Investor Sentiment Rises on Heels of Interest Rate Drop

Stability of real estate favored amid financial market volatility

By Beth Mattson-Teig

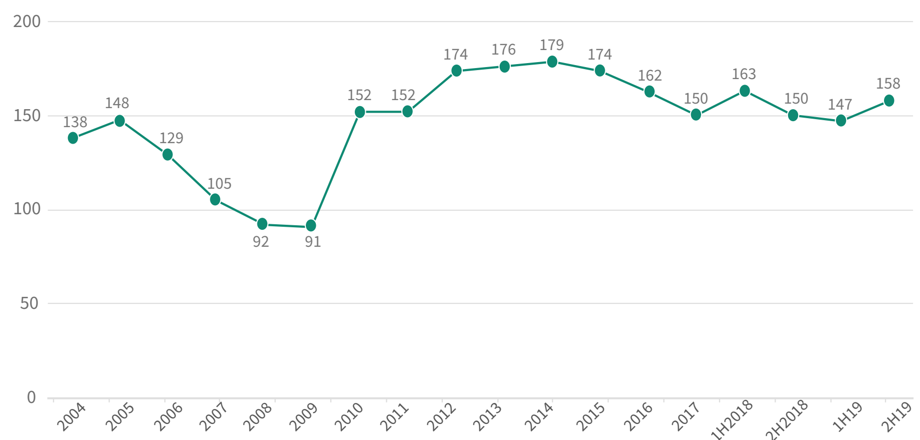
The sharp drop in interest rates together with strong capital market liquidity has fueled the near-term outlook for commercial real estate. Exclusive results of the latest NREI / Marcus & Millichap Investor Sentiment Survey show that the Investor Sentiment Index climbed from 147 early in the year to 158 in the latest second half survey [Figure 1].

The Sentiment Index reflects investor expectations for property value appreciation and overall plans to buy, hold or sell property in the coming year. Current levels point to a solid outlook for the commercial real estate industry. Although survey respondents expressed lingering uncertainty regarding the economic outlook, the Sentiment Index has rebounded to a level approaching the 163 in first quarter 2018 when confidence moved higher on the heels of tax reform. Survey results indicate that tax reform is continuing to create some positive ripple effects on investor activity. "Tax reform provided a bump to sentiment last year, and we're starting to see that play out," says John Chang, senior vice president of research services at Marcus & Millichap. The new tax law has sparked activity, with 22 percent of respondents saying they have bought property in the last 12 months and/or plan to buy property in the next 12 months primarily because of the favorable provisions in the new tax laws.

FIGURE 1 **INVESTOR SENTIMENT INDEX**

Investor sentiment in the second half of 2019 moves higher in wake of falling interest rates.

*The Q3 survey reflects a change in that land and mixed-use property types were eliminated and seniors housing and self-storage were added to the survey. Data analysis shows that the change did not substantively alter the results of the Sentiment Index.



Consistent with previous surveys, respondents continue to agree that commercial real estate offers favorable returns to other investment classes and that they have an abundance of capital ready to invest. Overall, a majority of respondents (61 percent) plan to increase their commercial real estate investment in the next 12 months, while 31 percent expect no change and 8 percent intend to decrease their real estate holdings over the next year. Among respondents who plan to grow portfolios, the amount of increase averages 22 percent [Figure 2].

Survey results also show that respondents are slightly more bullish compared to early in the year when 58 percent said they planned to add to portfolios.

