AEW RESEARCH

U.S. ECONOMIC & PROPERTY MARKET PERSPECTIVE

Q1 2017

AEW

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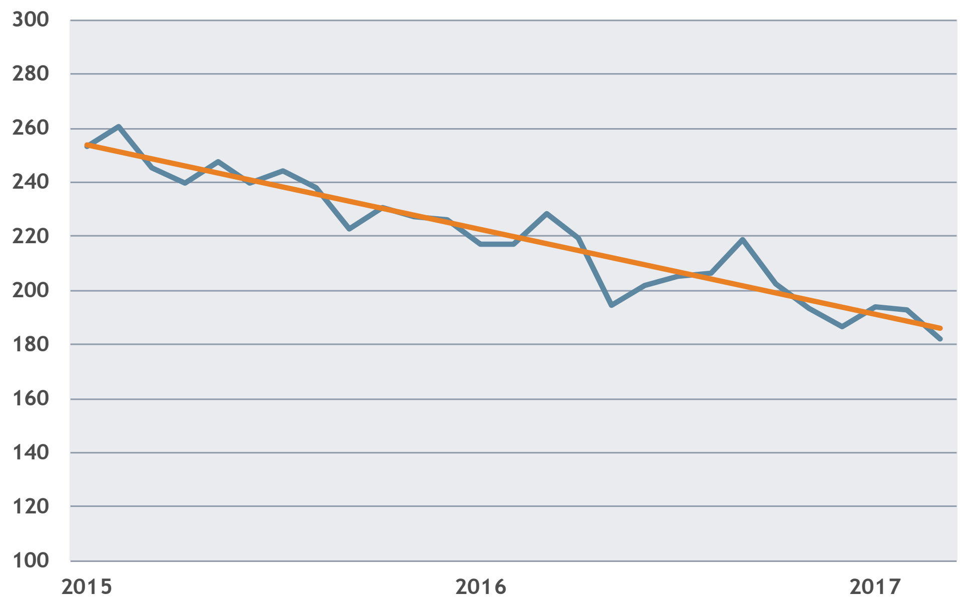
U.S. Economic and Property Market Overview

U.S. economic growth slowed during the first quarter of 2017 with the preliminary estimate for real GDP growth showing an annualized pace of 0.7%, significantly slower than the fourth quarter growth rate of 2.1%, but consistent with the 0.8% growth rate in the first quarter of 2016. Despite a strong rebound in consumer confidence, particularly post-election, annualized real growth in personal consumption was only 0.3% while real government spending declined at an annual rate of 1.7%. First quarter GDP figures have tended to show slower growth in recent years, perhaps signaling a change in seasonal patterns that has not yet been identified. As such, we continue to expect growth for 2017 as a whole to be approximately 2.0%, roughly in line with the prior year. While the administration's stated plans for tax reform and infrastructure spending may ultimately lead to accelerating growth, it seems unlikely that either of these initiatives will have much impact on 2017.

FIGURE 1

AVERAGE MONTHLY EMPLOYMENT GROWTH OVER THE PRIOR 12 MONTHS (000S)

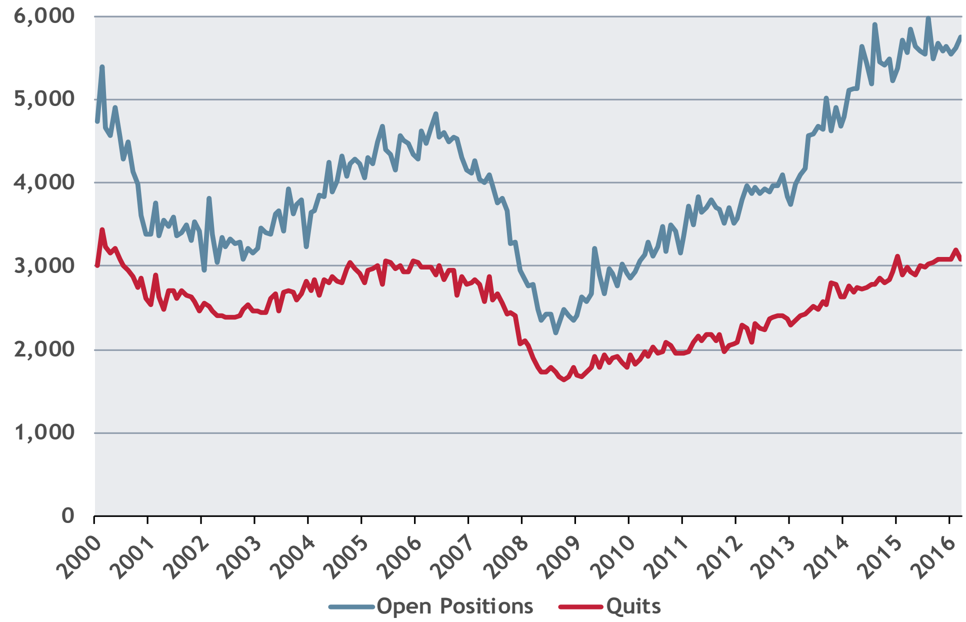


Source: Bureau of Labor Statistics

More significantly, U.S. employment growth also continues to slow, with the average monthly increase in jobs downshifting from approximately 250,000 at the beginning of 2015 to 180,000 as of March 2017. In large part, the slowdown in job creation reflects an emerging labor shortage, particularly in job categories requiring specific skills or education levels. Indeed, U.S. employers are currently reporting nearly six million open positions, the highest level ever recorded. While the openings are broad based, the single largest category of open positions is found in health & education services (1.2 million) and professional & business services (1.1 million).
At the same time, the number of people leaving their job voluntarily (quits) has returned to pre-recession levels, which suggests that worker confidence in being able to find a job has largely recovered from the financial crisis.

