

The Three Rs of Election Year Economics: Recovery, Rhetoric, and 'Rithmetic

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Commentary

In the first quarter of 2004 the economic picture continued to brighten. There were signs that the resurgence in business activity and the stock market recovery might be sustainable, at least over the near term. Investors who took long-term views and waited out the recovery welcomed this turnaround, but many others were left wondering where they had missed the boat. In particular, nagging fears of a weakening dollar, the record deficit, spiraling health care costs, continued world unrest, and weak employment growth placed a damper on widespread enthusiasm. This feeling was prevalent among the unemployed and filtered over to consumers who lost some of their enthusiasm. Despite this undercurrent, the economic recovery is showing signs of staying on track, with the Administration putting on its best face during this critical pre-election period.

Business also is continuing to improve, although business gains have not translated into the levels of hiring that would suggest a new expansionary period. Thus, performance during the first quarter will be closely examined to determine where the economy is headed over the intermediate term.

In this environment, the real estate market is expected to show some moderate improvement. It should benefit from a strengthened business environment and continued limitations on new supply. However, excess capacity still hangs over the broader real estate market, suggesting the industry will have to wait for the good times to return. Assuming investors remain patient and continue to be content with the moderate returns of the past several years, demand for product should remain strong, both on the debt and equity side of the capital market. If the likely scenario holds, the real estate market should be in for a lagged recovery amid a lot of election-year rhetoric. The combination of these two forces

should add up to interesting and profitable, but unspectacular, times.

The Economic Environment

Economic Growth

In 2003, gross domestic product (GDP) grew at an outstanding rate with a midyear peak, falling back somewhat in the third quarter. Despite this decline in the rate of growth, the fourth-quarter figures were strong, indicating the recovery would stay on track. Indeed, prospects for economic growth continued to improve during the 2004 first quarter, with forecasters raising their estimates. Going forward, economic growth is expected to continue to improve moderately and carry into the second half of 2004. In addition, the outlooks for unemployment and inflation are expected to remain positive, helping to bolster the economic outlook. At the same time, the potential for a decline in GDP has decreased, a situation that should continue in the absence of some external shock to the system.

Employment

Despite the positive forecast for GDP, the labor market remains rather flat. The pace of layoffs has declined, however, suggesting more security for those already holding a job. Unfortunately, this situation offers little solace for those who have already lost their jobs and are waiting for employment gains. The flat job market in the face of rising business prospects is explained in part by increased productivity. There are some signs that productivity gains are peaking, however, which suggests that companies may need to increase labor to sustain further expansion. There are no clear signs, though, that an increase in hiring activity will translate into new jobs for American workers. That is, although the absolute number of jobs supported by the U.S. economy may improve, the

“offshoring” of existing and new jobs will continue. Thus, the demand for domestic workers may lag the pace of employment gains predicted on the basis of prior recoveries. The employment issue is expected to receive continued scrutiny during the election period. Some emerging political rhetoric and legislative initiatives have taken on a protectionist aura, focusing on short-term solutions. On the other hand, the Federal Reserve’s recent assertion that education is the key to domestic job growth emphasizes a market-based approach that takes a longer-term view. Finding a balanced approach that addresses both views will be elusive. Thus, the stage is set for heated debates that will peak during the summer—with voters, employees, and unions dragged into the fray. It is hoped that economic expansion will dampen the political tension surrounding these fundamental issues since there is so much riding on the results over the longer term.

Despite modest wage increases, the rise in benefit costs (especially health care) has continued to place upward pressure on total labor costs. In addition, attention is expected to continue to be drawn to the plight of pension funds, resulting in more pressure on companies to bolster funding of reserves. If the stock market remains on track, the pressure will be mitigated, but the longer-term outlook is for companies to continue to reduce pension liability by offering fewer benefits or shifting retirement risk to employees. The timing of this structural shift away from private funding of retirement is likely to set up a future crisis in retirement funding for American workers. The result may be more pressure to shift jobs offshore to countries where retirement-funding pressures are considerably less.

