AEW Research Perspective

Q4 2016

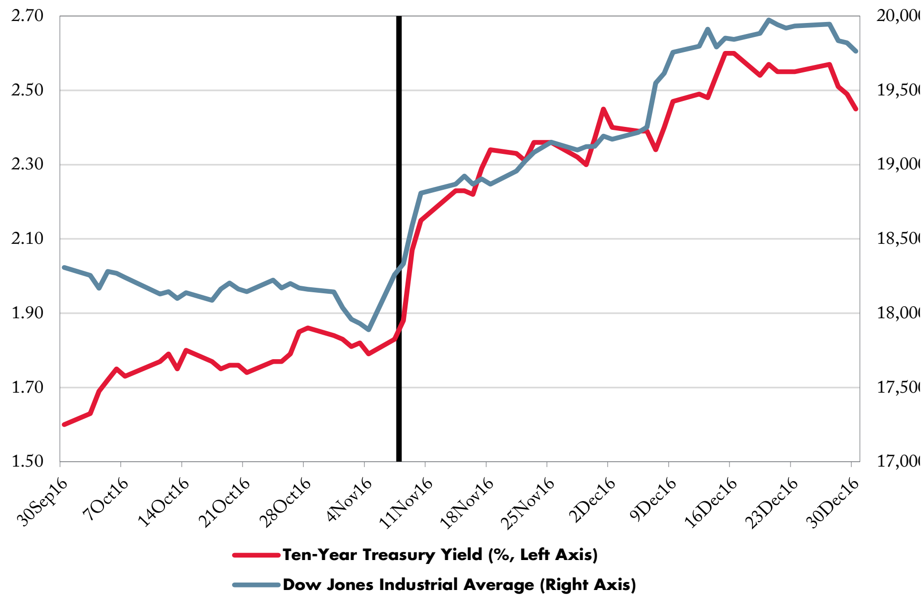
U.S. ECONOMIC AND PROPERTY MARKET OVERVIEW

Total employment growth averaged approximately 185,000 jobs per month for the year.

As the U.S. moves through the eighth year of economic recovery, growth remains consistent if unspectacular. Real GDP growth was again uneven during 2016, but averaged approximately 2% for the year, roughly on par with the 2.2% average annual pace over the previous six years. Similarly, total employment growth averaged approximately 185,000 jobs per month for the year, somewhat lower than the 225,000 per month average of 2015; however, with the economy nearing full employment, large employment gains will be harder to turn out. Indeed, with job openings running near record levels of 5.5 million positions, the most significant limiting factor on near-term job (and economic) growth is the limited supply of available labor, not business demand for labor, particularly in high-skill job categories and in gateway markets. To this point, the official U.S. unemployment rate stood at 4.8% in January 2017 while the unemployment rate for college graduates was only 2.5%.

Investors clearly reacted positively to the 2016 U.S. Presidential election in November with the Dow Jones Industrial Average rising more than 10% and the yield on the U.S. Treasury bond rising roughly 60 basis points between election night and year end. Investors are now clearly anticipating stronger economic growth, higher inflation and a faster pace of Federal Reserve tightening of monetary policy than prior to the election. In large part, this change in expectations is based on campaign rhetoric that called for significant increases in government spending on infrastructure and defense, substantial proposed changes in U.S. tax rates and policies and promised meaningful reductions in government regulations, particularly in the finance and energy sectors.

Figure 1
The Dow Jones Industrial Average and the Ten-Year Treasury Yield



Source: Blooomberg

With respect to U.S. inflation, there are now clear signs that wage pressures are building across most parts of the domestic labor market, with the Atlanta Federal Reserve Bank reporting year-over-year growth in wages of approximately 3.9% through November 2016; this is the highest level since the financial crisis[1]. Similarly, core inflation (i.e. food & energy) has been running above 2% on a year-over-year basis since the beginning of 2016 and is finally being reflected in investor expectations for future inflation (Figure 2).

Key Real Estate Indicators

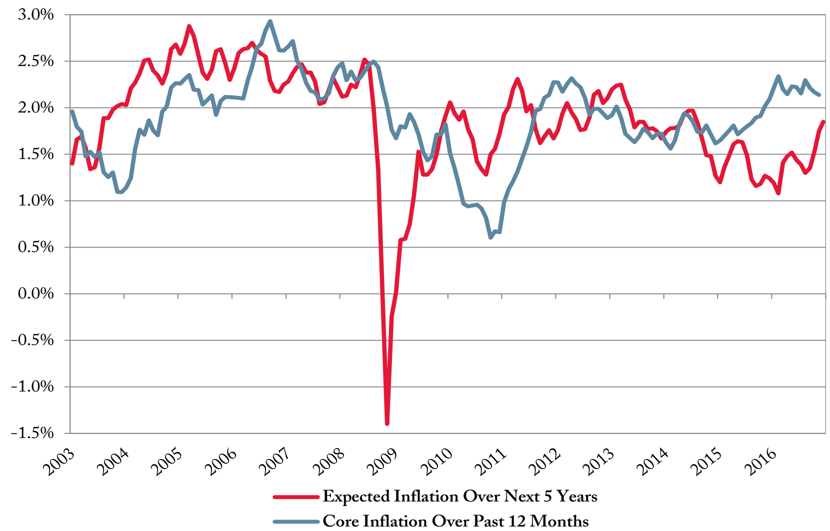
Property Type	Vacancy Rates		Rents	Absorption	Completions	Cap Rates	Transaction Volume
Office	12.9%	↓	↑	↓	↔	↓	↓
Industrial	8.2%	↓	↑	↔	↑	↓	↓
Retail	10.2%	↓	↑	↑	↔	↓	↓
Multifamily	4.6%	↑	↑	↑	↑	↓	↑

