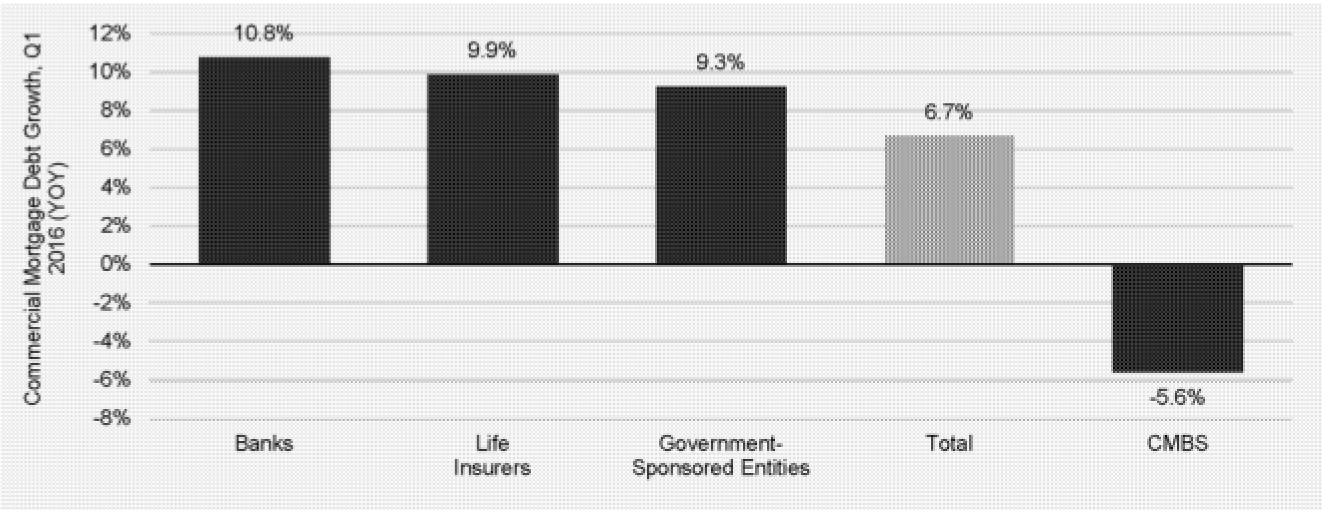
Domestic institutional investors were net buyers of real estate in the first half of 2016. As equity markets tumbled and credit spreads widened in January and February, fears mounted that investors would reverse course in order to rebalance portfolios — the so-called "denominator effect". However, now that equity prices have bounced to all-time highs and fixed-income yields have retreated, it seems likely that any pullback will prove fleeting and could give way to stronger inflows.

Foreigners' appetite for U.S. commercial real estate is undiminished. Direct cross-border investment (excluding capital channeled through domestic funds or REITs) accounted for 17% of transaction volume in 2015, double its 15-year average.[14] In our view, several factors will continue to drive heavy foreign inflows, including negative interest rates in many developed economies, America's relatively strong economy and reputation as a safe haven, and legislative changes that will exempt most foreign pensions from the Foreign Investment in Real Property Tax Act (FIRPTA).

3.2 Public and Private Debt

The volume of commercial (including multifamily) mortgage debt outstanding increased 6.7% year-over-year in the first quarter 2016, down slightly from 7.1% in the fourth quarter 2015 (see Exhibit 5). Mortgage growth was led by banks, which represent about 50% of the market. Life insurers and government-sponsored entities (primarily Fannie Mae and Freddie Mac) also aggressively expanded their mortgage books. The major outlier was CMBS, where outstanding balances declined 6% year-over-year: CMBS issuance of $18 billion in the first quarter 2016, down from a quarterly average of $24 billion in 2015, was not enough to offset the volume of securities that were retired (through maturity, prepayment, or default).[15]

Exhibit 5: Growth in Mortgage Debt Outstanding



Source: Federal Reserve. Data as of March 2016. Past performance is not indicative of future returns.

Prospects for the CMBS market are uncertain. CMBS spreads widened sharply at the beginning of 2016, as credit-market stress originating in the energy industry upended the broader bond market. As spreads increased, conduits curtailed originations, in part because they were less competitive with other debt providers but also to avoid the risk of incurring capital losses on loans pending securitization. CMBS spreads have narrowed substantially since February and reference rates have dropped as well, improving the economics of the CMBS business. However, the market faces two structural challenges: First, new risk-retention rules under the Dodd-Frank regulatory reforms that are scheduled to take effect in December 2016 will likely increase the cost and reduce the supply of CMBS loans. Second, the market faces $112 billion of CMBS maturities in 2017, nearly double this year's total, which will need to be refinanced or retired.[16]

[14] Real Capital Analytics. Data as of March 2016.
[15] CRE Finance Council. Data as of March 2016.
[16] CRE Finance Council. Data as of June 2016.