



May 2017

# U.S. ECONOMIC AND PROPERTY MARKET OUTLOOK

What to Expect Late Cycle

FOCUSED ON THE FUTURE OF REAL ESTATE

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# U.S. ECONOMIC AND PROPERTY MARKET OUTLOOK

## What to Expect Late Cycle

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# Introduction

## UNITED STATES

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Growth agenda enthusiasm beginning to fade as economic data weakens and Washington appears as broken as ever



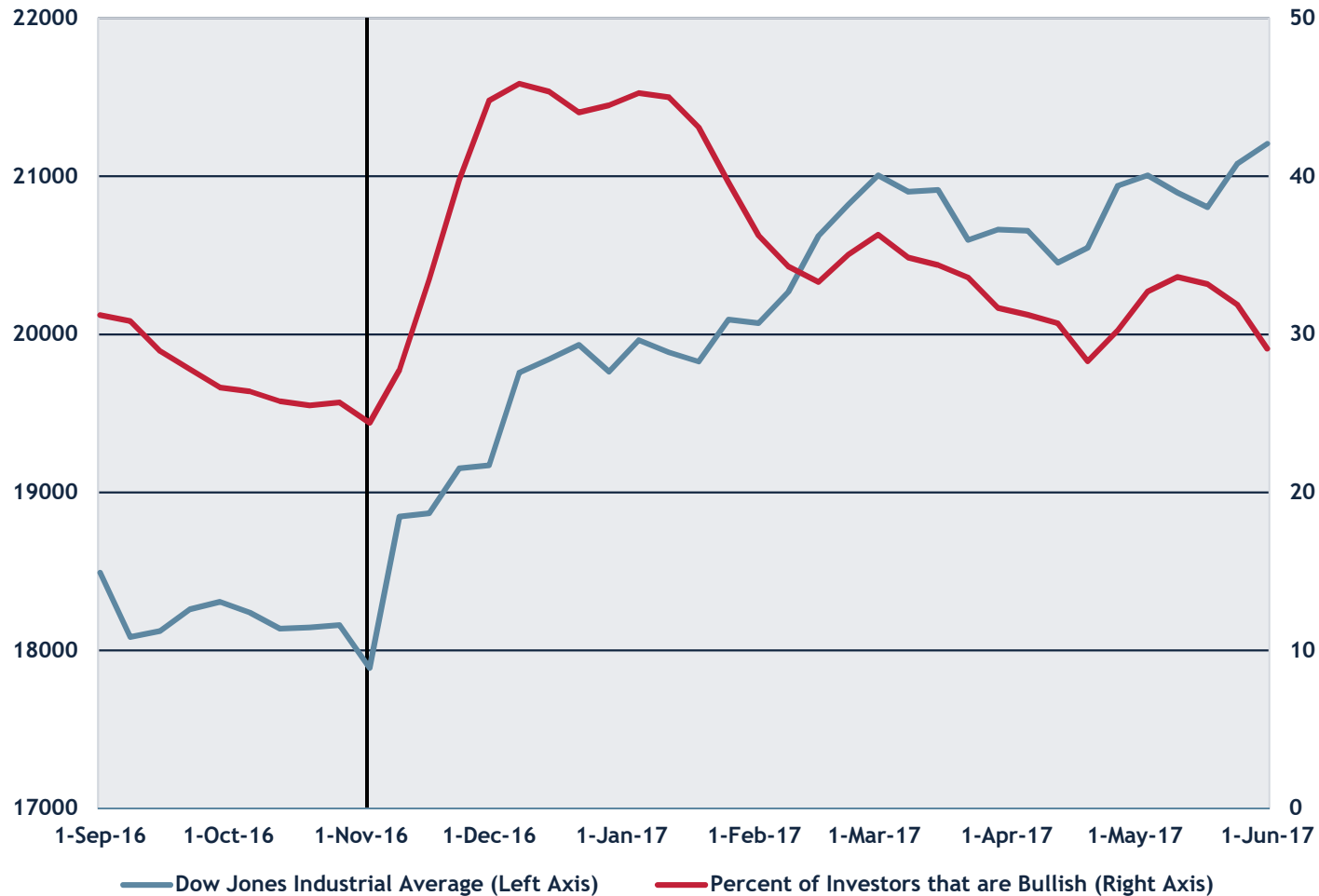
Property market fundamentals still strong, but peaking for this cycle



Go forward property returns will be lower, but competitive with other asset classes

# TRUMP TRADE STARTING TO FADE?

## DOW JONES INDUSTRIAL AVERAGE AND INVESTOR SENTIMENT INDEX



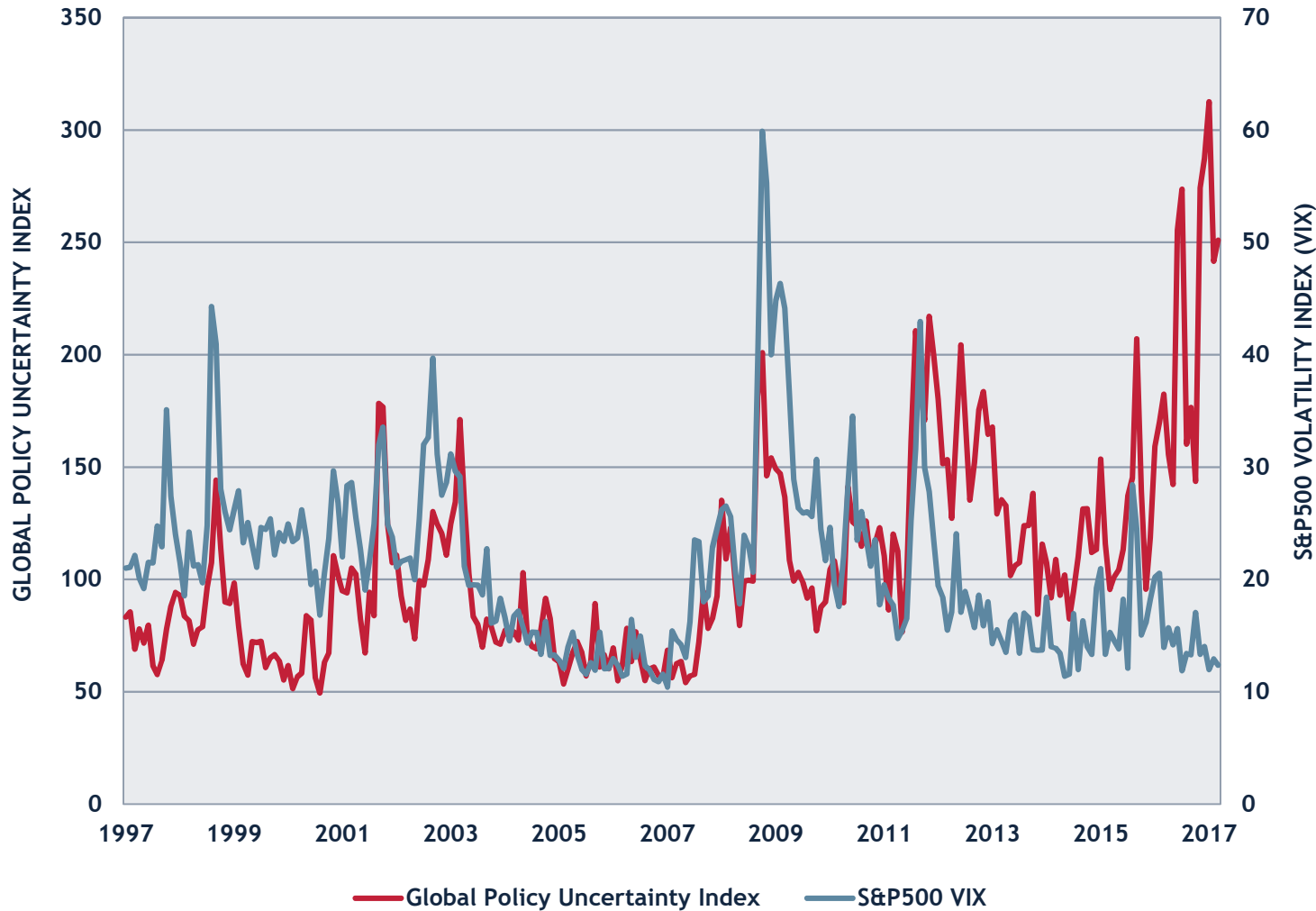
Investor sentiment rose sharply after the election but is slowly returning to pre-election levels

Equity markets have begun to move sideways as legislative agenda has slowed and global uncertainty has increased

