

# Lessons (To Be) Learned

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## Commentary

At a recent academic conference, one of the younger speakers who was relatively new to the real estate discipline made a PowerPoint presentation that ended with the phrase “Lessons to be Learned.” Whether the choice of words was conscious or not, it had ominous overtones to those who have been around long enough to have accumulated a vast portfolio of “lessons learned.”

While somewhat subtle, the revised wording of the well-known phrase highlights that for some newer players, there has been a shift in emphasis away from drawing on “learning” to help prevent history from repeating itself toward emphasis on “discovery,” which can lead to a number of surprises. In many respects, this subtle shift in wording exemplifies one of the classic problems in real estate: short-term memories and lack of learning and knowledge accumulation. While this tendency has been around for a while, its impact has been amplified by the recent movement toward a Twitter nation, characterized by short attention spans, a tendency toward speed connecting, and in too many cases, speedy decision making.

The importance of drawing on lessons learned to help guide decision making is paramount during uncertain times such as the current phase in the real estate cycle. This need is amplified in the real estate arena by the acceleration of key trends such as globalization, consolidation, environmental awareness, and technological innovation. Furthermore, the real estate industry is highly regulated, and a number of interventions (e.g., changing tax policies, changing land use restrictions, modification of legal requirements, and introduction of new accounting standards) have been interjected

by outsider players who are new to the industry. While many of these players are well intentioned, they often lack the insight and experience necessary to avoid unintended consequences. These unexpected events can have a devastating impact on the market, thwart efforts to achieve certain desired goals, and wind up doing more harm than good.

To provide a sense of perspective for new and old players alike, it is important to explore some of the lessons learned from prior experiences that are likely to resurface. With that goal in mind and to stimulate much-needed critical thinking, before delving into an update on the current economic situation, it is useful to consider the following noteworthy but often-overlooked lessons learned from the not-too-distant past.

- **Beneath all is the land.** Almost thirty years ago, an academic colleague coined the phrase “The Death of Dirt.”<sup>1</sup> This lament reflected the fact many investors and other players had apparently turned away from an emphasis on real estate fundamentals in favor of reliance on capital flows and market timing. This trend was bolstered by the dramatic growth of securitization (commercial mortgage-backed securities; real estate investment trusts) that occurred in the mid-1990s as the industry recovered from the collapse of the late-1980s. This trend culminated in the introduction of the four-quadrant investment model, which included public/private and debt/equity markets.

Some proponents of new forms of investing in real estate argued that investors could diversify their real estate holdings across these new forms of ownership. While this contention had some intuitive appeal, the position was an overstatement since

1. Terry V. Grissom, PhD, former MAI; observation coined around 1985 and codified in a t-shirt emblazoned with the phrase and worn at an academic meeting.

the values of securitized or financially engineered investments were only as secure as the value of the underlying real estate that collateralized them. Thus, the lesson is, rather than looking at the financial structures or vehicles, it is important for investors to pay attention to the underlying spatial market fundamentals that ultimately determine the residual value as well as the products that are built upon it.

- **It's Not the Price, It's the Terms.** In one of his more prescient lecture quotes, the late James A. Graaskamp noted, "It's not the price, it's the terms." This observation provides a simple, intuitive explanation as to the real cause of the collapse of the housing, condominium, and commercial real estate markets. That is, access to easy, cheap, nonrecourse financing placed upward pressure on transaction prices by creating an elastic expansion of the ability to pay in the face of relatively inelastic supply. As might be expected, developers were quick to rise to the opportunity, which explains the surge in construction that outpaced the demand for the underlying space. While some have argued that lenders and investors learned from this recent experience, historical evidence belies such a conclusion.
- **Lemmings Create Lemons.** One fundamental problem that plagues the real estate industry is the tendency of institutional investors, lenders, developers, and other participants to act as lemmings. That is, real estate behavior is often typified by a herd instinct in which players do what others do rather than taking a hard look at recent trends to avoid the boom/bust cycle that characterizes the real estate market over time.

In some respects, one could argue that the real estate industry has a three- to five-year memory span, which results in seven- to ten-year market cycles. Another way of characterizing this lesson learned is the saying "Capital ebbs and flows create spatial woes." For evidence of the validity of this observation, one only has to look back at the office sector in the 1980s, the commercial real estate industry itself in the early 1990s, the housing market in the early 2000s, and the commercial and condominium markets in the mid-2000s. Clearly, in each of these cases the lemming strategy created imbalances in market fundamentals that led to an unexpected correction. The most

recent example of this pattern is the apartment market, which recently has been the darling of developers, investors, and lenders.

- **Buy Low, Sell High; Buy High, Bye-Bye.** Over the past year or so, top-tier and trophy properties have been trading at record prices and historically low capitalization rates. Part of this trend has been attributed to institutional investors who have adopted a spread investment strategy in setting hurdle rates for real estate. For such investors, the combination of a long-term hold, the lack of concern over mark-to-market accounting, and the low yields offered by duration-matched investments has shifted focus from real estate fundamentals and risk-return relationships to capital preservation.

This approach to pricing is somewhat understandable and helps explain the sub-5% capitalization rates at which some properties are trading. However, from an investment perspective the approach is fundamentally flawed because it fails to look at holding-period returns and the importance of exit strategies. For example, when capitalization rates return to historical levels, it is likely market values will decline, resulting in lower net terminal values that could drag yields down to unacceptable levels. If this occurs, institutional investors that have recently been drawn to real estate may get burned by the repricing that is likely to affect disposition prices. As in the past, if this occurs investors may begin to dump assets, take their hits, and avoid the asset class going forward.

- **It's A Small, Small World.** Despite a growing body of evidence about the impact of globalization, some developers and investors contend that real estate remains a local market unaffected by national or global capital events. As such, they ignore macro-economic conditions in favor of focusing on local market fundamentals of supply and demand. While there is some appeal to this approach, the integration that has occurred between the real estate and capital markets as well as the dramatic growth in globalization argue against such a myopic approach. In essence, relying on a localized strategy is like putting all of one's eggs in a small basket and trying to protect it from outside forces. Unfortunately, given the recent history of the debt crisis in Western Europe and the slowdown in the US economy, it is

clear such a narrow view can make one vulnerable to risk associated with unexpected offshore events.

The small-world phenomenon has been bolstered by the explosion of Internet-based communications, social networking, and the resultant transparency across the globe. Going forward, the “Twitter nation” is likely to be supplanted by the “Twitter globe.” In addition to shrinking the world and blurring borders, the associated instant-messaging mindset is likely to shorten the memories of investors, leading to a greater frequency and amplitude of cycles and affecting the capital and real estate markets across the globe.

