# At the Crossroads of Expansion and Recession

*by James R. DeLisle, PhD*

## Commentary

Over the past several years, the U.S. economy has enjoyed a period of record-low interest rates, low inflation, and relatively strong growth in terms of gross domestic product (GDP), corporate earnings, consumer spending, and consumer wealth. Much of this growth can be attributed to the strong housing market, which both benefited from, and contributed to, the low interest rate environment.

Over the past six months, the situation has dramatically changed. One of the most visible elements of this change is the rapid erosion in the housing market. While some were caught off guard by the retrenchment in housing, industry experts knew the record run-up could not last. The challenge was figuring out what the trigger would be and when it would be pulled. As a result, a number of players got caught in the correction, joining homebuyers who were drawn into the fray. Unfortunately, the effects rippled across the housing market. Thus, the overstressed strands of market support from the subprime market began to unravel and started to collapse.

While the housing market is a long way from bottoming out, the real question facing consumers and businesses is whether it is an isolated event, or a symptom of widespread problems in market fundamentals and stability. This uncertainty, coupled with recent weakness in employment and an anticipated slowdown in GDP, has many questioning whether the U.S. economy might slip into a full-blown recession.

This concern no doubt was factored into the Federal Reserve's (Fed) move to ease interest rates. Despite this much-needed stimulus, for a number of players, the possibility of a recession will remain a real and frightening prospect. At this point, the oddsmakers are betting that the United States will be able to avoid outright recession. However, many investors, consumers, and businesses are likely to adopt a defensive posture.

## The Economic Environment

### Economic Growth

During the third quarter of 2007, troubles in the housing and credit markets began to weigh heavily, setting the stage for downward adjustments in GDP growth. While the prospects of a recession have increased, a more likely scenario is a temporary slowdown that will extend into 2008. The mere fact that fears of a recession are being more widely discussed should put the GDP in the spotlight and create pressure on politicians and policymakers to pay closer attention to the downside risk for the economy.

In addition to the much-publicized housing market, several factors have tempered the outlook for the GDP. Of particular note is the growing crisis in the subprime mortgage market, which is symptomatic of the market excesses created by the combination of easy, cheap credit. While most attention is focused on the residential side of the equation, the reliance on financial engineering and aggressive underwriting that has characterized the competitive commercial market is also a cause for concern.

The plight of the subprime market has rippled across the credit markets, creating upward pressure on spreads and renewed interest in pricing risk in securitized investments. The surprising decline in jobs reported in August caught many off guard. These declines spoke to the tentative nature of business as this sector tried to understand the mixed signals in the economy and get a better handle on the debt of the credit crunch. Business will pay close attention to the role the Fed is willing to play to help avoid

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a recession. The aggressive move by the Fed in its September 18th meeting should go a long way to appeasing business's concerns.

On a positive note, even before the Fed stepped up to the plate, business investment in plant and equipment held up relatively well and corporate balance sheets remained relatively healthy. On the government side, there has been some improvement in the federal deficit, although some remain concerned over hidden liabilities that are being accrued for various entitlement programs and are not being reflected in the official figures.

The cheaper dollar has helped on the export front, including both the manufacturing and distribution sectors. At the same time, the decline in the dollar has helped attract international investors searching for short-term gains and long-term investment opportunities. On the other hand, the weak dollar has put downward pressure on imports, although consumers have not made major adjustments in preferences for American-made products over imports. This situation could change, as scandals surrounding additives in pet foods and lead paint in toys force more scrutiny on the safety of imports and the lack of government inspection at critical points in the supply chain.

Unfortunately, the reliance on self-regulation and monitoring makes more scandals a real possibility. While these risks may not play out, when coupled with weaknesses on the job front, continued high energy costs, declining investment performance, and softening of wages, the prospects for retail sales are somewhat clouded. Despite the many pressures that consumers face, they are expected to do their part in the absence of further unanticipated shocks or surprises in the fragile residential market.

