The Hunt for Product Lessens Summer Market Doldrums

by James R. DeLisle, PhD

Commentary
Despite some mixed signals and downside risks, the United States economy seems to be on a fairly solid but unspectacular road to recovery. Although inflation continues to be a concern in some sectors, there is little risk of a major spike with the exception of energy prices. Interest rates appear to be on a moderate upward trend, with the flattening of the yield curve providing good news for long-term borrowers. Although employment gains have been spotty, it appears that the trend is toward gradual improvement, with limited pressure on wages. The record deficit and the balance of trade remain a major concern, although no short-term backlash is anticipated that could derail the recovery.

On the real estate front, the picture is somewhat optimistic, with gradually improving market fundamentals being reported in many markets. Despite these improving fundamentals, the spatial side will continue to face excess capacity until the economic recovery kicks in and the positive effects ripple into the real estate market. However, the capital side of the market will encounter no such lags. Indeed, pressure on cap rates is expected to hold prices over the near-term, with pent-up demand from domestic and foreign investors alike fueling the market. These investor appetites should place significant stress on acquisitions teams who will remain fully engaged in the hunt for product. The good news is that more and better product is likely to be drawn to the market as owners seek to cash in on some of the record transaction prices that have been reported.

With so much money on the table, few will have time or reason to complain about the market. Thus, the traditional summer doldrums will be little more than a memory. Indeed, the frenetic pace of activity is not likely to satiate the appetites of investors, with momentum carrying into the fall.

The Economic Environment
Economic Growth
During the first half of 2005, the U.S. economy was fairly healthy, with business activity either up or holding steady in most regions. In terms of gross domestic product (GDP) growth, the year is unfolding on a restrained note, likely to come in around 3.5% or so for the year as a whole. These numbers could be revised downward moderately if the decline in long-term rates accurately reflects the expectation of further deceleration in growth. This outlook is somewhat disappointing relative to other post-recovery periods and strong figures from 2004, which saw the highest level of growth in 5 years. However, given the uncertainty surrounding the overall economy and other nagging problems, the levels of GDP growth should be welcome news for many observers.

In a global context, the outlook for the domestic economy is favorable, with a number of regions struggling with prospects that are more tepid. Indeed, dampened demand on the global front is one of the drags on the U.S. domestic economy, with Western Europe having the softest outlook. On the other hand, the prospects in growth economies remain strong, especially in markets with a significant cost advantage and those that are benefiting from the continued off-shoring of jobs. As a result, the prospects for economic growth can be labeled “steady state,” a status that is likely to hold over the near-to-intermediate term.
Employment
The employment scene has been closely watched on all fronts, ranging from consumers concerned about their future prospects, to investors and businesses looking for insight into the prospects for accelerating growth. While job growth has been generally favorable, recent figures are troubling, especially given that there was solid growth in early spring. The tepid growth in new jobs has created significant concern in a number of quarters, leading some to question whether the recovery was losing its momentum.

Among employment sectors, health care and construction led on the positive side, while most other sectors were flat. Construction numbers improved in the residential market, which offset moderate declines in the commercial sector. The number of unemployed persons and the unemployment rate both remained stable going into summer. Despite the near-term figures, the rolling two-month averages were on par with those of the past two years, providing some solace to those concerned about a significant reversal in employment growth.

In addition to concerns regarding the number of new jobs, employees have been increasingly frustrated by the lack of opportunities for promotion within their firms. This “stickiness” can be attributed to a number of factors, including cut backs on in-house training programs and the use of outside trained help. In addition, companies continue to turn to outsourcing to access specialized and higher-cost functions that are noncore and only periodically needed. The decline in unionization has also had an impact, resulting in less pressure to help employees advance their careers while staying at the same company. This situation is likely to get worse as employees defer retirement due to concerns about their financial security and the viability of the Social Security program. Further complicating the situation are the high-profile cases surrounding underfunded pension liability, and growing recognition that the Pension Benefit Guaranty Corporation does not have the deep pockets necessary to cover the loss of a significant share of retirement benefits by countless retirees.

Inflation and Interest Rates
Inflation has remained squarely in the spotlight, driving the Federal Reserve’s string of increases. Indeed, over the past eight months, it has gradually raised the federal-funds rate a full percent, going into the June meeting at 5%. Due to the start-stop cycles in the economic recovery, this measured approach has allowed the Federal Reserve (the Fed) to walk a fine line between inflation and recession. Going into the summer, the consensus is that the Fed will make some moderate rate increases to thwart inflation, with limited danger of a major spike in rates. Thus, the interest rate outlook remains positive for businesses and consumers.

