RREEF Real Estate Minute
June 2023

# Real Estate Fundamentals Defy Higher Interest Rates

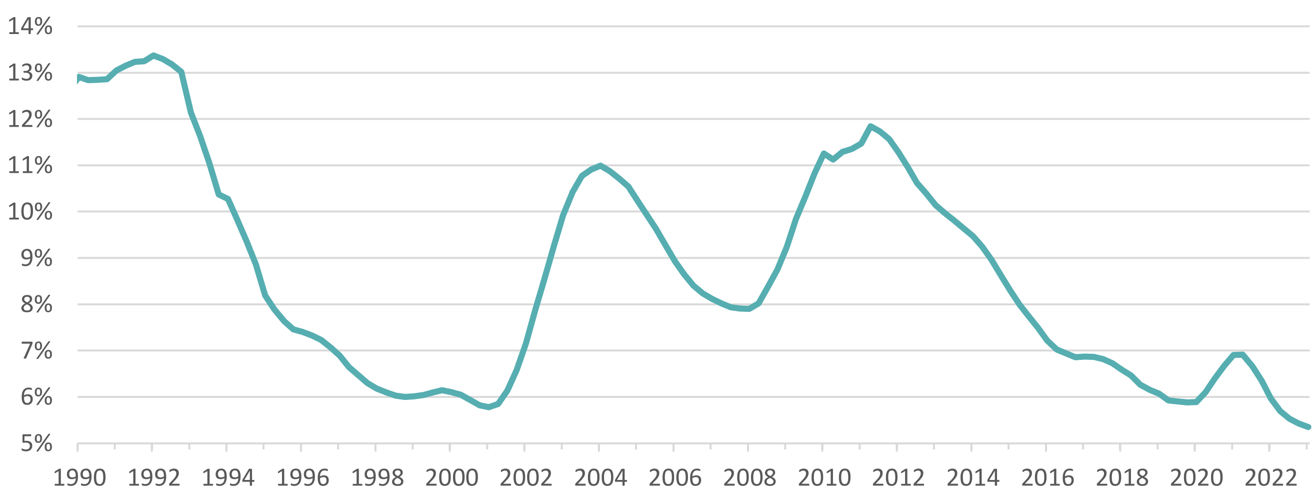
U.S. real estate investment performance has struggled in response to rising interest rates. Yet underlying fundamentals remain robust: Vacancy rates held at an all-time low (5.3%) and rental income jumped 7.4% (year-over-year) in the first quarter of 2023.[1] Vacancy rates remained at or near all-time lows in the apartment, industrial, and retail sectors, although they increased in the office sector.[2]

**Industrial:** A post-COVID normalization of spending patterns has dampened absorption, which was essentially flat in the first quarter. [3] However, longer-term growth drivers remain intact: In our view, e-commerce penetration is poised to increase from 19% to nearly 30% by the end of the decade. We believe that efforts to protect supply chains from geopolitical, pandemic, and other disruptions will accelerate the pre-COVID tend toward increased inventory accumulation. While the development pipeline is active (about 550 million square feet underway), warehouse construction spending (inflation-adjusted) is down 7% from last year's peak, and we expect that it will continue to recede in response to lower market prices and higher construction (including financing) costs.[4]

**Residential:** Residential demand has moderated as Americans have reallocated spending from housing to recreation and other services.[5] However, we believe that this reset is largely finished, as apartment absorption stabilized in the first quarter.[6] Looking ahead, we believe that Millennial household formation will provide enduring support, while rising mortgage rates will skew demand toward rental properties. A dearth of construction since the Global Financial Crisis (GFC) has also created a structural housing deficit: rental vacancy rates (across both single- and multifamily units) are near their lowest level since 1984.[7]

**Retail:** Retail conditions have tightened further, driven by the neighborhood and community (N&C) segment, where vacancies fell to their lowest level in at least 17 years.[8] In our view, N&C centers have benefited from a recovery of in-store shopping following the pandemic. Given that they are largely service-oriented, they are also relatively insulated from e-commerce threats, and to the extent that they dispense goods (e.g., groceries), they can help to fulfill online orders (i.e., delivery or pickup from store). We believe that because they are typically

**NCREIF All Sectors Vacancy Level**
4-Q Moving Average, %



Source: NCREIF, Q1 2023.

1. Source: NCREIF. As of March 2023.
2. Source: NCREIF. As of March 2023.
3. Source: CBRE-EA. As of March 2023.
4. Source: CBRE-EA (pipeline); Bureau of Economic Analysis (construction spending). As of March 2023.
5. Source: Census Bureau. As of March 2023.
6. Source: CBRE-EA. As of March 2023.
7. Source: Census Bureau. As of March 2023.
8. Source: NCREIF. As of March 2023.

located in or near residential areas, they may capture more sales as people move to suburbs and spend more of their workweek at home. Years of underperformance have also curtailed construction and kept yields at comparatively attractive levels.[9]

**Office:** The office market continues to struggle. According to CBRE, vacancy rates climbed to their highest levels since the early-1990s (above their Global Financial Crisis peak) as absorption slumped.[10] Although more employees will likely return to the office as the pandemic fades, the widespread adoption of hybrid working may leave a permanent dent in demand. Over time, this slack may be absorbed through population and job growth, particularly as construction shuts down and some existing buildings are converted to alternative uses (net deliveries are poised to plummet after next year, based on current pipelines).[11] However, the experience of the retail sector, which is now successfully emerging from an equivalent structural change (e-commerce), implies that this adjustment can take several years. In our view, even without remote working, office is the most cyclically sensitive of the major sectors, and therefore most at risk from a possible recession.

9. Source: CBRE-EA (construction); NCREIF (yields). As of March 2023.
10. Source: CBRE-EA. As of March 2023.
11. Source: CBRE-EA. As of March 2023.



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222 South Riverside Plaza, Chicago, IL 60606-5808
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