The Recovery: Weathering the Storm?
James R DeLisle
The Appraisal Journal; Fall 2004; 72, 4; ABI/INFORM Global
pg. 291

The Recovery: Weathering the Storm?

by James R. DeLisle, PhD

Commentary

Despite various setbacks, the economy remained on track through the summer of 2004, suggesting that the economic recovery might be enduring. This outlook for an improved economy continued going into the fall, although the hoped-for momentum had not yet materialized. Indeed, high energy prices, increasing medical costs, and acrimonious preelection posturing created more than a little angst among consumers.

One of the big stories in the early fall was the series of major hurricanes that plagued Florida and the Southeast. The barrage of severe weather and its aftermath disrupted domestic industries, shipping patterns, and offshore oil extraction. Considerable uncertainty remains over the final scope of such impacts, which are unprecedented in the current economic environment in terms of number, breadth, intensity, and duration.

Looking at the U.S. market from a broader perspective, business indicators remain relatively positive in spite of periodic setbacks and isolated concerns. Although still tenuous, business confidence levels appear to be rising, as companies position themselves for the recovery. Labor markets are poised for growth; there are few constraints on business expansion, productivity levels are up, and capacity is at a historical low.

With respect to real estate, the news is also positive, especially since real estate already has been identified as a lagging sector due to excess capacity. Indeed, the gradual improvement in real estate fundamentals has provided some stability to the overall market and helped it avoid the potential of volatility.

As voters have been reminded, however, not all is right in America. A number of long-term issues such as health care and Social Security have to be addressed during the next administration. The good news is that since it will be some time before these tough issues are dealt with, they will not affect the near-term economic recovery.

The Economic Environment

Economic Growth

During the second quarter of 2004, the increase in real gross domestic product (GDP) was slightly less than 3%. This was a disappointing figure in light of the relatively strong numbers for the first quarter. The slowdown can be attributed to declining personal consumption, as the job market continued to dampen consumer enthusiasm. This situation is likely to continue until some of the uncertainty that surrounds the economy and the election is resolved. The real estate market helped soften potential downturns, with both residential and nonresidential fixed investments increasing at an accelerating rate over that in the first quarter.

The airline industry has continued to struggle with lagged effects from 9/11. Despite a strong rebound in domestic travel, increased load factors have not erased the deficits that built up over the past several years. For the major airlines, this situation has been exacerbated by the strength of discount carriers who have placed downward pressure on rates. In addition, rising fuel prices have contributed to the plight of the industry by eroding gains in passenger volume. With the threat of bankruptcy looming, many airlines have redoubled efforts to obtain concessions from unions and have sought near-term financial relief by underfunding pension plans. The situation for the airlines is unlikely to change soon, with the peak vacation season behind the industry and few indications of a major increase in business travel. The winners in this equation will be travelers, as the airlines continue to concentrate on per flight profitability rather than market share.

The series of hurricanes hitting the Southeast placed an additional drag on economic growth in the United States. The food supply will likely be disrupted and the regional pressure on the price of materials and labor will intensify. Furthermore, the tourist industry has been dealt another blow, with

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Florida bearing the brunt of the losses. Despite a cushion on insurance losses established by Florida, the insurance industry is likely to face significant drags on earnings. The aftermath will continue to be felt on the economy as well as those directly affected by the recent natural disasters.

Going into the 2004 third quarter, the outlook for jobs and economic growth are being tempered, with concerns placing a governing effect on business confidence levels. Near-term GDP growth is expected to be less than 4% —somewhat disappointing in light of the expectations held earlier this summer. Due to the challenges hanging over the economy, this tempered growth is both understandable and more sustainable than the earlier projections for growth.

While interest rates are likely to continue to experience upward pressure, the tenuous job scene might cause the Federal Reserve Board to back off on its much-anticipated series of increases. The election results and the finger pointing leading up to it, together with turmoil in the Middle East and concerns over domestic terrorism will continue to hang over the economy through the balance of 2004. Moving into 2005, GDP should continue to hover around the same rate, indicating stable but moderate growth. This situation hinges on a relatively steady state and a rekindling in business confidence as the year winds down.

