

# The Long Big Chill or a Temporary Deep Freeze?

by James R. DeLisle, PhD

## Commentary

In many respects, the economic outlook mirrors the deep freeze that spread from coast-to-coast this winter. Many Americans are looking forward to a warming spell as are investors and others who have been forced to deal with the fundamental question of whether the economy is facing a temporary chilling phase or whether it is entering a long-term downward slope. This new sense of uncertainty has been fairly widespread, rippling across the globe, rattling confidence, and having a chilling effect on markets.

While nothing can be done about the weather, the Federal Reserve (the Fed) and its international counterparts are doing what they can to regain some of the traction they had picked up in 2013. Unfortunately, the cost of quantitative easing has soared like that of propane gas although the bill has not yet been sent and the payment shock is yet to come. Even worse, whether expensive or cheap, propane can still provide enough heat to neutralize the effects of the deep freeze and provide some warmth. Much to the chagrin of observers, the same cannot be said for the government interventions, which may have burned out in terms of their efficacy.

Fortunately, there are also a number of positive signs that suggest the recent cooling of the markets may be a temporary seasonal disorder. The residual uncertainty, however, is going to take some additional momentum to overcome, creating more headwinds than those that are currently being discounted in the market.

## The Economic Environment

Going into 2014, the economic environment was generally positive, with some mixed signals as might be

expected on the heels of the political wrangling and rising concern over the state of the global economy. As the early phase of the calendar year began to unfold, economic indicators revealed a somewhat unexpected rocky start with a series of bad news reports beginning to weigh on the collective psyche of the market. For example, sentiment and expectations started to freeze once the news of the unexpected weakness in the Institute for Supply Management (ISM) index and the decline in retail sales were factored in. When coupled with disappointing news on the global economic front, rising volatility in the stock market, and concern over investor confidence, this could signal the beginning of difficult period for the economy. While the emergence of new concerns could create an additional drag on an already modest and somewhat tentative recovery, some of the momentum that has been gained could still carry the day. For example, business confidence levels regarding expectations have been increasing, which suggests companies may be looking forward to stronger growth in the second half of 2014.

In a surprising fashion, attention seems to have shifted away from the Washington malfunction. For example, the Super Bowl blowout and the last minute scurrying in Sochi in anticipation of the Winter Olympics captured more headlines than the fact the latest deadline on the debt limit is right around the corner. This lack of attention may be something of a learned behavior as well as anticipation that improvement in the deficit and political fallout from the last deadlock may lead to a bipartisan agreement to raise the limit. Such an agreement will be critical to the economy as the Treasury has run out of ways to manage debt without some additional wiggle room.

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I would like to acknowledge the contributions of Stacie Babilon and Jonathan DeLisle in the preparation of this column.

At this point in the cycle, government interventions are likely to play a significant role in the plight of the domestic economy and will be closely watched by a growing number of parties. How the Fed deals with continuation of its phaseout of quantitative easing under Chair Janet Yellen will be of particular interest both at home and abroad. It should be noted that a number of countries are faced with similar issues on their own domestic stages. As such, they are looking for “lessons learned” regarding domestic reaction to changes in intervention levels; this may create something of a contagion effect if things do not improve as hoped. This risk is exacerbated by the fact many countries do not yet recognize that the locus of control over their own fates has shifted as a result of the integration of global economies. This situation is not new, but the stakes are higher than ever as countries struggle with domestic issues that are increasingly affected by global phenomena.

### **Economic Growth**

On a seasonally adjusted basis, real gross domestic product (GDP) growth increased by 3.2% in the 2013 fourth quarter, which was slightly down from the prior quarter but still above the recent trend line. Part of this downturn may be attributed to the government shutdown although there were a number of other drags on the economy. Despite some recent setbacks in terms of economic indicators and rising concern about the global economic environment, US GDP growth is expected to improve beyond the paltry 2% rate at which it has stagnated for the past several years. Assuming no major shocks to the system, GDP growth could approach 3% by year-end and demonstrate moderate improvement in 2015. However, this scenario is subject to downside risks emanating from Washington. Despite the obvious lack of affection between the two sparring partners, the pressure of midterm elections and voter unrest may place a governor on the dysfunctional behavior that has led to lose-lose propositions. This behavioral response may suggest why investors have discounted the shenanigans in Washington and appear to have assumed that putting political posturing aside, a real crisis will be avoided.

