CenterSquare
INVESTMENT MANAGEMENT

Entrepreneurial Culture, Institutional Strength.

E. Todd Briddell, CFA, Chief Executive Officer and Chief Investment Officer

TRUMPING THE NEW NORMAL

A rendering of the tower under construction known as One Vanderbilt in New York City. PHOTO: SL GREEN REALTY CORP

Financial markets in the fourth quarter of 2016 were dominated by the U.S. Presidential election and the anticipation of a U.S. federal funds rate increase. With the election of aligned U.S. executive and legislative branches, markets reacted to assumed policy shifts toward fiscal spending, lower taxes, and reduced regulatory burdens, happening at a time of re-acceleration in the U.S economy and stabilization in emerging markets. The 25 basis point federal funds increase in December and the signal of further hikes in 2017 was also easily digested.

There is an important shift occurring across markets following the events of the fourth quarter. From a cyclical perspective, the defining factors of the post-Great Financial Crisis (GFC) real estate market have been low interest rates, low supply, and low growth, and from a structural standpoint, urbanization, technology, and an emphasis on Gateway markets. However, we may be at the cusp of material change to these factors. As better growth and more inflation shapes the economy, as regulations are relaxed and policies advance from monetary to fiscal, the investing environment is changing. Likewise, the middle aging of Millennials is beginning to shift secular demand—away from multi-family and toward home ownership, for example. Continued technology penetration and a broadening of investor focus on non-Gateway markets are also creating opportunities for real estate investment. However, some sectors will likely face structural challenges this year, including the negative impact of technology on retail and hospitality, and of spending reform on healthcare. Combined, these factors may reduce real estate returns from the double digits witnessed post-GFC to mid-single digits in 2017.

THE SECOND HALF OF THE CYCLE

U.S. commercial real estate appears to be exiting a mid-cycle slowdown and entering into the second half of the cycle. This is exemplified in the comparison between

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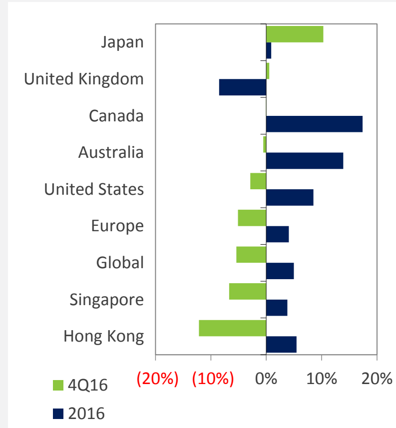
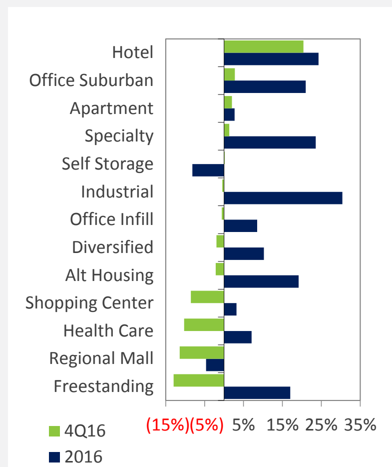
4Q16 PERFORMANCE REVIEW

FTSE EPRA/NAREIT DEVELOPED INDEX



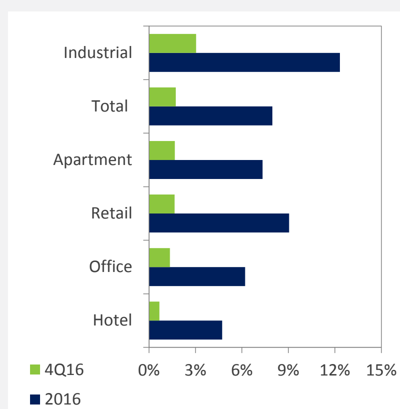
All returns in local currency.
Source: Bloomberg, FTSE, January 2017

