

Economics Group

Special Commentary

Mark Vitner, Senior Economist
mark.vitner@wellsfargo.com • (704) 410-3277
Charlie Dougherty, Economist
charles.dougherty@wellsfargo.com • (704) 410-6542
Matthew Honnold, Economic Analyst
matthew.honnold@wellsfargo.com • (704) 410-3059

CRE Chartbook: Property Prices Picking Up

With the Fed Poised to Cut Rates, CRE Prices Should Continue to Climb

The interest rate outlook has changed considerably since late last year, with yields falling at all maturities and the yield curve inverting, as long-term rates have fallen below rates on short-term Treasury Bills and the federal funds rate. An inverted yield curve has preceded every recession since World War II, but every inverted yield curve has not necessarily been followed by a recession. While the latest drop in yields likely has more to do with slowing global economic conditions, we expect the Federal Reserve to make some precautionary cuts to the federal funds rate in an attempt to get ahead of any potential contagion that might unduly slow domestic economic growth. The Fed appears poised to cut the federal funds rate by a quarter percentage point this summer and another quarter point later this fall, most likely at its July and October meetings. While deteriorating global economic conditions are the driving influence for lower rates, the Fed is also concerned that domestic demand has weakened, as evidenced by the lack of inflationary pressures. We have recently downgraded our 2019 real GDP forecast to 2.6% from 2.8%.

The interest rate outlook has changed considerably since late last year.

Slowing domestic demand has had only minimal impact on operating fundamentals for commercial real estate. Rent growth across all major property types remains positive and vacancies are lower than at any point during the prior expansion. Property prices began to cool in the second half of last year, but have reaccelerated in the past few months. Considering cap rates have barely budged over the past year, the pick-up in prices reflects the underlying strength in occupancy and rent growth as well as some downshifting in expectations for interest rates going forward. With the exception of suburban offices, prices have regained momentum across every major property type. Industrial properties remain at the top of the list of strongest price gains. E-commerce continues to transform supply chains, which has generated a seemingly insatiable demand for warehouse and distribution space, as evidenced by Blackstone’s \$18.7 billion acquisition of nearly 180 million square feet of urban warehouse space. With the exception of a few megadeals, transaction volumes have mostly plateaued in recent years. That noted, if the Fed follows through with rate cuts this year, we would expect a modest boost to transaction volumes and property valuations later this year.

Figure 1

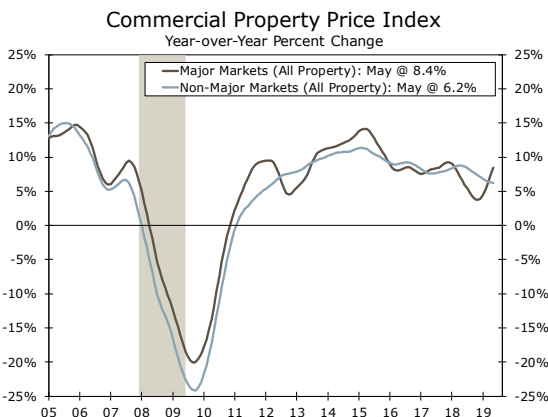
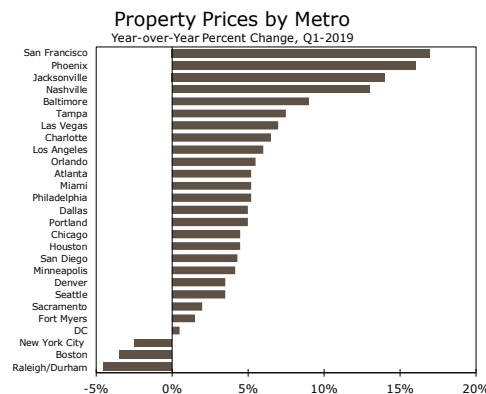


Figure 2



Source: Real Capital Analytics, CoStar, Inc. and Wells Fargo Securities



Many coastal markets in the West have seen property prices gain alongside rapid employment and population growth.

Inner Mountain Markets Flourishing in the Booming West

Overall commercial real estate prices are being influenced by resurgent valuations in major gateway markets, which rose 8.4% year-over-year during May, the fastest appreciation since the end of 2017. Many coastal markets in the West have seen property prices gain alongside rapid employment and population growth. The San Francisco market fully embodies this trend, with both commercial property and apartment building prices rising in excess of 10% over the past year.

Despite mounting regulatory threats in the tech industry coming to the fore recently, office building prices continue to grow as tech companies, large and small, cluster in the Bay Area, seeking to tap the region’s talent base and rich tech ecosystem. Commercial development in the broader Silicon Valley area is constrained due to high regulatory, land and construction costs. These constraints limit new commercial and residential construction, which helps push rents and property prices higher. With massive tech companies such as Google, LinkedIn and Nokia continuing to expand their footprints and lease space, office rents are rising in the entire region at a faster clip than nearly any other region in the country. The KPMG building in downtown San Francisco recently sold for a record \$1,054 per square foot. Rents and sales prices in parts of downtown San Francisco are well above what is seen in the market as a whole, particularly buildings near mass transit and other amenities.

Figure 3

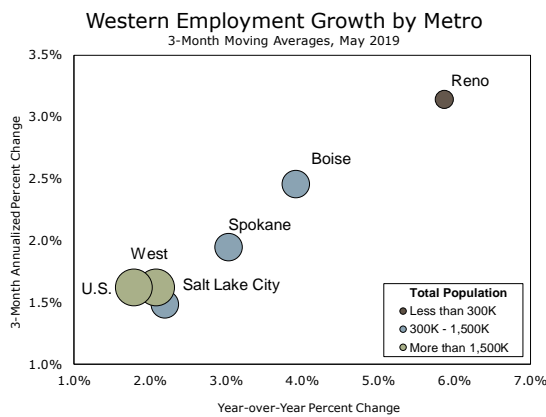
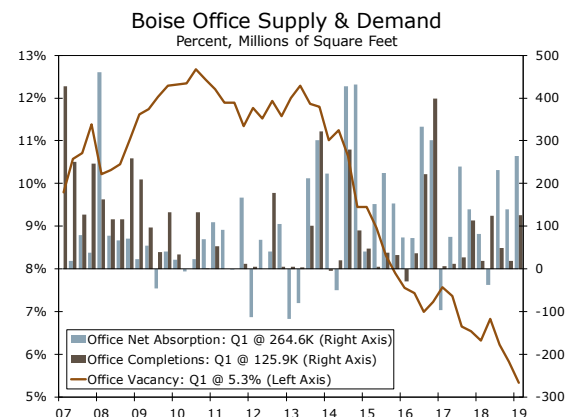


Figure 4



Source: U.S. Department of Labor, CoStar, Inc. and Wells Fargo Securities

Boise Blossoming Amid Tech Resurgence

A similar phenomenon is playing out in other West Coast markets. The persistent rise in rents and property prices in Los Angeles, Seattle and Portland has encouraged businesses and property investors to seek out more affordable markets. The migration from higher cost markets has boosted growth in several Western markets, including Boise, Salt Lake City and Reno.

