Solid Foundation Steadies Uncertain Economy

by James R. DeLisle, PhD

I would like to acknowledge the outstanding contributions of Rebecca Griego to Financial Views and the Runstad Center for Real Estate Studies.

Commentary

As February 2007 came to a close, the national economy seemed to be plugging along. There were few signs that the economic picture would spring forward with a surge in activity, or fall back into the doldrums of recession. Then in early March, the stock market did the unexpected, falling dramatically. While a number of factors contributed to this pullback, there were two key triggers.

First, former U.S. Federal Reserve (Fed) Chairman Alan Greenspan suggested that the economy could head into a recession in the latter part of the year. Second, global financial markets experienced a hiccup, led by declines in China. While the setback got the attention of investors worldwide, the reaction was somewhat contained.

With respect to Greenspan's comments, the Fed's public relations machine kicked into full gear to assert that his comments had been taken out of context and that the speaker was not privy to some of the factors that have led policy makers to a different interpretation of the economic picture.

In terms of the global capital market ripples, the U.S. stock market reaction was portrayed as a temporary phenomenon that was a byproduct of the globalized capital market. Indeed, the market soon began to gain back some of the ground it had lost, although the market is expected to remain tentative as a result of the earlier ripples. This more sober environment is likely to carry throughout 2007, with the markets paying close attention to economic news to determine if we are experiencing a midterm correction or if the end of this stage of the recovery is in sight.

At an aggregate level, the economy is fairly well balanced, with relatively few major upside or downside risks that would suggest a major reversal over the near term. In spite of this, a couple of key questions bear close monitoring:

- How far will the housing market fall and who will it take with it?
- How high will energy prices surge and will the surge undercut consumer confidence?
- How deep is the subprime lending debacle in the residential market and is it a precursor of things to come on the commercial front?
- Will the market begin to recognize risk and tilt up the yield curve, driving up costs of capital?
- Will the recent sense of exuberance and ready capital lead to oversupply of new real estate, outpacing the economy and weakening fundamentals?

The general attitude toward these and other questions regarding the economy is one of moderation, suggesting cautious optimism and a sense of realism. However, the nature of the questions suggest there is some latent risk of a recession or pullback that could be caused by significant erosion in several factors or a resultant confluence of events.

Despite this risk, the economy should be able to withstand the levels of turbulence that are likely to occur. In this environment, the real estate market should fair well, continuing its steady path of improving fundamentals and moderating returns, especially on the capital side of the equation. However, the real estate industry does face some risk from exuberance on the construction side as well as a return to long-term return requirements from investors. This outlook may change by midyear.

The Economic Environment

Economic Growth

Despite some temporary deceleration, the U.S. economy has been able to continue on its expansionary path. While the pace of economic expansion has not kept up with some forecasts, most observers believe the economy will continue to expand at a modest but relatively healthy rate during 2007. Thus, the debate focuses on the question of whether it will be a soft landing or a hard landing; there are few calls that a recession is on the horizon.

A notable exception to this outlook was provided by former U.S. Federal Reserve Chairman Alan Greenspan, who recently suggested in a satellite link to a business conference in Hong Kong that the country could slip into a recession by the end of the year. While these comments triggered a quick sell-off in the stock market and created significant consternation in Washington, DC, their impact was dampened by clarifications and defensive responses by the Federal Reserve.

While the reassurances seem to have appeased some of the naysayers, it is clear the economy will face downward pressure coming from such usual suspects as the housing market, as well as some unanticipated, but perhaps even more foreseeable sources such as the sudden deterioration in the subprime mortgage market. Thus, going into the second quarter, the U.S. economy remains on track, showing potential for a moderate slowdown to be followed by an uptick later in the year.

One of the major indicators for economic growth is the outlook for consumer expenditures. While not expected to bolster the economy and elevate it to new heights as seen earlier in the cycle, consumers remain an important building block in the current economic cycle. The concerns stem from consumers' negative reactions to the recent increase in gasoline prices and growth in inflation.

Over the past several years, consumers seem to have learned to expect periodic shocks at the gas pump as oil companies transition into the peak driving season. However, the fact that the surge occurred earlier this year than in the past has been disconcerting for many consumers. The prospects for further spikes throughout the important summer season

"Going into the second quarter, the U.S. economy remains on track, showing potential for a moderate slowdown to be followed by an uptick later in the year."

may prove to be more troublesome in adjusting their financial and consumer spending.

