U.S. ECONOMIC OVERVIEW

U.S. economic growth during the first half of 2015 was, similar to 2014, uneven with a weak first quarter (+0.6%) followed by a stronger second quarter (+2.3%). Overall, growth in the first half was on pace with 2014 and slightly ahead of the seemingly "new normal" growth rate of approximately 2% so far in the recovery period of this economic cycle. Historically, U.S. real GDP growth has averaged slightly more than 3% per year in the post-World War II period, roughly 1% higher than the growth during this recovery. Political discord in Washington has proven to be one of the main reasons that growth has not been stronger in recent years as real government spending actually declined at an annual rate of 1.4% since the start of the recovery in the second quarter of 2009. This government drag does appear to be lifting, however, as real spending has increased over the past year and spending growth is now accelerating. We anticipate this trend will continue as we move past next year's presidential election with spending growth accelerating more significantly in 2017 and beyond. More immediately, recent data from the Institute of Supply Management (ISM) shows a surge in the non-manufacturing portion of the U.S. economy to the strongest level in ten years, suggesting a significant acceleration of U.S. real GDP growth during the second half of 2015.

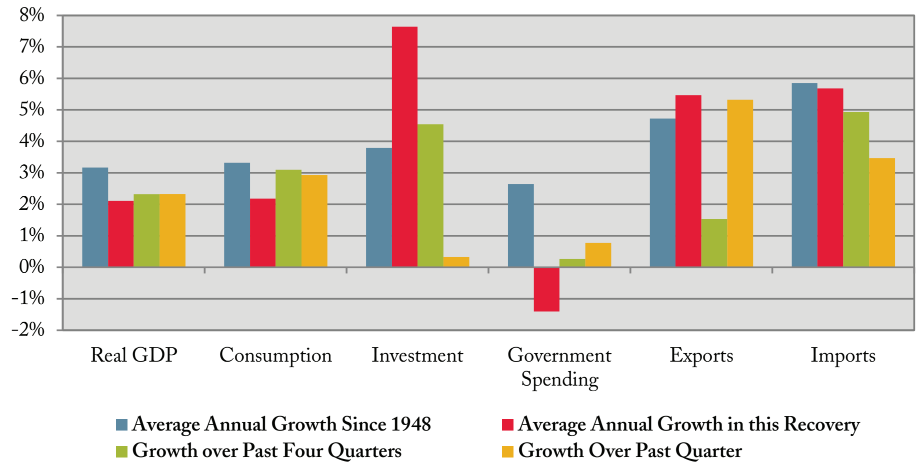
Key Real Estate Indicators

Property Type	Vacancy Rates		Rents	Absorption	Completions	Cap Rates	Transaction Volume
Office	13.5%	↓	↑	↑	↑	↓	↑
Industrial	9.8%	↓	↑	↑	↑	↓	↑
Retail	11.4%	↓	↑	↑	↔	↓	↑
Multifamily	4.7%	↓	↑	↑	↑	↓	↑
Seniors Housing	10.0%	↔	↑	↔	↑	↓	↑

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

Source: CBRE-EA, NCREIF, RCA, NICMAP
Note: The arrows reflect the trend for the 12 months ending in Q2 2015 with the comparable period for 2014 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 or an improvement in market fundamentals. For cap rates, a down arrow indicates falling cap rates or rising prices.

Figure 1:
Breakdown of Real GDP Growth

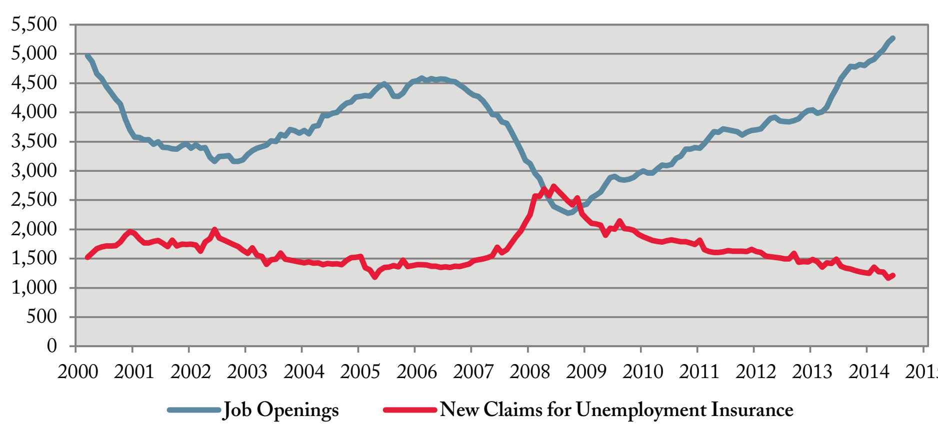


Source: Bureau of Economic Analysis

In aggregate, the U.S. has added more than 12 million new jobs since total employment reached a cyclical trough during the first quarter of 2010 and the national job count today is 2.5% above the pre-financial crisis peak.

