The Real Estate Ripple: Catching the Wave?
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The Real Estate Ripple: Catching the Wave?

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Commentary

The summer of 2004 is shaping up as an interesting economic period, one in which the fledgling recovery tries to maintain momentum as it seeks to get back on track. There are a number of signs that things will continue to improve: domestic job growth has finally begun to resurface, the housing market remains strong, the stock market is holding onto its recent gains, economic indicators are generally positive, and businesses appear to be gearing up for more expansion. Despite these optimistic notes, a number of clouds remain, especially the spillover effects of rising energy costs and the seemingly endless fight against terrorism. Even with the continued angst over such issues and some recent slippage, consumer confidence remains relatively strong and long-awaited job growth is providing some sense of optimism. Consumers continue to play their role in the economic recovery, as evidenced by the increase in air traffic and vacation plans that have been dampened over the past several years. However, the sustainability of the recovery ultimately hinges on the business sector remaining on track.

The election rhetoric will continue to build over the summer, with both sides expected to accelerate their attacks. As the debates heat up over the summer, more attention will be focused on the actual state of economic affairs and the longer-term implications of the efforts to stimulate the current economy. In this environment, voters and consumers are likely to harden their positions, resulting in little prospects of major change in the absence of some new breakthrough or event that forces them to revisit their views. The same scenario holds for the broader economy, with most parties leaning toward the optimistic side. This outlook bodes well for the real estate market, which due to excess capacity will continue to depend on a broader economic recovery before it begins to pick up. The good news is that investor demand and capital flows to real estate are likely to remain strong notwithstanding the likelihood of moderate increases in interest rates and a moderate shift away from debt-dependent buyers. Despite a continuation of low yields, there will be greater upside potential for investment returns as real estate fundamentals improve over the intermediate term. Thus, for the real estate market, the summer and fall will continue to be busy periods characterized by capital chasing deals.

The Economic Environment

Economic Growth

As 2004 has unfolded, economic growth has continued to surprise economists, with upward revisions fairly commonplace. Gross domestic product (GDP) came in at 4.4% in the first quarter, well ahead of the general trend line. This improvement, which has held for the past three quarters, has not gone unnoticed. It has created an upward momentum that has rippled across the business and financial sectors, leading to job creation and a relatively strong stock market. A number of positive signs, including moderate increases in the U.S. Leading Index, coupled with prospects for strong export to complement domestic demand, suggest that GDP growth is likely to continue its strong pattern. The fact that this is an election year will put added pressure on the Federal Reserve (the Fed) to avoid jeopardizing the economic expansion, with the recovery on a strong enough track to avoid risk associated with a slight tightening of rates. Further, the healthy balance sheet of financial institutions, both in terms of excess reserves and availability of cash, suggest that businesses will have adequate sources of capital to maintain the pace of business expansion. This situation is especially true in light of the general loosening of credit standards as financial intermediaries compete for business. The end result is the prospect of healthy gains in business fixed investment, which should translate to additional GDP growth over the intermediate term. When coupled with continued strength in productivity gains and increased employment, GDP growth appears to be on a solid base.

Employment

The domestic employment scene has improved at last, taking some pressure off the growing debate over the offshoring of U.S. jobs. This improvement, which has continued for several months, has been watched closely as many feared the jobless nature of the recovery would continue to characterize the economy. One sign of the stabilizing employment situation is the decline in mass layoffs, which trended downward during the first half of 2004 and remain significantly below the pace of the prior year. Furthermore, after three months of employment gains, the evidence suggests that companies are increasingly becoming more confident that the expansion will hold. Thus, a growing number of companies have begun to expand their base of employees. This improvement has been led by the service sector, although the beleaguered manufacturing sector has also been adding jobs, albeit at a slower pace. At the current rate of expansion, the employment rate is expected to show some moderate improvement.

