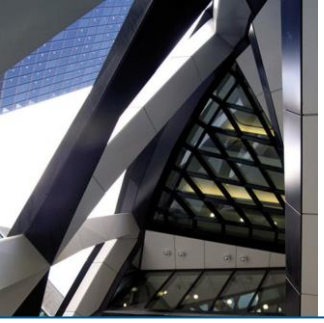

Helaba

REAL ESTATE REPORT

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US real estate market: in a mature phase

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- Although the rise in US housing prices has already reached a remarkable extent, a change in the trend is not evident so far.
- In the US office real estate market rents have increased only modestly, quite in contrast to the robust rise in property values.
- Commercial real estate credit is lagging the economic cycle and so far is not showing any imbalances. It is therefore likely to still be some time until the end of the cycle.

1 At a glance **1**
2 Selected real estate analyses **2**
2.1 US housing market: on the way to old heights? 2
2.2 Office market: a rather tired upswing 3
2.3 Credit market: from the peak on, it's downhill 4

1 At a glance

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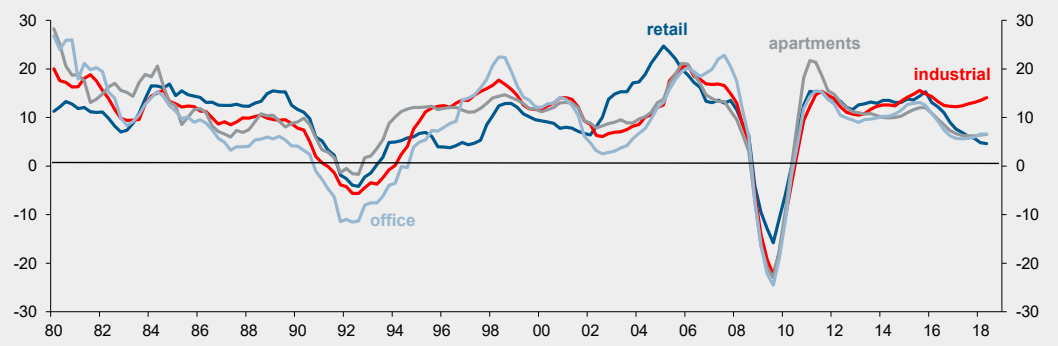
Normalisation, but still no end to the upswing

NCREIF real estate index, total return, % y/y



Sources: NCREIF, Helaba Research

The US real estate market is in the late phase of a long-term upswing. Measured in terms of the total return (which comprises capital growth and income return) on commercial real estate, the real estate index of the NCREIF association has now been in positive territory for eight years since the collapse as a result of the financial crisis. After more than five years with persistently high total returns in the double-digit range, a normalisation has taken place since the beginning of 2016. Of the most important property types performance has declined most markedly for retail properties. Only industrial properties, which are benefiting from, among other things, the growth of e-commerce, continue to show a strong performance. Despite the advanced stage of the cycle, an end to the price increases does not seem to be imminent thanks to the robust economy and still low interest rates. At 7.2 % in the second quarter of 2018, the total return across all property types was roughly at the level of the previous quarters.

2 Selected real estate analyses

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2.1 US housing market: on the way to old heights?

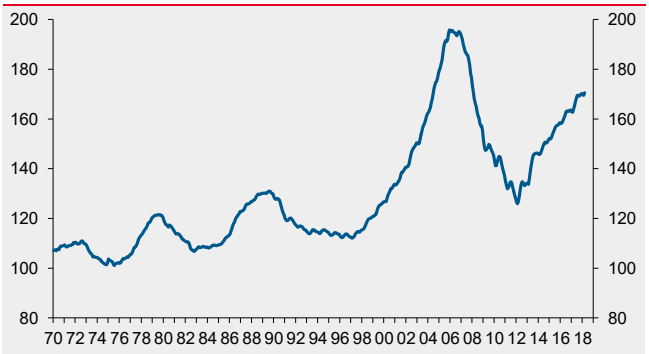
The current upswing in the US housing market is remarkable. However, both the size as well as the duration of the rise in prices clearly lags behind the last boom. At this time there is little to suggest a change in trend any time soon.

US housing prices continue to rise unchecked

Since the global financial crisis began a good ten years ago with subprime loans in the USA, the housing market there has drawn particular interest. And as in the last boom, the price increase for homes has now reached a remarkable extent again. The Case-Shiller Composite Index, which covers prices in a total of 20 conurbations, has risen continuously since its low in spring 2012 and, according to the latest reading in May, was 3 % above its historic high in 2006. In fact, with an increase of 6.5 % compared to the previous year, the prices have even accelerated slightly since mid-2016 (5 % y/y). In inflation-adjusted terms the picture does not look quite as spectacular (see chart on the left). Here, the increase of US home prices has so far reached a total of around 35 %, compared with 74 % in the upswing before the financial crisis. The duration of the phase of rising house prices is also still significantly shorter than in the years 1997 to 2006 (116 months back then, compared to 74 months this time).

Home prices are once again amibitious...

