Changing of the Guard, Guarding of the Change

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Commentary

Election years are always tricky in terms of economic, capital, and real estate outlooks. This year was no exception, with the polls coming down to the wire as the two candidates and their parties squared off. Regardless of the election, one certainty can be counted on: changes are coming. That is, the economic status quo is neither acceptable nor possible.

A purely defensive strategy that guards against change is not viable. Without purposeful change, the country will fall off the fiscal cliff and things will change on their own as the economic situation gets very ugly, very fast. Specifically, unless Congress acts before the end of the year, the United States faces the fiscal cliff created by the simultaneous expiration of the temporary payroll tax cuts passed last year and the tax cuts passed in 2001–2003 to stimulate the economy. Further amplifying the problem will be changes in business tax breaks and the alternative minimum tax that increase tax burdens at the same time as new taxes kick in to cover health care reform. Finally, the automatic spending cuts that will kick in as a result of the debt-ceiling agreement reached in 2011 will go into effect, slashing 9.2% from defense spending, 8.2% from nondefense programs, and 2% from Medicare. Other entitlement programs are exempt, although that might change as lawmakers struggle to stay within the budget limits. The fiscal cliff represents around $600 billion in combined new taxes and spending cuts, which could plunge the economy into a darker and longer recession than the one the country is struggling to put behind it.

The path to effective change must be carefully guarded to ensure it does not get embroiled in politics, semantics, or histrionics. Such obfuscation will only lead to failure, which is clearly not an option at this precarious point.

While some of the headwinds the United States faces are of our own making, other headwinds are beyond our control and emanate from global forces that the United States must come to terms with. During these challenging times, there is a desperate need for effective leadership that can identify action plans and initiatives that marshal bipartisan support. The emphasis here is on *effective* leadership, which cannot occur unless there is a willingness to join together and get through these troubled times.

Once a national economic agenda is developed and approved, the country must be on guard to ensure the nation does not fall back on old bad habits, i.e., relying on the passage of time to cure the problems. Indeed, a failure to adopt and implement necessary changes in a forceful and timely manner will put the United States at risk of being passed by in the global arena and losing even more traction. Hopefully, federal policymakers and economic guardians will recognize the perils of the current position and take appropriate actions. This will be of paramount concern to the economy and capital markets, as well as to the real estate market that ultimately houses that activity.

On an interesting note, the real estate and macroeconomic environments during 2012 have exhibited a growing pattern of disconnect, with concerns over the economy being eschewed by many players who are making the market. To this point, this lack of integration or correlation has been concentrated on the capital side of the equation, resulting in record-low yields for institutional real estate. This trend has been most pronounced for larger core assets and assets located in select gateway markets, although investors have begun to expand their horizons in search of higher returns. The situation is reminiscent of the capital-driven surge in real estate prices that led up to the 2008 correction. In the current situation, however, there has been a dramatic recovery in reported market values that was unprecedented and unexpected by those who had experienced the prolonged recovery after the 1980s market collapse. In more normal times, a recovery in pricing would have had to overcome investor angst and a lack of tolerance for risk, and the value recovery in the real estate industry would have depended on an overall economic recovery, with sufficient improvement on the spatial side of the market to drive up net operating income. This requirement clearly has not been met, and yet values reported in the NCREIF Index have made a remarkable recovery after a surprisingly brief respite.

Granted, a certain level of the recent surge in values of private institutional holdings may be supported through traditional appraisals based on a combination of comparable sales and discounted cash flows. However, it should be noted that the outcome of such analysis is based on extraction of market behavior from the "most probable buyers." To this point, the active players in the market have exhibited low yield requirements. It is important to note that the pricing behavior exhibited by these players is based on spread investing, which depends on the low interest rate environment created by intervention from the Federal Reserve (the Fed). Over the near-to-intermediate term, this situation is likely to continue based on the Fed's pledge to hold short-term rates low until 2015 and its introduction of a third wave of quantitative easing to suppress long-term rates. While this stimulates the market, the situation cannot hold over the long term.