↑ **Higher** ↓ **Lower** ↔ **No Significant Change**

Source: CBRE-EA, NCREIF, RCA, NICMAP
Note: The arrows reflect the trend for previous 12 months for rents, absorption, completions and transaction volumes; and current quarter versus year ago for vacancy rates and cap rates. For vacancy rates, a down arrow indicates declining vacancy rates. For cap rates, a down arrow indicates falling cap rates or rising prices.

[1] https://frbatlanta.org/chcs/wage-growth-tracker/?panel=1

Figure 2
Core Inflation and Expected Inflation Over Next Five Years

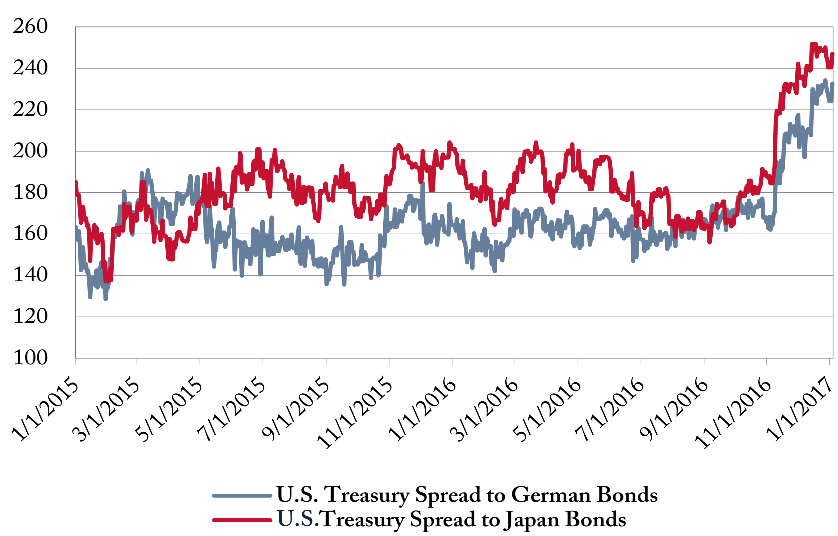


Source: Bureau of Labor Statistics, Federal Reserve

The U.S. yield curve will likely flatten slightly during 2017.

As a result, we expect that the Federal Reserve will likely follow through on the policy rate expectations indicated at their December 2016 meeting and will attempt to raise the Federal Funds rate (overnight borrowing rate) two to three times during 2017. Movement in the long end of the yield curve will not, however, keep pace with movement at the short end for two reasons. First, the long end of the U.S. yield curve has already moved more than 100 basis points since the low yield point of July 2016 (post-Brexit). Second, the yield spread between U.S. Treasury bonds and German or Japanese 10-year bonds has widened by 60-80 basis points since the November election, creating additional buying pressure for longer duration U.S. sovereign debt (Figure 3). As a result, we see the U.S. yield curve likely flattening slightly during 2017 with the 10-year Treasury yield perhaps reaching 3% by year end, but unlikely to move beyond this.

Figure 3
Yield Spread with U.S. Treasury Bonds



Source: Bloomberg

Despite the renewed enthusiasm for future growth exhibited in post-election market pricing, we do not currently anticipate any significant changes to our U.S. macroeconomic outlook for 2017. Indeed, the Federal Reserve's December assessment of 2017 growth was revised up by only 0.1% relative to their September projections. Most of the proposed pro-growth economic measures currently being discussed in Washington will largely be a story for 2018 and beyond, if at all.

Table 1
Federal Open Market Committee Assessment of U.S. Economy – December 2016[2]