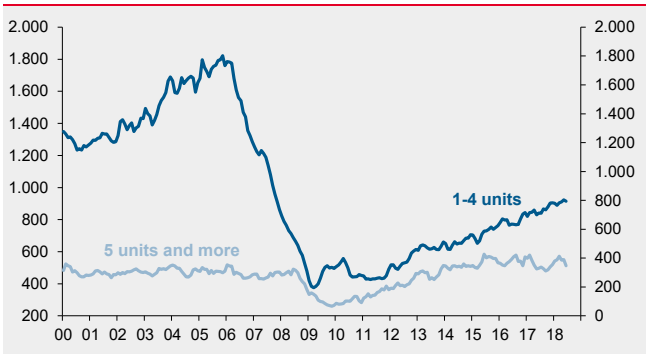
Real house prices USA, index



Sources: R. Shiller, Irrational Exuberance, Helaba Research

…but housing construction activity is still moderate

Housing starts, thousand units, 3mav



Sources: Datastream, Helaba Research

No exaggerations on the supply side

So far, a number of indicators on US residential construction activity argue against an excessive expansion of the housing supply. For example, investment in residential construction rose only moderately last year at 3.3 % in real terms. Data for the first half of 2018 even show a decline, while the economy as a whole has recently gained considerable momentum. At just under 4 %, construction intensity, measured in terms of residential construction investment as a percentage of GDP, is quite low – it averaged 6 % between 2003 and 2006. The number of housing permits, housing starts, and completions has also been rising for years, but is currently only slightly more than half as high as during the last boom phase. Only in the smaller segment (in volume terms) of residential buildings with five or more units has the supply already been significantly expanded, so that vacancy rates could increase slightly from low levels. By contrast, the owner-occupied housing segment still has a lot of room for improvement. After several years of decline, the home ownership rate has long since bottomed out and has recently risen slightly to 64.3 %. This is creating increasing demand for homes, even if a return to the high of 69 % is unlikely in view of the negative experiences in the recent financial crisis. Higher house prices against modest wage increases and rising mortgage rates could further reduce the affordability of home ownership. Mortgage rates with a 30-year fixed-interest period have already risen by a good percentage point since the end of 2016 from around 3½ %, but are still well below the 20-year average of 5.4 %.

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2.2 Office market: a rather tired upswing

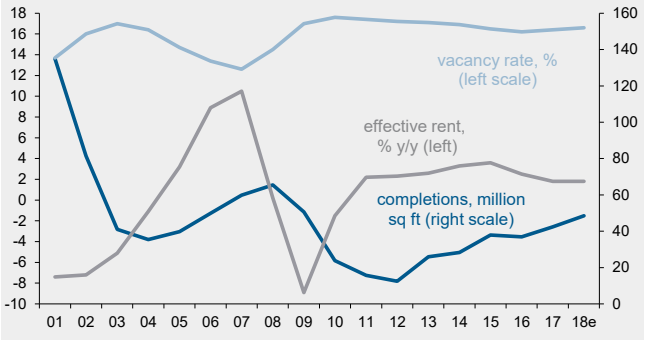
The office rental market in the US has profited only little from several years of rising employment. Modestly increasing office rents and a still high vacancy rate across the country contrast with robustly higher real estate values.

High vacancy rate, moderate rise in rents and construction activity

The economic conditions for the US office market are actually very positive. The economy is running smoothly and has recently gained considerable momentum once again thanks to additional fiscal stimuli. After real GDP growth of 2.2 % in 2017, around 3 % is expected for the current year. Although the labour market recovered quite slowly in the first years after the financial crisis compared with earlier cycles, it has long since closed in on full employment with an unemployment rate of around 4 %. The office market should also have benefited from the continuous annual increase of two to three million jobs since 2011 (which so far totals more than 19 million). In fact, however, the recovery here is slow. Construction activity has increased since the record low for office completions in 2012, but remains at a low level, especially compared to earlier upswing phases – especially compared to the very high completion volumes at the beginning of the millennium. Nevertheless, there has been no significant absorption of office space in recent years. The more efficient use of office space is also likely to have played a role here. As a result, the national vacancy rate has declined only by a modest percentage point from an average 17.6 % since its peak in 2010. The increase in effective office rents is also modest this year, averaging around 2 %, as in the previous year.

Stubbornly high vacancy rate

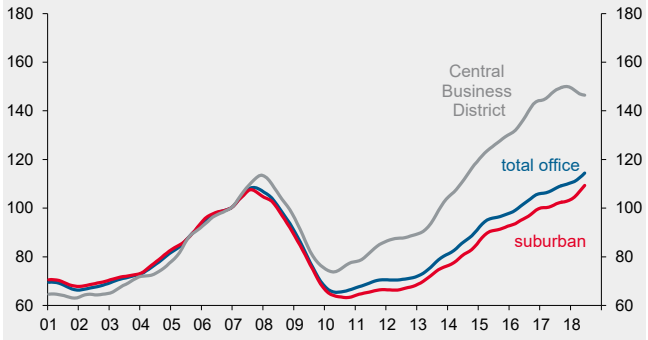
% or % y/y — million sq ft



Sources: REIS, Helaba Research

Real estate prices running well ahead

RCA commercial property price index, 12/2000 = 100



Sources: RCA, Helaba Research

The development of the leading office centres varies considerably depending on the regional employment structure, but is usually better than the national average. Thus, the vacancy rate in San Francisco, which is characterized by the technology sector, is only just under 10 % and rents here are increasing significantly, at 4 % y/y. The New York conurbation has an even lower vacancy rate of around 8 %. An exception among the largest office locations is Chicago, with above-average vacancy rates of around 18 % and a slight annual increase in office rents, at best.

