

Spring Thaw, But Not for All

by James R. DeLisle, PhD

Commentary

By the end of the 2014 first quarter, the economy began to thaw out, which was a marked improvement from the deep freeze that characterized the economic climate during the long winter season. However, the improvement was somewhat uneven and not for all. This has created sets of winners and losers.

On the winning side of the ledger are investors, higher-net-worth individuals who have benefited from a record run-up in the stock market, and more educated workers with specialized skills that are in demand in selected sectors that have started to expand. The benefits these workers have enjoyed are punctuated by a recent Labor Department report that the top 20% of wage earners have accounted for some 80% of the income gains since the recession.

On the short end of the ledger are the lowest 20% of wage earners, who have experienced a modest decline in income levels since the recession. Despite this disparity some things have improved for segments of lower-income and unemployed Americans. For example, the Affordable Care Act appears to have had a positive impact on many marginalized citizens previously unable to afford health care. However, the debates over the merits of health care reform are far from over. Regardless of how the health care reform and associated debates play out, one thing that remains clear is that the recovery has a long way to go before any trickle-down kicks in and creates a rising tide sufficient to help the lower income and unemployed recover from the losses they incurred as a result of the recession.

The not-for-all aspect of the economic improvement is not just a domestic phenomenon but one that has played out among countries

across the globe. The International Monetary Fund (IMF) has joined in the discussion of an uneven global recovery and has brought attention to the widening gap between richer and poorer countries. In its recent report, the IMF points out that this inequality has placed a drag on global economic growth and may contribute to political instability. Unfortunately, many developed nations are struggling with the aftereffects of the recession and are focused on short-term problems at home. Thus, the IMF suggests that developing countries adopt more progressive tax policies and seek additional revenues to bridge the gap.

The global economic recovery will likely remain selective and, as in the case of the United States, somewhat tentative and dependent on factors beyond the control of any individual country. This situation is exacerbated by increasing turmoil in many regions of the world and the absence of clear leadership or consensus opinions as to how these issues should be resolved. Thus, while economic conditions are thawing in many regions, there are also increasing hot spots that could flare up and create a wave of global economic turmoil.

While the uneven recovery and global concerns will continue to receive much-deserved attention, in the absence of unexpected shocks the domestic economy is likely to stay on the path toward gradual recovery. In addition to positive reports on a number of economic indicators, this outlook is based on the fact attitudes and confidence levels have shifted to the positive side of the spectrum. For example, small business confidence levels have been bolstered by easier access to capital and improving sales. In a recent *Wall Street Journal*-sponsored survey, small business owners with less than \$20 million

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in revenue reported improved economic conditions over the prior year. This sense of optimism belied recent concerns that the political wrangling in Washington and extreme winter weather would put a damper on sales. Looking forward, less than 10% of small business owners said they expect conditions will deteriorate over the next several months. Based on these expectations, almost half the respondents said they plan to increase spending on equipment and facilities, and around 60% plan to add new employees. The small business owners' positive expectations indicate the freeze that had affected this important player in the economy has thawed a bit; this should help bolster the recovery.

Economic conditions are expected to continue to improve, especially for those who have already begun recovery from the recession. However, even if the domestic economy continues to improve, acceleration of the turmoil on the global horizon or the occurrence of shocks and unexpected fronts could have a chilling effect on the economic outlook.

The Economic Environment **Economic Growth**

Real gross domestic product (GDP) growth for the 2013 fourth quarter was revised upward, coming in at 2.6% on a seasonally adjusted basis. Despite this revision, the growth rate was still lower than expected. It was also significantly lower than the pace set during the prior quarter that had created a sense of optimism.

The net slowdown in growth was attributed to an interesting mix in attitudes. On the positive side, consumers provided more stimulus than expected but not enough to offset the drawdown in inventories and a decline in government spending. Despite the mixed results, the generalized improvement in economic indicators led to a concomitant decline in the risk of recession, which fell to 20% during March.

While much attention is placed on the domestic scene in trying to gauge the likely pace of economic growth, the integration among the financial and economic sectors of many countries make the outlook for global economic growth a major area of concern. Given the gradual and somewhat tentative nature of the domestic recovery, expectations for economic growth are further moderated by global expectations. This is evidenced by the bifurcated expectations of industrial manufacturing executives as reported in the PricewaterhouseCoopers (PwC)

“Large manufacturing companies are increasingly optimistic about the US economy.”

Manufacturing Barometer: Business Outlook Report (April 2014).

According to PwC's survey results, large manufacturing companies are increasingly optimistic about the US economy. This improvement in sentiment among larger manufacturing companies explains some of the recent increases in the investment in labor and equipment.

The reported improvement in expectations is understandable for companies focused on the domestic scene where economic prospects do appear to be improving. However, a nagging concern that has not received as much attention is the plight of the global market that affects companies looking to the export market to bolster revenues. This risk of a global slowdown has not been lost on the collective psyche of manufacturers. PwC reported a 6% decline in optimism and a high level of uncertainty (50%) among manufactures regarding their global prospects. This concern is fairly widespread due to the integration that has occurred across developed and developing nations. Areas of particular concern range from the euro zone, which has been struggling with stagnant conditions for some time, to China, which is a dominant player in the global economy.

