

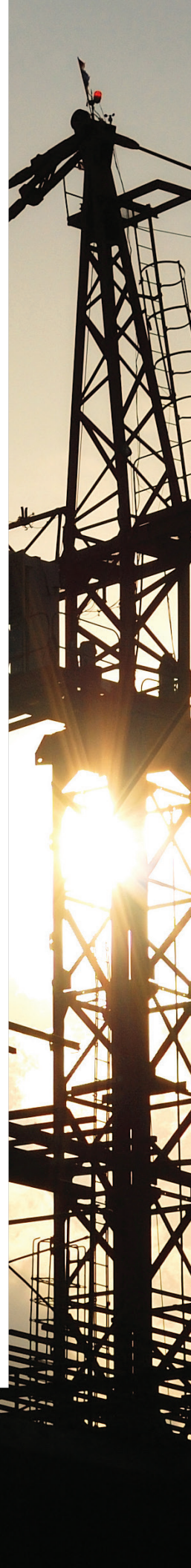
# 2018 Summer Global Real Estate Outlook

REAL ASSETS | REAL ASSETS INVESTING TEAM | INVESTMENT INSIGHT | JUNE 2018

The global macro picture continues to look quite healthy, with 2018 likely to be the peak year for global growth, as most regions move upward together. On the back of stronger global growth, inflation is increasing and long-term rates have risen (most notably in the U.S.). Geopolitical tensions, including recent events in Italy, North Korea as well as ongoing global trade issues, continue to threaten global growth and create heightened volatility and investor uncertainty. Despite this market turbulence, capital flows into real estate remain strong and returns are at or above historical average levels. Morgan Stanley Real Estate Investing (MSREI) believes that the combination of strong economic growth, divergent interest rate policies and volatile currency movements will continue to create a favorable investing environment for commercial real estate (CRE), albeit one that requires increased levels of caution and prudence given the abundance of available capital and cycle maturity.

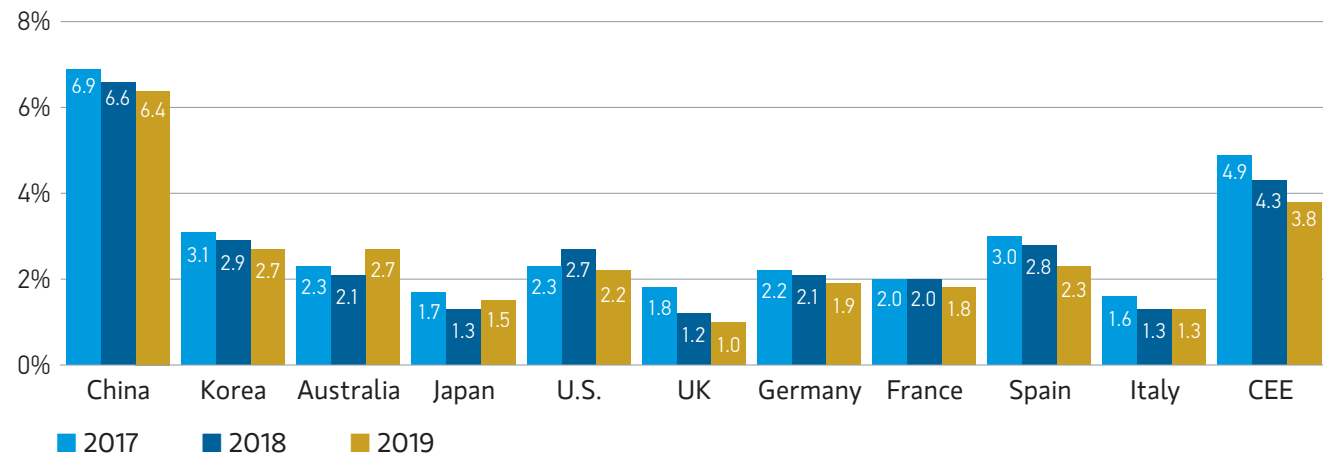
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**DISPLAY 1****Steady Real GDP Growth**

YoY



Source: Morgan Stanley Research data as of June 2018.

**Global Macroeconomic Environment**

The global growth cycle is expected to moderate but remain at an above-trend pace over the forecast horizon, averaging an estimated 3.9%Y in 2018 and 3.8%Y in 2019, as compared to 3.7% in 2017 and 3.4% per annum over the period 2012-2016.<sup>1</sup> Growth is being sustained by strong capex investment in developed markets and improving productivity growth. While there is ongoing discussion about the length of the global macro cycle (that we believe is likely to enter its tenth year in 2019), the recovery was preceded by a very deep recession and has been interrupted by a number of temporary crises. Additionally, although the global cycle is undoubtedly maturing, there are important regional differences. The current cycle is clearly more advanced in developed markets, with the U.S. being furthest along followed by Japan and the Euro area. The majority of emerging markets, excluding China, are still in the early- or mid-cycle stages of the business cycle.

