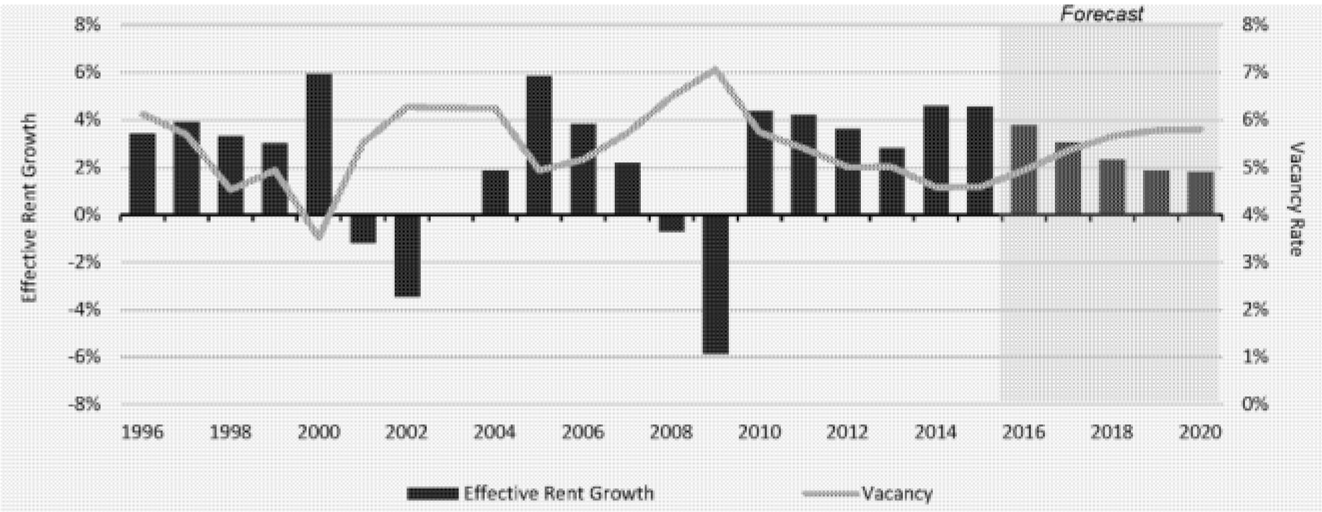
CBDs. Softening fundamentals in downtown submarkets have not deterred investors: we estimate that the average going in cap rate for urban core product remains at 4.5% in our 26 investable markets, with many prime assets trading under 4.0%.[49] The lofty prices investors are willing to pay for CBD assets helps explain why developers continue to build downtown despite softening fundamentals. These neighborhoods are potentially at risk of further supply build-up in the outer years of our forecast if pricing does not adjust.

NPI total returns for the apartment sector slowed to 10.9% (trailing four quarters) in the first quarter 2016 from 12.0% as of late 2015.[50] Western metros have been the primary outperformers: Oakland, Denver, Portland, Riverside, San Jose, San Francisco and Orange County all exhibited total returns of 16% or more over the past year. In contrast, several slower growth Midwest and East Coast markets, along with Houston, made up a majority of the underperformers with total returns in the single digits. Among apartment property subtypes, garden apartments were the top performers, returning 13.9% over the last year. Despite their popularity with investors, high-rise properties lagged behind, returning 9.3%, 200 basis points below the subtype's 5-year average annualized return.

7.2 Outlook and Strategy

While favorable macro trends should continue to sustain healthy renter demand, it is unlikely to offset the expected flood of new supply. New deliveries are projected to average 234,000 units per year from 2016 to 2018 – 74% above their long-term annual average of 137,000 units.[51] Still-healthy net absorption will likely not keep pace and as a result, vacancies are forecasted to increase. Upward pressure on vacancy is projected to cause rent growth to moderate. As many major coastal markets exhibit decelerating rent growth, late-recovery Sunbelt markets are expected to take the lead. By the later years of the forecast, continued deliveries, competition with home-buying and moderating payroll expansion will likely push vacancy above historic averages to the upper 5% range and cause rent growth to slip below 2% per year (see Exhibit 15).

Exhibit 15: Apartment Vacancies and Rent Growth



Sources: CBRE-EA (history); Deutsche Asset Management (forecast). Data as of June 2016. No assurance can be given that any forecast or target will be achieved.

Slowing rent growth and rising vacancy, combined with very low yields, will likely limit apartments' ability to produce strong total returns relative to the other main property types. Given that many prime apartment markets are fully valued, attractive investment opportunities have become more limited, putting a premium on patience and selectivity when acquiring assets. Although we believe the prime markets should be viewed as strategic long-term performers, elevated pricing in these locations will likely constrain total returns in the near term.

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[49] Deutsche Asset Management. Data as of June 2016.
[50] NCREIF. Data as of April 2016.
[51] Deutsche Asset Management. Data as of June 2016.