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Research Report

Europe Real Estate Strategic Outlook

February 2017

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1 Executive Summary¹

- European real estate has provided investors with exceptionally high levels of return over the past few years. However, we are now seeing signs that the market as a whole is starting to moderate. While yields may not yet have reached a trough, and further rental growth is certainly likely, countries such as Germany look to be entering the more mature stages of this cycle.
- The economic outlook remains one of expansion and falling unemployment. Office and retail space will benefit from further job growth, while logistics will likely gain from improving terms of trade. In time, the unwinding of monetary loosening will likely prevent the very high returns of recent years, but this process will almost certainly be extremely gradual, and with sustained occupier demand and diverging business cycles, should provide opportunities to achieve outperformance through stock and market selection.
- Importantly, we see real estate market cycles starting to diverge. While yield compression has been a lead driver of returns over recent years, performance going forward will be driven far more by the occupier market. With this, we strongly urge investors to focus on the fundamentals at both the macro level – supply and demand – and at the micro level – location and asset.
- The European occupier market outlook remains positive, particularly for logistics, where underlying demand trends should remain in force for the foreseeable future. For offices we expect rising levels of development to dampen the market towards the end of the decade, although rent growth should remain positive. However, this is not universal; in the United Kingdom, despite the short-term demand implications of the Brexit vote, we expect the reduced supply pipeline and current rental correction to act as a positive driver toward the end of the decade. The retail sector is perhaps where the most significant challenges lie. While the most successful high streets, shopping centres and retail parks should continue to thrive, secondary space is likely to struggle.
- Real estate in Core Europe still looks highly attractive relative to other asset classes, but further falls in initial yields during the second half of 2016 are adding to the likelihood of lower absolute returns over the next five years. In the short term, we still see the potential for further real estate yield compression, driven in part by the current large spread over bonds, as well as the expectation of further rent growth. By around 2019 we anticipate that real estate yields will be starting to rise, although the projected increase of just 25 basis points in the period to 2021 will be far less than that seen in the bond market.
- The quarterly MSCI/IPD Global Property Fund Index showed asset level performance in Continental Europe moderating to 9.4% in September 2016, from 13.8% a year earlier. However, figures from the more comprehensive local property indices showed diverging trends.
- Given the lower interest rate outlook, our prime total return forecasts have improved in all sectors since six months ago when viewed over comparable time periods, although the pecking order remains unchanged. Prime returns in the European logistics sector over the next five years are now forecast to average 7.6% per annum, compared to 6.4% for shopping centres and 5.2% for offices.
- On a risk-adjusted basis, we see Spain, the Netherlands, Sweden and the Top 7 German cities offering the most attractive returns over the coming two years. However, with some of these markets nearing or past their cyclical peak, this does not necessarily make them the best locations for increasing exposure. Today we see the best opportunities to purchase in the Netherlands, Regional France and Finland, as well as the United Kingdom in around 12 months time once the current price correction has run its course.
- With yields low, some may be tempted to compromise on fundamentals in order to secure a higher yield at this point in the cycle. We stress against this sort of style drift. While we are not adverse to selective bets on long-term demand trends or taking leasing risk in supply constrained markets, these strategies should have a solid underpinning, and should not be undertaken solely for the purpose of a higher initial yield.

¹There is no guarantee the forecasts shown will materialise. Past performance is not indicative of future results.

2 European Real Estate Strategic Themes²

The European real estate cycle is maturing and diverging. Large parts of the real estate industry have experienced exceptionally high returns over recent years, in part reflecting a bounce-back from the financial crisis, but also a general increase in values across fixed income assets.

This level of performance is unsustainable though, and while 2016 looks to have been another strong year, the market is moderating. In countries such as Spain and the Netherlands we still see momentum, although in the United Kingdom price falls have already been recorded. But despite these diverging fortunes, the overriding theme is that returns are now moving towards a more normal level, and we expect parts of the continent to experience a period of below average performance.

It is therefore important to consider an investment approach that aims to achieve market outperformance, without compromising on a diligent approach to risk.

With that in mind, we believe core investors should take a three pronged approach. First, continue to focus on good quality space in those markets that are expected to outperform over the next five years, and don't succumb to style drift. Second, make selective bets on submarkets and sectors that are expected to benefit from sustained increases in demand due to long-term trends such as demographics and technological change. Third, optimise existing portfolios, both through sales of underperforming assets in potentially weaker markets, and the use of refurbishment to enhance and reposition assets situated in strong locations.

I. Generally stay defensive and avoid style drift

Over the next five years, returns from core real estate will likely be lower than the period following the end of the financial crisis. However, this is likely to be the case for the majority of fixed income assets, as the gradual withdrawal of central bank support weighs upon returns. Furthermore, on a relative basis, core real estate looks defensive in this environment. Not only is the yield spread between real estate and government bonds near record high levels, the market is well positioned to see a period of sustained rent growth.

- **Rely on long-term value:** Prime offices and dominant shopping centres provide both an avenue for large-scale capital deployment and the opportunity to achieve a stable income return throughout the economic and real estate cycle. While returns may be lower than in previous years, a focus on our favoured markets such as Amsterdam in the immediate term or Central London from next year onwards should also help to provide a better risk-adjusted return.
- **Mitigate void risk with residential:** Similar to the main commercial sectors, the residential market, particularly in Germany, may also be prone to yield adjustments over the next 5-10 years. However, void risks are exceptionally low as the sector is still suffering from a large demand overhang, especially in large agglomerations. Also, as most of the (second hand) stock is still valued significantly below replacement cost, owners are exposed to significant upside risks for rental growth, despite the current regulatory regime in place.
- **Increase your debt allocation:** Mezzanine loans, and to lesser extent senior loans, still tend to offer relatively attractive yields. Allocating a larger share of a direct real estate portfolio to debt has the potential to lower a portfolio's interest rate sensitivity, while also helping to stabilise valuations over time.
- **Avoid style drift:** Our analysis has shown that historically, higher yielding strategies at this point in the cycle increase the risk of underperformance, as downsides are most acute. The yield spread between prime and secondary has already closed considerably and therefore seeking yield will often push investors towards assets and markets that lack solid fundamentals.

II. Make selective bets on long-term trends

More than ever, fund managers need to provide a genuine growth story on both an asset and a segment level when deploying additional capital. By choosing the right assets in the right locations they can expect to outperform in a downward cycle, because there is reasonable evidence to suggest that the impact of long-term megatrends such as demographics, urbanisation and technology leads to the potential for rents to grow at above average rates.

² Any forecasts provided herein are based upon Deutsche Asset Management's opinion of the market at this date and subject to change dependent on the market. Forecasts may not materialize.

- **Urban offices:** Central, urban (but non-CBD) locations will increasingly provide superior connectivity, amenities and urban design, characteristics that are typically of particular importance to a new breed of tenant. These pull factors will initially be strongly supported by an aspect of affordability, although this will fade over time to the benefit of owners who anticipated rents converging towards established submarkets. We have seen examples of this in submarkets such as the City Fringe in London, and the Paris 3/4/10/11 market.
- **Gentrification:** Population inflows into large cities are well established and low affordability will continue to push tenants into locations with development potential. Over the past 15 years the ten largest urban areas in Europe have seen population growth of nearly 15%, compared to an average of around 5% across the continent as a whole.³ This trend is set to continue and also has positive implications outside the residential market, as rising local average household income provides a growth story for retail and mixed use concepts.
- **Cross-sector competition:** Urbanisation and technology have started to create some interesting dynamics relating to the utilisation of land. While certain sectors have often complemented each other in the past, competition for land use is rising inside large agglomerations. The surge in online sales has increased the demand for urban logistics, while at the same time local administrations are under pressure to increase the supply of housing.
- **Build to hold:** The biggest obstacle for investors in deploying those strategies above will be the limited access to suitable product. Those with significant dry powder at hand may still only be able to make a limited number of selective bets. To start developing may well be an option for those who have the necessary resourcing and knowhow. Project developments can offer investors access to the desired strategic product, but with less exposure to current high market valuations.

III. Optimise your existing portfolio now

Funds that have shown a strong track record over the past 10-15 years have typical features in common - they not only bought heavily at the beginning of the cycle but they also disposed of non-core holdings between 2006 and 2008. In those markets where we have an underweight and trending lower call, such as Poland, 2017 should be a good opportunity to dispose of non-core assets at a price above or at least near current valuations. If the window for disposal is missed, assets will likely become illiquid for a number of years and could eventually become a significant drag on portfolio performance.

- **Reduce asset / location risk:** As the definition of prime and core has softened in recent years, current pricing suggests that risks are no longer being fully reflected in less secure locations and older assets. Current owners should take advantage of this and should seek to reduce exposure to these assets in their portfolio.
- **Reduce market risk:** Investors should underweight markets where economic, political or regulatory risks are not being priced in appropriately. Poland and Italy are currently trading near record low yields, despite rising uncertainty.
- **Reduce segment risk:** We see mid-sized, out-of-town shopping centres as vulnerable to trend reductions in demand as online sales will continue to increase their share of total retail sales. Investors should reduce exposure to avoid void risks or even obsolescence in the future.
- **Revive hidden value:** Despite our recommendation to dispose of non-core assets, investors should clearly distinguish between the long-term uncompetitive and those buildings fit for refurbishment or repositioning. Investors should not be giving away upside potential to developers or specialist investors too easily. Rather than selling at a discount, strategically reposition well-located, older assets, especially given that vacancy is currently low, rents are rising and investor competition for core assets remains strong.

³ Oxford Economics, February 2016.

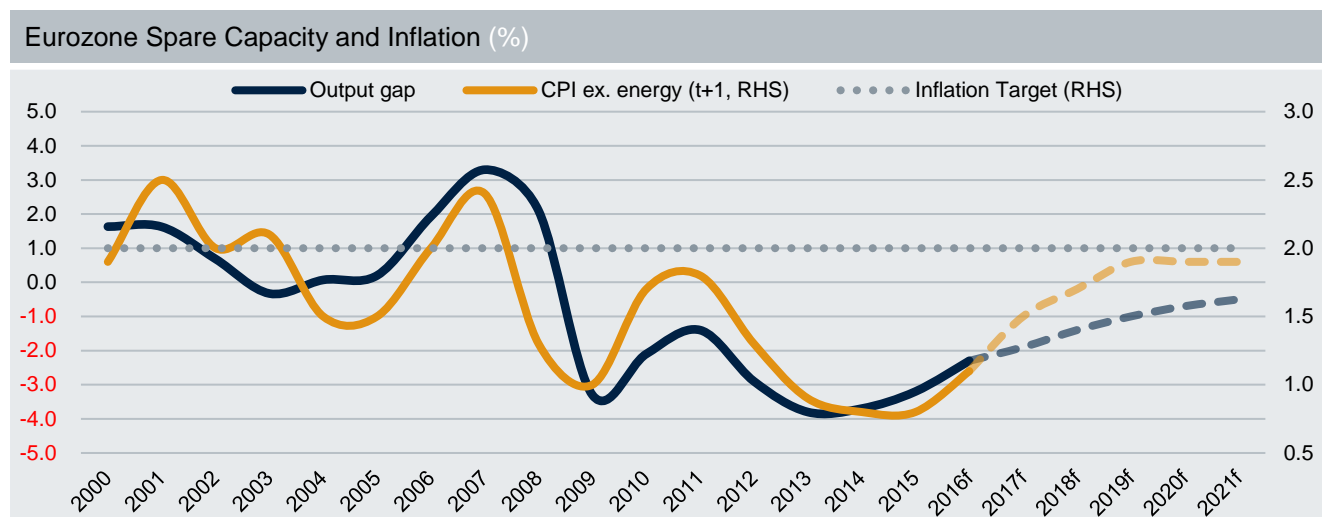
3 Economy

In a year characterised by uncertainty and political shocks, the European economy grew at a surprisingly robust pace. Indeed by the end of the year, the Purchasing Managers' Survey showed the Eurozone expanding at its fastest pace for over five years, while the continued strength of the U.K. economy has confounded expectations of a sharp slowdown.⁴ With growth translating into employment and retail sales, it was evident that this helped drive demand for real estate space across the majority of markets.

We expect the momentum in Europe to continue into 2017. Fiscal drag has lessened, monetary policy is loose, while a strong dollar and accelerating U.S. economy should support exports. Furthermore, with the unemployment rate at just over 8% across the European Union, and recent reform programmes helping to boost productivity, there remains on average spare capacity to support the recovery.⁵

In contrast, we still expect a significant slowdown in the United Kingdom during 2017. There is already evidence that consumers are concerned about import led inflation, while the uncertainties surrounding exit negotiations from the E.U. will likely weigh upon business investment for the next few years.

Over the next five years, the European outlook remains one of gradual expansion although in some places the business cycle is now well advanced. Countries such as Germany are running at full capacity and with an aging workforce there seems little room to boost growth substantially. That said, spare economic capacity is generally abundant and with high levels of public and private debt, this should prevent any swift withdrawal of central bank support. With rates expected to settle at a lower long-term average, the relative attractiveness of real estate income should be maintained.



Sources: Macrobond, Oxford Economics, January 2017.

Notes: f = forecast. There is no guarantee the forecast shown will materialise.

Over the course of the next five years, the converging Central European countries should remain among the top performers in Europe, with Spain, Ireland and the Nordics also doing well. The outlook for the United Kingdom is unclear; while the economy has done well so far and many of the country's fundamental strengths remain, political uncertainty and import led inflation are set to curb growth over the coming years.⁶

Political risk will again be a dominant feature this year, with notable elections in the Netherlands, France, Germany, and possibly Italy. Financial sector stress also can't be ruled out, as shown in Italy, while the fundamentals of the Eurozone, particularly following the U.K. referendum, will need to be monitored.

In sum, the economic outlook suggests that real estate demand should remain robust over the coming years. Office and retail space will benefit from further job growth, while the logistics sector should gain from long term structural changes as well as rising export volumes due to the weaker euro and pound. The unwinding of loose monetary policy will likely prevent the very high returns of recent years, although this will be extremely gradual, and with sustained occupier demand and diverging business cycles, it should provide some opportunities to help achieve market outperformance through stock and market selection.

⁴ Markit, January 2016.

⁵ Eurostat, January 2016.

⁶ Oxford Economics, January 2017.

