ARA House View H1 2024

January 2024

U.S. Real Estate Investment Outlook

Higher Degree of Volatility Expected Going Forward Requires a Focus on Fundamentals and Operational Stability.

Macroeconomic Context

- Policy rates have peaked in our view given moderating demand and price growth.
- We still expect a mild recession in 2024; rate cuts expected in latter half of the year to reignite growth.
- Cyclical inflation is trending down, but structural factors could drive prices back up in the medium term.
- Rate cuts likely in the near term (12-18 months) but outlook for relatively higher rates and inflation mid- to longer-term (18-36 months); expect more frequent Fed intervention.

Real Estate Impacts

- We are beginning to see more attractively priced investment opportunities, a pipeline that is expected to grow in the near term.
- Decline in interest rates in H2 2024 would help restore real estate's risk premium and thaw the transaction market.
- Industrial and residential experiencing oversupply, but with new construction slowing down, we could see attractive opportunities to buy in late 2024/2025 and benefit from strengthening rent growth in 2026 once supply is absorbed.
- Office occupancy and rent growth bottom coming into view, but demand recovery timeline is less certain and structurally weaker.

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I. Macro Outlook

Growth and inflation trajectories may be bumpy:

- Inflation outlook: short-term cyclical downtrend in 2024 with medium-term structural upside risk beginning in 2025.
- Increased tradeoffs between inflation and GDP growth may lead to more ups and downs in the economy.

Expecting lower near-term inflation:

- Money supply has only dropped this much four other times in 150 years, each leading to deflation and higher unemployment.
- The pace at which the economy can grow continues to gradually decrease, which suggests less demand overall.
- Raw materials prices falling amid weakening global demand.

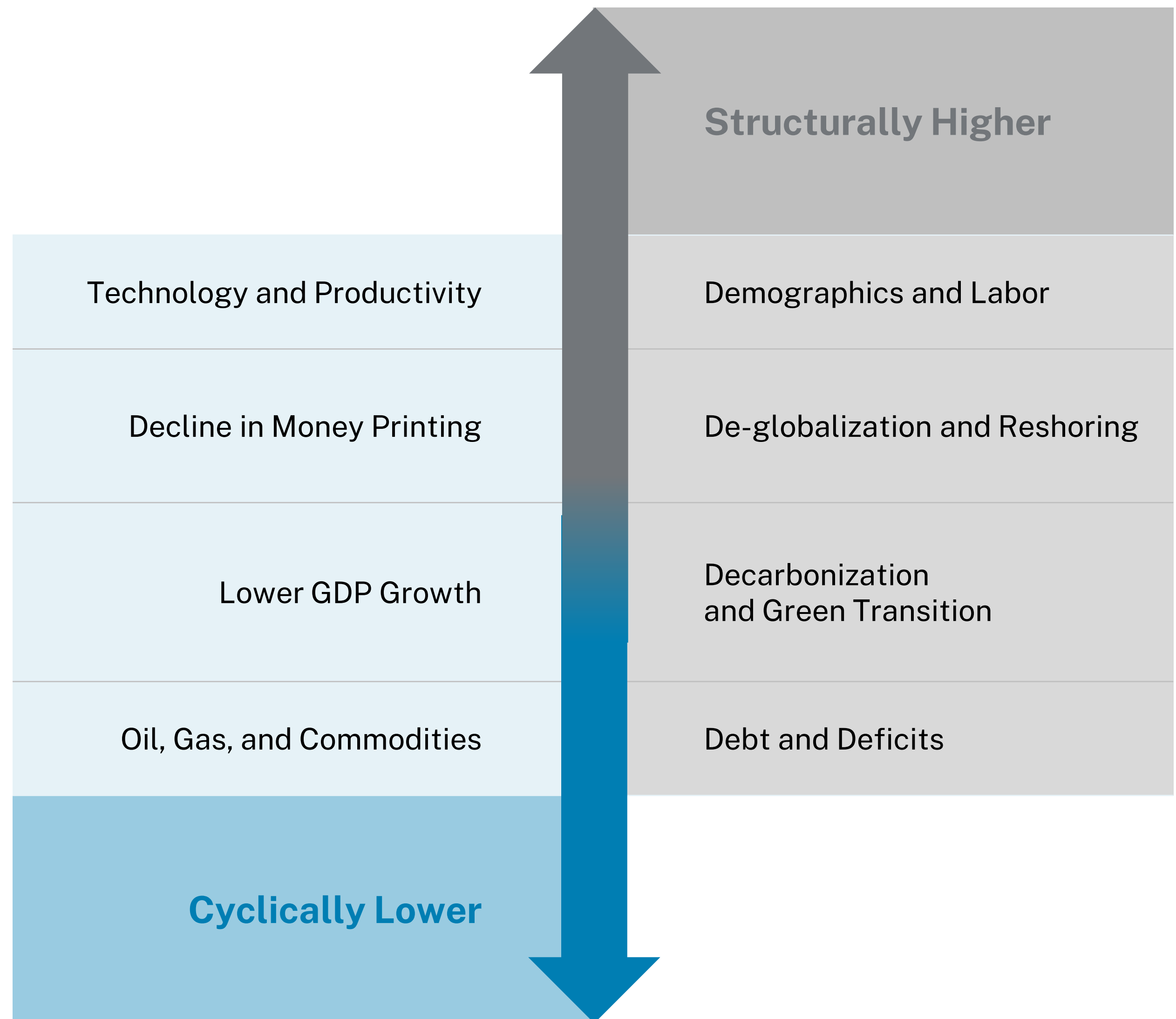
Higher medium-term inflation likely:

- Chronic labor undersupply suggests higher wages.
- Fracturing trade relationships are prompting companies to diversify supply chains, which could make products more expensive for consumers.
- Expiring government debt may need to be reissued at higher rates; fewer buyers could push bond prices down and set base interest rates higher.

Today's inflation dynamic may lead to the upcoming cycle being one of increased volatility.

Several factors are driving a short-term relief in inflation, but there is the potential for a resurgence that is being overlooked.

- Cyclical elements are likely to push inflation **down in 2024**, but structural forces may force it **higher heading into 2025**.
- Many are focused on what inflation coming down in the near term will be mean but not paying enough attention to how to navigate the second phase.



Source: American Realty Advisors as of November 2023.

Key Inflation Themes

1

Lower potential GDP growth, less money, and cheaper commodities are likely to push prices and interest rates down in 2024.

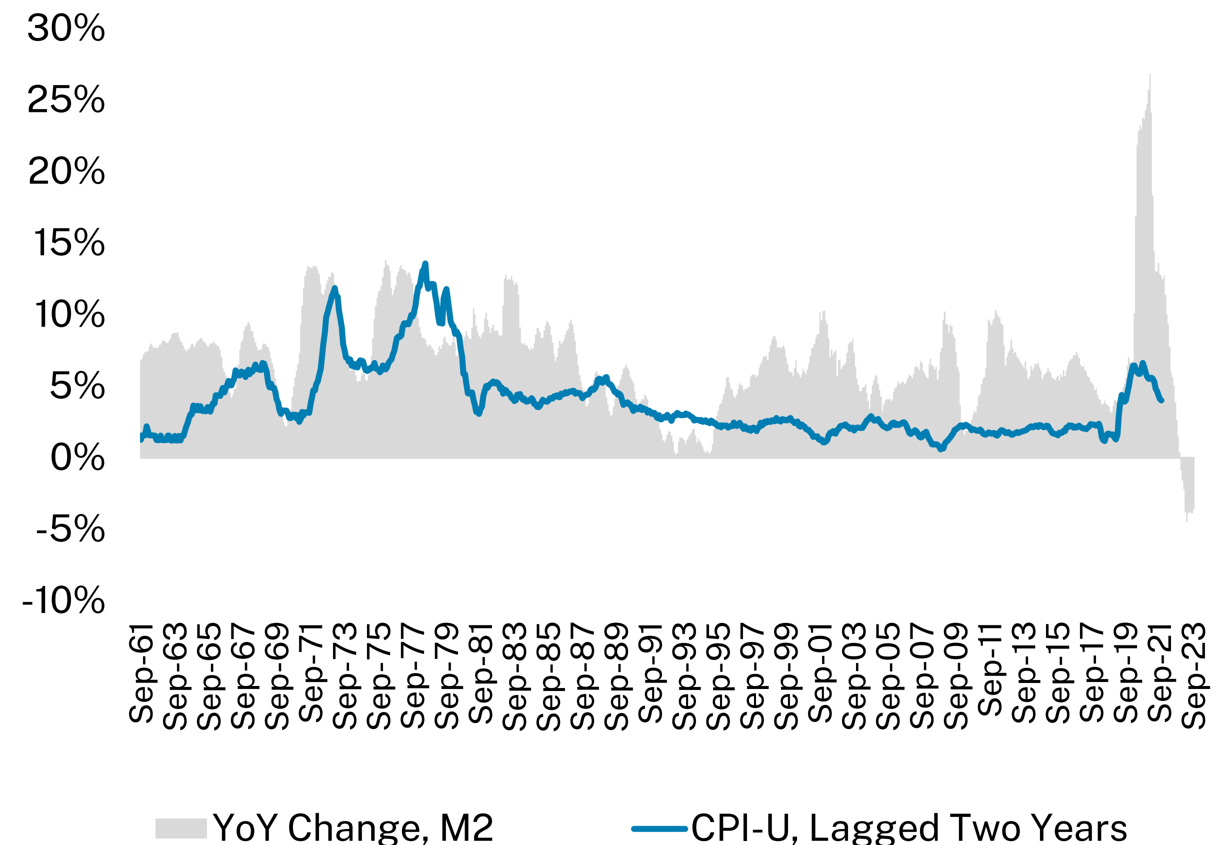
Source: American Realty Advisors as of November 2023.

A sharp drop in money supply points to falling demand and inflation, supporting rate cuts in the near term.

Less money in circulation means there are **fewer dollars to pay for higher-priced goods and services, reducing demand.**

- Changes in the amount of money available usually signals what will happen with inflation two years later – **it has been contracting for 10 months.**
- This may help the Fed to achieve a soft landing (disinflation without recession), but **there is a risk they may have already gone too far.**

Year-over-Year Change, Money Supply (M2) and Inflation Lagged Two Years



Source: American Realty Advisors based on data from Macrobond as of November 2023.

GDP growth has been weakening for decades, suggesting less demand.

Official projections from the Congressional Budget Office suggest potential **growth over the next 10 years will be lower than it has been on average over the last 30.**

Slower labor force and productivity growth means less demand for goods and services, which is deflationary.

Growth of Real Potential GDP and Components, 1950 – 2033p (%)

5
4
3
2
1
0

1950 - 1973
1974 - 1981
1982 - 1990
1991 - 2001
2002 - 2007
2008 - 2022
2023 - 2033p

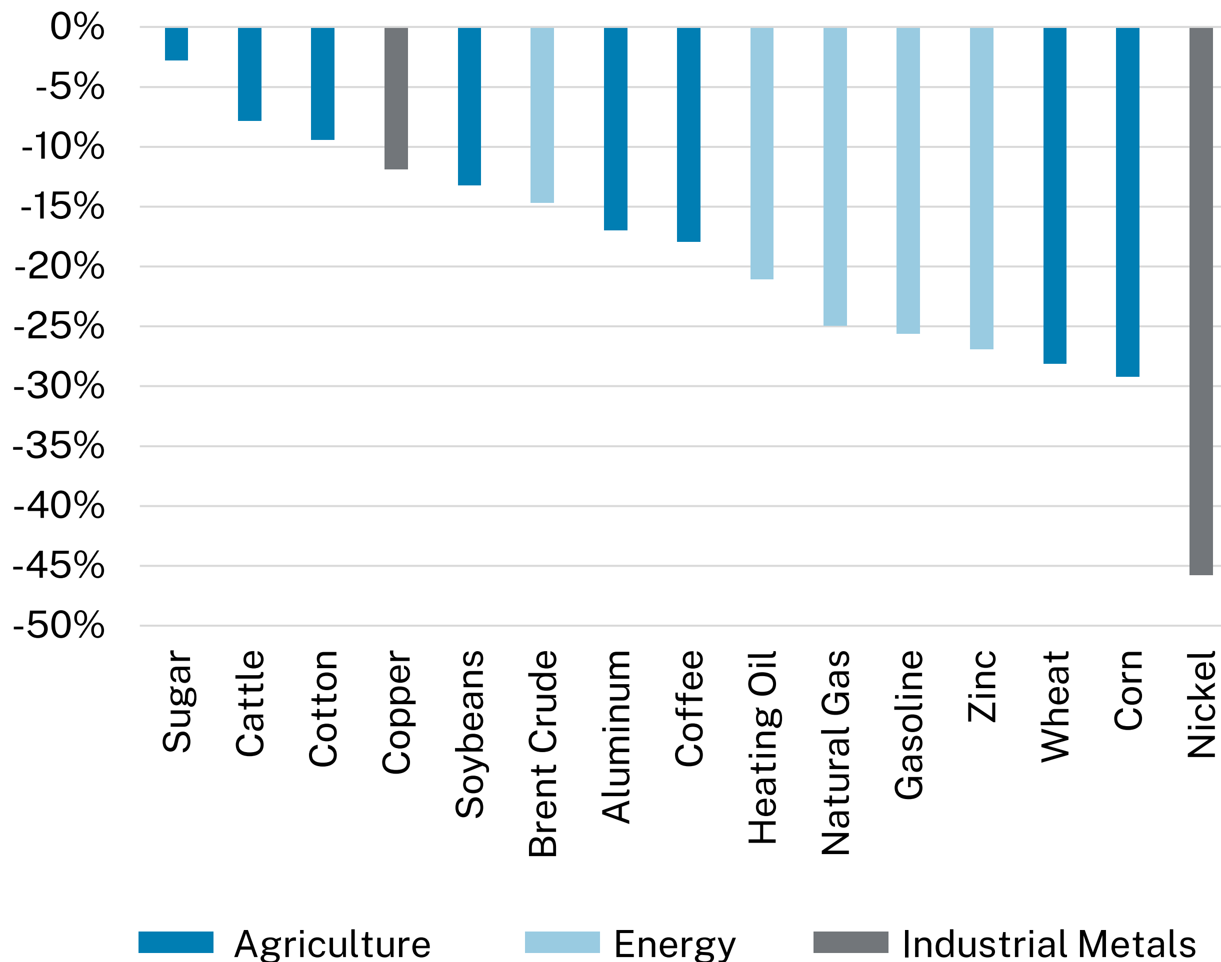
Potential Labor Force Productivity
Potential Labor Force

Note: p=projected.
Source: American Realty Advisors based on data from the Congressional Budget Office 30-Year Federal Budget Forecast dated November 2023.

