Real Estate Pulse
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A cycle upturn meets uncertainties

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Key takeaways

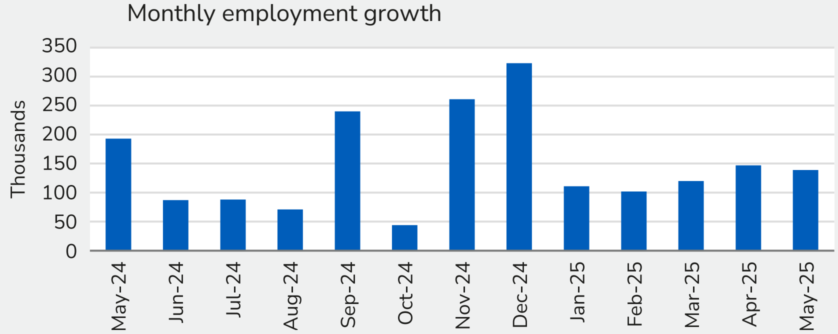
- Investors who can overlook near-term macroeconomic uncertainty may find an attractive opportunity in US commercial real estate.
- A weakening in expected US economic growth accompanied by higher expected inflation will challenge Federal Reserve policymakers in 2025.
- During the first quarter of 2025, the pace of CRE transactions held up well, property pricing increased and credit availability was robust.
- Upturns in net operating income growth and stabilizing cap rates contributed to positive appreciation in most sectors.
- The top 50 metro area markets are reporting stable to improving market fundamentals, which we believe should further benefit as inflows of new supply diminish.

US commercial real estate (CRE) investment performance during the first quarter of 2025 confirmed expectations for a cycle turnaround. The NCREIF National Property Index (NPI) benchmark delivered its third consecutive quarter of positive total return, following seven quarters of negatives. Three positive quarters are a solid basis for declaring a cycle upturn supported by steady economic growth through year-end 2024 and ongoing employment growth.

Positive income return accompanied by a small positive quarterly appreciation component drove the total-return results. Among the four primary sectors, only office continued to report negative appreciation amounting to -0.57% for the quarter. Retail led with the strongest quarterly total return followed by residential and industrial, while office lagged. For the full year ending in March, all property total return amounted to 2.8%, with retail at 6.7%, industrial at 3.8%, residential at 3.7% and office at -3.0%.[1]

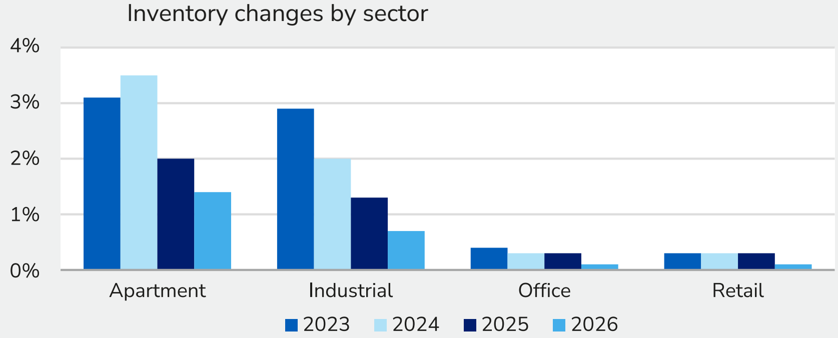
The cycle turnaround is benefiting from the decline in new supply in the space-heavy industrial and apartment sectors, along with continuing scant new supply in retail and office sectors, as shown in Figure 2. The US economy continued to support the demand side of CRE with solid employment growth through May and ample credit availability. The rising economic uncertainty related to tariff policies that emerged in the first quarter had little discernible effect on property total return, reflecting the usual lag between CRE and the macroeconomy. Nonetheless, the first quarter's -0.3% GDP growth, which resulted from a flood of imports intended to front-run tariff changes, foreshadowed tariff worries to come.

Figure 1 – Solid employment growth is supporting the CRE cycle upturn
Monthly employment growth



Source: BLS. Data as of May 2025.

Figure 2 – Supply is declining in space-heavy sectors
Inventory changes by sector



Source: CoStar.

Solid US CRE performance so far in 2025 faces foggy future

While diminishing new supply this year should support the CRE cycle upturn from here, prospects for the quarters ahead have become highly unpredictable due to the evolving federal policies introduced by the second Trump administration. The most unsettling are the tariff policies covering all US trade partners that were announced on April 2. The new tariffs included a 145% levy on goods from China, the largest source of US imports. Financial markets convulsed after the announcement with stock values plummeting, long-term Treasury yields rising, credit spreads widening and the value of the dollar slipping.