Boise currently sits near the top of the list of fastest growing metros in the country, both in terms of population and employment. Not only does the Boise area have relatively lower real estate costs, but the region also boasts a highly educated labor force aided by a host of technology-focused post-secondary education programs. Alongside years of strong employment growth, the office vacancy rate in Boise has plummeted to close to 5.0% at the start of this year from roughly 12% in 2013. Boise has long been home to Micron Technologies as well as a sizeable Hewlett-Packard presence, two tech companies which have helped develop an immense ecosystem focused around microelectronics research and development. In addition to a new office building at its corporate campus, recent expansions at Micron have spurred a new hotel as well as a wave of apartments in the surrounding area. Hewlett-Packard has scaled back operations in recent years, but maintains a significant presence in Boise. Still, the lineage of many of Boise’s tech start-ups such as Cradlepoint, VisitPay and Covr Financial Technologies, can be traced directly to these two influential tech companies.

The migration from higher costs markets has boosted growth in Boise, Salt Lake City and Reno.

Utah Economy Gliding Down Silicon Slopes

Salt Lake City is perhaps an even more potent example. Proximity to other Western tech centers, a large and growing talented workforce and lower real estate costs have spurred development of the “Silicon Slopes” cloud computing cluster and the “Bionic Valley” bioengineering epicenter around Salt Lake City. Growth has not been constrained to just Salt Lake City, and has extended to the surrounding Provo and Ogden markets. Provo has added over three million square feet of office space since 2014, while rents have continuously climbed alongside sturdy tech-driven job growth. Just 40 miles north of Salt Lake City, Ogden has seen similar success. The Falcon Hill Aerospace Research Park project is one of the state’s largest new developments and will replace 1.5 million square feet of antiquated buildings with retail, hotel, office and restaurant space within and around Hill Air Force Base.

Utah commercial properties have surged.

It is not difficult to see why commercial real estate throughout Utah has performed so well. The Beehive State consistently ranks as one of the nation’s fastest growing economies and has a large and growing presence in some of the most rapidly growing parts of the tech sector, including cloud computing, big data and software development, as well as aerospace and life sciences. Utah’s growing population and highly educated workforce remain valuable assets. Utah posted the nation’s third fastest population gain in 2018, driven by both rapid in-migration and a high birth rate. The state’s growing population has fueled demand for residential and commercial real estate and is drawing firms from other parts of the country.

Figure 5

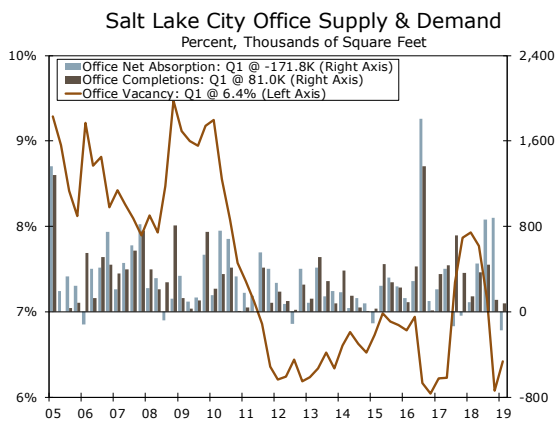
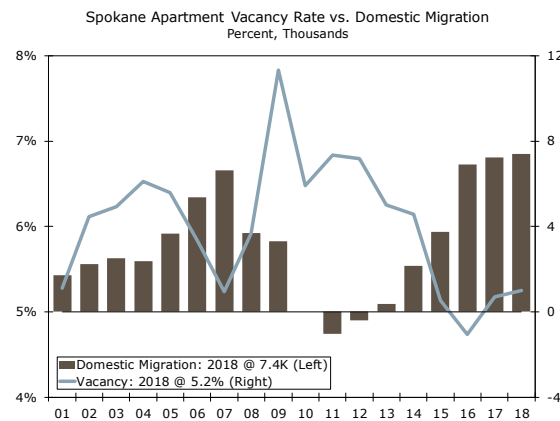


Figure 6



Source: CoStar, Inc., U.S. Department of Commerce and Wells Fargo Securities

Rising In-Migration Boosting Spokane Apartment Market

Nationwide, both rents and home prices have climbed as new residential development has generally failed to keep pace with population growth, a trend most acutely experienced on the West Coast. As the issue has reached a near-boiling point, construction of more affordable housing has quickly taken prominence for lawmakers in many Western markets. Legislators in Oregon recently passed a bill allowing multifamily construction in areas previously zoned only for single-family residences. A California bill would seek a similar outcome. But as the issue remains largely unresolved, businesses and residents are seeking out more affordable housing options in many mid-sized markets in the West.

Businesses and residents are seeking out more affordable housing options in many mid-sized markets in the West.

Spokane is an increasingly popular destination, particularly for residents desiring a change of season and an outdoorsy and artistic culture. Downtown Spokane boasts a vibrant social scene with a wide variety of shops and restaurants and a sizeable assortment of craft breweries. Among the Intermountain West’s largest metros, Spokane boasts the most affordable apartment rents. Asking rents in Spokane averaged \$941 in Q1, which is lower than Salt Lake City, Boise or Reno and well below the sky-high rents of Portland and Seattle.

A well-balanced apartment market has allowed Spokane to maintain its affordability advantage over its regional peers and is the driving force behind the robust population growth experienced over the past few years. Spokane has seen an increasingly large number of movers from outside of

the metro. Over 7,000 net new residents moved in during 2018, the most since 1993. The wave of new supply delivered over the past few years has been met with even stronger demand for rentals, which is supported by employment growth that far exceeds the national average. The vacancy rate has steadily trended lower and rents have risen 4.2% over the past year. Investors have taken notice—multifamily transaction volumes doubled their previous high to \$200 million last year.

Reno Industrial Market No Longer a Roll of the Dice

No market has benefited more from the rising costs of Western coastal markets than Reno. Sitting just across the California state line and a mere two hour drive from Sacramento, the Reno economy has soared over the past year. In terms of job growth, Reno was the fastest growing metro in the entire country on a year-over-year basis in May, thanks to a booming manufacturing and logistics sector. Reno has become a top destination for manufacturers of high tech products fleeing higher costs in California, Oregon and Washington, fueling demand for industrial space. Industrial rents rose an average 7.6% year-over-year, a pace much faster than the national average. Even after rising at a consistently robust clip over the past five years, rents remain a relative bargain compared to the nearby Sacramento and the Inland Empire. Much of the demand is closely tied to the gigantic 7 million square foot Tesla Gigafactory in Sparks, which when fully completed will have the largest footprint of any building in the world.