Although the economy has adjusted to the gradual increases in short-term rates, compression of the spread between short-term and long-term rates has been somewhat troubling. The flattening of the yield curve has been perplexing, as it was expected that long-term interest rates would have started to increase as uncertainty about the economic recovery rose. The fact that long-term interest rates have remained low has helped fuel the housing market, prolonging the bull cycle that might well have played out if mortgage rates had risen as fast as short-term rates.

Although inflation, as measured by the Consumer Price Index (CPI), seems to be under control, medical costs and prices at gas pumps and grocery stores have created something of a disconnect between reported figures and consumers’ perceptions.

Two explanations for this divergence in perceptions have been argued. First, a number of observers question the validity of how housing costs are factored into the calculations. Rather than mirroring the rapid escalation in housing prices, CPI focuses on rental housing costs. To this point, increases in rents have paled in comparison to the surge in housing prices. The dampening of CPI increases, caused in part by the differential between rental rates and housing prices, has led to a disconnect between these measures and the actual economic situation. Thus, the recent explosion in prices in many markets has left many homeowners facing higher total costs of living and more pressed to make ends meet than suggested by the published CPI figures. Second, the continued use of quality adjustments has understated the impact of rising absolute prices on consumers’ pocketbooks. These adjustments were introduced to recognize that due to increases in features and functionality, some price increases are not really comparing apples to apples. To adjust for this phenomenon, CPI calculations do not include rising prices associated with enhanced or improved

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.
features. While such adjustments to the CPI make sense in some respects, many consumers are focused on bottom-line prices, rather than capacity. This is especially true where capacity improvements transcend consumers’ needs or their ability to benefit from the product improvements, as in the case of computers and other technology-based goods. For many consumers, CPI is only part of the story; the rest of the story weighs on their confidence levels and consumer behavior.

With respect to inflation, the Fed’s concern will lead to close monitoring and quick reaction, which might cause some negative ripples for the broader economy. However, it appears that inflation can be managed, at least in the near future.

There is some potential for unexpected inflation on the agricultural front that should be noted. In particular, the prospects of another drought could have an adverse effect on agricultural productivity. When coupled with rising costs of fuel and fertilizers, rising food prices might place an upward pressure on inflation.

On another front, workers will continue to argue they are overdue for some wage adjustments. However, the tenuous nature of job growth suggests that such inflationary pressures are unlikely to emerge. Indirect costs associated with benefits, especially health care, are likely to continue to increase the total cost of labor.

Because of all these forces, it is likely that there will be a moderate increase in inflation, but it will not be sufficient to derail the recovery or consumer confidence.

**Business Indicators**

In general, business conditions were moderate to stable going into the summer. While a sense of uncertainty continues to pop up periodically in some regions and among some indicators, business indicators suggest the recovery will be sustainable. Manufacturing activity has been healthy, logging in ahead for early reports and showing gains over 2004. Manufacturers report upward price pressure for a range of inputs, especially energy and transportation-related items. However, manufacturers have had limited success in passing such costs through to end users due to long-term contracts and competition from foreign producers. The result has been some erosion in recent gains, with rising input prices eating into profit margins and dampening momentum.

Capacity utilization increased moderately in the first half of 2005, sustaining the four-year highs that were reached earlier in the year. Despite this improvement, a number of sectors have excess capacity. While this overhang will help balance sheets as business picks up, it will also have a dampening effect on the breadth of the recovery by providing a cushion that will drag capital expenditures and investments in plant and equipment.

The current trade deficit widened in the 2005 first quarter, as consumer demand for imports continued to rise. This rise was offset in part by increases in exports of goods and services, although this increase did not rise at the same pace as imports. Given global conditions and the domestic economy, the deficit is expected to continue to widen, heightening concerns about the ability and willingness of the world to continue to finance domestic purchases in the United States.

Reflecting on the various business sectors, a number of observations give insight into the underlying market fundamentals. With respect to financial services, overall demand for loans has been strong from a number of sectors. Mortgage demand has been somewhat mixed, especially on the refinancing front, although the continued flattening of the yield curve has left rates attractive. Tourism activity has picked up, providing much-needed relief to that sector. In some markets, hoteliers have been able to boost room rates along with occupancy, helping the sector recover from the recent doldrums.

