REAL ESTATE INVESTORS

Strategy & Research Group

2Q 2019 QUARTERLY REPORT[1]

AS OF JUNE 30, 2019

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U.S. ECONOMY

The U.S. economy has continued to grow, and on July 1st, the current economic expansion became the longest in U.S. history at 10 years. The Q2 2019 GDP report recorded that the U.S. economy grew by 2.1%, exceeding expectations. This followed the 3.1% growth rate logged in Q1 (see Chart 1).

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Consumer spending, which accounts for approximately 2/3 of the U.S. economy, increased 4.3%, the highest rate in five years. This helped alleviate concern that consumer spending growth had slowed. The goods consumption component of consumer spending increased 8.3% compared to 1.5% in the prior quarter, while services increased 2.5% compared to 1.0% in Q1.

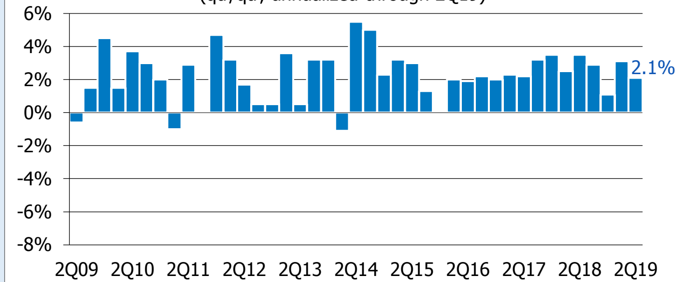
Intellectual property investment, a component of GDP, recorded a 4.7% year-over-year increase, slowing from the torrid 10.8% logged in Q1 and average growth of 10.2% in 2018. Government spending increased 5%, which represents its largest contribution to GDP in a decade. The government spending category was buttressed by a 15.9% increase in federal nondefense expenditures. Some of that was a reflection of delayed compensation for some federal employees after the government shutdown. Business investment weakened by 0.6%, as nonresidential structures investment contracted by 10.6% and residential investment declined by 1.5%. This is the sixth straight quarterly decline for residential investment (the longest consecutive decline since 2009).

There is an indication that trade is weighing on the expansion, as exports dropped 5.2% while imports rose just 0.1%. Last quarter's increases from trade and inventories proved to be ephemeral. In anticipation of an increase in trade tensions, manufacturers expanded their output and rushed goods into the U.S., building inventory. The subsequent drawdown of inventories subtracted 0.9% from GDP growth this quarter.

Nominal construction spending declined at a 1.3% seasonally-adjusted annual rate in June. The June 2019 figure is 2.1% below the June 2018 estimate. The decline of 3.7% in public construction spending was a major contributor to the fall. Private residential construction spending declined 0.4%, while private nonresidential construction spending declined 0.3%.

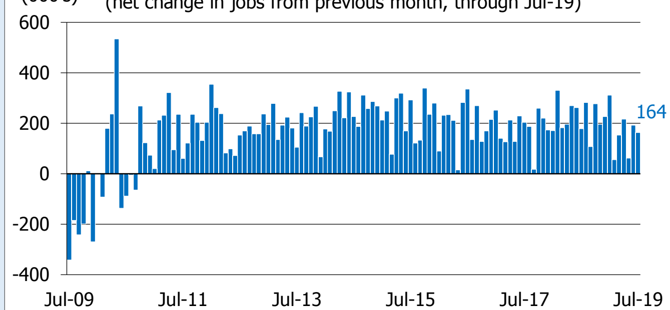
Challenges to maintaining a future GDP growth rate of 3.0% or higher include the fading impact of the December 2017 tax cuts, the strong dollar, and tariffs that have been proposed or already implemented. Concerns remain that China's decelerating economy and its trade conflict with the U.S. could negatively impact future GDP growth. According to the Bloomberg Private Sector Forecast August 2019 Survey, the median U.S. GDP growth rate for 2019 is expected to be 2.3%.

Chart 1. Real GDP Growth
(qtr/qtr, annualized through 2Q19)



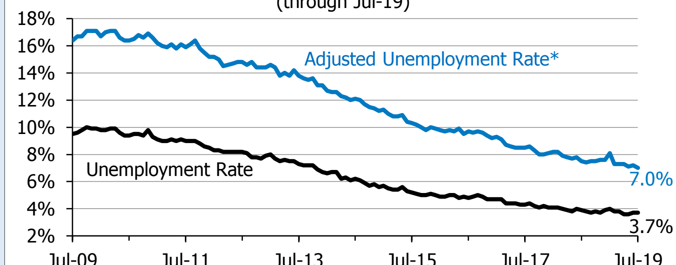
Source: "Gross Domestic Product: Second Quarter 2019 (Advance Estimate)," Bureau of Economic Analysis

Chart 2. Job Creation: Nonfarm Payrolls
(net change in jobs from previous month, through Jul-19)



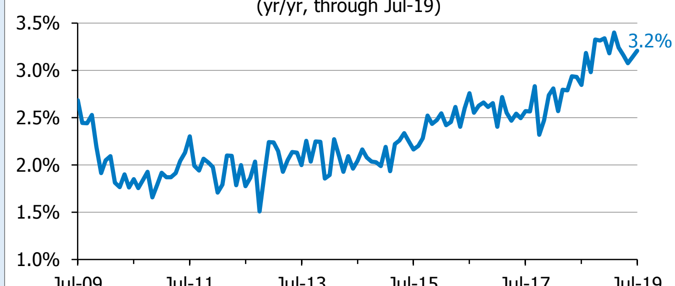
Source: "The Employment Situation – July 2019," Bureau of Labor Statistics

Chart 3. Unemployment Rate Measures
(through Jul-19)



Source: "The Employment Situation – July 2019," Bureau of Labor Statistics
*U-6 unemployment rate (official unemployment rate broadened to include all persons marginally attached to the labor force plus total employed part time for economic reasons).