4 Real Estate Performance

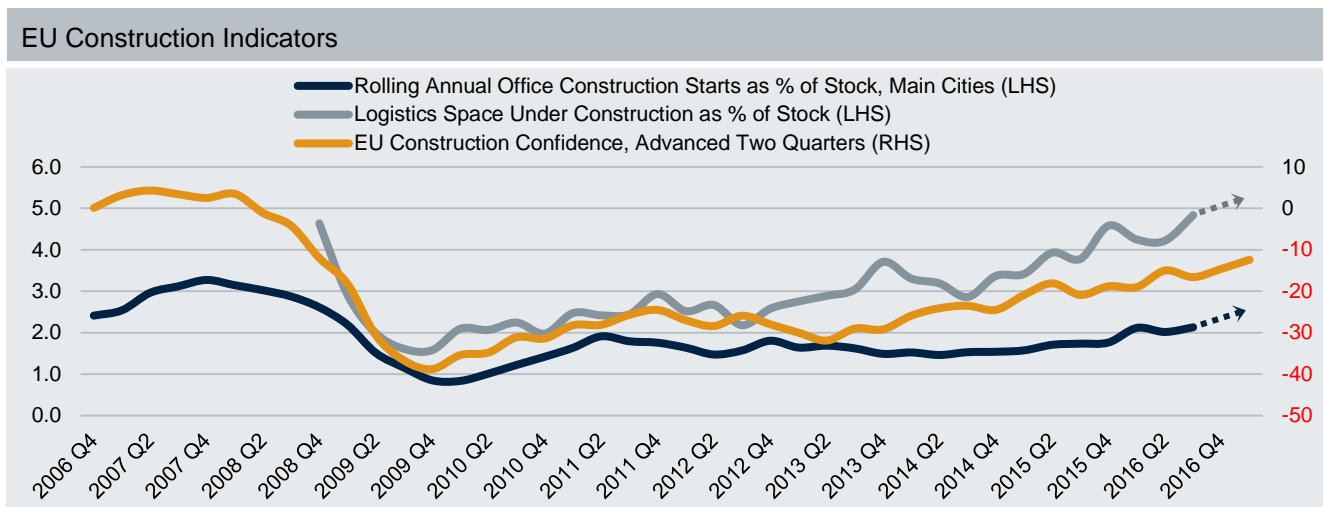
4.1 Occupier Fundamentals

The European real estate occupier market had another strong year in 2016. In Continental Europe, resilient underlying economic fundamentals have continued to drive occupier demand for real estate. Take-up of office space during the first three quarters of the year was up by 8% year-on-year,⁷ and given the relatively low level of recently completed space, availability has continued to fall. Leasing activity for logistics space also remained at near-record levels over the same period,⁸ comfortably outstripping the high levels of new completions.

Despite predictions of a sharp slowdown in the United Kingdom, economic growth in the second half of the year has beaten expectations. Of key importance to the logistics sector, U.K. manufacturing accelerated towards the end of the year, with the highest PMI readings for two and a half years in December.⁹ This was largely driven by the weaker pound, but capital spending also helped industrial output growth.

However, occupier demand for U.K. real estate has taken a hit. Despite the economy holding up better than expected since the E.U. referendum, significant uncertainty over the United Kingdom's likely future relationship with the rest of Europe has led many firms to delay major occupier decisions. Take-up of office space during the first nine months of the year was down by more than a quarter compared to the same period in 2015, while the vacancy rate increased by more than a percentage point.¹⁰ What's more, the weak pound is leading to inflation, which is likely to begin to affect consumer confidence, retail sales and retail margins.

The likely extent of potential relocations from London to continental Europe is still far from being known. The U.K. government announced in January that it will not aim to remain part of the European single market, but the likely complexity of negotiations mean there will be a high level of uncertainty for some time to come. With many large relocation decisions on hold, we are expecting a period of weaker demand and rising vacancy over the next 12 months. However, with building starts already down by more than 40% since a year ago, this should begin to provide some relief once space currently under construction has completed.



Sources: European Commission, PMA, JLL, Deutsche Asset Management, January 2017.

Trends in the United Kingdom are not representative of Europe as a whole though. Across the rest of Europe, developer confidence is at its highest level for eight and a half years and the pipeline of space under construction is beginning to ramp up in both the office and logistics sectors. Rolling annual building starts for Core European offices were up by almost 50% year-on-year in the third quarter,¹¹ driven by large increases in Paris, the Nordics and Central Europe, although the total equates to a modest 2% of existing stock.

⁷ PMA, December 2016.

⁸ JLL December 2016.

⁹ Markit, January 2017.

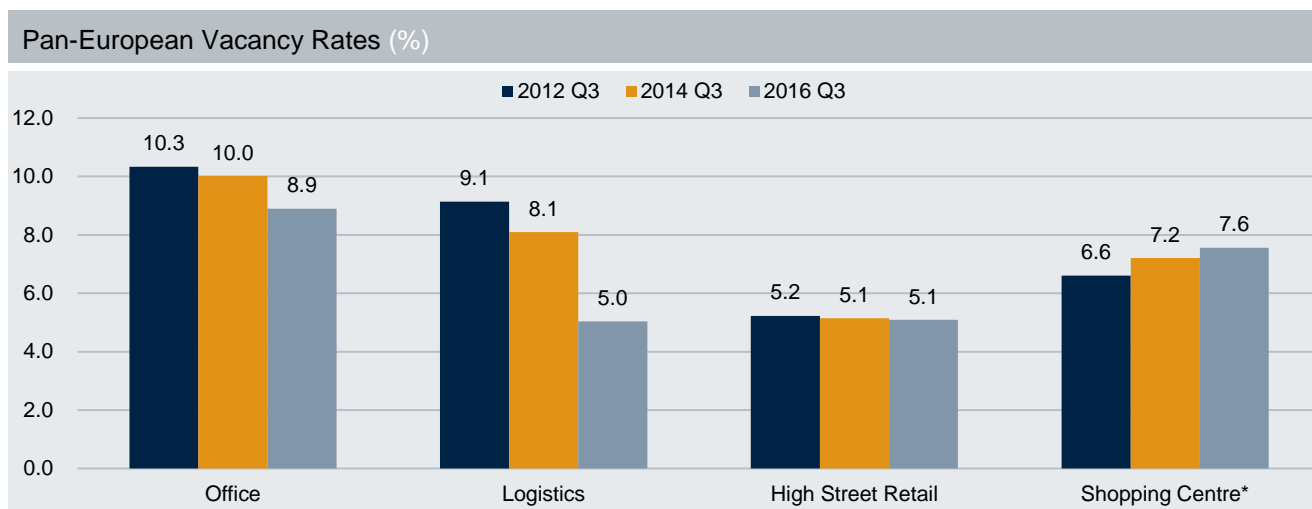
¹⁰ PMA, December 2016.

¹¹ PMA, Deutsche Asset Management, December 2016.

Logistics space under construction was also up by 21% over the same period, equivalent to 5% of current European stock.¹² This has been driven by structural change from the rise of online retailing, but also by general demand expansion as the economy recovers. The United Kingdom, Germany and Central Europe have led the way in terms of rising development activity, but the trend is now broadening to the Benelux, France and Southern Europe. Nevertheless, on a pan-European basis most logistics development remains build-to-suit, with only 20% of space underway being developed speculatively (excluding Russia).¹³

Pan-European vacancy rates have continued to fall in both of these sectors. We also expect there to be sufficient demand in the short term to eclipse new supply, particularly for logistics, where demand from online retailers and third-party logistics operators is unlikely to abate. This should lead to a further improvement in the occupier balance over the next 12-18 months, in turn allowing rents to continue growing at a reasonable pace.

The retail sector, on the other hand has seen a steady decline in new construction since 2008. In the first half of 2016, around 1.3 million square metres of new shopping centre space was delivered, down by 8% compared to the same period the previous year.¹⁴ The majority of new space being completed at the moment is in the CEE region, with Turkey and Russia accounting for almost half of all European completions in 2016 and a similar story expected in 2017.¹⁵ Shopping centre vacancy continues to trend upwards in many locations, while high street vacancy, which had been trending downwards, has now stabilised at around 5% on aggregate.



Sources: PMA, JLL, Deutsche Asset Management, January 2017

Notes: Retail vacancy relates to % of units. Weighted by volume of stock. Latest shopping centre vacancy is for 2016 Q2.

Generally speaking, the European occupier market outlook remains positive, particularly for logistics where underlying demand trends should remain in force for the foreseeable future. Rent growth for large logistics properties, although forecast to remain positive, will typically be subdued by a more plentiful supply of land and the relative speed of construction for such buildings. However, urban logistics facilities are in growing demand, and due to the scarcity of urban land plots it is here that we expect to see the strongest rent growth.

In the office sector we anticipate development to dampen the market towards the back end of the decade, although rent growth should remain positive in most locations.

The retail sector is perhaps where the most significant challenges lie. Shopping centre development, while on a downward trend, remains at not insignificant levels. And at the same time, demand for physical space continues to be eroded by online retail. The most successful high streets, shopping centres and retail parks, particularly those able to provide services and experiences over and above the standard retail offering, should continue to thrive. However, with secondary space continuing to struggle, average occupancy rates are unlikely to improve.

¹² JLL, December 2016.

¹³ JLL, Q3 2016.

¹⁴ Cushman & Wakefield, November 2016.

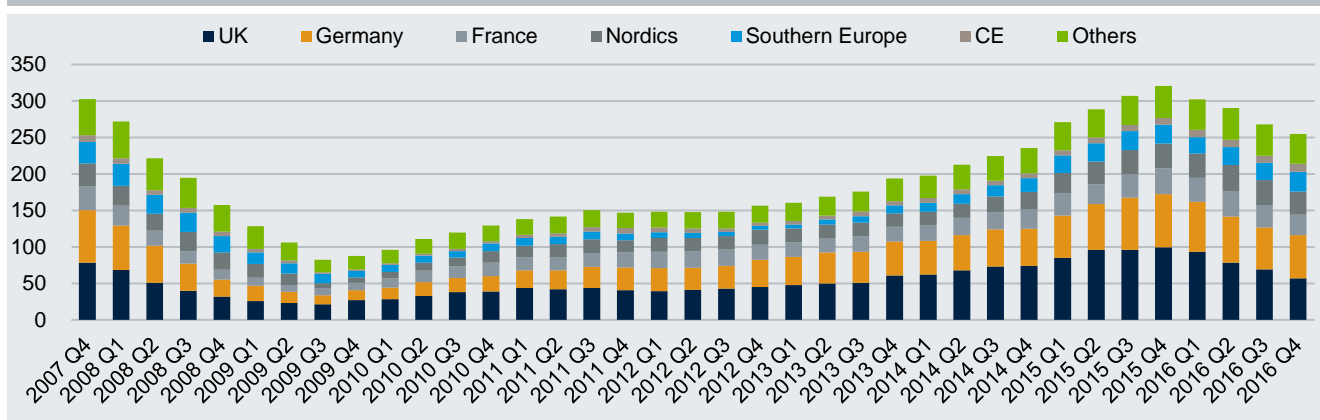
¹⁵ C&W, November 2016.

4.2 Capital Markets and Pricing

While real estate in Core Europe¹⁶ still looks attractive relative to other asset classes, further falls in initial yields during the second half of 2016 are adding to the likelihood of lower returns over the next five years. In the short term, we still see the potential for further real estate yield compression, driven in part by the current large spread over bonds, as well as the expectation of further rent growth. Yet with bond yields having already risen somewhat from their historical low earlier in 2016, further falls in bond pricing should eventually begin to push property yields higher.

During the first half of the year we noted a marked slowdown in European transaction volumes, and the final six months of the year saw a continuation of this trend as European investment activity returned to more normalised levels. The fall was caused in large part by a 40% drop in investment activity in the United Kingdom, where sovereign wealth funds have taken a step back due to the drop in oil prices and Brexit uncertainty has put off investors. A downward trend was also seen across other parts of the continent, as volumes fell by 20% in France and Germany, although there was a pick-up in activity in Spain, Sweden and the Netherlands.

Commercial Real Estate Investment Volume (rolling annual total, € billion)



Source: RCA, February 2017.

Both domestic and cross-border capital pulled back during 2016, but it was non-European foreign capital that saw the greatest retrenchment. North American investors, for example, invested little more than half the volume they did in 2015. This may be in part due to increasing difficulty in achieving required returns in the value-added and opportunistic spaces. On the other hand, South Korean investors have been increasingly active.¹⁷ The 10-15% discount on U.K. property afforded by the sharp fall in the pound after the Brexit vote may also be enticing new Asian investors into London, although it is difficult to determine the extent of this one single factor.

While there is still a risk-off attitude among investors, the investment net is being widened, both in terms of geography and real estate sectors. Investment into alternative sectors such as student housing, senior housing, data centres and medical offices has grown to more than 5% of the all property total for the first time.

Meanwhile, smaller markets such as Utrecht in the Netherlands and Malmö in Sweden saw investment grow by more than 50% year-on-year in 2016, with volumes around twice their long-term average.¹⁸ Nevertheless, according to a recent survey, investors believe that the top markets for investment and development prospects in 2017 are overwhelmingly large German cities, with four of the top five falling into this category.¹⁹

Immediately following the Brexit vote, investor sentiment towards the United Kingdom plunged to its lowest level on record, and although it recovered significantly by the end of 2016, remains well below average.²⁰ With less transactional evidence in the United Kingdom during the second half of the year, determining current values is more difficult. Many valuers have moved the prime U.K. office yield out since the Brexit vote, but opinions are split on the scale of outward movement. We expect that yields for Central London offices could move out by around 50 basis points during 2017, although the impact should be less keenly felt in regional office markets and logistics, sectors likely to be less affected by potential Brexit volatility.

¹⁶ Core Europe is defined as: Germany, France, Benelux, Nordics, Switzerland and Austria.

¹⁷ RCA, February 2017.

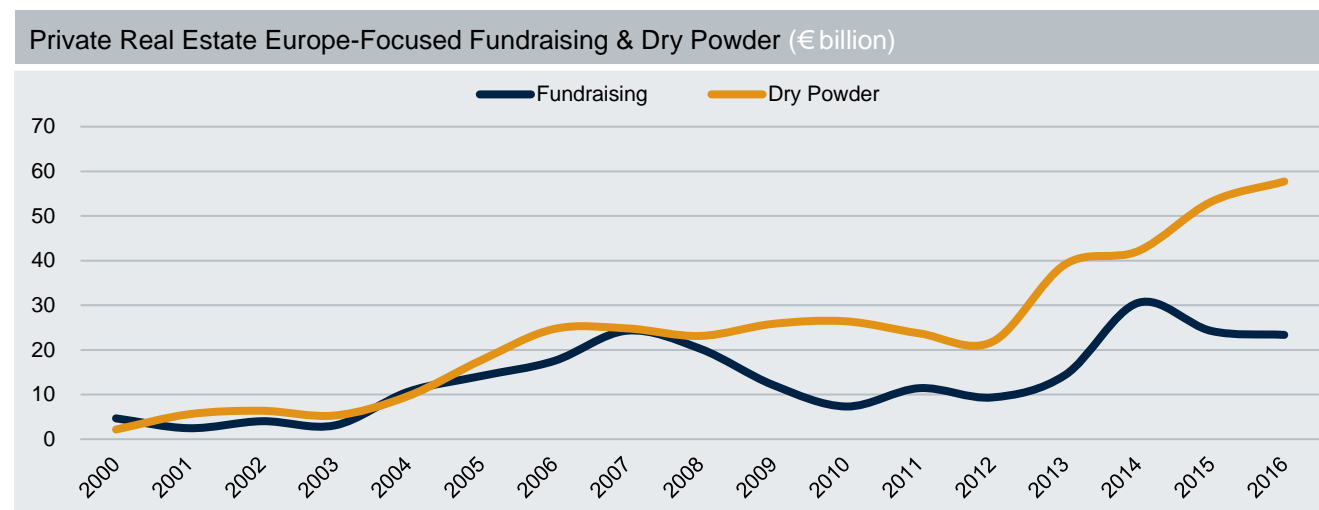
¹⁸ RCA, February 2017.

