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CIO Weekly Commentary
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CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Commercial real estate not vacant of opportunity

Bottom line up top

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On behalf of Nuveen's Global Investment Committee

As Nuveen's CIO and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm's most senior investment leaders to deliver our best thinking and actionable investment ideas. In addition, she chairs Nuveen's Equities Investment Council and is a portfolio manager for several key investment strategies.

Headwinds aren't blowing the house down. In a modern-day economic adaptation of a centuries-old fable, one could argue that today's housing market appears as structurally sound as a house made of bricks. Despite fluctuating mortgage demand, which tends to fall when interest rates rise, some data points released last week highlighted continued resilience in the U.S. housing market:

- **Building confidence.** The National Association of Home Builders Index, which measures homebuilder sentiment, improved for the fifth month in a row, continuing its climb from a rate-hike cycle low of 39 in December to 50 in May — a level not seen since last summer.

- **Breaking ground on new homes.** Housing starts ticked up 2.2% in April, reaching an annualized pace of 1.4 million, versus 1.37 million in March. Starts for apartments were particularly strong at 5.2%, surpassing the 1.6% increase for single-family homes.

Sturdiness in the new-home market, however, has come at the expense of a rickety existing-homes counterpart. Last week, the National Association of Realtors reported a sharp decline in existing home sales and prices in April. A lack of inventory is the main culprit, as the current supply of existing homes is only about half of what's normally considered a healthy level.

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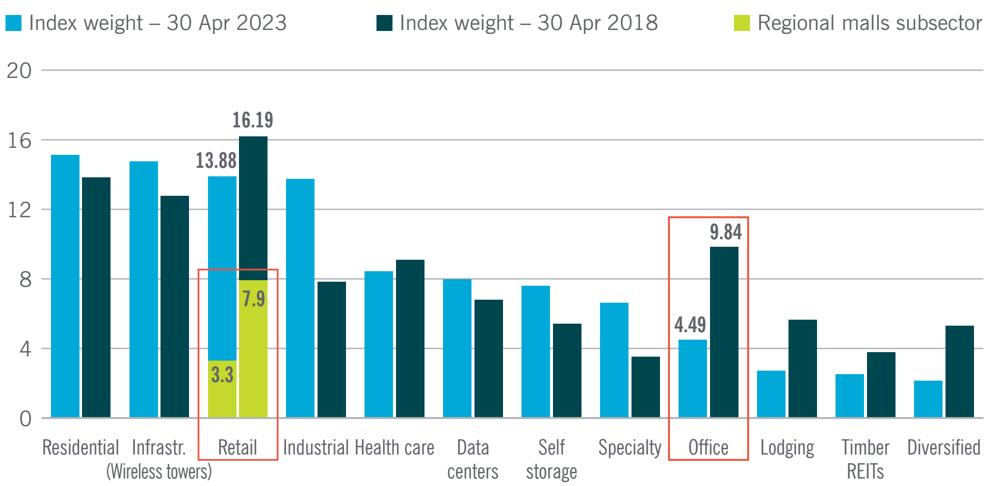
But will higher interest rates and empty offices be the final straw for commercial properties? Banking system instability, still-elevated interest rates and high vacancies in office buildings have been hogging the headlines in commercial real estate. Some of these concerns may be disproportionate to the degree of actual risk reflected in the broad commercial real estate asset class. In public markets, for example, office and regional mall properties, which together accounted for nearly 20% of the FTSE Nareit All Equity REITs Index five years ago, have each seen their weightings cut in half, to just 4.5% and 3.3% of the index, respectively (Figure 1). Meanwhile, the industrial, data centers, wireless towers and self-storage sectors have grown increasingly important thanks to prudent use of debt and strong cash flow growth.

FIGURE 1: REGIONAL MALLS AND OFFICE WEIGHTINGS SHRINK

Property sector composition FTSE Nareit All Equity REIT Index (%)



Data sources: FactSet, FTSE™, Nareit. As of 30 April 2023: "residential" property sector comprised of three subsectors: apartments (10.08%), single family home rentals (2.55%) and manufactured homes (2.50%); "retail" property sector comprised of three subsectors: free standing (5.66%), shopping centers (4.91%) and regional malls (3.32%). As of 30 April 2018: "residential" property sector comprised of three subsectors: apartments (10.98%), single family home rentals (1.28%) and manufactured homes (1.57%); "retail" property sector comprised of three subsectors: free standing (3.33%), shopping centers (4.99%) and regional malls (7.87%).

