The Future is Now (or Not?)

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Commentary
The US economy continues to improve, although recent gains are modest compared to other post-recessionary periods. Attitudes and expectations among many key players have firmed up, with a number of polls reporting a renewed sense of optimism that should translate to further improvement.

This positive mind-set is fairly widespread, ranging from economists to investors and from corporate executives to real estate professionals. Rising confidence levels have occurred in spite of a number of headwinds, which include turmoil in the Middle East, spillover from the recent nuclear disaster in Japan, and the budget stalemate in Washington that almost shut down the federal government. The resilient attitudes in the face of such obstacles suggests the economic recovery may benefit from a self-fulfilling prophecy, where optimistic attitudes beget optimistic decisions and lead to optimistic outcomes. There are a number of positive factors that reinforce this sense of optimism, including gross domestic product (GDP) growth, improving credit markets, strengthening conditions at the global level, and record corporate profits at home.

On the other hand, there are a number of clouds that hang over the economic outlook, including the housing market, which cannot seem to find a bottom; high delinquency and foreclosure rates; rising fuel and food costs; stagnant income growth; and a nagging unemployment rate. While the list of negatives is fairly long, the glass-is-half-full frame of mind that many have embraced suggests that, in the absence of unexpected shocks to the system, the economic recovery may endure and open the door to an expansionary phase that has been elusive up to this point in the cycle.

In some respects, improvement in the commercial real estate market has outpaced the economic front, which belies earlier projections of a lagged recovery. For example, the NAREIT Index has continued a relatively prolonged surge that began in early 2010, while the NCREIF Index has been playing catch-up and has closed the gap in performance. There is some evidence that the improvement in real estate equity markets has broadened. Investors have been drawn to a broader range of products and have expanded their interests in secondary markets as they search for higher returns. A similar story can be told on the mortgage front, led by increases in private and institutional capital flows. While underwriting remains disciplined, standards have relaxed a bit, and they have enfolded a broader range of product classes and more diverse array of borrowers than those targeted in the recent past. Similarly, commercial mortgage-backed securities (CMBS) issuances have begun to pick up, with 2011 first-quarter activity of $10 billion, which approaches totals for 2010, and with forecasts calling for a five-fold increase.

In addition to improving capital flows to real estate, transaction activity has started to rebound and has spread beyond the top end of the market of core assets, which dominated activity in 2010 and traded at record prices. The increase in transactions can be attributed to a number of factors, such as more realistic price expectations among sellers and more aggressive pricing. In addition to individual transactions, there has been an increase in portfolio sales, which has allowed some buyers to avoid the trophy pricing of individual assets. These bulk...
sales have also allowed buyers to take advantage of economies of scale in sourcing product and satisfying investment appetites. The ranks of buyers have also broadened, with some pension funds reentering the market, new opportunity funds beginning to make acquisitions, and off-shore capital (including sovereign wealth funds) looking for acquisitions.

The positive signals on the economic and real estate fronts lend some credence to the “Future Is Now” theme adopted in this edition of Financial Views. However, there is risk that the capital markets have gotten ahead of the spatial markets and are discounting a future world that may prove to be illusory over the near term. This then argues for the caveat “or Not?” when characterizing the current real estate outlook.

### The Economic Environment

During the first quarter of 2011, the US economy continued to expand, although GDP growth came in lower than expected. Despite some disappointment with the early results, the economy is expected to continue to improve throughout the year. At this point, GDP growth in the 5% plus range is plausible and appears to be discounted in the market. Despite the optimistic outlook for the economy, however, a number of challenges are beginning to surface, and they are placing a damper on enthusiasm for the recovery.

One of the major clouds is the record budget deficit, which continues to grow and shows no signs of abating. The depth of concern over record-deficit spending has been punctuated by the recent downgrading of US government debt by rating agencies that expressed concern over the ability of the federal government to rein in deficit spending.

The heated budget debates, which put the government on the brink of a shutdown, are not likely to abate anytime soon. Indeed, while Democrats and Republicans agree that the deficit should be reduced, there is no agreement as to the steps that should be taken to ensure that this occurs. Thus, although Congress dodged a bullet by coming to a last-minute agreement to avoid a shutdown of the government, all it really achieved was a deferral of the inevitable. The federal government will likely hit the $14.5 trillion borrowing limit imposed by Congress in the upcoming weeks unless the ceiling on debt is raised. Although Treasury Secretary Timothy Geithner has not indicated how much the cap would have to be raised to be meaningful, he suggested a $300–$400 billion increase to merely forestall the debate several months. Thus, the past rancorous debates and outrage expressed by both parties over the deficit are a foreboding of even more heated debates going forward. In this environment, reaching compromises across party lines on controversial issues (or even those that are not so controversial) is likely to be increasingly difficult. This trend could make it more difficult—if not impossible—to arrive at consensus decisions.

The political situation in Washington is being similarly played out across the country by most state and local government bodies. Unlike the federal government, which has a number of tools to address budget deficits, state and local bodies have few options for dealing with deficits. As a result, politicians have been forced to make extremely difficult decisions regarding how to cut costs. In many cases, governmental officials have had few options other than cutting into what constitute essential services for the needy and others who depend on government aid for basic needs. Since there are few prospects for an increase in federal funding to offset these losses, the situation is expected to deteriorate even more. This is likely to lead to additional heated debates regarding which services to cut and which to protect.

