Commentary

As 2007 came to an end, the prospects of a recession had increased to the point that such an outcome appeared plausible. Whether the economy actually tilts into a recession depends on a number of factors, ranging from continued economic stimulus from abroad to surprising resiliency on the consumer front. Unfortunately, neither of these factors are givens, especially with consumers struggling with a number of pressures on household budgets and confidence levels. Thus, the situation will be somewhat precarious, with players on all sides of the market taking a defensive posture. The absence of any clear answers is likely to do little to appease the market and may actually create more uncertainty.

One of the major drags on the economy has been the unfolding subprime debacle and the widespread cracks in broader credit markets that it has highlighted. The continued erosion in the housing market with no clear bottom in sight has rippled across the economy. High and sticky energy prices, coupled with disappointing news on the job front, has spilled over to consumers, putting a damper on consumer confidence that will likely continue to create a drag on retail sales.

The continued weakening in the dollar has created some good news, with rising prices placing something of a damper on imports. The weak dollar also has created a stimulus to exports, which is one of the bright spots on the horizon. Similarly, the cheap dollar has helped attract global capital, placing something of a cushion on the market as foreign investors gobble up a wide range of U.S. assets including stocks and commercial real estate.

On the real estate front, market fundamentals are expected to continue to improve modestly, although the recent weakness in the economy and turmoil in the credit markets remains a concern. The recent interest in green buildings and sustainable investing is likely to continue to expand and warrants particular attention as the market reacts to the trend. Capital markets continue to favor real estate and should be adequate to support the industry in an orderly manner. While mortgage financing will hold up, the contraction in the commercial mortgage-backed security industry (CMBS) and tightening credit will bear some attention.

The Economic Environment

Economic Growth

Exports helped offset slowdowns on the domestic front. However, the credit crunch that began in the United States has had global ripple effects, spilling over to Europe, the Middle East, and Asia. Since world economies have become more aligned over the years, the global credit market clogged as it tried to figure out what types of securities would be affected by the tightening and how the credit crunch would play out.

As in the United States, other governments and their central banks have been unwilling to subsidize those players who ignored the risks associated with easy credit. However, they have been willing to try to ease the aggregate pain in an effort to bridge the cyclical adjustment.

Assuming such interventions work and the credit markets begin to stabilize, global market expansion should help bolster economic growth and allow the
U.S. economy to avoid a recession. As the housing market approaches the bottom of its cycle, the drag it has placed on economic growth should evaporate. While some argue that the housing market has begun to stabilize, the consensus thinking is that the bottom will not be reached until well into 2008. At the same time, the bottoming out for the housing sector will likely be a prolonged process and a bumpy ride. This situation will carry over to the broader economy, although the economy itself is likely to regain momentum before the housing market.

**Employment**

Employment growth has been slowing, but is still in positive territory. The gains have been led by service jobs, with some improvement in export-oriented jobs in the face of the weak dollar. The dramatic contraction in the housing market has led to job losses in construction and ancillary business services, especially in the troubled financial services field where layoffs have become commonplace. At the same time, the slowdown in economic growth has had a dampening effect on employment growth.

On the other hand, productivity levels have continued to improve, helping to hold wages and take pressure off inflationary forces. The recent deceleration in employment growth is understandable in light of the current economic environment and may portend some additional softening. The unemployment situation has held fairly well, although the jobless rate is expected to trend moderately upward. At a national level, the year-end picture was evenly mixed, with slightly less than half of the states reporting an increase in new jobless claims while the balance reported a decline.

Going forward, economic uncertainty and tight credit is likely to put upward pressure on unemployment rates, although no major spikes are anticipated. However, if the economy begins to stumble, the situation could change somewhat as employers retrench to weather the downturn. Relatively strong balance sheets and stabilization in the credit markets should allow employers to avoid major cutbacks and help them posture for the eventual recovery.

**Inflation and Interest Rates**

The Federal Reserve (Fed) has struggled with finding the right balance between fighting inflation and stimulating the economy. The fragile state of the economy has created significant angst among policy makers. While the Fed has been pressured to cut rates to provide some stimulus to the fragile economy, inflation fears have not subsided. To complement rate cuts, the Fed also introduced the Term Auction Facility (TAF), a new mechanism that will hopefully improve liquidity and stability by encouraging interbank lending to the tumultuous credit markets.

