The Wave of Recovery: Capital Flows and Spatial Ripples

by James R. DeLisle, PhD

Commentary

Going into the fourth quarter of 2004, a number of major issues loomed over the economy, including the presidential election, while the election is behind us, other issues continue to nag—in particular, the conflict in Iraq, the value of the dollar, health care costs, and oil prices. However, there are a number of signs that the economy remains on track, including relatively low interest rates, moderate inflation, increasing business investment, strong productivity levels, and rising exports. In addition to such business and economic indicators, eyes continue to focus on Washington, DC, as the president rolls out his economic agenda, which includes simplification of the tax code, a massive overhaul of Social Security, and health care reform. Assuming there are no major shocks on the legislative front or the geopolitical scene, the domestic economy seems to be on a path to recovery that may prove to be sustainable though not as stellar as some might want.

Overall, the real estate market has fared remarkably well in the recent economic environment. While fundamentals continue to struggle to turn the corner, the lagged recovery that was anticipated is still playing out. There are some markets in which developers are posturing themselves for a new wave of expansion. Similarly, momentum is building for more innovative developments, such as lifestyle centers and mixed-use development that some see as a panacea for managing urban growth by “densifying” and revitalizing our central cities. This trend will carry into 2005 and bears monitoring as the depth of the demand for such projects and their economic viability becomes clearer.

On the investment side of the equation, the real estate market continues to outperform other sectors in terms of total returns, although the upside pressure has been derived from strong investor demand that has driven cap rates to historical lows. During 2005, it is likely that capital flows into real estate will become more tempered, with investors demanding more competitive returns. This concern has raised interest in the growing debate over whether we are in a commercial and residential real estate “bubble” or whether the market is merely “overvalued” and improving fundamentals will catch up to values. The good news is the broader economic recovery might take some pressure off yields driven by cap rates, and allow the market to settle into its natural mode of providing competitive, risk-adjusted returns as the capital and spatial markets fall into alignment.

The Economic Environment

Economic Growth

The prospects for U.S. economic growth remain generally positive, although the scene still is rife with mixed signals. The two strongest sectors that have bolstered the economy over the past several years—residential construction and inventory investment—may have played out. While neither industry is in imminent danger of a major retrenchment, rising interest rates and a generally cautious attitude within corporate America should dampen both sectors as they move toward long-term averages. Indeed, business profits seem to be peaking, with earnings growth tapering off moderately. This pressure on bottom line performance is expected to continue as companies increase labor and investment expenses to position themselves for the anticipated economic recovery. Little help is expected from the government sector, which already is under pressure from the record federal deficit, weak revenue flows, and depleted state coffers. With consumer enthusiasm and
capacity somewhat reduced, the level of gross domestic product (GDP) growth will depend on business investment and exports that, in turn, depend on expectations and a cheap dollar. Prospects for growth in GDP appear to be positive but tempered, building on the moderate improvement in the second half of the year and pushing 1% for the 2004 fourth quarter. The general outlook for economic growth in 2005 is around 3.5%, with some slippage before strengthening later in the year.

**Employment**

As during much of 2004, the employment scene remains one of the more troubling areas of the recovery, with employment gains continuing to disappoint. This underperformance remains a concern; many observers are looking at employment as a key indicator that businesses have sufficient confidence in the economy to stake their bottom lines on the recovery. On a positive note, nonfarm payroll employment did pick up in October 2004. While the rise in employment was welcomed, enthusiasm was weakened by knowledge that some of the gains were a temporary phenomenon associated with hurricane cleanup. During the first three quarters of 2004, the pace of mass layoffs moderated, both in terms of the number of layoff events and the number of affected employees. There is some solace in the annualized rate, which is the lowest since 2000. In terms of industry sectors, layoffs in manufacturing accounted for about one third of all losses, followed by administrative and waste services, with most of those jobs in the temporary category.