Inflation and Interest Rates

The inflation scene remained bullish during the 2004 first quarter, with few signs of upward pressure. The Federal Reserve (the Fed) is expected to stay out of the picture over the near term as a weak job scene provides impetus to hold low interest rates. Over the intermediate term, however, moderate increases in the federal funds rate may be on the horizon as the Fed lets the economic revival play out. This scenario is particularly likely in light of the Fed’s comments that interest rates must ultimately rise and that the bottom cannot be sustained without exposing the economy to a new round of inflation. Globally, the dollar gained a little ground by midquarter, although it remained weak against most currencies. Indeed, the

improvement was a reaction to the potential for falling global rates as the price of the euro and other currencies against the dollar are drawn back in line by interest rate cuts designed to bolster domestic economies. A wave of protectionist policies is plausible, as European countries and other trading partners seek to offset some of the advantages they perceive the United States holding due to the cheap dollar and supportive tax policies.

Arguably it is the bottom of the interest-rate cycle. That is, there is little downside to gain in interest rates, while upside adjustments and regression toward the mean or long-term averages seem more likely. The only real areas of price concern over the near term are in the food and energy sectors, with health care continuing to exact a bigger portion of the disposable income. Energy prices can be expected to surge before summer as tourists return to the road after eschewing longer road trips the past several years. Consumers are likely to view such increases with cynicism, believing they are being gouged by the energy sector. During an election year, such concerns are likely to draw the attention of politicians who will try to use the issue as a part of their election platform. Despite this rhetoric, rising gasoline prices will dampen consumer optimism and provide a reminder that inflation never really goes away but ultimately returns like the proverbial bad penny. Over the near-term, however, no major spike in inflation or interest rates is expected to threaten the economic recovery.

Business Indicators

By the middle of the first quarter, U.S. leading indicators began to improve—especially those for consumer expectations, stock prices, average manufacturing hours, and initial claims for unemployment insurance. In addition, inventory growth has been building, as companies position themselves for the recovery and anticipate growth in business and consumer spending. This trend should pick up steam and create additional upward support for economic growth during the second half of the year.

Productivity gains continue to propel the overall economy and bolster the balance sheets of companies. It is unlikely, however, that the productivity gains will parallel those of the past several years. This suggests a moderating impact on profits as companies turn to new employees to continue expansion.

In the nonmanufacturing sector, business indicators pointed upward in early 2004, with increases

in business activity, new orders, and supplier deliveries leading the charge. With respect to other sectors, legal services, agriculture, entertainment, and wholesale trade reported the highest rates of growth. Also, manufacturing activity continued to build momentum as companies geared up for the recovery and inventory/sales ratios declined.

In terms of current spending, investment in information and communications technology is expected to increase as companies upgrade aging hardware and explore new platforms and wireless networks. Such purchases will be bolstered by falling prices and improved performance. In addition, favorable tax treatment of capital investments, which expires in 2004, will also encourage this activity. While the impact of higher technology investments will stimulate business demand over the near term, the long-term impacts are less clear. The interactive effects of technological innovation and offshoring will place added pressure on specialization and the search for competitive advantage. Over the longer term, there will be a weeding out of domestic operations that are marginalized due to costs and/or logistical disadvantages and an emergence of others who can effectively compete on a total cost of business basis. Over the near term, however, the interactive effects should help stimulate business prospects and sustain the recovery.

Stock Market

After several years of disappointment, the stock market finished 2003 on a strong note. The Dow-Jones Industrial Average, NASDAQ, and S&P 500 indices all showed strong gains for the year. While long-term investors who stuck by their allocations captured the associated wealth gains, the market timers were left on the wayside. The speed at which the recovery occurred and the uncertainty surrounding it, caught most prognosticators off guard. This has set the stage for a second wave of capital that will help sustain the recovery. In some respects, memories of the past will fade slowly and expose the market to higher-than-normal levels of volatility as investors remain somewhat skittish. However, investors have brought strong net inflows to equity mutual funds over the past nine months.

