

Research Report

U.S. Real Estate Strategic Outlook: Mid-Year Review

September 2016

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1 Overview

The U.S. economy and financial markets have absorbed a series of mini-shocks over the past year, including a Chinese slowdown, slumping commodity prices, a soaring dollar, a retrenching energy industry, a Federal Reserve interest rate hike, and the United Kingdom's "Brexit" vote to leave the European Union. U.S. commercial real estate has not been immune to these developments, but it has proved remarkably resilient. NCREIF Property Index (NPI) total returns of 10.6% (trailing four quarters) in the second quarter 2016 were down from 2015 (13.3%) but compared favorably with returns on stocks (4.0%) and bonds (6.7%).¹

In our view, the outlook for commercial real estate is bright. Despite global headwinds, the U.S. economy is fundamentally sound, supported by a resurgent consumer and housing market, and lacking in acute imbalances (e.g., inflation or asset bubbles) that have precipitated past recessions. While supply is increasing, it is generally doing so at a measured and sustainable pace, allowing absorption to propel occupancies and rents. Cap rates are historically low, but they are elevated relative to interest rates. Accordingly, we expect that unlevered total returns to core real estate will average 6%-8% in 2016 and annually through 2020, down from the double-digit levels of recent years, but on a par with historical levels on an inflation-adjusted basis.

While our real estate outlook is favorable, there is no denying that after six years of strong returns, we have entered a more mature phase of the cycle. Construction, although generally subdued, has emerged as a risk in certain corners of the market. Our sector and market allocation strategies account for these emerging supply-side risks, among other factors.

1.1 Sector Allocations

We believe that fundamental drivers and risks currently favor the industrial sector and to a lesser extent the office and retail sectors, while we are more cautious toward the apartment sector.

- **Industrial (Overweight):** E-commerce fulfillment has been a boon to warehouse demand, which is expanding at nearly double its historical pace. We believe this trend has further to run and will receive additional support from more traditional drivers including imports and housing activity. Construction is accelerating, particularly for large, modern warehouses in national distribution hubs. However, it is generally not keeping up with demand, and smaller, well-located facilities close to urban population centers are becoming especially scarce.
- **Office (Market-weight):** On an absolute return basis, the case for Office is compelling. Vacancy rates are at a 15-year low, rents are rising briskly, demand is accelerating on the back of strong office-using job creation, supply remains disciplined in most markets, and leases are rolling up to rent levels that are on average 20% above those prevailing five years ago, coming out of the financial crisis.² Despite these positive attributes, we assign a market weight to the sector in view of its historical volatility, which tempers its appeal on a risk-adjusted basis.
- **Retail (Market-weight):** The challenge to retail real estate from e-commerce has been well documented. However, an expanding population and a growing taste for services that cannot be delivered online (e.g., dining, health care, fitness, etc.) is fostering demand for well-configured retail space in the right locations. Meanwhile, retail construction is virtually absent. Finally, we recognize that as the property type with the lowest cyclical volatility (thanks to long leases and the durability of necessity-based consumption), the retail sector can help to mitigate downside risks to a portfolio.
- **Apartments (Underweight):** Apartments performed very well coming out of the financial crisis, as households (particularly Millennials) eschewed homeownership due to stringent mortgage lending, an overhang of student debt, and shifting lifestyle preferences. However, the sector has underperformed the NPI over the past one, three, five, 10, and 20 years, in part due to its lower income returns.³ While we believe that apartment demand will remain healthy for the foreseeable future, it may moderate as the oldest Millennials enter their

¹ NCREIF (real estate); Standard & Poor's (stocks); Barclay's U.S. Aggregate (bonds). Data as of June 2016.

² CBRE-EA. Data as of March 2016.

³ NCREIF. Data as of March 2016.

mid-30s. More troubling is the large influx of new supply that has begun to come on line in virtually every market in the country. Accordingly, we assume an underweight position to the sector.

1.2 Market Allocations

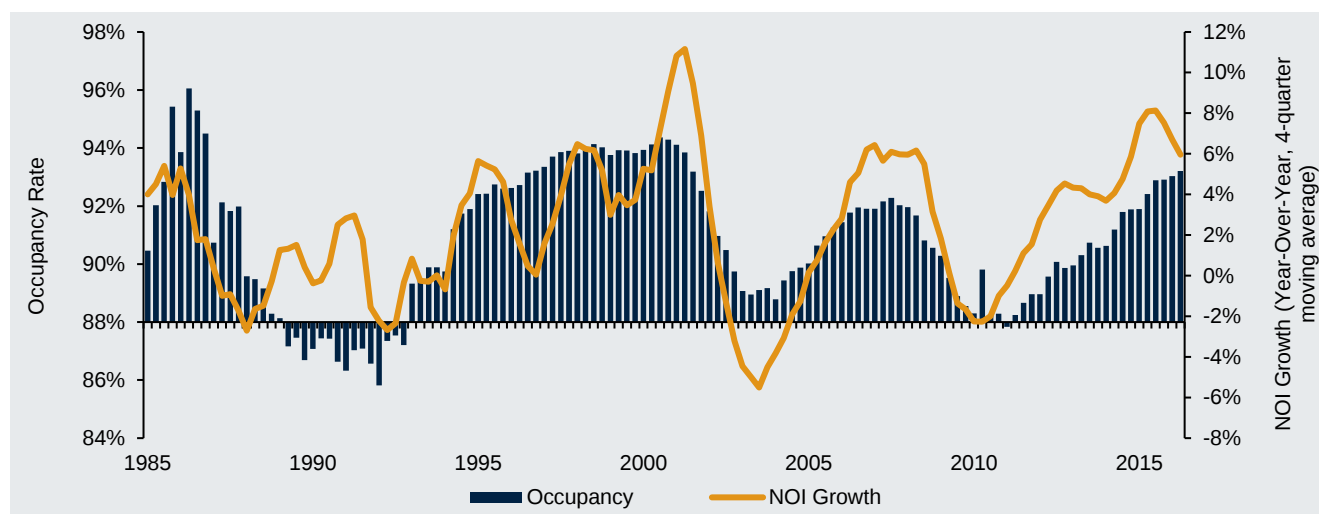
From a strategic perspective, we continue to favor large, coastal, “gateway” markets (e.g., Boston), which have produced stronger rent and price appreciation over time while providing superior liquidity. Conversely, we are wary of smaller markets with poor demographic trends (e.g., some cities in the industrial Midwest), which have generally underperformed over the long term. Nevertheless, current market conditions warrant some modulation around this general posture. Specifically:

- **Gateway Markets:** Prices have risen substantially in several coastal markets. We remain optimistic toward Los Angeles and Boston, where fundamentals are on a strong footing. However, we are more cautious toward markets with weaker or riskier fundamentals, including San Francisco, New York, and Washington D.C. (albeit with important property-type exceptions).
- **Regional Markets:** Our most favored markets are generally smaller coastal cities that share some of the natural supply barriers of gateway markets but with yields that are somewhat higher, including Portland, Oakland, Orange County, San Diego, Fort Lauderdale, and to a lesser extent, Seattle and Miami. Meanwhile, our view of inland markets is mixed: in traditional fashion, a few are at risk of oversupply (e.g., Charlotte, Austin, and Houston), while others are more balanced (e.g., Atlanta and Phoenix).

2 Commercial Real Estate Fundamentals

U.S. commercial real estate (CRE) fundamentals have rarely been stronger. According to the NPI, in the second quarter 2016 occupancy levels and Net Operating Income (NOI) growth were near their highest since 2001 (see Exhibit 1). Commercial real estate’s robust performance is all the more remarkable given the pedestrian pace of economic growth. We believe that fundamentals will remain firm for the next several years, supported by a prolonged (albeit temperate) economic expansion and a generally moderate supply pipeline.

Exhibit 1: NPI Occupancy and NOI Growth

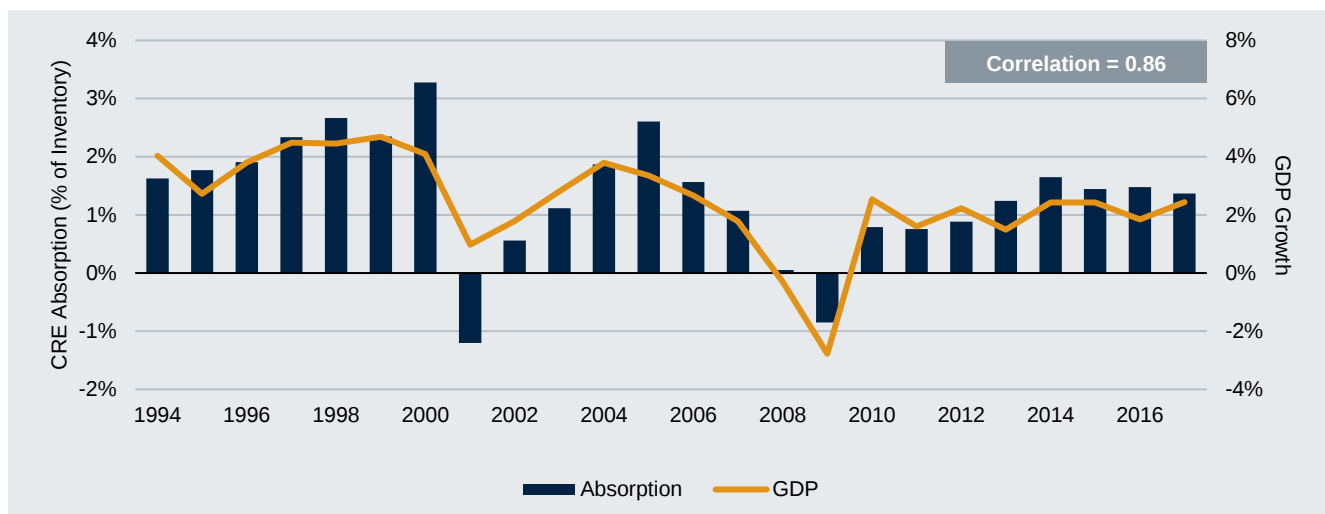


Source: NCREIF. Data as of June 2016. Past performance is not indicative of future returns.

