Deutsche Asset
& Wealth Management

Research Report

U.S. Real Estate Strategic Outlook: Mid-Year Review

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Passion to Perform

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Overview

The U.S. commercial real estate market has delivered impressive total returns over the past five years. So impressive, in fact, that some investors are beginning to wonder how much longer the momentum can run. This cycle, like all others, will eventually come to an end. Yet real estate has historically performed well in moderate-growth, low interest rate environments, conditions that we expect to persist for several more years.

The National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index (NPI), a measure of unlevered private commercial real estate, returned 13% year-over-year in the second quarter of 2015[1], handly outperforming the return on large-cap stocks (7.4%)[2] and bonds (1.7%)[3]. Capital values have advanced on strong cash-flow growth as well as yield compression, while income returns have continued to provide healthy spreads relative to those on other asset classes.

Fundamentals are expected to remain healthy in the context of moderate economic growth and historically low levels of construction. Rising cash flows and loosening capital markets should continue to fuel investor appetite. However, rising interest rates are a potential headwind: Although they are unlikely to rise sharply, an increase from today's low levels might weigh on future capital gains. Accordingly, NPI total returns are expected to average 7.3% annually over the next five years: lower than in the past, but still attractive, we believe, on a risk-adjusted basis relative to other investment options in a rising interest-rate environment.

Yet the rising tide will not lift all boats, or at least not uniformly. As total returns normalize, we believe that the rewards from judicious sector, market, and asset selection may be significant. This paper will outline some of the strategies that we believe hold the potential to generate superior risk-adjusted returns over a five-year horizon. Highlights include:

Sector Allocations

From an investor's perspective, the Industrial and Office sectors have historically performed pro-cyclically while Apartments and Retail have been more defensive.[4] Five years into the real-estate recovery, we believe that a modest pro-cyclical overweight is justified (see Appendix 1: Real Estate House Portfolio). In particular:

- **Industrial (Overweight):** The cyclical recovery in retail sales plus structural factors such as trade liberalization and e-commerce distribution and fulfillment should continue to support a robust pace of warehouse absorption. Although construction is increasing, particularly in a handful of large distribution markets, on a national basis it is not expected to catch up with demand until late in our five-year forecast. Accordingly, cash-flow growth should remain strong.

[1] NCREIF. Data as of June 2015.
[2] Standard & Poor's (S&P 500). Data as of June 2015.
[3] Barclays (Barclays U.S. Aggregate). Data as of June 2015.
[4] NCREIF and Deutsche Asset & Wealth Management. Even when job growth cools, causing demand for office space to contract, demand for necessities and residential space persists. Long leases also contribute to the retail sector's relative stability.

- **Office (Market-weight):** Office lagged behind other sectors both from a fundamentals and pricing perspective during the recovery. A trend toward increased occupational density and an overhang of "shadow space" (unused space already under lease) weighed on demand, holding back rents. However, these challenges have dissipated. Meanwhile, job creation continues unabated and new supply remains broadly muted, laying the foundation for a stronger recovery. In addition, leases signed during the recession are rolling up to higher market rates, providing a further boost to cash flow.

- **Apartment (Underweight):** Demand for apartments remains buoyant, driven by a resurgence of household formation and declining homeownership rates. [5] So far, deliveries of new buildings have failed to keep up. [6] However, development is accelerating: permitting is reaching levels not seen since the mid-1980s. Meanwhile, a steady flow of capital into the sector, including from government sponsored entities (Fannie Mae and Freddie Mac), is keeping cap rates low.[7] Accordingly, apartments are expected to underperform the NPI over five years. Yet we see opportunities in select supply-constrained, low-affordability markets.

- **Retail (Underweight):** The retail sector has been a tale of two segments: Regional malls have posted stellar investment returns while power centers have lagged far behind.[8] E-commerce and shifting spending patterns are two of the forces that are driving sharp disparities in performance. In general, historically high vacancy rates and subdued absorption militate for an underweight allocation. However, the sector offers compelling investment opportunities and serves as a stable anchor in a balanced portfolio.

Market Allocations

Our preferred market strategies vary by property type. In general, however, we see opportunities in both gateway and secondary markets.

- **Coastal Markets:** From a cyclical perspective, cap rates in coastal markets (e.g., Los Angeles, New York, and San Francisco) have compressed significantly since the financial crisis (although they are not unusually low relative to risk-free rates).[9] However, these markets have proved to outperform over the long term, benefitting from supply constraints that support rising net operating incomes (NOIs) and valuations over time.[10] We believe that in general, coastal markets remain attractive, particularly for long-term investments and more tactical development and value-add opportunities.

- **Regional Markets:** Regional markets have historically tended to underperform, despite somewhat higher income returns, as their lack of supply constraints has tempered capital gains. However, in a selection of secondary markets, higher relative yields, strong demographics, and low prices (which act as an economic barrier to new supply), could create tactical opportunities in some locations.

[5] Census Bureau. Data as of June 2015.
[6] CBRE-EA. Data as of June 2015.
[7] Federal Reserve and NCREIF. Data as of June 2015.
[8] NCREIF. Data as of June 2015.
[9] Real Capital Analytics. Data as of June 2015.
[10] NCREIF and Deutsche Asset & Wealth Management. Data as of June 2015.

Commercial Real Estate Outlook

We believe that U.S. commercial real estate is positioned to generate healthy risk-adjusted returns over the next five years. A moderate economic expansion should continue to support absorption across property types. Commercial construction is expected to remain historically low. Attractive relative yields should also support liquidity in the asset class, offsetting any adverse effects from rising interest rates.

Economic Outlook

The U.S. economy hit a soft patch in the early months of 2015.[11] While disheartening, there is ample reason to believe that the slowdown marked a short-term speed bump in the longer-term expansion.

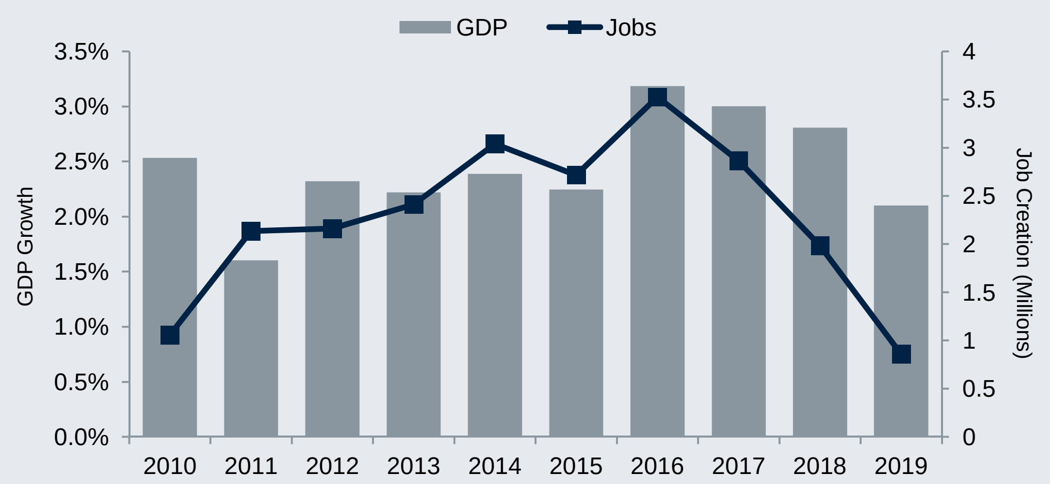
Fundamentally, the U.S. economy is on a strong footing, having finally cast off many of the imbalances that either caused the last recession or hindered the recovery. Deleveraging, a restraint on public and private spending since the financial crisis, appears to have run its course: the federal deficit has dropped to a sustainable 3% of GDP or lower (although entitlements pose a longer-term threat)[12]; state governments have for the most part balanced their books[13]; household net worth as a share of disposable income is near an all-time high[14]; and savings rates are back to historical norms[15]. The financial system has recapitalized and is lending again: bank credit is growing at a healthy 8% annual rate[16]. Interest rates remain low, held down by accommodative Federal Reserve policy, quantitative easing around the globe (which has attracted capital flows to the U.S.), and tepid inflation. Low interest rates have in turn helped reduce household debt-service burdens to a record low and have rejuvenated the housing recovery. Finally, tepid inflation, thanks to lower oil prices and a strong dollar, have buttressed spending power: cheaper energy alone might give the average households an effective 2% pay hike this year.[17]

The economy is not without challenges: Softer global growth and a 15% appreciation of the trade-weighted U.S. dollar are significant headwinds to exports.[18] The sharp drop in oil prices has curtailed investment in America's hitherto burgeoning energy industry.[19] Economic risks stemming from China and Greece, though likely manageable, cannot be ignored. Still, time-tested leading indicators such as the yield curve continue to send positive signals.[20] Provided that global conditions do not deteriorate further, the U.S. economy should grow by 2.2% and generate more than 2.5 million jobs in 2015, rising to 3% and more than three million jobs in 2016.[21] Thereafter, once the economy is operating at full capacity, growth will fall back in line

[11] Bureau of Economic Analysis. Data as of June 2015.
[12] Congressional Budget Office. Data as of July 2015.
[13] National Association of State Budget Officers, "Fiscal Survey of States, Spring 2015." Data as of May 2015.
[14] Federal Reserve. Data as of March 2015.
[15] Bureau of Economic Analysis. Data as of June 2015.
[16] Federal Reserve. Data as of June 2015.
[17] Deutsche Asset & Wealth Management.
[18] Federal Reserve. Data as of June 2015.
[19] Bureau of Economic Analysis. Data as of June 2015.
[20] An inverted yield curve has predicted every recession since World War 2. The curve was comfortably upward sloping (10-year Treasury yields were more than 200 basis points above the Fed Funds rate) as of July 31, 2015.
[21] Deutsche Asset & Wealth Management. Data as of July 2015.

with its long-run potential, which will be lower than in the past due to the adverse effects of ageing demographics on labor-force growth (see Exhibit 1).

