by James R. DeLisle, PhD

Uncertain Times and Uncharted Waters

Commentary

I have been writing this series of articles for the past eighteen years, spanning five election cycles. During that period, we have experienced a number of "regime shifts" in real estate and economic markets, some of which were associated with the changing of the guard in Washington, DC. Leading up to the elections, we avoided speculation on what policy changes might occur, focusing rather on emerging trends that have a more direct impact on the economic, capital market, and real estate markets that have been the focus of this series. In the past, once the election was over and the dust settled, we began to incorporate the impact of political changes. This approach has worked fairly well, because most transitions were incremental, especially early in the transition periods. This time around, the situation is dramatically different, with the potential for more revolutionary change hanging over the market. The election of Donald Trump as president was unexpected by market players, and prior to the election, most players had discounted an orderly transition. The unexpected election results, however, created shock waves that rippled across the country and beyond. Since the positions of the president-elect on many key issues are dramatically juxtaposed to the current administration's, any prognostication regarding the market must address some of the uncertainty and point out some of the potential effects in the various economic and real estate sectors.

In many respects, the outcome of the presidential election may appropriately be labeled as "unprecedented," at least in modern times. However, in some respects it is reminiscent of the Brexit vote, which also caught many off guard and continues to have uncertain implications for the United Kingdom, the European Union, and the rest of the world. Interestingly, both events have triggered a lot of second-guessing and have increased speculation on the future in a broad spectrum of areas. The changes have also wreaked havoc on many forecast models, rendering them invalid and unreliable due to the emergence of new variables that heretofore have not been included. Clearly, we are in a period of "politics as unusual" and the economy will have to deal with uncertainty for some time and will have to prepare for unexpected shocks. By definition an increase in uncertainty translates to added risk that markets, consumers, and government factor into decisions. For many, pricing these risks will be problematic, setting the stage for some unpredictable times. The *Wall Street Journal*'s (*WSJ*) Economic Forecasting Survey of over 60 economists punctuates the fact that postelection period will be characterized by uncertainty, with 41.5% of those polled indicating a period of "somewhat more uncertainty" and 45.3% indicating "much more uncertainty."

It should be noted that the unusual and uncertain times ahead have not yet shown up in confidence surveys. For example, Moody's Analytics Survey of Business Confidence remained relatively strong in the initial postelection reading, suggesting that global business sentiment has been fairly resilient in line with global economic growth. Similarly, the University of Michigan Consumer Sentiment Survey increased to 93.8 in late November. In addition, the November 21–27 Gallup poll reported that its US Economic Confidence Index surged ahead 6 points, reaching the highest level in over six years. In terms of attribution, Gallup pointed out that the confidence increase was attributable to Republicans who were more optimistic than they had been going into the election. While still early, these results were somewhat surprising. At this point, it is not clear if shifts in sentiment reflect a temporary change related to the fact consumers were anxious to open a new chapter and tuned out the postelection rhetoric to focus on the upcoming holidays. This interpretation could help explain the recent increase in retail sales. Whether the positive outlooks will continue remains to be seen. Indeed, the calls for election recounts suggest a stormy transition period without the honeymoon period typically enjoyed by presidents-elect.

The Economic Environment

The US economy continued to experience some improvement through October, with the Federal Reserve's Beige Book reporting modest to moderate improvement for most of the twelve Federal Reserve Districts. The report noted that labor markets were relatively tight, with shortages occurring in skilled positions along with some difficulty in hiring for manufacturing, hospitality, health care, truck transportation, and sales. At the same time, wage growth was modest along with increases in prices.

Industrial production improved in September, helping assuage some of the concern that reigned through the first half of the year. Wholesale and retail inventories declined during the third quarter, led by a decline in nondurable goods. Business inventories were relatively flat in October, with the increase in sales helping slow inventory buildup. Durable goods orders surged 4.8% in October, led by nondefense capital goods, which benefited from strong aircraft orders. Factory orders rose modestly in September, with nondurables gaining and durables slipping slightly. Industrial production overall was flat, as was capacity utilization, which hovered around 75% for much of the year. The Institute for Supply Management's (ISM) Manufacturing Index continued to improve in October, rising to 51.9, which was off the peak in June but still above the 48 at the beginning of the year. The numbers also continued an 89-month trend of positive growth for the overall economy. On the other hand, the Institute for Supply Chain Management's Non-Manufacturing Index (NMI) slipped to 54.8 in October, a 2.3 percentage point decline from September. While a slowdown, the reading above 50 still indicates positive growth, albeit at a slower pace.

On a positive note, estimated growth in the gross domestic product (GDP) increased in the third quarter, rising to 2.9% after disappointing figures for the first half of the year. These figures were revised upward in November, with seasonally adjusted GDP of 3.2%, which was the highest level in two years. Near-term recessionary fears are relatively muted, with economists in the *WSJ*'s Economic Forecasting Survey reporting a 20% chance of a recession over the next year; notably, the expectations of a recession increase to 60% over the next four years. This expectation trends upward, which suggests the recession will come in the third or fourth year of the period. This estimate was made regardless of the election results and relates to long-term experience with finite life expansionary periods. Thus, the fact that economy continues to expand on a number of fronts and business confidence levels remain positive suggests the near-term prospects of a recession are not likely, opening the door for some upward momentum that might keep the expansion going. However, this outlook is tempered by the political uncertainty that will hang over the market and has yet to be fully factored into the equation.

