A Washington Malfunction and Unintended(?) Consequences

by James R. DeLisle, PhD

Commentary
In these unusual times, the catchphrase “Washington malfunctions” most adequately sums up the recent political and budget machinations. Some pundits believe the current situation may have evolved through acts of omission—the result of a series of unintended consequences of business as usual. If that were true, then a little education and common sense would go a long way to help us steer the ship around. Unfortunately, it is vividly clear that the situation is the result of acts of commission and deliberate political maneuvering. Although there have been other noteworthy malfunctions in the not-too-distant past, the most recent incarnation has evoked too much about what’s behind the curtains.

At this point, some might lament “here we go again,” when in reality we’re on the same path as back in 2011 when Washington discovered that punting could extend the game. However, those who adopted this approach have failed to realize that no games are ever won by punting unless you can back it up with action on the next series. Furthermore, although field position matters in sports, the fallback to punting makes no sense on the economic field of play.

Economic punting in Washington has divided the players and pitted them against each other as they try to fend off the blame. Anyone with any sports background—even fantasy football aficionados—knows that bickering and divisiveness among coaches and players is a formula for losing. While the stakes in Washington are much higher than any game, and losing is not an option, not everyone sees the same outcomes as victories. Thus, until something shakes up the teams and the coaching staffs, we are likely to be stuck in a seemingly endless state of déjà vu. The good news is that in the end the “fans” matter, so hope rests on a grassroots movement that punctuates the need to focus on getting our team on track.

When the government furlough occurred, public and political outrage and pressure rose to a sufficient level to force at least a temporary solution. Although that solution led to another delay that stopped the clock, the gridlock came at a high cost to political ratings and economic activity. Congressional approval ratings now are at an all-time low, with Republicans facing more wrath from voters than Democrats but none of the players escaping blame.

While the settlement agreement ultimately signed by the president was welcomed, those outside of Washington took little solace in the fact that the agreement was no more than a reprieve. Some who have become jaundiced by the failure to arrive at a permanent solution to the budget woes appear to be taking advantage of the brief respite. This behavioral response was punctuated by the reaction of the stock market, which suffered a brief hiccup during the impasse but bounced back quickly when the temporary settlement was reached. This reaction was far-reaching, as global stock markets recovered from some of the volatility induced by the gamesmanship in Washington. The extent to which this sense of positivism continues ultimately depends on the fundamentals of supply and demand that drive economic growth.

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The Affordable Care Act (or “Obamacare”) was one of the key sticking points in the stalemate in Congress. This situation was unfortunate on a number of fronts, ranging from the spillover effect that manifested itself in the temporary government shutdown to the plight of Americans lacking access to health care. The rhetoric and outrage was directed at the shutdown; however, the focus of the outrage should have been the fact that America has fundamentally failed to take care of its own in terms of health care, with the number of uninsured adults in October 2013 greater than at any time since Gallup started tracking the statistic in 2008. In fact, the most recent poll reported that 18% of adults lacked basic health insurance. This non-coverage was felt across the entire age spectrum, with the exception of those 65 and older who are served by existing entitlement programs. Interestingly, 75% of the uninsured were unaware of health insurance exchanges; although, two-thirds of them indicated that they plan to buy insurance by the January 1 deadline. How they are going to do that is another question.

Regardless of the debates surrounding the merits of the Affordable Care Act, the snafus that plagued the launch of the insurance exchanges triggered universal outrage. While some of the problems were attributable to the rapid deployment of a complex system, it was clear that those responsible for the technology failed to deliver a system that can handle the foreseeable volume. Some called for the ouster of Health and Human Services Secretary Sibelius as well as others who were in charge of the program’s launch. The House of Representatives called the contractors for HealthCare.gov into a hearing at the end of October to discuss what happened and to identify who should be held accountable. Ultimately, the administration pledged to resolve the problems; it deployed a number of alpha teams of technology experts with insurance companies and other industry experts to come up with a quick fix as well as a permanent solution.

The technology-related problems associated with the launch of the insurance exchanges created something of a red herring, shifting focus from the program’s ultimate goal, the fundamental issues of affordable health care, and the debates about what the term affordable should mean and to whom it should be applied. These questions and other issues continue to be of paramount importance, as pointed out by complaints from some of those who discovered that costs were higher than expected, and in some cases, even more expensive than what they already had purchased on the open market for comparable packages.

In addition to determining what affordable means, another issue that may have to be addressed surrounds the term universal and how to measure the program’s success on that metric. For example, a Gallup poll in late September reported that one-third of uninsured respondents said they would not sign up as required by law and would rather pay a fine for failing to comply with the program. It is unclear whether this is a bit of bravado or actually will turn out to be the case. The responses may be partly attributable to the widespread lack of familiarity with the program; however, if this plays out then the universal nature of the program will come into question.

Although no official statements have been issued at this time, it would not be surprising if the deadline for compliance were extended to account for the technology and educational issues that plagued the initial launch. If this occurs, the deadline would come after the next round of congressional budget and debt ceiling debates in January. Since it is likely the debates will result in more suggested changes, the list of issues that will need to be resolved surrounding affordable care is likely to get longer rather than shorter. This will be unfortunate for those caught in the middle and will cause a number of additional unintended consequences, some of which may have life-changing impacts on individuals.

