Executive Summary

With the year drawing to a close, we turn our attention to the outlook and identify eight major occupier and investment trends that we expect to influence market conditions and investment performance in 2016 and beyond.

1. **Transaction Volume Increases**: We expect global transaction volume to increase further in 2016, as investors have plenty of capital to deploy and occupier fundamentals are improving.

2. **Investment Horizons Broaden**: Portfolio deals and cross-border capital flows are gaining market share, a sure sign that investors are searching more widely for returns and looking to deploy capital quickly.

3. **Yield Compression Continues**: Real estate yields are at record lows in many markets, but we expect further yield compression in 2016 due to relative pricing and market momentum.

4. **Diversification Makes a Comeback**: Recent years have called the benefits of market-level diversification into question, but correlations have dropped, making active allocation strategies more attractive.

5. **Investors Follow Occupier Performance**: Investors typically respond to expected occupier market performance. We anticipate a rotation of capital away from gateway markets as growth broadens.

6. **Vacancy Falls Further**: Even if demand growth is modest, a low supply pipeline points to falling vacancy, which normally goes hand in hand with rental growth.

7. **More Markets Reach Peak Rents**: Occupier momentum is positive and CBD rents are finally getting back to pre-crisis levels. Falling availability means that we expect more leasing activity and stronger rental growth in non-CBD markets.

8. **Emerging Markets Stabilize**: Emerging markets have had a rough ride recently, but growth should start to improve again next year. Expectations of a rebound in capital inflows bode well for real estate investment activity.
Introduction

Conditions for real estate investors remain attractive, thanks to a combination of steady economic growth, extensive monetary policy support, and an abundance of capital targeting property acquisitions. While there are pronounced differences in performance across sectors and markets, the global real estate cycle is moving into an upswing phase, characterized by improving occupier fundamentals and a broadening of investor preferences towards higher risk strategies, non-prime assets and late cyclical markets. At the same time, persistently low interest rates and a lack of available product point to ongoing demand for high-quality, income-producing real estate assets.

When we look ahead to the outlook for the next 12 months and beyond, we can identify a number of occupier and investment trends and, with some degree of confidence, assess their likely impact on market conditions and investment performance.

Trend 1: Transaction Volume Increases

We expect global transaction volume to increase further in 2016, as investors have plenty of capital to deploy and occupier fundamentals are improving.

Global real estate transaction volume has increased in each of the past six years. Despite a few signs that deal flow eased off in the second half of 2015, about $880 billion of income-producing deals – excluding land transactions – have been completed over the past 12 months, up 8% compared to 2014’s total (Exhibit 1).

Pricing is now at record levels in a number of major markets, making it tricky for investors to source transactions that meet target returns. Nevertheless, we expect overall investment volume to increase further in 2016 for three main reasons.

Firstly, investors have plenty of capital to deploy, even accounting for a pull back from some sovereign wealth funds due to low energy prices. According to Preqin, $91 billion of capital has been raised by private real estate funds over the past year, with an additional $240 billion that is ready to be invested. Secondly, available equity capital is being supported by increased debt market capacity, owing to a high number of new entrants and debt funds that are now actively lending.

Thirdly – and the most important factor for us – is that market fundamentals continue to improve. Investors in search of higher returns buy into expected occupier market performance, meaning that faster rental growth is typically accompanied by higher investment volume and vice versa. Based on market expectations for a tick-up in global economic growth in 2016, we have factored in a steady improvement in rental growth next year, which translates into an expected 5% increase in transaction volume to about $920 billion in 2016.
**Trend 2: Investment Horizons Broaden**

Portfolio deals and cross-border capital flows are gaining market share, a sure sign that investors are searching more widely for returns and looking to deploy capital quickly.

Global real estate markets are awash with liquidity. Investors have a lot of capital to allocate to real estate, and the total available to deploy is boosted by low interest rates and increased debt availability at higher loan-to-value ratios, making each unit of equity stretch further.

A challenge in today’s market is to deploy capital efficiently to capture value growth and performance. Pricing is elevated in a number of major markets and one option for investors is to look further afield for opportunities.

Cross border investing – where investment capital is deployed outside its domestic market – has been rising steadily and is gaining an increasing share of global volume (Exhibit 2). Over the past year, there have been $340 billion of cross-border deals, equivalent to about one third of total volume and the highest total since 2007 – a sure sign that investors are searching more widely for places to put their capital to work.

At the same time, investors are deploying capital more rapidly, demonstrated by an increasing share of portfolio deals in the global total (Exhibit 3). Boosted by a number of large retail and industrial transactions in Europe and the United States, the share of portfolio deals is growing steadily and is now at the same level as in early 2007.