Prospects for additional employment growth remain guarded, with the lack of growth in the manufacturing sector creating concern. The help wanted index increased moderately in the 2004 fourth quarter, although the trend was unstable. The good news is that the increases have been dispersed across industry sectors. Within the manufacturing sector, durable goods eked out a slight gain in jobs, while nondurables jobs suffered from further erosion. The absence of growth in manufacturing could continue to affect the employment scene, especially if the dollar begins to improve and exports lose some recent momentum. Jobs continued to expand in the temporary worker sector, despite some layoffs and total employment levels below the peak levels reached in 2000.

The unemployment rate has remained relatively flat at around 5.5% and is an improvement over the peak reached in 2005. The pace of initial unemployment claims has continued its downward trend, reflecting a 10% decline in year-over-year figures, while continuing claims fell even more dramatically. The bottom line on the employment scene is that some improvement is expected to continue, although not at the pace needed to certify the recovery and bolster consumer confidence on a sustainable basis.

**Inflation and Interest Rates**

Inflation remains under control in spite of recent increases in oil prices. This situation should hold well into 2005, with limited risk of a major increase. Strong commodity futures suggest some upward pressure, although much of the increase can be attributed to rising exports. Assuming employment growth continues to rise, labor costs might begin to tick up. With the exception of apparel prices, which could benefit from elimination of quotas, import prices also might rise in response to the cheap dollar.

The Federal Reserve (Fed) has gone down its anticipated path, raising short term interest rates five times in 2004 in a deliberate and predictable pattern that is expected to continue over the near term. The outlook for short-term rates is another 100 basis points increase over the next year; however, the yield curve is expected to flatten, with rising short-term rates creeping up and long-term rates holding. The tenuous nature of the recovery may factor into decisions, may prolong the inevitable increases, and may provide some inflationary risk. In this environment, the federal funds rate should increase somewhat, but remain attractive relative to historical levels. The market will be pricing such changes into its behavior, suggesting a gradual adjustment to rising rates with little risk of an overreaction that could disrupt the economic scene.

The dollar continues to struggle globally—a situation that caught many off guard due to the breadth and depth of the dollar’s decline relative to other currencies. This was especially true for those observers who had anticipated gradual improvement in the dollar based on mid-2004. By the 2004 third quarter, however, it was clear that the deficit would not be peaking over the near term, and that the Fed would be aggressively bolstering rates. Thus, the dollar has continued to slip across the board, especially relative to the euro and many Asian currencies. This continued erosion is an ongoing cause of concern. In particular, in some circles it is becom-
clear that foreign capital sources are growing wary of funding U.S. deficit spending. If this scenario plays out, it will put more pressure on raising rates to attract much-needed global capital. At the same time, politicians in Washington, DC, have shown little interest in addressing the deficit, instead focusing on increasing tax cuts and spending. Concern over the global scene has important implications for the bond market, which has come to depend on such investment and is vulnerable to declining investor demand. This situation is likely to create some near-term volatility as issuers try to float new issues before the market peaks.

**Business Indicators**

Economic growth concerns continue to focus on the business sector, where business expansion and investment are important components of the recovery. Businesses have set the stage, with business spending rising in the 2001 fourth quarter. Unfortunately for the broader economy, employment growth has not been as robust, creating some downward drag on the economic outlook. Employment costs have risen moderately, with gains in goods-producing sectors outpacing those in service sectors. A significant portion of increases in employment costs were attributed to the spiraling costs of benefits, leaving employees with modest salary gains and declining benefit packages. This scenario is likely to continue, with benefits coming under more scrutiny as companies seek to maintain their shipping profit margins.

The recent increase in exports was somewhat higher than expected and helped bolster overall economic growth in the 2001 fourth quarter. The outlook for export industries is relatively healthy, with much of the credit attributable to the weak dollar. Despite improvement in exports, the trade deficit has continued to increase. The health of the dollar and the United States' perceived reluctance to intervene remains a wild card that could trigger backlashes on the global front and place downward pressure on exports.

