MARKET COMMENTARY

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CenterSquare INVESTMENT MANAGEMENT

Entrepreneurial Culture, Institutional Strength.

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INVESTING THROUGH A HOLDING PATTERN

Chevron Building, Houston, TX

The influence of central bankers and politicians has been a prominent feature of this cycle. As of the end of the third quarter of 2016, central bank action now appears past the point of maximum benefit. The U.S. Federal Reserve is expected to raise rates again by year's end, which means that the tailwind assisting asset prices and markets is now shifting to a moderate headwind. In Europe, talk of tapering quantitative easing (QE) arose, as the European Central Bank (ECB) reaches the limits of its available bond purchase pool. Similarly, the Bank of Japan (BoJ) remained deficient in reaching its inflation goal and is now attempting to navigate the uncharted waters of yield curve targeting.

In the U.S., the election cycle has outlined promises of significant policy changes from both candidates. Regardless of the outcome of the election, important ramifications await the economy and markets, as we anticipate policy focus moving from the monetary to the fiscal. One implication of more fiscal spending may be the catalyst for a change in inflation expectations over time, as fiscal policy has a solid chance of increasing inflation through consumption of goods and services. Further, fiscal investment on infrastructure should prove a material tailwind for the sector and provide an opportunity to attract investors to the infrastructure asset class.

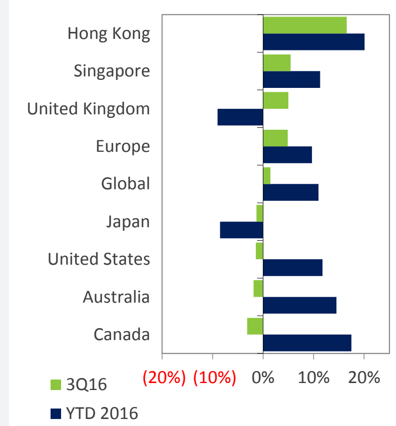
At the end of the third quarter of 2016, we find ourselves in what seems like a holding pattern for markets. But this holding pattern does not necessitate inaction. Long-term secular trends have emerged and seem to be dictating a number of investment opportunities, as clear winners and losers surface.

SEEKING OPPORTUNITIES VIA SECULAR DEMAND TRENDS

We acknowledge that the cyclical aspect of investing is always uncertain, but a number of secular demand patterns and opportunities have emerged that we believe will have a significant impact on real assets in the short and medium term.

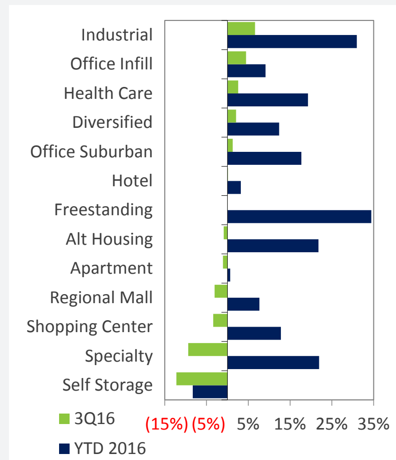
3Q16 PERFORMANCE REVIEW

FTSE EPRA/NAREIT DEVELOPED INDEX



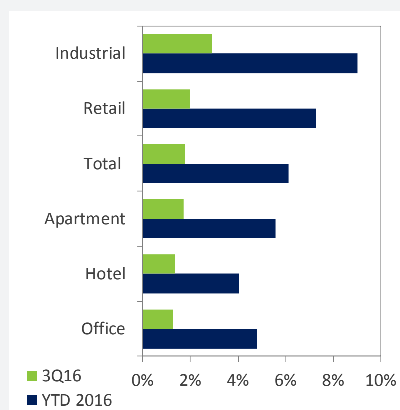
All returns in local currency.
Source: Bloomberg, FTSE, October 2016

