Aegon Asset Management

Real Assets Research
December 2023

AEGON **INSIGHTS**

US CRE Market Insights

Executive summary

- *The US Federal Market Operating Committee (FOMC) agreed to hold interest rates steady for the second consecutive time in November at a target range of 5.25-5.50%.*
- *Financial conditions have tightened with the 10-year Treasury rising in October to the highest level since 2007.[1] This, coupled with tensions in the Middle East, continues to put pressure on the global economy. As a result, many economists surveyed by the Blue Chip Economic Indicators believe the fed-funds rate has peaked and the first rate cut to occur in the second half of 2024.[2]*
- *Inflation continued to slow with its slimmest year-over-year gain at 3.5% as measured by the core personal consumption expenditure, that was slightly above the 2% Fed target.[3]*
- *Within commercial real estate (CRE) debt, lenders are beginning to deploy 2024 allocations, and spreads are compressing slightly and are in the 180-210 range as of early December. However, corporate bond spreads continue to tighten, maintaining the commercial mortgage loans to corporates spread gap.*
- *Property transaction volume was down 53% during the third quarter of 2023 and 55% year-to-date compared to the same period a year ago.[4]*
- *Property value declined by 0.6% on an annualized basis from August to September, and 9% compared to last year.[4]*
- *NCREIF National Property Index (NPI) returned -8.4% for the year ending September 30, 2023, compared to 16.1% a year ago. Capital appreciation was reported as -12.1%, with income return at 4.1%.[5]*

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Property sector outlook

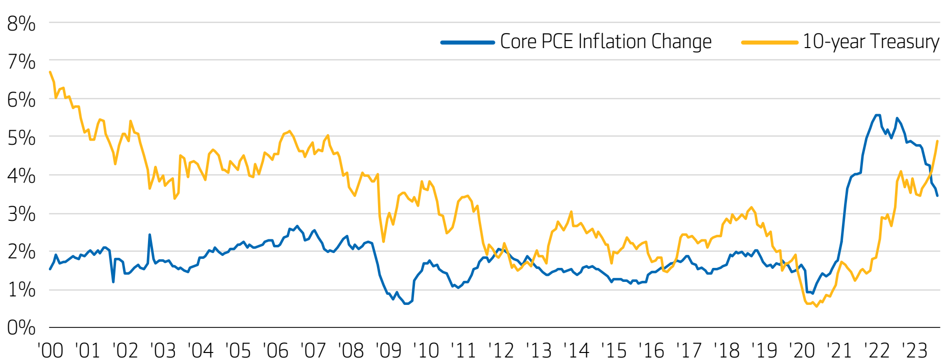
	3Q 2023 total return	Under construction as % of inventory	3Q 2023 vacancy rate	3Q 2022 vacancy rate	3Q 2023 YoY rent growth	3Q 2022 YoY rent growth	Aegon AM Real Assets sector outlook
Apartment	-7.6%	5.1%	7.1%	5.9%	1.1%	5.6%	Neutral
Industrial	-5.3%	2.8%	5.1%	3.9%	7.4%	11.6%	Neutral
Office	-17.1%	1.4%	13.3%	12.2%	0.6%	1.4%	Most Cautious
Retail	-1.4%	0.5%	4.1%	4.3%	3.7%	4.4%	Cautious

Sources: National Council of Real Estate Investment Fiduciaries, CoStar Realty Information Inc., and Aegon AM Real Assets US. As of September 30, 2023.

Economic outlook

The FOMC agreed to hold interest rates steady for the second consecutive time in November at a target range of 5.25-5.50%. Inflation as measured by core personal consumption expenditures continued to ease but remains above the Fed's 2% target.[3] Financial conditions have tightened since then with the 10-year Treasury rising in October to the highest level since 2007.[1] This, coupled with tensions in the Middle East, continues to put pressure on the global economy. As a result, many economists surveyed by the Blue Chip Economic Indicators believe the fed-funds rate has peaked and the first rate cut to occur in the second half of 2024.[2]

Core personal consumption expenditures (PCE) ease but remain above Fed's 2% target



Sources: US Bureau of Economic Analysis, as of October 31, 2023, and US Department of Treasury as of October 31, 2023.

Despite tightening monetary policy, the US economy expanded 5.2% in the third quarter of 2023 on an annualized inflation-adjusted basis, much faster than market expectations. The jump in real GDP growth was driven by a very strong consumer spending over the summer. This acceleration in spending is likely not sustainable as both real disposable personal income and personal savings rates decreased over the same period.[6] The labor market is showing signs of a cooling economy as employers added 150,000 jobs in October which was half of the prior month's gain and the slowest increase since June. As of November, the unemployment rate increased 50 basis points (bps) since April to 3.9%.[7]

