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Weekly commentary

BlackRock.

May 8, 2023

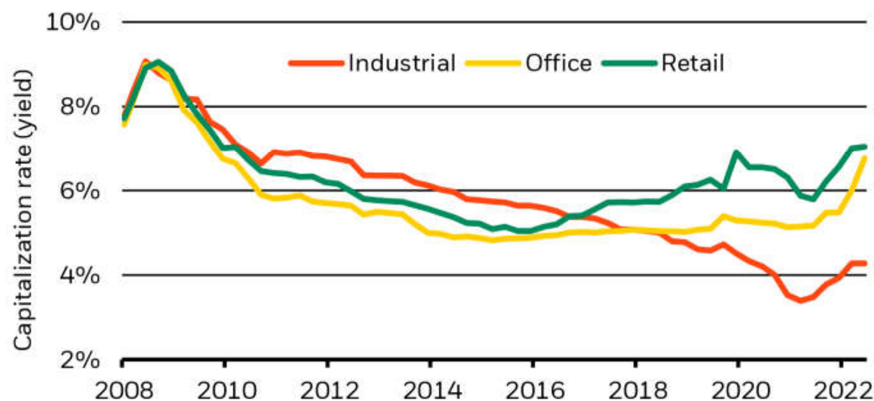
Commercial real estate: going granular

- Financial cracks from rate hikes have led to jitters over commercial real estate. Yet granularity is key. We see opportunities in some U.S. industrial properties.
- The Federal Reserve signaled a pause may follow last week's rate hike. Yet jobs data showed a tight labor market. We expect a pause but no rate cuts this year.
- We expect U.S. inflation data out this week to show services are keeping inflation sticky, while survey data should gauge how U.S. consumers are holding up.

The fastest rate hiking cycle since the 1980s is causing financial cracks. This has caused bank turmoil and raised concerns over U.S. commercial real estate due to its high vacancy rates and reliance on bank loans. Yet we see varied risks across sectors, regions and investment choice. So we use our new playbook and get granular. We favor selected sectors such as industrial real estate as we see long-term forces like e-commerce and geopolitical fragmentation fueling demand.

Not a monolith

Capitalization rates by real estate sector, 2008-2023



Source: BlackRock Investment Institute, with data from Green Street Advisors, May 2023. Notes: The chart shows the nominal capitalization rates for industrial, office and retail properties as implied by transaction values per quarter. Nominal cap rates are used to gauge the yield of property transactions.

We went underweight private growth assets from a view of five years and over in 2022's first quarter. That includes broad commercial real estate – a sector we've projected negative returns for since June 2022. Yet we know commercial real estate is not a monolith. Case in point: Capitalization rates – a yield metric that rises when valuations fall – have diverged. We expect retail cap rates to keep rising (green line in chart) due to pressure from e-commerce growth. Office cap rates (yellow line) are likely to rise too as they have since 2022. Investors are requiring higher cap rates for offices given rising interest rates and higher vacancy rates due to remote work. We expect industrial cap rates (dark orange line) to stay low relative to peers as we see higher earnings growth for the sector. Private assets can play a sizeable role in long-term portfolios, with potential to diversify returns, in our view. Private markets overall are complex, with high risk and volatility, and aren't suitable for all investors.

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The impact of the pandemic and bank turmoil on commercial real estate sectors has varied, too. Shifting work habits have cut demand for U.S. offices, based on a high vacancy rate of about 13% in March, National Council of Real Estate Investment Fiduciaries (NCREIF) data show. Banks' exposure to real estate added to market jitters. Banks held 40% of outstanding real estate debt as of 2022's third quarter, the Mortgage Bankers Association found. That has raised fears high-vacancy or highly-levered U.S. properties will struggle to refinance debt, causing some to hit the market at cheaper valuations or default. That dynamic may create a funding gap but also chances to scoop up discounted assets – with risks. We see the gap as a bigger concern for U.S. assets: Private European valuations are cheaper than U.S. peers, MSCI and NCREIF indexes show.

We're cautious on private commercial real estate valuations: We think they need to fall more as rate hikes raise financing costs and cool inflation. That combo will likely bite into commercial real estate income growth. Exchange-listed real estate valuations are largely lower across the U.S., UK and Europe as real estate investment trusts (REITs) sold off with stocks in 2022, indexes show. Public REIT values tend to lead private markets by a few quarters. Yet REITs' near-term correlation with stocks means they diversify portfolios less and may see more volatility when stocks fully price in economic damage.