FIGURE 2

OPEN POSITIONS AND THE NUMBER OF PEOPLE QUITTING THEIR JOB EACH MONTH (000S)



Source: Bureau of Labor Statistics

Going forward, we see labor constraints as perhaps the greatest headwind on stronger economic growth and, ultimately, the degree to which the current business cycle can be extended. While the official unemployment rate is now at 4.5%, it can be argued that this overstates the health of the labor market because the labor force participation rate of 63% is far below the 66% pre-recession level at the end of 2007. This argument does not, however, account for categories of labor that have the most potential to be more fully utilized. In figure 3, we break down the U.S. labor market into component pieces by age and education level. As illustrated, the three labor groups with the most excess capacity are people under age 20, people over age 65 and people with an education level less than a high school degree. While participation rates in all three groups could likely be driven higher, it is unlikely this would alleviate the current skilled labor shortage. Given this, we expect monthly employment gains to continue to moderate in the near term. Longer-term growth will be driven by both productivity and labor force growth and will largely depend on business investment, education and immigration policy.

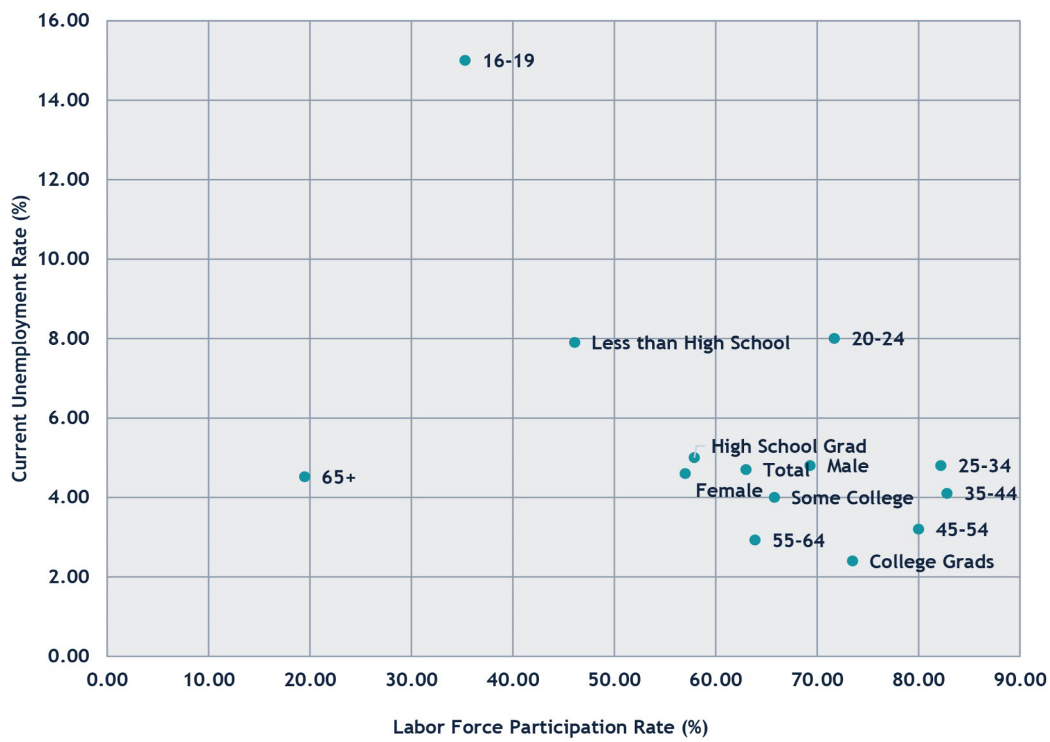
Key Real Estate Indicators

KEY REAL ESTATE INDICATORS

PROPERTY TYPE	VACANCY RATE		RENTS	ABSORPTION	COMPLETIONS	CAP RATES	TRANSCATION
Office	12.6%	↓	↑	↓	↑	↔	↓
Industrial	8.0%	↓	↑	↓	↑	↓	↑
Retail	10.1%	↓	↑	↔	↔	↓	↓
Apartment	4.9%	↑	↔	↔	↑	↓	↓

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.

