2025 Market Outlook

FINDING SUNNY SKIES IN CLOUDY MARKETS

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Volatile and uncertain real estate markets have become familiar over the last few years amidst evolving capital markets and monetary policy, especially in relation to the cost and availability of debt capital. As we look forward to 2025, many of our base case assumptions remain consistent with the views we shared last year, but we anticipate broader acceptance of the market environment is likely to catalyze the beginning of a new real estate market cycle driven by:

- **A new era of interest rates –** a "higher for longer" interest rate environment for the long end of the yield curve, regardless of the impact of monetary policy on the short end of the yield curve.
- **Survival of the fittest –** the upcoming wall of debt maturities will finally unveil troubled real estate capital structures and generate opportunities for disciplined investors.

While this piece examines this macroeconomic environment, the rest of our 2025 outlook series will dive further into the niche real estate strategies we believe are likely to provide the most attractive risk-adjusted returns for real estate investors in the coming year across global listed REITs, non-core private equity, and enhanced income debt, as we look for sunny skies in the middle of a cloudy backdrop.

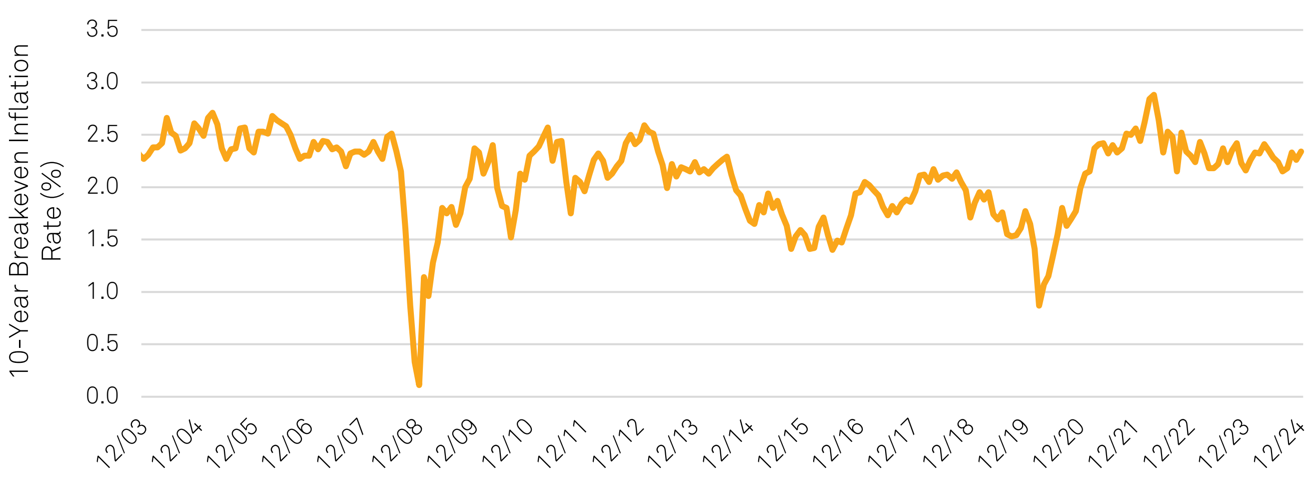
A new era

Though the Fed's interest rate cuts had been a long-awaited catalyst for the listed REIT market, as real estate investors we have been keenly focused on the long end of the yield curve, namely, the 10-year treasury yield. While the Fed controls the short end of the yield curve, their actions have little to do with the 10-year treasury yield. In last year's outlook, we explained our conviction behind an elevated 10-year treasury yield by dissecting the yield into its component pieces – inflation, real growth, and a term premium – and identifying upward pressure, particularly in inflation, due to structural changes within the economy. As we assess these components looking into 2025, our conviction is even stronger.

Inflation

The case for stickier inflation has gained even more traction, particularly as it relates to the expectation for nationalistic policies from the incoming administration driving higher tariffs and tighter immigration policies reducing labor supply. Additionally, while elevated multifamily supply in 2024 pressured rent growth, we expect supply to decrease in the coming years, exacerbating the housing shortage. This shortage puts upward pressure on housing costs in the long-term, which is a meaningful component of inflation. While the expectation for inflation has been fairly range-bound since 2022 based on the 10-year breakeven inflation rate (Figure 1), it is finally capturing the attention of the broader market.