At the same time, investor psyche and behavior is likely to shift as it becomes clear that real estate is not the safe harbor some have come to expect. As this plays out, investors are likely to take a more guarded approach with respect to real estate values and shift attention to preservation of capital. This is especially true for investors who are in mark-to-market accounts that may experience downward pressure on values as yield requirements rise. This will be more pronounced for investors who need or desire liquidity over the next phase of the cycle. That said, a lot of money remains to be made while the market plays musical chairs, which creates a real conundrum for those trying to place capital in the institutional market as well as those charged with valuing current holdings.

The Economic Environment

Economic Growth

The US economy continues to struggle to hold its own, much less gain the momentum needed to put the country on the path to a sustainable recovery. During the first three quarters of 2012, growth in real gross domestic product (GDP) decelerated, falling under 1.5% during the second quarter. Since those figures were released, there have not been signs of a reversal and the economy has been buffeted by a number of forces, including the prolonged drought, the impending fiscal cliff, the slowing global economy that weakened exports, and the lack of confidence in leadership. The unexpected decline in durable goods orders in the summer and the downward revisions for the second quarter weighed heavily on the collective outlook of business leaders who play a critical role in turning the economy around. Granted, much of the decline in manufacturing activity was attributable to the commercial airline industry, but slippage was fairly widespread across most durable categories.

With an already-slowing economy and GDP forecasts in the 2% range, the odds that the United States will fall off the fiscal cliff and plunge the economy into a recession are greater than indicated by the press the issue is receiving. Indeed, a recent *Wall Street Journal* poll of economists reports that almost a fifth of economists believe a standoff will occur, while only slightly more than that believe a compromise will be reached. Most economists believe Washington will continue to kick the can down the road and avoid addressing the serious issues at hand. While this scenario might play out, it would merely forestall the issues that must be addressed by the next administration and Congress. In the meantime, unless some sort of deal is cut, the automatic expiration of tax cuts and wave of mandatory spending cuts could throw the economy into a prolonged downspin and offset some of the ground that has been gained on the housing and employment fronts.

On the global front, the European Central Bank (ECB) made a commitment that it would do whatever it takes to ensure the euro zone remains intact. This commitment included bond purchases to reduce borrowing costs for euro-zone members, as well as purchases of mid-term sovereign debt. To qualify, governments had to accept strict oversight and make structural changes to stabilize their economies and reduce the risk of ultimate failure. Given these measures, the short-term crisis across the euro zone appears to have been resolved, although no long-term solution has been offered. Indeed, a number of difficult decisions must be made and implemented during the brief respite the ECB intervention has provided. In the meantime, the debates are likely to be heated as competing objectives are rationalized. The economic outlook across Europe remains guarded with significant downside risk.

The euro zone slowdown rippled across the overall global economy—slowing the frenetic pace of growth in China and affecting the US economy, which had been looking at exports as a rallying point for a recovery. Although progress has been made on the global front, the overall outlook will remain guarded well into 2013. This backdrop will create an even more difficult environment for developing the critical consensus needed in Washington to overcome obstacles.

Employment

After a strong 2012 start, employment growth has tapered off with the exception of a brief uptick. The summer decline was led by the manufacturing sector, as companies reacted to concerns over a global slowdown. Small businesses also continued to struggle, taking a guarded approach that slowed employment growth and decreased total hours worked. At an overall level, job openings have been flat, with little sign of improvement. Employment growth was mixed across the country, with some 60% of states reporting increases going into the third quarter and the balance reporting net losses.

In terms of layoffs, job cuts remained low in August, continuing the downward trend that held through much of the year, with the exception of a temporary spike that occurred midway through the second quarter. Employment costs remained in check, with wages and salary growth continuing to disappoint workers. Growth in the benefits component of total compensation was slightly higher, although employees' share of benefits costs continued to increase.