- **The TINR Principle Rules, Reality Fools.** One of the major contributions of Richard U. Ratcliff to the appraisal discipline was his recognition of the inherent behavioral nature of the real estate market. He argued that all real estate transactions are negotiated and occur in an inefficient market. As such, he argued for the adoption of the most probable price as the objective of an appraisal. The notion endures and is widely accepted in appraisal and real estate business practices. Ratcliff argued that by approaching real estate as a behavioral science, it is possible to develop more accurate forecasts of future behavior.

One of the major corollaries to this reasoning is the importance of perception in forming consumer attitudes and behavior. The TINR principle (There Is No Reality) was coined by the author of this column to punctuate the fact the market relies on its perceptions and expectations rather than objective, deterministic facts that they may not be aware of or may not consider germane to their decisions. To operationalize this concept and make it more meaningful, it is important to approach real estate markets from a market segmentation perspective, with emphasis on identifying the subset of that market that will be drawn to a particular real estate opportunity. It is this group (e.g., institutional investors, sovereign wealth funds, hedge funds) that will ultimately affect the price at which the underlying property or interest trades (i.e., the most probable price).

- **Bubble, Bubble Leverage Trouble.** As noted earlier, one major factor leading up to the collapse of the residential and commercial markets in the

mid-2000s was the easy access to cheap financing. In the current economic climate, some investors are facing a redux situation reminiscent of the pre-2008 collapse. Indeed, despite concern over the imminent surge in maturing bullet loans, some well-capitalized opportunistic investors have had ready access to 3.5%–4.0%, seven-year bullet, nonrecourse, 70%–80% loan-to-value mortgages. This aggressive financing has allowed leveraged investors to pay record prices for prime real estate without compromising returns. As such, it helps explain some of the aggressive pricing and record-low capitalization rates that have been observed. Some of these seasoned investors have adopted exit strategies that can be triggered within the refinancing window to allow them to lock-in acceptable holding-period returns, although others will not be so lucky.

While not discussed in mainstream press, the dangers of cheap credit have caught the eye of a number of industry leaders, including Barry Sternlicht, CEO of Starwood, who recently said, “Competition to buy high-quality commercial real estate has led to a debt ‘bubble’ in some U.S. property sectors.” He noted that this trend was particularly dangerous since, “You don’t know where rates will be in two years, and that creates a difficult investing challenge.”<sup>2</sup> Unfortunately, players who are relatively new to the industry may not recognize that interest rates are at historical lows and values are subject to significant downside risks. Thus, real estate values will be under downward pressure and underwriting standards will make it difficult to pencil out on properties for which acquisition prices, and thus current debt, were inflated beyond sustainable levels.

- **Double Dips Sink Ships.** The economic outlook for the United States dramatically improved since early last fall. Indeed, the gradual but steady economic improvement shifted attention away from concerns over the possibility of a double-dip recession and to questions regarding the speed of the economic recovery. This shift in emphasis occurred in spite of tailwinds from the prolonged housing market recovery, disappointing job performance, and the ongoing debt crisis in Western Europe. Since that time, positive news for most of these fronts has helped bolster confidence levels

2. <http://www.bloomberg.com/news/2012-04-30/debt-bubble-in-property-is-like-2007-sterlicht-says.html>.

and shift attention toward the future rather than current situation. The recent double-dip recession in the United Kingdom and problems across Western Europe are stark reminders of the tenuous nature of the economic recoveries. With the exception of the last recession, downturns in the United Kingdom have historically preceded downturns in the United States, which if the pattern holds is somewhat ominous. From a cyclical perspective, this scenario sounds too familiar and reinforces the importance of lessons learned.

The list of lessons learned could go on and on. However, the important message is that the real estate industry is a cyclical industry in which past mistakes can come back to haunt it. In the current environment, the best approach is to look back before looking forward. The final words of wisdom are from the adage, "Don't be a Fool, Fundamentals Rule." While this might not hold in the short term, it inevitably applies in the mid- to long-term due to the durable, capital-intensive nature of real estate.

### **Economic Environment**

Over the past several months, the general psyche of the market has made a dramatic turn moving from a sense of anomie to a sense—or hope—of optimism. Interestingly, this shift occurred during a period in which little progress was made on the political front other than the GOP settling on a candidate and Congress taking a breather before much of the heavy lifting that will have to be done before the year is over. Indeed, on a number of fronts political leaders have taken a time out, adopting temporary measures in hopes of forestalling a slowdown. This tendency has occurred across a range of governmental levels including local, state, national, and in the case of Europe, continental. For example, due to declining tax revenues that have exacerbated the plight of state and local government coffers, a number of projects have either been slowed or put on hold. At the federal level, little real progress has been made on long-term issues with some hoping to get through the election before dealing with fundamental problems for which there are no easy answers, obvious choices, or permanent solutions.

At the global level, while it looked like the economic and financial crisis affecting several Western European countries and festering in others were improving, more recent events suggest that is not necessarily the case. This situation has

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spread to China and some other markets that had seemed to be flying above the turmoil, causing some prognosticators and decision makers to ratchet back their growth plans. That is not to say the world is entering into a global recession, but the recent round of optimism remains tenuous and vulnerable to new economic shocks or other unexpected events.

On the other hand, the recent shift in outlooks to a more positive glass-is-half-full mentality is understandable; there is some positive news. For example, despite a disappointing performance in April, consumers generally have stepped up their game, catching up on some deferred spending that has actually occurred ahead of improvement in consumer confidence levels.

Relatively strong employment growth during the 2012 first quarter was a key factor behind the improvement in consumer and business attitudes, although the more recent figures have been a bit disappointing and have been a reminder that the recovery will be gradual. Again, the recent slip in employment figures led to a quick pullback on Wall Street, punctuating the still tenuous nature of the recovery and the importance of real economic growth to sustain a recovery. The housing market, which has yet to fully bottom out, has passed the free-fall stage and reached a plateau. While far from in full recovery, the shift has led to an increase in transaction activity and a growing sense that the industry is stabilizing.

