

The Perfect Storm Rippling over to Real Estate

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Commentary

The first half of 2008 has seen erosion in economic fundamentals. While some argue that the economy still is not in a recession, consumers and businesses and government budgets are all feeling the pressure of a contraction. Indeed, there is little positive news to suggest a near-term turnaround in economic fundamentals. Rather than debate whether there is a recession, attention is more properly focused on how deep the contraction will be and how long it will last.

Many of those who were in the “it-will-be-fine-by-2009” camp have tempered their predictions and are now expecting further erosion in market fundamentals and a delayed recovery. While some are more optimistic, the general consensus among emerging economic signals suggests the economy is in for a difficult period.

Given the financial stress many households are facing, the debates on the economy and what to do about the housing crisis, high and sticky gasoline prices, and the rising costs of food and other essentials are likely to catch the attention of voters. As election campaigns get into full swing, the economy is likely to move to center stage. Debates will occur on the national stage, as well as on many local stages as jurisdictions struggle with declining revenue streams. Unfortunately, there are no easy solutions as the economy continues to wind down.

On the real estate front, the housing market certainly has more problems in front of it as the sector contracts to find the bottom of the inflection point. The commercial real estate market is faring somewhat better, although tightened credit, weakening employment, rising costs, and rekindled interest in risk taking is forcing many on the defensive.

Clearly, the heyday of the housing and commercial market is behind us, with many challenges ahead. The positive news is the commercial market has been able to avoid a major collapse due to the absence of industry-wide overbuilding, voluntary curtailment of new construction, and continued appetite for product—albeit more selective—among institutional investors. However, the commercial sector will not escape the economic downturn unscathed. In particular, market values will face downward pressure as capitalization rates rise to reflect higher risk premiums and a return to longer-term averages. In addition, investors facing refinancing of bullet (balloon) loans and buyers dependent on new financing will face added scrutiny. In addition to tighter underwriting standards, many borrowers will be forced to accept recourse loans, turning back the pages to the times where lenders originated loans for their portfolios rather than for securitized offerings.

The Economic Environment Economic Growth

The pace of gross domestic product (GDP) growth remains disappointing, with limited prospects for a seasonal surge in the second half of the year. On something of a positive note, a June report showed that manufacturing activity outperformed expectations although the improvement was moderate and just slightly above the expansion threshold.

However, employment figures and other signals are likely to put a dampener on any optimism that might be gleaned from the figures. The fact that the United States shifted to a service economy also reduced the importance of the manufacturing sector as a true leading indicator. Although, when combined with the

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pattern of leading indicators, the data suggests that the economy may be able to avoid slipping into a major recession.

The near-term outlook for GDP is tempered by a number of factors that suggest the current weakness is likely to continue into next year. Diminishing state coffers due to declines in sales and income taxes are likely to put a dent in state employment figures, creating budget pressures that could curtail additional spending. While exports might provide some upside potential due in part to the cheaper dollar, the global economy is slowing down as well, dampening demand for U.S. exports.

Rising energy costs are affecting many markets across the globe, with little respite in sight as the demand for energy rises on the global front. Similarly, shipping costs are rising and placing upward pressure on import prices, with some additional upside risk if the labor unrest on the docks cannot be resolved. Increasing tensions in the Middle East punctuate the tenuous nature of the global economy and the worldwide dependence on foreign oil.

Employment

Through the first half of 2008, a contraction of employment has been symptomatic of the slowing economy and lack of confidence among business leaders. Declining employment levels are the most significant in the financial services sector, which is still reeling from the spillover effects of the subprime mortgage market and the expanding credit crisis.

However, other sectors have not been immune to the slowing economy. According to the latest statistics, employment continued to fall in the following sectors: construction, manufacturing, retail trade, and temporary help services. On the positive side of the spectrum, health care, education, and local government employment have avoided some of the downward pressure. However, the latter sector is likely to start feeling the pressure in earnest as the dramatic erosion in the coffers of local government hit home and forced budget cutbacks.

As in other contractions, the softening in employment has been hardest on marginal households who are at the mercy of the economy. The plight is evidenced by the challenges students faced as they struggled to find summer employment. In the second quarter, unemployment rates continued to rise with a significant increase in newly unemployed and an increase in the long-term unemployed.

Given the current economic malaise and lack of any obvious turning points, the job market is expected to remain soft over the near term with further increases in the unemployment rate. Additional layoffs are possible as companies continue in their defensive mode and wait for signs that the bottom has been reached. However, absent a major shock to the system or unexpected occurrences, the softening should be tempered although this outlook will provide little solace to those who have lost their jobs and are struggling to find new positions.