Chart 4. Average Hourly Earnings: Private Industry Workers
(yr/yr, through Jul-19)



Source: "The Employment Situation – July 2019," Bureau of Labor Statistics

Healthy job growth (see Chart 2) and an unemployment rate near a 50-year low (see Chart 3) have supported consumer spending. There are substantially more job openings than workers available to fill them. It is hoped that the tight labor market will spur further real wage growth and further drive consumer spending (see Chart 4). Hourly earnings are up by 3.2% year-over-year through July, the 12th consecutive month with a growth rate above 3%. Earnings growth has not been this high since 2009. Despite the most recent encouraging observations, both real wage and benefits growth remain below pre-crisis rates. The Employment Cost Index (ECI) is up 2.8% year-over-year, down slightly from the previous quarter of 2.9%.

The Fed's preferred underlying inflation measure, the Personal Consumption Expenditures Price Index excluding food and energy, was 1.5% year-over-year in the quarter, lower than policymakers' 2% objective.

The ISM Manufacturing Index continued to decline in July as the survey's headline composite decreased to 51.2 from 51.7 in June. This is the lowest level in nearly three years, perhaps a reflection of the trade war. While manufacturing makes up only about 11% of the U.S. economy and 8% of employment, the risk is that further weakness will extend to service providers.

The ISM Non-Manufacturing Index decreased to 53.7 in July from 55.1 in June. Although this is the index's lowest reading since August 2016, when it registered 51.8, it still reflects continued growth in the non-manufacturing sector, albeit at a slower rate. Respondents indicated ongoing concerns related to tariffs and employment resources.

The University of Michigan Consumer Sentiment Index increased to 98.4 in July from 98.2 in June, a modest increase and suggestive of a fairly optimistic consumer. The variations in the index have been remarkably small, ranging from 91.2 to 101.4 in the past 30 months.

Outside of the U.S., the data points from Europe showed signs of slowing during the quarter. Trade war escalation and a no-deal Brexit may negatively impact European economies. There is also concern over the further slowdown in Chinese growth and the potential for further escalation in the trade war with China. The latest calendar year's Chinese data have provided more evidence of slowing growth. China's 2018 growth rate was 6.6%, the slowest pace recorded since 1990. Some observers believe things may be even worse than official numbers show. The second quarter seasonally-adjusted annual growth rate was 6.2%, lower than the 6.4% in the previous quarter and the 6.7% recorded at the same time last year.

In September 2018, President Trump announced new tariffs on $200 billion in Chinese imports, prompting Beijing to retaliate with levies on $60 billion in U.S. goods. Mr. Trump then vowed to further ratchet up pressure on China by kicking in tariffs on another $257 billion of Chinese products. On May 5, 2019, President Trump issued a pair of tweets criticizing China and threatening to raise tariffs on about $200 billion in goods to 25% from 10% and extend the new 25% tariff to an additional $325 billion of imports. On August 1, 2019, President Trump said he would impose a 10% tariff on $300 billion of Chinese imports that aren't yet subject to U.S. duties. The new tariff would be imposed Sept. 1. As a result, fears of an economic cold war with China have amplified. The negative consequences of a full trade war with China would be significant.

On another trade front, the $1.2 trillion United States-Mexico-Canada Agreement (USMCA) trade pact signed on November 30, 2018, has been met with congressional opposition, stalling its progress toward final approval. On a positive note, the Mexican Senate approved the treaty on June 19, 2019.

Another cause for concern may be a slowing housing market. According to the S&P CoreLogic Case-Shiller Index of property values, year-over-year home prices in 20 U.S. cities rose by 2.4% in May, the slowest pace since 2012, decelerating for the 12th straight month despite lower interest rates as potential buyers are challenged by student loan burdens and down payment hurdles amidst a lack of affordable listings. Mortgage rates have fallen recently to the lowest levels since 2016. The average rate on a 30-year, fixed-rate mortgage was 3.75% at the end of July, down from 4.94% in November 2018. The U.S. homeownership rate fell for a second straight quarter to 64.1%. This Q2 rate represents a slight decline from 64.2% in the first quarter and down from 64.3% one year ago. The second quarter marked the first time the homeownership rate fell on an annual basis since 2016.

As expected, the Federal Open Market Committee's (FOMC) July meeting resulted in an interest rate cut. The Federal Funds target rate range was moved to 2.00% - 2.25%, representing the first reduction since the Global Financial Crisis (December 2008). The Fed cited concerns over a slowing global economy, trade tensions, and lower-than-expected inflation are reasons given for the move.