FTSE NAREIT EQUITY REITS INDEX



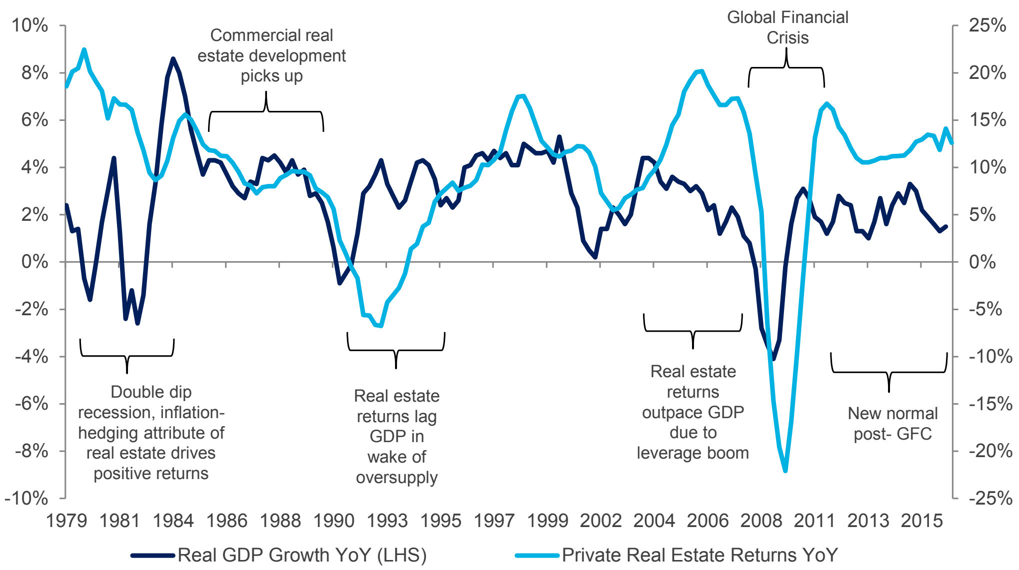
Source: Bloomberg, FTSE January 2017

NCREIF PROPERTY INDEX



Source: NCREIF, January 2017

Commercial Real Estate Returns and Economic Growth



The New Normal (post-GFC)	The Second Half of the Cycle
Low interest rates	More inflation
Low growth	Higher growth
Low supply	Policy shift from monetary to fiscal
Urbanization	Millennials middle-ageing
Technology Penetration	Continued Technology Penetration
Investor concentration in gateway markets	Broadening focus to major non-gateway markets and development

Source: Private Real Estate is represented by the NCREIF Property Index. GDP and NCREIF quarterly data from June 1979 through September 2016. Past performance is no guarantee of future returns.

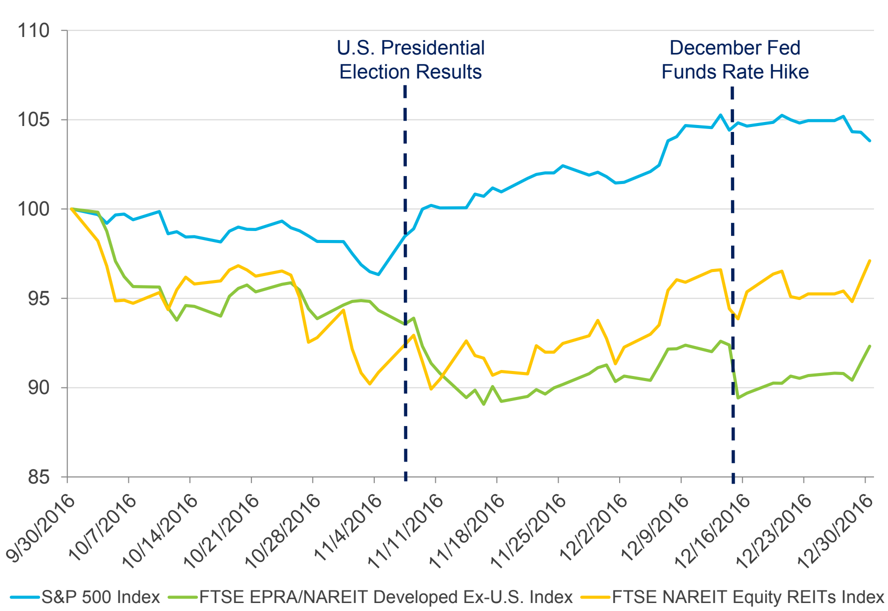
current market behavior toward monetary tightening vs. just a year ago. At the end of 2015, the prediction of four interest rate hikes popped bubbles in commodities and emerging markets, producing a feedback effect on the U.S. capex cycle and credit spreads, which moved to dangerous levels. That is not the case today. The oil complex is improved following supply rationalization and emerging markets have moved beyond economic low points. We believe this second cyclical half will be supported by numerous tailwinds such as greater demand, higher rents, and increased credit availability, despite the moderate drag of higher base interest rates.

