The global macroenvironment begins 2019 having achieved forecasted Gross Domestic Product (GDP) growth of 3.8%, the strongest year of growth in this cycle. However, despite strong underlying global fundamentals including two quarters of above-trend growth in the U.S. (4.2% in the second quarter and 3.5% in the third quarter), the year has ended amid significantly higher capital markets volatility triggered by continued uncertainties over trade, Brexit, other geopolitical tensions and Central Bank actions. This increased volatility has yet to create any broad-based weakness in real estate markets, with underlying fundamentals remaining strong, underpinned by the strong global macro backdrop and secular trends including ecommerce and urbanization. Real estate capital markets have also remained relatively immune to this recent market turbulence with pricing levels remaining at or above historical highs, due to the abundance of capital targeting the sector (allocations increased to 10.4% in the U.S., up 30bps over 2017) and interest rates at near historic lows in most markets.

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1 Morgan Stanley Research, November 2018.
3 Hodes Weill & Associates, 2018 Institutional Real Estate Allocations Monitor.
In 2019, Morgan Stanley Real Estate Investing (MSREI) believes economic growth will moderate globally and diverge across major markets, while interest rate policies are expected to converge and financial conditions will likely tighten. The combination of lower macroeconomic growth and higher interest rates will likely lead to lower commercial real estate returns broadly as a result of moderating real estate fundamentals and flat to marginally higher cap rates. However, returns will likely be more differentiated by market and sector, requiring investment managers to be more discerning in defining optimal investment strategies and deploying capital against those strategies.

Global Macroeconomic Environment

The global growth cycle is expected to moderate in 2019 with forecasted GDP growth of 3.6% (from 3.8% in 2018), which remains above the historical average of 3.5%. The moderation will be driven by a slowdown in developed markets, predominantly in the U.S., as tighter resources and less supportive policy become more significant headwinds. We expect continued moderation in growth through 2020, with heightened recession risk in the U.S. due to tighter financial conditions and less fiscal support. In most developed markets, we expect that tighter labor markets will lift wage growth, bringing inflation levels higher and near cycle peaks. Given recent US Federal Reserve System ("Fed") rhetoric, we expect a pause in the U.S. interest rate hiking cycle in the third quarter of 2019, while the European Central Bank (ECB) is expected to embark on the next stage of policy normalization and begin their gradual rate hiking cycle. Emerging markets are expected to retake the lead in driving global growth helped by the expected pause by the Fed, a weaker USD and softer oil prices.

Key global risks worth noting include corporate credit defaults in the U.S. (non-financial corporate leverage is now 73% of GDP, up from 64% in 2012, with the rise driven more by highly levered companies); trade and technology/Intellectual Property tensions with China (which are expected to continue despite recent positive news around the “tariff pause”, reduction in tariffs on U.S. autos and reemergence of China buying U.S. agriculture products), and other idiosyncratic risks including Brexit, Italy’s (and France’s) fiscal situation and political uncertainty in Germany.

United States

GDP growth is expected to accelerate in the first half of 2019 as a result of a record-high tax refund season propelling consumer spending. However by mid-to-late-2019 growth is expected to slow below trend as fiscal stimulus fades (GDP impact dropping from 0.8pp in 2018 to 0.2pp in 2019) and tighter financial conditions from earlier interest rate hikes take hold. As real interest rates are likely to reach “neutral” in the middle of 2019, it is expected that the Fed pauses, with future rate changes dependent on incoming data. Further moderation in growth is expected into 2020, with a chance that the economy flatlines or enters negative territory at some point during that year.

From a capital markets perspective, this heightened volatility seen over the past several months is likely to continue into the first quarter of this year. Ten year bond yields have dropped 39bps from their high of 3.24% in early November 2018 back to 2.85% in early December (leading to a widening of cap rate spreads from 155bps to 194bps), while the equity markets have corrected by 12% since October. Treasury yields are expected to creep back up next year supported by growth, inflation, Fed tightening and a widening budget deficit. While this volatility is reportedly leading to thinner bidder pools, it has not yet led to any broad-based negative pricing impacts, with the Moody’s Commercial Property Price Index up 7% through the end of November on a year-over-year basis.