Lower commodities prices suggest a cyclical easing of inflationary pressures.

Commodity prices reflect the health of the global economy; falling prices suggest tighter monetary policy is effectively reducing demand.

- A global economy flirting with recession drives **weaker demand for raw materials.**
- Cheaper commodities translates to lower prices to business and consumers, **which contributes to disinflation,** though commodity prices can move quickly**.**



Source: American Realty Advisors based on data from Macrobond and the S&P GSCI Commodity Index as of November 2023.

Key Inflation Themes

1

Lower potential GDP growth, less money, and cheaper commodities are likely to push prices and interest rates down in 2024.

2

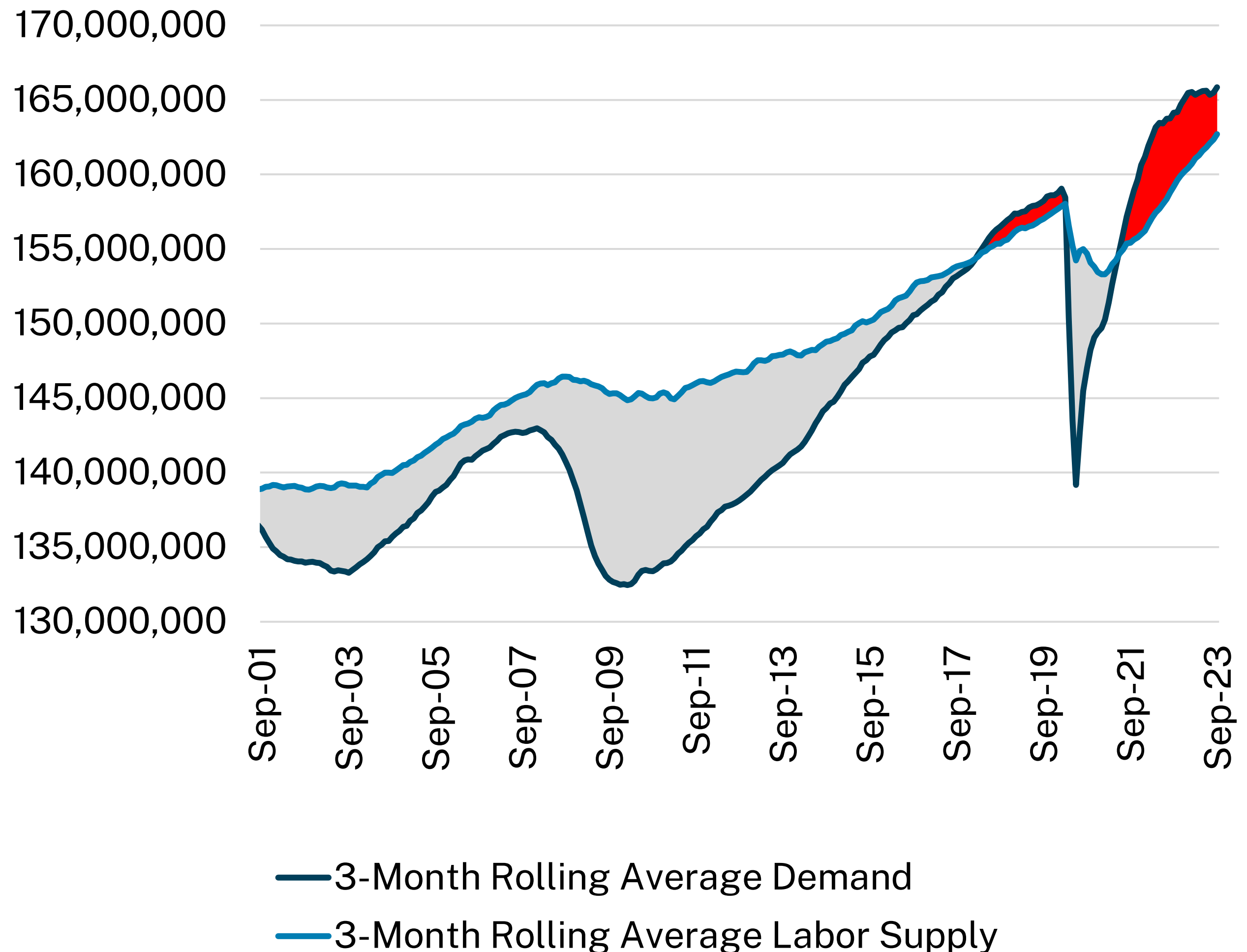
Lack of labor, geopolitical supply chain disruptions, and expiring government debt are poised to add upward pressure to prices and rates in 2025 and beyond.

Source: American Realty Advisors as of November 2023.

Growing labor tightness may lead to a “higher-for-longer” scenario.

Fewer workers means higher wages, which would serve to **keep rates more restrictive.**

- Backlogged immigration, an aging Baby Boomer population, below-replacement birth rates, and lack of family-friendly policies are all contributing to a shrinking working-age population**.**
- Although job openings are gradually softening, **labor demand still far exceeds supply**.



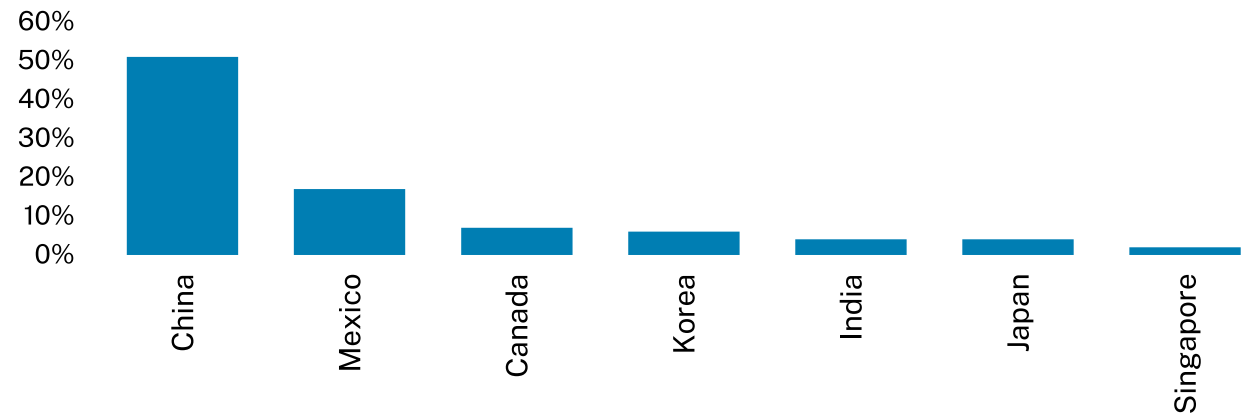
Source: American Realty Advisors based on data from the Bureau of Labor Statistics, FRED St. Louis and Macrobond as of November 2023.

Changing trade dynamics could reintroduce price pressures.

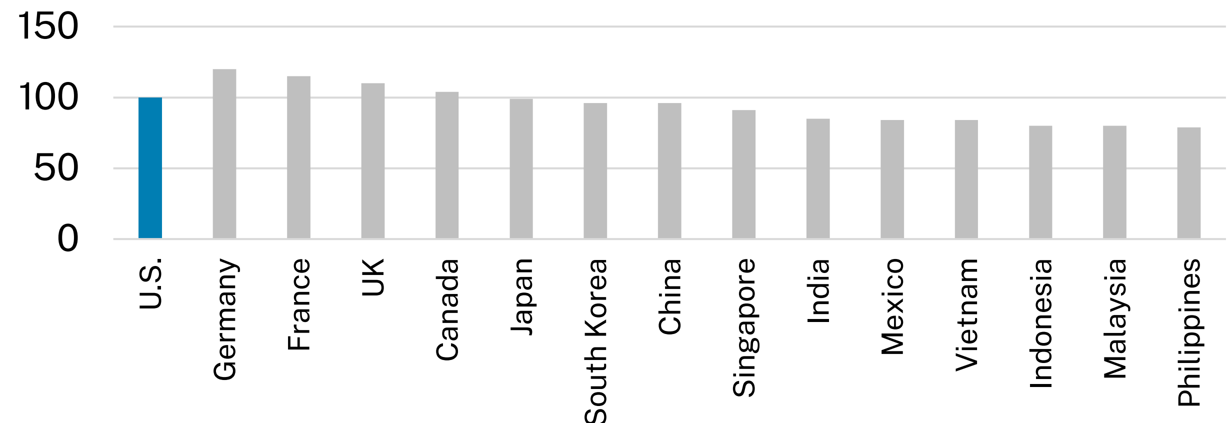
Diversifying supply chains could push prices up again and create mid-term inflation pressure.

- **Increased reshoring would be inflationary** given the tightness and cost of U.S. labor.
- Shifting to closer trading partners could also produce price increases as many friendly nations' costs are more expensive than China.

Share of Jobs Reshored to the U.S. by Country, 2010 – 2022



Cost of Manufacturing a Product and Shipping to U.S., 2022 (U.S. = 100)



Note: Cost includes logistics, productivity-adjusted labor, machinery, electricity, fuel and tariffs.

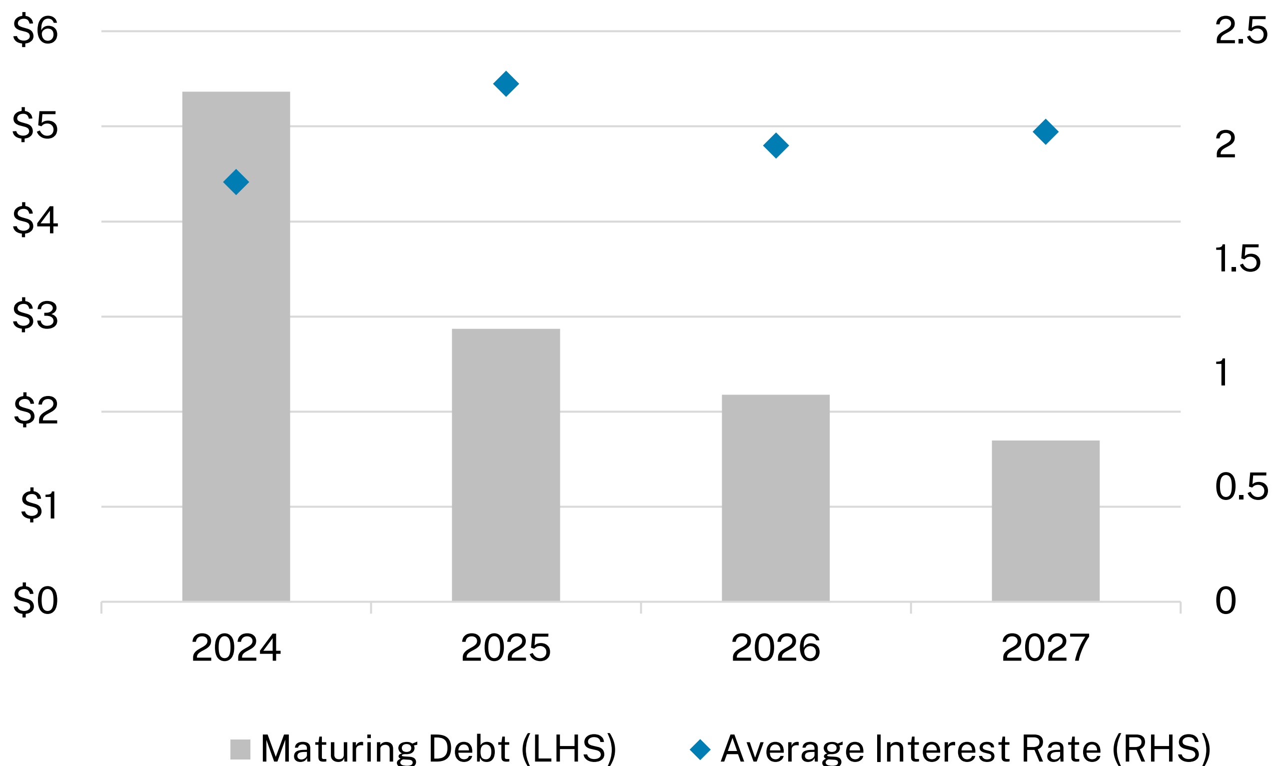
Source: American Realty Advisors based on data from Reshoring Initiative 2022 Data Report and Boston Consulting Group's BCG Global Manufacturing Cost Competitiveness Index dated September 2023.

Re-issuance of U.S. debt amidst weaker demand could keep base rates elevated in the mid- to longer-term.

Over the next two years, an estimated $8.2 trillion in government debt will reach maturity.

- This will necessitate the issuance of new bonds to repay those maturing.
- With fewer overseas investors buying these bonds, prices may drop (pushing yields up)**, leading to a new, higher baseline for interest rates.**

Marketable Government Debt Expiring Through Year-End 2027 (Trillions) and Average Interest Rate (%)



Note: $8.2 trillion in maturing government debts refers to amount outstanding on marketable Treasury Bills, Treasury Notes, TIPS, Treasury Bonds and Floating-Rate Notes expiring between December 1, 2023, and December 31, 2024.

Note: Expiring debt instrument values do not account for new issuances of shorter-duration debts that may be issued and mature over the course of the period shown.

Source: American Realty Advisors based on data from Fiscal Data Monthly Statement of the Public Debt of the United States dated October 31, 2023.

Key Inflation Themes

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Lower potential GDP growth, less money, and cheaper commodities are likely to push prices and interest rates down in 2024.

2

Lack of labor, geopolitical supply chain disruptions, and expiring government debt are poised to add upward pressure to prices and rates in 2025 and beyond.

