Yardi Matrix Viewpoint

October 2017

A Word from Jeff Adler
Vice President, Yardi Matrix

As leaves fall to the ground and the end of another year is in sight, it appears that the economy and the real estate market have steadied. Property values seem to be high and a bit stagnant, and real estate fundamentals are solid if unspectacular. New supply, which has slowed throughout the year and will come in slightly above 2016 levels, has led to decelerating but stabilizing multifamily rent growth. Valuations have plateaued as transaction activity has declined compared to 2016. Job growth and inflation are positive, yet domestic output remains slow and steady.

That said, there are very promising signs on the horizon, especially for multifamily players. Long-term demographic tailwinds will overpower short-term supply and affordability headwinds, as the Millennial population will sustain housing demand for years to come. Retiring Baby Boomers will downsize, and many will turn to renting as they elect a more flexible lifestyle. Long-term interest rates seem poised to remain low for the foreseeable future, providing ample financing options for investors across the real estate industry.

One trend we think will continue to show promise is the increased importance of mixed-use and flexible space, specifically in urban cores. Restaurants are leasing out space as offices, new developments are designed for both commercial and residential purposes, and retail is rapidly becoming more experiential. Blended real estate, where one property serves a wide variety of needs and users, will likely be a focus for developers, investors and property managers alike.

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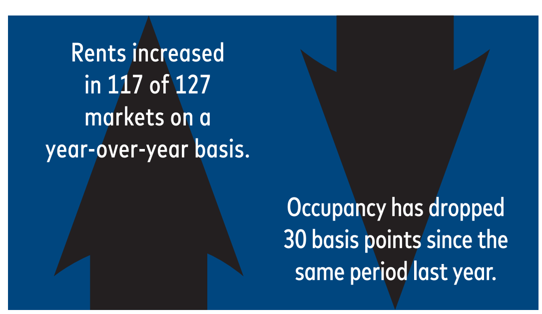
MULTIFAMILY



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Multifamily

Multifamily trends have shifted significantly this year. Markets like Denver and San Francisco that recorded year-over-year rent increases hovering around 10% only two years ago are now experiencing significant deceleration.

Interestingly, the markets that are now posting the highest rent increases are smaller ones in close proximity to the hot markets of two years ago. Colorado Springs, Sacramento and Tacoma—to name three—have all benefited from spillover and affordability concerns in larger markets nearby. Remarkably, Seattle continues to chug along with its well-above-average rent growth. Rents in the Emerald City have increased 37% in the last five years.

The worst-performing markets also reflect another trend that has been prominent this year: The weakest markets for rent appreciation are those that either flirted with the upper limits of affordability in recent years (New York City, Austin) or have been hit hard by the slump in oil prices. After a year of slumping performance, markets like Houston and Corpus Christi now have to tackle the aftermath of Hurricane Harvey.

Top 10/Bottom 10 Rent Growth

Top 10	YOY Rent Growth
Reno	10.7%
Colorado Springs	7.6%
Tacoma	7.5%
Sacramento	7.3%
Spokane	6.0%
Seattle	5.8%
Boise	4.9%
Central Valley	4.5%
Inland Empire	4.5%
Eugene	4.4%

Bottom 10	YOY Rent Growth
Lubbock	-7.6%
New York City	-2.3%
Central East Texas	-1.8%
Houston	-1.6%
Corpus Christi	-1.4%
Amarillo	-1.3%
Tulsa	-0.9%
Oklahoma City	-0.4%
Charleston	-0.3%
Austin	-0.1%

Source: Yardi Matrix

Image by alice-photo/iStockphoto.com

Office

Office properties continue to look like a long-term, stable investment in 2017. Investors seeking yield have turned to fast-growing secondary cities with robust economies, such as Seattle, Denver and Charlotte. The growing tech industry in smaller cities has driven demand for high-end office space.

Demand for office space looks strong overall as office-using employment continues to grow faster than the national rate for all nonfarm payrolls. Retiring Baby Boomers and an aging workforce should lead investors to be cautious over the long term, but in the near term the number of office workers should keep rising. While the peak supply being delivered in 2017 may create some short-term absorption issues, long-term fundamentals remain healthy.