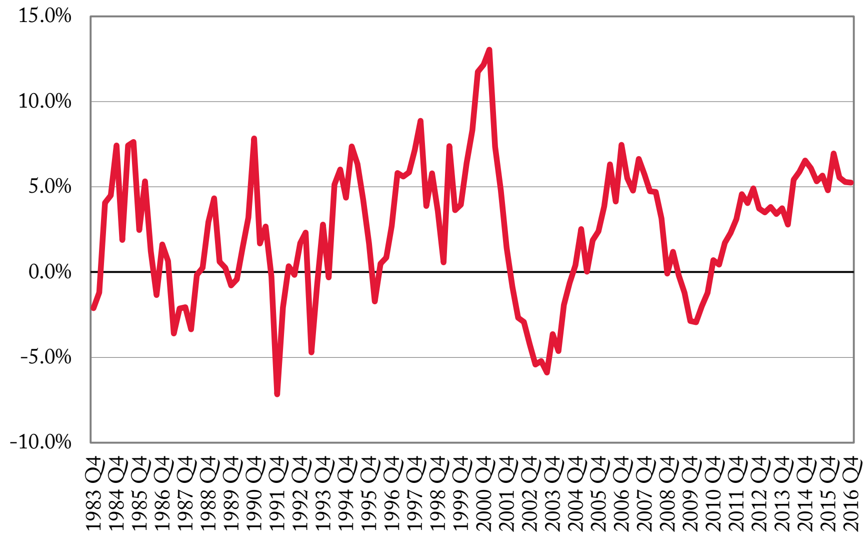
	2016	2017	2018	2019	Longer Run
Change in Real GDP	1.9%	2.1%	2.0%	1.9%	1.8%
September Projection	1.8%	2.0%	2.0%	1.8%	1.8%
Unemployment Rate	4.7%	4.5%	4.5%	4.5%	4.8%
September Projection	4.8%	4.6%	4.5%	4.6%	4.8%
PCE Inflation	1.5%	1.9%	2.0%	2.0%	2.0%
September Projection	1.3%	1.9%	2.0%	2.0%	2.0%
Federal Funds Rate	0.6%	1.4%	2.1%	2.9%	3.0%
September Projection	0.6%	1.1%	1.9%	2.6%	2.9%

U.S. PROPERTY MARKETS

The U.S. commercial property investment market remains strong, albeit below the torrid pace of the past several years. The NCREIF Property Index (NPI) reported an unleveraged total return of slightly less than 8% during 2016, down sharply from the 13.3% recorded during 2015 and the 10.9% average of the past five years. All of the moderating of the total return has come from much lower levels of capital appreciation as the rapid decline in property yields (cap rates) of the past several years has finally begun to taper off. Going forward, we do not expect an additional decline in average cap rates; therefore, property performance will once again be driven by growth in property net operating income (NOI).

[2]Source: https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20161214.htm

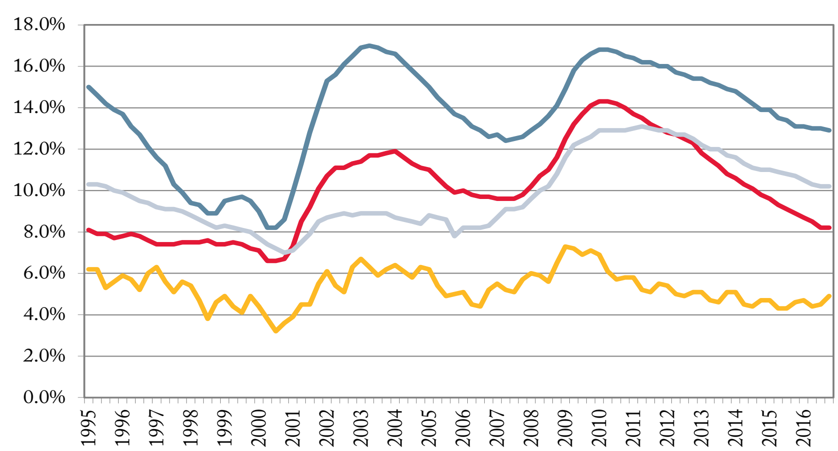
Figure 4
Year-Over-Year Average Property NOI Growth



Source: NCREIF

As shown in Figure 4, NOI growth has remained consistently strong at roughly 5% per year over the past several years. While we do not anticipate accelerating near-term NOI growth, property market fundamentals such as occupancy rates and rental rate growth do suggest continued positive growth. In general, average rental rates are now at or above prior (i.e. pre-financial crisis) peaks and the rate of growth in rents in most markets is slowing. Similarly, the rapid improvement in property occupancy (i.e. declining vacancy rates) is also slowing (see Figure 5). We do not expect vacancy rates to rise in the near term as long as job growth remains near current levels. At the same time, we do not anticipate significantly lower near-term vacancy rates as new construction is completed and delivered to the market. In 2016, the total U.S. commercial property stock increased by slightly more than 1%. We anticipate somewhat higher levels of construction in 2017 as projects currently underway progress towards delivery.

Figure 5
Average Vacancy Rate by Property Type



Source: CBRE-EA

In short, U.S. economic and property market conditions are highly consistent with the later stages of prior cycles. Property investment performance is expected to remain positive and competitive with other asset classes; however, the period of post-financial crisis property outperformance is largely over and total returns will likely be more in-line with long-term historical averages, both in magnitude and in composition (i.e. the majority of return coming from in-place income and income growth).

