Aegon Asset Management

US CRE MARKET INSIGHTS BRIEF

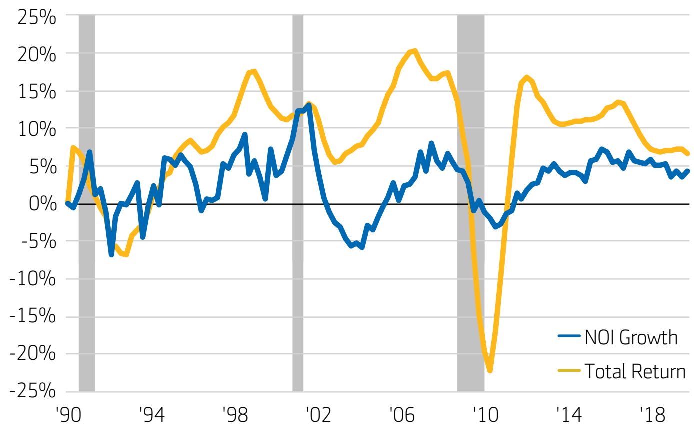
Applied Research

The US economy moderated in the fourth quarter of 2018 after above-trend growth earlier in the year. The pace of growth was supported by a robust labor market, a pick-up in non-residential fixed investment, and positive momentum in personal consumption. For 2018 as a whole, real GDP growth registered a 2.9% pace reflecting the impact of the first year following tax reform. In 2019, it is widely expected that economic growth will further moderate due to slower global growth prospects and fading stimulus impacts. However, the financial market volatility that marked the fourth quarter of 2018 has since faded as a new and more patient tone from the Federal Reserve has helped to ease market fears of a potential policy error. For US commercial real estate (CRE), a supportive macroeconomic backdrop propelling demand, a relatively moderate supply cycle and favorable current occupancy fundamentals bode well for investment performance in the quarters ahead.

Big picture update

- The US economy delivered an above-consensus pace of real GDP growth of 2.6% in the fourth quarter of 2018. This brought the annual total to 2.9%, a healthy increase from 2017's 2.2% but was a clear moderation from the stronger growth produced in the second and third quarters.[1] The moderation is seen as a signal of the waning impact of the 2017 tax cuts.
- Despite a poor headline number in February, job growth has averaged a solid 186,000 per month over the last three months.[2] But, at the same time, the Federal Reserve (Fed) is reporting that employers are having difficulty filling job openings as the available supply of labor tightens which could constrain economic growth in the quarters ahead.[3]
- Citing concerns of global economic headwinds and moderate inflation pressures, the Federal Reserve did not tighten in January and announced a more patient stance on future rate hikes and flexibility in managing its balance sheet.
- US corporate bonds and public market equities experienced heightened volatility in the fourth quarter. BBB bond spreads posted their widest level since early 2016 indicating that investors were re-evaluating their appetite for risk in light of comments from the Fed about pace of rate hikes and concerns about economic growth.[4] Following the reassuring change in tune from the Fed in December, financial markets have stabilized with prices recovering much of their end of the year losses.
- In the property markets, transaction volume escalated 14.9% in 2018 to $562 billion. This follows a modest decrease in 2017 and represents a volume slightly below the all-time high in 2015, suggesting ongoing ample liquidity in the real estate capital markets. RCA's Commercial Property Price Index increased 6.2% in 2018 compared 8.4% the prior year. The rate of price growth has now moderated each year since 2014.[5]
- US CRE performance remained solid in 2018 despite financial market turmoil. Total return for the NPI was reported at 6.71% for the year, down slightly from 2017.[6]
- Focusing on property performance, net operating income growth reported for the NCREIF Property Index (NPI) totaled 4.29% in 2018, well above the long-term average. Additionally, vacancy rates were their lowest since 2000 signaling healthy fundamentals and continued prospects for solid rent growth ahead.[7]

NCREIF Property Index
Year-over-year change (1990-2018)



Source: NCREIF Property Index Detail Report as of December 31, 2018.