The 7.8% unemployment figure reported for October caught many off guard and provided a boost to President Obama's campaign. The unexpected decline in unemployment, however, evoked quick responses that called the figures into question. As might be expected, the charges were met with vociferous denials and punctuated the key role of employment in the elections. While mainstream candidates avoided attacking the statisticians who compiled the unemployment data, there were questions as to whether the figures provided an accurate picture of the plight of the unemployed. For example, it was pointed out that the figures ignored the decline in labor-force participation, resulting in an understatement of the real unemployment rate. While labor-force participation had indeed declined, the pattern was cyclical and did not appear to differ from other recessionary periods. This debate is likely to continue as policymakers try to deal with continued softness on the employment front in the face of a slowing economic outlook.

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Inflation and Interest Rates

While the slowdown in gross domestic product (GDP) growth has created a number of challenges for the economy, it also has made it possible for the Fed to continue its low-interest-rate policy. Indeed, the Fed has committed to hold interest rates low into 2015, providing some stability to the market. At the same time, the commitment to low interest rates has helped bolster prices for investments that benefit from low-cost capital. This upward pressure on prices has been particularly pronounced in the real estate arena, where spread investors have been willing to accept lower income yields than in more normal interest-rate environments. To help bolster these pricing effects, the Fed introduced a third round of quantitative easing (QE3) that involved a new wave of mortgage-bond purchases.

Despite having the desired affect and holding down rates, this latest intervention has eroded profit margins and created additional challenges for banks and other mortgage providers. This situation was exacerbated by the wave of refinancing activity in which more mature, higher-rate mortgages were supplanted by lower-rate loans. The fees generated by the surge in activity were welcomed by the industry, but they were a short-term phenomenon that largely has run its course. The low rates also have wreaked havoc on retirement plans, creating unwelcomed challenges that are particularly pronounced for 401(k) plans, which depend on safe investments to offset the lack of investment savvy and market acumen that characterizes most individual investors.

On the inflation front, the Consumer Price Index (CPI) has exhibited moderate increases—but, only after the energy and food sectors have been removed from the equation. The energy component has been particularly volatile, with prices soaring by 4.5% in September. Food prices increased, in part due to the drought, although not nearly enough to cause long-term concerns for consumers. With the exception of energy, import price increases moderated, in part due to the euro crisis that caused a global decline in growth in demand. The Producer Price Index (PPI) spiked in late summer, driven by the surges in energy and food prices that are likely to prove temporary and not signs of an impending wave of inflation. This is particularly true in the case of energy, where prices already have fallen back in light of the global slowdown.

On the employment front, tempered business confidence levels and the lack of hiring activity have combined to keep pressure off of wages. This situation is likely to hold over the near term.

Business Indicators

Business indicators remain mixed, with an increasing number slipping over the recent past. This decline pulled some business barometers to their lowest level in three years, bringing back memories of the Great Recession. For example, the manufacturing slump continued to hang over the industry with few signs of a near-term reversal. The service sector also experienced a slowdown, reversing the upward trend that occurred earlier.

Business confidence levels have continued to trend downward as businesses have become more guarded with the fiscal cliff and other impending issues looming. This outlook is particularly true for the near-term as businesses wait to see how policy changes in Washington—or lack of them—will play out. The result of this angst is likely to be a decline in business investment, which will take out one of the bright spots that has helped the fledgling economic recovery up to this point in the cycle.

Amid this uncertainty, the near-term outlook remains guarded, with much depending on what happens post-election and Congress's willingness to focus on the issues and put partisan politics aside. Given the heated debates leading up to the election, this may prove to be a formidable challenge even as the stakes continue to rise and fewer degrees of freedom in which to maneuver are left on the table.

