CBRE

Econometric Advisors

Q4 2023
Industrial Overview & Outlook

REPORT

February 2024

Executive Summary

- A critical shift is underway in the industrial sector, marked by large increases in availability and unprecedented levels of new supply. This transition to heightened availability rates and rapid supply expansion reflects a sector adjusting to a new market reality. Larger assets are primarily driving the sharp increase in availability rates, but smaller assets are being challenged as well. Moreover, an increasing proportion of newly delivered buildings are entering the market vacant, a stark departure from the previous two-year trend.
- Current market dynamics underscore the sector's challenge of managing excess supply and aligning that supply with a softer leasing environment. Stakeholders are now tasked with adapting to these shifts, indicating a period of reevaluation and response to an industrial landscape that is shifting faster than expected.
- Despite the supply pressures, asking rents are forecasted to grow by 3.5% annually over the next five years on the heels of improved macroeconomic conditions and a resilient U.S. consumer base.

Q4 2023 Forecast Summary

	2022	2023	2024F	2025F	2026F	2027F	2028F
Absorption Rate (%)	2.8	0.6	1.8	1.2	1.3	1.5	1.6
Completions Rate (%)	2.7	3.1	2.2	2.1	2.0	2.0	1.9
Availability Rate (%)	4.8	7.1	7.3	8.0	8.5	8.7	8.9
EA Asking Rent Growth (%)	13.9	6.5	4.1	3.3	3.2	3.4	3.7

Source: CBRE Econometric Advisors Q4 2023

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Macroeconomy

2024 CBRE Econometric Advisors' Economic Forecast Brief

- Continued economic growth paired with the 'Fed pivot' suggests that the U.S. economy is heading toward a 'soft landing'. But regardless of whether GDP has a '+' or '-' sign in front of it, the pace of growth will likely be much more modest than in recent quarters. A key reason for the slowdown is that consumers are unlikely to repeat their strong showing in 2023 as most households have less cash on hand and overall credit growth is slowing. Further, the business sector is a mixed bag. Interest rate sensitive sectors, such as autos and housing, are holding steady. Currently, many large corporates appear skeptical about growth prospects in 2024. The greatest investment is centered around technology and the potential productivity boost it can bring.

- This cautious tone from firms is filtering into the labor market. Although conditions remain tight the demand for labor is rebalancing from its heights of 2021 when the job openings rate hit 8%—nearly double pre-COVID levels. Today the openings rate is down to 5.6%. This trend coincides with slower wage growth and inflation. Our Baseline forecast expects that progress on inflation is enough to halt the Fed's tightening cycle, but it probably will not quickly return to the Fed's 2% target either. This suggests that interest rates will remain elevated relative to past cycles. Other uncertainties confronting inflation and financial markets include an array of conflicts and elections around the world.

- On a positive note, the latest data suggests we will get a mix of continued economic growth amid easing interest rates and financial conditions. This is good news for both real estate fundamentals and capital markets. Regarding the latter, some leading indicators suggest this thaw is beginning and cap rates are likely near their peak for most sectors.

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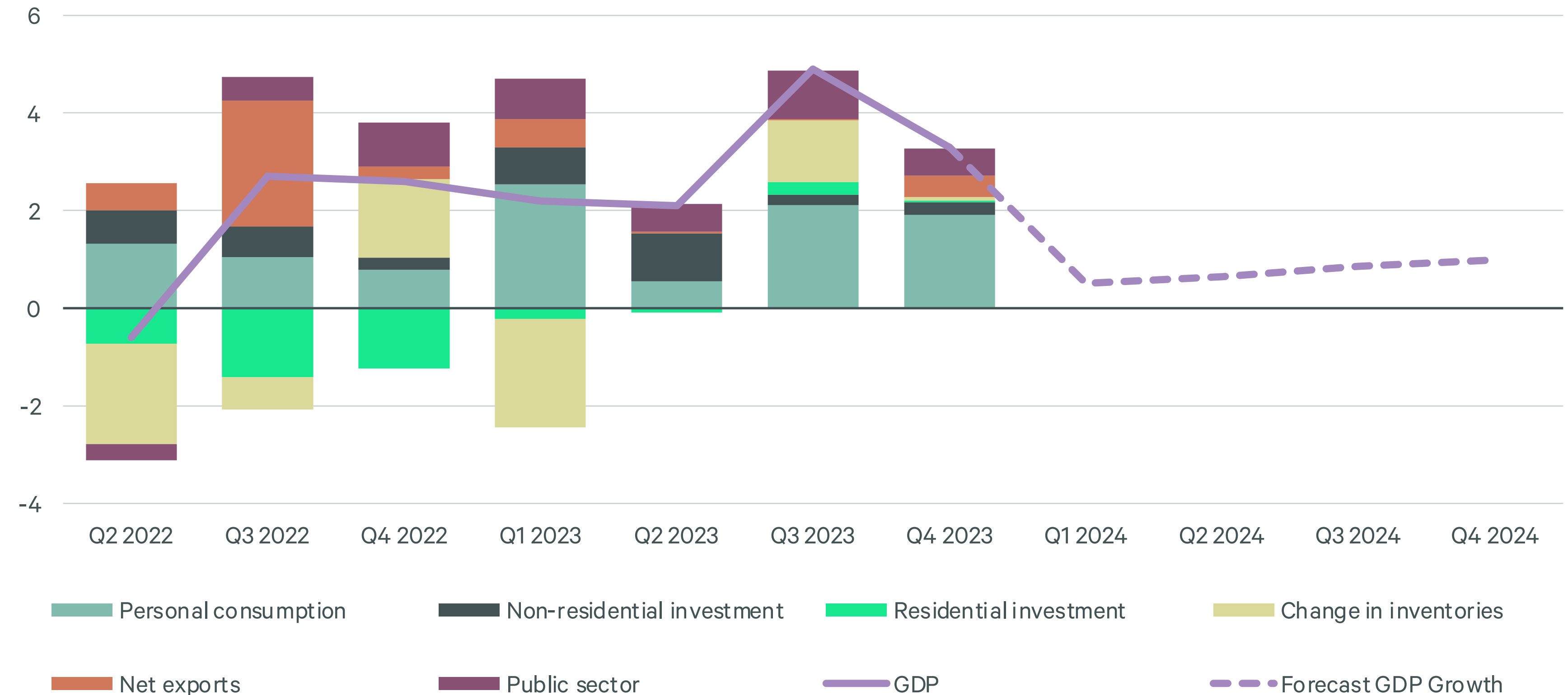
What will drive the slowdown in growth?

Most key economic indicators suggest that the U.S. economy is on the path for a 'soft landing' rather than a very moderate recession. We do expect that the pace of economic growth will slow this year relative to 2023. Key reasons include:

- The U.S. consumer was a key factor in 2023's sturdy performance but we doubt there is enough spending power, especially amongst lower-income households, to drive outsized growth.
- Inventory growth contributed to GDP during H2 2023, but their cyclical nature suggests they will likely be a drag on growth in H1 2024.
- Perhaps the most uncertain component of growth is the public sector. Government stimulus continues to circulate throughout the economy and has contributed to growth during the past six quarters.



Source: Bureau of Economic Analysis, CBRE Econometric Advisors

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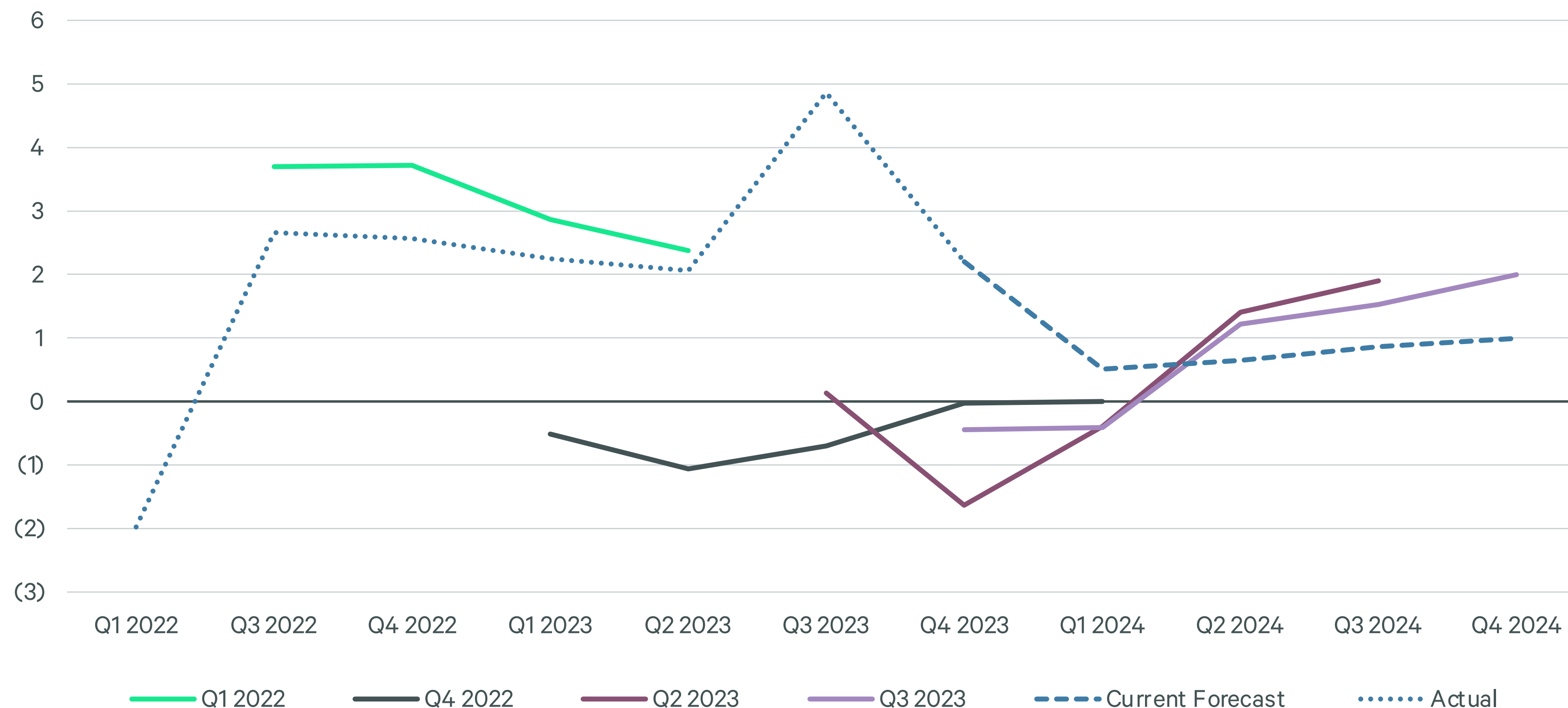
How our outlook has changed

- CBRE EA's macro-outlook has undertaken a data dependent evolution in recent years, tracking the rise and fall of inflation and a very dramatic tightening cycle.

