CUSHMAN & WAKEFIELD RESEARCH

U.S. Macro Forecast

Just Right...Goldilocks Economy Bodes Well for Property Demand

September 2017

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- U.S. economy maintaining a comfortable, sustainable stride
- Fiscal policy uncertainty remains, but odds still favor some stimulus (e.g., tax cuts) will be enacted by year-end 2018
- Rising vacancy rates will be supply-driven for most asset classes, as demand persists
- Capital markets activity to moderate slightly from 2016 levels but still strong

Executive Summary

Property Market Demand Strong, Construction Levels Rising

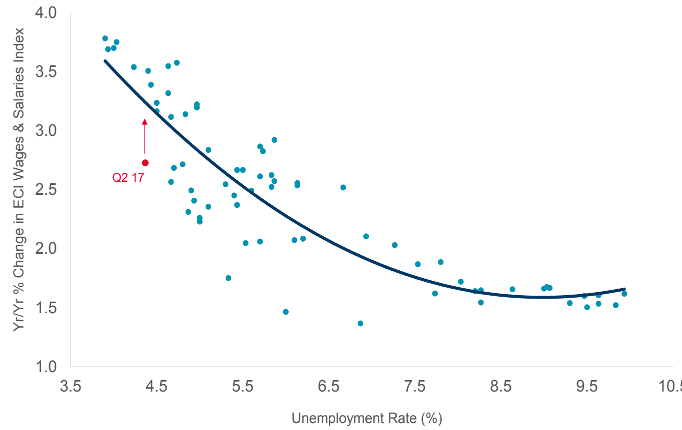
The U.S. economy has entered a Goldilocks scenario, one that is not too hot or too cold, but "just about right." Real GDP is on track to grow slightly better than 2% in 2017, generating just under 2 million net new jobs this year. The economy's temperature also seems to be "just about right" for consumers. Confidence is hovering at a near-15 year high, retail sales are accelerating at a 5% rate year-over-year and credit is flowing. In addition, the global economy is also firing back up: world nominal GDP growth is expected to be four times greater this year than it was last year, bolstering global trade and business confidence.

But by many metrics, the economy is certainly not "too hot." Inflation is one such measure. Despite a low unemployment rate, wage growth remains mostly muted and core inflation remains stubbornly below the Federal Reserve's target rate of 2%. History suggests that when the labor market is near full employment, core inflation should be higher; however, in August, the Fed's preferred measure of inflation—the core PCE—was up only 1.4% year-over-year. While this may be related to transitory factors (e.g., pass-through effects from lower oil prices, a one-off decline in medical costs and cell phone prices, etc.), the reality is that inflation, or lack thereof, has been baffling economists for years. Complicating matters further are Hurricanes Harvey and Irma.

The effects of these storms will distort the monthly data and make it very difficult for the Fed to get a clean read on economic performance. The next interest rate hike, which was previously expected in December, now looks less likely. Prospects for 2018 look good. Downside risks lie mostly on the policy side, but assuming there is a bit of fiscal stimulus real GDP will finally flirt with that 3% threshold next year, at least on a quarterly basis. There is a decent chance that the current economic expansion will be the longest in the post WWII era.

