A Flood of Economic Trouble, a Ray of Political Hope

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Commentary

Over the past six months, the economy and capital markets have dominated the news. This attention blossomed in late fall as the economic environment continued to implode and Washington debated what it could do to avoid a complete meltdown and forestall a depression, which has become a plausible, albeit moderate, downside scenario.

Unfortunately, there has been little positive to offset news of the economic devastation that has rippled across the country and globe. In such an environment, everyone is looking for answers or at least for a list of indicators that could be monitored to signal an end is in sight. While this is understandable, the reality is the economy and capital markets are in such unchartered waters that it is impossible to identify the set of indicators that will foretell when we have changed course and can look forward to calmer seas.

Predicting what will happen in these uncertain times, which will continue well into 2009, is complicated by a number of factors. First, the federal government is still debating the course of action to take regarding an economic stimulus package. Thus, to an extent, we have shifted from a market-based economy to a political economy in which all bets are off until the new administration settles into office and the boundaries that will be placed on further interventions become clearer.

Second, due to the lack of data, monitoring, transparency, and regulation, it is impossible to identify the problems that are lingering beneath the surface. For example, the impending credit-driven contraction in the commercial real estate market has not received much attention outside of real estate circles. As such, there is no way to objectively quantify the impact of the easy credit environment of the recent past, which would allow us to determine where the economy is at in the cycle and how it is likely to play out, with or without further stimuli.

Third, the erosion in consumer and business confidence levels has been so dramatic and revolutionary that it has rendered traditional economic models and forecasts invalid. That is, we are now in an environment in which perceptions and market behavior will rule the day rather than rational models driven by economic considerations. Fundamental questions include several dimensions: Who are the key players? What will they do next? What will be the collective impact when it all plays out?

In light of the challenges we face, one response would be to shut down, to ignore the fray. Unfortunately, that is easier to say than to do, especially when personal and corporate wealth and revenue streams are in play. Although the arrival of the Obama administration in Washington, DC, has been much heralded and has worked to get a jump-start on action plans, the reality is there are no obvious solutions for deleveraging the economy without creating further disruptions to collateral values and market activities. This situation will affect both the wealth and income sides of our individual and collective balance sheets and will warrant close attention.

The commercial real estate market in particular is vulnerable to a number of downside risks that are now beginning to surface and are being talked about more openly as industry advocates try to belly up to the bailout bar before the last call is issued. Since this situation is likely to continue to unfold, it is useful to try to focus on where we are at, what is
likely to occur, and what to monitor to stay on top of things. Unfortunately, even with perfect foresight, the time for developing proactive or defensive plans is long past. Due to the economic house of cards in which we live, most of us will have to deal with the hands that we have been dealt, and hope not to get caught in the changing rules of the game that will be decided in the political arena.

**A Note on Market Interventions and Market Behavior**

The current economic collapse can be attributed to the lagged impact of three major, related phenomena: the issuance of easy and cheap credit that created market bubbles; the resultant collapse of confidence as it became clear the market had gotten out of balance; and the actual and anticipated collapse of collateral values that had been artificially bolstered by excess capital flows and the lack of attention to risk. Of the three factors, the confidence issue is the most disconcerting since it is so widespread and ingrained.

At this point, using traditional remedies—such as addressing the credit crisis by stimulating credit flows or supporting collateral values at current levels by driving down interest rates—may provide some respite, but cannot be relied on to rekindle confidence levels. That is, traditional approaches based on the assumption of rational thinking will not work in a situation where one of the major obstacles that must be addressed is more psychological than economic. This is especially true when the negative news and underlying facts are so pervasive and seemingly never ending. In some respects, the situation is analogous to the problems a coach faces in turning around the fortunes of a languishing team that has been infested with negativism—one in which players are waiting for the next bad break. In that situation, as in the current economic situation, the downside can become a self-fulfilling prophecy. To turn things around, it is necessary to work on the psychological side of the issue as much as on the technical side.

Unfortunately, econometric models and financial theory do not handle such intangibles very well and are unlikely to do so over the near term. This disconnect from the reality of the market is evidenced by the fact that consumers and businesses knew we were in a recession long before the official numbers came out; the market could sense it and was feeling the pain it was causing.

In this environment, one of the key signs that the economy and credit markets are turning the corner will come from improving confidence levels for the key players in the market (i.e., consumers, CEOs, homebuilders, investors). The importance of regaining the market’s confidence is one of the major factors behind the attention being placed on the changing of the guard in Washington.

While most realize there will be no quick fix, the bipartisan support for addressing the credit and economic crises has been embraced by most observers. Indeed, the passage of legislation to free up the $300 million in unallocated capital contained in the initial bailout plan prior to the inauguration reflected the objective of allowing the new administration to hit the ground running and gain the momentum necessary to reestablish confidence.

