Manulife Investment Management

U.S. commercial real estate:
Q1 2019 market outlook

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Private Markets
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U.S. GDP and employment growth accelerated in Q1, but will likely moderate going forward

First-quarter headline U.S. economic data was impressive by any measure, with GDP growth coming in at 3.2%[1] and employment showing gains of 557,000, which pushed the unemployment rate down by 10 basis points (bps), to 3.8%.[2] Given this record, we believe consumer spending, bolstered by strong labor markets, will be the primary growth driver going forward. On the other hand, first-quarter growth was conditioned by a number of factors—probably temporary in nature—and, as a result, we expect that overall economic growth will likely moderate through the remainder of the year.

First-quarter growth is likely to moderate

First-quarter GDP growth was mainly driven by net exports, inventory accumulation, and government spending, all of which are expected to moderate through the rest of this year. The growth in net exports was due to weaker imports, following a spike last year as firms attempted to get out in front of impending tariffs. As for inventory accumulation, it may drive growth in a single period, but firms eventually have to sell down the accumulated stock, which may cast the current high levels of inventory as a potential drag on future growth. Finally, government spending in Q1 was driven by defense spending, which is typically on a contract basis with lumpy payouts and unlikely to show growth through the rest of the year. With all the principal Q1 growth drivers likely to diminish over the remainder of the year, we believe GDP growth is bound to trend down from the current level.

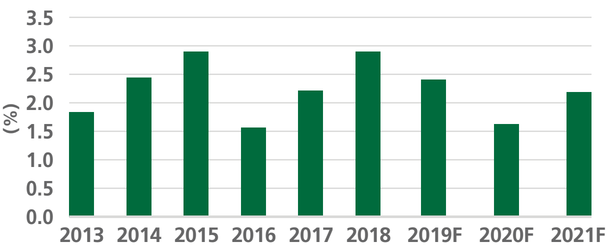
A strong labor market drove wage growth

Employment gains over the first three months in Q1 may have been volatile, but the overall addition of 557,000 jobs showed that the job market's strong, especially given that the unemployment rate is hovering near a 50-year low. More recent data suggests ongoing momentum in employment gains, with a preliminary April job gains estimated at 263,000, pushing unemployment down even further, by 20bps, to 3.6%.[2] For the first time in this cycle, continued tight labor market conditions have resulted in strong wage growth, which has hovered above 3.0% since October 2018.[2]

The U.S. Federal Reserve is staying on the sidelines

Even though recent GDP and employment data all point to above-average growth, inflation pressure remains muted. The core Consumer Price Index for inflation, which excludes the more volatile food and energy categories, hit the U.S. Federal Reserve (Fed) target of 2.0%, as of March 2019. With the Fed outlook taking into account slowing global economic growth and uncertainty over trade policy, we believe the likelihood of a rate hike in the near future has diminished.

Real GDP growth



Source: Moody's Analytics, March 2019. F refers to forecast.

Wages and employment cost growth, YoY

Source: U.S. Bureau of Labor Statistics, March 2019.

1 U.S. Bureau of Economic Analysis, as of April 26, 2019. 2 U.S. Bureau of Labor Statistics, as of May 3, 2019.

Investment markets[3]

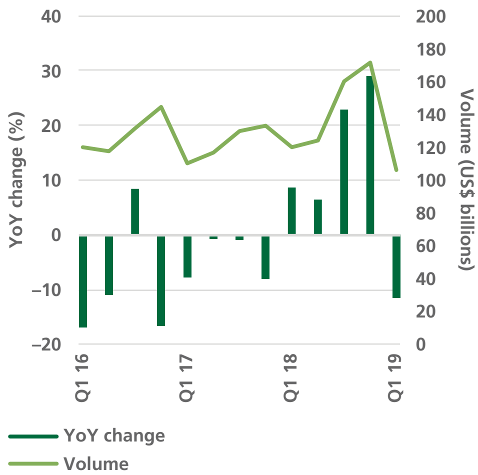
Economic uncertainty and the spike in 10-year U.S. Treasury yields to above 3.0% late last year led to investors pulling back, with total investment volumes falling 11.0% year over year (YoY) for the first quarter of 2019. Since then, however, healthy economic growth and the easing of 10-year Treasury rates to 2.5% suggest that this trend could reverse going forward.

