Park Madison Perspectives – 2017 Halftime Report

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About Park Madison Partners

Park Madison Partners is a New York-based real assets placement and advisory firm focused on the global alternatives and private funds industry. To date, the firm has participated in the placement of over $9 billion of private equity capital globally.

Park Madison Partners was founded to offer clients capital raising and strategic consulting services with a high degree of customization, integrity and accountability. The firm provides a relationship-driven approach to structuring and marketing assignments and offers its clients access to global institutional investors. Our team comprises professionals with backgrounds across the buy-side and sell-side, and we leverage this experience to provide a thoughtful approach to global real estate markets.

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Public market volatility may be at historic lows, but one would be hard-pressed to say 2017 has lacked excitement. In sports, halftimes are frequently used as a way for players to rest, recover, and reflect following the first half. While we don't promise any rest or recovery, we think reflection is a wise and useful exercise. So with that, here are five updates to Park Madison's 2017 Outlook that we published in January:

1. The Fed will slow its pace of rate hikes
2. US commercial real estate performance will be widely mixed
3. US tax reform will get pushed to 2018
4. Europe will continue its upward momentum
5. Geopolitical tensions will rise in East Asia

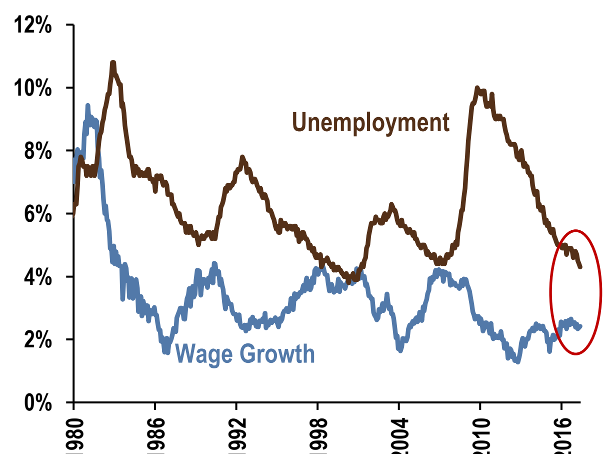
2017 HALFTIME REPORT

1. The Fed will slow its pace of rate hikes

At the start of 2017, we outlined all the reasons why we believed the Federal Reserve would become more hawkish this year. Global inflation pressures were on the rise. The US economy was growing at a healthy clip as business and consumer confidence hit multi-year highs. US unemployment had fallen well below what economists refer to as the "natural rate of unemployment," causing wage growth to pick up steam. At the same time, the new Trump Administration was promising economic stimulus through a combination of fiscal and regulatory measures, which increased the risk of the economy "overheating" if applied during a time of full employment. Various "Trump Trade" market indicators appeared to signal that the US economy would soon transition from an environment of low growth, low inflation to one of higher growth and higher inflation. The Fed had to move.

The Fed has so far reacted as we expected, with 25 bp rate hikes in March and June, along with recent discussions about shrinking the Fed's balance sheet and unwinding QE. However, we also called for market conditions to intervene forcing the Fed to moderate its hawkish stance. We expect the Fed to officially hit the brakes on monetary tightening in H2 2017 for a variety of reasons. Global inflation pressures appear to have crested for now after peaking in Q1. Low unemployment has thus far not stoked the same levels of inflation and wage growth as it has in past periods, confounding economists and causing them to question the strength of the Phillips Curve* in today's economy. Additionally, the Trump stimulus is off to a slow start as grand expectations collide with the realities of Congressional gridlock. Many of the Trump Trade market indicators have slowly unwound, with some of them now closer to pre-Election levels.

Where is Phillips? – Wage Growth vs Unemployment, 1980-2017

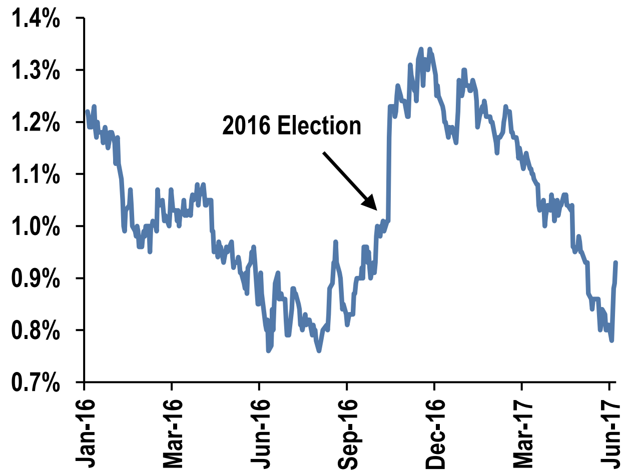


Source: FRED Economic Data

*The Phillips Curve is an empirical economic model which suggests lower unemployment should stoke higher inflation and wage growth, all else being equal.

