Marcus & Millichap

The Economic Outlook

Summer 2015

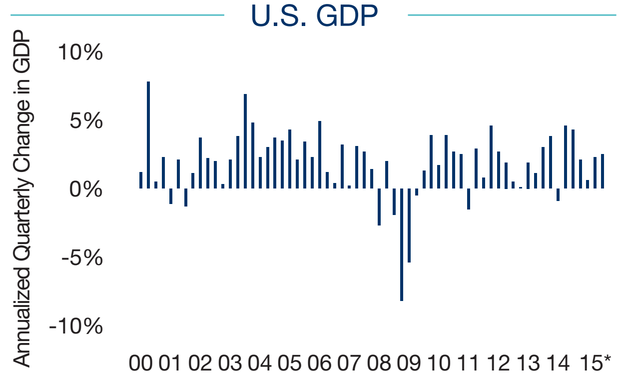
Steady Economic Gains Raise Prospects of Fed Rate Increase; Housing and Consumption Maintain Growth

Fed rate hike increasingly likely as the economy posts gains. The strong U.S. dollar and lowered gasoline prices will join other positive economic forces to prompt Federal Reserve action on interest rates later this year. Low interest rates and improved job-market prospects have heightened consumer confidence and promise to support greater consumer spending in the months ahead. As consumers position to lead the economy over the second half of 2015, domestic manufacturing will likely make a smaller contribution to the economy. A stronger dollar is cutting into exports, while many companies are also seeing a decline in orders for oil-and-gas extraction equipment from their energy sector customers. Despite the soft energy market, broader trends point to steady momentum as the maturing growth cycle continues to gain steam. Total employment now stands 3.5 million greater than the pre-recession peak, and unemployment has tightened dramatically. The favorable trends will likely continue through the remainder of the year as inflation remains in check and the index of leading indicators points to consistent growth.

Economic growth will reinvigorate as barriers fall. The second quarter GDP rose 2.3 percent, following a discouraging 0.6 percent growth in the first quarter. Consumer spending, state and local expenditures, exports and residential fixed investment made positive contributions to growth while inventory investment, imports and federal government spending were drags. The outlook for the remainder of the year remains optimistic as the U.S. economy may follow its 2014 trend: The economy contracted in the first quarter under inclement winter, then rebounded robustly in the second through fourth quarters. For the rest of the year, there are no major challenges anticipated to thwart growth. Though a recent drop in oil prices to the mid-$40 per barrel range could delay a resumption of drilling in the second half of 2015, a drop in gas prices could augment consumer spending as dollars are reallocated on leisure, recreation and travel. Spending on these items rose in the early summer months and that is expected to continue into the fall. Most importantly, wage pressure is finally building; wage growth in the first half of 2015 finally advanced beyond inflation in a modest but meaningful way. Given the health of both household debt and personal savings, higher wages should provide the final push to activate consumers, thereby boosting economic growth.

Rising demand will advance housing market. Sales of existing single-family homes shot to a multiyear high in June, up 9.8 percent from last year, and pending home sales have built momentum, offering the latest evidence that the housing market is gaining traction. Many homeowners are once again building equity in their homes, enabling them to sell, and millennials appear more likely to purchase their first home this year. The median price of an existing single-family residence continued to rise in the first half and is approaching the pre-recession peak. As confidence in the housing recovery accumulates and lending standards loosen, more prospective homebuyers will enter the market to capitalize on low mortgage rates. In the new single-family home market, sales were up 18.1 percent year over year in June. Housing starts also escalated over the past year, primarily reflecting vigorous activity in the multifamily segment. Single-family starts are growing but remain muted by historical standards. Additional progress in single-family building will occur as faster-paced sales shrink the inventory of homes on the market. Elevated homebuying should generate a ripple effect on retail sales as new homeowners furnish and decorate.

