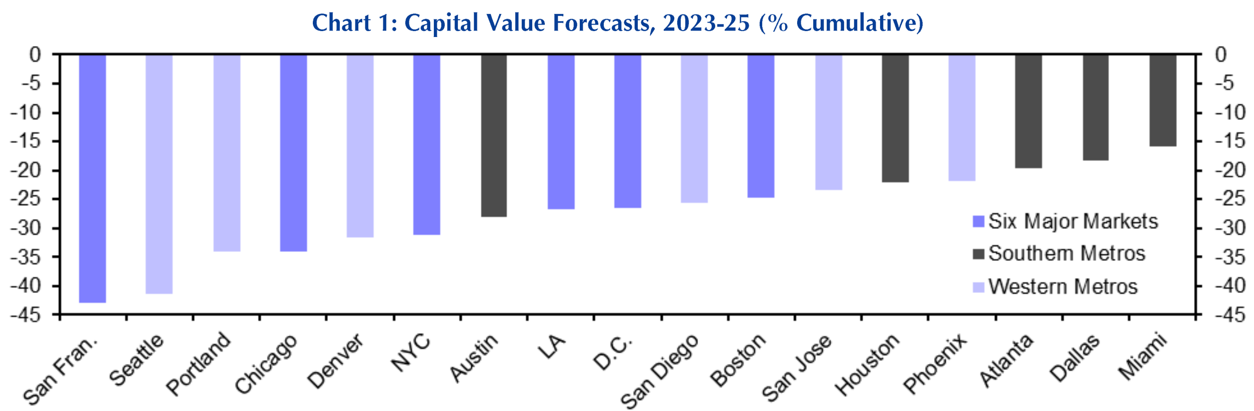
OFFICE METRO OUTLOOK

San Francisco and Seattle values to drop 40% in 2023-25

- **Overview** – Further downgrades to our national office outlook have driven corresponding cuts to return prospects in our metro-level forecasts this quarter. San Francisco still has the poorest outlook, with our projections for demand implying vacancy rises by more than 10%-pts from its end-2019 low. Austin will see a similar increase, but *its* main driver will be a huge swathe of new supply completing over the next few years. The biggest downgrades this quarter are in some of the western cities, with Seattle and Denver of particular note. Indeed, we now expect capital values in Seattle to see a similar fall in 2023-25 as San Francisco. (See Chart 1.) At the other end of the spectrum, southern markets will generally outperform, with capital values in Miami falling by "just" 15% in 2023-25. Dallas and Atlanta are forecast to see slightly better total returns than Miami at just over 3% p.a. in 2023-27, due to their solid income returns.
- **Forecast Summary Charts**
- **Six Major Markets – Boston, Chicago, Los Angeles, New York City, San Francisco, Washington D.C.**
- **Southern Metros – Atlanta, Austin, Dallas, Houston, Miami**
- **Western Metros – Denver, Phoenix, Portland, San Diego, San Jose, Seattle**

Our forecasts for metro employment, vacancy, rents, yields, capital values, income returns and total returns are available on our US Metro Commercial Property dashboard.

Chart 1: Capital Value Forecasts, 2023-25 (% Cumulative)



Source: Capital Economics

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Charlie Cornes, Assistant Property Economist, charlie.cornes@capitaleconomics.com

Forecast Summary Charts

Chart 2: Office-Based Employment Forecasts, 2023-27 (% p.a.)

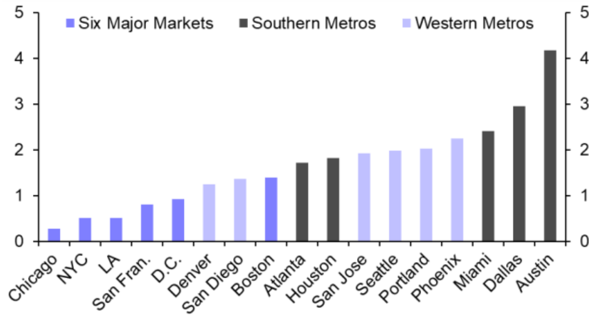


Chart 3: Net Absorption Forecasts (% of Inventory, Cumulative)

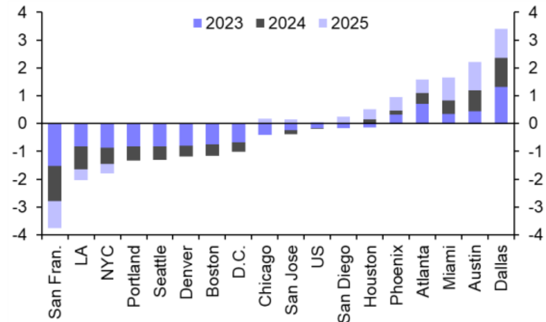


Chart 4: Completions Forecasts (% of Inventory, Cumulative)

