The Capital and Spatial Markets: Converging or Diverging?
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The Capital and Spatial Markets: Converging or Diverging?

by James R. DeLisle, PhD

Commentary

Over the past several years, real estate fundamentals languished as capital flows to the sector increased. The result was a strong bull market driven in large part by a willingness of investors to accept lower yields. This acceptance of lower yields was unusual in the sense that it reflected a repricing of the asset class without the promise of higher returns. Recently, this situation has changed as the improving economy has begun to stimulate demand and bring the spatial markets back in line with a more balanced supply-demand mix. Despite this improvement, the tremendous buildup in demand for assets has led to even more aggressive pricing. In some markets, this surplus of capital has led to increased construction, especially in attractive products such as condominiums, mixed-use developments, and life-style centers. While there does not appear to be any danger of a widespread surge in construction that could erode the market balance, fundamentals will play an increasingly important role in determining the winners and losers. Indeed, it is likely that a greater appreciation for the drivers of value and the ability to create and capture value will become more important to players in the real estate industry.

The Economic Environment

Economic Growth

In the second quarter, the U.S. economy appeared to be on firm footing. In general, economic growth remained relatively healthy, with most indicators coming in on the positive side. The economic expansion should continue, but moderate a bit in the second half of the year, and GDP growth is projected to come in at a healthy pace for the year as a whole.

The record federal deficit remains a major concern for the economy, it has not dampened current conditions or corporate and consumer attitudes. The outlook is for continued growth in federal spending, and this situation is expected to garner greater scrutiny. The trade deficit also continues to increase, as modest improvements in exports have more than offset gains in imports. Calls for more protectionist policies should draw more attention to trade policies and the commitment to fully participate in the global economy. In addition, efforts to introduce new laws to safeguard American security may jeopardize foreign investments. The record deficit with China, and China's increasingly important role as a trading partner also bear close watching and provides some downside risk on the global front. Finally, the generally weak economic prospects in other countries are a concern in terms of exports, although a continued U.S. economic recovery could have positive ripple effects on the global economy and provide some relief in the trade deficit.

Employment

In March, the jobless rate was near a five-year low after 400,000 new jobs were created in the first two months of 2006. In addition, there are some signs that wage growth is accelerating. Despite the improvement in domestic employment, employers remain guarded and focused on the bottom line. On a geographic basis, employment gains were fairly widespread with the majority of states reporting improvement, especially the Sun Belt markets. The Midwest continued to languish due in part to sluggish durable goods.

Unemployment rates also improved in early 2006. The pace of mass layoffs declined, suggesting that corporate retrenchment may have subsided. The exception to this is in the automobile industry where further contraction is expected in the face of sluggish demand for domestic product. Over the past several years, modest improvements in productivity have taken pressure off employment; however, there are no signs that this situation will hold. Companies

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are expected to look to an increase in labor and productivity, although further improvements may have to come from the employment side of the equation.

Debates are expected to continue as policymakers struggle with immigration reform and job loss to international competitors. The wave of unauthorized immigrants has created a number of ripples that have affected state and local governments trying to figure out how to approach this new labor force. Domestic companies struggle with how to compete in a more global economic environment. States seek to protect their economies. At the same time, the offshoring of jobs and globalization has loomed in the background. While compromises are likely to be hammered out that will provide some respite for current unauthorized workers who have been in the country for a period of time, the ultimate resolution and its impact on the economy will remain unknown for some time. In the meantime, an expanding domestic economy is likely to take some pressure off the debates, although concerns stemming from national security considerations will remain.

Inflation and Interest Rates

Inflation remains the number one enemy of the Federal Reserve (Fed), especially as the labor market improves and recent price gains continue. While no major surge in inflation is expected, the recent figures are at the upper boundary of what the Fed feels is acceptable as it searches for the elusive neutral point. Producer prices have softened due to declining energy prices. Import prices have continued to vacillate, with no clear upward pattern to suggest inflationary pressure. The long-anticipated slowdown in the housing market may take some upward pressure off inflation if consumers rein in spending as expected. However, there are no signs that health costs will moderate, and energy prices remain a wild card. Despite some upside risk, inflation is expected to remain in check, although pressure may build as the labor and materials markets tighten.