In China, GDP growth moderately declined to 7.4% due, in part, to the slowdown in the global economy. This dependency is evidenced by the fact its exports unexpectedly declined in February 2014 and led to a monthly trade deficit. This was an unusual turn of events and has occurred on only four other occasions over the past decade. Three of the previous trade deficits were only marginally negative, with the most significant a \$31 billion deficit in February 2012. The most recent decline, in February 2014, was a \$22 billion deficit, but it was short-lived with the economy moving back into more familiar positive territory. Despite some concerns, China will continue to play a major role in the global economy, as evidenced by the fact its foreign exchange reserves continued to trend upward, hitting \$3.82 trillion at 2013 year-end. With growth

solid and inflation in the 2%–3% range, China is relatively well positioned compared to other nations.

Emerging markets experienced a rocky start to 2014, exemplified by the worst sell-off in emerging market currencies in five years. Part of this contraction was attributable to the announced pullback of the Federal Reserve (the Fed) from its stimulus program in late 2013. However, the domestic issues in these markets were also a major contributing factor, with rising political, military, and financial instability hanging over a number of countries that had been at the forefront of global growth. The reversal of fortunes has been dramatic. For example, Bloomberg's customized emerging market currency index, which covers twenty markets, fell to its lowest level since the 2009 first quarter and was down almost 10% on a rolling twelve-month basis.

While little can be done to address political uncertainty and geopolitical risks, central banks have aggressively tried to intervene and defend exchange rates. Looking forward, reduced expectations for emerging markets will place something of a governor on growth, which while difficult over the near term, may lead to less volatility and alignment of emerging and developed market economies. The bottom line is that there are no white knights out to jump-start the global economy, leaving the near-term prospects for a moderate recovery a best-case scenario.

Employment

After a disappointing start to the year, employment growth picked up much-needed momentum with 192,000 jobs added in March. Some of this improvement may be related to the easing of lending policies for businesses and the generally positive business indicators that have led some companies to invest in plant, equipment, and labor.

The improved labor market has translated to increased earnings for some workers. At an overall level, during the first quarter of 2014 weekly earnings for typical full-time employees rose 3% on a year-over basis. That was the fastest annualized increase since the recession began. When adjusted for inflation, median earnings stood at the highest level in the past two years, with earnings growth doubling the increase in the consumer price index (CPI) on a year-over basis.

Another indicator of improvement in the national employment situation was that separations (including layoffs, discharges, and voluntary departures) remained stable during the first quarter.

As in other aspects of the recovery, there are the haves and have-nots. Some metro areas—such as Austin, Billings, Honolulu, Iowa City, New Orleans, and Salt Lake City—have been experiencing labor shortages with unemployment rates falling toward 5%, which is the Federal Reserve's definition of full employment. This tightening has resulted in additional wage pressure in certain markets, with increases in compensation outpacing the national averages. Indeed, according to the Fed's Beige Book, employers in six of the twelve districts reported a shortage of skilled workers in a variety of industries, ranging from construction to petroleum refining. In some cities where unemployment rates have fallen the most, workers in lower-wage jobs have benefited as employers offer increased compensation to attract relocated workers. On the other hand, twenty-nine cities—including a number in Southern California, Illinois, and New Jersey—are still struggling with unemployment rates over 10% with few prospects for short-term improvement.

At the same time as the employment picture continued to improve the unemployment scene has been relatively stable. In mid-April, new weekly jobless claims were reported at 304,000 and helped bring the four-week rolling average (which dampens weekly volatility) to 312,000. This rolling average was the lowest level since the recession hit in 2007. Continuing jobless claims also fell to the lowest level since late 2007 although some 2.74 million unemployed workers were still without jobs.

While the downward trend in unemployment claims has been welcomed news, some improvement can be attributed to the decline in labor force participation. Indeed, one of the more enduring byproducts of the prolonged recovery may be a structural trend toward lower workforce participation rates than in the period before the recession.

Again, in looking at the case of the haves and have-nots, improvement in employment conditions has been particularly frustrating for certain segments of workers. For example, there has been little improvement for the long-term unemployed who have lost benefits and are unlikely to see any near-term respite. Unfortunately, history has shown that the longer the unemployed are out of the workforce the more difficult it is to find jobs. This historical pattern does not portend well for those struggling in what continues to be a slow and uneven recovery. In addition to the long-term unemployed, legions of older

workers laid off during the recession have taken jobs beneath their experience and skills. The situation is even direr for less-educated workers who lost their jobs and are not fortunate enough to be in markets where employment growth has been the hottest.