With government in an economic survival mode, the burden of nurturing the fledgling economic recovery will remain on the shoulders of the private sector. Unfortunately, consumers will likely continue to face uncertainty on a number of fronts. These include the prospects for slow job growth, upward pressure on energy and food prices, and the hangover from collapse of the housing market. Therefore, business, not consumers, will play a central role in the recovery. While there are some signs that some businesses may be willing to step into this void, many others are facing their own challenges and are likely to remain in a defensive stance. As such, new hiring is likely to be tentative at best, as businesses try to increase output by investing in plant and equipment.

The good news is that there are number of positive signs that suggest the US economy may be able to navigate these headwinds and pick up some much-needed momentum as consumers do get back on board.

### Economic Growth

Although the demand from US consumers remains tempered, US manufacturers and investors have
taken solace in the growing demand from offshore. As a result of this stimulus, manufacturing activity increased over 9% in the 2011 first quarter and has been one of the bright spots on the economic frontier. The recent surge in manufacturing activity has been led by increased spending on equipment by companies that are anticipating additional demand. These companies have been able to tap their strong balance sheets to take advantage of anticipated demand as the global economy improves.

The offshore and domestic demand drivers are fairly broad based. For example, the launch of major infrastructure projects in several emerging markets has increased the demand for heavy construction equipment. Closer to home, increases in freight traffic have translated to a surge in demand for new trucks, especially more fuel-efficient vehicles that can help offset the erosion in profits attributable to rising fuel costs.

Despite the recent improvement in fundamentals, the manufacturing sector is expected to cool off in the second half of 2011. Even with this dampening, GDP growth should still be around 3%, which is on par for the gradual recovery that most players have anticipated. These projections have been affected, however, by concern over international turmoil. Indeed, a major spike in fuel prices could cause the global economy to slip back into recession. This would obviously wreak havoc with the economic prospects for the United States, but would also spill over across the globe.

Employment

In developing their outlooks, a number of economists predicted the US would experience a jobless recovery, with employment lagging improvement in market fundamentals and placing a drag on market fundamentals. That prediction has proved to be fairly accurate, with employment growth unable to eat into unemployment rates. While unemployment rates remain stubbornly high, the pace of initial claims fell to the lowest rate in over fifteen years. This improvement was seen in a number of key industries, including manufacturing and services. It also extended to the retail sector for which the downturn at the beginning of the year reflected layoffs of temporary, seasonal holiday workers. Also, the pace of mass layoffs continued to tail off, suggesting that companies had rationalized their workforces and were holding steady in anticipation of an eventual recovery.

Going into the 2011 second quarter, the unemployment scene remains more than a bit troublesome. For example, initial unemployment claims have been declining while continuing claims remain flat. Despite modest improvement in trends in unemployment, rates are likely to remain stubbornly high, which will place more stress on the shoulders of the long-term unemployed. Thus, while Congress’s recent extension of emergency, long-term benefits will help the unemployed over the near term, there are no assurances that the program will be extended again. This possibility is especially plausible in light of the recent furor over the budget, and it is likely to resurface on every front where discretionary programs are up for renewal. A number of states also are cutting back on unemployment benefits, which typically are supplemented by federal payments.

Improvement in the overall pace of job creation got off to a slow start in early 2011, as state and local governments pulled back to reduce budget deficits. On the other hand, the private sector reported some modest, but fairly widespread, gains with most regions showing some improvement in hiring. This improvement is most evident in the professional and business services industries, where there is a shift from the trend of hiring temporary workers to the more recent trend in employment growth with the dominance of permanent hires.

Despite the improvements in hiring and layoffs, the soft labor market continues to place a governor on wage gains. While offering little solace for those out of work, strong balance sheets suggest that companies may begin to take on new employees at a faster pace than projected. Indeed there are some signs that employment gains may start to kick in, although at a tempered rate. This situation is already being played out in the manufacturing sector where companies have pushed workweeks to the limit and have already elevated productivity levels to capacity.
**Inflation and Interest Rates**

The Federal Reserve has made it clear that it intends to hold interest rates at historical lows until the fledgling economic recovery gains some traction. While many other countries are taking a similar approach, some countries have started to focus more attention on the risk of inflation. This is especially true in emerging markets, which have raised interest rates to thwart the risk of inflation.

These actions have had a significant impact on exchange rates and have created winners and losers. On the winning side are the countries that have raised interest rates to thwart inflation. Emerging markets have taken the lead, creating an influx of global capital and putting pressure on countries to try to keep currency levels under control. On the losing side are countries like the United States, which have held rates low and have been forced to face the prospects of weakening currencies. Given the dependence of the United States on outside capital, prospects for additional erosion in the value of the dollar could create capital shortages. This could lead to further erosion in what is already a difficult position in terms of budget deficits and exchange rates. The situation could be exacerbated even more if global capital providers lose confidence in the United States’ ability to navigate toward a more robust economic environment.

In addition to concerns regarding inflation at the global level, inflationary pressures in the United States are clouding the outlook of investors and consumers alike. This is particularly true in the case of rising fuel prices, which are at record levels and show no signs of abating. Some of the increase in gasoline prices can be explained by the turmoil in the Middle East and the risk to supply. However, from Washington to Main Street, there is rising suspicion that fraud or price gouging may be behind some of the recent surge. This led US Attorney General Eric Holder to create to the Oil and Gas Price Fraud Working Group to look into illegal activity. The scope of this inquiry will be carefully monitored and, where possible, mitigated upward pressure on inflation and interest rates should be avoided and, where possible, mitigated by defensive strategies.

