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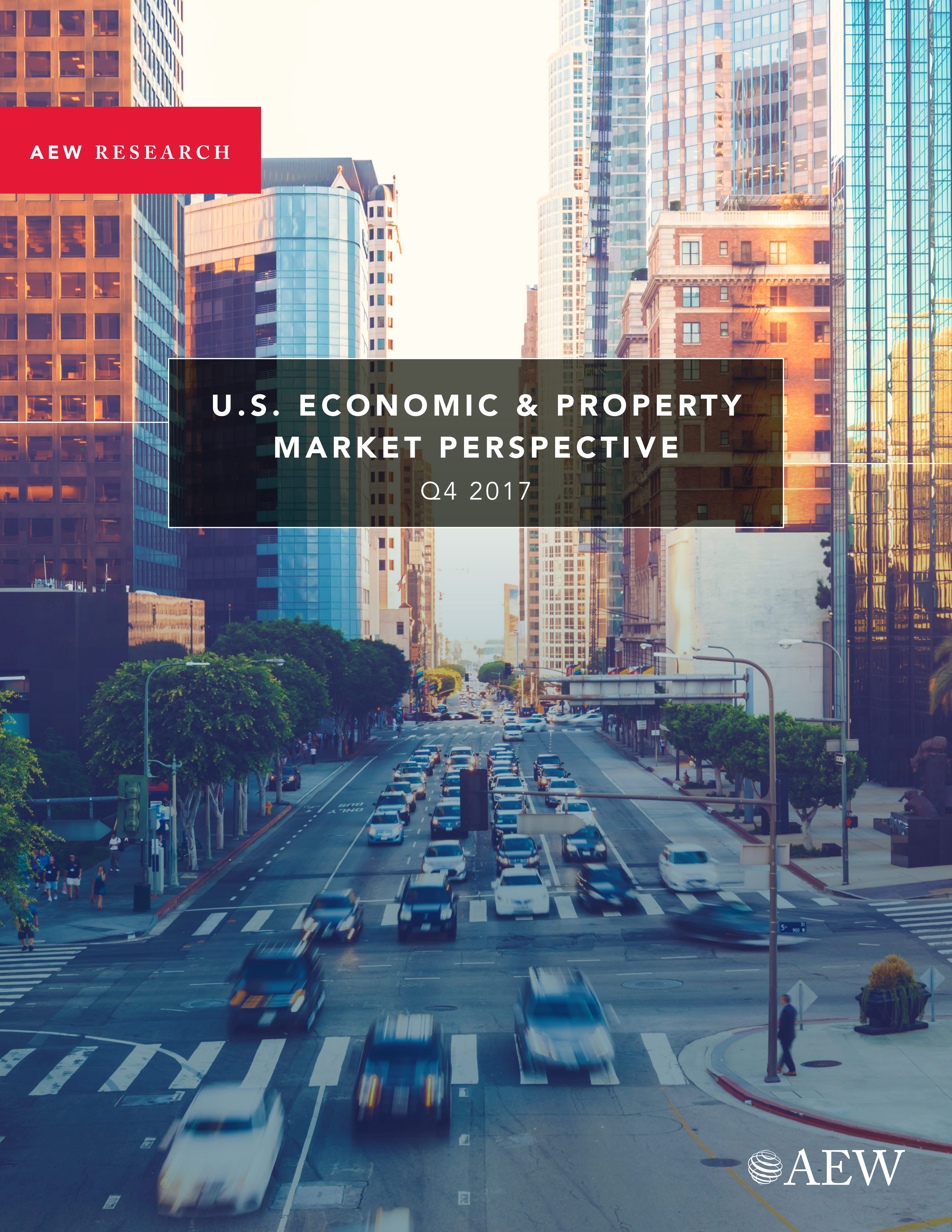

U.S. ECONOMIC & PROPERTY MARKET PERSPECTIVE

Q4 2017

AEW

Prepared by AEW Research, December 2017

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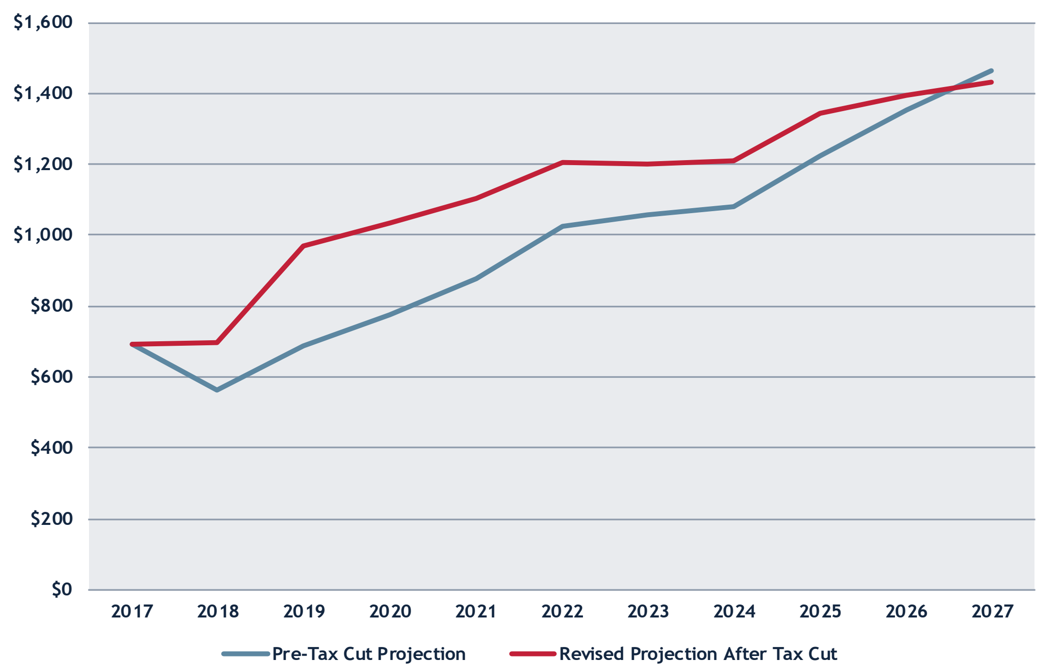
Under the new tax plan, the median U.S. household should see an increase in after-tax income of approximately 2% to 4%, which should be supportive of somewhat stronger consumer spending.

