June 2017

US Real Estate Summary.

Edition 2, 2017

Income return drives real estate performance today

Property-level income growth is good, just not stellar

Occupancy rates trending sideways

Rent growth continues to outpace inflation

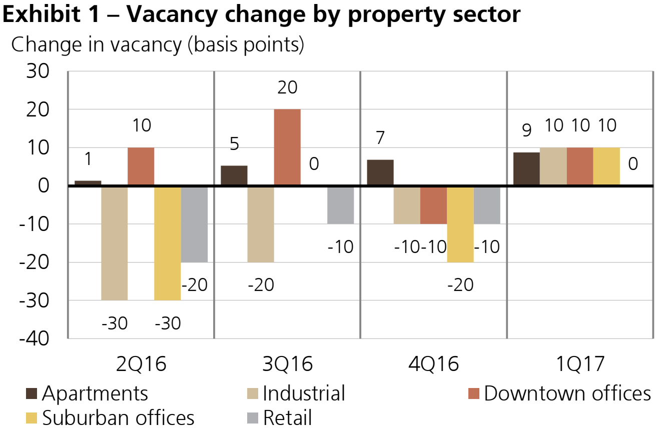
Commercial Real Estate

Income continues to be the leading driver of US commercial real estate performance, a change that has taken place gradually as the real estate sector transitioned from recovery to expansion over the past two years. The fact that income rather than capital market effects is driving the returns, is in-line with long-term performance of the sector and is consistent with our expectations for the foreseeable future.

Income again dominated appreciation during the first quarter of 2017. During 1Q17, income provided two-thirds of the NCREIF Property Index quarterly total return of 1.5%, representing performance of unlevered properties. Details of the relative performance of key asset classes are shown in *exhibit 5* on page 6.

US commercial real estate has avoided many of the stresses of a long expansion, but is experiencing a period of relatively flat occupancy levels and average rent growth. The flattening in occupancy levels is illustrated in *exhibit 1*, which shows vacancy rates influenced by a mix of upward and downward pressures.

Exhibit 1 – Vacancy change by property sector



Source: CBRE-Econometric Advisors and Axiometrics as of March 2017.

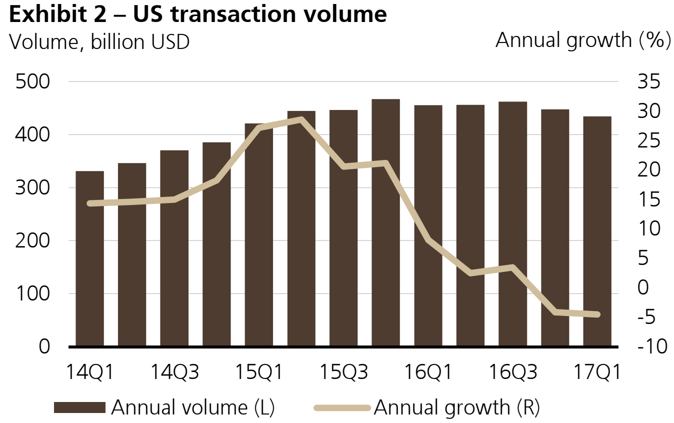
Taken together, the last two quarters show little movement in vacancy overall. Our positive outlook for the US economy and labor markets imply that income growth will continue to be supportive of property fundamentals.

Capital market effects are settling down. For the year ended March 2017, total transaction volume in the US was USD 434 billion (excluding privatizations and REIT mergers), which is 5% below the year-ago level.

Headlines that warn of a sharp slowdown in US real estate transactions may exaggerate the slowdown by including highly volatile entity-level mergers and privatizations. With those firm-level transactions removed, we show real estate sales volume is still high relative to history, even though volume is unlikely to trend higher in the current environment.

The recent slowing in transactions is indicative of volume plateauing, *exhibit 2*. The high growth rates of 15% to 25% achieved during 2014 and 2015 were just too high to be sustainable.

Exhibit 2 – US transaction volume



Source: Real Capital Analytics as of March 2017. Note: excludes entity-level sales.

