AEW RESEARCH

U.S. ECONOMIC & PROPERTY MARKET PERSPECTIVE

Q4 2019

AEW

Prepared by AEW Research, February 2020

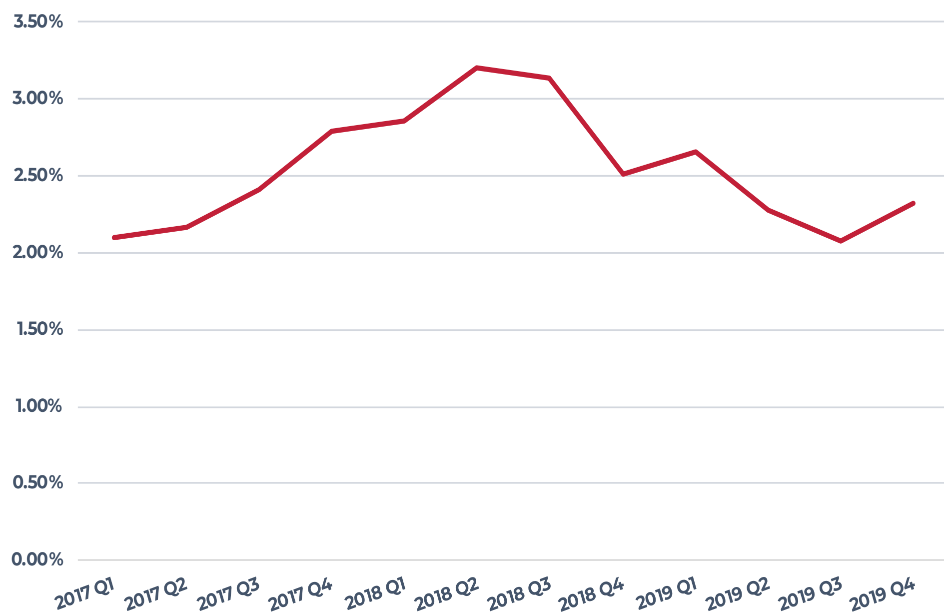
The U.S. Economic and Property Market Outlook

2020 – What Has Changed for the Year Ahead?

The U.S. economy expanded at an annual rate of 2.1% during the fourth quarter of 2019 bringing growth for the entire year to 2.3%, in line with the average growth rate over the prior ten years, but sharply slower than the accelerated growth of 2018. Consumer spending remained solid during 2019 with total private consumption growing 2.65%, slightly ahead of the 2.5% ten-year average, and government spending growth accelerated to 3% during the year, far outpacing the average growth rate of 0% over the past decade. The glaring weak spot for the U.S. economy during 2019 continued to be private domestic investment, which declined by nearly 2% for the year, pulled down by a sharp decline of 7% in non-residential structure investment. While U.S. businesses do continue to increase investment in technology and intellectual property, they are simply not adding to plants and equipment despite significant tax code changes designed to encourage such investment.

FIGURE 1

YEAR-OVER-YEAR GROWTH IN U.S. REAL GDP



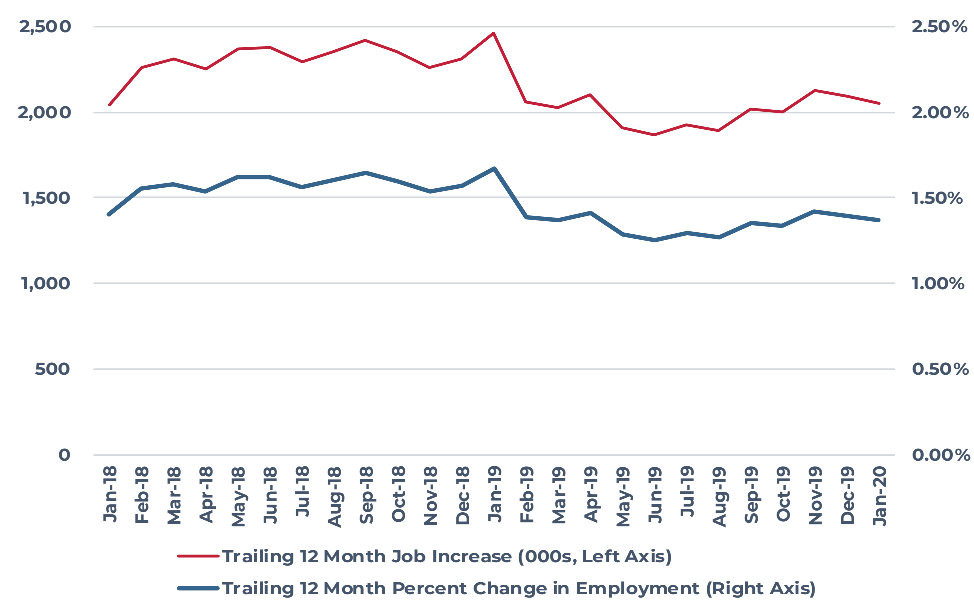
Source: Bureau of Economic Analysis

Similarly to GDP, U.S. total employment growth slowed noticeably during 2019 with year-over-year growth dropping by approximately 50 basis points from the beginning of the year through mid-summer before accelerating slightly during the latter half of the year. The U.S. economy added just over two million jobs during 2019, slightly below the 2.2 million average annual increase since job growth resumed at the beginning of 2010. Today, there remains more than one million more open positions in the U.S.

economy than unemployed workers, suggesting a significant skills and location mismatch between available jobs and labor. It is worth noting that while this gap between available jobs and workers has remained relatively constant near one million over the past year, the total number of open jobs has declined by more than 10% over that period. On a go-forward basis, we expect continued, albeit more moderate, near-term job growth. Looking out over the coming decade, the Bureau of Labor Statistics (and others) expect average annual job growth to moderate from the current level of two million per year to less than one million per year, largely reflecting very slow labor force growth.

