytics

Note: Assumes that loans for which the maturity date is unknown have the same maturity distribution as loans with known maturities.
Source: RCA, Newmark Research

Real Estate is not immune to current credit climate

The coming wave of CRE debt maturities offer no clear path to resolution

Key risk factors

- ▶ Declining NOIs + higher interest rates for floating rate debt = difficulties meeting debt service obligations
- ▶ Higher cap rates + declining NOI = lower values
- ▶ Pullback in regional bank and CMBS lending
- ▶ Tightening lending standards and available credit
- ▶ Higher interest rates upon maturity for fixed rate debt
- ▶ Over \$2 trillion of CRE loans maturing through 2024

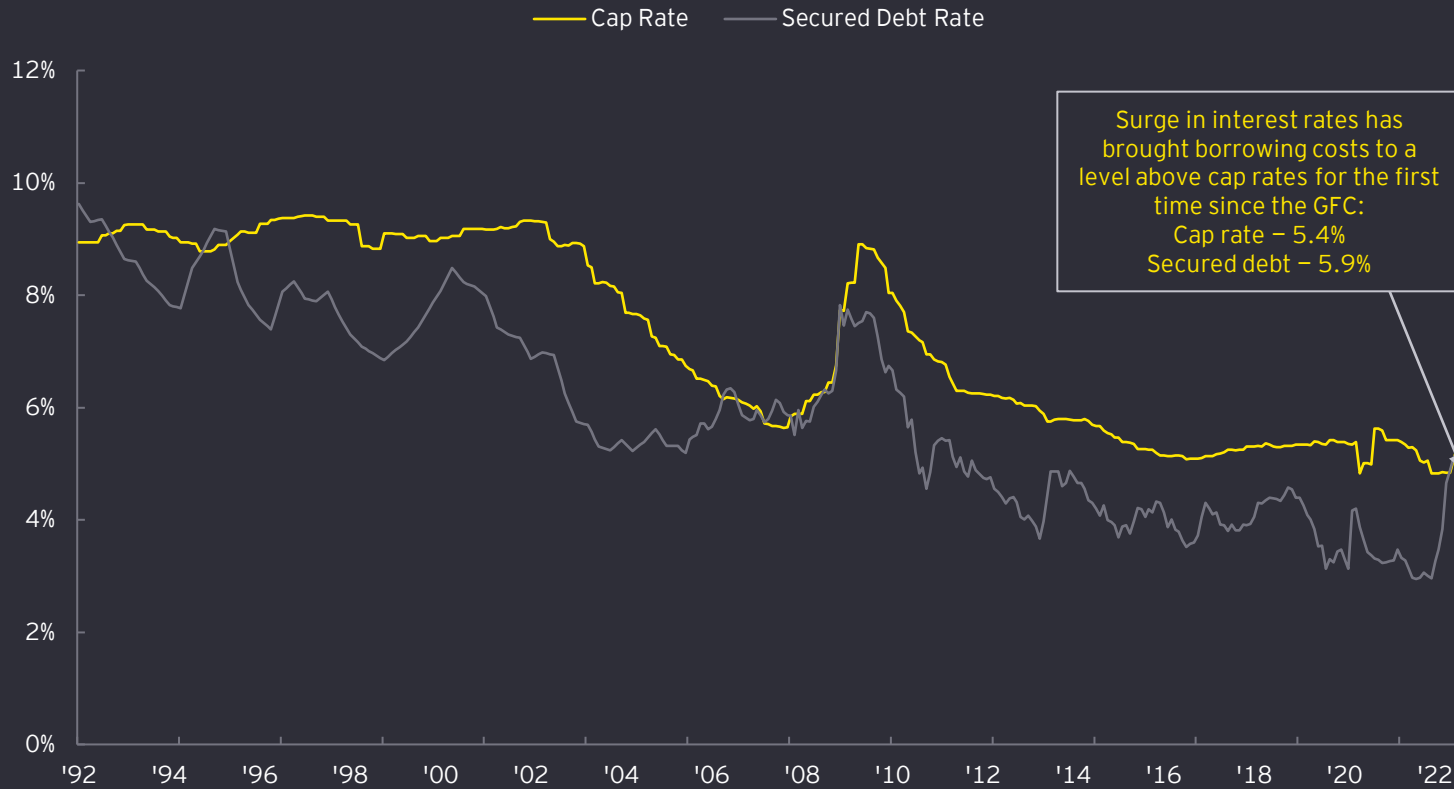
Key questions