While efforts to stabilize the economy are generally welcomed, the announcement of the TAF was quickly discounted by the market, which saw it as further evidence of the potential for a recession. The end result was a spike in oil prices that has exacerbated an already difficult situation. Indeed, the rise in energy prices and the recent surge in consumer prices are likely to place even more pressure on interest rates.

The recent batch of bad news on the inflation front has rippled through the market. At this stage, the market is unsure of what the Fed will do next, while the Fed is pondering its next move as well. This is evidenced by the fact that the rate-setting Federal Open Market Committee has been reluctant to address its traditional risk assessment statement in which it compares the risk of slower growth against the risk of inflation. This uncertainty is likely to continue over the near term with no quick fix on the horizon. Thus, there remains some downside risk that the economy could falter and inflation may heat up again.

**Business Indicators**

While the news on the overall economy remained guarded at year’s end, business indicators continue to be somewhat mixed. This was welcomed news and suggested that the economy may be able to avoid slipping into a recession caused by widespread retrenchment. A surge in vehicle production reflected some success in the automobile sector’s efforts to stimulate demand with product lines and innovations, along with growing interest in hybrids and more energy efficient vehicles. The recent run-up in oil prices is likely to bolster this demand even more, although lower consumer confidence levels may place a damper on the sector.

One of the bright spots has been in export industries, with the cheap dollar translating to increased overseas demand. On a positive note, business investment turned up, although levels were still down from longer-term averages. Capacity utilization also moved up moderately, with excess capacity suggesting the
industry is positioned to respond to improving economic conditions or increased demand for goods and services.

Stock Market
During 2007, the stock market moved into more volatile times, with investors anxious about the economic outlook, the housing market, and the broader credit markets. Despite these concerns, the S&P 500 managed to eke out a modest gain. However, the market is poised for a rocky ride and an increase in volatility, especially as the economy appears to be slowing down. Of particular note is the shellacking that some financial institutions have taken as a result of the turmoil in the subprime. Losses have forced a number of changes at the top as investors look for someone to blame and the institutions attempt to forestall government intervention, which would inject new regulations and constraints.

At the same time, the private sector has taken some steps to prevent the bottom from falling out, searching for new products that can bring much-needed liquidity. For example, four of the major banks have indicated their intention to launch a Master Liquidity Enhancement Conduit in an attempt to help bail out structured investment vehicles that have racked up significant losses.

Other banks are taking matters into their own hands, searching for options to help avoid further losses and forced sales. While these efforts may provide some relief, they are unlikely to spill over to the broader equity markets, suggesting volatility is likely to rise even more. At the same time, stock valuations remain relatively attractive, with price/earnings ratios in line with long-term averages. The bottom line may lead to a flight to quality as investors seek a semblance of stability until the direction of the economy and the fate of the credit markets become clear.

Consumer Confidence
In addition to moderate declines in the current situation component of the index, the expectations component declined even more precipitously as consumers became more pessimistic about the economy. This pessimism is understandable in light of slowing growth, rising energy prices, the threat of more inflation, continued fallout from the housing market, tightening credit, and disappointing news on the employment front.

While the list of negative factors is long and likely to grow, the fact that consumers remain moderately positive in terms of their current situation suggests that sentiment could turn positive if some of the uncertainty is removed from the equation. Unfortunately, prospects for a near-term economic recovery are somewhat limited, suggesting consumers are likely to remain anxious. This sentiment will have a dampening effect on economic growth, keeping consumers on the defensive and seeing the world through a pessimistic eye rather than the optimism they portrayed up to this point in the cycle.

Retail Sales
At the end of the day, the challenges facing the economy have clouded the collective psyche of consumers. While there have been some bright spots, the overall retail industry racked up a disappointing year-end finish to an already sober year in terms of retail sales. However, this is not to suggest the beginning of a major retrenchment on the part of consumers, but a more sober approach in which purchases are more aligned with earnings than with access to credit.