¹⁹ PwC Emerging Trends in Real Estate Europe 2017.

²⁰ PMA Survey of Investor Preference, 2016 Q4.

Despite the overall fall in European investment, there are a number of indicators that continue to signal strength within the market. Sentiment towards Continental European real estate remains positive, and in some cases may have benefitted from the increased uncertainty surrounding the United Kingdom.

Since the referendum result in June, London offices have moved down to fourth in the list of preferred investment locations according to a recent survey,²¹ having topped the list in early 2016. The top three spots are now occupied by Berlin, Paris and Frankfurt, all locations that stand to benefit from potential relocations away from London, the extent of which will depend upon the eventual deal struck between the United Kingdom and the European Union.



Sources: Preqin, Oxford Economics, January 2017.

Note: Converted from USD to EUR at current exchange rates.

In addition, there is a large amount of capital waiting to find a home. In the private real estate market, Europe-focused fundraising, while down marginally from the previous year and some way below the record total from 2014, was still well above the ten-year average at over €23 billion. Furthermore, total capital ready to deploy continued to rise to new record levels, reaching €58 billion by the end of the year. Within the private market, another trend that is also apparent is that investors are stepping up the risk curve. Core and core-plus activity has fallen away over the past two years, but value-added strategies have seen a significant rise in fundraising. Almost two thirds of dry powder is targeting either value-added or opportunistic strategies.²²

Inflows into German open-ended funds have also continued to strengthen. In the first eleven months of 2016, net inflows measured €4.5 billion, up 50% compared to the same period in the previous year.²³

Further, given the recent weakening of both the sterling and the euro against the dollar, this has made European property cheaper for U.S. investors. And with both major European currencies expected to strengthen gradually from 2018, dollar-based investors would stand to benefit from currency gains, which could soon lead to renewed inflows from the United States. On top of this, with sovereign wealth funds building up revenues through higher oil prices again, we expect sustained liquidity in 2017.

Yields in Core Europe, Southern Europe and the CEE region all remained on a downward path during the first nine months of 2016, and given the large amount of capital looking for a home and significant spread over bonds we are forecasting this trend to continue for the next 12 months. However, with news in December of the ECB's decision to begin tapering its huge quantitative easing programme this year and interest rates rising in the United States, we expect the property yield spread to narrow in 2017.

In Germany, having averaged -0.1% in the third quarter in 2016, the 10-year Bund was up to 0.5% by the end of January this year.²⁴ Nevertheless, while the prime property spread over Bunds is likely to have narrowed by around 50 basis points in the fourth quarter, it remains significantly above average and leaves room for further real estate yield compression in the short term.

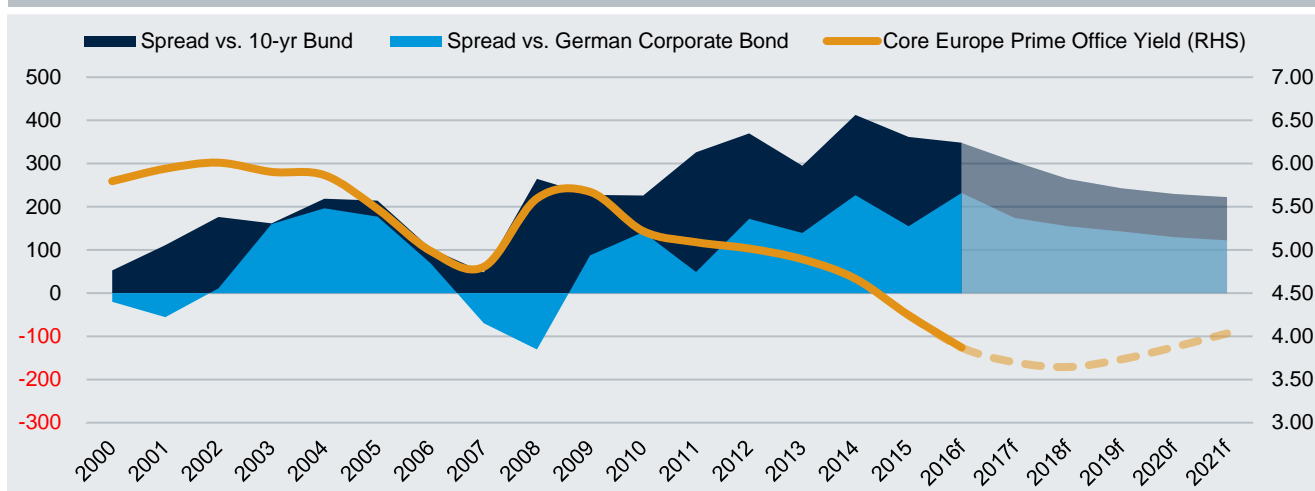
²¹ INREV Investment Intentions Survey, January 2017.

²² Preqin, January 2017.

²³ BVI, January 2017.

²⁴ Macrobond, February 2017.

Core Europe Prime Office Yield Spreads (%)



Sources: PMA, Oxford Economics, Deutsche Asset Management, January 2017.

Notes: f = forecast. There is no guarantee the forecast shown will materialise. Past performance is not indicative of future results.

4.3 Commercial Real Estate Returns

Following a strong year for European real estate in 2015, total returns remained elevated in 2016 despite easing back in a number of markets. At the time of writing, full year performance figures were not yet available from MSCI/IPD; however, higher-frequency indices have suggested that while the market is beginning to offer lower returns on aggregate, cycles are diverging between locations.

The quarterly MSCI/IPD Global Property Fund Index shows that asset level performance in Continental Europe has moderated to 9.4% in September 2016, from 13.8% a year earlier.²⁵ However, figures from the more comprehensive local property indices show trends varying by location.

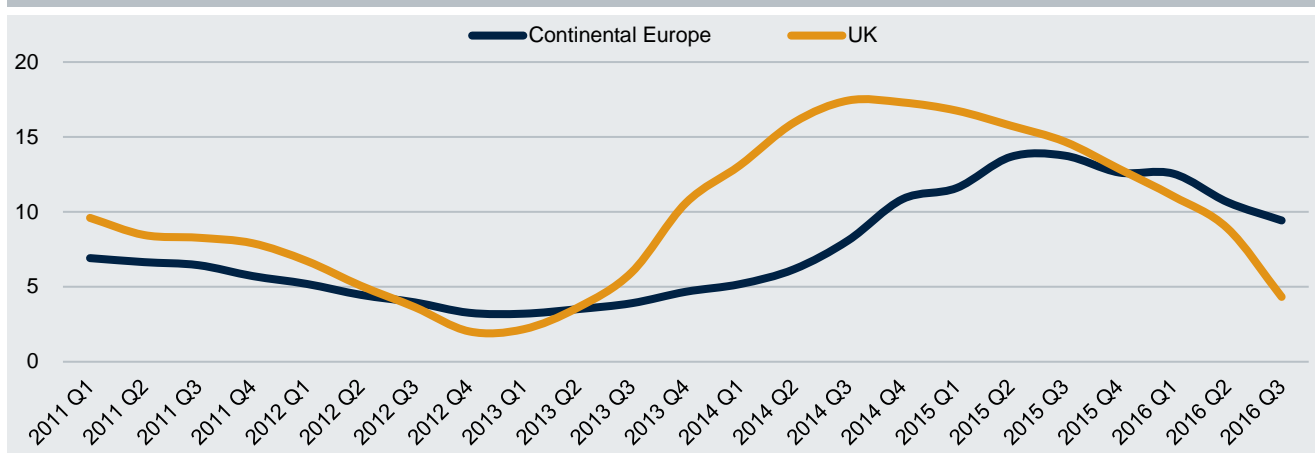
In France, annualised returns from the local property index edged down from 11.9% in 2015 to 11.2% during the first half of the 2016, while Italy saw an improvement from 4.0% to 4.5% over the same period. The Netherlands, a late recovery market, has been on a positive trajectory of late. Annualised total returns were flat there at 10.7% in the third quarter, although it is still likely to be among the top performing markets when year-end numbers are released. Irish returns in the third quarter fell to 14.9% on an annual basis, and with yields beginning to bottom out, capital growth there is likely to moderate further.

Meanwhile, the U.K. market saw a correction following the June referendum, although to a lesser extent than many had feared initially – all property values were down 2.5% between June and December according to the MSCI/IPD monthly index. That said, the downward trend in performance has been much more pronounced than in continental Europe, with annual returns falling from 13.9% to 2.6% in the 12 months to December 2016.²⁶ And given the significant uncertainty likely to persist surrounding the exit negotiations, we believe that a further value decline in 2017 is likely.

²⁵ MSCI/IPD, January 2017. Past performance is not indicative of future results.

²⁶ MSCI/IPD, January 2017. Past performance is not indicative of future results.

MSCI/IPD Property Fund Index Asset Level Returns (%)



Source: MSCI/IPD, December 2016.

Note: Past performance is not indicative of future results.

Quarterly prime data, which is more widely available, also shows similar trends. At the pan-European all-property level, annual prime total returns peaked in the fourth quarter of 2015. However, performance began to moderate during the first three quarters of 2016, albeit still at levels well above historical averages.

Recent history has seen the high street retail sector consistently outperforming, with logistics not far behind. Nevertheless, strong yield compression in the German markets and average prime rent growth of over 4% year-on-year, as well as limited re-pricing in London so far, boosted the European office sector into first position during the second and third quarters of 2016.

Looking ahead, we expect a further moderation in returns across all sectors. While offices have been the best performing sector over the past year, we expect logistics to move comfortably ahead over the next five years. The office market has enjoyed a period of very low development activity, although a run of positive capital value growth has led to increasing development activity. Towards the end of the decade, we expect this to slow rent growth and to act as a brake on performance.

Shopping centres have been an underperforming sector since the last financial crisis, although average prime rents are estimated to have grown in 2016 at their fastest rate since 2007,²⁷ albeit at still modest rates. As rents continue to pick up in the best-managed centres, driven by a pick-up in the consumer economy, we see prime shopping centres as a relative outperformer over the next five years.

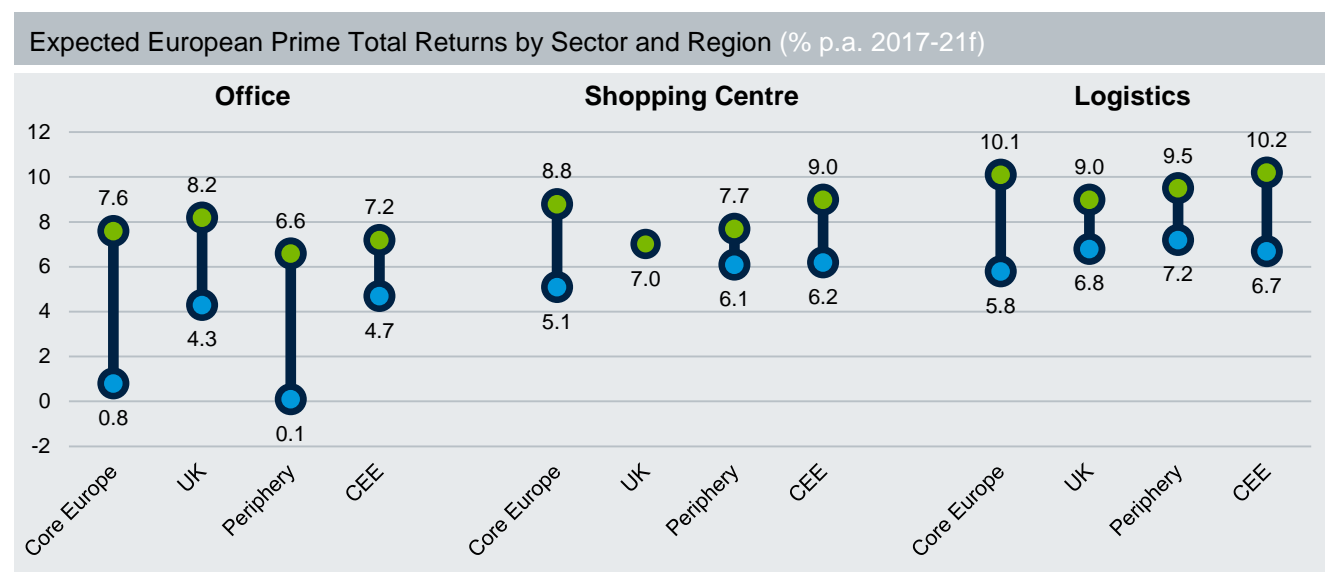
Offices and high street retail should continue to see modest rent growth, but significant yield compression has led to a lower income return, holding back overall performance. Logistics, on the other hand, typically enjoys an income return premium of 150-200 basis points, and at the same time continues to benefit on the occupier side from the rise of online sales. Strong investor demand for logistics, reflected in recent transaction volumes, is set to drive further convergence between logistics yields and other sectors as well. Generally this has led us to have an overweight call on European logistics, although as a proportion of the overall investable market it remains significantly smaller than both office and retail.

Given the lower interest rate outlook, our prime total return forecasts have improved in all sectors since six months ago, when viewed over comparable time periods, although the pecking order remains unchanged. Prime returns in the European logistics sector are now forecast to be 7.6% per annum, compared to 6.4% for shopping centres and 5.2% for offices. Based on our estimates of a typical institutional investor's required return, most office markets still fall short of the target rate, with the exception of the United Kingdom. On the other hand, logistics markets are typically expected to match or exceed their required return, while the shopping centre market is divided.

In terms of location, it is Core Europe and the United Kingdom that we expect to offer the best risk-adjusted returns over the next five years. Central Europe is forecast to offer competitive returns on an absolute basis, but risks in the region are still somewhat higher than in Western Europe, meaning that it may be difficult to meet higher required returns.

²⁷ Cushman & Wakefield, Deutsche Asset Management, December 2016.

We can be reasonably confident in predicting that real estate returns will be lower over the next five years than in the period since the financial crisis, but diverging trends between sectors and countries could provide opportunities to maximise returns through timing and market selection.



Source: Deutsche Asset Management, December 2016.

Notes: f = forecast. There is no guarantee the forecast shown will materialise. Range shows top and bottom performing market in each region.

