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Still Bouncing and Being Bounced Along

by James R. DeLisle, PhD

Commentary

As the first quarter of 2003 unfolded, prospects for the economy became much more guarded, with the risk of a double-dip recession gaining attention. This deterioration can be attributed to a number of downside forces and the absence of any major, sustainable rallying point. One major downside force is the geopolitical risk. This risk is multifaceted, including military conflict as well as the threat of terrorist activity. Another downside force is the fact that the previous strength in the economy was built largely on consumer buying and low interest rates. Unfortunately consumer exuberance has proven unsustainable, with the cumulative appetite for automobiles satiated regardless of new incentive programs. Similarly the refinancing cycle has largely played out, with homeownership at record levels and interest-rate driven surpluses fully tapped. Finally although the corporate scene has settled down in terms of scandals, no sector has emerged as a leader able to reinvigorate investor confidence and seed a sustainable market rally. Rather we are left in a situation where economic, consumer, and business confidence levels are all shaken, with rising levels of cynicism and angst lurking in the collective mindset.

While this commentary might appear bleak, there are few compelling arguments on the positive side. That is not to say that there are no positive signs, but that the preponderance of the evidence leads to a guarded outlook at best. The good news is that interest rates appear to be on a stable path, with little movement expected in either direction. Similarly despite the spike in energy prices and upward pressure on health care, inflation should remain in check. In terms of employment the situation has also stabilized, although there may be another round of contractions. Capacity utilization has also bottomed out, but remains well below averages. Finally the housing market continues to perk along, although it is showing signs of peaking as homeownership rates hit a natural ceiling and appreciation rates begin to slow. The end result of the positive and negative forces may surprise on the upside later in the year, but a more realistic outlook is for more bouncing along.

On the real estate front the news is a bit more upbeat. The capital markets continue to favor real estate, with plenty of debt and equity available to support transactions. Indeed sourcing product will remain a challenge as lenders and investors compete for limited opportunities, especially for prime real estate with credit tenants and stable rent rolls. The public real estate markets should continue to benefit from net capital inflows; however, this allocation preference will depend on relative attractiveness more than on solid real estate fundamentals. Private real estate markets should remain extremely competitive, especially for favored property sectors and cities. Foreign capital should continue to flow to the United States, but the level will depend on the geopolitical scene. Capital should also be more available for opportunistic investments, as some segments of the market begin to search for returns. Construction activity is expected to be moderate, although some niche opportunities will begin to emerge. With respect to property types, it is likely that fundamentals will slip further in most markets and property sectors. However the key term in that statement is the word "slip." It is unlikely that there will be a significant meltdown in the real estate market, although there could be several pause points as the market adjusts to external shocks. All in all there will be a lot of bouncing and being bounced, with prospects for settling down and getting a clearer sense of direction developing by mid-year.

Economic Growth

Going into 2003, the economy had provided some signs that it might finally be stabilizing. The near-term outlook has become much more clouded, how-

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ever, with the possibility of a major reversal. Some policymakers attribute the recent weakness to concerns over military conflict and terrorism. While these factors undoubtedly affect the economy, they are not the only risks to economic growth. Rising energy and health care costs are wreaking havoc on household and business budgets, eating into retail sales and inhibiting employment growth. The record trade deficit suggests that the United States's plight is not an isolated phenomenon; economic prospects in many markets are even weaker than here. Unfortunately there are few countervailing factors. In this environment economic growth is expected to be moderate with another quarter of more downside risk than upside potential.

Employment

The employment scene is one economic indicator that has shown little sign of improvement. The outlook for employment remains extremely guarded, as many companies remain on the defensive. During the first quarter of 2003 some of the declines in employment experienced at 2002 year-end were reversed, resulting in a moderate increase in nonfarm payrolls. On a related note the unemployment rate also showed very modest improvement, some of which was attributable to an increase in the nonlabor force category. This pattern of fluctuating gains and losses is expected to continue. Attention will be focused on increasing productivity with a smaller workforce in order to avoid forced cutbacks if the economy continues to falter. This situation is most evident in the business services category, which continues to struggle reflecting widespread weakness.

Inflation and Interest Rates

Although inflation has remained low many consumers still feel pinched by rising costs that seem to belie popular statistics. Consumers are being hit hard at the gas pump in a manner reminiscent of summer price spikes. Health care costs continue to rise with no relief in sight. While the brunt of these increases is being felt by businesses, consumers and government are also struggling with higher medical costs.