OFFICE

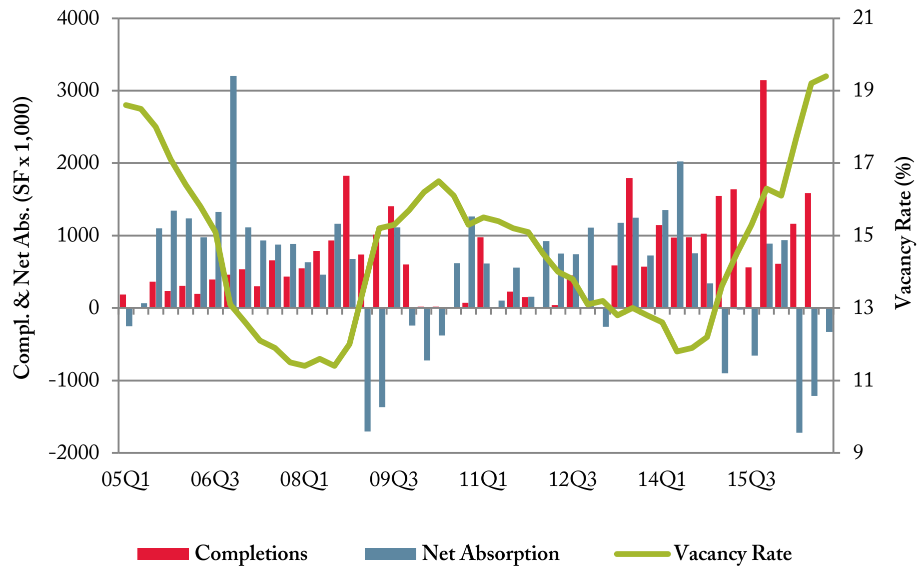
According to CBRE-EA, office vacancies declined 10 basis points in the fourth quarter of 2016, dropping to 12.9%. The fourth-quarter improvement in market conditions brought vacancies below 13% for the first time since early 2008. Demand was solid in the quarter with nearly 15 million square feet being absorbed on a net basis, the greatest level of the year. New supply, meanwhile, totaled roughly 11 million square feet, allowing for the overall improvement in vacancies.

Reflecting the length of the property market recovery and the tighter market conditions that exist today, vacancies declined by only 20 basis points over the course of the year, the slowest annual improvement of the recovery. Again, demand was healthy over the course of the year and outpaced supply as roughly 41 million square feet were absorbed on a net basis and 38 million square feet were completed.

Across the country, 43 of the 63 markets tracked by CBRE-EA reported flat or declining vacancies over the course of the year. Five markets reported an increase in vacancies of between 10 and 30 basis points – Orange County (11.0%, up 10 bps), Pittsburgh (9.6%, up 20 bps), San Francisco (6.5%, 20 bps), Austin (7.8%, 20 bps) and Washington, D.C. (15.8%, 30 bps). Markets with a more sizeable increase in vacancies included Chicago (14.2%, 50 bps), Minneapolis (15.9%, 60 bps), New York (9.6%, 60 bps), San Jose (8.9%, 70 bps), Denver (13.0%, 80 bps) and, notably, Houston (19.4%, 310 bps); among the aforementioned markets, demand was flat or positive in all markets, except for Houston and New York.

In Houston, nearly 2.3 million square feet of space was returned to the market in 2016, nearly four times the setback experienced in 2015. Importantly, however, the demand picture in Houston improved somewhat in the most recent quarter, with less than 350,000 square feet being returned to the market, following the second and third quarters' negative demand of 1.7 and 1.2 million square feet, respectively. We expect office demand in Houston will improve modestly in 2017, while supply growth continues to slow. Vacancies may edge slightly higher in the market; however, we believe the worst is likely over for the market, especially as oil prices have begun to climb following OPEC's and Russia's decision to cut production. Over the course of 2016, the price for West Texas Intermediate crude oil rose from a low of roughly $38 per barrel to nearly $55. Still, with today's level of vacancy it will take time for rents to recover. Overall, we still believe the market has a positive long-term outlook given the growth in its medical sector, high-skilled and highly educated workforce and relatively low business and living costs relative to many East and West Coast markets.

The Worst is Likely Over for the Houston Office Market



2017 will likely be the peak for new deliveries in most office markets across the country.

In New York, meanwhile, roughly 1.1 million square feet was returned to the market. Given the market's size, this is a relatively small amount of negative net absorption that accounted for 20 basis points of the total 60-basis-point increase in vacancies. The additional 40-basis-point uptick in vacancies, however, was driven by the delivery of nearly 2.0 million square feet. The softness on the demand side was largely concentrated in Manhattan's East Side, primarily in CBRE-EA's Midtown South and Midtown Manhattan major markets. Within Midtown South, the Hudson Square/TriBeCa, NoHo/SoHo and PAS/Madison Square submarkets returned a combined 1.0 million square feet to the market, while Grand Central, Park Avenue, East Side and Sixth/Rock Center reported negative net absorption of nearly 1.6 million square feet. Winners on the West Side of Manhattan included the Penn Station submarket, which reported positive net new demand of 1.5 million square feet for the year. Both Midtown South and Midtown Manhattan's East Side have been pressured by tenants relocating to the West Side's Hudson Yards, which falls in the Penn Station submarket. Wells, Fargo, KKR, Norwegian bank-DNB and Time Warner are just a few tenants who have made the move to Hudson Yards. Near term, there is very little underway with anticipated completion in 2017; however, deliveries will pick up in 2018 and 2019 as there is nearly 11 million square feet underway in the metropolitan area that is expected to deliver after 2017. The bulk of supply underway is at Hudson Yards and the World Trade Center; pre-leasing across the market is relatively healthy at over 40%; however, some of the pre-leasing will create vacancies elsewhere, particularly in the East Side of Midtown. Overall, however, demand should remain healthy, limiting the potential uptick in vacancies. Further, should Dodd-Frank regulations be eased, New York financial firms and, by extension, New York office demand would benefit.