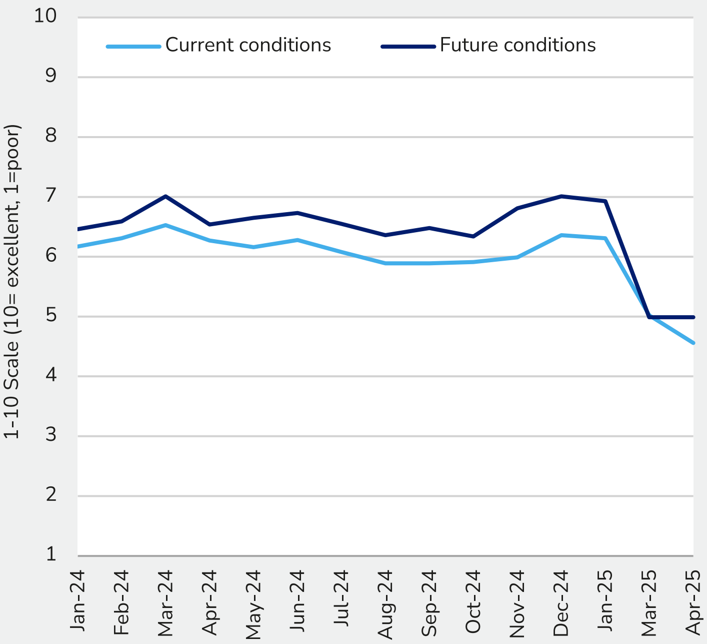
Global investors were clearly alarmed and dumped US assets. In response to the turmoil, the US administration paused most of the new tariffs for 90 days, leaving the 145% tariff on China and a 10% across the board levy elsewhere. More recently, the 145% has been reduced to 30% on some items for 90 days pending further negotiation. Financial markets calmed even though the reduced tariffs are still high enough to be disruptive.

Even after the pause, the tariff situation remains problematic for the US economy. Tariffs have been shown historically to be inflationary, with the related disruption to the economy threatening growth as well. Moreover, the uncertainty surrounding on-again, off-again tariff policy has negative effects as well.

Other Trump administration actions are adding to economic uncertainty. Shrinkage in the federal government labor force and shutdowns in activities and agencies are in the headlines, but court ordered delays are making it impossible to gauge effects. Halts on federal research grants also have potential negative impact on economic growth that is not yet measurable. In addition, the crackdown on immigration is making headlines but without a clear measure of its impact on the labor force, especially in the construction, agriculture and food processing sectors.

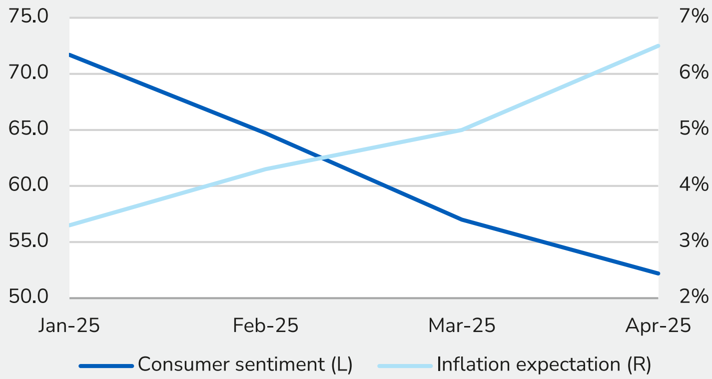
Long-horizon business commitments and consumer spending decisions need policy clarity and stability. All told, CEO confidence is down, and consumer sentiment has deteriorated with rising inflation expectations, as Figures 3 and 4 show. Through early May, the Federal Reserve has maintained interest rate policy while commenting on the heightened risks to growth and inflation.

Figure 3 – CEO confidence is down
CEO confidence index



Source: Chief Executive Research. Data as of April 2025.

Figure 4 - Consumer sentiment has deteriorated with rising inflation expectations



Source: University of Michigan via FRED. Data as of March 2025.

