It's All About Timing: Spring Forward, Fall Back?

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Commentary

There are a number of positive signs that suggest the economic recovery has begun to gain some traction and should be able to overcome some of the headwinds it will face during this election year. This situation is a fairly significant improvement from early in the 2011 third quarter when there was a 50/50 risk the United States would slip back into a recession. However, the improved forecast does not mean the country will face smooth sailing. Indeed, the economy will be rocked by a series of waves that will push it forward as well as swells that will make it seem like it has been buoyed down and stuck in a lull. These forces will come from a number of economic forces, both global (e.g., uncertainty surrounding the Greek bailout) and domestic (e.g., the hangover from the housing debacle).

Given the tenuous nature of the global economy and the high degree of economic integration across developed and emerging nations, the turmoil is expected to continue. It will be amplified by the lack of unified leadership on the domestic front. The recovery will also be rocked by growing parochialism as we focus on our domestic problems. Although the parochialism is somewhat understandable, it will not protect the United States from the impact of economic and geopolitical events occurring offshore. Indeed, recognition that we are not in a position to exert much political influence over the global economy will hang over our own economic recovery and, by extension, the global recovery upon which our long-term success will ultimately depend.

On the real estate front, market fundamentals are expected to mirror the overall economic recovery, with periods of improvement followed by periods of disappointment. However, pent-up demand for investments is likely to provide some insulation against the downside of such cyclical fluctuations, as investors continue to take a longer-term view of the asset class. That said, some of the commoditization that has occurred will give way to greater price differentiation. Consequently, the improvement in economic conditions will benefit solid assets with strong underlying market fundamentals and leave other product in the wake.

In addition to greater integration between the economy and real estate markets at the national level, an even stronger alignment will be struck at the local and regional levels, creating near-term winners and losers. That is, markets with diversified economic bases in employment concentrated in growth sectors will outperform markets that will depend on the spillover effects from a broad-based economic recovery. Even then, some markets will be left behind, which will place additional pressure on investors to target markets and expand their investment horizon beyond the gateway cities in search of higher returns that compensate for the risks associated with investing in the relatively inefficient, somewhat illiquid asset class. This is especially true as the economy picks up and other asset classes benefit from higher returns that will take time to trickle down to the real estate market.

Economic Environment

Before discussing the economic environment, it is important to recognize that election years introduce a number of challenges for prognosticators whose crystal balls can become clouded by the rhetoric and political posturing that typically occurs. This year, the situation is more volatile than in recent history; innuendoes and vilification in Washington have threatened to create a stalemate that prevents us from addressing the key issues that cloud the economic, capital market, and real estate outlooks. With ratings of congressional performance at all-time lows and the stakes higher than ever, voters, businesses, and consumers can expect a barrage of increasingly visceral ads and negative campaigning. As this continues, the collective psyche of the nation may be in play, creating some downside risk for the economy. The result may be a nagging anxiety that hangs over the country as we focus on the political scene instead of on moving the economy forward.

During much of 2011, congressional leaders seemed to be satisfied with calling timeouts and adopting interim agreements, but these merely postponed the resolution of problems that need to be reckoned with. While the general tone of political discussions will likely be contentious, there are signs politicians might be willing to take more collaborative approaches to avoid a meltdown and the risk of incurring the wrath of voters. The recent preliminary deal to extend payroll tax cuts, extend unemployment benefits, and modify Medicare payment rules is an example of some of the progress that may be made on critical issues. Thus, debates surrounding many critical topics over the next three quarters will no doubt be heated and acrimonious; however, there is some hope more rational minds will prevail on critical decisions. If that does not occur, all bets will be off and the country will be in for a rough ride.

In some respects, the impending problems in Washington pale in comparison to the challenges in the euro zone. While those with a parochial view of global issues might take solace in the problems faced offshore, the reality is globalization has caused unprecedented economic integration among most countries. Thus, although the pressure US voters place on office seekers and their parties will provide a modicum of control domestically, global issues will remain beyond the control of American voters and politicians. The recent and ongoing economic battles surrounding Greece and other countries on the brink of bankruptcy punctuate the vulnerability the United States faces on the global stage. Despite some progress, the underlying structural problems in the euro zone and individual countries are far from being resolved. Thus, 2012 will clearly be an interesting year with twists and turns coming from a number of fronts.

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Economic Growth

In general, the US economy has demonstrated remarkable resiliency, especially in light of the headwinds spilling over from the European debt crisis, the housing market hangover, and political wrangling in Washington. Despite these and other negative forces, gross domestic product (GDP) growth has been fairly solid, although the growth is tempered when compared to other post-recessionary cycles. Revised estimates for real GDP growth in the 2011 fourth quarter revealed a 2.8% increase on a seasonally adjusted basis after a disappointing 1.8% increase in the previous quarter. For the year as a whole, GDP grew at a rather disappointing rate, which was about half of the 3% growth in 2010 and far below the level necessary to reflect a sustainable recovery.