### **Economic Growth**

Going into 2012, the economy was gaining some momentum with real gross domestic product (GDP) growth revised upward to 3%, which moderately outpaced expectations. This growth was bolstered by a pick-up in inventories that, while welcomed by most, set the stage for a downward drag in the first quarter. Some of that downward drag was offset by an unexpected increase in retail sales. Indeed, during the first quarter, economic growth appeared to slow down, with estimates falling to 2% which was

slightly off earlier forecasts. While disappointing, this pattern echoed the “Spring Forward, Fall Back” theme adopted for this column in the first quarter. The fact that this is an election year and the stakes are bigger than ever for the two parties, means this pattern is likely to continue. Unfortunately, evidence from the willingness to shut down the economy last fall suggests that the politics of rancor and pettiness will be even more vociferous this time around. Given the tenuous nature of the recent economic recovery and the likelihood of additional offshore ripples, economic growth will be subject to some additional downside risk that could dampen economic growth. The good news is the risk of a recession has continued declining, falling to half of the level it was in early fall. In this environment, the state of business and consumer psyches will take on added importance and bears close monitoring.

One of the issues that will receive added attention during this phase of the cycle is the federal deficit, which continues to grow at an accelerating rate. Given the economic slowdown, the situation is expected to deteriorate even more. The budget issues in the United States have not been isolated, with the euro zone also experiencing significant issues and facing a continued decline in economic activity. The year began with a grim reminder of economic challenges facing the euro zone when Standard & Poor’s downgraded the sovereign debt of France and eight other countries. This action highlighted the fact that the problems are not isolated to Greece and Spain, which have received the most attention, but are fairly widespread. The downgrades called attention to the fact a significant number of euro-zone countries were increasingly vulnerable to economic shocks emanating from outside of their borders.

Despite some progress in forestalling the collapse of Greece, the euro zone continues to struggle and is headed for its third-consecutive quarterly decline in economic growth. The most significant trouble spots are Spain, Italy, and France. While Germany’s economy has continued to expand at a modest rate, the country is facing the prospects of a recession, which appears to have already begun to spread across the euro zone. Even if the region is not in a technical recession, the rise in unemployment, increase in energy prices, and decline in consumer confidence as countries adopt austerity programs hang over the region and could have ripple effects in the United States. Rising political uncertainty is also

creating some concern. The results of elections will provide insights into the depth of voter unrest and the difficulty member countries will face if called on to respond to new challenges that may emerge.

While the European slowdown has received the most attention, other global regions are also scaling back their growth prospects. In early May, Australia’s central bank reduced its economic forecast, dropping below 3% for the fiscal year ending June 30. While still ahead of the United States and a number of other nations, the results were disappointing. They also reveal the integration that has occurred across the globe as the European sovereign debt crisis, the economic slowdown in eastern Asia, and the moderating of growth in China in line with government policies has put downward pressure on the Australian and US economies.

The recent cooling off of economic growth in China and India has placed a damper on prospects for US exports. For example, exports to China that had surged over 30% early last year fell to the single-digit mark by 2011 year end. If this pattern of tempered offshore demand for US goods holds, it will be difficult, if not impossible, to hit the double-digit growth target that had been set by President Obama’s administration in his 2010 State of the Union address. The situation is likely to get even more volatile if counties become more parochial and trade disputes flair up as have between China and the United States, exacerbating the 4 to 1 advantage China already enjoyed. Since these conditions are unlikely to abate, economic growth in the United States will face additional offshore drags, and domestic growth will depend more on the organic growth the economy can support leading to a moderate but upward trending outlook through the year with some downside risk.

### **Employment**

During the 2012 first quarter, unexpectedly high job growth received a lot of attention and was cited as evidence that the economic recovery was gaining traction. In April, however, employment growth slowed to a net 115,000 jobs, with private employment growth stalling and government jobs declining by 15,000 across all levels of government. These disappointing results provided a somber reminder that the economy remains on soft ground. The slow-down led to renewed calls from President Obama to refocus attention on domestic issues, especially the need to create jobs. As might be expected, the

call for stimulus spending on jobs drew attention to runaway government spending and the lack of political leadership as manifested in the failure to pass a budget. Since this polarization and posturing is likely to continue, the stalemate may also continue and lead to additional weakening for job growth.

On the unemployment front, the jobless rate fell to 8.1% in April despite the slowdown in private employment growth. While it's good news on the surface, with a little digging it becomes clearer that the decline provides a negative signal on the employment scene. That is, the decline was attributable to a drop in the number of people actively seeking jobs over the prior month. This reveals that many prospective employees have given up hope of finding a job, retreating to the sidelines. This pattern has held during much of the post-recessionary period and is manifested in a reduction in the labor force participation rate.

In a recently released study by the Labor Department, the average number of weeks spent seeking a job before unemployed workers found a job has significantly changed over the past five years. Prior to the recession that began in 2007, the average job seeker spent slightly over five weeks looking for a job. In 2011, that figure rose to around ten weeks on average, with some faring better but many remaining jobless for prolonged periods. These data also hint at the plight of the long-term unemployed, with over 3.5 million out of work for over a year at the end of the quarter. While disturbing in terms of the sheer number, the situation is even bleaker when considering the fact that the longer an employee stays out of the work force, the more difficult it becomes to reenter, especially when job requirements and conditions are likely to have changed.

Another concern lurking behind the aggregate employment figures is the fact many employed workers are actually underemployed in terms of their training and career aspirations. One of the distinguishing dimensions of this post-recessionary recovery is the fact most of the new jobs are in lower-wage sectors. Indeed, almost 70% of job growth has been in restaurants and hospitality, health and home health care, retail, and temporary jobs, which typically offer lower wages than many other job categories. The pace of growth of such jobs is even more pronounced when compared to the fact that such jobs have historically accounted for less than one-third of total private employment. The plight

of many of these marginalized workers is likely even starker, since many of these jobs lack basic benefits such as insurance and retirement plans. On something of a positive note, productivity levels tapered off in the first quarter, suggesting companies may open the door for additional hiring.

### **Inflation and Interest Rates**

During the first quarter, the consumer price index (CPI) was in line with expectations, with moderate increases in energy prices and core CPI. Despite a broad-based increase in consumer prices, expectations are in line with the Federal Reserve's target inflation rate of 2% as noted in a recent Atlanta Federal Reserve's survey. Although the average survey responses were on track, it should be noted that the responses were skewed upward, suggesting there is some upside risk that figures may come in higher than expected. However, the weak jobs report for April provided some relief on the inflation front.

The lower-than-expected job growth and rising concern over a global slowdown led to a decline in oil prices as speculators came increasingly concerned about the potential for a decline in demand for oil. At the same time, the supply side of the equation helped take pressure off of oil prices as Iran dropped its threats to blockade shipping routes. In the absence of some unexpected geopolitical event or natural disaster, oil prices are expected to remain relatively flat and in line with global demand. While good news on the inflationary front, gasoline prices are expected to remain at historically high levels through the summer, putting a damper on vacations and discretionary consumer spending. In this environment, inflationary pressures should be moderate and are not likely to be a major factor in the pace of the economic recovery.