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5 Haver Analytics, Morgan Stanley Research.
6 Morgan Stanley Research, Global Macro Outlook, November 2018.
7 Morgan Stanley Research, 2019 Global Outlook.
8 Bloomberg, MSREI Strategy, data as of December 2018.
9 Moody’s Commercial Property Price Index, RCA, November 2018.
On the margin, lower quality, non-core properties in secondary/tertiary markets are likely to be more impacted as capital becomes more selective and focused on defensive asset types and liquid markets. Overall, in the absence of a more pronounced equity market correction that could lead to capital outflows from portfolio rebalancing, we would anticipate that investors will continue to allocate similar levels of capital to the real estate sector, eyeing its long-term stability, attractive income component and strong absolute and relative returns.

Property fundamentals in the U.S. will likely remain relatively strong, buoyed by above-average economic activity this year and through the first half of next year. Vacancy rates will likely remain below their long term averages in all sectors, supporting continued rent growth in the absence of significant new supply, which has been constrained by rapidly rising construction costs and lending restrictions. Industrial property continues to perform very well, vacancy is currently at record lows (below 5%) and Net Operating Income (NOI) growth is expected to do better than the other sectors (4.5% over the next five years versus 2.2% on average for the other sectors) supported by e-commerce tailwinds (growing at 15% p.a.), continued strong global growth and higher manufacturing output. Supply is increasing but is being absorbed.

---

**DISPLAY 2**

**Cap Rates**

*Major Sector Average*

<table>
<thead>
<tr>
<th>Year</th>
<th>Yield, %</th>
<th>Spread to 10-year UST, bps</th>
</tr>
</thead>
<tbody>
<tr>
<td>01</td>
<td>8%</td>
<td>500</td>
</tr>
<tr>
<td>02</td>
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<tr>
<td>17</td>
<td>8%</td>
<td>500</td>
</tr>
<tr>
<td>18</td>
<td>8%</td>
<td>500</td>
</tr>
</tbody>
</table>

Source: NCREIF, Bloomberg, MSREI Strategy, data as of December 2018

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**DISPLAY 3**

**Performance by Property Type**

*Annualized Returns (unlevered)*

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<thead>
<tr>
<th>Property Type</th>
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<th>5%</th>
<th>10%</th>
<th>15%</th>
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<td>Overall</td>
<td>7.6</td>
<td>7.6</td>
<td>7.6</td>
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</tr>
<tr>
<td>CBD</td>
<td>6.3</td>
<td>6.3</td>
<td>6.3</td>
<td>6.3</td>
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<tr>
<td>Suburban</td>
<td>6.9</td>
<td>6.9</td>
<td>6.9</td>
<td>6.9</td>
</tr>
<tr>
<td>Industrial</td>
<td>7.4</td>
<td>7.4</td>
<td>7.4</td>
<td>7.4</td>
</tr>
<tr>
<td>Office</td>
<td>8.7</td>
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<td>8.7</td>
<td>8.7</td>
</tr>
<tr>
<td>Retail</td>
<td>7.6</td>
<td>7.6</td>
<td>7.6</td>
<td>7.6</td>
</tr>
<tr>
<td>Malls</td>
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<td>6.3</td>
<td>6.3</td>
</tr>
<tr>
<td>Centers</td>
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<td>7.4</td>
<td>7.4</td>
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</tr>
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<td>Hotel</td>
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<td>7.3</td>
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</tr>
<tr>
<td>Historical Average</td>
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</tr>
<tr>
<td>YoY</td>
<td>8.4</td>
<td>8.4</td>
<td>8.4</td>
<td>8.4</td>
</tr>
</tbody>
</table>

