

A key question concerns the future path of cap rates. Capital appreciation was driven more by cap rate compression than NOI growth over the past five years, as sentiment improved following the financial crisis. We believe that it is prudent to assume that cap rates will gradually increase over time as interest rates normalize to higher levels. Yet cap rate spreads to Treasuries are historically wide and have room to narrow. Were Treasury yields to double to 3% and spreads revert to their 20-year average, cap rates would increase by 50 basis points, subtracting 2% annually from capital appreciation. In this scenario, total returns would average 6.2% annually through 2020, nearly two percentage points below the average from 1981-2010, although only slightly lower on an inflation adjusted basis (4.2% versus 4.8%).

However, it is worth noting that market-based measures of interest rate expectations place 10-year Treasury yields in the 2%-2.5% range through 2020. If market expectations prove correct and fundamentals also remain intact, it is conceivable that cap rates could remain stable. In this scenario, total returns would average 8% annually (6% after inflation). While this is not our base case, it is an upside risk. In a low-yield, volatile financial environment, prospective returns of 6%-8% annually are competitive, we believe, with those available from other asset classes on a risk-adjusted basis.

4 Industrial Sector

4.1 Current Conditions

The U.S. industrial market has performed well in recent years and remains well positioned as cyclical and structural forces continue to benefit the sector. Industrial space demand remained strong this year, despite eroding global economic growth and mixed domestic manufacturing indicators. Healthy demand, vacancy and rent fundamentals have spread broadly across markets, particularly in the warehouse segment. National drivers and local economic growth are fueling strong conditions in gateway and primary inland logistics hubs as well as in smaller markets with healthy economies.

Declining vacancy rates have given rise to continued market rent growth and also a larger development pipeline, although new construction totals have yet to match demand levels. Net absorption for 2015 totaled 250 million square feet, compared to just 155 million square feet of new construction.²¹ Momentum in 2016 indicates a similar pace with 125 million square feet of net absorption and 74 million square feet of construction deliveries through mid-year.²² National availability declined 40 basis points in the first half of 2016, ending the second quarter at 8.8%. This was 90 basis points below last cycle's low and the lowest rate in the past 15 years. New demand as a percent of stock has consistently measured 1.9% per year since 2013, while the supply pipeline has slowly been increasing, reaching 1.2% in 2015.²³

Solid leasing fundamentals supported rent gains of about 5% over the past year.²⁴ On average, national market rents are 23% above recessionary levels and at or above 2007 peak levels for new warehouses.²⁵ The strongest markets have been Northern and Southern California, New York/New Jersey, South Florida, and Seattle.

A maturing growth cycle is bringing supply and demand into balance in inland hubs. Rising supply in Atlanta, Dallas, Chicago, Riverside, Denver, and Central Pennsylvania is expected to moderate near-term rent gains, but fundamentals should remain healthy. New supply has been heavily weighted to large bulk warehouses, but demand for smaller and mid-sized properties has also been strong, driving relatively sharp vacancy declines and rent gains.

²¹ CBRE-EA. Data as of June 2016.

²² CBRE-EA. Data as of June 2016.

²³ CBRE-EA and Deutsche Asset Management. Data as of June 2016.

²⁴ CBRE-EA and Deutsche Asset Management. Data as of June 2016.

²⁵ CBRE-EA. Data as of June 2016.