While inflation is set to rise, it is projected to remain close to central

banks' targets. In developed markets, inflationary pressure will likely arise from a further tightening of labor markets and a rise in capacity utilization. However, more moderate wage growth at this stage of the current cycle and structural factors such as technology diffusion and globalization should continue to keep upward pressures in check.

As a result of higher inflation, central banks in developed markets are expected to reduce monetary accommodation. Following the 25bps rate hike on June 13, Morgan Stanley Research expects the Federal Reserve to raise rates again in September 2018, followed by three hikes in 2019. They expect the European Central Bank (ECB) to begin tapering asset purchases in October this year and raise deposit rates in June 2019. Further, they expect the Bank of England (BoE) to raise rates in 3Q 2018, followed by two hikes in 2019. Lastly, they expect the Bank of Japan (BoJ) to adjust the 10-year JGB yield to around 0.15% in 1Q 2019.<sup>2</sup> In the U.S., most of the increase in interest rates to date has been absorbed by spread

compression, however, it is anticipated that cap rates will rise, per the chart below. There will likely be a two-to-three year lag before this occurs in Europe and Asia given the expected timing of monetary policy tightening. Fiscal policy, unlike monetary policy, is expected to become more expansionary, particularly in the U.S., where the fiscal deficit is expected to increase from 3.4% in 2017 to 4.1% in 2018 and 4.5% in 2019.<sup>3</sup>

Key global risks worth noting include financial stability risks in the U.S., given that there has been a meaningful pick-up in leverage in parts of the private sector, particularly among corporates; China policy tightening, which while slowing credit growth, may adversely impact domestic demand; trade protectionism, predominately between the U.S. and China (we still expect an eventual negotiation); other geopolitical risks, including but not limited to midterm elections in the U.S., Brexit, and political uncertainty in Spain and Italy; and lastly the adverse impact that rising U.S. yields and an appreciating USD might have on emerging market economies.

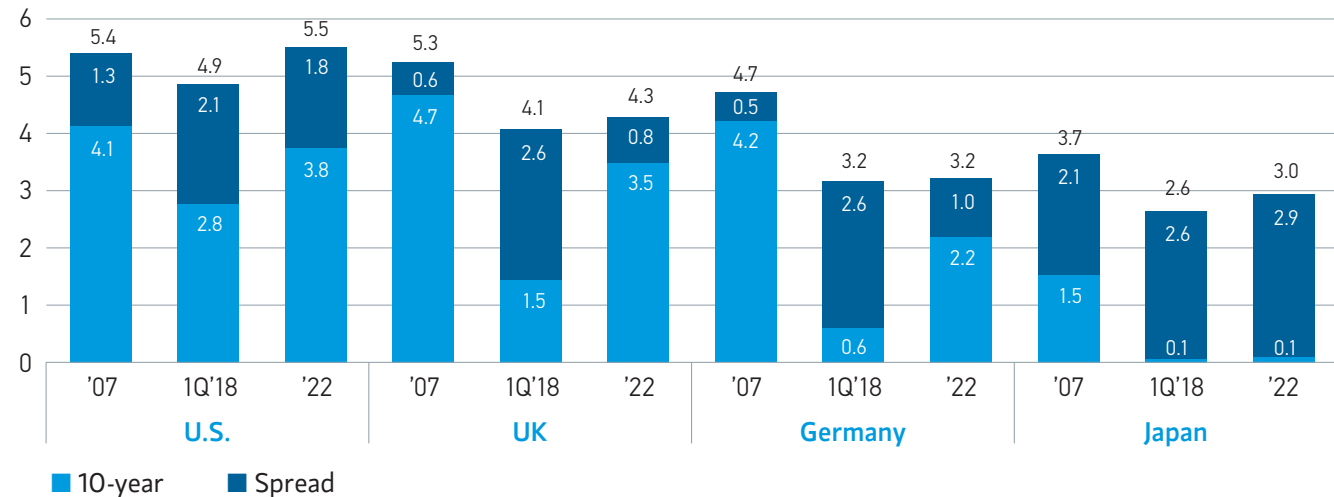
<sup>1</sup> Morgan Stanley Research, Mid-year Outlook, May 2018.

<sup>2</sup> *ibid.*

<sup>3</sup> *ibid.*

**DISPLAY 2****Healthy Cap Rate Spreads<sup>4</sup> Should Help Absorb Most of the Rate Increase**

Office Cap Rate Spread (Bps)



Source: Bloomberg, NCREIF, PMA, MSREI Strategy, data as of February 2018.