Interestingly, the recent improvement in the economy has led to some speculation as to the underlying forces and whether they are sustainable. For example, the improvement recorded in the 2011 fourth quarter was largely attributable to increased inventory investment and a moderate increase in consumer spending, neither of which is likely to continue without improvement from other sectors. In addition, some pundits suggest that a lot of the recent upside has been serendipitous and was created by a moderate winter. The relatively mild weather has provided much-needed support to stressed budgets in terms of lower utility bills and lower-than-normal seasonal layoffs related to bad weather. On a more intangible but equally important front, the moderate weather also bolstered consumers' attitudes and explains some of the unexpected improvement in retail sales in spite of flat incomes and tempered expectations. Regardless of the degree of credit that mild weather conditions should receive, the fact remains that there has been a somewhat unexpected and unexplained uptick in the economy and a corresponding improvement in consumer and business confidence.

Looking forward, GDP growth is expected to be somewhat tempered over the first half of 2012, although the figure should improve if the global economy gets past some of the same issues that have hung over the domestic economy. This improvement will be important to the US economic outlook, with exports playing an important role in helping build momentum on the home front. Assuming things stay on track and the headwinds can be managed, GDP should come in around 3% for the year with some upside potential going into 2013 as the election sorts itself out and the administration focuses attention on critical issues affecting the economy. However, this outlook presupposes Congress will ultimately be able to set politics aside and make the hard decisions necessary to address the impending economic and budget crises that need to be addressed. If this scenario does not pan out, all bets are off and the economy could slip into a tailspin.

Employment

Over the past several years, the employment front has taken center stage and has been a bellwether for the overall economic recovery. After a number of disappointing jobs reports through 2011, the situation seemed to turn the corner in the 2011 fourth quarter. Indeed, upward revisions in reported job growth for early fall set the stage for a surprisingly strong December in which over 220,000 new jobs were created. This surge in job growth helped lead to an unexpected decline in unemployment rates, which had been forecast to remain stuck around 9%. While declining unemployment levels were well received, it should be noted that some of the improvement was associated with a contraction in the labor force attributable to a reduction in immigration rates and a decline in labor force participation rates, which fell 2% in the latest figures. Regardless of the reasons, the fact that unemployment rates declined to around 8.5% at 2011 year-end caught the attention of consumers and businesses alike and has helped contribute to rising confidence levels.

While the improvement in unemployment rates has been a plus for the collective psyche, it is clear that much remains to be done to create a more sustainable rally on the critical labor front. For example, the pace of mass layoffs unexpectedly rose in December, with increases in both the number of layoff events as well as the number of employees who were affected. The increase in layoffs was led by cutbacks in temporary help services and food services, along with declines in infrastructure construction activity and some manufacturing sectors. While the increase in layoffs has received some attention and reminded us that we are not yet out of the woods, there are no signs of a widespread spike in such activity. Furthermore, despite this slight uptick, the trend in layoff activity remains subdued relative to 2010 and reflects isolated cases rather than a generalized weakness in the economy.

Cutbacks in government payrolls have placed a downward drag on employment front, with state and local government leading the charge. With the record deficits faced by many state and local jurisdictions, this trend is likely to continue. An additional drag on the employment scene that has affected private-sector employment is the mismatch between job openings and applicant qualifications. That is, despite an increase in job openings companies are reporting an inability to find qualified employees with the appropriate training and geographic mobility to take advantage of the openings. The Administration's commitment to fund technical training and other educational initiatives to fill this gap may provide some relief over the long term, but will do little to help close the gap that is hampering growth in the current economic environment.

Up to this point in the cycle, the pace of voluntary departures has remained dampened by the lack of viable opportunities. However, with the improving economy and positive news on the job front, that situation could be poised for dramatic change as workers start looking for new opportunities. This is especially true if the housing market begins to stabilize and employees see an exit strategy that lets them move to where the jobs are.

Despite some improvement on the employment front, most employees have not benefited from wage gains. Indeed, many employees experienced erosion in disposable income as companies cut back on health care and other benefits. A number of companies have also taken a hard look at retirement programs, as reflected in the recent announcement by General Motors that it is abandoning defined benefit programs. Other companies are likely to focus on the benefit side of the equation, adopting austerity measures over the near-term in an attempt to manage the cost side of the equation. The situation will not change until economic activity reaches sustainable levels of growth and employers are forced to compete for labor.

Inflation and Interest Rates

One of the constants characterizing the economy over the past several years has been its dependence on low inflation and low interest rates. This dependency will continue over the next several years, with the market already discounting both factors. Fortunately, it appears that inflation rates will remain in check over the near term. Although consumers will feel the pressure of rising costs for staples and other necessities, a dramatic increase in across-the-board inflation rates does not appear to be in the cards. There was some concern that the weak dollar would create surging import prices, but the global economic slowdown has taken the pressure off of imports as evidenced by a decline in prices for imported food and industrial goods. The outlook for import prices is fairly sanguine and without inflationary concerns due to the situation in Western Europe and the challenges emerging in some Asian countries that have benefited from strong exports.

While declining gasoline prices in 2011played an important role on the economic recovery, gasoline prices are a wild card in the inflationary outlook. Indeed some of the recent forecasts suggest that gasoline prices will push $5/gallon during the peak driving season. The fact that this scenario is based on speculation, not on some geopolitical event, is somewhat disconcerting since actual events in the Middle East could create an even greater surge in prices.