In its April meeting, the Federal Open Market Committee made some minor adjustments. Thus, on the interest rate front not much has changed since the start of the year, with the Federal Reserve maintaining its low target rate that it pledged last year to hold until at least 2014. In the current environment, credit remains relatively cheap and is likely to continue to be so as long as the Federal Reserve maintains its policy stance and inflation remains in check. Thus, the real issue with credit is not the cost of credit, but the access to credit, the willingness to take on additional credit, and the implications of increased credit on borrowers and

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the economy. As in the past, discussion of credit levels and access has focused on business credit, especially small businesses that have been seen as key to a sustainable economic recovery.

Throughout 2011, senior loan officers reported banks were relaxing standards on commercial and industrial loans to businesses. Although welcomed by many observers, small businesses were reluctant to take on added debt in the face of economic uncertainty. During the 2012 first quarter, the net percent of banks tightening standards increased for both large and small businesses, making it more difficult to access debt. On the other hand, they eased underwriting standards on commercial real estate loans in the face of competition from other sources of capital. Similarly, standards for households eased a bit. After a slight uptick at the beginning of the year, outstanding consumer credit levels have fallen off due to a contraction in revolving (i.e., installment) credit. This decline was offset in part by an increase in non-revolving credit, including auto and student loans. Indeed, through the 2012 first quarter auto credit increased, continuing the upward trend that held through most of 2011.

### Education

The recent surge in student loan balances is one of the trends in increased consumer debt that has received significant scrutiny from Congress and the administration. While not necessarily a near-term issue, the worsening plight of students has triggered debates that are likely to be in the spotlight during this election year. The magnitude of student debt has been amplified by the dramatic shift in funding models for higher education, which warrant some discussion since the trend has significant implications for the long-term health of the US economy and its ability to win on the ever-more competitive global arena. In particular, a growing number of states have cut back support for higher education, which in turn has forced universities to raise tuition to cover a greater share of the cost of education. This

trend has resulted in 20% plus tuition increases that show no signs of abating.

The most immediate and direct impact of higher tuition is being felt by students and their families who are taking on more debt to cover the costs of education, which for prior generations had been offered as something of an entitlement for in-state students. The increase in tuition also has restricted access to higher education for some. This is unfortunate at both a personal level and at a collective level since trained “knowledge workers” is of paramount importance to global competition. One lagged effect of higher student debt is its impact on real estate in the future as the outstanding burden makes housing less affordable or forces graduates to postpone home buying.

The revision of the bankruptcy laws in 2005, which prohibit student debt from being discharged by bankruptcy, has made self-funding of education a high-stakes game, especially for those whose career paths may not provide an adequate revenue stream to repay the debt without compromising other economic needs. Even before the recent surge in tuition, the cost/benefit equation for higher education had come into focus. Average student-loan balances rose some 25% over the past decade, while average earnings of full-time workers with a bachelor’s degree rose around 15% during the same period. While there is some talk about changing the bankruptcy laws, the fact that federal student loans make up some 90% of all such debt make such a change untenable. Also, the mere discussion of such a change has triggered vociferous opposition from private lenders.

As might be expected in an election year, Congress has taken on the student loan problem in principle, but remains divided on how it should be addressed and how it should be paid for without adding to the deficit. Like some of the budget battles that were waged last fall, the student loan issue is being approached with Congress’s back against the wall. Unless action is taken, on July 1 interest rates on subsidized federal student loans will double to 6.8%, which is the current rate on most federal student loans. At this point, it appears the debates are likely to go down to the wire.

The cutbacks in state funding are also having ripple effects on the institutions themselves. Since the tuition increases are not sufficient to make up the reduced funding, the state schools are making a

number of changes in their business models. One of the changes is the movement toward activity-based budgeting, where support for individual programs will be a function of revenue generation. While such an approach may make sense in a business model or for-profit setting, without strong internal advocacy the trend is likely to put pressure on the nature of educational offerings and opportunities that are afforded by public universities. Most at risk are fields of study and disciplines that are not revenue positive due to limited enrollment or higher costs of education. While this is not a factor for larger, established real estate programs, some of the smaller, more focused programs may be at risk.

In some cases, changes in education models may come at the expense of interdisciplinary education, which is already difficult to sustain in the academic community in which traditional rewards, merit, and tenure decisions tend to focus on narrow disciplinary inquiry. Unfortunately, this added pressure for narrower approaches comes at a time when there is growing recognition that the complex problems the world faces cannot be resolved through disciplinary inquiry but must be approached through a broader perspective that draws on critical inquiry that spans traditional silos. This is particularly true of real estate education, where a number of programs approach real estate as an interdisciplinary field and have students take courses from across campus as part of their curriculum.

### **Business Indicators**

At an overall level, business indicators have been generally favorable and consistent with a modest economic recovery as noted by the Conference Board's index of leading indicators. The leading indicators slipped a bit toward the end of the first quarter but were still positive, marking the sixth consecutive monthly increase. One disappointment was the decline in business investment that occurred in the first quarter, with investment levels coming in at one-fourth of the 2011 year-end pace that had raised hopes that businesses were entering into an expansion mode.

The cutbacks in business spending were fairly widespread, including equipment, software, and commercial construction. Factory orders declined in March, although the slowdown had been anticipated and was expected to turn around during the second quarter. Inventory levels were up moderately as sales tapered off ahead of business contraction. While a cause

of some concern, the increases were not sufficient to suggest a major correction. Additionally, the bulk of inventory accumulation was in the automobile sector ahead of an expected increase in demand.

Going forward, strong balance sheets due to continued strength in corporate earnings have positioned companies to ratchet up activity levels if the economy regains its lost momentum. This level of responsiveness benefits from businesses' ready access to relatively cheap credit that could help leverage activity levels and increase response times. In this environment, business indicators are likely to remain mixed, creating some uncertainty that will hang over the economy and cloud near-term outlooks.

### **Stock Market**

The stock market has continued to enjoy something of a rally with the DJIA hovering around 13,000 and the mid-1,300s for the S&P 500. Despite some recent volatility, both indices have made a dramatic recovery since mid-2011 and have helped many 401(k) programs regain lost ground. This rebound has had a positive halo effect on investors and has helped bolster consumer and business confidence levels, which are ahead of what might be expected if based entirely on economic indicators and GDP growth.