Interest rates remain one of the few bright spots on the economic scene, although low rates have been around for so long that they have been built into the market. This condition is a cause of concern, since businesses and consumers have limited tolerance for rising costs of capital. The Federal Reserve appears willing to sit this round out, arguing that the economy will correct itself once fears of military/terrorist activity abate. While rates are expected to remain low, the tenuous economic situation and rising uncertainty cloud the outlook. In addition, record budget deficits that cut across federal, state, and local coffers suggest that interest rates might rise if governmental bodies turn to the bond market to raise funds to cover operating expenses. If this occurs the rising competition could cannibalize capital flows to the mortgage market, placing upward pressure on rates.

Business Indicators

Business indicators provided mixed signals during the first quarter. There were some signs of life in the industrial sector, with a moderate increase in production early in the quarter. Factory orders also went up modestly early in the quarter due to strength in the nondurable category. Unfortunately by mid-quarter manufacturing activity lost the momentum it had been building as companies struggled with uncertainty and pulled back.

Capacity utilization increased for the second straight quarter, but remained well below average. While this was good news on the inflationary front, it suggests that business investment will lag an economic recovery. The financial sector is expected to remain relatively healthy in spite of a difficult environment. Credit quality is expected to slip, however, before an economic recovery. Continued turmoil in the financial markets should create a drag on the investment sector. Given the widespread nature of these weaknesses, there is little hope for a reversal in the hiring slump. The outlook is even worse in sectors dependent on business spending.

The airline industry is in a particularly difficult situation, posing a risk to the overall economy. While the current problems can be traced back to the decline in traffic after 9/11, the industry also suffers from a high cost structure that makes it difficult to adjust to a sustained decline in demand. In an attempt to carry through the down cycle, airlines turned to the debt market to cushion the blow. Despite low interest rates the sheer volume of debt has placed the industry at record levels of leverage. The only bright spot in the industry is confined to low-cost carriers that are not saddled with high labor costs. The airline industry is unlikely to improve

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without major restructuring. Unfortunately the industry's hands are tied, making self-correction a seemingly impossible task.

After a difficult period the insurance industry should be able to continue its recovery from losses incurred in 2001. Unfortunately, while stability in the insurance sector is important to the broader economic environment, it will come at the expense of businesses and consumers in the form of higher rates. Some of these increases are directly attributable to terrorism-related insurance rates. Others are related to insurers' efforts to raise rates across the board. Upward rate pressure has been particularly high for property and casualty insurers that have been hurt by a combination of rising claims (e.g., mold, asbestos) and weak investment returns.

On the public front the struggling economy has caused a significant drain on state and local governments. For example as more Americans have joined the ranks of the uninsured, it has placed additional pressure on already-strained public health budgets. The budget pressure on government has been pervasive, forcing cutbacks in services and placing upward pressure on fees and taxes. In many jurisdictions businesses and taxpayers are resisting taxpayer bailouts. There is a growing sense of cynicism, with taxpayers attributing budget shortfalls to a lack of fiscal responsibility and accountability in the public sector. Although some have turned to Washington for federal intervention, it is unlikely that they will get much more than a sympathetic ear. The end result is a rather bleak period until the economy improves and income tax revenues increase. An increase in consumer spending would stimulate a rise in sales tax revenues. Given the dire financial straits of many state and local jurisdictions, however, the demand for services will likely outpace such revenue growth over the near term. Thus the budgets of state and local governments are likely to remain under significant pressure resulting in lower services and higher fees.

Stock Market

The uncertainty surrounding the economy and international incidents has translated into a tumultuous stock market. After small rally in the fourth quarter of 2002, the market bounced around at the top of the cycle in early 2003. This tenuous situation eroded quickly, with widespread declines during the balance of the quarter. As might be expected the bright spots were isolated and did not spill over into the entire sector. For example during early 2003 there were scattered gainers in health care, consumer cyclicals, technology, and energy. At the broader level returns for these sectors were on the negative side, reflective of the broader market. When rallies have occurred they have later disappeared. Over the near term this situation is unlikely to change, suggesting a high level of uncertainty and attendant volatility in the market. Despite this turmoil investors are looking for opportunities to regain some of the ground they have lost and have not completely turned their backs on the market. In the meantime the volatile market offers little hope of stabilizing until the economic and military/terrorist issues are resolved. Depending on how the situation unfolds, there will be some pockets of improvement as the market adjusts to the international scene and jumps on emerging opportunities. A broader-based recovery is unlikely, however, until economic fundamentals improve and an increase in business and consumer confidence occurs.

