Uncertain Times with Business as Unusual

by James R. DeLisle, PhD

Abstract

This column explores the current status of the US real estate market. It discusses the players and elements impacting various market segments, summarizes latest developments and figures, and offers analysis of recent trends in the real estate market.

Commentary

The third quarter of 2015 was a continuation of "interesting times," with typical long-term trends in business supplanted by unusual circumstances. The third quarter started on an upbeat note, but gross domestic product (GDP) growth then faltered somewhat, creating ripple effects across the economy. The slowdown in growth can be attributed to global uncertainty and to a number of US economic indicators that had fallen off. The result was a return to a gradual pace of economic recovery. While creating some understandable concerns, the recent slowdown did not create significant angst among investors and policy makers, but it did force the Federal Reserve to defer raising interest rates. This is likely to continue as some global central banks tsignaled that they will employ more measures to stimulate domestic economic conditions.

Interestingly, the slowdown in economic growth did not affect the real estate market, with many players remaining positive. This bifurcation between economic realities and business as usual in the real estate industry bears close watching. Strong capital flows have created an environment in which strong performance has translated to positive expectations. This situation may be sufficient to carry the market through a temporary slowdown. If the economic conditions do not improve as expected, however, then the real estate market may be in for a correction.

The Economic Environment

The US economy is at an interesting point in the cycle. The Bureau of Economic Analysis (BEA) reported an upward revision for second-quarter GDP growth, which increased at a 3.9% seasonally adjusted annual rate. The 0.6% improvement in GDP between the first and second quarter was attributed to personal consumption expenditures, exports, nonresidential and residential fixed investment, and state and local government spending. Unfortunately, the situation deteriorated during the third quarter, with GDP stumbling to a 1.5% seasonally adjusted growth rate. There were some positives however, as the consumer spending, business equipment, and homebuilding segments helped offset some of the drag on manufacturing from the turmoil overseas.

The Chicago Fed National Activity Index (CFNAI) edged downward in September, revealing that national economic activity was slowing, and remained below historical trends. The index incorporates 85 indicators of national economic activity that are clustered into four categories: production and income; employment, unemployment, and hours; personal consumption and housing; and sales, orders, and inventories. The drains on growth were fairly widespread, with 59 of the 85 indicators on the negative side. This spread of negative indicators was more diffused than in August when the positive/negative split was fairly equal.

The October 2015 edition of the Federal Reserve Districts' Beige Book noted economic activity expanded modestly during the mid-August to early-October period. Of the twelve districts, Kansas City was the only one to report a decline. Activity in Richmond and Chicago slowed from the prior period, although still expanding, with the rest of the districts reporting modest-to-moderate gains. Consumer sales were up moderately, with vehicle sales leading the increases. Manufacturing activity was mixed due, in part, to the strong dollar and a decline in export demand. On a positive note, the housing and commercial real estate markets were up over the prior period. This improvement included strengthening home prices and sales activity in most regions, especially for moderately priced units. Residential and commercial rents were also up in most markets, while construction activity, led by the multifamily segment, was relatively strong. On the labor front, conditions tightened somewhat in most regions, with some reporting spot shortages for skilled labor as well as for housing workers. Despite some improvement in labor conditions, wages were fairly stagnant. Prices were also flat, with some districts reporting declines. Conditions for banking and financial services were positive, with demand for loans increasing in a number of districts. Credit conditions were generally positive, and there has been some easing of lending standards, except for San Francisco where residential lending conditions tightened.

There are some positive signs in the economic outlook and most observers are generally upbeat, but there also are some areas of concern. For example, in September the Conference Board's leading indicators declined, continuing the trend that began in June following recovery during much of the second quarter. The declines were led by the stock market, building permits, and manufacturing.

Through mid-October, the growth rate in the Economic Cycle Research Institute (ECRI) Weekly Leading Index slipped to –2.7%, continuing the generally downward trend that effectively wiped out much of the recovery that occurred during the first quarter (although the index itself increased). Looking at the economic environment from a cyclical perspective, ECRI's US Coincident Index—which is a composite measure of aggregate output, employment, income, and sales—revealed a more prolonged period of decline and its September figures continued an eight-month slide, approaching the level reached in the second quarter of 2014.

Employment

The employment scene continues to be closely monitored as one bellwether of the economy. While other factors remain significant, at the end of the day a sustained economic recovery is dependent on a solid employment environment. Thus, concerns increased when the Bureau of Labor Statistics (BLS) reported that growth in non-farm payrolls were a disappointing 136,000 for August and 142,000 for September. However, in October, job growth bounced back, rising to 271,000 new jobs which came on top of an upward revision of 12,000 jobs for the prior two months.

During the third quarter, the Intuit Small Business Employment Index remained in slightly negative territory, which was disappointing after relatively solid gains during the first half of the year. This situation suggests small business owners have been paying more attention to the slowing economy and are likely to remain on the sidelines until the economic outlook picks up. The number of separations in August came in at 4.8 million, and were relatively stable throughout 2015, although a 5% increase over the prior year. Of those, 2.7 million job changes were due to voluntary quits, which was stable for the year but an 8.9% increase over 2014. Layoff activity was also relatively stable, with the 1.7 million jobs affected.

Average hourly earnings were relatively flat for September, although they were up some 2.2% seasonally adjusted for the prior twelve months. As of September, real average-hourly earnings were \$10.56 for all employees on non-farm payrolls adjusted for inflation. Earnings for production and nonsupervisory workers were lower at \$9.08. Given the expanding scope of initiatives to raise wage levels, average earnings may experience modest increases going forward, although these increases will not be bolstered by a tightening labor market.

On the unemployment front, the unemployment rate in September was 5.1% and in October decreased slightly to 5.0%, a significant improvement over the 5.7% rate at the beginning of the year and the 5.9% rate on a year-over basis (Figure 1). Initial claims increased slightly in mid-October but still trended downward for the year as a whole. One factor behind the changes was the increase in voluntary turnover as some employees began to look for greener pastures. The same pattern occurred for unemployment continuing claims, although the pattern was more volatile. The number unemployed for less than five weeks increased 268,000 to 2.4 million, while long-term unemployment was flat at 2.1 million and 26.6% of total unemployed. The number of involuntary part-time workers fell 447,000, although the total number was still high at 6.0 million employees. The number of marginally attached workers declined by about 16%, although the total number still comes in at 1.9 million, of which some 635,000 had given up on finding a job.

Looking forward, the BLS has projected a modest 0.5% annual increase in employment over the 2012–2022 period, adding 15.6 million new jobs, most of which will be in service-providing industries. Of the 50.6 million total job openings forecasted, about 67% will come from replacement needs. This pattern will be widespread, with 4 out of 5 occupations expected to have replacement needs outpacing new job growth.

