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Which Real Estate Booms Will Continue?

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Market Action Summary

- Prospective US homebuyers report a record level of uncertainty over where they might choose to live. A low level of home inventories and escalating prices likely drives some of this. Importantly, we see great public uncertainty over the flexibility of work arrangements and future commutes.
- "Work from home" flexibility has meant a boom in single-family suburban housing and a 60% jump in US homebuilder shares since end 2019. Urban rents in the largest cities have fallen and related asset prices have had a meager rebound. This dichotomy could be sustained. However, fundamentals and valuations are at risk if employers demand a return to a five-day urban work week.
- Telecommuting carries risks such as cyber-security threats and broader social concerns. On the positive side for economic potential, it opens opportunities for a larger work force to include those with care-giving needs and the disabled. Commuting time and energy (including fuel) is, by definition, a frictional input cost to the economy.
- Mobility data show greater activity at physical retail and recreation locations than a return to office work. US corporate profits have likely gained more than 50% in 1H 2021 despite the empty cubicles.
- There are many uncertainties regarding the durability of COVID-impacted real estate trends. While we have been overweight Real Estate since June 2020, we increasingly believe overall assets have appreciated (recovered) too much for all sectors to offer strong returns from here.

A Zero-Sum Game for Real Estate Assets

Back to work does not necessarily mean back to the office. Diminishing COVID infections have allowed a rapid economic reopening. As we watch the economy accelerate, we can clearly see that populations in both the US and globally are returning to recreational activities far faster than they are returning to their offices (Figures 1 and 2). Of course, its early days and companies are just beginning to implement their “back to office” strategies. Lagged vaccinations of school-aged children and closed schools remain major impediments. But after 15-18 months of working from home, the idea that everyone is returning to the office full-time and that business travel will lastingly return to the level it did before is unlikely. Workers are indeed making a conscious choice to work from home.

Figure 1: US Workplace Visits Well Below Pre- Pandemic While Other Mobility Measures Have Recovered: Google

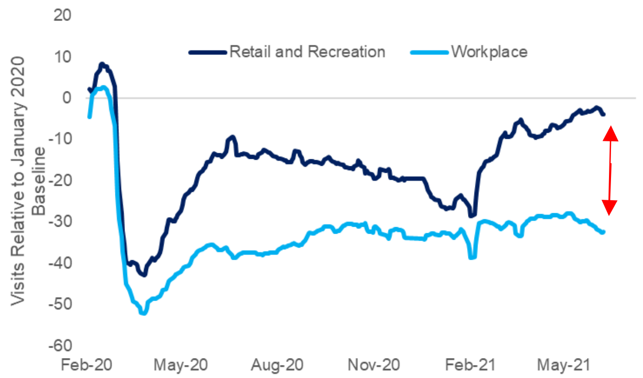


Figure 2: Global Workplace Visits Well Below Pre- Pandemic While Other Mobility Measures Have Recovered: Google

Source: Haver Analytics as of June 30, 2021.

The economic benefits of working from home are clear. Data suggest that workers are reinvesting their commuting time into increasing their output. S&P 500 EPS are expected to rise 54% in the first half 2021. A record high share of firms reported higher-than-expected profits in the first quarter despite their empty urban office space.

Power to the Workers

As it turns out, people like working from home. Although very few people want to be “remote full-time”, the percentage that wish to have more flexibility has increased materially (Figure 3). Of even greater significance is the impact that this has had on employee attitudes relative to that flexibility. If employees are forced to return to the office, a full 30% have indicated a strong willingness to consider alternative employment (Figure 4). Thus, the more skilled the work force, the more likely it is that companies will need to become more attuned to worker preferences. This means that flex-work, where employees will be in the office less frequently, is likely to become more prevalent over time.