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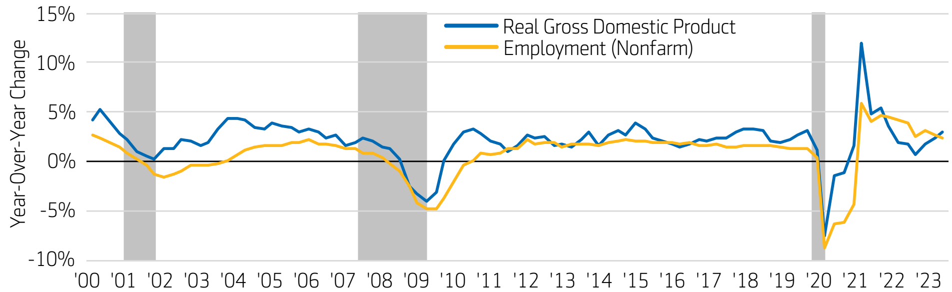
The US economy grew at a faster-than-expected pace though the labor market is easing

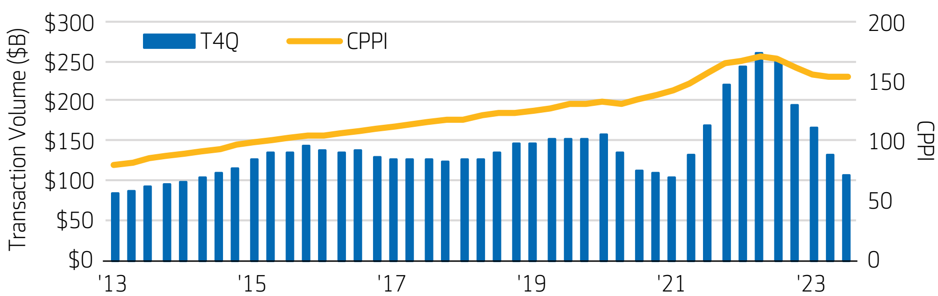


Sources: US Bureau of Labor Statistics as of November 10, 2023. Bureau of Economic Analysis as of November 29, 2023. Employment figures reflect private and government non-farm jobs. Shaded areas indicate US recessions.

The Fed's aggressive interest rate hikes continue to take their toll on property transaction volume as a disconnect remains between buyers and sellers. Property transaction volume was down 53% during the third quarter and 55% year-to-date compared to the same period a year ago. Similarly, property values declined by 9% compared to last year. However, much of this value decline was frontloaded falling only 0.6% on an annualized basis from August to September.[4]

The Fed's aggressive interest rate hikes continue to take their toll on property transaction volume as a disconnect remains between buyers and sellers.

Economic uncertainty continues to take its toll on transaction volume



Sources: Aegon Real Assets US and. Real Capital Analytics. As of September 30, 2023

Transaction volume by property type

	3Q 23	3Q 22	YoY changes
All Apartment	**$30.1 B**	**$78.7 B**	**-61.7%**
Garden	$18.5 B	$50 B	-62.9%
Mid/Highrise	$11.6 B	$28.7 B	-59.6%
All Industrial	**$21.1 B**	**$38.7 B**	**-45.5%**
Flex	$3 B	$8.1 B	-62.9%
Warehouse	$18.1 B	$30.6 B	-40.9%
All Office	**$10.6 B**	**$30.5 B**	**-65.3%**
CBD	$1.8 B	$7.4 B	-75.8%
Suburban	$8.8 B	$23.1 B	-62.0%
All Retail	**$14.9 B**	**$21.5 B**	**-30.5%**
Strip Center	$10 B	$14.3 B	-30.2%
Mall & Other	$5 B	$7.2 B	-31.3%

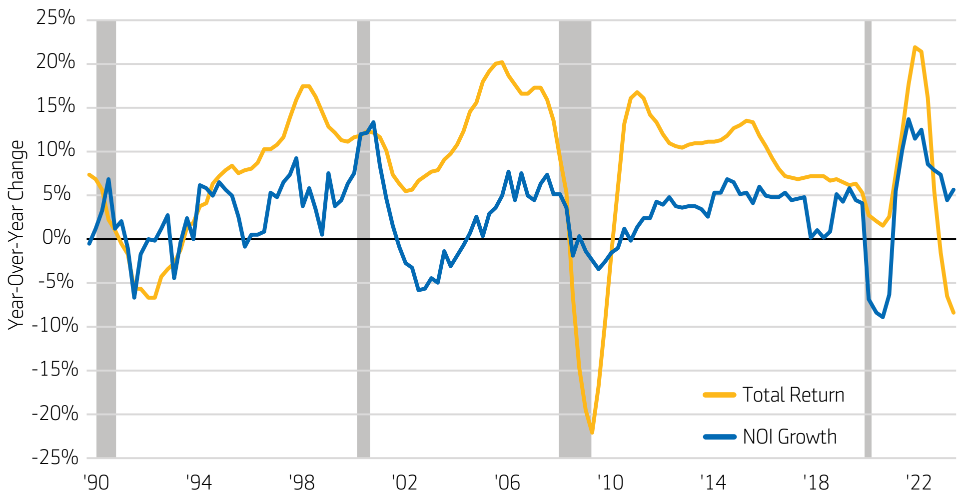
Source: MSCI Real Capital Analytics. As of September 30, 2023.