- ▶ If borrowers are unable to make up the negative equity at maturity, are lenders prepared to: 1) extend the loan; 2) absorb the loss, or 3) take ownership of the asset?
- ▶ Are borrowers willing or able to invest further capital to right size loans or pay for interest rate cap renewals?
- ▶ What bridge solutions will the private markets make available?

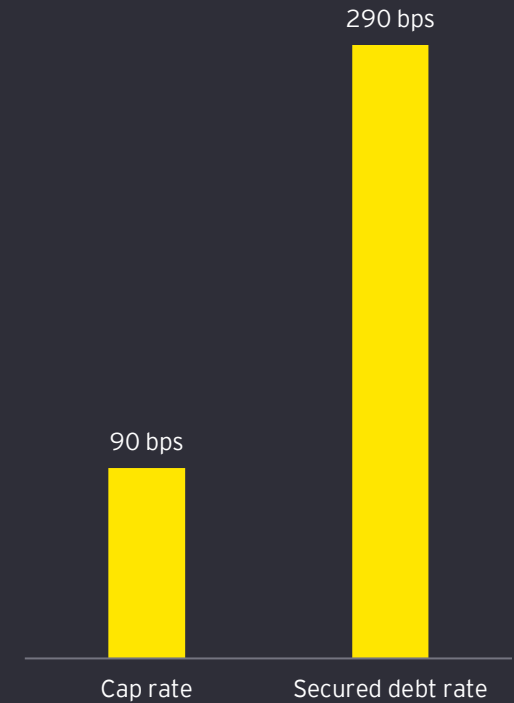


Negative leverage persists – cap rates vs. secured debt

Cap rate vs. debt cost (traditional sectors)



Change since January 2022



Source: Green Street Advisors

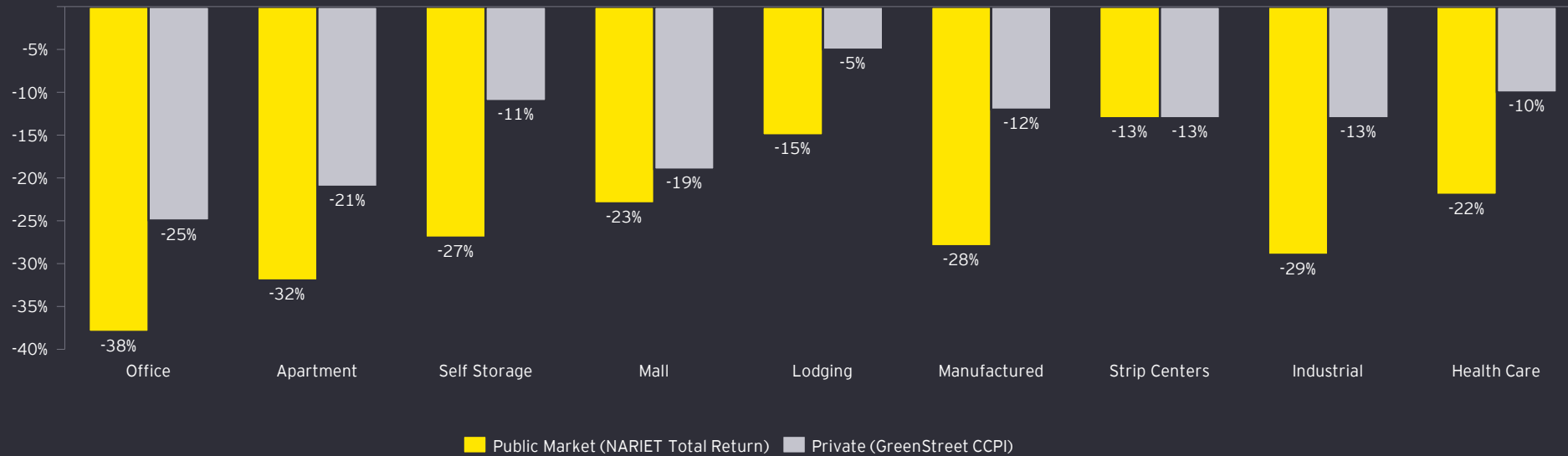
GFC = Global financial crisis

Bps = Basis points

Differing opinions of value

Did the public market go too far and what does this mean?

