EXPECTATIONS & MARKET REALITIES IN REAL ESTATE 2014

THE FUTURE UNFOLDS

THE ECONOMY
Inching Ahead

THE CAPITAL MARKETS
Flush with Liquidity

THE PROPERTY MARKETS
Turning the Corner

SUMMARY & OUTLOOK
Looking Ahead to 2014

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Expectations & Market Realities in Real Estate 2014—The Future Unfolds

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FOREWORD

January 2014

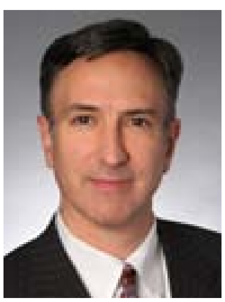
Dear Readers,

This is the third year that our three organizations—**Real Estate Research Corporation (RERC), Deloitte, and the National Association of REALTORS® (NAR)**—have worked together to publish this annual forecast report. Our hope was that the research-based views and information presented in ***Expectations & Market Realities in Real Estate*** would provide the kind of thoughtful analysis and interpretation that are so necessary in challenging economic periods.

There are no guarantees, but as ***"the future unfolds,"*** we are pleased to see that the recovery continues. Strong growth continues to elude this economy, although we anticipate that growth in 2014 should slightly exceed that experienced in 2013. We are keeping our eyes on interest rates, which increased in 2013, but they remain low on a historical basis. In addition, there is a very ample supply of capital available, and as such, commercial real estate transaction volume continues to increase. Fundamentals continue to improve, albeit slowly. Returns in the form of appreciation and income are expected to remain quite attractive in 2014, although they may be slightly less than what investors enjoyed last year.

We extend our appreciation to all who have contributed to ***Expectations & Market Realities in Real Estate 2014—The Future Unfolds***, especially our researchers and data providers, economists, business associates and colleagues, research survey respondents, board members, reviewers, and the many others who have shared information, insights, or observations. We also thank you—our clients, subscribers and membership professionals, and consultants—for your continued interest and support. We hope you find this outlook report a useful tool as you strategically plan for the future.

Sincerely,



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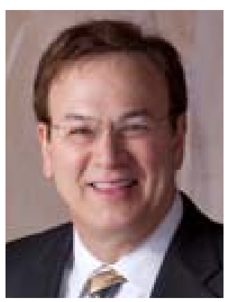

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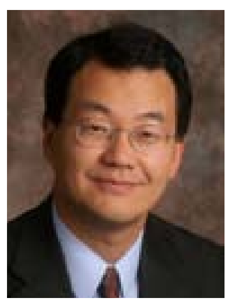

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INTRODUCTION

THE FUTURE UNFOLDS

THE FUTURE UNFOLDS

In preparing this issue of ***Expectations & Market Realities in Real Estate***, Real Estate Research Corporation (RERC), Deloitte, and the National Association of REALTORS® (NAR) reviewed the progress made during the years since the Great Recession (December 2007 through June 2009), and particularly during the past year. Our collective view was that investors started out the year 2013 determined to "turn the page" on past uncertainties and to focus on what laid ahead. The 2012 presidential election was in the past, tax increases and reductions in government spending were in place, and we and many others thought that with the help of a third round of quantitative easing policies implemented by the Federal Reserve, the economy would finally pick up speed.

The economy did begin to pick up speed in the second half of 2013, with gross domestic product (GDP) growth of 4.1 percent in third quarter 2013 and a first estimate of 3.2 percent growth for fourth quarter 2013. However, there were plenty of events during the year causing uncertainty, both in the U.S. and throughout the world, including a major drop in the stock and bond markets in the spring of 2013 when the Federal Reserve first announced plans to begin tapering its monthly purchases of bonds and securities. In addition, there was a terrorist attack in Boston in April and the bankruptcy of Detroit in July. Then in September there was the threat of new military action against Syria, and in October the partial government shutdown and the rollout of the Affordable Care Act. Through it all, however, the economy continued its modest growth and unemployment gradually declined, dropping to 7.0 percent in November 2013. Further, inflation remained low, and interest rates—while increasing during the past few months—remain low relative to historic rates.

In addition, there has been meaningful improvement in many major U.S. industries. The investment banking industry has continued to stabilize, and the Federal Reserve's Comprehensive Capital Analysis and Review and Dodd-Frank Act stress tests have helped to ensure that financial institutions have a robust capital planning process and adequate capital. In fact, the U.S. banking industry has continued its recovery by reducing the number of troubled loans and by increasing total loan balances to approximately $7.8 trillion in third quarter 2013, according to the Federal Deposit Insurance Corporation (FDIC). Further, despite reduced home values and more than 4 million home foreclosures since the beginning of the recession, per CoreLogic, the housing market is climbing back with home price growth forecasted by NAR to close out this year 11.3 percent stronger than a year earlier. In a hopeful sign of further improvement to the manufacturing industry, the end of 2013 also saw increased consumer spending, especially for big-ticket items, according to the Commerce Department's November report.

LOOKING AHEAD TO 2014

Despite the economic progress in 2013, we recognize that there is plenty of uncertainty remaining as the future unfolds, and that risk has increased as the Federal Reserve's balance sheet has increased to $4.1 trillion in assets. As the year gets underway, investors will keep a watchful eye on the Federal Reserve and the comments and potential actions that Chairwoman Janet Yellen and the Board make regarding the recovery. Many investors question if the reduction in future asset purchases will continue as planned, or if the Board will determine that asset purchases need to continue longer than anticipated (and at what level) in order to support economic growth. Although former Federal Reserve Chairman Ben Bernanke stated at his December 2013 news conference that "…compared to other countries and advanced industrial countries recovering from financial crises, the U.S. recovery has actually been better than most," he also noted that "It's not been good, it's not been satisfactory."

After the recent partial government shutdown, there is also uncertainty-about whether the federal government will raise the debt ceiling this spring. Although Congress and the president were able to come to agreement on a 2-year budget and tax receipts are up, deficit spending is still occurring, and as such, the federal debt has increased to more than $17.3 trillion as of the end of 2013. The congressional elections this fall may have an impact on fiscal policy discussions.

Another key concern is higher interest rates. Estimates vary, but as noted in this report, NAR projects 10-year Treasury rates to increase to 3.4 percent by fourth quarter 2014, and as such, 30-year fixed mortgage rates could easily reach 5.0 percent to 5.5 percent. The risk is that such interest rate increases could slow the economic recovery, particularly as it relates to the housing market, although many prognosticators believe that the economy should be able to absorb this change. Further, according to Dr. Bernanke at his December 2013 news conference, the majority of Committee members do not expect an increase in the federal funds rate before 2015. "Most see our target for the federal funds rate as rising only modestly in 2015….the median projection for the federal funds rate is 75 basis points at the end of 2015 and 1.75 percent at the end of 2016."

And although inflation has been very low to date, it remains a risk for the future. Given the historic high levels of accommodative monetary policy intended to jumpstart consumer and business spending and job growth, there has been an increased expectation of higher inflation. However, as time passes with only little effect on economic or job growth, along with the failure to reach the Federal Reserve's inflation target of 2 percent, the greater risk to the economy may be stagnation or even deflation. Nonetheless, the Federal Reserve has been determined to avoid inflation that is too low (as well as inflation that is too high), and we anticipate that it will continue to do so under Chairwoman Yellen's leadership in trying to move inflation back toward its 2-percent objective.

EXPECTATIONS & MARKET REALITIES IN REAL ESTATE 2014—THE FUTURE UNFOLDS

Despite the slow economic growth and weak job growth that have characterized this recovery thus far, commercial real estate investments have generally produced solid returns. As noted in this report, it is increasingly likely that the economy will continue to expand in 2014, but the speed of the expansion is less certain. However, the year 2013 ended with positive economic growth that was somewhat stronger than expected, and returns from the major stock market indices were much higher than anticipated, which may serve as a leading indicator for the year ahead. Based on our collective analysis, our expectations are for relatively steady economic growth in 2014 and continued low interest rates, which indicate that commercial real estate investments are likely to produce solid returns in 2014. In addition, as noted in ***Expectations & Market Realities in Real Estate 2014—The Future Unfolds***, property fundamentals are steady and improving slightly, and total expected returns on a risk-adjusted basis appear very reasonable in the year ahead.

In Chapter 2 of this annual outlook report, we take a close look at the U.S. economy and the major indicators for economic growth in 2014. An examination of personal consumption expenditures, investment, government expenditures, and net exports and imports suggests slow but continuing growth over the next year. In addition to the discussion about real GDP growth and employment trends, we consider the most likely uncertainties, and present our forecast for the year ahead.

We examine the capital markets in Chapter 3 of this report, including the spread between internal rates of return for commercial real estate and 10-year Treasurys. We also examine transaction trends, including international transactions, as well as the debt and equity markets. We conclude the chapter with our value outlook for commercial real estate.

In Chapter 4, we offer our highlights and expectations for the five major property sectors—the office, industrial, retail, apartment, and hotel markets. Our analysis examines volume, pricing, capitalization rates, vacancy/occupancy rates, absorption and completions, and rental rates/revenues for each of the property types. We also include our property and income performance expectations for 2014.

Chapter 5 of this report serves to summarize and highlight our analysis and expectations for the economy, capital markets, and property markets. We also provide our collective analysis for commercial real estate investment based on three alternative economic scenarios for 2014 and beyond.

2 THE ECONOMY

INCHING AHEAD

INCHING AHEAD

This forecast projects a U.S. economy plodding along with no recession imminent—but also no strong growth. Absent unexpected negative shocks, major tax increases, or significant changes in current levels of government spending, NAR projects the economy in 2014 to grow at an annual rate of approximately 2.5 percent, up from 1.8 percent in 2013. Approximately 2.3 million jobs are expected to be added, with the 2014 unemployment level projected at 6.6 percent, compared to 7.4 percent in 2013, according to NAR.

Both positive and negative considerations impact the economic forecast and could cause the forecast to be overly conservative or possibly even optimistic. After considering a number of external factors impacting the economic environment, we have concluded that the outlook is for moderate but slower than normal growth. On the positive side, federal monetary and fiscal policies on balance continue to be expansionary. Energy availability and prices are much less of an issue than previously thought. In addition, many consumers have rebuilt their balance sheets to a significant degree. Prices in the financial asset and housing markets have increased, and these positive wealth effects support current levels of consumption. On the negative side, the negotiations over the fiscal cliff and the ensuing federal government shutdown created increased levels of economic uncertainty in 2013. In addition, the media have been filled with reports of uncertainties and frustrations by businesses and consumers associated with the implementation of the Affordable Care Act. Finally, long-term unemployment continues to be significantly above historical averages, possibly as a result of a variety of factors: lack of consumer demand, underlying changes in the U.S. economy, and a lack of U.S. competitiveness in some world markets, among potentially others. Such economic uncertainties may have negatively impacted job growth and economic activity. Although tight credit underwriting conditions have eased to some degree, many financial institutions continue to be cautious about lending, and many households appear to be more restrained in spending than expected.

Additional significant risks to the 2014 forecast which appear to be negatively impacting the economy are related to taxes, spending, and a variety of other uncertainties. The future level and economic impact of additional federal fiscal austerity is unpredictable but would have a negative impact on GDP in the short run. The budget battle/debt ceiling debates (in addition to impacting confidence and probably economic growth) did not resolve the basic uncertainties of tax and spending levels. The Ryan/Murray budget deal provided some minimal relief to the ongoing budget issues but was not a long-term solution. The trajectory for Federal Reserve monetary policy is also unknown and likely subject to significant risk, particularly in terms of the winding down of quantitative easing. There continue to be uncertainties and potential problems from the operations of various financial intermediaries. For example, Warren Buffet has characterized derivatives as "financial weapons of mass destruction." Concern about the world's economies and financial markets continues, with the potential of negative spill-overs to the U.S. economy.

As such, NAR's economic outlook for 2014 is for relatively slow levels of gross domestic product (GDP) and jobs growth:

- GDP: Real GDP growth of 2.5 percent in 2014, up from 1.8 percent in 2013.
- Jobs: Job growth of 1.7 percent in 2014, up from 1.6 percent in 2013.
- Unemployment Rate: Unemployment at 6.6 percent in 2014, down from 7.4 percent in 2013.
- Interest Rates: 30-year government bond at 5 percent, up from 4 percent in 2013.

OVERVIEW OF MAJOR GDP SEGMENTS

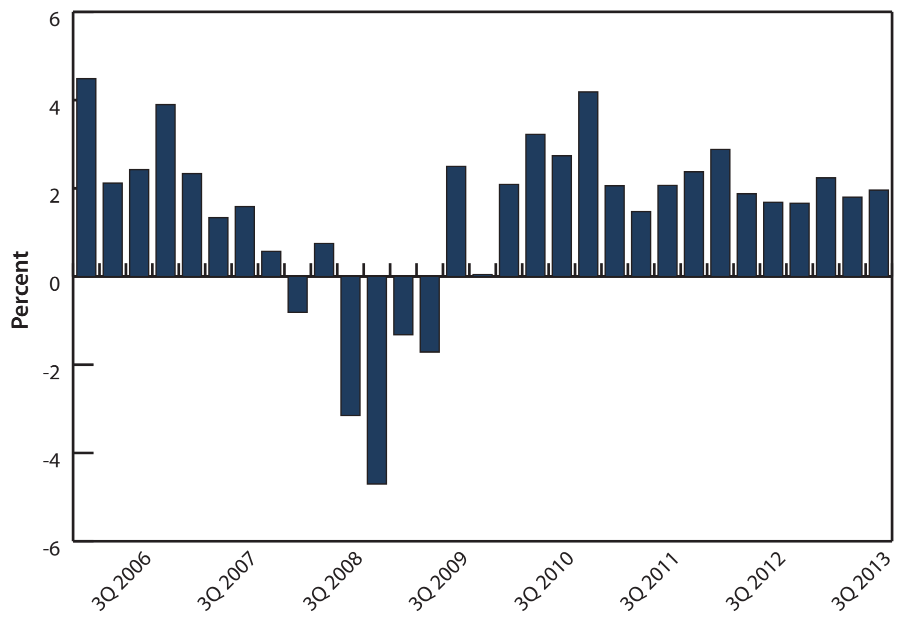
The GDP has four major components: consumption, investment, government, and exports/imports. The analysis of each of the components shows that the economic expansion should continue at a rate somewhat slower than the normally expected 3-percent or greater rate.

Consumption

Macroeconomic analysis of personal-consumption expenditures (see Exhibit 2-1), investment, government expenditures, and net exports and imports indicates slow but continued growth, with a GDP increase somewhat below the 3-plus percent level in real terms that one would expect in a normal economy.

At approximately 68 percent of the GDP, personal consumption expenditures are the largest segment of GDP. However, none of the three most important drivers of consumer spending (changes in personal incomes, aggregate consumer wealth, and expectations) appear to favor significant increases in expenditures.

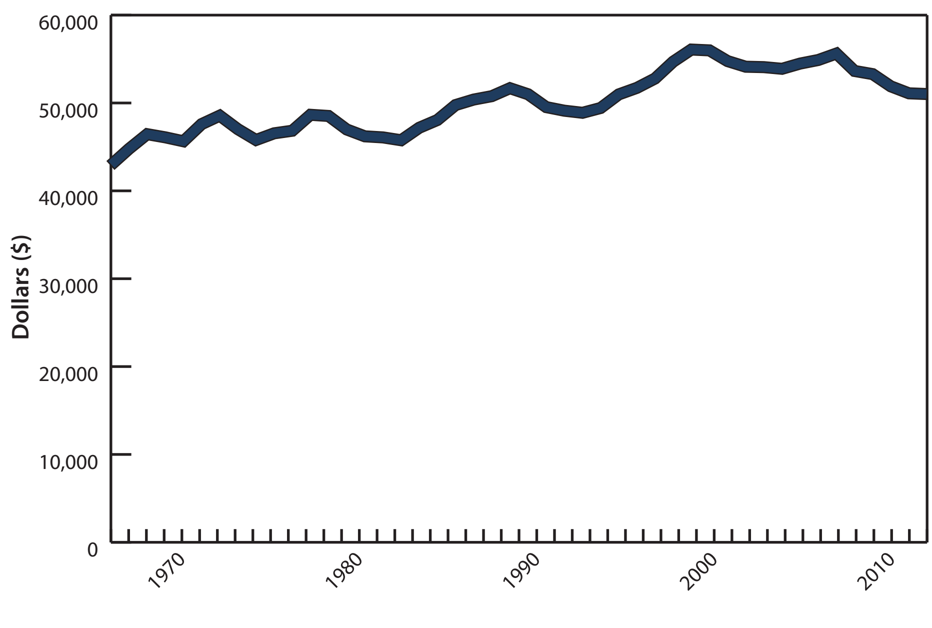
Exhibit 2-1. Personal Consumption Expenditures



Sources: BEA, Haver Analytics, January 2014.

Incomes: The news has been filled with stories of how the top 1 percent (or whatever percent the reporter is focused on) has much of the nation's wealth and income. Regardless of whether one includes government benefits and/or analyzes the statistics focusing on various demographics, according to the U.S. Census Bureau, well over 50 percent of U.S. households have had minimal or declining changes in real (after inflation) incomes in recent years, and that income distribution has been increasingly skewed towards the upper brackets. Current trends do not appear to support a significant upturn in consumption, as median household incomes have been declining (see Exhibit 2-2).

Exhibit 2-2. Constant Dollar Median Household Income



Sources: CPS Survey Tables. Table H-8. Median Household Income by State, U.S. Census Bureau, 2012.

Aggregate Wealth: The Great Recession, defined by the National Bureau of Economic Research (NBER) as lasting from December 2007 through June 2009, caused major declines in household balance sheets. According to data provided by the Federal Reserve, household wealth has recovered significantly as demonstrated in Exhibit 2-3, but consumers apparently are continuing to be cautious with spending. The recovery of real estate values, along with an upturn in the stock market, has had a favorable impact on consumer balance sheets.[2]

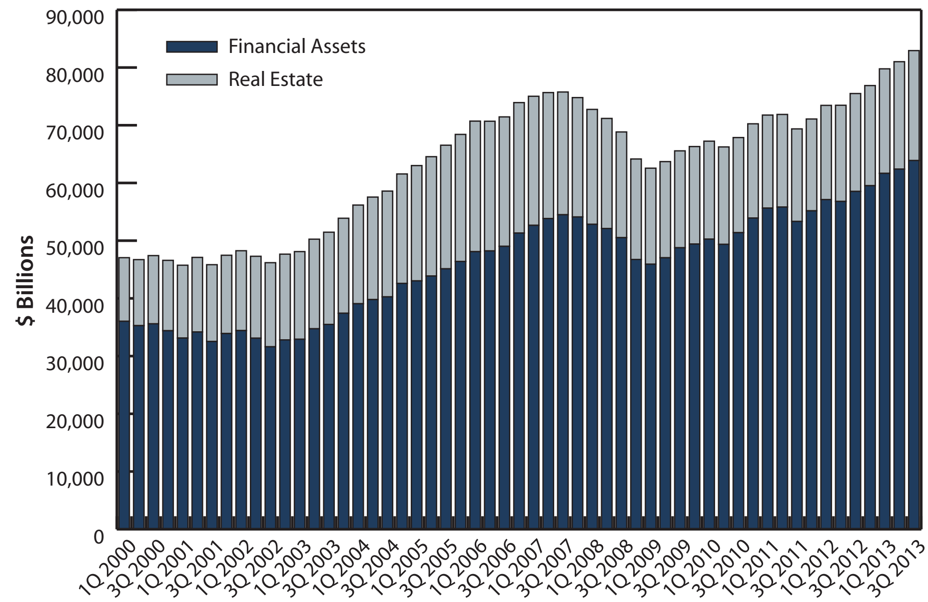
[2] ***Housing data is for households. Financial data cover households plus nonprofits (the Flow of Funds data do not provide a more detailed breakout).***

However, given the severely negative consumer experience in the Great Recession (job losses, stagnant wage growth, foreclosures, bankruptcies, limited credit availability, etc.) a sharp, continued upturn in consumer expenditures seems unlikely.

Expectations: Consumer confidence is less depressed than was the case in 2012, but as shown in Exhibit 2-4, it continues well below the 100-point level associated with a robustly expanding economy. In general, one would expect a significantly higher level of confidence during an economic expansion—again indicating why the current economic forecast is relatively modest.

Based on NAR's research and analysis, personal consumption expenditures are estimated to grow at a rate of 2.7 percent in 2014.

Exhibit 2-3. Household Wealth

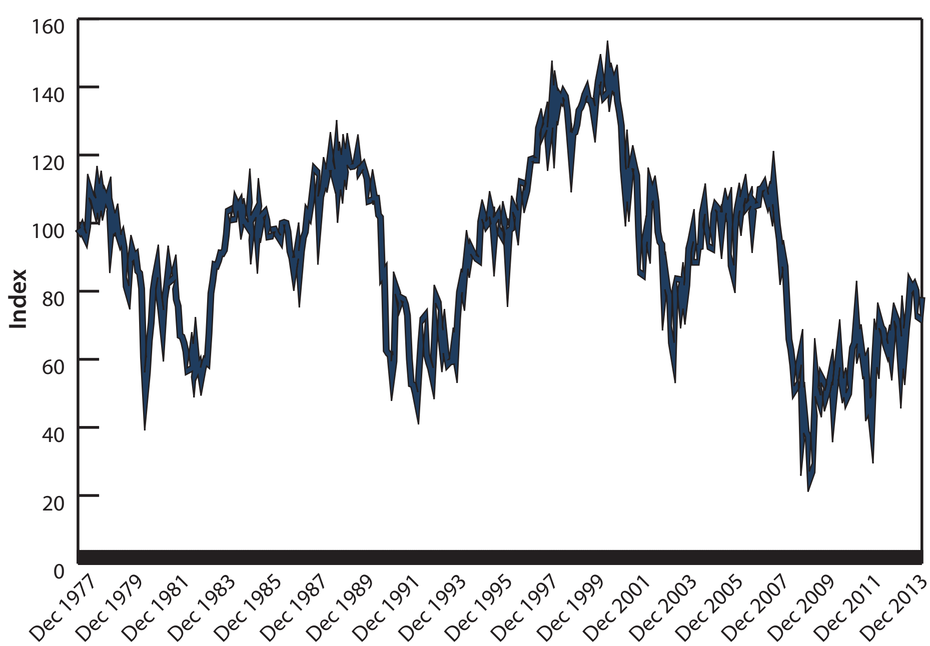


Sources: Federal Reserve Board, Flow of Funds, and Haver Analytics, January 2014. Household real estate is at market value, including second homes that are not rented, vacant land, and vacant homes for sale. Financial assets also include assets of non-profit organizations, the data not being available in finer disaggregated form.

Investment

The analysis of non-residential investment (business investment, which accounts for approximately 12 percent of GDP), and housing investment (which accounted for

Exhibit 2-4. Consumer Confidence



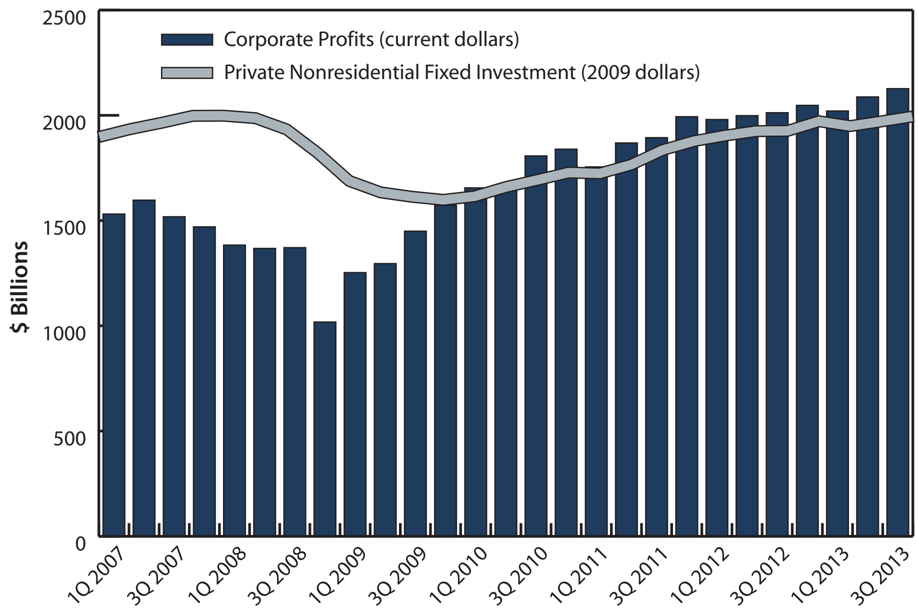
Sources: The Conference Board, Haver Analytics, January 2014.

approximately 3 percent of GDP in 2012) shows continued but slow expansion.

Corporate profits on an aggregate basis have recovered from the Great Recession, as shown in Exhibit 2-5, and there appears to be an abundance of cash on corporate balance sheets. In addition, banks have substantial cash reserves for potential loans. While it appears that the economy is awash in liquidity, various regulatory and business uncertainties seem to be causing many corporations and banks to be cautious in loans and investments. Business investment, now approximating the levels of pre-Great Recession, is projected to grow at a rate of 3 percent in 2014, according to NAR.

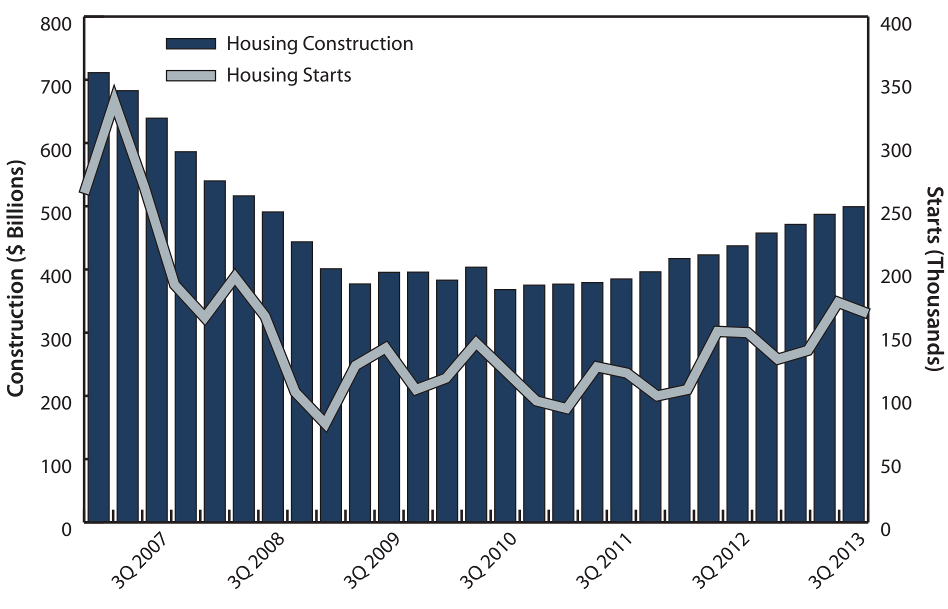
In contrast, residential housing construction continues to underperform relative to long-term trends (see Exhibit 2-6). A major part of the new-home supply vanished during the Great Recession. A significant number of the small builders exited the business due to market conditions and the lack of capital availability. Many of the larger firms, with greater capital access and financial staying power, survived but in total are providing a somewhat lower overall level of construction. In addition, credit continues to be tight, especially for many smaller builders.