### Employment

During the third quarter of 2007, employment growth eroded with moderate increases in service jobs being partially offset by declines in production employment. Employment growth was also dampened by layoffs in the residential market, as well as the financial and service sectors that had expanded to meet the frenetic and seemingly insatiable appetites for housing and ancillary goods and services. Within the construction industry, some of the losses in residential employment were offset by expansion in the private commercial sector, although the skill sets of displaced workers and the location of new employment opportunities were somewhat out of line.

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While the slowdown in employment growth has attracted a lot of attention, not all is negative on the employment front. For example, the health care and service industries continued to lead in job formation. Unemployment levels are fairly stable. Productivity levels have also remained relatively strong, allowing companies to maintain margins and strong balance sheets. Finally, the sluggish job market is taking pressure off wages, a situation that is likely to carry forward for the balance of the year.

### Inflation and Interest Rates

Going into the Fed's September 18th meeting, the latest inflation report suggested that core inflation had remained in check. In the current environment, it is likely that inflationary forces will remain in check over the near term, although energy and health care costs will remain a concern.

The increasing concern over the plight of the economy placed additional pressure on the Fed to ease rates in its September 18th meeting. The Fed surprised many, making something of a preemptive strike with a 50 basis point cut in both the federal funds rate and the discount rate. This move triggered a quick reaction onshore, as investors scrambled to action.

Offshore, the signal was reminiscent of the half-full/half-empty debate, with investors reacting positively and the dollar slipping due to concerns that inflation risk was worse than previously perceived. The fact that the decision was unanimous, and pointed out the importance of sustaining economic growth in addition to fighting inflation, suggests rates may ease a bit further if conditions warrant.

While the Fed has not backed off on its avowed fight against inflation, it has become clear that the Fed is willing to walk the fine line between inflation management and recession inducement. Indeed, the Fed has made it clear that it is not going to step in to bail out the stock market or the housing market and risk fueling inflationary pressures that could easily flare up. However, the Fed's actions would be quickly reversed if inflationary pressures begin to mount.

Over the near term, interest rates charged to businesses and consumers should trend down slightly as rates are passed through to the broader market. At the same time, however, it is likely that spreads will increase, especially for higher risk investments that may suffer from the subprime syndrome.

### Business Indicators

In general, business indicators remain rather healthy, although a recent report from the Business Roundtable suggests that CEO confidence has eroded. Some pessimism can be traced to the housing and residential credit-related markets and the fact that the issues these industries face may be precursors to those in the broader market. There are a number of positive indicators that are noteworthy. Productivity levels have held up, although gains have been moderate compared to earlier in the expansion cycle. Labor costs have continued to creep up, although the recent weakening of the job market in August should take some pressure off wages. Business inventories increased in the second quarter, but the rate of buildup has held fairly constant. On the other hand, the inventory-to-sales ratio climbed moderately.

At the wholesale level, inventory-to-sales ratios experienced gradual declines before flattening out in the third quarter. Capacity utilization has remained relatively flat. The decline in rates may help stimulate greater investment. Orders for durable goods showed some moderate improvement in the early summer although the declining housing market took some wind out of consumer durable sales. In general, manufacturing activity pulled back, although the retrenchment was moderate and in line with some of the uncertainty surrounding business and consumer demand. On the other hand, the airline industry showed some gains.

### Stock Market

As with the rest of the market, the stock market has had a fairly rough ride. Somewhat understandably, investor sentiment has wavered at times, due in large part to a generalized concern that the economy has lost sufficient momentum. While these issues have played out over the past several months, the unexpected decline in jobs in August was a major source of consternation, as investors worried that it might have underscored a fundamental weakness in the economy.

When the Fed in September acted in a decisive manner, the stock market experienced an immediate surge as prices adjusted to lower rates. Over the short term, the asset-backed sectors that have suffered the most retrenchment and other sectors depending on credit and investor confidence are likely to be beneficiaries, taking some of the downside risk off the table.

Despite this adjustment, investors are likely to remain skittish, with some concluding that the threat of recession is actually higher than they anticipated and is what forced the Fed's hand. The language in the Fed's statement left the door open for more changes. In this environment, investors can be expected to try to insulate their portfolios from downside risk, while they ride out the extended wave in the market. At the same time, some investors will be drawn to the emerging void in asset-backed products, attracted by the lure of wider spreads and the prospects for improving fundamentals as the economy works through this phase of the cycle.

