December 07, 2018

WELLS FARGO SECURITIES

Economics Group

Special Commentary

Mark Vitner, Senior Economist
mark.vitner@wellsfargo.com • (704) 410-3277
Charlie Dougherty, Economist
charles.dougherty@wellsfargo.com • (704) 410-6542
Matthew Honnold, Economic Analyst
matthew.honnold@wellsfargo.com • (704) 410-3059

Q3 CRE Chartbook: Outlook

Strong Economic Growth Will Bolster CRE in 2019

The U.S. economy continued to grow solidly in the third quarter, with real GDP rising at a 3.5% annual rate. Real GDP is on pace to rise 2.9% for the year, making 2018 one of the strongest years of the expansion. The economy's strong momentum should gradually fade over the next year, however, as the boost from strong consumer spending and fiscal stimulus diminishes. We still expect conditions to be favorable and real GDP to expand at around a 2.6% pace in 2019. Employment growth has shown persistent strength in the face of near record low unemployment. Nonfarm employment has risen by an average of 206,000 jobs per month so far this year, up from an average of 182,000 jobs per month last year, even though the unemployment rate has fallen to just 3.7% and there are now more job openings than unemployed persons. The tightening labor market has pushed wages and salaries higher. Productivity growth has also picked up, however, which should help offset some of these increases. Inflation remains very close to the Fed's 2% target, which provides policymakers with some leeway in normalizing interest rates.

We expect the current favorable economic conditions to extend through 2019, which will support commercial real estate as the cycle extends to its tenth year. Commercial property prices have displayed signs of waning this year after accelerating towards the end of 2017. Much of this moderation, however, can be attributed to a significant slowdown in property prices in major gateway markets. By contrast, many secondary markets, particularly those where employment and population growth remain robust, have seen prices ease only modestly. Still, property prices have appreciated in each month since January 2011 and valuations are now 25% above their prior peak level. Despite those gains, higher property prices do not appear to be dissuading investors. According to Real Capital Analytics (RCA), volumes reached $152.7 billion in the third quarter of 2018, a magnitude not reached since 2015 and the second strongest quarter of the expansion. In addition, cross-border capital inflows have also picked back up, as slower global growth has boosted the relative attractiveness of U.S. commercial real estate.

We expect the current favorable economic conditions to extend through 2019, which will support commercial real estate.

Figure 1

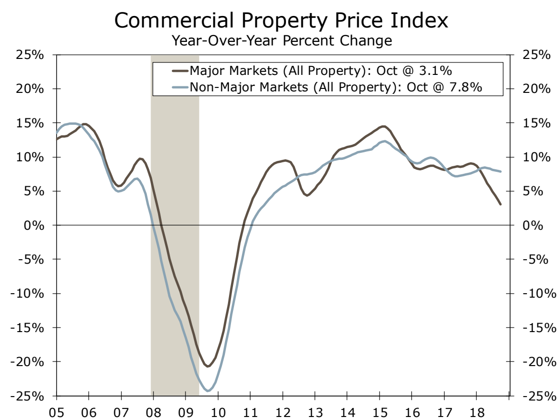
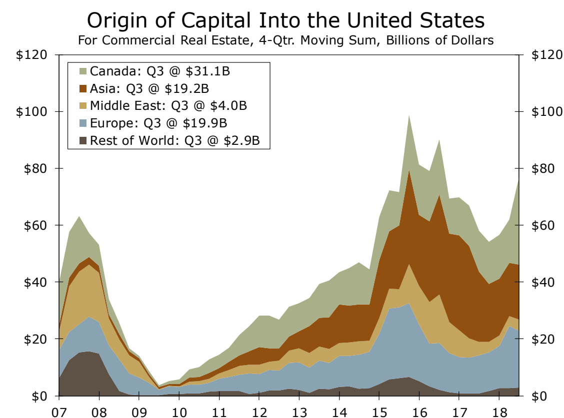


Figure 2



Source: Real Capital Analytics and Wells Fargo Securities

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

Tax reform may also be playing a role in the recent pickup in transaction volumes.

Tax reform may also be playing a role in the recent pickup in transaction volumes. Overall, the effects of tax reform should continue to be a net positive for economic growth and be especially beneficial to the commercial real estate industry, as lower tax rates translate into higher risk-adjusted returns. For example, the new 20% deduction for pass-through entities should make structures a better cash flow investment and more attractive to investors. In addition, 1031 like-kind exchanges, which defer capital gains tax on one property when it is exchanged for another, were preserved in the tax law.

Similarly, newly established "opportunity zones" also provide preferential tax treatment to investments in distressed communities, most of which have seen little commercial development during the current cycle. The net effect of these provisions will likely be to draw significantly more capital into the industry in 2019, which will further support property valuations and restrain cap rates, even as interest rates increase. The stated purpose of the new provision is to spur economic development and job creation in low income communities. Under the new law, taxes on capital gains from investments in a Qualified Opportunity Zone (QOZ) can be deferred and partially reduced if held until 2026. Moreover, capital gains on the newly acquired property will be tax-free if held for ten years. The net effect of this should be to pull some of the roughly $6 trillion in estimated untaxed capital gains off the sidelines and direct it towards properties and businesses in the nearly 9,000 designated census tracts deemed economically distressed throughout the country. Additionally, current owners will likely utilize the tax benefits provided by 1031-exchanges to purchase new properties after selling to new investors, which will further support prices.

We expect the overall effect of opportunity zones to be positive for commercial real estate in coming years. Commercial properties in opportunity zones will likely see an influx of new capital between 2019 and 2021, as the program imposes several timeframes that progressively reduce the tax burden. For example, 10% of the reinvested capital will be excluded if held for five years, up to a 15% reduction if held for the entire seven years when the initial deferred taxes eventually come due in December 2026. Moreover, realized capital gains must be placed in an opportunity fund within 180 days and substantial improvements equal to the real property cost must be made within a 30-month period.

Nearly 87% of opportunity zones are located outside of the major gateway markets.

The new initiative also comes at a time when overall property prices have begun to ease, especially in major gateway markets. Outside of Puerto Rico, the markets with the most opportunity zones are located within New York, Los Angeles, Chicago and Houston, areas that will likely be on the receiving end of a substantial amount of new investment. However, nearly 87% of opportunity zones are located outside of the major gateway markets. Topping the list are relatively more affordable markets such as the Inland Empire, Phoenix and Philadelphia, areas that have seen double-digit growth in prices this year alongside robust employment and population growth.

