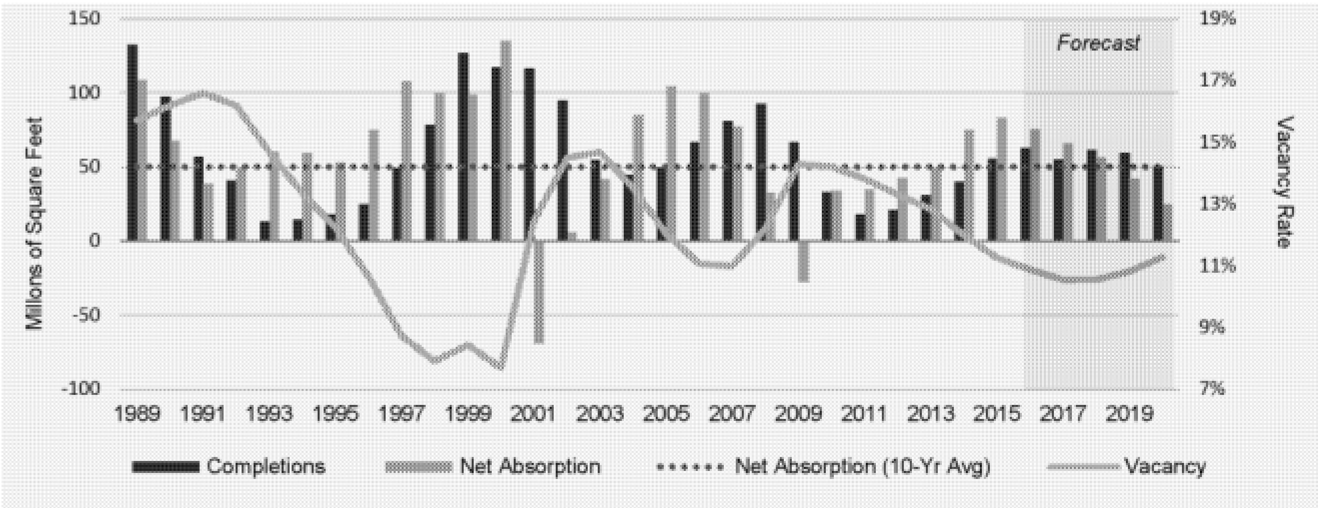
5 Office Sector

5.1 Current Conditions

Indicators during the last six months show a disciplined and fundamentally strong national office market. Alongside healthy job gains dominated by office-using sectors, the office market showed positive but modest improvement. Vacancy at the end of 2015 was 11.3%, on a par with the previous cyclical trough of 11%.[26] Effective rents increased 3.8%, slightly less than in 2014 (see Exhibit 9).[27] During the last cycle, as vacancy declined to the 10%-range, effective rents spiked 14.1% over two years. [28] Amid increased financial volatility in early 2016, businesses appeared to delay action on leases, particularly early renewals or expansion options, translating into a modest slowdown in occupancy and rental momentum.

Exhibit 9: Office Fundamentals



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

Supply-side dynamics also continue to underscore discipline in the office markets. Nearly 180 million square feet are slated to deliver during the next two to three years, adding less than 1% to office stock annually compared with a 1.6% average annual increase during the last 15 years. [29] Supply risk has materialized in some markets, but these markets have other vulnerabilities. San Francisco, Seattle and Austin, for instance, all have large pipelines but also have overweight exposure to high-technology. Much of the riskiest speculative supply is in CBD markets, where the expansion has been strongest.

CBD markets continue to outperform suburban markets, but with the majority of CBDs across the U.S. nearing or at equilibrium occupancy, growth is slowing. CBD absorption pulled back to 1.3% of stock in 2015 from 1.7% in 2014.[30] In contrast, suburban absorption continued on an upward trajectory to 1.9% of stock, up 50 basis points from 2014.[31] Rents are responding. During the first quarter, the CBD to suburban office rent premium narrowed 60 basis points (see Exhibit 10). While still a ways off from expansion mode, select urbanized, high-amenity suburban markets are beginning to benefit from demand squeezed out or priced out of proximate CBDs. Total returns on a rolling four-quarter basis through first quarter showed a narrowing in spread, with CBD just 50 basis points over suburban, compared with a long-term historical spread of 100 basis points. [32] Suburban markets also showed a wider spread relative to the long-term average than CBD markets.

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[26] CBRE-EA & Deutsche Asset Management. Data as of July 2016.
[27] CBRE-EA. Data as of July 2016.
[28] CBRE-EA. Data as of July 2016.
[29] CBRE-EA & Deutsche Asset Management. Data as of July 2016.
[30] CBRE-EA. Data as of July 2016.
[31] CBRE-EA. Data as of July 2016.
[32] NCREIF. Data as of July 2016.