



Market Commentary

Weekly perspective on current market sentiment

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Last week's S&P 500 Index: +2.4%

More real estate trouble ahead

Key takeaways

- Higher interest rates are just one of the issues having a negative effect on residential and commercial real estate segments.
- These numerous headwinds have combined to make residential and commercial real estate investment unattractive.

Investors and the general public have been hearing about residential and commercial real estate market woes for some time. Higher interest rates are having a negative effect on both segments of the market, but there are a completely different set of variables that are keeping residential prices higher than many expected and pushing (crushing might be a better word) commercial real estate prices in many large cities across the country. We wanted to take a look at the latest data covering the current state of each as well as make a projection for both segments as we look ahead over the balance of this year and into 2024.

Let's start with the real estate segment that is near-and-dear to many of our hearts, single-family residential real estate. According to the National Association of Realtors (NAR), the median price for an existing home in the U.S. increased from \$274,500 in December 2019 to a record high of \$413,800 in June of 2022. That is a whopping 50.7% increase in just 2½ years. As home prices jumped higher, mortgage rates surged during the course of 2022 as the yield on the 10-year Treasury moved from 1.47% up close to 4% by October of that year. More recently, as the 30-year fixed mortgage rate touched 7%, the median U.S. price has pulled back slightly to just over \$396,000 (May 2023 data).

Note that homebuilder sentiment has risen and the homebuilding subindustry group within the S&P 500 Index (SPX) is up nearly 48% on a year-to-date (YTD) basis versus a 17.8% rise for the SPX at the time of this writing. However, low inventory of existing homes, the reluctance of owners to opt out of their current low-rate mortgage loans for one carrying a much higher interest rate, and a dramatic decline in affordability for the average borrower are major headwinds. In addition, we believe tighter credit and job worries should impact demand. For these many reasons, we are cautious on residential markets.

On the commercial real estate (CRE) front, most of us know the pandemic and resulting work-from-home migration have left many larger U.S. cities with high office-vacancy rates. In some major cities, vacancy rates are above 20%. Small businesses that made their living off the foot traffic of downtown workers are suffering. Many are going out of business or reducing staff. As existing office leases roll over, new lease rates are falling in many markets, sometimes dramatically. As a result, the delinquency rate for office-backed commercial mortgage-backed securities has jumped to the highest rate in five years. Not surprisingly, with all the negative news, the office subsector of the NAREIT All Equity REIT¹ Index is down approximately 13% YTD. We expect commercial real estate to underperform on a relative basis in the near-to-intermediate term.

Overall, our rating on the Real Estate sector remains unfavorable. Numerous headwinds have combined to make residential and commercial real estate investment unattractive based on our current analysis. We expect that further deterioration of the underlying fundamentals is likely.

¹ REIT = Real estate investment trust.

Risk considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions. Other risks associated with investing in listed **REITs** include the use of leverage, unexpected reductions in common dividends, increases in property taxes, and the impact to listed REITs from new property development.

In addition to the risks associated with investment in debt securities, investments in mortgage-backed and asset-backed securities will be subject to prepayment, extension and call risks. Changes in prepayments may significantly affect yield, average life and expected maturity. Extension risk is the risk that rising interest rates will slow the rate at which mortgages are prepaid. Call risk is the risk that if called prior to maturity, similar yielding investments may not be available for purchase. These risks may be heightened for longer maturity and duration securities. Commercial Mortgage Backed Securities (CMBS) are a type of mortgage-backed security backed by commercial mortgages rather than residential real estate. CMBS tend to be more complex and volatile than residential mortgage-backed securities due to the unique nature of the underlying property assets.

Definitions

FTSE NAREIT All Equity REITs Index, a subset of the All REITs Index, is designed to track the performance of REITs representing equity interests in (as opposed to mortgages on) properties. It represents all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets, other than mortgages secured by real property that also meet minimum size and liquidity criteria.

FTSE NAREIT All REITs Index includes all REITs that are listed on NYSE, American Stock Exchange or NASDAQ. This includes mortgage REITs, Timber REITs, Infrastructure REITs, and Manufactured Housing REITs. It is the most expansive of all the FTSE REIT indices.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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