Figure 3

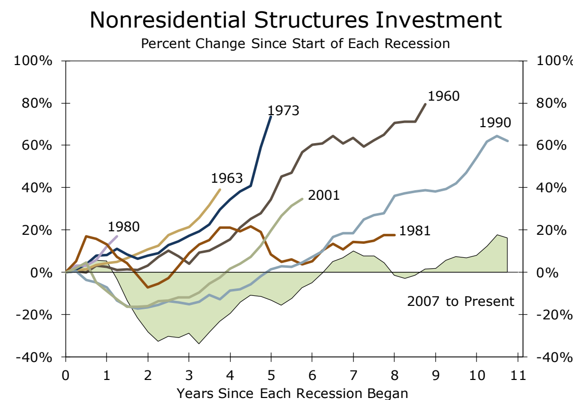
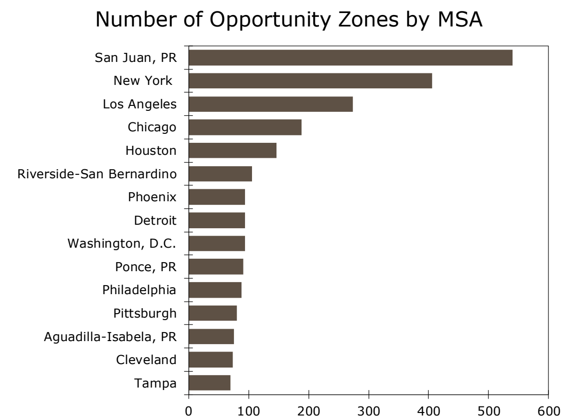


Figure 4



Source: U.S. Department of Commerce, U.S. Department of the Treasury and Wells Fargo Securities

Fears of overbuilding as a result of a wave of incoming capital are likely unwarranted. With the exception of apartments, commercial construction has come back exceptionally slowly during this cycle and new development has been focused primarily in gateway cities, tech hubs and a handful of rapidly growing Sun Belt markets. Moreover, the wave of new apartments coming to market has been matched by strong demand for rentals alongside deteriorating affordability of single-family homes. Solid GDP growth, sturdy employment growth and rising wages next year will keep demand for commercial properties strong.

Rising interest rates tend to cause angst among real estate investors, as higher rates tend to lead to higher cap rates. Fears may be partially assuaged by the fact that the relationship between all-property cap rates and the 10-year Treasury yield has weakened over the past several years. Cap rates are also a function of other variables, such as occupancy levels and rent growth, both of which will benefit from solid economic growth in 2019. Despite small upward movements recently, cap rates also remain below the lows seen prior to this cycle. We anticipate the rise in cap rates should be minimal and largely offset by other factors such as stronger rent growth and increased foreign investment.

We anticipate the rise in cap rates should be minimal and largely offset by other factors such as stronger rent growth and increased investment.

Overall, demand for commercial real estate appears to be strong. The apartment market has been reinvigorated by deteriorating affordability of single-family homes. The combination of rising home prices and higher mortgage rates has persuaded many renters to put off homeownership even further. While the homeownership rate recently reversed course and is trending higher, the number of renter households has also slowly been rising. Through the third quarter of 2018, demand for apartments has already eclipsed the demand registered in 2017 in its entirety, and effective rents have risen at the fastest pace since 2016. Moreover, the apartment vacancy rate recently receded to a cycle low.

Many of the single-family affordability issues giving multifamily properties a late-cycle boost will likely remain present in 2019, but to a lesser degree. Mortgage rates should continue to gradually tick up alongside higher Treasury yields. Single-family inventory levels have also improved, which will lead to further moderation in home price appreciation. Still, demand for apartments will remain strong as amenity-rich apartments increasingly represent an acceptable substitute for single-family living. New apartment building, especially of commuter-friendly higher-end units with gyms and outdoor space near retail and restaurants, has boomed for much of this cycle and has not shown many signs of coming to a dramatic halt. The number of multifamily building permits issued through October is roughly on par with the pace seen in 2017, which should translate to building activity remaining elevated in coming months. Despite a robust pipeline of new apartments under construction, strong demand for rentals should restrain vacancy rates and support modest rent increases in 2019.

Demand for apartments will remain strong.

Figure 5

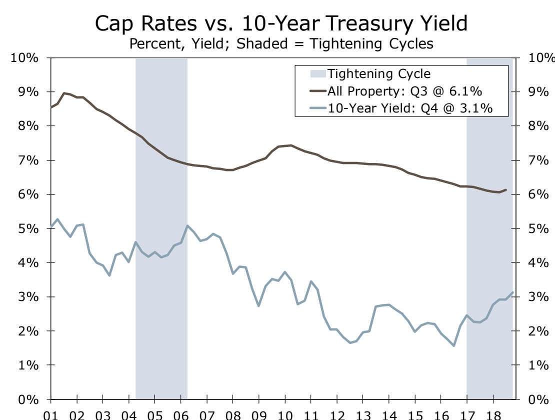
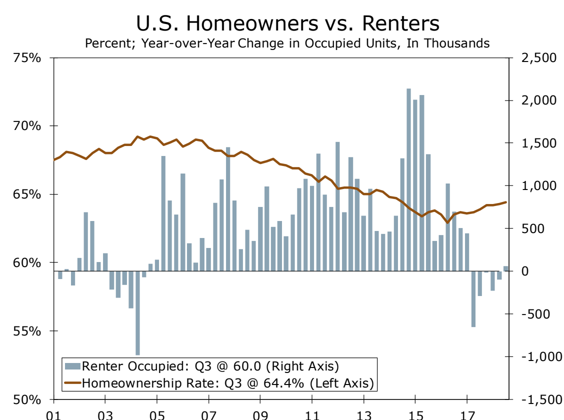


Figure 6



Source: Federal Reserve Board, Real Capital Analytics and Wells Fargo Securities

Warehouses and distribution centers will remain a top priority for retailers.

Ecommerce-inspired supply chain modernization and growing international trade volumes will continue to keep industrial properties in high demand. Consumer spending will remain firm in 2019, backed by a sturdy labor market and a healthy saving rate. As a higher share of consumer spending is channeled through ecommerce, the need for efficient supply chains facilitated by warehouses and distribution centers will remain a top priority for retailers. Inland logistics hubs that serve as key distribution points to reach wide swaths of the nation's consumer base, such as Chicago, Dallas, Atlanta and Southeast Pennsylvania, will continue to see substantial investment.

Despite ongoing negotiations, growing international trade volumes will continue to be a major driver of industrial properties. Port cities, such as Savannah, New York/New Jersey and Los Angeles, have seen cargo volumes surge in recent years as growing container capacity has reduced costs and spurred a realignment of global shipping routes. Properties in the surrounding regions will continue to attract more investment as a wide array of exporters and other industrial users flock to these areas. Moreover, the preliminary agreement with Mexico and Canada left most of the legacy NAFTA agreement intact and should unleash investment in areas with significant cross-border processing hubs and transportation linkages such as Detroit and El Paso. We anticipate a similar outcome with China in which the core tenants of prior trade arrangements are maintained.

While industrial properties will remain a growth area, the sector may soon brush up against supply constraints. New development has not kept pace with surging demand, which has pushed the vacancy rate to 4.9%, the lowest since available data started being recorded in 2001. Higher material and labor costs have been a significant headwind to both new construction and in-fill projects. Older properties near major job centers are also increasingly candidates for conversions into higher value-add apartments, breweries or entertainment space. Somewhat ironically, with fewer available options, retail space left vacant in the wake of the rise of ecommerce may soon be a viable alternative.

