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Cautionary Signals from Commercial Real Estate Markets and Consumers

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Abstract

This column explores the current status of the US real estate market. It discusses the players and elements impacting various market segments, summarizes latest developments and figures, and offers analysis of recent trends in the real estate market.

Commentary

On the surface, there are a lot of positives on both the economic and real estate fronts. While not stellar, the underlying statistics on the job scene continue to improve, inflation remains in check, interest rates are low with moderate increases priced into the market, and economic activity and consumer sales reported by the Federal Reserve (Fed) Beige Book have increased in all twelve districts.

On the real estate front, overall market conditions have continued to improve in line with the economy, as indicated by a general decline in vacancy rates that has translated to moderate increases in rents in some markets. While there are some weaknesses on the economic front, the probability of recession remains low, and the recovery seems on track albeit still at a rather anemic rate. However, it appears that the commercial real estate market may be reaching a cyclical peak and may be in for a correction in pricing. Since this is occurring on the capital market side of the equation rather than market fundamentals, it has drawn little notice to date but now that may be changing.

The aggressive commercial real estate pricing, which has been discussed in this column for the past several quarters, has started to receive more attention, which may be a warning sign. For example, a *Wall Street Journal* article, published on August 12, included the headline "Surge in Commercial Real Estate Prices Stirs Bubble Worries: Soaring demand for commercial properties has drawn comparisons to delirious boom of the mid-2000s." The article displayed a number of graphs that highlighted the almost exponential increases in the commercial property price index, the volume of quarterly sales, and private equity fundraising since the market trough in 2009.

While many sellers have enjoyed the increase in prices, the trend is not without some justified concern.

There are signs that some owners are beginning to cash out while others are spreading out to opportunities in new venues. Unfortunately, as history has proven, some bullish buyers have a hard time backing off when it appears there is more left on the table. Chasing assets is always a dangerous strategy in the world of real estate cycles.

Although these observations should be taken as a cautionary note rather than a prediction, it may be time to start getting defensive in terms of portfolio composition and liquidity. The bottom line is that we are in for some interesting times especially with politicians stirring the pot as they gear up for the upcoming primary elections.

The Behavioral Imperative

Recently, the behavioral side of market drivers has received increased attention. This emphasis is particularly appropriate at this stage of the real estate cycle. Indeed, the timing of the next inflection point will be determined by changes in expectations and behavioral responses of the key players that have driven the prolonged bullish run in commercial real estate markets.

The importance of expectations was hinted at by the recent economic forecast for *The Wall Street Journal* in which the biggest upside risk (i.e., a good thing) is the potential for faster consumer spending than what is being forecast by traditional econometric models. This position is somewhat ironic, as it comes at a time when consumer sentiment has been shifting downward both at home and on the global stage. According to the Nielsen's second-quarter report, more than half the respondents in sixty of the largest economies in the world believe they are still in a recession. This perception varies across the globe, with the most-negative perceptions occurring in South America. Getting an accurate read on consumer sentiment and incorporating it into economic forecasts has become increasingly difficult due to external forces. For example, despite the Greek crisis, the outlook for European consumers improved modestly, led by Russia, although Italy and France are still in the doldrums. On the other hand, rising concern over the Chinese economy has become a particular concern, as illustrated by the swift reaction of stock markets and capital sources to the economic slowdown in China and the devaluation of the Chinese yuan. At the same time, there are signs that consumer sales in China, and in some other markets with economic challenges, may not be as negatively affected as anticipated due to a combination of pent-up demand and wishful thinking by consumers.

On the US domestic front, there are a number of behavioral signals that suggest the economic reality may be dampened from current expectations. For example, the National Federation of Independent Business (NFIB) Small Business Optimism Index fell dramatically at the end of the second quarter to the lowest point in fifteen months. The biggest drag on small business confidence levels was a decline in earnings attributed to disappointing sales and higher costs. Small business owners also expressed concerns about the recent slowdown in economic growth.

It should also be noted that with the United States entering the presidential primary season there will undoubtedly be a lot of talk about all that is wrong with the country and the economy and how to fix it with new leadership. Although the debates leading up to the primaries, caucuses, and conventions will be focused within party lines, the range of candidates vying for attention will result in more extreme positions than characteristic of some election cycles. This may be particularly true for the Republican Party for which the number of declared candidates is three times that of the Democratic Party.

The Economic Environment

Economic Growth

During the 2015 second quarter, real gross domestic product (GDP) growth increased, reversing the downward trend that began a year earlier. The contributors to the GDP figures were mixed, with consumer spending on the upside and inventory investment and imports on the downside. Despite GDP improvement, economic growth remains below long-term averages, with no assurance that an upward trend is imminent. This is especially true with a number of downside risks lurking in the background, such as the economic slowdown in China and the continued economic turmoil in Greece.

The Conference Board Leading Indicators slowed down a bit in June after a healthy rise that started in February, and the indicators still remain below the prior-year figures. The Chicago Fed National Activity Index rose into moderate but positive territory after a series of negative figures that held since January. Looking forward to third quarter results, the outlook for economic growth remains tempered in the 2% to 3% annualized range, with inventories and consumer spending the biggest concerns.

On a positive note, the Fed's Beige Book reveals that moderate economic expansion was fairly widespread in the second quarter, with all twelve Federal Reserve districts reporting increases. The Economic Cycle Research Institute (ECRI) Leading Index slipped during July, continuing the recent downward trend but still remaining in positive territory. Despite lingering concerns over various economic indicators, the probability of a recession is relatively low and significantly below figures for the same period in 2014.

Business and Economic Indicators

During the first half of 2015, business and economic indicators were mixed, with a slightly positive trend. After falling into negative territory in January, business

inventories trended upward, although the pattern was uneven and reflective of changing expectations. Despite the increase in inventories during the second quarter—which might place a dampener on future GDP growth—the inventory-to-sales ratio remained flat. The most recent figures were bolstered by wholesale inventories, while retail and manufacturing levels were flat.

