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The Future Is Not Now (or At Least We Hope Not)

by James R. DeLisle, PhD

Commentary

These are what can be referred to as defining times; times where our true nature shows. The fact that leaders based in Washington seem to have lost touch with their constituents is more than a bit disconcerting. It also makes it extremely difficult to polish one's crystal ball and come up with a clear vision of how this will play out and what the road ahead will look like. The fact that the rules are being defined as we go and will be redefined over the next several years makes any prognostication even more daunting. In this environment, it is challenging to put on one's behavioral economist hat and try to look forward through the different lenses of the key players who will ultimately define the future. In this situation, only one statement can be made with certainty, the future is not what it is, but what it will be.

In times like these—which is a misnomer since these may well be unprecedented times—it is useful to look to other past experiences to see if there is some analogous situation that can be turned to for critical lessons learned. In this case, I harken back to my days on the University of Wisconsin football team in the late 1960s when the team was 0-19-1 for two years. In many respects, the federal government has about the same record, at least on the budget/deficit front. So, what do the lessons learned from a losing football team tell us?

First, there is the impact of something called a self-fulfilling prophecy. Simply stated, after an extended losing streak there is a loss of confidence that can have ominous implications. You start looking around, wondering what bad things will happen next to make you lose again. Instead of thinking about the things to do to win, you wind up waiting for the next ball to be dropped; this becomes a guaranteed recipe for losing.

Sound familiar? That's about where Americans sit today; our coaches, the referees, and the management are all fumbling trying to figure out a game plan in the face of lost confidence. So, what are the players—small businesses, homeowners, employees, and consumers—to do that will ultimately lead to a win? Indeed, how do we even figure out the best way to prepare for a game for which the rules have not even been written?

Well, as a team with a losing record at Wisconsin, to turn things around we went back to fundamentals, changed some coaches, brought in some new players, and bonded together with a commitment to do what we had to do to achieve our shared vision: to win. How did it turn out? We built some character along the way, but turned the corner and racked up some wins, including important wins such as a first win over Penn State and its famed coach—Joe Paterno. So based on some of the football lessons learned, it appears that the advice for the national economic scene is simple: bond together and focus on the fundamentals and the future. While that might seem like an impossible task, it is not without precedent. In the meantime, the question for the nation's future is, are we ready to do what it takes to turn the situation around and get some wins?

Economic Outlook

It goes without saying that the economy is at a teetering point. Indeed, even before the embarrassing chain of events unfolded in Washington, the prospects of a double-dip recession had been growing. As of late summer, the odds of a US recession were better than 50/50. While this position is not shared by a majority of economists, the real deal makers are the American public, and they are the ones who

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are going to decide how they play the cards they have been dealt.

Given the public angst, and even anger that many are feeling, the prospects for a recession have increased. At the present time, it is likely that the odds will continue to shift toward another economic stumble. These odds are likely to grow until leadership starts focusing on the real and growing challenges facing the economy. Unfortunately, the prospects of that occurring over the near term are limited, and it is doubtful the political rancor that put the country in danger of a credit default will abate soon. The very fact that the high-stakes budget/debt game was played out at a time when the economy was already showing signs of weakness is more than a bit ominous.

Before addressing the economy itself, it is useful to step back and take a look at the budget agreement that saved the day, or more accurately, extended the game. Briefly, the ceiling on the deficit was temporarily increased in return for agreement on a first round of budget cuts. These cuts can be viewed as the easy ones that could more readily be put on the chopping block. The hard part comes with the remaining cuts that will have to be decided before the end of the year and whether some revenue enhancers will be added to ease the blow. The preliminary determination of what budget cuts will be made has been remanded to a newly appointed "Committee of 12" that will represent the two parties. If they cannot come to an agreement on how to close the deficit gap, a fallback agreement of across-the-board cuts will be triggered. Since this would affect many sacred cows (e.g., defense, Medicare) on both sides of the political debate, it is unlikely that those in control will let this occur. However, by frame of reference, few anticipated that the deficit ceiling debate would go down to the wire or that the two sides would keep their game face on for so long. To prevent this from happening again, the Committee of 12 will have to make some difficult decisions and will have to get buy-ins from the factions within their own parties.

Common sense suggests that the deficit crisis cannot be satisfied by one-sided solutions. This will open the door to talks about growing the revenue side of the equation. It puts tax increases, tax breaks, and tax reform itself on the table. So, to this point in the discussions nothing really has been settled; the ultimate outcome was merely postponed, and the stakes were raised. It is this backdrop that must be kept in mind as one ponders the future of the economy, and the real estate and capital markets.

On something of a positive note, the fact that Republican and Democratic leaders ended their twelve-day standoff over FAA funding the same day the stock market collapsed in August suggests that the two sides can get together when they need to make a decision. Unfortunately, the decision was more of a nondecision that reversed the partial shutdown that began in July and only extended the funding through September. Despite the temporary nature of the decision, it was important that it allowed more than 250 airport-related construction projects to get back online. Ironically, the sticking point in negotiations was a fight over subsidies for a baker's dozen of smaller airports that cost the government around half of what was lost in airline ticket tax revenue each day during the closure. Hopefully, this is not the same economic model that will be applied to the deficit talks.

