SVN RESEARCH®

Deconstructing The Puzzle: Falling Recession Fears Renew Prospects of A Soft Landing

EMERGING TREND REPORT | Q4 2023

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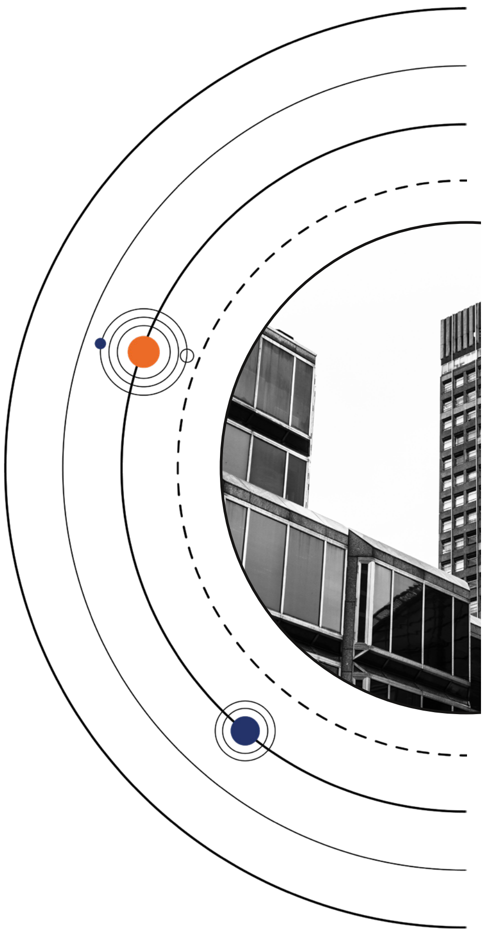


Whether or not The Fed's intense efforts to curtail inflation would cause a US recession has remained an elusive question for economists in 2023.

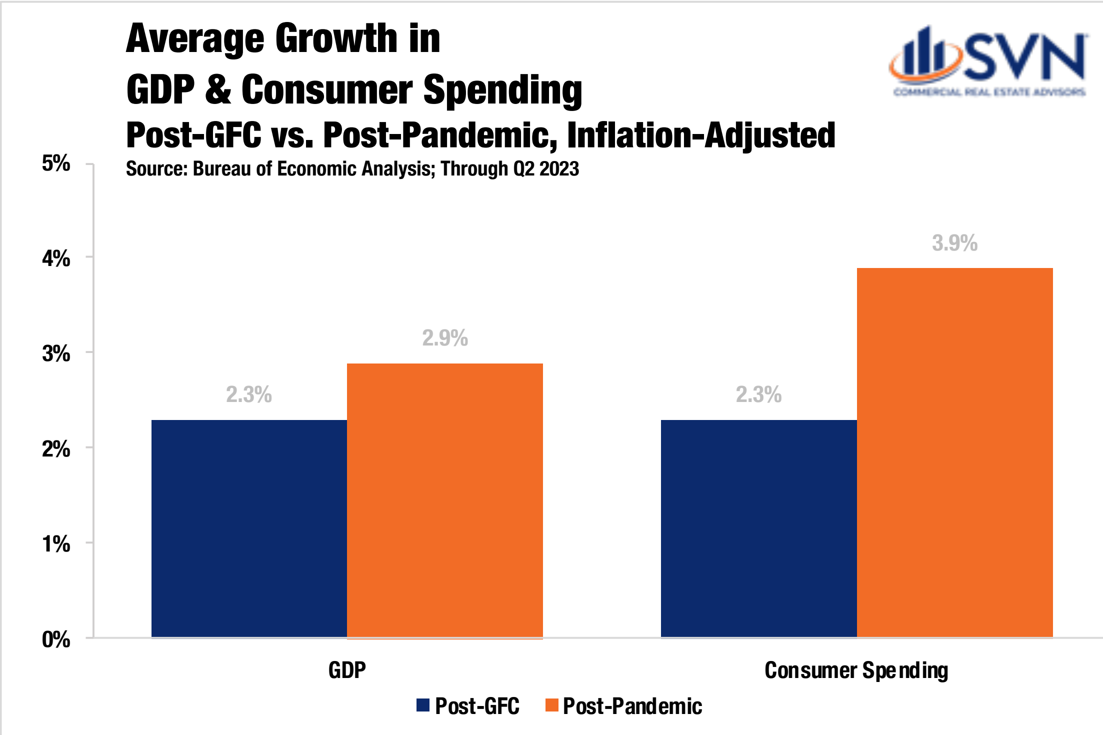
While the steep rise in borrowing costs in the past year has visibly affected commercial real estate investment and homebuying, the worse recession fears have not come to pass.