Durable goods orders moved into positive territory during June, reversing two months of moderately negative growth. New orders for manufacturing goods increased modestly in June and moved into positive territory after two negative months. Although improving over the prior two months, growth in industrial production was relatively rather anemic. Similarly, the Institute for Supply Management (ISM) purchasing managers index tapered off a bit but was still in a moderately expansionary phase. The ISM nonmanufacturing index rebounded in July, racking up the largest increase in over seven years and winding up at the highest level in over a decade. This improvement was a very positive note given the importance of the nonmanufacturing component in GDP figures. The services component improved during the first quarter although a number of sectors slipped. The most positive gains were in the administrative, professional business, and health care services sectors.

One positive note for businesses, consumers, and homebuyers is the recent Federal Reserve Survey of Senior Loan Officers, which reveals that banks have continued to loosen the purse strings and have relaxed lending standards across business lines. Commercial banks also have increased their willingness to make loans to consumers and have eased up on credit card standards. Lending standards for commercial real estate loans have loosened by almost 10%, while demand for commercial loans is relatively strong. This trend is consistent with the residential mortgage front, especially for government-sponsored enterprise eligible mortgages from Fannie Mae and Freddie Mac. Thus, capital providers appear to be more than willing to do their part to help bolster economic activity, shifting focus to how business and consumer confidence levels and expectations will translate to actions.

The Global Scene

The global economic environment is one of the key uncontrollable factors that affects the plight of the US economy.

During the second quarter, the US current account balance, which broadly tracks US trade against its global peers, declined. This raised concerns regarding the continued downward trend that began at the end of 2013 after a promising string of seven quarters of gradual improvement (albeit still in negative territory). The second quarter deficit, however, was the lowest since mid-2012. During June, the foreign trade deficit fell to $43.8 billion, which was disappointing compared to expectations. Food exports fell the most, declining 4.2%. At the same time, the US experienced a 1.7% decline in capital imports, with more sectors experiencing the same trend. The situation was exacerbated by the strong dollar and weakening economic conditions affecting many countries.

On a positive note, international capital flow into US Treasuries increased in the second quarter, continuing a trend that began in February. In terms of capital providers, the increase was led by private investors while foreign institutions were net sellers.

The eurozone has been caught up in spillover from Greece's economic problems that have hung over that country for the past five years. That situation has, and continues to be, complex and difficult to solve. While the economic tragedy in which Greece is caught will ultimately be resolved, at this point it is difficult to see a clear path to resolution. What is clear is the solvent nations are not going to provide an endless stream of bailouts, and the recent third round may well be the last. The International Monetary Fund (IMF), which has been pressuring creditors to provide additional support, is running out of options, and it is waiting for a clear plan for reducing the ever-accelerating debt. Unfortunately, the current extemporaneous approach is adding to the confusion and lack of cohesiveness. The situation may be even more dire than currently believed if the mid-August report by European Union officials confirms the prediction of significantly higher Greek debt. The austerity measures that are being forced on Greece continue to dampen expectations within its own borders. It also taints the infrequent good news that does emerge, such as the economic growth reported for the second quarter. For now, the lack of a clear course of action or a commitment to implement any of the options that have been suggested hangs over the economic outlook across Europe and makes it more vulnerable to added shocks such as the unexpected slowdown in China.

China was the center of a lot of attention in the summer of 2015. The 8.5% decline in shares on

July 27 created an economic tsunami. Adding further to the economic turmoil, the People's Bank of China (PBOC) unexpectedly decided to devalue the yuan in early August, an action that rippled across the globe. The combination of the volatile stock market in China, the devaluation of the yuan, and the economic slowdown that triggered them had an immediate and dramatic impact on China's Asian neighbors. While it is not clear how things will play out over the long term, the economic shocks have created immediate downside pressures. The clouded economic picture and the uncertainty over how regional policy makers will react ultimately will be priced into the market as added risk.

The actual impacts of the recent events in China are impossible to quantify at this point, as there is limited precedence to draw on. Given the importance of China to the global economy, the resultant uncertainty has spread across Europe, the Americas, and other countries whose fates are all intertwined. The situation in the United States is illustrative, with the devaluation of the yuan weakened by 1.9% against the dollar. The explanation was that the PBOC wanted to bring the yuan in line with the market. Also factored into the decision was news that the export sector had weakened, with July exports falling 8% over the prior year's figures. Imports declined at about the same pace, much to the chagrin of its global trading partners. The decision to devalue the yuan led to complaints that the move put companies that trade with China at a disadvantage. It also put pressure on other countries to take a hard look at their own currencies as they try to protect their export businesses.

The current economic slowdown and other problems in China are making it uncertain that the central bank's goal to open up the markets by year-end is still feasible. Among all this uncertainty, bond yields have been driven up and prices have declined, and Chinese companies have been forced to pay higher interest rates to investors, putting them at a disadvantage relative to other Asian competitors.

The global outlook has slipped due to the economic weaknesses in a number of countries in addition to Greece and China. Indeed, even before the difficulties in China the IMF's projection for 2015 global economic growth fell to its lowest level since the global financial crisis in 2009. The IMF has noted that countries are more vulnerable to the impact of negative externalities due to their high debt levels and low interest rates that leave little room for stimulus actions. Despite these concerns, global economic growth is still forecast to come in around 3.3%, which while disappointing is still higher than consensus forecasts for the United States. Indeed, despite concerns over economic growth in China, many countries would love to have the same problem as China's government target of 7% economic growth, which is over twice that of the rest of the world. Thus, it is hard to view the Chinese situation in the same terms as that in Greece.