More importantly for U.S. property investors, steady American job growth continues to be one of the clear bright spots in the global economy as employment gains through July remained at an annual pace of nearly 3 million new jobs (2.1% year-over-year growth). In aggregate, the U.S. has added more than 12 million new jobs since total employment reached a cyclical trough during the first quarter of 2010 and the national job count today is 2.5% above the pre-financial crisis peak. Through July 2015, total employment had increased for 58 consecutive months, the longest continuous employment expansion since record-keeping began in 1939, and has averaged slightly more than 200,000 new jobs per month. Looking ahead, job growth is expected to remain near or above the current pace as total open positions in the U.S. remain at a record high of more than 5 million while new unemployment claims have retreated to levels not seen since the early 1970s.

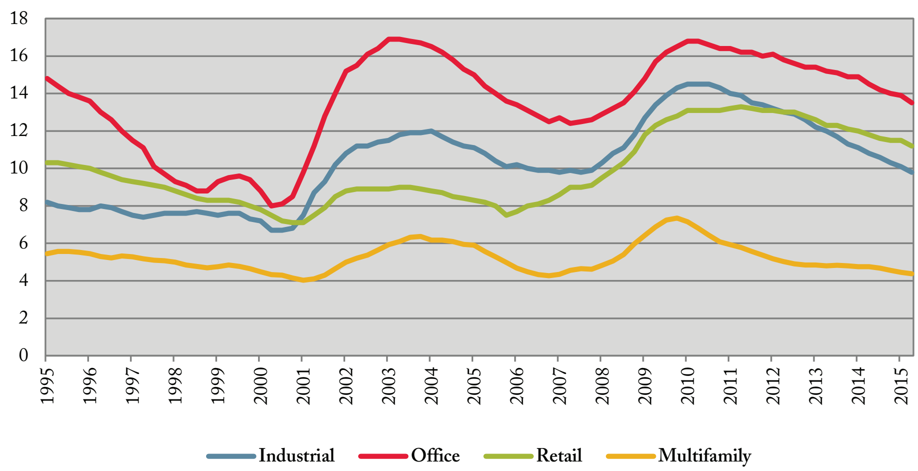
Figure 2:
U.S. Job Openings and New Claims for Unemployment Insurance



Source: Bureau of Labor Statistics (JOLTS)

Reflecting this moderate but steady pace of recovery and expansion, property fundamentals continue to strengthen with vacancy/availability rates falling across nearly all markets and property types and rent and net operating income (NOI) growth continuing to show mid-cycle strength. Nationally, office vacancies are at their lowest level since mid-2008, dropping to 13.5% in the second quarter, down 100 basis points from a year earlier. Industrial availability also continues to improve, declining to 9.8%, the lowest level since the end of 2007 and also a 100 basis point reduction from mid-2014. Apartment vacancies declined 30 basis points year-over-year to 4.7% in the second quarter; following a slight uptick in vacancies over the previous two quarters. Overall, the apartment sector appears to be shrugging off new supply with occupancies and rents climbing to new heights. Effective rents advanced 5.0% on a year-over-year basis, the strongest four-quarter gain since mid-2011. For its part, the retail property sector (Neighborhood & Community Shopping Centers) continued to improve as well; but, at a more modest pace with availability declining by 30 basis points year-over-year to 11.4% in the second quarter of 2015.