Stock Market

The stock market has not been immune to slowing economic conditions and growing concerns among businesses regarding the near-term outlook. In addition to the impending fiscal cliff, the recent spate of lower quarterly earnings has added to stock market volatility. This disappointing news led to a decline in stocks in late October that was the greatest single-session loss since the end of the second quarter. The decline occurred despite positive news on the housing and retail sales fronts, indicating investors have started to focus on some of the challenges facing the economy that might disrupt the market.

The declines in the stock market were fairly widespread and extended to commodities, suggesting the guarded attitudes among investors. Concerns over the market skewed investors to Treasury bonds, placing downward pressure on already-low yields, which fell to 1.76% for ten-year Treasuries.

The setback in the stock market was not confined to the United States, with European stocks experiencing similar declines and Asian markets somewhat mixed. This global slowdown manifested itself in declines in the transport sector, with FedEx and UPS reporting lower earnings outlooks. Similarly, the broader Dow Jones Transportation Average—which is comprised of twenty airlines, railroads, and trucking companies—exhibited declines and remains in negative territory for the year-to-date.

Corporate profits and news from the euro zone are likely to continue to hang over Wall Street and its global counterparts, although the US market has enough challenges on its own turf to create uncertainty and near-term volatility. This is likely to put added pressure on stocks and skew investors toward more guarded strategies. The search for ever-more elusive safe havens may benefit the commercial real estate market as long as fundamentals are stable and capital flows to the asset class remain strong.

Consumer Confidence

Although business confidence levels have slipped, consumers seem unaware or indifferent to the challenges facing the economy.

In general, consumer sentiment slipped late in the third quarter, but consumers remained surprisingly hopeful. This situation can be traced, in part, to reports of an improving housing market and some stabilization in employment. The fact that both of these indicators were in negative territory for so long and hit home so hard may explain why even a modest recovery would bolster consumer sentiment. While the housing market and employment indicators are likely to remain moderately positive over the near term, at some point after the election consumer attention will shift to the need to address the fiscal cliff, the likely increase in taxes, and the reduction in government spending. The heated debates that are likely to surround these issues are expected to put a damper on consumer confidence levels.

Retail Sales

In retrospect, the slowing economic outlook and recent declines in consumer sentiment should have led to a decline in retail sales. In reality, retail sales continued to expand moderately during the third quarter and reversed the declines experienced in the first half of 2012.

A number of consumer categories enjoyed increases in sales activity, which was led by automobile sales. Retail sales overall have been relatively steady but far from stellar. Chain store sales were surprisingly strong at the end of the summer, coming in ahead of expectations. Department store sales were particularly strong, while the apparel and luxury segments also surprised on the upside. Retailers are doing their part to bolster retail sales, with the holiday season arriving even earlier than in recent years and stores rolling out a spate of layaway plans.

Going forward, the outlook for retail sales is moderate, with much riding on the housing and employment fronts and the willingness of consumers to take on debt. These three drivers are all at risk in a slowing economy. In this environment, retail sales are expected to lag a recovery, although some segments will continue to outperform.

Real Estate Market

Housing Market

Since the collapse of the housing market in 2006, it has been the bellwether for the economy.

The housing market has finally shown some signs of bottoming out. While a number of issues remain and a significant backlog of distressed product hangs over the market, there have been some positive signs. Indeed, on a relative basis the housing market has been one of the few bright spots on the economic horizon. While far from entering a bull run, the downward drag of the housing market on the overall economy may have finally run its course, setting the stage for a modest recovery.

In terms of housing prices, a number of markets have experienced some improvement. Existing home prices have risen on a year-over basis, outperforming expectations in many markets across the country. This marks the continuation of a trend that began during the second quarter and helped build a modicum of momentum for the much-maligned sector of the economy.

Homebuilder sentiment has improved throughout the year, rising to the highest level since the beginning of the housing market collapse in June 2006. Improved sentiment associated with the increase in new home sales has led builders to begin to build up a modest pipeline and buyers to take advantage of low mortgage rates.