Interestingly, over the past several months stock market gyrations have been closely aligned with the debt crisis in Western Europe, which seems to have edged out employment, housing and consumer confidence levels in terms of dominant short-term drivers. While this evidence is anecdotal and may be something of an overstatement, it is consistent with the continued trend toward globalization and the integration of the US and UK markets.

In the first week of May, disappointing news on the employment front and rekindled concerns over the health of the global recovery caused stocks to plummet, racking up the biggest drop in the quarter. The situation was exacerbated by a surge in trading on the heels of a rumor about an unexpected increase in the Japanese yen against the dollar that triggered a spate of computer-driven buy-sell orders. The unexpected and frenetic pace of sales triggered by a buy order on yen just ahead of the jobs figures released led some to argue that the imminent news had been leaked. Regardless of what led to the move, the result was reaffirmation of the integration that has occurred across country boundaries. The situation also suggests that uncertainty and global vulnerability have placed a

governor on the market, a situation that might endure in spite of relatively strong corporate balance sheets.

Despite rising angst, the fact the stock market is up around 6.5% year-to-date provides some solace to investors. The banking sector continues to show signs of stability, with bank failures in the first half of the year on a pace to come in at the lowest level since 2007. Over the past five years, over 400 US banks have closed, although only 23 banks have been closed in 2012 on a year to date basis through early May. The latest casualty in North Lauderdale was taken over by another bank continuing the trend toward consolidation and absorption and reducing losses for the FDIC reserve. Going forward investors will remain concerned over whether the stock market rally will hold in the face of recent setbacks, a situation that will be carefully scrutinized at home and across the globe.

### **Business and Consumer Confidence**

In general, small businesses have retained their cautious attitudes: with the National Federation of Independent Business Index of Small Business Optimism fell moderately in March. Despite this decline, small business confidence levels increased in the first quarter and were reportedly more confident than their counterparts in other countries across the globe. At the same time, small business owners continued to be concerned about factors that could eat into profits, including increasing energy costs and inflation in costs of goods. At a global level, business confidence levels showed moderate improvement through the first quarter and were on par with expectations. However, confidence levels are likely to decline due to renewed concern over the European debt crisis, although not as precipitously as in mid-2011.

During the first quarter personal income growth continued to tick upward but remained below most post-recessionary recovery periods. However, when coupled with the stock market recovery and the impact that it has had on consumer wealth, economic conditions have helped bolster consumer confidence levels. This pattern held in March with the University of Michigan Consumer Sentiment Index reporting another increase in confidence levels, extending the string of improvement that began in Summer 2011. Despite this improvement, it should be noted that the rate of increase has tapered off and confidence levels are likely to remain vulnerable to downside

risk. Indeed, the Conference Board's Consumer Confidence Index actually tapered off a bit in March, citing consumers' concerns over rising inflation and gasoline prices. The weak jobs report in April and renewed concern over the euro-zone debt crisis are likely to place downward pressure on confidence levels. It should also be noted that as election rhetoric heats up, consumers are likely to be bombarded with negative hype that may affect confidence levels.

### **Retail Sales**

During the first quarter, consumer spending outpaced business investment. That pattern reversal is more a commentary on declining business investment than a sustainable rally in retail sales.

Through the first quarter, consumer spending levels remained rather strong compared to the previous-year figures. Chain store sales increased 4.5% on a year-to-year basis. Increased sales activity was fairly widespread, with the exception of furniture and general merchandise sales, which declined. The increase in sales was attributable in part to unseasonably warm weather that caused a surge in building supply and outdoor product sales. The increase in sales was also attributable to strong Easter sales and an increase in mall traffic. Interestingly, factory outlet sales were relatively weak as consumers turned to other store formats. Despite relatively robust spending early in the year, retail sales activity tapered off toward the end of the quarter with cooler weather and a cooling economy taking some of the momentum out of the sector.

At this point, retail sales are expected to continue to grow through the balance of the year but at a decelerating rate. While consistent with general economic conditions, this tempered outlook is a disappointment to those who hoped the strong figures at the beginning of the year were a promise of things to come. Internet sales have continued to increase as they have over the past several years. Despite this increase, Internet sales account for less than 5% of total retail sales. It should be noted, however, that these figures understate the impact of the Internet on retail sales, as almost every retailer has continued to bolster its Internet presence. Retailers have also focused more attention on other technological advances, especially in the fulfillment and logistics sectors as they seek to drive down shipping costs and increase productivity of existing retail outlets.

## Housing Market

The housing market continues to receive significant attention and remains a key component of sustainability of the economic recovery. There are some positive signs that the housing market has bottomed out. For example, despite a modest slowdown in February, the pace of existing home sales has continued to trend upward. In terms of housing inventory supply, homes for sale increased as more homeowners tried to take advantage of the fledgling recovery going into the peak selling season. At the same time, the decline in existing-home prices has softened over the past several months. This trend was in line with general expectations although the results were mixed across cities, with larger cities tending to lag the overall market.

Some of the stabilization in the housing market can be attributed to the fact foreclosed property sales are not getting the deep discounts they were in the past. While this is good news, the pace of foreclosures is likely to accelerate through the year-end on the heels of the settlement agreement between state attorneys general and mortgage servicers. However, there is not expected to be an abrupt spike in foreclosure activity, as mortgage servicers take time to ensure compliance with the agreement as they work through the backlog of distressed properties. In terms of potential problems, some 15% of homes are reportedly still underwater. This figure could decline as prices improve, but there will be no quick fix. Many homeowners continue to struggle and ponder whether they should continue to hang on or join others who have already thrown in the towel.

One positive trend in the housing market has been the dramatic increase in acquisitions by investors seeking to take advantage of below-replacement-cost housing. In some cases, investors have been driven by the lure of market timing, hoping to exercise the option to sell at significantly higher prices once the market has recovered. In other cases, investors are looking for an income play, acquiring houses to rent out and generate a stable stream of income. While this is generally positive news and benefits the overall market, there is some risk that the trend may be setting the stage for disappointment down the road. This is particularly true in cases in which the buyers have not considered the maintenance and full carrying costs of investment properties and may be unable to adequately maintain them to preserve value.

Real estate veterans would likely avoid such issues. Lessons learned from the past indicate that strategies relying on a pure market timing are fraught with peril and real estate assets must be actively managed.