Industrial assets – referring to warehouses used for distribution, manufacturing and research and development – have fared better than office. Industrial assets have a vacancy rate around 2% as of March and their share of the commercial real estate market has doubled since 2016 to take up roughly a third of the market now, according to NCREIF data. This differentiation is why we get granular. We like industrial assets that could see structural trends feeding demand in the long term, like distribution and last-mile logistics centers. The expansion of e-commerce looks set to keep on driving demand as it has for decades, in our view. We also think geopolitical fragmentation will likely shift supply chains and prompt companies to re-shore operations – bringing manufacturing closer to home. Companies have already been storing more goods locally to prevent renewed supply chain snarls, U.S. Census Bureau data show. Some may aim to widen their web of warehouses to cut transportation costs and to support new manufacturing plants. Construction spending on the latter rose to about $147 billion annualized this March vs. $90 billion in March 2022, U.S. Census data show.

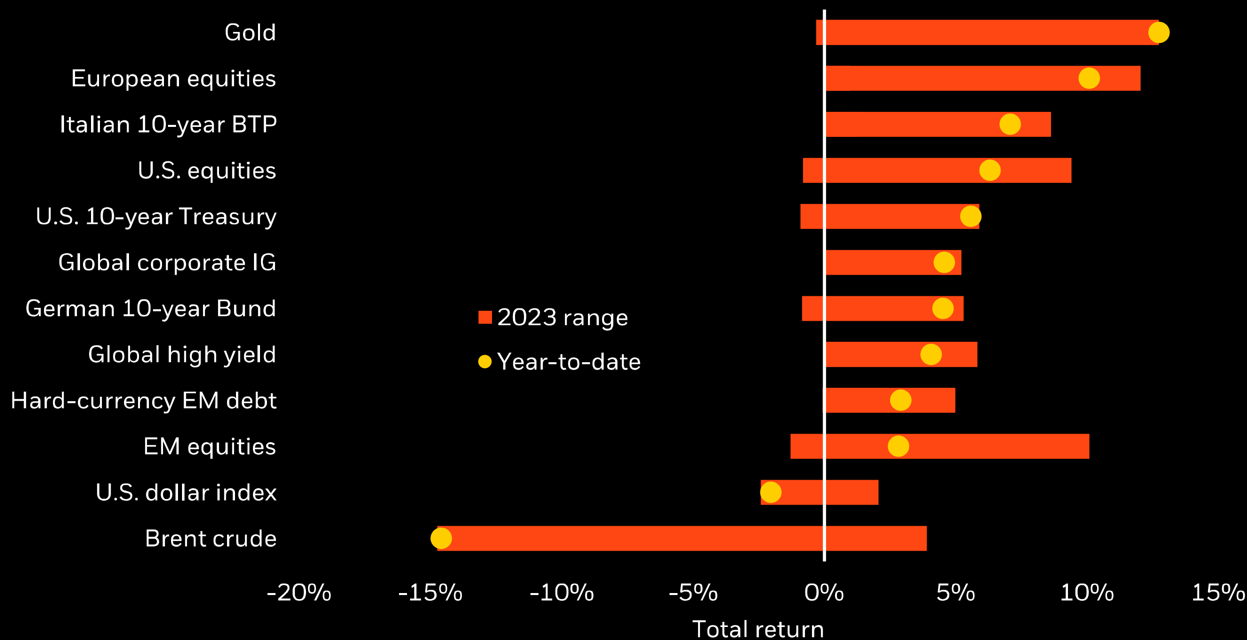
Bottom line: Financial cracks have fed concerns over commercial real estate's outlook. We're cautious on the sector. Yet we go granular in our portfolio views. We see better value in real estate sectors that may see long-term demand, like industrial.

Market backdrop

The Fed signaled a pause may follow last week's rate hike. The U.S. two-year Treasury yield sank 0.5% percentage points near 2023 lows before reversing about half the fall by Friday when April U.S. payrolls beat market expectations. The data also confirmed a tight labor market and wage pressure keeping inflation sticky. That makes rate cuts unlikely this year, in our view. We think that's true for the European Central Bank, too: It pointed to more hikes after raising rates again last week.

Assets in review

Selected asset performance, 2023 year-to-date return and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of May 4, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12-months, and the dots represent current year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot Brent crude, ICE U.S. Dollar Index (DXY), spot gold, MSCI Emerging Markets Index, MSCI Europe Index, Refinitiv Datastream 10-year benchmark government bond index (U.S., Germany and Italy), Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index and MSCI USA Index.