Going forward, some segments of workers will have to wait for the economy to pick up sufficient steam to ripple over to the markets and companies that to this point have been left behind. Alternatively, some of these workers may decide to relocate to seek new opportunities, although they are likely to hedge their moves by seeking out low-cost regions that are more affordable but may not have near-term upside potential. Longer term, these lower-cost markets may recover ahead of faster-growing markets as baby boomers seek places where they can stretch their retirement savings.

Inflation and Interest Rates

Inflation has remained in check in the United States as it has in many developed economies. Indeed, when compared to other countries it is clear the aggressive intervention taken by the Fed, including its unprecedented asset purchasing program, helped stimulate price increases to a healthier rate than otherwise would have been the case.

Since taking on the position of Federal Reserve chair, Janet Yellen has maintained the Fed's consistent approach to striking a balance between the dueling forces of inflation and economic growth. She has also been able to appease the concerns of investors and business leaders with her commitment to maintaining low interest rates as the Fed continues to phase out its quantitative easing (QE) policy, phasing out \$10 billion per month of its asset purchase program. This reduces the \$80 billion pace in 2013 to \$55 billion, with the decline spread equally between Treasuries and mortgage-backed securities. Indeed, after initial reactions to her comments that rates might increase after QE was finally phased out, pundits turned to the minutes of the Federal Open Market Committee to reassure themselves that neither the Fed nor its chair were ignoring the tepid and vulnerable nature of the economic recovery. The minutes point out that committee members recognize that both their stated intentions and their ultimate actions will be closely scrutinized and could cause dramatic shifts in attitudes and expectations that could expose the recovery to additional risks and uncertainty. In this environment, interest rates are expected to remain low, although spreads may start widening in line with

the shifts in capital flows and perceived risks that will affect investor demands for yield.

On the international scene, the Bank of Japan has also continued its easy money policy to bolster the economy and achieved healthier levels of inflation than the deflationary cycle that it experienced between 2008 and 2012. However, the successes of US and Japanese interventions are juxtaposed to the experience in the euro zone, where the annualized inflation of 0.5% is significantly lower than the European Central Bank's (ECB's) 2% target rate. This concern was noted by the recent warning from the International Monetary Fund (IMF), which indicated that continued low inflation and the risk of price declines could threaten the global recovery by eroding consumption and creating a slow-growth economy that would make it increasingly difficult to reduce historically high public debt levels.

If inflation doesn't pick up in the euro zone, it is likely that the European economy will be even more vulnerable to some of the downside geopolitical risks it already faces. This is particularly true as a result of the growing tensions with Russia over the conflict in the Ukraine. Due to the significant connections between the euro zone and Russia, the turmoil in the region has created significantly greater downside risk than would be the case if economic conditions and prospects were normalized.

Business Indicators

During the 2014 first quarter, the Conference Board's Leading Indicators Index trended upward, outpacing expectations and helping reverse the 2013 year-end decline. Despite this improvement, the rolling six-month annualized rate of increase was moderately off the earlier pace. Part of the decline in leading indicators may be attributable to the deep freeze that created a drag on a number of fronts. With the spring thaw, some of this drag has been lifted, setting the stage for moderate improvement.

This outlook is consistent with the Federal Reserve's Beige Book, released in mid-April, which indicated that economic conditions improved in the majority of districts. This improvement was particularly noteworthy in some of the areas that were the hardest hit by the harsh winter weather. One of the pleasant surprises across much of the country was the improvement in retail sales, which were led by cold weather products. Manufacturing was another sector that exhibited widespread

improvement, and it has built some momentum. The service sector experienced mixed results, with financial services benefiting from increased demand for consumer and business loans.

Improving economic conditions helped bolster small business sentiment toward the end of the 2014 first quarter, offsetting a February decline that broke the general upward trend. This improvement was attributed to more optimism regarding the broader economy as well as moderate improvement in sales activity and rationalization of inventory levels. While this improvement does not foretell a significant increase in hiring, smaller businesses are expected to try to retain current employees by increasing compensation levels, which is good news for workers and may create some positive spillovers for the broader economy. Productivity levels continued the positive trend exhibited since an upturn at the beginning of 2013, and they remain on par with the economic recovery.

Industrial production improved during the first quarter, reversing a decline that occurred during the uncertainty that characterized the economic outlook at the end of 2013. Manufacturing activity and new orders also increased during the first quarter, although they were still below the disappointing downturn that occurred during the third quarter. On a positive note, the composite manufacturer index continued to strengthen during the first quarter, marking the fifth consecutive quarter of improvement. Going into the second quarter, the general pattern of business indicators suggested that in the absence of unexpected shocks, the economic expansion in the United States should remain on track.

Stock Market

The stock market successfully weathered its own deep freeze, which manifested itself as a brief downturn in mid-January. Since that time, the market has recovered and has been able to continue the upward—albeit somewhat choppy—trend that has characterized the prolonged bull market. The early going during the second quarter suggested that the thawing of the economy and relatively strong earnings reports along with continued low interest rates may be enough to keep the bull running for much longer.