Employment

The U.S. economy has continued to pick up jobs. The level of employment growth, however, has been disappointing and has fluctuated dramatically. This troubling volatility can be traced to the risk-averse nature of employers. Even more troubling has been the trading down in jobs. This has dampened consumer enthusiasm, especially among those who have been forced to settle for lower-paying positions in new, often unrelated fields.

In spite of growing criticism and election rhetoric, the trend toward offshoring of jobs appears to be a natural by-product of globalization of world markets. In the future, analysts will have to adjust forecasting models and pay close attention to global competitiveness of industries. They will need to look at the vulnerability of local economies that are dependent on industry sectors most likely to turn to outsourcing.

Despite the current status of employment, the United States faces the longer-term prospect of a shortage of skilled labor. In the future, there could be a gap between job requirements and workforce preparedness. Workers who lack top management experience may be thrust into leadership roles when the aging workforce systematically retires and steps out of the corporate scene. Over the near term, however, employment prospects will remain tempered and volatile until the economy stabilizes and business confidence levels firm up.

Inflation and Interest Rates

Going into the fall, the Consumer Price Index (CPI) relaxed a bit, dipping below the 3% level, and the core rate of inflation continued at historical lows. Within the consumer breadbasket, inflation was uneven. Health care, food, and transportation costs added upward pressure before tapering off with the drop in motor fuel costs and a softening of prices for new vehicles at the end of the model year. Used-vehicle prices rose slightly, but are expected to remain relatively low with the glut of product depressing prices. Energy costs remain a wild card for consumers and for the overall economy, although these costs might abate in the absence of major changes on the global scene. Overall, inflation should remain in check going into 2005, with little danger of major spikes, despite concerns over medical and food costs.

In terms of wages, employees are likely to continue to make some gains. However, softness in employment growth, a surplus of available employees, and strong productivity levels will affect some of the upside potential. The trickle-down effect of the improving economy in terms of wage levels will continue to be eroded by benefit pressures, as high medical costs cannibalize potential wage gains. In this environment, consumers are expected to play a minor role in the recovery. The business sector will lead the way in the recovery until consumers see stronger gains in real disposable income.

While the slight rise in interest rates has contributed to an increase in dividend and interest income, such effects are expected to remain modest and be more of an "effect" rather than a cause in inflation.

Low interest rates continued to drive much of the economy during the first half of 2004 in spite of the fact that the Federal Reserve Board (the Fed) began increasing the rates. After two rate increases in early summer (good news on the inflation front), some of the pressure on the Fed was alleviated. This

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

improvement, coupled with political pressure to maintain a steady state, set up the possibility that anticipated rate increases toward the end of the year might be deferred.

Regardless of how the Fed acts over the balance of the year, it is likely that interest rates will remain relatively low well into next year. This is good news in light of the buoyant role that interest rates have played in the recovery—especially in the housing industry, which continues to provide a boost to the broader economy. Looking forward, expectations are for moderate increases in interest rates, with some upside potential as the Fed continues to focus attention on inflation.

Business Indicators

Leading business indicators remain mixed, as the strong housing market largely offset weakness in other sectors, especially the financial sector where the modest rise in rates has eroded market volume.

Factory inventories increased over the summer as firms geared up for the anticipated recovery. This was the strongest buildup in over three years and helped to bolster the manufacturing sector. Complementing the inventory increase was a rise in shipments, new orders, and unfilled orders, which suggests a healthy pickup in both sides of the supply chain. Prices, however, have remained relatively flat, especially in terms of producer prices and finished consumer goods.

On the production front, the news has continued to be positive. Productivity gains in the manufacturing sector have been particularly strong, a trend that should continue as business confidence rises and companies increase investment activities to posture for the recovery. Capacity utilization increased moderately during the summer, although it still remains historically low. Manufacturing capacity also remains below inflationary levels, indicating the ability to expand output without placing upward pressure on prices. Factory orders have continued to increase by low double-digit levels on a year-to-year basis, led by business investment and other capital goods orders. With respect to business inventories, the news remains fairly positive, although increases have slightly moderated.

When combined with strong gains in sales, the inventory-to-sales ratio continued to hover at record lows, which bodes well for upside production potential due to the short supply of available product. On the flip side, shortages in product could have a dampening effect on the recovery if there is a surge in demand and overall business growth.