This vote of confidence should buy some much-needed time to allow the administration to get its team assembled and develop a plan of action without proposing more stop-gap measures with questionable prospects for success. A growing cadre of politicians, businesses, and consumers seem to be resigned to the fact that things will get much worse before they get better. This sober but understandable mindset will take some pressure off short-term fixes and open the door to additional debates regarding what steps should be taken.

At the same time, the administration will be under pressure to prevent the situation from eroding further. Because of the staunch criticism triggered by the lack of transparency and accountability embedded in the initial bailout awards, new programs are likely to contain a number of requirements, including disclosure and compensation limits.

A number of initiatives have been discussed regarding the allocation of the initial bailout funds and the key elements of a second stimulus package. While the details are far from being final, the new programs are likely to address a number of key issues including stimulating the flow of credit to the mortgage and commercial industries; providing...
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financial assistance to help key industries buy additional time to survive the economic crisis; introducing programs to stimulate employment through government spending on infrastructure; and increasing spendable capital through some forms of tax relief or tax credit for consumers and businesses.

The proposed economic stimulus package contains a combination of new spending as well as tax cuts. Much of the spending, however, will be to shore up state entitlement programs including Medicaid, unemployment benefits, and food stamps. Unfortunately, while needed to dampen the suffering of the growing ranks of the economically challenged, such expenditures will have little impact on stimulating the economy. In terms of tax cuts, the temporary programs should target households through the use of tax credits and tax breaks, and businesses through the use of various investment incentives.

While the Obama administration works on its plans, the Federal Reserve (Fed) continues to explore additional actions to try to stimulate the flow of credit and forestall additional credit losses that could have catastrophic effects. Although it is clear that this credit crisis differs from the one that created havoc on the commercial real estate industry, the government may turn back to its old playbook. Reminiscent of the days of the Resolution Trust Corporation (RTC), there is talk of providing government guarantees to indemnify investors against losses and help reestablish confidence in mortgage-backed securities. In addition, officials at the U. S. Department of the Treasury, the Fed, and the Federal Deposit Insurance Corporation are considering the creation of a government bank that would buy up the toxic paper that is being held by banks and investors.

Assuming the new administration gets behind these efforts—or develops a comparable program—the capital markets may be able to avoid further losses that are lurking beneath the surface. Indeed, there are some estimates that there could be some $2 trillion in losses on U.S. credit before the cycle plays out, with a significant portion of that yet to be realized. Thus, such interventions could forestall a significant collapse in the credit markets.

This risk is particularly acute in the commercial real estate industry as borrowers who benefited from easy, cheap, short-term financing are now facing maturing bullet loans and seeking to refinance in the face of severely tightened credit standards, declining property values, and limited credit in the aftermath of the collapse of the commercial mortgage backed securities (CMBS) industry. Ironically, this situation has come full circle: the CMBS industry sprung up on the heels of the RTC’s success in recapitalizing the commercial market in the early 1990s and now, an RTC-like intervention is being reconsidered.

Regardless of how it proceeds, the federal government faces a number of challenges as it seeks to slow down the hemorrhaging economy and avoid further losses. First, given the crisis conditions in many industries, government interventions are focused on defensive measures to prevent additional failures rather than on an offense that would stimulate growth.

Second, there is widespread support for more interventions and the need for additional stimulus programs. However, there is a groundswell of disagreement over who such programs should target, how they should be structured, and how they should be overseen.

Third, due to the severe budget crunch faced by governmental and business entities, it will continue to be difficult to achieve the level of coordination of efforts needed to turn the economy around. For example, the federal government is likely to allocate funds to state and federal agencies to increase spending on infrastructure and development; however, some agencies may opt to use the funds to balance budgets and avoid deficits rather than for new initiatives.

Thus, the government will continue to face a conundrum as it seeks to control how bailout and stimulus funds are actually deployed by the recipients. Over the near term, most recipients will be operating in survival mode and will likely focus on their own best interests rather than on what they can do to stimulate the economy.

The Economic Environment
Economic Growth

At this point, most readers have been inundated by a cornucopia of negative data, charts, and graphs. The contraction in the gross domestic product (GDP) in
the 2008 third quarter matched consensus forecasts as economists recognized the cumulative impact of deteriorating fundamentals. While some anticipated the economic slowdown, few expected the rapid erosion in market fundamentals that characterized the fourth quarter.

Going into 2009, it was hard to find any good news. The decline in GDP was attributable to across-the-board slowdown in such diverse factors as employment, building permits, retail sales, stock prices, and manufacturing activity. Indeed, the hope that the cheap dollar would help bolster exports was quashed by the global recession, which has sharply curtailed demand for U.S. goods and services.

While there was some hope the decline in energy prices would provide some relief for beleaguered consumers, manufactures, drivers, and distributors, such benefits were short lived. Although government spending held up, the strain on state and local governments signaled a slowdown without new fiscal policies to stimulate spending. At the same time, the decline in corporate profits and the prospects for further erosion in sales helped rein in business spending and focused attention on the near-term bottom line and stock prices.

