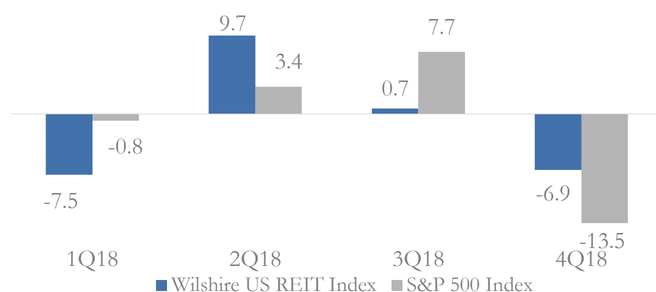
Expansionary but... The US economy is still expanding, albeit at a slower rate. The third estimate of Third Quarter GDP growth came in at 3.4% while Fourth Quarter GDP growth is projected by the Federal Reserve Bank of Atlanta to slow to 2.8%. According to the Bureau of Labor Statistics, changes in total nonfarm payroll in the past three months were 312,000, 176,000 and 274,000, respectively, an average of 254,000, better than the average of 211,500 for the 12 months prior. Despite the positive GDP and job growth, the long end of the yield curve actually declined as the yield on the 10-Year Treasury Note went from 3.056% on September 30 to 2.686% on December 31; the yield curve flattened with the spread between the 3 Month Treasury Bill and the 10 Year Treasury Note (identified by recent research from the Federal Reserve Bank of San Francisco as the "best summary measure" of the potential for a recession in the US economy) tightening in Fourth Quarter from 86 bps to only 31 bps.

The Wilshire US REIT Index ("Index") was down -6.9% in Fourth Quarter, providing a bit more safety in a risk-off environment than both the S&P 500 and Russell 2000 Indices which declined -13.5% and -20.2%, respectively; while this is nominally the third consecutive year of underperformance vs. the S&P 500 Index, subsequent to the sharp sell-off at the start of 2018, REITs have consistently outperformed the broader equity indices. For the year, only about a third of the Index constituents produced positive returns. Aside from M&A targets like LaSalle Hotel Properties and DCT Industrial Trust, it was the various constituents of the four sectors that produced positive returns that populated the leaderboard, including Omega Healthcare Investors, the best performing REIT for the year (+39.9%); B-mall REIT, CBL & Associates posted the worst returns for two years in a row (-60.0%).

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



Source: Bloomberg and Wilshire Associates.

Sector Performance of the Wilshire US REIT Index
Ranked by Fourth Quarter 2018 Performance

Sector	4Q18	Trailing 1-Year	Current Yield
Health Care	3.3%	7.6%	5.8%
Storage	2.1	2.9	4.0
Apartments	-1.3	4.0	3.4
Mfd. Housing	-4.0	1.9	2.2
Diversified	-4.4	-1.8	4.6
Wilshire US REIT	**-6.9**	**-4.8**	**4.3**
Industrial Mixed	-7.3	-8.6	4.0
Retail-Regional	-7.8	-6.1	5.4
Factory Outlets	-10.3	-19.1	6.9
Retail-Local	-11.0	-14.3	5.5
Industrial	-11.5	-8.3	3.4
Office	-11.8	-14.0	3.9
Hotels	-20.2	-13.7	6.2

Source: Wilshire Associates.

Back to normal. It is clear that both Fed Chairman Jerome Powell and President Donald Trump were touting economic progress based on lagging indicators while the financial markets were painting a very different picture in Fourth Quarter, one of a global synchronized slowdown. Even in a small GICS sector like Real Estate, the relative performance of the various sectors/property types was telling investors that something is rotten in the state of Denmark.

For the Fourth Quarter (and for the year), property types which are cyclical: Hotels, Office, Industrial and Retail, all underperformed the Index while property types which are insulated from the vagaries of the economy: Health Care, Storage, Apartments and Manufactured Housing, all outperformed. And, unlike in past real estate cycles, it seems that the demand side of the equation is having a bigger effect on relative performance than supply, most likely because introduction of new supply has been muted; new construction of commercial real estate in the US, as a percentage of total stock, remains below historical averages. Ironically, supply of new Senior Housing, Storage and Apartments are all above historical averages whereas only Industrial is seeing a modicum of new construction among the cyclical property types.