Business Indicators

Small business confidence levels reported by the National Federation of Independent Businesses (NFIB) declined in September, falling modestly after bottoming out in the first quarter and peaking during the second quarter. The results were mixed, with half of the ten components declining and half improving. In general, small businesses—in which the majority of jobs reside—anticipated an improving economy although their responses in terms of investment and inventories lagged. Interestingly, large-company CEO sentiment in 2016, as reported by the Conference Board Measure of CEO Confidence, has tracked that of smaller-business CEOs, with an increase in the second quarter followed by a modest decline in the third quarter. In the third quarter, the index fell 2 points to 50, the tipping point between positive and negative responses. Despite this modest decline, the short-term outlook remained positive for the United States, with concern over global conditions weighing down the outlook. Closer to home, CEO confidence was more guarded, with 23% expecting improved conditions over the next six months—a 10-point decline. CEOs' concerns over their investment prospects were also mixed, with a quarter increasing capital spending since the beginning of the year and another quarter pulling back.

Productivity rose in the third quarter, racking up the highest increase in over two years and following three quarters of declines, which was the longest downturn in some forty years. Despite this near-term improvement, the ten-year trend remained in negative territory. The downward trend in productivity was attributable to a number of factors, ranging from weak business investment, concentration of employment growth in service jobs, and nagging uncertainty over the recovery and government policies. With the changes in Washington, small and large businesses will be waiting to determine the winners and losers of any major policy changes.

Employment

The employment front continued to improve in the 2016 third quarter, with 161,000 jobs added in October, bringing the three-month average to 176,000 new jobs. This is down from the 181,000 for the year-to-date and the 215,000 monthly average in 2015, but it is still ahead of the rate needed to keep up with population growth. On another positive note, job cuts in October fell to 30,740, which was down 30% from September and 39% from the prior year. Seasonal hiring plans also increased in the third quarter as retailers and shippers prepared for the expected increase in holiday retail sales.

The increase in employment helped push unemployment down slightly to 4.9% in October. Initial jobless claims also trended downward, while continuing claims with the four-week moving average were slightly above 2 million through mid-November. The underemployment rate continued to lag improvements in unemployment but declined to 9.5%, the lowest level since the recession. The improvement in the job market has translated to wage growth, which has reached the highest level since the Great Recession. While up only 2.8% over the prior year, the increase in wages may signal the beginning of an upward trend. It has also contributed to an uptick in the share of the 25–54-year-old population that is either working or looking for work. Despite that increase, as of October over 94 million Americans remained outside the labor force. As population growth continues and the labor force ages, it is likely that the sheer number of Americans outside of the labor force will continue to increase, with Labor Department estimates putting the figure over 101 million over the next four years.

Inflation and Interest Rates

Consumer prices continued to rise in September, increasing 0.3% from the prior month and 1.5% over the prior year. Although the rate of increase is modest, the rolling twelve-month pace of inflation is the highest it has been in over two years. Core inflation, net of the more volatile energy and food sectors, rose 2.2% over the same period. The Employment Cost Index for private workers rose 2.4% in the third quarter on a year-over basis along with a 2.3% increase in benefits, translating to 2.2% change in compensation. Producer price increases were rather flat in October, rising 0.9% on a year-over basis, which was above the pace over the past two years. Import prices increased 0.5% in October, led by petroleum prices. Despite the increase, import prices were still lower than the prior year. In a sign that inflation pressure is building, the ECRI Future Inflation Gauge for October rose to 113.7, a 10% increase over the prior year. For the first postelection reading, the US Weekly Leading Index rose to 141.6, the highest level in over five years. In its weekly commentary, ECRI predicts that inflation is likely to increase, which would put an end to the historically low price rises that have characterized the market. However, the Federal Reserve (the Fed) has indicated it will keep its 2% target inflation rate. The *WSJ*'s Economic Forecasting Survey pegs December inflation of 1.8%, rising to 2.2% by June 2017 and 2.3% for December 2017.

Mortgage rates have already increased, ahead of the Fed's expected move in December after it deferred action at its previous meeting. During those deliberations, officials pointed out that they wanted to see "some further evidence" that the economy was on track before they increased interest rates. At this point, the CME Group's FedWatch Tool, which is based on 30-Day Fed Fund Futures prices predicts a 93.5% probability of a Fed increase of 25 basis points in December. This outlook is consistent with the *WSJ*'s Economic Forecasting Survey, which reports a 96.4% probability of a 25-basis-point increase in December. This is expected to be followed by another increase in June 2017 to an average of 0.86%, rising to 1.17% by December 2017. The respondents also predict that ten-year notes will rise to 2.05% in December 2016 and move up to 2.49% over the next twelve months.

While the Fed has yet to act, interest rates and mortgage rates have already increased, as reported on November 23, 2016 in Freddie Mac's weekly

Primary Mortgage Market Survey (PMMS). The PMMS reported that thirty-year fixed-rate mortgages rose 9 basis points, slightly above the 8 basis-point increase in 10-year Treasuries. That brought the weekly rate on the fixed mortgage to 4.03%, the first plus 4% reading in over a year. The fifteen-year fixed-rate mortgage rate increased 11 basis points to 3.25%, while 5-year Treasury-indexed, hybrid adjustable-rate mortgages rose to 3.12%, a 5 basis-point increase.

