MARKETBEAT

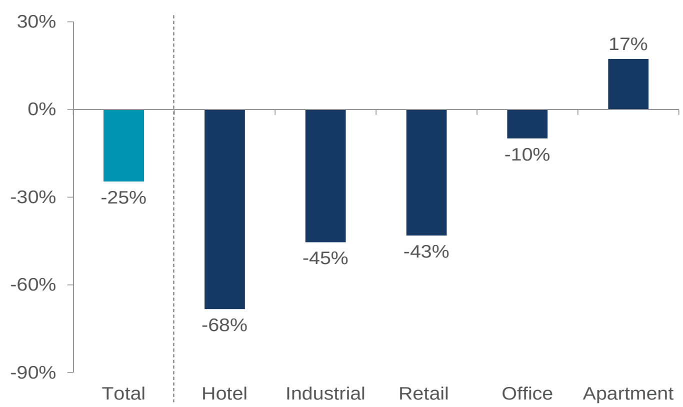
U.S. Capital Markets Q1 2016

CUSHMAN & WAKEFIELD

U.S. CAPITAL MARKETS

Tough Start to 2016

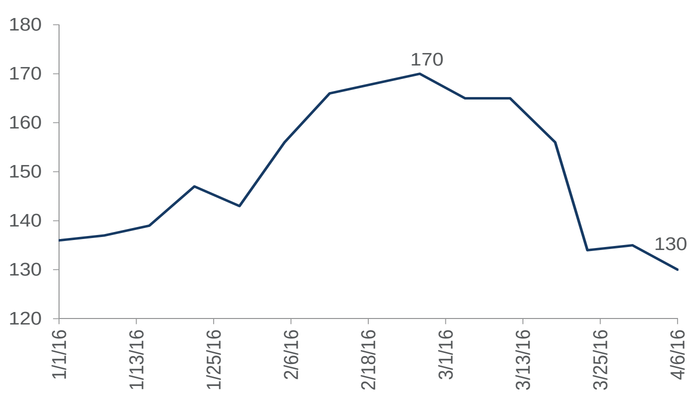
SALES VOLUME (JAN-FEB 16' VS. JAN-FEB 15', % CHG.)



Source: Real Capital Analytics, Cushman & Wakefield Research

But Now Conditions Calming Down

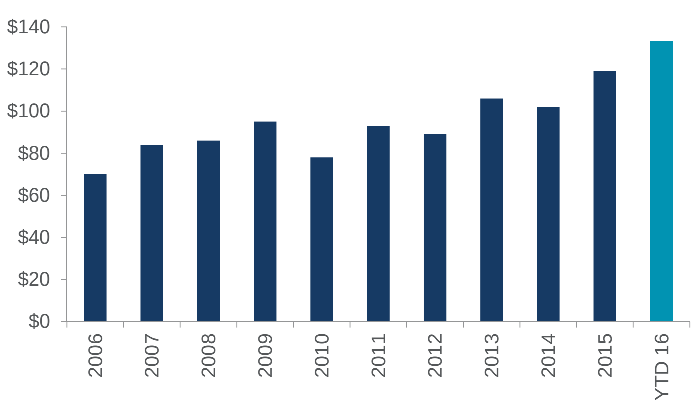
10-YR AAA SWAP SPREAD



Source: Commercial Mortgage Alert, Cushman & Wakefield Research

Tons of Dry Powder Targeting U.S.

$ BILLIONS



Source: Preqin, Cushman & Wakefield Research

Rocky Start to the Year but Tides are Turning

The capital markets got off to a rocky start in 2016. Global uncertainty stoked fears that the economic expansion was coming to an end which weighed heavily on equity and debt markets. As a result, total sales volume of significant properties plunged by 25% in January and February from a year ago, and pricing in nearly every U.S. market was registering either flat or down. Much of that anxiety has dissipated, however, and by the end of March equity prices had fully recovered and market volatility had returned to more normal levels. That, combined with a strong job market, improving leasing fundamentals, and growing rent pressures due to muted construction levels, indicate that transaction activity will accelerate going forward.

The brightest spot on the demand side has been the consistently robust trends in the labor markets. The U.S. economy created 215,000 net new nonfarm payroll jobs in March and has averaged 209,000 new jobs per month so far this year. The current pace of job creation is slightly better than last year's robust pace, and is driving even tighter conditions in leasing fundamentals. Another strong positive in the market has been the continued very low interest rate environment. Even though the Federal Reserve raised the Fed Funds rate by 25 basis points (bps) in December of last year, global economic uncertainty is keeping downward pressure on the 10-year Treasury yield which has remained well below 2% for most of 2016.