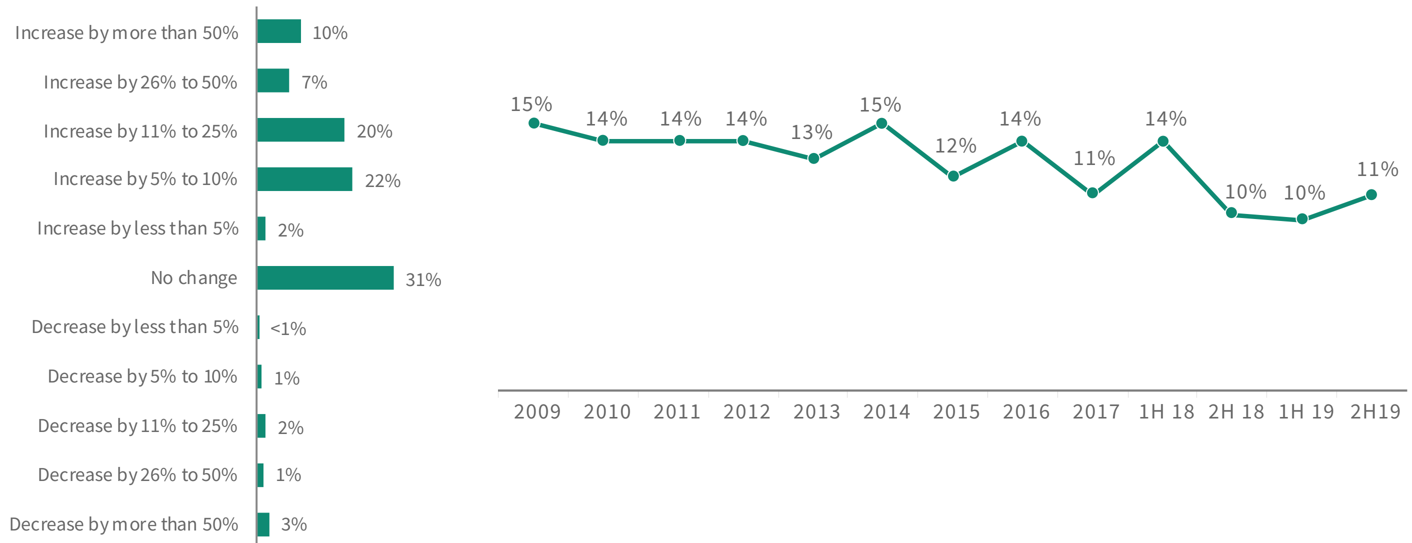
Investors enjoy good liquidity

Respondents were polled during the first half of August. That timing was excellent for getting a read on current sentiment as it was immediately after the Fed rate reduction and in the midst of escalation of the trade war between the U.S. and China, notes Chang. The 10-year treasury had dropped to 1.55

FIGURE 2 **CHANGE IN REAL ESTATE HOLDINGS**

Respondents plan to increase their real estate investments by an average 11%.

The majority of respondents (61%) plan to increase their commercial real estate investment in the next 12 months. An additional 31% expect investments to remain the same. Eight percent of respondents expect their real estate portfolio to decrease over the next year. Among respondents who expect their real estate investment to increase, an average 22% increase is predicted.



percent by the time the survey closed in mid-August, which was approaching the lowest level since the 10-year reached a similar record low in 2016. The 10-year has since dropped further to start September in the 1.45 percent range. Given that backdrop, it is no surprise that investor expectations on interest rates have changed dramatically compared to previous surveys.

Respondents now have mixed views on how interest rates are likely to move in the coming 12 months. Thirty-nine percent believe rates will drop further over the next 12 months as compared to 34 percent who expect no change and 26 percent who think rates will rise. Those results are a sharp contrast to the first quarter survey when 77 percent were predicting an increase in rates and only 3 percent thought rates would fall. Even with the decline in rates that has already occurred, more investors expect rates to fall rather than rise.

"This really ties to the uncertainty surrounding the outlook for the U.S. economy and the impact of the trade war on financial markets. There was a flight to safety that drove down interest rates," says David Shillington, president of Marcus & Millichap Capital Corp. "We're seeing this downward pressure on the cost of capital, which is pretty unique at this stage considering that the economic momentum is still so strong." There has been some tightening in lending on new development and value-add projects, while Fannie Mae and Freddie Mac have reset their multifamily lending plans with new lending limits. The broader capital market remains very active, adds Shillington.

Recession on the Horizon?