Consumer Confidence

Consumer confidence continues to erode as the cumulative effect of the weak economy and international situation. Consumers are becoming even more pessimistic about their future prospects. These concerns are focused on expectations for business conditions, as well as employment levels. Consumers are also becoming more realistic in terms of income expectations, with many consumers anticipating limited earnings growth in light of the weak economy. Many consumers remain more concerned about staying on the job than reaping wage increases. There is little to suggest that consumer confidence is poised for a recovery. Many consumers are cynical, attributing the explosion in energy prices to price gouging rather than the international situation. Consumers are likely to remain on the defensive, creating an additional drag on economic recovery.

The international situation also is weighing heavily on consumer confidence and adding to consumer angst. The situation is even more tenuous in light of the rising threat of terrorism on the home front. Interestingly the elevated alert status in late February did not seem to resonate with many consumers, suggesting that they may be getting hardened to the situation. Regardless of how the United States deals with these risks, they remain a factor

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over the near-to-intermediate term. There are few signs of a reversal of consumer perceptions, suggesting that the economy will have to turn elsewhere for a catalyst to pull it out of the doldrums.

Retail Sales

Over the past several years, retail sales have held up surprisingly well despite the weakening economy. The effects of the economic downturn finally were seen during the holiday season, with retail sales reflecting the reality of a struggling economy. Year-end sales were further hurt by a shorter shopping season and inclement weather. The automobile industry did have some gains at year-end, but this improvement was related to favorable financing and price-breaks rather than a fundamental shift in demand. During early 2003 the retail scene continued to languish due to poor economic fundamentals. In light of the weak economy and concern over consumers' financial stability, banks have been tightening credit standards, reigning in some of the potential growth in consumer credit and retail sales. The outlook for retail sales will remain guarded, with weak economic conditions and the threat of international conflict placing consumers on the defensive.

Housing Market

The single-family housing market was one of the few sectors with solid gains throughout 2002. The pace of sales during 2002 increased by about 5% and median prices rose at a slightly higher rate. In light of weak economic conditions and eroding consumer confidence, this strength was surprising. To some extent the housing market can be explained by the uncertainty of investments in other sectors, making the housing market a kind of a safe haven. At the same time, record low interest rates increased the buying power of potential homeowners. This created upward pressure on prices and amplified the investment potential of single-family houses. These factors coupled with positive demographic trends have led to record homeownership rates, with over two-thirds of households owning homes as of the end of 2002. There are some efforts in Washington to boost this rate even further, in the form of new programs to help first-time homebuyers.

While the rise in ownership rates has bolstered the housing market, there is some downside potential in terms of decreased mobility. If the economy and the employment situation deteriorate further, home ownership could inhibit mobility and anchor homeowners to their existing markets. At the same time since the housing market is highly leveraged with many buyers stretching the limits of affordability, a disruption in certain strata of the market could cause ripple effects that spread across the sector. For example the inability to sell an existing house and walk away with positive net proceeds could prevent potential buyers from moving up the housing chain. On the other hand a slow market could prevent buyers from trading down to more affordable housing.

Despite an active housing market in terms of volume and average prices, there is some evidence that the housing market is peaking. For example during the 2002 fourth quarter, the rate of appreciation slowed to its lowest level in over five years. Given the uncertainty in the economy and flat wages, there is little reason to believe that this phase of the housing cycle will be reversed. If the economic climate remains the same, the housing market is expected to continue to expand although at a lower rate than in the past. If the economy picks up, the sector could regain some of its previous momentum. In the meantime potential homebuyers can be expected to become more creative and expand their housing options to include neighborhoods and properties they would avoid in more normal times. The circumstances point to continued strength in the housing market. The housing market is not without risk, however there are few signs that a collapse in the market is imminent.

Real Estate Capital Markets

Capital Markets Overview

Going into 2003 real estate capital flows remained stable despite weakening market fundamentals on the spatial side of the equation. The search for investment opportunity caused investors to broaden their horizons, especially on the equity side where capital is outpacing the availability of product. The good news is that investors have not turned to the supply side to satisfy demand, but have begun to consider less mainstream options in terms of product cycle and markets. On the other hand the mortgage market has maintained its somewhat conservative bent, creating stiff competition for prime lending opportunities.