The U.S. Economy

Preliminary fourth-quarter data show the U.S. economy expanded at an annual rate of 2.6% during the last three months of 2017 and 2.5% for the year as a whole, slightly ahead of the 2.2% average growth rate of real GDP since the recovery began in mid-2009. The Federal Reserve's economic projections call for 2018 growth at roughly the same level as 2017 with somewhat slower growth in 2019 and 2020[1]. In contrast, private forecasters[2] are generally calling for slightly stronger growth in 2018 and 2019 due, in large part, to the near-term stimulative effects of the tax cuts approved at the end of 2017. Under the new tax plan, the median U.S. household should see an increase in after-tax income of approximately 2% to 4%, which should be supportive of somewhat stronger consumer spending. Overall, the tax package represents an increase in deficit spending between $100 and $150 billion per year through 2025, roughly 0.5% to 0.75% of nominal GDP. Most forecasters have added approximately 0.5% to their 2018 projections. Thus, we anticipate real GDP growth for the coming year to be in the 2.5% to 3.0% range.

FIGURE 1

ANNUAL U.S. BUDGET DEFICIT (BILLIONS)



Source: Congressional Budget Office

[1] Federal Open Market Committee, "Advance release of table 1 of the Summary of Economic Projections to be released with the FOMC minutes". December 13, 2017.

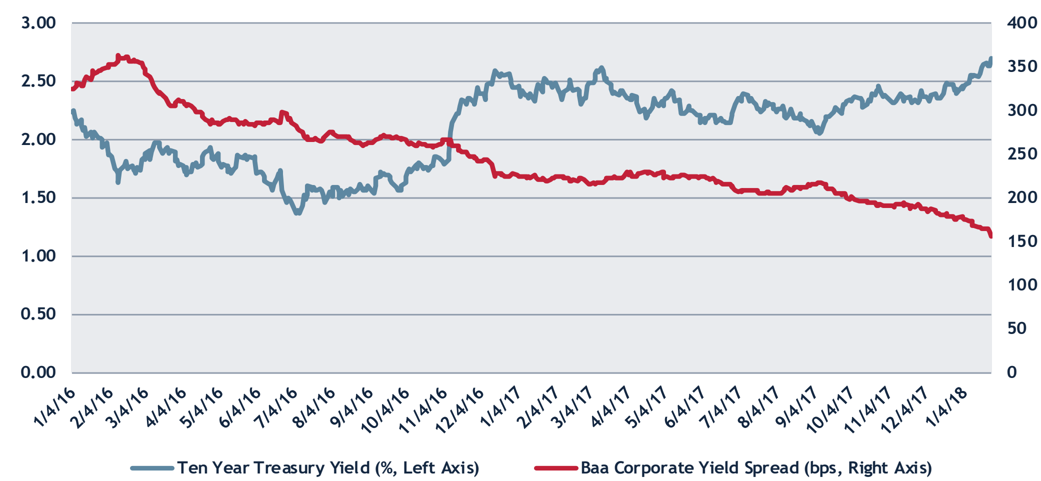
[2] See, for example, Mark Zandi, Moody's Analytics "U.S. Macro Outlook: Mistakes Can Happen.", January 18, 2018

Despite somewhat stronger aggregate growth, we do not expect U.S. employment growth to accelerate during 2018 for the very simple reason that, absent a significant change in labor force participation, the U.S. is slowly running out of workers. As recently as September 2016, the year-over-year growth in the U.S. labor force was nearly 2%, an increase of approximately 250,000 per month. This growth rate slowed abruptly, ending 2017 at a year-over-year rate of only 0.54%, or an average monthly increase for the year of less than 75,000 new workers per month. Over the past year, U.S. employment growth has averaged approximately 175,000 jobs per month and the unemployment rate has fallen to nearly 4%. Going forward, we expect labor force growth to pick up as the tight labor market translates into somewhat stronger wage growth, drawing people back into the market. However, we do not see labor force growth increasing enough to allow aggregate job growth to pick up from current levels and therefore anticipate monthly job gains continuing to slow during 2018.

At present, there are few signs of an impending economic downturn. As expected, the Federal Open Market Committee (FOMC) again voted to raise short-term interest rates in December, increasing the federal funds target rate range to 1.25% -1.50%. The Fed also affirmed its intention to bring the federal funds rate above 2% by the end of 2018 with a target of 3% by 2020. While the yield curve has flattened as the Fed has raised short rates, the long end of the curve has also risen recently with the ten-year Treasury yield sitting at 2.7% as of the end of January. Offsetting this, credit spreads have narrowed significantly, falling from 350 basis points at the beginning of 2016 to nearly 150 basis points in January 2018. This narrowing of credit spreads in the corporate debt market is also evident in real estate lending markets and property pricing as borrowing costs and property yields thus far remain relatively stable despite underlying increases in base Treasury rates.

