

The supply of private debt seems relatively secure. Bank regulators have expressed some concerns regarding banks' exposure to CRE loans (the Office of the Comptroller of the Currency has flagged a loosening of underwriting standards).¹⁷ Perhaps responding to such concerns, the Federal Reserve's second quarter 2016 loan officer survey indicated that banks are tightening lending standards on commercial mortgages, particularly in the multifamily space.¹⁸ Nevertheless, attractive margins on mortgage loans (4%-5%) relative to deposit rates (0%) create a powerful incentive for banks to continue to grow their portfolios.¹⁹

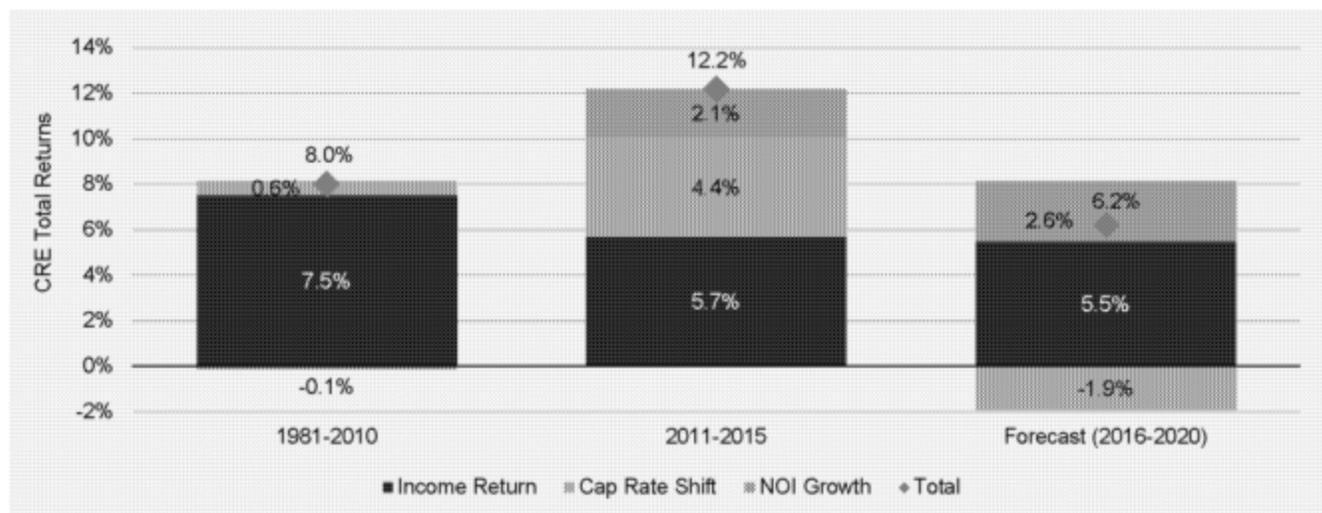
3.3 Commercial Real Estate Total Returns

The commercial real estate market cooled at the beginning of 2016 amid a turbulent financial environment. Still, the asset class performed well on both a historical and a relative basis. While NPI total returns of 10.6% (trailing four quarters) in the second quarter 2016 were down from 13.3% in 2015, they were in line with their 5-year average (11.9%) and well above their 10-year average (7.6%). Moreover, they compared favorably with returns on stocks (4.0%) and bonds (6.7%) over the year.²⁰

The near-term outlook for commercial real estate has improved somewhat over the past six months. While the economic environment is fluid, recent data suggests that growth has picked up from its winter lull. Real estate fundamentals are robust and NOIs are growing vigorously, even as corporate earnings sag. The financial stress that gripped markets earlier this year resurfaced briefly after the UK's Brexit vote, but has since receded. And interest rates have dropped to historic lows around the world, raising the potential for increased debt and equity flows, both domestic and foreign, into U.S. real estate.

We expect that total returns will moderate over the next five years but remain quite healthy on a relative basis (see Exhibit 6). Income returns will be weaker than in the past, reflecting today's lower cap rates. But NOI growth is expected to be much stronger, underpinned by low vacancy rates, persistent demand, and moderate construction.

Exhibit 6: CRE Total Returns



Source: NCREIF (History); Deutsche Asset Management (forecast). Data as of July 2016. Past performance is not indicative of future returns. No assurance can be given that any forecast or target will be achieved.

¹⁷ Office of the Comptroller of the Currency, "Semiannual Risk Perspective," July 2016.

¹⁸ Federal Reserve Senior Loan Officers Survey. Data as of June 2016.

¹⁹ Real Capital Analytics. Data as of March 2016.

²⁰ NCREIF. Data as of March 2016.