Real Estate and the Economy: The Train Has Left the Station

by James R. DeLisle, PhD

Commentary
Going into the 2003 fourth quarter, the economy provided generally positive signals, suggesting that it might be emerging from the doldrums of the past several years. However, there had been enough false starts and carry-over risk exposures to restrain the sense of exuberance. As the economic situation unfolded, the optimists found support for their enthusiasm, with a number of signs suggesting that the near-term economy would continue to improve. Approaching year-end, the economic recovery appeared to be in the works, although still nowhere near the heyday levels of the 1990s when the "New Economy" created momentum in the market. Thus, it appears that the worst times may well be behind us.

Unfortunately, this prognostication offers little solace for those who have lost their jobs and are waiting for real gains on the employment front. While there has been some hiring, the jobs tend to be on the margin, both in terms of stability and pay. At this stage of the cycle, some members of the jobless ranks will continue to struggle to get on board the recovery train. However, with the inventory draw downs that have occurred, if the current momentum can be sustained it is likely that job prospects will improve.

A somewhat similar outlook holds for the real estate market, where overcapacity will cause the sector to lag the economic revival. The real estate market may be the caboose of the recovery, with another round of "much of the same" in the near term. This is not to suggest that the real estate sector will suffer further erosion, but rather it is likely to continue to be delayed in its recovery. It is important that the real estate sector stay positioned to make a comeback when the time and place is conducive to demand-driven expansion.

The Economic Environment
Economic Growth
News on the economic scene was largely positive during fall 2003, with GDP growth once again coming in above expectations. Indeed, revised figures for the third quarter revealed GDP surged above 7%, outperforming consensus forecasts of even some of the more bullish economists. The GDP is expected to continue to trend upward, causing many economists to revise their estimates upward over the 4% threshold. Much of the improvement in GDP can be attributed to a combination of low interest rates, tax rebates, and the absence of further terrorist actions on domestic soil. The importance of the latter to the economic picture is evidenced by increased air travel that has stimulated the troubled tourist and hotel/travel sectors. The improvement in GDP also bodes well for business confidence, a key component of a sustained improvement in the economy, especially with consumers likely to step back in terms of the leadership role they have played over the past several years as business struggled and shifted into a survival mode. While the economy is likely to continue to improve, the general outlook is for a pattern of amplified economic cycles, with periods of improvement periodically interrupted with short-term weakness.

Employment
Despite relatively strong economic news in early fall, the employment picture remained guarded with much of the improvement coming from productivity gains rather than increasing employment levels. The unemployment rate declined moderately midquarter, although a more accurate description is that it stabilized. On a positive note, employment levels actually picked up in the 2003 third quarter,
providing a much-needed boost to the economic recovery. In general, employment gains were concentrated in the professional and business service sectors, followed by health care employment. The increase in hiring suggested that businesses are beginning to respond to increased sales and are recognizing that productivity gains cannot continue at the recent pace. Manufacturing employment has yet to recover, although inventory depletion and rising sales should ultimately translate to job gains in this sector. The increase in jobs suggests that business confidence levels are improving and companies are posturing for the next wave of demand. Assuming the economic revival stays on track, employment levels are expected to continue to gradually improve. However, additional contractions are expected in some sectors as companies shed employees to improve margins and remain attractive to investors.

If the economy continues to improve and employment growth is sustainable, many companies may be in for a surprise in terms of employment stability. That is, over the past several years many companies have contracted employment to focus on their bottom lines. However, they did not necessarily cut back on production quotas, placing more pressure on existing employees. Unfortunately for many salaried workers, the increased load was not offset by improved paychecks. At the same time, although those who hung onto their jobs might have been grateful in the near-term, watching their colleagues and associates cut loose has led to further disenfranchisement of workers. The end result is that many companies will find their employee base more footloose in a strengthening job market. This will make it difficult to retain employees and sustain production without having to buy employee loyalty through rising paychecks and improved working conditions.

