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CONTENTS

1 | Economic Overview........................................................................................................ 5
2 | Commercial Real Estate Investments........................................................................ 8
3 | Commercial Real Estate Fundamentals.................................................................... 12
4 | Outlook........................................................................................................................ 14
Gross Domestic Product

Economic activity continued on an upward trend in the last quarter of 2016, but at a slower pace, as the first estimate of real gross domestic product (GDP) from the Bureau of Economic Analysis documented. Preliminary figures indicated that GDP rose at an annual rate of 1.9 percent, on par with the average 1.9 percent typical of fourth-quarter GDP growth over the 2000-15 period. The slower quarterly economic performance closed the book on 2016 with an annual GDP growth rate of 1.6 percent.

The fourth quarter increase in economic activity stemmed from moderately positive contributions across most of the main GDP components. Net exports offered the only exception—experiencing the impact of a strengthening dollar. The 4.3 percent decline in exports coupled with the 8.3 percent jump in imports led to a negative contribution to quarterly GDP.

Consumer spending—the main driver of GDP—continued on an upward swing for the 28th consecutive quarter. Personal consumption rose at an annual rate of 2.5 percent in the fourth quarter. Benefitting from the traditional holiday season, the fourth quarter experienced solid gains in durable goods spending, especially cars and light trucks (up 11.8 percent), as well as recreational goods and vehicles (up 16.2 percent). Consumers also spent more on furniture and durable household appliances (up 4.0 percent). Nondurable goods spending increased at a comparable 2.3 percent during the quarter, with more consumer dollars flowing toward grocery store purchases. Spending on services rose 1.3 percent on an annual basis, with transportation, recreation and financial services leading the spending gains.

Disposable personal income—adjusted for inflation—rose 1.5 percent in the fourth quarter, according to the Bureau of Economic Analysis. The personal saving rate was 5.6 percent in the fourth quarter, slightly lower from the previous quarter.

The corporate outlook improved in the last quarter of the year. Nonresidential fixed investment increased at a 2.4 percent annual rate, the strongest quarterly gain of the year, as companies boosted investments in equipment. Spending on intellectual property products advanced by a solid 6.4 percent in the fourth quarter. Investments in commercial real estate declined at a 5.0 annual rate, while investments in residential real estate rose at a 10.2 percent rate.

Government spending rose at a 1.2 percent annual growth rate, on the strength of state and local government spending. Federal government spending declined by 1.2 percent, as defense spending retrenched.
Employment

The pace of employment growth remained positive, but softened slightly in the fourth quarter. Payroll employment advanced by 495,000 net new jobs during the fourth quarter, closing 2016 with a net total of 2.2 million new employees, according to the Bureau of Labor Statistics. Private service-providing industries continued as the growth engine during the quarter, with 455,000 net new jobs. Within the service industries, education and health services added 163,000 net new payroll positions, the largest industry sector advance. Professional and business services posted the second-highest number of net new employees—122,000—while financial services added 29,000 new positions, indicating continuing demand for office space.

With the retail shopping season in full swing, retail trade employment gained 23,500 net new positions, as the wholesale trade sector added 13,800 net new employees to the quarterly payrolls. In a nod to the rising profile of electronic commerce and demand for industrial properties, transportation and warehousing gained 39,100 net new employees, the strongest quarterly gain of the year for the sector. Employment in leisure and hospitality advanced by 81,000 new positions.

Exhibit 1.2: Payroll Employment (Change, '000)

Exhibit 1.3: Payroll Employment: 12-Month Change ('000)

Source: BLS
The unemployment rate declined from 4.9 percent in the third quarter to 4.7 percent in the last one, based on data from the Bureau of Labor Statistics. The average duration of unemployment also declined from 27 weeks in the third quarter to 26 weeks by the end of the year.

The labor force participation (LFP) rate declined slightly, moving from 62.8 percent in the third quarter to 62.7 percent in the last quarter. In comparison, before the Great Recession the LFP rate was 65.9 percent.

Following gains in employment, consumer confidence picked up. The Conference Board’s Consumer Confidence index advanced 12.3 percent year-over-year, to 107.8, the highest value since the first quarter of 2007. The value for December 2016 was 113.3, indicating growing optimism about the outlook. Separately, the Consumer sentiment index compiled by the University of Michigan also advanced in the fourth quarter of the year to 93.1, compared with the 91.3 value from the fourth quarter of 2015.

