AEW RESEARCH

U.S. ECONOMIC & PROPERTY MARKET PERSPECTIVE

Q2 2017

AEW

Prepared by AEW Research, June 30, 2017

The U.S. Economy

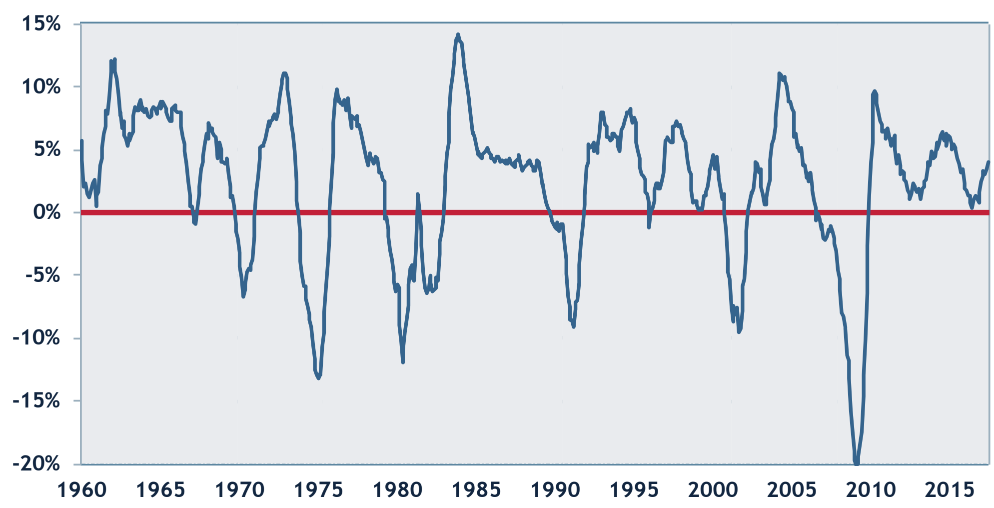
In July, the U.S. recorded the 82nd consecutive month of positive national employment growth, the longest uninterrupted employment expansion on record. Overall job growth in the first half of 2017 was remarkably similar to the growth recorded during 2016 with total employment gains averaging 180,000 per month to date this year, compared to 187,000 per month during 2016. While still positive, this level of employment growth represents the continued gradual deceleration of monthly employment increases that has been in place for several years and is likely to continue as skilled labor shortages grow more acute. Going forward, growing labor shortages will become another factor that will likely hamper the overall level of economic growth the U.S. economy can achieve.

To this point, the U.S. unemployment rate has now fallen to 4.3%, the lowest rate of the past ten years. Wage growth pressures, however, remain relatively muted, with growth in average hourly earnings only gradually accelerating from an annualized rate of 2.0% in 2014 to an annualized rate of 2.5% over the past twelve months. This low level of wage growth is also occurring within a broader context of even slower growth in labor productivity, which has increased at an average annual rate of less than 1.0% in each of the past five years. As a result, even these slowly rising wages are putting pressure on corporate profit margins, and we expect profitability concerns to emerge as a more significant issue in 2018.

Reflecting the above, the inflation outlook remains relatively benign with the bond market currently pricing in an expectation of 1.5% to 2.0% annual inflation over the next five years. Given this, we anticipate a continued slow pace of tightening by the Federal Reserve as it moves towards a policy goal of a 3.0% Fed Funds rate by the end of 2019. In this environment, we anticipate a continued flattening of the U.S. yield curve, consistent with a slow economic growth environment and low inflation. While the U.S. economy is clearly in the latter stages of the current recovery/expansion cycle, there is no obvious indicator of a near-term recession. For example, the composite index of leading indicators has accelerated slightly over the past year (as shown in Figure 1), consistent with slow but positive near-term GDP growth.

FIGURE 1

YEAR-OVER-YEAR PERCENT CHANGE IN COMPOSITE LEADING INDICATORS INDEX AND PAST RECESSIONS



Source: The Conference Board

This does not mean there is no risk of near-term recession, but rather it suggests that the causes of any potential economic downturn are more likely to originate from an exogenous shock or domestic policy mistake than from the economic fundamentals themselves. This is particularly true given the recent acceleration of global growth. One development that may contribute to further extension of the current cycle is the weakening of the U.S. dollar since the beginning of the year (see Figure 2). While the causes of this weakening are open to debate, stronger global growth (in Europe in particular) suggests that other central banks may join the Federal Reserve in moving towards normalization of monetary policy earlier than previously expected. Whatever the reason, the U.S. dollar has fallen by more than 10.0% in value relative to the euro over the past six months, bolstering consumption growth in Europe as well as export growth in the U.S.

FIGURE 2

DOLLAR-EURO EXCHANGE RATE (EUROS PER DOLLAR)

