Real Estate Capital USA

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NEWS & ANALYSIS

BGO's Severino sees brighter outlook after uptick in Q1 activity

The interest rate outlook is still critical to the recovery of commercial real estate.

The US commercial real estate market is expecting to see more activity after a year of consecutive rate hikes and muted transactions as the bid-ask spread continues to narrow down and the clarity over valuations is increasing, said Ryan Severino, chief economist and head of US research at Miami-based manager BGO.

In Q1 2024, the market sentiment has improved in both interest and ability in transacting in the commercial real estate space.

"It's a relative improvement. I don't want to overstate it, but it certainly seems like things are more optimistic than they've been in the last couple of years," Severino said.

Still, Severino said market participants set their projections on interest rates based on the relatively benign inflation data seen recently. That bet could be ahead of the curve compared to what the Federal Reserve has hinted for months and what was stated in chairman Jerome Powell's commentary this week in which he underscored that the central bank is not ready to walk back rates yet.

"I do think that optimism is there and that we will see more momentum as we push farther into the year. But I still feel comfortable that [rate cuts] are more of a second-half phenomenon than the first-half phenomenon," Severino added.

Sector outlook

While some commercial real estate sectors were painted in broad strokes during market downturns, Severino said the outlook on property types still depends on the underlying fundamentals and specific analysis of individual properties.

Among major property types, Severino noted retail has been holding up well and has seen a rare vacancy rate decline across 2023.

The sector finished 2023 with a 4 percent national vacancy rate – a new all-time low – while each of the other major sectors endured a vacancy rate increase, according to data from Washington, DC-based market intelligence provider CoStar.

After the global financial crisis, retail was left as one of the least favorite sectors for investors due to falling valuations and excessive inventory. Investors believed the sector was overbuilt and under-demolished, with markets being oversupplied while some retail properties became obsolete over time.

Severino said the narrative of retail has shifted in recent years.

"As we right-size the inventory, what's happened is that the dominant space that retailers like is pretty much non-existent in terms of vacancy. Anything new that gets developed tends to get leased up quickly because retailers recognize that it's an attractive space," Severino said.

He added that though mall development in the US has declined, more selective spaces – including smaller retail centers, lifestyle centers and neighborhood centers – are still being built, with new and attractive spaces staying well leased.

Similarly, the right-sizing of inventory that occurred in retail over the last decade is probably going to happen to office in today's market, Severino noted.

Last year saw the largest and fifth consecutive calendar-year increase in the office vacancy rate, which has been rising to a new record high of 13.4 percent, according to CoStar. Still, Severino said the overall headwind seen in the sector doesn't necessarily speak to the leasing status of newer and higher-quality office assets.

"Demand is not stuck for office. As we continue to grow the economy, and as employment increases, we will continue to generate jobs that are at least traditionally considered office-using employment, [such as jobs in] financial services, business and professional services, and technology," Severino said.

In other words, right-sizing office inventory doesn't mean the demand won't expand. "It just means demand is going to expand into a different inventory environment than what we've experienced through most of the office's history," Severino added.

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Transaction volume

As for the pace of market recovery, Severino said the market pulse is still heavily dependent on when and where interest rates will go down.

"If we somehow ended up in the year and the Federal Reserve hasn't done anything, then I think all bets on capital markets are off, because [the market] is so interest rate-dependent right now," he said.

Having said that, Severino believes the good side is that the underlying fundamentals and the economic environment are supportive. If the interest rate environment is heading in a direction that's in favor of investors, it can make a good combination of market incentives that push commercial real estate to recover through booming transactions, he noted.

"The last time we had that combination of factors, it was a good market environment for commercial real estate. I'm not saying we're going to get exactly a repeat of that, but if history is any guide, that was a pretty powerful combination of forces," said Severino.

What he noted of driving forces included interest rates coming down, the economy reaccelerating after recessions and market fundamentals such as rents, leasing, construction and absorption improving.

"If we can resynchronize cycles together, that could be incredibly powerful for commercial real estate investment over the next four or five years," he added.

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