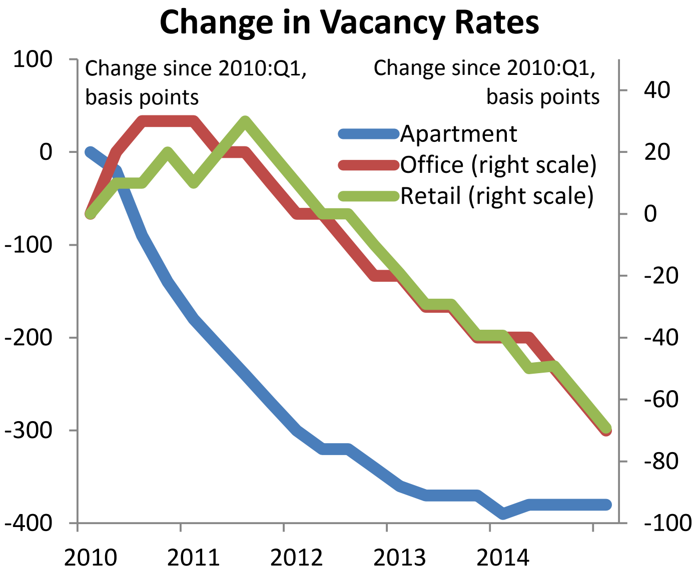
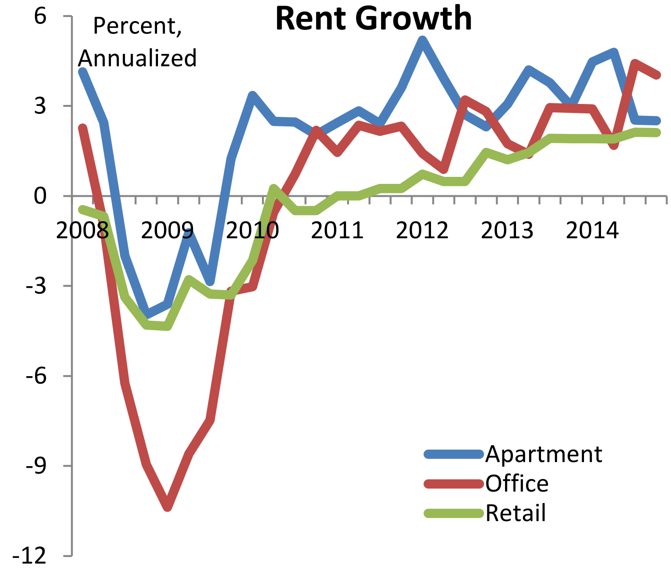
Commercial Property Update 2015:Q1





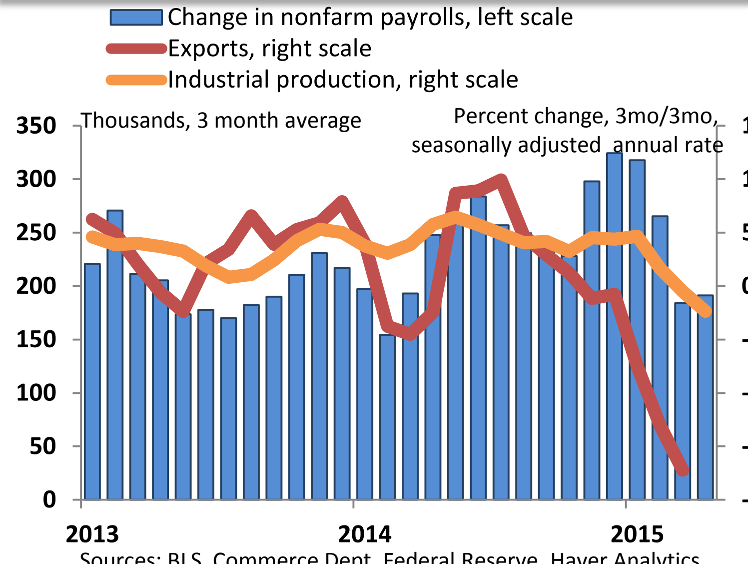
The apartment sector remains robust, with vacancy rates at 4.2%, a decade-low level that indicates little (if any) excess supply. Renewed vigor in the job market over the past year has spurred household formation (page 2 has more details) and continues to fuel strong demand for apartment rentals. Rent growth eased to a 2.5% annual rate, according to Reis, although Axiometrics reports stronger growth in apartment rents.

