SPECIAL REPORT

Marcus & Millichap

IMPLICATIONS OF THE INVASION OF UKRAINE ON COMMERCIAL REAL ESTATE

MARCH 2022

Ukraine Crisis to Reverberate Across Global Economy
U.S. Real Estate Positioned to Withstand Impacts

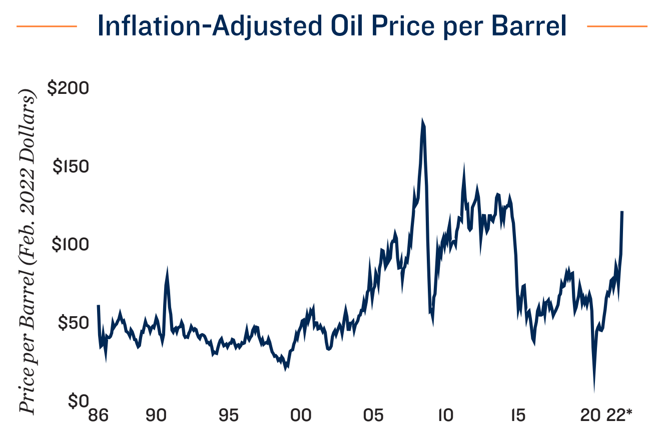
The humanitarian, social and political crisis unfolding in Ukraine has begun to deliver some economic fallout in both global and United States markets. Oil prices have surged, the stock market moved into correction territory and a flight-to-safety pushed interest rates lower. As the war plays out over the coming days, weeks or perhaps months, a wide range of economic consequences could emerge. Setting aside worst-case scenarios, the war in Ukraine likely holds little direct risk to U.S. commercial real estate. Although some ripples will likely be felt by investors, hard assets have historically demonstrated durable results in times of turbulence and uncertainty.

Inflation Risks Intensify as Oil Prices Surge

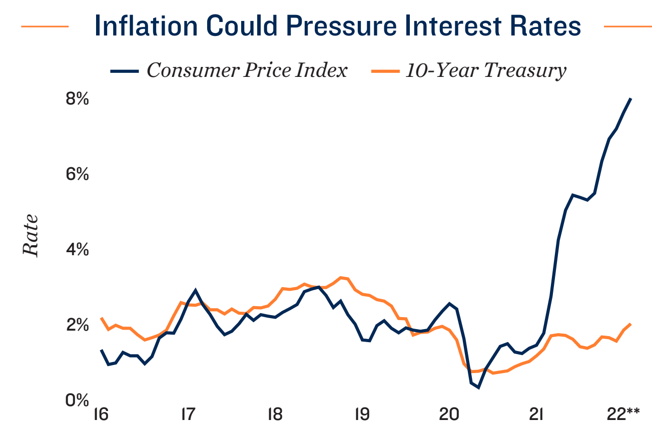
War having clear and immediate impact on energy costs. Russia is one of the world's top oil producers, delivering about 12 percent of the global supply, and oil is the country's most valuable export. The financial sanctions already placed on Russia in the wake of their invasion of Ukraine, together with the U.S. oil boycott and rising global public pressure to shun Russian products, will weigh on the country's ability to export oil. This is placing new strains on global oil supplies, sparking a surge in energy prices. Oil prices were already on the rise, prior to the invasion. At the start of 2022, oil was in the $75 per barrel range, but rose by 20 percent through Feb. 23 — the day before the invasion started. Since the war began, oil prices have jumped. Prices reached the $120-$130 per barrel range following the announcement of the U.S. oil boycott on March 8, more than 60 percent higher than at the start of the year. The dramatic surge has already impacted gasoline prices, pushing the U.S. average to a new record high above the $4 per gallon threshold. Beyond the gas pump, rising oil prices will drive increased inflation, as costs of manufacturing, transportation, plastics and other products are pulled higher. The magnitude and duration of this inflationary increase will largely depend on how the war and sanctions play out, but U.S. inflation could be boosted by 1-2 percent this year, according to some estimates. With U.S. headline inflation already at a 40-year high of 7.9 percent before the war started, rapid oil price escalations could place significant additional pressure on the American economy.