- ▶ Cap rate spreads have widened sharply in the public market leading to severe valuation declines in most sectors
- ▶ Why do such differences exist between the public and private market and who is right?
- ▶ The result is a widening gap in opinions of value for the same asset - very often, among different layers of the same capital stack or between two parties on either side of a transaction, leading to conflict and disagreements

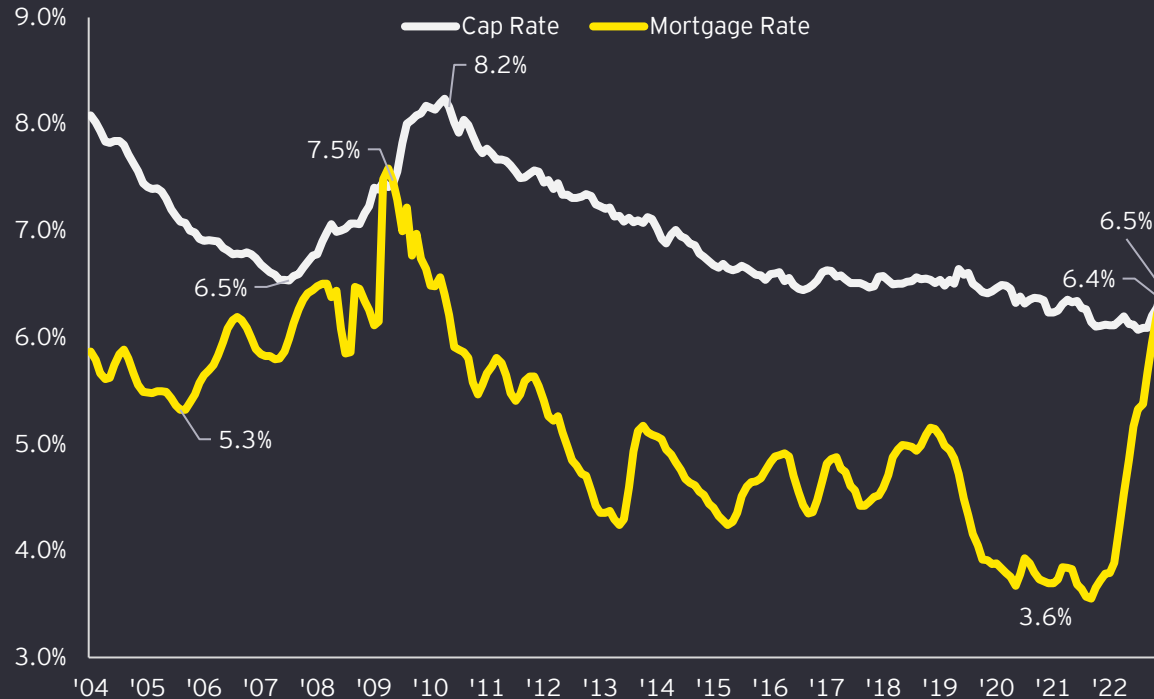


Source: NARIET Total Return; Green Street CPPI March 2023

Public market: cap rate changes historically are a lagging indicator

Only one way to move - Up

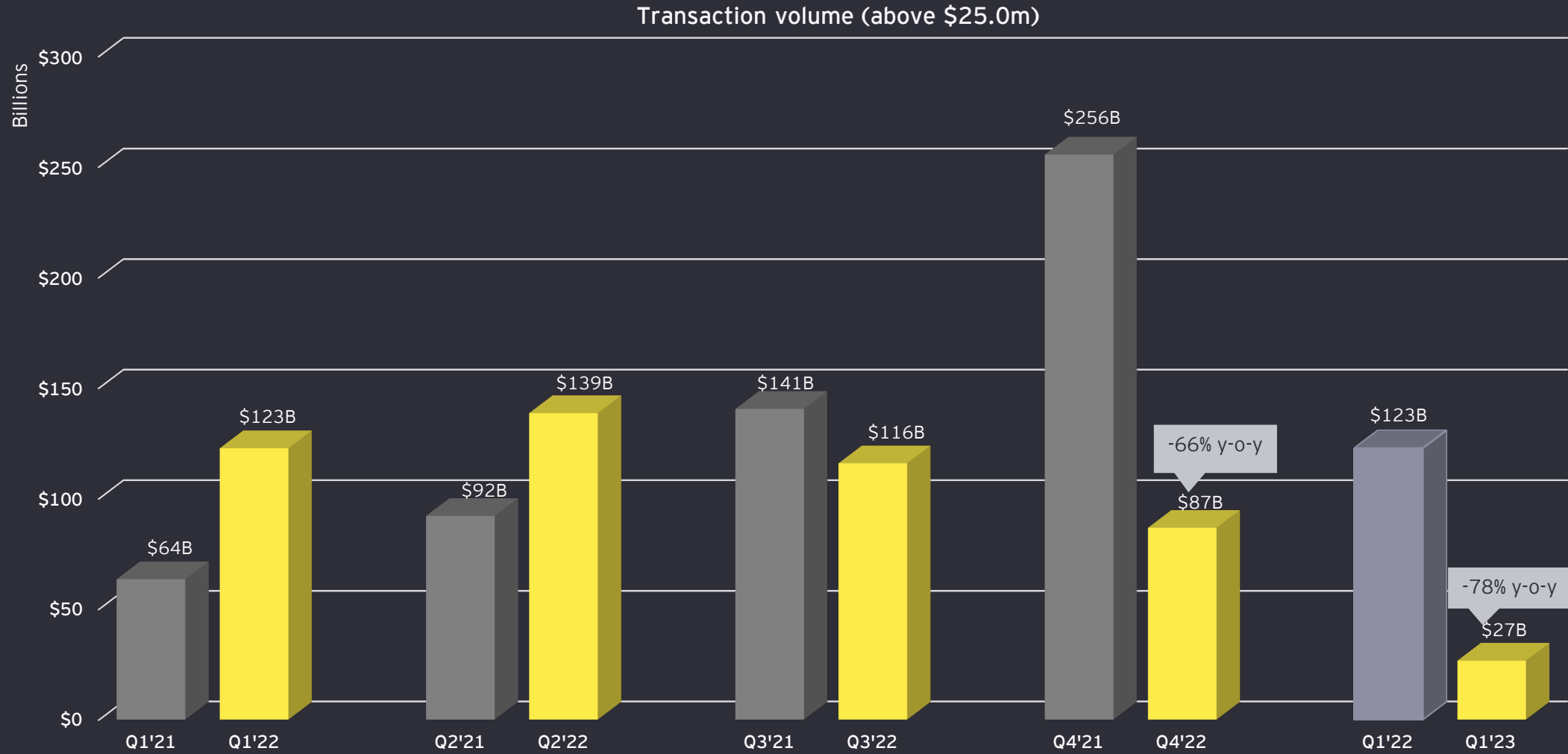
Cap rates vs. mortgage rates



- ▶ Mortgage rates have historically correlated to debt costs in the broader capital markets, which led to a cooling transactions market (~\$110 billion decrease in volume YoY between 2021 and 2022)
- ▶ In turn, this led to decreasing prices, which would typically lead to widening cap rates
- ▶ Historically when mortgage rates have increased 230bps, cap rates increased by 170bps. However, this market correction has not happened **yet**.
- ▶ Mortgage rates started increasing in Q1 2022 and it took until December 2022 for cap rates and mortgage rates to even reach parity.
- ▶ In 2009, the sharp increase in mortgage rates led to the widening of cap rates by nearly **100 bps** in the following year

Source: RCA, data as of December 2022

Transaction volumes have declined significantly, given market conditions and bid-ask spread



Source: Real Capital Analytics



What is Next??