The economic slowdown is expected to continue, with GDP growth flat to slightly negative for the year as a whole. Given the pervasiveness of the weakness, a near-to-intermediate turnaround will depend on the effectiveness of government interventions and the ability of the various programs to bolster credit flows and restore confidence in the economy.

Employment
One of the most visible signs of the economic malaise, and a major contributor to it, has been the dramatic erosion in employment growth. As 2008 wound down, the pace of job losses accelerated, catching even some of the more pessimistic observers off guard. In the fourth quarter, some 1.5 million jobs were lost bringing the total for the year to almost 2.6 million losses. The seemingly endless string of layoffs has spread like a plague across the country and spilled over to most sectors, including the technology sector that until recently had been considered insulated from downturns.

Record job losses have been registered in a number of industries including construction, retail, and financial services. Indeed, the government and educational sectors, which had seemed to dodge the bullet, are starting to catch up as state and local governments struggle with budget deficits due to sticky costs and erosion in income. As personal and corporate incomes decline, property values have plummeted and retail sales have dramatically contracted. The unemployment situation has deteriorated rapidly, with rates rising above 7% at the beginning of the year and prospects that they could end up in the upper single-digit range.

The employment situation is likely to continue to deteriorate as companies are forced to rationalize their workforces and focus on bottom-line survival. While not showing up in the unemployment figures, a number of companies have shut down temporarily to cut costs and shift some of the burden to employees. The end result has been a decline in hours worked as companies cut back operations to try to retain employees without incurring additional losses.

More recently, companies have announced pay base wage cuts for those in both the working and executive ranks. Many employees who rely on bonuses and incentive compensation have seen dramatic declines in excess compensation as sales and profits lagged under the weight of the economic slowdown. Going forward, the employment scene is going to be one of the key bellwethers regarding the fate of the economy.

Due to the lack of confidence, weakened balance sheets, and eroded stock prices, businesses will be reluctant to expand their work forces. Indeed, the downside risk of additional employment losses suggests the employment situation will be closely watched by regulators, employers, and consumers alike.

Once the bottom has been reached, employment levels are likely to languish for some time, with unemployment creating a drag on the economy and government coffers. Those looking for signs the economy is turning around should keep a close eye on employment and focus on some of the more subtle signs of a recovery, including increases in workweeks that have been curtailed, increases in

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Inflation and Interest Rates
The widespread economic collapse, declining employment levels, expanding crisis in the credit markets, and decline in GDP growth have shifted the Fed’s attention away from inflation. Consumers are feeling angst at the cash registers because rates have crept up since retailers pulled out all the stops and offered deep discounts in a largely unsuccessful effort to stimulate sales. Consumers have experienced some relief at the gas pump, although there, too, rates have begun to creep up.

Even import prices, which had been expected to increase as a result of the cheaper dollar, have backed off due to the global recession that has dampened demand worldwide. The dependence on U.S. consumers to support exports from many of our trading partners has also backed off. At this point, the concern over inflation has been largely supplanted by a concern over deflation as businesses get more desperate to ring up sales and consumers hold off.

While the notion of declining prices might have some short-term benefits for consumers, it could have a devastating impact on manufacturing and businesses, resulting in even more bottom-line pressure. Over the near term, with the exception of energy prices, the risk of a deflationary cycle should supplant fears over the risk of inflation. However, once the economy begins to pick up, there may be some inflationary catching up, as producers who have throttled back try to catch up with improvements in the demand side of the equation.

Interest rates are at record lows, although for many prospective borrowers, the credit markets are largely frozen. In the current situation, interest rates are only a part of the credit problem, with access to capital being the major concern. Thus, in addition to reducing the federal funds rate as much as possible, the Fed has increased its balance sheet dramatically, surging from under $1 trillion in July to over $2.3 trillion at year-end 2008.

This dramatic increase is even more noteworthy in the sense that it does not include some of the previously approved bailout funds. Furthermore, the Fed is likely to expand its credit support activities even further, moving into other asset classes, including private MBA loans, CMBS, and municipal debt. Some of this support may take the form of guarantees that would leverage the total dollars, although the Fed balance sheet is likely to increase significantly as the new stimulus programs are launched.

Despite efforts to stimulate credit flows, the availability of credit continues to plague businesses and consumers as lenders remain cautious. Although this cautiousness is understandable in the face of additional credit losses that have not yet surfaced, it flies in the face of government interventions and frustrates efforts to slow the contraction by stimulating spending.

On the mortgage front, interest rates have fallen below 5%, down some 75 basis points from a year ago. The recent reduction in interest rates has been heralded by many as a precursor to a rebound in the housing market. Unfortunately, the admonishment that it is a great time to lock in low interest rates has fallen on deaf ears. Despite low rates, the housing sector continues to languish as potential buyers struggle with personal finances and job security, coupled with the perception the market has not yet bottomed out.