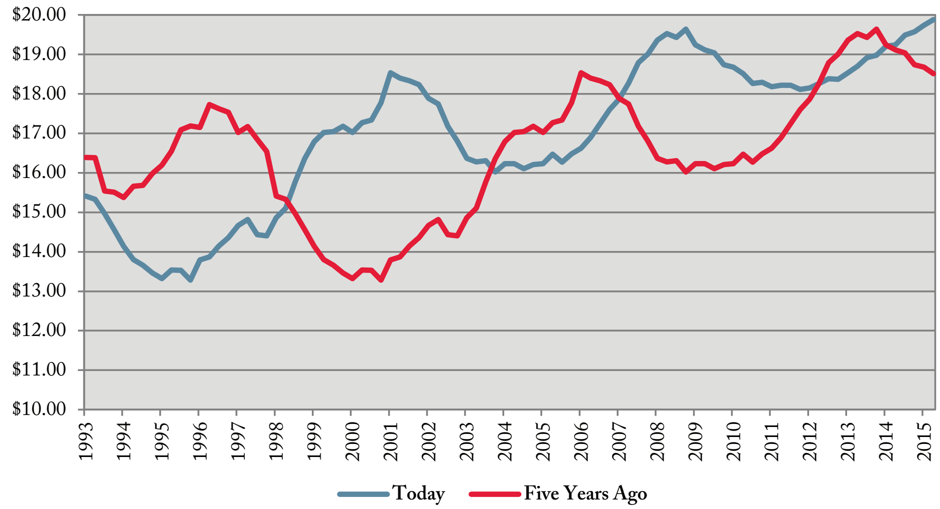
Figure 3:
U.S. Average Vacancy Rate by Property Type (%)



Source: CBRE-EA

While the economic and property market fundamentals are clearly positive, increasingly these characteristics are already reflected in property pricing. Similar to pre-crisis conditions, vacancy or near-term tenant rollover is again becoming as valuable (or more valuable) than stable rent rolls. This change in preference is consistent with earlier recovery/expansion cycles and reflects the imbedded gain that is typical at this point in the cycle when rents for in-place leases are brought to new market rent levels. Figure 4 provides a simple illustration of the so-called "loss to lease" phenomenon where average net effective office rents nationally are now nearly 10% higher than the typical rent level five years ago.

Figure 4:
U.S. Average Net Effective Office Rent



Source: CBRE-EA

Reflective of a near-zero asset yield environment globally, U.S. property yields across all property types are also at or near all-time lows. While this is worrisome in terms of risk to current valuations, property yield spreads remain above long-term averages suggesting room for spread compression if interest rates begin to rise. For its part, the Federal Reserve continues to signal the beginning of the end of the U.S. zero interest rate policy (ZIRP) with the first increase in overnight lending rates widely expected in September. Once the Fed begins tightening, short rates are expected to rise slowly but steadily to 3%-3.5% by the end of 2017 making it the most gradual Fed tightening ever and the lowest “neutral” Fed Funds rate target ever. In this environment, we expect property yields to rise slowly as well, increasing perhaps 50-75 basis points over the next three years.

As a result, we expect outsized property returns again for 2015 with low double-digit total returns for the NPI, accompanied by appreciably lower total returns over the 2016-2018 period as somewhat higher property yields may hold down property capital appreciation. Indeed, consensus expectations for 2015 are likely conservative given the near 7% total return recorded for the NCREIF Property Index during the first half of 2015.

Figure 5:
Consensus NCREIF Property Index (NPI) Return Expectations

NPI	2015	2016	2017	2014Q4 to 2019Q4
Appreciation Return	5.2%	3.3%	2.3%	2.5%
Income Return	5.3%	5.3%	5.4%	5.5%
Total Return	10.6%	8.6%	7.7%	8.0%