FIGURE 2

TEN-YEAR TREASURY YIELD AND BAA CORPORATE SPREAD

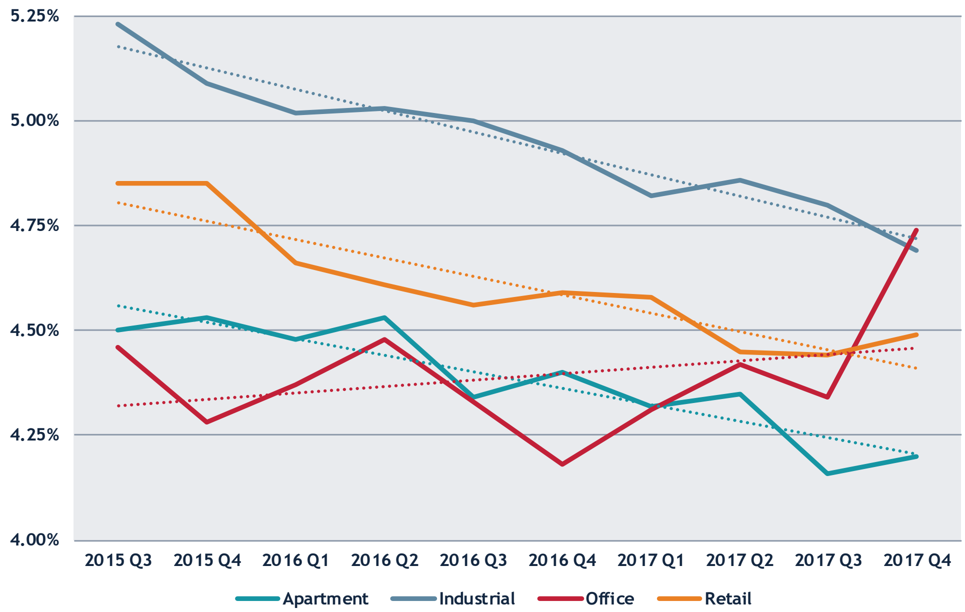


Source: Moody's Analytics

One recent divergence of note is in the appraisal capitalization rate for office properties in the NCREIF universe. In recent quarters, office property yields have been fairly consistent; however, the fourth-quarter data show a significant increase in the average office yield of approximately 30 basis points. Moreover, the increase was nearly identical in both suburban and central business district properties.

FIGURE 3

AVERAGE CARRYING VALUE CAP RATE BY PROPERTY TYPE



Source: NCREIF

KEY REAL ESTATE INDICATORS[3]

PROPERTY TYPE	VACANCY/AVAILABILITY RATE		RENTS	ABSORPTION	COMPLETIONS	CAP RATES	TRANSACTION
Office	13.0%	↔	↑	↓	↑	↑	↓
Industrial	7.4%	↔	↑	↓	↑	↓	↑
Retail[1]	9.6%	↑	↑	↓	↓	↓	↑
Apartment	4.9%	↔	↔	↑	↑	↓	↓

Source: CBRE-EA, NCREIF, and RCA

Note: The arrows reflect the trend for the previous 12 months for rents, absorption, completions and transactions volumes, as well as the current quarter versus one year ago for availability/vacancy rates and cap rates. For vacancy/availability rates, a down arrow indicates declining vacancy/availability rates. Industrial and retail are reported as availability while office and apartment are reported as vacancy. For cap rates, a down arrow indicates falling cap rates or rising prices.

[1] Represents the neighborhood and community shopping center segment of the market.

U.S. Property Markets

In terms of supply and demand, the U.S. property markets remain largely in equilibrium with little or no change in aggregate vacancy or availability rates over the past year outside of a small increase in the availability rate of neighborhood and community shopping centers. During 2018, we expect average vacancy rates to remain static or trend up slightly across all major property types as delivery of new space reaches a peak for this cycle.

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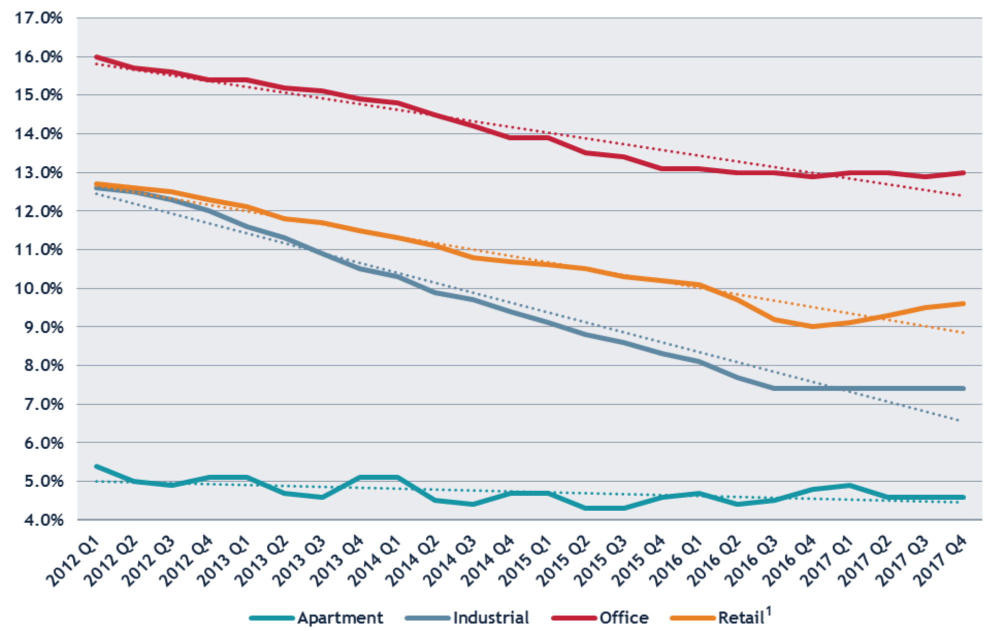
FIGURE 4

FLATTENING IMPROVEMENT IN VACANCY/AVAILABILITY RATES



Source: CBRE-EA

Over the next 12-18 months, we expect net operating income (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 growth. Indeed, some of this slowing is already happening in apartment and retail properties and we expect the same slowing to occur in office and industrial over the next 12-24 months.

With flat (or possibly slowly rising) yields and slowing NOI growth, the consensus expectation for U.S. property returns remains positive. In general, near-term unlevered property returns should approximate the current yield and expected inflation. Today, this suggests total returns of approximately 6% (or less). While lower than the recent past, we continue to believe that U.S. commercial property returns will be competitive with both equity and fixed income returns for the foreseeable future.

[1] Represents the neighborhood and community shopping center segment of the market.