Sources: The Conference Board, University of Michigan
Commercial space is heavily concentrated in large buildings, but large buildings are a relatively small number of the overall stock of commercial buildings. Based on Energy Information Administration data approximately 72 percent of commercial buildings are less than 10,000 square feet in size. An additional eight percent of commercial buildings are less than 17,000 square feet in size. In short, the commercial real estate market is bifurcated, with the majority of buildings (81 percent) relatively small (SCRE), but with the bulk of commercial space (71 percent) in the larger buildings (LCRE).

Commercial sales transactions span the price spectrum, but tend to be measured and reported based on size. Commercial deals at the higher end—$2.5 million and above—comprise a large share of investment sales, and generally receive most of the press coverage. Smaller commercial transactions tend to be obscured given their size. However, these smaller properties provide the types of commercial space that the average American encounters on a daily basis—e.g. neighborhood shopping centers, warehouses, small offices, supermarkets, etc. These are the types of buildings that are important in local communities, and REALTORS® are active in serving these markets.

Large Commercial Real Estate Markets

The decline in large cap CRE sales volume which began at the beginning of 2016 continued into the fourth quarter of this year. The volume of commercial sales in LCRE markets totaled $133.8 billion, a 20 percent year-over-year decline, according to Real Capital Analytics (RCA). While sales of single assets declined nine percent, portfolio sales dropped 29 percent in the last quarter, a trend which characterized most of the year. Given the preponderance of portfolio and entity-level transactions in 2015, their absence is casting a long shadow over this year’s activity.

The trend of diverging markets continued, with sales in the six major metros tracked by RCA posting a 16 percent decline year-over-year during 2016.

Exhibit 2.1: CRE Sales Volume ($2.5M+)

Source: Real Capital Analytics

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In comparison, sales in secondary and tertiary markets declined only six percent, while volume in tertiary markets rose a noticeable 17 percent in the third quarter. Apartment transactions comprised the largest share of volume, with $158.4 billion in sales in 2016, followed by office properties, which accounted for $141.7 billion. Retail and industrial sales totaled $75.7 billion and $59.2 billion, respectively. Sales volume for all property types were down year-over-year in 2016, except for apartment properties, which posted a three percent advance.

Separately, additional price indices also advanced. The Green Street Advisors Commercial Property Price Index advanced a more modest 3.7 percent on a yearly basis during the fourth quarter, reaching a value of 126.5. The National Council of Real Estate Investment Fiduciaries (NCREIF) Price Index increased at 7.7 percent year-over-year in the fourth quarter of 2016, to a value of 267.4.

Capitalization rate compression continued into the fourth quarter in LCRE markets. Based on RCA data, cap rates averaged 6.8 percent, 10 basis points lower compared with the prior year. On a yearly basis, industrial and hotel properties posted slight cap rate bumps—one basis point and 9 basis points, respectively. The other property types recorded cap rate declines for the year.
Small Commercial Real Estate Markets

Commercial real estate in small cap markets continued on a divergent path, with sales volume accelerating during the fourth quarter of 2016. REALTORS® reported continued improvement in fundamentals and investment sales. Following on the first and second quarters’ above-8.0 percent advances in sales volume, and the third quarter’s 11.0 percent gain, the last quarter of the year witnessed sales volume rising 12.9 percent compared with the same period in 2015.

During the fourth quarter, 69 percent of REALTORS® closed deals, an improvement from the prior quarter’s 61 percent. The direction of commercial business opportunities during the last quarter of 2016 rose 6.2 percent from the prior quarter.

As domestic and international investors across the value spectrum broadened their search for yield into secondary and tertiary markets, the shortage of available inventory remained the number one concern for commercial REALTORS®. Prices for SCRE properties increased 5.5 percent year-over-year during the fourth quarter of 2016. The pricing gap between sellers and buyers remained the second highest ranked concern. International transactions comprised 11.0 percent of commercial members’ total volume. The average international sale price was $1.7 million in the fourth quarter of this year. With banks tightening underwriting standards for commercial loans in the wake of increased regulatory scrutiny, financing availability remained a concern in REALTORS®’ markets—12.0 percent of members ranked it as a main challenge in the fourth quarter.
Capitalization rates in SCRE markets averaged 6.6 percent across all property types. Class A apartment properties in REALTORS® markets posted the lowest average cap rate, at 5.9 percent, followed by Class A office properties, at 6.6 percent.