On the interest rate front, the Federal Reserve has continued to hold interest rates at historical lows and has taken the unusual step of committing to do so through 2014. This announcement has provided some solace to borrowers, but has wreaked havoc on many investors, especially those who eschew risk and choose to remain in liquid assets. In addition, access to credit has seen some improvement. In a recent survey of loan officers, lending standards have continued to improve, but businesses and consumers alike remain reluctant to take on additional debt in the absence of a clear path to recovery and the prospects of improving revenues. That said, consumer credit increased during the fourth quarter, which was attributable to the dramatic increase in nonrevolving credit and a spike in student loans as universities turn toward tuition hikes to offset declining revenues from state allocations that were fairly widespread. The level of revolving credit also increased dramatically, which helped explain increases in retail sales despite flat income levels.

Looking forward, consumers are expected to take a cautious attitude toward credit and try to eschew taking on additional debt until the improvement in the economy ripples over to their own take-home pay and balance sheets.

Business Indicators

While the economy faces a number of challenges and business indicators remain tempered, there are some positive areas. In terms of leading indicators, the Conference Board reports an upward trend that has pushed figures back toward the positive levels

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registered in early 2011. All indicators are generally positive, suggesting that near-term economic growth should be moderate and fairly broadly based. Manufacturing surveys across the country reveal the rather widespread nature of the economic recovery. This news was echoed in the Federal Reserve’s Beige Book report for the year, which indicated improvement in most Federal Reserve districts. This improvement was also reflected in a number of economic sectors, including consumer spending; travel and tourism; nonfinancial services; and heavy equipment manufacturing. Commercial activity was also positive in a number of regions, with lenders tending to hold underwriting standards fairly stable.

Despite some improvement in the economy, business confidence levels remain flat. While there has been some improvement in expectations for the economic outlook, there are few signs those expectations are sufficiently strong to lead to improvement in hiring intentions, a situation that is unlikely to change over the near-term. This situation is particularly relevant to small businesses whose attitudes were somewhat stronger at the end of 2011. Despite this improvement, small business owners continue to be concerned over the sustainability of economic recovery in general. Small business owners continue to focus on the outlook for improved sales as the primary factor in making decisions to invest in plant, equipment, and, more importantly, labor.

Among chief executive officers of larger businesses, confidence levels are somewhat higher but still far from the optimistic levels needed to trigger a wave of hiring and investment that may be needed to catapult the economy forward. With the uncertainty emanating from Washington over key issues affecting taxes, compensation, regulations, and other issues that are germane to corporate attitudes, attention will be focused on underlying economic fundamentals and potential shocks to the system that could set the economy back on its heels. As such, the outlook is for business as usual; a situation that is somewhat disappointing for those anxious to get on the recovery wagon, but rational in light of the uncertainty and shockwaves that could ripple across the globe. The good news is that many major companies have the financial wherewithal to allow them to rapidly ramp up activity which could lead to some upside surprises. Absent that, the situation is likely to be steady state with business activity closely aligned with political activity and economic prospects.

Stock Market

During 2011, the stock market broke out of the doldrums and turned in a choppy but upward-trending performance that reversed some of the earlier declines. Solid corporate balance sheets and improved profits led to some of the gains, although uncertainty over the economy continued to make investors somewhat skittish. The improvement in the stock market, which began in late summer of 2011, wiped out the declines that had eroded many investment portfolios and created much consternation among investors. This improvement carried into the 2012 first quarter. The situation is expected to continue, with the fate of the market subject to the economic recovery at home and stabilization of the debt crisis in Western Europe.

In the face of continued concerns over the long-term economic outlook, stock market investors have been looking for new niches that have the potential to break away from the pack and that are not subject to the same pressures as the broader market. This may explain some of the success of social networking and social media stocks, which experienced solid performance in 2011 as investors anticipated the trend will continue to spread across the globe. LinkedIn and the online gaming firm Zynga were the leading contenders on the social media front, suggesting investors were willing to roll the dice a bit. These stocks also likely benefited from anticipation of the launch of the Facebook's IPO and the desire to get in early. Whether the initial hype and business models will translate to enduring value remains to be seen, but this has not put a damper on investors seeking winners in what is likely to be a tumultuous period in the market until there is clearer indication of the future direction for the United States and its offshore partners.

Consumer Confidence

The improving economic outlook has triggered improvement in consumer confidence levels, although the improved figures still lag other post-recessionary recovery periods. The good news is that the consumer confidence index has trended upward for the past five months, benefiting from improvement in employment levels and recovery of the stock market. As might be expected, consumer confidence levels vary dramatically among demographic segments; lower-income segments continue to struggle and higher-income, well-educated segments report higher confidence levels. Improvement in confidence can be attributed to the recovery in the stock market and the growth in jobs that outperformed expectations. Unfortunately, improvement in the labor market has not translated to increases in disposable income. This has forced some consumers to defer savings, and savings rates are at five-year lows.

Going forward, consumer confidence levels will be vulnerable to downside risk associated with political wrangling as well as the more tangible financial crises that continue to hang over Western Europe. Consumers will also pay close attention to inflation, including a forecasted increase in gasoline prices, and to the continued struggles in the housing and labor markets, which hang over the near-term outlook. Given these pressures, consumer confidence levels are expected to continue to remain below long-term averages.