Uncertainty in retail sales rippled through some of the upper-end retailers who in the past were able to sail through the economic cycle. While higher-end consumers are likely to have avoided direct exposure to the subprime market, its effects on the broader housing and credit markets—especially jumbo mortgages—may have had a greater impact than first anticipated.

Short of an unanticipated rally, consumers are likely to tighten their belts until the broader economy and housing market begin to stabilize. Unfortunately, the late signals indicate retail sales may suffer further compression as energy prices continue pushing upward, fueling a rise in inflation, and the job market remains tempered. Recovery depends on the overall state of the economy and stabilization in the troubled housing market.

Housing Market
The housing market continues as the biggest news on the economic front, stimulating debates on whether the contraction has played out or if the market is in for an even greater correction. The dramatic rise in foreclosures has forced national attention on the crisis. Indeed, 90% of states reported higher foreclosure rates, with rates accelerating in many
markets. Home prices of existing homes continued to slip, declining almost 5% compared to the prior year, the largest decline in the 21 years covered by the S&P/Case-Shiller National Home Price Index. In markets with weakening economies and marginal borrowers, prices may decline another 10% before bottoming out.

As might be expected, housing starts have continued to tail off, although some projects in the pipeline are bolstering recent completions. This situation should prove temporary as homebuilders, lenders, and homebuyers step back and reassess prospects for the sector. The inventory of for-sale housing has built up as transaction levels for existing and new product continue to taper off. Building permits have contracted across the country. Housing starts are likely to fall even further in 2008 with some improvement in the following year, although nowhere near the frenetic pace of the past several years.

The breadth and depth of the housing crisis has triggered heated debates that are likely to become even more pointed during the upcoming election year. This attention is warranted on a number of fronts ranging from the heart-wrenching plight of those caught in the crunch, as well as the importance of the housing sector to the broader economy.

In the minority view—held mostly by industry insiders—proponents are arguing that the market is about to stabilize and will show some improvement in early 2008. However, the general consensus holds that the beleaguered sector may be struggling for some 12–18 months even if the economy avoids a recession. Given recent economic events, the sector faces more downside risk and could stumble even further.

One surprising element of the crisis is that so many were caught off guard. Clearly, the eventual correction was foreseeable in a market with record levels of homeownership triggered by a combination of unsustainably low interest rates, easy credit, and rhetoric hyping housing as the ultimate investment. However, many players were lulled into a false sense of security due to the remarkable resiliency the sector had demonstrated by its extended bull run. As such, the timing and speed that the crisis hit with caught many off guard.

Once the severity of the problem started to become clear, private lenders stepped back and realized there was little they could do in the face of the sheer magnitude of the credit crunch. Despite being on the radar screen for some time, the housing crisis is only now surfacing. Critics of proposed federal intervention argue that current initiatives are too little, too late to help the majority of homeowners who are on the bubble.

Many proposals do not attempt to help those who are already in trouble. The five-year freeze plan, in which the White House and mortgage companies negotiated interest rates for certain subprime mortgages, may help some homeowners but will do little to address broader problems beyond the subprime sector. Calls for more intervention by the Federal Housing Administration through refinancing support and increased loan limits will provide some help, but will not be sufficient to stimulate a recovery. Since this is an election year, it is likely that a number of new initiatives will be launched. Unfortunately, rhetoric and legislation will do little to turn the sector around.

Going forward, tightened credit standards for jumbo mortgages, added scrutiny of low-doc mortgages, and moderate increases in interest rates are likely to have a domino effect. The inability to sell houses could inhibit mobility and affect job growth in certain higher-growth markets since potential employees may have trouble liquidating their current housing. This is especially true for homeowners who did not move, but who refinanced their houses and mortgaged their equity.

The risk would be exacerbated if the economy slipped into a recession while the job market stagnated. In such a scenario, a significant number of marginal homeowners who avoided the lure of adjustable rate and low down payment mortgage financing may be caught in a situation where they find themselves upside down, with debt exceeding net realizable market value. Even without a recession, the housing market is in for a difficult period of adjustment.