The interest rate on 10-year Treasury Notes—a standard measure of risk-free investments—experienced a post-election bump, rising to 2.0 percent by the end of 2016. Based on the prevailing rates, the spread between cap rates and 10-year Treasury Notes hovered around 450 basis points. In addition, the Federal Reserve’s decided at the Open Market Committee’s December meeting, to hike the short-term rate another 25 basis points. The Chairwoman indicated that additional rate increases are projected for 2017. As rates begin an upward migration this year, CRE investors can expect a moderation in the trajectory of pricing.
Large Commercial Real Estate Markets

Commercial fundamentals in LCRE mirrored the cumulative gains of the past eight years of economic growth, with solid demand and rising construction. Vacancy rates declined for most properties—except multifamily—as rent growth reached new peaks for the industrial and retail sectors.

Office net absorption picked up speed in the last quarter of 2016, totaling 13.0 million square feet, almost double the amount from the third quarter, based on data from CBRE. Office construction added 9.7 million square feet to the supply pipeline during the quarter. With the robust demand, office vacancies declined to 12.9 percent, the lowest level in eight years. The decline was driven by solid improvement in suburban office occupancy. Rents for office properties rose 0.9 percent during the fourth quarter, to an average of $31.61 per square foot. Yearly rent growth for office properties advanced by 6.0 percent in 2016.

Benefitting from the growing economy and continued gains in e-commerce, the industrial sector posted solid performance figures in the fourth quarter of 2016. Industrial net absorption totaled 47.0 million square feet, marking the 27th positive demand quarter, according to CBRE. Industrial developers tightened the gap between supply and demand to its closest level of the cycle, as new completions totaled 44.7 million square feet. As demand continued outpacing new construction, industrial vacancy dropped to 4.9 percent. Industrial rents advanced 6.3 percent on a yearly basis—the highest level since 2007—to an average of $6.58 per square foot.

Going into the last quarter of 2016, demand for retail properties remained steady, as employment growth and rising wages boosted consumer spending.

Retail net absorption totaled 12.5 million square feet during the quarter, bringing to yearly total to 74.8 million square feet, according to CBRE. Retail construction activity continued at subdued levels, with 12.8 million square feet of new completions. Availability moved sideways during the last quarter of 2016, staying at 7.1 percent. Retail rents—up for 12 consecutive quarters—advanced 4.0 percent year-over-year, to $16.59 per square foot.

With steady economic growth and rising household formation, demand for multifamily properties remained solid in the last quarter of 2016. Net absorption of multifamily units advanced 4.9 percent on a yearly basis, to a total of 201,000 units for 2016, according to CBRE. Development of multifamily properties outpaced demand, as 243,000 units were delivered during the year. The national vacancy rate averaged 4.9 percent during the fourth quarter, 30 basis points higher from the same period in 2015. With increasing supply and rising vacancies, rent growth moderated, posting a yearly advance of 0.2 percent.
Small Commercial Real Estate Markets

Commercial fundamentals in smaller markets strengthened during the fourth quarter of 2016. Leasing volume advanced 2.5 percent from the prior quarter, as leasing rates rose by 3.1 percent.

Vacancy rates continued declining, ranging from a low of 7.2 percent for apartments to a high of 14.6 percent for office properties. Industrial availability witnessed a yearly decrease of 80 basis points—to 10.6 percent. Lease terms remained steady, with 36-month and 60-month leases capturing 59.0 percent of the market. One-year and two-year leases made up 26.0 percent of total.

NAR members’ average gross lease volume for the quarter was $953,700. New construction echoed the broader economic landscape, posting a 6.6 percent gain from the third quarter of 2016.