While some economic indicators have remained strong, a number of disappointing results have cast a chill over the outlook. For example, in late January the ISM index plummeted over 5 points. This figure was noteworthy on several fronts, including the fact

“While some economic indicators have remained strong, a number of disappointing results have cast a chill over the outlook.”

that this was only the fourth time it has experienced such a dramatic drop in the last two decades. Some observers blamed the winter weather as a major factor, but that may be too easy an excuse and may mask other issues. Indeed, there is some evidence that the recent figures leading up to the decline may have been overly optimistic. This is especially true relative to other economic indicators. At an overall level, manufactured orders in December declined moderately, offsetting the gains reported the prior month and leaving behind some of the optimism of the generally upbeat economic outlook. During December, new orders for durable manufactured goods also declined, led by disappointing results in the transportation sector. Production of business equipment also slipped at year-end, losing part of the ground that had been gained during the first half of the year.

Some recent disappointment in economic indicators can be attributed to the wave of optimism that led to the buildup of excess inventories. This is now being corrected, and the pullback may have been a significant factor behind the decline in manufacturing activity. A similar fate struck the retail sector, which is now faced with burning off excess inventory levels in the face of declining consumer demand in response to economic uncertainty and lack of gains in disposable income.

On a positive note, the Conference Board’s index of leading indicators eked out a slight gain in December following improvement in November. The increase was somewhat mixed with 5 of the 10 indicators turning in positive numbers, led by the financial components. On an annualized basis through year-end, the index increased around 6%, which was slightly lower than the previous figure and suggested the economy might be moving toward more normal recovery levels. However, this outlook is far from secure as reflected in the disappointing ISM figures which will affect the leading indicators during the 2014 first quarter. This dampening effect is reflected in the Economic Cycle

Research Institute's leading index, which slipped a bit during January by 4.2% but remained twice the level it was at on a year-ago basis. While some recent news suggests the economy may have to overcome part of the recent chilling news, the probability of a recession remains relatively low on a year-over basis.

During much of the 2013 fourth quarter, the Organisation for Economic Co-operation and Development (OECD) leading indicator index continued to trend upward, suggesting the global economy will expand during 2014. The improvement was fairly widespread except for some emerging markets. This convergence reflects the degree of economic integration that has emerged across countries. Despite the general decrease in the global uncertainty at the beginning of 2014, the plight of individual nations and tiers of markets will continue to depend on domestic policies and the impact on global competitiveness. For example, after several years of aggressive intervention, Japan's economy appears to be on track as evidenced by relatively strong growth and low unemployment levels. The situation in China is also relatively strong, although not as robust as it had been compared to other countries; its GDP growth remained strong at 7.7%—more than double that of most developed nations. Retail sales growth in China is slightly over 15% on an annualized basis, with housing prices pushing a 10% annualized rate of growth and creating concern over a bubble in the market.

After appearing to strengthen during 2013, it is now apparent that the euro zone is going to continue to struggle with its economic recovery. This is especially true in the sense that many member countries are likely to languish with tepid growth and high unemployment rates that are creating an overall drag on the euro zone that is likely to prevent any country from breaking out from the overall pack. The recent data suggest that the euro zone may be on the cusp of a phase of contraction, with average unemployment rates at 12% and fears of falling prices spreading across much of the region. The situation has been closely monitored by the European Central Bank (ECB), which may step in with some quantitative easing in spite of concern from a number of member nations.

## Employment

The news on job growth was disappointing at 2013 year-end, with a paltry 74,000 new jobs. This caught many prognosticators off guard. The fact that the weakness was fairly widespread raised new questions as

to the sustainability of the economic activity. Despite the disappointing news, some sectors did experience strong job growth, including retail, wholesale, and professional and business services. On the other hand, the construction sector and the federal workforce experienced net job declines.

January employment figures came in at a disappointing 113,000 jobs, which was over 60,000 less than consensus forecasts. This second straight month a weak employment growth raised additional concern about the health of the economic recovery. Interestingly, the weak figures were not attributable to the usual suspects and reflected significant changes in the fortunes for various sectors. On the negative side of the equation, job growth in services and government employment declined, while goods-producing sectors—led by construction—showed significant increases.

Despite disappointing news on job growth, there were some positive signs on the employment front. For example, the number of initial claims for jobless benefits declined at the end of January, indicating a degree of stabilization. In addition, the recent improvement in worker productivity was a pleasant surprise, coming in at an annualized rate of 3.2% during the 2013 fourth quarter. The good news for companies was a decline in per-unit labor costs despite a modest increase in hours worked. In real terms, wages continued to stagnate with little hope for much change until companies begin to hire new employees to take the pressure off of current employees.