FTSE NAREIT EQUITY REITS INDEX



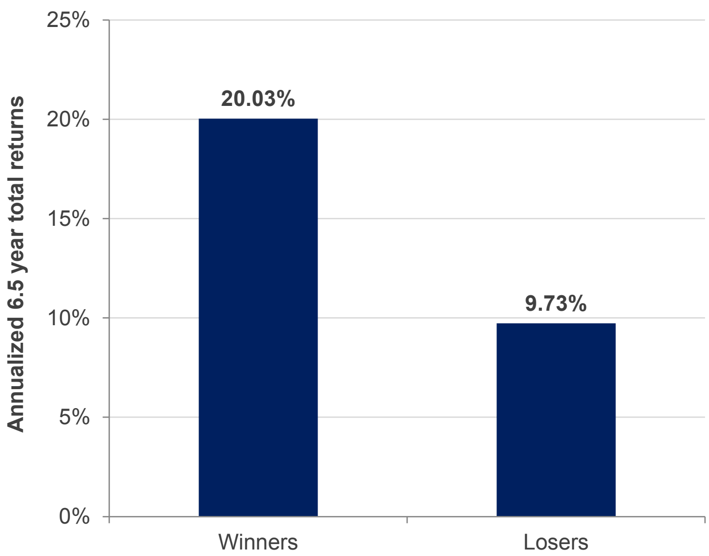
Source: Bloomberg, FTSE October 2016

NCREIF PROPERTY INDEX



Source: NCREIF, October 2016

Figure 1 - Annualized Total Returns of Technology Disruption Winners and Losers (12/31/09-06/30/16)



Source: CenterSquare, FTSE NAREIT Equity REITs Index, as of June 30, 2016. CenterSquare defines "winners" as companies whose sector and geographic focus have been positively influenced by technology, observed as positive net absorption as a result of technological advancements. "Losers" are companies focused on property types and geographies that have suffered from negative net absorption as a result of technological advancements. Companies classified as "neutral" have real estate exposure where there is no clear positive or negative impact. For the purposes of this analysis, the market was divided by market capitalization and was based on the FTSE NAREIT Equity REITs Index. Past performance is not indicative of future results.

For example, we recently studied the way that technological disruption has impacted the U.S. REIT market, attempting to identify the sectors and trends most likely to benefit from this major shift in secular demand trends. To do so, we identified a number of real estate sectors that either benefitted from or were scourged by the technological disruption that has redefined the way we live in a modern society. Sectors benefiting from this digital evolution include high barrier office (particularly with a West Coast focus), apartments, high-quality retail, industrial, and data centers. Those impacted negatively include suburban office, homebuilders, and commodity retail. In retail, online shopping is significantly and negatively impacting lower quality retail as more and more sales move online. Conversely, technology has buoyed the industrial and datacenter sectors— the infrastructure of ecommerce—which have evolved to facilitate the new way that we shop and conduct business. As shown in Figure 1, these trends have meaningful impacts on returns – investing only in those REIT sectors identified as "winners" would have doubled an investor's annualized returns since the Global Financial Crisis.

While REITs with exposure to technology and urbanization trends have significantly outperformed, underwriting secular demand is not enough. The effects of supply on real estate are ever present and merit careful consideration. Following years of strong performance in high barrier apartments, this sector is now experiencing a material supply response, as significant increases in values and rents over the past eight years mean that underwriting new development now makes sense. In fact, market rents in high barrier cities are now at or above replacement cost rents in many instances. As a result, as shown in Figure 2, the cap rate differential that had accumulated between high and low barrier markets has now disappeared as high barrier apartment REITs have underperformed. This reflects emerging investor trepidation regarding the future growth prospects of these higher barrier apartment markets, as landlords lose pricing power in the face of new construction.

BEYOND THE GATEWAY

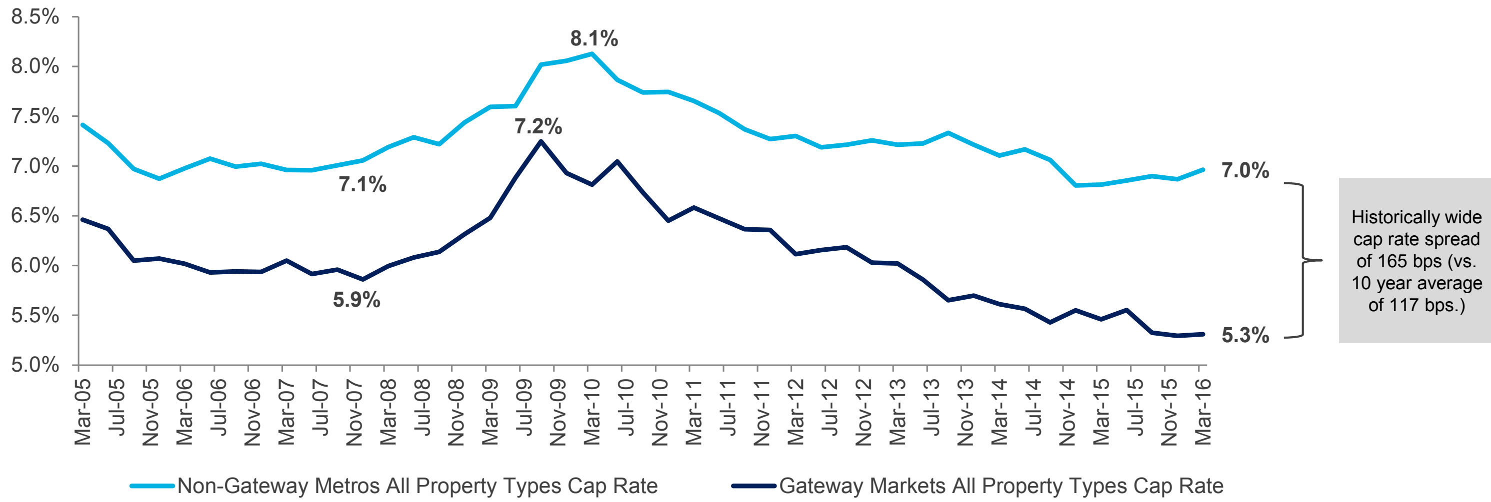
The pricing moderation observed in the apartment REIT sector as a response to supply is to some extent foreshadowing what we expect in the direct real estate market, where cap rate spreads between gateway and non-gateway markets in general are historically wide (see Figure 3). One of the unique aspects of this cycle has been that high barrier markets are where most of the supply is actually being built. In a sense, gateway markets are victims of their own success, as this supply is following 8+ years of strong returns and growth in rents and valuations.