While passenger activity is up among airlines, the competitive situation has not been sufficient to allow ticket prices to rise. Going into the busy summer season, airlines are expected to benefit from high load factors. Increased passenger volume coupled with moderate price increases should boost revenues. Unfortunately, rising fuel prices and pressure to address unfunded pension plans may undercut gains.

The bottom-line outlook for business activity is generally positive, with recent gains suggesting that periodic ripples will not be sufficient to derail the recovery.

**Stock Market**

The stock market has experienced a difficult time recovering from the dramatic declines of the late 1990s. The fact that price-earnings ratios are above long-term, historical averages has created angst among
some investors. However, some observers argue that high prices are warranted in the face of low interest rates and economic recovery. On the other side of this argument is the fact that companies have excess capacity, making it unlikely they can parlay low-cost debt into a competitive advantage as they gear up to respond to improved demand for goods and services.

Going into the historically flat summer, investors are expected to slow down. The result is less volatility than earlier in the year, when the market’s response to short-term news and earnings reports was more pronounced. The past volatility is likely to trigger more interest in larger cap stocks, as investors seek positions that are more defensive and seek value rather than higher yielding growth. Investors can look toward the fall for a more accurate reading on the market.

**Consumer Confidence**

Consumers appear to have learned how to adjust to economic news. Just as economic indicators have vacillated, consumer confidence has experienced a series of gains and losses, with no clear direction in sight. Consumers continue to have the same fears as business leaders, although bargains and the lack of significant negative news seem to draw out more of the “glass is half full” attitude.

Assuming interest rates and inflation remain low (which is likely) and import prices remain attractive, consumers should continue to respond to economic improvement in a positive manner, while moderating their downside reactions to the periodic bits of bad news. Thus, the gap between consumers’ feelings about their current situations and future expectations should remain stable. Despite this relatively benign view, it should be noted that consumer attitudes about current situations are likely to respond negatively to unexpected inflation. Thus, during the summer and early fall, prices at the gas pump and grocery stores will be important barometers of consumer confidence.

Similarly, given the recent honeymoon with homeownership and the fact many homeowners have tapped into their newfound equity, the fate of the housing market will play a major role in forming consumer attitudes.

Since there is little to suggest a major shock is imminent and employment gains seem to be holding if not gaining a bit of ground, consumer attitudes should be on a moderately upward tilt.

**Retail Sales**

On the retail front, gasoline prices have proven to be sticky and a drag on sales. Inflation fears have rippled over to the retail arena, although the impact of expectations for further inflation has been tempered. Overall, retail sales have continued to be mixed, with sales up moderately on a month-over-month basis and strong relative to the year-over-year figures.

Despite increasing competition among retailers and store formats, mall tenants have experienced relatively healthy gains, lagging the overall market slightly on year-over-year figures. Department stores fair particularly well, leading gains during the 2005 second quarter even though their relative performance benefited from weak prior sales levels. Higher-end retailers continued to do well, with some of the moderate stores also benefiting from consumer activity. On the other hand, discounters for whom core customers were most affected by gasoline prices and concerns over the overall economy fell off the pace.

With respect to regions, results were mixed with some experiencing disappointing results in the second quarter due in part to unseasonably cool weather. Automobile sales have been particularly troublesome, especially for SUVs and light trucks that have suffered the most in the face of high gasoline costs.

Going into the summer, retailers appear to have realistic expectations, with outlooks that have been moderated by the economic reality facing consumers. This should lead to solid but unspectacular gains, with some upside potential if the employment picture and consumer confidence pick up.

**Housing Market**

One of the exceptional, and increasingly perplexing sectors of the economy, has been the housing market. In particular, the extended housing cycle has received increased attention, with some suggesting that the United States faces a significant housing crisis that could throw the economy into a major tailspin. Indeed, the housing market has caught the attention of Alan Greenspan, who has suggested that many housing markets have been “foamy.” While some have been advocating a doomsday scenario, most observers continue to defend the sector and suggest that the market should be able to make the transition to the next stage—whenever that occurs—rather smoothly, with moderate adjustments rather than radical corrections.
Additional scrutiny of the housing market is expected as it moves into the late stage of the cycle. This scrutiny will come from a number of sources, ranging from regulators seeking to avoid a major market collapse, to advocates concerned about housing affordability and the crisis of workforce housing, to homebuilders seeking to find the appropriate balance between supply and demand in their targeted markets.