The FOMC statement appeared to leave their options open regarding the possibility of more cuts this year, stating as follows: "As the committee contemplates the future path of the target range for the federal funds rate, it will continue to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion."

Fed Chairman Jerome Powell characterized the interest rate cut as a "mid-term policy adjustment," implying that the central bank is not necessarily at the start of an easing cycle.

At the press conference following the July 2019 FOMC meeting, Chairman Jerome Powell characterized the quarter-point cut as a "mid-term policy adjustment," implying that the central bank is not necessarily at the start of an easing cycle. In the same press conference, Chairman Powell said the Fed hasn't ruled out further cuts.

In announcing the rate cut, the Fed couched the message in the following terms: "In light of the implications of global developments for the economic outlook as well as muted inflation pressures, the Committee decided to lower the target range." This implies that the ease was caused by the perceived threat to the

U.S. economy, in the form of a contagion from global developments and muted inflation, not necessarily economic weakness in the U.S. Nevertheless, the Fed also noted that "uncertainties" about the economic outlook remain.

The unemployment rate has fallen to a level typically considered "maximum employment"; i.e., unemployment is low enough that competition for workers should put upward pressure on wages and, ultimately, prices. The central bank introduced its 2.0% inflation objective in 2012. The CPI headline measure was 1.7% in June, while the core measure was 2.1% year-on-year. However, the most recent observations (June 2019) for the PCE Deflator and the Core PCE deflator (the Fed's preferred inflation gauge) were 1.4% and 1.6%, respectively (see Chart 5). This reflected a significant decline from December 2018 when they stood at 1.8% and 2.0%, respectively. The slowing of inflation comes in the face of a strong economy and low unemployment.

Interest rates moved significantly lower during the second quarter. The 2-year to 10-year Treasury yield curve moved tighter as 2-year notes declined 51 basis points while 10-year notes were 40 basis points lower. The 3-month to 10-year yield curve was inverted during the last half of the second quarter. As of August 9, 2019, the inversion had grown to 22 basis points and the 12-month to 10-year yield curve was inverted by 5 basis points. Yield curve inversion has historically been a precursor to recessions, usually within 18 months following the event. However, the unprecedented government monetary policy intervention may possibly be a reason that this may prove to be an exception.

In the second quarter of 2019, equity markets added to the previous quarter's gains, with the DJIA, S&P 500, and Nasdaq rising 2.6%, 3.8%, and 3.6%, respectively. Equity markets are up substantially for the first half of the year with the DJIA, S&P 500, and Nasdaq rising 14.0%, 17.3%, and 20.7%, respectively.

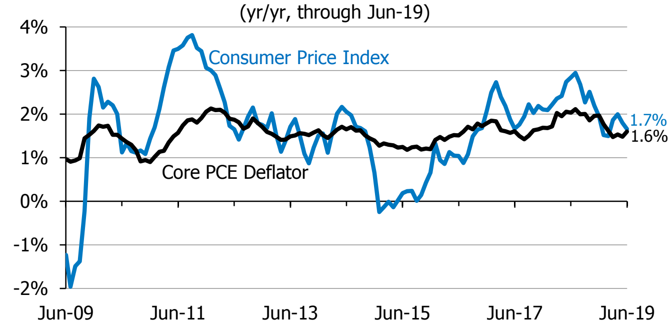
Looking forward to the balance of 2019, we believe primary risks to the U.S. economic outlook include:

- An economic slowdown in Europe, China and other parts of the world impacting the U.S. economy;
- Higher-than-normal domestic policy risk under President Trump. President Trump's economic policy decisions have been hard to predict, and with equity market price-to-earnings multiples toward the upper part of their historical cyclical range, it would seem the economy and the financial markets are susceptible to a policy misstep;
- The uncertain political environment leading into the 2020 presidential and congressional elections and its influence and impact on the U.S. economy;
- Efforts in the U.S. and across the globe to introduce tariffs and other barriers to international trade; and
- Weak wage growth and increased income concentration resulting in political change and less business-friendly government policies. Slow growth may also negatively impact consumer spending.

REAL ESTATE EQUITY MARKETS

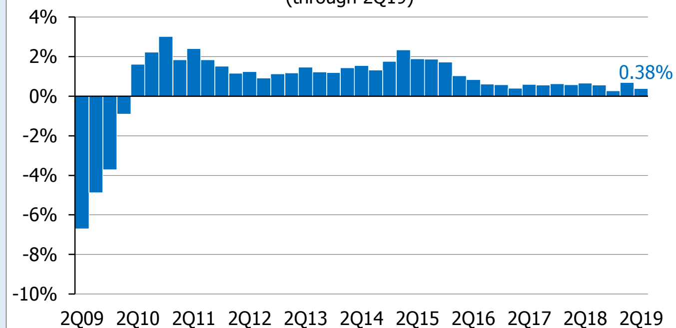
In the second quarter, investments in U.S. commercial real estate produced a 1.5% total return, consisting of 1.1% income and 0.4% appreciation, as measured by the performance of the

Chart 5. Two Measures of Consumer Price Inflation
(yr/yr, through Jun-19)



