

Q4

Think
U.S. cities
Trends and tactics
Q4 2019 outlook

Tomorrow's view

Continued growth but trade risks are rising

The U.S. economy is entering its 11th year of expansion, the longest since 1854. During Q2 2019, the U.S. economy grew at an annualized rate of 2.1% and is on track to grow around 1.8% in Q3 2019.¹ Strong employment and solid household income growth should support consumer spending during the next two quarters of 2019. We expect the U.S. economy to grow between 2.0% and 2.5% in 2019.

During the July 2019 Federal Open Market Committee (FOMC) meeting, the Federal Reserve lowered the target range for federal funds rate to 2.0 – 2.25%. Should the U.S. economy enter a recession, the Federal Reserve will have little room to cut the federal funds rate significantly. The federal fund futures market is pricing in a 95.8% chance that the FOMC will continue to cut rates by the end of 2019, the consensus likelihood of a recession this year remains at 31%.²









In our view, the key risks to U.S. economic growth and, by extension the U.S. real estate market, are the U.S-China trade war and slowing global economic growth. To-date the trade war has minimally affected U.S. economic growth but an increase in the amount of tariffs would hurt U.S. consumer spending and would hurt businesses that rely on trade and global supply chains to generate revenue.

U.S. real estate prices rose 1.8% in the 12 months ending July 2019, a modest increase relative to the past several years.³ The NFI-ODCE saw a total return of 5.46% net of fees for the year ending Q2 2019. NOI grew 4.8% during this time period.⁴ Given the maturity of this real estate cycle, we expect NOI growth to generate the majority of U.S. real estate total returns in 2019.

Sources:

- 1 U.S. Bureau of Economic Analysis
- 2 CME FedWatch Tool, August 2019
- 3 Green Street Advisors, Q2 2019
- 4 NCREIF, Q2 2019

Fig. 1: Current economic health

Country	GDP	Retail sales	Job growth	Inflation	Bond yields
United States ¹					
Canada ¹					

Notes: Weather icons constitute projected performance relative to past trends (i.e. sun constitutes more favorable outlook relative to previous quarters/years). Bond yields are illustrative of whether they are supportive of real estate pricing.

Tomorrow's view

Economic and financial market forecasts

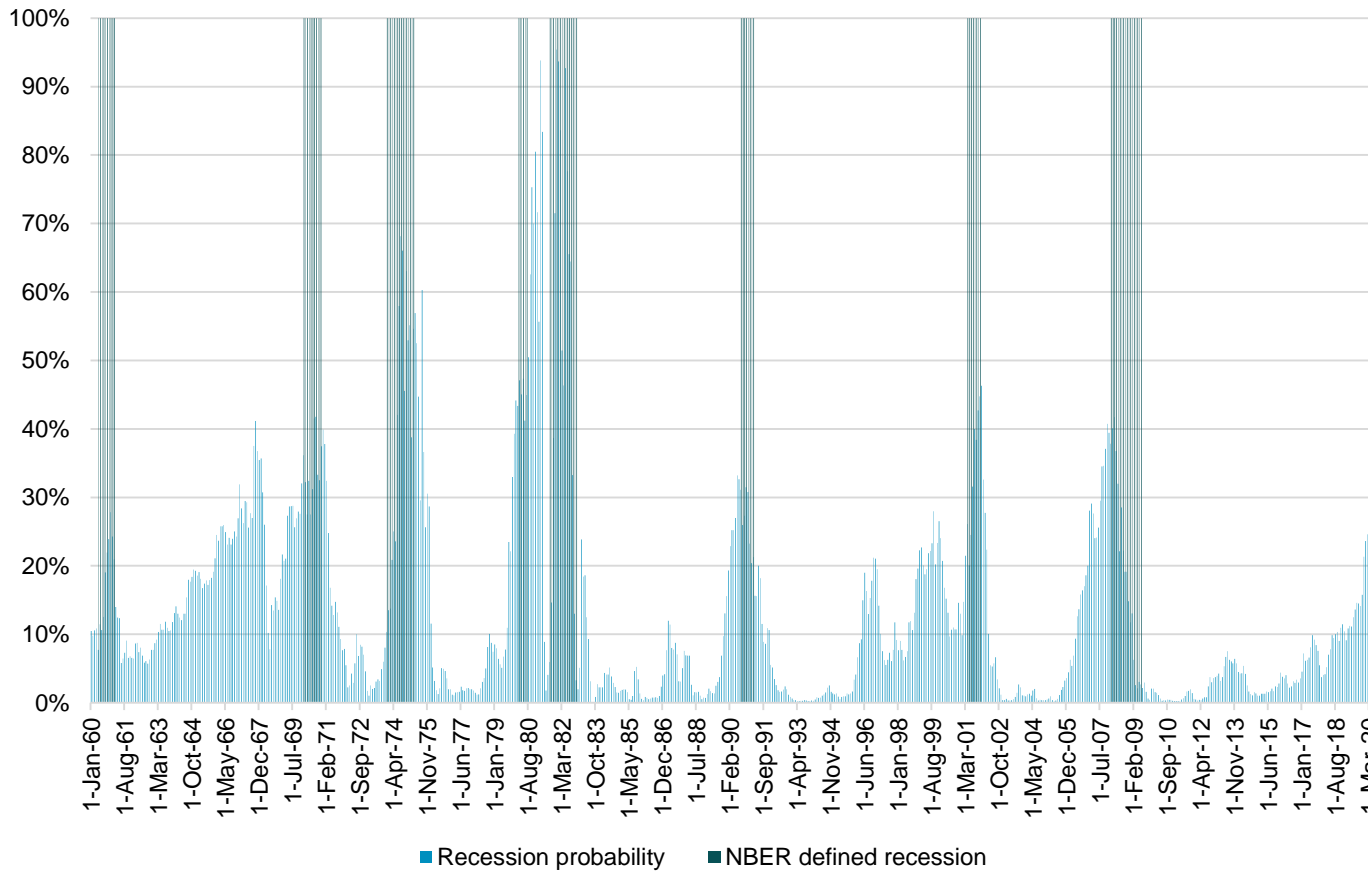
United States	Expansion average 2009-2018 ¹	Q2 2019 ¹	2019*F	2020*F
Real GDP	2.2	2.1	2.5	1.8
Consumer Price Index (growth per year)	1.6	1.8	1.8	2.1
2-year U.S. Treasury Bills (yield per annum)	0.9	1.8	1.9	1.9
10-year U.S. Treasury Notes (yield per annum)	2.5	2.0	2.2	2.3
Unemployment rate	6.8	3.6	3.7	3.7
Recession probability	N/A	N/A	31.0	N/A

