COMMERCIAL REAL ESTATE OUTLOOK: 2017.Q4
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CONTENTS

1 | Economic Overview........................................................................................................... 5
2 | Commercial Real Estate Investments.................................................................................. 8
3 | Commercial Real Estate Fundamentals............................................................................. 12
4 | Outlook............................................................................................................................. 14
Gross Domestic Product

The economy continued to grow at a solid annual rate of 3.0 percent in the third quarter of 2017, sustaining the growth gain from the second quarter (3.1 percent). Private consumption and investment spending continued to be the engines of growth, as exports rose at a slower pace while government spending contracted for the third straight month.

Private consumption spending—the biggest component of GDP—moderated to 2.4 percent, after a strong recovery in the second quarter (3.3 percent), and a pullback in the first quarter (1.9 percent). Compared to the annual pace of spending in the second quarter, consumer spending increased for motor vehicles and parts, food and beverage, gasoline/fuel, other non-durable goods, recreation, as well as food services and accommodations. The Conference Board’s Consumer Confidence Index indicates that consumers have become more bullish, as the index rose to 125.9 in October 2017, up from the previous month (120.6) and one year ago (100.8).

Sustained job growth and tame inflation have fueled the recovery in consumer spending. Since March 2010, private payrolls have increased by an average of nearly 190,000 jobs per month, to a total of 17.1 million new jobs as of October 2017. Hurricanes Harvey and Irma momentarily held back the number of jobs created to 18,000 in September 2017, but the number of new jobs recovered quickly, to 252,000 in October 2017. The total number of post-recession net new jobs more than offsets the 8.8 million jobs lost during the 2008-09 recession.

The corporate outlook remained upbeat, yet with a healthy dose of caution. Private investment spending expanded at an annual pace of 6.0 percent as business investments rose at 3.9 percent, offsetting the contraction in residential fixed investment.
spending (-6.0 percent). Compared to the second quarter, the annual pace of business investments picked up for information processing (13.3 percent) and transportation equipment (5.8 percent). Investment in the broader equipment category also rose strongly (9 percent). The only component of business investment that declined was investment in non-residential structures (-0.8 percent).

Nonresidential investment consists of new construction and improvements to existing structures in commercial and health care buildings, manufacturing buildings, power and communication structures, and equipment installed as part of the structure, such as elevators or heating and air-conditioning systems. Investment in structures tends to be marked by large swings.

On the other hand, private residential investment spending, adjusted for inflation, contracted by 6.0 percent. The number of building starts, an indicator of the level of residential investment spending, was essentially unchanged at 1,165 in the third quarter of 2017 compared to 1,150 in the third quarter of 2016. Residential construction has not kept pace with the 1.5 million demand due to net household formation and replacement for demolished units.

Exports expanded at a slower annual pace of 2.3 percent. Compared to the dollar volume of exports one year ago, exports of commodity types increased, except for agricultural exports (food and live animals, animal and vegetable oils). Exports of minerals/fuels/lubricants, the third largest export commodity, grew by 39 percent, the fourth consecutive month of year-on-year double-digit growth. Exports have recovered as oil prices climbed back up to an average of $51.67 in the third quarter of 2017 after slipping to $46.02 in the second quarter of 2017 (West Texas Intermediate spot price). Meanwhile, imports contracted by 0.8 percent. With export growth outpacing import growth, the real trade deficit improved.

Government spending declined at a 0.1 percent annual growth rate, following cuts in state and local spending (-0.9 percent). Federal government spending increased by 1.1 percent.

**Employment**

Payroll employment advanced in the third quarter of 2017, with a net gain of 471,000 new jobs, according to the Bureau of Labor Statistics (BLS).
Private service-providing industries continued as the growth engine during the third quarter, with 383,000 net new jobs. During the 12-month period of November 2016-October 2017, the sectors with the largest gains were professional and business services (536,000), education and health (464,000), and leisure and hospitality (284,000). Other major industry groups with net new jobs: manufacturing (156,000), construction (187,000), and mining and logging (58,000). The noticeable declines came from retail trade (-65,000), resulting from department store closings across the country, information services (-64,000), and utilities (-3,000).

The labor force participation (LFP) rate improved to 63.0 percent in the third quarter from the second quarter’s 62.8 percent, the same rate one year ago.

The unemployment rate dropped to 4.3 percent in the third quarter of 2017 compared to the rate in the second quarter (4.4 percent) and one year ago (4.9 percent). Among the unemployed, the average duration of unemployment was 25.4 weeks, slightly up from the second quarter’s 24.5 weeks, but down from one year ago (27.6 weeks).