On the other hand, the refinancing market has dramatically picked up, accounting for almost 85% of residential loan activity. Interestingly, the fact refinancing in the not-too-distant past was used to tap into built-up home equity and led to a surge in consumer spending, seems to have been lost on the current generation of households seeking to refinance.

This time around, it appears that many owners are turning to refinancing to reduce mortgage payments to help them maintain a positive cash flow and meet other financial obligations. Indeed, the strenuous underwriting and scrutiny on borrowers’ ability to pay has made it much more difficult to refinance existing loans, especially for owners whose credit scores or income have suffered as a result of the economic slowdown.

Going into 2009, upper-end houses were a somewhat unexpected problem segment in the broader market in terms of access to capital. Given the industry’s dependence on mortgage transfer, capital flows had become dependent on the ability to sell mortgage loans to Fannie Mae and Freddie Mac. In order to purchase loans, mortgages had to conform to maximum limits. Without such exit strategies, lenders on nonconforming loans charged rates that were more than 140 basis points over conforming loans. This situation placed buyers of higher-end homes at
a competitive disadvantage, making it more difficult and pricey to take out mortgages.

In 2008, for most markets the loan limit was $417,000, with limits of up to $729,750 for high-cost markets such as California. As of January 1, 2009, the national ceiling for conforming loans was rolled back to $625,000, creating downward pressure on values in high-cost markets. Members of Congress have been lobbying to get the limits raised as part of the economic stimulus package. Given the importance of supporting the housing market, it is likely that some form of relief will be granted although the issue bears close watch, especially in high-cost markets.

**Business Indicators**
The widespread nature of the economic downturn is echoed throughout leading business indicators. Indeed, the negative signals are broad based, cutting across most sectors and regions of the country. Significant declines were reported in retail sales and manufacturing activity, with output falling significantly and spilling over into the technology sector that had been somewhat insulated from the downturn earlier in the cycle.

The declining fortunes in retail and manufacturing led to softness in the real estate market, with store closings on the increase and capacity utilization falling to levels not experienced since the early 1980s. The weak dollar, which normally would have bolstered manufacturing and distribution, was neutralized by the global recession that dampened demand worldwide. The decline in import prices placed downward pressure on domestic production and led to further erosion in sales and bottom-line performance for many sectors.

The housing market continued to languish in spite of efforts to stimulate activity, forcing ancillary industries to cut back even further. The commercial sector began to show signs of stress as layoffs and employment cutbacks placed a dampener on demand for offices and other facilities. Corporate cutbacks also hit the hotel and airline industries, while consumer angst took the wind out of tourism.

Even though it did not show up directly in business indicators, the lack of credit placed a major dampener on business activity as companies struggled to retain credit lines necessary to conduct business and carry inventories. While the initial stimulus plan was intended to break up the log jam of commercial credit, to this point there has been little respite, with many smaller companies locked out. This has constrained the ability of many local and regional companies to hit pro forma projections and cover fixed expenses.

As a result, a growing number of business owners have opted to revisit contracts with suppliers, vendors, and other business partners to save money. Such activities have had ripple effects, forcing affected companies to look for ways to pass the cuts to alleviate stress in their own supply chains.

The result of all this negativity has been a collapse in business confidence levels, which has placed many businesses on the defensive. In order to turn the corner in this downward cycle, credit flows and business confidence will have to be restored and bear close monitoring.

Some of the elements of the stimulus package, as well as allocation of the remaining $300 billion in the first tranche, may provide some respite, although there will be tremendous competition for dollars, which are likely to be less than the demand for such support. Thus, an important indicator will be the extent to which bailout and stimulus plans are directed at helping existing businesses create new jobs, rather than channeling funds through government programs that will provide temporary help to selected areas of the economy.

**Stock Market**
The stock market has experienced significant volatility over the past year with little hope for a rally that would reverse fortunes. Legions of investors, large and small alike, have seen their collective wealth eroded and languish as the market seeks a bottom. The stock market remains under pressure in the face of a relentless barrage of bad economic news that has dominated.

Despite the widespread economic malaise, one positive development has been the thickening of the skin of investors who have tempered their responses to the negative short-term. This apparent sense of indifference was evidenced during the recent bout of bad news regarding employment losses and declining GDP that might have triggered additional sell-offs. Rather than panicking and dumping stocks in the face of disappointing news regarding corporate profits and earnings, prospects hit the street.

In addition to the thickening of skin by investors, some of those sanguine responses can be attributed
to the realization that there are few viable alternative investments. At this point in the cycle, many investors have resigned themselves to the situation and are trying to hold on to recoup some of their losses. Individual and institutional investors have also joined the ranks of the hopeful and are waiting to see if the Obama administration can rally the forces in a meaningful way to turn the economy around.