Real Estate Outlook

Office Market

The office market has continued to show some moderate signs of improvement in spite of some of the uncertainty on the economic front. Net absorption has been uneven but positive, with the suburbs experiencing the most volatility. In terms of new construction, activity levels have been trending upward but are still moderate, especially in central business districts (CBD). On the other hand, suburban construction has expanded at a somewhat higher rate.
in anticipation of increasing tenant demand and the need for new product.

The improvement in office market fundamentals has been strongest in CBDs where the vacancy rate has gradually fallen toward the single-digit range. Suburban vacancy rates have held steady in the mid-teens. The office sector provided the highest returns among other major property types in the NCREIF Property Index (NPI). On the public front, total returns for office real estate investment trusts (REITs) were more negative than the broader index. These returns suggest a modest cooling off of the sector, which brought it more into balance with other property types.

Going forward, the office market may face some near-term challenges as the subprime problem places a drag on financial institutions and other tenants whose fate is somehow tied to the credit markets. The recent weakness on the economic front and more cautious attitudes among tenants suggests that growth in asking rents and net operating income may taper off. However, the tightening of credit and added scrutiny on underwriting and valuations will put a damper on office construction, thus helping forestall overbuilding of the sector.

One factor that may stimulate new office construction in this tempered environment is the push for more sustainable buildings and the pressure on companies to demonstrate corporate social responsibility (CSR). While unlikely to create a major surge in office construction, the growing demand for green or Leadership in Energy and Environmental Design (LEED) certified buildings may trigger new construction activity. This is especially true in markets and submarkets that attract national and global tenants who are under the most scrutiny with respect to CSR.

LEED certification is relatively new, but its importance is growing dramatically. This is good news for developers since the incremental cost of achieving LEED certification on new construction has come down to a cost-effective level. The momentum for constructing green buildings has been bolstered by a number of policy changes (e.g., expedited approvals, tax credits, density bonuses) that a growing number of municipalities are passing.

Unfortunately, the costs of gaining LEED certification for existing buildings has proven to be a challenge, so that some buildings may experience an unanticipated degree of functional obsolescence. This could occur on both the tenant side as well as the investment side.

**Retail Market**

Consumer confidence has tumbled in the face of the housing crisis, tighter credit, rising energy prices, and a disappointing job market. While these factors provide some downside risk to the retail market sector, in the absence of a recession the prospects remain relatively stable. This is evidenced by relatively low and stable vacancy rates, solid net absorption, and moderate additions to stock. Indeed, the construction activity that has occurred has been concentrated in nontraditional formats, with regional mall construction well off the normal pace.

On the other hand, construction activity in neighborhood and community centers has been somewhat higher than longer-term averages as investors and lenders have been attracted to the sector. Retailers have experimented with new concepts in outlets in order to grow revenues, though tightening in the credit market and more stringent underwriting should put a damper on some of that activity.

The trend toward reinvestment in existing malls is likely to remain strong and may pick up some momentum as owners respond to competitive pressures from alternative formats including urban villages, lifestyle centers, and mixed-use development. Going forward, the retail sector should remain relatively stable. The sector is unlikely to regain the lead over other property types over the near term.

As in the case of the office sector, the increased interest in green retail buildings and sustainable development has caught the interest of developers, owners, tenants, and consumers alike. Some studies have suggested that daylighting a store can create a significant boost to unit sales. Similarly, more efficient systems, recycling, water recapture, and other innovations have piqued the interest of the retail developers.

In some respects, this interest has the potential to take on more importance in the retail arena than some other sectors, since the investment in green practices may be more visible to consumers who are becoming sensitive to the challenges posed by global warming. This interest is likely to operate on two levels: increased sales of green products and a preference for supporting socially responsible retailers and shopping centers.
Industrial/Warehouse Market
The industrial/warehouse market has continued to remain relatively stable. Additions to stock have been met with a commensurate increase in demand, generating positive net absorption. This has provided the opportunity to raise rates in a number of key markets, and is especially true in markets with limited supply of developable land or higher barriers to entry.