Exhibit 2-5. Business Investment and Corporate Profits



Sources: BEA, Haver Analytics, January 2014.

Exhibit 2-6. Housing Construction



Sources: BEA, Census Bureau, Haver Analytics, January 2014.

Housing starts are projected at 1.2 million units in 2014, up from approximately 900,000 units in 2013, but well below the historically expected level of 1.6 million units per year, according to NAR. Private residential fixed investment continues to underperform. Overall, business and residential investment will contribute to the continued economic expansion, but are not projected to be at levels significantly high to have a major impact on growth rates.

Government Expenditures

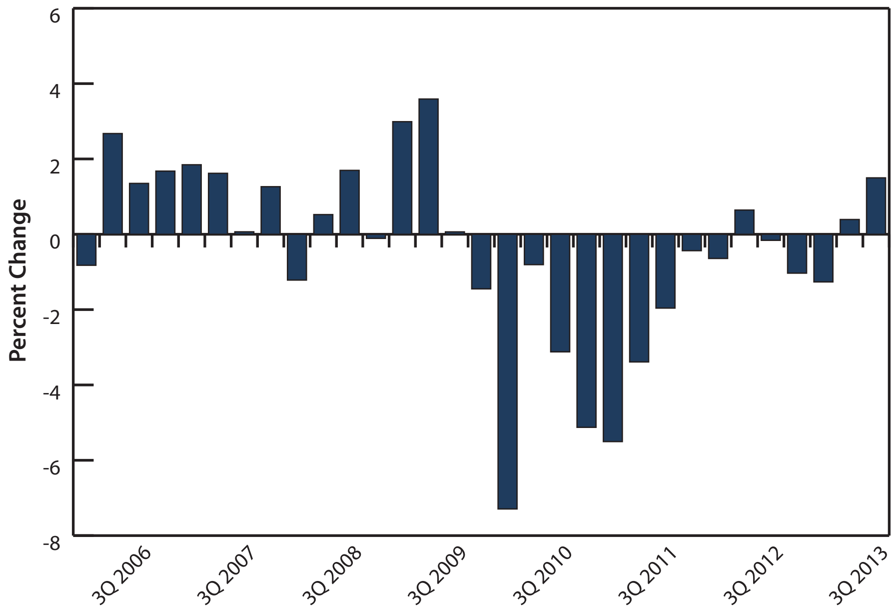
Spending by state and local governments accounted for 11 percent of GDP in 2013, and federal government spending accounted for approximately 7 percent of GDP in 2013. Recent measures to reduce government spending have impacted the economy, but looking to the future, no significant additional impacts from government cutbacks are expected. While the federal government tends to run deficits, state and local governments generally need to balance their budgets and often have very limited capabilities to engage in deficit financing. All else being equal, declines in government spending typically result in lower levels of economic activity. Although there have been significant cutbacks at the state level and some modest reductions in contractors at the federal level, the degree of budget contraction appears to have diminished, suggesting that the impact on GDP from government cutbacks over the next year will probably be minimal. Given projected health spending trends and the potential for unanticipated needs, the impact could even be slightly positive.

State and local government spending has trended lower in recent years as government receipts were adversely impacted by the Great Recession (see Exhibit 2-7).

NAR projects that state and local government expenditures will grow in the neighborhood of 0.7 percent in 2014—a very modest rate of growth after major cutbacks.

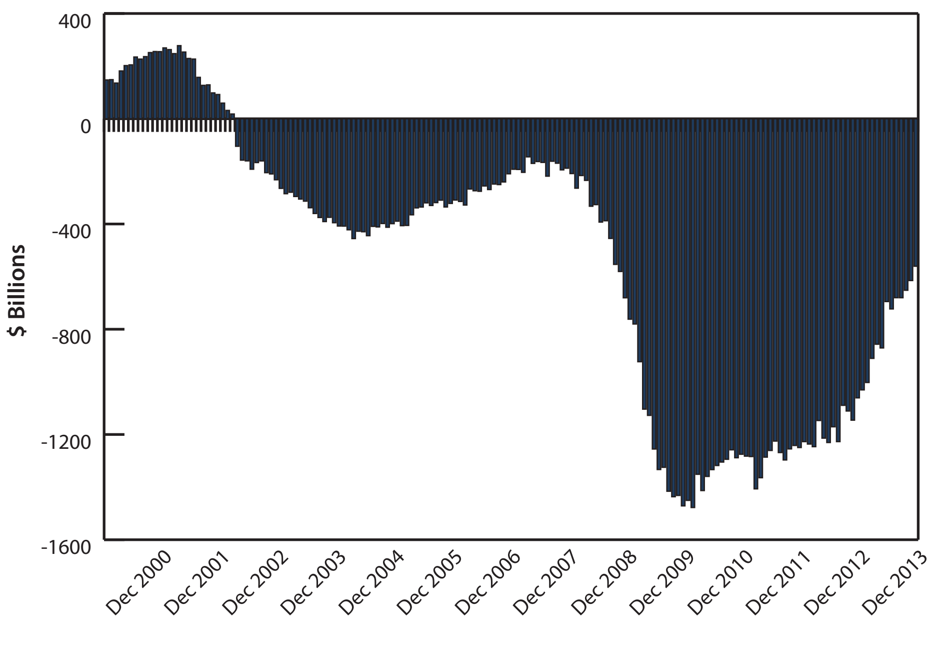
With a few years of exceptions, federal deficits have a long and ongoing history. The Great Recession slowed economic growth so severely that significantly higher federal deficits resulted, as shown in Exhibit 2-8. Concern over the high levels of budget deficits were addressed in early 2013 through the sequester. The Ryan/Murray budget deal provided a resolution of some budget issues in late 2013, but longer term, some combination of spending cuts and revenue increases will likely be necessary. It is unlikely that the federal budget will decline in the forthcoming year in terms of overall expenditures, given that the bulk of expenditures are required and fixed by law. Consequently, total federal debt outstanding is expected to continue rising in the near term (see Exhibit 2-9). Whether the Affordable Care Act will result in major additional increases in federal expenditures is unclear, but such an outcome is mentioned in ongoing media coverage as a possibility.

Exhibit 2-7. Changes in Constant Dollar State and Local Government Expenditures



Sources: BEA, Haver Analytics, Nov. 14, 2013.

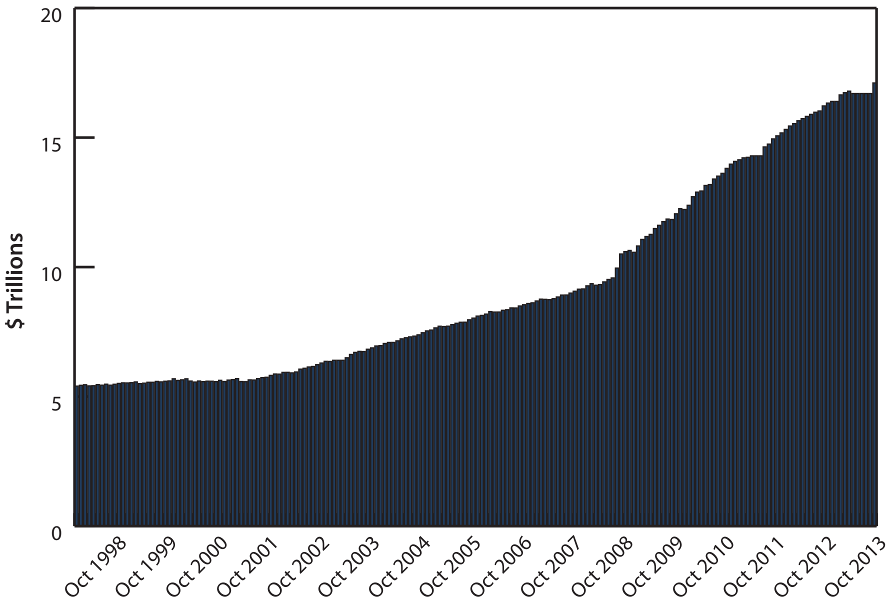
Exhibit 2-8. Federal Surplus and Deficit (12-month moving total)



Sources: U.S. Treasury, Haver Analytics, January 2014.

The Congress, as evidenced by its inability to avoid the fiscal cliff/partial government shutdown of October 2013, appears to have been split on the role and size of the federal government and associated expenditures. Whether this level of divisiveness will continue is unclear. Since there does not seem to be agreement on the major budget issues, continued short-term resolutions appear to be likely in the forthcoming year in addressing the level of federal expenditures. We are assuming that the net additional impact from the federal government will be neutral.

Exhibit 2-9. Total Federal Debt Outstanding

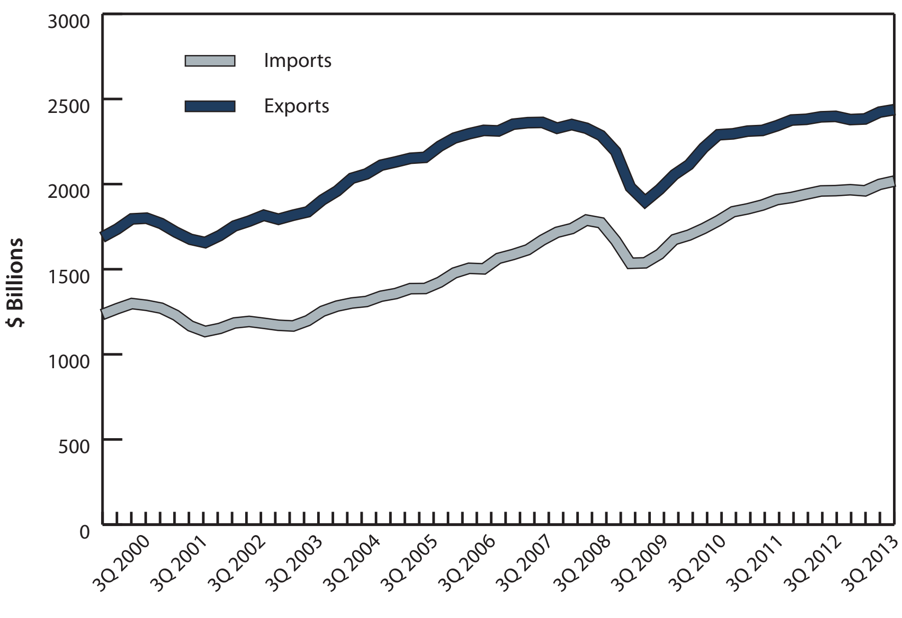


Sources: Monthly Statement of the Public Debt of the U.S., Haver Analytics, Nov. 15, 2013.

International Trade

The fourth major component of GDP—international trade—has been increasing since the Great Recession (see Exhibit 2-10), with exports at 13 percent of GDP in 2012 and imports at 16 percent, per the BEA. The longstanding U.S. trade deficit will most likely continue but will probably neither measurably widen nor contract. The impact on GDP growth is projected to be neutral. The nation's automated manufacturing processes, which combined with their low levels of labor and high levels of technical sophistication, create a competitive advantage for U.S. industry. In contrast, U.S. products that are low-tech and/or labor intensive are well

Exhibit 2-10. Imports and Exports of Goods and Services (4-quarter moving average)



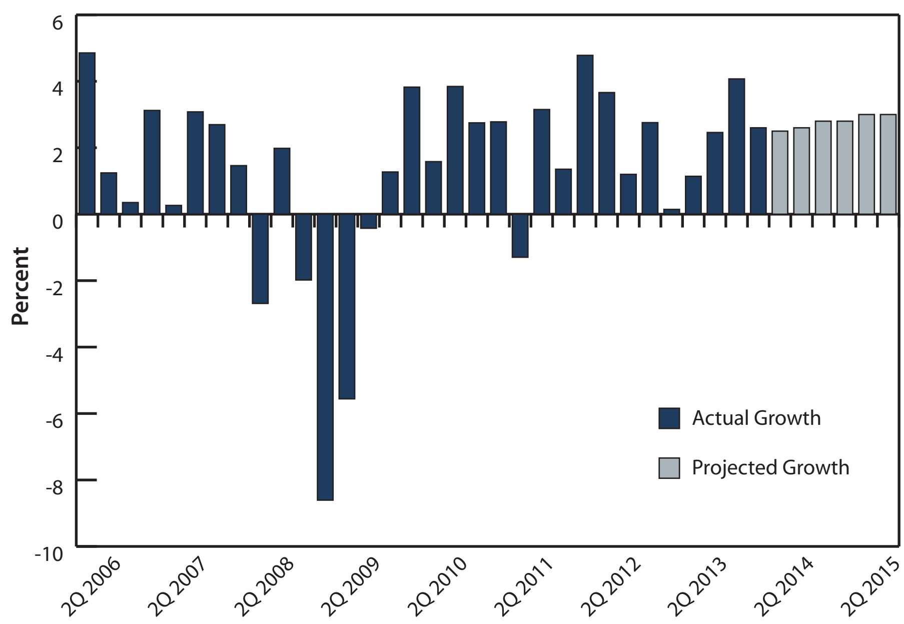
Sources: BEA, Haver Analytics, January 2014.

known to be frequently non-competitive in international markets. Current trends in imports and exports appear likely to continue, and moderating oil prices will tend to close the deficit gap.

PERCENT GROWTH OF REAL GDP

Based on the analysis of the various components of GDP, economic growth is projected to remain positive according to NAR, but to be relatively slow in real terms at 2.5 percent per year in 2014, as shown in Exhibit 2-11. The economy is not headed into a recession (a prolonged period of declining output, with two consecutive quarters of decline, per most economists) based on currently available data (see Exhibit 2-12); however, clearly the current indicators,

Exhibit 2-11. GDP Growth: Actual and Projected



Sources: BEA, Haver Analytics, NAR, January 2014.

Exhibit 2-12. Economic Outlook Summary

	Growth Rate Real GDP (percent)	Nonfarm Payroll Empl. (percent growth)	Consumer Prices (percent growth)	Percent Unempl.	Interest Rates (Percent)					
					Fed Funds Rate	3-mo T Bill	Prime Rate	Corp. AAA bond	10-yr Govt. Bond	30-yr Govt. Bond
1Q 2013	1.1	1.9	1.4	7.7	0.1	0.1	3.2	3.9	2.0	3.0
2Q 2013	2.5	1.7	0.0	7.5	0.1	0.1	3.3	4.0	2.2	3.1
3Q 2013	4.1	1.4	2.6	7.2	0.1	0.1	3.3	4.5	2.9	3.7
4Q 2013	1.9	1.7	0.9	7.0	0.1	0.1	3.3	4.6	2.8	3.7
1Q 2014F	2.4	1.6	2.3	6.7	0.1	0.1	3.3	4.8	2.9	3.9
2Q 2014F	2.6	1.7	2.7	6.7	0.1	0.1	3.3	5.1	3.1	4.1
3Q 2014F	2.8	1.7	2.9	6.6	0.1	0.2	3.3	5.2	3.3	4.3
4Q 2014F	2.8	1.8	3.1	6.5	0.1	0.2	3.3	5.3	3.4	4.5
1Q 2015F	2.9	1.8	3.3	6.4	0.3	0.4	3.5	5.5	3.7	4.8
2Q 2015F	3.0	2.0	3.4	6.4	0.8	0.9	4.0	5.8	3.8	4.9
2012	2.1	1.7	2.1	8.1	0.1	0.1	3.1	3.7	1.8	2.9
2013	1.8	1.6	1.4	7.4	0.1	0.1	3.3	4.3	2.5	3.4
2014F	2.5	1.7	2.6	6.6	0.1	0.2	3.3	5.1	3.2	4.2
2015F	2.9	1.9	3.6	6.3	1.0	1.1	4.2	5.8	3.8	4.9

Sources: GDP Growth rate: BEA/Haver Analytics, Nonfarm Payroll Employment: BLS, Consumer Prices: BLS CPI-U, Federal Funds rate (effective): FRB, Table H.15/ Haver Analytics, 3-month T-bill rate: FRB, Table H.15/Haver Analytics, Bank prime loan rate: FRB, Domestic Interest Rates Updated Before FRB Publication/Haver Analytics, Moody's Corporate AAA Corporate Bond Yield: FRB, Table H.15/Haver Analytics, 10-yr Treasury Note Yield at Contant Maturity: FRB, Table H.15/Haver Analytics, 30-yr Treasury Note Yield at Contant Maturity: FRB, Table H.15/Haver Analytics, January 2014.

as well as the projections for 2014, are disappointing in terms of normal expectations.

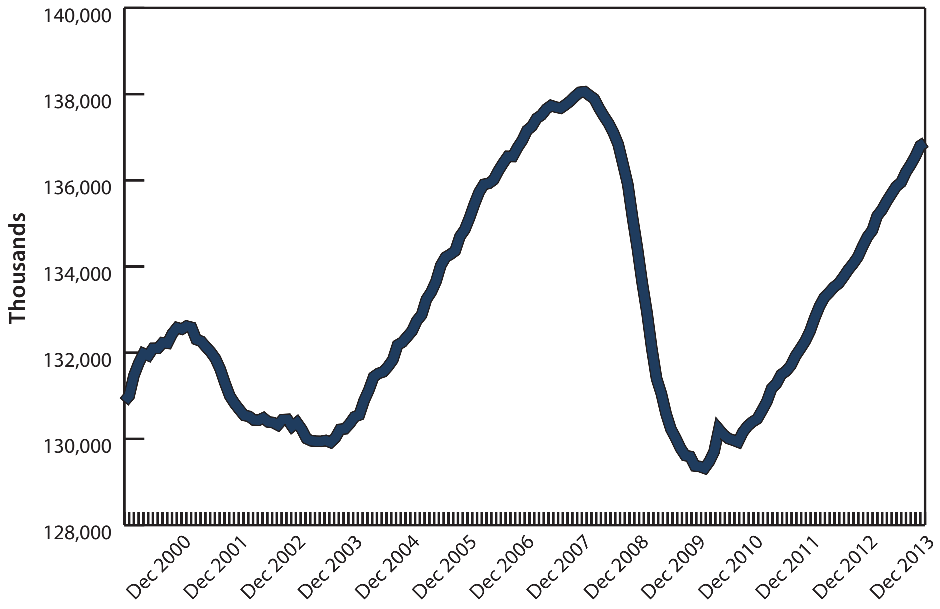
EMPLOYMENT TRENDS

Since the economy tends to drive the job market, a major economic problem (to many people the major problem) facing the U.S. is current employment levels and slow creation of new jobs. The low point for jobs was in early 2010 (see Exhibit 2-13), as reported by the Bureau of Labor Statistics (BLS) *Establishment Survey*, when there were 8 million fewer people working compared to two years previously. As the graph indicates, the economy has recovered a significant number of jobs since the Great Recession, but current job creation is not sufficient to get unemployment down to 5 percent or less in the next year.

Employment and job creation are the major drivers of both residential and commercial real estate markets. For commercial real estate, jobs usually drive the demand for office space, and incomes and jobs tend to drive the demand for apartments and retail space. In addition, a significant portion of commercial industrial space is warehouse space, typically serving the retail market or industries serving retail. Without job growth, there is little demand for more space in the commercial real estate sectors.

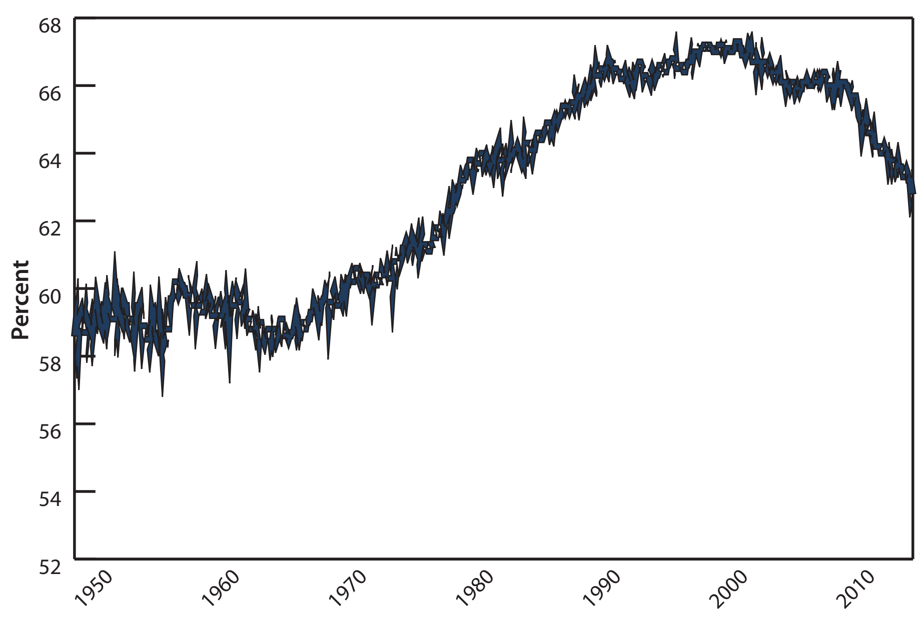
A measure of the health of the job market may be the employment rate—defined as the percentage of working adults among the adult population. For a historic perspective, Exhibit 2-14 shows the labor force participation rate starting in 1948. Since that time period, the economy witnessed a variety of social, economic, and political environments—all of which have impacted the rate. Although it is unlikely that the peak rate for labor force participation is an equilibrium rate, it is also likely that there have been a significant number of recent labor force drop-outs for economic reasons. As of December 2013, the labor force participation rate dropped to 62.8 percent, matching its lowest level since 1978.

Exhibit 2-13. Total Nonfarm Employees Working



Sources: BLS, Haver Analytics, January 2014.

Exhibit 2-14. Percentage of Adults in Working Population



Sources: BLS, Haver Analytics, January 2014.

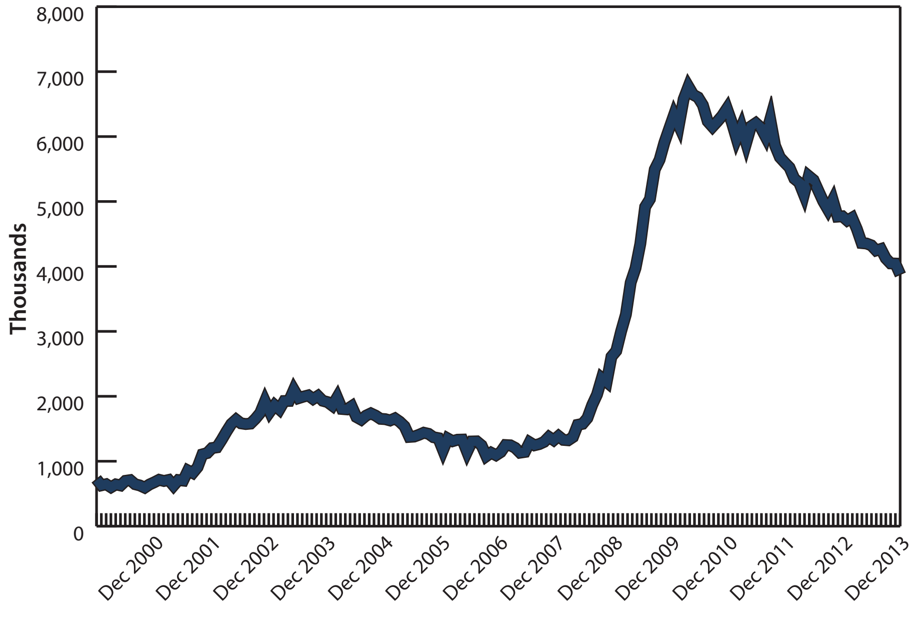
Long-term unemployment appears to have become a new characteristic of the economy. Although the number of workers unemployed for 27 weeks or longer has declined (see Exhibit 2-15), this number is still significantly higher than prior to the recession. There has been increasing concern that long-term unemployment could morph into permanent unemployment, particularly for many older workers, workers in technologically-obsolete industries, and workers in depressed parts of the country.

The Quit Rate

Exhibit 2-13 showed some improvement in non-farm employment, although underemployment and unemployment continue to be significant. However, another measure of improving job market conditions is the "quit rate." Quitting a job may be a sign that better opportunities are available elsewhere. When the "fire rate" (involuntary termination) rises, it is typically a symptom of declining economic activity. However, the quit rate (a voluntary action) usually occurs with an expanding economy. Unfortunately, while the quit rate, as shown in Exhibit 2-16, is increasing, it is still relatively low.

