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BETTER OFFICE RETURNS BUT SOFTER FUNDAMENTALS

For the commercial office sector, the first quarter is usually the weakest quarter of the year, and not surprisingly Q1 2018 showed muted results. According to CBRE EA the U.S. office vacancy rate increased by 14 bps, due to continued uptick in construction and moderate demand. The 5.8 million sq. ft. of space that was absorbed across the CBRE EA Sum of Markets, is the lowest level since Q1 2013. On other hand, rising rents and strong demand for office space in the past few years gave momentum to new construction. First quarter multi-tenant completion volume was 12.6 million sq. ft., the largest quarterly volume since the end of the Great Recession.

Although divergence between supply and demand has produced an increase in vacancy, the rate remains at one of the lowest levels since the recession. With the economy adding fewer jobs than expected for two consecutive months, we will need to monitor the pace of employment growth and office absorption in the coming quarters to judge the direction of market fundamentals.

On the investment side, Q1 2018 office total returns took the second spot after industrial, which continues to outperform all other property types. It was the highest office total return within a year and mainly driven by improved appreciation return, while income return lagged other property types except for apartment. Total returns were largely driven by the South and West regions, which showed persistent strength over the East and Midwest in the past year. This regional growth is consistent with economic fundamentals, where according to Bureau of Labor Statistics, annual employment growth in South and West outperformed East and Midwest.

After suburban total return outperformed CBD for three consecutive quarters, CBD and suburban total returns converged. This convergence is largely due to the rising appreciation returns in the CBDs. At the same time, according to Real Capital Analytics, in Q1 2018 office transaction volume declined by 20.1% year-over-year for CBD and by 6.4% for suburban properties. The share of suburban volume has been on the rise in past 3 years. Traditionally suburban volume tends to capture larger share in the mid-to-late cycle, as suburban properties give expanding economy room to breathe, and spur transaction activity.

We would expect balanced office investment performance in 2018, prompted by strong economic fundamentals and low probability of occurrence of the event that may disrupt U.S. economic growth. Recently enacted tax reform is also expected to be positive for employment growth in the short run. Even though office completion volume reached a post-recessionary high, in absolute terms it is well below the two previous cyclical peaks. In general, current metro-level supply is well matched with demand. From other side, rise of interest rates may put upward pressure on cap rates, moderating appreciation returns. Overall, old challenges and new prospects such as advent of flexible office model, can make navigating the commercial office market more complex in the coming years, requiring new research methods and techniques to assess market risk and to find opportunity.

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