Assuming the Fed's rate increases are realized, mortgage rates can be expected to rise over the next twelve months at a rather measured pace. This will have a number of impacts on the housing market, including a reduction in refinancing activity. This is reflected in Freddie Mac's prediction of $1 trillion in refinance mortgage originations in 2016, followed by just under $600 billion in 2017. However, forecasts for mortgage activity as well as the outlook for both inflation and interest rates are subject to the same uncertainty that will characterize the market during the changing of the guard in Washington.

The Global Scene

In the second half of 2016, the global scene was rocked by a number of unexpected shocks, ranging from Brexit in the United Kingdom to the surprising election of Donald Trump in the United States. Despite dramatic differences among the two phenomena, they share some commonalities, ranging from the underlying discontent among voters that triggered the events to the fact that neither of them was automatically considered a done deal afterward. On the Brexit front, a UK court recently ruled that the government cannot initiate the exit from the European Union without a vote from Parliament. Unless reversed on appeal, this requirement puts the decision on the backs of lawmakers, the majority of whom voted to stay in the European Union. This ruling adds more uncertainty to the equation making it difficult for companies that could be dramatically affected by the outcome. On the US front, the call for a recount of the election results and the potential realignment of electoral votes hung over the country in December. As 2016 drew to an end, the resolution of both issues garnered international attention and added some downside risk to the global economic outlook.

The international arena is one of the greatest areas of concern in the postelection period, given the strong promises made by the president-elect related to trade agreements, global warming, and US collaboration with its allies on a range of global issues. This uncertainty has garnered much attention across the globe and will remain a wild card until the rhetoric is translated into action. In general, the global outlook is fairly consistent with where it was during the second quarter. The Organisation for Economic Co-operation and Development (OECD) composite of leading indicators suggests stable growth in the 32 OECD member countries overall, with momentum increasing in some of the major emerging markets. In terms of developed nations, the outlook is for stable growth in the United States, Japan, and eurozone, although some downside risk remains. With respect to emerging nations, leading indicators point to increased momentum in China and India, along with Brazil and Russia, which are starting from a lower baseline.

The US dollar has remained strong despite some angst over policy changes in Washington that could affect its global standing. The upgrade in GDP growth to 3.2% in November should help attract more offshore investment and help bolster the economy. This also should continue to help the US trade deficit, which has already improved as foreign companies increased purchases of US products, with a 0.6% increase in exports in September and a 1.3% decline in imports. As a result, the trade deficit in September was down around 10%, falling to $36.4 billion, which was the lowest rate in almost two years. Whether this improvement will continue is unclear, with a lot riding on how the new administration handles global affairs.

Consumer Confidence

The University of Michigan's Survey of Consumers fell to 87.2 in October, with the most dramatic decline occurring in the expectations component, which was down 6.5% over the prior year. The Conference Board Consumer Confidence Index experienced a five-point decline in October, falling to 98.6 and reversing the upward trend that it had exhibited leading up to that point. Some of the decline was attributed to uncertainty leading up to the election as well as a slowdown in the job market. The confidence levels reported by the Gallup poll continued to hover around −10 as it has since first slipping into negative territory in March 2015.

While it is too early to tell if consumer confidence will hold up in the postelection period, early indications suggest that consumers have been quite resilient, as reflected in the improvement in the University of Michigan Consumer Sentiment Survey, which rose to 93.8 in November; this was the strongest increase since April and reversed the midyear downward trend. Improvement was reported in the present conditions component, which rose to 107.3, as well as the expectations component, which rose almost to 85.2 compared to 76.8 in October.

A number of factors have helped bolster consumer confidence levels, including wage gains that have been reported at 2.8% for the year, the highest level since the recession. Personal bankruptcy filings declined by −6.2% in the third quarter, which was similar to declines in the first half of the year. Confidence levels were also likely bolstered by the improvement in economic growth, which also picked up to 2.9% in the third quarter. Household wealth also improved during the first half of the year, with net worth rising 3.1% over the prior year. At the same time, financial burdens of households remained constant and relatively low. Consumer credit growth slowed a bit in the third quarter, led by a decline in credit card debt. Looking forward, consumers' inflation expectations have remained rather consistent, with a 2.4% expectation for the next year and 2.6% for the next five years.

Retail Sales

During the third quarter, retail sales were fairly strong, benefiting from the positive employment situation and wage gains that had a positive impact on consumers. According the Department of Commerce Advance Monthly Sales, there were some distinct winners and losers among traditional retailers. On the positive side, the strongest year-over increases in October were in the health and personal care, building materials and garden supplies, motor vehicles, and retail and food services sectors. On the other hand, general merchandise sales were down 7.3% as were electronics and appliance sales, which were down 4% from the prior year. As has been the case for some time, non-store retailers continued to improve, with 12.9% increases over the prior year.

Going into the holiday season the outlook was generally positive, although brick-and-mortar retailers were expected to continue to struggle to stave off the competition of online retailers. The National Retail Federation (NRF) projected holiday season sales of some $655 billion, a 3.6% year-over increase. This outlook is keeping with those of other forecasters, including the International Council of Shopping Centers (ICSC), which forecast a 3.3% increase. Retailers are certainly doing all they can to push sales, as noted by the flurry of activity around Black Friday, which has become a misnomer with sales beginning before Thanksgiving and extending through Cyber Monday and beyond.