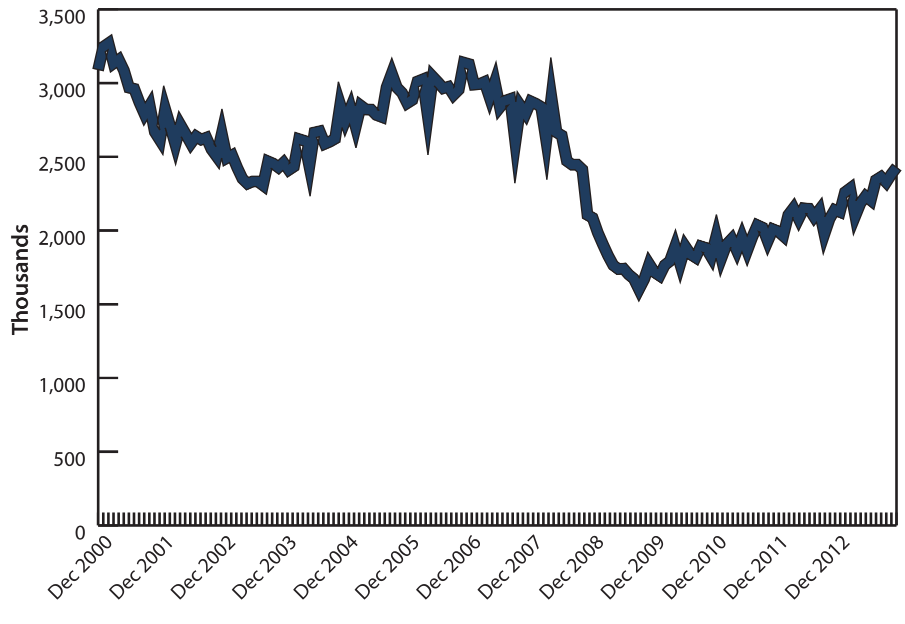
As noted previously, for real estate markets, the key issues are the level of jobs and growth of jobs. NAR forecasts that job creation will continue to be disappointing—in the neighborhood of 2.3 million new jobs per year, averaging out to approximately 200,000 new jobs per month. For purposes of comparison, the economy needs to create approximately 125,000 jobs each month just to accommodate people coming onto the job market. As shown in Exhibit 2-12, unemployment is projected to decline to 6.6 percent in 2014; however, there are significant issues to consider related to jobs. As of December 2013, approximately 10.4 million people were unemployed. Approximately another 7.8 million people worked part time for economic reasons, and would have liked to have a full-time job but could not get one. Another approximantely 5 million people were not in the labor force at all compared to the labor force participation rate in December 2007, the start of the Great Recession.

Exhibit 2-15. Civilians Unemployed for 27 Weeks or Longer



Sources: BLS, Haver Analytics, January 2014.

Exhibit 2-16. The Quit Rate

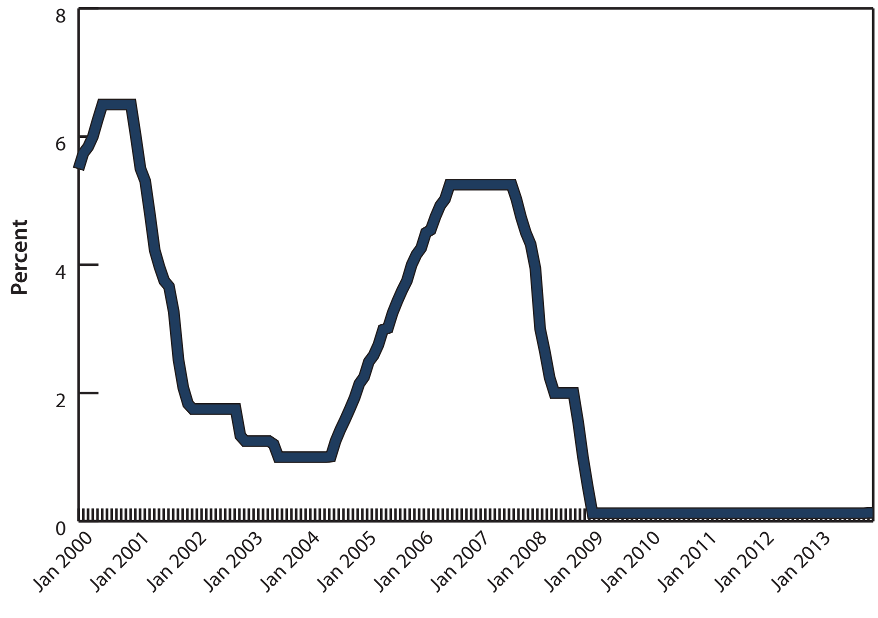


Sources: BLS, Haver Analytics, January 2014.

UNCERTAINTIES AND THE FORECAST

Many of the short-term uncertainties potentially impacting the forecast are political—monetary policy, the budget, sequester, and deficit, and international economic uncertainties. The longer-term uncertainties appear to be structural. Any one of the uncertainties can change the economic forecast. Multiple economists using the same data will frequently arrive at very different predictions for the economic outlook—simply because their assessments of the exogenous factors driving the economy and the associated uncertainties are different.

Exhibit 2-17. Federal Open Market Committee Federal Funds Target Rate



Sources: Federal Reserve Board, Haver Analytics, January 2014.

Uncertainty—Monetary Policy: The Federal Reserve has signaled that interest rates will remain low until unemployment is brought down. Using a program of bond purchases denoted as "quantitative easing," the Federal Reserve has been implementing a low interest federal funds target rate policy since 2009 (see Exhibit 2-17), with continuation on a winding down basis for the immediate future. Quantitative easing has been implemented through purchases of mortgage-backed securities, and the Fed's balance sheet has grown substantially. Relative to historical experience, the economy is awash in liquidity. In addition, job creation continues to be positive but slow, as evidenced by the monthly numbers. Since the beginning of the financial market turmoil in August 2007, the Federal Reserve's balance sheet has grown in size and has changed in composition. Total Reserve Bank Credit Outstanding of the Federal Reserve has increased from \$833 billion in August 2007 to almost \$4 trillion as of December 2013.

Uncertainty—The Federal Budget (Taxes, Expenditures, and Sequestration): Federal agencies mitigated the first round of sequestration by making adjustments to their budgets, such as temporary furloughs or zeroing-out unobligated funds that were authorized but not spent. These efforts slowed the economy somewhat. Congress continues to arrive at short-term budget solutions. If Congress enacts longer-term spending and taxation reforms, there may be a significant impact to the forecast.

Uncertainty—Credit Issues: A number of mutually reinforcing factors are making credit tight. Many lenders have reassessed how much risk they are willing to take, both in reaction to losses suffered in the collapse and because they now recognize costs associated with riskier lending that were not fully appreciated before. These include the cost of servicing distressed borrowers and the reputational and legal risks associated with servicing significant numbers of delinquent or defaulting loans.

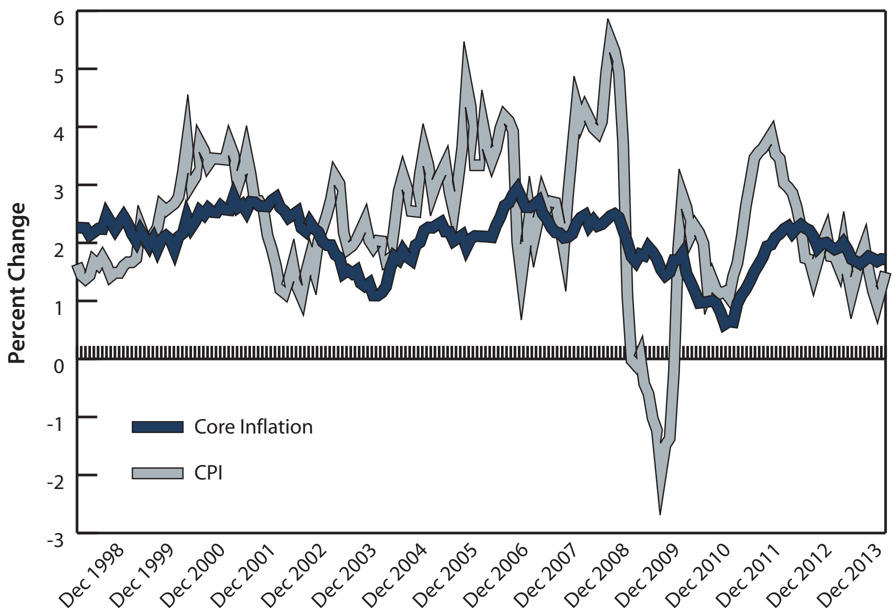
Uncertainty—Foreign Economies/ Europe and the Rest of the World: Potential recessions impacting international economies could subsequently impact the U.S. economy. NAR's forecast assumes that this does not occur.

Uncertainty—Changing Demographics: Changing demographics are unlikely to affect the forecast for 2014. However, on a longer run basis, many members in the millennial generation face problems—particularly high student debt levels, the lack of jobs, and mismatches between job openings and worker skills. The rebound from the Great Recession has probably been impeded to some degree by this situation.

Uncertainty—Mid-term Elections: The mid-term elections in November will likely add to the uncertainty in 2014. If the Senate or the House of Representatives should change majority parties, it could have a major impact on interest rates, government spending, banking, employment, healthcare, and how the future unfolds in the years ahead.

Uncertainty—Inflation: The Federal Reserve has announced that it is willing to tolerate a higher inflation rate in order to bring down the unemployment rate. Up to this point, inflation has been relatively minimal, as shown in Exhibit 2-18. Various theories have been advanced for the low inflation level: international competition impacting U.S. markets, excess domestic production capacity keeping U.S. prices down, productivity increases by U.S. workers, misalignments of resources in the economy, etc. Regardless of the reason, low inflation has prevailed.

Exhibit 2-18. Core Inflation Rate: All Items Less Food and Energy



Sources: BLS, Haver Analytics, January 2014.

How much longer low inflation can continue is not clear. The two generally accepted economic theories for macroeconomics are Keynesian (focus on changes in government or other major expenditures to drive the economy, as noted by John Maynard Keynes), and monetarist (focus on the money supply working its way through the economy to impact GDP, generally mentioned in conjunction with the economist Irving Fisher). Both theories predict higher inflation in association with government deficits and increases in the money supply. At a time when

government deficits are substantial, and when the monetary liquidity is at an all-time high, one would think that inflation could be a major possibility—although it has not yet appeared as a problem.

So far, however, inflation remains under control. Despite the current non-threatening inflation rate, however, recent increases in apartment rents should raise concerns. Apartment rent is one of the biggest weights in the overall consumer price index (CPI), and rents are increasing, which should indicate the start of additional inflation. NAR forecasts 2.6 percent inflation in 2014. Housing, as computed in terms of apartment rents and comparable theoretical rents for owner-occupied housing, makes up a major portion of the CPI. Those costs are headed higher, as shown in Exhibit 2-19, and by 2015, it is likely we will see a higher inflation rate.

The Forecast

In applying an economic forecast, a key issue is the identification of the variables that predict the market. For example, the level of commercial real estate sales is well-known to be related to a wide variety of factors—capitalization rates, vacancies, space needs, interest rates, investment policies, underlying trends in space utilization, etc. Many of these variables are related to the economic outlook. However, a key predictor for the demand for commercial space—and often the driver of greatest interest in an economic forecast—is employment.

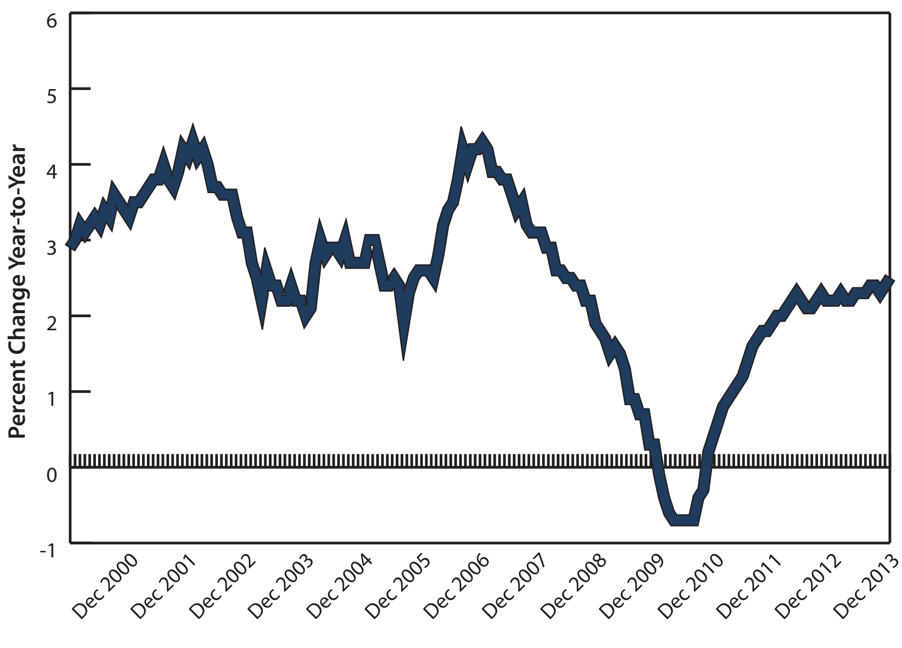
NAR's outlook for 2014 is for modest economic growth in the neighborhood of 2.5 percent in real terms. Economic growth and job creation have been disappointing since the end of the Great Recession. The outlook for 2015 is for continued but slower than normal expansion. The economy appears to be essentially stalled in slow growth. A variety of reasons for this slow growth have been hypothesized:

- The Great Recession was heavily financial, and recoveries from financial recessions are slow, particularly when the recession has spread world-wide.
- Uncertainties and major deleveraging hurt consumer and business confidence—too much fear when we should have "nothing to fear but fear itself."
- The older, established parts of the economy have continued to contract, while the high-tech parts of the economy have been slow to generate jobs.
- Too many resources have been drained from "Main Street" to "Wall Street," particularly with the development of "financial engineering" over the past decades.
- The ongoing mismatch of skills and job openings has continued—particularly as technology has advanced rapidly and college students have not, in many cases, acquired necessary workplace skills.
- Government regulatory policies.

These are only a few of the many hypotheses that have been noted in the media and by various economists. It is not the purpose of this section to offer insight on whether any, all, or different hypotheses are correct. Rather, the data indicate that, for a variety of reasons, we are headed towards continued relatively slow growth for a few years.

It is also important to keep in mind that the outlook could be wrong if some of the exogenous factors change. For example, increased international economic growth, changes in regulatory policies, changes in consumer confidence, and possibly additional incentives focused on investment could potentially go a long way to render this forecast unnecessarily bleak. However, until the exogenous conditions affecting this forecast and which are outside the realm of economics in terms of prediction change, slower rather than more rapid growth appears likely.

Exhibit 2-19. CPI-U: Housing



Sources: BLS, Haver Analytics, January 2014.

3

THE CAPITAL MARKETS

FLUSH WITH LIQUIDITY

FLUSH WITH LIQUIDITY

As investors continue to look for opportunities in the investment environment, the consensus is that the U.S. economy is finally starting to turn the corner. There are a few good signs in the recovery—household wealth is improving, employment is slowly increasing, business and corporate profits are growing, and the housing market is showing positive signs, as discussed in Chapter 2 of this report.

The investment environment is also a little less uncertain compared with the past few years, particularly as it relates to fiscal and monetary policy, than it was just a few months ago. The president and Congress have passed a budget, and although a record-high level of debt continues, it appears unlikely that the government will shut down over the need to raise the debt ceiling. Federal Reserve Vice-chairwoman Janet Yellen was approved as the next Federal Reserve chair, and it is expected that she and the Board will keep the federal funds rate low for another year or longer. It also appears that the tapering of the Federal Reserve's monthly bond purchases will commence with less fear than was anticipated when plans were announced in mid-2013.

However, challenges remain as the Great Recession is worked off, and although the year 2013 ended with economic growth that was somewhat stronger than anticipated, a continued slow recovery in 2014 is generally expected. With the yield rate for 10-year U.S. Treasurys increasing slightly in late December, interest rates are expected to inch upward. Despite the increased risk of higher interest rates, we remain cautiously optimistic about commercial real estate investment for the year ahead.

INVESTOR VIEWS ON CAPITAL

Global wealth increased 68 percent over the last decade to reach an all-time high of $241 trillion in September 2013, according to an annual survey conducted by Credit Suisse Group. Most of this year's 4.9-percent increase may be attributed to wealth increases in the U.S., primarily from the stock market rally and the increase in home prices. Therefore, it is not surprising that there is an abundant amount of capital available for investment, but given market uncertainty in general, it is also understandable that many investors remain cautious.

The stock market continued its strong performance during 2013, as reflected by the high index readings in Exhibit 3-1, as many investors increasingly put risk aside in search of returns. Fourth quarter 2013 stock market

Exhibit 3-1. Financial Market Returns

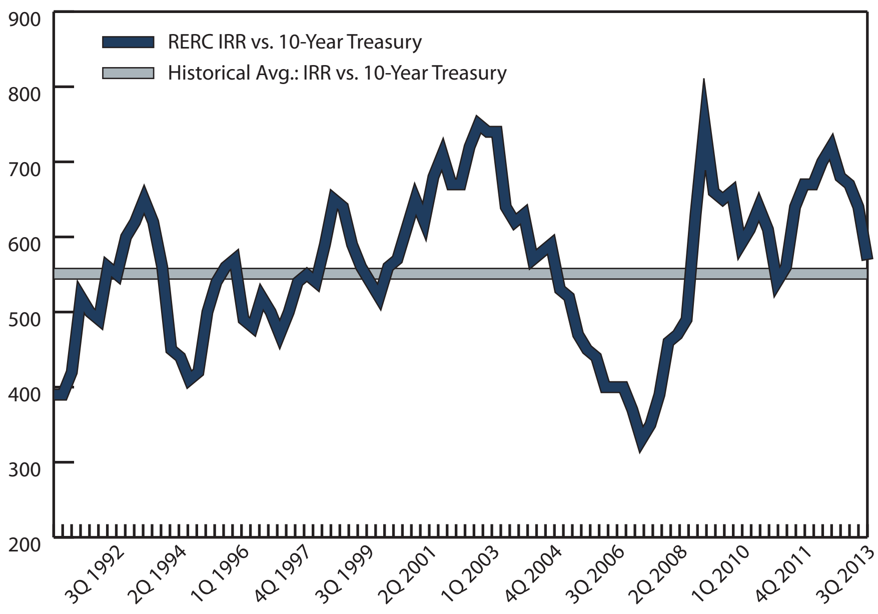
Compounded Annual Rates of Return as of 9/30/2013	YTD[4]	1-Year	3-Year	5-Year	10-Year	15-Year
Consumer Price Index[1]	1.29%	1.10%	2.32%	1.35%	2.37%	2.42%
Baa Corporate Bonds	5.40%	4.97%	5.27%	5.92%	6.21%	6.73%
10-Year Treasury Bond[2]	2.22%	2.09%	2.32%	2.68%	3.53%	4.05%
Dow Jones Industrial Average	17.64%	15.59%	16.89%	9.93%	7.74%	6.92%
NASDAQ Composite[3]	24.90%	21.03%	16.77%	12.51%	7.76%	5.48%
NYSE Composite[3]	13.95%	16.61%	9.74%	5.02%	5.48%	4.01%
S&P 500	19.81%	19.34%	16.26%	10.01%	7.56%	5.33%
NCREIF Index	8.25%	11.00%	12.67%	3.36%	8.66%	8.93%
NCREIF ODCE	10.44%	13.04%	14.27%	0.68%	7.08%	7.92%
NAREIT Index (Equity REITS)	3.03%	6.23%	12.78%	6.00%	9.67%	10.29%

[1]Based on the published data from the BLS (seasonally-adjusted).
[2]Based on Average End of Day T-Bond Rates.
[3]Based on Price Index, and does not include the dividend yield.
[4]Year-to-date (YTD) averages are not compounded annually.
Sources: BLS, Federal Reserve Board, S&P, Dow Jones, NCREIF, NAREIT, Moody's Baa Corporate Bond, compiled by RERC.

returns were even higher, setting new records. Bond prices dropped in 2013, with some of the largest outflows in history, and continue to hold much risk. Meanwhile, the institutional commercial real estate market, as demonstrated by the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index and the NCREIF Fund Index-Open End Diversified Core Equity (NFI-ODCE), performed somewhere between stocks and bonds, and generally remains an attractive investment alternative on a risk-adjusted return basis.

During 2013, the spread between RERC's pre-tax yield rate (or internal rate of return [IRR]) and U.S. Treasurys experienced a sharp decrease. This decrease was due to the continued compression of RERC's expected pre-tax yield rates, in addition to 10-year Treasurys increasing off of their lows from 2012. Despite the decrease in the spread, commercial real estate's risk-adjusted returns still remain attractive, as the current spread is still slightly higher than the historical average back to 1990, as demonstrated in Exhibit 3-2.

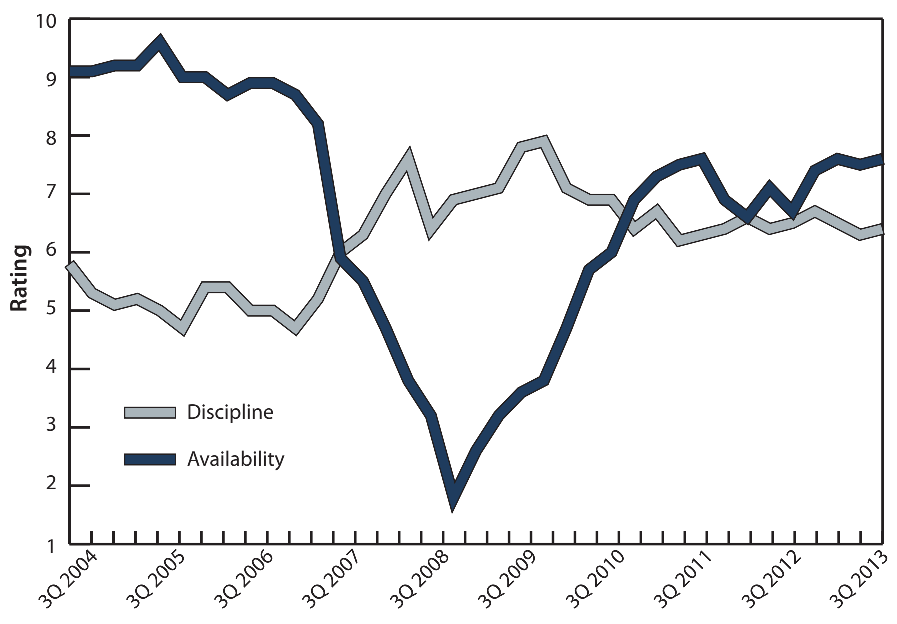
Exhibit 3-2. Spread Between RERC's Required Pre-Tax Yield Rate and 10-Year Treasury Rate



Sources: RERC, Federal Reserve, 3Q 2013.

As shown in Exhibit 3-3, the gap between the availability of capital and the discipline of capital continues. RERC's institutional investment survey respondents rated the availability of capital at 7.6 on a scale of 1 to 10, with 10 being high, in third quarter 2013, and the discipline of capital at 6.4 on the same scale. Survey respondents noted that in some cases, there was more capital available than there was product to invest in, and as a result, many investors have been trying to outbid each other in the same core markets. Others noted that pricing was quite aggressive for some deals, and that exit capitalization rates in these situations were being stretched beyond what typical analysis of long-term trends could support. This lack of discipline has been bleeding into some secondary and tertiary markets, as well as into slightly more risky property types. However, many investors also noted that higher interest rates have helped to keep buyers' assumptions in check, at least for now.

Exhibit 3-3. RERC Availability and Discipline of Capital



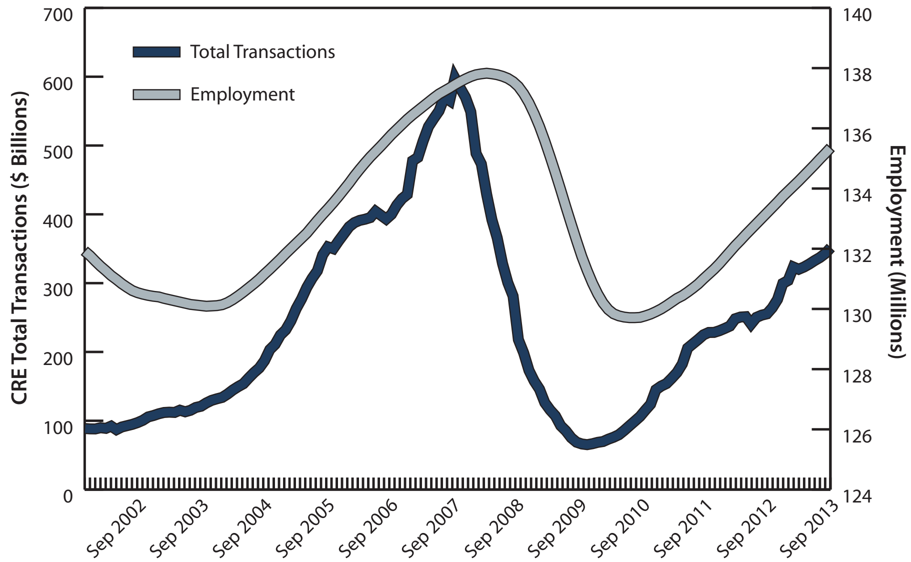
Ratings are based on a scale of 1 to 10, with 10 being highest.
Source: RERC, 3q 2013.

TRANSACTION TRENDS CLIMBING STEADILY

At the national level, there is an 80-percent correlation between commercial real estate sales (as reported by Real Capital Analytics) and the level of employment (establishment employment jobs as reported by the BLS).[3] Of course, with the correlation between jobs and sales at only 80 percent, there are a variety of other factors driving sales. In addition, all real estate is local, so a substantial refinement of the economic analysis as related to specific cities or regions would be necessary to explain in detail for commercial markets in specific areas. Further, commercial sales are "lumpy"—that is, major, high-value projects occur on a discrete basis. Therefore, Exhibit 3-4 illustrates the relationship between transactions and employment, but a more detailed analysis would be needed for accurate forecasting.

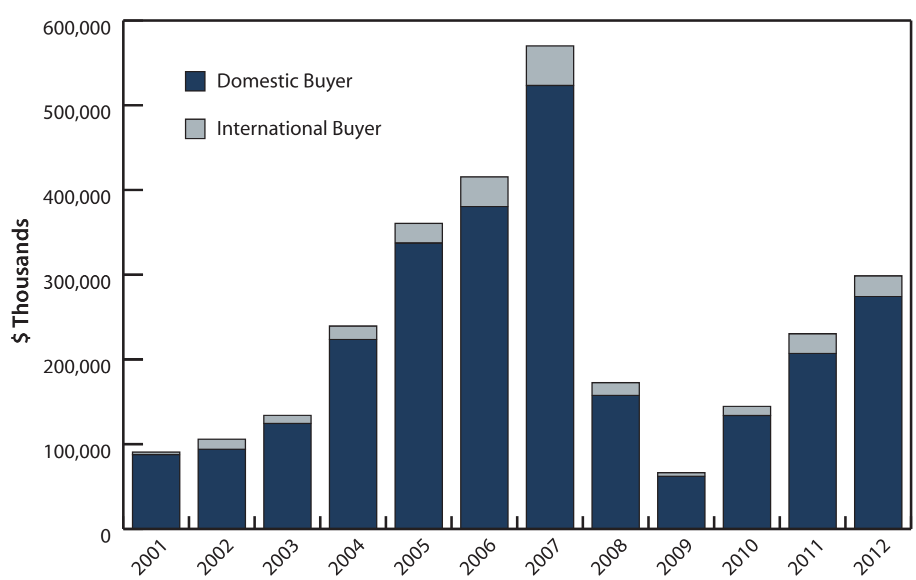
Based on information from Real Capital Analytics, the cumulative total market for commercial property sales over the 2001 through second quarter 2012 time period was estimated at approximately $2.8 trillion. Foreign buyers purchased approximately $223 billion of commercial property, or 7.9 percent of the total commercial sales.[4] Exhibit 3-5 shows how the demand for commercial real estate has fluctuated significantly from year to year among international and domestic purchas-

Exhibit 3-4. Commercial Real Estate: Sales and Employment



Sources: BLS, Real Capital Analytics, Haver, Oct. 2013.

