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Nareit is the worldwide representative voice for real estate investment trusts—REITs—and publicly traded real estate companies with an interest in U.S. real estate and capital markets.

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A Look Back at 2017 and a Look Forward to 2018

by Brad Case and Calvin Schnure

Macroeconomic developments, especially those pertaining to real estate investments, were positive in 2017, and we expect both macro and real estate conditions to remain favorable in 2018. Against that backdrop, it was surprising that total returns for REITs during 2017 averaged just 9.27 percent—slightly less than their long-term average performance (9.72 percent per year over forty-six years), and well below the performance that would be considered normal in such solid bull-market conditions.

In this outlook, we review current and expected market conditions, noting both the risks and sources of support that could shape the REIT market in 2018, including recently passed tax cuts and strong, persistent fundamental real estate market conditions. We expect that strong fundamental real estate market conditions will persist through 2018.

GDP Growth

GDP growth decelerated a bit in the final quarter of 2017, as weak net exports and a decline in inventory investment more than offset robust consumer spending. GDP for the year as a whole was 2.3 percent higher than the prior year, indicating the economy had gained some momentum from the 1.5 percent growth recorded in 2016.

Our outlook on GDP is relatively optimistic, with more upside potential than downside risk. The issues that typically lead to recessions—overbuilding, overheating, overleveraging—are not present, and monetary and fiscal policy conditions are supportive of continued GDP growth.

REITs in the News	
BRIXMOR	**Brixmor Property Group** (NYSE: BRX) Reports Third Quarter 2017 Results
COPT CORPORATE OFFICE PROPERTIES TRUST	**Corporate Office Properties Trust** (NYSE: OFC) Reports Third Quarter 2017 Results
LTC REIT	**LTC Properties** (NYSE: LTC) Reports 2017 Third Quarter Results; Announces New Investment
MACERICH	**Macerich** (NYSE: MAC) Announces Quarterly Results
MREIC Monmouth Real Estate Investment Corporation	**Monmouth Real Estate Investment Corporation** (NYSE: MNR) Reports Fourth Quarter Results
NATIONAL RETAIL PROPERTIES NYSE:NNN	**National Retail Properties** (NYSE: NNN) Announces Third Quarter 2017 Operating Results and 2018 Guidance
Safety, Income & Growth Inc. The Ground Lease Company	**Safety, Income & Growth, Inc.** (NYSE: SAFE) Announces Third Quarter 2017 Earnings Results
UMH PROPERTIES, INC	**UMH Properties** (NYSE: UMH) Reports 3rd Quarter 2017 Earnings
W. P. CAREY	**W. P. Carey** (NYSE: WPC) Announces Third Quarter 2017 Financial Results

Inflation

Inflation has been running below the Federal Reserve's 2-percent target, with the core PCE (personal consumption expenditures) deflator rising just 1.5 percent over the twelve months through November. The Fed has a dilemma: It doesn't want inflation rates to fall too low, as this limits its ability to boost a weakening economy, but neither does it want tightening labor markets to overheat and lead to accelerating inflation.

There's little risk of the economy overheating; in fact, the millions of people who are currently out of the workforce—but could enter it again—are a safety valve against wage and price pressures. Inflation in 2018 is more likely to undershoot than to overshoot.

Long-Term Interest Rates

The yield on the 10-Year Treasury note ranged between 2.0 and 2.5 percent throughout 2017. The Fed, however, is not simply raising short-term interest rates; it is also allowing its $2.5 trillion portfolio of Treasury securities to shrink, potentially putting upward pressure on long-term interest rates as well.

Nearly everything we see suggests that long-term rates will increase—but, with inflation under control, it is likely the increase in long-term interest rates will be modest. In the event of a geopolitical event or other crisis, however, a flight to quality could push Treasury yields down significantly.

