Real Estate Investors

Quarterly Market Update
December 31, 2013

New York Life Real Estate Investors is a division of NYL Investors LLC.

The Economy*

The U.S. economy performed admirably in 2013 despite facing strong headwinds from higher taxes and a delevering government sector, setting the stage for increased, broad-based economic growth in 2014 as those headwinds fade.

In the fourth quarter of 2013, the U.S. economy grew at an inflation-adjusted annualized rate of 2.4%, down from 4.1% in the third quarter (see Chart 1). Economic growth in 2013 as a whole was 1.9% versus 2.8% in 2012 and 1.8% in 2011.

In 2013, consumers withstood a number of tax increases, including a hike in the payroll tax from 4.2% to 6.2% which effectively took $1,000 from the annual after-tax income of a typical household earning $50,000 per year. In addition, government fiscal tightening subtracted a Congressional Budget Office-estimated 1.5% from 2013's economic growth rate. Despite these effects, consumer spending and the overall economy remained resilient.

An examination of the economy's key sectors suggests that the outlook is promising for 2014. Now that the total government (federal, state, and local) budget deficit has been halved over the past four years (see Chart 2) – revenues are recovering nicely and spending has declined from a peak of 39.2% of GDP to today's 34.5% – government purse strings should loosen. In 2014, this should allow the government sector – which represents 19% of the economy – to contribute to, rather than to detract from, economic growth for the first time since 2010.

Consumer spending on goods and services, which represents 68% of the economy, increased a moderate 2.0% in 2013 versus 2.2% in 2012. The tepid labor market didn't do much to boost the ability of consumers to spend: inflation-adjusted after-tax incomes increased only 0.7% in 2013. Job creation over the past three months has averaged only 129,000 jobs per month. In 2013, average job creation was 194,000, up from 186,000 in 2012 and 174,000 in 2011 but below levels indicative of a healthy jobs recovery. However, what consumers lacked in spending power because of sluggish increases in incomes they made up for in strong increases in wealth. Household net worth in 2013 increased $9.8 trillion, or 14%, with $5.6 trillion of that increase coming from corporate equities and $2.3 trillion from real estate. Equity values and home values appear to be reasonably priced and therefore may continue to contribute to consumer spending through the "wealth effect," but for higher levels of spending to be achieved and sustained, greater contributions will need to come from job growth and wage gains.

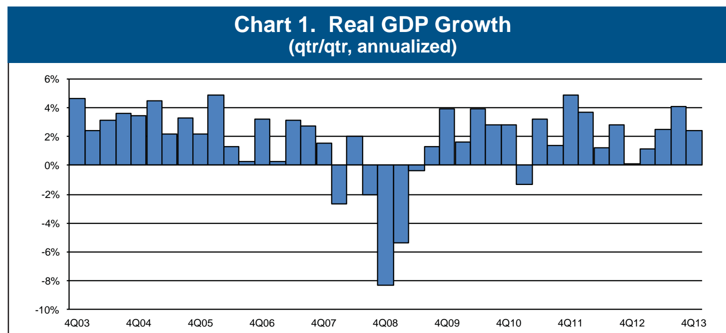
Finally, durable goods spending and business and housing investment all remain below their long-term trend levels. Aided by the current low interest rate environment and growing confidence in the economy, these sectors should provide boosts to economic growth in 2014.

There is little to suggest there could be a near-term change to the Federal Reserve's low short-term interest rate monetary policy. Inflation as measured by the Consumer Price Index stands at just 1.6% year-over-year, and the current unemployment rate of 6.7% remains stubbornly higher than the minimum threshold of "well below 6.5%" the Fed has set to re-evaluate its policy stance on its short-term interest rate target.

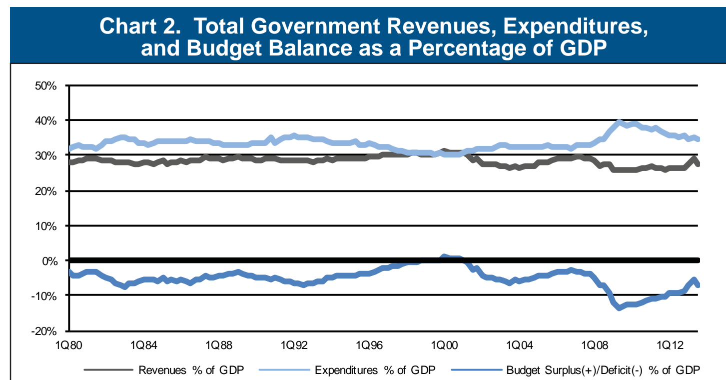
Long-term interest rates as measured by the 10-year T-note yield are at 2.70%, nearly identical to the 2.64% rate at the beginning of the fourth quarter.

