Economic Update

SVN | Research

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1. SEPTEMBER JOBS REPORT

- The US economy added 336,000 new jobs in September, according to the Bureau of Labor Statistics, almost double the consensus forecasts. The unemployment rate remained unchanged at 3.8%.
- September's employment growth was the highest since January, reflecting continued economic and labor market growth despite higher interest rates and falling business sentiment.
- While the figures are strong, gains were mostly seen in industries that had lagged during the post-COVID recovery, and some economists suggest that this may reflect workers being forced to accept positions with lower pay as the breadth of opportunities dwindled.
- Average hourly earnings rose by 0.2% during the month and 4.2% year-over-year, both measures growing at their slowest all year.
- The report has expectedly brought closer inspection of the Federal Reserve's upcoming interest rate decision. However, fed futures markets have overwhelmingly foreseen a no-hike scenario at the FOMC's November policy meeting.

2. JOB OPENINGS AND LABOR TURNOVER

- Preceding September's jobs report was the BLS' Job Openings and Labor Turnover Survey, which showed that job openings rose larger than expected in August, a leading indicator of the labor demand that caught some forecasters off-guard after the recent jobs report.
- Openings rose to 9.6 million, with hires and total separations remaining stable at 5.9 million and 5.7 million, respectively. Among separations, quits and layoffs/discharges were mostly unchanged at 3.6 million and 1.7 million, respectively.
- Following the report, markets fell out of concern that the Federal Reserve would renew its rate increases in the face of a continuing hot labor market. However, futures markets have remained firm on a no-hike forecast for the November meeting.

3. FOMC MEETING MINUTES

- Minutes from the Federal Reserve's September meeting show that on balance, officials believe that one

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additional rate hike will be needed in 2023, though consensus on the forecast was fairly weak.

- In the FOMC's Summary of Economic Projections, about two-thirds of members forecasted one additional rate hike before the end of the year. Members also predict that the median federal funds rate in 2024 will be 5.1%, above the 4.6% forecast at the June meeting.
- However, officials were unanimous on the need to keep rates elevated until inflation returns to its 2% long-run target and to "proceed carefully" on future rate decisions as the US economy deals with multi-directional economic forces.

4. THE RISE OF SMALLER FLOORPLATES

- As the Office sector grapples with post-pandemic impacts, transactions containing assets with smaller floorplates have become an increasing share of deal volume, according to data from MSCI.
- While the percentage of office transactions containing smaller floorplates had steadily risen between the Great Financial Crisis and 2020, it has accelerated during and after the pandemic as companies re-assessed their space needs in the face of the new remote-work equilibrium.
- Transactions in the 5-10k square-foot range have jumped from about 18% of the market pre-pandemic to roughly 25% today, while the under 5k share has jumped from about 10% pre-pandemic to 15% in 2023.
- Both remote work's impact on offices and shrinking space demand is more than a US phenomenon. Global deal volume for offices has declined to the lowest since 2008, while smaller floorplates now take up half of all European office transactions, reflecting a global industry shift.

5. HOME AFFORDABILITY

- Home affordability fell in the US during the third quarter of 2023 compared to the previous quarter, according to the latest US Home Affordability Report by ATTOM.
- Affordability fell in 99% of the counties tracked nationwide by ATTOM, extending a two-year trend of declining home affordability.
- Entrenched higher mortgage rates and a modest uptick in asset prices during the third quarter have led to further affordability constraints, with homeownership now requiring 35% of today's average wages to

meet costs. Common lending standards call for a 28% debt cost-to-income ratio, rendering today's levels unaffordable.

- Counties with the largest populations that were unaffordable in the third quarter were Los Angeles County, CA; Cook County (Chicago), IL; Maricopa County (Phoenix), AZ; San Diego County, CA; and Orange County, CA.