As a result, we do not believe the Fed can maintain its current footing without triggering a negative market reaction. Take for instance the Fed's plans to reduce its balance sheet, or what we should call quantitative tightening ("QT"). If the Fed moves as expected, QT will entail allowing maturing securities to run off of the Fed's balance sheet, starting with approximately $10 billion per month and gradually ramping up to $50 billion per month. By comparison, the Fed was purchasing $40 to $85 billion per month during its last round of quantitative easing, QE3. The net result of QE was, in theory, lower interest rates, higher liquidity, and easier financial conditions. The net result of QT should therefore be the opposite: higher interest rates, lower liquidity, and tighter financial conditions. Add one or two rate hikes to that equation, and suddenly monetary policy looks not only restrictive but potentially disruptive. With the economy currently showing little risk of overheating, such action by the Fed does not appear warranted at this time.

Tempered Expectations - 10yr-2yr Treasury Spread, Jan 2016-June 2017



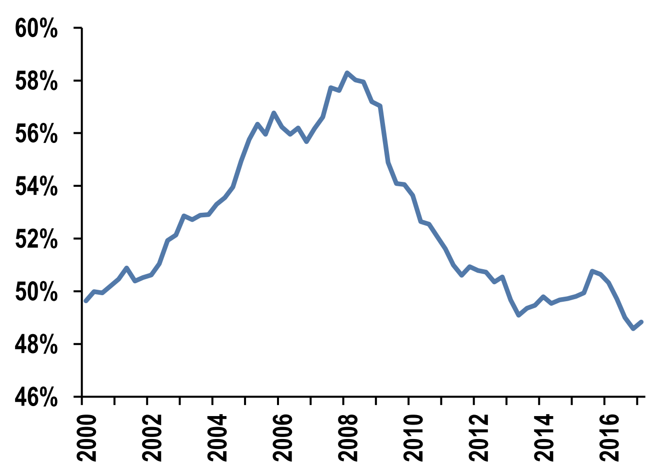
Source: FRED Economic Data

Real estate investors will therefore need to watch the Fed closely in H2. If economic growth begins to slow or credit spreads start increasing, the Fed should take a breather. If, however, the Fed uses low unemployment as justification to keep tightening policy while ignoring other potential warning signs, the Fed risks slowing the economy more than intended. We believe the Fed is aware of these risks and will act accordingly, though perhaps not without the markets throwing at least one tantrum along the way. Assuming QT goes forward, we expect at most one additional rate hike this year.

2. US commercial real estate performance will be widely mixed

If there is one common theme that has united real estate investors across all sectors and geographies in 2017, it is "caution." A 7-year bull run in commercial real estate has caused many to speculate that the market is simply due for a correction. While we believe certain sectors and localities will indeed experience price declines over the coming quarters, we would expect such a correction to be relatively mild. For one, investors and managers are much more cautious today than they were 10 years ago. Underwriting and leverage have both remained fairly conservative as bad memories of the GFC still remain fresh. Fundamentals are also quite healthy due to the strong state of the US economy. That being said, we expect performance to become increasingly localized and sector-dependent, and successful investing in this environment will require a more proactive and targeted approach to asset class and market selection.

Lessons Learned – NAREIT Debt/Book Value, 2000-Present



Source: NAREIT

Office

Office fundamentals across the US have been stable this year, as job growth and high business confidence have spurred expansion and investment. A disproportionate share of net new absorption is being captured by secondary and tertiary markets, whereas larger gateway markets have been more mixed as a wave of new supply comes online. Several gateway markets, particularly San Francisco and New York City, are already experiencing heightened uncertainty as rents hover near record highs, absorption turns flat to slightly negative, and transaction volume drops. Even in these markets, however, there are pockets of opportunity buried in the noise. Within New York City, for instance, office demand overall remains healthy as job creation continues apace and more TAMI tenants move in; however, most of the absorption is concentrated among new construction or recently retrofitted creative office space, while older building stock – particularly in Midtown and along 6th Avenue – struggles to compete. For real estate investors, this environment reinforces the need for diversification across markets, as well as the value of working with local operators in high barrier gateway cities.