Amazon picks a "Winner!" Amazon, Inc. sent hundreds of municipalities into frenzy in September 2017 when the e-commerce juggernaut announced plans to establish a second corporate headquarters in North America. Nearly 250 cities responded to Amazon's Request for Proposal (RFP), with hopes of adding 50,000 full-time, highly-paid employees to its tax coffers within 15 years in addition to $5 billion of promised capital expenditures over a similar time period. HQ2 is also expected to have a multiplier effect - a new ecosystem of tech talent similar to Seattle where Amazon followed Microsoft and is now the dominant employer, with Apple, Facebook, Google and others similarly drawn to the area.

Amazon quickly whittled its RFP hopefuls to 20 finalists by the beginning of this year, yet took several more months to evaluate (negotiate?) tax incentives/subsidies offered to the company. Amazon ultimately decided to split the baby in half, naming Northern Virginia's National Landing (f.k.a. Crystal City, including the surrounding Pentagon City and Potomac Yards) and the Long Island City (LIC) neighborhood of Queens (adjacent to and east of Manhattan) the "winners"…huzzah!

Amazon is really the clear winner in the HQ2 dog & pony show, having coaxed significant tax incentives from cities that were likely in the crosshairs of CEO Jeff Bezos anyway. Also inarguable winners…commercial real estate and several REITs! The office market in Northern Virginia/National Landing has suffered for years following the slow erosion of its former tenant base, which included defense-related government agencies and contractors. The most dominant office landlord in the area is JBG Smith (JBGS), a REIT that had been developing a "place making" strategy for Crystal City to attract more private sector tenants. Amazon will accelerate the revitalization process, with plans to initially lease 500,000 square feet from JBGS and purchase land parcels entitled for up to 4.1 million square feet of development as well as engage JBGS as its development partner. Amazon's presence should also be a long-term positive for the residential market in the surrounding area. The Washington DC region has faced significant new apartment construction of late that has kept a lid on rent growth. Apartment owners, including Equity Residential and AvalonBay, which have investment in both named cities, are surely celebrating the arrival of at least 25,000 new employees over time which should create added demand for their units. Owners of retail properties like Kimco Realty, Regency Centers and Simon Property Group are also expected to benefit from enhanced spending in the region.

Observations from the Field – Elvis Rodriguez

We recently had an opportunity to tour a NYC office development project - One Vanderbilt - owned by SL Green Realty (SLG); it is a 1.6 million sf office development which is adjacent to the Grand Central Terminal, an iconic project given its location and size, ultimately the fourth tallest building in NYC.

The development site was assembled and entitled over a 15 year period. SLG acquired several buildings, demolishing them in 2015 to create the land site for One Vanderbilt. Besides the office space that is now ~50% preleased to financial and law firms, One Vanderbilt will be sandwiched by an Observation Deck at the top of the building and a Daniel Boulud restaurant at the base. This will be an exciting addition to a city where the average building age is approximate 65 years.

Besides One Vanderbilt, World Trade Center and Hudson Yards office developments, J.P. Morgan announced its plans to build a 2.5 million sf office headquarters in NYC. Disney has also acquired a land site for $650 million to develop its NYC campus in Hudson Square, joining Google which has committed to doubling its employee base in NYC with its recent $1 billion announcement for a second NYC campus in Hudson Square. With Amazon establishing its NYC presence in Long Island City and Facebook growing their office footprint, NYC is clearly becoming the tech hub of the east coast, although in a diaspora away from midtown Manhattan.

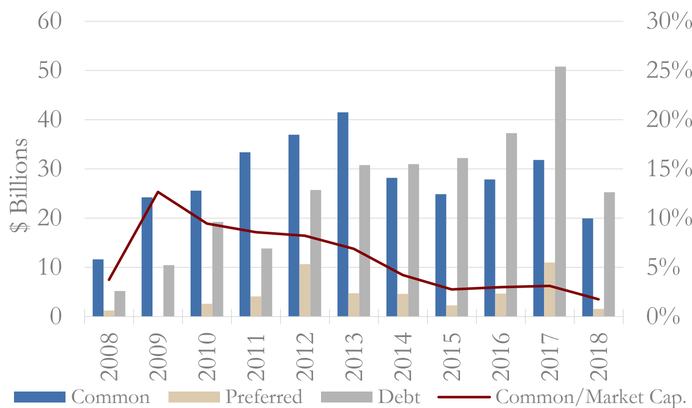
2018 marked an outstanding year for the midtown south market, which has become the hottest office real estate submarket in Manhattan. A major reason is Google's main NYC presence in Chelsea, slightly west of the submarket. Co-working giant, WeWork, leased a full building redevelopment project from Columbia Property Trust (CXP). Midtown south asking rents are now 20% higher than midtown rents, a comeuppance for what had been a flagship submarket in Manhattan where FIRE tenants have traditionally roamed; historically, midtown south rents have lagged rents in midtown proper by approximately 10-15%.