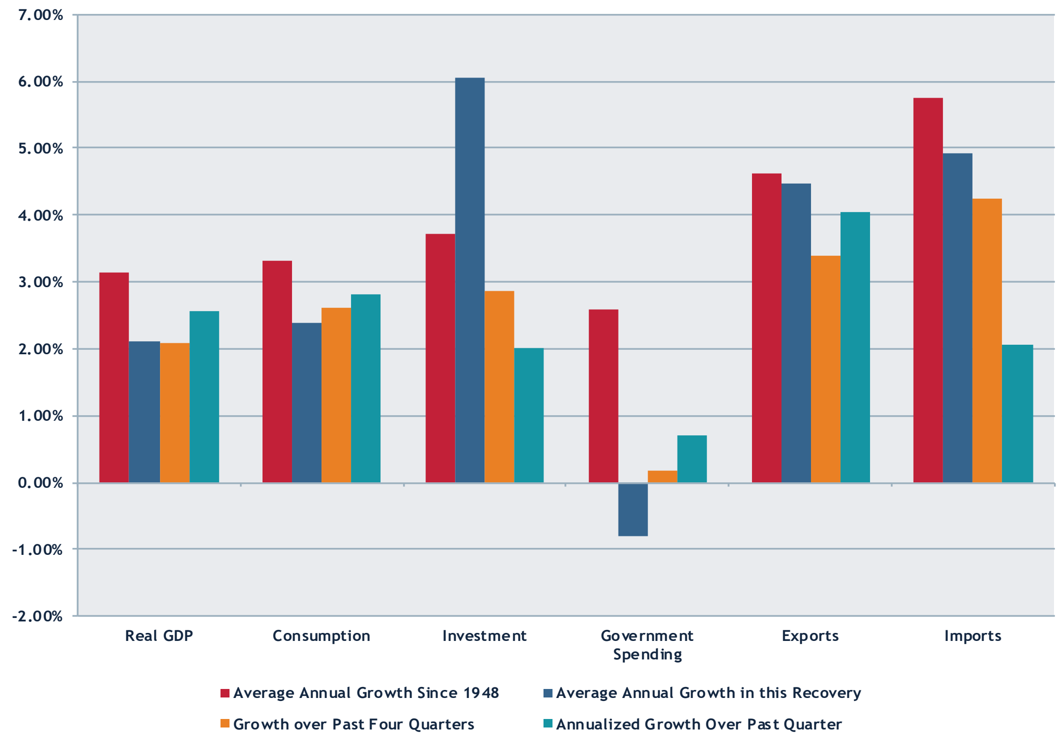
Source: Federal Reserve

As shown in Figure 3, the acceleration in export growth, as well as modest increases in consumption and government spending, all contributed to slightly higher growth in real GDP during the second quarter of 2017. Overall though, government spending continues to be a significant constraint on aggregate growth as is the abrupt slowdown in business capital investment in the wake of the oil price bust. For the near term, we expect continued real GDP growth of approximately 2.0%, consistent with the slowing job gains and continued weak productivity levels noted previously. Growth-oriented policy initiatives such as corporate tax reform and increased infrastructure spending seem unlikely to materialize in a timeframe that would have any impact on 2017 growth and, increasingly, look less likely to have a material impact on 2018.

U.S. property market fundamentals remain strong but the pace of improvement is generally slowing.

FIGURE 3

BREAKDOWN OF REAL GDP GROWTH



Source: National Income and Product Accounts

KEY REAL ESTATE INDICATORS

PROPERTY TYPE	VACANCY RATE		RENTS	ABSORPTION	COMPLETIONS	CAP RATES	TRANSCATION
Office	13.0%	↔	↑	↓	↑	↔	↔
Industrial	7.8%	↓	↑	↓	↑	↓	↑
Retail	10.1%	↓	↑	↓	↔	↓	↓
Apartment	4.6%	↑	↔	↑	↔	↓	↔

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.

U.S. Property Markets

U.S. property market fundamentals remain strong but the pace of improvement is generally slowing. Broadly speaking, growth in property demand is meeting comparable levels of new supply, leaving occupancy rates largely unchanged. For example, the national average vacancy rate for office properties has held steady near 13.0% for seven consecutive quarters, while the availability rate of industrial properties had been constant at 7.9% for three consecutive quarters before dropping 10 basis points to 7.8% in second quarter of 2017. Stable occupancy rates at current levels do, however, leave room for positive, albeit more modest, increases in rental rates. For example, average industrial rents in the U.S. increased more than 6.0% over the past year and average office rents increased nearly 4.0% over the same period.

Absent a change in the outlook for inflation and interest rates, the prolonged period of U.S. property yield compression appears to have ended for this cycle. The average property capitalization (cap) rate in the NCREIF investor universe has remained nearly constant at 4.5% for the past four quarters and this trend is largely consistent across the various property types (see Figure 4).

FIGURE 4

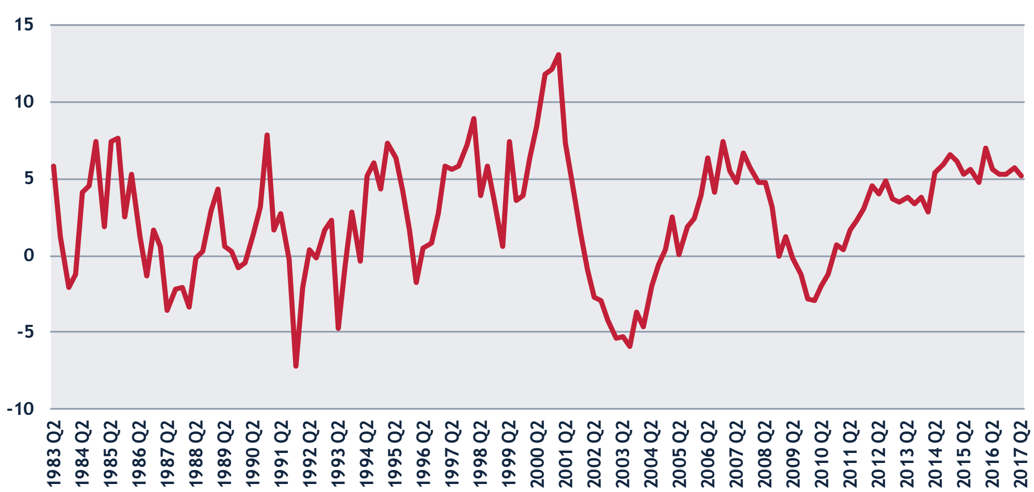
MARKET VALUE WEIGHTED AVERAGE CAP RATE BY PROPERTY TYPE

Source: NCREIF

In the near term, we expect stable to modestly rising property yields as investors begin to lower their expectations for property income growth. As such, property price appreciation will flow almost entirely from the growth in property net operating income (NOI). Currently, property NOI growth directly reflects the rent increases described above, with year-over-year growth of approximately 5.0% over the past four years (Figure 5).