Despite rising employment rates, there is little danger of a major increase in wage rates, as excess capacity and productivity gains take some of the edge off of the expansion in employee bases. The exception to this outlook will be in the benefits area, where rising benefit costs are anticipated to continue to contribute over two-thirds of the rise in total employment costs. Since these implicit benefits will be invisible to many employees, they are unlikely to translate to higher employee satisfaction. At the same time, rising labor costs will be closely monitored as companies continue to focus on the bottom line and move quickly to cut variable costs to respond to signs of an economic downturn.

A wild card in the employment-cost equation will be the potential for a spike in the rate of turnover, as employees who have felt trapped in their existing jobs and pressured to bolster productivity begin to look at new, and presumably better compensated, opportunities.

Finally, over the past several years, an increasing number of professionals have turned to self-employment, becoming entrepreneurs out of necessity as companies outsourced jobs and became more dependent on temporary labor. While still relatively moderate compared to corporate rosters, the specialized talents and experiences of such workers will likely be attractive to companies and at the same time difficult to reel in as captive resources. Thus, many companies are likely to be placed on the defensive with respect to attracting and retaining talented employees who can operate as free agents on the open market without the cloud of salary caps needed to dampen competition.

Inflation and Interest Rates

On the inflation front, the overall figures suggest that inflation remains in check. The most notable exception has been in the energy sector, where fuel pump prices are breaking records across the country. Ignoring the rise in petroleum products, upward pressure continues to build on core inflation, pushing the 2% limit set by the Fed for its target range, but still below other expansionary periods. Despite modest rises in inflation, the perceived reality among consumers belies the statistics, with upward pressure on food, health care, and gasoline hitting their personal bottom lines more than the aggregate numbers would suggest. Although energy prices are expected to moderate somewhat as capacity increases, prices will still be under pressure as demand continues to build as the broad-based recovery spills across consumer and business demand.

The recent pace of economic expansion and improvement on the job front has placed more pressure on the Fed to raise rates; this creates the prospect for a round of increases over the summer and fall. While such increases are likely to occur, the general consensus is that they will be moderate, both in the near term and then in aggregate, with a likely rise in the 50 to 100 basis point range over the next 12 months. The level and speed of change will remain tempered and somewhat predictable as the Fed walks a fine line between inflation and the still vulnerable economic recovery. The fact that this is an election year is likely to dampen near-term changes, although efforts will be made to keep politics out of the equation.

Despite the prospect of rising rates, such changes are likely to be moderate, and have limited impact on the overall economic environment. This tempered view is attributable in part to the fact that rising rates are somewhat inevitable, as the Fed's concerns over deflation have been put to rest. Further, the financial and business sectors have already factored a moderate rise in interest rates into their outlooks. Thus, the economy will face limited downside risk as a result of the eventual tightening. Given the moderate rate of anticipated changes, rates will continue to remain below long-term averages, removing major interest-rate risk from downside scenarios of economic and business forecasters who will set the stage for expansion plans.

Business Indicators

As highlighted by both the business and popular press, business indicators are on a generally positive track. For example, factory activity remains high, providing much-needed stimulus to the overall economy and suggesting that the manufacturing sector has benefited from the recovery and growing demand. Despite general improvement earlier in the year, durable goods orders stumbled during the second quarter. However, the declines were more attributable to a brief cooling off after an unusually strong first-quarter growth rather than a major reversal.

Despite the increase in manufacturing output, the business inventory-to-sales ratio has declined throughout 2004, continuing the downward trend begun in the second quarter of 2003. Given strong productivity and employment gains, this improvement attests to the growth in demand for manufactured products. Rising demand for U.S. product has spread across the international scene. Export prices have been supported in part by the weak dollar, although the weakening of the dollar is at a more modest rate than in the recent past. Export price increases were the most dramatic for the agricultural sector, rising almost 25% for the year ended in April, which is almost ten times the rise in nonagricultural export prices. On the other hand, prices of imports remained rather flat, although prices were up moderately over the past year. The obvious exception to this pattern was the petroleum industry, which racked up significant and largely unanticipated changes over the prior year.