Office

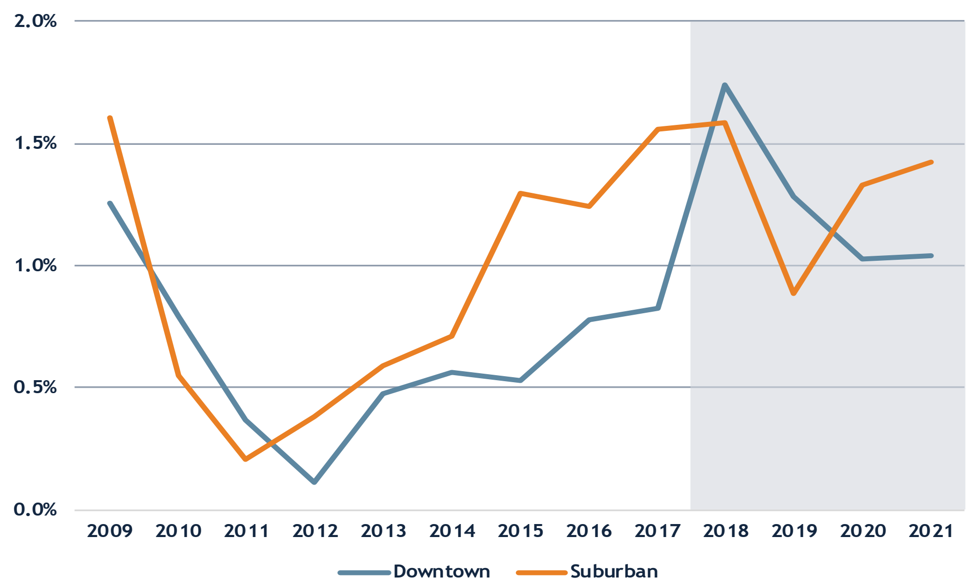
Office vacancies stood at 13.0% at the end of 2017, marking the seventh straight quarter that vacancies have been between 12.9% and 13.0%. Nearly 13.8 million square feet (msf) were delivered in the quarter, which was slightly ahead of new deliveries for the past six quarters, while roughly 9.0 msf was absorbed. Vacancies edged up 10 basis points in the quarter and on a year-over-year basis, as new supply was slightly ahead of net new demand. On an annual basis, roughly 48.9 msf was completed, which was the highest annual total since the Great Financial Crisis began, but still accounted for just 1.3% of total inventory. Net absorption, meanwhile, moderated to 38.5 msf (or 1.0% of total inventory). The slowdown in demand, while notable, was moderate on a relative basis and was both expected and consistent with the slower job creation at the national level.

Markets showing particular strength on the demand side include Las Vegas, San Jose, Phoenix, Austin and Columbus, all of which reported absorption rates that exceeded 3.0%.

By market, Seattle continued to show exceptional strength. Nearly 3.2 msf, or 3.5% of existing stock, was absorbed on a net basis in the year, the second greatest absorption among the nation's 63 largest markets. Further, the new demand was more than enough to offset the 3.0 msf delivered, allowing vacancies in the market to compress an additional 40 basis points to 7.7%. Seattle is currently tied with San Francisco for the fourth-lowest vacancy rate in the nation behind Albany (5.7%), Long Island (7.3%) and Louisville (7.5%). Other markets showing particular strength on the demand side include Las Vegas, San Jose, Phoenix, Austin and Columbus, all of which reported absorption rates that exceeded 3.0%. Columbus continues to surprise on the upside, showing particularly strong private sector job growth in a variety of industries, including technology and finance. Facebook is building a $750 million data center in the metro while J.P. Morgan has 600 open positions at its local office. Washington, D.C., which reported the best demand in terms of square footage (3.6 msf), remained only an average performer with an absorption rate of 1.2% for the year versus 1.0% for the nation. Other notable markets with more moderate absorption rates included Boston (0.9%), Los Angeles (0.8%), San Diego (0.5%), Chicago (0.3%) and New York (0.3%); job growth in these markets slowed over the course of the year, a factor that has likely contributed to the more modest absorption. Further, San Francisco, Minneapolis, Houston, Oakland and Portland actually backpedaled with space being returned to the market in aggregate for the year; the aforementioned markets were among the 22 markets that reported an uptick in vacancy for the year. Twenty-nine markets reported flat or declining vacancies.

Construction activity in the urban core picked up in earnest in 2016 and 2017 with just over 10 msf added to downtown markets in each year; this was up roughly 80% from the 6 msf added to the market in 2013. Still, urban construction remains relatively low with stock increasing by only 0.8% in 2016 and 2017. Suburban markets, on the other hand, have seen a steady increase in development; in 2017, 38.1 msf, or 1.6% of stock, was added to suburban markets. Overall, completions in the suburbs are up 156% from their 2013 level. San Jose (12.6%), Salt Lake City (6.0%), Nashville (4.6%), Fort Worth (4.2%) and Austin (3.5%) had notable levels of supply added in the suburbs; further, all the aforementioned markets with the exception of Austin reported increases in suburban vacancies as a result of supply outpacing demand. In Austin, demand eclipsed supply and suburban vacancies declined to 7.9% in the fourth quarter of 2017, down 30 basis points from a year earlier. Austin's suburban vacancy rate is currently the fourth lowest in the nation behind Albany (7.1%), Long Island (7.3%), St. Louis (7.7%) and Louisville (7.7%) and is well below the U.S. suburban average of 14.2%. Despite the increase in vacancies, San Jose (12.8%), Salt Lake City (11.1%) and Nashville (9.1%) all maintained vacancy rates below the U.S. average. Fort Worth, however, which experienced a 300-basis-point uptick in vacancies, had the third highest suburban vacancy rate in the nation at 20.2%; only Chicago (20.4%) and Houston (21.9%) reported higher suburban vacancies.

FIGURE 5
SUBURBAN CONSTRUCTION HAS OUTPACED URBAN CONSTRUCTION (COMPLETIONS AS A SHARE OF INVENTORY)



Source: CBRE-EA

Going forward, overall construction activity is expected to peak in 2018 and slow substantially in 2019 and beyond. CBRE-EA is tracking nearly 71 msf of space underway (62.3 msf of multi-tenanted space and 8.5 msf of single-tenant space) for delivery in 2018 and less than half that total, 32.7 msf (30.2 msf multi-tenant and 2.5 msf of single-tenant space), for delivery in 2019 or beyond. By subsector, the suburban markets will account for the bulk of deliveries in 2018, with roughly 47 msf expected to be completed by year end. Beyond 2018, the pipeline drops to less than 15 msf of suburban space underway. Completions in downtown markets, meanwhile, are expected to total nearly 24 msf in 2018, more than double the 10.8 msf delivered in 2017, before the pipeline thins to less than 18 msf in process for delivery in 2019 and beyond. Overall, both the 2018 suburban and downtown pipelines total just under 2.0% of inventory while the longer term suburban pipeline drops significantly to 0.6% of inventory. The urban pipeline, meanwhile, slows to 1.4% longer term. Overall, the moderation in supply expected in the coming years will coincide with the continued slowdown in job growth. Still, the office market will remain in equilibrium, and vacancies will likely continue to linger around their current level. There may be instances where vacancies edge slightly higher until new supply is leased up; overall, however, we anticipate office fundamentals will remain healthy.

