Real Estate Summary

US Real Estate – Edition 3, 2019

Spreads return to normal,
while property sector performance diverges.

UBS

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Commerical real estate

Current economic conditions create optimism for commercial real estate to maintain positive performance, even as uncertainty around future economic growth has increased. Capital flows are supportive but not excessive, supply should be monitored closely.

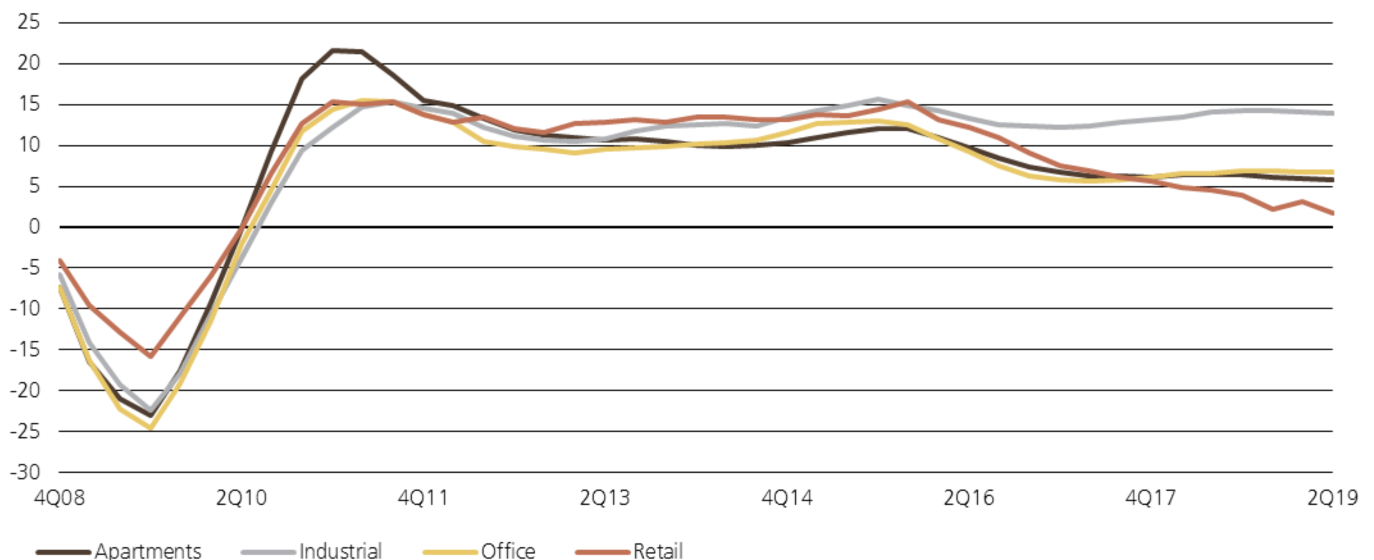
Private commercial real estate continues to produce steady returns, in line with long-term expectations, even though there are big differences across property types, see *exhibit 1*. The income side of the equation is positive. Expectations are for continued growth, likely at a diminished rate. Appreciation returns range from high in the industrial sector to negative in the retail sector, driven by valuation changes and increasing capital expenditures.

The risk premium available in US real estate increased. After four short-term rate hikes in 2018, the US Federal Reserve lowered rates in July, the first time in more than a decade.

For US commercial and multifamily real estate, lower interest rates mean a widening of the recently compact spreads. Cap rates moved sideways or slightly downward in all but the retail sector, where cap rates increased.

Demand for space is supported by economic expansion and a strong labor market. Supply growth must be monitored closely. Supply eased in the office sector and is low in retail. For apartments and industrial, development remains elevated, but currently, new construction levels are being met by strong demand, resulting in relatively stable occupancy rates and positive rent gowth.

Exhibit 1: US real estate returns across property types
Rolling four-quarter total return (%)



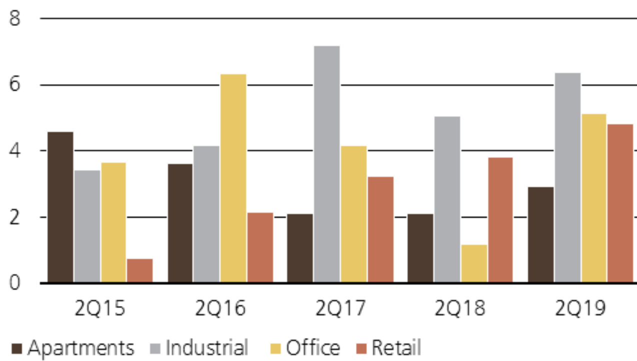
Source: NCREIF Property Index as of June 2019. Past performance is not indicative of future results.