Source:
¹ Bloomberg, Q2 2019
 * Forecasted value

Tomorrow's view

Bond market suggests recession risks are rising

Fig. 2: New York Fed yield curve-derived recession probability¹



Source:

¹ New York Federal Reserve, July 2019

Recession indicator is based on the spread between the 3-month T-Bill and 10-year US Treasury yield

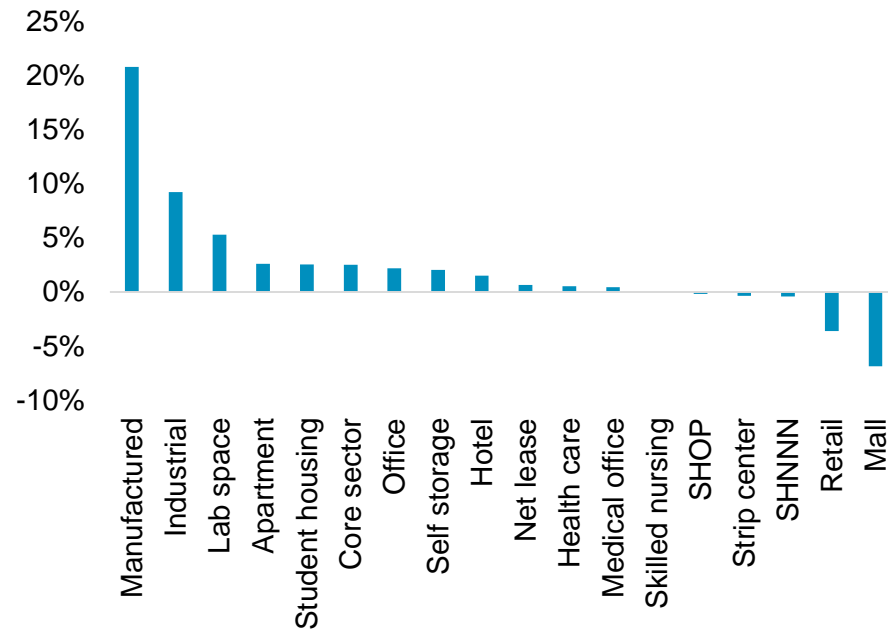
Key economic risks

- *Deteriorating global growth landscape*
- *Brexit*
- *Escalating trade war*
- *Prolonged currency war*
- *The rise of populism globally*
- *Nearly \$17 trillion of bond globally with negative yields*
- *Rising recession probability*

Tomorrow's view

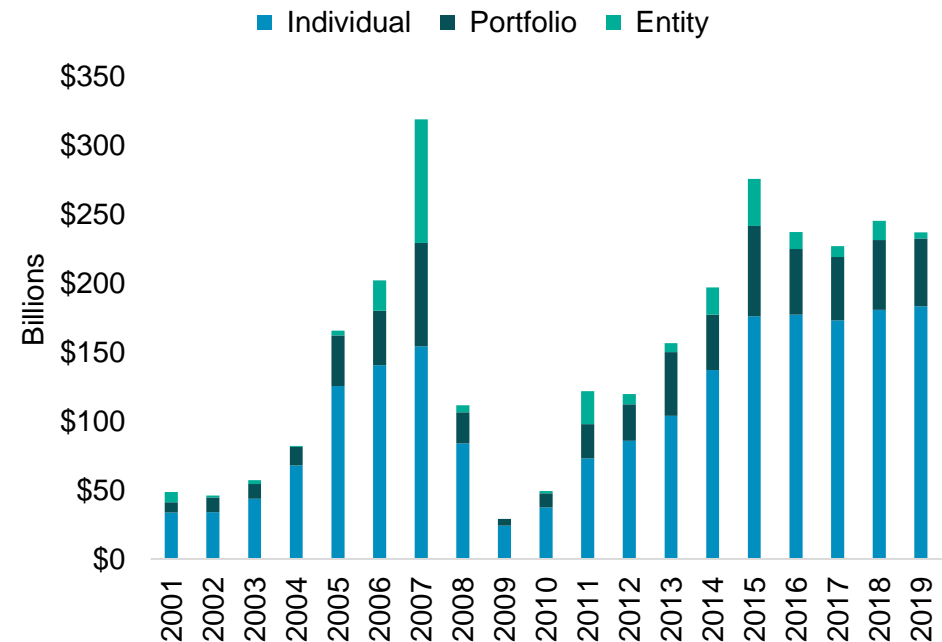
U.S. real estate values remain steady

Fig. 3: Property prices by type YoY ending June 2019¹



*Core Sector consists of mall, strip center, office, apartment and industrial categories

Fig. 4: U.S. total transaction volume January - July²



According to the Green Street Advisors' Commercial Property Price Index, property values, in aggregate, rose 1.8% in July 2019 relative to one year ago. Manufactured housing saw the strongest price appreciation, followed by industrial and lab space while mall values fell 6.9% during the last year and are down nearly 22% from their January 2017 peak.¹ During the first half of 2019, U.S. individual and portfolio transaction volumes remained in line with that of the last several years but entity transactions are 1/3 of the previous year's level. Despite the escalating trade tensions, cross-border transaction volumes increased in the first half of 2019 versus the same period in 2018 as shrinking capital flows from China and Canada were offset by an uptick in allocations by investors from Germany.