The influx of manufacturing operations has paved the way for tech-focused research and development facilities. Significant investments from tech stalwarts Google and Apple have helped bring critical mass to the region’s R&D sector. Autonomous vehicle research, commercial drone delivery, fintech and medical devices research have flourished in Reno, which has bolstered demand for office space, data centers and research facilities. In addition to new investments from Switch, Clear Capital and Flirtey, New Deantronics recently announced plans to a build a 200,000 square foot medical device technology campus in Reno. The Reno office market has added close to 240,000 square feet of space over the past three years, yet the office vacancy rate remains relatively low at just 8.9%.

Figure 7

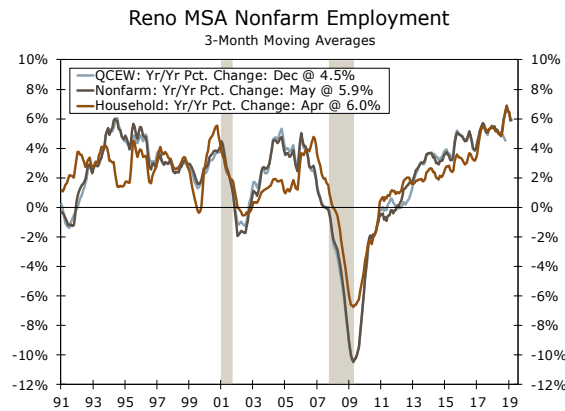
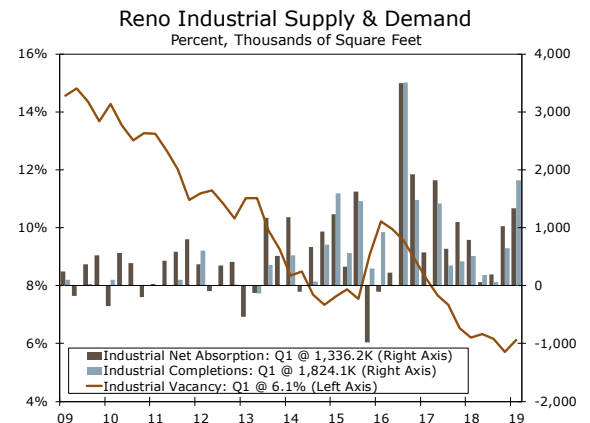


Figure 8

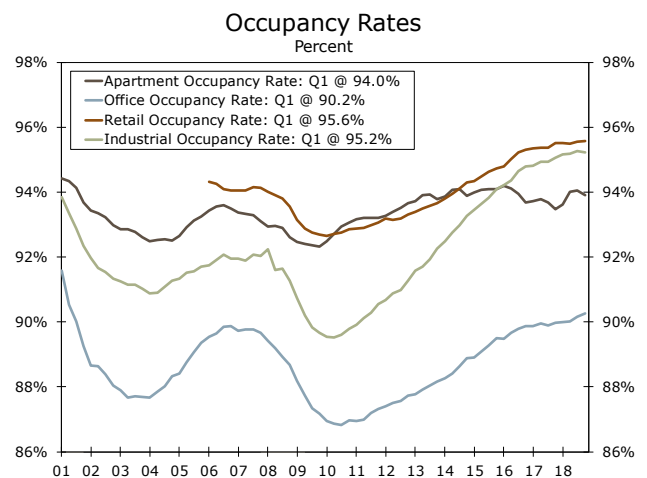
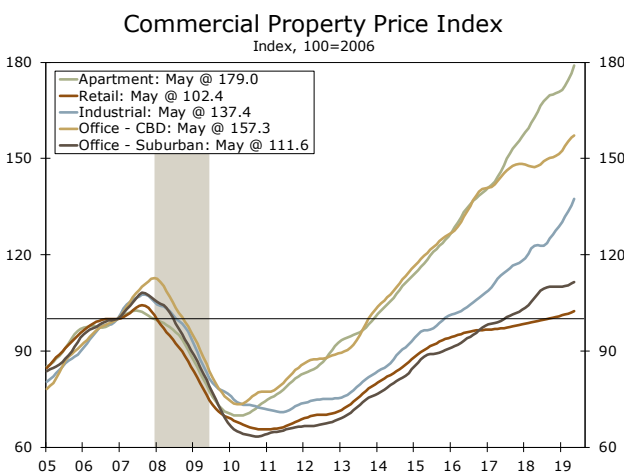
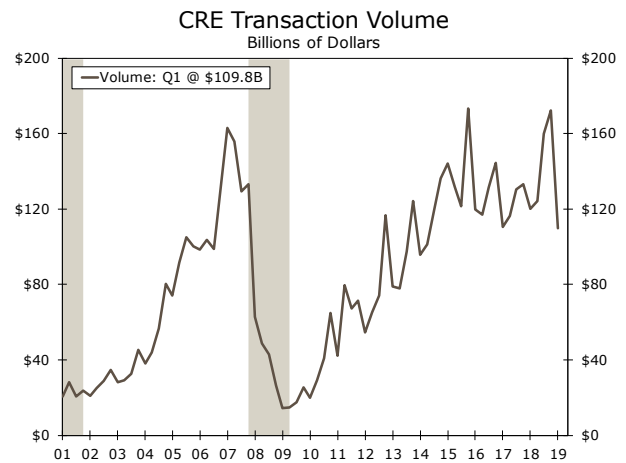
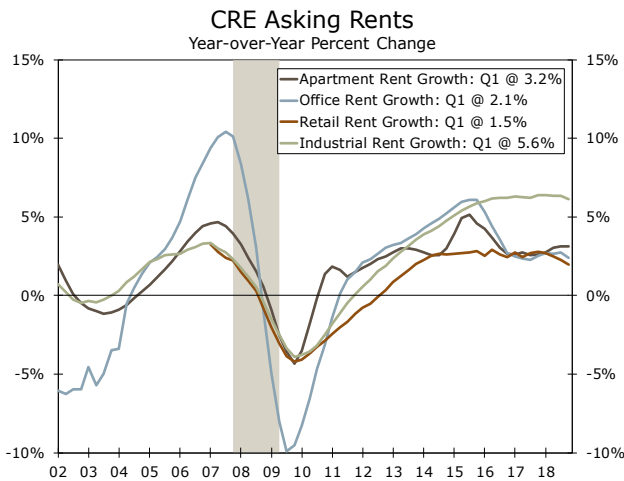
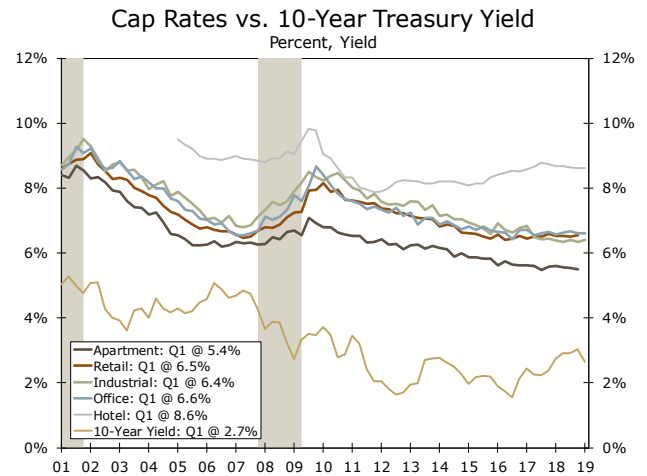