With respect to leading indicators, the results through October 2001 were disappointing, with the leading index falling moderately for the fifth straight month. These declines, however, have not been sufficient to indicate the recovery has been derailed. During the 2001 third quarter, manufacturing activity and shipments picked up, with rising orders across most sectors. Unfilled orders also gained, continuing a trend that has held for more than a year. Inventories of durable goods also increased modestly, although the total inventory-to-sales ratio remained flat and well below long-term averages. In terms of durable goods, defense-related industries enjoyed strong gains. However, the results were disappointing for nondefense, durable goods orders, which fell moderately in the quarter. Capacity utilization also held steady, above levels over the past several years but still below long-term averages. As in the recent past, improvement is expected for industries associated with defense, technology, equipment, health, and distribution. The outlook is for continued improvement in the manufacturing sector as demand for exports builds, helping achieve moderate but positive expansion during 2005.

**Stock Market**

In the 2001 fourth quarter, profits continued to improve over the prior year, although the rate of increase declined and caused concern among some investors. Other investors, however, read this as a sign that companies are shifting from a defensive to an offensive posture. In effect, optimism attributed the decline to justified investments in equipment and labor by companies gearing up for economic expansion. There also was recognition that aggregate figures had been affected by losses associated with the hurricanes.

The combination of slowing profits and rising rates might portend a softening in the stock market, although it appears that many investors have already discounted this phenomenon and remain focused on other stock market indicators. The final outcome of the national election was welcomed by many investors and caused a shift from bonds to stocks. The weaker dollar also helped offset the slower recovery and might help corporate profit margins and earnings forecasts in some sectors, especially larger U.S. multinationals. In some circles, the emphasis has shifted from price-earnings ratios to its inverse—earnings yields, which are relatively attractitive compared to alternative investments. This is especially true in a low interest rate environment and one in which forward-looking earnings growth is anticipated. There also may be a flight to quality as investors try to pick winners that can recapture historical performance levels. Predicting the market in this environment is particularly challenging; expectations are for a positive, but not stellar, year. This outlook will depend on a number of factors including
energy prices, interest rates, and consumer confidence. Thus, assuming economic expansion does not stumble, the market is likely to fluctuate with some upside potential as investors search for returns.

**Consumer Confidence**

There was some concern that consumer confidence would fall in the 2001 fourth quarter after a period of optimism. Indeed, consumer confidence did slide in November 2001 — disappointing Wall Street and retailers who were hoping for a post election rebound. In general, consumers are relatively comfortable with their current situations, but are expressing growing concern regarding the future. A number of factors have led to this angst, including employment prospects and rising costs (e.g., health, energy). Also, it appears that the prolonged involvement in Iraq has helped to move away at confidence levels. Some say, for the Iraqi elections to signal a point of departure.

In terms of market segmentation, confidence levels in late 2001 varied significantly; consumer confidence eroded the most among those at the bottom of the income spectrum, while upper-income consumers actually reported higher confidence levels.

Going forward, confidence levels will depend on improvement in the employment picture and on the geopolitical front. Clearly, consumers will not propel the recovery, although they will be ready to do their part if the recovery continues to expand and employment and wages begin to trend upward.

**Retail Sales**

Consumer sales figures benefited from an uptick in the 2001 third quarter, raising hopes for a strong seasonal surge in year-end retail sales. This was good news, especially after the disappointing pace of sales growth registered by many retailers earlier last year. Optimism was bolstered by strong October sales gains, surveys of households that pointed to increasing expenditures, resolution of election uncertainty, and relatively strong consumer confidence levels with respect to their current situation. As a result, many retailers entered the holiday season with high hopes. For many, however, those hopes were dashed after a brief post Thanksgiving rally gave way to a disappointing weekend. This situation varied across the industry, with the electronics and upper end markets doing well and the middle and lower ends of the market struggling. Even within these categories, the results were mixed, with upscale discounters (e.g., Target) doing well and downscale retailers suffering. This latter situation was punctuated by Wal-Mart, which launched a wave of price cuts to try to stimulate sales.

Despite mixed results in the early season, there was some hope that the holiday sales would improve as consumers indicated that they expected to increase holiday purchases over last year. Holiday sales have become something of a waiting game between consumers and retailers, with the fate of holiday sales going down to the wire as consumers wait for retailers’ spurt of last-minute promotions.

