



Will Manhattan Rents Drop 20-25% if the S&P 500 Stabilizes at Current Levels?

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Beginning Friday March 20, 2020, Manhattan entered a period of shutdown and isolation unlike anything experienced before. This unprecedented action was taken to slow the spread of COVID-19 as it continues to upend life across the globe. Shops and restaurants closed, non-essential businesses moved to remote working, and office buildings became virtually empty across the city.

Now, nearly three weeks in, it is almost impossible to believe that just prior to current events, the U.S. economy was fundamentally at its strongest coming into the beginning of this year. Unemployment remained at historical lows (3.5%), an estimated 50,000 jobs were added to the economy in the first week of March, and we were enjoying one of the most prolonged economic recoveries in U.S. history, an expansion that started in mid-2009. The S&P 500 index peaked at 3,386 on February 19, 2020 and it has been almost 12 years since the collapse of Lehman Brothers and the ensuing financial crisis. Many were wondering what event would reverse one of the longest-sustained economic growth cycles in U.S. History. Needless to say, few saw this coming.

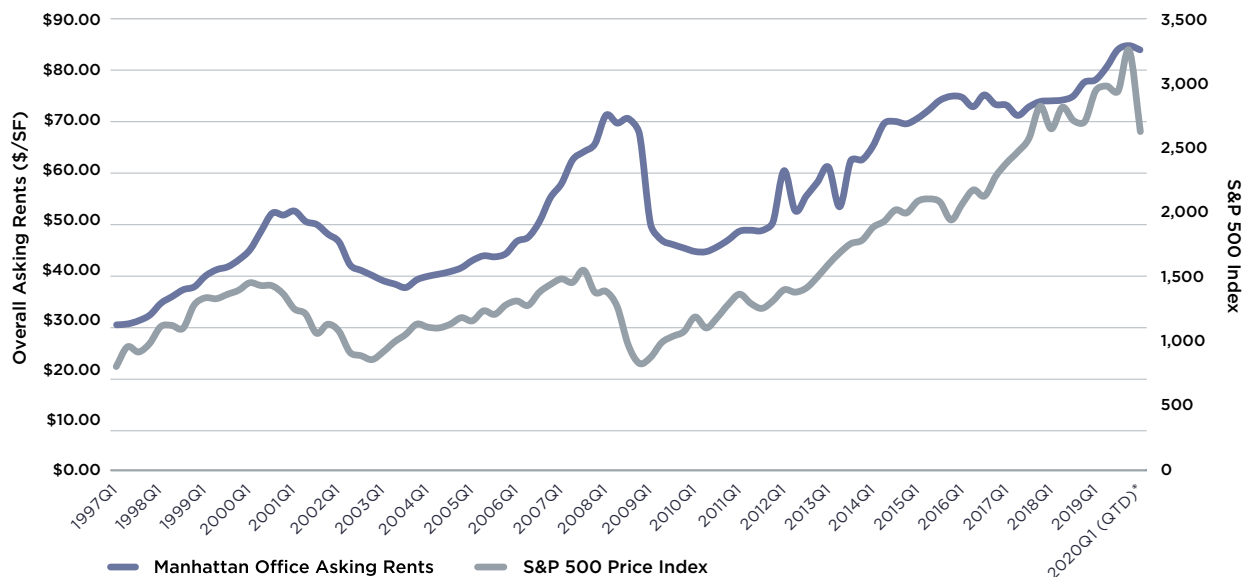
In one week, everything changed. Hiring stopped, many employees were furloughed, and a record 3.3 million workers filed for unemployment during the week of March 16th, the largest jump in jobless claims in history.

Nobody knows the extent of the impact that COVID-19 will ultimately have on the mid and long-term health of the New York City commercial real estate market. We do know there will be significant disruption and can only look to previous downturn scenarios for a glimpse of what could be in store given historical trends and correlations. History has shown these downturns tend to be quite favorable to tenants.

Strong correlation between Manhattan asking rents and the S&P 500

As the chart below illustrates, there has always been a strong correlation between Manhattan overall office asking rents and the S&P 500 Index.