Stock Market

The stock market has been able to maintain gains associated with strong revenue increases despite some moderate slippage. Much of the downside pressure has focused on the energy market and the rise in core inflation, with fears over the potential for rising prices to sap the strength out of the recovery. On the other hand, the dramatic improvement on the employment front has provided some upside momentum. On a positive note, there are some signs that oil production will increase and take the edge off of energy prices, removing some of the downside risk. This situation could change rapidly. Political turmoil and terrorist threats that could curtail oil shipments continue to remain high. However, the prospects for continued economic expansion bode well for the overall stock market. Despite this generally optimistic note, the financial markets will continue to be skittish as investors seek to understand the implications of the array of factors that can affect earnings and stock prices.

Assuming that employment growth continues without placing significant upward pressure on wage levels, the stock market should benefit from earnings growth as long as productivity remains high and demand continues to expand. However, there are still a number of downside risks that will hang over the market, suggesting continued volatility until the recovery fully sets in. Similarly, companies will continue to pay close attention to the bottom line; this will place a governor on excess expansion that could get ahead of the broader economic recovery.

Consumer Confidence

Consumer confidence began to stabilize in the second quarter of 2004, falling from the peak in January but still ahead of last fall. This improvement in year-over figures can be partially explained by a rise in per capita income during 2003, which was more than double that of the prior year. Toward the end of the quarter, however, confidence levels slipped somewhat, with the drop the most pronounced for the forward-looking expectations component. In light of generally positive economic news, the decline in consumer confidence can be attributed to growing concern over the situation in Iraq and rising energy costs, especially at the gas pump. Unlike prior quarters, there are no obvious short-term catalysts (e.g., tax refunds and surpluses from refinancing) to bolster consumer sentiment beyond the realities dictated by personal incomes and investment prospects. At the same time, if inflationary forces continue to build, consumers may be faced with a round of price increases that could dampen attitudes and retail spending. The prospect of high gas prices during the peak vacation period will heighten concern over household budgets. Thus, through the summer it can be expected that confidence levels will continue to fluctuate, with consumers paying close attention to the geopolitical scene and election rhetoric.

Retail Sales

Retail sales have also demonstrated some near-term weakening as consumers show growing concern over their budgets. This belt-tightening was expected, with the temporary stimulus of tax refunds and surpluses from refinancing having largely burned out and uncertainty in Iraq and rising gasoline prices weighing on the collective psyche of consumers. Despite the recent slowdown, retail sales in the first quarter of 2004 remained significantly above those of the prior year. The strongest gains were in building materials, and garden equipment and supplies, which were all up over 20% from 2003. Electronics and appliance sales have also been strong, followed by food services and clothing. Vehicle sales have been somewhat disappointing, due to a combination of a pullback in incentives and saturation levels associated with previous purchases. This situation should remain stable, although rising gas prices have renewed interest in hybrid vehicles at the expense of the gas-guzzling SUVs that have been in vogue among many consumer segments.

In addition to moderation in demand for retail goods and services due to budget concerns, the potential for retail sales growth has been somewhat cannibalized by a rise in expenditures for travel and vacations. Travel and vacation spending, which have been suppressed for several summers due to terrorism concerns, have been increasing as households return to more normal expenditure patterns and release some of the pent-up demand of the past several years. If early travel patterns hold, and price increases and terrorist threats do not dampen demand, airline passenger loads are likely to remain high, with demand outstripping expansion in flight capacity by the struggling airline industry. Absent any external shocks, consumers might come back from summer activities with a fresh attitude that complements the improving economy and stimulates the retail sector.

Internet retail sales continue to grow at a robust pace, with year-over sales rising almost 30%. Despite this increase, Internet sales are still off the frenetic pace in the 2003 fourth quarter; this pattern reflects the seasonal pattern of the broader retail sector. Over the near term, retail sales are likely to be somewhat flat, but there are prospects for moderate increases as improvements in the employment picture and the general economy ripple over into consumer sentiment and retail appetites.