Online retailers are expected to enjoy the strongest gains on a year-over basis, with the NRF projecting increases in the upper single digits, and other prognosticators predicting even stronger, 25% increases. According to the Nielsen survey, consumers across demographic categories continue to spend more online, with millennials leading the pack with a 25% increase in online expenditures during the holidays compared to 19% of shoppers overall. In addition to online purchases, consumers have turned to the Internet for product research, comparisons, and price checking. Small businesses have entered the fray in earnest, focusing on providing novelty gifts and limited-time promotions to improve sales. The Small Business Administration (SBA) continues to try to help small retailers in the hypercompetitive retail arena by offering a number of self-help blogs. Small business sales have also benefited from Small Business Saturday, an initiative launched by American Express in 2010 with continued support in the form of free personalized ads and formal recognition by Congress in a 2011 Senate resolution. The early results for the holiday season have been generally positive, with millennials leading the charge in terms of timing and increases in expenditures.

Housing Market

The housing market has improved recently, along with the general economy, employment, and consumer confidence. Existing home sales bounced back up in September, rising to 5.9 million units on a seasonally adjusted basis, which represented a slight increase on a year-over basis. New home sales also increased in September, rising 3.1% to a seasonally adjusted level of 593,000 units. On a year-to-date basis, new home sales were up 13% over the prior year but still at only half of the peak reached in 2005. Pending home sales also rose in September, suggesting that the pace of closings will increase over the next several months. Whether this trend will continue depends in part on interest rates, which are likely to increase moderately, with the Fed paying attention to the tenuous nature of the housing market recovery. The Mortgage Bankers Association's Weekly Mortgage Applications Survey showed that mortgage applications increased for the week of November 18, even in the face of uncertainty surrounding the election and rising interest rates. This suggests some homebuyers may be trying to get into the market ahead of the curve.

In terms of price levels, the S&P CoreLogic Case-Shiller Housing Index accelerated in the rolling three-months through August, with the 20-city composite index up some 5% on a year-over basis. When compared to the peak that occurred in 2006, the price index is essentially back on par to where it was before the collapse. The Black Knight Home Price Index tells a similar story, with prices rising some 5.3% through August. The CoreLogic Home Price Index was up even more, with September increases of 6.3% over the prior year. This was consistent with FHFA Purchase-Only House Price Index, which continued an eighteen-month stretch of 5% plus increases. According to the National Association of Realtors (NAR), the median price of single-family houses rose to $240,900 during the third quarter, which translated to a 5.2% year-over increase.

On the demand side of the equation, household formations have increased, with the majority of new households opting for ownership. The subtle but significant shift in tenure choice boosted the share of first-time buyers to over a third of home sales in September, which was a four-year high. However, increasing prices have created access problems for many millennials who remain locked out of the market due to debt hangover from student loans, lack of capital for down payments, and shortage of entry-level housing. As the economy improves, homebuilders are expected to try to address the supply issue, although the National Association of Home Builders' Index dropped to a seasonally adjusted level of 63 in October, which is a 2-point decline from September but still above the 50 level that is the balance point between a positive and negative view of the market. More importantly, the expectations or forward-looking sentiment stayed elevated at 70, the high point for the past year. This was consistent with the surge in single-family permits in August, which reached a two-year high. Despite the increase in permits, housing starts fell 9% in September, suggesting builders are keeping some powder dry and plan to ratchet up construction as the economy improves. The anticipated rise in interest rates may place a damper on builder enthusiasm, especially if earnings growth continues to lag. Another risk factor is on the construction side, with the industry still struggling to replace the skilled workers who left the industry during the downturn. This situation may be exacerbated in the future by changes in immigration policy promised by the president-elect.

On a positive note for homebuilders, the homeownership rate edged upward to 63.5% during the third quarter, after slipping to 62.9% in the second quarter, which was a 51-year low point. Mortgage delinquency rates have continued to edge downward, falling to 4.5% in the third quarter. The re-entry of previously foreclosed households into the ownership track has also helped bolster the housing market. This trend is likely to continue as "time heals all wounds." That is, credit scores that were tainted by foreclosure are beginning to clear up, enabling them to get back on the homeownership track. According to FICO, a foreclosure remains on a credit report for seven years. Thus, the passage of time has already helped elevate FICO scores for borrowers who faced foreclosure early in the cycle, with more of the 5 million families who lost their homes becoming eligible for mortgages each year. This may add some needed momentum to the housing market, but it also creates some downside risk for the rental market.

Real Estate and Capital Markets

Overview

In general, real estate market fundamentals remained in balance through the third quarter. This situation was reflected in investment performance, which was bolstered by capital flows, investor demand, market expectations, and yield requirements. While the interaction of these forces is complex and subject to a number of dynamics, the end result translates to investment performance that affects the private and public sectors as well as the debt and equity components.

The uncertainty triggered by the election is likely to change some of the market dynamics that drive real estate performance. For example, the Fed's anticipated interest rate increases have already spilled over to mortgages. In the absence of an offsetting surge in net operating income, which is not anticipated in light of market fundamentals, an increase in capital costs will put downward pressure on values. In addition, the market has yet to factor the uncertainty surrounding a range of new policies (e.g., taxes, regulation, immigration, health reform, stimulus spending, trade policies, and global relationships) into current valuations. When coupled with the recent slowdown in transaction volume, declining returns in both the private and public side of the market, and growing evidence of some profit-taking (e.g., apartments, retail, health care), the industry may be facing an inflection point. Since there are no clear signals as to which policy changes will actually be implemented and in what form, the market is likely to take a pause, which may put pressure on bid-ask spreads. At the same time, investors and other players are likely to revisit the risk side of the equation in the face of volatility emanating from market uncertainty. Staying ahead of the game will be a daunting task, at least over the near term, since both the rules and their enforcement are likely to change.

