AEW RESEARCH

U.S. ECONOMIC & PROPERTY MARKET PERSPECTIVE

Q1 2018

AEW

Prepared by AEW Research, March 2018

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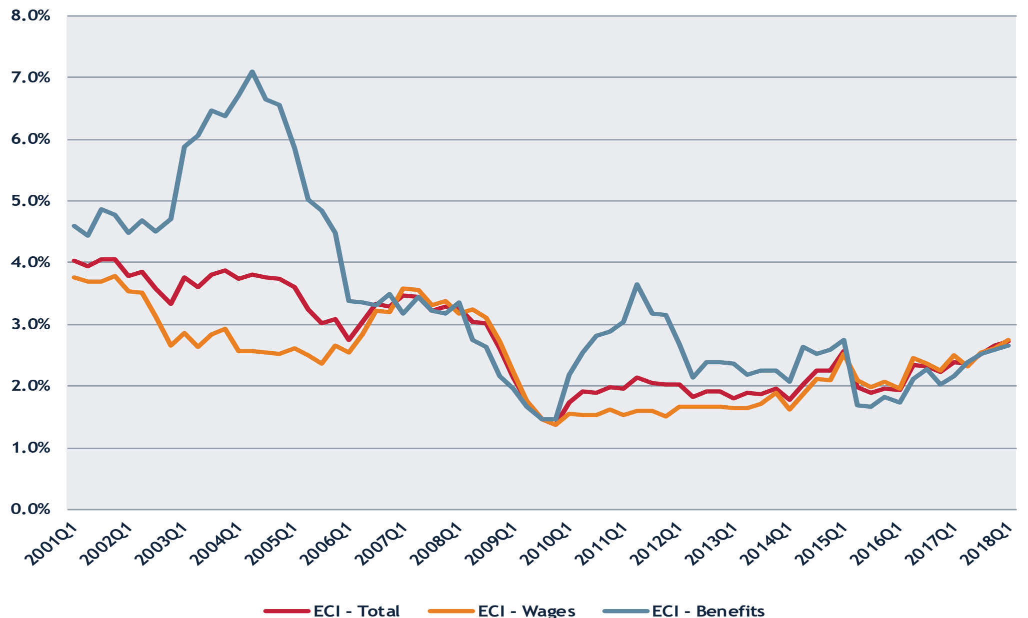
The U.S. Economy

Preliminary data suggest the U.S. economy expanded at an annual rate of 2.3% during the first quarter of 2018, bringing the four-quarter growth rate to 2.9%. Despite the introduction of personal tax cuts during the first quarter, growth in real consumption spending was particularly tepid, increasing at an annual rate of just 1.1% following fourth-quarter growth of 4.0%. In large part, this slowdown reflects the consumption that was pulled into the fourth quarter of last year, particularly automobile sales, due to hurricane damage in September. Prior to the first quarter of this year, real consumption growth has averaged slightly more than 3% per year between 2014 and 2017. Going forward in 2018, we expect growth in consumer spending to normalize to higher levels due to both tax cuts and the somewhat stronger personal income and wage growth typically seen with late-cycle low unemployment. To this point, both the wage and benefit components of the employment cost index (ECI) show year-over-year increases of 2.7% through the end of the first quarter, the fastest increase since 2008.

FIGURE 1

EMPLOYMENT COST INDEX (ECI) – PERCENT CHANGE FROM PRIOR YEAR



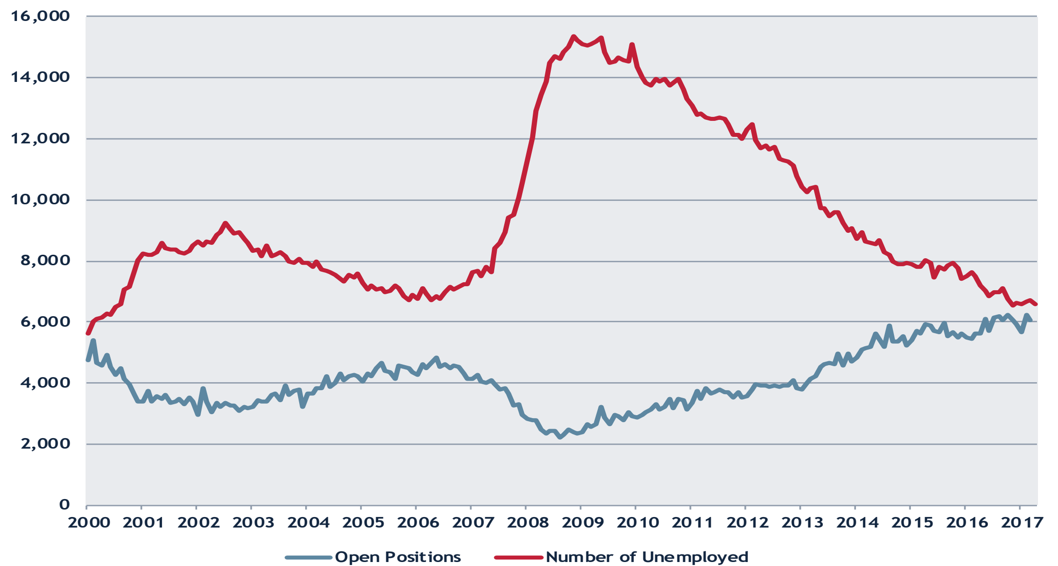
Source: Bureau of Labor Statistics

The U.S. labor market remains tight with the overall unemployment rate holding steady at 4.1% for six consecutive months, the lowest rate recorded since 2000. Labor scarcity will remain a constraint on business growth for the remainder of the expansion, and labor costs will increasingly