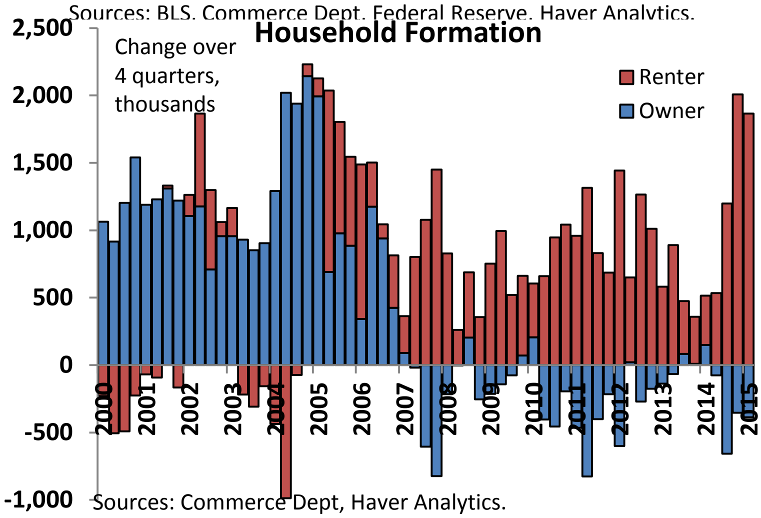
The office sector gained further momentum, bolstered by healthy job growth. Rent growth remains at a 4% annual rate, nearly double the average pace over the last four years. Vacancy rates edged downward by 10 bps to their lowest level in the recovery to date. The acceleration in job growth over the past year (despite a weak showing in March) may bode well for an inflection point in the office market recovery, with more rapid declines in vacancies and higher rent growth ahead.

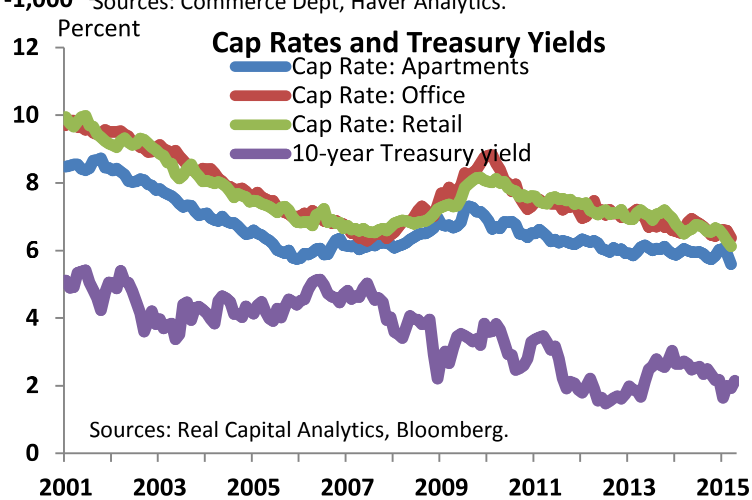
The retail sector remains sluggish. Net absorption fell 16% to its lowest level in six months, as many malls suffered from store closures and tenant bankruptcies. Nevertheless, vacancy rates edged down 10 bps as new tenants appear ready to sign leases on vacant space. Rent growth is still subdued at a 2.1% annualized rate, continuing the very gradual improvement developing since 2010.

Calvin Schnure
Senior Vice President,
Research & Economic Analysis
cschnure@nareit.com
202-739-9434

Economic Fundamentals for Commercial Real Estate







Economic activity slowed again. Nearly all the main indicators stumbled in Q1, including GDP, job growth, retail sales, exports and industrial production. Wintry weather, a stronger dollar/weak growth in Europe and a West Coast port strike each took a toll. It's not quite fair to say "two steps forward, one step back," though, especially for the job market, which had taken four or five big steps forward before the latest slowing. The macroeconomic outlook remains quite favorable as these temporary drags will soon fade.

Demand for rentals is still on steroids. Growth of rental households continues to surge (red bars in second chart), as improving job market trends, especially for millennials, are releasing the "pent-up demand" of those doubled-up and living with parents and roommates. This wave, despite its recent strength, is just beginning; NAREIT research estimates there are as many as 3 million pent-up households, enough to drive rental demand for several years.

Cap rates are still wide to Treasuries. Treasury yields have moved off their lows, fanning fears of an impact on real estate. Much of the move, though, is a reversal of the flight to quality in prior months. Risk spreads of all types are narrowing, but are still wide by historical patterns—the cap rates in the chart at left are well above the Treasury yield, and future increases in interest rates may be absorbed through further spread compression. More importantly, REITs and real estate typically perform well when interest rates recover in a healthy economic environment, as rising rents generate an organic gain in cap rates and property prices continue to rise.

The views expressed in this commentary are those of Calvin Schnure, PhD, of the National Association of Real Estate Investment Trusts (NAREIT®) and reflect the current views of Dr. Schnure as of May 19, 2015.

1875 I Street, NW, Suite 600, Washington, D.C. 20006-5413
Phone 202-739-9400 Fax 202-739-9401