Despite the turmoil surrounding the broader financial market, the prospect for continued stabil-

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ity in real estate capital flows remains high. Real estate is expected to continue to look attractive in relation to other investment classes. This conclusion is based in part on the fact that the recent wave of equity investors appears to have taken a longer-term view of commercial real estate. They seem willing and able to hold assets through a bottoming-out phase. The fact that investor demand has been strong for some time and investors have been willing to acquire assets at lower yields also suggests that many marginal investors have already exited the asset class. Furthermore, it is likely that investors with a commitment to real estate as an asset class have been able to take advantage of strong investment demand and have been able to cull their portfolios. As such there is relatively limited danger of the market being undercut by a glut of product as investors flee the asset class.

In addition to the insulation provided by the "stickiness" of current real estate investors, capital market allocations to real estate might benefit from some of the economic stimuli being discussed in Washington. Unfortunately these efforts might get sidetracked by major disruptions on the international scene. Even with this distraction, the dire straights of the overall economy suggest that there will be some form of federal stimulus. It is increasingly difficult to anticipate the nature and impact of such initiatives on real estate capital flows, due to the growing divide between the political parties and the lack of a consensus approach to such issues. Despite this uncertainty it is clear that few initiatives would have a negative impact on the sector, with the possible exception of the move to exempt dividend payments from taxation. If such a measure moves forward, it could undercut the advantage that REITs have as a single-tax entity. Such a change would place more pressure on dividends, forcing REITs to take a shorter-term view that could compromise long-term performance potential.

Looking ahead the real estate capital market environment is expected to remain on a steady-state course. There should be adequate capital flows to maintain balance in the market and support a normal flow of activities. Even with the United States involved in a military conflict, real estate capital flows should not suffer more than other sectors of the economy. This situation could differ with respect to terrorism, since such activity could have a pronounced impact on particular markets or property types targeted by terrorists. It is unlikely that real estate capital flows would be disrupted on a widespread basis, however, and there are few prospects for a wholesale collapse of real estate capital markets.

Construction Activity

In early 2003 construction spending measured on a month-over basis rose modestly, continuing an upward trend. Despite this increase annualized rates were still negative, hampered by a weak start in the previous year. The gains in construction activity were concentrated in the residential sector, with commercial construction still languishing under the weight of high vacancy rates. In the future commercial construction is expected to lag behind the economy, with activity concentrated in niches that address a void in the market or that accommodate a particular demand segment. Public spending is also expected to be weak, as governmental bodies struggle with budget deficits and declining revenues. While the housing market can be expected to expand, strength in that sector should show signs of flattening out as the housing market reacts to the broader economy. Despite this downward pressure the December–January housing permit levels broke new records, carrying momentum into the year. On the multifamily front housing starts and permits declined as rising vacancy rates rippled through the supply chain. In this environment new activity will be suppressed by excess capacity and the construction sector will lag behind the economic recovery. Some projects can be expected to go forward, however, as the market responds to pockets of opportunity.

Commercial Mortgage Market

The commercial mortgage market has maintained a relatively steady course despite a slowing economy, declining interest rates, and rising delinquency rates. Although mortgage volume was slightly down from the prior year, it remained strong through the end of 2002. This strength was more pronounced in the second half of the year, setting the stage for a healthy market in 2003. This situation has carried through the first quarter of 2003, despite nagging concerns over the economy, a rise in bankruptcy, and continued tenant contraction. Locked-in financing should place a damper on volume, suggesting a shortage of product for lenders and continued competition for deals. In terms of property types, the multifamily sector has continued to capture the bulk of com-

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mercial mortgage activity, followed by office, retail, and industrial sectors. With respect to sources of capital, conduits have outpaced other investors, followed by life insurance companies, FNMA/FHLMC, and commercial banks. Pension funds remain a relatively minor player in the direct commercial mortgage market, although they are much more active on the conduit front.