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

Industrial

The U.S. industrial market continued to show stability in the fourth quarter of 2017. Industrial availability held steady at 7.4%, which marked the sixth consecutive quarter in which availability remained unchanged. More than 54.7 million square feet (msf) were completed in the final quarter of 2017, slightly ahead of the 45.5 msf of net absorption. Both totals were above their historical quarterly averages of 41.9 msf and 40.9 msf, respectively. Nationally, demand had outpaced supply for 26 consecutive quarters from the third quarter of 2010 to the fourth quarter of 2016. While industrial market demand remains above average, supply levels are increasing and outpaced absorption every quarter in 2017. In total, 200.1 msf were completed in the past year, which represented the highest level of new deliveries on an annual basis since 2008. Demand, on the other hand, slowed to 177.6 msf, the lowest total since 2012. Importantly, while supply has outpaced demand as of late, the spread between deliveries and new demand is minimal. Vacancies, as opposed to availability, increased a modest 10 basis points to 4.5% over the course of the year due to supply slightly surpassing net new demand; however, the percentage of space that is actively being marketed for lease or available remained unchanged at 7.4%.

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West Coast markets continue to dominate the nation's industrial space from an availability standpoint. Indeed, amongst the markets with the ten lowest availability rates in the nation, nine of them are in the West. The top five spots belong to Honolulu (3.4%), San Francisco (3.9%), Los Angeles (4.4%), Orange County (4.7%) and Salt Lake City (4.7%). The other West Coast markets that round out the top 10 include Seattle, Portland, Oakland and Ventura. Long Island is the lone East Coast metropolitan area that ranks in the top 10, and it is tied for 10th at 5.3%. Though these markets still boast the tightest fundamentals, six of them saw availability expansion in 2017, largely the result of supply outpacing more modest demand. A lack of available space and rapidly rising rates are likely tempering market conditions in coastal Southern California in particular. With rents rising at a robust pace, demand paused in Los Angeles and Orange County in 2017, as markets like Reno, Las Vegas, Salt Lake City and Riverside created a value proposition for users. Indeed, Riverside boasted the greatest net absorption in the nation in 2017 with nearly 25 msf being absorbed, yielding an absorption rate of 4.7%, more than three and a half times the national average of 1.3%. Likewise, Las Vegas (5.7%), Reno (4.4%) and Salt Lake City (3.1%) saw above-average demand as a percentage of inventory. Overall, demand this year was generally much stronger on a relative basis in metropolitan areas in the South and Midwest, as well as in secondary and tertiary markets scattered across the country as tenants have sought out available and more affordable space than what is currently available in coastal Southern and Northern California.

Indeed, an emerging trend in 2017 was strong fundamental improvement in secondary and tertiary markets. Of the 10 metropolitan areas that saw the largest declines in availability in 2017, seven are smaller, non-gateway markets including Tucson (-260 bps), Cincinnati (-200 bps), Sacramento (-160 bps), Hartford (-140 bps), Memphis (-120 bps), Albuquerque (-110 bps) and Milwaukee (-110 bps). While these industrial markets may be small, they are not isolated; Tucson, Albuquerque and Sacramento can access most major metropolitan areas on the West Coast within a day. Hartford and Memphis are accessible to major northeast and southern markets. Cincinnati has 160 million people, or roughly half of the nation's population, within a 600-mile radius (one day drive time). Milwaukee is largely considered an extension of the greater Chicago market. The top 10 was rounded out by Salt Lake City (-120 bps), Phoenix (-110 bps) and Riverside (-110 bps), of which only Riverside is truly considered a top-tier industrial market. The strength in performance of these smaller markets highlights the rise of industrial as the strongest performing property sector as of late. Meanwhile, construction has been on the rise in recent years, and supply has increased as a percentage of national inventory each year since bottoming out at 0.2% in 2010. In the last two years, new construction has been recorded as 1.4% of U.S. inventory. While that is up significantly from post-recession lows, supply has averaged about 1.5% of inventory on an annual basis over the course of the last 30 years. Even annual inventory growth, which has also been expanding in recent years and hit a post-recession peak of 1.5% in 2017, is on par with average annual growth of 1.5% going back to 1989. Despite the fact that construction is on the rise, most metrics show that supply levels still remain at or slightly below historical levels. At the metro level, Las Vegas (5.8%), Riverside (4.0%), Fort Worth (3.9%), Jacksonville (3.4%) and Trenton (3.4%) saw the largest supply growth as a percentage of existing inventory. While growth in all five of these markets was robust, absorption outpaced inventory growth in four of the five markets, the lone exception being Fort Worth, where 10.9 msf of supply edged 9.4 msf of demand. Despite a post-recession peak in completions, 32 of the nation's 63 largest markets saw availability hold steady or decline in 2017, and 21 markets saw availability tighten 50 basis points or more, indicating that the industrial sector is still healthy and can extend solid performance deeper into this economic cycle.

Going forward, market size is not necessarily going to be an indicator of strong sector performance as the improvement in market fundamentals has broadened substantially and now includes secondary and tertiary markets. The ongoing economic expansion, while moderate, should support industrial demand; this coupled with a tapering of construction should allow for industrial fundamentals to remain in equilibrium conditions or slightly better in the years ahead.

INDUSTRIAL	
Availability Rate	7.4%
12-Month Trend	
Availability Change	↔
Rent	↑
Absorption	↓
Completions	↑
Cap Rates	↓
Transaction Volume	↑

Apartment

Broadly speaking, the multifamily sector remained in equilibrium in 2017. Vacancies stood at 4.9% in the fourth quarter of the year, matching the first quarter's rate and up only 10 basis points (bps) from a year earlier. This marked the fifteenth consecutive quarter in which national apartment vacancy has oscillated between 4.0% and 5.0%. Demand remains very strong with more than 241,000 units being absorbed in 2017, the strongest annual demand reported since 2010. Supply also increased, which kept vacancies relatively unchanged despite the healthy absorption in the year.