weigh on profit margins. Overall, there is now roughly one open job for every person identifying as unemployed, the lowest ratio of available workers per position in nearly two decades. As such, we do not expect near-term average monthly job growth to accelerate much beyond the current pace of approximately 180,000. Rather, absent a significant increase in labor force participation, we expect average monthly job growth to slow further over the remainder of the expansion.

FIGURE 2

OPEN JOBS AND NUMBER OF UNEMPLOYED (000S)



Source: Bureau of Labor Statistics

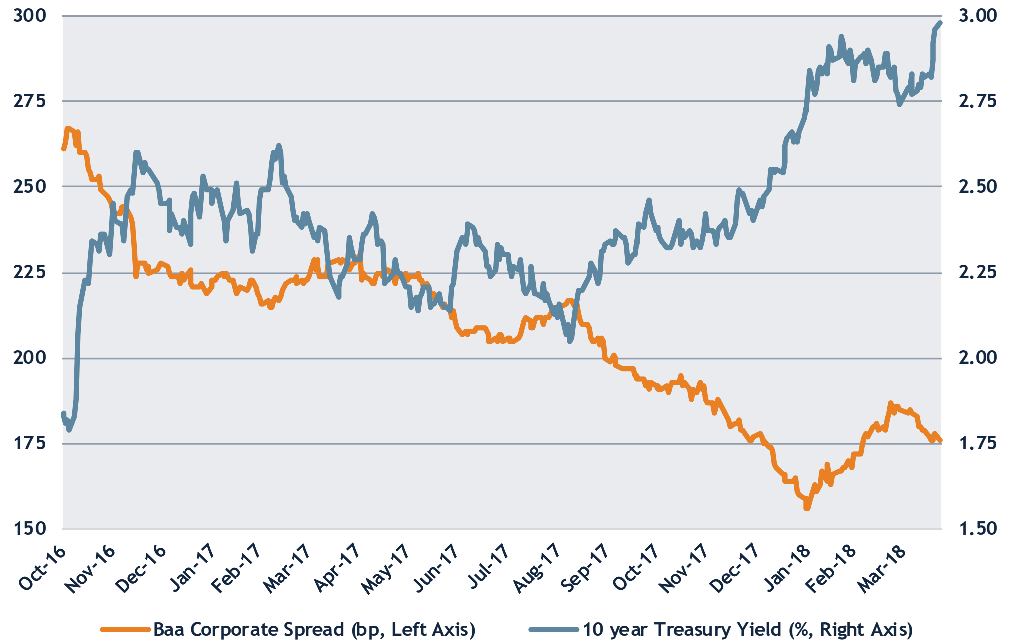
There is now roughly one open job for every person identifying as unemployed, the lowest ratio of available workers per position in nearly two decades.

With labor-driven inflationary pressures rising, the Federal Reserve continues to enact slow but steady monetary tightening, raising short-term interest rates as well as gradually reducing the size of its balance sheet. While the yield curve has generally flattened due to the Fed's increase in short-term rates, the long end of the curve has risen recently, with the ten-year Treasury yield climbing to 3% at the end of April. Additionally, credit spreads appear to have bottomed at the end of the January, rising only modestly since then. With sovereign bond yields still close to historic lows across much of the globe, we continue to believe that U.S. long rates are somewhat bound near the current level. Taken together, however, moderately rising rates and spreads suggest that property-yield compression has also likely ended for this cycle. At the least, we believe there is more risk to yields rising than falling during the remainder of this year and into 2019.

Absent a meaningful acceleration of property demand growth, we do not expect property fundamentals to improve further in this cycle.

FIGURE 3

TEN-YEAR TREASURY YIELD AND BAA CORPORATE YIELD SPREAD



Source: Moody's

In broad terms, the supply and demand balance in U.S. property markets remains in equilibrium, with vacancy rates generally holding steady at current cycle lows. There is, however, some evidence that property demand is softening as first-quarter data from CBRE-EA shows the lowest level of office, industrial and apartment property absorption in more than five years. Despite this, moderating supply growth has helped keep the national apartment vacancy and industrial availability rates stable, while the national average office vacancy rate increased by only 20 basis points during the first quarter. Absent a meaningful acceleration of property demand growth, we do not expect property fundamentals to improve further in this cycle. At the same time, we do not anticipate a rapid deterioration in these fundamentals either. Near-term fiscal stimulus from lower tax rates and higher government spending should more than offset the immediate dampening effects of Federal Reserve monetary policy tightening. For investors, all of this suggests a more typical environment of property returns roughly in line with current property yields and appreciation somewhat below expected inflation. To this point, the current consensus return expectation survey from the Pension Real Estate Association (PREA) indicates core property annual total returns of 5.0%-5.5% on average over the next five years.