The commercial mortgage market sector is not without its own issues. For example tenant bankruptcies and put-backs have continued to increase, raising questions over the sustainability of income streams on affected properties. Commercial mortgage delinquency rates also continue to trend moderately upward, although remaining very attractive relative to long-term averages. This situation is unlikely to change since the market has become more defensive as the economy and real estate fundamentals have worsened. Underwriting standards have tightened up as lenders have become more defensive, however, such constraints have not prevented the market from operating relatively smoothly. The demand for solid, core-mortgage opportunities is rather heated, with lenders seeking to lock up stable, predictable yields. Moving out on the risk spectrum, capital is somewhat more difficult to access, however, adequate mortgage capital is available for those projects with short-term challenges but solid fundamentals. On a positive note for the overall real estate market, construction funding remains difficult to source, suggesting that the supply side should stay in relative balance. In the absence of major shocks, this situation is likely to hold through much of the year with yields being competitive relative to other asset classes. This is good news for the commercial real estate market because available, low-cost mortgage debt has been one of the major catalysts to transaction volume.

On the public side of the mortgage market, the volume of Commercial Mortgage-Backed Securities (CMBS) has remained solid, although issuances have been lower than the prior year. In terms of market share, conduit business has emerged as a major player, leading mortgage activity. With respect to rate structure, floating-rate debt increased on the CMBS front, while falling back in the private market. The CMBS delinquency rates have also edged up, but are not a major concern. More noteworthy is the fact that these delinquencies are at the individual loan level rather than at the bond level, providing insulation for investors. With respect to rating agency actions for seasoned CMBS, upgrades continued to outpace downgrades although the margin weakened significantly over previous years. The major factor behind the shifting ratio has been concerns over tenant credit, with secondary factors including the weak economy and international turmoil.

On a positive note for the sector, prepayment restrictions along with relatively conservative underwriting—in terms of properties and credit risk—have combined to provide stable, predictable returns to investors. In addition loan maturities will be modest over the next 4–5 years, suggesting that the sector will not be hurt by an intermediate term cyclical downturn. Market spreads remain attractive with significant tightening over the prior year's figures. Overall the CMBS market is expected to maintain its strength, in spite of further erosion in real estate fundamentals and a generally weak economy. This is especially true for investment-grade securities where sources of capital are expanding. In terms of below-investment-grade debt, the demand is still rather confined, but it is also expanding as new classes of investors seek higher and more stable yields in the commercial real estate market.

Private Equity Market

Moving into the second quarter of 2003, the private equity market continues to be supported by sustained investor interest and a ready mortgage market. Institutional investors continue to seek stable core assets and are placing additional pressure on yields for new acquisitions. When coupled with the widespread erosion in market fundamentals, the question remains one of how far down the yield curve investors are willing to go. Some investors are pulling back, yet demand remains pent-up for product. While creating a downward drag on income returns, the lower yields being accepted by buyers are placing upward pressure on prices. In most market cycles this dichotomy would result in a bid-ask spread that would slow the market down while the two sides held out to maintain their subjective values. However, for much of the past 18 months, the market has not behaved in a traditional manner, as investors have been willing to move toward sellers' prices. This rather sticky asset demand function and the widening gap between real estate allocations and acquisitions for many investors has not been lost on sellers, many of whom are willing to patiently wait

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out the market. This situation could change if the economy were to pick up and other asset classes provided signs of a sustainable recovery, as capital could be expected to chase returns. However, the general malaise that hangs over the economy and the significant downside risk that lurks behind the scenes argues that this situation will not unfold over the near-to-intermediate term. Thus demand for private equity real estate is expected to remain firm.

On the supply front there is some evidence that more product will be coming to the market, helping sustain activity levels. Currently, there is no glut of product, as investors seem to be testing the market to determine if they can liquefy existing holdings at the aggressive prices being captured by some sellers. This situation could shift the perceived bid-ask spread, as sellers remain firm in their ask prices while buyers begin to anticipate additional product availability. With respect to property sectors, private investors remain drawn to apartment and retail product that comes in digestible sizes, as well as office and industrial product that offers some stability in returns. These appetites could shift during the year if the erosion in consumer confidence and economic malaise continue to eat into retail sales. Similarly there is increasing talk of a real estate "bubble" in the commercial sector analogous to that in the residential sector where many feel the market is being bolstered by historically low interest rates rather than sustainable income levels. In the commercial sector, the situation is a bit different. A change in interest rates could marginalize the purchasing power of highly leveraged private investors. On the other hand, since institutional appetites are less dependent on low-cost debt there should be no precipitous change in investor demand. This position is bolstered by the fact that institutional investors continue to accept lower yields for new and existing products, as evidenced by the continued decline in NCREIF Property Index returns. This gradual decline in yields is no surprise to existing owners and new investors who have opted to hold or seek products, despite widespread forecasts of further erosion in market fundamentals. This situation will also hold for the new real estate allocations being reported by public and private pension plans, along with endowments and foundations.

