Real Estate Summary

US Real Estate – Edition 2, 2019

Demand remains strong and
spreads reversed somewhat in early 2019.

UBS Asset Management

Commerical real estate

US real estate investors are entering year four of a period of relative calm, income-driven performance. Demand is strong. Supply should be monitored closely. Capital flows are supportive but not excessive, even as spreads show signs of easing.

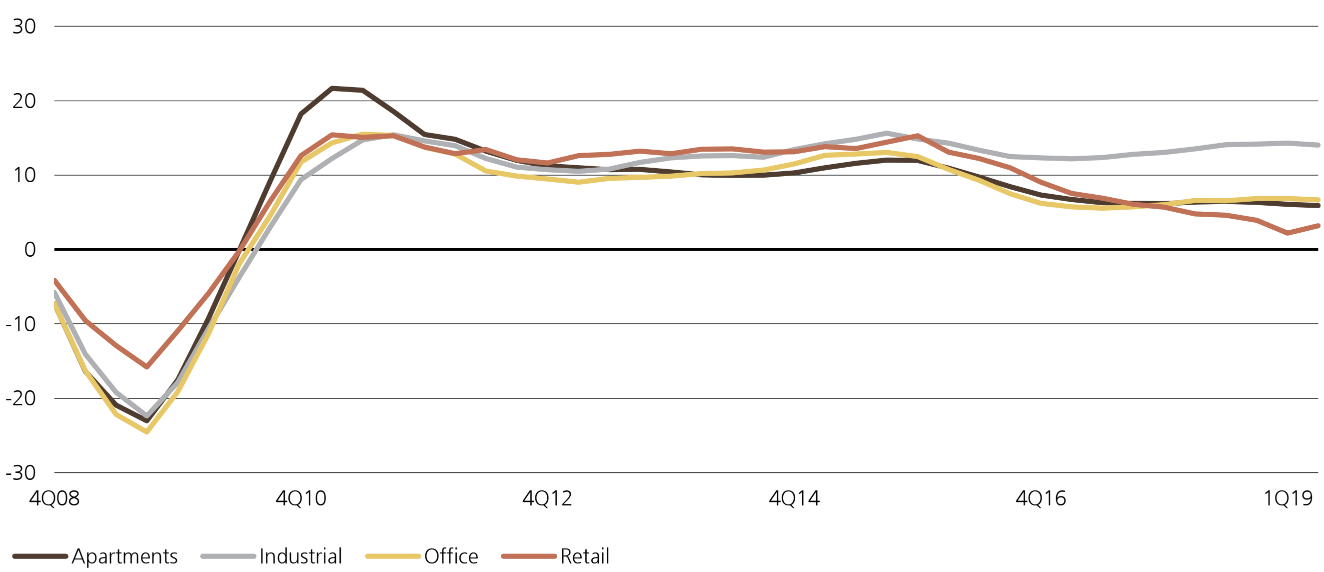
Private commercial real estate continues to produce steady returns, in line with long-term expectations, even though there are some differences across major property types, see *exhibit 1*. For long-horizon real estate investors, this outcome was expected. After all, rent growth is positive. Expectations are for continued growth at a diminished rate compared to recent performance.

During late 2018 and early 2019, investors experienced heightened uncertainty and volatility in equity and bond markets. After four short-term rate hikes in 2018, the US Federal Reserve indicated the December 2018 rate hike would likely be followed by a pause.

Boosts to sentiment were short lived as a partial government shutdown followed by volatile trade negotiations added uncertainty to investor outlooks. Federal budget negotiations and debt ceiling debates loom on the horizon. Yet, tight labor market conditions support consumers. Favorable credit conditions support economic growth, which most economists expect to be positive and at or slightly above-trend during 2019.

In real estate markets we turn to the fundamentals; demand for space is supported by economic expansion and a strong labor market. Supply growth must be monitored closely, but currently, new construction levels are meeting strong demand, resulting in relatively stable occupancy rates and positive rent growth.

