ARA House View H1 2025

January 2025

AMERICAN REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

U.S. Real Estate Investment Outlook

Policy recalibration from moderating inflation sparking capital markets, economic optimism, but risks remain.

Macroeconomic Context

- Inflation progress has continued, allowing for a gradual easing in monetary policy.
- GDP growth has remained healthy given a strong overall consumer position supported by wage growth.
- Demographic shifts and policy decisions on immigration could keep labor market tight and put upward pressure on wages.
- Soft landing feels as if it has been achieved, though the potential for inflation to return in the medium term could spur additional policy recalibration and subsequent instability.

Real Estate Impacts

- Soft fundamentals plus higher borrowing costs are curtailing new development, which may help oversupplied markets rebalance more quickly.
- Improving liquidity and narrowing bid-ask spreads are fostering measured optimism in capital markets.
- Residential demand remains steady as affordability barriers in the for-sale market sustain occupancy and rent growth.
- Office fundamentals are slowly improving, making current pricing compelling, but structural challenges remain a headwind for the sector.

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I. Macro Outlook

The Fed has, in our view, safely landed the plane:

- The economy is on strong footing; inflation has continued to ease without triggering a material weakening in employment.
- Though inflation risks remain skewed to the upside, the growth outlook has also improved, mitigating the risk of recession.

Labor market outlook appears positive for workers:

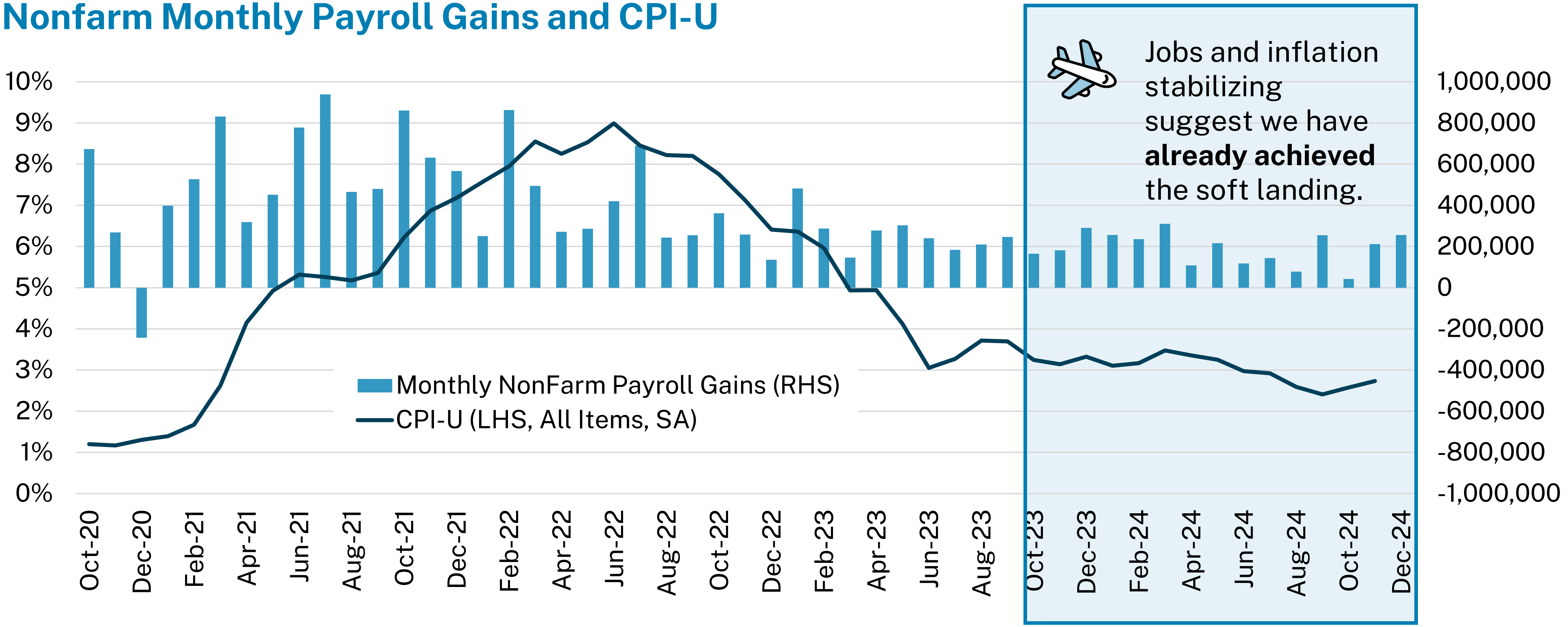
- Fewer new entrants into the workforce is expected to keep unemployment low and markets tight.
- Wage growth outpacing prices has kept spending strong; a competitive job market should continue to support the critical consumer.

Potential policy changes reinforces higher for longer:

- Less immigration could stifle growth in the labor pool but also add more pressure to wages.
- Tariffs are inherently inflationary, though the likely timing of their effects this round suggests a re-acceleration isn't likely until 2026.

Inflation moderating without weakening in the labor market has reduced fears of recession.

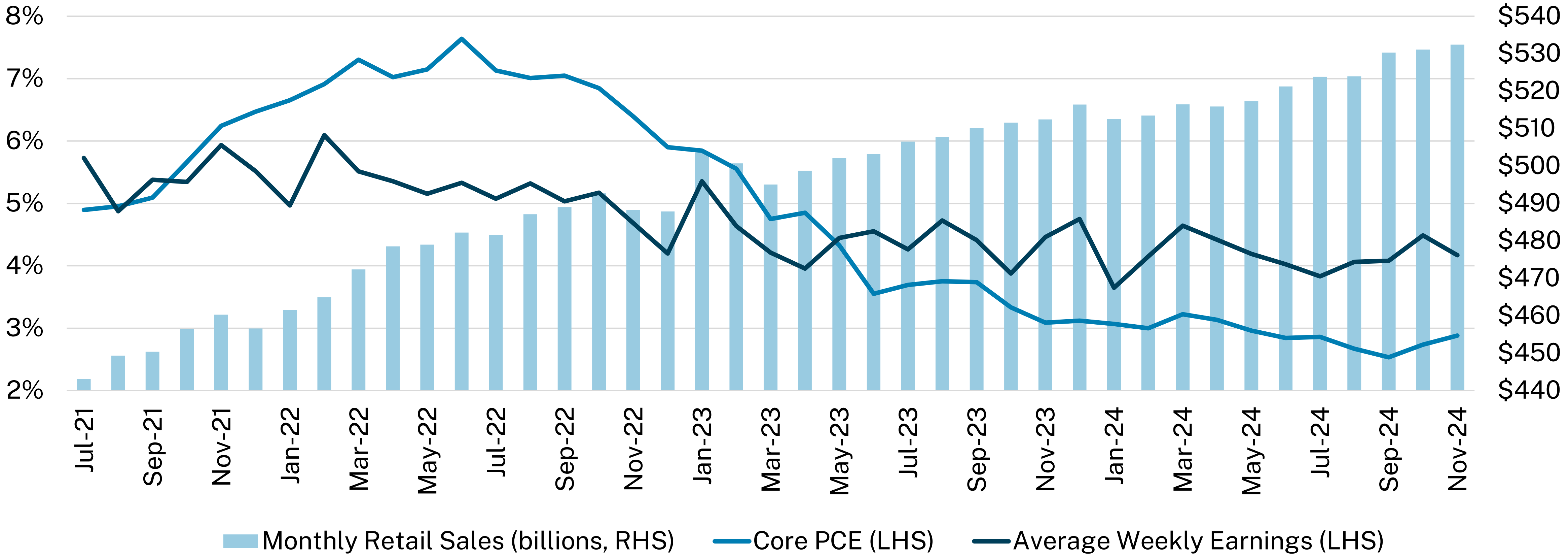
Nonfarm Monthly Payroll Gains and CPI-U



Source: American Realty Advisors based on data from Macrobond and the Bureau of Labor Statistics as of January 2025.

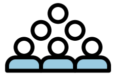
Wage growth has outpaced costs, allowing consumers to continue to spend.

Core Personal Consumer Expenditures vs. Weekly Wage Growth, YoY

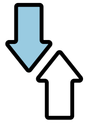


Source: American Realty Advisors based on data from Macrobond as of January 2025.

Tighter labor market conditions are expected to persist in part due to structural constraints.

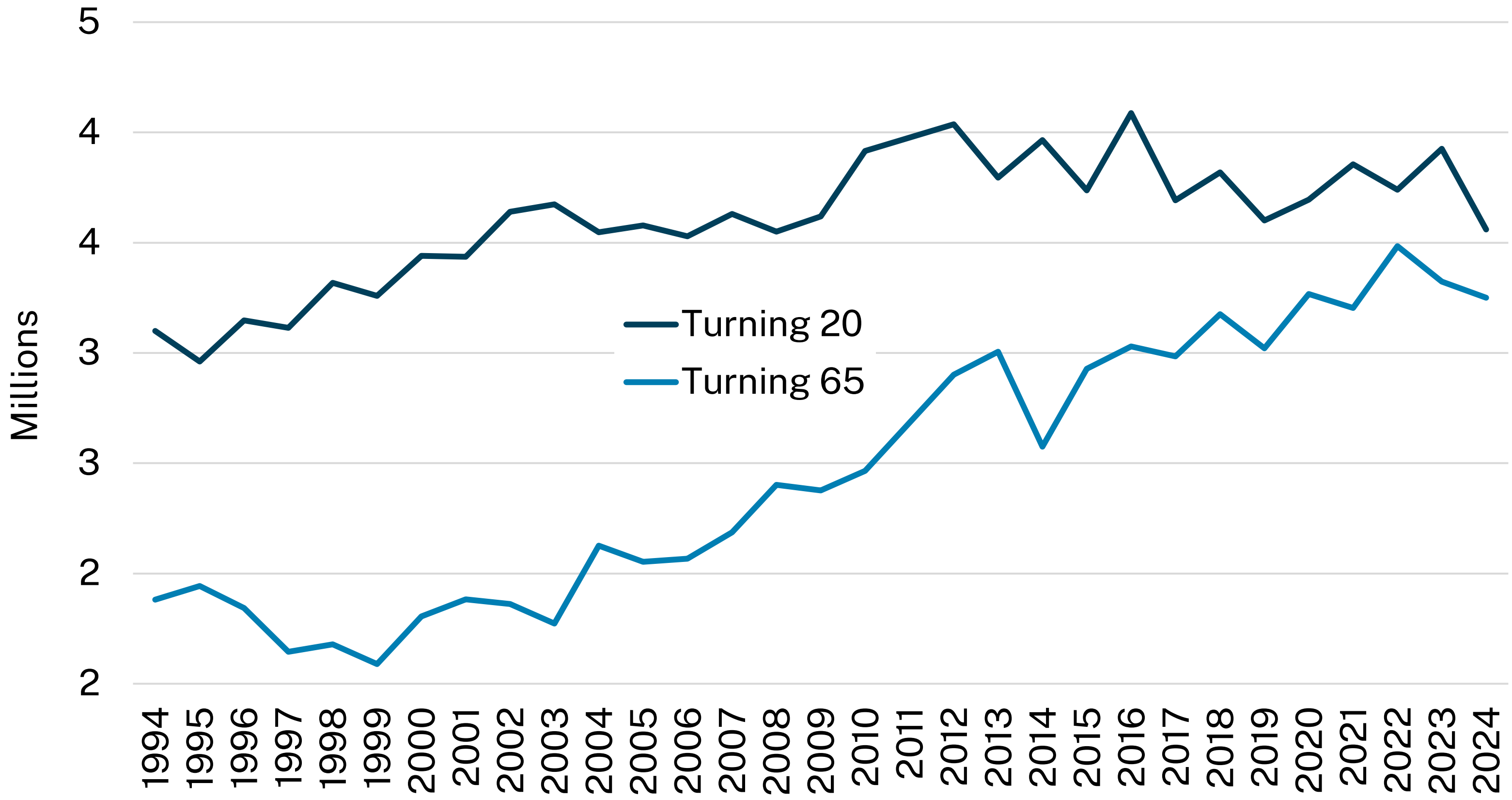


Fewer young entrants into the workforce relative to exits may keep **unemployment tight for the foreseeable future.**



