We are pleased to present the 2017 House View. At the beginning of each year, USAA Real Estate Company (USAA RealCo) publishes its annual House View, which highlights our economic outlook, real estate strategies, and market themes for the next 12 months. The goal of this research-driven report is to articulate a thoughtful perspective to our current and future investors and partners.
In many respects, history might view 2016 as a pivotal point in which political and economic pressures converged, reshaping the global investment environment for many years to come. The following section highlights several notable events of 2016:

President Trump defied the odds. U.S. voters opted for a candidate from outside the establishment, sending President Trump to the White House with over 62 million votes – the most by any Republican nominee in history. The election, however, revealed a bitterly divided U.S. political climate, as the Democratic candidate actually won the popular vote by nearly 3 million ballots. Republicans also captured majority wins in the House of Representatives and the Senate, and will now control both the executive and legislative branches of government for the first time since 2007. While the new administration may initially have enough political capital to push certain measures through Congress, it is not clear how much of President Trump's campaign rhetoric (which, at times, has been described as vague, divisive, and intriguing) will actually become policy.

Exhibit 1: 2016 U.S. Presidential Election Results

Sources: Politico

Brexit happened. In most instances, the United Kingdom’s (U.K.) referendum to leave the European Union (E.U.) would probably have been the biggest story of the year. Brexit was effectively a bellwether for an emerging anti-globalization, anti-political establishment, and anti-immigration sentiment that has taken hold across several countries. While President Trump’s victory casts a large shroud of uncertainty, Brexit carries significant ambiguity as well. Legislators have yet to identify exactly when/if the referendum will be final, and the economic implications are murky at best.

Exhibit 2: British Pound Before/After Brexit

GBP/USD EXCHANGE RATE

June 23, 2016
Brexit vote

Source: USAA Real Estate Company Research
The U.S. economy delivered what investors have come to expect in recent years, which was slow (but steady) growth. The Gross Domestic Product (GDP) stumbled in the first half of 2016 – averaging 1.1% over the first two quarters – the slowest start since 2011. The economy rebounded in the third quarter, and early indications suggest 2016 annual GDP will top 2.0%. This performance would be in line with the 2.1% average annual growth rate since the recession ended in 2009. The market appears optimistic regarding near-term economic growth given President Trump’s victory; however, it is unclear whether reality will keep pace with expectations.

**Exhibit 3: Federal Funds Rate**

![Federal Funds Rate Chart](image)

Source: USAA Real Estate Company Research

The Federal Reserve’s (Fed) 2016 interest rate forecast was overly hawkish. The Fed had projected four quarterly rate hikes, but only one increase occurred in mid-December 2016. The Fed raised short-term rates 25 basis points, pushing the Fed Funds range from 0.50% to 0.75%. This was only the second such rate increase in the last decade. The previous occurrence in December 2015 preceded the slowest six months of GDP growth since 2011. While correlation does not necessarily imply causation, anecdotal evidence suggests the rate hike played a material role in the economy’s sluggish performance. The current market appears to have priced in the most recent rate increase, so we do not anticipate a similar response. Every monetary policy decision going forward, however, will continue to face scrutiny from market participants.
The labor market flirted with full employment in 2016. The unemployment rate hovered near 5.0% through much of the year, and in November, it fell to 4.6% for the first time in almost 10 years. The U.S. economy added about 2.0 million jobs through the first 11 months of 2016, a monthly average of 180,000. Many economists consider 200,000 new monthly jobs as the threshold for a healthy labor market; however, the economy requires fewer jobs to maintain momentum as it approaches full employment. Wage growth remained solid (up 3.5% year-over-year) and overall, employment conditions have been relatively healthy.

The U.S. stock market did something it has never done before. The S&P 500 experienced its worst start on record, erasing $1.4 trillion in the first 10 days of 2016. Stocks eventually rallied and reached record highs in the weeks following President Trump’s surprise victory. What is more astonishing (or disconcerting) is while the stock market surged, corporations reported having six consecutive declines in quarterly earnings, suggesting equity prices may have become detached from corporate performance.

The U.S. real estate market was a magnet for both domestic and cross-border capital. Direct foreign investment to the U.S. was $69.0 billion through mid-December. While this was down 25.0% compared to 2015, it is still the second-largest year on record, by a wide margin. Total commercial real estate transaction volume was down 12.0% through October, compared to 2015, largely attributable to a slower start to the year. According to the NCREIF Property Index, unlevered returns on real estate investments have declined for the last six quarters and will deliver approximately 8.0% annual growth in 2016, down from 13.0% in 2015 and 12.0% in 2014. This slower growth environment has been largely due to a moderation in asset appreciation; however, income returns remain strong and overall real estate fundamentals are relatively healthy.

