New Year Begins with Tempered Optimism

by James R. DeLisle, PhD

Commentary
As 2006 came to a close, the U.S. economy headed for a soft landing. The general consensus was that the economy would recapture lost momentum. In 2007, the housing market will continue to draw attention. This factor will likely mitigate the downside risk the sector could face if a recession occurs. Further, the economy is expected to pick up steam in part from anticipated declines in interest rates. This is good news for the real estate markets, which could use some help to increase net income and bolster yields from the historical lows that have characterized the market for the past several years.

In terms of commercial real estate, the near-term situation will remain much the same as it has been over the past eighteen months, with capital continuing to chase deals and hold prices. The same phenomenon is expected to occur in the commercial mortgage market. Nevertheless, private banks and lenders are expected to come under increasing scrutiny to relax underwriting standards.

Commercial construction activity is expected to increase as investors shift to value creation strategies to increase overall real estate yields. While construction is expected to pick up across the board, hotels, mixed-use projects, and lifestyle centers will draw the most interest. This activity is being driven by a bullish sense of optimism, which in many regards, exceeds the levels achieved in the late 1980s. At the same time, institutional investors and other capital providers are expected to heed more attention to risk and spreads, putting pressure on increased rents and cost containment to bolster net income.

A sense of optimism pervades the commercial real estate market. This optimism and recent history of pent-up capital flows should help cushion the market over the near-term. However, we could be in for some challenging times, which could translate to higher capitalization rates and a correction in prices, bringing current-period yields to more sustainable levels relative to other asset classes.

The Economic Environment
Economic Growth
In 2006, the economy continued to grow at a moderate pace; however, there were some signs of slowing down, particularly in the housing and automobile industries, which had been fairly well discounted by the market.

Recently, the trade deficit has shown some modest improvement. The softening of oil prices has taken some of the pressure off the deficit, along with the economic situation and weakening dollar, which had taken pressure off imports. The prospects for additional upside from a further softening of oil prices remain slim, especially on the heels of the December 2006 announcement by the Organization of the Petroleum Exporting Countries (OPEC) of its intent to curtail oil production in 2007 to hold prices. The dollar has shown some signs of strengthening, although it is unclear if the U.S. economy is strong enough to sustain the recent gains.

Economic growth is expected to expand modestly with somewhat disappointing growth in gross domestic product. The outlook for 2007 is for moderate growth in the first half of the year, setting the stage for higher growth in the second half. Despite some concerns over the possibility of a recession, the market remains relatively optimistic. The housing market remains one of the wild cards adding some downside risk to the economic outlook. While it is likely that housing prices will continue to soften, there are few signs of implosion.

Employment
The employment picture is somewhat clouded as unemployment rates declined in some unexpected sectors including manufacturing, where shortages of skilled
labor are constraining output. Despite moderate increases, jobless claims remain low, signaling a fairly tight labor environment, although wage pressures on inflation have been moderate. There is some risk that layoffs may ensue as the housing market continues to deteriorate. The same concern surrounds the automobile industry as it struggles to get its feet back on the ground. Despite these issues, the employment picture looks fairly healthy going forward.

The prospects of an increase in the minimum wage will create additional stress among a number of firms, especially those relying on low wages to compete on costs. On the other hand, retailers and other businesses might benefit from an increase in demand for goods and services. This increase could come from consumers at large, as well as low-income consumers. The ultimate determination of how this all plays out depends in part on the fate of the housing and automobile industries where additional layoffs are expected.

Over the past decade, the employment mix has undergone a number of changes with the most dramatic change in the service sector. Looking out over the next ten years, the rate of employment growth is expected to increase over that of the past ten years. The largest increases are forecast for services including education, social assistance, health care, and professional and business services. Construction employment is projected to grow, but slower than it did in the past decade. Manufacturing employment is projected to decline, but not as radically as did over the last ten years. At an aggregate level, two distinct service groups are expected to account for almost sixty percent of new jobs: professional and related occupations and unskilled service occupations.