For many, the return on investment calculations depends on being able to attract tenants and realize a gain on the ultimate sale of the property. While that scenario is possible, there are no guarantees and investors have a lot riding on the presumed recovery of the housing market. Furthermore, there is significant downside risk in market timing and cycle plays that could lead to disappointment. The unprecedented scale of such activity and the fact that many residential investors entered the market at the same time with the same strategy and holding-period expectations creates the possibility that there could be a flood of residential listings in several years. This risk could be amplified by contagion theory, where investors could be panicked into selling due to a herding instinct as they seek to dump houses to avoid losses. Thus, while the surge in investor sales that has received so much attention and support has helped the market bottom out during this critical phase of the cycle, it may well have set the stage for a lagged downturn. For the market as a whole, this potential correction is not likely to be dramatic given the relative scope of activity. However, for individual investors the dream of quick riches may well turn into a nightmare.

Despite some improvement in the market for existing homes, new-home construction remains on a bumpy road to recovery. Homebuilder sentiment has continued to languish with no signs of an impending reversal in light of disappointing sales volumes. In the latest figures, the NAHB/Wells Fargo Housing Market Index slipped for the first time in over six months, which brought it back down to the beginning of the year which was still the highest since the market collapse in 2007. The good news is that traffic is up a bit, but potential buyers remain reluctant to pull the trigger. Despite this slowdown, NAHB reports the supply of new homes continues to hover around five months, which is about half of what it was in 2007–2008 when builders got caught long on product. In terms of building permits, through March activity was up 18% on a year-over basis, although permits in 2011 remained significantly below historical levels. The lessons learned from that experience is likely to rein in builders until there is clearer evidence that the market can support expansion.

## Real Estate Market

### Overview

In general, the commercial real estate market has shown a surprising degree of resiliency, especially on the capital flows side of the industry. Due to strong capital flows to the asset class, prices have continued to tick upward, outpacing improvement in underlying fundamentals. This situation has occurred on both the equity and debt sides of the market, although in both cases the demand for assets has continued to be skewed toward the top of the market. While some investors have been willing to move down the food chain in search of higher yields, the greatest pent-up demand for assets continues to be in the top-tier markets. This situation has been changing over the past six months or so and is expected to pick up as investors get comfortable with their ability to source and manage assets that may be located in smaller markets and/or are in need of some form of value-enhancement to capture appreciation potential.

In terms of spatial market fundamentals, the commercial real estate market has enjoyed moderate improvement. This improvement has been on par with improvement in the overall economy, which is expected to be the pattern throughout the balance of the year. With the exception of the multifamily sector, which is receiving an inordinate amount of attention, commercial construction activity levels are expected to be tempered, thus setting the stage for improved fundamentals when the economic recovery regains some of its recently lost momentum.

### Office Market

During the 2012 first quarter, the office market exhibited some stabilization of overall vacancy rates. Rates remained flat at around 16% compared to the low double-digit range the sector experienced prior to the recession. Although some markets have experienced improvement in market fundamentals, at an overall level the office market has gained little traction. This plateauing can be attributed to a number of factors, including nagging concerns about the economy and additional downside risk that has kept many employers in a defensive mode. Interestingly, suburban markets have continued to outperform their central business district (CBD) counterparts due to stable vacancies in the suburbs compared to a slight uptick in vacancies in central markets. The exceptions to this pattern were markets that benefited from expansion of professional and business services as well as

those with strong technology concentrations.

On the public side of the market, office REITs had a disappointing track record in 2011 with total returns slipping into negative territory. The improvement in the general economy and prospects for office users helped reverse the pattern during the first quarter of 2012, with office investments coming in slightly above the overall NAREIT averages at slightly over 10.5% on a yearly basis. On the private market side of the equation, trailing twelve-month basis office returns were healthy at around 12.8%, but lagged the overall index and other property types with the exception of hotel. On a regional basis, office market returns mirrored that of the overall economy with the strongest returns in the Pacific region and in the Northeast led by gateway cities. In terms of subtypes, CBD offices have outperformed suburban offices' trailing twelve-month basis, although that advantage disappeared during the first quarter.

With respect to transactions, Real Capital Analytics reported that office transaction levels have led other property types with over \$14 billion in sales during the first quarter. Despite the volume of transactions, the increase in sales was lower than other property types coming in a third higher than in the first quarter of 2011. In terms of pricing, capitalization rates have remained relatively flat—a pattern that has held for the past year or so. This situation differs dramatically by submarket, with CBD capitalization rates falling significantly over the past six months and suburban capitalization rates increasing moderately over the same period. As with retail properties, portfolio sales were fairly significant, accounting for over 20% of total transactions. The increase in transaction volume was driven by investors who remained focused on core CBD properties, while distressed assets remained out of favor.

With respect to market size, investors continue to focus on major markets, with the top-six markets accounting for some 60% of total volume. Despite this concentration in activity levels, a number of secondary markets have benefited from an increase in investor activity as they seek higher returns. In terms of additions to the volume of distressed assets, the office sector led all property types, with over \$4 billion worth of new distress. On a positive note, services were able to work off over \$3 billion of troubled assets, although that still leaves over \$44 billion worth of assets in the distressed asset category.

## Retail Market

Despite modest improvement in retail sales during the first quarter, on the real estate front there has not been much change in terms of the balance of supply and demand. Retail vacancy rates are holding at around 13% overall. This experience was fairly widespread, with the majority of markets holding their own while others experienced moderate deterioration in fundamentals. In terms of investment performance, retail properties continue to lead the pack in the public market side with year-to-date returns through March approaching 15% on the heels of a relatively strong showing in 2011 when retail returns beat out other property types with the exception of residential.

In terms of types of retail REITs, regional malls led in performance through the 2012 first quarter, followed by general shopping centers and freestanding retail, which lagged the sector and the overall REIT index. In terms of market capitalization, retail properties dominated the REIT universe, accounting for over \$135 billion of the over \$500 billion applied market capitalization.

On the private market front, retail investments were in the middle of the pack on a trailing one-year basis although still approaching 13% annualized returns. In terms of total market value, retail investments comprised \$64 billion dollars of the \$300 billion NCREIF Index. In terms of regions, the strongest retail returns were in the Southeast and Pacific divisions, while the lowest were in the West North Central region. With respect to retail subtypes, superregional malls led all retail properties, followed by regional malls, community centers, and power centers. Specialty and neighborhood retail lagged, at around 10% annualized total returns.