Sources:
 1 Green Street Advisors, Q2 2019
 2 Real Capital Analytics, Q2 2019

Tomorrow's view

U.S. real estate fundamentals to remain solid in 2019

Fig. 5: Vacancy rates across property types¹

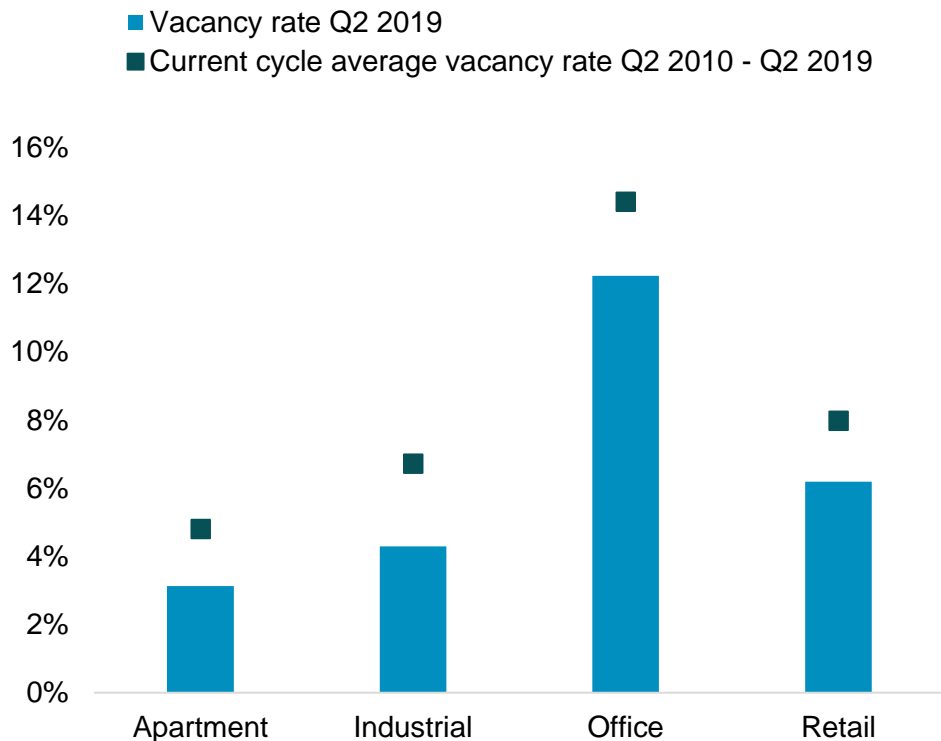
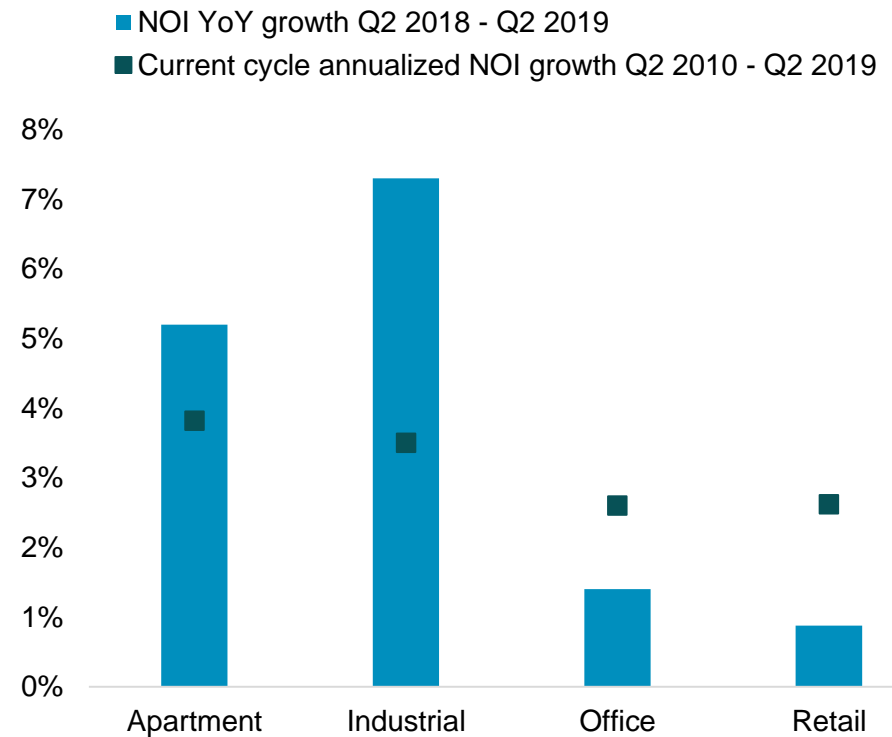


Fig. 6: Current cycle rent growth²



Supply and demand continue to remain roughly in balance which has driven above inflationary rent growth. We expect real estate fundamentals to continue to remain solid as long as the U.S. economy can generate at least 1.5% to 2.0% growth per annum.