At the beginning of Chairman Bernanke's tenure, many hoped an understanding of economic fundamentals would make it easier to anticipate where the Fed was headed in terms of interest rates. During the Fed's meeting in March, observers were forced to fall back on linguistics, analyzing subtleties in wording to help anticipate future changes. Despite concerns over the economy, the Fed felt pressured to continue to increase the federal funds rate as it has in the past fourteen straight meetings, hitting the highest level since April 2001 at 4.75%. Haunted by the fact that short-term rates have exceeded long-term rates in advance of the past six recessions, the flat-to-inverted yield curve has created angst in a number of circles. However, the strength of the economy, and confidence in the Fed's ability to strike a balance between controlling inflation and maintaining economic momentum, has helped avoid widespread concern over a recession. Indeed, there is some evidence that the decline in long-term rates reflects a relatively benign view of inflation and strong capital flows. At some point, the yield curve should begin to return to more normal spreads, placing additional upward pressure on long-term rates. At the same time, increases in short-term rates should ripple over to the mortgage market and help nudge rates up.

In general, rising rates should further dampen the residential market and reduce refinancing activity. It also may lead to an increase in fixed-rate mortgage activity. The outlook is for greater uncertainty about interest rates, with key questions being where the Fed will ultimately draw the line and when the yield curve will return to a more normal pattern.

Business Indicators

The general consensus is that businesses will have to take the lead in helping the economy hit full stride. During the 2006 first quarter, this situation largely played out, with leading business indicators generally positive. For example, after a weak start, nonmanufacturing activity has picked up, continuing the improvement last year that was partially derailed by the hurricanes. At the same time, the manufacturing sector appears to be on a positive path as companies gear up in anticipation of further economic expansion. While inventory levels built up, the ratio of wholesale inventories to sales has continued to improve, as increasing sales have offset a moderate increase in inventory levels. On the purchasing front, the news continues to be positive, with gains in new orders and employment fueling more expansion. Although there is still excess capacity, the growth in demand should continue to increase utilization rates and may lead to more expansion in plant and equipment. Over the near term, the outlook is for increased business spending as companies respond to improvements in the overall economy.

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Stock Market

The domestic stock market has been caught in a choppy, upward slope. For example, despite some near-term volatility, the NASDAQ Composite Index continued to hold during the first quarter, finishing off slightly above the year-end figure. The Dow Jones Industrial Average and the S&P 500 experienced similar patterns, reflecting the tension between rising interest rates, a strengthening economy, and anticipation of improved earnings. While the markets have not shown any signs of a rally, the general outlook is for respectable returns as the recovery stays on track. However, investors continue to be skittish, with concern over the slowing housing market, consumer confidence, retail sales, oil prices, rising interest rates, and inflation nagging away at their confidence. The appetite for U.S. securities from foreign investors will be a concern, especially if the trade and budget deficits continue unabated and protectionist attitudes translate to restrictive legislation. Despite this anxiety, the market seems likely to continue in a give and take mode. Aggressive investors will seek higher returns by picking individual stocks and targeting sectors; longer-term players will be content to ride out the market.

Consumer Confidence

The somewhat surprising resiliency in the housing market and improvement in economic indicators and employment have helped bolster consumer attitudes. However, rising gasoline prices, flat wages, increasing health care costs, the rising deficit, and the prolonged war in Iraq continue to trouble consumers. Despite these concerns, consumer confidence rose in the first quarter of 2006, outperforming expectations and reaching a four-year high. The rebound also offered further evidence regarding the overall strength of the recovery and its spillover to consumers. Confidence levels were particularly high in terms of current conditions, indicating that consumers anticipate more improvement in the long-term prospects. While this optimism is a welcome sign, confidence levels will depend on the overall economic recovery. In the absence of a major shock associated with the delicate geopolitical situation or a collapse in the housing market, consumer confidence should hold fairly well. If the economic expansion continues, and employment and wages show more signs of strengthening, confidence levels could further improve. Rising interest rates and inflation will also be an important component of this overall equation.