In this special report, the SVN Research team will deconstruct the current economic puzzle and detail how each piece fits into the look ahead.

A Demanding Consumer

The American economy found itself in an unorthodox position as it arose from the COVID-19 pandemic. Stimulus tools implemented during the pandemic towards businesses and consumers drastically increased the US money supply, resulting in robust labor market growth and a surge in US savings rates. Due to an unprecedented cutback of in-person economic activity during this time, a wave of pent-up demand flooded consumer markets in the pandemic's aftermath.

On the one hand, this has facilitated today's high inflation environment. On the other, it appears to have enabled the US economy to weather the storm of tighter financial conditions. **Despite 11 rate-hikes by the Federal Reserve over 19 months, economic output has remained robust, with consumer spending at the driver's seat.**



Real Gross Domestic Product (GDP) has increased for four consecutive quarters after a brief drop off to start 2022. Real consumer spending (PCE), GDP's largest contributor, has averaged an annual growth rate of 2.3% in 2023.[1]

While this year's spending growth is below the highs seen during the pandemic-rebound, it is line pre-pandemic averages.

Moreover, inflation-adjusted PCE growth has averaged 3.9% since the beginning of 2021 — well above the post-GFC/pre-pandemic average and a trend that largely explains the post-pandemic jump in US economic growth.

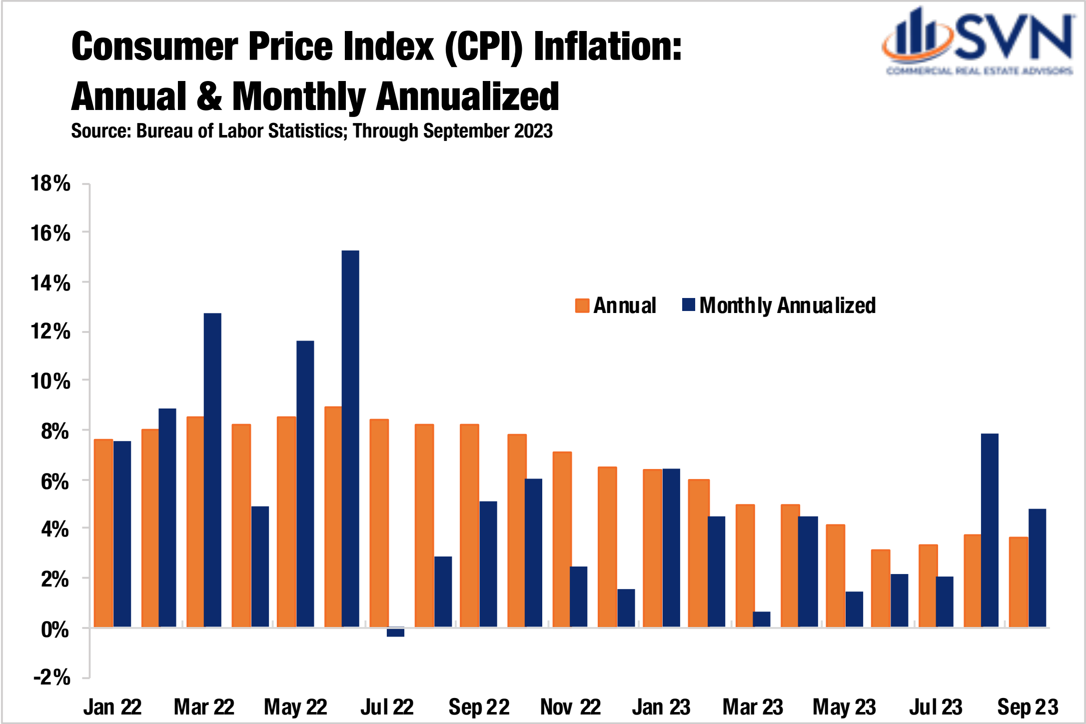
1. Annual growth rate is compounded.