The NCREIF Property Index (NPI) is recognized as the bellwether for private-market institutional real estate performance. The index is based on data contributions from investment managers and investors holding assets on a mark-to-market basis. As such, the properties are valued on a quarterly basis, with the change in value reported as an appreciation return (i.e., an unrealized gain/loss in value), which when coupled with an income return converts to a total return. As of the 2016 third quarter, the NPI consisted of 7,371 investments totaling $516.4 billion, with an average investment of $70 million. During the first three quarters of 2016, investment performance for the NPI continued to taper off, with total returns slipping to 1.77% for the third quarter. This decline was attributable to a decrease in appreciation in the market value account, which fell to 0.6%, while income returns also declined to 1.16%. (Exhibit 1).

On the public side of the market, real estate investment trusts (REITs) have had an interesting ride in 2016, with the FTSE NAREIT All Equity REITs Index generating 6.57% total returns on the year-to-date basis through October. These figures included a 3.9% dividend, with changes in REIT share prices placing a drag on total returns. This performance was somewhat disappointing on the heels of the elevation of real estate to distinct financial sector. After REITs traded up during the first half of the year, year-to-date returns slipped into negative territory. Despite the recent weakness in performance, on a trailing three-year basis, REITs still provided low double-digit returns, which were more competitive with other asset classes. Going forward, REITs should continue to attract attention of asset allocators and those drawn by the promise of stable dividend payments.

Real estate transaction volume reported by Real Capital Analytics (RCA) flattened through the first three quarters, averaging $114.4 billion. This was $11.5 billion off the same period in 2015 and a significant decline from the 2015 fourth quarter when volume surged to $168.4 billion. Capitalization rates for industrial, retail, and office properties converged around the 6.5% rate, while capitalization rates for apartments continued to decline to 5.6%, 40 basis points

Exhibit 1 NCREIF Property Index Snapshot, 2016 Third Quarter

	Profile			Returns (%)		
	Number of Assets	Value ($ millions)	Share (%)	Total	Appreciation	Income
Apartment	1,655	128,129	25	1.72	0.60	1.12
Hotel	115	5,407	1	1.35	-0.83	2.18
Industrial	3,056	73,042	14	2.89	1.60	1.29
Office	1,401	189,034	37	1.26	0.15	1.11
Retail	1,144	120,782	23	1.98	0.79	1.18
Total	7,371	516,393	100	1.77	0.60	1.16

Source: NCREIF Property Index

lower than the same period in 2015. Hotel capitalization rates continued to trend upward, averaging 8.5% for the first three quarters, a 30-basis-point increase over the prior year. The downward trend in sales activity carried into the fourth quarter, with October sales of $32 billion, a 43% decline over the prior year. The decline in sales volume was the most dramatic for portfolio sales, although individual transaction volume was also down. The decline in transaction volume was widespread, with hotel transactions the only positive sector.

In terms of buyers, during the first three quarters international players led the pack with $18.9 billion in acquisitions followed by $6.7 billion from institutional and fund buyers and $6.7 billion from private capital sources. In terms of trends, during 2015 international investors also led in volume with $64.7 billion, while other private capital sources and institutional and fund investors were net sellers at $17.6 billion and $15.8 billion, respectively. Investors in listed REITs (i.e., public REITS traded on a national securities exchange) remained net sellers, with $29 billion in net sales through the first three quarters on the heels of $9.4 billion in net sales during 2015.

Office Market

The office market exhibited uneven performance during the third quarter, with some markets enjoying the benefits of strong job growth in office-using occupations, while others lagged as companies held off on making major commitments in the face of rising uncertainty. Tenants were more selective, which created some winners and losers at the local market level. Many tenants are focusing on amenities and flexibility within the walls of their offices as well as walkability and accessibility that appeal to workers.

The absence of major construction (other than in some gateway cities and technology hubs) has contributed to an increase in net absorption, albeit as slower levels than earlier in the cycle. At the same time, rent growth has continued in some markets, although at moderate rates in-line with local market conditions of supply and demand. Some higher-cost, technology-oriented markets have benefited from strong employment growth and have become landlord havens, which has forced some tenants to look to other markets with more affordable office space as well as lower costs of living for employees. While this does not suggest a reversal for the technology-oriented markets, it does suggest the recent upward pressure they have benefited from may be cooling off. At the same time, the outlook for office markets is likely to be affected by policy changes coming out of Washington, especially if the move to cut regulations plays out, which would favor the financial sector and could stimulate office-related employment growth.

In terms of the private institutional market, the $189 billion of office investments in the NPI accounted for a 37% market share, leading other property types. The 1,655 properties came in with a $134.9 million average value, which also led other property types. At an aggregate level, office returns in the NPI have tapered down after a strong performance in 2015, with 7.5% trailing four-quarter returns. For the third quarter, total returns fell to 1.26%, with suburban assets outperforming their urban counterparts (Exhibit 2). In terms of market share, CBD properties accounted for 58% of total office investments. On the public front, office REITs were on par with overall REIT averages, coming in at 6.6% year-to-date returns, including a relatively low dividend yield of 3.2% compared to industry averages.