Employment

On a positive note, employers added 215,000 jobs in July, which translated to the fifty-eighth consecutive month of improvements. This is the longest string of employment gains on record. Despite this streak of generally good news, the 2015 monthly average on a year-to-date basis is around 211,000 new jobs compared to 240,000 during the previous year. The slowdown that occurred was attributed to smaller companies, while larger companies actually added jobs at a higher rate. From a regional perspective, oil states have been particularly hard hit with the decline in prices translating to significant layoffs. This trend resulted in the loss of 25,000 jobs in Texas in March and is likely to continue as the global economic slowdown suppresses the sector.

The Intuit Small Business Employment Index increased in July over the prior month, but it still was down from earlier in the year, suggesting small businesses have pulled back a bit and are waiting for the economy to regain some momentum. In terms of layoffs, the reduction of 57,000 army troops contributed to the increase in the number of layoffs in July, which reached 106,000—the highest level in over four years. A couple of sectors remained bright spots in terms of new hires, including retailers and computer/technology firms that are expanding. On a cautionary note, the recent declines in productivity are also a cause for some concern, especially when combined with the modest increase in wages that has elevated per-unit labor costs.

During the second quarter, the unemployment rate remained flat at 5.3%, with the improving labor market attracting more people back into the labor force. The percentage of employees who are stuck with part-time jobs or have dropped out of the labor force fell to around 10%, which is significantly below the 17% reached in 2010 but still above the prerecession levels. In addition, the number of

underemployed remained at unacceptable levels. In terms of wages, the average earnings of private workers approached $25 per hour in July, which is an increase of about 2.1% over the prior year.

The labor force participation rate remained relatively flat at 62.6%, which when combined with the percentage of workers who are underemployed suggests that there is still a lot of ground to be regained in the labor market. This is not deterring workers seeking new jobs as the quit rate has continued to increase.

While not getting as many headlines recently, the debates over minimum wage legislation are not likely to go away and are expected to accelerate as the primaries loom ahead. As expected, a number of companies that rely on minimum wage workers continue to argue that an increase in minimum wages will actually hurt those who the legislation is designed to help. This potential unintended consequence was punctuated by Wendy's announcement that mandated minimum wage increases would force the company to pull back on employment and experiment with other delivery systems such as self-order kiosks and reliance on automation. Whether the Wendy's claims pan out, the ramifications of the much-ballyhooed increase in wages at Walmart suggest there is some merit to the assertion. In an internal memo leaked in August, the firm warned employees to prepare for an "unexpected" wave of layoffs at the home office.

On the other end of the spectrum, the recent experiment by Dan Price, CEO of Gravity Payments, a credit card processing company, to raise the minimum salary to $70,000 and cut his own salary by 90% captured a lot of attention but backfired. Despite elevating him to a hero status with outsiders, the strategy created a lot of angst among the existing employees who felt undercut. They complained that the strategy essentially rewarded "clock punchers" at the bottom of the productivity curve at the expense of those who were working hard to make the company successful. The bold move also hurt the revenue side of the business, as some customers pulled back to make a political statement or left due to the fear that higher prices would be necessary to cover the pledge. The result was a loss of some key employees and customers, which were both expensive propositions. The lesson is that there is no clear answer to appropriate wages, and the changes may play out in unexpected ways. This adds uncertainty to economic forecasts that will linger until the net behavioral responses are better understood.

Inflation and Interest Rates

Inflation moderated during the first half of 2015, which was consistent with expectations and the slowdown in the global economy. The ECRI Future Inflation Gauge rose modestly in July. Despite the increase, the inflation gauge is still 3.6% below the prior year, and it remains below long-term averages, especially those in the heyday period leading up to the great recession.

After four quarters of relatively healthy gains in employment costs, the second quarter figures came in lower than expected but still 2% above the prior year. The Producer Price Index was also up during the second quarter, with the increase in core goods leading the increase. Import price changes slipped into slightly negative territory, reversing the increases in April. Despite this decline, import prices increased some 4% on an annualized basis. Energy prices continued to receive significant attention. Despite modest gains in petroleum and natural gas prices, price levels are still dramatically lower than the prerecession era and have provided an upward lift to the economy and consumer sales. The recent slowdown in the economy is likely to translate to an annualized inflationary rate lower than the Fed's 2% target rate but on par with expectations.

The September meeting of the Fed's Open Market Committee will determine whether interest rates will be increased, and this potential move is receiving significant attention. While some recent weaknesses and the slowdown of the economy will be factored into the decision, the market seems prepared for a modest increase as the Fed begins to normalize rates. According to a Reuters poll in mid-August, some 55% of economists believe the Fed will raise short-term rates twice this year, with a 60% probability of an increase in September and an 85% chance by the end of the year. The estimates are for an increase to 0.375% in September, followed by a second increase to 0.625% toward the end of 2015 or early next year. These estimates are consistent with June figures; even if the increases occur, rates will be low by historical standards. As might be expected, not all parties are calling for an increase in rates. Most notably, the International Monetary Fund in June urged the Fed to hold off on interest rate changes until 2016. Due to weakening global economic

conditions since then, the IMF position has likely firmed up more, especially with its recent downward revision in global growth forecasts.

Even if the Fed increases short-term rates, the historically low interest rate environment that has bolstered the economy and real estate capital markets is likely to continue, with a number of factors suggesting the normalization process will take longer than anticipated earlier. The near-term outlook is for modest increases in interest rates, which when combined with easing loan standards, is good news for borrowers and the economic outlook.

Consumer Confidence

The slowdown in job growth compared to a year ago has weighed heavily on consumer confidence and is reflected in the decline in the Conference Board's Consumer Confidence Index. The Confidence Index plummeted to 90.9 in July, down from around 99.8 in June. In terms of trends, this was the lowest level since early last fall when the economic and job figures were stronger. The decline was attributed to weakening in the Expectations Index, which declined sharply to 79.9 compared to 92.8 in June. The Present Situation Index was generally positive at 107.4 in July but down from 110.3 in June.