During 2001, online retail sales gained some ground, with expectations for a slight increase in the percent of households making purchases online; these purchases are led by books, followed by apparel, toys, and music CDs. Of those consumers who make purchases online, reports suggest they spent over half of their budgets online, indicating strong market capture rates. Since a high percentage of online shoppers report satisfaction with their prior shopping experiences, the market is likely to continue to expand, though it remains dwarfed compared to traditional in-store shopping.

The automobile industry showed signs of life late in 2001, with manufacturers having some success in bolstering demand through new product innovations. This is particularly true at the upper end of the market, where sales of luxury vehicles are outperforming the broader sector.

Looking ahead, retailers will receive a boost to their bottom lines in 2005. On January 1, the quota system for apparel expired, which had established mandatory allocations to poor countries. This should create a windfall for U.S. retailers who will be able to concentrate apparel purchases in countries that have the lowest cost base, such as China. The end result will be consolidation of apparel production and declining prices of imported clothes. While some of the cost savings will be passed on to consumers, the level of transfer will vary widely. At the upper end of the market, which has been doing well on its own, prices are expected to hold, thus enhancing profit margins. Retailers at the middle and lower ends of the price points are expected to pass more savings on to consumers, although they will also benefit from improved margins until competition forces them to adjust.
Housing Market

The housing market continues to belie predictions of eventual softening in spite of the increases in interest rates that occurred in mid-2001. While the rate increases caused some consternation within the financial community, they did little to rein in the charging housing market. During the 2001 fourth quarter, new home sales continued to outperform expectations and sales of existing homes remained strong. In terms of single-family housing unit authorizations, the market held up throughout 2001 and showed few signs of slippage. Indeed, housing starts and units under construction increased moderately throughout the year. This suggests that in the absence of major increases in mortgage rates, the strong housing market will carry into 2005. With this positive but cautious outlook, the housing sector will be closely watched this year.

As in the retail market, the top-end housing market has remained particularly strong, especially sales of luxury homes. Since these buyers tend to be insensitive to interest rates, this sector is expected to stay vigorous as long as the economic recovery continues. At the low end of the market, appreciation has placed pressure on workforce housing, especially in housing markets where prices have outpaced purchasing power despite low interest rates. As a result, there has been a skewing outward of growth as moderate-income workers pursue the American Dream of homeownership. While this sprawling effect runs counter to the smart growth movement that seeks to satisfy housing needs through greater densification of central areas, it is responsive to some consumer preferences and market behavior. This is especially true for middle-class Americans for whom the quality of schools, levels of services, recreation, and facilities are selling points. Many financially stressed cities have been unable to ratchet up to support the new demands on services. Accordingly, a number of cities have been forced to make cutbacks in family-friendly amenities, which has only exacerbated the sprawling pressure induced by spiraling housing costs.

A couple factors have helped extend the housing boom and sustain it beyond what ordinarily would have been its natural peak. In some of the faster growing markets (in terms of households and appreciation rates), the upward spiral on prices has been supplemented by the emergence of housing speculators who have taken temporary positions in new projects, only to sell their interests before the buildings actually open for occupancy. Obviously, this speculative game can only be played for so long, exposing investors to risk if rates turn up or the appreciation trend stalls. A second stimulus to the housing market that has yet to play out is the increase in the ceiling for conforming Fannie Mae and Freddie Mac mortgages. As of January 1, the conforming loan limit is $410,000, which with a 20% equity payment translates into a loan on houses costing up to $515,000. This increase provides more affordable loans for higher priced homes.

Going forward, housing appreciation rates are expected to flatten out and start are expected to moderate. There is rising concern that homeownership rates, which are pushing 70%, may not be sustainable or may be approaching saturation levels. This situation is most dramatic in the suburbs and nonmetropolitan areas, where over 75% of households own their houses compared to slightly more than half of the central city households. This situation may continue in 2003 if the recovery stays on track, mortgage rate increases are moderate, and the economy finally shows employment and earnings gains.