The good news is that the "Martha Stewart effect" should have little impact on the market, with investors getting more jaded and less affected by such scandals. It should be noted that this recent wave of

indifference has occurred during a period in which investors are doing well and are riding an upward tide. At the same time, the fate of Michael Eisner at the Walt Disney Company argues that scrutiny of corporate governance and leadership will continue and may become political fodder. If more scandals break out, the cynicism could return with a vengeance since investors have little tolerance for nonmarket-induced declines. Despite this risk, the outlook for the stock market is relatively positive, with gradual improvement and some downside risk and continued volatility.

Global investors have played a significant role in recovery of the U.S. stock market. During 2003, foreign purchases of U.S. securities set a record. The fourth quarter was especially strong, although the torrid pace set in November declined by year-end. A change in foreign investment was in the mix of securities, with treasury notes, federal agency issues, and corporate bonds all increasing in market share.

Both domestic and foreign investors welcomed a decline in default rates among high-yield investments. This provided further fuel for the recovery by helping sustain net capital flows. At the same time, returns were up for many global indices, reflecting the broad-based and long-overdue nature of the recovery. Initial public offerings (IPO) also picked up, with pipelines expanding to help build market momentum for promising companies. With respect to bonds, a significant decline in downgrades in 2003 signaled improvement in overall credit quality and reversed a three-year trend.

Consumer Confidence

Consumer confidence began to waffle in early 2004 after a strong showing in late 2003. This reflected rising concerns over job prospects, acceleration of outsourcing, and health and retirement costs. As might be expected, consumer confidence levels varied across income and demographic segments; lower-income workers with less job security and older workers with eroding retirement prospects reported the most consumer angst.

While some of the consumer angst can be attributed to the rhetoric surrounding the Democratic caucuses, it is more attributable to the fact the recovery seems to be skipping significant pockets of employees. The debate over the prospects for the economy will no doubt accelerate as the political scene heats up and attention shifts to the national election. Ris-

ing gasoline prices and lagged employment growth will heavily influence the attitudes of a number of consumer segments. Consumer confidence is expected to vacillate, ebbing and flowing on the waves of economic and political news. However, further improvements in the economy that lead to an increase in employment levels should appease consumers and provide some stability to confidence levels.

Retail Sales

In January 2004, retail sales were up moderately over the prior year, continuing the pattern of improved sales experienced in the 2003 fourth quarter. Chain store sales surged at the beginning of the year, racking up the highest sales gain in five years. Within sectors, the strongest retail sales gains were in electronics and appliance sales, followed by sales of food and beverage services. The major weakness on the retail front was in the automobile industry, where sales languished.

To some extent, the recent round of strong retail sales growth is attributable to tax refunds resulting from changes in tax policies intended to stimulate the economy. While this pattern may hold, the early results have been somewhat disappointing, with average refunds not pushing the lofty forecasts that accompanied the tax cuts. This lagged effect may be due to delayed filings by larger taxpayers who benefit the most from the legislation. Regardless of the tax stimulus, retail sales in the high-end sector have been particularly strong. This situation is expected to continue as taxpayers benefit from a surge in refunds and see improved net worth due to a stable stock market. Consumer demand for large-ticket durable goods and automobiles, however, is expected to remain tempered until the recovery ripples over into improved employment and wages.

In addition to retail sales, tourism and service expenditures have improved, as a surge in leisure travel offsets continued softness in business travel. The outlook for leisure and recreation should remain healthy as consumers catch up on deferred or scaled-back vacation plans. Rising energy prices and potential shortages of gasoline could place a damper on this activity during the important summer months. If the economy stays on track, however, tourist activity is likely to continue to improve, with business travel expected to amplify the recovery.

On the Internet front, e-commerce sales have continued to experience growth, with 2003 fourth

quarter sales up about 25% over 2002. Despite strong year-end growth, e-commerce sales remain dwarfed by total sales, still hovering under 2% market share. When the full range of e-commerce-related activity is factored into the equation, however, the growing influence of the Internet on retail activity becomes more apparent. In addition to increasing sales through new channels that expand market reach, other technological advances associated with e-commerce have been having an even more significant impact on inventory management, supply chains, logistical models, customer service, and affinity programs. These will continue to affect the retail sector by adding efficiency to the system, expanding markets for retailers, and breaking down market and political barriers.