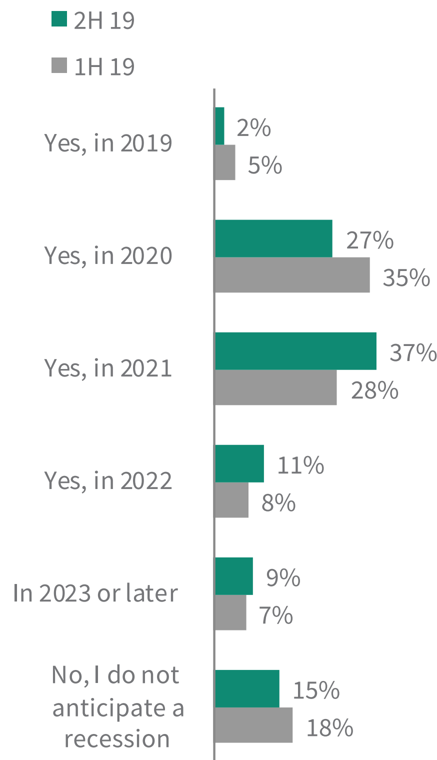
Survey results do reflect some contrasting views. On one hand, sentiment is rising due to the decline in interest rates, steady job creation, healthy consumer spending and strong underlying fundamentals. Unemployment is hovering near 3.7 percent and the country is on track to add 2 million jobs this year. The majority of respondents do not anticipate big changes in job growth for 2019. Eighty two percent of respondents expect job growth to be the same if not better than last year, while 18 percent said that job growth is more likely to decline. Respondents have lower expectations for job growth in 2020, with 34 percent predicting a decline.

On the other hand, investors do recognize some looming challenges ahead for the U.S. economy. Specifically, the top three concerns are political uncertainty / geopolitical issues (49 percent), unforeseen shocks to the economy (45 percent) and the state of the U.S. economy (39 percent). Views on a possible recession are similar to the first quarter survey. The majority of respondents (85 percent) believe the U.S. is likely to experience a recession sometime in the next few years, albeit one that is less severe than the 2008-2009 recession [**Figure 3**].

"It is by no means a foregone conclusion that we will hit a recession in the near future, but the risk of a recession has risen in recent months," says Chang. It's also interesting that expectations of a recession have pushed further into the future, he adds. In the current survey, 29 percent believe a recession could hit in 2019 or 2020, while 57 percent think a recession could occur in 2021 or later and 15 percent do not expect a recession. In comparison, 40 percent of respondents in the first quarter survey thought a

FIGURE 3 **EXPECTATIONS FOR RECESSION**

The majority of respondents expect the U.S. to experience a recession. However, views on when a recession could hit has moved further out in the future.



recession was more likely in 2019 or 2020.

The wild card to the current outlook for both the economy and interest rates is trade policy. "If there is a resolution to a trade war in the near future, then the risk of a recession will go down significantly and interest rates could rise fairly substantially, and the change would likely happen relatively fast," says Chang. If the trade war continues to escalate, the probability of a recession will rise over time, he adds.

Investors bullish on seniors housing, storage

One of the notable changes in the current survey is that questions were added to include seniors housing and self-storage property types, while land and mixed-use were removed. The change was a recognition of growing investor interest in those sectors, and the first data set on investor views shows that even those respondents who are not actively invested in the two sectors have a very positive opinion on near-term performance for both property types.

When respondents were asked whether it was a better time to buy, hold or sell properties across different property types, seniors housing rated the highest as being a good time to buy at 52 percent; followed by industrial at 36 percent; self-storage at 31 percent; apartments at 28 percent; office and retail each at 15 percent; and hotels at 10 percent. Views were consistent, although slightly higher, when the same question was asked only those investors who already own assets in a particular property type with seniors housing once again taking a commanding lead at 55 percent **[Figure 4]**.

Investors are attracted to the compelling demographics of an aging population that will spur demand for seniors housing. "When you look at the number of people turning 75 years old over the next ten years and the demand drivers for these types of properties, it is very significant," says Adam A. Lewis, vice president, national director of the Seniors Housing division. In addition, the pace of construction is not yet where it needs to be to accommodate that demand, Lewis adds. A majority of respondents (76 percent) believe that senior housing property values will rise in the coming year, while 21 percent expect no change and 3 percent think values could decline. Respondents also have a fairly lofty expectation that values will rise by 8.9 percent **[Figure 5]**. On a national basis, that is an aggressive estimate based on recent performance where rent growth has been achieving a mid-3 percent growth rate. However, it could be achievable in some local markets, notes Lewis.