Source: Bloomberg

# HEIGHTENED POLITICAL UNCERTAINTY AND LOW VIX?

## GLOBAL ECONOMIC POLICY UNCERTAINTY INDEX



Source: IMF, CBOE

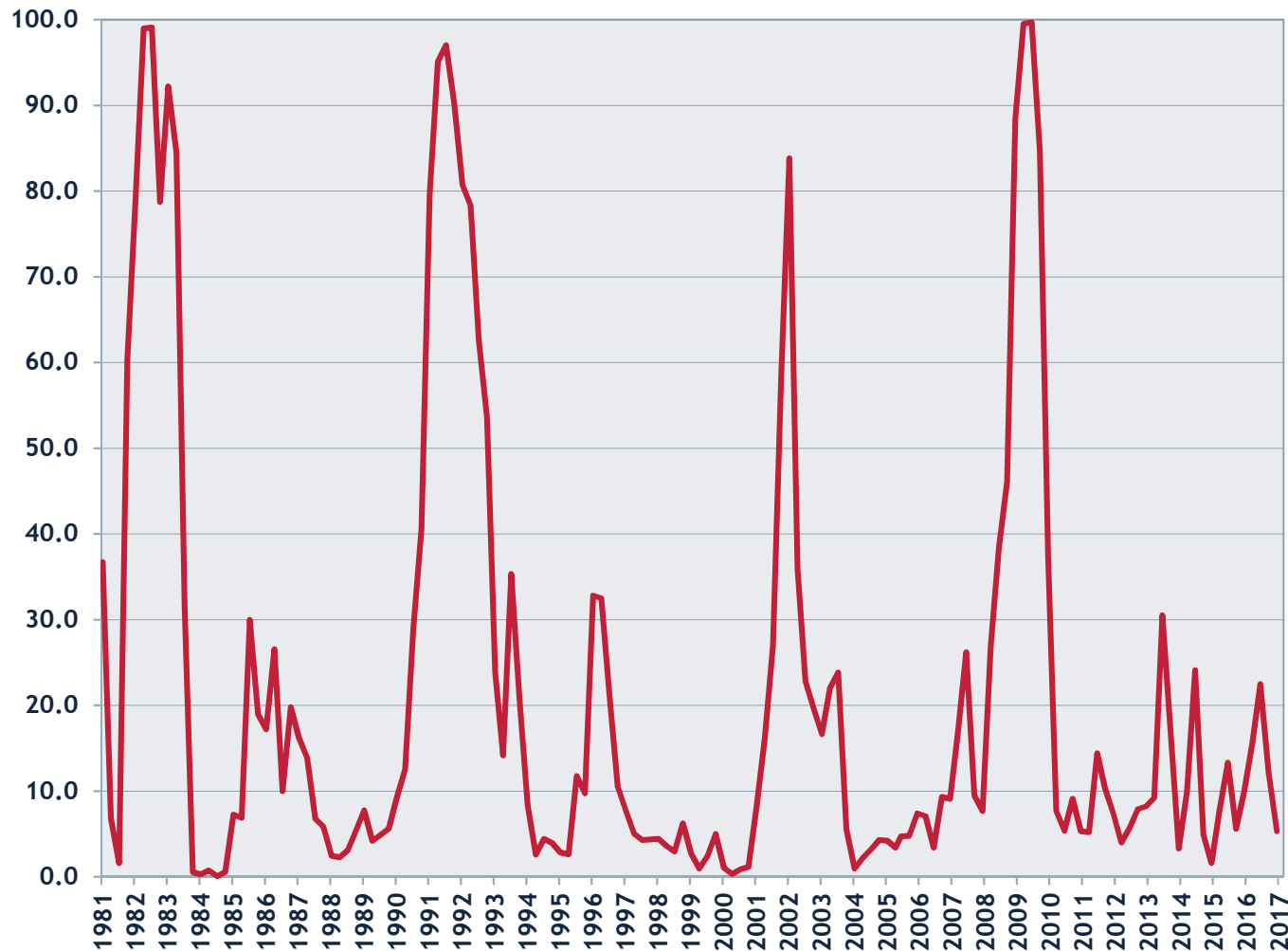
Brexit, Trump and European elections contributing to global policy uncertainty

Populist/nationalist movements are even stronger in Europe than the U.S.

Why is market volatility so low?

# THERE IS NO SIGN OF A RECESSION

## PROBABILITY THAT THE U.S. ECONOMY IS IN RECESSION (%)



Source: Federal Reserve Bank of Atlanta

Expansions do not die from old age

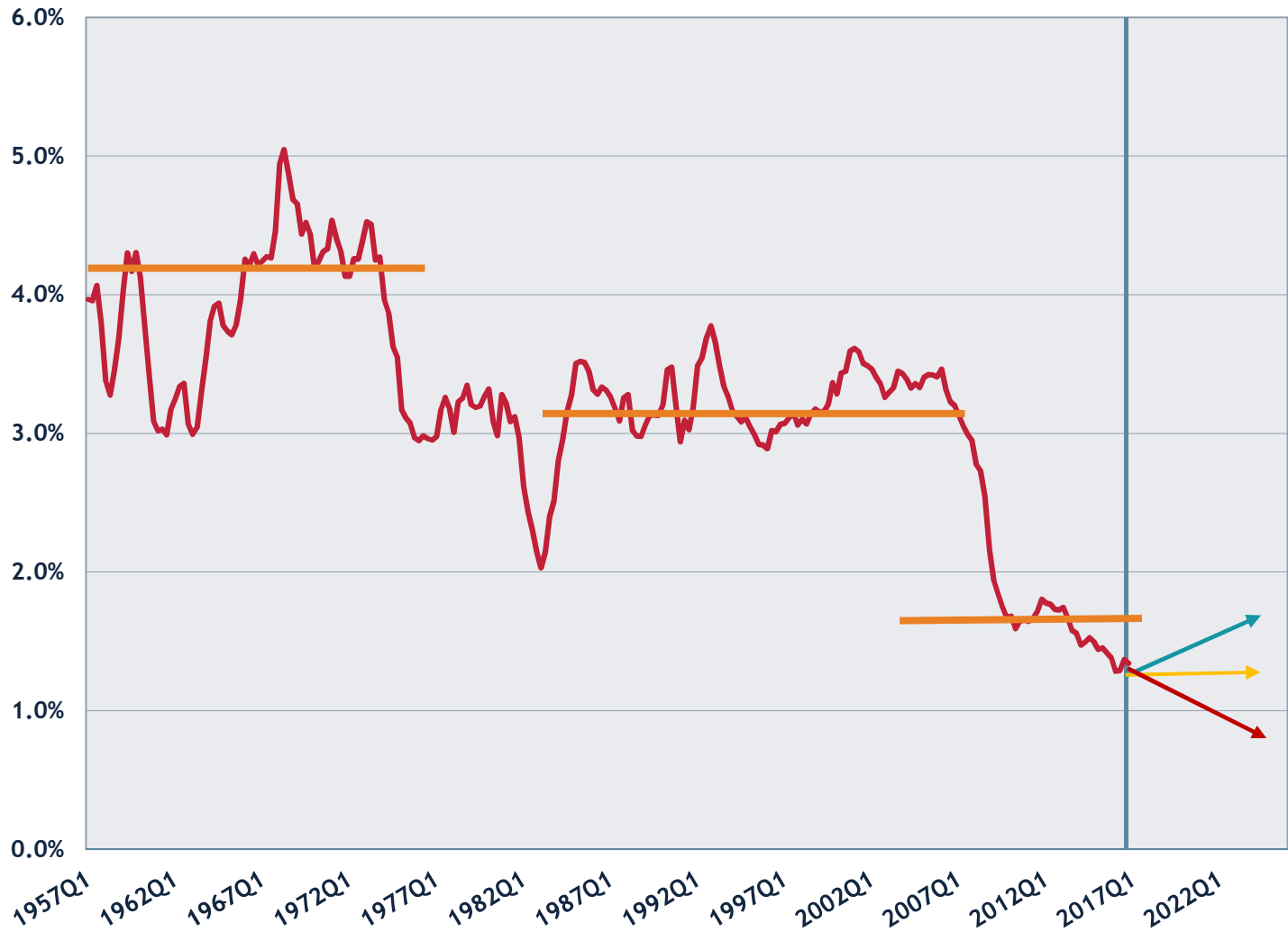
Expansions end because imbalances become unsustainable or from policy mistakes

Most common policy mistakes originate with the Fed and the tightening cycle

Today, greatest policy risks are likely in trade or immigration policy

# WHERE DOES GROWTH GO FROM HERE?

## ROLLING TEN-YEAR AVERAGE ANNUAL GROWTH IN REAL GDP



Source: NIPA

From mid-1950s to mid-1970s, U.S. ten-year growth averaged 4% per year

From mid-1970s to 2000, U.S. ten-year growth averaged 3% per year

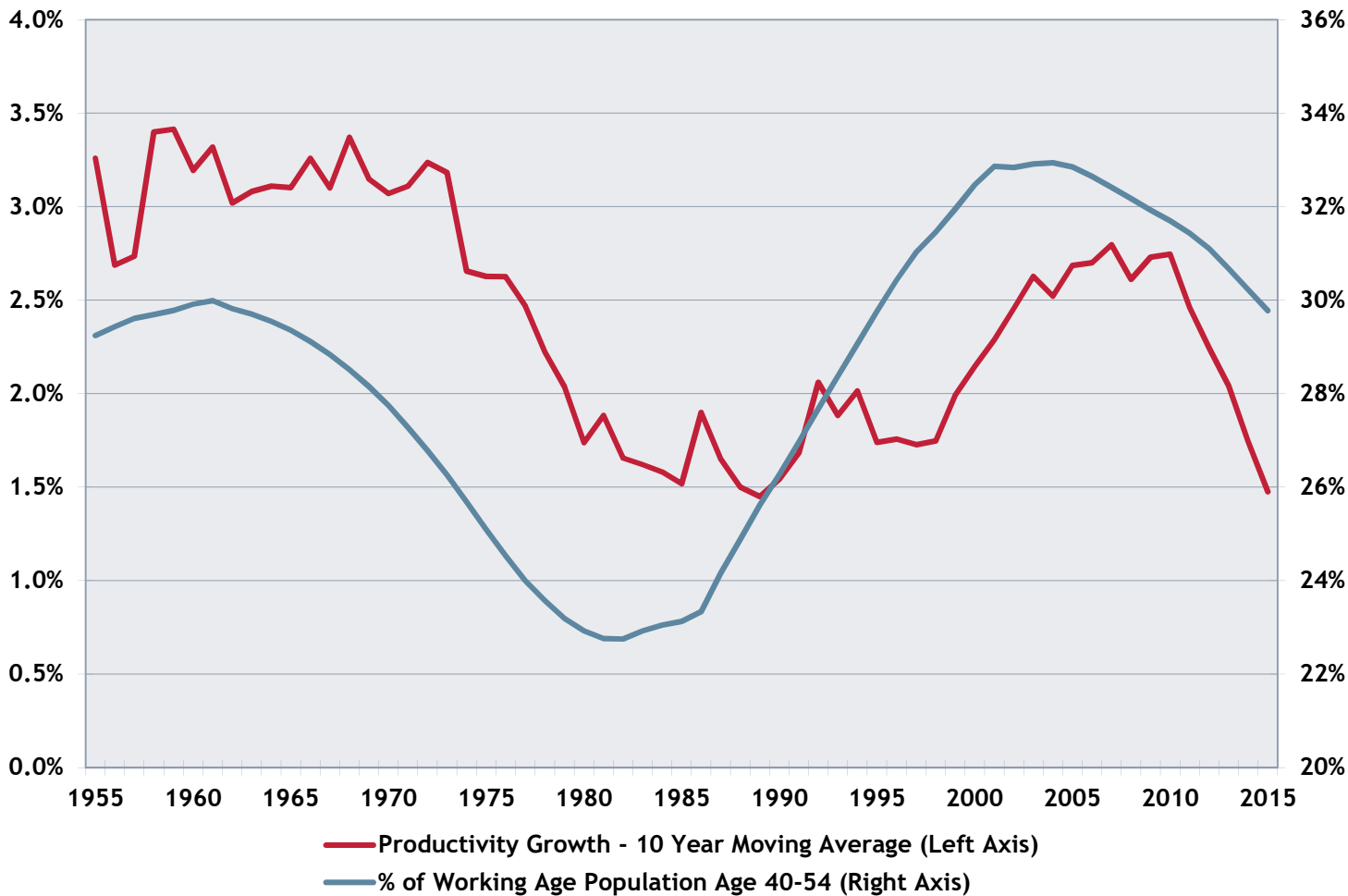
Since 2005, U.S. ten year growth has averaged only 2% per year

What drives higher growth? Labor force, productivity, something else?