In international trade, the news continues to be mixed. The U.S. exports remain relatively strong but not sufficient to offset the increase in imports, thus, the record U.S. trade deficit shows no signs of abating despite the relatively cheap dollar. The trade imbalance is particularly high with some of the major U.S. trade partners, including China and Japan.

In the future, the trade deficit will continue to be problematic, but it currently is receiving little attention. The relative lack of focus on the trade imbalance is itself symptomatic of bigger problems looming over the U.S. economy. Unfortunately, there are few signs of improvement as the government struggles with funding the Iraq war and with the stagnant domestic economy.

Stock Market

Stock market performance has had a sawtoothed pattern through much of 2004. The Dow Jones Industrial Average has followed this pattern of ups and downs, fluctuating above the 10,000 level. The market volatility, while disconcerting for those hoping to break out of the rut, shows that investors have been able to absorb a succession of mixed news and election hype without pulling back.

The transportation sector has exhibited a pattern similar to that of the entire market, although the fluctuation has been less pronounced and the overall trend has been positive. The technology sector has had a more difficult time and has continued to struggle, although the increase in business investment and other factors have reversed the slide.

The outlook for the stock market mirrors that of the overall economy. Business profits are expanding along with the economy, although growth rates have moderated somewhat. While the market remains plagued by the issues that nag away at consumer confidence, investors are primed for a rebound, tending to see the glass as half full. In the absence of unexpected surprises, the recent pattern should hold, with some upside potential.

Consumer Confidence

The upward trend in consumer confidence levels reported in the first half of 2004 peaked in late summer and suffered some erosion as consumers focused on employment, health care access and costs, rising food costs, and uncertain energy prices.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Among employees, confidence levels differed markedly by sector, with those in health care, business and (to a certain extent) technology outpacing those in the manufacturing and service industries. This dichotomy reflects the increased attention by employees and consumers to the bigger economic scene. As might be expected, private-sector employees are generally more upbeat than their public counterparts, where budget deficits have cut across all levels of government.

After the elections, policy makers and consumers are expected to refocus their attention on longer-term problems that have been set aside. In particular, the challenges associated with an aging population and the relentless increases in health care costs will demand attention and may undermine consumer optimism. Concern over retirement prospects and pressure on retirement age will frustrate many Americans. At the other end of the spectrum, younger workers struggling to move up the ranks of a "sticky" workforce of their elders will focus more on the burden of supporting the retirement boom, eroding long-term confidence levels.

Although these issues will not affect the economy over the near term, they are likely to come into focus later, creating a drag on confidence levels. This situation might cause a shift in emphasis from the "current" versus "expectations" components of consumer confidence, forcing a cyclical convergence between the two dimensions. In the meantime, consumer confidence levels are likely to be tied to the overall economic scene, reinforcing the belief that consumers will not lead the recovery.

Retail Sales

Retail sales have been problematic for the overall economy. This year there are no stimuli, in the form of tax refunds or surplus from mortgage refinancing, to help bolster sales. Consumers have been flipping their pocketbooks open and closed, creating a pattern of ups and downs. After a strong first quarter, both in absolute and year-over terms, retail sales have fluctuated with a gradual downward trend, reinforcing the earlier conclusion that consumer spending would not lead the economic recovery.

The late Labor Day holiday, in the midst of the hurricane-related weather in the East, contributed to disappointing sales in the third quarter. While back-to-school sales were not improved, the fact that households expected to spend about the same as last year, suggested the season may have been temporarily postponed, with some modest gains over the near term. Sales of luxury retailers remained strong through the summer and into the fall, while discount retailers and others dependent on mainstream consumers floundered. This situation is expected to continue, with well-heeled consumers leading a surge in high-end product sales. At the same time, the conservatism among the bulk of consumers is expected to continue, setting the stage for moderate gains for the holiday season and another spate of promotional activity, as mainstream retailers are forced once again to compete for market share.

Looking beneath the total sales figures, the gains in same-store sales have been troubling, with no sector outperforming first-quarter figures, and average results coming in at about half the earlier pace. This situation is likely to continue and may erode further, until there is meaningful, sustainable employment growth. Indeed, with consumer confidence where it is, employment gains will not be sufficient to bolster consumer spending. Improvements will have to translate into gains in disposable income that more than offset the erosion in benefits. In the interim, retailers are expected to continue to focus on bottom line and unit profitability. Retailers will also continue to experiment with different store concepts and retail outlets, seeking approaches that allow them to grow in absolute terms and respond to shifting demand and competition.