On the small business front, companies with fewer than 20 employees created some 20,000 new jobs in December, accounting for a significant share of net employment growth. Despite this improvement, average compensation levels and worker hours both slipped. On a positive note, businesses announced only 30,000 layoffs in December, which was the lowest figure in over a dozen years. For the year as a whole, layoffs cost workers around 510,000 jobs, which was the lowest number since the recession. Not surprisingly, the largest number of losses was in the financial services sector, which faced a number of challenges, and in the health care industry, which was something of a surprise.

The unemployment rate declined to 6.7% at year-end 2013 and fell to 6.6% in January in spite of lackluster job growth. This led to the search for new insights into the apparent disconnect between the supply and demand for workers. One key question

asked regarding this apparent anomaly is why the downward trend in labor force participation rates has continued.

The recent expiration of the five-year program that provided extended federal unemployment benefits may create an even greater disconnect for some of the 1.3 million jobless who had benefited from the program. In some cases, expiration of the program may take some pressure off workers to continue searching for jobs, especially those workers who exhausted themselves and their self-confidence as a result of their futile endeavors to find permanent employment. Some workers may give up and fall back into survival mode, looking for new ways to cut costs. At the same time, some of those who had been stuck in the ranks of the unemployed may have made the difficult decision to make compromises and accept jobs that they had previously eschewed. When coupled with legions of workers who are already underemployed, this new tranche of workers may be masking a growing shadow force of workers who will bolt from their current positions at the first sign of significant job growth. To the extent this occurs, real improvement on the employment front will be dampened and create additional drags on the pace of the economic recovery.

One employment issue that will receive significant attention during 2014 is the minimum wage rate. As of the beginning of the year, 21 states had minimum wages that exceeded the \$7.25 minimum federal wage rate, 19 states were at the same level, and the balance either had no minimum or set it at a lower level but by default the minimum was the federal standard. Thus, efforts to raise the federal rate emanating from Congress would have far-reaching implications for workers at the bottom of the wage spectrum. Despite generally widespread concern for workers who are barely scraping by, the minimum wage debate remains heated. On the one hand, opponents argue that increases would only exacerbate an already difficult employment outlook and force smaller employers to cut back on employees, which would bolster the ranks of the unemployed and cripple the fledgling economic recovery. Despite resistance to changes in the federal minimum wage, a number of states have taken up the issue, with over 30 states considering increases in state minimum wages. The debate is likely to continue through the year, with the pressure to increase minimum wages likely to gain momentum, especially in states facing gubernatorial elections and worker unrest.

“The euro zone inflation rate fell below the 2% target, creating a downward drag on the economic recovery.”

### **Inflation and Interest Rates**

Despite the weak jobs report for December, the Fed decided to continue to taper its quantitative easing program in January. While it looked like the tapering would continue as expected, it has become clear that if the economy shows more signs of stumbling the Fed might be convinced to put the strategy in temporary abeyance. In the face of rising uncertainty as to where the economy really stands, observers will pay close attention to how Yellen launches her new regime as the new Fed Chair, replacing Bernanke who had been the architect and champion of various intervention programs.

Of particular interest will be how the Fed approaches interest rates in the face of unemployment rates that are declining toward the 6.5% threshold, which had been set as the target before interest rate increases would be considered. The situation is complicated by the realization that there are a number of factors behind the improvement in unemployment rates, which makes it an unreliable barometer for measuring the state of the economy.

For example, the improvement in unemployment is at least partially attributable to a number of factors other than the net job growth that would be expected in a typical recovery. The confounding factors include the decline in labor force participation, the plight of many underemployed workers forced to settle for part-time employment, and the general lack of wage gains for many employees. In this environment, interest rates are likely to remain tempered although the natural tension between low rates and inflation will take on increasing importance and keep Fed watchers on their toes.

On the global front, the euro zone inflation rate fell in a number of countries below the 2% target set by the ECB, with soft prices creating a downward drag on the economic recovery. Despite on-going concern, ECB president Draghi indicated that no action will be taken during a separate meeting and pointed to the complexity surrounding the economic



condition of the euro zone. However, if the situation does not improve, the ECB is likely to reduce interest rates in an attempt to stimulate economic activity and reduce the 12% unemployment rate.

Echoing the strategy of the Fed, Draghi also suggested that a range of tactics, including slowing down the crisis bond purchase program, were on the table. While Europe struggles with stagnant economic growth, the situation is markedly different from the one in Japan. After several years of interventions, the aggressive program of quantitative easing has been successful in firming up consumer prices and reducing the unemployment rate.