More broadly, we expect 2017 will likely be the peak for new deliveries in most markets. Nationally, roughly 61 million square feet of multi-tenanted space is underway and set for delivery in the coming year. Beyond 2017, there are an additional

34 million square feet underway; we anticipate construction starts, and thereby deliveries, will slow going forward, particularly as credit markets tighten and further restrict access to construction financing. Demand should remain healthy, supported by continued but more moderate employment gains, and rent growth will be strongest in the near term, with long-term growth more in line with inflation.

The industrial market continues to fire on all cylinders.

Office	
Vacancy Rate	12.9%
12-Month Trend	
Vacancy Change	↓
Rent	↑
Absorption	↓
Completions	↔
Cap Rates	↓
Transaction Volume	↓

INDUSTRIAL

The industrial market continues to fire on all cylinders, despite the long tenure of the current economic expansion and property market cycle. Availability remained at 8.2% in the fourth quarter, maintaining the lowest level since early 2001. Vacancy, meanwhile, declined to 4.9%, the lowest level recorded since CBRE-EA began tracking vacancy in early 2002. Over the course of the year, both availability and vacancy declined by healthy margins of 70 and 50 basis points, respectively.

Exceptionally strong demand and somewhat limited supply have continued to propel the market forward. For the second year in a row, nearly 259 million square feet of space was leased on a net basis, a steady acceleration from the already healthy 250 million square feet absorbed in 2013 and 2014. Overall, 2016 yielded the strongest net new demand since 2005 and the fourth highest annual total reported since CBRE-EA began tracking the market in 1989.

Supply has continued to accelerate, but remains well behind demand growth. Roughly 184 million square feet of space was completed in 2016, up from 157 million square feet in 2015 and nearly 1.5 times the 2014 level. Still, the 2016 construction tally represents an increase in stock of only 1.4%. Further, throughout the current expansion stock has increased at an average annual rate of 0.7%, well below the annual averages of 1.5% and 2.0% during the previous two expansions.

In 2016, supply has been greatest in Allentown and Riverside, with inventory increasing by 6.2% and 4.0%, respectively. The 7.3 million square feet added in Allentown was spread across 12 buildings in the Lehigh Valley, and was met by exceptionally high demand with all but 1.0 million square feet of the space delivered in the year being leased. Uline and Amazon led the way, taking down 1.7 and 1.1 million square feet of new supply, respectively. FedEx, Behr Paints, Barry Callebaut, Tesla, Ryder Systems, Herman's Warehouse, Wasserstrom and East Penn Manufacturing accounted for the remainder of the 3.5 million square feet of new product that was absorbed in the year. In addition to the strong demand for new product, there was a healthy demand for existing product. In sum, more than 8.0 million square feet was absorbed in the year, outpacing the new supply total and pushing availability down to 7.7% in the market, a reduction in availability of 120 basis points over the course of the year.

Meanwhile in Riverside, 68 buildings containing 20 million square feet of industrial space were completed in 2016. Like the Lehigh Valley, demand for new product was strong with roughly 70% of the space delivered being absorbed. Medline, General Mills, QVC, Amazon, Floor & Décor, Black & Decker, LG Electronics and UPS all took space in the newly delivered buildings. Overall, however, total demand fell short of new deliveries, and availability in the market increased 50 basis points albeit to a still low and below average level of 7.5%.

Going forward across the country, supply is expected to ease slightly in 2017, with 163 million square feet underway and scheduled to be completed during the year. Meanwhile, demand should remain healthy, supported by a growing U.S. economy and a recovering global economy. Nonetheless, it will be important to monitor both national trade policy changes and the broader geopolitical environment. For example, President Trump's executive order with respect to a border wall with Mexico has the potential to spark a trade war as President Trump has stated a 20% tariff on Mexican goods could be used to pay for the wall. Further, the new administration has made re-negotiating NAFTA an immediate priority and has threatened to levy tariffs on Chinese goods as well. The administration has yet to impose tariffs on any nation; however, there is a risk tariffs will be imposed and this could impact industrial markets across the country. President Trump has withdrawn from the Trans Pacific Partnership, although it was not likely to gain congressional approval anyway and does not impact our trade or industrial market outlook. Overall, we do not believe a trade war will occur in the near term, again, leaving our economic or industrial market outlook unchanged for 2017. Longer term, we will continue to monitor U.S. trade policy.

Industrial	
Vacancy Rate	**8.2%**
12-Month Trend	
Vacancy Change	↓
Rent	↑
Absorption	↔
Completions	↑
Cap Rates	↓
Transaction Volume	↓

MULTIFAMILY

Apartment vacancies closed out 2016 at a 4.9% rate, up 20 basis points from a year earlier and up 40 basis points from the previous quarter. Fourth quarter apartment absorption is typically slower than other parts of the year and this was indeed true in 2016 with only 12,600 units absorbed on a net basis. While well below the more than 110,000 units typically absorbed during the second quarter, fourth-quarter absorption in 2016 was actually stronger than the fourth quarters of 2014 and 2015. The increase in vacancy is thus more reflective of the 71,300 units that were delivered during the quarter. Overall, the fourth quarter of the year marked the high water mark for completions to date during the current property market cycle; that said, the fourth-quarter increase was a mere 0.5% of stock.