The University of Michigan's Consumer Sentiment Survey revealed more consistent results, with the present conditions component relatively flat, averaging around 107 despite a decline in May, which has since been reversed. On the other hand, the expectations component slipped modestly. In terms of consumer credit, borrowing slowed modestly during the second quarter, although still indicating growth. Personal income growth was relatively strong after a decline in March. The outlook for consumer credit is for continuation of the upward trend, assuming economic conditions continue to improve and loan standards do not tighten to the point that they throttle growth.

Retail Sales

Retail sales have been uneven, with increases in March and May and declines in April and June. This sawtooth pattern reflects some of the uncertainty that hangs over consumers as the economy slows and wages remain relatively stagnant. The recent declines were relatively widespread, including apparel, furniture, building supplies, and department stores. US Census Bureau estimates of Retail and Food Services for July were up modestly from June and up 2.4% from the prior year. The same pattern was revealed on a year-to-date basis.

The improvement in retail sales was fairly widespread across economic sectors. The most dramatic increases were in Food Services and Drinking Places, which rose 9%, along with Vehicle and Parts Dealers sales, which increased 7% on a year-over basis. Automobile sales were relatively strong during July, recovering from a decline in June and returning to the upward trend exhibited for most of the year. On the other hand, e-commerce sales continued to increase, reaching a record $80 billion during the first quarter of the year. This represented a 3.5% increase over the 2014 fourth quarter and pushed the market share of total retail sales over 7% on a continued upward trajectory.

Housing Market

The housing market keeps receiving significant attention—especially the apartment sector, which continues to surge on the new construction front while the single-family housing sector remains rather guarded. Indeed, construction of multifamily units are back on par with pre-crisis levels. In addition, multifamily construction has increased in market share of new housing units due to tempered growth in the single-family sector. Part of the surge in construction of apartments can be attributed to the continued decline in the homeownership rate, which fell to 63.4% during the second quarter, continuing the downward trend that has been experienced for a number of years and is well below long-term averages. In terms of market share, single-family permit activity came in at 685,000 units in June, compared to 498,000 multifamily units. The share of multifamily units is much higher than historical averages and if it holds, would reflect a structural shift in tenure choice. While there are clearly some inhibitors that are constraining homeownership levels, it is doubtful the dramatic shift is more than a cyclical phenomenon. This situation warrants close attention, especially for investors still buying apartments at record-low capitalization rates.

There are some signs that the single-family housing scene might experience some improvement, including the relaxation of lending standards and increases in baseline jumbo mortgage thresholds. Currently, the jumbo mortgage threshold is $417,000 in most of the United States, while some high-cost

cities have higher thresholds of $625,500. The increase in housing prices is increasing pressure to raise these limits, with the Federal Housing Finance Agency (FHFA) requesting public input on its indices and thresholds. These thresholds are important to the upper-middle to upper housing segments, since those seeking conforming loans (i.e., those under the limits) have greater access to mortgages and lower mortgage rates, even with lower credit scores, than those seeking jumbo loans that are over the limit.

Other good news on the housing front is the decline in homeowner vacancy rates and in rental rates. While the former may be at sustainable levels, the surge in apartment construction may put upward pressure on vacancy levels, especially at the mid-upper tier of units that are being favored by developers, lenders, and investors. On the mortgage front, Mortgage Bankers Association's reported delinquency rates have continued to fall, although there was a modest increase in the percent of foreclosures started during 2015. Mortgage application activity was unsteady during the first half of the year but continues to trend upward. The combination of positives has helped bolster builder confidence, with the National Association of Home Builders (NAHB) Housing Market Index trending upward and reaching its highest point in a decade.

In terms of housing prices, a number of competing price indices provide insights into the health of the single-family market. For example, the Black Knight Home Price Index trended up through the first half of the year, although it still remains below the previous year. When broken down by price quintiles, houses in the lowest 40% of markets experienced the highest rate of growth at 5.6%, while houses in the next two tiers appreciated at the lowest rate, averaging 4.4% on an annualized basis. While not broken out by price, the CoreLogic Home Price Index reveals a similar pattern with modest improvement in prices. On a year-over basis, prices increased 6.7% in June. The FHFA Monthly Purchase-Only Price Index revealed a similar pattern and showed fairly widespread improvement, with gains in six of the nine census divisions on a month-to-month basis. On a year-over basis, the FHFA index revealed increases in all nine census regions. The S&P/Case-Shiller Home Price Index revealed a similar pattern, with improvements in the top-twenty cities leading the way, followed by the top-ten cities, and the national averages. Despite these increases, all three indices are below their peak at -13.3%, -14.3%, and -6.8%, which suggests that smaller cities have recovered at a faster pace than their larger counterparts.

Real Estate Market

Real Estate and Capital Market Fundamentals

At an overall level, the real estate spatial markets continued to improve during the first half of 2015. This improvement can be attributed to a number of factors, including the combination of generally tempered construction levels and gradual improvement in tenant demand. As might be expected, this situation varies across markets and property types, with low capitalization rates leading some investors to turn to development in search of higher returns. In addition, investors have continued to expand their investment horizons, turning to secondary and tertiary markets that have not experienced the feeding frenzy of the top markets targeted by investors.

In general, real estate capital markets have been active with healthy transaction levels fueled by strong investor demand. According to Real Capital Analytics (RCA), transaction volume for the second quarter was $118 billion, a 23% increase over the prior year. Despite this healthy pace, it was off a bit from the 2015 first quarter, which was up almost 50% over the prior year; the total figures were up 36% over the first half of 2014. The $251 billion in transactions for the first half of 2015 included 15,214 properties with an average price of $16.5 million.