There are some concerns, however. The downturn in the NASDAQ Biotechnology Index has caused investors to steer away from the riskier edges of the market. Also, investors are paying close

attention to the valuations of stocks in the S&P 500, trading in at a 15.2 P/E ratio, which is 200 basis points (bps) over the average of the past five years.

In this environment, the recent flattening out of the stock market indices has been received with good news, as it may allow corporate earnings to catch up with valuations. At the same time, after rotating into longer-term bonds in response to the slow economic recovery, some bond investors have shifted to shorter-term issuances, which are less sensitive to interest rates but are expected to offer lower returns. Since the Fed is committed to holding rates low and to keep financial markets stable, there are signs that a downturn could be short-lived. However, investors will likely do some shuffling in their portfolios as they try to hedge against concerns about a pullback in the market or global uncertainty.

Consumer Confidence

Consumer confidence levels have echoed those of businesses and have surprised on the upside. During March, the Conference Board's Consumer Confidence Index continued the upward trend that began last November and resulted in the highest readings since the recession. This improvement was attributable, in part, to a rise in the expectations component. In general, consumers seem to have put last year's political rhetoric and wrangling behind them and seem to be paying more attention to the economic conditions that are most likely to affect them. While consumers remain somewhat guarded about employment prospects, that has not dampened their expectation that business conditions are likely to improve and translate to a more stable employment market.

The University of Michigan's Consumer Sentiment survey has also continued to improve, mirroring its counterpart. This includes a concurrent improvement in attitudes toward present conditions and for expectations, both of which bode well for the near-term outlook. This outlook is further bolstered by the decline in personal bankruptcy filings, which were down over 10% during the 2013 fourth quarter on a year-over basis. When combined with earlier declines, the rate of personal bankruptcies is down over 40% from the peak in 2010.

Given the rise in household earnings during the first quarter and the report that small businesses and other employers may start focusing on employee retention (i.e., increased wages), it is likely that

consumer confidence levels will continue to show improvement and may actually benefit from an unexpected surge at mid-year. However, as with other outlooks there are some significant downside risks that might temper this outlook and cause a downturn in confidence levels that remain somewhat tenuous in light of the moderate pace of economic growth.

Retail Sales

The disappointing decline in retail sales at the end of 2013 carried over into January, exacerbating an already difficult environment for Main Street retailers. After this rocky start, retail sales levels broke out of the deep freeze and increased for two straight months. This improvement was fairly broad with the exception of electronics and appliances sales. Factors contributing to the increase in retail spending include improvement in consumer confidence, a growing willingness of households to take on additional consumer credit, and tax refunds for some 80% of early filers. Whether this trend will continue depends on the pace of the economic recovery and whether consumer expectations turn into realizations. Given the importance of the retail sector to the overall economy, retail spending is likely to be one of the most important indicators as to the speed of the recovery.

Despite the general increase, chain store sales have been relatively volatile. Department stores have had a particularly hard time, with a number of retailers being forced to rationalize operations and pay more attention to unit profitability than market share. Several retailers (e.g., Target, Neiman Marcus, Michaels) also have had to deal with the fallout from security breaches that have understandably alienated customers.

Interestingly, the online shopping segment seems to have been immune to security breaches, which has helped continue the gradual but consistent expansion of its market share. But even with some twenty straight increases in online sales, this channel still only accounts for 6% of total sales activity. This figure understates the impact of nontraditional retail, however. The emergence of Internet shopping has forced most retailers to make major commitments to online sales to protect their existing franchises. Nonetheless, the retail arena is becoming even more hypercompetitive, which is forcing retailers to take a hard look at their brands and market positions. This scrutiny and how it will play out is far from clear, but it may lead to dramatic changes in retailing,

“The housing sector has been impacted by the cooling off of the pace of housing price appreciation.”

including additional disintermediation of traditional stores and the emergence of new hybrid operations.

In the first quarter, one leading retail segment was the automobile industry, which experienced a late surge in sales activity. This was an important trend for the industry and marked a rebound from the downturn that occurred in the 2013 fourth quarter and the relatively spotty performance during the second half of 2013.

The improvement was attributed to a combination of pent-up demand and a wave of promotions as automobile dealers tried to rekindle consumer interest once the weather thawed out. The increase in vehicle sales was most noteworthy with respect to truck sales, which bounced back the most and was attributed, in part, to the improved outlook for construction and the housing market. In addition, despite some recent setbacks (e.g., GM recalls) that will play out in the second quarter, the domestic automobile industry was particularly strong, driving import sales down to the lowest market share in over eight years. Given the expected improvement on the economic and employment fronts, the outlook for automobile sales is relatively positive, especially with the easing of credit that is being phased in.

Housing Market

The improvement in the housing market during early 2013 was seen as a harbinger of good times to come for the beleaguered industry. Since that time, the sector has experienced significant swings, which has been a source of frustration for homebuilders and housing advocates. This situation carried into 2014, with the industry exhibiting schizophrenic behavior.

