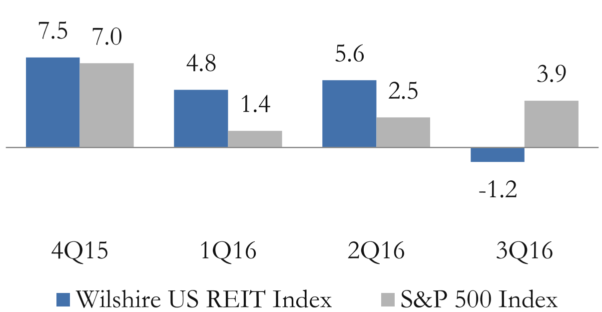
Brexit, Schmexit. To reverse paraphrase Ron Burgundy, that de-escalated quickly! Brexit, an event touted as the beginning of the end for the EU, quickly receded into the background as investors shifted from "the sky is falling" mode to "wait and see." While fall-out day one was immediate with the S&P 500 Index down 3.6%, the recovery was equally sharp; after some follow-through selling, global equities made a quick recovery and the S&P 500 Index closed one week later down just 0.5% from the pre-Brexit close.

Rapidly diminishing fears of a Brexit contagion, steady improvement of US employment, reports of a potential tapering by the ECB, continued insistence on a December rate hike by the FOMC, and growing consensus on prospects for fiscal stimulus globally all had the opposite effect on bond prices and the 10-Year Treasury Note yield crept back from 1.488% to 1.608% during the quarter.

The Wilshire US REIT Index ("Index") delivered a total return of -1.2% in Third Quarter, underperforming both the S&P 500 and Russell 2000 Indices which advanced 3.9% and 9.1%, respectively. The results of the various constituents in the Wilshire US REIT Index were mixed (68 out of the 115 constituents were positive) and there was significant dispersion in total returns with the best performing REIT, CBL & Associates Properties, Inc., returning 33.2% compared to -15.9% for the worst, CoreSite Realty Corporation.

REITs vs. S&P 500 Index (%)
Total Return



Source: Bloomberg and Wilshire Associates.

Sector Performance of the Wilshire US REIT Index
Ranked by Third Quarter 2016 Performance

Sector	3Q16	Trailing 1-Year	Current Yield
Office	3.5%	20.6%	2.8%
Industrial-Mixed	3.2	47.0	3.3
Health Care	2.4	22.0	4.9
Mfd. Housing	1.3	28.8	2.2
Diversified	1.0	13.5	2.6
Hotel	0.6	0.2	6.3
Industrial	-0.4	43.0	3.3
Wilshire US REIT	**-1.2**	**17.9**	**3.6**
Apartments	-1.3	10.5	3.2
Factory Outlet	-2.3	23.0	3.3
Regional Retail	-3.0	14.3	3.4
Local Retail	-3.8	23.8	3.3
Storage	-12.2	7.0	3.4

Source: Wilshire Associates.

Retail dominated the list of underperformers for a number of reasons: (i) sales figures from high profile apparel retailers continue to underwhelm, (ii) investors always get concerned before back-to-school and holiday seasons and (iii) both generalists and dedicated REIT funds loath to invest in retail landlords in the face of increasing threat from internet retail. However, both the National Retail Federation and the International Council of Shopping Centers are projecting decent sales growth in 2016 (3.6% and 3.3%, respectively) so investors may once again be underestimating bricks and mortar retail.

The real outlier of underperformance was Storage, however, trailing the Index by 11.0%! This Icarus of REIT sectors, having flown too close to sky high valuations, fell precipitously in Third Quarter based on concerns about supply and decelerating revenue growth. Unlike some of the other "core" property types, there is not very much reliable information on new supply in the various markets or a coherent narrative on what drives demand. As a consequence, investors at times are flying blind in a sector with short-duration leases; with most of the Storage companies still trading at premiums to NAV, this son of Daedulus may have further to fall.

The sun is still shining in the Sunbelt. On August 15, Mid-America Apartment Communities ("MAA") announced an all-stock deal to acquire Post Properties ("PPS"). PPS has long been considered a take-out candidate in the apartment space given its smaller, concentrated portfolio ($3.9B equity market cap with 24,000 units focused in the Southeast) so investors were not completely surprised to see the announcement. Given a 0.71 exchange ratio at the time of the announcement, the deal implied a ~$72.50 stock price for Post or a 17% premium to last sale and in-line with the NAV. At the time of announcement, Mid-America was trading at a 5% premium to NAV (as of June 30, MAA was the second most widely held name by Mid Cap Core managers at 36.4%) vs. Post's 15% discount and the 10% discount to NAV on average for the Apartment sector.