Public Equity Market

The public real estate market has held up relatively well, especially in light of the economic and geopolitical turmoil. However, REITs have not been immune to the broader environment, as noted in the moderately negative total return the Equity REIT Index recorded for 2002. The bulk of this slippage came in the form of price declines that jumped to the low double digits in the third quarter. While still slightly negative in the fourth quarter, the slippage was reversed, avoiding a major price adjustment. For 2002 REITs provided a positive return, with dividend earnings that more than offset the moderate price declines. While disappointing relative to recent history, the decline paled in comparison to those in 1998–99 when REITs were repriced from growth to income vehicles, as well as to the broader equity market. Despite price declines REITs have continued to generate positive income flows and dividend payments, although dividends have slipped moderately.

Even with some downward pressure associated with deteriorating market fundamentals, REIT prices should benefit from further allocations as capital flows into the sector in search of attractive risk-adjusted returns. The anticipated continued volatility in the broader equity market should maintain this balance, with changes in real estate markets remaining more gradual. As in the private market, REIT investors seem to be ratcheting down their return expectations in return for more stability. The ability to make this adjustment will be important to the outlook for the sector, since real estate fundamentals are expected to diminish net income from existing assets. At the same time strong competition for new assets will suppress going-in yields. These market forces coupled with the divergence of market fundamentals across property sectors will result in a greater spread of REIT returns. In this environment sector rotation and stock picking will be important elements that differentiate results for investors.

In addition REITs face some risk that Washington might undercut the sector in its attempt to stabilize the equity market. In particular the president's plan to eliminate taxes on dividend payments to help draw investors back to the stock market could erode some of the competitive advantage REITs have as a single-tax entity. The impact of such a change could be amplified by the continued erosion in market fundamentals that places downward pressure on the dividends that REITs can actually distribute to investors. While the ultimate disposition of this proposal and other economic stimuli remains unknown,

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it is a development that bears watching for REIT investors. Regardless of what happens on this front, the underlying fundamentals of the market will not change, with real estate likely to remain a significant asset class for institutional and individual investors.

Foreign Investment

During 2002 foreign investment in U.S. real estate remained active, although off the pace of the prior year. Interestingly, this decline was attributable more to the difficulty in finding attractive investments than to a change in attitudes towards the U.S. market. Most foreign investors were unable to meet their U.S. acquisition targets during the year, creating some build-up going into 2003. Net capital flows to the United States are expected to remain strong. It is questionable whether the United States will continue to capture the bulk of new global allocations, a threshold that was reached last year after climbing significantly in the prior year. Despite this increase in market volume, the share of global real estate investment captured by the United States slipped due to difficulty in placing deals and softening values in light of weaker market fundamentals.

As might be expected the maturing of international investors with respect to U.S. real estate has resulted in a widening of investment horizons, with investors in multifamily, office, industrial, hotel and retail. Despite this property type expansion, office properties still dominated investment activity. Foreign capital also remained targeted on the top markets, with a preference for CBD locations. It can be expected that geographic boundaries will also widen as investors seek returns in the competitive arena. With respect to transaction size, foreign investors continue to have higher average transaction size than their domestic counterparts. In terms of sources of capital, Western Europe accounts for the bulk of holdings, followed by Japan, Latin America, and Canada. This situation is likely to continue, with prospects for investors from the Middle East guarded due to the political situation. There is also some risk of a global political backlash against U.S. investments as the country moves forward alone on the international frontier.

With respect to public debt the volume of CMBS with non-U.S. collateral increased significantly in 2002, comprising almost one-third of total issuance. This growth is noteworthy since non-U.S. CMBS were extremely limited going into the decade. The increase in global issuances has been on a steady path of expansion following the pattern of growth on the domestic front started in the mid-1990s. In terms of market share, the bulk of non-U.S. CMBS emanated from Europe, followed by Japan, the United Kingdom, Australia, and Canada. Foreign capital sources have been especially active in large-loan, investment-grade issuances, accounting for over one-fifth of total proceeds. Despite the uncertain times, these capital flows are expected to continue over the near term, helping support the global real estate market.