TABLE 1

CONSENSUS RETURN EXPECTATIONS

2018 Q1 Survey	2018	2019	2020	2018 to 2022
NPI Total Return	6.0%	5.3%	4.8%	5.2%

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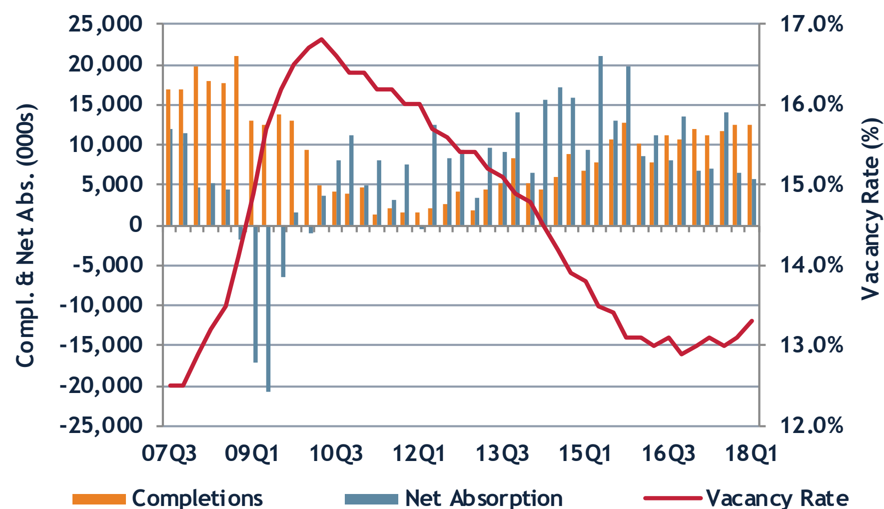
Office

U.S. office vacancy was 13.3% as of the first quarter of 2018, which represented a moderate 20-basis-point (bps) increase from the previous quarter. First-quarter supply was on par with recent quarters, as 12.6 million square feet (msf) of office space was delivered at the national level. To lend perspective, quarterly office construction has fallen between 10 msf and 12.7 msf for 10 of the previous 11 quarters. Demand, however, proved to be the cause of the slight uptick in national office vacancies. Net absorption slowed to 5.8 msf, the lowest quarterly absorption total since the first quarter of 2013. While demand was weaker at the national level in the first quarter, office absorption was robust in a number of the nation's largest office markets, including San Francisco (2.1 msf), San Jose (1.9 msf), New York (1.2 msf) and Washington, D.C. (521,000 sf). We fully expect demand will continue to be healthy in these markets due to their ability to attract top firms, talent and start-ups alike.

While demand was weaker at the national level in the first quarter, office absorption was robust in a number of the nation's largest office markets.

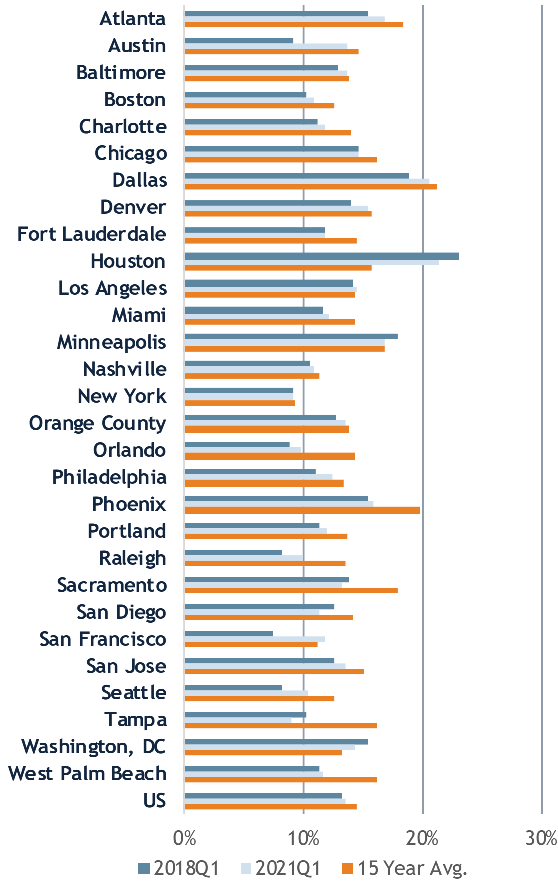
More broadly, office fundamentals are expected to hold steady near term. Demand is projected to taper due to slower economic growth as we extend further into the current economic cycle; however, supply is forecasted to peak in 2018 before regressing towards the historical average thereafter. Vacancies may edge higher as new construction comes online, but are expected to hold between 13–15% as they have since the end of 2013, according to CBRE-EA. While the office market is expected to remain in equilibrium, we will generally be more cautious investors in the sector given the extended length of the ongoing expansion, the large capital expenditures needed to maintain and attract tenancy and the low current and projected cash yields in the sector. Further, any potential acquisitions in the sector will likely be focused on opportunities in the strongest, historically most-stable office markets that benefit from well-diversified economies, relatively healthy demand, well-educated workforces and steady projected job growth.