Less available labor supply could **limit aggregate national job growth** going forward but **should support ongoing wage growth.**

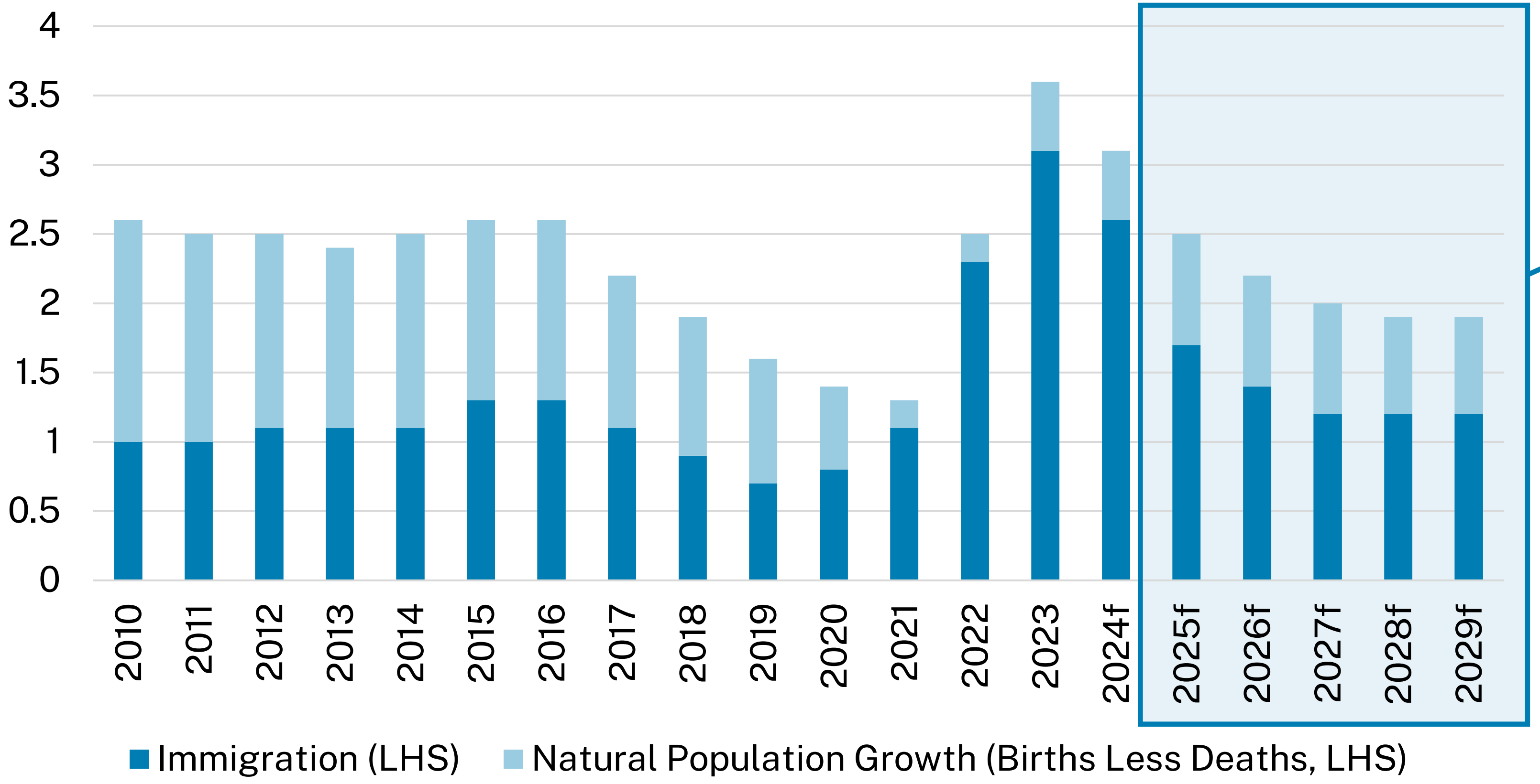
Native-Born U.S. Population Turning 20 and 65 Annually



Source: American Realty Advisors based on data from the Conference Board Employment Trends Index, the Bureau of Labor Statistics, and John Burns Real Estate Consulting tabulations of U.S. Census Bureau data as of December 2024.

Changes to immigration policy could change how job and GDP growth track going forward.

Source of U.S. Population Growth, 2010 – 2029f (millions)



Roughly **2/3rds of annual population growth over the next five years** is expected to come from immigration.

Policy changes that lower immigration could further temper overall job growth (less supply) but also GDP growth (less demand).

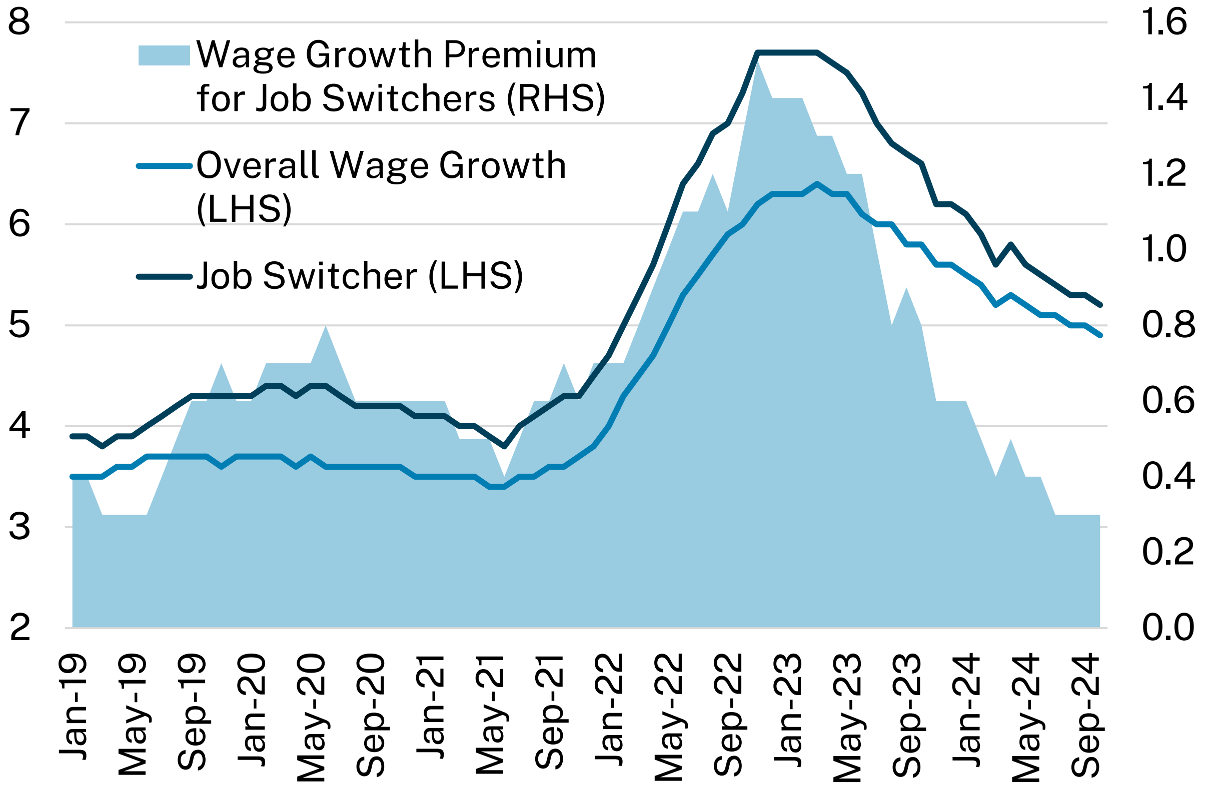
Source: American Realty Advisors based on data from John Burns Real Estate Consulting's calculations of U.S. Census Bureau Population Estimates with data through December 2023 published September 2024. f=forecast.

Fewer available workers is likely to spur greater wage growth.

Workers earn greater pay increases when they switch jobs than if they stay with the same employer.

Competition for limited labor should drive further wage growth as employers are forced to compete to attract within a relatively static talent pool.

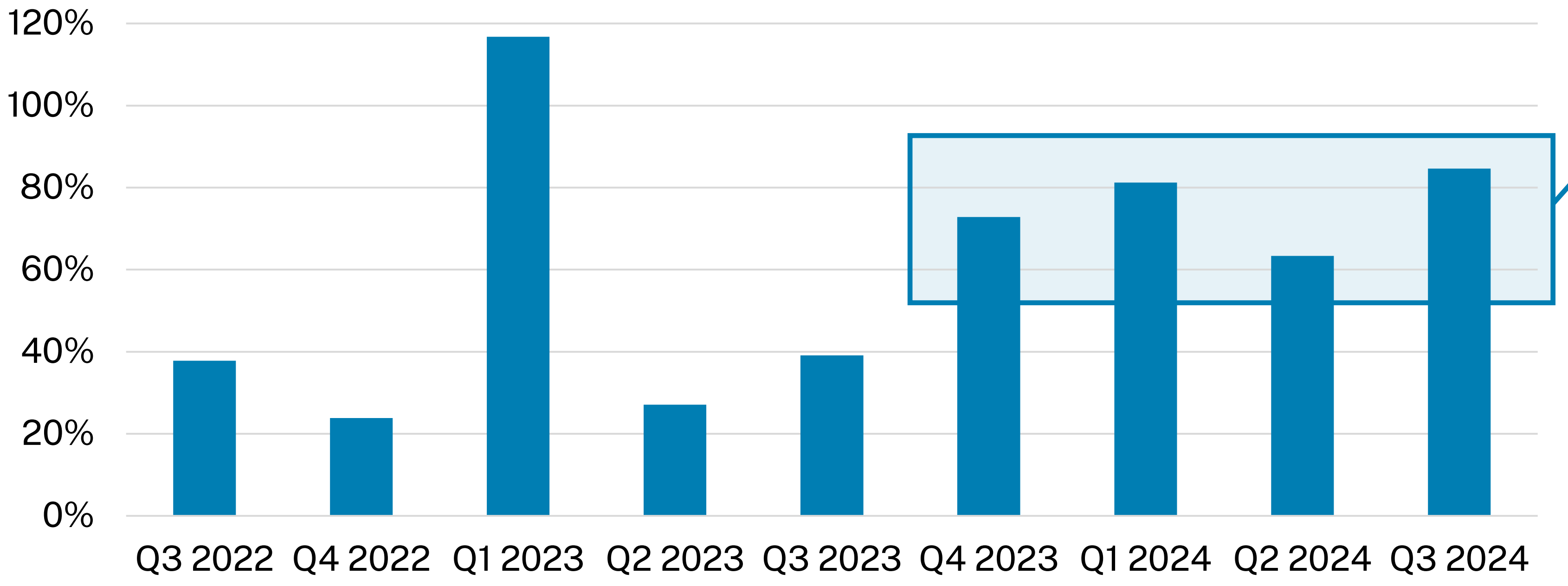
Median Wage Growth, 12-Month Moving Average, Overall vs. Job Switchers (%)



Source: American Realty Advisors based on data from the Federal Reserve Bank of Atlanta as of December 2024.