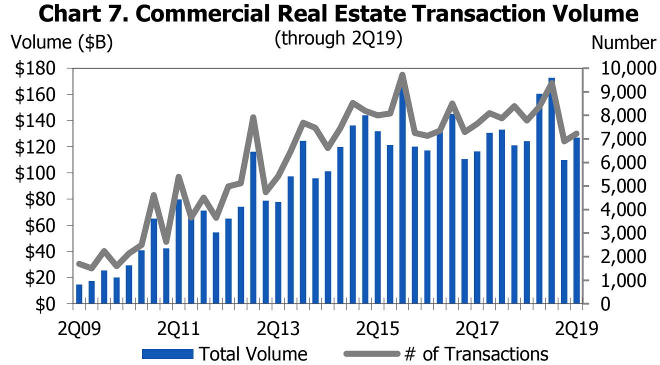
Source: "Personal Income and Outlays, June 2019," Bureau of Economic Analysis; "Consumer Price Index – June 2019," Bureau of Labor Statistics

Chart 6. Commercial Real Estate Appreciation Returns
(through 2Q19)



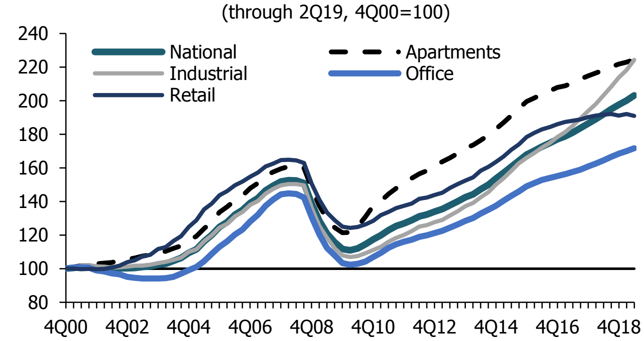
Source: NCREIF Property Index

Chart 7. Commercial Real Estate Transaction Volume
(through 2Q19)



Source: Real Capital Analytics

Chart 8. Market Value Indices
(through 2Q19, 4Q00=100)



Source: NCREIF MVI Indices

approximately 8,300 properties in the NCREIF Property Index[2]

Overall, investments in U.S. commercial real estate have steadily increased in value over time, delivering 37 consecutive quarters of value appreciation, above and beyond capital invested (see Chart 6). However, the good news does not stretch to every corner of the commercial real estate landscape: the retail property type saw its streak of positive appreciation broken in early 2017, and then followed by value losses that have worsened over time up through the second quarter, particularly among larger-sized retail investments such as malls and power centers.

Investments in U.S. commercial real estate have steadily increased in value over time, delivering 37 consecutive quarters of value appreciation.

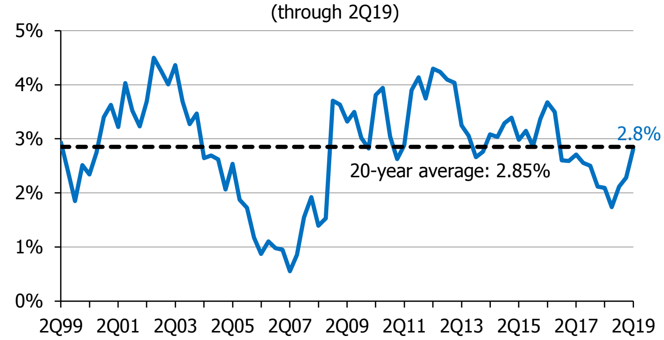
With the exception of retail, unlevered property returns were positive for all property types during the quarter; however, there were significant inequalities among property types, sub-property types, regions and metros (see Tables 1, 2 and 3). Once again, industrial was the best performing property type by a wide margin, producing a quarterly total return of 3.4% and a trailing 12-month total return of 13.9%.

Office was the next best performer with a quarterly total return of 1.7% and a trailing 12-month total return of 6.8%. The office sector has witnessed outperformance in the high-growth tech-related job markets in the West and Sun Belt. Particularly, the West region has continued its dominance (9.1% trailing 12-month total return) highlighted by top-performing San Francisco and Seattle (11.2% and 10.3% respectively). Conversely, the East region – which makes up the largest office region by gross asset value in the NCREIF Property Index – lagged the West by 410 basis points, delivering a trailing 12-month total return of 5.0%. The largest two metros in the East, New York and Washington D.C., make up nearly 70% of the gross asset value of the index and posted trailing 12-month total returns of 3.8% and 3.4%, respectively.

The apartment sector produced a quarterly total return of 1.4% and a trailing 12-month total return of 5.8%. At this stage of the cycle, most of the apartment sector's return is coming from income, whereas appreciation has slowed. This has occurred largely due to a wave of new construction of Class A urban product that has led to moderate oversupply and stagnating net operating income growth in certain markets. Additionally, garden-style apartments – the primary apartment sub-type in suburban markets and one which typically offers more affordable rents and has seen less new supply – significantly outperformed high-rise apartments over the last year (8.2% vs 4.6% trailing 12-month total return).