On an annual basis, nearly 243,000 units were completed, the largest total ever reported by CBRE-EA. Relative to inventory, however, the increase in stock totaled only 1.4%, less than half the 3.3% increase in 2000 and just barely above the market's long-term average of 1.2%. Further, in the context of the overall housing market, both owned and rental units, total stock increased by 0.7% in 2016, well below the market's long-term historical average of 1.2% (1981-2016), and has increased at an average annual rate of only 0.4% since the start of the decade.

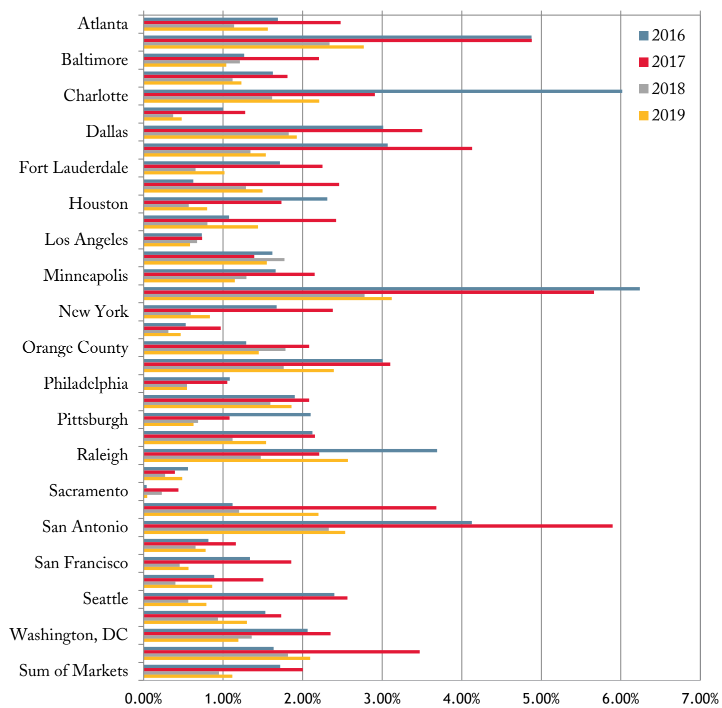
As always, supply varies greatly by market. In 2016, completions as a share of inventory were greatest in Nashville, Charlotte, Austin, San Antonio, Raleigh, Denver, Dallas, Orlando, Columbus and Seattle. The level of completions relative to inventory in the aforementioned markets ranged from just over 6% in Nashville to 2.4% in Seattle. That said, in many of the markets highlighted above, demand has essentially kept pace with supply, including Charlotte, San Antonio, Raleigh, Columbus and Seattle. Further, nationally, rents were relatively flat over the course of the year, according to CBRE-EA; however, Raleigh, Nashville, Seattle, Charlotte, Orlando and Dallas reported some of the highest rent growth in the country. Meanwhile, Sacramento, Riverside and Fort Worth are at the opposite end of the supply spectrum, with completions totaling less than 0.7% of inventory; as such, rent growth in the three markets was 4.8% or greater, with Sacramento registering the largest gain in the year at nearly 10%.

Going forward, nationally we expect supply will begin to taper after 2017, particularly as construction debt becomes increasingly difficult to obtain. Across markets, Atlanta, San Antonio, West Palm Beach, Orlando, Orange County, Denver and Dallas will follow the national supply pattern, with deliveries peaking in 2017. However, peak construction has already occurred in some markets, such as Charlotte, Nashville, Raleigh and Houston. Washington D.C., which had been pressured by robust supply growth and tepid demand, is turning the corner. While supply is still projected to be fairly healthy in 2017, demand in the market is improving. Indeed, vacancies in the Washington D.C. market are stabilizing and rents have grown modestly.

On the demand side, all markets are expected to benefit from the continued growth in employment, the formation of new households led by millennials, downsizing among baby boomers and rising mortgage interest rates, which will all work to buoy demand for apartments. Many millennials have yet to enter the rental market, and we expect these younger millennials will move out of their parents' homes and form households of their own over the next few years. Additionally, millennials are delaying homeownership relative to previous generations and as such, demand from this cohort will be more sustained even as they age. Meanwhile, many empty-nester baby Boomers are selling their homes and moving into Class A apartments, and as more boomers reach retirement age, we anticipate this trend will continue. With a favorable demand outlook and slowing construction levels, fundamentals should remain healthy well into the future. Rents, however, will advance at a more moderate pace, particularly as we are in the later stages of the current property market cycle and have experienced several years of well above average rent growth.

Multifamily fundamentals should remain healthy well into the future.

Supply is Slowing across most Markets



Multifamily	
Vacancy Rate	4.6%
12-Month Trend	
Vacancy Change	↑
Rent	↑
Absorption	↑
Completions	↑
Cap Rates	↓
Transaction Volume	↑

RETAIL

It is eight years into the current recovery/expansion and, to date, the consumer environment has been uneven, particularly with respect to wage growth. Indeed, sustained wage growth has remained elusive given both the late stage of the business cycle and the fact that we are very near full employment. That said, it does appear that wage pressure is mounting with more economic indicators showing healthier wage gains. Indeed, average hourly earnings advanced at the best post-recession year-over-year pace of 2.9% in December 2016, before moderating slightly to 2.5% year-over-year in January. Further, the Atlanta Federal Reserve Bank reported year-over-year growth in wages of approximately 3.9% through November 2016; this is the highest level since the financial crisis.