Exhibit 1: U.S. GDP and Job Growth



Source: Moody's Analytics. Data as of July 2015. Past performance is not indicative of future returns.
No assurance can be given that any forecast or target will be achieved.
There is no guarantee that the forecasts will materialize.

In recent years, job growth has been concentrated in metros with significant economic exposure to energy (e.g., Houston and Dallas), technology (e.g., San Francisco, San Jose, Austin, and Seattle), or both (e.g., Denver and Dallas). As the expansion matures it is expected to broaden to more areas, including Sunbelt markets with strong demographic drivers that are finally emerging from the housing bust (e.g., Atlanta, Phoenix, and south Florida).

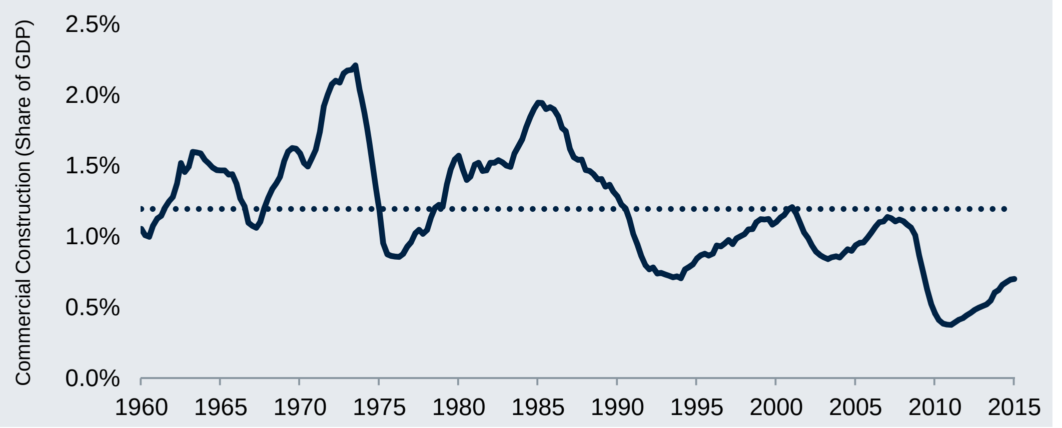
Commercial Real Estate Fundamentals

Economic growth, and job creation in particular, is a critical driver of real-estate performance. When companies hire workers they often need to lease more office space to accommodate them. Paychecks give people the wherewithal to rent an apartment or shop at the local mall. As retail sales rise, more warehouses are needed to facilitate the distribution of goods. In our view, moderate economic growth over the next five years will be sufficient to sustain a healthy pace of absorption across property sectors.

But economic growth does not tell the whole story. Since 1979, GDP growth has had a correlation of 0.5 to NPI total returns.[22] Clearly, other factors are also at play. One of these factors is construction: too much supply can overrun even the strongest economy. In this regard, it is noteworthy that although commercial development has nearly doubled from its financial-crisis depths, it remains approximately half the average of the past 50 years (see Exhibit 2).

[22] NCREIF and Deutsche Asset & Wealth Management calculations. Data as of June 2015.

Exhibit 2: Commercial Construction (Share of GDP)



Source: Bureau of Economic Analysis. Data as of June 2015.
Past performance is not indicative of future results.

The reasons for the low level of supply are twofold: First, until recently, lenders had been cautious about providing capital for development, which is perceived to carry higher risk. This constraint has begun to lift as banks have recapitalized and risk appetite has increased. Second, in many markets and for many property types, it has been cheaper to buy a building than to build a new one. This calculus is evolving as real-estate prices increase, and the economics are fueling new construction in some of the nation's most dynamic markets (e.g., San Francisco). However, in many other places, prices are not yet high enough to incentivize developers to launch new projects, at least not in excessive quantities. Indeed, U.S. construction employment remains more than a million (nearly 20%) below its pre-crisis peak.

Some have lamented the lackluster pace of the current economic expansion relative to past cycles, such as the Reagan recovery of the mid-1980s. And make no mistake: By most yardsticks — GDP, jobs, household formation, and retail sales — this recovery has been woefully deficient. Yet construction is even weaker relative to past cycles, especially the 1980s boom. Today's balance of temperate demand and even weaker supply may be disappointing for developers, but for owners of existing buildings who can profit from the tightening of market fundamentals, it is favorable.

Vacancy rates are below their 20-year average in the apartment, office, and industrial sectors.[23] Retail vacancies remain somewhat elevated, but a dearth of new supply should see vacancies breach this threshold by the end of the year.[24] Under these conditions, landlords are expected to accrue significant rental increases averaging 4% annually through 2019 (ranging from 3% for apartments to 5% for offices) on a national basis, roughly double the rate of inflation.

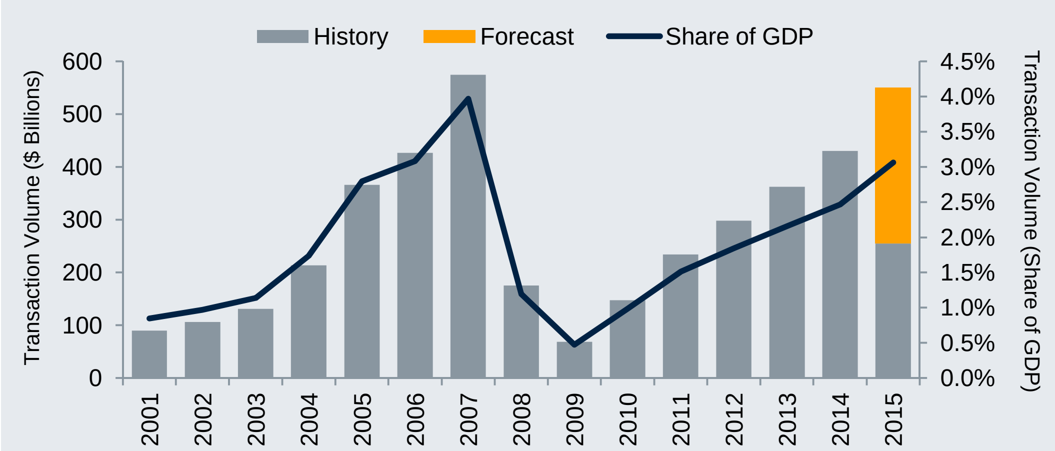
Commercial Real Estate Capital Markets

Commercial real estate capital markets are liquid. Equity and debt, public and private — all capital channels appear to be functioning normally. Transaction volume reached $255 billion in the first half of 2015, up nearly 36% from a year earlier.[25] On current trends, transaction

[23] CBRE-EA. Data as of June 2015.
[24] CBRE-EA. Data as of June 2015.
[25] Real Capital Analytics. Data as of June 2015.

volume could surpass $550 billion in 2015, near its 2007 all-time high in nominal terms, although not as a share of the economy (see Exhibit 3).