On a related note, further erosion in the overall housing market is likely to weigh heavily on consumer and business attitudes and place another dampener on growth.

On the business front, the economic picture has been relatively stable, although the recovery has lost some momentum. In this environment, businesses are likely to pause to reassess the situation, joining the ranks of consumers and investors who are more cautious or are waiting for some answers on the economic outlook before charging ahead. Although the federal deficit remains a matter of concern, domestic producers have welcomed the improvement in export levels.

At the same time, imports remain strong, with commodities flowing in from across the globe as retailers seek competitive advantages to bolster consumer sales.

Thus, while the economic outlook is somewhat tempered, there are enough positive signs to suggest that the expansion may have enough traction to carry on and prolong the recovery. At the same time, the most likely downside scenario is for a soft landing, although a recession should still be considered a possibility. Despite these risks, the bottom line is that economic growth is expected to experience some deceleration or flatness followed by moderate gains.

Employment

Employment gains in 2006 were somewhat stronger than initially reported, with a fairly significant upward revision in job growth shown in the revised figures. Last year, job growth decelerated, with new job formation lagging consensus forecasts. Some of this softening was attributable to the slowing housing market and the ripple effects it was having on related industries. The slowdown also came from other business sectors as companies reined in their hiring in line with economic realities and expectations of moderate growth.

In early 2007, employment gains were relatively healthy in light of the overall economy, although by no means robust. Thus, the labor market remains fairly tight, with spot shortages in certain sectors placing upward pressure on wages.

In terms of industry sectors, manufacturing has stumbled a bit, with the general slowdown in economic expansion creating a drag. The construction industry and other housing-related sectors have also declined as homebuilders rein in their activity levels to match the slowdown in demand.

Commercial construction activity has picked up in a number of markets as developers prepare to meet anticipated tenant needs.

Employment growth in the service sectors has remained fairly resilient with steady increases in jobs characterizing most industry segments.

The unemployment rate has been relatively stable, with moderate increases associated with the slowing of employment and contractions in a number of sectors. Going forward, job growth is expected to be moderate in the first half of the year, with some increases in the latter half as the downside risks burn off and the economy stabilizes. Unemployment rates should increase moderately, assuming no major shocks to the broader economy that could lead businesses to pull back.

Employees should benefit from some gains in compensation levels, although benefits will take a significant chunk and dampen wage growth. While the general outlook for employment remains relatively healthy, the growing frustration of employees with their current jobs should be noted. Thus, as the economy picks up, employers may find themselves under additional pressure to retain and attract employees, which could translate to higher aggregate labor costs.

Inflation and Interest Rates

The outlook for 2007 is for moderate inflation, although it should continue to trend below long-term averages.

Even though inflation has been moderate and the outlook is tempered, the perception of many lower- and moderate-income consumers–who are sensitive to price increases for food, staples, health care, and other essentials–is that inflation is actually higher than reported. For such consumers, current consumption requirements are likely to eat up discretionary funds and prevent any significant increase in savings rates.

This situation should lead to more consternation among consumers, especially those with variable rate mortgages and other creative financing mechanisms that have a prior claim on income. The prospects for additional softening in the housing market and the flattening or decline in values will focus more attention on current cash flows and budgets. The end result may be a pullback or dampening on consumer expenditures, which would make it difficult or impossible for companies to pass through higher operating and production costs.

Once again, when discussing inflation, energy prices remain a major wild card. While this concern is not new, the fact that energy plays an ever-increasing role in the economy, both direct and indirect, makes it difficult to isolate the potential ramifications of price changes. Unfortunately, an understanding of the laws of supply and demand is not adequate to model near-term price fluctuations due to uncertainty on the supply side. That is, production levels will remain somewhat unpredictable in today's geopolitical environment.

What is predictable, however, is the seemingly insatiable appetite for energy both domestically and globally, especially with the explosive growth of the Chinese economy. While U.S. consumers remain concerned over high energy prices, the reality is that consumption behavior has been relatively inelastic, with consumers and businesses apparently accepting higher prices and factoring them into their overall budgets. Until this behavior changes, consumer and business expenditure patterns will be vulnerable to cannibalization by energy prices. Growing concern over global warming and environmental degradation are likely to raise awareness of the true costs of energy-dependent lifestyles, although it is unlikely that there will be any significant change without more governmental or economic interventions.

