

The Capital and Spatial Divide: On a Path Toward Convergence

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Commentary

Going into the summer of 2003, the economic scene is capturing more attention than in normal times when the focus would be on vacation plans instead of the stock market. There are signs that we are emerging from the endless stream of challenges of the past eighteen months. The national psyche remains guarded, however, due to the uncertain economic and geopolitical scenes. This situation is unlikely to change soon. Thus, business and consumer confidence should wax and wane, rising with intermittent good news and falling with signs of trouble.

The domestic economic scene has a number of persistent trouble spots (e.g., employment, stock market turmoil) as well as new problems (e.g., deflation). This situation is confusing to consumers and investors and creates ripple effects for businesses trying to emerge from the economic malaise. While there are signs that the economy might be turning in the right direction, there is little evidence that such improvement is sustainable. Also, there are heated debates over which economic battles are worth fighting and how to approach them. For example, although the Jobs and Growth Tax Reconciliation Act of 2003 was signed into law, debates continue over whether it will stimulate the economy. Many are questioning the motives and rationale behind the tax plan, especially in the face of growing budget deficits. The widespread fiscal crisis that has rippled across state and local government coffers has created a situation where it is difficult to focus recovery efforts, especially in times of limited resources and growing needs.

Although the geopolitical and economic scenes have nagging trouble spots, there is some good news on both fronts. For example, the initial military conflict in Iraq was resolved rather quickly and with limited U.S. casualties. On the economic front, in-

terest rates remain extremely low, with the housing market continuing to power forward despite earlier signs that it had peaked. Consumer confidence bounced back in late spring, suggesting that consumers are ready to pick up on good news and overlook some of the lingering challenges. Most recognize, however, that the carryover effects will be with us for some time. Heading into the summer, it is likely that this situation will continue, setting the stage for an uneven recovery and new challenges.

With respect to the real estate asset class, expectations and realizations appear to be converging in the capital and spatial markets. Over the near term, the capital markets will continue to accommodate additional weakness in the spatial markets. However, capital will remain disciplined and will focus on longer-term performance and relative risk. As such, sourcing product will continue to remain a challenge, with lenders and investors being forced to accept lower yields to compete for investments. More opportunistic investors are expected to emerge from both sources of capital; for these investors yield has become more important than mitigating risk. Real estate market fundamentals are expected to fall in line with the broader economy, with a lag in recovery attributable to the excess supply and overcapacity that characterizes the current market. As the economy begins to turn around, the real estate capital and spatial markets are expected to converge, resulting in increased yields that should start during the next twelve to fifteen months.

The Economic Environment Economic Growth

The U.S. economy continues to struggle, with few signs of an imminent recovery. In the 2003 first quarter, Gross Domestic Product (GDP) growth was slightly under 2%, on par with expectations. This situation has been

a major disappointment to prognosticators who thought the favorable resolution of the war in Iraq would jump-start the economy. As it turns out, the economic problems in the U.S. have roots that extend far beyond the military conflict, stemming from deeply seated economic weakness. It will take time to address these fundamental issues, so the economic environment will remain a challenge over the near to intermediate term. On a positive note, the stock market continues to flirt with a recovery, although there remains some doubt over whether recovery is sustainable. Alan Greenspan remains committed to thwarting off deflation, hinting that the Fed might cut rates once again if the situation does not improve by early summer. In evaluating the level of economic growth, it is important to factor in the productivity gains seen over the past several years. The end result has been upward pressure on the level of GDP growth needed to support job growth. This has raised the bar and makes the launch of a sustainable recovery more difficult.

While there are some signs that the economy may be posturing for growth, a more realistic assessment is that the economic climate is stabilizing with tempered growth as a likely scenario for the next twelve months. The Institute for Supply Management index shows that nonmanufacturing activity (which makes up around two-thirds of total U.S. economic output and is largely service-based) rose to a five-month high of 54.5, above the level of 50 that is considered evidence of expansion. Assuming conditions remain relatively stable, business, investor, and consumer confidence may ultimately be restored sufficiently to break out of the doldrums. A number of risks remain, however, and there is significant potential over the near term for further erosion. As such, a certain level of cynicism and uncertainty will temper the reaction to improving economic signals and stimulus measures. This reaction is evidenced by the controversy surrounding the recent tax cut.

The Jobs and Growth Tax Reconciliation Act of 2003 triggered debates regarding the nature, magnitude, and distribution of benefits. Indeed, there have been debates over whether the tax cut is needed, with Federal Reserve Chairman Greenspan arguing the economy is on the right track and will grow during the second half of the year without such a stimulus. He has also reiterated his belief that deficits do matter, and that they should weigh heavily against short-term benefits. Others question the efficacy of the tax cut in stimulating the economy, because the distribu-

tion of benefits is unlikely to stimulate widespread consumer spending. Despite these debates, it is generally agreed that the Act will provide some short-term stimulus to the economy. However, it is also recognized that the tax cut will create significant issues in the long-term, where the real costs will be borne. The magnitude of these costs is uncertain since the \$350 billion measure could more than double if the temporary measures are extended. The tax package has a number of key features that are noteworthy.

