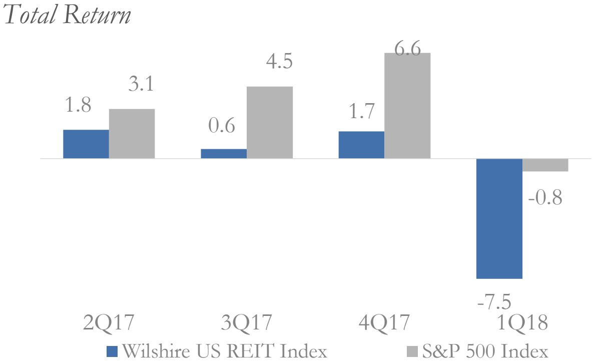
Volatility returns. After a start to the year where the equity markets moved close to hitting year-end targets in one month, volatility returned with a vengeance, spurred most likely by the release of the Employment Situation Summary on February 2 reporting a 2.9% year-over-year increase in average hourly earnings. Everyone became a Philips Curve acolyte and fears of runaway inflation took hold, leading to a sharp correction in risk assets. For the rest of the quarter, financial markets were buffeted by the daily drama emanating from the White House and shaken by the specter of trade wars and untested leadership at the FOMC; as First Quarter drew to an end, investors were left eagerly awaiting earnings with risk assets trading near February lows.

The third estimate of Fourth Quarter GDP growth came in at 2.9 %, compared to 3.2% for Third Quarter 2017 and average GDP growth of 1.9% and 2.0% in 2016 and 2015, respectively. According to the Bureau of Labor Statistics, changes in total nonfarm payroll in the past three months were 176,000, 326,000 and 103,000, respectively, an average of 202,000 compared to an average of 182,000 for the 12 months prior. The yield on the 10-Year Treasury Note rose from 2.405% to 2.741%.

The Wilshire US REIT Index ("Index") was down 7.5% in First Quarter, lagging both the S&P 500 and Russell 2000 Indices which fell 0.8% and 0.1%, respectively; this is the seventh consecutive quarter of REIT underperformance. Only 11 out of the 114 constituents of the Index produced positive returns of which five were Hotel REITs; Ryman Hospitality was the best performing name, advancing 13.5%, compared to the worst, Cedar Realty Trust, a small-cap shopping center REIT which fell 34.5%.

REITs vs. S&P 500 Index (%)

Total Return



Source: Bloomberg and Wilshire Associates.

Sector Performance of the Wilshire US REIT Index

Ranked by First Quarter 2018 Performance

Sector	1Q18	Trailing 1-Year	Current Yield
Storage	-2.4%	2.7%	4.0%
Mfd. Housing	-2.8	16.9	2.1
Hotels	-4.8	3.0	5.5
Apartments	-4.9	-1.8	3.6
Industrial	-5.7	21.6	3.0
Industrial Mixed	-6.7	7.6	3.4
Wilshire US REIT	**-7.5**	**-3.6**	**4.2**
Office	-7.5	-3.9	3.3
Diversified	-8.7	-10.2	4.2
Retail-Regional	-10.2	-8.1	5.1
Health Care	-11.3	-17.2	6.7
Retail-Local	-15.0	-17.6	5.5
Factory Outlets	-15.9	-29.3	6.2

Source: Wilshire Associates.

Back to the future. With the sharp increase in the 10-Year Treasury Note yield in First Quarter and conservative guidance proffered by the various REITs for 2018, established patterns of relative performance by property type reasserted itself. Supply is an issue for almost all of the different property types, particularly in the gateway cities in which REIT portfolios are located; however, investors chose to see the glass half full for those sectors that have the shortest lease durations like Storage, Manufactured Housing, Hotels and Apartments while eschewing sectors with longer lease durations like Office. Interest rate sensitivity was a headwind for Health Care REITs as well but tenant viability and rent coverage was the real issue for senior housing and skill nursing. Real estate benefitting from secular demand like Industrial and Data Centers outperformed the Index.

The Fourth Quarter bounce in retail real estate proved short-lived as the realities of operating in an environment of secular decline overwhelmed the short-term positives of visits by tourist investors like Third Point LLC. The cynical bid by Brookfield Property Partners LP for two-thirds of GGP that they do not own suggested limited options and investor interest for regional malls, even of the highest quality, and the entire retail sector was dragged down as a result.

