

Economy Set for Soft Landing

by James R. DeLisle, PhD

Commentary

While the housing boom has finally played out and consumer exuberance has been reined in a bit as interest rates have crept up, the overall economic outlook is relatively positive. At the same time, concern over inflation and the prospects for a recession nag away at some observers. While the economy is indeed at something of a transition point and has some downside risk, it appears to be in for a soft landing. The residential market is in something of a tailspin, creating a cloud over the economy that is being extensively monitored. At the same time, fears over inflation have not gone away despite the Federal Reserve's (Fed) recent decision that it could pause in its stream of interest rate increases.

Despite the uncertainty and risks in the current environment, one constant that continues to hold is the appeal of commercial real estate as an asset class and the market's willingness to accept low current yields relative to historical averages. The recent improvement in market fundamentals has bolstered the situation, suggesting that plentiful capital flows to real estate will likely continue over the near-to-intermediate term, helping sustain record prices and low current yields. This will push the inevitable return to more normal activity levels and downward pressure on values well into the next year, with some prospects for a smooth transition toward more normal times.

The Economic Environment Economic Growth

The U.S. economy weathered the summer in an orderly fashion. While the high price of gasoline dampened the economy, moderate interest rates and the absence of any major external shocks helped

stabilize the economic environment. Unfortunately, the two sectors hurt the most by the rising fuel prices, the automotive and airline industries, were already vulnerable and took the hardest hits. The impact on the automotive industry was particularly understandable, given the industry's reliance on incentives and easy credit to help bolster the market and prolong the cycle. On the other hand, the airline industry was just getting back on track with rising demand helping fill seats; however, despite higher revenues, profit margins were eroded by the rising costs of jet fuel. The dampening effect of fuel prices was also experienced in the retail industry, especially at the lower end of the market where discretionary spending was most vulnerable to rising gasoline prices. The recent decline in energy prices has taken some pressure off of consumers, although it is unlikely consumers will reemerge as the major driver of economic expansion. This is especially true with the housing market correction, which is gaining more attention as rates rise and the wealth effect abates. On the other hand, business investment and expansion is expected to provide some relief, although the intermediate outlook remains tempered. In this environment, growth in gross domestic product (GDP) is expected to moderate in the latter part of the year, as the slowdown continues in a relatively orderly manner.

Employment

Entering the fall, the domestic employment picture can be characterized as steady state, with moderate job growth led by health care, education, and the broader services sector. Overall, the late summer employment scene is reminiscent of the prior year, reflecting moderate improvement in jobs and unem-

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ployment rates. Despite disappointing employment growth, labor costs have increased as companies pushed output levels by extending hours to compensate for a flattening in gains in productivity. This increase has been most pronounced in the business service sector where the shortage of educated, skilled, computer-literate workers continues to place upward pressure on wages.

At an overall level, prospects for job growth remain positive. Indeed, the recent softening of the job market may help take some of the pressure off interest rates, which could help the employment scene. With some exceptions, the manufacturing sector is expected to continue to expand, although at a lower rate than earlier in the summer. This job growth continues the long string of expansion that stems back over the past three years as the economy perked along.

However, mass layoffs catapulted to the forefront in the automotive industry in late summer. The good news is that, unlike the wave of layoffs earlier in the economic cycle, this last round seems to be industry specific and has its grounds in the excesses of the recent past in which the automotive industry relied on aggressive marketing campaigns and promotional sales featuring generous incentives and low financing to move product. Thus, while there are signs that the massive layoffs at Ford and General Motors portend more difficult times for the struggling automotive industry as a whole, they do not signal a wave of such activity across other sectors. Rather, the employment scene is likely to reflect that of the overall economy, positive but moderate growth associated with a soft landing for the economy.

Inflation and Interest Rates

After its unremitting string of interest rate increases, the Fed finally paused in August, an event that was generally expected as concern over the impact of rising rates on economic growth began to supplant some of the concern over inflation. In September, the Fed held off again, suggesting the cooling housing market and declining energy costs had taken some of the pressure off inflation. At the same time, the Fed made it clear that it was more than willing to resume increases to combat inflation, which continues to be its primary concern. While the housing market contraction was expected, the decline in energy prices was a welcome respite. Through late summer, energy prices were one of the key drivers of inflation,

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putting upward pressure on the consumer price index directly via inclusion in the index and indirectly via ripple effects on other components. Due to this lagged effect, when energy prices softened inflationary signals did not abate as they might have if the lag had not been so ingrained in core inflation, which is calculated by removing the volatile components of energy and food.

