CBRE

Econometric Advisors

Q3 2023
Retail Overview & Outlook

REPORT

November 2023

Executive Summary

- Retail remains resilient, fueled by a strong consumer and lack of new space hitting the market, but its future continues to be shrouded in the fogs of consumer debt, high inflation, and the resumption of student loan payments. As consumers continue spending closer to home, suburban availability has dipped below downtown availability for the first time in 15 years.
- Retailer bankruptcies are set to deliver approximately 1% of total retail square footage back to the market in the short run. Normally this amount of space would be a concern, but retailers are hungry for well-positioned spaces.
- Despite headwinds of overbuild in other sectors, retail overbuild in the U.S. is finally coming to an end, and we remain bullish on fundamentals especially in the Sun Belt.
- Regionally the South is set to cool from its outstanding pandemic performance, the West looks the best for future rental growth, the Midwest will have a middling performance, and the Northeast is set for a greater recovery and resilience to minor economic downturns.
- Overall, the retail market looks to be settling into a new steady state with predictable demand and rental growth. Of course, this comes with the caveat of consumer footing becoming more and more unsteady.

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Macroeconomy

2023 CBRE Econometric Advisors' Economic Forecast Brief

- The U.S. economy has defied expectations for a slowdown and even exhibited some signs of acceleration despite sharp tightening of credit conditions and ongoing write-downs in the banking sector. This resilience is due to several factors such as the Chips and IRA Acts, which stimulated the construction sector. Also, the Federal Reserve and FDIC have provided significant support to the banking sector. Perhaps the most important component is the consumer and strong household balance sheets. This was evidenced in the latest Q3 2023 GDP print, wherein consumption accounted for 270 basis points of the 4.9% GDP print for Q3 2023.

- However, headwinds such as higher oil prices, resumption of student loan payments, and a weakening global economy are intensifying. These headwinds, though not serious individually, are hitting home at a time when interest rates are beginning to squeeze important sectors of the economy. Business credit costs are up significantly, and this appears to be weighing on profits. This will cause the labor market to soften and consumers to be more prudent in coming quarters. With consumers losing their firepower we believe the economy will moderately contract in H1 2024.

- The upshot for real estate is that the Fed is likely finished with its tightening cycle, allowing a clearer path for real estate capital markets to unfold. Although we expect economic growth to deteriorate it is likely that valuations will begin to stabilize during 2024.

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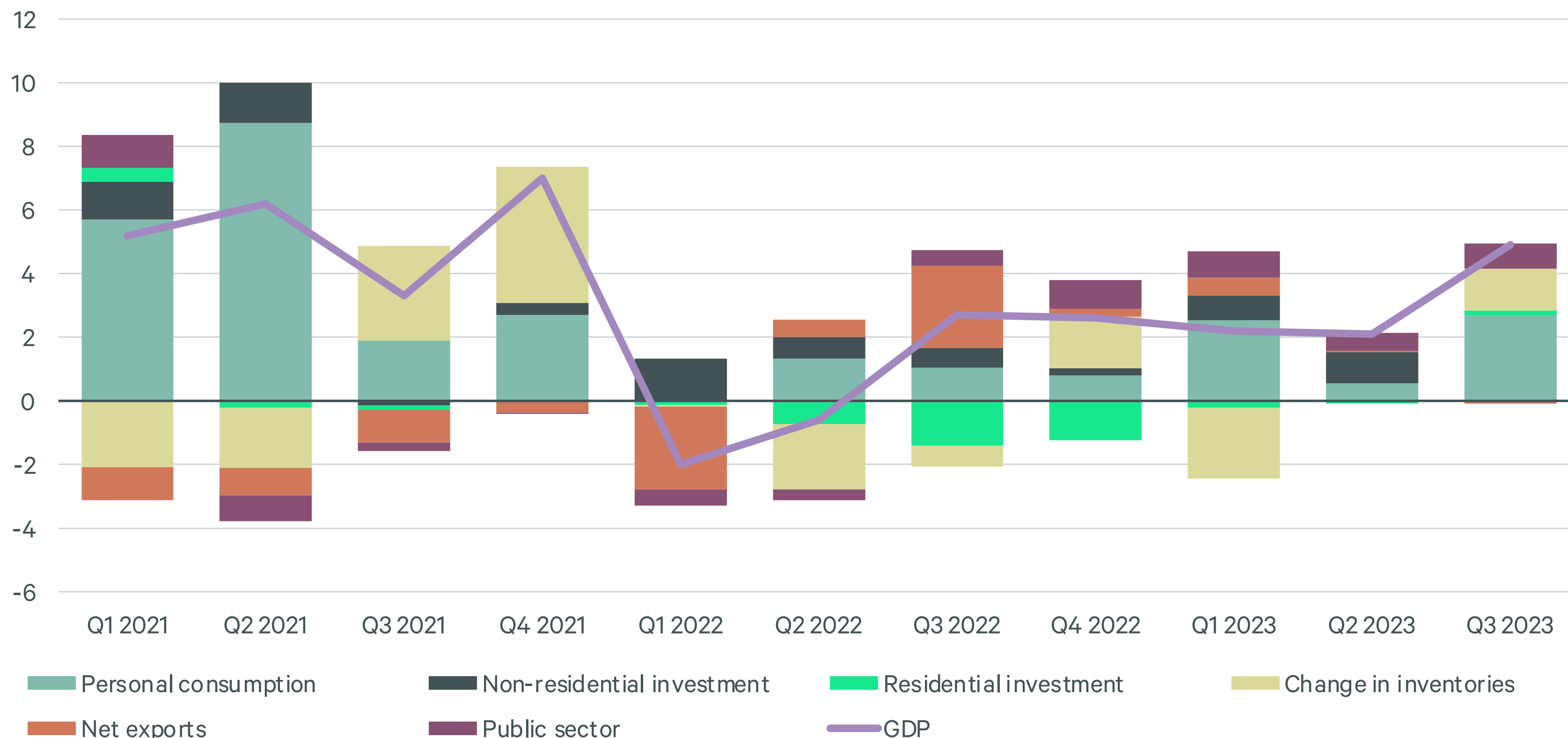
Consumption drove the economy during the summer

- Personal consumption has played an outsized role in the economy's expansion in the wake of COVID-19 lockdowns. This theme continued during the summer as households treated themselves to discretionary services, such as travel, dining out, and entertainment. We believe this current pace of consumption is unsustainable and will not make outsized contributions to GDP into 2024.

- Government stimulus continues to circulate throughout the economy and has contributed to growth during the past five quarters. Looking forward, spiraling government deficits will likely inhibit generous Federal stimulus.



Source: Bureau of Economic Analysis, CBRE Econometric Advisors

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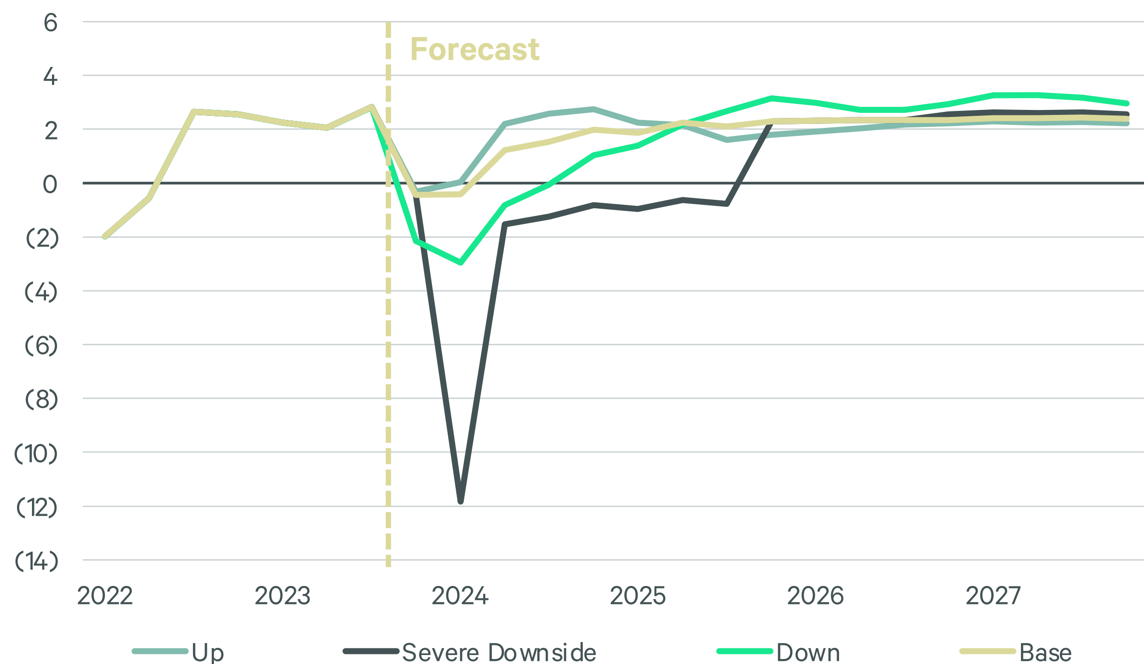
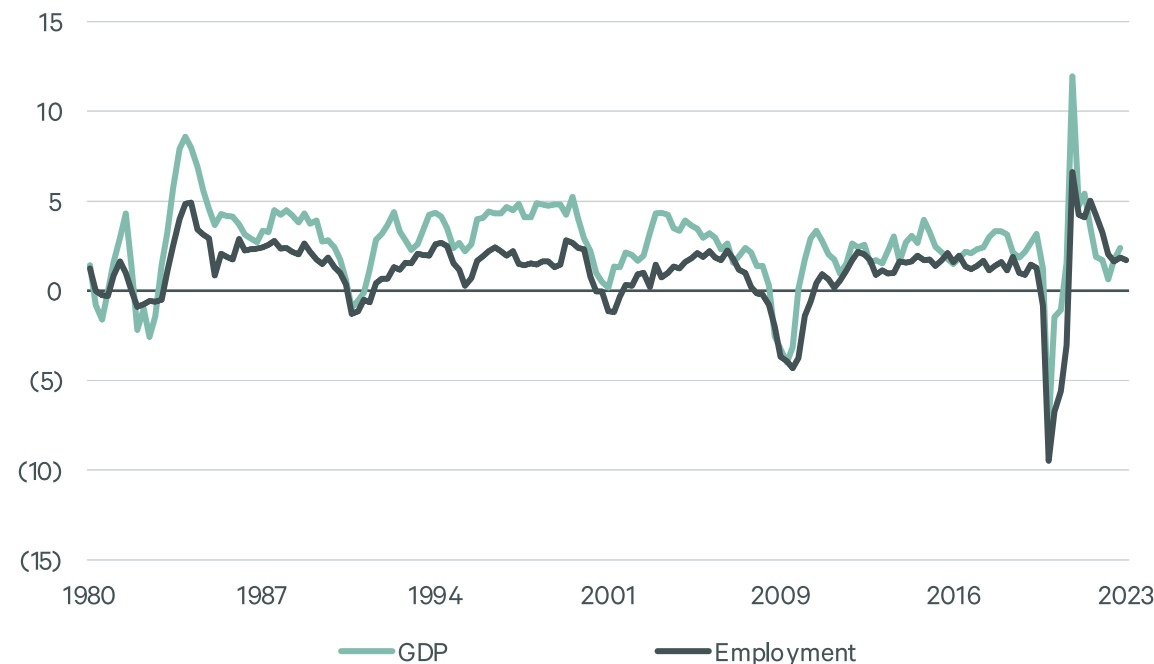
However, we still expect the economy to contract in H1 2024

GDP Scenarios, Quarterly Growth at Annualized Rate (%)



Source: Bureau of Economic Analysis, CBRE Econometric Advisors

'Soft Landings' Are Rare, Employment and GDP, Y-o-Y (%)



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, CBRE Econometric Advisors

- We believe that many of the trends driving outsized growth are unlikely to continue. Foremost, higher borrowing costs will begin to strain the important machinery of the economy, such as capital markets and business balance sheets. The upshot is that GDP is poised to moderately decline in H1 2024.
- Another reason to be cautious about future growth prospects is that 'soft landings', or continued growth amid monetary tightening, does not have a rich precedent. It is typically the case that an upward shift in interest rates results in a contracting economy.