Figure 3: Most employees would prefer a more flexible working model after the pandemic is over

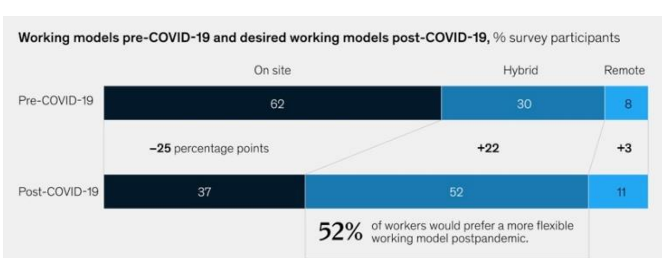
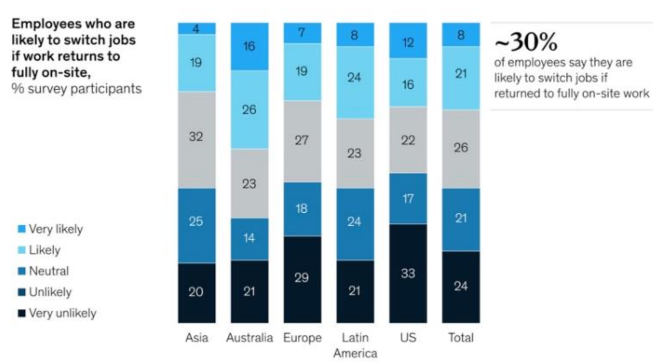


Figure 4: Going back to a fully on-site model might have significant talent implications



Source: Reimagine Work: Employee Survey (Dec 2020-Jan 2021), n=5,034 full-time employees who work in corporate or government settings.

The Skyscraper is Not The Limit

US public homebuilders, who largely focus on constructing single-family dwellings on individually-owned plots of land, have seen their shares return 60% from the pre-COVID period. Shares are up a stunning 187% from their March 2020 low. This is roughly double the S&P 500 return since end 2019 (see figure 5).

We believe there has been too much appreciation in overall US real estate equities since early last year for every real estate equity class to be a winner from here. As discussed in our latest Quadrant: We Can Rebound. Can We Grow?, given high prices across most real estate equities, there are likely to be winners and losers once the economy stabilizes in 2022 and beyond.

There remain some notable "tailwinds" still benefiting the homebuilding sector. This includes the broad acceptance of technology for telecommuters in a population that has five times as many service-sector jobs as "goods producers." Housing booms driven by an "investor mindset" tend to sustain momentum once underway. Signs also hint at an alleviation of homebuilder input costs such as lumber (see figure 6. And we expect interest rates to remain low for quite some time (please see last week's *CIO bulletin – June 27* and our *Outlook for 2021*).

However, after such a strong equity performance catalyzed by a "one-time" pandemic, we think that housing equities depend heavily on the new "status quo" where workers maintain a high degree of flexibility and mobility in their choice of work locations.

Figure 5: S&P 500 Homebuilders & Relative to S&P 500

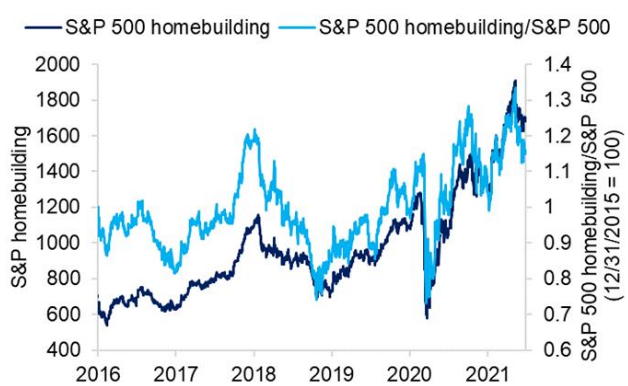
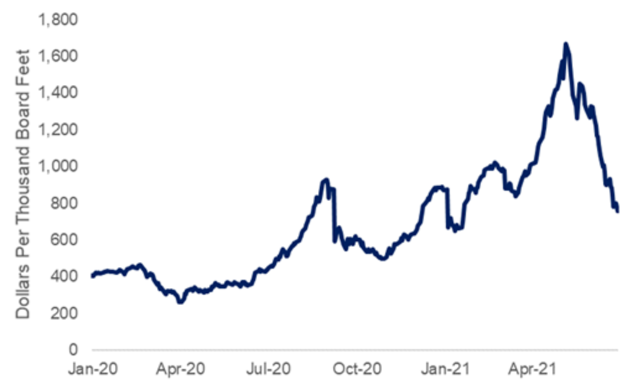


Figure 6: Lumber Futures Price



Source: Haver Analytics as of June 30, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Buyer Uncertainties Create Potential Homebuilder Headwinds

The Conference Board – a US business think tank – reports that 2.2% of US consumers intend to buy a new or pre-existing home in the next six months. This is not a particularly high level overall. With inventories dwindling and prices accelerating, only 0.4% of them say they would buy a newly constructed home (see figure 7). While this would seem to be a big concern for certain homebuilder shares, the data may be skewed by the uncertainties that employees face. As figure 8 shows, a record high share of consumers said they were "uncertain" as to what type of property they would buy. We believe that's because people are uncertain as to where they will have to work and what their commute will be.