**Business Indicators**

First quarter 2011 business indicators were generally positive and pointed to gradual but continued improvement for the economy. This situation has been mirrored in a number of countries, as reflected by the improvement in the composite leading indicators published by the Organisation for Economic Co-operation and Development (OECD).

Indeed, the leading indicators for the United States slightly outperformed other countries over the previous six months. The Conference Board’s leading indicators reflect the improvement on the home front. The modest but widespread improvement across eight or ten indicators suggests the domestic recovery should stay on track in the absence of unexpected shocks to the system. These results were echoed in the Beige Book published by the Federal Reserve, which revealed modest expansion across each of the twelve Federal Reserve districts. This was welcomed news, especially among some of the higher-growth districts that suffered the most in the economic slowdown.

One of the challenges the United States faces is the international trade deficit, which continues to grow in spite of increases in export activity. Unfortunately, the export improvement has been more than offset...
by an increase in imports that has been fueled, in part, by an increase in imported petroleum products. During the 2011 first quarter, crude oil inventories continued to trend upward, although the pace of imports moderated and domestic production was fairly stable. Some of the increase in inventory levels can be attributed to the decline in consumer and business demand for petroleum products due to rising costs. Given the turmoil in the Middle East, inventory levels and prices will be something of a wild card and will provide some downside risk to the economy.

In terms of industry sectors, automobile and truck exports were fairly strong and further gains are expected, in part, due to the disruption of the Japanese vehicle market and increased infrastructure investment by emerging markets. With respect to trading partners, the deficit was uneven, and the United States lost ground with respect to China and gained ground with Japan and Canada. Despite a number of challenges, net offshore investment in US securities improved, with increases from government institutions and sovereign wealth funds moderated by declines in private holdings. The dependence on offshore capital to support deficit spending suggests that efforts may have to be extended to avoid further erosion on the global front. The failure to attract offshore investment could drive up capital costs and stall the domestic recovery, which would leave the country behind its trading partners.

The stock market has continued to outperform the general economy due to a combination of factors, ranging from strong balance sheets to an improvement in first-quarter earnings. Despite the improved balance sheets, companies have continued to position themselves for growth rather than pursuing the hiring of permanent employees. A number of companies have used their arsenal of capital and access to credit to position themselves for the future by acquiring smaller firms.

Among small businesses, confidence levels continue to increase moderately but still remain below levels sustained prior to the recession. Small businesses also report plans to increase expenditures over the next six months, although few see this as a time ramp up, especially when it comes to new hires.

Despite some concerns among small business owners, corporate America is well positioned to respond to an uptick in demand. Such a response is likely to translate to increase hiring since productivity levels are at all-time highs and investments have already been made in computers and equipment. This could have dramatic ripple effects that may propel the economy forward and create a solid foundation for further improvement.

**Consumer Confidence**

Consumer confidence levels have continued to bounce around with no clear trend, although there are few signs that the situation will change dramatically in either direction over the near term. On the one hand, consumers continue to be nagged by concerns over the housing market (which has yet to bottom out), moderate gains in hiring, and inflation in fuel and food prices. On the other hand, consumers are paying close attention to the economic recovery as well as to the plight of the stock market. While still struggling to make ends meets, those with investments in the stock market have no doubt taken solace in their ability to recoup some of the losses in their 401(k)s during the recession.

On the credit front, consumers have slowed down the pace of contraction, although they continue to keep a close eye on credit card debt. While many households still struggle with credit problems, the pace of delinquencies and defaults remains significantly below levels during the height of the consumer crisis. Some declines in consumer balances can be attributable to write-offs as lenders seek to clean up their balance sheets. In this environment, lenders have begun to relax some of the credit standards they imposed earlier. At this stage, consumers are likely to remain guarded and avoid turning back to plastic until the housing market and the employment front improve. Given the state of the economy, the prospect for such improvements is likely to dampen consumer confidence levels over the near term.

**Retail Sales**

At a national level, retail sales have continued to improve across much of the country after only spotty increases earlier in the year, which were partly attributable to weather conditions. Retail sales have been mixed to positive during the 2011. Many consumers continued to focus on essentials, especially with rising gasoline prices eating at already-strained budgets. This translated to relatively strong performance for big-box and membership club stores that deliver value-oriented goods. At the other end of the spectrum, improvements in the economy, coupled with a rising stock market, have helped bolster sales.
in the luxury category. Internet sales have also continued to improve, although they remain a relatively minor share of total retail sales.

The automobile industry lost ground in March 2011, partly due to a decline in domestic sales. However, for the first quarter as a whole, sales were up as drivers sought higher mileage vehicles to offset rising gasoline prices. Although domestic sales slipped a bit, the outlook for domestic vehicle sales should improve due to disruptions in the supply chain for Japanese vehicles. However, shortages in the availability of electronic components and other parts manufactured in Japan may dampen domestic production. On a positive note, Kia Motors announced plans to shift production of its Optima sedan from Korea to its plant in Georgia. Nissan also announced it will begin building its new SUV in the United States next year. These actions are attributable to the combination of increasing demand in the United States and the weakening dollar, which makes such expansion more economically attractive to global companies.

The improvement in retail sales has been fairly widespread; the exception has been furniture, electronics, and appliance stores. The chain store sales levels have improved moderately, although year-over-sales gains have continued to be elusive.

In addition to improvement in retail sales, restaurant sales have increased as consumers choose to eat out. This penchant for dining out has no doubt benefited from the fact that prices at restaurants have not increased as much as raw food prices. This phenomenon is due in large part to the high labor component associated with restaurant operations, and the ability to attract workers from the ranks of the unemployed and underemployed without increasing wages.