Housing valuations are likely to come under more scrutiny as well, with appraisers being caught in the market’s feeding frenzy. While some appraisers may have succumbed to pressure to support inflated values, it is important to recognize that the market is actually paying inflated prices. In terms of best practices, the challenge to appraisers is to provide factual reports on adjusted transaction prices rather than opining on the sustainability of such prices. This latter opinion is properly left to buyers, sellers, and lenders, who make the market and bear the risk.

The housing market has played an important role in the economic recovery and in the overall economic scene. A number of factors have contributed to the strength of the housing market and the length of the bull run.

- First, rates on fixed-rate mortgages have continued to hover around record lows, fueling housing demand, sustaining inflated values, and contributing to further price increases.
- Second, the demand for ownership housing has outpaced demographic statistics, with gains in prices benefiting in part from dramatic increases in the purchase of second homes. Similarly, an increasing number of households have turned to single-family residences as investment properties, buying properties in anticipation of rental income and continuation of dramatic price appreciation that has characterized many markets.
- Third, lenders have become more creative, providing homebuyers with a range of new mortgage products (e.g., limited-term interest-only mortgages, 40-year mortgages, and no-downpayment mortgages) that have enhanced purchasing power of households.
- Fourth, the secondary market has continued to expand, with strong capital flows helping sustain origination volume and helping lenders avoid surges in their own mortgage portfolios.
- Fifth, although homebuilders have cranked up capacity and have held starts at high levels, lags in production have created a shortage of product that has added inflationary pressures. This phenomenon has been especially acute in growth-controlled markets where the supply of developable land has been constrained and in markets where infrastructure improvements have lagged growth, creating a premium on scarce properties with logistical advantages.

Despite rising concern over the sector, homeowners and builders who have benefited from the strong gains remain confident. While not expecting the boom to accelerate further, builders have a generally positive outlook for strong sales through the end of 2006. However, in certain overheated markets, there is a growing potential for fairly abrupt and dramatic correction in prices. This risk can be explained by reference to two long-standing elements of mortgage underwriting: the buyer’s ability to pay and the buyer’s willingness to pay.

An example of where the ability to pay could be at risk is the situation where a significant share of buyers have extended their purchasing power by relying on alternative loans that shift interest rate risks to their already strained budgets. This situation is related to the fact that many of these marginal buyers stretched their finances to access housing and may not be able to afford rising mortgage payments. This situation also reflects the fact the buyers have little cushion to respond to unexpected financial drains (e.g., health crises, job losses) that could pop up at any time.

An example of risk associated with the willingness to pay is the situation where investment-driven goals have supplanted (vs. supplemented) the demand for shelter and have led to purchases of rental housing with little thought to the downside risks attendant with investment properties. This has occurred in both single family and multifamily markets (“condo fever”), where transaction prices have been driven by speculative investors.

Despite the need to recognize the potential for such negative scenarios, the good news is that there is limited danger of widespread correction in the housing market over the near term. However, there is a growing likelihood that there will be significant downward pressure on housing appreciation rates during the next phase of the housing cycle. If interest rate increases are moderate, and the economy
recoveries, the market may make a smooth transition to times that are more normal. Over the near-term, the prospects for such macro forces and longer-term adjustments are likely to make the homebuying decision more stressful than normal for those who may be buying at the top of the market. This angst will be especially acute among potential homebuyers faced with limited housing stock and a pool of competing buyers.

Overall, the outlook for the housing market is solid, but a bit tempered from the levels of the recent past. At this point, the sheer momentum in the housing market and limited risk of a surge in long-term interest rates suggests that the sector may continue to power on, albeit at a more moderate pace.

**Real Estate Outlook**

**Market Overview**

In general, commercial real estate markets have experienced moderate improvement. Office leasing activity has been on the upswing in some markets, and this has helped stabilize rents. Construction activity also has been tempered, which is a welcomed change since demand fundamentals remain uncertain and excess capacity still plagues many markets. Some of the thinner submarkets surrounding major urban markets have seen a dramatic improvement as firms in selected industries have begun to focus on expansion to catch the economic wave. The commercial real estate market can best be characterized as firming up around the bottom, rather than as having passed the trough. The good news is that the real estate recovery is on pace with investor expectations, reassuring investors who paid up in hopes the bottom had been reached.