2.1 Economic and Structural Demand Drivers

Absorption across the apartment, office, retail, and warehouse sectors has closely tracked the economy over time, advancing (as a share of inventory) at roughly half the pace of GDP growth (see Exhibit 2). Economists have lamented the mediocre pace of the post-financial crisis expansion, with GDP growth averaging 2% compared with 3% in the 2000s and 4% in the 1990s.⁴ The recovery of CRE demand has also been somewhat weaker. However, since 2013 demand has increased slightly faster than economic growth alone would imply, courtesy of a declining homeownership rate (supporting apartments), strong job growth (office), and burgeoning e-commerce distribution (industrial).⁵ We believe that economic and structural support for absorption could remain firm at least through 2017.

Exhibit 2: GDP Growth and CRE Absorption



Sources: Bureau of Economic Analysis (GDP); CBRE-EA and Deutsche Asset Management (Absorption). Data as of March 2016.

Note: Absorption is equal-weighted across the Apartment, Office, Industrial, and Retail sectors. Past performance is not indicative of future returns.

The U.S. economy has weathered multiple headwinds over the past year, including weaker Chinese growth, a surging dollar, and financial-market volatility. The economy decelerated in late-2015 and early-2016 as manufacturing (about 15% of GDP) slipped into recession.⁶ A soft global economy and strong dollar will likely continue to weigh on exports, manufacturing, and corporate profits. However, housing and consumer spending, which together constitute about 70% of GDP, are resilient and may receive additional support from lower interest rates in the wake of the UK's "Brexit" vote.⁷ Home sales, prices, and construction are rising at a solid but sustainable rate of about 5% annually and household finances are in pristine condition, with balance sheets, debt service levels, and savings rates at their healthiest levels in decades.⁸

A note of caution: The yield curve has flattened in recent months, a move that has historically signaled economic slowdown. Some observers have discounted this indicator, arguing that quantitative easing and a flight to quality around the world have artificially suppressed long-term bond yields. While there may be some truth to this assertion, we are cautious about drawing too much comfort from it. Formidable global headwinds will likely cap GDP growth at a moderate 2% pace through 2017. Resurgent financial volatility, prompted by concerns around China, Brexit, Italian banks, geopolitics, or other factors, represents an enduring risk to the U.S. economy.

⁴ Bureau of Economic Analysis. Data as of March 2016.

⁵ CBRE-EA. Data as of March 2016.

⁶ Bureau of Economic Analysis and Deutsche Asset Management. Data as of June 2016.

⁷ Bureau of Economic Analysis. Data as of March 2016.

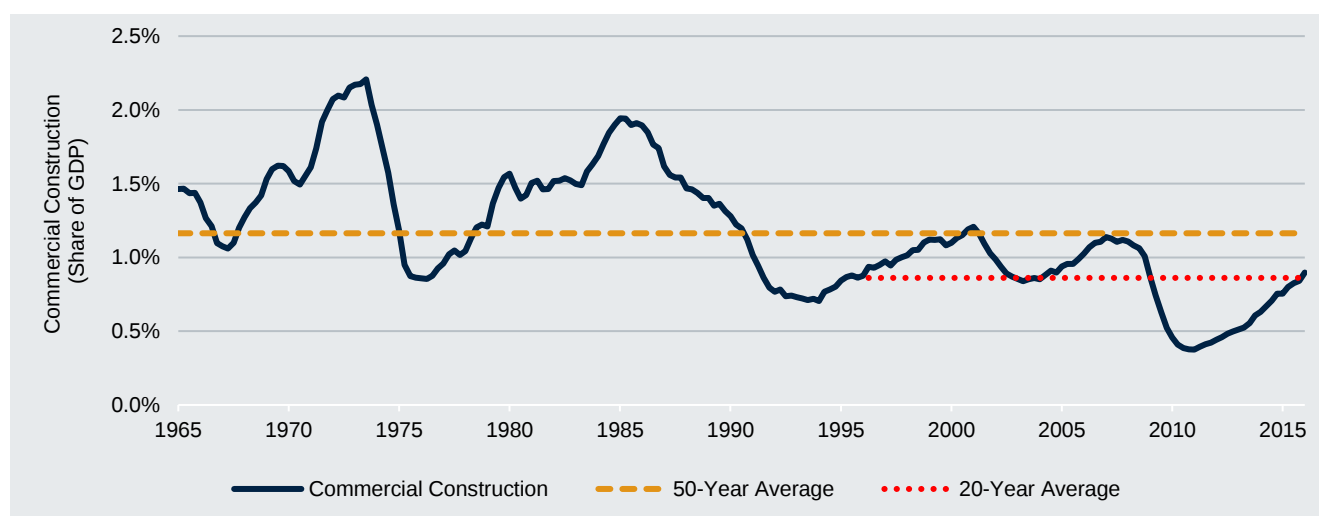
⁸ National Association of Realtors (sales); Case-Shiller (prices). Data as of May 2016.

Economic and structural forces are expected to support CRE demand, with some modest shifts around the margins: With the unemployment rate below 5%, job creation will likely ease from its heady pace of the past two years, even though population growth and low participation rates leave room for further gains. Slower job growth could temper office absorption, although intensifying competition for talent should underpin demand for quality space. A stabilizing homeownership rate (as Millennials in their mid-30s contemplate home-buying) may dampen apartment absorption. At the same time, a tighter labor market will likely put further upward pressure on wages, fueling consumer spending. Some brick-and-mortar retail will struggle to benefit as sales of goods move online, but necessity and service-oriented centers should fare well. And strong consumer spending, cheaper imports (thanks to the strong dollar), an expanding housing and home renovation market, and e-commerce distribution should support warehouse absorption.

2.2 Real Estate Supply

Real estate development is gathering momentum, but it remains generally under control both relative to demand and historical levels (see Exhibit 3). On a national basis, construction of multifamily and commercial space totaled 0.9% of GDP in the first quarter 2016, in line with its 20-year average (0.8%) and close to the lows set in 1994 (0.7%) and 2001 (0.9%).⁹ To be sure, aggregate national numbers overlook pockets of potential oversupply: multifamily starts have reached their highest levels since the 1970s and a handful of office markets are at risk.¹⁰ But in general, real estate conditions are balanced and appear poised to remain so.

Exhibit 3: Commercial Construction



Source: Bureau of Economic Analysis. Data as of March 2016

In our view the benign supply picture in part reflects the heterogeneous nature of the recovery. In many markets, prices have not increased enough to justify new construction (i.e., it is still less expensive to buy a building than to build one). In markets where prices have rebounded sufficiently, including several coastal metros, land constraints, rigid planning regimes, and labor shortages have delayed the supply response. Lenders have also been cautious about financing development: in its second quarter 2016 survey, the Federal Reserve reported that a net 25% of banks were tightening lending standards on commercial development loans, likely in response to stringent regulatory oversight.¹¹ These hurdles will lift over time: San Francisco, Austin, and Charlotte are expected to see a significant increase in office supply over the next two years. However, on a national basis the pickup is expected to be gradual.

⁹ Bureau of Economic Analysis. Data as of March 2016.

¹⁰ Census Bureau. Data as of May 2016.

¹¹ Federal Reserve Senior Loan Officers Survey. Data as of June 2016.

3 Commercial Real Estate Capital Markets

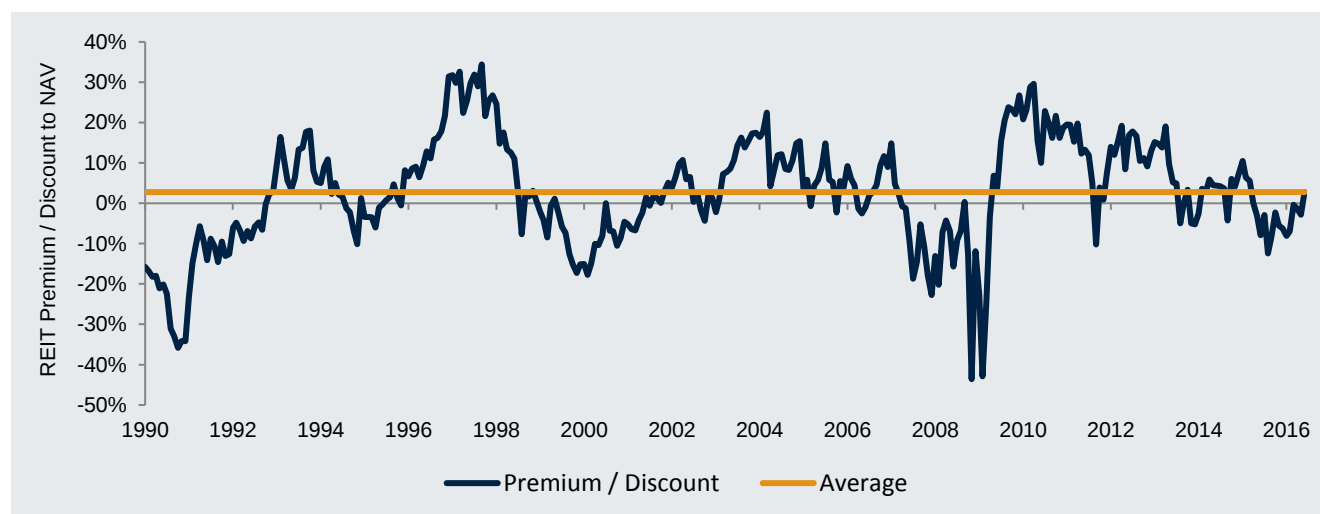
While commercial real estate generally exhibits a low correlation with other asset classes, it is not immune to broader capital-market forces. In the first quarter 2016, market turmoil stemming from concerns around China, the U.S. energy industry, and the pace of Fed rate hikes caused CMBS and REIT prices to slump, resulting in higher mortgage rates, accelerated REIT dispositions, and more generally, a sense of unease among some institutional investors. In the first half of 2016, transaction volume slumped 16% (year-over-year), the NPI posted its weakest quarterly returns since 2010, and some measures indicated that CRE prices plateaued on a national basis.¹² However, financial conditions improved markedly in the second quarter 2016, interrupted only briefly by the Brexit vote. While capital markets remain fluid, the outlook has tentatively improved since our Strategic Outlook in February 2016.

