GUGGENHEIM

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Guggenheim Real Estate: Market Update

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Economic Outlook and Key Themes[1]

Fiscal boost to growth while trade policy remains a risk

Second-quarter real GDP was boosted by several one-off factors, but the fiscal boost from tax cuts and higher government spending should keep growth strong over the next several quarters, around 3%. Real GDP growth of 3% means the economy is in a late stage, as demographic factors and slowing productivity growth have dragged supply-side sustainable growth down to 1.0-1.5%. Consumer confidence near cyclical highs, tax cuts, and healthier household balance sheets bode well for near-term consumption. The trend rate of job growth should continue to slow. Even so, the unemployment rate could fall to 3.5% by the end of 2018 and even lower in 2019. A tighter labor market and increasing worker shortages will put upward pressure on wage growth, which has been held back by meager productivity gains. Elevated business optimism and tax reform could boost capex in the coming quarters, especially if tariffs concerns fade. One area of weakness will continue to be housing, while deteriorating affordability and limited supply are holding back the sector.

Core inflation is near the Fed's 2% and stronger output growth and reduced labor market slack should push it higher. Inflation modestly above 2% would be welcomed by the Fed to reinforce the symmetry of their target. The main near-term risk is further imposition of tariffs, which could spark higher prices that the Fed has no choice but to lean against with higher rates.

We expect two more Fed rate increases in 2018

As inflation rises and the unemployment rate falls lower than the Fed expects, the Fed will look to keep delivering quarterly rate hikes. Moreover, financial conditions remain accommodative, giving the Fed further room to raise rates and fiscal stimulus will give the economy an additional boost that the Fed will lean against. We expect the Fed will deliver two more rate hikes this year. We expect another four hikes in 2019, more than the market is pricing in. Because the real neutral fed funds rate is currently close to zero, the Fed is already closing in on a neutral stance of policy, and by mid-2019 will be sufficiently restrictive to invert the yield curve. While the 2018 economic outlook is positive, the Fed is moving to increasingly tight policy, which could ultimately result in a recession in a few years as higher rates prove unsustainable, given record high corporate debt levels. Fiscal policy will also turn to a drag in 2020, further raising the risk of an economic downturn.

Slowing of growth in Europe and China

Although eurozone growth momentum has slowed from 2017, inflation should continue to head higher, which has prompted the European Central Bank to announce an end to quantitative easing by this December, setting the stage for a rate hike in the second half of 2019. Tighter monetary policy could exacerbate political risks, particularly in Italy.

Continuing to Asia, recent activity data reflects a slowdown in the Chinese economy. The focus on deleveraging and reducing risk in the financial system is weighing on output, leading policymakers to deploy fiscal and monetary stimulus. Although Japan’s economy picked back up in the second quarter, inflation remains far from the Bank of Japan’s target. Quantitative and qualitative easing policies should remain in place for the foreseeable future.

Emerging markets stability breeds instability

After years of benefiting from easy monetary policy from developed market central banks, emerging markets have come under pressure as global liquidity recedes. Events like the Turkey crisis may appear small but these situations tend to have a domino effect. Trade war risks and a China slowdown further add to emerging market concerns.

Real Estate Market Update[2]

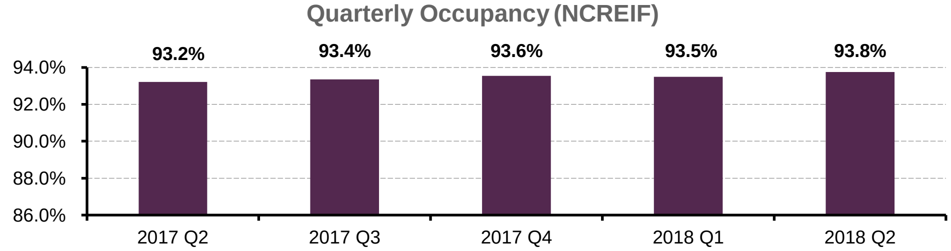
Income comprises the majority of the total return for core real estate

The NCREIF Property Index (NPI) unlevered total return for the second quarter 2018 was 1.8%, comprised of 1.1% income and 0.7% appreciation. On a trailing four quarter basis, the NPI was 7.2%. Total returns have moderated over the last several years, but the deceleration appears to have stopped in the second quarter of 2017. The second quarter 2018 total return was the highest since second quarter 2016.