Increasing fuel production comes with host of hurdles. If oil shortages amplify, international strategic reserves will be tapped to cover the short-term needs. Over the longer term, U.S. energy companies could ramp up production by an estimated 600,000 barrels per day, on top of the 11-12 million barrels the U.S. currently produces. Other countries that could potentially increase production include Iran, Iraq, Saudi Arabia, the United Arab Emirates and Venezuela, but increasing output would likely face significant political or infrastructural headwinds. Even in the U.S., ramping up production will face logistical hurdles, including labor and equipment shortages, that reiterate the challenges faced by the sector. Higher extraction costs mean the newly added oil only makes sense to sell when prices are elevated.

Inflation-Adjusted Oil Price per Barrel



Inflation Could Pressure Interest Rates



* Through March 9
** Through February
Sources: BLS; Federal Researve; U.S. Energy Information Administration

Interest Rates Face Complex Outlook Amid Monetary and Financial Cross-Currents

Fed's balancing act just became more complicated. The Federal Reserve faces a new set of challenges in its battle with inflation, as the war in Ukraine introduces a range of new variables. The stock market correction, with an ensuing flight-to-safety, placed downward pressure on long-term interest rates, while expectations of Fed rate hikes have applied upward pressure on short-term rates. This combination has flattened the yield curve, narrowing the gap between the long and short-term yields. With climbing oil prices adding to the rising inflation outlook, the Federal Reserve faces the difficult prospect of slowing price growth without inducing a recession, or even worse, stagflation.

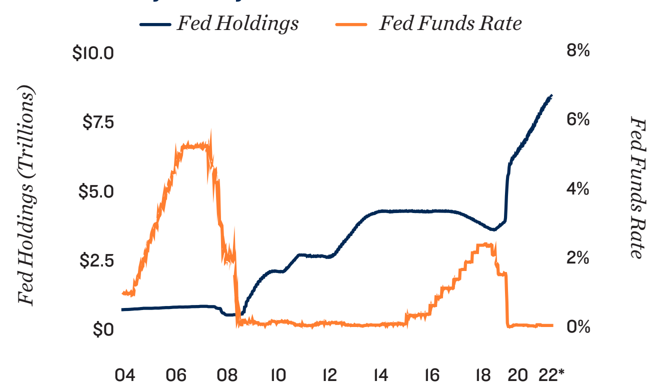
Consumer sentiment key to stagflation risk. Prior to Russia's invasion of Ukraine, the prospects of stagflation — where inflation is high but real economic growth stalls — were nominal. Despite this, the added pressure created by rising fuel prices and a potential yield curve inversion, in conjunction with the ongoing labor shortage and supply chain problems, could dampen economic growth. Much will depend on consumers, as they drive two-thirds of the economy. Consumer confidence has been sagging under the pressure of the last two COVID-19 waves, but with the omicron variant in retreat and mask mandates ending across the majority of the country, a consumption revival could be on tap for the summer. While rising consumer demand could add to inflationary pressure, it would also sustain economic growth, mitigating stagflation risks.

Multiple policy tools still on the table for the central bank. The Federal Reserve has reiterated its commitment to raising the overnight rate by 25 basis points on March 15, but plans beyond that are likely fluid, as Fed leaders closely monitor market conditions. Raising interest rates is the most prominent tool available in the Federal Reserve's efforts to rein in inflation, but it tends to be a slow process. Moving the overnight rate will become increasingly difficult if the yield curve remains flat, potentially pushing the Fed to favor quantitative tightening — the sell-off of Fed assets, such as long-term bonds and mortgage-backed securities. Quantitative tightening would reduce the Fed balance sheet, which doubled during the pandemic, while also putting upward pressure on long-term interest rates, like the 10-year treasury. Implicit to that strategy would be higher borrowing costs for commercial real estate investors.

