Aegon Asset Management

Aegon Real Assets US

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COMMERCIAL REAL ESTATE OUTLOOK 2019

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We at Aegon Real Assets are catching our breath after the rollercoaster ride in financial markets during the last weeks of 2018. The turmoil included the stock market downdraft and volatility, corporate bond spread widening, a decline in the 10-year Treasury yield back below 3%, tightening monetary policy with a flattening yield curve, decline in CEO confidence, and worries about global economic growth prospects. With this backdrop, it was difficult to appreciate the twinkle of holiday lights. But, now we are looking ahead and assessing what all the turmoil might mean for US real estate investors in the months ahead.

We take heart in the absence of commotion in US real estate markets despite the turbulence in financial markets. But, commercial real estate (CRE) typically responds to macroeconomic and financial market factors with a lag. Leases-in-place cushion rental income and demand for additional space reflects tenant long-term needs rather than short-term cycle concerns. Property pricing is more vulnerable to financial market gyrations but property and commercial mortgage investments are less liquid than stocks and bonds, which impedes the rapid buying and selling associated with the market timing trades that so roil more liquid assets.

We believe US CRE market conditions are showing no signs of imminent distress as 2019 begins. Investment performance is holding in positive territory driven by property income, with cap rates largely stable if not still shrinking a bit. Occupancy is at or above long-term averages across property sectors and rents are growing in line with inflation or better. New supply under construction is modest in the aggregate with only a few metros expecting sizeable deliveries (mostly apartments) in 2019.[1] All told, these metrics show that CRE is holding in a mature phase of its cycle with minor vulnerabilities.

Yet investors are not without angst. Property transactions slowed a bit in the fourth quarter but price indexes continued to rise, up 7% in November from a year prior according to Real Capital Analytics.[2] With largely minor imbalances as the year starts, we believe what comes next for US CRE will depend on forces outside of the real estate sector. Most importantly, if economic growth weakens significantly, the demand for space and rent growth will suffer. The severity of the effect will depend on the severity of the shortfall in economic growth. The 2008 recession was intensely severe and hit property performance hard in 2009. The 2001 recession was mild leaving property performance in positive territory throughout.

Economists, including our own here at Aegon Asset Management, are forecasting weaker but positive growth in 2019 and 2020. The Blue Chip Survey of forecasters estimates a benign 24% probability of a recession in 2019 rising to a 35% probability for 2020.[3] However, forecasters have a poor record of accurately predicting recessions. Economic cycles do not have expiration dates even though it is hard to ignore the record-breaking longevity of the current cycle, which will be 10 years long in mid-2019. There is no science that can tell whether the market is so mature that a recession must occur soon, versus so mature that it is super resilient to recession. Economic history does tell us that recessions in modern times have been ignited by "shocks." By definition, shocks are not predictable.

On balance, we are confident that US CRE is well-poised to maintain solid performance in 2019 and, if the macro economy cooperates, into 2020. At the same time, macroeconomic uncertainties are material. In response, we are weighing additions of real estate risk carefully. We believe it prudent that our clients do the same, bearing in mind that investment in commercial property and commercial mortgages is best managed for the long-haul.

[1]Source: Co-Star Realty Information, Inc. Data as of 12/27/2018
[2]Source: Real Capital Analytics, Data as of 11/30/2018
[3]Source: The Blue Chip Survey, Data as of 12/10/2018

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Disclosure