Exhibit 2 NCREIF Property Index, Office Subindex, 2016 Third Quarter

	Profile			Returns (%)		
	Number of Assets	Value ($ millions)	Share (%)	Total	Appreciation	Income
CBD	403	110,293	58	1.13	0.13	1.00
Suburban	998	78,741	42	1.44	0.18	1.26
Total	1,401	189,034	100	1.26	0.15	1.11

Source: NCREIF Property Index

Office transactions declined a modest 4% on a year-over basis in the third quarter, with $33.9 billion of sales volume. On a year-to-date basis, office transactions declined 7% to $99.5 billion due in large part to a decline in portfolio and entity-level transactions, which were down 32%. CBD sales were down 6%, compared to a 9% decline in suburban sales. In terms of subsectors, single-tenant office sales were down 10%, while medical office sales declined 24%. In October, office sales continued to decline, falling to $10.5 billion, a 20% decline on a year-over basis. Office capitalization rates trended downward through the third quarter, falling to 5.4% for CBD properties and 6.7% for suburban offices. Reflecting a search for yield, suburban office sales, which traded at 6.8% capitalization rates, rose to $5.9 billion, a 10% increase on a year-over basis. With respect to buyers, private capital sources and international investors increased their share of office acquisitions at 31% and 24%, respectively. The market share for institutional and fund investors was relatively stable at some 34%, while the share of listed REITs declined to 6% of acquisitions and remained net sellers, laying off $16.3 billion in sales.

Retail Market

The retail market has received close scrutiny in light of store closings and continued growth in online shopping. While a reason for concern, it should be noted that these forces are not revolutionary but have been played out for some time. In the face growing competition from their online counterparts, traditional retailers have pulled out all the stops in trying to attract customers. These efforts range from investment in their own digital platforms to increased advertising budgets, new advertising campaigns, and increased media spending to raise awareness and stimulate traffic. In addition to increasing traffic, traditional retailers have also focused significant attention on nurturing customers once they get to the store by enhancing "consumer experiences." These initiatives range from hiring additional workers to helping customers find products to adding exclusive products in stores that are not available online. Retailers and developers have also redoubled efforts to reposition stores and enhance successful centers, making them more attractive to millennials and other shoppers who value in-store experiences. At the same, developers have also been active in repositioning and/or redeveloping troubled centers. In some cases this has translated to complete demolition and conversion to other uses, while in other cases it has involved partial deconstruction and the addition of mixed-use spaces. Going forward, the retail market is expected to continue to reinvent itself as it has been doing for some time, with centers in strong locations and proactive management outperforming while others continue to languish.

In the private institutional arena, retail investments accounted for 23% of the NPI, with a total value of $120 billion. The 1,136 properties broken out by subtype had an average value of $105.3 million. Due to the number of subtypes that range from individual single-tenant properties to super-regional malls, the average value can be misleading. Indeed, the 65 super-regional malls in the NPI had an average value of $685.1 million, compared to 58 regional malls at $267.7 million, fashion/specialty centers at $138.2 million. At the other end of the spectrum, single-tenant properties averaged $36.2 million, with neighborhood centers at $37.3 million, community centers at $59.5 million, and power centers at $82.4 million. A snapshot of subsector returns is shown in Exhibit 3.

In terms of investment performance, the NPI retail component outperformed the overall index despite a downward trend through the first three quarters. Even with this slowdown, retail investments continued to provide 11% returns on a trailing four-quarter basis.

On the public side of the market, retail REITs had a challenging time in 2016, with total year-to-date returns through October coming in at 2.7%, shopping centers at 4.7%, and regional malls declining 3.7%. Freestanding retail REITs were the exception for the sector, finishing with 21.3% total returns through October.

Retail transaction volume as reported by RCA came in at $18.4 billion for the third quarter, a 10% decline over 2015. This was the fourth consecutive quarterly decline on a year-over basis. On a year-to-date basis, retail sales of $57.1 billion were down 14%, led by a 20% decline in shop sales (i.e., single-tenant or small retail) and a 14% decline in shopping center sales volume. For the year-to-date, regional mall sales were up 30%, due to large portfolio transactions, while grocery-anchored and urban/storefront sales were down. The decline in retail sales volume continued in October, falling 41% to $5.2 billion on a year-over basis.

Exhibit 3 NCREIF Property Index, Retail Subindex, 2016 Third Quarter

	Profile			Returns (%)		
	Number of Assets	Value ($ millions)	Share (%)	Total	Appreciation	Income
Community	231	13,744	11	1.92	0.58	1.34
Fashion/Spec.	85	11,749	10	1.43	0.31	1.12
Neighborhood	450	16,778	14	2.09	0.79	1.30
Power Center	170	14,002	12	1.43	0.05	1.39
Regional Mall	58	16,050	13	2.08	0.94	1.14
Single Tenant	77	2,790	2	1.24	0.39	0.84
Super-regional	65	44,532	37	2.30	1.21	1.09
Total	1,136	119,644	100	1.98	0.79	1.18

Source: NCREIF Property Index

In terms of buyers, private capital sources were the most active in the retail arena, accounting for $27.8 billion in acquisitions along with $27.2 billion in dispositions. Institutional and fund investors dominated the acquisition market with $5.8 billion in net purchases, while listed REITs were net sellers with at $6.8 billion through the third quarter. Canadian investors were the dominant international buyers of retail properties during 2016, supplanting European investors who led in 2015.