### Consumer Confidence

While consumer confidence levels have slipped during the year, the silver lining is the fact that they have remained relatively flat and have not plummeted out of control. This is especially true in light of the troubles plaguing the housing market, the slowdown in employment growth, the weak wage growth, and the continued high energy costs.

As has been the case for the past several years, consumer confidence levels have not held across the board, but have been correlated with the economic status of consumers. For those at the top of the food chain, confidence levels are relatively strong, while those at the moderate and lower levels are reflecting increasing stress.

The erosion in confidence levels is particularly pronounced for consumers facing the prospects of upward adjustments in floating-rate mortgages and those looking to lines of credit to support already strained budgets. Over the next six months or so, the fate of the housing market, employment growth, inflation, and interest rates will weigh heavily on consumers. Similarly, interest rates will play an even more important role than normal, as this situation is a dramatic reversal for consumers.

### Retail Sales

Given the current state of the economy and consumer sentiment, aggressive selling and marketing will likely characterize the critical holiday period. While these efforts may draw consumers into stores, the pressures on consumer spending are unlikely to go away over the near term. However, an easing of credit going into the holiday season may help ameliorate some of the pain that credit-stretched consumers would otherwise face.

As has been the case over the past several years, there are some bright spots at the higher end of the market, which has proven to be resilient and insulated from the fate of the general economy. Also, auto sales have benefited from strong promotions, the introduction of a spate of new models, and growing interest in hybrids.

Going forward, the Fed's aggressive rate cut should provide some solace to consumers and help cushion retail sales from more downside risk. However, the cut is likely to have little impact on purchasing power, as it will take time to work its way into spendable cash. Rather than a near-term stimulus to sales, the impact will be somewhat belated and defensive, taking pressure off consumers that would have been hit hard as mortgages with variable rates and teaser rates reset.

The auto industry is likely to experience more immediate benefits from the decline in rates. Lower interest rates could also help avert some bankruptcy filings and consumer credit problems. Over the near term, the cut may reduce consumer anxiety over the prospect of a recession and provide a modest boost to sales. Sales growth for the balance of 2007 is expected to be moderate, but at one of the lowest rates experienced in over five years. If the economy holds ground, holiday sales should be up moderately, but below that of 2006.

### Housing Market

The housing market has come under tremendous scrutiny as new home sales have plummeted, existing sales have stumbled, and inventory levels have dramatically increased. In August, annualized housing starts declined to the lowest level in over a decade. This overall decline was dampened somewhat by an increase in multifamily construction that has partially offset the decline in single-family starts.

Construction permits also have declined significantly, suggesting that the housing sector is likely to continue to struggle well into next year. Despite this deceleration, completions will likely outpace sales. In terms of mortgage choice, buyers are expected to pull back on adjustable-rate mortgages (ARMs), which should cut market share in half, and fall in line with historical standards. Unfortunately, those stuck with current ARMs may have no choice as fixed-rate options may be beyond their grasp due to tightened lending standards.

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The correction in the housing market that is being played out was inevitable and had been creating concern for many observers. However, a number of industry insiders, investors, and businesses operating in ancillary sectors were caught off guard by the speed and broad scope of the collapse.

In addition to marginal buyers who depended on a combination of easy credit and lax underwriting, the reversal has also hit at other price points, including those depending on jumbo loans and those who made limited down payments and are now facing an equity crunch. While households who are not actually in the market may not feel the drag on the housing market, the industry will be closely watched.

The subprime mortgage market and the related collapse of the housing market have raised attention on a number of fronts, triggering a combination of soul searching and finger pointing. The soul-searching will be the most challenging for the first-time homeowners who were drawn into the market by the lure of easy credit. However, previous owners who stretched beyond their means to compete for more expensive housing, or cashed out the paper wealth associated with rising values and turned to variable-rate mortgages and low-equity options, will also face some soul searching as the tides turn.