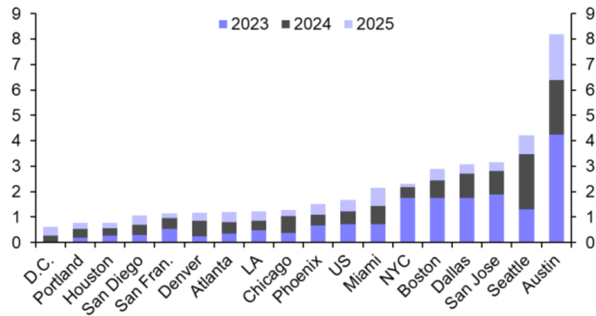


Chart 5: Change in Vacancy Rate (Bps, Cumulative)

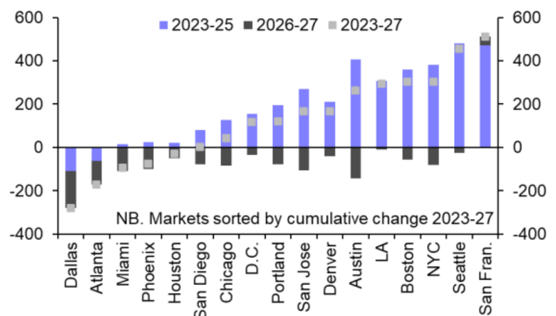


Chart 6: Asking Rent Forecasts (% p.a.)

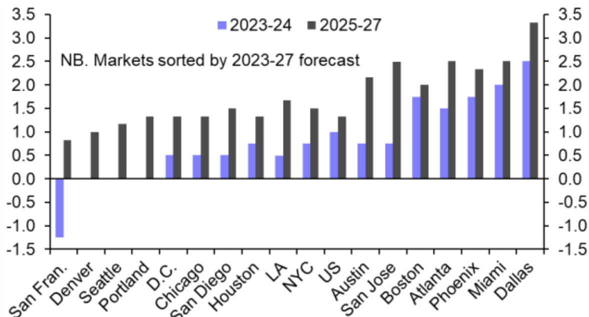


Chart 7: Gross Yield Shift Forecasts, 2023-27 (Bps)

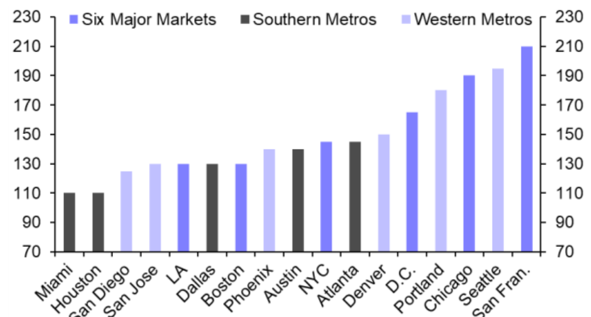


Chart 8: Capital Value Forecasts, 2023-25 (%, Cumulative)

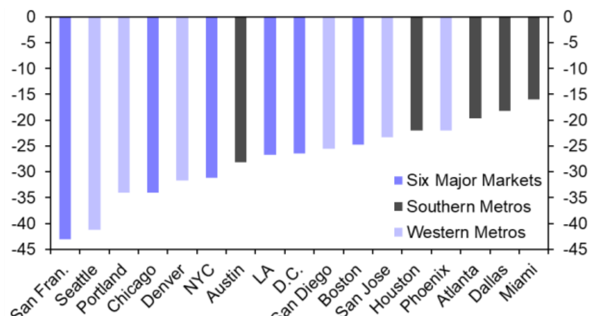
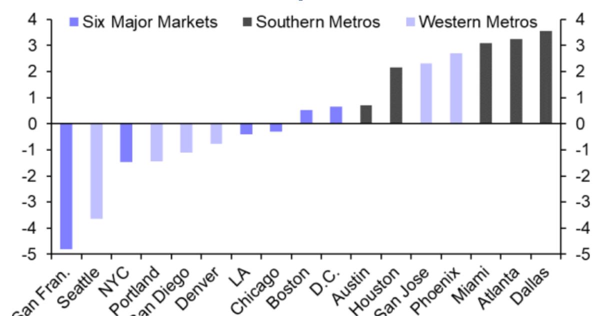


Chart 9: Total Return Forecasts, 2023-27 (% p.a.)



Source: Capital Economics

Six Major Markets – Boston, Chicago, LA, NYC, San Francisco, Washington D.C.

