AEGON Asset Management

INVESTMENT OUTLOOK FOR US COMMERCIAL REAL ESTATE

January 2019

The big picture

- Economic growth and capital markets factors drive the performance of commercial real estate (CRE) by affecting the demand and supply of space as well as property investments.
- The US economy delivered above-trend growth at a 3.5% pace in the third quarter of 2018. Consumer spending growth remained strong despite a drop off in vehicle sales and weakening in home sales and residential construction. A material pop in inventory accumulation provided a positive offset.
- Job creation during the fourth quarter of 2018 was strong with an average pace of 254,000 per month. With the unemployment rate at 3.9%, the Federal Reserve (Fed) Beige Book survey is reporting widespread difficulty among employers looking to hire. Labor market tightness will contribute to an expected slowing in economic growth in 2019.
- Inflation remains tame and near the Fed's 2% target. Nonetheless, the Fed increased the funds rate by 25 basis points in December, the fourth such increase in 2018. Longer-term Treasury yields have displayed volatility as of late, with the 10-year Treasury rate peaking at 3.24% in the fourth quarter before falling to 2.69% by year-end.
- US BBB corporate bonds have widened since the beginning of the year implying that investors are re-evaluating their appetite for risk. BBB's are the lowest investment grade category.
- US CRE performance reflected this macroeconomic strength. Focusing on real as opposed to financial performance, net operating income growth reported for the benchmark NCREIF Property Index totaled 3.6% for the four quarters ending September, in line with its performance since the end of the recession. Vacancy rates among NCREIF properties averaged 5.8% in the third quarter of 2018, the lowest yet since the fourth quarter of 2000.
- Turning to financial performance, CRE investor's sustained appetite for US properties with NCREIF transactions cap rates very slightly below the low posted just prior to the recession. At the same time, total return performance of the NCREIF Property Index has been easing to the 7% range, down from double digits as recently as 2016.[1]

Setting the stage for 2019

- Macroeconomic forecasters, including ours at Aegon Asset Management, expect slower US economic growth in 2019 as the deficit spending boost, labor constraints, and rising interest rates take hold. To date, we believe the stage is set for weakening exacerbated by intensifying uncertainty. The US stock market is correcting, the 10-year Treasury yield is again below 3% with the yield curve nearly flat, there is labor market tightness, and concerns about tariffs and Brexit are pervasive.
- Since CRE responds to growth with a lag, it is reasonable to assume that 2018's strong growth will sustain demand for space through 2019. New supply coming to market in 2019 is known and of modest proportion. Together these forces should support occupancy across property sectors.
- Property pricing and investor appetite for US CRE is less predictable because it responds to capital markets conditions quickly. To date, investors remain hungry for US CRE as demonstrated in the 17% increase in transactions volume during the third quarter year-over-year accompanied by a 7.2% increase in prices, according to Real Capital Analytics.
- With this backdrop, the Pension Real Estate Association (PREA) consensus survey shows a 5.7% total return predicted for 2019, the weakest since the last recession. Forecasts range from 4.3% for the most pessimistic to 7.0% for the most optimistic. Aegon Asset Management's macroeconomic outlook and assessment of CRE conditions support the consensus PREA forecast.

Sector prospects mixed[1]

- **Apartments:** Delivered the third highest total return among the four major property sectors; the national vacancy rate is below the long-term average despite very strong flow of new supply; and solid job growth is absorbing demand by maturing millennials plus ongoing constraints on homeownership are positive forces along with diminishing delivery of new units after 2019.
- **Industrial:** Posted the highest total return among the four major sectors; vacancy rates were below the long-term average nationally; and pockets of strong construction activity in several metros have been driven by demand from the e-commerce.
- **Office:** Had the second highest total return; the national vacancy rate was below the long-term average; and substantial new construction is to be delivered next year in several markets where rent growth is weakening. Overall, the structural evolution in office space demand is roughly balanced by modest construction.
- **Retail:** Delivered the lowest total return just under 4% reflecting the ongoing process of reconciling physical space with evolving demand; and the shift in consumer behavior toward online purchasing is one source of turmoil but more important is the weak pace of wage growth, enormous income inequality and geographic concentration of economic vigor on the east and west coasts. But, there is little new space in these regions.

[1]As of September 30, 2018

Aegon Asset Management

INVESTMENT OUTLOOK FOR US COMMERCIAL REAL ESTATE

January 2019

Aegon Asset Management US Economic Forecasts

	2016	2017	2018*	2019*	2020*
GDP (Real %, YoY)	1.60	2.30	2.90	2.25	1.80
Unemployment (%)	4.90	4.40	3.80	3.60	3.90
Core PCE	1.70	1.50	1.90	2.00	1.90
Fed Funds (Upper Bound, %)	0.75	1.50	2.50	2.75	1.75
Tsy10 (%)	2.45	2.41	3.10	3.00	2.50

Source: Aegon AM US as of 12/31/18. Includes historical data sources from Bureau of Economic Analysis, Congressional Budget Office, Haver Analytics. *Estimated

Property Sector Outlook

	Top 50 Metros*						
	Under Construction as % of Inventory	3Q18 Vacancy Rate**	3Q17 Vacancy Rate**	Metros With Rising Vacancy Rate	3Q18 Year-on-Year Rent Growth**	3Q17 Year-on-Year Rent Growth**	Aegon Real Assets Sector Outlook
Apartment	4.43%	5.96%	6.56%	5	3.52%	2.53%	Neutral
Industrial	1.53%	4.56%	4.86%	20	5.77%	5.85%	Favorable
Office	1.72%	8.96%	9.11%	20	3.12%	3.34%	Neutral
Retail	0.71%	4.42%	4.59%	15	2.22%	3.03%	Cautious

*Top 50 by metro areas by population; CoStar Realty Information, Inc., Aegon Real Assets US; as of September 30, 2018
**Equal weighted average

Sources: Aegon Real Assets US, Aegon Asset Management US, Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Board of Governors (US), CoStar Realty Information, Department of the Treasury, National Council of Real Estate Investment Fiduciaries (NCREIF), Pension Real Estate Association (PREA)

Martha Peyton, PhD, Managing Director
mpeyton@aegonusa.com

Callie Yeary, MAI, CCIM, Chief Appraiser
cyeary@aegonusa.com

Brad Bohl, Associate Director
brbohl@aegonusa.com

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

AdTrax: 1831861.13
Exp Date: 5/31/2019