


November 2017

Guggenheim Real Estate: Market Update

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Economic Outlook and Key Themes[1]

Economic growth likely to remain robust into 2018

Economic activity has been accelerating in the second half of 2017 and should benefit over the coming months from hurricane rebuilding activity and favorable financial conditions in the U.S. and abroad. Third quarter 2017 growth results were strong and similar to the previous quarter as GDP posted a 3% annual growth rate, which outpaced expectations. While significant tax reform hurdles remain, the U.S. should ultimately see some form of tax cuts given the political necessity to produce results before the 2018 midterm elections. Tax cuts would likely push real GDP growth consistently well above 2%, an indication that the economy is performing comfortably above potential.

Consumer confidence levels in the U.S. remain near cyclical highs. Combining this with continued income growth and healthier household balance sheets bodes well for consumption in the coming quarters. Meanwhile the trend rate of job growth should continue to slow as the U.S. has been near full employment for quite a while. Even so, the unemployment rate, which is currently 4.1%, could continue to decrease and approach 3.5% by the end of 2018. An even tighter labor market and increasing worker shortages would put upward pressure on wage growth which has been constrained by meager productivity gains. A potentially positive factor for growth and productivity would be an increase in capex plans as a result of elevated business optimism. Core inflation has consistently lagged expectations this year and is expected to remain well below the Fed's 2% target in the near-term. However, stronger growth and reduced labor market slack should push core inflation closer to the Fed's target by the middle of next year.

A series of interest rate increases expected

Despite weak realized inflation, the Fed continues to believe in the Phillips Curve framework which suggests that a tight labor market will lead to increased inflation. Easy financial conditions will also embolden the Fed to press ahead with interest rate hikes. As such, the Fed will likely raise rates again at the December meeting, marking the third rate hike in 2017, which would be consistent with expectations that the Fed communicated earlier in the year. We anticipate that four more hikes are likely to follow in 2018, even if tax reform fails, as the Fed will try to keep the economy in check. As expected, the Fed finally began the process of tapering reinvestments of its Treasury and mortgage-backed securities (MBS) holdings which we think may put upward pressure on rates in the belly (i.e., intermediate segment) of the yield curve. The Fed's ultimate goal is to significantly reduce its balance sheet after several years of buying Treasurys and MBS as well as reinvesting proceeds upon maturities as a way to stimulate growth in response to the financial crisis.

European economic progress continues while China growth cools

The eurozone economy continues to show signs of improvement but, like the U.S., core inflation is expected to persist below the European Central Bank's (ECB) target in the coming quarters. The reasons are quite different though as there is substantial slack in the economy and the euro is gaining strength. The accelerating economy warranted the announcement by the ECB of its plans to taper its quantitative easing (QE) policy. However, ongoing purchases and the low rate environment will continue to provide significant accommodation to the European economy through 2018.

The Chinese economy is expected to slow in the coming months based upon leading indicators such as tighter credit conditions and a moderating real estate market. The post-Party Congress focus of policymakers is shifting to better quality growth and reducing risk in the financial system. Meanwhile, Japan's economy has finally been revived and it continued the trend with the seventh consecutive quarter of expansion, its longest streak in almost two decades. However, similar to many other developed countries, inflation remains low and well short of the Bank of Japan's 2% target. At the same time, the yield curve control policy should keep the yen relatively weak and help drive capital abroad.

Oil prices expected to remain below $60 per barrel in the near-term

OPEC production cuts and increasing non-OPEC production should keep oil prices below $60 per barrel over the next year, barring significant supply disruptions. We expect the OPEC production quota will remain in place throughout 2018. However, the quota may be lifted sooner if prices are sustained above $60 a barrel as faster growth from U.S. shale and other unconventional oil producers would present a threat.

