Conservative Investor Outlook Extends Real Estate Cycle as Economy Approaches 10th Year of Growth.

Investors kick off 2019 with a favorable, though more cautious, outlook; Sentiment on par with past peak.

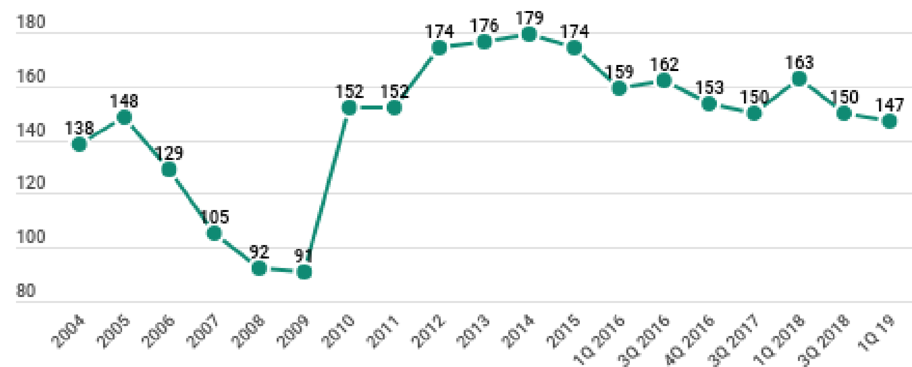
By Beth Mattson-Teig

Investors coming off another robust year of investment sales activity appear to be adopting a more conservative outlook, but sentiment levels point to an active 2019.

The latest NREI/Marcus & Millichap Investor Sentiment Survey shows that the Investor Sentiment Index notched back slightly from the 150 recorded in the second half 2018 survey [**Figure 1**]. "Although the index remains elevated, the modest reduction of Investor Sentiment reiterates caution sparked in the fourth quarter," says John Chang, senior vice president, director of research services at Marcus & Millichap. The caution weighing on sentiment likely reflects sensitivity to interest rates and the length of the growth cycle, he adds.

The outlook for improving property fundamentals is slightly more neutral than the prior survey. Forty percent of respondents anticipate that property values will rise faster in the next 12 months; 38% were neutral; and 22% do not believe values will rise faster in the coming year. That sentiment is consistent with a broadly held perception (70%) that values are near a cyclical peak. Nineteen

FIGURE 1 **INVESTOR SENTIMENT INDEX**



percent were neutral on their view on whether values were at a peak, while 11% do not consider values to yet be at a cyclical peak. This belief reiterates the conservative investor outlook, and it will influence how they will allocate their investments this year.

"I think people generally feel good about where things are going over the next year to 18 months, but looking beyond that timeline shows a little bit more concern about the economy, and investors are taking a slightly more cautious approach as they underwrite investments," adds Chang. Another issue that is weighing on sentiment is the political climate, which has emerged as a top concern in the survey. There are geopolitical issues people are watching, such as tariff negotiations, the softening of European economies and the divided congress. These factors cloud the longer-term outlook, he adds.

Political uncertainty, unforeseen shocks to the economy and rising interest rates were cited as the top concerns for about half of respondents. One notable shift from the prior survey is that concerns related to political uncertainty/geopolitical issues increased from 44% to 51%, while there was actually a decline in the number of respondents concerned about rising interest rates, which dropped from 67% to 50% [**Figure 2**].

FIGURE 2 **INDUSTY CONCERNS**

Q: As a real estate owner/investor, what are your top concerns over the next 12 months?

Top 5 Concerns

Long-term thinking and positive yields drive strong appetite for CRE

Despite caution creeping into the market, an increasing share of respondents believe that commercial real estate offers superior yields compared with other investment classes. Three out of four respondents think that CRE offers favorable returns relative to other investment classes, up from 67% who held that view in the second half 2018 survey. In addition, investors remain well capitalized. Sixty percent said they have abundant capital to invest, which also reflects an uptick from 56% in the prior survey.