On a similar note, the role of technology will continue to increase as retailers seek ways to nurture sales out of reluctant consumers and reduce costs. This will include a variety of innovations including expansion of self-checkout systems, use of information kiosks, and tools to enhance the shopping experience and address the needs of customers without adding to payrolls. Behind the scenes, technological innovations will help manage inventory and replenishment. At the same time, intelligent systems and software developments will allow retailers to respond to shifting consumer preferences. As has been the case for some time, retail e-commerce sales continued to increase in a generally upward slope, although they were not immune to softening demand in the second quarter. Despite these gains, e-commerce sales remain at less than 2% of total retail sales. The outlook for both in-store and on-line sales is positive but moderate (better for upper-end items), with some upside potential if the employment picture and consumer confidence rally.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Housing Market

The housing market has continued to belie predictions of eventual softening, even with the moderate increases in interest rates. While the change in rates has caused turmoil in the financial community and mortgage originators have been forced to cut back on employment, homebuyers have not retrenched as much. Indeed, although the pattern of sales prices for existing homes has come to reflect the sawtooth pattern in the stock market, prices are still increasing. New home sales tapered off a bit in early fall, with much of the decline in the South, which previously had accounted for over half of new home sales and had experienced strong gains. The aftermath of the hurricanes will introduce a level of uncertainty, as labor and materials will be skewed toward rebuilding, placing some upward pressure on the prices of new housing in the impacted region.

Despite continued concern over the ability of the market to sustain the housing rally, homebuilders remain optimistic, although they are expected to pay close attention to market fundamentals. Nonetheless, housing starts have not retreated and are likely to continue to expand at a moderate rate.

The continued strength in the housing market can be attributed in large part to the continuation of low rates, which are anticipated to carry into 2005. This situation should be bolstered by the broader economic recovery, as employment and income growth begin to ripple across the economy. Thus, rising rates will dampen the housing market, but such a drag is likely to be moderate. In testimony before the Senate Banking Committee, Federal Reserve Board Chairman Alan Greenspan weighed in on the housing bubble question, suggesting that prices in some markets may be out of alignment with fundamentals. Whether such warnings catch the attention of buyers, who have been driving the market in anticipation of continued appreciation, remains to be seen. While some softening in price growth is inevitable, an economic recovery might continue the strong market, especially if interest rates continue to favor homeownership.

Construction Activity

Construction activity has strengthened along with the overall economy. Nonresidential construction provided an unexpected boost to economic growth in the second quarter. Through the first two-thirds of 2004, total construction activity increased almost 10% above the previous year, signifying a relatively healthy recovery. Private construction activity was even stronger, led by gains in the residential single-family market.

Public construction remained rather flat due to lack of funding. This situation is unlikely to change given the economic plight cutting across all levels of government and the continued anti-tax sentiment. Thus, government construction spending is unlikely to emerge as an engine of growth. However, the need to accommodate growth and replace aging and antiquated infrastructure will continue to build up, creating intermediate-term pressure on construction capacity.

Despite the increased activity in private nonresidential construction and continued strength in the residential sector, there are few signs that real estate activity will accelerate enough to help lead the economic recovery and offset faltering business growth. The recent increase, however, does point to the resiliency of the industry and the favorable alignment of capital flows and development capacity. On the other hand, low capacity utilization and excess stock will create a lagged effect in the construction sector despite isolated pockets of activity.

Going forward, both residential and nonresidential construction activity are expected to respond to demand indicators, with contraction on the nonresidential side likely if business growth begins to stumble. On the other hand, the unrequited strength of the residential market in the face of a number of potential setbacks has entrusted it with a sort of buoyancy that may be hard to shake, creating a lagged adjustment to an eventual softening in demand. When coupled with material shortages that will be exacerbated by the hurricanes, pressure on prices is likely to rise. Assuming the recovery continues on track, price pressures might translate to higher real estate values for existing stock that can satisfy tenant demand.

Real Estate Capital Markets

Overview

The real estate and capital market alignment has continued, with real estate capital flows benefiting from the improving economy and continued volatility in the equity market. Despite some further erosion in market fundamentals, there is no shortage of capital for real estate.