Given the current market conditions, USAA RealCo will maintain a defensive stance in 2017, while actively probing for the right investment opportunities. Why are we still defensive despite rising optimism in the public markets? In reality, the only material change in markets since the election on November 8, 2016 has been an overwhelming expectation of growth. While President Trump’s economic plan appears to have a large focus on making wholesale changes to fiscal, trade, regulatory, and diplomatic policy, the actual details are quite limited. History tells us it will be difficult, if not impossible, to make significant progress on all these issues within his first year in office. This is not an indictment against the new administration but rather a reflection of the arduous nature of accomplishing policy change in Congress. While having single-party control in the executive and legislative branches of government could be advantageous, not all Republicans align with President Trump’s views, which could prove to be an obstacle. Ultimately, we believe the market is overly optimistic in the same way it was initially overly pessimistic regarding President Trump on Election Day (as Dow futures fell 827 points before rebounding to record highs).4

In addition, we cannot ignore the fundamental changes occurring in the commercial real estate industry. Pricing has begun to recede from all-time highs, lending conditions have tightened, and we have seen smaller buyer pools on many asset sales as compared to recent years. While property rents are rising in most markets, the Fed will likely raise short-term rates over the next 12 months and it is not clear whether rents will keep pace with interest rates such that values are preserved. As the real estate cycle enters its late stages, we believe the risk remains to the downside from a real estate valuation perspective.

While the public market optimism sparked by President Trump’s surprise victory is noteworthy, only time will tell if this enthusiasm is sustainable. It took Presidents Bush and Reagan six and eight months, respectively, to pass comprehensive tax bills.5 Former President Obama’s hallmark legislation, the Affordable Care Act, originally had a six-year implementation schedule (2010-2015).6 In short, it will take a long time before we fully understand how the Trump administration’s policies will impact the economy and the real estate market.

As always, we remain true to USAA RealCo’s Guiding Investment Principles:

- Acquire, develop, and finance only high-quality assets with strong elements of design, size, and access such that the asset will outperform the greater marketplace over time
- Acquire, develop, and finance assets in the best locations
- Acquire, develop, and finance assets with broad appeal to future institutional purchasers
- Maintain discipline concerning replacement cost

Furthermore, we categorize Gateway, Primary, and Secondary target markets as shown. Certainly, the classification varies by product type, but these descriptions should generally hold true for office and multifamily, with slight variations between categories for hotel and retail. For the industrial sector, other major markets include Baltimore, Central Pennsylvania, The Inland Empire, Central Valley, St. Louis, Indianapolis, Tampa, Portland, Sacramento, Nashville, Orlando, Louisville, Cincinnati, and Kansas City. In addition, we would consider grocery-anchored retail in a number of large population centers.

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**ACQUISITION CAPITAL**

USAA RealCo has taken an increasingly cautious approach to acquiring stabilized core assets, as these properties have been fully priced in most markets. As a result, our team continues to focus on value creation opportunities with an emphasis on markets experiencing job and population growth. These cities are likely to outperform the broader market should an economic correction occur. We also favor properties with core characteristics, below-market rents (with near-term rollover), and upside potential, such as the ability to harvest additional development capabilities in the future. Asset enhancements are critical elements of our acquisition strategy, particularly via recapitalization, physical improvements, and/or the implementation of higher quality management. We believe it is critical to pursue assets offering attractive risk-adjusted returns rather than take greater risk in an effort to achieve yield, especially given the abundance of capital chasing real estate today. In 2017, USAA RealCo will continue to allocate acquisition capital in the following areas:
Underutilized Malls in Class A locations: Despite the significant negative commentary about the future of malls that can be found in the media today, meaningful value creation opportunities currently exist among certain malls with untapped potential. This is especially true for properties situated in strong trade areas with a solid tenant mix. These properties have the potential to create value through redevelopment of outparcels and repurchasing tenant-owned sites which can be leased to occupants with stronger credit quality and consumer drawing power. The density of some sites can be increased to include multifamily and office usage. There may even be an opportunity to generate additional revenue through the introduction of freeway billboards or other signage. These attributes are key components in differentiating healthy malls with upside potential, versus lower-tier malls that have underperformed in recent years and which we believe will continue to do so. Concerning the media commentary, we do believe that as many as half the existing malls in the United States may in fact close over the next twenty years, but we also believe the best of the remaining malls will remain viable. After all, bricks and mortar will continue to represent the majority of retail sales for many years to come.

Grocery-Anchored Shopping Centers: We target properties anchored by dominant grocers with a focus on locations where key grocers are achieving the highest level of sales per square foot. This property type has proven to be the most resistant to the growth of e-commerce relative to other retail segments. Accordingly, this sector has seen an increasing level of investor demand and price appreciation. We are closely monitoring the ongoing emergence of e-commerce in this segment, but to date, online sales have not become a major disruption within the sector.