Certain retail properties continue to perform well.

Retail's hardships have been well documented and were underscored most recently by Sears—for decades the nation's largest retailer—filing for Chapter 11 bankruptcy. Amid the store closures and bankruptcies over the past few years, new development has dropped off considerably, and rents continue to head in the wrong direction. The dire straits some retail properties have found themselves in should be viewed in the broader context—that the sector is in a constant state of evolution and must continuously adapt to shifting consumer preferences and time constraints. In contrast to the struggling suburban malls and strip centers, well-located retail properties with more experiential offerings such as bars, restaurants and live entertainment continue to perform well. Evidence of this trend is apparent in recent investment activity, which has picked up substantially due to several megadeals which have tended to include large portfolios of Class A retail assets.

Figure 7

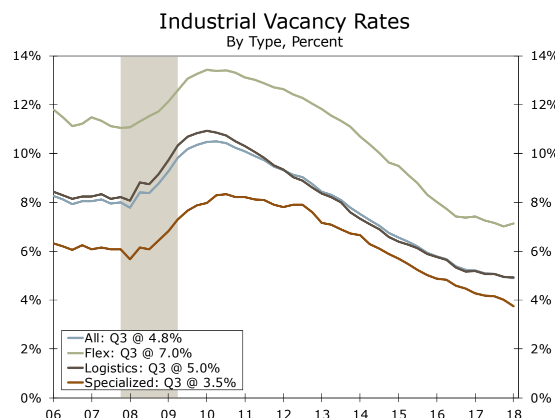
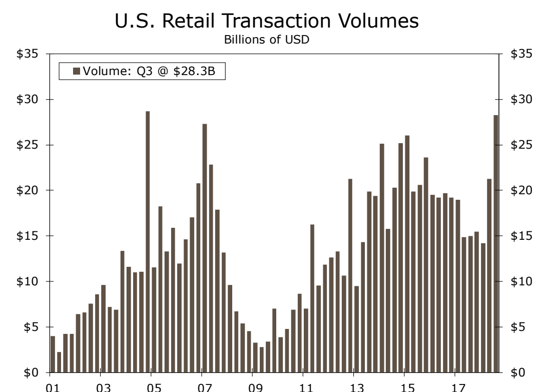


Figure 8



Source: CoStar, Inc. and Wells Fargo Securities

Sluggish development has kept the office market in balance. The vacancy rate has been relatively steady, hovering around 10% over the past two years. Rent growth has been subdued for the past two years, slowing to a sub-3% pace. Outside of the major gateway cities, the only markets that have seen significant new supply are the economies driven by tech and energy. Slow new development is a trend that will continue into 2019. Through the first three quarters of the year, the number of square feet under construction has declined to an average of 128 million square feet, below the 132 million square feet averaged in 2017 during that same period. The effects of a lower corporate tax rate should be noticeable and support office demand next year. Despite strong employment growth this year, however, many office-using sectors have intensified focus on increasing efficiency through space reduction and more agile workspaces. When combined with the rise of co-working space, overall demand for office space has risen only slightly. With the unemployment rate at its lowest level in decades, employment growth will likely moderate in 2019 and further limit demand for new office space.

Employment growth will likely moderate in 2019 and further limit demand for new office space.

Demand for hotel rooms continues to be exceptionally robust. Overall occupancy remains high, particularly in the upscale and luxury segments. The occupancy rate for hotels breached 66% at the end of 2017, the highest level going back to 1986, and has remained near that level for much of the year. Demand has been bolstered by many of the factors that have lifted overall GDP growth, including strong consumer spending underpinned by robust employment growth and rising wages. Demographics are also providing a strong tailwind, with baby boomers traveling more and Millennials opting for experiences and travel over consumption of goods. Tax reform is another positive, providing a boost to corporate profits and propelling business travel for company meetings and conventions. Despite a stronger dollar and slower global economic growth, tourism spending from overseas visitors has also picked up.

Occupancy has likely peaked for the cycle given the wave of new supply delivered in recent years. Heightened demand has also induced spending on renovations to older properties as visitors demand more lifestyle amenities and greater technological access. Looking ahead, the number of new hotels coming to market should slow off the torrid pace seen recently, as the pipeline of projects under construction and in planning stages has moderated in 2018 relative to prior years.

Daily room rates and RevPar growth has remained relatively muted and have been restrained by increasingly stark competition from online hospitality services like Airbnb and HomeAway. The hotel industry is also not immune to the economy-wide shortage of workers, which will continue to be a challenge for operators looking to maintain profitability amid rising labor costs and modest revenue growth. Still, demand for hotel rooms tends to track overall GDP growth, which bodes well for the sector's outlook as we expect the strong economic momentum seen so far this year to extend into 2019.

Demand for hotel rooms tends to track overall GDP growth.

Figure 9

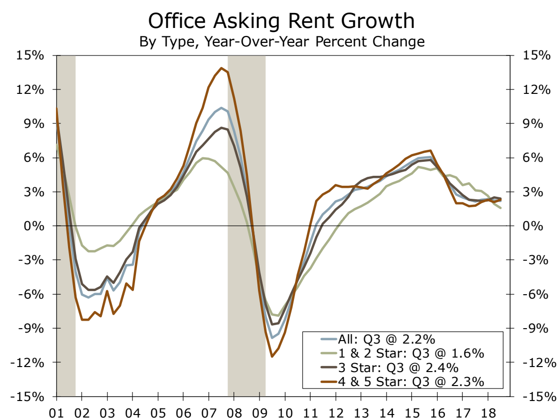
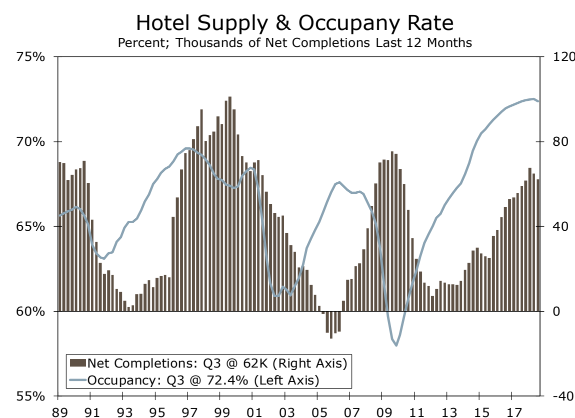