Although there is some positive news on the housing front, the sector is still not out of the woods. The industry must still deal with a substantial overhang of distressed properties and homeowners who are underwater. The recent uncertainty surrounding the overall economy must also be overcome. Buyers who have returned to the market and builders who have increased production will remain guarded and will be quick to react to negative news. Similarly, discussions of tax reform—including changes to mortgage deductions and other initiatives —will hang heavily over the sector.

Office Market

On the spatial front, office market fundamentals have exhibited some moderate improvement, which is expected to continue unless the economy slips back into a recession.

At an overall level, national office-vacancy rates have trended downward, falling to the mid-teens as net absorption improved. Despite this improvement, rent growth has been relatively modest, creating a gap between rents needed to support new construction and current values.

The lack of new construction has been fairly widespread, as speculative development capital remains tight. However, a select number of markets (e.g., San Francisco, Seattle, San Jose, Houston, New York, and Washington) have benefited from strong

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technology, energy, health, and education sectors and have experienced an increase in development and leasing activity. With the exception of these hot spots, the outlook for the office market is somewhat guarded, a situation that is likely to continue until there are some signs the economic recovery is back on track and companies begin expanding their operations.

Even when the demand side of the equation improves, changing tenant-demand preferences, led by technological innovation and flexible workplaces and workforces, will create more differentiation in demand. This will work to the disadvantage of Class B space, tertiary markets, and submarkets that have no competitive, logistical, or agglomeration advantages.

On a transaction basis, the office market has been fairly active, with Real Capital Analytics (RCA) reporting some $47 billion in transactions through August. This volume accounted for about 27% of transactions, with an average value of $25.7 million.

In terms of regions, the Northeast and West accounted for nearly 54% of transaction volume of the six regions reported by RCA. Capitalization (cap) rates for central business district (CBD) offices increased some 40 basis points from the beginning of the year to 6.5%, while suburban cap rates were slightly under 8% but flat. In terms of relative value, the spread between office cap rates and interest rates is at historically wide level, suggesting that some capital sources may take a harder look at the sector. At the same time, investors continue to expand their geographic focus to include some secondary markets where prices are more in line with historical levels and thus may be more sustainable in the face of rising yield requirements that are likely during institutional holding periods.

In terms of existing institutional investments, the office sector in the NCREIF Property Index (NPI) through the first half of 2012 accounted for over one-third of the total $310 billion in the NPI. Total returns for offices were slightly under 5%, continuing the downward trend in returns. CBD properties continued to outperform suburban properties due to a combination of strong spatial fundamentals and investor demand. On the public market front, total returns for office real estate investment trusts (REITs) through August were slightly over 14%, reversing a moderately negative return for 2011. As was the case for equity REITs in general, August returns slipped, although total returns remained above 2011 as a whole. Dividend yields were on par with the overall all equity index.

Retail Market

Retail market fundamentals improved in the first half of 2012, but then lost some momentum as retailers became more cautious in light of the slowing economy and the lack of improvement in household earnings and consumer confidence. Despite these downward pressures, retail sales have continued to surprise on the upside, causing some to question where the money is coming from, and even more, how long will it continue to flow. Some retailers are continuing to expand (e.g., Walmart, Target, Family Dollar, Whole Foods) and have led developers to jump-start abandoned projects. These developers include local players with strong sites as well as national players with connections to tenants, such as Regency Center, Weingarten Realty Investors, and a subsidiary of the Blackstone Group LP.

While some retailers are expanding, a significant portion remain on the defensive and continue to cull their portfolios by closing non-performing outlets. On the mall front, a growing trend has been the recycling, repositioning, and de-malling of regional centers that fell by the wayside as the market contracted. The result is a widening gap between winners and losers, and greater differentiation in product performance based on a combination of solid spatial market fundamentals, proactive leasing strategies, intangible value creation, and demographic trends.