Inflation and Interest Rates

Inflation is taking center stage as a major factor in the erosion of consumer confidence levels. The most obvious of these pressures is at the gas pump, where consumers are likely to see little respite from record prices throughout the summer. Increasing energy costs are not only plaguing U.S. consumers but also causing concerns that spread from Western Europe to Southeast Asia.

Another inflationary area that is creating more angst among consumers is a dramatic increase in food prices due to a confluence of events ranging from flooded farmland in the Midwest to drought conditions in much of the South. At the same time, costs of medical care continue their upward spiral. Commodity prices are also on the upswing, with prices close to record levels. This upward pressure is particularly strong on dollar-denominated commodities. These conditions are expected to continue creating upside risk for inflation.

The inflationary forces on the domestic front are affecting the global economy, leading to a call to increase loan rates to thwart inflation. The price of oil is likely to remain a major wild card, with efforts to moderate energy demand in the United States expected to have limited impact over the near term. Rising global demand for energy is likely to continue to put pressure on prices. The role of speculators in driving up oil prices has provided insights into some of the forces behind the recent spike in prices.

While stirring up a lot of debates and calls for intervention, the problem of spiked prices is too insidious and ingrained to be resolved with minor fixes or regulations. This is especially true since the practice is pervasive, affecting global commodity prices across the board. Thus, debates are likely to add to the growing cynicism of the public, but lead to little real action, especially during an election year where special interest groups have a strong hand.

The decision to hold interest rates at their current levels typifies the difficult tradeoffs the Federal Reserve (Fed) must consider as it plays its hand to balance anti-inflationary efforts against the risk of a full-blown recession. Although there was hope for some easing on interest rates, most believed rising pressure on the inflationary front would be sufficient to prevent the Fed from trying to stimulate the economy. Indeed, increasing inflationary pressure due to factors beyond the control of the Fed is likely to force it to work on the interest rates side, a key variable it does control.

This situation is likely to prevail through the balance of the year as pressure on inflation grows. Thus, the outlook is for a continued increase in inflation that is likely to trigger a moderate increase in interest rates. The nagging concern over the state of the economy is likely to moderate such increases however, although at the end of the day, the economy may prove more troublesome than inflation.

Business Indicators

On the business front, a number of factors triggered an increase in angst among corporate America although not all signs were negative. For example, the leading indicators showed some improvement during the second quarter, although the index continued below long-term averages.

The manufacturing sector reported some moderate improvement, although the levels remained disappointing and do not point to an expansion. Factory orders picked up a bit in the second quarter, although durable goods orders were off as consumers deferred major purchases. Inventory levels were relatively flat, with a slight decline in nondurable goods as manufacturers tightened up the supply chain and sales picked up a bit more than expected. Productivity levels remained high, taking some pressure off of wages and allowing companies to cut back on employment levels without compromising output.

The automobile industry was particularly hard hit as manufacturers were forced to pull back on the more profitable truck and SUV lines in favor of smaller, more energy efficient cars. While interest in hybrids and high-mileage vehicles is likely to grow, it will be some time before the domestic automobile industry can catch up with demand. In the meantime, contraction in the automobile industry had widespread implications for the broader economy, ranging from plant closings to layoffs.

In the six-month period leading into late spring, business confidence levels tapered off in a downward pattern. On a welcome note, confidence levels exhibited a modest improvement at the end of the quarter. Interestingly, this improvement came from real estate and financial services sectors that had been the hardest hit and had led the downward spiral, taking many other sectors with them.

In the troubled sectors, some of the bleeding is likely to continue and most sectors have pared back to the point that the bottom is in sight. Unfortunately, the bottom may prove to be a long trough with a series of ups and downs as the credit fallout continues to play out in the broader market.

Stock Market

The year has turned out to be particularly challenging for the stock market. Investors who were already on the defensive in light of the slowing economic growth continued to struggle to find safe havens that might be immune to such forces. The resultant series of declines in the stock market started to signal a bear phase, with three quarters of decline and few prospects for a near-term recovery. The hardest hit sectors were financials and automobiles, although the damage was widespread.

Despite added scrutiny from Congress, commodity speculation remained rampant. Indeed, commodities were one of the few areas where investors could look to more upside, albeit not without attendant risk going forward. While pressure will likely mount to try to curtail speculation, the political environment and election-year status is unlikely to lead to any meaningful action. However, more disclosure requirements and further studies are likely to lead to some additional regulatory requirements. While the debates will rage on as to what, if anything, can and should be done to curtail speculation, the market is likely to experience even more volatility.