On the transaction front, institutional sales of retail properties in the first quarter were around \$12.5 billion—a significant increase over the prior year. Unlike other property types, portfolio sales accounted for the bulk of total retail transactions. Interestingly, due to a combination of the capital-intensive nature of regional malls and the complex nature of management required to deliver top-tier sales performance, partial interests accounted for over half of total transaction volume. This market share reflects recognition by institutional and offshore investors of the importance of proactive management of retail properties. Despite the increase in transaction volume and modern

improvements in underlying market fundamentals, distressed properties changing hands approached \$2 billion in the first quarter. With respect to pricing, retail capitalization rates varied dramatically by type of center, with larger retail properties enjoying declining capitalization rates, while smaller properties trended upward. Investors in search of product paid increasing attention to secondary markets, which experienced the greatest increase in transaction volume. Going forward, investors are expected to continue to take a hard look at retail properties, especially if economic conditions continue to improve and consumers do not pull back.

## Industrial/Warehouse Market

In terms of market fundamentals, the industrial market on the national level experienced a decline in vacancy rates. This improvement, which spans almost two years, has brought vacancy rates down to about 13% overall. As with other property types, the improvement in fundamentals varied by markets, with more markets experiencing improvements than those reporting deterioration in market fundamentals. From a geographical perspective, industrial returns were the highest in major distribution markets and ports, including the Pacific and Southwest regions.

With respect to investment performance, the industrial sector experienced the most dramatic reversal on the public side of the market, with returns in the first quarter pushing 24% after about a 5% loss for 2011 as a whole. On the private market front, industrial properties have also been relatively solid performers, with trailing one-year returns slightly above the overall NCREIF Index. In terms of attribution analysis, industrial investments had the highest income return or implicit capitalization rate with the exception of hotels, which are recognized as the riskiest of the major property types. That said, the 6.5% capitalization rate is still below historical averages but not as much as that of the apartment sectors.

In terms of industrial subtypes, research and development (R&D) properties had the highest returns, benefiting from relatively high capitalization rates commensurate with the underlying risk of the sector. Warehouse investments, which account for the bulk of the institutional investments in industrial properties, were also relatively strong, with over 14.6% on a trailing twelve-month basis. The worst performing industrial sector was flex space due in large part to a lack of any appreciation component.

“In approaching the apartment sector, it should be recognized that the dramatic growth has already occurred.”

With respect to transactions, sales of institutional-grade industrial properties approached \$6 billion in the first quarter, an increase of almost a third over the prior year. The majority of the increase related to sales of flex space, which increased some 86% over the prior year to \$2.6 billion. Warehouse property sales were up modestly, for a total of \$5.1 billion.

During the first quarter, capitalization rates remain relatively flat, hovering under 8%; stronger properties and stronger markets were trading at some 150 basis points below that range. As investors search for new opportunities, transaction volume has increased for data centers and R&D properties—a trend that is likely to continue over the near-term.

In terms of bulk sales, portfolio transactions constituted over 20% of total industrial sales in the quarter. Distressed sales as a share of industrial property transactions was relatively low compared to other property types, which reflects the relative health of the sector and the lack of speculative buying at the peak of the market.

In terms of pricing, capitalization rates for flex properties trended downward and capitalization rates for warehouse properties trended upward, converging at the same point. This is likely a function of shifting demand for assets rather than changes in fundamental risk-return relationships in the underlying property types. With respect to market size, the lowest capitalization rates were in the larger industrial markets as well as major distribution hubs, with investors expanding their horizons to include more markets as they seek product at appropriate price points.

### Apartment Market

The apartment market remains the favorite property type for many institutional investors. On the surface, this interest might appear to be well founded given the improvement in underlying apartment market fundamentals, vacancy rates, and rental rates. Indeed, at a national level apartment vacancy rates declined in most markets, with a few exceptions that

lagged the overall recovery. Due to the improvement in the supply/demand balance, in many markets owners were able to increase effective rents, which at a national level approach 5% on an annualized basis.

Although apartment fundamentals have strengthened, there are some signs the market is getting overheated as lenders, developers, and investors plan to create new product to satisfy what some think is an insatiable appetite for rental properties. In terms of building permits, multifamily activity at a national level was up 65% on a year-to-date basis through mid-March, building on the modest permit activity that came in slightly under 200,000 units in 2011. The fastest growth in multifamily permits was in the West (87%), followed by the South, Northeast, and Midwest. At a metro-level, permit activity varied dramatically, with some markets reporting significant increases and others languishing.

In approaching the apartment sector, it should be recognized that the dramatic growth in Generation Y and Echo Boomers has already occurred, suggesting the much-ballyhooed surge in apartment demand has already been experienced. Granted, the number of such households renting will remain relatively high despite the decline in the rate of growth in this important sector. As the economy picks up, net migration levels, which are important predictors of apartment demand, are likely to change. This will result in a number of winners and losers in terms of markets. Markets that are postured for strong job growth will outperform others as new employees join the workforce and those who have been trapped in jobs move in search of new opportunities. Another concern is demand for homeownership may regain some of its lost luster as a single-family market stabilizes and values begin to recover. When these trends will occur is unknown, but they are likely to fall within the expected holding periods of many apartment investors.

The enthusiastic pursuit of apartment investments has led to a spate of new construction, most of which has been clustered in central cities while the exurbs have been largely overlooked. This pattern of development is a dramatic shift from recent times when the bulk of the population growth and housing focused on the suburbs. Some are arguing that this is a permanent shift in locational preferences. The near-term experience of tightening rental markets in central cities would appear to provide compelling evidence that the rental housing

market is undergoing dramatic change including the movement back toward cities.

Whether this is a cyclical phenomenon or a structural shift is not clear at this time, especially since the recent trend is complicated by the collapse of the single-family market and the weak economy. The question will not be resolved until the housing market and the economy recover, which will give consumers the ability to choose their preferred type of tenure as well as their locational preferences. The end result may be another “lesson learned” regarding the difference between cyclical (i.e., temporary) and structural (i.e., permanent) changes in demand; the latter tending to happen gradually and infrequently in the absence of a major shock to the system.

In terms of investment performance, apartment REITs led other property types throughout 2011 with 15% plus returns. Despite improving market fundamentals for the first quarter of 2012, apartment REITs slipped in the rankings and currently trail the other property types, although total returns are still around 8.5% on a year-to-date basis. In terms of market capitalization, equity apartment REITs were a significant component of the public market, with an implied market capitalization in excess of \$73 billion. On the private market side of the apartment market, the sector has led all property types on slightly under 15% trailing one-year returns through the first quarter of 2012. Testifying to the potential overheating of the sector, income returns in the implicit capitalization rate for apartments were lower than all other property types coming in at an annualized rate slightly over 5.2% for the first quarter. In terms of market capitalization, apartment investment levels approached \$70 billion, leading other property types with the exception of offices, which came in around \$106 billion of the total market value of around \$300 billion.