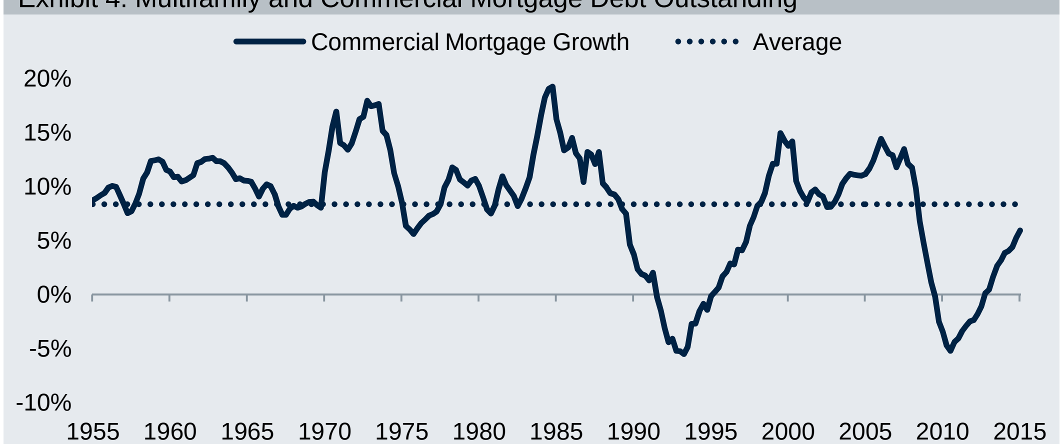
Exhibit 3: Commercial Real Estate Transaction Volume



Sources: RCA; Deutsche Asset & Wealth Management. Data as of July 2015. Past performance is not indicative of future returns. No assurance can be given that any forecast or target will be achieved. There is no guarantee that the forecasts will materialize.

- **Public and Private Debt:** The volume of commercial mortgages increased 6% year-over-year in the first quarter of 2015, slightly slower than the historical average (see Exhibit 4).[26] Banks (50% of mortgages outstanding) and life insurers (11%) are leading the credit expansion.[27] CMBS (12%) continue to shrink as 10-year loans issued during the last boom mature; however, new issuance is on track to surpass $100 billion in 2015 ($52 billion in the first half of the year) for the first time since 2007.[28] Still, while the lending markets are recovering nicely, there is scant evidence of overheating: Although CMBS issuance is picking up, it remains far below its 2007 peak ($230 billion). Average life-insurer loan-to-value ratios (60% in the first quarter of 2015) and debt-service coverage ratios (2.2) are at or close to their most conservative levels in at least 50 years.[29]

Exhibit 4: Multifamily and Commercial Mortgage Debt Outstanding



Source: Federal Reserve Board. Data as of July 2015.

[26] Federal Reserve. Data as of March 2015.
[27] Federal Reserve. Data as of March 2015.
[28] Commercial real Estate Finance Council. Data as of June 2015.
[29] American Council of Life Insurers. Data as of March 2015.

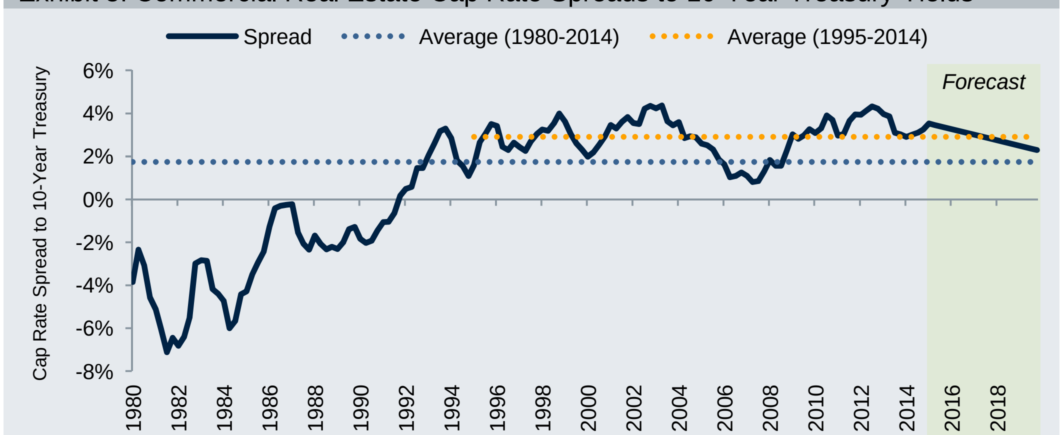
- **Public and Private Equity:** Real Estate Investment Trusts (REIT) struggled in the first half of 2015, underperforming the broader equity markets as investors priced in slower economic growth and expectations of rising interest rates.[30] Despite the setback, at the end of June 2015 prices were at a modest premium to net asset value (NAV), implying that conditions were still ripe for REITs to purchase real estate on an accretive basis.[31] We believe that the outlook for U.S. REITs is positive, thanks largely to strong underlying fundamentals. Although REITs have suffered during past periods of rising interest rates, they have fared very well in the immediate aftermath.

  Private equity capital is also increasingly abundant. According to a recent study, institutional investors in the Americas are increasing their target allocations to commercial real estate, from 8.9% in 2013 and 9.4% in 2014 to 9.6% in 2015.[32] Foreigners have also emerged as an important source of capital: International buyers accounted for 9% of U.S. acquisitions in 2014, in line with their average since 2001.[33] But this might understate their influence on the market, as it ignores foreign capital channeled through private domestic funds and REITs, which has been anecdotally significant. U.S. commercial real estate appears well positioned to capture a growing share of foreign funds, courtesy of its competitive yields, healthy fundamentals, and reputed stability.

Commercial Real Estate Valuations

Average commercial real estate cap rates have compressed approximately 140 basis points since 2009 to 5.4% on a national basis.[34] Although cap rates are currently low relative to their historical average (7.5%), we believe they are justified by low interest rates and strong rent growth prospects. It is noteworthy that cap-rate spreads to 10-year Treasury yields remain well above both their 20- and 35-year averages (see Exhibit 5).

Exhibit 5: Commercial Real Estate Cap Rate Spreads to 10-Year Treasury Yields



Sources: NCREIF (Cap Rates); Federal Reserve (10-year Treasury Yield); Deutsche Asset & Wealth Management (Forecast). As of June 2015. There is no guarantee that the forecasts will materialize.

Economists have been predicting higher interest rates for years, and these calls have grown louder as the U.S. economy has strengthened and the Federal Reserve has moved past

[30] NAREIT and Standard & Poor's. Data as of June 2015.
[31] Deutsche Asset & Wealth Management. Data as of June 2015.
[32] Hodes Weill & Associates, "2014 Institutional Real Estate Allocations Monitor."
[33] Real Capital Analytics. Data as of June 2015.
[34] NCREIF. Data as of June 2015.

quantitative easing to contemplate higher policy rates. We believe that interest rates will increase over the next several years due to several factors, including stronger economic growth (boosting the demand for capital), somewhat slower reserve accumulation in emerging markets (limiting the supply of capital), and modestly higher inflation. However, we expect that rates will rise only gradually, with 10-year Treasury yields increasing toward 3.7% in 2019. (Our view is conservative relative to the 3% level anticipated in the forward market.)[35]

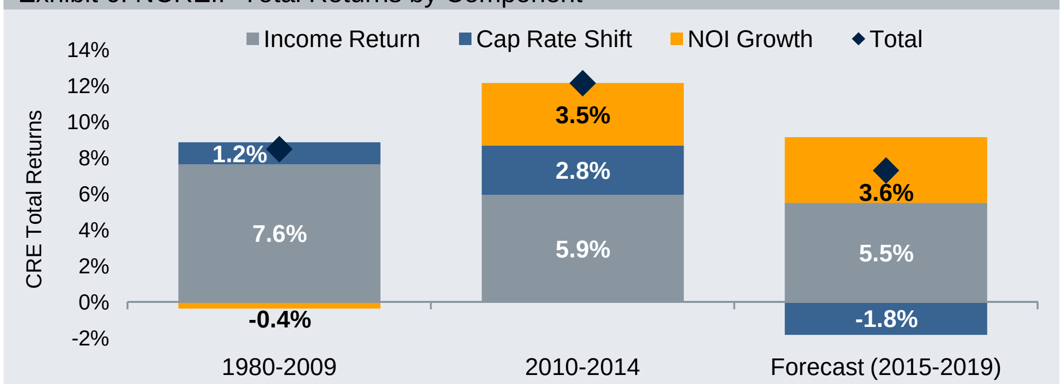
It is conventional wisdom that real estate is highly sensitive to interest rates, yet history proves otherwise. Over the past 35 years, NPI total returns have been positively correlated with interest rates.[36] In part, this reflects the fact that interest rates typically increase when either the economy is strong or inflation is high, both of which support net operating incomes (NOIs). Cap rates also do not move in lock step with interest rates: Under inflation or a stronger economy, investors might price in more vigorous future income growth and lower credit, vacancy, and liquidity risks, narrowing spreads. Often, spread compression can more than offset higher base rates, pushing cap rates lower.

We believe that there is ample capacity for cap-rate spreads to absorb interest-rate increases as the real estate market strengthens and capital markets loosen further. Provided that interest rates increase gradually, we expect that cap rates will rise by no more than 50 basis points over our five-year forecast. This would drive spreads to levels between their 20- and 35-year averages, still well above the lows of 2007 and the 1980s (see Exhibit 5).