**The Economic Environment**

These have been challenging times for prognosticators, with the impact of uncertainty emanating from Washington amplified by the freeze on data from Bureau of Labor Statistics and other government sources during the government shutdown. The absence of data was particularly challenging for econometricians whose quantitative models depend on timely data feeds for forecasting. This disruption in data flows forced analysts to move into uncharted territory, where they had to fall back on judgment, scenario planning, and common sense. (Interestingly, these are the same traits that seem to have eluded decision makers in Washington.) Prognosticators have had to take into consideration the uncertainty surrounding recent data and the possibility that elected officials might let the country default on the national debt.
The changing of the guard at the Federal Reserve (Fed) is being closely watched as investors, business leaders, and consumers have all come to appreciate Fed Chair Bernanke’s continued support of the low interest rate environment that has been the mainstay of economic activity. After much speculation and the voluntary withdrawal of Larry Summers from contention, President Obama selected Janet Yellen to lead the Federal Reserve when Bernanke steps down at the end of January.

Assuming Yellen’s appointment is confirmed by the Senate, she will become the first woman to run the Federal Reserve. While some wonder how she’ll put her stamp on her tenure, her long history with the Fed and her recent stint as vice chair suggest the near-term prospects are for much of the same. In her previous role on the Fed she helped draft some of the current policies. She is also clearly aware of the role that quantitative easing has played in stimulating the economy by holding interest rates at historically low levels.

Under Yellen, the Fed is likely to continue to honor its pledge to hold interest rates low until unemployment dips below the current 6.5% target. In the meantime, the road ahead will be rocky as Fed officials debate when to back off its $85 billion bond and mortgage purchasing program. As they have in the recent past, investors and business leaders will keep a close eye on the Fed to determine when and how much it will begin raising interest rates. While these questions are of importance, for many they will be supplanted by concern over how Congress will deal with the budget deficit and debt ceilings after the holidays. In the meantime, the Fed is likely to stay the course and avoid any abrupt policy changes.

**Economic Growth**

While 2013 started off with hopes for improving economic growth, the reality was a meager 1.1% gross domestic product (GDP) growth in the first quarter. Economic activity picked up in the second quarter, which came in at a 2.5% annualized rate of growth. That increase in growth was attributable to a number of factors, including increases in investment, consumer spending, and import and export activity. An increase in corporate profits also helped bolster growth, with the financial sector leading the pack.

Preliminary third-quarter indicators suggested that economic growth had slowed. This was one of the major unintended consequences of the failure to resolve the budget and debt ceiling issues, which created a negative mindset that placed a drag on business and consumer confidence—both of which are critical to economic growth. In addition, economic growth was slowed as furloughed employees went without pay and government expenditures declined.

During the second quarter, the US current account deficit, which measures the US balance of trade, declined almost 6%, with the aggregate deficit falling under $100 billion. While still a significant negative balance, this was the lowest deficit in over four years. The improvement was attributable to a lower trade deficit, with exports moderately improving while imports remained flat. At the same time, income from receipts outpaced outlays, creating a modest improvement in the income surplus component.

Looking forward, improvements in the global economy should help stimulate exports with growth in imports tied to improvement in the domestic economy. The significant integration between the United States and global economies suggests there will be limited improvement in the balance of trade over the near term. Evidence of additional unintended consequences of the deadlock in Congress manifested itself in the newfound appeal of the euro, which has climbed against the dollar since the end of the second quarter. This trend reversal is fairly pronounced when one looks back at the plight of the euro zone, which had helped strengthen the dollar earlier in the year.

**Employment**

Employment figures continue to be seen as a bellwether of times to come. Even without the most recent data, signals had been growing that the country would experience disappointing employment growth. When the data were released that scenario turned out to be true, with job growth coming in around 148,000 for September.

Despite the meager job growth, the unemployment rate edged down to 7.2%, which some saw as a sign of hope. A little more probing, however, revealed that employment growth wasn’t
behind the numbers but rather a decline in labor force participation, which fell to a post-recession low as frustrated workers gave up and left the workforce. Indeed, the Bureau of Labor Statistics’ latest figures reported that over 90 million Americans over the age of 16 had fallen out of the workforce.

In addition to challenges in finding employment, the change in health care access and costs may have an impact on labor force participation. That is, prior to the launch of the Affordable Care Act, many workers were forced to hold onto jobs for benefits sake. Assuming the problems associated with the launch of the program are resolved and the public becomes more educated about their options, some of those who stayed in jobs or in the workforce may step back and consider alternative lifestyle choices. This tendency will be amplified by the fact that many of the new jobs that are being created remain at the lower end of the wage spectrum and are limited in terms of benefits and job satisfaction.

Going forward, employment growth rates will be even more difficult to forecast as previous econometric models may well prove to be unreliable. That is, many models will need to be recalibrated to account for the still-unknown effects of the government shutdown. Unless the issues in Washington are resolved, this new set of independent variables may have to be added to existing quantitative models.