Real estate equity

Real estate equity

The trailing one-year return for the NCREIF National Property Index (NPI), a measure of unleveraged returns, was -8.4% in the third quarter of 2023 compared to 16.1% a year ago. Capital appreciation was reported as -12.1%, with income return at 4.1%.[5]

Unlevered core real estate total return continues to decline



Source: NCREIF Property Index Detail Report as of September 30, 2023. **Shaded areas indicate US recessions.**

During the third quarter of 2023, retail property performance outpaced the other three main sectors with a -1.4% total return. At the other end of the spectrum, office property returns remained the lowest, totaling -17.1%.[5]

Within property sectors, subtypes continue to show broad dispersion in performance. The range is particularly wide in the office sector where there is a 7.5% difference in the third quarter returns between central business district (CBD) and suburban office properties.[5]

During the third quarter of 2023, NFI-ODCE investor's distributions and redemptions exceeded contributions by $2.7 billion compared to last quarter's $2.5 billion. Contributions declined by 83% compared to last year, the largest decline since 2009. For the year ending September 30, 2023, contributions were $6.8 billion, and distributions and redemptions were $14.9 billion which resulted in an annual net cash flow of -$8.2 billion.[5]

The NCREIF Fund Index for Open-ended Diversified Core Equity (NFI-ODCE) returned -12.1% gross of fees (-12.9% net) and inclusive of leverage over the past four quarters spanning from 3Q 2022 to 3Q 2023 with a -1.9% gross (-2.1% net) return in the third quarter separately. Over the last 10 years, the NFI-ODCE averaged a 6.7% gross (5.7% net) annual return.[5]

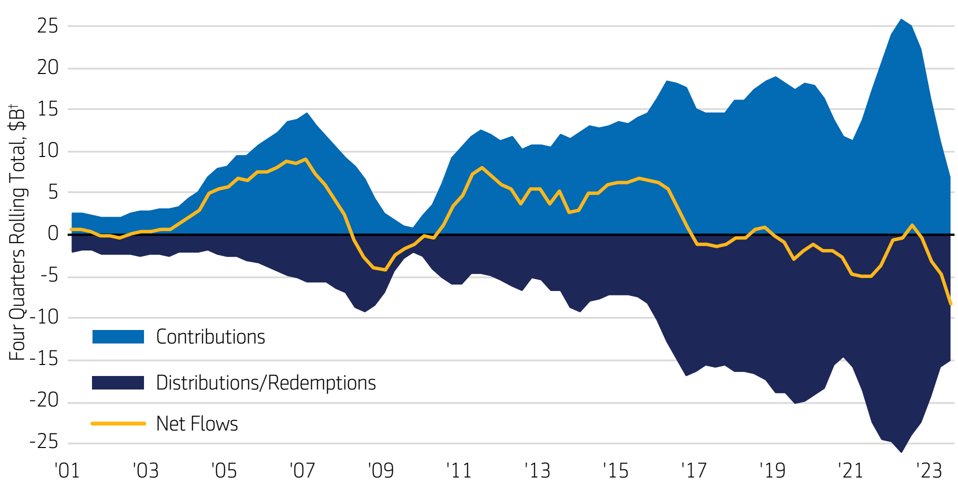
We believe it is unlikely that we have seen the full impact of repricing on NCREIF's appraisal-based indices.

Property sector subtypes continued to show broad dispersion in performance

Trailing four quarter return by sub property type (%)			
	3Q 23	3Q 22	YoY changes
NPI	**-8.4%**	**16.1%**	**-24.5%**
All Apartment	**-7.6%**	**18.2%**	**-25.7%**
Garden	-6.5%	24.2%	-30.7%
Highrise	-8.4%	14.9%	-23.4%
Lowrise	-6.2%	19.0%	-25.2%
All Industrial	**-5.3%**	**34.6%**	**-39.9%**
R&D	-2.2%	19.8%	-21.9%
Flex	-4.0%	32.4%	-36.4%
Warehouse	-4.9%	34.8%	-39.7%
Other	-1.4%	38.1%	-39.5%
All Office	**-17.1%**	**3.2%**	**-20.3%**
CBD	-20.5%	0.8%	-21.3%
Suburban	-13.0%	6.3%	-19.3%
All Retail	**-1.4%**	**6.7%**	**-8.1%**
Community	0.1%	10.9%	-10.8%
Neighborhood	-0.4%	8.7%	-9.1%
Power Center	0.7%	9.7%	-9.0%
Regional	-4.1%	2.9%	-7.0%
Super Regional	-2.0%	5.3%	-7.3%

Source: NCREIF Property Index Detail Report. As of September 30, 2023. Trend is the year-over-year change of sub property type trailing four quarter return. **Past performance is not indicative of future results.**