The Phillip's Curve

Unemployment Rates vs. Wage Inflation, 2000-present



Source: U.S. Bureau of Labor Statistics

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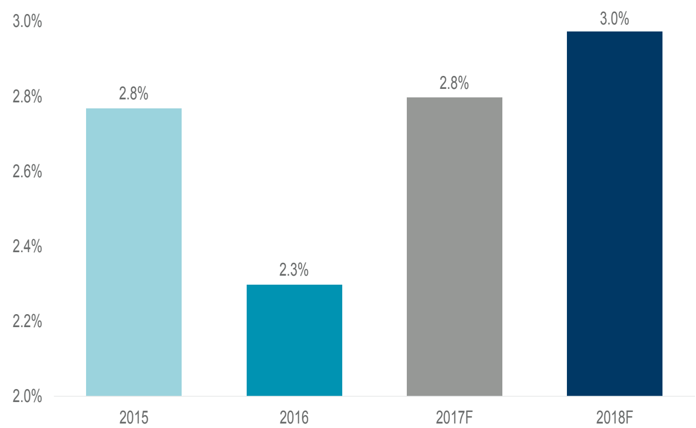
Property market fundamentals are performing well, aside from retail which continues to face headwinds from eCommerce. Demand metrics such as net absorption are on par with, if not slightly off, last year's levels. Construction will soon start to drive vacancy rates upward, but any increase will be gradual. Leasing markets will be carried by the broad and steady health of the labor markets and consumers. The wave of new supply that hits in 2017 and 2018 will put a cap on rent growth, and a shift towards a more occupier-friendly market should be expected in most U.S. cities next year.

The capital markets are a bit slower in terms of sales volume, but pricing continues to hold, and investors continue to seek opportunities in primary and secondary cities. However, the tenuous interest rate outlook adds to the uncertainty in capital markets. Even so, supportive global monetary policy and relatively low interest rates are expected to drive sufficient capital into CRE over the coming years.

Global Economic Picture Brightens

For the first time in years, we are observing synchronized growth globally. In the first three years of the recovery, emerging markets (Brazil, China and Russia) led the way. Growth was anemic virtually everywhere else. In the second phase of the recovery, maturing economies (the U.S., U.K. and Canada) took the lead while growth became choppy elsewhere. Today, all three major global regions are accelerating together, with the pick up in APAC due in part to China's economic intervention late last year. The result was soaring equity markets after the Brexit vote and the U.S. presidential election, and a strong wealth effect, along with highly accommodative monetary policy. The global revival will provide an additional jolt to U.S. economic growth. Indeed, after slumping last year, growth in U.S. exports is currently tracking around 3% year-over-year. Corporate profits are

Global Real GDP Growth
AR, %



Source: Oxford Economics

up, as is industrial production. U.S. factories are getting busier. These are all functions of a rosier world picture, inevitably creating positive multiplier effects for factors that impact commercial real estate.

Monetary Policy Changes on the Horizon

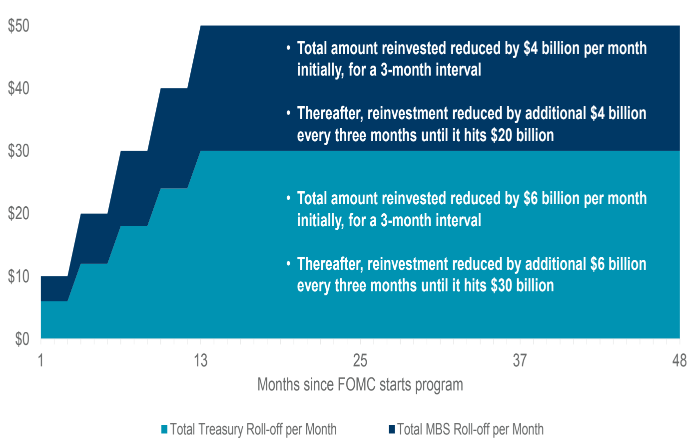
The Federal Open Market Committee (FOMC) continues to emphasize that the federal funds target rate will continue to be the mechanism driving monetary policy normalization, despite its announcement of a plan to commence balance sheet reduction. The Fed is in a tough spot. On one hand, the labor market is considered to be near or at full employment; on the other hand, inflation remains stubbornly low and the monthly economic data are going to be distorted by Hurricanes Harvey and Irma. Our outlook calls for one more rate hike this year (of 25 basis points (bps)), but it's a coin toss at this point. Balance sheet normalization remains a "go," and it will start this October.