Finally, performance of the retail sector has continued to lag the other major property types, with retail's total return approximately flat, but still negative at -0.1% in the quarter (1.8% over 12 months). As the retail sector has continued to evolve with the emergence of e-commerce, there has been substantial variation in performance among the retail sub-property types. The largest sub-property type – malls – led the sector's underperformance with a -2.2% appreciation return and -1.0% total return in the quarter

Chart 9. Spread of Cap Rates Over 10-Year Treasury
(through 2Q19)



Source: NCREIF and Board of Governors of the Federal Reserve

Table 1. Total Return by Property Type

	3Q18	4Q18	1Q19	2Q19	1-Yr
Apartments	1.6%	1.4%	1.4%	1.4%	5.8%
Industrial	3.4%	3.4%	3.0%	3.4%	13.9%
Office	1.7%	1.7%	1.6%	1.7%	6.8%
Retail	0.6%	-0.4%	1.7%	-0.1%	1.8%
All	**1.7%**	**1.4%**	**1.8%**	**1.5%**	**6.5%**

Source: NCREIF Property Index

Table 2. Occupancy by Property Type

	3Q18	4Q18	1Q19	2Q19	1-Yr Change
Apartments	94.0%	93.9%	94.0%	94.3%	0.2%
Industrial	95.3%	95.3%	95.2%	95.0%	-0.3%
Office	90.3%	90.3%	90.3%	90.4%	0.1%
Retail	95.6%	95.6%	95.5%	95.5%	-0.1%

Source: CoStar Portfolio Strategy

Table 3. Rent Growth (yr/yr) by Property Type

	2Q15	2Q16	2Q17	2Q18	2Q19
Apartments	4.9%	3.6%	2.7%	3.0%	3.2%
Industrial	5.4%	6.2%	6.3%	6.4%	5.5%
Office	6.0%	4.5%	2.4%	2.8%	2.3%
Retail	2.7%	2.9%	2.5%	2.7%	1.4%

Source: CoStar Portfolio Strategy

(-5.6% and -1.1% over 12 months, respectively), and strong headwinds remain on the horizon. The emergence of e-commerce and the sector's perceived heightened risk, in part from mall store closures, has impacted investor interest and has led to a continued void of mall transactions. This dearth of clarity on pricing may suggest that additional retail asset write-downs loom on the horizon, and are not yet fully reflected in current NCREIF Property Index values.[3]

In the second quarter of 2019, transaction volume rose slightly, increasing 2% year-over-year as measured by dollar volume. This was largely driven by major office deals closing in technology markets and a large increase in garden-style apartments transactions. However, transaction volume slipped by 7% as measured by transaction count (see Chart 7).[4] Uncertainty in interest rates, and trade conflict between the U.S. and China, contributed to a slow start to the year in the first quarter; whereas the second quarter was characterized by a return of relative calm to the markets, providing a better picture of the overall trend for growth in deal volume. Notably, entity-level transactions have been more muted during the first half of 2019 when compared to previous years. This is possibly due to meaningful changes in interest rates since November of 2018. As U.S. interest rates have continued to decline in recent months, the cost to foreign investors of hedging investments in U.S. real estate has also declined. This could potentially provide a boost to transaction volume for foreign investors. The New York Life Real Estate Investors team expects transaction volumes will remain healthy for the rest of 2019 barring a significant deterioration of the economic environment.

The NCREIF Market Value Index (MVI), which is not adjusted for inflation, indicates that, as a whole, commercial property market values are still rising, albeit at a somewhat slower pace than during the years immediately following the downturn (see Chart 8).[5] Over the past year, the national MVI Index is up 5.6%. However, there has been significant variation in market value growth rates between property types. Over the past year, industrial market values are up 9.9% and show no sign of slowing, while office and apartment market values are increasing more slowly at rates of 4.3% and 2.9%, respectively. In contrast, retail market value growth, at -0.4% over one year, is negative for the first time since 3Q2010. Within retail, sub-property type market value changes range from a high of 1.0% for neighborhood centers to lows of -2.7% and -3.8% for super-regional malls and regional malls, respectively. The market values of super-regional malls and regional malls now stand -3% and -6%, respectively, below their recent cyclical peaks. Similarly, there is significant variation in market value growth rates between metros, another key determinant of investor relative performance. For example, Phoenix apartment market values have increased a strong 10.4% over the past year – driven by job creation, a low cost of living, migration patterns, and relatively restrained new construction – while apartments in Baltimore have slipped in value by -2.3% over the same period. A discussion of performance differentials by metro is beyond the scope of this report, but the underlying causes of these performance differentials are closely scrutinized by the New York Life Real Estate Investors team and quantified through the team's market screen model and other research efforts.

> NCREIF data indicates that the property income yield compression seen in recent years has largely ended, with the exception of the industrial property type.