The low interest rate environment that has been so important to economic expansion in the United States should continue through 2007. While there are a number of warning signs, it is clear that the Fed is fully aware of the risks of tipping the economy into a recession and will exhibit restraint in any upward adjustments in rates. On the other hand, the Fed appears willing to step in and lower rates to help avoid tipping the economy into a recession.

Evidence that inflation remains in relative check, with the exception of energy, coupled with growing concerns over the economic expansion suggest the Fed is likely to hold interest rates constant. Indeed, there are some prospects that rates may actually decline moderately if the economy shows additional weakness.

Over the near-to-intermediate term, global capital flows are likely to remain strong, helping ensure that U.S. players continue to enjoy access to relatively low-cost capital. One of the wild cards on the interest rate front that may affect long-term rates and tilt the yield curve back up to more traditional levels is the subprime mortgage market in the residential loan industry. The fact that the situation of subprime mortgage market appears to be so unexpected is something of a shock. Many observers have been pointing to the dangers of aggressive lending practices and creative financing to prolong the housing cycle and achieve homeownership. Thus, it is surprising that regulators and various governmental bodies feel the need to step in now to address mistakes of the past that, due to normal time lags associated with residential lending, are only now surfacing.

Regardless of how widespread the problem proves to be and how it affects individual borrowers and lenders, the bottom line may be renewed recognition of the risks associated with real estate lending, both residential and commercial. This recognition may place additional upward pressure on long-term rates, helping the yield curve transition to a more traditional level reflecting the higher risks associated with long-term capital flows. Thus, while interest rates are expected to remain relatively low, residential mortgage rates may experience more upward pressure. At the same time, the spread on commercial mortgage rates may also widen, given the dramatic increase in the use of creative financing. With flattening values and limited prospects for a new surge in appreciation, refinancing options may be constrained by limits on loan-to-value ratios in addition to debt coverage ratios.

Business Indicators

In terms of business indicators, the picture remains mixed to generally positive. Producer prices experienced a short-term dip recently, but are expected to hold and trend moderately upward, trailing overall inflation rates. Energy prices remain something of a wild card, with more upside potential. This risk has led companies to be more sensitive to operating costs and the contribution of green buildings, but has failed to translate to a significant shift in demand for such facilities that would materially change development and leasing decisions.

At the same time, increased emphasis on corporate social responsibility and concern over global warming and environmental degradation are likely to sensitize companies to such issues and may help set the stage for additional fixed investment that are more environmentally friendly. However, such a change is likely to be gradual as the bottom line orientation continues to drive corporate real estate decisions.

Industrial production has been relatively stable, and after a recent dip is expected to pick up modestly, mirroring the broader economy. Companies will keep a close eye on consumer spending to ensure they do not get caught with excess inventory in the face of further contraction in demand.

Exports have remained firm and should experience improvement during the year as global demand increases and the relatively cheap dollar continues to hold. At the same time, imports are expected to continue to trend upward, although not at the same pace, with the end result being moderate improvements in the balance of trade. Further, inventory buildups have received some attention, with companies pulling back to bring them into line with somewhat tempered expectations for demand. This dampening is likely to affect both the manufacturing and service sectors, creating a drag on gross domestic product.

Business investment has been somewhat inconsistent as companies revisited the strength of the recovery and their own needs for plants and equipment; however, capacity utilization has remained relatively stable and is expected to hold through the year due to a combination of increased utilization and additional investment in plants and equipment. Overall, real estate costs are expected to rise moderately due to a combination of improving market fundamentals and capacity requirements.

Stock Market

In early March, the stock market provided a major wake-up call to investors, with a significant drop that forced many to revisit their asset allocation strategies and reassess their risk tolerances. Although the drop was explained by a number of factors and seemed to stabilize, the market has not been able to regain all of the ground it lost. The good news is that investors did not panic, although the market may be in for a round of uncertainty and increased volatility.

> "The housing market is receiving significant attention over whether it has turned or is in for additional declines."

It is important to try to gauge the general sentiment of the market and look at some of the scenarios that may play out. Although uncertainty has increased in the stock market, most signs suggest that it will continue to attract strong asset allocations, especially as domestic and foreign investors pursue higher returns than offered by other asset classes such as bonds and real estate. However, as the economic picture unfolds, investors are likely to shift assets among sectors as they respond to the recent turmoil in the market and concern over the near-term prospects for the economy.