Purchase prices no longer rising in the core segment

In contrast to the restrained development on the rental markets, the investment market is dynamic. Driven by low interest rates, office property prices have risen sharply in recent years – measured by RCA's real estate index by around 75 % since 2010. By contrast, office rents only increased by an average of about 20 %. Particularly high price increases were recorded in the best inner-city locations. Here, however, prices have not increased further recently, while less central locations are now catching up. A turnaround in the price trend on the entire office market is not yet discernible, but the air is becoming thinner. US monetary policy is unlikely to have a restrictive effect in 2019 and therefore also not impact the economy negatively. However, investment alternatives in the bond market are becoming relatively more attractive as the cycle of interest rate hikes progresses. This could dampen demand for already highly valued real estate investments and end the period of increasing prices.

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2.3 Credit market: from the peak on, it's downhill

The expansion phase for commercial real estate loans (CRE) is getting on in years. This market likely has seen its best days. However, it may take a few more years until the end of the cycle, as commercial real estate is lagging behind in the economic cycle – and no significant credit imbalances are yet discernible.

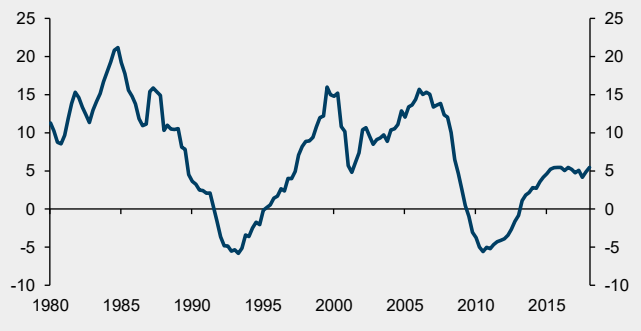
A slow-mo cycle

The CRE market is in some ways symptomatic of the current economic cycle in the US. Although the economic expansion has lasted an above-average nine years by now, late-cyclical excesses have so far largely failed to materialize. Despite record low interest rates, the outstanding volume of CRE loans recovered only gradually. At around 5 % y/y, growth rates in recent years were significantly lower than in previous cycles.

At this time it does not look as if the Fed will noticeably increase its pace of interest rate hikes. A restrictive interest rate level, usually a necessary condition for a correction in credit growth, is therefore far off. In real terms, i.e. adjusted for inflation, even the yields on 10-year treasuries are currently still negative. The default rates on CRE loans are close to their all-time lows. Here, too, the message is: things can really only get worse – the only question is when.

Credit volume: growth rates stable at 5 %

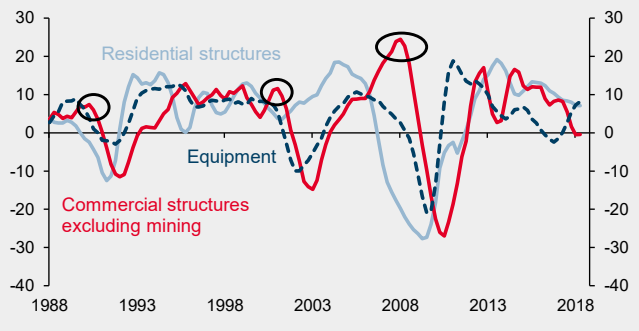
Commercial real estate credit, % y/y



Sources: Macrobond, Helaba Research

Commercial construction lagging behind in the cycle

Private investment, % y/y*



* Smoothed
Sources: Macrobond, Helaba Research

A breather in commercial construction?

Of course, the CRE credit cycle does not move "in a vacuum" – it depends on the real economy and especially on the ups and downs of the real estate sector. Most recently, the relevant macro data were distorted by a boom in the mining and energy sectors. For non-residential construction ex-mining, however, there is definitely a regular economic cycle. As a rule, it lags behind other demand and investment categories, certainly also because planning periods here are considerably longer than for residential homes or when purchasing a machine. In past cycles, commercial construction, at any rate, consistently was the last type of investment to turn downwards. Currently, the smoothed rate of change is noticeably lower – in Q2 2018 it was even slightly below the zero line. However, the year-on-year rates on most individual components of that series have now stabilized – the recent weakening of the overall category was due not least to a subsiding boom in logistics buildings. Growth rates in this segment had reached 40 % per year and more at times.

All in all, a picture emerges that points to an advanced position in the CRE cycle, though without its (ultimately unavoidable) end already becoming apparent in concrete terms. The risks to the overall economy and financial stability are therefore not negligible, but manageable for the foreseeable future. ■