The housing sector has been impacted by a number of factors, including the cooling off of the pace of housing price appreciation. For example, according to the Case-Shiller Home Price Index, on a rolling three-month basis through January 2014, the rate of housing price appreciation declined, continuing a disappointing trend that began during the 2013 third quarter. This pattern was consistent

with the downward trend in the rate of change in the FHFA Purchase-Only House Price Index, which began to cool off in mid-2013. Despite the cooling off, the index remained above the prior year and over 15% above the low point reached in mid-2011. This improvement can be attributed to cheap credit and a lack of new construction, which has reduced inventory levels and days on the market.

As might be expected, the pace of housing sales has fluctuated even more than price indices. For example, during February the annualized pace of pending sales fell precipitously to the lowest level since mid-2011. This deterioration was fairly widespread, with sales down across the country on a year-over basis. Of particular concern to new-home builders was the shift in homeownership patterns that is most pronounced among younger households. This same shift was exhibited for existing-home sales, which continued the downward trend that began in mid-2013. The result was a 7% decline in existing home sales on a year-over basis. Despite this decline in sales volume, median prices were up 9% over the same period. The downturn in residential sales activity can be attributed, in part, to seasonal softening and to the tightening of mortgage standards.

Despite mixed results in the housing sector, there are some positive signs that the market may be stabilizing. For example, delinquency and foreclosure rates continue to decline, suggesting the worst for the housing market is over. Indeed, recent figures on foreclosure starts are at their lowest level since the housing market collapsed in 2006. Inventory levels of distressed housing have also declined, suggesting the market has made significant progress in burning off the backlog of foreclosed properties. In addition, the failure to extend the debt forgiveness tax reprieve is likely to put added pressure on underwater homeowners to hang onto housing until prices recover and the tax burden can be reduced to manageable levels.

There are a couple nagging issues that hang over the housing market. First is the uncertainty as to whether homeownership rates will return to longer-term averages or whether there has been a structural shift in tenure choice. This concern is especially pronounced for younger households in the traditionally peak-ownership years of 35–44. According to the US Census Bureau, this age segment currently has the lowest ownership rates among all age segments. Many of these households fall into

the first-time buyer category, and first-time buyers accounted for only 27% of home purchases in December, a significantly lower figure than the 40% long-term average. Another nagging issue relates to the transition that is likely to occur in housing purchases as flattening appreciation rates place a damper on investor acquisitions that to this point have been a significant share of market activity—especially in the harder hit markets where prices plummeted more than overall averages.

The good news is that interest rates are likely to remain low over the near term and mortgage originators are beginning to relax underwriting standards, which might help stimulate the housing market. Continued improvement in the economy and the employment scene will also be key factors that homebuilders will monitor before ratcheting up activity levels. Some builders are likely to jump the gun to get back to business as usual; however, this tendency will prove problematic in the unusual times that are expected to hang over the industry.

Real Estate Market Overview

At a national level, the commercial real estate market has continued to exhibit improvement in terms of the overall fundamentals of supply and demand. As with the economic recovery, this improvement has varied across markets, with some markets gaining momentum and others languishing. The disparity has led to spot labor shortages and has placed a restraint on construction activity in some markets where workers who left the industry have yet to return to the market.

At the same time, while lenders are relaxing underwriting standards there are no signs that a boom in construction activity is on the horizon. This lack of overbuilding was one of the mainstays that prevented the commercial market from taking a longer-term hit during the recession than it did, and it is important in maintaining balance during this phase of the cycle. The respite in new construction activity also has had a more subtle but critically important effect on valuations, as it has allowed some properties to catch up on pro forma forecasts and reduced volatility for other properties by keeping risk-adjusted returns in balance.

Over the near term, market conditions are likely to continue to gradually improve although not enough to bail out properties with poor fundamentals. As the

market firms up, these properties are likely to remain out in the cold as attention shifts to newer product that is more flexible, appropriately scaled, and in the right location to meet the spatial needs of changing and more differentiated tenants.

In this environment, product differentiation and finding the right balance between “hot and not so hot” commoditized approaches will be of paramount importance. Developers and investors will have to focus on product differentiation rather than faddish trends that result in oversupply of the trend du jour. This caveat applies to property types as well as choice of location, with the classic central business district (CBD) versus suburbs battle yet to fully play out.

Although investor demand remains fairly strong, transaction activity has been relatively volatile, with year-over sales activity negative for two of the past three months through the end of February. This pattern may be attributable, in part, to the strong competition for deals. This placed added pressure on transaction pricing, with capitalization (cap) rates during February declining across the board.

According to Real Capital Analytics (RCA), suburban office cap rates exhibited the greatest decline—44 bps—with apartments exhibiting a 15-bp decline. Despite this difference, apartment transactions at an overall level remained the priciest, with an average cap rate of 6.02%. This cap rate was lower than all other property classes except CBD office, which came in at 5.85% due to strong investor appetites for core assets. At the other end of the pricing spectrum, industrial properties traded at 7.4% cap rates and suburban offices traded at 7.1% cap rates.