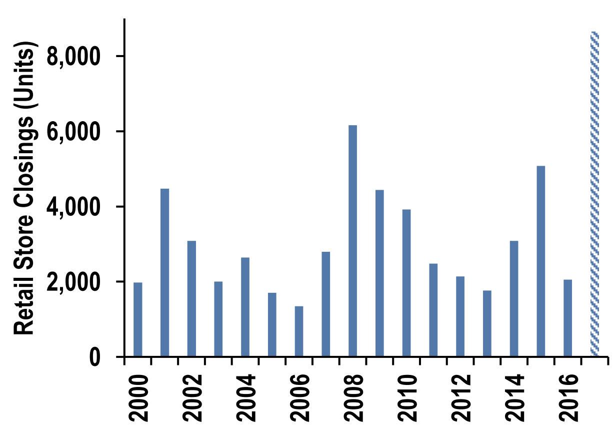
Industrial

JLL estimates that new supply in the last 5 years combined with the current construction pipeline will add nearly 1 billion square feet to US industrial stock by 2018, increasing total inventory by more than 8 percent. Despite this surge in new supply, the industrial sector continues to fire on all cylinders as rents hit record highs and vacancies hit record lows. Supply simply can't keep up with demand. Still, investors must choose their markets and assets carefully. E-commerce continues to generate seismic shifts in how companies think about inventory, supply chains, and distribution, creating both winners and losers in industrial properties. For instance, corporate acquisitions such as Amazon's purchase of Whole Foods could signal that certain retail properties will start to disintermediate other parts of the retail supply chain. With the pace of change accelerating, investors should be mindful that the industrial sector is historically a commodity asset class and prone to volatility.

Retail

Cue the proclamations of doom... After starting the year on an uncertain footing, "retail" has since become a four-letter word. The media certainly seems to be having a fun time dreaming up intensely negative headlines: "Brick and Slaughter," "The Great Retail Apocalypse of 2017," "The Retail Death Spiral." Then of course there's our favorite new word of the year, "Amazoned," as in "that store just got Amazoned to death." Indeed, whereas e-commerce has brought sunshine to the industrial sector, in retail it has wrought a chilling winter of discontent. Credit Suisse has estimated that more than 8,000 stores could close in 2017, eclipsing the more than 6,000 that closed in 2008 – during the worst recession since the Great Depression. While we do not dispute that the retail sector has its challenges or that many existing centers have become obsolete, we do think the negative headlines are overblown. No matter how efficient the internet becomes, humans still want to get out and have experiences away from work and home. As such, more "experiential" retail properties such as those that incorporate entertainment, dining, and service venues should keep performing well. The current turmoil is merely capitalism engaging in a healthy bout of creative destruction, and the end result should be a new and improved retail experience for consumers. Meanwhile, the transition period is yielding significant distress, which should create some interesting opportunities for investors possessing the right combination of vision and foresight.

Worse than 2008 – Annual Retail Store Closings by Unit



Source: Credit Suisse estimates

Multifamily

US multifamily rents in aggregate have been flat in 2017 and vacancies have risen modestly as new supply reaches a post-GFC peak. Like other property types at this point in the cycle, performance has varied widely across different markets and asset types. Sunbelt markets continue to outperform many other parts of the US thanks to strong demographics and economic growth. Gateway cities have been mixed, with New York City and San Francisco rents declining YTD after a multi-year upswing, while other markets like Seattle continue to march higher. Properties targeting middle-income renters have benefitted from increasing demand and limited supply, while higher-end properties are likely to face short term dislocations due to pockets of oversupply. Young professionals continue to face high student loan balances and low savings rates, which has prevented many of them from buying homes. Given the multifamily sector's favorable long-term structural, demographic, and cultural drivers, we expect experienced managers will be able to capitalize on a range of attractive value-add, growth, and cycle-specific opportunities for the foreseeable future.

3. US tax reform will get pushed to 2018

We wrote in our 2017 Outlook that tax reform would fundamentally change the way real estate is priced. We still believe that to be the case, but reform itself might have to wait until 2018 or beyond. With Congressional Republicans dealing with both a fractious conference and a thin majority in the Senate, the entire Republican legislative agenda is moving much slower than previously expected. Healthcare reform, which was supposed to be enacted "immediately," now looks likely to drag well into the Fall. Healthcare reform is thought by many on Capitol Hill to be a necessary prerequisite to tax reform, as Medicare is one of the single-largest components of the Federal budget. Forging a workable consensus to healthcare reform looks likely to take several more months barring a sudden breakthrough, which means tax reform will likely not even be taken up for debate until late this year.