Self-storage has undergone a dramatic transformation over the past decade, which has helped put the property type firmly on the radar for investors. People are using self-storage more as an off-site closet or storage locker for bulky active lifestyle items that they don't have room for in their apartments or homes, such as bikes, kayaks or other outdoor gear, notes Joel Deis, vice president, national director of the Self-Storage division. Facilities themselves have evolved along with the growing demand to now offer higher quality, climate-controlled units with security and technology that give renters 24-hour access.

"A significant volume of development has come online over the last few years which is creating pockets of oversupply, but on a macro level occupancy has stayed relatively stable," says Deis. Marcus & Millichap is forecasting a slight uptick in vacancy this year to 9.9 percent. Among survey respondents, 58 percent expect values to rise in the coming year, 37 percent believe values will remain the same and 5 percent think values might decline. The average increase expected is 4.3 percent.

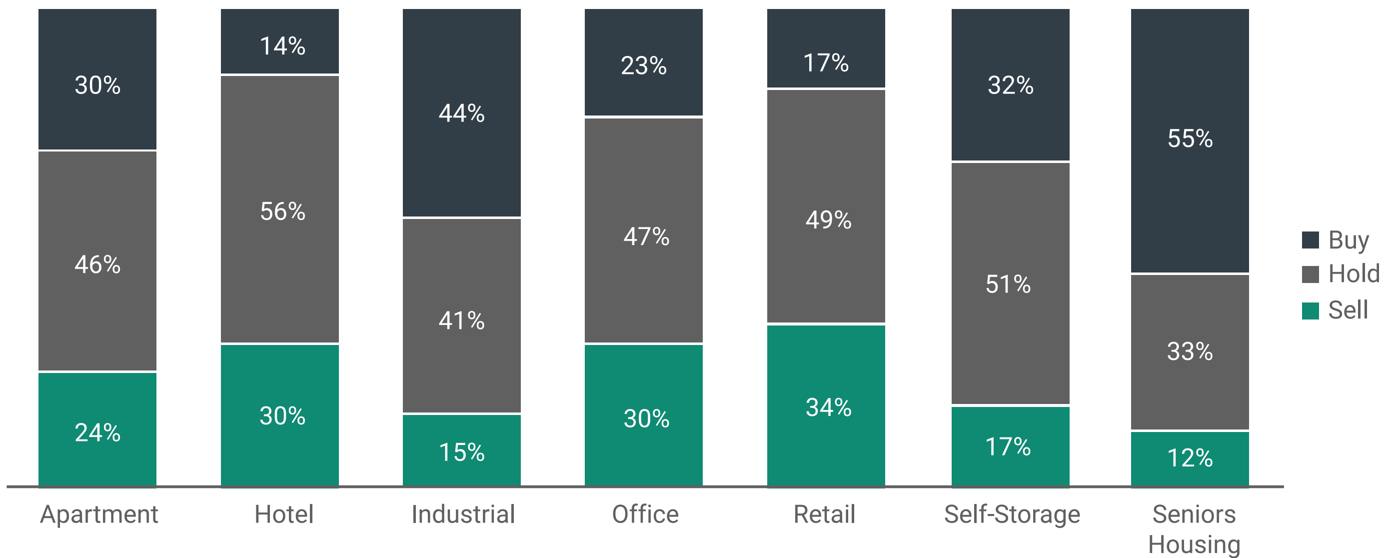
Apartments maintain momentum

Despite a robust development pipeline, multifamily continues to sustain its momentum. In fact, apartment owners are slightly more bullish on improving values as compared to the previous survey. Sixty two percent of respondents expect values to rise over the next 12 months by an average of 3.7 percent. That is higher compared to the first quarter survey where 56 percent were predicting an average increase of just 2.2 percent.

The apartment sector posted record high absorption in the second quarter thanks to a combination of factors that include a high level of completions, strong demand coming from a well-rounded renter pool and accelerated growth in new household formations, notes John S. Sebree, first vice president, national director of the Multi-Housing division at Marcus & Millichap. The nearly 1.4 million new households that are expected to form in 2019 is outpacing housing construction. The 2019 forecast for new apartment unit completions is 315,000 and 885,000 for single-family homes.

FIGURE 4 **BUY, HOLD, SELL INVESTORS**

Respondents invested in apartment, industrial, self-storage, and seniors housing are more likely to consider now the time to buy than sell. Hotel, office and retail investors are more likely to consider now the time to sell.