On a positive note for the real estate market, some retailers are beginning to explore expansion opportunities, although they continue to focus on unit profitability rather than on market share as a fundamental driver of expansion. This situation is likely to continue as retailers try to gauge consumer sentiment and anticipate prospects for an increase in appetites for goods and services.

**Housing Market**

The housing market has gone through some difficult times over the past several years. The Senate hearings on the future of Fannie Mae and Freddie Mac suggest that the crisis has a long way to go before it plays out. Pressure is still on Congress to wind down the government-sponsored entities, a process that will be both contentious and time-consuming. Indeed, Treasury Secretary Geithner is pushing for reforms within the next two years. While this pace may be on par for Washington initiatives in general, it would likely be too late for the housing market, which is still looking for a bottom. While the nature of the reforms are being hammered out, most of the initial proposals call for much greater reliance on private capital to fund residential mortgages. At the same time, there is increasing pressure for government involvement as it assumes the role of a guarantor. Such an approach has precedence in early Federal Housing Administration (FHA) and Veterans Affairs programs, and it is likely to be tied to the success of efforts to privatize the industry without creating a surge in rates associated with wider spreads on mortgages. Some parties are arguing that the government should not provide such a backstop and that it should let the residential markets fall back to a level in which success is contingent on the ability to stand on the backbone of the private market. The stakes will be high and lobbying efforts frenetic as various stakeholders try to influence policies and have a dramatic impact on the future of the housing industry.

While debates are likely to continue for some time as to the future of the residential mortgage market, most attention remains focused on the current plight of the housing market. Unfortunately, the situation remains bleak and suggests that previous interventions and stimulus programs may have dampened some of the hardship, but failed to trigger a turnaround. For example, while the surge in transaction volume during the housing tax credit programs did provide some support for home sales, the impact was not enduring. That is, while the programs encouraged some buyers to get off the fence, the continued erosion in fundamentals and stagnant economic conditions for employees prevented the industry from gaining any real traction. Similarly, there has been as surge in foreclosures since with the end of the temporary curtailment of foreclosure activity in the face of criticism of the mortgage industry. This has increased sales of distressed housing and put additional downward pressure on prices.

Widespread price declines have occurred in many housing markets during the past six months and have been a shock to industry observers who had hoped...
that the industry had bottomed out. Pending home sales rates have been relatively flat, but remain well below prior year figures. New home sales levels have been even more disappointing, with 2011 exhibiting a downward trend in sales volume, which has fallen to record lows. Homebuilders remain frustrated in their efforts to create a compelling value proposition for new houses even after pulling back on size and reducing median new home prices by almost 10% on a year-over basis.

While a number of transient factors have been cited to explain some of the declines in new home sales, the situation is somewhat ominous going into the peak housing season. It has translated to additional declines in housing starts, which are pushing record lows. The pause in construction will help avoid further erosion in the face of the growing inventory of foreclosed properties. In the meantime, the industry will face additional downward pressure which is likely to hang over the industry until mid-2012 if not longer.

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Real Estate Market Overview
A number of signs suggest that fundamentals of supply and demand have stabilized in the commercial market, and that the overall market has bottomed out. This situation is most apparent in the case of the multifamily and hotel sectors, which have benefited from a lack of new construction and gradual improvement in demand. While the retail sector has shown some stabilization on the heels of improved sales, the overhang of surplus space and tempered consumer demand may push the sector back a bit. The office market has also shown some signs of stabilization, although demand for new space and net absorption have been tempered by the jobless nature of the recovery. The industrial sector showed some earlier improvement along with the uptick in manufacturing and imports and exports. Further gains are likely to be modest and dependent on continued improvement in the global economy.

The commoditization of commercial real estate characterized the industry over the past several years, but the tempered nature of the economic recovery and renewed emphasis by tenants on quality versus quantity of space suggest that this pattern will not prevail. Improving fundamentals at an overall level will not occur across the board, and there is some danger that capital providers may not recognize the differentiation in values during the early rounds of a rally.

Regardless of how the overall market plays out in the near term, some property types, subtypes, markets, and submarkets will come out ahead of the curve while others will lag. Some of this differentiation will be attributable to differences in demand that is driven, in part, by demographic shifts and job growth. For example, over the past decade the US population grew by slightly under 10% to 308 million. This growth was led by a surge in metropolitan areas, which grew twice as fast as rural areas. At the same time, almost half of rural areas in the country actually lost population. This shift occurred during a period when interurban migration rates were dampened by the widespread lack of job growth. It was exacerbated even further due to the collapse of the housing market, which anchored down employees and locked them into jobs and locations that had long ago lost their allure.

The plight of the housing market is likely to still hang over many households, but the prospects for opportunities in greener pastures are likely to prove too alluring. This may lead to another string of strategic foreclosures as households move to where the jobs are and try to get their lives back on track. The same may be true for companies that realize that relocation may be both attractive and necessary to respond to shifts in demand and increases in competition. Such shifts in demand will create winners and losers among markets, will have significant impact on real estate demand and market balance, and will place renewed emphasis on understanding market dynamics and real estate fundamentals.

Office Market
The office market has shown some signs of recovery, with vacancy rates stabilizing or declining and occupied space increasing in a number of markets. Despite a significant block of sublease space, the net absorption rates have moved into positive territory after languishing for several years. This
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Office Property

Trend reflects a dramatic improvement over the steady increases in vacancy rates in the office sector in the recent past. Even with this improvement, however, office rents remained relatively flat and the potential for any meaningful improvement is tied to the economic recovery and job growth among office-using employers.