Sources:
 1,2 NCREIF, Q2 2019, Axiometrics, Q2 2019

Alternatives

Driven by demographic trends

Fig. 7: Trends in U.S. demographics¹

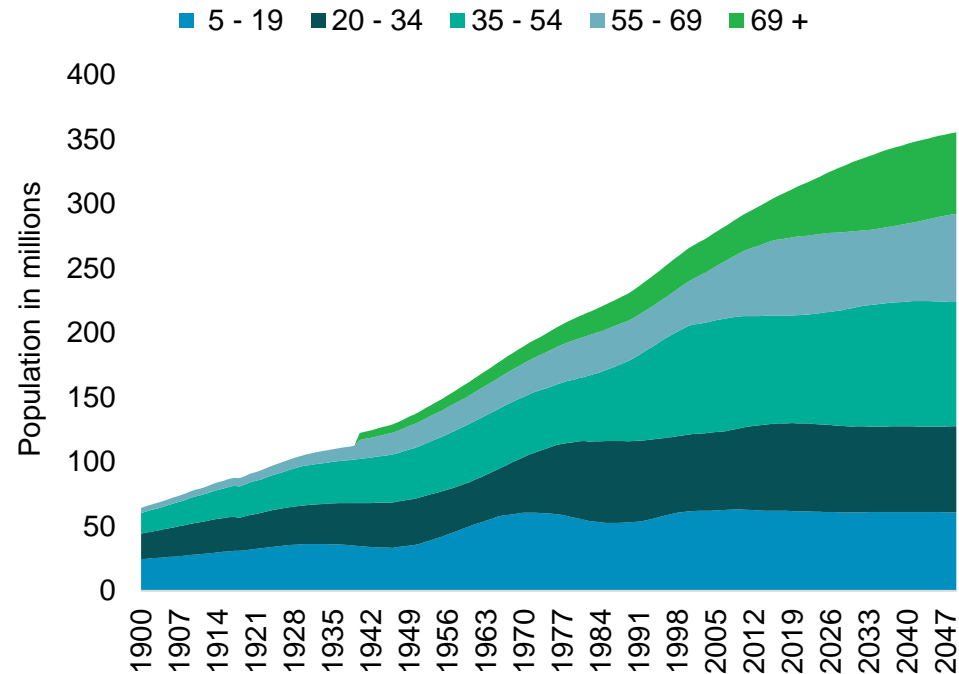
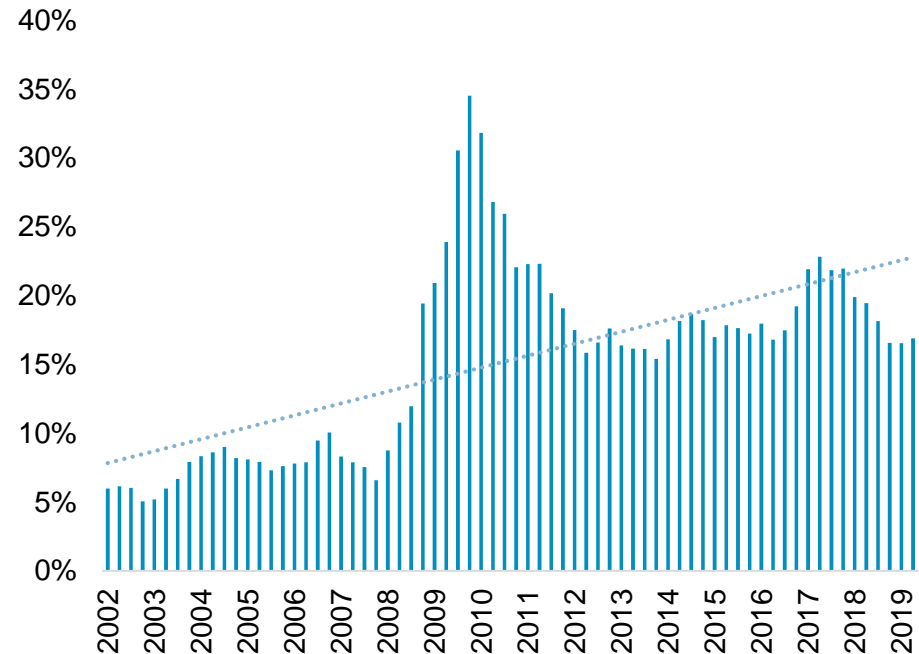


Fig. 8: Annual U.S. alternative transaction volumes as % of total transactions volumes²



The U.S. population is aging and will continue to age in the coming decades. The corresponding uptick seen in the past ten years in alternative transactions volume (senior housing, elder care, assisted living, skilled nursing and healthcare in general) is likely to be a long-term trend. Transactions in the alternatives sectors comprised 17% of total real estate transactions during the first half of 2019, just below this cycle's 20% average.

Sources:
 1 U.S. Census Bureau, 2018
 2 RCA, Q2 2019

Industrial

Sunbelt cities are seeing strong industrial absorption

Fig. 9: Retail sales vs. industrial sector net absorption¹

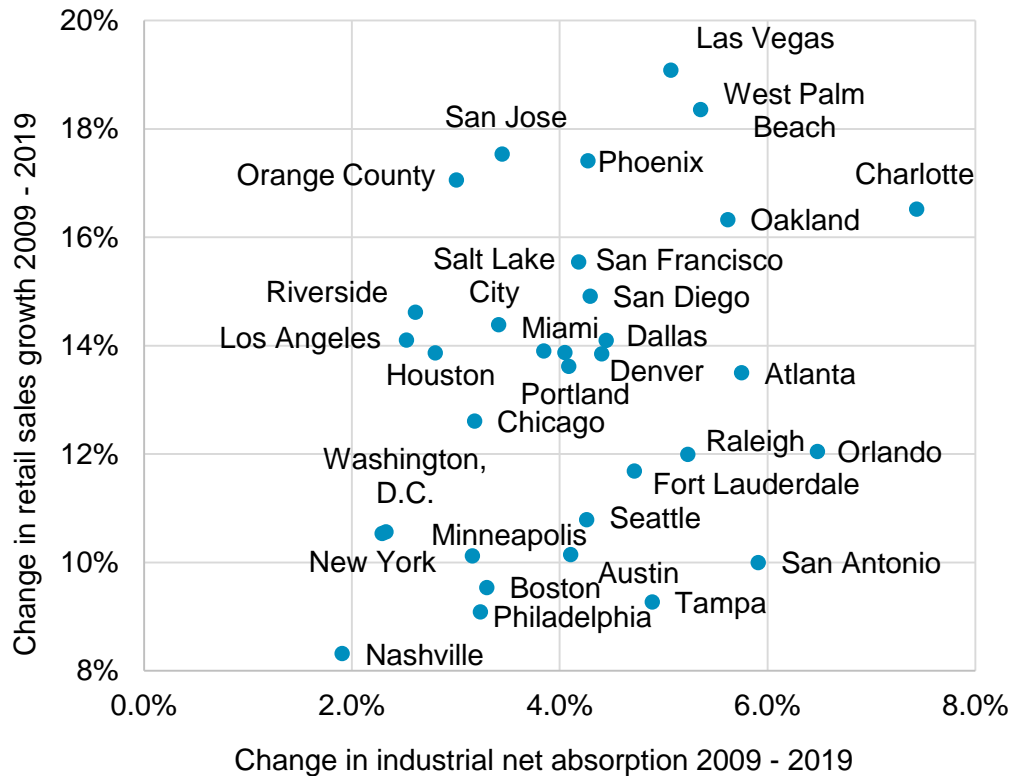
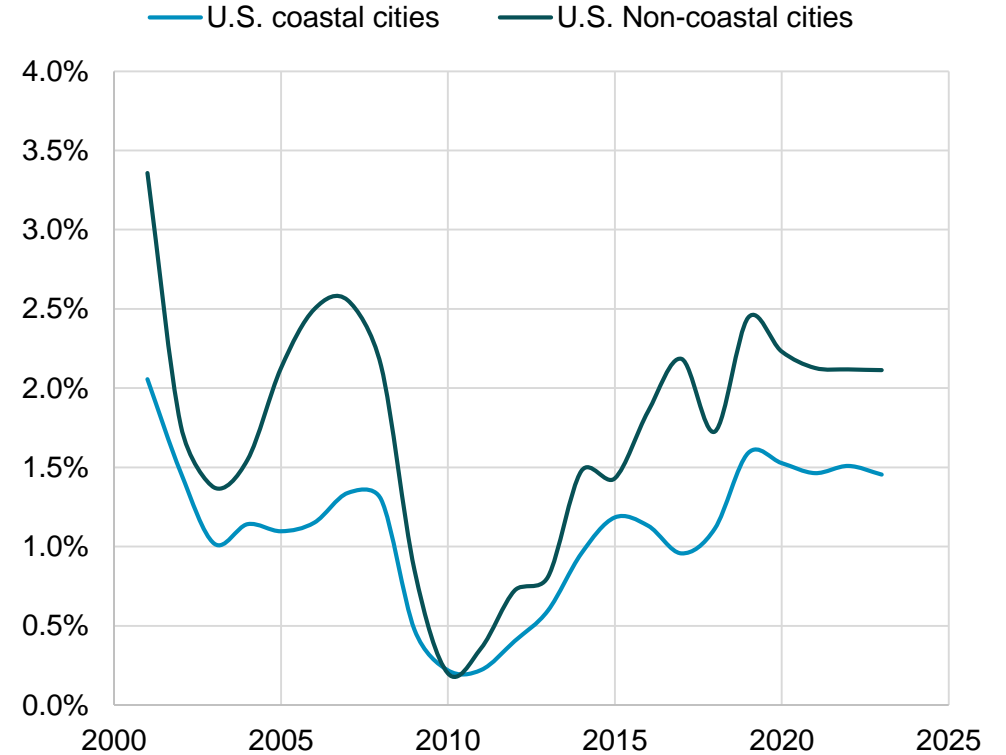