FIGURE 2

YEAR-OVER-YEAR EMPLOYMENT GROWTH



Source: Bureau of Labor Statistics

In response to slower economic growth, the Federal Reserve reversed course on monetary policy during 2019 by both cutting interest rates and resuming the expansion of its balance sheet. As a result, yields have declined across the entire yield curve by approximately 100 basis points (see Figure 3) and, more significantly, the market's forward curve now shows the yield on the benchmark ten-year Treasury bond remaining below 2% for most of the next decade—lower for longer indeed.

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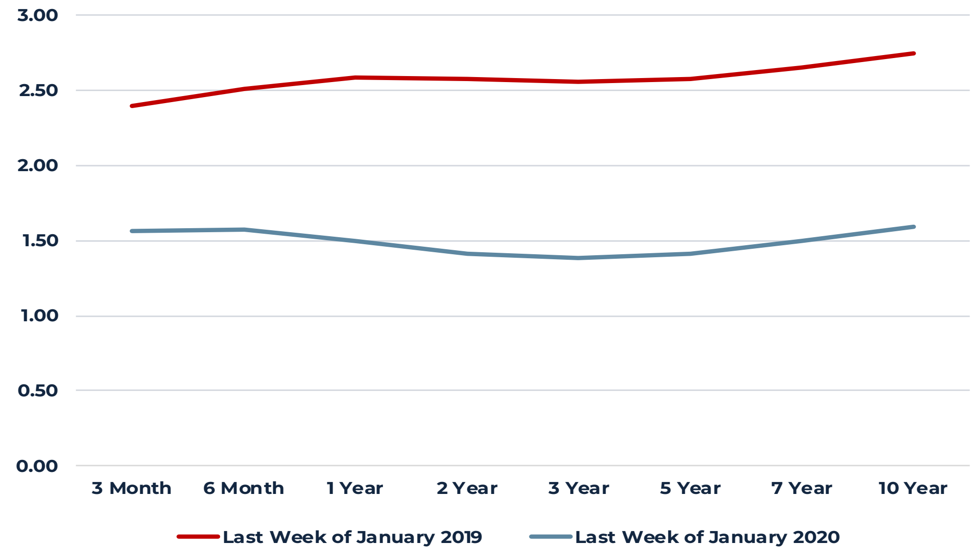
FIGURE 3

THE YIELD CURVE TODAY AND ONE YEAR AGO

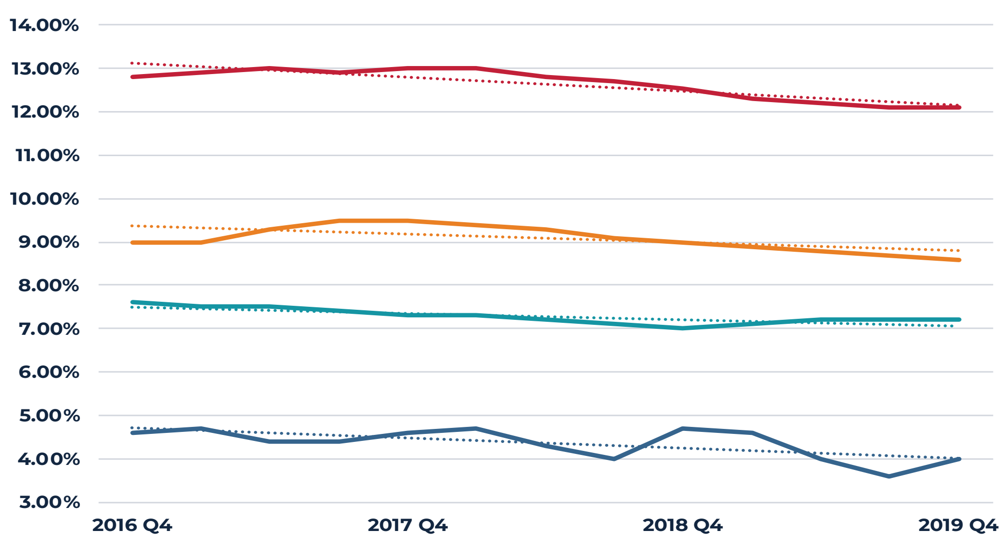


Source: Federal Reserve

In terms of property market supply and demand fundamentals, average vacancy rates across major property types remain flat or in modest decline as absorption and deliveries of new space stay largely balanced. Of note, the U.S. average apartment vacancy rate reached an all-time low of 3.6% during the third quarter of 2019 before rising slightly during the fourth quarter.

FIGURE 4

U.S. VACANCY RATES BY PROPERTY TYPE



Source: CBRE-EA 2019 Q4

Growth in property stock has remained flat or slightly declined over the past year from levels that were already well below the norms of prior cycles. At the same time, property absorption has remained largely flat or declining modestly over the past year except for a more significant slowdown in industrial property absorption, likely reflecting both the negative impacts of the trade war with China as well as the generally low level of available space in many major markets. With trade tensions easing in the wake of the Phase One trade agreement with China and the broader renegotiation of the North American trade agreement (USMCA), we expect industrial property absorption to remain healthy in the near-term, although the Coronavirus epidemic may counteract the progress made on the trade front.