**Inflation and Interest Rates**

In the search for good news, the interest rate outlook signals that the economic ship will not be buffeted from unexpected headwinds. Leading indicators suggest economic growth is stumbling; as such, it is likely that the Fed will be forced to continue its $85 billion monthly bond-buying infusion program at least into next year. This deferral will take the upward pressure off interest rates that would have placed additional drags on the recovery. However, it is important to note that prolonging the program is a defensive move that will do little to stimulate economic growth. Just as it is understood that “the best defense is a good offense,” it is recognized that winning economic battles in the global arena is dependent on the success of the offensive. Until that happens, economic victory will remain an elusive goal.

On the inflationary front, the data reveal little upward pressure on prices. For example, slowing employment growth, along with few prospects for a reversal, continue to inhibit raises. This in turn forces workers to stay on the defensive and focus on cost-cutting measures to balance their personal budgets.

The global pause in economic growth triggered, in part, by uncertainty in the United States will also keep pressure off of import prices. Anecdotal evidence and the recent decline in gasoline prices at the pumps suggest a fairly wide-based softening in both import and export prices. This is a marked change from during the summer, when a surge in shipping volume suggested that retailers were gearing up for a stronger holiday season. At this point, the recent decline in consumer and business confidence suggests that sales will once again lag expectations. In this environment inflation is likely to remain fairly well in check over the short-to-intermediate term; longer-term prospects, however, are less certain. In the meantime, interest rates are likely to stay low.

**Business Indicators**

Despite disappointing results in mid-summer, going into the fall business indicators suggested that the economy and business activity levels were beginning to pick up. For example, the Conference Board’s leading indicators rose slightly above expectations during August, continuing the upward trend that began in July.

The improvement in business indicators was fairly widespread, with six of the ten indicators increasing during the month. Durable goods orders eked out a positive gain after more than an 8% decline in July with automobile sales leading the way. While monitoring these and other business indicators provide meaningful signals on the direction of the economy in normal times, in the current environment they are less meaningful since they fail to indicate how businesses will react to discussions in Washington.

There are some signs that businesses may have discounted the next iterations of Washington malfunctions that are likely to occur over the near term. Thus, some appear to be focusing attention on the longer-term outlook, with a presumption that the threat of being put on waivers by the American public will force politicians’ hands. This interpretation is based, in part, on the fact that the National Federation of Independent Business (NFIB) Index flattened out in September rather than retreating as the deadline for the government shutdown approached. However, it is unlikely that business and corporate
leaders envisioned that politicians would allow a government shutdown. Given the unexpected behavior that actually transpired, business indicators are likely to face some downward pressure.

Assuming the fate of the stock market is an indicator of how things might play out for business prospects, it is possible that business growth may get back on track. This pause will provide them with time to shift attention out of the current arena and consider the impact that improvement on the global scene will have on business growth. Finally, while facing some headwinds, business confidence will likely benefit from stabilized expectations regarding the Fed’s path of action in the face of a slowing economy and weak employment figures.

Stock Market
The stock market has been surprisingly resilient in light of the stalemates and inaction on the budget and deficit that have captured attention in Washington. This situation may be explained by a couple phenomena that affect investors’ psyche.

First, a “good news = bad news” syndrome may be operating behind the scenes. That is, the disappointing employment figures were generally bad news on the economic front. However, the same data constituted good news on the interest-rate front, suggesting that the Fed would delay the phasing out of its quantitative easing program constituting good news for investors.

A second phenomenon may be something of a Pavlovian response or learned behavior as investors look back to the 2011 budget crisis and its short-lived aftershocks. Indeed, after a brief downturn the stock market made up for lost ground and was on pace for further expansion until the current crisis forced investors to start looking at scenario planning to deal with alternative outcomes.

Despite rising concerns among higher-income households and investors over the impact of a prolonged shutdown, investors appeared to have discounted some form of settlement—or at least another timeout—that forestalled a major stumble in the stock market. At this point, attention of investors is shifting toward earnings reports. While some of the early reports came in below expectations, investors did not overreact. Despite the lack of action at that point, investors are likely to be on edge, creating more volatility as they try to get a handle on the near-term economic outlook and a better feel for how the broader market will respond to breaking news.

While the broader stock market appears to have stabilized, banking stocks have been much more mixed and have become disengaged from the broader market or economic outlook. This can be attributed to some of the scandals that are continuing to play out as banks settle lawsuits and pay fines associated with the meltdown of the real estate markets. The impact on expenses is occurring at a time when a number of banks are struggling on the revenue front. This is especially true due to the slowdown in refinancing activity on the residential front and a pullback in the bond market attributable, in part, to the double-whammy of uncertainty surrounding the Fed’s next moves and Washington’s lack of moves.

The pressure on the revenue side of the balance sheet for some of the larger national and global banks was met with severe stress on the expenditure side. A vivid example of this crisis is the case of JPMorgan Chase, which racked up its first quarterly loss under the leadership of James Dimon, its chair and chief executive officer. The real culprit behind the losses was the $13 billion fine JPMorgan faced as a result of prior mortgage-related scandals. This included the London Whale scandal that led to $6.2 billion in losses in 2012 and combined fines of some $920 million levied by US and UK regulators.