Spain is becoming increasingly expensive, although rising rental values are likely to drive further short-term value growth. The Amsterdam office market has seen a significant improvement in economic and occupier market conditions and still offers a modest yield premium over other Western European capitals. We also see opportunities in the regional French markets in 2017, where yields are substantially higher than Paris and occupier fundamentals have been stable historically.

Conversely, we have an underweight call on the United Kingdom for the next 12 months. Timing beyond this largely depends on progress in the Brexit negotiations, but our central case view assumes a market correction in 2017 and a recovery in 2018/19, leading to pro-cyclical opportunities during this period.

Market selection and timing are always important, but an increased focus on locations and segments with long-term growth trends, as well as taking selective bets on emerging micro locations and niche segments, should help to achieve relative outperformance. However, investors should be wary of style drift as a means for meeting absolute return targets.

4.4 Market Positioning Calls

The table below provides a summary of suggestions for market positioning given the performance outlook for real estate across cities and sectors over the next five years. Our recommendations are not all encompassing within the real estate investment universe and therefore should be viewed in conjunction with the strategic themes shown in this document.

Market	Offices		Shopping Centres		Logistics	
	Current	Trend	Current	Trend	Current	Trend
Spain	Overweight	◀▶	Overweight	▼	Overweight	◀▶
Sweden	Overweight	▼	Overweight	◀▶	Overweight	▼
Netherlands	Overweight	▲	Overweight	▲	Over / Neutral	▼
German Top 7	Overweight	◀▶	Overweight	◀▶	Over / Neutral	▼
Regional France	Over / Neutral	▲	Over / Neutral	◀▶	Overweight	▲
Central Paris	Over / Neutral	▼			Overweight	▲
Belgium	Neutral / Under	◀▶	Overweight	◀▶	Overweight	▲
Czech Republic	Underweight	▼	Neutral / Under	◀▶	Over / Neutral	◀▶
Finland	Neutral	▲	Over / Neutral	▲	Underweight	▼
Italy	Underweight	▼	Neutral	▼	Underweight	▼
Central London	Underweight	▲	Underweight	▲	Underweight	◀▶
Regional UK	Underweight	▲			Underweight	◀▶
Poland	Underweight	◀▶	Underweight	▼	Underweight	▼

Source: Deutsche Asset Management, January 2017.

Note: There is no guarantee the forecast shown will materialise.

Based on our forecasts, the market calls provide guidance on where we believe investors will find the highest risk-adjusted returns, and where they should currently be looking to position their exposure to real estate.

This latest iteration provides greater insight on market timing, showing both our current suggested market weighting and the direction of travel over the five year forecast period. The following table gives an overview of how this new approach should be interpreted.

Current	Trend	Comment
Overweight	▲	Strong performance over next five years. Increase exposure.
Overweight	◀▶	Strong performance over two years, then moderating. Selective investment.
Overweight	▼	Strong but moving towards end of outperformance. Prepare weak asset disposal.
Neutral	▲	Average performance but gathering strength. Increase exposure.
Neutral	◀▶	Sustained average performance. Asset led investment strategy.
Neutral	▼	Average performance and weakening. Reduce exposure.
Underweight	▲	Nearing end of downturn. Prepare to invest in core assets.
Underweight	◀▶	Weak over two years, then gradually improving. Selective sales.
Underweight	▼	Weak over next five years. Tactical sales and consider strategic asset sales.

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Source: Deutsche Asset Management, January 2017.

²⁸ This information is intended for informational purposes only and does not constitute investment advice, a recommendation, an offer or solicitation

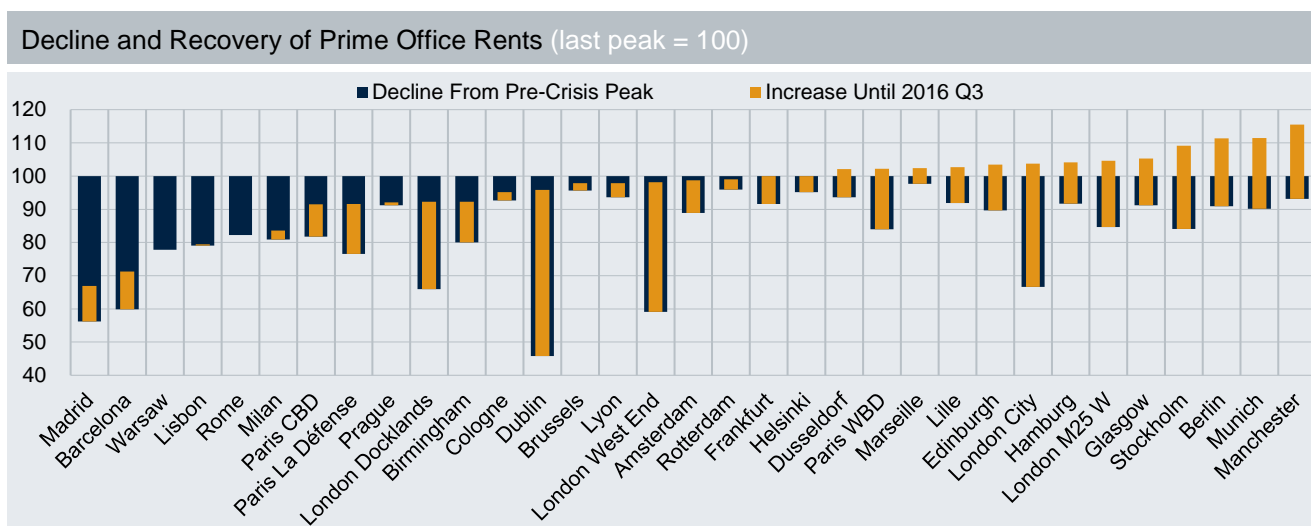
5 Office Market Outlook and Strategies

5.1 Current Conditions

Economic sentiment has continued to improve in the Eurozone despite uncertainties in the aftermath of the U.K. referendum. The resilience of the Eurozone economy translated into 1.2% year-on-year employment growth in the third quarter of 2016, with the Netherlands, Spain and Ireland all growing at more than 2.5%.²⁹

In this context, office occupier demand has maintained an upward trend that began in 2014. European take-up amounted to over 10 million square metres on a rolling annual basis in the third quarter of 2016, 18% above its long-term average.³⁰ Central Paris, Stockholm and the main German cities were among the best performers, whereas letting activity slowed in the United Kingdom and Poland.

The low level of new completions has also helped the average vacancy rate to fall further, reaching its lowest level since the end of 2008. Central Paris, Berlin, Munich and Barcelona have experienced sharp falls in available space, whereas vacancy rose in Central London and in Warsaw due to the high level of net additions in recent quarters.³¹ CBDs in general have seen limited construction activity, which has continued to drive vacancy down. On the contrary, peripheral office districts are still facing high vacancy rates, although obsolete stock has begun to be removed from the market through conversions.



Source: PMA, November 2016.

Note: Last peak between 2006 and 2009; Trough between 2008 and 2016 Q3. Past performance is not indicative of future results.

While prime rent growth has stalled in Central London, rents have followed a more positive trend in the rest of Europe. Rental values in Dublin, Paris La Défense and the main Spanish cities are still recovering from their last trough on the back of healthier office market conditions. At the same time, the strong momentum in Berlin and Stockholm resulted in double-digit year-on-year rent growth in the third quarter of 2016.³² Conversely, abundant supply in Warsaw has triggered further downward adjustments in rental values.

5.2 Outlook

The ongoing improvement in the labour market still has some way to run and is forecast to generate around five million jobs across the European Union by 2021.³³ Around half of these jobs will be office based, and therefore we continue to expect strong demand for a number of years to come.

²⁹ Oxford Economics, January 2017.

³⁰ PMA, November 2016. Europe= 37 cities.

³¹ PMA, November 2016.

³² PMA, November 2016.

³³ Oxford Economics, January 2017.

Cities such as Frankfurt, Paris, Dublin, Luxembourg and Amsterdam are well positioned to attract potential office jobs from London following the Brexit vote. However, the likely extent of any financial and services relocations from the United Kingdom is unlikely to become clear until negotiations with the E.U. are some way down the line.

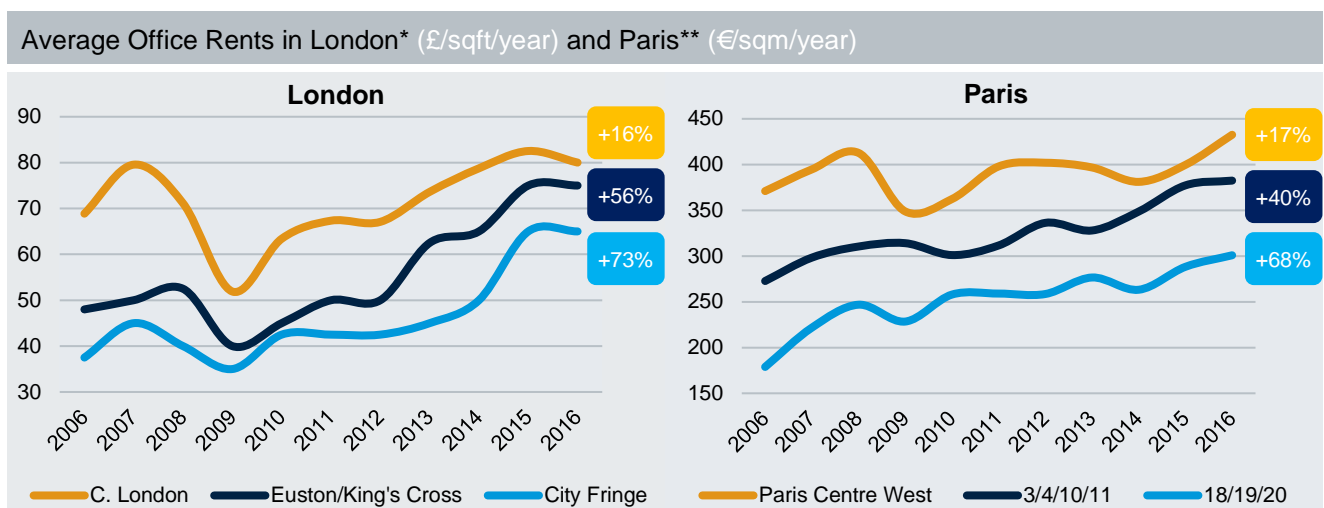
During the next two years, rents should continue to grow strongly in central locations as new office deliveries will be limited. However, the office pipeline is also beginning to rise in Continental Europe and we expect net completions to be back to their long-term average from 2018 onwards. This could start to reverse the downward trend vacancy in Western European markets and act as a drag on rental growth.

In the United Kingdom, the outlook is somewhat different. We anticipate a correction in rental values over the next 12-24 months, as a wait-and-see attitude among occupiers will constrain letting activity, while a significant level of new supply will still be coming onto the market. However, the pipeline is starting to thin and with lower rents and more clarity on the terms of the U.K. exit, we believe rent growth should start to recover and even outperform other European markets by the end of the decade.

The major German cities, Paris La Défense and central locations in Madrid, Barcelona, and Amsterdam are forecast to record above-average growth over the next few years. Helsinki is entering the early stages of recovery and could also start to provide opportunities by 2018.

5.3 Strategies

- **Focus on prime CBD offices:** CBD offices should continue to benefit from solid market fundamentals and are expected to perform throughout the real estate cycle. Demand for Grade A office space will remain strong while vacancy for this type of property is unlikely to rise much. As such, targeted refurbishment and shorter hold period strategies may be attractive.
- **Select 'converging' urban locations:** Occupier demand is gradually shifting towards alternative locations, close to the city centre with good accessibility in a mixed-use urban environment. We expect those areas increasingly to attract TMT companies and a new generation of employees through the development of innovative and flexible work space: start-ups, 'fab labs', incubators and co-working space. Importantly, this type of location is more affordable than space in the CBD. Above-average rent growth prospects and yield convergence will provide opportunities for creating value through refurbishments, particularly in cities such as Paris, London, Berlin, Amsterdam or Stockholm.



Sources: PMA, BNP Paribas Real Estate, February 2017.

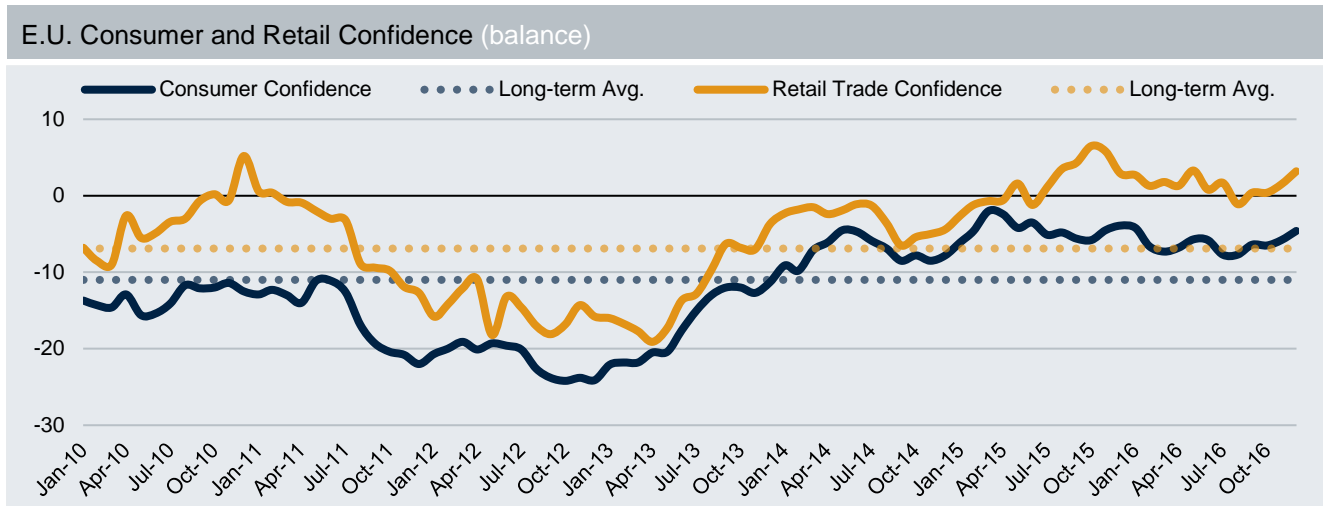
Notes: *For prime properties. **For second hand properties. Past performance is not indicative of future results.

6 Retail Market Outlook and Strategies

6.1 Current Conditions

Consumers and retailers closed the year in an upbeat mood.³⁴ Falling unemployment and rising real wages helped to keep confidence levels above their historical average, in turn boosting sales.

With the impact of technology and online sales migration showing no sign of waning, the increase in retail sales certainly didn't translate fully into in-store sales growth. Nonetheless, as vacancy on the most sought-after pitches is often running close to historically low levels, prime rental growth was evident across a number of the major cities.



Source: European Commission, July 2016.

