US real estate market
Outlook 2015 *travel companion*

William Hughes, Dan Bu, Kurt Edwards, Tiffany Gherlone, Amy Holmes, Kim House, James McCandless, Brian O'Connell, Joshua Rome, Shane Russo & Laurie Tillinghast

Economic expectation
As 2015 begins, the US economy is approaching self-sustaining expansion. Economic momentum should be positive, supporting commercial real estate income growth even as interest rate movements attract increasing focus.

With more jobs, higher incomes, stronger balance sheets and renewed confidence, US consumer spending should remain buoyant. A steep decline in energy costs will likely boost buying power in the short term. The corporate sector should respond to more expensive labor by increasing capital investment.

Three primary wildcards restrain the potential for stronger growth: 1) lingering effects of the Global Financial Crisis; 2) under-performance in the residential housing market; 3) global decoupling, the contrast between the US economy and weak growth in much of the world. If the outlook progresses as we expect, the Federal Reserve is likely to raise short-term interest rates before the end of the year.

Scenarios
The table below displays our economic and real estate market conditions under *Base Case* (expected), *Upside* and *Downside* scenarios.

Incrementally higher Net Operating Income (NOI) growth is consistent with our call for slightly higher inflation. Market cap rates could experience minor upward pressure, slowing appreciation.

Performance scenarios

	2015 scenarios		
	Rebound	Base Case	Recession
GDP (%)	4.1	3.1	(1.6)
Employment (mill jobs/year)	3.3	3.0	(2.2)
Inflation (%)	2.7	2.0	0.2
Retail sales (%)	6.0	5.5	(2.2)
NOI growth (%)	3.9	3.7	1.5
Cap rate change (bps)	(15)	5	30
Income return (%)	5.4	5.4	5.6
Appreciation (%)	6.9	2.7	(4.0)
Total return (%)	12.3	8.1	1.6

Source: UBS Global Asset Management, Global Real Estate Research & Strategy based on data obtained from NCREIF, Moody's Analytics and Real Capital Analytics as of December 16, 2014. Economic series are expressed as fourth-quarter over fourth-quarter rates of change.

2015 conceptual investment themes
Reluctantly positive economy - Impediments to growth remain but the greatest probability is that the economy continues to slowly build toward strength. This is an environment in which savvy investors can perform.

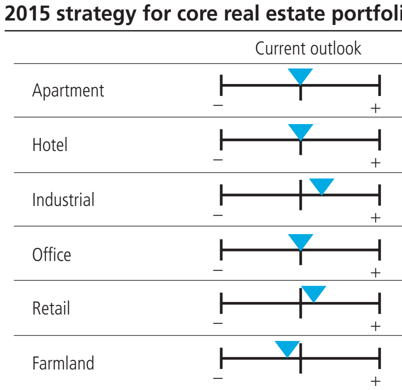
Move toward neutral - As we take a wide view of our 2015 strategic outlook (right hand exhibit), we discover a collective move toward neutral underwriting and neutral allocation. Indicating a balanced fundamental environment.

Second wave markets (high beta) - With improving confidence in economic expectations and very competitive pricing in the safest markets, investors should consider taking an incremental step out on the risk curve by expanding their target markets.

Willing, if patient - It may take longer to realize the benefits of a value enhancement strategy if the overall market is not charging forward. Patience is a required component of this theme because value-add investing is aided by growth, and the growth outlook is limited.

Property sector outlook
The scale below indicates our relative aggressiveness in fundamental underwriting. It is the relationship between the underwriting and the pricing available that drives investment decisions. We believe continuous comparison of these relationships can lead to the best investment choices.

2015 strategy for core real estate portfolio



Source: UBS Global Asset Management, Global Real Estate Research & Strategy as of November 2014

Portfolio & Client Services
Thomas O'Shea
thomas.oshea@ubs.com

Thomas Anathan
thomas.anathan@ubs.com

Maria Bascetta
maria.bascetta@ubs.com

Thomas Klugherz
thomas.klugherz@ubs.com

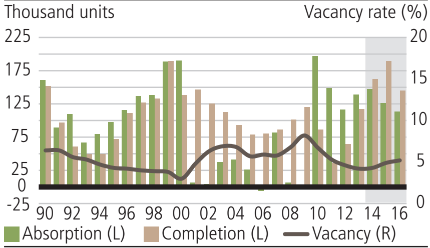
Ronald Lanier
ronald.lanier@ubs.com

Wm. David Lawson
david.lawson@ubs.com

Julie Pierro
julie.pierro@ubs.com

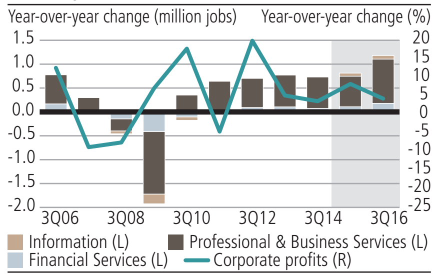
Wayne Wallace
wayne-j.wallace@ubs.com

Apartment fundamentals



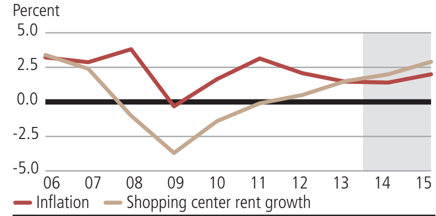
Source: Reis as of September 2014
Shaded area indicates forecast data