Two of the major assets on the balance sheet of the Federal Reserve are U.S. Treasury securities and Agency Mortgage-Backed securities (MBS). These assets will be treated differently, albeit with the same passive step-up approach, under the path outlined by the Fed.

It is generally assumed that the markets can handle a smaller Fed balance sheet. The reaction of the markets was muted—stock prices even rose—in the days following the June FOMC meetings when the plan was released. In fact, since the September meeting last week, when the Fed announced the intended start date of the policy, stock markets have risen slightly. Also, it's worth emphasizing that the quantitative easing (QE) programs around the world will contribute approximately $1.9 trillion U.S. dollars to the global money supply this year. As long as U.S. Treasury bond rates are slightly more attractive than other stable, advanced alternatives, appetite for safety and yield will continue. Although the nominal size of the Fed's Treasury holdings is large, its share of the Treasury market has shrunk back to pre-crisis levels, signaling that there is likely to be nominal demand ready to absorb these securities.

Outlook for Commercial Real Estate

FOMC Balance Sheet Reduction 'Roadmap'



Source: Federal Reserve

Office: Construction on the Upswing, but Demand Holding Steady

Office-using industries have churned out an impressive number of jobs this year so far. Even as total nonfarm employment decelerated over the last two years, gains in finance, insurance, professional/technical services, and administration led a job creation spree that recently hit a cyclical peak. In the first half of 2017, these industries added jobs at an average year-over-year pace of 794,000—or 66,200 per month. Declines in information employment averaging 32,000 over that same timeframe dampen headline figures slightly. The reason why office-using job growth appeared stronger in 2016 on an annual basis is the downshift in the information subsector. For 2017, total office-using job growth is forecast to reach 619,500 before slowing in 2018 to 519,000.

The combination of these trends and a robust economic backdrop suggests that demand for office space will remain healthy. Just under 50 million square feet (msf) of net absorption is anticipated this year—tempering further from last year's pace—before dropping below 40 msf in 2018. In the face of new supply, demand will not keep pace, allowing vacancy rates to tick upward by the end of 2017, for the first time during this cycle. On an annual basis, vacancy rates will average 13.3% this year, an increase of 10 bps from 2016 and 10 bps below next year's expected vacancy rate of 13.4%. National asking rents will rise at a slower rate over the next few years, averaging $30.54 psf in 2017, a 4.7% increase from the 2016 average of $29.16 psf, before rising in 2018.

Still, pockets of relative strength and weakness remain, and while overall deceleration is a theme, some markets will buck that trend. Leasing fundamentals in secondary and tertiary cities—where, with a few exceptions, supply is constrained—will even look robust. New supply is

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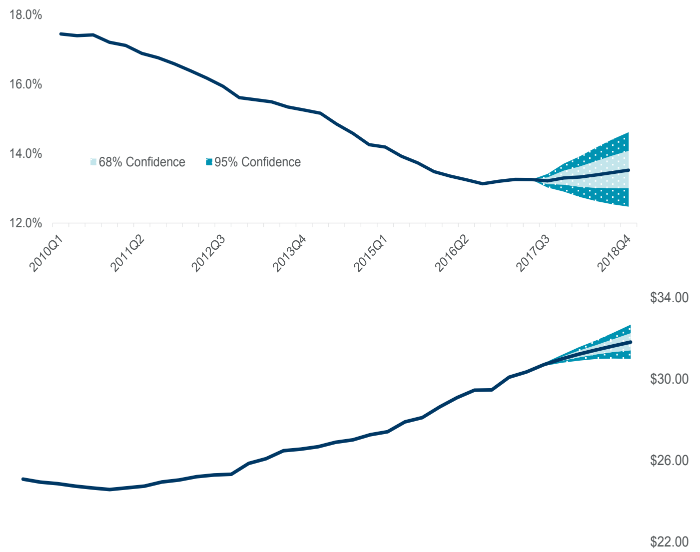
Office Fundamentals Set to Soften Gradually