As to economic indicators, in the 2011 second quarter, gross domestic product (GDP) growth slipped and was a disappointment with respect to earlier expectations. This called into serious question the widespread belief that the economy was picking up sufficient momentum to propel it out of danger and on to the path a sustainable recovery by the end of the year.

Today, that previous rosy outlook is more than a bit in doubt. Indeed, based on the dramatic and largely unexpected events in the stock market in early August, most economists have been forced to step back and adjust their forecasts. Also, for many Americans who were looking forward to a much-awaited economic recovery, the outlook is likely to shift from the glass is half-full to the glass is half-empty. This mindset could easily become a self-fulfilling prophecy and force many players into a defensive stance. If this happens, the economy could fall over the precipice and into a recession, and one for which the bottom may be deeper and the recovery longer than the last one.

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Unfortunately, the increasing prospects for a recession cannot be attributed solely to the standoff in Washington; the economy was already starting to gasp for air before that time. Indeed, for the first half of 2011, downward revisions in GDP growth came in at around 2%. Despite that slowdown, expectations were that economic growth would rekindle in the second half of the year, building on improvement in employment, retail sales, exports, and manufacturing. At this point, the likelihood of that scenario playing out is doubtful.

Angst over what is or is not going on in Washington is exacerbating the headwinds from the housing hangover, sticky unemployment, and weakening job reports. These multiple forces have caused an erosion of confidence that has forced many players into a defensive posture and others to call it a game. Indeed, Treasury Secretary Geithner has been flirting with stepping down after resolution of the debt-ceiling situation. It is expected, however, that the administration will push him hard to stay on to address the critical issues and to meet the need for stable leadership in the current situation—especially going into the election. Whether or not Geithner stays, his consternation about the partisan politics that put the nation on the brink of default was shared by many voters.

Also, while the football adage "the best defense is a good offense" is just as true on the economic field of play, the country's collective psyche may preclude such a game plan. At this point, there are few signs that the economy will get its second wind, especially as it faces the political storm in Washington. The bottom line is for a guarded to negative economic outlook, with prospects for moderate growth overshadowed by downside risks and rising uncertainty. To avoid a "sky is falling" sentiment, which can easily become a self-fulfilling prophecy, it is useful to try to take politics out of the equation and take an objective look at the leading indicators and see how things stack up. Unfortunately, as will become clear shortly, that advice will be hard to follow until Washington, Main Street, and Wall Street can get back to the fundamentals that are necessary to their own success and that of the country.

Employment

Going into the 2011 second quarter, things were looking up on the job front. This was long-awaited news and kindled hopes that the situation was finally turning around. Unfortunately, it was simply too soon to make that call, as became clear when later job reports came out. Some recent figures put the situation in context. In June, job growth came in at a tepid pace of 18,000 jobs. Not only was this a shock to many, it came on the heels of a downward revision for May, which was cut almost in half to 25,000 jobs.

Until this trend is reversed, little progress will be made in terms of unemployment. Indeed, unemployment rates may rise even further once budget cuts hit home and government workers join the ranks of the unemployed from the private sector. Even without additional job losses, the recent rate of growth remains significantly below the levels needed to keep up with a growing labor force. This is especially true in light of growing pressure for older employees to extend their careers to help make ends meet and offset some of the recent losses in wealth triggered by the declining stock market.

At this point, it is hard to find good news on the employment front other than (with a couple of exceptions) companies are not cutting back en masse as they did when the unemployment rate spiked several years ago. However, this is not to say that layoffs are not coming. Indeed, reports have indicated that employers plan to make more job cuts during August than they did over the prior sixteen months. These cuts are likely to come from a diverse array of sectors, ranging from pharmaceuticals to financial services and even technology. The manufacturing sector is also expected to experience some adjustments, with growth rates falling to the lowest level in two years. The recent build-up in inventory will put additional downward pressure on manufacturing and place an added damper on near-term job growth.

A major cloud that is hanging over the employment scene is small business sentiment, which is at its lowest level in several years. Interestingly, this negative rating comes in spite of the fact that current business conditions for many have actually improved. The problem is not with current conditions, however, but with prospects for the future. At the present time—and even earlier, before the ceiling deficit battle—small business owners see few signs that revenues will increase over the next year. This negative sentiment helps explain the reported reluctance of small business operations with fairly solid financial foundations to expend capital or take on a credit burden necessary to

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expand operations. At the same time, many smaller businesses that are under financial stress and need credit to carry them through the bottom of the market are finding it difficult to get credit approvals.

At this point, private-sector employment growth is expected to continue to be flat and below previous outlooks. Indeed, there will be little activity until the economic situation settles down and some of the uncertainty is taken out of the market. Many companies can be expected to stay on the defensive and try to maintain their current positions so they can make a move when the time is right. Even some of the industries that had been showing signs of growth are likely to step back and take a time-out. The very real prospect of this scenario is likely to create an additional drag on the economy and lead to additional erosion in consumer and business confidence levels.