Real Estate Outlook

Overview

Real estate fundamentals have continued to erode across most of the country. The factors underlying this deterioration are fairly widespread, including the general economic malaise, international conflict, and excess capacity that hang over most property types and markets. The good news is that the situation has been gradually unfolding, with few major disruptions. Although the real estate market has clearly struggled, it has been dealing with similar forces for some time. Given the broad-based nature of weakness and the anticipation of its continuation, no major change in real estate balance is anticipated. However, there are likely to be more declines, especially as the international scene deteriorates. At the same time real estate performance will be under more downward pressure as rising operating expenses eat into the bottom line. On the revenue side, lease expirations will place downward pressure on rents as landlords will be forced to negotiate in a tenants' market. Given the limited prospects for a market reversal, some owners may opt to maintain or reestablish occupancy rates rather than hold out for higher rents that could be captured if a recovery occurs.

Office Market

Over the past 18 months the office market has been under significant pressure as companies have pulled back, weakening the demand side of the equation. The good news is that there have been few additional shocks to the system. Demand contraction has been a gradual, consistent phenomenon that has been priced into the market. There is growing recognition that the recovery of the office sector will

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be a prolonged event. This perception is attributable in part to the uncertain environment, as well as the sheer volume of excess capacity that hangs over the market. Of particular concern to the sector is sublease space, which continues to grow as companies adjust to the stagnant economy and business confidence slips even further. The supply side remains largely in check, with the exception of isolated projects to fit a particular tenant need and build-to-suit projects. Even though such action is limited, when combined with the prospects of further erosion on the demand side, there could be more slippage in the property sector.

Given the limited prospects for a near-term recovery, landlords are expected to become more aggressive in terms of attracting new tenants, placing more emphasis on rental discounts. This situation is becoming more widespread, as the prospect of payoffs from holding out for better deals lessens. Landlords are also expected to redouble their efforts to retain tenants. This situation bodes well for tenants, especially credit tenants who can help stabilize income streams and elevate investments to the desired class of properties with stable, predictable income streams that investors covet.

Investors' appetites for office properties remain strong, especially for core assets. Of particular note is the fact that the pool of potential investors is rather broad, suggesting that demand for product is durable despite forces that affect certain classes of investors more than others. Unlike the prior recession in the sector, office investors do not appear to be building rent spikes and near-term market cures into their discounted cash flow models. Rather they are seeking secure investments with downside insulation and moderate upside prospects. They appear to be willing to trade stability for performance. In addition investors' appetites are becoming more finicky, with many eschewing the suburbs for CBD properties that benefit from higher barriers to entry and more secure market fundamentals. Investors are more cognizant of the importance of risk management, seeking to assemble more diverse holdings that can withstand external shocks at the portfolio, rather than property level.

Retail Market

The retail market remains one with varying prospects by product class and price points. While institutional investors have historically tended to avoid these opportunities, the sector is receiving renewed interest. As with other property types, the retail market continues to struggle with weakness on the demand side. This situation has become more pronounced recently as consumers have reigned in their spending. Declining consumer confidence and pressure on bottom-line performance are likely to hang over the sector, dragging down performance and curtailing expansion plans. In the retail sector shifting demand fundamentals associated with demographic trends and economic conditions place continuous pressure on retailers to reengineer their offerings to adjust to cyclical and structural changes. At the same time retail is one of the more dynamic sectors on the competitive front, with new concepts and categories constantly emerging as retailers seek out new niches. The end result is that retailers continue to expand operations and adjust store layouts and locations throughout the business cycle. Economic conditions and bottom-line pressure are forcing retailers to cull their operations, closing underperforming assets and focusing on unit profitability rather than market share. This market bifurcation is expected to continue, with some downside risk associated with the demand side of the equation.

On the public market front of the retail sector, retail REITs seem to have been able to continue to avoid the shocks felt by office and apartment sectors, generating returns slightly over 20% for 2002. These return levels are four times those of the overall composite index, making them significant outliers within the asset class and even more-so when compared to other asset classes. Within the retail sector regional mall REITs outperformed their counterparts, although the performance of the shopping center category–which includes smaller product— and freestanding retail was not far behind. To some extent this performance can be attributed to consumers who seem to have carried the flag among REITs as well as among the economy at large. This relatively strong sector performance carried over to the private market as well, with the retail component of NCREIF generating solid returns for investors. The outlook for the retail sector is for continued investor demand, with the private market exhibiting a preference for smaller retail properties. Investors should continue to have limited appetites for Class B malls, power centers, and the new genre of centers including lifestyle, entertainment, and unanchored strip centers. At the upper end of the

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market, regional malls may remain the darling of the sector, due in part to the fact that they had have been avoided by private investors for some time as they turned to smaller, more digestible assets as a risk management device strategy.

