The Economic Environment
Going into the fall, the US economy continued plugging along with moderate growth in gross domestic product (GDP) on par with expectations. On a seasonally adjusted annualized basis, real GDP increased 1.7%. Although low compared to historical post-recession recoveries, economic growth came in above the disappointing 1.1% estimate for the first quarter, which had been revised downward from 1.8% in the initial reports.

The midyear improvement in GDP was welcomed as the economy struggles to regain momentum. The increase was led by expansion in investment and consumer spending. The latter growth was stimulated, in part, by positive gains in wealth coupled with moderate increases in personal income. This attribution is important to the economic outlook, since both factors depend on the expectation and reality of improving economic fundamentals. The good news is that the likelihood of the economy slipping back into recession is relatively low. However, the tenuous nature of the global economy and its impact on the domestic front warrant close attention.

While the news on the economic front is on par with expectations and is generally positive, the recovery faces a number of known headwinds. Some of these emanate from Washington. In addition to the malaise and outright bickering that has characterized the political scene for the past several years, other factors have the potential to place additional dampeners on economic growth. Of particular concern is the eventual tapering off of quantitative easing (QE) by the Federal Reserve (Fed), a scenario that is becoming more likely and has Fed watchers on the edges of their seats. Concern over this situation and future actions has been amplified by uncertainty regarding who will replace Fed Chairman Ben Bernanke when he steps down from office in 2014. Of equal concern over the near term is how the tightening of governmental budgets associated with sequestration will play out and whether cutbacks will erode the economic recovery.

The biggest wild card in the economic outlook is not directly related to factors that can be built into economic forecast models. Rather, it comes down to the fundamental question of how committed and willing the two political parties will be to dealing with the myriad problems that must be addressed. While recent history provides little positive news on this front, it is becoming increasingly clear that failure to deliver solutions this time around is not an option. Lack of the bilateral leadership needed to garner support for solutions that address the critical issues could undermine the economic progress made to date and undercut the sputtering economic growth. In addition, more delays in development and implementation of action plans would erode consumer and business confidence, which are already somewhat tenuous. Unfortunately, the list of issues continues to grow, as punctuated by the recent turmoil in Egypt and growing political unrest in many countries that, in part, can be attributed to economic and financial woes.

Sequestration, one of the new buzzwords in the popular lexicon that was initially met with a sense of denial, has become the new reality. While some argued that the economy would be able to withstand the drag associated with sequestration, it is becoming clear that the impacts on the economy and the ability of agencies to provide mandated services may be more dramatic than envisioned when it was
Concerns over political unrest in several regions hangs over the global economy.

set up as a default strategy. To avoid cutbacks in critical services, a number of agencies have gone to great lengths to work around the mandated budget cuts. Ironically, the agencies would not now be scrambling if Washington had spent as much time solving the underlying problems.

Some noteworthy examples of work-around initiatives illustrate the sense of desperation and frustration of agency heads, advocates, and those directly affected by the cuts. These include the Food and Drug Administration (FDA), for which lawmakers are trying to exempt fees that have been paid by private industry from the automatic cuts. Other agencies that have taken measures to mitigate the impact of cuts include Health and Human Services (HHS), which has turned to cloud computing to reduce costs associated with desktop applications. The military has also sought ways to reduce the impact on basic operations by being allowed access to a pool of restricted funds. This change in policy allowed the Department of Defense (DOD) to significantly reduce the mandated number of furlough days that affect some 650,000 employees. The Department of Homeland Security (DHS) has also felt the effects of the budget knife, although last-minute scrambling did insulate the Transportation Security Administration (TSA) from some cuts that would have created choke points—and angry travelers and voters—at airports across the country. Since that temporary reprieve, DHS has been forced to cut back on training and communication efforts. Cutbacks in funds to combat cyber threats come on the heels of an increase in the number and severity of cyber threats and could have far-reaching impacts on business confidence. Indeed, according to a recent survey for Lloyds Risk Index, cyber risk was the third-greatest concern of chief executive officers in 2013, up from twelfth in 2012.

In addition to impacting federal agencies, sequestration has also spilled over into other areas of critical support. For example, the judicial system has been exerting efforts to dampen the impact of forced budget cuts on the integrity of the courts and their ability to carry out their mission. These cuts have been far reaching and forced cutbacks in such sensitive areas as security, provision of public defenders, technological enhancements, and administrative support. The cumulative impact of these cuts triggered so much angst that judges from 87 of the 97 national judicial districts wrote to lawmakers seeking their intervention to help restore funds and prevent additional cuts that would cause further degradation in the justice system. At some point, the efforts to circumvent the cuts will prove fruitless and force agencies to make structural changes in how they operate and the services they provide to the public.