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Housing Market

Despite a moderate rise in interest rates, the housing market has remained relatively strong. With respect to housing volume, homebuilders continued to add to the stock at a healthy pace, with completions in the 2004 second quarter up about 10% over 2003. Housing starts are also continuing to rise, with April figures about 20% over the prior year, although the monthly rate of growth has softened somewhat. This moderate cooling off relative to prior years was echoed in building permit activity, which fell in line with completions. Thus, there will likely be a surge of new product hitting the market in the summer/fall, followed by a more moderate rate later in the year. This forecast depends heavily on the overall economy, with homebuilders more than ready to gear up to respond to increasing demand. Similarly, a rise in the cost of building materials, land, and labor could put a damper on new housing activity, especially if mortgage rates trend upward as expected. This potential is punctuated by the dramatic decline in the sales of new homes in April, which plummeted 12% from March, but were still above those of the prior year. On the other hand, existing home sales are expected to remain strong, especially if employees show a willingness to shop for new jobs and relocate.

Some of recent strength in the single-family housing market can be attributed to the recent upward momentum in prices that has bolstered the perception of housing as a solid investment. This positive halo will likely continue, assuming there are no major interest rate or terrorist-related shocks that cause a price correction. Going forward, the economic recovery should help the housing sector as rising incomes offset increases in mortgage rates. There is some risk that marginal buyers may get caught in the lag effects of the recovery, especially if they have to relocate to access higher wages and better jobs. Homeownership rates remain strong, continuing to break records although recent gains have moderated. While there will be less upward pressure on homeownership rates than in the recent past, there are few signs of a major reversal. Indeed, homeownership rates are expected to be rather sticky, although sellers who bought at the peak might experience some disappointment as they move on. Further, rising mortgage rates and increased mobility of the workforce is expected to put moderate downward pressure on homeownership, especially for households on the margin that have internalized low interest rates in order to buy their current homes and will have less access to such price support going forward, especially if their housing gets caught in the affordability gap.

Construction Activity

As over much of the past several years, weakening conditions in the economic and spatial markets has placed a damper on new construction activity. This situation has resulted in commercial construction patterns that vary significantly from that of the housing market, with more moderate increases in recent months and year-over figures. The year-to-date private construction levels have increased at a moderate pace, with the residential sector contributing the most to new stock and the office/commercial sectors remaining rather flat. The exceptions to this pattern were in the retail sector, which showed some gains as retailers explored new concepts to capture market share, and the warehouse component where changing supply-chain requirements created the need for new product.

Despite these increases, it should be noted that private-construction levels remain tempered. The cyclical constraints on new construction activity have served the market well, helping avoid premature activity that periodically springs up early in market recoveries as developers seek to be the first to catch the next wave. While the reliance on recourse construction debt has helped align the interests of developers and lenders, and helped constrain new product, the momentum that is building on the economic front has been setting the stage for new construction activity. This tendency has been amplified by the tight market for existing product and the inability to capture assets at cap rates that fall in line with long-term levels. The intense competition surrounding brokered transactions for existing product has led some investors to the development frontier as a way of sourcing assets. This tendency is expected to continue to play out as the broader economic recovery spills over to the real estate market and investors seek higher returns than available for existing, fully priced assets.

Through the second quarter of 2004, total public construction activity has reflected a similar pattern to that in the private sector with moderate increases. On the public front, the majority of increases in construction activity have been in the educational and infrastructure components. Examples of these infrastructure components include transportation, power, highways and streets, sewage and waste disposal, and water supply. The demand for such activity is likely to continue to build in light of aging infrastructure and limited capacity, although the sources of funding for such projects remains in doubt given the overall budget situation. The outlook for private and public construction is somewhat positive, yet moderated by excess capacity on the private side and fiscal limitations on the public side.

Real Estate and Capital Markets

In the words of the late James A. Graaskamp, "real estate is a space-time, money-time product." As such, it is important to look at both sides of the equation since the two perspectives approach the asset class from markedly different perspectives, but in the end converge to form the overall market environment of supply and demand.