CBRE-EA OFFICE MARKET FUNDAMENTALS



COMPARATIVE OFFICE MARKET FUNDAMENTALS

CBRE-EA VACANCY RATES[1]



[1]Based on Moody's Analytics Scenario

OFFICE	
Vacancy Rate	13.3%
12-Month Trend	
Vacancy Change	↑
Rent	↑
Absorption	↓
Completions	↔
Cap Rates	↔
Transaction Volume	↓

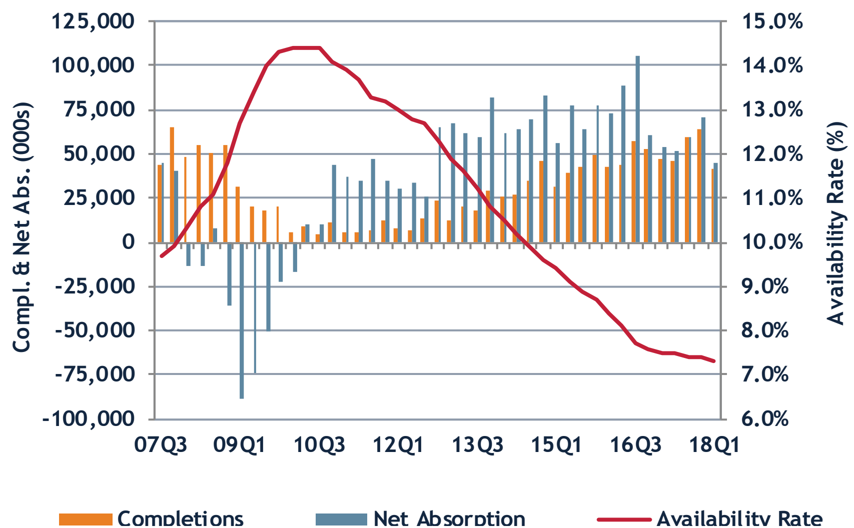
Industrial

U.S. industrial sector fundamentals continue to tighten. Availability dropped to 7.3% in the first quarter of 2018, a 10-basis-point (bps) improvement from the prior quarter and a 20 bps year-over-year decline; this marked the 32nd consecutive quarter of declining or flat availability. The improvement in the market was driven by steady demand of 45 million square feet (msf) and more modest completions of 42 msf. Overall, construction and absorption were less active in early 2018, as the 45 msf of absorption was the lowest mark since the third quarter of 2012 (23 quarters ago) and the 42 msf of completions was the lowest quarterly total since mid-2015 (12 quarters ago). The result of the sustained improvement in fundamentals has been strong rent growth; CBRE-EA reports that national industrial net asking rents topped $7.00 per square foot for the first time ever in the first quarter of 2018. Indeed, rents increased an impressive 6% from a year earlier, are roughly 12% above their prior peak and are up over 31% from their recessionary low.

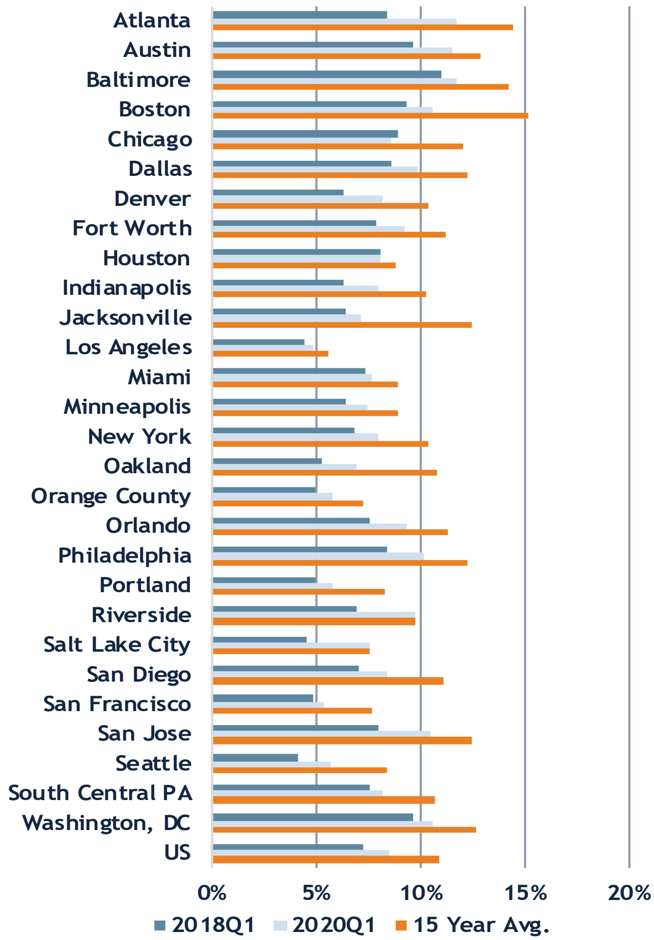
We anticipate industrial fundamentals will be strong as demand for industrial space continues unabated.

