AEGON Asset Management

Aegon Real Assets US | Applied Research

INVESTMENT OUTLOOK FOR US COMMERCIAL REAL ESTATE

October 2018

The domestic labor market, along with economic activity, continued to exhibit strength through the third quarter of 2018. Additionally, core inflation remains near the Federal Open Market Committee (FOMC) target of 2%. Overall, the macroeconomic backdrop continues to remain favorable in regard to real estate demand. Coupled with a relatively tame supply cycle, real estate sector fundamentals that drive income returns remain largely balanced.

Based on the inflation and labor market realizations mentioned previously and the FOMC's expectations, the committee increased the target range for the federal funds rate in the September meeting from 2% to 2.25%. Further out on the yield curve, the 10-year Treasury rate began the fourth quarter at its highest level since 2011 and is up roughly 25 basis points from a quarter prior. The spread between real estate capitalization rates and interest rates remains well above historical lows, but we continue to expect interest rates to have a moderating influence on capital returns within the real estate sector as they cool economic growth.

While real estate performance has largely been unaffected by trade concerns to date, news of the completion of a new North American trade pact is an added reason for optimism as trade uncertainty has diminished. However, hurdles remain with regard to trade policy involving China. These outstanding policy items coupled with continued reduction of the FOMC's balance sheet bring into question the appropriate pace of monetary policy tightening which may have broader market implications.

Demographically, the heart of the influential and populous millennial generation is now approaching the age of 30 and it is important for investors to pay attention. This urban-inclined generation has helped to push employers back downtown, is quick to adapt to new technologies, and has historically had a strong tenancy to rent. This generation has also delayed life relative to prior generations. The median age of marriage in 2017 was 29.5 for men and 27.4 for women, roughly two years later than just a decade ago and roughly five years later than the baby boomer generation. Life events are known to change the financial dynamics of a household and change consumption behavior for goods, services and housing. Real estate investors will need to balance these historical tenancies against the economic hurdles that await them.

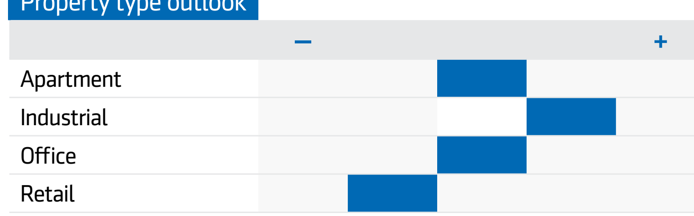
While there has been variability in homeownership rates for each age cohort, it still holds true that homeownership increases with age. With growth in the 20-29-year-old age cohort slowing and growth in the 30-39-year-old cohort beginning to accelerate, it is reasonable to assume that the desire for homeownership among this generation will begin to increase as well. However, potential buyers are faced with many economic challenges that will impede their ability to transition to homeownership even if the desire exists. Single family housing construction since 2010 is well off the pace of any decade going back to World War II and is contributing to inventory constraints. Student loan debt, increasing interest rates, tight mortgage underwriting standards, and increasing construction costs are additional barriers. We believe these barriers will help to counteract adverse sector outcomes relating to an aging millennial generation but these factors should be closely considered market-by-market and asset-by-asset.

The firm considers office fundamentals to be near equilibrium and our investment outlook for the office sector remains neutral from a quarter ago. However, construction activity within the sector and a tight labor market are signals for moderating rent growth prospects. San Francisco, Austin, Raleigh, Seattle, and Charlotte currently have the largest construction pipelines relative to existing inventory. New York is another market that has seen elevated construction levels this cycle. Demand growth has largely been concentrated toward the high-end of the quality spectrum within the sector. Our expectations are for this trend to continue as employers look to attract and retain talent in an increasingly competitive labor market.

The industrial sector continues to exhibit strong performance, and historically low vacancy rates suggest this trend will continue over the near-term. Functional space near major population centers is particularly scarce as supply chains continue to seek quicker access to e-commerce customers. Millennials and the generation behind them have shown higher preferences to shop online and should continue to drive e-commerce related demand growth in the years to come. Construction of industrial space is responding to demand as it has become more economical to build than buy in many markets. But, the availability rate in projects under construction has spiked relative to a year prior and is one of the reasons we believe outsized rent growth will begin to gradually moderate. As the trade fog begins to clear with Mexico and Canada, top North America trade markets may stand to benefit from renewed investment. These markets include Laredo, Detroit, El Paso, San Diego, Buffalo, and Chicago.

Headlines have referenced the end of brick and mortar retail; however, sector fundamentals are telling a less draconian story. With a relatively light supply cycle, retail vacancy rates are near historical lows and net absorption remains positive despite store closure announcements. However, e-commerce has changed space dynamics and siting decision for many retailers. Though opportunities in the market remain, we expect the sector to continue to evolve which is why we remain cautious in our sector outlook.

Property type outlook



Aegon Real Assets' view is derived by the Applied Research Group and is based on both forward and backward looking measures.

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Aegon Asset Management US Economic Forecasts	2015	2016	2017	2018F	2019F	2020F	2021F
GDP (Real %, Year-over-Year)	2.6	1.6	2.3	2.75	2.2	1.8	1.0
Unemployment (%)	5.3	4.9	4.4	3.9	3.7	4.1	4.8
Core PCE	1.3	1.7	1.5	1.9	2.0	1.8	1.7
Fed Funds (%)	0.5	0.8	1.5	2.3	2.5	1.8	1.8
10-year US Treasury (%)	2.3	2.5	2.4	3.1	3.2	2.5	2.1

As of 8/15/2018

Sources: Aegon Real Assets US, Aegon Asset Management US, Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Board of Governors (US), Census Bureau, CoStar Realty Information, Department of the Treasury

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Aegon Real Assets' Applied Research Group utilizes primary and secondary research to monitor commercial real estate property fundamentals, capital markets, and macroeconomic conditions. Our platform applies both qualitative and quantitative techniques in its contribution to an investment outlook.

Disclosures

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