Inflation

Inflation edged up slightly in the third quarter to an average of 2.0 percent compared to the second quarter (1.9 percent). Core inflation, which excludes food and energy items, rose at a slower pace of 1.7 percent. Non-food prices have increased at a faster pace that overall inflation, with energy prices leading (6.6 percent), followed by transportation (3.6 percent), and shelter (3.2 percent). Core inflation hit the FOMC’s 2.0 percent inflation target during the fourth quarter of 2015 through the first quarter of 2017, and the uptick led the FOMC to hike the federal funds rate four times, starting in December 2015, from the zero lower bound to the 1.0-1.25 percent range as of the latest rate hike on June 15, 2017. However, core inflation weakened to below two percent in the second and third quarters of 2017.
Commercial space is heavily concentrated in large buildings, but large buildings are a relatively small number of the overall stock of commercial buildings. Based on Energy Information Administration data approximately 72 percent of commercial buildings are less than 10,000 square feet in size. An additional eight percent of commercial buildings are less than 17,000 square feet in size. In short, the commercial real estate market is bifurcated, with the majority of buildings (81 percent) relatively small (SCRE), but with the bulk of commercial space (71 percent) in the larger buildings (LCRE).

Commercial sales transactions span the price spectrum, but tend to be measured and reported based on size. Commercial deals at the higher end—$2.5 million and above—comprise a large share of investment sales, and generally receive most of the press coverage. Smaller commercial transactions tend to be obscured given their size. However, these smaller properties provide the types of commercial space that the typical American encounters on a daily basis—e.g. neighborhood shopping centers, warehouses, small offices, supermarkets, etc. These are the types of buildings that are important in local communities, and REALTORS® are active in serving these markets.

Large Cap Commercial Real Estate Markets

Investment volume in LCRE markets continued into the third quarter of this year. The volume of commercial sales in LCRE markets totaled $114.2 billion, a nine percent year-over-year decline, according to Real Capital Analytics (RCA). The decline curve masked mixed performance across and within the property types. While office sales were down 18 percent on a yearly basis—mostly due to a drop in CBD office transactions—suburban office sales rose. Meanwhile, the industrial sector posted strong sales volume, exceeding the prior peak set in the third quarter of 2007. However, the gains were outpaced by the 32 percent drop in retail sales during the third quarter.

Glancing at the broad landscape, markets seem much more nuanced this year. Portfolio sales increased three percent in the third quarter of this year, while single asset sales declined 13 percent. The trend of diverging markets continued, with sales in the six major metros tracked by RCA posting a 12

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percent decline year-over-year. In comparison, sales in LCRE secondary markets declined only six percent, while volume in tertiary markets dropped 14 percent.

Highlighting the nuanced environment, prices in LCRE markets advanced 7.5 percent in the third quarter, according to RCA. The increase was driven by strong appreciation in prices of apartment and industrial properties, which advanced 10.0 percent and 8.2 percent, respectively. Prices for retail properties were virtually flat, with a slight 0.8 percent year-over-year increase. Office property prices rose 5.1 percent during the quarter, as both CBD and suburban properties experienced appreciation.

Commercial pricing mirrored the mixed performance of various property sector, as illustrated by other commercial real estate price indices. The Green Street Advisors Commercial Property Price Index—focused on large cap properties—was virtually flat, with a 0.3 percent gain on a yearly basis during the third quarter, at a value of 126.57. The National Council of Real Estate Investment Fiduciaries (NCREIF) Price Index increased 9.9 percent year-over-year in the same period, to a value of 288.54.

Capitalization rates in LCRE markets continued on a slight downward trend, moving from 6.9 percent in the second quarter to 6.8 percent in the third, based on RCA data. On a yearly basis, cap rates were flat, as the 20 basis-point compression experienced by apartment properties was balanced by an equal cap rate increase for office and hotel properties.
Small Cap Commercial Real Estate Markets

Commercial real estate in SCRE markets continued to experience advances in investment sales, however the momentum moderated during the third quarter of 2017. Following on the first quarter’s 4.4 percent decline and the second quarter’s 4.4 percent increase in sales volume, REALTORS® reported sales volume rose 3.6 percent in the third quarter.

In small cap markets, investors remained active, seeking higher yields. The shortage of available inventory—a defining market feature during this cycle—remained the number one concern for REALTORS® engaged in commercial investments.