Investor appetites for existing product remain strong, with both domestic and international capi-

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

tal continuing to chase product. This situation is expected to continue. Investors in search of higher returns in real estate may jump onto the construction bandwagon when the economic recovery begins to take off.

Capital is beginning to flow to new niches (mixed-use development, transit-oriented development, lifestyle centers) that have emerged as new solutions to long-standing urban problems. While the movement to more efficient and effective real estate and urban solutions is attractive, there is little empirical work to support such a movement. Indeed, in many cases the success of such activities hinges on the ability to educate the market and change consumption patterns—a two-stage process that has historically been challenging at best. The questions surrounding the role of real estate and optimal urban form will complement capital flows, leading to a dynamic stage in which win-win situations can be created. There is a danger, however, that unknown risks associated with real estate innovations and normative beliefs will backfire as pressure builds to remain competitive with other asset classes. Despite such concerns, the overall outlook for real estate capital markets remains very positive well into 2005.

Mortgage Market

The mortgage market has remained relatively steady during 2004, with private and public sources continuing to compete for loans. This competition is strongest for core assets that have relatively limited downside risk. The moderate softening in credit standards reported earlier in the year continues to characterize the origination business. Lenders continue to exhibit restraint, however, especially with regard to new construction. Nevertheless, they have been drawn into new product types (e.g., infill development), despite limited actuarial experience upon which to base underwriting decisions.

With respect to yields, returns on prime mortgages were at historical lows in late summer, with spreads over 10-year Treasuries equally compressed as a result of strong investor demand. Debt-coverage ratios approached 2.0 overall, led by industrial properties and, somewhat troubling, lagged by mixed-use properties that are receiving the biggest increase in interest in terms of new construction potential. On the other hand, mortgage delinquency rates remain solid by historical standards, but have been drifting up moderately. This situation should hold or improve along with the general economy, and strong investor demand that will continue to help hold values.

The market for commercial mortgage-backed securities (CMBS) remains strong in terms of issuances. At the same time, spreads in the lower tranches have compressed, reflecting the maturing of the sector and strong investor appetites for returns. A significant volume of securitized mortgages is beginning to mature, creating additional opportunities for the industry. However, a large proportion of mortgages in these maturing pools of loans have current debt-coverage ratios that lag industry standards and may not be generating sufficient net operating income to cover debt payments. Since these loans may not be serviceable in terms of replacement issuances, it is likely there will be more pressure to extend maturities to bridge the cyclical lull in the market. The good news is that the coupon on these mortgages tends to be higher than existing rates, providing a cushion.

Despite such concerns, the CMBS market should finish the year on a strong note with plentiful capital to service demand. Thus, both the private and public mortgage markets are expected to remain extremely competitive over the near term. Furthermore, improvement in real estate fundamentals for solid properties should more than offset the moderate increases in rates that are anticipated, setting the stage for a healthy mortgage market in 2005.

Private Equity Market

The private equity market has generated surprising results, with returns through the first half of 2004 improved over the second half of 2003. While not as strong as returns posted in previous recovery periods, the increases were noteworthy in the face of weakening in some real estate market fundamentals. Furthermore, the low double-digit returns exceeded the expectations of real estate advisors and analysts. Even more noteworthy, the improvement in private returns was fairly widespread—led by the retail, apartments, and industrial sectors, with office and hotel lagging. In terms of geography, the East and West enjoyed the strongest performance while the Midwest and South regions trailed.

The moderate improvement in private market returns was due in large part to gains in the appreciation component; income yields were relatively flat, although the annualized rate was slightly below long-

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

term averages. In the current spatial environment, the improved appreciation figures reflect strong investor demand, as real estate continues to attract capital from other asset classes due to the perceived risk/reward.

If the economic recovery continues to build, real estate should show moderate improvement. The recent uptick in returns might be sufficient to help bridge the trough in the private equity market. This should set the stage for stronger gains in total returns as the income component responds to improved market fundamentals. The fact that institutional investors stayed with real estate during the bottom of the performance curve, suggests there is some additional cushion in the private market that can withstand any near-term challenges that might arise. Even if the economy stumbles somewhat, real estate is poised to capture additional private capital as investors continue to seek security and alternatives remain mixed.