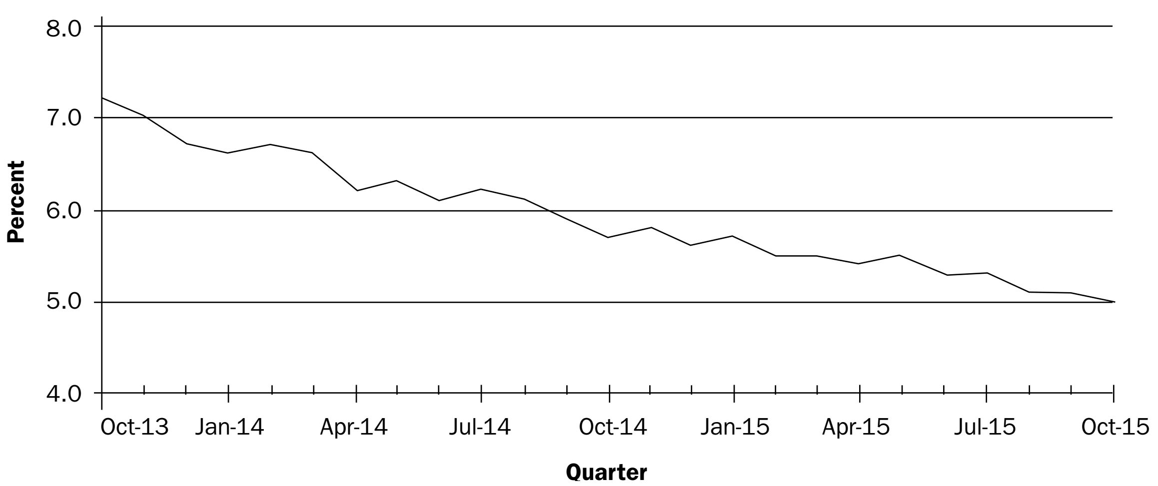
As a result of the aging population and delayed retirement, workers age 55 and over are expected to make up over a quarter of the workforce by 2022. Projected declines in labor force participation rates will place a drag on employment growth. The fastest-growing industry sectors will be in the services categories, especially health and social assistance, educational services, and professional and business services. In the goods categories, increases will be led by construction and mining. On the losing side of the equation, agriculture self-employed jobs are projected to decline by 2.8% per year, followed by jobs in federal government, utilities, manufacturing, and somewhat surprisingly, the information sector.

Inflation and Interest Rates

Inflation rates have remained low and are likely to remain so in the face of weakening domestic and foreign demand for goods and services. The BLS's Employment Cost Index increased a meager 0.6% for the third quarter, with the wages and salaries component—which makes up 70% of compensation costs and benefits—rising fairly equally. The weakening jobs report suggests little upward pressure on wages over the near term. Compensation for state and local government employees increased 2.3% on a twelve-month basis compared to 1.9% for private employees, with the difference attributable to increases in benefits. Agriculture prices increased 3% in August, but not enough to offset the declines for the prior two months. On a year-over basis, agriculture prices experienced a 3.6% decline. Import prices were also down slightly in September, continuing a three-month string of declines. The Producer Price Index (PPI) also declined in September, with a –0.5% seasonally adjusted rate that translated to 1.1% year-over decline in the final demand component.

The Bureau of Economic Analysis (BEA) price index for gross domestic purchases increased 1.5% in the second quarter after slipping 1.6% during the first. The Consumer Price Index (CPI) slipped into negative territory in September, marking two months of declines. However, when the more volatile food and energy components are removed, prices were up modestly as they have been throughout the year but still below the Fed's targeted 2% level. The Producer Price Index declined more than expected

Figure 1 Unemployment Rate, October 2013–2015*



*Seasonally adjusted.
Source: US Bureau of Labor Statistics

in September wiping out some of the moderate improvement that occurred in the second quarter. ECRI's US Future Inflation Gauge declined in September, suggesting that the low inflationary environment will continue. Import prices slipped moderately in September, continuing the prior two months of declines and putting downward pressure on overall inflation. The strengthening dollar relative to other currencies has contributed to declining import prices as has the volatile energy sector.

Several factors are weighing heavily on Federal Reserve (Fed) policy makers as they struggle with the timing of their oft-delayed increase in interest rates. Of particular concern are the slowdowns in job formation, capital spending, and economic growth. The declines in exports and manufacturing also factored into the equation. Consumer spending remains something of a wild card in the face of tepid wage growth, as total compensation slipped in the second quarter and fell below averages for the past two years. Inflation also has remained below targeted levels with little upward pressure. Many central banks are making efforts to stimulate their domestic economies (e.g., China, eurozone). In its October statement, the Fed softened its previous language that warned global and market developments might restrain economic activity and suppress inflation. Rather, it merely acknowledged the existence of such forces and indicated that the economy was improving at a "moderate pace." The Fed also noted it would consider raising rates, but even if it does act, rate changes will be moderate. Thus, the low inflation and low interest rate environment is likely to continue for the foreseeable future.

Business Indicators

Business indicators were mixed to negative through September, with the downward decline that started in the third quarter wiping out some of the second quarter gains. This pattern was reflected in a number of indexes. The Institute of Supply Management (ISM) Purchasing Index declined to 50 after climbing up to 53.5 in June, with the declines affecting all of the categories, including production, new orders, inventories, supplier deliveries, and employment. The ISM Non-Manufacturing Index also declined in the third quarter, falling to 56.9 in September, some 2.1 points lower than August. The recent deceleration was concentrated in business activity and new orders, while employment and supplier deliveries were stable. In terms of industries, contraction was reported in mining; arts, entertainment and recreation; retail trade; and other services. Despite the slowing rate, however, the latest figures represented the 74th straight month of growth in the non-manufacturing sector. Also during September, the ISM Inventory Sentiment measure declined to 65 from 69, suggesting that inventory levels may be too high and place downward pressure on GDP as businesses burn off surpluses.

Sales of merchant wholesalers in August came in at $445 billion, a 1% decline from July and 4.7% decline from the prior year. The weakness in durable sales was spread over six of the ten categories. The picture for nondurable sales was more mixed. Inventories of merchant wholesalers were up modestly. The increase in inventories was led by computers, computer peripheral equipment and software, and beverages. The inventory-to-sales ratio in August for merchant wholesalers was 1.31 on a seasonally adjusted basis compared to 1.2 for the prior year. This reversed the decline in July but was still significantly off the pace of the upward trend during the second quarter. Productivity in non-farm businesses rebounded to a 3.3% increase during the second quarter, reversing two consecutive quarters of declines. With wages relatively flat, the increase in productivity translated to a decline in unit labor costs. Output at non-financial corporations slipped during the quarter, but this was offset by an increase in manufacturing output.

The Index of Small Business Optimism, published by the NFIB, remained flat during September at 96.1, but this was significantly lower than the long-term average. The drag on small businesses reflected the slowing economy in general as well as several factors that hit small business owners in particular. The top three factors, which accounted for 60% of the problems, included taxes, government requirements and red tape, and quality of labor. While the first two factors were on par with the prior year and continued to lead the list for most of its history, labor issues related to problems in finding qualified workers rose dramatically from 9% to 16% and edged out "poor sales" as the third-most important issue. Interestingly, credit availability and costs were not a significant concern for small businesses, while 41% cited the lack of decisiveness by the Fed as a significant stressor.

The slowdown in the manufacturing sector during the third quarter was disappointing after strong numbers carried through the first half of the year. On a seasonally adjusted basis, US manufacturing corporations' after-tax profits in the second quarter were down slightly from the first quarter and were down significantly from the prior year. Nondurable goods manufacturers' after-tax profits in the second quarter totaled some $55 billion, which was a decline from the first quarter and $22 billion below the prior year. Seasonally adjusted sales for nondurables were also off the earlier pace, with the exception of apparel, leather products, and pharmaceuticals. Durable goods manufacturers' after-tax profits came in at $60 billion, which was an increase over the first quarter but a decline from the prior year. Durable manufacturer profits benefited from the fact sales were up for the quarter and over the prior year, coming in at $843 billion. Sales increases in durable goods were seen in nonmetallic mineral products, computer electronics, transportation, and furniture and related products.