- Concerns surrounding tighter financial conditions began to weigh on our economic outlook during H2 2022. This stance was emboldened by a string of bank failures in early 2023. However, monetary policy was balanced enough to quell the banking crises, allow for a benign decline in inflation, and maintain growth. This disconnect was a key driver of our forecasting error in recent quarters.

Annualized Quarterly GDP Growth (%) by Forecast Vintage



Source: CBRE Econometric Advisors

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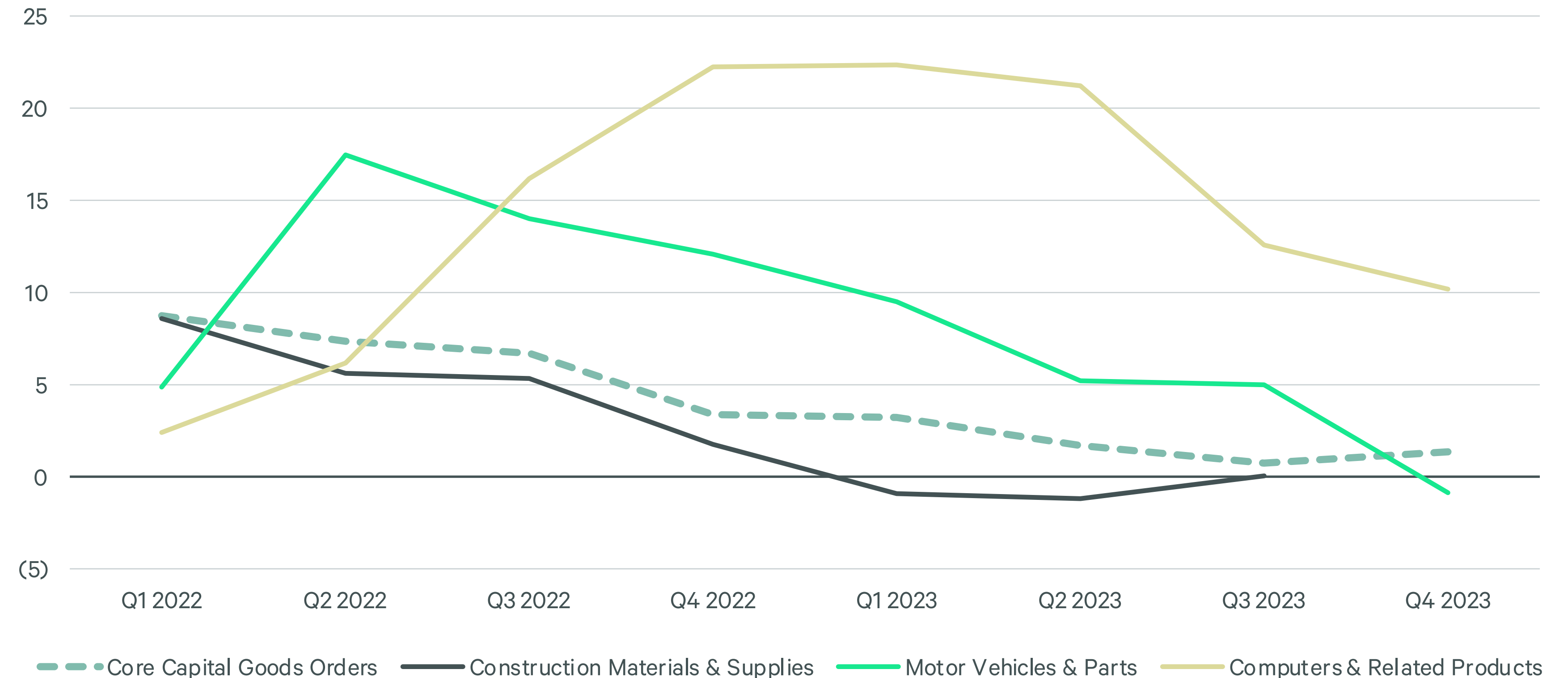
Technology is driving business orders

- Core capital goods orders, a reliable barometer of economic health, are settling at a lower range as supply chains are normalizing.
- Capital goods orders in the auto space have slowed dramatically and are now beginning to contract. This reflects the post-COVID rebalancing but also higher interest rates weighing on sales. Similar factors have influenced orders for construction products.
- High-tech is a clear winner as investments in AI and other productivity enhancing tools are driving orders (and equity market performance).

Capital Goods Orders, Y-o-Y Change (%)



Source: U.S. Census

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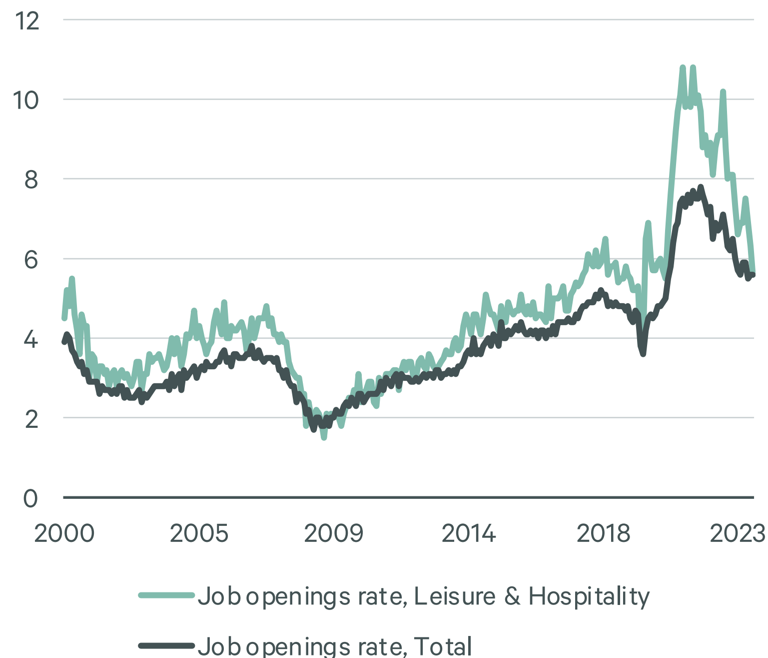
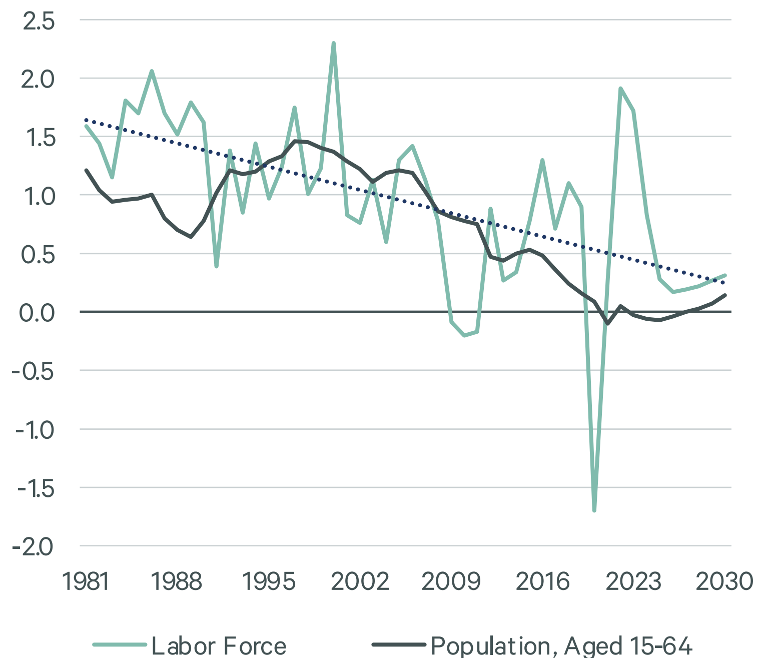
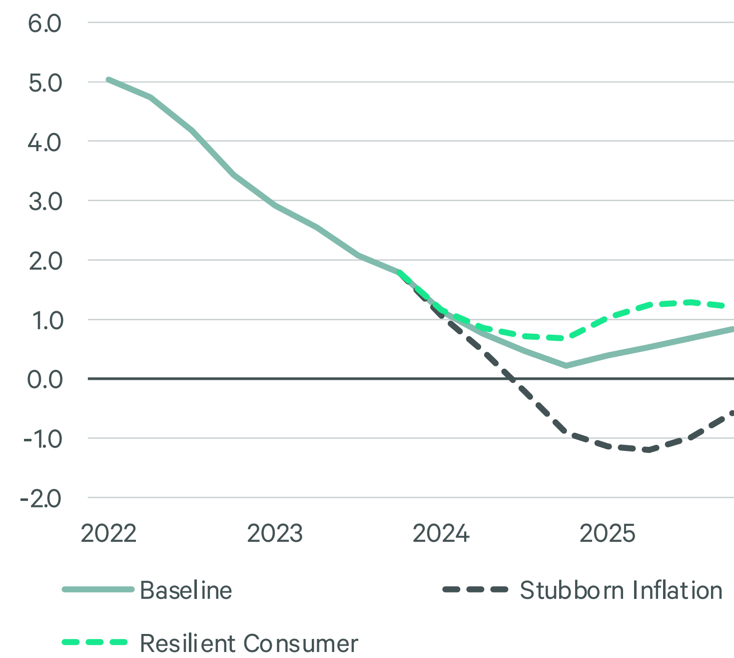
Demand for labor is moderating but remains healthy



Source: U.S. Bureau of Labor Statistics



Source: U.S. Bureau of Labor Statistics, U.S. Census Oxford Economics



Source: U.S. Bureau of Labor Statistics, CBRE Econometric Advisors

- The job openings rate continues to fall. Interestingly, openings within the once over-heated hospitality sector are now on a par with the broader labor market.
- Future hiring will be constrained by limited labor force growth, as the growth of the working-age population is expected to stall in coming years.
- Because the surplus supply of labor is already so thin, job growth would only be marginally better within our Upside, or 'Resilient Consumer' scenario. There is much more room to fall should stubborn inflation keep interest rates elevated long enough that growth eventually stalls.