Retail Sales

While retailers stumbled a bit through the holidays, retail sales rebounded to a fairly robust pace in January. There was a slight pullback in consumer spending in February, with weakness across the board in most merchandise categories. Despite this setback, there are no signs of a major reversal for retailers during 2006. Indeed, chain store sales posted four straight weeks of improvement through mid-March. The recent rebound in consumer confidence levels, and the likelihood that the economic recovery will lead to additional gains in employment and wages, suggests a fairly stable year for retailers. However, the cooling off of the housing market, increasing interest rates, and record consumer debt provide some downside risk to the outlook.

In terms of sectors, the most challenging area of retail will be in the automobile industry where sales are a major concern as the industry struggles with excess capacity and inventories. The electronics industry should benefit from the lagged shipment of product during the holidays; new innovations in cellular technology; the graying of lines between phones, PDAs, and MP3s; and declining prices for HDTVs. The computer sector is likely to struggle a bit, especially with the delayed release of Microsoft's new operating system, which might have stimulated sales across the industry. The bottom line is that overall sales should come in at a healthy pace.

Housing Market

During 2005, the dramatic rise in housing values, coupled with low mortgage rates, created momentum in that sector. In January, housing starts peaked even as housing analysts began to forecast a decline in residential activity for 2006 as a whole. As the year unfolds, the robust housing market appears to be slowing. This deceleration is reflected in a number of indicators including inventory build-up, longer times on the market, and flattening appreciation rates. While there are signs that pricing levels are set to decline in some markets, the fact that housing prices tend to be sticky on the downside has prevented any major patterns from emerging. Although there are few signs of a major adjustment to current values, the housing market has begun to exhibit signs of a slowdown. This market adjust-

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ment was evidenced by the 10% decline in new housing sales that occurred in February. In anticipation of a deceleration, builders pulled in the supply reins leading to a decline in residential building permit activity. Construction activity is still high by historical standards, however, and may be subject to further contraction. The building industry will be squeezed by a combination of rising costs for materials, labor, and land in the face of downward pressure on prices. Despite this pressure, the industry should be positioned to weather the storm. There are few signs of a major correction in housing prices, but activity levels will decline and sellers will likely become more creative, especially those needing to sell quickly.

Real Estate Outlook

Office Market

The office market has begun to benefit from job growth and corporate posturing for the recovery, with vacancy rates continuing to decline. The rate of improvement in market fundamentals has been somewhat measured, lagging the overall economy. Despite the gradual pace of improvement in market conditions, the activity levels in the transaction market and increases in appreciation have been much stronger. Indeed, 2005 was a record year in terms of transactions with over $100 billion of properties changing hands. This situation was partly due to profit taking as institutional holders cashed in on low cap rates. With respect to submarkets, central business districts (CBD) have faired better than their suburban counterparts in terms of vacancy levels. However, due to higher absorption rates in the suburbs, the more recent trend has reflected stronger improvement in the outlying areas as smaller companies gear up for the recovery. In terms of construction, activity levels are also creeping up as developers dust off projects that were shelved in the past downturn.

The most significant activity is in the suburbs, with lower barriers to entry and a more responsive supply pipeline than in CBDs. The pent-up demand for debt and equity deals and the search for higher yields have also attracted capital to development deals. In spite of renewed interest in development, activity levels are not expected to explode as they did in the past cycle. Assuming this pattern holds, rental rates should continue to increase, creating some shuffling of tenants. There is some downside risk associated with dependence on the economic recovery, increasing construction activity in some markets, and the potential for cap rate increases as investors begin to focus on risk-adjusted returns

Retail Market

The retail sector appears to be relatively healthier than other property types in terms of market fundamentals. This can be attributed to the decline in construction of new regional and super-regional malls, and the moderate pace of additions of smaller retail product. At the same time, the strong consumer run, fueled in large part by the booming housing market, has allowed retailers to expand and absorb new space.

In terms of construction activity, lifestyle centers, redevelopment, and urban mixed-use projects are garnering the most attention. This situation is likely to continue as retailers experiment with new concepts and off-mall strategies to hedge their bets against reliance on regional malls. The market dynamic has forced regional mall operators to revisit existing properties, leading to a round of renovations and expansions to add more lifestyle attributes to maintain market share. Construction activity will depend on access to capital and the ability to avoid getting drawn into new fads that are long on investors and short on consumers. This risk is particularly true in the case of markets where successful concepts are imported without an adequate understanding of the local demand and supply characteristics.