Exhibit 3-5. Commercial Real Estate Sales, 2001-2012



Sources: Real Capital Analytics (as analyzed by authors), July, 2013.

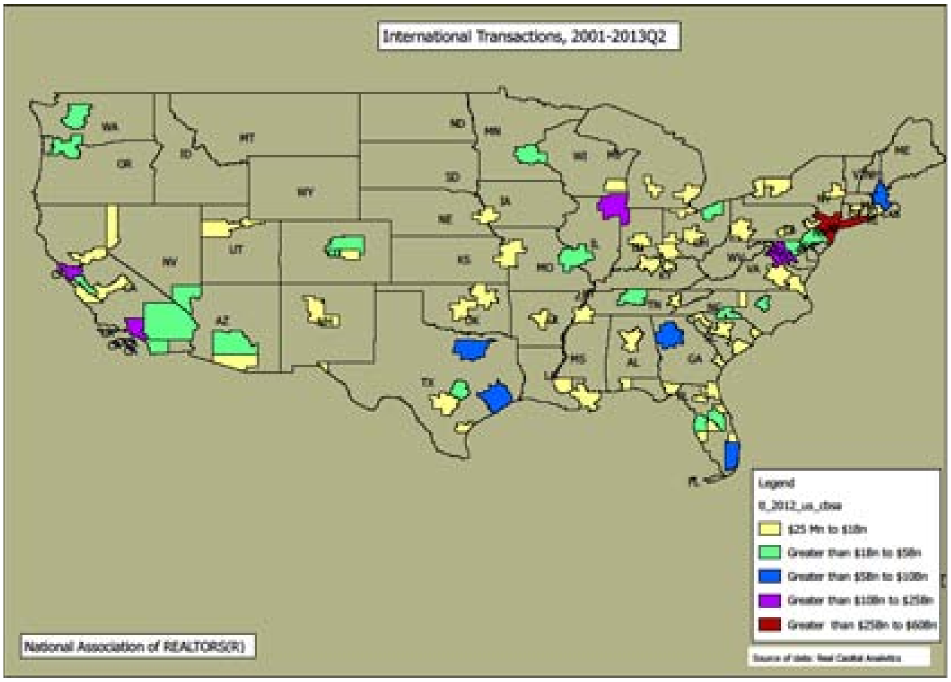
[3] *The graph is based on 12-month rolling averages. Correlation does not necessarily imply causation, but it useful for predictive purposes.*

[4] *Real Capital Analytics transaction data cover commercial sales in excess of $2.5 million only.*

ers, and was significantly impacted by the Great Recession.

Foreign investors have purchased commercial property in a relatively large number of metropolitan areas, although the volume of transactions in many of the markets has been relatively modest. Data from Real Capital Analytics on a metropolitan statistical area (MSA) basis were analyzed for foreign purchases over the 2001 through second quarter 2013 time frame for 84 MSAs, based on data availability. Exhibit 3-6 depicts the MSAs with foreign purchases by dollar volume reported over the time period, and Exhibit 3-7 identifies the size of foreign purchases relative to the total level of reported transactions in the major MSAs (where data are available), based on computed percentages.

Exhibit 3-6. Commercial Real Estate Transactions By Foreign Investors (Total Volume)



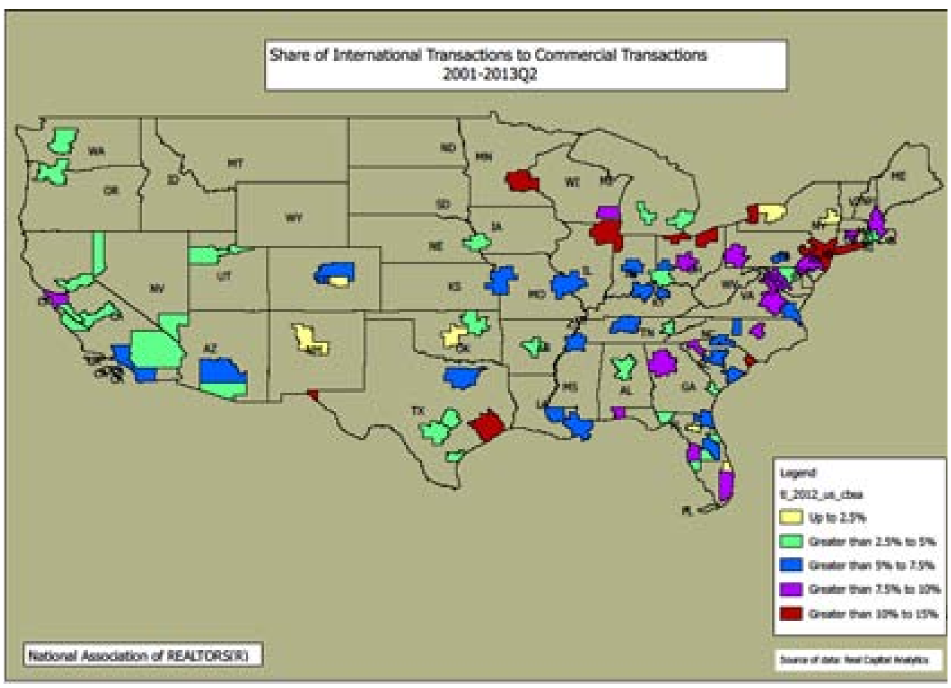
Source: Real Capital Analytics data compiled by NAR, November 2013.

THE COMMERCIAL REAL ESTATE CAPITAL STACK

Although investment in commercial real estate has been steadily increasing since the Great Recession, the amount of capital invested in this asset class is still down approximately 25 percent from its peak before the Great Recession, according to figures compiled by the Urban Land Institute (ULI), PricewaterhouseCoopers (PwC), and the Mortgage Bankers Association (MBA). More than $3.56 trillion was invested in commercial real estate as of second quarter 2013 compared to the peak of $4.76 trillion in 2008.

Real estate is generally held within one of the four quadrants: private equity, public equity, private debt, and public debt. Private equity consists primarily of private real estate held by private companies or by individuals, and can be structured in a variety of formats and legal structures. Public equity generally refers to the securities of publicly-traded REITs and other non-REIT publicly traded real estate operating companies (REOCs). Private debt is mostly comprised of whole commercial loan mortgages, but can also refer to participating mortgages and loan syndications. Public debt usually refers to commercial mortgage-backed securities (CMBS), but according to most definitions, can also include public

Exhibit 3-7. Commercial Real Estate Transactions by Foreign Investors (% of Total Transactions)

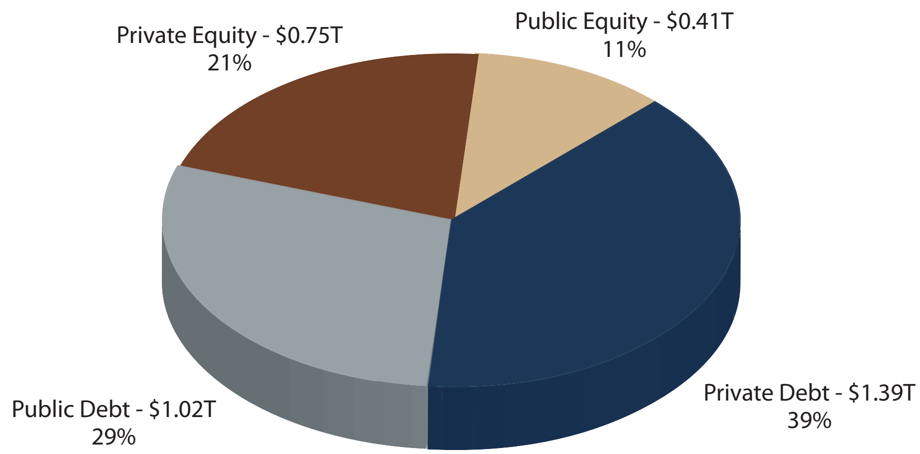


Source: Computations based on data from Real Capital Analytics and compiled by NAR, November 2013.

bond issues from public and private companies and agencies.

According to ULI and PwC, approximately one-third of the $3.57 trillion total investment capital is invested in equity (21 percent, or $0.75 trillion, in private equity, plus 11 percent, or $0.41 trillion, in public equity). The remaining two thirds of total investment capital for commercial real estate is invested in debt products (39 percent, or $1.39 trillion, in private debt, plus 29 percent, or $1.02 trillion, in public debt), according to MBA (see Exhibit 3-8).

Exhibit 3-8. Current Capital Stack for Commercial Real Estate



Sources: Urban Land Institute, PwC, MBA, 2011.

EQUITY REAL ESTATE

Investment in private equity real estate and real estate investment trust (REIT) funds has continued to increase in the U.S. in 2013. Private real estate has historically reflected very positive returns compared to traditional investment alternatives, but due in large part to the increase in interest rates, REIT stocks have underperformed compared to other asset classes.

According to Preqin, private equity real estate funds in the U.S. raised nearly $34 billion through third quarter 2013, and will likely maintain positive annual growth for the third consecutive year. Due to the recovery in real estate prices, these funds exhibited improved performance in 2012, with an average internal rate of return of 6.4 percent compared to 4.9 percent in 2011, per Thomson Reuters.

However, according to third-quarter 2013 findings, total returns according to the NFI-ODCE declined from the prior quarter to 3.56 percent, with income holding mostly steady at 1.31 percent and appreciation declining to 2.25 percent. During third quarter, the total return for the NFI-ODCE was higher than the Dow Jones Industrial Average (DJIA) total return of 2.12 percent, demonstrating that commercial real estate may be an attractive investment alternative, especially compared to the risk involved.

In comparison, REIT fundraising rose 11.5 percent through third quarter 2013 on a year-over-year basis, bringing the total to $60.0 billion, with nearly two-thirds of the capital raised through the equity route, according to the National Association of Real Estate Investment Trusts (NAREIT). The number of initial public offerings for REITs (per transaction value) have been at their highest level since 2005, and have ranged from traditional real estate asset classes to more non-traditional real estate classes, including single family rental properties and data centers.

In contrast to the past 3 years, traditional asset classes outperformed REITs, with REITs returning 4.3 percent as of Oct. 10, 2013, compared to 20.7 percent for the S&P 500 and 27.2 percent for the Russell 2000, per NAREIT. On a historical basis, however, REIT performance and commercial real estate values have improved during periods of rising interest rates and a strengthening economy, and historical data suggests that REIT performance will likely improve going forward. (According to Cohen & Steers, during the six monetary tightening cycles since 1979, when U.S. Treasury yields rose significantly, REITs generated cumulative returns of 56.5 percent compared to 38.3-percent returns on stocks and 4.2-percent returns on bonds.)

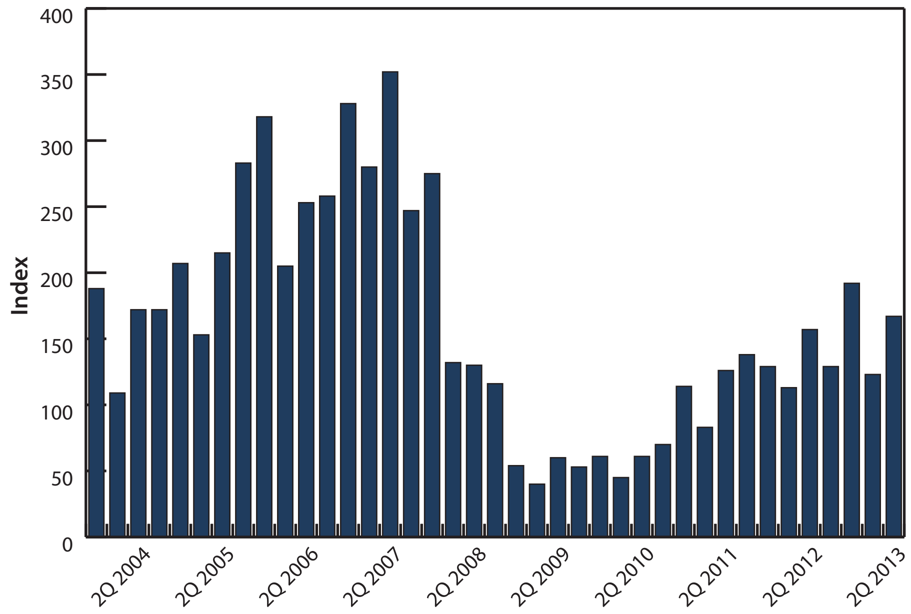
DEBT MARKETS

Although credit availability remains bifurcated across the markets and credit in the primary markets is often more accessible compared to relatively scarce lending in some secondary and tertiary markets, the lending environment overall for commercial real estate was more steady in 2013 than it was a year earlier.

After the swell of originations at the end of 2012, commercial real estate originations dipped in first quarter 2013 but resumed growth in the second quarter. As such, during first half 2013, commercial and multifamily mortgage originations were 8 percent higher than during the same period in the previous year, according to the MBA (see Exhibit 3-9).

As for originations for the specific property types, the apartment market dominated the other major sectors, with first half 2013 multifamily originations 31 percent ahead of originations in first half 2012. Hotel and industrial sector originations increased by 13 percent and 1 percent, respectively, in first half 2013 over first half 2012 originations. Conversely, originations for the office sector decreased 2 percent in first half 2013 compared to a year earlier, while originations for retail properties decreased 19 percent, per the MBA.

Exhibit 3-9. Commercial/Multifamily Mortgage Bankers Originations Index



Sources: Mortgage Bankers Association, NBER, 2Q 2013.

Also according to the MBA, there was approximately $2.45 trillion in outstanding commercial/multifamily mortgage debt in second quarter 2013, which was $24.5 billion, or 1 percent higher, than the previous quarter. Three of the four major investor groups (banks; Fannie Mae, Freddie Mac, and Federal Housing Authority; and life insurance companies) increased their holdings.

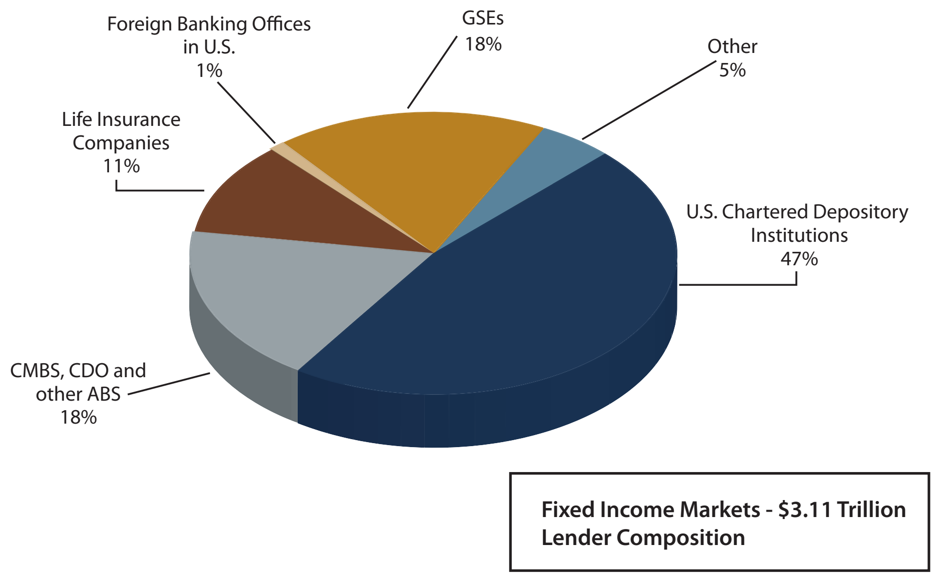
According to the MBA, loans for conduits for CMBS saw an increase in loan volume of 22 percent in first half 2013, compared to first half 2012. Further, CMBS issuance totaled $41 billion in first half 2013, slightly less than the $44 billion total issued in all of 2012; early reports indicate that by the end of third quarter 2013, $64.6 billion in CMBS was issued.

In addition, loan volume for government-sponsored entities (GSEs—Fannie Mae, Freddie Mac, and Federal Housing Authority) increased 20 percent in first half 2013, while originations for commercial bank portfolios increased 11 percent and loans for life insurance companies were about the same as a year ago, per the MBA.

Mortgage performance also continued to improve in first half 2013, and delinquency rates fell for many investor groups, including those for the CMBS market. According to the MBA, the decline in delinquency rates for CMBS was the largest on record. Delinquency rates for life companies and GSEs also declined.

According to the Federal Reserve Flow of Funds, there was $3.11 trillion in commercial real estate lender composition for the fixed-income market as of second quarter 2013 (see Exhibit 3-10), with banks and other chartered depository institutions holding 47 percent of debt. Debt held by GSEs and by CMBS, collateralized debt obligations (CDOs), and other asset-backed securities (ABS) was equal to 18 percent each, followed by life insurance companies with 11 percent, and foreign banking offices with 1 percent.

Exhibit 3-10. Fixed-Income Lender Composition



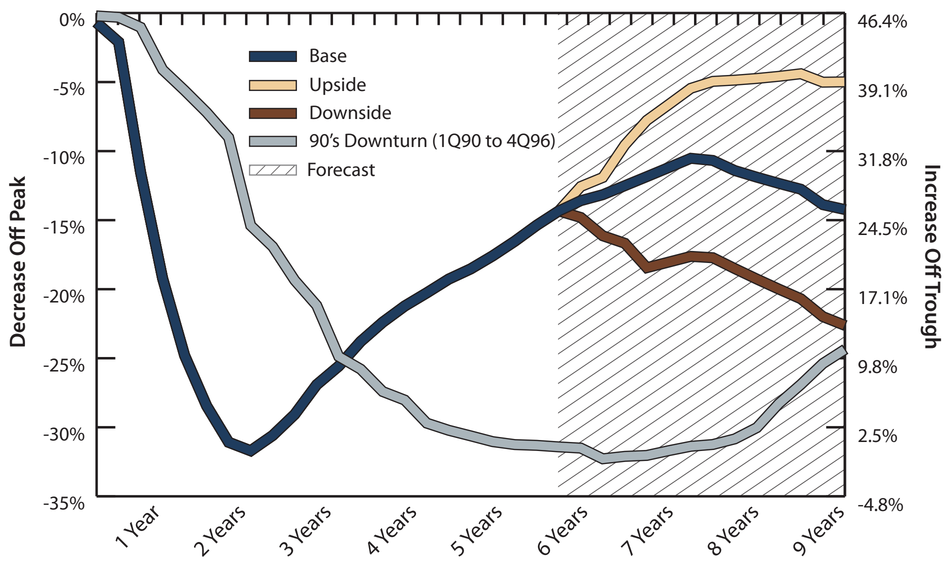
Source: Federal Reserve, 2Q 2013.

RERC'S OUTLOOK

RERC forecasts aggregate NCREIF values as presented in the NPI to increase by approximately 2.75 percent throughout 2014, which is a decrease from 2013. During third quarter 2013, the capital return decreased 20 basis points to 1.2 percent as compared to the previous quarter. Exhibit 3-11 demonstrates a cumulative value increase from trough to third quarter 2013 of approximately 25.5 percent (note that trough was reached in first quarter 2010). By the end of 2013, the value increase from the trough is forecasted to be around 30.0 percent.

In addition, RERC's projection is bracketed by upside and downside scenarios that reflect a projected value change

Exhibit 3-11. RERC Value Outlook

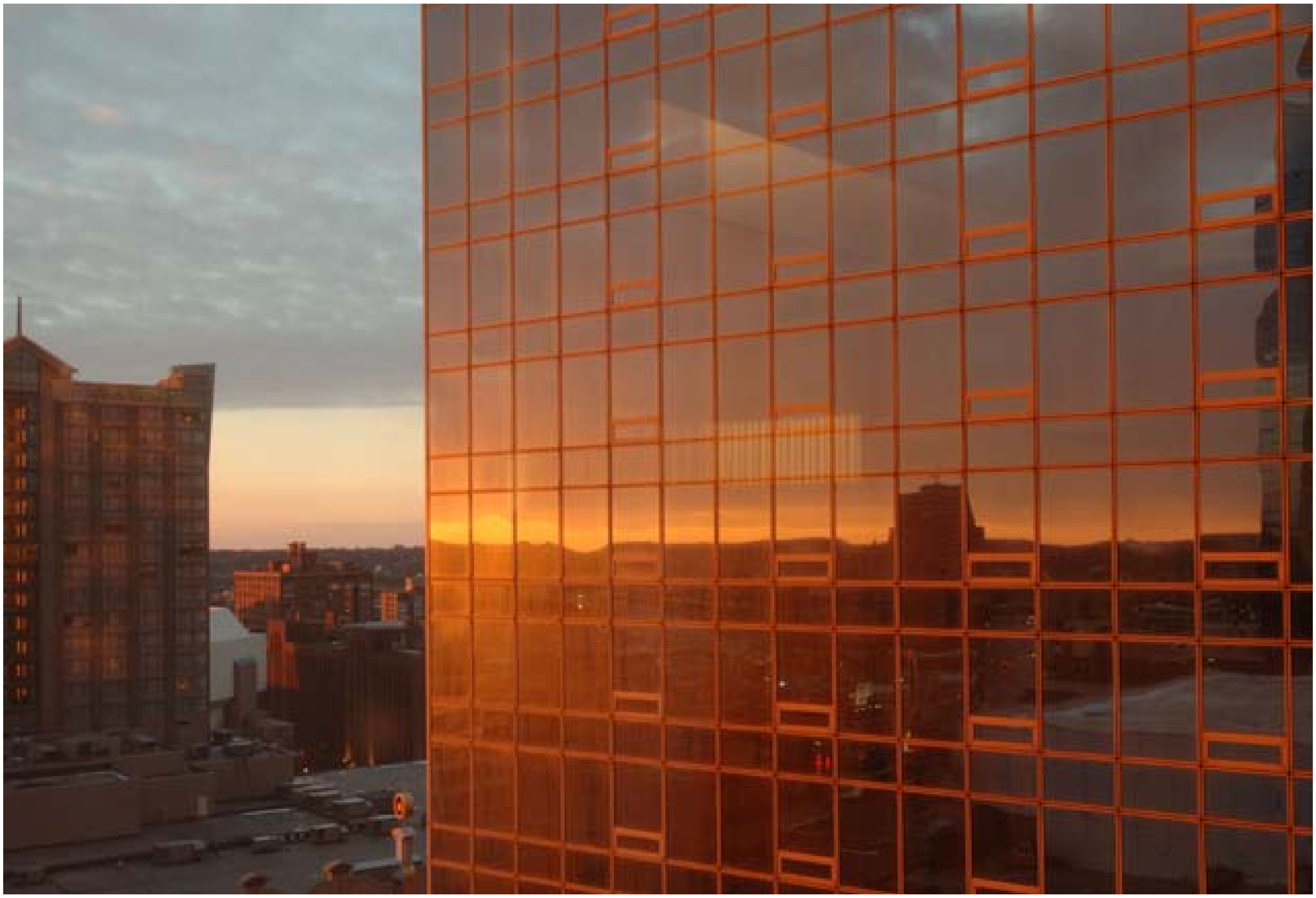


Note 1: The most recent downturn depicted above (baseline) started in 2q 2008.
Note 2: It is important to understand that RERC's presentation provides an aggregate view for the entire commercial real estate industry, and is not a projection specific to tiers of funds that exist throughout the industry.
Sources: NCREIF, RERC, 3q 2013.

with the base case near 2.75 percent. If you add an income return of 6 percent, the commercial real estate total return in 2014 is expected to be approximately 8.75 percent on an unleveraged basis. It is also important to note that RERC's estimates are unleveraged, and the use of debt (even prudent levels exhibited by core funds) has a compounding impact on value increases going forward and could increase the unleveraged return to the low teens on a leveraged basis. Thus, if positive leverage is added to these estimates, one can see that commercial real estate may offer attractive risk-adjusted returns for a core strategy and relative to alternative investments such as stocks and bonds.

A message from the market today is that commercial real estate investment appeal going forward will continue to be the "assurity" of income (dividend) component versus the "speculative" value appreciation element—a back-to-basics approach as to why, for generations, many funds have invested in commercial real estate. Further consideration of the back-to-basic investment strategies can be found by examining the historical NCREIF capital (value) index. NCRIEF, in combination with RERC's value projection, indicates that true value "appreciation" would have been just 1.5 percent over the 35-year reporting history of NCREIF, if one deducted the capital expenditures required to maintain the value of the assets during this period of time.

The recovery in commercial real estate financing and increasing property values are expected to continue in 2013. As discussed previously, the availability of capital (Exhibit 3-3) has been increasing, lending standards are easing, and the value outlook for commercial real estate in 2014 will likely be positive (although slightly lower than 2013), assuming that the economy continues its relatively slow growth and that interest rates do not increase excessively during the year. In addition, conduits and private lenders are expected to continue to help fill the lending void in the secondary and tertiary markets as many investors are likely to continue to extend out on the risk spectrum beyond the core and value-add investment strategies in search of higher returns. An analysis of the individual property markets and expectations for 2014 follows in Chapter 4.



