U.S. Research Report

CAPITAL FLOWS

2017 Year-end Review and 2018 Outlook

Colliers INTERNATIONAL

Accelerating success.

Still Crazy (Strong) After All These Years

Andrew J Nelson, Chief Economist | USA

With transaction volumes and price appreciation rates continuing to slow, there seems little doubt that U.S. commercial property markets have cooled. Indeed, together with other indicators, it seems clear that markets have peaked for this cycle, as we predicted in our report from a year ago.

But the bigger story is just how vibrant commercial real estate remains nearly nine years since the Great Recession ended, in terms of both property market fundamentals and capital markets. Occupancies and rents remain at or near historic highs nationally across most property sectors, though this expansion certainly has been much kinder to some markets than others. Meanwhile, both sales and leasing transaction levels remain at historically high levels, if off their recent peaks, and assets in many markets command record pricing.

If there's a notable weakness, it's the pullback in cross-border capital flowing into the U.S. While acquisitions by domestic capital are down a relatively modest 7% cumulatively over the past two years, acquisitions by offshore investors are down a staggering 47% (though on a much smaller base). But even here, the market dynamics are more benign than the headline figures would suggest: the vast majority of this pullback is accounted for by just one country—China—and reflects not waning investor interest, but rather mandates by Chinese regulators.

With Chinese authorities continuing to pressure Chinese firms to refrain from offshore investing and even divesting from current holdings, the impact on U.S. capital markets are material, particularly for trophy assets in leading markets like New York. Still, U.S. markets retain their appeal for both domestic and cross-border capital due to its compelling returns and relative security, which will limit near-term downside risks to the U.S. capital markets..

Key Takeaways

- Overall U.S. transaction volumes in 2017 fell 7% from a year ago, after dropping 9% the prior year. While sales volumes remain robust by historical standards, sales have fallen from their peak in 2015, with year-over-year volumes declining in seven of the past eight quarters.
- Entity purchases continue to account for a disproportionate share of the recent sales declines, while individual property transactions have been relatively stable.
- The industrial property sector continues its star turn as the only major property sector to register sales gains in 2017. Both industrial and multifamily properties continue to maintain larger shares of transactions than they have historically, while office, hotel and especially retail all account for smaller shares than before.
- Cross-border flows into U.S. property markets continued to decline last year after dropping significantly in 2016. However, China alone essentially accounted for all of the decline last year.
- The decline in sales by foreign investors far exceeds those by domestic investors, but foreign investors remain net buyers of assets—buying more than they sell—in contrast to most types of domestic investors, who are net sellers.
- Investment momentum continues to shift from primary into secondary markets, and from CBDs into inner suburban submarkets, particularly for offices and apartments, as both foreign and domestic investors eschew premium pricing in the top markets.
- The continued slowdown in sales activity is now more clearly impacting pricing. Average prices per square foot fell in the second half of 2017 for most property types, as income growth is slowing and capitalization (cap) rates are flattening or rising. With investors opting for less expensive assets, falling average prices also reflect lower asset quality.
- U.S. commercial real estate remains a compelling investment option for both domestic and offshore investors, which is likely to keep property capital markets strong. While Q1 2018 GDP is likely to disappoint, continuing a pattern of weak first quarter growth, economic growth is forecast to strengthen this year, supporting property fundamentals. Nonetheless, rising interest rates and rising tensions with our trading partners will act as an increasing headwind this year.

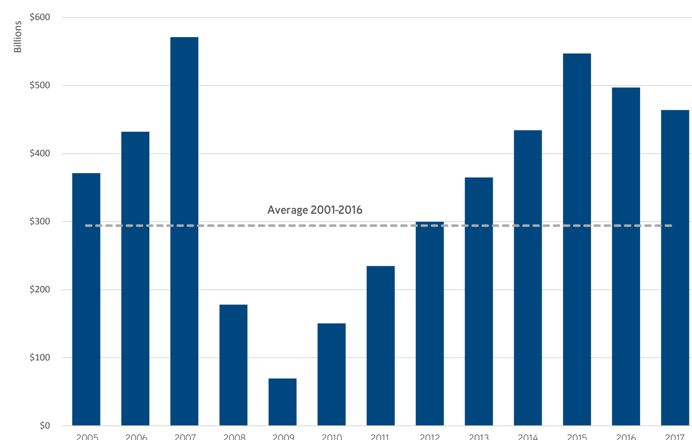
Overall Transaction Volumes and Investment Flows

Property markets in the United States continued to slow throughout 2017, though transaction volumes remain relatively robust in concert with moderately strong economic growth. Based on trends over the past two years, it seems increasingly clear that transaction volumes peaked in 2015, after which property markets began to cool on several fronts including price appreciation and financial returns. Year-over-year transaction volumes have declined in seven of the last eight quarters, including all four this past year.

As prices continue to push into record levels, investors have been more selective, increasingly seeking strategic individual assets rather than portfolio and especially entity sales. Portfolio and entity sales account for a disproportionate share of the recent decline in sales volumes.

Though the U.S. markets remain attractive globally, cross-border flows into U.S. property markets have slowed more significantly than have acquisitions by domestic capital sources. The U.S. share of global transactions is also falling.