Figure 1: 10-year breakeven inflation rate

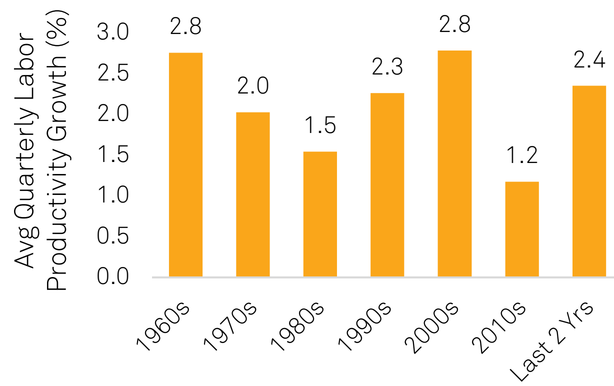


Source: Federal Reserve Bank of St. Louis, as of December 1, 2024.

Real Growth

The economy has surprised investors to the upside in the last two years, and continued strong data have moved the market past the fear of recession. As such, the expectation for growth going into the new year is notably higher than it had been in the last two years, limiting the opportunity for an upside surprise. Additionally, growth could be materially impacted by competing forces based on the incoming administration's policies in relation to immigration, tariffs, and government efficiency on one side with deregulation, tax cuts, and small business optimism on the other. While the policy environment is creating many uncertainties around growth in the coming year, there has been a positive, more structural impact on growth that is worth noting – the resurgence in productivity in the U.S. economy driven by the focus on automation and digitization, fueled by the pandemic and further accelerated by the focus on artificial intelligence (Figure 2).

Figure 2: U.S. labor productivity growth through prior cycles vs. last two years

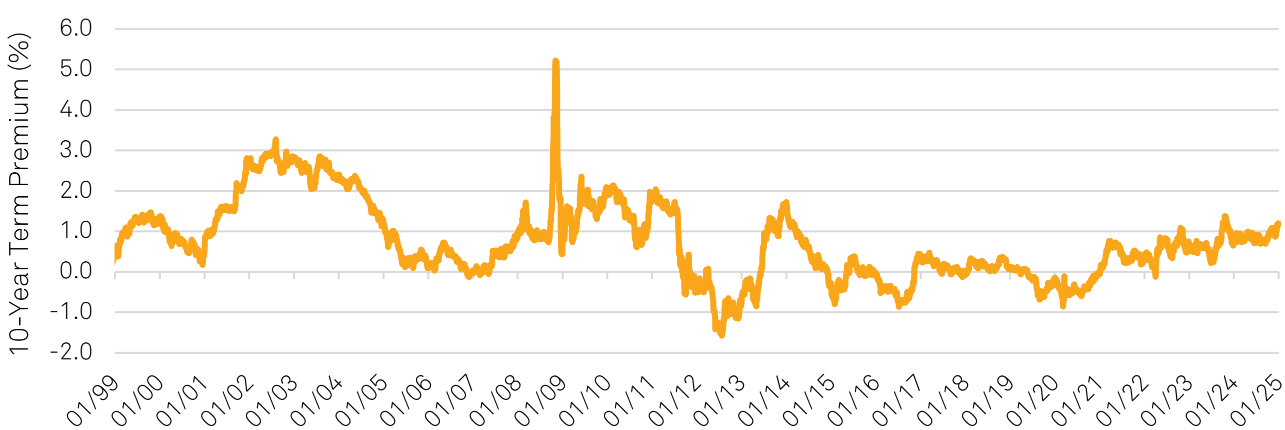


Source: Federal Reserve Bank of St. Louis, as of July 7, 2024.
Note: Nonfarm Business Sector: Labor productivity (output per hour) is real output divided by hours worked, including employees, proprietors, and unpaid family workers.

