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Marketing Material

Research Report

Real Estate - Impact of U.S. Election

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PRESIDENT-ELECT TRUMP: REAL ESTATE IMPACT

With Trump's election victory, the policy backdrop for the economy and commercial real estate will likely change. Although the time frame and degrees of change are uncertain, we believe there are certain policy items to consider.

Overseas, the immediate market reaction during the election showed a sharp sell-off in the futures market. However, when the election ended, that sentiment was reversed, reducing the risk of any acute near-term disruption to either the economy or real estate markets. Furthermore, with Republicans having retained control of Congress, it is reasonable to assume that the President-elect has a chance to implement some – perhaps most – of his agenda over the course of his term, although checks and balances remain.

For example, it is important to note the Republican Party did not walk away with a landslide mandate. While Donald Trump won the Electoral College vote, Secretary Clinton won the popular vote. Also, Republicans are likely to lose at least one seat (Illinois) and possibly two, declining from 54 to 52 seats. President-elect Trump has stated he wants to repeal the Affordable Care Act. While he can take certain executive actions, it would require 60 votes in the Senate to overcome a filibuster and actually repeal it. Finally, within the Republican Party, there will still be some divisions. For example, groups such as the Freedom Caucus are likely to take a hard line on raising the deficit ceiling which could serve to limit some of the fiscal stimulus proposed by the Trump campaign.

Over the coming months and years, the impact of the 2016 election on U.S. real estate will hinge on two main factors:

— The general impact on economic growth; and
— The impact of policies relating to specific real estate property types and markets.

From a top-down perspective, real estate performs well against a backdrop of an expanding economy and low real interest rates. In general, many of the policies being proposed appear conducive to real estate in our opinion and should serve to support GDP growth and maintain stable real interest rates. Some, such as the positions on trade and immigration are less supportive. However, these policies do not work in isolation and the ultimate outcome will depend upon how far any one of these policies goes.

To step back, the factors that drive GDP growth relate to fiscal policies (tax and spending), regulatory policies, trade policies and population growth. These in turn impact tenant demand for real estate. The impact these have on inflation and interest rates can then shape the capital market environment for each of the main property sectors.

Tax and Spending[1]: These proposals seem to provide support for economic growth. On the tax side, both the Trump Plan and the GOP House tax plan call for a cut in personal income taxes and corporate taxes. The following highlights several key policy proposals:

Personal Taxes:

— Replace the current seven personal income tax brackets with three: 12%, 25% and 33%. The current top marginal rate is 39.6%.
— Increase the standard deduction to $15,000 for single filers and $30,000 for joint filers (indexed to inflation thereafter), while the House plan calls for an increase of $12,000 and $24,000, respectively.
— Tax capital gains and dividends at a 20% maximum rate while the House plan calls for a maximum rate of 16.5%.
— Eliminate federal estate and gift taxes as well as the Alternative Minimum Tax (AMT). Deductions may also be restricted: Under the Trump plan, overall deductions are capped for individuals at $100,000 and $200,000 for married households, while the House plan proposes "significant" limits on deductions except in the case of charitable and mortgage deductions.
— Eliminate the tax on investment income of high-income households enacted to help pay for the Affordable Care Act.

[1] Moody's Analytics, "The Macroeconomic Consequences of Mr. Trump's Economic Policies.", June 2016. Cornerstone Macro, "U.S. Policy, Election Aftermath".

Corporate Taxes:

- The highest federal marginal tax rate on corporate taxes currently stands at 35%. The Trump plan would reduce the marginal corporate tax rate to 15%, while the House plan would bring it to 20%.
- One-time repatriation tax of 10% of corporate profits held overseas under the Trump plan and 8.75% under the House plan.

Spending Plans: More spending on national defense and infrastructure (estimates range from $500 billion to $1 trillion over 10 years), and veterans benefits. No changes to entitlements.

We see the tax and spending policies creating the potential for a meaningful increase in after-tax corporate profits and a significant inflow of capital that would support equity markets, corporate investment, and household wealth. Together with personal income tax rate cuts, this could mean a boost for retail sales and provide additional demand for warehouse space. Both should be a net positive for job growth and tenant demand.

In addition, knowing that the median house price in the United States is around $200,000, the provisions on overall deductions under the Trump plan are not likely to impact the large majority of homeowners in the United States and still provide support for housing demand and homebuilders. In the case of business tax cuts, and the elimination of tax on investment income of high-income households to pay for ACA, this could also support small business job growth.

The key risk to these plans is the impact to the deficit. The estimates under the Trump plan suggest the revenue loss to the government for these initiatives could range from $4.4 - $5.9 trillion. Estimates from the Congressional Budget Office and Tax Foundation indicate the budget deficit could increase from its current level of 3% of GDP and trend towards 6% of GDP. Bringing back profits overseas at a deemed rate of either 8.75% (House) or 10% (Trump), is one way to help fund these items. If the economy were to grow at a higher sustained pace, it would also help pay part of the cost for these initiatives. Knowing the Freedom Caucus in the Republican Party wants to restrain the increase in the deficit, it seems reasonable to expect the ultimate solution lies somewhere between the Trump and House Plans.

In isolation, it's reasonable to expect inflation and interest rates to increase to some degree, although the impact to cap rates in the property market would presumably be offset to some degree by tenant demand growth.

Trade and Immigration: While tax cuts and spending programs on defense and infrastructure would provide a boost to GDP growth, the immigration and trade policies could detract from growth.