It is unlikely the Fed will be able to do more to intervene in financial markets, leaving little hope of bailouts if individual banks run into more trouble. At this point, financial firms are trying to shore up their own balance sheets, raising billions in capital to maintain operations. These firms will be closely watched by investors, although most have either discounted problems in the sector or continued to eschew it until it is clear the credit crunch has fully played out. Investors will pay close attention to earn-

ings announcements at the beginning of the third quarter, with expectations of a decline in earnings.

Fortunately, these expectations are already priced in the market, although some surprises are likely to occur as ripple effects from the credit and energy crises spill over to seemingly unrelated sectors. While investors' eyes will be focused on digging out some good news, there are few obvious measures that could signal a turnaround. With little prospects for a housing recovery and the economy showing signs of a widespread slowdown, the stock market could experience further erosion.

Consumer Confidence

The debate over whether the U.S. economy is in a recession has little meaning to American consumers who are seeing price increases on all fronts. Continued erosion in the housing market, the trends of rising prices for food and energy, a slowing economy, and softening of employment have taken their toll. To add insult to injury, the seemingly seasonal pattern of severe storms, flooding, and raging wildfires have combined with concern over the economy to create something of a perfect storm that has caused a collapse in consumer confidence.

Many areas in the United States have been designated disaster zones, making owners eligible for some grants and assistance, although for most, such assistance is unlikely to be sufficient to offset the devastating losses, both emotionally and financially. In some respects, the plight of households who found themselves literally underwater as a result of the floods in the Midwest and South is analogous to those who find themselves financially underwater on their homes, with values below mortgage levels and credit almost impossible to access.

Given the fragile nature of consumer confidence, additional shocks to consumers could drive confidence levels even further down, pushing them to levels that have not been seen since 2002. For example, a repeat of threats to the integrity of the food supply—as triggered by the salmonella outbreak that devastated the tomato industry—could force consumers to pull back on purchases, eschewing imports and other products of unknown origin and safety. While this is positive for local producers, such a change could drive up food prices even more than the recent surge.

Unfortunately, there are no obvious offsets that could mitigate such pressures and few opportunities to escape the pressures. Indeed, summer travel is

turning into a constant reminder of the difficult times, with record prices at the fuel pump forcing travelers to rethink their plans. Even those turning to air travel cannot escape reality, with airline prices rising, more pay-as-you go charges (e.g., baggage, beverages) kicking in, flight cancellations, and sardine-like conditions being the norm. This situation is likely to get even tougher toward the end of summer as airlines cut back even more on flights.

The weakening of the employment front has placed downward pressure on wages, eroding the purchasing power and confidence of consumers. When combined with record consumer debt and erosion of housing equity, many households are feeling tremendous budgetary pressure. Similarly, rising mortgage rates on conventional and adjustable rate mortgages could put an additional dampener on the housing market and push more households to the breaking point. This situation is particularly acute among those with variable rate mortgages.

Unfortunately, tightened credit standards are making it difficult for even creditworthy borrowers to refinance their way out of their problems, removing one of the bailout options that had helped them in previous downturns. Some banks are also pulling back on equity lines of credit, taking a more conservative approach to avoid additional risk as the housing market plays out.

Not only is this trend curtailing expenditure plans, in some cases it is also raising havoc with credit scores as credit models pick up a reduction in credit lines as a negative signal. The end result is limited access to credit and higher rates as affected households have to borrow at higher rates.

Even those households not directly affected by such manifestations of the credit pullback are likely to be affected by the negative press. Unfortunately, the combination of a softening economy and further corrections in the credit market are likely to play out even further during this phase of the market cycle. With no hope of immediate help coming out of Washington or Wall Street, consumer confidence is likely to struggle with more downside risk as interest rates rise and outstanding credit levels remain at record highs.

Retail Sales

The troubled retail sector experienced something of a rally with a slight improvement in sales. After stumbling early in the spring, chain store sales rebounded a

bit in response to tax rebate checks. Unfortunately, due to the downward pressure of a slowing economy, record consumer debt, and falling consumer confidence the rebates are unlikely to have an enduring impact.

Indeed, many households were not able to enjoy the fruits of their rebates, facing the stark reality that at today's gasoline prices, the average stimulus check might buy them 8-10 tanks of gas. While the automobile industry would like to help by converting them to new fuel-efficient vehicles, record credit levels, plummeting values of existing SUVs, and a shortage of product are inhibiting those efforts.