The transaction is strategic in nature for MAA as they look to upgrade their portfolio quality in key Sunbelt markets like Atlanta, Dallas, and Charlotte where Mid-America's existing portfolio is more suburban in nature. With overlap in asset footprint across different submarkets, MAA believes it can offer various rental price points which should be advantageous over a full apartment cycle. In addition, the Post portfolio provides MAA scale in those markets to create efficiencies and provide MAA opportunities to redevelop certain assets (as MAA did with the Colonial Properties portfolio which it acquired in 2013). Prior to the acquisition, Mid-America was not much of a developer but Post's development platform will give MAA a new avenue for growth. Pro-forma for the acquisition, Mid-America will become the largest multifamily REIT by number of units with 105,000.

Interestingly, Mid-America and Post structured a two-tier termination fee which many believed might encourage other bidders to come to the table. The first deadline for the termination fee has since passed without a new bidder emerging so the common perception is MAA will be the owner of the assets by year-end when the deal closes. However, as of the end of 3Q, MAA's stock had declined 8% since the deal's announcement (shareholders were not happy with the price paid for PPS nor with the dilution of MAA's identity as a suburban/defensive Apartment REIT) and, with no collar structured as part of the deal, PPS was only trading ~6% above the share price at which it was trading prior to the merger announcement. Will another bidder emerge before November when Post and Mid-America's shareholders vote on the merger? Only time will tell!

Observations from the Field – Benjamin Yang

We attended the Bank of America Global Real Estate Conference in September, one of the few occasions to meet with non-US management teams on home soil and gain a global perspective on commercial real estate fundamentals. Attendance at the 2-day event was 20% higher than the prior year, attributable to greater generalist investor interest as real estate became the 11th headline equity sector just 2 weeks earlier on August 31, based on the S&P Dow Jones and MSCI Global Industry Classification Standard.

Individual meetings and presentations were abundant, with nearly 150 corporate teams making the annual autumn trek to New York. An overwhelming majority of the CEOs in attendance believe interest rates will have the greatest impact on REIT performance in 2017 (close to 90% polled), which is not surprising following the May 2013 "taper tantrum" when US Treasury yields surged 100 basis points and REIT shares fell nearly 15% by year end. Also unsurprising is the corporate view that earnings will remain firm or grow next year (90% polled), despite the long-in-the-tooth real estate cycle and likelihood that capital will become pricier in the coming year(s); durable cash flows are a hallmark of high-quality commercial real estate owned by the global REITs. More unexpected were the disparate views on corporate strategy: 37% focus on NAV growth, 37% on cash flow growth and 27% on SSNOI growth. While not mutually exclusive, we believe that NAV should be the highest priority as there are fewer ways to "goose" this metric.

The group panels were similarly insightful, touching on topical discussions including Brexit (London office rents are falling, as 20-25% of banking jobs could migrate to the EU if passporting rights disappear), yield (the bubble will eventually pop, but probably not for at least 3-5 years) and e-commerce (inarguably positive for industrial, less clear for retail real estate and not the death knell for higher quality centers). The savvier global REITs are also taking long-term steps to cater to the differing preferences of millennials, a cohort that will represent 75% of working professionals by 2025. Mall owners are more accepting of restaurants as tenants as millennials prefer experiences over buying stuff, while offices are becoming less fortress-like to appeal to a more social and liquid employee. REITs that are best positioned to recognize and capitalize on the slowly shifting landscape should fare well over the longer term.

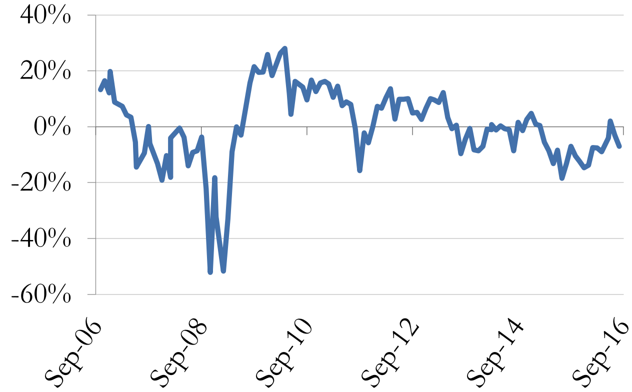
Capital issuance is up slightly. According to NAREIT, $21.3 billion in capital was raised in Third Quarter 2016, on par with the $22.7 billion raised in the prior quarter and significantly more than the $8.7 billion raised a year ago in Third Quarter 2015. The capital activity was divided evenly between (i) the issuance of unsecured bonds (there were 31 offerings totaling $10.9 billion during the quarter, slightly less than the $12.3 billion issued in the prior quarter and significantly more than the $6.7 billion issued a year ago) and (ii) the secondary issuance of equity (there were 20 offerings totaling $9.1 billion during the quarter, more than the $7.6 billion issued in the prior quarter and the $1.7 billion issued a year ago).