4 THE PROPERTY MARKETS

TURNING THE CORNER

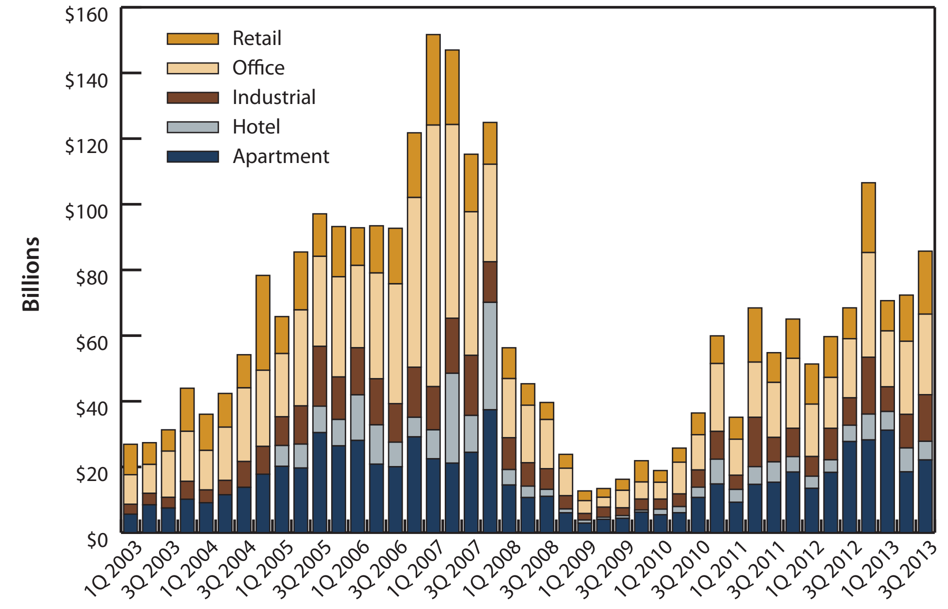
TURNING THE CORNER

As macroeconomic trends moved upward in 2013, the commercial real estate markets continued their upward climb toward prior peaks. As market fundamentals strengthened, many investors took advantage of low interest rates and favorable terms to expand their holdings into higher risk territory. Secondary and tertiary markets gained wider prominence in 2013, as many investors continued their efforts in the latter half of 2012 and shifted from the safety of the major metropolitan areas into higher yield opportunities. The metropolitan markets clustered around technology and energy sectors were the leaders in attracting capital inflows.

Sales of major properties (priced at over $2.5 million) rose 24 percent on a year-over-year basis, totaling over $145 billion in the first half of 2013, according to Real Capital Analytics (see Exhibit 4-1). (Comparatively, there were $570 billion in transactions during the peak in 2007.) Sales increased by double-digit growth rates for most property types in the first half of 2013. The pace of investments accelerated in third quarter 2013, with sales totaling $89.7 billion, a 26-percent yearly rise. Third quarter advances were driven by retail and industrial property sales, which rose 104 percent and 70 percent, respectively, from the same period in the prior year.

The bifurcation of commercial properties along high-priced versus low priced, and gateway cities versus secondary and tertiary markets, which characterized the 2011-2012 markets, softened noticeably in 2013. Based on NAR data, sales of properties at the lower end of the price range (mostly below $2 million) notched increases of 12 percent on a yearly basis.

Exhibit 4-1. Commercial Property Volume



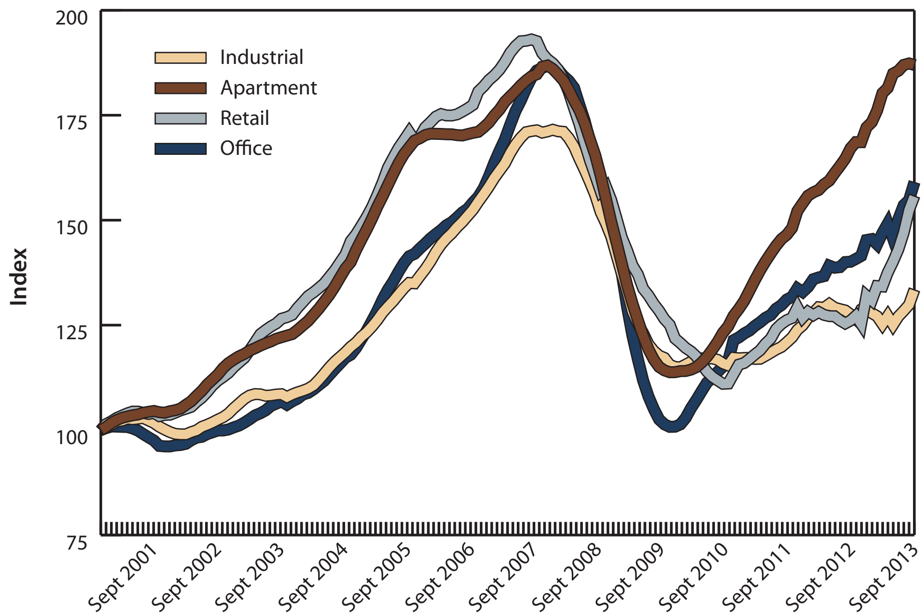
Source: Real Capital Analytics, 3q 2013.

According to Real Capital Analytics, the investment volume in the first three quarters of 2013 was dominated by the apartment sector, which, with $71.8 billion in sales, comprised 30 percent of all sales. Office assets accounted for 27 percent of all transactions, with $63.8 billion in sales. Retail and industrial property transactions followed, with 18 percent and 13 percent of sales, respectively. Hotels accounted for 8 percent of total transactions, with sales rising 49 percent on a year-over-year basis.

Portfolio sales contributed 28 percent to transaction volume in the first three quarters of 2013, per Real Capital Analytics, signaling a bullish environment, especially for apartment properties. Archstone's sale of apartment properties accounted for over $14 billion of portfolio sales. Hotels also comprised a large portion of portfolio transactions, with the Government of Singapore, Blackstone, Omni Hotels, and Starwood Capital Group making the largest hotel acquisitions.

At midyear 2013, New York City retained the top investment spot, followed by Los Angeles and the Northern Virginia suburbs of Washington, DC. In addition, Dallas and Houston moved into the top five investment markets, surpassing Atlanta, Chicago, and Boston according to Real Capital Analytics' ranking of investment volume. However, investor interest in secondary and tertiary markets remained a dominant trend, and markets like Jacksonville, Long Island, Philadelphia, and Las Vegas posted triple-digit growth rates in sales volume.

Exhibit 4-2. Property Prices Increased in 2013



Sources: Moody's Investors Service, Real Capital Analytics (Moody's/RCA CPPI), September 2013.

Commercial property prices rose 9 percent in the first three quarters of 2013 compared with the prior year, according to the Moody's/Real Capital Analytics Commercial Property Price Index (CPPI) shown in Exhibit 4-2. Apartment prices posted the steepest increase, gaining 14 percent over the period and closing within striking distance of their 2007 peak. Retail space saw prices rise 12 percent, changing hands at an average of $167 per square foot. Office buildings recorded the third steepest price growth at 9 percent year-over-year, trading for an average of $221 per square foot. Reflecting the shift towards lower priced secondary markets, industrial properties notched a 1-percent price decline in the first nine months, with sales prices averaging $64 per square foot.

Following the Federal Reserve's stated intent to curtail its quantitative easing program, interest rates surged at midyear. In response, cap rates increased a modest 17 basis points, as many investors pursued deals in secondary and tertiary markets. According to Real Capital Analytics, the apartment sector retained the lowest cap rate at 6.3 percent (see Exhibit 4-3). At 7.1 percent, office and retail properties tied for the second lowest cap rates. Industrial and hotel properties posted cap rate yields of 7.7 percent and 8.0 percent, respectively. With rates for 10-year U.S. Treasurys rising at a fast pace towards 3.0 percent, the spreads narrowed, and by the end of third quarter 2013, the impact seemed minimal. However, as monetary stimulus is expected to gradually end over

 |

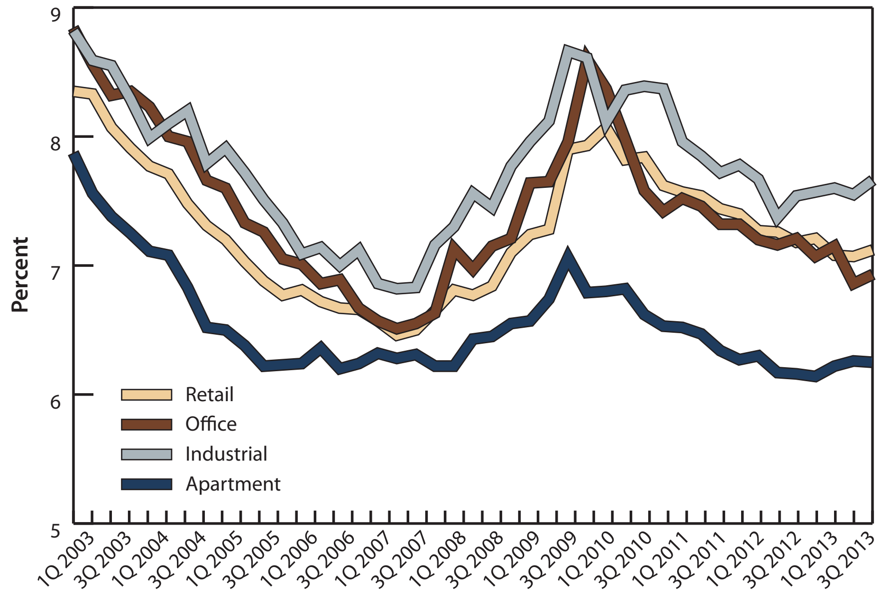
the next two years, further increases in interest rates are likely to exert upward pressure on cap rates.

Capital availability increased in 2013, along with the sources of funding. In the first half of the year, financing market share was distributed fairly evenly for GSEs, insurance companies, national banks, and regional/local banks at the high end of the market (deals over $2.5 million). CMBS issuance accounted for 24 percent of the total, according to Real Capital Analytics. However, funding varied considerably by property type. CMBS comprised the bulk of financing in the retail and hotel sectors, accounting for 45 percent and 42 percent of the total, respectively. Similarly, CMBS was the dominant issuer in the tertiary markets, making up 34 percent of all deals. At the lower end of the market (sales below $2.5 million), private investors, along with regional and local banks, comprised the bulk of funding, accounting for 55 percent of the total, according to data from NAR.

Outstanding commercial distress volume totaled $103 billion across all property types in the first nine months of 2013, according to Real Capital Analytics. Continuing a positive trend, workout rates have been steadily climbing, reaching 63 percent in the first half 2013. The apartment and hotel sectors recorded the highest workout rates, at 68 percent and 67 percent, respectively. As asset values continued to appreciate, instances of new distress declined (see Exhibit 4-4). Sales of distressed properties accounted for only 8 percent of total sales. At 45 percent, CMBS remained the largest holder of outstanding distress, while U.S. banks were the second largest holder of distressed properties, accounting for 25 percent.

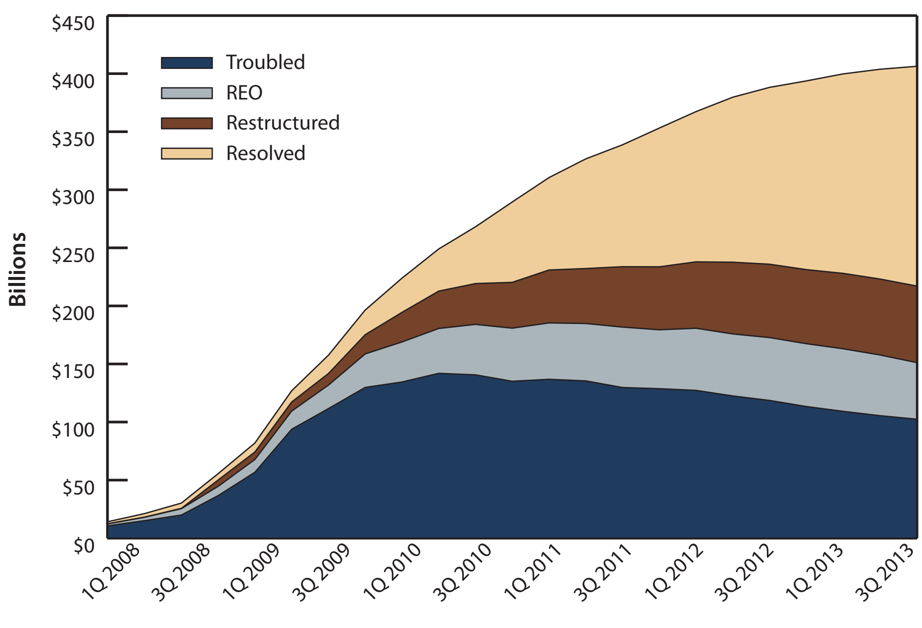
In the wake of the 2012 expansion, commercial real estate offered a strong investment option for many and provided solid returns during 2013, especially in light of fiscal and regulatory uncertainties. Despite the global economic slowdown posing likely challenges in 2014, commercial assets appear to remain well-positioned for growth.

Exhibit 4-3. Cap Rates Inched Up Slightly



Source: Real Capital Analytics, 3q 2013.

Exhibit 4-4. New Distress Declines

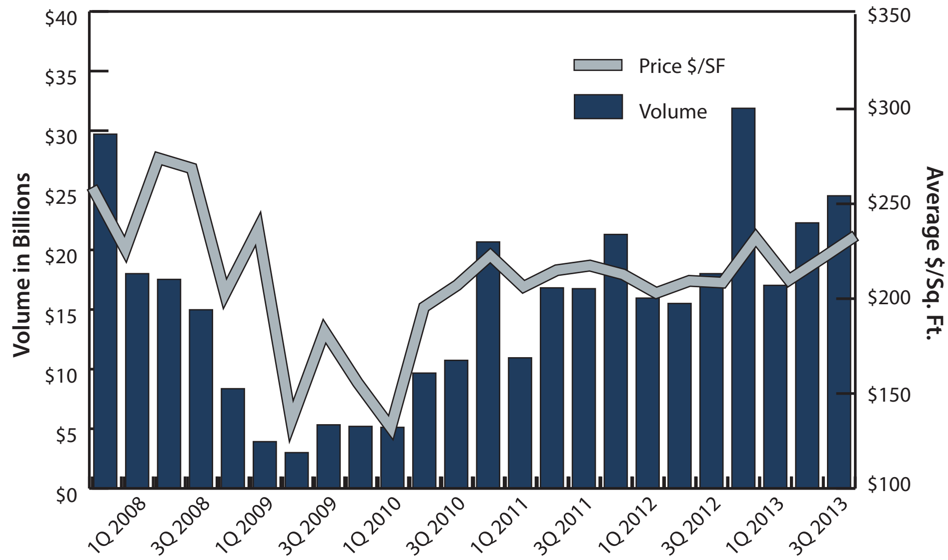


Source: Real Capital Analytics, 3q 2013.

THE OFFICE MARKET

According to the BLS, nearly 7 million net new jobs have been created since the depths of the 2008-2009 recession, offering a solid foundation for the office sector. With a rising and diversifying capital pool, sales of major office properties totaled $63.8 billion in the first three quarters of the year, according to Real Capital Analytics (see Exhibit 4-A1). Despite rising interest rates, sales rose 29 percent over the first nine months of 2013, as many investors moved away from the stability of gateway cities into the growing opportunities and higher yields of secondary markets. Suburban office space was a clear winner in 2013, as volume rose 32 percent for the subsector, compared with an increase of 26 percent for central business district (CBD) space. In particular, suburban office sales in the six major metros rose 50 percent on a year-over-year basis, accompanied by noticeable cap rate compression (see Exhibit 4-A2), which helped to lift prices.

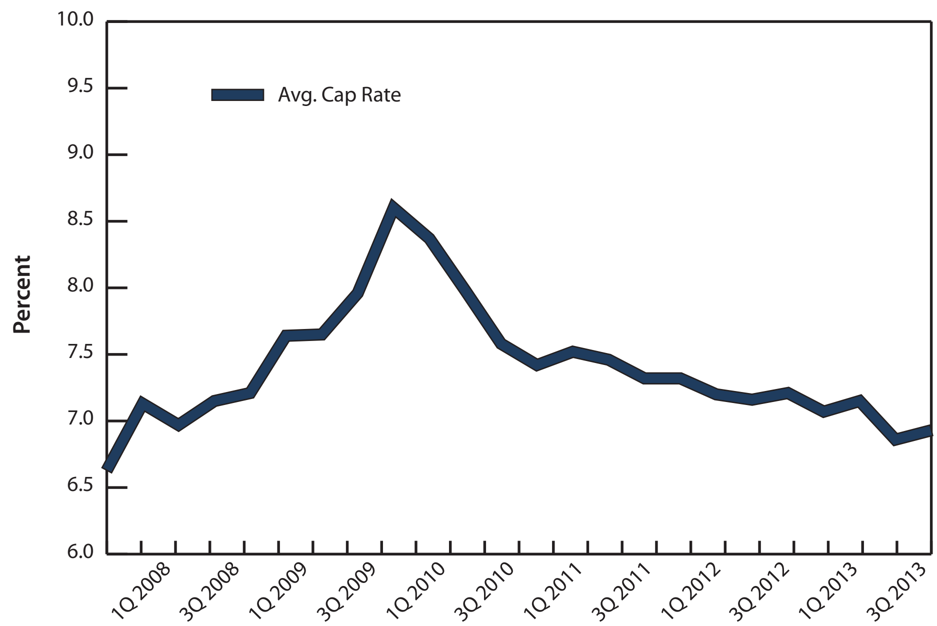
Exhibit 4-A1. Office Property Volume and Pricing



Source: Real Capital Analytics, 3q 2013.

Investors generally remained focused on purchasing quality assets offering strong returns. Average prices for office properties rose 9 percent on a yearly basis in the first three quarters of 2013, based on data from Real Capital Analytics. CBD office space posted a 5-percent yearly appreciation rate, averaging $304 per square foot. Prices for suburban office buildings rose 13 percent to an average of $173 per square foot. The pricing recovery accelerated, as both CBD and suburban office prices were within 15 percent of their 2007 peak averages. Cap rates benefitted from compression in the suburban space, declining 22 basis points in the first nine months of 2013, to an average of 6.9 percent. CBD space posted an average cap rate of 6.0 percent in the third quarter, compared to 7.3 percent for suburban properties.

Exhibit 4-A2. Average Office Property Capitalization Rates



Source: Real Capital Analytics, 3q 2013.

Investor Composition

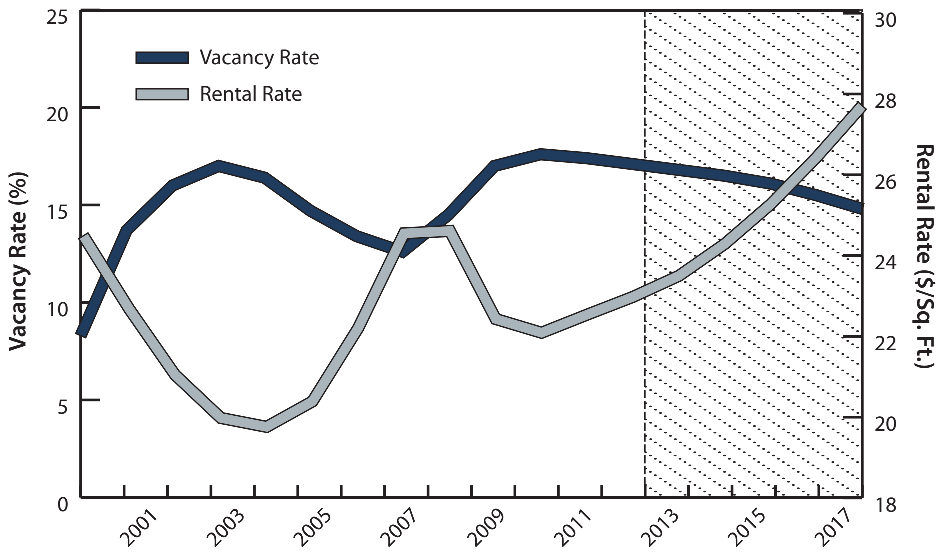
There was a broad diversification of capital sources for office properties during the first nine months of 2013. According to Real Capital Analytics, private investors and institutional/equity funds accounted for 65 percent of buyers. However, national banks returned to the fray, with JP Morgan topping the list of top buyers. In addition, cross-border investors—particularly from China, Brazil, Korea, Kuwait, Singapore, and Norway—were major players in the market, accounting for 13 percent of total acquisitions. Real estate investment trusts (REITs) and listed funds accounted for 12 percent of total deals, with $7.5 billion in acquisitions. While Manhattan retained its top spot for office investments, secondary markets proved to be the stars of 2013. At the center of the booming energy sector, Houston rose to third place in top office sales, following Los Angeles, which took the number two spot. Solid investor demand led Atlanta, Jacksonville, Greensboro, New Orleans, Minneapolis, and Austin to record triple-digit growth in sales volume in the first six months of 2013.

Market Fundamentals

Underpinning investor demand for space, office fundamentals posted a positive first half 2013, marked by rising absorption and modestly declining vacancies. According to Reis, Inc. the national vacancy rate declined from 17.0 percent in first quarter 2013 to 16.9 percent in third quarter, as shown in Exhibit 4-A3. Availability declined 30 basis points on a year-over-year basis. Net absorption of office properties totaled 18.8 million square feet over the first nine months of 2013, while new completions brought 15.6 million square feet of office space to the market, mostly during the second quarter of the year (see Exhibit 4-A4).

The average asking and effective rents rose 0.7 percent in the first quarter 2013, 0.4 percent in the second quarter, and 0.3 percent in the third quarter, respectively, with the third quarter marking 13 consecutive quarters of positive rent growth. However, the growth over the 13-quarter period amounted to only 8.1 percent for asking rents and 9.4 percent for effective rents. The markets with the strongest effective rent growth were mostly characterized as technology and energy markets, like San Jose, San Francisco, New York, Seattle, Houston, and Dallas. The Washington, D.C. office market—normally a top performer—felt the strongest impact to its fundamentals due to the effects of the “sequestration” process, which

Exhibit 4-A3. Office Property Vacancy and Asking Rental Rates



Source: Reis, Inc., 3q 2013.

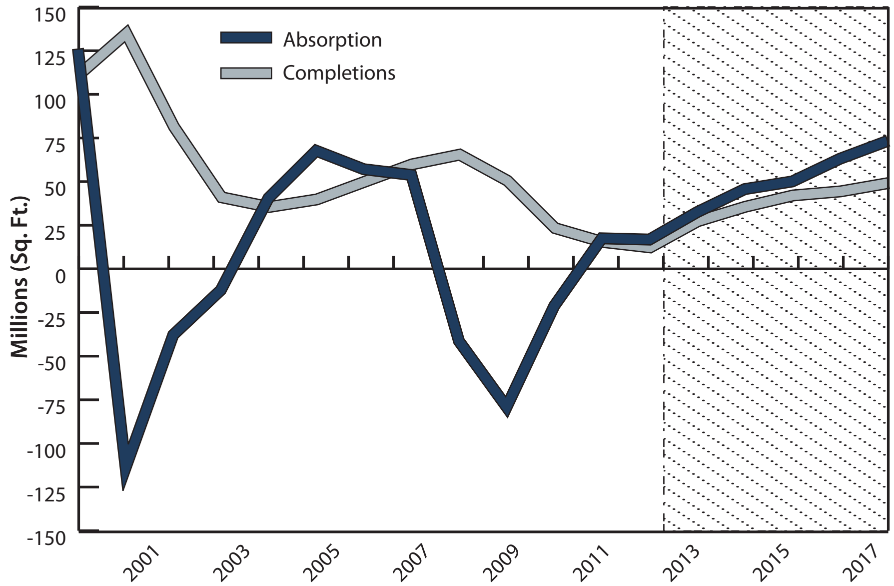
impacted federal government budgets and operations in the metro market.

Outlook

The 2014 outlook for the office market remains cautiously optimistic. Employment trends during the first half of 2013 remained steady, avoiding the midyear slowdown from prior years. While higher taxes are expected to continue to act as a drag on employment, demand for office space is expected to grow. Net absorption for 2014 is projected to reach 46 million square feet, on top of the estimated 33 million square feet in 2013 per Reis. Against a stream of new completions adding up to 27 million square feet in 2013 and 36 million in 2014, the office vacancy rate is estimated to decline to 16.5 percent by the end of 2014, according to Reis. Asking office rents will likely increase a moderate 2.1 percent in 2013 and 2.8 percent in 2014, as tenants will continue to shrink their space requirements and to leverage opportunities in newly constructed space.

On the investment front, a slowing pace of growth in the global economies is generally making U.S. office properties more attractive relative to many global properties. Office sales volume is expected to continue growing as many investors seek opportunities in secondary and tertiary markets. Rising interest rates are likely to continue compressing the spreads between cap rates and 10-year Treasurys. However, given the 423-basis-point spread for office properties at the end of third quarter 2013, investors retain a significant buffer, and rising interest rates are unlikely to impact cap rates in any significant way in 2014.

Exhibit 4-A4. Office Property Absorption vs. Completions

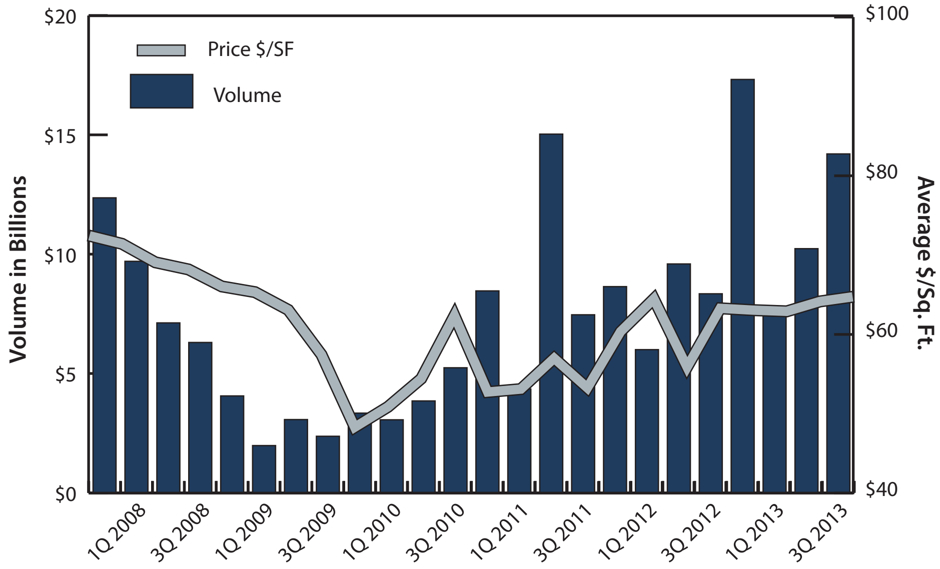


Source: Reis, Inc., 3q 2013.