U.S. GDP



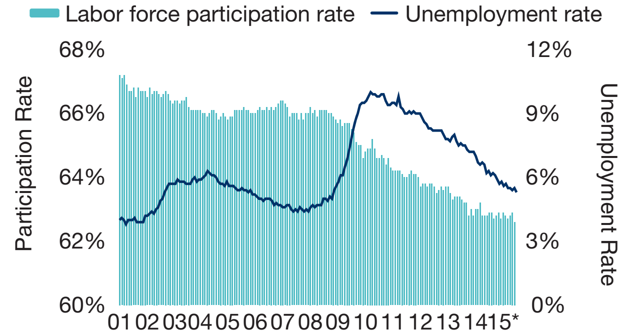
* Forecast

Economic trends are positive; Fed prepares for liftoff. Employment growth has been extensive in both scale and breadth. In April 2014, payrolls finally surpassed their pre-recession peak, and 3.5 million jobs have been added since then. Though the pace of hiring in the first quarter was disappointing, U.S. employers came back and added an average 226,000 positions monthly in the second quarter, moving back into alignment with last year's trend of 200,000-plus jobs per month. Unemployment dipped to 5.3 percent at midyear, while a broader measurement that counts the underemployed stands at an eight-year low. The labor force participation rate has struggled to rise since the end of the recession, but a measure that covers the percentage of employed 25- to 54-year-olds, the core of the job market, remains elevated. Despite the strength in this segment of the labor market, some slack remains.

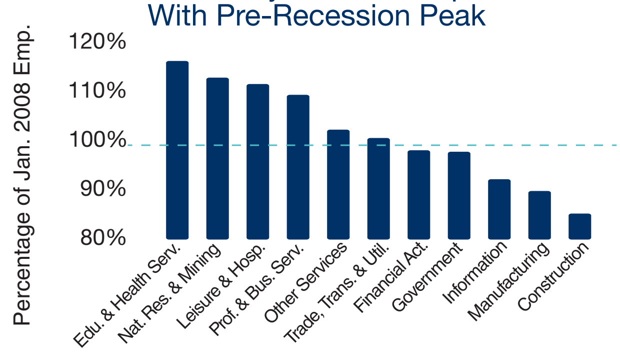
Hiring trends year have been broad-based, both by sector as well as geographically. Growth has been primarily concentrated in the service economy, with professional and business services; trade, transportation and utilities (which mostly comprises retail trade employment); and education and health services contributing the most to payrolls. The financial activities sector is also relatively healthy, but many jobs lost during the downturn, especially in the mortgage industry, have yet to return. The strengthening housing market, together with mounting demand for commercial space, will accelerate construction job creation, adding to the already solid hiring pace. Over the past year, job growth has also varied geographically. Outperforming metros included not just tech-focused areas like San Jose and San Francisco but also Orlando, Riverside-San Bernardino and Salt Lake City. Dallas/Fort Worth has also continued to add jobs at a consistent pace despite reduced oil prices, though Houston's pace of hiring has slowed dramatically.

Forecast: The economy has shown momentum since the first quarter, though manufacturing and exports will continue to grapple with currency and demand headwinds in the short term. Successful quantitative easing in both Europe and Japan should stimulate U.S. exports, leading to greater corporate earnings in the second half of the year. In addition, the demand for business loans has been climbing since early 2014, which should begin to manifest in capital investment. These trends will be further supported by rising consumer spending as sturdier household balance sheets and rising incomes lift consumption. Absent an unanticipated exogenous shock, these trends should boost U.S. economic growth to the 2.5 percent range in 2015, significantly faster than the past several years, and create more than 3 million jobs.

Pace of Hiring

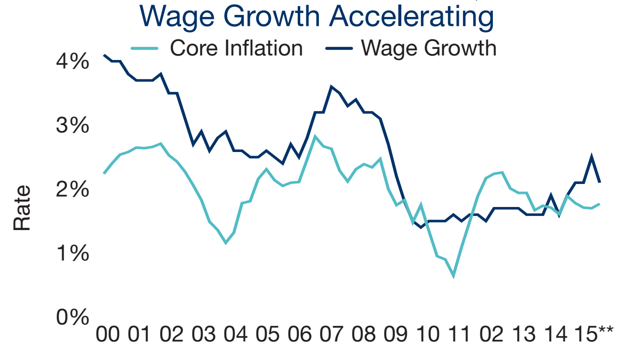


Total Jobs by Sector Compared With Pre-Recession Peak



Note: As of June 2015

Core Inflation Restrained; Wage Growth Accelerating



* Through June ** Through 2Q

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The Retail Outlook

Summer 2015

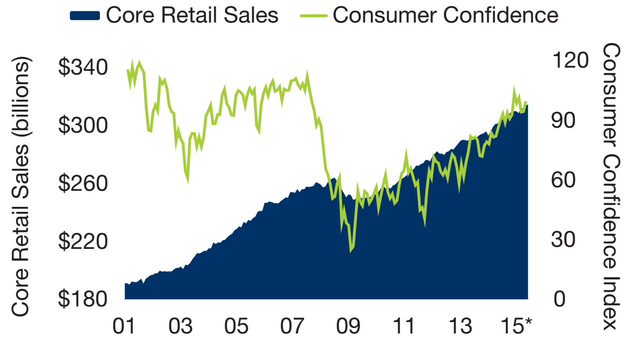
Millennials' Purchasing Power to Bypass Baby Boomers' As Consumer Spending Maintains Steady Gains

