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RESEARCH NEWSLETTER

Tighten Those Seatbelts

In 2016 Fortune Will Favor the Balanced Over the Bold

While 2015 was not as advertised, it was largely as we expected. As late as December 2014, a Wall Street Journal survey of economists projected the 10 year Treasury rate to end the year at 3.2%, 100 basis points above the actual year-end rate. This was based on expectations of accelerating economic growth, rising inflation, and resultant Fed rate hikes – none of which occurred. Instead, 2015 started out with an economic whimper as first quarter GDP contracted 0.2%, in stark contrast to the same WSJ forecast of a 2.8% advance. Inflation declined in two of the first three months of the year on a year-over-year basis, putting the previously expected mid-2015 Fed rate hike on hold.

As we predicted in our spring research newsletter, **"Spring Transition Brings Stormy Weather"**, there was significant financial market volatility. Daily price movements in Treasuries spiked to 2.5% in June, the highest level for a spring period since 2009 and the equivalent of an average daily price move of 450 points in the DJIA. Financial market volatility then transitioned from the bond market to both domestic and global equities. Intraday price movements in the DJIA more than doubled from 178 for the first eight months of the year to 354 for the period from August – September, while Chinese equity markets increasingly resembled a rollercoaster. Collectively, this resulted in Treasury rates ending the summer four basis points below the previous December as investors continued to seek safe haven assets.

In spite of a year-end spike in equity market volatility driven by increasing concerns surrounding high-yield debt, the Federal Reserve raised the discount rate target 25 basis points in December. This was a welcome relief to those who saw this as a signal of the Fed's belief that the U.S. economy was able to withstand a rate hike in spite of events at home and abroad. The actual calculus likely signals less the Fed's positive outlook on the U.S. economy and more its weighing the risks of increasing rates in the face of weakening global economic growth against the need to "reload" its monetary bullets before the next recession

Real Estate Performance

During the course of 2015, commercial real estate returns continued to defy consensus return expectations. Conventional wisdom at the beginning of the year was for more normalized long-term returns in expectation of moderating appreciation rates due to an anticipated increase in interest rates and the resulting upward pressure on cap rates. However, much as we anticipated, interest rates largely remained flat and inflation non-threatening. As financial market volatility increased, returns were in line with our projections as commercial real estate once again experienced strong rates of appreciation, mirroring investors' continued flight to asset classes offering favorable income yields and relative stability.

In our November 2014 newsletter, we predicted that during the course of 2015 investors would succumb to the siren song of smaller markets offering higher initial yields, in sharp contrast to our disciplined approach of focusing on markets offering a combination of superior long-term income growth prospects and pricing resiliency subsequent to a downturn. This largely turned out to be the case during the year, and, as economic weakness played out in the latter half of 2015, those investors are now becoming increasingly concerned about pricing levels and future performance, while our approach already has us well-positioned for 2016.

Property fundamentals[1] were increasingly strong across all property sectors, with multi-family and industrial assets surprising most – including us – to the upside. Unexpectedly robust demand combined with limited supply created stronger than anticipated gains in occupancy and rents. Year-to-date (through third quarter of 2015) multi-family net absorption is 187,000 units, more than double the 2005-2007 average of 89,000 units, and the vacancy rate stands at 3.7%, well below the 2005-2007 average of 5.8%, all leading to higher year-over-year rent growth. Industrial net absorption is a robust 112M SF, yet supply year-to-date remains in line with the 2005-2007 average.

As a result, the 8.1% industrial vacancy rate is well below the 2005-2007 level, leading to robust year-to-date rental growth rate in the sector.

Office demand, although less robust than in the previous cycle, combined with exceptionally limited supply to produce strong rent growth in the sector for 2015. Year-to-date office net absorption is 68M SF, healthy but down from the 2005-2007 average of 90M SF, and supply remains muted compared to prior recoveries. As a result, rent growth year-to-date has been strong at 4.3%, mirroring the 2005-2007 average.

Lastly, retail, also benefitting from limited supply, remains in the earlier stages of its recovery and, we believe, has yet to realize its rent gain potential. 2015 retail net absorption was 54M square feet, down significantly from the 2005-2007 average of 132M SF as was supply, leaving the national retail vacancy rate at 5.9% with year-over-year rent growth of 2.7% versus the 2005-2007 average of 4.3%.