6. CHINA RE TROUBLES: IMPACT ON GLOBAL GROWTH

- In a previous SVN economic update, our team forecasted little impact from China property giant Evergrande's woes on US markets, but recent distress in other parts of China's real estate sector and its economy at large may pose risks to global markets.
- "Country Garden," China's largest property developer, recently indicated that it may default on US dollar-denominated bonds. Believed to account for up to 30% of China's GDP, a broader crisis in the nation's property sector would weigh on its entire economy. China has been the largest source of growth for the world economy in recent decades.
- The IMF recently cut its forecasts for Chinese growth and noted that commodity exporters that rely on Chinese demand could be at risk ahead. Still, there is little to suggest that the nation's property market woes will significantly spill into US commercial real estate.

7. CRE & NET ZERO

- A new report by HSBC reviews how the real estate sector is transitioning to net zero, highlighting operator views and strategies in approaching the challenge.
- According to the report, 97% of real estate companies say net zero is commercially important to their business.
- 56% of real estate companies say that technology developments are helping them progress towards their net zero goals, while 39% claim to be spending more than 10% of capex on the transition, with 51% expected to do so within the next three years.
- Retrofitting and embodied carbon received specific shoutouts in the report as critical segments of the

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company's strategies. Retrofitting existing buildings is believed to be less carbon-intensive than building new ones, while policymakers are increasingly looking to embodied carbon to make new construction more sustainable.

8. TAX INCENTIVES FOR LOAN MODIFICATIONS & DEBT RELIEF

- A recently proposed bi-partisan US House bill aims to amend the tax code for commercial real estate borrowers during loan modifications. The bill zeros in on the cancellation of debt income policy and treats debt forgiveness as a taxable event, where borrowers are taxed on the amount canceled.
- The proposal would expand the cancellation of debt income to policies to include pre-2022 loans canceled between 2023 and 2027. It also aims to preemptively respond to the challenge of $1.5 trillion in commercial real estate debt maturing by 2025.
- If passed, the legislation could alleviate the distress in the industry by incentivizing loan modifications and debt workouts. While the house sponsors crossed party lines, the bill will still need to seek support in the US Senate and the White House for eventual approval.

9. UBS SIX BURNING QUESTIONS ON REAL ESTATE

- A recent report by UBS attempts to answer 6 of the "most burning questions" facing CRE in the face of converging economic trends.
- Regarding housing affordability, the firm confirmed trends showing higher stress levels than in recent years, noting that renting is "significantly less" expensive than buying in 48 out of 50 of the largest markets.
- Regarding the housing supply and demand imbalance, UBS views that the "lock-in effect" from previously low-interest rates will keep homeowners in a holding pattern for some time while would-be homebuyers remain cautious, perpetuating the imbalance.
- The firm expects home prices to stay afloat due to the supply-demand imbalance with potential increases in 2024. It also predicts that CRE distress may increase in the short run, but a highly capitalized financial system likely limits its impact.

- Regarding office conversions, UBS projects that only 10-15% of existing office stock may be viable for this solution. Meanwhile, they see residential and industrial markets as the most robust CRE investment opportunities in real estate.

10. DATA CENTERS AND NUCLEAR POWER

- Data centers have grown in importance in the CRE space as our digital economy needs to converge with an office sector looking to reinvent itself. As SVN Research has covered previously, power demand has driven much of the strategy on where to construct new centers, and a recent operator has turned to an unorthodox source for power needs: nuclear reactors.
- According to an analysis by Globe Street, data center operator Standard Power will deploy up to two dozen small modular reactors (SMR) to power new centers in Ohio and Pennsylvania for AI training and blockchain mining.
- The 24 reactors will generate roughly 2 gigawatts of power, similar to the scale of reactors used to power US Navy subs and aircraft carriers.
- Experts note that with older grid capacity shrinking and a lack of new sustainable options on the market as demand for AI and other intensive computing rises, nuclear power presents a creative but controversial solution.

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SUMMARY OF SOURCES

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