Public Equity Market

During the past year, real estate investment trusts (REITs) have proven to be resilient, although total returns dived early in the 2004 first quarter. After a brief price adjustment, REIT returns recovered much of the loss and have shown respectable year-to-date returns. Despite continued problems in the underlying spatial markets, REITs have demonstrated an ability to weather cyclical fluctuations.

The IPOs for REITs have increased dramatically over 2003, both in number of offerings and value of issuances. Mergers and acquisitions have been active, including the acquisition of Rouse Company by General Growth Properties, the Kimco Realty Corporation's joint venture with DRA Advisors to acquire Price Legacy Corporation, and the acquisition of Chelsea Property Group by Simon Property Group. In some cases, the merger and acquisition activity was designed to diversify property location and quality, while in others it was to broaden product lines as a hedge against structural shifts, especially in the extremely competitive retail arena.

REITs have been active in joint ventures. REITs are seeking alignments with capital partners that have a lower cost of capital and an appetite for specialized skills. While this trend is expected to continue over the near term, the need for such arrangements is expected to abate as the spatial markets pick up, allowing REITs to focus on their core activities and owned portfolios.

As the overall economy improves and real estate markets continue their lagged but gradual recovery, REITs should continue to hold their own. The overall market is somewhat pricey, however, and might experience some softening if the equity market picks up markedly. If the volatility in stocks and bonds continues, REITs may enjoy additional breathing room and continue to be perceived of as a strong income vehicle with moderate risks.

Real Estate Outlook

Overview

Going into the second quarter of 2004, real estate fundamentals showed signs of improvement despite excess capacity and tempered demand. This improvement was attributable to restrained supply and patient capital that was willing to absorb weakening net income streams. The low interest rate environment and the emergence of real estate as a defensive investment helped carry real estate through the bottoming out of the market.

Although conditions remain guarded and fundamentals continue to languish, the real estate market is well positioned to weather the inflection point. At this stage of the cycle, attitudes are beginning to shift from survival and tolerance to optimism and growth. Thus, investors, developers, and lenders are expected to pay more attention to opportunities to break out of the doldrums and capture the economic upturn. The positive momentum for the asset class is likely to sustain it even if the recovery is dampened or deferred. Although there will be selective opportunities to hit homeruns, most investors and developers will be content with the current investments and perhaps more patient than if the downturn had been shorter and investor psyche were less tolerant.

Office Market

The office market has had a difficult time over the past few years, with private and public returns lagging other property sectors. Despite disappointing performance, investors continue to pay close attention to the sector. The office market accounts for a significant proportion of the "investable" universe and has historically benefited from market recoveries more than other property sectors. Concerns remain, however, related to the off-shoring of jobs and uncertainty regarding job formation in the economic recovery. In addition, a significant volume of underutilized shadow space remains, masking what might be a challenging environment.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

In spite of these concerns, there has been a modest improvement in occupancy rates in the office market. Major indicators suggest, however, that this improvement will be a gradual, with net absorption rates continuing to trail long-term averages. Thus, rents are likely to lag, suggesting a relatively steady state during this phase of the economic recovery.

It should be noted that low interest rates have provided owners and investors with a cushion against declining revenues and fixed expenses. Assuming the interest rate increases gradually, the improvement in market fundamentals should be sufficient to absorb moderate increases in the cost of capital. Looking forward, despite concerns in the office market sector, capital flows remain strong, helping maintain a healthy pace of transactions.

Retail Market

Over the past several quarters, the retail market has continued to pleasantly surprise, due in large part to strong consumer demand that helped support existing space. The retail sector also benefited from strong investor capital flows, drawing off of the strong performance in the public and private arenas during 2003. While retail REIT returns have lost some of their luster, they remain competitive with respect to other property sectors, leading all property types in year-to-date figures. This situation carried over to the private market, where retail returns in the first half of 2004 were almost double those of other property types and outperformed their public counterparts. This performance advantage can be traced to a combination of strong leasing activity and a moderate increase in effective rents.

As in the past, the retail sector continues to be one of the more dynamic property types, with retailers and property owners continuously reinventing themselves to respond to changing demographics, urban growth patterns, and consumer demand. During much of the 1990s, with the exception of smaller retail properties, private investors eschewed retail due to this constant change. Over the past five years, however, investors seem to have become more comfortable with the sector, with strong performance outweighing concerns over uncertainty. The sector also benefited from the sustained consumer-led economy, which was characterized by strong retail sales across many merchandise categories and price points. The ability of retailers and investors to respond to shifting demographics and business cycles, has served the industry well. While the consumer-led economy is expected to take a brief respite, the outlook for retail remains positive as retailers fine-tune their strategies.