With respect to returns for institutional holdings, the preliminary figures (with 94% coverage) for the NCREIF Fund Index—Open-End Diversified Core Equity indicated a 2.47% total return before fees. This figure was about equally split between income and appreciation. This split differs from expectations for core investments, which generally provide the bulk of returns from income rather than appreciation. On an annualized basis, the appreciation component came in at a surprising 8.2%, outpacing the 5.2% income figure and translating to a 13.7% total return before fees. This strong appreciation component is consistent with the trend over the past three years during which appreciation outpaced income by some 200 bps and total returns averaged slightly over 13% per year. The shift in attribution is dramatically different from historical averages—where the

ten-year returns of 7.3% are dominated by income at 5.8%, and the long-term returns from inception (36 years) average 8.5%, and are dominated by income at 7.5% and appreciation is at less than 1%. These appraisal-based returns are also dramatically different from the public sector market, in which annualized returns through February were under 8% and three-year returns were under 10% for the FTSE NAREIT All Equity REITs Index.

On the private side of the market, it is vividly clear that the private institutional real estate market is being valued at historical highs. Annualized income returns are less than 5.2% for the full array of assets (i.e., the good, the bad and the ugly) in the \$104.7 billion index. This situation belies current pricing and is a disconnect from the gradual improvement in spatial fundamentals that are consistent with a slow-growing economy. Indeed, current return figures suggest that valuations face significant downside risk, especially if interest rates rise and investment premiums for illiquid assets revert to long-term averages. At a broad industry level this aggressive pricing has amplified exit-strategy risk that some investors are likely to face as interest rates and yield requirements increase and pricing reverts to long-term averages. While a bout of inflation might help mitigate some of this risk, it is unlikely that investors will be able to rely on increases in net operating income to bolster values when assets are eventually repriced. Although long-term investors have eschewed this risk for some time, focusing instead on spread investing, many of the funds included in the NCREIF Fund Index are mark-to-market accounts that are managed under fiduciary standards that require that values come in line with contemporaneous yield requirements.

In the current environment, transaction levels will likely continue to fluctuate until the economic expansion picks up speed and companies begin adding net new employees. In terms of prices, even though the overall market is fully priced, some overlooked subsectors have more upside potential. For example, over the next several years it is likely that institutional investors in the United States will turn to infrastructure investment to provide stable and predictable risk-adjusted returns collateralized by a real asset base.

The potential for approaching portions of the infrastructure market as real estate would open the doors to a wave of investments that far outpace

“Suburban office sales significantly outpaced CBD assets in both number of transactions and total transaction volume.”

the recent interest in timber and agricultural investments, which are something of a stretch with respect to being considered a subset of real estate due to the difference in their revenue streams and pricing compared to traditional income properties. However, the same caveat does not apply to certain segments of infrastructure that derive revenues from usage fees that are analogous to rental streams for income-generating properties. How current valuations and investor preference change over the intermediate term will be interesting and provide additional lessons learned for an industry with a short-term memory that contributes to its cyclical nature.

Office Market

Office market fundamentals have gradually improved due in large part to a lack of new construction and moderate increases in office employment. As a result, vacancy rates have continued to trend downward, although vacancies are still above historical highs and structural levels at around 13.5%. Increases in net absorption have been fairly widespread, with the majority of markets reporting positive figures.

In terms of transactions, trends in capital flows continued to favor CBD assets, with sales up significantly on a year-over basis despite a decline in portfolio transactions. Average prices per square foot for CBD assets were nearly double that of suburban properties, with cap rates some 90 bps lower. This pricing and the differences in returns might explain why suburban office sales significantly outpaced CBD assets in both number of transactions and total transaction volume when compared on a twelve-month moving average.

In addition to shifting attention to the suburbs, investors continue to focus more attention on secondary and tertiary markets as they seek higher returns and more product than available in CBD assets. While private market office returns are not available for the first quarter, the competitive performance in office REITs was 190 bps above the all-equity average,

suggesting the sector is on fairly firm ground. This situation is likely to continue to play out with improved economic conditions and an increase in employment helping to sustain positive absorption figures.

Retail Market

Retail market fundamentals of supply and demand have exhibited some improvement, although this improvement also echoes the “haves and have nots” divide that has dominated other fronts. While many retailers continue to struggle, some sectors have been fairly stable and have avoided the pressure to pull back.

The relative dearth of new retail construction has been a major factor behind the balance in the sector. However, continued pressure on traditional stores and the need to respond to increasing competition from both the bricks and clicks sides of the equation will force retailers and shopping center owners to revisit their operations and create or protect value for existing assets. In some cases this may translate to the need for defensive capital, while in others it will involve expansion and repositioning plans to respond to changing demographics, consumer demand, and competitive alternatives.