When viewed in a vacuum, higher interest rates can be a headwind for real estate as they negatively affect values through upward pressure on yields. However, markets don't exist in a vacuum. Higher interest rates imply higher growth, which is positive for real estate cash flows. REITs are already showing encouraging evidence of resilience despite one of the fastest increases in 10-year Treasury yields in decades, with share prices up over 6% since the U.S. Presidential election[1]. Also, despite base rate increases, credit spreads have narrowed. We believe this year will be transitional as we move away from low interest rates assisting cap rate compression and low supply assisting net operating income (NOI) growth. Instead, U.S. real estate markets now face a backdrop of higher interest rates and the first meaningful supply response since the GFC. If expected deregulation policies are enacted, access to debt capital will improve, increasing capital flows from the financial system and proving positive for real estate values and development.

REIT PERFORMANCE

The two dominant stories of 2017—the U.S. Presidential election and the federal fund rate hike—greatly influenced

Equity and REIT Markets in 4Q 2016

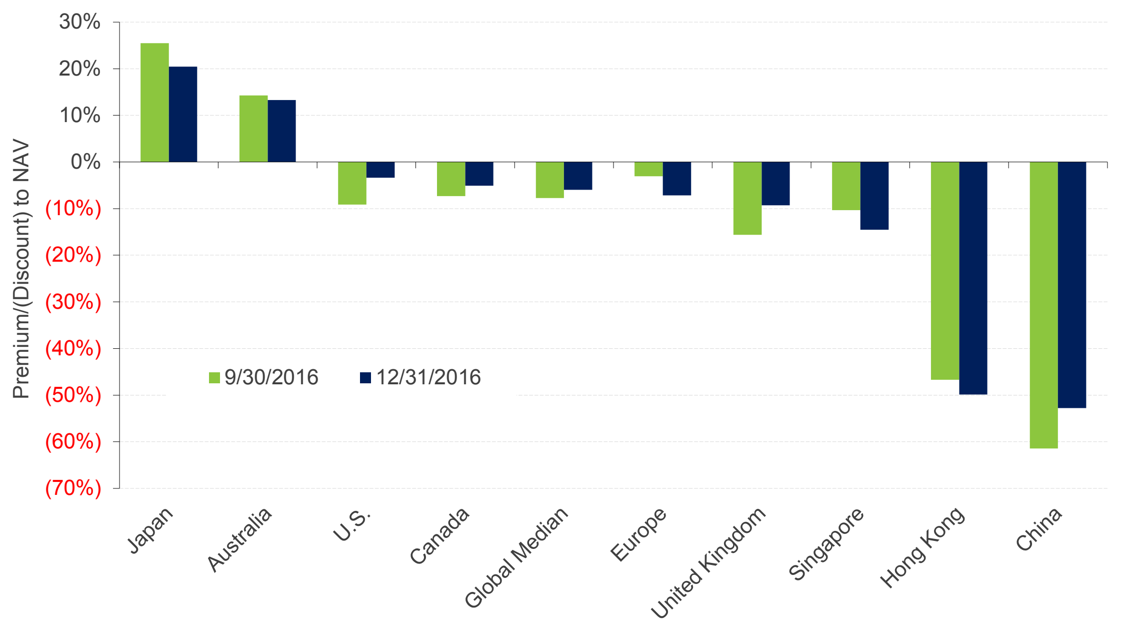


Source: CenterSquare, Bloomberg, FTSE, S&P, January 2017.

[1] *Source: Returns based on the FTSE NAREIT Equity REITs Index for the period from 11/8/2016 - 1/20/17. The 10-year U.S. Treasury yield increased by 61 bps in the same period.*

REIT performance in the fourth quarter of 2016. Both U.S. and ex-U.S. REITs dropped nearly 5% in the first week of the quarter, and U.S. REITs continued to fall an additional 5% in the lead-up to the election. Although still declining immediately post-election, U.S. REITs slowly rebounded through December's rate increase, finishing the quarter down about 3% with mean reversion affecting numerous sectors. International REITs also dropped post-election but rallied after the Fed hike, although currency produced a tangible weight on performance. From a valuation perspective, at the end of the year, Japan and Australia were the most expensive in terms of premium to net asset value (NAV), while China, Hong Kong, and Singapore remained discounted.

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



Source: SNL Financial, January 2017. 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.*

NORTH AMERICA

U.S. In the United States, listed real estate performance remained on stable footing given continued employment growth, high occupancy, and rational levels of supply. Hotel stocks were clear outperformers, up 20% on growth expectations and from discounted valuation levels. Alternatively, long-duration assets such as freestanding retail and health care were out of favor, down over 10% given the 10-year bond rate increase and outlook for higher inflation. Both regional malls and shopping centers also fell significantly on fears of the increasing market share of e-commerce relative to bricks-and-mortar retail.