FIGURE 5

AVERAGE PROPERTY NET OPERATING INCOME (NOI) – YEAR-OVER-YEAR PERCENT GROWTH

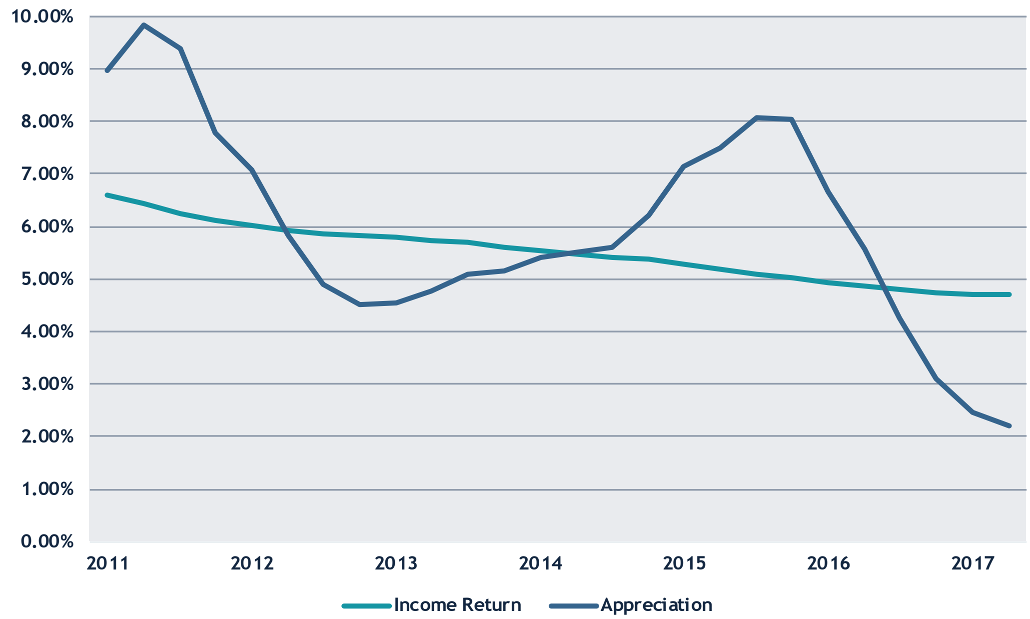


Source: NCREIF

Over the next several years, we expect NOI growth to moderate in step with slowing rental rate growth as well as somewhat lower average occupancy rates as new supply moves ahead of slowing demand growth. As a result, capital appreciation will continue to account for a declining share of total return (see Figure 6). To this point, the June 2017 PREA consensus forecast for U.S. property returns shows investor expectations of unleveraged property returns below 6.0% over the next five years, a decline of 40 basis points for the same period as compared to the March 2017 survey (see Table 1).

FIGURE 6

NCREIF PROPERTY INDEX – CAPITAL APPRECIATION AND INCOME RETURN



Source: NCREIF

TABLE 1

EXPECTED RETURN FOR THE NCREIF PROPERTY INDEX (NPI)

JUNE 2017 SURVEY	2017	2018	2019	2017 to 2021
NPI Total Return	6.3%	5.4%	5.1%	5.6%
Income Return	4.8%	4.8%	4.9%	5.0%
Capital Appreciation	1.5%	0.7%	0.3%	0.6%

Source: PREA

Office

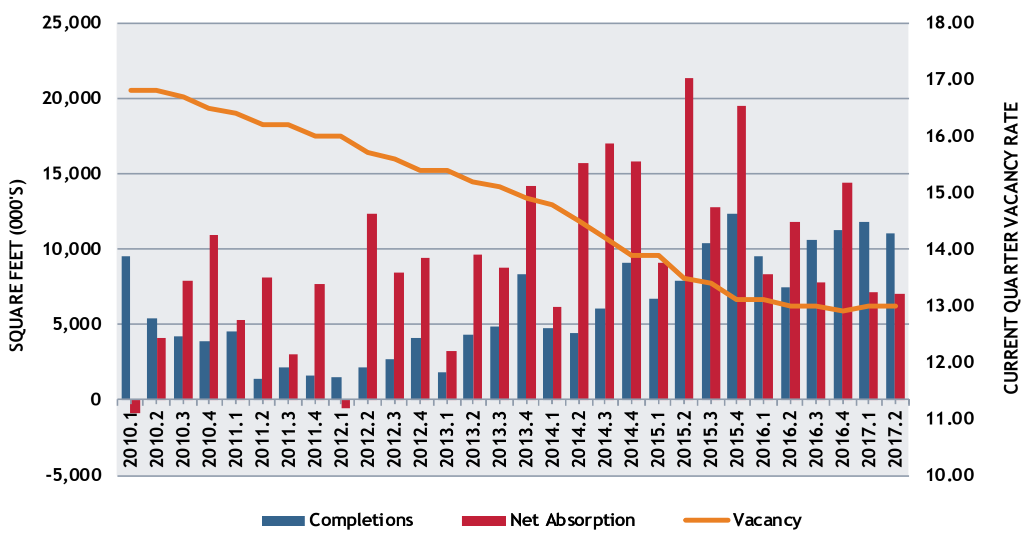
The U.S. office market recovery/expansion continued to mature in the second quarter, and vacancies stood at 13.0%, consistent with both the prior quarter and year-ago levels. Notably, the second quarter marked the first time since late 2010 that vacancies did not decline on a year-over-year basis. Indeed, over the past year and a half the improvement in fundamentals slowly began to flatten with the four-quarter vacancy contraction becoming smaller and smaller until vacancies leveled off altogether. Prior to this, vacancies had declined on a year-over-year basis for 26 consecutive quarters. Still, office fundamentals appear to be in balance, with supply and demand being roughly evenly matched since the end of 2015, allowing vacancies to stay around their current level.

U.S. office net absorption remained positive in the second quarter, a trend that has now continued for 21 consecutive quarters.

