Out of the Economic Doldrums?

by James R. DeLisle, PhD

Commentary
The economic indicators of the summer of 2003 were among the more closely watched in recent history, with consumers, companies, and investors keeping an anxious eye on an economy that showed signs of breaking from its doldrums. Although a number of risks could change the economic outlook, the end of a difficult period might be in sight if corporate spending steps up to take some of the pressure off consumers. However, there are enough lingering problems—high unemployment, depleted government coffers, excess capacity—to suggest that the recovery will be tempered. Given these downward pressures, the situation could again slip into the trough that has lingered in the market.

Interestingly, the recent blackout in the Midwest and Northeast was an eye-opener in terms of both the deferred maintenance of U.S. infrastructure and the underlying optimism and sense of resolve in many Americans. Within a few days of the blackout, New York was humming along as if it had endured only a temporary brownout. However, the commentary on our "third-world infrastructure" and antiquated grid system focused attention on the problems the United States faces in modernizing its infrastructure to accommodate growth and maintain security.

In the meantime, assuming the economic recovery stays on track, the real estate market should experience moderate improvement, although high vacancy rates will place a damper on rental recovery. Since the economic improvement has been gradual rather than dramatic, the real estate market should follow a similar—although lagged—path to recovery.

The Economic Environment
Economic Growth
Despite mixed economic signals, by late summer the general signs revealed that economic activity was picking up. Higher-than-anticipated growth in gross domestic product (GDP) in the second quarter was a welcome change for observers who had feared economic growth would continue to languish. This improvement occurred both in actual economic indicators and, more importantly, in attitudes that are critical to a sustained improvement. Improvement in manufacturing activity was one of the more significant positive trends, along with modest improvement in services and energy. Of particular note was the improvement in business investment, especially in equipment and technology.

Consumers and the federal government have helped fuel the recent recovery, although the reliance on deficit spending is not sustainable and sets the stage for future problems unless earnings pick up. Business investment must continue its recent trend and ultimately translate into new hires to take the pressure off vulnerable debt-denominated growth. The near-term outlook is for continued improvement, with some concern over the long-term outlook. In the meantime, the economy should remain in a moderate expansion mode.

Employment
The employment situation remained a trouble spot in the economy during the last quarter. The generally positive news surrounding business investment had little spillover for the depressed job market, with companies relying on increased productivity rather than expanded employment to fuel growth. On a positive note, the advance figures for initial unemployment claims continued to trend down moderately. Similarly, claims under the federal Temporary Extended Unemployment Compensation Program declined moderately, although levels remained high. On the other hand, the modest decline in reported unemployment rates was attributable largely to a decline in labor force participation rates, as potential employees dropped out of the job hunt. There was an increase in temporary help through the early summer, with three consecutive months of growth.
through the end of July. Capacity utilization remained low by long-term averages, suggesting that companies have the ability to respond quickly to economic indicators without concern about limited facilities dragging employment growth. While it is unlikely that employment levels will improve over the near term, the good news is that these levels should not experience significant erosion.

Inflation and Interest Rates
There have been few signs of a return to an inflationary cycle, and the recent moderate increase in inflation was a welcome sign for those who feared that the economy would slip into a deflationary cycle. On the other hand, not all were happy with the consequences of moderately increasing inflation, especially vacationers caught by a spike in fuel costs around the Labor Day holiday. While attributed to a combination of low reserves and temporary pipeline problems in the Southwest, the spike in gasoline prices was a wake-up call that inflation could re-emerge as an economic concern. Similarly, the relentless upward pressure on medical care and declining benefits contributed to inflation worries. When coupled with geopolitical and infrastructure concerns, the possibility of a return to inflation has caught the attention of some observers and will be closely monitored by the Fed and other interested parties.

The moderate rise in interest rates during the summer was a healthy sign for investors, suggesting that investment prospects were improving over the lackluster levels associated with the cyclical low in interest rates. Assuming the economy continues to improve, interest rates should experience upward pressure, although there are no signs of a major spike in rates. The rise in interest rates triggered an increase in residential and commercial mortgage rates, but both continued well-below long-term averages. While the speed of the rate increase caught some buyers and investors off-guard, many had been waiting for such an occurrence. In most cases, the rise in interest rates was largely offset by improved economic conditions, especially in light of the modest increases and widespread discounting in the market.