We expect both of these trends to continue in 2016. Investors have raised plenty of capital and will want to deploy it quickly, while market conditions are favorable and the outlook for non-prime assets – that normally get bundled in with portfolios – is improving. Low prime yields in major markets and a lack of available product mean that investors will broaden their horizons to meet return targets, pointing towards a further increase in cross-border activity.
**Trend 3: Yield Compression Continues**

Real estate yields are at record lows in many markets, but we expect further yield compression in 2016 due to relative pricing and market momentum.

During the course of 2015, prime real estate yields moved to record lows in many markets, breaking through an apparent psychological barrier set by exuberant pre-crisis levels in the process. Given that interest rates were much higher eight years ago, our view is that the market has further to go, although yields in some gateway cities such as London, New York and San Francisco appear to be approaching lower bounds. In aggregate, though, we expect yields to fall again in 2016 as there is scope for further movement based on relative pricing and favorable market momentum.

Today’s low interest rate environment appears set to persist in the medium term. The U.S. bond yield – which is the closest proxy we have for a global risk free rate – is above its record low, but is still well below historic averages. As a result, the spread between income yields on property and government bonds remains high, despite property yields being so low (Exhibit 4).
Since 2009, prime property yields have compressed by an average of 25 basis points per year across all sectors and markets. If this pattern continues over the next two years and interest rates rise in line with current market forecasts, the gap between property and bond yields would close, but only to 200 basis points – well above levels recorded in 2006 and 2007.

Current market momentum is also in favor of further yield compression. Investment volume is rising, while the share of cross border and portfolio deals is also increasing, implying ongoing pricing pressure as competition for a limited pool of assets grows fiercer. We are already seeing evidence of this: in global office markets, 55 out of 60 major cities we track have recorded a drop in prime central business district (CBD) office yields over the past year (Exhibit 5).

**Trend 4: Diversification Makes a Comeback**

Recent years have called the benefits of market-level diversification into question, but correlations have dropped, making active allocation strategies more attractive.

During the period of time characterized first by the mid-2000s upswing and then by the synchronized global downturn of 2009, the correlation of real estate value movements among major global regions was elevated. The effect of large capital flows was so dominant that global real estate markets became almost completely harmonized, implying little or no benefit from market-level portfolio diversification.

Over the past five years, real estate value correlations have fallen sharply (Exhibit 6). To date, Asia Pacific, Europe, and the United States have all recorded different recovery patterns, leading to contrasting performance across markets. Rolling correlations between the major regions have declined substantially – in the case of Europe and the United States, to levels not seen since the early 1990s.
While yields have been falling in most markets, real estate supply and demand fundamentals have become increasingly misaligned, reflecting contrasting economic performance. We can see this clearly when we break up the data: each region-sector group is currently running an average correlation with other groups that is well below pre-crisis norms (Exhibit 7).

**Exhibit 6: Rolling 5-Year All Property Capital Value Growth Correlation (Local Currency Basis)**

| Period                  | Correlations
|-------------------------|---------------|
| 90 92 94 96 98 00 02 04 06 08 10 12 14 | 0.2 0.1 0.0 0.6 0.5 0.4 0.3

Correlations have fallen sharply

**Exhibit 7: Average Correlation Coefficient by Region-Sector Group**

Sources: NCREIF, Cushman & Wakefield, JLL, Prudential Real Estate Investors; As of December 2015.

The global growth story for 2016 – which can be broadly summarized as faster in the United States, slightly improving in Europe and a mixed picture in Asia Pacific and Latin America – suggests that real estate performance will remain diverse and that low correlations should persist.

The upshot is a return of market diversification potential as differences in macro outlooks, policy decisions and supply-demand dynamics start to matter more than just the weight of capital. As a result, active allocation strategies that seek to diversify market risk are more attractive now and we expect this to stimulate more investors to deploy capital outside their domestic markets.

**Trend 5: Investors Follow Occupier Performance**

Investors typically respond to expected occupier market performance. We anticipate a rotation of capital away from gateway markets as growth broadens.

Investors typically respond to expected occupier market performance. To demonstrate this, most of the current top 10 office investment markets by total volume reported annual rental growth equal to or above the global average since markets reached their post-global financial crisis trough (Exhibit 8).

The upshot is a return of market diversification potential as differences in macro outlooks, policy decisions and supply-demand dynamics start to matter more than just the weight of capital.
In recent years, investment demand has focused heavily on major markets that were most successful in retaining and attracting key occupiers in the initial recovery phase of the cycle. Strong tenant demand in gateway cities – such as Boston, Los Angeles, New York and San Francisco in the United States, and London in the UK – has been set against a relatively low supply of new space, fostering strong rental growth that investors have been eager to buy into. Similarly, Asia’s structural growth story has benefitted occupational markets in Hong Kong and Shanghai, encouraging investor demand.