THE INDUSTRIAL MARKET

Accelerating international trade was mirrored in the rising pace of economic activity in the first three quarters of 2013. Riding favorable winds, industrial properties—especially warehouses—proved attractive for many investors. Industrial sales volume rose 33 percent year-over-year from January through September 2013, totaling $31.9 billion, according to Real Capital Analytics. Warehouses drove investment activity, with volume advancing 46 percent on a yearly basis. The warehouse subsector saw two specific niches flourish—large properties (those over 150,000 square feet) and warehouses with long-term net leases. Flex space sales increased 12 percent in the first nine months of 2013 compared with the first nine months of 2012.

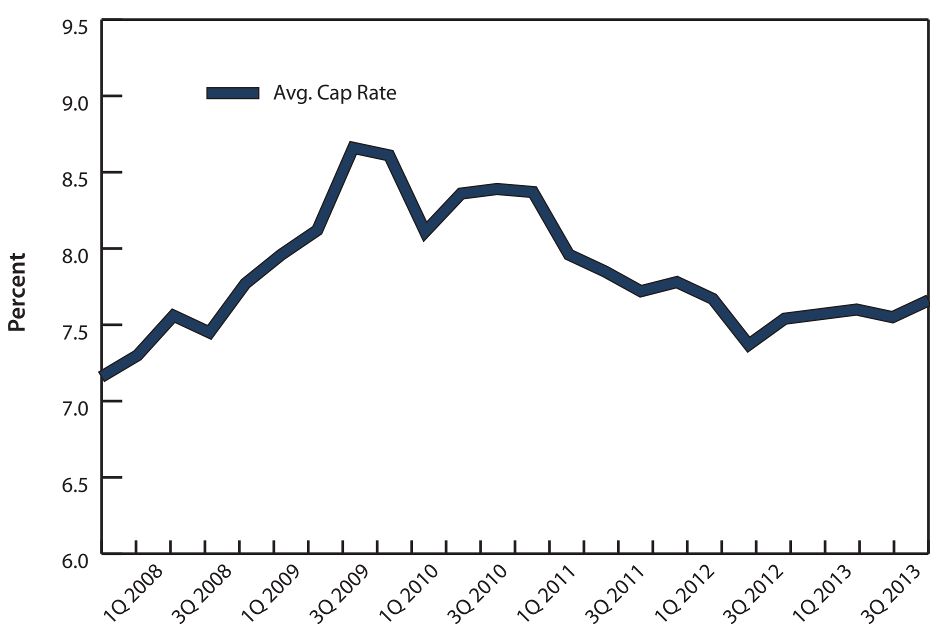
Exhibit 4-B1. Industrial Property Volume and Pricing



Source: Real Capital Analytics, 3q 2013.

Based on data from Real Capital Analytics, pricing for industrial space declined 1 percent on a yearly basis during the first three quarters of 2013, to an average of $64 per square foot, as shown in Exhibit 4-B1. The downward drift came from the warehouse side, and the shift towards activity in secondary markets. The industrial sector reflected the broader trend of investor capital seeking higher returns in regional and smaller markets. There were several industrial markets in the first half of 2013 that registered significant inflows of capital, albeit from low bases. Northern New Jersey, Philadelphia, Jacksonville, St. Louis, Cleveland, and several other metropolitan areas posted triple-digit gains in sales, with a few of them exceeding 300-percent growth on a year-over-year basis. Industrial cap rates increased 30 basis points on a yearly basis, to an average of 7.7 percent in third quarter 2013 (see Exhibit 4-B2).

Exhibit 4-B2. Average Industrial Property Cap Rates



Source: Real Capital Analytics, 3q 2013.

Investor Composition

Individual transactions dominated the first nine months of the 2013 industrial property landscape, with a 24-percent yearly increase in sales volume, according to Real Capital Analytics. Private investors accounted for 41 percent of the market, acquiring $13.2 billion of industrial assets. Non-listed REITs, along with institutional and equity funds, comprised 39 percent of the market, and made some of the largest purchases. Realty Income, BioMed Realty Trust, and Duke Realty led a list of buyers who moved $12.3 billion in industrial properties. Cross-border investments accounted for 4 percent of the sales activity during the first three quarters of 2013, suggesting increased interest in U.S. industrial properties.

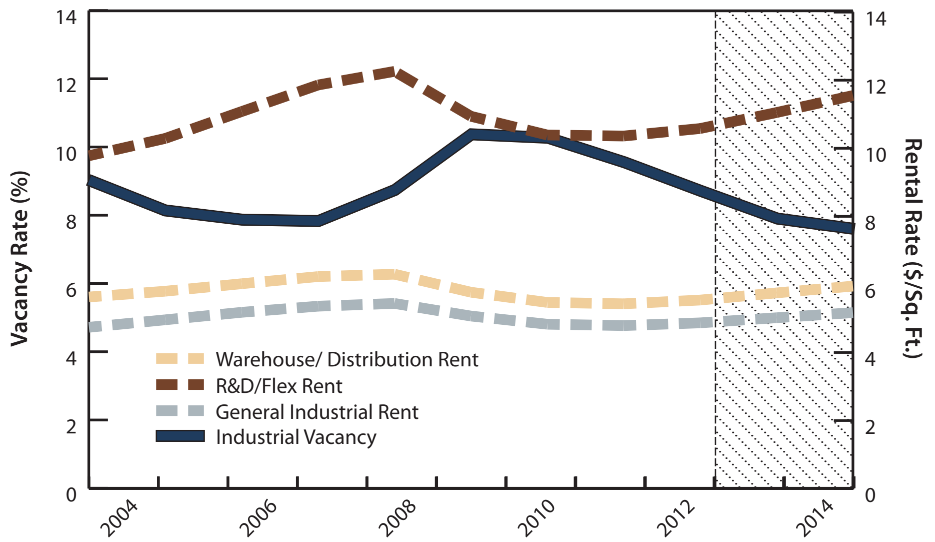
Market Fundamentals

Compared with other investment alternatives, many investors found industrial investment returns favorable, as the fundamentals underpinning those assets continued to recover. Based on data from Newmark Grubb Knight Frank, industrial vacancy rates declined from 8.7 percent in 2012 to 8.1 percent by third quarter 2013 (see Exhibit 4-B3). However, the pace of recovery slowed, likely by a moderation in global economic growth. As depicted in Exhibit 4-B4, absorption of industrial space totaled 115.7 million square feet in the first nine months of 2013. On the supply side, 51.3 million square feet of new space entered the market during the first six months of the year. The pace of construction is expected to grow in 2014, as developers offer solutions to increased demand for large warehouse facilities.

The largest portion of the net absorption of industrial space was concentrated in a cluster of port and intermodal centers. Los Angeles, Riverside/San Bernardino, Chicago, Fort Worth, Houston, Dallas, and Atlanta took the lion's share of warehouse leasing activity. On the flex side, technology hubs were at the center of the action—San Diego, Boston, San Francisco, and Seattle accounted for a high volume of net absorption.

The average asking rent rose 3.3 percent over the first three quarters of 2013, to an average $5.72 per square foot (triple net), according to Newmark Grubb Knight Frank. Flex/research and development (R&D) rents gained 4.0 percent, while warehouse rental rates rose 2.5 percent.

Exhibit 4-B3. Industrial Property Vacancy and Asking Rental Rates



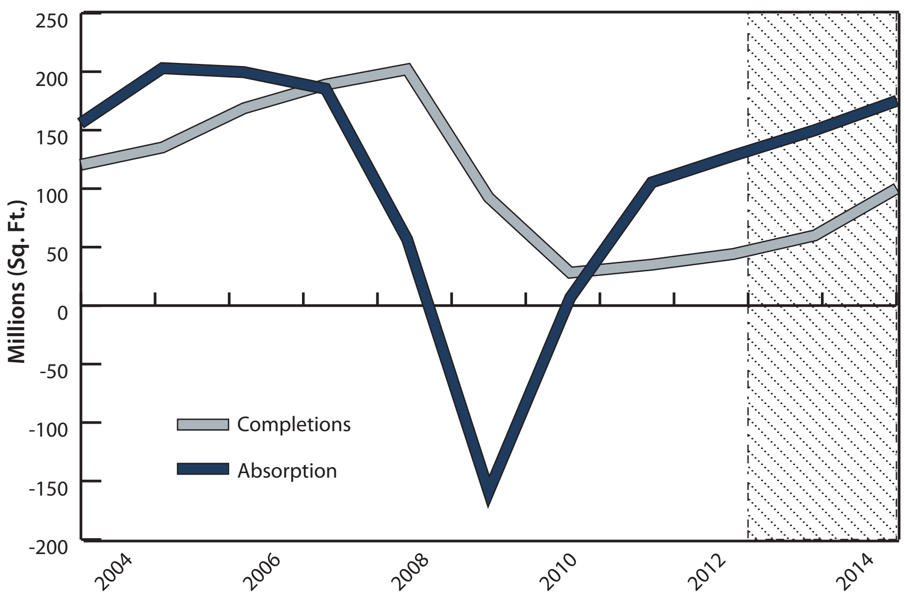
Source: Newmark Grubb Knight Frank, 3q 2013.

Outlook

With economic growth projected to continue on a moderate path, improvements in the residential housing market is likely to lead to increased consumption of home improvement materials, furnishings, and appliances. In tandem, a recovering auto sector is also boosting demand for warehouse space. For 2014, net absorption is expected to total 175 million square feet. Even with supply expected to accelerate to 100 million square feet of new space, industrial vacancies are projected to decline to 7.6 percent in 2014, according to Newmark Grubb Knight Frank. As demand is expected to remain solid, landlords will likely be in a stronger position—asking rents are expected to gain 3.5 percent by the end of 2014, with warehouse rents growing 3.0 percent and flex/R&D rents advancing 4.5 percent.

Industrial investments are likely to continue at a steady pace of growth, as expectations of cost efficiencies from the completion of the Panama Canal are likely to drive opportunity plays.

Exhibit 4-B4. Industrial Property Absorption vs. Completions



Source: Newmark Grubb Knight Frank, 3q 2013.

As with other property types, rising interest rates could impact prices for industrial space through cap rate compression. The mitigating factor for industrial deals is that spreads between cap rates and 10-year Treasurys are second highest among the property types (after hotels). At the end of third quarter 2013, spreads averaged 495 basis points, providing many investors with enough elbow room as they head into 2014. Higher interest rates are not expected to lift cap rates in the short term.

THE RETAIL MARKET

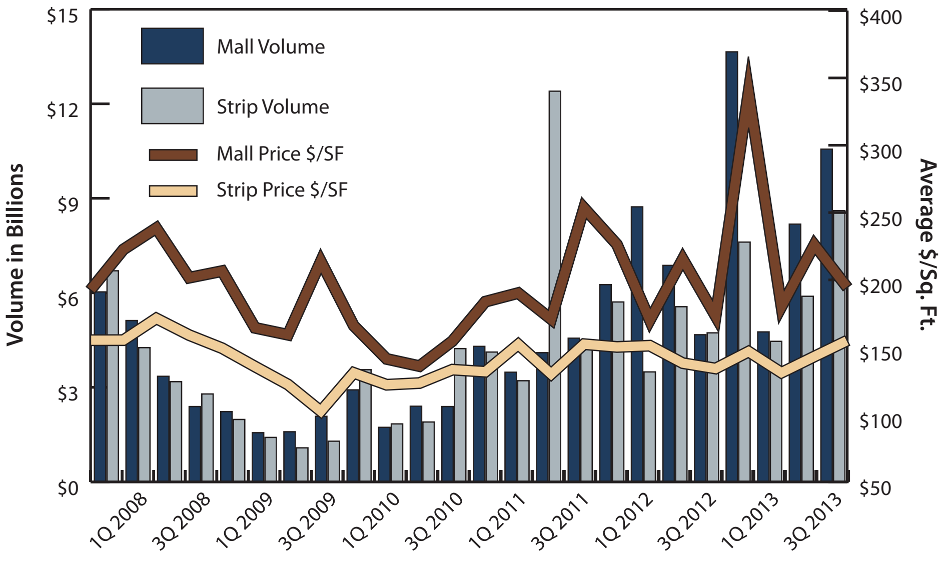
According to the International Council of Shopping Centers (ICSC) – Goldman Sachs U.S. Retail Chain Store Sales Index, there was a 2.1-percent increase in year-over-year same-store sales for the month of November 2013, which was less than earlier projections of increases of 3.5 percent to 4.5 percent. However, the ICSC is still expecting growth of 3 percent to 4 percent for the month of December. The Thompson Reuters/University of Michigan Survey of Consumer Confidence Sentiment reported an unexpected decline to in the overall consumer sentiment index of 72.0 for November 2013, which is the lowest since December 2011.

However, a strong holiday season is expected to be the shot in the arm that retailers are hoping for, despite six fewer shopping days between Thanksgiving and Christmas compared to last year. Holiday sales are expected to climb to between $963 and $967 billion for the months of November through January 2014, according to Deloitte's 2013 Annual Holiday Survey, and represent a 4-percent to 4.5-percent increase over last season. Despite the lower consumer confidence scores, healthier occupancy cost ratios leading to improved retail real estate fundamentals should result.

Year-to-date sales of significant retail properties totaled $42.5 billion through September 2013, which is almost a 25-percent increase for the same nine-month period in 2012. The current data presented by Real Capital Analytics shows that the volume is comprised of 55 percent mall sales and 45 percent strip center sales compared to 60 percent mall sales and 40 percent strip center sales in the prior year. The slight shift in strip center transaction percentages correlates to the higher number of total property transactions, which is up 30 percent from the previous year, as shown in Exhibit 4-C1. This may indicate that many investors are willing to invest in retail properties other than trophy malls, which was the trend in recent years. For all retail properties transactions, the average price per square foot year-to-date was $167 compared to $159 in the prior year.

Capitalization rates reported by Real Capital Analytics have remained rather constant over the year. September 2013 ended with a reported capitalization rate of 7.1 percent for all retail properties compared to 7.2 percent in September 2012. The September 2013 rate was comprised of cap rates of 6.6

Exhibit 4-C1. Retail Property Volume and Pricing



Source: Real Capital Analytics, 3q 2013.

percent for malls and 7.5 percent for strip centers (compared to 6.8 percent for malls and 7.6 percent for strip centers in September 2012, as shown in Exhibit 4-C2).

Investor Composition

The retail property market continued to be dominated by private investors who comprised 42 percent of the buyer pool year-to-date through November 2013, and is equal to the 42 percent of the 2012 buyer pool. Real Capital Analytics indicates that private investors are heavily active in the unanchored neighborhood center, making up 81 percent of the active buyers in that subtype, including buyers who are trading smaller properties. Real Capital Analytics noted that there were over 1,500 transactions in third quarter 2013, which was the largest total since fourth quarter 2012 and the second largest total since first quarter 2008. Listed REITs composed the second largest buyer pool, at 31 percent.

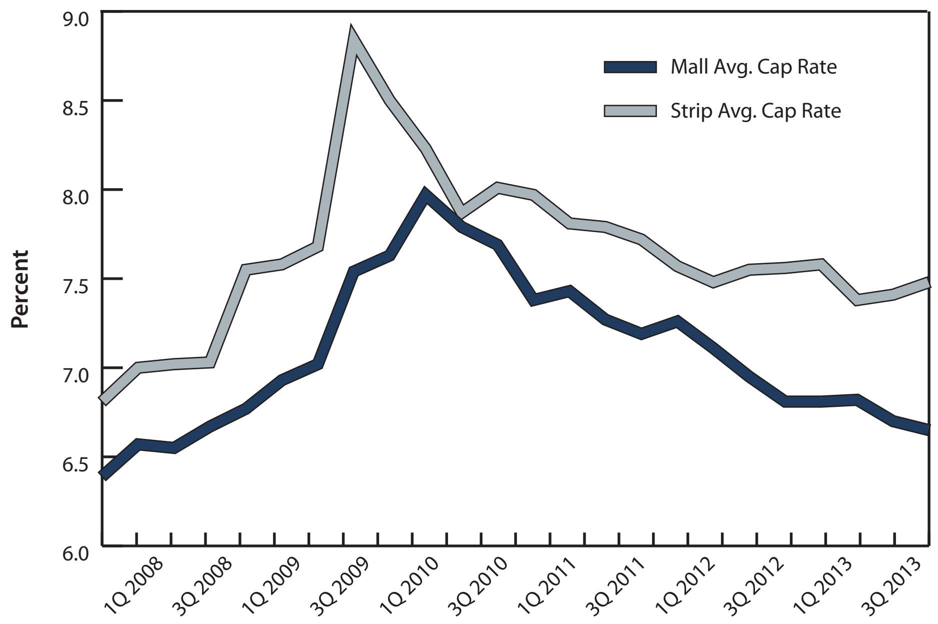
Retail Property Fundamentals

According to Reis, the combined vacancy rate for community centers and neighborhood centers decreased to 10.5 percent in third quarter 2013 (see Exhibit 4-C3) from 10.8 percent the third quarter 2012. The vacancy rate for community centers fared slightly better at 9.6 percent vacancy for the current quarter compared to the vacancy rate for neighborhood centers at 11.5 percent. However, occupancy in all subtypes has shown improvement over the past four quarters. Information provided by Reis and Newmark Grubb Knight Frank indicates that demand will likely continue to outpace supply over the next four years, with positive absorption through 2017.

The positive absorption, as reflected in Exhibit 4-C4, may be a result of just fewer store closings than store openings. It appears that many of the troubled retailers who planned closures have now completed those store reductions, while some of the budget and thrift stores are planning expansions.

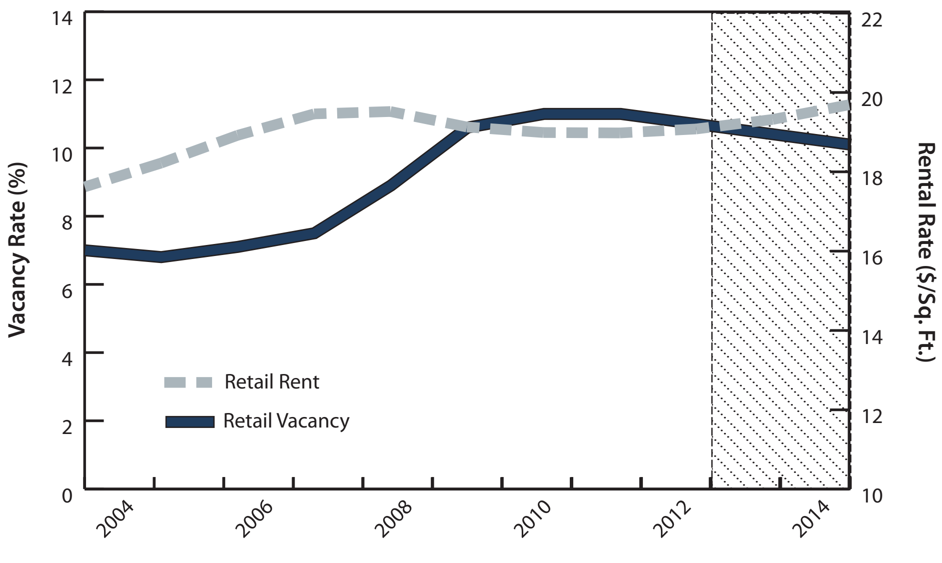
Another factor affecting demand resurgence is online shopping. According to the U.S. Census Bureau, online sales accounted for 5.9 percent of total retail sales in third quarter 2013 on a seasonally-adjusted basis, and was a 17.5-percent increase over the same period in 2012. Many retailers continue to strategically adapt their physical space, which may

Exhibit 4-C2. Average Retail Property Cap Rates



Source: Real Capital Analytics, 3q 2013.

Exhibit 4-C3. Retail Property Vacancy and Asking Rental Rates

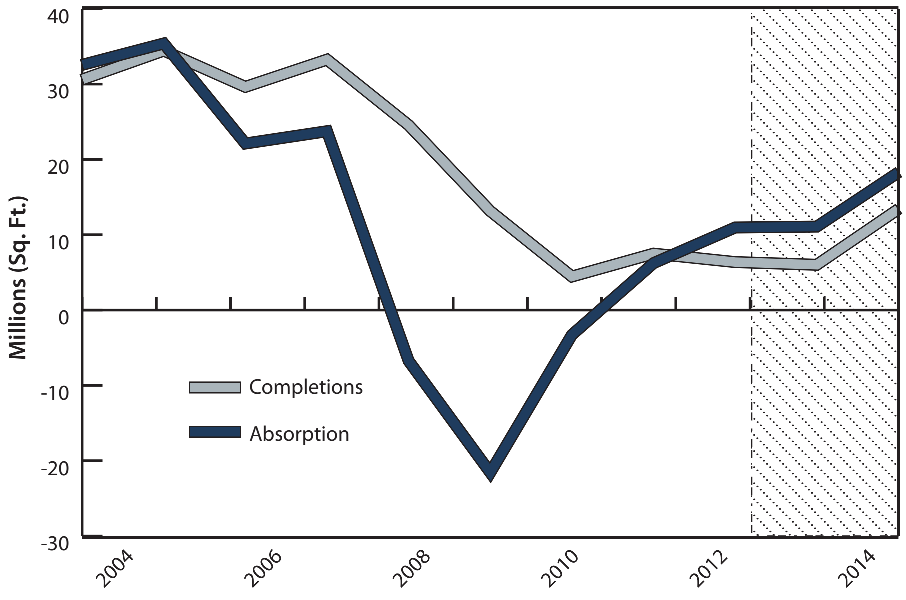


Sources: Reis, Inc., Newmark Grubb Knight Frank, 3q 2013.

not always include downsizing, but repurposing the space to provide an improved customer experience.

According to Reis, rent for community centers and neighborhood centers increased to $19.25 per square foot in third quarter 2013, a 0.3-percent growth over the prior quarter. The expectation is that rental growth will be about 1.3 percent annually, with rental growth expected to increase to 2.0 percent to 2.5 percent over the next two years.

Exhibit 4-C4. Retail Property Absorption vs. Completions



Source: Newmark Grubb Knight Frank, 3q 2013.

Outlook

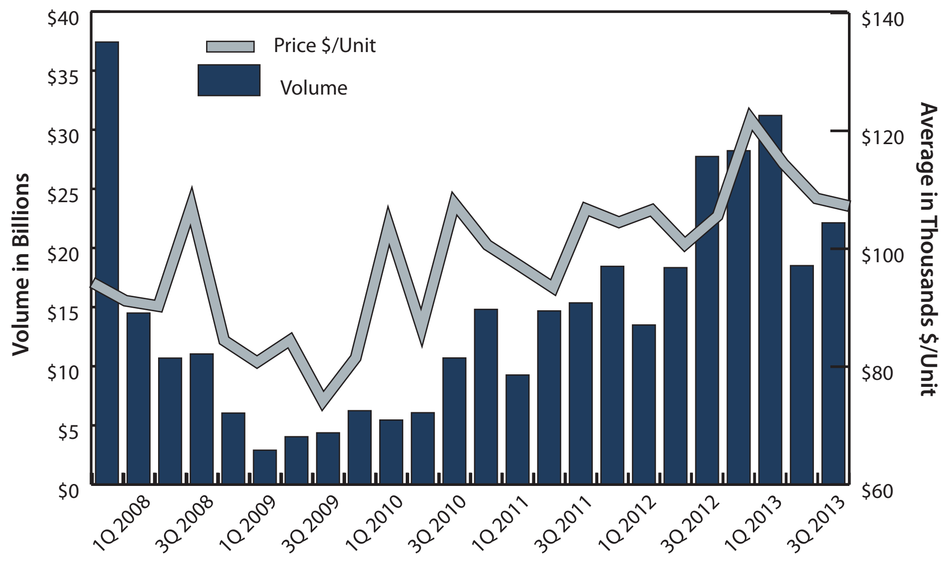
Retail property transaction activity has been generally moving in a positive direction over the course of the past year. Volume is up, at higher prices per square foot and with lower capitalization rates. More investors are getting involved, and transactions are occurring in the secondary and tertiary markets involving assets other than Class A. As liquidity continues, these trends should continue into 2014 barring any near-term increase in interest rates. Also, with some of the larger portfolio deals taking place recently, it is expected that there will be a wider supply of properties available for sale as many investors jockey to balance their portfolios and manage risk.

Property fundamentals were lackluster in 2013, with vacancy and market rent improving modestly at best. The Reis forecast calls for absorption to outpace supply over the next couple years, which should help continue to slowly drive down vacancy rates. The market is a new environment with many retailers having downsized and redesigning their space to focus on the future and grown in the stronger markets as they meet customers' expectations. Rents too should continue to improve, as customer spending is expected to increase. According to Reis, with the exception of any significant events, market rent is expected to increase 2 percent to 3 percent over the next two years.

THE APARTMENT MARKET

The apartment sector, largely considered the strongest performer of the major commercial real estate property types for the past several years, continued to show its dominance in the first half of 2013. A total of $48.1 billion of significant apartment properties were sold in the first half of 2013, representing a year-over-year increase of 51 percent and marking a record level of volume for the first half of a calendar year, according to Real Capital Analytics. An additional $22.1 billion of significant apartment properties were sold in third quarter 2013. Following increases of 104 percent in 2012 and 23 percent in 2011, the growth in volume this year appears to be moderating somewhat. It is noted that portfolio transactions, including the sale of nearly $15 billion of Archstone apartment properties, represented $24.8 billion (or nearly half of the total) throughout the first half of 2013. Excluding the Archstone deal, the growth in volume is more moderate relative to the prior year. Among apartment types, garden-style apartment properties observed the highest growth, accounting for nearly two-thirds of the total sales volume in the first three quarters of 2013.