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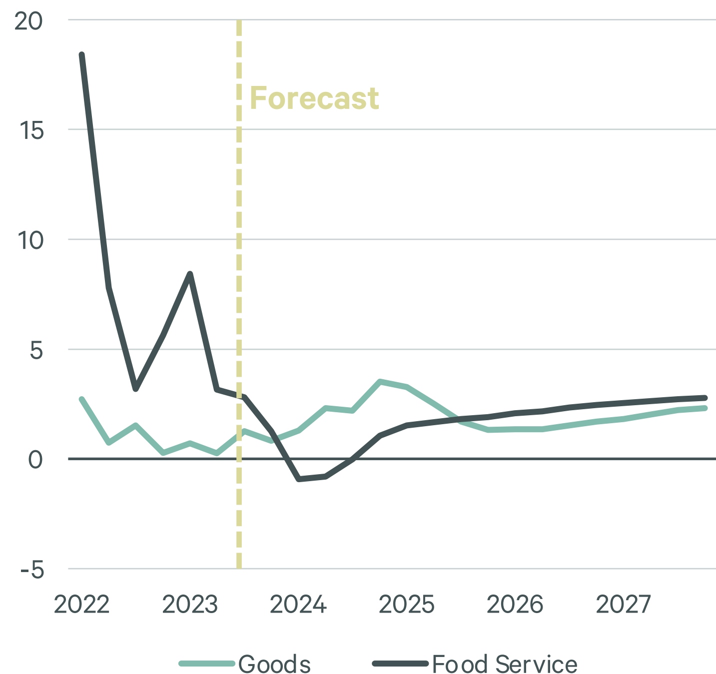
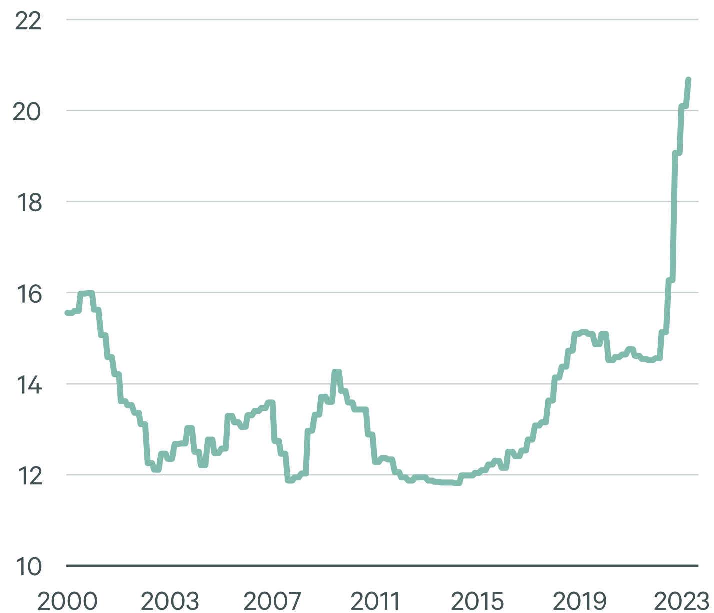
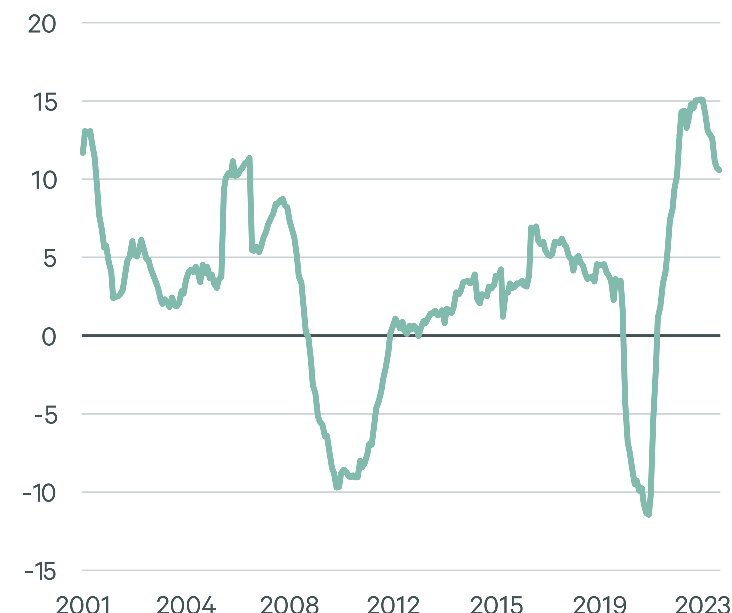
The U.S. consumer will struggle to drive greater growth



Source: U.S. Census, CBRE Econometric Advisors



Source: Federal Reserve, CBRE Econometric Advisors



Source: Federal Reserve, CBRE Econometric Advisors

- Consumer services (e.g., dining out, travel, recreation) is driving the boom in consumption. As the pace of economic growth slows, we believe spending on discretionary services will slightly contract in 2024.
- It is unlikely that U.S. consumers can maintain spending via borrowing as credit costs are prohibitive. The ability of households to service existing debts is sturdy but recent data shows the pace of credit growth is slowing.

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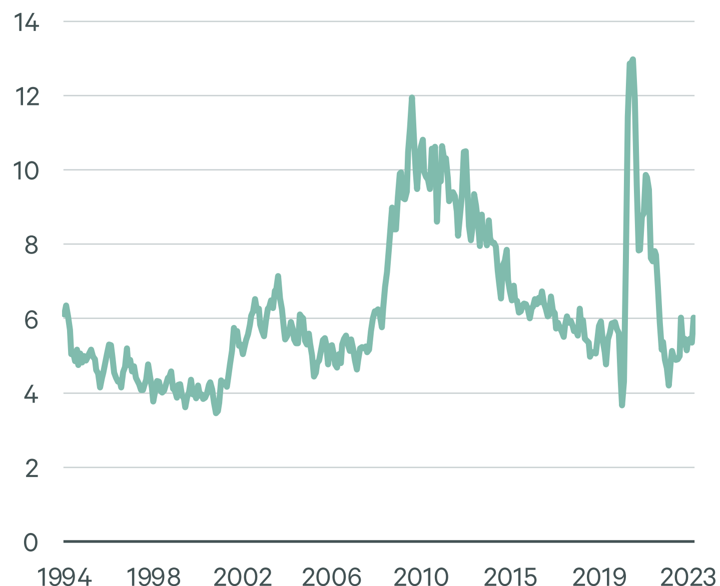
Despite strong payroll growth the labor market is softening

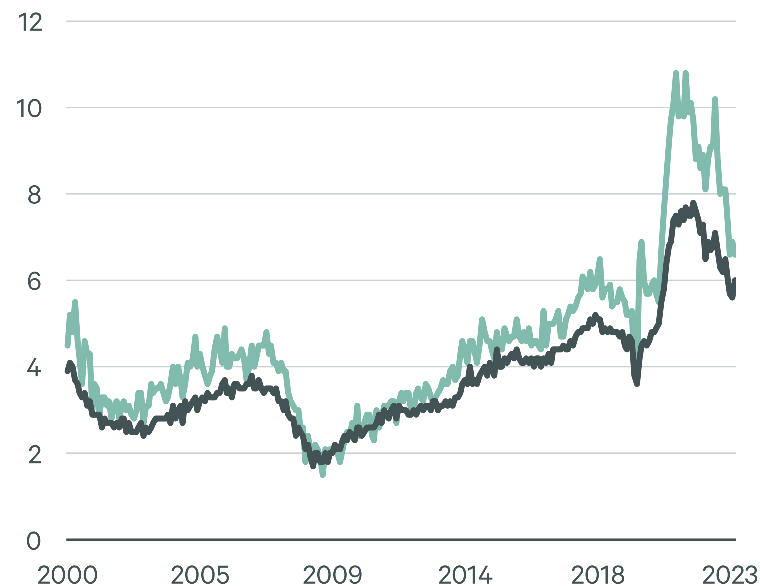
Duration of Unemployment Is Ticking Up



Months (3-months moving average)

Source: Federal Reserve, NBER, CBRE Econometric Advisors

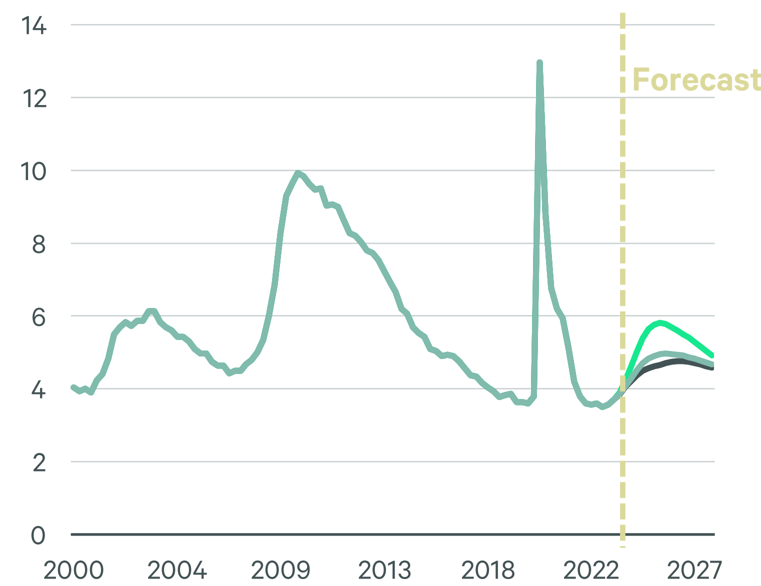
Job Opening Rates Are Trending Down (%)



Job openings rate, Leisure & Hospitality
Job openings rate, Total

Source: BLS, CBRE Econometric Advisors

Unemployment Rate and Forecast Scenarios (%)



Upside Downside Baseline

Source: Federal Reserve, NBER, CBRE Econometric Advisors

- A few signals suggest that the labor market is no longer tightening as some cracks begin to form. One interesting indicator is that the duration of unemployment is slowly increasing. Conditions are likely softer within the tech and professional services, where layoffs are measurably higher.
- The demand for labor, represented by currently employed and job openings, continues to exceed supply; however, the openings rate is trending down.
- The combination of softer labor market dynamics and falling GDP will push the unemployment rate up slightly within our Baseline scenario, peaking in the upper 4% range.