Multifamily: Our emphasis is on acquiring assets below-replacement cost that offer a chance to add value through renovation and enhanced management of revenues and expenses, while maintaining a competitive cost advantage compared to fully priced modern core assets. The multifamily sector has experienced strong demand fueled by robust job growth and household formations. Our strategy includes acquisition of portfolios as well as individual properties, particularly in urban infill locations. Supply levels have become a concern due to rapid construction growth in our target markets. Yet, affordability remains an issue in several major U.S. markets as well. Therefore, a strategy targeting well-located (high quality, but lower cost) alternatives remains attractive. It is worth noting that apartments are typically strong hedges against inflation, as landlords can adjust rents as short-term leases (usually 6 to 12 months) roll over. This attribute could prove beneficial if inflation rises, which appears likely under the current presidential administration.

Industrial: We prefer to pursue assets with current vacancies or opportunities with near-term lease rollovers and below-market rents that can be purchased below replacement cost. The industrial sector has experienced an increasing level of new supply in recent years, largely due to strong e-commerce demand and rising trade/consumption volume. Consequently, we will continue to monitor supply and demand levels across target markets. Industrial rents do not typically keep pace with economic growth in an inflationary environment. This is largely due to long-term leases, which tend to have only modest rent bumps. While these properties still make for attractive opportunities given the favorable supply/demand conditions, investors should factor in the impact of inflation during the deal underwriting process.

Hotels: USAA RealCo and Square Mile Capital Management will seek to capitalize on emerging softness in the hospitality sector, by acquiring high quality assets significantly below replacement cost. We will target undervalued assets and utilize sophisticated capitalization structures to create additional value and provide downside protection. Additionally, we will focus on the acquisition and repositioning of individual assets or portfolios, recapitalization of existing capital structures, and selective acquisitions of secondary market debt.

Office: We will continue to seek out value add office buildings with below-market in-place rents as one of the more attractive opportunities in today’s market, while targeting markets with strong job growth in key sectors of the economy, such as technology, health sciences and media. The ability to aggressively manage these assets, while mitigating risks, offers the potential to produce substantial returns. This approach has been a hallmark of our success.

Government Leased Office: We will continue to seek opportunities to expand our portfolio of Class A assets leased to mission critical government tenants.
DEVELOPMENT CAPITAL

Development remains attractive due to rising rents, healthy occupancy levels and the significant spread between the cost of new development and the market value of stabilized assets. USAA RealCo has been a leader in this segment, but we are ever cautious due to the risks of overdevelopment. Construction pipelines have increased significantly in several markets. As we initiate development projects, we are mindful of the supply/demand conditions that will exist upon delivery in 2017 to 2019. Therefore, we continue to focus our development activity in the best submarkets we believe will outperform should a market correction occur. Our overriding thesis is to be an active developer in times when assets are trading well above replacement cost, as is the case in many markets today. USAA RealCo differentiates itself by its highly skilled development management professionals. This team, with expertise in all major product types, collaborates with our development partners through the entire process (including site selection, design concepts, and construction management). This approach improves efficiency, encourages communication, and results in a best-in-class product while producing optimal returns for our investors. USAA RealCo will continue to provide development capital in the following areas:

- **Multifamily Sector:** Although tenant demand has generally kept pace with the rising supply levels in recent years, we are taking an increasingly cautious approach to new multifamily development. Supply pipelines are robust in many of our target markets and rising land/construction costs make it challenging to source viable new projects. We conduct ongoing research on approximately 50 U.S. markets (and a large number of submarkets), tracking supply and demand fundamentals in order to select and deselect target markets. While several markets may not meet our investment criteria, select opportunities remain in markets where demand will outpace supply over the next several years. We see reduced emphasis on tactical developments and a greater focus on a build-to-core strategy, targeting a small number of submarkets with strong population growth. We believe these areas will outperform over the long term, even if vacancy rates rise in the near term. Our high-quality multifamily developments are not only competitive today, but also compete over the long term. As noted earlier, apartments serve as a strong inflation hedge, which is particularly beneficial with new developments because it allows property owners to recalibrate rent rates in accordance with market conditions.

- **Government Leased Office:** Government leased office properties continue to offer an attractive opportunity at this point in the cycle given the strong cash flow and limited ongoing capital requirements. Government leases are naturally defensive, as the tenant base has high-quality credit and typically signs leases for terms of 10 years or more. These characteristics can help stabilize a multi-asset portfolio, which is particularly beneficial late in the real estate cycle as investors shift toward more defensive strategies.