To some extent, further easing by the Fed, the aggressive application of fiscal and monetary policy, and the introduction of the stimulus package have been discounted by the stock market. Whether or not such efforts pan out will be closely watched and will dictate the fate of the market. Thus, the near-to-intermediate term prospects for stocks exhibit additional downside risk and should remain volatile. The timing and extent of recovery, as well as the sectors that will lead the recovery, remain an elusive target and will depend on the government’s ability to help restore confidence, both here and abroad.

Consumer Confidence
After a brief uptick in the 2008 third quarter, consumer confidence levels once again turned negative, dragging the overall index down. In terms of components, the present-situation component caused much of the drag although the decline in the expectations component was even more troubling.

At this point, the sheer volume of bad economic news including layoffs and reduced workweeks, flat wages, falling housing values, rising foreclosures, tightening credit, and declining retirement accounts continue to weigh heavily on consumers. While there is little positive news, consumers and their business counterparts have turned to the incoming Obama administration for hope. The bipartisan support for an added stimulus package and the elements likely to be targeted to individual taxpayers will provide a much-needed boost for consumer confidence.

At the same time, many consumers realize the tenuous nature of the economy and the fact that there will be no short-term cure for a crisis that took many years to create. This sober realization should buy some time for the new administration and temper the expectations of consumers. Once the administration has taken charge and the honeymoon is over, political wrangling and resource limitations are bound to collide and force some compromises.

Consumers will pay close attention to how these conflicts are worked out and the consequences they may have in terms of their own economic welfare. Two of the more important elements in this equation will be stabilization of the housing market and renewed employment growth.

Retail Sales
Retail sales took a major hit in the second half of 2008. While not unexpected in light of the slowdown in the economy and plummeting consumer confidence, the widespread decline was somewhat surprising. Of particular concern was the plight of upscale retailers who had been somewhat insulated from the plight of consumers in general. For this segment, the realities of the economic turmoil and the significant declines in portfolio values was a rude awakening and forced many to revisit current consumption versus long-term financial needs.

With the housing market still in turmoil and no bottom in sight, consumers pulled back on durable goods and other nonessential purchases. The automobile industry was particularly hard hit as consumers realized they could get by without replacing vehicles. While more energy-efficient cars still caught the fancy of many commuters, the decline in gasoline prices and the promised introduction of a new generation of green vehicles convinced many that they could wait until the economy and technology stabilize.

Since retail sales are a major component of the U.S. economy, trends in activity levels should be closely monitored by those looking for leading indicators for the broader economy.

Housing Market
The housing market was the first sector to reveal the cracks in the credit system. While the subprime problem was the most visible signal of the impending doom, the house-of-cards nature of the broader housing market quickly surfaced.

While certainly not new, the housing market continues to weaken with no relief in sight. Existing home sales continued to decline in the 2008 fourth quarter, setting a new record for the recent cycle. These results are particularly disappointing in light of the fact that a growing portion of these sales are related to foreclosures and distressed sales, a trend that should increase over the near term.

In terms of new home sales, buyer traffic and intent to buy remains at cyclical lows in spite of advertising campaigns, builder incentives, and the
first-time homebuyer credits designed to stimulate sales. As a result, builder confidence levels have fallen to record lows placing emphasis on survival rather than profitability. This situation has been disappointing to mortgage holders, brokers, builders, and the legion of service providers whose businesses are dependent on the housing market.

In spite of the efforts to help the growing ranks of homeowners, who are in situations that are upside down (i.e., housing values less than mortgage balances) and are falling behind on payments, foreclosure rates continue to increase. In this environment, the National Association of Homebuilders (NAHB) and other trade associations are lobbying heavily for more aggressive interventions to stem the tide of additional foreclosures and help draw qualified buyers back to the table.

Given the important role the housing market plays in the broader economy and in consumer confidence levels, the attention paid to rekindling the housing market in the proposed stimulus packages and in the development of any new intermediary to acquire troubled assets should be closely watched. At the same time, it should be recognized that efforts to stop declining housing prices through temporary solutions may be merely forestalling the ultimate correction and punting the problem of unsustainable values to future generations.

This recognition will take some of the remaining bloom off the rose of homeownership. It may lead to further declines in the purchase versus ownership tenure choice of marginal households.

Real Estate Outlook

Office Market

At a national level, the office market has begun to demonstrate some signs of stress as a seemingly continuous string of layoffs have cut demand. While these employment losses have been most pronounced in some of the financial centers, they have not been confined to such markets and have spilled over to other markets. As a result, vacancy rates have continued to climb, with prospects of hitting midteens during 2009. The hardest hit areas are secondary and tertiary markets that have no competitive advantage, as well as suburban markets surrounding strong urban cores.

