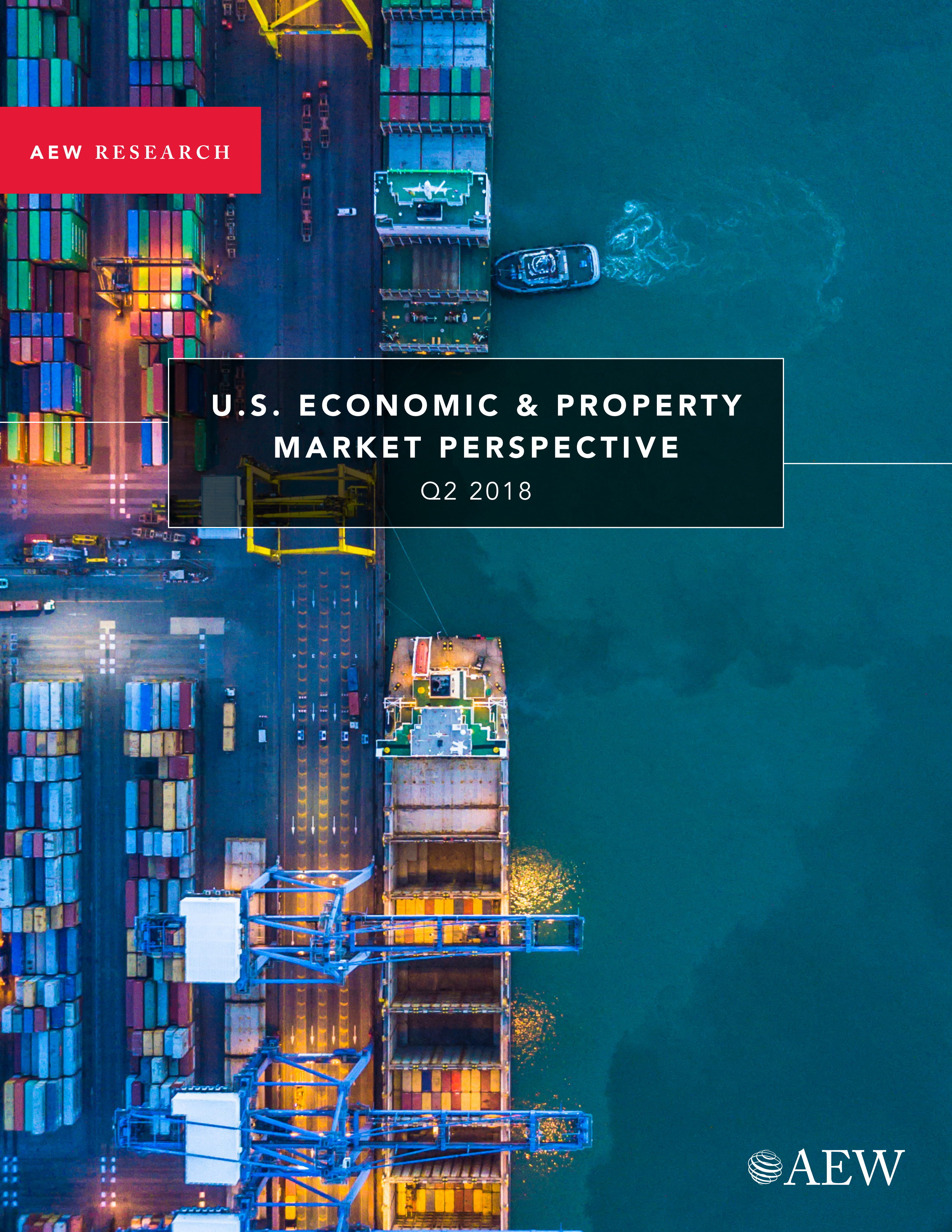
AEW RESEARCH

# U.S. ECONOMIC & PROPERTY MARKET PERSPECTIVE

Q2 2018



AEW

## Prepared by AEW Research, June 2018

We expect GDP growth to remain above trend in response to fiscal stimulus.

## The U.S. Economy

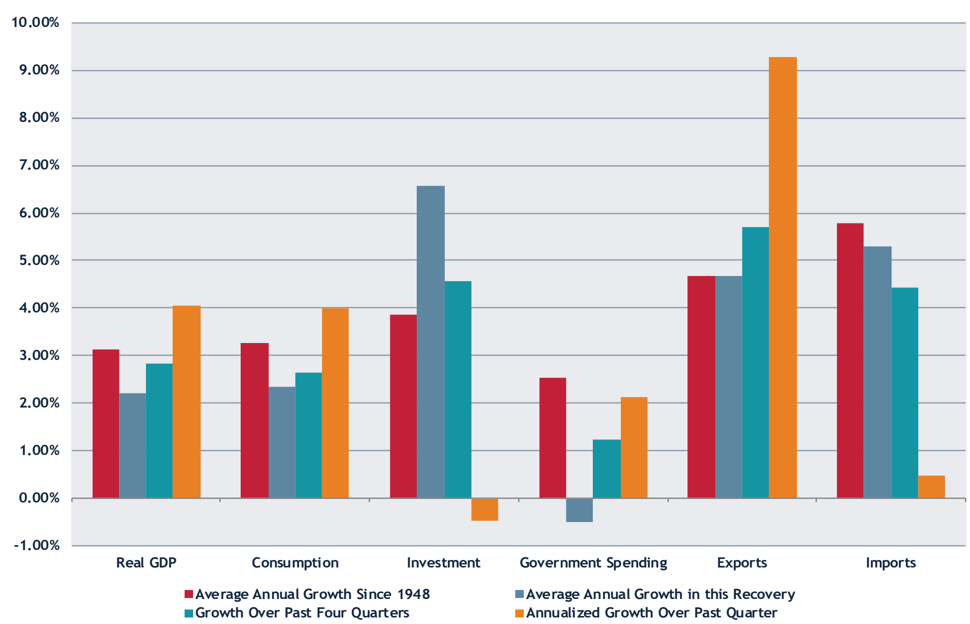
As expected, U.S. economic growth accelerated during the second quarter with real GDP increasing at an annual rate of 4.1%, the fastest growth since the 5.1% posted in the second quarter of 2014. To a large degree, the increase in growth from the 2.2% annualized rate in the first quarter reflects specific policy changes in Washington—tariffs, tax cuts and increased deficit spending. Notable in the preliminary GDP report was a surge in exports during the quarter as foreign buyers accelerated orders in advance of tariffs. Soy bean sales alone accounted for 0.6% of the total GDP growth rate for the quarter, or roughly 15% of all growth.