2015 was another Goldilocks years for commercial real estate. Continued low yields, just enough financial market volatility to drive increasing capital flows to the relative stability of the asset class, and strong property fundamentals creating a favorable environment for commercial real estate returns.

The Five C's of 2016

Lenders use the five C's of credit – Character, Capacity, Capital, Collateral, and Conditions – to evaluate prospective borrowers. We evaluate the prospects for the 2016 investment environment using our own five C's: Consumer spending, China, (investor) Confidence, Central bank policies, and Crude (oil).

Consumer Spending

Consumer spending will be pivotal to 2016 U.S. GDP growth. Business investment is likely to come under increasing pressures as profits and revenue growth face continued headwinds including a strong dollar, weakening global growth, unstable financial markets, rising credit risk premiums, and eventual wage pressures. Consumers are beginning the year well-positioned to drive economic growth, with debt levels and debt service ratios down and household wealth up. Purchasing power has increased as a result of low energy costs, the strengthening dollar and continued employment growth. How much these factors translate into increased consumption depends on consumer confidence.

Consumer spending is critical to both the U.S. economy and to the U.S. commercial real estate sector. Today, occupancy rates and rent levels across the four main property types are near or even above previous highs. Future gains will be directly impacted by U.S. economic growth and levels of consumer spending. While this impact will be most directly felt by retail assets, industrial assets will benefit since goods require warehousing and sorting. Office and multifamily housing will also be influenced by consumer spending, as many office tenants include consumer products companies, and many renters work for companies in a wide variety of industries including goods manufacturers, transportation and warehousing industries, and professional and business services, impacted by consumer spending.

China

The second largest economy is currently experiencing turbulence in both its economy and financial markets, as China's leadership continues the balancing act of transitioning to more of a consumption-based model, liberalizing financial markets, and attempting an orderly depreciation of its currency. Any large-scale economic transition involves risk, and the speed and magnitude of the evolution of the Chinese economy and financial markets poses significant challenges for global financial markets – especially within the equity markets. As a result, even absent a hard landing, continued deceleration in China's rate of economic growth and sustained financial market volatility will negatively impact global economic growth and equity markets, depressing investor sentiment.

(Investor) Confidence

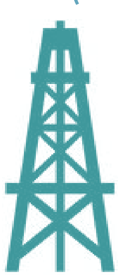
Investor confidence will have a material impact on equity markets, interest rates, risk premiums, and real estate returns. We expect diminishing investor confidence in 2016 with continued volatility in equity markets and currencies, weakening global and domestic manufacturing activity, commodity price volatility, divergent central bank policies, and increasing risks of conflict in the Middle East. This will negatively impact capital flows to equity markets, and safe-haven assets should benefit, potentially perpetuating today's favorable long-term rate environment. Spreads between higher and lower quality credit bonds will increase as investors require greater risk premiums, placing increasing pressure on high-yield debt and opening the door for stress to seep into other areas of the corporate bond market.

Absent a severe and importantly, sustained decline in equity values and a resulting over-allocation to commercial real estate, increasing investor preference for safe-haven assets should result in positive capital flows to real estate offering relative income stability and favorable total return potential. We expect core real estate strategies to shift from the yield-chasing seen in 2015 toward strategies focused more on stable income streams, including a reemphasis on higher quality assets with longer term leases in place, markets with greater liquidity, and, most importantly, markets that feature resiliency in the face of adversity. We began advising investors to depart from the herd and take this approach back in 2014 in our newsletter titled, "Two Roads Diverged". This allowed investors time to begin positioning their portfolios for what looks to be an increasingly uncertain and volatile 2016.