Retail Sales

In the fourth quarter of 2011, there were a number of signs that consumers had relaxed the grip on their purse strings. The early holiday sales results were fairly positive, with Thanksgiving sales coming in stronger than expected, leading some to predict that consumers were back and sales would continue to trend upward. While the initial numbers were indeed strong, sales benefited from early openings with a number of retailers pushing “Black Friday” to “Black Thursday.” While sales did improve on a year-over basis, this improvement benefited from the relatively weak base in 2010 and did not prove sustainable as final sales estimates were somewhat disappointing. As in the past, sales performance was somewhat divided, with sales of luxury goods outperforming and sales of mainstream products lagging. The strength at the upper end of the market was bolstered by improvement in the stock market and signs that the economy was picking up steam. Value continued to be the underlying theme for many consumer segments despite retailers' efforts to wean them off of sales and discounts. In January, retail sales improved modestly, led by improvements in electronics, home and garden centers, sporting goods and department stores, general merchandising, and restaurant sales.

Vehicle sales were relatively strong at the 2011 year-end, leading to the highest level of sales since the peak in 2008. The domestic auto industry fared well in total sales, in part due to inventory shortages in Japan earlier in the year. The end result was the highest ratio of domestic to foreign auto sales in over three years. While advances in fuel economy and the introduction of new models have piqued the interest of consumers, uncertainty has placed a damper on sales that is likely to continue as consumers stretch the useful lives of existing vehicles. The prospect of a surge in gasoline prices in summer 2012 is likely to stimulate interest in more energy-efficient vehicles. However, the economy will have to continue to improve to create a significant wave of buyers willing to take the plunge. This situation will characterize the overall retail market, with consumers not willing to step up and lead the economic recovery as some had hoped. That task will be left to businesses, which in turn will look to Congress to take some definitive actions and make a commitment to economic growth.

Housing Market

The housing market continues to place a significant drag on the overall economy, although there are signs that the market may be stabilizing. Despite some positive news, housing market indicators remain mixed to negative and continue to be tempered by hangover from the 2006 bubble. For example, the improvement in economic conditions and employment levels reported in the 2011 fourth quarter were lost on the housing sector as existing home prices ended the year down some 3% over the prior year. This deterioration was fairly widespread and affected most markets, especially those that enjoyed the strongest gains leading up to the peak of the market. Some of the recent declines in prices can be attributed in part to the increase in foreclosures and related distressed sales, which continue to comprise a significant proportion of overall transaction volume and thus help define the market.

The decline in foreclosure activity in December 2011 was seen as a sign that the sector was finally stabilizing. Unfortunately, this sense of euphoria proved to be premature as it became clear that the decline was a seasonal blip. Also, there was a growing backlog of troubled loans created by processing delays associated with faulty loan documents. Therefore, foreclosure activity is expected to increase in 2012 as mortgage servicers begin to work through the backlog of delinquent loans.

The recent agreement among states' attorneys general and the top five mortgage servicers over foreclosure abuses suggests that attention will become more forward-looking. However, interventions to move the market will have both positive and negative effects for the near-term housing recovery. On the negative side, it is likely that the rate of foreclosure activity will accelerate as servicers are empowered to move forward with foreclosures. This will create another surge on distressed sales, which will increase foreclosures' market share of transactions and place downward pressure on appraised values. As such, the recent erosion in housing values is expected to continue until the backlog is cleared up. On the positive side, the bulk of the attorneys general settlement will be used to reduce principal balances for owners of distressed mortgages and help them avoid falling into foreclosure. These efforts will be bolstered by recent changes to the Making Home Affordable Program announced by President Obama. The combination of these two interventions could provide assistance to some 650,000 homeowners who otherwise would likely fall into default and face foreclosure. While the interventions will not be sufficient to help all of the homeowners who participate, preliminary indications are that the majority of the beneficiaries may be able to hang on, especially if economic conditions continue to improve. Thus, while the scope of the intervention pales in comparison to the depth of housing problem, the added support may be sufficient to shift emphasis from the past problems and help settle the waves enough to help get the sector back onto smooth waters.

In mid-2011, new-home sales began to trend upward, reversing the declines that had occurred early in the year. This improvement proved to be unsustainable, however, with new-home sales slipping backward toward the end of the year. For 2011 as a whole, new-home sales were down over 6% compared to the prior year, which was a disappointment for those who had expected some improvement. Indeed, for the year as a whole, new sales activity plummeted toward 300,000 units, the lowest annual pace since such data were tracked back in the late 1960s. On a similar note, after experiencing some gains in early 2011 fourth quarter, pending home sales slipped in December although they were up compared to year-earlier figures. In terms of prices, the average for existing homes slipped below $200,000, which is the lowest level in over a decade; this punctuates the windfall and wipeout scenario that characterized the single-family market during the decade.

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While the housing market faces a number of obstacles, there are signs overall housing fundamentals are beginning to improve. For example, the National Association of Home Builders (NAHB) Housing Market Index continued to increase in February. While not a dramatic improvement and not yet in positive territory, the increase brought the index to its highest level since attitudes plummeted after the market peaked in 2006 and the industry all but collapsed. While still low compared to historical averages, the upward trend suggests that homebuilders are starting to see the light of day. However, the sense of optimism has not and is unlikely to translate to a surge in building permits except in selected markets where activity levels are beginning to pick up. These pockets of activity will be closely watched, with attention focused on trying to understand the rationale of buyers and how they overcame the negative hype surrounding homeownership. Anecdotal evidence suggests that the new wave of home buyers will approach homeownership in terms of cost/benefit analysis focused on budget impacts rather than on wealth building, which fueled the overpricing that occurred prior to the market collapse. Going forward, homebuilders will place greater emphasis on understanding the needs and wants of their buyers, trying to deliver the right product at the right location and price points. While creating a number of challenges, this renewed emphasis on fundamentals of supply and demand, and customer satisfaction, will add greater discipline to the industry and help avoid another unsustainable run-up.