Over the past decade, the money-time perspective has risen in importance, concurrent with the rise in securitization (e.g., real estate investment trusts and commercial mortgage-backed securities), globalization, and positive net capital flows to the asset class. During this period, real estate also became more recognized as an asset class, as attested to by the inclusion of Equity Office in the S&P 500 earlier in the decade and the inclusion of some twenty REITs in various Wall Street indices. Attendant with the emergence of a long-term position on Wall Street, a number of new national data vendors, clearinghouses, and other sources of market monitoring have sprung up. This growth has also carried over to the rating agencies who have come to play a key role in monitoring capital flows and real estate fundamentals as a by-product of their rating activities. Over the past several years, the greater insights into real estate fundamentals offered by such sources, coupled with more traditional real estate advisory and consulting operations, have highlighted the impending weakening in market conditions that have characterized the overall real estate market. Despite this added scrutiny and the prospects for further erosion in market fundamentals, capital flows to the asset class and related capital market activity have not been dampened.

To a certain extent, the continued influx of capital into real estate in a declining market can be attributed to the defensive nature that the asset class took on, providing a safe haven for investors shocked by the more traditional markets. As the overall economy recovers and other asset classes regain their momentum, there will be pressure for real estate to produce competitive risk-adjusted returns. This pressure will be greatest among those who view real estate as an industry sector rather than an asset class with a long-term asset allocation. In this environment, capital players are expected to develop a greater appreciation for the "Main Street" side of the industry, seeking out value creation and enhancement opportunities. This cyclical trend will be interesting to watch, as greater attention will be paid to risk within the asset class, and investors seek higher returns with commensurate increases in risk. On the other hand, investors who do not focus on such market subtleties are likely to be disappointed and find themselves on the wrong side of transactions.

Looking forward, the capital markets will continue to favor real estate, with ample flows of debt and equity helping maintain values and support transactions. This situation remains on par with prior quarters, with little on the horizon to suggest any major changes. The anticipated rise in interest rates could adversely affect buyers that have been using positive leverage to enhance returns, as they will be forced to the sidelines. However, such a change would have little affect on the broader real estate market given pent-up demand from institutional investors who tend to use leverage in an incidental manner and do not rely on leverage to help support transactions.

Commercial Mortgages

During the second quarter of 2004, the commercial mortgage market remained extremely competitive, with private and public sources battling for limited opportunities. Competition was particularly strong for seasoned, core assets that have upside potential and relatively limited downside risk as the overall economy improves. The pressure on deal flows has resulted in some recent softening in credit standards, as evidenced by the growing availability of interest-only loans that reduce debt coverage requirements and soften the blow of flat rents. Similarly, more lenders have been willing to waive escrow requirements, freeing up cash-flow management to favor borrowers. This moderate shift has no doubt been in response to a recent decline in loan opportunities, as pipelines have shortened, raising the stakes on existing opportunities and forcing lenders to approach individual transactions more aggressively. This situation has also created a window for refinancing of less attractive products, with lenders less likely to discriminate as much among individual applications.

For commercial mortgage-backed securities (CMBS), the competition for product and the search for yield has skewed investor interest toward lower-rated traunches and allowed more deals to come to market. However, the percent of issues that are in the bottom end of subordination levels has actually declined, as more recent securitizations have been more selective, avoiding some of the problem sectors such as hotel and health care. Similarly, there has been growth in new product mixes, with increases in issues collateralized by fewer significant assets, as well as those with a large number of smaller assets. Going forward, the commercial mortgage market—both its private and public components—is expected to remain extremely competitive, although rates are likely to rise moderately in reaction to the Fed's likely tightening. This situation bodes well for the lagged recovery of the real estate market, with ample capital flows and somewhat relaxed underwriting standards helping bridge the lagged recovery period.

Private Equity Market

As with the commercial mortgage market, the private equity market remains extremely competitive with investors continuing to compete for product. This situation has been extremely frustrating for pension funds and other institutional investors that have lost normal market share of commercial purchases to nontraditional investors—both domestic and international—who have been willing to sacrifice current returns for product. Thus, there is significant pent-up demand from institutional buyers, many of whom are looking forward to rising rates to level the playing field and allow them to compete with more aggressive, highly leveraged players who have taken advantage of low-cost financing to bolster current returns. These buyers have also tapped into the growing mezzanine-financing market, which has allowed them even greater flexibility to engineer higher returns from fully priced real estate.