NCREIF data indicates that the property income yield (i.e., "cap rate") compression seen in recent years has largely ended with the exception of the industrial property type, where prices have risen and cap rates have fallen by approximately 25 basis points over the past year from 5.07% to 4.81%.[6] With industrial being the exception to the rule, today, market value gains are being driven primarily by net operating income (NOI) growth. Year-over-year same-store NOI growth for the overall index is 2.9%, reflecting the solid condition of the commercial real estate market, which is characterized by high occupancy rates, modestly increasing market rents, and in-place rents rolling to higher market rents upon lease expiration. The range of NOI growth rates across the property types echoes their market value growth rates: 6.5% for industrial, 3.2% for office, 2.8% for apartments, and only 0.5% for retail.[7]

At the end of the first quarter, property cap rates were 2.3 percentage points above the 10-year Treasury yield, which is toward the lower end of the historical average. Since then, long-term interest rates have significantly declined. Since hitting a peak of 3.24% in November, the 10-year Treasury note yield ended the second quarter at 2.00% and now stands at 1.71% (as of August 7th), down a substantial 41 basis points and 70 basis points, respectively, since the end of the first quarter. Cap rates overall have remained in a narrow band between 4.7% and 4.8% over the past year (with cap rate declines seen in the industrial sector, little change seen in apartments, and increases seen in office and retail). This decline in long-term interest rates indicates that the current "yield premium" spread of cap rates minus the 10-year Treasury note yield is 2.8 percentage points, which is in line with the long-term (20 year) historical average (see Chart 9). For comparison, during the two-year run-up to the Great Recession of 2008, this spread averaged just 1.0 percentage point, with a quarterly low of only 0.6 percentage points. Wider spreads this quarter may suggest that overall, commercial real estate is fairly priced by historical standards, particularly given the consideration that most commercial buildings have in-place rents that are below current market levels, providing "built-in" income upside when expiring spaces are re-leased at market. Yet like all asset classes, commercial real estate values are vulnerable during economic recessions, should one occur. It remains to be seen whether the reduction in the 10-year Treasury rate provides additional support for commercial real estate values or is instead a harbinger of economic weakness.

The advantages of investing in commercial real estate continue to attract both domestic and foreign investors, especially in light of the relatively low yields offered by many other asset classes and the uncertainty reflected in the performance of the global economy. This has led to a competitive acquisition environment, particularly for investor-favored property types in prime locations. As a result, those commercial real estate investors who are nimble, creative, and judiciously adjust their investment approach stand to benefit. This change in approach may take the form of investing in less popular but thriving secondary markets, alternative property types, or prudent amounts of non-core opportunities, all of which may hold potential for attractive risk-adjusted returns.

REAL ESTATE DEBT MARKETS

Real Estate capital market conditions remain largely unchanged from the previous quarter, with capital available for both debt and equity. While not all second quarter data is yet available, healthy loan production volumes persisted during this period. Life company commercial mortgage loan spreads reversed their tightening trend during the second quarter, responding to the rally in Treasuries. However, this modest spread widening did not offset lower base rates as coupon levels drifted below 4.00%. The most recent U.S. Federal Reserve survey on bank lending practices revealed that while there has been a modest net trend of lender tightening on all loan types, most banks have kept lending standards unchanged (see Table 4).

CMBS, bank and thrift loan, and life company loan delinquency rates are below the 10-year average. Rates have declined steadily since the global financial crisis and show no signs of stress (see Chart 10). Additionally, relatively low loan to value (LTV) ratios indicate lenders are currently more cautious than they were before the peak of the crisis; the current average LTV of 60.5% among life insurance companies is lower than the pre-financial crisis high of 65.9% (see Chart 11).

Meanwhile, securitized real estate debt's share of the market has continued to decline. The share of the outstanding commercial real estate debt universe securitized via CMBS, CDOs, and other issues has declined from 27% in 2009 to 14% in the first quarter of 2019. Over this period, the slack has been picked up by banks and thrifts, which increased their share from 33% to 39%, agency and government-sponsored enterprise portfolios which increased their share from 13% to 20%, and life insurance companies, which increased their share from 13% to 15% (see Chart 12).

PROPERTY TYPE FOCUS

Industrial: The industrial sector's total return increased in the second quarter from 3.0% to 3.4%, and year-over-year rent growth decelerated modestly from 5.9% to 5.5%. Occupancy weakened slightly from 95.2% to 95.0%. Strong consumer spending figures in the second quarter, coupled with the continued growth in e-commerce sales, have been supportive to industrial occupancy and rent growth. According to the U.S. Census Bureau, e-commerce sales now comprises 10.2% of retail sales, and e-commerce sales growth was up from 12.1% to 12.4% in the first quarter. Moreover, retail sales from non-store retailers accounted for 22.4% of core retail sales.[8] This represents an unprecedented share of the slice of retail sales that excludes items for which e-commerce would be impractical. Completions in the first half of 2019 lagged previous years, due in part to construction delays. However, construction deliveries are expected to ramp up through the balance of the year. Net absorption in the second quarter hit 28 million SF nationally, a 20% improvement over last quarter. This relatively stronger absorption may dampen any decline in occupancy that could result from a pickup in construction deliveries in the second half. Although trade tensions remain a concern for industrial investors, even west coast port cities, the markets most exposed to tariffs, have seen few material effects manifest in industrial demand thus far. Overall, fundamentals have remained strong from the industrial sector in the second quarter.