Commercial Real Estate Transaction Volume > $2.5MM ($Billions)



Source: Real Capital Analytics and Colliers International

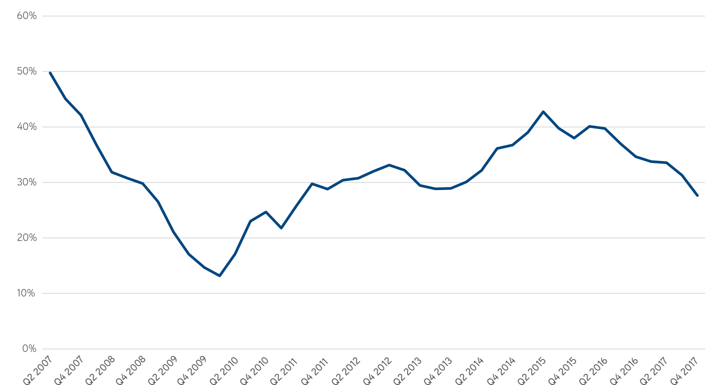
- An estimated $464 billion in U.S. commercial real estate changed hands in 2017, down 6.7% from 2016, which was on top of a 9.2% decline from 2015, the peak year of this cycle, for a two-year drop of more than 15%. Nonetheless, investment volumes remain strong by historical standards. Sales volumes logged the third greatest yearly total since the recession and are well above their long-term historical average.

- Individual asset sales accounted for 76.4% of the transaction volume in 2017, up from its historical average of 70.2%; portfolio sales accounted for 19.2% of transactions, on par with its 20.7% average. However, only 4.4% of sales were through entity transactions, less than half of average.

- While overall deal volume is down 6.7% over the past year, single-property deal volume is down only 4.8% over this period. Similarly, portfolio deals slipped last year about on par with overall deal volumes at 7.0%. By contrast, entity deals are down substantially versus a year ago at 29.9%. Since peaking in 2015, entity deals have declined the most by far, almost 64%.

- The U.S. share of the global investment market continues to slide, suggesting cross-border interest in U.S. property may be waning. After peaking in early 2015 with over 40% of global investment sales, the U.S. share has since fallen below 30% by late 2017. While sales in the U.S. fell by 6.7% last year, global transactions excluding the U.S. rose 26.2%. Accordingly, the cross-border share of U.S. property sales fell from 18% in 2015 to just 11% in 2017.

U.S. Shares of Global Property Transactions (Two-Quarter Moving Average)



Source: Real Capital Analytics and Colliers International

Property Sector Trends

The composition of transactions by property type has shifted over the past decade away from office and hotels and decisively toward apartments and, more recently, industrial. Indeed, the warehouse sector was the only major property type to experience sales growth over the year.

- Hotels and retail declined the most, while office and apartments declined more modestly. Meanwhile, industrial was the lone major sector to register year-over-year gains. These trends were generally more pronounced when focused on larger deals of at least $25 million: hotels and retail dropped more, while multifamily slid less and industrial gained more.

- Since transaction volumes peaked in this cycle in 2015, every sector has lost ground led by hotels and retail, while multifamily and industrial have declined the least.

- Compared to their long-term averages, apartments have scored the greatest gains in this cycle, accounting for virtually a third of all transactions last year, compared to its average of about a quarter. Industrial properties have also gained, while offices, hotels and especially retail have lost favor.

Sales Transaction Volume

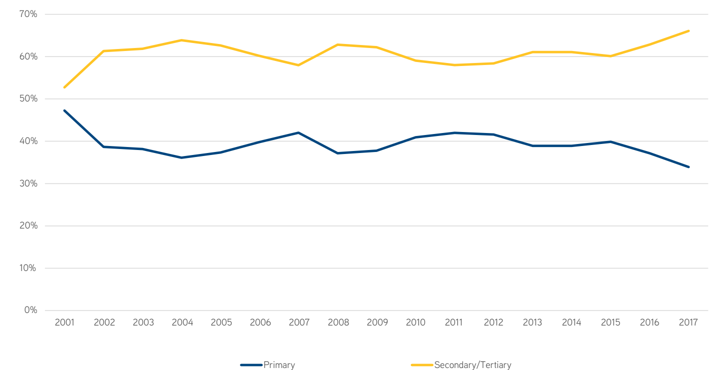
	Percent change 2016-2017		Percent change 2015-2017	
	All Deals $2.5M+	Large Deals $25M+	All Deals $2.5M+	Large Deals $25M+
Office	-8.0%	-9.9%	-12.4%	-17.0%
Multifamily	-6.9%	-5.3%	-2.5%	+4.1%
Industrial	+19.7%	+32.8%	-7.1%	+24.9%
Retail	-17.7%	-35.9%	-29.8%	-41.8%
Hotel	-24.0%	-27.2%	-45.2%	-43.0%
TOTAL SALES	-6.7%	-10.0%	-15.2%	-13.3%

Source: Real Capital Analytics, Real Estate Alert and Colliers International

Top Markets for Investors

The top six U.S. markets still account for a disproportionate share of investment activity nationally compared to their share of total market inventory, but their share continues to drop as investors seek out greater returns (and risk) in secondary markets. However, relative to domestic investors, offshore buyers still focus more on the leading markets, as foreign entities are less motivated by short-term yield and less comfortable investing in smaller, less familiar metros.