Some of the weakness of US transaction volume comes as a result of publicly-traded Real Estate Investment Trusts (REITs) whose lackluster performance in the equity markets in 2015 followed by only moderate gains in 2016, led to weaker acquisition activity.

Flows of capital into US real estate from overseas were positive but weaker in 2016, facing an appreciating US dollar, slowing cross-border flows from China and weakening investment activity by oil-rich nations.

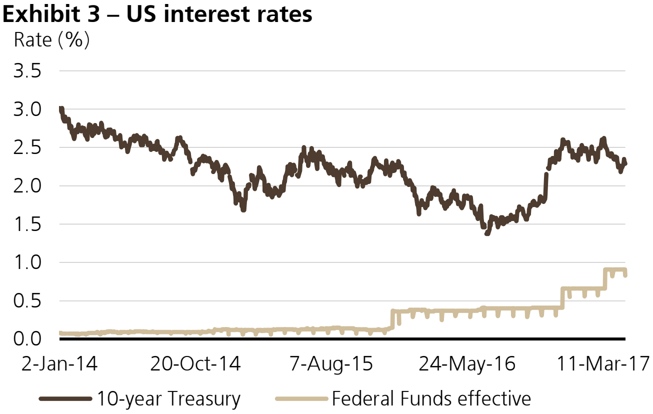
Spreads offered by real estate investments are near long-term levels, representing a change from the wide spreads that drew capital so quickly in the wake of the last recession. Shifting from wide spreads back to long-term average spreads gradually removes one of the pressures that had been pushing cap rates lower.

After the sharp increases in interest rates that occurred at the end of 2016, the 10-year Treasury rate gave back 22 bps during the final weeks of March to end the first quarter at 2.4%. Long-term interest rates remain low, which is favorable for commercial real estate investment.

Real estate debt capital is low cost and generally available but not as free-flowing, as in the past. Debt markets can be described as operational but are not deemed excessive, encouraging development but not an abundance of supply.

Focusing on the short end of the yield curve, we expect the Federal Reserve, *exhibit 3,* will continue to tighten monetary policy at a modest pace as the national conversation moves toward an expected shrinking of the Fed's balance sheet.

Exhibit 3 – US interest rates



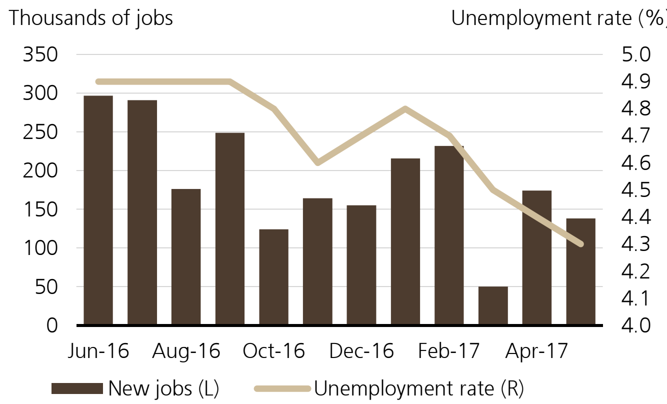
Source: Moody's Analytics as of May 2017.

US Gross Domestic Product (GDP) grew 1.2% during 1Q17, an underwhelming start to the year. Slower consumer spending was one reason for the pullback in broader economic growth.

We anticipate some rebound in spending as the year progresses given the tight labor market and positive consumer confidence. Our Research & Strategy team's base case expectation is for real GDP growth to pick up to 2.4% for all of 2017.

US labor markets continue to improve even as it becomes nearly impossible to maintain the pace of hiring achieved in recent years. A total of 533,000 new jobs were gained during the first three months of 2017— a good result even though it is 55,000 jobs fewer than the first three months of 2016. *Exhibit 4* helps illustrate and explain the gradual slowing in the pace of job growth. The unemployment rate declined by 50 basis points (bps) over the past year, implying that there are fewer people available to fill openings.