NFI-ODCE investor cash flow trends



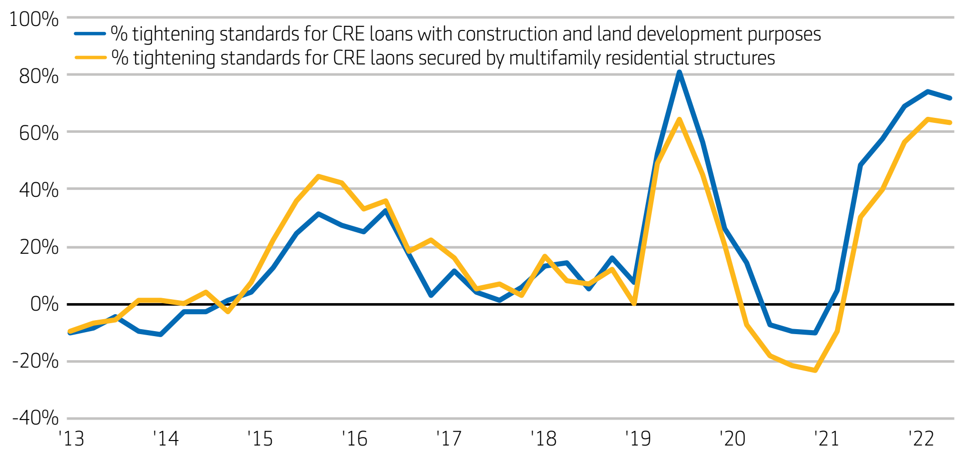
†The Open End Diversified Core Equity (NFI-ODCE) fund index is a capitalization-weighted index based on each fund's Net Invested Capital, which is defined as Beginning Market Value Net Assets (BMV), adjusted for Weighted Cash Flows (WCF) during the period. Source: NCREIF. As of September 30, 2023.

Real estate debt

Banks continue to take a more cautious stance towards all CRE lending categories with lending standards remaining tight. According to MSCI Real Capital Analytics, the regional/local banks' market share fell from 34% in the first quarter to 25% in the second quarter of 2023, the largest decline by smaller bank lenders since MSCI started tracking this data in 2011.[8] While bank lending is down, banks' origination volume remains near its pre-Covid level, and many are willing to be aggressive for the right asset or client. CMBS remains the lender of last resort while the various debt funds' hurdle rate/return requirements have put them mostly on the sidelines. Government-Sponsored Enterprises (GSEs) remain competitive on multifamily assets. .

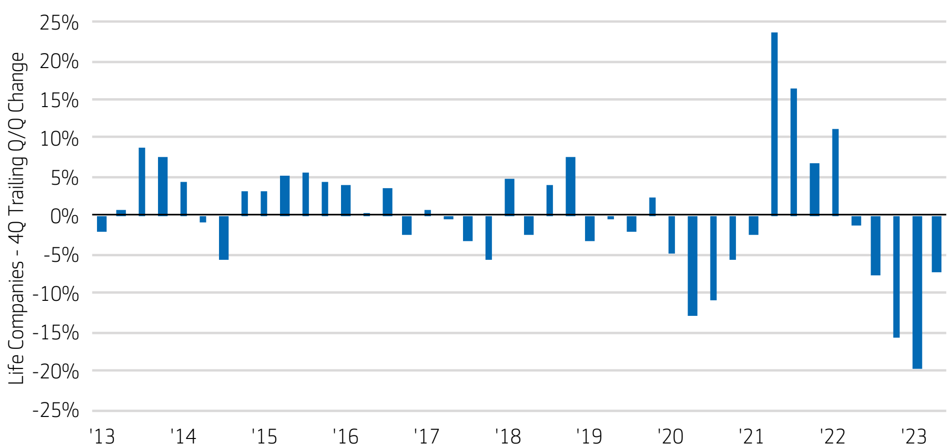
Life insurance companies and other non-bank lenders looking to deploy capital should be well positioned as borrowers seek alternative sources resulting from any pullback in bank lending activities.

US banks continue to tighten lending standards for CRE loans



Source: Board of Governors of the Federal Reserve System (US) as of July 31, 2023.

Commercial mortgage commitments (life companies)

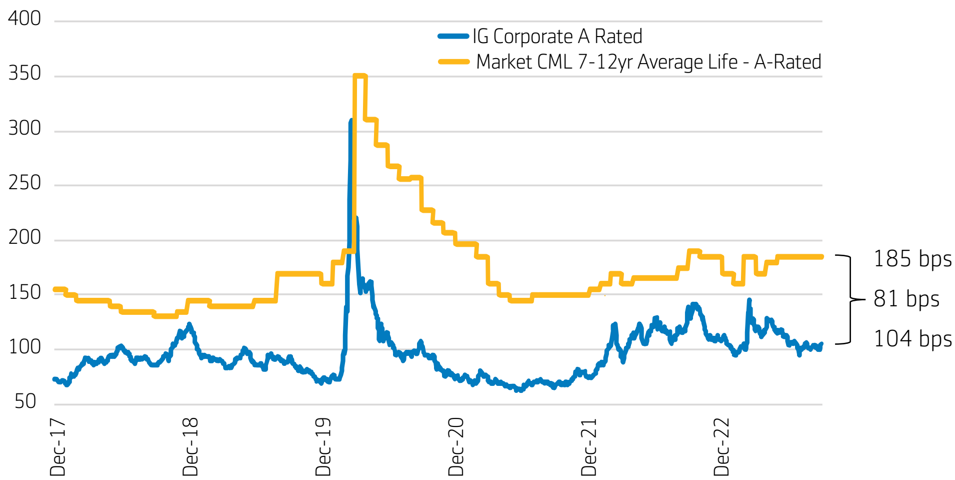


Source: American Council of Life Insurers (ACLI) as of June 30, 2023.