Term Premium

The steady rise of uncertainty driven by geopolitical tensions globally and increasing government debt is driving investors to seek higher returns for investing capital for longer periods. As such, we have seen a notable increase in the term premium in the last few years to over 100 basis points to start this year (Figure 3). Given the limited visibility into these overarching concerns and a lack of resolution on the horizon, we do not anticipate this trend in rising term premia to reverse in the coming year.

Figure 3: Term risk premium associated with 10-year Treasury yield



Source: Federal Reserve Bank of San Francisco, as of January 3, 2025.

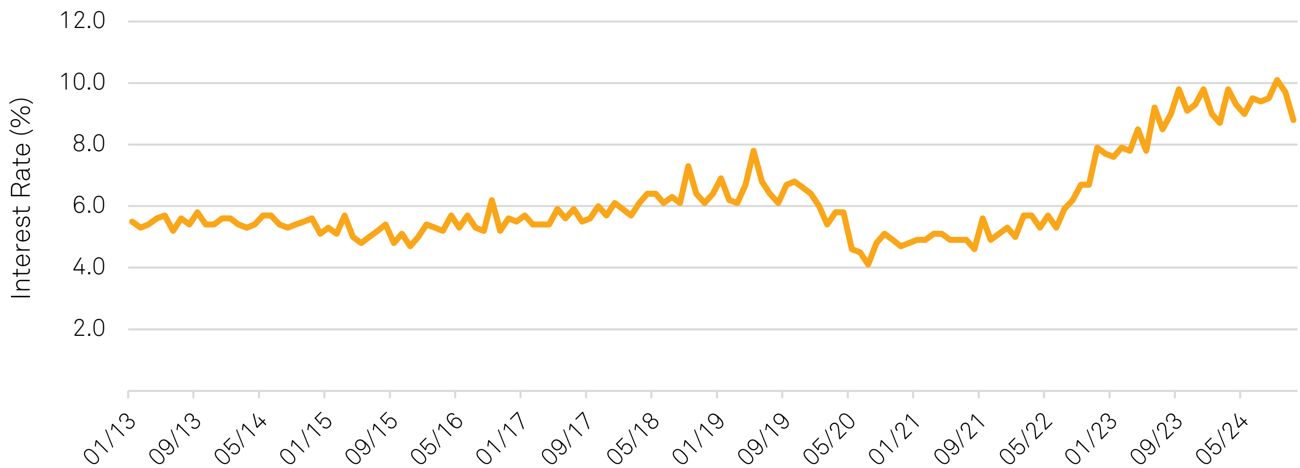
Putting this together, we see continued upward pressure on inflation and heightened uncertainty around growth and long-term risks, creating a cloudy market environment for real estate investors. It also underpins our conviction that the 10-year yield should not structurally fall below 4% for the foreseeable future. Yields could fall if we see a meaningful recession in the U.S., which is not currently supported by economic data, or if lower growth globally results in lower yields globally, bringing capital flows to the U.S. as investors seek higher yields. . This remains consistent with the views presented in our 2024 outlook, though it seems the broader market is slowly arriving at the same conclusion. Broader acceptance of the new reality of debt costs by buyers and sellers should result not only in increased transaction activity but will also uncover weak business models and capital structures unable to survive in this new reality, creating opportunities for disciplined investors.

Survival of the fittest

Excess money supply and effectively free borrowing costs following the COVID-19 pandemic resulted in irrational exuberance and aggressive capital allocation decisions that no longer work in this new era of debt costs.