Some of the metropolitan areas reporting the greatest apartment rent growth include Orlando (5.8%), Jacksonville (5.5%), Sacramento (4.7%), Columbus (3.8%), Long Island (3.7%), Phoenix (3.6%), Denver (3.1%) and San Jose (3.1%).

Among CBRE-EA's top 50 markets, vacancies declined or held steady in 22 metropolitan areas, despite the fact that supply has steadily gained momentum in recent years. The strongest year-over-year improvements in vacancies were seen in Houston (-180 bps), Pittsburgh (-110 bps), Jacksonville (-50 bps), Orlando (-40 bps), Riverside (-40 bps), Las Vegas (- 30 bps) and Long Island (-20 bps). Not surprisingly, most of these markets, in addition to registering solid absorption totals this year, also had limited new supply brought online in 2017. Although vacancy contraction has moderated in more recent quarters, rent growth is unabated in many West Coast and southern metropolitan areas. There were a number of apartment markets that saw 2017 net effective rent growth of 3.0% or more, compared to a slight decline (-0.3%) nationally. Some of the metropolitan areas reporting the greatest apartment rent growth include Orlando (5.8%), Jacksonville (5.5%), Sacramento (4.7%), Columbus (3.8%), Long Island (3.7%), Phoenix (3.6%), Denver (3.1%) and San Jose (3.1%). The fact that these areas continue to show strong growth is an indicator that the multifamily sector has more room to run as economic growth goes on uninterrupted in the post-Great Recession era. That said, performance will likely vary by market as highlighted above. On average, we expect multifamily performance to remain solid in the years ahead, but with more moderate rent growth (3%-4%) relative to the 8%-12% gains reported as the nation emerged from the Great Financial Crisis.

The outlook for the multifamily sector is positive going forward, especially considering the current status of the overall U.S. housing market. Home prices are rapidly rising as a lack of new single-family housing supply is keeping the inventory of homes available for sale low and demand continues to backlog. Further, the Federal Reserve increased the Fed Funds Rate three times in 2017, to the tune of 75 basis points. Moody's Analytics is currently forecasting multiple rate hikes in 2018, and there is consensus that rates will steadily rise near term. The rate hikes have caused mortgage interest rates to rise, as Freddie Mac's average 30-year commitment rate climbed 35 basis points from 2016 to 2017. The mortgage interest rate averaged 3.99% in 2017 and is forecasted to rise to 4.72% in 2018. While these relatively small increases in interest rates may seem insignificant, they have a noticeable impact on the average monthly mortgage payment on the average median home price in CBRE-EA's top 50 markets. In fact, the average monthly mortgage payment (assuming 30-year amortization and a 20% down payment) rose to $1,307 in 2017, a 12% increase over the 2016 average monthly mortgage payment of $1,165. According to Moody's home price and interest rate forecasts, the average 30-year mortgage payment is expected to rise to $1,480 per month in 2018, which would represent a 13% increase (see following table).

PREMIUM TO OWN ANALYSIS CBRE-EA'S TOP 50 MARKETS (Assumes 20% down-payment, 30-year mortgage)							
Year	Average Median Home Price Top 50 Markets	Down Payment ($)	Avg. Annual Interest Rate	30 Year Monthly Mortgage Pmt. ($)	Monthly Insurance Payment	Monthly Tax Payment	Avg. Monthly Housing Payment
2016	$318,303	$63,661	3.7%	$1,165	$163	$305	$1,633
2017	$342,550	$68,510	4.0%	$1,307	$175	$328	$1,810
2018	$358,206	$71,641	4.7%	$1,480	$183	$343	$2,006
2019	$358,994	$71,799	5.4%	$1,609	$184	$344	$2,137
2020	$369,526	$73,905	5.4%	$1,652	$189	$354	$2,196

Source: Moody's Analytics, CBRE-EA, AEW Research

While these monthly mortgage payments are still affordable relative to CBRE-EA's fourth-quarter national effective rental rate of $1,628, they do not account for the additional costs of homeownership such as taxes, insurance and maintenance. Once the national average insurance and property tax payments are factored in, the 2017 U.S. monthly homeownership payment rises to $1,810 per month, an 11% premium to 2017 monthly rent. These figures apply broadly to the comparison of homeownership and renting; there are no doubt affordability issues amongst units being brought online at the highest end of the rental market, particularly in luxury and uber-luxury towers. That said, the general reality of the housing market today is that homeownership is getting more expensive relative to renting, even without considering the maintenance costs of homeownership or the more than $50,000 down payment required to purchase the average American home. Indeed, among CBRE-EA's Top 50 markets, the premium to own is positive in nearly 30 markets, meaning it is cheaper to rent than to own; by 2019, 43 markets are expected to have a positive premium to own. This environment will likely push more households into rental housing in the coming years, especially if home prices and interest rates continue to rise. Although multifamily construction has been growing, it is expected to peak in 2018-2019, and demand for apartment units will remain healthy enough to keep vacancies from expanding significantly. Long term, many of the variables involved with the cost of homeownership will inflate, keeping rental units an affordable and hassle-free alternative to purchasing a home outright.

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

In total, more than 5,000 stores were closed in 2017 and new announcements of closings have continued into 2018. Toys R Us, Sears and Kmart, Sam's Club, J. Crew and Macy's have recently released details on upcoming closings for 2018 and 2019.