Exhibit 4-D1. Apartment Property Volume and Pricing

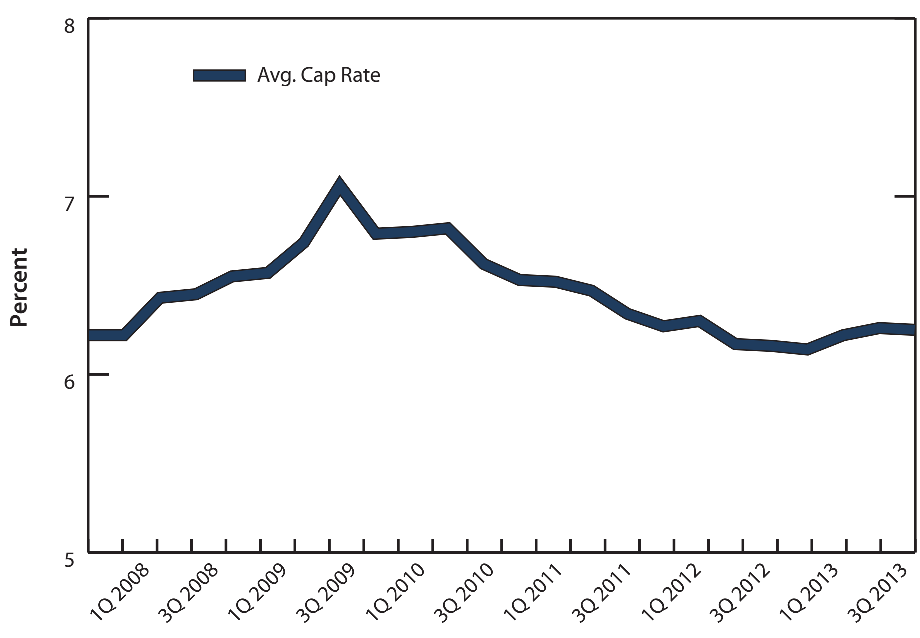


Source: Real Capital Analytics, 3q 2013.

Apartment properties had the second highest transaction dollar volume of all major property types (trailing office slightly) in the first half of the year, and it is clear that many investors continue to favor this category of commercial real estate.

Based on the Moody's/RCA CPPI, pricing for apartment properties nationally has increased approximately 15 percent year-over-year through second quarter 2013 and is only 1 percent off of peak levels. In the first three quarters of 2013, the average price per apartment unit decreased slightly below the average 2012 level, per Real Capital Analytics. However, this reflects the impact of high portfolio transaction volume, as well as increasing transaction activity in secondary and tertiary markets with lower price points (on a per unit basis). As presented in Exhibit 4-D2, capitalization rates for the apartment sector have essentially held steady, increasing slightly to an average of 6.24 percent during the first three quarters of 2013. This represents a 4-basis-point increase from the average cap rate in 2012. Even though the average is up slightly, it is noted that capitalization rates for top tier assets continue to compress primarily due to intense competition for core properties.

Exhibit 4-D2. Average Apartment Property Cap Rates



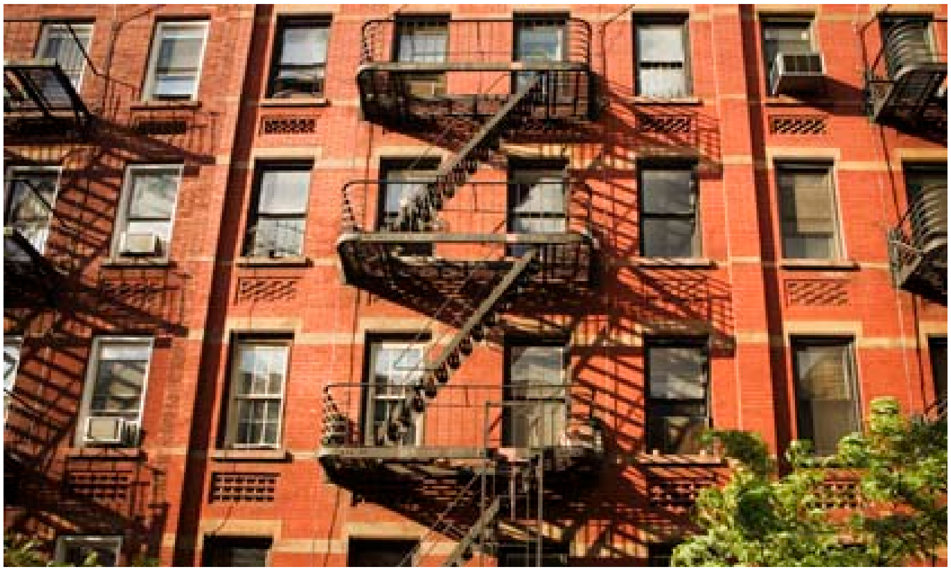
Source: Real Capital Analytics, 3q 2013.

The average cap rate for garden apartments (6.4 percent) continues to be well above that of mid/high-rise apartments (5.5 percent), according to Real Capital Analytics. However, it is noted that the cap rate spread between these subtypes is beginning to widen, as cap rates for garden apartments are trending upwards and cap rates for mid/high-rise apartments continue to trend downwards.

Based on Real Capital Analytics data, the apartment sector is currently the only property sector where the national average cap rate is back to levels exhibited prior to the start of the economic downturn in 2008. Several factors that have contributed to lower cap rates include sustained and historically low interest rates, increased availability of capital, strong sector fundamentals, and the perceived safety of apartment assets relative to other property types. Additionally, GSEs Fannie Mae and Freddie Mac often provide apartments with a financing advantage relative to other property types. Investors are likely to see further upward pressure on the average cap rate in the apartment sector in 2014, given the potential impact of rising interest rates and a greater proportion of transactions occurring in secondary and certain tertiary markets.

Investor Composition

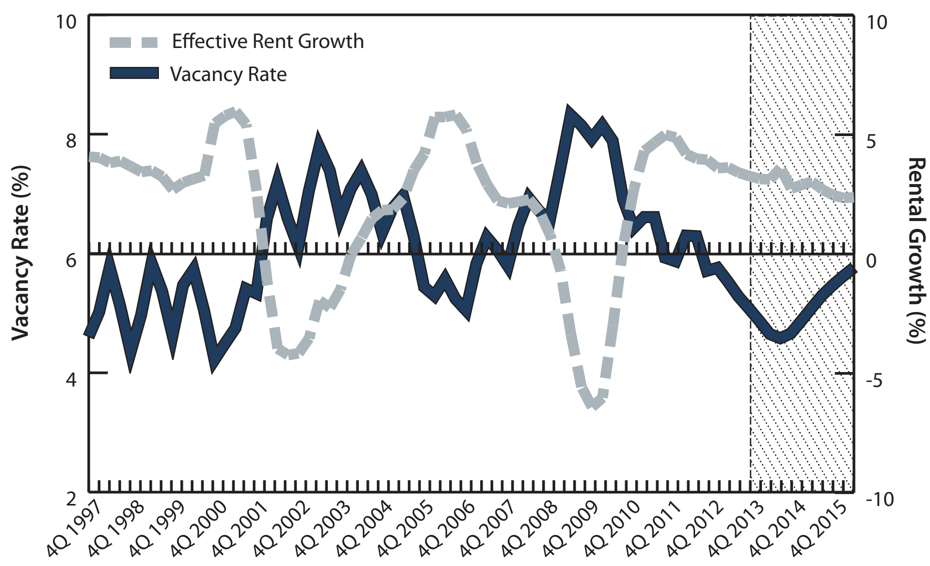
Throughout first half 2013, competition for multi-family product by REITs, private equity, and institutions has continued. Equity Residential and Avalon Bay Communities, who each purchased a large portfolio of Archstone properties, were the top two most active buyers (in terms of investment volume) by a large margin, according to Real Capital Analytics. They were also the only two REITs in the top 25 most active buyers, which was otherwise comprised of private equity and institutions. Other notable active buyers were Greystar Real Estate Partners and Goldman Sachs. Lehman Brothers, Equity Residential, and Avalon Bay Communities were the top sellers during the period.



An appetite for core assets in major markets such as New York City, Washington, D.C., Los Angeles, Boston, Chicago, and San Francisco has remained fairly steady. However, continuing upon a trend which developed in 2012, many investors are broadening their focus to secondary and certain tertiary markets, as well as exploring lower-tier properties in search of greater returns. As a result, markets such as Orlando, Northern New Jersey, East Bay, Inland Empire, Jacksonville, Kansas City, Rochester, San Antonio, and Minneapolis have experienced elevated transaction volumes throughout the first half of 2013.

A diminishing supply of apartments, strong sector fundamentals, and intense competition for properties has led to a growing pipeline of new apartment projects as developers look to capitalize on the tight market conditions. According to Property and Portfolio Research (PPR), approximately 160,000 apartment units are expected to be delivered in the top 54 major metropolitan markets in 2013, followed by over 350,000 more units in 2014 and 2015. These figures are significant compared to the new supply of approximately 38,000 units and 78,000 units experienced in 2011 and 2012, respectively. The total apartment stock as of third quarter 2013 was approximately 13.1 million units.

Exhibit 4-D3. Apartment Market Vacancy and Effective Rental Rate Growth



Source: Axiometrics, Inc., 3q2013.

Apartment Property Fundamentals

U.S. apartment market fundamentals continue to perform well in 2013, although they have moderated. Nationally, annual effective rent growth peaked in second quarter 2011 at 5 percent, but rent has decreased every quarter since and is averaging 3.28 percent through the first three quarters of 2013, according to Axiometrics, Inc. Even with the decreasing rate of rental growth, vacancies have continued to decline, moving from a peak of 8.3 percent in first quarter 2009 to 4.9 percent in third quarter 2013. Since the apartment recovery began in second quarter 2010, annual effective rent growth has been positive for 14 consecutive quarters, averaging approximately 3.7 percent per year. Over this same time period, the vacancy rate has fallen from 6.9 percent in second quarter 2010 to 4.9 percent in third quarter 2013 (see Exhibit 4-D3).

According to Axiometrics, Inc., annual effective rent growth is expected to be approximately 3.1 percent by the end of 2013, inch up to 3.6 percent in first quarter 2014, and decline to approximately 2.4 percent by the end of 2015. The vacancy rate is expected to continue to decline to a low of 4.6 percent in 2014, subsequently increasing to approximately 5.8 percent by the end of 2015 due to an anticipated increase in supply brought about by new construction.

A large number of markets may outperform the U.S. average in terms of cumulative potential rental revenue growth from 2013 to 2015. (Potential rental revenue growth is the combined change in effective rental rates and occupancy.) Nearly all of the Top 20 markets in Exhibit 4-D4 are expected to outperform the U.S. average over the specified period, with San Francisco, Atlanta, Las Vegas, and Seattle leading in performance. The lower performing markets are expected to be Washington, D.C., New York, and Charlotte.

Outlook

The overall outlook for the apartment sector appears to be positive, given the strong fundamentals, demand, and the relative availability of financing for apartment investments. The positive fundamentals have no doubt been a direct result of the decreasing homeownership rate, which has fallen and remained close to the lowest level in nearly 20 years (from its peak of over 69 percent in 2004 to approximately 65 percent in third quarter 2013 per the U.S. Census Bureau), as well as the lag in new supply coming on line. However, this downward trend in homeownership may begin to reverse, with housing affordability still at historic lows in many markets and apartment rents on the rise.

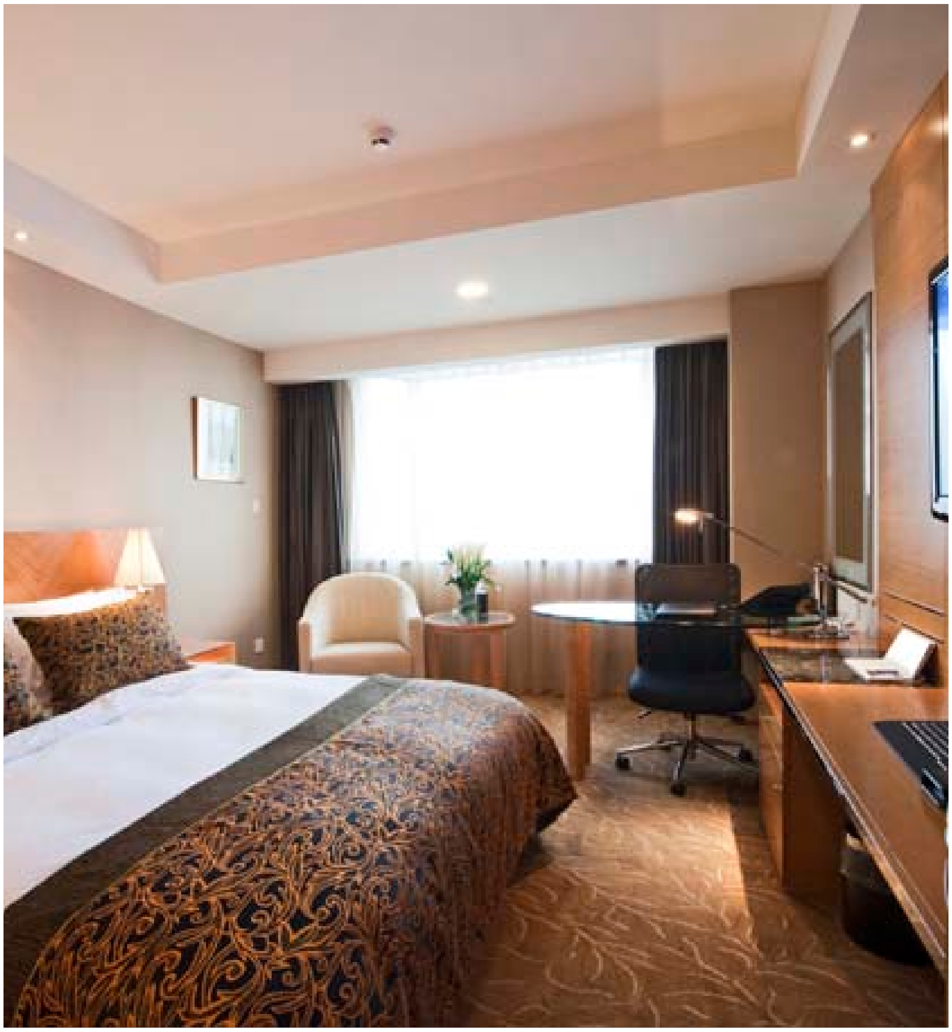
The growing pipeline of apartment development projects, the increase in unit completions this year and over the next couple of years, and the potential for further increases in interest rates are some trends which may pose headwinds to the apartment sector. However, continued job growth and pent-up demand from the younger demographic group that never moved out or returned to their parents' homes after their college years is expected to keep fundamentals relatively strong, even considering the new supply. It appears that many investors will continue to favor the apartment sector in the foreseeable future, as evidenced by the transaction volume and supply trends. Based on the aforementioned factors, apartments are well-poised to possibly experience another year of solid growth in 2014, albeit at a slightly more moderate pace.

Exhibit 4-D4. Forecasts of Effective Rental Rate Growth, Vacancy, and Potential Rental Revenue for the Top 20 Apartment Markets (2013-2015)

	Effective Rent Growth						Vacancy						Potential Rental Revenue					
Market	2011A	2012A	3Q13A	2013AF	2014F	2015F	2011A	2012A	3Q13A	2013AF	2014F	2015F	2011A	2012A	3Q13A	2013AF	2014F	2015F
Atlanta	3.5%	3.4%	4.4%	4.5%	4.2%	3.1%	9.0%	8.1%	7.2%	6.9%	5.4%	5.7%	3.7%	4.8%	5.5%	5.7%	5.7%	2.1%
Austin	7.4%	5.0%	4.6%	4.8%	3.7%	2.5%	5.0%	4.9%	4.7%	4.7%	5.4%	6.2%	7.6%	5.4%	4.7%	4.9%	2.6%	1.6%
Boston	7.2%	2.9%	3.8%	4.3%	3.7%	2.2%	3.7%	4.2%	4.2%	4.2%	4.4%	4.9%	7.1%	2.4%	3.7%	4.6%	3.3%	1.7%
Charlotte	6.8%	6.0%	2.7%	3.6%	3.3%	2.2%	6.2%	5.1%	5.0%	4.9%	5.2%	6.0%	8.6%	6.8%	2.6%	3.8%	2.8%	1.2%
Chicago	5.0%	3.6%	2.7%	3.1%	2.9%	2.6%	5.0%	5.1%	5.0%	4.8%	5.0%	5.8%	5.0%	3.4%	2.9%	3.7%	2.5%	1.8%
Dallas	6.4%	4.1%	3.8%	3.9%	3.4%	2.6%	6.4%	5.7%	5.3%	5.2%	5.7%	6.3%	7.9%	4.5%	4.4%	4.4%	2.5%	2.2%
Denver	6.2%	6.5%	7.0%	6.6%	3.7%	2.3%	5.0%	5.0%	4.6%	4.5%	4.9%	5.8%	6.3%	6.9%	7.6%	7.0%	3.1%	1.1%
Houston	4.5%	6.8%	5.4%	4.9%	3.6%	2.7%	9.1%	7.2%	6.1%	5.9%	6.2%	6.7%	6.2%	8.5%	6.5%	5.9%	3.1%	2.2%
Las Vegas	-1.6%	-0.2%	2.1%	1.7%	3.4%	4.0%	8.0%	8.3%	8.3%	8.0%	6.3%	5.3%	-0.8%	-0.8%	2.5%	2.8%	5.1%	4.8%
Los Angeles	3.9%	3.1%	3.9%	3.3%	4.0%	3.1%	5.1%	4.6%	4.6%	4.7%	4.5%	4.9%	5.1%	3.3%	3.9%	2.8%	4.4%	2.7%
New York Metro	4.2%	3.4%	1.5%	1.4%	3.4%	3.0%	3.3%	3.3%	3.2%	3.0%	3.1%	3.2%	4.9%	3.2%	1.5%	2.2%	2.7%	2.8%
Orlando	4.2%	3.4%	3.0%	3.9%	3.3%	2.2%	6.9%	6.0%	5.5%	5.3%	5.5%	5.9%	5.3%	4.4%	3.5%	4.6%	2.4%	2.1%
Phoenix	3.0%	2.4%	3.0%	3.0%	4.2%	3.0%	7.5%	7.2%	6.8%	6.5%	5.4%	6.2%	3.5%	3.0%	3.3%	4.0%	4.7%	2.1%
Riverside	2.8%	1.1%	2.5%	2.1%	3.7%	3.1%	5.8%	5.7%	5.5%	5.4%	4.2%	5.1%	2.7%	1.7%	2.7%	2.4%	4.6%	1.7%
San Diego	2.4%	3.5%	3.5%	3.8%	3.1%	2.1%	4.5%	4.7%	4.2%	4.1%	4.5%	5.0%	2.6%	3.6%	3.8%	4.3%	2.6%	1.5%
San Francisco	14.0%	7.4%	7.1%	6.9%	4.8%	2.9%	3.5%	4.2%	4.5%	4.3%	4.4%	4.9%	14.4%	6.1%	7.3%	7.6%	4.5%	2.4%
Santa Ana	5.4%	4.1%	3.9%	3.1%	3.7%	2.7%	4.7%	4.8%	4.7%	4.6%	4.2%	5.1%	5.6%	4.3%	4.1%	3.4%	3.8%	1.6%
Seattle	6.0%	6.2%	6.9%	7.0%	4.0%	2.8%	4.9%	4.8%	4.4%	4.3%	4.9%	5.7%	5.8%	6.9%	7.4%	7.6%	3.0%	2.0%
Tampa	3.2%	3.8%	2.8%	2.4%	3.2%	2.4%	7.2%	6.5%	6.0%	5.8%	5.7%	6.2%	3.1%	5.1%	3.3%	3.4%	2.5%	2.2%
Washington, DC Metro	3.5%	1.8%	-0.7%	-0.3%	-1.9%	3.3%	4.6%	4.8%	5.0%	5.1%	5.7%	5.1%	2.6%	2.1%	-1.2%	-0.5%	-2.7%	4.3%
U.S.	**4.2%**	**3.6%**	**3.2%**	**3.1%**	**3.0%**	**2.4%**	**6.2%**	**5.8%**	**5.5%**	**5.3%**	**5.5%**	**6.0%**	**4.5%**	**4.3%**	**3.4%**	**3.7%**	**2.6%**	**1.7%**

Source: Axiometrics, Inc., 3q 2013.

THE HOTEL MARKET



U.S. hotel rooms sold have climbed to an all-time high and three key performance metrics continue to rally through September 2013. According to STR Global (STR), U.S. hotel industry occupancy rose 0.3 percent to 63.4 percent; its average daily rate (ADR) was up 3.3 percent to $111.03, and revenue per available room (RevPAR) increased 3.6 percent to $70.36. Even with these positive performance results, the price per hotel unit (PPU) began waning. According to many market participants, we may be approaching the peak of the cycle in terms of PPU. Further complicating future projections, the value-minded transient traveler has held ADR increases down below expectations as many hoteliers crave and look for the return of group business to offset and drive revenue. However, optimism still exists in this sector as the underwater mortgages have faded, consumer confidence is on the rise, consumer debt is down, and financing has returned to full strength. Many in the hotel sector are forecasting a stronger future, with consistent RevPAR increases near 6[5] percent to 7.2[6] percent, and with ADR outpacing inflation.

Geographically, the markets are diverse. Mature urban markets are generally stagnant with the exception of the coastal markets (Boston, New York, and San Francisco) and Chicago; however, secondary urban markets that have trailed the recovery are beginning to experience momentous improvement in demand and ADR. According to STR, U.S. hotel industry occupancy was up 1.4 percent to 64 percent in the year 2013 through October; meanwhile, ADR rose 4.0 percent to $110.71, and RevPAR increased 5.4 percent to $70.80. Supply additions were up 0.7 percent over the same period compared to 2012, however supply continues to lag hotel demand's 2.1-percent growth during the same period[7]. During the first week of December 2013, the Chicago hotel market reported the largest RevPAR increase at 58.4 percent. These strong gains can be attributed to a citywide medical convention, but nonetheless a significant boost to potential results for the calendar year-end, according to STR. Among the top 25 markets, occupancy in San Francisco/San Mateo fell 14.3 percent to 74.7 percent, reporting the largest decrease in that metric. Aside from Chicago, Phoenix posted the next highest RevPAR growth at 19.4 percent, followed by New Orleans at 17.7 percent, Boston at 13.0 percent, Denver at 11.4 percent, and Houston at 10.5 percent. Philadelphia reported the largest decrease in RevPAR, as it fell by 17.4 percent during the first week in December 2013[8].

Among the chain-scale segments, midscale hotels (+3.4 percent to 47.5 percent) and economy hotels (+3.4 percent to 47.4 percent) reported the largest occupancy increases, according to STR. The luxury segment (+7.4 percent to $307.86) posted the largest ADR growth for the week, followed by and the upper-upscale (+2.6 percent to

[5] ***STR releases updated 2013, 2013 forecasts, STR Global, September 2013.***

[6] ***Hotel Horizons, Volume VII- Issue III.***

[7] ***Hotel Investment Barometer, Dashboard, YTD October 2013.***

[8] ***STR US Weekly Results, December 1-7, 2013.***

$160.37) and upscale (+2.6 percent to $120.82) segments. The economy segment rose 5.7 percent in RevPAR to $24.69, achieving the largest increase in that metric. The midscale segment followed with a 5.1-percent increase in RevPAR to $33.96. The upper-upscale segment reported decreases in two of the three key performance metrics during the week, with occupancy down 2.9 percent to 68.5 percent and RevPAR down 0.3 percent to $109.79[9].

Investor Composition

According to Real Capital Analytics, over the past 12 months, the number of entities that have made significant hotel acquisitions has doubled since 2010; however this total represents approximately half the number of hotel buyers that were active in 2007. Although all capital sectors report fewer active participants through 2010, the private investor segment contracted significantly. Most recently, the re-emergence of the CMBS market has promoted renewed investment from private operators where the largest growth of all capital sectors was recorded. Private investors have increased their share of hotel acquisitions to 41 percent this year, up from 33 percent in 2012.

The latest results reflect a shift from institutional and private equity funds, which peaked about a year ago to more acquisition by public and private sectors. Improved financing conditions are fostering a rebound in acquisitions, and in fact, Real Capital Analytics reports that the public and private sectors are the only capital groups that have increased market share in 2013. The market share of hotel acquisitions by cross border buyers was unchanged and the equity fund and institutional sectors decreased over the previous 12 months, as of August 2013. Acquisitions of distressed hotels appear to be the focus of private buyers, accounting for 35 percent of the group's acquisitions thus far in 2013.

Market Fundamentals

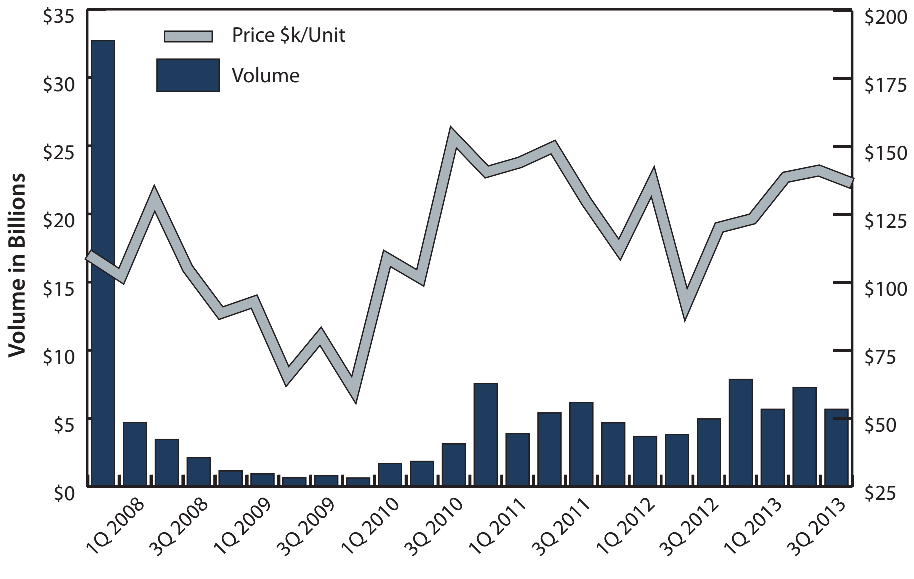
This year's transaction volume is displaying a strengthening growth trend. According to Real Capital Analytics, year-to-date through August 2013 sales of significant hotels totaled $16.3 billion, as shown in Exhibit 4-E1, an increase of approximately 50 percent over same period 2012 results. Significant growth is still needed, as year-to-date 2013 volume total is only 37 percent of the previous volume high recorded in 2007. Seventy-one percent of the activity was concentrated in the full-service sector, where a volume of $11.5 billion was among the highest this year, a 34-percent increase over previous year-to-date results.