Industrial Market

The industrial market has turned out to be one of the strongest of the core property types in terms of market fundamentals. Despite new construction activity, the industrial market has experienced solid net absorption with demand at the highest level in over ten years and rents approaching record highs in many markets. According to CBRE, the industrial sector experienced 77.4 million square feet of net absorption in the third quarter. This continued a 26-quarter steak of positive absorption. At the same time, development completions have increased, with a surge of construction in the pipeline. As vacancy rates have declined, rents have increased and in many markets are ahead of where they were before the recession.

In addition to improved economic conditions, the industrial sector has benefited from the dramatic growth in e-commerce, omni-channel distribution models, and importance of fulfillment and timely delivery across a range of retail and production segments. In addition to affecting locational preferences, these changes have continued to drive warehouse design favoring modern facilities with high-throughput capability. These trends with new logistical models make the industrial sector increasingly dynamic. There is some risk that existing space will be left behind. There is also some risk that a wave of new construction could be driven by investors seeking yields rather than underlying fundamentals.

Industrial properties accounted for 14% of the NPI through the third quarter, with 3,033 properties in the detailed subindices having an average value of $24 billion, the smallest of any core property type. Despite a modest decline in performance through the first three quarters, industrial investments led all property types with 12.5% trailing four-quarter returns. Industrial REITs hit it out of the ballpark with 26.7% total returns through October on a year-to-date basis.

Industrial transaction volume picked up in the third quarter, increasing to $14.2 billion on the strength of large portfolio sales. Unlike other property types, but in-line with logistical models and trends in supply chains, the growth in industrial transactions was concentrated in secondary and tertiary markets, which were up 11% on a year-over basis, while major metro market sales experienced a 6% decline. Despite the third-quarter increase, industrial transactions were down 20% on a year-to-date basis. Reflecting a search for yield, on a year-to-date basis flex industrial transactions were up 13%, compared to a −30% decline for warehouses. As noted by RCA,

Exhibit 4 NCREIF Property Index, Industrial Subindex, 2016 Third Quarter

	Profile			Returns (%)		
	Number of Assets	Value ($ millions)	Share (%)	Total	Appreciation	Income
Flex Space	240	3,500	5	2.56	1.15	1.41
Other	39	945	1	3.00	1.57	1.43
R&D	43	1,188	2	2.76	1.60	1.16
Warehouse	2,711	66,911	92	2.91	1.63	1.28
Total	3,033	72,544	100	2.89	1.60	1.29

Source: NCREIF Property Index

these comparisons were somewhat distorted by the fact portfolio transactions played a significant role in the 2015 figures, a trend that did not carry over into 2016 with a −51% decline on a year-over basis. The increase in industrial transactions in the third quarter did not carry into the fourth, with October sales falling two-thirds on a year-over basis. Across industrial sectors, capitalization rates compressed in the third quarter for all industrial subtypes with investor demand for more yield driving down capitalization rates for flex facilities that are by nature riskier than warehouse space. With respect to buyers, private capital sources dominated the industrial market, with market share surging to 47% of transactions on a year-to-date basis, a dramatic increase from 32% in 2015. Institutional and fund investors also took a bigger piece of the industrial pie, with market share increasing from 15% to 27%. On the other hand, the share held by international investors declined dramatically, falling from 35% to a paltry 4% of acquisitions. A snapshot of the industrial sector in the third quarter is shown in Exhibit 4.

Apartment Market

The apartment market continued to enjoy solid performance during the third quarter, with rents and values in a number of markets ahead of where they were going into the recession. Despite this performance, there are signs that the sector may be losing some steam. That is not to say the market is near a correction, but that in a number of markets the pace of new construction may have gotten ahead of the growth in demand. This is particularly true for luxury properties, which have been the darling of developers, lenders, and investors for some time. In many markets recent demographic trends and high employment growth in technology and other industries will help sustain the apartment market. However, there are some signs the prediction that millennials would continue to eschew homeownership may have overstated the case. In addition, some millennials and other apartment-seeking residents have turned their attention to the suburbs. However, these are not the far-flung suburbs but infill locations and nodes that have the scale and synergy to emulate urban living with the benefits of suburban living, including strong school systems and access to recreation, shopping, and other amenities.

Looking forward, there are signs the recent pace of rent growth may be tapering off along with occupancy rates, which have reached historical highs. This has occurred especially in the preferred markets of investors and developers, including San Francisco, San Jose, New York, and Houston. In some other markets, landlords are already feeling some of the pressure and are turning to incentives to attract tenants. To the extent this occurs, the corrections are likely to be more rapid than in past cycles due to the advent of technological innovations and new apps that make it easier for tenants to shop for apartments.

While the outlook for apartments at the national level remains positive, the market is likely to become more competitive and stratified, with some markets and submarkets winning and others losing. This equation will operate across the spectrum of housing, including student housing and senior housing, which are niche plays in the broader apartment spectrum. In this environment, aligning market segmentation and product stratification will be the key to success.

Exhibit 5 NCREIF Property Index, Apartment Subindex, 2016 Third Quarter

	Profile			Returns (%)		
	Number of Assets	Value ($ millions)	Share (%)	Total	Appreciation	Income
Garden	707	40,845	32	2.20	0.92	1.28
High-Rise	773	75,767	59	1.42	0.39	1.03
Low-Rise	175	11,517	9	2.00	0.89	1.10
Total	1,655	128,129	100	1.72	0.60	1.12

Source: NCREIF Property Index

Apartments accounted for 25% of the NPI in the third quarter, with a total value of $128.1 billion in 1,655 investments, which translated to a $77.9 million average value (Exhibit 5). At an aggregate level, apartment returns tapered off through the first three quarters, reflecting a fairly dramatic decline from 2015 with 8.5% trailing four-quarter returns. On a year-to-date basis, apartment REITs recorded disappointing performance through October with total returns falling to −1.7%. Dividend yields were also low at 3.3%, trailing other core property types with the exception of the office sector.