FIGURE 7

VACANCY RATES FLAT OVER THE LAST 2 YEARS

TOTAL OFFICE SUPPLY - DEMAND 2010 Q1-2017 Q2



Source: CBRE-EA U.S. Office Market Fundamentals

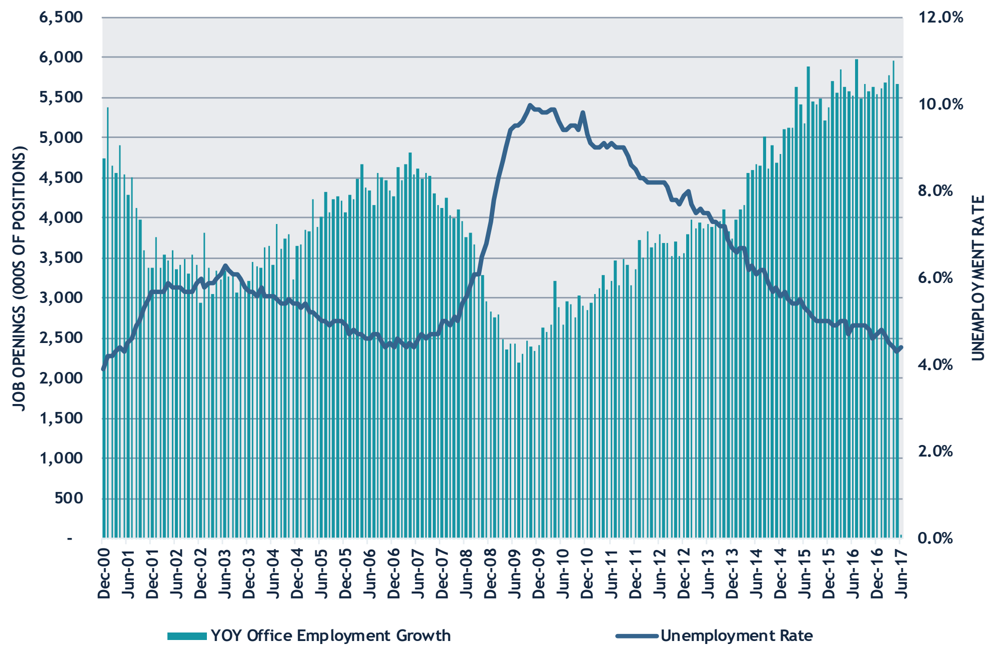
U.S. office net absorption remained positive in the second quarter, a trend that has now continued for 21 consecutive quarters. Roughly 7.1 million square feet (msf) was absorbed in the second quarter, nearly a mirror image of demand seen in the previous quarter. While demand on a trailing four-quarter basis remains healthy (36.4 msf), it continues to slow from the cyclical peak of 63.6 msf seen in the fourth quarter of 2015. That said, construction totals of 11.1 msf for the second quarter came in below those seen in the first quarter, which helped keep vacancies flat. As expected, the pace of inventory expansion accelerated slightly to 1.2% on a trailing four-quarter basis. However, in context, this uptick in inventory growth is modest as the trailing four-quarter inventory expansion was consistently above 3.0% during the dot-com bubble of the early 2000's, and peaked at more than 2.2% during the Great Recession. Office construction today is limited relative to other late-stage economic cycle periods in recent history where markets quickly became overbuilt.

At the end of the second quarter, 41 of CBRE-EA's 63 largest U.S. markets had seen positive net absorption year to date. As the current cycle continues to move forward, demand is becoming increasingly concentrated in a handful of markets. Nearly half of the square footage absorbed by the 41 markets with positive year-to-date absorption can be attributed to the top 10 performers —Dallas, Atlanta, Kansas City, Phoenix, Charlotte, Baltimore, Austin, New York, Denver, and Las Vegas—while one-third of that space can be attributed to the top 5 aforementioned markets. At this point in the cycle, many well-located, discounted secondary markets are responsible for the lion's share of national absorption as companies seek to find value in more affordable markets. Going forward, it is likely that the bulk of rent growth for the remainder of this cycle will be concentrated in secondary markets that have cheaper, less competitive labor forces and have seen considerable economic and population growth during this expansion. However, this is not to say that rent growth will evaporate in top-tier markets; AEW simply expects most above-average rent growth to be concentrated in these secondary markets. Growth in top-tier markets will likely hover around 3.0% as the "pops" in rents in these markets have already been achieved. While AEW expects rent growth to be more moderate in top-tier markets, these markets are likely to outperform secondary office markets as they generally have more stable economies and stronger occupancy rates. Further, secondary markets, like Phoenix and Las Vegas, have greater valuation risk in the event of a downturn, as cap rates tend to be more volatile in these markets.

Overall, we continue to believe that office vacancies will remain relatively flat but could face slight near-term expansion as building labor shortages limit office employment growth and office space absorption. The latest employment report shows a national unemployment rate of only 4.3%. The tighter the labor market becomes, the larger the gap becomes between the skills required for open positions and the skillset of available labor. This has been evidenced in recent job opening numbers; the Bureau of Labor Statistics reported that there were 5.7 million job openings at the end of May, down slightly from a record high of 6.0 million in July of 2016, but well above the historical average of 4.0 million. The lack of available workers that meet the requirements of today's numerous available positions will place further restraints on demand for office space as labor markets continue to tighten. That said, as of now, office employment has yet to experience any sort of notable slowdown; office employment nationally increased 2.4% year over year in June of 2017, which is on pace with levels seen throughout this economic expansion. Overall, we still do not expect any meaningful deviations in office market fundamentals. Vacancies are expected to remain near today's lows; however, rent growth, again, on average, will be more modest going forward.