Housing Market

During early 2004, the housing market remained one of the mainstays of the U.S. economy, continuing to surprise prognosticators as it perked along. After one of the strongest years in terms of single-family housing starts, the pace is expected to moderately drop off during the balance of 2004. Despite this decline, single-family starts are still forecast to exceed the annual rates of the past twenty-five years. In 2003, the multifamily market softened, and housing starts declined moderately. However, the level of multifamily starts was in line with the average rate over the past eight years. The rate of multifamily starts in 2004 is expected to decelerate even more, although not materially off the pace.

The market has continued to accelerate in terms of housing prices, with low mortgage rates and strong homeowner demand fueling continued price increases. This trend may continue over the near term, but is expected to decelerate as homeownership rates peak and softening demand dampens upward pressure on prices. Although no major change in mortgage rates is expected over the near term, moderate increases in the second half of 2004 could dampen the housing market.

The importance of a strong housing market to the economy has been demonstrated over the past several years. The robust housing market helped stimulate the overall recovery while business stayed on the sidelines. The continued importance of the housing market during this economic revival can be illustrated by the Fed's suggestion that homeowners revisit their penchant for fixed-rate mortgages and

consider switching to variable rate instruments. The rationale for this “interference” is not clear; however, the lower going-in rate for variable rates clearly would have a stimulus affect and would help buyers bid up the price for housing. This price subsidy could prove costly for homeowners on the margin as well as those who have stretched their budgets in terms of real estate allocations. A rise in interest rates could trigger an increase of variable rate debt that may make continued homeownership untenable. Despite concern over sustainability of a low-rate housing boom, however, the outlook for the sector remains solid with few signs of abating near term.

Capital Markets and Real Estate Fundamentals

Real Estate Capital Markets Overview

The story on the real estate capital markets front is much like an “easy listening” rhythm has been assimilated rather smoothly with few complaints. This tolerant attitude by investors is important, since the market is unlikely to change over the near term. As such, there will be plentiful capital for deals, especially those that are seasoned and weathering the downturn. Capital for new construction will continue to be rationed, although the market is likely to see increasing demand as developers and landowners join the economic revival. Unfortunately, these efforts may be a bit premature in light of excess capacity and the absence of a new hiring that would increase demand.

On the equity side, investors will continue to compete for deals, holding cap rates at the bottom of a prolonged cyclical trough. Although some properties have traded at sub-6% cap rates, there is little likelihood that such rates will decline even further. Indeed, there will be upward pressure on cap rates as talk of moderate increases in interest rates become more common in the second half of the year and as other asset classes continue to perform. With respect to mortgages, lenders will continue to compete aggressively for new investments and to retain existing loans through renewals and/or refinancing.

Construction Activity

During 2003, construction activity levels varied by sector, with a relatively strong residential market benefiting from the continued run-up in single-family housing and a relatively stagnant commercial market. Both sides of the industry welcomed this

split performance, with demand rising to meet supply on the residential side, and the relative absence of commercial construction taking some of the downward pressure off that sector. In early 2004, the residential market remained strong, although activity slipped a bit from the year-end figures; they still remained higher than the same period in 2003. Looking forward, construction activity is expected to moderate in the residential sector, especially the multifamily component, which is experiencing further erosion in market fundamentals. Commercial activity will be tempered due to a combination of excess capacity and continued reliance on productivity gains. Once the economic expansion translates into new domestic jobs, construction activity is expected to increase, although the excess capacity and a lagged recovery in the real estate sector will dampen the upside. While this outlook is bad news for those actively engaged in the construction sector, it is welcomed by investors looking for a tightening of the supply/demand equation to drive up rents and elevate returns.