Share of Investment in Primary vs. Other Markets



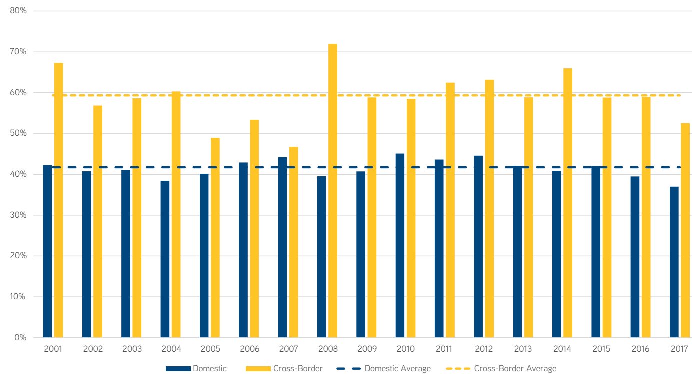
Source: Real Capital Analytics and Colliers International

- After peaking at 42.0% in 2011, the share of investment dollars flowing to the top six metros has declined steadily to just 33.9% of investment shares this past year—another clear sign we're in the late stages of the market cycle, when investors broaden their horizons in search of greater yields.

- There continues to be a significant spread between U.S. and foreign buyers: the top six market share is just 37.0% among domestic investors, compared to 52.5% for offshore*. Moreover, while the top six market share fell this past half year among all investors, the drop was greater among domestic investors (-6.4%) than for foreign buyers (-2.5%).

* Note that these figures are not additive. Rather, these figures refer to the proportion of each source's investments that are concentrated in the top six metros.

Domestic vs. Foreign Capital in Top Six Markets



Source: Real Capital Analytics and Colliers International

- Manhattan remains the top metro market for attracting cross-border capital, though their dominance waned in 2017. Foreign investors invested just under $9 billion in Manhattan last year, a drop of more than half (-54%) from 2016, while offshore investment grew more than a third (+36%) in Washington, D.C. with just over $5 billion in transactions. This reversal in fortunes largely reflects the pullback in Chinese investment, which had been focused on New York City.

- Moreover, New York has relinquished its crown among U.S.-based investors this year. Los Angeles has edged out New York, with $42.5 billion in sales, just ahead of New York's $40.9 billion.

- Focusing on the top investment markets, U.S. metros account for six of the top 10 markets globally, but its share is dropping: last year the U.S. share of the investment volumes in these top 10 markets declined from 72% to 62%. New York and Los Angeles remain the two top markets globally, as they have been each of the past three years, though volumes have slid again this year.

- These trends are broadly consistent with the results of the latest survey of the Association of Foreign Investors in Real Estate (AFIRE) in which New York has slipped behind London as the top spot among investors, followed by Berlin and then Los Angeles.

- Together, the top ten metros account for more than-two thirds (69%) of foreign capital invested in U.S. property markets but for just over half (53%) of the domestic capital.

Top U.S. Metro Markets for Cross-Borders and Domestic Capital Sources

Cross-Border Sources			Domestic Sources		
	2017 Deals	2016-2017		2017 Deals	2016-2017
New York City Metro	$8,996.20	-53.9%	Los Angeles Metro	$42,465.50	5.0%
Washington, D.C. Metro	$5,026.40	36.0%	New York City Metro	$40,883.40	-22.2%
San Francisco Metro	$4,519.70	-27.9%	San Francisco Metro	$25,337.20	-15.7%
Los Angeles Metro	$3,543.30	-41.6%	Dallas	$20,122.30	0.3%
Houston	$3,222.30	598.4%	Washington, D.C. Metro	$18,440.50	5.5%
Boston Metro	$2,682.20	45.8%	Atlanta	$16,360.90	3.1%
Chicago	$2,380.40	-15.8%	Chicago	$16,307.70	-12.0%
Dallas	$1,977.40	-25.0%	Miami/South Florida	$13,502.00	-16.1%
Atlanta	$1,735.50	-18.2%	Boston Metro	$13,187.90	-5.5%
Seattle	$1,511.50	-28.8%	Houston	$11,994.20	13.6%

Source: Real Capital Analytics and Colliers International

Buyers and Sellers

Private investors remain the dominant buyers of U.S. property and increased their share of acquisitions in 2017, as did real estate investment trusts (REITs), while foreign and institutional shares declined. Nonetheless, the dollar value of acquisitions declined for all capital sources in the year except for REITs, while transaction by private investors were down only slightly.

Taking dispositions into account as well, foreign entities and private sources of capital were net buyers in 2017, while institutional investors, REITs and owner/users were net sellers. Collectively, all domestic sources together were net sellers. In contrast, foreign buyers again led all capital sources in net acquisition volume, as they have almost every quarter since mid-2013, despite their pullback in new acquisitions.

- Private buyers accounted for over half (50.5%) of the total transaction volume while institutional buyers comprised a fifth (22.8%); private buyers have been increasing their shares of the sales consistently since late 2015. On the other hand, both foreign entities and institutions registered declining shares.

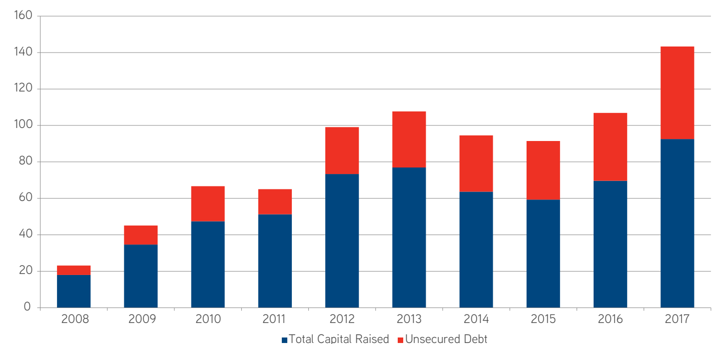
- Of the major capital sources, only REITs purchased more this year than they did in 2016, with foreign entities and institutions bearing the most substantial declines, -25% and -21%, respectively, compared to only a 2.4% drop for owner/users. The volume from private buyers was almost even at -0.5%. By contrast REIT purchases jumped an impressive 27%, reversing a 29% slide 2015-2016.