- Office-based jobs growth started the year poorly in five of the six major markets. Boston has been the exception and we think office jobs will grow by nearly 3% this year before growth slows from 2024. Elsewhere though, jobs growth will be minimal in 2023-24 and annual averages over the next five years will limp to rates of less than 1% p.a. (See Chart 10.) Even Boston's steady growth will be beaten by the "Rest of US" average and the other 11 markets average.
- The solid outlook for office jobs in **Boston** is in contrast to the outlook for office demand though. REIS report four consecutive quarters of negative absorption, with the first two months of Q2 faring no better. Along with the slowdown in life science-related demand, that contributes to our expectations for negative absorption over the next few years, placing the city in the bottom half of markets. (See Chart 11.)
- That reflects a downgrade to our demand outlook at the same time as we have increased our completions forecasts for each of 2023-25. As a result, we see vacancy climbing to nearly 19% by end-25, a 6%-pt gain from end-2019. That will weigh on rent growth from H2 2023, but Boston will still outperform the other five major markets.
- We expect negative absorption in all of the major markets in the 2023-25 period. (See again Chart 11.) **Chicago** looks the least bad on this measure, but that relative strength is likely to weigh on the recovery further out. And, similar to Boston, we have increased our completions forecasts for this year and next. This will keep vacancy rising and will keep rent growth weak, averaging a little over 0.5% p.a. in 2023-25. (See Chart 12.)
- The outlook for rents in **Washington D.C.** over the next three years is also poor. That's despite the capital having the lowest volume of new completions forecast across the next three years. Indeed, no new office space is projected to complete this year. (See Chart 13.) But below-par job growth and continued negative net absorption on the back of a higher rate of remote work in the public sector than we had initially expected means the outlook for D.C. is fairly poor.

Chart 10: Office Employment, 2023-27 (% p.a.)

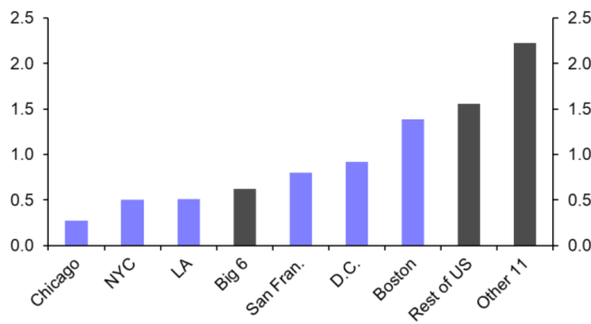


Chart 11: Net Absorption by Metro (% of Inventory)

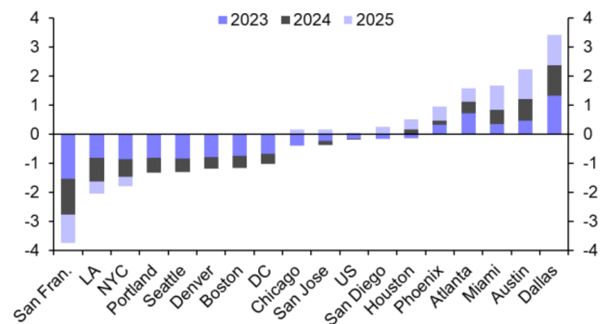


Chart 12: Asking Rents, 2023-25 (% p.a.)

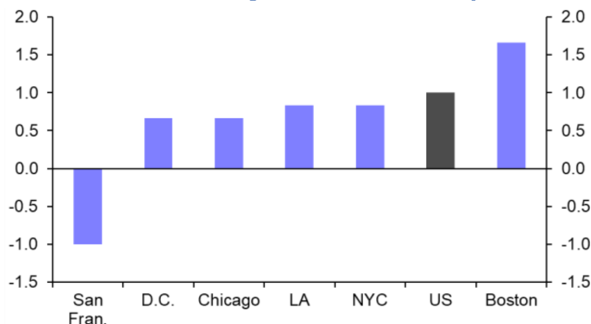
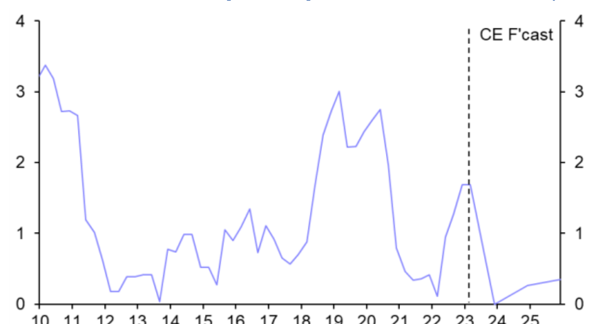


Chart 13: D.C. 4-qtr Completions (% of Inventory)