# OUR MOST PRODUCTIVE WORKERS ARE AGING OUT OF THE LABOR FORCE

## PRODUCTIVITY GROWTH AND SHARE OF WORKING AGE POPULATION AGE 40-54



Entire Baby-Boom is now over 50

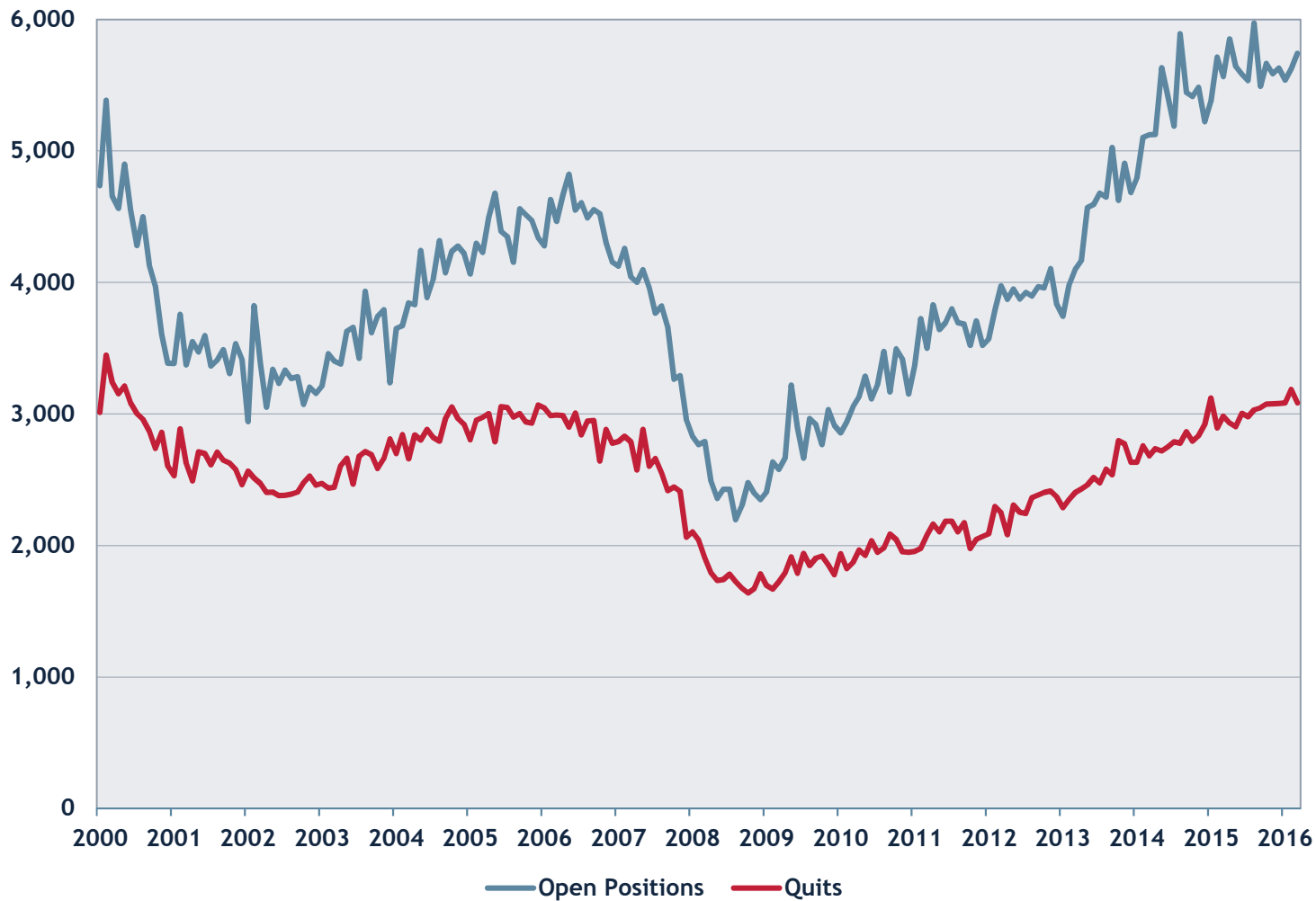
Aging high productivity workers being replaced by young low productivity workers

Wage growth constrained by productivity growth in the near-term

Source: CBRE-EA, 2016 Q4

# HIGHEST NUMBER OF OPEN POSITIONS IN U.S. HISTORY

OPEN POSITIONS AND NUMBER OF PEOPLE QUITTING THEIR JOB (000S)



Source: BLS

Nearly six million open positions in the U.S. today

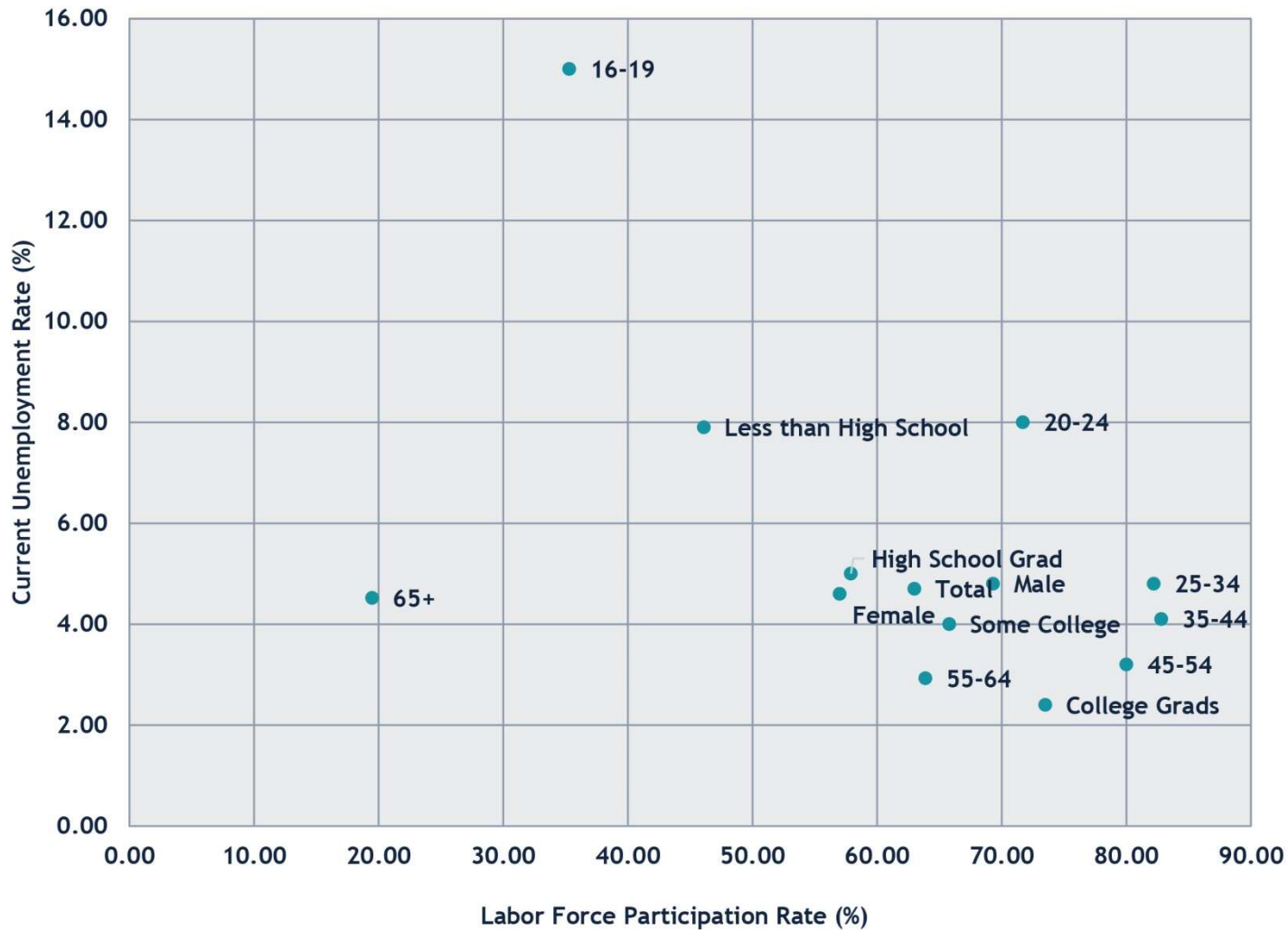
1.2 million positions in education and health services

More than one million positions in professional and business services

Number of quits is back to pre-crisis level as workers feel confident in finding new jobs