Source: U.S. Department of Labor, CoStar, Inc. and Wells Fargo Securities

No market has benefited more from the rising costs of Western coastal markets than Reno.

CRE Property Pricing & Fundamentals

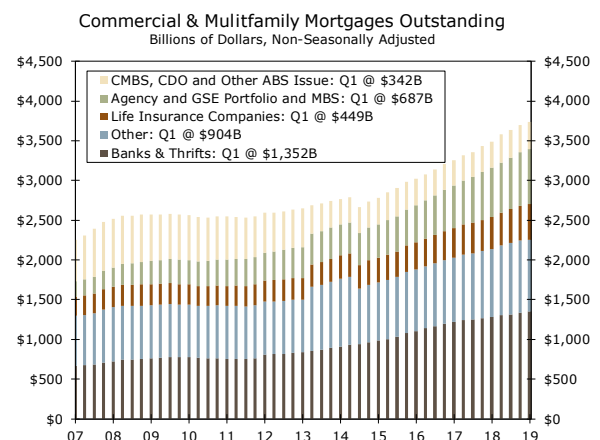
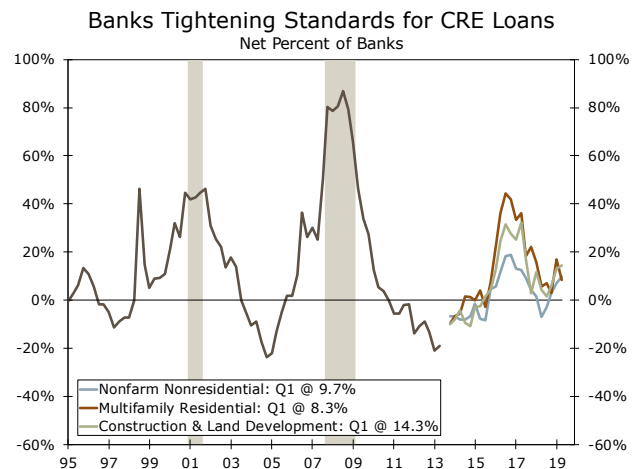
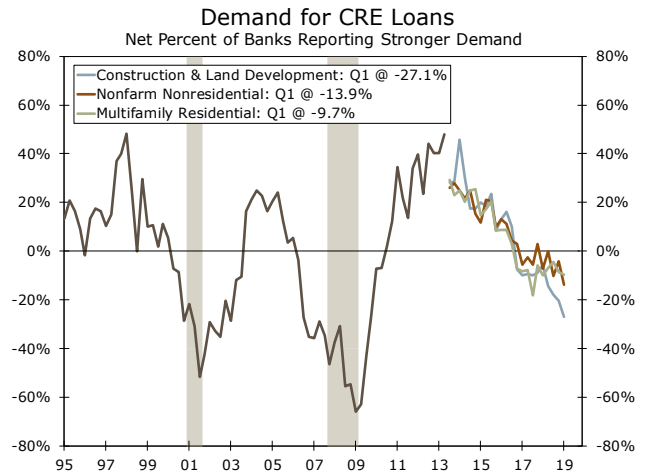
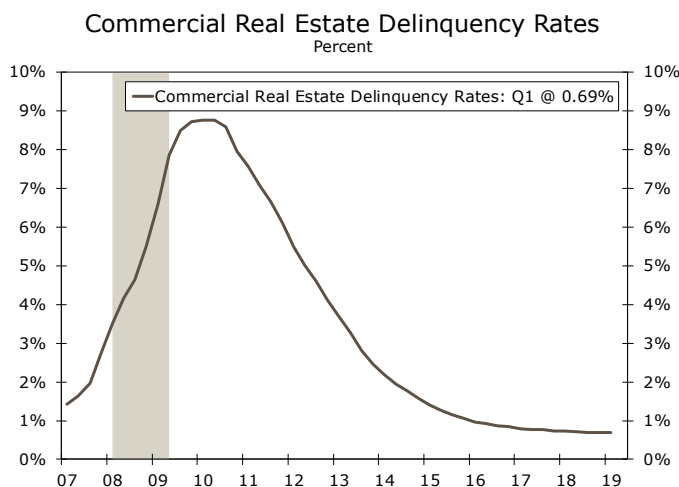
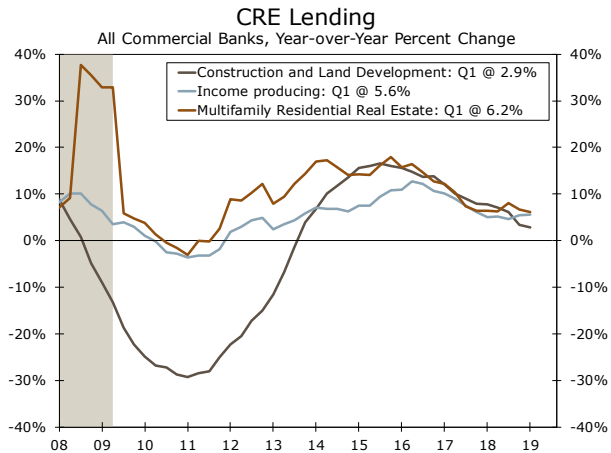
- Property prices are back on the upswing. The national all-property price index rose 7.2% year-over-year during May. Prices began to cool in the second half of last year, but have reacclerated in the past few months. With the exception of suburban office valuations, prices have regained momentum across every major property type. Overall prices are being driven by resurgent valuations in major gateway markets, which rose 8.4% over the year, the largest gain since 2017. Non-major market prices eased to 6.2%.
- The all-property cap rate has been mostly steady over the past 12 months. Transaction volumes fell to \$109.8 billion in Q1, although activity has plateaued through the quarterly volatility.