While many will conclude that the recent vacillations are confined to the housing and subprime sectors and are not a precursor to difficult times to come, others will adopt more defensive stances, seeking investments that can withstand the drags of a slowing economy. In particular, stock pickers and funds are likely to look at their current balance sheets and seek out companies that appear to be able to effectively use earnings to improve share prices or increase dividends.

In this environment, the broader market is likely to experience some near-term volatility as domestic and global factors weigh the prospects for the economic recovery as well as on the collective mindsets of investors.

Consumer Confidence

Despite some setbacks and concerns over jobs and geopolitical risks, consumer confidence levels have trended upward rather consistently since hitting a trough in mid-2006. There are some signs these gains may not be as durable as they appear, with the more recent increases reflecting consumers' comfort with their current conditions rather than their expectations for the future.

A number of factors could lead to deterioration in consumer confidence including the recent spike in energy prices, and the continued softening of the housing market and realization that the downturn is not a localized issue. Additionally, the plight of the subprime mortgage market is likely to exact a toll on consumers.

The drag on confidence may be even more insidious. Scrutiny of current conditions is likely to punctuate the fact that easy credit and low rates propelled the market beyond its normal peak, creating an unsustainable foundation that could rapidly erode. This deterioration could have far-reaching effects, especially since many homeowners who benefited from the rapid escalation in housing values have had a nagging sense that it simply couldn't go on.

Despite these pressures and the likelihood of near-term erosion in consumer confidence, the positive signals coming from other sectors coupled with the prospects of additional improvement in the broader economy should help bolster confidence levels. However, such an effect is likely to be tenuous and subject to a rapid reversal that could take the wind out of the sails of consumer optimism.

Retail Sales

To help stimulate sales, retailers pulled out the stops, offering "amazing deals" in furnishings, appliances, and other home-related products. Unfortunately, results were somewhat disappointing, mirroring the cooling off in the broader housing industry. In particular, the electronics and auto industries struggled, while other sectors experienced only moderate gains.

In February, the cold spell put a chill on consumer spending, although it did provide a late-season surge in winter clothing sales that up to that point had struggled due to a warmer than usual weather pattern across the country. In addition to the weather, rising economic uncertainty and concern over the housing market played into the equation.

Over the near term, the prospects for retail sales remain guarded, especially as the downturn in housing and the subprime market plays out. Recent volatility in the stock market, coupled with a softening employment outlook, is also a source of concern. In spite of these issues, the prospects are for moderate gains in retail sales, mirroring the tempered outlook for the broader economy of which retail sales are such a vital component.

Housing Market

As might be expected, the housing market is receiving significant attention over whether it has turned or is in for additional declines. Several industry leaders have continued to raise the caution flag, suggesting that the industry will struggle through the year, with the likelihood of further erosion. At the same time, some industry pundits and other vested interests have argued that the market has already begun to stabilize, which may lead to a recovery in the second half of 2007.

This second viewpoint may be too optimistic in light of some of the market forces that are building such as energy prices. Some argue the jump in energy prices is a temporary phenomenon, triggered by production lags associated with retooling refineries from the heating to the driving season. However, strong appetites for fuel and constrained commodity flows may make this a long-term trend and one that is more troublesome to the market in general, and the housing market in particular.

The surge in commercial construction has created some negative spillover effects for the residential market, creating upward pressure on prices of materials and labor. These price increases are being combined with increasing land costs associated with the imposition of new growth management policies to limit sprawl, increase densities, and help create more compact cities.

Further, the movement toward green and sustainable building practices has created additional upward pressure on prices, although such construction elements have not been fully flushed out to determine the true winners and losers.

The plight of the subprime mortgage market has triggered a number of calls for reforms and increased disclosures to protect marginal homebuyers who might be drawn into mortgage contracts that are likely to prove unsustainable. Indeed, for many marginal buyers who entered the housing market just before its inflexion point, the real question may not be how to survive, but when to pull the plug. Of particular concern are adjustable rate mortgages that were aggressively underwritten by resorting to low teaser rates and limited or no down payments, or easy credit that was extended to marginal borrowers.

Real Estate Outlook

Office Market

At an overall level, the commercial real estate market is exhibiting signs of firming up, closing some of the natural lag that occurs between the economic cycle and the real estate market. This trend is most evident in the office market, which has experienced generalized improvement in terms of the balance between supply and demand, and improving investor interests. Despite this forecast, the office market remains bifurcated, with strong markets doing well and weaker markets lagging.