With respect to the recent tax cuts, growth in aggregate investment activity has now declined for two consecutive quarters, with the entire decline coming from residential fixed investment, most likely a reflection of rising mortgage rates and higher construction costs. Non-residential fixed investment, the type of investment targeted in the tax bill, continues to show strong year-over-year growth, particularly in new plant and equipment. Finally, government spending increased more than 2% over the past four quarters, continuing the reversal of declining real spending that has marked most of this expansion cycle.

Looking ahead, we expect GDP growth to remain above trend in response to fiscal stimulus. For 2018 as a whole, we anticipate growth to average approximately 3% before moderating somewhat in 2019. Any additional expansion of the simmering trade war with China and others would likely result in slower than expected growth in 2019.

**FIGURE 1**

**BREAKDOWN OF REAL GDP GROWTH IN 2018 Q2**




*Source: Bureau of Economic Analysis*

U.S. employment growth has also reaccelerated over the past year, with trailing twelve-month average job change increasing from approximately 170,000 in September of 2017 to roughly 200,000 in recent months. This acceleration in employment growth has been broad based, but is being led by manufacturing, construction and retail. With the unemployment rate near historical lows and labor force growth averaging less than 140,000 per month during the second quarter, it is unlikely that job growth will continue to accelerate in the near term. While there have been significant recent increases in labor force participation rates among younger women, minorities, and older men, these gains have not yet resulted in a meaningful increase in the overall force participation rate, which remains roughly 400 basis points below the pre-crisis high of 67%.

**FIGURE 2**

**AVERAGE MONTHLY EMPLOYMENT GROWTH OVER PRIOR TWELVE MONTHS**


*Source: Bureau of Labor Statistics, June 2018*

Against this backdrop, the yield environment remains largely static. Short-term interest rates will continue to rise as the Federal Reserve proceeds with their well-disclosed tightening policy. This in turn will lead to further flattening of the yield curve, as longer-term interest rates remain constrained by continued low government bond yields in Europe and Japan. The primary risk to this scenario is an acceleration in inflation that raises investor term premium and causes other central banks to begin to normalize their monetary policies. Growing funding needs from the mushrooming U.S. budget deficit may also put upward pressure on the entire U.S. yield curve, most significantly the longer end.

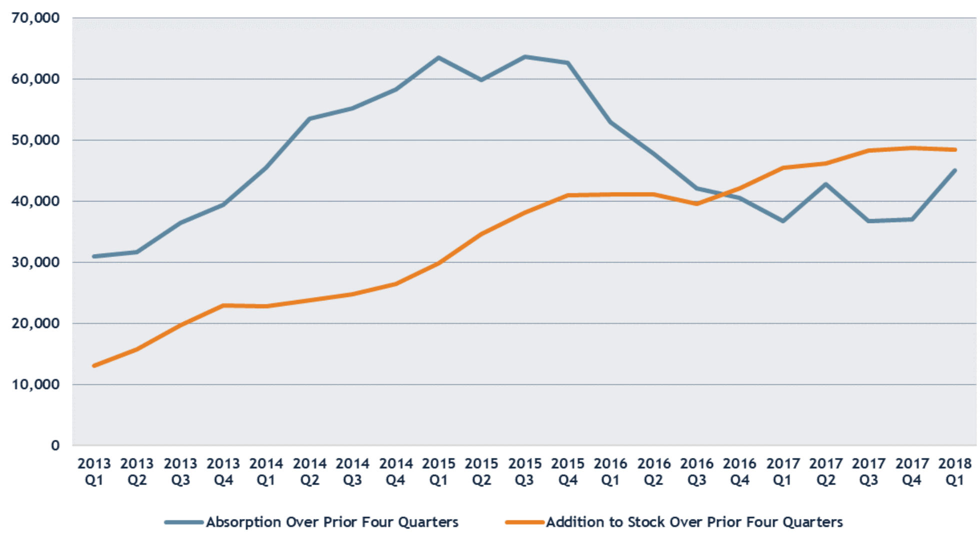
## The U.S. Property Market

As with the broader U.S. economy, the U.S. property market is also in the latter stages of the current cycle. 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% for ten consecutive quarters, while the availability rate of industrial properties has been consistently below 8% for seven consecutive quarters.