- Despite the decline in their acquisitions, offshore sources continued to increase their share of owned U.S. assets in 2017 as dispositions were only half of new acquisitions. Foreign buyers are attracted by the relative strength and stability of the U.S. economy, as well as compelling returns compared to returns in their home markets.

- Domestic capital sources collectively were again net sellers (-7%) last year, now a three-year trend. Within this group, however, only institutional investors and owner/users were strong net sellers (-22% and -29%, respectively), as they have been for the two prior years as well. REITs were modestly net sellers (-3%), while private investors were again net buyers (+5%).

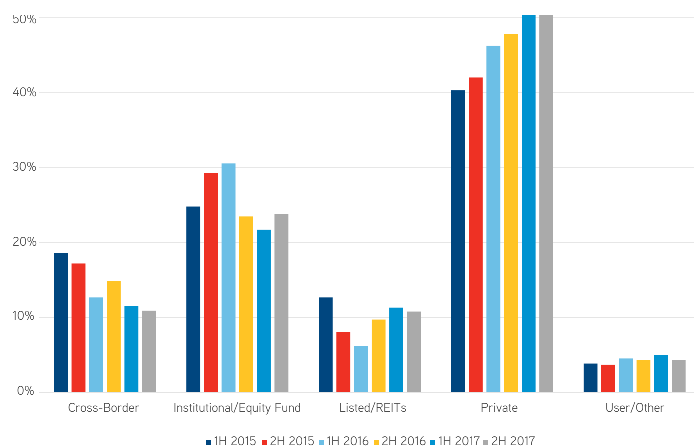
- Despite their net acquisition this year, REITs have been raising an increasing stockpile of both debt and equity.

Debt and Equity Capital Raising by REITs



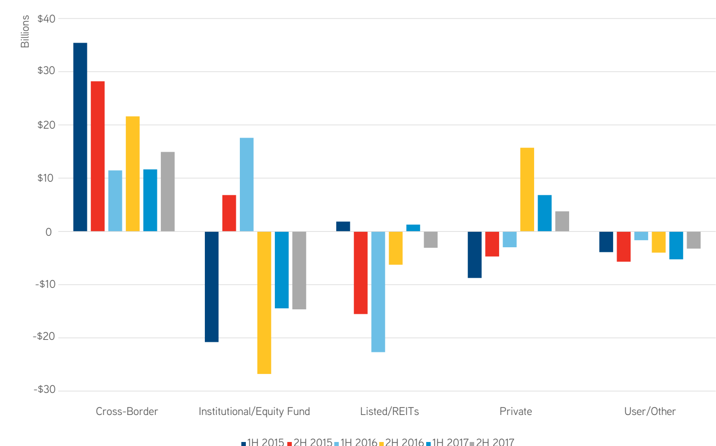
Source: National Association of Real Estate Investment Trust (NAREIT) and Colliers International

Acquisitions Shares by Type of Investors



Source: Real Capital Analytics and Colliers International

Net Investment by Type of Investor



Source: Real Capital Analytics and Colliers International

Offshore Demand

Canada had long been the leading offshore investor in U.S. commercial real estate but lost the mantle to China in 2016 owing to a modest increase in Chinese investment and a significant decline in Canadian acquisitions. Last year saw a return to more typical patterns as Canada again topped the rankings of foreign investors while China fell to third place as outbound investment was severely cut under the direction of Chinese regulators.