A favorable market for workers is usually good for growth.

Share of Quarterly GDP Growth from Personal Consumption



After softening in late 2022 and much of 2023, spending's share of GDP growth accelerated to **around 75% in the last year.**

Consumer spending is the largest driver of GDP; **stronger wage growth could translate to stronger spending and GDP growth.**

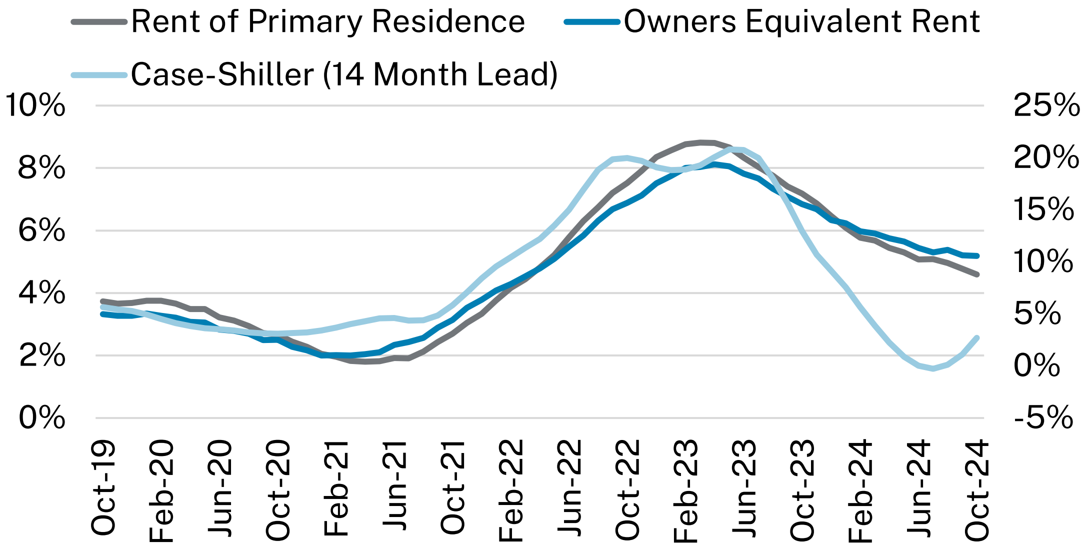
Source: American Realty Advisors based on data from the Bureau of Economic Analysis 3Q2024 GDP Second Estimate as of December 2024. A share greater than 100% means that personal consumption's contribution to percent change in GDP growth was greater than overall GDP growth; put another way, GDP growth was lower than consumption's contribution due to other factors that were negative, such as negative drags from private investment.

The key question: Will inflation continue to cool or not?

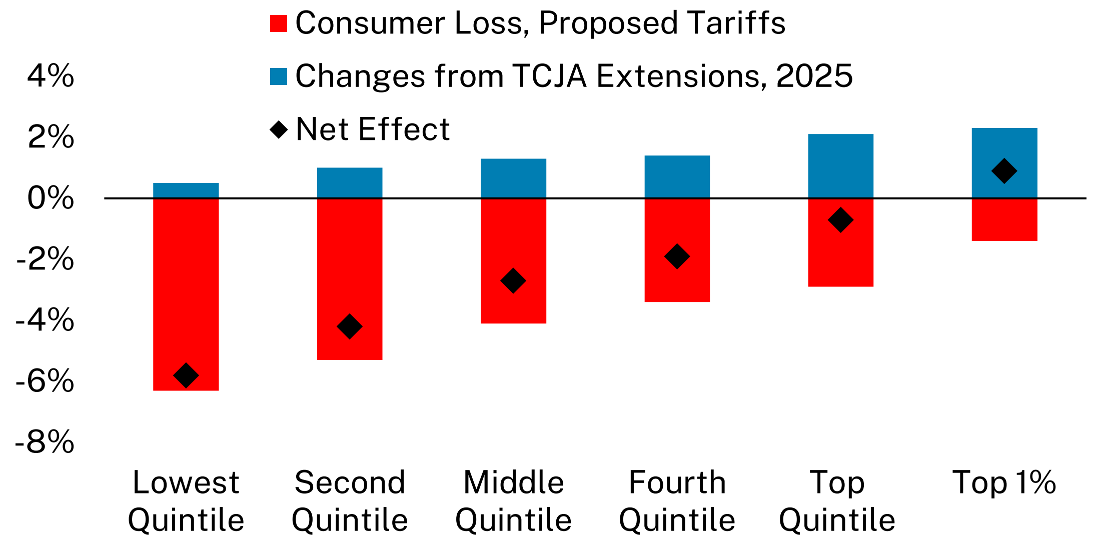
Leading indicators of housing inflation, which comprises 37% of the CPI basket, reflect the potential for a rebound that **could re-accelerate inflation in 2025.**

Tariffs on imports **may add further upward price pressure**, though tax cuts may allow for consumers to absorb some of the higher costs that **may not materialize until 2026.**

S&P CoreLogic Case-Shiller Home Price Index with CPI-U, Rent and OER Lagged 14 Months



Distribution of Tax Increases and Reductions under Trump Proposals, Percent Change in After-Tax Income by Income Quintile



Source: American Realty Advisors based on data from Case-Shiller and Macrobond as of December 2024 and the Peterson Institute of International Economics analysis as of August 2024. The tariff estimates assume a 20% tariff for most goods beyond the 60% tariffs imposed on imports from China. The net effect shows the combined effect between the losses from tariffs related to higher prices less the gains from an extension of the Tax Cuts and Jobs Act. Tariff calculations are done using data from the Consumer Expenditure Survey on consumption patterns. TCJA extension estimates are from the Tax Policy Center; these do not include many business provision extensions that have been proposed.

Policy changes could disrupt inflation path, but we believe the timing of effects reduces the risk.

	The Labor Market	Consumer Spending	Inflation & Interest Rates	GDP Growth
Base Case	• Job growth continues to moderate as a tighter market restrains potential gains. • Unemployment stays anchored in the sub-5% range.	Wage growth continues to outpace inflation, supporting spending.	• Continues gradual trend downward through 2025, though reaching Fed 2% target may not be realistic. • Policy easing will continue, though pace slows to prevent flare up resulting from tight labor market.	A healthy consumer combined with a generally business-friendly administration could fuel nominally higher growth.
Upside	• Tax cuts spark greater business expansion. • Administration action on immigration more benign than campaign rhetoric suggests.	Tax cuts extend to households (fiscal stimulus).	Tariff price increases don't materialize until 2026, allowing for inflation pressures elsewhere to continue to ease.	GDP growth accelerates firmly above trend.
Downside	• Tariffs negatively affect corporate profits in near term, reducing job growth. • Curtailed immigration could exacerbate shortages in key industries (construction, hospitality).	Wage growth stagnates as jobs become less plentiful.	• Full scope of tariffs applied creates retaliation, hurting U.S. businesses. • Prices rise, reaccelerating inflation and halting future Fed easing.	GDP growth weakens as consumers and businesses struggle with higher prices.

Source: American Realty Advisors as of December 2024.

II. Capital Markets

Capital markets recovery underway:

- Ongoing easing of interest rates is serving to gradually loosen financial conditions.
- Greater liquidity is improving access to loans, which are becoming slightly less expensive.
- Transaction volumes are still muted but have turned the corner from the recent trough.

Further real estate repricing likely to be isolated:

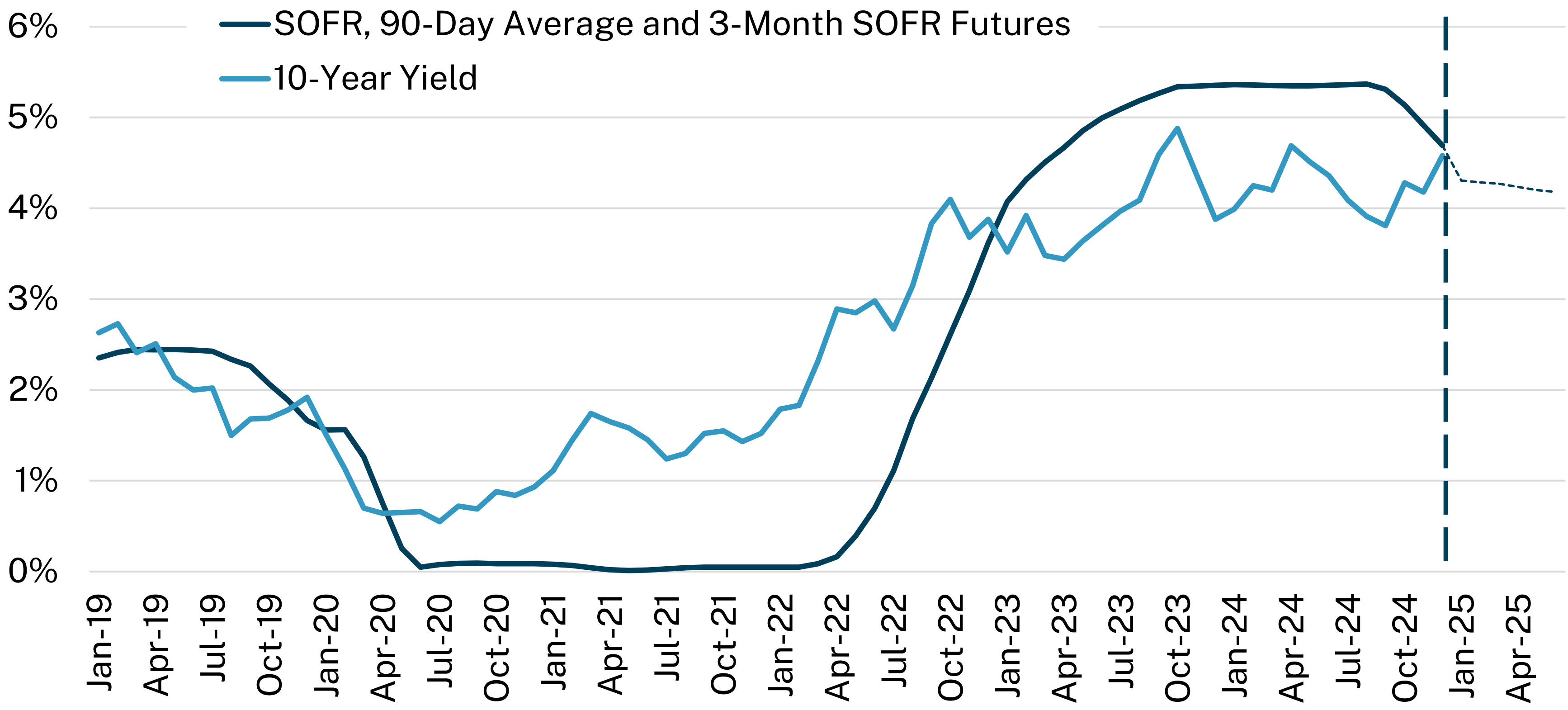
- Prices have been holding steady even amidst Treasury yield volatility, suggesting widespread markdowns are behind us.
- More activity should help further enforce current marks as debt availability continues to improve.