That said, the retail industry has always been one of the more competitive property sectors, providing competitive risk-adjusted returns on a long-term basis. While a number of factors might affect this proposition, it is likely that successful retailers and investors will be able to adjust to the changing landscape. These efforts will be more successful, but not necessarily easier, if the economy continues to pick up speed and shoppers return to more normal consumption patterns.

On the transaction front, retail sales started the year off on a slower pace than other property types but still were almost a third higher than the year-over period. Investor preferences varied dramatically by subtype, with sales of smaller strip centers declining moderately on a year-over basis and larger retail formats, urban assets, and single-tenant properties trading at twice the volume on a year-over basis. Similarly, when comparing transaction volume on the basis of size, sales of smaller assets dramatically outpaced larger assets.

In terms of performance, the broad retail sector lagged other core property types in early 2014. Within the property sector, smaller shopping center REITs outperformed their regional mall counterparts

with a 250-bp advantage through February. While representing a smaller portion of the retail pie, freestanding retail properties led all REIT categories, racking up returns that were double the industry averages. Part of this performance edge might be attributable to the bond-like nature of long-term single-tenant properties, although that sector is not immune from pullbacks. This caveat is especially true since many of these properties are unique in terms of scale and location and do not benefit from the agglomeration effect that retailers in traditional shopping center formats typically enjoy.

Industrial/Warehouse Market

Fundamentals on the spatial side of the industrial market have generally improved along with the growth of manufacturing and warehousing sectors. At an overall level, industrial vacancy rates have trended downward, benefiting from positive absorption and muted supply. As with other property types, however, this improvement has been somewhat selective and has involved shifts in locational and product demand. In markets that are positioned to take advantage of the Panama Canal expansion and other changes in the global supply chain, construction activity has increased and has involved some speculative activity.

To this point, the increase in demand has favored inland markets while ports have continued to serve as transfer points for multimodal operations. Looking forward, the industrial sector should benefit from moderate improvement in line with an expanding economy, although a global economic slowdown could put a temporary dampener on the industry. The good news is that there is little evidence of oversupply, which should contribute to moderate improvement in spatial market fundamentals.

With respect to transaction volume, the industrial sector sputtered during the first two months of the year. Indeed, the \$2.1 billion in sales in February was the weakest figure in the past two years and was almost 20% off the pace on a year-over basis. As with office transactions, the slowdown in volume was attributable to a decline in portfolio sales while individual transaction activity remained positive.

With respect to subtypes, warehouse properties traded at a significantly higher dollar volume than their higher-risk flex counterparts, although average prices were almost 50% lower. On the performance front, industrial REITs generated competitive returns

through February, outpacing office REITs by 100 bps, and had a 220-bp advantage over the broader industry averages.

Apartment Market

For several years the apartment market has been the darling of the industry, attracting the attention of developers, lenders, and investors. A number of factors have been behind this attention, ranging from the push factors associated with the collapse of the single-family market to the pull factors associated with changing demographics and lifestyle preferences that favor renting over owning.

While supply and demand fundamentals remain relatively in balance across the country, there are some pockets where overbuilding in rather narrow segments of the market may create imbalances. However, this warning does not seem to have registered with the current players who continue to push on or with the new players who are just entering the arena—including international investors who have historically eschewed apartments in favor of other income generating property types.

At this point in the cycle, the apartment sector appears to have cooled off a bit with vacancy rates approaching structural levels and rental growth in line with supply/demand conditions. Over the near term, the outlook for the sector is relatively sanguine as long as additions to supply remain aligned with increases in demand and household formation. Longer term, the debate over whether there has been a structural change in homeownership preferences will remain something of a wild card, with proponents on both sides of the argument. That said, structural shifts rarely occur over a short period, especially when preferences are formed by a convergence of factors that are unlikely to repeat.

After several years of strong sales activity, apartment transaction volume fell off in the early part of 2014, coming in at the lowest pace in over two years. This pattern was repeated on a year-over basis as well, although those figures were distorted by several large portfolio transactions that skewed the market in early 2013. This observation is reinforced by the fact that individual transactions were up by a quarter over 2013, with smaller suburban properties selling at a faster pace than larger-scale mid-rise and urban properties.

On a positive note, apartment REITs appear to have turned the corner in early 2014. Through February, total returns for the apartment sector

exceeded 12%, which was a dramatic improvement from the negative 6.2% return for 2013 as a whole. Whether apartment REITs can continue to outperform the broader index depends on a number of factors, including supply-side risk due to potential overbuilding. Much of this risk of overbuilding is concentrated in large, higher-end apartments in urban cores; however, this concentration is not reflected in the portfolio mix held by many REITs. Therefore, REITs will be able to avoid some of the spillover effect from the favored status of this property subtype among developers, lenders, and investors. At the same time, the fact offshore investors have finally warmed up to apartments may provide a cushion in terms of pricing and valuations as well as short-term relief from the overexuberance, especially on the private side of the market.

Real Estate Capital Markets

At this point in the cycle, capital flows to real estate are in line with market needs, with no major shortages of debt or equity affecting the broad picture. The market appears to be in balance, with the possible exception of private, direct investment, which is exhibiting some signs of excess capital flows as evidenced by historically low income yields.