Fig. 10: Coastal cities industrial supply growth²



During the current expansion cycle, major warehouse markets along the Boston – Washington, D.C. corridor saw a slower pace of both retail sales growth rate and industrial absorption rate than sunbelt and California’s Bay Area warehouse markets. The sunbelt markets saw the strongest amount of warehouse net absorption relative to other U.S. regions. Much of this strong net absorption was due to strong consumer spending.

Sources:
 1 GCBRE-EA, U.S. Census Bureau, Q2 2019
 2 CBRE-EA, Q2 2019

Office

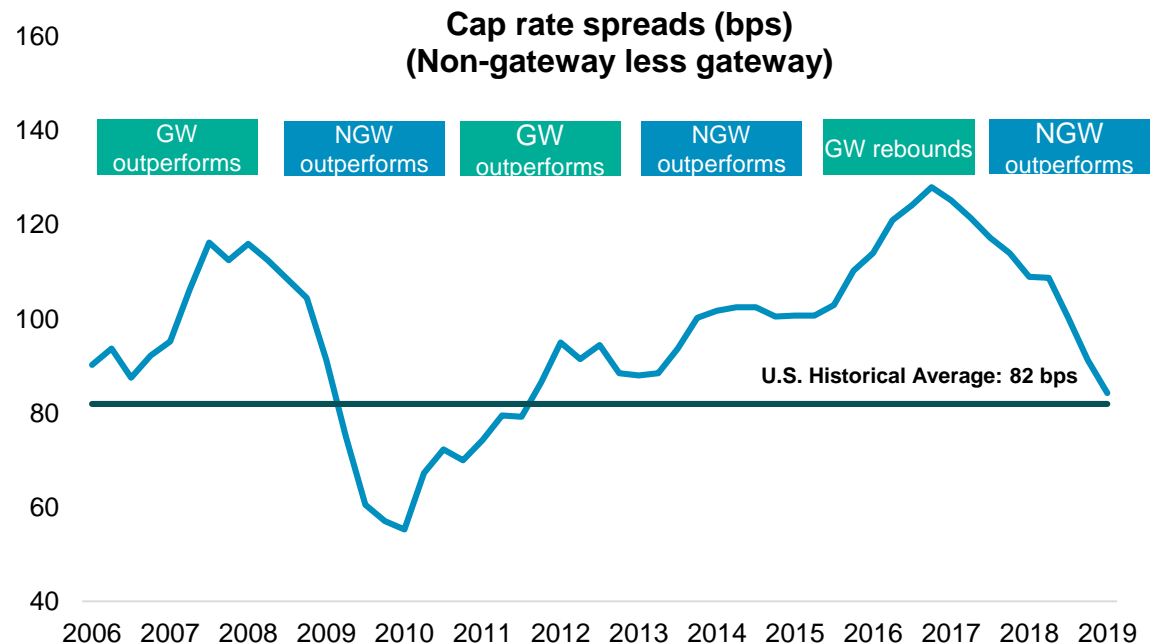
Gateway versus non-gateway office markets



On average, suburban office properties trade at an 82 basis point premium to gateway office markets. Tracking the cap rate spread¹ between gateway and non-gateway offices provides insight into when pricing is more attractive in suburban versus urban office market locations. Currently, non-gateway markets are set to outperform but this will change should pricing in gateway office markets become more attractive.

Competition for talent is shaping the growth of emerging Class A markets in areas traditionally represented by Class B and C product. Adaptive re-use projects, new amenities, partnerships with local universities, local retail and live-work-play environments are redefining what constitutes Class A space across markets. Some of the top technology tenants are growing their presence in Midtown-South in Manhattan, Fulton Market in Chicago, Bakery Square in Pittsburgh and Arts District in Los Angeles. Historically, these were not office submarkets targeted by institutional investors but this is changing as these submarket emerge as true office locations.