There is some risk that developers will jump into the fray too fast, especially in those markets that are attracting the interest due to improving employment level. This is especially true in suburban markets where barriers to entry remain low and development sites are plentiful. However, in some commercial business district markets, the fact that developers are beginning to build speculative space also bears watching.

Despite these potential supply-side risks, the exposure is relatively limited, especially when compared to the markets during the past cycle when things got completely out of hand. Assuming this supply-side balance remains as the economy regains its footing, office fundamentals should continue to improve, with some opportunities to capture the threshold rents necessary to support another round of development to support tenant requirements.

While office investors appear to be discounting improved fundamentals in current transactions, it is likely that some have overestimated, or at least overgeneralized, the scope of the recovery. Despite growing demand, tenants will continue to favor buildings that satisfy their needs, both in terms of product attributes (e.g., size, scale, quality, location, and image) and price and eschew those that do not measure up.

Given the frenetic pace of activity over the past several years as investors–many with limited infrastructure, human capital, and market linkages–swooped up office spaces, it is likely that many properties will not live up to investor expectations and may end up back on the market. However, a significant number of other investors share a positive outlook for the sector as evidenced by recent transaction levels and prices. Consequently, the office market should continue to hold its own in terms of prices although yields might be somewhat disappointing.

Retail Market

The retail property sector has been one of the leading property types, with returns in the public sector significantly outperforming other property types. This environment was caused by the robust and prolonged expansion of consumer spending, along with limited additions to stock, especially malls.

While consumers have done their part to help support the retail sector, there are signs that this support may be losing some ground as housing values peak, and consumers pay more attention to rising gasoline prices, the faltering stock market, and the mortgage market. Consumers are also likely to begin to pay more attention to their deficit savings rates, although they are likely to push off any major reform in behavior until later in the cycle.

On the tenant front, a number of cutbacks and regional contractions have pointed to a new wave of consolidations and rationalizations of store offerings (e.g., CompUSA, Mervyn's), suggesting that retailers are hunkering down in anticipation of some tighter times. The good news is that the strong performance of the past several years has left mainstream merchants, who have been able to maintain their connections with their primary consumer segments, with fairly strong balance sheets. Thus, despite some pressure on retail sales, the property sector should remain relatively healthy.

Going forward, moderate increases in supply should help prolong the period of solid fundamentals at the overall industry level. However, certain markets and submarkets may struggle as developers and retailers explore new ways of segmenting the market and tapping into new trends. Noteworthy among these trends is the continued interest in mixed-use and lifestyle centers, and renewed interest in transit-oriented development. In a complementary manner, there has been a surge in efforts in existing regional malls to add lifestyle and housing components that build on the current asset base and take advantage of existing infrastructure and unused capacity.

Industrial/Warehouse Market

The slowdown in the manufacturing sector has taken some of the wind out of the industrial market, although market fundamentals remain relatively attractive. This situation has benefited by the restraint of developers and lenders who have tempered the pace of new construction to balance changes in demand.

With respect to the warehouse market, increases in export activity have been on a positive trend, with strong imports complementing the other side of the equation. Investor interest in industrial properties remains strong, with some markets improving through redevelopment and infill activity. This is especially true in major distribution hubs and port markets in which there has been a mismatch between supply and demand due to the natural inertia in existing industrial parks and the relatively high costs attendant with replacing facilities.

Despite this rather benign outlook, there is a risk that the industrial sector may experience some erosion in 2007, especially if the economy cools off more than anticipated and global demand for U.S. products dries up. As in other property types, the risks of downturns and the promises of upturns will not be experienced across markets. The industrial market will be correlated with local market fundamentals and the role the markets play in the larger logistical and manufacturing arenas. While investor demand is likely to remain strong, investors will pay more attention to such fundamentals and exhibit more discipline in an effort to avoid being trapped with the wrong product in the wrong markets.

Apartment Market

The apartment market has regained some momentum as the single-family ownership segment has cooled off and concerns about overbuilding have put the brakes on condominium conversions in a number of leading markets. The end result has been a continued tightening of the market, with a decline in free rent and concessions that had undercut the sector in the recent past.