While transaction activity has fluctuated, the market continues to function in a relatively efficient manner. On the equity side, there is no shortage of players as domestic and international investors continue to search for product. In general, debt capital is fairly accessible from traditional and new capital providers. The supply of debt will benefit from the relaxation of underwriting standards by senior loan officers facing increasing competition and pressure to put capital to work.

The CMBS sector has continued to stabilize due to the ongoing improvement in delinquency rates, which are at their lowest level in four years. This explains the increase in CMBS issuance during 2013, which totaled some \$84 billion. While significantly lower than the \$200-billion-plus figures prior to the market collapse, the growth has been fairly dramatic and consistent when compared to the \$5 billion activity in 2009, which was the bottom for the industry. CMBS activity has been varied, with some concentration in key markets. For example, according to Trepp research, lenders in New York City alone originated some \$12 billion on 235 CMBS loans during 2013. This activity included some large single-asset loans,

which is a marked departure from the prerecession period when such financing was hard to source.

The generally sanguine nature of the debt side of the market is particularly interesting in light of the concerns over a spate of distressed asset sales forced by the maturing bullet loans that had been common at the peak of the market. While there is still some risk that distressed assets will not be able to find traditional financing, banks and other lenders have exhibited an unusual knack for postponing the inevitable. (In some regards, this ability is reminiscent of what has been happening in Washington for some time and ultimately will have to be addressed.) If the economic expansion continues to pick up and the demand side of the equation improves, the correction will be less pronounced than if a short-term solution had been necessary. This opportunity is one reason hedge funds have focused more attention on domestic real estate, as they seek to capitalize on the potential surge in maturing bullet loans.

While new sources of debt financing from hedge funds and private equity are a welcome addition to the real estate market, the introduction of new players may generate some interesting dynamics. For example, it is likely that some of the distressed and troubled assets yet to hit the market have weaker fundamentals than the assets that have cleared. At the same time, some of the assets are likely to have suffered from deferred maintenance or to have lost ground in the competitive landscape. These assets will prove challenging, although they will provide the opportunity for old-fashioned value creation. As has been proven in the past, value creation in real estate is far from a no-brainer and may be beyond the skill set or tolerance levels of many market timers who have not been able to look beyond acquisition pro formas.

The outlook for the edges of the real estate market, where there is potential for value creation, is somewhat clouded. This is because a significant number of assets developed during the peak period of cheap, non-recourse debt are fundamentally flawed, may have to be scrapped, and have limited residual value compared to current book value. These will be the losers in what will be something of a mixed bag as the market returns to more normal levels.

Unfortunately, passive investors who have approached real estate as a safe haven may not be able to differentiate good assets from the bad, and they may be caught off guard as the market becomes

more selective on both the spatial and asset sides of the equation. In the meantime, the public and private sides as well as the debt and equity sides of the industry are likely to be able to sustain operations during this transition period in which fundamentals catch up with expectations.

Conclusion

During the first quarter of 2014 the economy showed some signs of thawing, which was welcomed news for those who had weathered the deep freeze that stuck through much of the winter. The economic recovery is somewhat tempered but more importantly is ahead of where some observers thought the market would be after battling headwinds on both the domestic and international fronts. While not much has happened in Washington in terms of long-term solutions, there has been something of a truce that will provide a modicum of stability until after the fall elections when things will once again heat up.

The economic improvement that has occurred has been somewhat uneven and has created sets of winners and losers among investors, businesses, employees, and nations. While many have come out ahead, those who have been left behind have found little insulation from the prolonged hangover effects of the recession. This situation might improve over the longer term, but that is little solace for those who struggle to maintain solvency, regain their lost fortunes, and join those already basking in the thaw of the early wave of recovery.

The good news is that the ranks of those who are benefiting from the economic recovery appear to be growing. This includes the average worker who is finally enjoying some increases in earnings, although not as much as some of their better-educated and more-skilled counterparts.

On the business front, both large and small businesses are seeing some improvement, which is especially good news for small businesses that heretofore have been left on the sidelines. In the absence of unexpected shocks this situation is likely to continue as confidence levels rise and access to the credit market improves. This is especially good timing since small businesses and consumers appear to be postured to take advantage of the credit markets as they begin to focus on the future.

The same situation extends to the real estate market, although there are some signs that there

may be a correction on the horizon as capital markets and economic conditions revert to more normal times and investors begin to focus on risk and absolute returns. In the meantime, debt and equity flows are likely to continue to support transactions and set the stage for a generally recovering market. However, this improvement will not benefit all sectors and markets, in particular those struggling with weak fundamentals and those most vulnerable to unexpected shocks. Looking forward, this latter caveat seems appropriate as the world appears to be more than willing to dish out unexpected events, ranging from geopolitical turmoil to natural and man-made disasters. This mix should make for interesting times as the spring transitions to what may be a long, hot summer.

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