Interest Rates
Concern remains over the continued slowdown in the housing market and automobile sector as well as the inventory buildup that may lead to further deceleration in the manufacturing sector. On the other hand, inflationary pressures remain troublesome although concerns over the health of the economy and the potential for additional slowdowns mitigate the situation. The general consensus is that interest rates will remain flat during the first quarter of 2007, with the possibility of declining rates as the Federal Reserve (Fed) seeks to stimulate the economic recovery.

On the mortgage front, the continued slowdown in the housing market has taken some pressure off rates, which has led to some near-term improvement, especially in light of strong capital flows. On the other hand, residential delinquency rates have turned up. Part of this increase is due to the decline in residential loan volume.

However, the increase raises some concern of the credit quality of the residential market. Further erosion of credit quality could lead to tightening credit standards, which would be healthy in the long run, but may create some problems at the margin especially for those seeking to refinance subprime mortgages. In fact, these products have been losing market share. Despite these concerns, there are few signs of a major reversal of fortunes in the residential market, so it should remain relatively tight. Indeed, based on the recent trends, rates should remain competitive and allow the housing market to adjust to return to supply and demand forces in a relatively orderly manner appropriate for this stage of the cycle and in line with long-term patterns.

Business Indicators
At the end of 2006, business indicators were somewhat mixed to positive, signaling the market’s assumption that the economy would experience a soft landing before making up for some of the lost momentum. While figures were generally positive, there were some signs that the manufacturing sector could be heading toward a moderate contraction or pause.

In terms of product categories, business production increased moderately but construction fell back, reflecting the general outlook for the two sectors. The manufacturing sector remained below par in terms of utilization, suggesting little upward pressure on prices and the ability to expand without additional investments in plant and equipment. However, the pressure on productivity gains may trigger some redeployment of assets, as companies revisit their bottom lines and struggle with the tight labor market and pressure on payrolls.

Stock Market
The strong showing by the stock market at the end of 2006 caught many investors off guard and demonstrated the resiliency of the market. The new record signifies the confidence of investors in the economic recovery, and the Fed’s ability to manage inflation without triggering a recession. One of the factors behind the recent strength of the market has been mergers and acquisitions activity, leading to anticipation
of further activity, which will provide the opportunity for short-term gains.

In addition to profit taking options, a spate of mergers and consolidation of power in larger companies provides an opportunity for further gains as acquiring firms take advantage of economies of scale. However such improvement depends on careful management, implementation, and a continuation of the economic expansion, which provides opportunities for new and established firms to build market volume and increase market share. In the meantime, profit margins are expected to remain strong as corporate balance sheets provide further insulation from downside risk associated with the overall economy. In the current environment, investors are expected to continue to focus on the yields, pushing concerns over risk further into the background.

**Consumer Confidence**

Moderate interest rates and a fairly stable employment situation suggests consumers will be able to hold their own when it comes to supporting the economy. Concerns over the housing market and inflation, which contributed to the slowdown in consumer expectations, are likely to place a governor on consumer confidence levels until they have shown some signs of stabilization. Despite these factors, the relatively high overall level of confidence suggests that an improving economy in the first quarter will spill over into higher confidence levels.

**Retail Sales**

Despite the uncertainty over the economic outlook, near-term prospects suggest retailers may have enjoyed a relatively healthy end of the year. Optimism is most pronounced at the upper end of the market, where sales of luxury goods and high-end items were expected to lead to strong sales gains. While providing some solace to the industry, the retail sector is by no means out of the woods and must look to a surge from postponed purchases, online shopping, and gift cards to bail them out. Although sales activities should be relatively strong in light of the competing pressures on consumers, margins will remain tight with retailers depending on volume to carry the day.

**Housing Market**

The housing market continues to show signs of stress, although not near the levels suggested by some of the doomsayers. That said, the ripple effects of the deteriorating market continue to reverberate through the economy. This has led to a number of related problems, including significant losses of jobs and housing, erosion in homeowner equity, and a general deterioration in the quality of the residential mortgage market.