From a valuation perspective, at the end of the fourth quarter, REITs were trading at a discount to NAV, and maintained a significant yield spread to the 10-year U.S. government bond relative to history, in spite of the climbing 10-year yield. Relative to equity multiples, REITs were in-line with the Standard & Poor's 500 Index, representing a significant discount to the relative multiple witnessed over the past decade.

Looking forward, the new administration's first 100 days will be crucial in setting market expectations and providing clarity on policies that may significantly affect various sectors and geographic regions. Overall, we expect companies within sectors that possess shorter lease duration, higher potential growth, and longer-dated liabilities to outperform. We continue to favor apartments as well as shopping centers due to attractive valuations, and are bullish on hotels' positive cyclicality despite a neutral valuation. Within retail, we believe prime shopping centers offer the most attractive risk-versus-reward profile, as demand remains strong yet supply is near all-time lows. Data centers will likely continue to experience strong demand regardless of shifts in the economy, and industrial is expected to benefit from e-commerce. Conversely, net lease companies and low-quality malls negatively impacted by e-commerce do not appear poised for growth.

EUROPE

The United Kingdom

Brexit continued to be a major driver of both United Kingdom and European real estate performance. A recent U.K. Supreme Court ruling that forces a Parliamentary vote to exit the European Union (EU) could complicate matters, although we still expect the formal departure process to begin by the end of the first quarter.

Despite the proceedings, the U.K. economy remained robust; 2016 gross domestic product (GDP) growth is likely to be the strongest amongst the G7 countries, and is expected to continue its trajectory despite Brexit. A significant rebound in U.K. stocks transpired after the Brexit sell-off, led by industrials and particularly buoying office names, as earnings beat expectations. While we expect continuation of capital value and rental declines in London office and residential over the coming quarters, niche markets such as healthcare and student accommodation should prove more resilient. Stocks overly discounted since the Brexit vote provide valuation opportunities as well.

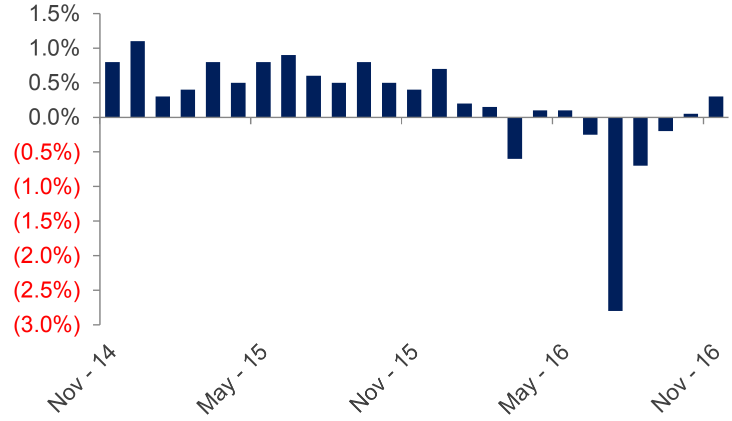
European Union

Europe is in the midst of a major election year, with upcoming votes in France and Germany holding great importance, as the potential for anti-EU wins could drastically reshape Europe's future. In light of this, the French economy appears riskier, while the Nordics and the German residential sector should be fairly insulated from political uncertainty and continue to see healthy rental growth. Select periphery markets are also currently attractive; for example, Ireland should benefit from Brexit and Spain's market has seen some recovery.

We expect overall economic growth in the EU to slow but remain positive, although there could be wide variations dependent on the election results. Inflation appears likely to rise from a low base, leading to further tapering of quantitative easing, but we expect a stable interest rate environment for the remainder of 2017.

IPD UK Capital Value Growth

UK capital values recovered since Brexit, led by Industrial



Source: IPD, December 2016.

ASIA-PACIFIC

Hong Kong / Singapore

The outcome of the U.S. election and expectations for tightening U.S. monetary policy led to the broad-based sell-off in Singapore and Hong Kong, whose monetary policies are linked to that of the United States. Fearing a housing bubble, Hong Kong doubled its stamp duty on property purchases, forcing a pullback after a gangbuster year of surging prices and volume of residential units. Hong Kong's retail sector appears to have bottomed with falling sales starting to stabilize and the Central office market remaining tight with sub-2% vacancy. In Singapore, housing unit prices continued to fall and demand remained weak, while supply of commercial space in office, retail, hotel, and industrial continues to be delivered at a high level, leading to a challenging market. However, recent merger and acquisition activity in Singapore's industrial segment propped up the market, with industrial-exposed names now trading at premiums.