Other global operators are also facing significant fines. For example, the Dutch Rabobank is looking at some $1 billion in fines in the aftermath of the LIBOR scandal, which cost UBS AG a previous record of $1.5 billion in 2012. Similarly, on October 23, 2012 a jury convicted Bank of America of defrauding Fannie Mae and Freddie Mac through the bank’s Countrywide unit. The Bank of America fallout is hardly over, despite the fact that it settled a case with Fannie Mae in January. This settlement included a $5.6 billion payment to the agency and another $6.8 billion to repurchase mortgage loans.

The Federal Housing Finance Agency (FHFA) is also pursuing the Bank of America on behalf of the two government-sponsored enterprises (GSEs), seeking another $6 billion settlement for Fannie Mae and Freddie Mac to offset losses suffered after being...
misled by the bank. Finally, in New York a federal jury found Bank of America liable for one count of civil fraud in the “hustle” process engaged in by its Countrywide subsidiary when it sold residential loans to the two GSEs. The $848 million settlement sought by the US Department of Justice in this case pales in comparison to the more than $40 billion the bank has already spent on claims that led to the 2008 financial crisis. However, the recent decision is noteworthy in the sense that one of the bank’s officers was individually found guilty of fraud, which may portend more actions to come and has raised the stakes for future transgressions.

Previous fines for bank fraud, and the promise of more to come, have sent a resounding message to the banking community. This is especially true since the settlements did not insulate the banks or their employees from criminal probes that still hang over the industry. In almost simultaneous actions by the House of Representatives and the Senate, separate bills were introduced on October 25 to step up enforcement and penalties for money-laundering schemes after banks incurred over $5 billion in fines and settlements. The banks involved in the scandals covered a wide array of institutions, including HSBC Holdings, Standard Chartered, and ING Bank NV. The irony of this action is that it was triggered by outrage from the same members of Congress who were willing to take the nation to the brink of bankruptcy.

Regardless of how the bills fare in Congress or how banks settle with regulators, the result will be a lot of belt-tightening as banks rein in expenses until some of the uncertainty subsides and business returns to more normal levels. Evidence of this trend was provided by Bank of America’s announcement that it would cut 3,000 mortgage-related jobs in the 2013 fourth quarter.

Consumer Confidence
In late summer, consumer confidence came in higher than expected as consumers seemed to focus on the positive news and eschewed the political wrangling that has hung over the economy since 2011. As expected, the government shutdown and disappointing news on the job front took a dramatic toll on consumer confidence in the government as well as in the economy. The daily Gallup Economic Confidence Index tracked the reaction of American consumers to the shutdown; the economic confidence index plummeted to -55 in early October and then dropped to -43 as the shutdown dragged on. In the week following the settlement, the index demonstrated moderate improvement.

The lack of confidence in government showed up in a Wall Street Journal/NBC News Poll, in which respondents were asked if they felt the country was on the right track. Not surprisingly, it showed the most significant decline in over a decade, with 78% of Americans indicating they believe the country is going down the wrong path. As might be expected, frustration with Congress also reached record levels, with the congressional approval rating in a Gallup poll falling to 11% in October, just 1% above the lowest rating in history.

At the same time that Congress’s ratings plummeted, President Obama’s approval ratings were relatively stable, with only a moderate decline to 47% in the week before the shutdown took effect. This divergence in ratings may be an indicator that some of the recent polarization that forced the shutdown may be supplanted by a more moderate approach in the negotiations as it becomes clear that unwillingness to compromise puts Congress in a negative light.

Over the past decade, consumer confidence indices have taken divergent paths, which is understandable since various indices place emphasis on different factors. Thus, when the various indices converge, it suggests widespread agreement. This has occurred in the latest polls, which converged during the recent government shutdown. For example, during September the Conference Board’s index fell moderately with consumers expressing some concern over the slow pace of employment and earnings growth. By mid-October, just prior to the government shutdown, the index fell to -54, drawn down by broad-based concerns that were shared across most income spectrums, demographic segments, and geographic regions.

A similar pattern occurred in the University of Michigan Consumer Confidence Index, which fell to its lowest level since the beginning of the year. The declines were most dramatic for the expectations component, while present conditions remained fairly stable despite the disappointing economic growth.

The generalized lack of confidence in the future across indices and the failure of Congress to arrive at a permanent solution suggests that consumers will remain tentative until there is evidence that the brinksmanship has been set aside. In the current
environment, that may prove to be a formidable task. In the meantime, consumer confidence levels face significant headwinds, with political posturing and promises that come out of Washington met with an understandable level of cynicism.

**Retail Sales**

As the summer wound down, retailers were faced with a back-to-school season that got off to a slow start. This was especially true for clothing and electronics, which are traditionally important back-to-school categories. This was a reality check and created a dampening effect on sales forecasts for the upcoming holiday season. The results were particularly disconcerting for mainstream retailers who are dependent on back-to-school and holiday sales to bolster revenues and profits.

While overall retail sales figures were disappointing, vehicle sales were still fairly strong, although car buyers did pull back from relatively strong activity during the summer. Despite this slowdown, vehicle sales still averaged 15.5 million per month, which was healthy given the relatively slow economy and stagnant income levels for most households. On a positive note, domestic vehicle manufacturers experienced a slight increase in market share, while imported cars—especially those from Japan—lost some ground. It should be noted that some of the strength in automobile sales came from households’ willingness to take on additional debt, which increased during the July through September period when vehicle sales were at the strongest point for the year. This situation may change as households revisit their attitudes toward credit as consumer confidence slides.