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

**FIGURE 3**

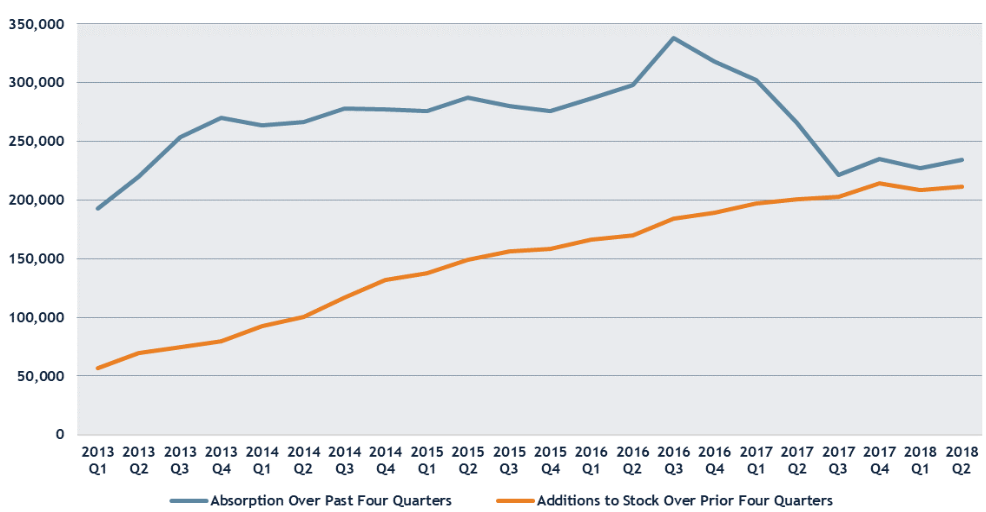
**U.S. OFFICE SUPPLY AND DEMAND (000S SF)**




*Source: CBRE-EA*

**FIGURE 4**

**U.S. INDUSTRIAL SUPPLY AND DEMAND (000S SF)**



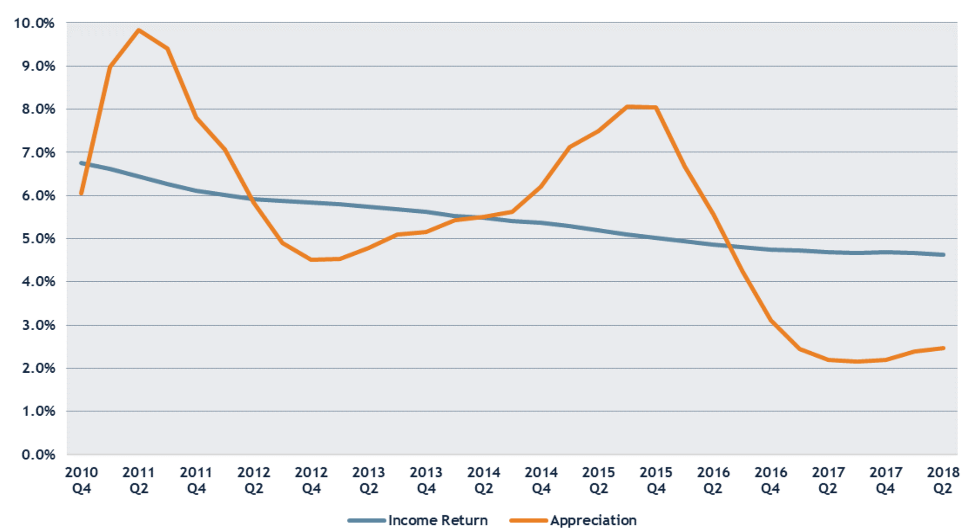

*Source: CBRE-EA*

Figures 3 and 4 highlight the slowdown in absorption of space that has occurred in the office and industrial property markets over the past two years. With somewhat stronger near-term economic growth, we expect this slowing to level off during the second half of this year through 2019 and the supply/demand balance to remain stable.

Reflecting the equilibrium between supply and demand, aggregate four-quarter property net operating income (NOI) growth has been above 5% for fifteen of the past sixteen quarters. Over the next 12-24 months, 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 marginally ahead of slowing demand. At the same time, in the face of long-term interest rates remaining low, we anticipate flat or slightly rising property yields, which will result in capital appreciation continuing to account for a declining share of total return (Figure 5). For its part, consensus surveys by the Pension Real Estate Association (PREA) currently project aggregate capital appreciation below inflation over the next five years, resulting in expected total unleveraged annualized returns of less than 6% over the next five years.