3.1 Public and Private Equity

Publicly-traded REIT prices slid nearly 20% from January 2015 through February 2016, punctuated by sharp declines in the summer of 2015 and the first six weeks of 2016. The drop was alarming for two reasons: First, publicly-traded REITs are sometimes considered leading indicators of the private real estate market (although their track record is mixed). Second, and more tangibly, the sharp increase in REITs' cost of equity created incentives for them to dispose of assets, either piecemeal or through wholesale privatizations. Indeed, REITs were net sellers of \$39 billion of real estate in the nine months to June 2016, the most since the REIT privatization wave of 2006 and 2007.¹³

Since February REITs have staged a remarkable comeback, rising to all-time peaks. Having traded at a steep 12% discount to net asset value (NAV) in September 2015, REITs closed the gap and edged to a premium over NAV (see Exhibit 4). While it may take a few months for this reversal to reverberate through transactions markets, it seems likely that it will quell REITs' drive to sell assets and might, if sustained, lead them to pursue acquisitions. At the very least, the rebound has allayed fears that REITs were signaling an impending correction in the private real estate market.

Exhibit 4: REIT Premium / Discount to NAV



Source: Green Street. Data as of July 2016.

¹² Real Capital Analytics (transaction volume); NCREIF (NPI); Moody's/RCA (CRE prices). Data as of June 2016.

¹³ Real Capital Analytics. As of June 2016.

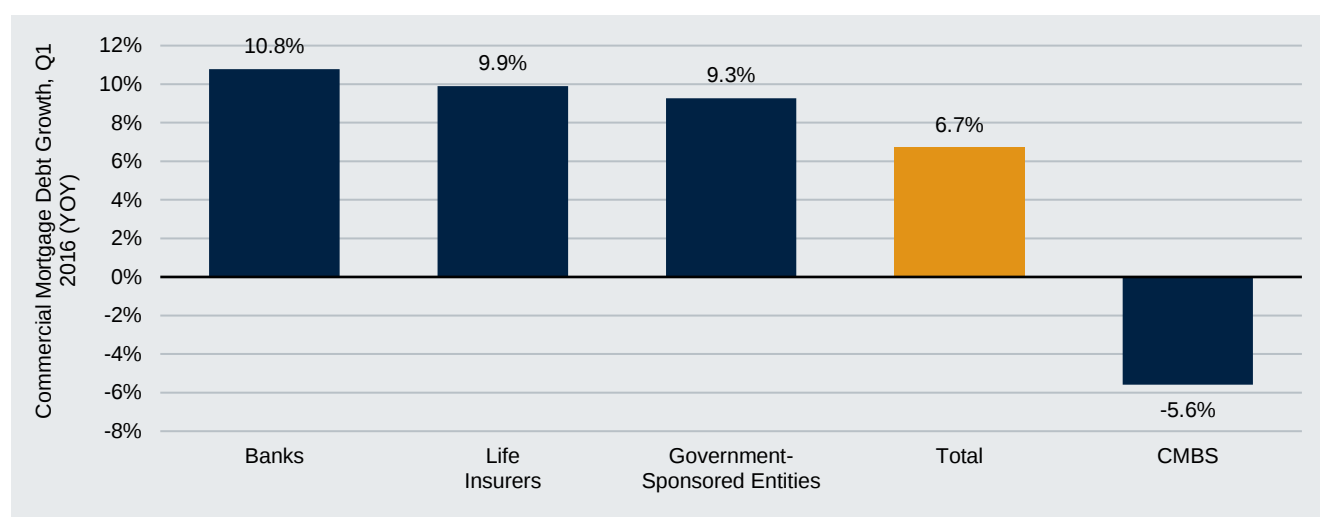
Domestic institutional investors were net buyers of real estate in the first half of 2016. As equity markets tumbled and credit spreads widened in January and February, fears mounted that investors would reverse course in order to rebalance portfolios — the so-called “denominator effect”. However, now that equity prices have bounced to all-time highs and fixed-income yields have retreated, it seems likely that any pullback will prove fleeting and could give way to stronger inflows.

Foreigners’ appetite for U.S. commercial real estate is undiminished. Direct cross-border investment (excluding capital channeled through domestic funds or REITs) accounted for 17% of transaction volume in 2015, double its 15-year average.¹⁴ In our view, several factors will continue to drive heavy foreign inflows, including negative interest rates in many developed economies, America’s relatively strong economy and reputation as a safe haven, and legislative changes that will exempt most foreign pensions from the Foreign Investment in Real Property Tax Act (FIRPTA).

3.2 Public and Private Debt

The volume of commercial (including multifamily) mortgage debt outstanding increased 6.7% year-over-year in the first quarter 2016, down slightly from 7.1% in the fourth quarter 2015 (see Exhibit 5). Mortgage growth was led by banks, which represent about 50% of the market. Life insurers and government-sponsored entities (primarily Fannie Mae and Freddie Mac) also aggressively expanded their mortgage books. The major outlier was CMBS, where outstanding balances declined 6% year-over-year: CMBS issuance of \$18 billion in the first quarter 2016, down from a quarterly average of \$24 billion in 2015, was not enough to offset the volume of securities that were retired (through maturity, prepayment, or default).¹⁵

Exhibit 5: Growth in Mortgage Debt Outstanding



Source: Federal Reserve. Data as of March 2016. Past performance is not indicative of future returns.

Prospects for the CMBS market are uncertain. CMBS spreads widened sharply at the beginning of 2016, as credit-market stress originating in the energy industry upended the broader bond market. As spreads increased, conduits curtailed originations, in part because they were less competitive with other debt providers but also to avoid the risk of incurring capital losses on loans pending securitization. CMBS spreads have narrowed substantially since February and reference rates have dropped as well, improving the economics of the CMBS business. However, the market faces two structural challenges: First, new risk-retention rules under the Dodd-Frank regulatory reforms that are scheduled to take effect in December 2016 will likely increase the cost and reduce the supply of CMBS loans. Second, the market faces \$112 billion of CMBS maturities in 2017, nearly double this year’s total, which will need to be refinanced or retired.¹⁶

¹⁴ Real Capital Analytics. Data as of March 2016.

¹⁵ CRE Finance Council. Data as of March 2016.

¹⁶ CRE Finance Council. Data as of June 2016.

The supply of private debt seems relatively secure. Bank regulators have expressed some concerns regarding banks' exposure to CRE loans (the Office of the Comptroller of the Currency has flagged a loosening of underwriting standards).¹⁷ Perhaps responding to such concerns, the Federal Reserve's second quarter 2016 loan officer survey indicated that banks are tightening lending standards on commercial mortgages, particularly in the multifamily space.¹⁸ Nevertheless, attractive margins on mortgage loans (4%-5%) relative to deposit rates (0%) create a powerful incentive for banks to continue to grow their portfolios.¹⁹

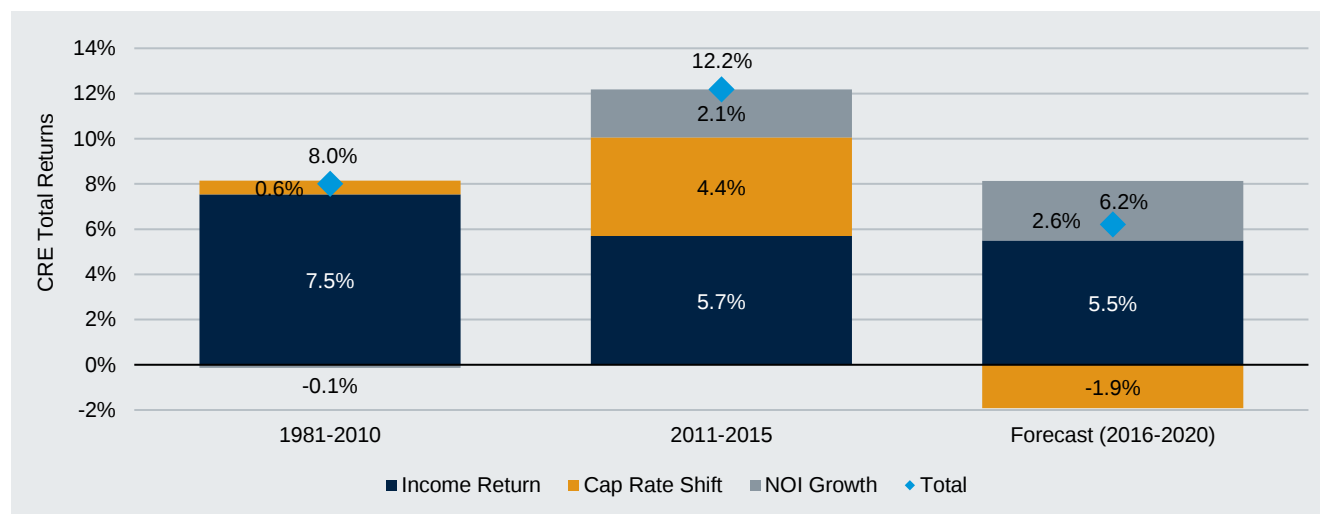
3.3 Commercial Real Estate Total Returns

The commercial real estate market cooled at the beginning of 2016 amid a turbulent financial environment. Still, the asset class performed well on both a historical and a relative basis. While NPI total returns of 10.6% (trailing four quarters) in the second quarter 2016 were down from 13.3% in 2015, they were in line with their 5-year average (11.9%) and well above their 10-year average (7.6%). Moreover, they compared favorably with returns on stocks (4.0%) and bonds (6.7%) over the year.²⁰

The near-term outlook for commercial real estate has improved somewhat over the past six months. While the economic environment is fluid, recent data suggests that growth has picked up from its winter lull. Real estate fundamentals are robust and NOIs are growing vigorously, even as corporate earnings sag. The financial stress that gripped markets earlier this year resurfaced briefly after the UK's Brexit vote, but has since receded. And interest rates have dropped to historic lows around the world, raising the potential for increased debt and equity flows, both domestic and foreign, into U.S. real estate.