Borrowers continue to seek shorter-loan terms, interest-only options, and flexible prepayment during the last 12-24 months of the loan term. Shorter-term transactions have gained popularity since rates began rising in 2022 with borrowers continuing to believe they will trade into a lower coupon at maturity, though most lenders have a finite amount of shorter-term money available and much of that has been deployed. Prepayment flexibility is increasingly in demand for the same reason. However, with an inverted yield curve and additional spread often required for flexible prepayment, DSCRs become stressed and frequently become the limiting factor for loan proceeds. The interest-only option remains desired but is less available.

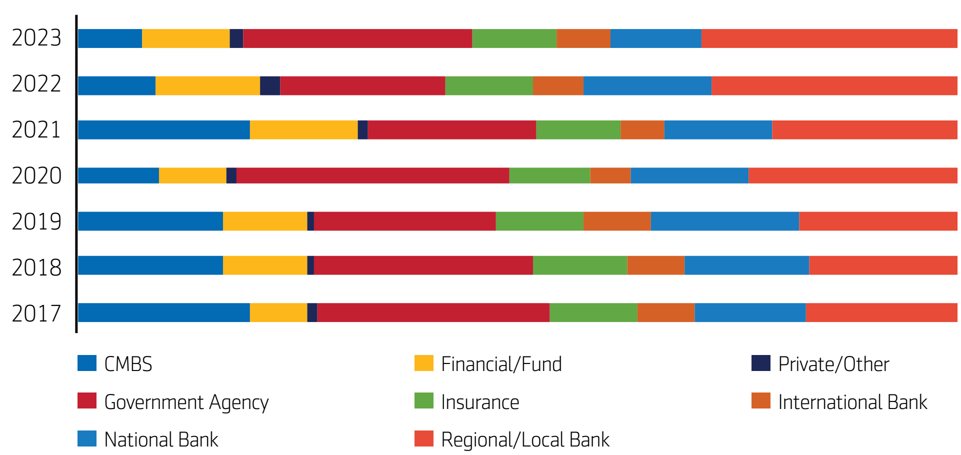
The 10-year US Treasury yield crossed the 5% threshold in October for the first time since 2007.[1] With lenders beginning to deploy 2024 allocations, spreads are compressing slightly and are in the 180-210 range as of early December. However, corporate bond spreads continue to tighten, maintaining the commercial mortgage loans to corporates spread gap.

CMLs continue to offer a spread advantage over investment grade corporate bonds January 2018 - October 2023



Sources: Corporate Bonds – Bloomberg Barclays. Aegon Real Assets US Commercial Mortgage Mark-to-Market Matrix - A Internal rating using Proprietary CML pricing matrix, developed, and maintained by Aegon Real Assets US as of October 31, 2023. **Past performance is not indicative of future results.**

Lender composition



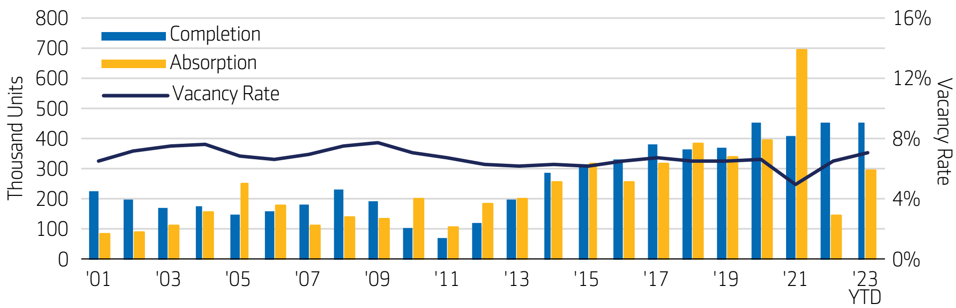
Sources: Real Capital Analytics – US Capital Trends Report, August 31, 2023..