Looking ahead, we anticipate industrial fundamentals will be strong as demand for industrial space continues unabated. Supply is expected to peak in 2019 with deliveries of roughly 254 msf; thereafter, supply growth will ebb with deliveries reverting towards the historical average of 165 msf per year in 2022 and beyond. Future demand will be bolstered by changing consumer spending habits, which continue to shift more towards online and e-commerce purchases. National retailers are still determining how best to serve the nation's population through the establishment of extremely efficient, highly optimized supply chains that can deliver goods to end users as quickly as possible. As e-commerce sales rise as a percentage of overall retail sales, so too will demand for industrial space nationwide. It will be increasingly important to focus on demographics when looking at industrial property, as demand, and subsequently rent growth, will be strongest in areas that can reach large populations or multiple metropolitan areas within a single day's drive or less.

CBRE-EA INDUSTRIAL MARKET FUNDAMENTALS



COMPARATIVE INDUSTRIAL MARKET FUNDAMENTALS
CBRE-EA AVAILABILITY RATES[1]



[1] Based on Moody's Analytics Scenario

INDUSTRIAL	
Vacancy Rate	7.3%
12-Month Trend	
Vacancy Change	↓
Rent	↑
Absorption	↓
Completions	↓
Cap Rates	↓
Transaction Volume	↑

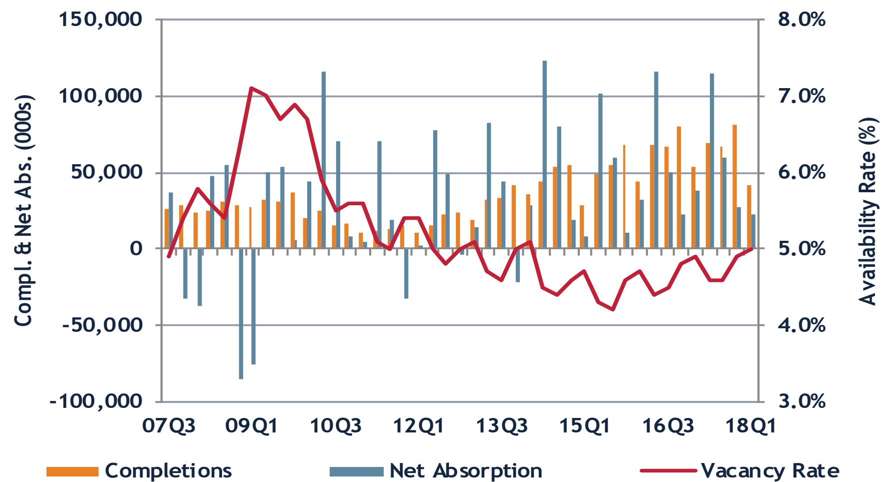
Apartment

Vacancies in the apartment sector edged slightly higher in the first quarter of 2018; still, at 5.0%, vacancies remain healthy and are up a modest 10 basis points both quarter over quarter and year over year. Roughly 23,100 units were absorbed on net, below the 30,000-plus units absorbed in the first quarters of 2017 and 2016, but generally reflective of seasonal trends. On the supply side, meanwhile, nearly 41,500 units were completed, a marked slowdown from the previous three quarters and the lowest quarterly deliveries since the fourth quarter of 2013. Despite the slight uptick in vacancies, rents continued to rise. Indeed, the average rent reported by CBRE-EA increased 2.0% year over year, the fastest year-over-year gain since mid-2016. Still, rent growth is more moderate relative to the early stages of the recovery/expansion and there are significant differences by location and class. Per Axiometrics, rent growth in secondary markets has outperformed growth in "primary" markets. Orlando led the way, reporting year-over-year rent growth of roughly 7%, double the 3.3% average of Los Angeles, the "primary" market leader. Further, Class B and/or C rent growth outpaced Class A rents in 25 of 37 major markets. Among the Class A segment, lease up of new product and affordability constraints are limiting effective rent growth.

Demand should remain steady as well, driven by continued job growth and household formation.