While these trends are concerning, it is important to note much of the supply has already been discounted into stocks; REIT markets have forecast some moderation in the significant deviation in valuation between gateway markets

Figure 2 - Apartment Implied Cap Rate Spreads

Source: Green Street, as of June 30, 2016

Figure 3 - Cap Rates in Gateway and Non-Gateway Markets



Source: Real Capital Analytics, as of Q1 2016

and other primary cities. In our direct real estate business, we are focused on investing the marginal dollar on non-gateway primary cities where we see more value and less risk at this point in the cycle.

REIT PERFORMANCE

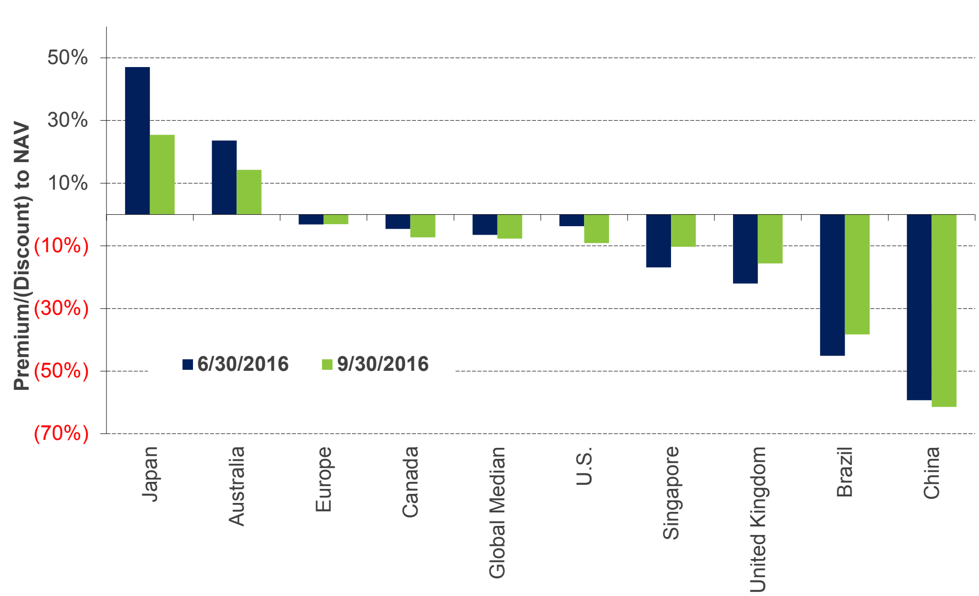
Global REITs started the third quarter strongly, gaining about 5% from a market rebound post-Brexit. However, September saw a retreat in performance, related to concerns surrounding a likely U.S. Federal Fund rate hike and QE tapering in the European Union (EU). Although REITs finished the quarter in positive ground, up 1.4%[1], they further sold off into early October. Hong Kong developers and landlords were the strongest performers, while Canadian REITs floundered. Net asset values (NAVs) grew precipitously in Japan and to a lesser extent in Australia, while China remained the cheapest for a reason. However, most regions appeared attractively priced by the end of the period, as shown in Figure 4.