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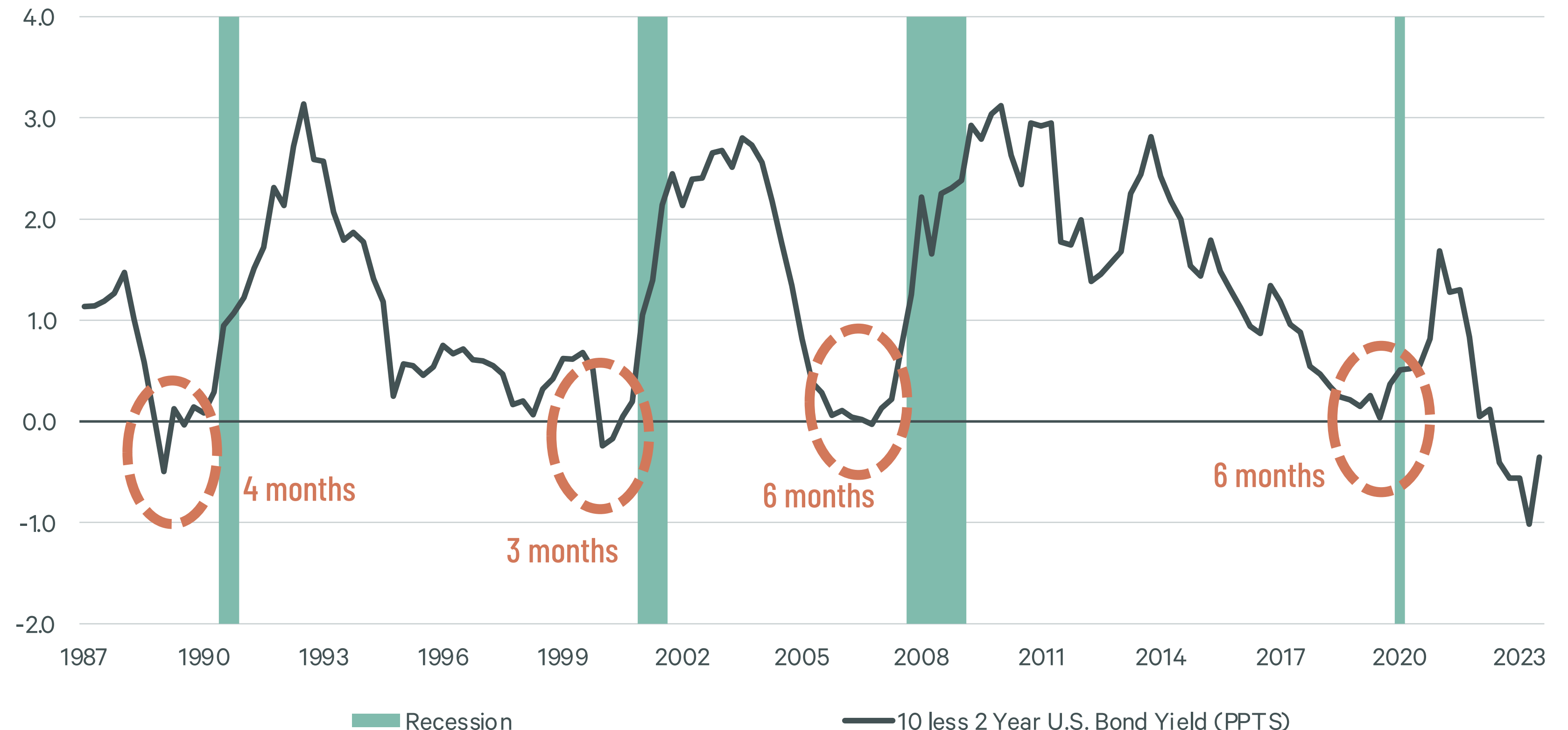
Financial market signals point to a weaker economy

- An inverted yield curve can signal that an economic cycle is overripe. A ‘bear steepener’, or when long-term rates quickly rise causing the yield curve to un-invert, historically suggests that an economic contraction is around the corner.

- The current uptick in long-term rates is not driven by expectations for future rate hikes but rather due to an increase in the term premium. This concept is discussed more on the next page, but the upshot is that markets are aligned that rates will likely remain higher for longer. CBRE Econometric Advisors believes this backdrop will ultimately stress the business sector, households, and even government finances.

Average Time(s) Between Yield Curve Un-Inverting and Beginning of a Recession



Source: The Federal Reserve, CBRE Econometric Advisors

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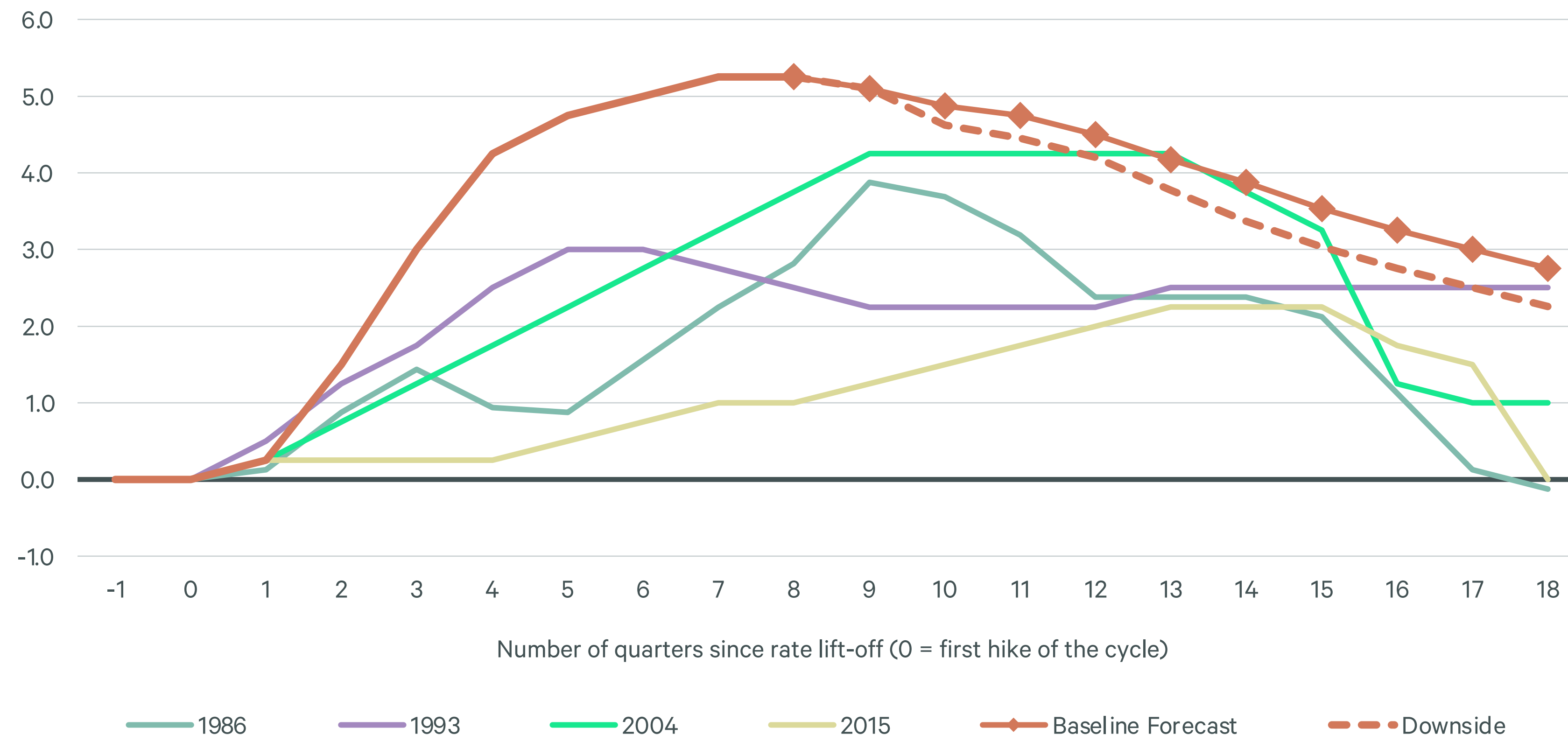
Policy rates are likely to stay higher than past cycles

- Easing Y-o-Y inflation suggests the Federal Reserve will take a pause on future hikes. But they are also unlikely to make significant cuts in the near-term, despite our outlook for a moderate recession in early 2024. Rather, the Committee will wait until inflation shows clear signs of progressing towards its 2% target.
- CBRE EA expects that the Fed Funds Rate will remain relatively heightened compared with previous tightening cycles. This 'higher-for-longer' outlook will have implications for CBRE EA's cap rate and value growth forecast.
- Should higher interest rates trigger more financial distress analogous to our Downside scenario, then policy rates will likely taper off at a faster pace.

Change In Fed Funds Rate From Beginning of Each Tightening Cycle (Percentage Points)



Source: The Federal Reserve, CBRE Econometric Advisors

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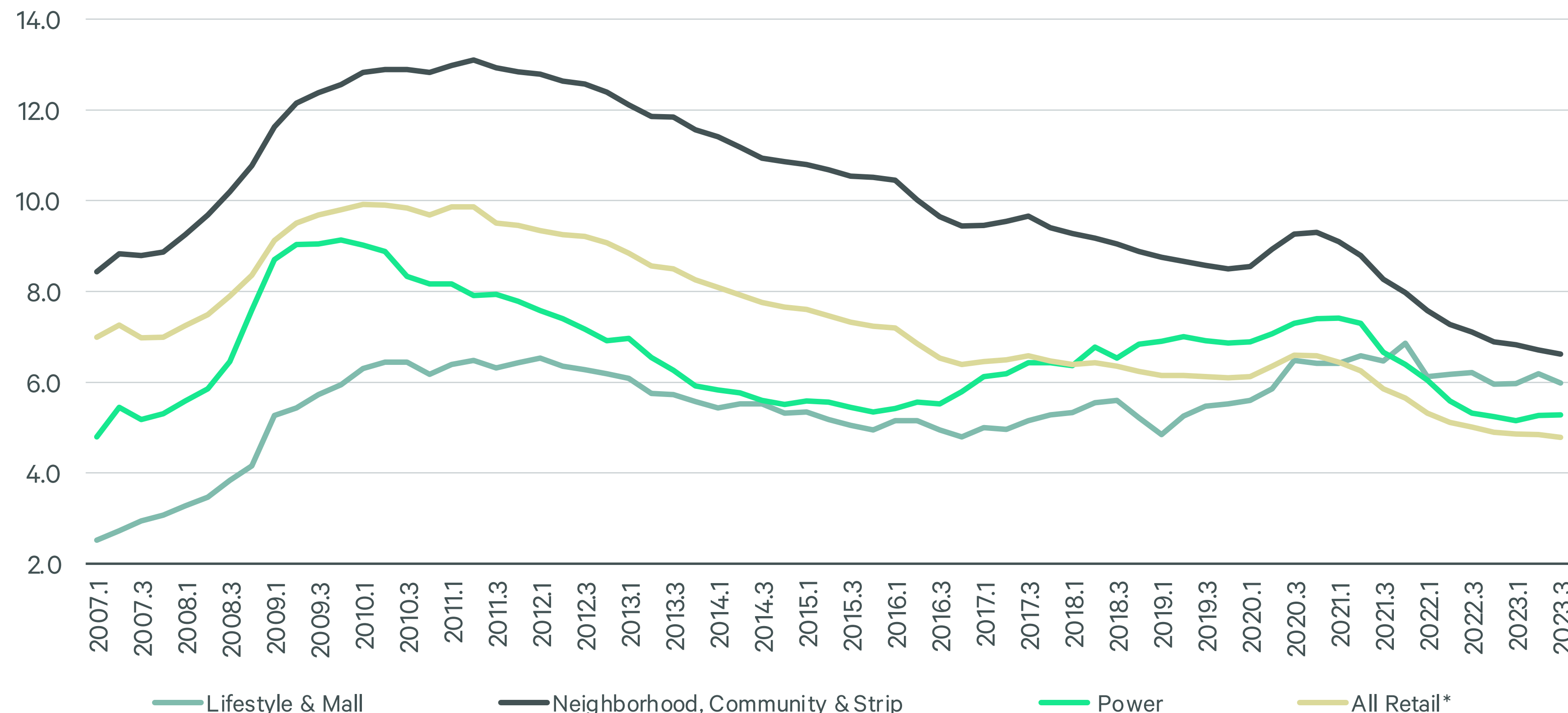
Market Fundamentals

Availability settles as prime space remains scarce

- The robust 2022 experienced across all retail sectors has begun to give way to more tempered demand as little available space remains.
- Retail bankruptcies are set to launch approximately 1% of all retail square footage back on the market over the next year, leading to upticks in availability.
- But much of the space coming available is highly desirable and will be absorbed by occupiers hungry for well located spaces.
- NC&S centers' availability continued its decline (excluding the pandemic trials) from the past decade - fueled further by consumers spending more closer to home.