A bottom for prices should drive stronger positive returns:

- Appreciation recovery likely to be flatter than in past cycles that were fueled by significant cap rate compression, though should still contribute to positive total returns.
- The start of new cycles has historically created multi-year periods of positive returns; we think this time will be similar.

Interest rate easing (and an outlook for further cuts) is expected to support a capital markets recovery.

Secured Overnight Financing Rate (SOFR) and 10-Year Treasury Rates



Rates have begun to come down off their peaks; expectations of additional easing appear to be **loosening financial conditions.**

Where's the risk?

A healthy economy plus the potential for fiscal expansion and tax cuts could push Treasury yields higher, **possibly stalling financing conditions' gradual improvement.**

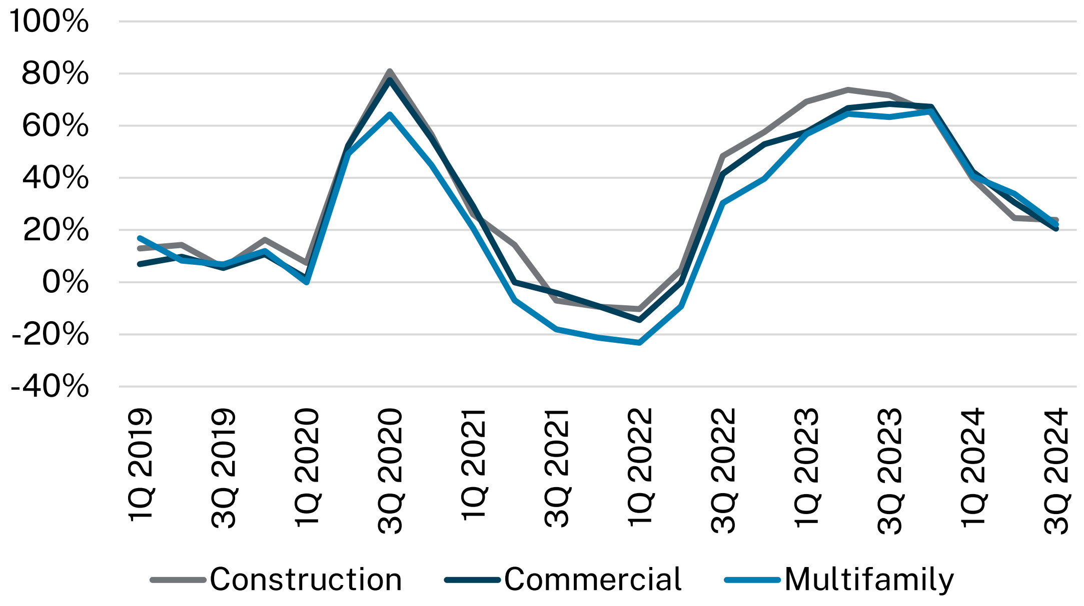
Source: American Realty Advisors based on data from the Federal Reserve, CME, and Green Street Advisors as of January 2025. Market-implied SOFR forward rates are as of January 13, 2025, and reflect estimations of the market's assessment of future target ranges that the Federal Open Market Committee sets. SOFR is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.

Access to loans is improving as lenders are finding more to be optimistic about.

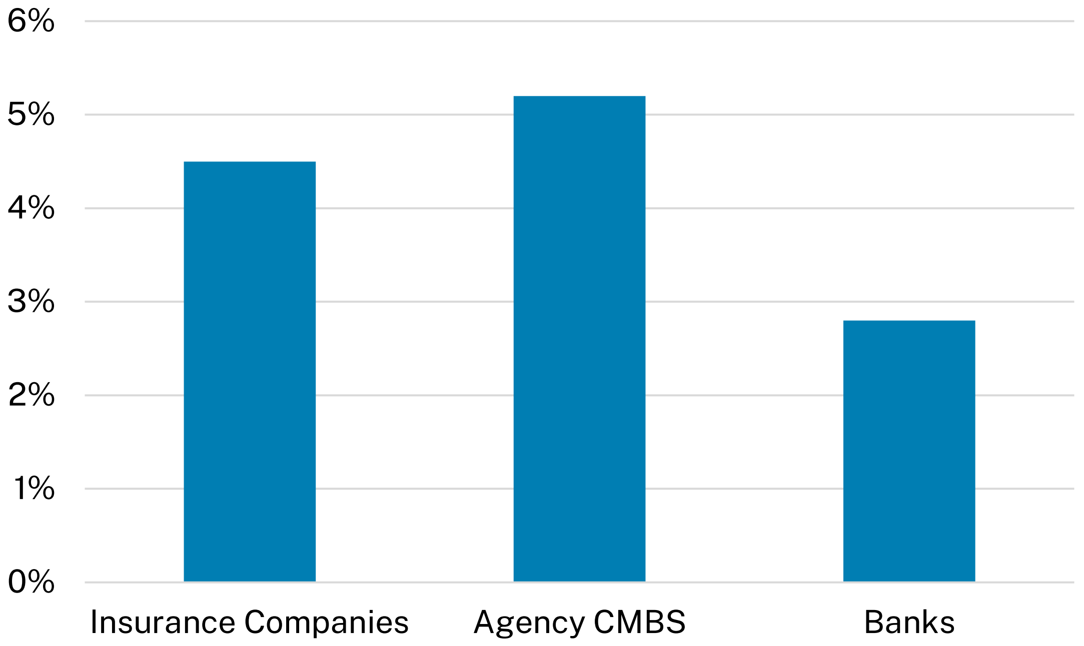
Fewer banks are tightening standards required to underwrite new real estate loans relative to a year ago.

Growth in other debt sources' lending volume in the last year has outpaced the banks **given an improved outlook**.

Net Percentage of Banks Tightening Standards for Real Estate Loans



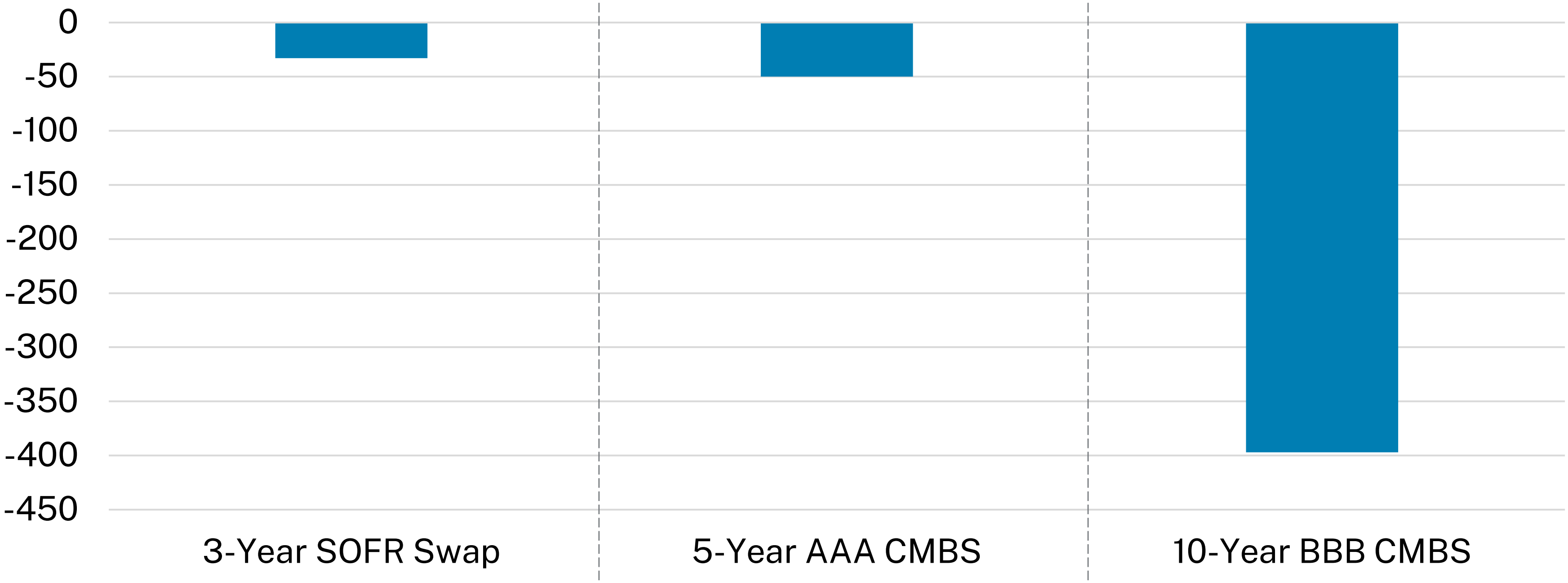
Last 12 Month Growth in CRE Loans by Capital Provider



Source: American Realty Advisors based on data from The Federal Reserve and Green Street Advisors as of December 2024.

Greater availability is gradually bringing down the cost of debt as lenders compete to place loans.

Year-over-Year Change in Basis Points on Different Loan Durations



Measures short-term borrowing costs, key for short-term and floating-rate debt.

Benchmark for borrowing against safe, mid-term commercial real estate debt (low-risk capital).

Reflects cost of long-term, higher-risk CRE debt costs.