In the current environment, for a growing legion of households, there is not enough added fuel to support summer vacations, much less splurge on nonessential purchases. The weakness in retail sales is fairly widespread, affecting a full spectrum of the price value continuum. The end result is increased interest in valuable and essential goods versus apparel and luxury items. This situation is likely to carry into the fall, creating a drag on back-to-school sales. At this point, it is likely that stagnant sales will carry over into the critical holiday season.

The tepid outlook for retail sales is likely to be something of a self-fulfilling prophecy, with retailers curtailing purchases and cutting back on inventory. In this environment, a number of retailers have announced store closings, focusing on unit profitability versus market share. Even some of the high-flying retailers with aggressive expansion plans may see many of those capital programs on temporary hold. This cyclical correction may prove to be problematic for developers of new projects, especially those located in marginal areas where sales have been hardest hit. The general retail outlook is guarded, with consumers expected to shift even more attention to the necessities.

Housing Market

Despite grabbing headlines for well over a year, the housing market dominated the economic news. Housing starts continued to plummet as builders are forced to rein in activity and focus on survival rather than margins and profits. The plight of homebuilders is shared by a number of regional and small banks who bankrolled them with construction loans. The concern is justified as evidenced by the spike in delinquency rates for outstanding construction loans.

While banks might prefer to work through these problems, federal and state regulators are expected to put additional pressure on them to address prob-

lem loans regardless of relationships they may have established with homebuilders. The resultant stress will likely force banks to take losses on bad construction loans and curtail loans to projects that are already underway but struggling to meet loan tests. This situation will place added stress on both the financial and housing sectors as troubled loans exceed risk-based capital and delinquency rates rise even further.

Within the homebuilding industry, confidence levels fell off in the second quarter after a brief recovery that proved to be premature. The state of the industry suggests builders will remain in this mode for some time, with attention focused on survival, unloading inventory, and retaining key employees. This situation is likely to prevail for some time, with no bailout in sight for the production side of the industry.

On the demand side, some progress is being made in the form of easing credit to help troubled homebuyers. However, the sheer magnitude of the problem and politics have entered the equation and are likely to limit efforts to bail out homeowners, leaving those in the most severe situations with little hope of salvaging an already difficult situation.

As a result of the current malaise surrounding the residential market, the mortgage market depended heavily on agency purchases, with Fannie Mae and Freddie Mac purchases accounting for over three-quarters of the total market activity. On top of that, Veterans Affairs and Federal Housing Administration activities added another 6% or so, leaving private mortgage activity at an unusually low market share.

Indeed, of the private share, a large percentage was allocated to the jumbo market for which credit remained tight. The bottom end of the jumbo mortgage market received some relief when conforming loan limits were increased providing additional capital flows for upper-moderate income households. This freed up some additional capital to the jumbo market, although most of those loans are being held in bank portfolios.

As such, underwriting standards have tightened as lenders seek to manage risk at the individual property level rather than relying on risk management by transfer, a common strategy during the height of the market. In addition to requiring real equity, these higher standards have turned attention toward borrower quality, which has in turn increased the importance of credit scores for this segment of the market.

While payment patterns are a major factor in credit scores, some households are being downgraded by cutbacks or freezes in home equity lines of credit.

Thus, some borrowers with stellar performances saw their credit scores erode, pushing some down to the point that qualifying for jumbo loans on favorable terms is no longer plausible. The prospects of rising mortgage rates will only exacerbate the challenges faced by homebuyers, with little respite in sight.

Real Estate Outlook

Office Market

During the first half of 2008, the office market experienced a moderate increase in vacancy rates as the slowing economy and layoffs curtailed demand. This trend was especially pronounced in markets driven by financial services where the ripple effects of the credit crisis and housing market collapse are still being played out. Despite the increase in vacancy rates, rental rates held up with moderate gains reported in many central business districts and suburban markets.

However, the softening economy and resultant contraction in demand is likely to put a damper on rental growth going forward. The increase in vacancy rates was a combination of a decline in net absorption and the delivery of new product. In many markets, tenants have also become more tentative, looking for the possibility of lower rents as the market softens further. While attention is being focused at sublease space, there has been no obvious surge in such activity as tenants seem to be cutting back on employment but holding onto space in hopes of waiting out the cyclical downturn.