FIGURE 3
U.S. LABOR FORCE PARTICIPATION RATE AND CURRENT UNEMPLOYMENT RATE BY AGE AND EDUCATION

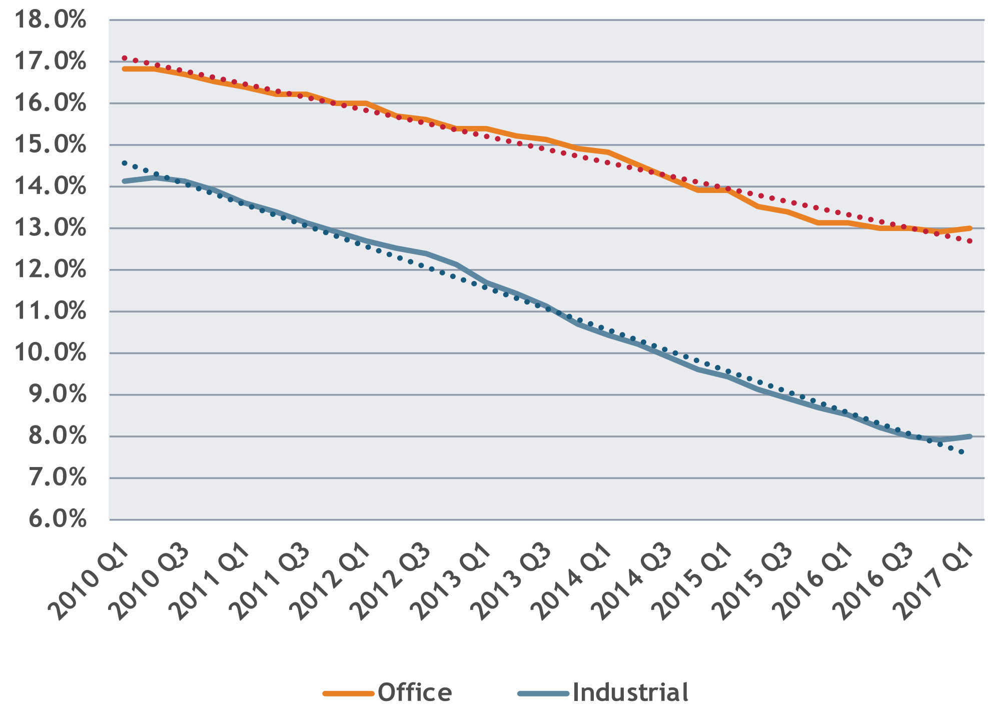


Source: Bureau of Labor Statistics

The broad improvement in property market conditions that we have enjoyed over the past 5+ years is moderating, primarily due to the slowing in economic and employment growth as well as a small but steady increase in new construction. Figure 4 shows a very clear flattening in national office and industrial vacancy/availability rates. In the case of the office market, we anticipate that average vacancy rates will increase slightly during 2017 as the pace of new construction deliveries accelerates from the roughly 1% to nearly 2% this year. While still quite low compared to prior property market cycles, when office construction topped 3% for extended periods of time, this 2% figure must be viewed in the context of job growth which is now averaging only 1.5% on a year-over-year basis, down from 2.0% roughly a year ago.

FIGURE 4

VACANCY RATE IMPROVEMENT IS SLOWING



Source: Bureau of Labor Statistics

Despite flattening vacancy rates overall, average rental rates in most markets will continue to rise for some time, albeit at moderating growth rates. Similarly, property net operating income should also show positive but slower growth over the next several years. Given this, we expect near-term property appreciation to also remain positive, but at levels comparable to or even lower than the general level of inflation. 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 the return will come from in-place income and income growth).

TABLE 1

EXPECTED RETURN FOR THE NCREIF PROPERTY INDEX (NPI)

	2017	2018	2019	2017 to 2021
NPI Total Return	6.6%	5.9%	5.5%	6.0%
Income Return	4.8%	4.8%	4.9%	4.9%
Capital Appreciation	1.8%	1.3%	0.7%	1.0%

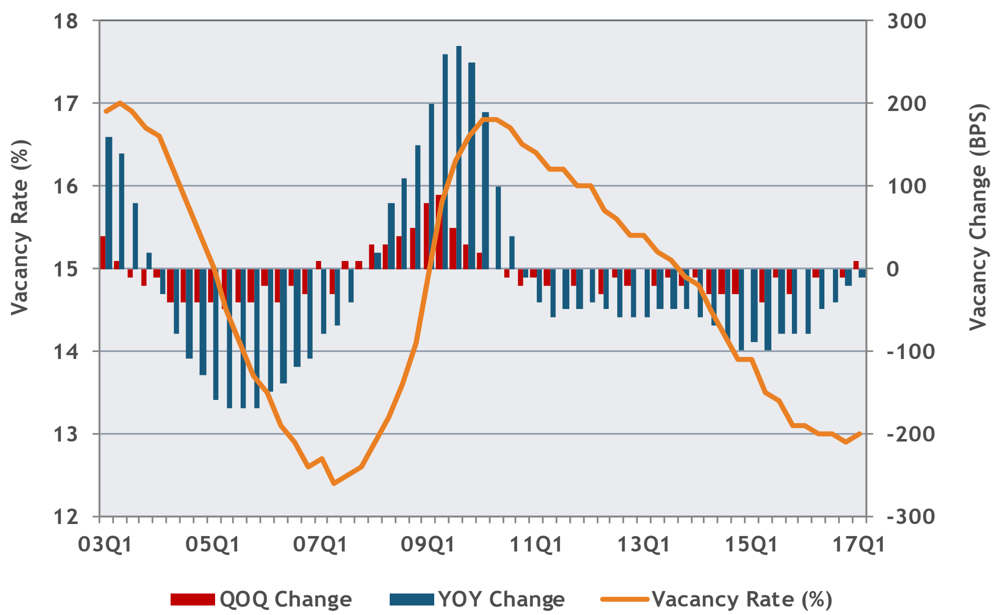
Source: Bureau of Labor Statistics

Office

The recovery in the U.S. office market continues to mature, with recent performance consistent with the later stages of an economic cycle. The decline in office vacancy rates slowed in 2016 and vacancies actually increased 10 basis points in the first quarter of 2017 to 13.0%, yielding the first quarterly uptick since early 2010. Year-over-year, vacancies still declined a modest 10 basis points; however, there has been a clear flattening pattern in recent quarters (see chart below).

CHART 1

VACANCY RATES ARE FLATTENING



Source: CBRE-EA

Demand remained positive and consistent with the historical trend of being somewhat softer in the first quarter. Roughly 7.2 million square feet (msf) was absorbed on a net basis in the first quarter of the year, nearly on par with the 8.0 msf of new demand reported in the first quarter of 2016. On a trailing four-quarter basis, aggregate net absorption as of the first quarter was 40.7 million square feet, the lowest level since the end of 2013. Construction picked up in the quarter, with nearly 12.0 msf completed, which contributed to the uptick in vacancies. The pace of expansion in stock, while not currently alarming at 1.1% over the previous four quarters, is expected to accelerate over the course of the year.