On the global front, significant changes have occurred in terms of economic activity. For example, over much of the past six years, emerging markets had taken the lead in worldwide economic growth, with developed nations lagging in the aftermath of the global financial crisis. This situation shifted in the first half of 2013, with advanced economies picking up in global economic growth and emerging nations slowing down. This shift in relative growth rates may create strong ripples across the bow of emerging markets and force global companies to revisit their expansion programs. It should be noted, however, that the change is not from a surge in economic growth among developed nations, but from disappointing forecasts for emerging markets. In terms of attribution, the slowdown in China has been one of the major factors as spillover effects ripple across other emerging markets. Despite the slowdown, economic growth in China, with a revised 7.5% annualized target, is still significantly higher than in developed nations. At an aggregate level, developed nations are forecasted to account for some 60% of global economic activity, although growth rates remain rather muted relative to more robust expansionary periods. The turmoil in Egypt and rising concerns over political unrest in several regions hangs over the global economy and may create some unexpected shocks that could ripple across the globe and create additional economic uncertainty.

Employment
The employment front has been a net positive economic indicator, with job growth averaging some 190,000 per month over the past year. The good news is that the pickup in jobs is fairly widespread, including most industry sectors and most companies
in terms of size. The increase in hiring activity was led by hiring at existing establishments rather than new firms.

Of particular note is the fact that smaller companies, which heretofore had been fairly tentative in terms of adding employees, were the leading sector in terms of new hires. However, this situation was not the case across the board, with companies with fewer than twenty employees reporting negative job growth. This contraction continued the downward trend that began in the second quarter and is likely to continue until the growth in economic activity achieves more momentum. With the exception of these companies, smaller companies outpaced large companies in terms of hiring, while midsized companies came in slightly above large companies with over 1,000 employees. With respect to employment sectors, service jobs dominated employment growth. On the production front, the increase in construction jobs offset a decline in manufacturing with much of the pickup related to the strengthening in the housing market.

In terms of job losses, the second quarter settled down after a surge at the end of the first quarter. The number of job separations—both voluntary and involuntary—has been rather flat, although the number of voluntary separations has risen as employees begin to seek out new opportunities. Despite this increase, the rate of voluntary separations is significantly lower than in the prerecessionary period. With respect to employment categories, job losses were more pronounced in the financial services and retail sectors, which accounted for around a quarter of total job losses during the first half of the year.

With respect to unemployment, jobless claims trended downward in the second quarter despite a slight increase in July. Even with the July uptick, the rolling monthly average of jobless claims through mid-August was at its lowest level since the recession hit employment in 2007. At an aggregate level, the unemployment rate declined to 7.4% due to a combination of increased employment and defections from the labor force.

To this point, the relatively positive numbers on the employment front are particularly noteworthy in the face of contraction in the public sector caused by sequestration. Whether that situation will continue depends in large part on the ability of Washington to resolve the budget issues and economic uncertainty that hangs over companies and spills over into the job market.

### Inflation and Interest Rates

The Consumer Price Index increased by a modest 0.5% in June, led by increases in food and energy prices. In particular, gasoline prices surged over 6% at midyear, which contributed to an overall increase in energy costs. Despite this increase, consumer prices are still less than 2% higher than they were the prior year.

In terms of financial markets, the implicit discount rate for inflation remains modest in terms of expectations and pricing. After a slight uptick in the first quarter, import price increases have been in negative territory, echoing the situation at the end of 2012. Going forward, the tenuous and widespread weaknesses in the global economy, ranging from Western Europe to China and the rest of Asia, is expected to continue to put downward pressure on prices. Although this is good news for consumers, it is a double-edged sword that will adversely impact the manufacturing sector by placing downward pressure on export demand. Agricultural price changes have been relatively positive news, with the rate of increase dropping significantly after a surge at the end of 2012.

President Obama’s recent initiative to put pressure on colleges to make higher education more affordable received support from a number of sectors, with the notable exception of college administrators and faculty concerned over the potential impact on budgets and wages. Students and parents are especially interested in the success of such a campaign and realize that it must survive the political wrangling in Washington. Even if it does succeed, however, the benefits will be enjoyed by future generations of students and will skip over current or recent graduates who are struggling with record debt levels. Regardless of how the initiative fares, the commitment to provide greater access to higher education has placed the crisis in higher education on center stage and has resonated among those committed to advancing educational attainment in this country. It has also been well received by companies in underserved segments of the economy that have been struggling to find skilled employees and have turned to immigration reform to provide some relief.