Economic conditions create some optimism that comercial real estate will maintain positive revenue growth momentum. Real estate revenue is directed by the comingling of occupancy and rents. Occupancy rates are high relative to the past 10 years and occupancy faces a small degree of downward pressure with supply growth matching or exceeding demand. As there is little room to increase occupancy, rent growth is the driving force behind income gains, *exhibit 2*.

Expectations continue to be for modest inflation in 2019. US consumer price inflation slowed to 1.6% in the year ending second quarter 2019. At 3.7% as of July 2019, the national unemployment rate is near its lowest point since 1969.

Exhibit 2: Property sector rent growth

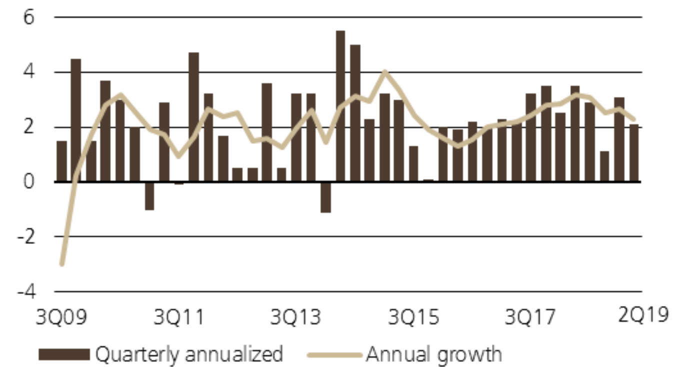
Year-over-year change (%)



Source: CBRE-Econometric Advisors as of June 2019.

Exhibit 3: US real GDP growth

Real GDP growth (%)



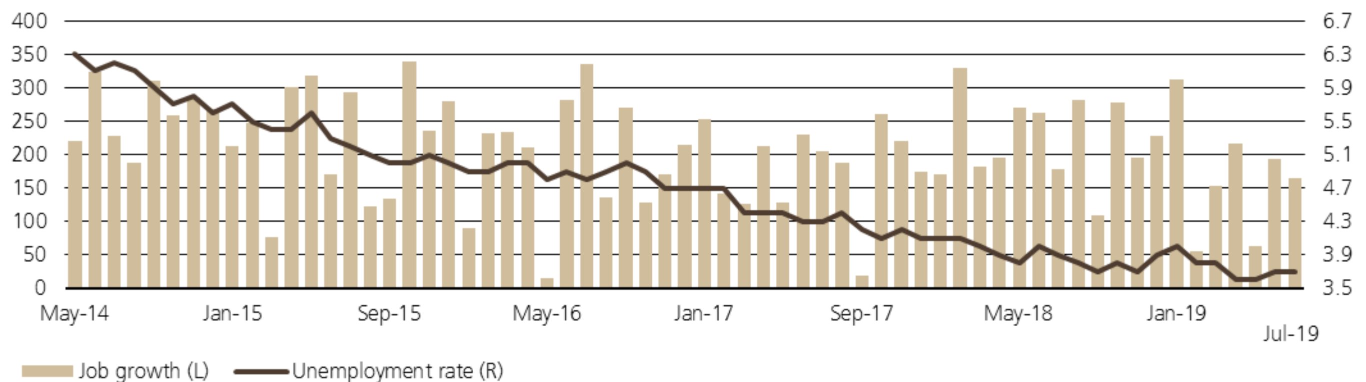
Source: Moody's Analytics as of 26 July 2019.

A growing economy and tight labor market should continue to generate demand for real estate which supports income growth. After the first half of 2019, economic growth remains positive, although notably slower than during the first half of 2018. In 2Q19, GDP growth was 2.1%, which is near the long-term trend, see *exhibit 3*.

A tight labor market makes it tougher to fill open positions but bodes well for continued upward pressure on wage inflation; which is is expected to support consumer spending . Average monthly job gains softened somewhat in the first half of 2019, to 192,000 per month. Monthly additions continue to be lumpy, *exhibit 4.*

Exhibit 4: US job growth and unemployment rate

Change in employment (thousands of jobs)