Implications for US CRE

The macroeconomy represents only a portion of the factors that drive "the CRE cycle" and determine CRE investment performance. Fundamental market and property performance are also factors:

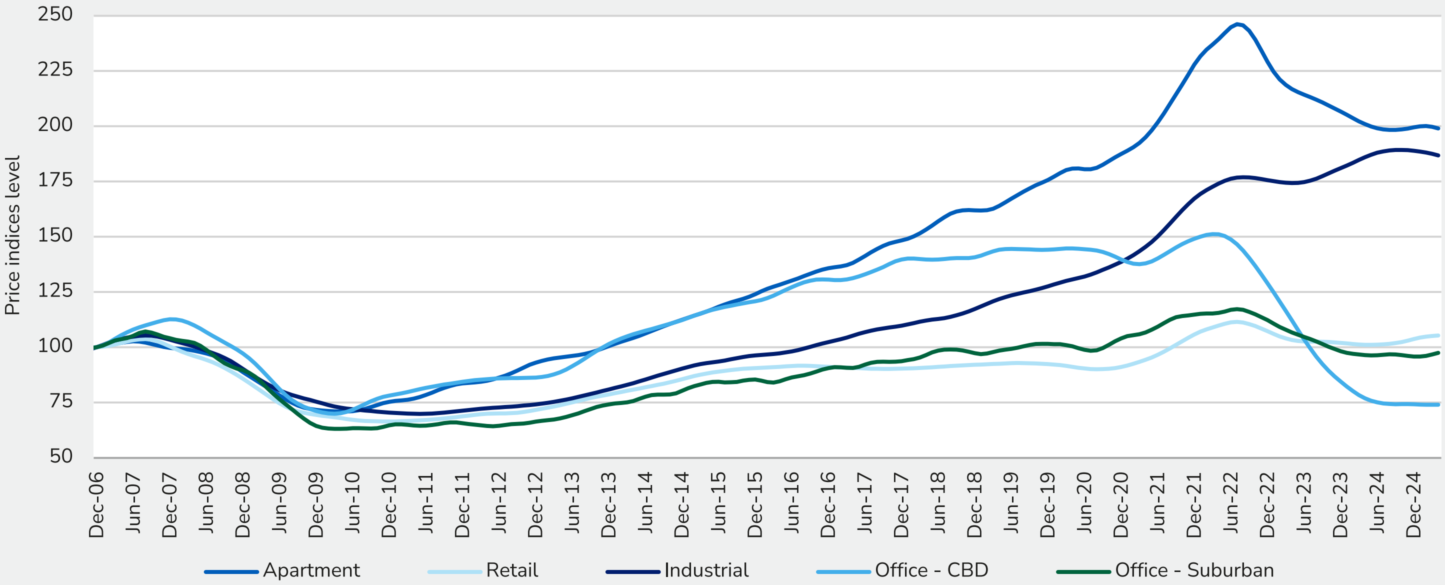
- Weaker economic growth is most likely to affect the demand for industrial space most directly. Slower growth especially with tariff disruption will impair the flow of goods and the warehouse space that houses them. Industrial space vulnerability depends on the relative supply-demand balance in individual metro markets. Some are grappling with excess supply; others are more balanced.
- Retail space demand will also respond to weaker growth as it flows from slower consumer spending. But supply-demand is well-balanced across the sector, leaving it more resilient.
- The office sector is in the midst of restructuring. Weaker leasing activity will accelerate the shakeout of excess space.
- The residential sector is also working through excess supply in some metros with others well balanced. Slower economic growth will slow the rotation of tenants to single-family purchases.

Overall, slower economic growth combined with borrowing rates elevated to curb inflation will likely discourage new construction projects beyond current expectations. Higher prices for construction materials affected by tariffs may slow new projects as well, along with uncertainty regarding construction labor as immigration is tightened. We believe any further shrinkage in supply as result of these factors will benefit CRE investors.

CRE investors will likely also benefit from the recent bottom in cycle pricing. Unlike stocks, which are trading at rich prices even with the tariff volatility, CRE is coming off the bottom of its pricing cycle, as shown in Figure 5. At the end of first-quarter 2025, the preferred apartment sector was priced 18.5% below its cycle peak, while industrial was barely off its peak and retail was down 5%. Office pricing was down most severely, off 23% from its peak.