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Macro take

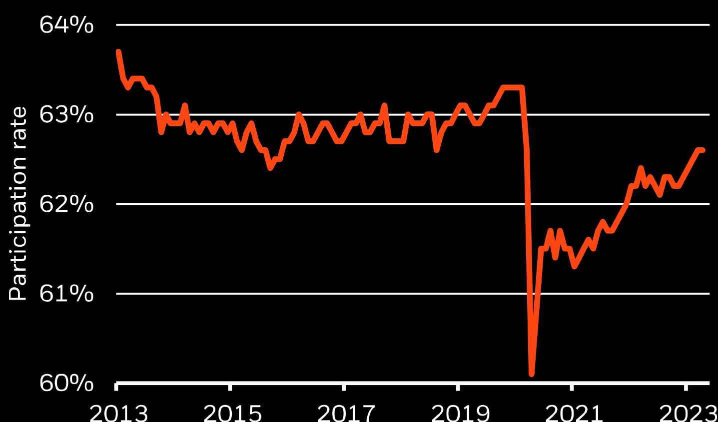
Last week's U.S. jobs report came after key central bank decisions and ongoing banking turmoil. It showed that the U.S. labor market is still very tight, with a worker shortage persisting. Employment growth has slowed slightly this year, but is still increasing at an annualized rate of around 1.7%, not much slower than the historical average. We've long said the labor force participation rate will be a key gauge of how labor supply is recovering. It stalled in April after several months of improvement. See the chart.

As a result, the unemployment rate fell to 3.4%, the lowest level since before man walked on the moon. And on top of that, wage growth is not slowing. Average hourly earnings increased at an annualized rate of almost 4% in the three months to April and nearly 6% on the month. The Employment Cost Index – the Fed's preferred measure of wage growth – was already close to 5% in Q1. If the labor market remains this tight, that's consistent with inflation settling at 4% – well above the Fed's 2% policy target.

Explore our recent Macro take blog posts here.

Labor supply remains constrained

U.S. labor force participation rate, 2013-2023



Source: BlackRock Investment Institute, Bureau of Labor Statistics, May 2023. Notes: The labor force participation rate shows the labor force – those who are in work or looking for work as a percentage of the population.

Investment themes

1 Pricing in the damage

- Recession is foretold as central banks try to bring inflation back down to policy targets. It's the opposite of past recessions: Rate cuts are not on the way to help support risk assets, in our view.
- That's why the old playbook of simply "buying the dip" doesn't apply in this regime of sharper trade-offs and greater macro volatility. The new playbook calls for a continuous reassessment of how much of the economic damage being generated by central banks is in the price.
- In the U.S., it's now evident in the financial cracks emerging from higher interest rates on top of rate-sensitive sectors. Higher mortgage rates have hurt sales of new homes. We also see other warning signs, such as deteriorating CEO confidence, delayed capital spending plans and consumers depleting savings.
- The ultimate economic damage depends on how far central banks go to get inflation down. The Federal Reserve signaled a pause after hiking rates in May. But it also reiterated that persistent inflation means no rate cuts this year. We see the European Central Bank going full steam ahead with rate hikes to get inflation to target – regardless of the damage that entails.
- **Investment implication:** We're tactically underweight DM equities. They're not pricing the recession we see ahead.

2 Rethinking bonds

- Fixed income finally offers "income" after yields surged globally. This has boosted the allure of bonds after investors were starved for yield for years. We take a granular investment approach to capitalize on this, rather than taking broad, aggregate exposures.
- Very short-term government paper looks more attractive for income at current yields, and we like their ability to preserve capital. Tighter credit and financial conditions reduce the appeal of credit.
- In the old playbook, long-term government bonds would be part of the package as they historically have shielded portfolios from recession. Not this time, we think. The negative correlation between stock and bond returns has already flipped, meaning they can both go down at the same time. Why? Central banks are unlikely to come to the rescue with rapid rate cuts in recessions they engineered to bring down inflation to policy targets. If anything, policy rates may stay higher for longer than the market is expecting. Investors also will increasingly ask for more compensation to hold long-term government bonds – or term premium – amid high debt levels, rising supply and higher inflation.
- **Investment implication**: We prefer very short-term government paper over long-term government bonds.

3 Living with inflation

- High inflation has sparked cost-of-living crises, putting pressure on central banks to tame inflation with whatever it takes. Yet there has been little debate about the damage to growth and jobs. We think the "politics of inflation" narrative is on the cusp of changing. The Fed's rapid rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. We think we are going to be living with inflation. We do see inflation cooling as spending patterns normalize and energy prices relent – but we see it persisting above policy targets in coming years.
- Beyond Covid-related supply disruptions, we see three long-term constraints keeping the new regime in place and inflation above pre-pandemic levels: aging populations, geopolitical fragmentation and the transition to a lower-carbon world.
- **Investment implication**: We're overweight inflation-linked bonds on a tactical and strategic horizon.