- **Tax Rates:** replaces current tax rates with a simplified, lower structure ranging from 25% to 35% at the top compared to 27% to 38.6%, retroactive to the beginning of 2003
- **Capital Gains:** shaves 25% off capital gains tax rate, reducing the rate on investments held at least a year to 15% from the typical 20%; short-term capital gains will be taxed at an individual's income tax rate
- **Dividend Tax:** introduces a 50% reduction in the top dividend tax rate, falling to 15% from the current 38.6% maximum
- **Child Tax Credit:** doubles the credit and applies it to the alternative minimum tax (AMT)
- **Marriage Penalty:** reduces the penalty with a 10% deduction for dual-income households
- **Business Spending:** expands the temporary tax break for business spending
- **Small Companies:** increases write-off to \$100,000 from \$25,000; raises ceiling for first year write-off to 50% from 30%
- **Death Tax:** phases out the federal tax by 2005, although states may not follow suit
- **Charitable Deductions:** extends deductions to non-itemizers
- **Alternative Minimum Tax:** increases exemption for married couples to \$58,000 from \$49,000, with a similar increase for unmarried taxpayers
- **Research and Development:** makes temporary tax credits permanent
- **State Aid:** provides \$20 billion in aid to states in 2003 and 2004

The impact of the tax cuts will be mixed, creating sets of winners and losers. For example, with less tax on dividends, stocks that pay high dividends should increase in value. The change also will place more pressure on companies to pay dividends, although the ability to pay will depend on an eco-

conomic recovery and will come at the expense of reinvestment. The provisions of the tax cuts will force individual investors to take a fresh look at their investment and tax planning in order to take advantage of the changes. Decision making will be complicated by the fact that many of the changes are temporary and will be phased out after several years. While some argue the cuts will be extended, it will depend on the state of the economy and the level of concern over the rising long-term federal deficit.

The flagging U.S. economy and weakening dollar have led to criticism on the global scene, with some European and Japanese leaders suggesting the situation will undercut a global economic recovery. This issue triggered pointed discussions at the recent meeting of Group of Eight (G8) leading industrialized nations. This ripple effect is particularly pronounced in the five G8 countries that are in a recession. There is concern that the global situation could worsen if the U.S. does not take action to bolster the dollar or lets it slip in an effort to bolster domestic manufacturing by increasing demand for exports. There is also concern that U.S. tax cuts could exacerbate the situation, raising long-term deficits and current account deficits. On a positive note, concern over the dollar is forcing some countries and the European Central Bank to take a hard look at their own economic competitiveness; this may add pressure to address some of the structural issues that inhibit growth. It is anticipated that interest rates in Europe are in for a round of decreases, pushing them to the lowest levels since the euro was introduced. Despite these efforts, the intertwined U.S. and global economies will continue to have downside risks. There are prospects for a global recovery, but it will depend on concerted efforts rather than natural forces.

Employment

Despite some signs of a stabilizing U.S. economy, there has been little relief on the employment front. Unemployment continues to be one of the major trouble spots, inducing Congress to extend unemployment benefits again as the economy struggles and the duration of unemployment increases. While the benefits extension is welcomed by the unemployed, it is a defensive measure that does not address job growth. During the first three months of the year, stronger than expected productivity gains were a mixed blessing; good for corporate bottom

lines, but bad for employees. Indeed, during the first half of 2003, businesses lopped off more than one million jobs. When combined with the lack of expansion hiring, the unemployment rate rose above 6%, with more job cuts on the horizon.

On the technology front, the moderate increase in business investment has yet to translate into jobs. Many manufacturers continue to shift jobs overseas and productivity gains have offset the demand for workers. The SARS epidemic might throw a wrench in the technology sector, as the supply chain has been streamlined to the point that it is vulnerable to disruption by a major health crisis. On the demand side, if the business climate continues to improve and companies look to technology as a way to bolster gains, the employment situation could change. There is growing debate in boardrooms, however, whether technology will fuel competitive advantage. Many companies are operating on a relatively level playing field after embracing technology during the last bull market. In addition, the rapid advances in technology have led to significant underutilization of existing capacity in many companies. There are few compelling new technologies that are likely to garner the approval of chief financial officers.

Inflation and Interest Rates

During the second quarter, inflation concerns have abated and have been supplanted by rising concern over deflation. This situation can be traced to a decline in consumer demand in the first quarter, which triggered a softening in retail sales. In addition, relatively inexpensive imports have undercut prices, pushing the economy closer to a deflationary cycle. Prices have declined for oil, electronics, and appliances. Not all prices have declined, however, creating a situation where consumers are reading about deflation but seeing prices rise, especially at drug stores. While deflation is not imminent, the economic devastation it could trigger is sufficient to move it to the top of economic concerns. Also, concerns over deflation are not confined to the U.S. For example, there has been a downward trend in prices across the European Union, with cheaper import prices contributing to the situation. Fears of global deflation are putting upward pressure on bond prices and driving yields down, both in the U.S. and Europe.