Additional inflationary pressure has emerged in the form of labor costs, which have risen as a result of a flattening of productivity growth and efforts to increase output as companies gear up to respond to rising demand associated with the broader economic expansion. At the same time, some of the unexpected increases in unit labor costs can be attributable to accounting for stock options and stock buyback programs, which came on the heels of strong performance last year and are not an indication of future earnings. This caveat is especially true in the housing and automotive industries that are experiencing a significant correction and are likely to underperform in terms of historical average over the forecast period. Thus, while wages are likely to increase in some industries, inflationary pressure should moderate with strong corporate balance sheets absorbing some of the pressure. Over the near term, interest rates are expected to rise moderately as the Fed seeks to maintain control over inflation, which it still sees as its primary mandate.

The prolonged pattern of inversion of the yield curve with long rates below short rates troubles a number of observers given the historical track records of recessions following inversions. While fears of a recession are not totally unfounded and nag away at some, the general consensus is that the economy will avoid a recession and settle in for a soft landing as it cools off and growth moderates over the balance of the year. However, there are some nagging concerns, many of which can be attributed to the housing market. Clearly, the dramatic and unsustainable run-up in the bull housing market has

come to an abrupt stop. The extent of the correction and its impact on the broader economy remains one of the wildcards with little historical precedent as to how it may play out. Regardless of how the bulk of the housing market makes the adjustment, there will be some fallout as marginal buyers get squeezed as payments increase and budgets are thinned. This will call attention to the risk side of the equation and may place upward pressure on mortgage rates, which are expected to continue to gradually return to long-term averages.

Business Indicators

Business indicators remain mixed to positive, with concern over some of the ripple effects of the declining sectors such as housing and automotive being offset by the prospects for moderate growth for the broader economy. The broader economy may be stimulated further by declining oil prices. Despite gains in labor costs, companies have been able to maintain profits due to the combination of strong balance sheets and cost containment. Capacity utilization has been relatively stable but is slightly above figures for the prior year and long-term averages. The biggest gains have been in manufacturing, especially in companies in the finished and semi-finished stages of production. At the same time, companies have increased investment in plant and equipment, suggesting the expansion has been moderate and in keeping with overall economic conditions and market demand.

The decline from longer-term averages in the ratio reflects the combination of increased sales gains that outpaced the inventory gains indicating a slight but healthy lag in adjustments to economic growth. Among sectors, retailers had the highest inventory/sales ratios compared to manufacturers and merchant wholesalers. Despite higher levels, retail inventories are within acceptable ranges and should benefit from the decline in gasoline prices that may bring consumers back to the cash registers earlier than usual, particularly leading up to the important holiday season.

In early fall, business confidence levels declined, dragged down by concerns over spillover effects of the housing contraction and turmoil in automotive industries. In addition to these obvious trouble spots, confidence levels have also been eroded a bit in the broader real estate and construction sectors. Despite some concern, these declines have been gradual and

are in-line with expectations for slower economic growth in the second half of the year rather than a recession.

There are some signs that price pressures have abated, with fewer companies reportedly raising prices than earlier in the year. Furthermore, lower energy prices have yet to be factored into the equation. Despite these concerns and some recent softening, companies have not backed off on proposed investments and hiring, and business investment levels are expected to remain positive, although somewhat guarded.

Stock Market

Since 9/11, the stock market has weathered a number of storms and has emerged with a stronger sensitivity to the global and geopolitical context within which it operates. While investors remain appropriately guarded and pay close attention to external risks, they have also exhibited their resilience and belief in the market. At the same time, investors remain risk conscious and pay close attention to market fundamentals. The absence of a major national disaster on the heels of last year's tragedies has provided a welcome respite from the seasonal crises that have a penchant for hitting in September, a bellwether month for the stock market. More recently, the stock market has benefited from the combination of strong balance sheets, continued economic expansion, and strong capital flows.