Roughly 108 million square feet of space is currently under construction across the U.S., which represents 2.9% of existing stock. There are 13 markets where construction in process as a share of inventory exceeds the U.S. average. These 13 markets, which include San Jose, Nashville, Seattle, San Francisco, Austin, Dallas, Denver, Fort Worth, Atlanta, Miami, Columbus, Washington, D.C. and Orange County, account for over 66 million square feet (or 61% of supply underway nationwide). Importantly, these 13 markets currently have an average pre-lease rate of 59% and only two markets, San Francisco and Denver, have pre-leasing of less than 50% (see table below). Still, it will bear watching to see if tenants vacate existing space to move into newly constructed space. In the case of San Jose, it appears that the bulk of new supply will be absorbed by net new demand as tech companies in the market that are building space, such as Apple and Google, continue to take down space elsewhere and acquire additional properties.

Overall, however, it is likely that national vacancies will remain relatively flat or edge slightly higher in the near term. Generating continued demand for space will be difficult in the face of today's tight labor market. The U.S. labor market is approaching full employment with the unemployment rate dropping to 4.4% in April, the lowest level in more than a decade. Further, the markets with the most supply under construction have even tighter labor market conditions. Indeed, the 13 markets highlighted earlier have an average unemployment of 3.9% as of February 2017. Again, it will be difficult for demand to keep pace with that of the previous few years with a lack of available workers to fill the space. Thus, while we don't expect office market fundamentals to depreciate meaningfully, we also do not expect them to improve meaningfully from where they are now. Rent growth will likely be in the 3-5% range in the near term, before settling back to 3% or less over the long term. Again, this is a reflection of where we are in the current economic cycle, the largest "pops" in rents and significant gains in occupancy are likely behind us, thus yielding more normalized NOI growth over the coming years.

TABLE 2

OFFICE CONSTRUCTION, PRE-LEASING & DEMAND

OFFICE CONSTRUCTION, PRE-LEASING & DEMAND SITUATION							
METRO AREA	NRA (SF X1000)	TOTAL UC	SHARE OF NRA	PRE-LEASED %	AVAIL SF	FEB. 2017 UNEMPLOYMENT RATE	2016 ABS RATE
San Jose	47,093	9,919	21.1%	71.2%	2,857	3.6%	4.1%
Nashville	35,477	2,934	8.3%	68.7%	918	4.2%	4.1%
Seattle	91,343	6,739	7.4%	56.4%	2,938	3.5%	5.0%
San Francisco	94,608	6,866	7.3%	39.2%	4,175	2.9%	1.5%
Austin	41,743	2,971	7.1%	58.1%	1,245	3.5%	2.1%
Dallas	160,682	10,094	6.3%	68.2%	3,210	4.0%	1.2%
Denver	97,005	5,267	5.4%	46.8%	2,802	2.8%	0.1%
Fort Worth	27,005	1,122	4.2%	75.0%	281	4.2%	0.9%
Atlanta	138,259	4,999	3.6%	55.7%	2,215	5.1%	0.8%
Miami	45,060	1,621	3.6%	51.1%	793	5.4%	1.1%
Columbus	30,924	1,059	3.4%	87.5%	132	4.1%	3.4%
Washington, DC	308,406	10,461	3.4%	58.7%	4,320	3.7%	0.5%
Orange County	72,867	2,203	3.0%	56.1%	967	3.8%	0.6%
Sum of Markets	**3,758,098**	**108,098**	**2.9%**	**55.7%**	**47,887**	**4.7%**	**1.10%**

Source: CBRE-EA

OFFICE	
Vacancy Rate	13.0%
12-Month Trend	
Vacancy Change	↓
Rent	↑
Absorption	↓
Completions	↑
Cap Rates	↔
Transaction Volume	↓

Industrial

The national industrial availability rate increased 10 basis points during the first quarter of 2017 and now stands at 8.0%. This ended a record 27 consecutive quarters of falling availability. Despite recording robust demand of over 33 million square feet of net absorption during the first quarter of 2017, completions outpaced demand as developers added nearly 46.5 million square feet of new product to inventory.

Overall, 38 of the 63 markets tracked by CBRE-EA recorded increases in availability during the quarter. Austin, Houston, Denver, and Fort Worth saw notable year-over-year increases of 120 basis points (bps) or more. Meanwhile, 20 markets recorded decreases and 7 were relatively unchanged. The quarter's largest declines from year-earlier levels were recorded in Tampa (-270 bps), Allentown (-240 bps), Jacksonville (-190 bps), Philadelphia (-180 bps), Orlando (-160 bps), and Memphis (-150 bps).

Despite the influx of new supply, demand for industrial space will remain strong as e-commerce continues to expand and delivery times shorten. The bulk of industrial demand will continue to be focused both in big-box, super-regional distribution facilities and the rapidly growing need for urban, centrally located in-fill sites for "last-mile" delivery. The supply pipeline, however, is focused in the latter product (i.e. large super-regional facilities) and these properties are largely concentrated in select gateway markets. While gateway markets have the most active development pipelines they also happen to be the strongest industrial markets with outsized demand.