**FIGURE 5**

**NCREIF PROPERTY INDEX – CAPITAL APPRECIATION AND INCOME RETURN**




*Source: NCREIF, 2018 Q1*

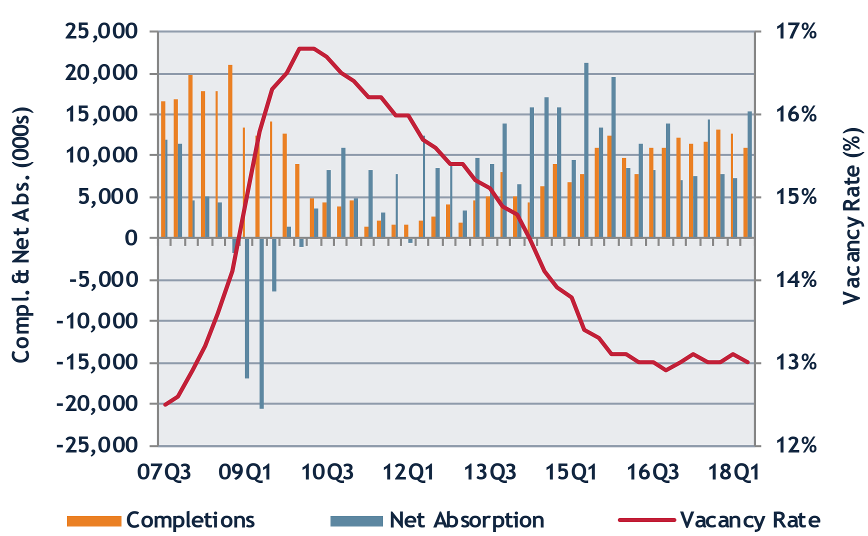
## Office

U.S. office vacancy stood at 13.0% in the second quarter of 2018, a healthy 10-basis-point (bp) decline from the previous quarter, according to CBRE-EA. Completions totaled 14.7 million square feet (msf) in the quarter, the tenth time in the past 12 quarters that construction surpassed 10 msf. Demand, meanwhile, totaled more than 18 msf, the largest single-quarter total since the final quarter of 2015. Further, this was only the third time since the fourth quarter of 2015 that absorption surpassed the historical quarterly absorption average. The robust demand in the most recent quarter was the driving force behind the slight decline in vacancy. Overall, the market still remains in equilibrium, as vacancies have hovered within 10 bps of 13.0% for much of the past three years.

The nation's largest office markets continue to outperform due to their vast employment bases and top-tier talent. New York (3.6 msf), Washington, DC (2.4 msf), San Francisco (1.8 msf), Denver (1.8 msf), Chicago (1.6 msf), San Jose (1.6 msf), Boston (1.2 msf) and Los Angeles (1.0 msf) all saw more than 1 msf absorbed in the second quarter. Among the aforementioned markets, New York, Chicago, Washington, DC, San Francisco, San Jose and Denver all delivered over 1 msf as well. Fifteen markets reported vacancies below 10%, including San Francisco (6.4%), Seattle (7.6%), Raleigh (7.7%), Orlando (8.4%), Boston (9.7%), Nashville (9.8%) and Austin (9.9%). Supply is expected to peak this year, as construction costs have increased and investors, developers and lenders have grown more cautious given the length of the continued expansion. Thus, demand and supply are expected to remain largely in balance, keeping the office market in equilibrium. That said, we will continue to approach investments in the office sector with caution due to slower expected future NOI growth, coupled with higher capital expenditure requirements of the sector and the gradual slowdown of overall employment growth—all of which will temper returns in the sector. Future office acquisitions will be focused in stronger urban or edge-city locations and in assets that are highly amenitized with access to restaurants, shopping and a highly-skilled and educated labor force.

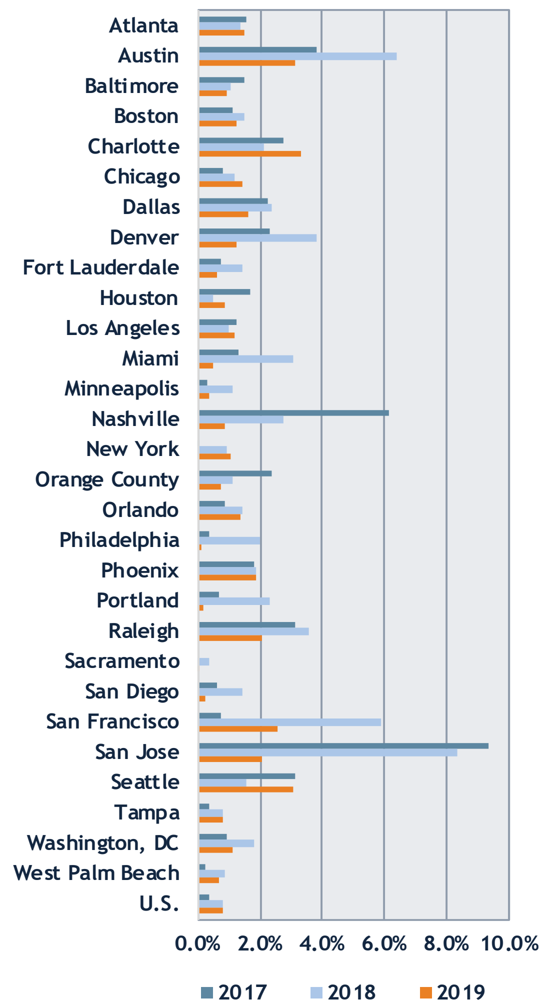
The nation's largest office markets continue to outperform due to their vast employment bases and top-tier talent.