Exhibit 1: US real estate returns across property types
Rolling four-quarter total return (%)



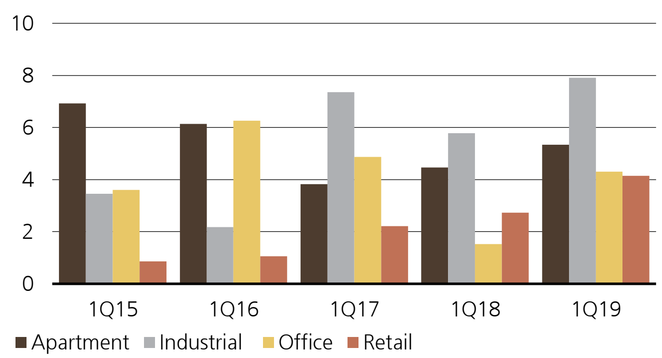
Source: NCREIF Property Index as of March 2019. Past performance is not indicative of future results.

We can further break out real estate revenue into occupancy and rents. Occupancy rates are high relative to the past ten years but face a small degree of downward pressure with supply growth matching or exceeding demand. As there is little room to increase occupancy, rent growth is the driving force behind income gains, *exhibit 2*. Economic conditions create some optimism that growth will continue to reflect positive momentum in the US.

At 3.8% as of March 2019, the national unemployment rate is near its lowest point since 1969. Job growth has been lumpy but is strong overall, *exhibit 3*. During the past year average monthly job gains approached 220,000 per month. A tight labor market generally puts slow, upward pressure on wage inflation but has made it tougher to fill open positions.

Exhibit 2: Property sector rent growth

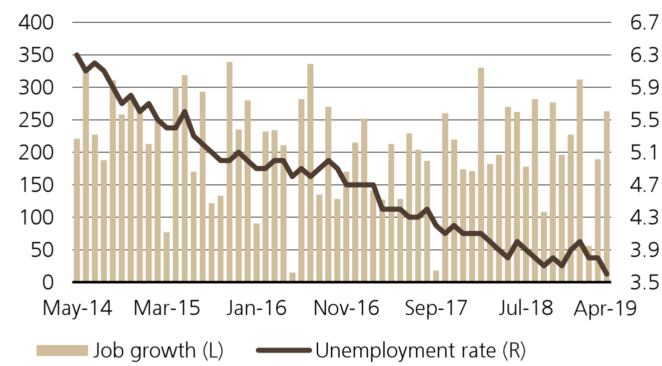
Year-over-year change (%)



Source: CBRE-Econometric Advisors as of March 2019.

Exhibit 3: US job growth and unemployment rate

Change in employment (thousands of jobs) %



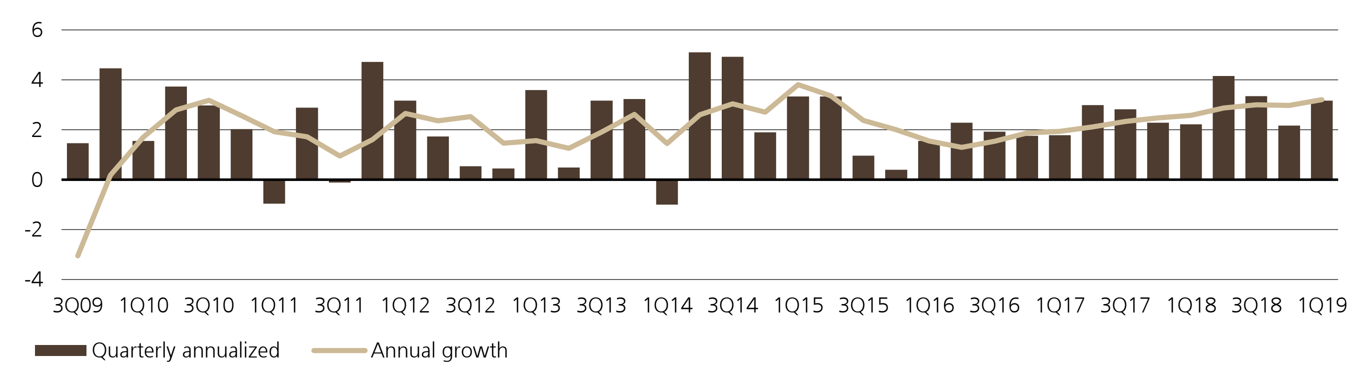
Source: Moody's Analytics as of 3 May 2019.

