Overview

Commercial real estate market poised to continue to recover amid rising interest rates and high inflation

Strong fundamentals in property segments of the multifamily, office, industrial, and retail markets are likely to keep the commercial market recovery going although at a moderate pace amid rising interest rates and elevated inflation of over 2% during the next two years. The hotel market is expected to slow amid rising airfare, transportation costs, and belt-tightening by consumers as inflation outpaces wage gains.

In the apartment market, rising mortgage rates will tend to increase the demand for rental units. Given the pace of home price appreciation (+23% from March 2021 through May 2022 based on NAR median existing-home sales price) and the rise in 30-year fixed mortgage rates (+2.1 percentage points), the monthly mortgage payment has increased by about $750 dollars, pricing out about 4 million 25-44 year old renter households. As of April, multifamily rents are up 9.4% year-over-year, ahead of the inflation rate of 8.5%, making multifamily rental acquisitions a good investment hedge against inflation. Moreover, 27% of metro areas are experiencing double-digit rent growth, mostly in the South region, specifically, Florida (see p.8). Rents are rising faster in Class B/C buildings than in Class A buildings, an indication of the desire for more affordable units.

Another good hedge against inflation is the industrial property market, with rents up 11% year-over-year, with 37% of 390 markets posting double-digit rent growth. Again, the fastest rent growth is in the South region, the only region to experience net domestic migration from 2019 through 2020, according to US Census Bureau data. To be clear, this sector is also facing headwinds: demand is expected to ease somewhat as consumer spending slows because inflation is rising higher than wage growth. However, the rising cost of oil could increase the demand for fulfillment centers as businesses seek to cut back on rising transportation costs should oil prices remain elevated. The demand for warehousing is also likely to increase as logistics operators and businesses engage in ‘just-in-case’ inventory management from “just-in-time” management to minimize raw material supply disruptions (see p.10).

In the office market, asking rents continue to increase although rents are still below the inflation rate, which reduces its attractiveness as an inflation hedge. Still, asking rents continue to recover, with an average growth of 1.3% year-over-year as of April. Only the Washington, DC metro area is suffering from a 0.2% year-over-year rent decline. Given the ongoing construction of about 150 MSF, vacancy rate will likely remain above 10%, but rents will continue to increase modestly (see p.9).

Retail stores such as strip centers, neighborhood centers, and power centers are likely to be less impacted than malls which the ongoing recovery in malls could likely slow, as evidenced by the faster rent growth of these stores types (over 4%) compared to malls (below 4%). However, with little construction underway, rent growth is not likely to decline, rising at the mid-3%. With rents rising at below the inflation rate, retail properties are not as good as an inflation hedge as against multifamily and industrial properties (see p.11).

The hotel industry faces renewed headwinds in 2022, with rising airfares and gas prices that could slow personal travel and therefore demand for lodging. A slowing economy could also lead businesses to cut back on business meetings and conferences (see p.12).

Enjoy this month’s issue!
20.8 million jobs as of April 2022

Non-farm payroll employment increased by 428,000 jobs in April, with 20.8 million net jobs created relative to February 2020, or 95% of the 22.4 million jobs lost during March and April 2020. There are just 1.2 million nonfarm payroll jobs still to be recovered. The unemployment rate held at 3.6%, just a tad over the 3.5% rate in February 2020. The largest net job creation is in professional/business services (+738,000) followed by transportation and warehousing (+674,000), which bode well for the recovery of demand for office space and sustained demand for industrial space. Even retail trade jobs were up (+284,000). Jobs in the finance and insurance industry increased (+87,000) while real estate, rental, and leasing jobs have still not recovered (-16,000).

As of April 2022, non-farm employment in 33% of 401 metro areas has surpassed the level of nonfarm employment in February 2020. The largest job gains are mainly in the South and West (Mountain division), led by Dallas, Austin, Atlanta, Riverside, and Nashville. The large job losses are in the primary markets like New York, Los Angeles, San Francisco, Washington DC, Chicago, Boston, Minneapolis, Philadelphia, and Pittsburgh.
Fraction of workers who teleworked due to the pandemic decreases to 8%

Workers continue to head back to the office. As of April 2022, just 8% of employed workers 16 years old or over teleworked because of the pandemic, down from a peak of 35%, but still twice than the 6% rate prior to the pandemic. The fraction of workers working from home could be higher because of a permanent shift towards full-time remote or hybrid work schedule. Google Trends tracks the number of visitors to workplaces relative to the pre-pandemic level. In the District of Columbia, visits to workplaces is still down 39% compared to the pre-pandemic level, and down by close to 20% in New York, New Jersey, Massachusetts, California, and Colorado.