CBRE-EA OFFICE MARKET FUNDAMENTALS



**OFFICE SUPPLY OUTLOOK 2017-2019**

**(SUPPLY AS A % OF INVENTORY)**




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

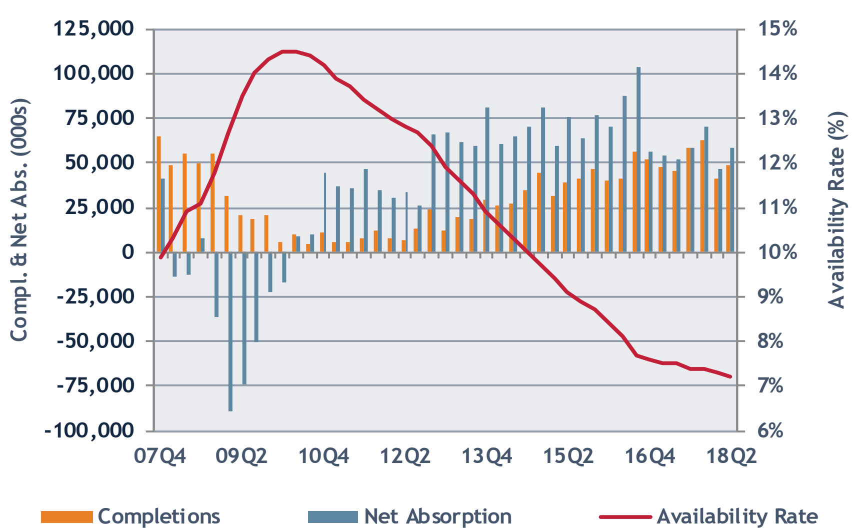
## Industrial

U.S. industrial availability fell yet again in the second quarter of 2018, extending a long streak of flat or declining availability that started more than eight years ago. Availability dropped to 7.2% in the second quarter, down 10 basis point (bps) from the previous quarter and 30 bps from a year earlier. Net absorption of 59 million square feet (msf) comfortably outpaced new supply of 51 msf. The year-to-date absorption total of 105 msf is now well ahead of the 93 msf of completions delivered year to date. The extension of the sustained improvement in fundamentals continues to result in steady rent growth; CBRE-EA reported 5.3% year-over-year rent growth nationwide in the second quarter.

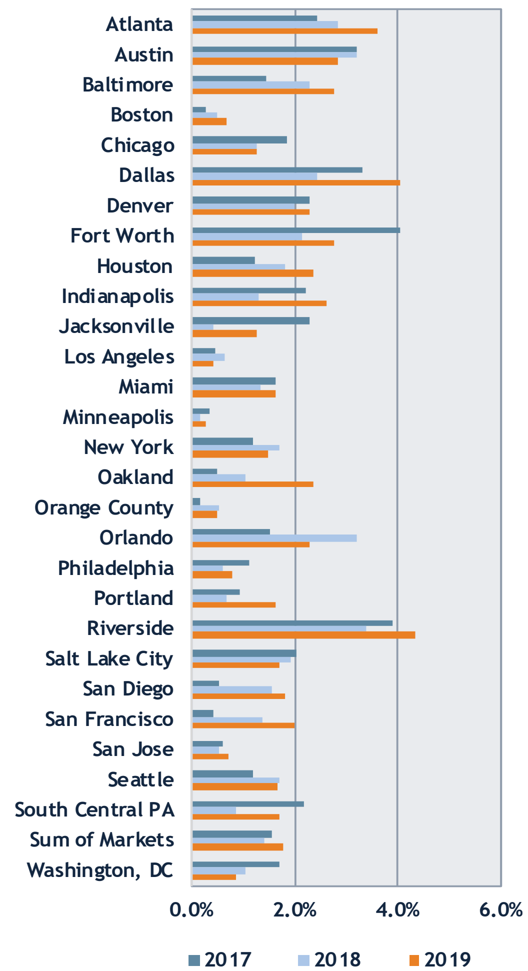
The ongoing economic expansion should fuel additional industrial space demand.

The nation's top performing industrial markets remain concentrated in the West. Indeed, among the top 10 markets with the lowest availability, eight are located in the West; of these, seven markets reported availability below 5%. Non-core industrial markets in the top 10, which have been among the strongest performers of late, are Cincinnati (4.8%; -70 bps YTD), Portland (4.2%; -50 bps YTD) and Ventura (5.2%; -20 bps YTD). Meanwhile, San Francisco, Seattle, Orange County, Honolulu and Salt Lake City, which have been top performers throughout the cycle, have seen availability expand 20–50 bps year to date. Still, these five markets continue to boast availability between 3.9% and 5.2%, all 200 bps or more below the U.S. average. In the near term, the industrial sector will continue to be one of the strongest performing sectors. The ongoing economic expansion should fuel additional space demand, although we are cautiously watching the ongoing trade discord as this could present downside risk to the demand outlook. Supply is expected to pick up in the near term, peaking in most markets next year. That said, the current trade environment is increasing construction costs by as much as 25%, a factor that could temper the supply outlook. Still, availability is expected to remain well below historical averages in the near term, supporting rent growth in the 4%–8% range, with West Coast, Florida and secondary Midwest markets leading the way. Longer term, as demand moderates, rent growth will temper and likely remain in the 2.5%–3.5% range, with coastal markets expected to be at the higher end of the rent spectrum.

**CBRE-EA INDUSTRIAL MARKET FUNDAMENTALS**



INDUSTRIAL SUPPLY OUTLOOK 2017-2019
(SUPPLY AS A % OF INVENTORY)




| INDUSTRIAL | |
|---|---|
| Vacancy Rate | 7.2% |
| 12-Month Trend | |
| Vacancy Change | ↓ |
| Rent | ↑ |
| Absorption | ↑ |
| Completions | ↑ |
| Cap Rates | ↓ |
| Transaction Volume | ↑ |