- **Speculative Office:** U.S. office fundamentals have improved, making new development viable in several markets where office pricing is approaching (or has surpassed) replacement costs, vacancy rates have compressed, and rental growth is positive. Furthermore, several cities are ripe for development due to:
  - Lack of high-quality blocks of contiguous space
  - Strong tenant demand for modern and efficient buildings to recruit and retain employees
  - Aging and obsolescence of current supply

USAA RealCo sees a limited opportunity in this area through 2018. Although new development has emerged in many markets, much of this new construction is typically 30.0% to 50.0% pre-leased with developers assuming lease-up risk for the remainder of the building. In our opinion, leasing the last 10.0% to 15.0% of these properties will become increasingly difficult in the later stages of the current cycle, especially given the increasing amount of supply in recent years.

Therefore, investors should remain committed to realistic underwriting assumptions, be cautious about market selection, and monitor leasing strategies (especially for large tenants) to ensure the remaining space is not unduly
VIEWING THROUGH THE EYES OF THE INVESTOR

“For us, being the best is not about growing AuM. It is about investing capital wisely. We are an INVESTOR FIRST.”

Len O’Donnell,
President & CEO
encumbered. Thus far, office demand has lagged office-using employment growth through the economic recovery. There are several factors contributing to this trend, including growing remote working trends and the utilization of less space per employee.

- **Grocery-Anchored Shopping Centers:** Following a solid year of development activity, the upcoming 12 months should offer additional opportunities for dominant grocers. There appears to be a focused opportunity to create community/neighborhood stores of 60,000 square feet or less, rather than the mega stores that once dominated the market. Such downsizing is a reflection of shifting consumer behavior, as customers are buying fewer items per visit. Certainly, e-commerce is partly responsible for this decline as more people are purchasing nonperishable items online. Consequently, grocers are evolving to better accommodate new technologies and consumer preferences.

- **Hotels:** Having successfully executed our three-year plan to take advantage of the lack of available capital needed to meet the demand for select service hotels, we concluded our hotel development initiative as of mid-year 2016. We are seeing deterioration in some of our target markets, most notably New York City. Therefore, we are shifting our focus to recapitalizations, highly secured debt positions and acquisition opportunities over the next couple of years.

- **Industrial Build-to-Suits:** USAA RealCo will continue to be an active source of capital with an emphasis on opportunities, which benefit from e-commerce growth in the industrial sector. However, pricing industrial build-to-suits will remain challenging in the near term, as current yields on cost are at historic lows. Moreover, interest rates and cap rates may increase prior to completion of projects commenced this year, eroding potential development profits. Accordingly, we will remain cautious in this area, focusing on investments with a few distinct characteristics:
  - Assets in Secondary markets
  - Properties with lower-profile tenants who have good credit quality and offer above-market returns
  - Core markets that can outperform the broader market should interest rates increase in the medium term

- **Speculative Industrial:** Shrinking inventories and rising rents continue to make this sector attractive, as does a significant level of liquidity for completed projects. This sector has attracted strong investor demand and construction pipelines have surged in a number of markets, which we will continue to monitor. In particular, smaller industrial space (150,000 – 350,000 square feet) offers strong investment potential. This segment makes up approximately 20.0% of the industrial square footage in the U.S., and only 20.0% of this inventory is Class A. This product type tends to produce stable cash flow. The current stock has high levels of obsolescence, and this segment is experiencing healthy demand. New construction has been limited while vacancy rates remain tight relative to historical averages. As noted, industrial leases do not respond quickly to inflation, so it is important for investors to underwrite current deals in the context of a rising interest rate environment.
DEBT AND CAPITAL MARKETS STRATEGIES

USAA RealCo and Square Mile Capital Management continue to manage various debt and preferred equity strategies. At this point in the cycle, these sectors offer highly attractive risk-adjusted returns consistent with our defensive posture, while also offering downside protection. Over the next few years, nearly $1.4 trillion in commercial real estate debt will mature, and neither collateral values nor available sources of conventional senior debt will support the complete recapitalization of such a large sum. USAA RealCo, in conjunction with Square Mile, is actively responding to this opportunity by providing loans that are accretive vis-à-vis common equity to fund remaining debt repayment, capex programs and leasing costs. In particular, USAA RealCo continues to focus on the following areas:

- **Whole Loans:** USAA RealCo is now offering whole loans on institutional grade properties throughout the U.S. We focus on long-term, fixed-rate loans for major property sectors in Primary and Secondary markets. Terms range from 5 to 30 years with loan-to-value (LTV) ratios of 50.0% to 70.0%.

- **Stretch First Mortgages and Mezzanine Debt:** Through Square Mile, USAA RealCo will continue to expand its activities in these areas with a focus on originating high-quality first mortgage loans and mezzanine loans. These loans, offering last dollar exposure between 65.0% and 85.0% of the capital stack, provide equity-like returns with lower risk, strong current income and superior returns.