Despite some of the challenges faced by traditional in-store retailers, Internet sales activity continued to increase during the third quarter, pushing 6% market share compared to total retail sales. This string of uninterrupted increases in Internet shopping has bolstered the confidence of online retailers as evidenced by the changes being introduced by eBay and Amazon as they compete in the same-day delivery market. For example, eBay announced that it was expanding its same-day delivery program, which it projects will be available in twenty-five markets by next year.

On the Amazon front, the online retailer announced that it was increasing its minimum order size for free shipping going into the key holiday season. Some observers noted that the increase of minimum order size by $10 to a new $55 break point by the dominant market leader was designed to shift frequent users to the Amazon Prime program, which offers two-day delivery for around $80 a year. Even with the increased threshold for free shipping, the minimum order level is still $15 lower than the threshold set by Walmart. This may lead to a bidding war that will benefit shoppers and push traditional retailers to up their games on the Internet front.

Despite increasing competition for retail dollars, the recent decline in consumer confidence, weakening employment, and signs that the housing market revival may have been overstated are likely to put downward pressure on retail sales for the upcoming holiday season.

**Housing Market**

During the first half of 2013, the housing market was seen as one of the bellwethers of an improving economy. While the market has somewhat stabilized, for many individual homeowners on the sell side the situation is much more sobering. This is especially true since some of them believed the hype that the market had recovered and, due to a large dose of wishful thinking, believed it had recovered enough to put them back in the driver’s seat.

While prices for existing properties have improved over recent figures they remain significantly below the heyday period before the market collapsed. Thus, many sellers have unrealistic expectations of what their houses are worth. This is especially true as the industry moves into a naturally slower time of the year.

On the buy side of the equation, the increase in activity in August might have been triggered by concern of potential buyers that they would miss the low-interest rate window if the Fed started phasing out its quantitative easing program. While there was some upward pressure on rates, the recent economic slowdown has forestalled near-term increases and given buyers some added breathing room in which to think about making a move.

The uncertainty surrounding the economy and the budget crisis forced some buyers to step back and wait to see how things play out. This is particularly true for buyers who have yet to unload their previous homes and are faced with strict debt-to-income ratios that either force them to delay purchases or decrease their price ranges for their new houses. Even those
who remain on the hunt are being slowed by the tightened scrutiny they face from originators and underwriters. These factors manifested themselves in the 2% decline in sales of existing homes that was reported in September as interest rates increased and the seasonal slowdown kicked in.

On the new-home seller front, during the first half of 2013 some markets experienced a resurgence in new construction activity as homebuilders jumped on the economic bandwagon and geared up for what appeared to be the next expansionary cycle. This exuberance was understandable, especially as lenders stepped up construction financing to support new housing starts. However, during October homebuilder confidence levels, which had risen steadily since last spring, hit an inflection point and began to decline among fears a malfunctioning Washington might delay or derail the recovery. This concern is likely to spill over to 2014. Uncertainty is likely to weigh heavily on the homebuilding industry and create more than a little angst for those who had geared up activity in anticipation of continued improvement in economic conditions.

After trending downward for most of the year, foreclosure activity picked up a bit in September. On an annualized basis, foreclosures were down 7% over the prior year, suggesting that the market bottom has been reached. Unfortunately, that statistic provides little solace to those who remain underwater and are struggling to hold onto existing houses. The year-end expiration of the IRS debt-forgiveness policy may create a late-year surge in product availability as sellers try to opt out of the market before the window closes. However, the prolonged time to close may have already shut that window for underwater homeowners who had been hoping that the existing-home market would continue to improve toward year-end as some forecasters had predicted. At this point, the outlook for housing is somewhat guarded, although interest rates should remain low for the near term.

**Real Estate Market**

**Office Market**

At a national level, office market fundamentals exhibited moderate improvement during the third quarter, with vacancy rates falling toward 15% overall. However, this improvement varied by region, with the East continuing to maintain its lead over other regions. This variation also occurred at the metropolitan level, with cities with solid technology and energy components and select gateway cities outperforming other markets.

The lack of new construction activity in most markets was a significant factor behind the moderate improvement in market fundamentals. However, some markets experienced an increase in speculative construction as developers anticipated demand for new product from employers looking for new space that would better serve their operations. In general, central business district (CBD) office markets tended to outperform their suburban counterparts. This pattern was especially pronounced in those cities that were benefiting from the trend to increased density and urbanization.

In late summer, the office sector saw an increase in investment activity that put upward pressure on prices. When looking at the full spectrum of office investments, year-to-date sales levels of office investments were up some 14% over 2012. Unlike other property types, in which trends in sales for individual and portfolio transactions were mixed, the office sector benefited from sales increases on both fronts. For the year as a whole, Real Capital Analytics (RCA) reported that suburban offices had the greatest market share, while interest in CBD investments continued to accelerate. Due to strong investor interest in higher-quality assets, prices for CBD investments continued to increase.