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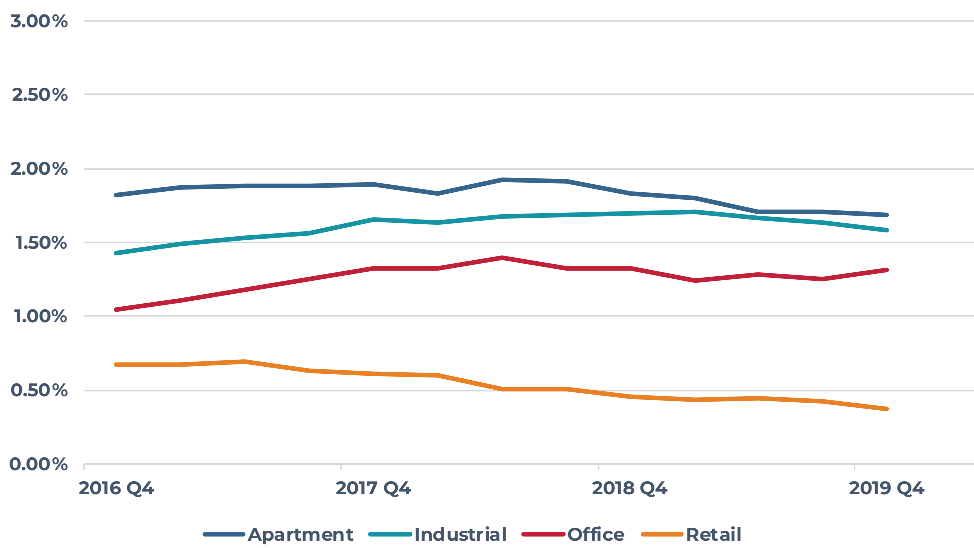
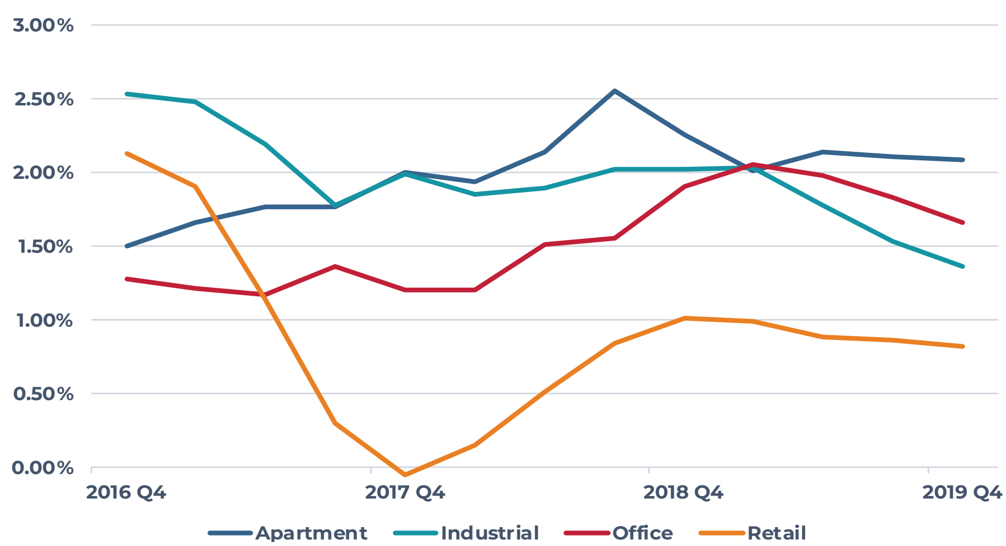
FIGURE 5
SUPPLY: YEAR-OVER-YEAR GROWTH IN TOTAL STOCK BY PROPERTY TYPE



Source: CBRE-EA 2019 Q4

FIGURE 6
ABSORPTION: YEAR-OVER-YEAR GROWTH IN OCCUPIED STOCK



Source: CBRE-EA 2019 Q4

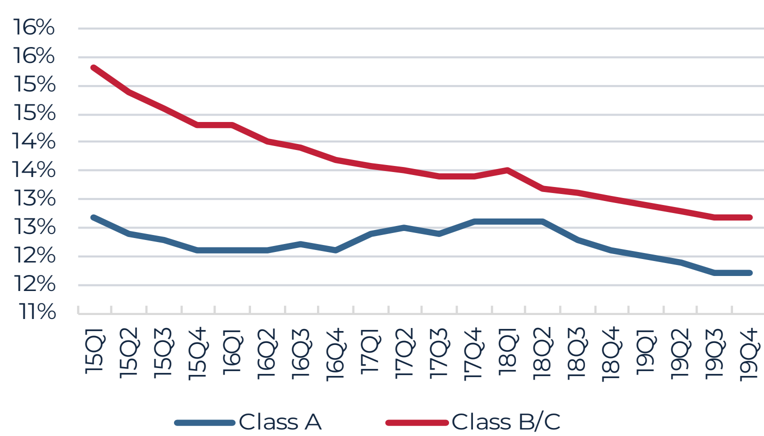
Office

The national office market remained healthy in the fourth quarter of 2019 with a vacancy rate of only 12.1%, flat from the previous quarter, but an improvement of 30 basis points (bps) year-over-year. Vacancy today remains at the lowest level in nearly two decades. The majority of markets across the country reported tighter conditions year-over-year. Per CBRE-EA, 37 of the nation's 63 largest markets posted a decline in vacancies over the course of 2019, while four markets saw no change. Only seven markets, Minneapolis (110 bps), Oakland (120 bps), Indianapolis (130 bps), West Palm Beach (140 bps), Jacksonville (160 bps), Hartford (170 bps) and Oklahoma City (300 bps), reported a year-over-year increase in vacancies of 100 bps or larger. That said, of the aforementioned markets, all but Minneapolis are in the smaller range with an inventory of 55.0 million square feet (msf) or less.