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Week ahead

May 9	China trade data	**May 11**	Bank of England policy decision; China CPI and PPI
May 10	U.S. CPI inflation	**May 12**	UK GDP; University of Michigan survey

All eyes are on U.S. inflation data this week. We expect services to keep inflation sticky even as interest rates stay higher. We're also watching survey data to see how the consumer is holding up. We expect pandemic savings to dwindle and further crimp spending. We see the Bank of England hiking again this week as inflation remains stubbornly high.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, May 2023

Underweight | Neutral | Overweight | ● Previous view

Asset	Strategic view	Tactical view	
Equities	+1	-1	We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched to us. Tactically, we're underweight DM stocks as central banks' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession. We are overweight EM stocks and have a relative preference due to China's restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
Credit	+1	Neutral	Strategically, we are overweight global investment grade but have reduced it given the tightening of spreads in recent months. We are neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're neutral investment grade due to tightening credit and financial conditions. We're underweight high yield as we see a recession coming and prefer to be up in quality. We're overweight local-currency EM debt – we see it as more resilient with monetary policy tightening further along than in DMs.
Govt bonds	Neutral	-1	We are neutral in our strategic view on government bonds. This reflects an overweight to short-term government bonds and max overweight to inflation-linked bonds. We remain underweight nominal long-term bonds: We think markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium. Tactically, we are underweight long-dated DM government bonds for the same reason. We favor short-dated government bonds – higher yields now offer attractive income with limited risk from interest rate swings.
Private markets	-1	—	We're underweight private growth assets and neutral on private credit from a starting allocation that is much larger than what most qualified investors hold. Private assets are not immune to higher macro and market volatility or higher rates, and public market selloffs have reduced their relative appeal. Private allocations are long-term commitments, however, and we see opportunities as assets reprice over time. Private markets are a complex asset class not suitable for all investors.

Note: Views are from a U.S. dollar perspective. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any particular funds, strategy or security.

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Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, May 2023

Underweight | **Neutral** | **Overweight** | ● Previous view

	Asset	View	Commentary
Equities	**Developed markets**	-1	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy and healthcare.
Equities	United States	-1	We are underweight. Financial cracks are emerging from Fed rate hikes. We don't think earnings expectations reflect the recession we see ahead.
Equities	Europe	-1	We are underweight. The impact of higher interest rates and elevated inflation pose a challenge for earnings, even as the energy shock fades.
Equities	UK	-1	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
Equities	Japan	-1	We are underweight. The Bank of Japan looks set to wind down its ultra-loose policy. Japan is exposed to the weaker activity we see in other DM economies.
Equities	**Emerging markets**	+1	We are overweight and have a relative preference over DM stocks due to China's powerful restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
Equities	China	+1	We see short-term opportunities from China's restart. But geopolitical risks have risen, and we still see long-term, structural challenges and risks.
Equities	Asia ex-Japan	Neutral	We are neutral. China's restart is a positive yet we don't see valuations compelling enough to turn overweight.
Fixed Income	Long U.S. Treasuries	-1	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
Fixed Income	Short U.S. Treasuries	+2	We are overweight. We prefer very short-term government paper for income given the potential for a sharp jump in Fed rate expectations.
Fixed Income	Global inflation-linked bonds	+2	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
Fixed Income	Euro area govt bonds	-1	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
Fixed Income	UK gilts	-1	We are underweight. Gilts won't be immune to the factors we see driving DM bond yields higher. We prefer short-dated gilts for income.
Fixed Income	China govt bonds	Neutral	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
Fixed Income	Global IG credit	Neutral	We are neutral. We see tighter credit and financial conditions. We prefer European investment grade over the U.S. given more attractive valuations.
Fixed Income	U.S. agency MBS	Neutral	We're neutral. We see agency MBS as a high-quality exposure within diversified bond allocations. But spreads near long-term averages look less compelling.
Fixed Income	Global high yield	-1	We are underweight. We think spreads are still too tight, given our expectation for tighter credit and financial conditions – and an eventual recession.
Fixed Income	Emerging hard currency	Neutral	We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.
Fixed Income	Emerging local currency	+1	We are overweight due to China's restart, and we see EM debt as more resilient to tightening financial conditions than DM as EM hiking cycles near peaks.
Fixed Income	Asia fixed income	Neutral	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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