THE REAL ESTATE SECTOR: A TALE OF TWO MARKETS

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There are some preliminary data pointing to an early recovery in the housing market. Mortgage applications to purchase a home have been in a consistently rising trend over the past seven weeks. Anecdotally, realtors and builders are reporting an increase in buyer traffic. Both home sales and new construction have been stronger than expected, and appear to be gathering momentum. Most surprising is the strong rebound in sales of newly built homes, which increased at an estimated 25% annual rate in May.

Summary and Major Conclusions:

- The central theme of this report is that the US real estate market is likely to witness powerful crosscurrents in coming years. While the fundamentals of the commercial property market are expected to steadily deteriorate, the outlook for residential real estate is favorable, especially for single-family dwellings.

- Housing market fundamentals were excellent prior to the COVID-19 outbreak because of a very favorable balance between supply and demand. Demand was supported by historically low mortgage rates and excellent mortgage credit quality. The outlook for the single-family market was especially bright.

- However, residential construction has suffered a major but temporary setback from the nationwide lockdown. Housing starts and new permits declined precipitously in April, as did home sales. Real estate prices have weakened, albeit modestly thus far.

- There is some very preliminary data signaling an early recovery in the housing market. Mortgage applications to purchase a home have been in a consistently rising trend over the past seven weeks. New home sales rose at a 25% annual rate in May.

- There is also anecdotal evidence that housing market conditions stabilized in late April and have begun a tentative recovery during May. Both homebuilders and realtors have reported an uptick in buyer traffic in recent weeks, especially for properties in secondary and tertiary cities.

- While the short-term outlook is uncertain, the long-term fundamentals of the housing market remain extremely favorable. With the exception of the 2008 Great Recession, spending on housing and autos has consistently led the economy out of recessions, using data back to 1950.

- The most compelling factors in support of a strong recovery in housing in coming years pertain to mortgage rates, demographics, affordability, lifestyle preferences, and an unprecedented shortfall in the supply of homes relative to demand.

- At less than 3%, mortgage rates are at an all-time low and should fall further in coming months. The current market yield on the ten-year US Treasury bond of 0.85% is consistent with a rate of 2.75% on 30-year conventional fixed-rate mortgages.

- The market for single-family homes is the tightest it has been in many decades. At only 1.5 million, the supply of existing homes for sale is at an all-time low, the equivalent of only three months of supply, one-half the long-term average monthly supply of six months.

- As opposed to the high-priced segment of the market, the supply of entry-level and medium-priced homes is especially tight. The homeowner vacancy rate is currently 1.1%, the lowest level on record, and in a long-term declining trend.

- Demographic factors are also supportive of strong demand. Although household formation is likely to suffer a setback in the very short term, the long-term uptrend remains positive.

- The shortage of entry-level single-family homes could be compounded by the rapid growth in the number of those aged 24 to 39. At 72 million, the millennial generation will be the primary driver of housing demand. At the same time, older homeowners are increasingly reluctant to downsize to an apartment or senior living facility.

- In theory, the coronavirus pandemic could accentuate the demand for single-family homes, especially those located in the suburbs and satellite cities and away from large cities. The demand for apartments in densely populated urban centers has weakened precipitously since the pandemic began.

- A potential exodus from major metropolitan centers could be reinforced if working-from-home arrangements become more lasting and widespread. There is already evidence that a shift away from big cities and toward towns and smaller cities is underway, as aging millennials are forming families at an accelerating pace.

- The current shelter-in-place experience could result in an increase in consumer spending on housing. New construction will benefit relative to existing homes as consumers demand innovative floor plans and technological advancements, including home automation and in some cases a home office and a gym.

- In stark contrast with the single-family market, the outlook for the commercial property market has worsened significantly since the COVID-19 outbreak began. The basic fundamentals of the property market were already weakening prior to the outbreak, mainly due to massive overbuilding and inflated prices.

- Inflated property prices are reflected in historically low capitalization (cap) rates, as rental income has not kept pace with rising property values. Cap rates for office properties declined from nearly 10% earlier this century to only 5% in recent years.

- All commercial property types are at risk. The demand for office space is vulnerable if remote employment becomes the new normal for large companies. Shopping malls are vulnerable to an acceleration in the growth rate of online shopping. And hotels are at risk as business and leisure travel remains depressed.

- Real estate investment trusts (REITs) have significantly outperformed the overall market in the years ending in 2019, as investors were captivated by the sector's attractive dividend yield and domestic orientation. The medium-term outlook is poor, assuming rents, operating income, and property prices decline as I expect.

