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Research *in* Brief

Christopher Macke
Managing Director, Research & Strategy

Stanley Iezman
Chairman & CEO

BREXIT: Minor Headache or Migraine?

Much to the surprise of financial markets, the U.K. voted to leave the European Union. In addition to the near-term financial market implications, there are very real economic ramifications not only for the U.K. and the Eurozone, but for the global economy as well. While recent financial market events do not signal the world is ending, Brexit is certainly going to create a headache for some time.

U.S. commercial real estate will feel the effects as investors seek out the relative stability of both the U.S. and private commercial real estate. As we have been taking an increasingly defensive position since the fourth quarter of 2014, no major or abrupt changes to our investment strategies are necessary.

The 1st 30 Days:

The immediate question is primarily financial market related: Will the vote translate into a financial instability event or be contained within a manageable range of volatility?

What to expect...

1. Significant increase in market volatility across markets and asset classes as investors sort out the financial market and economic implications
2. Downward pressure on high quality fixed income yields and upward pressure on lower rated fixed income yields
3. Increased Fed constraint
4. Increasingly cautious investor sentiment
5. Dampening of business confidence

What to Watch:

1. Does market sentiment stabilize in next 30 days or does it create a broader reduction in market liquidity and an extended, downward trend in equity markets
2. Does market instability impact CMBS yields

The 1st Year:

Here the primary question is related to the real economy: Will the global economy be tipped into recession?

What to expect...

1. Increased foreign capital flows to the U.S. as investors place an even greater value on the relative stability of the U.S.
2. Dampened business investment and hiring in the face of heightened uncertainty regarding the future of the U.K. and the Eurozone
3. Negative implications for Chinese economic growth as the Eurozone is China's largest trading partner
4. Rising U.S. dollar placing downward pressure on U.S. export competitiveness and corporate profits
5. Increasing pressure on dollar denominated debt with greatest implications for commodity based economies

What to watch:

1. How much do companies pull back investment and hiring
2. How much are corporate profits and consumer sentiment impacted

Beyond the 1st Year:

The future and form of the Eurozone becomes the primary question: Who stays, who goes?

What to expect...

1. Significant speculation and uncertainty regarding additional Eurozone defections
2. Continued negative effects of uncertainty on business investment and hiring

What to watch:

1. Does the EU maintain its current membership or shrink, and if so, to what degree?
2. Which countries are economic winners and losers

CRE Implications:

Acquisitions:

1. Lower yields and greater uncertainty further increases appeal of commercial real estate's yields and relative stability, subject to the occurrence of a significant and extended decline in equity values, causing a need for asset allocation rebalancing
2. Increasingly selective buyers further the shift toward higher quality assets and "name brand" markets

Financing:

1. Market instability may negatively impact CMBS
2. If financial markets become impaired enough, debt availability may be reduced

Investment Strategy Implications:

Beginning the fourth quarter of 2014 we began taking an increasingly defensive position and preparing for the next phase of the current economic and credit market cycle. As a result, major adjustments to our strategy outlined below are unnecessary.

1. Overweight larger markets and markets with greater likelihood of economic, pricing, and capital flow resilience subsequent to a negative economic or financial market event
2. Overweight markets with superior economic drivers such as elevated education levels
3. Overweight markets with greater long-term supply constraints
4. Selectively buy in markets with advantageous labor and tax environments
5. Overweight assets with longer-term leases and tenants with greater financial wherewithal

Brexit is a reminder that for some time now there has been more risk in being overly aggressive than overly conservative.

FOR MORE INFORMATION, PLEASE CONTACT:

Jay Butterfield | 818.409.3243 | butterfield@americanreal.com

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