Views on apartments remain fairly consistent with the first quarter survey. Nearly half of apartment owners (46 percent) believe it is a better time to hold, while the other half are split on whether it is a better time to buy or sell. Thirty percent said it is a better time to buy, and 24 percent think it is a good time to sell. "We are seeing more investors who are considering taking some chips off the table given the significant appreciation of recent years, and we also are seeing more momentum on diversification strategies," says Sebree. This combination has supported market liquidity while elevating the capital flows into secondary and tertiary markets as investors hunt for value creation opportunities across the country, he adds.

Weighing the e-commerce effect

Industrial and retail are increasingly on two sides of the same coin these days with fates that are linked by e-commerce. The industrial market continues to benefit from demand coming from growing online sales. Urban in-fill locations in particular are in high demand from both space occupiers and investors. Yet industrial has felt some of the effects from the trade war. "Since the trade war began to escalate, the pace of absorption of industrial space has started to ease from the hectic pace set last year," says Alan L. Pontius, senior vice president, national director of the Office & Industrial divisions of Marcus & Millichap.

Respondents continue to exhibit a strong appetite for industrial assets with 44 percent of industrial investors considering it to be a good time to buy more. Investors also have more confidence in performance outlook for the sector. Seventy percent believe values will rise in the coming year with an average increase of 4.5 percent, which is more bullish than the first quarter survey when 63 percent of respondents predicted values would rise by a more modest 1.2 percent. "Trade war risks could continue to soften the market a little bit, but performance remains exceptionally strong with industrial rent growth outpacing every other property type," says Pontius.

Retail remains hampered by negative perceptions surrounding announcements of store closings, and retail property owners continue to exhibit less desire to increase holdings. Eighty three percent believe it is a better time to hold or sell versus 17 percent who said it is a good time to buy more. That said, respondents are slightly more confident in rising values with 33 percent who think values will rise in the coming year as compared to 28 percent who anticipated higher values in the first quarter survey. The average increase in values expected over the next year is slight at 0.4 percent.

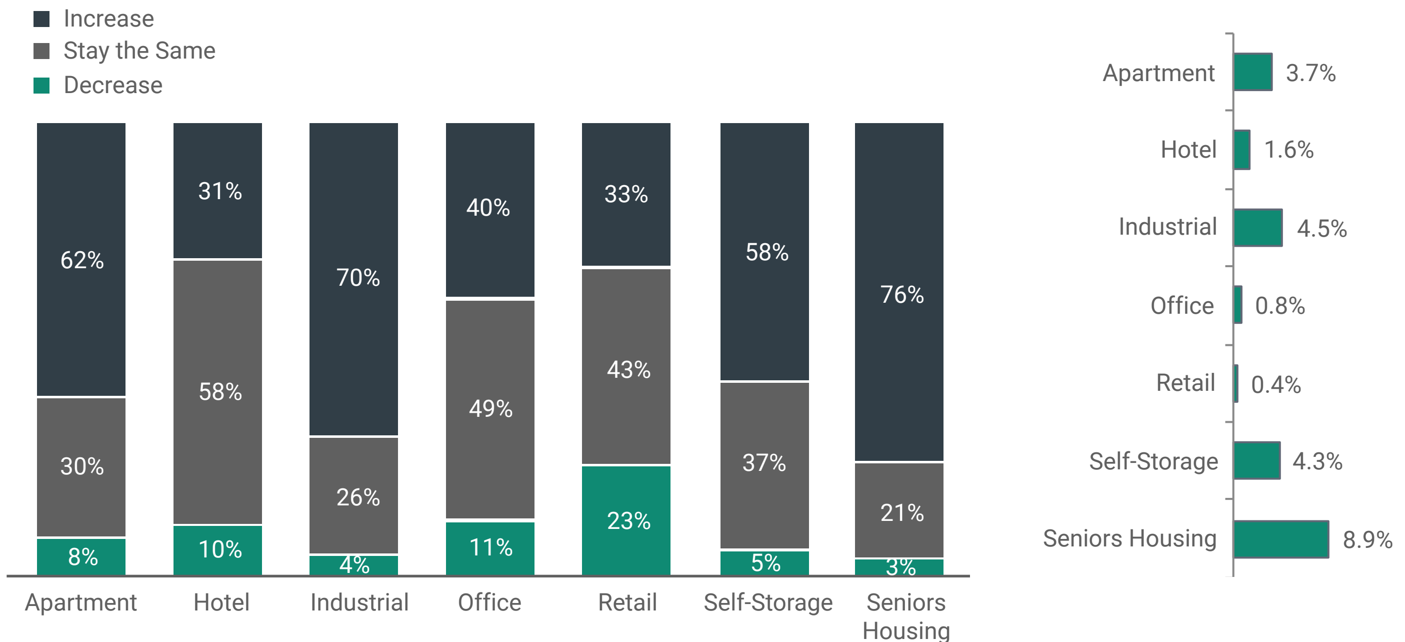
The positive story in retail is the reinvention occurring with more entertainment, food & beverage and also digitally native companies that are creating a brick-and-mortar strategy, says Scott Holmes, senior vice president, national director of the Retail and Net Leased Properties divisions of Marcus & Millichap. "When you look at the fundamentals, they continue to outpace expectations, both from a rent growth and vacancy rate standpoint," he adds. Marcus & Millichap's retail forecast for 2019 is that vacancies will tick up slightly to 4.9 percent with moderate rent growth of 2.1 percent.