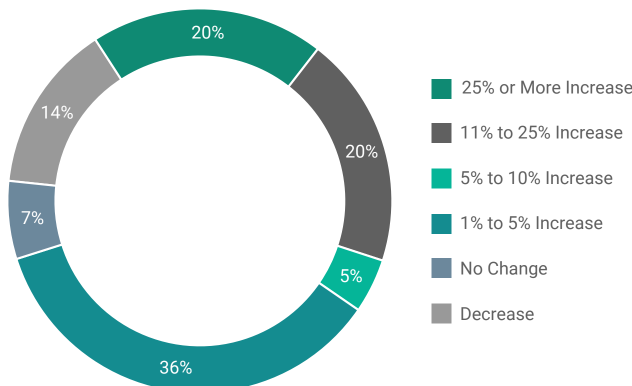
"Overall, investors are maintaining a positive outlook and are continuing to grow their portfolios," says Chang. More than half of respondents (58%) plan to increase their commercial real estate investment in the next 12 months, while 36% intend to keep investments the same. Only 7% of respondents expect their holdings to decrease in the coming year [**Figure 3**]. Although the share of investors growing their portfolios is trickling lower, it still points to strong activity levels. Based on the responses, investors suggest they will increase their real estate holdings by an average of 10% in the coming year.

In particular, investors continue to look for value-add opportunities across all property types, notes Chang. "Although investors aren't demonstrating a lot of pressure to buy and sell right now, they are open to the opportunities that are out there. That includes repositioning portfolios to diversify holdings and targeting assets with unique value-add propositions. Strategies like these have driven healthy transaction activity over the past four years," he says.

Most respondents believe it is generally a better time to hold assets. Assets that are viewed most favorably on the buy side are industrial at 39% and mixed-use at 31%. The assets respondents consider it an opportune time to sell are retail at 49% and office and hotels, each at 35%. When just the investors active in each property type are included, the views are more bullish. Fifty percent of investors who already own industrial assets believe it is a good time to buy, and the same holds for mixed-use investors. [**Figure 4**].

FIGURE 3

Q: Do you plan to increase or decrease your CRE investment in the next 12 months?



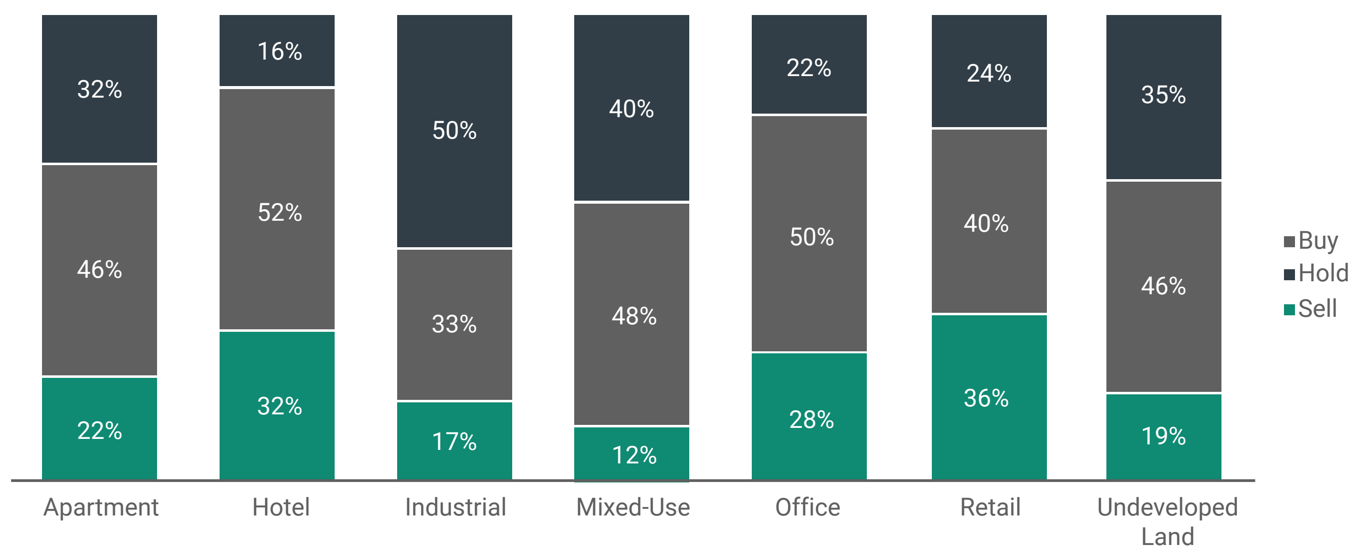
Investors Anticipate Another Year of Growth; Recession Timing Pushed Into Future