During the quarter, there were also 10 offerings of preferred shares totaling $1.0 billion and one IPO in the REIT space, MedEquities Realty Trust, Inc. ("MRT"), a small company which owns and operates health care facilities. Despite pricing at the low end of the range, lower than the pricing on the original 144A which seeded the portfolio, the stock immediately broke the $12 deal price and has subsequently traded at suppressed levels on very low volume. Going forward, MRT management will have to issue equity to grow, most likely at a discount to NAV; with the cost of capital so high, there will be very little accretion from acquisitions. Trafficking in out of favor asset classes (skilled nursing facilities and hospitals), the road ahead will be difficult to navigate.

Fund flows are mixed. According to AMG Data Services, net flows into dedicated domestic real estate funds, excluding ETFs, totaled $1.0 billion in Third Quarter 2016 compared to outflows of $3.1 billion in Third Quarter 2015. Flows from US and Global mutual funds registered in Japan continue to be strong, estimated to be $6.4 billion in Third Quarter 2016 (it was $8.2 billion for all of 2015) compared to $1.8 billion in Third Quarter 2015.

Transactions are down. According to Real Capital Analytics ("RCA"), at $114.8 billion total sales of commercial properties were down 2% year-over-year; year-to-date, sales totaled $343.1 billion, down 9% from 2015; all of the decline in quarterly activity was on the portfolio side as there was actually a slight uptick in transactions of single assets. RCA notes "deal volume improved… for the apartment sector, hotels, industrial properties, and suburban offices. The laggards include CBD office, retail, and development sites… Geographically, deal volume was strongest in secondary and tertiary markets." Private market activity feels late cycle.

Premium/Discount to Net Asset Value
REIT Universe
September 30, 2006 to September 30, 2016

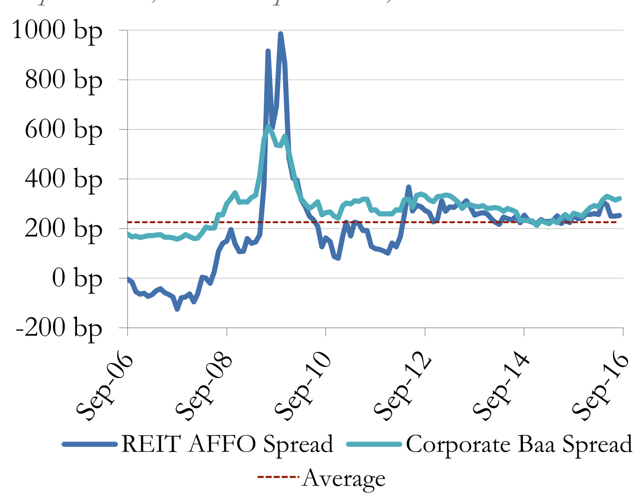


Source: Adelante Capital Management and Green Street Advisors.

Risk premium remains above the ten-year average. The risk premium for owning commercial real estate, as represented by the spread between REIT cash flow yields and the riskless rate of return, still trades well above the 10-year average. Due to the 1.2% retreat in the Wilshire US REIT Index during the quarter, the spread between REIT cash flow yields and the 10-Year Treasury Note yield widened from 293 bps to 302 bps (compared to the 10-year average of 225 bps) despite the 12 bps increase in the 10-Year Treasury Note Yield during the quarter. As of September 30, there was still a healthy premium for taking the risk of owning commercial real estate via REITs.

The Corporate Baa spread compressed from 283bps to 268 bps at quarter-end; the Corporate Baa spread is now below the 10-year average of 293 bps.

Spread Comparison
REIT Cash Flow and Corporate Baa Yields vs.
10-Year Treasury Note Yield
September 30, 2006 to September 30, 2016



Source: Adelante Capital Management and Green Street Advisors.