Sausage, Made Slower – Republican Agenda Timeline, 115th Congress

Source: Official statements, news articles, Park Madison Partners estimates

Once tax reform is finally addressed, we expect it to be a complicated and slow legislative process. Many sacred cows will be on the chopping block (e.g. individual itemized deductions) and new boogeymen will be introduced (e.g. the Border Adjustment Tax). Forming a consensus agreement around these issues will require a great deal of compromise, and when it comes to compromise Congress is a bit out of practice.

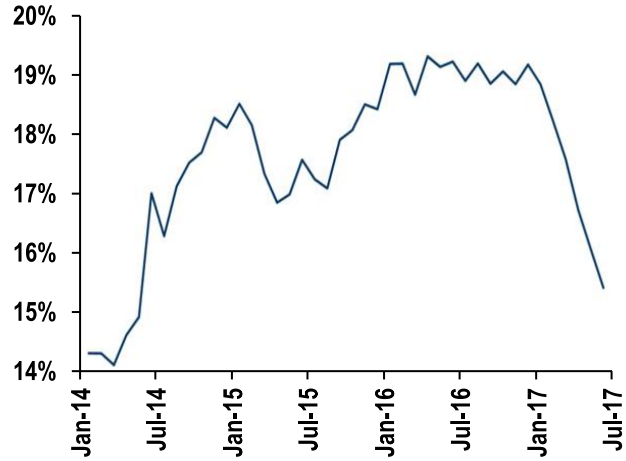
Ultimately we believe tax reform does get enacted, but mostly likely not until 2018. Within the final package will be several items affecting US real estate markets over both the short and long term. For instance, a proposal to replace current straight-line multi-year depreciation with an immediate, full cost expensing of real property could lead to a short-term boost in real estate prices as the present value of tax savings increases. However, such a move could also distort investment incentives as more investors and developers engage in real estate transactions purely for tax reasons, which in the long term would likely make real estate markets less efficient. Elimination of the net interest deduction would also have wide-ranging implications for capital structures, with potentially adverse effects on existing investments unless Congress allows a reasonable transition period.

Congress' stated goal with tax reform is to encourage growth and promote investment. Organizations such as the Real Estate Roundtable are currently working with Congress to ensure that reforms affecting real estate accomplish exactly that. The repeal of FIRPTA, for instance, would likely lead to increased foreign investment in the US. Other measures, as we allude above, are more nuanced and require a thoughtful legislative approach. We encourage all real estate industry players to be engaged throughout the upcoming debate on these issues.

4. Europe will continue its upward momentum

In January we were understandably cautious on Europe's prospects for 2017. While we highlighted the opportunities that could arise from an uncertain and volatile environment, Brexit taught us to not be shy about acknowledging political event risks. However, as we start H2, the political risk overhang has been significantly diminished and the bullish case for Europe is much stronger. The populist wave that has swept through Western democracies in the last couple of years seems to have finally crested. Both Dutch and French voters largely rejected populist anti-EU political movements, and Germany's ruling CDU/CSU coalition is looking firmer heading into September elections. Combine this newfound stability with high consumer confidence, accommodative monetary policy, and steady GDP growth, and we finally have all the makings for what could be a "real" recovery in Europe.

Looking Less Formidable – Monthly Average Polling % for 10 Eurosceptic Parties*

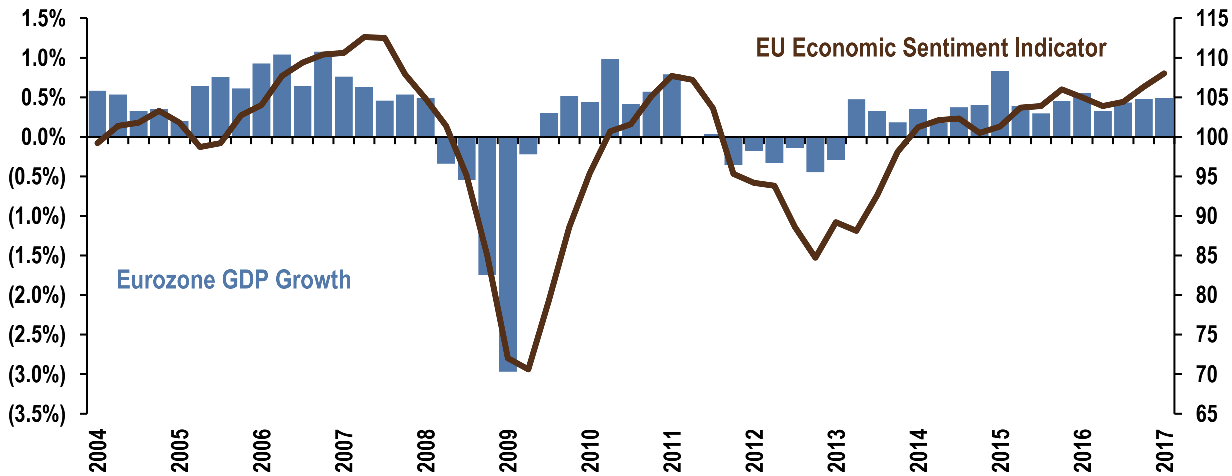


Source: Credit Suisse, monthly average of various polls
*The 10 parties included are FN, AfD, PVV, FRPO, Finns, LN, Podemos, CDU, and M5S