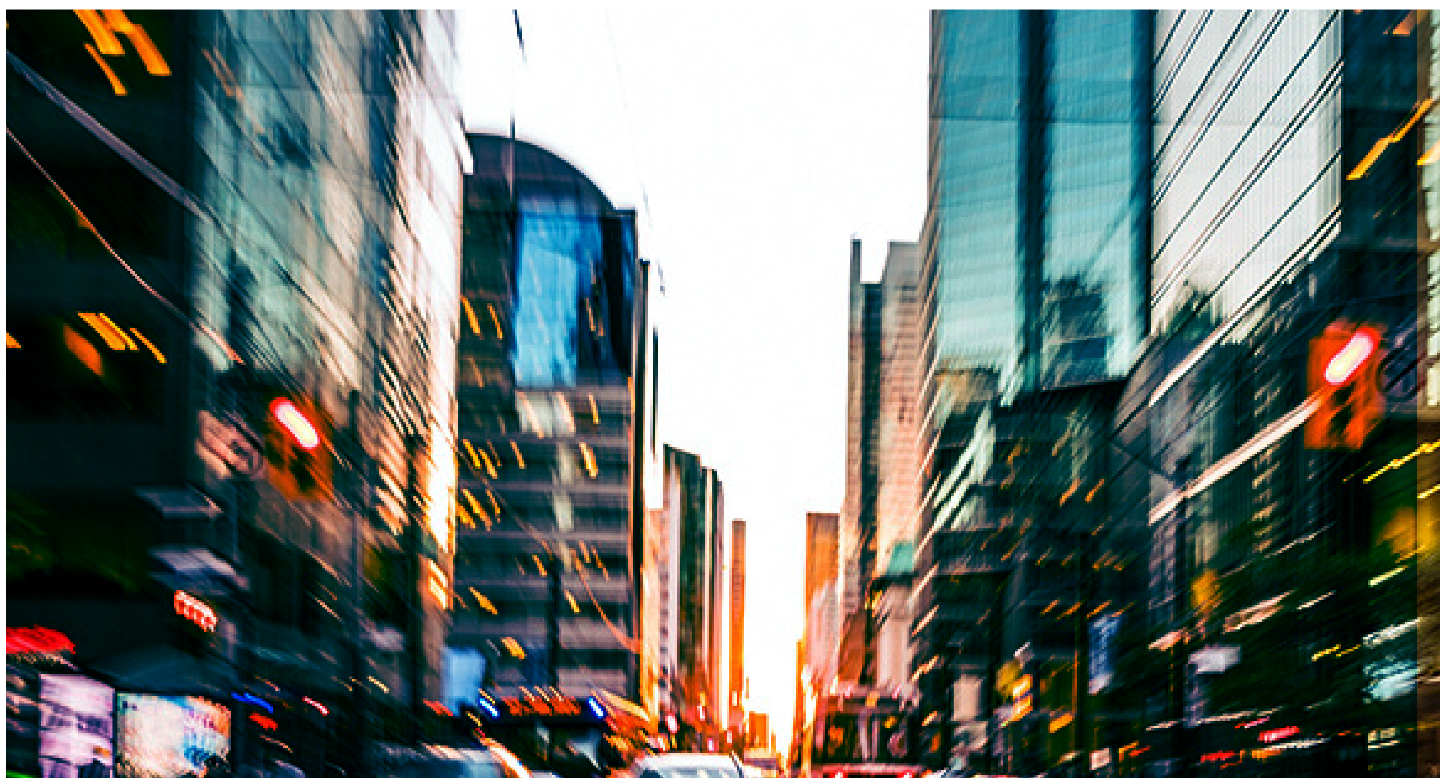
- Investments by Canadian investors surged more than 50% in 2017 to almost $21 billion, while investments from Singapore nearly tripled to $9.6 billion, pushing the island country past China, whose investments fell by almost two-thirds to $6.0 billion.

- Of the other countries among the top 10 foreign investors in the U.S., only the Netherlands increased its purchasing. All other countries saw double-digit declines including Germany, South Korea, Japan and Israel.

Top Foreign Sources of Capital—2016 and 2017*

	2016 Deals	2015-2016			2017 Deals	2016-2017
China	$16,661.20	+4.3%		Canada	$20,959.50	+51.2%
Canada	$13,858.60	-45.4%		Singapore	$9,557.60	+189.1%
Germany	$6,126.60	-14.0%		China	$5,988.10	-64.1%
South Korea	$4,221.70	+26.6%		Germany	$4,324.80	-29.4%
Singapore	$3,306.20	-77.7%		Netherlands	$3,231.00	+915.8%
Switzerland	$3,275.10	+3.0%		South Korea	$2,888.60	-31.6%
Qatar	$3,201.60	-30.6%		Japan	$2,411.00	-11.5%
United Kingdom	$2,841.80	+17.2%		Israel	$1,638.30	-37.0%
Japan	$2,724.80	+64.1%		Hong Kong	$1,602.20	-32.7%
Israel	$2,601.20	+45.8%		Switzerland	$1,207.00	-63.1%
Other	$12,130.80	-23.1%		Other	$7,586.50	-37.5%
Total	**$70,949.60**	**-33.7%**		**Total**	**$61,394.70**	**-13.5%**

* Deals with capital from more than one country are counted toward the tallies of all involved countries, so the total figures here are not comparable to those elsewhere in this report.
Source: Real Capital Analytics and Colliers International



Property Pricing and Return

The continued slowdown in sales activity is now more clearly impacting pricing—and visa-versa. Average prices per square foot fell in the second half of 2017 for offices, warehouses and shopping centers, though apartment prices per unit did gain. These declines reflect both slowing income growth as well as flattening to rising cap rates. In turn, the flat-to-rising cap rates reflect falling rates of return, encouraging investors to seek out greater profits in less expensive (and riskier!) assets and markets. Thus, falling average prices reflect lower asset quality as well as more general price weakness.

- The office, industrial and retail sectors all registered price declines in 2H 2017 relative to both 1H 2017 and 2H 2016, though apartment prices continued to rise. Viewed over the entire year, retail experienced the greatest price decline over the past year, followed by office, while both apartments and industrial managed small gains.

- Industrial has been the strongest sector, the only sector with price gains each of the past two years, helped by falling cap rates. These trends reflect the consumer shift from in-store retail to e-commerce, which favors warehouses over shopping centers. Indeed, retail was the only major sector with price declines in both 2016 and 2017. Falling quality among assets that transact is a contributing factor.