Another positive for the housing industry is the increase in refinancing activity, which suggests lenders are beginning to loosen up credit and underwriters are getting more confident that values have stabilized. Indeed, recent figures reveal that refinance applications accounted for over 80% of all residential loan applications. Interest rates for 30-year fixed mortgages are at record low levels around 4.1% for conforming loans and 4.4% for jumbo mortgages. Interest rates for adjustable mortgages are even lower, coming in under 3%, although economic uncertainty and lessons from the recent past have skewed many borrowers away from the interest rate risks they entail. Delinquency rates in the aggregate market vacancy rate reported by the Mortgage Bankers Association (MBA) declined through 2011 year-end, with a slowdown in past-due mortgages but an increase in the stock of foreclosed properties. This somewhat dichotomous situation is likely to continue until servicers are able to work through the queue of distressed properties and economic conditions improve to help stressed home-buyers catch up on the budget obligations.

One of the swords that continues to hang over the housing market for the longer term is the yet-to-be-resolved fate of the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. Despite heated debates and the search for solutions, little action has been taken to resolve the underlying issues. As such, it is unclear how the impending legislated changes will affect the entities and the ripple effects they will have on the housing market and the broader economy.

More recently, the plight of the Federal Housing Administration (FHA) has come into the spotlight. In early February, a House subcommittee approved a bill designed to shore up the fiscal health of FHA's mortgage insurance fund. This emergency action was triggered by an independent audit that showed the capital reserves were significantly lower than the mandated 2% level established by Congress. This preemptive action was taken to help avoid another taxpayer bailout by allowing the HUD secretary to invoke emergency tools to help avoid unexpected and unacceptable losses that could deflate the fledgling recovery, or more properly labeled, the plateauing of the single-family housing market. This intervention has yet to become law but its importance is punctuated by the fact that FHA insures over $1 trillion in over 7 million individual loans. As with other issues facing Congress, it will be interesting to see how the bill fares and the rhetoric that it triggers before it is ultimately resolved.

Commercial Real Estate Market

Overview

Given that the commercial real estate market was expected to lag the economic recovery, the industry wrapped up 2011 on a relatively upbeat note in terms of underlying fundamentals. In general, vacancy rates either stabilized or declined for most property types and markets. In many cases, this improvement was attributable to a lack of new product and modest increases in demand rather than a surge in demand for space associated with a robust economy. While there are some exceptions, this situation is likely to prevail for some time as the industry waits for economic conditions to improve.

The modest improvement in underlying market fundamentals helped contribute positive price appreciation—or at least market values—for existing assets. While welcomed by many, it should be noted that this appreciation has benefited from a willingness of investors to accept lower going-in returns as they focus attention on sourcing assets. While some argue that the willingness to accept lower returns is the new norm, it is likely a temporary phenomenon that can be attributed to spread investors who have few options to capture higher returns in the historically low interest rate environment. The commitment by the Federal Reserve to hold rates low for several years has likely reassured investors that such investments will be competitive over the near term. It is also likely that pro forma pricing models have built in an economic recovery scenario that would help explain the record-low capitalization rates at which some properties have traded.

The anticipation of continued improvement in supply and demand fundamentals and the absence of a surge in distressed sales have provided a temporary floor on the commercial market and dampened a downward swing that might otherwise have occurred. Indeed, despite increased transfers of distressed assets to special servicers and increased pressure to resolve problem assets, the market has remained rather orderly with hopes that the economic recovery is on the horizon and will provide a much-needed catalyst to the demand side. At the same time, with a few exceptions in gateway cities, the lack of construction has provided some respite and helped avoid further erosion in market fundamentals. The end result has been a gradual stabilization of overall fundamentals. Whether this situation endures will depend on economic conditions and the ability to nurture the gradual recovery through near-term uncertainty.

In terms of transactions, the majority of institutional investors continued to prefer trophy and core assets in top-tier markets throughout 2011. However, the limited supply of product and aggressive pricing have forced investors trying to source product to broaden their criteria in terms of property types, product positioning, and markets. The prospect that investors will cast a wider net has been welcomed news to property owners waiting for capital to spill over to a broader base of properties. Continuation of this trend will be particularly important for cash-strapped owners of solid but unspectacular properties. This is especially true for owners facing maturing bullet loans with few prospects for refinancing. It will also be important for current owners who can source financing but are unwilling to play under the new rules of engagement that require many to take on recourse debt and provide additional equity to satisfy stringent underwriting standards.

Office Market

The office market has experienced modest improvement, with vacancy rates at the national level gradually, but steadily, falling to the mid-teens. While high by historical standards, the improvement in vacancy rates was met with much fanfare. The improvement in market fundamentals has been somewhat mixed; markets that have job growth in key economic sectors have improved, while markets dependent on a more generalized recovery have languished.