Despite softening conditions, investor appetites for offices remained fairly strong, with institutional investors still seeking product. Indeed, the implicit capitalization rates in the National Council of Real Estate Investment Fiduciaries (NCREIF) Index tightened moderately. On the public side, office real estate investment trusts (REITs) did not escape the declines in the broader sector, although they did not fall off as much as industrial, shopping center, and lodging sectors. On a positive note, office construction activity tapered off, with developers postponing some deals and speculative projects sitting on the sidelines.

Going forward, office market fundamentals will take on increasing importance as investors and lenders focus on strong assets in solid markets. Given the lack of an overhang of construction, as has been common in other corrections, the office market should be able to weather the near-term economic slowdown. The record prices and low yields of the recent past will give way to longer-term thresholds. Assuming the economy

avoids a recession and there are no major shifts in capital flows, increased demand should dampen the downside risk for the sector.

Retail Market

Many retailers have taken on a defensive posture, looking at culling underperforming operations and pulling back on some expansion plans. Developers have also become more realistic, slowing some projects in the planning process and revisiting development and leasing assumptions for projects in the pipeline. As such, construction levels are expected to taper off, with something of a pullback from the bullish plans many carried into the beginning of the year. Interest has also risen in globalization, with retailers and developers looking offshore in an effort to grow and capture higher returns until the domestic front stabilizes.

In terms of returns, the retail sector has performed reasonably well, with NCREIF returns tying industrial for second place among other property types. Within the sector, larger super-regional malls outperformed other retail subtypes that struggled with flat to negative appreciation rates. The same situation played out in the public sector, with regional mall REITs outperforming smaller centers and free-standing properties, although all experienced negative returns through the end of June.

Despite the challenges the sector takes on, investors continue to seek product, with interest strongest in lifestyle centers that have been in vogue over the past several years. In terms of pricing, capitalization rates have moved up but still remain below long-term averages. As might be expected, prices have begun to diverge, with investors paying more attention to market fundamentals including trade area demographics, tenant quality, and market positioning. The current situation is likely to hold until the economy begins to pick up and consumers get back on board.

Industrial/Warehouse Market

The industrial market tended to provide more stable returns than other property types. Thus, the slowing of the sector in the first half of 2008 was fairly orderly. As the market softened, vacancy rates trended upward as manufacturers pulled back to deal with softening demand. This situation was fairly widespread, with the majority of markets reporting increases in vacancy and only a couple reporting lower rates.

At the same time, absorption rates declined as companies avoided taking on additional capacity until the economy begins to pull out of its downturn.

Due to the shortened pipeline and more elastic supply, industrial construction activity pulled back more quickly than other property types where construction time and project sizes tended to be larger and less able to respond to changing demand.

Despite the rise in vacancy, rates were not out of line with long-term averages, suggesting the sector should be able to weather this stage of the economic cycle without a major disruption. Although manufacturing has cooled off, distribution activity is expected to increase as exports become more attractive.

However, record prices for oil and tightened credit on the global stage have had a dampening effect on demand. This caught some port cities off guard, especially those in which developers made a bet that the combination of import/export volume would fuel an increase in demand for facilities. While there will be some spotty overbuilding as a result, many projects will wind up staying on the drawing boards until the economy stabilizes.

In addition to concern over the volume of new construction, the industry is likely to encounter a number of challenges related to the high cost of shipping goods. That is, given the sticky nature of gasoline and diesel prices, the industry is likely to rethink logistical models and supply chain management to provide for more efficient distribution channels. The end result may be a change in the preferred size and location of demand for warehouse facilities, creating some new development opportunities as well as creating challenges for existing space.

However, such a change is unlikely to render existing institutional-grade stock functionally obsolete, much of which has been developed with such factors in mind, although not to the extent forced by recent events. Looking forward, the industrial sector is expected to continue to attract institutional capital, although capitalization rates are likely to experience upward pressure.

Apartment Market

As a result of the fallout from the collapse of the housing market, the apartment market received increased attention as developers and investors evaluated the spillover effects on rental housing. Due to the unique situation surrounding the housing market, getting a handle on how it will all play out has proven to be problematic.

On the one hand, the fact that the bloom is off the rose of homeownership should shift more house-

holds to rent versus own, placing upward demand for apartments. On the other hand, the surge in new supply that accompanied the bull housing market has left a lot of product on the market, at least some of which will be converted to rental properties.

This situation is most pronounced in the condominium sector. In many markets across the country, the condominium market is facing an even more dramatic correction than the broader single-family market. While both sectors experienced record levels of construction, the supply of condominiums surged as apartment projects were acquired and converted to condominiums.