Sector overview

Apartment

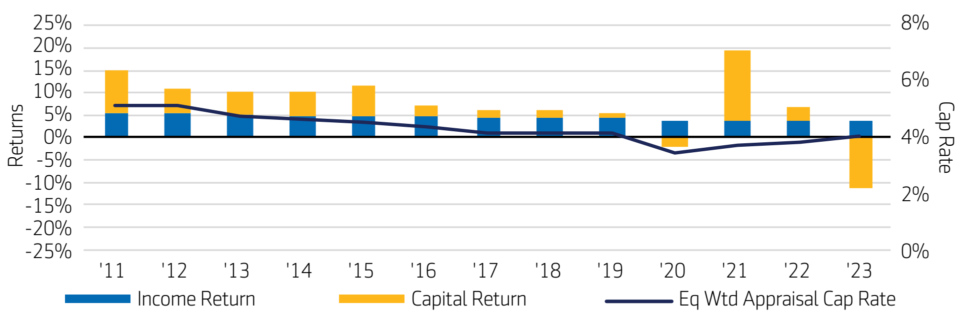
- The apartment sector continues to face cyclical supply headwinds, while demand fundamentals remain healthy. During the third quarter of 2023, 116,000 units were absorbed, marking the highest quarterly absorption in two years. However, these absorptions still fell short of the 140,000 units delivered, a pattern consistent over the last seven quarters. As a result, rent growth decelerated by 15 bps to 1.1%, and the vacancy rate increased by 21 bps to 7.1% during the third quarter.[9]
- Currently, the sector is at the peak of the supply cycle as cheap debt and strong demand drove new construction over the past couple years. Tightening monetary policy, lack of construction financing, and elevated construction costs are making it much more difficult for developers to break ground on new construction. As a result, supply across the majority of the top 50 markets remains elevated but is expected to drop off below its historical trend in late 2025 or early 2026.[9] At the same time, demand continues to be supported by demographic advantages, necessity of housing, and low homeownership affordability. As a result, we believe medium-quality apartments remain an investment sweet spot underpinned by relatively modest supply and renter-by-necessity demand.

Apartment sector vacancy rate continues to rise with near-term supply headwinds outpacing demand



Source: CoStar Realty Information Inc., annual data as of September 30, 2023. Current year returns reflect trailing 4-quarter average.

Apartment performance (3Q 2023)



Source: NCREIF Property Index (unlevered) - Equal weighted appraisal cap rate as of year-end or most recent in current year, current year returns reflect trailing 4-quarter average, as of September 30, 2023. **Past performance is not indicative of future results.**

Vacancy Rate[6]

▲ 7.1%

Rent Growth[6]

▼ 1.1%

Total Return[5]

▼ -7.6%

Outlook

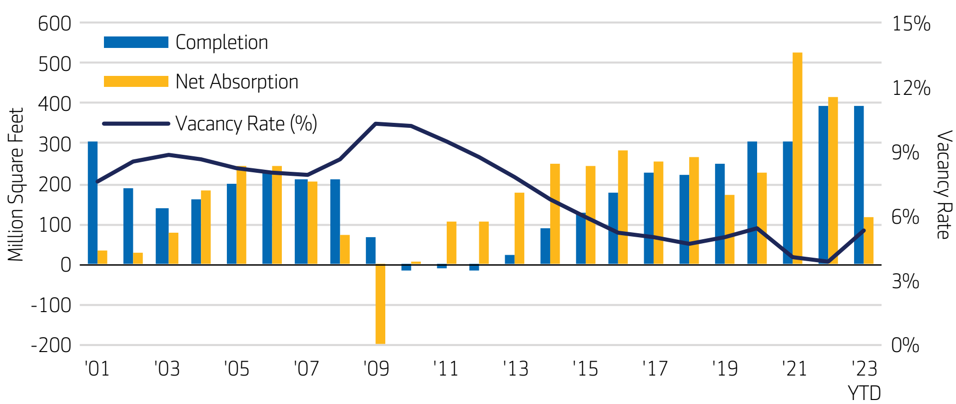
Neutral

Arrows indicate change from previous quarter.

Industrial

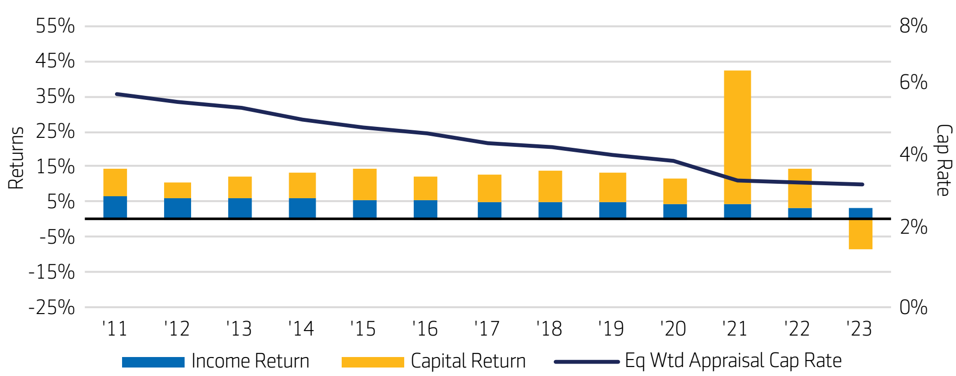
- The third quarter of 2023 marked a notable upswing in construction completions within the industrial sector, bringing more availability to a relatively tight market. However, these substantial increases in new completions, coupled with a normalization in demand, have contributed to slightly elevated vacancy rates, which rose by 16 bps to 5.1% during the quarter.[9] Heightened supply levels are projected to remain over the next several quarters, with increases in vacancy rates likely to persist.
- Simultaneously, rent growth has started to cool down, declining 159 bps reaching 7.4% in 3Q 2023.[9] Upon the completion of a record-high amount of construction projects, the supply pipeline should continue to tighten until the end of 2024, so we can expect a downward trend in rent growth until then.
- We believe there will be a reduction in new supply towards the end of 2024, as escalating construction costs and high interest rates continue to leave investors hesitant to start new projects.
- Overall, fundamentals for the industrial sector remains well-positioned against near-term supply headwinds, and we expect the sector to continue to normalize towards pre-pandemic levels in 2024.