In terms of returns, the office market has experienced some repricing, reversing the strong performance the sector had exhibited earlier in the cycle. Weakening fundamentals have created a drag on rents which, when coupled with rising vacancy rates, have placed downward pressure on values. At the same time, tightened credit and increased yield requirements have driven up capitalization rates resulting in additional declines in market values. While some investors have been able to weather these downward forces, highly leveraged investors who depended on easy and accessible credit to support aggressive pricing are facing a number of challenges.

Similarly, as competition for tenants heats up, investors in existing buildings are likely to be exposed to cannibalization of tenants, especially by new product that has recently come out of the ground or will be delivered in the near future. This shifting from a landlord's market to a tenant's market will place added pressure on tenant recruiting and retention that may have capital implications in terms of reduced rents, concessions, or increased tenant improvement allowances.

While the office market is unlikely to collapse in the face of such pressures, the sector is likely to experience some uncertainty until the broader economy begins to improve and confidence and capital flows return. In the meantime, many office markets will become more of a tenant's market.

Retail Market

The retail property market has come under considerable stress as a result of the prolonged and severe decline in retail spending that has cut across many markets. In spite of this pressure, the retail sector remains relatively healthy, although the industry is beginning to experience downward pressure in terms of supply/demand balance. At an overall level, retail vacancy rates have risen, while asking rents have begun to taper off.

Unfortunately, this phenomenon is not isolated to the bottom of the industry, but cuts across the price/value spectrum. Indeed, some of the retailers undergoing the most stress and in risk of closures are category killers that until recently had seemed immune to such pressures. Two recent examples of such retailers are Linens & Things and Circuit City, which have entered or announced liquidation.

In addition to these high-profile bankruptcies, a number of retailers who had seemed immune to a downturn have announced plans to curtail growth and/or close unprofitable units. Examples of such re-
tailers include Whole Foods, which had been viewed as a preferred grocer for upscale mixed-use projects; and Starbucks, which had become a fixture in new mixed-use and lifestyle center projects.

At the same time, a potpourri of luxury, value, and discount tenants have announced plans to shutter stores or cut back on expansion plans. In the face of abysmal consumer spending, retail values have slipped with capitalization rates rising and incomes declining.

Investors have stepped back and taken a hard look at their current assets and their plans to acquire or develop new assets. This situation is likely to prevail over the near term, although the sector is not likely to face a major collapse, especially in the case of core assets in solid locations that are appropriately matched to demographics.

**Industrial/Warehouse Market**

To this point in the cycle, the industrial market has benefited from its dual role in supporting both the import and export sectors of the economy. The economic slowdown has undercut some of the fundamentals on both sides of the equation, with the stimulus to exports from the cheaper dollar more than offset by the global recession. At the same time, the collapse of retail sales has decreased imports in spite of declining import prices.

Despite these downside forces, the industrial and warehouse sectors have avoided some of the imbalances associated with overbuilding that plagued other property types. In spite of prospects for additional weakening as the economy contracts, the sector continued to attract capital as investors sought to diversify portfolios and take advantage of a moderate decline in pricing and less competition for assets. Over the long term, such strategies should pay off, especially for well-positioned assets that satisfy the logistical and spatial demand of the industry.

**Apartment Market**

While the single-family housing market has continued to struggle, the multifamily market has been relatively stable. The ill fortune of the ownership market has placed upward pressure on demand for apartments. In general, apartment occupancy rates and absorption have outperformed other property types. Despite these forces, apartments have remained an attractive option for investors attracted by the relatively stable prospects for rental housing during the phase of prolonged turmoil in the single-family market. This is especially true in markets experiencing positive net migration and increased household formations.

At the same time, the collapse of the condominium sector in many markets has caused something of a surge in new supply as developers with projects on the drawing boards opted for rental versus for-sale product. Those with existing product explored re-apartmenting in an effort to buy some time to wait out the downturn in the ownership market. Although the apartment sector is expected to struggle as a result of the economic slowdown, the sector is expected to avoid any major correction and remain a favored property type for institutional investors. However, the apartment sector is not immune to rising capitalization rates and tightened credit, which could lead to some declines in prices of existing assets.

**Real Estate and Capital Markets**

**Capital Market Overview**

As might be expected from the widespread nature of the economic decline, the erosion in real estate fundamentals has been pervasive, cutting across most property types and regions. At the same time, the credit crisis, which had previously surfaced in the residential sector, has started to become more visible as thinly-capitalized borrowers dependent on strong growth in net operating income to cover fixed payments struggle under the weight of slowing absorption rates and declining demand.

To add further stress, the capital markets and investors have begun to pay more attention to risk, calling attention to the erosion in real estate market conditions and to the gap between market realities of declining revenue relative to the aggressive rental growth rates embedded in investments made at the peak of the market. The end result has been an increase in hurdle rates for equity yields. Unfortunately, there is a significant bid-ask spread that has caused a dramatic decline in real estate transactions.