Current conditions partially tighten capital liquidity. In light of added uncertainty, lenders have begun to assume a more cautious stance. Some financiers have begun to reopen their spreads and tighten their leverage requirements. Thus far, the movement has not been significant or broad-based, but if the war in Ukraine escalates, either militarily or through cyberattacks, lenders may adopt a more conservative posture. This implies that even though uncertainty can place downward pressure on Treasury rates, mortgage rates could still rise. Given that commercial real estate lending rates are currently still very low by historical standards, rates would have to rise by more than 100 basis points before a substantive share of investors begin to recalibrate their acquisition strategies, according to a recent investor survey.

Yield Spread Tightening

Monetary Policy Accommodative in Pandemic



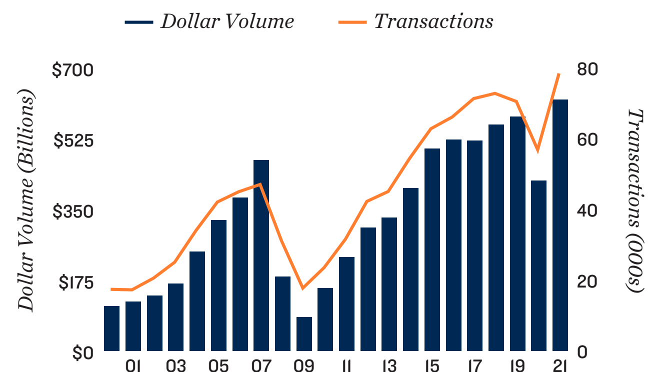
** As of March 9*
Source: Federal Reserve

Inflation Resistance and Stability Underpin Real Estate Advantage

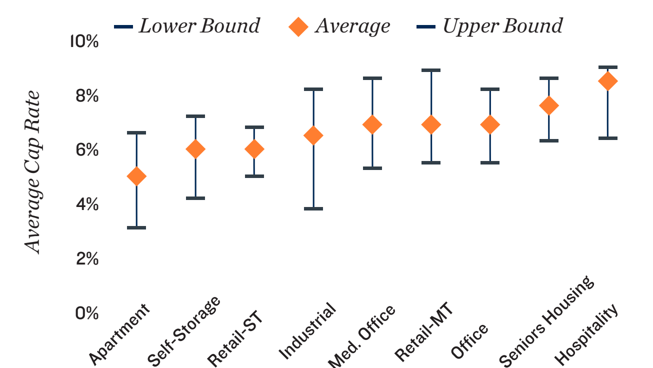
Macroeconomic factors highlight real estate attributes. The increasingly complex geopolitical, economic, financial market and inflation landscapes have aligned to reinforce the investment advantages of commercial real estate. Many of the factors weighing on the economic outlook and driving inflation, such as material, equipment and labor shortages, will restrain commercial real estate construction. This will help keep vacancy rates low and boost the commercial real estate revenue outlook. At the same time, these factors will increase real estate replacement costs, further bolstering real estate values and supporting the sector's inflation resistance.

Real estate stability increasingly valued by investors. Even the most seasoned political and military experts cannot predict how long the Ukraine crisis will last or what the ultimate outcome will be, but the economic and financial market ripples have already become readily apparent. Within this context, the combination of yield, stability and inflation resistance of real estate will become increasingly valued by investors, supporting transactional activity in the sector. Even after hostilities in Ukraine end, the impact of the war will resonate. Any potential rebuilding of Ukraine could spur global economic growth. By the same token, sanctions on Russia could persist beyond the actual conflict, as war crimes and other violations of international law are investigated. Under the context of this longer period of regional instability, U.S. commercial real estate offers a durable yield outlook and an extended runway of growth.