At the same time, the dynamics of demand growth have proven to be more problematic for the condominium market. That is, in a number of condominium markets, easy credit and the perception that appreciation was a given attracted a lot of speculative buyers who were looking at a purchase contract as a free option, one with limited downside risk. This surge in demand was factored into feasibility studies, fueling even more conversions and new construction, which tended to be concentrated at certain narrow price points. When the market began to turn, these units were given back creating a glut of speculative space and a trend toward re-apartmenting.

Given the volatility in the broader housing market, the apartment market has fared fairly well. Construction activity was relatively modest, with starts remaining below those of the past several years. While vacancy rates have trended upward, the cut-back in new construction activity is expected to take some pressure off the sector as builder confidence wanes and lenders curtail access to capital. Thus, while the economic slowdown may lead to further increases in vacancy rates, once the economy turns the corner, the pent-up demand for housing should be sufficient to reverse such pressures.

However, since much of the new product was built at the same price points, some markets are expected to struggle. At the same time, the demand for affordable rental housing is likely to surge, far outstripping supply. Despite rising interest in such issues, this situation is likely to continue with few solutions on the table and more households looking for affordable rentals as the economy stumbles and inflation eats into housing budgets.

With respect to private investors, demand for apartments should remain strong, although low capitalization rates are likely to creep up as they

come in line with other property types. Interestingly, on the public front, with the exception of self storage, apartment REITs are the only property type that have exhibited positive returns (5%) through the first half of the year. The fact that this comes on the heels of a 25% decline in 2007 suggests investors may think the downside spillover from the single-family market has played out. Whether it has will be interesting to watch.

Real Estate and Capital Markets

Capital Market Overview

In many respects, the commercial real estate market has dealt with the broad-based economic decline in a relatively orderly manner, avoiding a major downturn. This situation can be attributed to a number of factors including the absence of a surge in speculative construction that could have played out if the housing and credit crises had not drawn attention to the broader real estate markets. Indeed, the ripple effects of these trends rapidly swept across the industry, punctuating what many experienced players knew would ultimately come to pass.

However, many of them were caught off guard by the speed and depth of the correction, especially since there was no clear trigger event other than the housing market collapse and the associated credit crunch. While the housing market collapse and the associated credit crunch played on the debt side of the equation, they were not sufficient to offset continued capital flows from equity investors, especially well-heeled investors who could eschew leverage and associated restrictions. However, the commercial real estate market has not escaped the downturn, especially as demand has continued to soften in light of the slowing economy. Going forward, market values are expected to face downward pressure as investors and lenders focus more on the risk side of the equation and capitalization rates move upward toward long-term averages.

The current market conditions are likely to carry through the balance of the year including the important fall season in which institutional investors develop their asset allocation strategies for the following year. With the turmoil in the stock and bond markets continuing to play out, real estate should look relatively attractive, especially for institutional investors, foreign investors, and other capital sources with the ability to step into the market and take advantage of the slowdown. Thus, the market should continue to function, although buyers will be

much more selective and sellers will have to endure, especially those facing bullet loans or needing external capital to maintain operations.

In this environment, negotiations are likely to be much more heated, with fewer bidders and prices more reflective of individual property characteristics rather than the commoditized pricing of the past. As such, sellers will have to take significant losses to sell assets that were bought to satisfy quotas rather than deliver solid, risk-adjusted returns. Unfortunately, thinly capitalized owners who relied on financial engineering and aggressive values to tie up product will meet the same fate of their residential counterparts.

The difference is that, with the exception of weak product, there should be a party on the other side of the transaction, although such sellers will have to take a hit to make investments pencil out with more realistic assumptions that reflect a slowing economy. Market fundamentals will once again play an important part in helping buyers and sellers sift and winnow product to get the pricing right on both sides. Clearly, the days of record prices and speedy transactions are behind us; hopefully, the transition will continue to be smooth.

Construction Activity

The real estate market has been one of the early sectors to experience contraction during this economic slowdown. Declines in private construction outpaced a pullback in public construction, with residential the major drag as homebuilders continued to struggle with excess inventory of land and houses. Housing starts are hovering below one million units, a dramatic decline from the not-too-distant past. As might be expected, single-family starts experienced the strongest contraction, although multifamily starts were down as well.