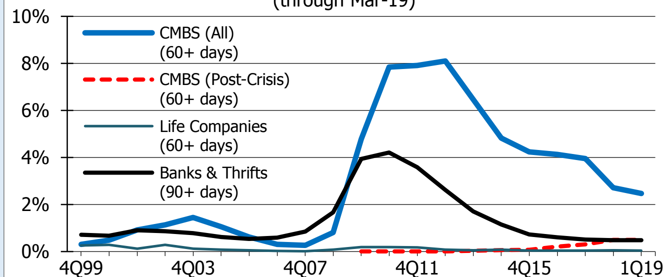
Over the last year, markets with the strongest net absorption activity as measured by square footage were the Dallas/Fort Forth (+25.0M), Inland Empire (+23.2M), and Atlanta (+14.4M), while the weakest markets were Orange County (-2.7M), East Bay (-1.2M), and New Orleans (-1.0M). Markets with the largest declines in vacancy rates over the last year were Tucson (-1.4%), Memphis (-1.2%), and Baltimore (-0.8%), while markets with the largest increase in vacancy were Nashville (+2.0%), Orlando (+1.3%), and New Orleans (+1.2%).

Table 4. Trends in Commercial Real Estate Bank Lending
(through 1Q19)

Type of Loan	% of Banks Easing vs. Prior Quarter	% of Banks Unchanged vs. Prior Quarter	% of Banks Tightening vs. Prior Quarter	Net Tightening Trend?
Commercial	3%	85%	13%	3 quarter in a row
Apartments	6%	81%	14%	14 quarters in a row
Construction/ Land Dev.	4%	77%	19%	15 quarters in a row

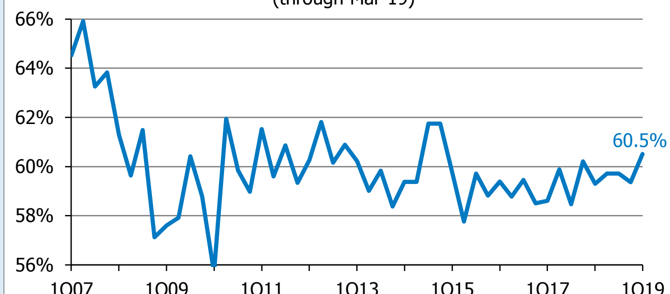
Source: "April 2019 Senior Loan Officer Opinion Survey on Bank Lending Practices," Board of Governors of the Federal Reserve System

Chart 10. Commercial Mortgage Delinquency Rates Among Major Investor Groups
(through Mar-19)



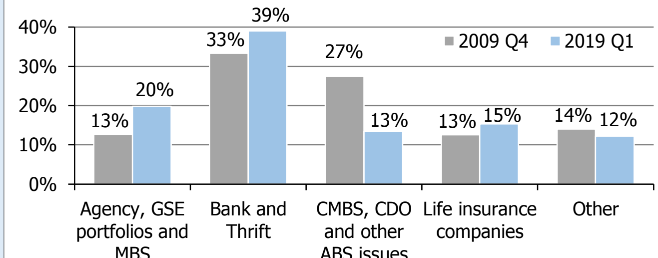
Source: MBA, Wells Fargo Securities, LLC, Intex Solutions, Inc., American Council of Life Insurers, OFHEO, and Federal Deposit Insurance Corporation

Chart 11. Average LTV of Fixed-Rate Commercial Mortgage Commitments
(through Mar-19)



Source: American Council of Life Insurers

Chart 12. Commercial and Apartment Debt Outstanding
(as of Mar-19)



Source: MBA, Flow of Funds Accounts, Federal Reserve Board of Governors, FDIC, Wells Fargo Securities

Office: In the second quarter, the office sector's total return ticked up slightly from 1.6% to 1.7%. Occupancy also moved up slightly from 90.3% to 90.4%, striking a new cyclical high, while rent growth slowed from 2.6% to 2.3% year-over-year, the third straight quarter of deceleration. However, it also marks a historical high of 34 straight quarters of positive rent growth. Net absorption rebounded in the second quarter, posting the strongest demand since 2016. In a bid to attract the best talent, office tenants have increasingly focused their search on newer, higher quality office space. The newest, most functional, most highly-amenitized locations will likely outperform in this environment. Markets with higher concentrations of tech tenants have outperformed, including Austin, San Jose, and San Francisco, which have exhibited the greatest rent growth in the U.S. over the past year. Densification trends in the form of increased office efficiency and co-working utilization may create headwinds for the office sector. Overall, office fundamentals, nationally, point to continued rent growth and price appreciation, albeit at a decelerating rate.

The second quarter marks a historical high of 34 straight quarters of positive rent growth for the office sector.

Over the last year, markets with the strongest net absorption activity as measured by square footage were Seattle (+6.3M SF), New York (+6.0M SF), and Charlotte (+4.5M SF), while the weakest markets were Rochester (-0.9M SF), Buffalo (-0.5M SF), and Pittsburgh (-0.2M SF). Markets with the largest declines in vacancy rates over the last year were Northern New Jersey (-2.5%), Salt Lake City (-1.3%), and Seattle (-1.2%), while markets with the largest increase in vacancy were Rochester (+2.3%), Buffalo (+1.1%), and Tucson (+0.8%).