Not with a bang but a whimper. After nearly five months of behind-the-scenes negotiations, regional mall REIT GGP Inc. recently agreed to be acquired by its largest shareholder Brookfield Property Partners (BPY) at a price that underwhelmed the investment community; the regional mall sector declined 2.6% on the day of the news, with GGP falling even more at 5.3%. With a cap on the aggregate cash consideration at $9.25 billion, GGP shareholders will likely end up receiving a pro-ration of 61% cash and 39% BPY units or a newly created tracking stock, BPR (traded in the US). As such, the updated offer for GGP, based on Brookfield's recent share price, is closer to $22/share, a slight premium to GGP's prior day's closing price but still well below most investors' view of net asset value (NAV), ~$27/share. Brookfield's unique position as GGP's largest shareholder significantly reduces the chances of a competing bid.

GGP's Special Committee was faced with few appealing choices: (i) continue to let the stock languish below NAV given the negative secular trends facing bricks & mortar retail real estate, (ii) accept Brookfield's revised bid at a price above the current share price but still below NAV, yet with the opportunity for investors to diversify into BPY and its global portfolio of commercial real estate, or (iii) reject the offer from the only logical buyer and watch the stock decline even more as the M&A premium evaporates. Brookfield's offer still needs to be approved by a majority of GGP's non-Brookfield shareholders, which the market seems to believe is in doubt as GGP shares continue to trade well below the value implied by the Brookfield bid. Apparently, investors are now willing to cut off their nose to spite their face.

Intrigue in lodging. On March 28, Pebblebrook Hotel Trust ("PEB") disclosed that it had made two overtures to LaSalle Hotel Properties ("LHO") for a share-for-share merger at $30/share, a significant premium; LHO share price had fallen precipitously in First Quarter due to (i) disappointing guidance for 2018 and (ii) the disclosure that it is likely to cut its dividend 50%. The share prices of both stocks traded up on the news suggesting that investors in both companies liked the idea of the combination – LHO's high quality portfolio in the hands of a better management team; there is significant overlap in terms of markets and asset quality. John Bortz was the CEO of LHO before starting PEB, so he's obviously familiar with the company; given PEB's lofty multiples, the deal will be accretive. The combination makes a lot of sense but agency issues at the board or management level could be an impediment; a competing bid from private equity is also a possibility.

Observations from the Field – Jeung Hyun

In March, we attended Citi's 23rd Annual Global Property CEO Conference in Florida. Despite the relative underperformance of the asset class, there was record attendance at the conference with over 1,250 registered attendee from around the globe comprising both investors (from 220 investment firms) and company representatives (from 175 companies); this year, there were 20 net new investment firms in attendance this year of which half were hedge funds. Citi is always the first industry-wide conference for the year, a good venue to gauge investor and company sentiment following fourth quarter earnings.

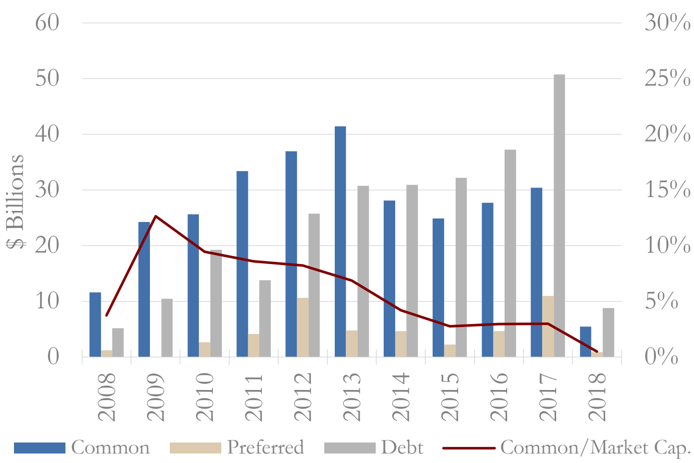
Michael Bilerman, head of Citi's REIT research conducts three surveys during the Conference, one targeted to CEOs and two to the broad audience (during lunches). This year, CEOs expected same-store NOI to be up just over 3.1% in 2018, down slightly from expectations in 2017; CEOs are also anticipating a 30 bps increase in 10-Year Treasury Note yield in 12 months but funny enough, Bilerman notes that CEOs have expected approximately 30 bps increase in each of the past eight years. As in 2017, attendees were equally divided between expectations for positive and negative total returns for REITs in the coming year, concerned mostly with the path for interest rates; they believed that the best performing sectors will be data centers, industrial and "other residential" while the worst performing sectors will be net lease and health care, not surprising given the source of their concerns. Aside from interest rates, the overriding concern for all property types is supply; for example, industrial displaced data centers as the top performing property type for 2018 primarily due to increased concerns about new data center supply that was aired during Fourth Quarter 2017 earnings calls. Given the ubiquity of supply in gateway cities that are home to most of the REITs' portfolios, it stands to reason that the greatest benefit of doubt was bestowed on sectors with the shortest duration of leases.