Stock Market

Until midyear the domestic stock market was fairly stable, with the Dow Jones Industrial Average hovering around the 18,000 mark. The situation changed dramatically in mid-August with the Dow taking a 10% plunge. After struggling for some traction, the market began to improve in late September, with a rally that trended upward and all but wiped out the decline; the S&P Index followed a similar pattern. Through the end of October, the Dow experienced an 8.5% increase, the largest monthly increase in four years. Investors seemed to take some solace from the interventions announced by a number of global central banks as well as the Fed's decision to delay its interest rate increase.

The recovery in the US stock market was echoed in a number of global markets, including the Stoxx Europe 600 and the Nikkei Stock Average. Despite the rally, the Dow was down around 1% for the year while the Stoxx Europe was up almost 10% over the same period. Due in part to the Fed's inactions, small cap stocks tended to underperform larger companies, which usually are more resilient in the face of such uncertainty.

In disappointing news, a number of US companies warned of expected declines in sales and profits. This situation was particularly pronounced for industrial companies facing declining demand from domestic and international customers. For example, in mid-October, Caterpillar Inc. reduced its expected profit and announced it would lay off some 1,500 employees. At an aggregate level, companies in the S&P 500 Index are expected to report a 2.8% decline in revenues per share with a 4% decline in sales. While the declines were most pronounced in the energy industry, other sectors also are expected to experience disappointing revenues. Unfortunately, the option of offsetting declining sales by cutting operating costs has played out for many companies, which suggests that net earnings will be under increasing pressure. Payrolls remain at risk, and could place a dampener on earnings at the same time as minimum wages are likely to increase.

While investors paid more attention to the weakening global economy and the slowdown in domestic growth, they have not written off the market. Indeed, corporate bond sales heated up, with $103 billion in October sales for companies with good credit. Assuming the pattern continues, corporate bond sales would be on pace to continue a four-year trend in record sales. The near-term prospects are positive, with investors drawing some comfort from the stock market rally and companies likely to try to lock in low interest rates before the Fed makes its move.

The Global Scene

The weak global economic environment has been a major factor behind the lagging US stock market and deflation in export prices. The US situation is far from unique and is likely to be felt across the intertwined global economies. For example, the core CPI inflation rate plateaued around 1.5% for Group of Seven (G7) economies, with headline inflation around zero. This removed interest rate hikes out of the G7 playbooks, a situation that is likely to hold for the intermediate term.

The global environment is becoming more difficult to predict as major central banks consider ways to stimulate domestic growth. In late October, European Central Bank (ECB) Chief Mario Draghi announced the ECB was prepared to step in to try to stimulate growth and inflation in the eurozone if conditions did not improve. It appeared Draghi had been able to assuage the central bank heads across the eurozone who had resisted additional quantitative easing. In making the announcement, he noted concern over the decline in inflation with consumer prices falling in September and the euro weakening. If the ECB takes action it will place added pressure on Fed policy makers.

China's economic condition continues to ripple across the globe. On the heels of the ECB announcement, the People's Bank of China preemptively cut interest rates, the sixth decrease since November 2014. At the same time, it reduced reserve requirements to help stimulate growth in economic activity, which is in danger of slipping below the 7% targeted rate. Whether recent interventions will reverse the effects of the sell-off in Chinese stocks in August, and the subsequent declines in the value of companies, will be closely watched. Similarly, attention will be focused on whether China is able to get the International Monetary Fund (IMF) to place the yuan in its approved basket of reserve currencies.

The weak global economy showed up in the US International Trade in Goods and Services figures for August when the deficit rose to $48.3 billion—a $6.5 billion increase from July. The changes in exports and imports both contributed to the widening gap, with August exports of $85 billion, which was down $3.7 billion from the revised July figures, and imports of $233 billion, a $2.8 billion increase. The deficit was boosted by an increase in goods of $6.6 billion while services eked out a slight surplus of $2 billion. Through August, the annual deficit in goods and services increased $17.6 billion, which was a 5.2% increase from 2014. Exports declined $15.9 billion, which was a 3.8% decline over the prior year.

During January through August, exports of services increased by some $7.5 billion, rising to $479 billion. Services exports were led by travel, other business services, intellectual property, financial services, and transport. On the goods front, during January through July export goods were down $50 billion to $890 billion, with the declines fairly widespread across end-use categories, including industrial supplies; food, feeds and beverages; capital goods; and automotive vehicles. The exception was consumer goods, which were flat at $15.7 billion. Using the same categories, on the import front there was a $50 billion decline, with $100 billion off industrial supplies, while the other categories all racked up increases.

On a geographical basis the deficit in goods exports differed by region, with a $3.3 billion surplus in Central America coupled with $1 billion with OPEC nations. While the deficits were fairly widespread, the most dramatic deficits were $32.9 billion with China, $14.5 billion with the European Union, $6.8 billion with Germany, and lesser amounts with Mexico, Japan, South Korea, Canada, Italy, France, and India. Looking forward, weak global economic conditions are expected to continue to place a dampener on exports and, by extension, GDP growth.

Consumer Confidence

The domestic economic slowdown, slowing employment gains, anemic wage increases, political wrangling, and uncertainty from the Fed have weighed heavily on consumer sentiment. This was reflected in the Conference Board's Consumer Confidence Index, which reversed itself in October, falling from 102.6 in September to 97.6 in October. The declines affected both the Present Situation Index, which declined 8.1 points to 112.1, and the Expectations Index, which fell 2.8 points to 88 in September. While the decline was a sign of concern, the Present Situation rating was still positive and the Expectations Index pointed to some level of optimism about future conditions. However, maintaining the spread on expectations will depend on improvement in underlying market fundamentals, which is less certain than earlier in the cycle.

The University of Michigan's Index of Consumer Sentiment told something of a different story about consumers, with the index increasing 3.2% in October to 90, which was a 3.6% increase on a year-over basis. The improvement in the measure was uneven however, with lower-income households driving the gains due, in part, to more frequent reports of income gains. At the same time, confidence slipped among the top-third of households who are more tuned into the economic slowdown and the impact on markets. At an aggregate level, despite some declines from the high point earlier in the year, the annualized Consumer Sentiment level was at its highest point since 2004. In weighing in on their outlook on future financial conditions, respondents were more positive than they have been since 2007.

The National Retail Federation's (NRF) Monthly Consumer Confidence Survey continued its moderate downward trend, falling below 45% in October after a 50% peak at the beginning of the year. The spectrum of confidence was somewhat negative, with over 40%

reporting "little confidence" compared to some 36% in the "confident" category, and "no confidence" outpacing the ranks of the "very confident." The NRF Survey also explored "life changes" that had occurred over the prior six months. The behavioral reaction to economic conditions reported by respondents indicated a consumer base that was focused more on needs than wants, more practical and realistic in purchases, more budget conscious, and eating more home-cooked meals.

One risk to consumer confidence levels that has yet to be factored into the equation relates to increased health care premiums and deductibles. For example, on October 15, the Social Security Administration announced there would be no cost of living increase in Social Security, which affects premium payments for 65 million recipients. Since the current law prevents increases in premiums from reducing Social Security checks, this would shift increased costs to those not covered by the protection. Those affected include higher income and new beneficiaries who could see more than a 50% increase unless Congress takes action by the end of the year.

Retail Sales

Retail sales have been inconsistent, with a general downward trend through September. Indeed, excluding automobile sales, changes in retail sales for August and September were slightly negative. Despite low gasoline prices, consumers did not shift consumption to retail cash registers, and there was only a modest 2.4% increase in retail sales over the prior year. This indicates a weaker setting for the 2015 holiday season than in 2014, and there is reason for concern among retailers trying to anticipate seasonal demand.