# WHERE WILL WE FIND OUR WORKERS?

## OPEN POSITIONS AND NUMBER OF PEOPLE QUITTING THEIR JOB (000S)

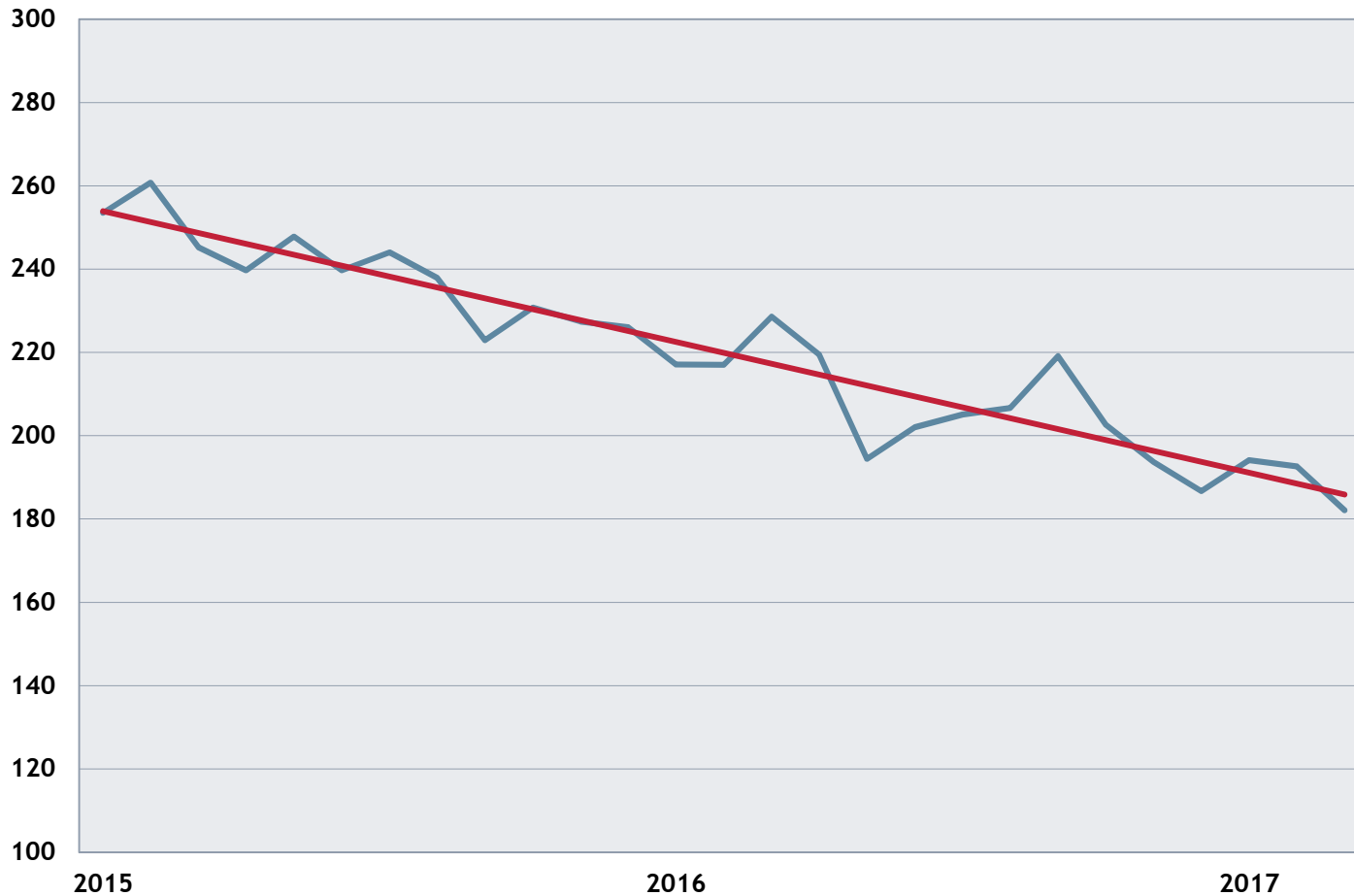


Large pockets of potential labor in the under 20, over 65, and less educated groups

Source: BLS

# U.S. EMPLOYMENT GROWTH SLOWING

AVERAGE MONTHLY CHANGE IN EMPLOYMENT OVER THE PRIOR YEAR (000S)



U.S. was adding 250,000 jobs per month at the beginning of 2015

Today, the U.S. is adding 180,000 jobs per month

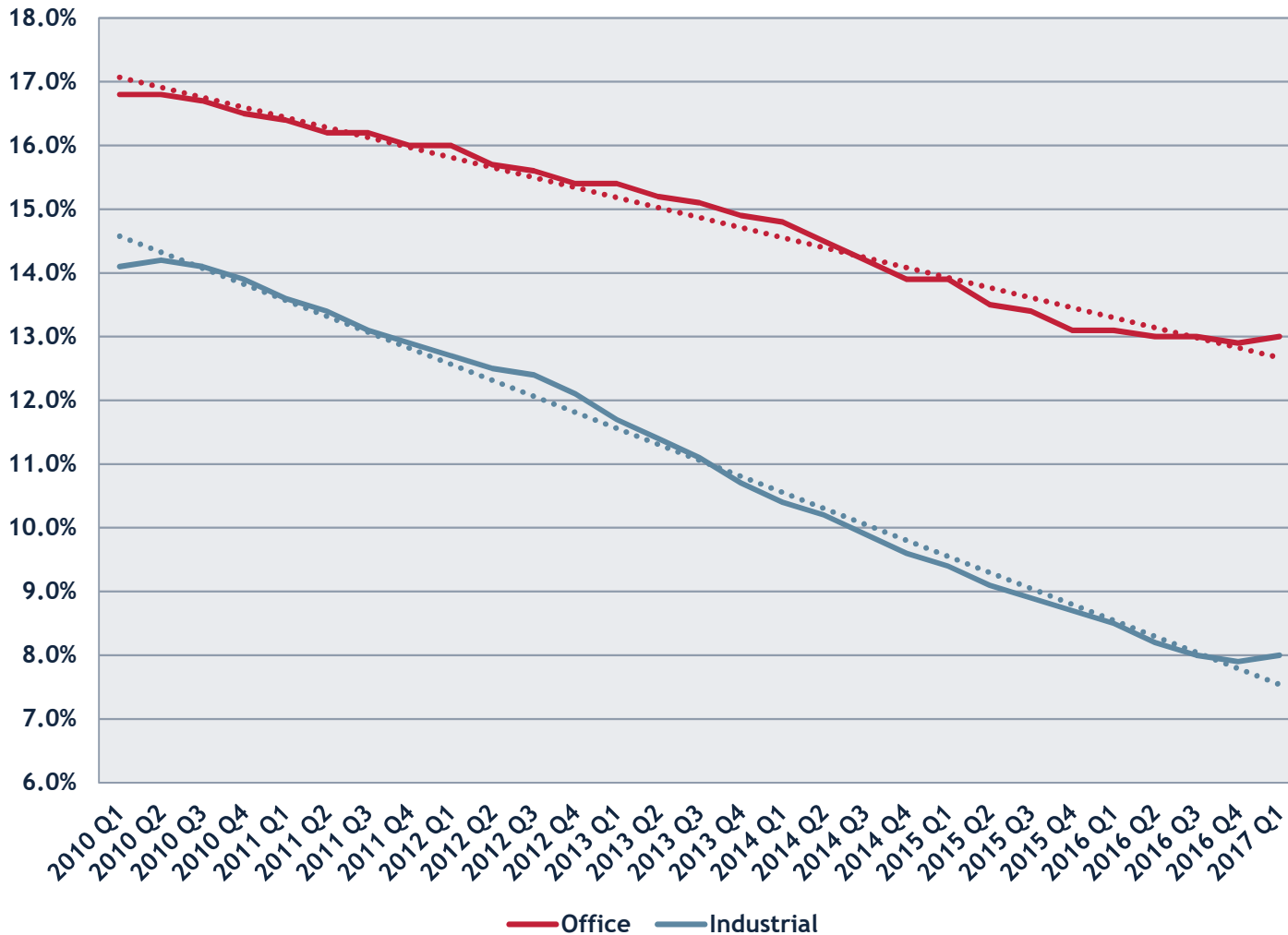
The slowdown is mostly due to lack of people to hire

U.S. now has more than six million open positions

Source: BLS

# IMPROVEMENT IN PROPERTY MARKET FUNDAMENTALS ALSO SLOWING

## AVERAGE VACANCY RATE

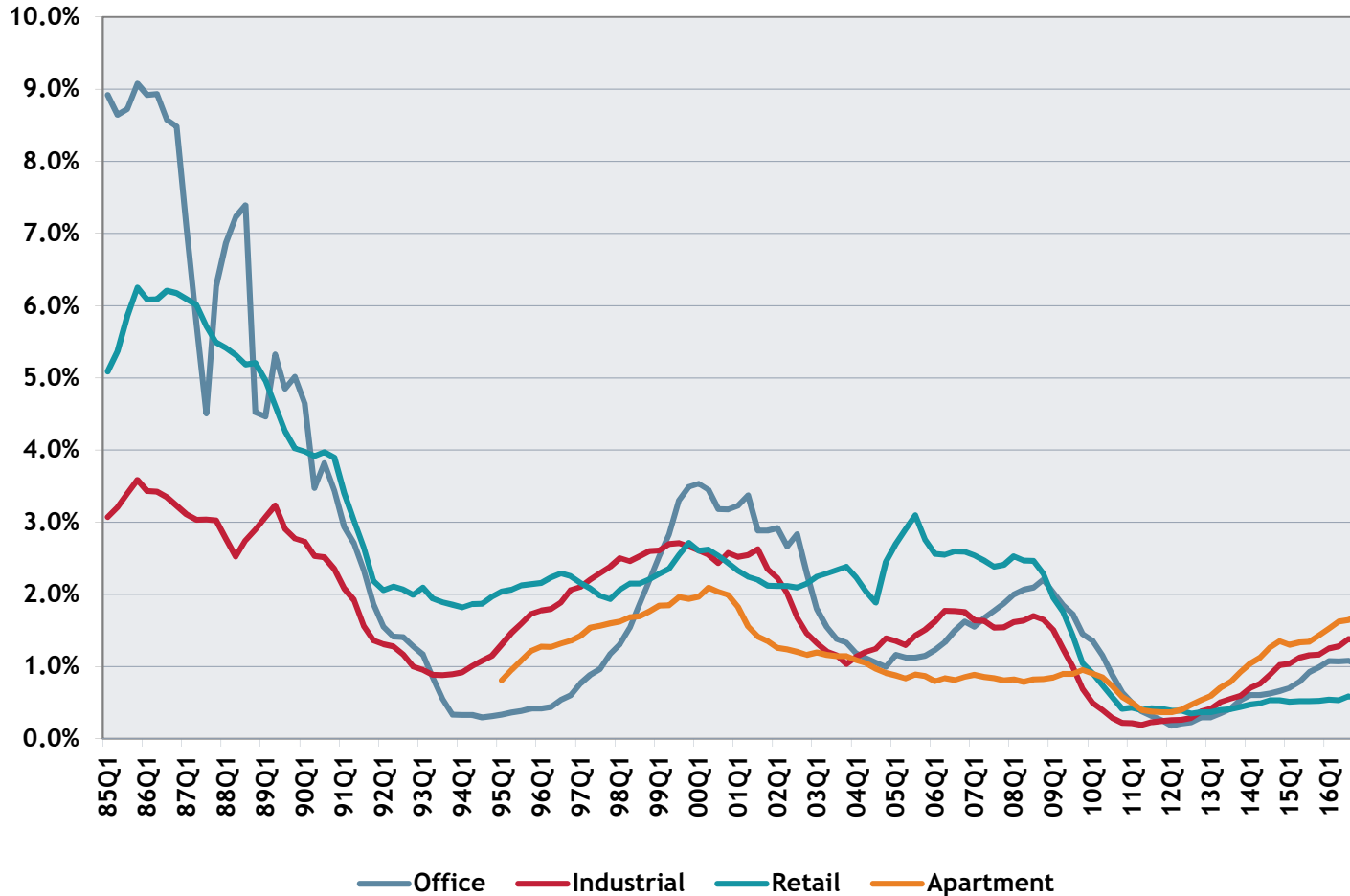


Vacancy rates at or below long-term averages but rate of improvement is flattening