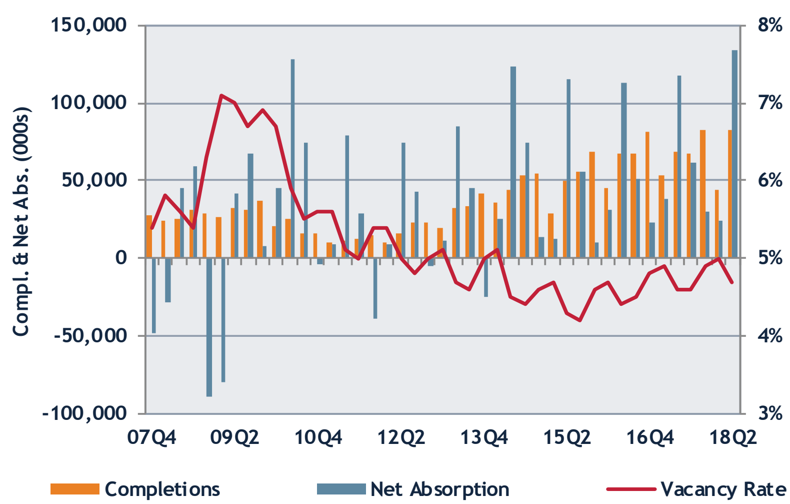
## Apartment

The apartment sector posted one of its strongest quarters of the post-Great Financial Crisis era in the second quarter of 2018. Vacancies dropped to 4.7% in the most recent quarter, down 30 basis points (bps) from the first quarter and consistent with the year-ago level of 4.6%. After a moderate 23,000 units were absorbed in the first quarter, more than 134,000 units were absorbed on a net basis this quarter, the largest single quarter total in U.S. history, per CBRE-EA. While seasonality trends typically cause Q2 to see the highest demand of the four quarters, net absorption totals certainly surpassed expectations. New supply of 82,200 units was also an all-time record, but was more closely in line with what was anticipated. To lend perspective, the new single-quarter construction record just edged out the first-quarter's high by 0.1%; meanwhile, the new absorption record was 4.5% higher than the previous mark of 128,500 units of demand seen back in the second quarter of 2010. The strong performance caused rents to rise after essentially holding flat for four consecutive quarters. CBRE-EA's national rent is up 2.2% from the previous quarter and 2.0% year over year.

New completions as a percentage of inventory are expected to peak this year and we continue to believe fundamentals will hold solid.

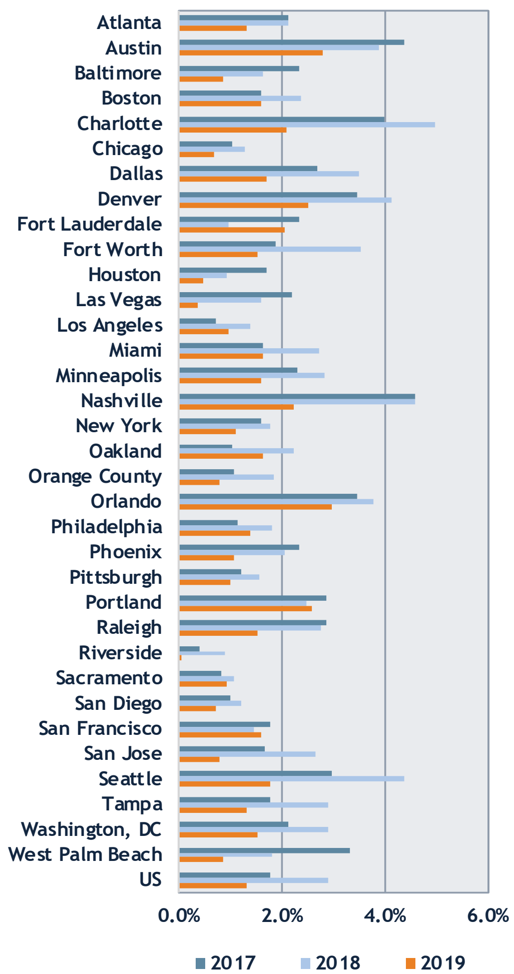
Although supply levels are up, new completions as a percentage of inventory are expected to peak this year. Indeed, completions totaled 1.8% of inventory in 2017 and will reach 2.9% of U.S. inventory in 2018, before dropping to 1.3% in 2019. Amongst 34 prominent apartment markets tracked by AEW Research, only three, Fort Lauderdale (2.1%), Portland (2.6%) and San Francisco (1.6%), will see supply as a percentage of inventory increase from 2018 to 2019. That said, each of these three totals is lower than their respective 2017 completion shares, suggesting these markets have also put the bulk of construction behind them. As supply levels dwindle, we continue to believe fundamentals will hold solid, particularly as demand is bolstered by the steady rise of mortgage interest rates, further employment expansion and a lack of "for sale" inventory. These factors, as well as the burn-off of rent concessions amongst new construction in lease-up, will all be positive catalysts for rent growth longer term.

**CBRE-EA APARTMENT MARKET FUNDAMENTALS**



**APARTMENT SUPPLY OUTLOOK 2017-2019**

**SUPPLY AS A % OF INVENTORY**




| APARTMENT | |
|---|---|
| Vacancy Rate | 4.7% |
| 12-Month Trend | |
| Vacancy Change | ↔ |
| Rent | ↑ |
| Absorption | ↑ |
| Completions | ↑ |
| Cap Rates | ↓ |
| Transaction Volume | ↓ |