3

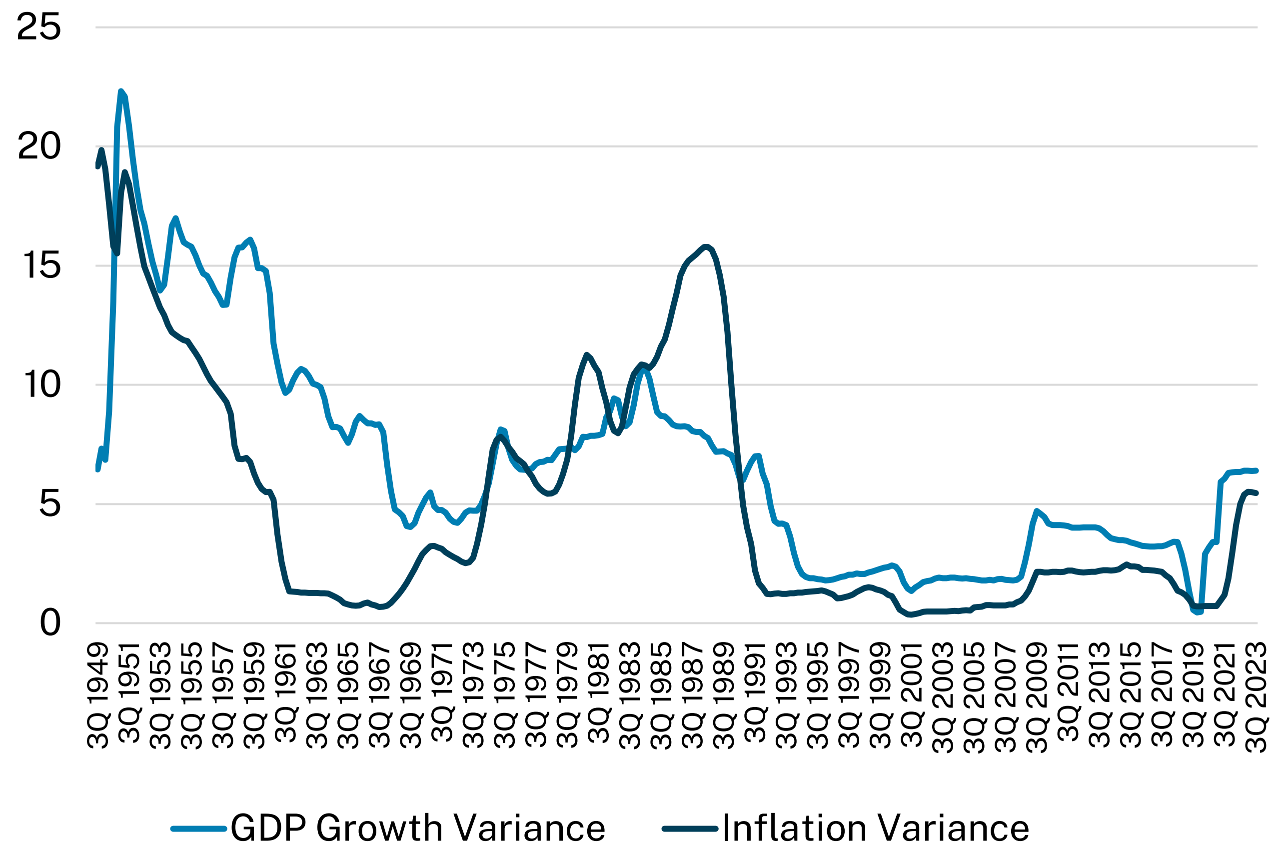
Expect more frequent Fed policy moves, both cuts and hikes, to keep inflation controlled while trying to balance against lower economic growth.

Source: American Realty Advisors as of November 2023.

Investors have grown used to prolonged periods of relative macroeconomic stability, which may be changing.

Geopolitical and structural shifts expected to increase macroeconomic volatility.

- The relative macroeconomic stability of the past 30 years appears to be coming to an end.
- Greater policy and growth volatility means there will likely be **more frequent ups and downs**; **long-term strategy and a focus on stability** is key.



Note: Variance refers to how much GDP growth and CPI inflation fluctuate from their mean over a 10-year period.
Source: American Realty Advisors based on data from Macrobond, the U.S. Bureau of Economic Analysis and U.S. Bureau of Labor Statistics as of November 2023.

Charting the inflation and economic path.

Near Term (12-18 Months)	• Inflation continues to moderate amid a contraction in credit and money. • Growth slows; a mild recession is still the base case for 2024. • First cut could be summer of 2024.
Mid-term (18-36 Months)	• Lower growth recovery. • Geopolitical developments, structural labor tightness, and green transition increase energy, labor, and output prices, and inflation resumes. • Interest rates remain above pre-pandemic levels.

Source: American Realty Advisors as of November 2023.

II. Capital Markets

Inflation and rate expectation tug-of-war:

- Consumers' mid-term views of inflation still above 2% target, may warrant an additional Fed rate hike to keep expectations firmly anchored.
- Bond market is pricing in no additional hikes and a first cut by March.
- Differing views between consumers, investors, and Fed are expected to add to near-term policy volatility.

Longer waits to easing, shorter shifts to tightening:

- It seems to be taking longer to pivot from hiking to easing; we don't expect first cut until the latter half of 2024 absent a material recession.
- Markets have enjoyed prolonged periods of Fed easing once it begins; we believe we could see shorter, more volatile, and more active Fed policy tooling this time around (less time between cuts and hikes).

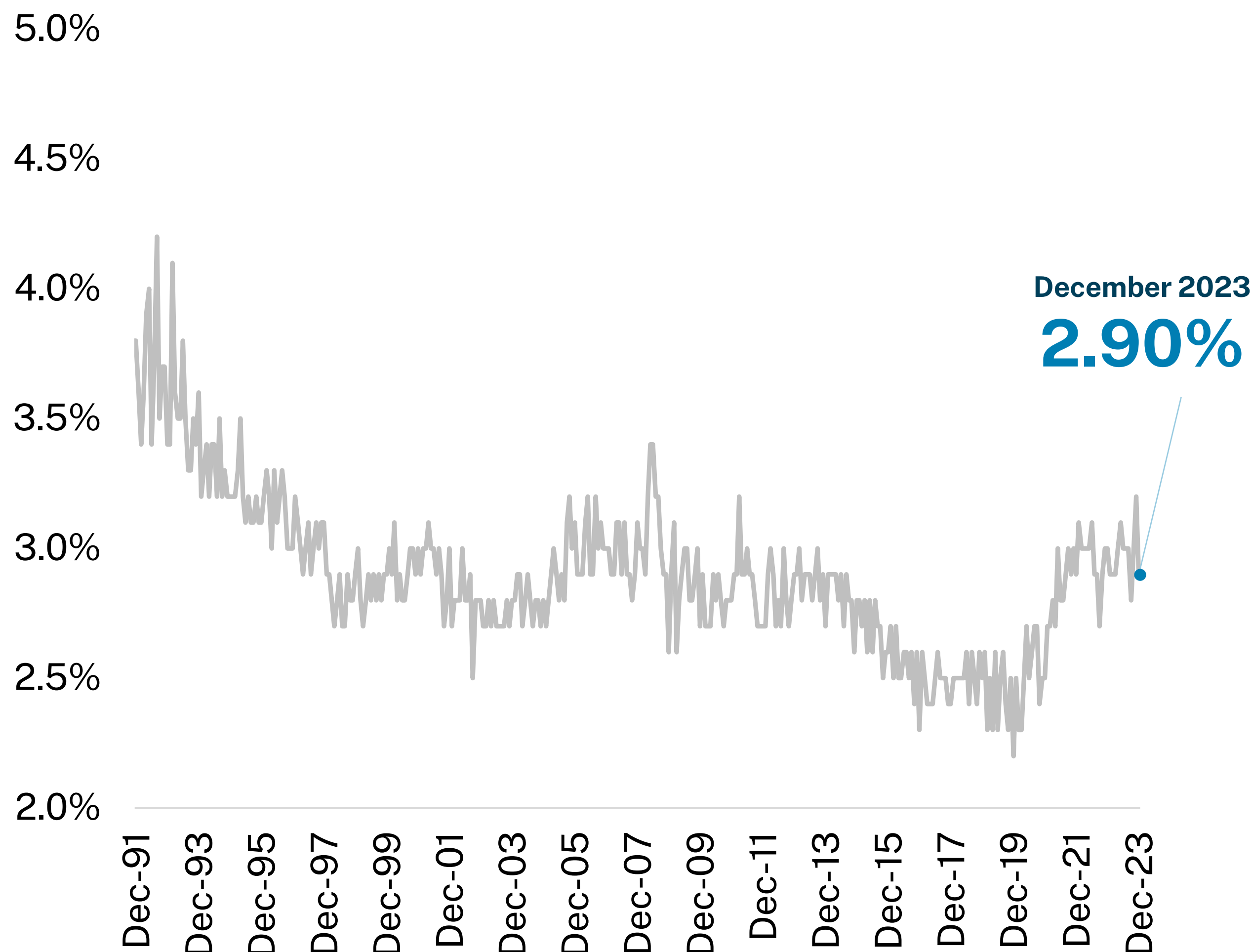
Real estate return perspectives from the peak:

- Real estate prices have fallen due to rising interest rates; while no property sector has been immune, office has suffered doubly from rates and weak post-pandemic fundamentals.
- Rate cuts could help restore the yield premium investors expect to receive from real estate.
- Annualized core returns tend overwhelmingly to be positive in the 1- and 2-year periods post-peak rates.

Consumers' outlook for higher inflation may necessitate an additional rate hike.

Medium-term inflation expectations are critical for Fed policymakers, as peoples' view of prices can influence spending behavior.

- Though not yet a cause for concern, the recent uptick in consumer expectations over the next five years suggests **consumers still do not anticipate inflation dropping below the 2% target.**
- There is a chance the Fed may elect to further tighten rates in the short term **to ensure expectations do not become unanchored** and lead to a wage-price spiral.



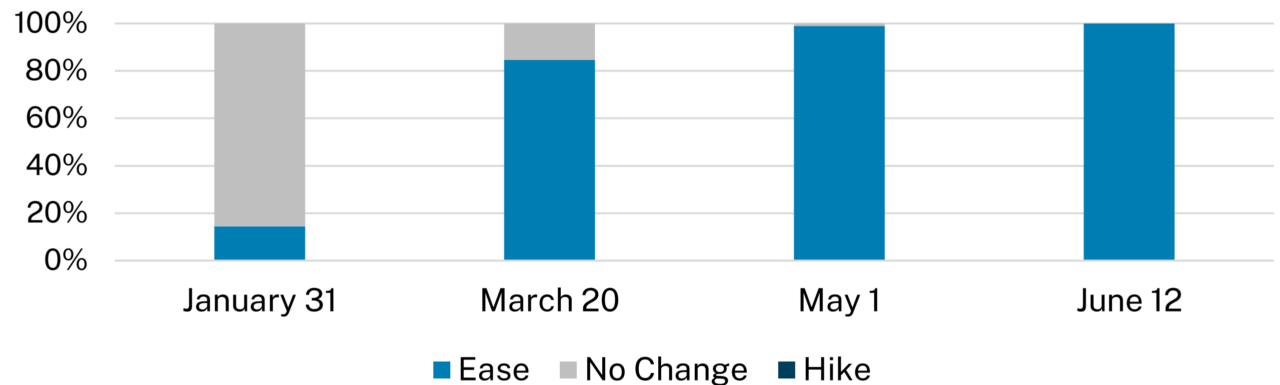
Source: American Realty Advisors based on data from Macrobond and the University of Michigan Consumer Sentiment Survey as of December 2023.

Bond market expectations of rate cuts may be getting ahead of the Fed.

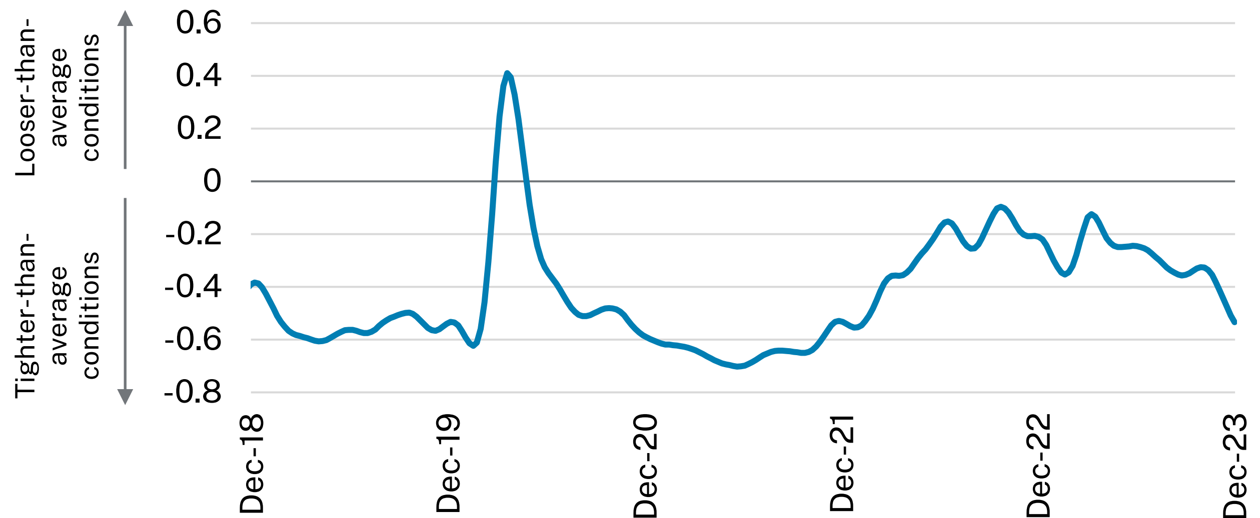
Bond investors are anticipating earlier rate cuts, risking conflict with Fed goals.