**Implications for Commercial Real Estate**

The strong macroeconomic backdrop and relatively low interest rate environment continue to attract significant capital flows into commercial real estate. Despite many

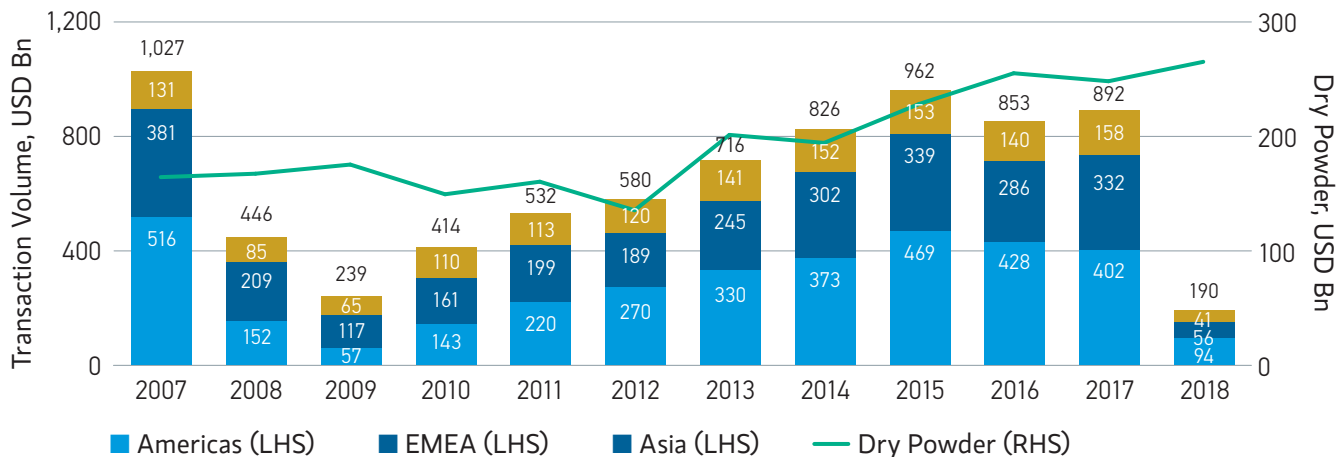
markets being late cycle and relatively fully priced, MSREI believes the current cycle still has room to grow. Real estate fundamentals remain sound with record-low vacancy rates supporting rent growth in most markets. Returns are at historical average levels, supported by durable income

yields of 4-5%<sup>5</sup> which are attractive versus alternatives, and the spread between cap rates and interest rates provides a cushion to absorb some of the expected rate increases.

Rising interest rates have led to asset value correction fears across various

**DISPLAY 3****Global Liquidity Robust**

Annual Transaction Volume &amp; Dry Powder



Source: Real Capital Analytics, Preqin, MSREI Strategy, data as of June 2018.

<sup>4</sup> Cap Rate Spread is defined as the Cap Rate over the 10-year government bond yield.<sup>5</sup> Costar, PMA, MSREI Strategy and Research, April 2018.

asset classes, with real estate, however, investors may be able to mitigate these risks by shifting to investments that can participate and benefit from economic growth, with a measure of downside protection offered by current income.

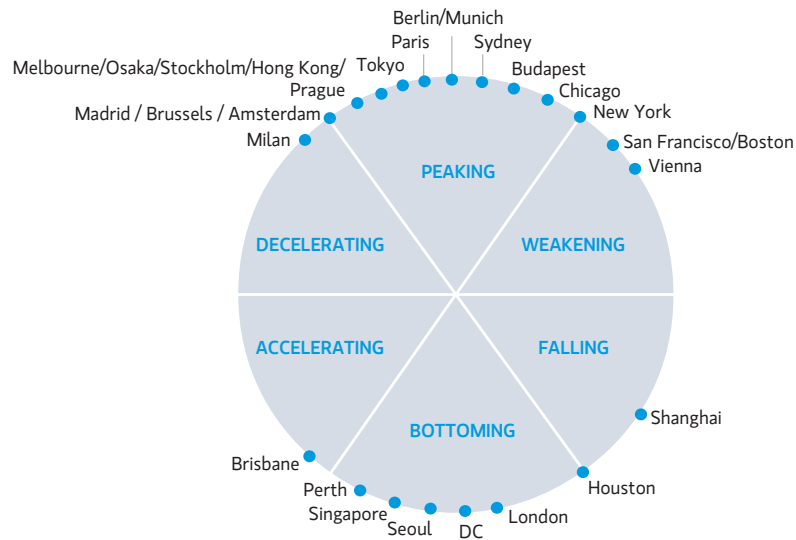
While macroeconomic growth continues to be synchronous, different growth drivers underpin major economies around the world. Capital markets are also divergent resulting in real estate markets that are at different cycle points (per the market cycle chart below). It is anticipated that more attractive investing opportunities might be found in Europe and Asia relative to the U.S. As discussed above, the U.S. is further along in the cycle from a macro and CRE standpoint. Interest rates are going up faster, pricing is “more” full, returns are decelerating and we will likely see cap rate expansion over the next several years. In Europe, on the other hand, it is expected that growth over the next five years will be stronger than the last five years and interest rates will remain lower for longer. As a result, real estate returns in the region have been accelerating. In Asia, the rate of economic growth is two times that of the West and interest rates also remain low, keeping cap rate spreads wider than in most parts of the world. The majority of Asia’s markets recovered later than markets in the U.S. and Europe, so rents and values are still below prior peak levels.