The recent more positive wage news, however, has yet to translate into a more favorable environment for retailers as they continue to feel the pinch of the more restrained consumer. While fundamentals continue to improve at a modest pace, the bifurcation in the market that we have highlighted for several quarters persists and is perhaps even more pronounced among retailers. Quite often we have discussed the fact that there are "winners" and "losers" or "haves" and "have nots" in the retail property markets, and this is also the case among retailers themselves as well. The environment for retailers remains very competitive, and retailers are feeling the pressure from online sales. The retail shake-up continues with Sports Authority shuttering its doors in 2016 and American Apparel, Pacific Sun and Aeropostale seeking bankruptcy protection. Retailers to watch in 2017 include The Limited, Claire's Stores, True Religion Apparel and Sears; all four are reportedly on the verge of bankruptcy. In addition, retailers continue to "right-size" stores and close underperforming locations—Macy's, JC Penney and CVS will all close underperforming stores in 2017. Overall, this creates a challenging environment for retail property demand and limits the ability for landlords to push rents in all but the best properties.

Against this backdrop, availability in both the lifestyle/mall and power center segments increased over the course of the year, primarily due to the large number of store closings related to bankruptcies and underperformance. Indeed, availability in the lifestyle and mall category of the market rose to 6.9% in the fourth quarter of 2016, up from 6.8% in the previous quarter and 6.3% a year earlier. Power center availability, meanwhile, increased to 6.5% in the fourth quarter, up from 6.3% in the previous quarter and 5.7% from a year earlier. Countering the softer conditions in the lifestyle, mall and power center segment was the neighborhood and community shopping center segment of the market. Shopping center availability remained at 10.2% for the second consecutive quarter, but was down 50 basis points year-over-year. The improvement in the neighborhood and community shopping center side of the market is typical in the later stages of the business cycle as smaller businesses are more confident in the economic expansion and have better access to small business credit, allowing them to secure leases and open storefronts. Total retail availability, meanwhile, was flat in the quarter at 7.1% and down 40 basis points year-over-year, with the year-over-year decline driven by the improvement in the neighborhood and community shopping center segment of the market.

As the consumer has remained cautious, the slower recovery in the retail market has largely been driven by demand side factors, as supply has been contained. Indeed, annual inventory growth has been less than 1% across all retail segments throughout the course of the current property market cycle. Putting construction in further context, total retail inventory has increased at a rate roughly one-third of the previous expansion.

Regionally, total retail availability declined on a year-over-year basis in 45 of the 62 markets tracked by CBRE-EA and was flat in 7 markets, leaving only 10 markets reporting a year-over-year increase. Nashville, Minneapolis, San Diego, Atlanta, Charlotte and Boston all reported a decline in availability that was double or more than double the 40 basis point improvement at the national level. Dallas, Fort Worth, Philadelphia, Portland, Tamp, West Palm Beach, Denver, Austin and Seattle also reported a notable improvement in market fundamentals. Meanwhile, San Francisco, Pittsburgh, Chicago, San Jose, Miami and Orange County were among markets reporting an increase in availability. Of note, however, San Francisco continues to maintain the lowest availability rate in the nation at only 4.4%. Likewise, despite the slight uptick in availability, Miami (4.7%), Orange County (5.1%), San Jose (6.0%) and Pittsburgh (6.8%) maintained an availability rate below the national average of 7.1%. Chicago, meanwhile, was at the other end of the spectrum with an availability rate of 10.4%, the highest in the nation.

Going forward, we expect fundamentals will continue to improve at a modest pace. While the economy is projected to continue to approach full employment, which should lead to better and more consistent wage growth and support improved retail sales, demand for space will continue to be pressured in the near term by store closures that will temper demand growth. Supply growth will also be modest, keeping availabilities on their slight downward path. As a result, rent growth will likely remain restrained as well, with better located centers outperforming their less desirable counterparts.

Retail	
Vacancy Rate	10.2%
12-Month Trend	
Vacancy Change	↓
Rent	↑
Absorption	↑
Completions	↔
Cap Rates	↓
Transaction Volume	↓

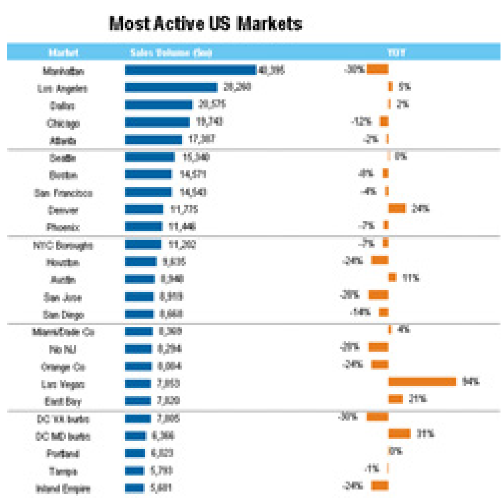
CAPITAL MARKETS

Capital markets have eased from their breakneck pace of the previous few years. Transaction volume slowed to $489 billion in 2016, a decrease of 11% from 2015's volume. The slowdown was entirely on the portfolio- and entity-level sides of the business as single-asset transactions were largely unchanged. Nearly $123 billion in portfolio- and entity-level based properties changed hands in the year, down 30% from 2015. Meanwhile, $366 billion in single-asset sales were reported in 2016, off 1% from 2015.