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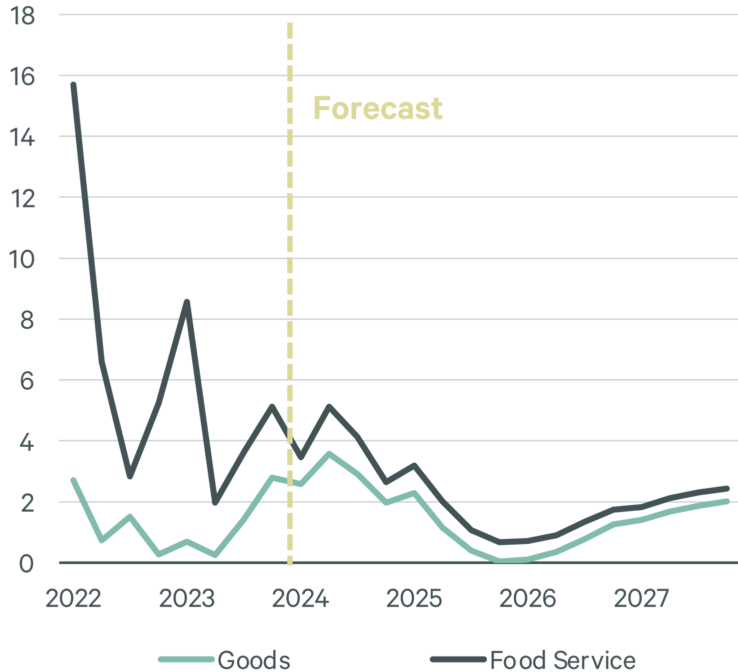
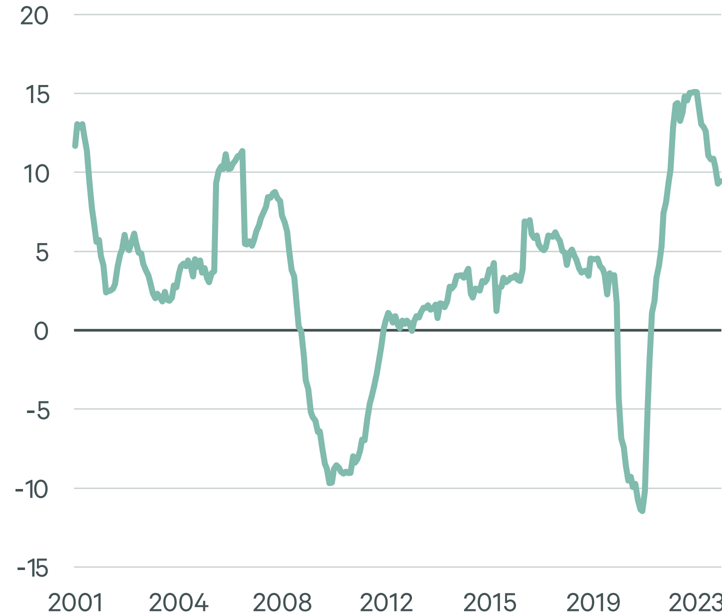
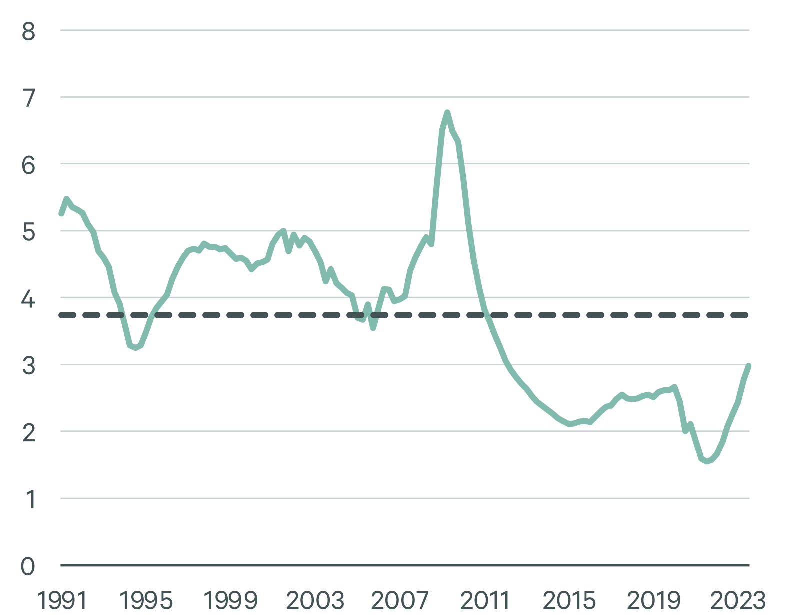
The labor market is supporting consumption



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) has driven the boom in consumption. Our upgraded economic outlook for 2024 now expects spending growth on discretionary services will continue this year—albeit an acceleration is unlikely.
- It is unlikely U.S. consumers will maintain spending via borrowing due to very high credit costs. Indeed, the pace of credit growth is decelerating. Also, some consumers are struggling with their existing debt load. Although credit card delinquencies remain below average, they are quickly trending upward.

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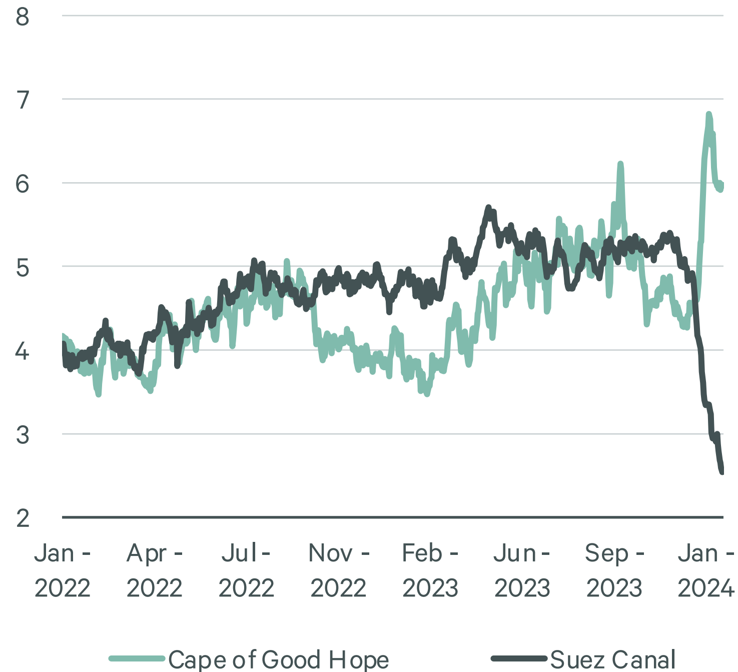
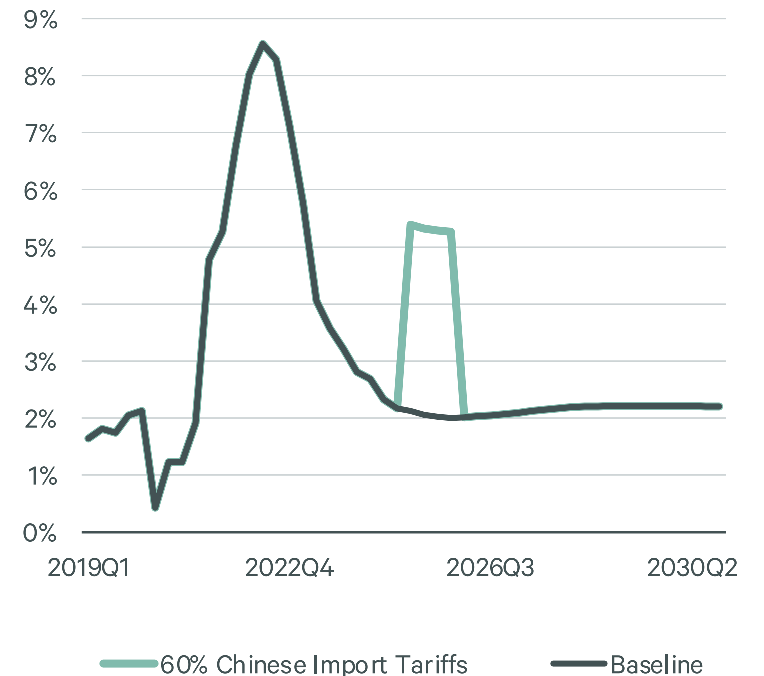
Conflicts and politics could impact U.S. inflation



Source: Port Watch/IMF

Source: Shanghai Shipping Exchange



Source: Peterson Institute for International Economics, CBRE Econometric Advisors

- Shelling of commercial ships in the Red Sea is forcing trade to divert away from the Suez Canal and travel around Africa. This has the effect of putting upward pressure on shipping costs, as shown by Shanghai Freight Index. Presently, the risk to the U.S. economy is manageable but the backdrop is a cause for concern.
- There are some domestic policy risks for U.S. inflation in the medium term. Presently, both leading 2024 U.S. Presidential candidates support more trade barriers. Donald Trump is considering a 60% tariff on all imports from China. Reportedly, these goods account for just 2% of the CPI index; however, such a dramatic tariff could have a significant one-off impact on U.S. inflation.