In the fourth quarter of 2019, completions of 15.8 msf did surpass net absorption of 12.2 msf. However, demand is still strong, as the 2019 full-year absorption of 56.3 msf outpaced the 50.9 msf completed in the year. Further, over the last 20 quarters, 14 quarters saw net absorption outpace completions and, in the last decade, full-year net absorption outpaced completions in eight of the last ten years, supporting the downward trend of the national vacancy rate.

Tenants have pushed for a flight to quality in an effort to retain millennial talent. The Technology, Advertising, Media, & Information (TAMI) sector, in particular, is emblematic of this phenomenon. TAMI is also leading the charge in overall leasing, relative to the more traditional office-using sectors like finance and law. Indeed, per JLL, in 2019, finance and law tenants reduced their square footage of leased space while leasing among tech companies increased by 7.4%. As a result of TAMI tenants' preference for high-quality office product, the spread between Class A (11.7%) and B/C (12.7%) vacancies has been expanding as of late; vacancies between the two classes had narrowed to 60 bps in mid-2018 before widening to 100 bps today.

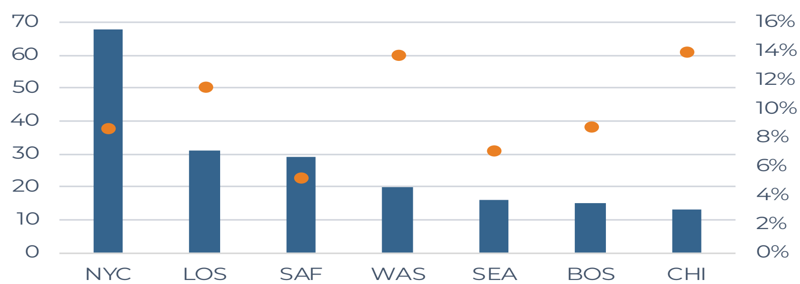
US OFFICE VACANCY RATES BY QUALITY



Source: CBRE-EA

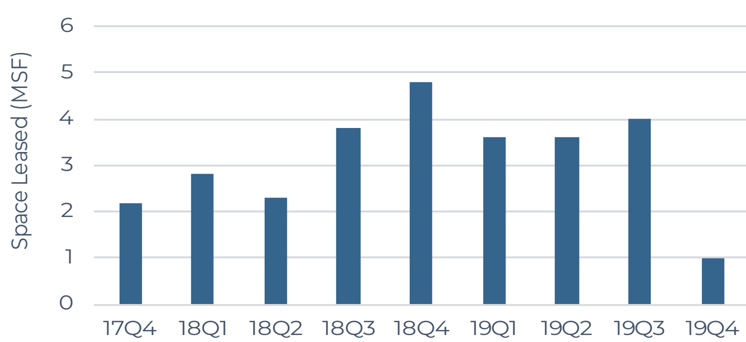
In the fourth quarter of 2019, there was a sharp drop in leasing by flexible office space operators, with 1.0 msf of flexible office space leased, down from 4.0 msf in the previous quarter and a peak of 4.8 msf a year ago. This is largely due to WeWork's slowed growth after its IPO failed in the end of the third quarter. In the fourth quarter, WeWork leased just 184,000 square feet, a sharp drop from its 2.5 msf quarterly average over the last year. The little leasing that was completed in Q4 was largely accomplished by WeWork's competitors, Spaces, Industrious, and Knotel. Much of WeWork's office space is clustered around the nation's largest office metros, and WeWork is even the largest tenant for office space in New York City. Today, only two of the seven largest WeWork markets have vacancy rates above the national average of 12.1%; however, all markets should be monitored for any fallout related to WeWork. Overall, going forward we expect office market fundamentals will remain in equilibrium with supply moderating in step with demand. This business cycle will likely mark the first time supply peaks ahead of a potential downturn.

