US private real estate still yield-ing good opportunity

The outlook for US real estate in 2018 is still bright, in our view. Drawing on more than four decades of historical real estate perspective along with insurance asset management modeling knowledge, we provide our outlook on a market that remains part of many alternative investment allocation discussions, especially at a time when the conversation is including both private debt and equity.

The economy gathered substantial momentum in 2017, a trend that might accelerate with additional support from recently-enacted tax reform and improving global conditions. Increased supply has neutralized some of the resulting impetus to real-estate fundamentals in some sectors and markets (e.g., apartments nationally and offices in some gateway cities), but with vacancy rates sitting near 15-year lows, rental growth should match or exceed inflation in most markets.[1]

Capital markets have been more volatile but they remain broadly supportive. After a 20% run-up in U.S. stocks in 2017, it is quite likely, we believe, that many investors are under-allocated to real estate. Interest rates have moved higher, but tightening credit spreads have preserved real-estate's yield advantage relative to corporate bonds and kept a lid on mortgage rates.[2] Commercial Mortgage Backed Security (CMBS) issuance has picked up following a brief regulatory-driven pause early last year and refinancing needs are slated to fall sharply now that 10-year loans originated at the peak of the last cycle (2007) have matured.[3] According to Federal Reserve surveys, banks' lending appetite appears to be increasing.[4] And a 20% deduction on pass-through income included in the tax reform package might attract additional inflows from taxable investors.

If there is an imminent threat to property values, it is likely centered on interest rates. After three hikes in 2017, the Federal Reserve's December "dot plot" implied three more in both 2018 and 2019. In theory, a rising cost

of risk-free capital is detrimental to all risk assets, including real estate. In practice, the implications are less obvious: historically, real estate performance has, if anything, been positively correlated with interest rates.[5] To be sure, with cap rates at historic lows, we do not expect them to compress further; however, given the market's strong fundamentals backdrop, we also do not expect them to rise materially, provided that interest-rate increases are measured.

Equity outlook

We believe that unlevered core real estate is positioned to sustain total returns of 6%-7% (annualized) in 2018. The outlook is more uncertain beyond 2018, but we remain sanguine, for four reasons: First, leading indicators such as the yield curve suggest that the likelihood of a recession, which would undermine occupational demand, is low, at least for the next two years.[6] Second, construction appears to be peaking amid increasing supply constraints.[7] Third, although valuations are not inexpensive, they appear reasonable relative to those of Treasuries and especially corporate bonds.[8] Fourth, the industry is not saddled with unsustainable debts that could otherwise cause or exacerbate a downturn (as occurred, for example, during the early-1990s savings-and-loan and the 2008-09 financial crises).[9]

There are risks to the outlook. While economic prospects appear relatively secure, they could be thwarted by political events (e.g., a military conflict) or adverse policy measures (e.g., a trade war). Construction could ramp up if lenders increased their appetite for development risk, labor shortages notwithstanding. Interest rates could increase sharply, disproportionate to any improvement in the economy, as a result of tightening Federal Reserve policy, including short-term rate hikes and balance sheet reductions. And capital market conditions could shift adversely (and suddenly) in response to any number of political or economic events, both global and domestic.

The medium-term outlook for real estate returns is also positive, but more measured. While recession risks appear low over the next two years, marking this expansion as the longest in U.S. history, a downturn in 2020 or beyond is certainly possible. Moreover, we believe that cap rates (and yields across other asset classes) will eventually revert to higher levels, imposing a drag on capital appreciation.

Debt outlook

We believe commercial real estate debt continues to play a pivotal role in portfolio construction, from cash flow, absolute return and risk mitigation perspectives. Relative to comparable corporate bonds in the public sector, commercial real estate debt has favorable risk-adjusted returns and attractive recovery rates.[10] In fact, one of the main reasons insurance companies are turning to private real estate debt is that these investments offer a very strong relative value compared to corporate bonds of a similar risk and term profile. In addition to these benefits, commercial real estate debt provides diversification customized to the individual lender's needs, and a broad risk return spectrum as well as flexibility of structure. This structuring can provide favorable mitigation of downside risk, throughout the cycle.

The continued volume of maturities due over the next several years and potential resulting funding gap, as well as favorable interest rate environment, strong economic conditions, and solid real estate fundamentals supporting the underlying real estate, continue to create demand for commercial real estate debt. Accordingly, in a more mature phase of the real estate cycle, we continue to see investment in commercial real estate debt as a viable risk-adjusted play in 2018.

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References

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3 CRE Finance Council, as of December 2017
4 Federal Reserve Senior Loan Office Survey, as of December 2017
5 NCREIF, Deutsche Asset Management, as of December 2017
6 Federal Reserve, as of January 2018
7 Census Bureau (multifamily); Dodge Data & Analytics (commercial), as of December 2017
8 NCREIF (cap rates); Federal Reserve (bond yields), as of December 2017
9 Federal Reserve, as of September 2017
10 Deutsche Bank Asset Management, as of January 2018

Important information