Also of note, sales prices per square foot are finally returning to pre-recession levels for Class B and Class C assets, following the lead set by Class A and Class A+ properties in the last couple of years.

Office Sales—Index 2008=100

Source: Yardi Matrix

Image by chandler photo/iStockphoto.com

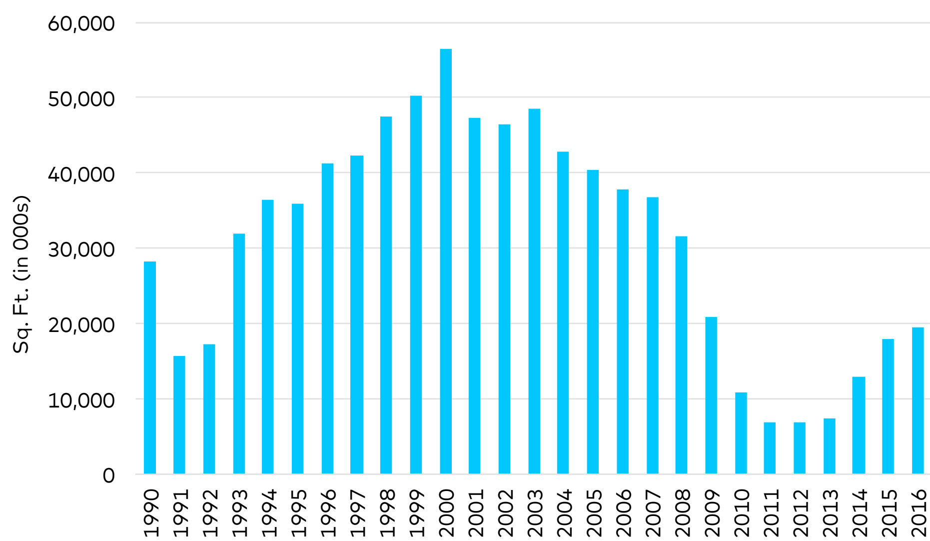
Self-Storage

During the past decade, self-storage investment returns for both private equity and REITs have outpaced those of most commercial real estate property types. Fundamental demand drivers are robust. The sector continues to enjoy strong tailwinds from job growth, rising demand from customers on the move, lengthening average rental terms and more active, efficient property management as the industry integrates better technology. Accordingly, rent growth has outpaced other asset categories.

Self-storage properties are enjoying demand from Baby Boomers who need extra space as they downsize, particularly as they retire or become empty nesters. In addition, younger residents, particularly Millennials, are increasingly turning to self-storage as an alternative to paying higher rent for more space in an apartment, since self-storage costs per square foot are approximately 20% to 30% less than apartment rents.

Meanwhile, the supply of new product has been modest in most metros, especially compared with the boom that characterized the past two decades. To a large extent, this reflects the difficulty of obtaining construction financing for self-storage compared to some other property categories. The supply trend suggests that most markets still have plenty of room for more self-storage facilities.