Inflation rate accelerates to 8.5% in March

The inflation rate measured using the consumer basket (CPI) accelerated to 8.5% in March, with the strongest uptick for items like used cars and trucks (35%), energy services and commodities (32%), and airline fares (26%). Food consumed at home rose 10% while food consumed away from home was up 6.9%.

Even with a tight labor market, wage growth has been tame at 4.7%. This is a good sign that there is no wage-price spiral, but negative income growth will tend to reduce consumer spending.
Economic Conditions
Rising inflation and interest rates are slowing down spending

Retail sales decreased 4% in real terms in March 2022

With rising inflation, retail sales rose 4.9% year-over-year in March in nominal terms, but adjusted for inflation that has increased 8.5%, retail sales are down about 4%.

New orders of non-defense capital goods rose 8% in real terms in March 2022

New orders of non-defense capital goods rose 16.7% year-over-year in March in nominal terms, and by about 8% when adjusted for inflation. Higher investment spending means businesses are still broadly optimistic about the medium-term outlook of the economy.

CRE loans up 7% year-over-year in March 2022

Commercial real estate loans outstanding held by commercial banks started picking in the second half of 2021, and as of March 2021, loans outstanding rose to $2.6 trillion, up nearly 7%. Commercial real estate loans are loans for the purchase of commercial real estate (like mortgage loans for the personal real estate). Rising loan volume indicates that businesses hold a positive outlook of economic and business conditions.

However, investors see greater economic risks ahead compared to last year, as indicated by the tighter spread between the 10-year T-note (2.75%) and 30-year T-note (2.81%).
Commercial Market Overview

Occupancy still rising amid higher interest rates

All commercial sectors experienced net positive absorption in the last three months through April 2022.

With rising mortgage rates, absorption of multifamily units in the past three months as of April 2022 rose to about 77,000 units, an increase from 58,000 units in 2021 Q1. However, deliveries over the past 12 months of 414,000 units outpaced absorption of 380,000, leading to a slight uptick in the vacancy rate to 5.2%. Rent growth moderated to 9.4% after rising at double-digit pace in the second half of 2021.

In the office market, 20.2 million square feet (MSF) was absorbed on a net basis in the past three months as of April, up from just 3.4 MSF in 2022 Q1. However, there is still about 115 MSF returned to the market since 2020 Q2, pushing up the vacancy rate to 12.2%, from 9.7% in 2020 Q1. Asking rents are now rising at over 1% year-over-year.

In the industrial market, 103 MSF of industrial space was absorbed in the past three months as of April 2022, up from 98.5 MSF in 2022 Q1. The industrial sector has the lowest vacancy rate among the core property markets and the strongest rent growth, at 11.2% year-over-year.

In the retail property market, net absorption totaled 22 MSF in the past three months ended April 2022, slightly lower than the 24 MSF net absorption in 2022 Q1. Net absorption in the past 12 months totaled 100 MSF compared to just 22.4 MSF in net deliveries, pushing down the vacancy rate to 4.4% and propping up rent growth to 3.9%.

Rent growths for multifamily and industrial assets are outpacing inflation, making these assets a good hedge against inflation. However, rent growth is running below the inflation rate in the office and retail property markets.
The volume of investor acquisitions over the 12-month period ended April 2022 slowed somewhat compared to the 12-month level ended in March 2022, but acquisitions are still outpacing the level one year ago. Total acquisitions for multifamily, office, industrial, and retail properties totaled $544.8 billion. Sales deals are 13% below the $623 billion in 12-month acquisitions ended March 2022 but are up 70% from the 12-month sales deal volume of $365 billion ended 2021 Q2. Of total acquisitions, 46% of dollar volume went into multifamily acquisitions.

On average, sales prices of industrial properties were up 15% from one year ago, yielding a 19% total return on sold properties. Multifamily property prices rose 10.5%, yielding a total return of 12.7%. Both these assets are earning rental income and returns that are higher than the current inflation rate, which make them attractive assets to hold at a time of high inflation.

Retail properties also fetched decent prices, up 5% from one year ago. On average, sellers gained a 10% return on their investment. Continuing worker re-entry is driving the demand for office space, with sales price up 2.4% on average with sellers earning a 7% total return on investment. However, the rent growth on these assets is lower than the inflation rate. The low vacancy rate on retail properties reduces the drag of low rent growth on net operating income, but not generally so for office properties which are suffering from high vacancy rates.
In the apartment market, Class A and B buildings offer a good hedge against inflation, with asking rents up 10% year-over-year. However, Class C apartment rents are rising below the rate of inflation. However, it will be hard to adjust rents on Class C apartments. These are less expensive and would likely be occupied by renters with lower incomes. With average weekly wages rising by just 4.7%, adjusting rents to keep pace with inflation will make these units unaffordable for renters.