Industrial/Warehouse Market

The industrial market has improved along with the economy, benefiting from the combination of an improved manufacturing sector and active distribution channels for imports. Given the growth of the economy and prospects that the expansion is gaining further traction, the industrial sector is poised for more improvement. Indeed, the increase in capacity utilization levels, and shifts in location to take advantage of competitive advantages in costs or logistics, should continue to stimulate demand and make for an active leasing market. In anticipation of further improvement in market fundamentals, industrial construction activity has accelerated. In some markets, the ready availability of land and capital has created the potential for a major surge in construction. While much of the growth in demand and supply will be concentrated in major manufacturing and distribution hubs, smaller markets are

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also expanding as supply chains get more refined and logistical models seek out new modes that offer some competitive advantage. There is some concern over relatively flat rental increases that still lag levels achieved during the late 1990s. On the other hand, rising costs for concrete and cement, upon which the sector depends for raw materials, should focus attention on the underlying economics behind new construction. Despite these concerns, the pent-up demand for investments and ready access to debt will help bolster construction levels. At the same time, cost-related concerns should help keep new product in line with demand and focus more attention on market balance and fundamentals.

Apartment/Condominium Market

Concerns over the cooling off in housing appreciation and rising interest rates have begun to slow the conversion of renters to owners. This situation is likely to continue as the housing market falls more in line with historical patterns. The moderate pace of new apartment construction, coupled with the conversion of product to condos in some markets has helped in terms of market fundamentals. The prospect of new job growth, and the need for more mobility to take advantage of the new employment opportunities, bodes well for the sector. Demographic trends will also favor the sector both in terms of increasing demand and the need for more flexible, customized solutions that apartments can offer. Assuming construction levels remain tempered, rental rates and occupancy levels should improve providing some upside potential. As with other property types, strong investor demand and ready capital should keep prices up and yields down over the near term.

The condominium market has been on an upswing in a number of urban markets, with price gains outpacing their single-family counterparts. This resurgence can be attributed to a number of factors including low-interest mortgage rates and strong appreciation. A number of markets were able to draw suburban owners back to central cities in search of enhanced urban living and reduced commuting times. This trend continues to play out in a number of markets. While the trend toward more dense urban housing solutions is laudable, there is a danger of overbuilding. In addition, it is unlikely that the condominium market will escape the impending housing slowdown, especially in markets where investors have fueled the recent absorption. While no collapse of the condominium market is anticipated, the sector will be more scrutinized than in the recent past.

In terms of workforce housing, one effect of the prolonged bull housing market has been a run-up in prices that dramatically outpaced salary increases. This along with government efforts to manage growth, the gradual increase in mortgage rates, and increasing inflation will eat into housing options for many moderate-income households. Interest will increase in creative approaches to providing more affordable housing, and this suggests upward pressure on new construction, although the challenges associated with solving the underlying problems should forestall any major surge in new construction activity.

Hotels

After several difficult years, the hotel sector is enjoying renewed vigor. Increases in business and leisure travel have helped stimulate the industry. The general mood in the industry has been characterized as euphoric. This general perception is evidenced by renewed investor interest and ample flows to the asset class. The industry continues to offer more customized solutions, seeking to match guest experiences with demand. Market fundamentals have benefited from constraints on new supply, although the pipeline is beginning to build up. Despite interest in new construction, the near-term prospects are for further improvements in the sector. Given the nature of the hotel sector, a round of new construction may be on the horizon that could change this sector's dynamic. Whether the demand will stay in line depends on the durability of the economic recovery and the impact it has on business and tourist travel.