- **Trade:** Trump proposes re-negotiating NAFTA, labelling China a currency manipulator, and disengaging from the Trans-Pacific Partnership (TPP).[3]
- **Immigration:** Remove 11.3 million undocumented workers (3.5% of the population, 5.1% of the workforce).

In the case of trade policies, ultimately the Congress has to approve legislation. However, the President has certain regulatory powers. For example, after consulting with Congress, the President has the power to impose tariffs or quotas to offset the adverse impact on national security or large and serious U.S. balance of payment deficits (i.e., trade deficits)[2]. If tariffs were introduced on imports, it would presumably not only increase the cost of those goods, but may also reduce the volume of goods imported. Thus, while lower personal taxes could support retail sales, imposition of tariffs and reduced supply of goods would hurt them to some degree. This could have an inflationary effect on the economy. If these actions lead to additional manufacturing in the United States, it could mitigate any adverse effects. However, until that production is brought on-line, it could negatively impact consumption and GDP growth.

In the case of immigration, it remains to be seen how this would be implemented and it is doubtful that the extreme positions taken during the campaign are implemented. Nevertheless, if they were implemented it could create a meaningful impact and result in lower consumption and have an adverse impact on GDP growth. Furthermore, it would reduce unemployment in the United States from an already low level.

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[2] Cornerstone Macro, "U.S. Policy, Election Aftermath", November 2016.
[3] http://www.bloomberg.com/news/articles/2016-11-09/trump-to-brand-china-currency-manipulator-treasury-veteran-says.

General Economic Impact on Real Estate

To summarize, the immediate economic impact of tax and regulatory relief and infrastructure and defense spending may lead to higher economic growth and tenant demand for real estate. Over time, trade frictions and reduced immigration could cause a contraction. Fiscal expansion coupled with higher tariffs and reduced immigration will likely put upward pressure on inflation and interest rates on the margin. The collective impact of these measures on the overall real estate market:

- Stronger growth from tax and regulatory relief could support more absorption across property types in the near term (2017-2018).
- Reduced immigration could exacerbate labor shortages that are already helping to constrain supply on new construction. A large infrastructure program could also lift construction costs (labor and materials).
- Weaker growth from trade and immigration restrictions could reduce absorption over the medium-term (2019-2020).
- The impact of higher inflation/interest rates may be broadly neutral on valuations: base rates may be higher but spreads could narrow (from levels that are above average today) as investors seek an inflation hedge, and nominal rent growth may be stronger. Further, higher base rates may also lead to more attractive debt yields for real estate debt investors.
- In short, the Trump agenda may be positive for real estate in the near term and negative over the medium term.

Sector- and Market-Specific Impacts

Sectors:

- In our opinion, deportations and reduced immigration could limit demand for class B & C apartments, especially in the South (e.g., southern California, Arizona, Texas, and Florida).
- The election results raise the possibility of Government Sponsored Enterprise (GSE) reform or privatization that could put upward pressure on apartment cap rates as the implied “subsidy” from GSE lending could be removed. On the one hand, this could restrict the supply of lending for new construction and support higher rents. However, if lending costs increase, then cap rates would presumably increase.
- Reduced trade could dampen warehouse demand in major ports (Los Angeles, Seattle, Oakland, New York, Houston, and Miami) if not offset by higher domestic demand.
- Lower personal income taxes could support retail sales and warehouse demand, assuming trade tariffs are not introduced.

Markets:

- Energy-dependent areas, primarily Houston but also Oklahoma, Louisiana, North Dakota, Pennsylvania, and West Virginia could benefit from regulatory relief.
- Additional defense spending could support key markets such as Washington D.C., Northern Virginia, San Diego, and San Antonio.
- Life science and technology clusters (Austin, Boston, Portland, San Francisco, San Jose, San Diego, and Seattle) could gain from cyber-security spending and a lighter regulatory environment. However, trade frictions and curbs on skilled immigration would have the opposite effect.
- If Trump’s trade policies succeeded in repatriating manufacturing to the United States, markets with heavier industrial exposure (the Midwest rust belt and the southeast) could benefit. Areas exposed to export industries such as Finance (New York, Chicago, San Francisco), entertainment (Los Angeles), higher education (Boston and college towns), tourism (New York City, Las Vegas, Orlando, Miami and Los Angeles) and technology could suffer.

Risk Warning

Investment in real estate may be or become nonperforming after acquisition for a wide variety of reasons. Nonperforming real estate investment may require substantial workout negotiations and/ or restructuring. Environmental liabilities may pose a risk such that the owner or operator of real property may become liable for the costs of removal or remediation of certain hazardous substances released on, about, under, or in its property. Additionally, to the extent real estate investments are made in foreign countries, such countries may prove to be politically or economically unstable. Finally, exposure to fluctuations in currency exchange rates may affect the value of a real estate investment.

Key Risks of Real Estate Investments

Investments in Real Estate are subject to various risks, including but not limited to the following:

Adverse changes in economic conditions including changes in the financial conditions of tenants, buyer and sellers, changes in the availability of debt financing, changes in interest rates, real estate tax rates and other operating expenses; adverse changes in law and regulation including environmental laws and regulations, zoning laws and other governmental rules and fiscal policies;

Environmental claims arising in respect of real estate acquired with undisclosed or unknown environmental problems or as to which inadequate reserves have been established; changes in the relative popularity of property types and locations; risks and operating problems arising out of the presence of certain construction materials; and currency / exchange rate risks where the investments are denominated in a currency other than the investor's home currency.

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