- In sharp contrast, investment opportunities associated with single-family home construction are positive. Despite strong performance in recent months, shares of the large national homebuilders should continue to outperform the broad equity market over the next one to two years.

What is the outlook for the US real estate market? The answer, of course, always depends upon factors pertaining to location. However, there is an even greater consideration: Residential versus commercial real estate. This week's *Economic Perspective* examines the key drivers of the US real estate market and provides a summary of investment implications.

The central theme of this report is that the two segments of the US real estate market are likely to move in different directions in coming years. Whereas the fundamentals of the commercial property market are expected to weaken, the outlook for residential real estate is favorable, especially for single-family dwellings.

Housing market fundamentals were favorable prior to the pandemic, with single-family supply and demand in excellent balance. Mortgage rates were historically depressed and mortgage credit quality was as good as it gets. *The outlook for the single-family market was especially bright*. Conversely, following a very robust recovery over the past decade, fundamental trends within the commercial office, retail, lodging, and apartment markets have steadily deteriorated.

Coronavirus Effect: The coronavirus pandemic has triggered a collapse in real estate markets, both residential and commercial. Residential construction has suffered a major but temporary setback from the nationwide lockdown. Housing starts and new permits declined precipitously in April, as did home sales. Real estate prices have weakened, albeit modestly thus far, but further price declines are likely.

Chart 1: Mortgage Applications Have Been Rising For Two Months
Index of Mortgage Applications for Home Purchase
Source: Mortgage Bankers Association

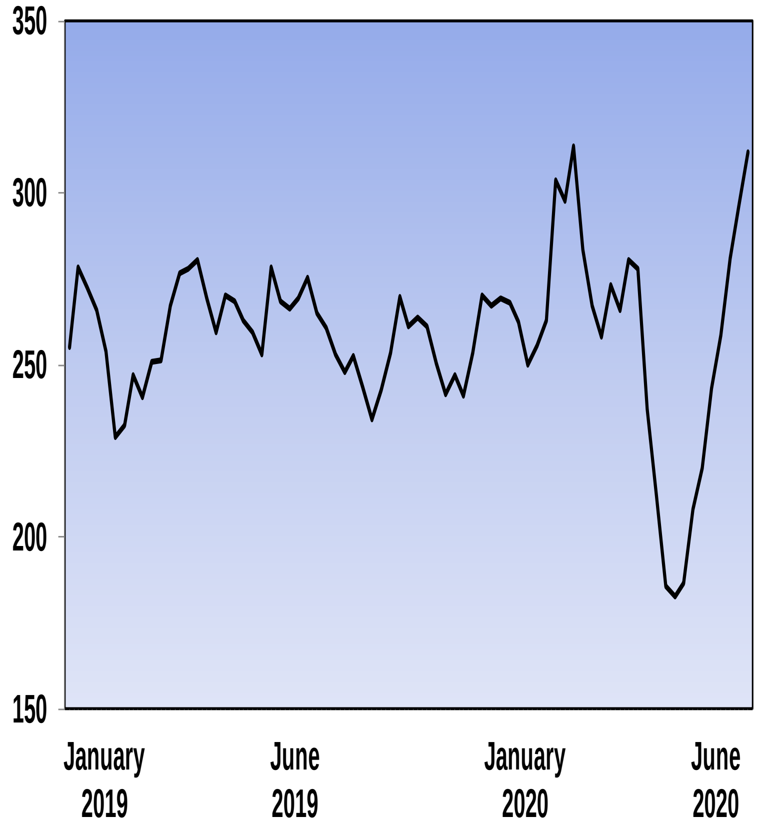
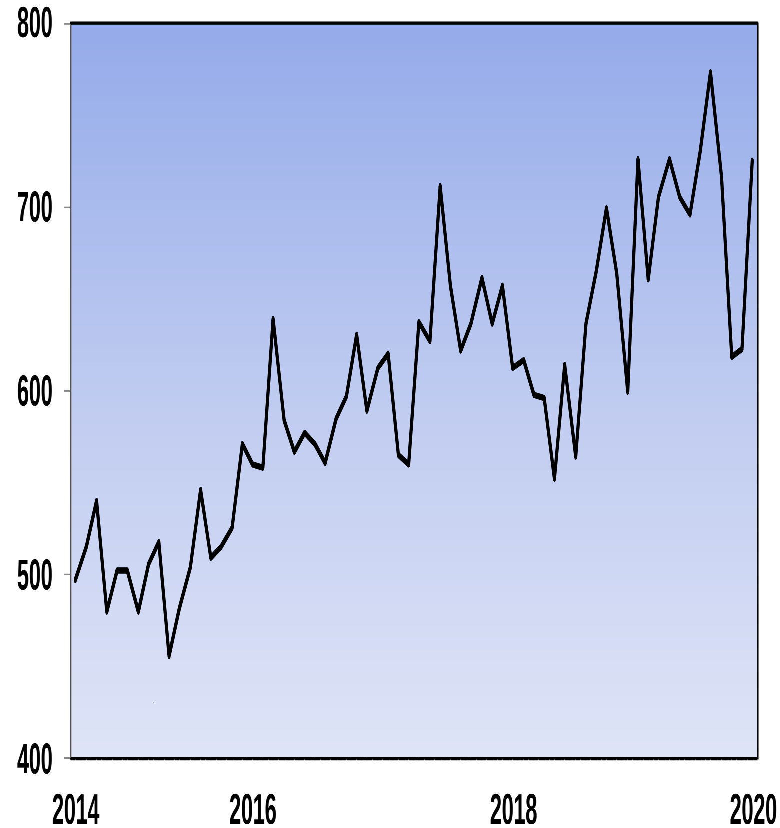