Going forward, there are positive signs that the pool of prospective renters will continue to expand, especially as younger households react to the current plight affecting the previous wave of buyers. At the same time, strong immigration levels and increasing migration rates are likely to bolster the sector. As the economy picks up, rental housing may also benefit from the need for greater mobility as employees explore alternative employment and locales.

On the investment side, institutional appetites are expected to remain strong, helping support prices and capitalizing on the sector. On the supply side, a lot of new activity will be focused on infill projects, mixed-use, and transit-oriented development, many of which will be sited in nontraditional locations, thus reducing the potential for cannibalization of tenants and providing a wider array of choice for the growing sector of households turning to apartments as both a lifestyle choice and mobility option.

Real Estate and Capital Markets

Capital Market Overview

Real estate has consistently led other asset classes in terms of relative returns. It should be noted that repositioning real estate assets is a cyclical phenomenon that is likely to peak during 2007. Particularly, the bulk of the returns in real estate over the past several years has come on the appreciation end of the value proposition as opposed to income returns.

This phenomenon is reminiscent of the heyday of the real estate investment trust (REIT) renaissance in the latter 1990s, when REITs were priced as growth vehicles rather than income vehicles. Just as the REITs were more than willing to accept the resultant influx of capital chasing returns, the broader real estate market and the private sector have been ready beneficiaries of the compression in capitalization rates.

While there is relatively little danger that the appreciation gains in commercial real estate will be reversed over the near term, it is likely that the sector will begin to feel some of the downward price pressure. The good news is that the adjustment process is likely to be manageable, assuming strong capital flows to the commercial sector continue as anticipated.

There are some mitigating factors that might forestall or preempt the adjustment some doomsayers have predicted. For example, there is no shortage of capital trying to access domestic real estate. Indeed, investors continue to exhibit creative means of entering the market, ranging from investment in private REITs and operating companies, to shifting to infrastructure and development opportunities.

On another front, the economy is likely to slow as the market absorbs the mixed news that is emerging on some fronts and recession fears. The level of new construction activity may increase, but upward pressure on construction costs and a rising appreciation for risk may forestall overbuilding.

While some markets and submarkets are likely to get overheated, there are enough checks and balances to ensure that the sins of the past are not repeated; at least over the short term. Thus, 2007 should turn out to be a solid year for net capital flows to real estate, although the outlook is more tempered than it was a year ago with less upside potential.

Construction Activity

Residential construction activity has continued to struggle, especially compared to the bull pace of the past several years. The movement toward revitalization of central cities has sustained residential construction activity in a number of urban cores, especially those known as twenty-four-hour cities. However, much of this activity has been concentrated in the luxury housing segment, including both rental properties and condominiums. While a number of markets have hit the point in the cycle where the brakes have come on, in others the trend continues, though history suggests the current pace of residential construction may experience additional slowdowns.

On the commercial side, construction activity has been robust, fueled in part by a recent surge in construction of office buildings. While many of these new projects have been conservatively underwritten and have substantial preleasing, the low interest rate mindset and lack of attention to risk have led to an increase in speculative office construction. Just as the overall markets have come to eschew risk, the real estate market may be no different, opening the door to some unexpected circumstances if the economy should stumble or if the pace of new construction picks up.

Construction costs have continued to increase, driven by dramatic increases in demand for materials on the domestic and global markets, especially China.

In a number of U.S. markets, the rise in commercial and condominium construction activity has triggered capacity issues, resulting in spot shortages of labor, materials, and construction systems, thereby placing projects that depended on aggressive timelines at risk. As such, developers are finding it difficult to lock in prices, and are being forced to accept additional development risk. To provide a cushion, projects are being penciled in with high single-digit increases in construction costs, along with increased contingency accounts.

In addition to inflationary forces, increasing acceptance of the green building movement is adding to the costs and duration of new construction that embraces such methods. This trend is stimulated by a combination of heightened awareness that global warming is real and must be addressed, and the spreading movement by municipalities that is placing additional emphasis on sustainable building practices.

This emphasis is taking a variety of forms, including market interventions ranging from the introduction of heightened energy conservation in local building codes to the development of new incentive programs. The incentives take a variety of forms, including tax credits and increased density limits for new buildings that are green and meet the Leadership in Energy and Environmental Design standards. Since these initiatives are relatively new and the market and infrastructure to support green buildings has not matured, it is likely that early adopters will face higher costs and more delays as part of the learning curve.