Central Bank Policies

Much like in 2015, investors are likely to continue to hyper-fixate on the Federal Reserve and thus potentially miss a key part of the interest rate story – foreign central bank policies. While the Fed will probably increase short-term rates only moderately due to a variety of domestic and global factors, key foreign central banks including the European Central Bank, Bank of Japan, and People's Bank of China will engage in more aggressive monetary policy. As a result, as we outlined in our research newsletter, *"Fed Rate Hikes: More Texas Hill Country Than Rocky Mountains"*, increases by the Fed will have a greater impact on the economy and financial markets than they otherwise would on their own. For example, a 25 bps move by the Fed combined with the ECB lowering rates by 25 bps resulting in an effective 50 bps move to the U.S. markets. This combination of rate movements and their potentially destabilizing effects vis-à-vis capital flows, currency devaluations, and commodity pricing (especially on economies highly dependent on foreign direct investment and commodity revenues) should bear close attention as opposed to viewing Fed rate moves in isolation.

Crude (Oil)



Lower oil prices will positively impact consumer purchasing power as reduced gasoline prices place more money in the hands of consumers. How much of that money goes into cash registers versus savings accounts depends on consumer confidence. Capital expenditures would also be impacted as some of the strongest growth in recent capex has come from the oil sector. With most forecasts indicating continued low pricing regimes for at least the short to medium term, significantly reduced capex should be expected throughout the sector. The retrenchment by the oil majors also affects companies outside of the industry. For example, steel producers suffer as demand for the steel piping utilized in oil production declines and emerging markets are affected as they import inflation, magnifying their debt burdens, while oil producing countries also face strained finances. Conversely, an intensified conflict in the Middle East would likely cause a spike in oil prices, resulting in reduced consumer purchasing power and, potentially, higher inflation.

2016 Winners and Losers

Aggressive or Conservative?

There are times to stretch for additional yield and shoot for making outsized gains . . . but this is not one of them. Rather, conditions suggest that now is the time to focus on stability, superior income growth, and pricing resiliency as the likelihood of an economic downturn or financial instability event increases. There is more downside to being overly aggressive than overly conservative. Investors are being shown definite signs that support overweighting the more conservative end of the risk spectrum.

Despite the warning signs, some investors continue to take on more risk, seeking out smaller markets in search of marginally higher yields at a time when prices are elevated, the economic recovery is entering the mature phase, global growth is weakening, and financial market volatility is increasing. This is likely happening since multi-asset investors are facing weak equity and bond returns and are incorrectly relying on commercial real estate to be the alpha generator in their portfolio. This view leads some real estate funds to acquiesce, most noticeably by entering secondary and even tertiary markets in search of those extra basis points of return potential. This has happened in the past, as investors convince themselves to take on risk because they generally don't include recessions in their underwriting. Since they don't take into account the longer period of time smaller and more liquidity constrained markets take to recover values and the greater impact that recessions generally have on those markets, this approach usually ends badly.

For Core Investors:

- "Don't get caught in the middle": Assets with either immediate lease rollover or long-term leases should perform better in the near-term in the event of an economic downturn while providing more stable returns over a longer-term hold.
- Focus on quality credit: Assets with higher credit tenants with greater access to financing should provide more stable returns both in the short-term and over the market cycle.
- Choose markets wisely: Invest in markets that demonstrate ability to withstand economic downturns, and to recover value more quickly following a recession. Markets that don't go in and out of favor depending on where we are in the cycle will fare better, especially in the event of a liquidity shock.
- Pay attention to supply constraints: As real estate enters the heart of the supply-response cycle over the next several years, markets that are less prone to excessive supply should do better in the near-term, as well as over the long-term.

For Value-Add investors:

- Speed matters: If investors believe that the current economic recovery is long in the tooth, the time it takes to execute a value-add strategy will play a significant role in determining tomorrow's value-add winners.
- Income matters: Yes, income does matter in value-add deals, especially today. Especially when achieving appreciation returns becomes more challenging, in place income goes a long way to achieving underwritten returns, and, at this point in the economic cycle, tilting the components of expected returns back toward income could have significant benefits in a low return part of the cycle.

The Seatbelt Sign Remains Illuminated

In 2015, we advised investors to put on their seatbelts and this proved to be useful in an increasingly bumpy environment. As the early days of 2016 already more closely resemble a rollercoaster than a lazy river, we think it's time to tighten those seat belts. While you are free to move about and invest throughout the country, astute investors will become increasingly selective as to where they place capital in the coming year.

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[1] Property fundamentals information based on CoStar data

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