In terms of existing home sales, aggregate transaction levels have been relatively stable with moderate declines in line with consensus expectations. Turnover rates have been moderate, as have the pipeline of existing homes. Thus, while the supply and demand for existing homes remains relatively balanced, the downward pressure on prices has not abated. The recent decline in mortgage rates has provided some respite, although any relief has been in the form of a softening of downward price pressure rather than resurgence in prices. This situation is likely to remain over the near term with the fate of the sector depending on moderate interest rates and improved economic fundamentals that translate to renewed confidence of homebuyers.

On the new housing front, builders have exhibited a disciplined approach, pulling back housing starts and permits. At the same time, they have become more aggressive in efforts to move existing stock. In particular, the success of early efforts to move product in the face of declining demand through the use of upgrades, add-ons, and other noneconomic factors has given way to price cuts. While committing downward pressure on appraised values for existing assets and future stock, builders have realized that holding the line and carrying excess inventory may not be adequate in the face of a prolonged softness in the housing sector.

Some of the smaller local and regional builders have begun to walk away from inventories of land, taking their losses rather than waiting out the recovery. This is an opportunity for larger homebuilders and well-capitalized investors who have the power and wherewithal to wait out the bottom of the market and take advantage of reduced prices for vacant home sites.

The current situation suggests that the homebuilding market has become more transparent and more efficient, and has the needed discipline and resiliency to survive. This phase of the market will require continued patience and more attention to customers' demands as mass building subsides and value-added, niche marketing strategies rule.
Real Estate Outlook

Office Market
On a positive note, the office sector has experienced some long-awaited improvement, with vacancy rates trending downward and some markets experiencing an improvement in rents. More recently, improvement in the office market has slowed down, with a deceleration in absorption and new stock coming out of the ground and going on the drawing boards at an increasing rate.

One of the most resounding votes of support for the office market has been the acquisition of Equity Office Properties Trust by Blackstone Real Estate Partners. While the recent improvement in sector fundamentals could help rationalize the transaction, the acquisition is more likely attributable to the overall arbitrage opportunity and anticipation of continued interest in the office sector.

In terms of market structure, the central business district (CBD) market enjoys lower vacancy rates, although the advantage has burned off a bit as suburban markets have improved over their peak in 2004. In terms of sublease space, the market has continued to tighten somewhat, with the CBD market enjoying an advantage over the suburbs, which should lead to more construction activity in CBD markets as developers respond to tenant optimism. With respect to geographic location, office appreciation rates in the National Council of Real Estate Investment Fiduciaries (NCREIF) Office Index have been strongest in the East and West markets, with the South and Midwest lagging.

Retail Market
Over the past five years, the retail sector has enjoyed a strong performance, bolstered by the consumer-led economy, which was attributable to the explosive housing market. The slowdown on the housing front coupled with high gasoline prices cut into retail sales for a number of merchants. However, as in the past, the upper end of the market has fared well. Over the near term, this situation is likely to continue, with strong performance in the stock market boding well for high-end merchants.

This performance is likely to help continue the pace of development of new lifestyle centers, as well as mixed-use projects that are targeted toward affluent shoppers. At the same time, existing regional malls are beginning to garner more attention in terms of untapped potential for expansion and densification. This interest is expected to grow, especially in some of the earlier malls that are well established and have become something of infill projects as the markets have expanded around them. Based on market fundamentals, the retail market is expected to continue to attract investor interest to enable the sector to hold values and maintain returns; however, appreciation rates should taper off as in other property sectors.

Industrial/Warehouse Market
The recent strength in the manufacturing sector has boded well for the industrial market, which has experienced an improvement in market fundamentals. On the global front, continued strength in imports despite the weak dollar has kept port-related facilities powering along, creating some backlogs in terms of throughput. Although some of the backlogs have been reduced in response to capacity increases and productivity gains, the warehouse sector remains relatively healthy. The anticipated increase in export activity should provide additional momentum to the industrial sector.