FIGURE 8

OPEN POSITIONS VS. THE OVERALL UNEMPLOYMENT RATE



Source: Bureau of Labor Statistics

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

Industrial

The national industrial availability rate was 7.8% as of the second quarter of 2017, declining 10 basis points from the prior quarter. This modest drop in availabilities comes after the first quarter's marginal 7-basis-point increase in availability, driven by particularly strong deliveries. Unlike the prior quarter, the second quarter experienced lower than expected completion volumes, which likely led to the drop in availability; 50.4 million square feet (msf) of deliveries was predicted, while only 45.6 msf actually delivered.

Overall, 42 of the 63 markets tracked by CBRE recorded decreases in availability during the quarter, while 14 recorded increases and 6 went unchanged. Some of the quarter's largest declines from year-ago levels were recorded in markets where industrial development has been subdued, such as like Wilmington (-370 bps), Dayton (-320 bps), Jacksonville (-230 bps), Cincinnati (-220 bps), Sacramento (-210 bps) and Boston (-200 bps).

Demand for industrial space has reached all-time highs, which has also spurred robust development.

While the global economic and domestic political environments remain uncertain, continued strength in domestic economic fundamentals, an ever-tightening labor market, anticipated wage growth, and resilient consumer activity should continue to support the current industrial market expansion. This cycle's demand has been largely driven by a reconfiguration of supply chains to accommodate e-commerce, and as a result, the bulk of industrial demand will continue to be focused both in big-box, super-regional distribution facilities and urban, centrally located in-fill sites for "last-mile" delivery. Interestingly, in the case of "last-mile" projects, property quality and high clear heights do not appear to be necessary criteria for tenants. Instead, access for cars, vans and smaller trucks, as well as an available pool of labor are driving factors in choosing locations. Compared with typical bulk distribution sites, goods are not stored at these locations long and are not stacked to the ceilings. One such example is Amazon's recent lease at 30 Northampton Street in Boston (see picture below). Amazon leased 26,700 square feet at this Class C property that was built in 1964 with 22' ceilings.

AMAZON'S 30 NORTHAMPTON STREET "LAST-MILE" SITE IN BOSTON

Source: Google Maps

While interest in "last-mile" industrial has risen recently, large spaces continue to be in demand, which tends to place super-regional distribution markets at the center of leasing activity. As such, not surprisingly, Chicago (7.7 msf) led the way in net absorption in the second quarter, followed by Riverside (6.9 msf) and Atlanta (6.4 msf). In aggregate, nearly 30 markets reported net absorption in excess of one million square feet during the second quarter.

Demand for industrial space has reached all-time highs, which has also spurred robust development. All told, markets with the highest demand also reported the most active supply pipelines. Indeed, Chicago (11.4 msf) again led the way, followed again by Riverside (5.1 msf) and Atlanta (4.4 msf). Moving through the rest of the year, the level of nationwide completions for this cycle will peak. This could cause short-term imbalances and slight upticks in availability. However, in aggregate, demand growth should keep pace with supply. So far, over 94 msf has been absorbed on a net basis year to date, outpacing the 92 msf of industrial space that has been delivered.

Beyond 2017, we anticipate supply growth will slow as development becomes increasingly challenging due to a lack of available land, difficulty obtaining entitlements, rising construction costs, and finally, a stricter lending environment. In the near term, rent growth will still be well above average in the strongest logistics markets, before settling down to 2.0%-3.0% growth over the long term.

INDUSTRIAL	
Vacancy Rate	7.8%
12-Month Trend	
Vacancy Change	↓
Rent	↑
Absorption	↓
Completions	↑
Cap Rates	↓
Transaction Volume	↑

Apartment

As has been the case for the past several years, the apartment sector showed particular strength in the second quarter. Vacancies dropped 30 basis points in the quarter to 4.6% as more than 113,000 units were absorbed and outpaced completions by a 2:1 margin. The second quarter marked the fourth consecutive year that net absorption topped 100,000 units. Further, over the previous four quarters, more than 220,000 units were absorbed, the first time the total has topped 220,000 since the first quarter of 2015. On the supply side, we are nearing peak for completions; however, as fast as units are being built, they are being absorbed.

In fact, Nashville, Austin, West Palm Beach, San Jose, Seattle, Denver, Salt Lake City and Orlando are among the leaders in terms of new supply, but they are also among leaders in net absorption (see Table 2). In the case of San Jose, Seattle and Denver, the increases in supply have been hefty year to date; however, demand has outpaced new supply by a sizeable margin and rents have continued to climb. In Seattle in particular, RealPage/Axiometrics reported it ranked 4th in year-over-year effective rent growth at 5.3% in the second quarter, behind Sacramento (9.1%), Honolulu (8.1%) and Riverside (6.0%). Other notable markets on the list where supply growth is sizeable but rents are advancing at an above-average clip include Salt Lake City and Minneapolis. Both Salt Lake City (4.7%) and Minneapolis (3.6%) ranked among the top 15 for year-over-year effective rent growth according to Real Page/Axiometrics.

Over the previous four quarters, more than 220,000 units were absorbed, the first time the total has topped 220,000 since the first quarter of 2015.

TABLE 2

TOP 15 SUPPLY AND DEMAND LEADERS

(Ranked by Inventory Increase YTD; highlighted markets are among Top 15 in demand YTD, Bold Italicized Markets saw Demand Outpace Supply YTD)

Market	Completions	Net Absorption	Demand Relative to Supply
Nashville	2.3%	2.2%	-0.1%
San Antonio	2.2%	1.8%	-0.4%
Austin	2.2%	1.7%	-0.5%
West Palm Beach	2.1%	1.5%	-0.6%
Kansas City	1.6%	1.4%	-0.2%
San Jose	***1.5%***	***2.6%***	***1.1%***
Seattle	***1.5%***	***2.2%***	***0.7%***
Denver	***1.5%***	***2.0%***	***0.5%***
Salt Lake City	1.4%	1.4%	0.0%
Fort Lauderdale	1.3%	0.8%	-0.5%
Charlotte	1.3%	1.1%	-0.2%
Washington, DC	***1.2%***	***1.4%***	***0.2%***
Dallas	1.2%	1.1%	-0.1%
Minneapolis	***1.1%***	***1.4%***	***0.2%***
Orlando	***1.1%***	***1.5%***	***0.4%***
Sum of Markets	***0.8%***	***1.0%***	***0.2%***