Figure 7: New Homes Buying Plans Have Fallen Sharply

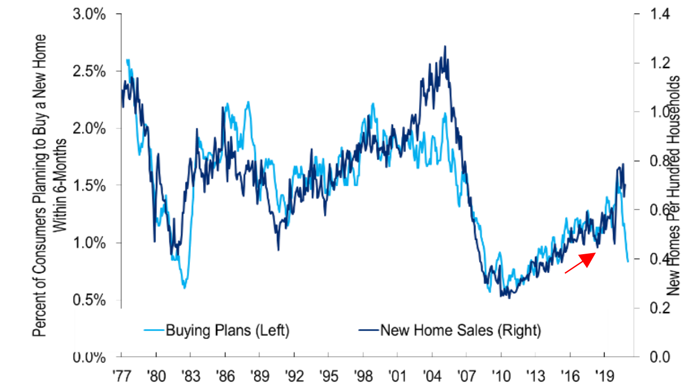
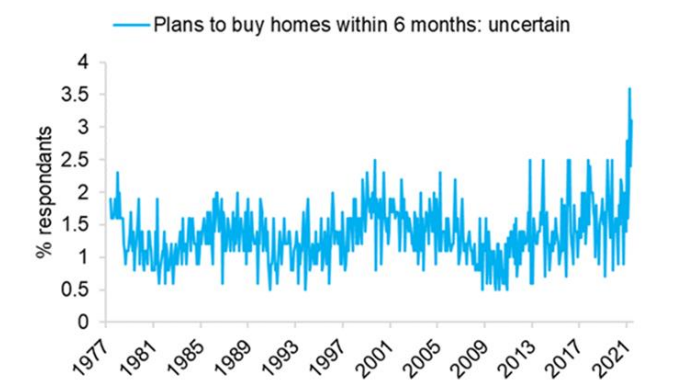


Figure 8: Record Uncertainty on Home Buying Decision (New or Pre-Existing?)



Source: Haver Analytics as of June 30, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Another headwind is home prices. The COVID impact is palpable with single-family home prices rising at a double-digit pace while national average rents are still falling (see figure 9). For now, rental costs are still falling in a few large urban centers like New York City, though we expect rents will broadly improve in smaller urban centers and the suburbs just outside (see figure 10).

Figure 9: US Home Prices vs Rent Y/Y%

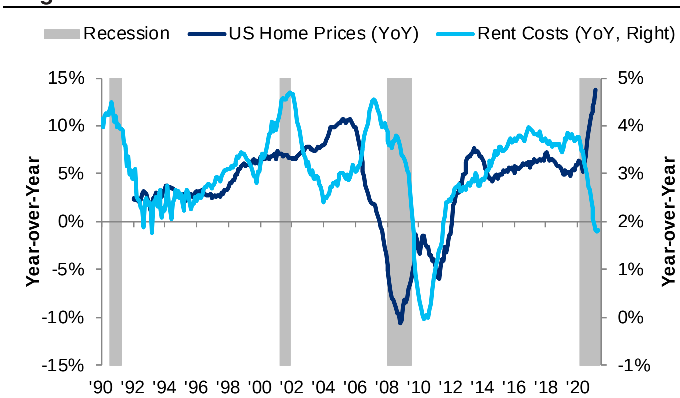
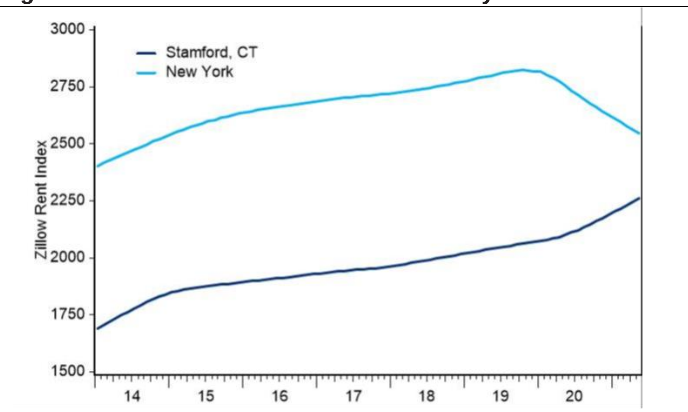