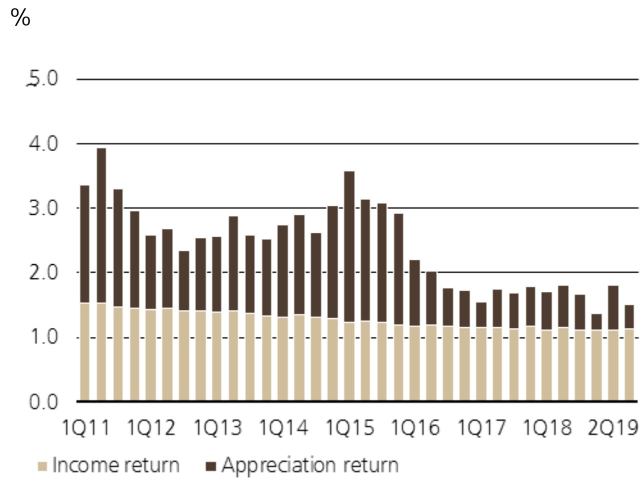
Source: Moody's Analytics as of 2 August 2019.

In 2019, we expect positive unlevered property returns, driven by growth in income, with moderation in appreciation relative to recent years. In second quarter 2019, appreciation return slipped below that of the previous quarter, softening the NCREIF Property Index gain to 1.5%, *exhibit 5*.

Total US commercial real estate sales volume was USD 470 billion in the twelve months ended second quarter 2019, up slightly compared to the prior twelve month period. During the first half of 2019, sector trends remained consistent with recent annual performance. Sales of retail and office properties flattened after several years of decline, and sales of apartments increased, *exhibit 6*. Industrial sales appear steady after tremendous growth in recent years.

Exhibit 5: US property returns

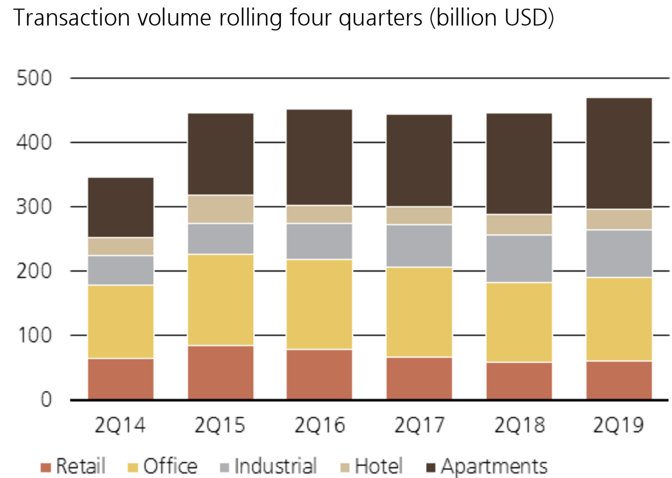
%



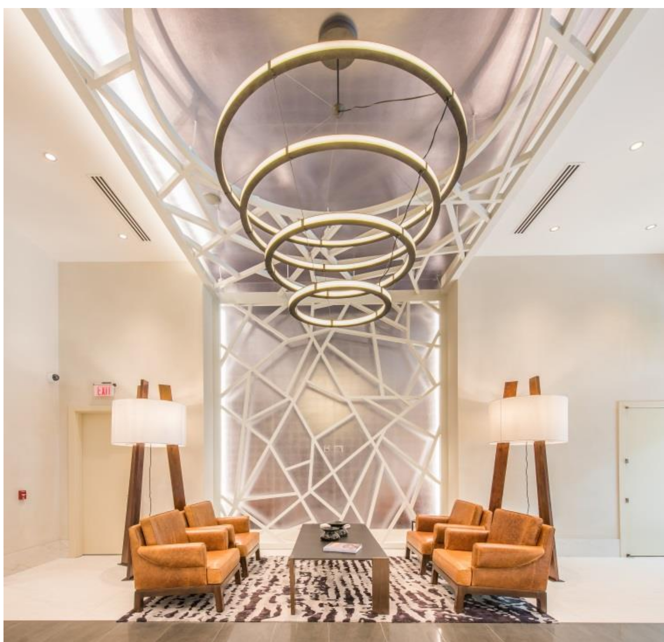
Source: NCREIF Property Index as of June 2019.
Past performance is not indicative of future results.

Exhibit 6: US transactions

Transaction volume rolling four quarters (billion USD)



Source: Real Capital Analytics as of June 2019.