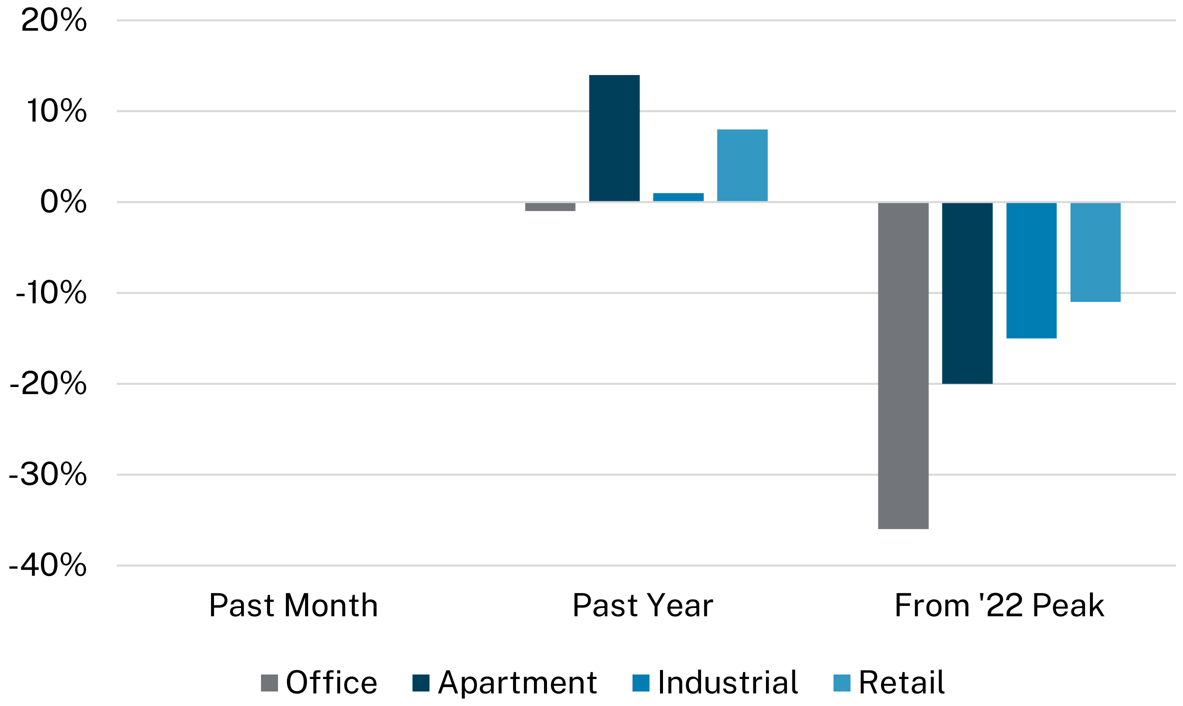
Though spreads remain elevated vs. long-term averages, **the cost of debt has decreased from last year's highs**, making borrowing and refinancing more palatable.

Source: American Realty Advisors based on data from Newmark with data as of December 9, 2024.

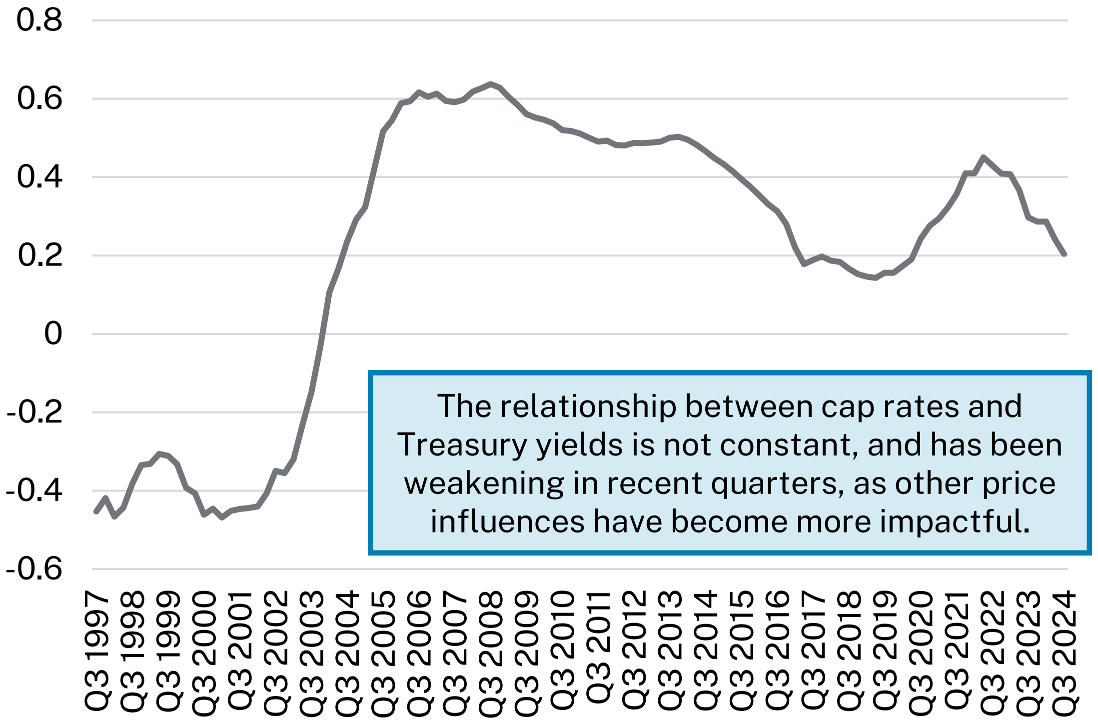
Stabilizing values suggests widespread repricing may be finished.

Most sectors have seen prices increase over the last year and held steady in the last month, even as the 10-Year Treasury has been volatile; this is because **cap rates are a function of many variables, not solely the direction of interest rates.**

Change in Property Values, Past Month and Past Year and From '22 Peak



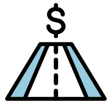
Rolling 5-Year Correlation, 10-Year Treasury Yields and Transaction Cap Rates



Source: American Realty Advisors based on data from Green Street Advisors, Macrobond, and NCREIF as of January 2025.

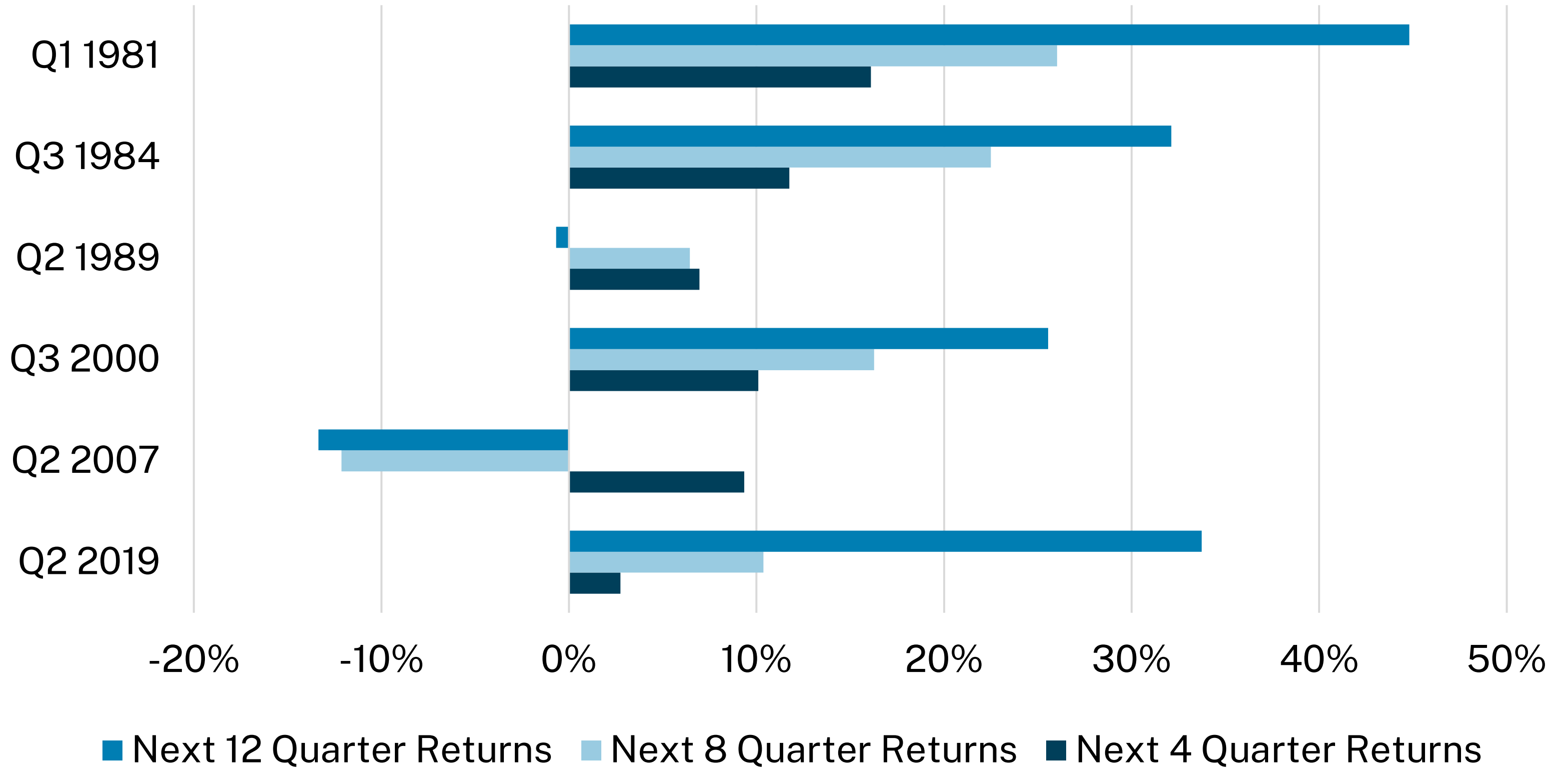
New capital markets cycles tend to bode well for real estate returns.

Absent the GFC, **real estate returns have generally performed well in the years immediately following the start of rate cuts.**



We think the next few years will be similar given an improving financing backdrop and strengthening fundamentals.

Cumulative NPI Total Return from the Start of Each FOMC Easing Cycle



Source: American Realty Advisors based on data from NCREIF and CBRE-EA as of December 2024.

III. Property Markets

The road to recovery still has some potholes:

- Fundamentals in most sectors continue to reflect gradual improvement from their recent lulls.
- Occupier markets are expected to improve later in the year as economic and policy uncertainty starts to fade.

Lack of construction today should strengthen 2026-28:

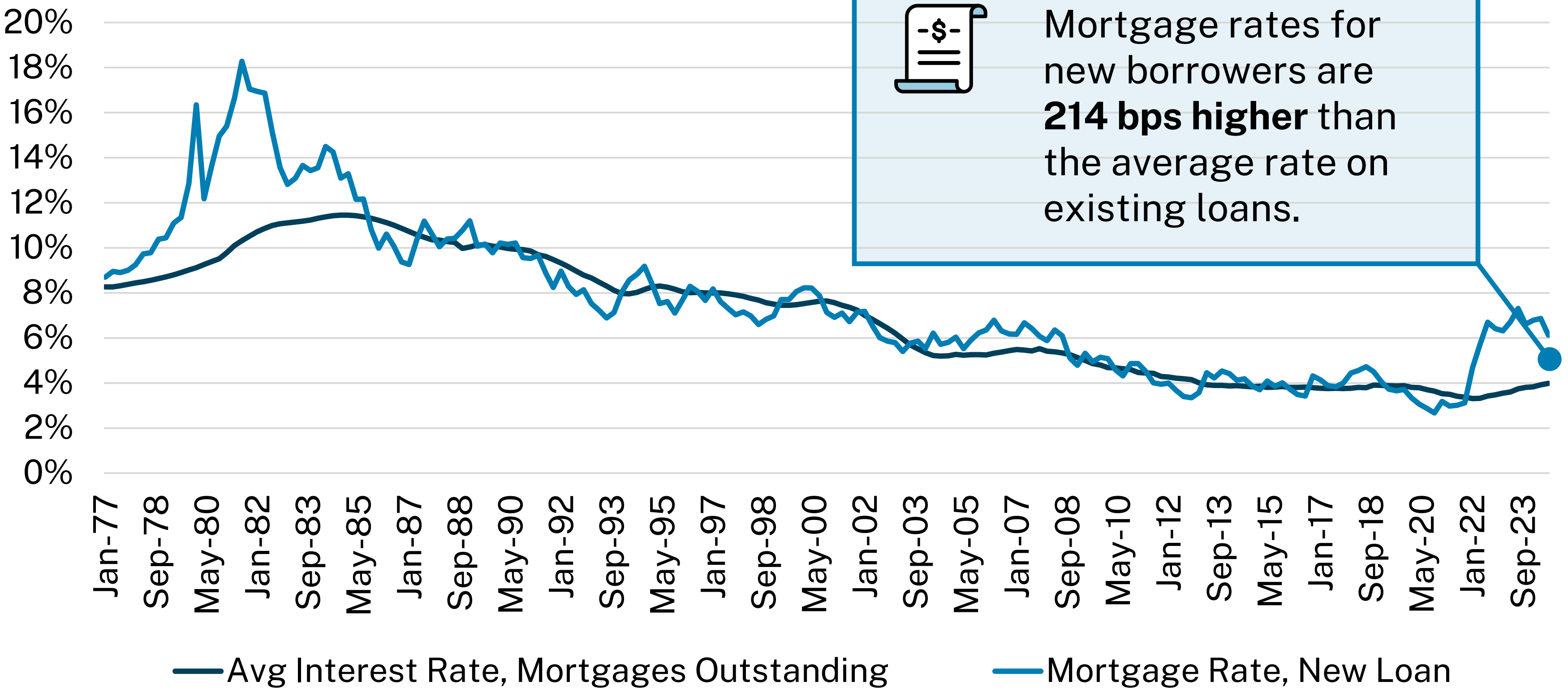
- Downside risk from new supply is declining as pipelines dwindle; we expect what little will deliver to capture demand amidst flight to quality.
- Fewer deliveries and a clearer macroeconomic and rate picture should lead to stronger NOI growth starting in 2026.