Furthermore, landlords and retailers are continuing to adapt their business models in order to work in tandem with online retailing. While in part consolidating their store portfolios, retailers are also acknowledging the value of stores as a means to build closer relationships with customers through activities such as showcasing, selling experiences and additional services.

It would, however, be wrong to suggest that the sector is in full health. Parts of the retail market are struggling. Last year saw the failure of retailers such as BHS in the United Kingdom, Rudolf Wöhrle in Germany and Vroom and Dressman in the Netherlands. In areas where demand is weak, these failures often compound the problems of high vacancy, falling footfall and lower rents, and without substantial intervention such locations may be unrecoverable.

Prime locations are generally doing well. Across major high streets and shopping centres vacancy remains low and rents are gradually picking up. On average we estimate that prime shopping centre rents increased by 1.6% last year, and major high streets up 3.1%. However, prime locations should not be complacent. Over recent years, prime high street rents have risen exceptionally strongly, to the point where store economics in some locations is now stretched. While it is correct to say that many retailers see these stores as part of their marketing strategy, in places such as Central London where rents are already 65% above pre-recession levels, there are signs this is pushing some retailers to consider less established submarkets.

6.2 Outlook

Over the coming few years we expect retail to be a relative outperformer. While structural challenges will remain, the cyclical recovery has tended to lag in recent years, and therefore we anticipate that the best locations are due a period of catch-up.

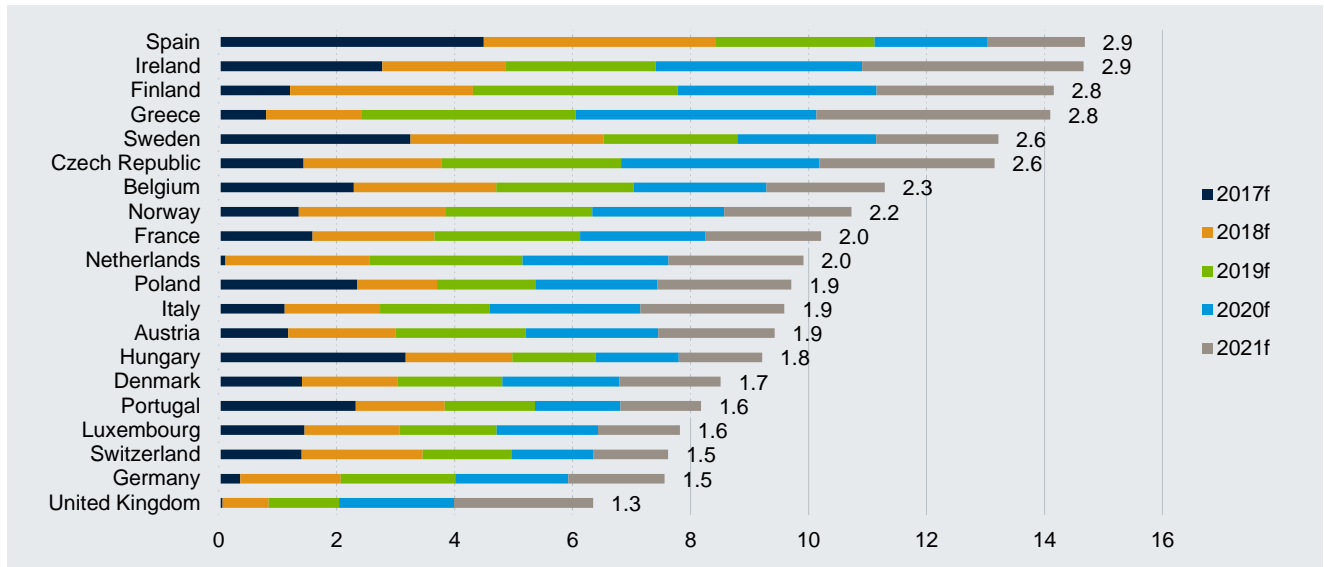
The outlook for some markets such as German shopping centres has been downgraded as they have so far failed to record much rental growth in recent years, despite improving fundamentals. However, in general, the

³⁴ European Commission, January 2017.

combined forces of rising real wages, focused retailer demand and continued low levels of development are forecast to lead to prime shopping centre rent growth of around 2% per annum for the next five years.

Over this period the top performing shopping centre markets in terms of rental growth are predicted to be Spain and Ireland (+3% per annum), with Germany (+1.5%) and the United Kingdom (+1.3%) at the other end of the hierarchy.

Cumulative Prime Shopping Centre Rent Growth (% , 2017-21f)



Source: Deutsche Asset Management, December 2016.

Note: f = forecast. There is no guarantee the forecast shown will materialise. Figures show annual averages.

Despite what seems to have been a good Christmas trading period in the United Kingdom, this was not necessarily seen in-store. With rising inflation and Brexit uncertainty likely to stress the market, 2017 is set to be a difficult period. Furthermore, the best locations here are tending to see low levels of vacancy, but the revaluation of business rates in April 2017 has the potential to raise occupancy costs substantially.

From a risk-adjusted perspective we see the most attractive opportunities in the Benelux countries, Finland and Ireland. Given the relative small size of these markets, this suggests the deployment of capital for European retail will likely be led more by asset than market specifics. In contrast, we recommend that investors consider disposals in Italy and Poland. While Italy has been attractive in recent years, the combination of rising macro risks coupled with recent falls in yield have tipped the balance towards a sell recommendation.

Over the longer term the United Kingdom should prove more attractive. It is leading Europe in online adoption, while its highly competitive environment has helped to shake out weak retailers, less suited to this new retailing model. With this in mind, investors should hold on to their best quality stock with an eye to increasing exposure following an expected price correction in 2017.

6.3 Strategies

- **Integrated urban locations:** These urban centres cater for their immediate catchment and the overflow from prime high streets. They have a far more intimate relationship with their shopper, encouraging loyalty and frequency of visit. With urbanisation supporting population growth and consumer spending, such locations should see strong sales growth and above average rent growth. By understanding catchment needs they should also prove defensive against the shift to online.
- **Dominant shopping centres:** Even in markets with high online sales rates, large dominant shopping centres are proving resilient. We recommend a focus on centres in large urban areas that dominate a growing catchment with high barriers to entry. We would also consider fashion-focused centres with quality food & beverage, niche retailers and the potential for asset management to refresh experience and drive higher sales and rent growth.

7 Logistics Market Outlook and Strategies

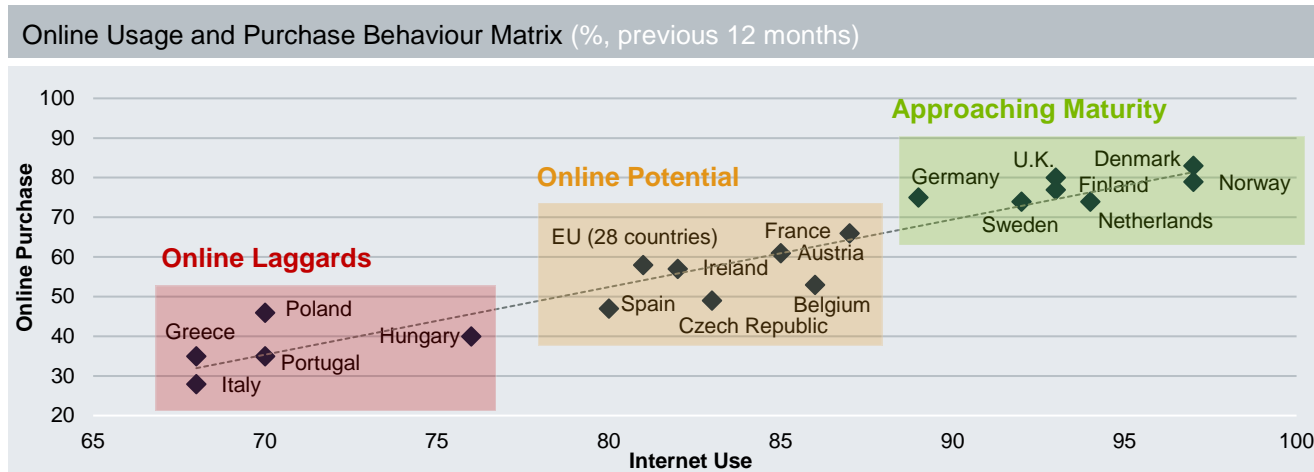
7.1 Current Conditions

Long-term megatrends such as urbanisation and technological change are fundamentally reshaping the relationship between consumers and retail. Forward thinking retailers are responding, developing and optimising omni-channel strategies that are underpinned by flexible payment channels and delivery options.

This trend is now broadening across retail verticals and geographic markets as more traditional store-based retailers enter the online space, while “pure-play” online retailers take physical store space to support brand building, showcasing, and click & collect activities. In addition, some brands such as emerging automobile manufacturers are circumventing traditional retail distribution channels and going direct to consumer.

Ultimately these trends are disrupting the logistics sector, leading to widespread reconfiguration of supply chain activities. There is now an arms race amongst a diverse array of occupiers including manufacturers, retailers, e-commerce companies and 3PLs to secure the best sites that will enable the efficient delivery of goods. To this end, some occupiers, driven by a desire to generate scale efficiencies and conscious of the costs associated with re-orientating supply chains, are consolidating distribution activities into larger infrastructure-linked “mega-sheds”.

Demand for urban ‘last mile’ logistics facilities that enable the delivery of parcels to click & collect locations or direct to consumer continues to accelerate, as parcel operators have seen significant growth in recent years. With online retail expected to grow by double digits across most European markets, the parcel sector is primed for further growth. Within the context of rising occupier demand, obsolescence of outdated stock and falling availability of well-located, quality modern stock, rental growth is beginning to emerge in a number of locations.



Source: Eurostat, December 2016.

Note: Horizontal axis shows the proportion of people who have used the internet in the past twelve months; vertical axis shows the proportion of people who have used the internet to make a purchase in the past twelve months.

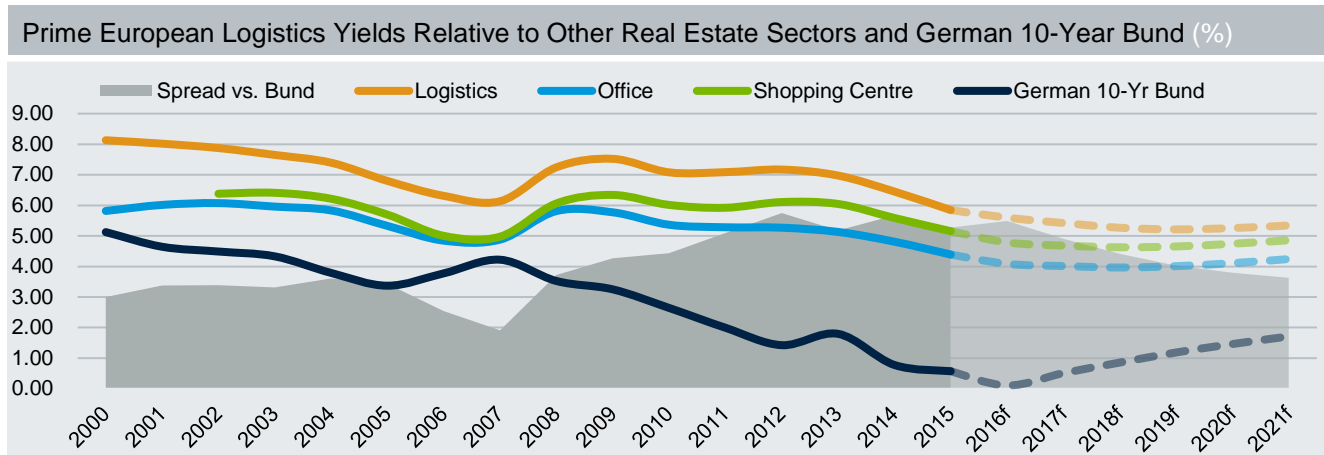
7.2 Outlook

We expect domestic demand to remain the engine of growth in Europe in the near term, despite rising inflation. Meanwhile, growing economic and political uncertainty will likely dampen prospects for a strong and broad-based recovery in global trade, offsetting some of the shorter-term benefits of a stronger dollar.

Double digit online retail growth across Europe, particularly in “Online Potential” and “Online Laggard” markets, will likely sustain demand for high quality XXL distribution / e-fulfilment centres as well as edge-of-town urban assets geared towards parcel deliveries.

Across most European markets, the erosion in the availability of modern Grade A logistics stock is prompting a rise in speculative development, although robust tenant demand will likely mean much of this new space will be absorbed quickly. For most tenants, build-to-suit (BTS) will remain the key route to fulfil their needs. With rents below pre-crisis peak in most markets, and occupier conditions remaining favourable, we expect to see a pickup in rental growth over the next five years.

Yields have continued to trend down in recent quarters, and with the spread to other commercial sectors relatively wide, there is further room for compression over the next two years. With bond yields expected to move out towards the end of the decade, we see prime logistics yields expanding, but to a lesser degree than other commercial property segments as the sector is expected to benefit from further institutionalisation.



Sources: Oxford Economics, November 2016; PMA, Q4 2016; Deutsche Asset Management, January 2017.

Note: f = forecast. There is no guarantee the forecast shown will materialise. Past performance is not indicative of future results.

Given emerging rent growth, anticipated near-term yield compression and a moderate back-end expansion, logistics is set to outperform over the next five years. However, we expect to see divergence in terms of occupier conditions, rental growth prospects and capital value cycles across markets.

Across the three largest markets, we see the most compelling opportunities in France. While the French recovery is lagging the United Kingdom and Germany, it is also behind in terms of e-commerce maturity, which should in time offer opportunities to benefit from the uplift in demand associated with rising online sales.

In the United Kingdom we expect rent growth to flatten over the next two years on the back of weaker retail sales, before picking up towards the end of the decade. Germany should continue to do well. In some locations rental affordability may become an issue, but this is not a universal concern, with the likes of Berlin set to outperform the national average.

Elsewhere, Barcelona and Madrid remain attractive, given the strength of projected rent growth. We have an underweight call on Italy, but select tactical investments could emerge in the north. Within the Benelux, we recommend a focus on markets with large population catchments such as Amsterdam and Brussels. And in the CEE, we advise caution on Poland, where potentially high levels of supply could impact the market negatively.