The exceptions to this rule are in cases involving motivated sellers. This motivation is coming from a number of sources including the impending need to refinance in the face of tightened credit standards, as well as negative cash flows associated with tenants going dark, and net absorption rates falling. Complicating matters, commercial credit markets have dried up, with the exception of top-tier deals
refinanced by borrowers with impeccable credit who can offer collateral that is squeaky clean and is facing no market-induced wrinkles.

Unfortunately, such opportunities are far from the norm, especially during this phase of the cycle. Thus, a resurgence of capital flows to the asset class, especially on the debt side of the equation, and the ability to clean out the toxic commercial loans in the system will be key indicators regarding the outlook for commercial real estate.

Construction Activity
The construction sector has been one of the harder hit areas of the economy, with a decline in commercial construction activity coming on the heels of the decline in residential activity. The exception to this contraction is in selected markets in which large-scale commercial projects that were well along in the pipeline are still coming out of the ground. Similarly, some preleased projects that were earlier in the construction cycle but had locked up tenants and financing were started in hopes the downturn would be slow or the particular projects and markets would be insulated from the correction.

Unfortunately, a number of developers started speculative projects, tying up enough equity and debt to carry through construction in anticipation of rising demand and ready financing upon completion. Some of these projects will be abandoned as developers and lenders stem their losses or try to wait out the downturn. This partially completed pipeline will hang over the eventual recovery, although restarting projects may prove to be problematic.

This is especially true for some of the more complicated and innovative mixed-use and lifestyle projects that had gained a lot of momentum. Thus, 2009 will be a period in which the construction industry feels the lagged effects of a declining economy. When coupled with the global recession, the resultant decline in demand for construction materials might provide a respite from rising costs, although such benefits are likely to be short lived.

Budget deficits hitting many state and local jurisdictions in the face of declining tax revenues have put a downside risk on government expenditures. At the same time, uncertainty in the bond markets has made some municipalities reluctant to charge ahead with major projects for which financing has not yet been secured. The good news for the much beleaguered construction sector is the inclusion of significant capital to fund new infrastructure investments ranging from roads and bridges to new power grids and green energy projects.

While the details are yet to be worked out, the administration has indicated a preference for shovel-ready projects that can be accelerated by the infusion of federal funds. State and local politicians have a ready slate of such projects that will force the administration to make some difficult tradeoffs as it balances political pressure against the need for funding projects that have high-multiplier potential and could stimulate additional public and private development. The nature and scope of such projects should be monitored carefully to get a sense of how new spending will affect employment and spill over to the broader economy.

Commercial Mortgage Market
The commercial mortgage market has experienced significant contraction as fears of the credit market collapse spilled over to the commercial real estate industry. The most dramatic fallout has been in the commercial mortgage-backed securities (CMBS) market, where a seemingly endless stream of record volumes hit the wall and fell over 90% in terms of new issuances.

On a positive note, the volume of CMBS loans that are scheduled to mature in 2009 is projected to be modest, taking some pressure off an already difficult situation. The industry might also benefit if the Fed accepts CMBS collateral in exchange for loans under its Term Asset-Backed Securities Loan Facility. In essence, holders of CMBS could swap them with the Fed for other securities that have lower risk.

Even if such interventions occur, they are not likely to help marginal property owners facing problems paying off loans or refinancing bullet loans. However, any help that would provide additional capital to the beleaguered industry would be welcomed by investors and borrowers alike. Thus, efforts to bail out the CMBS industry and reform it as a viable source of commercial debt should be closely monitored as a leading indicator for the commercial mortgage market.

The turmoil that has rippled through the credit market has created some downward drags on financial institutions that funded the bulk of construction and permanent loans. Some of these capital providers have been absorbed by other institutions and taken them out of the commercial mortgage market,
while acquiring entities have had to step back to assess the quality of acquired assets.

When coupled with the rapid erosion in the economy and weakening real estate fundamentals, the private mortgage market experienced its own contraction. The end result was a decline in mortgage capital flows and tightened lending standards. While credit-worthy borrowers with solid assets to pledge as collateral have been able to secure financing, lenders have been extremely selective, focusing on lower risk opportunities.

Although the infusion of capital into troubled financial institutions was designed to increase throughput of mortgages, the absence of strict requirements and the naturally conservative nature of lenders left much of the stimulus capital sitting in banks. The new provisions for the allocation of the remaining funds under the initial bailout, coupled with tightened disclosure and usage requirements for any additional funds should put some pressure on lenders to increase capital flows to the asset class.

However, whether such pressures will be sufficient to satisfy the growing demand for commercial debt remains in question and should be closely monitored. This is particularly true for borrowers and assets that are not at the top of the food chain and impose some additional risks on lenders. In more normal times, lenders would compensate for such risk by demanding higher returns; in the current market it is likely they will choose to avoid risk altogether.