Real Estate and Capital Markets

Capital Market Overview

The real estate capital markets have continued to provide surplus flows to the industry, helping maintain downward pressure on cap rates and force yield-driven investors to take on more risk. At the same time, longer-term investors have served up more product as they convert unrealized gains to realized gains at the peak of the market. This situation is likely to continue over the near term, with the prospect of increasing fundamentals helping to justify even more aggressive acquisitions. In some cases, investors are turning to new construction activity even though ris-

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ing costs have put additional pressure on margins. While this trend has been relatively mild overall, it has resulted in fairly significant activity in a number of markets. The situation bears some watching, especially because some of the capital sources fueling the market have limited experience in real estate. Of particular note are buyers and capital providers who appear to believe that cap rates have structurally shifted downward and will not revert to long-term averages. Over the past five years, cap rates have declined across the board, with multifamily housing leading the pack in both absolute terms and spreads over ten-year treasuries.

While low yields remain a concern, they should hold over the near term due to the overhang of equity capital seeking to access the asset class. While the historically low yields provide some downside risk to values, there are signs that the bottom of the cycle may be softened by the economic recovery and the growth in demand. There is some danger of overheating, especially with respect to newer investors operating in new structures (e.g., tenancies-in-common, foreign investors) or new arenas (e.g., mixed-use, lifestyle centers) for which long-term track records and risk profiles have not been established. Despite these risks, there are few signs of major market disruptions. Thus, while commercial real estate remains fully priced, the market is likely to stay the course over the near term.

Construction Activity

There are a number of signs that suggest that construction activity levels will increase, especially as the post-hurricane recovery activity shifts into high gear. During the first two months of 2006, nonresidential starts increased almost ten percent on a year-over basis. While the much-anticipated slowdown in the residential market will put something of a damper on construction activity, early indicators suggest that further expansion in the commercial arena and pressure on infrastructure investment will carry construction activity forward. The softening in the housing market will help take some pressure off of building material prices. Despite this relief, building prices are expected to continue to increase as activity levels accelerate, and the lagged effects of energy prices and high demand for raw materials place upward pressure on commodity prices. In terms of property types, commercial construction activity is expected to be led by hotels, office, and retail. On the public front, education and infrastructure investment are expected to lead the increase in construction activity. Thus, the outlook is for a healthy construction market, with the residential sector something of a wild card.

Commercial Mortgage Market

The commercial mortgage market has largely paralleled the real estate equity market, with a surplus of capital chasing limited opportunities. There is some concern regarding the apparent relaxation of underwriting standards for commercial mortgages, which have caught Chairman Bernanke's attention and led him to suggest commercial banks should reconsider their risk management policies. Despite this concern, there are no signs of a surge in troubled loans, with delinquency and foreclosure rates still below long-term averages. However, the level of structured financing and increases in unsecured development loans remain something of a concern.

Despite rising short-term rates, mortgage rates have held fairly stable and low by historical standards. This pattern reflects the combination of an inverted yield curve in which risk is not being priced or perceived, and there is strong competition for product. The competitive element has placed downward pressure on underwriting, and has forced lenders to be more aggressive and flexible than in more normal times.

During 2005, commercial mortgage-backed securities (CMBS) activity increased at a frenetic rate, with total issuance almost double that of the prior year. The most dramatic growth was in non-U.S. assets, although U.S. asset volume and market cap continues to dominate. In early 2006, the pace backed off somewhat, although the pipeline is active. Spreads remain attractive and borrowers continue to be attracted to the sector. Thus, CMBS should experience another strong year as transaction and refinancing levels provide ample opportunity for new issuances.

On the residential front, delinquency and foreclosure rates have crept up, although there are no signs of an impending crisis. The recent increases in short-term rates and the inversion of the yield curve have created an interesting environment for the residential market. Some borrowers with variable rates are opting to lock in relatively low long-term rates to avoid additional increases. On the other hand, the gradual rise in mortgage rates and the

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prospects for more increases has put a damper on traditional refinancing activity. However, the increase should be manageable, especially if homeowners begin to benefit from wage gains and increasing employment levels.

In terms of new trends in the mortgage market, the struggle between bankers and credit unions over fair play and competitive advantage will continue to play out in courts and legislature. This battle stems from credit unions expanding their customer base, size, and geographic scope. Some credit unions have begun to move into more lucrative areas of lending and have introduced more competition for attractive loans. Credit unions can be expected to continue to expand and look for creative ways to expand their asset bases and business lines. The end result may be additional sources of credit, which may be particularly helpful to smaller and more marginal deals that typically are the first to feel the impacts of a tightening of credit.