Stock market volatility has moved from the low levels seen the past two years back in-line with the long-term average, yet the outlook seems tempered, as GDP and corporate profits appear solid. Inflation worries are being assuaged by falling oil prices and the Federal Reserve's decision to hold interest rates steady. Also boding well is that since early September, stocks have risen sharply, and the S&P 500 and Dow Jones Industrial Average had their biggest September advance in eight years. Thus, going into the fourth quarter, the market was flirting with record highs.

Despite these upbeat prospects, the market is clouded by a nagging concern about the further slowing of the housing market, which could impede economic growth and scratch corporate profits. Up to this point in the cycle, investors seem to be focusing on improved consumer confidence figures rather than the weakening housing market, but these gains are moderating and as such, bear close monitoring.

Going forward, the stock market is likely to continue to flutter, with good news resulting in brief rallies as investors focus on the prospects for sustained growth and economic expansion, albeit at lower rates than earlier in the cycle. While the recent surge was attributable in part to improvement in consumer confidence, the market is properly focused on business prospects as the key to the recovery, with consumers following along rather than leading as in the past. This situation is likely to prevail until the housing market begins to settle down and the longer-term implications for retail and other consumer-oriented sectors become clearer.

Consumer Confidence

The somewhat relentless rise in energy prices during the summer, coupled with the prospects for higher inflation, caused erosion in consumer confidence going into the important back-to-school shopping season. Indeed, in early August, consumer confidence levels plummeted to their lowest ratings since the post-Katrina period. Going into the fall, the decline in gasoline prices took some of the edge off consumers and the pause by the Fed helped assuage consumers a bit. The uneventful passage of the fifth anniversary of 9/11 also helped consumer attitudes. However, little rebound is expected with geopolitical unrest unabated, the endless debates over the war in Iraq continuing, and the potential for more rhetoric and criticism associated with the upcoming elections. The cooling off of the housing market and high-profile layoffs in the automotive industry has also taken some steam out of consumers, although the full impact of a decelerating housing market has yet to sink in. Since these factors are likely to drag on, consumer confidence levels are expected to vacillate, with no major turn in either direction in the absence of some unexpected event.

Retail Sales

Over the past several years, consumers have played a major role in economic growth. To a great extent, this leadership capacity has been supplemented by the ability to tap into increases in home equity and convert paper gains to disposable income. The cooling off of the housing market, flattening values, and rising mortgage rates have caused a sharp curtailment in the ability to tap into housing wealth. While this catalyst will be lost, retail sales are expected to continue their recent pattern of stable, but un-

spectacular gains. Consumer confidence levels are expected to remain tempered in the face of economic and political uncertainty, placing something of a governor on sales activity. While the upper end of the market has been able to withstand such pressures and has done fairly well in terms of sales volumes, there are some signs that upper end consumer confidence levels are moderating along with the housing market. At the lower end of the market, the decline in gasoline prices has helped somewhat, although other budget pressures are expected to continue to temper sales.

In terms of holiday sales, the lack of a real blockbuster product going into the holiday season has taken some of the excitement out of the equation, setting the stage for a modest season. On the electronics front, a number of delays and market confusion have eroded potential sales. For example, the prospects of a delay in the Sony PS3 may have a much broader impact on game sales that are typically strong during the holiday season. In particular, parents are likely to remember the angst created last year by the pronounced and prolonged shortage of X-Box 360s and are likely to turn to other products or gift cards. Similarly, the lack of any clear direction in the format wars for the video industry is likely to create a drag on consumer electronics. This will moderate sales, even as high definition television prices continue to come down and production is ratcheted up. On a similar note, the delays in the much ballyhooed next iteration of the Windows operating system has placed a governor on computer sales as businesses and consumers wait to see what the implications of the new system are on hardware and software requirements.