While the impact of stagnant employment growth will create a drag on the economy and put pressure on the budget, the real losers will be among the ranks of the unemployed. This is especially true for the long-term unemployed and those who are likely to join their ranks. In the past, their plight has been offset, in part, by a series of extensions in emergency funding for long-term benefits approved by Congress. In the current environment, additional extensions cannot be taken for granted. A federal cutoff or decrease in funding would put many households at risk of economic collapse.

While this risk is real, a more difficult scenario is already playing out in some states that have cut unemployment insurance or tightened eligibility standards (e.g., Florida, Illinois, Michigan, Missouri, and Wisconsin). This decline in state support for unemployment benefits will worsen if the federal government has to cut back on programs lending money to states to bolster unemployment benefits. Over the past several years, the federal government has helped 32 states provide state-supported unemployment benefits totaling almost $50 billion in loans (through the 2011 first quarter.) As with emergency funding to support the long-term unemployed, there are no guarantees that federal funding to help states deal with this budget drain will continue.

It should be noted that the need for jobs has not been totally lost on Washington. For example, President Obama has made a recent push for new job programs to help jump-start the economy and get unemployed workers back on the job. While this and other jobs initiatives have some merit, to date none of the recent proposals to boost employment has gained much traction. This situation might change as the economy moves to center stage or if the American public decides to weigh in on the situation. Unfortunately, that may be too late for many who are on the economic brink.

Inflation and Interest Rates

With all the focus on the deficit battle and the stumbling economy, it is no wonder that concern over inflation has moved to the background. The good news is that, with the exception of food and energy, recent inflationary pressures have been rather benign. This situation is an improvement over 2010 when inflationary forces were building.

Recently, core inflation rates have been in line with the Federal Reserve's target rates. Indeed, during June consumer prices actually declined modestly, benefiting from a drop in energy prices. While energy prices are likely to remain volatile, the situation appears to be manageable, especially in light of the global slowdown that is likely to take pressure off energy prices. If food and energy prices are taken out of the equation, the core consumer price index (CPI) levels have continued to trend upward due to increases in prices for automobiles and apparel. The rise in automobile prices was temporarily boosted by Japan's recent crisis, which disrupted the Japanese automobile industry at home and affected production of Japanese cars in America. The increase in apparel prices was due to an increase in cotton prices as well as the weak dollar, which pushed import prices up some 12% overall. With growing weakness in the US economy and in many other countries, the ability to pass higher prices through to consumers will be limited. Since both automobiles and apparel are largely discretionary items, a decline in demand should take pressure off of prices and play out through lower margins.

The good news on the inflation front has allowed the Federal Reserve to hold interest rates at low levels. This is critical to the economy because a low interest rate environment has been discounted in the market. Indeed, the dependence on low interest rates across many sectors has left them with limited ability to weather an increase in interest rates without a major shock that could quickly spread across the economy. Given the tenuous nature of economy in

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the recent downturn, the Federal Reserve is expected to continue to push for lower rates. It has also created some much-needed flexibility that the Federal Reserve may have to take advantage of to bolster the economy and ensure adequate capital flows.

While the inflation and interest rate outlooks are generally positive, it should be noted that situation could change quickly and dramatically. This is because interest rates are not under as much control from government or its many appendages as many think. This limitation is due to the country's dependence on international capital flows. This dependence has been called into question by the recent debt debates and even more so, by the United States' undesired status as a debtor nation.

The ability to continue to attract offshore capital in the face of rising uncertainty is something that should not be taken for granted. The fact that no real solutions to the debt crisis have been offered and the prospects that the situation will drag on and go down to the wire once again will continue to hang over the country and place a dampener on its capital capture potential. This caveat is especially true since, unlike the United States, some countries have decided to make the tough decisions necessary to get their own houses in order. In our case, the political wrangling that will occur over the next six months and beyond will take place on the global stage. The debates will create some unwelcomed volatility, and their outcome will be closely watched in the financial circles as capital providers look for safe havens amid the global uncertainty that is likely to prevail.

An example of how quickly things can change can be drawn from the recent actual and threatened widespread downgrades of various government agencies. This chain of events had been completely off the radar screen for most investors here and abroad. Up until the question was called by Moody's in July, little attention had been paid to the tenuous nature of the US credit rating, since it seemed implausible and unthinkable that the federal government would let itself get in the position of a possible default. While the congressional agreement reached in early August on the deficit ceiling was enough for Moody's to back off of its threat to make widespread downgrades of US debt, Standard & Poor's did downgrade the United States' credit rating.