- Futures markets are pricing in an 85% likelihood that **the first rate cut will occur by March.**
- An overexuberant market has the effect of loosening financial conditions, which could complicate Fed efforts and result in **cuts being delayed.**

Rate Change Probabilities, Next Four Fed Meetings



National Financial Conditions Index

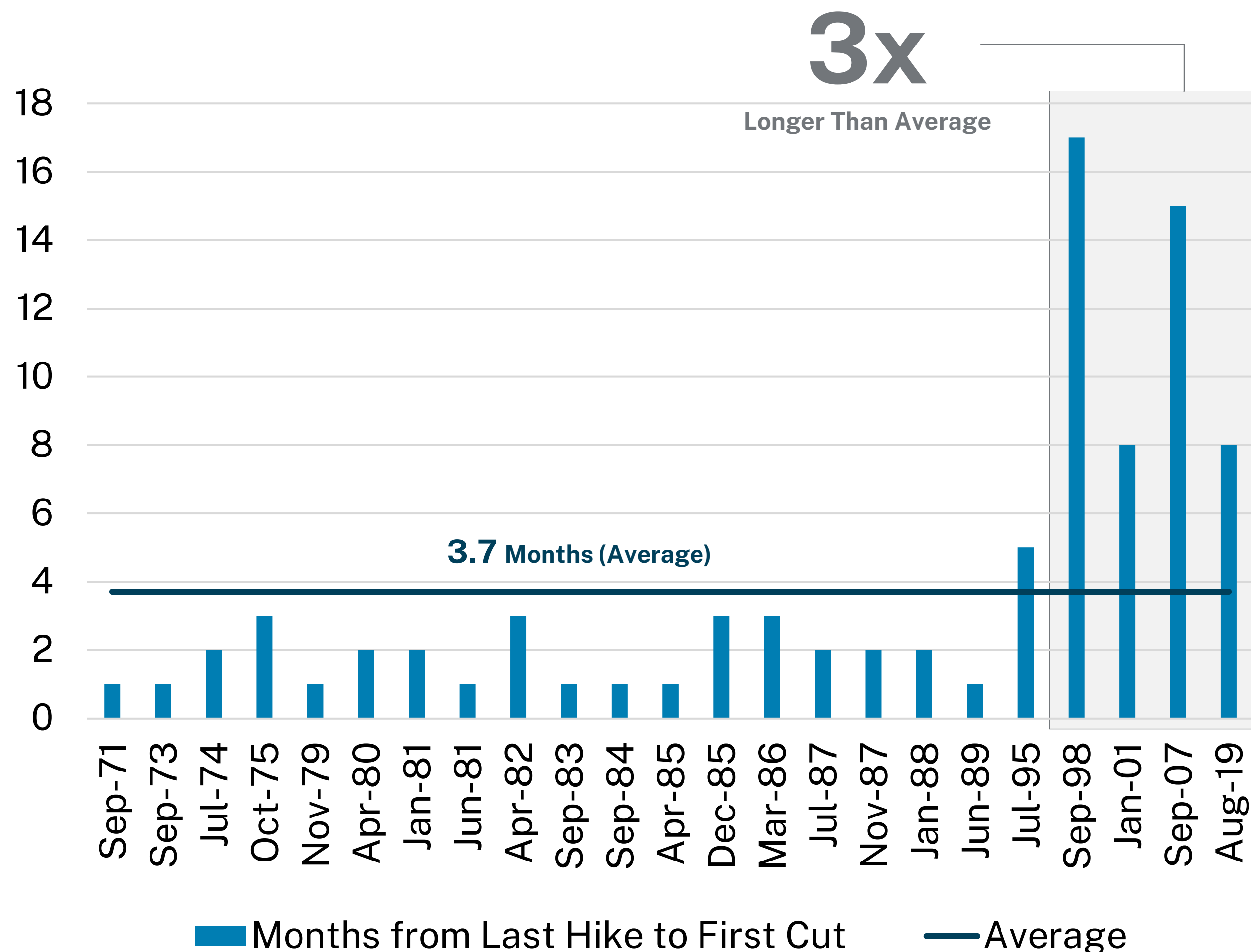


Source: American Realty Advisors based on data from Macrobond and the CME FedWatch Tool as of December 2023.

We expect the first rate cut to occur in 2024, but not until the latter half of the year.

Now that we are at peak, investors are wondering when rates will start to drop. **Recent pivots have been taking longer than usual.**

- The average lag between peak and first cut has historically been short, at 3.7 months.
- The last four cycles have taken approximately 12 months (3x longer than average) for the Fed to pivot, which means if July was the last increase, **expecting rate cuts to begin mid-summer seems reasonable.**



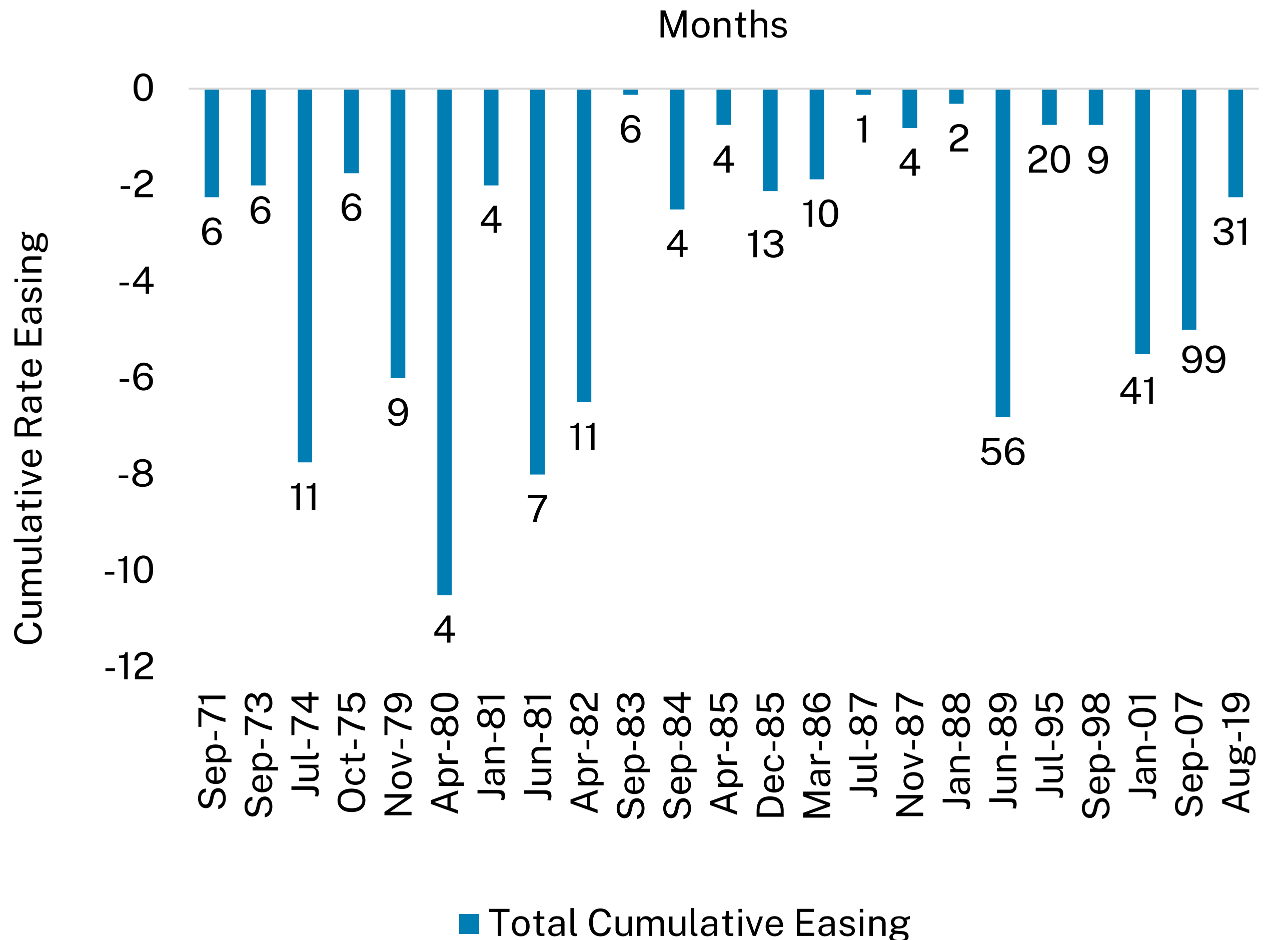
Source: American Realty Advisors based on data from Macrobond as of November 2023.

Markets have gotten used to long Fed easing periods – we think this cycle may differ.

Looking at past cycles can give guidance on how much and how quickly the Fed might reduce interest rates.

- In the past 22 times the Fed lowered rates, they usually cut by ~350 basis points over 17 months. In the last three instances, larger cuts (around 4.25% in total) occurred over a longer period (57 months).
- The current inflation dynamic could create an environment where the **Fed fluctuates more frequently between tightening and easing,** upending the recent longer, deeper easing cycles markets have grown accustomed to.

Past Rate Cut Cycles Duration and Magnitude

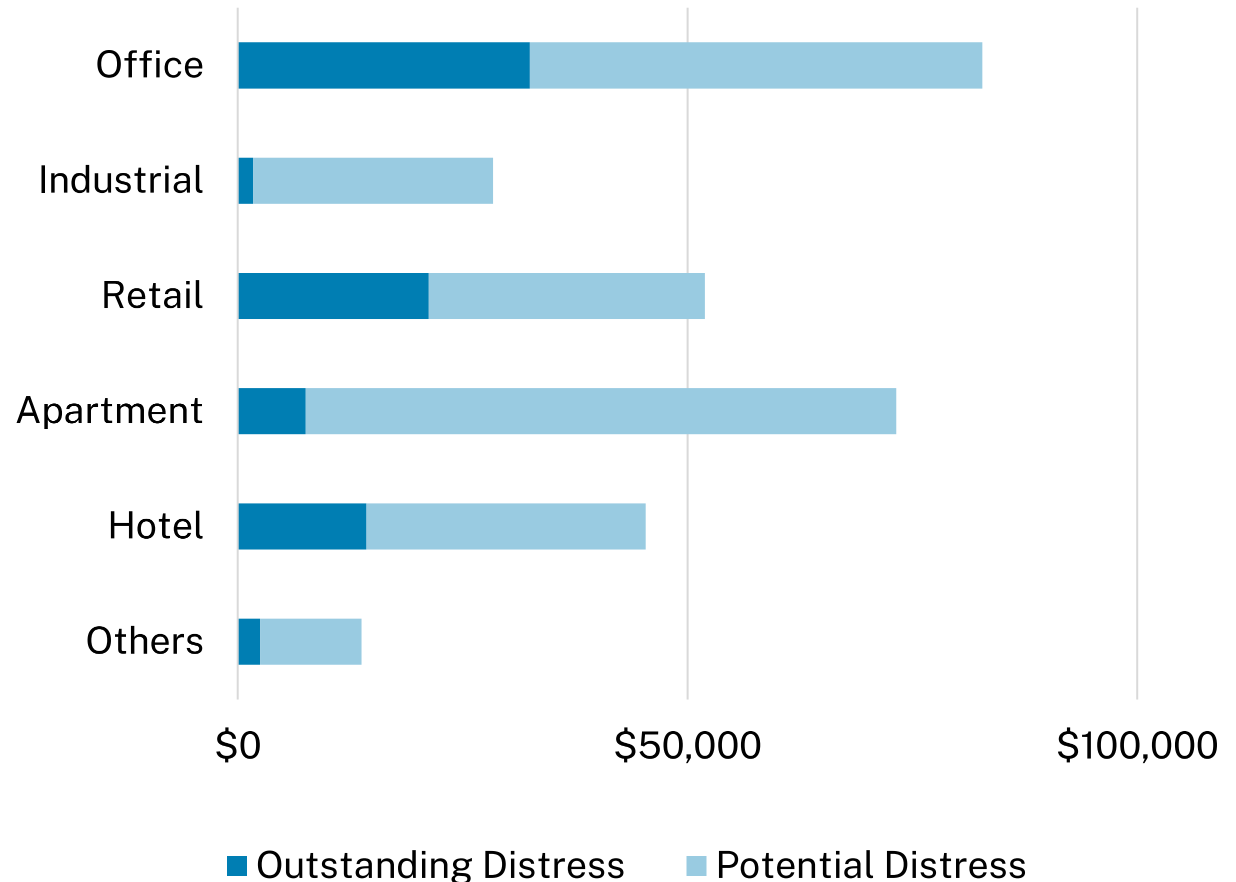


Source: American Realty Advisors based on data from Macrobond as of November 2023. Duration refers to the number of months from first cut until the next rate increase. Months where rates were left unchanged are included.

Distress is rising across all sectors but is most heavily concentrated in office.

Higher debt costs and softer fundamentals are creating distress, which could **create more forced sales at attractive values.**

- Loans originated with low interest rates maturing today are facing a more conservative refinancing environment.
- Higher loan payments on new loans exceeding property cash flows could force owners to either contribute additional equity or sell, potentially **boosting transaction volumes in 2024-2025.**



Note: Distress indicates direct knowledge of property-level distress and includes announced bankruptcies, defaults and court administrations as well as significant tenant distress or liquidation. Distress also includes CMBS loans transferred to a special servicer. Potential Distress indicates possible future property-level financial trouble due to such events as delinquent loan payments, forbearance and slow lease up/sell out, among others. Also includes CMBS loans placed on master servicer watchlists.