- **Capital Stack Restructuring:** Square Mile will focus on preferred equity investments (which tend to outperform in downside scenarios) that benefit from material sponsor subordination and may feature a current income component. In addition, the strategy will target special situations that require equity investments, including investing on a program basis in general partner interests alongside operators where returns are enhanced via LP capital promotes including participation in carried interest and other fees not typically paid to managers, while benefiting from cross-collateralized cash flows.

OTHER AREAS OF INTEREST

While the areas listed previously reflect USAA RealCo’s current focus, we will continue to advance opportunities in the following sectors:

- **Senior Housing:** As the Baby Boomers approach retirement age, the U.S. will experience significant demand for senior housing. Consequently, we are actively creating a senior housing platform to work in concert with our existing multifamily program. Our activities are increasing in this space with an understanding that this is a multigenerational opportunity. Today, the parents of Baby Boomers are the primary senior housing tenant, as the first Baby Boomers will not reach 80 years old until 2026. Consequently, we expect senior housing to continue to gain traction in the coming years.

- **Medical Office:** The Affordable Care Act (ACA) has added more than 20.0 million people to health insurance rolls since 2010. President Trump has threatened to repeal and replace the ACA, but regardless of the final shape the law takes, the aging U.S. population and longer life spans should continue to be key demand drivers for the medical office segment. USAA RealCo established its initial investment during the first half of 2015, and we have continued to expand this platform. This segment has potentially more opportunity as the aging Baby Boomer demographic and federal laws promote a favorable investment environment.

- **Single-Family Housing Lot Development:** The U.S. housing sector stands to benefit in the near term, as the oldest Millennials (in their mid-30s) are beginning to form families and purchase homes. The bulk of new household construction has occurred in the multifamily sector, and therefore single-family construction pipelines have been underdeveloped at a time when pent up demand is rising. Furthermore, strict lending standards have made it difficult for single-family developers to obtain capital. USAA RealCo believes there is an opportunity to capitalize on these conditions by sponsoring a single-family housing lot development program.
NON-U.S. STRATEGIES

Since 2014, USAA RealCo has completed numerous investments across Europe as several markets offered attractive opportunities. In 2016, we elected to slow our activity, in part, due to the global economic uncertainty, but more specifically, pending the Brexit referendum. We successfully sold our two most recently completed assets in the U.K. prior to the vote and we are largely delaying further development until we execute preleasing or until we have greater clarity on the impact of the vote.

While much of our European development activity has capitalized on surging demand for new Class A industrial warehouses, we also see an opportunity to develop institutional quality multifamily assets in select European markets. Institutional ownership of for-rent residential is becoming increasingly more mainstream in Europe, but there is a scarcity of high-quality modern product in the marketplace. Mortgage constraints for first-time homebuyers and demand for urban/amenitized living near job centers are driving demand for new supply of private rented sector housing. The residential sector in Europe is highly fragmented and heterogeneous with different forms of ownership, creating an inefficient market and an opportunity for USAA RealCo to leverage its multifamily acquisition/development expertise in Europe and create value.

We also believe there will be an opportunity to acquire existing assets in both industrial and residential properties across a number of markets. Many assets are currently priced well below replacement costs. As the European economy begins a more robust economic recovery, these assets will benefit from rent growth and increased investor demand, thereby achieving attractive risk-adjusted returns.

For now, however, we will remain patient while looking to strengthen our presence, as rising volatility may present unique opportunities. Over the long term, we will continue to cultivate this area of our investment platform, while holding to a cautious outlook in 2017.

DISPOSITIONS

In 2016, we executed dispositions in excess of $2.0 billion. This marked the second highest volume in our history, trailing only the $3.2 billion sold in 2014. Generally, we sold tactical assets while retaining the highest quality properties in strategic markets. Over the last several years, we have been steadily monetizing successful investments from earlier in the cycle, such that our investors can benefit from peak pricing. In fact, our disposition volumes total more than $9.3 billion since 2012.

Our disposition philosophy differentiates us from real estate managers who focus primarily on amassing assets under management. We are always an active seller – we do not fall in love with properties, and we do not hold them forever. We will continue to sell assets at the appropriate time, while holding investments we believe will outperform the broader market over time.
POLITICS: A PERSPECTIVE ON TRUMP

Like most investors, we are in “wait and see” mode given there are currently more questions than answers regarding the Trump administration’s fiscal, trade, regulatory, and diplomatic policies – all of which could have a significant impact on the U.S. economy and, ultimately, the commercial real estate market.