In terms of buyers, the office sector has attracted an array of buyers including institutional and international investors. Office capitalization rates have been relatively stable compared to other core property types, although rates have trended downward, approaching 5.5% for CBD investments and another 100 basis points (bps) for suburban product. The number of buyers has increased as new firms and non-traditional buyers move into the market. International investors have also remained active, accounting for a significant share of total transactions. Despite this increase in activity levels, the office sector remains relatively stable with institutional and international investors increasing and REITs slipping moderately.

The private side of the office sector lagged the overall NCREIF Property Index (NPI), with 9.6% annualized returns coming in 110 bps below the broader NPI. Despite this lag on annualized returns, for the second quarter the office index was on par with the NPI on both the income and appreciation
components. CBD office investments significantly outperformed suburban assets coming in over 10.5% compared to 8.7% annualized returns respectively.

On the public side of the market, office REITs slipped during August but avoided negative returns racked up by the broader FTSE NAREIT All Equity REITs Index. During September, office REITs recovered with 7.6% total returns, although dividend yields lagged most other property types. Mixed office/industrial REITs fared significantly better, coming in around 9.3% year-to-date with strong 4.5% dividend yields. In terms of market share, pure office REITs accounted for 14% of the total $450 billion all-equity index with mixed and diversified REITs, which contained office investments accounting for another 16% of the public market.

**Retail Market**

The retail industry experienced moderate improvement in supply/demand fundamentals, and positive net absorption through the third quarter of the year.

Construction activity remained tempered while retailers focused on rationalizing their current inventory of stores rather than embarking on expansion plans that may get ahead of consumers. The exception to this pattern was in some high-street or CBD locations, where retailers compete for limited space to take advantage of increasing density as households were drawn to the urban areas of selected markets.

Retail vacancy rates continued to trend downward, dipping below 10% at a national level. This moderate improvement was fairly widespread and spilled into secondary markets as well as smaller-format shopping centers—although they continue to operate at higher vacancy levels in the larger counterparts.

In terms of retail transactions, the story was divided by type, with portfolio sales activity levels increasing in late summer and individual property transactions declining. Portfolio sales should continue to increase, with RCA reporting several $1 billion transactions in the pipeline.

The relatively strong appetites for the full range of retail properties put downward pressure on capitalization rates, which hovered at over 7% despite the fact investors were moving further out on the risk spectrum in terms of market size and investment scale. To a great extent, increasing pressure on prices was driven by an influx of investors seeking higher returns and upside potential if the economy continued to strengthen. Indeed, the number of independent buyers continued to trend upward, approaching the number at the peak of the cycle in 2008. This trend is even greater when focused on institutional players, who are more active retail buyers than they were when the sector reached its heyday. That being said, private and regional investors also joined the foray putting upward pressure on prices across the retail product spectrum.

Private retail investments provided solid returns through June 2013 with 12.8% trailing twelve-month returns and led all other property types in the NPI. While low by historical standards, the implicit capitalization rate of some 6% constituted a positive spread over the apartment and office sectors of about 80 bps and 50 bps, respectively.

With respect to subproperty types, super-regional malls accounted for over a third of privately held retail investments. On an annualized basis, super-regional malls outperformed other retail formats with a solid 16.2% in total returns, which translated to a 5.8% implicit capitalization rate. Regional mall performance was also strong relative to other property types, with annualized returns of 12.7% total returns, which included a 50 bps spread over super-regional centers in terms of income returns. Community shopping centers and power centers were also competitive, generating around 10.5% in annualized returns.

On the public side of the market, retail REITs had the highest market share of core-property type REITs, accounting for 36% of the all-equity market. Within the retail sector, the eight regional mall REITs accounted for 57% of the retail sector, with over $94 billion in assets. Shopping center REITs accounted for another 28% of the index, with the balance comprised of free-standing properties. In terms of investment performance, regional mall REITs experienced negative 8.6% total returns for August, trailing other property types with the exception of apartment REITs. During September, regional mall REITs exhibited moderately positive returns, although they still lagged other core property types. Despite the improvement in September returns, regional mall REITs still racked up negative returns for the year-to-date. The broader class of shopping centers significantly outperformed regional mall REITs and the all-equity REITs, with year-to-date returns of 5.24% and relatively strong dividend yields.
Industrial/Warehouse Market
The industrial market has experienced moderate improvement in market fundamentals, although some markets have benefited from changing logistics and distribution patterns more than others. In general, demand for big-box facilities has increased especially in core distribution centers. The Northeast has experienced demand for larger and midsize warehouse facilities, as moderate-size firms geared up for what they hoped were improving economic conditions on both the global and domestic front.

Although construction activity remains guarded, speculative activity has been reported in most markets especially in moderate format facilities. Tenants seeking large warehouse spaces may be forced to turn to build-to-suit activity, as developers continue to eschew higher-risk, higher-cost facilities until the economic outlook is more sustainable. The recent trend toward same-day and next-day deliveries adopted by a number of retailers may create a surge in demand for facilities that can support the logistical needs of rapid delivery. However, such opportunities will be on the margin and will not have a significant impact on overall supply and demand fundamentals. Thus, at an aggregate level the sector should remain relatively stable over the near term.