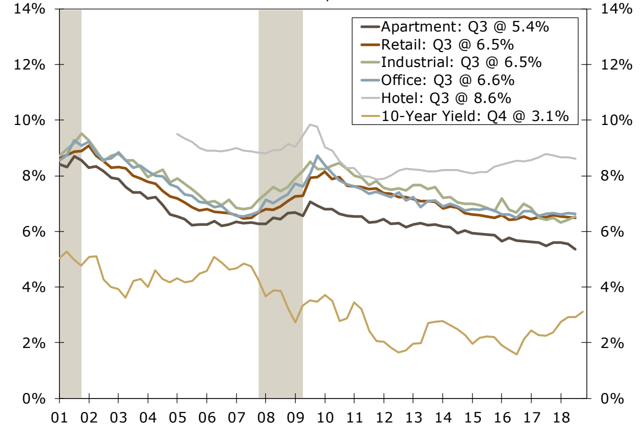
Figure 10

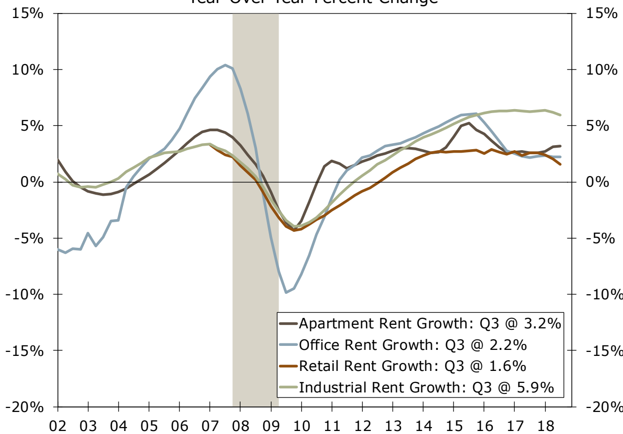


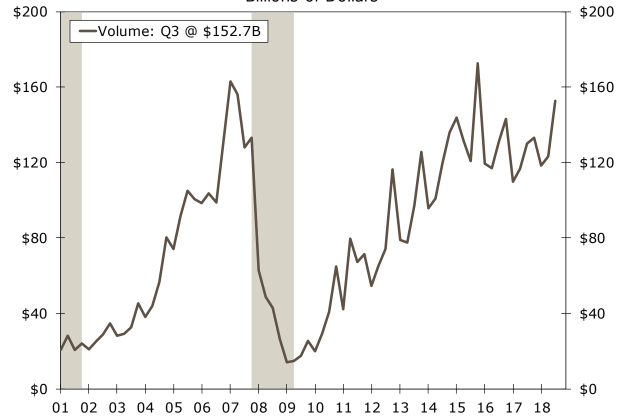
Source: CoStar, Inc. and Wells Fargo Securities

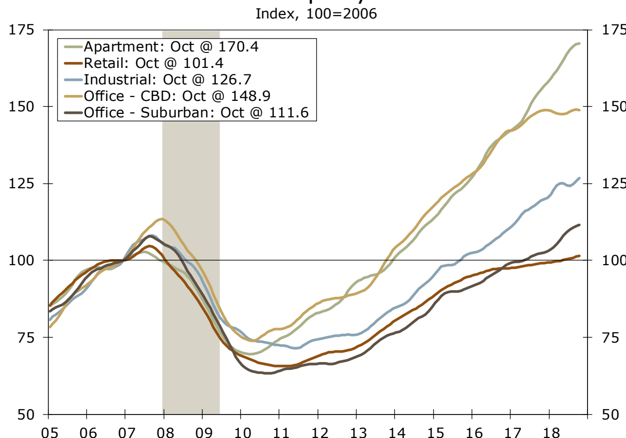
CRE Property Pricing & Fundamentals

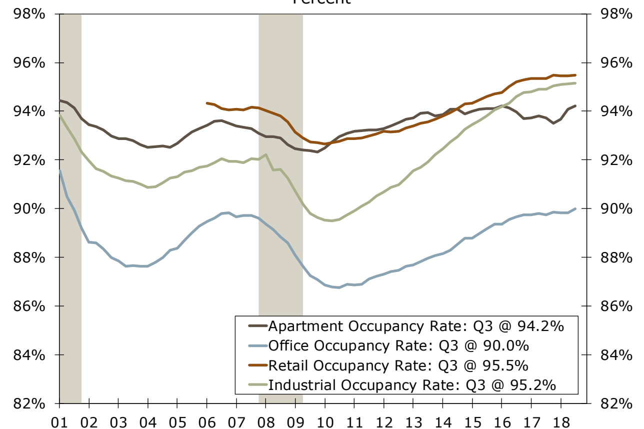
- Financial volatility and surging yields have yet to have a noticeable impact on cap rates, which have ticked up from their prior lows but still remain historically low. Investors with cap rate angst should feel some relief over the increasingly solid economic backdrop that is driving demand across CRE property types and supporting rising occupancy and higher rents.
- Property price appreciation has slowed recently, notably in gateway markets. Secondary markets continue to see a great deal of investor interest, reflecting strong employment and population growth. Valuations are at record highs, led by apartments and offices. Transaction volume surged to $153 billion in Q3.







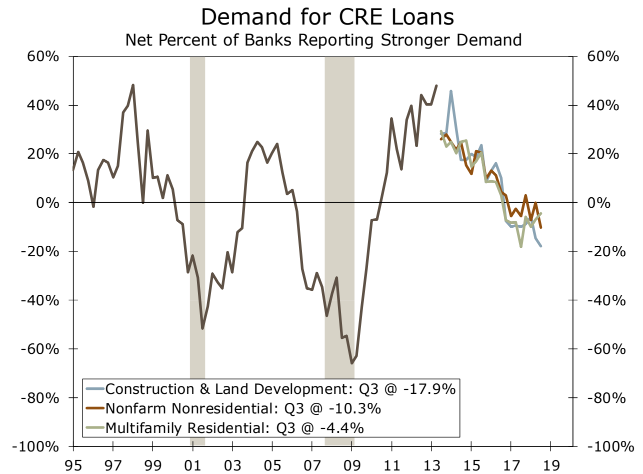


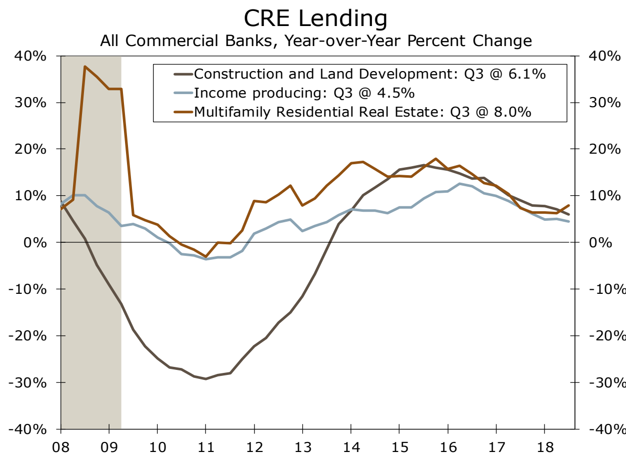


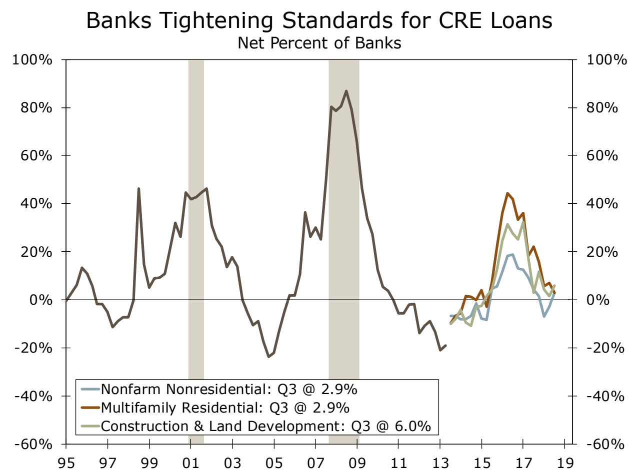
Source: CoStar, Inc., Real Capital Analytics and Wells Fargo Securities