Record-high completion rates lead to higher vacancy rates



Source: CoStar Realty Information Inc., annual data as of September 30, 2023. Current year returns reflect trailing 4-quarter average.

Industrial performance (3Q 2023)



Source: NCREIF Property Index (unlevered) - Equal weighted appraisal cap rate as of year-end or most recent in current year, current year returns reflect trailing 4-quarter, as of September 30, 2023. **Past performance is not indicative of future results.**

Vacancy Rate[6]

▲ 5.1%

Rent Growth[6]

▼ 7.4%

Total Return[5]

▼ -5.3%

Outlook

Neutral

Arrows indicate change from previous quarter.

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Office

- Office sector fundamentals continue to face structural challenges led by changing post-pandemic work arrangements. Firms continue to adopt a hybrid work model despite rising office-using employment. Office key swipes tracked by Kastle Systems remain near the 50% level compared to the pre-Covid level.[10] As a result, the sector's vacancy rate continues to climb and has now reached 13.3% at the end of 3Q 2023.[9]
- Firms continue to prefer high-quality, modern, and well-equipped office buildings to attract tenants back to office. Class A+ and new-vintage buildings have performed relatively well where net absorption and rent growth remains positive.[9]
- Higher interest rates and limited capital availability are causing financial distress particularly when loans come due. The delinquency rate for office CMBS loans has risen from 1.6% a year ago to 5.6% as of September 2023.[11]
- Anecdotal evidence suggests that only a third of office leases have come up for renewal since the pandemic so far. This suggests that further deterioration in office fundamentals is likely as those leases expire. We believe office tenants are likely to negotiate for lower rates or downsize to smaller square footage if the overall sentiment on office use does not improve.

Vacancy Rate[6]

▲13.3%

Rent Growth[6]

▼0.6%

Total Return[5]

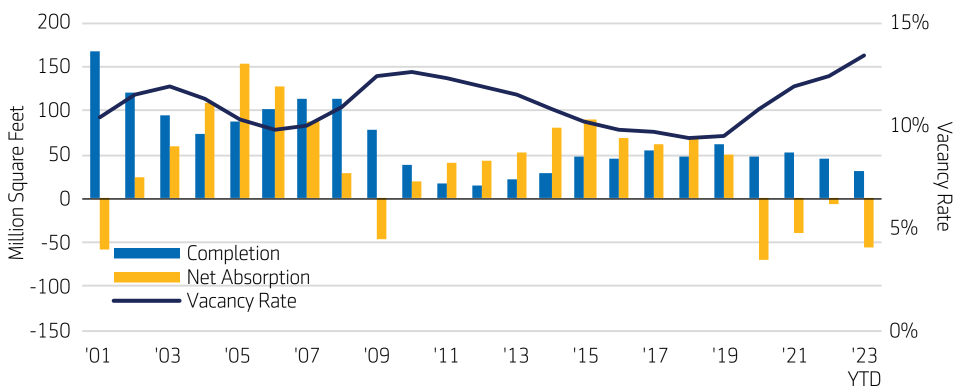
▼-17.1%

Outlook

Most Cautious

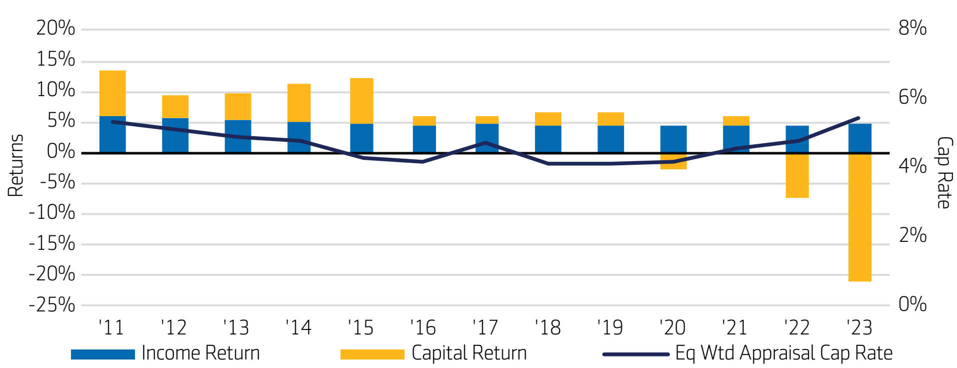
Arrows indicate change from previous quarter.