## Europe

GDP growth in Europe is expected to remain relatively robust and above trend, averaging ~2% over the next two years, moderating 50bps from 2017 due to weaker consumer spending and exports (given stronger euro), somewhat offset

### DISPLAY 4 Divergent Market Cycle<sup>6</sup>

Office, 1Q18



Source: MSREI Strategy, data as of June 2018.

by stronger capex.<sup>7</sup> Rising wages and oil prices are expected to push inflation up during the second half of 2018, which should position the ECB to begin to reduce monetary accommodation. While the situation in Italy may lead to a slowdown in growth in Europe, it is unlikely to lead to a broad-based European crisis. However, increased levels of uncertainty may create a pocket of illiquidity and higher risk premiums and may generate more attractive investing opportunities in Italy. Currently the gap between Italian 10-year yields and those of Spain is at its widest since 2012 (spread of 140bps versus 202bps in 2011 and average of 11bps since 2000).<sup>8</sup> The UK is expected to slow further due to uncertainty around Brexit, with the most likely outcome anticipated by Morgan Stanley Research

to be a soft, slow Brexit, likely involving the UK staying in a customs union with the European Union. A softer Brexit will likely lead to less economic disruption and may lead to improved investor sentiment, bringing it more in-line with current fundamentals which remain relatively strong (e.g., Central London office take-up is consistent with the long run average).

Commercial real estate transaction volume in Europe reached \$61 billion in 1Q 2018 down 17% from a year ago.<sup>9</sup> Industrial yields fell 20bps from year-ago levels to 6.3% in 1Q 2018, while office and retail yields were both 5.8%.<sup>10</sup> The United Kingdom and France were the most liquid markets in Europe over 1Q 2018, followed by the Netherlands. Dutch transaction volume increased

<sup>6</sup> The market cycle positioning framework is the outcome of the use of an internal tool being developed by MSREI based on a consistent set of real estate metrics available on a country-by-country basis. It is aimed to help identify drivers of market performance, market positioning relative to prior cyclical peaks and troughs, turning points and implications for investing strategies. It is updated on a quarterly basis in line with the release of macroeconomic and commercial real estate data.

The tool uses a mix of real estate fundamentals and capital markets metrics that are generally available in applicable countries (including rent, occupancy, cap rates and spreads and liquidity and values metrics). The majority of the metrics are based on “actuals”, versus relying on forecast data. Note that other outcomes could result if different inputs or assumptions are made. The market cycle positioning constitutes a “forward looking statement.” Due to various risks and uncertainties,

actual events or results may differ materially from those reflected or contemplated in such forward-looking statement.

<sup>7</sup> Morgan Stanley Research, Mid-year Outlook, May 2018.

<sup>8</sup> Bloomberg, as at June 14, 2018.

<sup>9</sup> Real Capital Analytics, May 2018.

<sup>10</sup> PMA, May, 2018.

93% from 1Q 2017 and Spanish volume rose 40%.<sup>11</sup>

Europe's property fundamentals remain very healthy across all sectors. Office markets saw continuing improvements across core locations on the Continent, with the average vacancy rate falling to 7.3%, 200bps below the ten-year average, helped by supply levels that are below the historical average. Berlin and Central Paris recorded vacancy rates of 3.0% and 2.6% in 1Q 2018, which were the lowest levels since 2000, while vacancy in the City of London recovered 50bps in 1Q 2018 and is now down to 8.4%.<sup>12</sup> Given uncertainties surrounding Brexit and future office demand in London, fully stabilized office buildings in London are trading at a significant premium to non-stabilized properties (132% higher price per square foot versus the historical average premium of 46%), suggesting an attractive spread for investors willing to take lease-up risk. Leasing velocity remains strong, helped by coworking (2.5m sq ft leased in 2017, a 190% increase on last year) and investor interest for core London product continues to be robust, with liquidity over the past twelve months of \$18 billion, which was higher than Manhattan (\$17 billion), Paris (\$10.5 million) and Frankfurt (\$7 billion).<sup>13</sup>

MSREI also believes that faster-growth Central and Eastern European 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.<sup>14</sup>

In the industrial sector, demand continues to accelerate, supported by occupiers orienting their strategies towards efficient urban distribution and "last-mile" delivery capabilities. There is a shortage of modern industrial stock (2 square feet per capita