To put the current transaction volume into perspective and provide some insights into the stage of the current market cycle, it is useful to compare recent levels to the peak of the market before the 2008 slowdown. On a trailing twelve-month basis, there was slightly under $500 billion in transaction volume through June 2015. This was the highest level since the market peaked in 2007 when there was a record $575 billion in transactions. Interestingly, the recent three-year trend is similar to the pattern that led up to 2008, when transaction volume plummeted 70% to $175 billion. Figure 1 illustrates the trend in transaction volume since 2001.

The second quarter slowdown in transaction volume can be attributed to a number of factors. One consideration may be the fact the market is experiencing a pause as attention shifts to concern over rising interest rates and the tempered rate of economic growth in the United States and abroad.

The decline in transaction volume is also likely attributable to the fact the somewhat frenetic pace was not sustainable, especially at this stage of the cycle when top-tier markets are fully priced and investors are expanding their horizons in search of higher returns.

With respect to players on the buy and sell side, there were some significant differences in activity levels. Of particular note was the fact about a third of the top twenty-five buyers were offshore investors, and another tranche included investors with a combination of US and international assets. On the sell side, the situation was significantly different, with none of the top players in the offshore category. This pattern suggests that a number of offshore investors in US real estate have taken a long-term hold perspective. It also suggests that some domestic investors may be taking a profit at a point in the cycle when prices are near or at their peak in what has been a prolonged bull run.

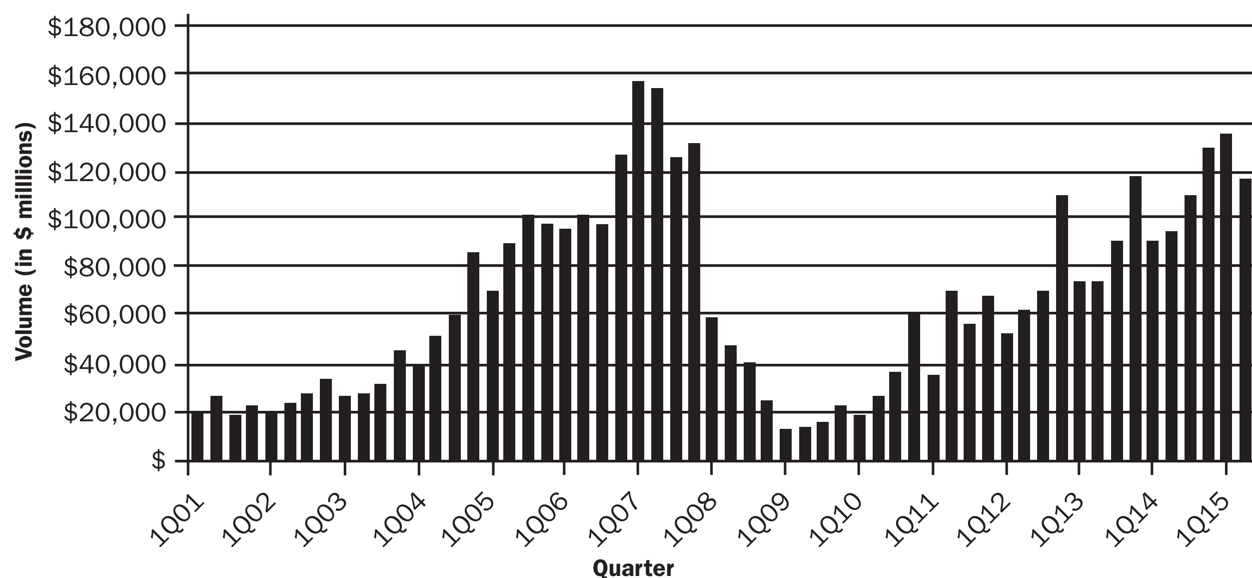
While transaction volume has been relatively strong for the United States as a whole, some regions and markets have outperformed the averages while others have lagged. From a regional perspective, the West (28%) and Northeast (21%) regions, as defined by RCA, accounted for almost half of the $251 billion in total transaction volume for the first half of the year. The most active markets in the West were Los Angeles and San Francisco, although sales in tertiary markets outpaced the latter and other markets with over $10 billion in sales, offering evidence of the movement out of the primary and secondary markets. The situation was different in the Northeast, where the New York metro area dominated the $53.6 billion transaction volume, with Boston coming in at $7.5 billion and tertiary markets at only $1.3 billion. In terms of top markets, the top ten included Manhattan, Los Angeles, Chicago, Dallas, Atlanta, San Francisco, Seattle, Boston, San Jose, and Houston. Despite the increase in transactions in secondary and tertiary markets, the top ten accounted for 42% of total US transactions during the first half of the year, and 55% of the total in the top-twenty-five markets. At a national level, tertiary markets accounted for 16% of transaction value and 23% of transaction volume. Table 1 shows transaction volume by property type in the top markets.

To provide more insights into what real estate performance statistics mean in terms of the overall market, it is useful to step back and explore the composition and market capitalization of the two leading benchmarks for the private and public real estate equity markets.

Real Estate Equity Market Benchmarks

With respect to the private commercial real estate market, the National Council of Real Estate Investment Fiduciaries (NCREIF) is the generally accepted benchmark for US real estate investment

Figure 1 **Transaction Volume by Quarter, Individual and Portfolio Sales**



performance. NCREIF was founded in 1977 to provide a benchmark for institutional investors to help stimulate pension fund investment in real estate that was a byproduct of the Employee Retirement Income Security Act of 1974 (ERISA), which supplanted the "prudent man" criterion for investment fiduciaries with the "prudent expert" criterion. Briefly, under the prudent expert standard, if real estate was considered an asset class versus an industry sector, investment managers held to the fiduciary standard had to make allocations to real estate to take advantage of the diversification benefits it could add to a mixed asset portfolio. The only holdup against implementation of the fiduciary standard was the lack of a benchmark that asset allocators could plug into quantitative asset allocation models. This void led to the introduction of the NCREIF Property Index (NPI). At that point, the NPI was an all-equity index of performance of assets in tax-exempt accounts in the industrial, office, and retail sectors.