Despite great, near-record leasing totaling 35.9 million sf in 2018, the bifurcation of offerings between new and older office buildings in Manhattan has kept tenants in control and vacancy levels elevated. Hopefully, this should reverse once new supply moderates and vacancies are absorbed; all that being said, the transaction market remains healthy and Manhattan real estate remains coveted by global investors.

Capital issuance is down slightly. According to NAREIT, $8.3 billion in capital was raised in Fourth Quarter 2018, significantly less than the $14.6 billion raised in the prior quarter and the $18.6 billion raised a year ago in Fourth Quarter 2017. About half the capital activity took place in the issuance of unsecured bonds (there were 11 offerings totaling $4.5 billion during the quarter, on par with the $6.3 billion issued in the prior quarter but less than half the $13.5 billion issued a year ago). There were 16 secondary equity offerings totaling $3.7 billion during the quarter, significantly less than the $7.9 billion issued in the prior quarter and on par with $3.5 billion issued a year ago. There was only one small offering of preferred equity and one small IPO.

Note that the NAREIT data does not take into account equity issuance by at-the-market ("ATM") programs, a low cost alternative that those REITs which are still trading above NAV are increasingly tapping; for the REITs trading below NAV, expect little activity from equity capital markets.

Historical Offering of Securities
2008 – 2018



Source: S&P Global Market Intelligence, NAREIT 2018.

Funds flow out. According to AMG Data Services, net flows out of dedicated real estate funds, excluding ETFs, totaled $11.6 billion in 2018 compared to outflows of $9.0 billion, $5.5 billion and $6.1 billion in 2017, 2016 and 2015, respectively; REIT ETFs saw outflows of $3.8 billion compared to flows of $1.9 billion $2.2 billion and -$0.2 billion in 2017, 2016 and 2015, respectively.

Flows out of US and Global mutual funds registered in Japan totaled $7.7 billion compared to flows of -$10.7 billion, $17.9 billion and $8.2 billion in 2017, 2016 and 2015, respectively. There is currently a vicious cycle in place with outflows negatively affecting US REIT performance leading to more outflows, etc.

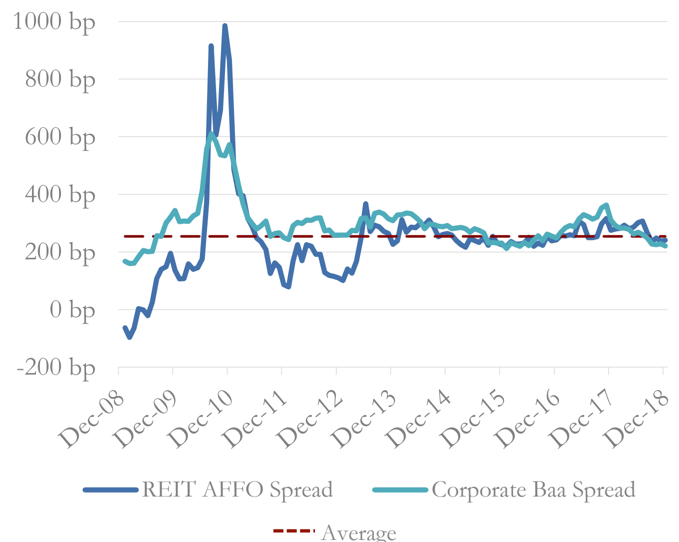
Premium/Discount to Net Asset Value
REIT Universe
December 31, 2008 to December 31, 2018

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 on par with the 10-year average of 254 bps. While the cash flow yield for REITs increased modestly to 5.0%, the yield on the 10-Year Treasury Note decreased 37 bps and, as a consequence, the spread between REIT cash flow yields and the 10-Year Treasury Note yield increased a whopping 60 bps to 234 bps.