On the interest rate front, anticipation of the Fed’s phasing out of QE2 has been discounted in the market, although investors have been left hanging as to the timing and magnitude of the winding-down process. Thus, policy watchers paid particularly close attention to the release of the minutes of the July policy meeting.
which suggested that the Fed would start ratcheting back its bond-buying program in early fall. Despite hints that a change in monetary policy is imminent, its launch depends on continued improvement in the economy beyond the recent tepid growth. Also, despite an increase in stock market volatility, there was no hesitation on the part of investors to pull out of the bond market. Indeed, concern over the likelihood of rising interest rates has resulted in withdrawal of over $30 billion from bond mutual funds. The magnitude of withdrawal was noteworthy, as it was the third largest outflow in almost thirty years, spanning several cycles that included recessionary periods and spikes in interest rates.

During the summer, interest rates on ten-year Treasuries dramatically increased from spring when prospects of the withdrawal of Fed support became a distinct possibility, although unknown in terms of timing. During the same period, thirty-year fixed mortgage rates rose to 4.7%, which was a dramatic increase of 140 basis points (bps) since bottoming out in the spring. This increase is likely to have a dampening impact on the housing market, although the predictions of an uptick may encourage some potential buyers to get off the fence before rates rise further. While concern over additional increases in interest rates will hang over investors and homebuyers alike, the near-term prospects are for rather flat rates, with some new vacillation due to uncertainty regarding the future direction of the Fed and the state of the economy.

**Business Indicators**

During the summer, a number of business indicators came in on the positive side of the ledger. This performance helped return The Conference Board Leading Economic Index to positive territory, maintaining the slightly upward trend exhibited earlier in the year. The improvement in economic indicators was fairly widespread, with the financial segment providing the greatest stimulus. On the other hand, after the rate of growth in business inventory levels spiked at the beginning of 2013, the economic indicator flattened out, resulting in moderate increases that held through the second quarter. The contraction in inventory levels coincided with the decline in sales, which helped hold the inventory-to-sales ratio in check. This situation is likely to continue during the third quarter, as companies try to get a better read on the economic outlook that has been ratcheted back in the face of economic, fiscal, and political uncertainty.

On the manufacturing front, the weakening economic outlook put downward pressure on the manufacturing sector, although the growth in orders for durable goods remained in positive territory. The transportation sector was particularly robust, with growth rates in the low double digits, benefiting from a surge in aircraft orders. The rate of growth in orders for manufactured goods remained in positive territory during the second quarter, reversing the deceleration in growth that occurred at the end of the first quarter. At an overall level, production activity increased throughout the second quarter, despite the decline in export activity levels. The outlook for the balance of the year is guarded, but positive, with some additional upside potential.

**Stock Market**

As the summer played out, the stock market began to show some signs of slowing down. Of particular concern was the fact that blue chip stocks experienced the longest losing streak in over a year in mid-August. This reversal of fortune may have benefited from the timeout induced by the technical issue on August 22 that killed data feeds on market data for NASDAQ-listed securities. During the forced downtime, the NASDAQ Composite Index was frozen while the Dow Jones and S&P 500 stock indices traded in a relatively narrow range. After the freeze was lifted, all three indices experienced moderate increases due, in part, to recognition that the halt in trading was caused by a temporary technical issue and not something more insidious. However, the angst that the temporary cessation in trading triggered reflects the vulnerability of the financial markets to cyber threats or other unexpected crises that could occur on the domestic or global front.

While Washington remains something of a wild card with respect to the overall stock market, it appears that some critical sectors may be able to weather the withdrawal of federal stimulus. For example, bank balance sheets have built up sufficient
liquidity and thus may be able to avoid having to make abrupt changes in lending standards or cut back on loan volume. Indeed, cash balances at banks accounted for some 16% of total assets at the end of the second quarter. This liquidity component of balance sheets is significantly higher than it was in 2008 before the first quantitative easing program was launched. Despite relatively high liquidity levels, there are no guarantees that the financial system will not face challenges as it addresses inflated asset values and rising pressure for banking reforms that are still hanging over the industry. With respect to the rest of the market, more volatility is expected as the market tries to get a read on the outlook for both the domestic and global economies.