Commercial Real Estate Returns

Unlevered commercial real estate has produced total returns averaging 8.8% annually over the past 35 years[37], outperforming bonds (8.4%)[38] but underperforming large-cap stocks (12%)[39]. Over the next five years we believe that commercial real estate returns will be somewhat lower, averaging 7.3%. Moreover, the drivers of returns will be substantially different (see Exhibit 6).

Exhibit 6: NCREIF Total Returns by Component



Note: NOI growth is net of capital expenditures.
Sources: NCREIF (history); Deutsche Asset & Wealth Management (forecast). Data as of July 2015. Past performance is not indicative of future returns. No assurance can be given that any forecast or target will be achieved. There is no guarantee that the forecasts will materialize.

[35] Bloomberg. Data as of July 21, 2015.
[36] NCREIF and Deutsche Asset & Wealth Management calculations. Data as of June 2015.
[37] NCREIF and Deutsche Asset & Wealth Management. Data as of June 2015.
[38] Barclays (Barclays U.S. Aggregate). Data as of June 2015.
[39] Standard & Poor's (S&P 500). Data as of June 2015.

From 1980 through 2009, total returns were overwhelmingly driven by income returns, while cap-rate compression provided an additional boost through capital gains.[40] Over the past five years, income returns were lower, but a combination of further cap-rate compression and NOI growth fueled capital gains averaging more than 6% annually, pushing total returns above 12%.[41] The return outlook over the next five years will differ both in scale and composition: Income returns will be lower and cap rate expansion will drag on capital gains. However, robust fundamentals are expected to drive strong NOI growth, allowing for value growth averaging 1.8% annually.

Risks to the forecast are balanced and center primarily on cap rates. There is a risk that interest rates could spike more dramatically: if this increase were not associated with a commensurate improvement in the economy, cap rates might respond more acutely, pulling values and returns lower. Conversely, it is possible that cap-rate spreads could tighten more than anticipated, driving stronger value growth, as capital markets heat up. In its latest survey, contributors to the Pension Real Estate Association's Consensus forecast predicted NPI total returns averaging 8% annually through 2019.[42]

Expected commercial real estate returns averaging 7.3% annually, though lower than in the past, compare favorably, we believe, with return prospects for other asset classes on a risk-adjusted basis. Index bond yields of 3%-4%[43] are likely consistent with even lower total returns given the potential for principal losses as interest rates increase. In the equity markets, dividend yields of 2% on the S&P 500 and earnings growth of 5% annually, in line with expected nominal GDP growth, would drive total returns averaging 7%, assuming that Price/Earnings (P/E) ratios, currently above their historical average, do not contract as interest rates increase.[44] Compared with those of the other major asset classes, commercial real estate returns are more stable than stocks, more volatile but less interest-rate-sensitive than bonds, and less liquid than both.[45]

[40] NCREIF and Deutsche Asset & Wealth Management calculations. Data as of June 2015.
[41] NCREIF and Deutsche Asset & Wealth Management calculations. Data as of June 2015.
[42] Pension Real Estate Association Consensus Forecast. Data as of June 2015.
[43] Barclays U.S. Aggregate. Data as of June 2015.
[44] Over the long-run, earnings per share (EPS) have not kept pace with nominal GDP, and profit margins are already near record highs. However, payout ratios are relatively low, leaving room for stock buybacks or dividend increases to boost EPS.
[45] No assurance can be given that any forecast or target will be achieved.

Industrial Outlook and Strategy

Current Conditions

The U.S. industrial market continues to enjoy very healthy conditions, matching our expectations as a leading sector for investment returns and outperforming our recent fundamentals outlook. Supply, demand, availability and rent fundamentals have improved sharply in the past year, as has the sector's investment performance. Future economic growth and robust investor demand should continue to fuel good relative performance during our five-year forecast.

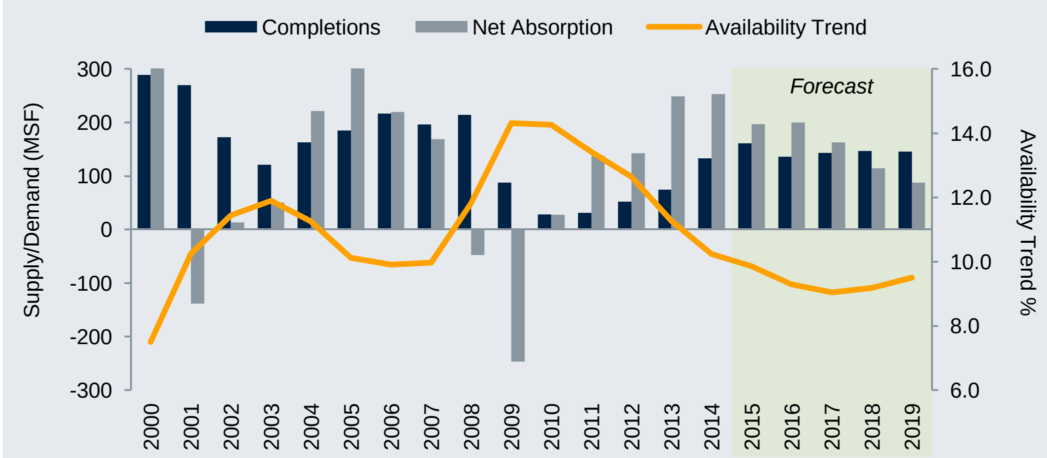
National trends are arguably healthier today than at the peak of the last expansion, with market availability sinking to 9.8% in the second quarter of 2015. This represents a 40 basis point decline, fueled by net absorption of 117 million square feet (MSF) and construction deliveries of 65 MSF through mid-year. Demand outpaced new supply by a factor of nearly two-to-one during the last six quarters. Net positive demand was broad with only four of 45 markets posting negative net absorption. The pace of new development is approximately 1% of stock (annualized), while the pace of demand registered about 1.8% year-over-year through mid-2015.[46]

Effective market rents, on average, have increased 5% in the past year and are up 18% from trough levels to within 6% of the last peak. However, individual markets and segments have been more volatile and many have outperformed the U.S. average. Markets in southern California experienced rent declines upwards of 30% and are nearly fully recovered to prior peaks. In Chicago, Dallas and Atlanta, market averages indicate that rents are back to past peaks while modern space is leasing at rates 10% or more above 2007 levels.[47] Higher land and building costs are likely driving required rents for new construction higher than in the last cycle, even though cap rates for stabilized properties are similar to 2007 levels.[48]

Investment performance has been excellent on an absolute and relative basis. The industrial sub-index of the NPI posted total returns of 14.8% in the past year and 12.7% (annualized) over the past three years through the second quarter of 2015. The sector has outperformed total NPI by 180 and 110 basis points, respectively, during these periods. Outperformance has been fueled by cap-rate compression and also NOI growth of nearly 4% (year-over-year) in the second quarter.[49] This is well aligned with broader market rent growth and occupancy gains. NOI growth is expected to remain robust over the next several years, which continues to attract investors into the sector (see Exhibit 7).[50]

[46] CBRE-EA and Deutsche Asset & Wealth Management. Data as of June 2015.
[47] CBRE-EA. Data as of June 2015.
[48] NCREIF and Deutsche Asset & Wealth Management. Data as of June 2015.
[49] NCREIF. Data as of June 2015.
[50] Past performance is not indicative of future returns. No assurance can be given that any forecast or target will be achieved.

Exhibit 7: Industrial Market Forecasts - National Fundamentals
U.S. Supply/Demand & Availability



Sources: CBRE-EA and Deutsche Asset & Wealth Management. Data as of July 2015.
Past performance is not indicative of future returns.

Outlook

Our U.S. forecast calls for continued availability rate declines and above average rent growth, broadly distributed across markets, through 2017. We also expect that supply will begin to outpace new demand as the cycle matures in 2018. Employment and GDP growth, income and retail sales gains, and expanding industrial production and international trade should provide significant support for industrial space demand. There is also upside potential linked to the outsized growth prospects of e-commerce sales and the related rise of rapid warehouse-to-door fulfillment.

Favorable market fundamentals are aided by a speculative development pipeline that was interrupted during the recession and slow to ramp up during the recovery. The displacement of millions of construction workers is playing into the measured pace and relatively high cost of new development. Nationally, there were 19% fewer construction workers in 2014 compared to the peak in 2006 and ramping up the labor pool could be challenging given other industry opportunities and government regulation. Outsized development has materialized in only a few notable metros, such as in Riverside, Atlanta, Chicago, Dallas and Houston, but remains balanced in most markets. The ratio of deliveries to net absorption is expected to be just 64% in 2015.