Fiscal Policy. President Trump will likely have some level of success implementing an active fiscal policy agenda, as Republicans have majorities in the House of Representatives and the Senate. This is in stark contrast to the bitterly divided government over the past six years, which ultimately resulted in one of the least productive Congressional periods on record.7 The investment landscape would stand to benefit from a sound fiscal agenda, in large part because the economy would no longer be relying solely on the Fed to spur economic growth. Currently, a trillion dollar infrastructure program and wide-ranging business/consumer tax cuts seem to be cornerstones of President Trump’s fiscal policy.8 There are certainly questions regarding these initiatives: 1) Are they enough to jump-start the economy? 2) How will the government finance the infrastructure program, and will it require private sector support? 3) Will the expected tax revenue be sufficient or will there be meaningful deficit spending? 4) How long will it take to see an impact in terms of greater economic growth? Whether one agrees or disagrees with the new administration’s proposals, investors should expect an active economic agenda going forward.

Trade Policy. So, will there be a trade war? Probably not. The odds of existing trade agreements changing dramatically seem relatively small, but future negotiations are worth monitoring. Trade policy is actually the one area in which President Trump has liberty to impose tariffs and withdraw from negotiations without the explicit approval of Congress.9 NAFTA (North American Free Trade Agreement), for example, was a point of contention during the campaign. While the Trump administration has the flexibility to impose changes, proponents would argue the existing agreement has benefitted the U.S. and Mexico. Mexico has become the second largest export partner to the U.S., with roughly 6 million U.S. jobs relying on the cross-border trade relationship. California (692,000 jobs), Texas (463,000 jobs), and Florida (312,000 jobs) currently have the most exposure.10,11 President Trump will likely take a protectionist approach, vowing to restrict international trade with the intent of shielding local jobs from foreign competition. While he will certainly have leverage given America’s standing as the second largest exporter in the world (nearly $2.3 trillion in exports), he will also be somewhat limited by the growing interdependence between the U.S. and many other countries.12

Regulatory Policy. President Trump campaigned heavily on reducing business regulations, and early signs indicate he will follow through on this promise. Several of his cabinet appointees are advocates for less regulatory oversight.13 The current regulatory environment has resulted in tight real estate lending standards. If President Trump is successful in rolling back banking regulations, it is conceivable that lending conditions could become less restrictive over the

medium term, but we do not expect any significant changes to lending conditions in 2017. A more investor-friendly environment appears imminent; however, it is critical to avoid excessive deregulation, which could lead to both economic and political destabilization.

**Diplomatic Policy.** The most problematic issue regarding President Trump’s occupancy of the Oval Office could be his ability to manage diplomatic relations. He has vowed to “destroy” the ISIS terrorist group, labeled China as a currency manipulator, forcefully advocated for nuclear options in the Middle East, boasted of building a wall along the border with Mexico (and making Mexico pay for it), and appears to have found an unlikely ally in Russia – a development that could potentially shuffle global alliances. While campaign rhetoric does not necessarily translate to policy decisions, escalating geopolitical conflicts may prove overwhelming for a war-weary America. War has cost the country $1.7 trillion and thousands of lives over the last 15 years. President Trump’s economic agenda would suffer in wartime, as it would be nearly impossible to spend a trillion dollars on infrastructure and cut taxes for businesses and consumers, while simultaneously financing an expensive war budget. We are not advocating for a hostile administration, and to be fair, President Trump denounced costly wars during his campaign, particularly regarding America’s financial obligation to NATO (North Atlantic Treaty Organizations). Nevertheless, President Trump’s ability to navigate geopolitical issues remains a wild card.

**U.S. ECONOMY: SLOW, STEADY, AND CONSISTENT**

One word in particular exemplifies the U.S. economy: Resilient. We expect continued steady growth in 2017, in line with the 2.1% GDP average since the recession ended in 2009. Over the next few years, however, growth expectations will depend largely on policies from the current administration. There appears to be a wide gap between some market participants and economists regarding the impact of President Trump’s surprise victory. Moody’s Analytics, for example, decreased their GDP outlook – citing an expectation of slower growth policies. So, how does this economic forecast square with the enthusiasm that has driven the bond and stock markets following the election? These matters do not completely reconcile; either the economic models are underestimating the “Trump Bump,” or investors have potentially mispriced markets due to overly optimistic expectations. It is too soon to know which logic will prevail, or if other factors are at play. Ultimately, if there is an upward (or downward) shift in GDP expectations, it will likely occur in 2018, as it should take at least a year for the economy to fully absorb President Trump’s fiscal policies.