Although already at a historical low, interest rates are in for another round of declines. Assuming the Fed makes a move soon, it is likely to be around 50

basis points to offset some of the lingering weakness. This situation is echoed in Europe, where the rising euro has undercut exports and may force the European Central Bank to reduce rates to help restrain its rise. Due to rising global interdependencies, the impact of such cuts could be dampened by further declines in U.S. rates, thus putting even more pressure on the euro. While low interest rates are welcomed by many, they are creating frustration for investors searching for returns in a market characterized by uncertainty. In addition, declining rates are raising havoc with pension funds, many of which are underfunded and losing ground against the rise in obligations. This situation is likely to continue, with more downward adjustments on the horizon.

Business Indicators

Although business indicators remain mixed, there are a number of important signs that cause some optimism. The service sector was one of the bright spots in the economy in the second quarter, and this contributed to the most recent stock market rally. Components of the manufacturing sector finally began to pick up, with some companies ratcheting up for increased activity in the third quarter. There are few signs of improvement for business spending, however, with capital spending for manufacturers falling in 2003 and rising moderately for nonmanufacturing side. Current data shows declines in new orders, shipments, unfulfilled orders, and inventories. Unfortunately for employees, improvement in the manufacturing sector was largely attributable to productivity gains that bolstered margins and improved balance sheets. Despite the decrease in capital spending, production capacity rose among manufacturers and nonmanufacturers, a trend that is expected to continue throughout the year.

The U.S. leading index increased in the second quarter. A number of factors led to the increase, including the index of consumer expectations, real money supply, the stock rally, low interest rates, and a strong residential market as reflected in building permits. These factors were partially offset by rising unemployment, reduced work hours offset by higher productivity, and orders for nondefense capital goods. On another front, capacity utilization remains low, continuing the downward trend that began over three years ago. This underscores the challenges embedded in the economic recovery and suggests that real estate recovery will lag in terms of demand for

net new product. Nonresidential investment was a drag on growth in the first quarter, with a decline in inventory accumulation and a decrease in fixed investment. The plight of state and municipal governments continues to inhibit public investment.

Falling import prices, which have declined at the fastest rate since the late-1980s, bode well for business margins and consumer spending. Although much of the decline was due to falling petroleum prices, other prices have also declined significantly. With respect to exports, prices declined moderately in the second quarter, offsetting three months of gains. The weakening dollar may change this situation, although the economic weakness and deflationary pressures that have spread across the globe mitigate that risk. Looking forward, there is a growing sense that the business cycle will pick up some steam, bolstered by gains in investor and business confidence. Improvements on the business front may help propel the economy forward, however, there remains significant downside risk that should not be overlooked.

Stock Market

In late spring, the stock market began a rally that continued through early June. This suggests that investors are hoping for a rebound in the second half of the year and that marginalized investors are interested in reentering the market. This is evidenced in part by the reduction in spreads between treasuries and corporate bonds, as investors seek higher returns and eschew some concerns over risk. While there is hope that this rally is sustainable, investors remain extremely guarded. Within the equity market, the tax cut may create some upward pressure on returns, especially among dividend-paying companies. The tax cut will place greater pressure on companies to start paying dividends, which in the short run may be positive for share prices, but in the long run may come at the expense of reinvestment and growth. For smaller companies, the extension and expansion of tax credits for research and development (R&D) and business spending will tend to improve bottom lines and support new investment. However, REITs, which are single-tax entities, will not benefit from the changes and may lose some of their relative appeal.

On a cautionary note, investors are looking for any hints of scandal or insider trading that could impact individual companies or the broader mar-

ket. Unfortunately, corporate managers do not seem to be as sensitive to these issues as might be warranted; corporate insiders sold over \$3 billion in shares in May 2003, the fastest pace of selling in over two years and twice the pace of earlier in the year. While there are no suggestions of wrongdoing, the timing of this activity is unfortunate because investors are paying much more attention to such early warning signs. The surge in selling can be explained by the fact insiders are coming out of lockout periods where sales were restricted, however, such subtleties could easily be lost on investors.

Consumer Confidence

Consumer confidence rose in the second quarter, reaching its highest level in over a year. Given the difficult employment scene, the rebound was attributable in great part to the end of the war in Iraq. In addition, consumers appear to believe that the economic stimulus provided by the tax cut and the decline in prices will bolster the economy in the second half of 2003. This forward look is attested to by the present condition component that slipped moderately, while the expectations for the future catapulted forward. Assuming the recent trends continue, consumer confidence is expected to improve, but be tempered by concerns over jobs, rising health care costs, and geopolitical risk. Similarly, consumers will continue to fret over limited prospects for increasing their personal wealth due to low returns and high debt levels. They will also keep a close eye on the stock market and the balances in their 401(k)s. Thus, consumers will not lead an economic rally, but will be early adopters if the business sector or stock market can set the pace.