For example, demand for industrial space in the Riverside is robust. Extreme users such as Amazon, Walmart, and General Mills are gobbling up massive blocks of space across the metropolitan area because the market functions as both a distribution hub for the bulk of California and a major arterial connection to other hubs across the U.S. The Riverside market absorbed over 7.1 million square feet of space on a net basis, the highest recorded quarter since late 2013 and the most of any U.S. market during the first quarter. As a result, the 6.8% availability rate is near record lows and well below the metropolitan area's historical average of 10.9%. The improving market fundamentals over the last couple of years have encouraged developers and deliveries are starting to ramp up. During the first quarter of 2017, Riverside recorded some of the nation's highest levels of completions, at 3.9 million square feet of space. Additionally, there are over 24 million square feet of industrial space under construction (representing 5.5% of inventory), roughly 25% of which are over one million square feet. To date, pre-leasing in Riverside has been healthy with the two largest buildings under construction (both over 1.2 million square feet) already fully leased prior to their scheduled 2017 completion date.

Dallas is another market that is experiencing simultaneous robust demand and supply growth. Indeed, Dallas delivered the most industrial space on an absolute basis during the quarter, 5.7 million square feet in total. Nearly all of the newly constructed projects were built on a speculative basis; however, the continued national economic expansion, coupled with strong regional demographics have fueled industrial demand, allowing new deliveries to be leased very quickly. Overall, third-party logistics providers and national retailers continue to look to Dallas as a key hub in their distribution networks as U.S. consumption and production continue to expand. For example, Mission Foods, Chewy Inc, and Lego all recently moved into the metropolitan area, absorbing big-box space of 660,000 square feet or more. In addition, Amazon typically takes one to two million square feet of newly built space in the Dallas market each year.

Moving forward, the level of nationwide construction will remain elevated in the near term, with the bulk of development projects being speculative. This could cause short-term imbalances and slight upticks in availability. However, in aggregate, demand growth should keep pace with supply. In 2017, deliveries are expected to result in a 1.5% increase in stock, which slightly outpaces the 1.4% and 1.2% increases in 2016 and 2015, respectively, but is below the 2.0% annual average that occurred during the previous two expansions. Overall, hiring and wage growth, as well as wealth effects from rising stock and home prices, appear to be boosting consumer spending, especially in e-commerce sales. The reconfiguration of supply chains to accommodate e-commerce has been a major driver of industrial demand in this cycle. Given this backdrop, it's not surprising that consumer products companies and e-commerce retailers and distributors are likely to remain the largest sources of demand for industrial space in 2017. Beyond 2017, we anticipate supply growth will slow as development becomes increasingly challenging due to 1) a lack of available land, 2) difficulty in obtaining entitlements, 3) rising construction costs and finally, 4) a stricter lending environment. Overall, industrial fundamentals should remain solid, allowing for continued healthy rent growth. Near term, in the strongest gateway markets, rent growth will likely remain in the 4-6% range, before settling down to 2-3% growth over the long-term.

INDUSTRIAL	
Vacancy Rate	8.0%
12-Month Trend	
Vacancy Change	↓
Rent	↑
Absorption	↓
Completions	↑
Cap Rates	↓
Transaction Volume	↑

Apartment

Apartment market conditions changed little in the past 90 days. Vacancies were flat at 4.9% on a quarter-over-quarter basis and were up a mere 20 basis points year-over-year. Demand has remained solid, with nearly 210,000 units being absorbed over the previous twelve months; this level of activity outpaces both the average over the previous expansion (112,000 units, early 2002-2007) and the long-term historical average (145,000 units). That said, supply has steadily increased in recent years and vacancies have nudged higher as a result. Over 252,000 units were completed in the trailing 12-month period, the greatest level of construction since CBRE-EA began tracking the market in the late 1990s. Going forward, supply will remain fairly active in the near term, as there are roughly 250,000 additional units underway and slated for delivery by year end. Thereafter, supply should ebb as CBRE-EA and Axiometrics are currently tracking 150,000 units underway with a delivery date beyond 2017.

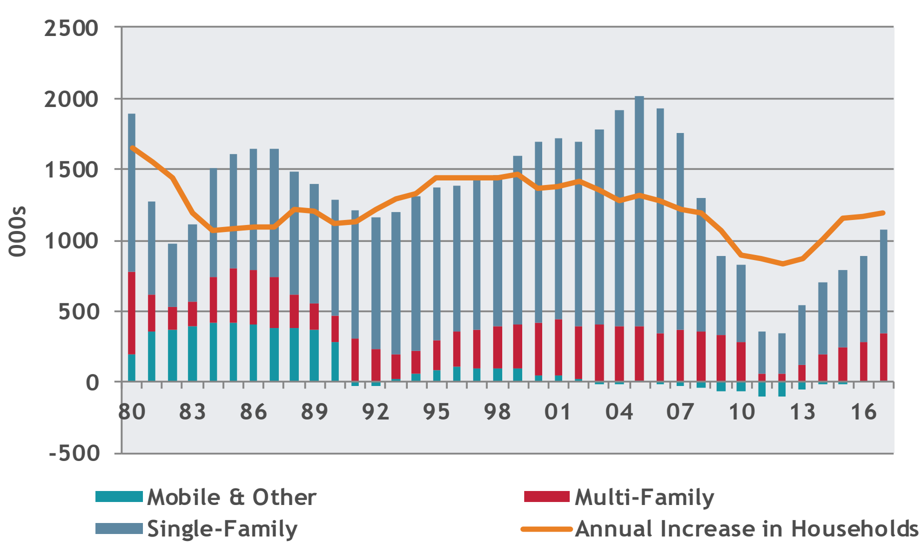
In aggregate, while new supply has been strong, the roughly 400,000 units underway represent just 2.8% of stock. If demand in 2017 and 2018 keeps pace with that of the previous year, the new supply will be absorbed in short order and limit downward pressure on effective rents. Further, despite this increase in construction, the U.S. is not building enough housing in total. Leading up the Great Financial Crisis (GFC), the U.S. was adding 1.2 new housing units per new household on average (1980-2007). Since 2007, however, the increase in stock has been 30% below historic norms, at less than 1 new unit per new household. Moreover, while the growth in stock has accelerated in recent years, it still remains below 1 for 1 relative to new household formation today and we have not made up for any of the shortfall created during the GFC (see chart).