Consumer confidence continues upward trend. Despite monthly swings, consumer confidence has consistently increased since the end of the recession six years ago. Although wage growth has been slow to gain traction, improving employment opportunities and a return of home equity for many homeowners have generally elevated consumer attitudes. Also, despite consumers being averse to, or unable to, assume more credit card debt since the end of the recession and saving more, consumer spending nonetheless continues to rise. Steady demand for long-lasting items, in particular, generally illustrate an optimistic outlook. In addition, leisure travel has accelerated, as demonstrated by a record level of occupied hotel rooms in the U.S. so far this year. In the months ahead, the strong U.S. dollar will sustain demand for imported goods, while gas prices that remain lower than one year ago will provide an added boost to consumer spending.

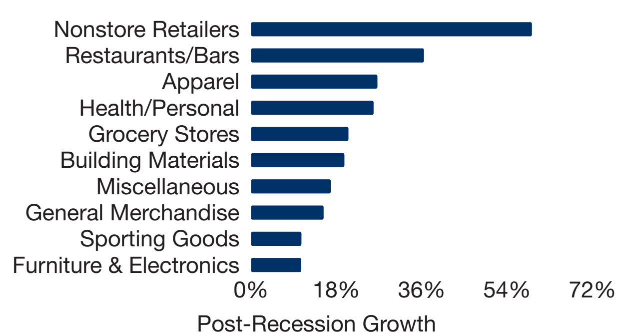
Retail sales choppy but likely to improve. Though total retail sales now stand 17 percent higher than their pre-recession peak, monthly trends have been erratic so far this year. Headline retail-sales growth was nominal through the first half as declining gas prices partially offset total expenditures. Core retail sales, which exclude automobiles and gasoline sales, have maintained their advancement this year but have slowed to an annual growth rate of 3.4 percent. Consumers are ideally positioned to spend given low energy costs, modest inflation and historically low household debt ratios, but they have preferred to save and pay down existing debts. With wage growth finally escalating, spending should gain traction, especially in the summer vacation months. Numerous employers, including McDonald's, Wal-Mart and Target, have announced they will raise staff compensation, which should improve consumption, particularly at stores catering to the less affluent. Consumption could also get a boost from accelerated home sales as purchasers furnish and decorate their new residences.

Demographic trends support optimism. The millennial generation, which has an estimated purchasing power of $2.5 trillion, will be key to raising consumption as hiring heightens. By 2018, millennials will match the $3.0 trillion spending power of the baby boom generation. Job creation for young adults will remain an essential factor, but the trend is materializing; unemployment for 25- to 34-year-olds dipped to just 5.6 percent from its peak of 10.6 percent in 2009.