Business Indicators
During the third quarter, industrial production provided a welcome respite from the negative news that dominated the scene earlier in the year. Once again, these gains were largely due to improved productivity levels in both the business and manufacturing sectors. The increased business investment that occurred in the second quarter and carried through the summer was welcome news, although the improvement was offset by a decline in inventory levels. Small business spending was tempered in spite of incentives and the generally favorable outlook for the broader economy. Although the decline in inventory levels dampened near-term figures, it should portend acceleration in overall activity as the market picks up speed. Export figures were disappointing in the early going, but improved by midyear, climbing to their highest level in two years as of June. The improvement in exports, coupled with slowing import sales, led to an improvement in the trade deficit. Going into the third quarter, it was expected that the trade balance would continue to improve, with the cheaper dollar providing a stimulus to export activity. Unfortunately, the euro began to slide against the dollar, eating into some of the gains and undercutting the foundation of the improvement in the manufacturing sector.

Stock Market
During the first half of the year, the stock market flirted with recovery, only to disappoint investors and slip back into the doldrums. However, by midsummer the stock market finally looked like it was breaking away from the forces that had eroded previous rallies and showed improved performance in the Dow Jones Industrial Average. This improvement had a number of ancillary benefits, including an influx of foreign capital that helped strengthen the dollar. The tax-cut package provided further stimulus to the stock market, helping bolster investment and further productivity gains. Similarly, strong defense spending and the prospects for even greater outlays propelled defense-related stocks. Finally, concerns over the integrity of critical infrastructure should bolster the prospects for related industries, as well as for public sector construction activity.

While it is difficult to predict the stock market, there are signs that the market is poised for a gradual recovery that matches the broader economy. The market is by no means out of the woods, however, with periods of profit-taking and sector adjustments adding to the near-term volatility. Similarly, negative geopolitical events and unexpected economic setbacks could undercut the fledgling recovery and
continue to add significant downside risk to the market. Nevertheless, momentum could continue to grow, helping propel the market and move it to the next level.

**Consumer Confidence**

Over the past several years, consumer confidence has been one of the few bright spots, helping support retail sales and bolster the overall economy. In early 2003, consumer confidence eroded, with concern over geopolitical risk, erosion in personal wealth, and a weak employment scene plaguing consumers. By midyear, the situation had improved somewhat, benefiting from the success in Iraq and moderate improvement in the economic outlook. Despite high debt levels, most consumers appeared to have limited concern over their near-term financial security. However, personal bankruptcy rates have continued to increase at record levels, a trend that could accelerate if interest rates and inflation take already-stretched household budgets to the breaking point. As might be expected, this risk is most pronounced among lower-income households and the unemployed. Going forward, consumers should remain wary but stable, drawing on the improved economic statistics, tax cuts, and rising but still low interest rates. The previous decline in confidence levels in midsummer suggests that consumer confidence cannot be taken for granted. As with the broader economy, consumer confidence levels remain vulnerable to a number of externalities, with the employment situation being a key factor.

**Retail Sales**

Despite improvement in many sectors, retail spending in the second quarter was unimpressive, suggesting that the consumer-led economy had largely played out. In particular, the modest rise in home mortgage rates had a marked effect, punctuating the fact that debt-supported consumer spending will remain vulnerable to rising rates. The blackout in the Northeast eroded retail sales in midsummer, although monthly figures continued to grow, rising to the highest level for the year. In this environment, the improvement in back-to-school sales was welcome news for retailers. Some of the activity was attributable to the tax refunds and heavy discounts, with the retail sales deflator continuing to slide. Going into the critical holiday period, the jury is out on retail sales, with much depending on whether the stock market and broader economy continue to improve. Fortunately, the bar is fairly low for year-over-sales due to the disappointing 2002 season. Improvement in retail sales will ultimately hinge on the employment and earnings picture that factor into consumers’ pocketbooks and confidence levels.