In exploring the sector, it should be noted that different drivers of the industrial and warehousing subsectors provide a natural hedge position for the composite mix. That is, while light industrial has come under pressure from imports, the recent weakness in the dollar has created an increase in demand for U.S. products. This provides stimulus to both the manufacturing and distribution centers, benefiting markets located along the channel of distribution. On the other hand, despite rising prices, imports remain relatively strong, stimulating demand for warehouses.

The R&D/flex subsector, which is also covered by the industrial umbrella, provides another diversification play. That is, as office market fundamentals improve and rents rise, some tenants who have moved in order to take advantage of bigger spaces with lower rents are likely to be forced back into more affordable space.

Another factor behind the relatively stable prospects for industrial and warehouse space is the relative speed with which new product can be delivered, especially compared to larger office, retail, and mixed-use projects that may involve long entitlement processes and construction periods. Thus, the sector is likely to remain attractive to institutional investors.

The strong demand for assets will help hold values and should enable the sector to weather a potential downturn in demand related to economic factors. In addition to demand from investors, the sector should be able to avoid a credit crunch since it has not been as highly leveraged.

In terms of the greening of industrial space, the diffusion of innovation has lagged other property types. This slower adoption is due to the nature of space, which tends to be more austere in the first place, allowing less obvious opportunities for more efficient design, construction, and operation than some of the more complex property types.

However, the industry relies heavily on the use of triple-net leases in which tenants pay utility costs. While tenants no doubt appreciate energy savings, they may not apply the same cost/benefit analysis in selecting properties and negotiating rents that an owner of a building with gross leases might use. On the other hand, some of the larger industrial REITs and operating companies are pushing the green movement to differentiate themselves, brand their businesses, and attract tenants with a commitment to sustainability.

Apartment Market
The significant correction in the single-family market has had a dampening impact on the broader housing market. While multifamily housing construction was caught up in some of the momentum, net absorption has been strong and vacancy rates have been moderate. Despite this improvement, apartment returns in the NPI have lagged other property types with the exception of retail. This situation can be explained in part by aggressive pricing on recently acquired properties, which has resulted in an implicit capitalization rate in the NPI slightly under 5%, fully 100 basis points below retail.

On the public front, apartment REITs have plummeted, with total returns falling some 22% in 2007. The returns for apartments can be attributed in part to lag effects from the exodus of renters who were drawn into ownership positions. This situation should improve with construction activity tapering off as developers, lenders, and investors worry over the near-term impact of the excess capacity on the rental market.

In addition to a slowdown in new construction, the multifamily rental sector is likely to benefit from the return of homebuyers who opted for homeowner–either single-family or condominium. Unfortunately, for many marginal households caught in the subprime market or others facing the impending reset of adjustable mortgages, rental housing will be the only viable option. The conversion of condominiums to rentals and the surge in single-family rentals as investors try to mitigate losses are likely to absorb some of that demand, although the bulk of it will be skewed toward multifamily properties.

The tightening of credit standards and renewed emphasis on market fundamentals will put a dampener on new starts, pushing down vacancy rates and reversing the recent moderate upward trend. Pricing for existing assets is likely to hold in this sector with rising rents in some markets offsetting higher costs.
of capital. The recent softening of the economy may work in favor of the multifamily sector, although those forced out of their homes through foreclosure will be operating under strained budgets and will have little to absorb increases in rent. Unfortunately, they also have little choice and may be forced to pay higher rents as the overall sector tightens up.

Environmentally, the multifamily sector is likely to lag other property types at an aggregate level. This response can be attributed to several factors including the fact that most properties are individually metered, with the benefit of higher efficiency passing to the tenant and the cost borne by the developer or operator. However, in some markets and submarkets the case for green apartments may be supported by tenant demand, with the threat of global warming resonating in some demographic segments.

This is especially true in some markets being driven by the knowledge industry in which households are more aware of social issues and can be attracted by green building practices. While this may result in slightly higher rents—especially as renters are educated to the benefits of greater energy efficiency on budgets—it can also result in quicker absorption, lower vacancy, and lower turnover rates. This situation is found in many of the newer genre of mixed-use projects that are springing up in infill locations and transit-oriented sites that are being encouraged by a number of local municipalities.