We expect that total returns will moderate over the next five years but remain quite healthy on a relative basis (see Exhibit 6). Income returns will be weaker than in the past, reflecting today's lower cap rates. But NOI growth is expected to be much stronger, underpinned by low vacancy rates, persistent demand, and moderate construction.

Exhibit 6: CRE Total Returns



Source: NCREIF (history); Deutsche Asset Management (forecast). Data as of July 2016. Past performance is not indicative of future returns. No assurance can be given that any forecast or target will be achieved.

¹⁷ Office of the Comptroller of the Currency, "Semiannual Risk Perspective," July 2016.

¹⁸ Federal Reserve Senior Loan Officers Survey. Data as of June 2016.

¹⁹ Real Capital Analytics. Data as of March 2016.

²⁰ NCREIF. Data as of March 2016.

A key question concerns the future path of cap rates. Capital appreciation was driven more by cap rate compression than NOI growth over the past five years, as sentiment improved following the financial crisis. We believe that it is prudent to assume that cap rates will gradually increase over time as interest rates normalize to higher levels. Yet cap rate spreads to Treasuries are historically wide and have room to narrow. Were Treasury yields to double to 3% and spreads revert to their 20-year average, cap rates would increase by 50 basis points, subtracting 2% annually from capital appreciation. In this scenario, total returns would average 6.2% annually through 2020, nearly two percentage points below the average from 1981-2010, although only slightly lower on an inflation adjusted basis (4.2% versus 4.8%).

However, it is worth noting that market-based measures of interest rate expectations place 10-year Treasury yields in the 2%-2.5% range through 2020. If market expectations prove correct and fundamentals also remain intact, it is conceivable that cap rates could remain stable. In this scenario, total returns would average 8% annually (6% after inflation). While this is not our base case, it is an upside risk. In a low-yield, volatile financial environment, prospective returns of 6%-8% annually are competitive, we believe, with those available from other asset classes on a risk-adjusted basis.

4 Industrial Sector

4.1 Current Conditions

The U.S. industrial market has performed well in recent years and remains well positioned as cyclical and structural forces continue to benefit the sector. Industrial space demand remained strong this year, despite eroding global economic growth and mixed domestic manufacturing indicators. Healthy demand, vacancy and rent fundamentals have spread broadly across markets, particularly in the warehouse segment. National drivers and local economic growth are fueling strong conditions in gateway and primary inland logistics hubs as well as in smaller markets with healthy economies.

Declining vacancy rates have given rise to continued market rent growth and also a larger development pipeline, although new construction totals have yet to match demand levels. Net absorption for 2015 totaled 250 million square feet, compared to just 155 million square feet of new construction.²¹ Momentum in 2016 indicates a similar pace with 125 million square feet of net absorption and 74 million square feet of construction deliveries through mid-year.²² National availability declined 40 basis points in the first half of 2016, ending the second quarter at 8.8%. This was 90 basis points below last cycle's low and the lowest rate in the past 15 years. New demand as a percent of stock has consistently measured 1.9% per year since 2013, while the supply pipeline has slowly been increasing, reaching 1.2% in 2015.²³

Solid leasing fundamentals supported rent gains of about 5% over the past year.²⁴ On average, national market rents are 23% above recessionary levels and at or above 2007 peak levels for new warehouses.²⁵ The strongest markets have been Northern and Southern California, New York/New Jersey, South Florida, and Seattle.

A maturing growth cycle is bringing supply and demand into balance in inland hubs. Rising supply in Atlanta, Dallas, Chicago, Riverside, Denver, and Central Pennsylvania is expected to moderate near-term rent gains, but fundamentals should remain healthy. New supply has been heavily weighted to large bulk warehouses, but demand for smaller and mid-sized properties has also been strong, driving relatively sharp vacancy declines and rent gains.

²¹ CBRE-EA. Data as of June 2016.

²² CBRE-EA. Data as of June 2016.

²³ CBRE-EA and Deutsche Asset Management. Data as of June 2016.

²⁴ CBRE-EA and Deutsche Asset Management. Data as of June 2016.

²⁵ CBRE-EA. Data as of June 2016.

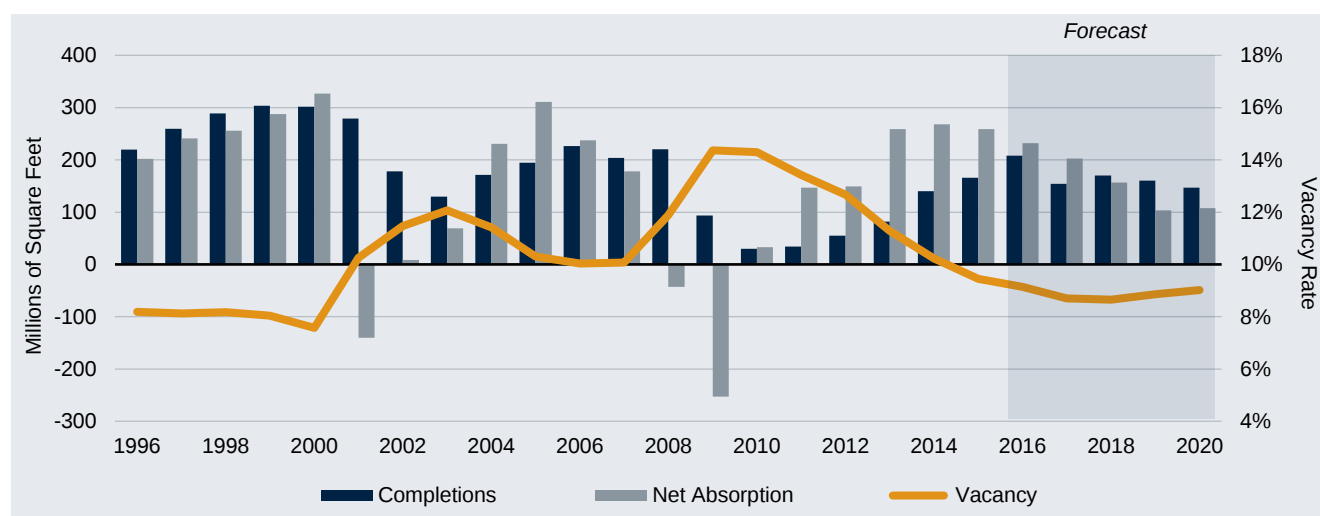
4.2 Outlook and Strategy

We anticipate favorable conditions in the industrial sector during our five-year forecast (see Exhibit 7). The availability rate is expected to decline through 2018 and then rise moderately. New supply should continue to ramp up, eventually surpassing demand levels. National availability is expected to reach a cyclical low of 8.6% in 2017. Market rent growth is forecast to average about 4.5% per year through 2017.

Increasing occupancy levels and above average rent growth through 2018 should support strong NOI growth and good mid-term total returns for investors. Longer-term rent growth is expected to moderate as new construction outpaces demand later in the decade. Elevated rents and sustained demand/supply balance should translate into high occupancies, stable cash flows and above-average total returns.

Modern logistics facilities stand to benefit not only from future economic growth but also from supply chain reconfiguration (the rise of e-Commerce and rapid fulfillment). Demand momentum is strong and forecast to outpace new supply in our near-term outlook. This should compress availability rates and allow for continued effective rent growth across most major markets. Sustained demand and capital market pressures will drive increased development as the cycle matures, but overall we think relatively balanced market conditions will persist. Developers have taken a more conservative tack in this cycle, generally kicking off new starts after achieving lease-up of existing stock.

Exhibit 7: Industrial Fundamentals



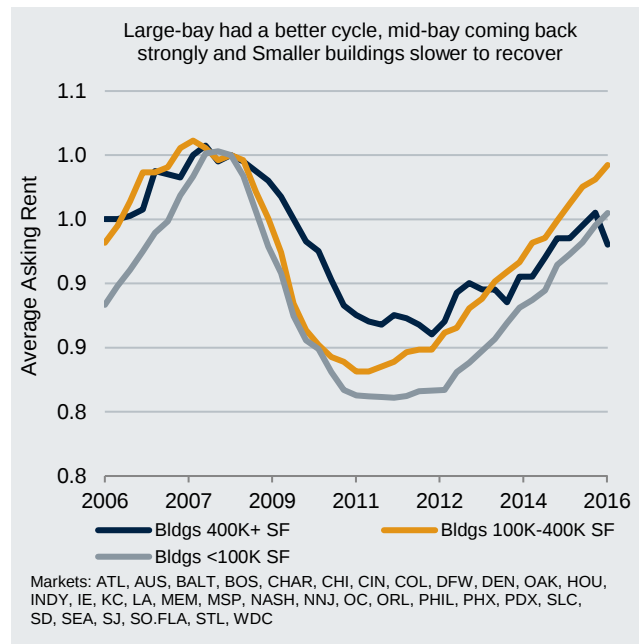
Source: CBRE-EA (history); Deutsche Asset Management (forecast). Data as of July 2016. No assurance can be given that any forecast or target will be achieved.

The national supply total is being elevated by outsized development activity in a few notable markets, such as Riverside, Atlanta, Dallas, Chicago and Houston. These five markets will account for about half of the national total in 2016. On the plus side, they also tend to exhibit consistently strong demand (except Houston). Labor constraints, increasing costs and economic uncertainty should serve to temper development compared to the mid-2000s.

While we hold a positive view toward the industrial sector overall, we note the following opportunities and risks:

- **Local/Regional warehouses:** Smaller and midsized warehouses, particularly in coastal markets, have performed well with solid demand momentum, rising rents and lower vacancy rates (see Exhibit 8). Market conditions for this segment are particularly strong in coastal markets, Denver, Austin, and infill submarkets of Chicago.