At the same time, the availability of such financing has also allowed more aggressive buyers to spread out limited equity, creating a ripple effect that has affected a disproportionate share of the market. In addition to allowing borrowers to stack mezzanine, or secondary, debt on top of existing permanent mortgages, the availability of mezzanine debt has also allowed marginal borrowers to draw on external financing to bridge over a decline in rental income and/or cover tenant improvements and capital expenditures necessary to stabilize bottom line performance of individual assets.

The strong demand for real estate from private equity investors is likely to carry through the balance of the year, with pension funds becoming more aggressive as they seek to bolster holdings. While the focus of pension funds will remain on core assets (with a target of some 60%–70% of total holdings), interest in value-added investment and higher returns will also continue to grow. This increased appetite will be most pronounced among pension funds that took advantage of aggressive buyers and have sold into the market using strong capital flows as an opportunity to cull their portfolios of underperforming assets and other holdings that were not seen as long-term holds.

In addition to allowing established institutional real estate investors to selectively sell assets to bolster returns, the strong demand for institutional product translated to strong total return figures for the NCREIF Index (published by the National Council of Real Estate Investment Fiduciaries). Despite weakening real estate fundamentals and an investor class committed to real estate for the long-term, total returns in the NCREIF Index pushed 10% in the first quarter of 2004, with relatively strong income figures and solid value gains. The returns varied dramatically by property type, reflecting the greater variability in asset performance that can be expected at the bottom of a market in terms of real estate fundamentals. The highest annualized returns were in the retail sector, with strong double-digit returns signaling a return to that property sector and strong retail fundamentals in the consumer-led recovery that characterized the past twelve months. While some of the fuel has been burned out of that sector and consumers are expected to temper their activity, strong investor demand for retail product and solid income figures are expected to continue to bolster performance.

Apartments also racked up strong year-over total returns, followed by industrial and hotel. While income returns for hotel and office remained competitive, values have weakened, with negative appreciation over the prior 12-month period. Since pension funds have been predisposed to lower returns for real estate, especially the core-type that dominates the NCREIF Index, the asset class should continue to attract capital with limited downside risk in terms of asset demand.

Public Equity Market

After several years of strong performance, the REIT industry has struggled slightly in the second quarter with returns for the first half of 2004 slipping to low single digits. While this movement was disappointing, the sector was able to recover from negative returns experienced through the first four months of the year. Fortunately, other asset classes have also struggled, allowing REITs to remain competitive especially on an annualized basis that benefited from a strong 2003.

Among property classes, declines in indexed returns were fairly widespread through June, with self-storage facilities, mixed industrial/office, and retail leading the property sectors. Regional malls also continued to show strength, although not on par with the prior year and the strong returns the sector had previously exhibited.

Despite the somewhat disappointing results for REITs overall, the industry retained a relatively healthy balance sheet with debt loads in line with long-term averages. Assuming the economic recovery continues and spills over to the real estate markets, the outlook for REITs should be positive, although not at the level of its recent performance. While REITs will continue to focus on existing assets and quarterly returns, they will also be looking for opportunities to inject additional revenues to their bottom lines, setting the stage for more creativity as they seek to create value that can be translated to share prices. The strong market for assets will also allow REITs to lay off underperforming assets or those that require capital expenditures that may not pencil out in the current environment, but which will not be fully discounted by asset-starved buyers.

Real Estate Outlook

The Main Street Perspective

The overall real estate outlook remains rather flat, with excess capacity and an anticipated lagged recovery dominating the asset class. While this outlook might appear to be negative, in reality it suggests that the real estate cycle is bottoming out, with moderate gains offsetting losses. Although there are few prospects for a major resurgence in demand, some markets and property types are experiencing improving market conditions. As in the past, this improvement benefits from continued constraint on new development that allows the market to absorb some excess capacity.