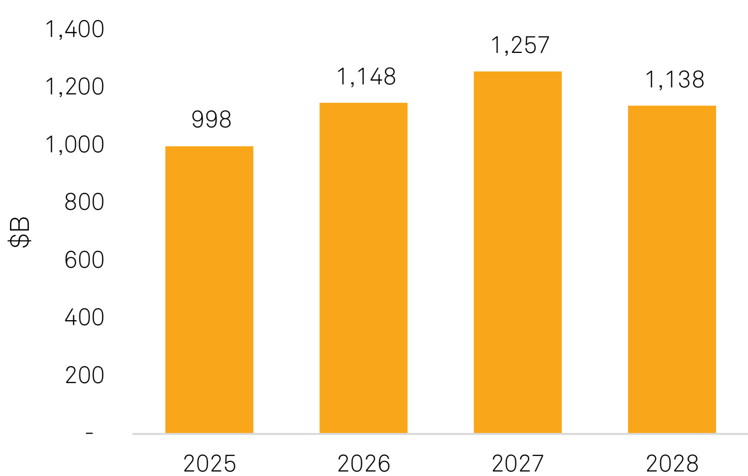
While many large businesses took advantage of low interest rates to fix long-term debt at favorable borrowing costs, the same cannot be said for small businesses that utilize short-term credit to fund spending. In fact, these small businesses are facing borrowing costs unlike what they have experienced in their recent histories (Figure 4). While the decrease in short-term rates should provide some reprieve, it will not be nearly as meaningful as was expected even six months ago. Additionally, capital providers are becoming more discerning – with capital no longer free, the hurdle to deploy capital has increased. Together, this is likely to result in the survival of the fittest. Those businesses that were not disciplined in their capital allocation decisions will be unable to survive in today's reality. Meanwhile, those that were disciplined will not only have the capacity to survive but also the opportunity to gain share from those that fail.

Figure 4: Average short-term interest rates for small businesses



Source: NFIB and Bloomberg, as of January 8, 2025. Series NFIB Small Business Actual Average Interest Rate Pain on Short-term Loans SA.

Figure 5: U.S. commercial real estate mortgage expirations



Source: S&P Global, as of August 19, 2024. Data aggregates 3.6M commercial real estate mortgages, with missing dates estimated using a random forest model. Data gaps had minimal impact on results.

This phenomenon is especially true in the real estate sector. The latest data indicate that nearly $1 trillion in commercial real estate mortgages are expected to expire in 2025 (Figure 5). However, the actual figure is likely greater. Many debt maturities from 2023 and 2024 were extended in the hopes of lower interest rates providing an easier way out for real estate owners facing refinancing risk, as aggressive underwriting assumptions and lofty valuations gave way to capital stacks that simply do not work in today's interest rate environment. While lenders have been patient in working with borrowers, we anticipate the broad-based acceptance of this new era of interest rates will prevent lenders from continuing to extend maturities and modify loan terms, forcing the unwinding of aggressive capital decisions that were made in the last five years.

Not only will this provide investors with accretive acquisition opportunities, but it should also catalyze an increase in transaction activity and lead to rational price discovery in relation to the elevated cost of debt. While cap rates across core private real estate (using the NCREIF ODCE Index as a proxy) have increased 95 basis points since the first quarter of 2022, they have not expanded nearly enough to account for prevailing debt costs. For example, the latest appraisal cap rate[1] across ODCE funds is just 4.68%, compared to the current 10-year treasury yield of…4.68%[2]. Historically, appraisal cap rates across ODCE funds have been at a 164 basis point spread to the 10-year treasury yield. If the 10-year treasury yield remains above 4%, appraisal cap rates would need to expand to at least 5.5% to compensate investors in line with historical levels. The lack of further cap rate correction on appraisals has been frequently attributed to the lack of comparable transactions to use for a guide on valuations. However, if the upcoming wall of debt maturities does spur transaction activity as we anticipate, valuations will be forced to align with some level of rationality, resetting valuations in earnest and beginning a new real estate market cycle.

Investing in real estate in the year ahead

Given the uncertainty around economic growth expectations, this new era of debt costs, and the valuation correction that should continue, our upcoming outlook pieces will dive further into areas where we believe investors can find the most compelling risk-adjusted returns across:

- **Global Listed REITs –** Sectors and regions poised for outperformance.
- **Private Equity Real Estate –** Niche property types where we, not capital markets, control our destiny and opportunistic acquisitions brought on by the unwinding of aggressive business plans.
- **Private Real Estate Debt –** High-quality income collateralized by strong rental housing assets in need of reconstituting their capital stack as debt matures.

> **Real estate markets thrive on resilience and adaptability—2025 marks a pivotal moment for disciplined investors to seize opportunities and shape the future amidst uncertainty.**

[1] As of 9/30/2024
[2] As of 1/7/2025.