The automotive industry is likely to continue to struggle over the near term, despite the introduction of a number of new models and wrappers. Despite the recent decline in gasoline prices, hybrids are likely to be the most intriguing sector of the industry. To this point, some of this interest has been supported in part by the provision of generous tax credits designed to take some of the manufacturers' risk out of conversion to more energy efficient vehicles. While tax credits have helped bolster sales of hybrids, this success has begun to play out as manufactures hit the ceiling in terms of the number of cars that would receive the most generous credits. This is especially true with respect to the most popular brands and lines that were in lesser need

of the incentives in the first place. Unfortunately, as manufacturers' sales hit these ceilings, the residual incentives may not be sufficient to stimulate sales of the less popular hybrids. While hybrid sales remain a minor part of the industry and limit the downside of the loss of tax credits, the situation will not help the struggling industry.

Going into 2007, retail sales prospects are somewhat weaker than they were during earlier stages of the cycle and will be more dependent on the health of the economy. With limited prospects for rekindling of the housing market over the near term, retail sales are expected to be tied to income gains and consumers' tolerance for revolving credit. Over the longer term, the growing dependence on revolving credit will bear close monitoring, especially in light of negative savings rates and high total debt levels. How and when consumers react to the strain of revolving debt and whether rising income levels associated with the economic recovery will assuage such concerns will be played out in 2007.

Housing Market

For the past five years, the housing market has been one of the pillars of the economy, helping stabilize the broader markets and stimulate economic growth. This economic impact operated directly through housing starts, transactions, and mortgage originations, as well as indirectly through the wealth effect, which bolstered consumer confidence and spending. The durability and extent of the housing boom was unparalleled in modern times and amplified its impact on the overall economy. While the end of the unsustainable boom was inescapable, the lack of historical precedent has made its impact on the broader economy difficult to quantify. Thus, the fate of the sector and its ripple effects will be closely watched.

While most homeowners will be able to weather further increases in mortgage rates, the plight of marginal buyers who got in at the top of the cycle and used creative financing to access housing are likely to receive more attention in the popular press. Unfortunately, this scenario is not isolated to lower-income borrowers who have historically had to struggle to enter homeownership. Buyers across the income spectrum who turned to variable rate products to extend their purchasing power to keep up with housing prices will also be affected. At the same time, those opting for fixed-rate mortgages may be

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insulated from direct budget stress associated with rising rates, although their wealth and mobility may become compromised as future buyers struggling with housing affordability, thus creating lagged effects on exit strategies.

Leading into the recent downturn, some housing aficionados remained optimistic, hoping the industry could continue to prolong its bull run. During the summer, it became clear that this was wishful thinking, with a more sober outlook being embraced across the spectrum of impartial and partial observers, including the National Association of Realtors. The plight of the housing market triggered concerns that the ripple effects on employment in related industries would create an unexpected drag on the broader economy. As usual, a number of investors hung on toward the end of the boom to make sure they did not jump off the gravy train too soon and got caught as the depth of the retrenchment began to sink in. Clearly, on the home front the impacts have been telling, with a broad range of homebuilder stocks taking a beating. Fortunately, the more savvy homebuilders had been reining back even before the slowdown became obvious to the greater market. Thus, the inventory and pipeline of new homes is not as out of balance as they could have been if builders had not pulled back.

Despite this discipline, the overall housing market remains in the midst of a downward spiral, with the existing housing market creating most of the drag. Looking back at prior adjustments, this situation is likely to continue over the near term while the market sorts out the bottom of the cycle. In general, the adjustment process may remain smooth relative to the potential fallout that could occur if investor-owners panic and try to unload recently acquired product. However, the combination of low mortgage rates and gradually improving economic prospects

should provide some cushion for a soft landing in the housing market. This sanguine view does not apply across markets, especially those that were caught up in the condominium boom driven by investors seeking short-term gains by flipping out at higher prices. Similarly, some of the overheated markets bolstered by second-home owners and creative financing will face downside risks and a rocky ride before settling down to more normal times.

Real Estate Outlook

Office Market

At a national level, the office market has continued the gradual improvement racked up earlier in the year with solid demand and investment activity. While rising oil prices and dampened job growth have moderated the office market, fundamentals are improving, and decreasing speculative construction due to rising construction costs will help stabilize the market. In addition, in many markets and for the industry as a whole, vacancy rates have continued to decline, with net absorption levels positive. At the same time, sublease space has contracted, setting the stage for moderate improvements in rents as demand firms up along with the overall economy. Transaction volume remains high, with investors targeting core assets in major markets, prices remaining high, and returns low. While the record prices experienced earlier in the year are likely a thing of the past for most markets, office values should hold over the near term as demand expands and supply lags, and investors remain cautiously optimistic.