Figure 10: Urban Rent Index: New York City vs Stamford Ct



Source: Haver Analytics as of June 30, 2021. Note: Urban Rent Index from Zillow.com Rent Survey Data. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Implications for Equities

Both homebuilders and apartment REITS have had solid recoveries since last April, but apartment REITS have lagged the homebuilders by about 65 percentage points. Looking purely at rental assets, apartment REITS have lagged single-family rental REITS by 25 percentage points since end 2019 (see figure 11).

We believe a sharp “U-turn” to a five-day urban office commute for most workers would harm homebuilder shares and soften existing suburban housing markets. But that appears unlikely. Allowing for a couple days of flexibility could make a long commute more bearable, increasing the value of housing assets at even greater distances from urban centers.

Figure 11: Share Prices of US Homebuilders, Single-Family Rental REITS and Multi-Family Apartment Rental REITS

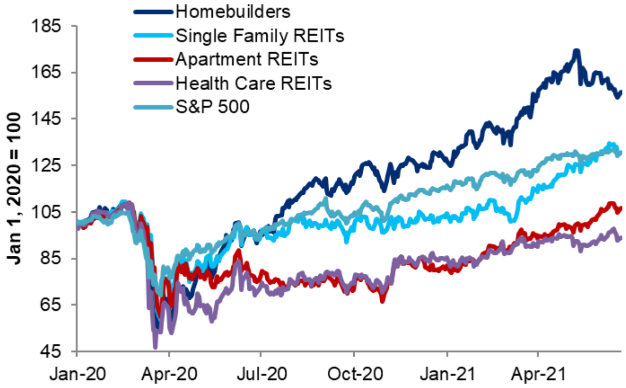
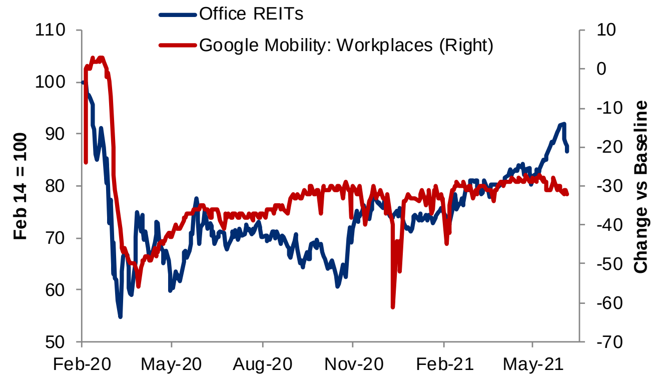


Figure 12: Share Price of Office REITs vs Google Workplace Mobility Index



Source: Bloomberg, Factset as of July 2, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Taking all these factors into consideration, we believe that homebuilder shares have achieved much of their gains with some upside for those that can accelerate and sustain higher new home construction levels. We believe that office REITS will see limitations on their recovery depending on the nature of their properties and locations (see figure 12).

Broadly speaking, portfolios of quality suburban office assets near large and medium-sized cities are likely to have better occupancies and rents than class B and C office space in major urban centers. This reflects the idea that "return to office" will also mean that office space closer to home will become preferable. In fact, the used of office to office video conferencing will likely become more prevalent as the number of days "everyone will be in the office" will become rarer.

Perhaps the biggest upside belongs to apartments and home REITS that will see sustained demand from those who cannot afford higher new and existing homes, or those who want to maintain maximum flexibility on their future location. Such REITS might also benefit if employers succeed in taking a hard line on returning to the "old normal" in urban centers.

However, as we discussed in our *Mid-Year Outlook 2021*, we are less inclined to believe that the post-COVID economy will resemble the pre-COVID economy in every respect. Knowledge learned and efficiencies gained during the pandemic shutdown should have lasting (if discrete) benefits. Remote work and a higher level of digital commerce are among them.

We've overweighted Real Estate assets *broadly* on their depressed valuation since June 2020. With a strong rebound in hindsight and a view that the role of real estate is changing with technology, it is increasingly becoming time to be more selective.