In 1984, the NPI was expanded to include apartments, and the NCREIF Timberland Index was introduced in 1986, followed by introduction of the NCREIF Farmland Index in 1990. In 1995, leverage properties were included in the NCREIF's expanded scope, with returns back cast to 1982 and reported on an unleveraged basis. In 2000, the NCREIF database was further expanded to include properties not qualifying for the NPI. Additional indices were used, including the NCREIF Fund Index Open-End Diversified Core Equity (NFI-IDCE) Index and the NCREIF Townsend Fund Index, which focuses on style differences including closed-end, value added, and opportunity funds. The potpourri of NCREIF products was rounded out in 2012 with the release of the Fund Index Open End Equity Returns, and the Timberland Fund and the Separate Account Index.

The introduction of these varied NCREIF indices has allowed asset allocators, investors, consultants, and researchers to create customized benchmarks for portfolios with different areas of focus or styles. The NPI is a quarterly index, tracking investment performance for core institutional real estate investment. At the beginning of the second quarter of 2015, the NPI included 6,863 properties with a gross fair market value of some $426 billion dollars. Although the number of contributing members varies from quarter to quarter, over ninety members participated at the end of the first quarter. These members include real estate advisors, corporate pension funds, endowments, private equity managers, and individual state funds.

On the public market front, the FTSE NAREIT All Equity REITs Index is the traditional benchmark for commercial real estate performance. As of June 30, 2015, the All Equity Index had a market capitalization of $826 billion while the All REITs Index had a market cap of $890 billion. According to the National Association of Real Estate Investment Trusts (NAREIT), the 224 REITs in the index owned some $1.7 trillion worth of commercial real estate. Of the total, $895 billion was traded on the New York Stock Exchange with an equity market cap of $838 billion. Through the first half of the year, the All REIT Index had an average of 4.34% dividends compared to 3.7% for the All Equity REIT Index. With respect to leverage, the Equity REIT constituency had an average debt ratio of some 32% with a debt coverage ratio of 4.5 overall. In addition, forty-six of the Equity REITs were rated investment grade, which translated to 60% of market capitalization. Looking at the All REIT constituency, the debt ratio was somewhat higher at 43.5%, with a debt coverage ratio of 3.6 for the overall index. In terms of average daily trading volume, the June 2015 figures were over 50% above the same period in 2010.

With respect to investment performance, the private and public markets were out of sync during the first half of 2015, with the advantage going to the private market. The NPI had a solid first half of the year, with total returns over 3% for each of the first two quarters. On a trailing twelve-month basis, total returns were 13%, with 5.2% income returns and 7.5% appreciations. REITs began 2015 with a strong start, before slipping to negative total returns in February, which pulled down returns for the quarter and led to a loss of momentum toward the end of the first quarter. This general downward spiral continued throughout the second quarter, with -5.7% year-to-date returns for the Equity REIT Index. On a positive note, the market turned around in July, with REITs regaining most of the lost ground and dividends hovering around 3.5% for the first seven months of the year.

Office Market

At a national level, spatial market fundamentals for the office market improved during the first half of 2015. Positive net absorption helped push vacancy rates down, with cities with viable urban cores

significantly outperforming their suburban counterparts. However, national net absorption has been highest in the suburbs, with urban space moving at a slower pace. While office construction remains tempered by long-term historical standards, first quarter deliveries were at the highest level in over five years. Much of this activity was concentrated in a number of select markets. Interestingly, some 80% of additions to office stock occurred in the suburbs, although that mix varied by market. In some markets, landlords benefited from an increase in rental rates during the first half of the year, which was welcome news to investors who bought or held office properties that were priced or valued at historically low capitalization rates.

Turning to the investment performance, the story differed for the private and public sectors. On the private market front, the office sector accounted for some 38% of the NCREIF Property Index at the end of the second quarter, with a total market capitalization of $168.7 billion. On a twelve-month moving average, office returns of 12.9% were on par with the overall index. Implicit capitalization rates came in at 5% annual, with a modest increase over the first quarter.

The public office market, which racked up solid 26% total returns in 2014, experienced a generally downward trend through July, with -1.3% total returns on a year-to-date basis. Dividends came in at 3.1%, trailing the equity REIT average and other property types. Blended industrial/office REITs slipped even more, with -2.2% returns but higher dividend rates of 3.5% year-to-date.

On the transaction front, the office market was the most active of the major property types during the first half of the year, accounting for 28% of sales. The average transaction value at $25.9 million was higher than other property sectors. The West region was the most active, accounting for 28% of value and 38% of sales. The most active markets were Los Angeles ($3 billion), Chicago ($1.9 billion), Dallas ($1.6 billion), Northern New Jersey ($1.5 billion), Orange County ($1.25 billion), and Seattle ($1.26 billion). The tertiary markets accounted for only 8% of transaction value, but 18% of transaction volume.