After a seasonal slowdown in the first quarter of 2003, retail e-commerce sales bounced up in the second quarter by almost 30% over the second quarter of 2002. E-commerce sales were also up compared to the first quarter, although lower than during the holiday season. Despite continued growth in e-commerce sales, direct sales continue to account for only 1.5% of total sales. Improved technology helped elevate total retail e-commerce sales. This was especially true for retailers who integrated traditional in-store sales with e-commerce sales. These retailers added efficiencies to purchasing, inventory management, and physical distribution that helped bottom-line performance but do not show up on sales figures. This situation is likely to continue, with technology-enhanced retailing becoming more important in the face of shifting consumer preferences and product demand.

**Housing Market**

During the summer of 2003, the housing market continued its bull run, with strong starts and sales figures. In July, new permits for single-family housing slipped somewhat, remaining above levels in the first quarter but slightly down from the prior year. Multifamily building permits fell dramatically, falling below levels for both the first quarter and the previous year. This pattern was echoed in the "authorized, but not started" category, suggesting that developers had become more anxious over the fate of the sector. However, private housing starts remained fairly stable for both single-family and multifamily units, suggesting a fairly active pipeline of new product is in the works. This situation was slightly different on the completion front, with the single-family category holding its own and the multifamily category declining in the face of weakening market fundamentals.

The rise in mortgage rates in midsummer threatened to squeeze out marginal borrowers. There was a stampede of activity as the market began to adjust to the anticipated, but heretofore untimed, increase in rates. Homebuyers got off the fence and set record sales volumes for existing homes. The influx of buy-
ers helped fuel a rise in median housing prices, which were 12% higher than the same period in the previous year. Sales of existing homes can be expected to cool off in the face of rising rates and record-high homeownership rates, although improving economic conditions should help the market. If mortgage rates increase but remain below long-term averages, refinance activity should decline but sales should remain healthy. This situation should continue during the economic recovery, assuming that there is not a reversal in the recent run-up in housing values and that interest rates do not unexpectedly spike.

Despite the current strength and stability in the housing market, there is some concern that the increase in homeownership levels among marginal buyers may have unintended consequences over the intermediate term. To a certain extent, the decline in mortgage rates and the perception of continuous value growth have drawn more households to the ownership option. The success of these factors is evidenced by record-level homeownership rates that have climbed even further. However, housing prices are critically important on both the “buy” and the “sell” side of a transaction. Thus, a run-up in values on the buy side due to low interest rates may well come back to haunt a buyer on the sell side, especially if interest rates continue to increase. While some may be able to wait out the softness in the market until incomes catch up, the need for many households to move for jobs may create an unexpected trap. In addition, the increase in purchasing power related to low rates and aggressive lending induced many homebuyers to pay more for housing than they might have otherwise. Whether these values will hold up will depend on a solid recovery that bolsters purchasing power on the income side of the equation rather than the debt side.

Real Estate and Capital Markets
Capital Markets Overview
During the first half of 2003 and carrying through the summer, real estate capital markets remained active as investors and lenders competed for product. Despite moderate improvements in the stock market, capital flows to real estate should remain strong as investors seek relatively stable, competitive returns. On the other hand, sellers may anticipate an inflection point in the buyer/seller balance that has favored sellers, and bring additional product to the market. Given the pent-up demand for product, additional supply should not lead to weakening of prices, with investors continuing to accept lower yields. This situation is especially true for core assets that investors believe will be insulated from downside demand risk and may have some upside potential as the economy and real estate fundamentals improve. As such, capitalization rates are expected to remain below long-term averages, with many investors continuing to accept low initial yields. Indeed, the low spread between capitalization rates and internal rate of return (IRR) hurdles should also continue, with investors willing to take lower but more stable returns than in past recovery cycles. Investors are also expected to shift preferences toward assets with more upside potential as excess capacity is gradually burned off and the market begins to experience upward pressure on rental rates.

Construction Activity
During the summer, there was little change in nonresidential construction activity, with activity levels continuing to languish compared to long-term averages. This situation continued to be welcome by real estate professionals and investors who realize that the recovery in spatial markets will lag the broader economy as the excess capacity is absorbed. The pattern of tempered construction activity was fairly widespread, with no commercial property sectors exhibiting an increase in construction levels. On the other hand, residential construction activity remained relatively strong, with the exception of multifamily property where rising vacancy rates have translated into lower construction activity.