The vast majority of the attendees thought that we were in the later innings of the real estate cycle, both public and private; interestingly, attendees voted that we're in the same inning (7.2) as last year, suggesting that investors believe that this administration's pro-growth policies have extended the cycle. Broadly speaking, it felt like we were attending a conference for an industry late in the cycle; the silver lining is that the companies (urged by investors) have spent the past eight years deleveraging their balance sheets and pruning the bottom 10% of their portfolio – battening down the hatches for the next downturn – and, as a consequence, there was very little sense of panic.

Capital issuance is down slightly. According to NAREIT, $15.0 billion in capital was raised in First Quarter 2018, significantly less than the $18.6 billion raised in the prior quarter and the $23.1 billion raised a year ago in First Quarter 2017. More than half the capital activity took place in the issuance of unsecured bonds (there were 19 offerings totaling $8.8 billion during the quarter, less than the $13.5 billion issued in the prior quarter and the $11.4 billion issued a year ago).

There were only 8 secondary equity offerings totaling $2.7 billion during the quarter, on par with the $2.6 billion issued in the prior quarter and significantly less than the $8.9 billion issued a year ago and six offerings of preferred equity totaling $0.8 billion, down from $2.5 billion issued in the prior quarter and comparable to $0.9 billion issued a year ago. There were three IPOs during the quarter totaling $2.7 billion. As more REITs trade below NAV and interest rates rise, expect little activity from both equity and debt capital markets for REITs.

Historical Offering of Securities
2008 – 2018 YTD

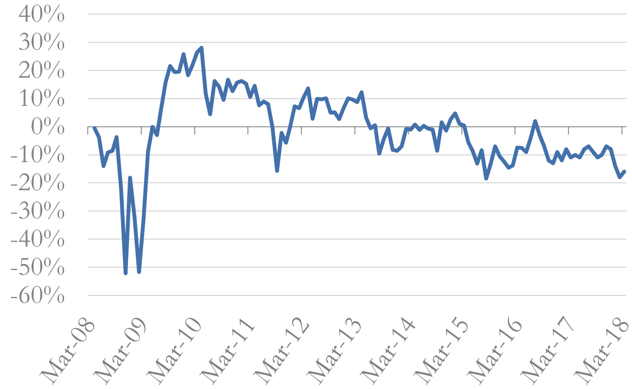


Source: NAREIT.

Funds flow out. According to AMG Data Services, net flows out of dedicated real estate funds, excluding ETFs, totaled $2.2 billion in First Quarter 2018 consistent with outflows of $2.3 billion in First Quarter 2017. Interestingly, REIT ETFs saw outflows of $2.7 billion in First Quarter 2018 compared to inflows of $2.0 billion in First Quarter 2017. According to Bloomberg, almost a quarter of all REITs are owned passively, the most of any sector; hopefully ETF outflows represent the capitulatory phase of asset allocation out of the asset class.

Flows out of US and Global mutual funds registered in Japan totaled $2.7 billion in First Quarter 2018 compared to outflows of $1.8 billion in First Quarter 2017.

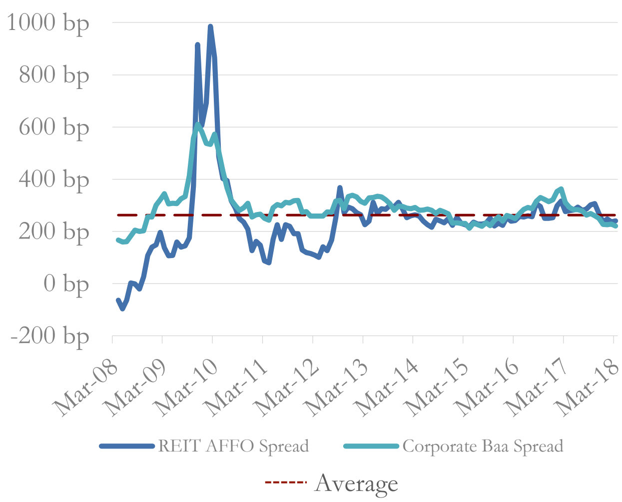
Premium/Discount to Net Asset Value
REIT Universe
March 31, 2008 to March 31, 2018



Source: Adelante Capital Management and Green Street Advisors.

Risk premium below 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, trades below the 10-year average of 263 bps. The cash flow yield for REITs increased 36bps to 5.05% but the yield on the 10-Year Treasury Note rose 34bps and, as a consequence, the spread between REIT cash flow yields and the 10-Year Treasury Note yield was relatively unchanged at 231 bps, which is still a healthy yield premium for taking the risk of owning commercial real estate via REITs. In Fourth Quarter, the Corporate Baa spread remained relatively unchanged at 185 bps, well below the 10-year average of 293 bps; bond markets are still favoring tenants over landlords, underwriting an improving credit profile as the economy improves.