**Inflation and Interest Rates**

One of the more interesting developments during the 2003 third quarter was the weakening of the dollar against most currencies. This situation is most pronounced on the European front, where the weak dollar helped strengthen the euro to record levels. While this erosion is good in the near-term for U.S. exports, the situation poses some intermediate-term risk. For example, while a weak dollar is a potential boost for domestic manufacturing (an important consideration going into an election year), the cheap dollar is beginning to trigger retaliation from countries whose trade balances and economic revivals are being undercut by cheap U.S. imports. This could have ripple effects, including putting the fragile global recovery at risk and jeopardizing global demand for U.S. products. There is a growing danger that some countries might begin to invoke tariffs to dampen domestic demand for U.S. imports. In addition to the cheap dollar, the effort to limit imports of clothing from China is likely to create backlash from this important global market and put other countries on the defensive.

With respect to inflation, the rapidly increasing budget deficit is another concern for the economy over the longer term. However, record levels of current spending and tax cuts have clearly provided stimulus to economic activity and strengthened the near-term outlook. Thus, inflation remains in check, with few signs of a major reversal. The increasing demand for U.S. goods from both domestic and foreign buyers and the ability of companies to respond by drawing down inventories and increasing productivity have put fears of deflation firmly to rest. Although the cheap dollar has been helping the economic recovery, it has also placed pressure on import prices. Despite an earlier decline in import prices, the trend is for rising prices that will place some upward pressure on sales and shift some buyers toward domestic goods. End-user energy and gasoline prices have receded and stabilized; however, oil prices are one of the potential risks on the inflation front.

In terms of interest rates, the situation is rather sanguine, as the Federal Reserve remains sensitive to the tenuous nature of the economic recovery and its partial dependence on affordable, accessible capital. Despite these concerns, the general consensus is that rates will trend moderately upward as economic expansion continues. Indeed, investors have begun to factor moderate increases into their decisions, as they anticipate further economic expansion. How the Fed will approach interest rates in 2004 will be closely watched. The good news is that there is little danger of a quick run-up in rates, with rates expected to remain below long-term averages. On the global front, there is mounting pressure for rate increases, although many central banks are wary of jeopardizing the tenuous recovery that characterizes most economies. However, some banks have raised rates moderately, such as the central banks of Australia and England. The outlook for interest rates is a good
sign for the domestic recovery, with little risk of an unanticipated spurt that could derail the economic recovery.

**Business Indicators**

One of the pleasant surprises on the economic front in the 2003 third quarter was a fairly widespread improvement in business indicators. For example, the inventory-to-sales ratio declined, suggesting that companies would be gearing up to replenish supplies and prepare for growing demand. This suggests a rather broad-based recovery with ripple effects across the business spectrum. In addition, some sectors are benefiting from their own cyclical nature, such as the replacement cycle in information technology for computer hardware and software.

During the third quarter, productivity continued to surge, racking up the highest gains since the official end of the recession in late 2001. To put the gains into perspective, the rolling five-year increase in productivity is at its highest level since the early 1960s. Although productivity gains have dampened employment, businesses have begun hiring new employees in recognition that such gains are not sustainable. This is especially true since some of the gains have come at the expense of existing employees who have been forced to carry a bigger share of production. This interpretation is bolstered by the recent increase in temporary hirings, which typically precedes a slowdown in productivity gains.

With respect to business demand, most of the signs are positive and point to a sustained recovery. For example, factory orders have increased, along with both manufacturing and service output. Despite these output increases, there has been an increase in unfilled orders as demand picks up speed. In addition, the low and declining wholesale inventory to sales ratio has triggered an increase in inventory stockpiling to replenish supplies in anticipation of additional demand. A notable exception to this trend is the auto industry, which has experienced a decline in sales. However, this situation is not a surprise in light of the fact the industry aggressively cannibalized future sales by using easy credit programs to carry it through the recession.

**Stock Market**

The stock market news continues to indicate an overall economic recovery. It suggests that investor and business confidence is holding up despite scattered instances of bad news. This interpretation is based in part on general improvements in the major indices, with periodic downturns being characterized as "breathers" and similar factors that suggest expectations are for continued improvement or, in a worst case scenario, a period of stagnation. This is a far cry from the paranoia that plagued investor psyche for some time. The recovery in a number of sectors, including the troubled technology sector, is fairly widespread. However, not all companies are doing equally well. Investors are searching for value, trying to match corporate prospects to economic sectors, and then picking stocks within those sectors.