Consumer Confidence vs. Retail Sales

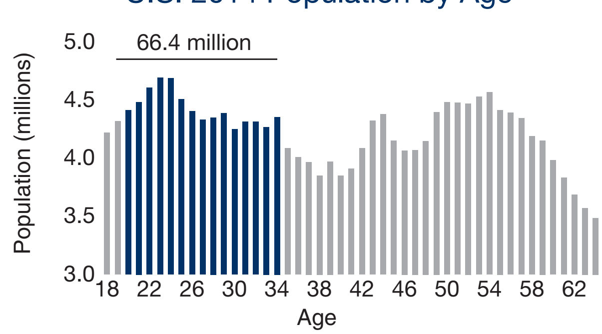


Internet Retail Growth Rising Rapidly



Change from Dec. 2008 to June 2015

Millennial Cohort to Drive Retail Sector; U.S. 2014 Population by Age



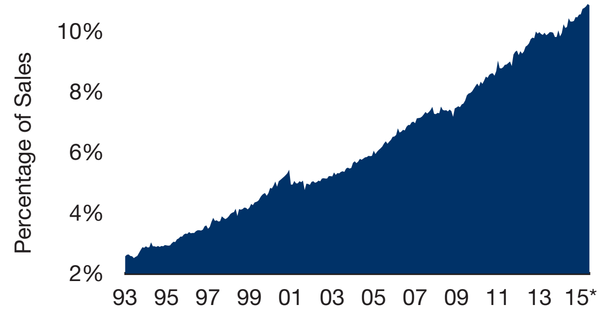
* Through 2Q

E-commerce offers structural tailwinds. E-commerce has grown dramatically with sales up 80 percent since the end of the recession. Despite concerns that e-commerce cannibalizes brick-and-mortar sales, the maturing sector has demonstrated success with omni-channel retail. Through this model, retailers bolster their online presence with brick-and-mortar locations to facilitate logistics, returns and customer care. This emerging trend, highlighted by sector leaders like Wal-Mart and Apple, has inspired Amazon.com to consider physical store locations.

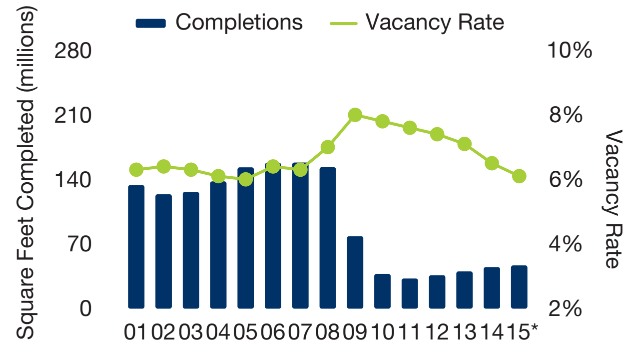
Retail properties healthy; stronger economy boosts space demand. The retail sector benefited from a sharp pullback in construction at the beginning of the downturn. Between 2009 and 2014, annual deliveries totaled just 31 percent of the annual average in the preceding nine years, while space demand steadily amplified. As a result, the U.S. vacancy rate has tightened greatly since 2010 to 6.4 percent in the second quarter, close to its pre-recession level. Though construction has begun to pick up, it is concentrated in the healthiest markets, which should be well-positioned to absorb additional space. With the national vacancy rate forecast to fall to 6.1 percent in 2015, many national and regional retailers have indicated that the limited available space could restrain their growth plans.

Accelerating sales activity pressures yields. Investment in retail assets has steadily risen since the end of the recession, and transaction volume in 2014 surpassed the previous peak. Deal flow continued to increase throughout the first half of 2015. The average cap rate for single-tenant assets has begun to flatten after tumbling to the low-6 percent range depending on lease term and tenant credit. Multi-tenant retail properties have experienced a less dramatic tightening, but the average cap rate for these assets has dropped to close to 7.3 percent after peaking at 8.7 percent in 2010. The cap rate spread between primary and tertiary markets has narrowed from nearly 200 basis points in 2012 to about 150 basis points in recent months. With cap rates levelling in the best markets, and additional activity in secondary and tertiary metros, the spread will likely continue to contract.

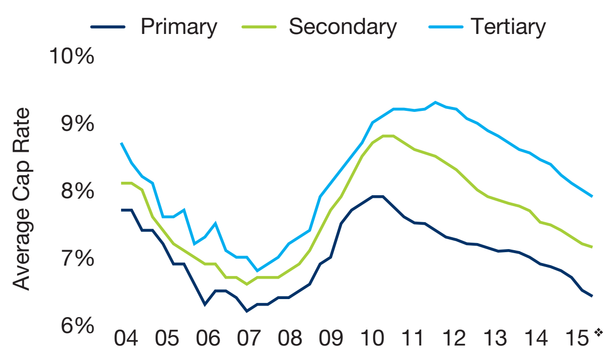
Internet Sales as Percentage of Core Retail Sales



Retail Construction and Vacancy



Retail Cap Rate Trends by Market Type



* Through June ** Forecast ❖ Through 2Q
Sources: CoStar Group, Inc.; Real Capital Analytics

Retail 2015 Outlook

47 Million Sq. Ft. will be completed

Construction:

Encouraged by consumer confidence and spending, retail tenants are expanding in both multi- and single-tenant properties. Developers are responding by completing 47 million square feet, 4.1 percent more than last year.

40 basis point decrease in vacancy

Vacancy:

The improving economy will boost retail demand, pushing down vacancy 40 basis points to 6.1 percent, following a 60-basis-point decline last year.

2.3% increase in asking rents

Rents:

As vacancy decreases, asking rents will move up 2.3 percent to $18.43 per square foot, in alignment with last year's 2.4 percent gain.