The real estate recovery is expected to continue to lag the overall economic recovery and fundamentals at the national level should continue to gradually improve through year-end and into 2006. Thus, the outlook is for much of the same, with tenants beginning to posture for the long-awaited recovery; this should lead to some opportunities to lock-in longer-term deals.

**Office Market**

The office market has enjoyed some good news on the spatial side, with solid but unspectacular leasing activity reported in a number of markets. In general, the suburbs are enjoying an uptick, with central business districts lagging. In some markets, conversion of Class B and Class C space to residential or mixed-use developments has created some supply contraction that has improved the demand/supply balance. In some urban markets, the supply of large floor plates has diminished, creating upward pressure on supply. There are few markets where rents are actually increasing, suggesting that the bottom may be in sight.

On a positive note, concessions seem to have declined. Tenants are weighing the desire to lock-in space for the long-term against the desire for flexibility. Over the near-term, the tenants’ market is expected to continue, with a gradual shift in negotiating power tied to the economic recovery.

Investment activity remains heated in the office sector, especially for larger properties that have solid rent rolls. While investors seem willing to wait out the eventual recovery in rents, there is still some downside risk for pro forma incomes. Indeed, in some markets there is a potential for further erosion in net operating incomes for existing properties, especially those with tenant turnover. There is also some risk to cash flows based on improving occupancy rates. This is especially likely in properties where tenants moved up to higher-quality space at lower rents earlier in the cycle, but now are seeking to migrate to more affordable space that fits their long-term needs and ability to pay.

Regardless of such risks, investor demand for top-tier properties remains strong, with institutional players competing with foreign investors whose appetites and pricing models have been subsidized in part by the cheap dollar. This situation is likely to continue, resulting in new, record-breaking transactions in some markets, especially if construction remains tempered. Due to the somewhat staggered nature of the economic recovery and excess capacity, the office market’s near-term prospects are for much of the same, with moderate improvement in demand and limited new construction.

**Retail Market**

Despite a few bumps in the road, the retail sector continues to be resilient due to consumer sales. Helping the sector has been the general moderating of new retail construction, and the dramatic fall in regional mall construction. Activity in lifestyle centers and mixed-use projects has increased as tenants seek overlooked and new niches. A secondary objective of these tenants is to hedge against reliance on regional
malls and to ensure that they retain market share. Developers can be expected to continue to create new solutions for tenants seeking new outlets, helping fuel new construction. The good news is that such activity has been manageable, with few signs that the market will overheat due to a surge in new stock.

In some markets, owners of retail properties have been able to push rents up a bit, a welcome difference from the stickiness that characterizes most other property types. However, rent increases have only worked in situations where sales revenues have justified higher rents, with tenants focusing on occupancy costs that stay in line with competitive norms and provide unit profitability. Retail properties in which tenants are underperforming will be subject to cutbacks as tenants focus on profit rather than on market share as a driver of square footage. Tenants also will be looking to new technologies and innovations to increase productivity of existing stores and thus spread out real estate costs over a higher base.

Investor demand will remain high for retail investments. Particularly hot will be smaller grocery-anchored properties that have dominant regional niche grocers, which are perceived to have a franchise position that insulates them from super-store competition. Similarly, investors will be aggressively looking for retail investments that can be repositioned or enhanced to create value and capture higher returns than offered by more passive investment strategies. In essence, the relatively strong near-term historical performance of retail has emboldened some investors to move out on the risk spectrum in search of returns, with proven properties providing a cushion or floor on sector returns.

**Industrial/Warehouse Market**

In 2004, the industrial market benefited from the combination of strong investor interest and improved market fundamentals. The result was an increase in construction activity as developers cashed in on the anticipated pick-up in manufacturing. In the 2005 first quarter, however, new construction activity fell back in line as manufacturing stumbled a bit. This supply correction is noteworthy; it was welcomed by those concerned about the spatial side of the equation. The result has been a gradual increase in market balance, although some markets and segments continued to struggle with excess capacity.

The distribution and wholesaling segment of the industrial sector has continued to enjoy a recovery in fundamentals, with strong imports and moderate increases in exports helping fuel demand. The supply of large blocks of space has also contracted, with availability rates dropping into the single digits. The result has been a modest improvement in vacancy rates, with some markets beginning to respond with a wave of new construction. In general, the industrial sector has behaved much as expected, helping attract additional capital and holding prices.

The acquisition of Catellus Development Corporation, an industrial real estate investment trust (REIT), by ProLogis, another industrial REIT, testifies to the strength of the sector and the posturing going on to respond to opportunities created by the economic recovery. Private investors also continue to clamor for industrial product, although deal size and pricing has remained problematic.