The fact that the current market contains a balance of bulls and bears suggests there is relatively limited risk of excessive swings, with buyers and sellers likely to find a ready market on the other side of the table. Once the belief in an economic recovery becomes more widespread, this balance is likely to shift in favor of the bulls, although it is unlikely that it will mirror the market profile of the 1990s when the stage was set for widespread sell-off with few on the other side of the pendulum.

Despite generally positive news on the stock front, there are a couple of clouds on the horizon. First, the rise in insider sales troubles some prognosticators and market observers. For example, in October 2003 the ratio of sales to purchases by insiders reached the highest levels in over 10 years, continuing the pattern in September and well above long-term averages. While not suggestive of widespread problems in valuations, if the trend continues it is likely to receive more attention and may induce another round of investor angst. Second, practices in mutual funds are still being scrutinized, with the potential for more scandal and the possibility of additional regulation. While not necessarily bad, the need for such intervention is likely to become fodder for politicians trying to emerge from the pack and establish themselves as heroes among voters.

**Consumer Confidence**

Over the past two years, consumers have been through a number of emotional and economic swings. Despite these externalities, consumers have maintained their sense of optimism, providing the much-needed stimulus to carry the economy through a very difficult period. Without this support, the current situation would be much more
tenuous. In the 2003 third quarter, consumer confidence levels improved, more than offsetting the previous decline. This turnaround was due to a number of factors, including the anticipation of employment gains and rising wages as the economy begins to pick up speed. Assuming the economy continues to strengthen, consumers should be responsive, setting the stage for further improvement in confidence levels and by extension, retail sales. The consumer movement should receive added stimulus in the second quarter of 2004, with rebate checks coming in at even higher levels than in 2003. This increase is somewhat axiomatic, with the 2003 decline factored into lower withholding after May, but the lower tax rate retroactive to the beginning of the year. This windfall bodes well for retail sales and consumer confidence levels, and perhaps not coincidentally may even translate into goodwill among voters in the upcoming election.

Retail Sales
As with the overall economy, midyear prospects for sustained expansion were rather limited. Although consumers did pull back, rising confidence levels began to ripple over to cash registers during the 2003 third quarter. The end result was an increase in retail sales, with the exception of the auto industry. Going into the holiday season, consumers appeared to be willing to do their part to help sustain the recovery, with retail sales beginning to build momentum. In addition to signaling that consumers are getting on board with the economic revival, the widespread nature of final sales growth is noteworthy.

While the outlook is for continued increases in retail sales, the situation depends on improved employment prospects and wage increases, coupled with the absence of major geopolitical shocks that could disrupt the economy. The increase in tax refunds in 2004 should provide a temporary bridge for consumer spending. On the other hand, it also should be noted that in the face of rising rates, it is unlikely that consumers will be able to tap into home equity through refinancing as in the past. On balance, retail sales should trend upward, with the economic revival allowing consumers to indulge in some of the luxuries deferred until personal earnings and portfolios were replenished.

In the Internet sector, retail sales are also turning up, with more consumers turning to this means of distribution. Indeed, market penetration in terms of household capture ratios continues to grow, although market capture ratios in terms of total sales remains slightly over 2%. The ability of online sellers to expand market share moderately while also satisfying investor demand for earnings suggests sellers are finding viable business models to sustain operations and support expansion. Online sales, however, are still below the projections that were battered about before the recession. On a positive note, the increase in broadband penetration in U.S. households bodes well for Internet sales. Data shows that sales activity for more "connected" households is significantly higher than those with lower-speed connections. While the industry appears to have worked out many of the kinks in the supply chain, security remains a concern. Despite improvements in security, fears over growing identity theft and computer viruses have not abated, placing a damper on further market penetration. However, the outlook remains strong for online sales, with growth rates significantly above the overall rate of retail sales growth.