2Q 2014 to 2Q 2015 Change in Retail Vacancy

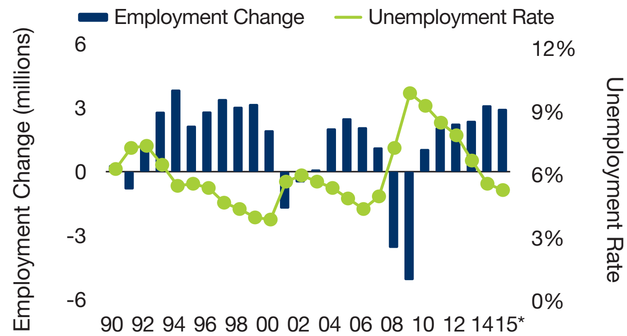
Top Markets By Change in Vacancy

Metro	2Q 2015	Y-O-Y Chg. (bps)
Jacksonville	7.5%	-110
Sacramento	8.7%	-100
Seattle-Tacoma	4.8%	-100
Orlando	6.2%	-100
Cincinnati	7.5%	-90
Columbus	5.9%	-90
Austin	4.6%	-90
Detroit	9.3%	-80
Charlotte	6.6%	-80
Kansas City	7.8%	-80
U.S. Metro Average	**6.4%**	**-40**

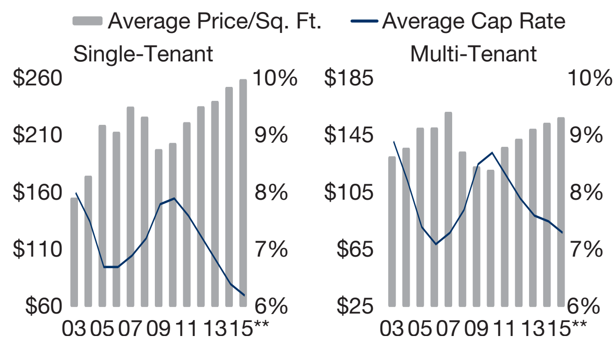
Bottom Markets By Change in Vacancy

Metro	2Q 2015	Y-O-Y Chg. (bps)
Minneapolis-St. Paul	5.6%	30
New Haven-Fairfield County	6.0%	30
Baltimore	5.0%	0
Salt Lake City	4.6%	0
Las Vegas	11.1%	-10
Philadelphia	6.4%	-10
San Jose	4.0%	-10
Washington, D.C.	4.9%	-20
San Francisco	2.4%	-20
Riverside-San Bernardino	9.2%	-20
U.S. Metro Average	**6.4%**	**-40**

Employment Change vs. Unemployment

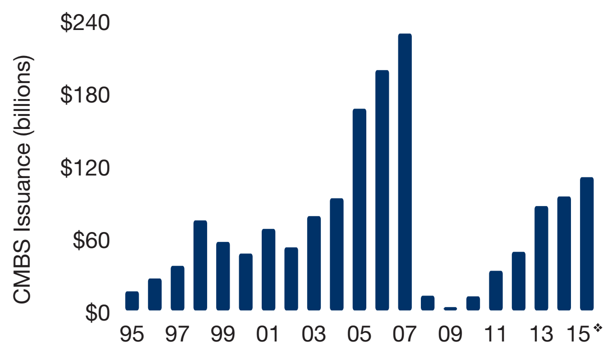


Retail Property Sales Trends

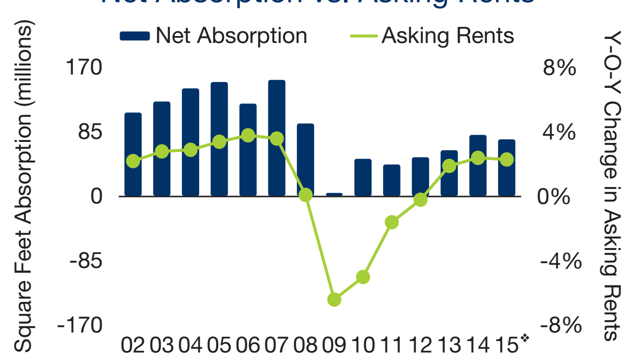


Sales figures represent transactions of $1 million+.

U.S. CMBS Issuance



Net Absorption vs. Asking Rents



* Y-O-Y Through 2Q ** Through 2Q ❖ Forecast

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