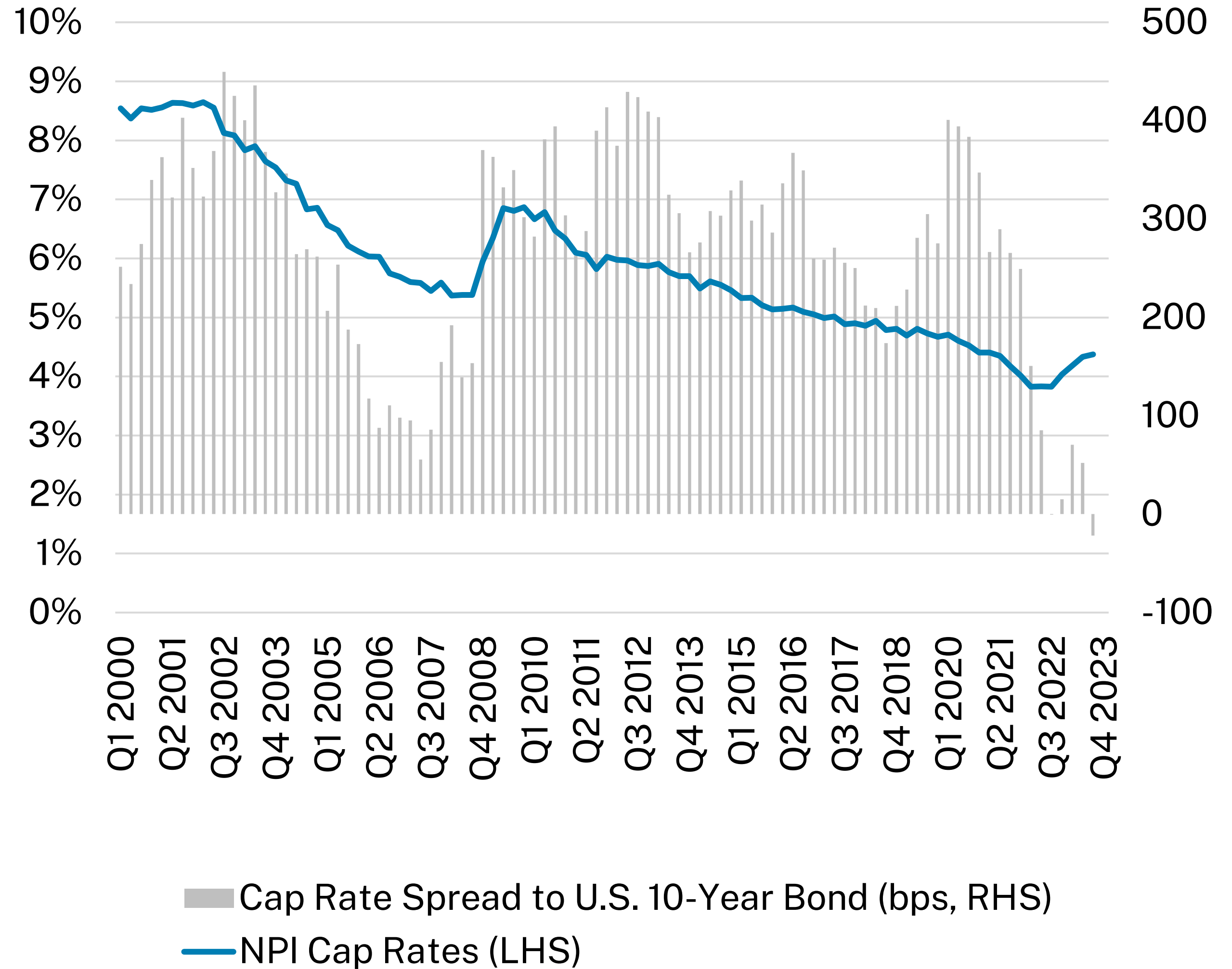
Source: American Realty Advisors based on data from MSCI Real Capital Analytics U.S. Distress Tracker as of December 2023.

Rate cuts would help restore real estate's risk premium and create more incentive to invest.

10-Year Treasury yields are frequently used as a benchmark to evaluate the attractiveness of real estate pricing compared to a risk-free government investment.

- Higher bond rates over the last year have reduced the spread between bonds and real estate to below-average levels.
- **Bond yields moving down (i.e., rate cuts) should improve real estate's attractiveness and help to stabilize cap rates and values.**

Real Estate Cap Rates and Spread to the U.S. 10YR

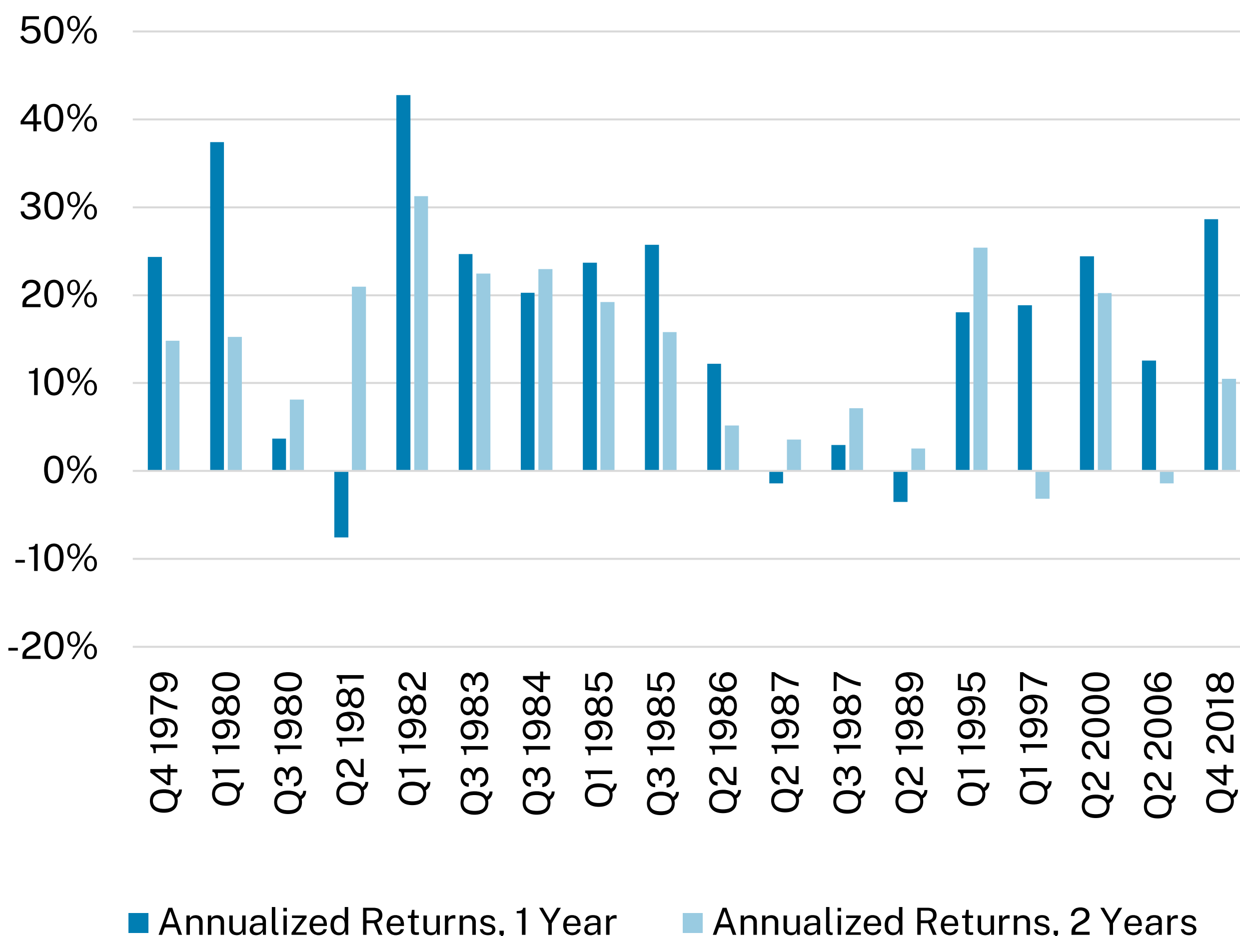


Source: American Realty Advisors based on data from Macrobond and NCREIF as of December 2023. Cap rate data based on NPI Current Value cap rates equally weighted.

Reaching peak rates is expected to mark a turning point for core real estate returns.

In the past, returns have been largely positive in the 1- and 2-year periods following peak Fed rates.

- ODCE returns were positive one year after reaching peak policy rates in 15 of the last 18 cycles, with the likelihood increasing to 89% of the time in the two years following peak.
- We think rates are now at their peak; we expect **subsequent easing will spur a return to positive total returns** in a relatively short amount of time.



Source: American Realty Advisors based on data from Macrobond and NCREIF as of December 2023. Private real estate total returns reflect ODCE performance. Quarters shown include the month of the last Fed rate hike after any pause or pivot – for example, rates peaked in October 1979, the 1-Year and 2-Year returns encompassed 1Q 1980 – 4Q1980 and 1Q1980 – 4Q 1981, respectively.

III. Property Markets

Residential market faces short-term challenges, but underlying drivers are intact:

- Current oversupply presents short-term hurdles; decline in permitting provides reason for optimism.
- Homeowners locked into low rates are keeping for-sale inventory low, insulating rental demand from greater weakness.

Industrial supply-demand imbalance is likely temporary, conditions improve by 2025:

- Construction providing tenants with more options to lease more functional, modern space.
- Persistent supply-demand imbalance favors emphasizing smaller industrial buildings going forward.

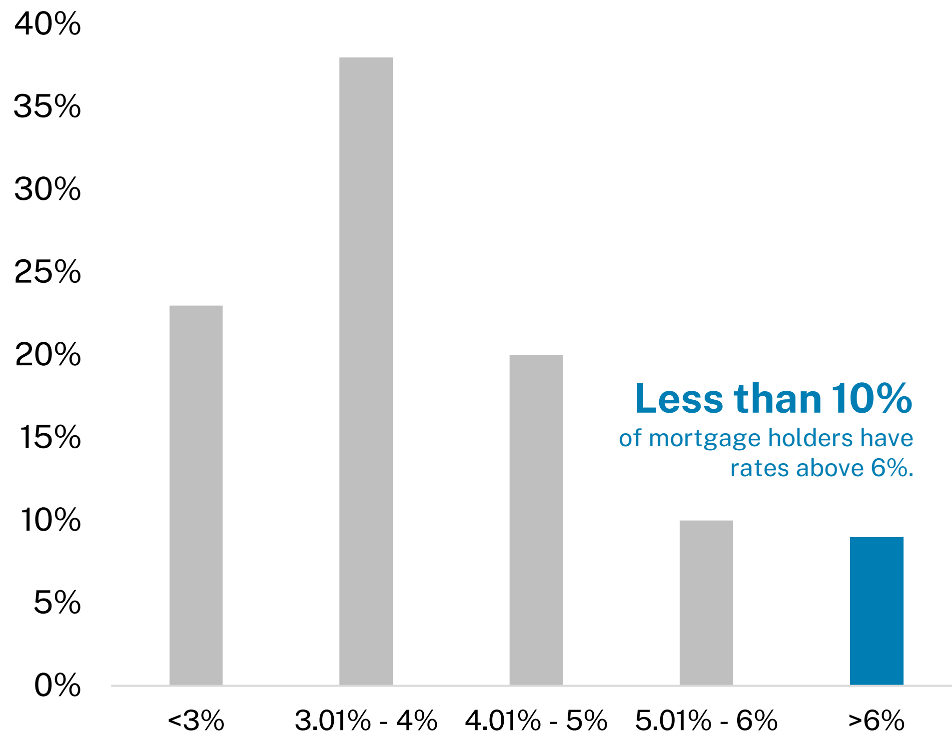
Office sector recovery expected to be slow given cyclical and structural challenges:

- Office occupancy is challenged by both fractured relationship to job growth and cyclical slowdown.
- Rising expectations for a full-time return-to-office could mark a turning point in occupancy and RevPAF growth rates.

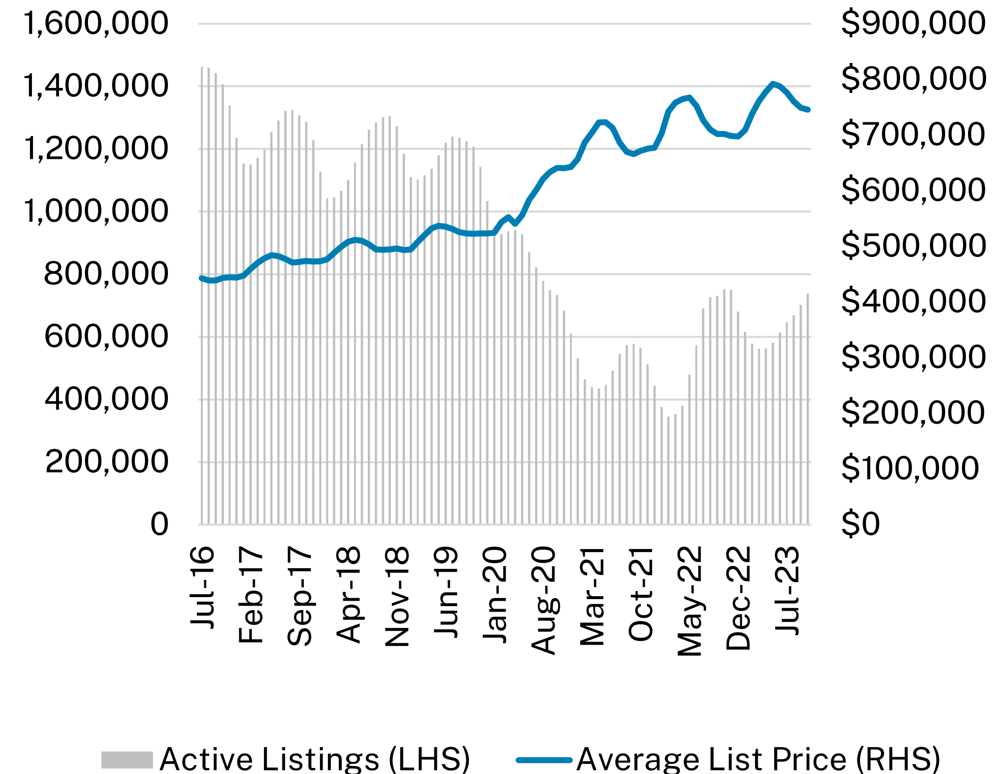
In-place, low-rate mortgages are suppressing for-sale inventory, keeping more households in rentals.

- Over **90% of homeowners with mortgages have fixed rates below 6%**, discouraging them from selling amidst higher current market rates.
- This 'lock-in-effect' has led to a notable decrease in active home listings, exacerbating undersupply issues and contributing to sustained high home prices.