Public construction levels remained relatively stable, with moderate increases over the prior year. As might be expected with the fiscal crisis in many states, state and local construction spending was a drag on growth, while federal construction activity was stronger. The bulk of public expenditures was for highways/streets and education. Both sectors declined slightly as a result of budget constraints rather than demand. Over the near term, public construction activity should continue to be moderate. However, growing concern over infrastructure vulnerability (e.g., the grid system) might portend an increase in activity from private and public sources.

Commercial Mortgage Market
During the second quarter, commercial and multifamily lending volume reflected strong increases
against the first quarter and the prior year. The increased volume was reflected across the major property types, with multifamily properties leading the pack. The competitive market for product had a positive ripple effect for health care and hospitality, both of which reported increases in lending volume. Going into the third quarter, the commercial mortgage market looked like it would stay on track for strong deal flows, with little change in the competitive balance. While rates rose on the rising tide of treasuries during the summer, spreads remained tight due to the plentiful supply of capital and a relatively attractive risk profile for the sector. Despite recent rate increases, it is likely that the cost of debt will remain favorable, helping offset some of the downside drag on cash flows attributable to the soft spatial market. As the economy picks up, improving fundamentals should take the pressure off tight budgets and help maintain lower-risk profiles for existing, seasoned commercial loans.

The public mortgage market has also remained extremely active, with a very strong first half of the year. Over the near term, commercial mortgage-backed securities (CMBS) volume should remain solid, although lenders will continue tightening underwriting standards to adjust for weak fundamentals in the spatial market. However, the competitive market for viable projects has dictated some softening of credit support and low spreads, which may slow investments or move some market participants to the sidelines. This situation will be amplified by the rise in delinquencies and increasing downgrades, although neither factor is a major concern given their relatively strong absolute levels. Thus, the current momentum should propel the industry through the bottoming out phase of the market and position it for solid growth once the economy picks up, excess capacity is absorbed, and demand for new product grows. Furthermore, the maturing of the CMBS industry, which took off about eight years ago, has set the stage for a spate of refinancing activity that should help fuel the next wave of CMBS growth.

Private Equity Market

During the third quarter, the private equity market remained on track, with investors aggressively competing for product, especially for the favored, core assets. The commercial real estate market continued to be characterized as a sellers market, in spite of soft market fundamentals, high vacancies, and flat rents. The rise in interest rates has had some impact on the margin, however, the impact was mitigated because rates are still below long-term averages and an eventual increase was already priced into the market.

Investors seem resigned to moderate yields, using real estate as a combination of cash cow—steady albeit low—and portfolio stabilizer. The recent strength in the stock market has not had an impact on capital allocations to real estate due to a combination of their uncertain nature and the institutional acceptance of equity real estate as a moderate-risk, moderate-return asset class. Indeed, rising portfolio balances attributable to an improving public equity market should provide incentives to institutional investors, who were pushing the limits of their real estate allocations, to increase their investment levels. In light of improved economic signals and moderating slippage in the real estate market, the near-term outlook for private equity investment remains positive. However, transaction volume may slow as current holders—especially institutional investors—stay the course with existing assets rather than look to cash in on cap rates. This scenario is likely to be played out across many property sectors as investors focus on longer-term performance and less on current yield.

Public Equity Market

During 2003, real estate investment trusts (REITs) have provided investors with solid returns, both on an absolute basis and relative to other asset classes. Through the middle of August, equity REIT returns have pushed 20% on a year-to-date basis. Retail REITs continued to lead other property sectors, followed by the health care, diversified, apartment, and industrial/office sectors. Interestingly, all of the major property sectors performed in the upper teens, attesting to the widespread interest in REITs compared to other asset classes. While REIT returns slipped a bit in August, the outlook remains fairly solid. Although returns might be adversely affected by continued erosion in market fundamentals, this situation is not new and has been largely priced into share values. On August 1, the Real Estate Investment Trust Improvement Act of 2003 was introduced in Congress. The proposed act is designed to change some of the tax rules surrounding REITs, remove ambiguities, and improve the investment environment. On a similar note, the Securities and Ex-

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change Commission (SEC) has proposed rules to strengthen disclosure requirements regarding the nomination of directors and shareholder communications with directors, adding more transparency to the process.

