

6.2 Outlook and Strategy

Our outlook for the retail sector remains optimistic as current conditions for consumers are supportive of future growth in spending. Low gas prices, rising home values, low interest rates, improving labor market conditions, and rising incomes should provide for moderate growth of retail sales. Retail sales in June marked a solid rebound after a slow first quarter, pointing towards stronger growth in the second half of the year.⁴⁰ While consumer spending has gathered momentum, the growing share of sales going to pure-play e-commerce players from traditional brick and mortar stores has created fierce retailer competition. Spending shifts into consumer segments that fall outside of malls and shopping centers are also pressuring traditional retailers' bottom lines. However, we do see positive momentum in retail demand drivers going into the crucial back to school and holiday shopping seasons.

Our forecast for shopping centers calls for sustained recovery with accelerating gains over the next two to three years as retailers continue to adjust, strengthen and strategically expand. While we do not expect to see the demand levels recorded in the previous two cycles, we are expecting to move into a more balanced market. Over the next five years, we expect new construction to remain well below the historical average at less than 1% of stock annually. As a result of improving demand and limited new construction, vacancy is forecast to fall under its historical 25-year average of 10% by 2017 and remain at or below the 9%-10% range through 2020. Rent growth will generally correspond with strengthening occupancy and retail sales; however, prior peak rents will not likely be reached in the majority of metros until 2019 or later.⁴¹

Our retail strategy remains largely focused on class A product, as we believe the most dominant properties that garner a large share of retail sales today within a trade area will be the most competitive, flexible, and durable over the long term. These properties are likely better positioned to provide future opportunities to add high-quality tenants. Additionally, class B centers in excellent locations with a clear path to growth, such as additional construction of single and/or multifamily homes, hotels or office space, may be prime targets for repositioning. Selectivity is important as the cycle matures. We favor areas which are densely populated, where growth is already visible, where other demographic factors (e.g., education and income levels, household size) are improving, or where there is a notable shortage of a specific retail offering.

A relevant tenant mix is the critical draw of a shopping center. We favor retailers with a strong omni-channel strategy where the online presence complements the physical store strategy to better service and reach customers. It is important to be realistic about tenant health ratios and the rent increases tenants can absorb.

Other key elements of our retail strategy include:

- Grocery-Anchored Retail: Traditional grocery-anchored centers offer durable customer traffic; updated uses such as entertainment, quick service restaurants, fitness and health/wellness concepts also act as complementary anchors, providing additional drawing power and cross-traffic. We believe these types of centers will be more insulated from e-commerce due to the service oriented, necessity-based or daily needs merchandising of their products.
- Malls: Dominant malls catering to well-heeled consumers may continue to draw best in class tenants. However, they are not immune to e-commerce risks, particularly to traditional department store anchors. To the upside, replacing these stores with new tenants at higher rents could drive NOI growth, although the capital expenditures necessary to do so could be onerous.
- High Street: A strong dollar and weakening global growth could hamper international travel and spending, reducing traffic and sales in High Street retail districts. Yet the pull and visibility of these locations underscore the long-term viability of the subsector. Uncertainty may energize a flight to quality and push luxury and best-in-class retailers to the most dominant shopping districts in top international gateways, while retailer expansion in secondary locations may slow.
- Power Centers: We continue to underweight power centers, which typically feature chain stores selling goods readily available online, and are therefore vulnerable to store closings, bankruptcies, and downsizings.

⁴⁰ Department of Commerce. Data as of July 2016.

⁴¹ CBRE-EA (history); Deutsche Asset Management (forecast). Data as of March 2016.