Source: PREA June 2015 Survey

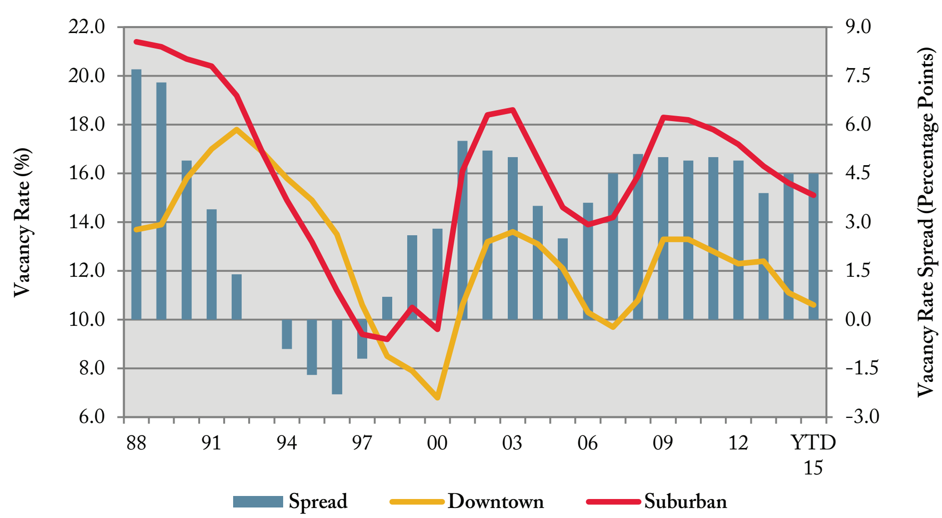
REGIONAL OUTLOOK

U.S. property markets continue to strengthen with vacancies trending down and rents advancing. The recovery is broader based with the office and retail sectors now beginning to catch up with the industrial and apartment sectors. The office market, in particular, is beginning to see rents pop. The robust growth in rents is the result of a clear improvement in vacancies. According to CBRE-EA, office vacancies are at their lowest level since mid-2008, dropping to 13.5% in the second quarter, down 100 basis points from a year earlier.

There may be differences within specific markets; but, nationally, the recovery in suburban markets has been healthy and suburban markets have actually outperformed downtown markets.

The recovery in the office sector is occurring across both downtown and suburban markets, despite the fact that the downtown office markets have been getting more than their fair share of attention in the press. Indeed, much has been made about the "death of the suburban office market". However, what has escaped attention is that the suburban markets are indeed well on the road to recovery. There may be differences within specific markets; but, nationally, the recovery in suburban markets has been healthy and suburban markets have actually outperformed downtown markets. Since the beginning of 2010, nearly 132 million square feet of suburban space has been absorbed, accounting for nearly 70% of all office absorption, which is above the suburban market's 65% share of inventory. Additionally, suburban vacancies have declined by 350 basis points from peak compared to a 290 basis point reduction for downtown markets. Of course, some may argue that the reason the reduction in suburban vacancies has been greater is that there has been no suburban office development while the downtown submarkets have experienced an uptick in construction. The reality, however, is that the suburban office stock has increased by nearly 3.0% since the end of 2009 compared to an increase in downtown inventory of 2.5%.

Figure 6:
Office Vacancy Comparison



Source: CBRE-EA

What does all this mean? That suburban office markets are not in fact dead; but, are alive and well. That said, there will continue to be the ‘haves and have nots’ in the sector just as there are in every other property type. Successful suburban markets will mirror downtown lifestyles in that they will need to offer a solid amenity base, have a 24/7, live-work-play feel and offer convenient transportation to both suburban and urban housing. In many cases these will be close-in suburbs or edge cities that have significant clusters of high-tech, bio-tech, education or health service activity and, longer term, energy. Examples of markets with the aforementioned qualities include Cambridge and Waltham in Boston; Sunnyvale in San Jose; the Northwest submarket in Austin, Buckhead in Atlanta, Walnut Creek in Oakland, Uptown/Turtle Creek in Dallas, the West Loop in Houston and the Southeast submarket of Denver to name a few. Vacancies in all of these markets are well below the national average and, in some cases, below their downtown market average.

Going forward, as the economy continues to expand AEW expects the recovery in both the suburban and downtown office markets will continue. Rent growth in the downtown markets, which has indeed outpaced suburban markets, will eventually push more companies to the suburbs. Thus, we expect the spread between downtown and suburban vacancies will gradually decline in the coming years.

Industrial availability nationally is at its lowest since the fourth quarter of 2007 and rents are just below their pre-recession peak.

Like the office sector, the industrial market is firmly in recovery and perhaps just shy of a full recovery. Availability nationally is at its lowest since the fourth quarter of 2007 and rents are just below their pre-recession peak. More specifically, however, the coastal port markets and the inland regional hubs of Southern California, South Florida, New York/New Jersey, Seattle, Atlanta and Chicago have all fully recovered with availability at or below their pre-recession levels and rents above their pre-recession highs. The recoveries in Atlanta and Chicago are particularly notable as these markets were slower out of the gate and had higher peak availability than the coastal port markets. Availability in Atlanta was 11.3% in the second quarter, the lowest rate in nearly 15 years and rents are at their highest rate in more than a decade. Likewise, availability in Chicago, 10.6%, is the lowest since mid-2007 while rents are at a new high.

The improvement in industrial fundamentals is also broad based. Among the 58 markets tracked by CBRE-EA, 28 are reporting availability at or below 10%, the greatest number of markets since early 2008, and 29 are reporting a current availability rate below their fourth quarter 2007 level. More telling, however, is that 52 markets currently have availability rates at or below their 10-year average while 44 markets have availability at or below their 15-year average.