Vacany Rate and Asking Rent Trajectory



Source: Cushman & Wakefield

heavily concentrated, but mostly in markets where vacancy rates are low relative to historical averages. The 11 markets with more than 1.0 msf of total deliveries so far this year have accounted for more than three-fifths of all new supply, or 17.9 msf of the total 28.4 msf completed year-to-date. All but three of these markets registered vacancy rate increases, although most of the increases were softened by demand reaching 10.5 msf in those markets. Vacancy rates still declined in Seattle, Phoenix and Charlotte. Year-over-year asking rent growth in these three markets averaged 5.5% in 17Q2, more than 100 bps above the U.S. average of 4.3%.

Industrial: No Signals of Slowing Down

For industrial sector industries, the first half of 2017 has been better on many fronts compared to the first half of 2016. Last year falling trade flows combined with battered commodity prices and a surging dollar had taken tolls on international drivers of the U.S. manufacturing sector and the industrial economy more generally. And while the shocks started hitting in the second half of 2014, the effects were felt well into 2016. So far in 2017, a turnaround is tied more closely to the performance of the global economy than to any political event or non-event in Washington, DC. Indeed, industrial property markets will be the beneficiaries of a stronger growing global economy.

In addition to improvements in industrial production, the energy sector, and investment in non-residential structures (materials that will eventually flow through warehouses too), warehouse demand of all types is still being fueled by the vast consumer appetite for eCommerce. We anticipate consumer spending to grow by 2.7% in 2017, the same rate as last year, and a pace that has translated into sufficient eCommerce-driven demand fundamentals. Since the second quarter of 2016, eCommerce sales are up by more than 16%, the highest such rate since the third quarter of 2012 five years ago. Total retail sales, while growing at less than one-third that rate, grew at an average year-over-year pace of 4.5% in the first half of this year, the highest reading since the first half of 2012.

The warehouse sector reflects these solid fundamentals, continuing its red-hot run as an asset class. Year-to-date, 107.2 msf of new deliveries have hit the market, the largest wave of new deliveries in the first half of any year on record. Even so, industrial tenants took 115.3 msf of space, pushing the vacancy rate downward by 10 bps quarter-over-quarter to 5.2%. In the next six months, we project new supply to more than double, with 2017 completions totaling more than 270 msf. Although we estimate that demand will be 234.1 msf, it will not outpace the pipeline, leading the U.S. vacancy rate to finally inflect by the end of the year. That trend is likely to continue through 2018; the vacancy rate is projected

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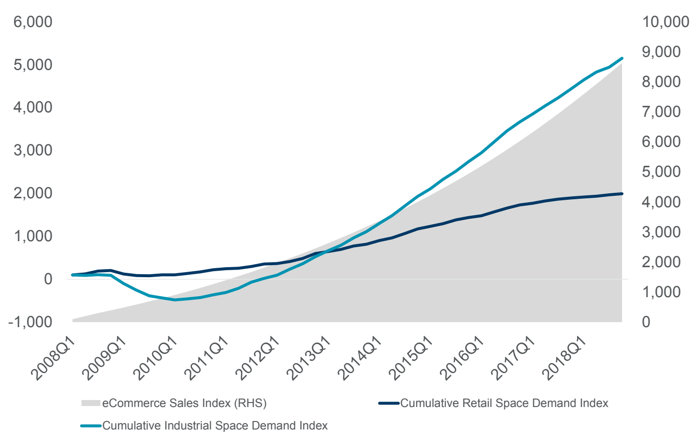
Industrial Demand Reflects eCommerce Dominance
Q1 2008 = 100



Source: U.S. Census Bureau, Cushman & Wakefield

to rise from its 2017 average of 5.3% to 5.6% in 2018 and 6.0% in 2019. As it remains a supply-driven increase and new buildings are likely to attract strong and, in some cases, pent-up demand, growth in asking rents is expected to decelerate slowly from its 2016 annual average of 4.2% to 3.7% in 2017 and 2.9% in 2018.