Appreciation Levels Stabilizing

Price appreciation has come in a bit recently and, in fact, inched down as uncertainty in the capital markets early in 2016 caused some investors to "tap the brakes." However, we think that this is indicative of a return to more sustainable price growth rather than a broader correction. After peaking in November 2015 at 17% above the previous peak level, the Moody's/RCA Index ticked down 0.7% between December and February. On a year-over-year basis, however, prices are up 8.5%.

The softness in pricing is spotty, varying from market to market and across property types. Asset values for core product in gateway markets are holding steady as investor interest remains strong. Pricing for lower quality assets in secondary and tertiary markets has receded from recent peaks, however, as weakness in the CMBS market has hampered financing prospects for many borrowers. That said, since late-February, CMBS spreads have improved. After topping out at 170 bps on Feb 26th, the 10-year AAA swap spread has tightened by 40 bps in early April. All CMBS tranches, from the highest quality to the lowest, are improving, indicating that the soft spot in the secondary/tertiary market pricing earlier this year is likely to be short-lived.

The Debt Markets Adjusting

The debt side of the equation is adjusting to the new regulatory environment but remains in mostly solid shape. Thus far in 2016, commercial banks have increased their position for commercial real estate loans; CRE loan volume (including construction loans) is growing at a rate of 11%. Life insurance companies are lending at near-record levels, and the GSEs also continue to grow their real estate portfolio. The primary area of weakness has come from the CMBS industry, which, as discussed earlier, links to the early-year volatility.

Still unknown, however, is the impact that “risk retention” regulations will have on the CMBS market towards the end of the year when these regulations take effect. Since many of the new regulatory changes that will impact the CMBS industry do not go into effect until December, there may be a big push coming from the CMBS markets to get as many deals done as possible under current rules. Now that the volatility has quieted down, the CMBS market activity could take off for the next several months, presenting a new wave of investment and refinancing opportunities. Perhaps momentum is already building; CMBS issuance was up 128% in March from January lows.

Tons of Capital Waiting to Be Deployed

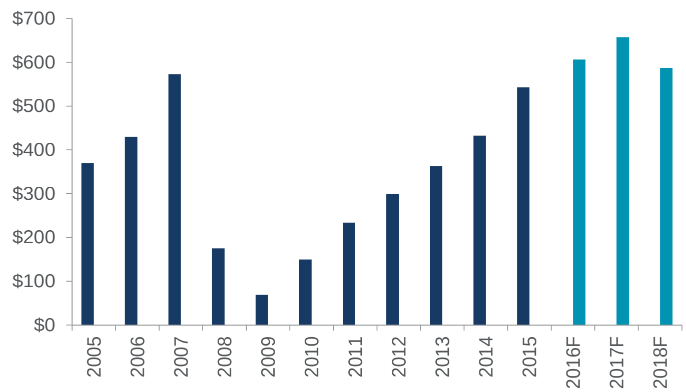
One of the primary drivers of U.S. real estate transaction activity in recent years has been the surge in offshore capital. In 2015, foreign investors accounted for 18% of total sales activity in the U.S., well above the historical average of nearly 10%. Based on the latest “dry powder” report from Preqin, foreign investment in U.S. real estate is only going to ramp up from here.

Whether it is low bond yields, negative rates in some countries, falling oil prices (although we’ve seen some recovery in March), or changes to FIRPTA, U.S. real estate is attracting more and more interest from the global investment community. According to the latest figures from Preqin, there is $133 billion of dry powder targeting North America, which is up 12% compared to year-end 2015 figures.

However, the global economic environment has engendered some uncertainty regarding the prospects for future investments. There is some concern that sovereign wealth funds tied to oil-producing countries will pull back their allocations this year. Moreover, increased regulations in China, combined with the country’s economic slowdown, have the potential to curtail state-owned entities’ investment activities. Still, high net-worth investors remain greatly interested in the U.S. and are even expanding their targets to include secondary markets such as Atlanta, Seattle, and Baltimore. With offshore investors still allocating capital into real estate and domestic buyers having mandates to place money, we expect U.S. sales volume to flirt with record territory in 2016.

Investment Sales Volume Forecast

ALL PROPERTY TYPES, $ BILLIONS



Source: Real Capital Analytics, Cushman & Wakefield Research

Outlook:

So what does all of this mean for sales activity in 2016 and beyond?

- The low interest rate environment will continue for at least one more year. The Fed’s cautious approach and global volatility will keep downward pressure on long-term Treasury yields.
- Fundraising for U.S. CRE remains spectacular. Despite the weak start to the year, sales volume will set a new record in 2016.
- Double-digit price appreciation years are over; the market will settle in at a more modest pace of 5-7% growth driven by solid NOI growth.

About Cushman & Wakefield

Cushman & Wakefield is a leading global real estate services firm that helps clients transform the way people work, shop, and live. The firm’s 43,000 employees in more than 60 countries provide deep local and global insights that create significant value for occupiers and investors around the world. To learn more, visit www.cushmanwakefield.com or follow @CushWake on Twitter.

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