Strategies for 2015

The implications for investment strategy are that many metros and industrial subtypes will experience owner-friendly fundamentals over the next several years. We note the following opportunities and areas of concern:

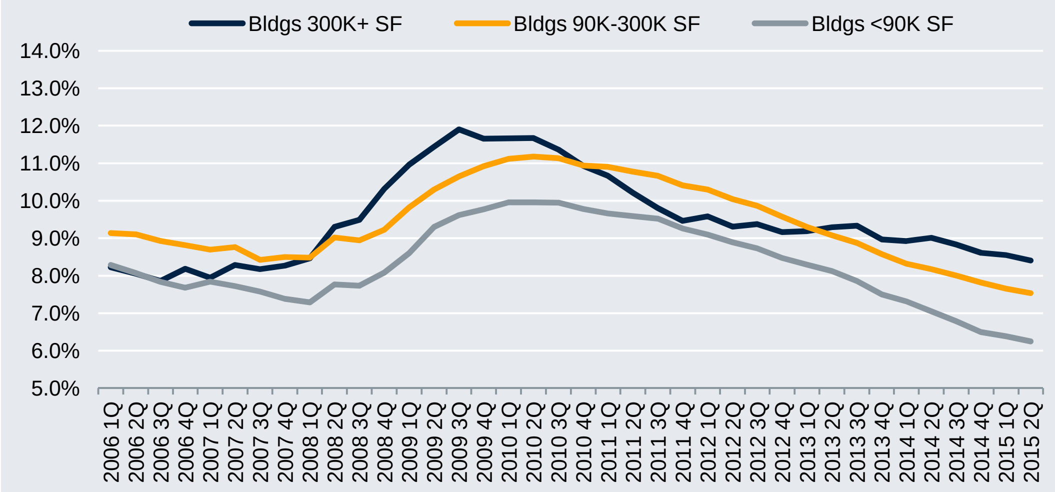
- **National Distribution Hubs:** The major national distribution hubs, many of which have strong linkages to international trade (e.g., Atlanta, Riverside, Los Angeles, Dallas, Chicago, New York, and Northern New Jersey) remain investment targets. While pricing is competitive and these markets are receiving a disproportionate share of new supply, they are expected to continue to post strong demand growth.

- **Thriving Local Markets:** Several local and regional markets, some of which also host international ports and are somewhat supply-constrained, also offer attractive opportunities, particularly for smaller and mid-bay warehouses. Examples include Portland, Denver, San Francisco, San Jose, Oakland, Orange County, and Miami. Conversely, we would generally avoid markets where local demand drivers are impaired, including Baltimore, Washington D.C., and Houston.

- **Class A Bulk Warehouse:** Prices for large stabilized class A bulk warehouse properties have increased markedly in recent years, in some cases surpassing replacement cost.[51] These assets can provide stable cash flow, but are generally underwritten to lower total returns. However, taking leasing or development risk in this segment over the near term should provide solid returns given the deep demand dynamics, healthy vacancy declines, and strong rent growth occurring in this segment (see Exhibit 8).

  We maintain an underweight to higher finish industrial property segments, including light industrial/flex, office/service, manufacturing and smaller business parks. Although conditions have improved, exhibited by a rising share of demand in the past year, over the longer term, they are tied to weaker segments of the economy and tend to be more expensive to lease and maintain than warehouses. We are highly selective in targeting R&D/Office in only a few high barrier markets that have good growth dynamics and/or tech drivers, such as San Jose, Oakland, San Diego, Orange County and Miami.

Exhibit 8: Market Trends by Building Size
Midsized and Small-Bay Buildings Showing Strength



Sources: CoStar and Deutsche Asset & Wealth Management. As of July 2015.

[51] Deutsche Asset & Wealth Management. Data as of July 2015.

Office Outlook and Strategy

Current Conditions

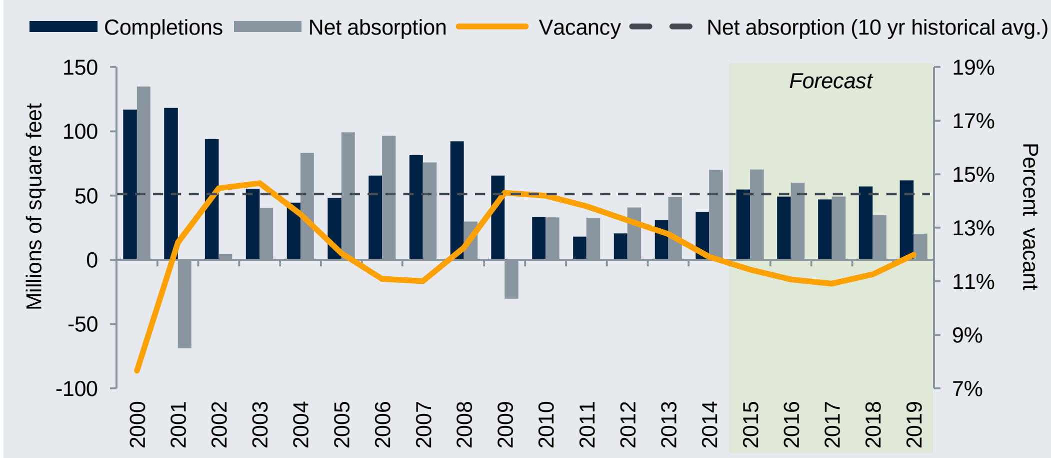
Although its total returns have been strong on an absolute basis, the office sector has underperformed on a relative basis since the financial crisis, having struggled to shake off an overhang of surplus space.[52] However, the sector gained considerable momentum in 2014, a trend that is expected to continue.

At the mid-year mark, vacancy improved 100 basis points from one year ago, and year-to-date absorption was nearly 30 million square feet (MSF).[53] This represents the highest level of mid-year absorption since 2007. Just as Central Business District (CBD) office markets led through the early stages of recovery, they are likewise leading the expansionary phase. In fact, all but one CBD are considered in a rising to peaking segment of the cycle. As occupancy continues to increase, rent growth has followed with effective rates growing 7.2% year-over-year through the second quarter of 2015.[54] Some gateway metros are so far entrenched in the growth phase, however, that it is becoming increasingly challenging to transact, both in the capital and leasing markets. These markets are viewed favorably among investors and tenants, are attracting an influx of global capital, and are increasingly seeing speculative development. CBDs ahead of the curve include Manhattan, San Francisco, Boston and Los Angeles. Manhattan, Chicago, Seattle and Houston have the highest numbers of speculative projects underway, which could challenge occupancy levels later in our forecast period.

Suburban market performance remains mixed, but notably accounted for 63% of the absorption recorded through second quarter.[55] Suburban markets with urbanized cores proximate to major gateway metros are at the leading edge of expansion. These include suburbs of San Francisco, Los Angeles, Dallas, Boston and Seattle. Although vacancy contraction has been more muted than in the CBD markets, through the second quarter 2015, effective rents showed a 4% increase year-over-year, and are at their highest level in six years.[56]

[52] NCREIF. Data as of July 2015.
[53] CBRE-EA multi-tenant. Data as of July 2015.
[54] CBRE-EA multi-tenant. Data as of July 2015.
[55] CBRE-EA multi-tenant. Data as of July 2015.
[56] CBRE-EA multi-tenant. Data as of July 2015.

Exhibit 9: Office Market Forecasts - National Fundamentals
U.S. Supply/Demand & Availability

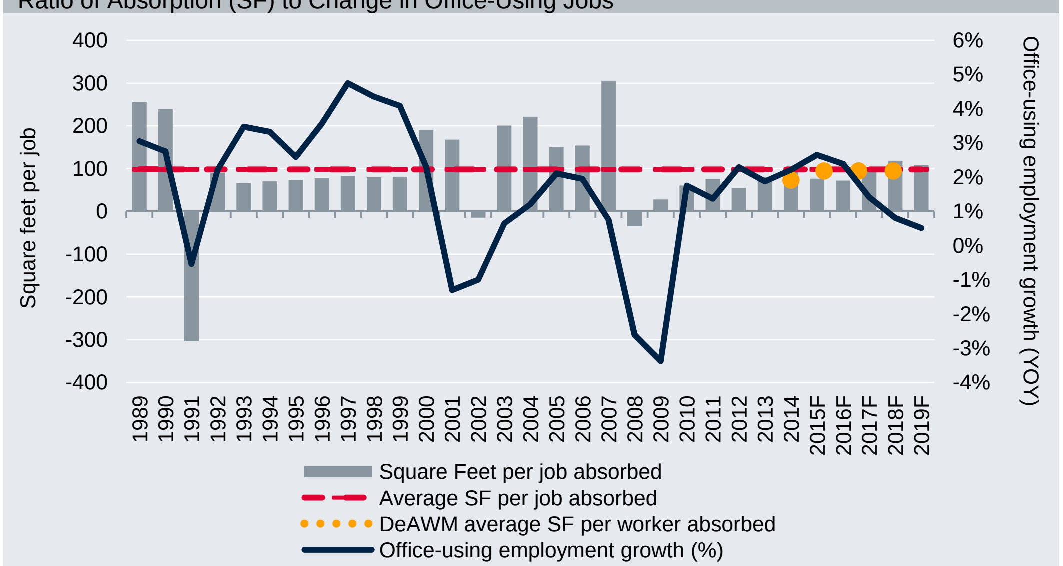


Sources: CBRE-EA and Deutsche Asset & Wealth Management. Data as of July 2015.
Past performance is not indicative of future returns. No assurance can be given that any forecast or target will be achieved. There is no guarantee the forecast will materialize..