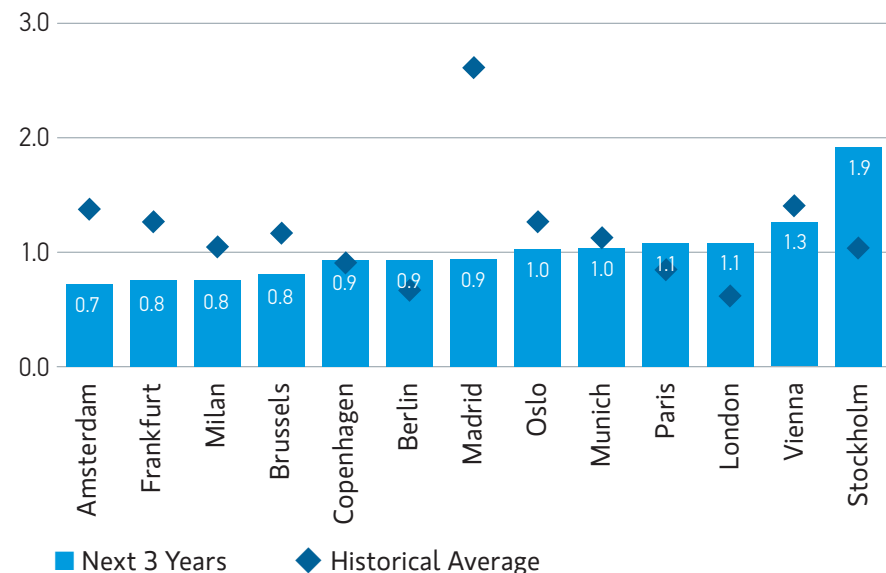
in Europe vs. 13 square feet per capita in the U.S.),<sup>15</sup> suggesting development is required to meet modern logistics needs. While industrial rent growth has been relatively more muted versus the U.S., yield compression has been evident across

#### DISPLAY 5

##### Supply In Check Relative to Historic Averages

2018-2020E Construction vs Historical Average

3 Year Addition to Existing Stock, % p.a.

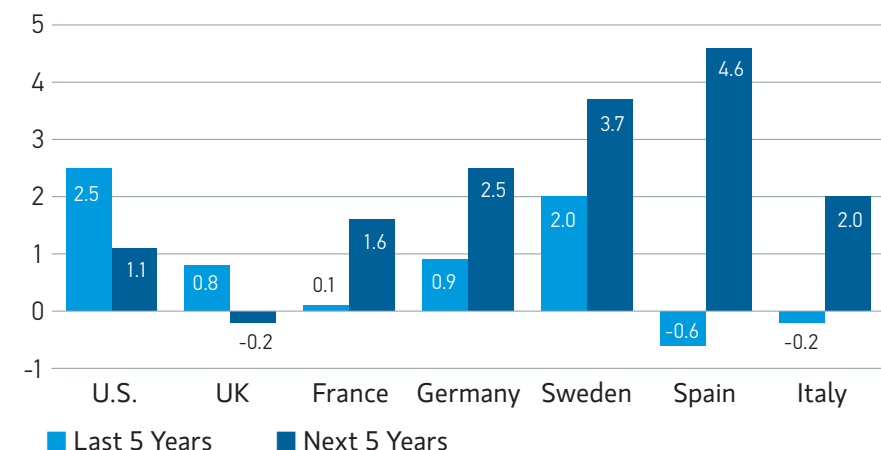


Source: PMA, MSREI Strategy, as of April 2018.

#### DISPLAY 6

##### Retail Rent Growth Accelerating in Europe

Annualized (%)



Source: CoStar, PMA, MSREI Strategy, data as of March 2018.

<sup>11</sup> Real Capital Analytics, May 2018.

<sup>12</sup> PMA, May 2018.

<sup>13</sup> Real Capital Analytics, June 2018.

<sup>14</sup> Real Capital Analytics, NCREIF, PMA, MSREI Strategy, data as of June 2018.

<sup>15</sup> CBRE, JLL, March 2018.



most markets, contributing to outsized one-year returns averaging 13% across the region.<sup>16</sup> Outside of development, acquisition of regional distribution centres in key logistics hubs with supply constraints and last-mile logistics in dense urban areas where long-term rental growth is anticipated may provide attractive risk-adjusted return opportunities.

In the retail sector, steady growth in consumer spending and a relatively “under-retailed” environment is supporting low vacancies and accelerating rent growth in most major markets. Opportunities to reposition existing retail assets that are less susceptible to e-commerce trends in markets with barriers to new supply are potentially attractive.

Lastly, there may be attractive development opportunities in the housing sector in countries such as Spain, where pricing has just begun to recover. House prices increased 5% year on year in 2017 but remain 40% below 2006 peak levels.<sup>17</sup> Construction remains below 10% of prior peak levels,<sup>18</sup> while demand is robust due to strong household formation and growing income as unemployment levels drop.