Sources: REIS, Capital Economics

Six Major Markets continued

- The outlook for demand in both **Los Angeles** and **New York City** is also poor. We expect office job growth to lag even the weak big 6 average. And while absorption will be more impacted by structural factors over the forecast period, these metros also fare poorly in that respect, with long and costly commutes, high housing costs and, in the case of NYC, its high office rents.
- But, while we think absorption will be slightly worse in LA than NYC, NYC has a substantial pipeline of new completions still due this year, meaning vacancy faces a larger rise. (See Chart 14.) Overall we expect both markets to see asking rent growth of just 0.5%-1% p.a. for 2023-27.
- The issues facing **San Francisco** probably require little introduction. A high share of tech, high rent levels, expensive housing and a growing crime and homelessness problem downtown all mean that San Francisco office owners are set for a torrid time over the coming years. We think REIS data will continue to show negative absorption for the next three years at least and that, despite relatively low completions, this will cause vacancy to rise by nearly 500 bps from its end-2022 level. (See Chart 15.) As a result, we are forecasting asking rents will fall by 1% p.a. over the next three years, but net effective taking rents face much larger falls.
- We expect the largest yield rises in some of the big 6 and western markets over the next few years. San Francisco and Chicago stand to see the most substantial increases, reflecting the poor prospects for NOIs in those markets. (See Chart 16.) In San Francisco, we think gross yields will reach 8.4% by end-2024, having risen from 5.4% at the end of 2019. The total increase in Boston over that same period is likely to be much smaller, at around 170bps.
- Combined with weak outlooks for NOIs, those yield rises paint a poor picture for capital values. San Francisco is set to lead the pack lower in 2023-25, with a capital value fall of 40%-45%. And, although income returns will mechanically rise as prices fall, this will not be enough to prevent negative average annual returns across all six major markets for 2023-25. (See Chart 17.)

Chart 14: Completions (% of Inventory)

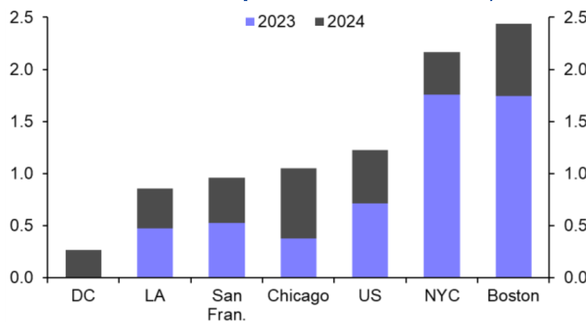


Chart 15: Vacancy Change by Metro (Bps, Cumulative)

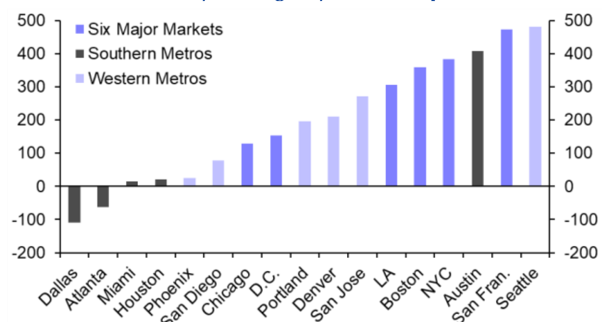


Chart 16: Gross Yield Shift by Metro, 2023-25 (Bps)

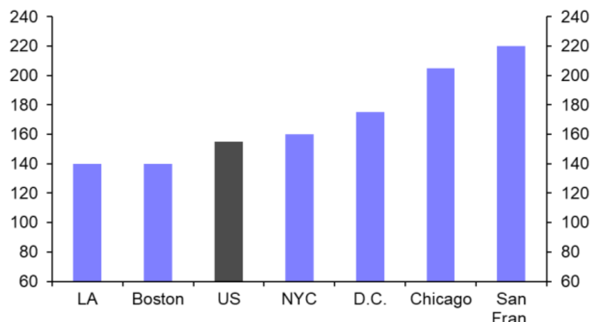
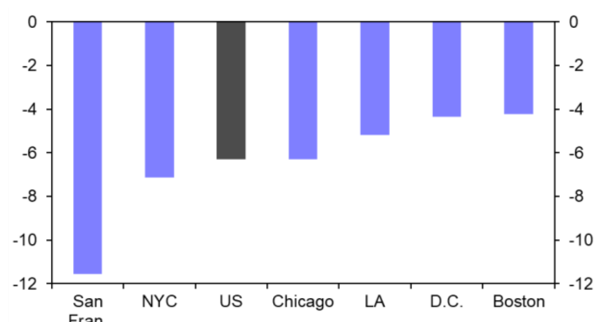


Chart 17: Total Returns by Metro, 2023-25 (% p.a.)