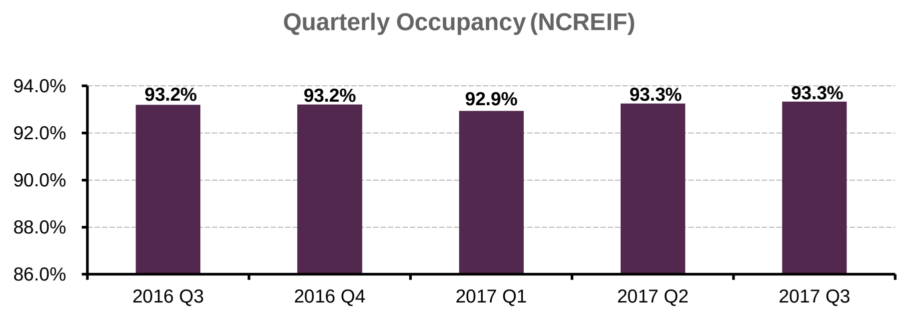
Real Estate Market Update[2]

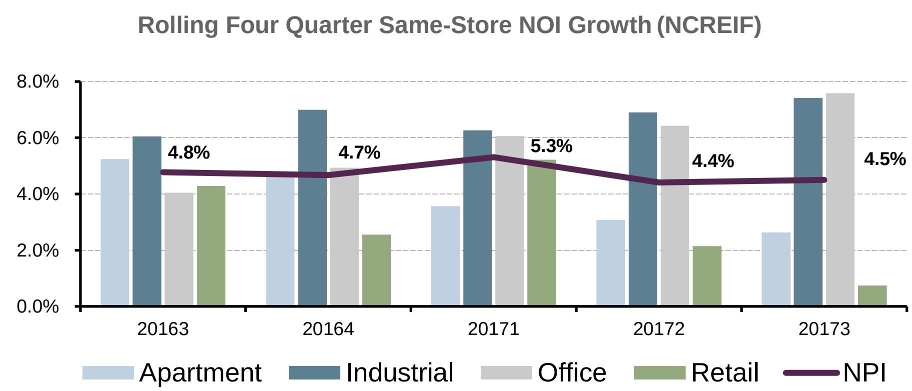
Occupancy remains near record high levels with compelling NOI growth

Despite being almost eight years into the recovery, commercial real estate fundamentals remain healthy and stable. Both income and appreciation returns have demonstrated consistency over the last five quarters. The NCREIF Property Index (NPI) unlevered total return was 1.7% for the third quarter 2017, or 7.0% annualized. Components of the return consisted of a 1.1% income return and a 0.6% appreciation return. Though the annualized total return for the trailing four quarters of 6.9% continues to taper, it still exceeds the annualized return over the past decade of 6.2%. However, current total returns are below the trailing five-year return of 10.4%.

Income yields remain low but maintain a healthy spread over the 10-year U.S. Treasury. The current spread between the third quarter NPI annualized income yield and the 10-year Treasury rate is 2.3%[3], more than the 30-year average spread of 2.1%. The income return has trended lower through most of the recovery but has stabilized and now accounts for the majority of the total return.

Occupancy remained at a 16-year high of 93.3% during the third quarter. Once again, the Industrial sector outperformed other property types by a wide margin for both the third quarter and the trailing year. The West region continued to outperform other regions for both the quarter and the trailing year, followed by the South region. Same-store net operating income (NOI) growth for the rolling four quarters slightly increased to 4.5%. The rolling four quarter growth still exceeds the 10-year average of 3.2%. Fundamentals are healthy with supply increasing in certain major markets and sectors.

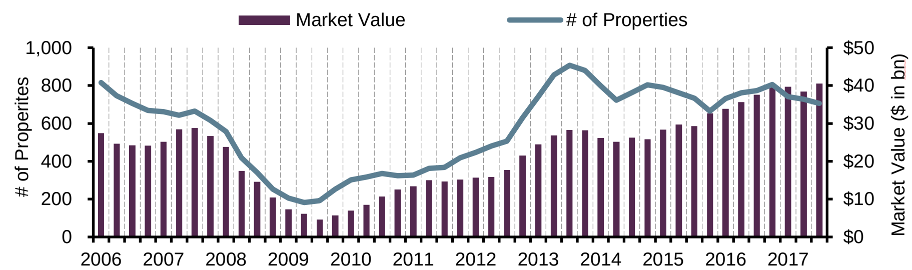




Transaction volume remains elevated

Liquidity remains strong for high-quality and well-located assets. As measured by NPI, the trailing four-quarter volume increased from second quarter and is the highest trailing four-quarter level since its tracking began in 1983. According to Real Capital Analytics (RCA), quarterly sales volume slightly increased from the second quarter 2017, however the year-over-year comparisons for the third quarter and year-to-date periods show a decline. Apartment and Industrial properties show a year-over-year increase for the quarter, but only Industrial showed an increase over the prior year period on a year-to-date basis.