On the demand side, the apartment market should be buoyed by continued job growth and the aforementioned household formation, particularly in renter-aged cohorts. Between the end of 2016 and 2025, the U.S. is projected to generate 11.5 million new jobs. This job growth should lead to continued new household formation and ultimately housing demand in general and apartment demand in particular. Indeed, household formation is projected to accelerate over the next five years with the U.S. projected to add over 7.1 million households in 2017-2022, up from 5.8 million over the previous five-year period (2011-2016). In total, by 2025, the U.S. is expected to add a total of 12.8 million new households.

CHART 2

AMERICA NEEDS TO BUILD MORE HOUSING UNITS

(Change in Housing Stock and Household Formation)



Source: U.S. Census Bureau

Further, according to a report from the Harvard Joint Center for Housing Studies (JCHS) that looked at the 2015 -2025 year period, nearly 30% of the projected increase in households over that period is expected to be in the renter-aged cohorts of 25-34 and 35-44 years of age. Roughly 2.5 million and 1.3 million households, respectively, are expected to be formed in the 35-44-year-old and 25-34-year-old cohorts, both up significantly from the prior 10-year period when on net the age cohorts lost 1.4 million households. In addition to the demand from traditional renter-aged cohorts, demand among baby boomers has been and is expected to remain positive. According to another study by the JCHS, the number of renter households aged 50 and over jumped from 10 million in 2005 to 15 million in 2015, accounting for more than half of the renter household growth over the decade.

Finally, the homeownership rate, which has steadily declined, dropping from nearly 69% in 2006 to only 63.4% in 2016, will likely remain low with current projections averaging 64% from 2017 through 2022. On net, however, with the shift of some existing renter households to homeownership, the number of new renter households is expected to total 1.6 million by the end of 2022, which is in excess of CBRE-EA's projected new supply of 1.0 million rental units. Further, CoStar, which provides projections through 2021, reports that the nation's apartment stock will increase by roughly 840,000 units over the 2017-2021 period which is 450,000 units less than the projected increase in renter households (1.3 million over the period).

Nationally we expect supply will begin to taper after 2017, particularly as construction debt becomes increasingly difficult to obtain, the entitlement process becomes more onerous and construction costs continue to escalate. Across markets, supply as a share of inventory is highest in Nashville, Denver, Austin, Charlotte, Orlando, Dallas, Washington, D.C. and Seattle, with all of the aforementioned markets reporting greater than 3.5% of stock currently under construction. The pipeline includes projects for delivery this year, next year and in some cases 2019; thus, the markets will have several years to absorb the new supply. Additionally, these markets have generated demand well above the national average. Indeed, the average net absorption rate among the aforementioned markets has ranged from 2.2% in Washington, D.C. to over 4% in Austin and Charlotte from 2014-2016, well above the U.S. average of 1.5%. This indicates that while supply is currently elevated, the staggered delivery over the next couple of years should allow the new supply to be steadily leased up, limiting the potential downward pressure on rents. As such, multifamily rents should continue to grow, albeit at a more moderate pace than the 8-12% increase we've seen in many markets over the past few years. Additionally, we expect there will be difference among product segments with rent growth being strongest within the older non-luxury segment of the market, versus the very top end of the market where rent growth will be somewhat more restrained in the near term due to new supply. On average, we expect rent growth will likely remain in the 3-6% range near term, before settling around 3% long term; again, there will be variation among markets and product subtype depending on specific pockets of supply.

APARTMENT	
Vacancy Rate	4.9%
12-Month Trend	
Vacancy Change	↑
Rent	↔
Absorption	↔
Completions	↑
Cap Rates	↓
Transaction Volume	↓

Retail

In the face of a torrent of recent press reports on failing retailers and store closings and in contrast to generally slower economic growth, the U.S. retail market continues to improve and total retail sales are increasing at a healthy pace: first quarter retail sales, excluding motor vehicles and parts, climbed 1.4% from the previous quarter and were 5% higher than the same period a year ago – which represented the largest year-over-year increase seen since the first quarter of 2012. In addition, the Atlanta Fed's Wage Growth Tracker showed the median wage increased 3.5% on a trailing 12-month basis in March 2017, up from 3.1% the same time last year. Consumers are becoming more comfortable with spending, as they get accustomed to the current lower-growth environment and their wages slowly rise. This sentiment was reflected in strong Consumer Confidence Index ratings of 124.9 in March and 120.3 in April, which represented the first time the index has surpassed 120 since December of 2000.