As might be expected, the strength in the industrial warehouse/distribution market has translated to an increase in construction, with activity concentrated in established distribution centers. In terms of product specifications, developers and investors remain focused on larger facilities with ceiling heights thirty-two feet and higher, dock-high loading, super-flat floors, and other design features necessary to respond to changing logistical models, including increased throughput and turnaround times. Despite these increases in supply, rising costs of land and building materials should help bolster total returns, with rents holding firm. At the same time, vacancy rates are expected to remain relatively healthy, although some short-term imbalances are expected, especially in the more established distribution points where expansion is becoming more difficult and costs are rising.

Apartment Market
For the past several years, the surge in homeownership rates has created challenges for the apartment market, as renters opted to take advantage of low interest rates and easy financing to experience the American dream. The recent, and continuing, slowdown on the single-family and condominium fronts has had a positive impact on the apartment market. Indeed, in a number of markets, condominium projects have been temporarily shelved or converted to rental projects in anticipation of an increase in demand.
As might be expected, developers have risen to the challenge and are increasing the pace of multifamily construction activity. Indeed, in the largest twenty-five metropolitan markets, starts are up dramatically in response to improving vacancy rates and the anticipation of further improvements in demand. There is some concern that the pace and location of new construction are not in balance, with the potential for overbuilding in the slower-growing markets. On the other hand, markets with high barriers to entry that experienced a contraction in supply due to condominium conversions are likely to remain tight, favoring landlords over tenants. At an overall level, fundamentals are expected to continue to improve, with moderate downside risk due to the risk of overbuilding.

**Real Estate and Capital Markets**

**Capital Market Overview**

In 2007, it is appropriate to step back and explore four recent market trends that have gained additional momentum and are likely to influence the domestic real estate market for the near term.

The first trend is the growth in offshore investing by institutional investors and funds. This trend has taken several forms, ranging from joint ventures between domestic developers and large public pension funds to self-directed investments in global real estate securities. While some advisors have focused on core global investing, the bulk of U.S. capital has been attracted to opportunistic investments that have the higher yields necessary to compensate for higher risk and uncertainty. These investments take the form of development projects in established markets or development and investment in emerging markets.

With respect to the domestic market, the trend toward offshore investing may provide some insulation for current low yields, with institutional investors content to receive lower-risk, core returns on the domestic front while looking offshore for higher returns to bolster overall real estate portfolio performance. While there is some concern that offshore capital flows will reduce domestic appetites, the pent-up demand for private real estate investments argues that the trend is unlikely to have an adverse effect on current prices. Indeed, due to the fledgling nature of such activity and the unknown risks that have yet to surface, the trend is likely to reinforce current domestic market pricing.

The second trend that is likely to affect capital flows to the real estate market over the near term is the wave of privatization that is impacting the real estate investment trust (REIT) sector. This trend was exemplified by the acquisition of Equity Office Property Trust by Blackstone Real Estate Partners, as mentioned earlier. The record-breaking acquisition followed the $35 billion acquisition of the hospital operator, HCA Inc., which came on the heels of a number of other, smaller deals and some $80 billion of privatization that occurred over the past two years.

The Equity Office deal provides a potent statement of the depth of the capital surplus continuing to chase equity real estate deals. It speaks to the arbitrage opportunity that exists between the private and public markets, with capitalization rates in the private sector below dividend rates in the public sector. While unusual in terms of size, the Equity Office deal further suggests the privatization trend has not played out. In addition to providing an added stimulus to REIT share prices, especially those considered takeover targets, the trend is likely to draw attention to the cyclical low in private market yields. While a rebalancing is inevitable, the market has such pent-up demand that it is unlikely to occur over the near term.

The third trend is the gradual acceptance of green or sustainable development by pension funds and other investors committed to socially responsible investing. For the past several years, the green movement has received increasing attention, bolstered in part by high energy prices. Despite this attention, several factors have inhibited the mainstream adoption of green investing.