From this point forward, it can be expected that rating agencies are going to take a much

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harder look at the creditworthiness at all levels of government and make decisions on a case-by-case basis. Ironically, this scrutiny comes from the same rating agencies that took so much heat for not providing clear signals that some have argued could have averted the financial and real estate meltdown that put the economy in a tailspin. The fact that the agencies have been criticized for past misses will force them to be more aggressive in assessing risk. It is ironic that the recent political turmoil has forced them to scrutinize the creditworthiness of the very governmental agencies that ultimately have the ability to regulate how they operate. This creates a real conundrum for the agencies as well as for the government, and it will be an interesting saga to watch as it plays out, especially with the fate of the economy hanging in the balance.

Business Indicators

Leading economic indicators had suggested that the economy was plugging along before the events of early August became factored into the equation. Over the past year or so, the economic outlook benefited from growing strength in the manufacturing sector, which had begun ratcheting up operations in anticipation of improving demand, both at home and abroad. This situation has changed fairly dramatically as the threat of another recession on the domestic and global fronts has become a real possibility.

Wholesale inventories have risen for the sixth straight month as sales tailed off faster than wholesalers could pull back on orders. The increase in inventory levels was comparable for durable and nondurable goods across most sectors. The biggest increase in durable goods was in the automobile industry. At the same time, the inventory-to-sales ratio also has crept up in both durable and nondurable categories. The increase in the inventory statistics reflects the disappointing retail sales figures

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that caught manufacturers and wholesalers off guard. At the same time, gasoline inventories tapered off as consumers responded to the brief decline in prices. Going forward, the situation will hinge on how businesses and consumers react to the recent news regarding employment and the stock market, both of which are struggling to regain lost footing.

Stock Market

Before addressing the dramatic decline and volatility in the stock market during early August, it should be noted that, up to that point, initial public offering (IPO) activity was relatively strong for the first half of the year. Indeed, at a global level some $64 billion in IPOs were raised in the second quarter, of which the United States enjoyed about a 25% market share. While that might seem low, it was an improvement over the prior year in which Asian exchanges dominated the market. On the US front, IPOs were led by Internet companies (e.g., Facebook, LinkedIn, Zillow), while nontechnology industries were relatively dormant. On another positive note, corporate coffers have never been stronger, with companies sitting on some $2 trillion in cash.

Going into the dog days of summer, the stock market had shown remarkable resilience, racking up modest positive changes over the prior year. Indeed, through much of July the stock market was on winning streak, bolstered by news of improvement on the critical employment and retail fronts. That situation changed dramatically with the stock market entering into a ten-day downward spiral before the wheels came off the track on August 4, 2011. Interestingly, the sell-off that drove prices down came a day before the government's official job report, suggesting the market sensed growing weakness in the economy. The declines were dramatic with the DJIA and the S&P 500 down over 4% and the NASDAQ plummeting more than 5%. The jobs report released on August 5 was positive but not enought to offset pessimism, and it contributed to additional significant sell-offs.

The stock market situation at home, however, was not isolated; it was repeated across the globe and caused much consternation. Investors eschewed the fact that corporate balances sheets remained strong and companies were sitting on record levels of cash. Indeed, the dramatic sell-off vindicated the decision of chief operating officers who had chosen to remain tightfisted in spite of encouragement to get back in the game with a new round of investment and new hiring activity.

Events on the global stage will be important in determining whether the sell-off will be reversed or whether it is merely the beginning of a series of downward shocks. The stock market is likely to be facing a tumultuous near-term outlook characterized by a number of swings as investors react to the latest news. In this environment of uncertainty and change, traditional forecasting models that fail to factor the behavioral side of the market into the equation are likely to provide a number of miscues that will amplify the frequency and magnitude of stock market swings.

In this atmosphere, the risk side of the risk/return spectrum will take center stage and the market will shift into a defensive mode. This change will create even more uncertainty in the stock market, which could easily tilt the economy back into a recession. Ironically, for many Americans this will not be seen as a double-dip or a new recession since most never really felt like they had gotten past the last one. This is especially true for the unemployed and those that continue to struggle from the housing market hangover. In the face of these prospects, investors are likely to eschew risk and focus on the return *of* investment rather than the return *on* investment. Unfortunately, there are few safe havens, and this will make for interesting times and raise the stakes across the board.

Despite their flush balance sheets, companies are expected to remain tightfisted. Even some of those that had been ratcheting up operations are likely to now pull back on plans to invest in plant, equipment, and labor. Instead, emphasis will turn back to productivity gains and increasing capacity utilization. This will put more pressure on employees, many of which are already disgruntled after having been pushed to do more with less (and for less) for several years. The economic situation, however, is likely to slow down voluntary terminations as employees decide to hang on to jobs that they otherwise might have walked away from, as some had started doing when it looked like employment prospects were improving. As such, employee discontent and low morale in a number of companies will continue to build, driving many to test free-agency when the time is right. How and when this will all play out remains a major question mark.

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In the absence of any clear sense of direction, investors who decide to hold their cards will experience much angst, a situation that is likely to carry into next year. Unless there is an unexpected rally, the stumbling stock market could be a game changer and place an additional drag on GDP and help plunge the economy back into a recession.