Source: CoStar, Inc., Real Capital Analytics and Wells Fargo Securities

Credit Availability & Lending

- On balance, more banks have been tightening credit standards for commercial real estate loans, citing reduced tolerance for risk, less favorable or more uncertain cap rates and a less favorable or more uncertain outlook for property prices as important reasons for tightening.
- Delinquency rates on CRE loans are at near-record lows and fell to 0.69% during Q1, the lowest rate dating back to 1991 when the Fed began compiling records.
- Despite solid demand for CRE loans, traditional banks have pulled back lending somewhat, which has allowed non-bank lenders, including private equity, hedge funds and insurance companies, to gain share in recent years.

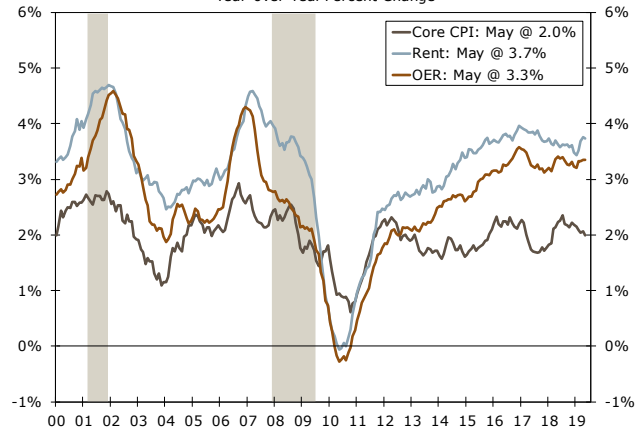


Source: FDIC, FRB, Mortgage Bankers Association and Wells Fargo Securities

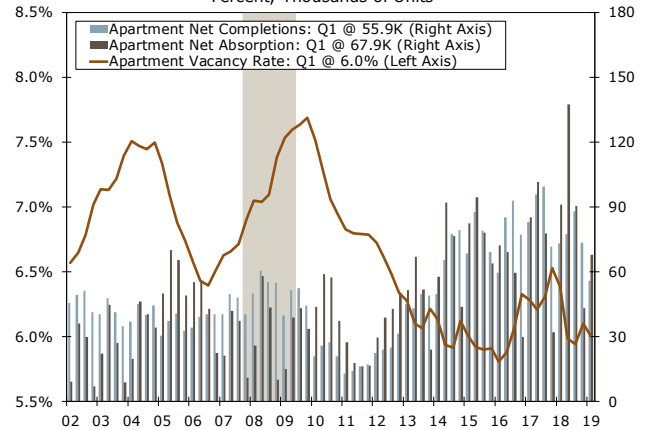
Apartment

- Over the past 10 years, apartment prices have risen a massive 125.8%, the largest gain of any major property type. The seemingly meteoric rise in apartment property prices has raised concerns about excessive speculation. Price appreciation, however, has been relatively subdued relative to prior cycles, taking nearly seven years to reach their prior peak. Demand for rentals has mostly matched the volumes of new supply added over the past decade. The apartment vacancy rate remains near a cycle low, hovering around 6.0% for much of the past year.
- The Fed is poised to reduce the federal funds rate, largely due to the absence of inflationary pressures. However, the year-over-year rise in rent of primary residences, a subcomponent of overall CPI, has accelerated to 3.7%. A lower effective federal funds rate will likely put additional downward pressure on mortgage rates, which have already sunk below 4.0% alongside a sliding 10-year yield. With rates heading lower, we expect to see more renters opt for homeownership.
- The Southeast and West have seen apartment prices rise the fastest. Some of the usual suspects—the Bay Area, Phoenix, Atlanta and Orlando—where job and population growth have surged and rents are growing the fastest are seeing the largest gains in sales prices. Florida and North Carolina are seeing the most new construction, with Miami, Jacksonville, Charlotte and Raleigh leading the way.

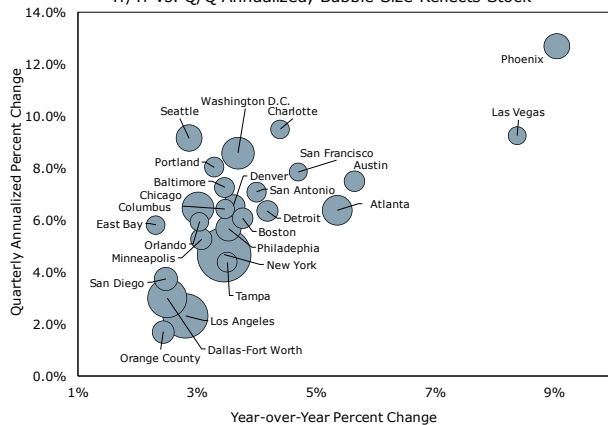
Shelter Costs vs. Core CPI
 Year-over-Year Percent Change



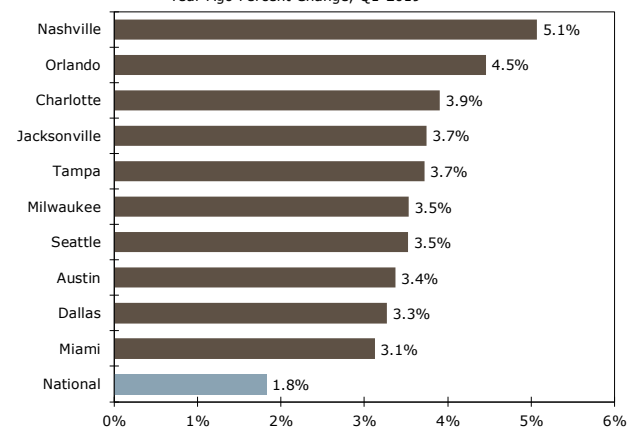
Apartment Supply & Demand
 Percent, Thousands of Units



Apartment Effective Rent Growth: Q1-2019
 Yr/Yr vs. Q/Q Annualized, Bubble Size Reflects Stock