Retail Market

The rise in gasoline prices took some of the wind out of the sails of consumers and hurt some of the lower-end merchants, but did little to disrupt the overall retail market. The decline in fuel prices and resiliency on the consumer confidence side of the equation bodes well for the sector, although the stimulation afforded by the wealth effect attributable to the housing market has been all but withdrawn.

The appetite for retail properties remains strong, despite the rising tide of closures as retailers continue to focus on unit profitability. In terms of additions to supply, the major action will be in lifestyle centers, mixed-use projects, and urban infill development as attention is shifted away from the suburbs and mall development continues to languish. Interest will also continue to rise in urban retail solutions, with retailers paying more attention to the urban core,

especially in markets with viable downtowns and/or those undergoing revitalization and densification.

While these innovations in retail real estate are somewhat warranted and generally positive, they do represent a shift toward uncharted territory in terms of the risk/return profile in these new formats. Similarly, a significant portion of these developments are being driven by players who are new to the retail arena and who may not have a firm grasp on the underlying value proposition that has helped the retail sector provide some of the most attractive risk-adjusted returns of any property types. Similarly, a number of them have neither the network nor established relationships with retailers necessary to assemble tenant mixes and negotiate leases and operating covenants that both maximize and stabilize value of the underlying real estate as have their earlier retail counterparts. The end result may be an increase in the risk component of retail that is neither perceived nor priced into the market but which will ultimately surface.

Industrial/Warehouse Market

At an overall level, the manufacturing sector has remained fairly strong, with vacancy rates exhibiting some improvement in a number of markets. Absorption rates have also been positive, with widespread improvement across most markets. Warehousing activity has been strong in response to increases in import and export levels. High fuel prices have placed something of a damper on the trucking industry, placing greater attention on logistics and causing some shifts in distribution models that affect demand at local and regional levels. Advances in technology and supply chain management have also caused a continued shift in the warehousing sector, creating opportunities for new supply and opening the doors for new product in heretofore overlooked markets. This is especially true in the import/export corridors where excess demand has forced a redistribution of activity to underutilized facilities and more remote locations.

Improving market fundamentals have also filtered over to some of the noncore sectors, as in the case of flex/R&D space, which has improved in a number of markets. This improvement has translated to rising rents, which has caught the attention of institutional investors seeking assets with more upside potential. The improvements in the industrial/warehouse sector have not been lost on

investors, with demand for assets continuing to place pressure on prices and driving up total returns and suppressing income yields. As the economy picks up and shipping activity expands, the sector is poised for further expansion.

Apartment Market

The downward spiral in the single-family market has not had a major impact on the apartment market, with contraction on both fronts over the near term. However, over the intermediate term, the plight of the single-family market bodes well for the multifamily rental market. These prospects were already translating to improved market fundamentals before the depth of the housing correction became apparent as a result of modest increases in new supply and withdrawals associated with condominium conversions.

The retrenchment in the ownership market has taken the wind out of the sails of conversion activity, creating downward pressure on values of rental properties that were likely conversion prospects. Given the frenetic pace of conversions earlier in the cycle, this slowdown is unlikely to undercut values in the broader apartment market, which should benefit from increasing occupancy and rents. Profit margins should also improve as pressure is taken off concessions to lure tenants. At the same time, apartment turnover rates that had been stimulated by the shift from renter-to-owner status and competition among projects are likely to abate. Investor interest in apartments is likely to accelerate even more than in the past as they discount the softening of the homeownership sector and focus on apartments as lifestyle choices that are well positioned to meet tenant demand for solid, well-managed, well-located space.