Manhattan Asking Rents vs S&P 500



*QTD 2020Q1 data available up to March 30, 2020

As expected, fluctuations in both trendlines are similar, with asking rents trailing dramatic changes in the S&P 500 by approximately two to three quarters. Until mid-2015, the two indexes shared similar rates of acceleration and deceleration. However, looking at mid-2015 through February 2020, growth in the S&P 500 was increasing faster, with the S&P 500 swelling by 67% in that timeframe. Growth in asking rents was more muted, increasing by only 14% over the same period. This suggests the S&P 500 was perhaps getting a touch ahead of itself. Many Wall Street bears reminded us of this disparity, with then-current valuations relative to earnings rising exponentially compared to historical averages.

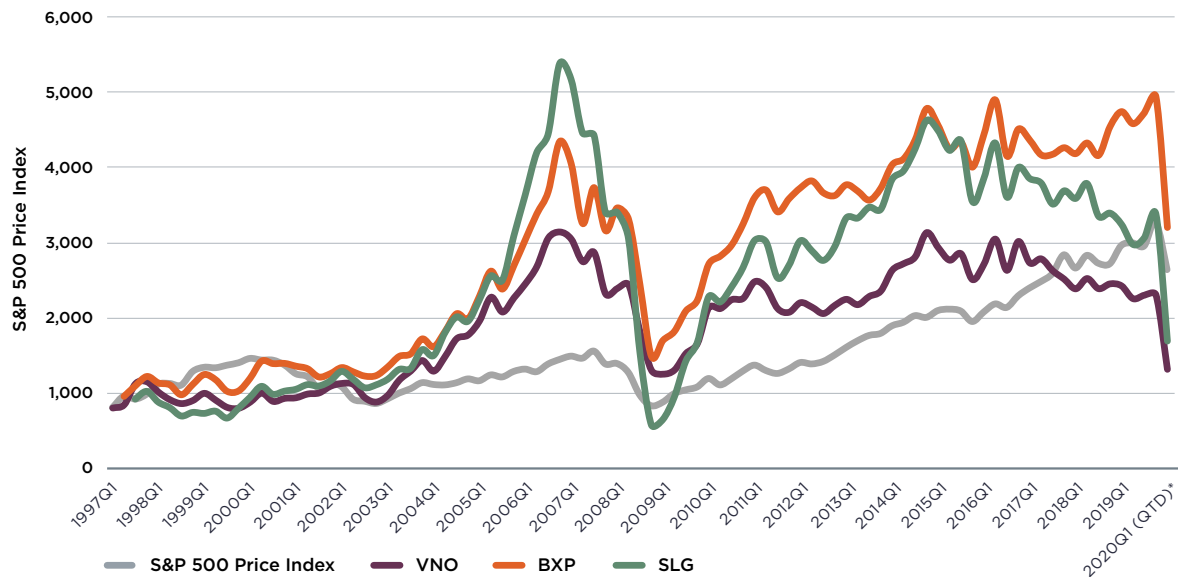
A look at REIT pricing correlation

Like office rents, REIT stock performance is also closely tied to movements in the S&P 500, albeit in a bit different way than the asking rent correlation described above. For the comparison below, we have plotted the stock performances of three major Manhattan-based REITs, Vornado Realty Trust (VNO), Boston Properties (BXP) and SL Green Realty Corp. (SLG) against the S&P 500. We have normalized the stock prices to be equal to the S&P 500 in Q1 1997. Though there is still strong correlation to the S&P 500, there are a few key periods in which the trajectories diverge. In the run up to the Global Financial Crisis in 2008, and again up until mid-2015, these three REITs grew by multiples of the S&P 500.

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S&P 500 vs Select Manhattan REITS

(REITS normalized for S&P Index)



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This can be explained by an increase in occupancy rates during those periods, disproportional growth in net rents achieved, and investor confidence in Manhattan's global status as a (relative) safe-harbor investment market. Let's quickly review the disproportional increase in net rents versus gross rents during the same period. A \$40.00 per square foot (psf) gross rent in 2004 with operating expenses and real estate taxes of \$30.00 psf produces a net rent of \$10.00 psf. By 2008, gross rents on average increased to \$70.00 psf; assuming moderate inflation in operating expenses and real taxes, resulting in net rent of \$35.00 psf. This represents an increase of approximately 75% in gross rents, while net rents increased by approximately 350%. REIT valuations reflect even higher increases, due to mortgage leverage and historically low interest rates.

However, from 2015 through February of 2020, two of the three REITs mentioned above experienced stock declines of approximately 25%. In the last month, the S&P 500 dropped roughly 25%, while all three of these REITS have dropped by between 40 and 50%.