The Q1 slowdown in investment activity affected all property types except multifamily, and so registered a decline in overall volumes. Retail real estate investment saw the biggest downturn, of 16%; followed by industrial, down 15%; and office, down 14%. Multifamily transaction volumes remained relatively unchanged, growing by just 1% YoY.

The uncertain environment late last year caused investors to pull back from major deals, so Q1 activities this year have been affected by a decline in portfolio and entity transactions. If we exclude these, individual asset transaction volumes were down by 8% YoY in Q1 2019.

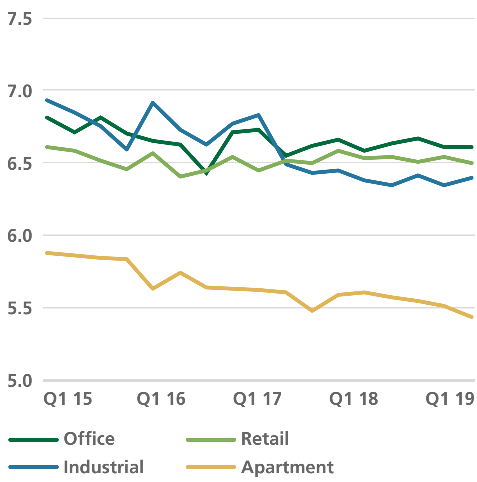
Despite the slowdown in activities, pricing has been stable, with average transaction yields compressing marginally by about 5bps YoY. Multifamily continues to outperform the overall market, with average transaction cap rates falling by about 15bps.

Annual transaction volume



Source: Real Capital Analytics, rcanalytics.com, March 2019.

Transaction cap rate, 12-month average (%)



Source: Real Capital Analytics, rcanalytics.com, March 2019.

3 Market fundamental statistics, including vacancy, absorption, completion, under construction, and rent growth, CoStar, Q1 2019. Capital market statistics, including transaction volume, cap rates, and price index, Real Capital Analytics, Q1 2019.

Office markets

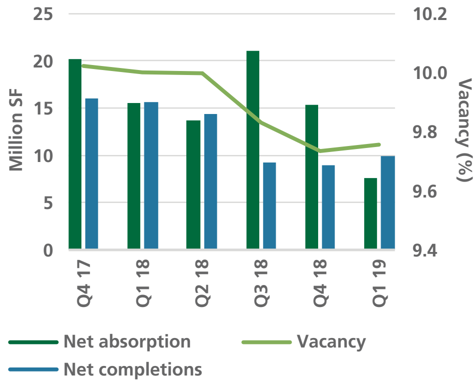
Although the overall pace of supply remains moderate, lower net absorption in the first quarter saw vacancies rise marginally, by less than 5bps. The forecast for completions is that they'll rise by 60% this year,[4] but demand is expected to keep up with new supply, providing stable vacancies through to the end of the year.

Construction activity overall has remained even since early 2016, with space under way as a percentage of existing stock still at ~1.7%. Although the current level is nearing peak activity for this cycle, construction activity is fairly conservative compared with prior cycles—in the 2000s, it peaked at double the current level. Current supply under way is highly concentrated in major markets, especially in those traditionally considered supply constrained, such as New York and San Francisco.

Demand for office space continues to be conditioned by labor market dynamics. With the unemployment rate for those with a bachelor's degree or higher near the historic low of 2.1%[5] and baby boomers beginning to exit the workforce, the availability of educated labor will be a major limiting factor for employment and office market growth over the next decade. As is to be expected, markets with more robust growth in their educated working age demographic are more likely to attract employers and experience stronger demand fundamentals.