Chart 2: Strong Rebound in Sales of Single-Family New Homes
New Single-Family Home Sales (Thousands)
Source: US Census Bureau



RESIDENTIAL REAL ESTATE

There are some preliminary data pointing to an early recovery in the housing market. *Mortgage applications to purchase a home have been in a consistently rising trend over the past seven weeks* (see chart 1). There is also anecdotal information signaling a moderate revival in housing market conditions. Both home sales and new construction have been stronger than expected, and appear to be gathering momentum. Most surprising is the strong rebound in sales of newly built homes, which increased at an estimated 25% annual rate in May (see chart 2).

Buyer Traffic: Both realtors and homebuilders have reported an uptick in buyer traffic in recent weeks, especially for properties in secondary and tertiary cities. *From a historical perspective, spending on housing (and autos) has led the economy out of recessions for all business cycles dating back to 1950* — with the obvious exception of the recovery from the 2008 financial crisis and housing bubble (see chart 3).

Chart 3: New Home Construction: A Classic Leading Economic Indicator
Housing Starts, Hundreds of Units
Source: US Census Bureau

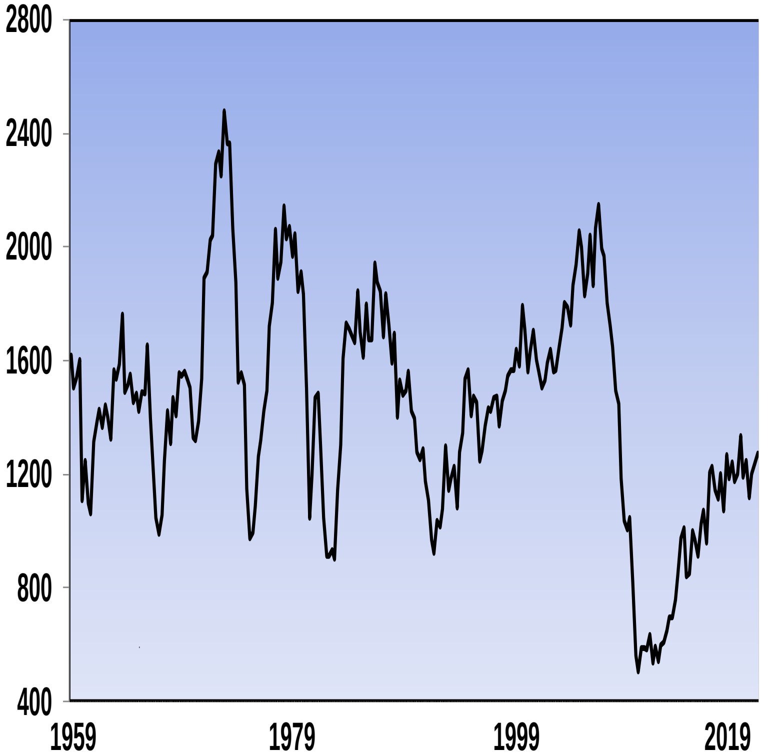


Chart 4: Mortgage Rates at an All-Time Low
Commitment Interest Rate (%)
30-Year Conventional Fixed-Rate Mortgage
Source: Freddie Mac

Long-Term Prospects: While the short-term outlook is cautiously optimistic, long-term fundamentals of the housing market remain extremely favorable. The most compelling factors in support of strong growth in the housing market pertain to mortgage rates, demographics, affordability, lifestyle preferences, and an unprecedented shortfall in the supply of homes relative to demand.