Of course, this is not to say that political event risk is completely gone from the EU, particularly when it comes to the single-currency Eurozone. Policymakers have increasingly accepted the reality that Greece's debt load is simply unsustainable and will require a restructuring. "Grexit" may seem like a stale topic five years after the term was coined, but the risk is still very much alive. The Eurozone banking system remains fragile, as Italy's banking crisis so recently reminded us. Russian aggression in Eastern Europe is also a potential flashpoint. Europe may be on the right course, but it is far from being completely out of the woods.

Despite the ongoing risks, the situation in Europe has clearly improved since early 2017, and that bodes well for real estate investors in the region. Real estate fundamentals overall appear attractive. Vacancies in prime markets are low, and limited development since the GFC has kept supply in check. Meanwhile, high business confidence and steady economic growth should drive demand for commercial space as companies expand and invest.

Real Recovery Ahead? – Eurozone Quarterly GDP Growth vs EU Economic Sentiment, 2004-Present



Source: FRED Economic Data and the European Commission.

With sound fundamentals as a backdrop, the real estate opportunity set appears particularly interesting at this point in Europe's recovery. Debt originated by Europe's banks at the peak of the last cycle is coming due in 2017 and 2018. Many of these loans will have a tough time getting refinanced as values remain below the prior peak, which should provide interesting deal flow for both value-add equity and private debt strategies. Additionally, Europe's commercial real estate recovery to date has been concentrated mostly on prime markets. If indeed Europe's recovery starts to pick up steam, then more secondary markets should start to benefit and provide opportunities for real estate investors. As such, we expect additional capital flows into European real estate strategies in the months ahead.

5. Geopolitical tensions will rise in East Asia

In our 2017 Outlook we spoke broadly about rising political risk around the world and how it would impact investment decisions. For the remainder of 2017, there is one region in particular that we are watching carefully: East Asia. Trade disputes, Chinese territorial assertiveness, and North Korea's pursuit of nuclear weapons have all contributed to an increasingly unstable environment in the region. Trade disputes reduce regional cooperation and put nations on a more adversarial footing. China's assertive posture in the South and East China Seas raises the prospect of an accidental military engagement, potentially spiraling into a brief but destructive "hit-out" between the region's major military powers.

The most significant near-term geopolitical risk facing East Asia, however, is that of a major conflagration on the Korean Peninsula. We've long grown accustomed to saber-rattling rhetoric from North Korea's Kim regime, so the current dispute may seem like business as usual. But we suspect – to use an old investment adage – that this time is different. The Kim regime is determined to acquire nuclear-armed intercontinental ballistic missiles ("ICBMs") as a means to guarantee its long-term survival. The US has repeatedly stated that it will not tolerate a nuclear-armed North Korea. Neither side appears willing to compromise, so we are likely approaching a historic inflection point. After decades of "strategic patience," the US and the world are running out of time to stop North Korea's nuclear program.

This means the final, current stage of North Korea's race towards nuclear armament will be the most dangerous. Once the North has a viable nuclear weapon delivery system, the general consensus is that it will be too late to intervene. The world would simply have to learn to live with a nuclear-armed North Korea, and all the nuclear blackmail that may entail. The US will therefore be under increasing pressure to take pre-emptive action against the North before this happens. Such a strike, were it to occur, would have to be swift, unexpected, and overwhelming in order to succeed. Any geopolitical consequences or corresponding market reaction would be unpredictable.

The US first developed nuclear-armed ICBMs in 1959, nearly 60 years ago. History shows that the proliferation of weapons technology across nations and cultures is a gradual, but ultimately inevitable process. Nuclear weapons and ICBMs are no exception. Despite the existence of the Nuclear Nonproliferation Treaty, nuclear weapons are likely to proliferate; it's only a matter of time. How the world reacts to and manages this proliferation is another question. Like the 1962 Cuban Missile Crisis, North Korea's nuclear armament is yet another test of how the world manages interstate conflict in the Atomic Age. Investors should therefore keep a close eye on this situation, as we believe it represents the most significant and difficult to quantify "fat tail" risk to the global economy today.