Among the product types, the apartment sector recorded the greatest volume of transactions. In addition, it was the only property sector to show positive year-over-year growth in 2016. The apartment sector accounted for nearly one-third of the total transaction volume for the year, with just over $158 billion in apartments changing hands in the quarter, up 3% from 2015. Volume across all other property types was down in 2016, with hotels reporting the greatest annual decline. Roughly $36 billion in hotels changed hands, down 28% from 2015. Additionally, industrial, retail and development site sales weakened with $59, $76 and $19 billion of sales down 24%, 16% and 26%, respectively.

Regionally, Manhattan, Los Angeles, Dallas, Chicago, Atlanta, Seattle, Boston, San Francisco, Denver and Phoenix were the 10 most active markets in the U.S.; however, as Figure 6 shows, transaction volume among six of the aforementioned markets was lower in 2016 relative to 2015. Conversely, Las Vegas, the D.C. Maryland Suburbs, Denver, the East Bay, Austin and Los Angeles reported some of the largest increases in sales activity in 2016.

Figure 6



Buyer composition continued to trend towards foreign buyers in 2016. Cross-border investors remained the largest net acquirer (less dispositions) of U.S. real estate, followed by private buyers (who were net sellers in 2015). All other investor categories (institutional/equity funds, listed/REITs and user/other) were net sellers in 2016. Cross-border investors acquired roughly $31 billion of properties (on net) in 2016, less than half the $66 billion of net purchases in 2015; however; 2016 marked the fourth year in a row that foreign investors were net acquirers of U.S. real estate. In sum, since the start of 2013, foreign entities have purchased over $120 billion of U.S. properties on net. Listed/REITs and private buyers have been the only other net acquirers of U.S. real estate since 2013. Overall since 2013, listed/REIT buyers have increased their U.S. real estate portfolios by nearly $3.3 billion while private buyers added just under $200 million to their portfolios. Institutional investors, meanwhile, have been net sellers since 2013, disposing of $66 billion in property; user/other investors were also net sellers, selling nearly $29 billion over the past few years on net.

Reflecting the overall moderation in transaction volume, the Moody's/RCA Commercial Property Price Index (CPPI), which tracks repeat sales pricing, reported the first single-digit gain since 2012; the NCREIF Property Index (NPI) also reported more normalized returns for 2016. The CPPI advanced by 9.1% in December 2016 on a year-over-year basis, down from the pace of 10.9%, 16.6% and 14.8% in 2015, 2014 and 2013, respectively. Meanwhile, pricing among the product types was strongest for the industrial sector with the Moody's/RCA CPPI Industrial index advancing by 14% over the course of 2016. The apartment and office sub-sector indexes also recorded double-digits gains, advancing a respective 12% and 10%. Hotels and retail lagged with the sub-indexes increasing in value by 4% and 2%, respectively.

Meanwhile, the NPI return totaled nearly 8% in 2016. Like the CPPI, this was the first year of single-digit gains for some time. Indeed, the NPI return has been in double-digit territory since 2010. The moderation in returns has largely been driven by slower appreciation—the 2016 appreciation return totaled 3.1% while the income return was nearly 4.8%. The appreciation return had previously been over 5% in each of the last three years (8.0% in 2015, 6.2% in 2014 and 5.2% in 2013); the income return has moderated only slightly, slowing to 4.8% in 2016, down from 5.0% in 2015, 5.4% in 2014 and 5.6% in 2013. As AEW has cautioned for some time now, property appreciation that results solely from falling cap rates is less likely going forward, particularly as cap rates across all property types are at or near all-time lows. Overall, investors should be preparing for both lower absolute returns as well as a more normalized return profile where returns will once again be driven more by income than appreciation; this is a return to historical norms, where income accounts for roughly 70% of total returns. Over the past few years, appreciation has accounted for a greater proportion of the total return.

DID YOU KNOW?

Investment themes we are observing in the market today…

…Brexit, Trump and upcoming European elections are contributing to global policy uncertainty; indeed, the IMF's index of Global Economic Policy Uncertainty is at its highest level ever.

…Despite the uncertainty, U.S. and China growth accelerated during second half of 2016. Economic data in Europe continues to surprise to the upside, while resource driven economies (Russia, Brazil, Venezuela) remain in recession. Expectations for 2017 are relatively unchanged; however, there is potential for stronger growth in 2018 and beyond

…Average apartment rents are now 25% above pre-crisis peak while office and industrial rents are now back to prior peaks.

…To date, newer Class A, ultra-luxury apartment demand has in fact been driven by the baby boomers. The number of renter households aged 55 to 74 has edged noticeably higher. This age cohort, who is largely made up of baby boomers, has added roughly 400,000 renter households per year since 2010, up from an average of roughly 200,000 in 2006 and 2007.

Prepared by AEW Research, December 2016

AEW

Two Seaport Lane
Boston, MA 02210
+1 617 261 9000
www.aew.com