In terms of submarkets, fundamentals in healthy central business districts (CBDs) have tended to outperform suburban markets, although the recovery has been somewhat spotty. Assuming the economic recovery stays on track, office market fundamentals are expected to gradually improve. The good news is that construction activity is expected to remain tempered, which will help place a governor on the market and allow demand to catch up with supply. The outlook for office fundamentals is for gradual improvement in terms of net absorption levels with rents expected to remain flat. That said, there will be some markets that will outperform the overall industry, especially those postured for additional employment growth. The health care industry, which will receive close scrutiny with health care reform, remains something of a wild card.

On the transaction front, investors are expected to continue to be drawn to the office sector, resulting in an increase in transaction volumes as more office product comes to market. While competition will be heated for top-tier properties, investors will be more patient and realistic in terms of underwriting office investments, which will create upward pressure on hurdle rates. The increase in product should also lead to greater price differentiation in line with risk/return profiles of individual projects. It will also encourage investors to pay greater attention to investment quality and underlying fundamentals.

During 2011, office returns for public versus private institutional investments told the tale of two cities. At year-end, there were 18 dedicated office real estate investment trusts (REITs) with an implicit market capitalization slightly over $50 billion. After a strong double-digit return (18.4%) in the previous year, total returns for office REITs were slightly negative for the year as a whole. From a competitive perspective, office returns trailed the overall FSTE NAREIT Equity Index, which provided over 8% total return.

On the private front, office properties were the dominant property type in the NCREIF Index, accounting for some $100 billion of the $284 billion total market value. While public office investments were slightly negative for the year, private, institutionally held office investments generated a solid 13.8% return. These returns benefited from strong appreciation with a 6% implicit capitalization rate, suggesting lower income returns than long-term averages.

In comparing CBD to suburban office returns, the differences between the public and private sectors were even more dramatic, with CBD office properties generating total returns over 15%. At the same time, strong investor preference for core assets led to lower than average income returns as reflected in the implicit 5.5% income returns. On the other hand, total returns for suburban offices investments were some 300 basis points lower than their CBD counterparts, while income returns were almost 100 basis points greater. In terms of market capitalization, suburban office properties accounted for over $51 billion, almost $3 billion more than CBD locations. If the strong interest in CBD office properties continues and prices hold up, this market share could shift over the near term as suburban properties fall out of favor and lose value due to higher perceived risk and concern over lack of demand for new office product in the suburbs.

Retail Market

For the past several years, the retail market has been fragmented with clear winners at the top, some properties at the bottom, and a wide swath of properties stuck in the middle. During 2011, retail market fundamentals experienced improvement due to a combination of restraints on new supply and a greater emphasis on unit profitability versus market share. In this environment, retail properties with strong fundamentals in terms of location and trade areas outperformed more generic, commodity-type product that has no clear competitive advantage.

At an overall level, vacancy rates were relatively flat in 2011 and were on par with those of the prior year. In terms of good news, absorption rates trended upward. In general construction, activity was tempered due, in part, to the fact rental rates hit a plateau and showed little change in either direction.

The general improvement in economic conditions in retail sales in early 2012 suggests that the sector may experience some moderate improvement while retailers struggle to find the right value proposition that resonates with consumers. This will translate to increased reliance on technology, improved logistical models, and other advances that improve the bottom-line performance of retailers. The industry will continue to reposition itself as it competes for discretionary consumer expenditures in an extremely competitive environment. This emphasis on fundamentals will create greater divergence between the winners and losers in the market and may lead to less commoditized pricing.

In terms of transactions, the pace of retail sector sales increased dramatically during 2011. Indeed, among all property types, retail sales experienced the most significant increase in transaction volume, accounting for over $42 billion worth of significant transactions. Of that total, over half the transactions were in strip shopping centers as investors focused on grocery anchored centers with strong anchors and solid demographics. At the other end of the spectrum, several large transactions dominated the regional mall scene, which ended 2011 on a strong note. Interest was particularly strong in portfolio transactions, which helped skew the numbers upward in terms of total sales activity.

Retail sales activity was modest on the distressed asset front in 2011, exhibiting a slight increase over the prior year in the face of strong investor appetite and willingness of lenders to resolve problem loans. With respect to the commercial mortgage-backed securities (CMBSs) delinquency rate, the retail sector outperformed other property types holding at about 7% during much of the year.

In terms of retail investments, 2011 returns were fairly broad and reflected differences in the quality and location of product. In general, public retail REITs provided total returns slightly over 12% for the year with implicit market capitalization of about $118 billion. While respectable relative to other property types, retail returns for the year paled in comparison to the 33% plus returns they racked up for 2010, a period in which retail led all property types other than apartments. Regional mall REITs, which accounted for some 60% of retail market capitalization, provided stellar 22% returns in 2011 while the overall shopping center category slipped into negative territory and freestanding retail properties eked out a slightly positive year. As a recent testimony to the appeal of regional shopping centers to investors, Westfield recently formed a $4.8 billion joint venture with the Canada Pension Plan Investment Board. Given the strong interest in US real estate from offshore investors in general and sovereign wealth funds in particular, more such ventures may be on the horizon. The reported capitalization rate for the transaction (mid-5% range) could place upward pressure on mall valuations, although this will not be as common as with the trophy office sales in the recent past.