Source: CBRE-EA, 2016 Q4

# SUPPLY GROWTH REMAINS BELOW PRIOR CYCLES (BUT IS RISING)

## ADDITIONS TO STOCK OVER PRIOR 4 QUARTERS AS A SHARE OF TOTAL STOCK



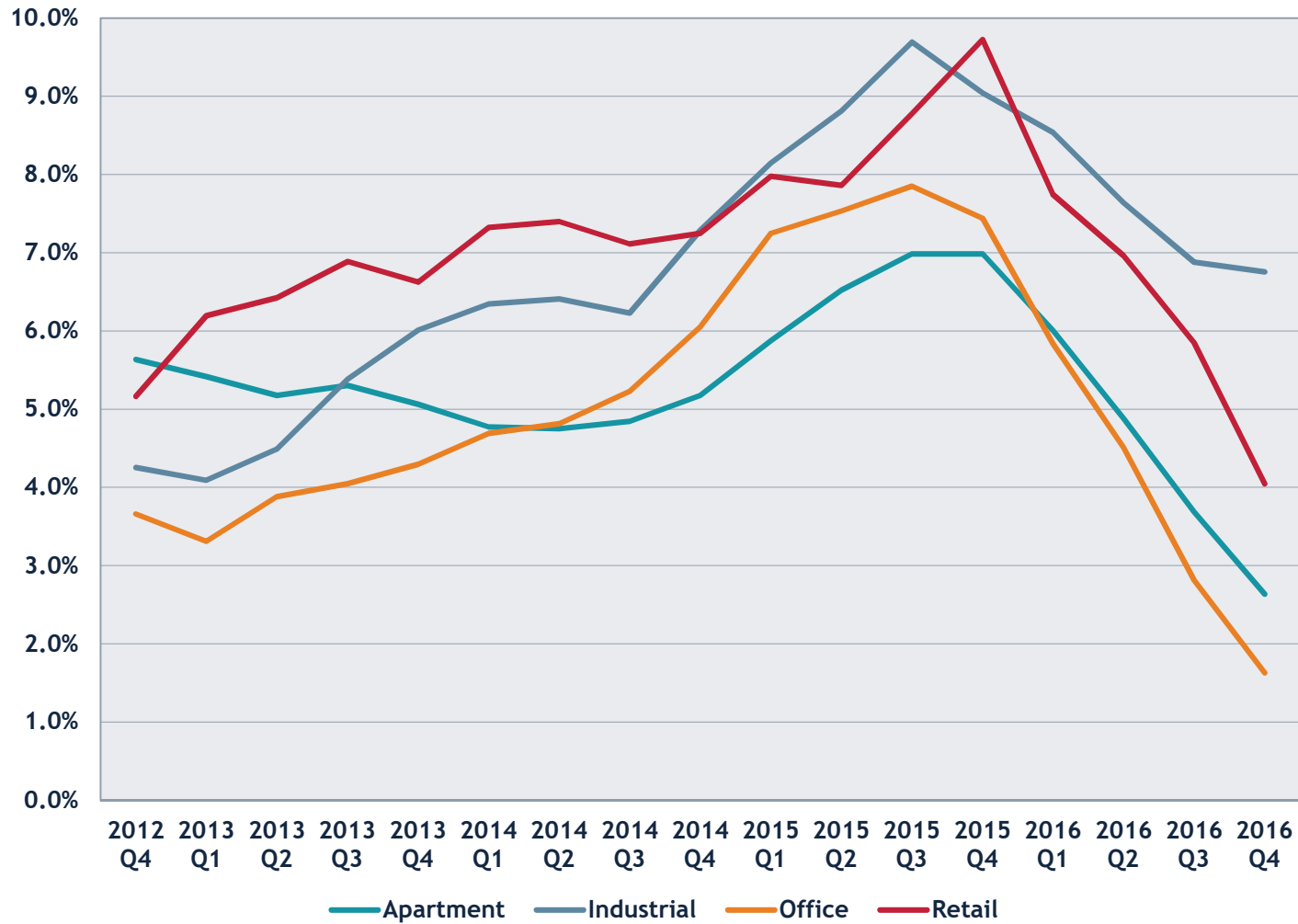
New supply risk is rising

In 2017, the U.S. office and apartment stock will increase by approximately 2% while the industrial stock will increase 1.5%

Source: NIC, CBRE-EA, 2016 Q4

# PROPERTY CAPITAL APPRECIATION SLOWING

YEAR-OVER-YEAR PERCENT CHANGE IN NPI CAPITAL VALUE INDICES



Property appreciation still positive but slowing

Source: NCREIF

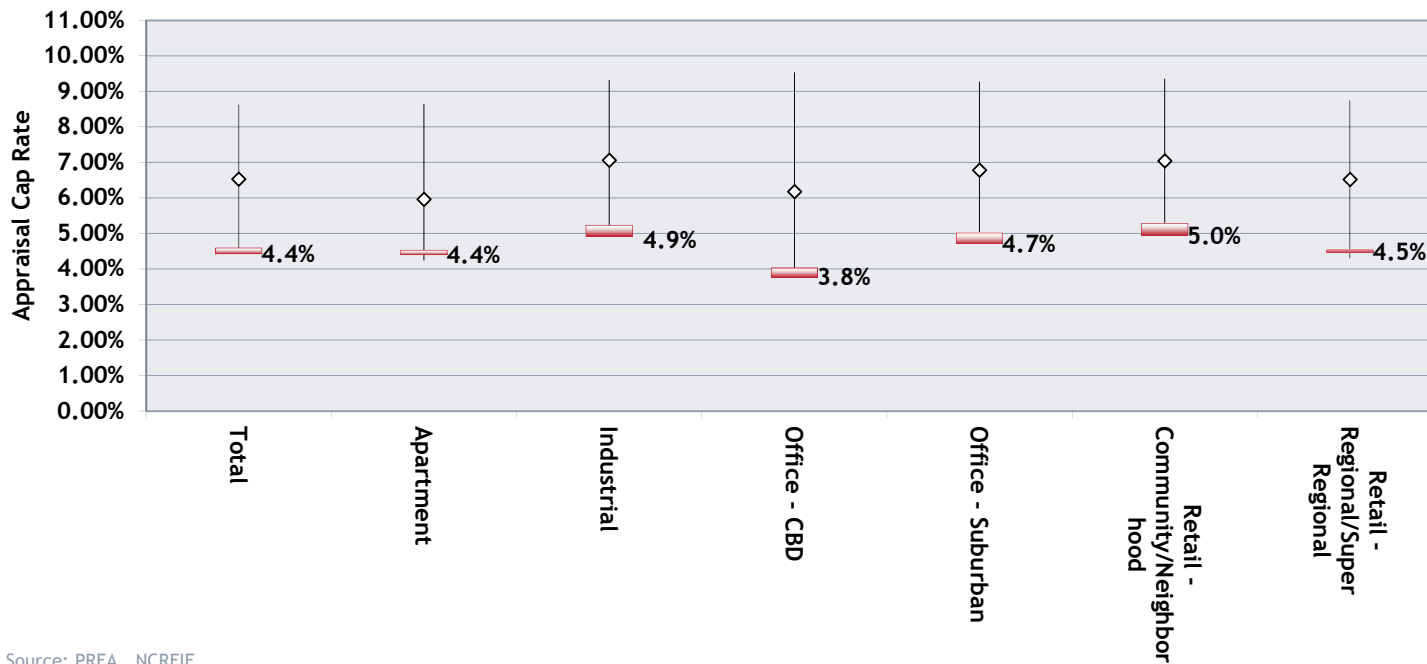
# RETURN EXPECTATIONS CONTINUE TO MODERATE

March 2017 Survey	2017	2018	2019	2017 to 2021
<b>NPI Total Return</b>	<b>6.6%</b>	<b>5.9%</b>	<b>5.5%</b>	<b>6.0%</b>
<b>Income Return</b>	<b>4.8%</b>	<b>4.8%</b>	<b>4.9%</b>	<b>4.9%</b>
<b>Capital Appreciation</b>	<b>1.8%</b>	<b>1.3%</b>	<b>0.7%</b>	<b>1.0%</b>

Real estate returns are typically somewhere between stocks and bonds

Multiple years of outsized returns should be followed by several years of lower returns