As a result, at the end of the first quarter every retail property market segment held steady or improved with the lone exception of the power center segment. Power centers continue to struggle amid store closings in the segment, as availability climbed to 6.8%, a 20-basis-point increase from the prior quarter and an 100-basis-point increase from year-ago levels. That said, lifestyle and mall centers rebounded from recent struggles and saw availability tighten in the wake of solid net absorption in the first quarter. Indeed, lifestyle and mall availability was 6.2% in the first quarter, a 40-basis-point decline from the previous quarter, as more than 3.4 million square feet was absorbed nationwide. Further, lifestyle and mall availability is down 30 basis points from a year earlier as 5.7 million square feet of absorption outpaced 5.1 million square feet of completions. While store closings and bankruptcies at major retailers (particularly department stores and big box retailers) nationwide have put downward pressure on absorption for lifestyle and mall and power center properties, these segments have started to devise creative solutions to get vacated space leased. The larger anchor spaces being left empty by retailers such as Sports Authority, Sears, JCPenney and Macy's are starting to be filled by less conventional mall tenants, such as grocers, movie theaters, and even call centers. Wegmans, Kroger's, and Whole Foods have opened or will open grocery stores in malls in 2017, while Bed, Bath, and Beyond and Conduent, Inc. have leased vacated anchor spaces as call centers. While it remains to be seen if these strategies are viable long-term solutions or even how quickly the transitions can occur given that many department stores own their own spaces, these alternative uses provide lifestyle centers and malls with new options to lease large blocks of space.

The steady improvement and performance of neighborhood and community centers continues to dominate the broader national retail landscape, as the 3.0 billion-square-foot segment makes up almost 40% of total retail space, per CBRE-EA. Neighborhood center availability stood at 10.1% at the close of the first quarter, unchanged from the fourth quarter of 2016, but down 40 basis points on a year-over-year basis. Net absorption of 4.2 million square feet comfortably outpaced 3.4 million square feet of new completions, marking the 21st time demand exceeded supply in the segment in the last 24 quarters. The trend is expected to continue because the local, smaller-sized neighborhood and community shopping centers typically perform well in late stages of the business cycle as small businesses gain confidence and have better access to credit, which allows them to more easily secure leases. The improvements in the neighborhood and community center and lifestyle and mall segments were enough to offset under performance in the power center segment, as total retail availability fell to 7.0% in the first quarter, a 10-basis-point improvement from year-end 2016 and a 30-basis-point improvement year-over-year.

The majority of retail markets continue to see total retail availability decline. In the first quarter of 2017, availability declined in 32 of the 62 markets tracked by CBRE-EA, with an additional nine markets holding steady from the previous quarter. Top performers included San Francisco, San Jose, Sacramento, Baltimore, Dallas, Fort Lauderdale, Fort Worth and Philadelphia, all of which saw at least a 40 basis point improvement from just one quarter prior. Pittsburgh, Seattle and Denver rounded out the top ten large market performers, all of which at least tripled the 10-basis-point improvement seen nationally. On the opposite end of the spectrum, the metropolitan areas with the largest availability increases in the first quarter tended to be smaller secondary and tertiary markets that are not typically targeted by many large institutional investors. Cities such as Richmond (100 basis point increase), Columbus and Fresno (60 basis point increase) saw the largest increases in availability, while Albuquerque and Miami rounded out the five metropolitan areas with the weakest performance in the first quarter. While Miami was among the five weakest performing markets in the first quarter, availability climbed by only 30 basis points as 610,000 square feet of completions outpaced healthy absorption of 291,000 square feet. Overall, among markets where availability edged higher, the increase was relatively modest for most. Among the 21 markets that saw availability rise, just four saw an increase of more than 30 basis points. In addition, more than half of these metropolitan areas (12) had availability rates that were at or below the national average of 7.0%.

Going forward, we expect fundamentals will continue to improve at a slower, but steady pace. The national economy continues to move towards full employment, which has led to larger wage gains and improved retail sales that in turn should bolster demand for retail space. However, demand is likely to continue to see near-term pressure from store closures by retailers that are struggling to adapt to the changing wants and needs of younger consumers. Fortunately, limited supply growth seen post-recession is a trend that is expected to continue for the foreseeable future, and this will help counterbalance any strains on demand for retail space. Given this backdrop, rent growth and property performance will increasingly depend on the quality and location of individual properties, with better located, best-in-class centers likely to outperform product on the other end of the spectrum.

RETAIL	
Vacancy Rate	10.1%
12-Month Trend	
Vacancy Change	↓
Rent	↑
Absorption	↔
Completions	↔
Cap Rates	↓
Transaction Volume	↓

Capital Markets

Transaction volume continued to ease in the first quarter of 2017. Roughly $95 billion in property changed hands during the quarter, down 18% from a year earlier and the lowest quarterly volume since mid-2014. The slowdown in sales spanned all market tiers, sales categories and property types, with the exception of industrial properties. Major, secondary and tertiary market transaction volumes were all down in the quarter. Surprisingly, volume among major and secondary markets declined more precipitously than tertiary markets with transactions down 22% and 19%, respectively, compared to 9% among tertiary markets. Meanwhile, all categories of sales – individual, portfolio and entity – declined in the quarter as well, although portfolio and entity-level transaction sales slowed most significantly. These were 27% and 60% lower, respectively, on a year-over-year basis, versus a 10% decline in transaction volume for individual property sales. Finally, the slowdown in volume by property type was greatest among apartments (-22%), followed by development sites (-25%), office (-12%), retail (-10%) and hotel (-3%). Meanwhile, industrial property sales volumes were up 3%.

Regionally, the combined New York/Northern New Jersey market, which includes Manhattan, Northern New Jersey and the New York boroughs, was the most active with nearly $12 billion in properties changing hands. Not surprisingly, within the broader New York/New Jersey market, Manhattan reported the greatest volume at $7.1 billion, followed by Northern New Jersey ($2.5 billion) and the New York boroughs ($2.1 billion). Other markets topping the list for transaction volume included the typical gateway core markets of Los Angeles ($5.1 billion), Boston ($3.7 billion) and San Francisco ($3.7 billion). Overall, 10 markets reported more than $2 billion in volume in the first quarter, while an additional 14 markets reported sales between $1 billion and $2 billion. Charlotte exhibited particular strength with the market reporting transaction volume of $1.9 billion in properties in the quarter, the most ever reported for the metro area by RCA.