Assuming the current economic environment continues, office leasing activity should continue to increase and provide some respite for the hard-hit property sector. Since office development has come to a standstill, the improvement in the demand side of the equation should set the stage for the eventual recovery of the sector and an increase in net effective rents. Over the near term, however, this improvement will be moderate and will continue to lag the general economic recovery.

With respect to investment returns, institutional office properties in the NCREIF Index represented some 35% of total assets. At an overall level, the annualized returns pushed 12%, with income returns around 7% and appreciation at 4.6%. Central business district (CBD) office properties had an even stronger year, with total returns around 16% with implicit capitalization rates around 6.3%. On the other hand, suburban office investments generated a total return of around 8.8%, with a higher implicit capitalization rate of 7.2% and modest appreciation. On the public side of the market, office real estate investment trusts (REITs) outperformed private investments in 2010, with total returns around 18.5%. This pattern has held in 2011, with office returns through February around 8.5% on an equity market capitalization of $47 billion.

In terms of transactions volume, Real Capital Analytics reported the office market had heated up significantly in the first quarter of 2011, with institutional sales levels double that of the prior year. The increase in transactions helped create momentum for the sector and drew potential sellers who had been waiting for the signal that the market is improving. This resulted in significant increases of for-sale product on the market. Unlike the situation earlier in the cycle, this round of sellers had more realistic expectations and priced product at capitalization rates comparable to those for recently closed transactions.

Indeed, strong demand for well-priced assets has placed downward pressure on capitalization rates, which are once again approaching the levels achieved in 2006 before the market collapsed. Demand for office product has been particularly pronounced for core properties located in strong CBD markets. This has manifested itself in a plateauing of capitalization rates for suburban properties over 120 basis points above their CBD counterparts. With respect to markets, investor demand remains focused on larger primary markets. There are some signs of an increase in activity, however, in secondary and tertiary markets as investors try to source product in a highly competitive market.

Despite the renewed interest in acquiring office properties, the sector is not without its problems—as noted by the increase in distressed assets relative to the percentage of workouts during the quarter. This increase was particularly pronounced among suburban office markets, which experienced more than a 55% increase in distressed assets on a year-over basis. At the same time, the pace of workouts is higher for CBD assets than for their suburban counterparts, as is the recovery rate. As a percentage of total office sales, distressed properties fell below the 10% figure after peaking in the upper teens in mid-2010.

In terms of buyers, activity in the 2011 first quarter was dominated by value-add or opportunistic funds, while the top sellers represented a broader array of players. Going forward, moderate improvement in office market fundamentals and the pent-up demand for assets are expected to continue to bolster transaction activity. These efforts will be supported by a moderate easing of lending policies, especially for many credit buyers and properties with solid fundamentals and occupancy rates.

Retail Market

The retail sector has seen some improvement in market fundamentals. Vacancy rates have declined as a result of lower construction levels and modest improvement in demand has led to positive net absorption rates.

Despite this improvement, rents remain below peak levels and are expected to remain rather flat until the economy picks up and consumers return to the registers. While retailers have been in something of a contraction mode for the past several years, there are some signs that they are gearing up for a round of expansions in anticipation of increased demand.

Since the improvement in demand will not be across the board, there will be some winners and losers in the retail arena as in other property types. For example, if recent trends hold, upscale retailers will line up to welcome shoppers back to the malls.
and boutiques in search of fashion and a respite from the recent doldrums. However, this is not likely to lead to a spate of new stores, with efforts focused on enhancing productivity and improving market share at existing facilities. The grocery industry will be interesting to watch as stores try to differentiate themselves and carve out a viable niche in what will be an increasingly competitive market. This situation will be exacerbated, in part, by rising food prices that will hit middle-American shoppers the hardest, but will affect higher-income shoppers as well.

The risks of continued increases in gasoline prices and deferred or abandoned infrastructure investment as a result of government budget crises are likely to force retailers to pay closer attention to linkages and connectivity. This will become even more important as nontraditional sales continue to expand, and pop-up retailers and others set up in unexpected places with the potential to change competitive balance and cannibalize established trade areas.

With respect to returns, institutionally held retail properties in the NCREIF Index represented around 24% of the pie. At an overall level, the annualized retail returns were over 12.6%, and income returns were around 7%. Community shopping center retail properties had slightly lower total returns at 11% and income returns at around the same level. Somewhat surprising in light of strong investor interest, neighborhood centers were even lower, slipping to annual returns under 10% with slightly higher income reflecting higher risk. Again, these numbers represent greater improvement in the capital market for assets than in the spatial market. At the upper end of the spectrum, regional malls had total returns around 14.5%, while super-regional malls pushed 16% total returns. Single-tenant retail properties, which many approached as bond investments, fared the worst among other retail categories and had total returns around 4.2%, which included moderate declines in value.

On the public side of the market, retail real estate investment trusts (REITs) had an advantage over private investments; in 2010 they had total returns exceeding 53%. Among size categories in the public market, freestanding retail had the highest total returns, which was the opposite experience from the private market. While losing some ground compared to office properties, retail REITs have experienced strong returns during 2011, with total returns through February around 7.4% and regional malls pushing 9% on an aggregate equity market capitalization of $102 billion.

During the first quarter of 2011, retail sales activity continued to increase and rose more than 50% above the activity levels in 2010. This increase was led by grocery-anchored neighborhood centers, as well as urban properties located in thriving downtowns.