With respect to transaction volume, retail properties accounted for around 20% of total sales reported by RCA, with an average value of $12 million. Sales were spread across the country, with the West accounting for over a quarter of transactions. Retail cap rates remained flat, hovering in the low 7% range.

Retail performance on the private institutional side of the market through the first half of 2012 led other property types at over 13% annualized. Cap rates on private institutional holdings were around 6%, around 100 basis points below transaction cap rates. Retail investments continued to attract interest among institutional investors, with retail accounting for around a quarter of the NPI holdings. Dominant super-regional malls continued to outperform the sector, although a number of regional malls at the lower end of the quality spectrum came under pressure as owners sought alternative redevelopment strategies, which created opportunities for risk-oriented investors.

Retail REITs benefited from unexpectedly strong retail sales, with returns through August leading all property types with 26.7% total returns including dividends, which were slightly below overall averages. At a stratified level, regional malls turned in the highest total returns, pushing 28% year-to-date, although dividends lagged the index. The regional mall performance was even more striking than over property sectors, coming on the heels of industry-leading 22% plus total returns for 2011. The broader shopping-center category also provided solid performance, with dividends slightly above average. Reflecting a thinner market and higher risk, freestanding investments provided the lowest returns in the retail sector with dividends above par.

Industrial/Warehouse Market

On the spatial front, industrial property fundamentals improved modestly during the first three quarters of 2012. In spite of the recent decline in manufacturing activity and slowing global economy, rents have increased modestly and vacancy rates have tapered off although still above historical averages. Demand has continued to increase for larger spaces located in gateway distribution centers or markets having other logistical advantages in terms of global supply chains.

Through August 2012, industrial transactions accounted for some 12% of total sales. Average prices were around $9 million, with over a third of sales in the West region and the others accounting for an equal share of the balance. Industrial cap rates declined some 30 basis points during the year, falling to 7.5%, which was the highest of the major property sectors with the exception of suburban office.

In terms of investment performance, private institutional industrial holdings provided competitive performance through the first half of 2012, slightly lagging apartment and retail in terms of total returns. Interestingly, in spite of generally lower risk levels, industrial holdings were priced at higher cap rates than other property types, with 6.4% annualized income returns. The public industrial sector exhibited competitive performance through August, with total returns pushing 22% on competitive dividend yields. The returns were a dramatic improvement over 2011, when the industrial sector lagged all property types and had negative total returns with the exception of lodging/hotel REITs. Taking advantage of diversification benefits, mixed industrial/office REITs led the two sectors with total returns over 23% and solid 4.8% dividend yields leading all property types.

Apartment Market

At a national level, apartment-market fundamentals have continued to improve, with vacancy rates falling below 5% and pushing structural vacancy levels. Due to strong investor and lender interest in the sector, apartment construction has trended upward, with some gateway markets reporting a surge in activity. Despite these increases, investors continue to be drawn to the sector, putting upward pressure on prices and increasing unrealized gains, which has attracted new waves of capital.

According to RCA, on the transaction front apartments led all other property types, accounting for over 30% of transactions with an average value around $16 million. Transaction volume was fairly dispersed across the regions, with the West accounting for about a quarter of transactions followed by the Southeast, Northeast, and Southwest. Apartments continued to be the priciest assets among the major groups, with cap rates declining some 20 basis points by May to 6.1% and then holding flat as investors continued to chase product.

At a broad industry level, apartments remained the darling of institutional investors, garnering the greatest attention among property types. As such, apartment properties provided relatively strong total returns through the first half of 2012, coming in on par with retail holdings. However, strong investor demand and a shortage of new product resulted in apartment cap rates that were over 100 basis points lower than retail, coming in around 5.4% on an annualized basis.