**Consumer Confidence**

In general, consumer confidence levels are fairly strong, benefiting from a combination of wealth effects associated with the improving the stock market and housing market, and a reduction in household debt obligations that are approaching historical lows.

Consumer confidence levels were fairly resilient during the first half of the year, with consumers focusing on the good news to bolster their psyches. However, in the summer, confidence levels were eroded somewhat by consumers ratcheting down their expectations for the overall economy. In spite of this downturn, consumer confidence levels reported by The Conference Board remained at a five-year high. The University of Michigan Consumer Sentiment Index reported a similar story, with confidence levels rising moderately at midyear. In terms of the temporal perspectives, consumers remained fairly comfortable in their current situation but are exhibiting signs of rising concern over the future prospects for the economy. This concern is understandable in light of the many challenges that Washington still faces in dealing with the fiscal crisis, sequestration, implementation of health care reform, and the general spate of political gridlock.

One of the most visible manifestations of consumer stress is the rate of personal bankruptcy filings. The rate of improvement in personal bankruptcy filings slowed during the second quarter, which is consistent with seasonal patterns. Despite this slowdown, the overall rate remains in negative territory on a year-to-year basis. The decline in personal bankruptcy filings continues an almost three-year trend that has seen the rate decline over 50% since the peak in 2010. This is attributable to a number of factors, including the continued deleveraging of households, which worked on the outlay side of the equation, and the improvement in employment, which addressed the income side of personal balance sheets.

The network side of the equation has also improved with the housing market and the broader stock market. Although few households have been able to monetize improving housing values, the widespread publicity about the housing recovery has bolstered household sentiment. As a result, some of those on the precipice of bankruptcy have stepped back from pulling the trigger. Whether this behavioral response continues depends on continued improvement in the overall economy and the ability of individual households to directly share in that improvement.

**Retail Sales**

Although consumer confidence levels are moderating, consumer surveys suggest some households have increased their intentions to purchase durable goods, including automobiles, homes, and appliances. As might be expected, these expenditures are linked in large part to the housing recovery and continued low interest rates that make automobile and home purchases possible. Growing press coverage that suggests interest rates will start rising has no doubt accelerated some consumer expenditures. Once this temporary surge is over, the outlook for near-term retail sales growth will hinge on whether perceptions of a strengthening economic recovery can reassure consumers that better times are on the horizon.

As summer wound down, retailers were faced with unexpected challenges as the back-to-school season got off to a slow start. This was a reality check for retailers and put dampeners on sales forecasts for the second half of the year. While numbers are not yet in for the season, estimates range from flat to negative sales levels compared to the same period in 2012. The results were particularly disconcerting for mainstream retailers that are dependent on back-to-school and holiday sales to bolster revenues. Retail sales levels are likely to be disappointing to those who looked to consumers to provide momentum to fuel the broader economic recovery. However, the fact that retailers reined in their inventory levels will lessen the impact slower sales on earnings and
will help avoid a more intense round of discounting than would otherwise occur.

The increase in payroll taxes and the increase in gasoline prices are likely to force consumers to place even more emphasis on value and price points. This situation could lead to erosion in profit margins as retailers are forced to compete for scarce dollars. Few mass retailers will avoid this pressure, with Walmart and Costco both struggling to hit sales targets. The decline in mall traffic that was observed this summer is likely to continue, which may adversely affect upper-scale retailers who, to this point, have been able to outperform the broader market.

Internet sales continued to grow during the second quarter, outpacing traditional in-store sales. On a year-over basis, sales in the second quarter were over 18% above the prior year. In terms of total retail sales, Internet sales continued to gradually increase in terms of market share, pushing 6% by midyear. This pattern is expected to continue, although the Internet sales tax reform will take away some of the advantage of online sales that benefited smaller operators.

**Housing Market**

The much-ballyhooed recovery in the housing market has been a major factor behind the optimism that has spilled over to the consumer psyche. While the general trend has been positive, there are some signs that the sector is cooling off a bit. Despite these signs, the good news continues to capture the headlines and has led to something of a self-fulfilling prophecy. For example, through July the pace of existing home sales pushed an annualized rate of 5.4 million, which outpaced expectations. The increase in sales ate into inventory levels, which created something of a seller’s market in some markets and a more balanced market overall.

As might be expected, improved sales activity and prices lured more sellers into the market. Not only did the pace of listings increase, but the quality of stock improved as sellers not under pressure to liquidate assets were drawn back into the market. This trend changed the composition of offerings, which, in turn, attracted a new pool of buyers in search of larger and higher-quality assets to choose from. This shift in the composition of product on the market exaggerated reports of appreciation based on median prices of sold properties, which provided further fuel to the market. At the same time more sellers came to market; the modest increase in interest rates and the prospects for further increases convinced some buyers to get off the fence. This created a surge in sales activity and added further fuel to the reported recovery as inventory levels fell to long-term lows.