While commercial construction spending declined through the first half of the year, it remained significantly above 2007 levels. Although new commercial starts are expected to decline in the second half of the year, the pipeline is not expected to dry up completely, offering testimony to the resiliency of developers and their ability to attract capital to take some of the risk off the table. Well-capitalized developers with the ability to put real equity into projects as demanded by lenders are likely to continue to power forward, especially in markets experiencing growth in demand.

The uptick in construction spending suggests the commercial sector was in an expansion mode that might have gotten ahead of itself if the recent economic slowdown had not occurred. Thus, the

softening economy and tightened credit standards may have helped the commercial sector avoid the scale of overbuilding that has characterized the market over the past several cycles.

In terms of property types, with the exception of multifamily, the additions to stock occurred across the board. This diversified activity helped spread some of the risk that might otherwise have hit the commercial market, although some property types and markets are likely to struggle with an overhang of new product because of a contraction of demand.

One of the sectors that underwent significant development was the hospitality sector as operators expanded supply in anticipation of a surge in foreign travel. That situation changed as well; surging fuel prices and a softening economy placed a drag on the hospitality sector.

In terms of construction costs, strong global demand is likely to place continued upward pressure on building products, which will also help reel in construction as the rental market softens due to the weakening economy. This situation will be punctuated this summer when Olympic coverage highlights the almost insatiable demand for real estate and rampant development that is sweeping many emerging markets.

Interestingly, significant capital flows from U.S. institutional players are funding that spurt as investors seek higher returns than available onshore in a fully priced market. Unfortunately, the risk side of such activity has not received as much attention as the return side, especially in light of market data and other information sources that would typically be applied in underwriting comparable domestic investments.

Commercial Mortgage Market

The commercial mortgage-backed securities (CMBS) market has been undergoing a prolonged stress test, with observers waiting to see how the sector will endure the correction that it is facing after a long bull run. During the first half of the year, the CMBS market remained at something of a standstill with volume around 10% of prior years and limited prospects of any near-term turnaround. Currently, spreads are widening and pressure on the pipeline is building up.

While delinquency rates are increasing moderately, the market malaise is more attributable to disagreement over pricing rather than to fears of an imminent collapse of the underlying real estate market. One of the major challenges investors confront is fear of a mark-to-market hit that could

force a write-down in CMBS holdings. Until some consensus is reached as to what spreads ought to be in this environment, the market is likely to remain at a standoff. Without new volume to attract attention, investors will be focused on how existing issues hold up in light of rising delinquency rates and softening real estate fundamentals.

The CMBS market is likely to continue to struggle well into 2009. Life insurance companies and other sources of private mortgage capital have stepped up to support the commercial real estate market. Some of the regional and smaller banks that made commercial loans to homebuilders will be out of the market, forced to focus attention on problem loans that are already on their books.

Since the housing market is still contracting, difficult decisions will have to be made since the ability to help builders move product by offering favorable financing, no fees, quick closings, and other incentives has not put a dent in excess inventory. Such bank efforts will include dumping troubled loans at discounts to get them off the books, pulling back on forward commitments to new and on-going projects, and slamming the door on new residential mortgages. Since these loans are classified as commercial loans, they are likely to keep affected players out of the market and make it difficult for them to work with marginal borrowers facing loan resets.

Regardless of whether a financial institution is dealing with problem loans related to the housing market, borrowers are finding that the lenders are taking a more conservative stance, which will force the market to slow down. This is especially true with life insurance companies who are in the driver's seat and can dictate loan terms. The end result is that developers are being asked for much higher equity contributions.

At the same time, underwriting standards have been increased, requiring greater documentation of underlying market fundamentals, significant preleasing activity, and higher tenant credit or credit enhancement. Debt coverage ratios have been elevated and loan-to-value ratios have been ratcheted down for both new projects and existing refinancing.

In addition, lenders are requiring valuations based on more realistic market assumptions that factor in a recession or slowing of tenant demand, and prohibiting addition of mezzanine debt. This heightened scrutiny is expected to hit highly leveraged investors hard as bullet and nonamortizing loans come up for refinancing on 3-5 year resets.

Since many of the prior financings occurred at the peak of the market, some owners will turn to bridge and mezzanine financing to hold on until the CMBS market kicks back in. However, some owners will not be able to access such interim financing and will be forced to liquidate assets and may have to take significant, unexpected losses.

Private Equity Market

Institutional investors are in for a period of price adjustments that may include some quarters of negative appreciation as values catch up with the economy and evidence of the softening in the broader real estate market gets factored into the equation. The good news for investors is that the bulk of properties in the NCREIF Index are institutional grade with a higher quality of product and tenant mix than that of the broader market.