Source: NCREIF, MSREI Strategy, data as of December 2018

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10 CoStar, Census Bureau, MSREI Strategy, data as of December 2018.
11 Capitalization rate, commonly known as cap rate, is a rate that helps in evaluating a real estate investment. It is calculated dividing the asset’s net operating income (NOI) by the current market value (sales price) of the asset.
12 A spread is the difference between the bid and the ask price of a security or asset.
Users and capital are flowing away from primary distribution hubs to secondary markets to be close to population centers and deeper labor pools. Conversely, retail continues to be the most challenged sector, but remains very bifurcated — Class A malls sales per square foot are trading at a 10% premium compared to 2007 peak levels, while Class B & C productivity is down 50%. Recent trades and recaps suggest pricing of 4.25-4.5% for Class A malls, indicating no apparent weakness for the best quality centers, while there continues to be zero/ few bids for Class B/C product. High street locations have also experienced more weakness across the entire quality spectrum due to lower sales productivity, higher occupancy costs and the proliferation of tenant location options. Similar to malls, the better quality high street locations are experiencing less rental decline than secondary/tertiary locations.

The office sector is expected to maintain moderate NOI growth, helped by low levels of supply this cycle, continued strong job growth and a bottoming/reversal of the densification trends seen over the past five years as firms try to attract and retain top talent. In the apartment sector, while headwinds from high supply growth continue to act as a drag on fundamentals, demand for rentals continues to be strong given the lack of affordability in the for sale market, a continued urbanization trend and lifestyle preferences of the millennial cohort. The healthcare sector is becoming increasingly attractive due to cashflow stability (particularly in medical office) and above-average healthcare job growth (2x that of other sectors), supported by aging demographics. Finally, hospitality has re-emerged as an attractive investment alternative given wider yields (300bps spread over traditional sectors), strong corporate profits (up 7.3% YOY) and increased foreign travel spending (up 3.3% YOY).

Europe

In Europe, growth is expected to remain relatively stable and moderate towards trend while inflation is expected to rise as labor markets tighten, capacity constraints build and exports slow. Growth will likely continue to be strongest in Central and Eastern Europe (CEE) countries, Spain and the Nordics. The expansion looks sustainable due to the underlying strength of domestic demand, with neither the existence of overheating requiring a sharp policy tightening nor evidence of major imbalances, outside of ongoing wage/productivity divergence between Northern and Southern European countries. Productivity looks set to rise, but should remain structurally below pre-crisis levels. The European Central Bank announced the end of the quantitative easing era on December 13, 2018, however interest rates are not expected to increase until the fourth quarter of 2019. In the absence of further monetary policy support, countries may revert to fiscal measures to stimulate demand, evidenced in recent budget proposals from Italy and France (largely in response to recent protests). Proposed structural reforms and spending, if approved, will likely increase budget deficits above the European Stability Mechanism limit of 3% of GDP, which may create more tensions within the European Union. Given Europe’s reliance on exports, rising trade tensions remain the key downside risk, in part offset by a weaker currency in the short term and a potentially bigger fiscal impulse in the long term.

In the UK, following the decision to postpone the meaningful parliamentary vote on the Brexit deal pending an attempt to gain further “assurances” on the backstop for Northern Ireland, the Brexit timeline and outcome remains uncertain. Prime Minister May’s victory in the confidence vote on her leadership on December 12, 2018 has potentially reduced the risk of a no deal outcome and improved the prospects for her deal (or a slightly modified version) passing. While the parliamentary majority opposed to a no deal outcome implies a soft spectrum of Brexit outcomes, at the moment the outcome remains open and a no deal, no transition Brexit or even a second referendum remain as possibilities, if nothing else is agreed. Assuming a soft Brexit outcome, growth is expected to slow sharply in the near term due to heightened uncertainty, but under this scenario, growth is likely to recover in the back half of 2019 due to a rebound in investment and business confidence.

From a capital markets perspective, real estate markets across Europe are enjoying a sustained period of above-average returns. Additionally, despite low overall cap rates, the continued low interest rate environment has resulted in attractive cap rate spreads versus other major markets, which has helped compensate investors for geopolitical strains and potential trade headwinds. Even if interest rates rise in late 2019 and 2020 (as expected), the impact on yields will likely be minimal due to the wide cushion that exists between investment grade real estate and government bonds. While returns are expected to moderate with slower growth and marginally higher interest rates, significant differences between the performance of different cities and sectors will continue, creating opportunities to outperform the broad market.