NORTH AMERICA

United States

U.S. REITs underperformed during the third quarter, down 1.4%[2] and faring worse than the S&P 500 and Dow Jones Industrial Average Indices, which were up 3.9 and 2.8%, respectively. Industrial and prime office led the group as both sectors saw demand outpace supply. Storage was the clear loser, down over 12%, as fundamentals began to normalize after several years of significantly outsized growth. The specialty sector fared poorly, as prison REITs declined and data center darlings gave back some of their prior period gains. During the quarter, U.S. REITs traded at a slight discount to NAV,

Figure 4 - Premiums / Discounts to NAV - 3Q16 vs. 2Q16 by Region*



Source: SNL Financial, October 2016. The companies comprising each country shown are based on SNL Financial's universe of real estate securities domiciled in each country.
** Calculated using company-reported NAV with the exception of the U.S. and Canada, which are calculated using an average of consensus NAV estimates.*

[1] Source: FTSE EPRA/NAREITDeveloped Index, 9/30/16.
[2] Source: FTSE NAREIT Equity REITs Index, 9/30/16.

had a significant yield spread to the 10-year U.S. government bond relative to history, and held a slightly discounted multiple relative to the S&P 500. Given the low U.S. rate environment and persistently low cash interest rates globally, we are surprised U.S. REITs are trading at discounted valuations.

Overall, U.S. real estate fundamentals remain on stable footing but should continue to trend to more normal growth levels as the cycle matures. We expect the upcoming election will add to market volatility and investors will continue to price in a December Fed Funds rate hike. Again, we anticipate companies within sectors that possess secular demand trends and/or superior organic growth to outperform companies that rely heavily on accretive acquisitions for growth.

Canada

Canadian REITs gave back some previous outperformance during the quarter as fundamentals continued to be challenged in both office and retail sectors. However, we believe that the Canadian real estate sector should benefit from a continued low interest rate environment despite low growth and economic uncertainty.

EUROPE

The United Kingdom

Brexit continued to take center stage in the United Kingdom during the period, as the government is expected to invoke Article 50 by the end of the first quarter of 2017; a process that will likely dominate regional economics. While in the short-term we remain worried about the U.K. economy, cyclical office and residential stocks are already trading at attractive discounts, suggesting that some risk is already priced in. Alternatively, retail and less cyclical niche sectors should see little weakness and perform well in the lower yield environment.

European Union

The ECB disappointed in the third quarter with no further extension of stimulus, and rumors of possible QE tapering drove the market down. European gross domestic product (GDP) growth appeared to continue its deceleration with a 1.3% forecast for 2017[3]. Additionally, anti-EU sentiment has increased in many countries post-Brexit; the Italian constitutional referendum vote in December will be the next major test, followed by French and German elections in 2017. Going forward, we expect stable-to-moderately tightening yields within the EU, with little rental growth outside German residential and the Nordic region.

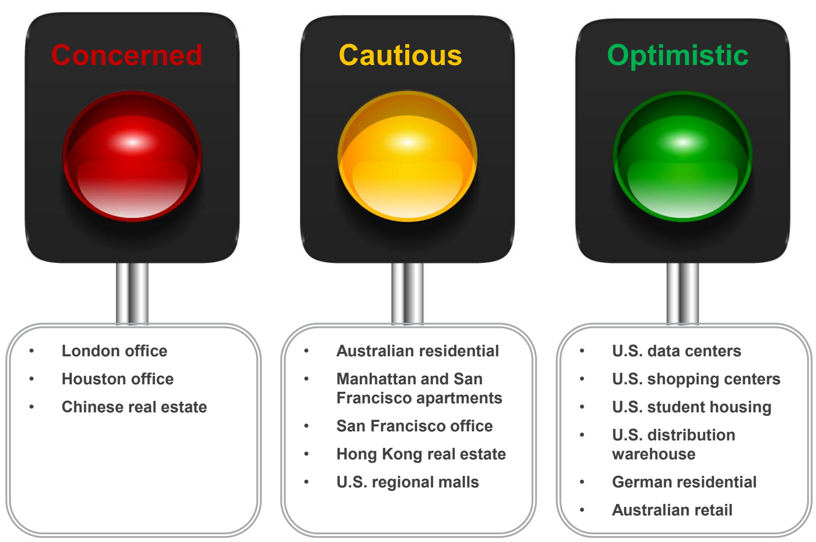
ASIA-PACIFIC

Hong Kong / Singapore

In Hong Kong and Singapore, two primary themes dominated the quarter: 1. Brexit and the expectation that it would lead to a lower-for-longer interest rate environment globally; and, 2. China's economic growth imbalances. Lower-for-longer rates led to a rise in Hong Kong residential sales volumes and prices, which benefitted Hong Kong developers and landlords, as well as Singapore REITs. China also saw residential volumes and prices perform strongly, particularly in Tier 1 and larger Tier 2 cities, as the government relied heavily on real estate investment to shore up GDP growth.