A growing economy and tight labor market should continue to generate demand for real estate, with steady demand supporting income growth. The tight labor market is one reason wage growth is expected to continue to accelerate in the US. US Consumer price inflation was relatively contained at 1.9% in the year ending first quarter 2019. Expectations continue to be for a strong, but slowing, labor market and modest inflation in 2019.

Realized and expected growth in real estate income directly offsets upward pressure on real estate cap rates from the tight spread. Current economic expansion is considered to be self-sustaining at or above the long-term average, US Gross Domestic Product (GDP) increased by 3.2% during first quarter 2019, *exhibit 4*.

Exhibit 4: US real GDP growth

Real GDP growth (%)



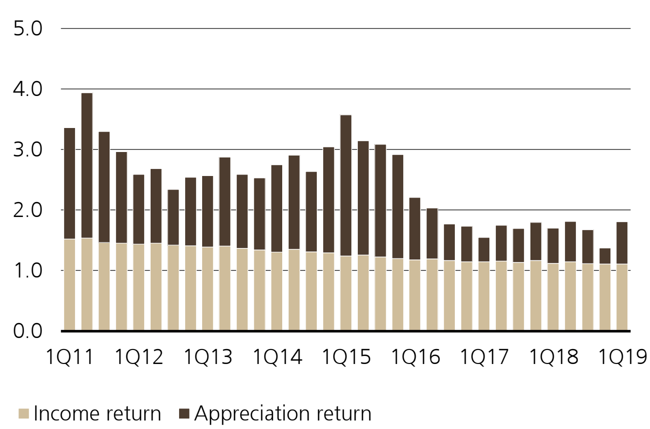
Source: Moody's Analytics as of 26 April 2019.

In December, the target range for the Fed Fund rate rose for the fourth time in 2018 to 2.25% to 2.50%. The Fed has adopted a more patient perspective for 2019; the target range remains unchanged from year end. While the labor market remains strong, national and global political hesitancy leads to the expectation for fewer changes to the Fed Funds Rate over the course of 2019.

In 2019, we expect positive unlevered property returns driven by growth in income with moderation in appreciation, relative to recent years. In first quarter 2019, appreciation return recovered somewhat from a dip the previous quarter, elevating the NCREIF Property Index gain to 1.8%, *exhibit 5*.

Exhibit 5: US property returns

%



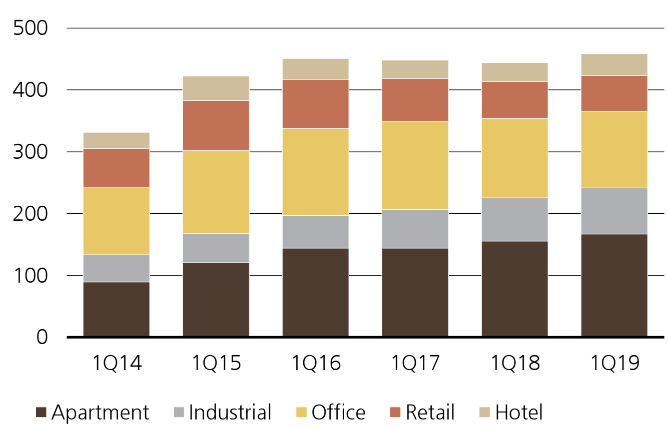
Source: NCREIF Property Index as of March 2019.
Past performance is not indicative of future results.