Sources: REIS, Capital Economics

Southern Metros – Atlanta, Austin, Dallas, Houston, Miami

- Office-based job growth has varied substantially across the South in the first five months of 2023. Office jobs growth in Atlanta has been soft so far this year, and was a below-average 0.2% 3m/3m in May. On the other hand, Dallas and Houston grew around 1.0% 3m/3m in May, after being consistently above-average for the past 12 months. That continued strength has led us to upgrade our end-2023 forecast for those two Texas metros by over 1.0%-pt, to 4.0-4.5% p.a.
- Over the next five years, migration patterns lead us to expect southern employment growth will surpass the rest of the US. For office markets, that will be supported by relatively affordable rents and generally shorter and cheaper commutes than the six major markets and most western cities, which will attract both companies and workers.
- This means cities such as **Austin**, deemed to have the "second hottest job market" nationally according to Moody's, just after Nashville, will outperform the US average, achieving 4% p.a. between 2023-27. Elsewhere, we still expect substantially weaker job growth in Atlanta and Houston. But these metros will continue to outpace the six major metros with 1.5-2.0% p.a. growth until end-2027. (See Chart 18.)
- Office utilisation rose slightly in Q2 in most markets, but the rate of recovery has slowed. (See Chart 19.) Longer term, our view remains that usage in the South will stay higher compared with the big six markets as the commute times in southern metros are significantly shorter. (See here.)
- Together, higher office utilisation and strong employment growth will support southern office demand. We expect net absorption in **Dallas** will exceed all other metros, at 1.0-1.5% of inventory p.a. between 2023-27. Meanwhile, we anticipate **Houston** office demand will be around the national average this year at -0.1% p.a., but stronger employment prospects will push the rate to around 0.2% p.a. over the five-year forecast period. (See Chart 20.)
- Supply in **Miami** will outstrip demand in 2023 for the first time since 2020. (See Chart 21.)

Chart 18: Office-Based Employment, 2023-27 (% p.a.)

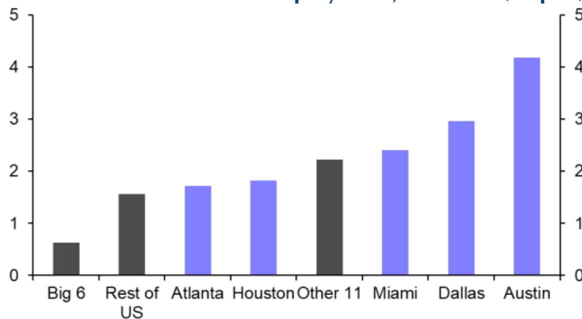


Chart 19: Office Utilisation Rates (% of Pre-Pandemic)

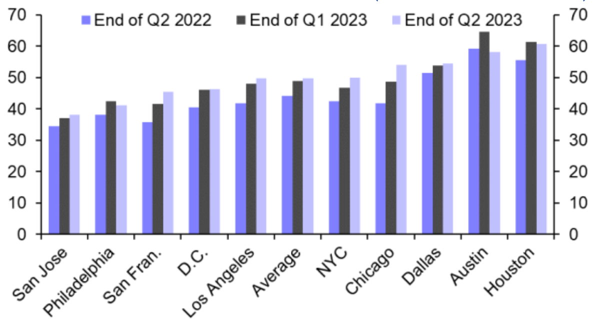


Chart 20: Office Net Absorption (% of Inventory)

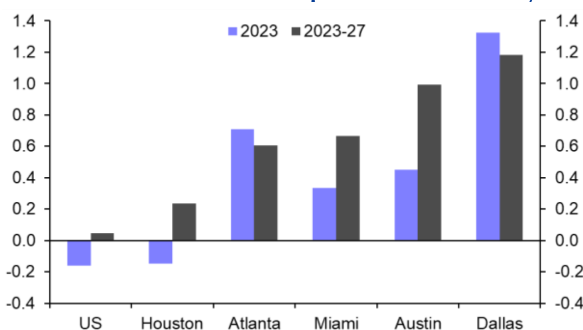
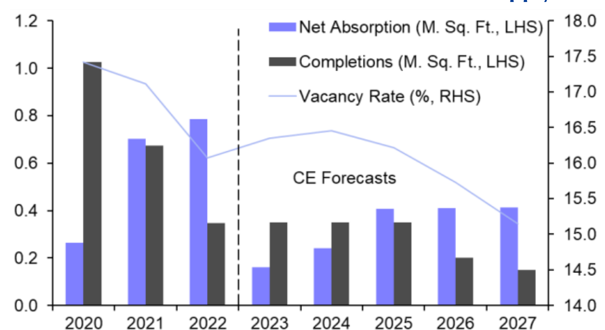


Chart 21: Miami Office Demand and Supply



Sources: Kastle Systems, REIS, Capital Economics

Southern Metros continued

Cushman and Wakefield reported over 1.5 million square feet of office space was under construction in Miami in Q1. Meanwhile, we expect net absorption will not exceed 0.25 million square feet annually for the next two years. Past 2024 however, we expect demand to gradually recover and outpace supply.