Historical Property Transaction Volume (Rolling Four Quarters)



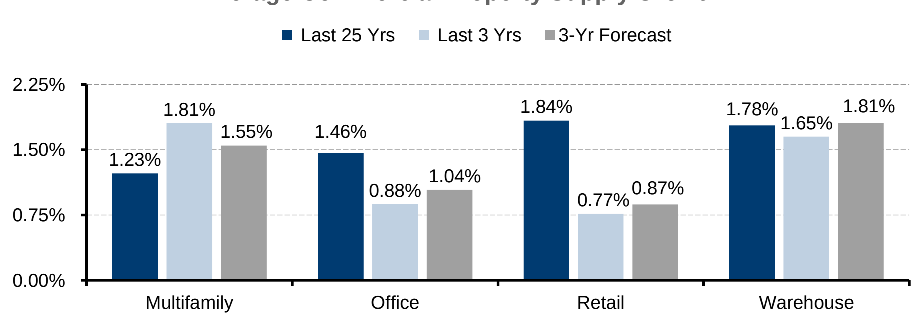
Debt financing is readily available but rising interest rates are likely

Leverage is readily available at moderate levels and secured from a variety of sources (banks, insurance companies, CMBS, agency, etc.). Overall, debt capital is accessible at 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 approximately 4% interest rates during the third quarter, implying nearly a 140 to 150 basis point spread over 10-year U.S. Treasuries.[4]

New supply is lower than historical averages for most property types

Supply growth remains modest overall. While some markets have seen increases in development, all property types, with the exception of multifamily and industrial, remain below their long-term averages. Multifamily construction has primarily been concentrated in urban markets with higher growth where the absorption has validated the demand. However, the pace of growth continues to decelerate in markets with the most supply. Though industrial supply is slightly elevated, it is manageable due to strong pent-up demand which has been sufficient to absorb new product.

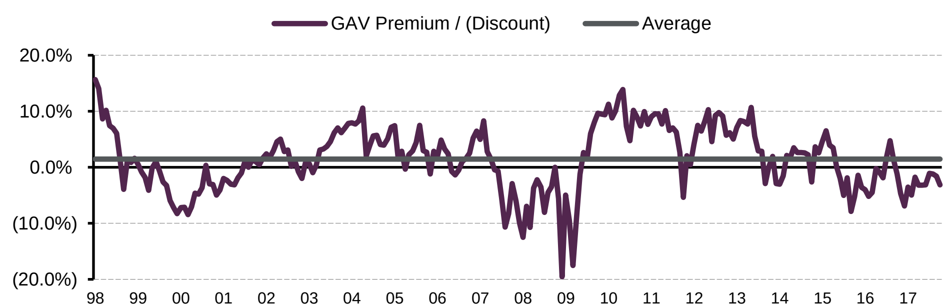
Average Commercial Property Supply Growth[5]



U.S. REITs demonstrate continued positive momentum

U.S. REITs, as measured by the FTSE NAREIT Equity REITs Index, continued positive performance with a total return of 0.9% for the third quarter (three straight quarters of positive performance). Strong July performance of 1.2% carried the quarter and compensated for lagging performance over its last two months. Sectors such as industrial with tenancies benefiting from e-commerce boosted returns. The retail sector experienced positive performance for the quarter although the sector still lags on a year-to-date basis. REITs are roughly trading near private market values overall, with variations by property type. As of the third quarter, the implied unlevered public real estate market value traded at a 3.1% discount to private values, which is materially below the long-term average premium of a 1.5% since 1998.[6] Further, merger and acquisition activity has increased in some sectors in which large discounts to private values have persisted. In a potential $15 billion deal, Brookfield Property Partners LP is seeking to acquire the 66% of GGP Inc. that it doesn't already own. GGP Inc. is an owner and operator of high-quality malls and retail centers, a sector that has had a negative stigma in the public markets due to the sweeping changes of e-commerce.