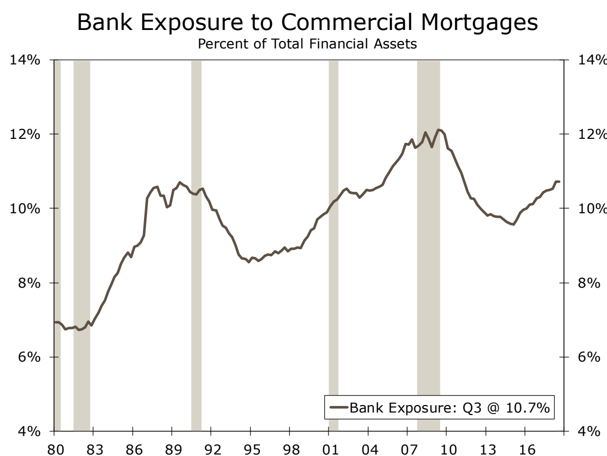
Credit Availability & Lending

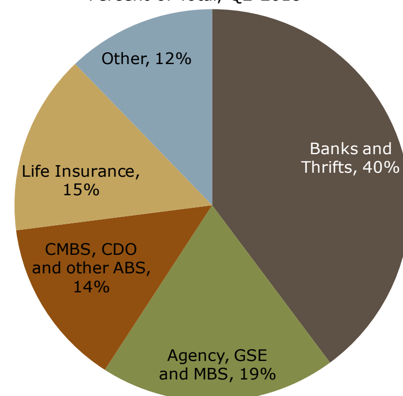
- Credit conditions eased in Q3, as banks loosened lending standards for commercial & industrial and multifamily loans. Lenders commonly cited increased competition and a generally sanguine outlook for economic activity. Banks also reported that if the yield curve were to invert, they would tighten lending standards.
- Fewer banks reported stronger demand for nonresidential loans. Multifamily demand, however, appears to be strengthening.
- The nation's banking system does not appear to be overly exposed to commercial mortgages. Currently standing at $1.7 trillion, commercial debt accounts for 10.7% of total financial assets, which is not out of line in a historical context.[1]









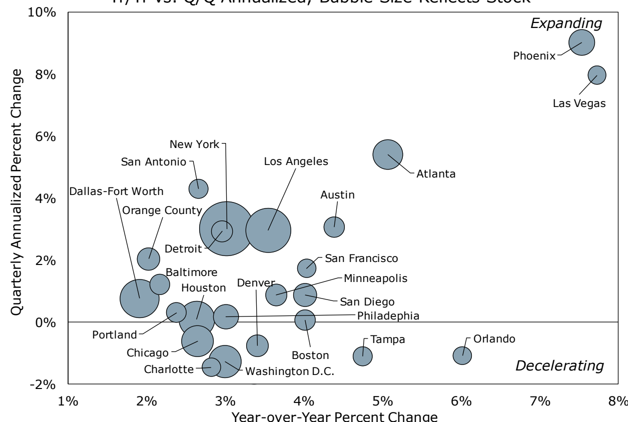


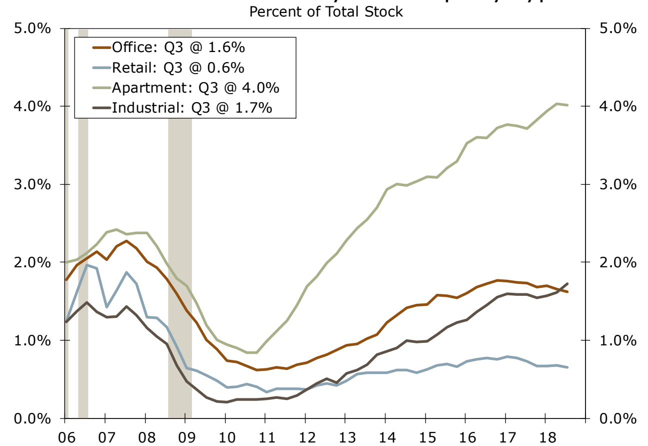
Source: FDIC, FRB, Mortgage Bankers Association and Wells Fargo Securities

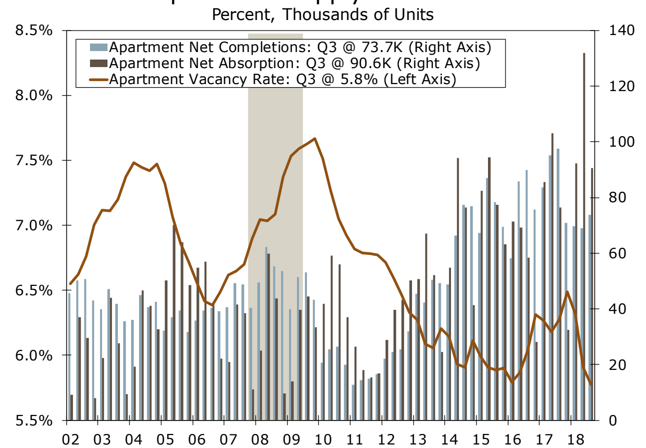
[1] *For more, please see our special report.*

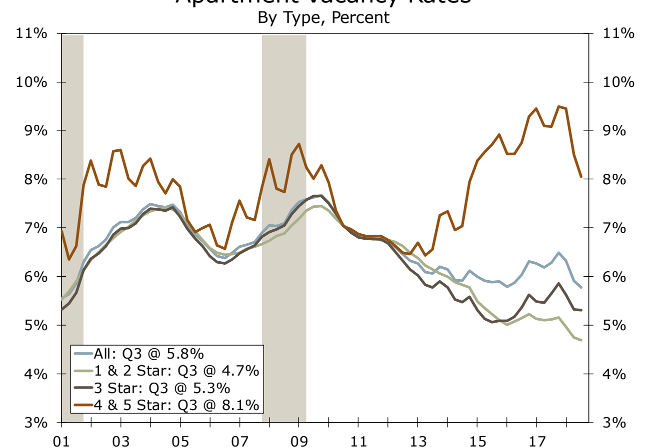
Apartment

- The multifamily market continues to exceed expectations. Mortgage rates climbed to near a seven-year high in November and have further eroded housing affordability, leading many renters to delay homeownership. Persistent weakness in single-family sales has coincided with a resurgence in apartment demand, particularly among Millennials. This trend is most evident in major tech hubs across the country, as well as larger gateway markets, where affordable single-family homes remain scarce.
- Development has kept pace with demand. Multifamily building permits have yet to significantly pull back after several years of booming growth. Net completions have averaged nearly 80,000 units per quarter over the past two years. Tempering the outlook, however, is the dip in builder confidence reported by the NAHB Multifamily Market Survey in Q3. Sentiment slipped on higher construction costs, and vacancy rates are expected to rise, particularly among 4 & 5 star properties where much of the new supply is concentrated.
- Rapid development in Charlotte and Houston may finally be taking its toll on rents, which moderated off their breakneck pace recently. Dallas has also seen rent increases moderate. Rents continue to rise solidly in Phoenix, Las Vegas and Atlanta, reflecting their white-hot labor markets, strong population growth and relative affordability compared to other rapidly growing metro areas.