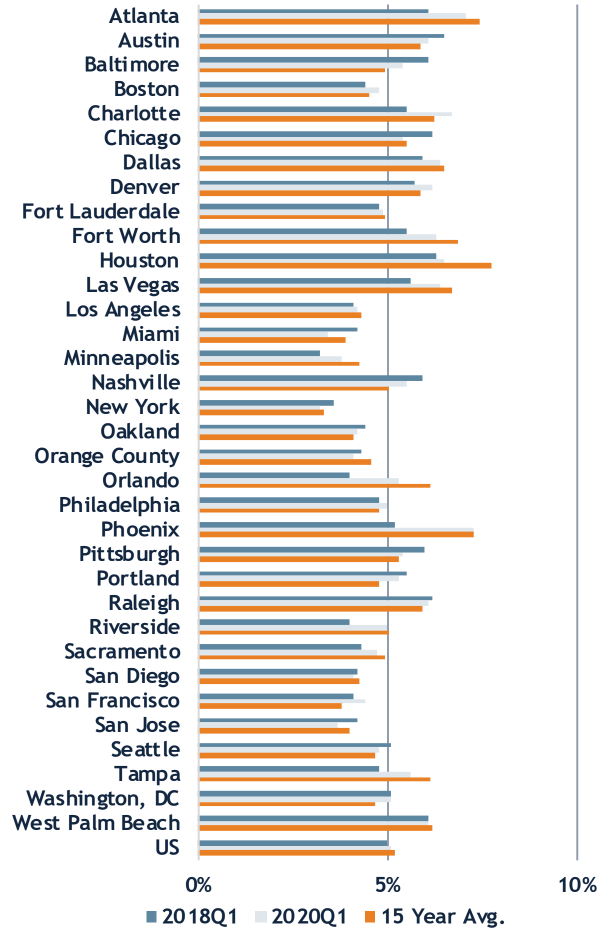
Going forward, we anticipate fundamentals will remain healthy, particularly as new supply is peaking. Demand should remain steady as well, driven by continued job growth and household formation. Rising mortgage interest rates, higher home prices and a lack of for-sale inventory will also work to create more renter-by-need households. Class B and C rent growth will likely continue to outpace Class A rent growth in the near term. Longer term, the thinning of supply pipelines should allow for a continued reduction in concessions in the Class A space and for better rent growth. Overall, rent growth will likely range between 3%-4% over the long term, with Class B and C properties and more secondary markets initially outperforming this rate.

CBRE-EA APARTMENT MARKET FUNDAMENTALS



COMPARATIVE APARTMENT MARKET FUNDAMENTALS

CBRE-EA VACANCY RATES[1]



[1]Based on Moody's Analytics Scenario

APARTMENT	
Vacancy Rate	5.0%
12-Month Trend	
Vacancy Change	↑
Rent	↑
Absorption	↓
Completions	↓
Cap Rates	↓
Transaction Volume	↑

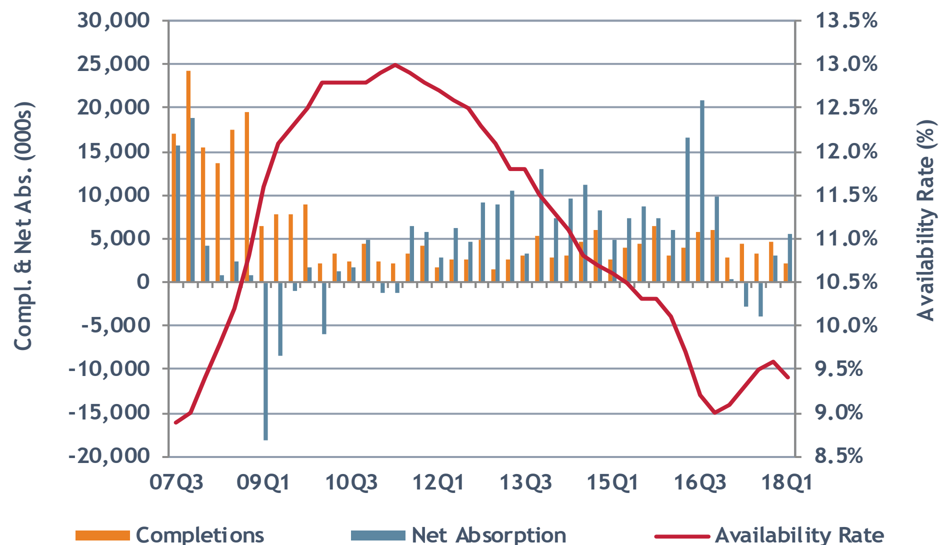
Retail

According to CBRE-EA, total retail availability improved 10 basis points (bps) in the first quarter of 2018, dropping to 6.5%; this represents the first contraction in availability since late 2016. Demand has been slowly improving following substantial weakness in early 2017. Roughly 14.2 million square feet (msf) was absorbed in the quarter; this outpaced the total annual demand of 9.7 msf in 2017. Meanwhile, new completions slowed to 7.8 msf, well below the 12.7 msf quarterly average reported in 2017. The neighborhood and community shopping center segment of the market showed the most improvement, with availability dropping 20 bps to 9.4%; the power center sector, which has seen rising availability since late 2015, reported a 10 bps decline in availability to 6.5%. Both the shopping and power center markets reported better demand and continued modest development. Fundamentals in the lifestyle and mall category were more tepid, with availability increasing 10 bps to 5.8%. Net absorption, which totaled 578,000 square feet, outpaced recent quarters, but was still weak by historical standards (1.2 msf quarterly average since 2005). Year over year, however, all segments reported an increase in availability; this reflects recent store closings related to bankruptcies (Charming Charlie, Gymboree, True Religion, Wet Seal, Payless, etc).