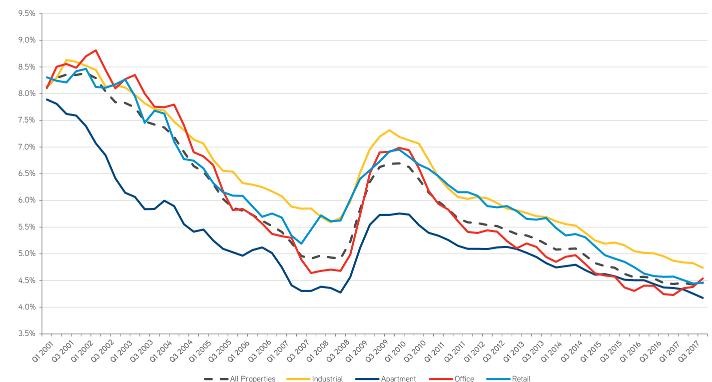
- Cap rates for all properties, as measured by the National Council of Real Estate Investment Fiduciaries (NCREIF) index for institutional quality assets, have been essentially unchanged over the past two years, at an average of 4.5%. During this time, cap rates for industrial and apartment buildings have fallen slightly, while flat for retail and rising for offices. Cap rates are at record lows for industrial and retail properties, and about even with prior lows for office and apartments.

Average Price Per Square Foot (Per Unit for Apartments)

	Office	Industrial	Retail	Apartment
2H 2017/1H 2017	-9.4%	-3.1%	-1.5%	+9.7%
2H 2017/2H 2016	-11.7%	-2.6%	-2.8%	+5.5%
2015-2016	+2.9%	+6.1%	-2.4%	+6.7%
2016-2017	-3.3%	+4.1%	-14.3%	+0.5%

Source: Real Capital Analytics and Colliers International

Capitalization Rates by Sector (Two-Quarter Moving Average)



Source: National Council of Real Estate Investment Fiduciaries (NCREIF) and Colliers International

A more accurate gauge of price movements is afforded by the RCA Commercial Property Price Indices (CPPI), which measures price changes based on "repeat sales" of the same properties, which thus controls for product quality (unlike in the prior metrics).

Measured by the CPPI, prices have broadly continued to rise this year, but appreciation rates have fallen steadily since peaking in 2014. Price gains have been concentrated within the major markets*, particularly in the multifamily and office sectors while gains for retail and industrial have been much more modest. Apartments are the sector to have established new pricing peaks in secondary markets significantly above those reached in the prior cycle.

- The price index for all property types nationally rose 7.1% over the past year. Since peaking at 12.8% in 2014, appreciation rates have fallen successively in each of the following three years.

- Apartments and industrial properties saw the greatest gains last year, followed by CBD office, but suburban office and retail both managed small gains. Outside of the major markets, however, both retail and suburban office continue to struggle.

- Reversing trends in the prior two years, appreciation in the primary markets outpaced that in the secondary markets, despite the pick-up in absorption and property sales outside these top markets.

*The top six markets are Boston, New York, District of Columbia, Chicago, San Francisco and Los Angeles. All other metros in this report are considered secondary or tertiary.

Annual Price Appreciation by Market Type

Year	All Markets	Top Six Markets	Other Markets	Difference Top vs. Others
2011	7.4%	10.0%	5.5%	+4.5%
2012	6.1%	5.1%	7.6%	-2.5%
2013	10.6%	11.4%	10.1%	+1.3%
2014	12.8%	14.8%	12.5%	+2.3%
2015	10.1%	10.4%	10.5%	-0.1%
2016	8.6%	7.4%	8.9%	-1.6%
2017	7.1%	8.5%	6.5%	+2.0%
Cumulative 2011-2017	+82.2%	+90.3%	+80.2%	+10.1%
Current vs. Prior Peak	+20.1%	+37.6%	+11.9%	+25.8%

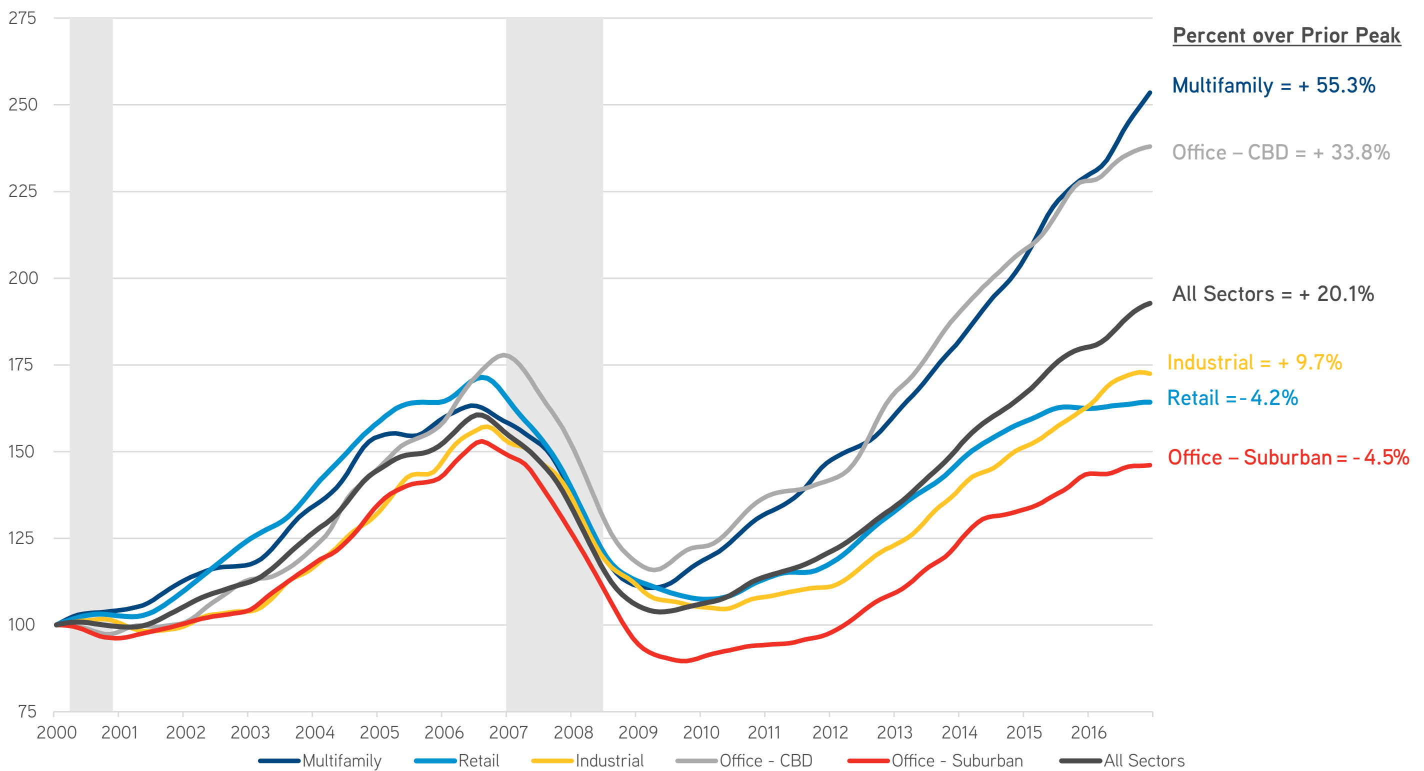
Source: Real Capital Analytics and Colliers International