Private Equity Market

The private equity market remains one of the more stable sectors in the real estate asset class. There is no shortage of equity capital to facilitate transactions. The end result has been further moderation in cap rates, although rates are showing signs of bottoming out as other asset classes begin to pick up momentum. As in the broader equity market, there is some profit taking; sellers realize they have ridden upward on the buoyancy of declining cap rates that are below sustainable levels for the longer-term. While investors recently have accepted lower real estate returns relative to historical averages, it is important to note this tolerance was skewed by defensive investment goals rather than yield expectations. This mindset is likely to carry over, with investors paying more attention to core assets at lower prices than higher-risk assets that provide higher yields. This appetite is expected to begin changing over the next twelve to fifteen months as investors begin to weigh real estate decisions on historical bases within the asset class rather than on a relative basis compared to other real estate investments. In the meantime, return requirements are expected to continue, making it more of a seller's market than a buyer's market. It is useful to note that this market balance is highly unusual in light of the current and near-term outlooks for soft and declining market con-

ditions that pervade many markets. Regardless, private equity capital flows to real estate from domestic investors are expected to remain strong. In addition, international investors will continue to be drawn to the U.S. market because of solid assets, which can be bought cheaply due in part to the weak dollar, and a relatively stable outlook for domestic markets.

Public Equity Market

The public real estate investment trusts (REITs) market was strong in 2003 in terms of performance and market cap. Overall returns for the NAREIT Index were stellar for 2003, both in absolute terms (i.e., some 38.5%) and relative terms, coming in significantly above those of the private real estate sector and other asset classes. REIT performance has been bolstered by a return of investor capital, especially to some funds that focus on real estate. Similarly, demand has been strong from other investment vehicles that have developed a penchant for investing in the more liquid, transparent real estate market that has evolved over the past decade. The strength of REITs has been fairly widespread, covering debt issuances as well as public common equity issuances. At the same time, REITs leveraged their share of the broader real estate market by increasing allocations to co-investment ventures. The outlook for REITs is generally positive, with the anticipation of strong capital flows to the sector. These allocations will come from institutional investors, as well as individual investors. Despite the prospects of positive investor demand, it is unlikely that REITs can continue to outperform other asset classes as they have in the recent past. But REIT returns and capital flows should remain healthy over the foreseeable future.

Commercial Mortgage Market

As with the equity side of the equation, the outlook for the commercial mortgage market remains fairly steady, with readily available capital to support transaction volumes. Due to strong capital flows to the sector, spreads remain tight and are expected to continue that pattern over the near future. Some investors have relaxed underwriting standards, especially for core assets, although the trend has been to avoid riskier product. Despite weak market fundamentals, delinquency rates remain rather healthy, with a moderate increase occurring over the past twelve to fifteen months. This situation is due in part to the gradual erosion in market fundamentals and in net

income from seasoned properties. The competition for assets on the margin—average properties with little competitive advantage that mirror market behavior in terms of occupancy and rents—has been particularly helpful. For such assets, the availability of low-cost debt and equity has helped buoy market values and mitigate some of the risk of default on loans. In essence, equity investors chasing product at low cap rates have placed a bottom on the market and insulated both lenders and owners from losses that could be expected in a period of weak market fundamentals.

The commercial mortgage market for construction loans remains tight, but functional, allowing developers with solid projects to finance new ventures. Despite the relatively limited supply of new product in the pipeline and strong competition for deals, construction lenders have held to their underwriting standards to avoid a repeat of the last major market collapse. In addition, the fact that construction lenders hold borrowers personally liable has created an environment where borrowers and lenders are motivated to work through problems. Given the tempered nature of new construction activity and the continued emphasis on risk management, there is little danger of a major disruption in market fundamentals. When combined with the continued gradual recovery of the commercial real estate market, the outlook for commercial mortgage market is rather sanguine, with a continued advantage on the borrower side of the equation.

With respect to commercial mortgage-backed securities (CMBS), the situation parallels that of the private mortgage market with plentiful capital available to support transactions. For 2003 as a whole, CMBS volume was very strong, pushing \$100 billion in new issuance. While not a major concern, investors and issuers are closely monitoring the gradual rise in delinquency rates among CMBS. There is also rising concern over increases in the severity of loss associated with loan foreclosures. Relatively healthy capital flows to real estate (both equity and debt) have helped alleviate potential stress points.