### Asia Pacific

Across Asia, Japan continues its late-cycle expansion (although the economy contracted in Q1, 2018), with the economy close to full employment and private consumption picking up on solid income growth, with front-loaded spending expected before the 2019 consumption tax hike.

China’s growth is expected to slow but remain sustainable and less reliant on credit amid improving private investment and productivity growth. Australia’s mixed growth trajectory is expected to continue in 2018 as weak income growth and a credit squeeze weigh on consumption and housing, which is

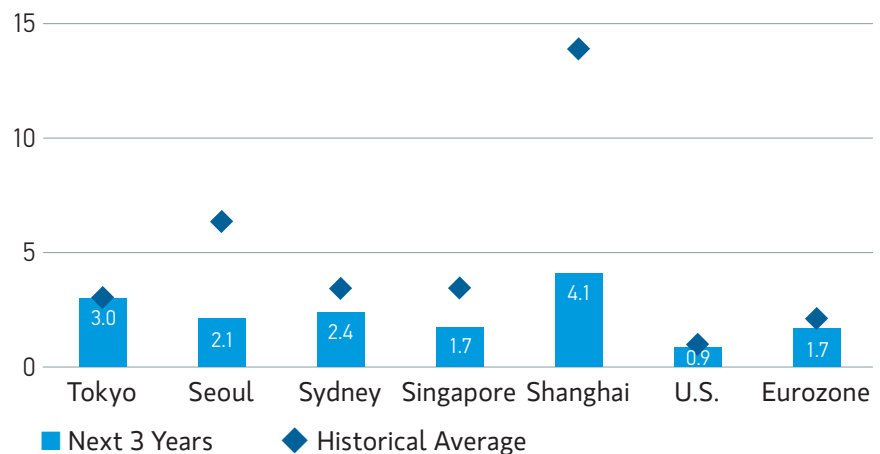
being partially offset by the weaker AUD. Lastly, Korea’s economy continues to grow at ~3% supported by exports and improved wage growth. While denuclearization and the liberalization of the North Korean economy would reduce the South Korean risk premium and support growth, risks remain that an uneasy equilibrium may continue which could be a headwind to growth.

Asia Pacific transaction activity increased to \$40.6 billion in 1Q 2018, up 21% from a year ago. The office sector accounted for \$18.1 billion in volume over 1Q 2018 while industrial activity rose 120% to \$10.0 billion. Office transaction cap rates compressed 30bps from year-ago levels, to 5.2% in 1Q 2018, with 80bps and 30bps office yield compression in Sydney and Tokyo, respectively. Industrial cap rates

#### DISPLAY 7

##### New Construction Below Historical Average

As a Percent of Existing Stock

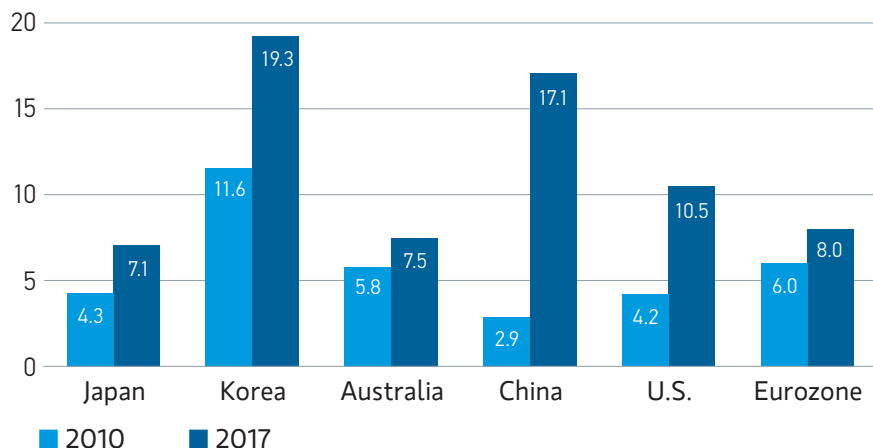


Source: CoStar, PMA, MSREI Strategy, data as of April 2018.

#### DISPLAY 8

##### Online Sales Penetration Increasing

Online Retail as a Percent of Total Retail



Source: Euromonitor, Quantum, ABS, ICSC, Morgan Stanley Research, data as of April 2018.

<sup>16</sup> IPD, May 2018.

<sup>17</sup> OECD, April 2018.