Retail capitalization rates fell 100 basis points over the prior year, but remained well above capitalization rates at the peak of the market in 2008. As with other property types, capitalization rates for retail properties were the lowest for primary markets, with smaller markets hovering closer to their 2010 peak. In spite of segmented investor demand, capitalization rates for large and small retail tended to converge, with larger properties enjoying the greatest declines. Despite this improvement, retail capitalization rates remain significantly above 2008 levels and are expected to hold until retail sales improve en masse rather than in just selected categories.

In addition to an increase in transaction volume, the retail sector has benefited from a slowdown in additions of distressed properties, with additions reaching the lowest level in over three years. During the 2011 first quarter, lenders were more willing to restructure loans, and this resulted in more workouts than in other property sectors. At the same time, lenders were more aggressive in pursuing troubled retail assets, which created a surge in assets that was partially offset by a willingness to restructure rather than acquire the REO properties. This behavioral response may be attributable, in part, to the more difficult management challenge posed by retail properties compared to other property sectors. In terms of players, the top buyers and sellers are both dominated by the combination of REITs and value-add or opportunity funds.

**Industrial/Warehouse Market**

As with other commercial property types, industrial and warehouse spatial market fundamentals improved modestly during 2010. The sector benefited from a combination of positive net absorption and a dearth of new space. This led to a decline in vacancy rates, although the current levels are still high by historical standards.

The improvement in fundamentals was particularly evident in markets that are an integral part of the global supply chain and benefit from a combination of imports and activities, which provides...
a hedge against a reliance on the domestic economy. While the manufacturing industry has slowed down a bit in early 2011, the strength on the global front and the weak dollar bode well for an increase in exports, and should add further strength to the industrial sector.

At the same time, improvements in the economic outlook and signs that employment rates may begin to pick up suggest that some improvement in the industrial sector may be on the horizon. With strong corporate balance sheets and plentiful supplies of potential employees at their doorsteps, manufacturers are well positioned to respond to increased demand, both here and abroad. Despite this potential for improvement on the demand side, it is unlikely that the market will be flooded by a wave of new construction, and this suggests that the recent improvement may continue and will stay in pace with the broader economic recovery.

Industrial properties in the NCREIF Index accounted for some 14% of total assets and provided an overall return of some 9.4% in 2010 with relatively strong income of 7.3% compared to other property types. At a subtype level, research and development properties provided slightly higher total returns, pushing 12% with implicit capitalization rates reflecting sector averages. Industrial/flex properties, which are inherently riskier than other industrial property types, provided close to a 6% return but this lagged other industrial categories. Industrial/warehouse properties provided solid total returns pushing 10% with an implicit capitalization rate around 7.2%.

Finally, manufacturing space provided the highest income returns due to the specialized and relatively illiquid nature of such investments. On the public side of the market, industrial REITs generated returns pushing 19% in 2010. While other property types have tailed off a bit in 2011, industrial returns through February held up better, providing a 12.6% return on an equity market capitalization of some $20 billion.

Transaction levels in the industrial and warehouse property sectors slowed during the 2011 first quarter, reversing the upward trend that held throughout 2010. This decline was attributable to a number of factors, including the market’s discounting of the moderate slowdown in manufacturing activity and the uncertainty over the volume of imports and exports. The slowdown in transactions was not spread equally across the sector on the heels of global unrest and fallout from the nuclear crisis in Japan. Warehouse transaction volume has picked up recently while industrial transactions have declined.

Although capitalization rates have trended down for the past two years, they remain in the 8% range, making the sector attractive relative to other core property types. At the same time, there were fewer differences in transaction volume rate when comparing primary, secondary, and tertiary markets than in the office and retail markets where size matters. Interestingly, although flex properties are generally perceived as riskier than other industrial categories, capitalization rates for flex properties in warehouse investments have converged after a surge in capitalization rates during the trough of the market. On a similar note, the price per square foot of closed transactions for warehouse properties has been much more stable than for their more volatile flex counterpart. As with retail property types, capitalization rates have converged among sizes of assets, with rates stabilizing for larger properties and declining for smaller properties.

Interestingly, the level of distressed industrial assets has continued to grow rather dramatically despite improved performance. Whereas the magnitude of distressed assets for some other property types was reduced by a surge in restructuring activity, in the industrial sector such activity was extremely low. The lower rate of restructurings and resolutions in the industrial sector may be attributable to a combination of smaller assets as well as higher recovery rates, which has led lenders to be more conservative and wait for the sector to improve in terms of market fundamentals. When compared to other property types, the list of most active industrial markets reflects the greater geographic distribution of industrial warehouse properties across the country. The same pattern has occurred with respect to the increase in distressed industrial assets that have been geographically widespread. This situation is not likely to significantly change over the near term, with few markets exhibiting much improvement in terms of distress despite improvements in underlying market fundamentals.

The most active buyers of industrial properties have been industrial REITs and core real estate funds seeking stable returns. On the other hand, sellers have been more diverse; they range from industrial REITs to institutional investors and developers seeking to liquidate or reposition assets.
The impending merger of the AMB Property Company and ProLogis may have a profound impact on the industrial market. This merger of equals will create the opportunity for economies of scale that may provide a competitive advantage over smaller counterparts. Rather than reflecting weakness of one of the parties, the merger may well reflect recognition of the dramatic impact of globalization on the industry and the need to achieve economies of scale to support an increasingly global and competitive industry. However, the industrial sector will continue to be characterized by a wide array of players, ranging from smaller local developers and investors to larger global parties.