Real Estate and Capital Markets

Overview

As the year winds down, the strength in real estate capital flows shows no sign of abating. This is good news for sellers and bad news for buyers, who have had an extremely difficult time sourcing product. The challenge is particularly difficult for equity investors seeking to grow core real estate in portfolios. This hits on both the public and private side of the market, with cap rates below real estate investment trust (REIT) targets and total returns unlikely to hold up against the existing, owned assets of private institutions.

Despite the extremely competitive arena, transaction volume has remained high, with near-record sales for 2001. Private investors have dominated the
market, outpacing public investors in acquisition volume. With respect to product life cycle, interest in properties suitable for rehabilitation, renovation, expansion, or redevelopment has increased. This interest is related to the search for returns, with investors looking for higher-yielding, opportunistic purchases to bolster core returns. While there is some hope that real estate fundamentals will improve and help stimulate income growth, it is doubtful that the market will recover sufficiently to strengthen current income returns.

On the debt front, the story remains the same, with plentiful capital at attractive rates flowing within the market. This situation is likely to continue well into 2005, with the cheap dollar attracting foreign capital that is likely to focus on the same core assets coveted by domestic investors. Although the pricing cannot hold up over the long term, there is little near-term relief in sight for buyers who have been hoping that prices would retreat.

During 2005, across the board appreciation will begin to moderate as institutional holders stop chasing deals as aggressively as in the past 18-24 months. The result will be more downward pressure on cap rates. This repricing, however, will not be a near-term phenomenon. There is a backlog of investable capital on the sidelines that is seeking to expand real estate holdings, and it will be lured back into the market by the promise of an economic recovery. The next wave of transactions is likely to focus on rental correction and internal rates of return, as investors shift from a defensive mode to one based on more sustainable pricing. The caveat here is that these expectations may not be met unless the economic recovery holds up and the market is once again able to capture positive growth in net income.

**Construction Activity**

In the 2004 fourth quarter, construction activity levels strengthened moderately along with the overall economy, with construction activity up almost 10% over 2003. Some improvement in construction was attributed to the recovery from the devastating hurricanes in the Southeast.

The residential sector was the driving force behind construction growth, with the single-family segment leading the way. During the fourth quarter, however, there were signs that the housing market was cooling off, with single-family and multifamily construction both tailing off.

Nonresidential construction activity rose early in the fourth quarter, led by the launching of some major office projects. This trend is expected to continue, although it should be noted that levels are being measured against the stagnant growth rates of 2003. During late 2004, other commercial property sectors also showed modest increases in construction activity, including hotels, storage, and warehouses. The only declining sector was manufacturing, which dropped from an unsustainable rise in the third quarter. The institutional and nonbuilding sectors were relatively flat for 2004, with major road projects remaining derailed until Congress passes a new, multiyear transportation bill.

Thus, the aggregate outlook for construction is for continued increases, but no major surge in new activity. This should be good news for the commercial real estate sector, which needs time to absorb the existing backlog. There is some risk, however, that developers may internalize low cap rates.

**Private Equity Market**

The private equity market has generated surprising results, with a significant out-performance rating for the NCREIF property index through the third quarter of 2004. This strong performance caught some off guard; many had expected total returns to slip into the single digits as investor demand drove yields down. Indeed, annualized income returns fell to 7.6%—well below 5-year averages by almost 100 basis points. On the other hand, appreciation rates came in at double the long-term averages, leading to the strong total return figures. This situation continues the recent disconnect between the capital and spatial sides of the market in which fundamentals remain weak, with limited prospects of a near-term cure. Furthermore, the market has become much less discriminating and has extended downward pressure on cap rates across the quality spectrum resulting in commodity pricing.