No Fall This Autumn

Inflation has continued to slow since a peak in June 2022, bringing the Fed closer to the end of its tightening cycle — evident in its decision to pause rate hikes at its June and September 2023 meetings. However, heading into the fall, both hiring and spending continue to rise at higher-than-expected levels, adding complexity to the Fed's upcoming choices.

In September, the US economy added 336,000 jobs, bringing 2023's total employment growth to 2.33 million — a moonshot beyond what many economists had predicted in the face of rising borrowing costs. Further, while upward price pressures dampen, inflation remains above the Fed's comfort zone.

According to the BLS, consumer price index (CPI) inflation rose 3.7% year-over-year in September. Further, monthly inflation is charting above growth rates seen earlier this year. As a point of context, If prices rose as quickly as they in September for a for a full year, the annual inflation rate would sit at 4.9%.



In the minutes from its September meeting, Fed officials reemphasized their data-dependent approach to upcoming rate decisions, with their famed "dot-plot" revealing a consensus that one additional hike may be needed before the year's end.

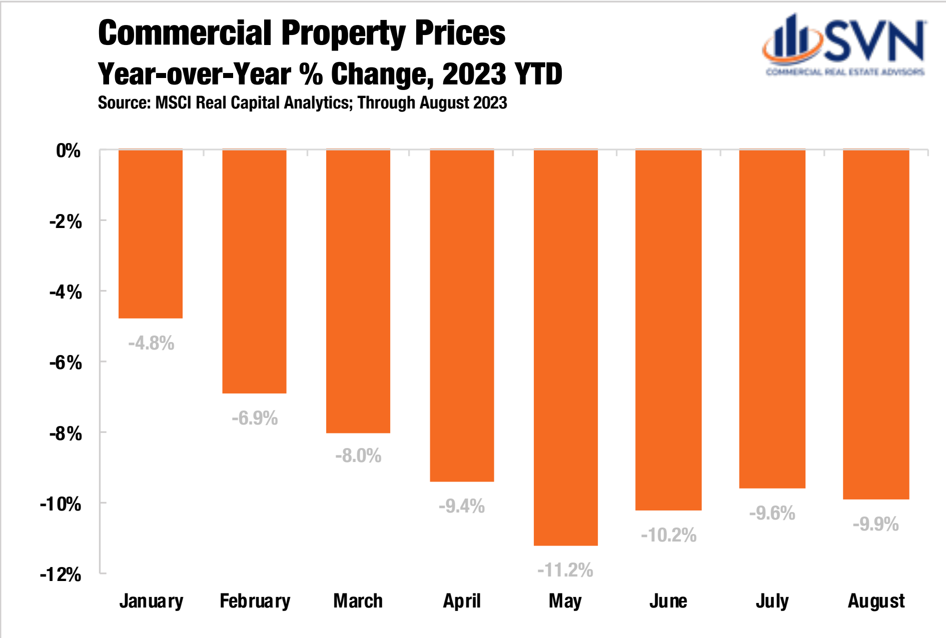
While September's job and inflation data arrived after the FOMC's latest meeting, their results will likely reaffirm the committee's appetite for at least one additional hike in 2023. Still, markets appear to be testing the Fed's bluff. According to the Chicago Mercantile Exchange's Fed Watch Tool, as of mid-October, futures markets project a roughly 90% chance that the Fed will not raise interest rates at their November policy meeting. Similarly, markets are assigning just a 32% chance that the Fed will hike rates again by the end of the year.