Investors who can overlook near-term macroeconomic uncertainty may find CRE an attractive opportunity. Their demand could put a damper on property value risk ahead. In this regard, the quarterly survey of foreign investors in US CRE conducted by AFIRE, shows that 44% were planning an increase in US investments, citing promising fundamentals and despite rising concerns with the US outlook.[2]

Figure 5 – CRE is coming off the bottom of its pricing cycle
National property types



Source: MSCI-RCA, RCA CPPI. Data as of March 31, 2025.

Macroeconomy

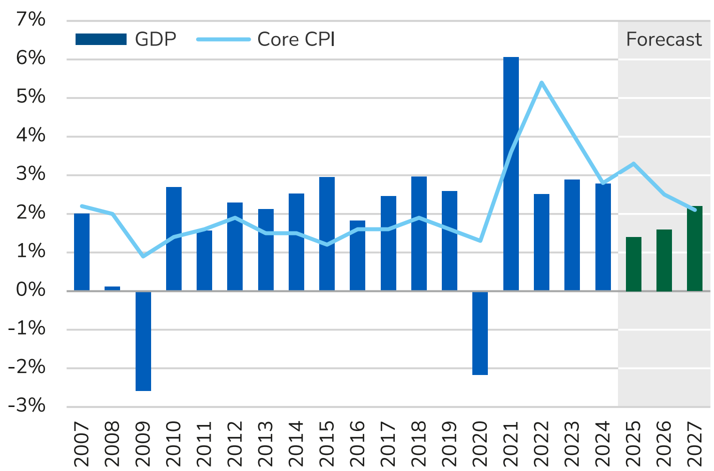
Projections for US economic growth in 2025 are subject to an unusual degree of uncertainty, reflecting the gyrations in tariff policy, shrinkage in federal government employment and activities, shrinkage in immigration flows, and the potential impact of these on consumers and businesses.

The most recent forecasts were collected in May by the Federal Reserve Bank of Philadelphia in its quarterly "Survey of Professional Forecasters." The survey reports a 1.4% median projected real GDP growth in 2025, down from the 2.4% projections reported in the February survey. Core inflation measured by the personal consumption expenditures metric is expected to rise 3.3% in 2025, up from the 2.4% expectation earlier. Weaker growth and higher inflation are projected for 2026 as well. The risk of negative quarters in the remainder of 2025 is gauged at 30%+.

The Survey does not ask explicitly about the risk of recession, which typically involves two consecutive negative quarters. CEOs were surveyed about recession, and 46% expect recession over the latter half of 2025.[3] Recession or not, the weakening in expected growth accompanied by higher expected inflation will challenge Federal Reserve policymakers.

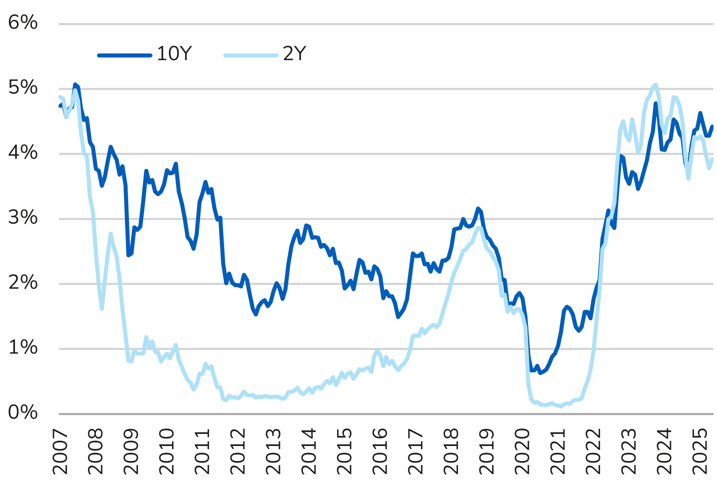
The challenge is illustrated in recent Treasury yields. Despite the 100 basis point cut in the federal funds rate since September, both the 2-year and 10-year Treasury yields have increased, as shown in Figure 7. The increase is notable as it implies that financial markets are more focused on rising inflation prospects versus weaker growth prospects. The Fed appears to be reinforcing this view, as rates were held steady at all four policy meetings so far in 2025. The federal budget negotiations underway in Congress are also weighing on Treasury yields, as the likelihood of a widening deficit increases.

Figure 6 – US real GDP and core PCE (annual)



Source: Federal Reserve Bank of Philadelphia, First Quarter 2025 Survey of Professional Forecasters; St. Louis FRED.

Figure 7 – US 10-year and 2-year Treasuries (monthly yields)



Source: St. Louis FRED. Data as of May 2025.