Outlook

We believe that several factors will support a strong performance for the office sector over the next five years. Persistent employment growth coupled with low levels of construction, will continue to drive occupancy and rental gains (see Exhibit 9). The impact on NOI growth will be amplified as leases signed during the recession roll up to higher market rates. Furthermore, we believe that the drag on office absorption from rising occupational density has reached a tipping point. While open office concepts continue to proliferate, densification efforts appear to have peaked as more non-tech companies have joined the expansion (see Exhibit 10).

Exhibit 10: Office Density Trends
Ratio of Absorption (SF) to Change in Office-Using Jobs



Sources: DeAWM (forecast), CBRE-EA (absorption) & Moody's Economy.com (job growth). As of July 2015.
There is no guarantee that the forecasts will materialize.

Our forecast calls for vacancy to contract further to approximately 11.4% at the close of 2015, eventually bottoming at 10.9% in 2017, when construction is expected to accelerate. Our baseline ends the forecast period just slightly higher than the 20-year long term average of 11.9%. While our net absorption forecast is considerably weaker than that of the last expansion, it is expected to last longer. Moreover, absorption during the forecast should only slightly underperform the 10-year average. On the heels of 4% effective rent growth in 2014[57], rents are expected to expand by 3.8% and NOIs by 4.2% annually through 2019, peaking mid-forecast.

Strategies for 2015

From a geographic perspective, we believe that core gateway markets — those with scale, economic vitality and diversity, demographic strength (including an appeal to young knowledge workers), and structural impediments to oversupply — generally provide a foundation for long-term investment performance. At the same time, there are secondary markets that may not possess all of these attributes — structural supply barriers in particular — but where pricing and fundamentals may justify shorter-term tactical investments.

- **Coastal Markets:** Los Angeles, San Francisco, Boston and New York exhibit strong fundamentals. We believe that core allocations to these markets are integral to a well-balanced portfolio and will outperform over the long run. However, these markets are not inexpensive. Current conditions are amenable to development and value-add strategies, as well as Class A acquisitions in vibrant, "urbanized" submarkets with transit access to the CBD. We remain underweight in Washington D.C. due to supply and valuation concerns.

- **Regional Markets:** Smaller markets with extraordinary demographic and economic trends — those with favorable business and living conditions as well as industry exposures — promise vigorous demand growth. The challenge in these markets has traditionally been a propensity to oversupply, yet there are several where supply risks appear contained. Well-timed, tactical acquisitions in these markets could make sense for a shorter hold period. Examples include Austin, Portland, Denver, Phoenix, and Atlanta. In these markets we would target stabilized acquisitions in prime locations that provide some insulation from longer-term supply pressures.

- **Areas to Avoid:** The corollary to these strategic targets is that we would generally avoid:
  1. Secondary markets with anemic economies, including several in the rust belt.
  2. Markets with outsized energy exposure (e.g., Houston), pending further visibility into the impact of lower prices on local economies.
  3. Suburban locations without ample transit connections, which we believe could suffer chronic demand shortages notwithstanding a recent, modest recovery of fundamentals.
  4. Class B or value-add investments in lagging submarkets, whether urban or suburban.

[57] CBRE-EA multi-tenant. Data as of July 2015.

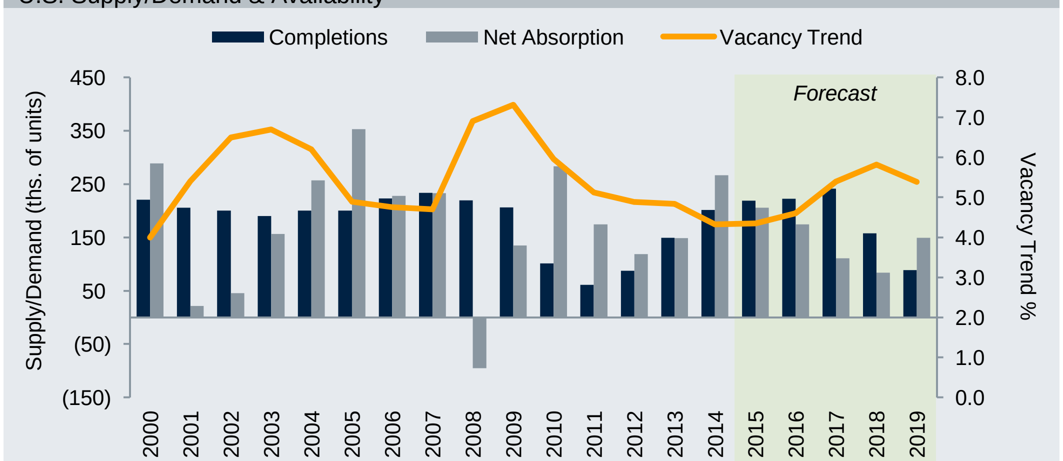
Apartment Outlook and Strategy

Current Conditions

Favorable demographic and lifestyle trends continue to support apartment demand, extending the sector's strong rent growth. June 2015's national annual effective rent growth rate of 5.1% year-over-year represented a 47-month high, and continued a streak of 5%-plus rent growth for five straight months.[58] The apartment sector continues to benefit from the proliferation of Millennials, who are delaying home buying either as a lifestyle choice or because they are saddled with student loans and cannot obtain a mortgage. The U.S. homeownership rate declined to 63.4% in the second quarter of 2015, compared with 64.7% in the second quarter of 2014.[59] Other macro factors like employment growth and new-household formation are also contributing to apartment demand. The U.S. apartment vacancy rate fell to 4.4% in the first quarter 2015, the sector's lowest vacancy in 15 years.[60]

Long coveted by real estate investors since the first years of recovery, apartment prices are at record highs. Apartment prices are up 10% on the year and are now 21% ahead of the peak prices seen in 2007.[61] Average cap rates for Deutsche AWM's investable apartment markets fell 40 basis points from a year earlier to hit 4.9% at mid-year 2015. Cap rates for mid/high-rise assets have been trending down since 2013, while garden apartment cap rates have been somewhat flat.[62]

Exhibit 11: Apartment Market Forecasts - National Fundamentals
U.S. Supply/Demand & Availability



Sources: CBRE-EA and Deutsche Asset & Wealth Management. Data as of July 2015.
There is no guarantee the forecast will materialize.

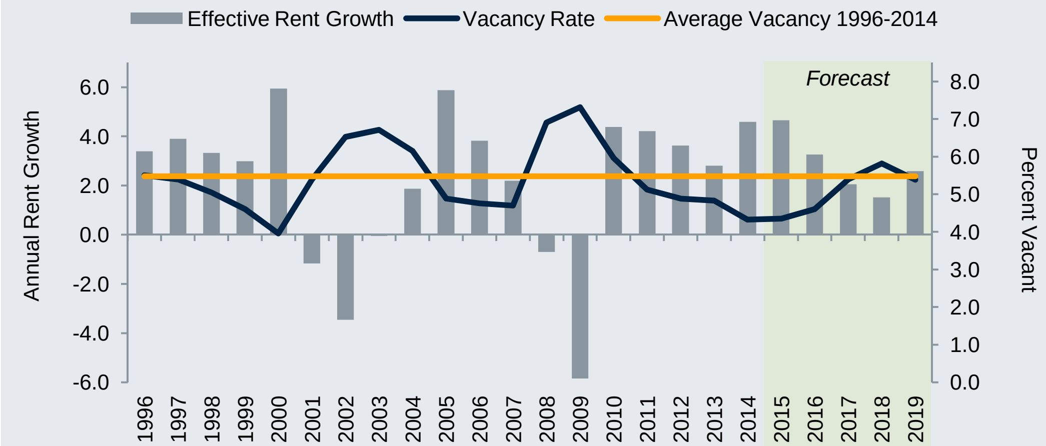
Outlook

Though the overall U.S. apartment market is tight, the sector is shifting towards a more mature phase of the real-estate cycle. The sustained strength in apartment fundamentals is

[58] Axiometrics. Data as of June 2015.
[59] U.S. Deparment of Commerce. Data as of March 2015.
[60] CBRE-EA. Data as of March 2015.
[61] Moody's/RCA Commercial Property Price Index (CPPI). Data as of March 2015.
[62] RCA. Data as of March 2015.

now expected to prolong construction for several more years. The development pipeline remains robust as multifamily permitting has surpassed its 20-year historical average by 16%.[63] Given the current permitting activity, we expect annual completions will average 230,000 units through 2017, a delivery rate that will exceed the sector's long term average by 34%. While most of this new supply is projected to be absorbed over the near-term, renter demand is expected to struggle to keep up with completions by the middle of the forecast as job growth softens and Millennials move toward homeownership. As a result, market fundamentals are forecast to swing back into balance as vacancy rates rise and rent growth moderates (see Exhibit 11). With demand indicators still favorable, we expect several more years of strong rent growth; however, it will slow as vacancy rates edge higher mid-forecast.