Suburban office is gaining momentum

Office investors remain fairly consistent in their views on investment strategy and valuations. Forty seven percent said it is a better time to hold, 23 percent believe it is better to buy and

FIGURE 5 **PROPERTY VALUES**

A majority of investors in apartments, industrial, self-storage, and seniors housing properties expect the value of properties in their portfolio to increase 12 months from now. Seniors Housing values are expected to increase the most



another 30 percent think it is a good time to sell. Although 49 percent anticipate no change in values, 40 percent think values will rise, which is slightly more optimistic than the 34 percent who predicted rising values in the first quarter survey. The average increase remained the same at 0.8 percent over the next 12 months.

Office performance has been really stable over the last several years. Vacancies that have been edging slightly lower are expected to end the year at 13.1 percent with sustainable rent growth that has been between 2.1-2.5 percent, according to Marcus & Millichap. "We're continuing to see momentum strengthen in suburban office," says Pontius. Suburban office fell out of favor following the last recession but it's making a comeback as millennials age into their 30's and consider lifestyle transitions including marriage and family creation that favor a suburban lifestyle. Companies have noticed that shift, and they are making location decisions to attract employees in this tight labor market, he adds.

Stellar hotel performance counterbalanced by caution

Survey results show a growing dichotomy in the hotel sector. "The performance metrics of hotels are fantastic. All the indicators continue to point to continued positive momentum, but investors also know that hotels can be very vulnerable to a recession or an economic downturn," says Skyler G. Cooper, national director of Marcus & Millichap's Hospitality division.

Data through July puts average occupancy levels at 66.3 percent, while 12-month trailing RevPAR of $86.61 and ADR of $130.70 are growing at a rate of 1.7 percent. Generally, investors believe hotel values will remain relatively stable in the coming year. Fifty eight percent anticipate no change, 31 percent said values are more likely to rise and 10 percent think values will decline. The average expected increase of 1.6 percent is slighter higher than the first quarter survey where respondents predicted a 1.0 percent rise in values.