As of April 2022, asking rents are up at a double-digit pace in 27% of 390 markets tracked by CoStar®. The highest rent growths are metro areas in the South region, led by 10 metro areas in Florida led by Naples (26%), Fort Myers (24%), Orlando (20%), Palm Beach (19%), and Fort Lauderdale (18%).

**Outlook for 2022-2023**
Rising mortgage rates will prop up demand for apartments, which will tend to lower vacancy rates in 2022-2023 and sustained double-digit rent and price growth which will further push down cap rates to the lower 5%.
In the office property market, asking rents continue to improve, with asking rents up 1.3% year-over-year on average nationally. Rents are growing faster in Class B/C office buildings at 1.5% to 2% while asking rents are up below 1% year-over-year on Class A buildings. That’s because Class A buildings are on average suffering from higher vacancy rates, at 16.6%, while vacancy rates are lower for Class B, at 11%, and Class C buildings where the average vacancy rate is 4.9%.

Asking rents are now up across all 390 markets tracked by CoStar except in Washington, DC metro area where office rents are -0.2% year-over-year (blue area in map). In New York metro area, asking rents are at par with the level one year ago. However, rents are rising below inflation even in the top rent growth markets led by Palm Beach, Miami, Colorado Springs, Fort Lauderdale, and Las Vegas.

**Outlook for 2022-2023**

With workers continuing to head back to the office, the higher demand for office space is expected to moderate the decline in demand due to slower new business formation. This will slightly reduce vacancy rates although the vacancy rate will likely remain above 10%. Rent and price growth will remain modest, but the stronger sales price appreciation will push cap rate towards 6%.

Y/Y Percent Change, Office Asking Rent as of April 2022

Office Rents likely to keep rising as more workers return to the office

**Office Outlook as of May 2022**

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<thead>
<tr>
<th></th>
<th>2021 Actual</th>
<th>2022 F</th>
<th>2023 F</th>
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<tbody>
<tr>
<td>Vacancy Rate</td>
<td>12.0%</td>
<td>12.0%</td>
<td>11.8%</td>
</tr>
<tr>
<td>Rent Growth</td>
<td>-0.8%</td>
<td>1.4%</td>
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</tr>
<tr>
<td>Price Growth</td>
<td>0.5%</td>
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</tr>
<tr>
<td>Cap Rate</td>
<td>6.4%</td>
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</tr>
</tbody>
</table>

**Top Asking Rent Growth**

- Palm Beach - FL: 7.2%
- Miami - FL: 6.6%
- Colorado Springs - CO: 5.1%
- Fort Lauderdale - FL: 4.9%
- Las Vegas - NV: 4.7%
- Reno - NV: 4.5%
- Lake Havasu - AZ: 4.1%
- Flagstaff - AZ: 4.1%
- Yuma - AZ: 4.1%
- Killeen - TX: 4.1%
- San Angelo - TX: 4.0%
- Las Cruces - NM: 4.0%
- Fort Myers - FL: 4.0%
- St. George - UT: 4.0%
- Enid - OK: 4.0%
- Prescott - AZ: 4.0%
- Laredo - TX: 3.9%
- Brownsville-Harlingen - TX: 3.9%
- Lawton - OK: 3.9%

Source: NAR analysis of CoStar data
Industrial

Migration to the South region spurs demand for logistics

In the industrial property market, logistics (warehouse, distribution, fulfillment centers) has been the growth driver. Asking rents for logistics space is up on average 12.4% year-over-year compared to 8.5% for flex space. The strong growth for logistics space is being driven by e-commerce sales, which accounts for 16% of sales, up from 13% before the pandemic.

Asking rents are rising at a double-digit pace in 37% of 390 markets tracked by CoStar. Several metro areas with the fastest rent growth are in the South region. According to US Census Bureau population statistics, the South region was the only region that had positive net domestic migration of 657,682 (the movement of people from one area to another within the United States) between 2020 and 2021. Rising population means more demand for goods which pulls the demand for logistics space.

Outlook for 2022-2023

Demand is expected to ease somewhat as consumer spending slows with inflation outpacing wages. However, the rising cost of oil and fuel is expected increase the demand for fulfillment centers even more as businesses seek to cut back on rising transportation costs should oil prices remain elevated. The demand for warehousing is also likely to increase as logistics operators and businesses engage in ‘just-in-case’ inventory management from “just-in-time” management.