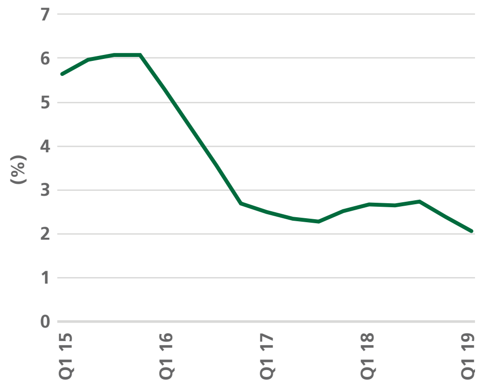
Competition from new supply is putting pressure on rent growth, which has continued to decelerate from 2015 peak levels and was at 2.1% as of Q1. Western region markets are still the front-runners, with San Jose, Seattle, San Francisco, and Sacramento among the top five markets with the highest rent growth.

Office supply/demand fundamentals



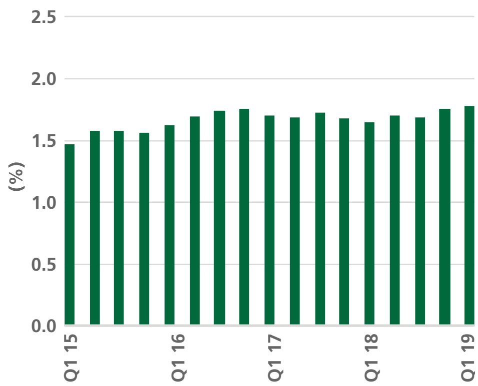
Source: CoStar, March 2019.

Office rent growth



Source: CoStar, March 2019.

Office under construction as % of stock



Source: CoStar, March 2019.

4 CoStar, as of Q1 2019. 5 U.S. Bureau of Labor Statistics, April 2019.

Industrial markets

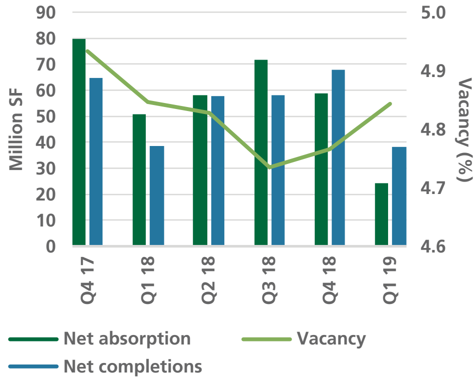
E-commerce logistics continue to be the primary demand driver for the industrial segment, accounting for 50% of absorption in 2018. Given the accelerating spread of e-commerce, demand for industrial space continues to outpace overall economic growth. At the same time, construction activity has trended up over the past two quarters, exceeding demand. With total net absorption of 24 million square feet (SF) against net completions of 38 million SF, vacancies have risen by 8bps, to 4.84%, as of Q1 2019.[4]

E-commerce logistics require a complex network of industrial space, including large regional and super-regional warehouses and small last-mile fulfillment centers. While overall supply was relatively slow earlier in the cycle, the supply of large regional and super-regional products is expected to catch up with demand in most markets this year.

As supply/demand dynamics achieve greater balance, rent growth will likely trend toward long-term averages. National annual rent growth was 5.6% as of Q1 2019, about 80bps lower than peak rates in 2018. Individual markets, however, show a wide spread, with the top three, Sacramento, Inland Empire (in Southern California), and Orlando, experiencing rent growth of above 9%.[4]

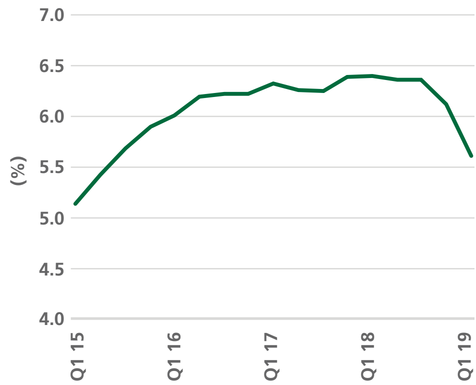
Although industrial rent growth will likely decelerate over the next few years, it's still expected to continue outpacing all other property types. With relatively low capital expenditure requirements, we believe industrial real estate is well positioned to generate stronger cash flow growth and investment returns over the next few years.