[1]Bureau of Economic Analysis, Gross Domestic Product Fourth Quarter and Annual 2018 (Initial Estimate), February 28, 2019
[2]Bureau of Labor Statistics, Employment Situation, February 1, 2019
[3]Board of Governors of the Federal Reserve System, the Beige Book, January 16, 2019
[4]Bloomberg Barclays, Baa Corporate OAS, as of December 31, 2018
[5]Real Capital Analytics, Inc., as of December 31, 2018
[6]National Council of Real Estate Investment Fiduciaries, as of December 31, 2018
[7]CoStar Realty Information, Inc. as of December 31, 2018

Moving forward

- While the end of the cycle has been heavily debated recently, our baseline economic forecast calls for continued economic growth, albeit at a slower rate. A healthy but tight domestic labor market, slower global growth prospects and the fading impact of fiscal stimulus underpin our base case of moderating growth. However, we believe risks surrounding corporate leverage, trade war escalations, monetary policy mistakes and Brexit help to skew the distribution of potential outcomes to the downside.
- Trade policy with China remains an economic wildcard with a wide spectrum of potential outcomes and impacts on economic projections. The progressing dialogue is a positive signal relative to stalemate but even if the outcome is eventually benign, the uncertainty itself is a drag on US growth prospects.
- Absent a strengthening in inflation pressures, the FOMC has cover to follow a neutral path and remain patient when evaluating the federal funds rate. Barring a significant deviation from our economic expectations, we expect the 10-year UST yield to remain range bound in the near-term and intermediate-term.
- With a supportive domestic macroeconomic environment, we are confident that US CRE is well-poised to maintain solid fundamentals into 2020. On balance, stable occupancy trends at or above their long-term averages are supportive of continued rental rate growth for the majority of property sectors and markets.
- With the Fed's new and more dovish stance helping to calm the financial market volatility and with no sign of accelerating inflation, we expect CRE capitalization rates to remain mostly stable in the quarters ahead. Given current levels, we believe meaningful capitalization rate compression is largely over for this cycle and expect CRE price appreciation to continue to moderate leaving investment performance dependent on growth in property level income.

Sector prospects

- **Apartments:** After moderating in 2017, operating fundamentals improved in 2018 as job growth and continued barriers to homeownership fed robust demand. We expect demand drivers to remain favorable in 2019 and keep pace with another year of elevated construction activity. Weak balance sheets for a wide swath of renters are expected to shield demand, particularly for properties that target renters at or below median market income levels.
- **Industrial:** Continues to post the highest total returns among the four major property sectors with outsize net operating income growth and price appreciation.[6] Construction has accelerated in the sector but remains constrained by local regulatory barriers, tight availability of land and labor, and increasing construction costs. As a result occupancy, backed by favorable demand drivers, continues to trend well above historical averages. While trade risks continue to threaten certain geographies and supply chains, the impact going forward is highly uncertain.
- **Office:** Fundamentals remain stable as a muted supply cycle and strong labor market have largely offset the trend toward more space-efficient work environments. Absorption trends have favored higher quality assets with technology companies driving a significant share of new demand in a competitive labor market.
- **Retail:** Has been the weakest performing property sector in regards to total return as structural challenges continue.[6] Retailers with larger formats are especially stressed with bankruptcies and store closures accumulating despite solid economic growth and low unemployment. A lack of new supply has helped to prevent major supply and demand imbalances but dark (leased but unoccupied) retail space is contributing to softer fundamentals than suggested in some data sources. However, higher quality assets with demographically strong trade areas have proven quite resilient and some investors are finding relatively greater flexibility with pricing and structure.

Property sector outlook	Top 50 metros*						
	Under Construction as % of Inventory	4Q18 Vacancy Rate**	4Q17 Vacancy Rate**	Metros w/Rising Vacancy Rate	4Q18 YoY Rent Growth**	4Q17 YoY Rent Growth**	Aegon Real Assets Sector Outlook
Apartment	4.42%	6.27%	6.78%	9	3.85%	2.54%	Favorable
Industrial	1.53%	4.53%	4.71%	18	5.90%	5.95%	Favorable
Office	1.73%	8.75%	8.97%	18	2.84%	3.49%	Neutral
Retail	0.66%	4.34%	4.41%	22	1.98%	3.20%	Cautious

*Top 50 by Metro Areas by Population; CoStar Realty Information Inc., Aegon Real Assets US; as of December 31, 2018
**Equal Weighted Average
[6]National Council of Real Estate Investment Fiduciaries, as of December 31, 2018

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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.

Disclosure