Availability Rate by Type (%)



Source: CBRE Econometric Advisors Q3 2023
*All Retail includes free standing retail and outlet centers – not included on this graph for clarity

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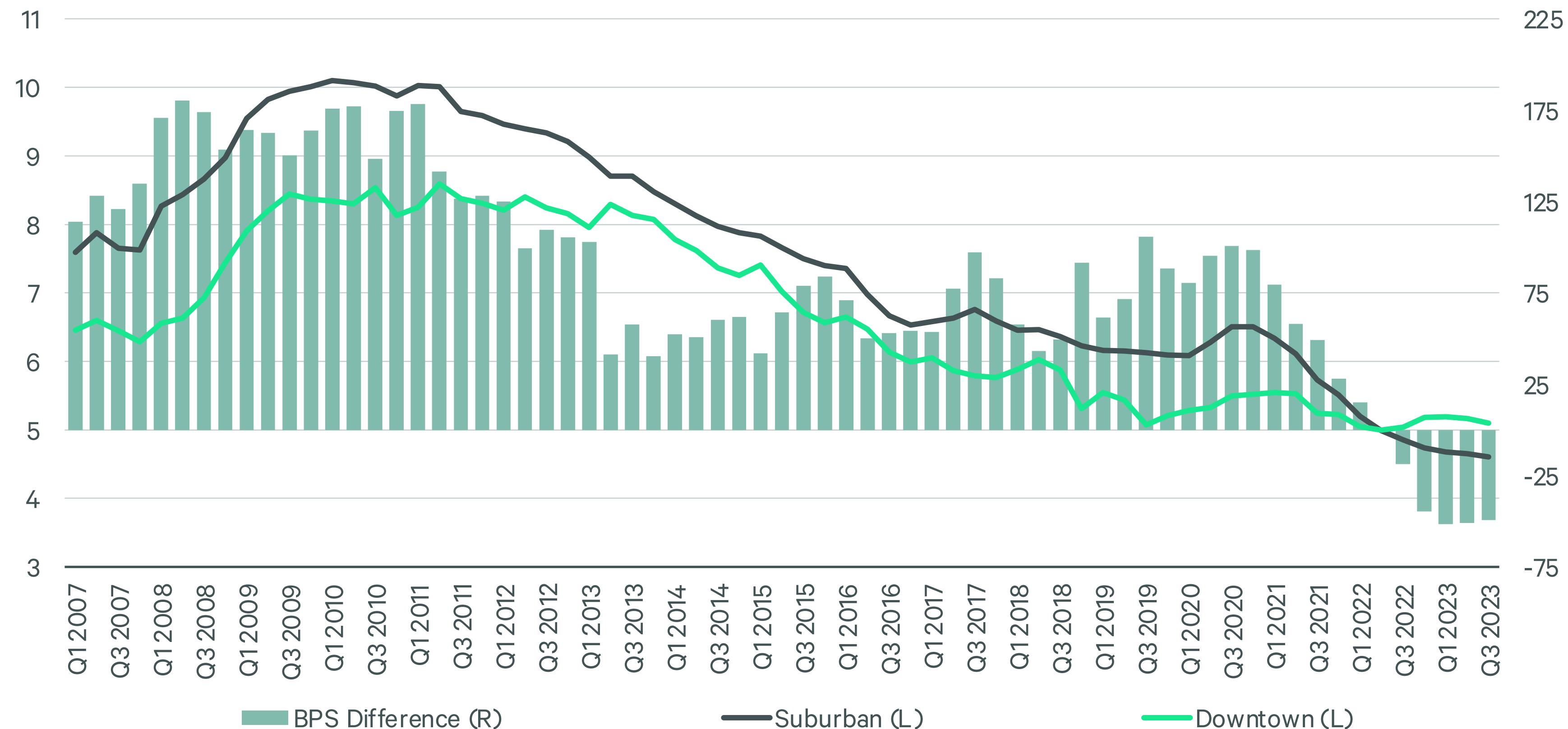
Remote work shifts consumer spending closer to home

- For the first time in more than 15 years availability of all retail space in downtown CBDs has surpassed that of all suburban retail.
- With the rise of remote work, workers began spending more money closer to home, forging new and lasting shopping habits. Retailers took notice.
- It's too soon to count downtowns out just yet as consumers are starting to shift their weekend excursions to the haunts they used to frequent for after work happy hours and socializing.
- Further hope for downtown revitalization may come in the conversion of office to multifamily to lure consumers back to more urban areas.

Total Retail: Downtown and Suburban Availability



Source: CBRE Econometric Advisors Q3 2023

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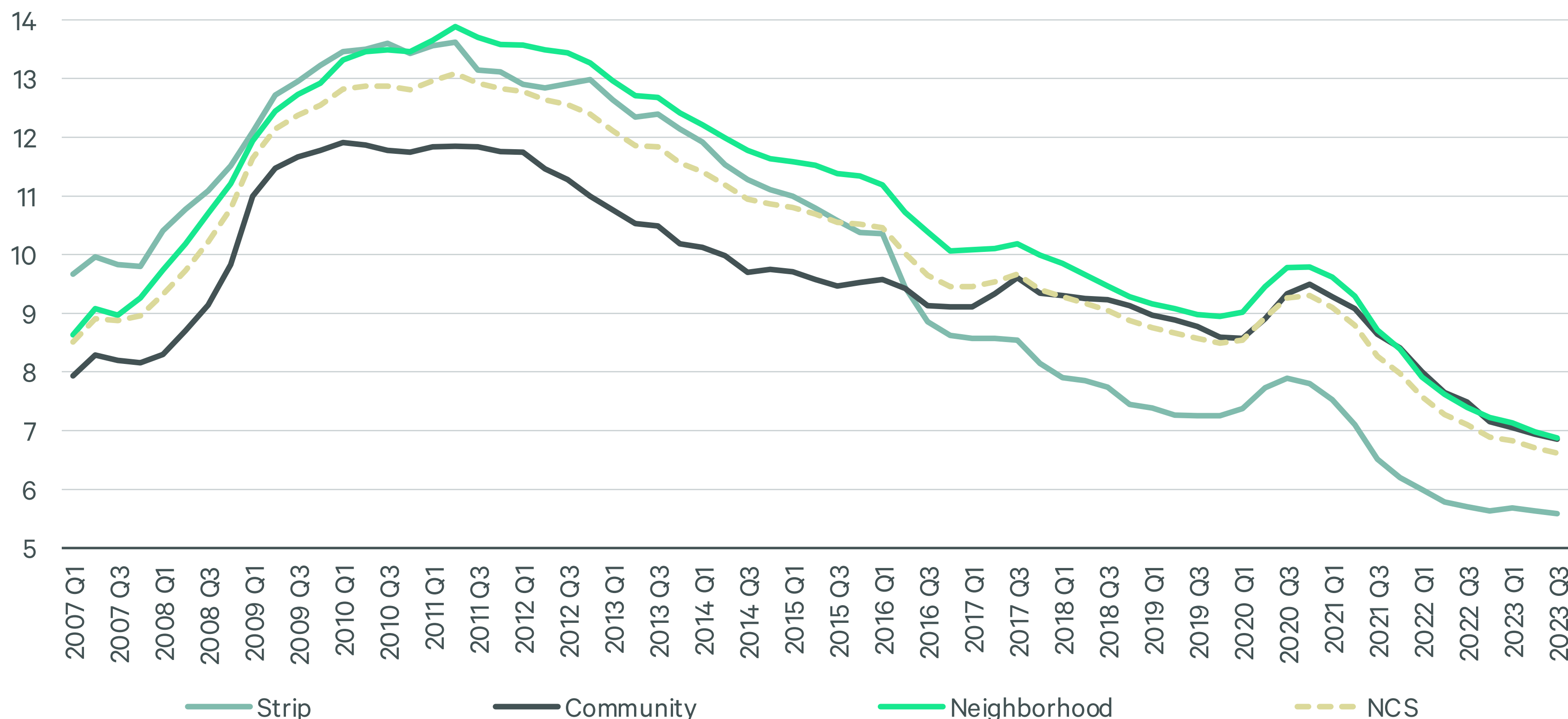
Are strip centers the new retail royalty?

- Though recent consumer trends have shown more spending closer to home, strip centers started to show increased interest from occupiers way back in 2016.
- Strip center rents have grown 22% since 2016 compared to the 18% growth for all NC&S centers. Despite outpacing other open-air centers in rent growth, they remain the most affordable option (rents 5-15% lower than other open-air centers).
- The affordability of these smaller strip centers continues to drive demand for occupiers looking to experiment or enter the market, and consumers have already expressed their willingness to consume closer to home.

Availability by NC&S Type (%)