The green movement has been hampered by a general lack of hard, empirical data to justify the investment in green projects. Also, the frenetic pace of competition for existing product has squeezed out recognition of green buildings as a major attraction, since finding product is the major challenge. In addition, the bottom-line orientation of corporate tenants, most of whom have been taking a minimalist approach to real estate consumption, has not translated to a willingness to pay rent premiums for green spaces. Finally, lenders have not embraced green in underwriting or valuation in the form of economic rewards. The end result has been an affinity for green investing, but relatively limited market reaction.

Recent activity, however, suggests increased interest in green projects. There has been an emergence of several socially responsible funds and the inclusion of green building preferences in the investment strategies of some other funds. Some leading pension funds explicitly favor green investment.
Also, an increasing number of local governments are creating incentives or requiring the attainment of certain levels of green building certification. The combination of these forces suggests the trend may cross over into a sustainable movement.

The fourth trend likely to influence the domestic real estate market is the trend toward urban revitalization and infill development. Frustration with traffic congestion in nonurban areas, concern over sprawl-related phenomena, and local governments’ incentive programs encouraging higher-density living have created a resurgence of interest in central cities.

This movement has been bolstered by the recent housing market, which supported surges in condominium development in many cities. While many cities are suffering from an overhang of high-end condominiums, the marketing and promotional efforts that built momentum for the sector has enabled urban living to gain additional attraction in a number of cities. The pace of housing construction in central cities and the upward demographics that have been attracted to the city has drawn the attention of retailers and other ancillary businesses. This in turn has led to a number of innovative, mixed-use developments that blend mid- to large-range grocers and some big-box retailers with dense residential projects.

The trend has also helped the surge in new lifestyle centers, which in many cases have turned inward, seeking infill locations instead of pushing the urban boundaries farther from the city core. Finally, institutional investors frustrated by the lack of investment options have targeted mixed-use, urban projects as one of their favored property types. While lenders are likely to remain somewhat skeptical about the economics of such projects, the strong capital pools of investors and the ability to eschew debt suggest plentiful capital for new projects. While it is too early to tell if the renewed interest in central cities will prove sustainable over the long term, the momentum is likely to propel the trend forward over the near term.

**Construction Activity**

Construction spending has slowed down, led by a decline in residential spending. The level of contraction was offset in part by robust spending on the public front, for which construction activity hit an all-time high. At the same time, the pace of commercial construction activity has picked up, with office construction and new retail formats (e.g., lifestyle centers, mixed-use projects) taking up the slack caused by the slowdown in condominium development.

The worldwide surge in demand for building components, such as steel, concrete, and other materials has placed upward pressure on costs. In some markets, rising costs have also contributed to a surge in thefts—in particular copper piping, which has drawn the attention of those targeting construction sites, and in some markets, has spilled over to existing buildings. Indeed, in some markets, commercial construction activity has created a backlog of cranes, forcing mothballed equipment back into production, thereby raising costs, extending construction periods, and delaying new projects.

Despite these pressures, rising costs and construction risks have done little to dampen the enthusiasm of developers as they position themselves to take advantage of the anticipated economic boon. In the absence of a major shock to the economic recovery, at a national level the surge in development activity should not be sufficient to undercut the recent improvement in market fundamentals. However, in this environment there is likely to be some overbuilding in some markets in which the pipeline is supported by strong capital flows of both debt and equity.

**Commercial Mortgage Market**

The commercial mortgage market continues to power on, with lenders aggressively competing for business. While delinquency rates have been rising, and there is some concern over credit standards and underwriting, there are no flags over a major correction. Indeed, lenders continue to aggressively compete for product, triggering some calls for intervention to rein them in and avoid a repeat of history as a result of relaxed underwriting standards.

These calls were articulated by the Federal Deposit Insurance Corporation and the Fed, which issued statements in October to warn smaller lenders about excess exposure to the commercial property sector. There have also been some calls for increasing reserve requirements and stricter internal controls for banks with larger commercial mortgage portfolios. Despite these interventions, the private commercial mortgage market remains flush with cash and is likely to continue to be extremely competitive, providing ample support for the market for existing and new properties.