Exhibit 8: Vacancy and Rent Trends by Building Size



Source: Deutsche Asset Management; CoStar Analytics. Data as of March 2016.

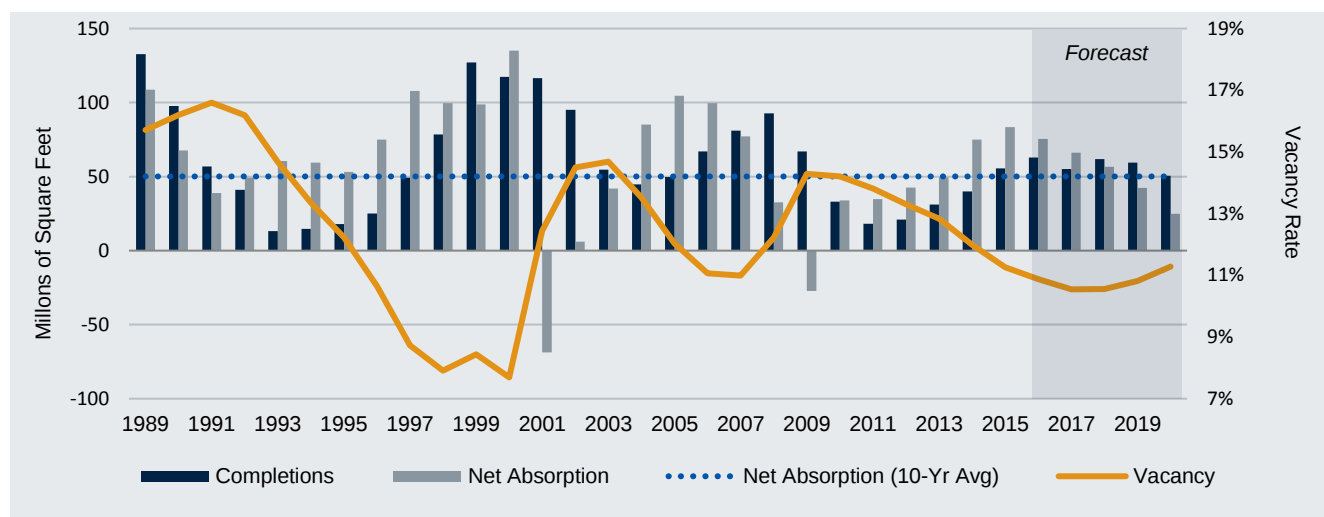
- **Class A Bulk Warehouse:** Prices for large stabilized Class A bulk warehouse properties have increased markedly in recent years, in some cases surpassing replacement cost. These assets, leased long-term to credit tenants, can provide stable cash flow, but are generally underwritten to lower total returns. Target Class A assets in core submarkets where in-place rents are below current market levels.
- **Leasing-up / Development:** In the context of healthy fundamentals, build-to-core should provide solid returns and a way to access scarce modern assets. Supply risks are rising in Dallas and Atlanta, but conditions are more favorable in New York/New Jersey, South Florida, Southern California, San Francisco Bay Area, Denver, Austin, Seattle and Portland.
- **National Distribution Hubs:** The major national distribution hubs, many of which have strong links to international trade (e.g., Atlanta, Riverside, Los Angeles, Chicago, New York, and Northern New Jersey) remain investment targets. While pricing is competitive and these markets are receiving a disproportionate share of new supply, they are expected to continue to post strong demand growth.
- **Underperforming Markets:** The current development pipeline in Dallas could outpace demand, causing vacancy to rise and rent growth to taper amid leasing competition. Additionally, we would generally avoid markets where local demand drivers are impaired and vacancy rates are high, specifically in Baltimore and Washington D.C. Notably, Houston has experienced availability rate increases in the past few quarters and fundamentals are expected to weaken further in the near term.
- **Non-Warehouse:** We maintain an underweight to high-finish industrial property, including light industrial/flex, office/service, manufacturing and smaller business parks. Although conditions stand to improve in this growth cycle, over the longer term, they are tied to weaker segments of the economy and tend to be more expensive to lease and maintain than warehouses. We are highly selective in targeting research & development (R&D)/Office in only a few high-barrier markets that have good growth dynamics and/or tech drivers, such as San Jose, Oakland, Seattle, Orange County and Miami.

5 Office Sector

5.1 Current Conditions

Indicators during the last six months show a disciplined and fundamentally strong national office market. Alongside healthy job gains dominated by office-using sectors, the office market showed positive but modest improvement. Vacancy at the end of 2015 was 11.3%, on a par with the previous cyclical trough of 11%.²⁶ Effective rents increased 3.8%, slightly less than in 2014 (see Exhibit 9).²⁷ During the last cycle, as vacancy declined to the 10%-range, effective rents spiked 14.1% over two years.²⁸ Amid increased financial volatility in early 2016, businesses appeared to delay action on leases, particularly early renewals or expansion options, translating into a modest slowdown in occupancy and rental momentum.

Exhibit 9: Office Fundamentals



Source: CBRE-EA (history); Deutsche Asset Management (forecast). Data as of July 2016. No assurance can be given that any forecast or target will be achieved.

Supply-side dynamics also continue to underscore discipline in the office markets. Nearly 180 million square feet are slated to deliver during the next two to three years, adding less than 1% to office stock annually compared with a 1.6% average annual increase during the last 15 years.²⁹ Supply risk has materialized in some markets, but these markets have other vulnerabilities. San Francisco, Seattle and Austin, for instance, all have large pipelines but also have overweight exposure to high-technology. Much of the riskiest speculative supply is in CBD markets, where the expansion has been strongest.

CBD markets continue to outperform suburban markets, but with the majority of CBDs across the U.S. nearing or at equilibrium occupancy, growth is slowing. CBD absorption pulled back to 1.3% of stock in 2015 from 1.7% in 2014.³⁰ In contrast, suburban absorption continued on an upward trajectory to 1.9% of stock, up 50 basis points from 2014.³¹ Rents are responding. During the first quarter, the CBD to suburban office rent premium narrowed 60 basis points (see Exhibit 10). While still a ways off from expansion mode, select urbanized, high-amenity suburban markets are beginning to benefit from demand squeezed out or priced out of proximate CBDs. Total returns on a rolling four-quarter basis through first quarter showed a narrowing in spread, with CBD just 50 basis points over suburban, compared with a long-term historical spread of 100 basis points.³² Suburban markets also showed a wider spread relative to the long-term average than CBD markets.

²⁶ CBRE-EA & Deutsche Asset Management. Data as of July 2016.

²⁷ CBRE-EA. Data as of July 2016.

²⁸ CBRE-EA. Data as of July 2016.

²⁹ CBRE-EA & Deutsche Asset Management. Data as of July 2016.

³⁰ CBRE-EA. Data as of July 2016.

³¹ CBRE-EA. Data as of July 2016.

³² NCREIF. Data as of July 2016.

Exhibit 10: CBD Premium to Suburban Rent



Source: CBRE-EA. Data as of July 2016.

San Francisco Bay area office markets continue to show the most robust growth, with San Jose and Oakland as top performers. Oakland boasted the highest rent growth (14.7%) while San Jose recorded the highest total return (16.7%).³³ While not without risk, high-tech dominated markets Austin and Seattle also outperformed, and Sun Belt cities Atlanta, Miami and Charlotte showed strong returns and rent growth. Houston continues to drop off due to energy-related contractions eroding absorption.

5.2 Outlook and Strategy

Our outlook for the national office market is positive, and we believe there could be more runway for further growth. Themes that will perpetuate further improvement in the office market include waning densification, a return to growth mode, mixed-use development in urban fringe locations, and a need for more cost-effective locations. Together, these factors improve occupancy across CBD and parts of suburban markets.

Densification is present, but to a lesser degree as more common areas and huddle rooms are incorporated. Pushback to densification is also emerging, particularly in traditional office-using industries that are only recently showing more expansion. CBDs will benefit from increased absorption as densification lessens in intensity, which in turn will further tighten occupancy, expelling demand. Urban fringe locations in the most outer rings of the CBD into the suburbs that have been repositioned as live/work/play or 24/7 locations will be the primary beneficiary of demand outflow. Broader demand levels will create value across office markets, driving NOI growth for a wider range of properties. With the caveat that markets across the U.S. are at various points in their respective cycles, there are different implications to our investment strategy:

- **Gateway Markets:** Gateway markets (Boston, New York, Washington D.C., Los Angeles, and San Francisco) have outperformed over the long term. Higher barriers-to-entry allow rents and prices in these markets to continue growing in inflation-adjusted terms over time. That said, cap rates are currently at record lows relative to the broader U.S. office market, and do not necessarily compensate for some of the risk that is materializing in these cities. We are underweight New York, Washington D.C. and San Francisco. Concerns in these markets include high-tech vulnerability, cost-prohibitive rents, elevated supply pipelines and subdued absorption levels. Boston and Los Angeles, however, still offer opportunity for portfolios in need of exposure to these historically strong markets. Value-add and development projects in “A” locations, and class A buildings in vibrant “urbanized” submarkets with transit access to the CBD remain the most advantageous asset types. Although suburban markets are recovering, we would continue to avoid class B or value-add investment, and any investment in suburbs without adequate transit connections.

³³ NCREIF (total returns); CBRE-EA (rent growth). Data as of July 2016.