During the second quarter, the S&P/Case-Shiller Home Price Index reported double-digit increases in existing home prices compared to the prior year. This improvement extended the streak of price gains, although the rate of increase tapered off a bit. This slowdown suggested the market recovery might be heading into a more moderate phase that is in line with supply and demand fundamentals, rather than buyer and seller perceptions. The fact that many potential buyers are saddled with illiquid assets has created a domino effect where the pace of sales has been disrupted by sellers’ unwillingness to accept contingent offers. This reticence is understandable given the appearance of rapid price appreciation and fears that rising interest rates and erosion in economic conditions might place a dampener on housing affordability, which could inhibit sales activity.

In addition to improvement in sales for both existing and new homes, the perception of an improved housing market can be attributable, in part, to improvement on the distressed side of the market. For example, the Mortgage Bankers Association reported that the percentage of mortgages 90 days or more overdue had slipped below 5% by the end of the first half of the year. While still high by historical standards, this figure was almost half of the peak hit in late 2009 at the height of the fallout from the housing market collapse. Despite improvement in delinquency rates, the housing market remains saddled by the fact that almost 10 million households are in a negative equity position in terms of values and outstanding mortgage balances. At the same time, lenders continue to favor buyers with higher credit scores, leaving marginal borrowers struggling to find financing.

With respect to the new housing segment of the market, the news during the first half of the year was generally positive. During June, new home sales continued to accelerate, coming in over a third above the year-ago figures. After a brief pause at the beginning of the second quarter, the NAHB Housing Market Index was on a sharply upward trajectory going into the peak building season. As a result of recent improvements, the index was at the highest level since the market’s collapse hit builders hard at the beginning of 2008. Despite a slightly downward trend in total housing starts at
the midpoint of the year, the industry remains on an expansion path. This is particularly true if the more volatile multifamily component of the industry is set aside and attention is focused on the single-family segment. Even with the recent cooling off in the rate of growth, starts for both multifamily and single-family housing are significantly higher than the year-over figures. Permit activity suggests that the multifamily and single-family components of the market are on divergent paths, with a pullback in the hot multifamily front and continued growth in the single-family segment.

In addition to downward pressure that can be attributed to a slowing economy and the prospects for rising interest rates, the outlook for the housing market has been clouded by proposed reforms for Fannie Mae and Freddie Mac. The likelihood that dramatic changes are in store for these government-sponsored enterprises (GSEs) was elevated by President Obama in a speech in early August. He stated that he would not support allowing the housing giants their former status, which depended on an implicit bailout by taxpayers in the event the market entered another major downturn. While short on details, the proposed reform of the residential mortgage market and the withdrawal of public support will create dramatic changes in the residential lending activity. Such structural changes that cut to the heart of the existing mortgage market might well be positive over the long term. However, the timing for significant reform is far from ideal and comes when the nascent housing market recovery is still tentative and remains dependent on the continuation of supportive policies and practices.

**Real Estate Market**

**Office Market**

Office market fundamentals of supply and demand balance showed moderate improvement during the first half of the year. These results were somewhat mixed, however, with knowledge- and energy-related markets, as well as central business districts (CBDs), outperforming. Assuming the economic recovery stays on track, suburban office markets are also poised for improvement, although location, connections, and synergy will create losers and winners as nondescript, commodity-type submarkets continue to languish.

While the demand side of the equation will depend on continued improvement in the economy, the lack of new construction in many markets may start shifting the competitive advantage back to landlords. However, in most markets this transition will not be dramatic and will take some time to translate to increases in rents. Since net operating income remains below the breakpoint needed to justify speculative construction, at a national level the office sector is expected to stay on the road to recovery.

With respect to pricing, investors have continued to search for higher returns, which benefited suburban assets that had been out of favor during early stages of the recovery. During the first half of the year, suburban transaction volume racked up an impressive 54% year-over-year increase, which doubled the rate of increase for CBD assets. At the end of the first half of the year, the office component of the NCRIEF Property Index comprised some 56% of total assets. In total, there were 1,410 office investments in the NCREIF index for an average value of $84.5 million. On the private side of the market, the mix between CBD and suburban office investments were split relatively equally, with $62.5 billion in CBD assets slightly ahead of suburban assets. In terms of total returns, CBD assets significantly outperformed suburban assets, with 10.5% and 8.7% annualized returns respectively. The continued interest in urban assets led to aggressive pricing, which drove the implicit capitalization rates for CBD assets toward 5%—110 bps lower than suburban assets.