Retail Sales

In early 2003, a confluence of events ate away at consumer confidence and directly impacted retail sales. During the second quarter, there was some improvement. Chain store sales increased modestly, attributable in part to the late Easter that shifted sales out of the first quarter. Despite this increase, many retailers were disappointed, with cold weather taking some of the blame for weak sales. Drug store sales remained strong, reflecting a combination of broadened product lines, higher-margin seasonal sales, and rising drug costs. Durable goods were on the losing side of the equation, with low inflation and tempered confidence levels helping to justify

postponing major purchases. In general, Memorial Day sales were above par, with discounters continuing to lead as they have much of the past year. Retail sales picked up late in the second quarter as shoppers purchased apparel and price-cutting stimulated sales.

The auto industry continues its recent struggles, with record incentives not reducing inventories. This situation is not a surprise; it was clear that previous incentive programs were not creating net new demand, but were merely accelerating purchases and cannibalizing future sales. Going into the summer, incentives have risen to record levels, pushing \$4,000 per automobile. In addition, the need for incentives to compete has spread across the industry, beyond the slow-selling models. Foreign automakers have not been immune to the situation, forcing many to offer incentives to compete in the U.S. market. The weakening dollar may place a floor on their ability to meet the market, suggesting a likely slowdown in both domestic and foreign sales. This situation has already triggered some cutbacks in production as manufacturers try to reduce inventory and buy time until the economy recovers.

The outlook for retail sales is guarded to positive, with tax cuts nudging consumers back to the registers. Low interest rates should help stretch budgets, although consumer debt burdens remain high. While consumers will continue to refinance to tap into lower interest rates, surpluses from refinancing will be more tempered than in the past. Many households have already tapped into their equity and slower appreciation rates will limit the ability to capitalize on paper gains in house values. Similarly, unless global deflation sets in, prices will begin to bottom out as the weak dollar makes it more difficult for retailers to bring in lower-cost imports.

Internet sales remained relatively strong through the first half of 2003. Although sales growth slowed down in the second quarter, e-commerce sales continued to rack up year-over gains exceeding 25%, a solid figure by any measure. The market share of e-commerce sales remains modest, however, still accounting for less than 2% of total sales. When looked at from a broader perspective, the use of e-commerce tools has strengthened overall sales for many retailers. Within retail categories, growth in e-commerce sales has been strong for furniture and apparel. Going forward, there are some signs that e-commerce sales will continue to increase, especially with fall-

ing prices, improved service, and expanded use of high-speed connections in consumer households. Similarly, improvements in on-line navigation and simplification of product comparisons should bolster on-line activity.

Housing Market

After a temporary slowdown early in 2003, the housing market has picked up speed and is poised for a strong third quarter. Residential starts and building permits rose during the first quarter. In terms of new home sales, the strongest region has been the Midwest, while the Northeast lagged due in part to harsh weather. Median home prices have risen during the year, after a moderate decline at the beginning of 2003. Price increases were widespread, with the West leading and the Northeast lagging after getting off to a fast start. Thus, home appreciation has picked up again, fueled by a combination of solid demand and falling interest rates. At the same time, pressure on housing costs has abated, as the decline in commercial construction has taken the edge off of prices for materials and skilled labor.

The rebound and the prospect for a strong second half of the year has muted the debate over the sustainability of the housing market run. It is generally agreed that the housing market will cool off and not be able to continue to play the role of a growth engine for the broader economy. However, the adjustment has yet to occur. Housing continues to account for an increasing share of GDP, exceeding the role it played in 2002. The decline in interest rates continues to bolster the housing market. Last year real estate prices grew three times faster than household incomes, although housing affordability actually improved based on declining mortgage rates. Thus, it is clear that record-low rates have been priced into the market and will require a similar adjustment on the other side of the cycle as rates pick up. Given the economy, this situation is not likely to unfold until next year and, depending on the speed of a recovery and growth in income, it might be avoided.

On the demand side, record homeownership rates continued to grow during the first half of the year. Households are drawn to the market to tap into the investment potential and to bolster their quality of life. In the first quarter, the executive administration reiterated its support for homeownership when it announced the Housing

and Urban Development (HUD) budget. The budget included over \$110 million for the HOME Investment Partnerships Program targeted at increasing the supply of affordable housing for low-income residents. Additional funding was announced to provide \$200 million in down payment assistance to low- and moderate-income households. These efforts, combined with low interest rates and a moderate economic recovery, bode well for the housing market. The multifamily market, however, will still struggle due to lost market share.

Real Estate and Capital Markets

Capital Markets Overview

Heading into summer 2003, real estate capital flows continue to hold their own despite the much-anticipated deterioration in market fundamentals for most property types. This situation should continue; pent-up investor demand and modified return expectations have created a competitive environment for transactions. In some markets, prices of core assets are beginning to trade above replacement costs due to the absence of new construction. This would normally trigger a round of construction, but the supply side has been tempered by stagnant tenant demand, an overhang of surplus space, and lack of ready capital for construction loans. Total returns for real estate remain flat and below the double digits of the bull market, but still above other asset classes. Real estate will probably continue to look attractive to investors on a risk-adjusted basis. This probability is bolstered by the fact that real estate transactions during the past eighteen months have involved investors with realistic expectations of return potential. Since these investors are in for the long haul, there is little risk of a major downturn in values or a glut of product flooding the market if the stock market surges.