Office sector vacancy rate continues to rise with no signs of easing



Source: CoStar Realty Information Inc., annual data as of September 30, 2023. Current year returns reflect trailing 4-quarter average.

Office performance (3Q 2023)

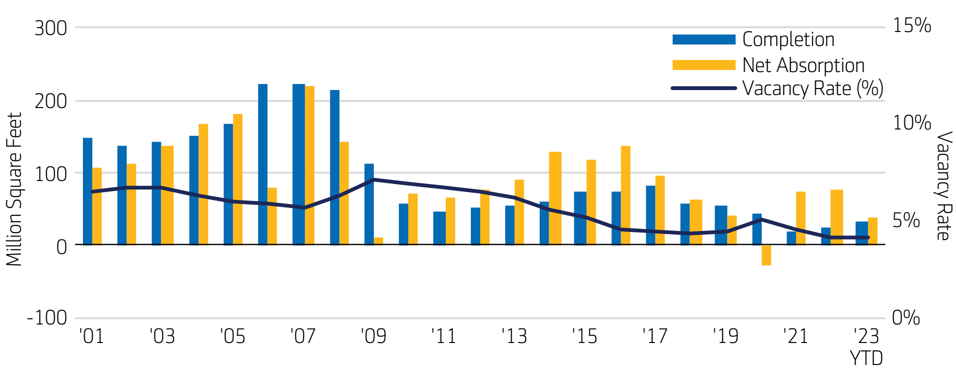


Source: NCREIF Property Index (unlevered) – Equal weighted appraisal cap rate as of year-end or most recent in current year, current year returns reflect trailing 4-quarter average, as of September 30, 2023. **Past performance is not indicative of future results.**

Retail

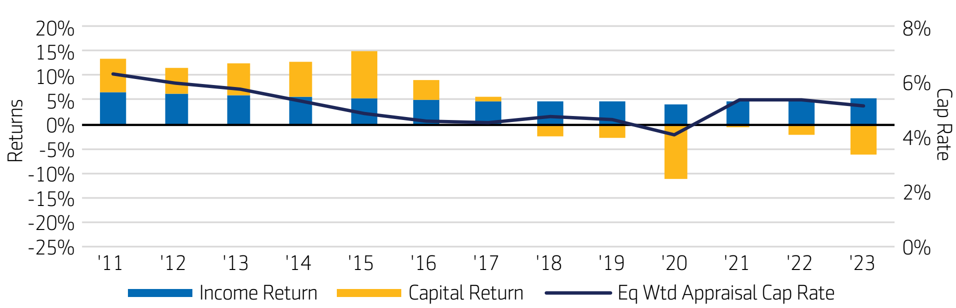
- The retail sector continues to demonstrate resilience. The vacancy rate declined for the second consecutive quarter to a new low of 4.1% while rent growth has stayed consistent at 3.7% over the past year.[9]
- A resilient labor market and high consumer spending supported the retail sector through the third quarter of 2023. While the retail fundamentals continued to hold in Q3, sales growth is expected to decrease compared to previous years as we move into 2024 due to elevated national credit card debt, exceptionally high interest rates, and widespread inflationary pressures on prices.
- Demand for retail space continued to rise through the third quarter of 2023, with availability in desirable locations tightening even further. Despite high demand, new construction remains very challenging due to high construction costs and stringent lending conditions.
- Grocery-anchored and necessity-based retail remains the most preferred retail subsector.
- We anticipate easing demand in the coming quarters as the US economy slows, but we expect the retail sector to remain well positioned to weather increasingly challenging economic conditions.

Retail fundamentals remain solid with minimal supply pressure



Source: CoStar Reality Information Inc., annual data as of September 30, 2023. Current year returns reflect trailing 4-quarter average.

Retail performance (3Q 2023)



Source: NCREIF Property Index (unlevered) - Equal weighted appraisal cap rate as of year-end or most recent in current year, current year returns reflect trailing 4-quarter average, as of September 30, 2023. **Past performance is not indicative of future results.**

Vacancy Rate[6]

▼ 4.1%

Rent Growth[6]

▼ 3.7%

Total Return[5]

▼-1.4%

Outlook

Cautious

Arrows indicate change from previous quarter.

[1]Board of Governors of the Federal Reserve System. October 31, 2023
[2]Wolters Kluwer. Blue Chip Economic Indicators. November 10, 2023
[3]US Bureau of Economic Analysis. Personal Income and Outlays. October 31, 2023
[4]MSCI Real Capital Analytics. September 30, 2023
[5]National Council of Real Estate Investment Fiduciaries. September 30, 2023
[6]US Bureau of Economic Analysis. Gross Domestic Product. November 29, 2023
[7]US Bureau of Labor Statistics. Employment Situation. November 3, 2023
[8]MSCI Real Capital Analytics, Capital Trends, US Big Picture. August 2023
[9]CoStar Realty Information, Inc. September 30, 2023
[10]Kastle. Kastle Back to Work Barometer. November 20, 2023
[11]Trepp CMBS Research. September 2023

Disclosures

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