In terms of investment performance, for the twelve-month period ending June 30 office returns came in slightly under 10% annualized basis with an implicit income return of 5.5% annualized. On the public side of the market, office real estate investment trusts (REITs) came in slightly ahead of the NAREIT Index, with 8.4% total returns through July. Mixed office/industrial REITs fared significantly better, coming in around 15%, with dividends leading the office and industrial sectors by over 100 bps. The outlook for office performance
is moderately positive, although the tenuous nature of the economic recovery, the global slowdown, and lack of resolution to politically induced challenges will hang over the sector as they will for other property types. In the meantime, investors will still be seeking returns and are likely to continue to move further out on the risk spectrum, which will favor suburban assets that have the potential to offer more upside than aggressively priced urban counterparts.

Retail Market
In terms of supply and demand, the retail property sector improved during the first half of the year, with strong sales and moderate expansions helping drive positive absorption. As has been the case for some time, the market remains bifurcated with value/discount properties and higher-end properties outperforming the broader market. However, the tentative nature of increasing consumer demand has not bolstered the fate of all retailers and properties falling in these sectors. Thus, retailer selection and individual property fundamentals remain a key factor in determining the winners and losers, with the gap between the two ends of the spectrum likely to remain wide for the foreseeable future.

In the private institutional market, retail investments accounted for around 23% of total NCREIF Property Index (NPI) with an average value of $70 million, slightly below that of the office counterpart. For the twelve-month period ending June 30, retail investments led all other property types in the index, with a 12.8% annualized return. The implicit capitalization rate for retail assets return was around 6%, which was 50 bps over the office sector and some 80 bps over apartments.

With respect to subtypes, super-regional malls accounted for over a third of privately held retail investments. Through the twelve-month rolling period that ended June 30, regional malls outpaced other property types and subtypes, with 16.2% annualized returns that included 5.8% income returns. Regional mall performance was also a strong subtype, accounting for 17% of the NPI and generating annualized returns of 12.7% with income returns about 25 bps higher than super-regional, conference, community, and neighborhood centers, which each accounted for around 15% of the remaining retail assets and came in on par with 10.5% annualized returns. Power centers accounted for another 10% of retail assets and were at 10.7% total returns. The specialized fashion center category remained rather a niche play, accounting for some 7% of total retail assets, providing a 12.8% annualized return and 5.1% implicit cap rate, which was lower than the other retail categories.

As with the overall public real estate market, retail REITs have experienced a significant decline this year, with total returns plummeting to 6.7% through July. This was on par with the overall REIT index but was significantly lower than in 2012. Regional mall REITs took the biggest hits, with returns falling below 4% compared to 11% for shopping centers and over 11% for freestanding facilities. This situation eroded further during August, with regional malls racking up the second-greatest declines in year-to-date returns—outperforming apartments, which have been in contraction for a couple quarters.

Consistent with the trend toward higher-risk investments exhibited in the office sector, retail investors also moved out on the risk spectrum in search of returns with significant increases in sales of smaller, unanchored strip centers. Transaction volume rebounded from a slow start at the beginning of the year and finished the first half with a year-over-year increase of slightly under 10%.

On a relative basis, investor demand for well-located and well-tenanted retail assets is expected to remain strong. Going forward, the inflation-hedging potential offered by retail investments may provide added stimulus to the property sector as investors take more defensive investment strategies as they prepare for higher-interest and higher-inflationary stages of the business cycle. However, this appetite will depend on the strength of the economic recovery and expansion of retail sales.

Industrial/Warehouse Market
Industrial market fundamentals exhibited some improvement during the first half of the year, despite the global economic slowdown that took some of the anticipated expansion of exports out of the equation. Several subsectors of the industrial market outperformed others, with big-box distribution centers taking central stage as an expanding list of tenants seek space to accommodate logistical and distribution models. On a similar note, the gradual improvement in the economy has stimulated modest expansion among smaller manufacturers in selected industries, which has translated to an increase in demand for multitenant industrial facilities. The lack of
speculative construction suggests that the supply/demand proposition for industrial space will continue to improve. Assuming the economic recovery stays on track, improving fundamentals should put downward pressure on vacancy rates and provide some ability to push rents, especially in selected markets that are benefiting from continuing changes in global and domestic supply chains.