**Private Equity Market**

After several years of pent-up demand, the private equity market is experiencing something of a correction with capital flows slowing as investors try to get a read on the market. Unfortunately, much of the news is negative, setting the stage for further erosion in market activity levels.

For example, in its early estimates, the quarterly appreciation loss for the NCREIF Property Index was in the range of a 12.5% decline. While this quarterly loss was staggering to some, it was not unprecedented when compared to value losses experienced during the correction in the latter 1980s and early 1990s.

During this recent phase, many observers have taken solace in the fact that the need for a correction has not been on the heels of a spate of overbuilding. Rather, the need for a correction has been a result of easy, cheap credit and acceptance of lower returns that led to overpricing.

Regardless of the source of the overexuberance that inflated values, the private equity market is in for a very difficult period as inflated values and record prices predicated on optimistic assumptions correct to more sustainable levels. Since that scenario has not yet played out, the private equity market will operate at a slow pace.

In addition to price/value gaps, the outlook for a decline in transaction volume and velocity is based on several factors. First, the denominator effect has forced many of the more aggressive and savvy institutional investors to the sidelines. That is, with the dramatic decline in the stock market, investors who had been fully invested in real estate relative to their asset allocations have found themselves overallocated to the asset class.

Second, while opportunistic investors with limited expertise in real estate have allocated significant capital to commercial real estate investments, they lack the knowledge and acumen to deploy those funds in the current state of the market. That is, the market is so frothy and values so difficult to pin down that no-brainer investing, in which investors buy at the bottom of the cycle and wait for the market to cure, is not an option.

Third, even with the reported $200–$300 billion sitting on the sidelines, there are no obvious players who can step in to manage portfolios of distressed real estate. To a great extent, traditional real estate advisors will be struggling with weak, trailing returns as values on existing assets decline. Most of the Wall Street firms who stepped into the void in the early 1990s and launched a number of opportunity funds are not around nor are they in a position to capitalize on the emerging opportunity to buy distressed real estate.

Finally, the government must come up with a viable strategy for taking toxic commercial mortgage debt off the market, or for taking the first loss piece, before buyers will be able to use leverage to take advantage of the market conditions. The bottom line will be an interesting period in which cap rates are likely to rise and investors look for some assurances that the market has bottomed out.

**Public Equity Market**

The real estate investment trust (REIT) industry faces a number of challenges in 2009, although
not materially different from the private real estate sector. For example, with the lagged decline in real estate market fundamentals, net operating income for assets under management will undergo some downward pressure. Similarly, an increase in capitalization rates will cut across the commercial real estate industry and place additional downward pressure on property values.

While this will be reflected in the private sector through the appraisal process, the public markets may be quicker to adjust, placing pressure on share values. The tightening of credit flows will also prove to be problematic, with the negative effect somewhere between what is experienced by core private investments that tend to have lower debt, and opportunistic private investments that depend more heavily on leverage. However, as in the case of General Growth Properties, REITs faced with maturing short-term debt may come under extraordinary pressure due to tightened credit standards and a dearth of capital for major refinancing.

In general, REIT performance should echo that of the private market and the underlying property sectors in which most REITs specialize. For example, industrial REITs will face some questions as export and import activity stumble in the face of tepid consumer demand and declining manufacturing activity, both here and abroad.

Similarly, shopping center REITs will have to deal with risks associated with declining retail sales and surges in store closings. Office REITs will experience some angst as employment levels contract, especially among business sectors most closely aligned with financial services, housing, and other ailing industries. Hotel REITs will struggle due to the uncertainty associated with declining business and tourism travel, while apartment REITs may benefit from some of the instability in the single-family market. Since share prices are more elastic than property values, the REIT sector should be monitored as a precursor to conditions in the broader real estate market.

Conclusion
Despite government efforts to prevent a total meltdown of the economy, the situation remains rather bleak. The economic turmoil has been widespread and has caused erosion in confidence that cuts across consumer, corporate, and government sectors. However, the situation is not as dismal as might be expected as a result of the pledge of meaningful change being promised by the Obama administration. A sense of optimism has been bolstered by the widespread, bipartisan support that has been raised as the country makes history with its latest changing of the guard.

In the months ahead, the details of the new administration’s plan will be unveiled, and will succumb to lobbying and political pressures. The country is ready to believe that new leadership can help us navigate to calmer waters and help regain the fortune and confidence that characterizes the American spirit. Since the commercial real estate market was dragged into the economic malaise and credit collapse later than other sectors, there is some hope that the industry will avoid some of the turmoil that it might have otherwise experienced.

That said, 2009 will be a challenging year for the new administration, the economy, and the real estate market. While it is likely to be a rocky trip and one that will face innumerable challenges that have yet to surface, it is one those of us with survival instincts—or a lifeline—should be able to navigate until calmer seas are reached. It will indeed be an interesting journey.

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