

OFFICE INDEX

THE LINGERING UNCERTAINTY

Only four months into 2023 and summarizing the year has been challenging due to the various conflicting results and perspectives. As anticipated, the economy, commercial real estate, and the office sector remain dynamic and difficult to forecast. Although the economy displays mixed signals, the general real estate outlook appears less than optimistic, and projections for the office sector have been particularly discouraging. Even though collectively, the tone seems more negative than positive this year, each point of view carries a weight of uncertainty.

Positively, the broader benchmarks have performed well through April, with a regained interest in more volatile technology stocks. The S&P 500 earning season has surprisingly outperformed 79% of analysts' expectations while recording its best relative performance since Q4 2021. Plus, April CPI year-over-year inflation declined slightly to 4.9%, below estimates and far better since the 9% peak in June 2022.

Despite those encouraging signs, talk of a potential recession and credit risk remains commonplace. The Federal Reserve Bank of Cleveland's April forecast predicts a 75.5% chance of a recession within a year, up over 10% from March. Meanwhile, the Federal Funds rate has been raised for the tenth time since March 2022, bringing the range to 5.0-5.25%. Additionally, three regional banks have already failed this year, underscoring concerns about credit risk. According to the April 2023 Senior Loan Officer Opinion Survey, mid-sized banks expressed greater concern and implemented stricter standards for all CRE loans than larger banks. To add to all of that, an ongoing political party disagreement over the debt ceiling raises the possibility of a potential default on the US financial obligations.

Even with conflicting messages, commercial real estate is a top institutional investor concern, with the office sector facing the most significant challenges. Tenant givebacks have pushed vacancy to a record 13.0%, and cyclical economic forces suggest a rapid slowdown in employment growth. Firms are bracing for a potential recession by foregoing space, resulting in decreased leasing volume and shrinking lease sizes. The leasing and capital markets are stagnant, and the commercial office market faces pressure from multiple directions.

NPI index returns follow this direction as office total returns fell 4.06%, mainly due to a negative appreciation return of 5.20%. However, income returns had a slight uptick at 1.14% over the last four quarters. The drop in value has been consistent for over a year, resulting in a year-over-year decline of 12.72%. The total returns for CBD and suburban offices were down 4.96% and 3.00%, respectively. Suburban office investment continues to outperform CBD in total, appreciation and income returns. Regionally all total returns were in the red, excluding Midwest suburban offices, up 23 basis points overall.

With more than \$900 billion of commercial real estate loans maturing through 2024 and interest rates continuing to rise, finding an exit strategy that won't be damaging is challenging. Refinancing has become even more demanding as the banking instability will limit opportunities. Overall, it seems probable that there will be additional cuts in commercial real estate valuations, which will increase the difficulty for new borrowers and those who need to refinance. Property owners and financiers should contemplate improving their protocols and systems if the uncertainty turns into what is expected.

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OFFICE TOTAL RETURNS

	Total NPI	Total Office	East	Midwest	South	West
1st Q 2023	-1.81	-4.06	-4.03	-3.39	-2.67	-4.67
4th Q 2022	-3.50	-4.80	-4.86	-3.51	-3.66	-5.30
One Year	-1.63	-8.75	-9.02	-8.85	-5.76	-9.42
Three Years	7.15	-0.45	-1.12	-1.40	0.89	0.02
Five Years	6.71	2.25	1.03	0.94	3.41	3.50
Ten Years	8.34	5.65	4.30	4.23	6.39	7.26
Twenty Years	8.43	6.76	6.51	4.60	6.62	7.71

OFFICE INCOME RETURNS

	Total NPI	Total Office	East	Midwest	South	West
1st Q 2023	1.01	1.14	1.05	1.24	1.30	1.16
4th Q 2022	0.95	1.06	1.03	1.19	1.14	1.05
One Year	3.92	4.38	4.15	4.78	4.91	4.42
Three Years	4.08	4.41	4.15	4.49	4.99	4.50
Five Years	4.26	4.43	4.15	4.55	5.07	4.51
Ten Years	4.64	4.64	4.34	5.23	5.44	4.65
Twenty Years	5.49	5.51	5.30	6.06	6.09	5.45

OFFICE APPRECIATION RETURNS

	Total NPI	Total Office	East	Midwest	South	West
1st Q 2023	-2.82	-5.20	-5.09	-4.63	-3.97	-5.83
4th Q 2022	-4.45	-5.86	-5.89	-4.69	-4.79	-6.35
One Year	-5.39	-12.72	-12.76	-13.15	-10.29	-13.39
Three Years	2.98	-4.71	-5.12	-5.70	-3.96	-4.33
Five Years	2.37	-2.11	-3.03	-3.49	-1.61	-0.98
Ten Years	3.58	0.97	-0.04	-0.96	0.91	2.53
Twenty Years	2.83	1.20	1.16	-1.39	0.50	2.17

OFFICE INDEX—QUARTILE RANGE OF RETURNS