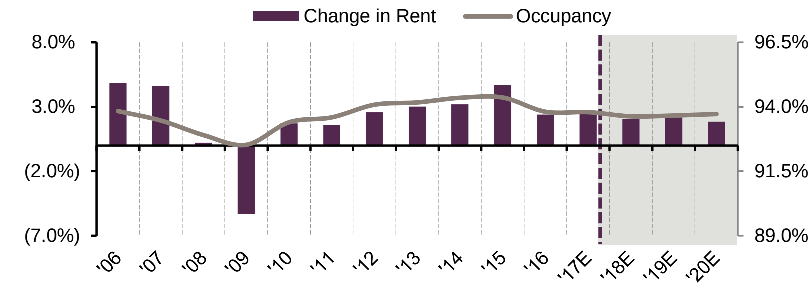
Public to Private Market Premium/Discount[6]



National Real Estate Market Update by Property Sector[7]

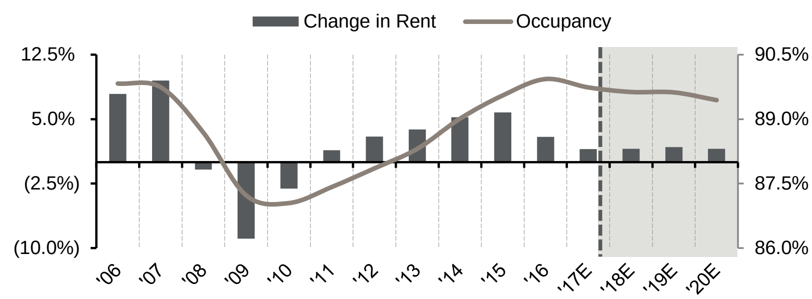
Multifamily

Apartment fundamentals are showing some signs of tapering with growth rates decelerating and supply continuing to apply pressure in particular markets. Transit-oriented, amenity-rich assets are well-positioned. Job growth is healthy but homeownership is beginning to rise. Job growth and labor participation for the 25-35 year-old cohort is strong, although it is moderating to some degree. D.C. is experiencing weak job growth but the West Coast continues to perform well. Third quarter occupancy was 94% and market rents averaged $1,379 per unit.



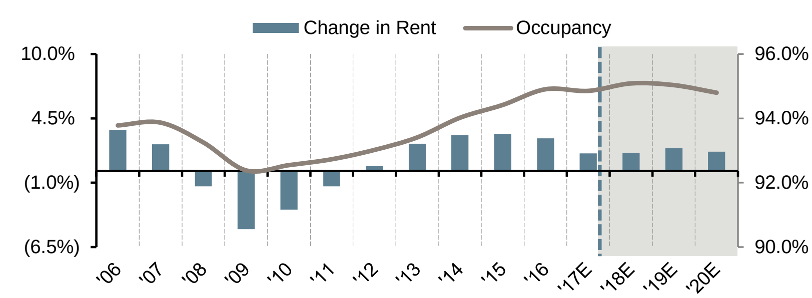
Office

Office fundamentals remain intact but are moderating in certain markets. Areas with strong STEM (Science, Technology, Engineering and Math) exposure and vibrant urban cores continue to outperform. Absorption remains healthy but new supply growth is rising in specific markets. New York City and D.C. remain soft, while the West Coast and Sunbelt exhibit momentum. Uncertainty persists in energy markets such as Houston where substantial shadow space poses a challenge. Nationally, third quarter occupancy was 90% and market rents averaged $29.87 per square foot.