Price Appreciation by Property Type

	2016-2017	2011-2017	Current vs. Prior Peak
National: All Properties	7.1%	82.2%	20.1%
By Sector			
Apartment	10.6%	115.4%	+55.3%
Industrial	6.1%	63.9%	+9.7%
CBD Office	4.4%	94.4%	33.8%
Suburban Office	1.9%	61.8%	-4.5%
Retail	1.1%	52.8%	-4.2%

Source: Real Capital Analytics and Colliers International

Property Prices Over Time—Indexed to 2001—Markets



Source: Real Capital Analytics and Colliers International

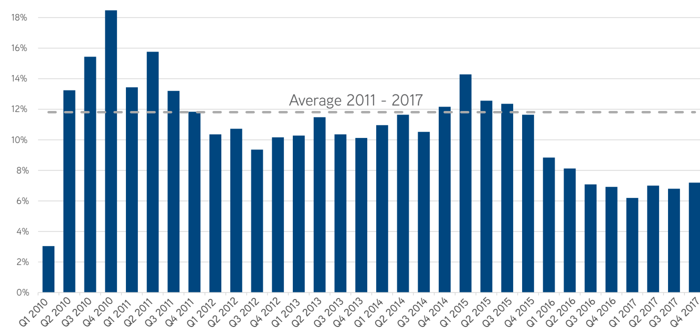
Property returns last peaked in early 2015 and have dropped almost every quarter since. Though commercial real estate still offers compelling risk-adjusted returns to investors, the falling returns—thanks to record pricing and record low cap rates—is a major factor in reducing sales transaction volumes.

- Returns averaged 7.0% last year, its lowest rate in this cycle, and just over half of the 13.3% return recorded in 2015. The industrial sector far outperformed all other sectors last year, with a return of 13.1%, followed by apartments, office and retail all around 6.0%, while hotels lagged at under 5%.

- Industrial has outperformed throughout the cycle, with the greatest five-year return at over 13%, followed by retail, then office and apartments and hotels again lagging behind.

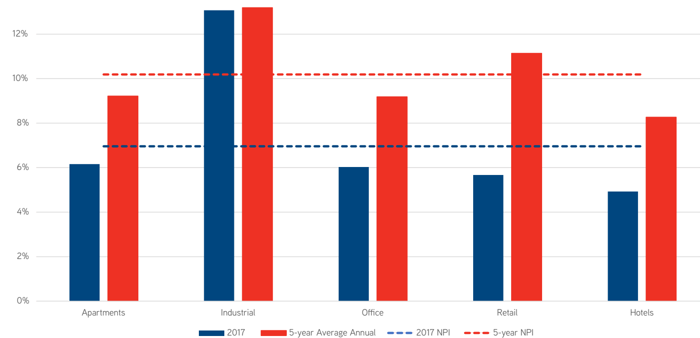
Though returns last year fell short of NCREIF's long-term 9.2% average, inflation remains relatively benign, so real returns (net of inflation) are actually on par with the NCREIF average.

Annualized Quarterly NPI Total Returns



Source: National Council of Real Estate Investment Fiduciaries (NCREIF) and Colliers International

NCREIF Returns by Sector



Source: National Council of Real Estate Investment Fiduciaries (NCREIF) and Colliers International

Debt Markets and Interest Rates

Despite the decline in property transactions, debt originations for commercial real estate were up strongly versus a year ago, with particularly sharp increases in Commercial mortgage-backed securities (CMBS) and agency lending (Fannie Mae and Freddie Mac). However, the Mortgage Bankers Associates (MBA) expects lending to fall both this year and next. Blame rising interest rates and a drop-off in CMBS expirations from the last cycle, as well as declining sales transaction volumes.

- After dipping slightly in 2017, MBA data shows that debt originations for commercial real estate rose 15% last year to an estimated $565 billion—despite falling transaction volumes and rising interest rates. Expiring CMBS loans are encouraging re-financings.