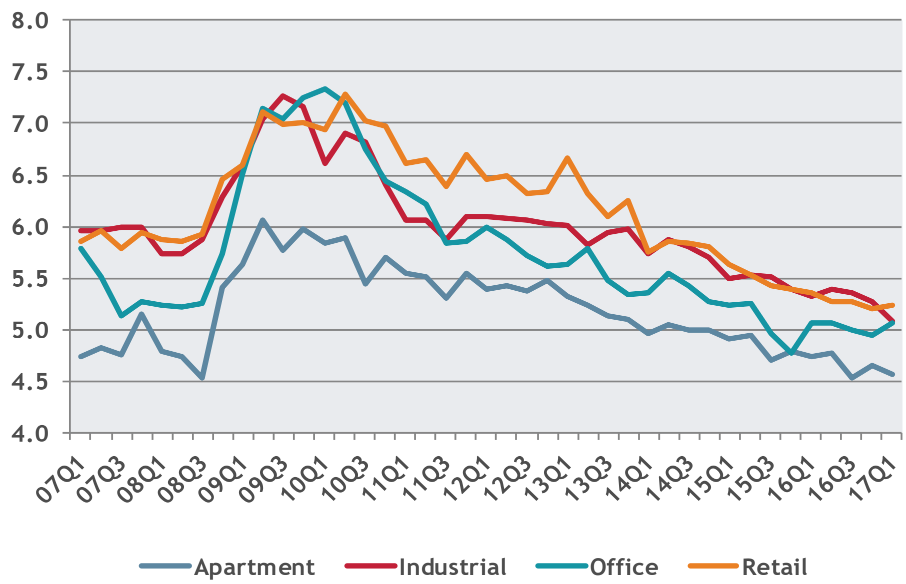
Foreign buyers remained the most active net acquirers of U.S. real estate in the first quarter of 2017. According to RCA, cross border investors bought more than $7.6 billion in U.S. real estate on net – acquiring $11.2 billion in new properties and disposing of only $3.7 billion in properties. In addition to cross border investors, private buyers were the only other investors to increase their U.S. real estate portfolios. Private buyers acquired roughly $3.5 billion of property on net and were the most active investors, acquiring $46.4 billion in property while selling $42.8 billion. Institutional/equity funds were the largest net sellers of real estate, shedding nearly $10 billion in net assets, with sales of nearly $28 billion and acquisitions of $18 billion. The U.S. real estate portfolios of listed buyers and REITs changed, on net, by $1.1 billion, with listed/REITs selling $12.1 billion in property and acquiring $11.0 billion.

Despite the broader slowdown in transaction volume, pricing trends remained healthy. The nationwide, all-property, Moody's/RCA Commercial Property Price Index (CPPI) rose 7.2% on a year-over-year basis in March. The CPPI, which measures repeat sales, showed the most sizeable gains occurred in the CBD office sub-index, which advanced 12.5% year over year, followed by apartment (8.1%), suburban office (7.7%), industrial (7.6%) and retail, which was flat, with growth of only 0.2%. Major market pricing advanced by 8.3%, outpacing price growth in non-major markets by 210 basis points. Notably, however, the year-over-year gain in the broad CPPI has been in single-digit territory since January 2016, following nearly three full years of double-digit growth.

Meanwhile, the NCREIF Property Index (NPI) return totaled nearly 1.6% in the first quarter of 2017 and 7.3% on a trailing 12-month basis. Like the CPPI, there has been a downward trend in the NPI returns as we have cautioned for some time. Indeed, as we noted last quarter, the moderation in returns has largely been driven by slower appreciation. In the first quarter, the NPI appreciation return was only 0.4%, the lowest capital return of this recovery/expansion. The income return remained healthy at 1.2%, where it has remained since mid-2015. The returns for the quarter highlight the slow shift back to historical norms where income makes up roughly 70% of the total return and appreciation accounts for the lesser 30% of total return. One year ago, the return was split 50/50 between income and appreciation, a shift from two years ago when income accounted for only 35% of the total return and appreciation accounted for 65% of the total return. Going forward, we anticipate the current return attribution will remain, with the bulk of future returns coming from income, particularly as it appears cap rates are leveling off as shown in the chart below.

CHART 3

NCREIF CAP RATES BY PROPERTY TYPE



Source: NCREIF

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Overall, retail demand remains healthy and, in fact, Kimco recently reported their strongest leasing volume of any quarter over the past 10 years in the first quarter of 2017 by executing 4.3 msf in new leases and renewals alike. Weingarten also reported solid leasing in the quarter as well, executing 89 new leases and 214 renewals across a spectrum of merchandising including pet stores, supermarkets, discount clothing stores, arts and crafts stores, restaurants, furniture stores and medical uses.

Retail sales at dining establishments have increased by $353 billion since 2000; this nearly matches the increase in the non-store retailer or e-commerce segment (+$378 billion) of the market. Further, last year sales at food and drinking places actually eclipsed grocery store sales for the first time ever.

The median home value in San Jose topped $1 million in mid-2016. San Jose home prices are now 26% above their prior peak. San Francisco is the only other metro area with a median home price greater than $1 million. If Manhattan were considered its own metro area, it would join the list with a median home price of $1.2 million.

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