Unfortunately, a growing number of these households will find themselves upside down in financing, where mortgage debt exceeds equity interest and the exit strategies are compromised if nonexistent. Even when there is positive equity, a repeat of the recent tightness in the jumbo loan sector may create difficulties at the upper end of the market.

On the finger-pointing side of the equation, a spate of lawsuits can be expected as the subprime crisis unfolds. Congress, policymakers, and candidates for office will likely look for someone to blame. At this point, the outcome of these debates is unclear and the form that interventions may take is unknown.

> "Recovery in the office market may well stay on track."

However, one needs only to look back to the outcome of the commercial real estate market collapse of the late 1980s for some insights as to what might happen. Borrowing from that experience, it is likely that some efforts will be made to allow existing government programs to increase conforming loan limits, provide some insurance to encourage investors to take on added risk, and purchase troubled residential mortgages.

Given the sanctity of the housing market in this country, it might appear that such approaches would be givens. However, naysayers will argue that it would be bad policy to bail out the secondary market, which in many respects helped create the problem in the first place. These same critics are likely to have little empathy for households who took advantage of easy credit that far exceeded their long-term capacity to buy. Tremendous scrutiny is also likely to be paid to the business practices of various market facilitators who benefited from the transaction volume but faced little or no risk.

When all is said and done and the market bottoms out, the housing recovery is likely to be a drawn out, painful process. This is particularly true for those at the end of the food chain who may ultimately lose their homes and be tainted with bad credit ratings. The likelihood of such a scenario is evidenced by some of the Federal Housing Administration's intervention approaches that have been discussed.

Under one of the early proposals, the program would only be extended to households who have been able to maintain payments and have not fallen behind in mortgage payments. Those who got in trouble early would be left to work out their own problems. Another proposal discusses increases in ceilings on conforming loan limits that could be purchased or insured by government agencies. Such increases are unlikely to close much of the gap in souring housing prices over the past several years, limiting their impact on the broader market.

Even moderate increases in maximum loans is likely to trigger heated debates about the wisdom of bailing out affluent homeowners who got caught up in the market while there is a crisis in providing adequate low- and moderate-income housing. Thus, while these and other interventions may help ease some of the pain, there is not going to be a quick fix. Thus, the housing market will continue to create a drag on the economy and create some downside risk of a recession.

## Real Estate Outlook

### Office Market

The decisive intervention by the Fed and the quick response of the stock market suggest that recovery in the office market may well stay on track. This suggests that the moderate improvement in occupancy rates should continue over the near term. While concern remains over the fallout from the subprime market and slippage in CEO confidence levels, there are no deal breakers on the horizon. This outlook is important to the overall office sector in light of the increase in construction activity that has begun to spread across the country in anticipation of a strengthening economy.

At a national level, vacancy rates have continued on a downward path, with central business districts (CBDs) outperforming suburban markets both in relative and absolute terms. At an aggregate level, CBD vacancy rates are pushing 10%, a dramatic improvement over the past several years, while suburban rates are lagging by some 3%. A number of attractive CBDs are in single-digit territory, setting the stage for new construction. Over the near term, however, the CBD/suburban spread is likely to widen, since the bulk of the recent wave of new construction is occurring in the suburbs and in second-tier markets.

The recent improvement in vacancy rates is leading to some much-needed increases in rents, with temporary spikes in some thin markets. Unfortunately, these increases are neither sufficient nor sustainable enough to match the increases that had been built into pro forma projections made at the top of the market. Fortunately, the capital pool for office products is ready to step into the fray, although speculative investors may have to leave something on the table relative to expectations made in the not-too-distant past.

Annualized office returns in the National Council of Real Estate Investment Fiduciaries (NCREIF) Index make it the leading property sector, which should provide a halo effect and attract additional capital.

Similarly, the extinction of Equity Office has removed one of the major office players, skewing investor capital to other office real estate investment trusts (REITs), which will provide a near-term stimulus to returns.

This relatively stable situation should hold over the near term, although the inimitable spirit of developers suggests they are more than ready and willing to step up to the plate with new supply. The tightening of lending standards, greater recognition of risk, and rising costs should help maintain a semblance of the current balance of supply and demand, leading to gradual but unspectacular improvement in fundamentals.