Rental housing supported by structural and cyclical factors:

- Gap between in-place and market mortgage rates and an unaffordable for-sale market is locking homeowners in place and driving rental demand.
- Still-elevated competition places greater emphasis on marketing, retention, and property operations in the near term.

Rates on new mortgages are still much higher rates than outstanding loans, keeping homeowners in place.

Average Interest Rate for Outstanding Mortgages vs. Mortgage Rates on New Loans (1977 – 2024)



Mortgage rates for new borrowers are **214 bps higher** than the average rate on existing loans.

This is driving a **'golden handcuff' effect**, where existing homeowners chose to remain in place to avoid the significantly higher rates that come with new mortgages.

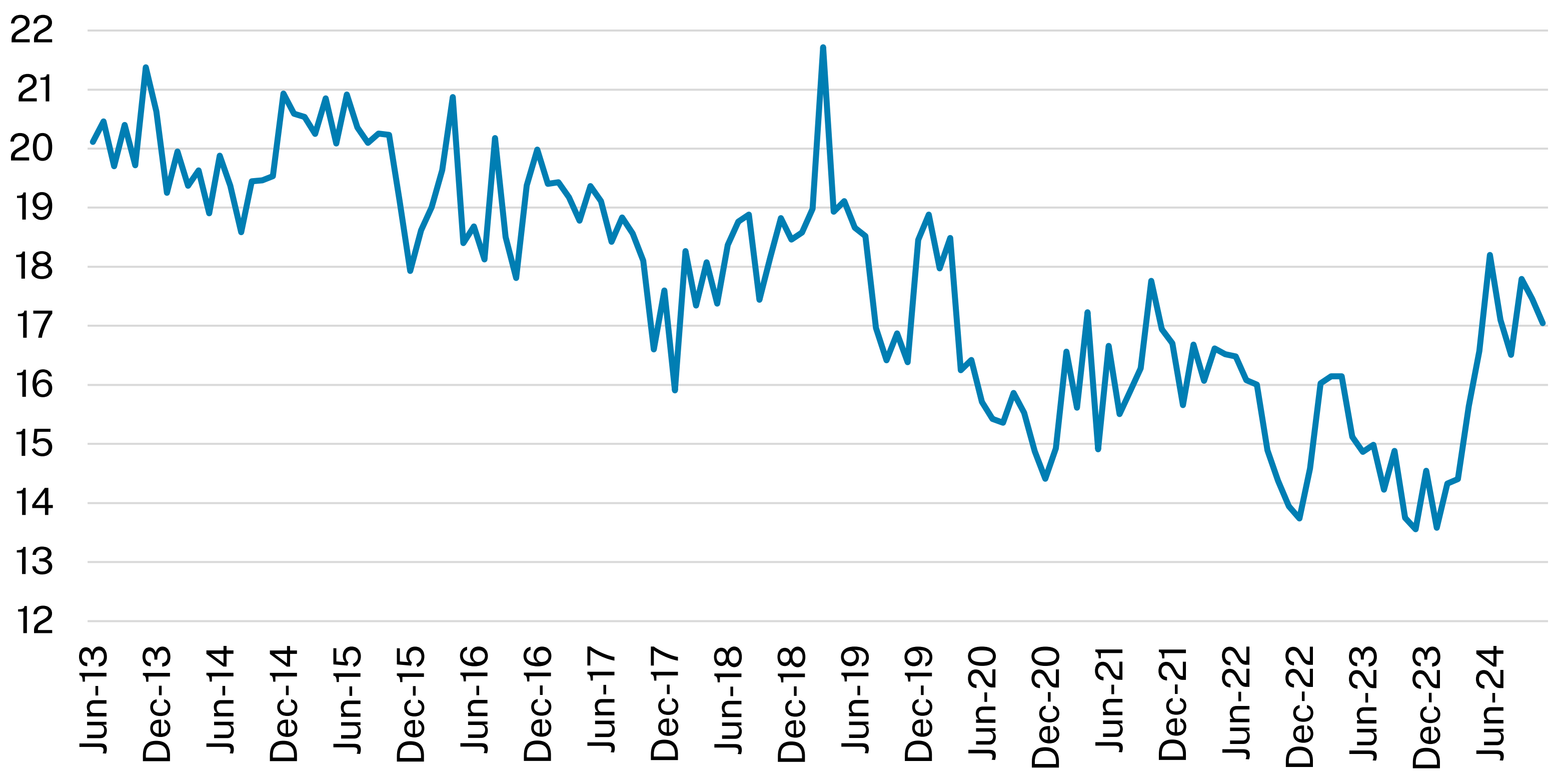
Source: American Realty Advisors based on data from Macrobond as of December 2024.

A rebound in household mobility may drive greater rental demand given barriers to homeownership.

The **number of households considering a move** within the next 12 months **has increased 24%** from its December 2022 trough.

Shrinking for-sale inventory and affordability challenges continue to keep homeownership out of reach for many, positioning **rising mobility as a potential tailwind for the rental market.**

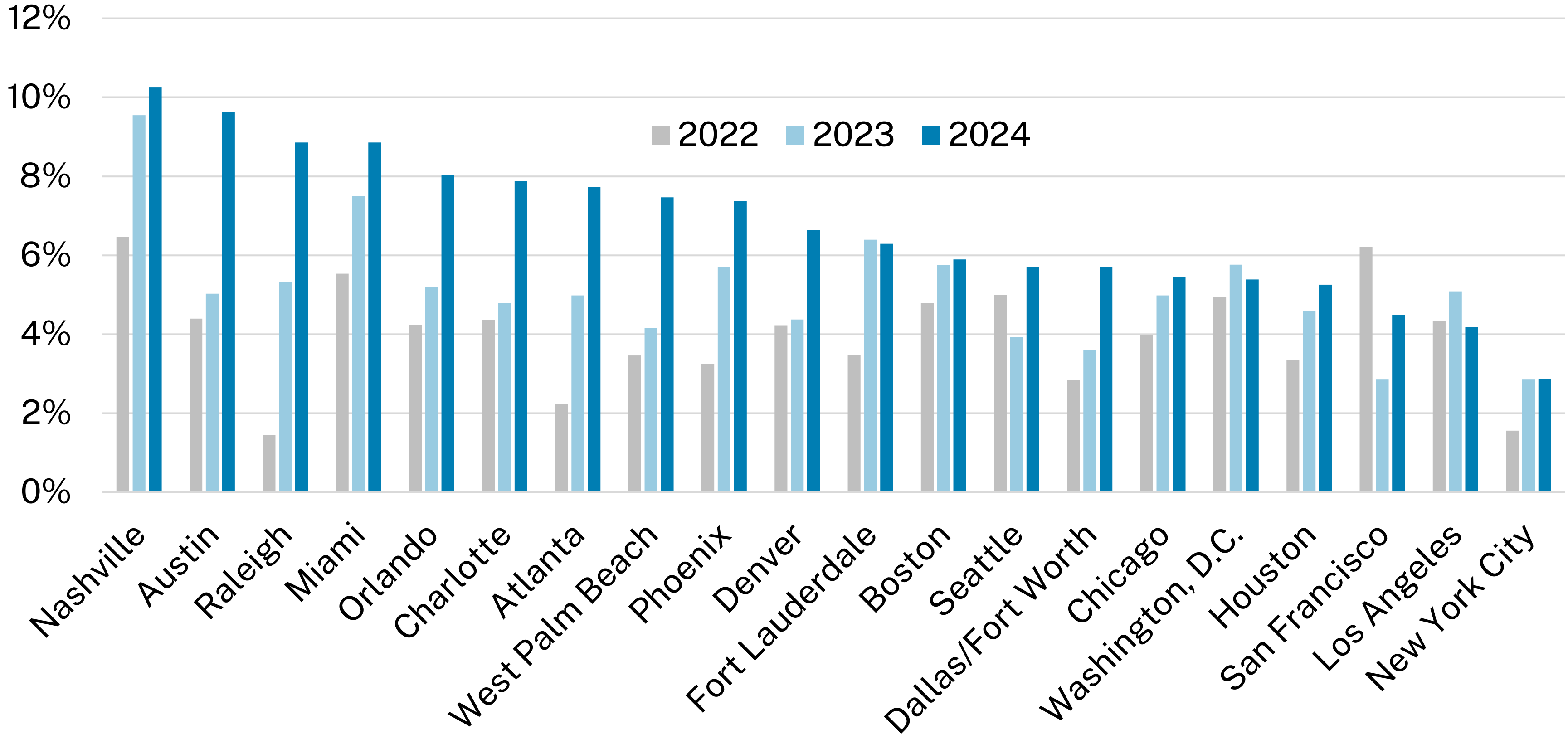
Probability of Moving Primary Residence, Next 12 Months (All US Households)



Source: American Realty Advisors based on data from the Federal Reserve Bank of New York Survey of Consumer Expectations and Macrobond as of December 2024.

Recent supply has allowed for an uptick in apartment absorption, outpacing recent years.