- CMBS issuances rose the most in the past year (+44%), though levels are still well below volumes during the last cycle. Agency lending (Fannie Mae and Freddie Mac) also rose sharply last year (+20%), while lending from commercial banks and other sources rose more moderately and lending by life insurance companies fell.

- Among the property sectors, retail saw a sharp 21% drop in originations.

- Looking forward, the MBA forecasts a 3% decline in new lending this year, and another 2% drop next. Nonetheless, MBA surveys shown that lenders remain optimistic, with nearly eight in 10 (78%) lenders expecting total market originations to rise again in 2018, and almost half (47%) expect their own lending to grow by at least 5%.

Commerical Real Estate Lending by Source and Sector

	2015	2016	2017E	2018E	2019E
Life Coc/Pension Funds	+25.4%	-1.3%	-2.6%	-2.6%	+1.4%
GSEs/FHA	+50.7%	+10.9%	+20.5%	+2.0%	+0.0%
CMBS	-6.6%	-22.2%	+44.2%	-5.4%	-4.8%
Others	+36.7%	-1.4%	+8.9%	-5.2%	-2.3%
Total	**+26.0%**	**-2.6%**	**+15.1**	**-2.8%**	**-1.6%**

	2015	2016	2017
Multifamily	+31.0%	+6.0%	+171.0%
Office	+23.0%	+6.0%	+12.0%
Industrial	+103.0%	-16.0%	+22.0%
Retail	+19.0%	-10.0%	-21.0%

Source: Mortgage Bankers Association and Colliers International

What to Expect in 2018 and Beyond

As we outlined in our recent State of the U.S. Market and 2018 Outlook, "faster economic growth and strong job growth will continue to provide a firm foundation for solid property fundamentals in 2018." Thank stimulus from the recent tax cuts and federal spending increases, as well as elevated business investment and synchronized global growth.

In addition to economic conditions and market fundamentals, investor expectations will be an important driver of real estate capital markets. Despite growing concerns, investors by and large remain optimistic about at least the near term.

According to the 2018 AFIRE survey, the U.S. was again viewed as the top country for real estate investment by a wide margin, with the top ranking in terms of both potential for capital appreciation and "country providing the most stable and secure real estate investments." Among the reasons: the relative strength and stability of the U.S. economy and transparency of our capital markets. Respondents to the Urban Land Institute's (ULI) Emerging Trends in Real Estate 2018 are similarly bullish, with 80% viewing business prospects this year as good or excellent.

Finally, though fundraising in the sector is slowing, there remains a considerable stockpile of dry powder to deal-making. Some capital remained on the sideline last year pending the outcome of the tax bill. With greater clarity, we might see more of that capital put to work.

Nonetheless, we anticipate the slowdown in property investment will continue next year as record pricing and rising interest rates squeeze returns. Chinese regulators show no sign of relaxing restrictions on outbound investment, which will limit a major offshore capital source.

In addition, we expect rising interest rates will finally start to have a material impact on property acquisition costs and development financing. As widely expected, the Federal Reserve raised its reference rate another 25 basis points at its March 2018 meeting, and the market is preparing for two to three more such hikes this year, and more next. Significantly, these hikes are finally moving longer-term rates, which are more relevant for property investors.

And investors clearly have concerns. The top issues cited in the AFIRE survey include lofty asset valuations, rising interest rates and growing supply risk. No wonder that the greatest share of ULI respondents believe now is an "excellent" time to sell but only a "good" time to buy. Nine years into this expansion, we're clearly very late in the cycle.

In summary, expect this year to be another good one for U.S. real estate capital markets, with healthy transaction levels and still rising asset prices. But there is little doubt that the strongest years of this cycle are already behind us, so we see transaction levels and price appreciation continuing to slow this year and especially next.

Thus, investors and other interested property professionals nonetheless should not be seduced by the relatively benign market conditions. Still, the markets do not exhibit the excessive leverage and construction levels we saw at the height of the last cycle, which gives confidence that the next downturn, when it surely arrives, will have a much softer landing than last time.

Our key specific market calls are as follows:

- The tax cuts and budget spending will provide a modest boost to the economy and property markets this year. But an economic downturn now seems increasingly likely within two years. Accordingly, most investors will want to lock in income returns now with longer-term leases, rather than betting on upsides to vacant space.
- With prices at record levels in many markets, interest rates rising and returns well below average, look for transaction levels to continue declining, though remaining at relatively healthy levels. But sales volumes are likely to slow more significantly in late 2019 and 2020.
- Returns have clearly peaked for this cycle and will continue to trend down, struggling this year to reach the 7% plateau achieved in 2017 due to flat/rising cap rates, rising interest rates and slowing NOI growth.
- Among the property sectors, we fully expect industrial to continue its recent outperformance, a view held by most respondents to leading industry surveys. Although multifamily has lost some favor among investors, we expect a return to outperformance, particularly during the next downturn, due to compelling long-term dynamics favoring the residential renting.
- On the other hand, there is little to suggest a reversal in fortunes for the office, retail or hotel sectors before the next downturn. Asset selection is key to avoid the increasing gulf between the best and worst performing assets and markets.
- Tenant and investor interest will continue shifting to secondary and non-CBD markets as vacant space in prime markets is increasingly scarce and expensive. But look for this trend to quickly reverse course once the economy and property markets cool.
- Inflation and interest rates will become more significant headwinds to property investing and performance this year, while stricter underwriting will make lending both more expensive and harder to secure.

FOR MORE INFORMATION

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