Annual Self-Storage Completions, 1990-2016



Source: Yardi Matrix

Retail

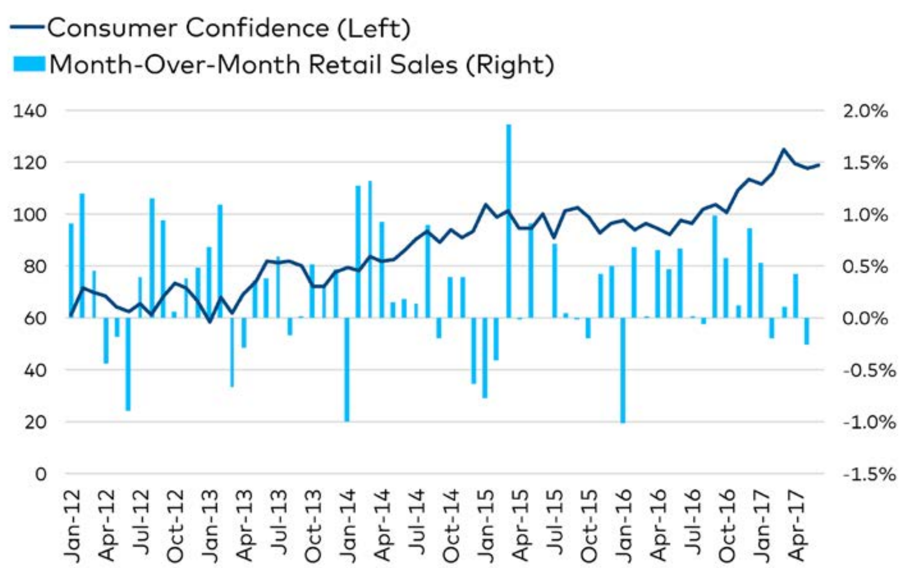
One of the most puzzling recent trends in economic statistics is the disconnect between "soft" data, which gauges sentiment and beliefs, and "hard" data, the concrete numbers that measure performance. This divide is particularly striking in data pertaining to the retail industry.

Soft data, like the Consumer Confidence Index (CCI), indicates a booming economy where shoppers are ready to step up spending, thus driving economic growth. The CCI sat at 119.8 in September after reaching a high-water mark of 124.9 in March, its highest level since December 2000. It should follow that Americans are spending more money on goods and services. The hard data, however, tells a different story. Retail sales have been stagnant for much of the year, currently growing at an annualized rate of 2.9% after increasing 4.0% in 2016. September, at 1.6%, was the best growth month for retail sales since early 2015, but only time will tell if this is the beginning of a trend or a momentary blip in the data.

There are many possible explanations for this divergence. Some point to a partisan political divide revealed by the CCI, which indicates that Republicans expect vigorous economic growth whereas Democrats anticipate a recession. Others argue that it is driven by e-commerce's growing share of retail sales and a market that has yet to catch up.

Yet another view is that weak wage growth is limiting the growth potential of retail sales. Three-fifths of the CCI is weighted toward expectations, as opposed to two-fifths toward the present situation; while the present-situation index is soaring, the expectations index has flattened. Although consumers are confident in their current situations, they may be choosing to spend less in anticipation of weaker future growth.

Consumer Confidence vs. Retail Sales Growth



Sources: Conference Board, U.S. Commerce Department

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Image by Nick Thompson/iStockphoto.com

Monetary Policy

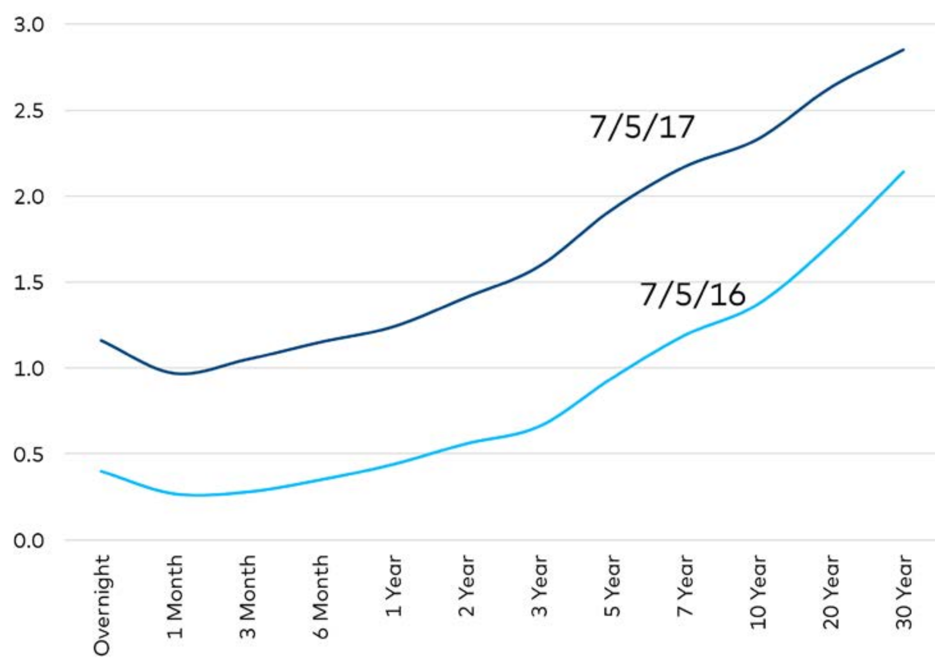
Following two rate increases in 2017, the Federal Reserve is expected to raise interest rates by 25 basis points at the December Federal Open Market Committee (FOMC) meeting. According to the Chicago Mercantile Exchange, as of October 17, there was a 91.7% probability of a December increase, which would bring the federal funds target rate to a range of 1.25 to 1.5 percent.