In terms of the eight NCREIF divisions, the highest apartment returns on a trailing twelve-month basis were the Mountain, West North Central, and East Central areas of the country. Interestingly, the weakest apartment performance was concentrated along the entire East Coast, although the property sector continued to outperform others on the low end of the spectrum as well as on the high end. With respect to subtypes, low-rise apartments led the pack with over 16% returns followed by garden apartments and urban high-rise apartments.

On the transaction front, sales of larger apartment projects in the first quarter were over \$10 billion, a 30% increase over the previous year. Some of this increase in volume was attributable to portfolio sales, which accounted for some \$2.6 billion of transactions in the quarter. Reflecting the mentality of investors, the top six markets account for 44% total transaction volume quarter. Interestingly, recompression has forced investors to look at other markets that had previously been overlooked due to high levels of distress. Given historically low capitalization rates, this trend is expected to continue as investors try to place a floor on capitalization rates and search for investable product. Due to strong investor demand, capitalization rates continued to decline, falling to 6.3% at an overall level, with mid- and high-rise capitalization rates some 100 basis points lower due to stronger investment interest.

On the other end of the market, distressed property sales declined to the lowest rate in over three years. At the same time, despite a moderate increase as lenders took advantage of strong investor interest, the share of total sales that fell into the distressed category were less than half the rate over the prior two years. Additionally, the rate of additions to the rank of new distressed apartment product was the lowest it has been in over five years. Over the near-term, the apartment sector is expected to continue to outperform other property sectors, although that situation is likely to reverse as investors begin to reemphasize the risk-return relationship.

## **Real Estate and Capital Markets**

Capital flows to real estate and strong demand from assets among institutional investors have helped bolster values ahead of improving market fundamentals. This boost in performance helped the real estate industry outpace other asset classes both in absolute and risk-adjusted bases. This situation is unlikely to change over the near term due to a combination of low interest rates and greater volatility in other asset classes that will continue to skew asset allocations toward real estate. Sovereign wealth funds and other offshore investors are also expected to continue to favor US real estate, creating an additional capital that will propel the market. This situation is likely to increase even more with the turmoil in Western Europe, the slowdown in China, and other market uncertainty that will spill over to property markets.

In a number of cases, the offshore investors who have been drawn to US soil have adopted a long-term approach to real estate investments. This explains some of the aggressive pricing and the willingness to accept lower total returns than more traditional real estate investors. However, with so much pressure on prices, investors are expected to expand their horizons to look beyond core properties in top-tier markets. At the same time, owners are likely to put more product on the market in hopes of cashing in on strong asset demand that may belie underlying fundamentals.

In addition to strong capital flows to real estate from institutional sources, advisors and sponsors have explored new products and investment vehicles to attract money to the asset class. One of the more interesting approaches is the renewed interest in private, non-traded REITs, which are being groomed to provide real estate investment options for 401(k)s and individual investors. In the past, such vehicles were criticized by some observers as too risky, too expensive, and too illiquid. One of the appeals of the previous iterations of private REITs was the exit strategy of capitalizing the assets by exploiting an arbitrage opportunity to go public providing a capitalization rate play between acquisition and disposition yields. Furthermore, larger investors were expected to hold their shares for seven to ten years and trade off lower dividends for the promised pop on disposition. Unfortunately, the results were disappointing at an overall industry level with only slightly over 20% of the ninety or so registered REITs returning investor principle over a five-year period.

Despite such criticism, a number of sponsors have lined up to offer a spate of new non-traded REITs, with four new funds launched and another five in registration with the Securities and Exchange Commission which oversees such investment products. The new genre of private REITs have addressed some of the past concerns, including increased transparency and disclosure, daily mark-to-market valuations,<sup>3</sup> and reduced fees that are more in line with institutional advisory fees. The new private REITs are scheduled to raise almost \$20 billion, providing another investment vehicle that will compete for investor funds. When coupled with public REITs and private investors, the equity side of the real estate capital market is expected to remain healthy and support further increases in transaction volume.

The commercial mortgage market has become increasingly competitive, in spite of the absence of a major resurgence in commercial mortgage-backed securities (CMBS). The surge in private lending continued the trend that held throughout the year. Despite tempered activity, the CMBS industry has gained some traction although there are few prospects for dramatic growth. However, the CMBS activity that has occurred has proven to be fairly flexible and willing to lend in secondary and tertiary markets ahead of their private counterparts.

As was the case in 2011, the commercial mortgage market remains somewhat bifurcated, with ready access for strong borrowers with strong properties and others struggling to source capital. While this trend is expected to continue, it is likely to moderate as it did on the equity side of the industry as lenders try to place debt in an increasingly competitive environment. Unfortunately, strong capital flows will not be adequate to satisfy the impending surge in refinancing activity as bullet loans start maturing at an accelerating rate. Thus, while a significant level of debt capital will be available at competitive and attractive prices, the real estate industry will not be able to meet its near-term capital needs across the board which will lead to interesting times. The shortage of capital will also create some attractive opportunities for capital providers willing to move out on the risk spectrum.

## Conclusion

Going into 2012, the commercial real estate market was at a surprisingly good place given the fact it was expected to lag the overall economic recovery. This situation was largely attributable to strong investor interest that fueled increases in value that attracted even more capital. The result was the ability of the real estate market to outperform other asset classes as reflected in private market returns in the low double digits.

Going forward, low interest rates are expected to provide additional price support for the real estate market with investors having few viable alternatives that can promise safety of principle on top of moderate income returns. Whether investors who have paid top prices for real estate will continue to enjoy safety of principle will depend on a combination of continued strong capital flows and improvement in underlying market fundamentals. The recent

3. For additional discussion of daily mark-to-market valuations, see "Daily Pricing: An Appraiser's Dream?" in this issue of *The Appraisal Journal*. —Ed.

economic slowdown has taken some of the ballast out of spatial market recovery, although there are few signs of an imminent collapse. At the same time, it is unlikely that the commercial real estate market will be able to continue to outperform other asset classes to the extent it has over the recent past. The continuation of low interest rates and strong capital support is likely to help the commercial market withstand the lag in improvement in underlying fundamentals. However, the extent to which this occurs will depend in large part on the market's ability to draw on lessons learned. The market needs to avoid the excesses that come from short memory spans, to pay attention to the drivers of value on the spatial side of the equation, and not to rely heavily on capital market forces.

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