- For completions, we expect Houston and Atlanta to lag behind the US average over the next three years. The supply outlook is much different in Austin, where we anticipate over 8% cumulative growth in inventory by end-2025. (See Chart 22.) In turn that will lead to a rise in vacancy of over 400 bps by end-2025, behind only the hardest-hit San Francisco and Seattle markets.
- More broadly, vacancy across the South has been gradually climbing since 2015, but we think it could peak by end-2024. Only **Atlanta** will not see vacancy rise over the next two years, in part due to limited new supply. Thereafter, the structural demand drivers will cause vacancy in southern metros to decline, compared to a continued rise nationally until end-2027. (See Chart 23.)
- Rent growth across the southern metros has outpaced other markets since 2019, and we expect this trend will continue over the next five years. (See Chart 24.) The volume of new supply in Austin this year will keep rental growth below the national average in 2023, but stronger demand later in the forecast period will boost rent growth to 2.5% p.a. from 2025.
- Our forecasts for office yields have been revised upwards this quarter (see more here), driving capital value expectations lower. Austin is set to see the largest decline in the South this year, facing a value fall of nearly 25%. However, total returns will be positive for all southern metros on a five-year basis, outperforming the national average. (See Chart 25.) Indeed, Dallas, Atlanta and Miami are forecast to be the top-performing markets over the next five years.

Chart 22: Office Completions (% of Inventory)

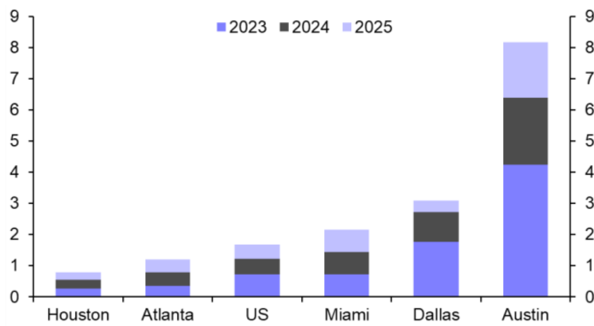


Chart 23: Office Vacancy Rate (%)

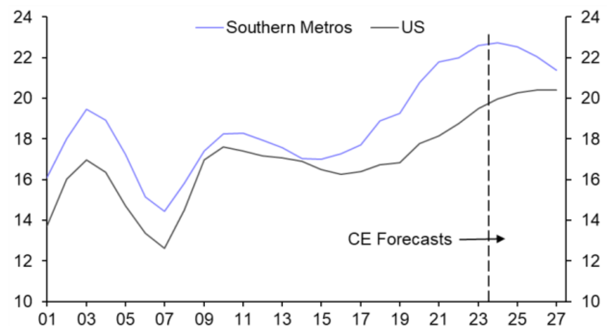


Chart 24: Southern Office Asking Rents (% p.a.)

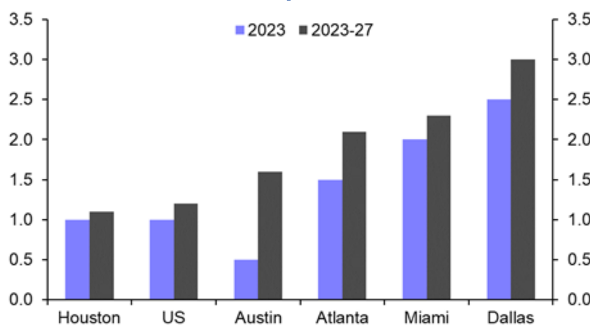
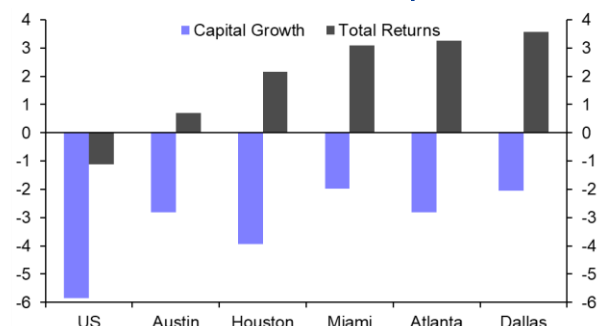


Chart 25: Southern Office Capital Values & Total Returns, 2023-27 (% p.a.)