## NCREIF CAP RATES BY PROPERTY TYPE 1982-2016

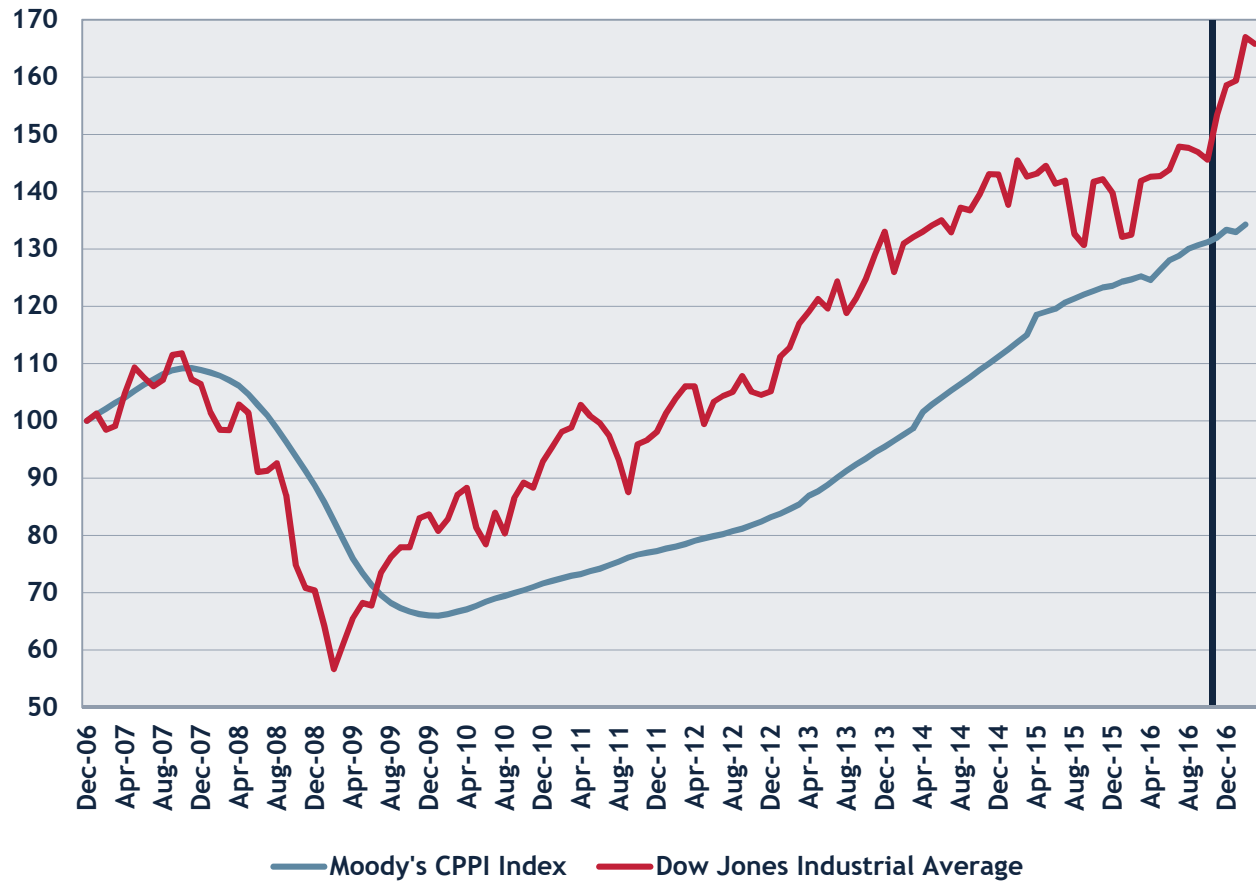


Source: PREA , NCREIF



# WHICH MARKET ARE YOU MORE WORRIED ABOUT?

## MOODY'S CPPI AND THE DOW JONES INDUSTRIAL AVERAGE (DEC. 2006 = 100)

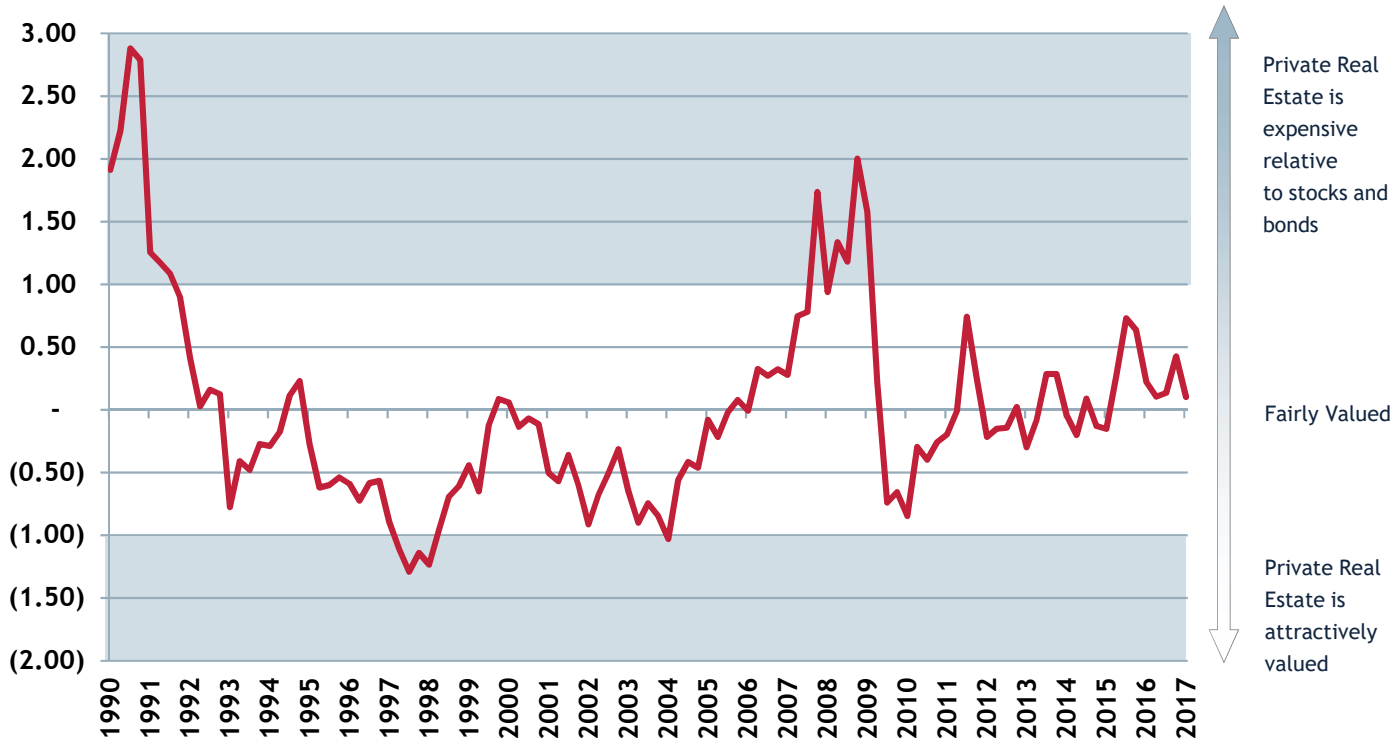


	NPI	CPPI	DJIA
Peak-to-Trough Decline	-23.9%	-39.6%	-49.3%
Trough-to-Current Increase	116.9%	103.5%	192.6%
Increase Since Election	0.6%	2.4%	13.9%

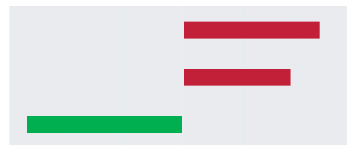
Source: Bloomberg, Moody's

# U.S. PROPERTY CLOSE TO FAIR VALUE IN A LOW YIELD WORLD

## AEW U.S. PRIVATE MARKET PROPERTY RELATIVE VALUE INDEX



Premium/Discount to REITs  
 Multiple vs. Equities  
 Spread to Baa Yields



U.S. property looks attractive relative to bonds and slightly expensive relative to stocks and REITs

AVG. 17Q1

Premium or Discount to REITs	-1.5%	5.3%
Property Multiple Relative to S&P500	1.04x	1.16x
Property Cash Yield Spread to Baa Yield (bp)	-234	-147