In China, the inflation rate has remained relatively stable, hovering around the 2.5% range as it has for the past two years. The Producer Price Index (PPI) has been slightly negative, suggesting no upward pressure on prices over the near term. Compared to many other countries, the situation is relatively stable, especially with GDP growth slightly under 8% over the same time period. However, the continued upward trend in housing prices has raised the question of whether China's housing sector is in a bubble phase that is reminiscent of the situation faced by the United States and other countries in 2006 when the market collapsed.

### **Business Indicators**

Business balance sheets remain relatively healthy, with access to capital not a factor for many companies. Despite this profile many companies remained reluctant to take on additional employees. On a positive note, the National Federation of Independent Business (NFIB) Small Business Optimism Index trended upward at the end of 2013. An increasing number of companies said they plan to make capital expenditures in the coming year despite concerns over earnings trends. This general sense of optimism is noteworthy since small companies have been forced to deal with a number of challenges, such as uncertainty related to health care reform, which could have had a chilling effect on optimism and performance. Whether their collective attitude is strong enough to offset some of the Arctic headwinds that chilled the economy at the beginning of 2014 will depend on expectations regarding the demand side of the equation. As such, many small businesses will be paying close attention to business and consumer confidence levels.

Business productivity increased during the 2013 fourth quarter, continuing the positive trend that kicked in after the declines earlier in the year. As a result, unit labor costs declined despite a modest increase in hourly compensation. Productivity gains were relatively strong in manufacturing, led by improvement in durable products. Depending on how the economy weathers the recent storm of bad news, business investment activity may increase as companies take advantage of low-cost capital to replace aging equipment, which is at the highest level in over two decades.

### **Stock Market**

The stock market had a rocky start to the year, with a number of declines rivaling those of 2008. This trend continued in February. The stock market bounced around as investors began to struggle with the possibility that the economy was not on as solid footing as had been expected going into the year and attention turned to troubled times in emerging markets. The early February sell-off constituted the seventh significant downturn since the beginning of the year, suggesting a rocky period and forcing some investors to look for safe havens in the face of growing uncertainty. Despite the declines, some argue that the situation is not dire, especially after the strength of the rally in 2013 and the decline in P/E ratios. In some circles, the stock market has become a leading indicator of the health of the overall economy, as it reflects the expectations of the growing ranks of retirees in terms of overall consumer spending.

On a positive note, after five years of steady declines the number of companies listed on the US exchanges rose by 92 firms, which increased net listings to slightly over 5,000 companies. While still significantly lower than the 6,000 or so companies listed in 2009—and dramatically lower than the over 8,000 companies during the Internet boom—the increase was well received on Wall Street. The pace of merger and acquisitions has declined, which also has helped stabilize the number of companies. At the same time, some companies that had been taken private during the downturn have returned to the ranks of public companies. Although the gains in the US company listings have been modest, the growth that has occurred has rekindled interest of listing in the United States among non-US companies. Whether these trends will continue depends on

economic growth and the relative strength of the economy compared to that in other countries.

As a reminder of the degree of integration that has occurred among global markets, rising uncertainty regarding the US economy has had ripple effects across the globe, affecting stock markets from Europe to Asia. During 2013, emerging markets were problematic for many investors. For example, the MSCI Emerging Markets Index experienced slightly negative returns for 2013 after pushing a 20% gain in 2012. At the same time, the MSCI World Index was pushing almost 30% returns in 2013 on the heels of a 16.5% return the prior year. The end result for many managers who were long on investments in emerging markets was a decline in assets under management, as both retail and institutional sources of capital pulled back to avoid future losses. The growing lack of confidence in emerging markets is likely to continue over the near term. Despite this behavioral response, the fact that long-term prospects for emerging markets are generally positive may pay off for investors who can afford to be patient and have the ability to pay close attention to the risk side of the proposition.

### **Consumer Confidence**

According to the Conference Board Survey, consumer confidence levels were relatively strong in December 2013 due to an improvement in the “expectations” component, which drove the index above November figures. This improvement was noteworthy since confidence levels were fairly mixed throughout much of the year. The result was that aggregate confidence levels were significantly above those at the beginning of 2013. Of particular note was the fact that consumer expectations looking forward six months showed dramatic improvement. This improvement carried forward in January 2014, with the index continuing to trend upward despite consumers reporting that they recognized the challenging job market and had little hope of much improvement in their own income levels over the next six months.

Although there is continued interest in consumer confidence levels, some observers have noted that the measure is difficult to quantify in terms of its ability to forecast economic conditions. This is particularly true since confidence levels are based on perceptions that may be unduly influenced by a number of factors that have little to do the reality consumers will face going forward.