Source: CBRE-EA

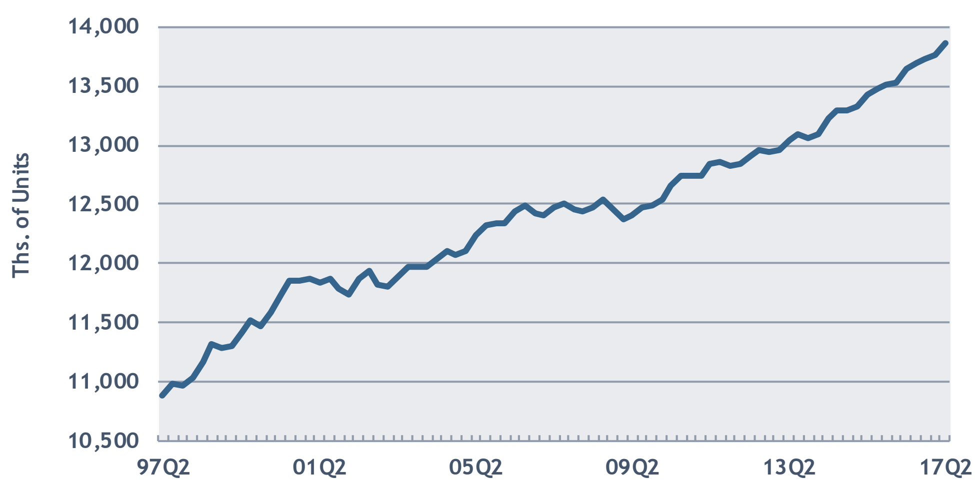
Across the country, two markets – Minneapolis (2.7%) and Newark (2.9%) – have vacancy rates below 3.0%, while four additional markets – Long Island (3.0%), New York (3.2%), Providence (3.4%) and Detroit (3.4%)—reported vacancies below 3.5% in the second quarter. The California markets dominated the next vacancy tier with less than 4.0% of units being vacant. Riverside, Sacramento, San Diego, Orange County, Ventura, San Jose, Los Angeles and

Oakland all reported vacancy rates between 3.6% and 3.9%. Boston and Seattle also remained among the tightest markets in the country with only 3.9% of units being reported as vacant. Meanwhile, according to RealPage/Axiometrics, older communities that have less modern amenities and generally lower rental rates are outperforming their newer counterparts with virtually no availability.

While many are worried about the state of the multifamily market and the potential for overbuilding or loss of renters to homeownership, the number of occupied rental units in the U.S. continues to climb to historic highs (see Figure 9). In fact, this increase in occupancy levels is occurring in the face of modestly rising homeownership rates. The homeownership rate rose to 63.7% in the second quarter of 2017, up 10 basis points from the previous quarter and 80 basis points from a year earlier. It is important to note, however, that the homeownership rate remains well below the mid-2014 peak of 69.2% and the 68.0% average of the previous decade. Moreover, while the outlook does assume some further improvement in the homeownership rate, there will still be an increase in the number of renter households due to ongoing household formation. By the end of 2025, there are expected to be nearly 2.5 million more renter households in the U.S., well above the expected increase in multifamily stock of 2.2 million units. Overall, our thesis remains unchanged: as a nation, we continue to produce too few housing units (including both for sale and rental units) and this is expected to persist going forward, with no "catch up" from the great recession when housing completions dropped considerably.

FIGURE 9

OCCUPIED APARTMENT UNITS



Source: CBRE-EA

Going forward, supply pipelines are thinning with projects that were once in planning being cancelled due in part to a lack of available labor/subcontractors which has driven construction costs higher. Additionally, cities and towns are seeing more opposition from constituents for development which is making the entitlement process more onerous. Finally, most national lenders are generally "full up" on multifamily construction and, thus, the ability to obtain debt, particularly non-recourse debt, is much more difficult. Nationally, inventory is expected to increase by 2.1% on an annual basis in 2017, before growth slows to 1.4% in 2018 and 1.1% in 2019. The slowing construction, coupled with ongoing demand from new renter households, should keep vacancies relatively low and allow for future, albeit more modest, rent growth going forward. Indeed, rent growth will likely hover around 3.0%, although some markets will outperform, particularly in the southeast and west. By product type, older or non-luxury properties will likely see outsized rent gains. The ability to push rents at newer, luxury product will be more challenging due to competition and affordability issues in some markets.

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

Retail

Retail fundamentals remained stable in the second quarter of 2017, with total retail availability at 7.0% for the third consecutive quarter. The neighborhood and community shopping center segment of the market, which accounts for roughly 40.0% of all retail space, reported a 10.1% availability rate, matching both the previous quarter and the fourth quarter of 2016. Lifestyle and mall availability, meanwhile, improved to 6.0%, down 10 basis points from the previous quarter and 20 basis points from the fourth quarter of 2016. Finally, power center availability remained at 6.8% in the second quarter, but was down 30 basis points from the beginning of the year. The lifestyle and mall and power center segments of the market are relatively small, each accounting for roughly 10% of inventory.

Retail space continues to be absorbed at a measured pace, despite the oft-touted demise of brick and mortar retailing. Roughly 26 million square feet (msf) of space was absorbed in the first half of 2017.