### Retail Market

At this point, aggregate additions to new supply in various formats have more than caught up with demand in the retail market, setting the stage for increases in vacancy rates and some softening in the sector. This situation has been exacerbated by moderation in retail sales growth. The decline can be traced to a number of factors, including consumer reaction to the growing crisis in the housing market. In addition to changing consumer psyches, the housing market decline has eliminated the housing market subsidy of purchases that had been provided by refinancing and equity lines of credit.

The Fed's move to ease rates should take some of the downside risk out of the equation, setting the stage for a competitive but somewhat disappointing performance for the once high-flying sector. Indeed, in the private market, retail performance has already begun to lag other property types. Despite this relative slippage, performance still outpaces the broader equity market and remains above long-term averages.

The story on the public side of the market is similar, with retail REITs outperforming other property types. Unfortunately, the numbers are all on the negative side of the ledger due to the widespread contraction in REITs; retail REITs merely had lower negative returns. Going forward, once the capital markets settle down, retail performance should benefit as consumers return to the registers and the economy improves.

The inflation-hedging potential associated with percentage leases may also offer some respite for the sector if the Fed loses its battle against inflation. Indeed, while creating some near-term problems, an increase in inflation could rekindle interest in real estate relative to other asset classes.

### Industrial/Warehouse Market

At a national level, the industrial/warehouse market has been relatively flat, with vacancy rates hovering around the 10% level. It should be noted that this steady-state performance occurred during a period in which additions to stock fluctuated, attesting to the ability of the property sector to respond to changes in demand in a tempered manner. This discipline is due in part to the quick response time for new product and the smaller scale of development relative to major office buildings or large regional malls.

Although the manufacturing and durable goods sectors have experienced some softening in terms of domestic demand, the cheaper dollar and emphasis on global trade have helped stimulate the sector. This positive impact has been even more pronounced for the warehouse and distribution sector, which benefits from improvements on the export front and strong demand for imports. These factors have helped maintain balance, but have yet to be translated to significant improvements in rents.

Of all property types on the public front, industrial REITs have suffered from the least erosion in value and are postured to benefit from stimulation of the national economy. On the private front, industrial returns have been competitive, reflecting solid fundamentals and continued interest from investors. This situation is likely to hold, with the easing of credit and prospects for economic expansion leaving some upside potential for the sector.

### Apartment Market

The crisis that is rippling across the country on the single-family front has a number of implications on the multifamily rental market. The good news is that the rental market has slowed down the pace of new construction. In some urban centers, this trend was driven by the fact that condominiums squeezed out rentals, with developers opting for short-term profits versus long-term rental income. Thus, in a number of markets, there have been relatively limited additions to rental supply, especially in the moderate or affordable end of the spectrum.

This contraction in the rental pool was amplified by the spate of condominium conversions that extracted existing product from the rental pool. The combination of these forces, together with renewed migration to cities, allowed the apartment market to benefit from improving fundamentals when a significant percentage of potential customers opted for ownership. Thus, once the single-family and condominium markets hit the skids, the stage was set for improvement in the rental market.

This situation is still being played out, suggesting upside potential for existing product in terms of occupancy levels and rent. While a number of speculative investors drawn to the condominium and single-family market are expected to turn to renters to help cover fixed costs, the fact that such efforts will be fragmented and lack the benefit of centralized management provides little risk for investors. In this environment, apartments are expected to outperform relative to the levels of the recent past, as well as to other property types that they have lagged during the recent cycle.

## Real Estate and Capital Markets

### Capital Market Overview

The turmoil in the residential market and the ripple effects of the subprime crisis have not been lost on the commercial side of the industry. Given the heavy reliance on creative financing and leverage to support prices, there is growing concern that the commercial market may suffer from some of the same excesses. The good news is that real estate fundamentals are exhibiting some signs of improvement, although in many cases not sufficiently robust to meet pro forma assumptions that were used to make deals.