13 Greenstreet Advisors 2018.
14 Greenstreet Advisors Discussion, August 2018.
15 Greenstreet Advisors, October 2018.
16 Bureau of Economic Analysis, Moody’s Analytics, data as of November 2018.
18 MSCI Pan European Index, MSREI Strategy, data as of December 2018.
Additionally, uncertainties surrounding Brexit and other idiosyncratic challenges (Italy, France, Germany, Spain), may create pockets of illiquidity and mispricing, an example of which exists today in the City of London, where the difference in yields between a long-term leased office building and a similarly well-located asset with some leasing risk has expanded to 200-300bps.19

Real estate fundamentals currently remain healthy across all sectors. In the office sector, the vacancy rate is now 200bps below the historical average20 and rents are rising, driven by the combination of low supply and accelerating absorption largely underpinned by increases in professional services and technology job growth. While yields at the prime end of the market have compressed to record lows, there are potentially opportunities for investors to target investments in emerging higher growth and higher yielding submarkets, perhaps adjacent to traditional Central Business District submarkets, which are being transformed by new technology, healthcare clusters or new transport links and other infrastructure. MSREI also believes that faster-growth CEE countries could offer opportunities to reposition high quality office assets in prime locations, taking advantage of the shift in middle and back office functions to markets like Budapest, Warsaw and Bucharest, which is helping to drive the rental recovery in those markets. Additionally, institutional liquidity is growing and yield spreads between primary and secondary cities remain attractive in those markets.

In the industrial sector, on-line sales growth continues to significantly outpace broad-based retail sales growth, contributing to strong demand for logistics, while there continues to be a shortage of modern industrial stock suggesting development is required to meet modern logistics needs. While industrial rent growth has been close to zero over the past five years, growth has accelerated above 2% in 2018 and is expected to remain strong over the next several years.21 Industrial yields remain higher than office and investor allocations to the sector are accelerating, which is likely to lead to more yield compression. In the retail sector, despite steady growth in consumer spending and a relatively “under-retailed” environment, fundamentals will be challenged due to continued growth in e-commerce, shifts in retailer business models and future store closures.

Looking beyond the three main traditional sectors, the occupier markets for European hotel and residential look to be in good shape. Supported by the improving business climate and rising international tourist arrivals, the hotel market is seeing a solid increase in demand. Average occupancy has reached

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19 MSREI Research and Strategy, October 2018.  
20 Property Market Analysis, October 2018.  
21 PMA, MSREI Strategy, data as of December 2018.
73% as at November 2018, up from 67% five years earlier.\textsuperscript{22} Demand for
private residential is also growing across
many European markets, driven by both
reduced access to mortgage products and
changing lifestyles. Home ownership
rates across the European Union fell to
around 70% in 2018, down from 73.2% in
2008.\textsuperscript{23}

**Asia-Pacific**

The Asia-Pacific region has been
disproportionately impacted by trade
disputes this year, given the more open,
export nature of most of their economies.
While economic fundamentals have
remained solid (regional growth still above
4% through the third quarter), trade
headwinds are likely to persist in the near
term, leading to more growth moderation.\textsuperscript{24}

Across Asia, growth in Japan is expected
to accelerate, but fluctuate around the
consumption tax hike scheduled for 2019.
Private consumption is likely to be front-
loaded leading to a strong first half of
2019, while productivity-enhancing capex
will help to offset lower expected exports
supporting growth of around 1.3% in
2019 (versus 0.8% in 2018).\textsuperscript{23} China’s
growth is expected to slow through the
first half of 2019 as the lagged effects of
deleveraging and trade tensions weigh on
consumption and business confidence,
before stabilizing amid increased policy
easing to support the private sector and
infrastructure. Recent positive news on
trade talks, including the ‘90-day pause’
as well as the Wall Street Journal report-
that China is rewriting its 2025 policy
and considering state-owned enterprises
competitive neutrality, suggests that more
escalation in tariffs may not be required.
That being said, Morgan Stanley
Research still believes tariffs will be
increased to 25% on the $200Bn of goods
already tariffed at 10%. However given
progress made, the remaining $267Bn of
exports may not be tariffed. This outcome
would lead to a pullback in GDP growth
of about 0.3pp (compared to 2018 levels)
versus 0.7pp under the previous, more
bearish scenario. Australia’s growth will
likely remain strong, but is expected
to ease back below trend due to a
deteriorating housing market weighing
on consumption and construction,
partially offset by increased government
expenditure and a weaker AUD. Lastly,
in Korea, growth momentum is likely to
drift lower as trade growth moderates and
domestic demand slows due to a pullback
in job growth and uneven wage growth.