7.2 Strategies

- **Distribution:** We foresee opportunities to forward fund XXL (50,000+ square metres) infrastructure-linked distribution and e-fulfilment centres close to major population hubs. Investors should target markets with diverse occupier demand from retail, e-commerce and 3PL occupiers and maintain preference for long-income assets let to excellent covenants. A core defensive strategy, targeting mature markets, could yield 5.00%-5.50%, while selective bets in “Online Potential” markets such as France and Spain could offer a premium of at least 50 basis points over mature markets, with potential for long-term convergence.
- **Cross-docked urban logistics:** Investors could benefit from megatrends such as urbanisation and technological change through acquiring or developing urban logistics. Cross-docked urban parcel delivery centres, often automated, that facilitate “last mile” delivery in infill locations will typically be let on long leases to strong parcel delivery operators. While previously there have been concerns relating to illiquidity and the niche occupier market, growth in e-commerce has broadened tenant demand and enticed investors. Yields in mature markets have converged towards prime logistics yields.
- **Reposition light industrial units:** We would recommend refurbishing dated light industrial assets in strong urban locations in order to meet requirements for “last mile” use. This strategy will likely be more asset management intensive and could see regular tenant churn. WALTs are likely to be shorter but rents could outperform in the longer term given significant demand pressure from a diverse array of potential tenants. Yields range between 5.00% and 7.00%, with higher yields typical for older assets requiring capex in “selective bet” markets. For this strategy to succeed, maintaining a focus on key locations is imperative.

8 Residential Market Outlook and Strategies

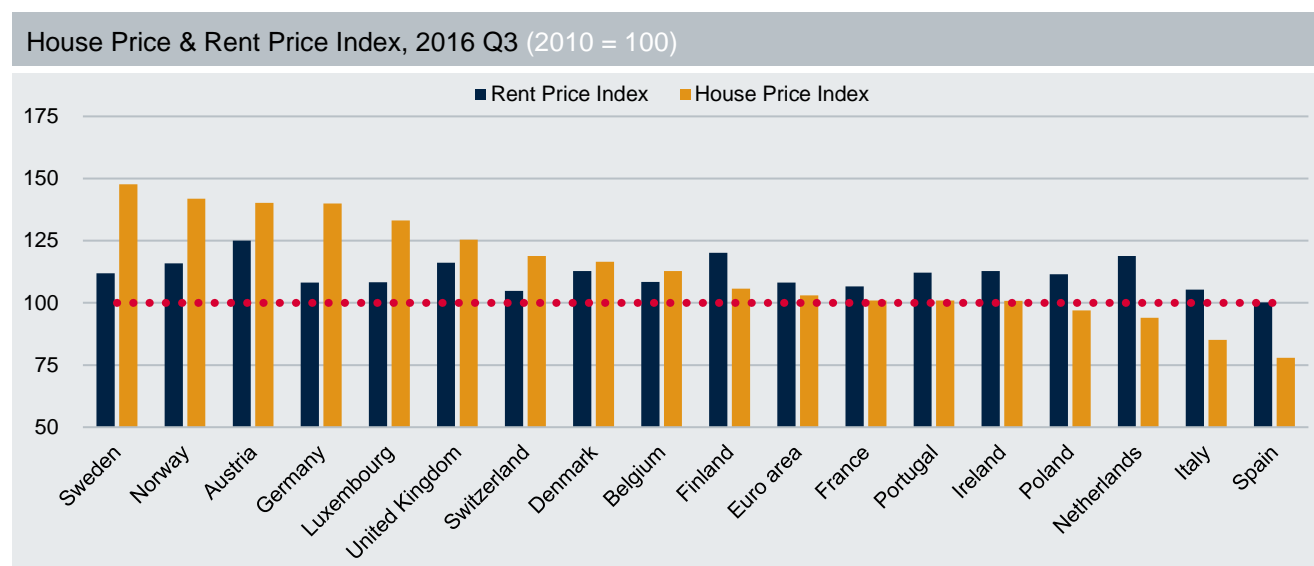
8.1 Current Conditions

With heightened uncertainty, investments with “safe-haven” characteristics typically receive increased investor attention. As a defensive real estate sector, which is mainly driven by local demand and supply fundamentals, the residential market has less exposure to major market downswings and as such appeals to investors. Demand is typically non-cyclical, void risks are limited and income streams show little volatility thanks to inelastic housing needs. In addition, a number of European residential markets are becoming more institutionally investable, offering opportunities for increased management efficiencies, but more importantly, diversification potential across locations and market segments.

Although a general trend towards a more institutionalised asset class is apparent, regional differences persist. Regulations on tax, investment and letting are important issues at a national level. Also, cultural discrepancies leave their mark with regard to ownership rates and dwelling types. Germanic countries, for example, stand out for their sizeable tenant markets, many of whom reside in multi-family homes, which are often favoured by investors as they are less management intensive. Interpreting the ownership rate as an indicator for availability of investible product, institutional stock is limited in certain regions, especially the Southern and Eastern European periphery.

With economic and demographic trends being two of the main drivers of demand, a diverging regional pattern becomes visible as well, overlapping the national picture and clearly favouring urban agglomerations. Although new supply is generally focusing on urban markets, household growth and demand for new and/or right sized stock is often outpacing residential construction volumes, leading to a pronounced demand-supply gap. German cities are an example of such trends. Here, the development pipeline is increasing, reaching the largest number of permissions for a decade. This implies that future completions will rise at a national level, but are still unlikely to satisfy current demand,³⁵ which is concentrated in urban agglomerations. On a European level, residential supply is even more subdued, only increasing significantly in the last two years in some Western European markets like Ireland and the Netherlands.

Residential markets have seen strong total returns recently, but with significant variation between markets. Countries like the United Kingdom feature high but volatile returns, whereas less valuation driven markets like Germany are steadier.³⁶ Most countries have seen rents and prices increase since 2010, but again to differing extents. Also, differences exist with respect to transaction volumes. On average over the last ten years, only Germany, the United Kingdom, Sweden, the Netherlands and France achieved annual transaction volumes above €1 billion, and hence it is these countries that form the backbone of the residential investment market.³⁷



Source: OECD, February 2017.

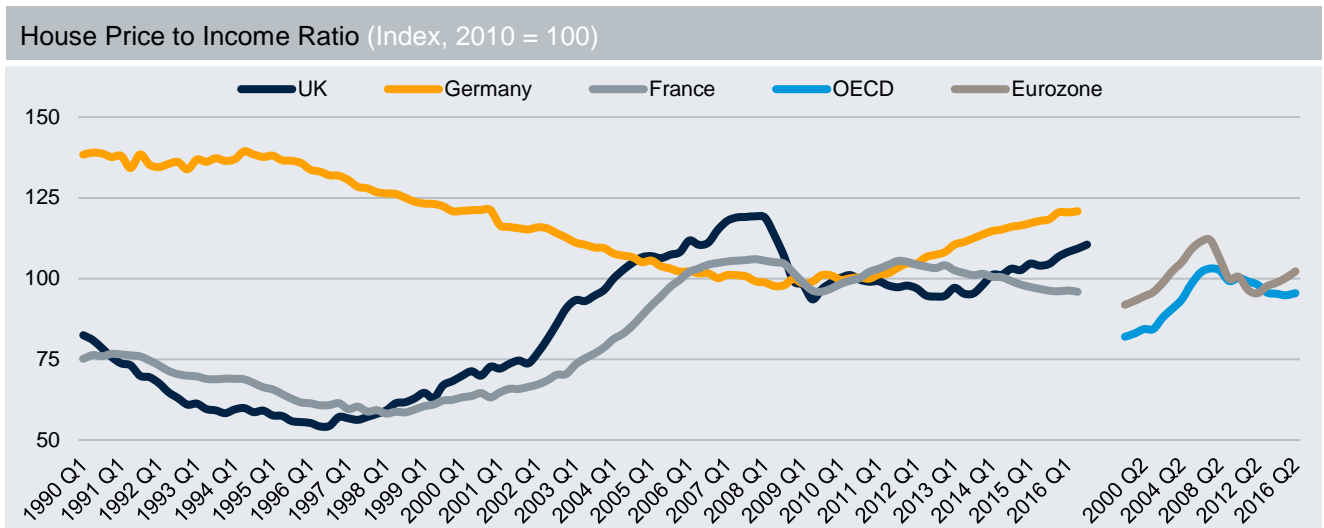
³⁵ Pestel Institut September 2015; Destatis December 2016.

³⁶ IPD 2016.

³⁷ Real Capital Analytics, February 2017.

8.2 Outlook

Given current political uncertainties and other downside risks, and with strong institutional demand for real estate, residential offers an additional market segment for defensive investments. Hence, long-term, cash-flow oriented investors in particular are widening their investment scope beyond domestic markets, seeking European exposure to residential markets. In line with this trend, house prices in markets like Germany, Sweden and the United Kingdom have increased significantly in recent years, both in absolute terms and in relation to income and rental payments. With prices rising, affordability of home ownership is becoming an issue in some markets, despite low interest rates and generous financing conditions, leaving landlords in a favourable position. Even markets like Italy and Spain, which saw large house price declines in recent years, are reverting to positive growth rates as the economic situation is improving and demand increases.



Source: OECD, January 2017.

Despite national regulations and standards, developments on a country level can be thwarted by regional trends. Especially in urban agglomerations that have a sound economic background, population growth, and hence pressure on rents and prices, tend to be more pronounced. Here too, the affordability of home ownership is restricted, making those locations favourable for landlords or residential developments, particularly in the mid-price market segment.

8.3 Strategies

- **Large agglomerations and swarm cities:** We recommend a focus on European metropolitan regions, key regional cities and smaller cities with considerable appeal for the younger population. Investment destinations should not only be characterised by positive net migration, but also by supply shortages and strong population growth.
- **Growing residential market segments:** We expect new residential sub-segments, which profit from developing megatrends like urbanisation, aging population or institutionalisation, to offer attractive investment opportunities. We would focus on affluent growing cities with favourable regulations and assets in integrated locations.
- **Residential developments:** We would consider large-scale development projects in selected cities, with the co-operation of local authorities. Significant population growth is also required, strengthening the demand for affordable housing as well as supply in the mid-market range.

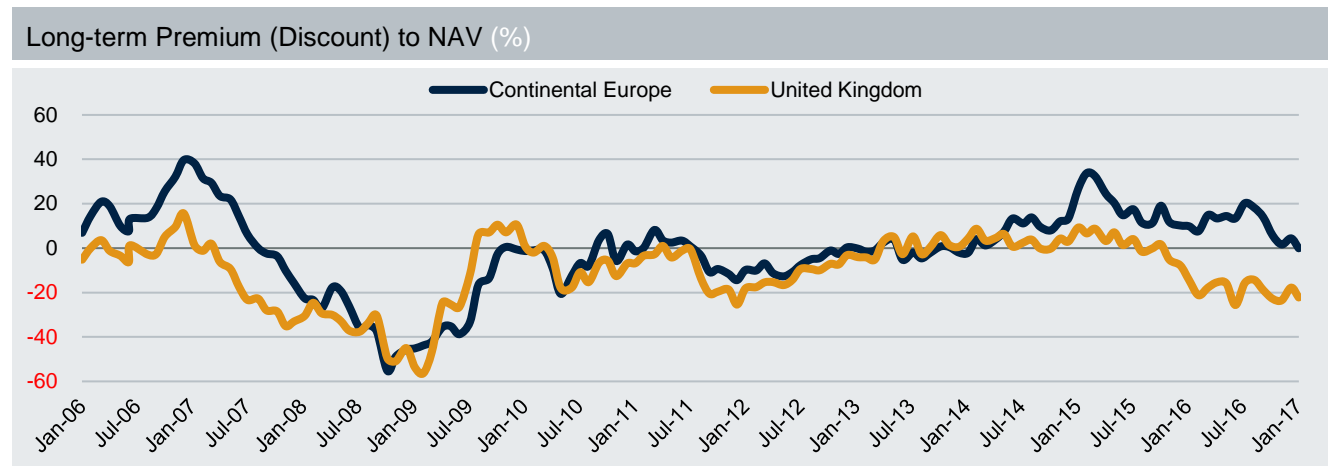
9 Real Estate Securities

Throughout the series of unexpected events in 2016, real estate shares could not escape the wider market volatility as a global repositioning from defensives to cyclical and banks played out, driven by an expectation of a steepening yield curve.

The listed real estate sector underperformed the broader equity market over the year. Within the sector, the outperformers were Norway, Finland, Switzerland and Germany while the underperformers were the United Kingdom, Spain and Italy.

The U.K. market continues to face uncertainty in the aftermath of the leave vote. Long-term demand in London is the most critical issue for the listed sector, as banks investigate the potential impact of a withdrawal of passporting rights.

As a result, U.K. property stocks have fallen behind since the referendum and the sector now trades at a 20% discount on average. This compares to around a 10% discount for Continental offices, a 20% premium on German residential (versus a historical average of 35% and a forward looking 7% premium based on 2016 consensus figures) and Continental retail trading at close to NAV.³⁸



Sources: UBS, DataStream, January 2017

Note: Past performance is not indicative of future results.

After a strong December the listed real estate market has been relatively flat in early 2017. This year will be pivotal on the macro front, with the extension of the ECB's quantitative easing programme, albeit at a slower pace, and U.S. policy rates widely expected to rise. A busy schedule of elections, including France, Germany and the Netherlands, means that political events will continue to be a possible cause of disruption. Overall, real estate, often seen as a bond proxy sector, could be volatile again.

In the United Kingdom, MSCI/IPD property values were down by just 3% between May and December 2016,³⁹ and broadly stabilised in the final months of the year as the drop in sterling supported values for higher quality assets. So while the listed sector should continue to trade at a discount to NAV, a number of 'mitigating factors' that have already provided support to the market suggest that this downturn will be relatively modest. Most management teams agree that the outlook has worsened, but few have a clear view on the shape and timing of the down cycle, having significantly de-risked their businesses to take advantage should opportunities arise.

In Continental Europe, German residential stocks, as one of the most correlated sectors to bond yields, have been negatively affected by the pick-up in 10-year German Bund yields. The fundamental background stays positive, however, and could provide support to valuations.

Continental retail largely underperformed in 2016 due to challenging retail sales figures in some countries and increasing internet competition. Continental offices should be supported by a positive rental outlook in Paris and by generally limited supply and low vacancy, while German offices keep attracting Asian money.

Following the resolution of the Spanish political situation, real estate names in the region were given a recent boost after lagging for most of the year and could maintain outperformance in the near term, assuming public companies start to show solid rental growth.

³⁸ EPRA, January 2017. Past performance is not indicative of future results.

³⁹ MSCI, February 2017. Past performance is not indicative of future results.

10 Overview of Key European Markets

Strategic Outlook: United Kingdom

We maintain an underweight position on the market but with an eye towards increasing exposure in 12 to 18 months. A material slowdown in economic growth is expected in 2017, driven by lower consumption in light of rising inflation and continued uncertainty weighing on business investment. This has led to lowered expectations of tenant demand. Rising availability is leading incentives to expand, while prime office rental decline is foreseen across most markets this year, with the steepest falls projected in Central London. Business rates are also set to compound the weak demand outlook in some locations, negatively impacting prime retail and London offices. Investment is expected to remain muted across all sectors in the short term, while prime yields are likely to move out further. However, supported by London's fundamental strengths, we see a high possibility of a strong market recovery led by the capital as economic uncertainty reduces and new supply moderates. We advise investors to prepare to re-enter the United Kingdom in a phased manner, maintaining a disciplined focus on prime assets and locations.