Prices for SCRE properties advanced, posting a 3.9 percent yearly advance in the third quarter of this year. The price trend mirrored broader markets, displaying a moderation in momentum. The pricing gap between sellers and buyers remained the second highest ranked concern. Capitalization rates in SCRE markets declined from the first two quarters of this year, to an average 7.2 percent across all property types. However, on a yearly basis, cap rates were flat.
International transactions comprised a noticeable share of REALTORS® activity, comprising 13.0 percent of responses. The average international sale price was $1.2 million in the third quarter of this year. The average cap rate for international deals was 6.5 percent.

Longer-dated bond yields moved in a narrow range for the better part of 2017. During the third quarter, 10-year Treasury Notes averaged 2.3 percent, maintaining a wide spread to cap rates in REALTOR® markets.
Large Cap Commercial Real Estate Markets

Commercial fundamentals in LCRE markets provided a solid performance during the quarter, mirroring broader trends in economic activity. Even with new supply, solid absorption led to increases in rents.

Office demand was solid in the third quarter of 2017, as a tight employment market in office-using industries is fueling higher tenant interest. Leasing activity reached a two-year high at 62.4 million square feet, based on data from JLL, mostly drive by leases larger than 250,000 square feet. Office construction expanded, with 2017 completions through the third quarter totaling 46.5 million square feet. Office vacancies increased to 15.0 percent in the third quarter. Asking rents for office properties moved up 2.7 percent on a yearly basis.

The industrial sector continued on its hot streak during the third quarter of this year, as e-commerce demand increased. Industrial net absorption over the first three quarters totaled 165.6 million square feet, according to JLL. The strong demand for space drove developers’ activity, as new supply moved toward demand levels during the period. In the first three months, completions totaled 161.0 million square feet. Industrial vacancy remained flat in the third quarter, at 5.2 percent. Industrial asking rents hit a new high, at $5.40 per square foot.

Low unemployment rates, rising wages and improving optimism led to growing retail sales in the third quarter. Demand for retail spaces was positive, even with department store closures. Retail net absorption totaled 7.4 million square feet during the quarter, according to CBRE. Retail construction activity slowed, with completions totaling 11.3 million square feet. Retail availability rate picked up, moving to 7.0 percent in the third quarter, as asking retail rents moderated, rising 4.1 percent year-over-year, to $17.15 per square foot.

Household formation firmed up during 2017, moving toward its long-run average. In tandem with strengthening employment, they drove demand for multifamily properties higher across the nation. Net absorption of multifamily units in 2017 totaled 230,400 units for the period ending in September, according to CBRE. Construction of multifamily properties maintained momentum, with 261,800 units delivered in the first three quarters. The national vacancy rate averaged 4.6 percent in the third quarter. Apartment rents declined 0.5 percent year-over-year, to an average of $1,653 per month during the quarter.
Small Cap Commercial Real Estate Markets

Commercial fundamentals in REALTORS®' markets stumbled in the third quarter of this year, despite an expanding economy. Leasing volume declined, posting a 5.9 percent slide from the preceding quarter. New construction increased by a slower 2.9 percent from the prior quarter, as developers were faced with higher construction costs and a shortage of labor. Leasing rates increased by a modest 1.1 percent, as concessions declined 1.6 percent.

Vacancy rates continued declining in the third quarter of this year across the property types, with the exception of retail. Office vacancies reached 12.7 percent, while industrial dropped to 8.0 percent. Multifamily vacancies declined to 5.3 percent as household formation numbers advanced. Retail vacancies rose to 11.1 percent, as national department stores announced further store closings during the quarter. Lease terms remained steady, with 36-month and 60-month leases capturing 61.0 percent of the market. Demand for one-year and two-year leases improved, accounting for 21.0 percent of total.

Tenant demand remained strongest in the 5,000 square feet and below segment, accounting for 82.0 percent of activity. Demand for space in the “Under 2,500 square feet” segment strengthened from the last quarter, capturing 41.0 percent of responses. Demand for properties in the “2,500 - 4,999 square feet” also picked up, accounting for 41.0 percent of REALTORS®’ responses to a market survey.
Economy

Economic output is expected to advance by 2.5 percent annual rate in the fourth quarter, closing the year at an annual rate of 2.8 percent, an improvement over the 2.2 percent growth in 2017. Payroll employment is projected to pick up speed over the latter half, averaging 1.7 percent for the year, which would push the unemployment rate down to 4.2 percent by the end of the year. Inflation is expected to increase to 2.5 percent in the fourth quarter, with a full year average of 2.0 percent. With core inflation rate moving below two percent in the second and third quarters, the pressure on the FOMC to increase rates one more time before the year ends has eased. Given the slight uptick in the overall inflation rate in the fourth quarter of 2017, NAR forecasts the 3-month T-bill rate to average 1.6 percent in the fourth quarter, and 1.0 percent for the year. NAR also expects the 30-year government bond rate to move up slightly to 3.4 percent in the fourth quarter, and 2.9 percent for the year.