Source: NCREIF, NREIT, Bloomberg

# CAN U.S. PUBLIC PLANS ACCEPT LOWERS RETURNS?

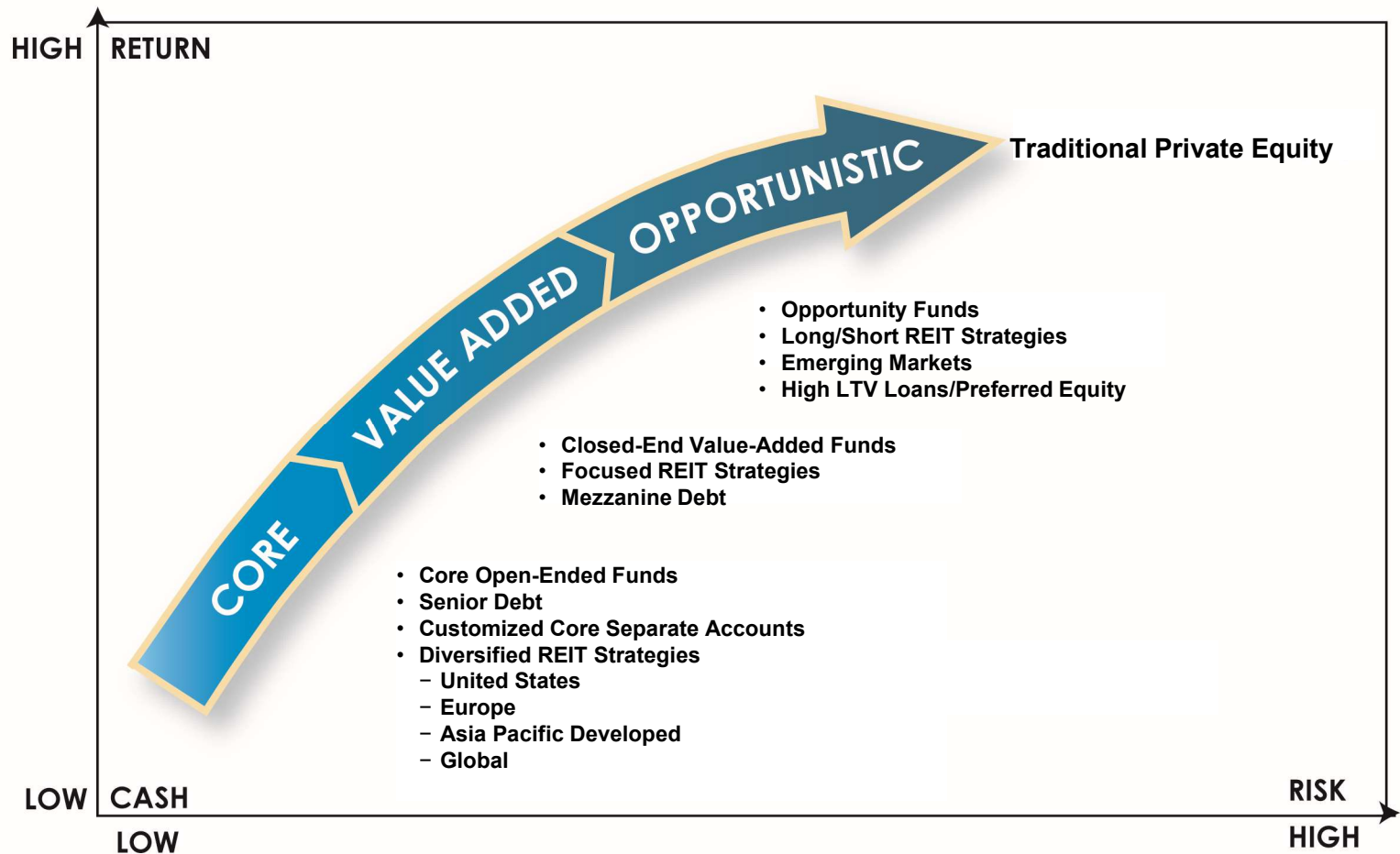
## FUNDING STATUS AND REQUIRED RETURN



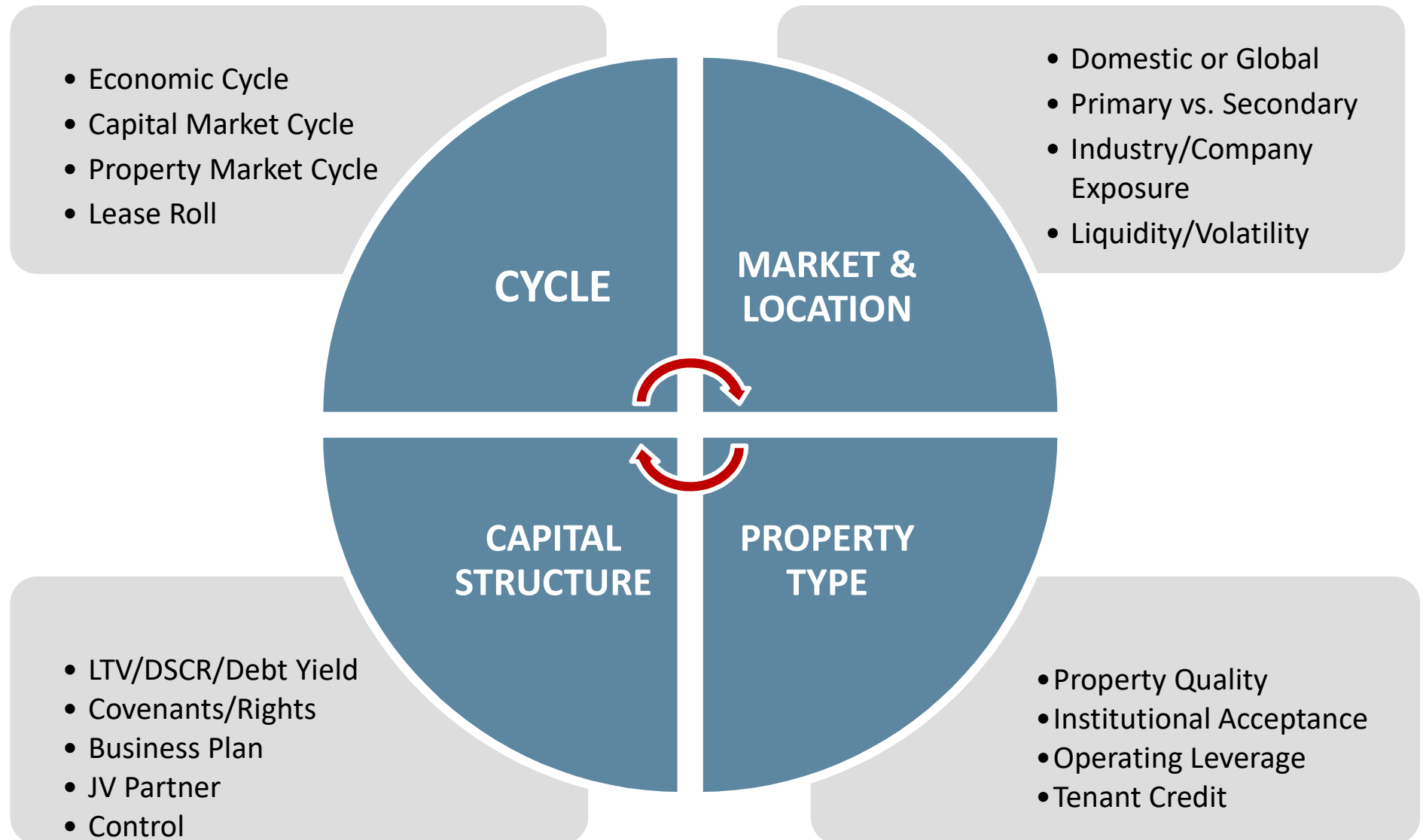
Property appreciation still positive but slowing

Source: Pew, NASRA, Milliman

# Property Risk/Return Spectrum



## Which Risks to Take? How Many to Take?



## CONCLUSIONS

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- U.S. economic growth constrained in the near-term by labor force and productivity
- Commercial property fundamentals still strong, but peaking for this cycle
- New construction risk growing, but still largely under control
- Demand for construction loans falling as lending standards tighten
- U.S. property close to “fair value”
- Long-term property performance should be somewhere between stocks and bonds
- If growth accelerates, property likely performs above bonds, but below stocks
- If growth stalls, property likely performs better than stocks, but trails bonds

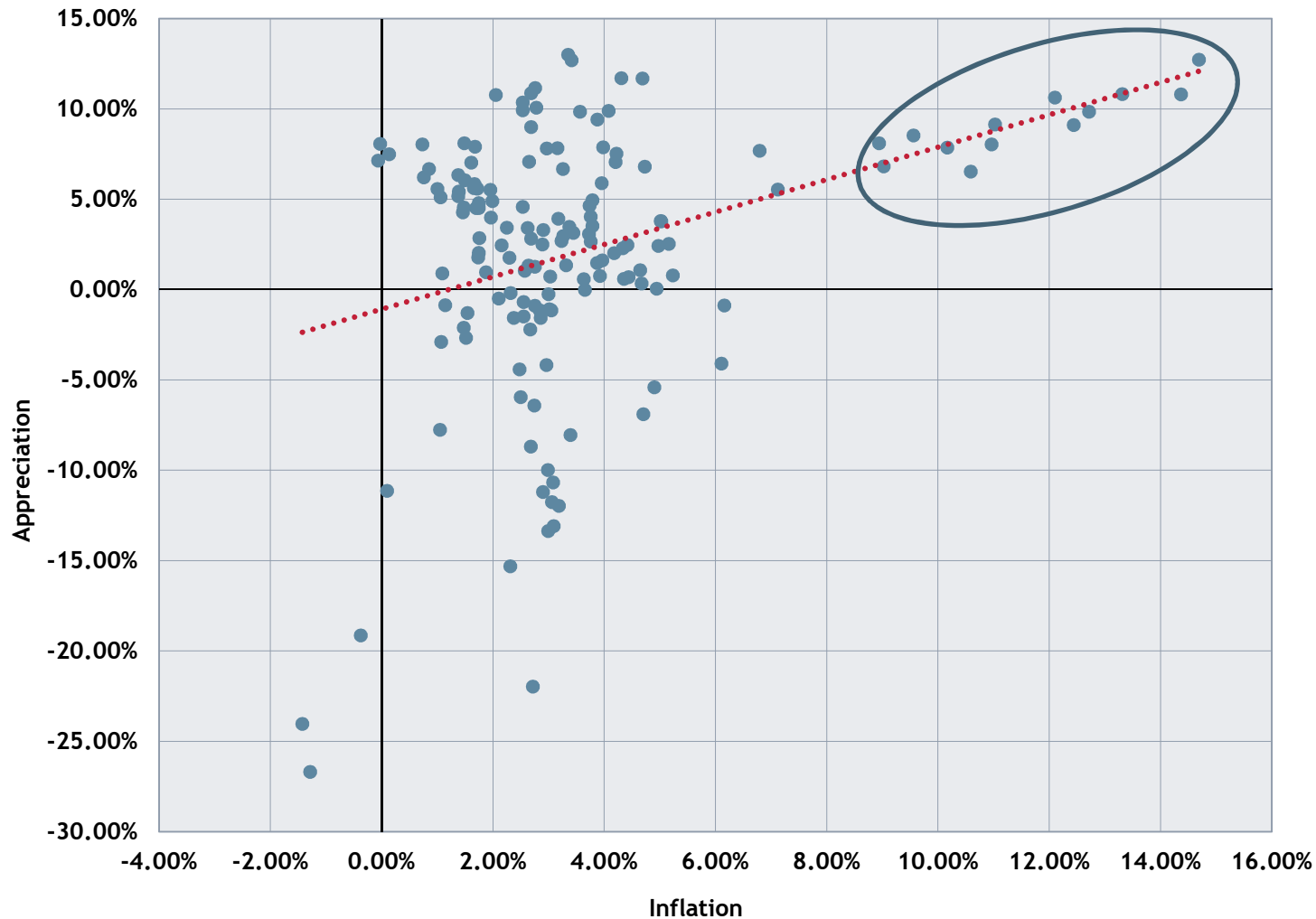
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## APPENDIX