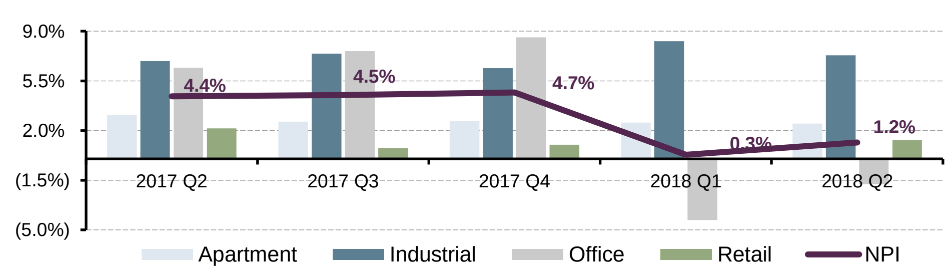
The 4.7% annualized income yield represented a 1.8% premium to the 2.9% 10-year U.S. Treasury. Appreciation was stable at moderated levels, as income return accounted for most of the total return. Low unemployment, steady job creation and recent tax policy fueled consumer spending and the overall U.S. economy in the second quarter. This positive economic backdrop provided confidence for the Federal Reserve to raise short-term rates in June and signal two remaining raises for 2018. Although the 10-year U.S. Treasury continued to rise, interest rates remain low compared to historical trends. Furthermore, periods of rising interest rates have not always resulted in rising real estate cap rates given that multiple factors inform cap rates, including the contractual cash flows (leases), debt capital markets and property sector fundamentals. Unlevered real estate remains attractive given total returns fall between current yields on investment grade corporate bonds and current yields on high-yield bonds, consistent with the long-term relationship[3].

Occupancy increased to a new sixteen-year high of 93.8%. Once again, industrial led property sector performance on a total return basis, followed modestly by apartment and office. While retail lagged the other sectors, it demonstrated positive momentum versus the first quarter. The West region sustained outperformance, followed by the South region. Rolling four quarter same-store net operating income (NOI) growth for the index rose in the second quarter of 2018, driven by improving office and retail performance. Industrial significantly outperformed with NOI growth of 7.3%. In addition, apartment growth exceeded the NPI index by 130 basis points.

Quarterly Occupancy (NCREIF)



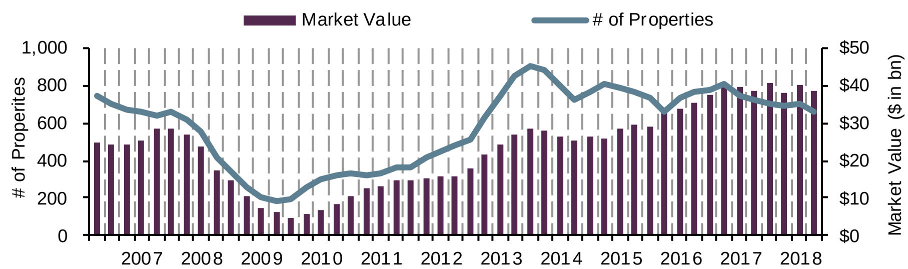
Rolling Four Quarter Same-Store NOI Growth (NCREIF)



Transaction volume remains at historically elevated levels

Strong liquidity persisted for high-quality, well-located assets. As measured by NPI, the trailing four quarter volume slightly decreased from first quarter but remains at historically elevated levels. According to Real Capital Analytics (RCA), sales volume for the second quarter of 2018 grew 2.0% from second quarter 2017. Year-over-year growth was boosted by strong volume increases for industrial and retail. For the industrial market overall and for single assets specifically, sales volume was the highest for any second quarter period in history. Retail sales volume growth was deceivingly high due to the $15.7 billion acquisition of Westfield Corporation, a shopping center REIT, by Unibail-Rodamco. Single asset sales in the retail sector are still declining. Sector differences emerged as cap rates compressed further and buyers became more selective. In addition, public REIT markets experienced a wave of privatizations and merger and acquisition activity given discounts to private market values.