Keep in mind that the problems that are plaguing the US economy and the domestic stock market are not isolated to the United States. These events are being played out across the globe. Indeed, with few exceptions, concern about eroding economic conditions have led to declining stock prices that have spread across Europe and carried into the far reaches of Asia. This is reflected in the fact that most stock markets have suffered from a sell-off, including the markets in Japan, Australia, South Korea, Hong Kong, and Shanghai.

Similarly, European markets have also taken it on the chin, led by Italy and Spain, which are facing tremendous pressure reminiscent to the collapse in Greece that has carried on for several years. Indeed, the situation is so dire that the European Central Bank has moved into crisis management mode to such a degree that it felt compelled to buy government bonds to avert a debt crisis that could have spread across Europe. The decision to intervene was not shared by some of the twenty-three board members of the euro zone. Most notably, Germany has opposed to such actions.

Going forward, European leaders are expected to continue to struggle to build a consensus in dealing with an increasingly difficult situation that is likely to play out for some time. Indeed, as in the United States, many countries will be struggling to figure out how to deal with weakening economic conditions. Since there are no obvious solutions, the heated debates that are likely to come will consume a lot of political capital.

Consumer Confidence

In the first two months of 2011, investors and business leaders took some solace from the fact consumer confidence levels had begun to move back upward. After peaking in February, the situation began to erode and confidence levels started trending downward. This situation deteriorated even more in early summer, which was particularly disconcerting in that it occurred in advance of the debt debates in Washington. As is often the case, consumers seemed to sense weakening in the labor markets, which when piled on top of the continued housing saga, proved to be too much.

While it is too early to tell what will happen next, it is likely that consumer confidence levels will lose even more ground. This is bad news on a number of fronts. Even though consumers have not been expected to lead the recovery, they were expected to do their part. Indeed, the increase in retail sales that many retailers reported were viewed as evidence that things had either turned around or that consumers were tired of being on the sidelines. That is clearly not the case at this point in the cycle, and the situation is unlikely to change until there are some positive signs as to the direction of the country and the economy.

Retail Sales

The increase in retail sales over the past year has received much attention and has been seen by some as a sign that consumers were ready to return to the cash register. To get a better picture on what is really going on, it is useful to look behind the raw numbers.

For many retailers and retail segments, sales have indeed increased, both in terms of total sales volume and same-store sales. The problem is not one of sales, but of how those sales have been generated. It should be noted that June is reportedly the second busiest month in terms of retail sales, followed by a letdown in July.

While June sales were generally positive this year, there were some factors that should be kept in mind when interpreting the results. For example, it is easy for the numbers to look good when the comparable is so weak. In this case, June monthly sales were up over the June 2010 sales, but that was a particularly dismal period last year. Similarly, many retailers led off June with heavy promotions in an effort to lure shoppers back to the register. While bolstering gross numbers, this strategy is likely to have placed downward pressure on margins that will be hard to make up over the balance of the year. Finally, the record heat in July and rising concerns among consumers may have led to something of a meltdown in consumer sales trends, which is likely to worsen now that the political debates have heated up and the stock market has gone down.

At this point in the retail cycle, attention has shifted from the summer to the critical back-to-school season that often sets the stage for the

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upcoming holidays. Despite some positive numbers, there are a number of red flags that should be considered. For one, retailers are going to have to figure out how to pass higher apparel costs through to customers. This is likely to be much more difficult today than it looked when buyers were placing orders. Passing through price increases will prove especially challenging as consumer confidence levels face more downside risks and consumers focus on essential needs. Also, consumers became accustom to deep discounts during the summer, so sticker shock may make many consumers revisit their retail appetites. Consequently, consumers are likely to hunker down until some of the economic uncertainty goes away or conditions really begin to improve.

Housing Market

The collapse of the housing market has been so pronounced and prolonged that nothing seems to surprise the market any more. In effect, bad times have been discounted into expectations and have created another self-fulfilling prophecy that is likely to prove hard to break.

The housing numbers are bleak across the board. For example, annualized housing starts are expected to come in around 500,000 or so units, which is less than half the long-term average and far below the peak in 2006. Even these figures may be difficult to hit, with the level of new-home sales running around 60% of that estimate.

Sales of existing housing have also been disappointing this year, although sales at mid-year were up compared to year ago. However, that comparison must be taken cautiously since the benchmark in 2010 was depressed by the end of the homebuyer tax credit program that was followed by pronounced drop in sales.

Unfortunately, the recent economic news suggests that there is more downside risk that should stretch out a recovery. Indeed, the very term *recovery* is a misnomer—the housing market will never get back to bubble prices. A more reasonable recovery scenario is that it will get back to sustainable prices and absorption of stock that can be supported by applying traditional underwriting standards, which focus on both the will and ability to pay, not just to borrow. Adding more uncertainty to the housing market's future is the fact that nothing substantive has been done with respect to Fannie Mae and Freddie Mac. This saga is likely to play out for some time, as political capital focuses on more pressing matters dealing with the deficit, budget cuts, and revenue growth.