Over the near term, investors are likely to continue to chase new deals supporting current values despite the current market dynamics. This situation bears careful attention, with pricing of both new and existing assets becoming more vulnerable to a correction. While the timing of an adjustment is not clear, the pressures are building. The pent-up demand from a myriad of private sources, however, suggests this process will be smooth and tempered, which bodes well for the broader market. Indeed,
recent investor surveys and the tone at investor conferences have been surprisingly optimistic. When coupled with a general consensus that this is an optimal time for cashing out of the market, the pace of transactions should significantly increase, setting the stage for a dramatic rise in product availability. As these buyers move back on the scene, a gradual improvement in market fundamentals may support increases in net operating income and thus allow a gradual pricing adjustment. On the other hand, there is also a risk that impatient capital may support a wave of new construction that could leave some markets languishing from oversupply. Thus, 2005 should be an interesting year for private investors and the broader real estate market.

Public Equity Market
During much of 2004, REITs proved to be resilient, bouncing back from a disappointing third quarter. Indeed, despite weak monthly figures, the year-to-date returns on the composite index pushed 25%, a very competitive level in this capital market environment. Dividend yields accounted for 50% of the yield, pointing to the strong price gains associated with the pricing for the underlying assets. At the same time, REIT premiums to NAV declined somewhat, falling to 10% from the 10% level going into the second half of 2004. In addition to growth through reinvestment in existing holdings' earnings, the REIT market cap has grown through a wave of initial public offerings (IPO) activity. In 2004, IPOs accelerated, with annualized rates pushing the levels of 1997-1998. Secondary offerings also were strong, although not on the same pace. As with their private counterparts, REITs have turned to the debt market to help bolster performance, drawing down over $17 billion of unsecured debt.

Going forward, it is likely that strong capital flows to REITs will continue, especially as the economy picks up and investors are drawn to real estate to tap into improving fundamentals. REITs have weathered the downside of the market, and investors may expect greater returns as fundamentals improve. The market for REITs will open up as the industry expands its global perspective. The globalization of the REIT format is evidenced by the introduction of the S&P/Citigroup REIT Index. Globalization should result in further maturation of the industry and expand the investment horizon of domestic investors. The U.S. market should benefit from additional capital flows as international investors take advantage of the cheap dollar to tap into the real estate market.

The Real Estate Improvement Act of 2005 (REA), signed into law in October 2004, should also foster globalization of the REIT market. Briefly, the REA changes the treatment of foreign investors in REITs to conform to how they are treated in other public companies, reducing withholding requirements and avoiding the requirement that they file a U.S. tax return. The REA also provides more flexibility in terms of permitted activities and allows REITs to avoid disqualification of REIT status by paying monetary penalties in cases of unintentional violations of REIT tests. The bottom line is a more flexible environment that allows REITs to be more creative and entrepreneurial, and consequently, more attractive to investors.

Commercial Mortgage Market
As with the equity side of the market, the commercial mortgage market has remained flush with capital, on both the private and public fronts. As a result, there was a flurry of activity in 2004 as investors sought to finance new acquisitions or lock in debt on existing product. The slight uptick in short-term rates did not spill over to long-term debt, however, with the yield curve flattening and rates remaining attractive for borrowers. Indeed, a number of owners used the low interest rate environment to help bridge the bottom of the spatial markets using lower-cost capital to offset disappointing net income levels from flat occupancy and rental rates.

The availability of mortgage capital has increased the flexibility of lenders. Interestingly, in the private market this flexibility has not taken the form of relaxed underwriting standards, such as loan to value and debt coverage ratios, which remain in line with long-term averages. Rather, the availability of mortgage capital has manifested itself in lenders' willingness to take on lower end credit and higher risk assets. This has opened capital flows to a broader spectrum of the market and has helped expand the commoditization of pricing. It has also opened revenue flows to innovative developments, such as lifestyle centers and mixed-use projects that might not have received capital support in a more traditional market. The low delinquency rates in the private market and the ability to lock in attractive (albeit historically low) yields should help maintain an active flow of private debt.
The commercial mortgage backed securities (CMBS) market continued to expand at a solid pace throughout 2001. This expansion occurred in spite of competition for deals. There is some evidence that the private market has looked to the securitized market to fund deals that may have stretched traditional underwriting, helping the public market maintain its pace of activity. To the extent that such skewing occurred, it has not shown up in delinquency rates or in indicators that the market has overheated and taken on more realized risk. The strong investment market has no doubt provided some insulation for the debt side, with ready buyers willing to cash out sellers struggling with debt loads or declining income streams associated with weak market fundamentals. This situation is unlikely to change soon, suggesting the capital markets should remain plentiful and supportive of an active real estate market.