The Thomson Reuters/University of Michigan index of consumer sentiment also improved in December before slipping back a bit in January. Despite the slippage, the index remains significantly above that of the prior year. Interestingly, the current conditions index was much stronger than the expectations index, suggesting some of the recent uncertainty is being factored into the equation. Continuation of low interest rates and improvement in the housing market appeared to contribute to consumer attitudes relative to personal finances. As might be expected, the results were mixed by respondent classes, with higher-income respondents more upbeat with respect to the job market than those who were the bottom two-thirds. Some 25% of respondents reported they were better off than they were five years ago and expected their financial situation to improve significantly over the next five years.

### **Retail Sales**

After some hope that consumers might loosen their purse strings in the critical holiday season, the results were somewhat disappointing. This came after a relatively strong November during which retail sales growth exceeded expectations. Overall sales on a year-to-year basis were up almost of 5% in November, setting the stage for high expectations for the upcoming holidays. This expectation was bolstered by the fact that retailers pushed the envelope even further than in the past with a number of merchants opening on Thanksgiving, which to that point had been sacrosanct.

Despite extending the shopping season, sales for the month of December were disappointing for a number of sectors, including electronics and appliances, furniture and home furnishings, and sporting goods. Automobiles also slipped significantly at year-end despite efforts to manufacturers to pique the interest of buyers with a range of new and revised vehicle lines. On the positive side, sales at grocery, apparel, and online retailers continued to trend upward. The rush to instant gratification for online shoppers and the promise of overnight delivery caught a number of traditional retailers and online competitors off guard as delivery capacity could not keep up with demand.

The disappointing results in retail sales for the holiday season carried into 2014, with the early results raising much consternation among retailers and economic forecasters. While the weather can take part of the blame for disappointing sales, there are other forces at work that are likely to be more resistant to

a spring thaw. In a number of cases, the post-holiday results were more problematic than normal as retailers struggled with burning off the excess inventory that many carried over from the holidays. The weak retail sales figures during January were fairly widespread, with chain stores experiencing declining sales through the end of January. On a positive note, Al Brands Inc. and Costco Wholesale reported positive sales figures in spite of the deep freeze that chilled sales at most retailers including Kohl's and Walmart. The situation is further complicated at Neiman Marcus and Target, which had to deal with the fallout from the credit card and personal data breaches by hackers during the holiday season.

A number of retailers have been forced to shift into a defensive mode despite some recent successes. A vivid example is at RadioShack Corp., which arguably featured one of the top Super Bowl ads, and heralded a dismantling of functionally obsolete 1980s-era stores in an attempt to create a destination store for a new wave of shoppers seeking entertainment goods. Before the ad agency could enjoy the fruits of its labor and creativity, RadioShack announced that it was actually shuttering some 500 of its 4300 stores nationwide as it shifted from a market-share strategy to one of individual-store-unit and aggregate corporate profitability. This situation is not isolated as JC Penney, Best Buy, and a number of other retailers struggle with rationalizing their stores as they seek to reposition themselves among consumers who have turned to other formats or retail channels. This situation is likely to continue over the near term, especially since retail sales are likely to lag expectations.

### **Housing Market**

Over the past several years the housing market has been seen as a bellwether for the economy. During 2013, there were a number of positive signs that fed pent-up hopes that the housing market had turned the corner and was on track for sustainable recovery. Unfortunately, in the second half of 2013 signals became somewhat mixed, as noted by the significant decline in existing-home sales, which trended downward throughout the second half of the year. This trend was particularly disconcerting in light of the fact that interest rates remained historically low, and housing prices seem to be firming up in a number of markets.

Despite a moderate uptake at the end of 2013, sales of houses were slightly down on a year over basis. Part of this trend can be explained by the fact

that inventory levels were down and median-home prices had risen some 10% on a year-over basis. This latter statistic was partially attributable to the fact that sellers of higher-priced houses, who had stayed off the market, had begun to come back into the market to capitalize on the apparent recovery. In some cases, sellers had internalized the hype regarding the housing market recovery and wound up losing out when they held the line and refused to come to terms with buyers who realized that the market still afforded them a number of competing alternatives.

While existing-home sales tapered off during the second half of 2013, new-home sales trended upward. This trend was due to a number of factors, including the increase in construction activity as homebuilders regained confidence and started adding to the inventory. While the upward trend in new-home sales was positive during the third quarter, the pattern reversed in the fourth quarter. This caught many homebuilders off guard and forced them to revisit their pipelines and near-term forecasts. Despite this decline, new-home sales levels were up around 5% on a year-over basis. In terms of median values, the price for new houses was around \$270,000, which was slightly under 5% over that of the prior year.