The strong demand for public real estate investments has had a significant impact on unlisted REITs, which have been attracting significant capital flows. In essence, unlisted REITs are “quasi-public” to the extent they register with the SEC and file quarterly reports. However, they do not trade and offer limited liquidity and disclosure compared with listed REITs. To some, the absence of public scrutiny is a positive, allowing the REITs to move quickly and creatively, focusing on deal flow and entrepreneurship that are limited when operating in the public eye. The dramatic growth of unlisted REITs has put them under significant pressure to acquire real estate and has forced them to meet market prices for targeted assets. At the same time, high front-end fees to investors have placed tremendous pressure on cash flows. Despite the high fees, aggressive marketing and continued access to investors should help these REITs bridge the downside of the spatial market and remain a viable investment product for non-institutional investors. Whether they can continue to deliver on their promises and/or convert to listed REITs remains to be seen.

Real Estate Outlook
Overview
During the third quarter, the commercial real estate market continued its recent trends of moderate erosion in fundamentals, tepid demand growth, and limited additions to new supply. This environment cut across markets and property types, with few exceptions. As a result, owners/investors have been forced to deal with flat to declining rents, with cyclically high vacancy rates and limited opportunities to fill up vacant space. The prospect of rising rent rolls has placed additional pressure on seasoned buildings, as managers are forced to compete for tenants. This competitive situation is especially strong for credit tenants who can anchor a building, adding baseline rent and, in some cases even more importantly, adding to the perceived safety of the investment. This latter attribute has become important in moving core assets at premium prices. This is apparent in risk-averse investors who forgo some near-term returns for limited downside risk and who anticipate an ultimate recovery as the market firms up as the economy improves. The near-term outlook is for continued stability in the space-time, money-time continuum, leading to a state of steady, but potentially moderate, deterioration in fundamentals. Since the recent level of investor demand has not been predicated on a recovery scenario as in the mid-1990s, there is limited downside risk in terms of transaction volume. Economic uncertainty and geopolitical risk will continue to hang over the sector, but it is unlikely that there will be major additional contraction in demand unless the bottom falls out across the board.

Office Market
The office market continues to be plagued by excess capacity shown in increasing vacancy rates, shadow space (i.e., unoccupied or underutilized but rent-paying), and subleasing activity. The recent changes in accounting rules on reporting excess space have raised the stakes in how companies report such events and make it more difficult to gauge the effective versus observed occupancy levels in a market. However, with the exception of the accounting-induced pressures, the situation of eroding fundamentals has been unfolding for some time, as companies have adjusted to the broader economic malaise. Although the economy has shown some signs of improvement, it has been largely a jobless recovery, with layoffs continuing as companies focus on bottom line performance and productivity gains. An additional threat to the recovery of the office market has been the recent trend toward exporting white-collar jobs. If this trend continues or accelerates as some have forecast, the office market may be in for a difficult recovery period. This caveat is especially true in markets and submarkets that specialize in the business services most likely to be exported.

Unfortunately, soft market conditions have not reduced the pressure on operating budgets and tenant improvement allowances. Indeed, many owners have been forced to provide extra support and benefits to retain existing tenants. Given the competitive nature of the market, these unanticipated expenses sometimes have been incurred well in advance of lease expirations. Property managers and leasing agents have been forced to respond to overtures from desperate competitors willing to buy out current obligations to fill up buildings and allow them to tap into favorable financing as a means of surviving.
the prolonged bottoming out phase of the market cycle. Fortunately, to a great extent these factors have been priced into the current market. Thus, office investments acquired or held with an eye to these externalities should be able to weather the storm and capitalize on the ultimate economic recovery.

Retail Market
The retail market has enjoyed a relatively healthy run, in spite of a recession and shakeout among marginal tenants. This situation has benefited from the combination of strong secondary demand from consumers, as well as moderate additions to supply, especially at the large end of the size spectrum. In addition, this has helped bolster the performance of mall REITs, which have continued to lead other property sectors in spite of increased turmoil and uncertainty among some department stores. On a positive note, in many cases mall owners have been able to respond to anchor losses by further diversifying tenancy and introducing nontraditional mall tenants, including some of the category killers who earlier were being pointed to as leading to the ultimate demise of malls. With respect to power centers, the shakeout has already occurred among major tenants, which when coupled with moderate additions to supply, have led to better market balance. Grocery-anchored centers have remained in the middle of the target zone for institutional investors for a number of years, although some of that appetite can be traced to their smaller deal size and greater liquidity rather than market fundamentals. The continued growth of Wal-Mart Super-Centers has eaten away at investor confidence, with many choosing to concentrate debt and equity investments exclusively on centers with the top one or two grocery chains in the market. This concentration of asset preferences is understandable, but has resulted in a bifurcated market in which product is extremely tight and pricey for favored centers, and relatively limited for centers not having the right tenant mix. Life-style centers have also received significant interest among developers and investors, although their long-term viability is uncertain. Consequently, the supply of such product should be moderate until retailers and investors can better judge their long-term viability.