Property Transaction Volume (Rolling Four Quarters)[2]



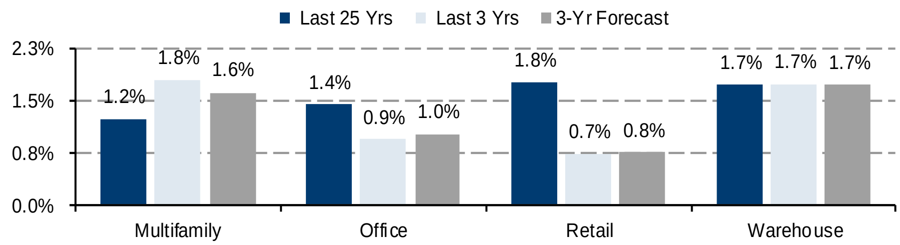
Debt financing is readily available, although interest rate increases are likely

Leverage remained available at moderate levels and can be secured from a variety of sources (banks, insurance companies, CMBS, agency, etc.). Overall, accessibility to debt capital continued with rates that remain attractive by historical standards. Senior mortgages with fixed rates, 10-year terms and 60% loan-to-value on stabilized properties were available at slightly over 4% interest rates during the second quarter, based on a 130 to 160 basis point spread over 10-year U.S. Treasuries.[4] For some favorable property types (such as industrial) in strong locations, spreads closer to 100 basis points over U.S. Treasuries have been achievable.

Supply growth more controlled than previous cycles

Supply growth neared long-term normalized levels, although supply has remained more disciplined than previous cycles. Office and retail are well below their long-term construction pace while multifamily and industrial development has increased to keep pace with demand drivers. While absorption continues to support multifamily development, new construction has begun to taper rental growth. Healthy demand has supported multifamily development, however continued construction is tapering rental growth and some new projects have offered rent concessions to entice new tenants. Industrial construction activity increased but was manageable given that growth in e-commerce demand has contributed to the absorption of new product.

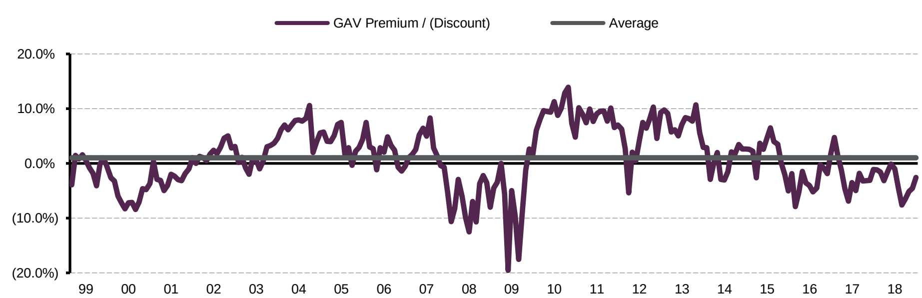
Average Commercial Property Supply Growth[5]



U.S. REITs bridged the large discount to private market values

U.S. REIT performance, as measured by the FTSE NAREIT Equity REITs Index, resulted in a 10.0% total return for the second quarter 2018, the largest positive quarterly performance since fourth quarter 2014. Depressed valuations of REITs from the broad overselling in the first quarter provided attractive entry points for investors given positive macroeconomic trends and earnings results that demonstrated stability. Privatizations, merger and acquisition activity and share repurchases also helped stabilize valuations. Approximately $26 billion of deal activity related to publicly traded REITs was announced in April and May stemming from the large pre-existing discounts. REITs were generally trading just below private market values by the end of the quarter, with variations by property type. As of the second quarter, the implied unlevered public real estate market value traded at a 2.6% discount to private values, just below the trailing 20-year average premium of 1.0% and within fair value range.[6]

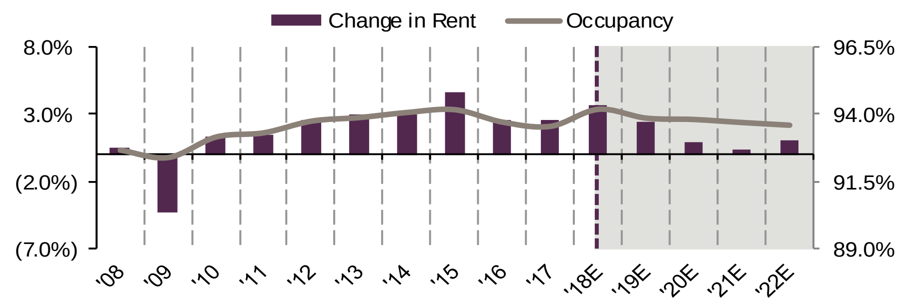
Public to Private Market Premium/Discount[6]



National Real Estate Market Update by Property Sector[7]