Sources: MSCI, REIS, Capital Economics

Western Metros – Denver, Phoenix, Portland, San Diego, San Jose, Seattle

- Office job growth in the western metros has underperformed against the national average in recent months. The region's high exposure to the rate-sensitive tech sector has meant the current tightening cycle has weighed heavily on office employment. Indeed, Seattle, where over 20% of office-based jobs are in the information sector, has seen only 0.1% 3m/3m growth in office jobs on average in the five months to May. Meanwhile, **Denver** saw its ninth consecutive month of negative 3m/3m growth in May, with a fall of 0.5%. Even Portland, which saw consistently strong rises over the past nine months, has experienced a sudden slowdown.
- The West's exposure to tech means we expect only 0.5-1.0% annual growth in office-based employment in 2023 on average. Seattle and Denver are likely to see an outright fall, whereas Portland (which is less exposed) is forecast to grow by 2.5-3.0% p.a. this year.
- As interest rates reverse course later in the forecast, job growth in most western metros will surpass the rest of the US – excluding the South – over the five-year forecast period. (See Chart 26.) Phoenix will lead, registering office job growth of more than 2.0% p.a. between 2023-27, whereas 1.0-1.5% p.a. is expected for Denver and San Diego.
- **Portland's** decent rate of job growth was reflected in net absorption of 220,000 sq. ft. in Q1, the strongest quarter since 2018. But we do not expect the strength in demand to last. Indeed, we expect the city to experience some of the most negative rates of absorption in the next couple of years, similar to Seattle and Denver. (See Chart 27.)
- Tech layoffs pushed demand in **Seattle** negative in 2022, causing vacancy to rise despite historically-low completions that year. As one of the metros with the biggest rise in available sublease space, we expect absorption to remain negative for the next couple of years at least and stay weak further out. Vacancy will therefore peak above 20%. Only in 2027 do we expect absorption to outpace completions, though the downward impact on vacancy will be limited. (See Chart 28.)

On the supply side, the outlook varies across the western cities. (See Chart 29.) **San Jose**

Chart 26: Office-Based Employment, 2023-27 (% p.a.)

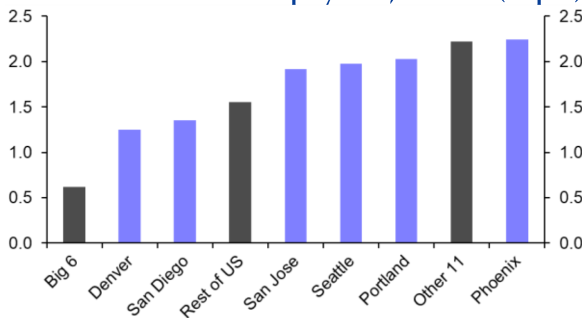


Chart 27: Net Absorption (% of Inventory)

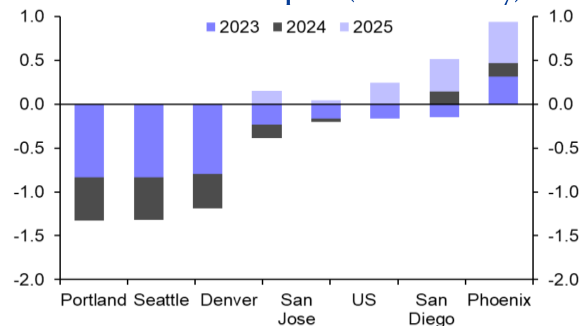


Chart 28: Seattle Office Demand and Supply

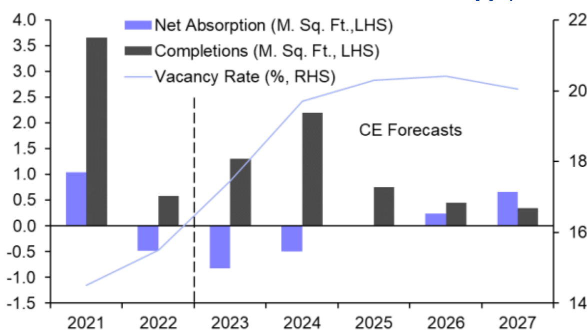
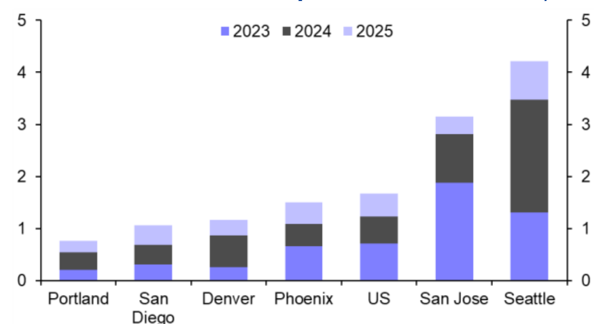


Chart 29: Office Completions (% of Inventory)



Sources: Newmark Research, REIS, Capital Economics

Western Metros continued

completions will surpass the national average each year between 2023-27, which will result in 3% cumulative growth in inventory. Unfortunately for San Jose landlords, the metro has also maintained the lowest office utilisation rate according to Kastle Systems. This will apply upward pressure to vacancy over the next three years as more tenants vacate existing space for newer buildings.