Source: CBRE Econometric Advisors Q3 2023

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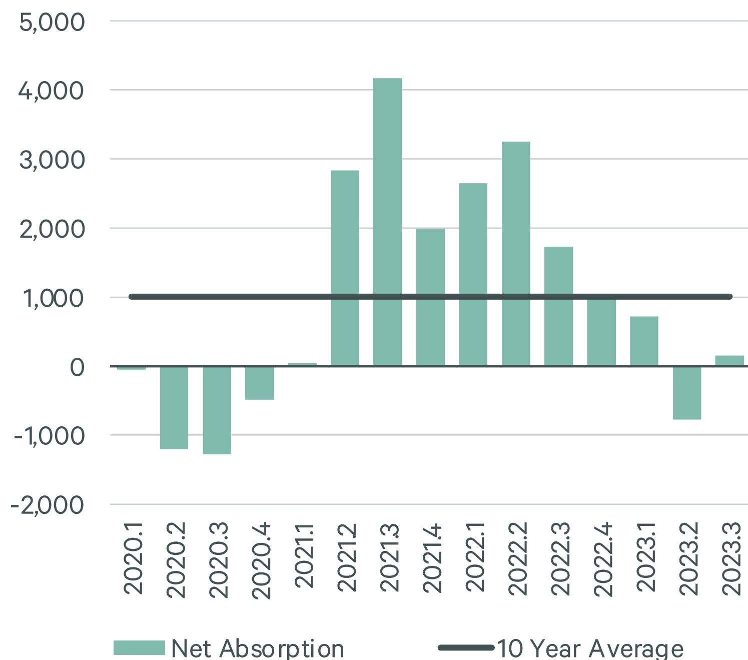
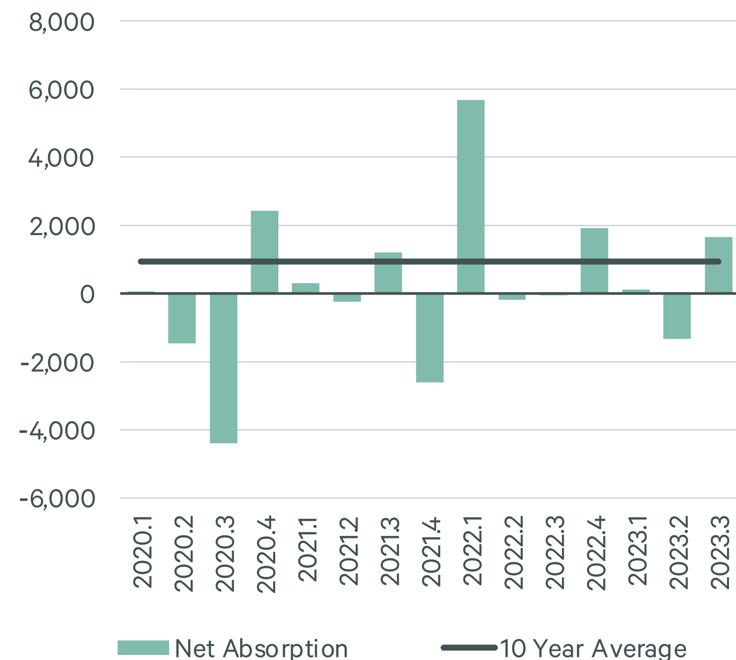
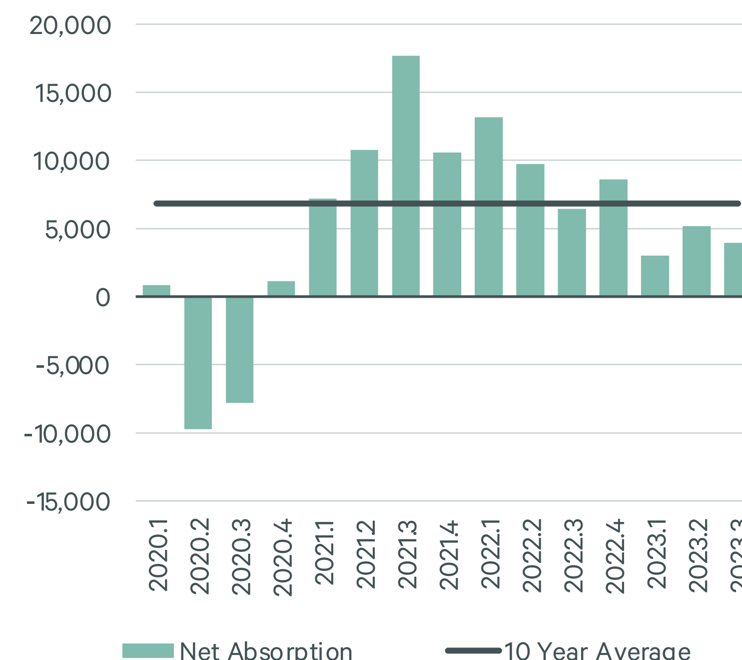
Absorption continues to cool despite surprise retail spending



Source: CBRE Econometric Advisors Q3 2023



Source: CBRE Econometric Advisors Q3 2023



Source: CBRE Econometric Advisors Q3 2023

- Absorption cools across formats with expected consumer budgeting, bankruptcies taking effect, and retailers in less desirable locations vacating their spaces.
- Neighborhood, Community, and Strip centers remain a relative standout, though lack of prime space has cooled absorption despite new consumer habits.

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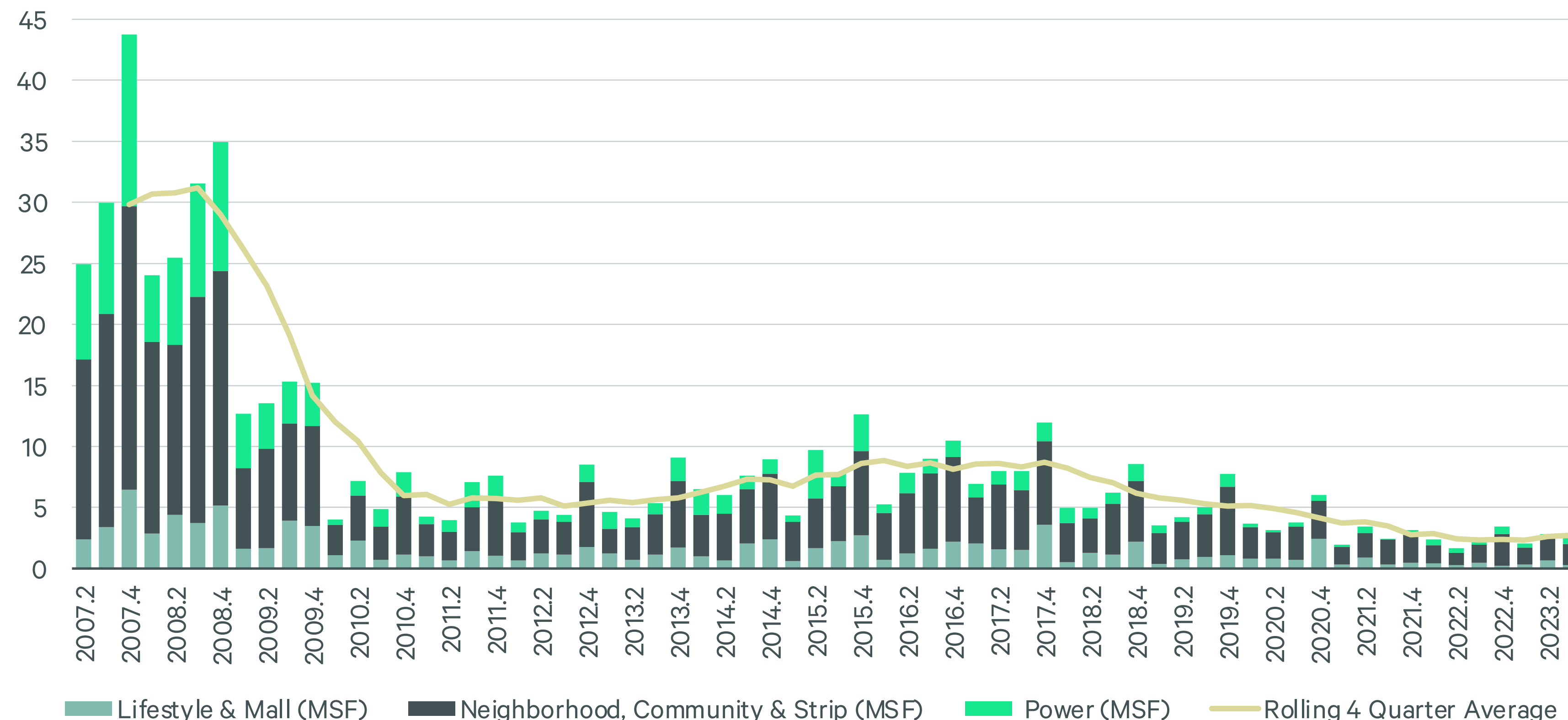
Lack of new supply dominates retail fundamentals story

- Following the trend, with little to no indication of change, Q3 completions totaled approximately 0.05% of stock as construction and redevelopment costs remain high.
- Record low completions drives strong and stable fundamentals across the retail sector, as tenants cannot and do not want to give up desired spaces.
- With few new spaces becoming available, prime locations remain in high demand. But many prime locations are established and aging, and development/redevelopment could shake up the current hierarchy of prime locations.



Source: CBRE Econometric Advisors Q3 2023

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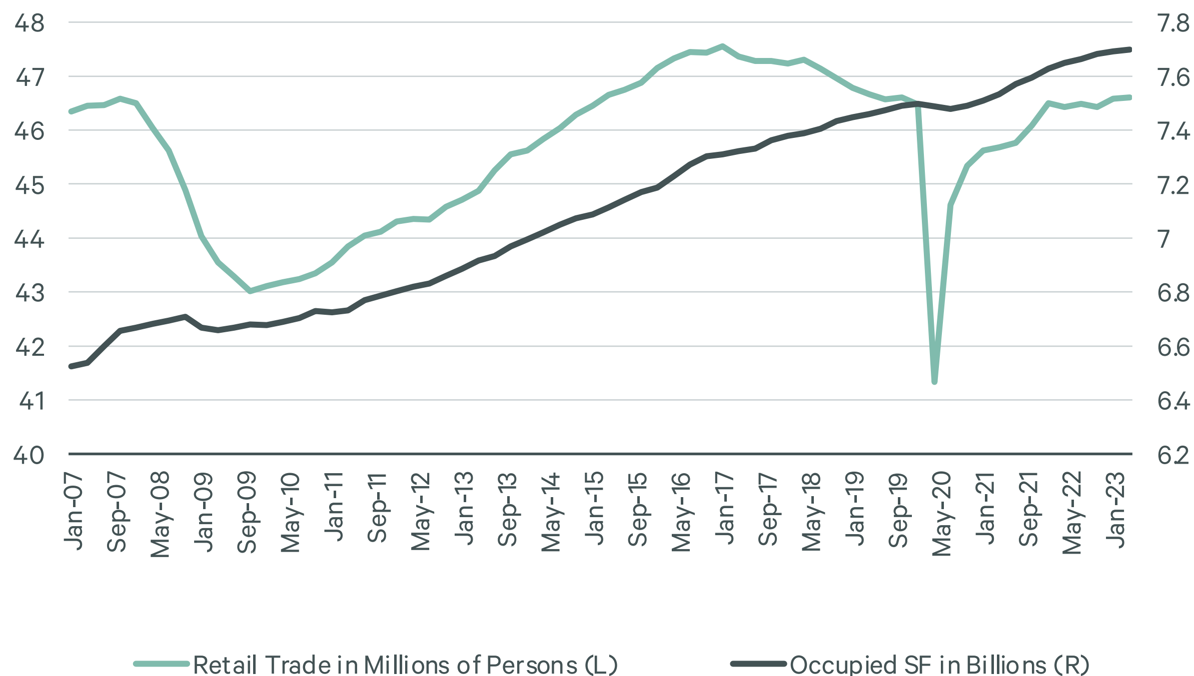
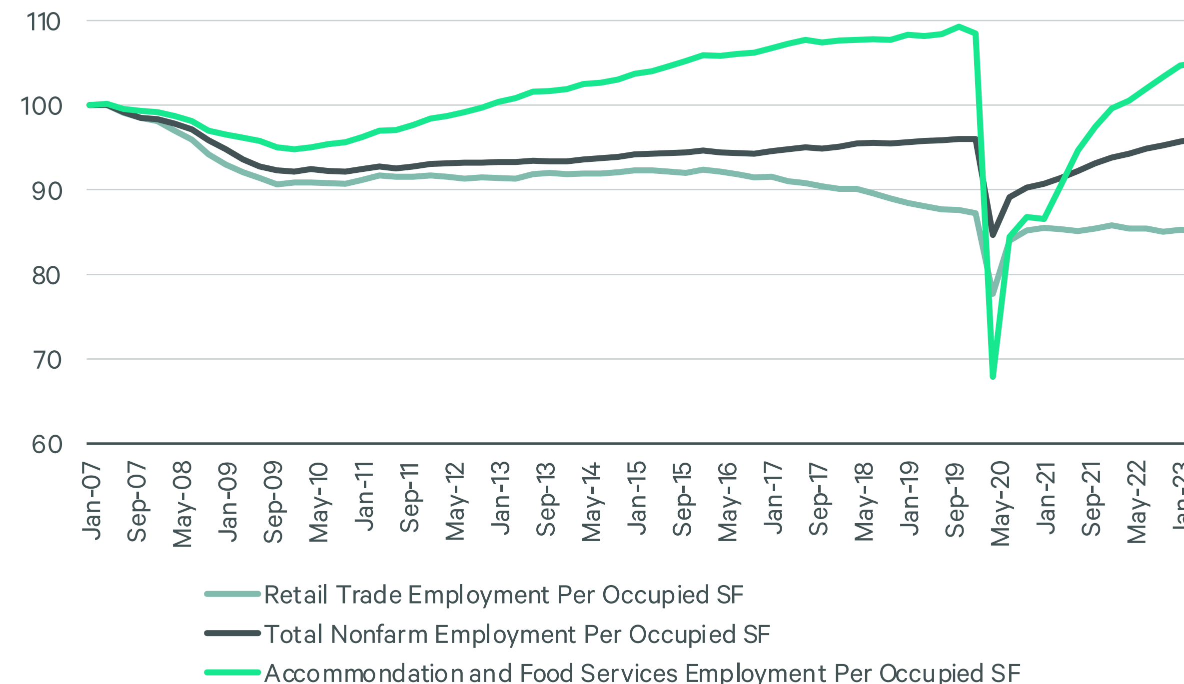
Retail labor productivity gains drive resilience for sector…



Source: CBRE Econometric Advisors, Federal Reserve Q3 2023



Source: CBRE Econometric Advisors, Federal Reserve Q3 2023

- Retail employment has separated from demand as occupied space continues to increase and employment holds steady.
- Despite lacking supply, retail employment per square foot continues to fall, implying increased productivity per square foot of retail.
- This increased efficiency per square foot could help to offset the real estate impact of macro headwinds to consumer spending.