This increase is unlikely to have an impact on commercial real estate in the short term. The slow escalation of rates has been anticipated for some time, making it likely that investors and the markets would be prepared for this increase. Moreover, interest rates are still at historic lows, despite short-term rates increasing 50 basis points so far in 2017.

Two long-term concerns emerged from the most recent FOMC meeting. First, the Fed announced that it is beginning to unwind its balance sheet by letting assets roll off. While this process will be slow and measured, there is some concern that the unwinding will affect liquidity in the debt markets.

Second, the increase continues the trend of flattening the yield curve that has started to take shape over the past year. On top of the general macroeconomic risk, effectively erasing the difference between the short- and long-term costs of capital could create shock waves in the commercial real estate industry.

Yield Curve



Source: U.S. Department of the Treasury

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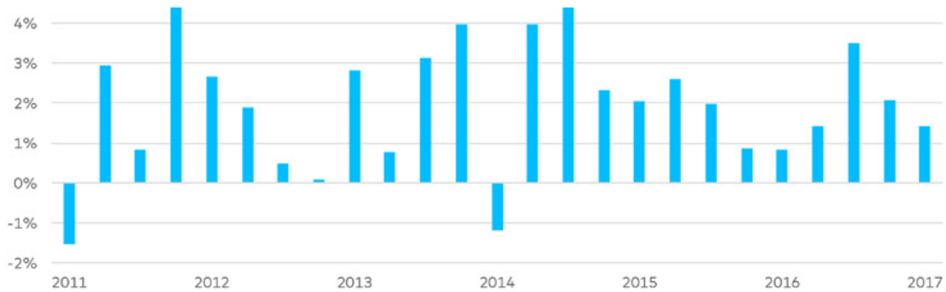
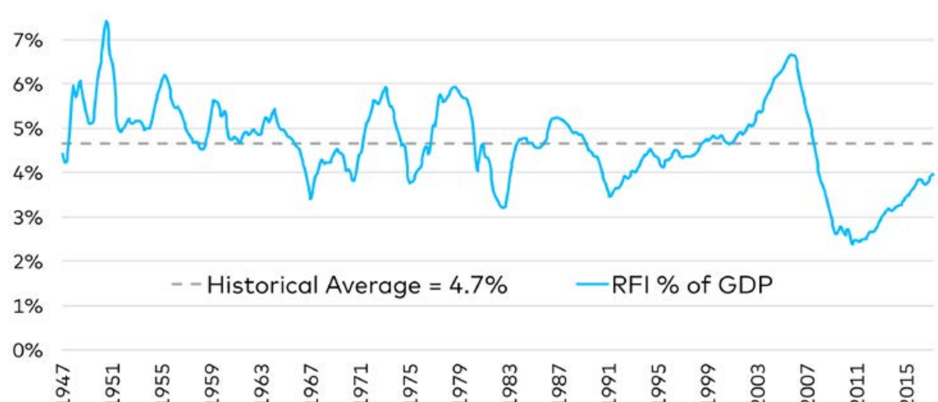
Digging Deeper into GDP

GDP Annualized Growth Rate (2011-2017)



Personal Consumption Expenditures (as % of GDP, 1947-2017)

Residential Fixed Investment (as % of GDP, 1947-2017)



Source: Bureau of Economic Analysis

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