Hotel Market

The hotel market has enjoyed strong performance as travelers returned to the airways and highways; however, the surge in gasoline prices hurt some locations as vacationers curtailed trips. Despite record load factors for many airlines, the crowded conditions, heightened security alerts, and changing security policies have taken some of the edge off airline travel, placing a dampener on hotels dependent on vacation travelers. Despite these inhibitors, the hotel sector has been able to raise occupancy levels and room rates, helping bolster the bottom line and increasing investment values. This strengthening has not been

lost on investors and is obvious to anyone trying to book rooms in major markets. The result has been an increase in institutional investor demand for hotels that has helped bolster current values and led to the recent increase in supply that has occurred in many markets. Assuming the economy regains some of its lost momentum and business activity leads the next expansion as anticipated, the hotel sector has some upside potential. At the same time, it remains one of the more volatile property sectors and is likely to remain an "opportunistic play" for institutional investors and will be priced as such.

Real Estate and Capital Markets

Capital Market Overview

Going into the fourth quarter of 2006, good news on the economic front and moderate improvements in market fundamentals bolstered the industry. To that point, construction had been tempered, although there were some signs that developers were gearing up for another round of expansion, fueled by ready access to capital. While there remains some concern over the supply side in some markets, there is limited risk of a major surge in construction reminiscent of previous boom periods that got ahead of the demand side of the equation. Thus, capital flows are expected to remain plentiful, placing upward pressure on prices that will hold total returns at acceptable levels. At the same time, the gradual increase in demand will likely translate to moderate increases in rental levels and improving near-term yields. However, the prospects for new supply will likely eat into higher profits, placing downward pressure on income yields. While this situation is not likely to create near-term problems with a fully priced commercial sector, total returns are likely to moderate down toward longer-term averages as appreciation rates fall back. Indeed, price declines can be expected in some markets in which rental increases are not adequate to bolster income returns.

As the cycle plays out, real estate will be forced to compete with other asset classes and provide higher income returns. Furthermore, total return requirements are also likely to increase as investors once again pay attention to the illiquidity and risk premiums inherent in lumpy, capital-intensive real estate assets. Over the longer term, these factors could set the stage for moderation in capital flows and downward pressure on prices. However, the

near-term prospect for such a correction is unlikely. Indeed, acceleration of the economic expansion may forestall the need for such a correction over the near term and once again, prolong the steady state scenario.

Construction Activity

The retrenchment in residential construction has been widely monitored, with a steady decline in new construction activity after a couple of periods of flirtation with additional expansion in the first quarter. This adjustment has occurred in both single-family and multifamily housing, although the decline in the latter was not as pronounced. Permits also declined in widespread action, with the exception of the Midwest, which was less caught up in the expansion than in the South and West.

On the commercial front, improving market fundamentals and the anticipation of further expansion has led to increased construction activity, with private office construction leading the way. While this improvement was a marked contrast to the retrenchment in the office sector at the turn of the decade, it remains below long-term averages and the recovery in the second half of the 1990s.

At an overall level, the declines in residential construction are likely to outpace the gains in commercial, especially as economic growth slows down. However, the anticipated rise in construction and material costs is likely to encourage some developers to continue to move forward to provide a competitive edge with a first to market position. In some markets, this exuberance might prove to be a bit excessive, especially in thin markets that are less diversified and vulnerable to industry-specific corrections.

In addition to offices, hotel construction has also been strong, with Las Vegas leading the way. In this case, what happens in Las Vegas has not stayed there, with hotel construction up across the country in anticipation of an increase in business and leisure travel.

Warehouse construction has also been positive, with developers responding to increased manufacturing and shipping activity associated with increases in both exports and imports. Retail construction has been more constrained, with the exception of mixed-use, which has become the darling of developers and planners across the country as part of infill, revitalization, and densification initiatives.

Going forward, commercial construction is ex-

pected to continue at a moderate pace, supported by plentiful capital for debt and equity and bolstered by the prospects for economic expansion. On the other hand, the single family market will likely continue to retrench, with some lagged expansion in the multifamily side and frothiness in some condominium markets.

Commercial Mortgage Market

Improving market fundamentals and low delinquency rates have translated to a continuation of strong capital flows for commercial mortgages. As over most of this phase of the real estate cycle, lenders have been forced to compete for quality deals, resulting in lower spreads and more aggressive underwriting. Despite this competition and a willingness to accept higher risk, delinquency rates on commercial mortgages remain low. However, regulators are becoming more vocal about their concerns over the dramatic increase in commercial loans by bankers. This concern is not over the total volume of outstanding obligations as it is with the dramatic increase that has occurred while real estate values are arguably at the top of the cycle with cap rates at record low levels. Similarly, fascination with the new genre of retail—including lifestyle centers, mixed-use, specialty, and free-standing—that lack track records in terms of their ability to withstand a downturn in the retail sector is also garnering concern over commercial lending activity. The recent improvement in market fundamentals and continued economic expansion coupled with the lack of a major surge in new supply, suggests that ample mortgage capital will continue to be available to support the overall commercial market.