Tenant demand remained strongest in the 5,000 square feet and below segment, accounting for 87.0 percent of leased properties. Demand for space in the Under 2,500 square feet segment increased in the last quarter, capturing 46.0 percent of responses. Demand also rose for properties in the 50,000 - 100,000 square feet segment and for those in the Over 100,000 square feet.
Economy

While economic growth in 2016 was tempered, expectations for 2017 call for a moderately positive outlook. GDP is expected to advance at a 2.4 percent annual rate of growth during this year. Payroll employment is projected to post a 1.4 percent annual growth rate for the year. The unemployment rate is estimated to decline to 4.6 percent by the end of 2017.

As the markets adjust to the expected Federal Reserve’s increases in the funds target rate, the short-term rate is forecast to reach 1.2 percent by December 2017. Inflation is expected to accelerate, and average 2.6 percent over 2017.

Exhibit 4.1: U.S. ECONOMIC OUTLOOK—November 2016

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<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
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<td>Level</td>
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<tr>
<td>Consumer Confidence</td>
<td>98</td>
<td>100</td>
<td>108</td>
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</tr>
<tr>
<td>Percent</td>
<td></td>
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<td></td>
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<tr>
<td>Unemployment</td>
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<td>Fed Funds Rate</td>
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<td>3-Month T-bill Rate</td>
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<td>4.3</td>
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<td>10-Year Gov’t Bond</td>
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<td>30-Year Gov’t Bond</td>
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Source: National Association of REALTORS®
Commercial Real Estate

**Exhibit 4.2: Commercial Real Estate Vacancy Forecast (%)**

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<tr>
<td>Office</td>
<td>14.3</td>
<td>13.4</td>
<td>12.3</td>
<td>12.9</td>
<td>13.4</td>
<td>13.2</td>
<td>13.0</td>
<td>12.8</td>
<td>12.4</td>
<td>12.1</td>
<td>11.8</td>
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<tr>
<td>Industrial</td>
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<td>7.1</td>
<td>6.7</td>
<td>6.3</td>
<td>9.4</td>
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<td>Retail</td>
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<td>11.7</td>
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<td>11.9</td>
<td>11.7</td>
<td>11.6</td>
<td>11.4</td>
<td>11.2</td>
<td>11.1</td>
<td>11.0</td>
<td>12.0</td>
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<td>Multifamily</td>
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<td>6.4</td>
<td>6.3</td>
<td>6.3</td>
<td>6.3</td>
<td>6.5</td>
<td>6.5</td>
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<td>6.3</td>
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Source: National Association of REALTORS®

Commercial fundamentals are expected to continue on a positive trend, with three of the four core sectors favoring landlords. With employment in business and professional services on an upswing, demand for offices should continue apace. The industrial sector remains a beneficiary of changes in consumer spending patterns and increased trade. Retail properties diverge along quality lines, with Class A spaces projected to continue advancing, as Class BC assets offer value-add opportunities through remodeling and repurposing. Apartment properties remain in high demand due to demographic shifts. However, new supply is adding upward pressure on vacancies.

On the investment side, the slowdown in sales volume in large cap CRE markets during 2016 signals the current cycle’s maturation. While volume is expected to move sideways in 2017 in large cap markets, small cap CRE markets should benefit from continued investor interest. With the three-year lag between large cap and small cap markets, secondary and tertiary markets remain well-positioned this year.

**Exhibit 4.3: Commercial Property Price Indices Forecast**

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<td>186.5</td>
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<td>211.9</td>
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<td>Green St. Advisors</td>
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<td>118.0</td>
<td>125.2</td>
<td>119.4</td>
<td>121.6</td>
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Sources: National Association of REALTORS®, NCREIF, Green Street Advisors
The National Association of REALTORS®, “The Voice for Real Estate,” is America’s largest trade association, representing over 1.2 million members, including NAR’s institutes, societies and councils, involved in all aspects of the real estate industry. NAR membership includes brokers, salespeople, property managers, appraisers, counselors and others engaged in both residential and commercial real estate. The term REALTOR® is a registered collective membership mark that identifies a real estate professional who is a member of the National Association of REALTORS® and subscribes to its strict Code of Ethics. Working for America’s property owners, the National Association provides a facility for professional development, research and exchange of information among its members and to the public and government for the purpose of preserving the free enterprise system and the right to own real property.

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The Mission of the National Association of REALTORS® Research Division is to collect and disseminate timely, accurate and comprehensive real estate data and to conduct economic analysis in order to inform and engage members, consumers, and policy makers and the media in a professional and accessible manner.

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