CRE transactions and pricing

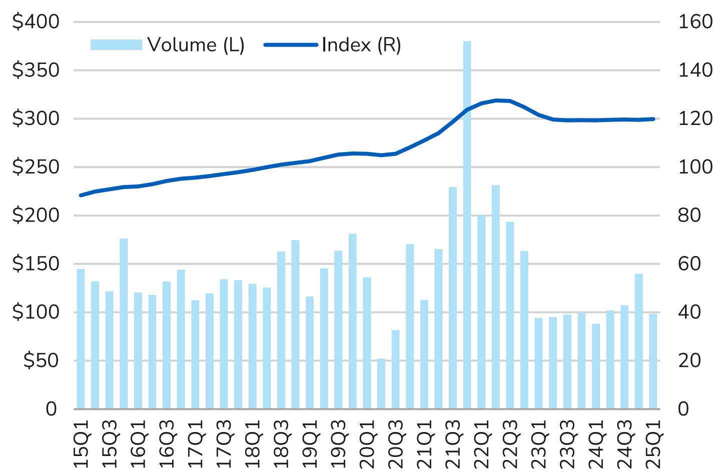
The pace of CRE transactions held up well through the first quarter of 2025, with the total 11% above first-quarter 2024 levels.[4] However, it bears repeating that transactions are closed weeks, if not months, after they are negotiated and signed. First-quarter transactions pre-date the upheaval of the April tariff news and may pre-date much of the news on federal cuts and immigration tightening.

Apartments, hotels and industrial had the strongest year-over-year improvements in transactions. Retail transactions were flat while office transactions contracted in the absence of entity deals. Interestingly, the hot data center segment of the market contracted sharply from year-ago transactions activity, but it is very small and volatile.[5]

Property pricing reported in the MSCI-Real Capital Analytics Commercial Property Price Index show a third consecutive quarterly increase in the first quarter of 2025 of 0.5% for the All Property Index. As Figure 9 shows, retail properties experienced the strongest increase, 1.8%, followed by office at 1.2%, and apartment at 0.4%. Industrial lagged with a -0.2% decline. The price increase in the office sector is noteworthy, as it indicates that some buyers are finding opportunity despite office sector restructuring.

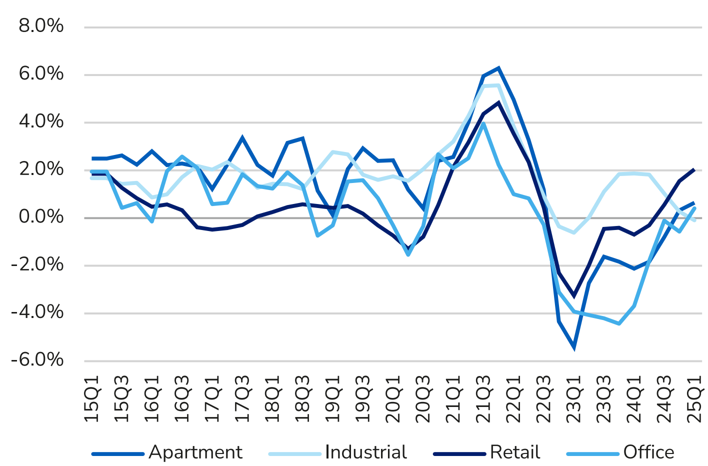
Credit availability was robust during the first quarter. The Mortgage Bankers Association reports that commercial and multifamily lending was up 42% in the first quarter from the same quarter last year and up 40% from the fourth quarter of 2024. Plentiful CRE credit has helped to modify distressed loans, with the total of modifications almost doubling from March 2024 to March 2025, according to Cred IQ research. However, the pipeline of distress continues to grow; RCA reports a 23% increase in the year ending March 2025. Office properties account for the largest portion of distressed assets.

Figure 8 – Transaction volume (quarterly, $b)



Source: Real Capital Analytics. Data as of May 2025. Index = RCA CPPI Core Commercial Index.

Figure 9 – RCA CPPI (% change quarter-over-quarter)



Source: Red Capital Analytics. Data as of May 2025.