Investor appetites for commercial mortgage-backed securities (CMBS) have been unsatiated, helping bolster the sector as a range of investors fill the coffers for issuers. As a result, the CMBS market continues to expand, with total market cap once again on a record pace. Improving market fundamentals have also bolstered interest in CMBS, with upgrades outpacing downgrades and helping appease any concerns that loose underwriting standards had begun to interject near-term risk to the sector. The gradual uptick in delinquency rates for the commercial mortgage market has also alleviated concerns about overreliance on creative financing being underwritten to support lofty commercial values. Despite these concerns, commercial mortgages

are expected to remain plentiful, with CMBS and private sources competing for deals and creative approaches to financing ruling the day.

Private Equity Market

The private equity market remains primed for more real estate, with investor allocations continuing to outpace the ability to place product without pushing the envelop beyond core investing. This increased investor demand can be attributed to the relatively low risk that has been attached to real estate investing over the past several years, as well as the general rise in portfolio values associated with the rising stock market and continued economic expansion. Given the competitive nature of the commercial real estate market, the moderate rise in interest rates has made cash king, with some buyers taking advantage of their flush coffers and jumping on deals before debt-dependent buyers can get their financing lined up.

Cap rates remain stubbornly low across the board, with many property sectors averaging some 200 basis points or more below long-term averages. Despite the lower income yields embedded in such figures, domestic and foreign equity investors alike continue to flood the commercial market in search of product. This situation is not likely to change over the near term, helping hold values at elevated levels. This is especially true since these higher valuations have been institutionalized in the National Council of Real Estate Investment Fiduciaries Index, which provides evidence of the private market's willingness to accept lower returns. While this situation will not prevail over the longer term, the improvement in market fundamentals and pent-up demand for assets suggests it will continue over the near term forecast period.

Public Equity Market

As with their private counterparts, real estate investment trusts (REITs) have experienced above-par performance with the majority beating analysts' earnings estimates through midyear. REIT performance has echoed that of the underlying property types, with apartment and office sectors leading the pack with returns pushing 30% for the year to date through the end of August. Industrial REITs have also had a strong year, with health care and lodging following. This widespread performance can be attributed to improving market fundamentals as well

as the frenetic search for product that has elevated property values and forced some private equity investors to look to the public sector to capture real estate returns.

Building on its strong foundation, domestic REITs have used their strong balance sheets and expertise to expand their outreach to a number of frontiers, including globally as characterized by the ProLogis recent expansion in Europe, joint ventures like Prudential's venture with Kite Realty, and mergers as in the case of Pan Pacific and Kimco. The recent strength of the sector should help propel it forward as market fundamentals continue to gradually improve and additions to supply remain tempered.

Conclusion

The U.S. economy has slowed down somewhat, but is fairly on par with consensus expectations. Despite some uncertainty and continued concern over inflation, the economy appears headed for a soft landing with the most likely near-term scenario being moderate increases in interest rates, inflation, and growth. The housing market is one of the wildcards but not in terms of whether it will correct, but how long and how deep the downturn will be on

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the heels of the record bull run it had enjoyed. The capital markets remain favorably disposed toward real estate, a situation that has held for the past several years and is unlikely to reverse over the near term. As in the case of the housing market, however, the good times are likely to come to an end at some point, with the timing the unknown. Clearly, the pent-up demand for commercial real estate and the relative absence of realized losses will help avoid any near-term correction, suggesting record prices

will continue to hold. The improvement in real estate fundamentals has provided some welcome relief to investors absorbing low current yields, although the increase in construction activity combined with moderating economic growth could take some of the momentum out of the market. Even if this unfolds, strong capital flows coupled with the fact that current pricing has been somewhat institutionalized is likely to propel the sector along and allow it to forestall its day of reckoning.