Apartment Stock Growth
 Year-Ago Percent Change, Q1-2019

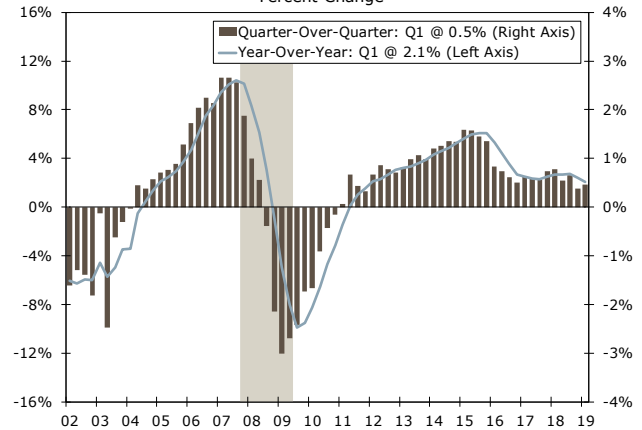


Source: CoStar, Inc. and Wells Fargo Securities

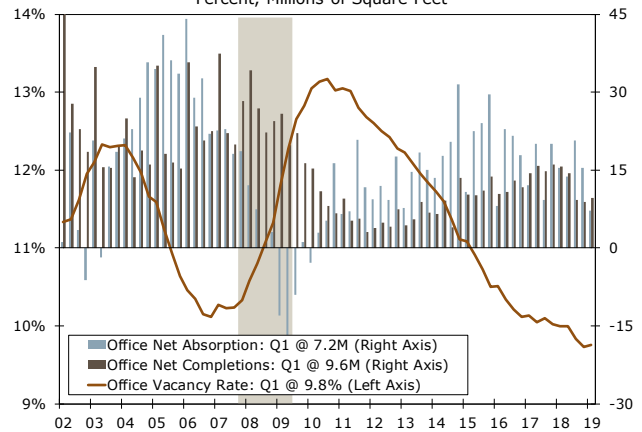
Office

- The office market remains incredibly balanced. Development in this cycle has been mostly confined to a handful of markets, most of which are either Gateway Cities or are major tech centers. Nashville, Salt Lake City and Charlotte are notable outliers to this trend, although all are also emerging tech centers. Nationwide, the office vacancy rate rose slightly to 9.8% in Q1, yet remains near a cycle low. Rent growth eased to 2.1% year-over-year in Q1 but has been amazingly consistent over the past three years, averaging roughly 2.5%. We expect slower overall employment growth, and thus less demand for office space, in the coming quarters.
- Office prices continue to rise. Central business district office prices have recently regained momentum, rising 6.5% over the past year after falling into a lull for most of 2018. Suburban office prices have largely continued to lose momentum. The gap between CBD and suburban office has widened to the point that it is arousing investor interest.
- San Francisco and New York City remain the hottest office markets, but rapidly rising rents in their dense urban cores is pushing tenants to newly developed areas. Wells Fargo, Ernst & Young and Amazon have all leased space in West Manhattan at the massive Hudson Yards, which just began phase two of construction this year. In San Francisco, Uber is constructing four office buildings in Mission Bay, while Slack is headquartered in the China Basin.

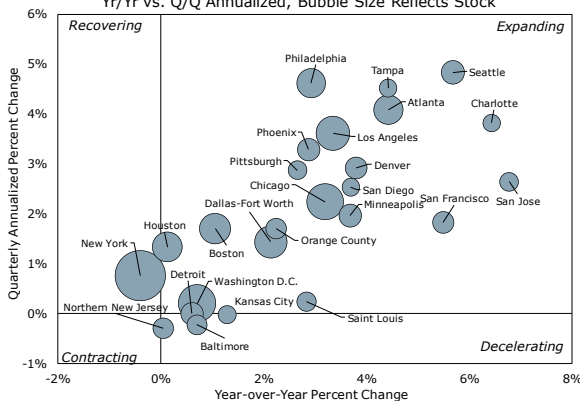
Office Asking Rent Growth
Percent Change



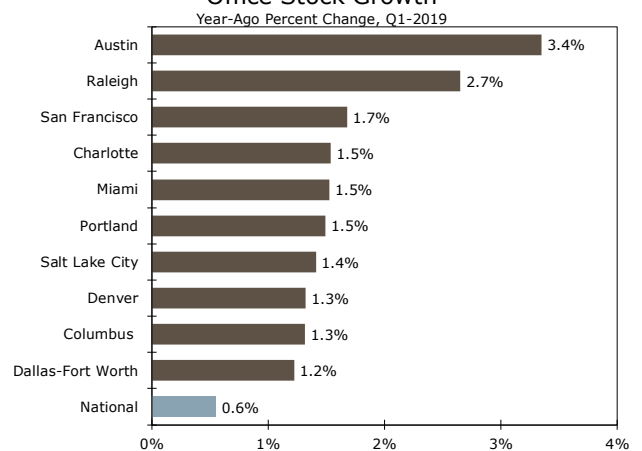
Office Supply & Demand
Percent, Millions of Square Feet



Office Asking Rent Growth: Q1-2019
Yr/Yr vs. Q/Q Annualized, Bubble Size Reflects Stock



Office Stock Growth

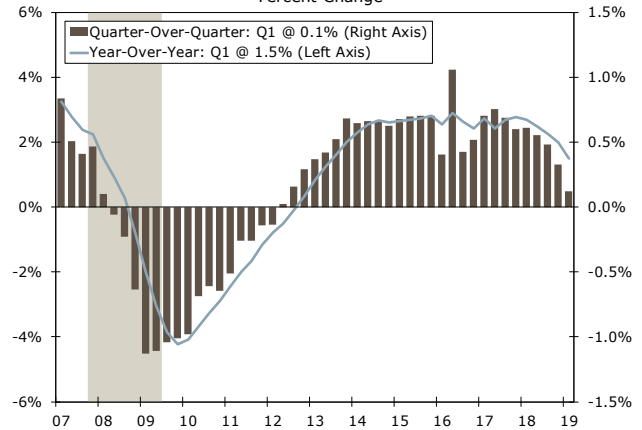


Source: CoStar, Inc. and Wells Fargo Securities

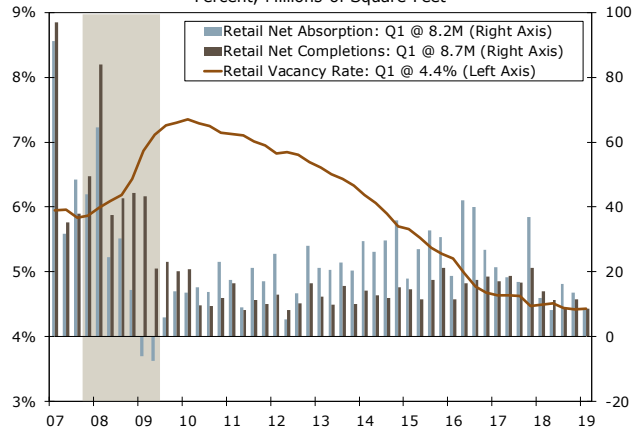
Retail

- Demand for retail space appears to be hanging in there. While new completions of retail space have roughly been cut in half, net absorption remains positive as growing chains and new concepts seek next generation space. While moderating from the tax-cut induced sugar high of 2018, we expect consumer spending to remain solid this year and next. More and more e-commerce-disrupted retailers are successfully engaging in a “bricks-and-clicks” strategy, which utilizes the online experience to drive store traffic.
- Store closures for longtime retail stalwarts such as Payless, Sears, and Kmart have been well-documented. Less publicized is the relatively strong leasing activity from the grocery, fitness and discount segments where e-commerce has yet to make its mark, such as Planet Fitness and HomeGoods.
- Retail rents rose 1.5% year-over-year in Q1, the slowest pace since 2012, however remain in positive territory. The sky-high rents in the greater New York City area continue to lose air and are experiencing outright declines. Owners in many Southeastern markets, which tend to have much stronger job and income growth, are having more success raising rents. Orlando and Tampa saw rents rise 6.5% and 6.2%, respectively, in Q1. Miami, where an incredible amount of new retail construction is underway, also posted a 3.7% gain. Rents in Nashville and Atlanta continue to climb at a rate much faster than the national average.