Industrial/Warehouse Market

The industrial sector is suffering along with other property types. In addition to the weak economy, the manufacturing sector has been in a particularly long downturn that has caused a cyclical downturn in demand. This has resulted in excess capacity that has translated into rising vacancy rates. The industrial/warehouse asset class's lower unit costs and the desire to maintain flexibility have created a phantom overhang that does not appear in published real estate statistics. They are revealed, however, in capacity utilization data that show a cyclical low point. As such when the economy improves, the industrial sector is expected to lag as companies utilize previously idle facilities before adding new space. At the same time supply-chain dynamics have caused shifting demand functions and a mismatch between the supply and demand segments. There is good news on the supply front, as speculative industrial development has continued to fall off, while build-to-suit activity has remained flat. The prospects for the sector are relatively flat, with some additional downside slippage before an eventual recovery. The vacancy rates show some signs of moderating in the upper single-digits level, which is dramatically below those of the last recession.

As with the other major property types, there is a significant dichotomy between the investor demand and the market fundamental sides of the sector. To some extent this divergence is due to the relative appeal of the overall real estate asset class, which is being sought out as a safe haven for investors. In addition to the spillover effect, industrial property has still delivered on its promise of stable, risk-adjusted returns despite some weakness on the private side of the market. Private investors remain interested in the sector, but have been frustrated in their attempts to acquire modern facilities. At the same time industrial appetites remain focused on the usual list of markets, some of which are suffering from overbuilding. Industrial REITs have continued to perform relatively well, lagging behind retail but leading other property types. Industrial REITs are expected to focus on existing product in the future, trying to maintain occupancy and rental levels in a soft environment.

Apartment Market

Although the overall housing market has held up surprisingly well, the apartment market has shown some signs of slippage. The apartment market can attribute some of its woes to additions to supply. These additions include increases in the actual stock of multifamily product, as investor demand helped support additional construction. Despite a rise in vacancy rates, there are some signs that the apartment sector is beginning to stabilize. In particular net absorption rates have climbed upward and new supply has been contained. Although apartment vacancy is low relative to other property types, these vacancies have a more pronounced impact on net operating income due to the higher tenant turnover in this sector. Due to shorter-term leases and a more mobile tenant group, apartment managers must compete aggressively to attract and retain tenants. Thus a moderate increase in vacancy rates can trigger a round of rent concessions, incentives, and rate reductions that dampen income streams. While this situation will translate to downward pressure on rents, there are few signs of a major disruption.

It should be noted that in the apartment sector, additions to supply are also associated with shifting tenure patterns. Due to historically low interest rates, in many markets apartments are losing tenants as they shift from apartment rental to homeownership. This trend could increase even further if mortgage rates stay low and ownership incentives (e.g., homeownership tax credits) being discussed in Washington become reality. The end result has been a rise in vacancy rates in many markets that has forced landlords to reinstate incentives to attract tenants. In addition property managers have redoubled efforts to retain current tenants to help stabilize occupancy and reduce turnover-related costs. While a positive development for tenants, this situation could cause additional slippage on the income front and create an additional drag on performance. Thus the apartment market appears to be in for an intermediate term of weakness, followed by a gradual recovery. Despite the challenges on the spatial side of the market, the demand for apartments among institutional investors has remained relatively strong.

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Conclusion

As we move into the second quarter of 2003, we are at a very difficult time for the overall economy. The nation is facing stress on a number of fronts, any one of which could immediately disrupt the delicate balance in the market. In the meantime the economy will continue to struggle, as will the equity markets. In this environment real estate fundamentals will likely erode, but there is little danger of a major shock to the system. If certain trigger events do occur, it is likely that the market will slow down while various players assess the nature of damage and probable fall-out for the real estate sector. Once this occurs–and it might well be a prolonged event—the real estate market will function more efficiently. That is not to say that there is no further downside risk as we face the real prospect of a double-dip recession. Rather it suggests that the real estate market should continue to bounce along in response to external shocks, but that it should maintain its rather steady, if unspectacular, performance profiles. Thus 2003 should be interesting, with an active transactions market and continued investor interest.

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