Exhibit 12: U.S. Apartment Rent Growth vs. Vacancy



Sources: CBRE Econometric Advisors, Axiometrics and Deutsche Asset & Wealth Management.
Data as of July 2015.
There is no guarantee the forecast will materialize.

Strategies for 2015

The apartment sector remains one of the best ways to participate in the demographic trends and behavioral changes occurring in the United States. However, with many of the prime markets fully valued, investors need to be more patient and selective when acquiring new apartment assets at the current time. While the prime markets should be viewed as strong long-term performers, there are a handful of large secondary markets that could offer investors outsized returns on a more tactical basis.

- **Coastal Markets:** While prime core apartment assets are priced above replacement cost at very low yields, various strategies that can be deployed to achieve strong performance. Though higher on the risk scale, a selective development strategy offers investors a viable alternative to buying existing properties at aggressive pricing. Capitalization rates are in the 3.75% to 4.5% range for existing prime core assets, while the untrended return on cost for new construction located in the same markets are in the 5.25% to 6.0% range. Not only is an investor buying a prime core asset at cost, but she also obtains an apartment community that has been designed to appeal to today's young renter. While downtowns and city centers have been the primary locations for development,

[63] Census Bureau. Data as of May 2015.

development in inner-ring suburbs with walkable locations and access to transportation should also be considered.

- **Regional Markets:** Strong market fundamentals along with positive economic and demographic trends have created the opportunity to tactically pursue select regional markets. We estimate that cap rates for core assets in the large Sunbelt markets are currently 75 to 125 basis points above those in prime coastal markets.[64] While higher initial yields have always been available in regional markets, fundamentals also appear favorable: many Sunbelt markets that were battered from the housing bust now have strong economic and demographic tail winds boosting demand. While supply and liquidity risks must be closely monitored, there are multiple Sunbelt markets where job growth is significantly outpacing new supply.

- **Class B Properties, Class A Locations:** With rents in new apartment communities commanding a far bigger premium over older communities than during previous construction cycles, a targeted value-add strategy offers investors attractive pricing with the potential for strong revenue growth. Repositioning class B properties in class A locations gives investors access to prime markets where class A properties are already fully valued. Also, this strategy recognizes that the current construction cycle has been heavily skewed towards the luxury segment (82% of the apartment units completed from 2012 to 2014 were in the luxury category).[65] We believe that new-household formation will help create a growing segment of renters who will want to live in prime locations, but cannot afford luxury rents.

Retail Outlook and Strategy

Current Conditions

Retail property fundamentals are strengthening as the sector continues to adjust to structural changes. Though retailer demand has been comparatively measured coming out of the recession, current indicators are pointing to 2015 as a transition year for the retail sector as it moves closer to a sustainable expansion. At the end of the first quarter 2015, the vacancy rate for neighborhood and community shopping centers stood at 11.5%, down 180 basis points from its peak.[66] New shopping center development remains at historic lows and is setting the stage for increased occupancy and robust rent growth. Rents began to rise modestly in 2014 and into 2015.

Key indicators for consumer demand were mixed in the first half of 2015. Despite support from lower gas prices, rising confidence, and improving wage growth, retail sales disappointed. Overall, these trends highlight changes in consumer behaviors, spending patterns, and attitudes that emerged as a result of the recession. Consumers are changing their shopping patterns, seeking value, experiences, and convenience versus excessive discretionary spending.

[64] Deutsche Asset & Wealth Management.
[65] CoStar. Data as of March 2015.
[66] CBRE-EA. Data as of March 2015.

Recent announcements of store closures in early 2015 were mainly in the department, apparel and electronics sectors (see Exhibit 13). Retailers such as JC Penney, Macy's, Sears, The Gap, and American Apparel will be shuttering underperforming stores to cut costs and realign store fleets. Additionally, bankruptcies such as RadioShack and mergers/acquisitions in the dollar store and office supply sectors during the first half of the year are overshadowing store openings. There are several segments that are planning store growth such as fast/casual dining, health and wellness, discounters, off-price, and entertainment.

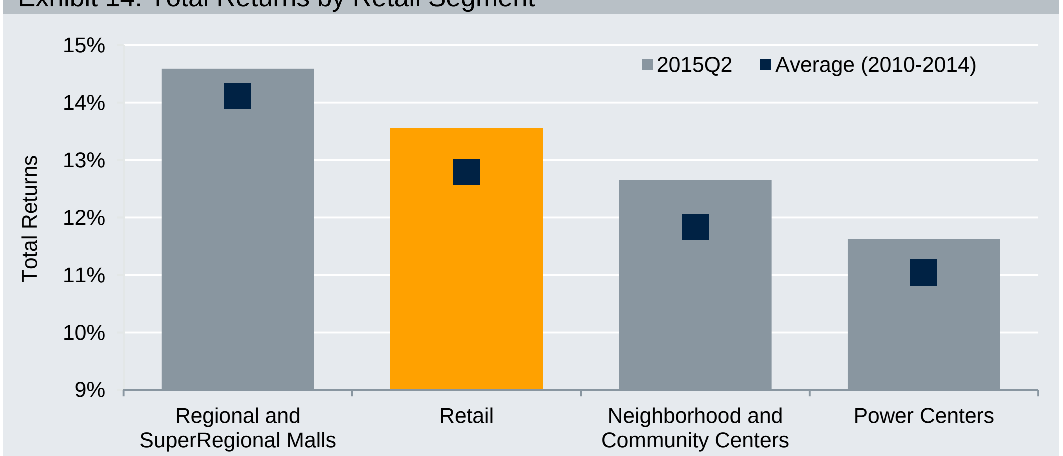
Exhibit 13: Planned 2015 Store Openings and Closings

Store Openings			Store Closings		
Retailer	Sector	# of Store Openings	Retailer	Sector	# of Store Closures
Dollar General	Discount/Dollar Store	730	Radio Shack	Electronics	1,784
Dunkin Donuts	Restaurants	410	Office Depot/Office Max	Office Supply	400
H&M	Apparel	400	Dollar Tree/Family Dollar	Dollar Store	340
Dollar Tree	Discount/Dollar Store	375	Wet Seal	Women's Apparel	338
Tim Horton's	Restaurants	300	Staples	Office Supply	225
O'Reilly Automotive	Automotive	205	Barnes & Noble	Books	223
V.F. Corp.	Apparel	150	Children's Place	Children's Apparel	200
GNC Holdings	Health, Fitness, Nutrition	125	Walgreens	Drug Store	200
Dick's Sporting Goods	Sporting Goods	105	Gap Inc.	Apparel	175
Hobby Lobby	Crafts, Hobbies, Toys	101	Chico's	Apparel	120
Men's Wearhouse	Apparel	100	Pier One	Home Decor	100
Carter's	Apparel	65	Sears	Department Store	77
Vitamin Shoppe	Health, Fitness, Nutrition	50	Fresh & Easy	Grocery Store	50
OshKosh	Apparel	45	JCPenney	Department Store	40
Whole Foods Market	Grocery	38	Macy's	Department Store	14

Sources: ICSC/PNC Bank, CoStar, Company reports and filings, Deutsche Asset & Wealth Management. Data as of July 2015.

The retail sector continued to outperform the NPI during the first quarter of 2015, mainly driven by returns in the mall segment. Regional and super regional malls fared exceptionally well, followed by neighborhood and community centers. Power centers have lagged well behind (see Exhibit 14).

Exhibit 14: Total Returns by Retail Segment



Source: NCREIF. Data as of June 2015.
Past performance is not indicative of future results.