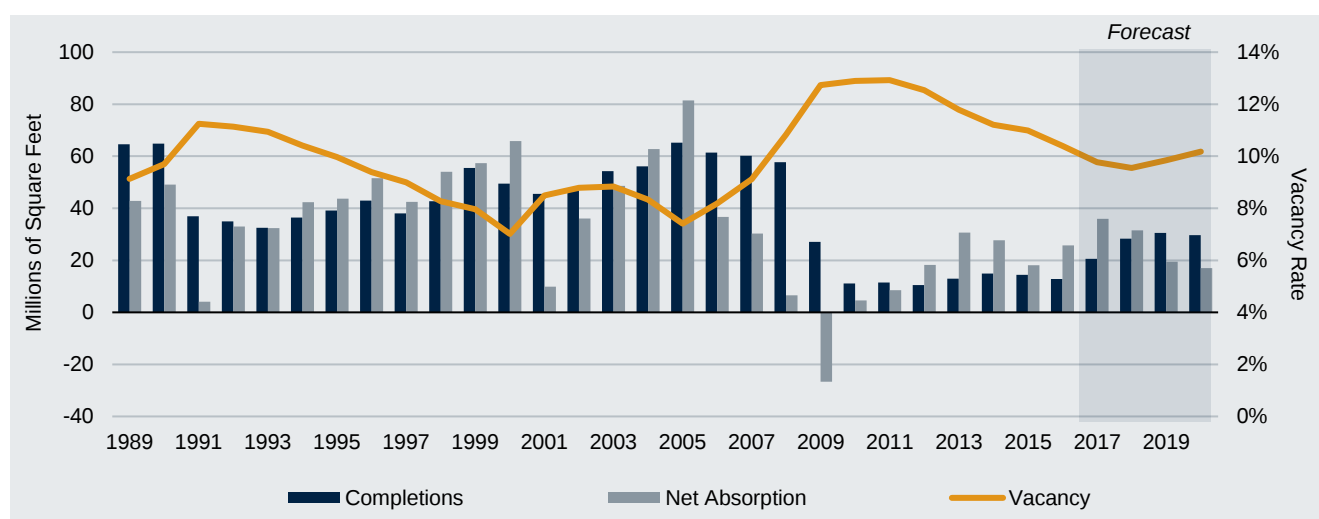
- **Regional Markets:** Regional (i.e., non-gateway) markets generally feature lower physical and regulatory barriers to new development; oversupply has therefore been both a risk and a source of inferior returns in many of these markets historically. Charlotte, Dallas, Austin and Houston are the most vulnerable today, where we believe demand may not match the pace of supply coming online. Yet, several markets have been disciplined in new office development in spite of accelerating demand. Orange County, Portland, Atlanta, Fort Lauderdale and Miami offer the opportunity to capture higher yields and capitalize on NOI growth through targeting best-in-class assets in “A” locations, including high-amenity, “urbanized” submarkets with a strong multifamily component.

6 Retail Sector

6.1 Current Conditions

Retail fundamentals continue to improve across the nation, helped by low levels of new construction. The availability rate at neighborhood and community centers ended the first quarter 2016 at 11.0%, a decline of 30 basis points (bps) from the third quarter of 2015 (see Exhibit 11). Availability has declined approximately 200 bps since peaking in early 2010 and is now below its 10-year average of 11.3%. Vacancy contracted in more than half of the 45 markets we track (year-over-year) and rents have increased in 36 of them.³⁴

Exhibit 11: Retail Fundamentals



Source: CBRE-EA (history); Deutsche Asset Management (forecast). Data as of July 2016. No assurance can be given that any forecast or target will be achieved.

Rent growth has been slow to take hold during this modest recovery, with rents up 1.6% over the past year. Miami, San Francisco, Austin, San Jose, and Seattle were the top performing metros with rents growing 3% - 5%.³⁵ In earlier outlooks, we recognized a performance gap between productive class A centers and less productive class B/C properties with low occupancy. Rent growth has now spread beyond the most productive assets and more markets and centers are participating in the recovery. While we believe this gap is narrowing, there are still a number of centers that will continue to struggle due to deteriorating demographics and weak anchors.

A lack of new retail construction is the primary factor that is differentiating retail's recovery from that of other sectors. On average, retail stock rose at a rate of 2.0% annually as a percent of inventory from 1994-2008; however, from 2009 to 2015 additions to new supply have averaged just 0.5% annually,³⁶ well below population growth and household formations. This virtual halt in construction activity is allowing for even modest population-driven demand to gradually absorb existing retail vacancy. We expect that household formations will pick up further, releasing pent-up demand for retail goods.³⁷

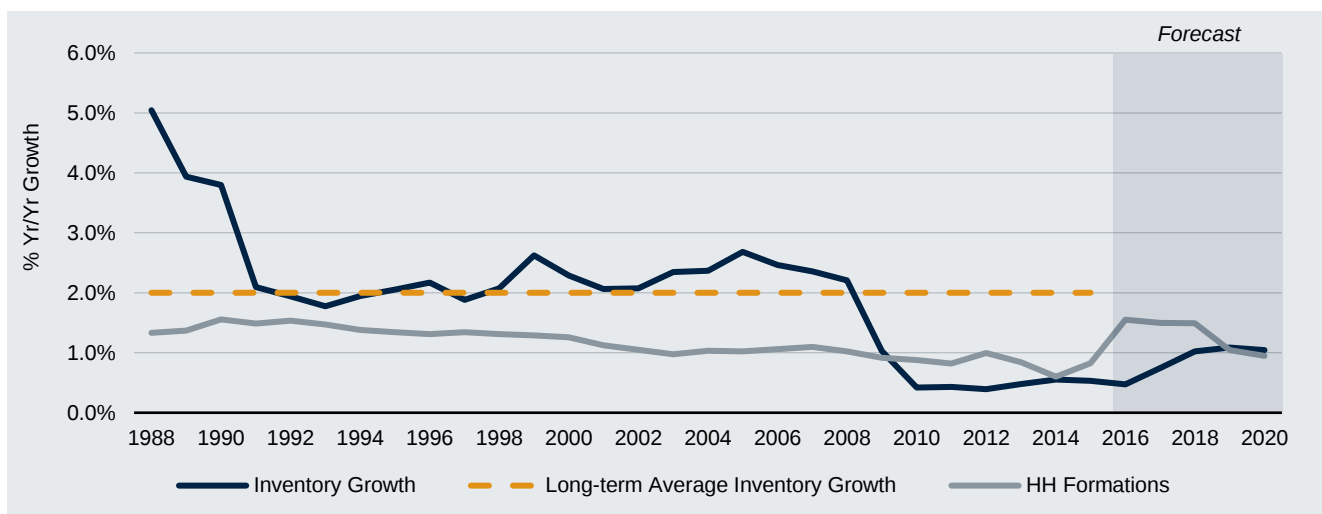
³⁴ CBRE-EA; Deutsche Asset Management. Data as of March 2016.

³⁵ CBRE-EA; Deutsche Asset Management. Data as of March 2016.

³⁶ CBRE-EA; Deutsche Asset Management. Data as of March 2016.

³⁷ Moody's Analytics; Deutsche Asset Management. Data as of July 2016.

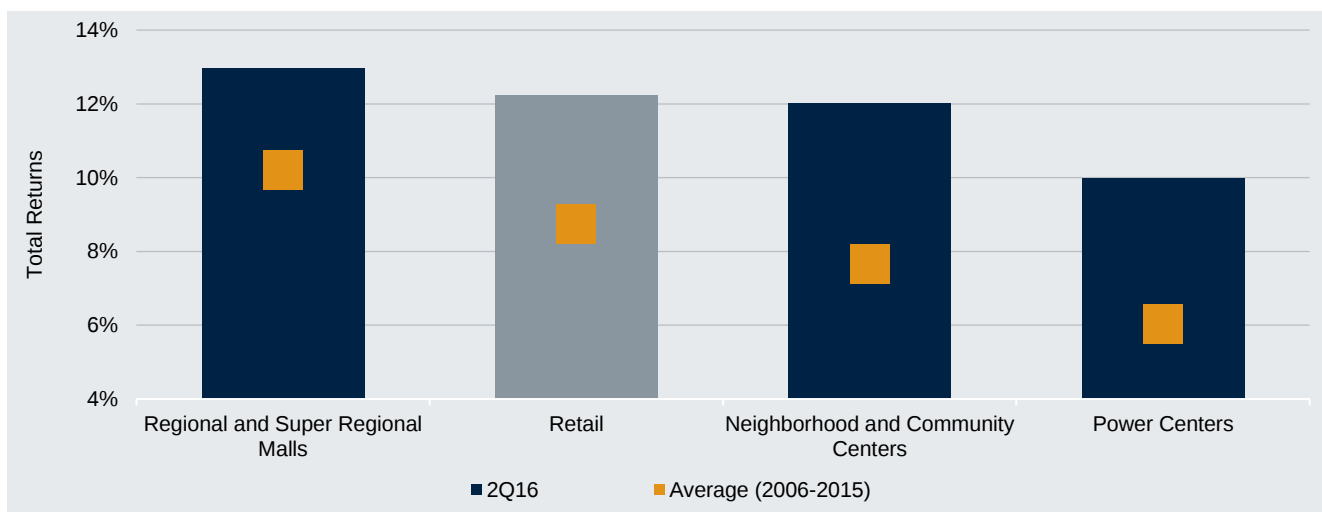
Exhibit 12: Household and Retail Inventory Growth



Sources: CBRE-EA (inventory); Moody's economy.com (households). Data as of June 2016. No assurance can be given that any forecast or target will be achieved.

Strengthening fundamentals continue to support investment returns (see Exhibit 13). Regional and super regional malls returned 12.9% (trailing four quarters) in the second quarter 2016, followed by neighborhood and community centers (12.0%) and power centers (10.0%).³⁸

Exhibit 13: Total Returns by Retail Sub-Type



Source: NCREIF. Data as of June 2016. Past performance is not indicative of future returns.

From a geographic perspective, the high-growth and tourist markets of Miami, Phoenix and Orlando delivered the highest investment returns over the past 12 months. Other top performers included Washington, DC, Riverside, and San Diego. Returns in the global gateways of New York, Boston and Los Angeles lagged the sector benchmark.³⁹

³⁸ NCREIF; Deutsche Asset Management. Data as of March 2016.

³⁹ NCREIF and Deutsche Asset Management. Data as of March 2016.