Real Estate Overview

Overview

At this point, the spatial/capital market divide that has characterized the commercial real estate market for several years appears to have a new analog: the real estate/economic divide. Indeed, while some warning signs are beginning to emerge, a sense of optimism continues to describe the attitude of many real estate players, and there has been at least enough optimism to keep the ball up in the air.

Granted, the recent news on the economy has not yet rippled over to the real estate industry, which historically tends to lag. However, it is somewhat telling that rather than lagging, the commercial real estate industry has led the economy, with strong returns on both the private and public side of the market and plentiful capital to get deals done. This is surprising on a number of fronts and will bear close monitoring as emphasis shifts to real estate fundamentals today rather than expectations for the future. This scrutiny is overdue and will be particularly revealing in the current and foreseeable economic environment. An early warning signal was the 10% plunge in REITs on August 8.

Office Market

During the first half of 2011, the office market showed improvement, with a number of markets reporting positive net absorption. Indeed, going into the summer the office sector was coming off its best quarter since the market collapsed some four years ago. Despite some improvement in fundamentals, however, few markets were able to push rents. Indeed, the good news is that rents remain below levels needed to justify new construction, which will give the market time to absorb excess stock. The absence of product in the pipeline also comes at a fortuitous time with respect to the recent economic shock. With respect to location, central business district (CBD) offices are expected to outperform their suburban counterparts with the exception of those tied to transit or with strong local demand drivers.

The demand for core office assets continues to be fairly strong. Capitalization rates for CBD properties are trending downward, but still remain

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somewhat higher than the record lows reached in 2008. However, strong investor demand for product has pulled average office capitalization rates below those for apartments, a sign of the aggressive pricing for properties that are trading. Suburban office prices have shown some improvement, although capitalization rates are some 120 bps above their CBD counterparts.

On the private investment front, NCREIF Index office returns enjoyed a strong second quarter, with annualized rates coming in around 15.5% due to strong appreciation rates. Through the end of July 2011, office real estate investment trusts (REITs) reported in the NAREIT/FTSE Index had turned in relatively solid 13.6% total returns, although the numbers were down from the prior year in which total returns were over 18%. Despite this modest slippage, office REITs were above the overall averages, which came in around 11.8% after a stellar return of almost 28% in 2010. On the debt side, office issues of commercial mortgage-backed securities (CMBS) had the lowest delinquency rates through July, although rates increased modestly to 6.6%.

Retail Market

During the first half of the year, the retail industry experienced some improvement, benefiting from improved retail sales and stable performance among core tenants. Vacancy rates remained relatively stable, with some tenants taking advantage of opportunities to improve locations. From an investment perspective, the retail sector came off a fairly strong first half of the year, although transaction activity was relatively slow compared to the office and apartment sectors. With respect to capitalization rates, retail properties have been trading as slightly lower yields, but still are coming in at the middle of the pack compared to other commercial property types.

On the private front, retail returns were relatively attractive while still lagging other property types. Through the first six months of 2011, retail provided 6.3% returns with annualized returns slightly over 15%. Retail REITs had fairly strong returns through the end of July. Overall returns were around 12.6%, which while competitive, pales in comparison to the 2010 returns that were over 33%. The retail sector was led by regional malls, which enjoyed returns of 18.4%. The general shopping center category that includes smaller retail properties came in at 7.3%, which was dramatically lower than the prior year. Freestanding retail REITs stumbled, having the only negative returns among any of the property sectors. This was a dramatic reversal of fortunes over 2010, when they led all retail categories. On the CMBS front, retail delinquencies remained below average, coming in around 6% of outstanding issuances.

> "It is somewhat telling that rather than lagging, the commercial real estate industry has led the economy."

Industrial/Warehouse Market

The industrial market has shown some signs of improvement, with vacancy rates gradually declining on the strength of improved manufacturing and shipping activity. While manufacturing has pulled back somewhat, the outlook remains fairly stable. Investor demand for industrial properties has been fairly healthy. Industrial capitalization rates have trended down, although they remain above other major categories with the exception of hotels.

In terms of investment performance, the private industrial sector has enjoyed relatively strong performance, with six-month total returns pushing 8% and annualized returns hovering slightly under 15%. Industrial REIT performance was slightly below the overall commercial industry through the end of July, with 11.4% total returns compared to 18.9% in 2010. The big news in the industrial sector during the second quarter was the completion of the AMB/ProLogis merger, which created a global powerhouse that will be closely watched by REIT observers. With respect to CMBS delinquencies, the industrial sector is slightly above industry averages due, in part, to the slowing economy.

Apartment Market

Apartments have been on something of a run, a situation that is likely to continue as long as the single-family market continues to struggle and supply does not get ahead of demand. Investors remain focused on the sector, and midrise and high-rise buildings that benefit from urban revitalization are the preferred type of apartment. The intense appetite for apartment investments has driven capitalization

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rates down to a level that is approaching the peak of the market, and this may be more ominous than reassuring in terms of risk/return tradeoffs.

