Real Estate

As discussed above, with inflation running at 6.5% at the end of 2022, the Fed will continue raising interest rates until it sees credible evidence that inflation is headed back to its 2% target. For real estate, a higher cost of capital due to financing costs means that asset values will go lower.

The fourth quarter of 2022 was the first drop in value for real estate, primarily driven by the office sector, where transactions gave indications of expected values. Demand for office space has been altered with the pandemic, and while hybrid work has proven beneficial to some companies, the sector needs to evolve as employers, cities, and employees rethink the future of physical space requirements and commuting. However, other primary property types maintained their value in Q4 as fundamentals remained healthy: industrial and data centers proved to have resilient demand, and the lack of housing supply in the US continues to provide tailwinds for multifamily.

For investors in need of liquidity due to the decline in public market values, the fourth quarter brought elevated redemption flows in real estate not seen since March 2020. The real estate sector has been one of the best performers during 2022, and institutional investors seeking to rebalance their portfolios leaned on real estate funds as a source of liquidity. This liquidity is generally offered on a quarterly basis, and elevated redemption requests put in throughout the year forced fund managers to institute redemption queues that will take several quarters to unwind. In the retail investor sector, the two largest private REITs, BREIT and SREIT, both gated redemptions during the quarter to maintain their balance sheet. As 2023 unfolds and the magnitude of a potential recession becomes apparent, more clarity will come for the underlying liquidity of real estate funds.

Another factor we are closely monitoring is new supply across property types. As rising interest rates continue to cool demand, new construction starts in 2023 will come down from record high values in 2022. These elevated levels were partially due to inflated construction costs, which are the sum of three components: materials, labor, and margins. We do not see the cost of materials rising in 2023 as supply pressures ease, but labor costs likely will increase as construction job wage growth has lagged general wage growth. Margins can vary significantly across property types and locations, and certain sectors like homebuilding will lose pricing power while contractors are unable to run at full capacity.

We continue to remain focused on our high conviction investment themes in real estate, where strong demand remains and distressed assets can be acquired at a discount. Some of these themes include affordable housing investments and agricultural real asset strategies.