Retail: Bifurcation Continues

Healthy consumer sentiment flies in the face of current shifting trends in retail. Overall retail sales are forecast to grow by 3.8% this year, compared to 3.0% in 2016, before accelerating to 4.1% in 2018. Consumers and workers across the U.S. are faring better; still, a number of retailers are confronting changing preferences.

GAFO retail activity (sales at stores that sell merchandise normally sold in department stores) has weakened significantly for nearly two full years. Since the fourth quarter of 2015, year-over-year growth rates in such sales started to decelerate before outright declining in the second half of 2016. National chains and department stores have faced this challenge since the second quarter of 2011 when the category's sales started to tumble. As of mid-year 2017, sales at these stores have receded by more $11.4 billion from their mid-2011 peak of $66.5 billion (these are annualized sales rates). That is a nearly one-fifth decline in total sales activity in five years. The wave of retail store closures in the market—and that is expected to reach more than 9,000 and surpass the 2016 total of 4,000—reflects changing strategies at retailers that are losing market share to eCommerce and to retailers more adept at courting spending by millennials.

Notably, recent drivers of demand—off-price apparel, dollar stores and restaurants—are either reaching saturation points or are likely to slow. Like other CRE sectors, retail net absorption will slow as the cycle matures, although different property types will experience this to varying degrees:

- Our forecast for neighborhood/community properties calls for deliveries to total 26.3 msf by the end of 2018, slightly outpacing absorption which should total 24.3 msf over the same time. Demand for this type of retail is being buttressed by an eCommerce-resistant tenant mix, including drug stores, grocers and service-oriented retailers.
- How Amazon's acquisition of Whole Foods affects the grocery space remains uncertain, although unlike the rivalry between traditional bricks-and-mortar and eCommerce in other sectors, existing grocery stores will still serve as the distribution hub for such online sales, muting effects on demand. Vacancy rates are forecast to inflect by the end this year, bottoming out on an annual basis at 7.8% in 2017 before rising to 7.9% by 2018.
- National asking rents, a sticker price that has not been immune to broader dynamics in the retail sector, are expected to decline to $23.55 psf in 2017, a 3.4% decline. By the end of 2018, rent pressures should be building again, although headline figures are still expected to drop on an annual basis.

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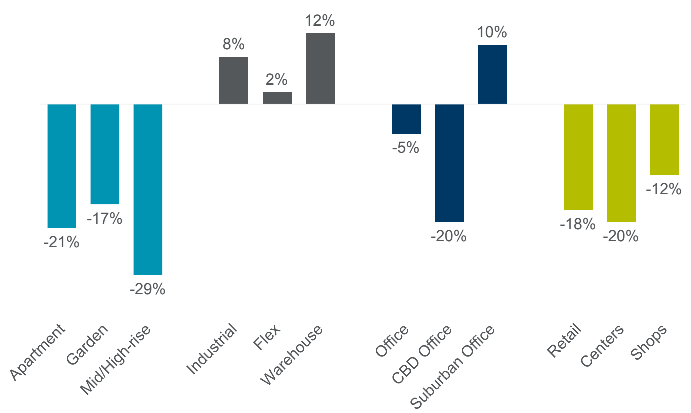
Capital Markets: Search for Yield Continues

Investment volumes in the U.S. reached a high point in 2015, totaling $546.5 billion, and have since trended downward. In the first half of 2017, trading activity for all property types totaled about $210 billion, down 8.5% from the same period one year ago. That pace is generally how we expect investment sales to unfold for the rest of this year, with year-end sales reaching $446.7 billion, a 10% drop in annual volumes from 2016. Investment sales are expected to decline further over the next few years; our baseline forecast calls for sales of all property types to slow to $428.4 billion in 2017 and $394.3 billion in 2018.