All sectors of the economy seem poised in 2014 to perform relatively well in a low inflation, low interest rate environment conducive to growth. The management team is cautiously optimistic that 2014 will be a solid year for the U.S. economy.

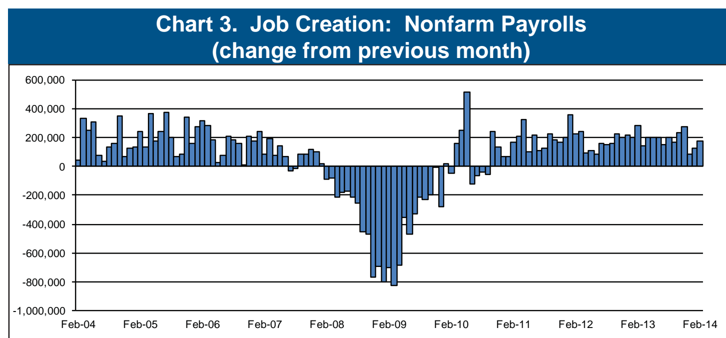
The largest threats to this optimistic outlook remain unchanged from the past few quarters: 1) failure of the Federal Reserve to move toward ending its unprecedented quantitative easing without spooking the bond market, 2) a return to recession of any of the world's largest economies, and 3) a major intensification of Middle East or Russia-area tensions.



Source: "Gross Domestic Product: Fourth Quarter and Annual 2013 (Second Estimate)," Bureau of Economic Analysis.



Source: Bureau of Economic Analysis' website, Table 3.1 of "Interactive Tables," March 14, 2014.



Source: "The Employment Situation — February 2014," Bureau of Labor Statistics.

*The views and opinions expressed are subject to change. There is no guarantee of future results, which will vary. Statistics and internal calculations are based on data from the following sources: Bureau of Economic Analysis, GDP report; Bureau of Labor Statistics, The Employment Situation report; Bureau of Economic Analysis, Personal Income and Outlays report; Bureau of Economic Analysis, National Income and Product Account tables; Bureau of Labor Statistics, Consumer Price Index Summary report.

Real Estate Markets

An improving U.S. economy and strengthening real estate fundamentals, combined with continued strong investor interest, have led to consistent and attractive returns on commercial real estate in recent years. This trend continued in the fourth quarter, with commercial real estate producing a 2.5% total return[1] consisting of 1.3% income and 1.2% appreciation. Industrial was the best performing property type (2.9% total return), followed by retail (2.7%), apartments (2.5%), and office (2.3%).

Commercial real estate continues to deliver an attractive income yield ("cap rate") relative to the 10-year Treasury note. Despite healthy value gains in recent years, cap rates stand at a 2.8% spread above the Treasury yield, slightly above the 10-year average spread of 2.7%. Liquidity in the real estate market remains healthy and transaction volumes have continued their upward trend (see Chart 1).

Overall, leasing activity has continued to improve (see Table 1). Apartments' average occupancy of 94.4% – already about the previous 2007 peak of 94.3% – has leveled off in recent quarters, and supply deliveries in many markets are beginning to slow rent growth. Rent growth in 2013 was 2.7% for apartments (down from 4.2% in 2012).

In the other property types, thanks in part to limited new supply, strong leasing activity is translating into occupancy gains and upward pressure on rents. Last quarter, industrial's average occupancy jumped from 92.0% to 92.4%, and it has now regained all occupancy lost during the recent downturn. Industrial rents increased 4.5% in 2013 (up from 2.7% in 2012). Retail and office have regained 58% and 52%, respectively, of occupancy lost during the recent downturn. In 2013, retail rents increased 1.9% (up from -0.9% in 2012), and office rents increased 3.1% (up from 1.7% in 2012).