With respect to private institutional investment, during 2011 retail properties accounted from some $62 billion of the NCREIF Index. Retail returns had a higher income component than office investments, with an implicit capitalization rate of 6.6% for the year. Among subtypes, neighborhood centers and super-regional malls provided the highest total returns due to strong investor appetites and fairly balanced market fundamentals. On the other hand, single-tenant retail had the lowest retail returns. Power center returns were also below par compared to other formats, although income returns were above average compared to other retail investments.

The dearth of new construction, the gradual but steady improvement in the economy, and the stabilization in the housing market should lead to further improvement in retail investment prospects. However, not all properties will benefit from this improvement, with differentiation reflecting differences in underlying market fundamentals. The outlook for the retail sector is fairly positive for 2012, although investors are likely to remain picky. There will be some upward pressure on capitalization rates, especially for assets in need of repositioning or remerchandising to respond to competitive threats and take advantage of demographic trends. Unfortunately, the ability to create value in the retail sector will depend on proactive management and a level of acumen and experience that some nonspecialists may not recognize. Thus, it is likely that the retail property sector will disappoint some investors who will experience a mismatch between expectations and realizations.

Industrial/Warehouse Market

The improvements in economic conditions in the manufacturing sector spilled over to the industrial and warehouse sector. With construction levels flat in 2011 and net absorption increasing, industrial vacancy rates declined in a number of markets, especially in key transportation hubs and manufacturing areas. This set the stage for increases in industrial and warehouse asking rates. While such increases were not dramatic, they boded well for investors, especially compared to other property types that were forced to wait for the economic recovery to spill over to the broader market and create ancillary demand for space.

The recent ripples on the global front have created a bit of a pause in manufacturing and distribution activity, although this situation is likely to be temporary and give way to the economic expansion when the situation stabilizes. However, it should be noted that the economic recovery will not be sufficiently broad based to bail out all manufacturing and distribution facilities. Indeed, due to advances in technology, changes in logistical models, and changes in infrastructure, the locus of activity may change and leave some owners on the winning end and others on the losing end.

During 2011, industrial investments provided mixed levels of performance, especially when comparing public versus private ownership structures. For example, industrial REIT stock prices reflected a decline of over 5% in 2011 compared to a respectable return in the previous year that pushed 19% overall. In terms of industrial REIT activity, the merger of AMB and ProLogis was noteworthy with the resultant $16.5 billion combined market capitalization, which dominated the overall sector that closed the year with an implicit market capitalization of $18.1 billion. The four self-storage REITs had a market capitalization of $27.8 billion and led all property types with 25% plus return in 2011, following almost 30% returns in the prior year.

On the private front, returns on industrial properties of 14.6% led other property types with the exception of apartments. However, the implicit capitalization rate of 6.6% was some 113 basis points over apartments, providing a higher income than apartments. With respect to subtypes, research and development led the sector followed by warehouse and manufacturing, with each category having over 14% total returns. Flex space, which accounted for less than a tenth of the total

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market capitalization lagged other industrial sectors, slipping below 10% total annualized returns.

Industrial transaction levels were fairly strong during 2011, rising some 75% over the prior year. Despite improving economic fundamentals at year end, transaction activity tapered off as the year unfolded. Due to strong investor demand, capitalization rates trended downward. This was especially true for assets that were well positioned in terms of market fundamentals and the rigorous standards established by institutional investors. Looking forward, the industrial sector is expected to continue to attract investor interest leading to an increase in activity.

Apartment Market

During 2011, the apartment market continued to be the darling of developers, lenders, and institutional investors alike. While welcomed by many, this interest is somewhat reminiscent of previous cycles where capital flows created imbalances that led to overbuilding relative to other property types. This caveat might not resonate with some who have bought into the hoopla surrounding the sector. However, a cursory review of permit activity and the surge in headline news and conference activity focused on apartments should raise a flag of caution. In addition, the recent decline in apartment capitalization rates, which has driven them below other property types and long-term averages, is a signal the sector is in danger of becoming overheated. Finally, the fact that apartment delinquency rates are higher than all property types may signal some downside risk that is not currently priced into transactions and underwriting policies.

In a number of markets, apartment vacancy rates have plummeted due to a combination of lack of new supply and a dramatic and abrupt shift in tenure preferences. In some cases, these market factors and shifts in demographics have triggered a wave of investor interest in existing product and set the stage for an increase in new apartment construction activity. The surge of such activity might be justified in a number of markets that are experiencing improvement in the demand side of the equation that should help absorb new product flooding the pipeline. However, other markets which have enjoyed a temporary increase in demand due to shifting housing preferences may well be forced to deal with the fallout associated with excess exuberance. This caveat is especially true in markets in which appetites for institutional product have skewed development toward narrow niches or target segments that are the easiest to build for and thus attract the most interest from developers, lenders, and investors rather than serving the full range of needs of the rental market. Thus, in a number of markets there is some risk that there will be excesses in both the quantity and quality of product; the former can be cured over time, but the latter may lead to functional obsolescence.

Due to the strong interest in apartments, it is no surprise that transaction volumes increased dramatically in 2011, although the absence of product and aggressive pricing no doubt inhibited activity. For the year as a whole, investment activity increased over 50%, rising to some $54 billion worth of transactions. Garden property accounted for the bulk of sales, although interest in infill and urban properties lured investor appetites toward the core of a number of gateway cities. Indeed, in some markets investor appetites and anticipation of future demand for core assets has skewed development activity away from the suburbs in favor of higher density, higher-end apartments.