With respect to public investments, apartment REITs slipped off the solid 15% plus returns for 2011; through August 2012, returns were slightly over 9% year-to-date. Reflecting strong investor demand for product, apartment dividends lagged all property types, slipping below 3%. The manufactured-home sector generated higher returns for 2011 and year-to-date, although the market cap remained relatively thin compared to other subsectors. While the near-term outlook for the apartment sector remains positive, there is a danger of overexuberance on the development side. Of particular concern is the need to approach the sector with a product differentiation strategy that matches demographic trends and is insulated from the eventual recovery of the single-family sector.

Real Estate and Capital Markets

Overview

During 2012, the institutional real estate market continued to perk along despite concerns related to the economy, political headwinds, euro zone, and Chinese economy. RCA reported almost a 40% decline in transactions during the June—August period. Despite this slowdown, transaction activity for the year-to-date for office, retail, apartment, and office properties over $2.5 million approached $150 billion—a 5% increase over 2011. On an overall basis, transaction cap rates in August hovered around 7%, down some 20 basis points from the prior year but basically flat for the year-to-date.

Core investment continues to attract the majority of interest due, in part, to the low cap rates at which properties are trading and the spread investing that some key players have adopted. In this environment, investors are expected to remain somewhat risk averse, although the pursuit of higher returns has forced them to expand their investment horizons. As a result, attention has shifted away from some of the gateway cities, with investors focusing attention on top-tier assets in secondary and, in some cases, tertiary markets.

In terms of players, the institutional market is fairly crowded with investors competing for deals. The range of active players is fairly diverse and includes traditional advisory firms, REITs, real estate operating companies, private equity funds, pension funds, and offshore investors. While the ranks differ somewhat on the buy and sell sides of the market, a number of players are active in both fronts.

Investment Performance

On the private, core equity side of the institutional market, mark-to-market real estate returns continued to hold up with double-digit returns. Preliminary estimates for the third-quarter returns for the NCREIF Open-end Diversified Core Equity (ODCE) Fund reported annualized 11.5% total return.

The increased performance in the recent quarter was driven by appreciation, with income returns falling to 5.4% on a trailing twelve-month basis. This implicit cap rate reflects some of the spread investing that has driven recent transactions, with investors willing to accept lower returns for core real estate. However, the fact that the income return is the dollar-weighted average of some $80 billion of investments in fifteen core funds suggests that cap rate compression has continued. In the dollar-weighted figures, large core properties—which have been favored by long-term investors—tend to skew the average income return downward.

To extract some insights into valuation assumptions, it is useful to compare the dollar-weighted index to the equally weighted index. In the latter case, all properties are treated alike regardless of quality or size when calculating averages overall and by property type and location. In comparing the preliminary third-quarter results, the equally weighted index reflects only slightly higher income return (10 basis points) for the trailing twelve months. This low spread reveals the continuation of cap-rate compression, which suggests lower-quality, smaller-asset valuations are benefiting from the positive halo of transactions at the top of the quality and size spectrum, as well as the dearth of transactions at the lower end. When the market returns to more normal pricing models, and interest rates and cap rates rise to longer-term averages, these properties will be at risk of unrealized value losses. While not necessarily of concern to longer-term spread investors, funds that are subject to mark-to-market valuation are likely to face challenges. To mitigate these forces and offset rising total return hurdle rates, owners will have to drive net operating income. The ability to do so will depend on a combination of spatial market fundamentals of supply and demand as well as asset quality and competitiveness.

At an aggregate level, the FTSE NAREIT Index was positive through the third quarter, although total returns continued to trend downward from the rebound in the 2011 fourth quarter. For the equity component of the index, returns exceeded 15% year-to-date, including dividend yields that have been fairly stable in the mid-3% range. Total returns for diversified REITs improved over 2011, but 2012 year-to-date returns lagged other property types and subtypes despite strong 4% dividend yields.