Portfolio considerations

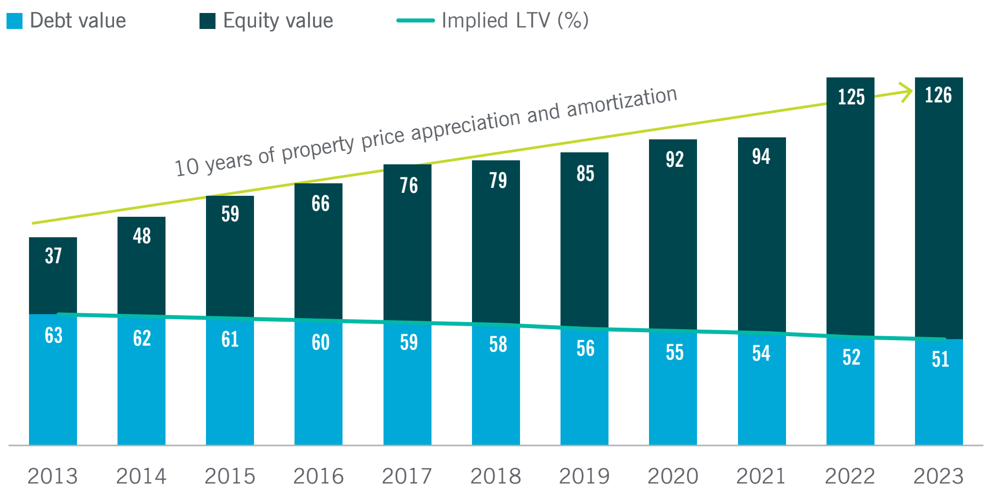
Under the microscope, not under the bus. This spring's banking sector turmoil has investors casting a wary eye on commercial mortgage-backed securities (CMBS). A dose of caution is understandable given the risks associated with commercial real estate debt on regional bank balance sheets. But while CMBS faces headwinds from slowing economic activity — and, more acutely, challenges in the office property sector — assessing the relative value of specific securities is best achieved through focused scrutiny rather than sweeping generalizations.

In our view, many investment grade tranches of fixed-rate deals maturing in the next one to three years look attractive. History shows that CMBS issued at least three years before the 2008-09 global financial crisis experienced much smaller losses than those issued just prior to its onset. Although there are no guarantees, this pattern may repeat itself during the likely upcoming recession. One reason for this: CMBS has benefited from both substantial property value appreciation over the past 10 years (Figure 2) and gradual amortization of outstanding debt. Debt issued earlier in an economic expansion tends to be relatively safer than debt issued near the end of a market cycle.

> ***We also see opportunities in floating-rate CMBS within more defensive property sectors like industrial and multifamily.***

FIGURE 2: CMBS DEBT HAS BENEFITED FROM PROPERTY VALUE APPRECIATION

Average 2013 CMBS loan de-levering



Data source: Morgan Stanley and Real Capital Analytics, 01 Jan 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

We also see opportunities in floating-rate CMBS within property sectors we deem more defensive, such as industrial and multi family. Floating-rate debt can offer attractive yields, and property revenues in those two sectors in particular have benefited from inflation. Additionally, fundamentals across the industrial sector are healthy, with vacancy rates below their long-term pre-pandemic averages in 49 of the top 50 U.S. cities. Among specific industrial property types, e-commerce related real estate should continue to perform well, as online shopping growth boosts demand for warehouse and distribution space to fulfill orders. As for multi family, rising home ownership costs mean that renting versus buying is very attractive. And more than a decade of underbuilding has created a cumulative deficit of several million homes, equivalent to about three years of new housing production.

As for the office sector, we see pockets of value. We're not optimistic on the sector overall, but we are finding opportunities in select deals that have repriced materially lower, largely due to market sentiment. We favor the highest-quality (class A+) properties that are able to retain and attract tenants paying top-of-market lease rates. Yields for investment grade office bonds are in the low-double digits — far higher than for other property types.

Although we're not optimistic on the office sector overall, it offers pockets of value.

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Regular meetings of the GIC lead to published outlooks that offer:

- macro and asset class views that gain consensus among our investors
- insights from thematic "deep dive" discussions by the GIC and guest experts (markets, risk, geopolitics, demographics, etc.)
- guidance on how to turn our insights into action via regular commentary and communications

For more information, please visit nuveen.com.

Endnotes

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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