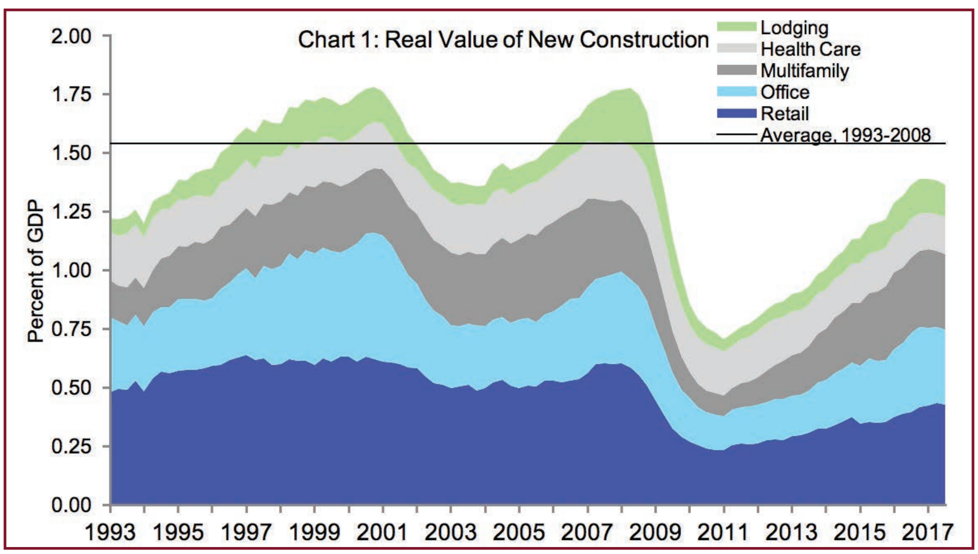
Tax Reform

In late December, the Tax Cuts and Jobs Act was signed into law. This legislation reduced tax rates and made other significant changes generally effective for 2018. The bill reduces individual income tax rates, including dropping the maximum rate from 39.6 to 37 percent; lowering the maximum corporate tax rate from 35 to 21 percent; and creating a 20-percent deduction for individuals receiving qualified business income. REIT ordinary dividends are fully eligible for the qualified business income deduction. Thus, REIT stockholders will pay substantially lower tax rates on dividends. For example, at the highest tax rate, the tax on REIT dividends will fall 10 percentage points, from 39.6 percent in 2017 to 29.6 percent in 2018.

The tax cut package should be moderately supportive of near-term economic growth as many households will see increases in take-home pay in 2018. Most analysis suggests the longer-term effects of the tax package will be positive, but very small and subject to great uncertainty.

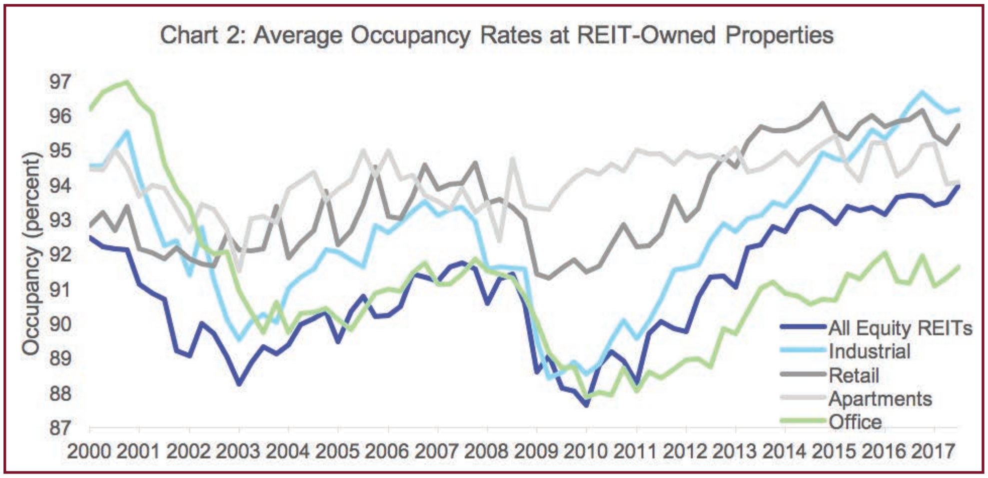
Real Estate Supply/Construction

The pace of new construction has been strong since 2011—but, as Chart 1 shows, the value of new construction hasn't yet even fully recovered to the level of just over 1.5 percent of GDP that was normal prior to the construction collapse that began in 2008. In fact, construction activity has actually moderated during 2017, reducing the risks of developing an oversupply problem.



REIT Occupancy Rates

The combination of moderate but steady growth in demand and moderating growth in supply has helped REITs maintain high average occupancy rates, as shown in Chart 2. In fact, the industry-average occupancy rate has held steady, in the range of 93 to 94 percent, for four full years, since the end of 2013. In addition, many investors may be surprised to learn that occupancy rates for REIT-owned retail properties have been higher than 95 percent in every single quarter since early 2013.



REIT NOI Growth

Over the long term, REITs have managed their properties to achieve consistent growth in net operating income (NOI), which averages in the range of 2.5 to 4.0 percent per year on a same-property basis, according to the T-Tracker® quarterly operating performance series published by Nareit. Over the last four quarters, same-property NOI growth averaged 3.2 percent, and with both supply and demand conditions stable, there's every reason to think that operating fundamentals will stay in that "sweet spot" for a relatively long time.

Property Prices

Commercial property prices have risen 52 percent over the past five years, and are 23 percent above the peak reached prior to the financial crisis, according to the CoStar Commercial Repeat-Sales Index (CCRSI). Price gains have slowed to 4.5 percent over the past twelve months, alleviating some of the concerns about possible overheating.

It would not be unusual for prices to give back some of the large gains they have made over the past five years, especially if interest rates were to rise more rapidly than expected. Conditions in property markets are solid, however, with low vacancy rates, a rough balance between new supply and the demand for commercial space, continued rent growth and some acceleration in NOI growth. Indeed, Real Capital Analytics recently reported that cap rates in the apartment, office, and industrial sectors declined in November to the lowest levels since at least 2001. Single-digit gains in property prices are most likely in this environment.

Conclusion

In short, the operating environment for REITs has been solid, both demand and supply drivers have been favorable, macroeconomic conditions and policy changes have continued to be supportive, and we expect—most importantly—that strong fundamental real estate market conditions will persist through 2018, if not for several more years to come.

If you are interested in Nareit's full economic outlook for 2018, please click here.

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Advisor-Access LLC was designed to bring compelling investment ideas to investors in the form of in-depth interviews with company management and the latest fact sheets and corporate presentations, in a concise format: the critical pieces of information an investor needs to make an informed investment decision.