Outlook

The Wilshire US REIT Index hit its peak on August 1 and has since been on a steady decline in absolute and relative terms versus the S&P 500 and Russell 2000 Indices. During the same time period, yield on the 10-Year Treasury Note moved from 1.458% to 1.608%; perceived as being interest rate sensitive, REITs have been victimized as have other "bond proxies" like utility stocks. Bond prices have been pressured by two short-term factors: one, a recent Bloomberg report about a possible tapering of bond purchases by ECB officials sent sovereign bond yields in the Eurozone higher with a spillover effect onto bonds in the US and two, inflation expectations and oil prices have been rising.

The United States, like other advanced economies, is undergoing a dramatic demographic transition related to the unfolding of the post-war baby boom. As a consequence, the growth rate of the labor force has declined and should remain low for the foreseeable future. In this paper, we investigate the extent to which demographic changes, especially those related to the baby boom, can explain the currently low levels of real interest rates and GDP growth. We build an overlapping generation (OG) model that is consistent with observed and projected changes in fertility, labor supply, life expectancy, family composition, and international migration. The model allows us to explore the extent to which demographic changes, in and of themselves, can explain the timing and magnitude of movements in real interest rates and real GDP growth during the post-war period and beyond.

In the model, the dynamics of interest rates and GDP growth are most directly connected to the consequences of the post-war baby boom. As the baby-boom generation reached working age in the 1960s, the aggregate labor supply, GDP growth, and interest rates all increased. The abundance of labor was accentuated by the fact that the baby boomers had far fewer children than their parents did, leading the United States to reap a "demographic dividend" by which the number of workers relative to the number of dependents climbed to historically high levels by the turn of the 21st century. The demographic situation stimulated aggregate capital formation as members of an unusually large cohort with few dependents simultaneously supplied labor and aimed to save ahead of retirement. The low fertility rates of the baby-boom generation also supported the accumulation of capital by facilitating greater labor-force participation of women and by freeing resources that families would have otherwise allocated to consumption by children. Furthermore, steady gains in health and life expectancy have increased the amount of time households expect to spend in retirement, in turn boosting their desire to save. The baby-boom generation has since begun to retire and the growth rates of the aggregate labor supply and aggregate output have accordingly slowed. From our model's perspective, these factors have led to a current abundance of capital relative to labor, depressing the return on capital and also causing aggregate investment to decline, a phenomenon that we see as consistent with puzzlingly low rates of capital investment in the recovery from the global financial crisis. Going forward, the model predicts that the capital-labor ratio will remain elevated despite low rates of aggregate investment in capital because the growth rate of the labor supply will also be low, so that both real interest rates and GDP growth will linger near their current low levels.

Source: Understanding the New Normal: The Role of Demographics
Etienne Ganon, Benjamin K. Johannsen and David Lopez-Salido
Federal Reserve Board, Washington, DC, October 3, 2016

The Federal Reserve Bank of San Francisco identifies two types of inflation: demand-pull inflation ("one potential shock to aggregate demand might come from a central bank that rapidly increases the supply of money") and cost-plus inflation ("rapid wage increases or rising raw material prices are common causes of this type of inflation"). Given the potential consensus building in the ECB for reducing monetary accommodation and apparent desire on the part of many members of FOMC to increase rates, inflation from the demand side seems unlikely. As for supply side, uptick in the unemployment rate accompanying an increase in nonfarm payroll of 156,000 in September suggests slack in the labor market. True, oil prices have seen recent increases but are virtually unchanged from the end of Second Quarter and have not been joined by other commodities. Longer term, there are arguments the anemic recovery subsequent to the 2008/9 recession is symptomatic of secular forces rather than cyclical. According to a recent paper titled *Understanding the New Normal: The Role of Demographics* by three Federal Reserve economists, Etienne Ganon, Benjamin K. Johannsen and David Lopez-Salido, the trend of baby boomers retiring with all their savings is creating an imbalance of capital to labor; to these economists, it is demographically preordained the return on that capital will be underwhelming, leading to persistently low GDP growth and interest rates.

If the short-term forces putting pressure on sovereign bond yield world-wide are limited in scope and there are convincing arguments being made for a longer-term cap on economic growth/interest rates, are we not potentially seeing a reprise of 2013, a resetting of expectations of monetary accommodation, *Taper Tantrum II,* so to speak? REITs are trading 10% below the peak, many below Net Asset Values, and the spread between REIT cash flow yields and the riskless rate of return is 302 bps – aren't they worth another look?

Plus ça change**,** plus c'est la même chose **–** Jean-Baptiste Alphonse Karr, 1849.