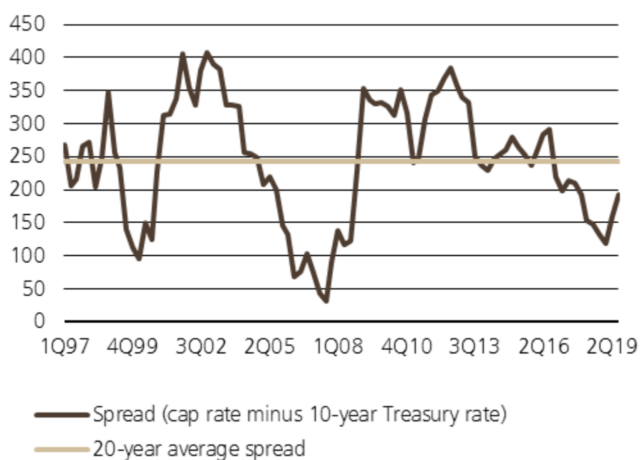
Museum Tower Apartments, Charlotte, NC

In today's low interest rate, low cap rate environment, real estate debt capital is inexpensive and generally available. However, debt is not free-flowing like it was during the lead in to the last downturn. The spread between property yields and the cost of debt decompressed somewhat in 2019. However, banks must contend with a flat yield curve. When both short- and long-term rates are nearly the same, it becomes difficult to pay depositors a market rate while charging a competitive interest rate on loans. On the whole, US debt markets can be described as operational but not excessive, which encourages development but not an abundance of supply.

With little movement in cap rates, the downward move in Treasury rates widened the spread available on stabilized US real estate, *exhibit 7*. While the real estate spread is no longer compressing, the higher risk premium seems warranted as uncertainty around future economic growth also increased.

That said, there is no obvious distress in the market that might put stronger upward pressure on cap rates. Income is growing; potential sellers can afford to be patient. In addition, debt is available and capital expenditures are increasing.

Exhibit 7: Commercial real estate spread
Basis points



Source: NCREIF Fund Index-Open-end Diversified Core Equity and Moody's Analytics as of June 2019.

Latitude Med Center, Houston, TX

Property types

Apartments

Our expectation for the US apartment sector is "steady-as-she-goes." Apartment vacancy experienced a typical seasonal rise in first quarter 2019, but a surge in demand brought second quarter vacancy down by 60 bps to 4.0%, see *exhibit 8*. New construction is expected to increase through the middle of 2020. Year-over-year rent growth has remained near 3% for the last four quarters. Returns are income-driven with near-inflationary appreciation.

Industrial

Growth in net rents remains strong. In the year ended 2Q19, industrial rents grew by 6.4%, notably above the five-year average of 5.2% per annum. Despite moderate easing during the first half of 2019, the pace of completions remains elevated, *exhibit 8*. Forecasts expect rising completions over the coming year. Industrial availability was 7.1% in second quarter 2019, unchanged from the previous quarter, nearly as low as it has been since 2000. Even as demand remains high, rising completions add increasing risk to the outlook.

Office

Exhibiting characteristic volatility, office rent gains outperformed inflation with Downtown's 8.3% annual growth; this unsustainable growth spurt far exceeding Suburban office's "steady-as-she-goes " 2.7% rent growth. Average office vacancy decreased 60 basis points from one year ago, *exhibit 8*. The gap between Downtown office vacancy at 10.4% and Suburban vacancy at 13.2% remains wide. Downtown deliveries remain elevated, while Suburban completions have likely passed a peak period and remain steady over the year.

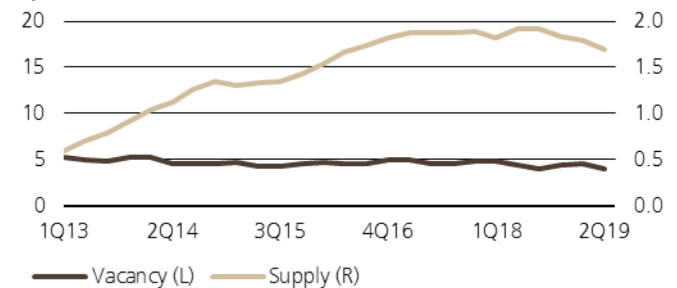
Retail

Increased disposable income and low unemployment should support retail sales in 2019. However, performance is likely to vary as the retail sector transitions to less apparel-based formats. Fundamentals are fluctuating. Mall/lifestyle center availability bounced between 4.8% and 5.6% over the past six quarters, while power center availability has been gradually increasing. At 8.8%, availability in the smaller-format, Neighborhood, Community & Strip (NCS) subsector is down 70 bps since the end of 2017.