### The Three R's: Reflation, Rising Rates and Real Estate

# IS REAL ESTATE AN INFLATION HEDGE?

YEAR-OVER-YEAR PROPERTY APPRECIATION AND INFLATION, 1978 Q4 - 2016 Q3



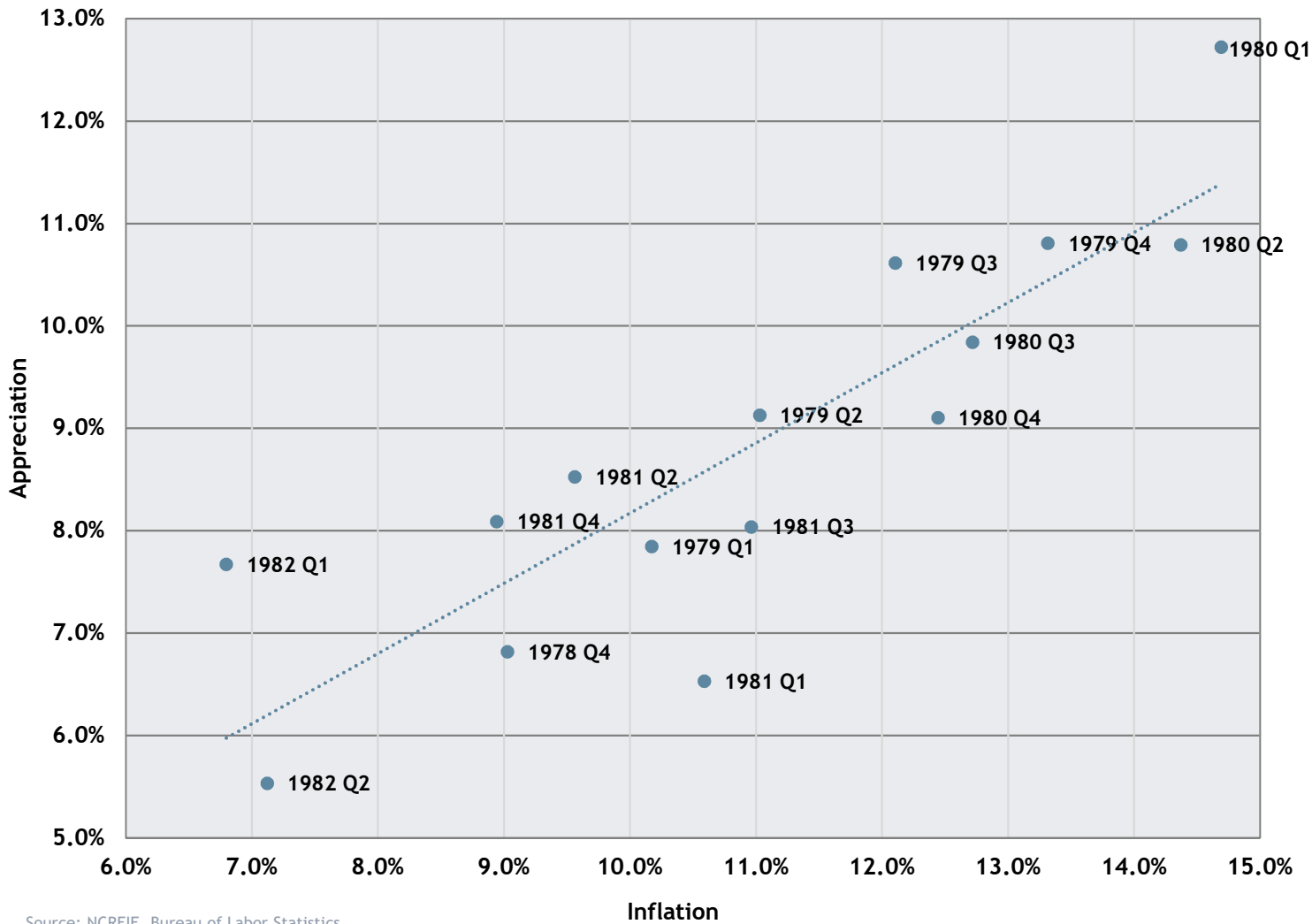
Real estate values move closely with inflation when inflation is extreme

Source: NCREIF, Bureau of Labor Statistics



# IS REAL ESTATE AN INFLATION HEDGE?

## YEAR-OVER-YEAR PROPERTY APPRECIATION AND INFLATION, 1978 Q4 - 1982 Q2



Source: NCREIF, Bureau of Labor Statistics

Real estate values move closely with inflation when inflation is extreme

## IS REAL ESTATE AN INFLATION HEDGE?

### Correlation of Annual Property Appreciation and Inflation (CPI) 1978 Q1 - 2016 Q3

	Apartment	Industrial	Office	Retail	Total	CPI
CPI	0.450	0.304	0.427	0.104	0.357	1.000

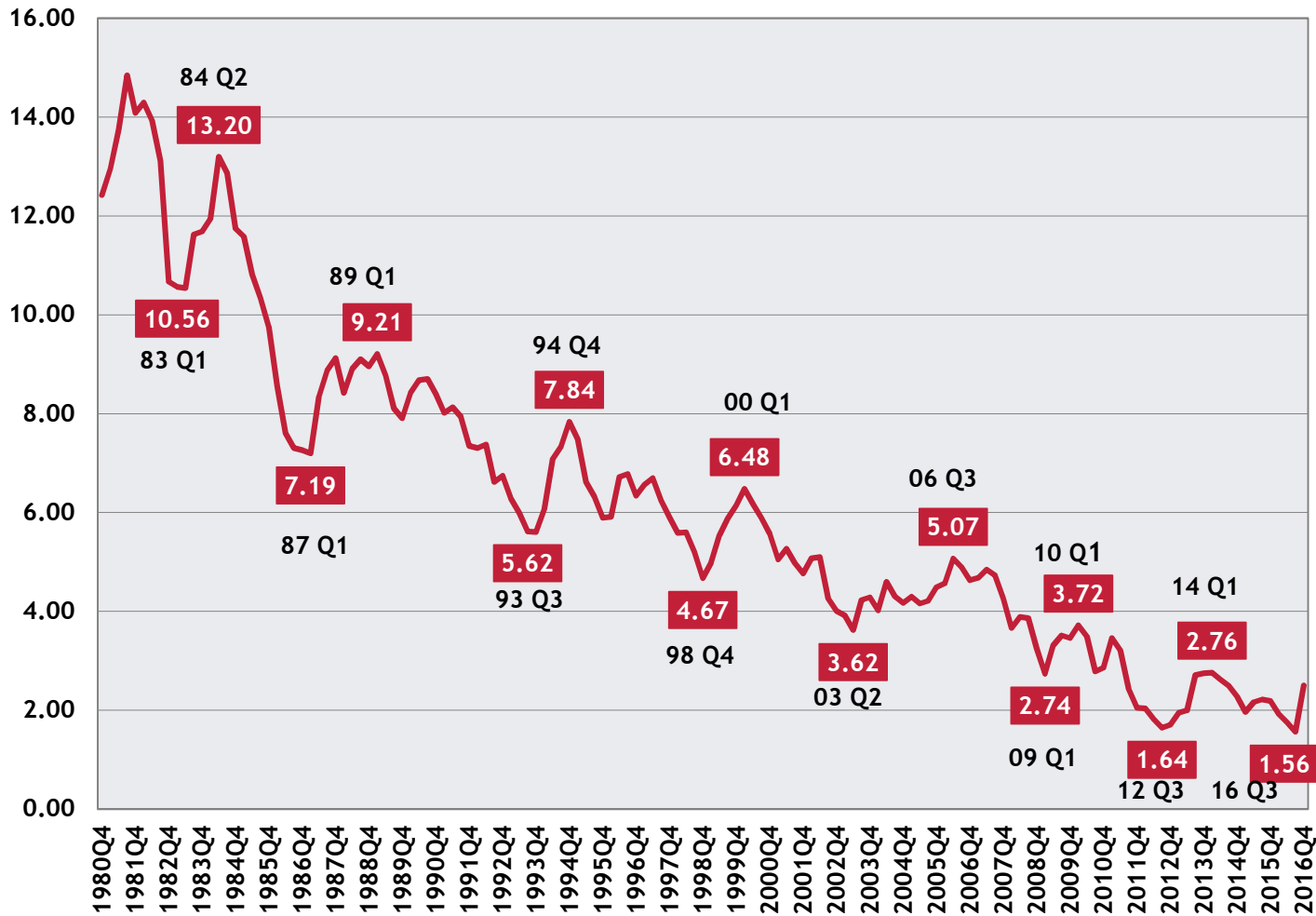
### Correlation of Annual Property Appreciation and Inflation (CPI) 1978 Q4 - 1982 Q2

	Apartment	Industrial	Office	Retail	Total	CPI
CPI	0.737	0.601	0.683	0.209	0.859	1.000

Source: NCREIF, Bureau of Labor Statistics

# WHAT HAPPENS WHEN INTEREST RATES RISE?

U.S. TEN-YEAR TREASURY YIELD 1980-2016 (%)



Source: Bloomberg

Interest rates have fallen nearly continuously for 35 years

Only limited periods of rising rates to study

# WHAT HAPPENS WHEN INTEREST RATES RISE?

## KEY METRICS FOR RISING RATE ENVIRONMENT

	10-Year Treasury Yield (%)	Average Cap Rate (%)	Cap Rate Spread (bp)	Change in 10 Year Yield (bp)	Change in Cap Rate (bp)	Change in Spread (bp)	NOI Growth	Capital Value Change
1983 Q1	10.56	7.92	-264					
1984 Q2	13.20	7.46	-574	264	-46	-310	0.26%	8.15%
1987 Q1	7.19	7.39	20					
1989 Q1	9.21	7.01	-220	202	-38	-240	0.86%	3.18%
1993 Q3	5.62	8.11	249					
1994 Q4	7.84	8.46	62	222	35	-187	9.44%	-4.49%
1998 Q4	4.67	7.92	325					
2000 Q1	6.48	7.73	125	181	-19	-200	5.89%	3.23%
2003 Q2	3.62	7.66	404					
2006 Q3	5.07	5.57	50	145	-209	-354	2.79%	29.43%
2009 Q1	2.74	6.11	337					
2010 Q1	3.72	6.72	300	98	61	-37	-2.92%	-15.31%
2012 Q3	1.64	5.49	385					
2014 Q1	2.76	5.00	224	112	-49	-161	4.65%	7.88%
2016 Q3	1.56	4.49	293					

Source: NCREIF, Bloomberg

Narrowing cap rate spread continues while NOI growth remains in place and visible

## QUESTIONS?

Please feel free to contact Mike regarding any of the information contained herein

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Michael J. Acton, CFA, is Director of Research for AEW Capital Management, L.P. with responsibility for directing the activities of AEW Research, the firm's highly regarded in-house research group. Mike joined the firm in 1990 and has more than 30 years of experience as an economic analyst and forecaster and is a standing member of the firm's Investment Committee and Management Committee. The resources of AEW Research are an integral part of AEW's investment process and Mike works closely with senior professionals in all areas of the firm to develop investment strategies that match clients' risk/reward objectives with market opportunities. Mike is also a member of the firm's Compliance Committee and Risk Management Committee. Prior to joining AEW, he was with DRI/McGraw-Hill where he managed the Metropolitan Area Forecasting Service. He is a graduate of Bates College (B.A.) and a CFA charter holder.

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