Cross-border flows as a share of total sales have been trending downward in recent quarters to 13% in the first half of 2017, down from a high of 18.5% in 2015. Going forward, a combination of capital controls in China, the effects of low oil prices on Middle Eastern sovereign wealth funds and improving growth in Europe make a reacceleration in cross-border investments unlikely.

Activity Spreads across Asset Classes
Investment Sales Volume, 2016H1 vs. 2017H1



Source: Real Capital Anlaytics

At the same time, U.S. yields, fundamentals and the depth of the market continue to make the U.S. the top destination for global capital, mitigating against significant further deceleration.

Deploying capital has been increasingly difficult lately, as both available money supply and fundraising remain at high levels with limited product available. Dry Power in private real estate funds hit another peak as of August of this year—with $148.0 billion waiting to be positioned into U.S. CRE assets and a record $246.0 billion searching for yield globally.

Spreads between buyer and seller pricing expectations remain elevated, particularly in the gateway markets where historically low yields have left relatively little bargaining space. Abundant debt capital meanwhile offers reluctant sellers an alternative pathway to partially monetize their gains, particularly in the major metro markets. As result, transaction volumes have fallen relatively more in the major metro markets than in the secondary and tertiary markets. Similarly, volumes are shifting from central business districts (CBDs) to the suburbs in both multifamily and office, as less extended pricing creates the conditions for greater liquidity. Industrial volumes also continue to grow, now driven by secondary and tertiary markets. Despite the focus on cross-border investors, institutional investors have contributed most to the decline in volumes as they continue to focus on the markets and product types where it has become most difficult to deploy (and, critically, redeploy) capital.

Price growth for most assets is still positive, and for the U.S. as a whole, values grew by an average of 6.6% in the first seven months of 2017. Assuming that a deceleration continues, our forecast calls for values to appreciate at a slower rate, increasing by a total of 5.2% in 2017 before rising another 3.4% in 2018. This undercurrent continues to underpin our expectation of moderating NCREIF returns, which remain buoyed by steady income returns. As the development cycle matures, particularly after a large wave of office and industrial product hits over the next two years, there is an upside risk of NOI revival in the out-years. NCREIF unlevered returns are forecast to average 6.2% in 2017 and 5.3% in 2018.

Fiscal Policy Remains the Biggest Wild Card

Federal fiscal stimulus remains a possibility, and one that we consider most likely to be implemented in 2018. Without serious legislative progress, the odds for any meaningful tax reform by the end of this year are low, and that affects the near-term outlook. Our assumed $500 billion stimulus (including tax cuts and spending increases, especially on defense) over the 10-year window is estimated to increase the deficit via deficit-financing, causing the debt-to-GDP ratio to rise, from 76.7% today to 95.0% in 2027. It is also expected to add 30 bps to overall GDP growth in 2018 and just less than 10 bps to GDP growth in 2019. If policy developments disappoint, it is still possible that the ensuing effects on confidence could lead to a panic sell-off in equity markets.

For now, the tailwinds from an improving labor market and a re-emergence of trade and investment activity are powerful. Add to that mix a consumer who has been spending more than initially expected, especially in the second quarter of 2017. This year's expected 2.1% real GDP growth rate is not a function of government stimulus inflating the figures; rather it is a reflection of most sectors performing better than they did last year. With some added juice on the federal spending side, that GDP growth rate will likely accelerate next year before tapering off. This prolonged economic cycle will carry real estate fundamentals with it.

The Goldilocks scenario will continue. That is generally good news for the property markets. That, of course, assumes the U.S. economy encounters no big bears.