The slowdown in the housing market was fairly widespread, with declines occurring in three of the four census regions. Despite understandable concern over the cooling off of the housing market among homebuilders, the situation is far from the deep freeze they experienced in 2006. This may explain why the NAHB Housing Market Index plateaued in early 2014 despite mixed sentiment among homebuilders. Housing permit activity remained fairly robust at year-end, suggesting builders are ready to respond to improved conditions and expectations after the recent chill burns off.

### **Real Estate Market**

#### **Office Market**

Despite an increase in office transaction levels, real estate fundamentals remained relatively flat during 2013, with vacancy levels generally on par with where they were over the past several years. In terms of subsectors, suburban vacancy rates remained above those of their central business district (CBD) counterparts although the gap closed moderately during the year. In terms of transactions, the office sector continued to exhibit an upward trend, with over \$100 billion in total transactions reported by

Real Capital Analytics (RCA) for 2013—more than doubled the pace in 2010. Despite the increase in transactions and premium pricing for trophy assets, office capitalization (cap) rates were relatively flat. At the same time, investors were willing to take on more risk in search of returns, turning to secondary and tertiary markets and exhibiting a renewed interest in suburban assets. On a positive note, the level of distressed office properties continued to decline, with workouts reducing the share of distressed office transactions to around 10% of the total volume.

Office properties comprised the largest share of the \$334 billion NCREIF Property Index, accounting for over \$27 billion in assets. For 2013 as a whole, office investments provided slightly less than 10% return, which lagged the overall index. Income returns were fairly competitive, coming in around 5.4% despite trending downward at year-end 2013.

In terms of spatial market fundamentals, the average vacancy rate for the 1,361 office properties in the NCREIF Property Index Trends report declined below 14%, the lowest figure since the beginning of 2009. Growth net operating income (NOI) for the office sector continued to improve from the trough in early 2011, although it still remains lower than the heyday period leading up to the 2008 correction.

Office REITs improved during the second half of 2013, with total returns coming in around 5.6%—about double that of the overall FTSE NAREIT Equity Index. Despite this improvement, dividend yields lagged other property types with the exception of industrial. While relatively attractive compared to other property types, annualized returns were still significantly below the 14%+ returns racked up in 2012. Returns for the category of mixed office/industrial REITs was on par with the office sector for the year, which generated a premium of over 160 basis points on the dividend yield.

### Retail Market

At an overall level, retail market fundamentals exhibited some improvement during 2013 although some retailers continued to struggle. Retail transaction levels continued to increase, exceeding \$60 billion for 2013 as a whole, which was an 8% increase of the prior year. However, transaction volume did slow down during the fourth quarter as investors observed some of the news on the retail front. For the year as a whole, the largest surge in transaction volumes centered on neighborhood and strip centers

“The average vacancy rate for office properties in the NCREIF Property Index Trends report declined below 14%.”

and single-tenant properties as investors favored smaller assets relative to the larger counterparts in the regional and superregional front. Portfolio sales made up an increased share of transactions, with individual property transactions remaining relatively stable. As with the office sector, retail investors seemed willing to move up on the risk spectrum, including the purchase of unanchored centers with attendant leasing and repositioning risk that depends on specialized skills and industry insights. In general, retail cap rates have trended downward, in line with improved fundamentals and expectations for an economic recovery, although those expectations may have been shaken bit.

On the private institutional front, retail investments have a significant portion of the NCREIF property index accounting for some \$83 billion was of investments. In terms of performance, retail investments led all property types with total returns approaching 13% and income returns 36 basis points above the overall index. Real estate fundamentals, as reflected in vacancy rates, improved over the past three years having fallen from slightly over 10% in 2010 to under 8% by the end of 2013. At year-end, growth and retail NOI slipped a bit, although still a marked improvement over 2010. At the subtype level, superregional malls constituted the highest market share of total retail investments followed by regional malls and neighborhood shopping centers. In terms of total returns the same pecking order held, with superregional malls leading the pack with 14.2% total returns. Neighborhood shopping centers trailed the rest of the pack, coming in around 11.5%, although income returns were higher than they were for their larger counterparts.

On the public side of the market, retail REITs struggled during 2013, with total returns of 1.86% lagging the overall index due to value declines but dividend rates remaining fairly competitive. In addition, returns fell more dramatically than other property types on a year-over basis. At a subsector



level, smaller shopping-center REITs provided improvement of total returns and dividend yields. This situation was dramatically different from regional malls, which came in with negative returns for the year and below-par dividend yields. Freestanding retail properties were the top performers in terms of annualized returns and, consistent with their risk profiles, provided the highest dividend yields.