The strength of the industrial property sector is not just across markets but across product size and vintage year. Properties totaling 10,000 to 49,000 square feet that were built between 1970 and 1979 reported the lowest availability rate among the industrial sector at 7.4% and properties in the same size segment, but built before 1970, followed at 8.0%. Overall, properties totaling 10,000 to 49,000 square feet, which accounts for over 31% of all industrial inventory, reported a second quarter availability rate of 8.4%, 160 basis points below the second lowest rate of 10% in the 400,000 square foot and over category.

Going forward, the industrial market outlook is exceptionally positive. Supply, which has picked up, remains largely in check. Demand, meanwhile, should be bolstered by a stronger U.S. consumer, improving housing markets and a projected recovery in the global economy. As such, AEW expects availability rates across all markets, size categories and vintage years will continue their downward trend, generating continued healthy rent gains and NOI growth.

The retail market continued its slow and steady recovery in the first half of 2015. According to CBRE-EA, neighborhood and community shopping center availability dropped 10 basis points to 11.4% in the first quarter of 2015 and remained at this level in the second quarter. Availability was down 30 basis points year-over-year in the second quarter and 190 basis points from a cyclical high of 13.3% in mid-2011. Broader retail availability, however, which includes malls, lifestyle and power centers, is considerably lower at 8.1% as of the second quarter of 2015. Meanwhile, CoStar Portfolio Analytics, which reports vacancy rates as opposed to availability, reported a first quarter 2015 vacancy rate of 6.2% across all retail segments. Additionally, as we've discussed in the past, the retail market is very much bifurcated with a sizeable subsector of properties which are essentially un-leasable and as a result the availability/vacancy remains artificially high. In fact, according to CoStar Portfolio Analytics, vacancies drop to a mere 2.7% once properties with vacancies over 40% are excluded from the broader average; in other words, properties with considerable vacancy account for 350 basis points of vacancy in the broader retail market.

Going forward, retail fundamentals, similar to industrial, should continue to improve, supported by a stronger consumer, a strengthening housing market and the projected global economic recovery. Availability and vacancy will likely continue to show modest improvement as the presence of dead or obsolete centers keeps upward pressure on the overall availability/vacancy rates. Rents, which have begun to move in earnest, will continue on their upward trend. The continued absence of new supply will work to support the improvement in fundamentals.

The apartment sector, meanwhile, continues to defy the odds. According to Axiometrics, apartment vacancies declined to 4.7% in the second quarter, down 50 basis points from the previous quarter and 30 basis points year-over-year. Effective rents advanced 5.0% on a year-over-year basis, the strongest four-quarter gain since mid-2011. Further, the average effective rent nationally eclipsed $1,200 per unit for the first time ever and all of the top 50 markets tracked by Axiometrics reported a quarterly gain, up from 36 markets in the first quarter and 14 at the end of 2014. This has occurred amidst the largest increase in supply since 2003. The rolling 8-quarter completions totals over the past three quarters have been over 250,000 units; this outpaces the building cycle prior to the recession and is more than three times the 2011 to 2012 development. The total housing inventory growth remains in check; however, the growth is skewed to apartment rather than single-family development.

Markets where inventory growth is particularly strong and ahead of long-term averages include Austin, Seattle, San Jose, Denver, Houston, San Francisco, Boston and Orange County. Despite the above-average pace of construction, vacancies in these markets remain below 5% (Houston is the only exception at 5.3%) and effective rents have been growing at a healthy pace. In fact, Denver posted the third highest year-over-year effective rent growth in the nation at more than 11%; among the aforementioned markets, San Jose followed, ranking 4th at 10.3%; San Francisco was 6th at 9.1% and Seattle was 7th at 7.5%. Meanwhile, Orange County, Austin, Boston and Houston reported growth of 6.0%, 4.8%, 4.4% and 3.7%, respectively.

DID YOU KNOW?
Investment themes we are observing in the market today…

…By 2060, the U.S. population will be 100 million higher. This is the largest increase globally, excluding India which will add 350 million new people. China, Japan, Germany, Spain and Portugal will actually lose population.

…Roughly 60% of the increase in U.S. population will come from immigration, ultimately yielding a U.S. population that will be "majority minority" with no majority race or ethnicity.