Total US commercial real estate sales volume was USD 458 bn in the year ending March 2019; up slightly compared to the prior two 12-month periods, see *exhibit 6*. Sector trends remain consistent, with sales of retail and office properties decreasing and sales of apartment, industrial and hotels increasing.

One reason transaction volume is lower for retail and office properties is that lenders have a higher appetite to provide debt for industrial and apartment assets. Real estate debt capital is low cost and generally available but not free flowing like it was during the lead in to the last downturn. In 2018, increasing interest rates compressed spreads available to lenders in a competitive marketplace.

Exhibit 6: US transactions

Transaction volume rolling 4Q (billions USD)



Source: Real Capital Analytics as of March 2019.

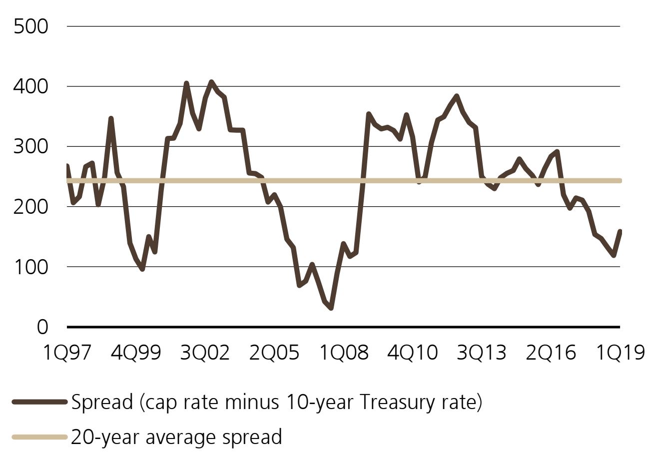
The spread between property yields and the cost of debt decompressed slightly in early 2019. On the whole, US debt markets can be described as operational but not excessive, which encourages development but not an abundance of supply.

Long-term interest rates remain low relative to US history even as those rates moved higher in 2018. The 10-year US Treasury rate was 2.4% at the end of 2017 gaining 60 bps over 2018 to an average of 3% in the fourth quarter. A subsequent 50 bps drop in the 10-year Treasury in early 2019 eased much of the capital market pressure but did not fully reverse the increase in long-term interest rates over the prior year.

With little movement in cap rates, the downward move in Treasury rates slightly increased spreads available in US real estate, *exhibit 7*. Yet, spreads offered by real estate investments are below long-term expectations, representing a change from the wide spreads that drew capital so quickly in the wake of the last recession.

While the real estate spread is no longer compressing, it is low enough to support our expectation for slightly higher cap rates by the end of 2019. There is no noticeable distress in the market that might put stronger upward pressure on cap rates. Income is growing; potential sellers can afford to be patient. In addition, debt is available, and capital expenditures are increasing.

Exhibit 7: Commercial real estate spread
Basis points



Source: NCREIF Fund Index-Open-end Diversified Core Equity and Moody's Analytics as of March 2019.

Liberty Green/Liberty Luxe, New York, NY

Property types

Apartments

The March 2019 US homeownership rate, at 64.2%, is unchanged from one year ago. Persistence in the labor market and consistent household formation help offset elevated homeownership, leading to sustained demand for multifamily rentals. Year-over-year rent growth was above inflation at 3.0% in first quarter 2019. After trending down through most of 2018, apartment vacancy rates rose modestly in the fourth quarter and again in first quarter 2019, see *exhibit 8*. At 4.6%, vacancy remains below the 20-year average of 5.4%. The pace of new construction is not anticipated to slow noticeably until 2020.