Annual Multifamily Absorption as a Percentage of Market Inventory



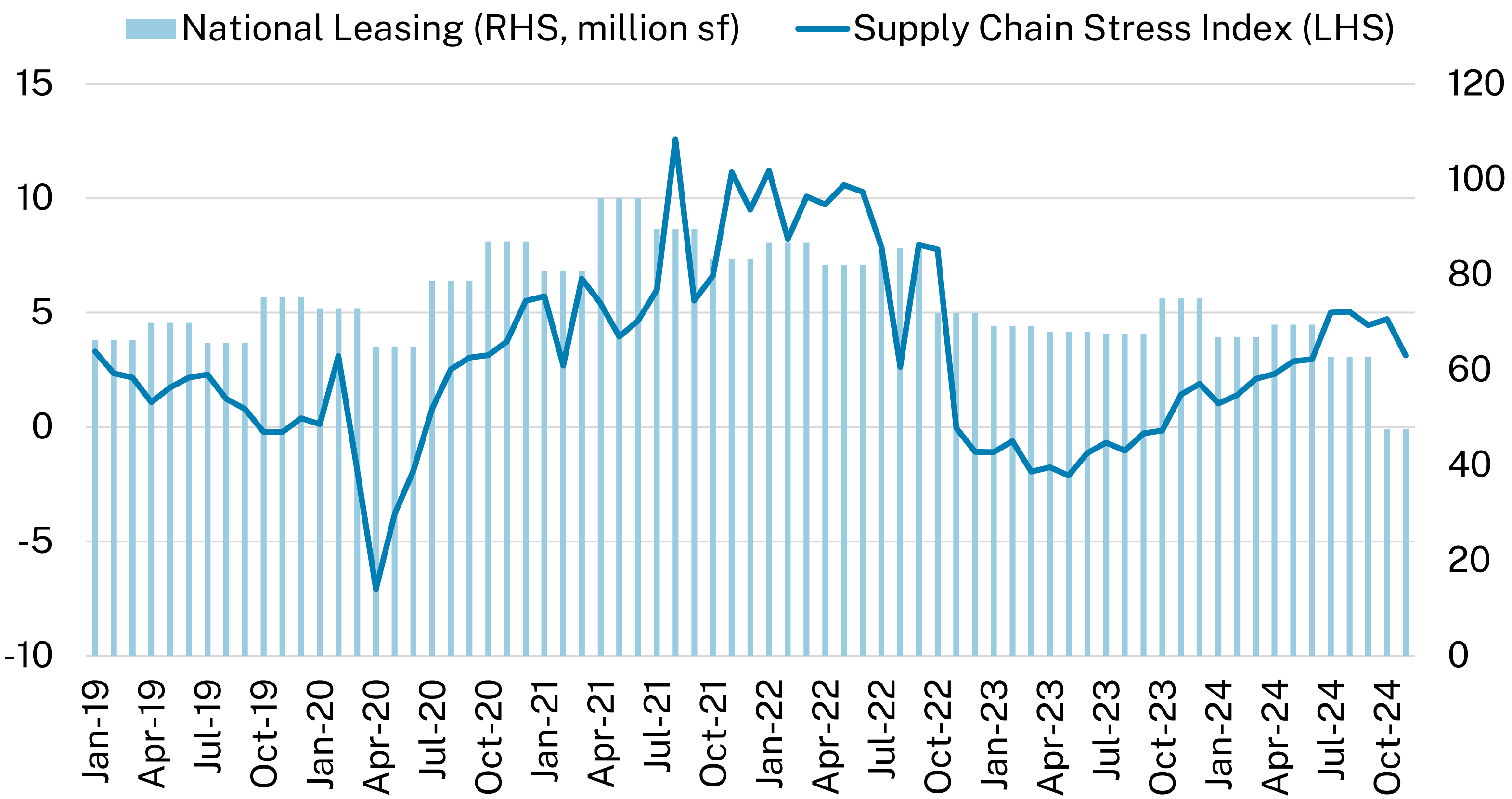
We expect a favorable labor market and a generally inaccessible for-sale market to continue to drive up demand for rentals.

Source: American Realty Advisors based on data from CoStar as of December 2024.

Growing strains on supply chains have dragged on industrial leasing, but tariffs could prompt activity.

Occupiers have been slow to sign leases amidst rising supply chain stress and uncertainty, but **looming tariffs could spark a frontloading of inventory and drive up absorption** this year.

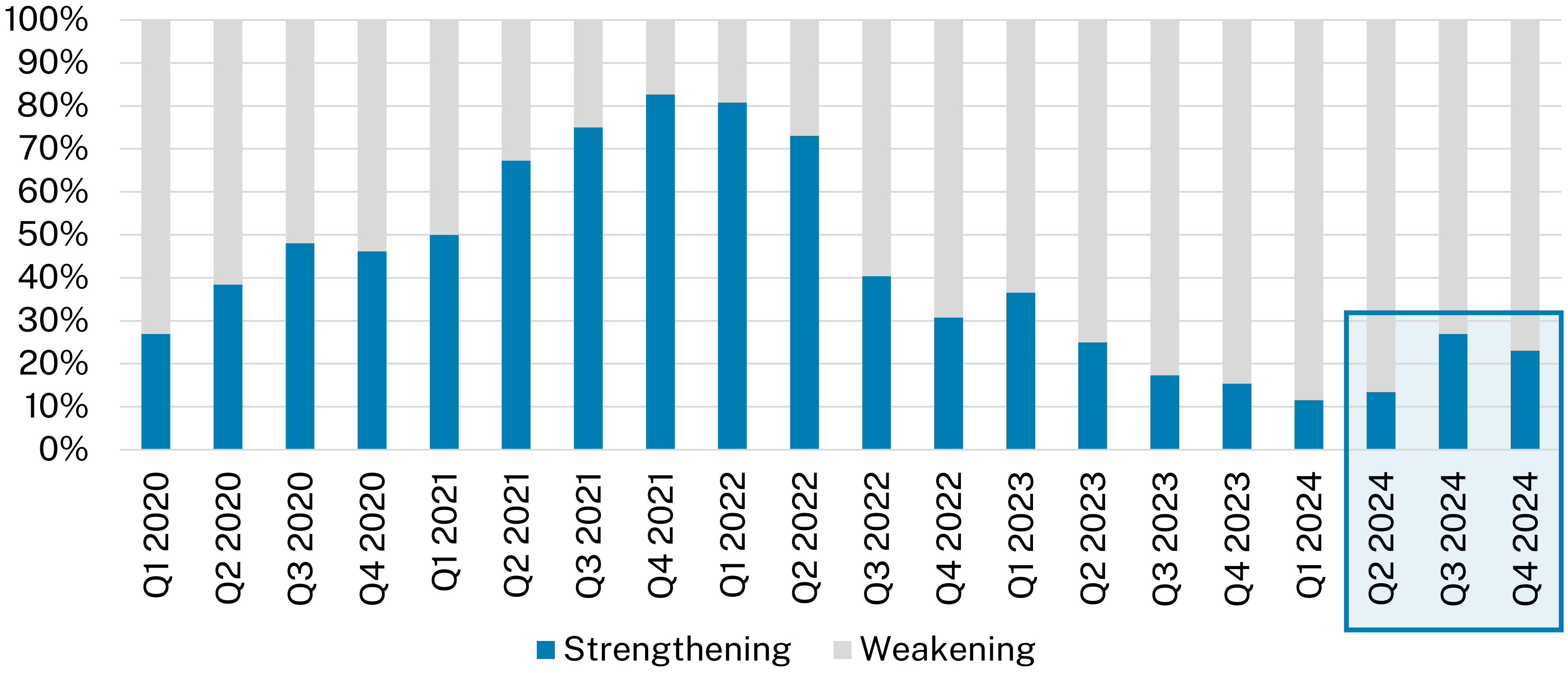
Supply Chain Stress Index and Industrial Leasing



Source: American Realty Advisors based on data from Oxford Economics and CoStar as of December 2024. Leasing data is a native quarterly series; monthly data reflects the quarterly leasing volume averaged over 3 months.

Industrial demand has been tepid, but more markets are beginning to show improvement.

Share of Markets Nationwide Experiencing Year-over-Year Strengthening or Weakening in Trailing 12-Month Net Absorption



Q1 2024 marked the trough, with the greatest number of markets experiencing weakening demand.

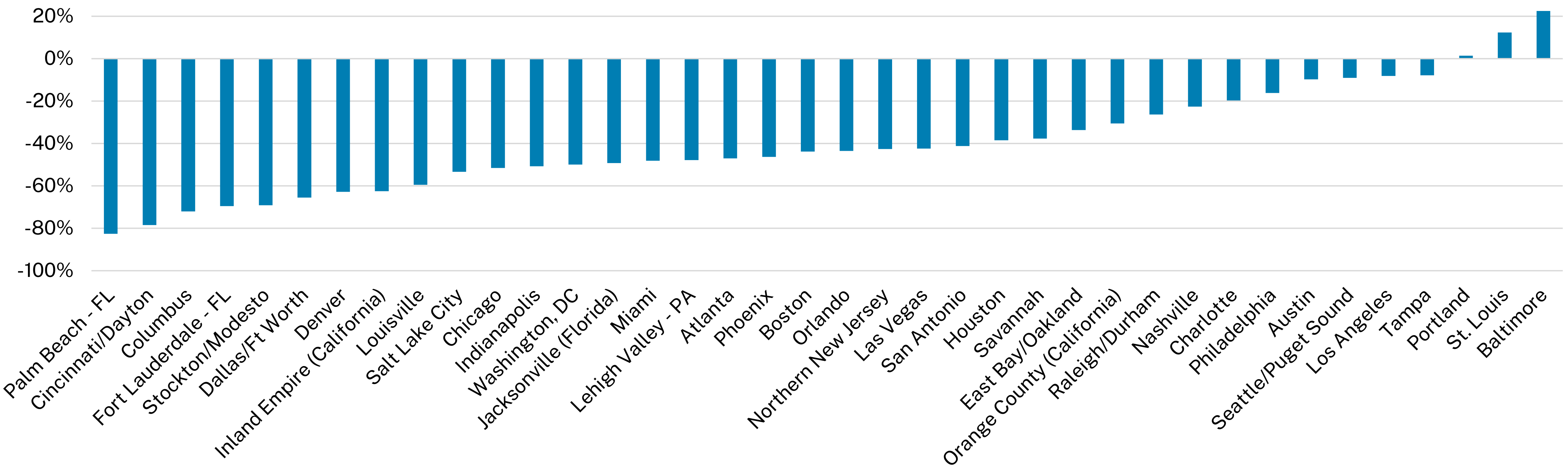
Since then, a growing share of markets have begun to re-accelerate, with absorption strengthening year over year.

Source: American Realty Advisors based on data from CoStar as of December 2024.

Rapidly declining supply pipelines should further help improve industrial fundamentals.