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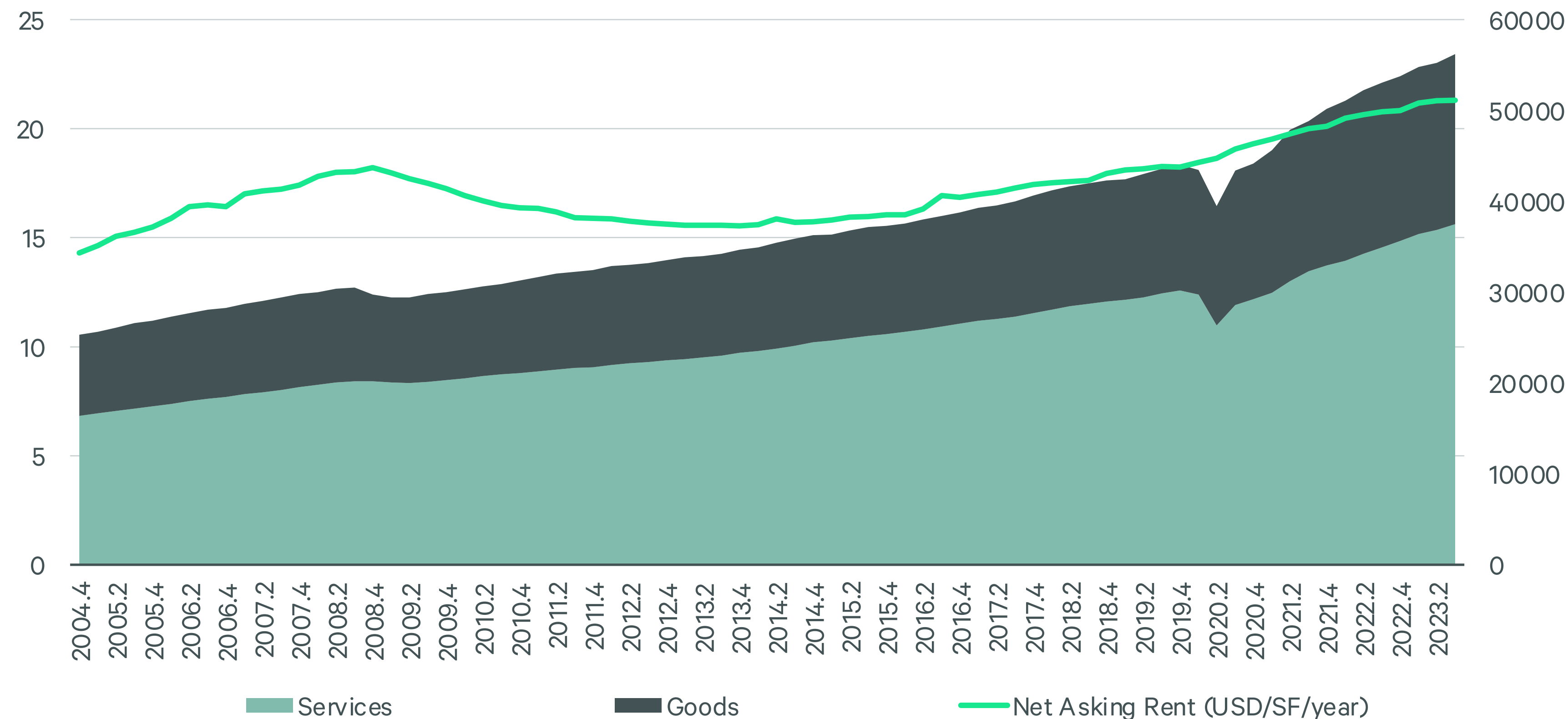
... But consumers' struggles may flow through to rents

- Historically, retail asking rents have failed to follow consumer spending on goods and services, but since the precipitous drop of new supply post GFC, consumer spending and rents have become highly correlated (above 95% post 2011).
- Further, with the continuing dearth of retail development, exacerbated by the pandemic, the ability to capture consumer spending in rents has increased (correlation of .99 from Q2 2020 onward).
- If the relationship continues and consumers begin to suffer (under the pressure of increased prices, depleted savings, rising interest rates, and the restart of student loan repayments), retail rental growth may be muted, even with lacking new supply.

Consumer Spending on Goods and Services in Billions of $s and Net Asking Rent



Source: CBRE Econometric Advisors, Federal Reserve Q3 2023

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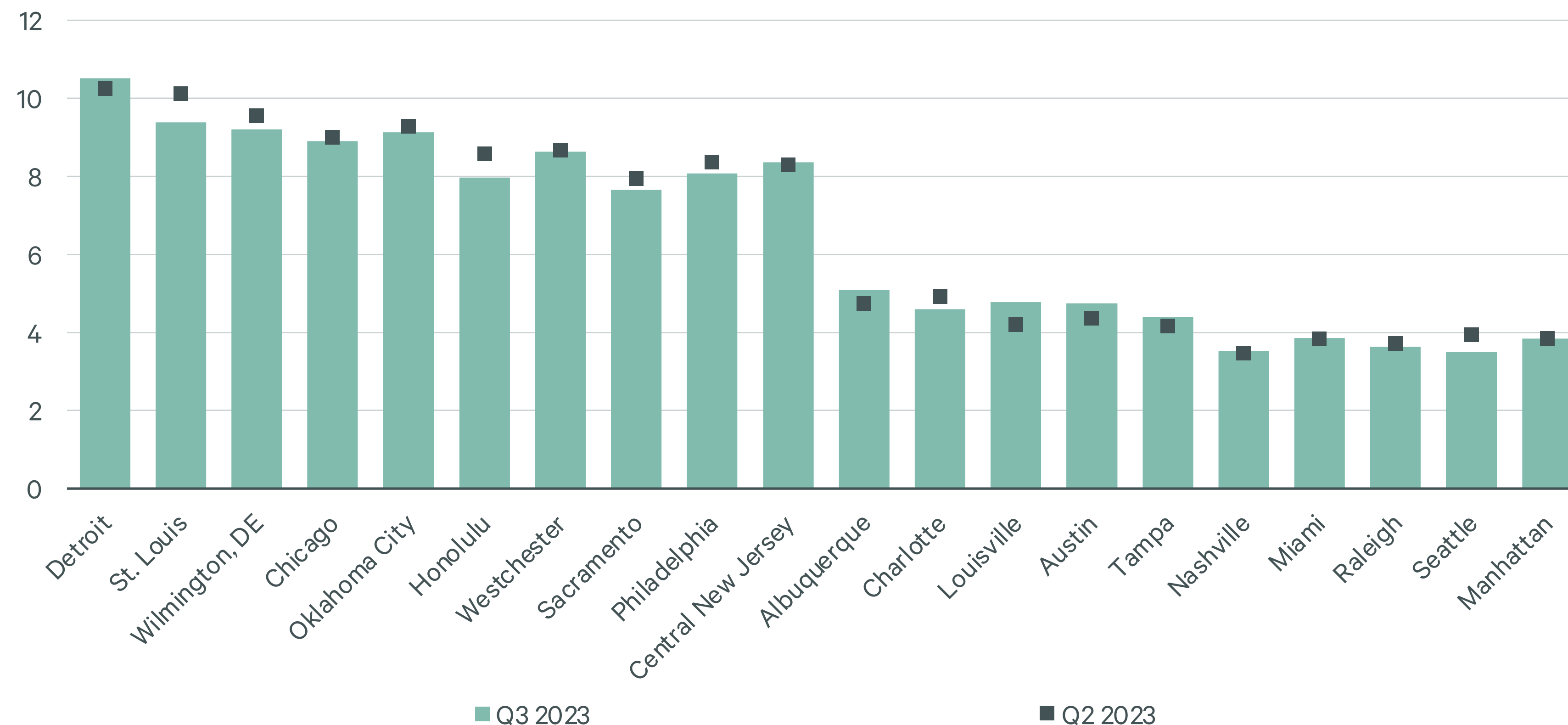
Markets stall as desirable space remains scant

- Both high and low availability markets have stalled as they approach equilibrium, and the economy cools overall.
- Occupiers are practicing patience and waiting for desirable spaces to become available from recent retailer bankruptcies.

Top and Bottom Markets for Availability Rate (%)