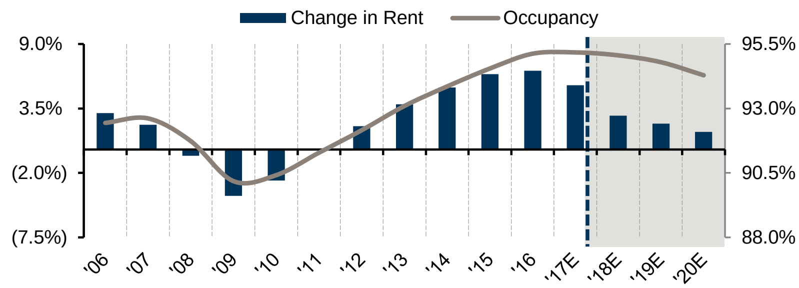
Retail

Higher quality retail centers offering both convenience and a unique shopping experience are positioned well going forward. Additionally, grocery-anchored centers remain strong and less impacted by e-commerce disruption. The sector still faces headwinds, although performance has yet to decline significantly. New supply has been limited and small shop demand continues to be healthy. Tenant sales growth has been volatile and recent retailer earnings were lackluster. Re-leasing rental rate spreads to in-place rents are positive, although tenant improvement costs are rising. The spreads between leased rates and physical occupancy rates are widening which implies momentum, but additional store closures and bankruptcies may be an issue. Recently announced bankruptcy filings include Toys 'R' Us, Vitamin World and Gander Mountain. Overall, third quarter occupancy was 95% and market rents averaged $21.82 per square foot.



Industrial

The industrial sector continues to outperform with strong demand from e-commerce and a favorable U.S. economy, specifically import activity. Occupancies are near record highs and rent growth continues to accelerate. While coastal locations should perform well due to increased port activity, other strong performers include infill locations near large population centers. The opening of the Panama Canal has positively impacted the East Coast. Supply is still in check but has started to increase in stronger markets. Third quarter warehouse occupancy was 95% and rents averaged $7.52 per square foot.



***Topic of Interest:* Supply & Demand Dynamics in the Multifamily Sector**

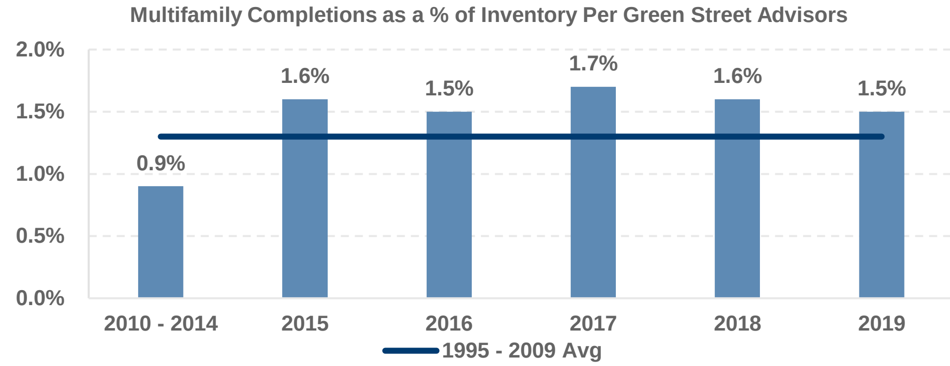
Multifamily fundamentals remain healthy, even as growth moderate

New construction in the multifamily sector has advanced at an elevated pace throughout the recovery. However, multifamily fundamentals are expected to remain healthy for the longer-term given:

- pipeline of new supply is nearing its peak and new starts are declining
- strong job growth and household formations support more supply
- homeownership is likely to remain restrained versus prior peaks
- development largely concentrated in luxury product and urban markets
- market specific imbalances expected to be short-term
- NOI growth remains positive and compelling, even as growth moderates

Multifamily supply growth has exceed long term averages

Amid tighter construction financing, new real estate supply has been relatively muted this cycle overall. However, apartment supply as a percentage of existing stock has meaningfully exceeded its longer-term averages over the past few years. Nearly 900,000 multifamily units were delivered in the U.S. between 2014 and 2016. In addition, approximately 600,000 new units are currently underway (twice the long-term average of 300,000 units) and more than 400,000 units are expected to be completed in 2017.[8]



