Chilton
Capital
Management

1177 West Loop South, Suite 1310
Houston, Texas 77027

TELEPHONE: 713 650 1995
FACSIMILE: 713 650 1739
TOLL FREE: 800 919 1995

For further information,
direct inquiries to Christopher L. Knapp,
Chief Executive Officer

info@chiltoncapital.com
www.chiltoncapital.com

US is the Best, or at Least Better than the Rest | January 2015

It is difficult, if not impossible, to perfectly predict the future, and 2014 was yet another year that defied most experts' predictions for US economic growth and the trajectory of the 10 year US Treasury yield. However, the coming year presents a constructive picture of slow improvement domestically, which is favorable when compared to the rest of the world.

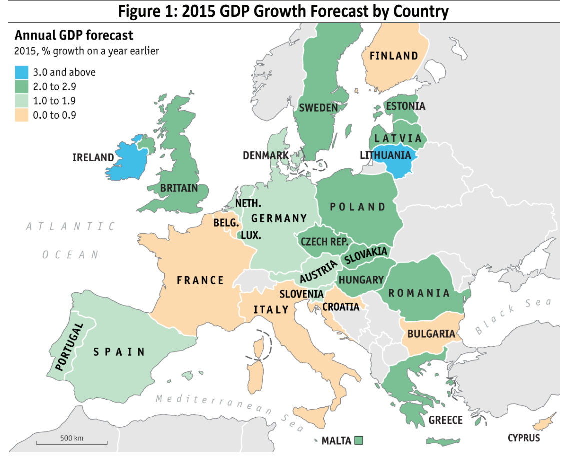
Looking across the oceans, other countries (and even continents) are still struggling to attain growth in the range that the US is experiencing, and we expect the trend to continue in 2015. For differing reasons, we see the US as the superior place for both international and US-based investors, particularly from a risk-adjusted point of view. We believe US equity REITs are poised to be major beneficiaries of these economic trends in 2015 and beyond.

United by Currency, not by Growth

The endless stream of bad news and economic false starts has been fairly accurate in illustrating the economic struggles of Continental Europe. Expectations for GDP growth have consistently declined throughout 2014, and the European Central Bank (ECB) recently reduced its growth expectation for 2015 to 1.1% from 1.7%. Inflation, a critical economic metric, is projected to be less than 1% in 2015.

With each change in growth and inflation expectations, the ECB must reassess its monetary policies. By charter, the ECB is tasked with conducting policy for the benefit of its member states. However, as the President of the ECB Mario Draghi is finding out, it may be impossible to please everyone as each country has its own economic idiosyncrasies despite sharing the same currency. Figure 1 shows the differing growth trajectories within Europe going into 2015; though none are projected to be in a recession, growth of less than 1% for some of the biggest economies will draw the attention of the ECB.

Figure 1: 2015 GDP Growth Forecast by Country



Source: European Commission, The Economist. As of 11/14/2014.

As many European economies struggled to be competitive in a post-2009 environment, compensation and prices have come under pressure. In 2014, compensation increased close to 1%, which is not terrible, but not enough to quell disinflation fears. Part of the difficulty for the ECB is the task of alleviating the fear that these pressures will result in disinflation, or even deflation. As a result, while the US is beginning to step back from its aggressive monetary policy, the ECB is becoming increasingly aggressive in its policy stance.

The combination of a muted outlook for growth in European GDP, compensation, and employment with a tightening tone from the US Federal Reserve, the Euro has weakened significantly against the US Dollar in the past 6 months. If the ECB goes forward with further easing, Draghi would be helping the net exporting countries by weakening the currency further, as European goods would be cheaper to US buyers. If Europe's version of quantitative easing (QE) works, growth on the Continent could surprise to the upside. However, this seems highly unlikely with the deeply embedded structural issues of debt overhang, population stagnation, and rigid labor markets.

Germany's positive current account balance (exports minus imports) has helped to buoy the Euro for a long time, but even the most resilient country in the EU is slowing. As such, we see the Euro declining further against the US dollar, especially in light of the US Federal Reserve slowly lifting stimulus.