Finally, while the condominium market is suffering from the same fate as many single-family markets, a number of developers are factoring condominium conversion into their exit strategies. Since the green movement is expected to become a more enduring element of demand for condominiums, many of the newer projects are incorporating green features that can be added during the design stage for a moderate cost, which would be prohibitive on a retrofit basis.

Real Estate and the Capital Markets

Capital Market Overview

The real estate market has continued to outperform the broader market, with strong capital flows driving activity. However, two major players have stepped to the sidelines: the commercial mortgage-backed securities (CMBS) sector, which has suffered from the contraction in the securitized market, and the highly leveraged players, who have depended on easy credit and low rates to acquire real estate.

Despite adjustments, institutional investors remain active, although the market is not as frenetic as it had been in the past several years. In terms of transaction volume, the market continues to hold up although the number of bidders has subsided. As a result, there has been some adjustment in expectations along with softening of bids on nonprime real estate. The top end of the market has held fairly well and is likely to continue to hold value. However, recent trends and investor surveys suggest the string of record-breaking prices of the past several years has been broken.

The cheap dollar has helped support the market, with foreign capital expected to remain a factor in the market. Despite strong interest, capitalization rates are likely to continue to rise, with many investors building a 50-basis point increase into their pricing models. Given the state of the economy and the resultant impact on demand, the adjustment in yield requirements could exceed that pace, especially for noncore assets that have benefited from commoditized pricing.

Construction Activity

During 2007, construction activity levels were mixed, with the contraction in residential activity placing a dampener on the overall industry and pulling down overall year-to-year figures. The contraction in the housing sector was most pronounced in the beleaguered single-family sector. The multifamily sector experienced less contraction, in spite of the pullback in condominium projects in some of the faster growing markets. Nonresidential completions—which track projects that were in the pipeline before the recent turmoil in the credit markets—held up, with completions trending upward through much of the year and coming in positive on year-to-year comparisons.

The softening in the economy and tightening credit may take some of the momentum out of the office and commercial sectors as companies pull back and reassess prospects for additional growth. On the public front, completions have been fairly robust, with state and local projects accounting for the bulk of activity.

The declining volume of construction in the residential sector will provide some relief from rising construction costs. However, strong global demand and the threat of rising inflation are likely to continue to place upward pressure on construction costs. Going forward, the situation is expected to hold with
more contraction in the single-family sector and some declines in the office and commercial sectors.

**Commercial Mortgage Market**

New issuances of commercial mortgages in the second half of 2007 dramatically declined as capital dried up. At the same time, spreads widened although the dramatic climb has flattened out a bit. The commercial mortgage market is likely to continue to struggle with new issuances coming in at a modest pace.

The decline in volume is likely to create some lagged effects on the broader sector and place some additional upward pressure on overall delinquency rates. This phenomenon can be traced to the new issuances that tend to perform well, with frequency of loss correlated with the age of loans. If the economy slips into a recession, credit standards tighten, and market fundamentals slip, borrowers may be hard pressed to refinance loans, creating something of a credit crunch.

While the public debt markets are struggling and likely to be under stress for the foreseeable future, the private markets should be able to pick up some of the slack. However, credit standards are expected to tighten, making it difficult for investors dependent on leverage. These challenges will be felt particularly hard by marginal projects that were acquired on the basis of easy and cheap credit, high leverage, and financial engineering. Many of these acquisitions involved shorter-term bullet loans that will require refinancing over the next several years. Thus, owners of such assets might find themselves caught in a squeeze that is analogous to the one in the subprime residential market.

Risk is especially grave if mortgage rates begin migrating toward more historical levels and growth in net income does not rise fast enough to enable them to meet higher underwriting standards for debt coverage and loan-to-value ratios. This impact could be further exacerbated if investors begin to revisit risk, placing upward pressure on capitalization rates that could place downward pressure on values. Fortunately, private institutional investors and REITs avoided getting drawn into highly leveraged deals that depended on cheap capital.