6.2 Outlook and Strategy

Our outlook for the retail sector remains optimistic as current conditions for consumers are supportive of future growth in spending. Low gas prices, rising home values, low interest rates, improving labor market conditions, and rising incomes should provide for moderate growth of retail sales. Retail sales in June marked a solid rebound after a slow first quarter, pointing towards stronger growth in the second half of the year.⁴⁰ While consumer spending has gathered momentum, the growing share of sales going to pure-play e-commerce players from traditional brick and mortar stores has created fierce retailer competition. Spending shifts into consumer segments that fall outside of malls and shopping centers are also pressuring traditional retailers' bottom lines. However, we do see positive momentum in retail demand drivers going into the crucial back to school and holiday shopping seasons.

Our forecast for shopping centers calls for sustained recovery with accelerating gains over the next two to three years as retailers continue to adjust, strengthen and strategically expand. While we do not expect to see the demand levels recorded in the previous two cycles, we are expecting to move into a more balanced market. Over the next five years, we expect new construction to remain well below the historical average at less than 1% of stock annually. As a result of improving demand and limited new construction, vacancy is forecast to fall under its historical 25-year average of 10% by 2017 and remain at or below the 9%-10% range through 2020. Rent growth will generally correspond with strengthening occupancy and retail sales; however, prior peak rents will not likely be reached in the majority of metros until 2019 or later.⁴¹

Our retail strategy remains largely focused on class A product, as we believe the most dominant properties that garner a large share of retail sales today within a trade area will be the most competitive, flexible, and durable over the long term. These properties are likely better positioned to provide future opportunities to add high-quality tenants. Additionally, class B centers in excellent locations with a clear path to growth, such as additional construction of single and/or multifamily homes, hotels or office space, may be prime targets for repositioning. Selectivity is important as the cycle matures. We favor areas which are densely populated, where growth is already visible, where other demographic factors (e.g., education and income levels, household size) are improving, or where there is a notable shortage of a specific retail offering.

A relevant tenant mix is the critical draw of a shopping center. We favor retailers with a strong omni-channel strategy where the online presence complements the physical store strategy to better service and reach customers. It is important to be realistic about tenant health ratios and the rent increases tenants can absorb.

Other key elements of our retail strategy include:

- **Grocery-Anchored Retail:** Traditional grocery-anchored centers offer durable customer traffic; updated uses such as entertainment, quick service restaurants, fitness and health/wellness concepts also act as complementary anchors, providing additional drawing power and cross-traffic. We believe these types of centers will be more insulated from e-commerce due to the service oriented, necessity-based or daily needs merchandising of their products.
- **Malls:** Dominant malls catering to well-heeled consumers may continue to draw best in class tenants. However, they are not immune to e-commerce risks, particularly to traditional department store anchors. To the upside, replacing these stores with new tenants at higher rents could drive NOI growth, although the capital expenditures necessary to do so could be onerous.
- **High Street:** A strong dollar and weakening global growth could hamper international travel and spending, reducing traffic and sales in High Street retail districts. Yet the pull and visibility of these locations underscore the long-term viability of the subsector. Uncertainty may energize a flight to quality and push luxury and best-in-class retailers to the most dominant shopping districts in top international gateways, while retailer expansion in secondary locations may slow.
- **Power Centers:** We continue to underweight power centers, which typically feature chain stores selling goods readily available online, and are therefore vulnerable to store closings, bankruptcies, and downsizings.

⁴⁰ Department of Commerce. Data as of July 2016.

⁴¹ CBRE-EA (history); Deutsche Asset Management (forecast). Data as of March 2016.

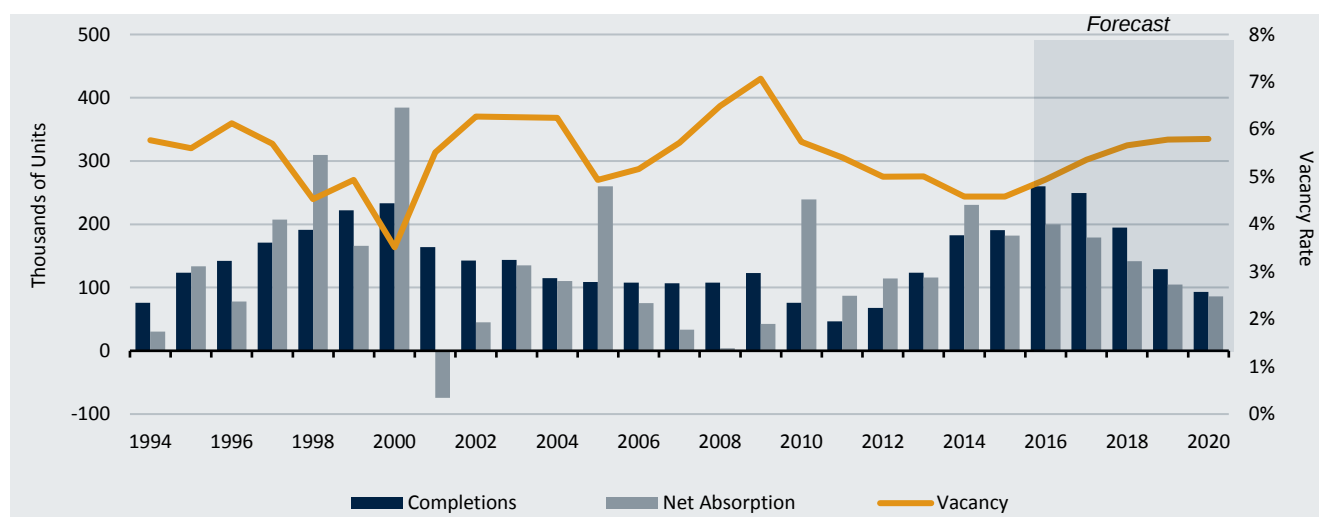
7 Apartment Sector

7.1 Current Conditions

The apartment market remained tight in early 2016, but signs that the sector is moving towards the mature stage of the cycle continue to emerge. The nation's vacancy rate was 4.4% at mid-year, up 10 basis points from a year earlier, the first increase since late 2009.⁴² While vacancy remains near its lowest level since 2000, rent growth likely peaked last year. Despite these signs, investors continue to covet the stable cash flow that apartments provide, keeping yields at historic lows.

Demographics and lifestyle preferences that have delayed homeownership still support strong apartment demand, as does steady job growth. Nearly 29,300 units were absorbed in the first quarter of 2016, the highest figure for a first quarter since 2010.⁴³ Homeownership remains near its lowest point in several decades.⁴⁴ We believe the homeownership rate has likely bottomed, but should remain at current levels for several years. The housing market is improving, but inventory is low, especially for homes that would be affordable for much of the prime renter cohort currently living in apartments.⁴⁵ This should restrict any large outflows of renters into homeownership. Moreover, according to the Nielsen Company, 62% of Millennials prefer to live in mixed-use communities found in urban centers, closer to shops, restaurants, and the office.⁴⁶ Low homeownership and demand for city living has led to a wave of apartment construction projects as developers have rushed to capitalize on demand. Multifamily permits totaled 428,061 units in the 12 months ending May 2016, compared to 398,648 units over the previous 12 months.⁴⁷ Metros with a significant annual increase in permitting include Dallas, Atlanta, Denver, Orange County, Portland and San Diego.

Exhibit 14: Apartment Fundamentals



Sources: CBRE-EA (history); Deutsche Asset Management (forecast). Data as of June 2016. No assurance can be given that any forecast or target will be achieved.

Despite increases in apartment completions over 2014 and 2015, renter demand was strong enough to push effective rent growth higher. However, new supply and elevated rent levels are already impacting rent growth. After reaching 5.2% (year-over-year) in mid-2015, growth decelerated to 3.5% in June 2016 as a wave of new supply delivered and rent level fatigue set in, especially within CBDs.⁴⁸ Markets where rent growth slowed markedly in the first half of 2016 include San Francisco, San Jose, Oakland, Portland, Denver, New York and Boston. In particular, downtown submarkets in many major metros saw rent growth pull back significantly. Meanwhile, rent growth remained quite robust in suburban submarkets which have not experienced the same level of supply growth as

⁴² CBRE Econometric Advisors. Data as of June 2016.

⁴³ CBRE Econometric Advisors. Data as of March 2016.

⁴⁴ Census Bureau. Data as of April 2016.

⁴⁵ National Association of Realtors. Data as of June 2016.

⁴⁶ Nielsen Company. Data as of January 2016.

⁴⁷ Census Bureau. Data as of June 2016.

⁴⁸ Axiometrics. Data as of June 2016.

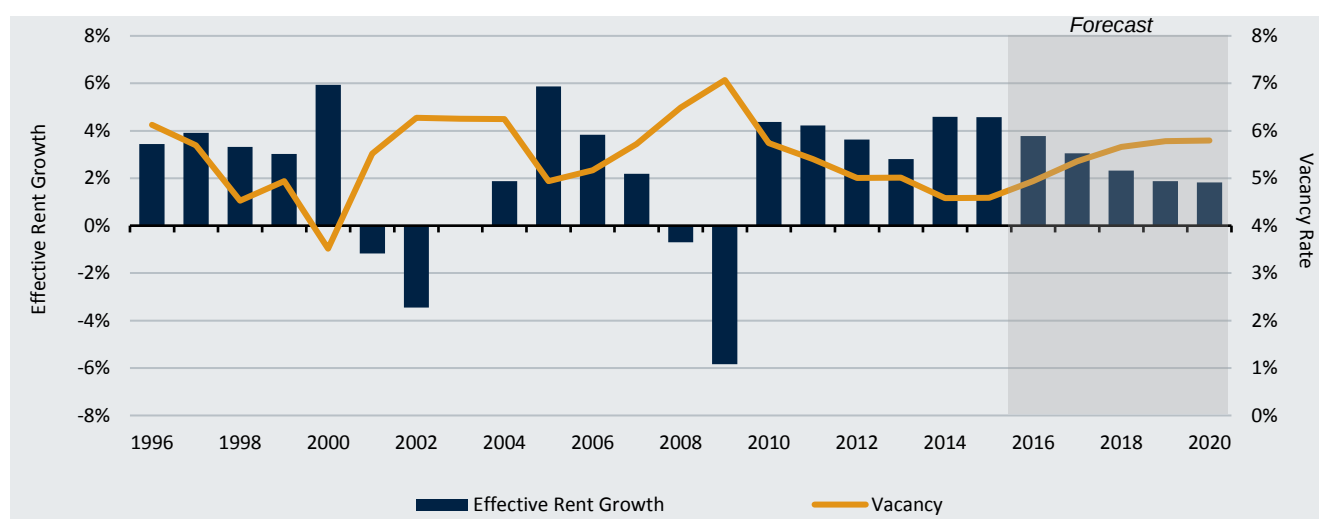
CBDs. Softening fundamentals in downtown submarkets have not deterred investors: we estimate that the average going in cap rate for urban core product remains at 4.5% in our 26 investable markets, with many prime assets trading under 4.0%.⁴⁹ The lofty prices investors are willing to pay for CBD assets helps explain why developers continue to build downtown despite softening fundamentals. These neighborhoods are potentially at risk of further supply build-up in the outer years of our forecast if pricing does not adjust.