NPI property performance

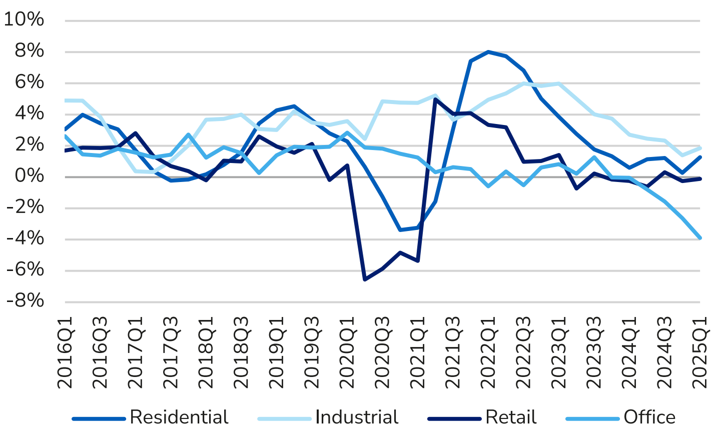
Most sectors see positive appreciation

The US CRE NCREIF NPI benchmark reported its first positive appreciation in the first quarter of 2025, after ten consecutive quarterly negatives. As Figure 10 shows, only the office sector continued to suffer value depreciation, though the pace of its quarterly decline has been waning. Upturns in net operating income (NOI) growth and stabilizing cap rates contributed to the positive appreciation in industrial, residential and retail, while office NOI and cap rates both contributed to its depreciation. Figures 10 and 11 examine NPI property performance in more detail.

It is worth remembering that NOI growth for each sector is influenced by the pace of lease rollovers. Residential apartments typically have short-term leases allowing rents to catch-up quickly to changing marking conditions. Lease terms are longer for the other sectors, prolonging the catch-up to market. Recent turmoil in the office sector is promoting tenant interest in shorter leases that accommodate further evolution in work-from-home arrangements.

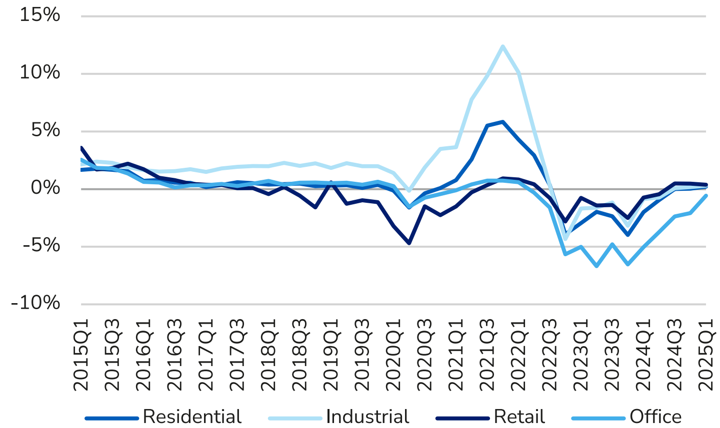
In the quarters ahead, the ebbing flow of new supply will likely improve NOI growth but only to the degree that new supply can be absorbed without compromising rents. We believe weaker economic growth and heightened economic uncertainty will challenge absorption and perhaps challenge rent growth as well. Cap rates will likely respond as well to the challenging environment, especially if interest rates remain elevated.

Figure 10 – Expanded NCREIF-NPI growth (rolling four-quarter average)



Source: NCREIF. Data as of April 2025.

Figure 11 – NCREIF-NPI capital return



Source: NCREIF. Data as of April 2025.

Metro market vacancy rates and rent growth

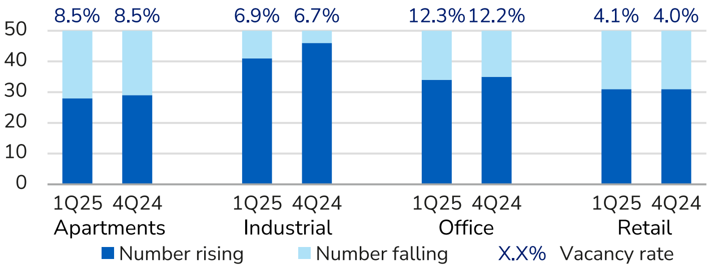
Improving most for apartments

Figures 12 and 13 are designed to portray the momentum in the top 50 metro area markets as defined by changes in vacancy rates and rents by property sector. The 50 top metros tracked in the figures are reporting stable to improving market fundamentals. For apartments, more than half of the top 50 metros reported declining vacancy rates and rising rents in the first quarter, somewhat better than in the fourth quarter of 2024. The retail sector also reported solid results but more as continuation than improvement.