Source: CBRE Econometric Advisors Q3 2023

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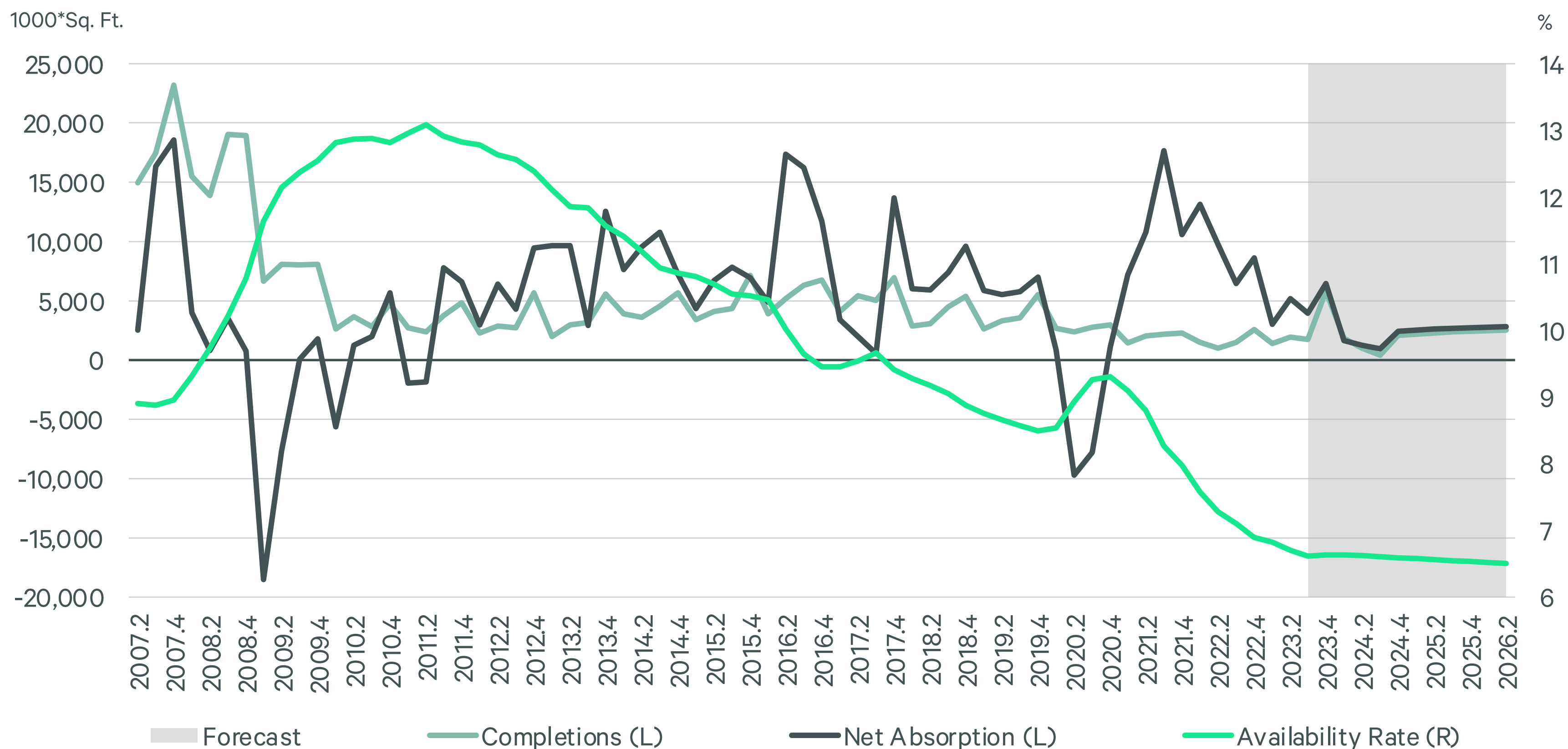
U.S. Neighborhood, Community, and Strip (NC&S) Forecasts

Prime retail space to remain scarce despite bankruptcies

– Availability declines in NC&S centers are set to decelerate but continue falling as net absorption outpaces deliveries.

– As currently available retail space remains less desirable, the opportunity provided by the recent retail bankruptcies will be welcomed by retailers who have been searching for well located spaces.

Baseline Forecasts for NC&S Centers Completions, Net Absorption and Availability



Source: CBRE Econometric Advisors Q3 2023

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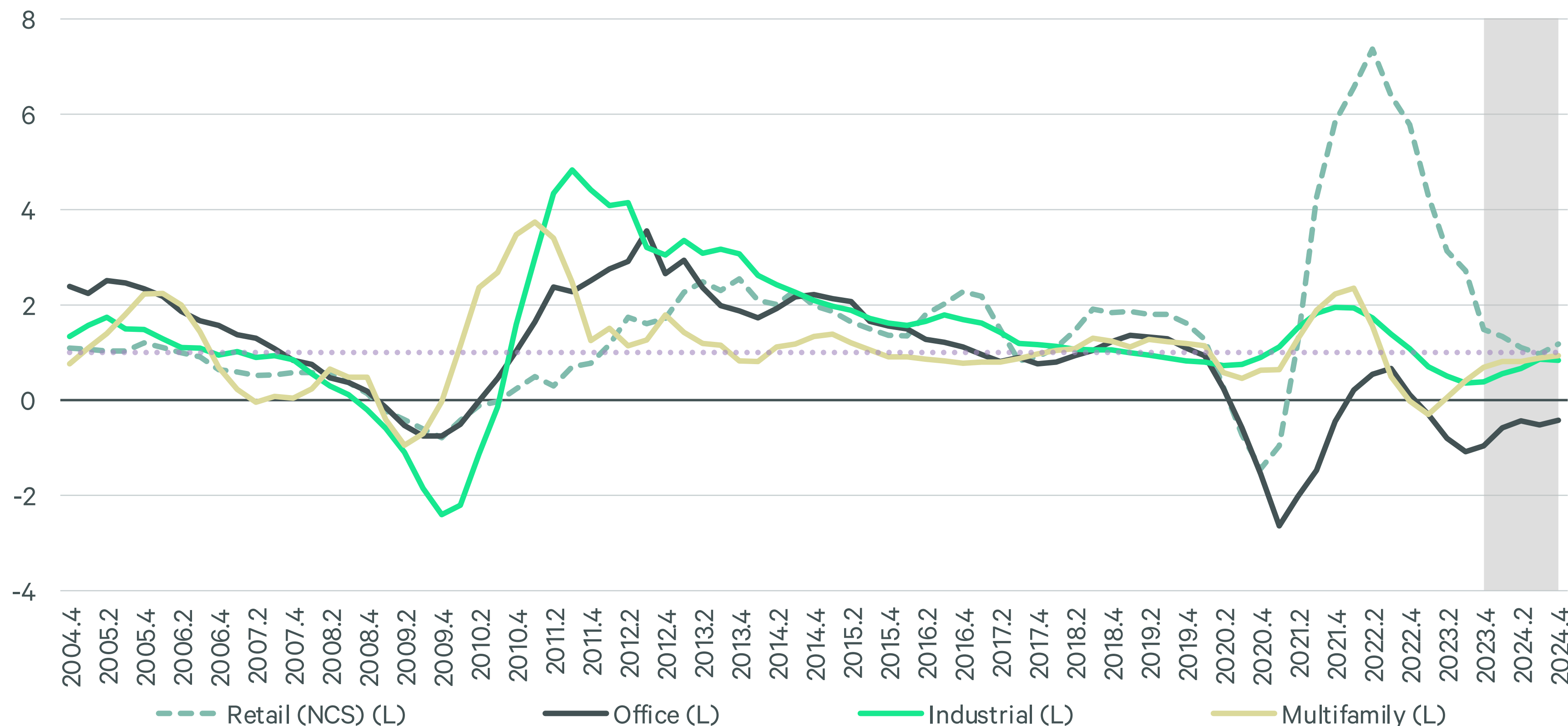
Occupier appetite reiterates desire for new retail space

- Occupiers gobbled up more than seven times the delivered NC&S space in the second quarter of 2022, an all-time high for any of the four property types. Since then, appetite for non-prime spaces has continued to trend down to more reasonable levels.
- However, space that is set to deliver over the next year is, in some cases, entirely pre-leased as occupiers are looking toward new and prime spaces to occupy and shunning the currently available space.
- This appetite indicator shows the imbalance between supply and demand in a given sector. When a value is greater than 1 (dotted purple line) more space is desired than has been delivered, which should push rents up under normal economic conditions.

Occupier Appetite for Retail Space: Net Absorption vs Deliveries



Source: CBRE Econometric Advisors Q3 2023

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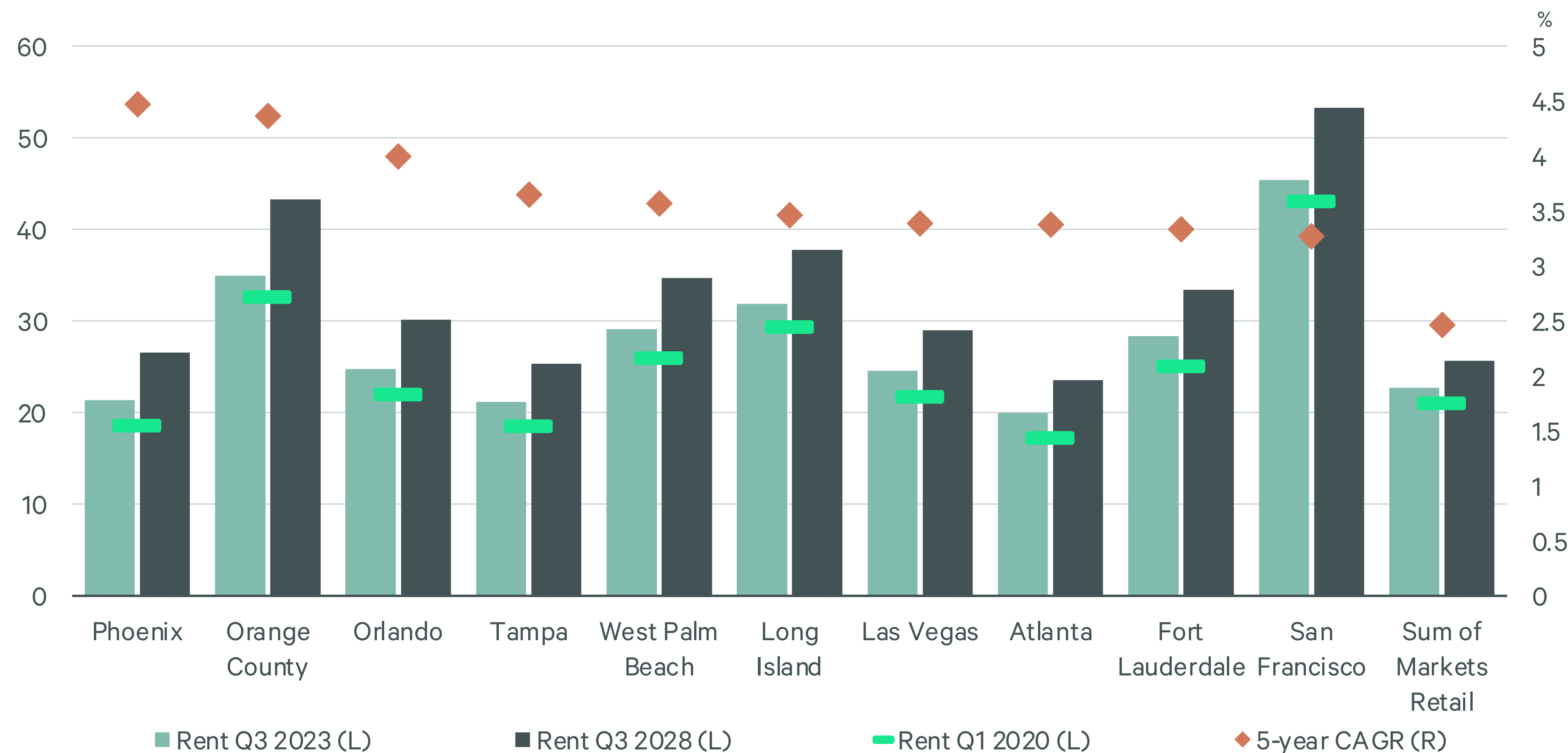
Sun Belt retail continues to lead rent growth expectations

- While the Sun Belt markets continue to dominate in rental growth, our Sum of Markets is expected to grow at 2.3% annualized over the next five years. This is a downgrade from previous forecasts as headwinds begin to take form for consumers.
- Surprisingly, San Francisco peaks its head into the top 10 despite several noteworthy and high profile exits. New retailers are expanding into the city and surrounding areas, set to drive rental growth.