TOP WEWORK MARKETS



Source: CBRE, WeWork

LEASING BY FLEXIBLE OFFICE OPERATORS



Source: CBRE

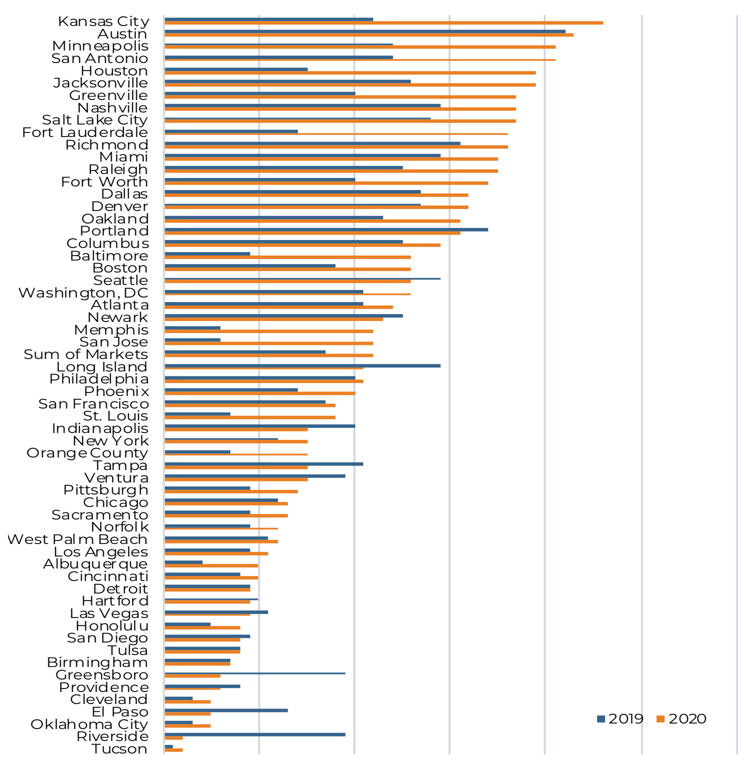
OFFICE	
Vacancy Rate	12.1%
12-Month Historical Trend	
Vacancy Change	↓
Rent	↑
Absorption	↓
Completions	↔
Cap Rates	↓
Transaction Volume	↑

Apartment

As is typical, apartment vacancies increased in the fourth quarter of 2019. Per CBRE-EA/RealPage, vacancies increased to 4.1%, up 50 basis points (bps) from the previous quarter, but down 40 bps from a year earlier. Net absorption was essentially flat in the quarter while 72,000 units were completed. On a rolling four-quarter basis, however, over 300,000 units were absorbed; this has been the case for six of the previous seven quarters and is notably higher than average four-quarter demand of 241,000 units over the 2016-2017 period. Additionally, year-over-year rent growth totaled 3.6% per square foot and 2.6% per unit.

Among CBRE-EA's top 62 apartment markets, 54 reported flat or declining vacancy rates year-over-year. Further, only one market, Providence (3.3%, +70 bps), reported an increase in vacancies over 50 bps. Meanwhile, Newark, New York, Long Island, Boston, Pittsburgh, Cincinnati, Providence, Minneapolis and Hartford all reported vacancies of less than 3.5% in the quarter. Overall, this highlights the f--act that we are ten years into this recovery/expansion and housing production continues to fall short of demand, keeping vacancies exceptionally low. Indeed, among the top 62 markets, 48 reported net absorption in excess of new supply for the year. As such, across the U.S., year-over-year rent growth per unit was positive in every market but Honolulu, which reported a modest decline of 0.6%. Rent growth was particularly strong in the Southwest with Phoenix (8.0%), Tucson (6.1%), Las Vegas (5.8%) and Albuquerque (5.6%) reporting the largest year-over-year increases in rent. The Southwest was late to the recovery as the local housing markets were harder hit relative to many of the West Coast, Northeast and Texas markets. Of note, Nashville, which has maintained elevated construction levels for some time, continues to outperform in terms of both demand and rent growth. In 2019, rents in Nashville grew by 5.4% even as supply increased by 2.8%, a pace well above the U.S. average of 1.7%.

2020 DELIVERIES WILL OUTPACE 2019(COMPLETIONS AS A SHARE OF STOCK)



Sources: CBRE-EA

Going forward, 2020 is expected to be the high-water mark for new supply with anticipated deliveries of 343,000 units (2.2% of stock). In total, 80,000 more units are expected to be completed this year relative to 2019; further, this will be the first time the completion rate tops 2% since 2000. The uptick in supply is broad based with 49 of the top 62 markets projected to see greater construction activity in 2020. Louisville, Charlotte, Orlando, Kansas City, Austin, Minneapolis, San Antonio, Houston and Jacksonville are projected to have the greatest activity as a share of current inventory, with the completion rate ranging from 3.9% in Houston and Jacksonville to 5.0% in Louisville. However, many of these markets, like Charlotte, Orlando, Austin and Jacksonville, have exhibited robust demand in recent years and continued growth, and in-migration to these markets should allow demand to remain favorable. Near-term, vacancies may nudge higher across the U.S., tempering rent growth, particularly in the urban core where supply is more prevalent. That said, a lack of buying opportunities for millennials and sizeable student debt burdens should shore up demand for apartments. In sum, we expect the market will remain in equilibrium over the long-term.

APARTMENT	
Vacancy Rate	4.1%
12-Month Historical Trend	
Vacancy Change	↓
Rent	↑
Absorption	↔
Completions	↑
Cap Rates	↔
Transaction Volume	↑

Industrial

Industrial availability stood at 7.2% to close out 2019, unchanged from the previous quarter and up a modest 20 basis points (bps) from a year earlier. Availability has remained between 7.0% and 7.2% for seven consecutive quarters, marking the longest period that availability has been at such low levels since 2000. The trend of moderating construction and leasing continued in the fourth quarter with 63 million square feet (msf) of new product completed and net new demand of roughly 56 msf, down from the year-ago levels of 69 and 82 msf, respectively. In aggregate for the year, 224 msf of new supply was completed, down from 236 msf a year ago and an increase of stock of 1.6%. Meanwhile, net absorption slowed to 183 msf, marking the first time since 2012 that annual absorption dropped below 200 msf and an absorption rate of only 1.3%.