Relative to a year ago, some markets' **supply under construction has dropped by as much as 80%.**

Change in Under-Construction Industrial Pipeline, Q3 2023 vs. Q3 2024

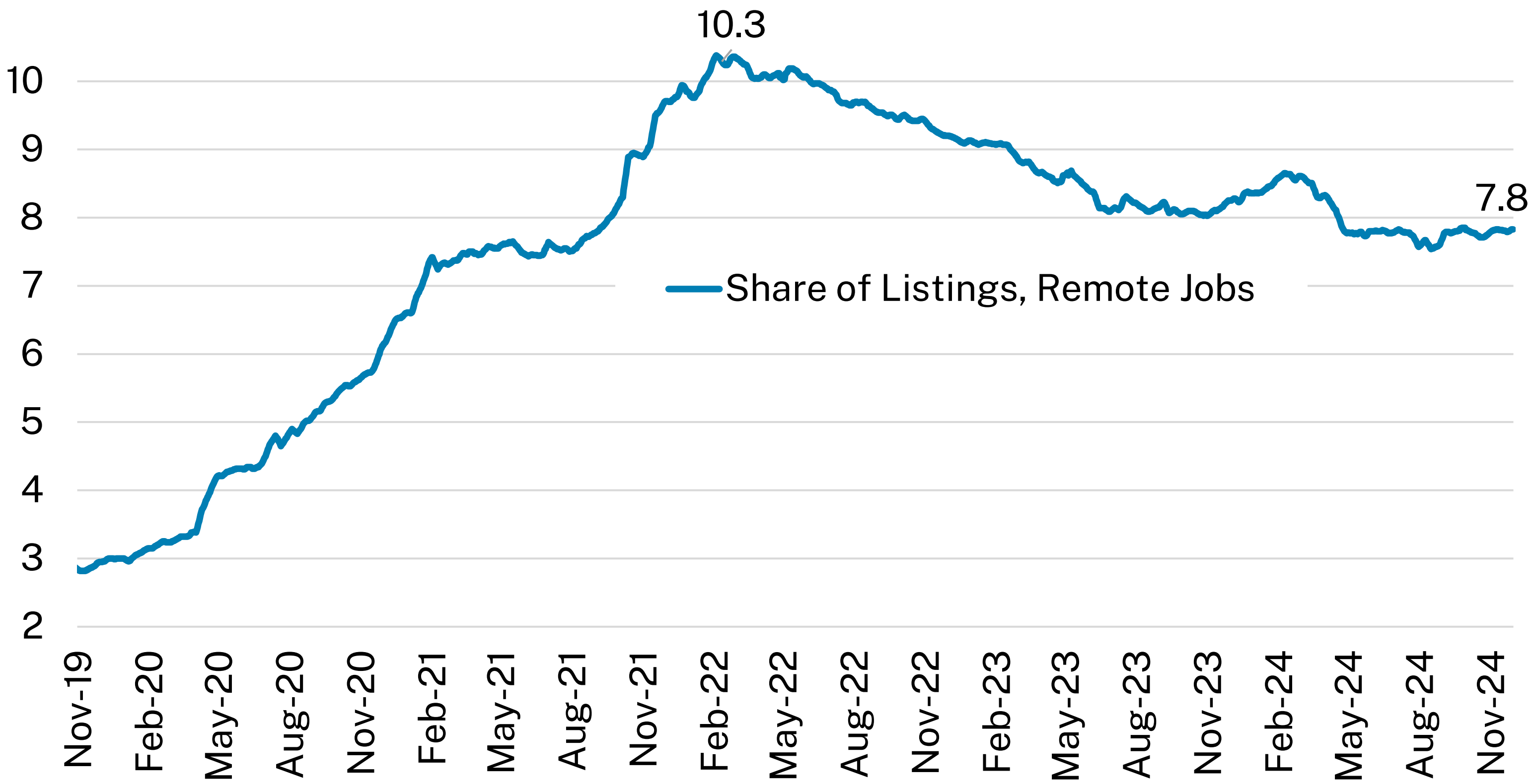


Source: American Realty Advisors based on data from CoStar as of December 2024.

Fewer fully remote positions should help support a gradual stabilization in office.

The share of job postings offering remote arrangements has come down from the early 2022 highs and **appears to be holding around 7-8%.**

Share of Indeed Job Postings Advertising Remote or Hybrid Work



Source: American Realty Advisors based on data from Indeed.com's Hiring Lab as of December 2024.

Office pricing may appear compelling if fundamentals improve further, but challenges to returns remain.

Office prices have declined ~40%, offering a reset basis.

Absorption has turned positive, improving vacancy…

…while nominal asking rents have continued to increase.

Real rents have been negative given elevated tenant improvement, leasing commission, and free rent allowances.

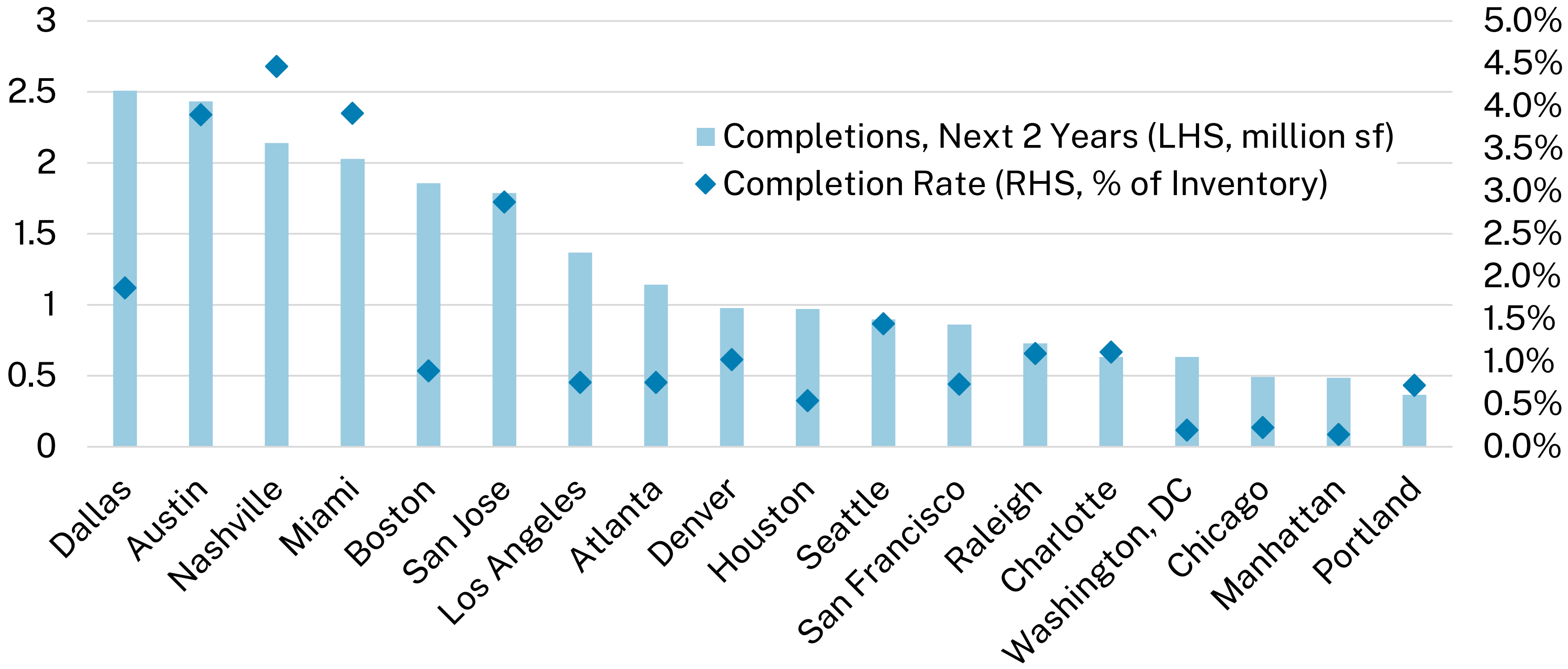
Hybrid schedules may keep days in office structurally reduced…

…while the potential for fewer job gains could further prolong the occupancy recovery.

Source: American Realty Advisors based on data from CBRE-EA and Green Street Advisors as of December 2024.

Select office markets may test how robust the flight-to-quality trend is given elevated construction.

Space Under Construction Scheduled for Completion Next Two Years (million sf and % of inventory)



We expect **existing prime buildings will benefit more in those markets with less space under construction** by function of lesser new competition (places like Seattle, Chicago, and New York) while prime buildings in places like Austin and Nashville may face unfavorable leasing conditions for longer.

Source: American Realty Advisors based on data from CBRE-EA as of December 2024.

Outlook for Property Sectors

2025 should represent a recovery turning point, after which an acceleration in fundamentals is expected.

Shrinking development pipelines across sectors signal recalibration, setting the stage for stronger rent growth prospects going forward.

Industrial

- Tenant demand remains strong, but leasing activity is tempered by economic and tariff uncertainty.
- A growing number of markets are seeing improved absorption levels.

Residential

- Elevated interest rates on new mortgages are keeping homeowners in place, limiting for-sale inventory.
- 2024 demand outpaced the prior two years as an uptick in mobility has benefitted rentals.

Office

- Decline in remote job postings is a potential positive for office occupancy rates.
- Flight to quality trends may be stronger in markets with less competition from new supply.

Retail

- Limited construction has kept availability low, driving retailers to sign longer leases and pay higher rents for prime locations.
- Consumer preference for brick-and-mortar retail remains strong, with occupancy levels at a decades-high rate.

Specialty Sectors

- Correlation between moving and self-storage demand suggests that markets with greater for-sale inventory offer better rent growth potential.
- Data center demand remains robust, though pushback from communities may curtail investment opportunities.

Implications for Core and Value-Add Strategies

We believe a measured pace of improvement in real estate fundamentals over the coming year requires a keen focus on cash flow quality and preservation and a thoughtful deployment of capital.

Asset Management

- More options and a willingness to move by renters necessitates more aggressive renewal and new lease offers to maintain occupancy.
- Explore viability of shorter-term industrial leases targeting renewals in 2026-28 (when pipelines are meaningfully reduced, and vacancies are expected to be lower).
- Accelerate improvement projects that directly contribute to net operating income (NOI) growth to mitigate against potential re-acceleration of inflation in a tariff-on scenario.
- Focus on expense management, particularly in states that have experienced a disproportionate increase in insurance costs (Florida, California).

Portfolio Construction

- Greater conviction on the outlook for rates and the economy should create a backdrop more conducive to strategic dispositions.
- Improved availability of debt offers a more attractive environment for refinancing existing loans.
- Avoid "momentum chasing" in longer-term underperforming markets that look good today by virtue of less cyclical headwinds (think: Midwest apartments).
- New investments being underwritten should assume slower lease-up velocity in 2025 and 2026.
- Office opportunities are likely to fall into two categories: unduly high risk without appropriate upside, or ultra-core assets with stable cash flow but limited ability to enhance returns further.

Summary and Strategy Implications

With a soft landing in sight, ongoing improvements in financing and fundamental conditions should fuel greater optimism.

- Wage growth has continued to outpace inflation, supporting consumer spending and bolstering the economy.
- While inflation has gradually trended the right way, potential headwinds from tariffs, housing, and labor costs threaten to undo some of the recent progress.
- A tight labor market, driven by fewer young workers and reliance on immigration, is expected to sustain low unemployment but may limit future job growth.
- Interest rates have eased from their recent highs, improving financial conditions and contributing to a gradual recovery in capital markets.
- Narrowing bid-ask spreads and stabilizing cap rates suggest that widespread repricing in real estate valuations may be nearing completion.
- Industrial fundamentals are improving as new supply slows, supporting a better balance between occupancy and rent growth.
- The office sector shows early signs of improvement as fewer remote job listings and successful hybrid schedules stabilize occupancy.
- Structural case for residential remains intact due to affordability constraints in the for-sale market, driving healthy levels of rental housing demand.

Disclosures

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