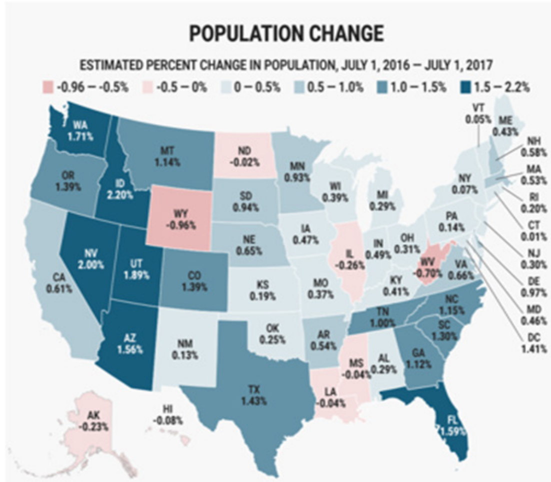
Retail

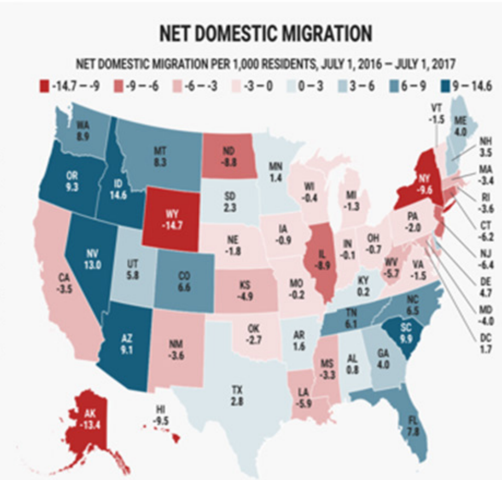
Store closings continued to make headlines through the fourth quarter 2017 and into 2018. In total, more than 5,000 stores were closed in 2017 and new announcements of closings have continued into 2018. Toys R Us (182), Sears and Kmart (103), Sam's Club (63), J. Crew (50) and Macy's (11) have recently released details on upcoming closings for 2018 and 2019. Importantly, these store closings are generally in weaker, underperforming markets with soft demographics or are the result of stressed balance sheets within the retailers themselves. That said, this recent wave of closings has begun to flow through to fundamentals; total retail availability was 6.6% as of the fourth quarter of 2017, up 10 basis points from the prior quarter and up 50 basis points over the course of the year. Of note, CBRE-EA has revised their retail data for the year and what once looked like relatively flat conditions now show the aforementioned uptick in availability.

The somewhat softer conditions can be seen across the three major segments of the market, lifestyle and mall, power centers and neighborhood and community shopping centers, which all reported softer demand and rising availability in 2017. The lifestyle and mall sector remained the tightest sector of the market with availability of 5.8%; overall, however, availability increased 80 basis points on the year as roughly 1.9 msf of space was returned to the market. Power center availability also rose 80 basis points to close out the year at 6.6%; here too, 1.8 msf was returned to the market. Finally, the neighborhood and community shopping center segment fared the best, with availability increasing only 60 basis points in the year to 9.6%.

In general, the coastal and southeastern markets have continued to show strength in terms of demand and smaller increases in availability. San Jose, Seattle, Jacksonville, Sacramento, San Diego, Phoenix, Dallas, Orlando and Fort Worth all reported absorption rates between 0.6% and 1.1%, far outpacing national demand of 0.1%. Additionally, availability declined by 40 to 50 basis points in Jacksonville (7.3%), San Jose (4.7%) and Seattle (3.6%) and was flat or up a modest 10 basis points in Phoenix (9.0%), Sacramento (8.3%), Orlando (6.6%), Dallas (6.4%) and San Diego (4.9%). Meanwhile, Fort Worth, which posted an absorption rate of 1.1%, reported a 70-basis point increase in availability to 6.4% as supply outpaced net new demand. Cincinnati, Salt Lake City, Trenton, Cleveland, Detroit, Indianapolis, Albuquerque and St. Louis all reported sharply negative demand; in all these markets, more than 0.5% of space was returned to the market and availability rose between 80 and 160 basis points. The Midwest was particularly hard hit with availability increasing the most. Moreover, the Midwest has overall higher levels of availability (between 8.2% and 9.1%) relative to the national average (6.6%). Demographic pressures in the Midwest make the region prone to store closures and weaker overall retail demand. In general, Midwestern states are burdened with out-migration and very weak overall growth in population. As highlighted in the maps that follow, the West and South are gaining population at the expense of the Midwest and Northeast.

The biggest influencer of dwindling supply is likely coming from the rhetoric that e-commerce is killing off brick and mortar retail, a factor that has made developers, lenders and investors more cautious. AEW contends, that opportunities remain in retail and the headlines of brick and mortar's demise are over blown.





On the supply side, new deliveries were relatively modest in 2017, slowing across the entire retail sector. Total retail inventory grew 0.6% this year, the slowest growth since 2012 and well shy of the 1.1% historical annual average. The lifestyle and mall segment expanded by 0.6% this year, below the 1.0% historical annual average. Meanwhile, the neighborhood and community center segment reported the lowest overall completions at 0.5% of inventory, which is only 40% of the annual average delivery rate since 2005 of 1.2%. The power center segment, which is the nation's smallest retail segment, saw nearly 2.2% growth in stock on an annual basis going back to 2005; however, 0.6% growth this year proves that development is occurring at a much slower pace.

Several factors are playing into the lack of new retail development, including rising interest rates, a stricter lending environment and rising construction costs. The biggest influencer of dwindling supply is likely coming from the rhetoric that e-commerce is killing off brick and mortar retail, a factor that has made developers, lenders and investors more cautious. AEW contends, however, that opportunities remain in retail and the headlines of brick and mortar's demise are over blown. Instead, retail performance remains strongly tied to economic growth and strong demographics. Coastal and southern markets are still faring well, reporting positive demand and falling or stable availabilities. Further, as we have reported previously, many e-commerce companies have moved to open store fronts to augment their business. This "clicks to bricks" phenomenon continues to grow with Amazon recently introducing Amazon Go in Seattle, a convenience store concept that is "grab and go," allowing shoppers to scan an app at entry, pick up items and then exit the store without ever checking out; instead, sensors, computer vision and learning algorithms track the consumer's purchases and charge them through the app. Amazon continues to increase its physical presence, opening more than a dozen bookstores to date, taking over space in some Kohl's department stores and, of course, integrating Whole Foods' 470 stores into their platform.

As we have long believed, the retail market remains bifurcated. The top-tier properties in the best locations will likely weather the upcoming rounds of store closures better than most markets and properties. In fact, in AEW's experience, most of these top-tier properties are able to replace tenants fairly quickly and typically at better rents than their underperforming predecessors, particularly as some of the weaker tenants might have rent relief in place. That said, it is clear that the strongest improvements in both availability and rents are likely behind us. Demand is expected to be more moderate as store closures resonate through the broader retail landscape.