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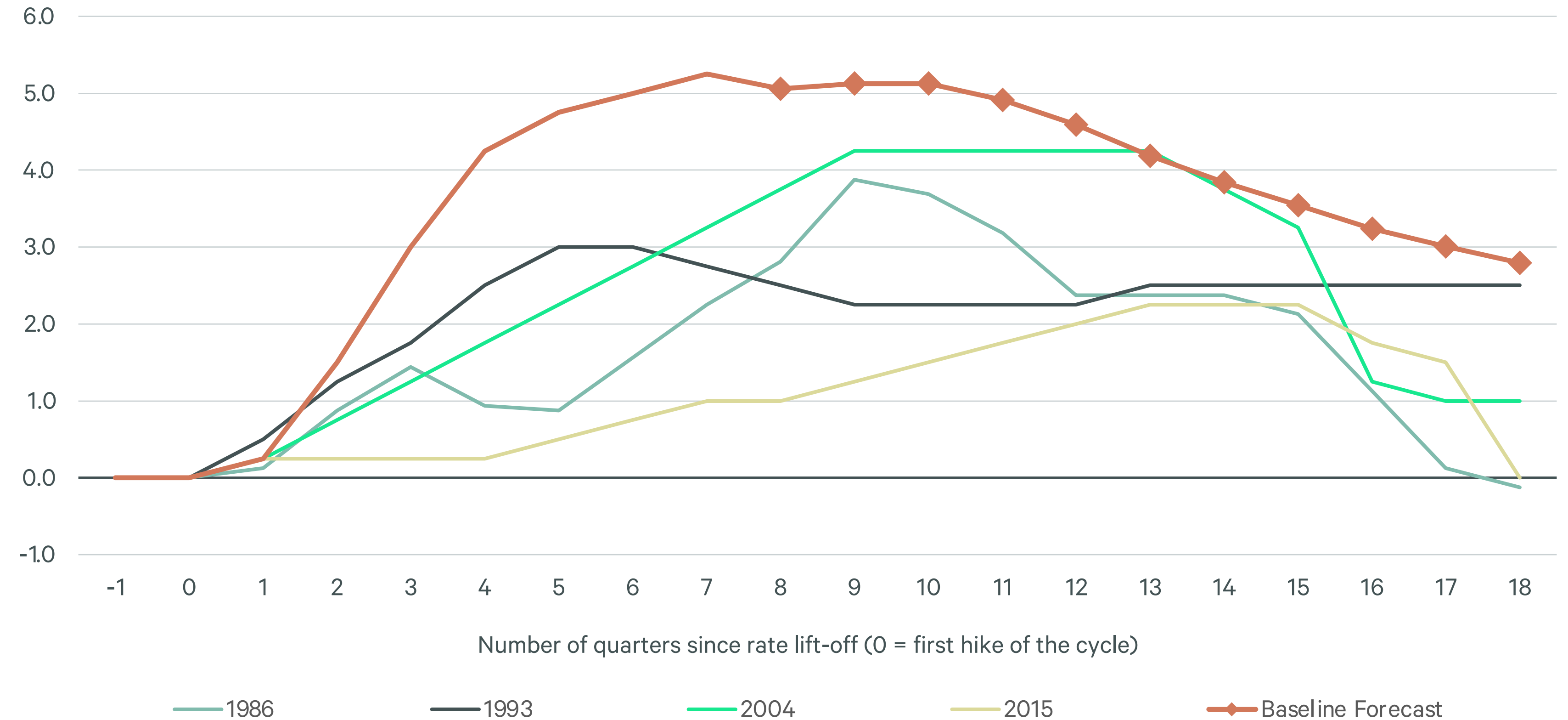
Policy rates are likely to stay higher than past cycles

- 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 very near-term. Rather, the Committee will wait until inflation shows clear signs of progressing toward its 2% target. We believe the first cut will occur in May 2024.

- 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. Presently, the conviction that rates have peaked has sparked a spirit of cautious optimism across real estate capital markets.



Source: The Federal Reserve, CBRE Econometric Advisors

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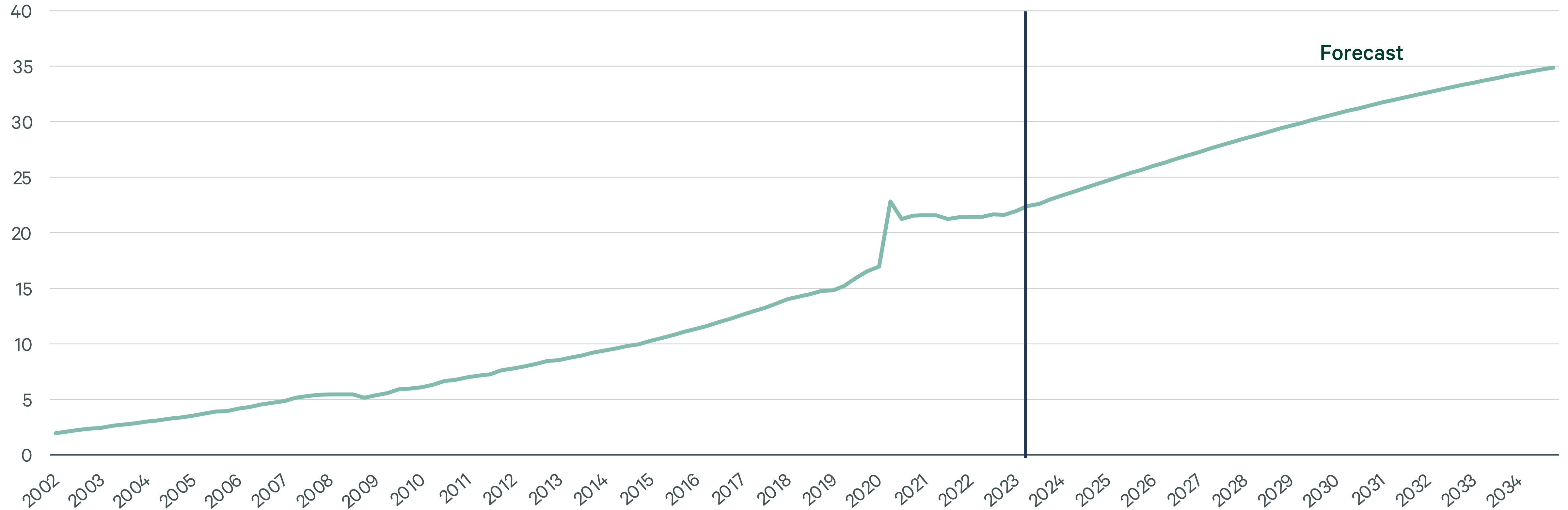
E-commerce activity looks to resume upward trajectory

E-commerce Share of Total Retail Sales ex Motor Vehicles and Gas; Inflation Adjusted (%)



Source: CBRE Econometric Advisors

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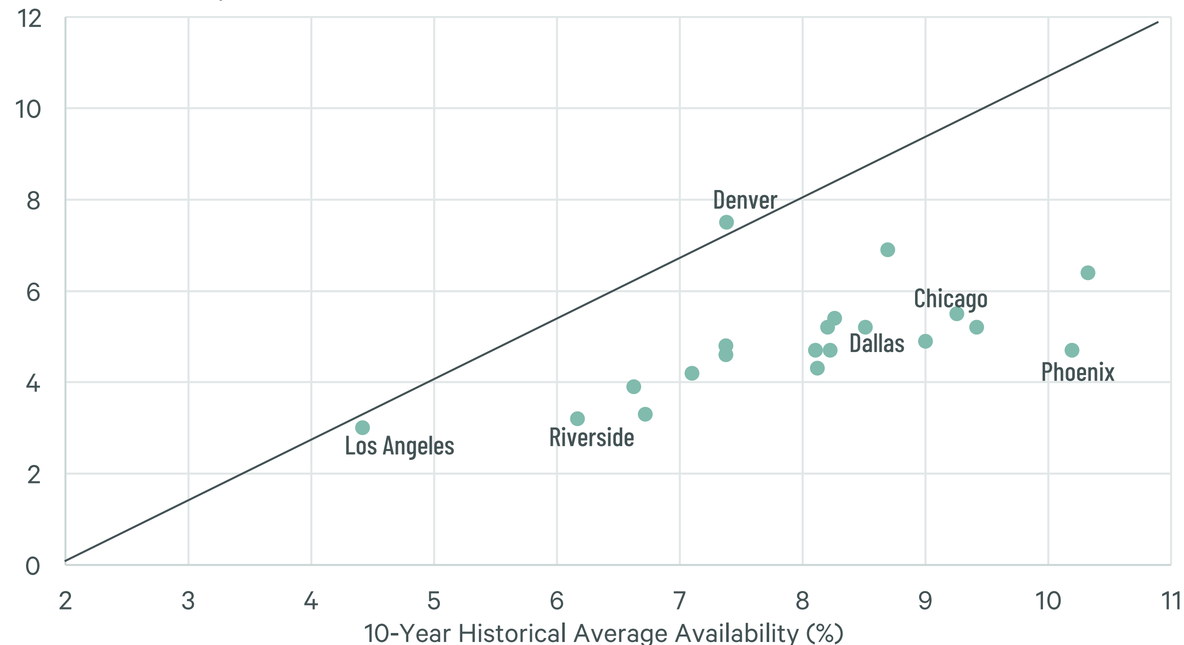
Market Fundamentals