As we have stated in the past, we believe the slower leasing activity in recent quarters is the result of today's exceptionally tight fundamentals. In fact, among the 19 markets reporting a slowdown in absorption rate greater than 200 bps from 2016 to 2019, 18 reported single-digit availability for 2019 and 12 reported availability rates that were 250 bps or more below their long-term averages. By market, Allentown reported the largest slowdown in absorption rate. In 2019, demand as a share of the previous year's stock stood at 1.3%, a 730 bps deceleration in demand relative to 2016. That said, Allentown's availability rate of 6.7% is more than 500 bps below average. Further, within the roughly 130 msf market, there is less than 4 msf of four- and five-star space available for lease. Indeed, the slowdown in demand was solely in the four- and five-star space where there is minimal available space. By square footage, meanwhile, the greatest change in demand occurred in Atlanta, where 2019 net absorption was more than 16 msf lower than 2016. Four- and five-star demand remained healthy with 15 msf of net new absorption; this roughly matches the 2016 level, but is slightly lower than 2017 and 2018. Absorption of lesser quality buildings also slowed; however, there are only 15 msf of vacant available product, the lowest level ever reported and half of the historical average.

The weaker demand is also likely attributable to weaker trade and manufacturing. In Atlanta, goods flowing through Atlanta's HartsfieldJackson Airport were down nearly 10% year-to-date through October (metric tons), while goods to and from China were down over 18% (metric tons) over the same period. Similarly, in Seattle, another market exhibiting a notable slowdown in demand, year-over-year trade with China and Hong Kong was down 40% in November. With improved trade relations as of late, any moderation in demand related to the trade war should reverse course. Still, moderation related to a lack of available supply may persist as well as moderation due to slower expected growth in the near-term, particularly in light of the ongoing Coronavirus outbreak.

On the supply side, however, new construction is slowing as well. As such, we expect supply and demand will remain relatively balanced, keeping the market in equilibrium. In the near-term, we expect rent growth will remain healthy, outpacing growth across all other property sectors. Longer-term, growth will moderate towards 3%.

MARKETS WITH THE GREATEST SLOWDOWN IN DEMAND					
	Net Absorption (% of Prior Year Stock)			Vacancy Rate	
Market	2016	2019	Change '16 to '19	2019	Relative to Hist. Avg.
US	2.4%	1.3%	-1.1%	7.2%	-2.5
Allentown	8.7%	1.3%	-7.3%	6.7%	-5.1
St. Louis	3.5%	-0.8%	-4.4%	9.7%	0.9
Columbus	3.9%	0.7%	-3.1%	6.5%	-3.8
New York	3.7%	0.8%	-2.9%	5.6%	-4.5
Hartford	1.6%	-1.0%	-2.7%	8.4%	-2.9
Atlanta	4.3%	1.7%	-2.7%	8.6%	-3.9
Ft. Lauderdale	2.5%	-0.1%	-2.6%	7.7%	-1.3
Orlando	3.4%	0.8%	-2.6%	7.5%	-2.7
Pittsburgh	3.1%	0.5%	-2.5%	8.4%	-4.7
Greenville	4.6%	2.1%	-2.5%	8.4%	-3.1

Source: CBRE-EA

MARKETS WITH THE GREATEST SLOWDOWN IN DEMAND					
	Net Absorption (SF)			Vacancy Rate	
Market	2016	2019	Change '16 to '19	2019	Relative to Hist. Avg.
US	323,357	183,260	-140,097	7.2%	-2.5
Atlanta	28,530	11,925	-16,605	8.6%	-3.9
New York	19,083	4,220	-14,863	5.6%	-4.5
St. Louis	9,641	-2,408	-12,049	9.7%	0.9
Chicago	28,786	17,773	-11,013	8.8%	-1.4
Boston	13,868	4,893	-8,975	8.6%	-5.0
Detroit	10,493	2,028	-8,465	6.4%	-5.2
Columbus	10,263	2,074	-8,189	6.5%	-3.8
Allentown	9,616	1,650	-7,966	6.7%	-5.1
Philadelphia	12,723	4,992	-7,731	7.2%	-3.8
Seattle	6,497	1,464	-5,033	5.4%	-1.9

Source: CBRE-EA

INDUSTRIAL	
Availability Rate	7.2%
12-Month Historical Trend	
Availability Change	↔
Rent	↑
Absorption	↓
Completions	↓
Cap Rates	↓
Transaction Volume	↑