### **Industrial/Warehouse Market**

Industrial market fundamentals experienced some improvement during 2013 with vacancy rates falling and a slight uptick in NOI. Perceptions of the industrial sector also improved based, in part, on expectations for an improving economy and a concomitant increase in import and export activity. In terms of transactions, industrial property sales approached \$50 billion for the year, which was a 16% increase over the prior year. To offset some of the underwriting costs associated with smaller properties, around one-third of industrial transactions were portfolio sales. Although there was no major change in industrial pricing, warehouse cap rates did decline in major distribution markets.

On the institutional front, industrial properties in the NCREIF index accounted for slightly under \$50 billion worth of the total index, significantly trailing other major property types with the exception of the hotel sector, which came in at \$8 billion. The industrial sector outperformed the overall index, trailing only the retail properties with a total return above 12.5% which was equally split between appreciation and income components. On the spatial front, industrial properties experienced significant improvement in occupancy rates in 2013. At an overall level, industrial occupancy rates were over 92%, the highest they've been since values collapsed in 2008. Despite improving vacancy rates for industrial properties, NOI growth rates flattened out over the past two years after significant improvement that began in mid-2010. With respect to subtypes, the warehouse sector comprised 80% of the total industrial allocation, with total annualized returns around 12.8% including relatively strong income returns at slightly under 6% annualized. Industrial flex space and R&D facilities lagged the warehouse sector with 8.7% and 9.6% annual returns.

Industrial REITs led all property types with the exception of lodging, with annualized returns around 7.4%, although dividend yields were slightly lower

than average. While competitive relative to other REIT sectors, total returns for industrial properties were dramatically lower than the 31+% racked up in 2012. However, annual performance reflected a significant improvement over the first half of 2013, when the sector generated negative total returns as did the overall index.

### **Apartment Market**

The apartment market has been something of an anomaly over the past several years, with signs of a disconnect between the spatial and capital sides of the market. For example, apartment vacancy rates have generally trended downward and NOI growth has been fairly strong. This has led to an increase in transaction levels, with the sale of significant assets of over hundred billion dollars in 2013, which reflected an 18% year-over-year increase in activity. Significantly, over half of the transaction volume occurred in portfolio sales while individual transaction volume actually declined. The apparent disconnect stems from the fact that apartment returns in both the private and public sector are lagging other property types. At the same time, apartment construction continues to lead other property types, which may signal that a cyclical correction is on the horizon as investor demand chills and prices fall in line with the risk/return proposition afforded by what might well have been an overheated sector. Despite this outlook, there has been no significant change in apartment cap rates although smaller and second-tier markets offer more attractive yields than those in some of the gateway markets.

On the private institutional front, the apartment sector was the second-largest property type in terms of market share in the NCREIF index, accounting for slightly over \$88 billion of total assets. The apartment sector lagged other property types in terms of annualized returns for 2013, and reflective of aggressive pricing, generated below-average cap rates that lagged the overall index by some 55 basis points. In terms of underlying market fundamentals, the average vacancy rate for the 1400+ apartments in the NCREIF Property Index was around 6.9% at the end of 2013, which represented a slight uptick and is the highest average occupancy level since the beginning of 2010. Despite improvement in occupancy rates, growth and NOI for apartments continued the cyclical decline that began in late 2012. This downward trend was very dramatic, indicating that the supply side

may have caught up to demand earlier than would be suggested by the continued surge in apartment construction across many markets. At a sub-property type level, high-rise apartments accounted for a greater share of assets, coming in at slightly under \$48 billion at 2013 year-end. Despite this preference among investors, high-rise apartments generated the lowest total returns and reflected the most aggressive pricing at 4.7% income returns.

As was the case for the first three quarters of 2013, apartment REITs generated the lowest total returns, with -6.2% for the year as a whole. This continued the disappointing pattern from 2012, when apartment REITs lagged all other property types and significantly underperformed the overall index. Due in part to negative returns, the market share of the apartment sector declined relative to the overall index with the exception of health care REITs, which slipped into -7% territory after robust 20%+ returns in 2012 and above-par dividend payouts.

### **Real Estate Capital Markets**

While the single-family housing market has chilled a bit, the commercial market continues to warm up in both the debt and equity markets. Both markets seem to have ignored the fact that prices and values for real estate assets remained somewhat pricey compared historical levels. For example, at an aggregate level the equal weighted cap rate for the NCREIF Property Index came in at 5.7% during the fourth quarter, while the value weighted cap rate, which places more emphasis larger properties, came in below 5.2% for the \$262 billion index. In addition to being below long-term historical averages, these rates are approaching the record-low sub-5% level reported in mid-2008 leading up to the collapse in values of institutionally held properties. On the transaction front, NCREIF cap rates are over 110 basis points higher than they are for assets being held by participants in the index, which raises some interesting questions as to the comparative quality of assets being sold and/or the sustainability of current values. At an overall level, four-quarter rolling growth in NOI in the NCREIF index slipped a bit from 4%+ during 2012, although NOI growth was still at the strongest level it has been since 2008.