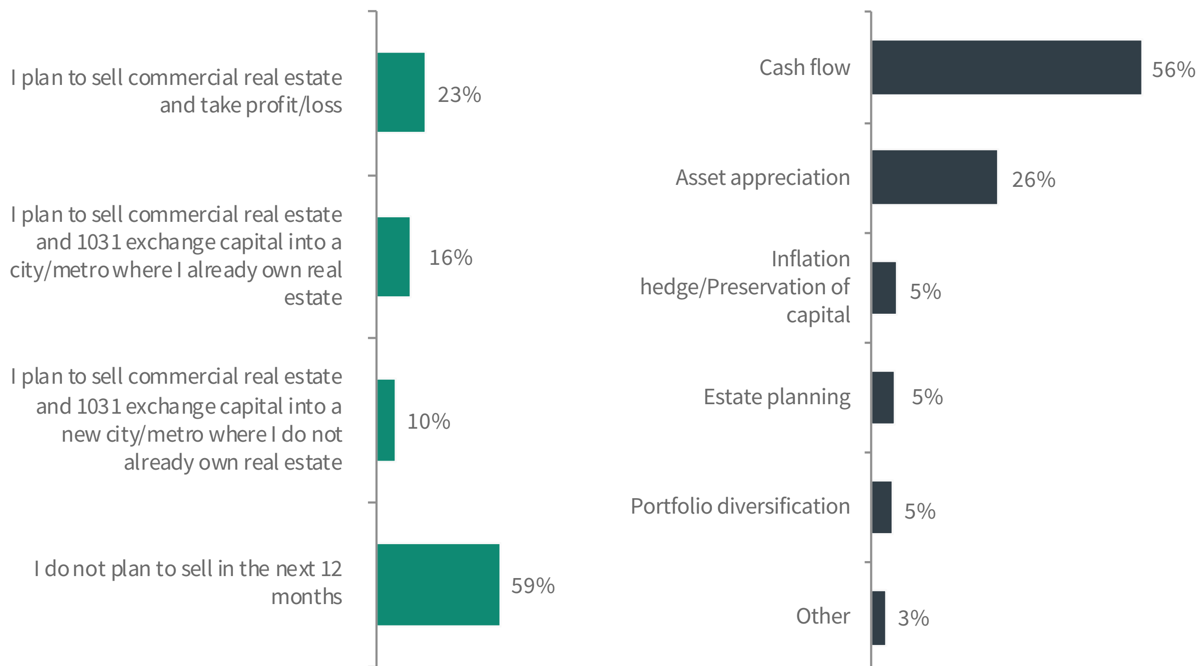
Concerns about recession risk or slower economic growth ahead is likely weighing on investment strategies. There is a clear trend in hotels that shows diminished investor appetite to buy hotels. Fourteen percent of investors think it is a good time to buy more, while 56 percent said it is better to hold and 30 percent believe it is better to sell.

Investors recalibrate portfolios

Overall, investor sentiment remains positive and the comparative stability of the sector is attractive considering recent financial market volatility. At the same time, respondents are keeping a careful eye on trade policy and what that might mean for the economy and commercial real estate fundamentals. "The outlook really hinges on how trade relations with China play out. If there is a resolution in the short term, then we could see the duration of the growth cycle extend, but that would likely come with rising interest rates," says Chang. "If trade tensions continue to escalate or drag on, then the risk of an economic slowdown rises and interest rates will likely stay low."

FIGURE 6 **INVESTMENT STRATEGY**

Although the majority of respondents do not plan to sell in the next 12 months, some investors see an opportunity to realize gains and/or diversify portfolios. Cash flow is the top priority in investment strategies.



Investors also are taking current conditions into account as they refine investment strategies. Respondents said their top two investment priorities are cash flow at 56 percent and asset appreciation at 26 percent. Generally, most investors (59 percent) plan to hold onto assets in the coming year. However, 23 percent plan to sell and take a profit or loss; 16 percent plan to sell and 1031 exchange into a metro where they already own property; and 10 percent plan to sell and exchange into a new market **[Figure 6].**

"Regardless of the outcome on trade policy, demand for real estate will remain substantial," says Chang. "Investors have the unique opportunity to refine their position ahead of the next cycle. There still appears to be some runway to recalibrate investment strategies and maximize returns through a potential down cycle then catch the rise into the next growth cycle beyond that."

Survey Methodology

National Real Estate Investor's research unit, Informa Engage, and Marcus & Millichap emailed invitations to participate in this online survey to public and private investors and developers of commercial real estate. Recipients of the survey included Marcus & Millichap clients as well as subscribers of NREI selected from commercial real estate investor, pension fund, and developer business subscribers who provided their email addresses. The survey was conducted between July 30 and Aug. 17 with 545 completed surveys received. Survey respondents represent a broad cross-section of industry respondents that include private investors, developers, advisors, lenders and REITs among others. The largest percentages of respondents are private investors at 39 percent, private partners at 16 percent and developers at 11 percent. Respondents are invested in a variety of property types with a majority of 71 percent invested in apartments, followed by office at 38 percent and retail at 35 percent. On average, respondents have $41.8 million invested in commercial and/or multifamily property.

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