Industrial supply/demand fundamentals



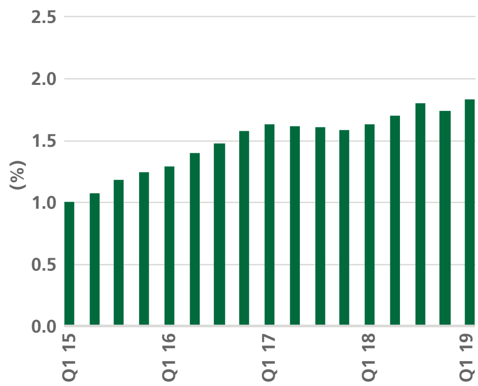
Source: CoStar, March 2019.

Industrial rent growth



Source: CoStar, March 2019.

Industrial under construction as % of stock



Source: CoStar, March 2019.

Multiresidential markets

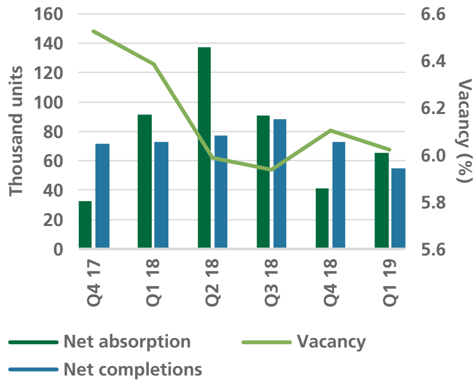
Although multiresidential real estate construction remains strong, it continues to lag demand. First-quarter 2019 demand for multiresidential totaled 65,000 units, with 55,000 units added to the market on a net basis. This translated into an average national vacancy rate decrease of 10bps quarter over quarter, to 6%.

Despite an increase in supply in recent years, U.S. housing markets remain undersupplied today. To fully meet the demand created by new household formation and the need to replace old units, some 1.4 million housing units per year would have been required over the last seven years. But in fact, total completions of single- and multifamily units averaged less than 1.0 million units per year.[4] Further putting pressure on supply, economic and lifestyle factors supportive of renting continue to strengthen, such as the increasing median age of marriage and the percentage of people living alone. Economic factors eroding home ownership affordability include ballooning student debt and weak wage growth over the current economic cycle.

Strong occupancy fundamentals have also helped fuel rent growth, which showed an average national growth rate of 3.2% as of Q1 2019.[4] With the higher-end space in core central business districts receiving a disproportionate share of supply, rent growth in those areas continued to lag the overall market.

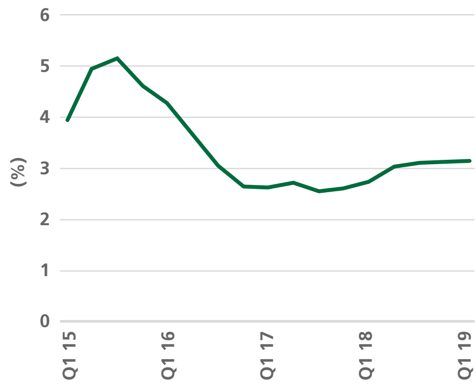
Construction activity remains strong, at a 20-year high of 666,000 units under construction—equivalent to 4% of existing stock—although this activity is highly concentrated in major markets, with the top 15 accounting for half of all national construction under way.

Multiresidential supply/demand fundamentals



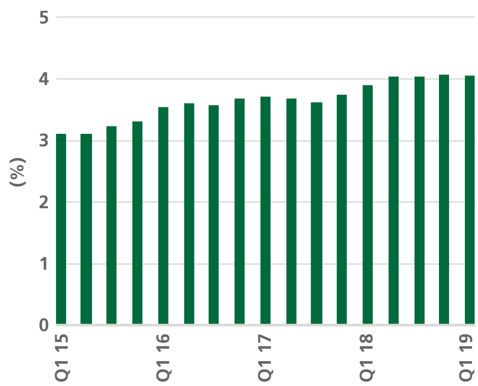
Source: CoStar, March 2019.

Multiresidential rent growth



Source: CoStar, March 2019.

Multiresidential under construction as % of stock



Source: CoStar, March 2019.

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