Industrial Outlook as of May 2022

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<th>2021 Actual</th>
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<th>2023 F</th>
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<td>4.3%</td>
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<tr>
<td>Rent Growth</td>
<td>7.4%</td>
<td>10.7%</td>
<td>9.8%</td>
</tr>
<tr>
<td>Price Growth</td>
<td>11.5%</td>
<td>13.1%</td>
<td>9.2%</td>
</tr>
<tr>
<td>Cap Rate</td>
<td>6.4%</td>
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<td>6.2%</td>
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</table>

Top rent growth as of 2022 Q2

<table>
<thead>
<tr>
<th>City</th>
<th>Growth</th>
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<tbody>
<tr>
<td>Miami - FL</td>
<td>18.6%</td>
</tr>
<tr>
<td>Columbus - OH</td>
<td>17.0%</td>
</tr>
<tr>
<td>Fort Lauderdale - FL</td>
<td>16.7%</td>
</tr>
<tr>
<td>Las Vegas - NV</td>
<td>16.2%</td>
</tr>
<tr>
<td>Northern New Jersey - NJ</td>
<td>15.3%</td>
</tr>
<tr>
<td>Inland Empire - CA</td>
<td>15.2%</td>
</tr>
<tr>
<td>Hinesville - GA</td>
<td>14.7%</td>
</tr>
<tr>
<td>Fayetteville - NC</td>
<td>14.6%</td>
</tr>
<tr>
<td>Rocky Mount - NC</td>
<td>14.5%</td>
</tr>
<tr>
<td>Goldsboro - NC</td>
<td>14.5%</td>
</tr>
<tr>
<td>Savannah - GA</td>
<td>14.4%</td>
</tr>
<tr>
<td>Dalton - GA</td>
<td>14.2%</td>
</tr>
<tr>
<td>The Villages - FL</td>
<td>14.0%</td>
</tr>
<tr>
<td>Macon - GA</td>
<td>14.0%</td>
</tr>
<tr>
<td>Florence-Muscle Shoals - AL</td>
<td>14.0%</td>
</tr>
<tr>
<td>Jonesboro - AR</td>
<td>13.9%</td>
</tr>
<tr>
<td>Alexandria - LA</td>
<td>13.9%</td>
</tr>
<tr>
<td>Spartanburg - SC</td>
<td>13.8%</td>
</tr>
<tr>
<td>Morristown - TN</td>
<td>13.8%</td>
</tr>
<tr>
<td>Lakeland - FL</td>
<td>13.8%</td>
</tr>
</tbody>
</table>

Source: NAR analysis of CoStar data
Rents are rising across all types of retail stores. However, stores that provide essential products and discounted prices such as strip centers, neighborhood centers, and power centers continued to outpace rent growth in malls. These type of stores* provide essential items and discounted prices, which make the less vulnerable to slowing consumer demand under inflationary economic conditions. As of 2022 Q2, rents in strip centers rose at the highest pace of 4.7%, followed by neighborhood centers, at 4.6%. In power centers, rents were up 4.2% year-over-year. On the other hand, rents were up 3.8% in malls.

As of April 2022, rents were up in 72% of 390 metro areas, with the strongest rent growth in the South region and Mountain division areas, led by Las Vegas, Nashville, Jacksonville, Fort Lauderdale, Miami, Charlotte, and Salt Lake City, with rents rising above the inflation rate.

**Outlook for 2022-2023**

Rising inflation pose headwinds to retail real estate as consumers cut back on spending in real terms, more so because wages are rising below inflation. However, retail stores such as strip centers, neighborhood centers, and power centers are likely to be less impacted than malls which the ongoing recovery in malls could likely slow. However, with little construction underway, rent growth is not likely to decline, rising at the mid-3%.

*Strip centers are anchored by convenience/mini-mart stores; neighborhood centers are anchored by supermarkets; power centers or category killers are anchored by home improvement, discount stores, warehouse clubs.
Slower economic growth and inflation stall the hotel recovery

Rising inflation and a slowing economy have taken some wind out of the recovery in the hotel sector. Hotel occupancy slipped to 52.5% in April 2022 after rising to 66% in August last year.

However, the average daily rate per room rose to $143/room, up 35% year-over-year. The revenue per available room (RevPAR) also increased 57% year-over-year to $88/room, an indication of improving financial position.

Sales acquisitions have been rising since 2021. As of April, the 12-month sales volume rose to $10.5 billion, from just $2.4 billion one year ago. Sales data does not provide information if the investors intended to continue operating the hotels as hotels or undertake an adaptive reuse, such as for residential purposes. However, most acquisitions were of luxury, upper upscale, and upscale hotels. As of April 2022, occupancy rates in the luxury and upper upscale segments was below 60%, which indicates the hotels may end up being converted for other uses.

Outlook for 2022-2023

In 2022, rising airfares and gas prices could put a dent on personal travel and therefore demand for lodging. A slowing economy could also lead businesses to cut back on business meetings and conferences.

ADR is the total revenue/number of rooms. RevPAR is ADR x occupancy rate.
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