After a nearly decadelong growth cycle, it is not surprising that investors are wondering if an end is in sight. Most respondents (82%) expect the U.S. to experience a recession within the next few years, though most agree that it will be less severe than the 2008-2009 recession. However, investors — and economists — have set a later timeline on when a recession is likely to materialize. Most respondents think it will occur sometime after 2019. Thirty-five percent believe a recession will occur in 2020, 28% said 2021 and 15% said 2022 or beyond [**Figure 5**]. "We don't currently see any signs that a recession is imminent, but there is still concern that it is out there somewhere," says Chang.

One indicator that has stirred talk of

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

Q: In your view, is now the time to buy, hold or sell each of the following property types? Percentages reflect the opinions of respondents invested in each property type.



a recession is the flattening yield curve or difference between the 10-year and two-year Treasury rates. The yield curve is very flat, with the 10-year rate moving very close to the two-year, and a yield curve inversion usually precedes a recession by 12 to 24 months. In the current climate, respondents had mixed views on whether an inverted yield curve would be followed by a recession. Nearly half of respondents (47%) were unsure, while 32% said it would mean a recession and 21% said it would not.

"When you look at all the forward-looking indicators — job growth, confidence levels, interest rates, demographics, household formation, retail consumption — all of them are still quite positive," says Chang.

The commercial real estate sector is riding strong momentum into 2019 after investment sales dollar volume jumped 17% in 2018 to $575.2 billion, according to Real Capital Analytics. Employment also posted another strong year with nearly 2.7 million jobs added. The vast majority of respondents do not expect job growth to improve measurably in 2019 with 78% who think job growth will be similar or improve a little. Only 6% believe job growth will improve measurably, and 17% predict a decline in job growth. Sentiment on job growth dips for 2020 with 38% who anticipate a decline in job growth in 2020 [**Figure 6**].

Capital Market Liquidity Offers Favorable Options

Another factor that bodes well for continued commercial real estate investment is a steady interest rate environment. The Fed had been very aggressively pushing rates higher, which raised concerns that Fed action could raise rates too quickly. "Coming into 2019 the Fed softened its tone, implying that they are unlikely to be as aggressive on interest rate movement in the coming year," says David G. Shillington, president of Marcus & Millichap Capital Corp. "So, concerns about rising interest rates have abated."

Investors also have a slightly more favorable view on the outlook for interest rates. Although a majority of respondents (77%) still think rates will rise in the coming year, that number has improved compared with 97% who held that view in the second half 2018 survey. In addition, respondents have pulled back on expectations for how much rates could rise. Among those who predict a further increase in the coming year, 42% said it will be less than 50 basis points; while 20% believe there will be no change; and 3% anticipate a drop in interest rates [**Figure 7**].

There was some volatility in interest rates last fall as they climbed to 3.2%, but the 10-year Treasury has since dropped back to hover in the mid 2% range. "Investors still think we face some upward movement on interest rates, but they are not as fearful of rates surging as they were three to six months ago," Shillington says. A majority of respondents believe the two main drivers behind interest rate increases in the coming year will be Fed action at 62% and inflation — including both expectations of higher inflation and actual higher inflation — at a combined 59%.

FIGURE 5 **EXPECTATIONS FOR RECESSION**

Q: Do you expect the U.S. to have a recession in the next 5 years? If so, when?