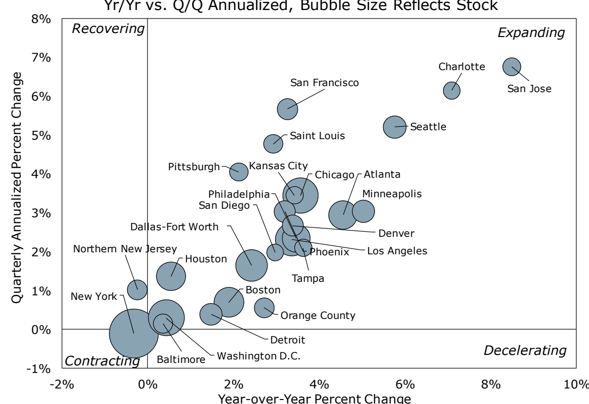


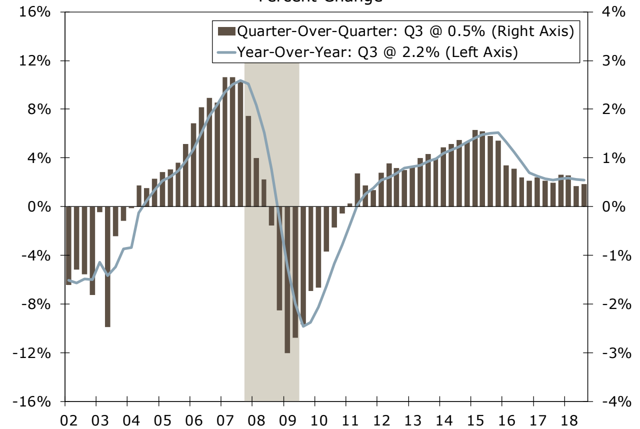


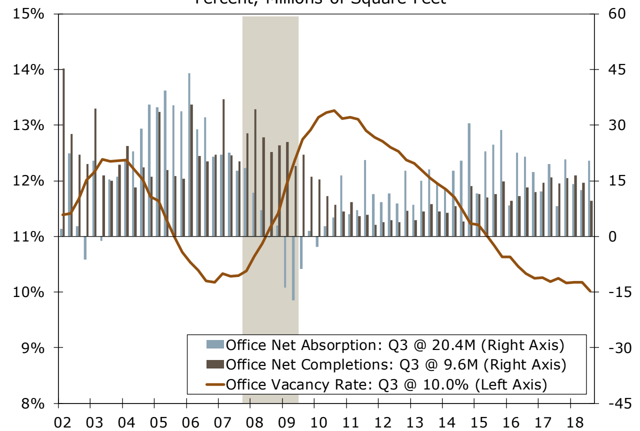
Source: CoStar, Inc. and Wells Fargo Securities

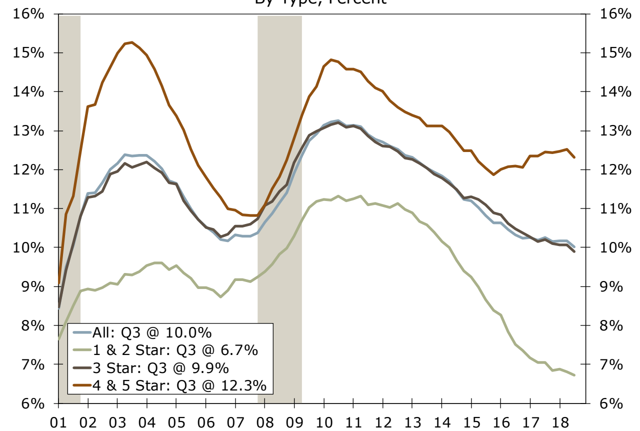
Office

- The national office market continues on a path of fairly balanced growth, which will continue as the economy heads into 2019. Still-solid real GDP growth will continue to be supportive of office fundamentals. The effects of a lower corporate tax rate should also be more noticeable and bolster demand. Slower job growth will be a significant headwind, however. While nonfarm payroll growth has accelerated this year, the pace of job creation will likely moderate as the unemployment rate falls further and employers increasingly struggle to fill positions.
- Vacancy rates have hovered around 10% as developers have been relatively restrained in meeting the steady pace of growth in office demand. With the market fairly balanced, rent growth has moderated since 2015 to a pace below 3%. Rent growth has been weakening in the Northeast, which is rife with industries currently focused on gaining efficiencies through smaller floorplans and agile workspaces, such as finance and other professional service firms, and where a bevy of new construction has taken place.
- New York has seen outright rent declines, which should continue as major projects like 3 World Trade Center and Hudson Yards significantly add to supply. The selection of Crystal City and Long Island City for Amazon HQ2 will likely provide a boost to Washington D.C., which had slowed recently. It is little surprise Amazon expanded to the East, as the West has some of the highest rents and fastest rent gains.