Retail space continues to be absorbed at a measured pace, despite the oft-touted demise of brick and mortar retailing. Roughly 26 million square feet (msf) of space was absorbed in the first half of 2017. There have been a number of store closing and bankruptcy announcements; however, the forfeited space has generally been absorbed by growing concepts. Overall, there are 22 major retailers that are in expansion mode, including Dollar Tree, Dollar General, TJ Maxx, Ross Stores, Aldi, Lidl and Costco. Common among each of the aforementioned retailers is their focus on off-priced merchandise, a shift that began during the recession and persists today. Consumers are shifting how they spend as well, spending more on entertainment and less on “things,” particularly apparel. While incomes have been growing, the post-recession recovery has been slow. In fact, the real median household income remained slightly below its pre-recession peak as of 2015, the last annual data released by the U.S. Census Bureau. Further, during this expansion, consumers have been unwilling or unable to draw upon the equity in their homes as they did during the prior cycle, so in aggregate, consumers have significantly less cash to spend and are stretching their dollars by frequenting off-price retailers.

Still, this does not signal an end to retail, rather, it points to the need for ongoing evolution. Successful retail projects will need to remerchandise to cater to today’s consumers and their more limited discretionary budgets. In addition, property owners need to continue to work to lure shoppers into their centers by offering a multitude of dining and entertainment options. Today’s consumers spend more on dining in restaurants than they do on groceries, and landlords need to incorporate this lifestyle shift into their merchandising mix. E-commerce does not currently compete in the restaurant segment, although Amazon’s acquisition of Whole Foods may eventually compete in food delivery or meal kits; for now, however, property owners can capitalize on the popularity of dining out as a way of drawing potential shoppers to their centers. Overall, value (TJ Maxx, Ross and the like), experience (restaurants, theatres, bowling, etc.) and convenience (e-commerce, omni-channel retailers) are the driving forces in retail today and stores or centers that fail to embrace this shift will underperform.

Amidst these changing demand trends, supply remains relatively modest, a factor that has helped foster the recovery in the market. Completions as a share of inventory remain at less than 1.0% and it is unlikely this will pick up going forward, given tighter lending standards and overall caution within the retail sector. Overall, only 6 markets are expected to add more than 1.0% of inventory to stock this year, namely Miami (2.0%), Fort Worth (1.9%), Nashville (1.5%), Dallas (1.5%), Houston (1.1%) and San Jose (1.1%). Beyond 2017, only New York has more than 1.0% of inventory under construction for delivery (1.2%). A common theme around many of the projects underway is that they are part of larger mixed-use developments: Miami WorldCenter, a 30-acre mixed-use project in Downtown Miami, will ultimately include 1,500 hotel rooms, 500,000 square feet (sf) of convention space, a mix of apartments and condominiums and 450,000 sf of retail space. The Shops at Clearfork (335,000 sf) in Fort Worth is part of a 270-acre mixed-use development that will include 2.0 msf feet of office space, a total of 1.2 msf of retail space and 2,500 multifamily residences.

Demand, meanwhile, has been strongest in the southeast and west with Charlotte (1.5%), Atlanta (1.1%), Fort Lauderdale (1.0%), Riverside (1.0%), San Jose (1.0%), Las Vegas (0.8%), Portland (0.6%) and Tampa (0.6%) reporting year-to-date demand well above the U.S. average (0.3%). Going forward, demand is expected to be strongest in these regions too with Houston, Atlanta, Fort Worth, Nashville, Orlando, Charlotte and Salt Lake City leading the way. The underlying population growth in these markets is the driving force behind this outlook with all of the aforementioned markets being among the top 20 in terms of population growth.

Likewise, markets in the southeast and west are generally showing the greatest year-to-date improvement in availabilities. San Francisco, Fort Lauderdale, Memphis, Sacramento, Jacksonville and San Jose reported some of the largest contractions in availability in the first half of the year, ranging from a 90-basis-point improvement in San Francisco to a 60-basis-point improvement in San Jose. San Diego, Dallas, Charlotte, Tampa and Ventura were not far behind in terms of performance with availabilities declining by 40 basis points during the first half of the year. Further, the majority of the markets reporting the greatest decline in availability had tighter market fundamentals; San Francisco (3.6%), San Diego (4.9%), San Jose (5.3%), Fort Lauderdale (5.6%), Dallas (6.7%), Charlotte (6.0%), Ventura (6.3%) and Tampa (6.4%) all posted second-quarter total retail availability rates below the U.S. average (7.0%).

Overall, while some markets are showing more strength than others, the one thing that remains true across all markets is that we are late in the cycle and the largest, most significant improvement in availability and rents has likely passed. Fundamentals are expected to remain steady going forward; however, any further contraction in availability will be modest at best and the ongoing turmoil among retailers, more budget-constrained consumer and competition from e-commerce will likely keep rent growth in check. Fortunately, construction has likely peaked as well, with investors and lenders becoming more cautious at this point in the economic cycle. As we have stated in the past, however, 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.

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

Capital Markets

Transaction volume declined on a year-over-year basis for the third consecutive quarter. Roughly $109 billion in properties changed hands in the quarter, down 5% from a year earlier, mostly driven by a sharp drop in the retail property sales volume. There is a growing gap between seller and buyer expectations and, as such, properties are being pulled from the market. Again, this is particularly the case in retail, where ongoing and overblown press regarding the demise of brick and mortar retail at the hands of e-commerce has caused substantial dislocation in the market. Retail transaction volumes were down 28% year over year, with less than $14 billion in properties changing hands, the lowest quarterly volume since early 2013. Office, apartment and hotel sale volumes were off only modestly year over year, between 1%-2%, with $33.6, $35.2 and $7.3 billion in properties, respectively, changing hands in the second quarter. The industrial sector was the only property type to report a year-over-year gain in sales; $15.3 billion in industrial properties changed hands in the quarter, up 10% from a year earlier.

While transaction activity has moderated, prices have continued to climb. All property sectors reported growth in the month, including retail.