Share of Outstanding Mortgages by Interest Rate at Origination



Homes for Sale and Home Prices (July 2016 – October 2023)



Source: American Realty Advisors based on data from Freddie Mac and Realtor.com as of November 2023

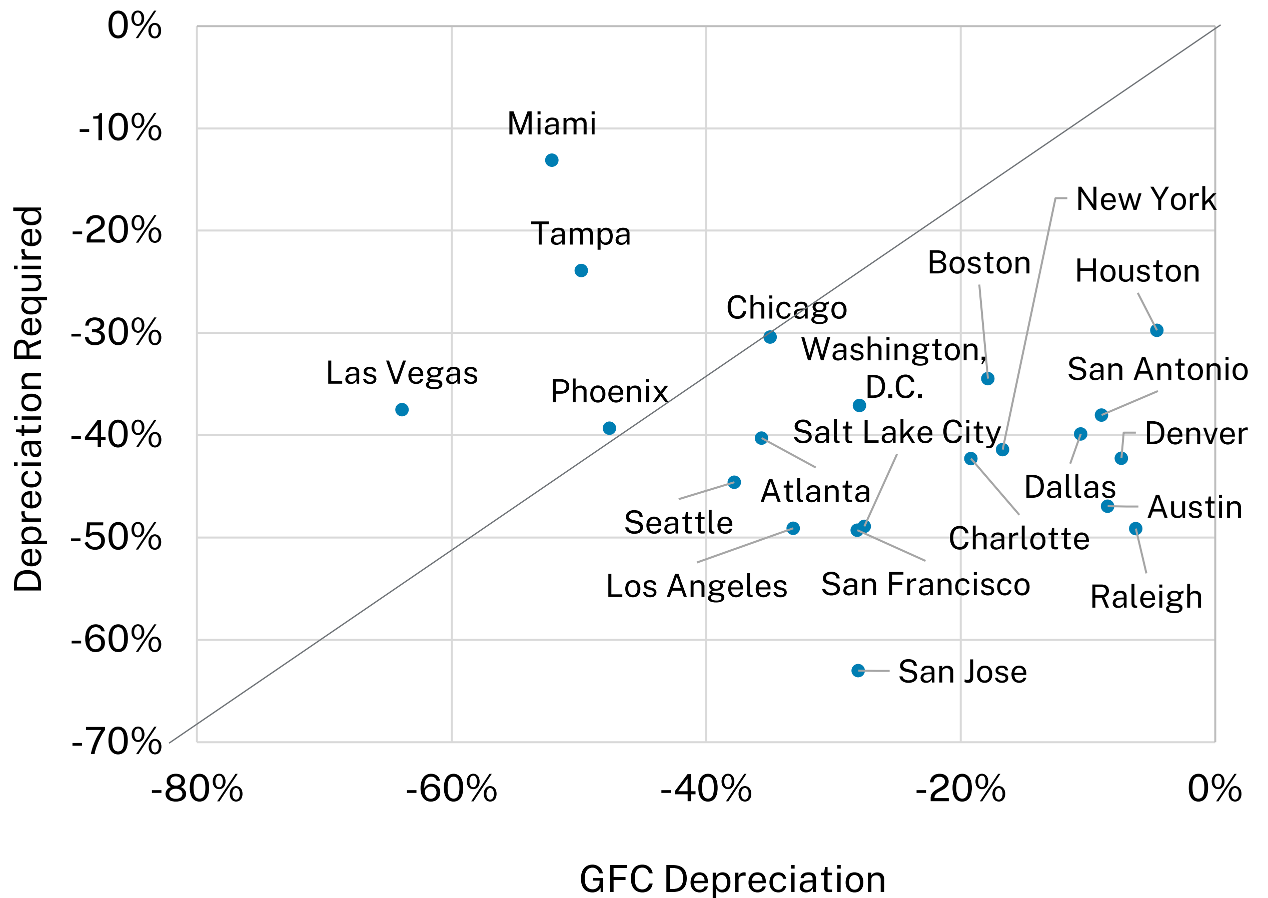
Most markets need significant home price drops to make owning as affordable as renting.

Would-be buyers are hoping for a market correction in for-sale values, but **the needed price drops to make owning affordable are improbable.**

- For mortgage payments to equal single family rental prices, **home values would have to decline 40% on average**, more than the 27% average decline during the GFC.

- Given lesser inventory, home prices are not likely to decline that much, which **bodes well for rental demand and rents.**

Depreciation Required to Align Mortgage Payments with SFR Rents vs. Depreciation that Occurred during the GFC



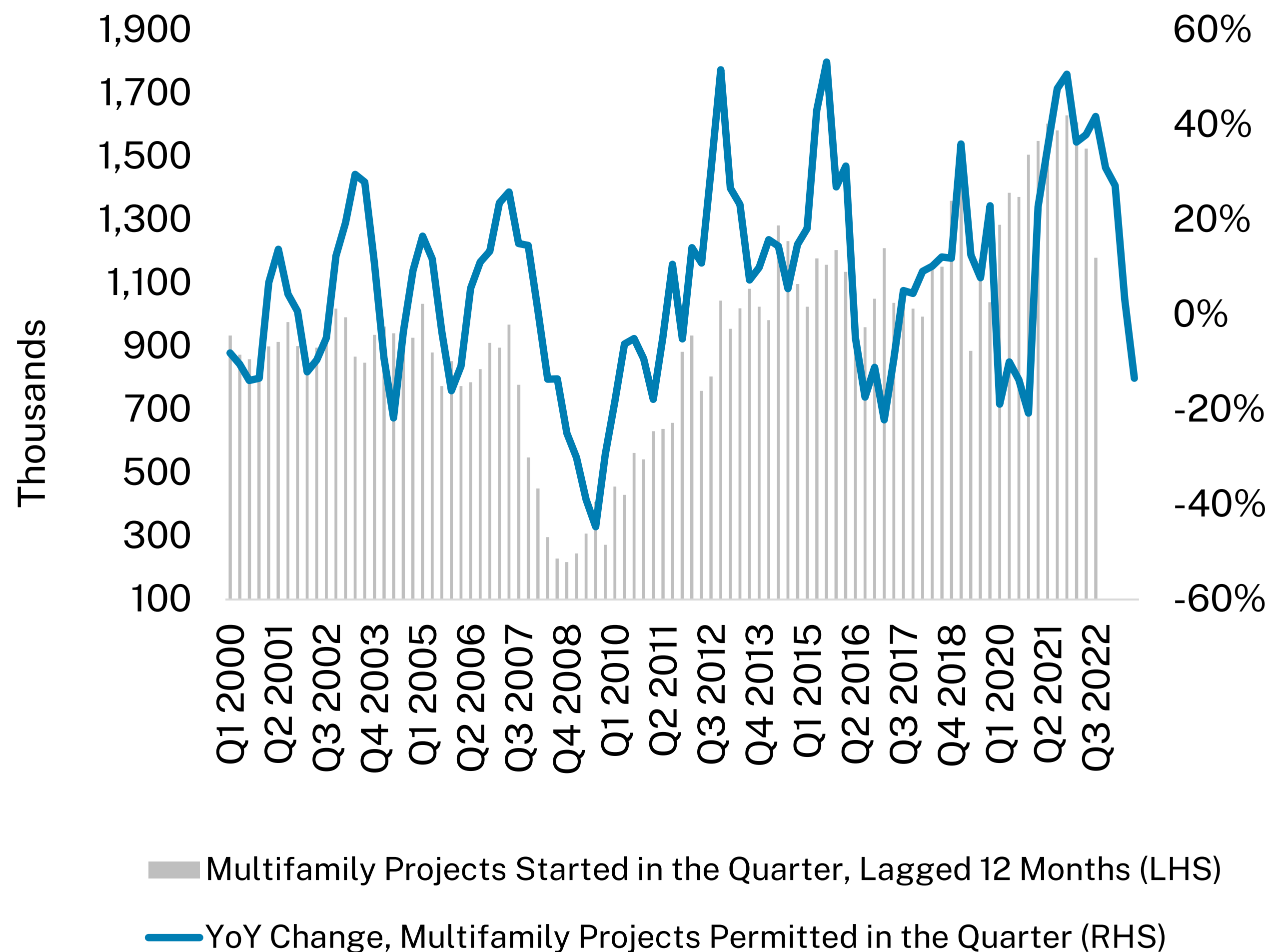
Source: American Realty Advisors based on data from Zillow and John Burns Research and Consulting as of November 2023.

Drop-off in multifamily permitting will drive further decline in starts and deliveries in coming years.

Decline in permitting today means fewer starts next year and **significantly fewer deliveries in 2025-27.**

- Permitting activity spiked in 2021 in response to robust pandemic rent growth; we are now seeing the effects of those projects coming online.
- Multifamily permits were down 14% year-over-year in Q3, and new projects starting have come down from peak too, **setting up the mid-cycle for stronger apartment rent growth.**

Year-over-Year Change, Quarterly Multifamily Units Permitted (5+) and Multifamily Projects Started Lagged 12 Months, Q1 2000 – Q3 2023



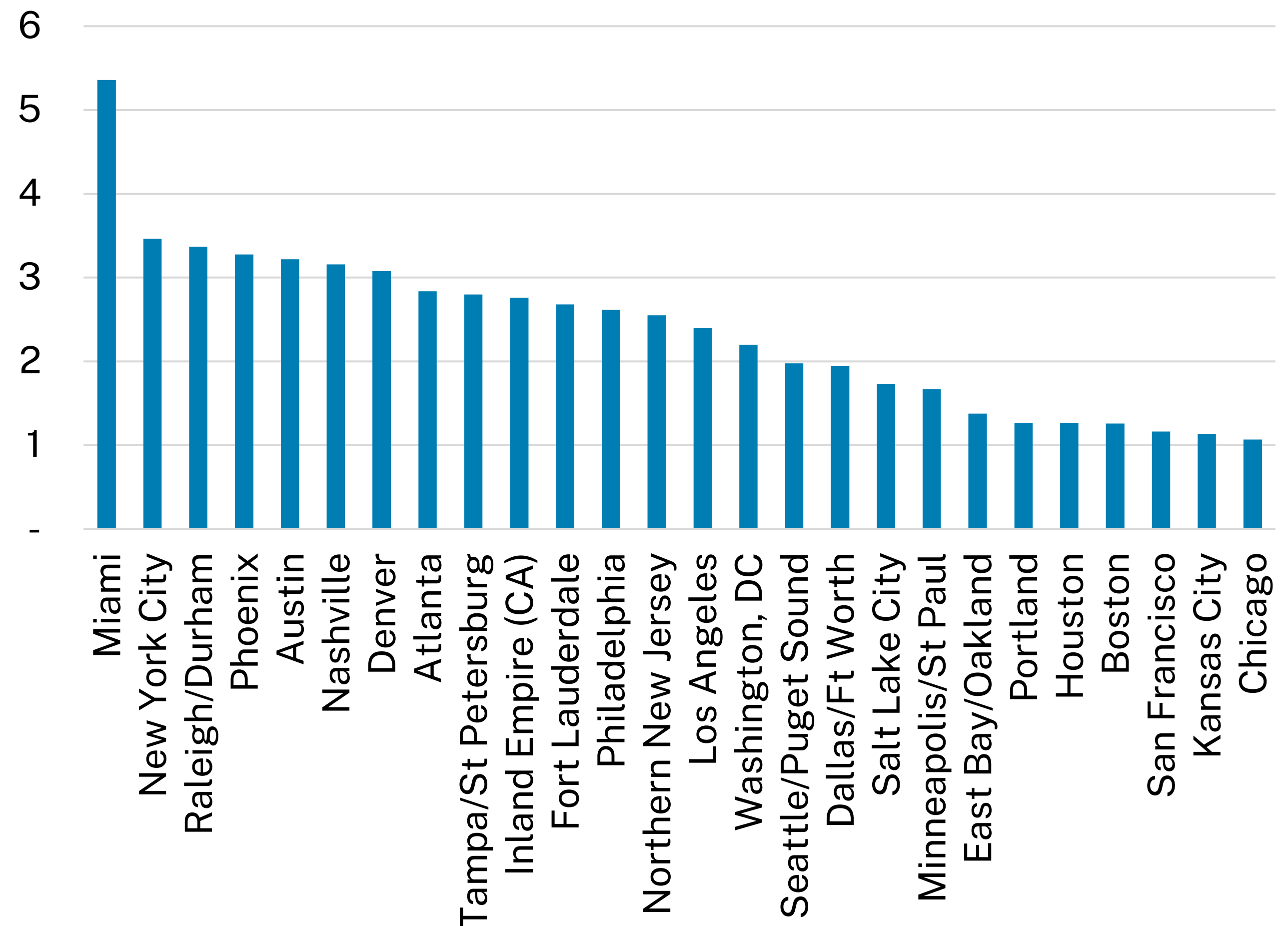
Source: American Realty Advisors based on data from the U.S. Census Bureau as of December 2023.

Today's apartment supply could yield attractively priced buying opportunities in late 2024-2025.

Supply under construction represents several years' worth of average demand in most markets, **pressuring rents and occupancies.**

- Current pipelines need to be absorbed before fundamentals rebalance.
- The resulting near-term headwinds could spur distressed sales just as fundamentals are beginning to improve, **creating a window for long-term investors to acquire quality assets at a discount.**

Annual Absorption Timeline: Number of Years of Average Annual Absorption Required to Absorb Current Multifamily Units Under Construction

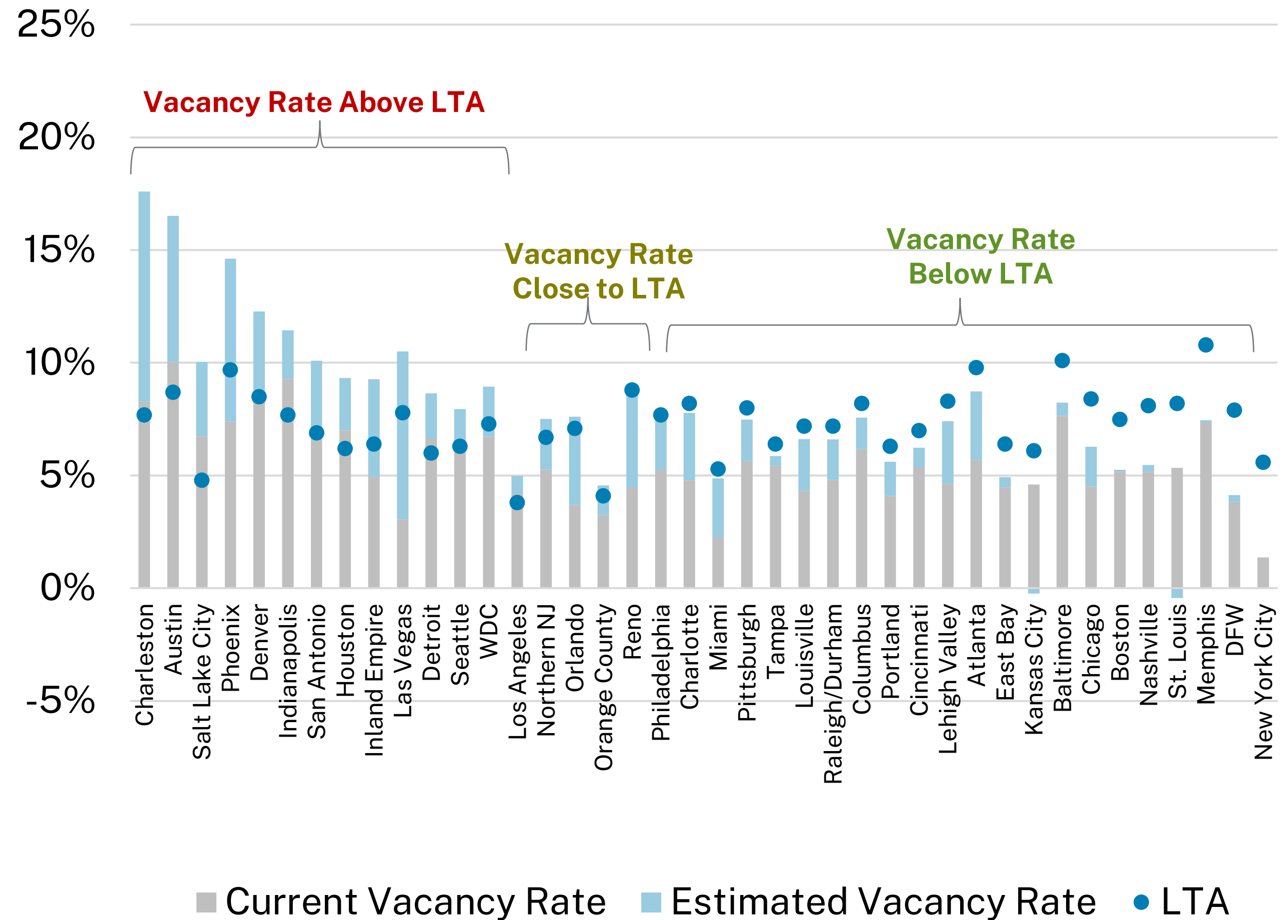


Note: Annual Average = 2015 – 2022 Average
Source: American Realty Advisors based on data from CoStar as of November 2023.