Table 1 Total Transactions by Property Type by Top-12 Markets ($millions, Jan-June 2105)

	Property Type						
Market	Office	Industrial	Retail	Apartment	Hotel	Dev Site	Total
NY Metro	$16,532	$2,653	$8,438	$8,571	$4,396	$3,746	$44,336
LA Metro	$4,921	$5,639	$3,730	$5,327	$1,651	$1,110	$22,377
SF Metro	$8,549	$2,916	$1,547	$2,190	$1,619	$1,218	$18,037
Chicago	$5,032	$1,862	$1,624	$1,711	$614	$270	$11,113
DC Metro	$3,885	$586	$1,794	$2,952	$479	$298	$9,994
Dallas	$1,572	$1,632	$1,333	$2,987	$690	$284	$8,498
Atlanta	$2,312	$1,057	$963	$2,812	$351	$146	$7,642
Boston	$3,655	$548	$786	$1,573	$602	$314	$7,478
Seattle	$2,727	$1,256	$1,069	$1,908	$211	$145	$7,316
Houston	$1,507	$912	$1,027	$2,517	$376	$224	$6,563
Phoenix	$1,380	$589	$830	$1,405	$873	$171	$5,248
Denver	$1,417	$493	$510	$1,979	$317	$133	$4,849
Top 12	$53,490	$20,142	$23,650	$35,933	$12,177	$8,059	$153,451
Other	$17,878	$16,867	$22,000	$27,300	$14,690	$2,933	$101,669
Total	$71,368	$37,009	$45,650	$63,233	$26,867	$10,993	$255,120
Top-12%	75%	54%	52%	57%	45%	73%	60%

DC Metro = DC, DC Maryland burbs, DC VA burbs

NY Metro = Long Island, Manhattan, Northern NJ, Stamford & Westchester

LA Metro = Los Angeles, Inland Empire, Orange County

SF Metro = San Francisco, East Bay, San Jose

Retail Market

In general, retail market fundamentals have shown limited improvement, although some markets and submarkets have been active with retailers trying to expand market share or move into new markets. This situation was most pronounced at the top end of the market, ranging from successful regional malls with a franchise in a local market to high-street urban locations. At the other end of the continuum, commodity-type space remained flat with vacancy rates over 10% at a national level. In some markets, the combination of shifting consumer preferences, hyper competition from traditional retailers, and continued emergence of online formats has placed some centers at risk. This situation has been exacerbated by the slowdown in economic conditions and the pressure on bottom lines as merchants focus on unit profitability and rationalize their outlets.

Retail sector companies also are facing pressure from activist shareholders who are demanding that they divest of real estate owned in favor of leased space, which would provide a temporary boost in share values. A vivid example of this phenomenon is Macy's, Inc., which is facing calls to spin off its real estate holdings. Although such pressure is not new (Target Corp. and Dillard's Inc. have faced similar pressure), it is unlikely to abate and will be an interesting trend to follow as it spreads among retailers. Hopefully, they will be able to avoid Mervyn's fate, for whom the reality of rising rents and a recession pushed it into bankruptcy.

On the investment front, private retail real estate returns were competitive with other property types through the second quarter, with 15.6% trailing twelve-month returns compared to 13% for the overall index. Income returns were 5.4% annualized, which was competitive with other property types. The appreciation component fell dramatically in the second quarter, trailing all property types with the exception of hotels.

The public retail property market led other property types for 2014 in terms of total returns, which came in at 27.6%, lagging only the apartment sector. Through July, year-to-date sales slipped 0.56%, a disappointing total return figure after a strong year. The fate differed somewhat by retail types, with regional malls eking out a slightly positive return. On the other hand, freestanding retail slipped almost 2%, which may be related to concern over rising interest rates that affect property types tied to bond-type pricing models.

With respect to transactions, the retail market was the most active of the major property types during the first half of the year, and it accounted for 28% of sales. The average transaction value was $13.4 million, which was lower than other property types with the exception of industrial. The West region was the most active, accounting for 28% of value and 38% of the number of sales. The most active retail markets included Manhattan ($4.8 billion), Los Angeles ($2.4 billion), the New York City boroughs ($1.6 billion), Northern New Jersey ($1.4 billion), and Seattle ($1.1 billion). Retail sales in tertiary markets led other property types, accounting for 18% of transaction value and 22% of transaction volume.

Industrial Market

Spatial fundamentals in the industrial market improved during the first half of 2015, building on the momentum established in 2014, which was a solid year.

During the first half of 2015, national vacancy rates declined as a result of growing tenant demand being in line with additions to new stock. In terms of deliveries, estimates vary by source, but the additions to space, which are likely to accelerate during the second half of the year, are raising no major flags for the sector. The good news for owners and developers is that demand has been able to keep up with supply, allowing owners to increase rents in some markets and submarkets. The recent global economic slowdown has created some concerns, but again there are no major flags that suggest the sector is in for a short-term correction.

With respect to investment performance, the capital markets were on par with spatial fundamentals. For example, during the first half of 2015, the industrial sector led all major property types in terms of total returns, racking up an industry-leading 14.8% total return. Interestingly, in light of the lower risk profile of industrial properties, the sector generated a very competitive total return, with the income component contributing to the overall performance. The public industrial market delivered acceptable performance during 2014 on a risk-adjusted basis despite lagging other property types. Unfortunately, the sector faced a number of challenges during the first half of 2015, with -3.6% total returns through July. This disappointing performance might be attributable to the global

slowdown in Western Europe and China, which is impacting exports and general economic conditions.

Industrial transaction volume in the first half of the year lagged other major property types with the exception of hotels, coming in at 14% of value and 22% of sales volume. Despite this relative positioning, the sector was up 40% compared to the prior year, indicating some increases in investor appetites. The average industrial transaction was $10.7 million, trailing all property types. The most active industrial markets were Los Angeles ($3 billion), Chicago ($1.9 billion), Dallas ($1.6 billion), Northern New Jersey ($1.5 billion), Orange County ($1.25 billion), and Seattle ($1.26 billion). The tertiary markets accounted for 16% of industrial transaction value and 19% of transaction volume.

Apartment Market

Apartment market fundamentals remained strong during the first half of the year despite the pace of additions in many markets. The decline in vacancy rates and strong net absorption allowed landlords to push rents in a number of markets, with rents increasing 6% or more over the prior year.