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LABOR MARKET: APPROACHING FULL EMPLOYMENT

The labor market is relatively healthy and continuing to approach full employment, but there is also an opportunity to reduce slack among inactive and underemployed workers. The Fed forecast calls for unemployment to fall to 4.5% in 2017, from a low of 4.6% in 2016. This would mark the lowest rate since 2007, leading many (but not all) to believe the economy has reached full employment. The labor market created a healthy 2.0 million jobs in the first 11 months of 2016, trailing the 2.9 million annual average over the prior two years. Wage growth has continued to improve, and jobless claims fell to the lowest level since 1973. Critics, however, tend to focus on the sluggish labor force participation rate when questioning the overall health of the employment market. The rate has been on par with historically low levels from the 1970s over the last few years, and it was 62.7% as of November 2016. Why are so few people participating in the labor force? While it is difficult to reconcile fully, researchers primarily attribute this issue to demographic shifts related to retiring Baby Boomers (more than 10,000 of which reach retirement age every day). Also, the Millennial cohort has stayed in college much longer than previous generations, largely due to a sluggish economy following the Global Financial Crisis. While these two factors explain much of the labor force participation rate, some would argue the unemployment rate is artificially low because the calculation ignores millions of inactive workers, and it also does not fully capture the many underemployed personnel. As such, the labor market still has room to improve despite inching towards full employment.

Exhibit 6: U.S. Unemployment Rate

Source: BLS, USAA Real Estate Company Research

U.S. CONSUMERS: OPTIMISTIC OUTLOOK TAKES HOLD

The U.S. consumer outlook is healthier today than it has been in a number of years. Consumer confidence recently reached a nine-year high in November 2016, driven by positive consumer expectations over the near term.21 This optimism bodes well for the U.S. economy, as discretionary spending tends to correlate with consumer confidence. Historically, consumers accumulate debt (especially credit cards and home equity loans) when their spending levels increase. Household balance sheets, however, appear relatively healthy. Debt balances have risen just 4.0% annually over the last 4 years, compared to double-digit growth rates in 2005 to 2007. U.S. households have generally avoided overleveraging, as debt service to disposable income levels were less than 10.0% as of June 2016 versus more than 13.0% in 2007. An economic shock would certainly affect these conditions, but if investors are looking for a reason to be optimistic about the economy, they need not look further than the U.S. consumer – especially given that consumer spending drives roughly 70.0% of the U.S. economic output.

Exhibit 7: U.S. Homeownership Rates

Source: USAA Real Estate Company Research

“We will pursue high quality properties in the best locations with a broad appeal to occupiers and eventual institutional buyers. We are always an active seller— we do not fall in love with properties, and we do not hold them forever.”

Len O’Donnell,
President & CEO
MONETARY POLICY: INTEREST RATES ARE ON THE RISE

The Fed’s 2017 forecast calls for three short-term rate hikes at 25 basis points each, but history suggests their estimate may be high. The Fed anticipated four rate increases during 2016, but in reality, they only initiated one. In fact, they have essentially overestimated the annual interest rate forecast every year since the economic recovery began in 2009. If the Trump administration, however, successfully implements their economic agenda (i.e., tax cuts and infrastructure spending) then inflation could increase, which might cause Fed officials to adopt a faster pace regarding interest rate tightening policy.

As touched upon earlier, this scenario seems unlikely given it should take at least six months to pass an initial tax bill (which was the case for the Bush tax cuts in June 2001, and the Reagan tax cuts in August 1981). Consequently, the full impact of the new administration will likely take hold in 2018 and beyond. President Trump has been critical of Fed Chair Yellen’s decision to maintain low interest rates, so it will be interesting to see if/how the administration aligns (or clashes) with the Fed’s current monetary policy. Another issue worth monitoring is the impact of a strengthening dollar going forward. Shortly after the presidential election, the dollar reached a 13-year high versus a basket of six highly traded world currencies. Rising interest rates would probably strengthen the dollar even more, causing volatility among global currencies, weakening U.S. exports, and potentially making the country less attractive to foreign capital.

Exhibit 8: Yield Curve / 10 Year Treasury

Source: USAA Real Estate Company Research


Real Estate Fundamentals

PROPERTY VALUES & CAP RATES

Core real estate prices are well above replacement costs in most major markets, but the question remains whether a rising interest rate environment translates into a capitulation point for asset prices. According to RCA/Moody’s CPPI index, national commercial real estate pricing is 22.0% above the pre-recession peak. The major market index, comprised of the top six MSAs, is up 39.0% from the pre-recession peak. While the non-major market index is only 8.0% above its pre-recession peak, the index is up 9.2% over the past year, indicating Secondary markets are improving as well. Recent price increases reflect an improvement to rents and net operating income as opposed to cap rate compression, which largely ended in 2015. Cap rates continue to remain near historical lows. According to NCREIF, implied cap rates were 4.5% as of third quarter 2016 – 41 basis points below the pre-recession trough. The spread over 10-year Treasuries is roughly 290 basis points, still above the post-1992 average of 232 basis points. Furthermore, spreads over BBB corporate bonds are nearly double the historical average (125 basis points vs. 68 basis points as a post-1992 average), which suggests real estate remains attractively priced on a relative basis.