Office jobs and corporate profits



Source: Moody's Analytics as of November 10, 2014

Retail rent growth



Source: UBS Global Asset Management, Global Real Estate Research & Strategy as of December 2014, Reis and Bureau of Labor Statistics as of September 2014
Shaded area indicates forecast data

Apartment

Vacancy remains low relative to history. Supply is increasing in the near term; however, demographics favor positive apartment performance. Landlords are still able to increase rents at rates above inflation.

Office

Growth in corporate profits should continue to lead office-using job growth, which will drive net absorption. Construction of office space is expected to continue, the pace of new supply is expected to be modest by historic terms.

Retail

NOI growth is being driven by slow rental rate improvements and a better outlook for leasing up vacant space. Consumer spending should put positive pressure on retail sales. Supply growth is expected to be modest.

Industrial

Supply is just beginning to increase in the industrial sector, driven initially by new development in large buildings. Our analysis of the prospects for industrial demand leads us to a tempered but still positive outlook for the sector.

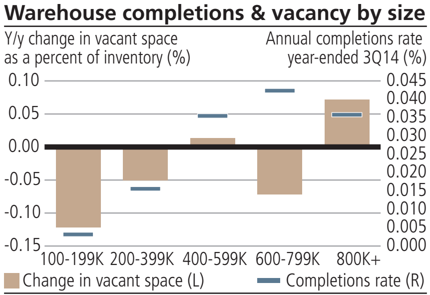
Hotel

Our expectation is for 2015 to be the year hotel occupancy and RevPAR pare down their gains. Well-capitalized investors who can manage through increased competition should look for buying opportunities in the hotel sector over the next several years.

Farmland

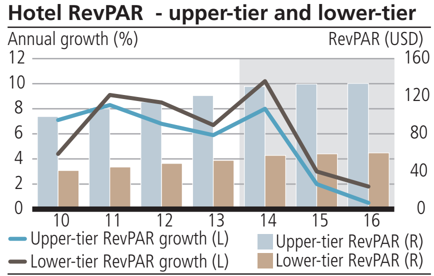
The dearth of investment-grade properties available for sale is a challenge for deploying investment capital. Investors seeking to deploy capital into farmland must be patient in this challenging market.

Warehouse completions & vacancy by size



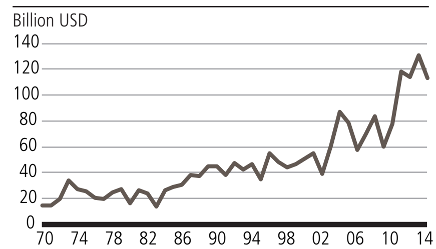
Source: CBRE-Econometric Advisors as of September 2014

Hotel RevPAR - upper-tier and lower-tier



Source: CBRE-Econometric Advisors as of September 2014
Shaded area indicates forecast data

Net Farm Income 1970-2014

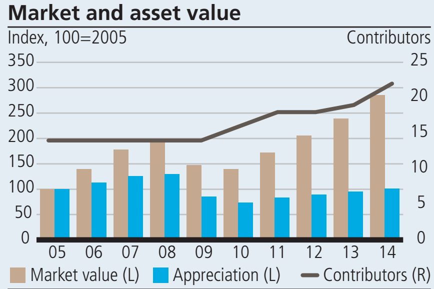


Source: USDA as of November 2014
2014 is forecast by the USDA

Real estate performance

Recent outstanding performance and the positive attention paid to institutional real estate have led to sense that things have gone well over the past five years, and there may be a tendency to believe that we have almost forgotten the concerns of 2009. Recent appreciation has been unsustainably high. More institutional investors are including real estate in their portfolios and quoted indices have been on the rise. The implied question is "Where is the market today?"

Market and asset value



Source: NCREIF as of September 2014

The answer depends on the focus. In terms of capital flow, we see that the market is reaching new heights. The chart shows the number of contributors and total asset value in the NFI-ODCE index. The relative position of capital value might impact current investment behavior. The appreciation index reveals that capital values have just returned to the 2005 level, only partially recovering the losses incurred during 2009. Notwithstanding nominally low cap rates and net migration to the sector, commercial real estate values are not elevated relative to the recent past.

The full **Outlook 2015** can be found at www.ubs.com/realestate

UBS Realty Investors LLC
10 State House Square
Hartford, CT 06103-3604
Tel. +1-860-616 9000

UBS