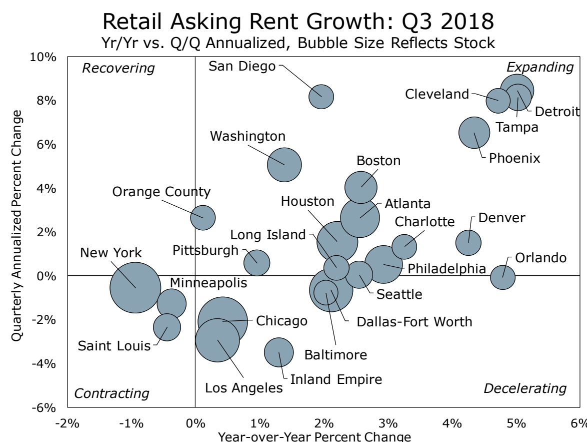


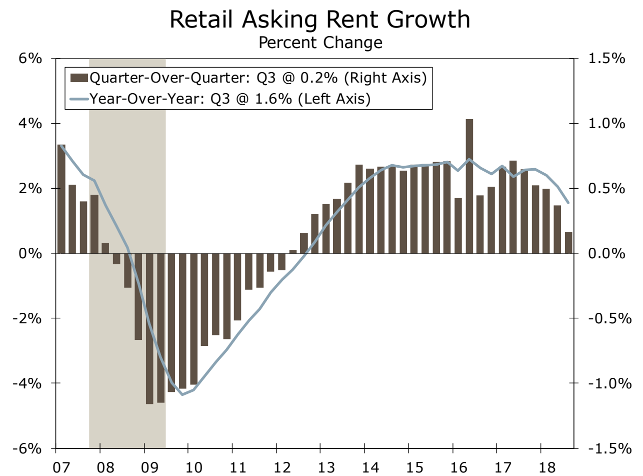


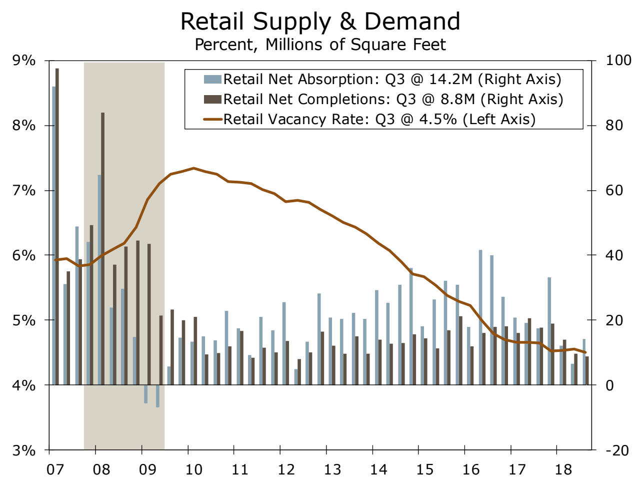
Source: CoStar, Inc. and Wells Fargo Securities

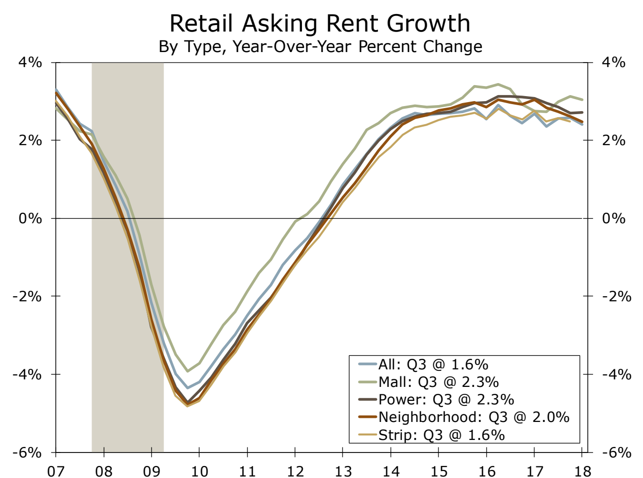
Retail

- Concerns of a retail apocalypse are largely overblown. The sector is currently evolving to meet the needs of shifting consumer preferences and focusing on new formats and advantageous locations. Consumer spending has been robust so far in 2018, and growth in retail sales has also picked up compared to 2017. Holiday spending has gotten off to a strong start and is expected to rise solidly this year. While the boost from tax cuts may be fading, the saving rate remains at healthy levels and average hourly earnings are rising faster than 3%, suggesting consumer spending will remain fairly stout next year.
- Still, the problems facing retail are significant. More than a third of 390 tracked markets experienced negative absorption in Q3. Q4 got off to an ominous start as Sears—for decades the nation's largest retailer—filed for Chapter 11 bankruptcy. Investors are already looking to repurpose recently vacated Sears, K-Mart and Toys-R-Us stores, and Kohl's has begun to slice up its stores, lease out unused space and partner with online retailers for in-store pickup.
- Amid the recent string of bankruptcies and closures, new development has slowed and rents continue to decelerate. Property prices have been among the most sluggish across commercial real estate, and cap rates have bottomed out over the past few years. Well located properties in high growth areas such as Phoenix and Tampa will continue to see valuations rise amid higher rents.





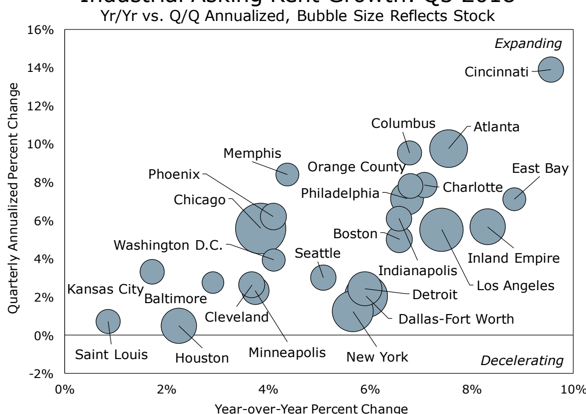


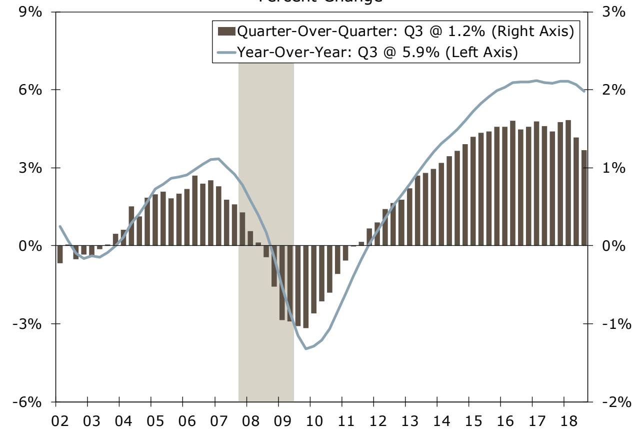


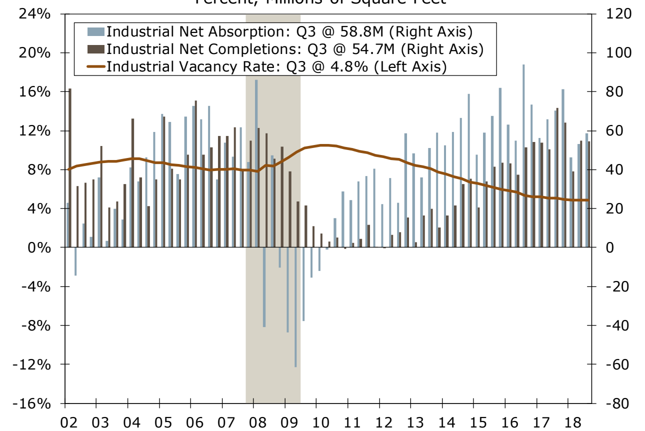
Source: CoStar, Inc. and Wells Fargo Securities