**Apartment Market**

The apartment market continues to be the darling of the commercial real estate market, benefiting from a combination of increased demand and dampened construction levels that are due, in part, to a lack of access to equity and debt capital. This situation has begun to change, with investors flocking to the sector to take advantage of the improvement in fundamentals, especially when compared to other property types.

Similarly, lenders have become more willing to fund construction for new apartments and provide capital to finance acquisitions of existing product. This renewed interest among lenders is somewhat at odds with the fact that apartments have the highest delinquency rate among commercial mortgage-backed securities (CMBS) pools, with some 17% of apartments in some form of distress. This fact reflects the heterogeneity within the sector, the need to pay attention to market fundamentals, and the importance of proactive management to retain value during the operating stage of the product lifecycle.

Institutionally held apartment properties represent around a quarter of the NCREIF Index, which reflects a relatively high market share compared to long-term averages. Some of this higher share can be attributed to the strong performance of the sector, which racked up total returns of over 18% in 2010.

Interestingly, implicit capitalization rates for apartments were the lowest among the major property types and were under 6%, which translated to an appreciation return pushing 12%. Garden apartments provided slightly lower returns than the overall sector at 16.8%, although implicit capitalization rates came in around 6.3%. High-rise apartments outperformed the apartment sector as a whole, with 2010 total returns pushing 20% and implicit capitalization rates falling below 5.3%. However, low-rise apartments led the pack with total returns pushing 20.6% for 2010. While private apartment returns led other property sectors, they paled in comparison to the public side of the market in which apartment REITs outperformed all property types, with total returns for 2010 of 47%. This pace has tapered off in 2011, although apartment REIT returns through February still came in a respectable 6.5% on an equity market capitalization of $58 billion.

Despite strong returns, the apartment market slowed in terms of transactions in early 2011 after a steady upward trend during 2010. Even with this slowdown, transaction levels for apartments were some 50% above those of a year ago. In terms of subtypes, garden apartments were the favored target for investors and experienced an increase in activity, while sales of mid-rise and high-rise urban properties tailed off.

Capitalization rates have remained relatively stable despite the change in activity levels. Sales of distressed apartment properties accounted for about 25% of total sales. At the same time, the ranks of distressed assets have flattened out due to the willingness of lenders to resolve problem loans through sales and liquidations rather than foreclosures that would increase the amount of REO properties. In terms of subtypes, distressed property levels for garden apartments have declined, while levels for urban and high-rise properties have plateaued.

Despite the significant changes and capitalization rates over the past several years, prices per unit have been relatively stable for garden apartments and for urban properties. Interestingly, the apartment sector exhibits a stronger divergence in pricing among primary, secondary, and tertiary markets, which is reflected in the widening spread and capitalization rates. However, many investors continue to focus on the primary markets, and this has caused more aggressive pricing for core or trophy properties. The top buyers of apartments have been apartment REITs and specialty managers, while sellers have included apartment REITs, property specialists, and institutional capital providers. Given the continued turmoil in the single-family housing market, improvement in apartment market fundamentals is expected to draw a wide array of buyers, and this should help bolster activity levels throughout the year.
Real Estate and Capital Markets

Real Estate Capital Markets

Some prognosticators approach the real estate capital markets as though the markets were rational and anchored on objective information rather than attitudes and perceptions. The reality is that real estate markets are inherently behavioral and depend on the attitudes, expectations, and perceptions of market participants. This caveat is important to note when opining on the current state of the capital markets, and it helps explain why capital flows may appear to ignore the underlying spatial market conditions.

Behavioral insights become even more important when trying to predict the future state of the capital markets. In the current economic environment, despite generally positive signs, there is significant uncertainty as to the durability of the recovery and the extent that it will ripple over and have positive impacts on the real estate market. Usually, this heightened sense of uncertainty would translate to higher risk that would be priced in the market and put upward pressure on yield requirements. Ironically, the capital markets do not appear to be placing additional emphasis on risk and have shown a willingness to accept relatively low spreads over alternative investments—despite having experienced significant losses in the recent past due, in part, to the failure to accurately price risk.

The recent spate of capital market activity suggests that some participants that are making the market have either discounted a bull run in real estate or have bought into the mantra that less is more. While this attitude may hold over a short period, it is not likely to stand the test of time or provide an adequate foundation to support the real estate capital markets over the long haul. This is especially true since capital flows to real estate are not likely to be sufficient to satisfy the demand for capital necessary to retire the $1-trillion-plus surge of bullet loans that are maturing over the next several years.

Thus, while transaction activity may heat up over the near term, it will not forestall the day of reckoning that is looming on the horizon. Until the market focuses attention on these problems, capital flows are likely to continue to accelerate with investors, lenders, and even CMBS sources returning to the table.

During this phase of the cycle, the “future is now” theme may appear to be warranted. Without dramatic support to real estate fundamentals that would spill over to distressed assets with tremendous capital requirements, something has to give. While an unexpected surge in demand (or some form of government intervention) may help, the recent spate of capital market exuberance is likely to be reined in. If this occurs, it will place a damper on capital flows to the asset class and force players to revisit their game plans. In the meantime, capital flows to real estate are likely to continue to be strong and lead to an increase in real estate activity levels which may even spill over to funding for new development. Given tempered prospects for improvement on the spatial side of the market, significant downside risk will likely hang over the capital markets. Given the elasticity of capital flows, this situation should be carefully monitored for early warning signs of a double-dip real estate recession.