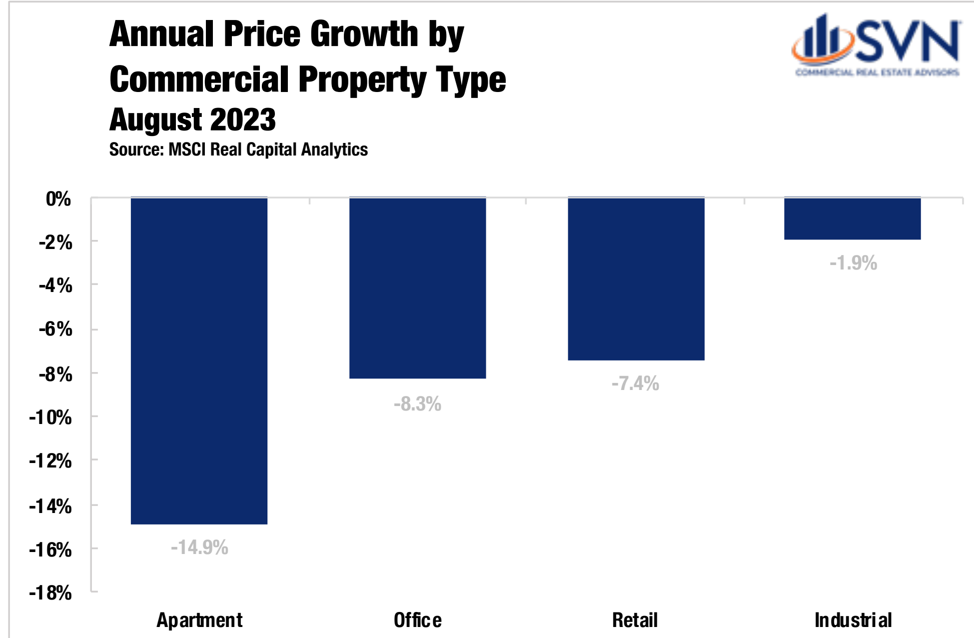
Descending Into A Soft Landing

The economy's resilience comes with a caveat: a soft landing is still a landing. According to the MSCI Real Capital Analytics (RCA) Commercial Property Price Index, all major property sectors posted annual price declines in August. However, these declines have decelerated from the early summer, and prices were flat in August month-over-month.

The national all-property index fell -9.9% year-over-year in August, a steeper dip than July's -9.6% decline but an improvement from May and June, which saw annual price declines of -11.2% and -10.2%, respectively — suggesting that directionality is shifting in favor of investors.

Deal volume has slowed across all sectors amid the high-interest rate environment. According to MSCI RCA, deal volume between January and August was 58% lower than the same period in





2022. Apartment values continue to post the largest declines, falling by -14.9% year-over-year, the only double-digit decline across all major sectors in August.