As the market matures CMBS competes for capital with other asset classes and for product with private sources of debt. Support for its ability to compete for capital can be seen in the compression of CMBS trading spreads, which by early 2004 were the lowest they have been in five years. Support for its ability to compete for product can be evidenced by the increasing market cap of the CMBS sector,

both in absolute terms and with respect to market share compared to other sources of commercial mortgages. Going forward, the CMBS market should remain active, with plentiful capital to help support transactions and refinancing activity.

Real Estate Outlook

Overview

The commercial real estate market remains relatively soft, and the moderate downward pressure associated with excess capacity is expected to cause further erosion in the market fundamentals. The key in this general outlook is the word "moderate," emphasizing that the market is beginning to bottom out with little risk of a major disruption.

As business confidence picks up, the real estate market will turn around in markets where the economic base is aligned with the engines of growth. Assuming the recovery stays on track, this focused recovery should spread, helping market fundamentals in other markets. It should be noted, however, that the economic recovery is unlikely to gain sufficient momentum to trickle down to marginal properties that have inherently weak fundamentals. This is especially true for product that has eroded through deferred maintenance by owners cutting back on discretionary spending. While somewhat short-sighted, such behavior is common during market downturns. This behavior is especially true in the last downturn, where recognition that the real estate recovery would be tempered and lagged did little to justify deficit spending.

The good news for the real estate market is that there is a surplus of capital chasing limited product, pushing acquisitions down the food chain in search of deals. This compression has helped extend the boundaries of investment appetite to some marginalized product that would have been otherwise eschewed by institutional investors.

Office Market

The fate of the office market has mirrored the overall commercial real estate market, characterized by generally soft to moderately weak fundamentals. The good news is that it finally appears that office vacancy rates have peaked, with some leasing activity beginning to eat into the negative absorption that has plagued the sector. Unfortunately, the flattening out of published vacancy rates is suspect in light of excess capacity that companies are still carrying

that is not reflected in the numbers. Since these hidden statistics have received significant attention, it is likely they have been discounted in market activity. Thus, there is limited risk that the market would be surprised by a glut of new product as companies shed excess capacity to offset further losses.

The soft office-market profile can be attributed to the erosion in demand associated with the recession and the malaise that has plagued business. This broad economic weakness rippled over to the office market triggering a rise in vacancy rates. While the economy has begun to turn around, excess capacity remains a major problem in the office sector. Furthermore, the reliance on productivity gains and the recent movement toward offshoring jobs creates some risk in the outlook for the office recovery.

The good news is that announcements of further layoffs in the office sector are nowhere near what they have been in the recent past. Indeed, signs that productivity gains are slowing down suggest that companies will begin to turn to new hires to stimulate growth. However, the strength of such a turnaround is not clear. Growing pressure on share prices to appease the stock market continue to force companies to focus on short-term benefits rather than longer-term, sustainable growth. In this environment, tenants will likely continue to hold the upper hand in most markets.

It is also likely that a number of submarkets and markets will benefit early from the economic recovery, especially those with strong product located in concentrated areas of economic growth (e.g., biomedical, health). Similarly, office product that can meet the needs for more flexibility and/or more intense use associated with recent productivity gains should benefit early in the recovery. For commodity-type space the recovery will be very gradual, depending on wide-ranging economic recovery before demand trickles down. Once the recovery kicks in and rents rise, there will be a lot of shuffling around, as tenants drawn into Class A space are forced back into Class B space that better fits their long-term financial capacity.

Retail Market

The retail market has weathered the economic doldrums better than most other property types. The strong consumer-led economy created a positive halo for the retail sector, however, the good times have not carried across the property class. In particular,

the "Wal-Martization" of America has continued to hurt some smaller, regional retailers and grocers as the giant merchant and its colleagues have increased market share via aggressive expansion of hybrid food/merchandise outlets. The result has been an increase in risks associated with some smaller grocery-anchored centers. At the same time, growth for some big-box retailers has surged, creating an active market for new and repositioned centers. This has driven down cap rates on some of the Class A- and Class B product. Going forward, investors' appetites for smaller retail properties with strong tenants is expected to remain robust, creating an active market on both the buy and sell side.