\textsuperscript{22} Smith Travel Research, data as of December 2018.
\textsuperscript{23} EuroStat, data as of December 2018.
\textsuperscript{24} World Bank, MSREI Strategy, data as of December 2018.
\textsuperscript{25} Morgan Stanley Research Global Macro Outlook, November 2018.
\textsuperscript{26} Bloomberg News Reports, MSREI Strategy, December 2018.
\textsuperscript{27} Net absorption is a measurement of the net change of real estate supply in a given real estate market over a specific period of time.
Interest rates across the region are projected to remain accommodative with central banks in Australia, South Korea and China expected to keep rates on hold through the end of 2019, while the Bank of Japan may move away from its negative to zero interest rate policy in 2019. As a result, cap rate spreads are expected to remain relatively wide with minimal impact on yields over the next several years. Returns are expected to slow below the long term average and will be driven by income yields as capital growth is expected to be held back by flat yields.

Property fundamentals across Asia-Pacific are expected to remain favorable, with the industrial sector likely to outperform, consistent with other global regions. Online sales penetration is highest in China and Korea, while modern logistics stock remains undersupplied across the whole region. Industrial rents continue to climb in most major markets in Asia Pacific, with the fastest growth in Australia, Hong Kong and China. Income yields are attractive relative to other sectors, and the sector is becoming more institutional which will likely lead to further yield compression in several markets.

Asia-Pacific office markets are expected to continue to offer broad-based growth over the next couple of years, particularly in Melbourne, Sydney and in core Japanese markets, with stable corporate occupier demand outpacing limited supply.

Diverging trends have developed in the retail environment across the region. Retail sales continue to underperform in some major markets in the region including Hong Kong and Singapore due to soft domestic consumption. However, key cities in Australia, South Korea and Japan continue to see relatively healthy rental growth supported by resilient domestic consumption, tourism and low levels of competing new supply. However, similar to other regions, structural shifts in consumer shopping behavior may continue to exert pressures on retailers, which will likely negatively impact all but the best performing and optimally located centers.

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**DISPLAY 7**

**New Construction Below Historical Average**

*As a Percent of Existing Stock*

- 15%
- 10%
- 5%
- 0%

Source: CoStar, PMA, MSREI Strategy, data as of December 2018

**DISPLAY 8**

**Attractive Industrial Yields**

- 7%
- 6%
- 5%
- 4%
- 3%
- 2%
- 1%
- 0%

Source: Broker Reports, data as of December 2018

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29 Property Market Analysis, October 2018.
30 Morgan Stanley Research, PMA, MSREI Strategy and Research, November 2018.
Conclusion
Over the next couple of years, global growth will be expected to move back towards trend and likely be characterized by more pockets of divergence, versus the synchronicity we have seen since 2017. Uncertainty and capital markets volatility will likely remain as dominant themes due to multiple, ongoing geopolitical events across the U.S., Europe and Asia. Commercial real estate may be a beneficiary of this environment given investor preference for longer term stability, cash flow and diversification. However, real estate returns across most markets may be lower and more variable compared with the broad-based, above-average levels achieved over the past five years. Additionally, compelling investment opportunities may become more challenging, as investors rationalize late cycle pricing with the changing growth environment. Within this investing backdrop, MSREI believes the ability to understand the macro investing environment, access in-depth local market knowledge, leverage strong partner relationships and create growth in income streams will differentiate managers in their pursuit of above-market returns.
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In addition, real estate investments are subject to a variety of risks, including those related to, among other things, the economic climate, both nationally and locally, the financial condition of tenants and environmental regulations.

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