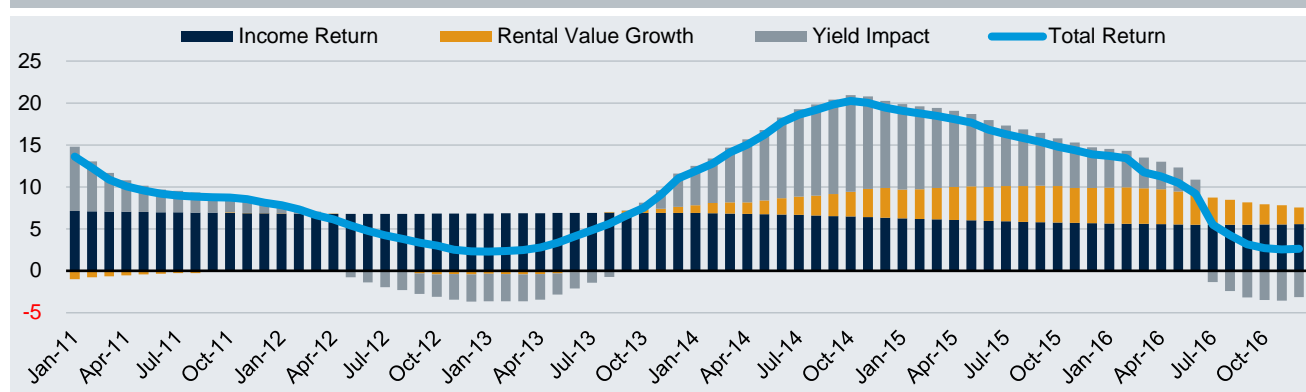
Occupier

- Take-up slowed during the run up to, and the aftermath of, the E.U. referendum. Availability has continued to trend upwards in Central London as projects under construction are delivered.
- Consequently, the twin effects of falling demand and rising availability are resulting in downward pressure on rents, with incentives increasing and headline rents falling.
- Retail is exposed to weakening consumption and stretched retailer margins, while logistics should remain relatively defensive as e-commerce growth continues to accelerate.
- A projected economic recovery towards the end of the decade combined with moderating new development activity sets the scene for a strong medium-term rental recovery.

Investment

- Investment activity slowed sharply in 2016⁴⁰ and is set to remain subdued in the near term.
- Overseas investors are undertaking select transactions, taking advantage of the weaker pound.
- MSCI/IPD all property returns are trending down in response to falling capital values. Prime values are forecast to decline by circa 15-20% in Central London in the near term. London typically bounces back quickly, and as such we see potential for a strong price recovery.
- Rising property yields are likely to widen the near-term spread over bonds. The gap is then likely to narrow as real estate values recover but should be moderated by rising bond yields.
- We recommend a focus on core strategies as the market approaches its trough, before considering selective bets on emerging submarkets and leasing risk.

IPD U.K. All Property Annual Total Return (%)



Source: MSCI/IPD, February 2017

Note: Past performance is not indicative of future results.

⁴⁰ RCA, February 2017

Strategic Outlook: Germany

Business sentiment improved significantly towards the end of 2016 and influenced letting markets in a positive manner, leading to record take-up volumes, declining vacancy rates and robust rental growth. Investment markets also recorded a strong year, but fell short of the 2015 all-time high. Nonetheless investment demand remained strong, pushing office yields to unprecedented low levels, with expectations of a further fall in the near term. In spite of the extended quantitative easing programme and continuously low interest rates, we expect outward yield movements from 2018 onwards. Coupled with signs that the development cycle is picking up, this is set to lower returns during the final part of the decade, pushing the risk-adjusted performance closer to the European average.

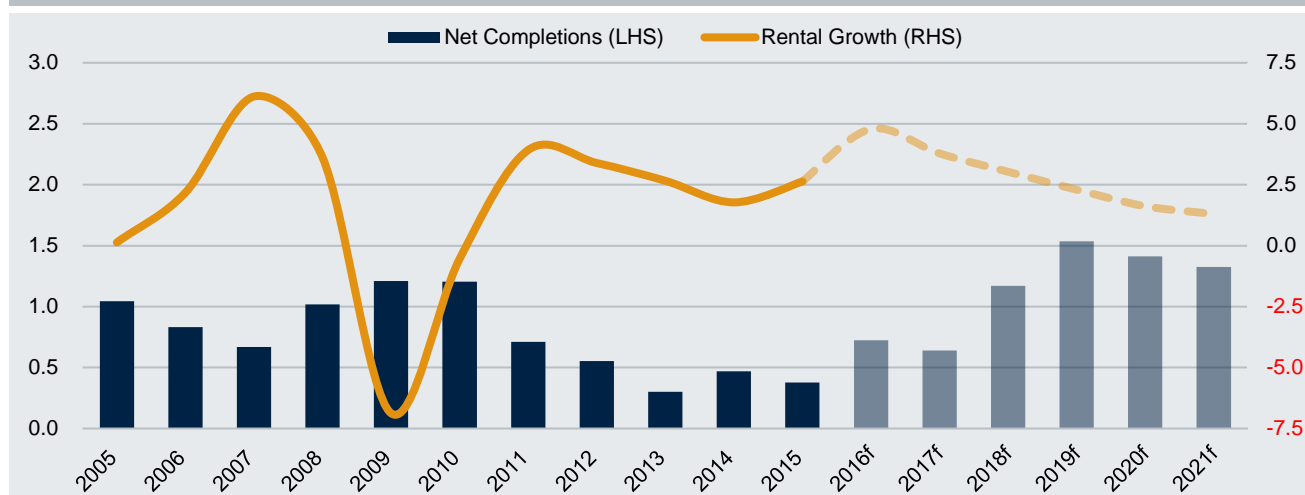
Occupier

- Tenant demand in the office market remains strong, leading to an even higher annual take-up volume than in 2015. Berlin was still the top-performer in terms of total demand volume, but Cologne and Stuttgart showed the strongest annual increases, thanks to large individual deals.
- In line with robust tenant demand, vacancy levels in the Top-7 markets fell again, reaching the lowest aggregate level since 2001. As some markets are falling below a level of 5%, supply constraints are becoming a concern. This is increasing pressure on office rents, which rose by more than 4% in 2016, mainly due to strong increases in Berlin.
- The volume of new space coming to the market increased in 2016, but did not keep pace with tenant demand. However, going forward the development pipeline is expected to grow, moderating rental growth as the decade comes to a close.

Investment

- The German investment market surprised on the upside in 2016. Thanks to a good fourth quarter, total investment surpassed the 2014 level, but was some way short of the record high seen in 2015, breaking a six-year streak of continuous increases.⁴¹
- The main reasons for the slight fall in transaction volumes were limited product availability and smaller deal sizes. At the same time, domestic and international investor demand remained high, as the ongoing yield compression to new all-time lows suggests.
- Going forward, investment pressure in Germany should remain high. As 2017 may be affected by political uncertainties, more defensive investment schemes remain the focus of investors. Given sharp pricing and limited product availability, project developments and repositioning might provide solutions as well.

Office Net Completions (% of existing stock) and Rental Growth (%) in Germany



Sources: PMA, JLL, Deutsche Asset Management, December 2016.

Note: f = forecast. There is no guarantee the forecast shown will materialise. Past performance is not indicative of future results.

⁴¹ RCA, February 2017.

Strategic Outlook: France

GDP growth in France is expected to be in line with the Eurozone average by the end of the decade, but could be dampened by growing political risk in the run up to the 2017 presidential election. In 2016, real estate market fundamentals improved, as demand for office space continued to increase while e-commerce growth is boosting the logistics market. We expect yields to remain low for all asset classes and to maintain wide spreads over bonds. But affordability is becoming an issue, with office capital values reaching new highs in Paris. Therefore, we see La Défense and the regional cities offering good alternatives, given the positive occupier market outlook and favourable yield premium over the Paris CBD. We anticipate French logistics to continue outperforming, especially in the Paris region.

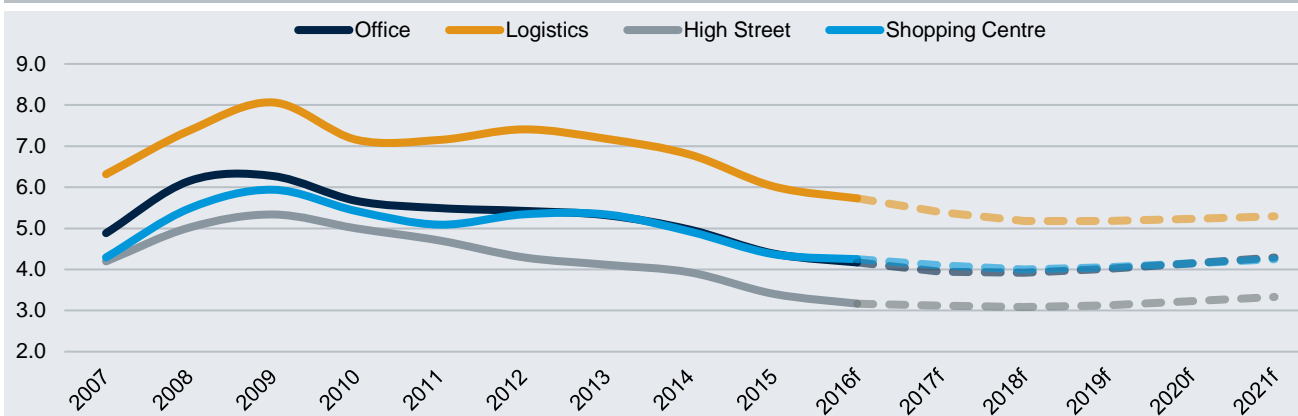
Occupier

- Faster employment growth in 2016 helped the office occupier market. Office take-up in Ile-de-France increased for the fourth consecutive year and remained above 10-year average levels, while letting activity remained robust in the regions.
- Office vacancy has reduced significantly in Central Paris but the increasing volume of office space under construction could start to reverse the downward trend in the coming years. As prime rents are still some way below their last peak, we see the strongest growth potential in Paris *intra muros* and La Défense, although the level of incentives remains high.
- Logistics market activity has remained buoyant, primarily along the central logistics backbone. We expect rents to grow faster than the European average, as e-commerce should continue to gain ground and Grade A supply is likely to remain scarce.
- Consumer confidence and retail sales have proven resilient, enabling prime high street retail to sustain high values, but the supply of refurbished shopping centres may curb rent growth.

Investment

- The French investment market proved resilient in 2016. Volumes failed to match the record levels from 2015, but were still comfortably above €25 billion, in line with 2014 levels.⁴² The market is still dominated by domestic players such as SCPIs and insurers, who should remain active in 2017.
- The scarcity of core product for sale has put further pressure on yields. Although yield compression could start to ease as interest rates rise, spreads remain wide over bonds.
- Investor interest in French logistics is still increasing given the positive impact of e-commerce growth on occupier demand and the favourable risk premium over other types of asset.

Average Prime Yields in France by Sector (%)



Sources: PMA (historical data), November 2016; Deutsche Asset Management, January 2017.

Note: f = forecast. There is no guarantee the forecast shown will materialise. Past performance is not indicative of future results.

⁴² RCA, February 2017.

Strategic Outlook: Spain

We continue to hold an overweight position on the Spanish market but see that the recovery is starting to mature. The occupational upturn still has some way to run, and with the economy one of the fastest growing in Europe, we see considerable rent growth on the horizon. This will almost certainly be the main driver of future capital value growth. Yields, both prime and secondary, have continued to fall sharply, but in parts of Madrid and Barcelona we feel the positive impact of yield compression has almost run its course. Despite this we still believe Spain offers compelling investment opportunities. The strength of rental recovery should be enough to provide sufficient returns in core and near-core office locations, while demand and limited stock are supportive of refurbishment. With the country lagging in terms of online activity, we also see great potential in logistics, particularly for assets and locations most aligned with online retailing.

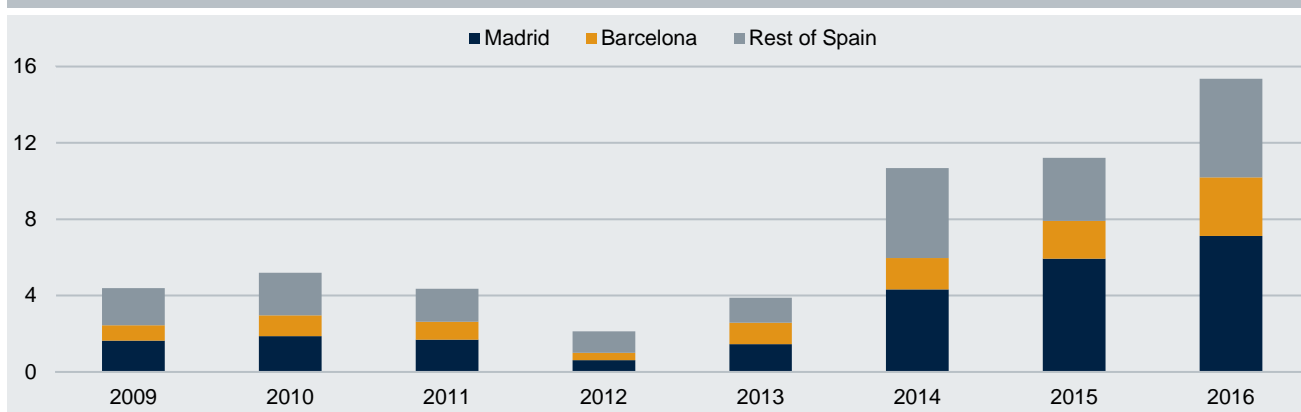
Occupier

- Spanish economic growth surprised on the upside in 2016. GDP growth is projected to have expanded by 3.3%, one of the fastest rates in Europe.⁴³
- The unemployment rate fell by almost 200 basis points in 2016 to near 18%. Employment rose by 540,000 and over half of all jobs lost in the downturn have been recovered.⁴⁴
- Economic and employment growth is translating into demand for business and retail space, leading to falling vacancy and higher rents.
- Prime rents are rising strongly across sectors, and although there are some signs of development, we still expect Spanish rents to be among the top performers in Europe.
- Vacancy remains high in non-core locations, but is now falling, while rents have stabilised.

Investment

- An exceptionally strong final three months of the year saw transaction volumes rising to €15.4 billion in 2016, an almost 40% increase on the previous year.⁴⁵
- With the recovery broadening, investors were also increasingly active outside Madrid and Barcelona, purchasing €5.2 billion of stock, over 50% higher than the previous year.⁴⁶
- Prime yields are now close to previous lows, although with bonds still well below average, the economy improving and strong rent growth, we still see room for further compression in 2017.
- Future returns will mainly be driven by NOI growth. While we foresee a continued period of strength, by the end of the decade returns are likely to moderate as the recovery upsides are spent.