Looking ahead, we do not expect major cities to continue to outperform to the same degree. As growth broadens, we anticipate a rotation of capital away from gateway cities towards late recovery markets, such as in the eurozone periphery, and smaller cities, where availability is starting to fall.

Trend 6: Vacancy Falls Further

Even if demand growth is modest, a low supply pipeline points to falling vacancy, which normally goes hand in hand with rental growth.

The global real estate supply pipeline is finally starting to pick up, but access to development finance remains constricted and many markets do not offer profitable development opportunities. In some markets, older office stock is being withdrawn and converted to alternative uses such as residential or hotel. While net additions to stock are expected to rise to their highest level since 2009 in the first half of next year, the projected increase in supply is still fairly low (Exhibit 9).

While we anticipate better market conditions in 2016, we do not know exactly how much space will be absorbed by occupiers. Here, we have made the assumption that demand remains constant at its current level – a conservative view, given that some leading indicators, such as hiring intentions, and rent growth forecasts, are pointing to stronger activity.
EXHIBIT 9: GLOBAL OFFICE SUPPLY, DEMAND & VACANCY (ROLLING 4Q)

Even based on a modest demand outlook, the relatively small office space pipeline should be easily absorbed by the market. As a result, unless there is a sudden market correction, the aggregate global vacancy rate should fall further in 2016 and into 2017, taking it towards its previous low point recorded in 2007.

Why is this important? The answer is simple: global office rents have risen in 80% of quarters when falling vacancy was recorded, giving us confidence that we can expect to see more rental growth in 2016.

Trend 7: More Markets Reach Peak Rents

Occulier momentum is positive and CBD rents are finally getting back to pre-crisis levels. Falling availability means that we expect more leasing activity and stronger rental growth in non-CBD markets.

Compared to previous cycles, the period since the market bottomed out in 2009 has been relatively a long and drawn out occupier recovery. However, leasing momentum is gradually improving, set against limited supply, which means rents are growing. Despite the severity of the downturn, prime rents are now at or above their pre-crisis peaks – typically recorded in 2007 or 2008 – in 63% of CBD office markets globally (Exhibit 10).
**Trend 8: Emerging Markets Stabilize**

Emerging markets have had a rough ride recently, but growth should start to improve again next year. Expectations of a rebound in capital inflows bode well for real estate investment activity.

After leading the recovery in the aftermath of the global financial crisis, emerging markets have had a rough ride recently. An unhealthy combination of factors – including a slowdown in Chinese growth, low commodity prices, weak capital flows and sluggish growth in key developed market trading partners – has culminated in weak business sentiment across emerging markets. Even excluding China, emerging markets GDP growth has fallen to its lowest rate since the financial crisis (Exhibit 11).
However, there are signs of life. Monetary policy is being loosened in many emerging market nations, while lower commodity prices are reducing production costs, boosting profitability. Stronger consumer spending in key export markets in Europe and the United States points towards an uptick in export-driven growth in 2016. As sentiment and optimism improve, the Institute for International Finance expects a modest recovery in capital inflows to emerging markets in 2016 (Exhibit 12).

Real estate transaction volume across emerging markets has taken a hit as economic growth has weakened. However, the prospect of first a stabilization, and then an improvement in the economic growth story, combined with a pick-up in capital inflows bodes well for real estate investment market activity in 2016 and beyond.
Conclusion

While we certainly do not claim to be able to predict the future, we can identify trends and assess their likely impact on markets and investment performance. Based on an assessment of today’s market conditions, we expect 2016 to be another good year for real estate investment and occupier markets.

We envisage an increase in the volume of real estate transactions, with investors looking further afield, beyond national borders, in search of available assets and diversification potential. The pace of investment is increasing, with more portfolio deals being completed, putting downward pressure on prime yields, which are set to move further below record low levels, supported by low interest rates. The occupier market outlook is brighter too, as low supply feeds through into falling vacancy and rental growth.

While elevated pricing is making target returns harder to achieve, our assessment of trends points to broad spectrum of opportunities for real estate investors in 2016. With yields set to fall further, core strategies remain appealing in a low interest rate environment, while core plus and value-add strategies in major markets stand to benefit from improving rental income growth and a shift in emphasis towards non-CBD markets. At the other end of the spectrum, more adventurous investors can seek to capitalize on an anticipated rebound in growth and capital inflows in emerging markets, where potentially higher returns are available.
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