Industrial

In the year ended first quarter 2019, industrial net rent saw a pop of 7.9% growth, notably above the five-year average of 5.3% per annum. The pace of completions remains elevated, *exhibit 8*. Forecasts expect rising completion numbers in 2019 and 2020. Industrial availability was 7.1% in first quarter 2019, down 20 bps from one year ago, nearly as low as it has been since 2000. Even as demand remains high, rising completions add some increasing risk to the outlook.

Office

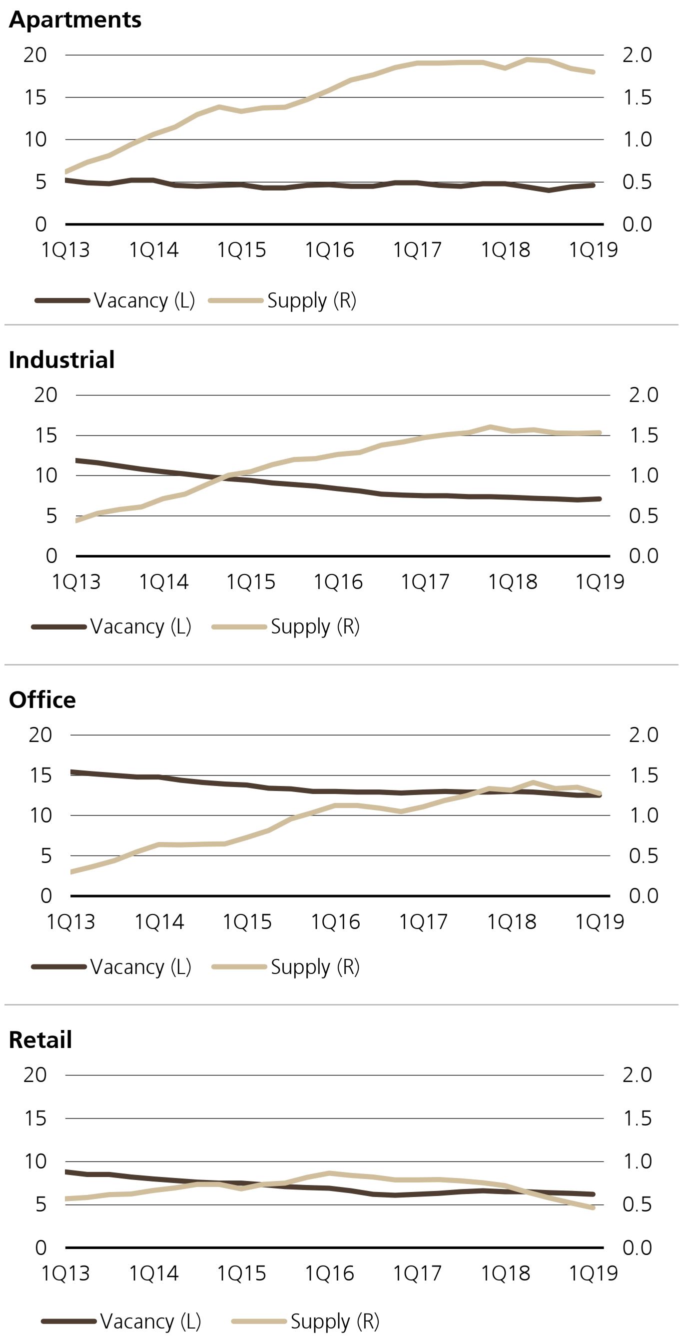
New office deliveries decelerated slightly in first quarter 2019, *exhibit 8*. Exhibiting characteristic volatility, office rent gains outperformed inflation with Downtown's 7.0% annual growth; this unsustainable growth spurt far exceeding Suburban office's 2.6% rent growth. Average office vacancy decreased 50 bps from one year ago. The gap between Downtown vacancy at 10.5% and Suburban vacancy at 13.5% remains wide. Downtown deliveries accelerated to 1.3% of inventory, while Suburban completions slipped to 1.2%, having passed a peak period.