**Private Equity Market**

Some insight into the cyclical nature of the private market can be extracted from a comparison of the level of returns with the year of acquisition. For example, in a recent release that analyzed returns by year of acquisition since 1990, which included some two-thirds of the $280 billion NPI, total returns are inversely correlated with year of acquisition. That is, the most recently acquired investments, which were fully priced, provided lower returns than more seasoned investments that benefited from the downward trend in capitalization rates. Indeed, properties purchased in 2006 had total returns around 10%, the average total return of the NPI since inception.

Several factors have helped bolster returns for privately held institutional real estate. First, although some of the highly leveraged players have been forced to the sidelines, institutional investors have tremendous pent-up demand for product, with real estate investment levels below allocations. This pattern is quite pervasive, affecting direct investment portfolios as well as commingled funds that have avoided getting drawn into the feeding frenzy and are sitting on cash.

Second, in addition to domestic investors, foreign investor appetites for U.S. real estate remain strong, bolstered by the cheap dollar.

Third, real estate fundamentals have experienced some moderate improvement, providing some solace to long-term investors who have committed to the asset class and have been willing to accept lower current returns in anticipation of stronger holding period returns.

Fourth, the contraction in the public real estate markets—both debt and equity—has tipped the advantage to well-capitalized institutional players who can move quickly.

Finally, the institutional market has internalized low capitalization rates, with implicit capitalization rates in the NCREIF Index at historically low levels.

In the absence of a major, unexpected shock to the system, there are some inherent lags built into the system, especially if institutional investors hold product off the market in the face of moderate corrections. Going forward, capitalization rates on commercial properties are likely to move upward in an orderly manner with an increase of 50–100 basis points a distinct possibility. Once again, however, this adjustment will not be spread evenly across investments, with weaker product that benefited from commoditized pricing facing more downside risk than upside potential.
Public Equity Market
Despite concerns in the REIT industry, the public equity market remained active on several fronts. While there has not been a flood of privatizations of large-scale REITs, the acquisition of the Archstone-Smith portfolio for some $22 billion by a partnership between Tishman Properties and Lehman Brothers Holdings, Inc. suggests the trend has not yet played out. The complex, piecemeal financing needed to pull off the transaction provided insight into some of the hurdles being faced in the capital markets as a result of tightening credit. Despite these challenges, privatization and mergers and acquisitions (M&A) activities are expected to pick up.

Mortgage REITs may be especially vulnerable to a wave of privatization and M&A activity. This risk can be traced to the double whammy: plummeting share prices, which make them cyclically cheap; and restricted liquidity needed to allow them to bridge the downturn stemming from turmoil in credit markets. Unfortunately, mortgage REITs have no offsetting revenue streams that can be drawn on to compensate for such downturns.

REITs should benefit from moderate but positive improvement in market fundamentals and greater volatility in the market that might favor real estate. If the Fed loses some of its battle with inflation, as long as the economy does not slip into a deep recession, REITs may benefit from some of the inflation-hedging potential the asset class offers relative to other assets. However, it may be a while before investors buy that argument and continue to focus on recent performance and near-term prospects rather than long-term arguments.

Conclusion
Clearly, the U.S. economy is facing a number of troubling issues, including the much-ballyhooed housing debacle, the collapse in the subprime sector, tightening credit markets, high and rising energy prices, the threat of inflation, and a slowdown in economic growth.

While these factors might suggest a recession, the economy has been able to weather other challenges. However, the housing market correction and its spillover effects on the broader economy are somewhat unprecedented, and they put the economy in unchartered territory. In this environment, the market is in for a period of higher volatility until there are clearer signals of how all the challenges will unfold and impact on the economy.

Despite this uncertainty and some carry-over effects on the commercial real estate market, the signs there are generally positive. Despite some disappointment regarding a slowdown in income growth, continued strength in investor demand is likely to help hold prices. That said, some price adjustments are likely to occur, with capitalization rates under some upward pressure. In the absence of a major unexpected shock that disrupts capital flows, this adjustment may be in the 50–100 basis points. At the same time, total returns on commercial real estate are expected to tail off, falling from high double-digit levels toward historical averages in the lower teens.

Finally, the movement toward green buildings and sustainable development will continue to unfold and receive more attention. However, the industry will struggle with the right approach to ensure more socially responsible decision making in real estate, affecting developers, tenants, investors, and the broader market of service providers and communities.

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