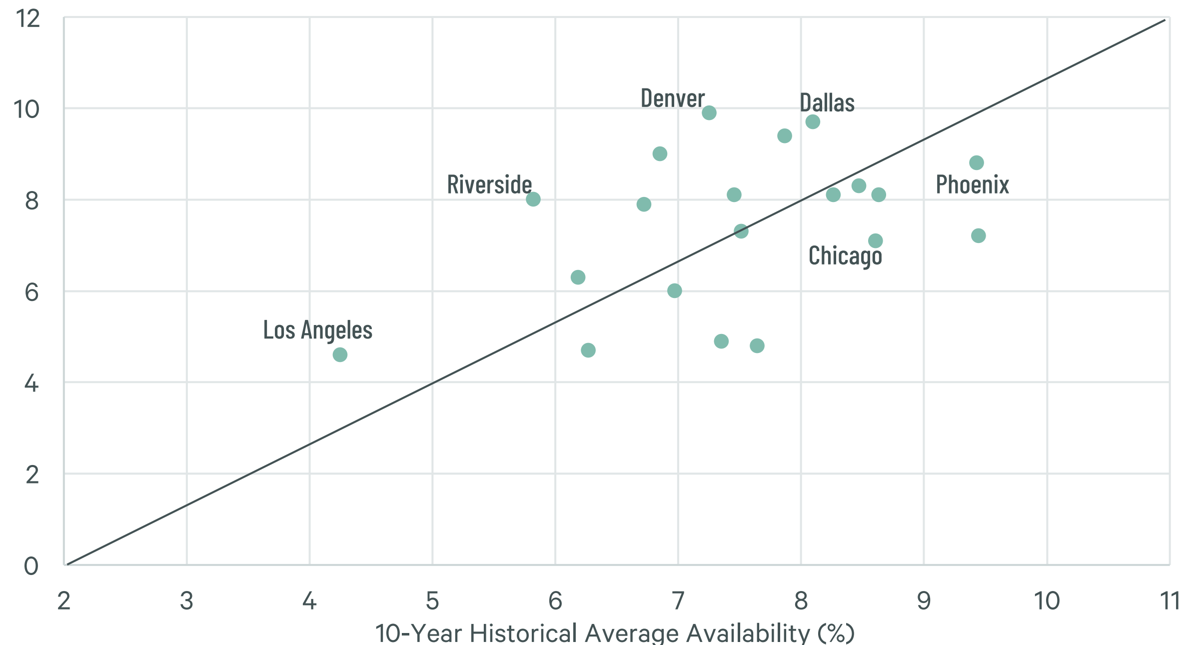
What a difference a year makes

Q4 2022



Source: CBRE Econometric Advisors Q4 2023

Q4 2023



Source: CBRE Econometric Advisors Q4 2023

- A year ago, industrial availability rates were comfortably below their long-run average in most markets. Twelve months later, that backdrop has completely changed.
- Phoenix's availability rate is still trending lower than its long-run average, but it saw a notable shift from Q4 2022 compared with Chicago, which historically has less volatile fundamentals.

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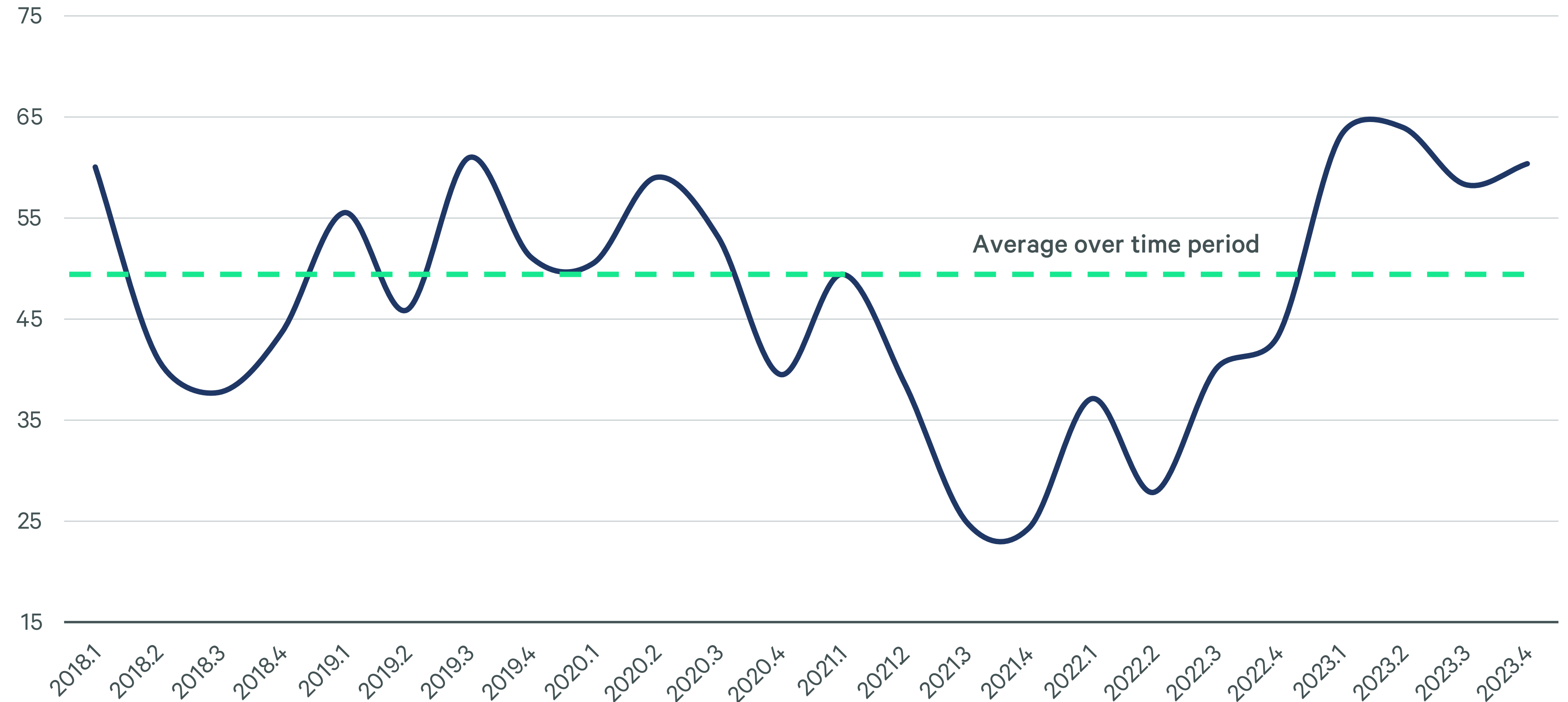
Drop in preleasing is exacerbating the supply/demand imbalance

- The sector is grappling with two major challenges regarding availability: existing buildings are struggling to lease due to macroeconomic and structural challenges, and a record level of supply flooding the market, leading to high availability rates.

- With a notable decline in completions expected in 2024, the sector should achieve a better balance over the next 12 months.



Source: CBRE Econometric Advisors Q4 2023

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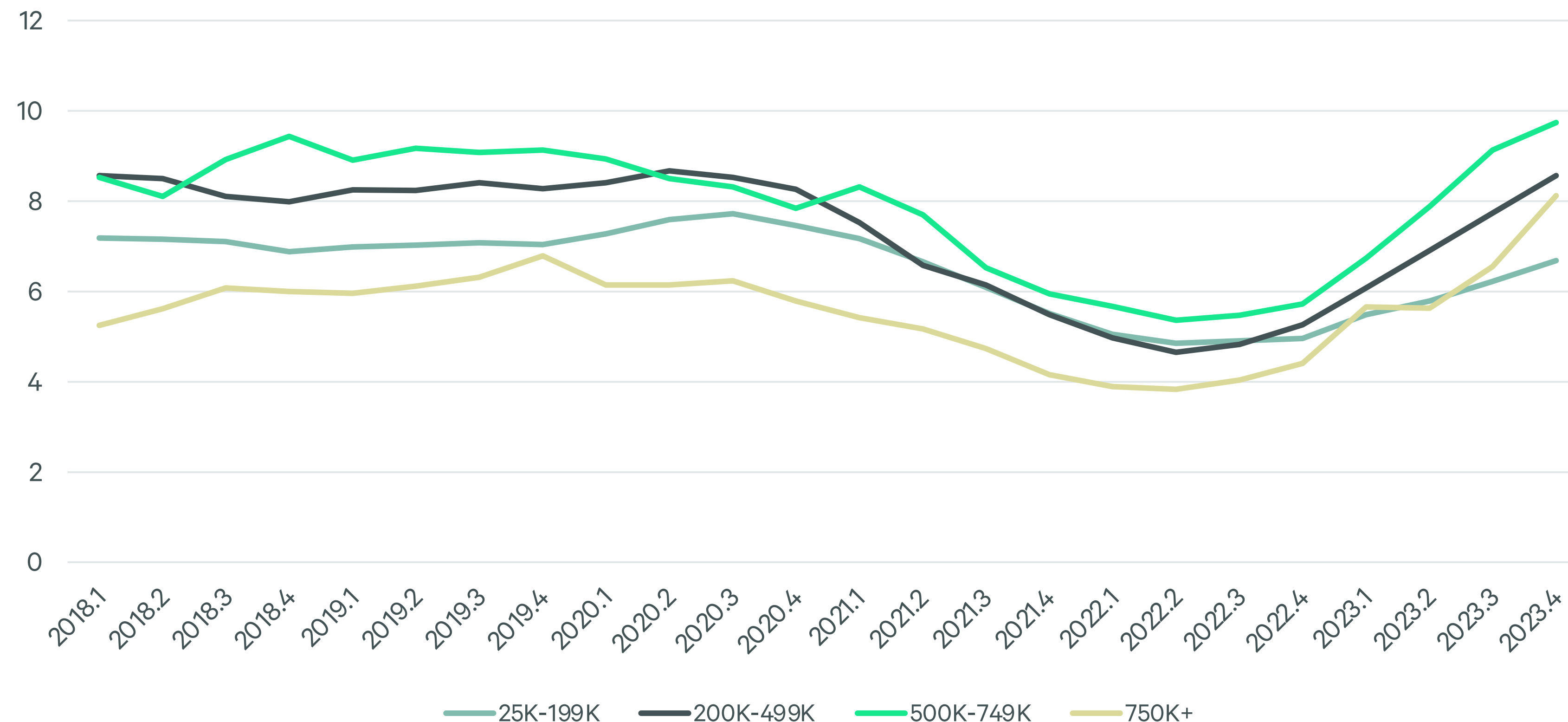
Larger assets take the lion's share of availability expansion

- The 500,000–749,000 sq. ft. size cohort has experienced the largest increase in availability rates since the beginning of 2023, expanding by 300 basis points.