However, given the economic barriers to converting existing buildings to green, new construction that is designed and built with such a goal in mind may have an advantage over typical, existing construction. Uncertainty regarding tenants' willingness and ability to pay for such enhancements, even with the promises of lower operating costs and utility expenses, will slow the diffusion of the innovation process.

Commercial Mortgage Market

The commercial mortgage market continues to be flush with capital on both the private and public side of the market. This situation is likely to continue through the year, although there is downside potential with respect to marginal deals that have eschewed market fundamentals in favor of creative financing in order to close and satisfy going-in underwriting and debt coverage ratios.

While strong capital flows and a continued lack of attention to risk may help carry these deals until the markets improve, it is doubtful that the rising tide of fundamentals will carry all properties. Functionally or economically obsolescent space is likely to be left behind as capital supports more attractive, market-friendly solutions. Given fairly widespread use of financial engineering and the frenetic pace that has characterized the commercial mortgage market for several years, there is some concern that the risks of such deals will begin to surface.

Although current delinquency and foreclosure rates for commercial loans remain low by historical standards, this situation could begin to change, especially at the marginal end of the market. There are some early signs of an upward trend in commercial mortgage delinquencies and defaults, with signs that further erosion in the market is likely to occur.

Overall the sector remains strong and is poised for another good year. While market cycle risks have increased, some of the idiosyncratic risks associated with noninstitutional deals have been absorbed by nontraditional capital sources. During 2007, this segment of the market is expected to continue to expand, especially as some of the new and more innovative projects (e.g., mixed-use, transit-oriented development, and lifestyle centers) take more time to mature and gain acceptance in the market than anticipated when they were initially underwritten.

Commercial mortgage-backed security issuances are relatively flat. However, prospects for the rest of the year are positive, with early forecasts for yet another record year on both the domestic and global fronts. Benefiting from strong capital flows and stable though moderate increases in delinquency rates, spreads over 10-year Treasuries continue to fall, showing compression at the lower end of the risk spectrum due to lower perceived risk.

At the higher end of the risk spectrum, spreads have benefited from strong investor demand, holding their own and exhibiting some additional compression. On the private side of the market, investor demand remains strong and is likely to continue to hold. Spreads should remain relatively tight, especially if the market can avoid getting drawn into the malaise facing the residential market. Assuming rates continue to hold, refinancing activity should help bolster loan volume as structured deals of the past hit trigger dates and borrowers seek to lock in fixed-rate deals.

Private Equity Market

The private equity market continues to experience strong capital flows, with investment advisors struggling to capture product. Despite the pent-up demand for real estate from domestic pension plans and other institutional investors, the rate of expansion is likely to begin to taper off. This downward growth can be attributed to a number of factors including the fact that some pension funds are reaching their target asset allocations, benefiting from significant gains in market value of existing holdings, along with recent acquisitions.

With respect to traditional property sectors, the private market is likely to exhibit strong appetites for domestic real estate. This outlook is bolstered in part by the fact that the National Council of Real Estate Investment Fiduciaries (NCREIF) returns came in above consensus. Looking forward, this stage of the cycle is likely to continue for some time, due to low capitalization rates gradually penetrating the NCREIF index and becoming somewhat institutionalized. In this environment, and in the absence of a major catastrophic event, the long time lags necessary to affect an orderly transition to long-term yields are likely to dampen near-term shock.

In the interim, the gradual improvement in market fundamentals will likely provide some insulation that will support current prices and prolong the cycle. It is also likely investors who have held on until the market exhibits some signs of flattening out or rolling back will come to market with new product. This eventuality will help stimulate sales activity and create a sense of energy that will help offset some of the softness that might otherwise occur.

While the prospects for solid, core assets remain strong, returns are likely to continue to disappoint as appreciation rates hold and income returns try to catch up to values. Similarly, pension funds are expanding the definition of real estate investment exposures, including investments in REITs, real estate operating companies, joint ventures, and offshore funds in the asset class umbrella.

A more recent example of this expansion is the flood of private capital that is looking toward infrastructure investment as a new component of the broader real estate asset class. This trend has emerged as investors seek out new options for higher returns, public coffers dry up, and voters remain reluctant to dig into their pockets to fund major infrastructure projects. This sector could provide plentiful opportunities for investors to fill up their real estate allocations. Over the near term, the lack of empirical evidence regarding the risks and return prospects that such investments offer will act as a governor on the influx of pension funds into this emerging arena.