Japanese Treadmill

Over the past two decades, Japan has been stagnant. Recently, Prime Minister Shinzo Abe has instituted 'Abenomics', a series of measures to reignite the Japanese economy. Thus far, the attempts have led to a depreciation of the Yen, but have yet to produce many tangible effects for the island's economy. The unemployment rate sits in the 3-4% range due to a cultural reluctance to layoff employees. Instead of outright firing, employers cut working hours when they are hesitant about the future or need to cut expenses. As a result, a better way to take the temperature of Japan's economy is the change in overtime hours. Thus far, overtime hours have not increased significantly, signaling the lack of certainty businesses have about their economic future. How businesses feel about current and future conditions has a direct effect on inflation expectations. Similar to the ECB, one of the principal goals of Abenomics is to increase inflation expectations in an effort to spur spending and investment.

Over the past 20 years, inflation has been non-existent in Japan as the price level has moved about 2% *cumulatively* according to OECD data. In fact, Japan's inflation only turned positive due to a tax hike in early 2014. Without the tax hike, the price level would've been lower than 20 years ago! In comparison, the US has averaged inflation of about 2% *annually* during the same period.

It is not a short path back to prosperity for Japan. Low inflation and a struggling economy mean interest rates should stay low despite a large fiscal overhang from government debt. Abe has delayed an additional tax hike after seeing how slow GDP grew in 3Q, but it is still on the table to be implemented in the next 1.5 years. Though we can't be totally sure about what the catalyst will be, we believe that Abenomics will inevitably continue to depreciate the value of the Yen, especially against a generally strong US dollar.

Waning Chinese Stimulus

Australia's economic prospects have become joined at the hip with China's growing demand in the past 20 years. This 'Chinese stimulus' is waning, as China's GDP growth has been decelerating from as high as 14% in 2007, down to 7% in the most recent quarter. Australia was more than happy to be along for the ride, sending over 35% of its exports to China as of May 2014. In fact, more than half of Australia's increase in exports since the start of the 21st century has been thanks to increased demand from China. Due to China's recent growth deceleration, commodity prices have plummeted. With four of the top five Australian exports being commodities in 2013, the country is struggling to find economic growth, thereby putting more pressure on the currency. Consequently, Australia's currency has experienced a rapid decline from $0.94 USD/AUD in early September to $0.81 USD/AUD as of Dec 17th.

We believe estimates for 2015 growth in China will continue to decline, and commodity-based economies like Australia will struggle in the face of falling demand. As an example of what can happen to a currency when a main export price falls, Russia's Ruble has declined more than 50% in the 3 months ending December 16 due to the fall in oil prices.

Figure 2: Central Bank Summary

Central Bank	Rate (%)	Policy Direction
Federal Reserve (US)	0.00-0.25	Less Accommodative
European Central Bank	0.05	More Accommodative
Bank of Japan	0.00-0.10	More Accommodative
Bank of China	6.00	More Accommodative
Reserve Bank of Australia	2.50	More Accommodative

Source: Futures Magazine, December 2014.

The Effects of FX

Foreign exchange rates (or FX) can have drastic effects on company earnings, investor returns, and fund flows. While a US-domiciled company earning 100% of its revenues in the US would be immune to changes in the US Dollar vs foreign currencies, a US company with foreign operations would experience a difference in revenue equal to the difference in exchange rates between the two countries over the year for that portion of the business. Similarly, a US investor with US-only holdings would be agnostic to changes in US foreign exchange rates, but a US investor with foreign holdings would be extremely susceptible to changes in FX.

As an example, Figure 3 shows the returns of investing in global real estate markets depending on the currency. In the most extreme scenario, a Japanese investor in the US REIT market gained 47% over the trailing 12 month

Figure 3: Trailing 12 Months Total Return as of 11/30/14 by Currency

	USD	AUD	JPY	EUR
FTSE NAREIT All Equity REITs	27%	36%	47%	39%
FTSE EPRA/NAREIT Developed Europe	12%	20%	30%	23%
FTSE EPRA/NAREIT Australia	12%	19%	29%	22%
FTSE EPRA/NAREIT Japan	-11%	-4%	4%	-2%

period ending November 30, 2014, but a US investor in the US REIT market gained only 27% over the same period despite owning the same companies. Currency effects created a 2,000 basis point (or 20%) tailwind for the Japanese investor in the US REIT market, but acted as a 1,500 basis point headwind for the US investor in the Japanese REIT market.

Given our views of a strengthening US Dollar against the currencies of most prominent international economies, we are cautious on investing abroad. However, the potential for the US Dollar to appreciate against foreign currencies should be appealing for non-US investors. In an affirmation of this view, many international investors including sovereign wealth funds and pensions are putting large sums of money to work in high quality US commercial real estate. More broadly speaking, this could be one of the reasons that the US 10 year Treasury yield continues to fall, as a higher US Dollar makes it more attractive to foreign investors.