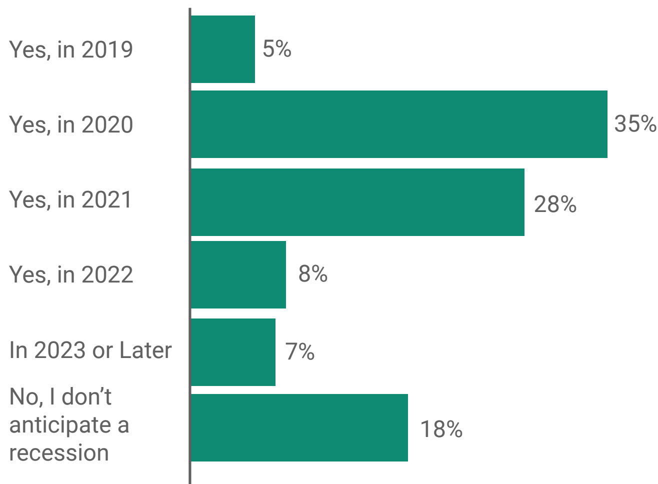
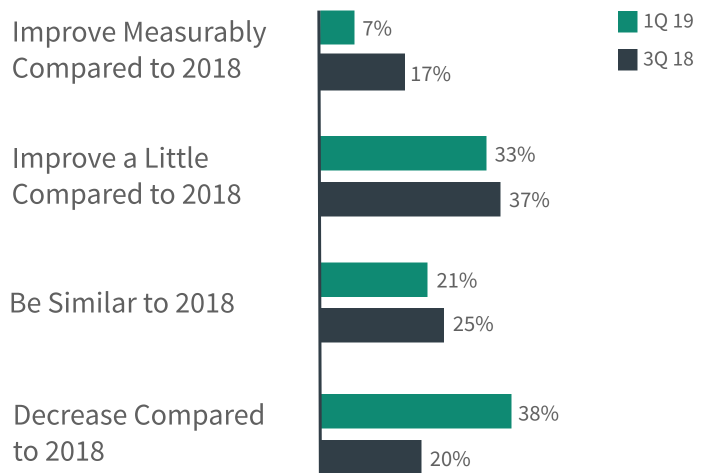


FIGURE 6 **JOB GROWTH**

Q: Do you expect job growth through 2019 to:



Industrial Enjoys Most Optimistic Outlook

Considering only the properties currently in their real estate portfolios, a majority of investors who own apartment, industrial, and mixed-use assets expect property values to increase this year. Owners of industrial are the most bullish, with 63% expecting gains, followed by apartments at 56% and mixed-use at 51%, while retail owners were the least confident about appreciation at 2% [**Figure 8**]. However, respondent expectations for increases are more subdued compared with the previous survey with a range on the low side of zero change for retail to 2.2% for apartments.

Industrial still has tremendous momentum across the entire sector, especially in logistics and last-mile fulfillment, due to the expansion from e-commerce. Brick-and-mortar retailers also are gaining more traction in their omnichannel platforms with online ordering that is fueling demand along the supply chain of warehouse, distribution and fulfillment space. "Industrial vacancies in port markets and intermodal hub markets are still relatively tight despite the elevated construction levels," says Alan L. Pontius, senior vice president, national director of specialty divisions at Marcus & Millichap.

Investors have a strong appetite to buy industrial, with the share who believe it's a good time to buy more industrial property moving higher in this survey. Half of investors who already own industrial properties think it is a good time to buy more, while one-third said it is better to hold and 17% said to sell. However, sentiment shows a more conservative outlook for appreciation. Although most industrial investors (63%) do expect the value of their properties to increase or remain the same (33%), the anticipated increase of 1.2% is a notable drop compared with the 5.4% prediction in the second half 2018 survey.

"It is surprising that the expectation of value growth has decreased, because we're seeing great momentum across the entire sector that points to continued industrial expansion," Pontius says. "It is a reflection of caution resulting from such outstanding gains over the past few years," he added. Last year, rents grew by 5.4% and Marcus & Millichap is forecasting that rent growth of 4.0% or higher in 2019 with vacancies likely to decline by 20 basis points to 4.5%. These metrics point to gains that will outpace expectations.