NPI total returns for the apartment sector slowed to 10.9% (trailing four quarters) in the first quarter 2016 from 12.0% as of late 2015.⁵⁰ Western metros have been the primary outperformers: Oakland, Denver, Portland, Riverside, San Jose, San Francisco and Orange County all exhibited total returns of 16% or more over the past year. In contrast, several slower growth Midwest and East Coast markets, along with Houston, made up a majority of the underperformers with total returns in the single digits. Among apartment property subtypes, garden apartments were the top performers, returning 13.9% over the last year. Despite their popularity with investors, high-rise properties lagged behind, returning 9.3%, 200 basis points below the subtype's 5-year average annualized return.

7.2 Outlook and Strategy

While favorable macro trends should continue to sustain healthy renter demand, it is unlikely to offset the expected flood of new supply. New deliveries are projected to average 234,000 units per year from 2016 to 2018 – 74% above their long-term annual average of 137,000 units.⁵¹ Still-healthy net absorption will likely not keep pace and as a result, vacancies are forecasted to increase. Upward pressure on vacancy is projected to cause rent growth to moderate. As many major coastal markets exhibit decelerating rent growth, late-recovery Sunbelt markets are expected to take the lead. By the later years of the forecast, continued deliveries, competition with home-buying and moderating payroll expansion will likely push vacancy above historic averages to the upper 5% range and cause rent growth to slip below 2% per year (see Exhibit 15).

Exhibit 15: Apartment Vacancies and Rent Growth



Sources: CBRE-EA (history); Deutsche Asset Management (forecast). Data as of June 2016. No assurance can be given that any forecast or target will be achieved.

Slowing rent growth and rising vacancy, combined with very low yields, will likely limit apartments' ability to produce strong total returns relative to the other main property types. Given that many prime apartment markets are fully valued, attractive investment opportunities have become more limited, putting a premium on patience and selectivity when acquiring assets. Although we believe the prime markets should be viewed as strategic long-term performers, elevated pricing in these locations will likely constrain total returns in the near term.

⁴⁹ Deutsche Asset Management. Data as of June 2016.

⁵⁰ NCREIF. Data as of April 2016.

⁵¹ Deutsche Asset Management. Data as of June 2016.

- **Regional Markets:** With institutional and cross-border investors still favoring major gateway metros, select regional markets offer investors higher yields with the benefit of strengthening fundamentals. At this stage in the market cycle, several regional markets are exhibiting sizeable NOI gains. Additionally, we estimate that cap rates for core assets in the large Sunbelt markets are currently 50 to 100 basis points above those in prime coastal markets⁵². In particular, many Sunbelt markets that were battered from the housing bust now have strong economic and demographic tail winds bolstering demand. This includes metros such as Riverside, Phoenix, San Diego, Atlanta, and Fort Lauderdale. Moreover, these markets have benefitted from relatively limited supply pressure up to this point, though permitting is rising. Investors should target select regional markets with strong market fundamentals paired with positive economic and demographic trends.
- **Selectivity in the Urban Core:** Given the flood of new supply into CBDs, especially within the luxury segment, coupled with still elevated pricing and low yields, selectivity will be key for any downtown acquisition. Only the best located properties with unique amenities should be considered. Proximity to grocers, parks, trails, etc. will help distinguish a property from the plethora of competitors. Moreover, the flood of high-end product being delivered may have implications for rent levels across the spectrum. As this product is delivered, downtown markets will likely experience an adjustment period as properties once considered class A may have to compete for renters further down the income scale. In the near-term, garden properties are likely to outperform given less supply headwinds and more affordable rent levels.
- **Urban Nodes Outside of the CBD:** With an unprecedented amount of high-end supply being delivered into the urban core, opportunities may instead exist in “urban nodes” located outside of CBDs. We consider “urban nodes” to be highly-amenitized, transit-oriented neighborhoods with an employment base that clusters in inner-ring suburbs. Many of these areas provide investors some yield premium over prime urban core product and are still supported by the demand trend towards living in more urbanized locations. These neighborhoods also benefit from “affordability migration” out of core urban locations as many people are priced out of CBDs due to several years of high rent growth and new supply being concentrated in the luxury space of the market. Suburban areas that share some characteristics with an urban node could also fit into this strategy, but should still be located in high-population growth markets.
- **Be Wary of Value-Add This Late in the Cycle:** A targeted value-add strategy has offered investors attractive pricing with the potential for strong revenue growth for several years now. However, as substantial new supply continues to hit the market, most value-add strategies will likely not provide the upside they once did earlier in the cycle. This is particularly true in markets where competition from new, high-end product is particularly intense. Attempting to compete with the amount of new luxury product coming online could be challenging. For any value-add opportunity, we are particularly cognizant of the effects new supply will have on properties not only in the luxury segment, but also in classes below it. Some upside may still exist in suburban or “urban node” locations where supply is not as significant.

⁵² Deutsche Asset Management. Data as of June 2016.

8 Appendix 1: U.S. House Portfolio

The Deutsche Asset Management House Portfolio presents the allocation by property sector for core portfolios in the United States which we believe would outperform the NPI. We develop the House Portfolio as an unlevered portfolio of properties for a U.S. investor without regard to tax consequences. The House Portfolio is formulated using both quantitative and qualitative modeling, integrated with our House View. The resulting weights, we believe, aid in providing long-term risk-adjusted outperformance to our portfolios versus the market as a whole and against relevant benchmarks and indices. The analysis focuses on the four major property sectors and excludes hotels. The following table summarizes our conclusions on weightings in comparison with the NPI. The analysis results in an active overweight to the industrial sector, a market weight to the office sector and retail sectors, and an underweight to the apartment sector.

House Portfolio Construction – Sector Allocation

Sector	NPI Weights	Research Perspective	House Portfolio ¹	Active Bet	Recommended House Portfolio Range
Apartment	25%	— Economic recovery fueling household formation. — Decline in homeownership may not continue. — Strong performance leads to more construction, limiting NOI growth. — Cap rates lowest among major sectors.	18%	(7%)	13% - 23%
Industrial	14%	— Benefits from expanding U.S. population and job gains as well as e-commerce, housing, and trade. — Speculative construction is rising but demand should still outpace. — Solid rent and NOI growth expected in near term. — Smaller and mid-sized warehouses poised to outperform. — Flex is recovering but still underperforming.	20%	+6%	15% - 25%
Office	37%	— Strong job growth will continue to increase office space demand and broaden the expansion. — Rent growth gathering momentum as vacancy is now at the long term average and is still contracting. — Rent recovery is spreading to more locations outside tech, energy and gateways.	38%	1%	33% - 43%
Retail	23%	— E-commerce restricting store openings, but convenience and service (health, fitness, dining) retail expanding. — Lack of new supply contributing to improving fundamentals. — Rent growth becoming more broad-based. — Long duration leases provide stable income.	24%	1%	19% - 29%
Hotel	1%	N/A	0%	(1%)	0%

9 Appendix 2: Real Estate Target Markets

Investible Metros: We screened top U.S. metros, which represent 86% of the NCREIF Property Index (NPI), and identified the investment markets for each property sector that we believe have the best prospects for superior performance during the market cycle or a portion of it. This metro selection is based on property market size, liquidity, growth characteristics, income, historical returns and other factors indicative of future performance. The list of these metros remains generally static, although some metros may be added or subtracted over time due to structural market changes

Target Investible Metros: These are a subset of the universe of investible metros and include markets expected to outperform or market perform during the next three to five years.

Investible and Target Markets				
	↑ Overweight	↓ Underweight	↔ Market Weight	
Market	Apartments	Industrial	Office	Retail
Atlanta	↔	↔	↑	↓
Austin	↔	↔	↓	↔
Baltimore	↓	↓		
Boston	↔		↔	↔
Charlotte	↓		↓	↔
Chicago	↓	↔	↓	↓
Dallas	↓	↓	↔	↔
Denver	↔	↔	↓	↔
Fort Lauderdale	↑	↑	↑	↔
Houston	↓	↓	↓	↓
Los Angeles	↔	↔	↔	↔
Miami	↔	↔	↑	↔
Minneapolis	↓	↓		↓
New York	↓	↔	↓	↔
Oakland / East Bay	↔	↑	↔	↑
Orange County	↑	↑	↑	↑
Philadelphia	↓			↓
Phoenix	↑	↔	↔	
Portland	↔	↑	↑	↔
Riverside	↑	↔		
San Diego	↑	↑	↔	↑
San Francisco	↓	↔	↓	↔
San Jose	↓	↑	↔	↑
Seattle	↓	↔	↔	↔
Washington DC	↓	↓	↓	↓
West Palm Beach	↑			↔

Source: Deutsche Asset Management. Data as of July 2016.

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