Low interest rates, coupled with reduced yield requirements and a ready list of buyers have set the stage for solid commercial transaction volume. Due to excess capacity across the board, interest will focus on existing product although yields will keep some investors on the sidelines. For example, opportunity funds that raised capital on the promise of 16% to 20% yields have a significant build-up of capital, with limited prospects for traditional equity investment. As such, they have turned to financial engineering, highly leveraged deals, mezzanine financing, joint ventures and entity level investing.

Others are seeking product through nontraditional channels, looking for motivated sellers wanting to quickly dispose of assets due to non-real estate factors. Finally, opportunity funds remain focused on international investments, however, international opportunities that can deliver high yields have remained elusive. The class of “core plus” investors—those seeking 200-400 basis point spreads over core investors—are increasingly looking at higher leverage, along with nontraditional assets in terms of life cycle, occupancy, or risk profiles. With core investors, emphasis remains on proven, leased properties, although many are starting to turn away from Class A product and search for stable assets with respect to tenant base and submarket position. Similarly, some funds are beginning to broaden their geographic concentration, looking for product in second- and third-tier markets. This situation is expected to continue, suggesting stable capital flows for both debt and equity positions.

Construction Activity

For much of the country, construction activity continues to be tempered, rising only moderately over 2002 levels. Construction activity has been tapering off in response to the weak economic environment and excess capacity. The strong housing market has helped bolster private residential construction. On the multifamily front, the situation is guarded; many markets remain oversupplied at the expense of occupancy rates, concessions, and effective rents. While some of this multifamily overhang can be attributed to an imbalance between supply and demand, it should be noted the demand side has eroded due to increased home ownership. In some markets, developers are betting on an economic recovery, and are adding new product in anticipation of a surge in demand; this could result in weakening fundamentals and exacerbate an already difficult situation. With respect to nonresidential construction, the sector has struggled to hold its own, with excess supply, tempered demand, and a lack of financing for speculative construction keeping a lid on new activity.

On the public side, budget deficits took their toll on construction activity, despite a slight upturn at midyear due to pent-up projects. Although the aid to states in the tax plan should provide some relief, the demand for funds for basic services and other deficit items is so great that it is unlikely the funds will flow to capital improvements.

Commercial Mortgage Market

Despite erosion in real estate fundamentals, there is a ready pool of investors in both the securitized markets and whole loan market. Heated competition has created a plethora of options that borrowers are snapping up to enhance yields and stabilize projects. The major sources of commercial loans—life insurance companies, commercial banks, savings and loans (S&Ls), commercial mortgage-backed securities (CMBS), Fannie Mae, and Freddie Mac—all remain active sources of mortgage capital. During 2002, lending by insurance companies remained strong, with a record-breaking fourth quarter. This momentum carried forward into the first half of 2003, although volume is being tempered by competition for loans. In addition, the spate of refinancing over the past several years will dampen activity levels due to the lockout periods, prepayment penalties, and yield-maintenance agreements attached to earlier loans. These market inhibitors will place a cap on volume and prevent many lenders from hitting production targets.

Insurance companies and most other private sources of permanent financing continue to hold to their conservative underwriting standards despite ready sources of funds and an interest in placing capital. As such, the declining rents in some markets are juxtaposed against debt coverage ratios, placing a ceiling on loan proceeds. The declines in rents are capping proceeds, even though rising property values associated with decreased yield requirements from institutional investors would support higher loan amounts. While putting some lenders at a disadvantage, especially for prime product, this system of checks and balances is a needed governor on price escalation and keeps the market in check. Some lenders, however, are more than willing to come to market to place capital, creating extremely attractive financial packages for borrowers. This is especially true for spread lenders, with benchmark figures continuing to trend down to record levels. With respect to types of loans, private sources of capital continue to favor fixed-rate debt, which accounts for over 90% of new loans. While this share has declined in response to market demand, the changes have been gradual. Lenders have also been moving to shorter-term loans, providing more flexibility and hedging against an increase in mortgage rates.

On the public side of the equation, the CMBS market continues to have strong market volume.

Through early May, CMBS issuances were up significantly over last year, with over \$24 billion of new issuances. In terms of types of loans, floating-rate loans have become more popular due to borrower demand and the inclusion of higher-risk properties. This shift impacts the types of investors drawn to the CMBS market and places a premium on an understanding of real estate fundamentals necessary to underwrite such investments. The demand for CMBS overall continues to be strong, with yield-driven investors focusing on positive spreads and relative values. However, there is an imbalance between the demand for higher-rated tranches and the lower-rated tranches necessary to support issuances and create a drag on volume. Similarly, concern over credit and lack of product may reduce volume, although CMBS volume for the year should be strong overall.

Many CMBS observers note with pride that loan delinquencies have been relatively stable over the past year, even as rental rates have declined and vacancies have increased. Although the shortage of new product creates some challenges in placing capital, the significant volume of maturing issues and the expiration of lockouts on existing issuances should keep transaction volume high. Some estimates place this business potential in the range of \$40 billion, which is moderate relative to total CMBS demand but significantly up from the prior years and reflects a maturing of the sector.