- **Mortgage Rates**: At approximately 3%, mortgage rates for conventional 30-year fixed-rate mortgages are near all-time lows and are poised for further declines. The current market yield on the ten-year US Treasury bond of 0.85% is consistent with a rate of 2.75% on 30-year conventional mortgages (see chart 4).

- **Severe Supply Shortage**: The market for single-family homes is the tightest it has been in decades. At only 1.5 million, the supply of existing homes for sale is at an all-time low, the equivalent of only three months of supply, and one-half the long-term average monthly supply of six months (see chart 5).

- **Homeowner Vacancy Rate**: As opposed to the high-priced segment of the market, the supply of entry-level and medium-priced homes is especially tight. The homeowner vacancy rate is currently 1.1%, the lowest level on record, and in a long-term declining trend (see chart 6).

Chart 5: Supply of Homes For Sale at an All-Time Low
Existing Homes for Sale (Millions of Units)
Source: National Association of Realtors

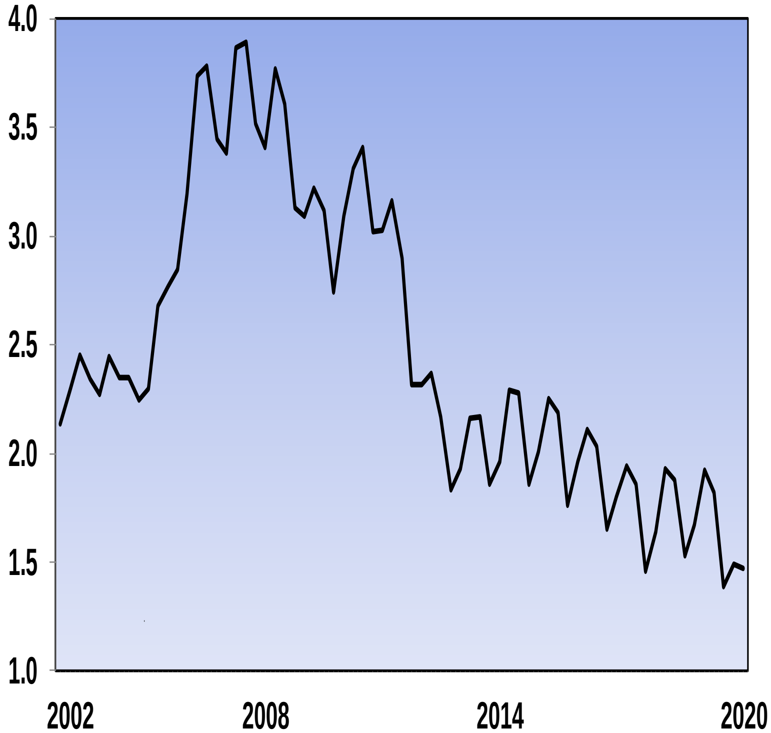
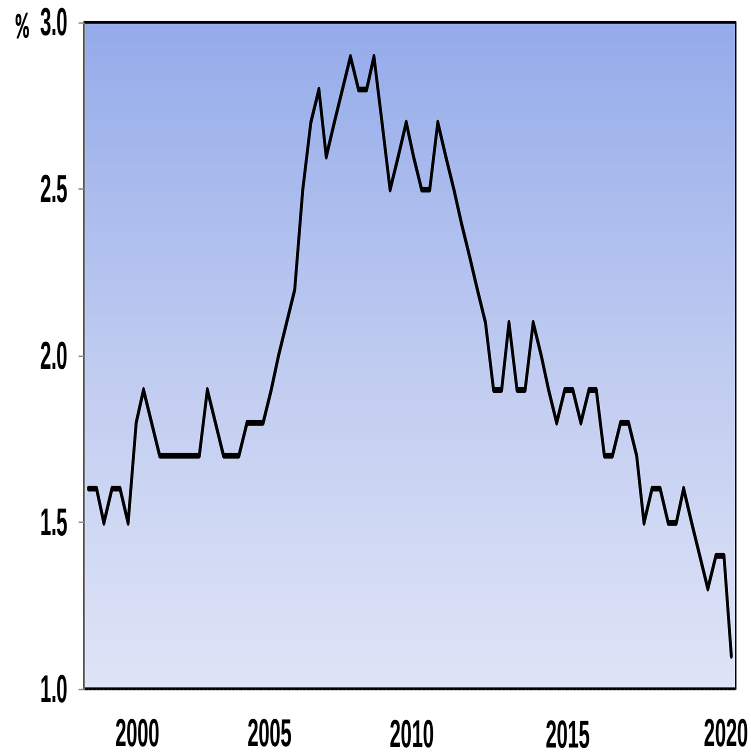