China

In China current monetary policy is less accommodative than last year as Beijing continues to support GDP growth via public infrastructure investment. In early 2016, easing measures inclusive of incentives and loosening restrictive debt policies were introduced, reducing the risk of a cooling residential market; volumes and prices surged in response. In the latter half of the year, new restrictions were imposed in Tier 1 and certain Tier 2 markets, leaving a bubble in lower-tier markets. This less-accommodative move may lead to a potentially slowing market in 2017.

Japan

The Bank of Japan's monetary easing policy remains in place, as policy to create inflation was unlikely to succeed with steady oil prices and slow global growth. The hope is that a tightening labor market will drive higher wage growth, which in turn will translate into consumption and rising inflation. During the quarter, discounted Japanese developers saw strong performance via a weakened Yen but remain dependent on the broader macro-economic environment. Concern surrounding impacts from deliverable office supply over the next few years also affects our outlook on Japanese REITs.

Australia

In Australia, economic data indicated weaker consumer sentiment and spending. This, paired with a peaking property market, led to concerns of slowing economic growth over the next 12 months. Declining mining capex in Western Australia continues to leave Perth in a tough spot, but conditions appear to have bottomed after a large plunge in office rents; prospects may start to gradually improve as several years of non-economic leases are coming. Sydney remained strong after a year of flat rent and rising concessions. Retail and residential also remained healthy in Australia's largest city, and industrial is patricularly strong, due to limited supply and removal of properties for better use and residential conversion. Melbourne was robust as well, although supply is leading to weak residential and industrial performance. We remained concerned about Australian retail in general, but are optimistic about flagship assets with very high sales productivity in long-term desirable locations.

2017 AND BEYOND

In 2017, we expect the key market drivers will shift from central bankers to politicians as the potential for anti-EU wins in European elections may create elevated risk for global markets. Likewise, an increasingly unilateral stance by the U.S. government toward trade may erode globalism over the coming months. Expectations of at least two U.S. federal rate hikes will have important consequences globally as tighter monetary policy will translate via a strengthening U.S. dollar, although we do not anticipate a repeat of the dollar-induced market sell-off witnessed about a year ago. Long-term bond yields are likely to moderately increase due to low rates internationally and still-moderate domestic inflation.

As for REITs, again, higher interest rates imply higher growth, a positive for real estate cash flows and valuations. We believe that real estate and REIT markets have already discounted the factors that should moderate returns in the underlying real estate markets in 2017, and should continue to show growth even with interest rate increases over the next couple of years.

We also expect the cycle to be propelled by greater supply and demand for credit. We do not foresee any significant increase in capitalization rates, given the cushion offered by the significant risk premium to bonds and the benefit of declining credit spreads; we believe cap rate compression is over for the time being.

The defining cyclical factors of the real estate market have begun to change, ushering in new areas of growth and shifting secular demands. Infrastructure is likely to gain from increased investment and relaxed regulations, presenting an investing opportunity well worth exploring. Prime ex-Gateway markets will likely be buoyed by a broadening recovery and oversaturation in some Gateway REIT markets. Despite declining fundamentals in the apartments and retail sectors, valuations are still attractive and worthy of attention.

Looking past 2017, we believe REITs offer an inexpensive entry point into the reflation cycle, as real estate will be a beneficiary of U.S. domestic expansion. As the economy improves and markets digest the near-term supply, NOI growth is likely to re-accelerate. We believe that there are still many years left in this real estate cycle, with the ultimate conclusion likely marked by a significant supply increase as a result of strong economic growth, looser lending standards, and the fundamental need for new commercial real estate infrastructure to accommodate the new economy. However, between now and the inevitable end of the cycle, we forecast higher real estate values as we move through a transitional 2017 and into more interesting times ahead. REIT investors may have the benefit of a discounted entry point that offers the potential for returns in excess of a moderating position in the private real estate cycle.

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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 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.

S&P 500

The S&P 500 is an index that is considered to be a gauge of the U.S. equities market. The index includes 500 leading companies spread across the major sectors of the U.S. economy. The index focuses on the larger cap segment of the U.S. market and represents approximately 75% of the market capitalization of U.S. securities. The index is the most notable of the many indices owned and maintained by Standard & Poor's, a division of McGraw-Hill Companies.

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