Real Estate and Capital Markets
Capital Market Overview
Despite the small prospect for near-term improvement in the asset class, real estate remains in vogue, and the market should find adequate capital flows to help it keep functioning. This situation was clearly the case through the 2003 third quarter and into the fourth quarter, as investors and lenders continued to compete for product. Interestingly, signs that the economic recovery have moved into the sustainable range were welcomed by real estate investors but caused little change in capital flows. This lack of responsiveness is due in large part to the general expectation that real estate will lag the recovery due to excess capacity in most property sectors and markets. Furthermore, real estate investors remain committed to the asset class on a long-term basis, suggesting there will be little profit if capital flows pick up. Indeed, the prospect of further appreciation in current prices due to improved market conditions is unlikely. Since real estate has been so aggressively priced there is little upside potential, especially as the spread between real estate returns and returns of other asset classes widens.

Despite the likelihood of yield differentials, real estate is expected to continue to attract investors due to lower volatility and rising concern over inflation. Even if the stock market continues to improve and
spreads widen, real estate capital flows should remain strong as investors seek to maintain asset allocation targets that were written into policy statements over the past several years.

Commercial Mortgage Market
Throughout 2003, the commercial mortgage industry remained extremely competitive, with plenty of capital to support the somewhat stagnant real estate market. Despite this competitive nature, lenders have held the line on debt coverage and loan-to-value ratios. Similarly, while capital remains available for seasoned deals and acquisition of existing property, funding for new construction has been more difficult to source. This is especially true for projects with speculative risk or that fall outside of the norm in terms of design or tenancy.

Going forward, the mortgage market is expected to remain strong, with plentiful capital holding down rates and spreads. However, mortgage rates are expected to rise along with general interest rates. Thus, there will be limited favorable financing and refinancing options available to offset declining debt coverage ratios triggered by high vacancy and weak or softening rents. Assuming the economy continues to pick up steam and interest rates remain in check, the commercial mortgage market should remain viable with strong net capital flows to the asset class. Once the markets begin to show signs of strengthening, developers should be able to find capital to support new development, although activity levels are likely to remain tempered with lenders paying close attention to market supply and demand.

The public mortgage market has remained active throughout the year, in spite of a continued increase in delinquency rates. While this trend is receiving increasing attention, it should be noted that delinquency rates remain relatively low compared to long-term averages. Among property types, delinquency rates were highest for senior housing and the hospitality and lodging sectors. While the former may reflect excess capacity as investors flooded the sector in anticipation of the aging demographic wave, the latter can be attributed to widespread decline in travel and tourism. As the economy picks up, pressure should come off the hospitality sector, although excess capacity will remain a concern. In terms of volume, commercial mortgage-backed securities (CMBS) issuance is expected to remain strong, although competition from private lenders will remain fierce. As such, CMBS spreads are expected to remain narrow, with the exception of the lowest-rated tranches. As a result, there will be plenty of capital at attractive rates and spreads to support the commercial real estate market as it bottoms out, as it begins to improve, and as the construction cycle ultimately kicks back into gear.

Private Equity Market
Over the past several years, the private equity market has demonstrated a tremendous amount of patience, following current returns downward in a declining market. This behavior was somewhat unusual, especially in light of the high-yield, opportunistic mindset that characterized the asset class in the late 1990s. However, it reflected the realities of the market, where real estate remained one of the safe havens in a falling tide. Although declining returns for real estate were a concern to many investors, the returns did little to deter investor appetites. However, the denominator effect pushed many of the more active real estate players up against their asset allocation limits and kept them on the sidelines. This was especially true since declining cap rates placed upward pressure on values, inflating the holdings of real estate investments that were marked-to-market.