The commercial mortgage-backed securities (CMBS) market continues on its record-setting streak, with new issuances for the year projected to...
beat the pace of the past three years. Continued demand for CMBS, coupled with low delinquency rates and moderate improvement in real estate market fundamentals, has contributed to a decline in spreads of AAA CMBS over ten-year Treasury notes. In terms of future capital flows, concern over the residential market may skew some capital to CMBS, especially higher-rated tranches that provide fixed income. The bottom line is that private and public debt markets are likely to exhibit no major changes in capital flows that could distort the market.

**Private Equity Market**

Despite concern in some circles over low income returns and continuation of historically low yields, the pent-up capital chasing domestic product argues that pricing is likely to hold up over the near term. However, as in the residential market, the pressure on market fundamentals and a recognition that appreciation rates are likely to taper off, if not reverse, are likely to start settling over the intermediate term. To this point in the cycle, institutional investors have been drawn to value-add investments and funds. Even with this moniker, income returns have been lackluster, depending on continued appreciation and value-added, higher-risk investments to justify acquisitions.

While some long-term investors may continue to accept historically low returns, investors are likely to start shifting attention toward other asset classes or seeking out more opportunistic ventures explaining some of the recent interest in China and other emerging markets among investors who to this point have eschewed offshore investing. At the same time, the pace of activity on the domestic front is expected to moderate somewhat, although demand for product should continue to outpace supply.

**Public Equity Market**

At an overall industry level, REITs have continued to rack up solid numbers as market fundamentals have improved and the market recovered from a hiccup in 2006. REITs have outperformed the broader equity markets. An additional stimulus to REITs has been the recent trend toward privatization, which has placed upward pressure on share prices. Despite this interest, REITs have raised relatively little common equity, as shown in the third quarter, which had the lowest capital raise in over three years and no initial public offerings.

On the other hand, REITs have been active in the debt markets, with unsecured bonds and debt rising at much higher than normal pace. Some REITs have also turned to CMBS to raise capital to take advantage of diversification benefits and structured risk/return packages they can offer to reduce overall costs of capital. However, they do come at the loss of flexibility, with CMBS more focused on individual properties than portfolio financings from traditional sources.

This shift toward unsecured debt and pooled debt structures where collateral can be substituted has been embraced as a means of providing more flexibility, allowing REITs to respond to opportunities in the market without triggering refinancing costs or delays. REITs have also turned to new ventures and new multi-investor funds to raise capital to help sustain growth, expand, and refresh their holdings. The outlook for REITs remains relatively stable, with continued improvement in underlying market fundamentals and flexible uses of debt providing some upside potential. However, low capitalization rates on the private front are likely to make it difficult to support acquisitions of exiting properties.

**Conclusion**

As the economy settles in for a soft landing, the real estate market should remain attractive. While capitalization rates are at a historical low, and spreads on mortgages remain tight, plentiful supplies of debt and equity are expected to continue. Despite some recent slowing in the economic recovery that may lead to short-term blips in market fundamentals, the real estate market should continue to improve. However, this rather sanguine outlook is not without risks that could be triggered by external or internal forces.

In terms of external forces, improving fundamentals depend on a renewal of the economic expansion and increasing employment that leads to the demand for more space. In terms of internal forces, the near-term fate of the real estate market depends on the ability to maintain a sense of discipline on the supply side, with the market as a whole avoiding a tendency to overreact to the promise of good times.

The housing market remains one of the wild cards in the equation and will receive close monitoring. Returns are expected to level off and decline, especially as appreciation rates fall back into line with longer-term averages. In some cases, this adjustment will reflect a pause in appreciation, while
in others, prices will be adjusted downward. This adjustment will be particularly pronounced for some of the commodity space and weaker product that rose with the flood of capital to U.S. shores. While creating challenges and disappointments for some investors late to the dance or those without an eye toward drivers of value, the process should be manageable and should create some opportunities for value-add and opportunistic investors.

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