…The real estate implications of a surge in population of this magnitude and changing demographic characteristics mean we will need 40 million new residences, 1 billion square feet of new retail space and 1 billion square feet of new office space.

…The target audiences for these new spaces and existing product will likely change over time and properties will have to be positioned/repositioned accordingly, perhaps increasing bedroom counts on apartment buildings or adjusting the tenant mix at a retail center.

…Geographically, gateway markets have historically been the largest beneficiary of international in-migration. This suggests that property markets in gateway cities like Seattle, San Francisco, Los Angeles, Houston, Dallas, Atlanta, Miami, Washington, DC, Boston, and New York will remain strong.

Going forward, with healthy job gains still expected household growth should remain healthy, buoying apartment demand. While the pressure from new deliveries and renter fatigue are not showing up in the data yet, a slowdown in rent growth to more normal levels is expected. Overall, however, apartment market fundamentals should remain healthy with low vacancies and continued rent growth, albeit more moderate growth.

The seniors housing sector experienced a healthy bounce back in the second quarter of 2015. Demand returned to more normal levels with 3,600 units absorbed in the second quarter across all markets tracked by the National Investment Center for the Seniors Housing & Care Industry (NIC); this follows a modest decline of 98 units in the first quarter. While the second quarter demand did not quite reach the 4,373 units absorbed a year ago, demand is running ahead of the pace averaged over the past five years suggesting that last quarter's issues were likely more temporary in nature.
On the supply side, NIC reported a notable increase in new deliveries during the second quarter of 5,861 units – the highest quarterly level in six years. This is up from 3,785 units during the same quarter last year and a muted 2,206 units in the first quarter. While demand appears to be back on track, the strong pace of new deliveries resulted in lower occupancies for the second quarter in a row. Seniors housing occupancies fell 20 basis points to 90.0% in the second quarter of 2015 and are at the same levels as a year ago.
Across the property subtypes, majority independent living (IL) and majority assisted living (AL) property types both experienced a healthy bounce back in demand during the second quarter that was matched on the supply side as some delivery dates were probably pushed back from the first quarter. Average occupancy rates for IL properties held at 91.2% as nearly 1,200 units were absorbed across all markets tracked by NIC. Meanwhile NIC reported AL net absorption of 2,422 units during the quarter, in line with year-ago levels and exceeding the average over the past five years. Still, occupancies dipped 40 basis points to 88.5% as nearly 4,200 new AL units come on line.

Going forward, the strength of the overall housing recovery, favorable demographics and healthy economic conditions suggest positive demand dynamics for this property type. Supply is accelerating across the industry, however, demand should exceed supply, leading to higher occupancies and continued rent growth in the coming years. The improvement in fundamentals should be broad based, across many markets and in both the AL and IL segments of the market.

The NPI is on pace for another solid year of double-digit returns. Both appreciation and income growth were strong through the second quarter which suggests a 2015 total return of over 10%. Indeed, over the first two quarters of the year, the NPI posted a total return of 6.8%. The strong total return was the result of continued outsized appreciation; the NPI appreciation component return totaled 4.3% year-to-date. The industrial and retail sectors boasted the strongest appreciation returns year-to-date at 4.6% and 5.4%, respectively, while apartments and office lagged at 3.5% and 4.0%, respectively. Both industrial and retail also reported above-average income returns at 2.7% and 2.6%, respectively, compared to the overall income return of 2.5% year-to-date. Again, we expect returns to be reined in over the 2016-2018 period as somewhat higher property yields hold down property capital appreciation.

With still-strong property returns, particularly relative to government bonds and equities (through the first half of the year the Barclays Capital U.S. Government Bond index was flat while the S&P 500 Index had a first-half return of 1.2%), the flow of capital to real estate remains strong. In the first half of the year over $255 billion in properties changed hands, a 36% increase over the 2014 pace, according to RCA. Volume is now just ahead of the 2006 pace. Roughly $118 billion of trades occurred in the second quarter, up 23% on a year-over-year basis. While volume was up across all property types, the industrial market was the strongest sector with a 40% year-over-year increase in transaction volumes. This is not surprising, however, given the strength of the underlying fundamentals and the above average returns being produced in the sector. Pricing among all property types remains strong with cap rates at or near all-time lows. Despite an expected uptick in treasuries, we expect property yields will remain low through 2016 as we expect the spread between cap rates and treasuries will begin to narrow.

Prepared by AEW Research, August 2015

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