New multifamily starts and permits are slowing

Even though a record number of multifamily units are under construction, starts have actually begun to moderate and permitting has declined significantly. Per Axiometrics, the cyclical peak for new multifamily supply is expected to occur by the fourth quarter 2017, although the peak has been moving out as a shortage of construction workers and the increasing costs of materials have caused developers to push project timelines back a quarter or two. As of September 2017, annual multifamily construction starts were down more than 36% from the December 2016 peak of 449,000 units. Multifamily permits declined sharply in September 2017, dropping more than 17% from August's annual rate of 360,000 units and down 25% from September 2016. Completions typically lag starts by approximately six quarters and the declines are expected to positively impact fundamentals as deliveries slow in 2019.[9]

Potential demand for new multifamily units may outpace supply on a national level

While the headline supply figures appear overwhelming, the potential demand for new multifamily units likely outpaces the current supply nationally. Overall inventory of new housing, including single-family homes and for-sale housing, remains near all-time lows. At a national level, the amount of new multifamily units getting added to the existing stock is not unreasonable based on job growth and household formation levels. According to Moody's, job growth was expected to be about 1.6% in 2017, which would be an estimated addition of 2.3 million new jobs. Based on that amount of job growth, multifamily rental demand could be in the range of 460,000 units.[8] In addition, new housing construction continues to lag behind the rate of household formation. CoStar estimates that household formation has outpaced construction by approximately 3.5 million units since 2010.[10]

Strong absorption has occurred in an environment of suppressed homeownership rates

Most of the new multifamily supply to-date has been met with strong absorption as the U.S. experienced a sharp decline in homeownership. Prior to the Great Recession, years of easy lending and pro-housing policies drove the homeownership rate to a peak of 69%, but the unwinding of the mortgage bubble resulted in a huge influx of renter demand over the last decade. However, homeownership recently registered a modest increase to 63.9% in the third quarter, the highest level since 2014, up from 63.7% in the second quarter and 63.5% a year earlier. Per Co-Star, a one-percentage point increase in the homeownership rate would subtract approximately 800,000 rental units from net absorption.[11]

Home buying may gradually increase but will likely remain restrained

While the uptick in homeownership may slow the pace of renter demand, home buying will likely stay restrained compared with long-term levels. Less single family supply exists as starts are currently 50% below the pace realized in the 15 years prior to the 2008 downturn. Starter home construction activity is even more anemic given most homes built today cost more than $250,000, making it difficult for first-time home buyers to transition from renting to owning. Strict lending standards this cycle have made it more difficult for potential buyers to obtain mortgages. Rising homeownership is expected to more significantly impact the single-family rental market versus the multifamily market as these renters have already opted for the single-family lifestyle. Going forward, the homeownership rate is not expected to exceed the historical average (closer to 65%) and additional growth could be further slowed by rising interest rates.[12]

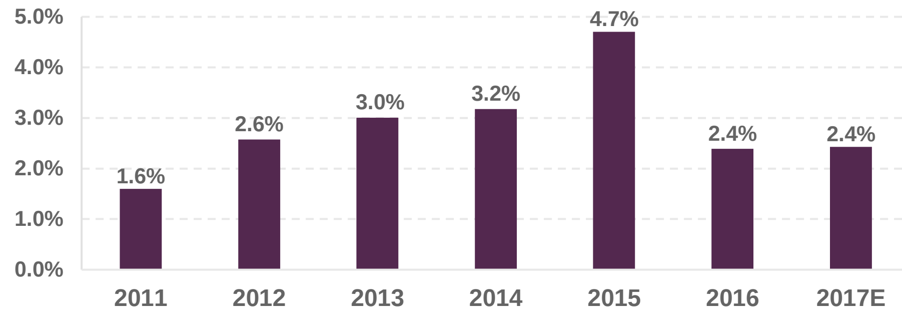
Developers have largely targeted luxury product in the urban core of gateway and primary markets

Although the housing market may appear to be undersupplied at the national level, much of the supply and demand dynamics vary greatly from metro to metro. New supply has largely been concentrated in a handful of markets, with only 12 MSAs[13] having more than 20,000 units completed or under construction since 2016. These markets include metros like New York, Washington D.C. and Los Angeles. Developers have primarily focused on higher quality, luxury projects in higher cost gateway markets. The cost of building materials is not usually dependent on the location of the construction project, thus, developers maximize profits by targeting luxury product in markets that cater to strong job growth, positive demographic trends and higher asking rents. Even within the markets, new supply has not been evenly distributed given construction has largely been concentrated in urban cores.[8]