- Vacancy is forecast to rise across each of the western metros this year. However, vacancy in **Phoenix** is expected to peak as early as next year. The strong employment outlook will lead vacancy to converge with the rest of the West and the US by end-2027 at around 20%. (See Chart 30.)
- Those metros with weak long-term demand prospects face a difficult period. Denver, Seattle and Portland will likely see below 1.0% asking rent growth p.a. over the next five years. Meanwhile, despite negative rental growth expected next year, limited new supply coming through from 2025 onwards will help boost rents in San Jose in the later years of the forecast period. (See Chart 31.) It should be noted though that while we are forecasting higher asking rents in all markets by 2027, net effective taking rents are likely to continue falling over the coming years.
- Yield forecasts have been pushed up for the majority of western metros this year, reflecting a faster and larger re-pricing than previously expected. **San Diego** is the exception, after a 10bps downward revision for 2023 on the back of a better-than-expected Q1 outturn. Despite this, capital values there are expected to fall by over 15% this year, and will begin to grow again only by 2026. (See Chart 32.)
- The larger rise in yields means we now expect office capital values in Seattle to decline by over 30% this year – slightly larger than even San Francisco and the largest fall across all our 17 metros. From next year, we expect it will see a improvement, but will only begin to see growth again from 2026. All of the West will see declines in capital values over the forecast, but total returns in Phoenix and San Jose will at least average out above zero in the 2023-27 period. (See Chart 33.)

Chart 30: Office Vacancy Rates (%)

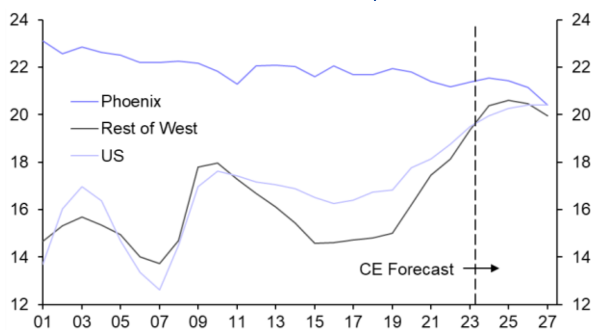


Chart 31: Western Office Markets Asking Rents (% p.a.)

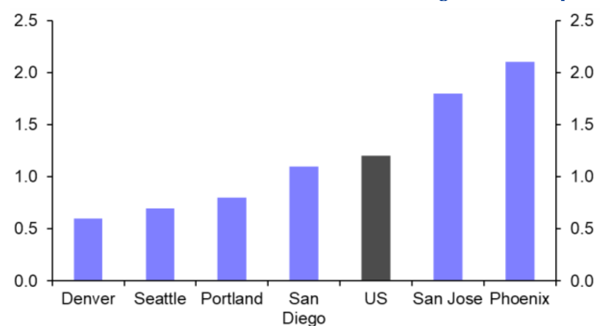


Chart 32: San Diego Capital Values, Income Returns and Total Returns (% p.a.)

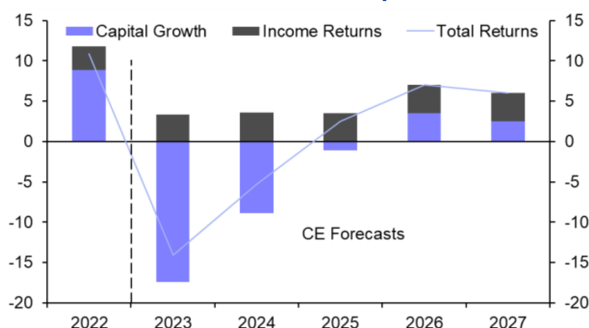
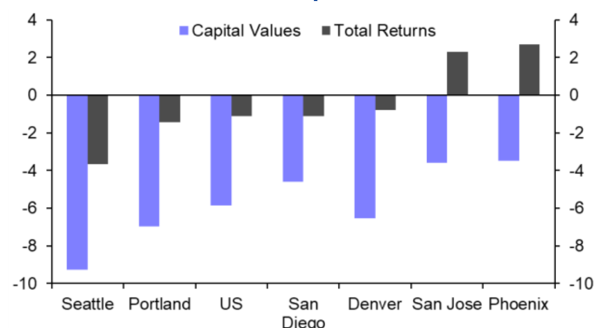


Chart 33: Capital Values & Total Returns, 2023-27 (% p.a.)



Sources: REIS, Capital Economics

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