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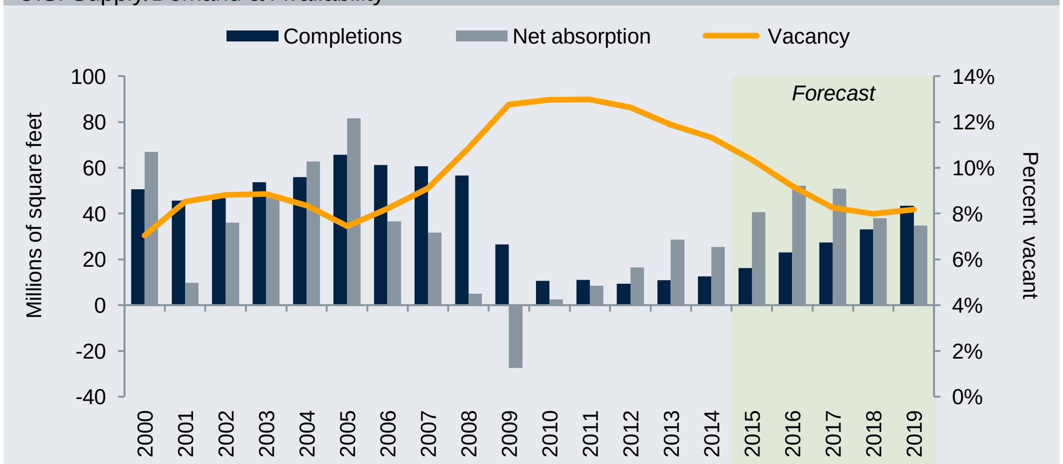
Outlook

We remain optimistic that consumers will re-emerge in the second half of the year as the housing market continues to firm up, workers become more confident, income growth picks up, and lower gas prices filter into the data. Meanwhile, subdued construction will help to support healing property markets. Over the forecast new supply is expected to remain well below the historical average, with the bulk of deliveries beginning in 2016. As a result of improving demand and limited new construction, vacancy is forecast to fall under 10% in 2016 and remain below the historical average of 9.8% through 2019 (see Exhibit 15).

Exhibit 15: Retail Market Forecasts - National Fundamentals
U.S. Supply/Demand & Availability



Note: Neighborhood and community centers only.
Sources: CBRE-EA and Deutsche Asset & Wealth Management. Data as of June 2015.
There is no guarantee the forecast will materialize.

Rising occupancy should result in accelerating rent growth. Still, we do not expect NOI growth to be as strong as in the office and industrial sectors, owing in part to the sector's extended lease terms. Although retail leases often have fixed contractual or inflationary rent increases, longer leases limit the potential for upside gains.

Strategies for 2015

E-commerce, changing consumer preferences, and urbanization are causing dramatic shifts in the retail market. Retailers are calibrating omnichannel strategies to seek an optimal mix of physical and online access points. While these changes have been coming for some time, the impact on property-market fundamentals is more visible today in the context of moderate retail sales than it was during the consumer-spending boom of the last decade.

Improvements are spreading across retail subtypes but at variable rates. Despite challenges from store closures by anchors like Macy's, JC Penney and Sears, mall NOI growth has been solid. High-quality grocery anchored centers in gateway markets and top secondary markets have also recovered strongly. As the cycle continues, a larger proportion of second-tier shopping centers will likely see sales improve. However, we expect that there will be a glut of functionally obsolete centers that will remain vacant. Accordingly, our retail strategy remains highly selective. Key strategies for 2015 include:

- **Coastal Markets:** Our top market picks remain gateway and other affluent metros with growing and dynamic economies and vibrant high-street retail corridors, including New York, Los Angeles, Miami, and San Francisco. Although pricing has become competitive, these markets offer the best opportunities to capitalize on tourism and urbanization trends. Vibrant new-economy metros such as Austin, Denver, Seattle, and San Jose are also attractive. Although Texas, northern Florida, and other Sunbelt cities boast strong demographic trends, they may not see significant growth from dominant retailers in this cycle.

- **Malls, High-Street Retail, and Grocery-Anchored Centers:** We believe that grocery-anchored centers will generally sustain durable consumer traffic due to the necessity-based and service-oriented merchandising of these centers. Dominant regional malls with the ability to attract trendy new retailers and provide a variety of service and entertainment options are also expected to perform well. Finally, we believe that urbanization and, in some markets, tourism will continue to support high street retail. Conversely, we believe that power centers are vulnerable to e-commerce competition and large-store format downsizing.

- **Focus on High Quality:** In contrast to past cycles, when a rising tide of consumer spending lifted all boats, we believe that in today's more temperate retail environment brick-and-mortar spending will skew heavily toward high-quality centers, causing inferior assets to falter. We would acquire centers with solid sales per square foot; best-in-class tenants; strong physical attributes such as visibility, access, and layout; and healthy local density and demographics. In the right locations, it may be possible to transform underperforming assets into high-quality and successful ones through active management, including repositioning anchors and adding density.

Appendix 1: U.S. House Portfolio

The Deutsche Asset & Wealth Management House Portfolio presents the allocation by property sector for core portfolios in the United States which we believe would outperform the NPI. We develop the House Portfolio as an unlevered portfolio of properties for a U.S. investor without regard to tax consequences. The House Portfolio is formulated using both quantitative and qualitative modeling, integrated with our House View. The resulting weights, we believe, aid in providing long-term risk-adjusted outperformance to our portfolios versus the market as a whole and against relevant benchmarks and indices. The analysis focuses on the four major property sectors and excludes hotels. The following table summarizes our conclusions on weightings in comparison with the NPI. The analysis results in an active overweight to the industrial sector, a market weight to the office sector, and modest underweights to the retail and apartment sectors.

House Portfolio Construction – Sector Allocation

Sector	NPI Weights	Research Perspective	Quantitative Input Weights	Qualitative Inputs	House Portfolio[1]	Active Bet	House Portfolio Range
Apartment	24%	• Strong demographic support in prime renter age cohort. • Ecomomic recovery fueling household formation. • Strong performance leads to higher construction activity, limiting future gains in NOI.	Model suggests market weight	Well into growth cycle, supply risk growing	22%	(2%)	17% - 27%
Industrial	13%	• Going-in returns compressed but still relatively high total returns as rents and occupancy rise. • Benefits from expanding U.S. population and job gains as well as e-commerce, housing production, and trade. • Speculative construction is rising but demand should still outpace through 2015.	Model suggests overweight	Attractive relative valuation, poised to outperform	20%	+7%	15% - 25%
Office	38%	• Strong job growth will continue to increase office space demand, and broaden the expansion. • Rent growth gathering momentum as vacancy is now at the long term average and still contracting. • Rent recovery is spreading to more locations outside of tech, energy and gateway hubs.	Model suggests market weight	Into growth phase	37%	(1%)	32% - 42%
Retail	23%	• Long duration leases at risk if interest rates increase. • Rent growth concentrated in top performing centers, slow to move beyond the top tier. • Bifurcation results in strong winners while e-commerce will squeeze weak retail centers further.	Model suggests underweight	Limited upside in growth cycle, albeit stable returns	21%	(2%)	17% - 27%
Hotel	1%	N/A	Underweight	N/A	0%	(2%)	0%

Note: Figures do not sum due to rounding.

[1] House Portfolio is the target allocation that incorporates both qualitative and quantitative views in addition to tactical and strategic considerations.

Source: NCREIF and Deutsche Asset & Wealth Management. As of July 2015.

Appendix 2: Real Estate Target Markets

Investible Metros: We screened top U.S. metros, which represent 86% of the NCREIF Property Index (NPI), and identified the investment markets for each property sector that we believe have the best prospects for superior performance during the market cycle or a portion of it. This metro selection is based on property market size, liquidity, growth characteristics, income, historical returns and other factors indicative of future performance. The list of these metros remains generally static, although some metros may be added or subtracted over time due to structural market changes.

Target Investible Metros: These are a subset of the universe of investible metros and include markets expected to outperform or market perform during the next three to five years.

Investible and Target Markets

✓ Target Investible Metros • Investible Metros

Market	Apartments	Industrial	Office	Retail
Atlanta	✓	✓	✓	•
Austin	•	•	✓	✓
Baltimore	•	•		
Boston	✓		✓	•
Charlotte	•		•	✓
Chicago	•	✓	•	•
Dallas	•	✓	✓	✓
Denver	✓	✓	✓	✓
Fort Lauderdale	✓	✓	✓	✓
Houston	•	•	•	•
Long Island				✓
Los Angeles	✓	✓	✓	✓
Miami	✓	✓	✓	✓
Minneapolis	✓	•		✓
New York	✓	✓	✓	✓
Northern New Jersey		•		•
Oakland / East Bay	✓	✓	✓	✓
Orange County	✓	✓	✓	✓
Philadelphia	•			•
Phoenix	✓	•	✓	
Portland	✓	✓	✓	✓
Riverside	✓	✓		
San Diego	✓	✓	•	✓
San Francisco	✓	✓	✓	✓
San Jose	✓	✓	✓	✓
Seattle	✓	•	✓	✓
Washington DC	•	•	•	•
West Palm Beach	✓			•
Total	**26**	**23**	**21**	**25**

Note: Newark removed as an investable market for Apartments. Due to the reconfiguration of MSAs, NNJ solely includes Newark. Edison is now included in the NY MSA.

Source: Deutsche Asset & Wealth Management. Data as of July 2015.

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