Industrial investments accounted for 14% of the NPI, with an average value of $16 million, which was significantly below other property types. Industrial investments generated a trailing twelve-month return slightly under 11%, with an income component greater than other property types. With respect to sale property types, the industrial warehouse category dominated the overall sector accounting for 80% of total assets. Compared to other core assets, industrial properties generated solid returns for both total returns and income components, which were 11.5% and 6.1% respectively. The industrial flex market accounted for only 7% of the total industrial category and provided a disappointing 6.8% return due to moderately negative appreciation. The R&D component comprised only 2% of the sector and provided 9.5% annualized returns, which included an implicit capitalization rate of 6.9% annualized.

On the public side of the market, industrial REITs came in some 280 bps over the FTSE NAREIT All Equity REIT Index though the first half of the year. At the same time, dividends lagged the overall index and other major core property types.

As with most other property types, the industrial sector lost some ground in August; although, year-to-date returns were slightly positive and ahead of overall retail and apartment figures.

During the second quarter of 2013, industrial transaction volume increased some 10% after a slow start to the year. Despite this increase, transaction volume for the first half of the year reflected a very moderate year-over-year increase. As with other property types, investor appetites differed by subtype, with warehouse transactions up almost a quarter and flex space showing a decline. This pattern differed from the office and retail sectors, where investors were willing to accept higher risk by shifting to smaller, non-core assets.

**Apartment Market**

Despite continued hype in seminars and the popular press, the apartment market is showing signs of slowing down. This has manifested itself in relatively flat transaction volume compared to 2012. Despite the slowdown in the pace of increases in transaction volume, sales activity during the first half of 2013 remained fairly strong, trailing only the office sector in terms of total volume.

The fact that the absolute value of apartment transactions still outpaces that of office investment suggests investment appetites still reflect short-term goals rather than long-term asset allocation targets. This observation is based on the fact that, over the long term, office allocations in institutional real estate portfolios are generally double that of apartments. Thus, the slowdown in the growth in apartment volume may suggest that asset allocators are returning to long-term averages, rather than eschewing the sector altogether.

The slowdown in apartment investment growth is somewhat understandable in light of the recent flattening (or slowing) in rental growth rates. In addition to being a disappointment for those who are championing apartments, this slowdown and the plateauing of vacancy rates has likely caused consternation for those who bought at the peak of the cycle and relied on assumptions of continued rental growth and low vacancies to support pro-forma values. This caveat is especially true in markets where construction activity has accelerated at the same time that development converged on a narrow band of investors as in the case of those chasing the new millennials at the expense of other households who have been the mainstream of apartment tenants over the long term. This is not to suggest that millennials are not a good target, but that developers, lenders, and investors should avoid getting drawn into narrow bands of demand that are being oversaturated by new construction.

The apartment property market accounted for slightly over 25% of the NPI, with an average value of $15 million. In terms of investment performance of the private side of the market, apartment returns came in at 10.7% annualized with the lowest implicit rate of all property types of 5.5% annualized. At a subtype level, high-rise apartments dominated the category with some 54% of total assets, followed by garden apartments (37%) and low-rise apartments (9%). Reflecting aggressive appetites for urban apartments, high-rise assets provided the lowest annualized returns and traded at some 4.9% cap rates, which were almost 100 bps lower than garden apartments.
“Apartment REITs continued to lag other property types.”

Apartment REITs continued to lag other property types through the first half of the year, continuing a trend that held for 2012 as a whole. The situation deteriorated even further during August, with the apartment sector underperforming the All Equity Index by over 350 bps. This relative performance was a marked contrast from the private sector on an annualized basis and through the first half of the year.

Hotel Market
The hotel market has enjoyed increasing market fundamentals with an increase in occupancy rates and revenues. Indeed, hotels may be one of the few property sectors that are benefiting from some tailwinds in terms of investor appetites. As an investment class, hotels are often considered “non-core” due to the heavy reliance on management to create and maintain value compared to other property types. Thus, investors generally seek higher returns for hotel investments to offset some of the added risk and the lack of a large pool of institutional investors to help perfect an exit strategy. That said, institutional investors have continued to turn to hotel investments in search of higher return and diversification benefits with hotel transaction volume up almost 70% for the first half of the year. In addition, the search for returns created a surge in transaction volume for higher-risk unflagged properties, as well as resort properties, which generally command higher price tags while demanding more amenities and experiencing higher operating expenses.