On a positive note, vehicle sales continued to trend upward. Sales of light trucks benefited from low gasoline prices and outpaced sales gains in the automobile category, which was relatively flat. The strong vehicle market was good news for domestic automobile makers, which saw their market share surge to 81% of total sales. This shift benefited, in part, from a number of scandals involving foreign auto companies, including Volkswagen's faked emissions results for diesels, Toyota's "sticky pedals," and Honda's massive airbag recall.

According to the Census Bureau, in the second quarter of 2015 large US retail trade corporations with assets over $50 million racked up after-tax profits of $22.1 billion—an increase of $1.6 billion from the prior year but down slightly from the first quarter. For the first half of 2015, profits of retailers were up from the prior year due to increased retail sales coupled with renewed focus on the bottom line. Sales for larger retailers came in at $673 billion on a seasonally adjusted basis, an increase of $14 billion on a year-over basis. Cash dividends charged to retained earnings increased on a year-over basis also but were down for the first quarter while retained earnings were stable during the first half of the year and up from 2014.

A number of retailers continued to struggle to retain their market share in a hypercompetitive environment. Challenges included strong competition from traditional and non-store formats as well as internal miscues. An example of this plight was Walmart, which predicted a 12% decline in profits for 2016 due to pressures to increase wages, improve in-store productivity, and stimulate online sales. Indeed, over the next fiscal year it said it would lay out an additional $2.9 billion in wage increases and another $2 billion on e-commerce initiatives. In the face of declining sales Walmart shares felt the brunt of these forecasts, dropping some 10% in mid-October. To adjust to declining sales, it focused on improving inventory efficiencies by reducing its in-store displays. These efforts resulted in a 15% decline in its product lineup over the past year and when coupled with its effort to reduce inventories created some product shortages. Walmart is likely to slow down new-store openings and pull back on capital investments. While Walmart's case is unique in terms of scale, a number of other retailers are experiencing similar pressures. How their defensive actions play out will be closely watched by shoppers, investors, and vendors.

The National Retail Foundation's (NRF) outlook for retail sales provides some useful insights into the 2015 holiday season. Based on survey results, consumers anticipate making purchases around $800 billion during the holiday season, which is on par for 2014, a record high over the fourteen-year history of the survey. Retailers will be frenetically seeking a share of this spending, which means another year of incentives such as exclusive sales, low prices, price-matching, and free shipping. In terms of formats, NRF predicts discount stores and department stores will be patronized by some 56% of consumers, with 53% buying some merchandise online. Of those buying online, over 46% indicate they will pick up merchandise in stores, attesting to the success of e-commerce initiatives among traditional brick-and-mortar stores. However, over 90% of shoppers will also take advantage of free shipping. Some 46% of shopper's time will be spent online, which is a slight increase over 2014 and the highest figure since the data series began in 2006. In terms of types of gifts, slightly over 60% of shoppers said they would be purchasing clothing or clothing accessories, with a similar number planning to buy gift cards or certificates. This will lead to a second wave of retail sales after the holiday season that will help bolster sales. The NRF forecasts holiday retail sales increase of 3.7% compared to 4% in 2014, a figure that is consistent with other forecasts.

Construction Activity

Through August, total construction activity was solid with the value of "construction put in place" hovering above $1.1 trillion. On a seasonally adjusted basis, August activity increased 13.7% over the prior year. The composite figures included a 16% increase in residential construction, led by the multifamily sector, and a 12% increase in nonresidential construction. On the private front, the highest year-over increases were for manufacturing, lodging, amusement and recreation, and office facilities. On the public front, construction activity remained fairly stable at around $300 billion, with the August figures reflecting a 7% increase on a year-over basis. Construction lending activity increased, with builders reporting that access to debt is no longer constraining new construction. Indeed, the Federal Deposit Insurance Corporation (FDIC) reported that construction loan balances increased 3.9% over the prior quarter, rising to $255.8 billion. This increase continued the modest but consistent upward trend of the past fifteen months. Despite the increase in access to construction loans, the underwriting has not loosened materially, especially for land development loans.

Housing Market Trends

The housing market continues to capture much attention from economic prognosticators, which reflects the importance of the sector to the overall economy. During the 2015 third quarter, housing statistics were somewhat mixed. On a positive note, the National Association of Home Builders (NAHB) Housing Market Index increased during September, continuing an upward trend that began at the end of the first quarter. The composite index came in at 64, compared to a 52 in March and was at its highest level since the trough in mid-2005. Expectations for the next six months exceeded the current figures, suggesting homebuilders anticipate an improving market. The current figures are higher than the long-term average of 48 and above the 50 threshold level that signals an expanding market. Despite improved attitudes, however, new-home construction levels were modest, with an increasing gap between expectations and realizations.

Housing starts were up for September, continuing the trend that began in March. Housing starts increased 6.5% over August, which translated to an annualized rate of 1.2 million new units. As has been the recent trend, the most dramatic increase in housing starts was in the multifamily sector, with starts up 18.3% over August and some 50% from February. During the same period single-family starts were up around 12%. In term of market share, multifamily starts accounted for around 39% of residential starts, which was down from 50% earlier in the year. Housing permits were up modestly, with the market share of multifamily units slipping to 37% compared to 42% earlier in the year.

Existing-home sales fell in September, revealing the tenuous nature of the housing market recovery. On a seasonally adjusted basis, sales fell to 468,000 houses, which was 11.5% below revised figures for August and significantly below expectations. In terms of supply, inventory of new houses stood at 5.8 months in September, which was the highest level in over fifteen months. The inventory would likely have been even greater if labor shortages had not created a governor on new construction activity. Indeed, a number of homebuilders reported that labor shortages suppressed completions, a situation that is likely to continue as many who left the industry have moved into other sectors. To lure them back, wages will have to increase, which then will put some upward pressure on new home prices.

Given the dramatic changes in the housing market over the past decade, it is useful to take a look at some of the changes in new supply that have occurred. In the recently released study entitled "2014 Characteristics of New Housing," the US Department of Commerce points out some interesting trends in both single-family new construction activity and new-home sales (Table 1). Significantly, while much has been written about the downsizing of houses, the data on new-home sales belies such a trend. For example, for the ten-year period through 2014, the share of houses under 1,800 square feet fell from 29% to 18% of new-home sales. During the same period, houses with 1,800–2,399 square feet held steady at 28% of sales, while houses with 2,400–2,999 square feet increased from 3% to 23% of sales. At the larger size of the market, sales of new houses with 3,000–3,999 square feet rose from 7% to 22%, while sales of houses with over 4,000 square feet increased from 3% to 10% of total new-home sales.

The increase in size of new homes was accompanied with increases in rooms as noted by the fact new single-family houses completions between 2005 and 2014 experienced a significant increase in the number of bedrooms. During this ten-year period, new houses with two or fewer bedrooms fell to 7%, and new homes with three bedrooms fell to 42%, while sales of homes with four or more bedrooms rose from 42% to a 51% share. Also, the number of bedrooms was highly correlated with price, and the ratio of larger, four-bedroom units accounted for 69% of the $500,000–$750,000 bracket and 85% homes selling for over $750,000.

During the same ten-year period, the number of baths shifted significantly, with the share of houses with two or two and a half baths falling from 34% to 30%, and the share with three or more rising from 28% to 41% of new home completions. As might be expected, the number of houses with three or more baths was correlated with price range, with a market share of 50% in houses in the $300,000 range, 64% of houses in the $400,000 range, 68% in the $500,000–$750,000 range, and 89% over $750,000.