- Assets exceeding 750,000 sq. ft. have seen the sharpest increase in their availability rates from Q2 2022, yet historically, they have maintained lower availability rates than smaller size cohorts.

- Institutional capital has been favoring small bay, multi-tenant assets over larger, credit assets due to the rental upside from their shorter WALTS.



Source: CBRE Econometric Advisors Q4 2023

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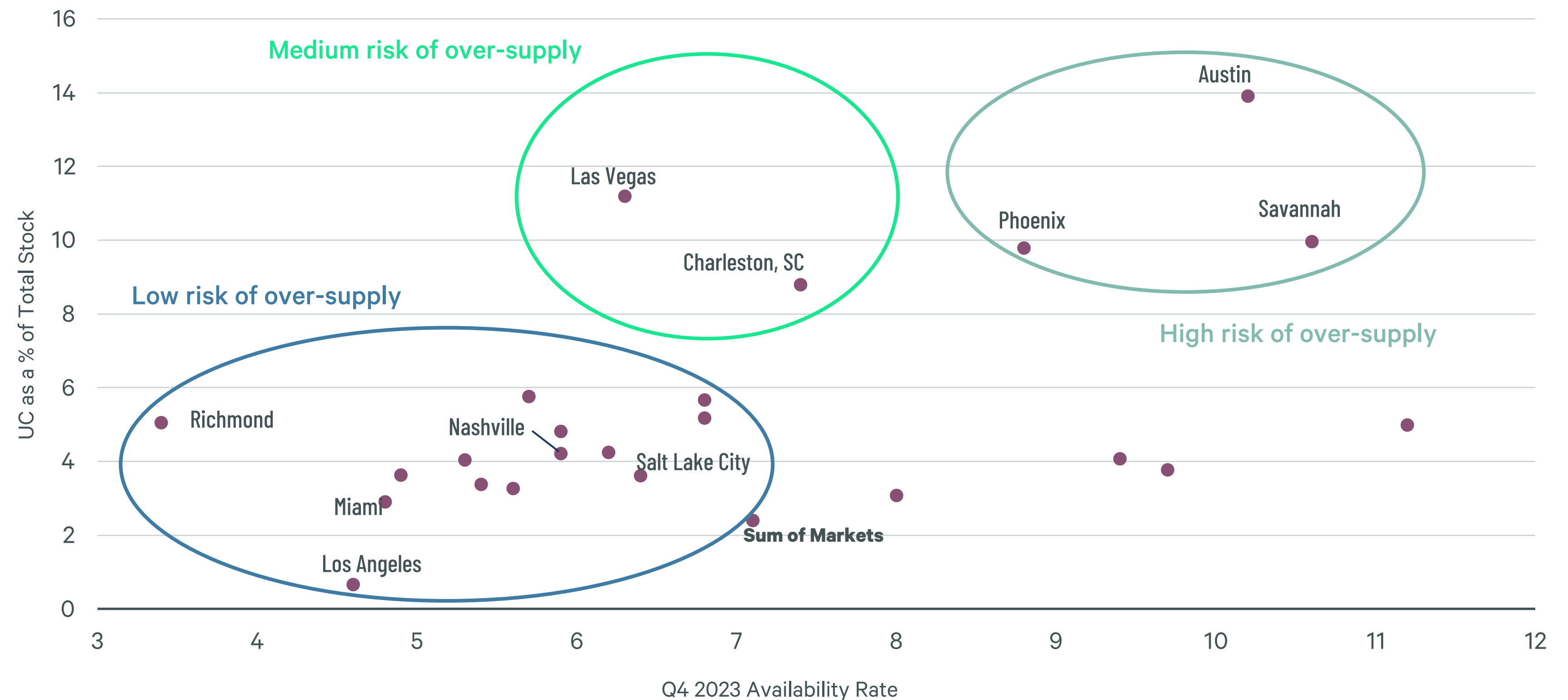
Top performing markets most at risk of oversupply

- Sun Belt markets face the greatest risk of oversupply; they have outperformed during the post-COVID period, which has driven significant expansion in their stock.
- Las Vegas maintains an availability rate below the national average, yet it has the second-highest under-construction pipeline when measured as a percentage of existing stock.
- Savannah has benefited from increased port activity, which structurally should maintain competitive market conditions. However, it is highly sensitive to directional trade, and any decrease in imports could pose a challenge to the sector.

UC Pipeline as a % of Total Stock, Current Availability Rate Sum of Markets (%)



Source: CBRE Econometric Advisors Q4 2023

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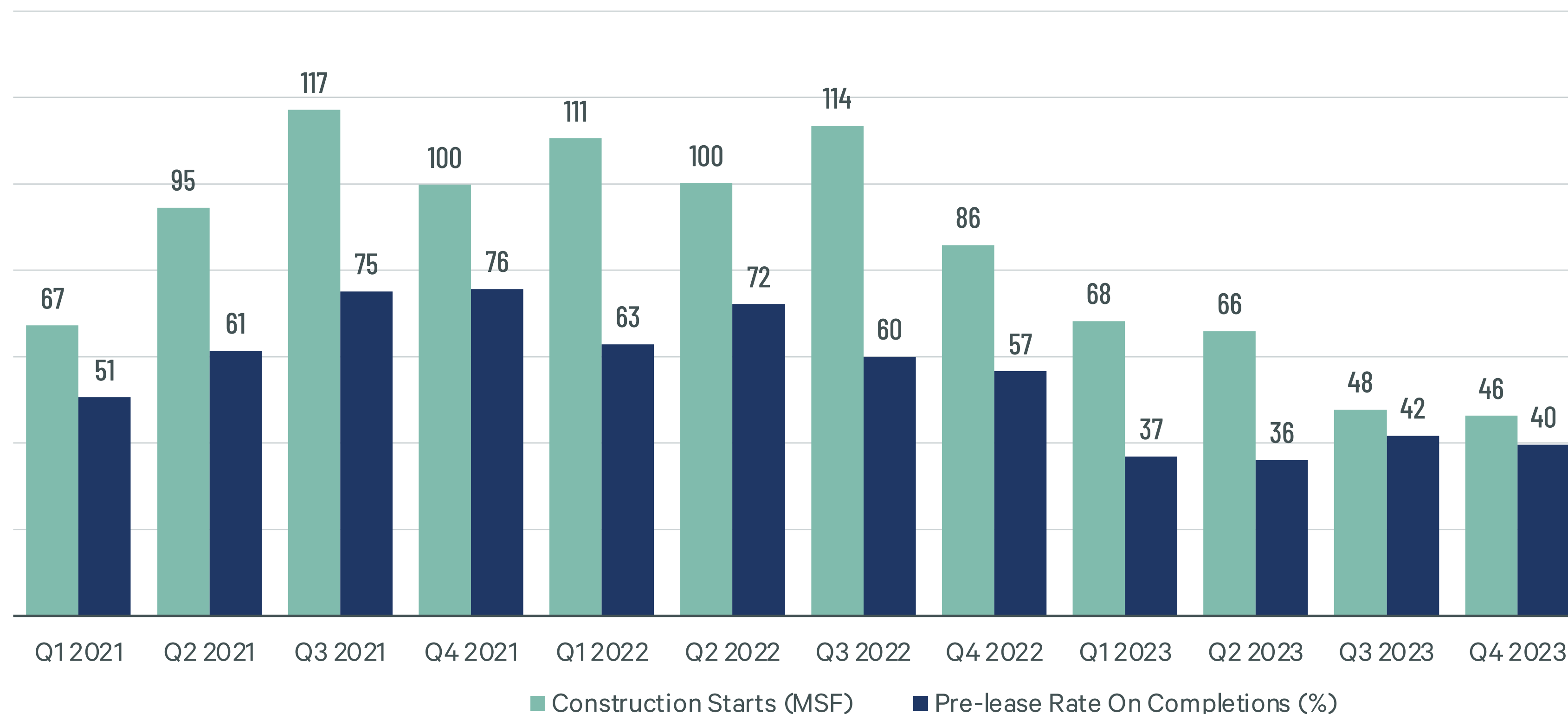
New starts hold steady in Q4

- Construction starts exceeded expectations with 40 million sq. ft. in Q4, remaining nearly unchanged from the previous quarter and notably above H1 2023 levels.

- Pre-leasing continues to trend well below post-pandemic highs, making it challenging for demand to catch up.