As the stock market continues to pick up with the broader economic recovery, this pressure will be reduced, allowing experienced, and often more aggressive, institutional players to rejoin the fray. The end result may be that more value-added opportunities will move to the front, as these investors can be expected to seek returns that are more competitive with other asset classes and more representative of long-term real estate returns. Furthermore, these investors can be expected to place stable product that has little upside potential but has strong investor demand on the market. Thus, the private equity market is expected to gain momentum, with activity levels exceeding a recovery in real estate fundamentals. However, cap rates will face upside pressure as investors look more carefully at the level of returns of real estate versus other asset classes and less at its defensive and diversification benefits. That is not to suggest that real estate will lose its role in portfolio allocations, but that such allocations will have to be supported by expected returns—both absolute and risk-adjusted—relative to other investments. The ability to offer such returns will be dampened by...
excess capacity and the inability to tap into the inflation-hedging potential of real estate until the market cures and supports upward adjustments of rents.

**Public Equity Market**

As for most of 2003, during the fourth quarter real estate investment trusts (REITs) continued to provide solid returns, both in an absolute sense and with respect to the rising stock market. While the erosion in real estate fundamentals remained a major challenge for REITs, the industry was able to hold up returns through a combination of cost-management programs and revenue initiatives that have helped stabilize cash flows. This relatively strong performance during a difficult period allowed REITs to emerge as a viable industry sector for a growing number of investors. This market acceptance is reflected in the inclusion of REITs in an increasing number of market indices. The end result has been a significant increase in REIT market capital, with growth attributable to portfolio appreciation, availability of favorable financing that helped reduce costs of debt, and capital offerings. The capital-raising activity has been fairly widespread, including increases in initial public offerings (IPOs), sale of preferred shares, and the use of secured debt.

Despite the expansion of the REIT sector and its emergence as a viable asset class, the outlook for REITs is tempered by the realities of the real estate market. REIT returns are likely to experience some erosion before the economic recovery kicks in and the market absorbs the excess capacity that hangs over the asset class. Similarly, although REITs have been able to maintain moderate leverage, the prospects for rising rates will prevent them from using financial engineering to protect bottom lines. However, market conditions are not expected to decline significantly and interest rates are unlikely to spike, suggesting that REITs should be able to manage the bottom of the market. This ability to manage cash flows should benefit from continued demand for products; this will allow REITs to use their balance sheets to maintain operations rather than turn to the debt or equity markets to compete for capital.

**Foreign Investment**

The past 18 months have been a difficult period for foreign investors, both in terms of lower performance in U.S. real estate holdings and increased geopolitical risk. Despite these concerns, foreign investment flows into U.S. real estate have remained relatively stable, with investors continuing to view domestic markets as favorable for long-term hold strategies.

As with their domestic counterparts, foreign capital sources have been forced to aggressively compete for real estate product, especially for the core-type investments that foreign investors favor. The decline in the dollar is expected to increase foreign capital flows to U.S. real estate, which the cheaper dollar makes more affordable. At the same time, the lagged but anticipated recovery in real estate market fundamentals places an upside on earnings potential and makes U.S. real estate an attractive investment alternative. Thus, going into 2004, the domestic transaction market should benefit from strong net capital inflows. However, foreign investors are expected to remain patient and avoid bidding up prices to untenable levels that have little promise of offering attractive holding period returns. The end result will be greater differentiation among property sectors and markets in terms of investment performance, and an increased interest in value-add and real estate fundamentals that can help investors differentiate among the likely winners and losers. On a similar note, more capital will begin to flow to “challenged” properties rather than core holdings, with investors seeking investments that offer higher risk-adjusted returns than the commodity assets that dominate the market.

**Real Estate Outlook**

**Overview**

Overall, the domestic real estate market remains static with limited prospects for a dramatic change as the market continues to have more downside risk than upside potential. The good news is that this situation is not new, but has characterized the market over much of the past 18 months. In spite of this tempered view, the market has continued to function rather efficiently, with sufficient players on the buy and sell side to support a healthy transaction volume. Over the near term, this situation is unlikely to change, although the economic recovery will bolster transaction activity and begin to bring the market into a better supply/demand balance. However, excess capacity and low utilization rates will preclude any significant improvement over the near term. This situation probably will continue during the first half of 2004, with market condi-
tions beginning to improve during the second half of the year. The results will be rather moderate, however, even as conditions begin to improve. Since the economic recovery will be more selective than widespread, the eventual improvement in market fundamentals will be rather spotty, with some markets and submarkets taking off while others remain on the sidelines. In this environment, market targeting and product selection will be a major element of success and investors will adjust their return expectations accordingly.