Concern over the future demand for office and industrial property has an increasing number of office and industrial developers looking at expansion into other property types, with residential and mixed-use properties of the most interest. The attraction of mixed-use properties has been enhanced by expansion of the overall smart-growth movement that has focused on infill development and densification of urban markets. The appeal of mixed-use development as a means of reinvigorating urban centers has trickled over into secondary and tertiary towns, with a growing number of communities encouraging new projects to help rekindle stagnant downtowns. Despite the intuitive appeal of such developments, it should be noted that mixed-use projects should not be seen as a panacea for developers or communities. That is, despite positive support from proponents of smart growth, the long-term success of mixed-use projects will depend on the ability to satisfy market demand in an on-going sense. This caveat applies across the board, with the outlook for real estate increasingly dependent on the ability of space producers to generate new product and reposition existing product to satisfy the enduring needs of space users.

Given the increasing fragmentation of demand as commercial users become more specialized and households become more diverse, real estate professionals will have to pay more attention to market segmentation and product stratification to ensure success. This added precision will be especially important as the economic recovery spills over into the real estate market on a more selective basis than the widespread recoveries of the past. Thus, the stage will be set for clearer winners and losers, with the rising economic tide proving elusive for commodity space that misses the mark in terms of tenant demand due to locational, physical, or functional obsolescence.

Office Market

The office market has continued to tease investors, with the modest improvement in the 2003 fourth quarter giving way to slippage in 2004. Although there are few promises of a resurgence for the office sector, vacancy rates appear to have stabilized, with downtowns holding in the midteens and suburban markets lagging by an additional 3% vacancy rate.

As might be expected, rental rates also have languished, with little signs of a near-term recovery. Indeed, most owners remained focused on retaining current tenants, putting pressure on disposable income as tenants are well aware of their bargaining power and have sought full compensation for their loyalty. Despite pressure on the bottom line, low interest rates and a decline in mass layoffs have helped avoid an increase in delinquency rates, suggesting buyers have been able to hold onto current assets without dumping product. The demand for core assets is also helping bolster values and provide access to refinancing, which when coupled with the availability of mezzanine debt, should allow owners of strong assets to wait out the recovery.

Thus, it appears that the majority of owners have figured out how to carry their holdings through the trough. For those who have decided to sell existing assets, those with solid rent rolls and market fundamentals have found a ready market. This situation extends to assets with solid fundamentals and some rent-roll risk, where opportunistic or value-add buyers can justify any risk in the anticipation of a market recovery. While there is little promise of a major turnaround on the demand front, the sustained growth in jobs (especially in the service sector) may portend an end to the long office drought. This potential may in part explain the improvement in net absorption that some markets have experienced and set the stage for moderate, lagged improvement in the latter half of 2004.

Retail Market

Compared to other property types, the retail sector overall has experienced a relatively easy path with few dramatic declines over the near term. The exception to this situation is aging retail centers with functional and locational obsolescence, and the loss of one or more anchors. This sector is seeking to firm up bottom-line performance and close under-performing assets.

Going forward, the contraction of some retailers presents expansion opportunities for others as merchants focus on unit profitability versus market share. This situation can be illustrated by negotiations between such retailers as Home Depot and Kmart, and the interest being shown in shuttered Mervyn's locations. In most markets, leasing activity remains strong with moderate increases in net effective rent attesting to strength in the sector. On the other hand, vacancy rates have been relatively stable, despite competitive threats from super centers.

While the retail sector has cooled somewhat on the demand side, retailers themselves continue to innovate and seek new opportunities to capture consumer expenditures. Most retailers are exploring new formats and revamped product lines, trying to position themselves for the next wave of economic expansion. Of particular interest are new urban formats, viable mixed-use options, and off-mall locations. This interest in product differentiation is attributable to a number of factors, ranging from the increasing diversity of the U.S. population, to the search for untapped opportunities in underserved markets.

In terms of investor demand, the retail sector should continue to attract strong interest in both the public and private sectors. This interest is relatively new, as many investors eschewed retail as too competitive and with little opportunity for stable returns relative to underlying risk. Over the past several years, however, investors have learned that change and competition are not necessarily bad or capital intensive, and that by linking up with credit tenants and proactive managers, retail can provide competitive risk-adjusted returns. This situation should continue over the near term. Furthermore, as concerns over inflation build, the inflation-hedging potential of participating leases and repositioning existing properties to exploit emerging opportunities provides some upside potential. On the other hand, it should be noted that not all retail properties will benefit from a rising tide and that it will become even more important to "act like a retailer" and "think like a consumer" to sustain performance levels and beat the overall market.