Looking forward, the ample supply of debt capital (both private and public) is expected to continue. Thus, investors should benefit from competitive bids from lenders who can deliver low-cost, fixed, or variable financing. This situation will be most pronounced for projects with credit tenants and stable earnings potential. The slight uptick in delinquency rates that has occurred pales by comparison with historical levels and remains well below those of the last real estate recession. The fact that the market has adjusted to the gradual erosion in real estate fundamentals, coupled with signs the economy may be turning, suggests that such a risk is manageable.

Private Equity Market

Heading into the third quarter, the private equity market remains strong, with investors struggling to find product, prices continuing to rise, and yields falling. This situation is likely to continue, with both institutional investors and noninstitutional investors seeking core assets with stable, predictable income

streams. A number of investors are stepping on the sidelines with respect to pricing, but others are following the market. In some cases these investors are accepting lower, all-equity deals, while others are turning to the mortgage market to leverage low coupons into acceptable returns. With mortgage rates at record lows, this strategy has allowed some investors to capture low double-digit returns with moderate leverage. This financial engineering might catch up on exit strategies if rates rise and yield requirements increase. Most investors, however, seem to be in for the long haul and are less concerned about near-term values than stable cash flows. This strategy is particularly important to core-plus investors who are seeking higher returns but are reluctant to accept the commensurate risk of noncore assets. Assuming the economy picks up, and capital does not flood out of real estate into other asset classes, such strategies may pay off for those with intermediate to long holding periods. However, investors with higher liquidity requirements or shorter investment horizons might be sacrificing holding-period returns in favor of short-term cash flows. The advisory community has been forecasting lower NCREIF Index returns—hovering around 7%—with ensuing investor backlash, suggesting capital flows should remain stable and investors remain patient.

Placing of product will remain a major challenge for opportunity funds (which have about \$20 billion to place), and for core-plus investors not able or willing to turn to leverage to enhance yields. Such investors can be expected to turn to more exotic means of accessing real estate, including entity-level investing and mezzanine positions. They also will seek out higher-risk product, either in terms of current occupancy levels or life cycle. Since few of these investors have the real estate expertise necessary to actively create value, many can be expected to turn to joint ventures or other partnership structures. In addition, some opportunistic investors can be expected to look for new product, trying to lock in higher yields associated with development risk. All in all, the outlook for private equity investors should remain strong, with memories of the troubled economic environment adding some discipline to the market and limiting the excesses of the past.

Public Equity Market

During the first half of 2003, the REIT market bounced back after a negative return in January. While

returns were disappointing to REIT investors, they were still competitive with other asset classes. During the balance of the first quarter, returns turned upward although still below those reported last year when the annualized returns were slightly above 5%. In the second quarter, REITs rebounded, finishing May with over 12% total returns on a year-to-date basis. This improvement was fairly widespread, with only the lodging/resort sector reporting negative returns. The stable underlying market fundamentals suggest there is limited risk of a major downturn. Even if REITs lose some value as funds from operations (FFO) decline in the face of weak spatial fundamentals, net asset values (NAVs) should hold due to strong investor demand for product on the private side.

The recent tax relief act provides some limited benefits to REITs with respect to the capital gain and dividend provisions. Since REITs regularly bypass the corporate tax on dividends, REIT dividends are generally ineligible for the 15% dividend rate established by the tax cut. However, the tax rate will provide some advantages to investors in terms of capital gains on the sale of REIT stock, REIT capital gains distributions, dividends attributable to taxable REIT subsidiaries, and dividends attributable to corporate level taxes (e.g., built-in gains or REIT distribution less than the required share). To the extent companies begin to offer dividends to investors that benefit from the tax relief, REITs may lose some of their luster with cash flow investors. Although REITs should continue to draw interest from investors, some of those drawn to the sector as a defensive move may shift out as the stock market improves. Given the turmoil that surrounds the market and the uncertainty over the economic recovery, there is little danger of a major implosion in the public equity market. For many investors, the recent challenges that turned their attention to public real estate equities in the first place can be expected to be rather "sticky." That is, once the investors have decided to add real estate to their asset portfolios and have adjusted their portfolio strategies to accommodate the new asset class, there is some inertia that will keep real estate in the portfolio. This situation should help carry REIT allocations through the bottom of the cycle until the economy and the real estate sector improve.

Foreign Investment

Despite the global criticism being leveled at the U.S., foreign investor demand for U.S. real estate remains

relatively strong. Some of this demand is a carryover from 2002, when foreign investors were unable to hit their 2002 investment goals due to the competitive market for product. Although some foreign capital sources have been willing to chase the yield curve down, others have joined their U.S. counterparts in trying to wait out the cycle. The weakening of the dollar bodes well for foreign investors, making high-priced U.S. real estate more affordable. In a relative sense, the global recession and fears of deflationary forces are offsetting some of the concern over the domestic economy, suggesting there will be an ample flow of foreign capital for real estate equity investments. As in the recent past, foreign investors can be expected to cast a wider net for real estate, looking at multifamily, industrial, and retail properties in addition to office properties, which have been their bread and butter property sector. In addition, foreign investors can be expected to broaden their geographic boundaries to include secondary markets and less-accessible primary markets. Deal size will continue to focus on larger transactions, although these levels can be expected to converge on those of their domestic counterparts. In the absence of new international trauma, foreign investment flows should continue to support the domestic equity market.