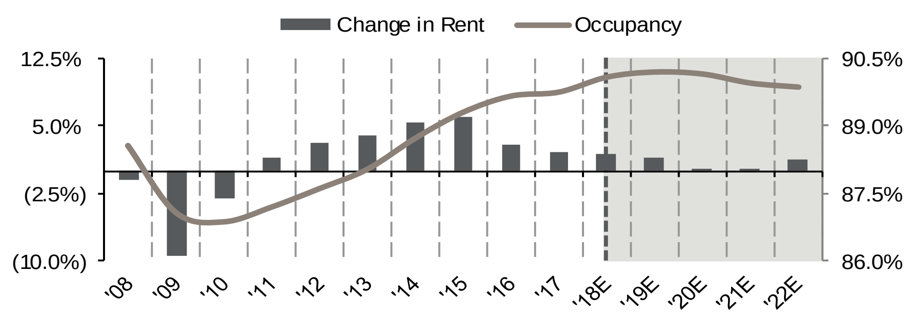
Multifamily

Apartment fundamentals remained intact with positive trends in absorption, turnover and renewal growth. Job growth, an important factor in multifamily demand, re-escalated and non-farm job creation exceeded the 200,000 level in both May and June. However, as the economy nears full-employment job creation is expected to taper. Additionally, rising homeownership rates and elevated supply are expected to pressure rental growth. The Sun Belt markets are positioned well with a lower cost of living that is attractive to both residents and employers. Second quarter occupancy was 94% and market rents averaged $1,297 per unit.



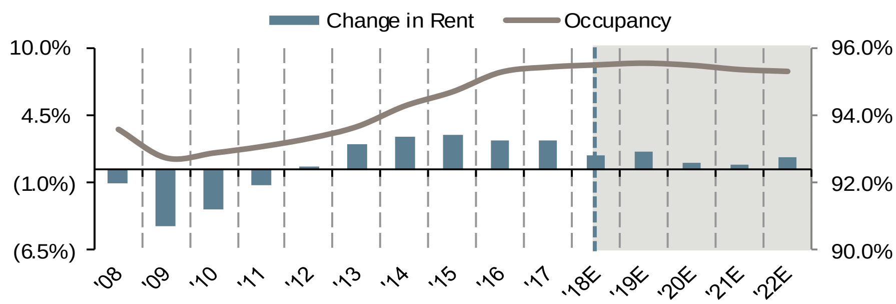
Office

Office fundamentals were pressured with lack-luster absorption in a concession driven market. Recent tax reform policy didn't create immediate demand change but is expected to have a positive impact in the future. Fundamentals fared better in tech-oriented, West Coast markets and the Sun Belt. Supply remained a concern in specific gateway markets, like New York and D.C., but it has been minimal in non-gateway locations. Areas with strong STEM (Science, Technology, Engineering and Math) exposure and vibrant urban cores continued to outperform. Nationally, second quarter occupancy was 90% and market rents averaged $31.90 per square foot.



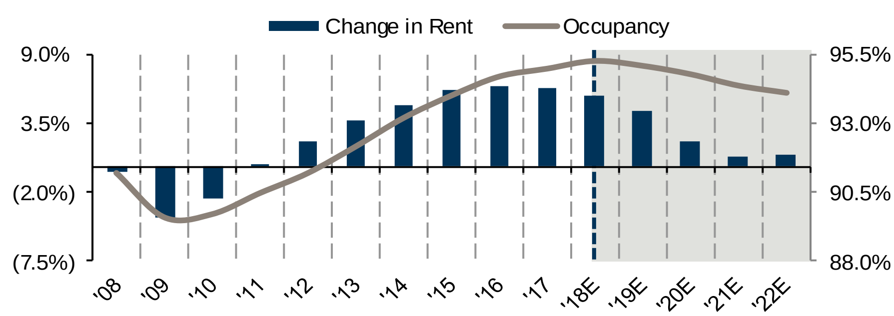
Retail

Higher quality retail centers that offer convenience and a unique shopping experience continued to be well-positioned. In addition, grocery-anchored centers remained strong and less impacted by e-commerce disruption (for now). Leasing activity was stable and embedded revenue growth opportunities from healthy re-leasing spreads protected net operating income. The sector faced headwinds from changing consumer behavior but new supply continued to be limited. In general, pressure on rent growth continued as further store closures loom. Overall, second quarter occupancy was 95% and market rents averaged $20.65 per square foot.