Commercial Real Estate Sales Trends



Cap Rate Ranges By Property Type

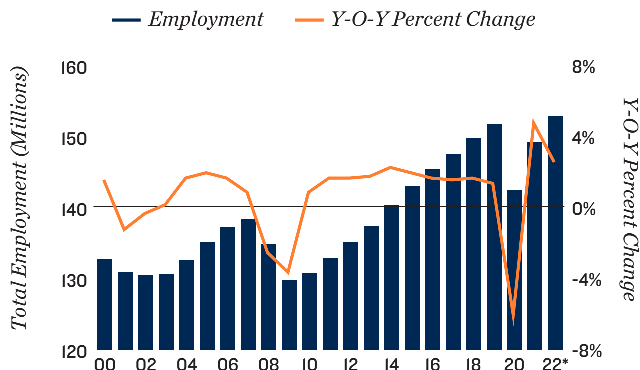


Transactions includes apartment, retail, office and industrial sales $1 million and greater
Cap rates as of 4Q 2021; Seniors housing includes skilled nursing
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics; NICMap; MNet

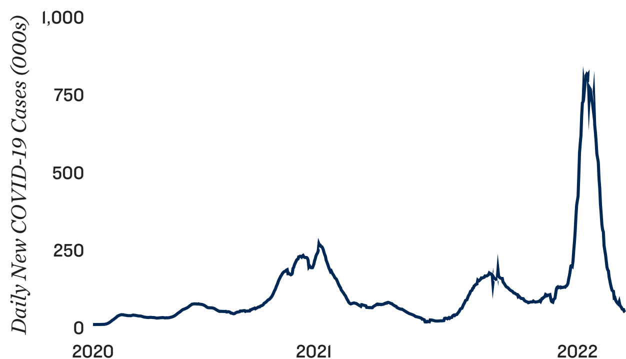
Key Demand Drivers Supporting the Commercial Real Estate Outlook

- While the U.S. economy certainly faces headwinds, and the war in Ukraine has increased the risk of a recession, core underlying drivers continue to support commercial real estate space demand. Positive demographics remain a key factor supporting the housing market, as millennials age into the prime rental cohort. Likewise, aging baby boomers, now predominantly in their 60s, have increased medical needs, supporting demand for both medical office space and senior housing.
- The wind-down of mask mandates across the U.S. will be another factor supporting commercial real estate demand, particularly in office and retail space. Many companies have reinitiated plans to return to the office, while consumers are once again venturing into retail stores, restaurants and entertainment venues. Hotels will also be a beneficiary of the changing mask rules, particularly if businesses capitalize on this change to reinitiate business travel. Vacation travel has already nearly recovered, but a revival of business travel will be a key ingredient in supporting the restoration of full-service hotels, particularly those catering to conferences.
- Self-storage demand outpaced expectations through the pandemic, and the construction pipeline for these properties has declined over the last two years, allowing the sector to achieve record-low vacancy rates. The proven recession resistance of self-storage will remain a top feature, attracting capital seeking diversification.
- Supply chain disruptions reiterated the need for businesses to maintain sufficient local inventory to cover logistics lapses, bolstering industrial space demand. The sector has also benefited from increased use of e-commerce platforms that leverage industrial space as an integral component of the sales fulfillment process. The investor appetite for industrial assets remains well above historical levels, supporting aggressive pricing in most markets.

Employment Trends



Infections Fall as Omicron Wanes



** Forecast*
Sources: BLS; New York Times

Mitigating Downside Risks

Commercial real estate offers long-term durability. The war in Ukraine will remain fluid, and even after the invasion ends, there will likely be considerable geopolitical instability across the region. Allegations of war crimes, potential radiation hazards, the displacement of millions of people and the destruction of entire cities will impact the global economy and political landscape long after the shooting stops. While there are some upside scenarios, downside risks are far more numerous and broad reaching. Countless scenarios could create financial market instability, surges of inflation, a recession or a rapidly shifting economic climate. Within that context, commercial real estate is one of the few investments that usually generates reliable returns. U.S. real estate, in particular, is recognized by many international investors as a "safe-haven" during times of turbulence, and the flow of capital from overseas may rise in the coming months. Domestic investors may also shift allocations from other investment vehicles to capitalize on the durability of commercial real estate.

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Sources: Marcus & Millichap Research Services; Federal Reserve; CoStar Group, Inc.; Moody's Analytics; MNet; NICMap; Real Capital Analytics; RealPage, Inc.; Yardi Matrix; Radius+; U.S. Census Bureau; U.S. Bureau of Labor Statistics; U.S. Energy Information Administration

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