U.S. MACRO FORECAST TABLE

	2016	2017				2018		Annual		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2016	2017	2018
U.S. Economy										
Real GDP, % (AR)	1.8	1.2	2.8	2.3	2.3	1.8	2.5	1.5	2.1	2.3
Chg. in Nonfarm Employment, ths.	510	545	491	504	376	497	466	2,332	1,917	1,764
Chg. in Office-using Employment, ths.	185	172	151	146	151	148	141	723	619	519
Unemployment Rate, %	4.7	4.7	4.4	4.4	4.3	4.3	4.2	4.9	4.4	4.2
Retail Sales & Food Services, % (SAAR)	3.9	5.1	3.8	3.5	2.8	3.3	4.3	3.0	3.8	4.1
CPI Inflation, % (AR)	1.8	2.6	1.9	1.9	1.6	1.4	2.1	1.3	2.0	2.0
Consumer Confidence Index	101	108	118	118	118	118	109	100	118	104
Federal Funds Rate, %	0.4	0.7	1.0	1.2	1.2	1.4	1.6	0.4	1.0	1.7
10-year U.S. Treasury note, %	2.1	2.4	2.3	2.4	2.5	2.6	2.6	1.8	2.4	2.6
ISM Manufacturing Index	53.3	57.0	55.8	54.8	53.2	54.0	53.5	51.5	55.2	53.0
West Texas Intermediate, $/bbl	49	52	48	48	50	48	48	43	49	49
Office Sector*										
Net Absorption, msf	6.8	7.2	15.6	12.6	14.4	10.2	9.9	52.7	49.8	38.2
Vacancy Rate	13.2%	13.3%	13.3%	13.2%	13.3%	13.3%	13.4%	13.2%	13.3%	13.4%
Asking Rent	$29.47	$30.10	$30.35	$30.71	$30.99	$31.23	$31.43	$29.16	$30.54	$31.53
Asking Rent Growth, Yr/Yr % Chg.	4.8%	5.1%	4.3%	4.3%	3.6%	3.1%	2.7%	5.4%	4.7%	3.2%
Industrial Sector*										
Net Absorption, msf	63.1	55.8	59.5	56.1	62.7	64.8	55.5	281.7	234.1	218.0
Vacancy Rate	5.5%	5.3%	5.2%	5.4%	5.5%	5.5%	5.6%	5.7%	5.3%	5.6%
Asking Rent	$5.63	$5.70	$5.72	$5.74	$5.80	$5.86	$5.92	$5.54	$5.75	$5.91
Asking Rent Growth, Yr/Yr % Chg.	4.0%	4.5%	4.1%	2.9%	2.9%	2.9%	3.5%	4.2%	3.7%	2.9%
Retail Sector*/**										
Net Absorption, msf	6.6	3.7	5.0	3.7	2.6	2.0	1.8	27.0	15.2	9.1
Vacancy Rate	7.9%	7.9%	7.8%	7.8%	7.8%	7.8%	7.9%	8.1%	7.8%	7.9%
Asking Rent	$23.43	$22.98	$22.24	$24.58	$23.10	$22.84	$22.29	$24.38	$23.55	$22.89
Asking Rent Growth, Yr/Yr % Chg.	-3.6%	-4.1%	-10.4%	-2.8%	-1.4%	-0.6%	0.2%	5.4%	-3.4%	-2.8%
Capital Markets***										
Total Investment Sales, $ Bil.	$139.7	$101.9	$109.2	$106.1	$129.4	$104.0	$102.1	$496.2	$446.7	$428.4
NCREIF Unlevered Total Returns, Qtr/Qtr % Chg.	6.9%	6.2%	7.0%	6.0%	5.0%	4.4%	4.0%	8.0%	6.2%	5.3%
Moody's/RCA CPPI (All Property Types), Yr/Yr % Chg.	7.7%	6.8%	6.1%	4.7%	3.5%	4.0%	3.5%	7.7%	5.2%	3.4%

**Annual rents and vacancy rates are averages, not year-end*
***Historical series based on CoStar; neighborhood/community statistics only*
****RCA, NCREIF, Moody's Analytics*
****Total Investment Sales includes office, industrial, retail, multifamily, hotel, and land sales*

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