Industrial

The industrial sector continued its outperformance with strong demand from e-commerce and a favorable U.S. economy. Demand fundamentals were boosted by increased import activity and manufacturing sentiment, however the ultimate impact related to recent tariff policies remained an unknown. Occupancies hovered near record highs, driving rental pricing power for landlords. Coastal locations with growing port activity and infill locations near large population centers continued to be strong performers. New supply increased, but strong absorption followed. Second quarter warehouse occupancy was 95% and rents averaged $8.19 per square foot.



***Topic of Interest:* What is the Impact of Tariffs on Commercial Real Estate?**[8]

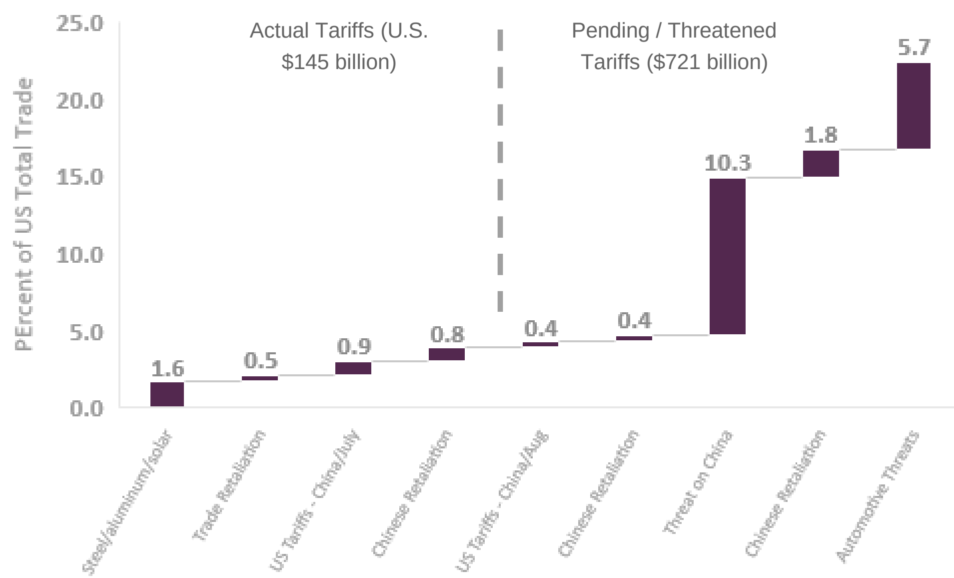
Tariffs are a form of taxation ultimately paid by the consumer rather than the exporter

Although the U.S. has the largest economy in the world, it also has the largest trade deficit. The U.S. has been running a trade deficit for nearly 42 years, but that deficit has increased substantially over time and is now almost a half-trillion dollars.[9] With an apparent objective to reduce the deficit and achieve better trading terms, the current administration has been threatening trade wars against countries targeted for renegotiation. Since 2017, the administration has been enacting tariffs against imports from targeted countries which have generally responded in-kind by enacting tariffs against U.S. imports. The primary detractor to this policy is that tariffs are essentially a form of taxation which are paid ultimately by the consumer, not the exporter.[10] While the U.S. economy is currently growing at a solid pace, a full-blown trade war could increase the cost of goods, impede spending, and reduce jobs, negatively impacting all industries of the economy. Thus, many analysts believe the current tariffs and threats may just be a temporary strategy to help renegotiate trade agreements. To date, real estate has not yet been significantly impacted given the modest level of tariffs and the strong economic environment. However, the real estate space is beginning to experience higher construction costs and the industrial sector could be at the forefront of impact if the disputes escalate into a full-scale trade war.

Current tariffs are modest and cover only 4% of U.S. trade

Tariffs levied by and against the U.S. currently total $145 billion, representing only 4% of U.S. total trade and 1% of world imports. The U.S. first responded to Canada's taxing of U.S. dairy products in 2017 by levying a roughly 20% tariff on Canadian softwood lumber producers. In March of 2018, Trump also imposed a 25% tax on steel and a 10% tax on aluminum imports. Temporary exemptions on steel and aluminum were initially granted to Canada, Mexico and the European Union, but those exemptions expired at the end of May. These previously exempt countries account for nearly a third of steel imports and half of aluminum imports. Additionally, the administration has threatened a 20% tariff on automotive imports from Europe, Canada and Mexico to defend the U.S. manufacturing sector, an element viewed as necessary for national security.[8]

Tariff Schedule[8]



The cumulative impact of threatened tariffs would be more substantial and affect 22% of U.S. trade