As with the number of bedrooms, the number of garages has increased over the past decade. In 2005, 19% of new houses sold had garages for three or more cars, while in 2014 some 24% of new houses sold fell in that category. The number of houses with two-car garages held steady at about two-thirds of the houses sold, while one-car garages declined to 5% of new-house sales.

Over the past decade, changes also occurred with respect to prices for new-home sales. In 2014, 20% of new home sales were in the $300,000–$399,999 category, a figure that increased 4% over the ten-year period. At the same time, the percent of sales under $200,000 declined, while those in the $200,000–$299,999 range increased moderately, along with sales in the $400,000–$499,999 bracket. Sales over $500,000 held steady with a 12%–13% market share. Median prices rose almost $50,000 to $345,800 over the past ten years. Prices rose most dramatically in the Northeast, increasing to $545,200 followed by $397,500 in the West, $316,700 in the Midwest, and $306,900 in the South.

In terms of financing, the median price for conventional and cash transactions were on par at around $300,000 in 2014, with cash prices increasing from $221,000 in 2005 and conventional prices up from $252,200. FHA-insured median prices were $215,200, up from $134,900 while median VA-guaranteed loans were $257,000, up from $161,500 in 2005.

With respect to prices per square foot for new single-family housing, the greatest market share was in the $100–$124 category (21%), an increase from the 18% market share in 2005. Of the other price categories, prices of $80–$89 per square foot had a 16% market share, followed by prices of $70–$79 at 14% market share, $125–$149 at 10%, and $150 and over at 9%, which was slightly higher than the 2005 figures. New houses coming in under $70 per square foot fell to 17% of sales, down from 27% in 2005. Prices per square foot were positively correlated with total prices, with 71% of houses over $750,000 coming in at over $150 per square foot.

At a national level, the US Census Bureau reported a decline in overall rental residential vacancy rates. Through the 2015 second quarter, rental vacancy rates continued to trend downward, ending the quarter at 6.8% while homeowner vacancy rates of 1.8% remained relatively stable. Residential rental vacancy rates were the lowest they have been in over a decade and dramatically lower than the 11.1% peak rate hit in the 2009 third quarter. Despite the collapse of the homeownership market in 2006, vacancy rates have been much more subdued than for rental properties, peaking at 2.9% at the end of 2008 due to lagged market adjustments to the recession. Rental vacancy rates were highest outside of metropolitan statistical areas (MSAs) at 8.4%, compared to 6.7% within MSAs. From a regional perspective, rental vacancy rates varied dramatically, with the West and Northeast having the lowest vacancy rates (4.9% and 5.4%, respectively) and the Midwest and South with the highest rates (7.7% and 8.4%, respectively).

Vacant units that were held off the market made up the gap between the figures, accounting for 5.3% of the total housing stock. When these figures are added to the equation, the 134.6 million total housing units in the United States had an overall occupied rate of 87%, with the 13% balance remaining vacant. In terms of rent versus own, some 55% of the total occupied stock was owner-occupied compared to 32% renter-occupied.

Median asking rents for vacant rental units continued to increase in 2015, exceeding $800 per month for the first time in recent history. At the same time, prices for vacant for-sale units have been relatively flat, coming in around $155,000; this reflects a gradual increase from 2012 but still was dramatically below the peak of over $200,000 reached in 2007.

Homeownership rates in the United States continued to trend downward during 2015, falling to 63.4% of households. This compares to the 69.2% peak reached in 2004, a level that had been fairly constant before the downturn began in 2006. This shift in tenure-choice continues to garner attention, with a number of apartment aficionados arguing that it represents a structural shift. Homeownership rates vary dramatically by market and region, echoing the same pattern as vacancy rates. The West and Northeast have the lowest homeownership rates (58.5% and 60.2%, respectively) while the Midwest and South regions have the highest rates (68.4% and 64.9%, respectively).

Table 1 Characteristics New Single-Family Housing, 2005–2014*

Characteristic	2005	2014
Square feet		
< 1,800	29%	18%
3,000–3,999	7%	22%
Bedrooms		
≤ 2	11%	7%
4 ≤	42%	51%
Baths		
2 or 2.5	34%	30%
3 ≤	28%	41%
Garages		
1	14%	5%
3 ≤	19%	24%

* Percentage of total
Source: US Department of Commerce

In terms of age of householders, the homeownership rate differences are dramatic. The millennials or "Under 35" category has the lowest ownership rates at 34.8%. This trough is followed by a series of increases for each subsequent age group: 58% homeownership for age 35–44 years; 69.9% for age 45–54 years; 75.4% for age 55–64 years; and, 78.5% for those over age 65 years. While some are banking on the millennials holding fast on rentals, history would suggest that as they move into the next age cluster a significant proportion will start shifting preferences toward ownership. Given the dramatic differences in tenure choice between the two groups, this could trigger a major shift in fortunes of those betting on the outcome. This is especially true as the market adjusts to changing demand and suburbs are becoming more walkable to respond to the draw of infill locations.

Real Estate Market

Overview

During the third quarter, real estate fundamentals of supply and demand continued to exhibit moderate improvement in line with the broader economy; this was evidenced by the general decline in vacancy rates across most property types. The improvement was dampened somewhat when the economic slowdown affected the demand side of the equation. On the supply side, in most markets construction activity remained modest and in line with increases in demand. This situation coupled with competitive returns translated to a renewed sense of optimism among institutional investors. This was punctuated throughout the *Emerging Trends in Real Estate 2016*[1] annual outlook for real estate, where surveyed expert-respondents were generally upbeat about prospects for the real estate market. However, that publication also noted the importance of keeping an eye on both the defensive and offensive fronts, suggesting that the market is cognizant of the underlying fundamentals and the realities of the prolonged bull run. Given the reliance on low-cost credit and equity hurdle rates to bolster total returns, such posturing is going to become even more important.

With respect to investment performance, the private market, as reflected by the NCREIF Property Index (NPI), experienced a solid 3.09% total return during the third quarter, with 1.86% in appreciation and 1.22% in income. On a trailing twelve-month basis, total returns were 13.5%, with income returns hovering at historical lows of 5.1% and appreciation at 8.1%. However, the public side of the market did not fair nearly as well. Through September 30, the FTSE NAREIT Equity REIT Index racked up a –3.8% total return. This negative performance paled by comparison to the robust 30% returns experienced during 2014. During October, REITs regained some lost ground, with year-to-date returns moving back into positive territory and finishing the month at 2.82% positive total returns.

On the transaction front, Real Capital Analytics (RCA) reported a total of $375 billion in transactions over $10 million through the third quarter. Of that activity, office sales led the pack at $108 billion, followed by retail ($65 billion), industrial ($50.7 billion), apartments ($38 billion), and hotels ($35 billion). Sales of development sites were also active with $17 billion in reported sales. With respect to regions, the West accounted for the greatest share of transactions ($101.9 billion), followed by the Northeast ($76.4 billion), the Southeast ($66 billion), the Southwest ($55 billion), the Midwest ($40.9 billion), and the Mid-Atlantic ($29.7 billion). Of the top-ten transactions in terms of value, five were office sales; these were complemented by one sale each for the retail, hotel, apartment, and development site sectors. Of the top-twenty-five transactions, fourteen were in the office sector, while the others were spread among the other major property types.