Given the prospects for a pick up in economic activity and continued strength in imports, the outlook for the industrial sector is for solid, but not stellar, performance. Throughout the balance of 2005, fundamentals in the industrial sector should continue to improve, ultimately translating to moderately higher rents. In this environment, investors will continue to focus on contemporary facilities that can compete in the global supply chain, placing a premium on such assets.

**Apartment Market**

The apartment market has been through some difficult times, with rising vacancy rates as tenants have moved to homeownership. Indeed, during the 2005 first quarter, homeownership rates continued to edge upward, a testament to low interest rates and the lure of housing as an investment. In the current environment of moderately rising to flat long-term interest rates, homeownership should continue to attract tenants. However, there are some signs that the market is returning to equilibrium and that rental housing will once again attract tenants seeking affordable shelter that has the advantage of flexibility in terms of mobility and financial commitments.

Improvements in market fundamentals are on the horizon, as demographic forces and the relative lack of new construction increase demand. While vacancy rates remain high in a number of markets, concessions seem to be softening, which suggests that the sector may be bottoming out. The construction activity that is occurring appears to be concentrated in markets that can handle new supply. Multifamily con-
struction, either freestanding or as a part of mixed-use development, has also been stimulated by the movement toward urban revitalization in a number of key markets. In some of those same markets, condominium conversions have helped contract the supply of competitive space, which has set the stage for an improvement in rental market fundamentals.

Despite these additions, there is little risk of a major surge in new construction. At the same time, there is little risk of another wave of interest rate momentum to shift renters to ownership. Thus, during the balance of 2005, apartment vacancy rates are expected to continue to decline, especially if mortgage rates begin to run up. Household growth associated with the economic recovery could also help the sector, especially in markets positioned to take off in the next economic wave. In the meantime, investor interest in apartment projects will remain strong. This situation should be echoed on the debt side of the market, which has already seen an increase in market share relative to other property types.

Real Estate and Capital Markets Capital Market Overview

Over the past year, real estate capital markets have been stuck in hyperdrive. Going into the summer of 2005, the markets continued on the same track. However, the real estate market relies on market fundamentals over the long haul, and observers have been reassured by the gradual improvement in those fundamentals. Indeed, pricing levels for commercial real estate are at historical highs. In this environment, sellers are finding it a great time to move lesser-quality assets as the market is more forgiving. Similarly, stubbornly low cap rates have enticed long-term players to cash in on the opportunity to sell core assets at record prices. As the market begins to sense an inflection point, or at least a bottoming-out of yields, it is likely that better product will come to market. As such, some of the recent record transactions may be short-lived, signaling a “frothy” period in the commercial market that may mirror that of the residential market.

One risk that some investors and lenders are concerned about relates to the potential expiration of the Terrorism Risk Insurance Act at year’s end. Since the Act has provided much solace to investors, there is some risk that the market could stumble if it is not extended. This could have a significant adverse impact on the commercial real estate mar- ket, since up to three-quarters of properties have conditional coverage that depends on the Act. This issue revolves around one of capacity for coverage, with the potential for disruption of the transaction flow until the market figures out how to price the shift in risk. The commercial mortgage-backed securities (CMBS) market has already begun to hedge against this risk, spreading some larger investments across different loan pools, and mixing them with smaller properties that are unlikely to be targeted. In general, market forces may well pressure an extension of the Act, an assumption that recognizes the important role that the real estate market plays in helping propel the economic recovery forward.

Construction Activity

During the first half of 2005, commercial construction activity rose moderately, with healthy gains around 9% on the year-over figures. Private construction has been solid, with residential activity increasing during the period and coming in much stronger than in 2004. Manufacturing construction has also been strong compared to the year-over, although weak growth in this sector in 2004 explains the gain more than improvement in the sector itself. Construction in the lodging sector has tapered off during 2005, down significantly from the year-over figures; this helps to explain some of the strength in the hotel sector. The losers on the year-over basis include amusement and recreation, which is understandable in such economic times.

Public construction has been relatively flat, reflecting the continuing budget crises in communities and the lack of major federal support for construction. Infrastructure investment has not kept pace with demand and deferred investment. Thus, there is little hope for near-term relief for beleaguered commuters stuck in traffic, with critical infrastructure also lagging earlier expectations of a surge in funding.