Exhibit 4.1: U.S. ECONOMIC OUTLOOK — November 2017

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<thead>
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<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
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<td><strong>Annual Growth Rate, %</strong></td>
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<tr>
<td>Real GDP</td>
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<td>1.6</td>
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<td>Nonfarm Payroll Employment</td>
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<td>Consumer Prices</td>
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<tr>
<td><strong>Level</strong></td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>Consumer Confidence</td>
<td>98</td>
<td>100</td>
<td>120</td>
<td>125</td>
</tr>
<tr>
<td><strong>Percent</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Unemployment</td>
<td>5.3</td>
<td>4.9</td>
<td>4.4</td>
<td>4.2</td>
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<td>Fed Funds Rate</td>
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<td>1.8</td>
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<tr>
<td>3-Month T-bill Rate</td>
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<td>1.0</td>
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<td>Corporate Aaa Bond Yield</td>
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<td>5.2</td>
<td>4.1</td>
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<td>10-Year Gov’t Bond</td>
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<td>1.8</td>
<td>2.3</td>
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<tr>
<td>30-Year Gov’t Bond</td>
<td>2.8</td>
<td>2.6</td>
<td>2.9</td>
<td>3.5</td>
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Source: National Association of REALTORS®
Commercial Real Estate

Commercial leasing fundamentals are expected to continue on a positive trend, benefiting from the tail winds of an expanding economy. Tax reform discussions have been favorable toward commercial investments, although questions remain about various aspects of the Senate and House proposals.

With the Federal Reserve’s commitment to unwinding its easing measures, in addition to a likely rate increase in December of this year, interest rates are expected to move upward in 2018. For commercial investments, there are downward pressures expected on cap rates going forward, although the impact is likely to be unevenly distributed across geography, sectors and property class. In SCRE markets, increased scrutiny from banking regulators has tightened lending conditions, a trend which will close out 2017.

Exhibit 4.2: Commercial Real Estate Vacancy Forecast (%)

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<tr>
<td>Office</td>
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<td>13.4</td>
<td>13.6</td>
<td>12.7</td>
<td>12.7</td>
<td>12.9</td>
<td>12.7</td>
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<td>12.3</td>
<td>12.2</td>
<td>12.2</td>
<td>12.0</td>
<td>13.0</td>
<td>13.0</td>
<td>12.4</td>
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<td>Industrial</td>
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<td>9.4</td>
<td>9.1</td>
<td>8.9</td>
<td>8.6</td>
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<td>7.6</td>
<td>7.5</td>
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<td>6.8</td>
<td>9.4</td>
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<tr>
<td>Retail</td>
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<td>10.4</td>
<td>12.1</td>
<td>11.9</td>
<td>11.7</td>
<td>11.4</td>
<td>11.3</td>
<td>11.1</td>
<td>10.9</td>
<td>10.5</td>
<td>12.0</td>
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<td>11.4</td>
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<td>Multifamily</td>
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<td>5.3</td>
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<td>5.2</td>
<td>6.3</td>
<td>5.8</td>
<td>5.9</td>
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Source: National Association of REALTORS®

Exhibit 4.3: Commercial Property Price Indices Forecast

<table>
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<td>NCREIF</td>
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<td>186.5</td>
<td>195.2</td>
<td>211.9</td>
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<td>Green St. Advisors</td>
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<td>87.1</td>
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<td>125.2</td>
<td>122.4</td>
<td>115.9</td>
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Sources: National Association of REALTORS®, NCREIF, Green Street Advisors
The National Association of REALTORS®, “The Voice for Real Estate,” is America’s largest trade association, representing over 1.2 million members, including NAR's institutes, societies and councils, involved in all aspects of the real estate industry. NAR membership includes brokers, salespeople, property managers, appraisers, counselors and others engaged in both residential and commercial real estate. The term REALTOR® is a registered collective membership mark that identifies a real estate professional who is a member of the National Association of REALTORS® and subscribes to its strict Code of Ethics. Working for America's property owners, the National Association provides a facility for professional development, research and exchange of information among its members and to the public and government for the purpose of preserving the free enterprise system and the right to own real property.

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