Real Estate Outlook

Overview

As noted last quarter, real estate fundamentals are weakening moderately across much of the country and for many property types. While some markets are beginning to stabilize, there is continued weakness in the business sector in general and employment in particular. The good news is that the erosion remains gradual, responding to further job cutbacks and postponement of expansion plans rather than any new driver. In most markets, high vacancy rates coupled with active sublet markets have placed a damper on rents, forcing many landlords to work hard to retain existing tenants and to restructure rental agreements to maintain occupancy levels. This general malaise will continue to hang over the market. When coupled with record lows in capacity utilization, it suggests that a spatial recovery will lag the general economy. This situation may vary by market and property sector, but early recovery will be the exception rather than the rule.

The tenants' market will continue, with owners becoming more aggressive in offering rental conces-

sions or rollbacks. The ability of current owners to adjust to the downward forces on net income is related to the plentiful supply of low-cost debt, especially for seasoned properties with strong rent rolls. There is little on the horizon that would suggest a major change in spatial conditions. However, due to the overhang of space and the on-going threat of geopolitical risk, there is more downside potential than upside promise. The good news at this stage of the cycle is that investors are willing to carry real estate through this phase, with high product demand bolstering values and blunting capital withdrawal. In terms of performance, the overall private equity market is on par with forecasts, with NCREIF Index total returns in the single-digit range. On the public side, total returns have been healthy, although the pace is expected to fall off and converge on private market returns as market conditions become more embedded in share prices. Despite these trends, real estate will remain an attractive asset class for investors, helping sustain transactions and provide liquidity for those seeking to take advantage of aggressive pricing for both core and noncore assets.

Office Market

During the first half of 2003, the office market continued to struggle with additional contraction in demand as many companies cut employment rolls and facilities. Unfortunately, there were few countervailing bright spots, creating a difficult leasing environment. As a result, the overall market experienced another bout of negative absorption, although not at the pace recorded during the dot-com compression of two years ago. Some of the recent improvement should be construed as temporary, since it can be attributed in part to Class B tenants moving into Class A space to take advantage of the renters' market. The good news is that the pace of additions to sublease space has tapered off, suggesting spatial commitments are coming into line with sustainable levels of demand. Assuming this pattern holds, office vacancy rates may flatten out and rental levels stabilize. While this outlook is hardly good news, it could be much worse if the development pipeline was not actually being burned off, as is the case.

Across the country, office conditions vary, with no discernable geographic pattern. Both strong and weak office markets exist among first-tier and second-tier markets. With respect to submarkets, con-

ditions remained stronger in downtown markets, due to the lagged effects from the surge in construction activity that started in the late-1990s. Interestingly, office construction in central business districts remains on par with long-term averages, while suburban construction has plummeted and is now on more equal footing in terms of construction levels.

As might be expected, office returns have fallen during this spatial adjustment, with private market returns moving into low single-digit territory, lagging other property sectors. During the first half of the year, office returns improved slightly, although the improvement still lagged other property sectors. Given the continued erosion in property fundamentals, the modest improvement in office returns can be attributed to strong investor demand for core assets. On the public front, office returns in the year-to-date period through May 2003 moved into the low double-digit range, a significant improvement over the negative return in 2002 and in line with the overall REIT index. Given the stabilization in the spatial market and strong institutional investor demand for product, the outlook for office investments remains flat to guarded, with the broader economic recovery being the key to a turnaround.

Retail Market

During the second quarter, the retail market took in stride the decline in consumer confidence. Retailer and investor behaviors suggest that they view the consumer pullback as temporary. The end of the war in Iraq, the avoidance of additional terrorist activities in the U.S., the tax cut package, and an improving stock market have helped rebuild consumer confidence and set the stage for a recovery in the retail sector. As such, there were no major shocks to the spatial side of the market.

Despite this observation, it should be noted the retail market continues to struggle to find the right equation in terms of long-term consumer demand and product offerings. Retailers and investors alike are responding to the times and seeking more effective ways to capture market share. Examples of such initiatives include experimentation with urban retail outlets by the traditional mall-based tenants and introduction of urbanized versions of big-box stores. While some retailers continue to struggle and bankruptcy activity has not abated, such events are isolated and can be traced to management errors rather than structural issues in the retail sector. On the leas-

ing front, the sector appears to be relatively healthy, with developers reporting gains in rents and pad prices. These gains are modest, but compared to other property types they are fairly robust and show few signs of abating.

Investor appetite for retail investments has remained remarkably strong during 2003 and follows record levels of investor demand in 2002. This interest is fairly widespread, ranging from grocery-anchored neighborhood and community centers to regional malls, which had been written off as the dinosaurs of the commercial real estate industry. Investors have also shown renewed interest in power centers, which had been eschewed by many who had concerns about a shakeout in big-box tenants.