Some markets indicate oversupply based on slowing job growth while other markets appear undersupplied

Competition from new supply is expected to persist but there will be a rotation as to which markets are out of balance at any particular point in time. Based on slowing job growth, some markets appear to be oversupplied in the near-term, including New York, Washington D.C. and Miami. Other markets facing oversupply include high-tech metros like Austin, Seattle and Denver where real estate developers have targeted millennials desiring to work and live downtown as the pace of high-tech job growth is slowing. Even metros that were expected to have above-average job growth, such as Nashville, encouraged developers to start building too many units in too few places. Alternatively, some markets appear to be undersupplied, including Orlando and Phoenix which are both positions to achieve strong job growth in 2017 from professional services, healthcare and tourism sectors.[8] Non-gateway markets may continue to benefit from outsized employment and household growth as large corporations relocate to more affordable employment hubs.[12]

Annual Multifamily Rent Growth Per CoStar



Imbalances in supply and demand are expected to stabilize over time as overall multifamily fundamentals remain positive

Despite the temporary misalignment of supply and demand in specific markets, the imbalance is only expected to be short-lived over the next 12-to-24 months and is typically concentrated in luxury product and urban submarkets. The multifamily sector's underlying fundamentals in these markets will likely stabilize or improve as wave of new supply begins its decline. Many industry participants feel the U.S. is still in the early stages of a longer term paradigm shift toward renting based largely on choice versus need. Young professionals are delaying life events; newer Class A multifamily product provides locations; amenities and finishes not affordably replicated in the single family housing stock; and an overall reduced stigma associated with renting have all helped support the change. This cycle has relied on both the traditional prime renter cohort and on renter household formation in the 55-64 year-old cohort as affordability has pushed some Millennials out of some luxury products and markets.[14] Despite reaching almost full employment, job growth is still expected to remain positive in most of the nation's major markets over the next two years, albeit at a slower pace of growth. Renter demand for apartments continued to accelerate in the third quarter as the market absorbed more than 70,000 units and overall national vacancy rate continued to trend lower after running up at the end of 2016.[11] Although some markets may experience increased concessions, slowing rental rate growth and slightly higher vacancies as new product is absorbed, the outlook for the multifamily sector overall remains positive, even in an environment of moderating fundamentals.

Footnotes

[1] Guggenheim Partners Economic Outlook & Key Themes as of 11/14/2017.
[2] Data sourced from the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index Quarterly Detail Report for the third quarter 2017. As of 9/30/2017, the NCREIF Property Index ("NPI") included 7,165 investment-grade, income producing properties with a market value of $544 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] 3Q17 Annualized NPI income return of 4.6% vs. 10-year UST as of 9/30/17 of 2.3% = spread of 2.3%. Analysis based on data sourced from NCREIF and the U.S. Department of the Treasury.
[4] Commercial Mortgage Alert newsletter as of 11/3/2017.
[5] Based on the average of 2Q17 Dodge and 3Q17CoStar supply growth data.
[6] Source: Green Street Advisors; GAV = Gross Asset Value.
[7] Analysis based on data sourced from CoStar 3Q17 and Green Street Advisors. Shading represents forecasted period.
[8] Fannie Mae, "Multifamily Supply and Demand Varies by Metro", June 2017.
[9] Axiometrics, "Permits and Starts Slow, But Don't' Panic", October 31, 2017.
[10] Wall Street Journal, "Millennial Home Buyers Send a Chill Through Rental Markets", Nov. 7, 2017.
[11] CoStar, "US Apartment Demand Bounces Back form Slow Down in Early 2017", Nov. 3, 2017.
[12] Green Street Advisors, "Keeping Homeownership in Mind", September 28, 217.
[13] Metropolitan Statistical Area[14] CoStar, "Pent-Up Millennial Renter Demand: Fact Or Fiction?", June 29, 2017.
[14] CoStar, "Pent-Up Millennial Renter Demand: Fact Or Fiction?", June 29, 2017.

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