According to Real Capital Analytics, cap rates on hotel acquisitions were stable throughout the year, averaging approximately 8.1 percent or approximately 30 basis points above year-to-date 2012 results (see Exhibit 4-E2). Pricing, as measured by the Moody's/

RCA CPPI for hotels, was up a robust 12.5 percent since the beginning of the year. Sub-indices reveal that the price appreciation has been almost exclusively for full-service hotels.

Various studies have suggested that pricing is nearing the peak of the cycle primarily in the major metropolitan markets. Many investors continue to bet on New York based on the high profile transactions in 2013, such as the Plaza Hotel and Langham Place, that range from approximately $1.0 million to $2.5 million per unit. Other notable acquisitions include the Peabody

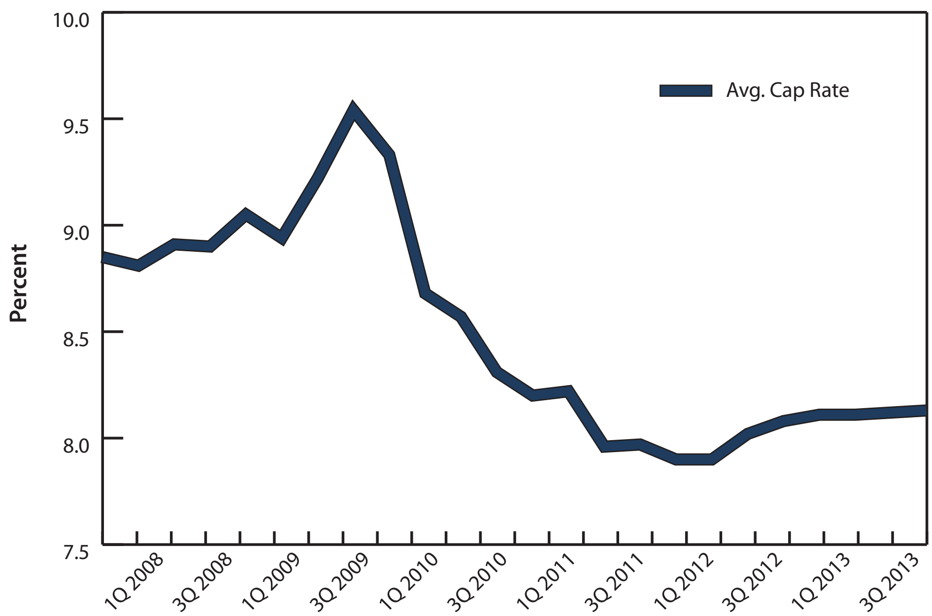
Exhibit 4-E1. Hotel Property Volume and Pricing



Source: Real Capital Analytics, 3q 2013.

[9] *Ibid.*

Exhibit 4-E2. Average Hotel Property Required Cap Rates



Source: Real Capital Analytics, 3q 2013.

in Orlando, Pier House in Key West, the Hyatt Regency Waikiki, and the Ritz Carlton San Francisco, and the Southernmost hotel collection, indicating coastal markets appear to be in demand. However, investors looking for yield may need to shift to value-added markets to support acceptable multiples going forward. On average, hotel prices still remain the farthest from peak levels of the property types, and one factor may be that the universe of active buyers is currently far below peak levels.

Despite pricing concerns, anemic group business, and continued global economic issues, the U.S. lodging investment industry continues to outperform the broader market primarily due to major market transaction activity and improvement in capital markets for this property sector. Short-term considerations regarding managing the transaction pipeline fluctuations appear to take priority, but going forward, buyer demand, ADR assumptions, and new supply will likely be the focal points. However, for the longer term, many lodging investors are considering if the pace of the current recovery cycle will provide continued support for further improvement in the overall lodging market.

Hotel Property Market Forecast
(Provided by PKF Consulting USA, LLC)

PKF-HR's outlook for the U.S. lodging industry remains positive, yet slightly less robust than 90 days ago. According to the December 2013 issue of Hotel Horizons®, PKF-HR is forecasting that RevPAR for 2013 will increase by 5.2 percent over 2012. While this rate of growth is nearly twice the long-run average, it is 70 basis points less than the firm's September 2013 forecast. Further, the firm's projected RevPAR growth for 2014 has declined from 7.2 percent (published in September 2013) to the current forecast of 6.6 percent. The lower forecast for 2014 is a combination of reduced expectations for growth in both lodging demand and ADR.

In 2013, upper-priced hotels continued their superior performance. The 2013 RevPAR forecasts for properties in the luxury and upper-upscale categories are greater than the national average growth rate of 5.2 percent. Conversely, properties in the upper-midscale and midscale segments are lagging in RevPAR growth during 2013.

Looking towards 2014, the story changes somewhat. PKF-HR is once again projecting above average RevPAR gains for luxury hotels. However, in 2014, RevPAR growth is forecast to eclipse 7.0 percent for economy hotels as well, as shown in Exhibit 4-E3.

After two years of less than 1.0-percent supply growth, hotel construction is expected to pick up through 2017. Fortunately, demand is forecast to increase at a greater pace than supply through 2015.

Exhibit 4-E4 (see next page) showcases the PKF Hospitality Research, LLC Hotel Horizons® forecasting universe.

Exhibit 4-E3. National Forecast Summary

Year	Occ	Δ Occ	ADR	Δ ADR	RevPAR	Δ RevPAR
2008	59.8%	-4.8%	$107.44	3.0%	$64.27	-2.0%
2009	54.4%	-8.8%	$98.20	-8.6%	$53.56	-16.7%
2010	57.5%	5.4%	$98.22	0.0%	$56.45	5.4%
2011	59.9%	4.2%	$101.95	3.8%	$61.04	8.1%
2012	61.3%	2.4%	$106.21	4.2%	$65.14	6.7%
2013F	62.1%	1.3%	$110.34	3.9%	$68.55	5.2%
2014F	63.2%	1.8%	$115.60	4.8%	$73.10	6.6%

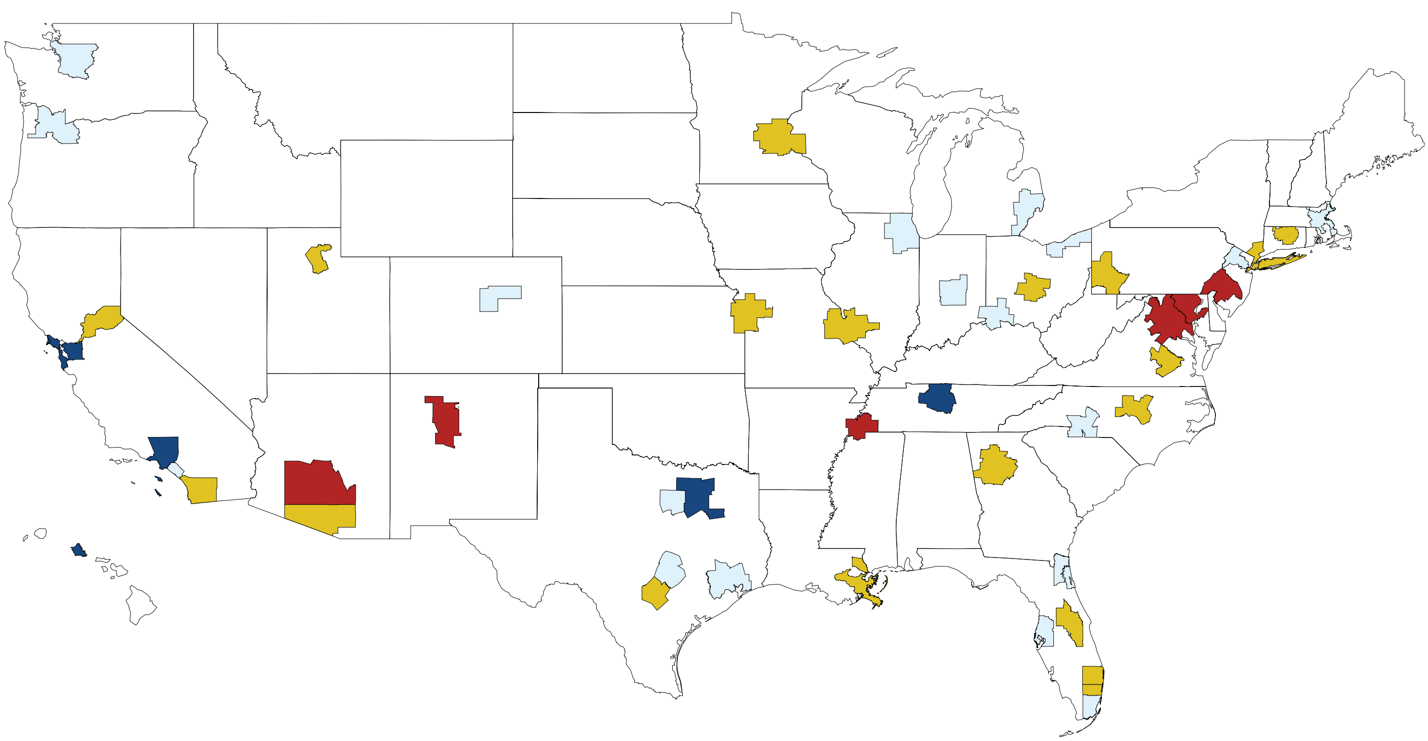
Sources: PKF-HR, December 2013-February 2014 Edition Hotel Horizons® report, STR.

Exhibit 4-E4. National Horizon Profile

National Horizon Profile: Average ADR Growth for 2014-2015
The map below displays the average annual change in average daily rate (ADR) from 2013 to 2014 and 2015.

Albuquerque
Anaheim
Atlanta
Austin
Baltimore
Boston
Charlotte
Chicago
Cincinnati
Cleveland
Columbus
Dallas
Denver
Detroit
Fort Lauderdale
Fort Worth
Hartford
Houston
Indianapolis
Jacksonville
Kansas City
Long Island
Los Angeles
Memphis
Miami
Minneapolis
Nashville
New Orleans
New York
Newark
Oahu
Oakland
Orlando
Philadelphia
Phoenix
Pittsburgh
Portland
Raleigh-Durham
Richmond
Sacramento
Saint Louis
Salt Lake City
San Antonio
San Diego
San Francisco
Seattle
Tampa
Tucson
Washington DC
West Palm Beach

Less than 3% | 3% to 5% | 5 to 7% | More than 7%



Source: PKF-HR, December 2013-February 2014 Edition Hotel Horizons® report.

5 SUMMARY & OUTLOOK

LOOKING AHEAD TO 2014

LOOKING AHEAD TO 2014

As the future unfolds and we look to 2014, the economy continues to plod along in this slow recovery. No recession is imminent, but neither is strong growth. Absent unexpected negative shocks, major tax increases, or significant changes in current levels of government spending, we anticipate that economic growth in 2014 will exceed 2013 growth only slightly.

There is a new chairperson at the helm of the Federal Reserve and tapering of the monthly purchases of the Fed's bonds and securities has begun. While the Board of Governors says that they intend to continue accommodative monetary policy in the form of forward guidance and low federal funds rate for another year or more, the Board remains challenged by weak job growth and a declining labor participation rate. With respect to the capital markets, interest rates increased in 2013, but they remain low on a relative basis. As such, there is a generous supply of capital available, as noted by just a few highlights from 2013:

- Zhang Xin purchased a 40-percent interest in the General Motors building in New York City. The total value of the tower was about $3.4 billion, making it the highest-valued asset to trade hands in 2013, according to Real Capital Analytics. This was one of a half dozen deals conducted in 2013 with assets valued at more than $1 billion.
- American Realty Capital Properties purchased Cole Real Estate Investments Inc., for approximately $7.2 billion in cash and stock, thereby creating the largest net-leased REIT in the U.S., according to Reuters. Both companies had previously been non-traded REITs.
- Henderson Group and TIAA-CREF agreed to combine their European and Asian real estate businesses to form a venture with $20 billion of assets under management. Earlier in the year, TIAA-CREF and Norges Bank Investment Management announced a joint venture to invest in high-quality office properties in Boston, New York, and Washington, DC.
- Hilton Worldwide Holdings, owned by Blackstone Group, raised $2.3 billion in the largest ever hotel initial public offering.
- Total CMBS issuance nearly doubled in 2013, increasing to $98.6 billion worldwide, according to *Commercial Mortgage Alert*, compared to $52.6 billion in total CMBS issuance in 2012.

As shown herein, compared with the investment alternatives, commercial real estate remains a very attractive investment in 2014. In general, the fundamentals are continuing to improve, albeit slowly, and as demonstrated in this report, transaction volume is increasing and returns in the form of appreciation and income are expected to be positive.

The trends, analysis, and outlook for the year ahead as presented by RERC, Deloitte, and NAR in ***Expectations & Market Realities In Real Estate 2014—The Future Unfolds***, are summarized in this chapter. We have also provided a collective forecast of what investors can expect to likely occur in 2014 if slow growth continues as anticipated. Alternately, we provide a brief summary of likely scenarios if the economy grows much more quickly than forecast, or much more slowly than expected, and what the effect would likely be on commercial real estate.

ECONOMIC HIGHLIGHTS

- The outlook is for modest but slower than normal growth. NAR projects the economy to grow at an annual rate of approximately 2.5 percent in 2014.
- Approximately 2.3 million jobs are expected to be added in 2014, and the unemployment rate is expected to decline to 6.9 percent, per NAR.
- Federal monetary and fiscal policies on balance are expected to continue to be expansionary.
- The positive wealth effect for many consumers based on increases in financial asset prices and the housing market supports further consumption, although consumer confidence remains well below the 100-point level associated with a robustly expanding economy.
- Economic uncertainty is likely to continue somewhat in 2014, as well as the historically high long-term unemployment rate.
- Risks include the potential of negative spill-overs from the world's economies and financial markets to the U.S. economy, along with increasing federal debt levels in 2014.
- Thirty-year government bond rates are estimated to increase to 4.2 percent in 2014, up from 3.4 percent in 2013, per NAR.

CAPITAL MARKETS HIGHLIGHTS

- Dr. Janet Yellen was approved as the next Federal Reserve chairperson, and forward guidance and low federal funds rate policies are likely to continue throughout 2014 or longer.
- Tapering of the Federal Reserve's monthly purchases of bonds and securities has begun, and is expected to conclude by late 2014 if the economy continues to expand as expected.

- Global wealth increased to an all-time high of $241 trillion in September 2013, according to Credit Suisse Group. The amount of capital available for investment is abundant, but investors remain somewhat cautious.
- Stock market performance in 2013 was outstanding, with the major indices reaching record highs. Bond prices dropped in 2013, with some of the largest outflows in history.
- Interest rates are projected to continue to inch upward in 2014, and although this would reduce commercial real estate performance, risk-adjusted returns are expected to still remain attractive.
- The availability of capital has been outpacing the discipline of capital for the past year or so, per RERC's institutional investment survey results.
- More than $3.56 trillion was invested in commercial real estate as of second quarter 2013, compared to the peak of $4.76 trillion in 2008, according to ULI, PwC, and MBA. Approximately one-third, or $1.16 trillion, is invested in equity capital, while about two-thirds, or $2.41 trillion, in debt products.
- Private equity real estate funds raised nearly $34 billion through third quarter 2013, according to Prequin, and will likely maintain positive annual growth for the third consecutive year.
- REIT funds raised nearly $60 billion through third quarter 2013, with nearly two-thirds of the capital raised through equity, according to NAREIT. The number of initial public offerings for REITs (per transaction value) is the highest it has been since 2005.
- The lender composition for the fixed-income market as of second quarter 2013 consisted of $3.22 trillion in commercial real estate, per the Federal Reserve Flow of Funds, with banks and other chartered depository institutions holding nearly half the debt.
- RERC forecasts aggregate NCREIF values to increase by approximately 2.75 percent throughout 2014, which is slightly less than 2013 increases. If you add an income return of 6 percent (expected by RERC), the commercial real estate return is expected to average approximately 8.75 percent on an unleveraged basis.

PROPERTY MARKET HIGHLIGHTS

- Sales of major properties (those priced over $2.5 million) rose 24 percent on a year-over-year basis, totaling over $145 billion in the first half of 2013, according to Real Capital Analytics.
- Sales of properties at the lower end of the price range (mostly below $2 million) rose 12 percent on a yearly basis, according to NAR.
- Although New York City, Los Angeles, and Washington, DC retained the top investment spots in mid-year 2013, investor interest in secondary and tertiary markets like Jacksonville, Long Island, Philadelphia, and Las Vegas remained a dominant trend, posting triple-digit growth in sales volume, per Real Capital Analytics.
- Commercial property prices rose 9 percent in the first three quarters of 2013 compared to the previous year, according to the Moody's/Real Capital Analytics CPPI.

Office Sector

- Investors were generally focused on quality office assets with strong returns, and average prices rose 9 percent on a yearly basis in the first three quarters of 2013, per Real Capital Analytics. Private investors and institutional/equity funds comprised 65 percent of buyers, but banks returned to the fray. Further, cross-border investors accounted for 13 percent of total acquisitions.
- The 2014 outlook for the office market remains cautiously optimistic, and demand for office space is expected to grow. Office volume is expected to continue growing in 2014, particularly in secondary and tertiary markets. Net absorption is expected to reach 46 million square feet in 2014, on top of the estimated 33 mission square feet in 2013, per Reis. The office vacancy rate is expected to decline to 16.5 percent by the end of 2014, while office rents will likely increase 2.1 percent in 2013 and 2.8 percent in 2014. Cap rates are likely to continue to compress, even as interest rates increase.

Industrial Sector

- The industrial sector—especially warehouses—benefitted from accelerating international trade in 2013. Industrial sales volume rose 33 percent on a year-over-year basis in the first three quarters of 2013, although according to Real Capital Analytics, pricing for industrial space declined 1 percent due to the shift to secondary markets.
- A strengthening economy is boosting demand for industrial space in 2014, and net absorption is expected to total 175 million square feet and supply is expected to accelerate to 100 million square feet of new space, according to Newmark Grubb Knight Frank. Industrial vacancies are projected to decline to 7.6 percent in 2014, and warehouse rents are expected to increase 3.0 percent and flex/R&D rents to increase 4.5 percent. Cap rates are not expected to increase due to higher interest rates for the short term.

Retail Sector

- Private investors continued to dominate retail property sales in 2013, and listed REITs comprised the second largest buyer pool. Year-to-year sales of significant retail properties totaled $42.5 billion in the first three quarters of 2013, which was an increase of approximately 25 percent over the same period in 2012, according to Real Capital Analytics. The 2013 percentage of strip center sales versus regional mall sales increased over 2012 sales, and the average price per square foot for all retail properties increased slightly to $167 in 2013.
- One of the challenges for the retail property type is the continued increase in online retail sales, but as liquidity continues, retail transaction activity is expected to continue, especially in the

secondary and tertiary markets in 2014; with some of the recent larger portfolio deals, a wider supply of properties is expected to be available. Although fundamentals were lackluster in 2013, absorption is expected to outpace supply over the new few years and should help to drive down vacancy rates. According to Reis, rents are expected to increase 2 percent to 3 percent over the next couple years if consumer spending continues to increase, as anticipated.

Apartment Sector

- Although the growth of apartment sales volume appeared to moderate in 2013, a total of $70.2 billion of significant apartment properties were sold in the first three quarters of 2013, according to Real Capital Analytics (however, the Archstone portfolio deal represented about one-third of the total). Based on the Moody's/Real Capital Analytics' CPPI, the average price per apartment unit for the first three quarters of 2013 decreased slightly, given the increased transaction activity in the secondary and tertiary markets. The national apartment sector's average cap rate is back to levels exhibited prior to the economic downturn in 2008.
- The outlook for the apartment sector appears to be positive, given strong fundamentals, demand, and financing, despite a growing pipeline of new construction. According to Axiometrics, annual effective rent growth is expected to inch up slightly to 3.6 percent in first quarter 2014, but decline to approximately 2.4 percent by the end of 2015. The vacancy rate is expected to drop to a low of 4.6 percent in 2014 but increase to approximately 5.8 percent at the end of 2015 due to the anticipated increase in new supply. Even so, the apartment sector is well-poised to possibly experience another year of solid growth in 2014, although slightly more moderate than in 2013.

Hotel Sector

- Sales of significant hotels totaled $16.3 billion from January through August 2013, an increase of approximately 50 percent over the same period in the prior year, according to Real Capital Analytics. Improved financing in 2013 fostered a rebound in acquisitions among public and private buyers, while the market share of equity fund, institutional, and cross-border buyers declined. According to STR, hotel occupancy increased to 0.3 percent to 63.4 percent, ADR rose 3.3 percent to $111.03, and RevPAR increased 3.6 percent to $70.36 in September 2013. Despite these all-time highs, the price per hotel unit began to wane in late 2013, indicating that the market may have reached its peak in the current cycle.
- The outlook for the U.S. lodging industry remains positive. PKF-HR forecasts RevPAR growth for 2014 to increase 6.6 percent to $73.10, ADR to increase 4.8 percent to $115.60, and occupancy to increase 1.8 percent to 63.2 percent. After two years of less than 1.0-percent supply growth, hotel construction is expected to pick up through 2017.

AS THE FUTURE UNFOLDS: SCENARIO ANALYSIS

RERC, NAR, and Deloitte compiled a summary analysis of the three most likely scenarios for the U.S. economy, capital markets, and commercial real estate in 2014.[10] We believe that the baseline forecast presented in the center column on the following table (see Exhibit 5-1) is the most likely scenario to occur in 2014 as the future unfolds. If economic growth is slower than expected, deflation may result, and the effects on the capital markets and on real estate are outlined in the left column. If economic growth is faster than projected, inflation and interest rates may increase to a more sustainable level, as noted in the right-hand column.

[10] ***We note that these are not the only scenarios that are possible, and there will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.***

Exhibit 5-1. Alternative Economic Scenarios for 2014

	Slowing Growth - Risk of Deflation/ Recession	Baseline - Continued Slow Economic Growth	Stronger Growth - Progress Towards Historical Long Term Averages
US GDP Real Growth	1.5 percent or lower	2.75 percent	4.0 percent or higher
Probability	Slightly Likely	Most Likely	Reasonably Likely
Employment	Job growth slows, and there are additional layoffs with unemployment rates increasing. Long-term employment becomes chronic, with labor participation rate further declining.	Approx. 6.5 percent unemployment by end of year due largely to laid-off workers dropping out of the workforce. Slow job growth of approx. 180,000 to 200,000 new jobs per month. Labor participation rate remains around 63 percent. Long-term unemployment becoming long-term problem.	Increasing job growth (approx. 350,000 - 500,000 or more per month), with unemployment dropping to 5 percent or lower and wage growth increasing 5 percent or more. Shortage of trained workers.
Housing Market	Potential home-buyers retreat, while investors may increase purchases of single-family homes to use as rental properties.	Continues to slowly improve in certain areas and in certain types of housing.	Although higher interest rates are likely, this will be offset by the confidence in the economy, and housing markets will improve, which will be more of a broad-based recovery.
Consumer Spending	Consumers retrench.	Median incomes continue flat to declining. However, household balance sheets have improved with increase in home values and upturn in stock market. Consumer confidence remains subdued and personal consumption expenditures are estimated to grow at a rate of 2.7 percent. Any sudden catastrophes or events could be detrimental towards a healing consumer soul.	Incomes will increase, which in turn will increase consumer spending. Assets will start increasing in value.
Business Spending	Businesses retrench, lay off employees, cut expenses (including healthcare benefits), etc.	Business profits expanding and there is cash on hand, but regulatory and other uncertainties continue. Business investment is expected to grow at a rate of 3 percent, per NAR.	Businesses have been sitting on a lot of cash, and have not been spending due to their lack of confidence. Stronger growth in the economy likely to encourage them to open up their pocketbooks re: infrastructure, wages, hiring, etc.
Government Spending	Possible decrease in government spending.	Federal debt is up against the current ceiling, as deficit spending continues.	As the economy grows, government revenues will increase as they receive more taxes and have fewer payments for unemployment and welfare programs.
Inflation	Drops to near-zero as Federal Reserve tapers monthly bond/securities purchases.	Remains in the Fed's target range of 1 to 2 percent. Slow inflation is not good for the long term.	Increases higher than expected (increasing prices on goods and services), and is working towards a sustainable level.
Interest Rates	Federal Reserve keeps interest rates at rock bottom levels and monthly bond purchases at high levels to prevent 10-year Treasury rate from returning to a historically normal rate within the year.	Federal funds rate remains at 0.25 percent throughout the year. Ten-year Treasury yields increase gradually to approx. 3.5 to 3.7 percent.	Federal funds/interest rates increase towards long-term sustainable levels.
Commercial Real Estate	If there are business closings and significant numbers of layoffs, fundamentals may deteriorate much like they did in 2009. Could be a race to the bottom with cap rates, or a race to the top in terms of price with highly sought-after properties reaching unsustainable areas. Rent growth would slow in retail, industrial, and office sectors, although apartment rent may be able to stay at current levels. Appreciation slows down for retail and office properties. Hotel sector gains could pull back in RevPAR and appreciation.	Remains well-positioned for slow growth. Fundamentals will continue to improve, with vacancy/occupancy rates inching downward and rents increasing slightly. Absorption and completions will continue to increase. Volume continues to increase, with sales continuing to expand to the secondary and tertiary markets. Prices will generally hold steady, although there may be challenges in some apartment and hotel markets. Cap rates are likely to continue to compress. According to RERC's value outlook, total returns are expected to be approximately 8.75 percent for institutional properties on an unleveraged basis.	If the economy improves more than expected, this will have a very positive impact on commercial real estate. Fundamentals will continue to improve, and also at a more broad-based level (secondary markets included). Cap rates will increase, but overall, commercial real estate will fare relatively well compared to the investment alternatives.

NOTE: These are not the only scenarios that are possible, and there will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

Sources: BLS, BEA, The Conference Board, RCA, Newmark Grubb Knight Frank, Reis Inc., Axiometrics, PKF, NCREIF, NAR, RERC, Deloitte, January 2014.

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[11]Pensions & Investment, Feb. 4, 2013.
[12]The American Council of Life Insurers (ACLI), 2011.
[13]Pension & Investments, Dec. 24, 2012.

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Sources: NAREIT, Retail Traffic, NREI, P&I, Builder on Line, ENR.

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