In terms of total transactions, Real Capital Analytics (RCA) tracked over \$355 billion of total transactions during 2013. This reflected almost the 20% gain over the prior year and is noteworthy

because the increase in transactions occurred in some of the weaker markets and property types that investors had heretofore eschewed. At the same time, investors' appetites for core property types in markets remained robust with investors willing to pay premiums for what remains a relatively limited pot of available assets. In some cases these premiums are closing the gap on replacement cost, setting the stage for new construction although the pipeline is far from robust. This reserve is a good sign in light of the recent economic turmoil that has cast some doubt on the strength of the demand side of the spatial equation. Reflecting strong investor demand, commercial property price indices trended upward across the board with the exception of industrial, which remained stable but relatively flat. Despite the increase in transaction volume, the year-over-year growth remains moderate compared to the heyday period from 2010-2012 when the market recovered from the dearth of activity in the prior two years.

In general, the supply of mortgage capital, from a combination of private and commercial mortgage-backed securities (CMBS) lenders, for the commercial real estate market is adequate to support transaction levels. At the same time, low interest rates that benefited from quantitative easing and mortgage purchases continue to support aggressive pricing relative to historical levels. The fact that nonrecourse debt is still available has added to the mix, allowing investors to focus more attention on satisfying appetites for scarce product than on underlying property fundamentals. While commoditized pricing has provided some insulation from the downsides associated with such a strategy, at some point fundamentals will put a chill on overall collateral values. While disturbing to some, this adjustment and requirement will force lenders and investors to pay more attention to the risk-return propositions associated with individual properties, which to this point have been carried along by the hunt for assets and willingness to accept low returns that belie historical standards.

Although the current commercial mortgage market is relatively healthy there are some problems that may create a deep freeze for portions of the sector. Turning the clock back several years, the market was braced for some \$300 billion in maturing bullet loans on commercial properties that were underwater as a result of the bubble leading up to the market collapse. Interestingly, the first tranches of 3- to 5-year bullets

that would have matured seemed to have dodged the bullet. However, this situation was only a temporary respite as banks were able to adopt various extend-and-pretend strategies in hopes that the market would recover. Despite commoditized pricing, which has bolstered the values of weaker assets in many institutional portfolios, the same cushion is unlikely to exist for loans that mature on distressed assets. Thus, while there is plentiful mortgage capital to support the mainstream commercial market, the same is not true for the remaining pool of underwater properties, many of which will require some significant efforts to reposition and create value. Since the banks have been generally successful in managing their exposure to distressed assets, almost half of the volume of distressed assets remains in the CMBS sector. This impending crisis has attracted the attention of hedge funds, with a number of managers gearing up to provide some form of bridge financing where sources of capital from traditional lenders will fall short of borrowers' needs. This trend will be interesting to watch as it plays out, especially since some will find it difficult to actually underwrite the inherent risk of the underlying properties, which by a number of measures are being carried at historical highs.

## Conclusion

Despite the growing sense of optimism that was building through much of last year, 2014 had gotten off to a mixed start. The economy has taken center stage, with some unexpected disappointments on the employment and housing fronts causing concern among investors and households alike. In addition to concern over the domestic front, investors have maintained a close eye on the global markets, which have become more volatile. When combined with relatively high prices for domestic stocks, the global situation has had a chilling impact on the US stock market. Due to the integration of global economics, the recent turmoil in emerging-market stocks has also affected the US market and has added volatility to markets across the globe.

While the global scene has had a significant impact on the US stock market, it is interesting to note that the Washington malfunction seems to have run its course in spite of the fact that the debt ceiling and other unresolved issues create potential for another crisis. Similarly, while it is clear that the spatial balance in the real estate market remains dependent

on the overall economy, positive expectations among investors have led to an increase in transaction levels and have bolstered the private side of the market. In some respects, this situation suggests a disconnect between the spatial and asset side of the market. This has allowed the commercial sector to avoid some of the volatility associated with chilling news that has spilled over to other asset classes. Assuming the economic recovery can get back on track and overcome the unexpected cold spell that has led to uncertainty, real estate fundamentals may come back in line with investors' and lenders' implicit optimism. If things don't warm-up as anticipated the market may be in for a game changer that could catch many off guard.

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