At the larger end of the retail spectrum (i.e., regional malls), interesting changes have occurred. One striking change has been a resurgence in investors' appetites for larger centers that they had previously turned away from in favor of smaller, more digestible retail investments. Part of this change can be attributed to lower returns for smaller centers and a ready supply of larger product with few takers. Another significant change is a dramatic reduction in the pipeline of new product. This curtailment of supply may change the preference and pricing for existing product. With less than a handful of new malls scheduled to open nationally over the next few years, retailers who have historically maintained market share and growth by following developers into new malls will be forced to seek alternative outlets. This may create infill opportunities at existing malls that can be repositioned or expanded to accommodate new tenants.

The retail landscape is expected to change significantly over the next several years. To address the challenges of a slower pipeline of new mall product, retailers are expected to continue to experiment with new retail outlets. This amplifies the shift in buyer habits and demographics that have forced retailers to rethink their store formats. The end result has been the introduction of new concepts in new locations, including freestanding and other off-mall formats. These new retail concepts include smaller urban stores, lifestyle centers, and neighborhood stores that fit into smaller retail centers. Since these new concepts are unproven, developers and investors will face unknown tenant risks as the market sifts through the experimental formats.

Another significant change in the retail market is the expansion of the "smart growth" movement

and the resurgence in new urbanism and other growth management techniques that establish rules for development that will affect retail both directly and indirectly. For example, the number of markets with urban growth boundaries is expected to increase dramatically, skewing development toward certain areas and restricting development in other areas. Similarly, the revival of interest in urban living and densification is creating opportunity and pressure for new urban retail formats to respond to pockets of demand. Urban planners and land use regulators are expected to exert increasing influence on the retail sector, creating incentives for favored development types (e.g., mixed-use, urban villages) and disincentives for other development types (e.g., suburban malls, leapfrog development). The combination of these forces will create a dynamic environment and stimulate new product that bears watching. Despite these forces, the retail sector is expected to remain relatively balanced.

Industrial/Warehouse Market

Until six months ago, the industrial sector was on par with most other property types, with gradual but steady increases in vacancy rates. This weakness was attributed to several years of weakness in the manufacturing and wholesale sectors. It was exacerbated by changing manufacturing and distribution models, and by changing business practices that exploited technological innovations to add more efficiency. The pickup in economic activity over the past six months has provided some relief, although excess capacity remains a problem. Industrial vacancy rates have declined modestly, with some flattening over the recent past. This situation varies by markets, with some outperforming the national averages. There has been a slight increase in construction activity in response to the improvement in business indicators. Reflecting the anticipation of a long-awaited recovery, two-thirds of new construction activity is speculative, with the balance owner-occupied and build-to-suit space. Despite this modest increase, new construction activity is expected to remain tempered as the market seeks to absorb existing product and return vacancy levels to their longer-term averages.

In spite of general weakness in market fundamentals, demand for industrial product remains strong with investors seeking to bolster their core holdings. As recovery in the industrial sector gains

momentum, leasing activity should increase for both industrial and warehouse product. Given the relatively short construction period for industrial buildings, construction activity is also expected to pick up in anticipation of rising demand. This activity will be somewhat concentrated in traditional manufacturing and distribution centers. However, pockets of construction activity should also spring up in new and emerging industrial markets that benefit from changes in supply chains and logistical models. In addition, investors will continue to favor modern facilities, placing upward pressure on prices of such product and creating some opportunities for more conventional space that has less sizzle.

In addition, interest is expected to continue to grow in industrial sites that can be converted to new highest and best uses. Interest in such opportunities began as communities and developers sought solutions for urban brownfields or other tainted sites. Initial redevelopment efforts involved government assistance, using public funds to remediate sites or help manage environmental risk. Given the success of some of these early projects, conversion has begun to shift into the private realm as developers seek new ways to convert underutilized space into more intense uses and capture the upside potential.