Fig. 11: U.S. gateway vs. non-gateway office markets²



Source:

1 The cap rate spread is the difference between the cap rate for Gateway Office markets and Non-Gateway Markets.

2 NCREIF, Q2 2019

Gateway Markets include: Boston, Los Angeles, New York, San Francisco, Washington D.C.

Housing

Steady appreciation across major U.S. markets



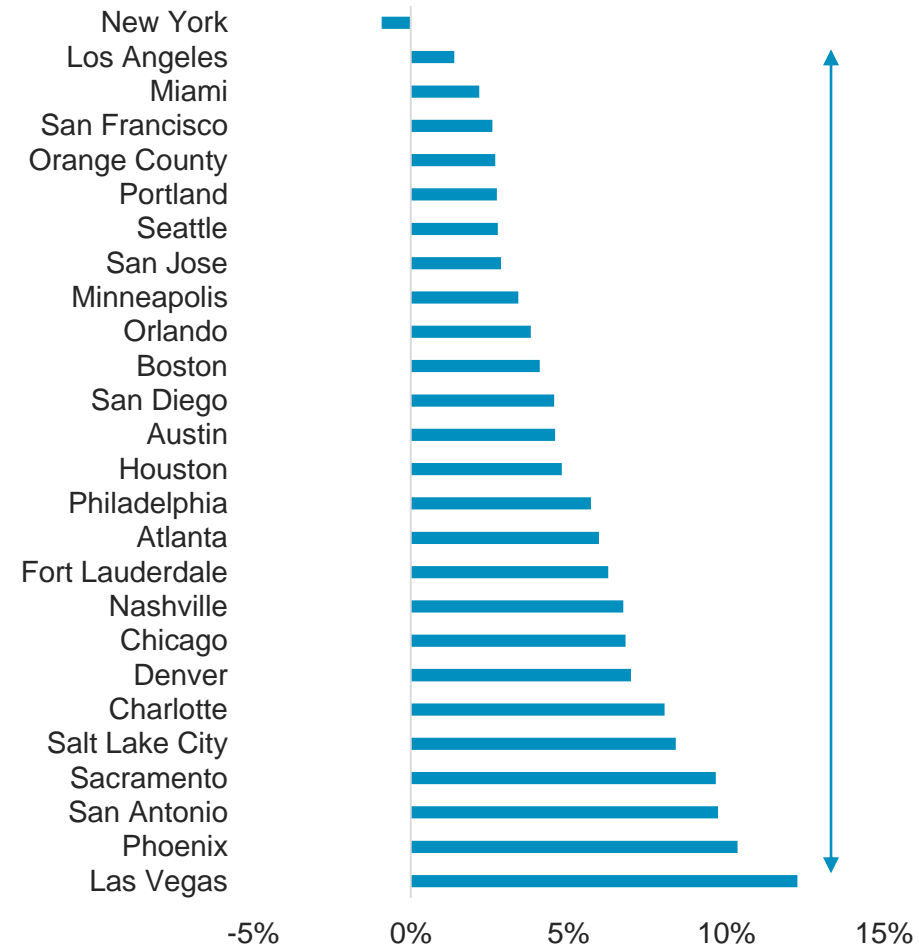
Demographic trends continue to support strong demand for rental housing across U.S. urban markets. Las Vegas, Phoenix, San Antonio and Salt Lake City have experienced 5%-10% appreciation growth during the last year. Meanwhile, appreciation for New York apartments has fallen during the last year.

The New York State governor signed historically significant rent control regulations into law in June 2019. This new legislation allows all counties in New York, beyond the currently covered New York City boroughs, to opt into the rent control system. Outside of New York, apartment rent controls are either being implemented or made stricter across California, Washington and Oregon.

The implications of rent control might already be traceable through the appreciation rates across the markets capping the rent increases and amounts allowable for CapEx on individual apartment units (IAI).

The longer-term consequences of apartment rent controls typically reduce the amount of apartment supply as rent controls make development less profitable. For landlords of market rate apartments, the reduction in overall supply is a benefit.²