Retail vacancy rates were essentially unchanged at 4.1%, with twenty of the top 50 metros showing falling vacancy but most reporting weaker rent growth. Industrial properties also reported weaker rent growth, but at a still robust 3.3% rate, accompanied by a small but pervasive increase in vacancy rates. Office continued to struggle, with rising vacancy rates and declining rent growth reported for most metros.

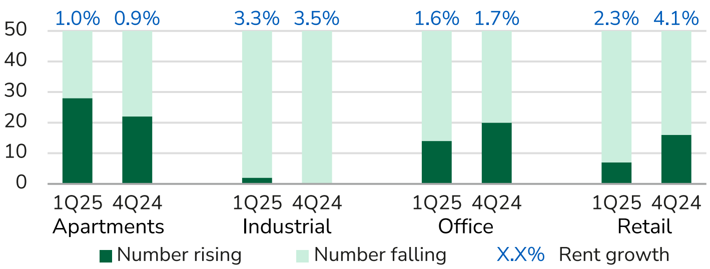
Looking ahead we believe metro market fundamentals should benefit as inflows of new supply diminish. But if weaker economic growth and higher interest rates materialize, the benefits could be offset.

Figure 12: Vacancy rate changes (top 50 metros)



Source: CoStar, Q1 2025 vs. Q4 2025.

Figure 13: YoY rent growth changes (top 50 metros)



Source: CoStar, Q1 2025 vs. Q4 2025.

Footnotes

1. NCREIF.
2. AFIRE, Pulse Report, Spring, 2025.
3. Chief Executive Research, survey conducted May 5-6.
4. Real Capital Analytics. Data as of May 2025.
5. Real Capital Analytics. Data as of May 2025.

Our assesment process

Analysis of real estate investment prospects commonly starts with a review of recent and expected macroeconomic performance. That starting point reflects the importance of the macroeconomy as a driver of the supply and demand forces that determine property investment performance. The macroeconomic environment influences those drivers and propels a national real estate cycle. That cycle is the dominant influence on performance with property sector and local geographic influences following in importance. At the same time, the idiosyncratic characteristics of specific properties and their specific locations combine with the national cycle feeding each property's bottom line. These diverse influences encourage investors to evaluate both the "top-down" macro environment and the "bottom-up" characteristics of each individual investment under consideration.

Economic growth affects property sectors through varying channels. For apartments, demand drivers include employment and income growth that enable maturing young people to form households along with the absolute number of that population cohort. Interest rates are also important as they influence the cost of buying a home versus renting. Stronger economic growth fuels both employment and income growth. Employment and income growth along with population growth also influence prospects for the retail sector. But growth that is too strong can promote inflation leading to rising interest rates which put a lid on growth.

The industrial sector depends on the widest definition of GDP including the international trade sector. Industrial space demand reflects the flow of goods through the domestic economy. Industrial space demand is very responsive to the macroeconomy in part because the sector can build new space quickly when compared with other types of structures. This responsiveness contrasts sharply with office space where construction lags dampen responsiveness to the macroeconomy.

But, at the same time, there are structural forces of various strengths affecting each sector. For apartments, the strongest is the ongoing shortfall in the supply of housing due to weak construction following the 2008 recession. For industrial, the adjustment to more online shopping and demand for faster delivery is an ongoing tailwind. For office, work-from-home appetite is still uncertain and space obsolescence is a mounting concern. Finally, the retail sector is enjoying a tailwind from disparate population growth contributing demand for space in growing localities while the headwind of excess space in declining areas and shrinking venues is ongoing.

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Martha Peyton is a Research Consultant to the firm's Real Estate Equity team. In this role, she is responsible for US economic and property market research, which is a foundation for the team's investment strategy.

Between 2018 and mid-2023, Martha was Managing Director of Applied Research for Aegon Real Assets US, primarily responsible for the development and application of research to real asset strategies. Between 1993 and 2016, Martha was Managing Director, Head of Real Estate and Global Real Assets Research for TIAA-Nuveen. While at TIAA, she built and oversaw the research function for the commercial mortgage loan and real estate businesses. This included managing research staff, setting the research agenda, conducting ongoing monitoring and analysis of the investment environment and asset class performance and authoring white papers and research publications.

Martha earned her BA, MA and PhD in Economics from Fordham University. She is a Counselor of Real Estate (CRE) and is a Fellow and past president of the Real Estate Research Institute.

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