Several factors argue this trend will continue and will have a significant impact on urban industrial sites. First, the emergence of the smart growth movement has placed emphasis on densification of markets and infill development. Second, while some investors avoid such opportunities as too risky, the success of early ventures suggests the risks can be managed and investors can capture attractive risk-adjusted returns. Third, although conversion of industrial property requires specialized and somewhat local expertise, institutional investors have shown an interest in joint ventures and co-investment activities that could capture the requisite skill sets and resources. This should reduce some of the barriers to entry and open up capital flows to fuel the trend. Fourth, some institutional investors have placed real estate in the category of alternative investments. The impact of this change is to dictate that the absolute level of required returns offered by real estate investments will have to increase as the overall market recovers. Fifth, capital sources are beginning to emerge to support such activity, including specialized equity funds that focus on opportunistic, socially responsible development. Finally, there is a

ready supply of such product in many markets and local governments are willing to change entitlements to induce development that will revitalize their urban cores. The result is that the industrial market should begin to improve, both for traditional industrial activities as the economy picks up, and for redevelopment activities as the overall real estate market recovers.

Apartment Market

The apartment market has had a difficult time as low interest rates and high housing affordability levels have combined to entice many previous renters to homeownership. Nonetheless, developers have added new supply in the face of eroding fundamentals. While the rate of construction is moderate compared to more bullish times, it is still problematic, especially in markets where economic weakness and job losses that have curtailed in-migration and household formations. Unfortunately, the availability of cheap equity and debt has combined to stimulate additions to stock as investors and developers seek to lock in low fixed cost in anticipation of a recovery in the demand side of the equation. While this strategy may work for some investors who can wait out the recovery and/or write off the period of excess vacancy as a cost of production, the situation may become more difficult for existing owners operating on stretched budgets. Over the short term, the apartment market should continue to struggle, with further increases in vacancy rates likely to occur.

On a positive note for current owners, apartments remain on the buy list for institutional investors. Indeed, many institutional investors are aggressively seeking product at the bottom of the market in anticipation of a recovery that will offset temporary weakness. Also, vacancy rates should be moderating, although improvement will lag other sectors due to the problem of new stock. Over the intermediate-to-longer term, as interest rates rise and appreciation rates for single-family housing begin to moderate, the apartment market may be in for a boost as tenure choice for some marginal homeowners shifts back to rental to support greater mobility.

Over the shorter term, a number of pockets of strength will emerge, especially in growth-managed markets where additions to supply remain tempered and housing affordability eludes potential homebuyers. Similarly, in some markets in which infill development is being supported through the

smart-growth movement, there may be opportunities to add new product and raise rents as urban living becomes more attractive. However, such cases will have to be analyzed very carefully, with an eye toward demand and the receptivity of potential renters to new housing options.

Conclusion

As noted, there are a growing number of signs that suggest the economic revival will stay on track this time around. If the economy does indeed continue to improve, the recovery should spread. While there are a number of risk factors lurking in the background—rising gasoline prices, increasing threats of terrorism mirroring those in Southern Europe, and skittish consumers—the overall prognostication is for continued improvement. This situation bodes well for the real estate market, although not over the near term. That is, the significant level of excess capacity will create a lagged real estate recovery. Despite this caveat, the real estate market can look forward to a period of gradual improvement, with limited risk of a major correction.

Although prices for existing product are expected to remain high, there will be some upward pressure on cap rates. This is especially true as the overall market improves and real estate must compete with other asset classes for investments. Since interest rates are expected to remain relatively low, there should be an ample supply of ready capital. Furthermore, the current players should remain patient over the near term, accepting lower returns than historically acceptable in anticipation of moderate improvement.

With respect to new opportunities, an expanding pool of investors should be willing to trade higher risk for returns, providing capital for investments that exhibit higher risk. Fortunately, there are enough opportunities to reposition or redevelop existing product, taking pressure of the tendency to fund new construction to capture higher returns.

Although the election year banter will raise a number of flags for the economy, the rhetoric and attention should turn out to be healthy as politicians are forced to address some of the more difficult domestic and economic issues that cloud the real estate market. The bottom line is the “arithmetical” is right for real estate and the lagged recovery should stay on track, although there will be some bumps along the way.

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