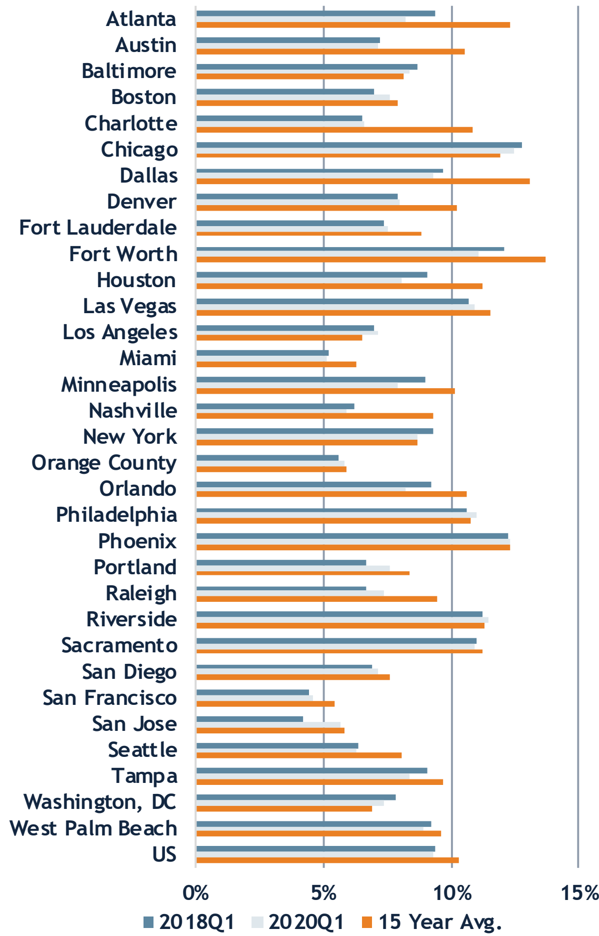
Despite the negative press on retail, we continue to believe the sector has a place and a purpose in a portfolio and there will be opportunities to acquire assets that may be mispriced in today's environment.

Going forward, retail availability is expected to remain largely unchanged in the near term. We anticipate demand will continue to be more modest, driven by changing consumer shopping patterns, constrained household budgets and Darwinism among retailers, all of which will ultimately moderate space needs. We continue to believe retail has a place and a purpose in a portfolio and the negative press that has prevailed in the sector will create opportunities to acquire assets that may be mispriced in today's environment. Dominant centers in areas with solid demographics should continue to outperform. That said, rent growth in the sector will be modest (2%-3% annually depending on the market); thus, NOI growth will be more restrained as well, unless outsized NOI growth is achieved through re-tenanting or reduced expenses.

CBRE-EA SHOPPING CENTER MARKET FUNDAMENTALS



COMPARATIVE RETAIL MARKET FUNDAMENTALS



[1]Based on Moody's Analytics Scenario

RETAIL[1]	
Vacancy Rate	5.0%
12-Month Trend	
Vacancy Change	↑
Rent	↑
Absorption	↓
Completions	↓
Cap Rates	↓
Transaction Volume	↑

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

Capital Markets

According to Real Capital Analytics (RCA), transaction volume and pricing increased in the first quarter of 2018. Roughly $114 billion in properties changed hands, up 5% year over year; meanwhile, prices advanced 8.5% over the twelve-month period as well. Prior to the first quarter's performance, transaction volume had declined for five consecutive quarters. Hotel (63%), industrial (35%) and apartment (25%) all reported sharply higher trading, while seniors housing (-45%), retail (-31%) and office (-12%) sales volumes were down markedly. Not surprisingly, with secondary market fundamentals and rent growth picking up and investors searching for higher yields, property sales volume in secondary markets advanced 3% in the year, outpacing major market and tertiary market volumes, which were flat over the same period.