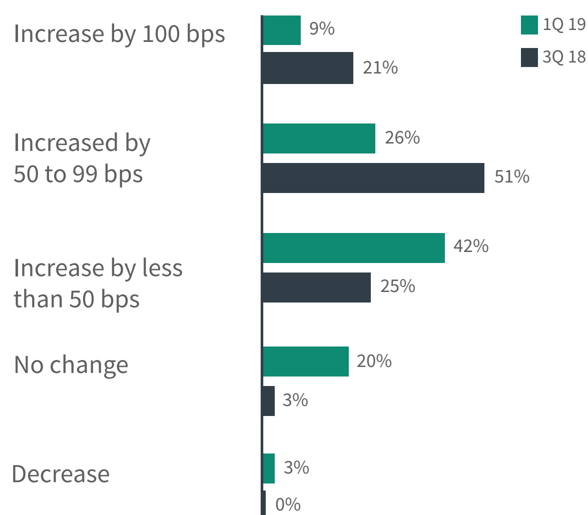
Tight Employment Market Drives Office Strategy

Office has been improving, albeit slowly, year after year. Investors remain fairly consistent in their views on investment strategy and expectations for rising office values. Half think it is a better time to hold, while 22% said it is better to buy and 28% said sell. Generally, the outlook is for continued stability in the office sector in the coming year. Although about half of investors anticipate no change in values, nearly one-third believe office values will increase and 16% think there will be a decline. The average increase in rents, according to investors, will be positive but slight at 0.8%.

One of the key themes in the office market that is influencing investment strategy is competition for talent. The focus on attracting and retaining key people in a tight labor market is

FIGURE 7 **INTEREST RATES**

Q: What are your expectations for interest rates over the next 12 months?



benefiting submarkets and properties that offer some type of value for tenants, whether that is a convenient location, walkability or proximity to nearby amenities. "The unemployment rate is so low that companies have to apply more aggressive tactics to attract talent," Chang says. Historically, companies would go out and recruit talent and bring the people to where they want that staff. Now companies are bringing facilities to the people, often locating smaller satellite offices in cities or suburbs near targeted talent pools that will help their organizations grow, he adds.

Marcus & Millichap is forecasting that vacancies will hold relatively steady in 2019 at 13.3% with rents that will rise by 2.5%, higher than the survey would suggest.

Apartments Maintain Steady Course

Views on apartments remain fairly consistent with the prior survey. Thirty-two percent said it is a better time to buy, while 22% think it is a good time to sell. Nearly half of apartment owners (46%) believe it's a good time to hold. This reflects the steady momentum apartment properties have enjoyed over the last ten years and the number of investors who have repositioned their portfolios over that time.

Apartments have generated exceptional results, but sales activity and pricing have aligned with that performance, rising substantively over the years. That's making it more difficult for investors to find buying opportunities in their targeted strike zone, notes John S. Sebree, first vice president, national director of the National Multi Housing Group at Marcus & Millichap. "Investors have been casting their nets across a wider range of options over the last couple of years, driving increased activity into secondary and tertiary markets as well as a range of suburban locations in an effort to create value," he adds.

"We continue to see fantastic momentum in terms of renter demand with performance metrics that are very strong," Sebree says. Fundamentals are holding up well considering the record development pipeline. Marcus & Millichap is forecasting that completions will rise to 315,000 units this year, the most new units completed in a single year since the 1980s. Still, vacancies are projected to increase by just 10 basis points to 4.7% on a macro level in 2019. Class A properties will face the most pressure from new supply, while Class C vacancies sustain their all-time best results, he adds.