Going forward, construction activity is expected to pick up moderately, with some upside potential in the nonresidential sector, and some tempered but positive numbers in the residential sector.

Commercial Mortgage Market

During the first half of 2005, the commercial mortgage market continued to operate at a frenetic pace, with plentiful capital making it difficult to find placement opportunities. To maintain volume, lenders
have used more creative means of sourcing product and have expedited approval processes. The pressure to place capital has forced lenders to accept narrower margins. The flat yield curve and the symbiotic relationship among long-term investments, has led to the tightening of spreads, allowing real estate to compete with other asset classes.

There is some evidence that lenders are continuing to ease up on underwriting standards to secure deals. Recently, lenders have begun to show some signs of concern over the possibility of a commercial “bubble” and are trying to widen spreads to cover risk. Unfortunately, capital flows are such that these efforts are hard to implement without widespread recognition of an impending correction. This situation will be watched carefully by the Federal Reserve and other industry observers in both the residential and commercial markets.

There is a concern about the sustainable nature of current pricing, especially for floating rate deals where a rise in rates may erode debt-coverage ratios if net operating income lags. The reliance on nonrecourse debt, and the involvement of nontraditional players without a long-term commitment to the asset class, could trigger an increase in foreclosures. However, such events are likely to be isolated and manageable over the near term. This is evidenced by the fact that in the current market, a number of underperforming loans have been able to obtain financing, due to increasing equity positions, or have been repaid upon sale.

The CMBS market continued its explosive growth in the first half of 2005. While some of this activity was an overhang from 2004, market conditions suggest that issuances in 2005 will set new records. Mortgage performance seems to be holding up well, with delinquency rates increasing, but still well below long-term averages. There was a slight increase in troubled loans in some sectors, such as multifamily and health care, but there have been no major issues, and there are some signs of recovery on the horizon, especially for the multifamily sector. Another sign of the durability of the CMBS market is the magnitude by which upgrades exceeded downgrades for currently issued transactions. This outperformance is likely to continue, although it is expected to gradually fall back to long-term averages.

As with CMBS, collateralized debt obligations (CDOs) for commercial real estate have increased dramatically and could double volume in 2005. In general, CDOs are smaller than CMBSs, and have higher credit exposures because they are comprised of junior CMBS bonds and subordinated tranches. The product provides more flexibility to portfolio managers interested in matching terms. In effect, issuers can substitute collateral, providing the ability to maintain size and asset quality to stabilize underlying pool.

In terms of spreads, the market remains heated with little risk of a significant widening of spreads. There is some evidence that spreads may have hit a floor, as suggested by the market reaction to some issues. Overall, the commercial mortgage market is well capitalized and ready to help sustain the current market and current pricing.

**Private Equity Market**

Strong capital flows continue to characterize the private equity market. These capital flows are unlikely to moderate over the near term, suggesting an unusually active summer. The gradual improvement in market fundamentals has offered some solace to owners who have been willing to absorb lower current yields. The downside risk for cap rates in the near-term market conditions has not deterred buyers. Indeed, the potential for a bottoming out in appreciation has led to an increase in activity, especially for coveted core properties. A number of private investors who have been locked out due to yield requirements are moving out on the risk spectrum. Unfortunately, the reward/risk premium is lower than many are likely to accept due to stiff competition, suggesting a further disconnect between the capital and spatial sides of the market.

Over the past 12-18 months, tenants-in-common investments (TICs) have played an increasing role in the real estate market. Briefly, TIC investors are groups of investors who purchase individual, undivided interests in properties, or different interests in terms of size and/or allocation of costs and benefits. In a TIC exchange, interests in real property are exchanged for security instruments. Although initially focusing on Section 1031 tax-deferred exchanges, this segment has taken on a significant new intermediary role connecting the capital market with the spatial market. This expanded role came about because of IRS Revenue Procedure 2002-22, which established that TICs could qualify under Section 1031 as an interest in real property rather than a business entity. The strong interest in real estate investments among
individuals and the IRS ruling set the stage for TICs to become a real force in the commercial real estate market—some $2 billion in sales in 2004 and the likelihood of double that amount in 2005.

The pooling of capital among these investors has allowed them to move up the food chain, nibbling away at traditionally institutional-grade property in terms of asset size and creating even more price pressure. TIC investments have some attractive advantages for investors including access to larger and higher quality properties than if investing individually; access to fixed-rate, nonrecourse financing; centralized management coordinated by TIC sponsors; and added flexibility in structuring positions without significant complexity. Since the market has grown so dramatically, there is some concern that TIC investors may not be protected from the excesses of the market, consequently pitting smaller investors against more formidable institutional foes.