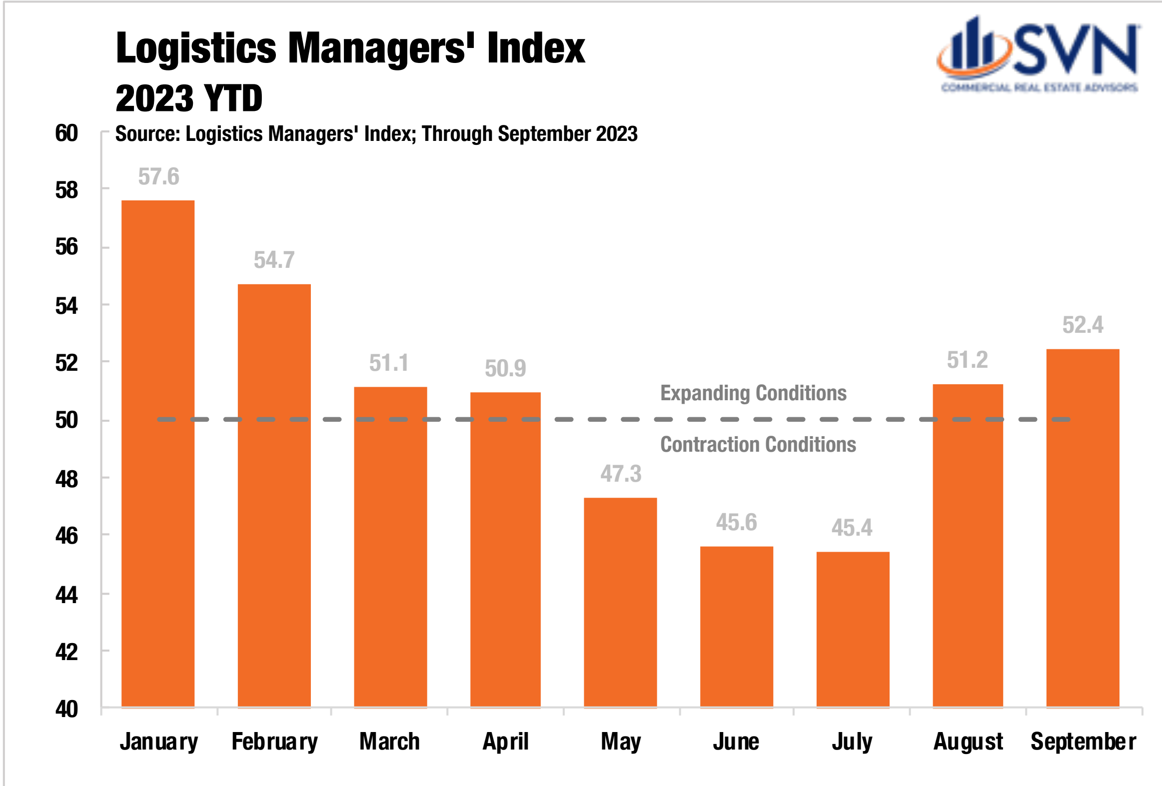
Nonetheless, a supply-demand imbalance in residential markets continues to favor investors. According to ATTOM's recent update of its Home Affordability Index, affordability fell in 99% of counties tracked nationwide, extending a two-year trend of declining home affordability. As mortgage rates remain entrenched at generationally high levels, rental markets will likely remain more active than buying markets.

Industrial Might

During the pandemic-upswing in commercial real estate prices, the Industrial sector outperformed the rest, driven by a seismic shift in consumer spending towards goods and away from services.

On the downswing, Industrial continues to stand out. In August, sector prices fell just 1.9% annually and -0.1% month-over-month.

Recent developments in warehousing and logistics activity back the trends seen in industrial price performance. According to the September 2023 update of the Logistics Managers' Index, warehouse capacity, utilization, and prices have each expanded in consecutive months.



Further, a recent report by UBS referenced the **Industrial and residential market as the most robust CRE investment opportunity in the near term.** Warehousing and Logistics generally experience a seasonal expansion during the 4th quarter as the holiday season takes off, suggesting a continuation of robust performance for the sector.

Conclusion

Recessions are notoriously difficult to predict, and today's complex economic picture is proof of the perilousness of trying to do so. A key challenge adding to the outlook is that as the US economy continues to show signs of strength, Fed policymakers may be keener on keeping their foot on the pedal, reinforcing recession fears. Despite this nail-biting feedback loop, the dominoes of our economy appear to be gradually turning rather than falling one by one.

Equity markets have seen vibrance but have remained nuanced in the face of "good" economic news. Consumers are skeptical but, on average, remain confident enough in their fundamental circumstances to continue to spend. Businesses remain cautious, but hiring efforts remain robust, with labor force participation increasing in recent months as a result. **Meanwhile, as commercial real estate weathers a few storms, expertise and innovation remain the industry's great counterbalance.**

Overall, Federal Reserve policymakers have a lot to take in, but to their credit, they appear committed to letting data lead policy, guided by their patient and critical eye. Perhaps, in the end, enough discussion of a soft landing will contribute to its realization — a classic example of a self-fulfilling prophecy. If only all of economic policymaking was as straightforward.

About SVN®

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