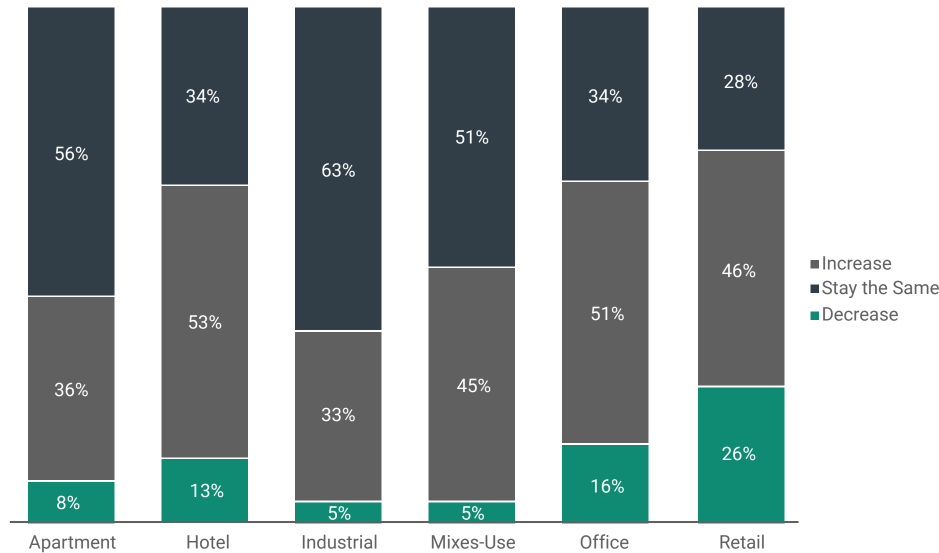
Apartment owners' expectations of value growth have eased, though they remain bullish compared with most other property types. A majority of respondents (56%) still anticipate apartment values to rise over the next 12 months, but that is lower than the 62% who held that view in the second half 2018 survey. Likewise, apartment owners believe values will increase by an average of 2.2%, the least optimistic expectation since 2011.

Retail Outlook Rising as Space Fills With Entertainment and Services

Retail sentiment made a subtle shift to the positive in the latest survey, though investors are still split on their views on whether it is a better time to buy (24%), hold (40%) or sell (36%). However, there has been an uptick in respondents who

FIGURE 8 **PROPERTY VALUES**

Q: Which of the following do you expect to drive the change in interest rates over the next 12 months?



think it is a good time to buy, rising from the 18% mark set in the second half 2018. Survey results also showed a significant disparity in views on retail when comparing the buy-hold-sell sentiment for all respondents versus those who currently own retail assets. Nearly half (49%) of the total respondent pool, many of whom do not own retail properties, think it is a good time to sell retail, while that percentage drops to 36% when only counting those who currently own retail "That disparity reflects the disconnect between the investors who are not active in this business versus those who own these assets and understand just how strong the sector is," says Scott M. Holmes, senior vice president, national director of retail at Marcus & Millichap. "We continue to see headlines on store closures, but we also continue to see aggressive expansion in retail. Retailers who are expanding just look a little different than they have in the past." Retail leasing is driven more by restaurants, fitness, entertainment and service-oriented businesses, he adds.

Similar to prior surveys, nearly half of respondents (46%) believe values will remain the same, while 28% think values will rise and another 26% said values would likely fall. The net result is that values will remain flat in the coming year, which is more favorable than expectations in the prior two surveys when the outlook was for a slight decline in values. Marcus & Millichap is forecasting that vacancies will hold relatively steady at 4.7% with modest rent growth of 3.3%.

Hotel Investors Cautious as They Consider Risks to Economy

Investor appetite for hotels has been steadily declining since 2010 when investor interest peaked at 70% who thought it was a good time to buy. Investors are more apt to think it is a better time to hold (52%) or sell (32%) hotels with only 16% who still favor acquisitions.

Generally, investors do expect hotel values to remain relatively stable in the coming year. Fifty-three percent think there will be no change, while nearly one-third predict an increase and 13% believe values will decline. The average increase anticipated is positive at 1.0%, but it also is the lowest level since 2009. "The hotel sector is very sensitive to the economy. So, if there's an economic setback, hotel properties will feel it first. Naturally, investors are very sensitive to this and it drives more caution in the hotel sector," says Peter Nichols, vice president, national director of the National Hospitality Group at Marcus & Millichap.