Chart 6: Homeowner Vacancy Rate at an All-Time Low
Vacancy (%) Rate for Single-Family Homes for Rent
Source: US Census Bureau



- **Affordability**: The housing affordability index is in an improving trend. Although down from its all-time peak in 2012, affordability remains nearly 15% above its long-term average. Plunging mortgage rates and flat house prices have contributed to the recent improvement in affordability.

- **Life-Cycle Patterns**: Demographic factors are also supportive of strong demand. Although household formation is likely to suffer a temporary setback in the short term, the long-term uptrend remains positive. The biggest factor is that millennials are getting married, having children, and moving from metropolitan centers to towns and small cities.

- **Millennial Generation**: The critical shortage of entry-level single-family homes could be compounded by the rapid growth in the millennial generation. At 72 million, the number of young adults in the 24 to 39 age group will be the primary driver of housing demand. At the same time, older homeowners are remaining in their homes longer than previous generations, increasingly reluctant to downsize to an apartment or senior housing facility.

- **Single-Family Segment**: Within the overall housing market, homeownership is expected to increase at the expense of rentals. And within homeownership, the demand for newly built single-family homes should outpace the demand for existing homes.

- **Pandemic Effect**: The current shelter-in-place experience could result in an increase in consumer spending on housing, especially as people continue to spend more time at home. _New construction will benefit relative to existing homes as consumers demand innovative floor plans and technological advancements_, including home automation, and in some cases, a home office and a gym.

The bottom line is that the outlook for single-family home construction appears quite favorable. An analysis of basic supply and demand strongly suggests that residential construction will lead the US economy out of recession as it has in virtually all previous business cycles since 1950. _Even more importantly, the recovery should be durable, implying that single-family home construction could be on a solid growth path for many years, with positive implications for economic growth_.

COMMERCIAL REAL ESTATE

In stark contrast with the single-family market, the outlook for the commercial property market has worsened significantly since the COVID-19 outbreak. The basic fundamentals of the property market were already weakening prior to the outbreak, mainly due to massive overbuilding and inflated prices.

- **Historically Low Cap Rates**: Inflated property prices are reflected in historically low capitalization (cap) rates, as rental income has lagged property values in recent years. Cap rates for office properties declined from nearly 10% earlier this century to only 5% in recent years, pushing prices to overvalued extremes.

Property Types: All commercial property types are at risk. The demand for office space is vulnerable if remote employment becomes the new normal for larger companies. Shopping malls are vulnerable to an acceleration in the growth rate of online shopping. And hotels are at risk as business and leisure travel remains depressed. The industrial warehouse segment of the market is at somewhat lower risk.

INVESTMENT IMPLICATIONS

Real estate investment trusts (REITs) have significantly outperformed the overall market in the years ending in 2019, as investors were captivated by the sector's defensive characteristics, domestic orientation, and attractive dividend yield. However, investment prospects for the property market have darkened in recent months. The medium-term outlook is especially poor, based upon the assumption of a declining trend in rents, operating income, and prices. I expect the real estate sector within the S&P 500 to be a market laggard over the next two years.

Conversely, investment opportunities with respect to residential construction are quite favorable. An extreme shortage of existing homes for sale implies several years of solid growth in new construction as builders respond to pent-up demand, especially for entry-level homes. Moreover, the largest national homebuilders should gain significant market share as a result of widespread failures of local mom-and-pop builders. In spite of strong performance in recent months, homebuilding stocks should continue to outperform the broad equity market over the next one to two years, supported by both strong growth in operating earnings and rising valuations.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

The financial indices referenced herein are provided for informational purposes only. You cannot invest directly in an index. The statistical data regarding such indices has been obtained from sources believed to be reliable but has not been independently verified.

Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: The S&P 500 or Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

S&P 500 Equal Weight Index (EWI) Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

Value Line Index is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.