Table 1. Occupancy by Property Type

Property Type	Prior Peak	1Q13	2Q13	3Q13	4Q13
Apartments	94.3%	94.2%	94.3%	94.4%	94.4%
Industrial	92.4%	91.6%	91.8%	92.0%	92.4%
Office	89.6%	87.6%	87.7%	87.9%	88.1%
Retail	94.0%	92.8%	93.0%	93.1%	93.2%

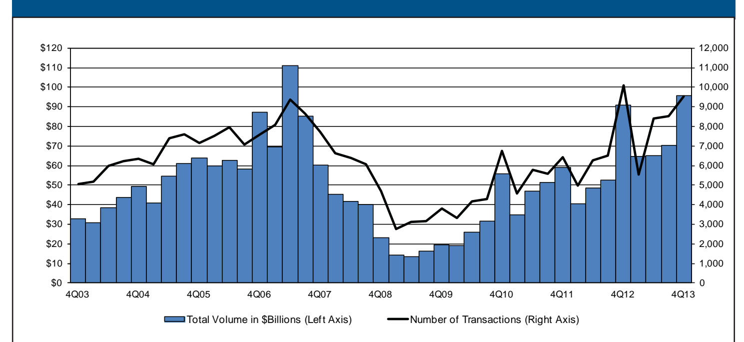
Source: Property & Portfolio Research (PPR)/Costar, 4Q2013 [2]

Of the major property types, apartments have enjoyed the earliest recovery in values (see Chart 2). Apartment values surpassed their previous 2007 peak in May of last year and now stand 6% higher. Meanwhile, the office, retail and industrial market cycles are less advanced, with property values 10%, 16%, and 17% below peak 2007 levels, respectively.

Since commercial real estate values troughed in early 2010, "major market" values across all property types have risen 68%, versus only a 46% increase for "non-major market" values.[3] The pricing contrast between major markets and non-major markets has been especially apparent in the office sector (see Chart 3). However, evidence suggests that this trend has shifted, and that investor interest has broadened into non-major markets which have yet to see strong price recoveries. Since this trend shift – measured from six quarters ago to today – non-major market CBD office values are up 41%, significantly outperforming the 19% gain in major market CBD office. Investors have also begun to show a willingness to bid up prices in major market suburban office (up 21%). This trend is likely to continue and should eventually spill over to non-major market suburban office (up 14%) as long as a compelling story can be told.

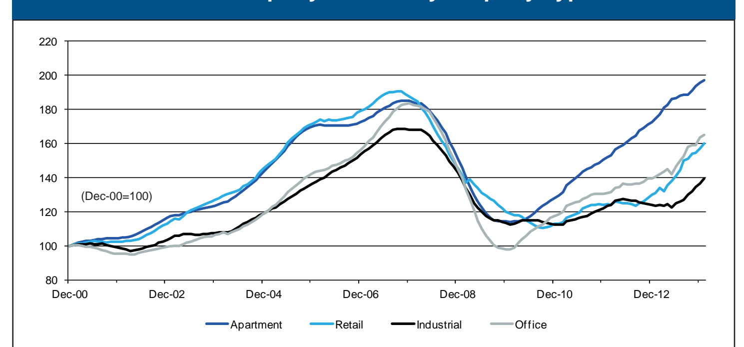
Looking ahead, property income returns should remain in the 5%-6% per year range in the near term, while unlevered appreciation returns should continue to stabilize at a long-term average of 1%-2% per year.

Chart 1. Commercial Real Estate Transaction Volume



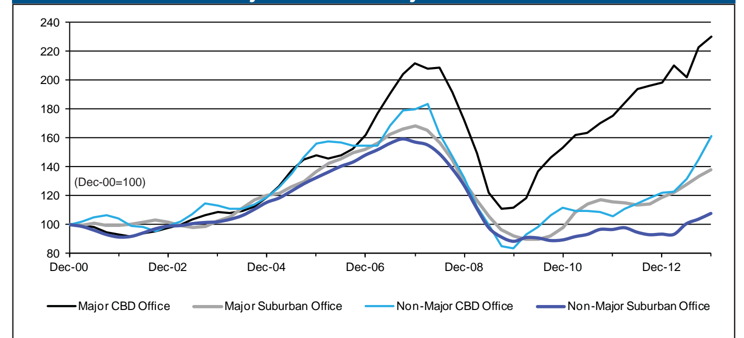
Source: PPR/Costar, 4Q2013 [2]

Chart 2. Property Prices: By Property Type



Source: RCA and Moody's Investors Service, January 2014

Chart 3. Property Prices: CBD Office vs. Suburban Office in Major and Non-Major Markets[3]



Source: RCA and Moody's Investors Service, 4Q2013

1. Unlevered property-level returns as measured by NCREIF's NPI-All Properties Index.
2. PPR/Costar data contained herein speaks only as of the date referenced and may have materially changed since such date. PPR has no obligation to update any of the PPR data contained herein. The PPR data herein should not be construed as investment, tax, accounting or legal advice. Any user of any such materials accepts them "AS IS" without any warranties whatsoever, express or implied.
3. The major markets are the six gateway metropolitan areas: Boston, Chicago, Los Angeles, New York, San Francisco and Washington, D.C.