Apartment: The apartment sector's total return remained largely unchanged from the previous quarter at 1.4%, and rent growth remained at a fairly strong 3.2% year-over-year. Transaction volume increased to a historic high of $42 billion. In the second quarter, about 82,000 new apartment units were delivered, while 113,000 units were absorbed, leading the occupancy rate to strengthen from 94.0% to 94.3%, a new cycle high. The historical ratio of housing starts to household formation is 1.1.[9] Over the past eight years, this ratio has declined to levels well below this long-run average, to as low as nearly 0.6, and has only recently seen recovery. New housing supply, both single-family and multifamily, has not kept up with household formation nationwide, largely for this entire cycle. As noted earlier, in the second quarter, the homeownership rate ticked down from 64.2% to 64.1%, following a further decline from 64.8% in Q4 2018, and well below the 20-year historical average of 66.5%. The homeownership rate is an important indicator of potential multifamily demand. According to CoStar Group, a one percentage increase in the homeownership rate results in a loss of roughly 800,000 renter households.[10] Overall, underlying national demographic and housing trends have supported strong fundamentals in the apartment sector.

Over the last year, markets with the strongest net absorption activity as measured by number of units were New York (+27.4K), Dallas/Fort Worth (+23.3K), and Seattle (+12.0K), while the weakest markets were Memphis (-0.0K), Detroit (+0.1K), and Tucson (+0.3K). Markets with the largest declines in vacancy rates over the last year were Austin (-1.8%), Nashville (-1.3%), and Louisville (-1.1%), while markets with the largest increase in vacancy were Jacksonville (+1.1%), East Bay (+0.8%), and Miami (+0.8%).

Retail: The retail sector's total return turned slightly negative once again this quarter, down to -0.1% from 1.7% in the first quarter, following -0.4% in Q4 2018. Rent growth declined precipitously this quarter to 1.4% year-over-year from 2.1% the previous quarter. Demand for retail space declined further this quarter, down to mid-2012 levels, with power centers and malls continuing to see the brunt of this structural decline. Net absorption was weak this quarter, and for power centers, it remained negative. According to Citi Research, 2017 was a record year for store closures with just under 8,000 announced. Following a slight deceleration in closures in 2018, the first half of 2019 has outpaced the first half of 2017, and has potential to break records through the balance of the year.[11] Over the past 18 to 24 months, mall tenants have reportedly been curtailing the size of new lease footprints by roughly half what was typical from 2014 to 2016. Broadly, e-commerce remains one of the driving forces behind the decline in demand for retail space. In the second quarter, a cycle low of eight million SF of retail space was delivered. The new supply that does come online is generally space in high-quality locations driven by strong demographic factors. Overall, the higher-quality centers that include fitness, dining, and other experience-based tenants are better-positioned for outperformance relative to other retail properties.

Over the last year, markets with the strongest net absorption activity as measured by square footage were Dallas/Fort Worth (+3.7M SF), Houston (+3.6M SF), and New York (+2.8M SF), while the weakest markets were New Orleans (-1.3M SF), Los Angeles (-1.2M SF), and Pittsburgh (-0.8M SF). Markets with the largest declines in vacancy rates over the last year were San Jose (-0.9%), Columbus (-0.7%), and Northern New Jersey (-0.7%), while markets with the largest increase in vacancy were New Orleans (+1.7%), Rochester (+1.0%), and San Antonio (+0.9%).

ENDNOTES

1. The comments, opinions, and estimates contained herein are based on and/or derived from publicly available information from sources that NYL Investors LLC believes to be reliable. We do the guarantee the accuracy of such sources or information. This outlook set forth our views as of the date noted. The underlying assumptions and our views are subject to change. This may not be copied or redistributed without prior written consent from NYL Investors LLC. The information presented herein is for information purposes only and does not constitute a recommendation to buy and sell or solicitation of an offer to purchase shares in any securities in any jurisdiction. No inference should be drawn that managed accounts will be profitable in the future or that the Investment Team will be able to achieve its objectives. Investing involves risk, you may experience a profit or a loss and investment results may vary substantially from year to year. References to market benchmarks or other measures of relative market performance over a specified period of time are provided for comparison and information purposes only and do not imply that a client account will achieve returns, volatility or other results similar to those shown. Past performance is not a guarantee of future performance results. Real Estate Investors is an investment group within NYL Investors LLC. NYL Investors LLC is a direct wholly-owned subsidiary of New York Life Insurance Company.
2. Unlevered property-level returns as of 2Q19.
3. "Mall Insights – Annual Grade Review – Silence is Not Always Golden," Green Street Advisors, April 2019
4. "US Capital Trends, The Big Picture," Real Capital Analytics, 2Q2019.
5. The NCREIF MVI indices are designed to measure the change in "same store" property values over time for those properties in the NCREIF Property Index. The indices are calculated by summing net capital appreciation and routing capital expenditures (i.e., the "typical recurring expenses related to changing tenancy and ordinary repairs") while excluding major non-routine capital expenditures (i.e., those which "alter the physical, functional, or economic condition of a property").
6. Equal-weighted current value cap rates, NCREIF Property Index "NPI Trends Report," 2Q2019.
7. NCREIF Property Index "Operational Benchmarks Report" through 2Q2019. Net operating income growth is on a "same property" basis.
8. Excludes automotive dealers, gasoline, building materials, and food services.
9. U.S. Census Bureau and U.S. Department of Housing and Urban Development.
10. "State of the US Multifamily Market Q2 2019 Review and Forecast Transcript," Costar Group, 2Q2019.
11. "Retail REITs, Never Really Over – Mid-Year Tenant Fallout Analysis," Citi Research, July 24, 2019.