Development remains in check, a factor that should keep availabilities relatively stable. Indeed, the market is expected to generally remain in equilibrium, prompting continued moderate rent growth going forward. Again, we fully expect that Class A centers in prime locations that pull from a strong surrounding demographic, which generally includes the institutional investment universe, are likely to outperform older centers of lesser quality going forward. Further, we continue to expect performance will vary by region as well with top-tier coastal and southern markets outperforming smaller secondary markets in the Midwest like Cincinnati, Cleveland and Detroit.

RETAIL[1]	
Availability Rate	9.6%
12-Month Trend	
Availability Change	↑
Rent	↑
Absorption	↓
Completions	↓
Cap Rates	↓
Transaction Volume	↑

[1] Represents the neighborhood and community shopping center segment of the market.

Capital Markets

2017 was a mixed year in terms of transaction volume. A very slow start to the year was followed by a roughly average middle of the year and then capped off with a modest end to the year. In fact, the $107 billion in transaction volume in the first quarter of 2017 was the weakest quarterly volume since early 2014. The second and third quarter total volume of $235 billion was roughly on par with the transaction levels for the same periods in 2016 and 2015, while the fourth quarter's $122 billion in trading volume was the lowest fourth quarter total since 2013. All told, 2017's total property sales summed to roughly $464 billion, down 7% from 2016 and 15% from 2015.

Industrial, which has become the darling of the property types, saw volumes rise 20% in the year to $72.2 billion; further, industrial volumes eclipsed retail volumes for the first time since RCA began tracking the market.

Transaction volumes were weaker across all property types except for industrial, which reported the only increase in volume for the year. Industrial, which has become the darling of the property types, saw volumes rise 20% in the year to $72.2 billion; further, industrial volumes eclipsed retail volumes for the first time since RCA began tracking the market. Finally, all industrial subsectors and market tiers reported growth in volumes.

On the down side, the hotel sector reported the greatest softness with volumes dropping 24% in the year to $27.5 billion. Retail followed with transactions dropping 18% to $63.4 billion. Within the retail sector, however, performance was mixed. Single-tenant and grocery anchored retail, which are less impacted by struggling big box and apparel tenants, outperformed and actually reported growth in transaction volumes. Grocery-anchored sale volumes rose 13% in the year to $15.3 billion, while single-tenant transactions increased 9% to $7.2 billion. Meanwhile, regional mall transactions declined 75% to $2.8 billion and urban/storefront volume dropped 21% to $8.6 billion. Office volumes declined 8% in the year to $131.9 billion; as with retail, certain office sectors outperformed. Not surprisingly, with buyers searching for yield, suburban and tertiary market volumes increased during the year, while central business district (CBD) and major market volumes took a step back. Finally, apartment transactions totaled $150.1 billion in 2017, down 7% from prior-year levels. Apartment transaction volumes were particularly soft in the first half of 2017 before recovering in the second half of the year. By market, tertiary market sales ($23.2 billion) increased slightly in 2017 (2%), while secondary volumes ($83.2 billion) were down slightly (-4%) and major market volumes ($42.8 billion) declined by a more pronounced 17%.

By market, volume picked up substantially in the Northern Virginia suburbs (+47%), followed by Houston (36%), Orlando (20%), the District of Columbia (17%) and the Inland Empire (15%). Interestingly, all of these markets are either somewhat softer from a fundamentals perspective (the Washington D.C. region and Houston) or are secondary markets (Orlando and Inland Empire). Again, this is likely a result of investors chasing yield. Markets with the greatest weakness in sales included Manhattan (-43%), San Francisco (-36%), Miami/Dade County (-32%), the New York City Boroughs (-27%) and Las Vegas (-25%). Of course, this is the flip side of markets that experienced the greatest growth in volumes; by and large, markets with the greatest softness in volume are uber-core, low yielding markets (excluding Las Vegas).

A factor that could be contributing to the moderation in volumes is the sustained run up in property prices. Many investors continue to cautiously watch the market as pricing has continued to advance. Indeed, according to the RCA Commercial Property Price Index (CPPI), the National All Property price index was 20% above its prior peak. Further, apartment prices are 55% above the prior peak level while CBD office prices are up nearly 34%. Meanwhile, capitalization rates (cap rates) remain at or near historic lows. The four-quarter moving average NCREIF current value cap rate held steady at roughly 5%. Apartment and industrial cap rates continued to compress, declining roughly 20 basis points each to 4.5% and 5.1%, respectively. Retail cap rates, despite the headlines of store closures, also declined, dropping roughly 10 basis points year over year to 5.1%. Office cap rates, meanwhile, moved up slightly to 5.1% from 5.0% a year earlier. Moreover, the quarter-over-quarter increase in the equal-weighted, non-moving average office cap rate was more pronounced at 40 basis points (5.4% from 5.0% in the third quarter of 2017). Still, on a relative basis, cap rates, even in the office sector, remain exceptionally low. Going forward, we expect NOI growth to continue, particularly in the office sector where occupancy gains and rents rolling to new levels will allow for better NOI growth in the near term relative to other property types. This should help offset any continued modest increases in cap rates and allow values to hold firm. That said, late-cycle capital expenditure requirements may temper returns. More broadly, relative to other asset classes like equities, bonds and even REITs, private real estate is roughly fairly valued and is expected to remain so for the foreseeable future. The PREA Consensus Survey anticipates an annual unleveraged total U.S. property return of roughly 5.5% over the next five years; this should compare favorably to bond yields, which are still near historic lows, and to equities, which are at record highs. Real estate has historically performed in the middle of these two asset classes and is expected to do so going forward.

Did you know?

Investment themes we are observing in the market today…

The U.S. is now in its ninth year of recovery and expansion. By mid-2018, this will be the second longest period of positive growth in U.S. history.

The number of job openings today is roughly equal to the total number of unemployed.

Retail absorption turned negative in the second half of 2017. This is the first time this has happened when the economy was not in recession.

Total U.S. debt was projected to increase by $10 trillion over the next decade before the tax cut. The recently passed tax cut will add an additional $1.5 trillion to the total debt.

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