Industrial Pre-leasing, Construction Starts Sum of Markets (%) (MSF)



Source: CBRE Econometric Advisors Q4 2023

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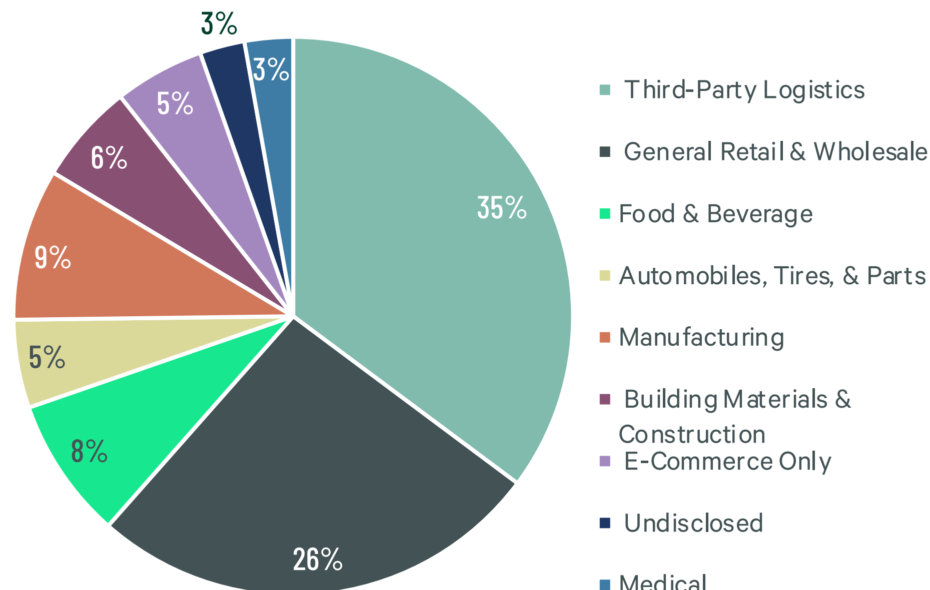
E-commerce leasing falls 36% from 2022

Leased Transactions 100,000 Sq. Ft and Above

Industry Type	2022	2023
Third-Party Logistics	208,754,004	156,165,816
General Retail & Wholesale	156,092,881	128,834,066
Food & Beverage	48,917,461	49,993,802
Automobiles, Tires, & Parts	29,953,291	45,862,115
Manufacturing	51,996,796	44,825,405
Building Materials & Construction	34,338,650	40,713,661
E-commerce Only	30,971,992	19,778,996
Undisclosed	15,147,988	13,912,697
Medical	16,841,967	13,674,362
Total	**593,015,030**	**513,760,920**

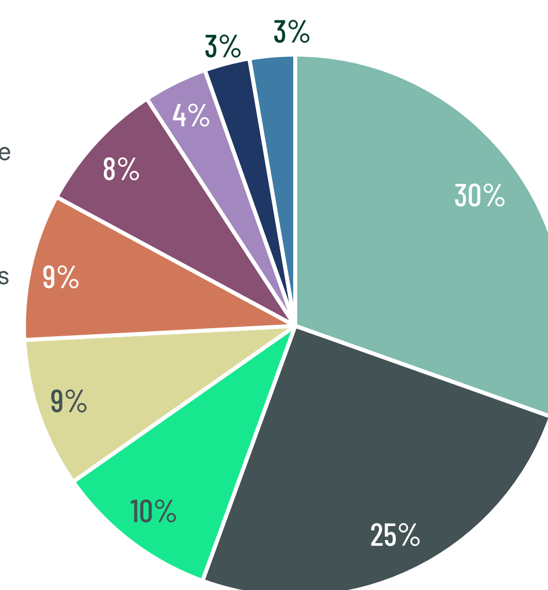
Source: CBRE Americas Research Q4 2023

2022 Market Share (%)



Source: CBRE Americas Research Q4 2023

2023 Market Share (%)



Source: CBRE Americas Research Q4 2023

- Bulk leasing declined 13.4% compared with 2022. Many of these occupiers are in interest-rate sensitive sectors, such as for-sale housing, and are being challenged by higher borrowing costs.
- E-commerce, along with 3PLs and general retail and wholesale, saw the largest declines in bulk leasing.

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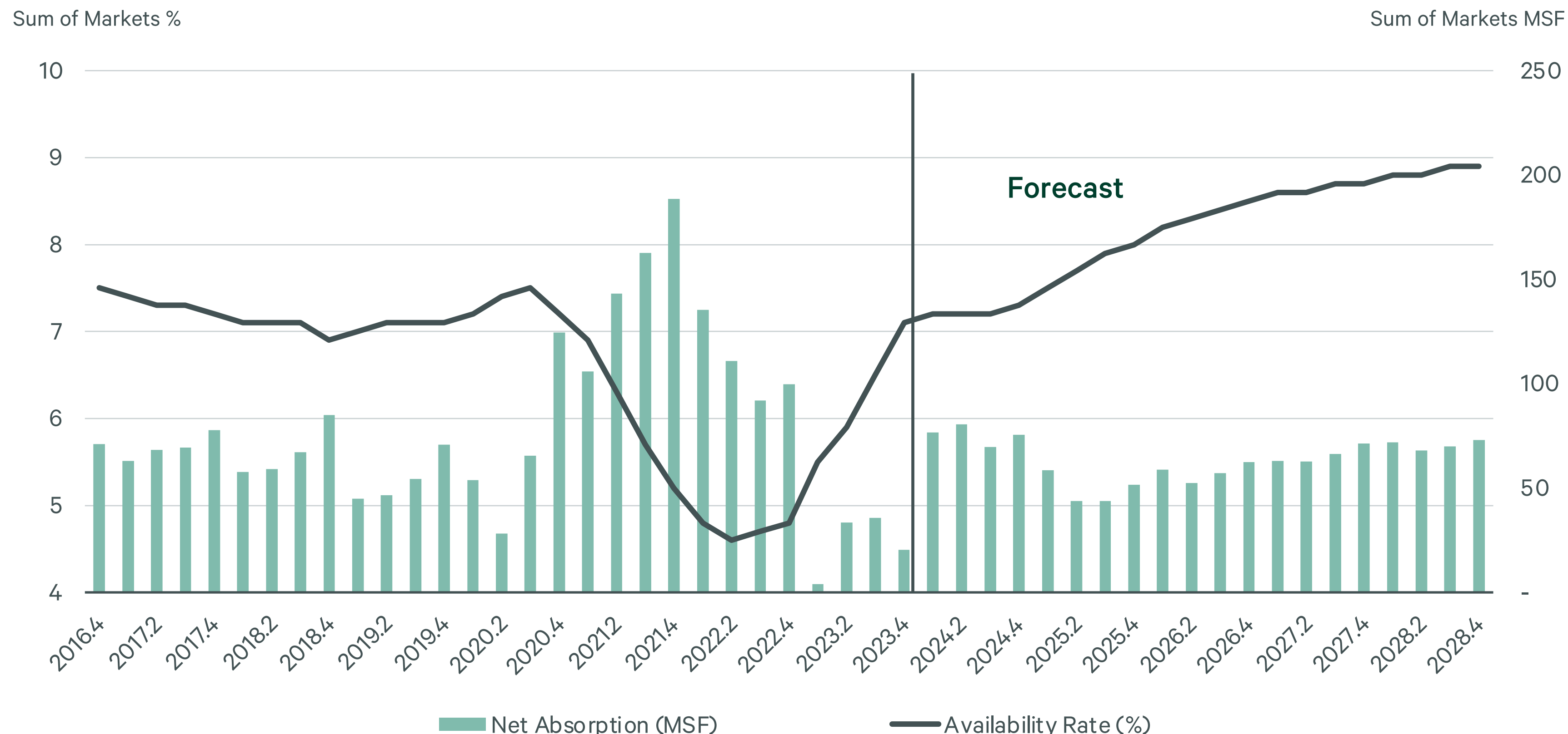
U.S. Industrial Forecasts

Availability increase mirrors parallel drop seen post-pandemic

– 2023 posed unique challenges: the sector experienced a simultaneous decline in leasing activity and an unprecedented level of speculative construction entering the market, causing availability rates to rise as rapidly as they had fallen during the pandemic-induced demand surge.

– With the availability rate now at 7.1%, the sector has returned to its pre-pandemic levels, mirroring the 7.2% seen in Q1 2020.



Source: CBRE Econometric Advisors Q4 2023

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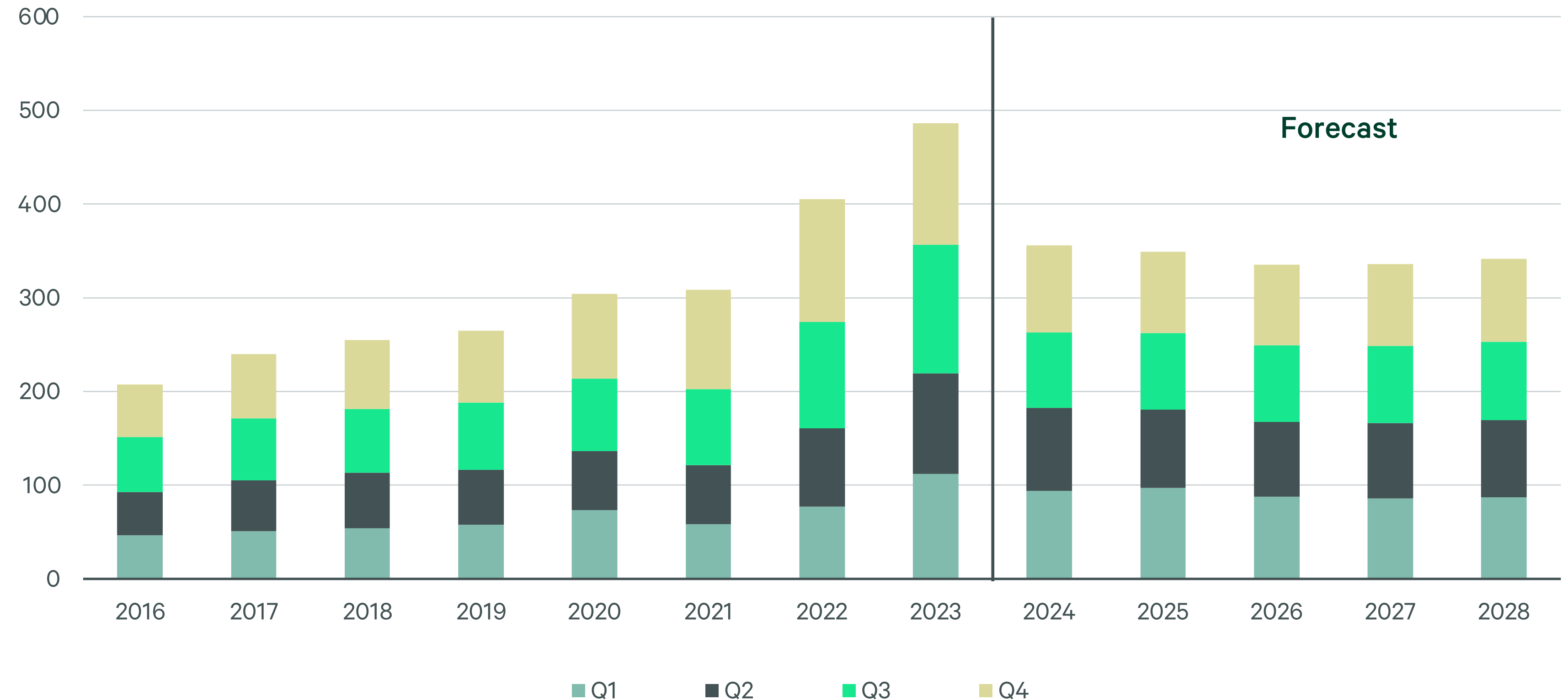
Delivery expectations are trending lower

- 2023 marked a record year for industrial completions, with nearly 500 million sq. ft. completed, representing a 20% increase from 2022.
- The downturn in new starts is now taking effect. Completion levels are projected to drop substantially in 2024, followed by successive annual declines through 2026.
- The near-term supply response should create a more cost competitive environment for tenants.