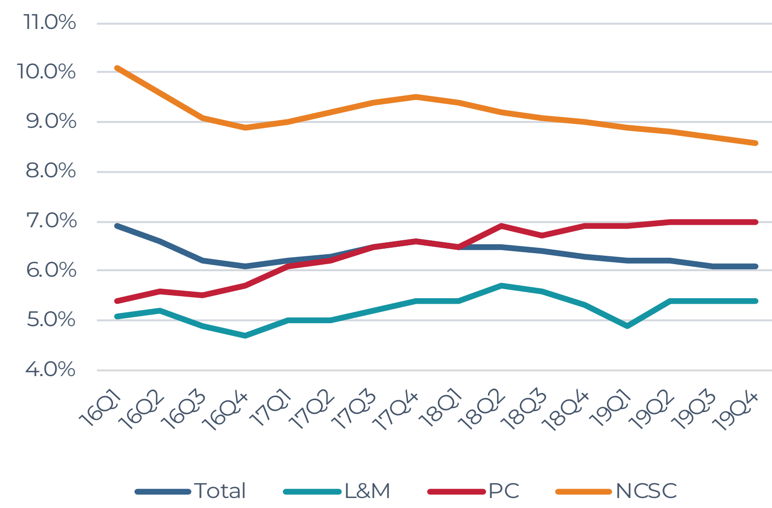
Retail

Over the last year, there has been continued headline-worthy concerns touting the demise of brick and mortar retail due to the rise of e-commerce and e-grocery and additional retailer bankruptcies. Nevertheless, fourth-quarter retail fundamentals remained largely in balance and are generally unchanged from the previous quarter. The total retail market maintained its 6.1% availability rate in the quarter, with no change from the previous quarter and a 20 basis point (bps) improvement from a year earlier. Of the 63 retail markets tracked by CBRE-EA, 48 saw their year-over-year total retail availability decrease or hold flat in 2019. Only one market, Ventura, reported a year-over-year availability rate increase of more than 100 bps, with a 120 bps increase. By subsector, availability in both the lifestyle & mall (L&M) and power center (PC) segment of the market edged slightly higher. L&M availability increased to 5.4%, an uptick of 10 bps year over year, while power centers (PC) availability stood at 7.0%, also up 10 bps year-over-year. As has been the case for some time, neighborhood, community & strip center (NCS) availability reported the most favorable momentum with availability dropping to 8.6% in the fourth quarter, down 40 bps year-over-year.

Impacting L&M outlook, Forever 21 filed for Chapter 11 bankruptcy in September and just recently agreed to be bought out for $81 million by a partnership between Simon Property Group, Brookfield and Authentic Brands. Forever 21 has already closed more than 100 stores since filing for bankruptcy, which impacts mall NOI growth as Forever 21 is a major tenant. Simon has also recently announced a plan to buy Taubman Centers, which owns 36 super-regional malls, for $3.6 billion. In terms of the L&M big picture, new consumer preferences reflect the need for either the convenience and speed of e-commerce or the enticement of innovative, experience-centered concepts. As a result, department stores will likely continue their decline over the next few years. This is a concern, as department stores represent nearly a third of mall square footage. Reflecting this outlook, mall valuations have declined, bucking the trend of continued appreciation in other property sectors.

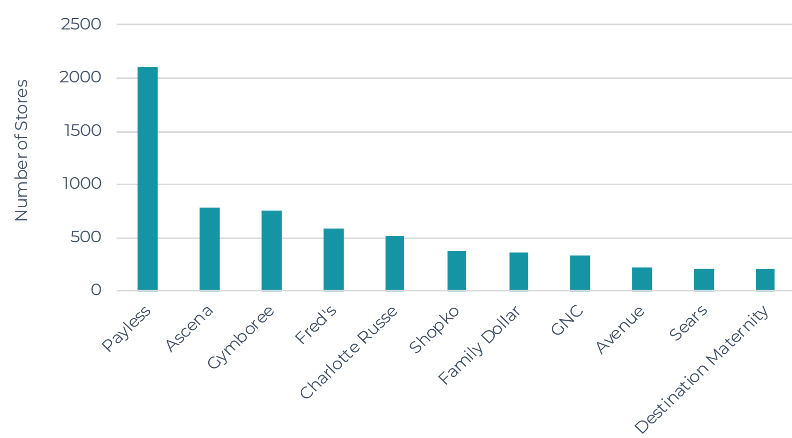
Affecting the NCS segment outlook, A.C. Moore announced in December that it would be closing each of the nearly 150 stores in its portfolio. Around 40 of these stores will have their leases purchased by competitor Michaels, slightly reducing the negative fallout. Additionally, Dressbarn is expected to close all of its nearly 650 stores in 2020. Pier I Imports is on the bankruptcy watchlist, and its portfolio of almost 1,000 stores is at risk of liquidation or in need of rent relief. On the positive side, for the NCS retail segment, food, fitness, and medical concepts have been demand drivers for shop space due to their experiential (and thus in-person) nature, insulating those tenants from the threat of convenient e-commerce. Additionally, the department store and big-box tenants that have been trending poorly as of late are not a major threat to NCS product. While e-grocery and app-based take-out ordering are on the rise, physical grocery stores are currently vital to that logistics chain and are not at risk of negative impact in the near term. However, grocery stores will either need to adapt and evolve in the age of prioritized convenience or face outsourcing if order pick-ups are not improved. Regarding the PC sub-sector, worries about exposure to big-box tenants under threat of trouble are justifiable, and thus PCs see the most concerning availability forecasts as those large leases may be harder to fill.

RETAIL AVAILABILITY BY MARKET SEGMENT



Source: CBRE-EA

TOP STORE CLOSURES IN 2019



Source: Coresight Research

RETAIL	Neighborhood & Community Shopping Centers	Lifestyle & Mall	Power Center
Availability Rate	8.6%	5.4%	7.0%
12-Month Historical Trend			
Availability Change	↓	↑	↑
Rent	↓	↑	↓
Absorption	↓	↓	↓
Completions	↓	↓	↓
Cap Rates	↔	↓	↑
Transaction Volume	↓	↓	↑

Capital Markets

Per Real Capital Analytics (RCA), $570.6 billion in industrial, apartment, office, retail, hotel, development sites and seniors/health care properties changed hands over the course of 2019. Transaction volume was down slightly in the year (-2%), driven solely by lower entity trades, which were off nearly 90% from 2018. Single-asset and portfolio sales rose by 6% and 28%, respectively. As we noted previously, REIT takeovers were viewed less favorably relative to 2018, leading to the lower entity-level sales in 2019.