"Currency effects created a 2,000 basis point (or 20%) tailwind for the Japanese investor in the US REIT market, but acted as a 1,500 basis point headwind for the US investor in the Japanese REIT market."

For companies investing abroad, revenue losses from currency movements can be offset by implicit hedging from expense savings or explicit hedging via derivatives. A sometimes-ignored benefit for US companies that operate abroad is the ability to take advantage of interest rate differences. For example, in October this year, Prologis (NYSE: PLD) raised 7 year debt in Euros with a coupon rate of 1.375%. In comparison, other PLD USD-denominated debt issues with similar maturities were trading at yields to maturity between 2.7% and 3.2%. Similarly, Simon Property Group (NYSE: SPG) issued EUR 700 million in Eurobonds in September 2013 with a coupon rate of 2.375%, which contrasts to a USD offering they did in January 2014 with a similar weighted average maturity, but a weighted average coupon of 2.975%. Today, the SPG and PLD Eurobonds are trading at yields to maturity of 0.879% and 1.138%, respectively. If they spend that money on activities in the same currency (which they have and will), they have essentially locked in a much lower borrowing cost than they would have if done domestically.

Very Average = Very Good

When compared to the countries and continents mentioned above, the US is in an economic 'sweet spot'. GDP growth will likely finish 2014 around 3%, and should continue in the mid-2% range in 2015 barring a shock to the system. Low oil prices pose a risk to the newfound oil economy in some geographic regions, but much of the decline in energy jobs and compensation should be offset by household savings from lower fuel prices, spurring consumer spending and job growth in other industries.

US inflation and interest rates are inextricably linked. Our view is that inflation will remain low, and the US dollar will remain strong. The Federal Reserve is likely to raise rates in mid-2015 with other important central banks either continuing their easing policies or expanding them. This should have the effect of maintaining the strength of the Dollar or even strengthening it further, thereby restraining inflation as the cost of foreign goods falls.

Chilton Capital 2015 REIT Projection

Using conservative assumptions for a rising 10 year US Treasury yield, higher implied cap rates, and consensus cash flow growth, we project total returns for US REITs will be in the +8% to +10% range. We believe interest rates in the US will have an upward bias as QE dissipates, albeit slowly. Most projections from industry experts assume the US 10 year Treasury yield finishes the year at 2.75%, which could result in total returns toward the low end of our projection. The relative strength of the US Dollar and the economic stability offered by a favorable geopolitical environment may drive fund flows to high quality US commercial real estate. We have already seen the resiliency of cap rates earlier this year due in part to strong demand from overseas investors and increased allocations to real estate (and public REITs) by pension funds. We see this trend continuing in 2015 and providing an anchor to cap rates even in the face of rising interest rates.

A rapid rise in rates without economic growth would be punitive to REIT investor returns, but would present a buying opportunity if private market cap rates remain flat. In such a scenario, public REITs could be the subject of public-to-public M&A or privatization by firms such as Blackstone (NYSE: BX), which has already publicly stated its desire to buy public REITs at a discount to NAV.

If the 10 year US Treasury yield remains below 2.75% through the year, US REITs could produce returns toward the high end of the range, or even exceed it. In a scenario where cash flow multiples, implied cap rates, and cash flow growth estimates stay near where they are today, REITs could produce returns in the +11% to +13% range.

Going into 2015, we have positioned the portfolio toward companies with high cash flow growth, low dividend payout ratios, flexible balance sheets, and value creation opportunities via development, redevelopment, or lease-up. We believe this combination of attributes will lead the portfolio to significantly outperform the index and peers if interest rates rise. We see very little risk to the long-term positive outlook, and will take advantage of short term mispricing that creates buying and selling opportunities along the way.

Matthew R. Werner, CFA
mwerner@chiltoncapital.com
(713) 243-3234

Samuel E. Rines
srines@chiltoncapital.com
(713) 243-3263

Bruce G. Garrison, CFA
bgarrison@chiltoncapital.com
(713) 243-3233

Blane T. Cheatham
bcheatham@chiltoncapital.com
(713) 243-3266

RMS: 1710 (12.31.2014) vs. 1312 (12.31.2013) vs. 346 (3.6.2009) and 1330 (2.7.2007)

Please feel free to forward this publication to interested parties and make introductions where appropriate.

Previous editions of the Chilton Capital REIT Outlook are available at www.chiltoncapital.com/reit-outlook.html.