There were fifteen dedicated apartment REITs that had an implicit market capitalization of $67 billion at year-end 2011. With the exception of storage REITs, the apartment sector led other property types in terms of total returns of over 15%, which was particularly striking in light of the leading 47% return racked up in 2010.

Despite relatively thin market capitalization of around $4 billion, manufactured-housing REITs were also solid in 2011, with the three dedicated REITs turning in over 20% returns after a solid 27% plus the prior year. On the other hand, lodging REITs trailed all property types in 2011 with over 14% negative total returns following 43% returns the prior year. Despite this relatively weak performance, this volatile property type ended the year on a fairly strong note benefiting from the improving economy and increased travel.

On the private market front, apartment properties led all property types with 15.5% returns. These returns were bolstered by high appreciation as investors chased the sector. This drove capitalization rates to a low of 5.5%, trailing all other property types. In terms of subtypes, low-rise apartments led the sector followed by garden apartments and high-rise properties.

Looking forward, the apartment market will bear close scrutiny, with the danger of oversupply and overpricing hanging over the sector. Despite this caveat, investors are likely to remain focused on the apartment sector, which will bring strong near-term performance but could lead to longer-term disappointment.

Real Estate Capital Markets

The real estate market enjoyed strong capital flows throughout 2011, although the capital was uneven and focused on core, trophy properties in selected gateway cities. This resulted in record-high prices and record-low capitalization rates. This focused investment strategy has caused a significant compression in capitalization rates as some investors seemed to accept that less is more.

Going into 2012, equity capital flows to real estate from both the private and public sectors are expected to continue to increase. While investors will remain focused on core assets, they will cast a wider net in search of higher returns. This will bode well for owners of assets in secondary and tertiary markets that have largely been ignored to this point in the cycle.

Despite the expansion of investment parameters, institutional players are likely to remain somewhat risk-averse, creating greater divergence in pricing. The end result will be upward pressure on prices for property types and markets that are able to get on the radar screen of investors, while other property types and markets will be left in something of a void. This will create opportunities for investors who are able to resist the tendency to follow the pack and adopt a somewhat contrarian strategy. On a similar note, buyers of distressed assets will have a plethora of product to pick and choose among with relatively limited competition as mainstream investors focus on more traditional plays.

In terms of capital sources, foreign investors will continue to be a major source of net capital flows to US real estate. The general outlook for 2012 is for increased capital flows. However, the outlook for equity markets is not completely sanguine, with some $1.3 trillion worth of maturing bullet loans that still have to be addressed. At this point in the cycle, investors seeking higher returns maybe willing to step into some of the void over the near term, although long-term prospects for these assets and the need for major influx of new capital will be problematic at best.

During 2011, the commercial mortgage market was bifurcated, with lenders continuing to favor borrowers with solid track records and pristine properties while eschewing risk. This situation has created a significant imbalance in capital flows, although the industry has been able to avoid a capital induced downturn. The increase in equity capital flows to real estate and the influx of new sources of capital will provide some respite for the industry. However, the void left by the dramatic contraction in the CMBS market will hang over the industry. While traditional sources of mortgage capital are expected to increase lending activity, these efforts will tend to be concentrated at the upper end of the industry. The situation is not expected to create a capital market crisis over the near-term, but the need for a dramatic influx of capital and the sheer magnitude of distressed assets still in the pipeline bears close monitoring.

Regardless of the need for additional government intervention, it is unlikely that Washington will be willing or able to step into the void. Thus, over the near term, the fate of the commercial real estate industry will remain in the hands of the private sector. Over the longer term, however, the industry will have to address the significant need for an influx of debt capital to avoid a meltdown in the commercial market. While the economic recovery may provide some respite, some form of intervention may be necessary before the commercial real estate markets hit full stride and are able to compete for capital with other asset classes that are likely to outperform the sector during these early phases of economic recovery.

Conclusion

The economy, capital markets, and commercial real estate markets are at something of a crossroads, with more than a little uncertainty as to how the near-term conditions will play out. This uncertainty is amplified by the fact this is an election year with a substantial political divide between and within parties. Congress's record-low approval ratings among voters will force politicians to consider some of the unintended consequences of their wrangling and political posturing. This is especially true since Washington punted on most tough decisions last year and now will have to face a day of reckoning on a number of crises that cannot be deferred until after the election. Even more disconcerting is the fact that many of the challenges that policy makers will have to address are beyond their locus of control and rest in the hands of our global partners.

Despite all the drama surrounding the market, life will go on and businesses, consumers, and politicians will have to carry on. While there are a number of positive signs that we will be able to navigate through these troubled waters, most will be somewhat on the defensive and will pay close attention to the signals that emanate from the market and other sources of information. Unfortunately, there will be a lot of noise and clutter that will create some false signals that will have to be sifted through to make sense of it all. The end result will be an environment characterized by a series of actions that seem to catapult us forward only to be countered by other forces that will cause us to fall back and take a hard look at the road ahead. Many of us will be left wondering where is that anchor that will help us hold our ground and stay afloat at the same time? Interesting times, indeed!

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