Private Equity Market

On the surface, the strong year-end and trailing twelve-month returns racked up in the NCREIF indices suggest that the price correction that caused the collapse in values has been reversed.

Interestingly, the strong returns have been fairly broad based and have cut across property types, markets, and fund styles. For example, core funds, which are inherently more conservative than funds with other investment styles, racked up 17% returns for 2010. These returns compared favorably to 13% returns for value-add funds, and an astounding 24% for opportunistic funds. What is even more impressive is that these record returns came on the heels of two years of negative returns, which approached 40% for core funds, 60% for value-add funds, and 65% for opportunistic funds. The impressive returns occurred during a period when real estate fundamentals languished, which argues that the spatial/capital divide has not gone away as hoped, but has actually widened. This divergence between the capital market performance of real estate as a financial asset and the spatial performance of real estate as a resource raises questions of whether the recent rally in performance is sustainable or whether it epitomizes the commoditization that prevailed through much of the past decade.

This situation bears close watching to see if institutional investors are indeed willing to accept that less is more. While this may be the case over the short term, long-term trends and yield requirements that are needed to justify allocation to the asset class argue against such a structural shift. Thus, the market faces significant risk, especially if other asset classes
continue to improve and real estate returns pale by comparison.

**Public Equity Market**

As noted in the discussion of the property types, the public REIT market appears to be out ahead of the private institutional market when it comes to total returns. Some of this performance premium may be attributable to proactive management; however, it is difficult, if not impossible, to sustain a competitive advantage over other investment formats over the long term. This is especially true if the market retains some level of efficiency and transparency, and the underlying spatial market fundamentals ultimately determine risk/reward levels.

That said, the risks that face other asset classes as a result of political unrest and the threat of natural disasters may continue to favor real estate as a defensive asset. But, as was the case in the late-1990s when the market realized that REITs were an income play rather than a growth play, a time of reckoning may be on the horizon. That is not to say that private and public real estate performance will collapse, but at some point in the not-too-distant future, the spatial market must catch up to the asset market to support recent prices increases.

**Mortgage Market**

One of the positive signs for the commercial real estate market has been a rekindling of interest in the debt side of the asset class. As market conditions improve, lenders have been returning to the sector.

Although initial efforts have focused on core assets held by strong borrowers with existing relationships, this pattern has been loosening up, and capital providers have begun to compete for deals. This relaxation in underwriting is expected to be moderate, and it will not spill over to the development side until rents rise to levels at which new projects will again pencil out. Over the near term, capital flows are expected to increase to levels necessary to support an orderly pace of transactions that are in line with improvement in underlying market fundamentals.

The CMBS market continues to struggle to gain traction. There has been some improvement in new issuances, but high delinquency rates continue to hang over the industry. Delinquency rates are pushing low double-digits across most property types, with apartment and hotel rates already in the mid-teens. While expected to continue to edge up, the trend of increasing delinquency has showed some signs of slowing down, which has taken some pressure off the beleaguered sector. This situation is likely to continue as real estate market fundamentals begin to improve.

It should be noted that some of the improvements in delinquency rates can be attributed to a denominator effect as recent issuances have increased the size of CMBS pool. First-quarter 2011 CMBS issuances were around $10 billion, and projections are for some $50 billion for the year as a whole. This is a marked improvement over the $10 billion total for 2010, but pales in comparison to the total of some $230 billion at the peak in 2007.

Despite some positive signs, the commercial mortgage industry faces significant headwinds as it tries to clear the queue of distressed assets. The pace of workouts, restructurings, and dispositions of troubled assets has shown some improvement, although much more work still needs to be done. Unfortunately, the long-awaited increase in mortgage capital flows will be nowhere near the level needed to recapitalize the commercial bullet mortgages. This is especially true for underwater assets that have few prospects for the recovery in value that is needed to support underwriting standards. This looming wave of maturing bullet loans will hang over the private and public mortgage sectors and, unless somehow abated, is likely to spill over to the broader commercial market.

Thus, while the mortgage industry is likely to have some moderate expansion in new business, neither the private nor the public side of the market show signs of regaining the swagger they enjoyed in their heyday only a few years back. That is good news for the asset class overall, as it will impose some much-needed discipline and help players remember the recent lessons learned, but it will be painful for those caught in the chasm between the capital and spatial markets.

The impressive returns occurred during a period when real estate fundamentals languished, which argues that the spatial/capital divide has not gone away.
Conclusion
Looking back over the past twelve years or so of writing this column, this has been the most challenging time to try to get a handle on where the commercial real estate market is at, and more importantly, where it is headed.

While the economy continues to improve and investors return to the asset class in droves, improvement in underlying real estate fundamentals has lagged the expectations that are embedded in this exuberance. In addition to patient capital, a dramatic improvement in the economic recovery could help bridge the chasm between the capital and spatial markets. However, there is also significant risk that the commercial market will suffer from a double-dip recession.

Although the pace of workouts has accelerated, and the increases in the ranks of distressed assets have abated somewhat, the fact remains that these improvements have left the industry with a biased set of problem assets for which there are few viable workout solutions. That is, during the early phases of the market adjustment, efforts were likely focused on properties that had the greatest potential for workouts or resolution. This would explain the relatively healthy recovery rates associated with the workouts that have occurred. It would also suggest that due to adverse selection, the remaining problem assets may be more difficult to resolve. This could cloud the recovery that has already been discounted in prices and has led some to act as though the industry has returned to business as usual. While the improvements in performance are indeed remarkable, business may well be more unusual than anticipated. Thus, one is left to wonder if the future is now—or not.

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