Apartment investment activity picked up in the third quarter, rising to $26.8 billion, which reflected a 7% increase on a year-over basis. The pace of activity fell off during October, with disappointing sales of $9.5 billion—which was 56% off the prior year and a slight decline to $121.4 billion for the year as a whole. During the year, the share of individual transactions as opposed to portfolio sales has increased, reflecting a 24% third-quarter increase on a year-over basis compared to a −41% for portfolio sales. In terms of subtypes, investors continue to prefer garden apartments, which experienced a 14% increase in the third quarter compared to a 6% decline in mid- and high-rise transactions. This pattern is consistent with the search for value among investors, with capitalization rates for garden apartments trending down to 5.8%, but still relatively attractive compared to 4.6% for mid- and high-rise projects. The search for value also turned investors to secondary and tertiary markets, which experienced a 14% increase through the third quarter, rising to $59.4 billion, with tertiary markets rising even faster, increasing 25% to $16.4 billion. On the other hand, transactions in major markets increased a modest 6%, rising to $35.5 billion.

While a relatively minor share of the overall apartment market, student housing transaction volume increased 26% in the third quarter, which translated to $7.2 billion for the year-to-date, a whopping 79% increase in activity. Senior housing also enjoyed a solid 41% increase through the third quarter, rising to $10.3 billion in sales. In terms of buyers, the apartment market continues to be dominated by private capital sources, which increased market share from 54% to 62%. These gains were attributed to a pullback from international investors that had increased market share to 13% in 2015 but fell back to a 6% share of the market, which was more in keeping with longer-term trends. REITs continued to be net sellers of apartments, with net transactions declining −$8.3 billion as REITs culled their portfolios and continued to sell into a surge of capital.

Summary

Going into the third quarter, the presidential election was one of the wild cards that hung over the economy and real estate activity. Even after the election, this uncertainty has not been removed from the equation. Rather, it is likely to remain for some time. Despite potential for increased volatility, the economy as well as the capital and real estate markets continue to function, with positive news on a number of fronts.

On the economic front, conditions have been mixed but favorable, with GDP growth increasing to 3.2% annualized in November. Recession risk is relatively low for the near term, although history and economic expectations suggest that one could occur over the next four years. Business confidence levels have tapered off a bit, due in part to uncertainty over the election and the global economy. While employment growth has slowed, it is still ahead of the rate needed to keep up with population growth and has contributed to the 4.9% level of unemployment.

Inflation and interest rates are both picking up with modest increases on the horizon. Mortgage rates have also increased and are likely to come under added upward pressure, although no dramatic increases should occur over the near-term. Consumer confidence has been positive but guarded. Despite uncertainty hanging over consumers, retail sales have surprised on the upside and are expected to finish the year on a strong note. The housing market has improved recently, with existing and new home sales both rising during the third quarter. Looking ahead, the rise in mortgage rates coupled with recent price increases will place a dampener on activity, but the improvement in wages and GDP may offset some of that drag if mortgage rates remain moderate.

On the real estate front, the market remains relatively healthy despite some decline in transaction volume across most property types and markets. At a national level, private real estate returns reflected in the NCREIF Property Index have tapered off, slipping below 10% for the first time since the market recovered from the last downturn. The public markets also slipped recently but finished at a positive 6.6% for the year-to-date through October. Real estate market fundamentals across property types have been fairly strong, especially in light of the slow economic growth in the first half of the year. The recent improvement in the economy should help the industry, although the uncertainty emanating out of Washington has yet to be factored into the market.

In terms of performance, industrial properties have led on the private side, followed by retail, apartment, office, and hotel properties. Industrial properties also led in the REIT arena, followed by office and retail with positive returns, while apartments slipped into negative territory through October. Looking forward, the outlook is generally positive for the near term. However, the uncertainty in the market is a variable that should not be overlooked and is likely to add some volatility to the equation.

About the Author

James R. DeLisle, PhD, is associate professor of real estate and director of Academic Real Estate Programs at the University of Missouri–Kansas City Henry W. Bloch School of Management. His charge is to help build a preeminent real estate program that strikes a balance between academic rigor and state-of-the art industry practices. Drawing on this foundation, students are trained in critical thinking and the spirit of entrepreneurship necessary to take on the complex real estate problems that the next generation of industry leaders must be able to solve. He comes to the Bloch School from the University of Washington where he was Runstad Professor of Real Estate and director of the graduate real estate studies. DeLisle has spent almost half of his forty-year career in real estate as a professional with specializations in applied investment research and strategic portfolio management. Before returning to academia in 1999, he was an executive vice president and head of strategic planning for Lend Lease Real Estate Investments, a global company and the successor firm to Equitable Real Estate, where he founded the Investment Research Department. He has published widely in academic and professional journals. DeLisle received his BBA in real estate and MS in marketing from the University of Wisconsin. He received his PhD in real estate and urban land economics from the University of Wisconsin under his mentor, the late Dr. James A. Graaskamp, one of the leading academic proponents of applied real estate research. To increase industry connections, DeLisle has created a personal website, http://jrdelisle.com. **Contact: delislej@umkc.edu**