Construction Activity
During 2003, the construction sector continued to pick up speed, with year-over-year comparisons up moderately over 2002. Going into the 2003 fourth quarter, this trend accelerated as the improving economy led to an increase in construction activity. However, this activity was not suggestive of a new wave of construction, but rather of a lagged reaction to the improving economy that allowed companies to respond to latent demand.

Private construction has been edging up modestly, leading public construction, which has been hampered by strained budgets. Within the private sector, housing has continued to lead the pack in terms of growth, while public housing construction has slipped. The lodging sector also has picked up some growth in year-to-year comparisons, although more due to the weak activity in the preceding period than any major resurgence in activity. The office sector has been mixed, with the private sector continuing to decelerate and the public sector expanding modestly. Educational construction has led most sectors, although the increase has been in private construction, with strained government coffers taking the edge off of public expansions. On the other hand, highway construction has been relatively flat, and will likely remain so over the near term. As might be expected on the heels of the summer blackout, power-related construction has been strong and is expected to pick up more momentum as critical infrastructures gain attention.

Looking forward, the recent trends in construction are expected to continue, with moderate expansion and isolated pockets of activity. With respect to the private sector, this situation will continue for some time as excess capacity is gradually burned off and the economic expansion takes hold.

Office Market
Among the major property sectors, the office market has experienced some of the more serious challenges over the past several years. This situation can be attributed to a number of factors including the over-exuberance that anticipated emergence of the "new economy." Indeed, the dramatic and largely unexpected collapse of the dot-com revolution was a sobering experience for real estate developers who had geared up to serve the relentless appetite for space among the new dot-com players. In addition, the performance of many office properties that catered to more traditional, slower-growing tenants also floundered. While eating into returns and eroding after-tax cash flows, the deterioration in the delicate supply/demand balance was met by investors in a deliberate, tempered manner. This somewhat unexpected market reaction had a stabilizing effect on the office sector, helping to avoid major fire sales that would have undercut investor confidence and rippled across the property sector.

Going into the 2003 fourth quarter, the office sector had some upside potential that had eluded it over the recent past. Despite this potential, it should be noted that much depends on how widespread the recovery is and whether the United States remains the preferred location for office-related activities, especially in light of the recent wave of exporting of white-collar jobs. While this trend bears careful monitoring, the outlook for the office sector remains neutral to slightly positive.

As economic activity picks up, the office sector can be expected to incur overall improvement. Within the broader office sector, it is anticipated that returns will deviate among players and products. At the beginning of the cyclical recovery, this differentiation will be dictated by overall supply/demand balance. Over time, however, returns for office product will be more closely tied to the integrity of the individual investments and the extent to which they add value to tenants and help create value for the firm. Thus, it is anticipated that the commoditization of office space will give way to greater product stratification on the supply side and market segmentation on the demand side. The outcome will be healthy for the sector, adding more precision to the matching of supply and demand in a market-based context.
Retail Market
Over the past 18-24 months, the retail sector has provided some of the highest real estate returns, both on an absolute and risk-adjusted basis. The competitive advantage can be attributed to a number of factors, some emanating from the property sector itself while others are externally derived.

With respect to external factors, the strong consumer movement and generally strong retail sales helped assuage the overall malaise that plagued most property sectors. To some extent, the drivers underlying the consumer movement were not sustainable, but were attributable to the surge in refinancing activity. As a result of this surge in mortgage activity, many homeowners were able to tap into some of the equity in their homes without raising mortgage payments. This phenomenon was made possible by the cyclical low in interest rates that more than offset the increase debt balances many borrowers took on during refinancing. Due in part to their ability to tap into their housing-related net worth, consumers fueled retail sales, creating high volumes and profits for retail operators, as well as for the investors/owners of the retail spaces.