The cheap dollar should provide some relief, with foreign investors expected to increase efforts to penetrate the market and take advantage of any opportunities created as others step back. In this environment, the pace of activity should remain strong, although the number of bidders may contract and the time to close may stretch out to allow more scrutiny on both the equity and debt sides of the table.

### Construction Activity

The strongest sectors in construction activity were office, retail, hotels, manufacturing, and hospitals. Public construction activity levels have also been strong, providing stimulus to the nonresidential segment. Although the overall residential sector was down, it should be noted the multifamily sector is experiencing continued growth. This situation is likely to continue as the single-family sector struggles with excess inventory and tepid demand, shifting attention toward the rental sector. Investor demand for product will also help fuel this trend, although the overall housing market is likely to remain under pressure well into next year.

The good news for residential developers is that the market's retrenchment has taken some of the pressure off construction costs. Unfortunately, the same cannot be said for the commercial market, where continued expansion put additional pressure on costs. This upward pressure on prices was especially pronounced for infrastructure projects. This situation will be exacerbated by the continuing global surge in demand for construction materials, especially from China and other emerging markets.

While rising costs will remain a concern for developers, they may help take some of the momentum out of the surge in new construction, which could help the U.S. market avoid a downturn if the economy stutters or the anticipated growth in demand does not materialize. However, the moderate rise in costs and the length of the current pipeline suggests a fairly active outlook for commercial construction. On the public side, deferred infrastructure investment will also likely receive more attention that will spill over to private investors seeking new outlets for investment opportunities.

### Commercial Mortgage Market

The plight of the residential mortgage market has not been lost on the commercial sector, drawing attention to recent underwriting standards and credit standards. Although the extremely competitive capital market for commercial real estate put pressure on commercial lenders, the initial read is that the market should be able to avoid the fate of its residential counterpart. However, there are some risks in the market that bear watching, especially at the bottom end where risk management by transfer to the secondary market has shifted the business model of many originators as it did on the residential front.

The recent increase in commercial loan delinquencies and foreclosures is of some concern, although a ready pool of capital on the equity side that can step in without turning to debt provides some insulation. However, this blanket of protection will not be spread across the entire industry, but will become increasingly selective in terms of underlying market fundamentals.

In September, on the heels of the subprime debacle, the market paused, with commercial mortgage-backed security issuances at a low point not experienced in recent years. This reaction was a characteristic of the broader asset-backed sector, and was not isolated to commercial real estate products.

The rise in delinquencies and foreclosures in commercial real estate, while still relatively low, punctuated the concern of investors and focused more scrutiny on the entire industry. This put issuers and rating agencies on the defensive, calling attention to the potential for sell-side bias that some have argued is a lingering time bomb. Rating agencies responded by focusing attention on their reliance of objective, fundamental analysis and pointing out their track records to date. While this provided some reassurance, more scrutiny is expected.

The market has already reacted to some of this attention, with issuers modifying offerings by pulling out mortgages that would likely raise red flags. While this trend should help with new issuances, it will do nothing to ameliorate problems in current issuances, especially those exposed to interest rate risk and lean equity positions.

Despite a growing sense of caution, over the near term the mortgage market should experience a round of tightened underwriting standards and some elevation in spreads. However, there should be a more than adequate pool of capital to help maintain recent activity levels, although the speed and competition will likely taper off.

**Private Equity Market**

The private equity market has continued to enjoy strong performance, with investors holding prices and contenting themselves with lower cash flow yields. There are some signs that capitalization rates may finally be moving up a notch, although strong investor demand and improving market fundamentals will place something of a governor on the rate of increase. With price increases moderating, total returns should start coming down.

However, this outlook is not new to those who have thought for some time that a correction was imminent only to be faced with strong double-digit returns. Even if investor demand moderates, the potential for declines in value will be cushioned by the lower yield requirements that have been built into institutional holdings. The growing spread between public and private returns suggests that the private market may be in for some pricing adjustments.

Core real estate holdings should enjoy some insulation from major price pressure over the near term, although they are at the top of the cycle. At the lower end of the market, which has depended on more aggressive use of low-cost debt, the picture is not as sanguine, suggesting a growing vulnerability to correction. The Fed's easing of credit will take some of the risk out of this proposition, although spreads are expected to begin to widen as attention shifts to the risk side of the equation.