## Retail

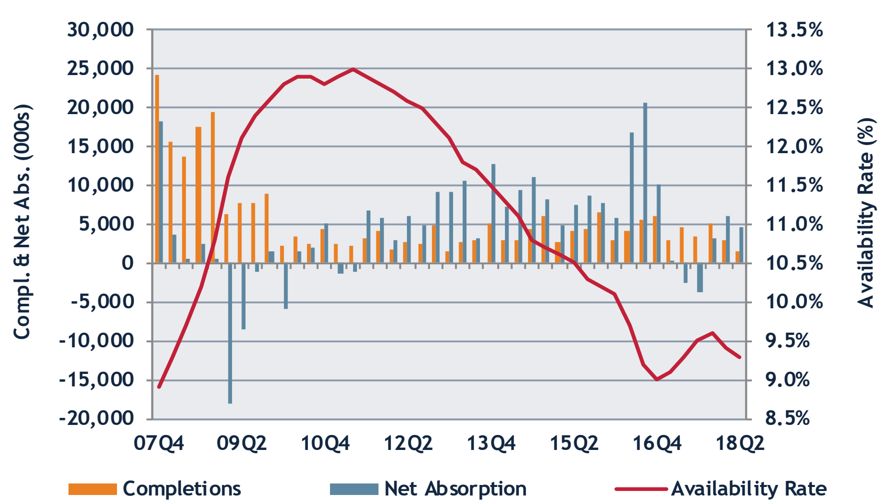
Total retail availability held flat at 6.5% in the second quarter of 2018, according to CBRE-EA. Supply of 7.9 million square feet (msf) outpaced demand of 5.3 msf during the quarter, though the difference was not large enough to impact availability meaningfully. Both totals were well below their respective historical quarterly averages, continuing a trend of declining activity in the sector that has been ongoing since the start of 2017. Still, supply and demand have found a good balance, as this quarter marked the ninth consecutive quarter of sub-7% availability in the sector, the longest such stretch since fundamentals were first tracked by CBRE-EA in 2005. Over the past nine quarters, availability has held steady between 6.1% and 6.6%, keeping net asking rents on an upward trajectory.

The shopping center segment of the broader retail market was the sole positive performer in the second quarter; availability declined 10 basis points (bps) to 9.3% in the quarter and was flat year over year. The lifestyle & mall (6.0%) and power center (7.0%) segments both saw availability rise in the most recent quarter, up 20 and 40 bps respectively; further, availability in both subsectors was up 70 bps year over year. Both segments of the market were hit hard by store closings. In particular, the shuttering of over 700 Toys R Us stores resulted in negative net absorption of 2.4 msf in the quarter, while Sears closings impacted the lifestyle and mall segment of the market.

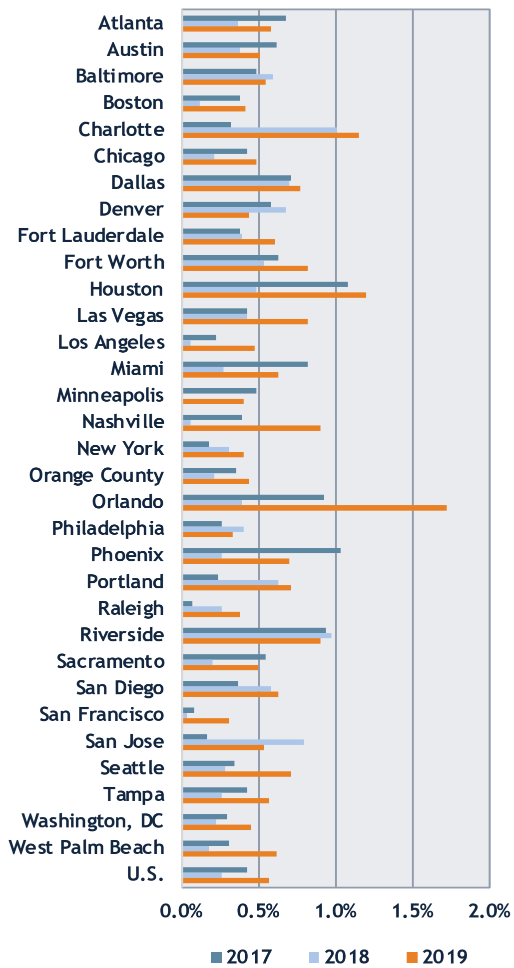
It is our opinion that well-located, top-tier assets with a healthy demographic base will continue to attract shoppers.

AEW continues to believe broader retail availability will remain consistent with current levels in the near term. Demand will continue to moderate in step with the expected slowing of the economic expansion, rising consumer prices and changes in spending patterns. That said, supply will be limited in the coming years, helping to keep the market in equilibrium. We believe retail will always have a place in a well-balanced real estate portfolio, and the overblown negative outlook on the sector will present buying opportunities due to dislocation in the retail capital markets. Despite what the headlines tout, it is our opinion well-located, top-tier assets with a healthy demographic base will continue to attract shoppers and outperform in the long run.

**CBRE-EA SHOPPING CENTER MARKET FUNDAMENTALS**



**RETAIL SUPPLY OUTLOOK**
**(SUPPLY AS A % OF INVENTORY)**




| RETAIL | N&C SHOPPING CENTER | LIFESTYLE & MALL | POWER CENTER |
|---|---|---|---|
| Vacancy Rate | 9.3% | 6.0% | 7.0% |
| 12-Month Historical Trend | | | |
| Vacancy Change | ↔ | ↑ | ↑ |
| Rent | ↑ | ↓ | ↑ |
| Absorption | ↑ | ↓ | ↓ |
| Completions | ↓ | ↓ | ↓ |
| Cap Rates | ↑ | ↑ | ↑ |
| Transaction Volume[1] | ↓ | ↓ | ↓ |

[1]*Excludes the impact of Unibail purchase of Westfield as it skewed the Q2 volume*

## Capital Markets

At the national level, transaction volume and pricing rose in the second quarter of 2018, per Real Capital Analytics (RCA). Nearly $119 billion of property was exchanged, which represents a 1.7% increase from year-ago levels. RCA's Commercial Property Price Index (CPPI) is up 6.5% in the last 12 months, as property values continue to rise year over year, albeit at a slightly slower pace than in the prior quarter. Amongst the four core property types, year-over-year price increases were strongest in the apartment sector (11.6%), followed by the industrial and office sectors (6.5% and 6.2%, respectively), with retail bringing up the rear (0.9%). On a positive note, retail pricing continues to climb, despite the negative headlines, and the pace of growth increased by almost 20 basis points (bps) between the first and second quarters.