On the transaction front, investors continued to show increased interest, with year-to-year sales gains in the low double-digits. This improvement was led by flex and R&D properties, which promised higher yields commensurate with higher risk; although, warehouse transaction levels also increased. Capitalization rates for industrial properties have been relatively flat for the past eighteen months after peaking in 2011. Industrial buyers have been led by REITs and private buyers, while institutional and private equity appetites have fallen off. Foreign investors have been relatively inactive in the industrial sector with the exception of some larger portfolio sales.

During the trailing twelve-month period ending June 30, 2013, industrial investments produced around 11% in total returns. Interestingly, industrial/warehouse investments, which are generally seen as more stable than other property types, generated higher implicit capitalization rates. For example, warehouses, which have an 80% market share of industrial investments, delivered a competitive 6.1% annualized income return. On the other hand, the industrial flex and R&D properties subtype, generated higher income returns commensurate with their higher-risk profiles.

On the public side of the market, industrial REITs showed strong positive returns through September with total returns of 7.46%; however, dividend yields lagged the broader market. This performance was a dramatic improvement over August, where negative total returns were 150 bps lower than the broader index that had negative 6.6% returns for the month and flat performance for the year.

Apartment Market
Going into the final stretch of 2013, the apartment market exhibited some signs of having leveled off, with vacancy rates starting to plateau in many markets. At a national level vacancy rates were around 5%, which is close to the structural vacancy level. This suggests a relatively healthy balance between supply and demand.

Despite the statistics, the heyday period—in which apartment owners benefited from dramatically increasing rents—has passed for most markets except high-density urban areas with high barriers to entry. In general, the recent surge of construction activity has been more than adequate to meet the needs of an expanding pool of renters, which is causing the market to flatten out in terms of fundamentals. As competition for tenants increases, owners are expected to shift attention from income growth through increasing rents to stabilized income through tenant retention and reduced operating costs.

In terms of investment activity, the apartment sector regained some of its lost momentum during late summer with RCA reporting transaction volume of $7.9 billion during August, coming in at the second-highest monthly level during 2013. It should be noted that this increase was attributable to some large portfolio sales while sales of individual properties continued to trend downward. At an overall level, capitalization rates remained rather flat, although investors’ search for assets in second- and third-tier markets put some upward pressure on rates.

In terms of appreciation, apartments continued to lag other property types as fundamentals of supply and demand for assets softened on a relative basis after the prior run-up in prices. Institutional appetites for existing product in prime markets tapered off as investors sought higher returns through value-add and development strategies. Offshore investors
continued to seek apartments at historically high rates, although they still account for a minor share of buyers.

When compared to long-term historical norms, apartments constituted a higher share of the NPI, accounting for over 25% of the $336 billion index. In addition, the average size of apartment investments at $58 million was significantly higher than the aggregate average of $47 million.

From a return perspective, apartments came in at a somewhat disappointing 10.7%, which echoed the overall NPI. This is after a string of recent highs that resulted in a fully priced sector as evidenced by the lowest implicit capitalization rate of all property types at 5.5% annualized. High-rise apartments dominated the category and accounted for over 50% of the total market. This market share is noteworthy because it is high by historical levels and may reflect the herd mentality that caused a shift toward urban properties over traditional suburban assets. In addition to increasing market share for urban apartments, strong investor demand translated to aggressive pricing with urban assets trading at sub-5% capitalization rates, which are low compared to other property types and 100 bps below capitalization rates for suburban apartments.

Apartment REIT performance was even more disappointing than private apartment investment performance. At an aggregate level, apartment REIT returns lagged all major property types during August and on a year-to-date basis. During September, the sector recovered somewhat, with returns turning positive and coming in slightly below the overall index. Despite this improvement, apartment REITs lagged all property types for September and finished with negative 3.4% total returns and lower-than-average dividend yields. Despite lagging the other property types, apartment REITs accounted for over 18% of the core property types compared to 20% at the end of 2012.

**Real Estate Capital Markets**

Going into the fourth quarter, Real Capital Analytics reported continued improvement in the commercial market, with $24 billion in transaction volume in August, some 12% above the prior year. This increase was attributable in large part to a rise in portfolio sales, with individual transaction sales exhibiting a moderate decline.

The increase in transaction levels was fairly widespread across property types, although retail transactions slowed down ahead of several portfolio sales that are still in the pipeline. Commercial price indices generally trended upward throughout the year with the exception of industrial properties, which were relatively flat. One of the drivers behind the increase in transaction volume was the concomitant increase in buyers. The pool of institutional buyers remained steady, while the number of foreign and private investors increased. On the international front, it is noteworthy that the number of active buyers exceeded the number in 2008 leading up to the market collapse.

The private real estate market enjoyed a relatively strong first half in 2013. Annualized returns through June 30 came in at 10.7%, which was higher than other asset classes with the exception of the domestic stock market. In terms of attribution analysis, income returns accounted for some 54% of the total returns, which is low by historical standards. Indeed, the relative parity between income and appreciation returns is more reflective of a growth vehicle than an income product, which is in line with most expectations for institutional-grade product. In terms of total market capitalization, the 7,099 properties in the NCREIF Property Index exceeded $336 billion for an average value of $35.5 million.