The hotel component of the NPI accounted for only 2% of total assets, with an average market value of $34 million. This relatively low asset allocation reflects the opportunistic nature of the industry and the management-intensive operating requirements needed to create and maintain value. As might be expected due to its high-risk profile, hotel investments provided the highest implicit capitalization rate of 7.4% annualized. On the public market front, hotel/leasing REITs trailed all major property types with the exception of apartments.

Real Estate and Capital Markets

Real Estate Capital Markets
In general, capital flows to real estate remain fairly robust with a full range of capital providers supporting the market. On the private side of the equity market, commercial real estate investment activity has continued to trend upward, unfettered by concerns over sequestration, unsteady economic conditions, moderate increases in interest rates, and modest increases in demand for space. This general sense of optimism is a marked departure from sentiment among securitized investors. Of particular interest is the periodic disconnect that has emerged between the private and public side of the market, with the private market going strong and the public market reflecting periods of lagging investment performance. For example, after a stellar total return in 2012 of slightly under 20%, the year-to-date returns for the FTSE NAREIT All Equity REIT Index slipped to less than 7% through the first half of the year.

During July, REIT returns returned to positive territory, reversing two months of across the board negative returns. The only exception to this pattern was the residential sector, which had maintained positive returns up to July when the sector slipped into negative territory. Unfortunately, positive returns did not hold up during August as the All Equity REIT Index slipped as did many other sectors of the market. For example, the S&P 500, Dow Jones Industrial, Russell 2000, and NASDAQ Composite were all in negative territory for August; although, not to the extent of the NAREIT Index. The result was two quarters of negative performance through the third week in August. This was a dramatic departure from the beginning of the year when total returns were over 9% for the first quarter. The decline in performance in the mortgage sector was even more dramatic, slipping from the same 20% level for 2012 to negative territory. In terms of attribution, disappointing performance for mortgage REITs was led by home financing at -8%, while commercial financing led all REIT categories at 24% through the end of July.

The transaction market for commercial assets remained active in the first half of 2013 with Real Capital Analytics reporting over $71 billion in transactions over $10 million in the second quarter. While off the pace at year-end 2012, this transaction
volume was on par with the first quarter and represented a 14% increase on a year-to-year basis. There was a shift in property preferences, with office and hotels leading the increase while industrial and retail were relatively flat. On the other hand, the apartment sector showed additional signs of cooling off with transaction volume falling some 7% and reversing the trend of positive increases, which held up over the past three years. For the first half of the year, transaction volume approached $150 billion, which was significantly higher than in 2012. When portfolio transactions are removed from the equation, sales volume was up some 25% on a year-over-year basis.

After a strong start for the first half of the year, the commercial mortgage market continues to be competitive, with capital flows supporting the upward trend in transaction activity. Commercial banks continued to increase commercial loan volume as they compete with a variety of other capital sources trying to place money. On the private side of the market, lenders continued to expand their investment horizons in terms of the type and quality of properties on which they are willing to lend. On the public side of the debt market, conditions continued to improve during the third quarter with delinquency rates.

The commercial mortgage-backed securities (CMBS) market has continued to show improvement, with new delinquency rates falling through July 2013 to the lowest levels reported since the end of the recession. Indeed, late payments declined 40 bps between June and July falling to 6.8% overall. Given continued improvement in market fundamentals of supply and demand, the outlook for private and public debt remains positive, but somewhat guarded, in light of the growing divide between the private and public sides of the equity market, which may signal an inflection point or a temporary pause as the economy tries to regain its momentum.

**Conclusion**

The economy is on par to continue to deliver positive but modest improvements in GDP. However, this assumption is not cast in stone and depends in part on the will and ability of Washington to resolve some of the festering problems that have not been addressed. This political divide, and its impact on the economy, is likely to return to center stage during the fall as the sides return to the table. How it will all play out remains to be seen and will be closely watched by business leaders, consumers, and voters. This last constituency might turn out to be the key players, assuming they can get the attention they warrant. In the meantime, the real estate market is likely to remain stable with moderate but positive improvement in terms of underlying market fundamentals. On the investment side of the equation, the widening divide between the private and public sectors of the market may signal that some correction in pricing is on the horizon. This is especially true as investors begin to focus on the risk side of the investment proposition that is likely to take center stage as underlying property fundamentals become more important in determining prices than the pent-up appetites for assets. This will set the stage for some interesting times for the real estate industry. This is particularly true with respect to the drama that will unfold as the private and public real estate markets ultimately converge to some balance point.

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