Fig.12: U.S. apartment markets Q2 2019 year-over-year appreciation¹



Sources:
 1 Green Street Advisors, Q2 2019
 2 Nuveen Research, Q2 2019

Retail

Generations Y+Z reshaping spending

Fig. 13: Share of total spending during the past 5 years

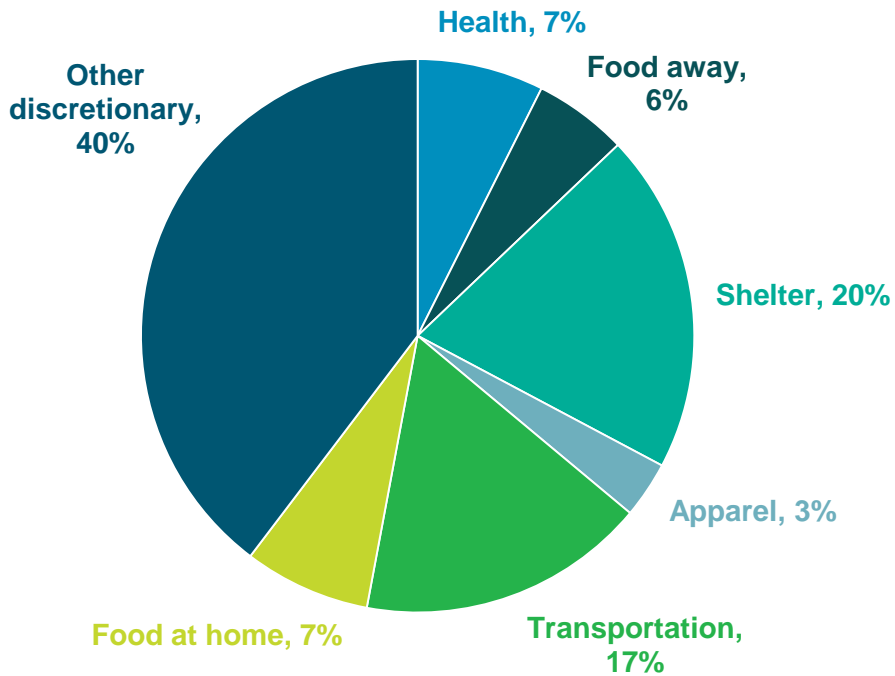
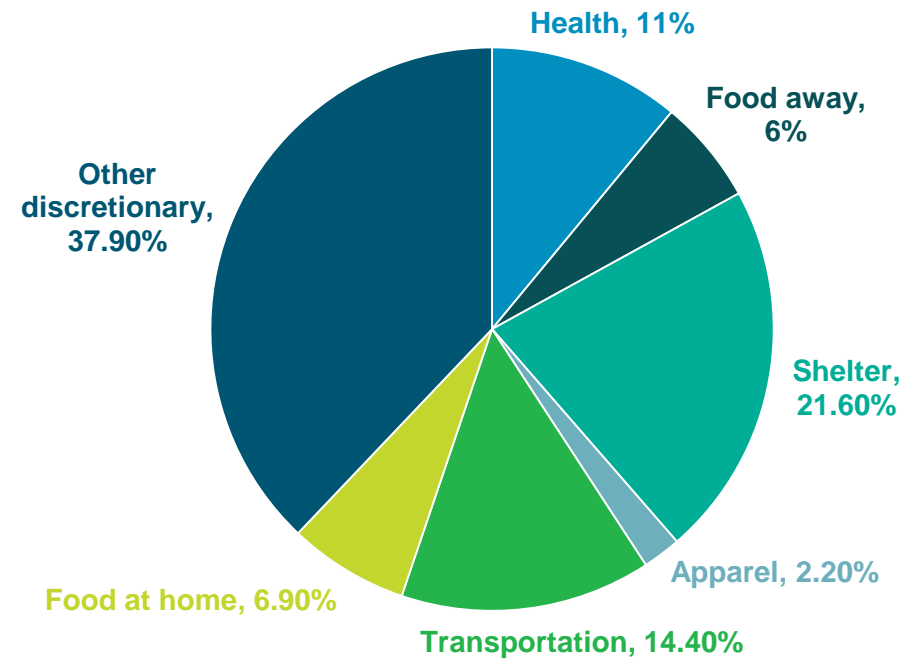


Fig. 14: Share of total spending projected for the next 15 years



Generations Y and Z are reshaping the retail landscape. They are buying more organic and healthy produce and are likely to spend more on self care as they age. These trends will continue during the next 15 years, resulting in higher spending in health and shelter with less spending on transportation and food at home. We expect apparel spending will continue to decline in the next 10-15 years.

Commercial mortgages

Apartments have highest recovery rates

Fig. 15: 2018 lender composition by investment style¹

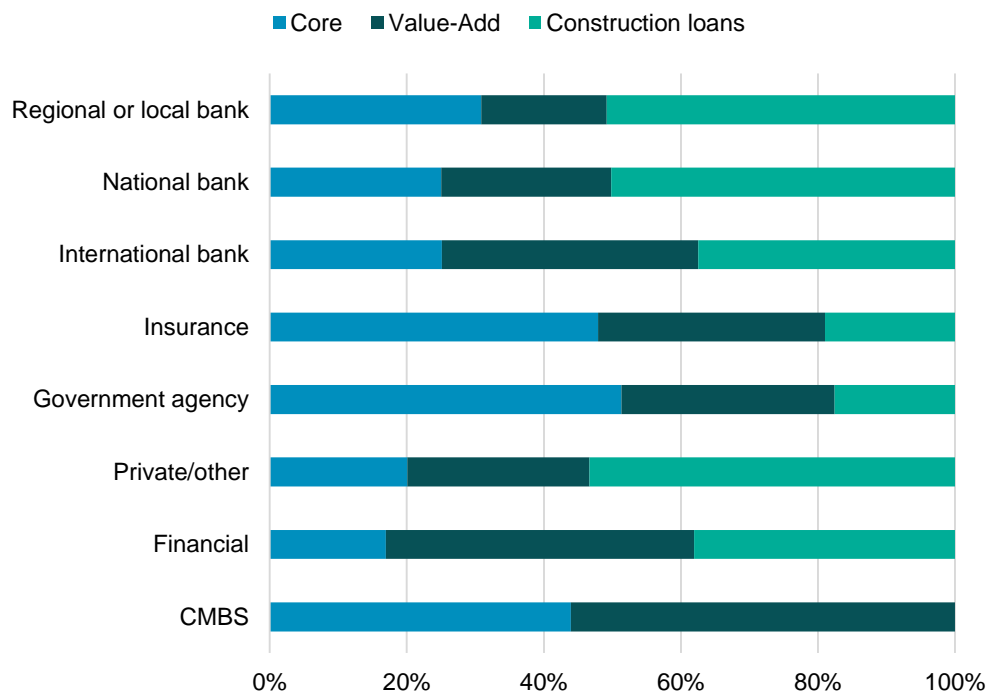
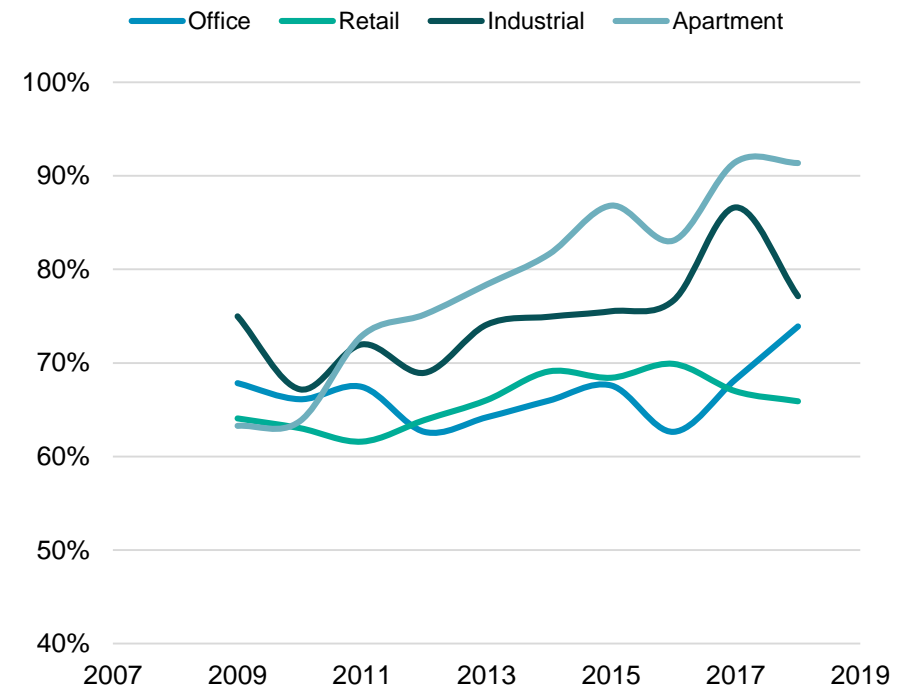