All Property Transaction Volumes in Spain (€ billion)



Source: Real Capital Analytics, February 2017.

Note: Past performance is not indicative of future results.

⁴³ Oxford Economics, December 2016.

⁴⁴ Eurostat, January 2017.

⁴⁵ Real Capital Analytics, February 2017.

⁴⁶ Real Capital Analytics, January 2017.

Strategic Outlook: Italy

We maintain an underweight investment call on the Italian market, reflecting weak economic growth prospects, increasing financial and political concerns and lower real estate return forecasts. Admittedly, recent labour reforms are expected to generate higher employment growth but so far this improvement has had only a minor impact on the office market, which is still showing an unbalanced market situation due to abundant supply. With clear risks in the occupier market, we feel recent increases in capital value are unjustified. We would recommend focusing selectively on prime logistics, where we expect more attractive returns relative to other sectors.

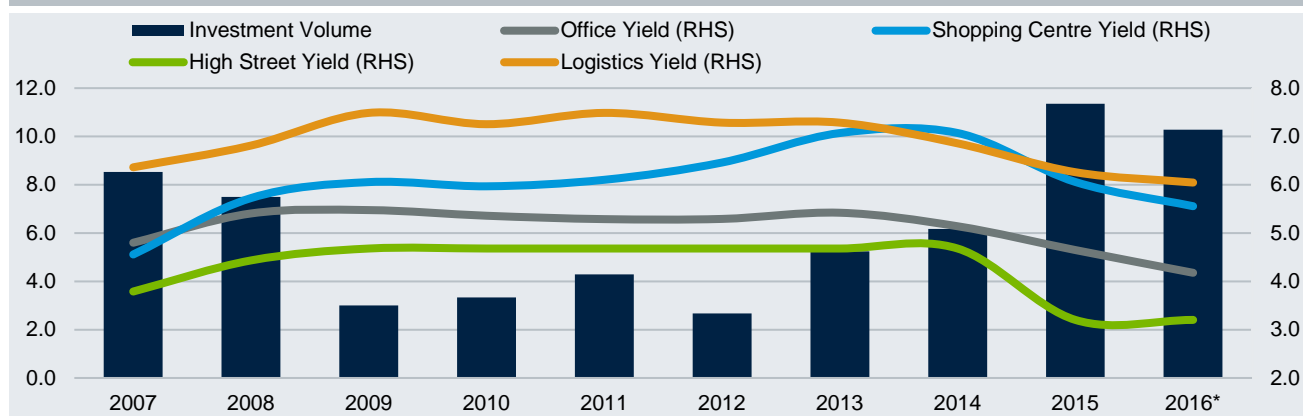
Occupier

- The combination of a subdued GDP growth outlook, rising political risks, a fragile banking sector and increasing state debt burden, are increasingly weighing upon the Italian real estate market.
- Although office take-up in Milan increased in 2016, it did not prevent a further rise in the vacancy rate, which is expected to remain elevated given the volume of space in the pipeline ready to be launched.
- Retail in high quality locations should benefit from resilient consumption, as long as the trend of growing tourism flows and retailer internationalisation continues to gather momentum.
- Growing take-up for logistics, boosted by 3PL demand, kept the national vacancy rate at just 3.4% by December 2016.⁴⁷ Current low levels of online retail penetration suggest high potential for logistics market activity from this sector.
- In this context, rent growth for all types of asset should be largely restricted to the prime segment, and will be broadly in line with the European average by the end of the decade.

Investment

- Investment activity remained strong in 2016. Totalling €10.3 billion, transaction volumes were down slightly on the record total of 2015, but well above the long-term average.⁴⁸
- Prime yields are still falling sharply across all sectors, reflecting increasing competition among investors for prime Italian assets. However, strong price increases in recent quarters should limit room for further yield compression, particularly for offices and retail.
- We see little prospect of strong risk-adjusted returns in Italy, as moderate rental growth is unlikely to offset the negative impact of future yield expansion, while the risk profile of the country is also increasing.
- We still expect the Italian market to provide selective opportunities in core logistics locations such as Milan. We anticipate returns to remain close to European average levels, driven by strong e-commerce growth potential.

All Property Investment Volumes (€billion) and Average Prime Net Initial Yields (%) in Italy



Sources: RCA, PMA, Cushman & Wakefield, Deutsche Asset Management, February 2017.

Notes: *Yields for 2016 as of Q3. Past performance is not indicative of future results.

⁴⁷ JLL, January 2016.

⁴⁸ RCA, February 2016.

Strategic Outlook: Poland

There is evidence that current policy uncertainty is having a negative impact on the Polish economy and particularly on business investment. Even when benchmarked against its peers – the Czech Republic and Hungary – Poland has started to underperform on almost all indicators. The current situation should be closely monitored and frequently reassessed. As long as the economic and political situation remains unclear, we continue to have an underweight call on most Polish real estate segments, with particular concerns about the Warsaw office market. But the situation should not necessarily lead to a complete stop to new allocations. Selective retail (because of the strong consumer market) and selective regional offices (due to relatively high yield spreads) could still offer opportunities. However, acquisitions must achieve above average performance, as investors should be rewarded for the additional risk.

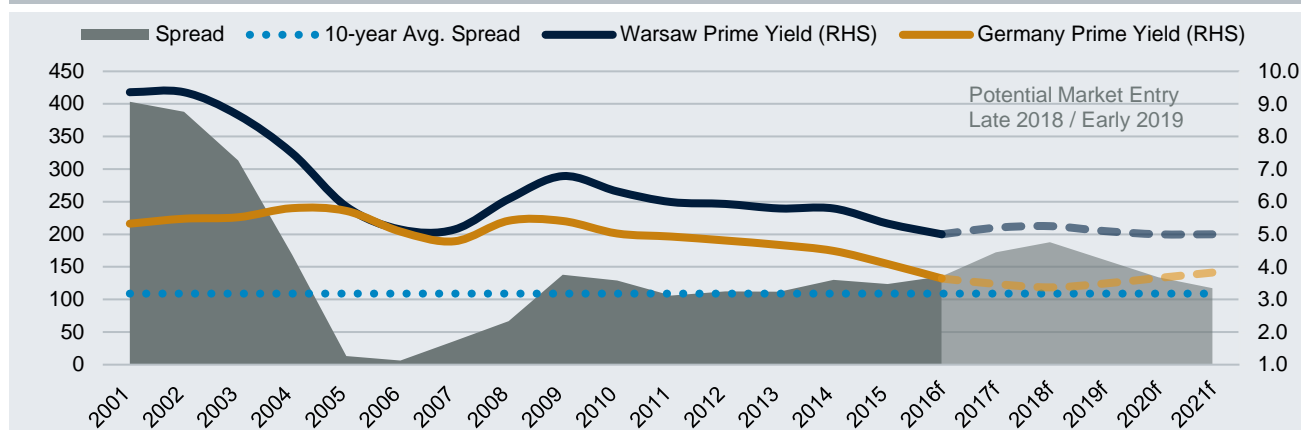
Occupier

- After a very strong year in 2015, demand growth for office space has levelled off in 2016. Take-up in the regions was up slightly on the previous year, with a small fall seen in Warsaw.⁴⁹
- Coupled with a continued high level of new deliveries, the Warsaw office market saw vacancy rates rise to around 16% last year. With this, we expect Warsaw office rents to continue to fall this year, before flattening in 2018.
- Despite the strong consumer market, supported by government initiatives like increasing child allowances, international retail outfits have either scaled back operations in Poland or are only focusing on a very selective number of centres.
- Online sales are expected to double in value over the next four years, particularly as Amazon is soon expected to announce its market entry. With logistics developers happy to build, this suggests a mixed outlook for the sector.

Investment

- Investment volumes in Poland fell significantly in the middle of 2016, after the first quarter was dominated by large portfolio transactions. However, the annual total was boosted by a particularly strong fourth quarter.⁵⁰
- It's difficult to judge whether a general slowdown in Poland is driven by higher perceived risk, as other established investment markets also saw lower activity in 2016. However, its main peers in the CE region have seen strong inflows.
- Prime office yields in Warsaw have compressed further and are now close to 5.00% (net). This looks hard to justify given the uncertainty. We would expect yield spreads to widen first before the market looks attractive for re-entry. In our forecast, this could be the case from 2019 onwards when the market should have a better balance in terms of new supply.

Prime Net Initial Office Yields in Warsaw and Germany (%) and Spread (basis points)



Sources: PMA (historical data), December 2016; Deutsche Asset Management, January 2017.

Note: f = forecast. There is no guarantee the forecast shown will materialise. Past performance is not indicative of future results.

⁴⁹ CBRE, February 2017.

⁵⁰ RCA, February 2017.

Strategic Outlook: Nordics

The Swedish economy has benefitted from solid private consumption and business investment recently and is expected to remain buoyant in the near term despite rising inflation, while Finland is showing signs of a tentative recovery. Growth projections are beginning to edge up in Norway as oil prices increase and Denmark's prospects remain healthy. The Nordics saw significant inflows of capital in 2016, a trend we expect to continue this year. Yield compression is likely to be modest as pricing is increasingly stretched, particularly in Sweden. Rising bond yields will likely put upward pressure on property yields towards the end of the decade, albeit to a lower extent than previously predicted. While the office segment is forecast to underperform, Helsinki offices offer more attractive risk-adjusted opportunities, although investors should maintain a focus on the prime segment.

Occupier

- Sweden's economy continues to perform, with inflation offset by rising wages. Finland is showing signs of recovery, while conditions in Norway and Denmark are improving.
- Demand across Swedish property segments remains healthy, supported by economic expansion and low vacancy in Stockholm. Helsinki's office market is seeing gradual improvement.
- Development activity is still limited in Helsinki and Stockholm, but rising in Copenhagen.
- Following exceptional growth in 2016, rents are set to moderate in Stockholm. Helsinki is expected to have reached the bottom and the economic recovery should provide impetus for future rental growth.
- Growing consumption is supporting retail and logistics demand in Stockholm and Copenhagen, but logistics rent growth prospects are limited by affordability constraints.

Investment

- Nordic investment volumes remain at elevated levels, supported by low bond yields. Activity is broadening to non-Nordic institutional players, demonstrating strong investor interest.
- With expectations of continued low interest rates and spreads remaining relatively wide, we see yields bottoming out in 2018 before rising as bond yields move further up.
- Prime total returns are trending down across the Nordics. Stockholm offices are set to underperform given stretched pricing but Helsinki offers opportunities. However, investors should maintain a focus on prime property.
- We would consider core logistics on a pan-Nordics basis, while being aware of affordability constraints limiting prospective rent growth. We also recommend retail selectively, focusing on the recovering Helsinki market.
- We currently have an overweight call on Stockholm offices, but see this trending to underweight, and would advise selling non-core assets.
- Residential is benefitting from longer-term demographic trends and may prove attractive to core investors. Entry yields are low, but there is solid rent growth potential and void risk is limited.

Nordics Total Return Outlook by Sector (2016-21f, %)



Sources: Deutsche Asset Management, January 2017.

Note: f = forecast. There is no guarantee the forecast shown will materialise. Past performance is not indicative of future results.

Strategic Outlook: Netherlands

The Dutch economy continues to experience GDP growth above the European average, with an estimated 2.1% increase in 2016.⁵¹ Political risks should be monitored around the elections this year but the improving economic environment is having a positive impact on real estate occupier conditions and bodes well for solid rental growth. Strong investor interest in the Dutch market is driven by improving occupation and attractive yields compared to other Western European markets. In this respect, we have an overweight call on the Netherlands, with office, retail and logistics expected to register relatively strong returns through to the end of the decade.

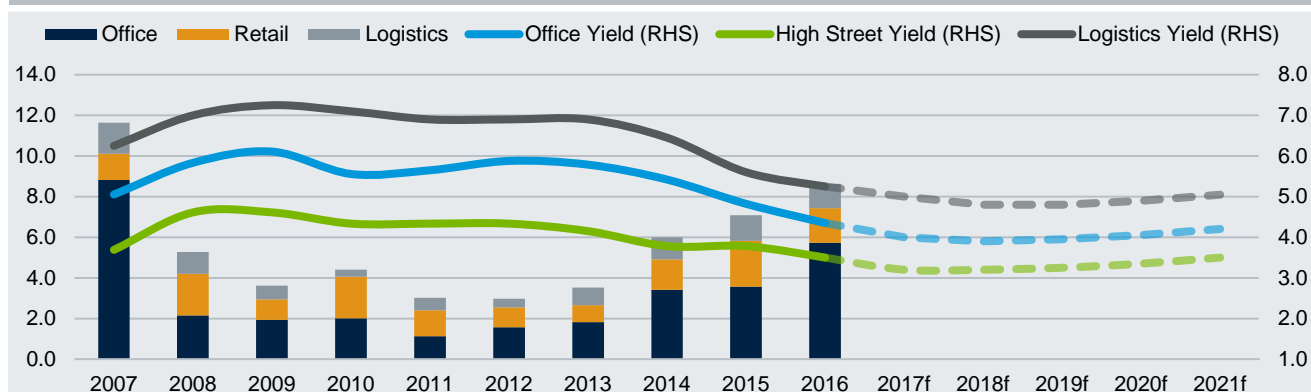
Occupier

- Improvements in the labour market have translated into higher office demand. Take-up in Amsterdam posted a strong performance in the first nine months of 2016, up by more than 50% on the same period the previous year.⁵²
- The withdrawal of obsolete office buildings from the market through conversions has helped reduce vacant space further. As new office completions remain very limited, we expect rents in Amsterdam to increase faster than in many other European cities over the next two years.
- Following the bankruptcies of major national retailers last year, the Dutch retail market is recovering on the back of rising private consumption and retail sales, which should support rent growth in the prime segment.
- The logistics market is still gaining ground, as buoyant demand for distribution centres has continued to sustain further falls in the vacancy rate. Nonetheless, low construction costs and increasing capital values could hold back stronger rent growth in secondary locations.

Investment

- Investors have increasingly deployed capital to the Dutch real estate market in 2016, particularly in the office segment, representing more than half of total investment volumes.⁵³
- The Netherlands remains a popular destination for foreign investors in search of strong fundamentals and higher yields than other Core European markets.
- We still see room for further prime yield compression, especially for office and logistics, before yields begin to move out gradually towards the back end of the decade.
- The shortage of prime assets for sale is driving investors to move further up the risk curve. Although market fundamentals are improving, we recommend caution in secondary locations where the recovery has not yet rebalanced the market.

Investment Volumes (€ billion) and Prime Yields (%) in the Netherlands



Sources: PMA (historical data), November 2016; CBRE, Deutsche Asset Management, January 2017.

Note: f = forecast. There is no guarantee the forecast shown will materialise. Past performance is not indicative of future results.

⁵¹ Oxford Economics, December 2016.

⁵² CBRE, January 2017.

⁵³ RCA, January 2017.

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