Despite robust sales through the first three quarters, the commercial market slowed a bit in September, with the sales volume of commercial properties over $10 million slipping into negative territory on a year-over basis. This was the first decline since November 2014 and may indicate the market is stepping back to focus on holding-period returns rather than current yields. However, some brokers attributed the decline to a lack of product rather than a pullback from investors. The decline in transaction volume on a year-over basis was fairly widespread with the exception of industrial properties. Portfolio sales fell from slightly under 50% of transactions in the first quarter to 30% in the third quarter. Despite the decline in transaction volume, capitalization (cap) rates continued to trend downward albeit at a slower rate than earlier in the year.

Real Estate and Capital Markets

Capital markets continued to support transaction volume through the first three quarters, although market share among lenders changed. RCA data indicates that during the first quarter, commercial mortgage-backed securities (CMBS) slipped to 21% of volume, which was down from 27% for 2014 as a whole. On the other hand, insurance companies increased loan activity, rising to 12% of commercial mortgage volume. Commercial banks were also active, with their market share increasing to 15% of loan volume. Although lenders supported transaction volume, underwriting standards for commercial properties firmed up with lenders requiring higher occupancy rates. At the same time, interest rates for seven- to ten-year loans increased modestly during the third quarter, forcing borrowers to shift to shorter-term loans. As a result, during the third quarter the share of short-term mortgages of less than seven years increased in market share to 37% of commercial loans. While helping support the current market, this shift also is introducing added interest-rate and cash-solvency risk if fundamentals get out of balance in the future. It may also affect unrealized gains/losses of long-term mark-to-market investors who have been paying limited attention to exit strategies and holding period returns. Looking forward, as PwC's *Emerging Trends* publications indicate, there will be no shortage of capital for the debt or equity sides of transactions.

In the global arena, according to CBRE Research and Real Capital Analytics, the United States remained the top destination for international capital flows, with $222 billion in investments, followed by a distant second for the United Kingdom ($54.6 billion), Germany ($24 billion), Japan ($13 billion), Australia ($10 billions), and a number of other markets accounting for under $10 billion of investments. Given the global economic environment, the United States is expected to continue to attract significant global capital, which will help support capital market activity. The influx of foreign capital is likely to extend the current bull market in real estate, with some US investors taking advantage of strong demand for product by cashing out and top-tier properties remaining in short supply.

1. PwC and Urban Land Institute, *Emerging Trends in Real Estate 2016* (Washington DC: PwC and Urban Land Institute, 2015); available at http://www.pwc.com/us/en/asset-management/real-estate/emerging-trends-in-real-estate-2016.html .

Office Market

At a national level, office market fundamentals improved during 2015, with improvement in absorption and declining vacancy rates in most major central business districts (CBDs) during the second quarter. Much of this improvement was related to the general economic environment in which office-related jobs increased, especially in the knowledge industry. During the third quarter, net absorption rates tapered off a bit in line with the economic slowdown, although the figures were still significantly above the trailing five-year averages. As a result, vacancy rates fell to the lowest levels since the recession. This translated to an increase in asking rents, which rose above the prerecession rates for the first time.

While major CBDs experienced some improvement in market fundamentals, many secondary and tertiary cities lagged the national averages. The improvement in market fundamentals led to an increase in construction activity, although still tempered compared to the three years leading up to the recession and in line with the demand side of the equation. The surge in apartment construction in CBDs caught the attention of corporate America, leading to increased interest in locating offices in such locations, especially among firms trying to attract millennials and other workers drawn to urban lifestyles.

The office component of the recent NPI included 1,421 office properties and $175.6 billion in market value (20% of NPI properties and 38% of NPI value). The average value of office properties led all property types at $123.6 million, which was 189% above the NPI average. For the third quarter, private office investment performance trailed other core property types (except apartments) at 2.97%. At the same time, with the exception of apartments, office income returns were lower than other property types (1.17%), suggesting aggressive valuations. On a trailing twelve-month basis, office investments provided a 13% total return, with 4.9% in income and 7.9% in appreciation. CBD office investments yielded a 3.1% total return for the third quarter, with a trailing twelve-month 13.9% return. On the other hand, suburban offices lagged, with a 2.8% third-quarter figure and 11.9% trailing returns. Suburban office income returns (5.47% on a trailing basis) outperformed the 4.5% CBD rate. This reflects the higher risk of suburban office investments and more aggressive valuations for CBD properties.

On the public front, office REITs underperformed the overall REIT Index, coming in with 0.8% returns and trailing one-year returns of 5.5%. While disappointing compared to the private side of the market, the October figures were a marked reversal from the −6.4% through the end of September.

In terms of transaction volume, according to data from Real Capital Analytics the office sector experienced a 13% decline during the third quarter. Part of this downward trend was due to a decline in large-portfolio and entity-level transactions, which bolstered sales during the first quarter. Interestingly, the CBD component dropped by 35% as investors drew the line on yields and owners held on to current investments. On the other hand, suburban properties, which had not been favored by many investors increased 18% on a year-over basis for the quarter. Despite the recent declines in the aggregate office sector, transaction volume for the year-to-date still came in at $108.5 billion, which was 26% greater than in 2014. The average price for CBD properties was $385 per square foot, compared to $177 per square foot for suburban properties. Prices in major metro areas averaged $360 per square foot compared to $167 per square foot in secondary markets.

Suburban office properties accounted for 56% of transactions during 2015. The West and Northeast regions were the most active, accounting for some 55% of total office transactions and 67% of CBD sales, with the Northeast alone accounting for 50%. Capitalization rates were lowest in these two regions, reflecting aggressive pricing for core assets in the New York, San Francisco, and Seattle markets. The most active office markets included Manhattan ($19.4 billion), the greater San Francisco market ($12 billion), the greater Los Angeles market ($8.5 billion), Washington DC area ($6.5 billion), Chicago ($6.3 billion), Boston ($4.8 billion), Seattle ($4.5 billion), and Atlanta ($3.4 billion).

At an aggregate level, capitalization rates flattened out, with suburban cap rates at 7.1% and CBD rates at 5.3%. This provides some insight into the slowdown in acquisitions as spread investors, who fueled the decline in CBD cap rates, remained content with their holdings, which were acquired at aggressive prices for long-term holds. The shortening of mortgage terms and the concomitant increase in rates made it difficult to pencil out CBD investments at the same pricing as earlier in the cycle. The situation differed for suburban properties, which have a wider spread between mortgage rates and cap rates, providing an opportunity for more arbitrage between the debt and equity positions. This situation could change if investors start focusing on the risk side of the equation, which would put upward pressure on equity yields.

With respect to office lenders, the average loan on office transactions was $22.7 million for the first half of 2015 with a loan-to-value ratio of 72%. The average price per square foot was $258, with a 6.7% cap rate and an average occupancy rate of 92%. International banks accepted a 5.1% cap rate and average prices of $432 per square foot. Financial lenders were the most aggressive with the highest loan-to-value ratio at 81% and lowest occupancy rates of 85%.

Retail Market

During 2015, retail market fundamentals improved, with national vacancy rates falling to the lowest level in over ten years. Indeed, some retailers reported a shortage of space to meet expansion plans, with construction activity lagging improved demand. Shifting demographics had a significant impact on the retail scene, with millennials and other segments driving the increased demand for food and beverage outlets. Despite the recent economic slowdown, retail market fundamentals continued to improve although not across the board. This situation is expected to continue as the industry adjusts to economic and demographic trends, the impact of which has been exacerbated by technological innovation. In this environment retailers redoubled efforts to maintain profitability in what is becoming a hypercompetitive environment.

The retail component of the NPI represented 16% of market share in terms of the number of properties and 23% of the total value. The average market value of retail properties was $92.8 million, trailing only office properties. With respect to investment performance, the private retail sector came in slightly above par for the quarter with 3.11% total returns and 1.26% income returns. On a trailing twelve-month basis, private retail investments outperformed other property types, with the exception of industrial, coming in with 14.4% total returns and 5.3% income returns.