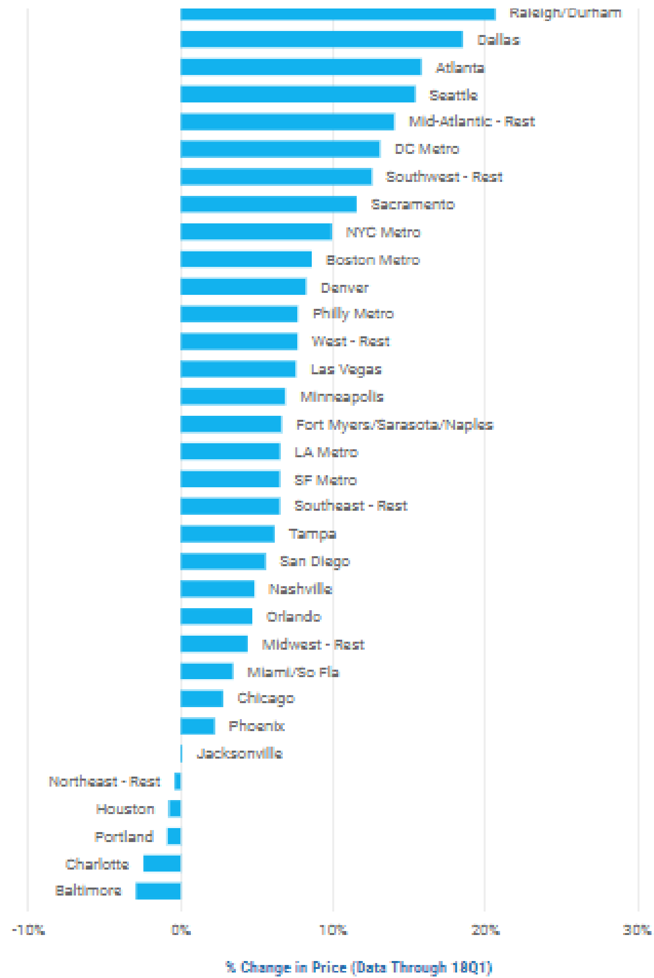
Transaction volume and pricing increased in the first quarter of 2018, following five consecutive quarters of declining volume.

Consistent with an acceleration in transaction volume, secondary markets reported some of the greatest year-over-year gains in pricing. According to RCA's Commercial Property Price Indices, Raleigh/Durham, Dallas, Atlanta, Seattle and Sacramento all reported price growth between 10%-20% on a year-over-year basis in March 2018, outpacing the 6 Major Market Index (Boston, Chicago, Los Angeles, New York, San Francisco and Washington, D.C.) average of 7.5%. Further, among the six major markets, only Washington, D.C. reported double-digit price appreciation (13.1%).

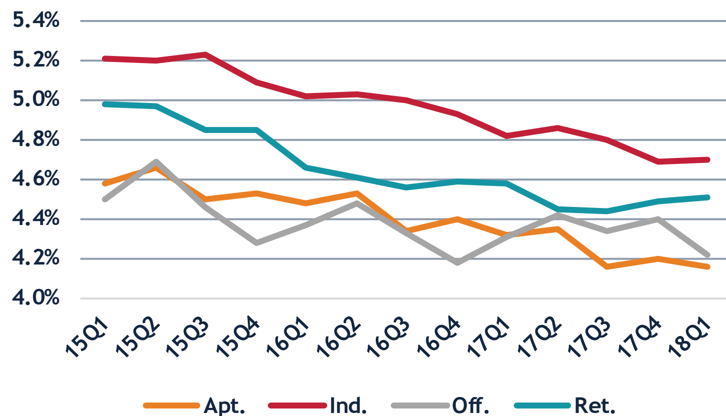
With pricing remaining strong, returns beat expectations. The NCREIF Property Index total return was 1.7% in the quarter; this puts the index on pace to exceed the PREA Survey return of 6.0% projected for the year if performance continues at this pace over the remaining quarter of the year. The appreciation return remained consistent with prior quarters, bucking the survey's anticipated slowdown. The strength in appreciation was driven by an acceleration in the office sector, where the appreciation return was 0.7% for the quarter, well ahead of the previous quarter's 0.4% return and the strongest appreciation for the sector since the fourth quarter of 2015. Appreciation moderated in the apartment sector, with the sector posting a 0.44% return for the quarter versus 0.55% in the fourth quarter of 2017. Industrial appreciation, at 2.03%, remained flat from the previous quarter, while the retail appreciation return was negative in the quarter (-0.42%) as investors have cooled on the sector due to the negative press surrounding recent bankruptcies.

Meanwhile, cap rates across all sectors were either flat or slightly lower on a year-over-year basis. Office cap rates, which picked up in the fourth quarter of 2017, dropped once again in the first quarter to 4.22% (market value weighted), down from 4.34% a year earlier. Apartment and industrial cap rates compressed about 15 basis points (bps) to 4.16% and 4.70%, respectively. The industrial cap rate likely has further room to compress. Recent sales on the West Coast have been reported at sub-4% cap rates. Finally, despite investor concern, retail cap rates declined by 7 bps year over year to 4.51%. The compression on the retail side likely reflects the quality of product in the index and still healthy occupancies among NCREIF-reported properties.

RCA COMMERCIAL PROPERTY PRICE INDEX



NPI CAP RATES BY PROPERTY TYPE



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