There is a growing concern over the proliferation of new retail formats, especially with the growth in lifestyle centers and mixed-use developments. While there are a number of compelling arguments behind the growth of such developments, the lack of empirical research regarding "what works, where, when, and why?" is of concern. Going into 2004, the momentum behind such investments is anticipated to dramatically increase, especially as developers from other sectors were drawn into the mix in search of new niches to tap. Thus, looking forward, the retail arena will be one of the more interesting property sectors to watch, with some winners and losers yet to emerge. Despite this caveat, the retail sector overall should continue to perk along as consumer confidence picks up, holding its own relative to other property sectors.

Industrial/Warehouse Market

As has been the case for a number of quarters, the industrial sector continues to exhibit moderate fundamentals, both on the spatial and capital sides of the equation. In terms of investment performance and investor demand the results have been relatively strong both on the public and private fronts. On the spatial front, however, the environment continues to be relatively flat, with excess capacity acting as a drag on the fundamental supply/demand balance in many prime industrial markets.

Despite this overall rating, the sector did experience positive absorption going into the fall. When coupled with a decline in new construction activity, the vacancy rate declined moderately, although it remained above historical averages. In this environment, rents have continued to languish, with low interest rates and costs of capital providing some cushion for the sector.

Going forward, the sector is expected to pick up some momentum as the economy gains ground in terms of industrial production and warehousing activity. Despite these gains, the sector will likely remain relatively flat in terms of rents and occupancies. This monition is especially true with respect to older space that fails to measure up to state-of-the-art requirements in many industrial sectors.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Apartment Market

The modest improvement in the apartment sector, reported earlier in 2004, has carried into the fourth quarter. Unfortunately, the prospects of new product coming on line over the near term have dampened the outlook. Nonetheless, apartment returns in both the private and public sector have been generally positive. As such, investors continue to maintain healthy appetites for apartments, although appreciation rates have been somewhat tempered as the reality of market fundamentals hangs over the property sector.

The demand side of the market should benefit from the economic recovery, with the anticipated moderate rise in interest rates unlikely to shift tenure choice further toward homeownership rather than rental. In some cases, the lack of mobility associated with sticky homeownership (i.e., time on the market, selling expenses, and punch lists) might move to the forefront, causing homeowners to rethink their pursuit of the American dream of homeownership. This phenomenon will be especially acute in markets suffering net job losses, with limited demand available to help executive exit strategies. For some the situation may be analogous to the plight of institutional investors who learned about the importance of viable exit strategies when the market collapsed a decade ago.

Regardless of whether this scenario unfolds, prospects for the apartment sector look fairly positive, assuming the supply side of the equation can exhibit more discipline and investor capital—both debt and equity—can resist the attraction of new construction. Looking forward, apartment market fundamentals should experience some moderate improvement, although the ability to increase rents will prove elusive in many markets. This situation is expected to continue over the near term, creating a relatively stable but unspectacular outlook with some upside potential.

Conclusion

In the fall of 2004, hurricanes, the election, global unrest, and moderate but uneven improvement in the economy will likely dominate the press. At the same time, the real estate market should continue to gain ground and draw the attention of investors, as the spatial markets begin to firm up, albeit gradually and somewhat unevenly. This situation is good news for the industry, which is unlikely to become a target for new stimulus programs designed to propel the economy forward.

Assuming the supply side remains constrained—and all indications support this conclusion—the outlook for real estate is modest but stable. As the economy improves, the real estate market will have some upside potential with relatively moderate downside risk. Thus, the industry has a somewhat stable foundation upon which to build as it moves into the second half of the decade. This will create the ability to capture above-market returns as a reward for taking risks and differentiating offerings to respond to changing market demand. The year 2005 should be an interesting one in which creative, entrepreneurial responses will be rewarded, while reactive or passive approaches will lag. Even in the case of risk-averse behavior, however, improved market conditions should help investors capture attractive, risk-adjusted returns if attention is paid to real estate fundamentals.

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

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.