Industrial supply under construction could push market vacancies above their long-term averages.

Some markets are better poised to weather worst-case scenarios.

- Current pipelines could put some markets above long-term average vacancy **if the space goes unleased.**
- Markets where construction has been less robust could see vacancies stay at or below long-term average even with the forthcoming deliveries.



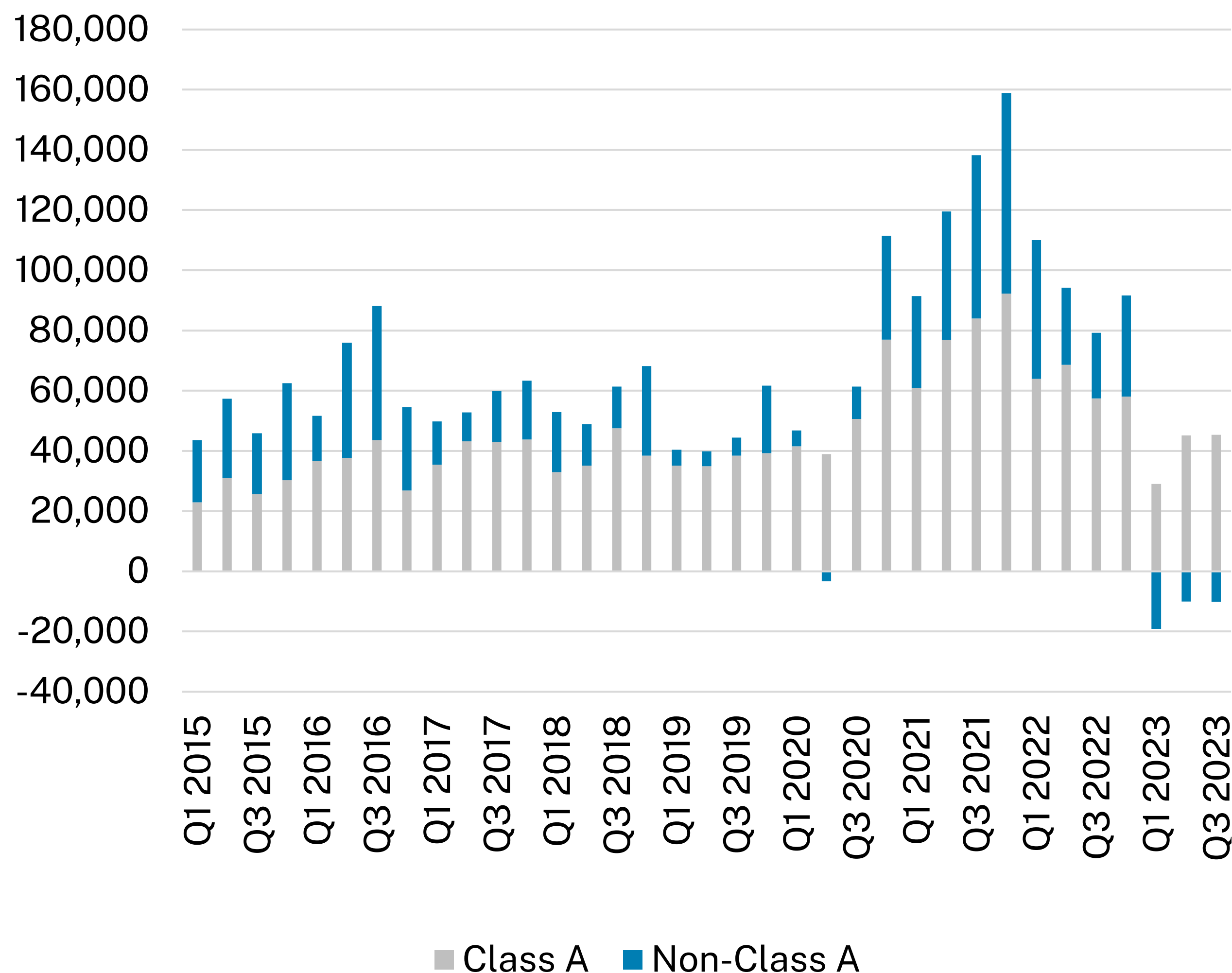
Note: Preleasing is accounted for in analysis.

Source: American Realty Advisors based on data from CoStar as of November 2023. LTA = long-term average, 2001 – 2022.

New construction is allowing industrial tenants to take advantage of flight to quality.

Despite competition from new supply, Class A warehouses are still benefitting from positive net absorption.

- Low industrial vacancy post-pandemic helped drive late-cycle leasing into non-Class A buildings, but **that rising tide is now receding.**
- Shifting market fundamentals often create last in, first out situations – **prioritizing investment in modern facilities is a more resilient all-weather strategy.**



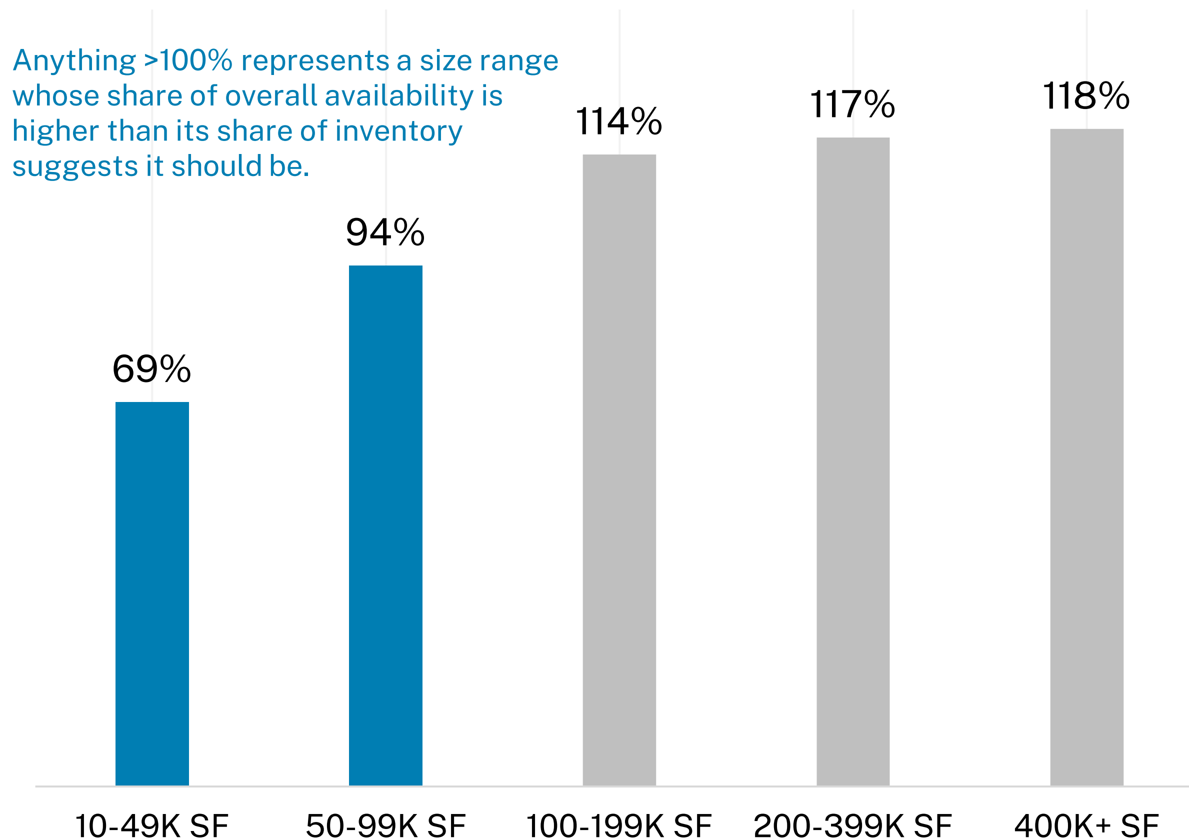
Source: American Realty Advisors based on data from CBRE-EA and Newmark Research as of December 2023.

Smaller industrial facilities appear poised to outperform given favorable supply-demand imbalance.

Infill/shallow-bay warehouses should be more insulated to softening fundamentals given less exposure to oversupply.

- The availability of smaller facilities indicates an ongoing squeeze that is expected to **support strong relative rent growth in the near term.**
- We favor supplementing an industrial portfolio comprised of bulk warehouses with long lease terms and credit tenancy with smaller infill facilities given the outlook.

Proportionate Share of Current National Availability by Building Range Size



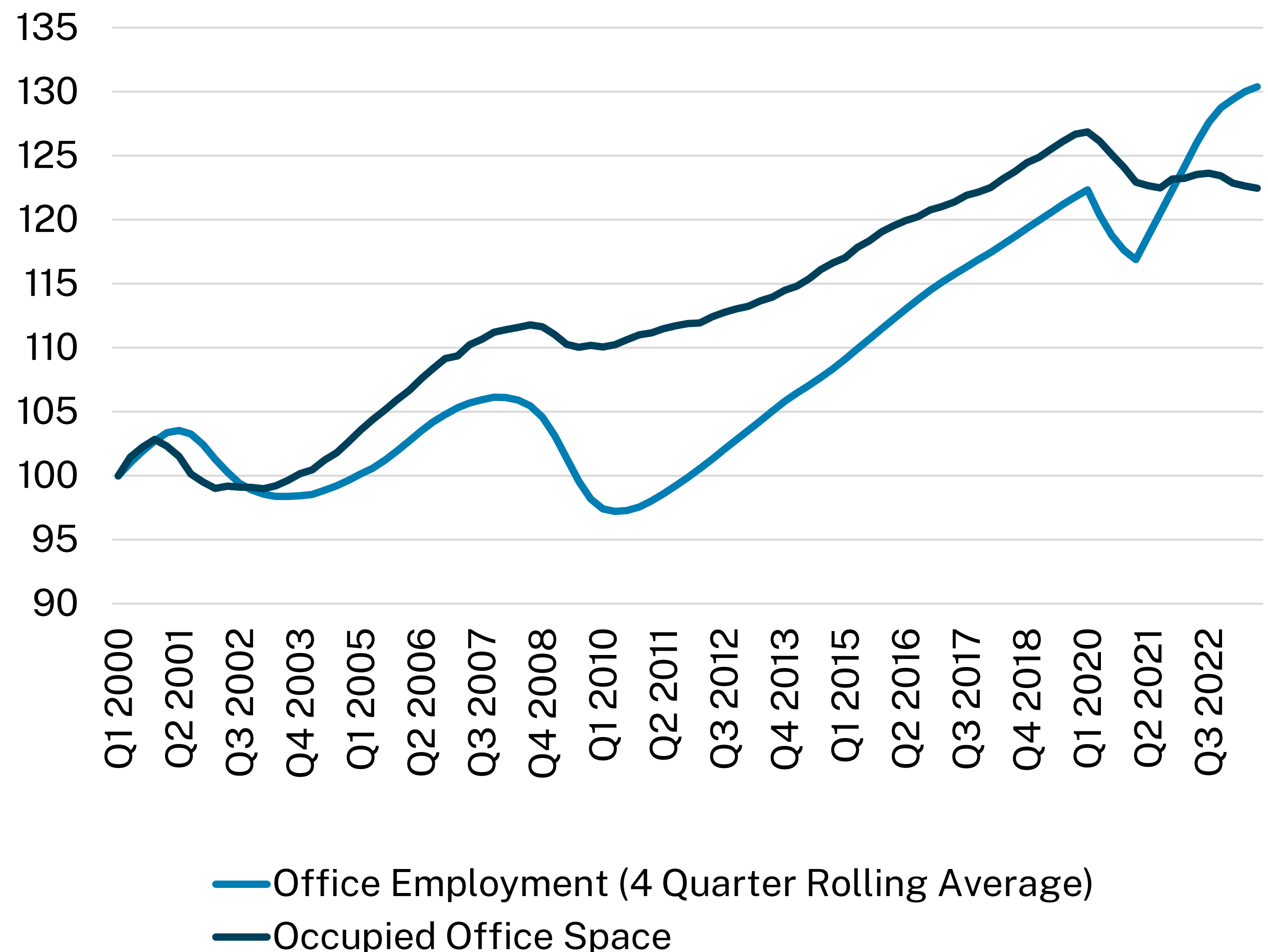
Source: American Realty Advisors based on data from CoStar and CBRE-EA as of November 2023. Proportionate share is calculated as share of overall availability divided by the share of overall inventory.

Normal job growth is unlikely to revive the broader office market.

The relationship between office-using employment growth and occupied space has diverged.