With respect to China, the U.S. imposed a flat 25% import tax on 818 Chinese products in July of 2018 which totaled $34 billion in value and primarily consisted of high-tech goods. The Chinese government responded with a 25% tariff on 545 U.S. products valued at $34 billion and concentrated on products in the automotive and agriculture industries. The U.S. has threatened to imminently enact an additional tax on $16 billion of Chinese goods. As a result, China has threatened imposing a tax on $15 billion of U.S. goods, including crude oil, propane and chemicals. President Trump has further indicated that future action could include another $200 billion of Chinese goods subject to a 10% tariff and an additional $200 billion of other goods subject to a tariff after the initial move. The administration has also indicated it would consider increasing the tariff rate to 25%. Thus, the total enacted and proposed tariffs on Chinese goods total $450 billion and account for almost 90% of all U.S.

imports from the country. Inclusive of existing tariffs and trade disputes with other countries, the potential like-kind responses to threatened tariffs could increase the total U.S. impact to $870 billion in total trade, affecting 22% of U.S. trade and 5% of world imports.[8]

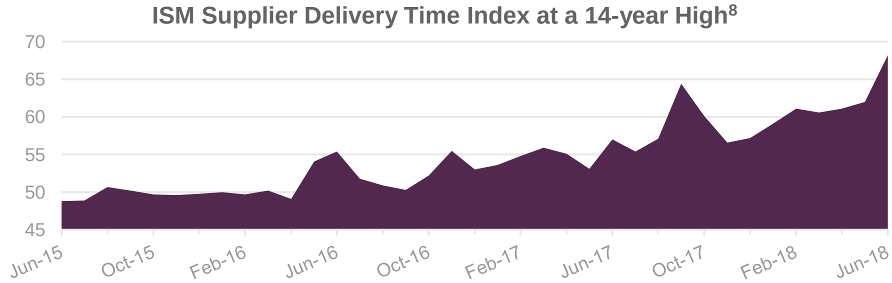
The U.S. economy grew at the fastest pace in four years during 2Q, posting GDP growth of 4.1%

Despite the potential for a larger scale trade war, the tariffs enacted to-date have been modest and have had a relatively low impact on total U.S. trade. In addition, the implementation of tariffs has coincided with the strongest U.S. economic environment since the Great Recession. During the second quarter 2018, U.S. exports continued to expand as the trade deficit declined. The U.S. economy grew at the fastest pace in nearly four years as GDP growth totaled 4.1% in the second quarter.[11] Robust consumer spending, solid business investment, surging exports and increased government outlays were among the contributing growth factors. Overall, the current strength of the U.S. economy has had little to do with import tariffs and continues to be primarily driven by the lagged effects of a strong 2017 economy, new tax cuts, low unemployment, steady job growth and the stimulus generated from only moderate increases in interest rates.

Current tariffs are expected to only create a marginal drag on economic growth and an incremental boost to inflation

Although some of the second quarter economic growth came from an increase in exports, there are some analysts who warned that export growth could be temporary given some foreign buyers were likely racing to procure goods before the new retaliatory tariffs became effective. Thus, it may take time for the economic data to reflect the uncertainties of any slowdown associated with an impending trade war. Manufacturing data has already begun to point to higher prices, a buildup in back orders and missed deadlines. In addition, tariffs on steel and aluminum imports, along with the threat of tariffs on other goods, have begun to disrupt the availability, cost and timely delivery of certain materials and supplies. Nevertheless, the trade tariffs enacted thus far are only expected to result in a marginal drag on economic growth and an incremental boost to inflation.[8]

ISM Supplier Delivery Time Index at a 14-year High[8]



Tariffs have contributed to the rising cost of construction, putting pressure on developers and potential new projects

As with the broader economy, the impact of the first round of tariffs on the U.S. real estate sector has also been minimal. However, participants in the design and construction industry believe more tariffs will ultimately result in significantly higher construction costs given the increased cost of raw materials. With respect to steel and aluminum producers in the U.S., it will take months or years to scale up operations to meet the renewed demand. Thus, consumers will incur higher costs for products in the interim. These products include building infrastructures that require steel and aluminum directly as well as sub-component materials, like concrete with rebar, ceiling grids, door frames, lighting fixtures and HVAC equipment. The price of equipment and tools, such as hammers and tower cranes, used in construction are also impacted by higher production costs. Even materials that are produced by machinery made from steel and aluminum will be impacted, increasing the costs for things like carpet, drywall and electric cabling. The rising costs of home construction is already playing a role in accelerating home prices which appear to be impeding sales growth. Continued tariffs on things like lumber, steel and aluminum imports put pressure on already escalating building costs. While the rising construction costs may cause developers and investors to postpone, cancel or avoid new projects, the reduction in supply and inherently captured inflation could prove positive for existing building owners.[12]