Fig. 16: Residential and commercial debt recovery rates²



Regional, national and international banks, as well as private debt players comprise the majority of all property construction lending. Government agencies, financial companies and CMBS make up a majority of the value-add lending strategies. Apartments have one of the highest recovery rates at 85%. Charlotte apartments recorded the lowest recovery rates across all U.S. markets, at just above 70% percent, followed by Atlanta and Manhattan markets (80%), and Houston (83%). The industrial sector's recovery rates have fallen from their 87% peak in 2017 reaching 77% as of Q2 2019.

Sources:

1 RCA, Q2 2019

2 RCA, Q2 2019

Tomorrow's cities

Tactical calls and market themes

Fig. 17: U.S. short-term city selection

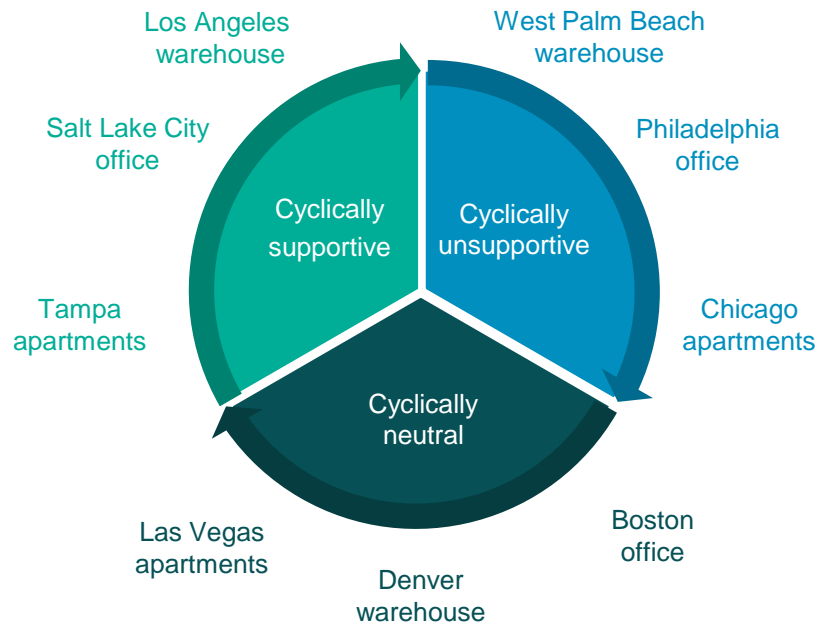
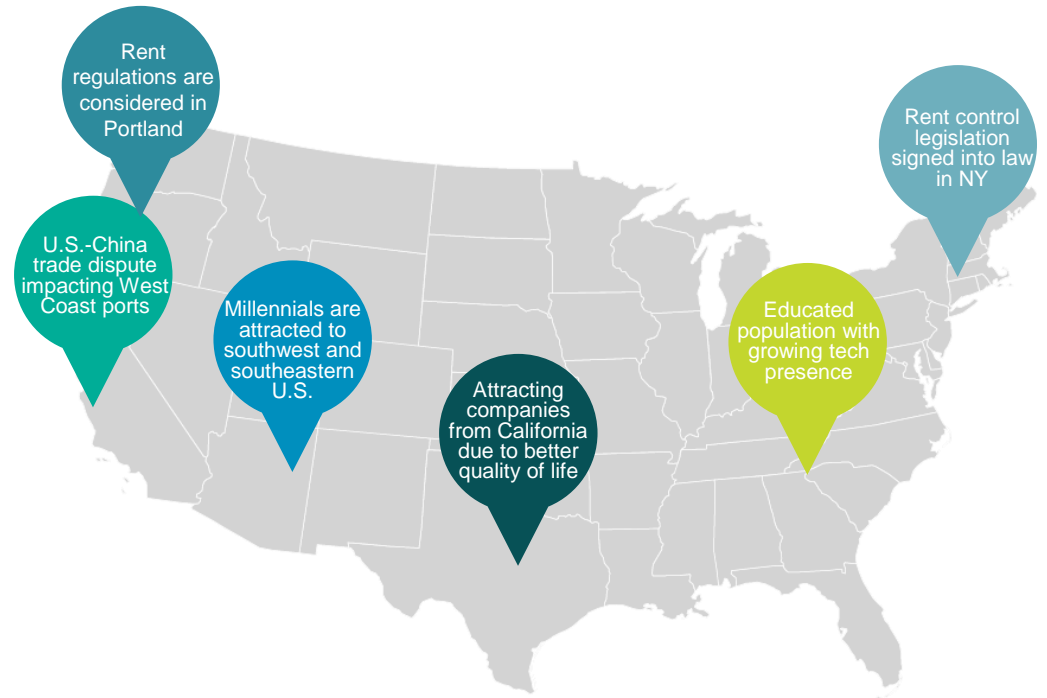


Fig. 18: Key U.S. market themes



At this stage of the current U.S. real estate cycle, carefully choosing markets and property types in which to invest remains critical. Our continued work on disruptors to commercial real estate and key trends across the different sectors directly contribute to which of our 'tomorrow's cities' and property types we believe will outperform in 2019 and beyond.

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