With respect to investment performance, apartments have led the pack on the private side of the market, with annualized returns through the first half of the year coming in at a shockingly strong 21.4%. This situation benefited from strong investor demand and low capitalization rates that have approached 5.5% overall. Since this implicit capitalization rate includes a wide spectrum of properties, the yields are not likely to hold up on the private side. Apartment REITs remain the darling of the industry, with total returns through July pushing 20%. Despite these stellar figures, some investors were no doubt disappointed with the sector, which had racked up 47% returns for 2010. Even with the strong performance numbers, the apartment market is not without its problems, as evidenced by its leading delinquency rate among CMBSs pushing 16% and continuing to uptick.

Real Estate and Capital Markets

Transaction Volume and Players

What is fascinating about the commercial real estate market is that while we have heard a lot of slogans since values began to collapse in 2007 (e.g., the new norm, extend and pretend, less is more), none of them has really told the true story. That is, it seems some believe the recovery is just a matter of time, and many are beginning to think that the future is now. This sense of exuberance is juxtaposed against the reality of the stumbling economy; nonetheless, this sense that the future is now continues to persevere. Granted, there has been some improvement in fundamentals, especially in the markets that have benefited from the resurgence in the technology and health sectors and are well positioned for the long term.

On the distressed asset front, the market has shown some improvement in the first half of the year. According to Real Capital Analytics, the rate of growth in troubled assets tapered off, hovering slightly above $140 billion. While that represents a lot of commercial real estate, the good news is that the pace of restructured and resolved loans has improved to the extent that net changes in distressed assets are actually on the negative side of the balance sheet. On the other hand, real estate owned (REO) has been stickier, with little improvement as lenders continue to deal with problem assets. The bottom line is that distressed assets warrant close monitoring and likely will have opportunities for value creation. However, creating and capturing value from the pool of distressed assets will get more challenging going forward as the pool quality gets diluted and the share of properties that are not candidates for resolution or restructuring increases in the residual pool. Also, the recent economic turmoil and the concerns that it may lead to another recession, hang over the industry and put many marginal properties at risk of falling off the precipice.

In terms of transaction volume, the commercial industry is regaining some momentum as investors revise their game plans and look to new frontiers as they shift to a more aggressive risk-taking strategy. For many players, this has manifested itself in a move away from a focus on top-tier assets. Investors are moving downstream on the quality spectrum and to a wider array of markets than in the recent past as they seek out higher returns. Underwriting is still aggressive at the top of the market. Investors are factoring rent spikes and turning toward pro forma returns rather than relying on current rent rolls to help justify some deals. Some investors are also benefiting from aggressive lending, with some well-capitalized opportunistic players able to lock in fixed-rate five- to seven-year mortgages at yields that create positive leverage even when capitalization rates are pushing 6% or lower. Unfortunately, the availability of mortgage debt is not evenly distributed across the market, leaving gaping holes in that are likely to remain for some time.

In terms of players, private investors have slowed down a bit and given way to equity funds that have exhibited the highest growth in market share. Institutional investors have been relatively stable, exhibiting a modest uptick in buying activity. This is to be expected, especially since a number of the larger public pension funds are in the midst of repositioning their holdings to more of a core strategy. Due to limited appetites for noncore assets at this point in the cycle, repositioning large portfolios has been difficult to achieve without resorting to cutting prices to fire sale levels—something institutional investors are reluctant to do unless under some pressure. The recent economic turmoil may change that mindset, however, especially if the problems get as bad as it looks they might.

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Commercial Mortgage Industry

On the mortgage front, the biggest news has been the return of the CMBS segment to the playing field, although it is not nearly as formidable or imposing as it had been prior to the collapse of the industry some five years ago. Despite this caveat, CMBS originators have been fairly aggressive, and they achieved around a 20% market share of commercial loan origination during the first half of 2011. This is a significant improvement over the prior year, but recent events have frozen several large offerings.

As a result of strong competition for product, commercial mortgage capital flows have kept pace with the demand for loans. However, there are some concerns that lenders may have become too aggressive, especially with respect to underwriting standards and increasing reliance on the same pro forma assumptions that some buyers are using in setting prices. Mortgage REITs struggled through July with total returns in negative territory, although dividend yields were relatively strong around 15%. Commercial mortgage REITs had a particularly challenging time adjusting to new market realities, with year-to-date total returns down 8.6% after a very strong 42% return for 2010.

While CMBSs continued to regain some lost ground in terms of new deals, the hangover from some of the earlier excesses has not abated. According to Fitch Ratings, CMBS delinquencies reached a new record high at slightly over 9% of outstanding issuances. This increase was due to a number of factors, including a surge in new late-pays and a reduction in resolutions. These figures were inflated by some larger packages and the reclassification of some loans that were unlikely to be resolved and had been in the hands of special servicers.