Retail Asking Rent Growth
 Percent Change

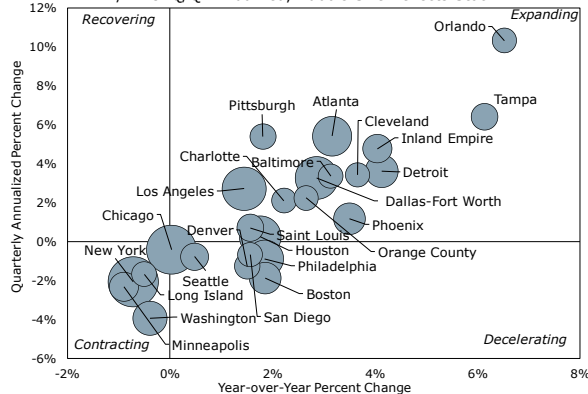


Retail Supply & Demand
 Percent, Millions of Square Feet



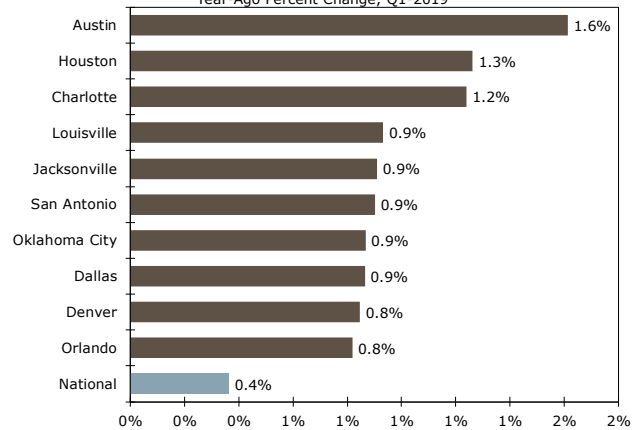
Retail Asking Rent Growth: Q1-2019

Yr/Yr vs. Q/Q Annualized, Bubble Size Reflects Stock



Retail Stock Growth

Year-Ago Percent Change, Q1-2019

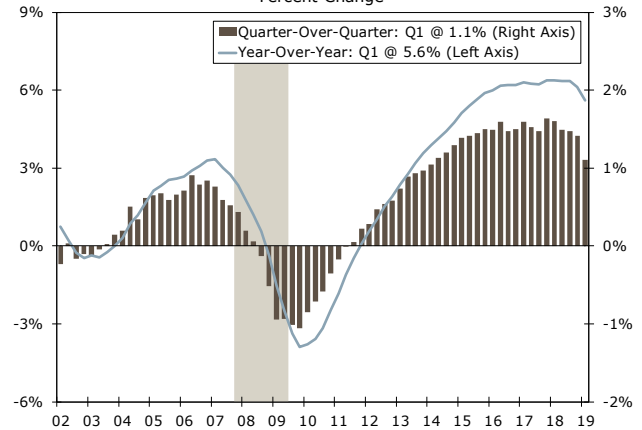


Source: CoStar, Inc. and Wells Fargo Securities

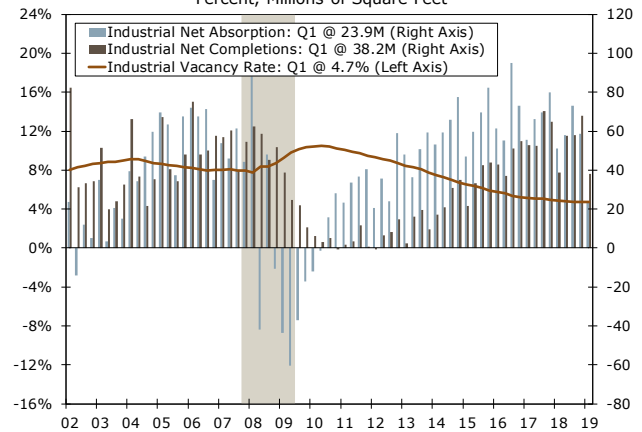
Industrial

- Investors continue to flock to industrial properties. Prices surged 11.8% year-over-year in May, the fastest gain since 2015. Blackstone's \$18.7 billion acquisition of nearly 180 million square feet of urban warehouse space underlines the huge demand for industrial buildings generated by last mile logistics and the rapid integration of e-commerce into retailing.
- New supply finally appears to be catching up to demand. The industrial vacancy rate ticked down to 4.7% in Q1, however rents moderated slightly to a 5.6% year-over-year pace, the first sub-6% reading in three years. The vacancy rate should continue to drift higher given the wave of new supply expected to deliver over the next few years. That noted, demand remains solid, and leasing activity appears to be strong.
- Rents are growing fastest in California's many logistics hubs. Sacramento, where development has lagged but which lies close in proximity to Reno and Stockton, saw rents grow 12% year-over-year in Q1. Stockton and the Inland Empire are also seeing rents rise in excess of 9%.
- Trade tensions have eased a bit as China and the U.S. have agreed to delay the imposition of addition tariffs. This should come as welcome news for industrial users in trade-centric port areas. Even with heightened trade risks, port cities continue to see the most new development relative to existing stock. Savannah and Spartanburg are two notable standouts, both are trade-driven markets with growing ties to China.