There are a number of signs to indicate that the TIC movement will be an enduring force in the real estate industry. Thus, at least over the near term, the cumulative impact on capital flows and real estate prices will continue. Indeed, even if there was a moderate market correction in the commercial real estate market to roll back excesses, the exit options and other nuances built into the industry should provide some insulation. Going forward, it is likely that the TIC industry will face added scrutiny that may be proactive or reactive depending on how the market unfolds. For example, the National Association of Securities Dealers (NASD) has reminded members that TIC investments may be considered securities under federal securities laws and NASD rules. The Securities and Exchange Commission (SEC) has yet to indicate that TICs are subject to SEC requirements. Until the SEC steps up and offers definitive guidelines, the industry faces a number of risks related to potential abuses and uncertainty.

The confluence of domestic and foreign capital flowing to the private market suggests the balance of 2005 will be particularly frustrating for institutional investors who keep a close eye on market fundamentals and have disciplined buy/sell strategies. Some of these players have been waiting for the market to settle down; unfortunately, due to the almost insatiable demand for product, the market has overreacted to short-term blips in occupancy and positive spins, and forced even more pressure on prices across the board. The good news is that when the market ultimately does settle down, a number of the players who are tactically underinvested on their long-term allocations can be expected to step in and fill the void. Despite this pent-up demand, there is some risk that the road to recovery may not be as smooth as some envisioned if the economy stumbles or real estate markets overreact. However, the real estate market has so much momentum that short-term disruptions are unlikely.

**Public Equity Market**

For the first quarter of 2005, REITs were down in widespread losses, providing the lowest quarterly performance in over 10 quarters of solid returns. Even with this disappointing performance, however, REITs still beat out the NASDAQ. Due in part to weak performance, REIT equity issuances fell off dramatically in the first quarter. In terms of REIT activity, portfolio acquisitions were the dominant theme with some large deals closing in the first quarter. Joint ventures continued to attract interest, although finding win-win situations in the current equity market

James R. DeLisle, PhD, is the Runstad Professor of Real Estate and Director of the Runstad Center for Real Estate Studies at the University of Washington.

Prior to his current assignment, DeLisle was the director of the Real Estate Research Center and the coordinator of the e-Commerce Program at Georgia State University. Before returning to academia, he was an executive vice president and head of strategic planning for Lend Lease Real Estate Investments, a global company and the successor firm to Equitable Real Estate where he founded the Investment Research Department and directed it for nine years.

He has published widely in academic and professional journals. DeLisle received his BBA in real estate and MS in marketing research from the University of Wisconsin. He received his PhD in real estate and urban land economics from the University of Wisconsin under his mentor, the late Dr. James A. Graaskamp, one of the leading academic proponents of applied real estate research. Contact: T 206-616-2090; E-mail: jdelisle@u.washington.edu
remained a challenge. Net asset value premiums did compress, with stocks trading around par on asset value toward the end of the first quarter.

In the second quarter, the REIT picture brightened once again, with total returns for equity REITs making up for lost ground. Through the end of May 2005, equity REITs returns for the year-to-date were led by regional malls, with retail overall leading the major property types. The industrial/office category was flat, with moderate gains in office offset by industrial and mixed industrial/office REITs, which lagged all property types. The residential sector was down moderately, while self-storage, which was under 5% of the total, led all property types. Mortgage REITs remained down, with residential and commercial pushing 10% declines. The outlook for the REIT industry is somewhat guarded to moderately positive. Compared to other sectors, REITs should remain attractive for investors assuming real estate market fundamentals continue to improve.

**Conclusion**

Going into the summer of 2005, the real estate market continued to be healthy. Capital flows have been strong and should remain so over the near term. While not without risk, the economic recovery appears to be on track, suggesting the potential for increasing demand for space.

In a growing number of markets, fundamentals have begun to improve, albeit at a tempered rate. This improvement can be attributed in part to the fact that construction activity has remained largely in check. This situation is likely to hold over the near term, although some markets can expect increases in construction. In this environment, transaction volume should remain solid, with sellers still maintaining the upper hand for a while. Given the competition for product on both the debt and equity side of the market, there is little risk of summer doldrums as the market seeks its natural bottom and players posture for the next wave of prosperity.