Industrial/Warehouse Market
The industrial market continues to enjoy a capital market/spatial market split, with investor appetites strong and supply/demand fundamentals relatively weak and subject to more downward pressure. This situation is not new, however, with the industrial vacancy rates continuing to rise. The market has been particularly challenging in the research and development sector, which has suffered along with the dot-com collapse and has yet to show signs of recovering. On a positive note, the weakening dollar has helped bolster the outlook for exports, providing some optimism on the demand side that might help the market recovery. Similarly, increased durable goods orders and improvement in some other indicators will be closely watched as owners and investors look for signs of a turnaround that could help the sector recover. Even when the economic recovery begins, the excess capacity and elasticity of new supply could cause the improvement in market balance and performance to lag recovery in other property sectors. Despite this outlook, the sector is not in danger of collapse and investors are willing to stay with core assets, suggesting that the industrial sector will continue to plug along. On the other hand, there are limited prospects for increasing rents until the economy takes off and businesses begin to ratchet up their activity levels.

Apartment Market
In some respects, the apartment market has been left in the dust by the single-family market. Indeed, the single-family market has continued to enjoy record construction activity, appreciation rates, and transaction volume. On the other hand, the multi-family market has languished, with falling construction levels, rising vacancy rates, softening market values, and inconsistent investor demand. Despite this disparity, investor interest in the apartment market remains relatively high as investors construct diversified real estate portfolios. Over the near term, apartment vacancy rates are expected to increase moderately, as modest additions to supply are met with tepid demand growth. This situation might worsen when the spate of renters who left the rental market in midsummer are factored into the equation.

Although this market behavior is bad news in the short run, it may actually portend a time when apartments move back into favor as problems arise with homeownership. Since the supply side of the apartment market has been somewhat disciplined in this cycle, some of the softening in the spatial side can be attributed to leakage caused by the lure...
of homeownership. A number of renters converted tenure choice to ownership when the costs were comparable due to the cyclical low interest rates. An additional draw was the perception that housing is a great investment in terms of increasing value trends. However, a lot of the upward pressure on prices can be attributed to the decline in interest rates; a situation that may well be reversed over the intermediate term. At the same time, many former renters who opted for apartments due to lifestyle preferences (e.g., no maintenance, yard work, mechanical worries) and mobility requirements are now in a situation where they enjoy none of the benefits of renting. They may have become anchored to their new houses and face the prospect of declining prices—or softening appreciation rates—when they are forced to sell, especially when the high transaction costs are factored into the equation. To the extent this scenario unfolds, the apartment market should benefit as tenants opt for more appropriate space-time, moneyme time solutions to their housing needs.

**Conclusion**

The summer of 2003 was interesting on a number of fronts. On the economic front, there were increasing signs that the economy might finally be turning the corner, with gradual rather than dramatic improvement. On a similar note, while still hanging over the country, the conflict in the Middle East and the terrorist threat appears to have been managed. Furthermore, there is a national sense of resolve not to get bogged down by concerns. At the same time, the blackout punctuated the state of our vulnerable infrastructure and pointed to some longer-term economic problems that were not on the radar screen. When coupled with rising national debt and the current fiscal crisis facing many state and local governmental bodies, there is a growing sense of anxiety about the longer-term health of the economy.

With respect to the capital markets, real estate continues to out-perform many other sectors, and should benefit from net inflow of funds. Thus, the transaction market should be active and supported by adequate supplies of equity and debt. On the spatial frontier, real estate fundamentals are expected to struggle with moderate weakening. Due to excess capacity, the recovery of the supply/demand balance will lag that of the broader economy. However, few potential risks on the horizon are specific to the real estate asset class, so it should remain relatively attractive compared with other asset classes.

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