As has been the case for a number of years, the condominium market continues to languish and remains well off the pace in terms of value recovery, transaction volume, and new construction. All three of these factors are likely to be under added pressure due to the restrictions on condominium mortgages that were enacted after the housing market crash between 2008 and 2012. For example, rules enacted by the Federal Housing Administration (FHA) require that in order to get insured mortgages in a condominium development, a minimum of 50% of the units must be owner-occupied and a maximum of 50% can be FHA-insured. For new developments, at least 30% must be under contract. These rules are much more onerous than for apartments, which typically have no preleasing, and thus become speculative projects that must compete for tenants.

While apartment construction has continued to surge, condominium construction has slipped in terms of market share. For example, prior to the housing market collapse, condominiums accounted for 40%–50% of multifamily housing construction. After a dramatic decline, the condominium market share has leveled off. However, the condominium market accounted for only 5.5% of new construction during the first quarter, the lowest ratio since 1974. The challenges facing condominium development and finance has helped skew construction to the apartment sector. It has also prevented developers from adding condominiums to the urban core, which has experienced something of a renaissance among millennials and others interested in urban living. Since some of those drawn to the core would prefer ownership rather than life-long rental, there may be gaps between current and preferred options that are masked by the surge in apartment demand and the willingness of investors, lenders, and developers to continue to add new apartment stock.

With respect to investment performance, the public apartment market was on fire during 2014, with total returns approaching 40% and outpacing all other property types. There are rising concerns that certain markets and submarkets are getting overstimulated in terms of new construction. However, REIT investors have not shared that concern and apartment REITs outperformed all property types through July, with industry-leading total returns of 7.5%. Although accounting for less than 10% of residential REITs, manufactured homes helped bolster residential returns, with 14.9% returns on a year-to-date basis.

During the first half of 2015, transaction activity in the apartment market was relatively high compared to other property types, accounting for 25% of the value of transactions and 23% of the volume. Despite this performance, the apartment sector lagged other sectors in terms of increases, suggesting the property type might be nearing its peak. The average value was $17.3 million, trailing only office and hotels and attesting to the interest in larger, top-end projects that investors have been seeking.

The most active apartment markets were Manhattan ($4.2 billion), Los Angeles ($3.4 billion), Dallas ($3 billion), Houston ($2.5 billion), Denver ($2 billion), Seattle ($1.9 billion), and the New York City boroughs ($1.6 billion). Interestingly, tertiary apartment markets were not as active as in the other property types, accounting for only 14% of transactions. Due to smaller average sizes in tertiary markets, the share of the number of transactions was on par with other property types with 19% of sales.

Conclusion

Reflecting on economic, capital market, and real estate market fundamentals, there are a number of positive signs that suggest the US recovery remains on track. As

noted, many key metrics point to a continued economic recovery, although there are also some warning signs. Of particular concern is the slowdown in employment growth from 2014 as well as the emerging issues on the global front. These range from the economic conditions in Greece to the recent slowdown in China. However, there are also some positive indicators, including low inflation, low interest rates, and access to capital for a broad range of players.

With respect to commercial real estate, spatial market fundamentals continue to improve in line with the economy as measured by a general decline in vacancy rates, which in some markets translated to moderate increases in rents. Despite this rather sanguine outlook, there are some signs that the aggressive pricing is likely to receive more and more attention as the market begins to approach its zenith. This was punctuated by the recent *Wall Street Journal* headline "Surge in Commercial Real Estate Prices Stirs Bubble Worries." So, it is time to ask a couple of questions. First, will the real estate capital market fall back in an orderly manner and avoid any pricing corrections? Second, will investors continue to clamor for deals and will profit taking be moderate, which will allow the market to stumble along in a state of nirvana? Finally, are we at the stage that the bubble might actually be ready to burst or at least lose a lot of hot air? If the latter occurs, politicians will bring their own hot air to center stage. Unfortunately, nothing on politicians' plates will stimulate the market and we are likely in for another round of political positioning. Enjoy the journey and consider whether it is time to venture on to the "road less traveled," which from a behavioral perspective may be good advice at this stage of the cycle.

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

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Web Connections

Internet resources for additional reading

Black Knight Home Price Index
http://www.bkfs.com/Data-and-Analytics/DivisionInformation/Solutions/Portfolio-Management-and-Due-Diligence/Pages/Black-Knight-Home-Price-Index.aspx

Bureau of Labor Statistics—Producer Price Indexes
http://www.bls.gov/ppi/

Conference Board—Business Cycle Indicators
https://www.conference-board.org/data/bci.cfm

CoreLogic Home Price Index
http://www.corelogic.com/about-us/researchtrends/home-price-index-report.aspx#.VdM7MbJViko

Economic Cycle Research Institute Indexes
https://www.businesscycle.com/ecri-reports-indexes/all-indexes#

Federal Reserve Bank of Chicago—Chicago Fed National Activity Index (CNAI)
https://www.chicagofed.org/publications/cfnai/index

Federal Reserve Bank of St. Louis—Federal Reserve Economic Data (FRED)
https://research.stlouisfed.org/fred2/

Institute for Supply Management (ISM)—Report on Business
https://www.instituteforsupplymanagement.org/ISMReport/

International Monetary Fund
http://www.imf.org/external/index.htm

Intuit Small Business Index
http://index.intuit.com/

Manufacturers Alliance for Productivity and Innovation
https://www.mapi.net/

National Association of Home Builders (NAHB)—Housing Economics
http://www.nahb.org/en/research/housing-economics.aspx

National Council of Real Estate Investment Fiduciaries (NCREIF)
—Data and Products
https://www.ncreif.org/data.aspx

—Resources (papers and minutes)
https://www.ncreif.org/resources.aspx

National Federation of Independent Business (NFIB)—Economic Trends
http://www.nfib.com/surveys/small-business-economic-trends/