Industrial/Warehouse Market

During the first half of 2004, the overall industrial market seemed to pause rather than make significant progress toward absorbing excess space. However, there was some moderate improvement in terms of positive absorption in the first half of the year. Unfortunately, additions to stock continued to outpace absorption; this placed upward pressure on overall vacancy rates and led to weakening market fundamentals. As might be expected in the current environment, rents have languished with few opportunities for improvement. However, some improvement has taken place in sectors that have not been in the bull's–eye of production, such as bulk space, flex, and R&D properties.

The fledgling recovery in manufacturing employment is being closely watched by industrial investors and developers. The weak dollar has helped stimulate warehouse demand, although the improvement has been concentrated in those markets positioned to respond to the global supply chain.

Looking forward, while there is concern over additions to supply, the outlook for the sector is moderately positive as the economy picks up steam and excess capacity is burned off. This situation explains some of the strong capital flows, with those seeking to unload product being met by a ready spate of buyers. Of particular interest are modern facilities, those that benefit from multi-modal capacity, and those with the ability to respond to future technological advances, such as radio frequency identification (RFID) technology, which may revolutionize supply chains.

Apartment Market

After a number of years of general weakness, the apartment sector has begun to demonstrate signs of improvement, although the market remains somewhat flat in terms of fundamentals. Overall, vacancy rates have moderated and rental inquiries have increased, suggesting that at least in some markets activity levels are picking up. In spite of the relatively weak market that has characterized many apartment markets over the past several years, capital flows into the sector have remained strong. This situation is expected to continue over the near term as investors seek to maintain asset class allocations across property types and grow their real estate portfolios. Despite these positive signs, rental rates remain inhibited and concessions continue to proliferate in many markets.

The good news is that the leakage to homeownership seems to have abated and supply growth has tempered in some of the more problematic, national markets. A number of national developers have cut back in major markets that clearly have supply-side issues, leading to modest improvements in market fundamentals. Interestingly, these declines in new construction have been offset by increased construction in secondary and tertiary markets where local and regional developers rule.

The demand for apartments has some upside potential associated with rising interest rates and the economic recovery. With respect to rising interest rates, higher mortgage costs should take some of the marginal households out of the homebuyer market and dampen continued expansion of homeownership rates. On a related note, as the recovery kicks in and employees begin to search for new jobs, there will be increased demand for interim housing due to relocation. This situation will be amplified as companies cut back on benefits to offset rising costs, which will in turn result in more job seeking.

Depending on how far mortgage rates tick up, homeowners on the margin who helped "bubble up" housing prices may find themselves trapped in their current locations because of their reduced purchasing power. Indeed, for some who bought at the top of the market, the friction associated with turnover may actually erode wealth and inhibit the ability to respond to new opportunities and seek greener pastures. While this scenario might not play out if recovery proves to be robust and widespread, and interest rates remain low, it does present an upside risk for the apartment market and may enhance returns for properties that have solid fundamentals but have suffered due to the conversion of renters to owners.

Conclusion

Going into the summer of 2004, the commercial real estate market continues to show signs of improvement, with the much-awaited economic recovery providing some upside potential. Despite the general outlook, much hinges on the overall economic recovery, the ability of the Fed to walk the fine line between inflation and expansion, oil prices, and the terrorism situation. Although rising interest rates will be a concern, the pace of increase is unlikely to create major issues for the real estate sector.

While consumers are likely to return to "summers as usual," the real estate industry will remain uncharacteristically busy as investors seek to fill appetites, from both debt and equity products. Overall, real estate fundamentals should exhibit more stability, with gradual improvement rippling across most property sectors and markets. Thus, real estate fundamentals should continue to improve, helping bring prospects for higher returns that will enable the asset class to compete for capital on par with other asset classes. The result will be a very interesting election year, one that could be a turning point in the real estate market.

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