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CenterSquare REIT Cap Rate Perspective Methodology

CenterSquare REIT Implied Cap Rates are based on a proprietary calculation that divides a company's reporting net operating income ("NOI") adjusted for non-recurring items by the value of its equity and debt less the value of non-income producing assets. The figures above are based on Q3 2024 earnings reported in June 2024.

The universe of stocks used to aggregate the data presented is based on CenterSquare's coverage universe of approximately 200 U.S. listed real estate companies. Sector cap rates are market cap weighted. Sectors and market classifications are defined by the following:

Apartment: REITs that own and manage multifamily residential rental properties; Industrial: REITs that own and manage industrial facilities (i.e. warehouses, distribution centers); Office – REITs that own and manage commercial office properties; Retail – REITs that own and manage retail properties (i.e. malls, shopping centers); Hotel – REITs that own and manage lodging properties; Healthcare – REITs that own properties used by healthcare service tenants (i.e. hospitals, medical office buildings); Gateway – REITs with portfolios primarily in the Boston, Chicago, LA, NYC, SF, and DC markets; Non-Gateway – REITs without a presence in the gateway markets.

The REIT ODCE Proxy is a universe of REIT stocks built to resemble the NCREIF Fund Index – Open End Diversified Core Equity (ODCE). The ODCE, short for NCREIF Fund Index - Open End Diversified Core Equity, is the first of the NCREIF Fund Database products and is an index of investment returns reporting on both a historical and current basis the results of 36 open-end commingled funds pursuing a core investment strategy, some of which have performance histories dating back to the 1970s. The REIT ODCE Proxy is proprietary to CenterSquare and uses gateway/infill names in apartments, retail, industrial and office, and then weights them according to the ODCE index to create a proxy.

Private Market Cap Rates represent the cap rate achievable in the private market for the property portfolio owned by each company, and are based on estimates produced by CenterSquare's investment team informed by various market sources including broker estimates.

About the Authors

Todd Briddell, CFA

Chief Executive Officer, Chief Investment Officer

As Chief Executive Officer and Chief Investment Officer of CenterSquare Investment Management, Todd Briddell brings three decades of real asset experience and vision to direct the firm's global strategy, with a sharp focus on growth, performance and corporate values.

Upon joining CenterSquare in 1993, Todd founded the firm's listed real estate securities group and served as a driver of both the public and private investment platforms, holding numerous leadership positions across the firm. He became Chief Executive and Chief Investment Officer in 2012, and in 2018 headed the firm's successful management buyout from BNY Mellon. Todd currently maintains oversight responsibility for all of CenterSquare's real asset investment advisory services including listed real estate, private equity real estate and private real estate debt across the United States, Europe and Asia. He also chairs the firm's Management Committee and CenterSquare's Private Real Estate Investment Committee.

Todd holds a B.S. in Economics from the Wharton School of Business at the University of Pennsylvania with concentrations in Finance and Real Estate. He is a member of NAREIT, the CFA Institute/Society of Philadelphia and PREA, where he was Co-Chair of the Green Building Committee. He is a Research Sponsor and sits on the Executive Committee of Zell/Lurie Real Estate Center Advisory Board at the Wharton School.

Uma Moriarity, CFA

Senior Investment Strategist and Global ESG Lead

Uma Moriarity is the Senior Investment Strategist and Global ESG Lead for CenterSquare Investment Management. She focuses on investment strategy and leads thought leadership across the firm's public and private real estate platforms. She is part of the listed real estate investment team and serves on CenterSquare's Private Real Estate Debt Investment Committee. Uma leads the firm's Environmental, Social, and Governance (ESG) strategy to incorporate ESG into the decision-making and management of listed and private real estate investments to create long-term value, reduce risk, and generate superior risk-adjusted investment returns. Prior to joining CenterSquare, she spent three years in corporate strategy and planning at ExxonMobil in Houston. Uma graduated from The Pennsylvania State University with Interdisciplinary Honors and High Distinction and holds a B.S. in Finance with a minor in International Business, B.S. in Accounting, and Master of Accountancy. She is a CFA charterholder and member of the CFA Institute, and a LEED Green Associate. She currently serves on the Board of Directors for Green Building United, the Penn State Smeal Sustainability Advisory Board, and the FTSE EPRA Nareit Americas Regional Advisory Committee.

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