In terms of retail subtypes, the fashion/specialty sector led other retail categories with 4.1% returns in the third quarter, followed by regional malls and single-tenant retail properties with 3.4% returns. On a trailing twelve-month basis, the picture differed, with single-tenant properties showing returns at 17.9%, followed by regional and super-regional malls with returns around 15.5%, neighborhood stores at 13.7%, fashion/specialty at 13.4%, community centers at 12.7%, and power centers at 12.6% returns. Income returns were the lowest for single-tenant properties at 4%, with power centers at the top with 6.1% trailing twelve-month income returns. Public retail REITs recovered in September with year-to-date 6.6% total returns, beating the overall index and other property types with the exception of residential. Regional mall REITs led other retail types with 8.7% total returns on a year-to-date basis and 11.8% on a rolling twelve-month basis.

Retail transaction activity tapered off during 2015, with September volume 8% off of the 2014 pace. The "regional mall" and "other" categories bolstered the retail transaction numbers with a 9% increase while the volume of strip center sales was off 21% through the first three quarters. In terms of pricing, retail cap rates flattened out during the third quarter, coming in at 6.5% overall, with regional malls at 5.9% compared to 7.1% for strip centers. Average prices for regional malls ($142 per square foot) trailed strip centers ($153 per square foot) although mall sales accounted for only 6% of transactions compared to 63% for strip centers. Single-tenant retail transactions accounted for 10% of sales and traded at $234 per square foot on 6.0% cap rates.

Interestingly, urban/storefront retail, which accounted for 21% of retail transactions during the third quarter traded at $877 per square foot on 5.1% cap rates. The urban/storefront figures were bolstered by the $5.6 billion in sales in Manhattan, which averaged $2,559 per square foot and was dramatically higher than any other market, with Miami coming in second at $854 per square foot on $1.3 billion in volume. From a regional perspective, retail transactions were more diversified than the office sector, with the West leading with 28% and the other regions generally in the mid-teens.

Through the first three quarters of 2015, $65.2 billion of retail properties were sold at a 6.6% blended cap rate. At an aggregate level, the average retail loan on transactions during the first half of 2015 was $9.6 million, with a 67% loan-to-value ratio. Occupancy rates were fairly consistent across lenders. International banks focused on the urban markets, with loans on properties averaging $905 per square foot, which was partially offset by higher equity requirements with a 62% loan-to-value ratio.

Industrial Market

Industrial fundamentals of supply and demand were fairly robust throughout 2015. During the second quarter, the industrial sector was on a roll with completions, absorption, and occupancy hitting seven-year peaks. Due to positive net absorption, vacancy rates declined, continuing a string of improvements. The improvements were fairly widespread with most markets experiencing tightening conditions, which in turn led to increases in asking rents. While the global slowdown placed a dampener on the demand side of the market, industrial fundamentals remained strong. In the third quarter, the industrial market continued to expand with some 55.6 million square feet of positive absorption reported by CBRE Research. Although a decline from the first quarter, the year-to-date figures were up on a year-over basis and the highest since 2005. At a national level, supply increased at a fairly high rate and was fairly widespread, with the majority of markets adding new industrial space. At a national level, vacancy rates hit a cyclical low in the third quarter, reaching the lowest level in fifteen years.

The industrial component accounted for 40% of the assets in the NPI, but due to smaller average value, comprised only 13% of total appraised values. In terms of investment performance, the industrial sector led all property types in the third quarter with total returns of 3.7% and above-par 1.35% income returns. On a trailing twelve-month basis, the industrial sector led all property types with total returns of 15.6%, comprised of 5.6% income and 9.7% appreciation.

In terms of subtypes, warehouse properties provided the highest returns in the third quarter (3.8%) and on a trailing twelve-month basis (16.1%). R&D and flex space returns lagged the sector at 9.6% and 12.2%, respectively. Income returns were higher across the board than other property sectors, with flex industrial space leading with income returns at 6.1% on a trailing twelve-month basis, followed by 5.9% income returns for other industrial, 5.5% for warehouse, and 4.6% for R&D. The latter is somewhat surprising given the high volatility of the sector.

With respect to public real estate, the industrial sector led other property types and subtypes with the exception of regional mall REITs. Through October, industrial REITs racked up 2.8% total returns, which translated to 7.4% returns on a one-year basis. However, the public market continued to trail the private market by a significant amount.

Industrial transaction volume slowed during the third quarter after a robust first quarter and industrial sales tapered off, although September monthly figures were up 8% over the prior year. Compared to other property sectors, industrial transaction levels were much more volatile, with up and down periods of year-over changes in sales. After peaking in the first quarter, when 59% of sales were attributable to large-portfolio and entity-level transactions, larger transactions fell to 25% of activity during the third quarter. In the absence of bulk sales, the smaller average transaction values of industrial properties placed a dampener on aggregate transactions. Cap rates for flex and warehouse properties trended downward, although it appears that warehouse rates may have flattened out around 6.7%. The spread between cap rates and mortgage rates for industrial sales was some 232 basis points in the third quarter, a slight decline from the post-2010 average but still attractive compared to other core property types.

Prices per square foot for flex space trended upward but remained significantly lower than the 2010 peak. Warehouse prices per square foot were more stable and continued to trend upward from the 2010 trough. In terms of prices per square foot, during the third quarter flex properties averaged \$108 compared to \$73 for warehouse properties.

In terms of volume, warehouses accounted for some 70% of industrial sales. Occupancy rates on leveraged transactions were solid at 96% overall. The average loan size for industrial properties was \$8 million with a 72% loan-to-value ratio. Through the third quarter, warehouses accounted for 77% of the \$50.7 billion in industrial sales, with an average cap rate of 6.7%, which was some 40 basis points lower than for flex properties. Due to the nature of the market, industrial transactions were fairly well distributed throughout the country with the exception of the Pacific region, which accounted for 36% of total transactions.

Apartment Market

The supply/demand component of the apartment market continued to benefit from a combination of economic conditions and shifting demographics. The most cited of these demographic trends are millennials entering the workforce and older households seeking to downsize. At the same time, the decline in homeownership rates helped bolster the apartment sector. Thus, despite a significant increase in new construction, national vacancy rates continued to trend downward to the mid-4% level. Positive rental growth was reported at over 5% on a national level. Going forward, near-term vacancy rates are likely to remain below historical levels. However, vacancies are expected to increase moderately due in large part to the surge in construction, which continues to exceed historical standards.

Within the apartment sector, opportunities are emerging to outperform the national averages. For example, as the economy improves it is likely that migration will increase as workers seek new opportunities. This trend will benefit markets that are positioned as attractive to a mobile workforce and will leave other markets behind. Furthermore, while the top end of the apartment market has been favored by developers and investors that attention could shift to other sectors of the apartment market (e.g., moderate income, specialized housing) where better opportunities may be realized.