Real Estate Outlook
Office Market
The office market continues to struggle with excess capacity in most markets. On a national level, there has been some moderate improvement in vacancy rates, especially in central business districts (CBDs) and suburbs with central business districts. Despite this improvement, the market is far from where it needs to be to generate improved leasing terms and increases in net operating income. Although there are signs of recovery, they remain isolated and local rather than associated with any sustainable, broad trend. Furthermore, the factors underlying improve ment in some markets are associated with relocations and tenant mobility rather than an increase in aggregate demand. This is reflected in the strong pace of leasing in 2001 that significantly outperformed the levels of 2005.

With respect to performance, the private office sector provided total returns slightly under 10%, with the CBDs slightly above that average and the suburbs trailing. Due to concern over the sector, appreciation returns have been tempered compared to other property types, although CBD appreciation beat 10-year averages, while suburban numbers lagged. In the public market, office yields have dropped off from strong numbers in 2005, although total returns are still relatively attractive in the niche.

In the current economic environment, investors remain appropriately concerned over the unwillingness of companies to expand their employment base to support the office market. Investors seem to realize there is more potential downside risk. They are paying particular attention to the trends affecting white collar employment—off shoring, outsourcing, and consolidations. Despite these concerns, office transaction levels have risen to record levels, again due in part to strong capital flows to the asset class allocation targets that skew a significant portion of investments. To the extent possible, office buyers are concentrating on markets where they see some competitive advantage and are likely to benefit first from the economic recovery. On the other hand, they are also seeking solid product that the market can grow into as the recovery plays out. With a few exceptions, the supply side remains in check with a number of office developers looking beyond the sector to keep busy while the market regroups. This situation is likely to continue, although the search for returns has set the stage for more development finance and investment when the market begins to recover. The dramatic increase in component prices (e.g., concrete, steel, wood) should further dampen construction levels, raising the rental rate hurdle necessary for new development.

Retail Market
During 2001, retail investments provided generally positive results for investors, both in the private and public markets. This experience has been attributable to a number of factors including consumer resiliency, cost cutting measures and focus on unit profitability, strong capital flows, and relatively stable supply/demand balance. In general, retail market fundamentals have remained steady due to continued consumer support and strong balance sheets; this has been particularly true in the upper end market.

The retail sector has reported very strong returns numbers. Although off the frenetic pace of total returns in 2005 (which pushed 16%), the retail REIT sector continued to outperform predictions through November 2001, with total returns around 7% and malls leading the pack. On the private side, retail returns also outperformed predictions, with annualized returns over 20% through the 2001 third quarter. These unusually strong returns have spread across the sector, with neighborhood retail not as strong with returns of 17% and super regional retail leading at 25%. As might be expected, these returns are due to double-digit appreciation with the
exception of neighborhood centers) and moderate income returns in the 7.8%–8.7% range. Going forward, it is unlikely that such returns will be sustainable, with some correction likely over the next year; however, a strong economic recovery and pent up investor demand may forestall that adjustment.

The acquisition of Sears by Kmart is an interesting indicator of the times. The acquisition will impact a number of malls, and the after-effects will be closely watched as the two struggling merchants try to make adjustments. The merger will have implications beyond the immediate chains. Mall owners undoubtedly will be faced with some upside opportunities to replace underperforming stores. Conversely, this situation will be problematic forailing properties, which face the loss of an anchor store that is well performing relative to the balance of the mall, and which have few prospects for comparable placements, much less tenant upgrades. At the same time, attention will focus on the impact to off-mall locations, as Sears adjusts to the acquisition and seeks economies of scale and lower operating costs to help them compete.

During 2004, several new shopping-center formats became prominent, including lifestyle centers, and mixed-use development. Although the drivers behind these two formats are somewhat different, they both are receiving significant attention and are positioned for a surge in new construction activity.