In Fourth Quarter, the Corporate Baa spread increased 106 bps to 292 bps, also on par with the 10-year average of 278 bps.

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



Source: Adelante Capital Management and Green Street Advisors.

Outlook

In light of the evidence on its predictive power for recessions, the recent evolution of the yield curve suggests that recession risk might be rising. Still, the flattening yield curve provides no sign of an impending recession. First, the evidence suggests that recession predictions based on the yield curve require an inversion (Bauer and Mertens 2018); no matter which term spread is used to measure its shape, the yield curve is not yet inverted. Second, the most reliable summary measure of the shape of the yield curve, the ten year–three-month spread, is nearly 1 percentage point away from an inversion.

Furthermore, when interpreting the yield curve evidence, one should keep in mind the adage "correlation is not causation." Specifically, the predictive relationship of the term spread does not tell us much about the fundamental causes of recessions or even the direction of causation. On the one hand, yield curve inversions could cause future recessions because short-term rates are elevated and tight monetary policy is slowing down the economy. On the other hand, investors' expectations of a future economic downturn could cause strong demand for safe, long-term Treasury bonds, pushing down long-term rates and thus causing an inversion of the yield curve. Historically, the causation may well have gone both ways. Great caution is therefore warranted in interpreting the predictive evidence.

Information in the Yield Curve about Future Recessions
FRBSF Economic Letter
Michael D. Bauer and Thomas M. Mertens
August 27, 2018

Since Michael Bauer and Thomas Mertens wrote their FRBSF Economic Letter titled *Information in the Yield Curve about Future Recessions,* the ten-year-three-month spread has gone from "nearly 1 percentage point away from an inversion" to a low of 15 bps on January 3, 2019. Put another way, investors were willing to lend money for **ten years** for only 0.15% more interest than for **three months**, not exactly a ringing endorsement for the future. Why is this happening?

On the short end of the curve, we have an FOMC that is trying very hard to (i) reduce the size of its balance sheet and (ii) normalize rates. While both are laudable goals, the pace/lack of calibration and thoughtfulness of the double-barreled monetary tightening have had negative consequences on risk assets, which became very readily apparent in Fourth Quarter. Jerome Powell seemed to be fighting ghosts of inflation past based on lagging indicators like the employment report (which had yet to produce the type of wage inflation predicted by the Philips Curve), while ignoring coincident and leading indicators like commodity prices and the ISM Index of New Orders. The economic weakness was significantly more pronounced overseas but the Chinese buy (or not) new iPhones too.

Globally, there is no question that things are slowing down. According to the IMF, the growth of global exports in US Dollars was showing an increase of only 4.7% at the end of 2018 compared to 14.5% at the end of 2017. According to the WTO, the volume of world trade was increasing at 2.7% at the end of 2018 compared to 5.1% at the end of 2017. Even in the US, ISM Export Orders Index experienced a sharp drop to 52.8 (albeit still expansionary above 50) and both the Bloomberg and Goldman Sachs US Financial Conditions Index showed recent tightening.

There is certainly a level of what George Soros labeled reflexivity in the events of Fourth Quarter. Throw in a few comments from the chairman of the world's most relevant central bank like "we're a long way from neutral at this point (October 3)," and "I think that the runoff of the balance sheet has been smooth and has served its purpose and I don't see us changing that (December 19)" and the financial markets start freaking out with risk assets selling off, financial conditions tightening and credit spreads blowing out, all but ruling out any further removal of monetary accommodation.

I can state the core idea in two relatively simple propositions. One is that in situations that have thinking participants, the participants' view of the world is always partial and distorted. That is the principle of fallibility. The other is that these distorted views can influence the situation to which they relate because false views lead to inappropriate actions. That is the principle of reflexivity

General Theory of Reflexivity, Financial Times,
George Soros,
October 26, 2009

In their global webinar titled *Clouds on the Horizon or Just a Passing Fog (January 10, 2019)*, economists Jim O'Sullivan and Carl Weinberg from High Frequency Economics ("HFE") suggest a few key takeaways:

1. World Trade is slowing: The pulse of the global economy is slowing.
2. Industrial production and survey data indicate output is faltering in many economies.
3. HFE has no indication of inflation risk in any major economy at this time, so…
4. Most central banks are not going to tighten in 2019.
5. Bond yields, already low; still have room to fall, although negative yields are unsustainable.

got reits?