Exhibit 9: Cap Rate Spreads

While interest rates are likely to rise in the near term, the impact on cap rates will vary across markets. Core assets in Gateway markets should experience only modest pricing volatility given strong investor demand from both foreign and domestic buyers. Conversely, Primary and Secondary markets (especially for those assets where buyers are more likely to be dependent on debt financing) could experience a decline in values. Rising interest rates will add to an already complex market environment, as it is unclear whether rent growth will keep pace with rising interest rates. It is reasonable for investors to remain defensive, particularly with asset prices receding from the recent peak, lending standards becoming more restrictive, and deal underwriting beginning to soften. Although overall real estate fundamentals are still relatively solid, market conditions have begun to moderate.
“We know what it means to be an investor. We understand how strong cash flow and asset appreciation can support a larger mission, why capital preservation is critical, and how service and integrity build lasting relationships.”

Len O’Donnell, President & CEO
TRANSACTIONS & CAPITAL FLOWS

U.S. real estate transaction activity should remain relatively healthy in 2017, although the depth of the buyer pool has become smaller in recent years. Through October 2016, transaction volumes topped $380.0 billion, down 12.0% from the same period a year earlier. According to Real Capital Analytics, foreign investors placed approximately $69.0 billion of direct foreign investment in U.S. commercial real estate through mid-December 2016, second only to the previous all-time high of $92.0 billion achieved in 2015. The true impact of foreign investment on U.S. commercial real estate is understated because of the difficulty in measuring the total volume of foreign capital due to the prevalence of private investment vehicles (e.g., domestic real estate funds). The following countries topped the leaderboard in terms of direct foreign investment in 2016: China ($16.4B), Canada ($12.9B), Germany ($5.7B), Singapore ($4.3B), and South Korea ($3.8B). Foreign investors continue to gravitate toward the safety and security of investing in a relatively robust U.S. economy, given the potential for healthy cash flows and asset appreciation. Following last year’s amendments to FIRPTA, enacting exemptions for non-U.S. pension funds should begin to take hold in 2017, potentially resulting in even more cross-border capital to the U.S. real estate market.26

Exhibit 10: U.S. Acquisitions from Foreign Investors

SUPPLY AND DEMAND

Generally, fundamentals are in balance across most markets. Office sector supply should continue to increase due to rising demand for modern properties as many cities have a surplus of older buildings, which are unable to accommodate demand for flexible, sustainable, and attractive office space. E-commerce growth and global trade have been the primary drivers for industrial demand; these trends will likely continue in the near term. The multifamily sector continues to produce significant supply while demand has largely kept pace, creating healthy occupancy levels. In the retail sector, supply is likely to experience modest growth. Tenant demand has been steady and the sector has experienced only limited supply growth, resulting in healthier fundamentals. It is worth noting that rent growth has moderated across the major property sectors; but overall, real estate fundamentals are relatively strong and seem poised for another solid year in 2017.

Exhibit 11: Supply & Occupancy

Sources: REIS, CBRE-EA, USAA Real Estate Company Research
Conclusion

As we look ahead into 2017, USAA RealCo will maintain a defensive approach to investment while continuing to be an active, disciplined investor. We will pursue high quality properties in the best locations with a broad appeal to occupiers and eventual institutional buyers. We will closely monitor our investment basis and if acquisition costs remain higher than replacement costs, we will choose to develop rather than purchase. Today, for instance, some assets are trading at prices as high as 125.0% of replacement cost. More than at any time in this cycle, it is truly a matter of finding the right opportunities at the right time, and being very selective.

Admittedly, it seems as though things are rapidly changing, especially considering the uncertain macroeconomic conditions, a daunting political atmosphere, and the potential for volatility across global markets. Nevertheless, we do not chase trends and our value-investing approach to real estate is consistent across market cycles – even when uncertainty reaches the levels that it has recently. In fact, these are the situations when disciplined underwriting, focused strategy, and market conviction matter most. Although early indications suggest 2017 will be ripe with uncertainty, we will act appropriately to protect our portfolio while also maintaining the flexibility to pursue opportunities as they emerge.

THE FOLLOWING ARE USAA REALCO RESEARCH REPORTS WHICH ARE AVAILABLE ON OUR WEBSITE (USREALCO.COM):

1. The Construction Conundrum
2. The Debtonation Countdown
3. How China’s Economic Malaise could affect U.S. Real Estate Markets
4. Will an Inverted Yield Curve Predict the Next Recession?
5. 2016 Mid-Year House View
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