Part of the allure of the lifestyle centers is that they provide fashion and upscale merchandise that satisfies consumer demand, while also providing a close-in, open-air format that appeals to consumers seeking a unique shopping experience. At the same time, the presence of indoor common areas creates an operating format that has appeal to tenants who can avoid the high occupancy surcharges they face in more traditional, enclosed malls.

On a similar note, the interest in mixed-use development has been stimulated in part by the smart growth movement, seeking greater densification of urban markets, and by the desire to recycle under-developed properties. Mixed-use development has the added appeal of helping create walkable neighborhoods that can operate as self-contained live, eat, work, and play nodes. Despite the intuitive appeal of such development, making the retail component work remains a challenge where neighborhood trade areas do not have sufficient purchasing power. While lifestyle centers and mixed-use development can indeed work, the jury is out on what it takes to ensure such development has adequate consumer demand for retailers. In the absence of empirical research upon which to base investment and underwriting standards, there is a risk that such projects may saturate the market with functionally obsolete space. This caveat is especially true for projects in which the retail space allocation has been constrained to satisfy normative standards that are detached from the reality of the market. Thus, the allure of retail investments based on recent returns and the appeal of innovations that promise higher returns will continue to attract significant capital and bear close monitoring.

Industrial/Warehouse Market

The general spatial trends in the industrial sector have tracked that of the office sector, although the drivers and numbers are somewhat different.

With respect to market balance, the market has been stuck at slightly under the 12% vacancy rate since early 2002. There has been some increase in demand associated with the economic recovery, but excess plant capacity and rising productivity levels have dampened increases in demand for space. At the same time, the construction pipeline has begun to build up, as developers respond to emerging pockets of demand associated with changing logistical models and supply chains. Income levels have been flat, although there are some signs that leasing activity will begin to pick up.

With respect to performance, the public industrial sector has outperformed the office sector and pushed retail for top honors. On the private front, industrial returns fell in the same relative rank as the public sector compared to other property types, with annual returns of over 10%. This improvement has benefited from strong capital flows and strong income returns running above long-term averages. From a spatial side, the outlook for the industrial sector includes gradual improvement in fundamentals as the economic recovery plays out and exports increase. During this adjustment period, industrial prices should hold and total returns remain competitive as investors pour capital into the asset class.

Apartment Market

In general, the apartment market has not fared as well as other property sectors in terms of recent demand shifts. This is due to the lure of homeownership
facilitated by low interest rates and perceived strong investment performance associated with rising prices. This latter caveat focuses on the fact that, for most homeowners, the investment return from their houses is an unrealized gain, one that may or may not be realized depending on their market timing, interest rate changes, and housing demand. Since these forces are all moving against the ownership model as they migrate toward long term averages, there is some upside in the apartment outlook. To this point, vacancy rates have slipped since 2005 due to tempered demand and construction activity. Despite this situation, there is some evidence that occupancy and rental rates may be headed up, although no major improvement is anticipated over the near term.

With respect to performance, on the public market front, apartments have had a strong run, with total returns at the upper end of the continuum across property sectors. Similarly, in the private sector, apartments provided surprisingly strong returns, with rates in the low double digits. This improvement was led by high-rise projects, many of which were new investments associated with the smart-growth movement and the trend toward densification to reduce sprawl and revitalize central cities. Thus, the returns have been skewed by strong appreciation—pushing 7% on top of below-par income returns compared to other apartment formats and other property sectors. This situation will bear close attention, since the depth and sustainability of such initiatives have yet to be demonstrated. Furthermore, the momentum behind such development which has attracted office and industrial developers in search of new projects—may well lead to oversupply of such niche projects. Overall, however, the prospects for apartments look relatively positive, assuming supply is kept in check and household demand continues to grow.

Conclusion
Going into 2005, the commercial real estate market is at a crossroads, with moderately improving fundamentals meeting increasing investor demand. Current holders, who have been waiting for the inflection point at which they can optimize sales prices, have heard enough collective wisdom to con

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

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