At the same time, the low levels of returns offered by existing core investments may encourage investors to be more aggressive in expanding their horizon to include this emerging segment. Similarly, the global arena is expected to continue to attract domestic investors, taking some of the pressure off the market. However, foreign capital flows are likely to continue on their strong pace, more than offsetting declines in net capital flows from other segments and helping sustain the tight market.

Public Equity Market

The REITs entered 2007 on a strong note, having beaten all other equity market benchmarks for 2006. This rather rosy outlook was bolstered by solid returns offered by core REITs as well as the buy rating assigned to the sector by many analysts. Some of this enthusiasm is no doubt based on the momentum in the sector. However, the outlook is also built on the talk of improved earnings as a result of improved real estate market fundamentals that are anticipated for most commercial property sectors that will mirror the overall economy.

While the sector is unlikely to be able to duplicate the strong performance it enjoyed in the prior year, returns should remain competitive relative to other asset classes. This is especially true with respect to the stock market, which has experienced some recent turmoil as a result of domestic and global shocks. Interestingly, on the domestic front the softening housing market and the subprime debacle may actually make REITs more attractive. That is, holding other factors constant, the decline in the single-family market should provide a stimulus to the rental market, helping apartment REITs that suffered through the shift in ownership preferences that pulled some tenants from rental apartments.

At the same time, the rising concern over potential overbuilding on the urban condominium front should refocus attention on urban rental properties, providing further impetus to the recent trend of improving market fundamentals. Outside of the housing sector, the fact that REITs have continued to maintain relatively low debt levels should provide some insulation from the risks that other investors who had turned to financial engineering may experience.

There may be some buying opportunities for REITs that have the market savvy to reposition troubled assets that may come to market in the form of real estate owned that lenders are forced to take back. While many of these properties will not be salvageable and may not be worth the risk, others may complement existing holdings and provide an opportunity for value creation that has been difficult to capture in the public markets due to the frenetic, somewhat undisciplined pace of acquisitions activity that has characterized the market.

In terms of recent trends, the public and private markets are converging on the venture level, with pension funds and REITs increasingly linking up to create positive synergies that will enhance returns during this phase of the broader market cycle. The waves of privatization that set off the new year are likely to continue during much of 2007.

The $3.5 billion acquisition of the Arizona-based sale-leaseback REIT Spirit Finance Corporation reflects this new wave of privatization. In March, the REIT entered into a definitive merger agreement with a consortium consisting of offshore investors spanning the globe from Australia to Western Europe. Such acquisitions are being driven by the net asset value discounts at which some REITs are trading as well as the opportunity to place significant capital in targeted property sectors through acquisition of specified portfolios of existing assets.

As the capital continues to surge into the domestic market, other deals are likely helping provide periodic, although not sustainable, stimulus to the REIT market. Real estate operating companies are also likely to be targeted, especially if investors can keep senior management in place to help nurture and maintain value.

Conclusion

The national economy is facing some uncertainty but appears to be positioned to weather near-term disruptions and maintain a soft landing. The foundation appears to be relatively solid and able to withstand periodic slowdowns and external shocks.

While the stock market remains a concern, there is little evidence that the market is in for a major correction. The Fed is likely to remain vigilant on the inflation front, but the softening of the economy may provide it with the ammunition it needs to actually lower rates if warranted later in the year.

The yield curve is likely to start tilting back up, especially as investors begin to focus on risk exposures that are likely to receive renewed interest. One of the major catalysts behind this heightened awareness is the subprime market, which is garnering increased attention. Ironically, the seeds of this recent discontent were sown some time back as homebuyers got drawn into easy credit deals with low teaser rates. Since a significant portion of commercial transactions also relied on creative financing, there is some downside risk to the commercial mortgage market. Fortunately, these concerns appear to be priced into the market, leading to a stage of guarded optimism. In this environment, the real estate market should fair well.

However, the real estate industry does face some risk if the economy should slip and developers and lenders get over exuberant. Absent such shocks, the real estate market should be able to make a relatively smooth transition to an income type asset rather than the growth asset it has been over the past several years. For some investors, this repositioning will be rocky and unsettling, but there are enough other players to soothe it over and make the aggregate transition more palatable. It should be noted this benign outlook depends on a variety of assumptions and continued market discipline, which suggests the need for more vigilance and scrutiny than required in the past several years to avoid major surprises.

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