Despite this unwanted news, Fitch reports that 85% of its CMBS portfolio is graded as "stable." That grade ratio may change if the general economic situation spills over into the commercial real estate market as expected. This caveat is particularly appropriate for weaker properties that are facing maturing bullets or are in need of capital to cover much-needed capital expenditures, tenant improvements, and other costs necessary to respond to tenant demands. This looming problem should not be overlooked with some $300 billion of commercial mortgages projected to be maturing over each of the next five years or so. This includes a mixture of CMBS and non-CMBS loans that will have to be dealt with during what is likely to be a very difficult period for the industry, one in which a capital shortage could put it on its heels without the injection of a new wave of capital.

Institutional Real Estate Industry

The outlook for the private real estate capital market is at an interesting point. Through the first half of 2011, NCREIF returns were surprisingly strong, coming in above 16.7% on an annualized basis. These returns were well received and consistent with NAREIT total returns. However, there is more than a little concern that the returns are not sustainable, and that they reflect aggressive pricing that is somewhat detached—or at least ahead of—underlying property market fundamentals. To this point in the cycle, the commercial real estate market performance is based on expectations that may not be anchored in reality. Given the dramatic decline and volatility in the stock market and the shock waves rippling across the globe, the prospect for aggressive pro forma assumptions to be realized is likely out of the question.

As noted in the property-type review, the public equity real estate market continues to enjoy strong returns. Somewhat serendipitously perhaps, the industry might actually benefit from the struggling stock market overall as investors seek out assets that have some inherent value. This is the same scenario that kicked in back in 2001, although the drivers of that bull market were quite different than this time around. At an overall level, equity REITs generated 11.8% total returns through July on the heels of some 28% returns for 2010. The good times were fairly widespread, with some sectors benefiting from the positive halo that hangs over the industry. This situation changed in August as REITs echoed other stocks.

Regardless of whether the private or public side of the industry has gotten ahead of the market, the real question is what will happen going forward. Unless things change unexpectedly and dramatically for the better on the economic front, underlying property fundamentals are likely to deteriorate as the industry loses some of the recent ground it has gained. However, the capital markets may just choose not to fully price the downturn. Thus, as unlikely as it appears to those who have been through down cycles before, the commercial real estate market may just be able to dodge the bullet or

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at least avoid the full brunt of its force if real estate once again emerges as a defensive asset in the face of uncertainty.

This scenario depends on the ability to attract new sources of capital that tend to be somewhat oblivious to underlying market fundamentals as they focus on the safety of assets rather than returns. It also depends on the willingness of some traditional players to accept the mantra that less is more. While that's a hard pill to swallow, it is not completely out of the question. If this occurs, the commercial real estate industry will have to embrace a new pricing model; one that places less emphasis on the risk side of the proposition than is warranted if the real estate market had to stand on its own. As it is, with all the weakness around it, the industry might just look relatively attractive. If this happens, it will not be a long-term solution and will merely defer the pain. However, if it buys enough time, the prospects of an economic recovery might just be enough to carry the day.

Conclusion

The US economy is on the cusp of slipping back into a recession. This situation can be attributed to a number of factors, ranging from domestic political uncertainty and rancor to the global economic crisis involving many other countries. While there is uncertainty as to how this will all play out, the recent events have been a major game changer. Unfortunately, few were ready for this turn of events, which has put businesses, consumers, investors, and others on the defensive as they struggle with this renewed crisis in confidence.

In this environment, a number of scenarios for the economy could play out. Until leadership in Washington develops a plan, it is impossible to determine what will happen on the economic front as well as on the real estate front. The markets are likely to take a time-out as the players step back and try to figure out what the new rules will be like and what they mean to their own game plans. In the meantime, the situation is likely to heat up more as politicians fan the flames of discontent and try to figure out how to win in upcoming deficit debates. Unfortunately, they may not understand that the deficit showdown is but a battle; the real war is much bigger and will be played out on a larger stage. It is unclear whether they will be willing to face up to the economic realities going into an election year when their personal stakes are so high. In the meantime, it is time to hunker down. Those wanting some much-needed distractions during this time of uncertainty can look overseas to see how things are playing out in other countries or just sit back and enjoy some real football where the rules are known and sometimes even enforced.

James R. DeLisle, PhD, is the Runstad Professor of Real Estate and Director of Graduate Real Estate Studies at the University of Washington. Prior to his current assignment, DeLisle was the director of the Real Estate Research Center and the coordinator of the e-Commerce Program at Georgia State University. Before returning to academia, he was an executive vice president and head of strategic planning for Lend Lease Real Estate Investments, a global company and the successor firm to Equitable Real Estate, where he founded the Investment Research Department and directed it for nine years. He has published widely in academic and professional journals. DeLisle received his BBA in real estate and MS in marketing research from the University of Wisconsin. He received his PhD in real estate and urban land economics from the University of Wisconsin under his mentor, the late Dr. James A. Graaskamp, one of the leading academic proponents of applied real estate research. To increase industry connections, DeLisle has created a personal website, http://jrdelisle.com.
Contact: T 206-616-2090; E-mail: jdelisle@u.washington.edu