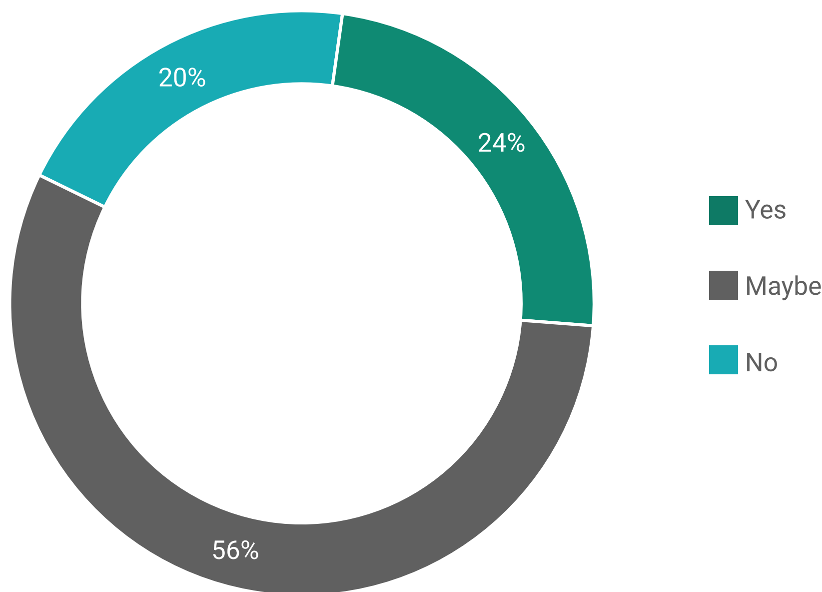
That being said, tax reform has been particularly favorable for the hotel sector. The accelerated depreciation rules put in place for the furnishings at hotels on recent acquisitions has sparked more activity as investors reposition their assets and portfolios to capitalize on the change. These owners are also capitalizing on the opportunity to make their portfolios a little more resistant to a potential economic downturn, Nichols adds.

When looking at the impact of the new tax laws, nearly one out of four respondents said that they have bought or plan to buy property in the next 12 months due to the favorable provisions in the new tax law. That is a positive as people are seeing opportunities that perhaps they didn't before, Chang notes. "In reality, there will be greater understanding of tax reform in the second and third quarter after investors complete their taxes for 2018. Then they will have a much better idea of how they can capitalize on the new tax rules," he says.

Another potential driver for transaction volume in 2019 could be related to shifting real estate strategies. One in five respondents said they plan to reposition into a different commercial real estate property type in the next 12 months, while an additional 24% indicate that they are

FIGURE 9 | INTEREST RATES

Q: Do you plan to reposition any commercial real estate holdings from one property type to another in the next 12 months?



considering this possibility [**Figure 9**]. That is a noticeable uptick compared with the last time the question was asked in third quarter 2016 when 17% said they planned to reposition portfolios and 18% said they were considering it. Among those who are considering repositioning, more respondents (35%) are likely to move into apartments while 20% vindicated they would move out of retail shopping centers. Portfolio repositioning is likely driven by a desire to capitalize on appreciation and/or improve diversification. "This reflects a perception that there has been a significant run-up in some real estate sectors and people are looking at a range of options and opportunities," Chang says. "Overall, investors seem to have a pretty steady outlook that could support activity levels on par with what we have seen over the last few years." ■

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 Feb. 7-27 with 661 completed surveys received. Survey respondents represent a broad cross-section of industry respondents that include private investors, developers, advisors, lenders and REITs. The largest percentages of respondents are private investors at 36 percent and developers at 14 percent. Respondents are invested in a variety of property types with a majority of 64 percent invested in apartments, followed by retail at 37 percent and office at 35 percent. On average, respondents have $37.2 million invested in commercial and/or multifamily properties.

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