Exhibit 4 – US labor market



Source: Moody's Analytics as of May 2017.

Wages should rise in response to tight labor market conditions, fueling consumption via growth in the demand for goods and services.

Wage growth might support additional inflation in the prices of goods and services. Consumer price inflation posted an increase of 2.4% over the year.

Some inflation in the economy is generally a positive for real estate. Real estate investors will pay more for future cash flows if they believe there will be inflation in the rent over time.

Property Types

Apartments
New construction is weighing on occupancy while rental demand still supports some rent growth in the apartment sector.

Vacancy was 5.5% in the first quarter of 2017, which is 40 bps above the year-ago rate but 60 bps below the 20-year average. Rents grew 2.4% year-over-year, below the elevated five-year average of 3.6% annual growth, as the pace of growth decelerates in response to supply.

Job growth, increasing household formation and relatively low homeownership rates provide persistent support for rental demand. As long as hiring continues and vacancy remains low relative to history, landlords should continue to be able to grow rents in most metros, if less robustly than recent years.

Hotels
Hotel development is above long-term average levels and is exerting pressure on occupancy levels. RevPAR (Revenue per Available Room) growth, which is influenced by occupancy and room rates, is slowing, as occupancy rates flatten. Room rate increases are still positive but will likely weaken in the face of new competition.

If the economy continues on a positive trajectory, growth should support fairly steady hotel room demand, which so far has avoided much of the negative impact of a stronger US dollar. Faster wage growth fostering more domestic travel would improve demand if it materializes. Investment opportunities may increase in the hotel sector when the construction pipeline begins to fade.

Industrial
Supply and demand are moving toward balance in the industrial sector in the US after a long run of demand outpacing new construction. As a result, after 27 consecutive quarters of decline the availability rate rose by 10 bps to 8.0% in the first quarter. We emphasize that one quarter does not make a trend; however, it does show up as a change for this sector.

Demand for general consumer goods and e-commerce continues to grow; however, for one big user of US industrial space—US auto manufacturing—sales now appear to be weakening.

Industrial rents grew by 7.2% during the year that ended in the first quarter of 2017, a large increase in rental rates. Upward pressure on availability may now begin to limit the pace of growth in coming quarters.

Office
With demand for office space overtaken slightly by supply during the first quarter 2017, office vacancy increased by 10 bps to 13.0%.

While downtown locations price at a higher rent level, there is no longer a wide difference in rent growth based on location. Rent growth in both downtown and suburban locations is moving toward 3%, with year-over-year growth of 3.4% in downtowns and 3.9% in the suburbs. The gap between downtown office vacancy at 10.7% and suburban at 14.2% remains wide.

Retail
Consumption was weaker-than-expected in the US at the start of the year, contributing to weak growth in Gross Domestic Product (GDP) during first quarter 2017. However, positive pressures on spending, including anticipated wage growth and low unemployment, should support stronger consumption throughout the remainder of the year.

Rent growth in Neighborhood, Community and Strip retail posted a 3.4% increase in the year-ended March 2017. At 10.1%, 1Q17 availability was unchanged from the previous quarter but decreased 40 bps over the year. Supply growth in the US retail sector is not coming from new development, as new construction is well-below 1% of total inventory.

Instead, available space is coming primarily from the closure of stores and expansion of e-commerce. Owners of physical retail space are adjusting to consumer preferences with high-tech customer loyalty programs driving more traffic to shopping centers where restaurants, movie theaters, and home improvement stores are replacing traditional anchors.

Viewpoint

As 2017 progresses, fundamental conditions continue to transition toward typical levels, after the unsustainably high growth rates of 2014 and 2015. Flat occupancy is likely the result of supply having responded to strengthening markets and meeting the positive demand for space. Demand continues to be supported by growth in the US economy and tight labor markets. The appreciation the market is experiencing today is generally a result of improved income expectations rather than the powerful capital market effects that support the above-average appreciation of the recent past.