<sup>18</sup> EuroStat, data as of June 2018.

compressed 60bps from a year ago to 5.9% and retail cap rates declined 20bps to 4.9%.<sup>19</sup>

Asia Pacific office markets continued to exhibit broad-based growth. Across Japan, vacancy rates tightened over the year to 1Q 2018, dropping to 3.7% in Nagoya and 2.8% in Tokyo and rents remain 30% below prior peak levels.<sup>20</sup> As a result, there continues to be opportunities to acquire assets at an attractive basis, with potential upside through asset management, re-tenanting and rolling rents to market, with exit to a J-REIT, once stabilized. Outside of Tokyo, regional Japanese markets offer a 100bps spread and equally tight fundamentals.<sup>21</sup>

Asia Pacific industrial rents continue to climb in most major markets, with the fastest growth in Melbourne, Hong Kong and Shanghai. Third-party logistics firms and online shopping fulfillment are driving the market in addition to global trade and manufacturing. Developing core logistics facilities in major distribution hubs in the developing markets of China and India remains an attractive investment theme, given the growth in the consumer segment, e-commerce penetration and the under-supply of modern fulfillment stock (e.g., China has 17% internet penetration and 0.2 square feet per capita of modern space).<sup>22</sup>

Tourism flows continue to support retail and hospitality fundamentals across Asia. In Japan, the government hit its inbound international visitor target of 20 million visitors four years ahead of its 2020 goal, and has doubled the target to 40 million, with 29.8 million visitors arriving over the last twelve months (March 2018), up 30% from the twelve months prior.<sup>23</sup> For China, the number of outbound tourist

visits to Southeast Asia increased fivefold from 2006 to 2016, yet just ~10% of China's population has traveled abroad.<sup>24</sup> Consequently, hotel fundamentals are strong in the region, with occupancy increasing by 1.5%, ADR by 8.2% and RevPAR by 9.8% (year-over-year, through April 2018).<sup>25</sup>

## United States

The U.S. economic expansion will shortly become the second longest on record. Rising gas prices, ongoing global trade tensions and interest rate increases may dampen (but are not enough to overcome) the tailwinds from fiscal stimulus and additional authorized government spending. While Washington's ever-changing stance on trade protectionism is creating heightened capital markets volatility, the latest proposal to place tariffs on \$50 billion of imports would likely have negligible impact on global trade and growth.<sup>26</sup>

In terms of growth, following a softer start to the year due to a pullback in consumption in 1Q 2018, a rebound in 2Q 2018 is apparent (currently tracking at 3.7%) and full-year growth remains on track for 2.7% in 2018 and 2.1%Y in 2019. Morgan Stanley Research pegs longer-term GDP growth (2020-2022) at 1.2%, which includes an implicit assumption that the U.S. is in recession at some point during that timeframe.<sup>27</sup>

U.S. investment activity totaled \$111 billion in 1Q 2018, down 13% from 4Q 2017, but up 4% from 1Q 2017. Cap rates compressed 50bps from 1Q 2017 in the industrial sector. Office and retail sector cap rates were flat and apartment and hotel sector cap rates rose 10bps and 50bps respectively from 1Q 2017. Trailing twelve month industrial sector volume rose 29% year on year. Cross-border capital totaled \$13.6 billion in

1Q 2018, down 1% year on year and accounted for 12% of total transaction volume. China's share of cross-border investing rebounded to 31% with the 1Q 2018 privatization of Global Logistic Properties.<sup>28</sup>

In terms of property fundamentals, U.S. office markets improved further as new supply has been constrained by rising construction cost, risk avoidance and banks' reluctance to back speculative developments. Vacancy fell 10bps year on year to 10.0% in 1Q 2018, improving most strongly in "Creative" and Class B office spaces. Asking rents have climbed 2.2% year on year to 1Q 2018,<sup>29</sup> with slower growth in East Coast core markets (where supply is more abundant) and the strongest growth in Seattle, Oakland and the Southeast. Late cycle/counter-cyclical markets potentially offer growth opportunities, either repositioning plays where physical product no longer meets market needs or lease-up plays in tighter markets.

U.S. industrial vacancy rates stayed close to their thirty-year low, at 4.9% in 1Q 2018. Robust industrial absorption continued, at 242 million square feet over the year to 1Q 2018. Demand and annual rent growth of 5.6% is supported by increasing e-commerce penetration and associated warehouse requirements for last-mile delivery.<sup>30</sup> The average age of warehouse stock in the U.S. is 34 years and in most cases does not meet the needs of e-commerce tenants. As a result, there are attractive opportunities to build/convert either large regional distribution hubs and/or smaller warehouses serving the last mile and located in population-dense locations to meet robust demand needs. However, supply levels are increasing quite rapidly which will likely lead to a slowdown in fundamentals in the medium term.

<sup>19</sup> Real Capital Analytics, May 2018.

<sup>20</sup> PMA, data as of June 2018.

<sup>21</sup> Property Market Analysis, May 2018, Real Capital Analytics, May 2018.

<sup>22</sup> CBRE, JLL, data as of March 2018.

<sup>23</sup> Japan National Tourism Organization, data through March 2018.