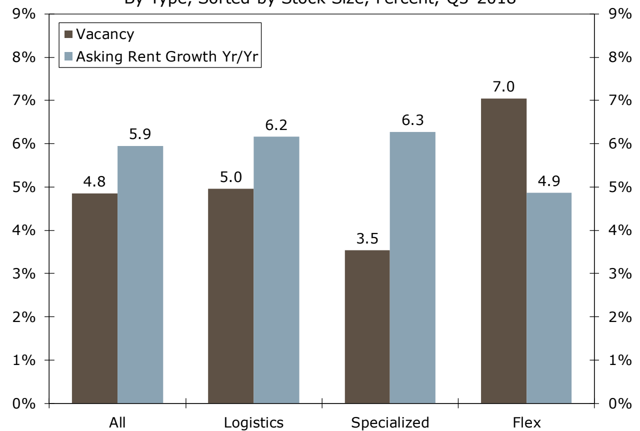
Industrial

- Retail's famine continues to fuel the industrial market's feast. Shopping patterns increasingly shifting to online stores has been a windfall for warehouse and distribution centers. Cities with advantageous geographic locations are seeing some of the best performance. Atlanta, which is the hub for the booming southeast; the Inland Empire near the Ports of Los Angeles and Long Beach; and Philadelphia as a hub for the northeast corridor are all seeing strong gains.
- Escalating tensions with China are a major cloud hanging over port-driven markets but should not present a threat to long-term growth. Rent growth remains very strong amidst historically low vacancy rates. Forty-one of the 54 largest metros saw positive absorption in Q3; clearly, sector strength has been more geographically widespread of late, as broadening economic growth reaches regions that had not seen all that much growth in prior years.
- The global economy has begun to flash warning signs more recently. Slower growth in China and fears about how Brexit will play out have slowed global economic growth and pushed the dollar higher. Domestic growth remains strong, however, and online sales continue to rise solidly, fueling demand for warehouse space and fulfillment centers.
- Growing supply chain challenges are another potential headwind. A severe shortage of truck drivers might delay some projects and keep vacancy rates near their recent lows.





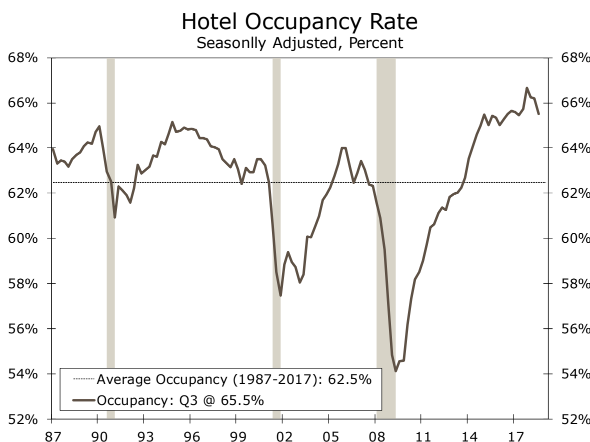


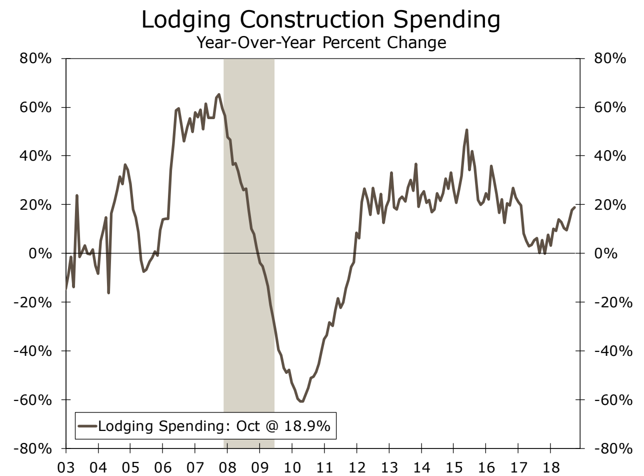


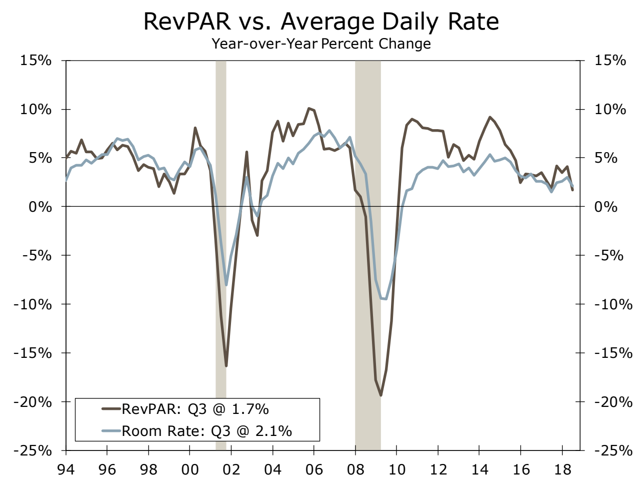
Source: CoStar, Inc. and Wells Fargo Securities

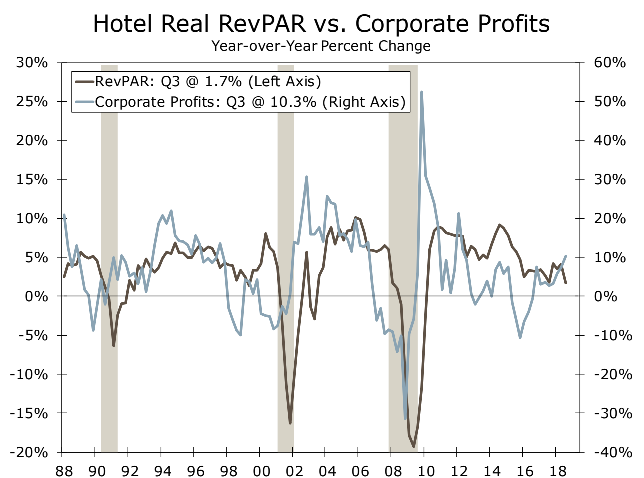
Hotel

- Hotels reported record levels of demand in Q3, as consumer spending surged on the back of improving job and income prospects and continued fiscal stimulus. With demand for travel and accommodations tending to track overall GDP growth, the strength in the hotel sector during a quarter that saw GDP growth of 3.5% (following 4.2% in Q2) is not wholly surprising.
- Occupancy averaged over 66% for the 12 months leading up to September—a modern era high. Occupancy has likely peaked, however, given the rush of new supply being developed and delivered in the next few years. Strong demand over the past few years has induced spending on renovations to older properties in need of greater technological access and luxurious amenities.
- RevPar growth has remained relatively subdued lately, limited by increased competition from online hospitality services. Yet, RevPAR growth has consistently been positive post-recession, with the first year-over-year decline in the last month of Q3. However, yearly comparisons are made difficult due to the massive demand a year ago due to Hurricane Harvey displacement.
- With over one million openings across the leisure & hospitality industry, rising compensation costs are likely the greatest headwind facing the hotel industry. A strengthening dollar will likely also weigh on international arrivals. But given our forecast of solid, albeit slowing, GDP growth for the next two years, the outlook remains strong.









Source: STR, U.S. Department of Commerce and Wells Fargo Securities

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Macro Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Erik Nelson	Macro Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	Macro Strategist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Abigail Kinnaman	Economic Analyst	(704) 410-1570	abigail.kinnaman@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Canada, Ltd., Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC. is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC. and Wells Fargo Bank, N.A. are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2018 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 ("the Act"), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU ("MiFID2"). The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

WELLS FARGO SECURITIES