- Even in the very strong post-pandemic job growth environment, office occupancy flatlined.
- This means the market will **require much greater job growth for even slight improvements in office occupancy.**

Office-Using Employment Growth and Occupied Office Space (Q1 2000 = 100)



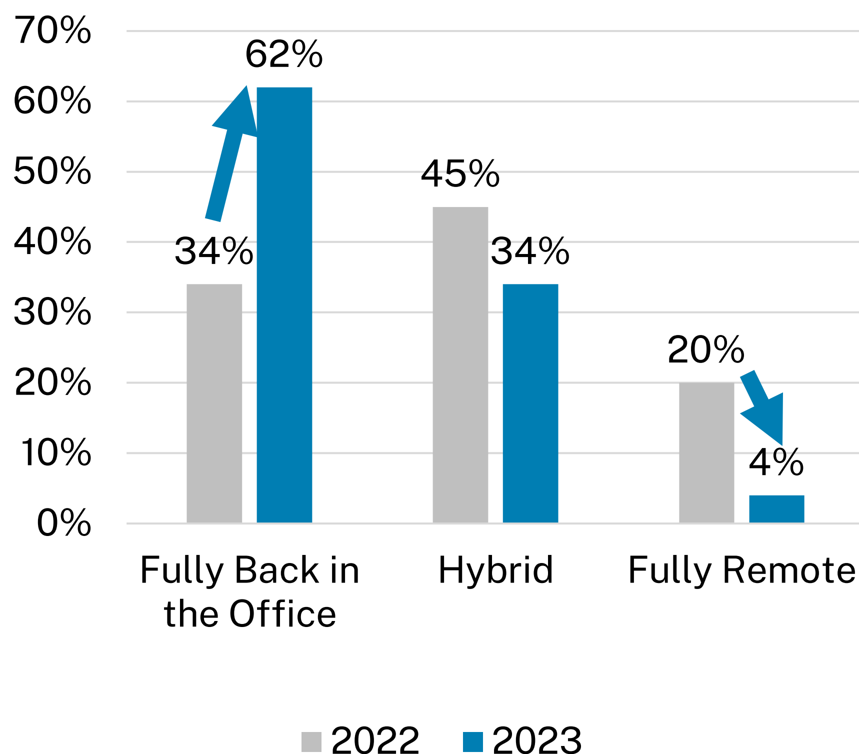
Source: American Realty Advisors based on data from CBRE as of November 2023.

Management may want "5 days a week," but utilization changes could challenge that scenario.

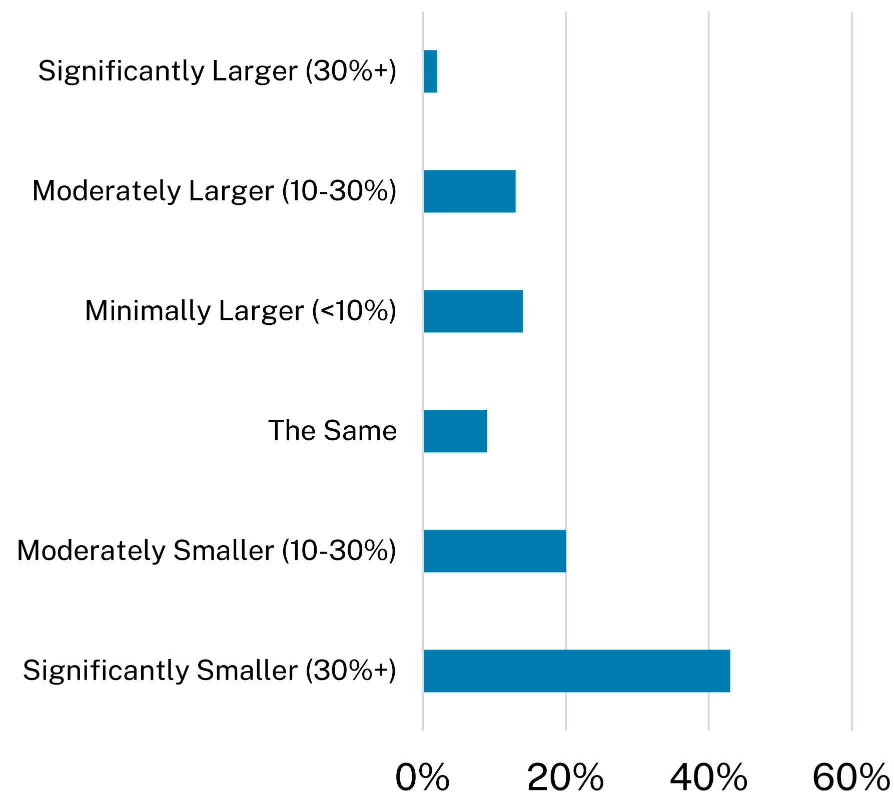
There has been a material change in CEOs' views on how they envision their teams working over the next few years.

Yet companies are overwhelmingly indicating their intentions to reduce their office portfolio, with **43% of groups planning to reduce more than 30% by 2026.**

CEO Responses: "In 3 years' time, how do you envision the working environment for corporate employees whose roles were traditionally based in-office?"



Corporate responses: "How do you expect the portfolio size to change over the next 3 years?"



Source: American Realty Advisors based on data from KPMG 2023 U.S. CEO Outlook as of November 2023 and CBRE's 2023-2024 Global Workplace and Occupancy Insights report.

Many office markets should reach a turning point in fundamentals by 2026.

Year-over-Year Change in Rents and Occupancy, Select Office Markets

Note: Markets are categorized by Annual RevPAF Growth. RevPAF = Market Rent/SF multiplied by Occupancy Rate.

Categories are generally defined as the following: Growth Accelerating: RevPAF growth increased more than the previous year. Growth Moderating: RevPAF grows but decelerates relative to previous year. Decline Accelerating: RevPAF decreases more than the previous year. Decline Moderating: RevPAF declines but by less than the previous year.

Note: The placement of cities on this cycle diagram is illustrative and not to scale. The positions are indicative of their general stage in the growth or decline cycle but do not reflect precise locations within the cycle. Additionally, distance between markets on this diagram do not represent the relative differences in their growth or contraction rates. Markets may not move in a sequential clockwise manner.

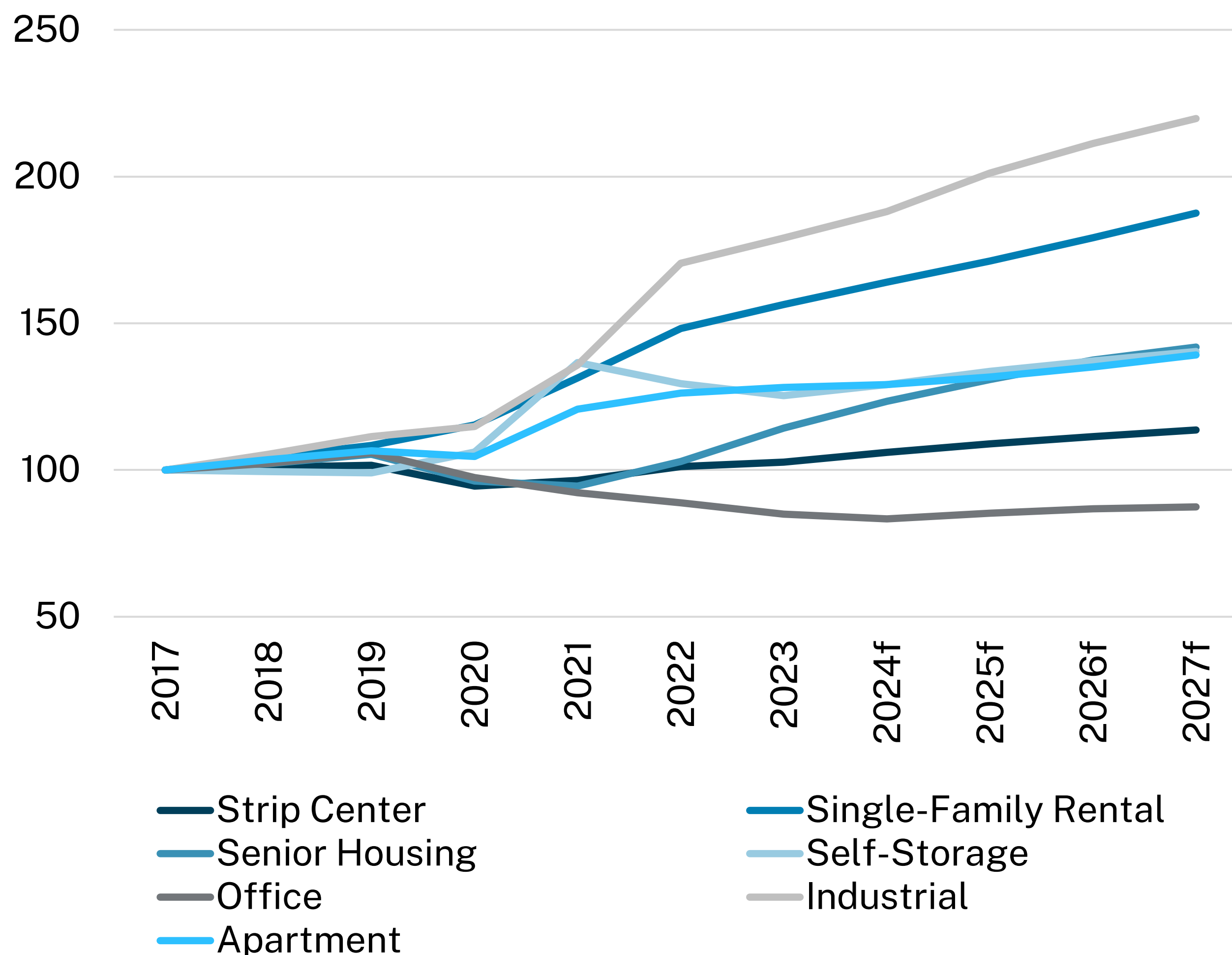
Source: American Realty Advisors based on data from CoStar as of November 2023.

Specialty sectors are becoming more attractive given their revenue growth outlook.

Divergence between specialty and core property types that began in 2021 appears poised to continue, but **not all are worth the added execution risk.**

- With offices facing their "retail moment," investors are looking to alternative/specialty sectors to fill the allocation gap.

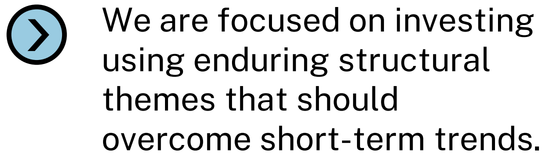
- **An allocation to traditional apartments may be just as compelling as senior housing** given comparable growth outlooks, without the added operational expertise required**.**



Source: American Realty Advisors based on data from Green Street as of November 2023. RevPAF growth = revenue per available foot growth, which captures change in rents and change in occupancy. f=forecast.

Outlook for Property Sectors

A slowdown in demand amidst high levels of supply has softened fundamentals. The recovery timeline differs by sector and market, but we envision owner-favorable conditions returning in 2025.



We are focused on investing using enduring structural themes that should overcome short-term trends.

Industrial

- Some oversupply, but impact depends on preleasing levels and starting vacancy rates.
- Smaller buildings may provide better opportunity to achieve outperformance.

Office

- Office fundamentals may bottom as more managers push for a 5-day return to office.
- Weak job growth and a potential recession mean overall occupancies have a long road to recovery; newer, higher-quality buildings should continue to capture a larger share of demand.

Specialty Sectors

- Hybrid/work-from-home should prop up self-storage occupancy as residents offload goods to make space.
- Healthcare advances expected to drive demand for cold storage facilities to store temperature-sensitive treatments.

Residential

- Supply glut weighing on rent growth in the near term (24 months), but today's permitting decline setting up recovery in H2 2025-2026.
- Homeowners with low-rate mortgages are "locked in," reducing potential supply and driving higher single-family rental demand.

Retail

- High construction costs are hindering new development, insulating existing asset occupancy and rents.
- Drop in consumer pandemic savings and a possible recession could further dampen spending.

Implications for Core and Value-Add Strategies

It is our conviction that today's market conditions provide unique opportunities to invest in assets that should benefit from long-term demand drivers at a discount.

Portfolio Construction

- Generate income through structured debt and preferred equity investments.
- Seek opportunities arising from debt market illiquidity and debt maturity-driven recapitalizations and restructurings.
- Target opportunities to acquire strategically located residential assets while fundamentals are temporarily challenged.
- Focus industrial acquisitions on smaller assets to capitalize on the supply and demand imbalance.
- Deploy dry powder in 2024-2025 as structurally sound sectors face temporary headwinds, creating an attractive buying window.

Asset Management

- Be a first mover in employing free rent and concessions to maintain high occupancy and preserve cash flow.
- Be creative in lease structuring and remain flexible to tenants' desire for optionality and expansion potential in office.
- Defer or delay non-return-on-investment expenditures to maximize in-place cash flow.
- Property operations should focus on increasing efficiency to increase bottom-line NOI and enhance property values amid low appreciation period.

Summary and Strategy Implications

A more volatile policy and GDP cycle presents chances to capitalize on well-priced properties underpinned by long-term demand drivers.

- The Fed's December guidance suggests we have approached overtightening but not surpassed it; nevertheless, recession risks remain.
- Ongoing inflation decline should prompt rate cuts in the latter half of 2024, but structural economic factors could reignite inflation in 2025, requiring further Fed policy adjustments.
- Adding to potential volatility is the upcoming presidential election and the spillovers from the winner's fiscal, trade, and geopolitical policies.
- Greater interest rate certainty should improve lending and liquidity, boosting transactions, stabilizing cap rates, and increasing values.
- Moving past peak rates has historically been a good thing for real estate performance; we expect returns to turn positive in 2024.
- Industrial and residential construction is pulling back, which should help bring supply and demand closer to equilibrium in relatively short order; office is the exception, with a much longer recovery tail.
- 2023 was a reset year for real estate, coming off a robust decade-plus expansion cycle; we expect 2024 to mark the turning point toward the recovery phase. We intend to be positioned to capitalize on emerging cycle opportunities.

Disclosures

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This presentation contains forward-looking statements within the meaning of federal securities laws. Forward-looking statements are statements that do not represent historical facts and are based on our beliefs, assumptions made by us, and information currently available to us. Forward-looking statements in this newsletter are based on our current expectations as of the date of this presentation, which could change or not materialize as expected. Actual results may differ materially due to a variety of uncertainties and risk factors. Except as required by law, ARA assumes no obligation to update any such forward-looking statements.

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