<sup>24</sup> ASEAN, The Economist, April 12, 2018.

<sup>25</sup> STR Global Hotel Review, May 2018.

<sup>26</sup> Morgan Stanley Research.

<sup>27</sup> Morgan Stanley Research, Mid-year outlook, May 2018.

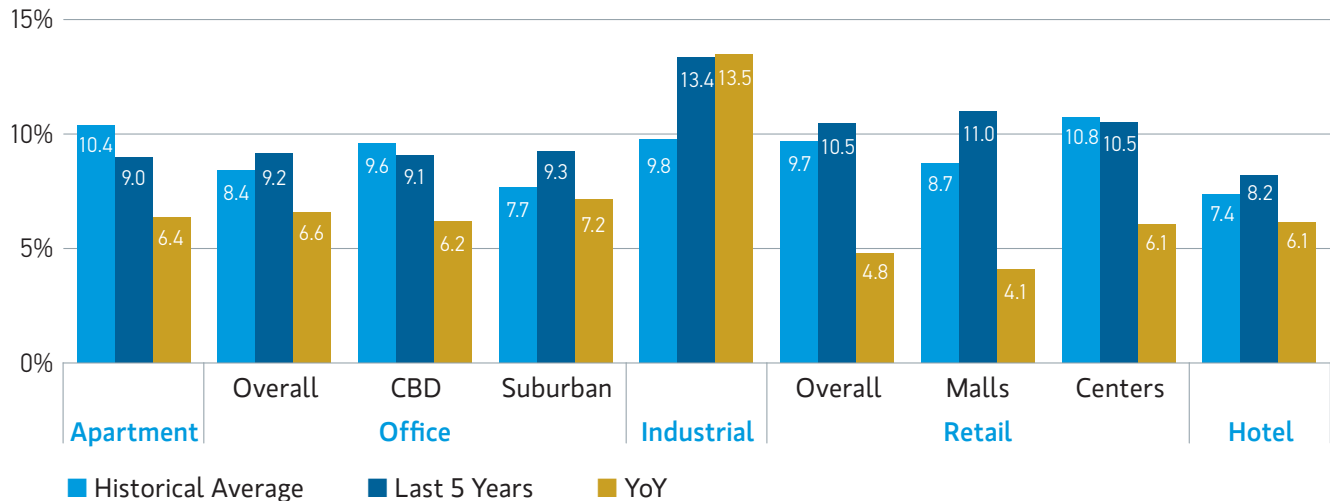
<sup>28</sup> Real Capital Analytics, May 2018.

<sup>29</sup> Costar, May 2018.

<sup>30</sup> Costar, May 2018.

**DISPLAY 9****Performance by Property Type**

Annualized



Source: NCREIF, MSREI Strategy, data as of May 2018.

Despite relatively strong consumer fundamentals (U.S. retail spending rose by 4.1% over the year to 1Q 2018, consumer sentiment is at its highest point for seventeen years, 125,000 new retail jobs created in the June BLS report),<sup>31</sup> the retail sector outlook remains challenged due to e-commerce growth, market-specific demographic challenges and overall market saturation. Significant bifurcation exists between Class A malls, which continue to outperform, and Class B/C/D malls which are struggling. Several planned Class A mall recapitalizations/sales suggest the best quality malls in the U.S. can be valued at a 4.25-4.5% cap rate.<sup>32</sup>

Apartment absorption remained at strong levels relative to long-term trends at 213,000 units over the year to 1Q

2018 while vacancy was level at 6.2%.<sup>33</sup> Healthy demand persists, supported by household formation trends, but new supply continues to be evident and rent growth has slowed in select markets including Austin, Nashville, Washington DC, and New York. A housing shortage in the entry-level segment and distress in the high-end segment may create potential opportunities in the for-sale sector, while Class B multifamily rehab strategies in later recovery markets are also attractive due to affordability issues among renters.

**Conclusion**

In this cycle, 2018 is shaping up to be the strongest year of economic growth, with synchronicity evident across most major economies. Uncertainty and capital markets volatility have been ratcheted up due to multiple, ongoing

geopolitical events across the U.S., Europe and Asia. The next several years will likely see higher interest rates and cap rates, lower returns driven by income growth, pockets of illiquidity and distress and a slowing of capital flows driven by fewer, more selective investment opportunities. Within this investing environment, MSREI believes there will be attractive opportunities to drive Net Operating Income growth through repositioning, retensing and lease-up strategies, as well as selective development opportunities in sectors aligned to structural trends such as industrial (eCommerce) and residential (housing shortage). Additionally, acquiring prime quality, cashflowing assets in non-core markets continues to offer an attractive yield spread and growth forecast relative to core markets.

<sup>31</sup> Morgan Stanley Research, May 2018.<sup>32</sup> Green Street Advisors, June 2018.<sup>33</sup> Costar, May 2018.



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