On the public side of the market, REITs did not fare as well as the private market counterparts and showed negative total returns for the second and third quarters. Despite disappointing performance, REITs were active players in the commercial real estate market. Indeed, REITs as active investors accounted for some 20% of commercial transactions in the year-to-date through September 2013. The increase in REIT activity levels was due, in part, to an increase in capital activity through IPOs and secondary offerings. Through September 30, REITs raised $3.1 billion in IPOs, with diversified REITs...
accounting for 71% of total equity offerings, which is significantly greater than the 11% that diversified REITs account for of total market share by property type. Industrial/office REITs accounted for 16% compared to 12% for health care REITs.

In terms of secondary offerings, REITs raised some $33 billion, with equity REITs accounting for 70% of total offerings. Industrial/office REITs accounted for the bulk of secondary offerings, with 32% of the total market share. The balance of secondary offerings was spread among other property types, including retail, residential, health care, and diversified properties ranging from 16% to 10%, respectively.

With respect to secondary debt, REITs raised some $17.8 billion through September, with industrial/office REITs around 30%, retail REITs at 18%, diversified REITs at 13%, and the relatively new category of infrastructure REITs at 14% of total offerings.

Going forward, a number of factors suggest the recent trends in transaction volume should continue over the near term. For example, the temporary reprieve offered by the eleventh-hour workout on the budget and debt ceiling is likely to bolster commercial transactions in the pipeline since there are no major factors that would trigger changes in pro forma assumptions that support current offering prices. Also, the decision by the Fed to delay the phasing out of quantitative easing has helped stabilize investors’ outlooks. Confidence in this assumption has been reaffirmed by the Fed’s commitment to hold interest rates at historic levels under the successor to Fed Chair Bernanke.

At some point, the Fed is likely to start shifting attention toward inflation; after an adjustment period, this might create renewed interest in real estate as an inflation-hedging asset. This transition will not be smooth, however, since current prices are built on low-interest rates and relatively aggressive underwriting standards as lenders have competed for mortgages due to their attractive spreads over other investments. Fortunately, this scenario is not likely to play out soon, leaving the commercial market on an upward trend as long as investors focus on current spreads rather than future exit strategies.

On the debt side of the equation, capital flows are more than adequate to support transaction levels. Indeed, competition for product—especially for prime properties in desirable locations—has been strong, which has created something of a bidding war upon which investors have been more than willing to capitalize. In general, investors and lenders continue to focus on spread, investing with capitalization rates for commercial properties around 440 bps over ten-year treasuries, which is some 60 bps higher than long-term averages. Competition to capitalize on the spread has bolstered prices, providing exit strategies for those seeking to monetize their investments as well as solace for lenders in terms of collateral values. In this competitive environment, lenders have relaxed underwriting standards and have been more willing to lend on non-prime properties in an effort to source product.

While still struggling for traction, the commercial mortgage-backed securities (CMBS) market has been able to stay in the game, benefiting from continued improvement in delinquency rates, which trended down throughout the year. In general, delinquency rates for multifamily, industrial, and retail product improved while delinquency rates for office and hotel properties increased moderately.

In terms of market capitalization, CMBS loan volume has been relatively stable; although, significantly below the peak in 2008. Despite some concern over economic conditions and business demand, the near-to-intermediate outlook for commercial debt is relatively positive and should be adequate to sustain current and anticipated activity levels.

**Conclusion**

Going into the fourth quarter, the national economy seemed to be on a positive trend line with modest increases in GDP built into most forecast models. Few observers had expected that the Washington malfunction would occur and political factions would force the government to shut down and put the country on the brink of default.

While things were worked out after a relatively short sixteen-day shutdown, the solution was another example of déjà vu, with politicians punting rather than trying to take the ball across the goal line. The political machinations that led to the shutdown and finger-pointing that tried to shift blame was not lost on the American public. This particularly affected the 7.2% of workers who continue to be left without jobs as well as the 90 million plus adults who are outside the job market. It also affected the scores of Americans who were looking forward to affordable health care and have been locked out due
to technical glitches as well as confusion over what options they have to secure health insurance as the deadline approaches.

In this environment of uncertainty, one would have expected the stock market to have taken a hit. Interestingly, both corporate balance sheets and stock prices have fared better than expected (with the exception of the banking sector, which is a victim of its own follies). This counterintuitive phenomenon is one of the positive unintended consequences of the fumbling in Washington. That is, concern over the fate of the economy is likely to keep the Fed on the sidelines and force it to continue to hold interest rates at historically low levels. When that pressure subsides, the economy and financial markets will face a significant game changer as the Fed ultimately backs off on quantitative easing and shifts attention to fighting inflation. In the meantime, the overall stock market and the commercial real estate market are likely to continue to plug along.

On the real estate front, the market will continue benefiting from spread investing, which will hold hurdle rates at historical lows. How long this will last depends on the Fed’s actions and how long the gradual improvement in market fundamentals continues. It should also be noted that this improvement has had more to do with the lack of new construction activity than with increases in the demand side of the equation. This scenario should hold for the near-term but is subject to downside risk early next year as Washington once again figures out its game plan. Unfortunately, the stakes are much higher than in any game, and the fate of the nation, its businesses, and its citizens lie in the balance.

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