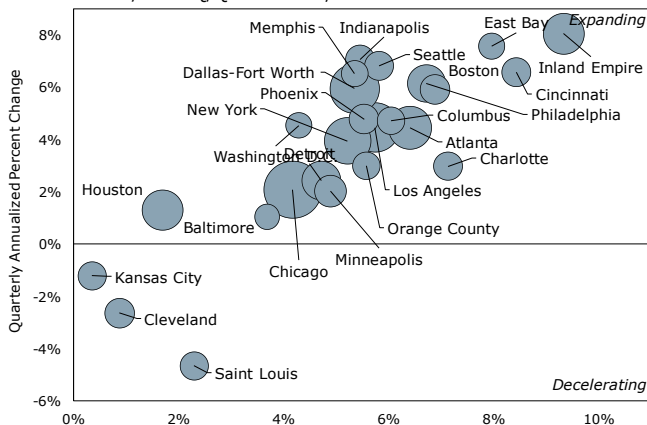
Industrial Asking Rent Growth
Percent Change



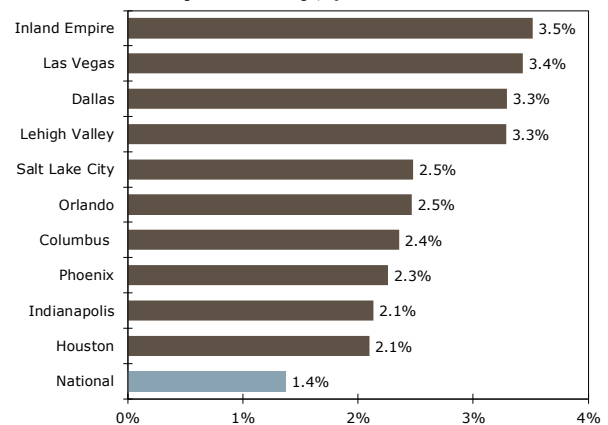
Industrial Supply & Demand
Percent, Millions of Square Feet



Industrial Asking Rent Growth: Q1-2019
Yr/Yr vs. Q/Q Annualized, Bubble Size Reflects Stock



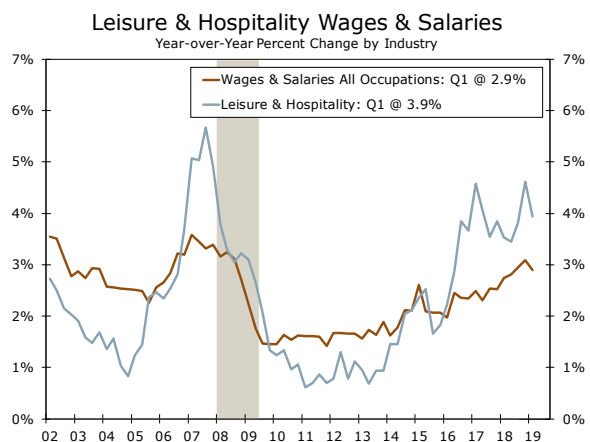
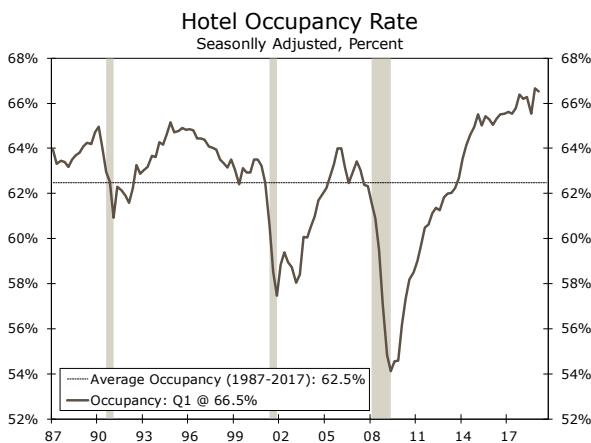
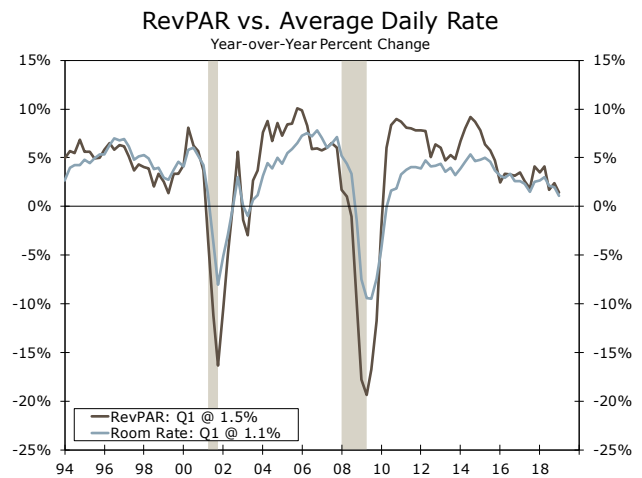
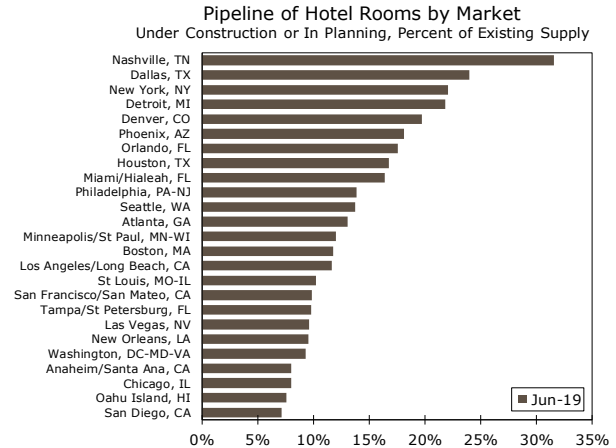
Industrial Stock Growth
Year Ago Percent Change, Q1-2019



Source: CoStar, Inc. and Wells Fargo Securities

Hotel

- Overall demand for hotel rooms remains robust. In Q1, the nationwide occupancy rate edged lower to 66.5%, but fell from the cycle high hit in Q4. RevPar rose just 1.5% year-over-year in Q1, the slowest increase since 2008. RevPar was likely negatively impacted by transitory factors in Q1, including the federal government shutdown and tough comparisons to last year's upturn resulting from hurricanes in the Southeast.
- Heightened competition from online-based home rental services such as Airbnb continues to keep a lid on daily room rate increases. In response, Marriot recently announced its own luxury home rental initiative in 100 markets across the globe, including many popular U.S. tourist destinations.
- Rising labor costs have risen in prominence as the top challenge facing the hotel industry. Despite wages in the leisure and hospitality sector rising at a pace well ahead of the national average, qualified workers are increasingly in short supply.
- Spending on hotel construction has ramped up headed into the summer, especially in the booming Sunbelt markets. Nashville and Dallas continue to lead, while development in Phoenix, Atlanta, Charlotte and Orlando has clearly increased. Tourism continues to be the driving force behind the white-hot Orlando economy. Along with several downtown properties, construction is well underway on an immersive Star Wars-themed luxury hotel at Disney World.



Source: STR, U.S. Department of Labor and Wells Fargo Securities

Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.	Acting Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Macro Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Erik Nelson	Macro Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	Macro Strategist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Canada, Ltd., Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC. And Wells Fargo Bank, N.A. are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2019 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 ("the Act"), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU ("MiFID2"). The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE