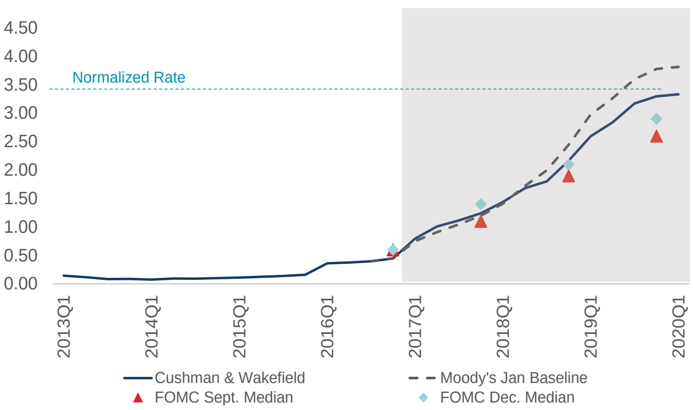
MARKETBEAT
U.S. Capital Markets
Q4 2016

CUSHMAN & WAKEFIELD

CELEBRATING 100 YEARS

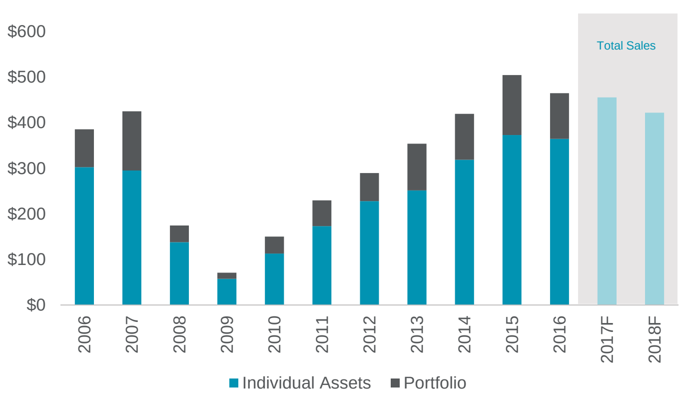
U.S. CAPITAL MARKETS

Fed Funds Rate Forecast



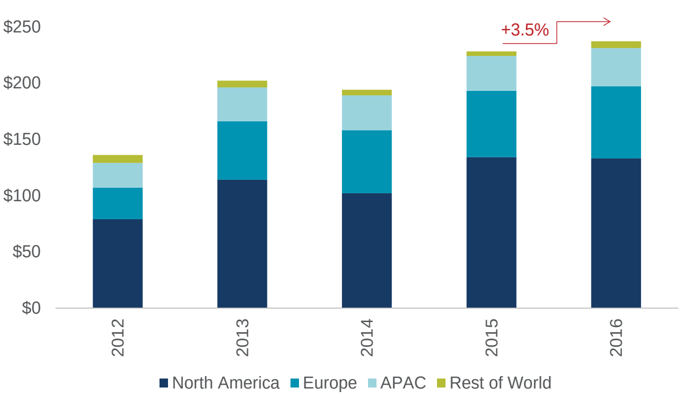
Source: Moody's Analytics, Federal Reserve, Cushman & Wakefield

U.S. Investment Sales
$ Billions



Source: Real Capital Analytics

Still a Lot of Capital
Global Dry Powder Targeted at Real Estate ($ Billions)



Source: Preqin

Key Takeaways

- "Measured Optimism" around U.S. economic outlook—growth is poised to accelerate in 2017 and conclude 2018 with further gains
- While debt and equity capital markets slowed in 2016, demand for U.S. commercial real estate assets remains high
- Foreign investors continue to play a larger role in equity capital markets than they have historically
- Global monetary policy and economic conditions as well as political uncertainty will continue to push investors towards the U.S. despite policy unknowns
- Valuations are high, moderating returns, but pockets of value remain

Near-term Measured Optimism

As discussed in Cushman & Wakefield's most recent U.S. Economic Forecast (January 2017), our overall view can be characterized as one of "measured optimism." In 2016, the world economy seemed to be constantly buffeted by new shocks. The U.S. and Chinese economies slowed markedly in the beginning of the year. Europe was rocked by the Syrian refugee crisis, terrorist attacks and renewed capital crises in the banking sector. And despite resurgent growth in both the U.S. and China at the end of the second quarter onward, those improvements were predominantly overshadowed by political concerns: the fallout from the Brexit vote and the U.S. presidential election.

Looking past the headlines, a broad range of fundamentals point to a strengthening U.S. economy, which was observed in the second half of 2016 and is expected to continue into 2017 and 2018. With diminishing headwinds, including, most recently, the effects of low oil prices and a strong U.S. dollar, and as financial markets calmed in the wake of fears related to China's economic health, the U.S. economy continued to be resilient. Job growth has been broad and robust, and wage growth is accelerating, indicating that the core drivers of commercial real estate (CRE) space demand remain healthy. With financial conditions remaining accommodative, the capital markets are poised to register a healthy performance yet again in the year ahead.

Markets Reassess U.S. Prospects

The inauguration of Donald Trump marks a major shift in U.S. policy agenda. Although uncertainty remains, the push for fiscal stimulus from a Republican-led Congress and Administration will buoy growth over the next two years, with tax cuts and targeted spending increases accounting for much of the expected boost to headline GDP growth. Moreover, an emphasis on deregulation, or on the paring back of regulation, may also benefit targeted sectors. Indeed, those sectors improved profitability prospects have already been priced into the equity markets.

One of the most evident developments, reflecting the promise of fiscal policy reform, has been observed in the bond markets, with the U.S. 10-year Treasury yield surging from 1.8% on November 7, 2016, to 2.4% on January 13, 2016. Most of this increase reflects a few major dynamics. First, there has been an upward revision to inflation expectations by market participants, as fiscal stimulus is now likely to occur in a near-full employment environment. Second, given the likely need to deficit-finance some of the proposals, a repricing on Treasury debt, however small a portion of the increase, is expected. Finally, with the stock market soaring to near-record territory, it makes sense that investors' renewed optimism results in less demand for bonds, pushing pricing down and yields up for the 10-year note.

Since the UK referendum to exit the European Union, when the 10-year yield was pushed below 1.4%, rates have increased substantially. Global conditions this year will be wrought with more turbulence, as the UK invokes Article 50—the formal initiation of the exit process—and as multiple countries representing nearly 50% of the EU's GDP move to have their own elections. Combining this with an aging global population and continued monetary stimulus across other advanced nations, the pace of upward movement in the 10-year note will moderate.

Monetary Policy Also Realigns

In tandem with the market-wide reaction to the U.S. presidential election, the Federal Open Market Committee (FOMC) updated its projections during its December 2016 meeting at the same time it voted to increase the target federal funds rate by 25 basis points (bps) to the 0.50%-0.75% range. As commodity prices stabilized and the effects of an appreciating dollar diminished, greater upward pressure on pricing means that core inflation—the FOMC's preferred measure is the core Personal Consumption Expenditures deflator—is more likely to accelerate in the upcoming year. The FOMC revised its trajectory for the fed funds rate upwards, also noting that policy may stimulate further inflation.

This means that monetary policy and financial conditions more generally will remain accommodative going forward, despite recent gyrations, while economic growth is expected to accelerate. A strong economic backdrop will drive NOI higher, leasing fundamentals will improve and low but slowly rising rates will continue to support both financing and the relative attractiveness of yields across CRE.

A Softer Year for CRE Capital Markets

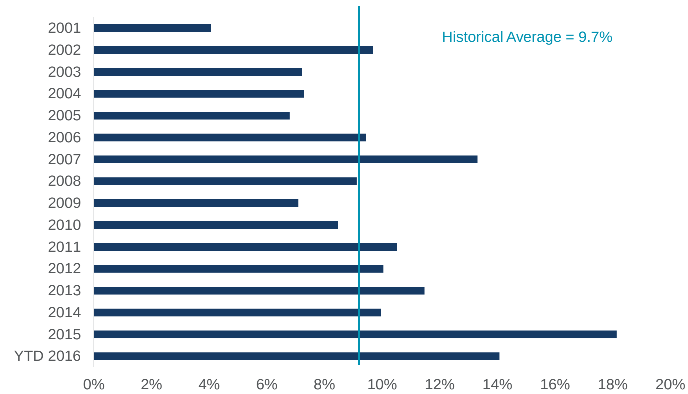
Commercial real estate capital markets softened in 2016 compared to the near record-breaking pace set in 2015. According to Real Capital Analytics (RCA), overall investment sales in the U.S. declined 8% year-over-year with decreases in activity across the top 25 U.S. markets. Notably, roughly two-thirds of the overall decline was due to diminished portfolio sales activity, which was down 24%. Individual asset sales, on the other hand, declined by only 2%.