Retail

Increased disposable income and low unemployment should support retail sales in 2019. Stability in high-quality properties is likely offset by deterioration in others. Mall/lifestyle center occupancy is flattening, while power center occupancy is increasing. Mall/lifestyle rent growth is volatile, while power center annual rents have seen modest growth in the last two annual periods. At 8.8%, availability in Neighborhood, Community & Strip (NCS) retail is down 70 bps since the end of 2017. In the year ending first quarter 2019, NCS rents grew at a pace of 4.1%, more than double the pace of inflation.

Exhibit 8: Property sector vacancy and completion rates

Vacancy rate (%) Percent of inventory (%)



Source: CBRE-Econometric Advisors as of March 2019. Supply is shown as a completion rate (i.e. completions as a percent of existing inventory).

Viewpoint

Even as capital markets face dimished spreads and cap rates are closer to the cost of debt, fundamental strength in the US economy acts as an offsetting factor by supporting income growth at the property level.

Beginning in early 2016, US real estate entered a widely-anticipated period of income-driven performance. US properties are appreciating at about the pace of inflation. Appreciation relates back to the positive rent growth generated by properties, as opposed to the outsized influence of capital flows the US experienced in 2014 and 2015.

Looking more closely at the drivers of income, rent growth is the true powerhouse behind the gains. An expectation for continued positive economic growth reinforces our view that property-level income growth should outpace inflation even as the pace of growth moderated in recent years. Income-generated performance is consistent with a long-term expectation for private commercial real estate investments.

Even though 2018's rising interest rate environment reversed and long-term interest rates fell during early 2019, uncertainty persists. Transaction volume is sustaining a high level but shows minimal acceleration. Appreciation remains modest. We expect a small upward movement in cap rates over the coming year.

Capital investment into stabilized assets is increasing, an expected outcome in a long expansion. Debt and equity capital is seeking growth strategies, and existing assets are under pressure to compete with new construction. Investors should pay careful attention to the risk-return expectations for incremental capital.

A tight labor market and optimistic confidence measures reinforce our expectations for relatively good occupancy rates and continued rent growth in the US real estate sector.

Exhibit 9 – Historical performance

Total returns (%)	2016	2017	2018	4Q18	1Q19	10 year	20 year
Bar cap	3.0	4.0	(0.4)	1.5	3.3	3.9	4.8
S&P 500	12.0	21.8	(4.4)	(13.5)	13.6	15.9	6.0
NAREIT	8.6	8.7	(4.0)	(6.1)	17.2	18.8	11.1
CPI	2.1	2.1	1.9	(0.5)	1.2	1.8	2.2
NCREIF Property Index							
Total	8.0	7.0	6.7	1.4	1.8	8.5	8.9
Income	4.8	4.7	4.6	1.1	1.1	5.5	6.3
Appreciation	3.1	2.2	2.1	0.3	0.7	2.9	2.5
NCREIF total returns by property type							
Apartments	6.2	6.1	6.1	1.3	1.3	8.6	8.8
Hotel	4.9	7.6	7.6	1.2	0.4	6.3	6.9
Industrial	13.1	14.3	14.3	3.4	3.0	10.4	10.0
Office	6.0	6.8	6.8	1.6	1.6	7.5	8.2
Retail	5.7	2.2	2.2	(0.4)	1.7	8.9	10.0

Source: NCREIF, NAREIT, Morningstar and Moody's Analytics as of March 2019.

Real Estate Research & Strategy Team – US

William Hughes
Tiffany Gherlone
Christopher DeBerry
Kurt Edwards
Samantha Hartwell
Amy Holmes
Joshua Rome
Ryan Watts

For more information please contact

UBS Asset Management
Real Estate Research – US

UBS Realty Investors LLC
10 State House Square
Hartford, CT 06103
1-860-616-9000

Follow us on LinkedIn

www.ubs.com/repm-research

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