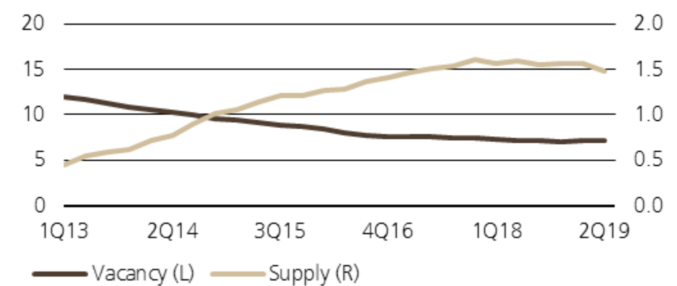
Exhibit 8: Property sector vacancy and completion rates

Vacancy rate (%) Percent of inventory (%)

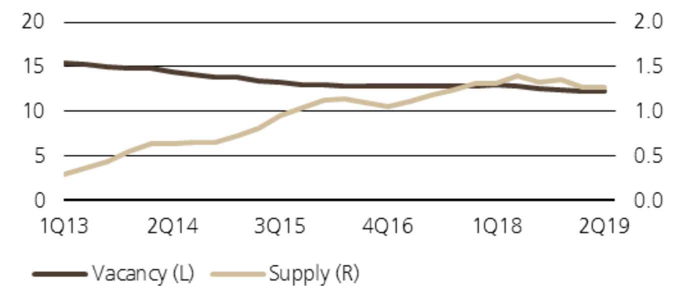
Apartments



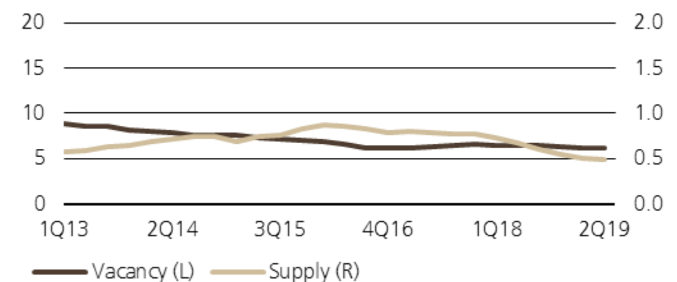
Industrial



Office



Retail



Source: CBRE-Econometric Advisors as of June 2019. Supply is shown as a completion rate (i.e. completions as a percent of existing inventory).

Viewpoint

Beginning in early 2016, US real estate entered a widely-anticipated period of income-driven performance. On the whole, US properties are appreciating at about the pace of inflation. Appreciation relates back to the positive rent growth generated by properties, as opposed to the out-sized influence of capital flows the US experienced in 2014 and 2015.

More recently, uncertainty increased around appreciation in US real estate. Falling interest rates eased upward pressure on cap rates, but the risk premium increased. Fundamental strength in the US economy acts as a stabilizing factor by supporting income growth at the property level. A tight labor market and optimistic confidence measures reinforce our expectations for relatively good occupancy rates and continued rent growth in the US real estate sector.

Income-generated performance is consistent with a long-term expectation for private commercial real estate investments. Looking more closely at the drivers of income, rent growth is the true powerhouse behind the gains. Property-level income growth should outpace today's modest inflation even as the pace of growth moderated in recent years.

Even though 2018's rising interest rate environment reversed and long-term interest rates fell during 2019, uncertainty remains and the increased risk premium appears warranted.

Capital investment into stabilized assets is increasing, an expected outcome in a long expansion. Debt and equity capital is seeking growth strategies, and existing assets are under pressure to compete with new construction. Investors should pay careful attention to the risk-return expectations for incremental capital.

Exhibit 9 – Historical performance

Total returns (%)	2016	2017	2018	1Q19	2Q19	10 year	20 year
Bar cap	3.0	4.0	(0.4)	3.3	3.5	4.1	5.0
S&P 500	12.0	21.8	(4.4)	13.6	4.3	14.7	5.9
NAREIT	8.6	8.7	(4.0)	17.2	1.8	16.0	10.7
CPI	2.1	2.1	1.9	1.2	0.8	1.7	2.2
NCREIF Property Index							
Total	8.0	7.0	6.7	1.8	1.5	9.2	8.9
Income	4.8	4.7	4.6	1.1	1.1	5.4	6.3
Appreciation	3.1	2.2	2.1	0.7	0.4	3.7	2.5
NCREIF total returns by property type							
Apartments	7.3	6.2	6.1	1.3	1.4	9.4	8.7
Hotel	4.7	4.9	7.6	0.4	1.1	7.0	6.9
Industrial	12.3	13.1	14.3	3.0	3.4	11.4	10.0
Office	6.2	6.0	6.8	1.6	1.7	8.4	8.2
Retail	9.0	5.7	2.2	1.7	(0.1)	9.2	9.9

Source: NCREIF, NAREIT, Morningstar and Moody's Analytics as of June 2019.
Past performance is not indicative of future results.

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