So, what lies ahead?

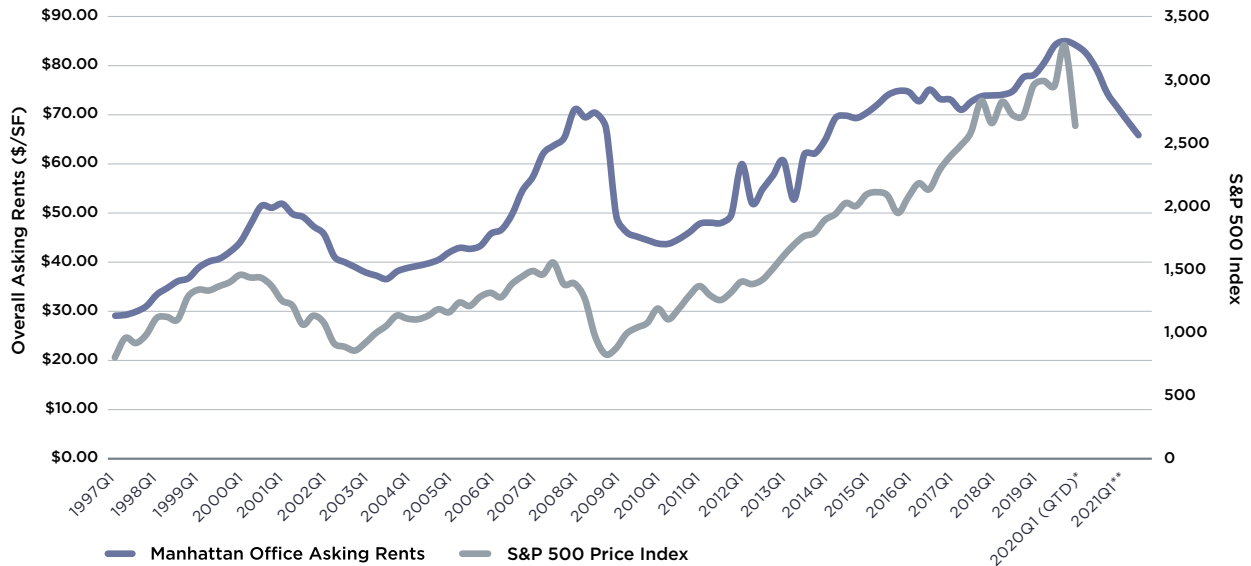
Using past correlations, we have provided a possible outcome scenario for near-term impact on Manhattan overall asking rents (assuming the S&P 500 stabilizes near its current level of around 2,500, recognizing this is a big "if").

Given that a significant asking rent drop will lag the current decline in the S&P 500 by two to three quarters, historical rent trends during previous downturns suggest that Manhattan overall asking rents could drop from their current (Q1 2020) average of \$83.93 psf to somewhere between \$65.00 to \$70.00 psf over the coming year. A similar potential 20-25% drop would apply to Class A asking rents, as well, which currently average \$96.60 psf (resulting in Class A asking rents in the range of \$72.00 to \$77.00 psf).

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Manhattan Asking Rents vs S&P 500

(with short-term forecast for Manhattan Office Asking Rents)



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**2021Q1 Predictive Scenario at Current S&P 500 Level

Current scenario forecasts are highly contingent upon how quickly and effectively the virus can be controlled, and the speed and efficacy of a public policy response in preventing structural damage to the economy, thereby allowing a quick recovery to pre-crisis fundamentals. While the recent CARES act offers substantial benefits to small businesses, the value of the liquidity injection into large corporations has yet to be seen, and whether these efforts will stem the tide of significant layoffs. The situation above presents a middle ground scenario, somewhere between quick recovery and a downturn of similar magnitude to the Great Recession.

Other factors that could impact this rate decline include space availability, such as the boom of construction over the past decade (more than 40.0 million square feet delivered and currently under construction), the pace and pricing at which sublease space comes to market, and the release of large coworking location spaces, given the sector's vulnerability at this time. Whether or not the viability of work-from-home options impact short and long-term occupancy trends will require further analysis as well.

Everyone hopes that a recovery will be swift given the solid economic footing achieved prior to this crisis, but this is entirely dependent on how long the current state persists and what, if any, permanent economic damage is realized.

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