Consolidation activity has been another major factor in shifting ownership patterns during 2003. This activity is widespread among REITs, ranging from regional malls to community shopping centers. It is not clear how far the trend will go, although over the past two and-one-half years, the number of shopping center REITs has fallen from thirty-one to twenty-one; this trend is expected to continue through the balance of the year. However, companies will have to retrench to ensure they can manage consolidated portfolios, which may be easier at the top end of the market due to the nature of tenancy.

On the private front, strong investor demand has helped bolster retail values, creating sector-leading returns last year that have carried through the first half of 2003. Given improvements in the economic outlook, returns should continue to be attractive, both on an absolute basis and relative to other sectors. In the public market, retail returns have tempered, but still have outperformed other sectors on a year-to-date basis through May. In a moderate adjustment among retail formats, smaller retail shopping centers have moved to the head of the pack, with regional malls trailing moderately. Looking forward, both the private and public retail sectors are expected to remain strong. Continued leadership on a total return basis will depend in part on investor interest. Given the prospects for improving fundamentals, this situation is expected to hold.

Industrial/Warehouse Market

Fundamentals in the industrial market continued to erode moderately during the second quarter. This situation can be attributed to a combination of weak demand and an increase in stock. It should be noted

that these increases were in line with the prior year and do not represent a major surge in activity. Some of the increase in construction activity can be attributed to the build-to-suit sector, where space users are taking advantage of the low interest rates to access more efficient space. On the rental front, industrial rates have been fairly stable, despite the slight deterioration in occupancy rates. This can be attributed in part to the relatively low unit cost of industrial properties that makes it feasible for tenants to carry excess capacity in anticipation of an increase in space requirements.

In terms of investment performance, private market performance for industrial investments picked up in the first half of 2003. It should be noted, however, that this improvement is attributable to strong investor demand rather than improvements in net operating income. In the public market, industrial returns have been disappointing through May; returns lag the overall index and are significantly down from 2002. The private and public sectors differ in that the private market has been willing to chase industrial assets down the yield curve, while public investors have been forced to the sidelines to avoid nonaccretive acquisitions. With respect to market fundamentals, the outlook for the sector is relatively flat, with some additional slippage before an eventual recovery. The declining dollar might bode well for the industrial sector if it translates to increased demand for exports. Imports might suffer somewhat, but the global deflationary pressures should decrease that risk.

Apartment Market

The overall housing market has experienced a prolonged bull market that has helped support the overall economy. Unfortunately for the multifamily sector, the real winner has been the single-family sector. Record-low interest rates have affected tenure choice, resulting in record homeownership rates. Home appreciation rates have added further stimulus to this trend by putting homeowners at an apparent advantage relative to renters. Over the past twelve to fifteen months, marginal buyers have increasingly been lured into the ownership position, cannibalizing demand for apartments. This situation is expected to continue, aided by prospects for further rate declines and implementation of home ownership programs sponsored by HUD. Because apartment owners, developers, and lenders did not

pick up on the conversion to home ownership, there has been overbuilding in the sector. As such, vacancy rates for apartments have increased, especially in the fastest growing markets where development activity has been concentrated.

In addition to raising vacancy rates, the imbalance between supply and demand has led to a spate of concessions such as free rent, which in turn has eroded net income streams. In the apartment market, shorter-term leases and higher migration/mobility rates make income more volatile than other property sectors. As might be expected, the deterioration in the spatial side of the apartment market has had a negative impact on returns. This situation has been most pronounced in the REIT sector, where apartments generated a negative total return in 2002. While public apartment REITs experienced a moderate rebound in the first half of 2003, the sector still lagged other property types in performance. Interestingly, the situation was different on the private market side, with apartments leading other property sectors—except retail—during 2002 and earlier this year. This apparent dichotomy can be explained in part by the strong private investor interest in apartments and the willingness to accept lower yields to capture core assets that can be held for the long term. Although some view the prospects for the apartment sector as guarded at best, the intermediate- to long-term outlook is more positive. As the appreciation rates slow and interest rates begin to climb, tenure choice can be expected to fall back in line with long-term averages and shift demand from homeownership to rental.

Conclusion

In a number of respects, the prognostication for the overall economy has improved over last quarter. The war in Iraq appears to be behind us, the tax relief act has passed, consumer confidence has ticked back up, and the stock market continues to flirt with a recovery. In the absence of external shocks, the economy appears to be headed in the right direction. There is still significant downside risk, however, and a number of false starts can be expected. There currently are few tangible signs of improvement. It is likely that there will be no major improvement until some

time in 2004, suggesting a moderate near-term outlook for economic conditions. In the real estate capital markets, there will be ample supplies of debt and equity capital, leading to a very competitive environment and keeping downward pressure on yields. While real estate fundamentals are expected to slip a bit further, there are no signs of a precipitous drop. Thus, although there will be a lag between the eventual economic recovery and a rebound in the real estate market, the market should remain active and fluid, setting the stage for an eventual recovery.

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