Private Equity Market

The private equity market has continued to surprise on the upside, with investors continuing to chase scarce deals and hold prices for new acquisitions at near-record levels. While cap rates have continued to bottom out and have dipped to new lows, low yields have done little to arrest the frenetic pace of activity. On the other hand, owners continuing to hold assets for long-term investment have enjoyed surprisingly strong returns that belie underlying market fundamentals and have outperformed forecasts. While many marvel at the resiliency of the private market and the resolve of investors, the fact that implicit cap rates for NCREIF have fallen to levels lower than those in 1989 is a source of concern. Furthermore, while the prior downturn was prolonged and took several years to play out, the recent decline in yield has been dramatic. In comparing the speed of the recent decline in cap rates to the surge in the latter 1980s, the rates of change are quite similar. In terms of historical experience, the rates of change are atypical and unparalleled. As other asset classes begin to pick up and gain momentum, the patience and apparent lack of risk-based pricing for commercial real estate will be both interesting to watch and challenging to negotiate. Thus, while there is a possibility that the recovery could bail out the private market, historical behavior and long-term averages place some downside risk on this outlook. While these caveats are a concern for the intermediate to long term, over the near term, prospects are for business as usual. Thus, the private equity market is expected to continue to operate in a low-yield range, with investors pushing the envelope in anticipation of improving market fundamentals and rising rents.

Public Equity Market

Over the past five years, real estate investment trusts (REITs) have outperformed other equities, providing total returns of around thirteen percent, with a strong dividend component. The solid REIT performance has continued in 2006, and total returns pushed the double-digit level at the end of the first quarter. While it is unlikely that REIT returns will increase dramatically over the near term, the economic recovery and improving market fundamental should be attractive on a risk-adjusted basis and continue to attract investors to the asset class. While the real estate market is clearly fully priced, the dividend yield in REITs ensures that total returns are reflective of distributable cash flows. This anchor differs from the private sector where recent high returns are being driven by the appreciation component. Among property types, industrial and apartment REITs experienced the strongest returns over the past year, with momentum in apartment returns carrying it beyond the rest of the pack in early 2006.

Retail returns have lagged the overall index, although at a subproperty level, regional mall REITs led all property types. Going forward, retail REITs are expected to provide attractive returns, although the upside potential for the overall industry is somewhat limited as interest rates and costs of capital increase.

Interest will increase in public REITs that are candidates for privatization, as managers seek more flexibility to create value. During 2005, some $20 billion of REITs were privatized, almost a tenfold increase over the prior year. Through March 2006, some $9 billion of additional privatization has come to market, continuing the momentum that exhibits few signs of slowing down.

Finally, international REITs will also attract increasing interest, as investors look to further expansion of the concept to support the development of globally diversified holdings without the risk and management overhead associated with direct investment in global real estate.

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Conclusion

Going into midyear, the economic expansion appears to be on solid footing. Despite some concerns, the prospects are generally positive and suggest strong economic growth for the first half of 2006, followed by a slight moderation in the second half. The capital markets will remain active, benefiting from relatively low interest rates and inflation. The real estate market should continue to benefit from strong investor interest, with plentiful debt available to support transactions. Cap rates should bottom out over the next several quarters, although the steady-state nature of market fundamentals and pent-up investor demand should hold yield requirements down. There is some risk of increasing costs of debt as investors turn attention to risk, placing upward pressure on yield requirements. Since the market is fully priced, more attention will be paid to market fundamentals putting more emphasis on income levels and pro forma returns than on appreciation rates. Despite these pressures, the near-term prospects for changes in pricing are rather benign. The exception to this may be in the housing market, especially where investor activity has helped fuel the recent run-up. With some luck and continued improvements in employment and wage gains, a correction may not occur, although appreciation levels are expected to cool. Construction activity levels should increase, although there are few signs of a major surge that would disrupt the gradual improvement in market fundamentals. Thus, the general outlook for the real estate market is for a relatively steady state.

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