During the first half of the year, capitalization rates began to spread out with a generally upward bias. Despite this adjustment, capitalization rates remained significantly below long-term averages. While some have argued that institutional real estate pricing changed, rendering longer-term averages moot as a bellwether of things to come, a more realistic assessment is that the commercial market experienced a prolonged cyclical period of aggressive pricing that was not sustainable.

Looking back, the extremely competitive nature of equity investing, coupled with ready access to low-cost debt, led to a surge in prices. Although capital flows fell off somewhat as leveraged buyers were forced to the sidelines, there was no shortage of capital to keep the market functioning smoothly. Indeed, the weak dollar brought more offshore capital to the market, while uncertainty and volatility in the stock market have focused attention on real estate as a viable asset class.

On the buyer's side, the sense of urgency will not be as great, with new product continuing to come on the market as the cycle plays out. Assuming the economy does not fall into a major, prolonged recession, the commercial market is expected to continue to function in a relatively smooth manner, although price declines are likely and negotiations will be more heated than in the past. However, the situation will be much more difficult for highly leveraged buyers who failed to price risk and downside scenarios into the equation when they acquired product at the peak of the market.

Public Equity Market

In the second quarter, REIT returns fell some 5%. The June figures were even more disconcerting, with total returns for the FTSE NAREIT U.S. Real Estate Index Series falling over 10%. Few REIT sectors escaped the declines, with the highest pullbacks in hotel REITs where investors fretted over declines in travel and tourism; small-center and free-standing retail REITs where angst rose over consumer spending and the slowing housing market; and industrial REITs where concern over slowing in manufacturing and distribution eroded investor confidence.

Because of the declines in REIT prices, REITs overall traded at a discount to net asset value. This situation can be attributed to a combination of factors including the market's expectation of further declines in underlying real estate values and concern that the credit market stress has not fully rippled over to the real estate market. On an interesting note, the mood of REIT investors is at odds with that of private investors who have a more sanguine view of the market and are still pursuing new acquisitions.

Rather than providing an insight into the future, this disconnect may well reflect the greater liquidity in the public market and the tendency of REIT investors to react more quickly to negative news. Going forward, REIT returns are likely to experience more volatility than normal as investors sort out the mixed signals and look for some signs that the market has turned.

However, the tenuous nature of the economy and the potential for added downside risk are likely to prolong the wait-and-see period, forcing investors to make some hard decisions with respect to asset allocation. At the same time, investors are expected to look more closely at individual REITs to try to pick those that are undervalued due to market overreaction, as well as those that have some downside protection in terms of underlying asset quality.

Conclusion

The first half of 2008 turned into one of those interesting periods with no clear sense of direction as to how things will play out in the second half of the year and how they will impact the real estate market. With respect to the economy, the slowdown is reminiscent of a recession even though some still debate where the economy is at, and where it is headed. The signs are for continued slowing as the plight of the housing market drags on, the credit crunch continues, finan-

cial firms struggle, consumer confidence wanes, oil prices continue to break records, and inflationary forces build.

While these factors provide more than a little consternation, the general consensus is that the recession will be moderate, with some improvement coming next year. In the meantime, the dour conditions will provide a lot of fodder for candidates, with voter attention being drawn to the economy and their personal plight rather than to global issues. Unfortunately, geopolitical risk is not likely to abate, creating a vulnerable situation in which things could get worse, fast.

On the real estate front, the sector has not been immune to external forces and is likely to undergo additional adjustments. Total returns will struggle below recent levels as capitalization rates rise and yields move back toward more sustainable, long-term levels. Value declines are likely as the economic downturn, higher awareness of risk, and tighter credit standards work their way into the market. Construction activity will be guarded, as investors and lenders focus on the broader economy and credit demands tighten. Borrowers will be expected to put more equity into development projects, while many investors will contend with tighter underwriting and recourse permanent loans.

Real estate activity levels will remain strong, although transaction times will be longer and negotiations will be more difficult. Investors will continue to allocate money to the asset class, although they will be more patient and willing to risk losing deals if sellers demand unrealistic prices. Credit will remain tight,

while well-capitalized investors will be able to take advantage of opportunities that will arise.

While the summer may be long and hot, it will not be boring. As such, buyers and sellers may be forced to defer vacations and remain on their toes as market conditions change. This situation is likely to carry on into the foreseeable future as we seek the inflection point that signals a turning point in the economy and in the real estate market.

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