The gradual leveling off in the real estate sector can be characterized by moderate-to-low vacancy rates, long-term average rent growth, and transaction volume transitioning from huge year-on-year growth to subtle annual declines. In an environment where income is growing across all property types yet is unlikely to accelerate materially, we highlight the virtues of diversification and movement toward long-term strategic positioning as reasonable ways to benefit and balance risks.

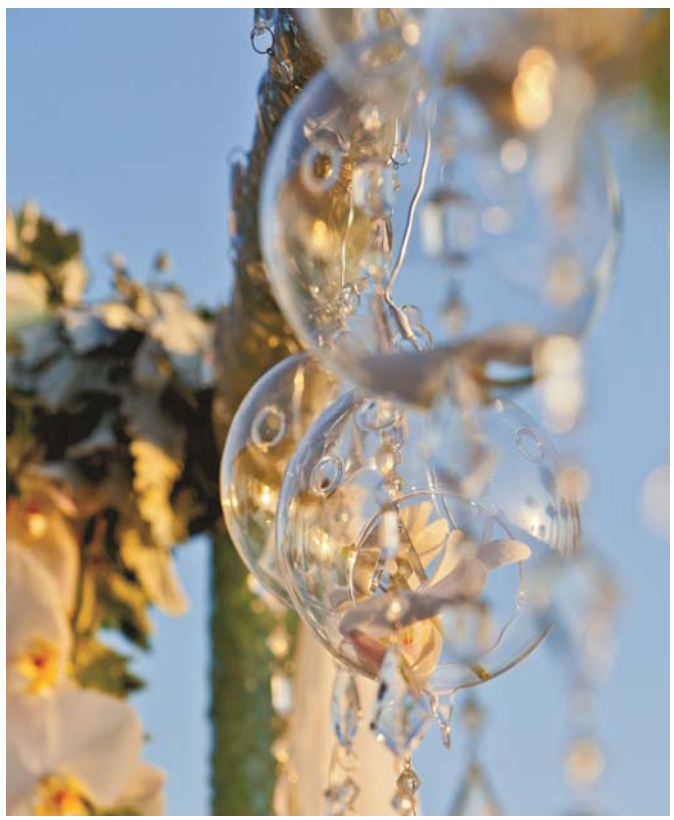
Generally good real estate sector fundamentals give us some confidence in income expectations, despite pricing uncertainty. Debt capital has avoided excess. Growth in income helps maintain high debt service coverage ratios relative to ten years ago, with more real property-level income backing mortgage payments today.

US commercial real estate should continue to experience positive performance at a pace that is similar to long-term expectations. Rather than mourn the passing of double-digit core returns, we recognize that such high returns were unstainable and the gradual transition to income-driven performance is welcome.

Exhibit 5 – Historical performance (%)

Total returns (%)	2014	2015	2016	4Q16	1Q17	10-yr	20-yr
Bar cap	6.0	0.1	3.0	(3.4)	1.0	4.3	5.4
S&P 500	13.7	1.4	12.0	3.8	6.1	7.5	7.9
NAREIT	28.0	2.8	8.6	(3.3)	2.5	5.0	9.8
CPI	0.7	0.7	2.1	0.8	0.4	1.7	2.1
NCREIF Property Index							
Total	11.8	13.3	8.0	1.7	1.5	6.7	9.7
Income	5.4	5.0	4.8	1.1	1.1	5.6	6.8
Appreciation	6.2	8.0	3.1	0.6	0.4	1.1	2.8
NCREIF total returns by property type							
Apartment	10.3	12.0	7.3	1.7	1.3	6.4	9.6
Hotel	11.1	13.2	4.7	0.7	(0.2)	4.4	8.3
Industrial	13.4	14.9	12.3	3.0	2.8	7.3	10.1
Office	11.5	12.5	6.2	1.4	1.3	5.9	9.4
Retail	13.1	15.3	9.0	1.6	1.6	8.2	10.7

Sources: NCREIF, NAREIT, Bureau of Labor Statistics, Morningstar and Moody's Analytics as of March 2017.



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