The retail sector also benefited from the continuous introduction of new retail concepts and formats that increased consumer interest and fostered greater sales. These innovations include the wave of lifestyle and festival centers that rippled across the country early on in the cycle and the more recent wave of mixed-use projects that blend retail with housing and/or office uses.

Going forward, the prospects for retail remain relatively strong, with the economic recovery expected to have a major impact on overall sales growth. However, this situation depends on a number of factors, including the ability to manage the terrorist risk and to keep consumers coming back to malls and retail outlets that are scattered across markets and regions.

Industrial/Warehouse Market
During the third quarter of 2003, the industrial/warehouse market continued to struggle, with weak tenant demand placing a governor on the sector. This situation is likely to prevail over the near term. Record-low capacity utilization suggests that the sector has a dramatic overhang of surplus space. The recent strengthening of the economy and the moderate increase in employment also suggest that the sector is subject to a number of external forces that will stimulate its recovery. As improved business confidence spreads, companies are expected to invoke a number of policies that will ultimately strengthen the industrial sector. For example, improvement in leading business indicators should translate into greater demand for space. Similarly, the increase in exports associated with the cheaper dollar should help bolster the demand for space, as companies seek to expand revenue-generating capacity by adding employees. The introduction of new technological innovations and reconfiguration of supply chains should also bolster the demand for industrial space, although such improvements may take some time to ripple across the sector.

Looking forward, increasing demand for light industrial and warehouse space will help improve the supply/demand balance in the industrial sector, setting the stage for solid but unspectacular returns that are commensurate with risk exposures.

Apartment Market
In general, the housing market has remained one of the bright spots in the economy, with demand for housing remaining unabated. This situation was particularly strong in the single-family sector, where demand continued to expand in spite of homeownership rates that are at a historical high.

To a certain extent, the strength in the single-family market has occurred at the expense of the apartment market. Renters have used plentiful, cheap mortgages to purchase housing. This shift in tenure choice has been healthy for the home-building industry and other third-party service providers. However, it has been problematic for some housing lenders and, by extension, potential renters who have taken themselves out of the rental market. Despite a generally widespread shift in housing preferences from rental to ownership, the rental market has not collapsed, although it has seen rising vacancy levels.

In some ways, the erosion of market fundamentals in the rental-housing sector has been a “victim of its own success.” That is, strong demographic trends well-documented among housing investors and developers resulted in relatively strong capital flows to the sector. In addition to supporting transactions for existing product, these capital flows translated into a new wave of construction as developers sought to tap into this unfilled demand. Unfortunately, a number of players jumped at the opportu-
nity to offer housing solutions, creating a situation in which the supply of new stock outpaced growth in demand. This situation will continue during 2004, as lenders and borrowers seek to gauge each other. Lessons learned should help avoid major overbuilding cycles that hurt individual owners. Institutional investors will seek greater scale and efficiency of investing, either debt or equity. The good news is that, as the economy picks up momentum, new hirings and a resurgence in net in-migration will bolster demand for apartments and lead to further improvement in market balance.

Conclusion
After struggling through 15-18 months of a cyclical bottoming out, the commercial real estate market is finally showing signs of improvement. However, this improvement will not be a near-term phenomenon. It will be a lagged event that will depend on a continuation of the fledgling economic recovery. In this environment, capital flows will remain strong, with public and private investors seeking product. Similarly, the commercial mortgage market will remain strong, with investors aggressively competing for product. At this stage of the cycle, this competition will be healthy in the sense that it will not trigger a surge in new construction. Rather, investors and lenders are expected to keep a wary eye on the overall economic environment, and remain cognizant of the fact that the real estate market is plagued by widespread over-capacity. Similarly, most observers realize the real estate market will not be the engine of growth, but will respond to growth as it ripples over to the spatial market. As such, real estate fundamentals should improve gradually, bringing prospects for higher returns that will help the asset class compete for capital on par with other asset classes. In this environment, once the real estate market catches on to the economic recovery train, it is likely to remain fully on board, carving out an enduring niche among investors and other market participants.

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; jdelisle@u.washington.edu