Additionally, foreign capital continued to play a critical role in equity capital markets. Cross-border transactions declined in 2016 from their record-setting level in 2015. However, at $57.7 billion, those transactions were still up 43% versus 2014 levels. Moreover, international deals made up 14.1% of all sales in the first three quarters of 2016 versus 10.8% during the same period of 2014. These proportions understate the importance of foreign capital in driving changes in transaction volumes. Prior to 2015, domestic investors, private equity and institutional players in particular overwhelmingly drove overall investment activity. However, in the last two years, foreign capital has taken a front seat as REIT activity decelerated substantially. As we continue through this cycle, we believe that cross-border capital will continue to play a larger role in driving equity capital markets than it has historically. The combination of relatively attractive yields, a higher-growth outlook and overall, a superior balance of risks, has and will continue to make U.S. CRE attractive to international investors.

There is a veritable mountain of capital targeting the asset class. Increasing money supply from advanced nations and a search for yield in a post-crisis era, one that has seen explosive growth in the global sovereign bond market, means that the appetite for CRE and other higher-yielding assets will mount further. According to Preqin, in 2016, dry powder targeting U.S. CRE assets remained roughly flat with 2015 levels at

Foreign Investment Activity

Foreign Investment Sales as a Share of Total Sales



Source: Real Capital Analytics

$133 billion. While this may seem tepid, recall that sales activity was down nearly 43% in the first half of 2016 relative to the first half of 2015. Throughout 2015 and 2016, global fundraising for U.S. CRE assets was at its highest level ever recorded and was 45% above the previous cycle's peak in 2009.

Robust Activity Is Still Ahead

This demand for CRE assets should support both transaction volumes and pricing moving forward. Investment sales are expected to remain healthy, though below their 2015 peak, at $455.7 billion in 2017 and $422.0 billion in 2018. Though it decelerated from 13.3% in 2015 to a more modest 7.8% in 2016, price growth remained healthy over the past 12 months. Data are only available through November, but the Moody's Analytics/RCA CPPI All Property Price Index is on track to perform in line with the S&P 500 and to outperform investment-grade bonds while lagging high-yield bonds and small-cap equities.

We expect that returns will continue to moderate but will remain attractive relative to alternative asset classes. Cap rates have stabilized at a historically low level. While there is the threat that rising interest rates, however gradual from here on out, could push cap rates up, spreads remain near historical averages and well above levels associated with late-cycle. As a point of comparison, investment-grade bond spreads have declined even as Treasuries have sold off, and while they are now comparable to cycle lows, they remain about 50 bps above the average level associated with the previous expansion. While we do not expect cap rates to increase substantially and put negative pressure on prices, neither do we expect further compression to drive returns going forward. Major markets and CBD office seem close to fully valued so that future returns will depend predominantly on NOI growth.

Non-major markets and suburban office, however, stand to benefit both from further cap rate compression and NOI growth. These markets have cumulatively underperformed major markets by about 41% since the market bottomed in January 2010. Such a large performance differential is not supported by employment and growth fundamentals but rather has been sustained by capital favoring the gateway cities. One example is that we are now seeing job growth decelerate in the major markets and pick up in non-major markets, many of which had led the previous cycle and suffered the worst in the downturn. Pricing too has begun to respond. 2016 was the first year since the downturn where non-major cities outperformed major cities. We believe this trend will continue over the next year and that it will gain further momentum as foreign and domestic capital seek the higher yields and superior value available in these markets.

Uncertainty and Fundamentals Drive Capital

As we enter 2017, the outlook for U.S. capital markets is also one of measured optimism. While there is no shortage of uncertainty in the world, the fundamentals supporting demand for and pricing of U.S. CRE are not only strong but seem likely to withstand most possible shocks. The global landscape—politically and economically—remains messy and uncertain. The safety of U.S. assets and the potential for upside will continue to work in favor of U.S. CRE.

About Cushman & Wakefield

Cushman & Wakefield is a leading global real estate services firm that helps clients transform the way people work, shop, and live. Our 43,000 employees in more than 60 countries help investors and occupiers optimize the value of their real estate by combining our global perspective and deep local knowledge with an impressive platform of real estate solutions. Cushman & Wakefield is among the largest commercial real estate services firms with revenue of $5 billion across core services of agency leasing, asset services, capital markets, facility services (C&W Services), global occupier services, investment & asset management (DTZ Investors), project & development services, tenant representation, and valuation & advisory.

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