

mid-30s. More troubling is the large influx of new supply that has begun to come on line in virtually every market in the country. Accordingly, we assume an underweight position to the sector.

## 1.2 Market Allocations

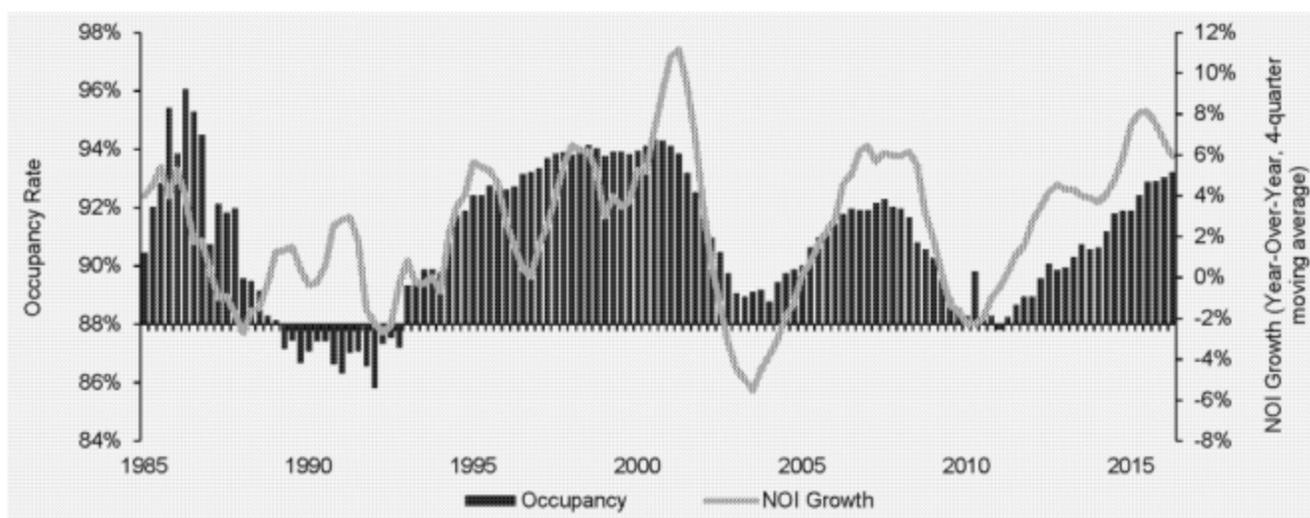
From a strategic perspective, we continue to favor large, coastal, "gateway" markets (e.g., Boston), which have produced stronger rent and price appreciation over time while providing superior liquidity. Conversely, we are wary of smaller markets with poor demographic trends (e.g., some cities in the industrial Midwest), which have generally underperformed over the long term. Nevertheless, current market conditions warrant some modulation around this general posture. Specifically:

- **Gateway Markets:** Prices have risen substantially in several coastal markets. We remain optimistic toward Los Angeles and Boston, where fundamentals are on a strong footing. However, we are more cautious toward markets with weaker or riskier fundamentals, including San Francisco, New York, and Washington D.C. (albeit with important property-type exceptions).
- **Regional Markets:** Our most favored markets are generally smaller coastal cities that share some of the natural supply barriers of gateway markets but with yields that are somewhat higher, including Portland, Oakland, Orange County, San Diego, Fort Lauderdale, and to a lesser extent, Seattle and Miami. Meanwhile, our view of inland markets is mixed: in traditional fashion, a few are at risk of oversupply (e.g., Charlotte, Austin, and Houston), while others are more balanced (e.g., Atlanta and Phoenix).

## 2 Commercial Real Estate Fundamentals

U.S. commercial real estate (CRE) fundamentals have rarely been stronger. According to the NPI, in the second quarter 2016 occupancy levels and Net Operating Income (NOI) growth were near their highest since 2001 (see Exhibit 1). Commercial real estate's robust performance is all the more remarkable given the pedestrian pace of economic growth. We believe that fundamentals will remain firm for the next several years, supported by a prolonged (albeit temperate) economic expansion and a generally moderate supply pipeline.

Exhibit 1: NPI Occupancy and NOI Growth



Source: NCREIF. Data as of June 2016. Past performance is not indicative of future returns.