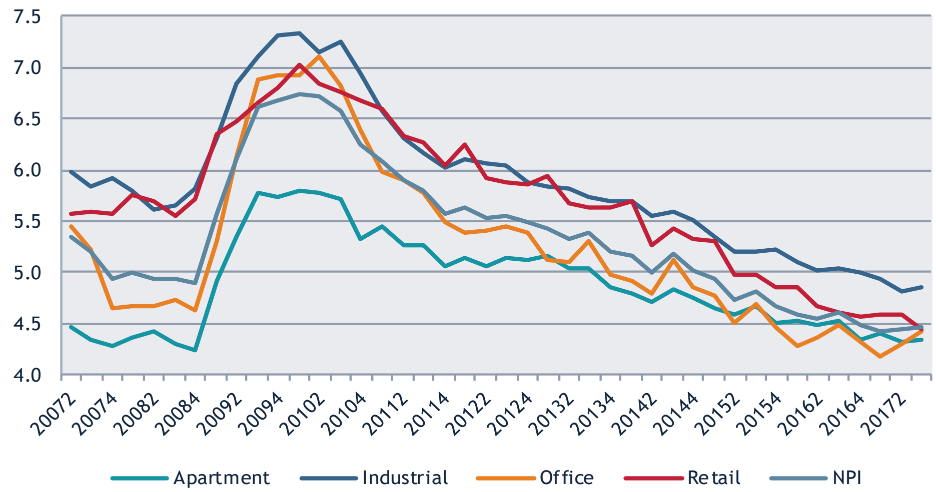
While transaction activity has moderated, prices have continued to climb. The RCA CPPI U.S. National All-Property Composite index rose 0.9% in the month of June and was up 7.9% on a year-over-year basis. All property sectors reported growth in the month, including retail; however, on a year-over-year basis, retail was the only sector to report a decline in pricing. The RCA CPPI for retail declined 0.7% over the June 2016 to June 2017 period. With respect to retail, we suspect June's month-over-month gain is the result of the ongoing dichotomy in the market, with the best properties in top-tier markets still able to transact at top dollar, while lesser properties often experience a broken sales process. Indeed, the RCA CPPI for retail for the 6 major metro areas (Boston, Chicago, Los Angeles, New York, San Francisco and Washington, DC) was flat on a year-over-year basis, while the non-major metro retail index declined 1.0% over the same period.

Still, while retail pricing for the 6 major metros was up, volume was down significantly in all but Boston and Chicago. Los Angeles, New York, San Francisco and Washington, D.C. reported retail transaction volumes dropped between 40% and 60% from their year-earlier levels. In comparison, Boston reported a nearly 50% increase in volume, while Chicago reported a more modest 4% increase in retail property sales. Again, this is likely a reflection of the fact that only the very best properties are trading. In addition, current owners are being very selective with respect to which properties they bring to market. More often than not, investors have already pruned their retail portfolios and are holding the properties they want to keep long term. That said, funds that are reaching the end of their lives may present an opportunity to acquire good retail at a discount due to the dislocation in the retail capital markets that persist today.

Despite the recent advance in the RCA CPPI, overall appreciation is slowing and we expect this trend to continue in the quarters ahead. Cap rates are at or near their historic low across all property types and their decline has leveled off. In the second quarter of 2017, the NCREIF all-property market value-weighted average cap rate stood at 4.5%, unchanged from the previous quarter and down only 10 basis points on a year-over-year basis (see Figure 10). Across the property types, the office cap rate, which stood at 4.5% in the second quarter, has hovered between 4.2% and 4.5% for eight consecutive quarters. The industrial cap rate actually edged 10 basis points higher in the second quarter to 4.9%, but was down 10 basis points year over year. The apartment sector, like the industrial sector, saw cap rates edge up 10 basis points to 4.4% in the second quarter, but decline 10 basis points from a year earlier. Finally, the retail cap rate edged down 10 basis points quarter over quarter and 10 basis points year over year, dropping to 4.5%. Generally, the changes in cap rates as of late, are roughly half the rate of compression that occurred in 2015.

FIGURE 10

NCREIF CAP RATES BY PROPERTY TYPE



Source: NCREIF

As the capital markets flatten, property returns have slowed from their double-digit pace over the last several years to more normalized returns in recent quarters. The NCREIF Property Index total return for the quarter was 1.7%, relatively unchanged from the 1.6% in the previous quarter, but down markedly from over 3.0% in mid-2015. For the one-year period ending June 30, 2017, the NPI total return was 6.9%, the fourth consecutive quarter that the annualized return was in single-digit territory and the first time since early 2010 that the return was below 7.0%. The NPI quarterly appreciation return for the second quarter of 2017 was 0.6%, slightly ahead of the first-quarter return, but down from 0.8% a year earlier and 1.9% in mid-2015. The NPI quarterly income return stood at 1.2% in the quarter, roughly on par with the return in each of the previous eight quarters. That said, the income return has slowed too (from a post-recession peak of 1.7% in mid-2010) but to a lesser extent relative to the appreciation component of the overall NPI return.

Again, this highlights the ongoing shift in the return composition that we have discussed for some time now. Overall, we are shifting back to a period where income will make up the bulk of returns going forward, a sharp contrast to what occurred earlier in the recovery when cap rate compression and capital appreciation drove returns. Going forward, we expect income will continue to drive the overall return and that returns, as a result, will moderate. We anticipate total returns will remain in the 5%-6% range for the foreseeable future.

Did you know?

Investment themes we are observing in the market today…

US has recorded 82 consecutive months of positive job growth, the longest streak in US history.

US consumer credit card debt outstanding is now back above pre-financial crisis peaks. Consumers are constrained by slow wage growth and the unwillingness or inability to access cash from home equity, forcing many to use revolving debt.

The median U.S. home price stood at nearly $246,000 in the second quarter of 2017, roughly 9% above the pre-crisis peak and up 50% from its recessionary low. To date, home prices in 224 of the nation's 382 metropolitan areas have returned to peak, 39 markets remain only 5% below their prior peak and an additional 31 markets remain within 5%-10% of peak. Major markets where housing prices are currently more than 10% below peak include Las Vegas, Riverside, the Greater Miami area, the Greater New York area, Orlando, Sacramento, Phoenix, Baltimore and Chicago.

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