Rising consumer prices and a significant drop in imports would negatively impact the industrial sector

In the event of an expanded trade war, the disruption to the U.S. economy could become more significant and result in negative impacts across all real estate sectors. Nevertheless, the most obvious impact would likely be felt in the industrial space. An increase in the price of goods would eventually result in less consumer purchases and, correspondingly, a lower demand for buildings that warehouse those goods. Imports generate the greatest demand for warehouses because goods must be landed, stored, transshipped and distributed. Exports, alternatively, generally go directly from factory to port. Thus, imports require more distribution and warehouse space than exports and the trade war impact on industrial properties would likely vary by city. Population centers or last mile markets may have some insulation versus distribution and logistics markets that serve other population centers. Markets like Memphis, which is a hub for UPS and FedEx that service national distribution, may feel more impact than primary user markets. If trade through port cities slows down, industrial real estate around ports will slow down as well. However, current conditions in the industrial space remain strong given historically low vacancies accompanied by escalating rental rates. The demand has also been driven by a paradigm shift in consumer preferences for e-commerce and the convenience of delivery. While a slow or no growth economy would negatively impact everyone, the strength of the current economy provides a positive outlook for commercial real estate.[13]

Analysts believe the current tariffs and trade war rhetoric may be a temporary strategy to help renegotiate trade agreements

Given the compounding and far-reaching impacts that tariffs could ultimately have on the economy, many analysts believe that the current tariff posturing by the Trump administration will not escalate into a full trade war. In fact, many view Trump's rhetoric as part of a negotiating strategy to improve the terms of trade for the U.S. Additionally, both U.S. and European financial markets have not experienced a meaningful response to the ongoing threat of tariffs, another indication that market participants may view the tariffs as a temporary and tactical strategy. Alternatively, the sell-off in equities in the Chinese and broader Asian financial markets may be indicative of the greater challenge for reaching trade terms with China. While the U.S. economy has powered ahead, pressure may be mounting as the economies of China, Europe and Mexico have recently indicated new signs of stumbling. As an example of progress, the U.S. and European Union agreed in late July to begin discussions about eliminating tariffs and subsidies in response to the U.S. metal tariffs and EU retaliatory tariffs. Although the trade policy remains unclear, many suspect it is more about sending a message than establishing a long-term policy of tariffs and protectionism.[8]

Footnotes

1 Guggenheim Partners Economic Outlook and Key Themes as of 8/14/2018.
2 Data sourced from the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index Quarterly Detail Report and Trends Report for the second quarter 2018. As of 6/30/2018, the NCREIF Property Index ("NPI") included 7,672 investment-grade, income producing properties with a market value of $581 billion. Occupancy calculation is based on leased square footage. NOI Growth reflects the change in NOI from quarter to quarter for properties that are in the index at the beginning and end of the respective quarter.
3 Green Street Advisors Real Estate Securities Monthly July 2, 2018.
4 Commercial Mortgage Alert newsletter as of 7/6/2018. Based on 10-year U.S. Treasury Yield of 2.9% for 2Q 2018.
5 Based on the average of 1Q18 Dodge and 2Q18 CoStar supply growth data.
6 Source: Green Street Advisors; GAV = Gross Asset Value.
7 Analysis based on data sourced from CoStar 2Q18 and Green Street Advisors. Shading represents forecasted period.
8 CBRE, "Trade Disputes So Far Having Little Impact on CRE", July 16, 2018.
9 National Real Estate Investor, "How Trump's Trade Balancing Act Could Impact Commercial Real Estate", March 23, 2018.
10 Guggenheim Partners, "Global CIO Outlook: No One Wins a Trade War", July 17, 2018.
11 Wall Street Journal, "U.S. Economy Grew at 4.1% Rate in Second Quarter", July 28, 2018.
12 CBRE, "Tariffs on Steel and Aluminum and its Impact on the Construction Industry", May 2018.
13 CoStar, "Could Industrial Real Estate Get Caught in Trade War Crossfire?", April 6, 2018.

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