> "The rise in delinquencies and foreclosures in commercial real estate punctuated the concern of investors and focused more scrutiny."

All in all, the private equity market should be relatively stable, with some downside risk in total returns as investors shift attention to market fundamentals and relative returns. This rather sanguine outlook draws on the assumption that mortgage rates will stay relatively low and access to credit is not compromised by the subprime problem emerging in the commercial arena.

**Public Equity Market**

A number of trends that occurred in the public equity market bear some attention and could affect the industry going forward.

First, consolidations will remain a major factor in REITs, with the Blackstone/Equity Office transaction as the most vivid example. Of particular interest and providing a strong statement to the exuberance in the market, was Blackstone's ability to edge out Vornado in the bidding and lay off major clumps of assets at more aggressive pricing and lower yields. The fact that a number of REITs are trading discounts to net asset value (NAV) suggests that this trend may continue in the form of a combination of friendly mergers and hostile takeovers.

Another noteworthy trend is the movement toward privatization of REITs and, in a less visible form, the growth of buyback programs and insider trades. Again, the discount to NAV, coupled with the low yields on new acquisitions due to strong competition for investments, has been a contributing factor to this trend. In this environment, a number of companies have concluded that buying back their own stock is a prudent investment of surpluses that will ultimately translate to higher prices and improved performance.

The continued trend toward globalization of real estate is another factor that is affecting REITs. This influence is something of a dual-edged sword, with both positive and negative implications on performance.

On a positive note, some REITs are expanding operations offshore in an attempt to capture new investment opportunities, leverage existing infrastructure and talent, and improve performance. Similarly, the cheap dollar and improving fundamentals in real estate are attracting offshore investors to the sector, helping to support prices and creating a foundation for growth when yields rise to make new acquisitions accretive.

On the other hand, the dramatic increase in REIT-enabling legislation across the globe has expanded the competitive pool of companies. This expanded choice, coupled with increased interest in global real estate investing, suggests that some of the capital that would have worked its way into domestic REIT coffers will be skewed offshore.

Again, over the near term, this dilution will be offset by the cheap dollar, which makes U.S. real estate investing more attractive even at the high prices that it commands. Finally, the relatively low levels of debt among REITs should provide some insulation from interest rate risk if the Fed is forced to renew its tightening to fight inflationary forces down the road.

## Conclusion

The U.S. economy is at an interesting crossroads, at a tipping point between renewed economic expansion and slipping into a recession. While concern over the threat of a recession is relatively new, the seeds have been planted for some time and began to spring to the forefront during the past several quarters. However, concerns have become more firmly ingrained in the economy as evidenced by the Fed's aggressive move to ease rates at its September meeting and its willingness to step up to the plate again if needed, to help sustain or rekindle the economic recovery.

While the Fed's actions brought some welcome relief, the economy is by no means out of the woods, especially with the continued meltdown of the housing market and the subprime debacle. Despite these adverse forces, the current read is that the economy will go through a moderate slowdown in economic expansion, but will avoid slipping into a recession. The fact that we are heading into an election year offers additional credence to this forecast.

The outlook for moderate GDP, employment, and business expansion seems both reasonable and likely, with some expansion in retail sales also in the cards. Inflation should remain in check while short-term interest rates will remain low, helping take some pressure off of long-term rates as risk begins to be added back into required spreads.

In this environment, capital flows to real estate should continue on a positive track, although not at the frenetic pace of the past. Yield requirements should begin moving up as attention focuses again on risk, and commodity pricing should evaporate with increasing attention being paid to real estate fundamentals.

There should be a steady supply of debt to support the market, although underwriting and equity requirements will be more disciplined than in the recent past. Some properties that are upside down–burdened with excess debt on limited earnings potential–will be put back, both in the public and private arenas. Investors should be ready to step in for the spoils, and this should help avoid any need for a formal government bailout.

At an overall level, market fundamentals should improve, although some markets and property types are in danger of becoming overheated. The bottom line is a return to fundamentals, with spatial markets taking the lead and capital markets following.

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