Source: CBRE Econometric Advisors Q3 2023

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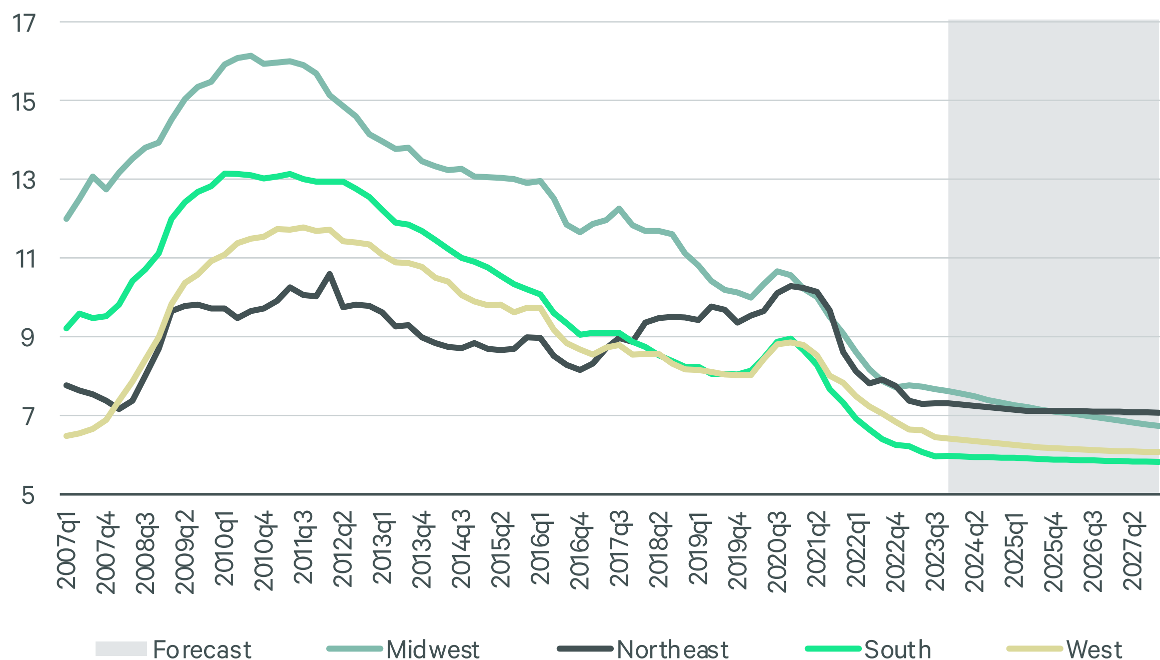
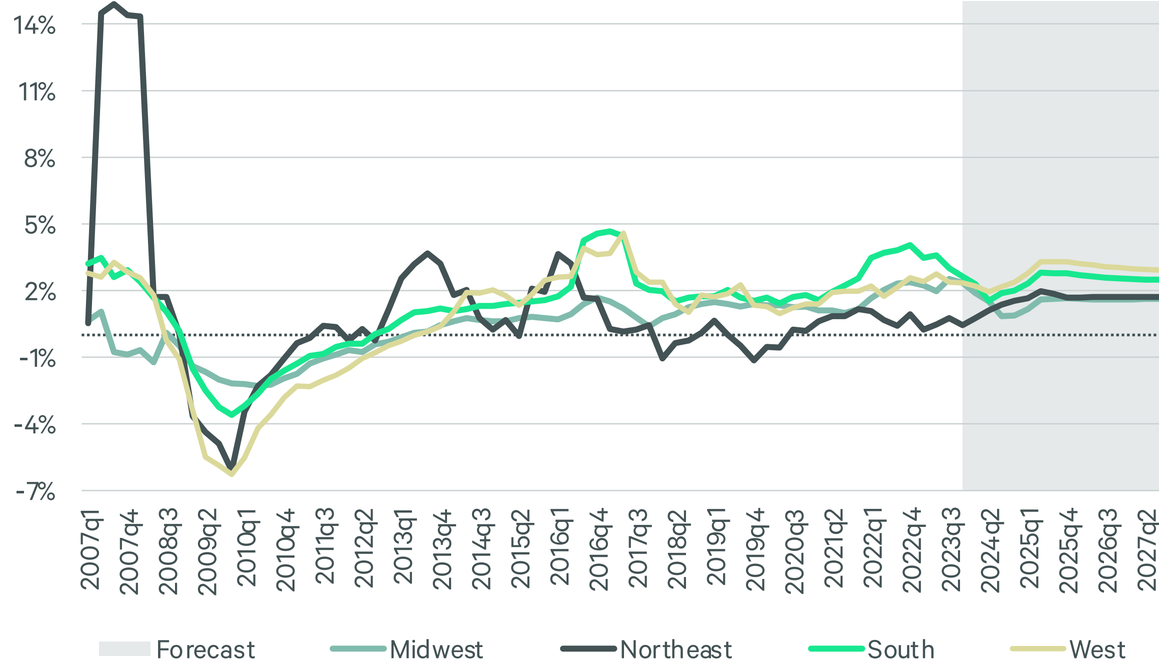
Rental growth flows over the South and heads West

Availability by Census Region (%)



Source: CBRE Econometric Advisors Q3 2023

Year Over Year Rental Growth by Census Region (%)



Source: CBRE Econometric Advisors Q3 2023

- The South's recent population gains due to its low cost of living, and economic freedoms helped it enjoy a recovery that outpaced other regions, in both demand for space and rental growth. Now, lacking prime available space the South may be a candidate for future development or redevelopment.
- The West, long a top performer for retail growth, will weather the downturn well with a strong well educated consumer base.
- The Midwest boasted the largest decrease in availability from its 2010 peak but is most at risk from slipping demand should we see another shift in consumer attitudes.
- The Northeast remains the most volatile of the four regions, but as it begins to stabilize, and local consumers settle back into new habits we see it bucking the trend of diminishing rental growth and even powering through a downturn.

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Economic Scenarios

‘Baseline’ Scenario

- The Baseline Scenario assumes that economic growth will contract as credit conditions remain tight and private investment and consumption weakens. Q-o-Q declines could emerge as soon as late 2023 and last through H1 2024. (NOTE: The figures to the right show Y-o-Y growth.) Our Baseline expects that the labor market will eventually roll over by 2024 and the unemployment rate will increase to the upper 4% range.
- Although recent CPI reports indicate a M-o-M uptick in inflation we believe it will generally trend downward from here. Some components of inflation, such as consumer services, could remain stubbornly high in the near-term.
- The combination of peaking inflation and weaker economic growth suggests that the Fed is done hiking this cycle, albeit one more rate hike this year is within the range of possibility.

Y-o-Y Change (%); 10-Year Treasury Displays Quarterly Yields

	GDP	Employment	CPI	US 10-Year
2021 Q1	1.6	(5.4)	1.9	1.3
2021 Q2	12.0	8.6	4.8	1.6
2021 Q3	4.7	4.7	5.3	1.3
2021 Q4	5.4	4.6	6.8	1.5
2022 Q1	3.6	5.0	8.0	1.9
2022 Q2	1.9	4.7	8.6	2.9
2022 Q3	1.7	4.2	8.3	3.1
2022 Q4	0.7	3.4	7.1	3.8
2023 Q1	1.7	2.9	5.8	3.6
2023 Q2	2.4	2.5	4.1	3.6
2023 Q3	2.4	2.1	3.6	4.1
2023 Q4	1.7	1.5	3.5	4.6
2024 Q1	1.0	0.8	3.2	4.4
2024 Q2	0.8	0.3	3.2	4.3
2024 Q3	0.5	(0.1)	2.8	4.1
2024 Q4	1.1	(0.0)	2.4	4.0
2025 Q1	1.7	0.3	2.3	3.9
2025 Q2	1.9	0.5	2.3	3.8
2025 Q3	2.1	0.7	2.3	3.7
2025 Q4	2.1	0.8	2.3	3.6

Source: Oxford Economics, CBRE Econometric Advisors

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‘Tighter Financial Conditions’ Scenario

- In this scenario, the U.S. economy is not able to withstand tighter credit conditions and output contracts more than expected. Business investment plans are shelved, and firms are not able to retain staff as they would be able to in a more moderate recession. Both employment and GDP decline for the duration of 2024. A key trigger of tighter credit conditions is interest rates drifting higher than our Baseline would suggest.
- The ‘Tighter Financial Conditions’ will have a disproportionate impact on the commercial real estate sector, which leans on regional banks as a key source of financing. With the key driver of this scenario being higher interest rates the impact on cap rates and valuations would be quite negative.

Y-o-Y Change (%); 10-Year Treasury Displays Quarterly Yields

	GDP	Employment	CPI	US 10-Year
2021 Q1	1.6	(5.4)	1.9	1.3
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2022 Q4	0.7	3.4	7.1	3.8
2023 Q1	1.7	2.9	5.8	3.6
2023 Q2	2.4	2.5	4.1	3.6
2023 Q3	2.4	2.1	3.6	4.1
2023 Q4	1.2	1.3	3.5	4.8
2024 Q1	(0.1)	0.1	3.2	4.6
2024 Q2	(0.8)	(0.8)	3.0	4.4
2024 Q3	(1.5)	(1.6)	2.5	4.3
2024 Q4	(0.7)	(1.6)	1.9	4.1
2025 Q1	0.4	(1.1)	1.6	4.0
2025 Q2	1.1	(0.6)	1.6	3.9
2025 Q3	1.8	0.0	1.7	3.7
2025 Q4	2.3	0.6	1.8	3.6

Source: Oxford Economics, CBRE Econometric Advisors

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'Soft Landing' Scenario

- The 'Soft Landing' is driven by consumers continuing to spend their excess savings with limited impact on inflation. Thus, the economy gets the benefit of more activity without the tax of higher interest rates. More clarity around the path of interest rates provides some relief for rate sensitive sectors, such as real estate and manufacturing. The pace of hiring will slow partly due to supply-side constraints.
- The 'Soft Landing' scenario has won more converts within the economic forecasting community. However, there is little historical precedent for a 'soft landing' following a dramatic uptick in interest rates or tightening of credit conditions.
- Indeed, a potential driver of outperformance this cycle could be an unchecked overhang of stimulus still circulating the economy.
- This scenario would create more stable real estate capital markets and support higher asset prices. Further, the stronger economic outlook would maintain occupier markets.

Y-o-Y Change (%); 10-Year Treasury Displays Quarterly Yields

	GDP	Employment	CPI	US 10-Year
2021 Q1	1.6	(5.4)	1.9	1.3
2021 Q2	12.0	8.6	4.8	1.6
2021 Q3	4.7	4.7	5.3	1.3
2021 Q4	5.4	4.6	6.8	1.5
2022 Q1	3.6	5.0	8.0	1.9
2022 Q2	1.9	4.7	8.6	2.9
2022 Q3	1.7	4.2	8.3	3.1
2022 Q4	0.7	3.4	7.1	3.8
2023 Q1	1.7	2.9	5.8	3.6
2023 Q2	2.4	2.5	4.1	3.6
2023 Q3	2.4	2.1	3.6	4.1
2023 Q4	1.7	1.5	3.5	4.6
2024 Q1	1.1	0.8	3.3	4.4
2024 Q2	1.2	0.5	3.3	4.2
2024 Q3	1.1	0.3	3.0	4.1
2024 Q4	1.9	0.6	2.7	4.0
2025 Q1	2.4	0.9	2.5	3.8
2025 Q2	2.4	1.1	2.4	3.7
2025 Q3	2.2	1.0	2.3	3.6
2025 Q4	1.9	0.9	2.2	3.6

Source: Oxford Economics, CBRE Econometric Advisors

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Downside risks could outweigh upside benefits

- Availability across scenarios is set to oscillate around a new steady state (around 6-7%) as new supply remains limited and occupier demand for retail space remains high.
- Upside rents under a Soft Landing scenario will slightly outperform the Baseline as consumers spend more in the short run due to inflationary pressure and continued steady earnings.
- The Downside scenario suffers significantly more from increased unemployment and tightening consumer budgets.
- Inflation-adjusted rents are likely to remain steady across scenarios as retail tends to efficiently capture inflation into asking rents.

Demand and Rental Growth by Economic Scenario

Source: CBRE Econometric Advisors Q3 2023

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Thank you

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