As we move into the fourth quarter, we expect that residential sales in this region will slow as the likelihood of a fourth quarter Federal Reserve rate hike intensifies. Singapore continues to struggle with a weakening economy, depressed demand, and elevated supply across most sectors. Likewise, prices and rents in all sectors except business parks are likely to decline due to weak fundamentals. Hong Kong, in general, is caught between the U.S. rate hike and a slowing China. Although Beijing continues to support GDP growth through public infrastructure investment, concerns surrounding the resulting structural imbalances have driven investor trepidation. Additionally, we expect the Chinese market to further slow as local governments implement tightening measures to cool price growth in some overheating areas.

Figure 5 - REIT Market Risk Check



Source: CenterSquare, October 2016

[3] *Source: Focus Economics Consensus Forecast, October 2016.*

Japan

In Japan, the BoJ reaffirmed its commitment to achieving sustained inflation but shied away from further intensifying its accommodative policy stance. Markets subsequently sold off, and a rebound is not apparent unless global economic drivers start to improve. JREITs and real estate stocks struggled, particularly retail and hotels, as did developers, who often trade in line with inflation expectations. Additionally, Japan's real estate environment is starting to weaken as demand remains muted, and supply-fuelled by low cap rates-is picking up across most real estate sectors. Recent organic growth in the office sector may stagnate due to new supply concerns, though logistics are likely to remain stable despite increasing volume.

We expect that the BoJ's decision will cause a flatline in earnings growth until Japan's economic environment begins to improve, weakening the outlook for organic growth across most sectors, and causing us unease regarding Japanese developers and JREITs.

Australia

Australia's economy is growing, thanks to public infrastructure spending, stable consumption rates, and residential investment. In fact, Australian residential sales proved more resilient in the first three months of 2016 than expected. However, although demand remains healthy, supply will likely increase over the next few years.

A recent selloff in the AREITs, which we believe to be transitory in nature, shifted our focus toward retail and office. Sydney's office market benefited from tightening supply and robust demand supported by sustained economic growth, which will likely continue well into 2017.

CONCLUSION

However, the outlook that we put forth at the start of 2016 anticipating a continuance of the low-growth, low-interest rate macroenvironment seems to be playing out. The U.S. Federal Reserve has adhered to a tempered course of interest rate hikes, and long-term bond yields remain-and will likely remain very low.

As the cycle progresses, we are paying attention to the key secular demand trends most likely to impact real estate, increasing exposure to beneficiaries of technological disruption, urbanization, and other trends. In the broader real assets market, we are also attracted to listed infrastructure companies poised to participate in America's quiet infrastructure boom—the modernization of the country's energy, electricity, transportation, and telecommunications. Lastly, we believe that real estate in general is likely to continue to benefit from top-line cash flow growth, and do not currently see a significant threat from long-term interest rates.

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FTSE NAREIT Equity REITs Index

The FTSE NAREIT Equity REITs Index is a free float market capitalization-weighted index measuring equity tax-qualified real estate investments trusts which meet minimum size and liquidity criteria and are traded on the New York Stock Exchange, the American Stock Exchange, and the NASDAQ National Market System. The performance presented is based on total return calculations which add the income a stock's dividend provides to the performance of the index and is gross of investment management fees. The FTSE NAREIT Equity REITs Index is part of the FTSE NAREIT U.S. Real Estate Index Series.

FTSE EPRA/NAREIT Developed Index and Developed ex-U.S. Index

The FTSE EPRA/NAREIT Developed Real Estate Index Series covers both the FTSE EPRA/NAREIT Equity Index and the FTSE EPRA/NAREIT Developed ex-U.S. Index. Designed to track the performance of listed real estate companies and REITs worldwide, the series acts as a performance measure of the overall market. The performance presented is based on total return calculations which add the income a stock's dividend provides to the performance of the index, and is gross of withholding taxes and investment management fees. The index changed names on March 23, 2009, and was formerly known as the FTSE EPRA/NAREIT Global Real Estate Index.

NCREIF Property Index

The National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index is a quarterly time series composite total return measure of investment performance of a very large pool of individual commercial real estate properties (apartments, hotels, industrial properties, office buildings and retail only) acquired in the private market for investment purposes.

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