The apartment component accounted for 22% of assets and 24% of the value of the NPI. Average per-project values came it at $51.4 million. Despite all the positive press and improving fundamentals at the national level, apartment returns were somewhat disappointing for the third quarter, with the 2.9% total return trailing the averages. At the same time, the income return was lower than any other property type, coming in at 1.2% and suggesting the sector is fully priced. This pattern held on a trailing twelve-month basis, with total returns a disappointing 12% (versus 13.5% overall) and income returns of 4.79% lagging all property types. In terms of subtypes, garden apartments experienced the highest returns in the third quarter with 3.5% returns, which translated to 14.2% on a trailing twelve-month basis. High-rise and low-rise properties were on par with 2.7% third-quarter returns, although low-rise apartments had the advantage of 12.1% returns on a twelve-month basis (versus 10.8% for high rises). Reflecting aggressive valuations for high-rise apartments, income returns of 4.4% trailed all property types and subtypes for rolling twelve-month figures. Apartment REITs led other major property sectors through October, with 11.8% total returns. The sector rebounded from some disappointment in the prior year after coming in with rolling twelve-month 24.8% total returns that led all property types.

During the first quarter, apartment transaction volume continued the frenetic pace set in the second half of 2014, with 73% year-over sales increases. This dramatic increase may have been attributable to some profit taking as the heated sector approached its cyclical high. Since that time, year-over growth rates in apartment transaction volume slipped before falling to 5% in the third quarter. Despite this apparent slowdown, transaction volume remains historically high albeit at something of a plateau in the $30-$35 billion range. Graphically, the pattern of sales volume is reminiscent of the mature stage of a product life cycle. With the continued increase in new apartment construction, it will be interesting to see if the apartment pipeline and fundamentals are sufficient to stimulate a new surge in transactions.

Cap rates for apartments also reached something of a plateau, with garden apartments trading at cyclically low 5.9% and the mid-/high-rise component hovering slightly over 5%. The increase in fixed mortgage rates ate into the spread between cap rates, especially for mid-/high-rise units. During the third quarter, the average per-unit price of garden apartments was $102,500 compared to the $262,688 for denser, more urban mid-/high-rise units. In terms of market share, garden apartment volume of $21.3 billion was almost twice that of the mid-/high-rise sector. In terms of financing, during the first half of 2015 the overall average per-unit price was $127,500, with a 69% loan-to-value ratio and a solid 94% occupancy rate. Insurance companies were the most aggressive on underwriting, with a 5% cap rate, 92% occupancy rate, and $184,142 per-unit value—the highest per-unit value of other lenders.

Through the first three quarters, apartment transaction volume totaled $98 billion, leading all other property types. Of that total, 64% were garden apartments with a 6.1% cap rate compared to 5.1% for mid-/high-rise units. From a geographical perspective, the Southeast, Southwest, and West had around at 22% market share. The most active markets were Manhattan and the NYC Burroughs ($11.4 billion), the greater Los Angeles market ($8.1 billion), Dallas ($5.4 billion), Atlanta ($4.75 billion), and Seattle ($3.5 billion).

Conclusion

The third quarter of 2015 was interesting as a number of external forces affected the economic environment. Global economic conditions were a source of concern, with slowdowns affecting economies from the eurozone to China, the latter of which garnered the most attention.

The global economic slowdown created a drag on the US economy, which manifested itself in a slowdown in manufacturing and export activity. During the third quarter, employment figures were disappointing, with two straight months of performance that came in below expectations. Wages were flat, which was not lost on consumers. The unemployment rate plateaued around 5% but varied by demographic segment and market. Inflation remained in check, with interest rates likely to stay low even if the Federal Reserve moves to increase rates.

In the third quarter, business indicators remained mixed with some slippage. Small-business owners were guarded, with access to quality labor a drag. The stock market was relatively flat throughout the first half of the year before slipping in August. Much of those losses were later recovered, with large cap stocks outperforming their smaller counterparts. The corporate bond market remained active, suggesting investors continued to be somewhat upbeat about the economy.

On the consumer front, the indicators were mixed, with downward pressure likely to carry over from the economic slowdown. Retail sales were somewhat disappointing and in line with the economy and consumer sentiment. Construction activity was solid with significant increases over the prior year. The housing market was mixed. Homebuilders' confidence levels rose, but that did not translate to a commensurate increase in single-family starts. However, total housing starts increased during the third quarter with multifamily driving the numbers. Existing home sales were somewhat disappointing with the inventory of new homes rising to the highest level in some fifteen months.

The commercial real estate market continued to improve at a national level with falling vacancy rates, increasing absorption, and moderate construction activity on par with improving demand. Investor sentiment remained strong, with many key players increasing investment levels over the next year. The private market continued to rack up solid total returns, with the NCREIF Property Index coming in at 13.5% on a trailing twelve-month basis; however, income returns remain at historical lows. The public REIT market was somewhat inconsistent, although a rally in October made up most of the declines earlier in the year. Going into 2016, the commercial real estate market is poised to continue business as usual. That said, an interesting phase of the cycle seems to be on the horizon, one in which the unusual could occur much faster than anticipated. This is especially true if the economy does not get back on track.

James R. DeLisle, PhD, is associate professor of real estate and director of the Lewis White Real Estate Center at the University of Missouri—Kansas City Bloch School of Management. His charge is to help build a preeminent real estate program that strikes a balance between academic rigor and state-of-the art industry practices. Drawing on this foundation, students are trained in critical thinking and the spirit of entrepreneurship necessary to take on the complex real estate problems that the next generation of industry leaders must be able to solve. He comes to the Bloch School from the University of Washington where he was Runstad Professor of Real Estate and director of the graduate real estate studies. DeLisle has spent almost half of his forty-year career in real estate as a professional with specializations in applied investment research and strategic portfolio management. Before returning to academia in 1999, he was an executive vice president and head of strategic planning for Lend Lease Real Estate Investments, a global company and the successor firm to Equitable Real Estate, where he founded the Investment Research Department. He has published widely in academic and professional journals. DeLisle received his BBA in real estate and MS in marketing from the University of Wisconsin. He received his PhD in real estate and urban land economics from the University of Wisconsin under his mentor, the late Dr. James A. Graaskamp, one of the leading academic proponents of applied real estate research. To increase industry connections, DeLisle has created a personal website, http://jrdelisle.com.

Contact: delislej@umkc.edu

Web Connections

Internet resources for additional reading

Bureau of Labor Statistics—Producer Price Indexes
http://www.bls.gov/ppi/

Conference Board—Business Cycle Indicators
https://www.conference-board.org/data/bci.cfm

CoreLogic Home Price Index
http://www.corelogic.com/about-us/researchtrends/home-price-index-report.aspx#.VdM7MbJViko

Economic Cycle Research Institute (ECRI)
—All Indexes
https://www.businesscycle.com/ecri-reports-indexes/all-indexes#

—US Coincident Index
http://econintersect.com/pages/releases/release.php?post=201503234236

Federal Reserve Bank of Chicago—Chicago Fed National Activity Index (CNAI)
https://www.chicagofed.org/publications/cfnai/index

Federal Reserve Bank of St. Louis—Federal Reserve Economic Data (FRED)
https://research.stlouisfed.org/fred2/

Institute for Supply Management (ISM)—Report on Business
https://www.instituteforsupplymanagement.org/ISMReport/

International Monetary Fund (IMF)
http://www.imf.org/external/index.htm

Intuit Small Business Index
http://index.intuit.com/

National Association of Home Builders (NAHB)—Housing Economics
http://www.nahb.org/en/research/housing-economics.aspx

National Council of Real Estate Investment Fiduciaries (NCREIF)
—Data and Products
https://www.ncreif.org/data.aspx

—Resources (papers and minutes)
https://www.ncreif.org/resources.aspx

National Federation of Independent Business (NFIB)—Economic Trends
http://www.nfib.com/surveys/small-business-economic-trends/

National Retail Federation (NRF)
—Retail library
https://nrf.com/resources/retail-library

—Monthly Consumer Confidence Survey
https://nrf.com/news/monthly-economic-review