Spread Comparison
REIT Cash Flow and Corporate Baa Yields vs.
10-Year Treasury Note Yield
March 31, 2008 to March 31, 2018



Source: Adelante Capital Management and Green Street Advisors.

OUTLOOK

A number of participants indicated that the stronger outlook for economic activity, along with their increased confidence that inflation would return to 2 percent over the medium term, implied that the appropriate path for the federal funds rate over the next few years would likely be slightly steeper than they had previously expected.

Minutes of the Federal Open Market Committee ("FOMC"), March 20-21, 2018

As we focus on the long-run fiscal situation, our goal should be to put the debt on a declining path as a share of the economy. That will require running smaller deficits in strong economic periods — such as the present — to offset the larger deficits that are needed in recessions to restore demand and avoid deeper crises. Last year's Tax Cuts and Jobs Act turned that economic logic on its head. The economy was already at or close to full employment and did not need a boost. This year's bipartisan spending agreement contributed further to the ill-timed stimulus. The Federal Reserve will have to act to make sure the economy does not overheat.

A Debt Crisis is Coming. But Don't Blame Entitlements
The Washington Post Opinions
Martin Neil Baily, Jason Furman, Alan B. Krueger, Laura D'Andrea Tyson and Janet L. Yellen
April 8, 2018

As another 7.5% decline in the Wilshire REIT Index and numerous quarters of underperformance to the various private commercial real estate and equity market indices demonstrate, being cheap is not reason enough for a positive outcome. At the recent Citi CEO conference, REIT management teams quietly bemoaned their Net Asset Value discounts and analysts and investors cried out for strategic initiatives but, with a nod to Vladimir Lenin, "What is to be Done?"

SL Green, the New York City landlord, is doing the most obvious thing, selling non-core assets in the private market and buying back shares in the public market (on a leverage neutral basis). As of March 1, the company has repurchased 11.9 million shares at an average price of $100.30; the shares closed at $96.83 at the end of the quarter, netting the company $41.1 million in losses.

There has been some M&A activity during the quarter but the discrepancy in implied cap rates that GGP and Westfield are being valued suggests that these deals have more to do with the cost of capital of the acquirer than the intrinsic value of the acquiree. Ditto Pebblebrook's bear hug on LaSalle; Pebblebrook's CEO, Jon Bortz, is afforded the opportunity to buy back his former company only because of the cost of capital advantage he has garnered in the public markets; wake us up if and when private equity gets involved.

REITs are fighting battles on a number of fronts. Dedicated REIT funds, both in the US and Japan, have been seeing steady outflows; while it is difficult to discern whether investor disinterest is the cause or effect of underperformance by the asset class, it is hard to make headway when funds are being steadily withdrawn. As we enter First Quarter earnings season, equity investors are eagerly anticipating the beneficial effects of recent tax cuts. Not so REIT investors; traditionally tax advantaged vehicles like REITs are suffering in comparison to their more heavily taxed brethren and will do so for at least the next 12 months.

Retail REITs comprise 18% of the Index and are experiencing a secular deflation in rents due to well documented technological disruption; until retail rents get to a point of equilibrium, expect continued headwinds for the entire Index. Put another way, many pundits have suggested that retail real estate is not overdeveloped but under-demolished; higher and better use has to be found for much of the obsolete retail real estate that comprises at least a portion of the afore-mentioned 18% but unfortunately, the rents that current tenants are paying are still too high. Retail is certainly one arena where the public markets are giving a more honest assessment of operating fundamentals than private; however, that does not mean that the outlook is rosy.

Finally, REITs are perceived to be interest rate sensitive and investors are concerned about rate path. Interestingly, since the sharp spike at the beginning of the year, the yield on the 10-Year Treasury Note has been on a steady decline. With the FOMC on a steady course to raise the federal funds rate three if not four times this year, the yield curve has flattened noticeably; the spread on the yields on the 2-Year and 10-Year Treasury Notes has gone from a high of 78 bps during the quarter to 47 bps, suggesting that the bond markets have a less sanguine outlook than the equity markets. This longer-term view of the future dovetails with what John C. Williams, the recently named president of the Federal Reserve Bank of New York wrote in a recent missive: "The sustainable growth rate of the economy has slowed dramatically from prior decades…This slowdown reflects a one-two punch of a sharp decline in labor force growth and slower productivity growth." Put simply, REIT underperformance may reflect the short term expectations of faster growth and higher inflation as a result of fiscal irresponsibility; however, stubbornly low rates on the 10-Year Treasury Note augurs a brighter future for the asset class once the sugar high wears off. However, REIT management teams, investors and analysts may have to exhibit a bit more patience.