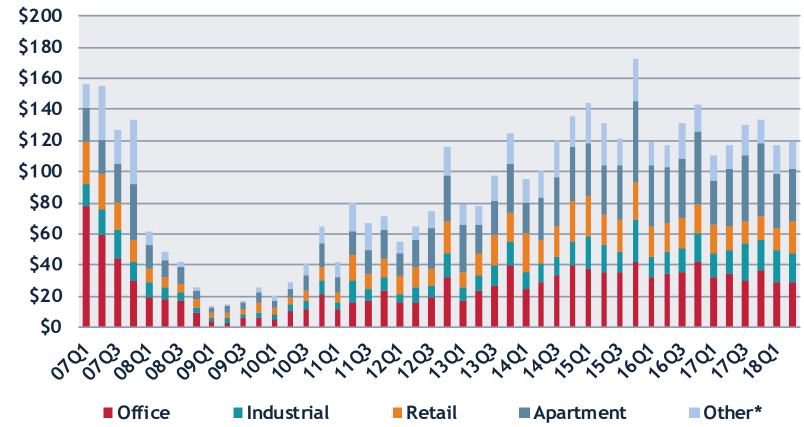
Pricing is pushing all-time highs, as the apartment, office and industrial sectors all set new peaks in the second quarter of 2018. Retail is the lone laggard, as it remains 4.4% below the pre-Great Financial Crisis peak reached in the third quarter of 2007. Unsurprisingly, apartment valuations today are strongest and are currently 62.5% higher than their second quarter of 2007 peak. Industrial property prices are a distant second, up 15.7% from their previous high in 2007. The office sector has seen values rise 5.4% since the third quarter of 2007; however, there has been a large disparity between CBD and suburban price growth. In fact, CBD properties are up 29.0% post-recession, while the suburban office index has risen just 1.6%. This perhaps highlights the push towards urbanization and the mass migration of people from the suburbs to urban cores that we have seen over the last decade.

Nearly $119 billion of property was exchanged as of the second quarter; a 1.7% increase from year-ago levels.

A substantial delta in pricing also exists between major-markets[1] and non-major markets, where total property values have risen 39.7% and 14.9% from pre-recession peaks, respectively. However, as would be expected of late-cycle performance, price gains are shifting outside of the six major markets and increasingly towards secondary and tertiary markets. Seattle, Raleigh/Durham, Sacramento, Fort Myers and Atlanta have seen the largest year-over-year property appreciation per RCA, none of which are amongst the six-major markets. The only major market in the top 10 with respect to price appreciation is Washington, D.C. Near-term, appreciation will remain strongest in these non-major markets, though we expect major markets will still see gains. Meanwhile, cap rates held relatively steady on a quarter-over-quarter market value-weighted basis in the apartment (4.2%), industrial (4.7%) and retail (4.5%) sectors, while office cap rates increased 30 bps to 4.5% in the second quarter of the year. On a year-over-year basis, cap rates in the apartment and industrial sectors compressed 20 bps, office and retail edged up 10 bps. Overall, however, there is a clear flattening of cap rates, with any movement limited to 10-20 bps on average.

[1]*Major markets include Boston, New York, Washington, D.C., Chicago, Los Angeles and San Francisco*

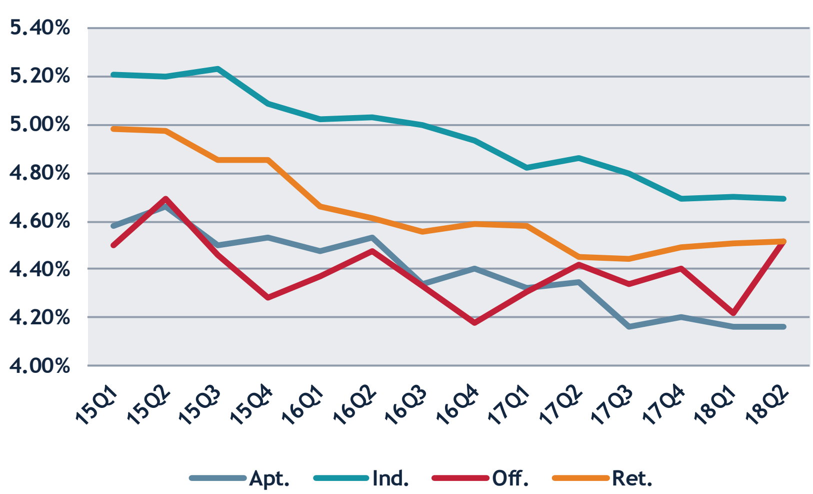
RCA TRANSACTION VOLUME BY PROPERTY TYPE
(BILLIONS OF U.S. DOLLARS)




*Other includes Hotel, Seniors Housing & Dev. Sites

| RCA CPPI Price Change as of June 2018 | | |
|---|---|---|
| | % Above/Below Peak | Prior Peak |
| National Total (All Property Types) | 22.6% | Q3 2007 |
| | | |
| Apartment | 62.5% | Q2 2007 |
| Industrial | 15.7% | Q3 2007 |
| Office | 5.4% | Q3 2007 |
| CBD | 29.0% | Q4 2007 |
| Suburban | 1.6% | Q3 2007 |
| Retail | -4.4% | Q3 2007 |
| | | |
| Major Markets[1] | 39.7% | Q3 2007 |
| Non-Major Markets | 14.9% | Q3 2007 |

NPI CAP RATES BY PROPERTY TYPE




[1]Major markets include Boston, New York, Washington, D.C., Chicago, Los Angeles and San Francisco

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