Industrial Completions



Source: CBRE Econometric Advisors Q4 2023

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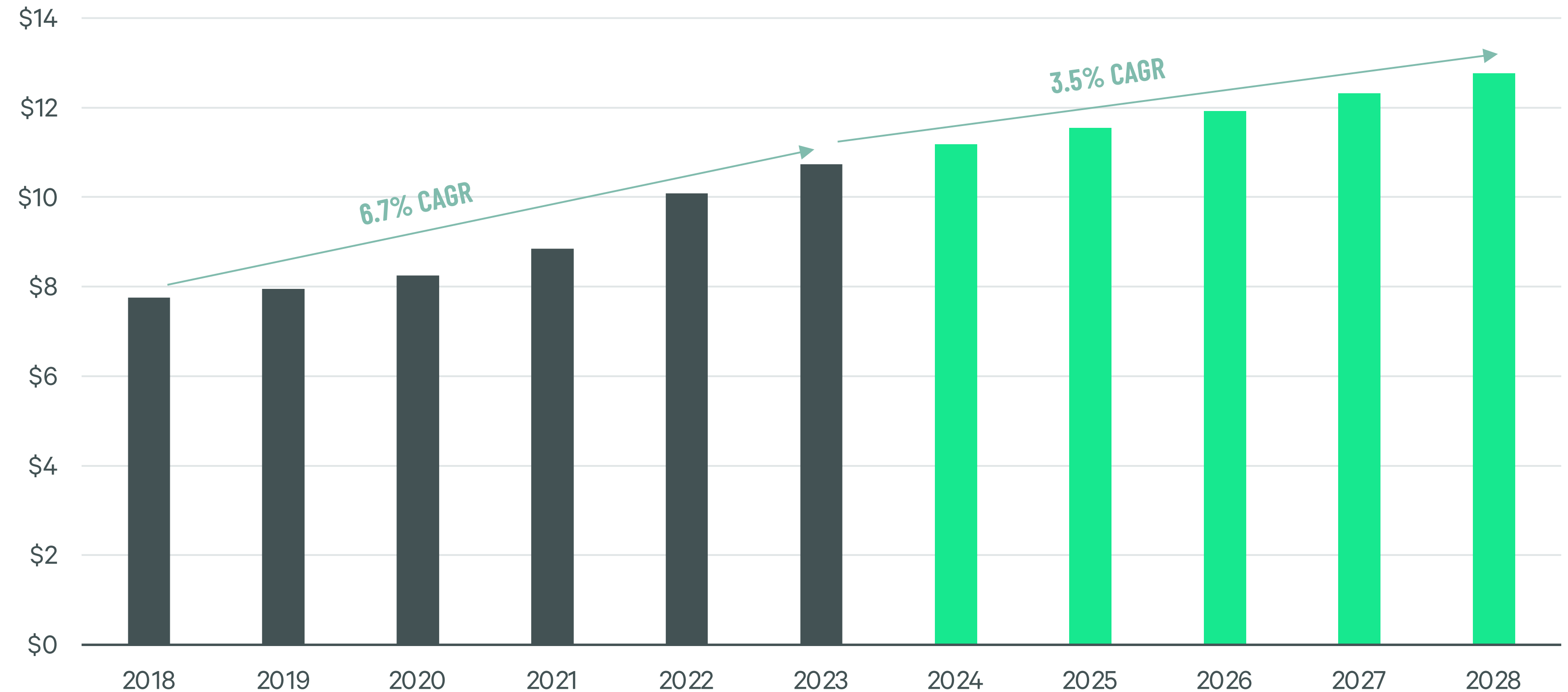
Annualized rent growth; a tale of two cycles

- The five-year forecast anticipates that annualized rent growth will be nearly halved relative to the previous five years.
- The decline in growth will be more evident in larger distribution markets, whereas your last-mile markets should see more sustained levels.

Nominal EA Asking Rent, 5-year CAGR

Sum of Markets ($) (%)



Source: CBRE Econometric Advisors Q4 2023

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Rent growth getting closer to equilibrium

- Year-over-year rent growth has decelerated to 6.5% in Q4, marking the lowest rate in more than two years.
- The substantial rise in vacant new construction, particularly bulk assets, is exerting significant pressure on landlords to reduce rental rates.

Source: CBRE Econometric Advisors Q4 2023

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EA Scenarios

‘Baseline’ Scenario

- The Baseline Scenario assumes that economic growth will persist into 2024, albeit at a moderated pace relative to H2 2023. This expansion will ultimately be driven by a steady labor market that will guide the economy toward a soft landing.
- Although recent CPI reports indicate an uptick in some components, we believe inflation overall will continue to trend downward. Some components of inflation, such as consumer services, could remain stubbornly higher than goods prices. Inflation would hit to the Fed’s target rate by 2025.
- The combination of peaking inflation and softer economic growth suggests that the Fed is done hiking this cycle. The Baseline Scenario expects the first rate hike will be in May 2024.

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	2.9	2.1	3.6	4.1
2023 Q4	2.8	1.8	3.2	4.4
2024 Q1	2.4	1.1	2.8	4.0
2024 Q2	2.0	0.8	2.7	3.7
2024 Q3	1.1	0.5	2.3	3.6
2024 Q4	0.8	0.2	2.2	3.6
2025 Q1	1.0	0.4	2.1	3.5
2025 Q2	1.3	0.5	2.1	3.5
2025 Q3	1.6	0.7	2.0	3.4
2025 Q4	1.9	0.8	2.0	3.4

Source: Oxford Economics, CBRE Econometric Advisors

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‘Stubborn Inflation’ Scenario

- In this scenario, inflation shows signs of escalation in early 2024 prompting the Fed to tighten further, holding Treasury yields above 4% during 2024. This change causes a retrenchment across financial markets and firms shelve expansion plans. The labor market rolls-over by H2 2024, which will eventually allow CPI to fall below our Baseline view in 2025.
- The ‘Stubborn Inflation’ Scenario 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.

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2024 Q2	1.5	0.5	3.1	4.4
2024 Q3	(0.0)	(0.2)	2.6	4.5
2024 Q4	(0.9)	(0.9)	2.4	4.6
2025 Q1	(0.9)	(1.1)	1.8	4.2
2025 Q2	(0.7)	(1.2)	1.7	4.1
2025 Q3	(0.1)	(1.0)	1.7	4.1
2025 Q4	0.7	(0.6)	1.7	4.1

Source: Oxford Economics, CBRE Econometric Advisors

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‘Resilient Consumer’ Scenario

- The more upbeat scenario is driven by consumers continuing to surprise on the upside but with limited impact on inflation. Thus, the economy gets the benefit of more activity without the tax of higher interest rates. In fact, dissipating inflation would encourage the Fed to cut quicker than our Baseline outlook. It should be noted that this scenario would not yield significantly stronger job growth given the labor market is already quite tight.
- More clarity around the path of interest rates provides some relief for rate sensitive sectors, such as real estate. The benefit to real estate would be two-pronged with lower rates supporting greater deal volume and stronger economic growth supporting healthier fundamentals and NOI growth.

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2023 Q3	2.9	2.1	3.6	4.1
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2024 Q2	2.2	0.9	2.5	3.5
2024 Q3	1.5	0.7	2.2	3.3
2024 Q4	1.4	0.7	2.1	3.4
2025 Q1	1.9	1.0	2.4	3.6
2025 Q2	2.2	1.2	2.4	3.7
2025 Q3	2.2	1.3	2.4	3.7
2025 Q4	2.0	1.2	2.4	3.7

Source: Oxford Economics, CBRE Econometric Advisors

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'Severe Downside' Scenario

- In this scenario the U.S. economy is shocked by a major exogenous event. There could potentially be an unknown financial threat triggered by the continued uptick in interest rates. This event would not take hold immediately but rather begin to bite as rates drift higher in early 2024.
- Such an event would trigger a severe recession in coming quarters analogous to the *Global Financial Crisis*. A key feature of this scenario would be lasting economic scarring as households, firms and the financial system struggles to regain its footing.

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	2.9	2.1	3.6	4.1
2023 Q4	2.8	1.8	3.2	4.4
2024 Q1	0.9	0.4	3.0	4.3
2024 Q2	(1.0)	(1.1)	2.7	4.4
2024 Q3	(3.2)	(2.5)	2.1	4.2
2024 Q4	(4.3)	(3.7)	1.8	4.0
2025 Q1	(3.2)	(3.6)	1.4	3.9
2025 Q2	(2.1)	(3.1)	1.5	3.8
2025 Q3	(1.4)	(2.6)	1.5	3.6
2025 Q4	(0.3)	(1.9)	1.6	3.6

Source: Oxford Economics, CBRE Econometric Advisors

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Thank you.

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