Not surprisingly, among the four core property sectors, the industrial sector reported the greatest increase in volume for the year with $112.1 billion in properties changing hands, an increase of 14% relative to 2018. The industrial sector was fittingly followed by the apartment sector, where $183.5 billion in sales occurred, up 4% from 2018. Meanwhile, office trades tallied $139.7 billion, up a more modest 2%. The sole laggard among the four core property sectors was the retail sector where only $62.5 billion in properties changed hands, a 28% decline in volume from 2018.

According to RCA, in 2019, transaction volume was greatest in the Tertiary Southeast, Los Angeles, Manhattan, Seattle, Dallas, Atlanta, Boston, Phoenix, Tertiary West, Chicago, Houston, San Francisco, the Tertiary Midwest, Tertiary Southwest and Denver. Among these markets, Boston, Seattle, San Francisco and Phoenix showed an improvement in ranking of two or more spots, while Chicago, Houston, the Tertiary West, Tertiary Midwest and Manhattan moved down by a notable amount (see table). The only new market to the top 15 was San Francisco, which reported $16.1 billion in sales, the 12th greatest volume in the country. In 2018, San Francisco reported the 16th largest transaction volume with $12.8 billion in property changing hands. Meanwhile, markets reporting the greatest growth in volume include Westchester, Seattle, Austin, Charlotte, Kansas City, Pittsburgh, San Francisco and Boston, all of which posted an increase in transaction volume of 20% or more. In Westchester, a significant portion of the uptick in volume was related to Mack-Cali's $490-millon sale of an industrial portfolio. Meanwhile, in Kansas City sales transaction volume was driven higher by the sale of the Sprint headquarters and Blackstone's Industrial Portfolio acquisition. Based on the 2019 rankings and growth reported, it does appear investors are looking for yield in more secondary and tertiary markets.

With respect to pricing, the RCA Commercial Property Price Index (CPPI) for all property types increased 7.8% on the year in 2019; this is a notable acceleration from the 2018 gain of 6.6%. Again, the darlings among investors, the industrial and apartment sectors, led the way with 12.1% and 9.6% annual price increases, while office and retail gains were notably more moderate at 4.1% and 3.8%, respectively. According to NCREIF, meanwhile, most core property sectors reported relatively flat cap rates, with changes of less than ten basis points (bps) on the year. The market value-weighted cap rates for apartment (4.19%, +4 bps), retail (4.63%, -7 bps) and office (4.14%, -1 bp) were roughly flat on a year-over-year basis, while industrial cap rates declined by 20 bps to 4.35%.

As expected, NCREIF property returns continued to moderate in 2019. The total NCREIF return was 6.42% for the year, 30 bps lower than the 2018 return. All property sectors, even the industrial and apartment sectors, reported lower returns for the year. Still, industrial reported the highest annual total return at 13.36%, followed by office (6.59%), apartments (5.51%) and retail (1.90%). Of note, retail reported capital depreciation for the year of 2.75%, which follows on depreciation of 2.40% in 2018. Appreciation was again strongest in the industrial sector at 8.39%, followed by office (2.09%) and apartment (1.19%), This performance is generally consistent with our expectations, although apartment returns were perhaps more tempered relative to what the property market fundamentals would indicate. Going forward, total returns are expected to moderate further with the PREA Consensus return expected to be around 5.5% over the next three-to-five years.

2019 RCA TRANSACTION VOLUME - TOP 15 MARKETS

Rank 2019	Rank 2018	Market	2019 (Bil. $)	2018 (Bil. $)	% Change
1	2	Tertiary SE	$31,784	$31,830	-0.1%
2	3	Los Angeles	$29,157	$29,568	-1.4%
3	1	Manhattan	$26,963	$35,628	-24.3%
4	9	Seattle	$25,743	$17,012	51.3%
5	4	Dallas	$25,260	$23,791	6.2%
6	7	Atlanta	$19,787	$17,998	9.9%
7	14	Boston	$17,990	$14,707	22.3%
8	10	Phoenix	$17,511	$16,005	9.4%
9	6	Tertiary West	$17,380	$22,112	-21.4%
10	5	Chicago	$16,569	$23,510	-29.5%
11	8	Houston	$16,180	$17,351	-6.8%
12	16	San Francisco	$16,116	$12,801	25.9%
13	11	Tertiary MW	$15,604	$15,630	-0.2%
14	13	Tertiary SW	$14,436	$15,225	-5.2%
15	15	Denver	$13,155	$12,982	1.3%

Source: RCA

RCA MARKETS WITH 20% GROWTH IN TRANSACTION VOLUME

Market	2019 (Bil. $)	2018 (Bil. $)	% Change
Westchester	$3,039	$1,833	65.7%
Seattle	$25,743	$17,012	51.3%
Austin	$10,848	$7,729	40.4%
Charlotte	$8,591	$6,506	32.0%
Kansas City	$3,463	$2,672	29.6%
Pittsburgh	$1,858	$1,446	28.5%
San Francisco	$16,116	$12,801	25.9%
Boston	$17,990	$14,707	22.3%

Source: RCA

For more information, please contact:

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