On the specialty front, timber REITs led other non-core property types on a year-to-date basis, with returns leading all core property types except for retail. Due to the nature of timber REITs, however, dividends lagged other property types except apartments. Lodging REITs had a relatively difficult time in 2012, with returns lagging the overall index on the heels of -14% plus returns in 2011. From a risk/return perspective, lodging REITs were also disappointing in terms of dividends. Self-storage REIT returns were below average for 2012, although performance was relatively strong in light of the 35% plus total returns racked up by the sector in 2011. Health care REITs reported below-par returns on a year-to-date basis despite higher dividend yields related to the specialized nature of the sector.

Distressed Assets

Since the collapse of the commercial real estate market in 2008, almost $400 billion of loans fell into the distressed-asset category. After peaking in mid-2009, the pace of additions to the ranks of distressed mortgages has trended downward. In terms of the outstanding balance, over the past two years the net change in distressed assets has been negative, with loan resolutions outpacing newly troubled loans.

On a year-to-date basis, during 2012 net transfers in and out of distressed-asset categories totaled $16 billion. This left some $167 billion outstanding, with $50 billion held as real estate owned (REO) and the balance in some phase of restructuring or workout. Of that total, commercial mortgage-backed securities (CMBS) accounted for the largest share of distressed assets followed by domestic banks, "other" lenders, international banks, and life insurance companies.

Of the outstanding mortgages that went through foreclosure in the third quarter, lenders recovered roughly two-thirds of outstanding balances before netting out costs of foreclosure and fees. As might be expected, recovery rates differed by property types, with in-favor apartments and CBD offices outpacing other property types. Industrial and hotel loans had the lowest recovery rates, ranging around half of the outstanding balances net of costs. In terms of life-cycle stage, recovery rates for development and redevelopment candidates surged forward as the market for land exhibited improvement. Based on anticipation of continued improvement in land values, some lenders held onto assets as developers begin to look for land to support new projects. In terms of lenders, insurance companies reported the highest recovery rates while international banks lost some ground and domestic banks and CMBS pools remained steady.

Mortgage Market

As with the equity side of the market, there is no shortage of debt capital for solid performing assets. With few options in terms of viable investment alternatives, lenders have increased the availability of debt and have become more competitive on already-low rates.

This activity has spilled over to the CMBS market, which while continuing to languish via historical standards, has benefited from an influx of capital as investors seek yield in securitized assets. This capital surge has included agency and private-label conduits as well as unsecured REIT notes. Seeking a combination of yield and product, the CMBS industry has led the foray into secondary and tertiary markets, helping expand the availability of capital across the country. Commercial banks continued to increase loan activity, accounting for over a third of originations. This activity was led by national banks, although regional and local banks have also expanded loan originations.

Despite the increase in commercial mortgage activity, the industry still faces significant challenges in terms of outstanding bullet loans that are underwater and scheduled to mature over the next several years. While some of the pressure has been taken off this pipeline through restructuring and extensions, lenders have not relaxed underwriting standards to address the impending problem. Thus, while the mortgage market remains active and access to credit at historically low rates is helping support aggressive pricing, the market remains bifurcated. An economic slowdown and a decline in property values could exacerbate this situation and bears close monitoring.

Conclusion

The United States is at a crossroads on the political and economic fronts, with no clear sense as to the best path to navigate through the many challenges ahead. Neither the status quo and nor kicking the can down the road are viable options. Without dramatic changes and action plans, the economy and real estate markets are in for a very difficult journey. Leaders at the helm should focus on developing a clear plan to guide the country forward and to guard against further malaise that could plunge the economy into an even graver situation than the one it is struggling to leave behind.

Until there is some clarity, the economy and the capital markets will continue to struggle. While the commercial real estate market gives the appearance of immunity from such forces, the current disconnect and euphoria propelling segments of the market will eventually come to a dramatic halt. However, in the absence of a major economic setback and a shift toward longer-term horizons, the commercial real estate market is expected to remain active, with a lot of money to be made over the short term. That said, during this period of change the best advice is to stay on guard and make sure a backup plan is in place.

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