No Clear Answers

by James R. DeLisle, PhD

Commentary

Going into 2008, there were some questions whether the U.S. economy was in danger of slipping into a recession. Until recently, some observers argued things were not as bad as they seemed, but many believed we were in the early stage of what could be a very difficult period. Indeed, in early April, Federal Reserve Chairman Ben Bernanke, speaking to a congressional committee, admitted, "A recession is possible." Given the hype surrounding the economy and its wobbly foundation, his reluctance to add fuel to the fire was understandable.

Consumers who have been hit by record-setting prices at the pumps, rising food prices, tighter credit, employment turmoil, and the near collapse of the housing market did not need any reminders of their plight. Similarly, businesses who have adjusted to the rapidly unfolding economic reality by slowing hiring and deferring expansion plans until the uncertainty abates already had discounted the economic contraction. Indeed, even government agencies, which tend to operate independently of the economic environment, showed signs that they are aware of the economic downturn and have put plans in motion to weather the downturn.

In some respects, the almost relentless string of bad news on the economic front might suggest that nothing can be done to prevent the bottom from falling out of the economy. While there is significant downside risk, the first wave of efforts to help soften the blow may provide some temporary relief. For example, the Federal Reserve (Fed) has demonstrated its willingness to set aside concern over inflation and focus its efforts and rhetoric on helping stimulate the economy.

Similarly, elected officials at the federal, state, and local levels have been drawn into the fray, and are exploring a variety of approaches that might help offset the credit crisis, which is at the heart of the problem. Indeed, concern over the economic slowdown and the prospects for a severe meltdown has shifted attention from who is to blame to seeking solutions. These debates are expected to take on even more urgency as the credit crisis spreads and the election kicks into high gear.

While some interventions are clearly needed, the urgency of the situation suggests we may be in for a wave of quick-fix, reactive, high-profile solutions that will have limited impact. The breadth and depth of the underlying problems, and the fact that many more issues have yet to surface, suggest that there is no quick fix, and that things are likely to get worse before any real improvement occurs.

In spite of this somber outlook, the federal government is expected to introduce additional stimulus packages throughout the year. The actual forms interventions will take and their impact on the bottom line remain unclear. However, it is safe to say that the U.S. economy is in for a difficult time, with no clear answers to the questions of how low can it go and how long will it last. Over the near term, these questions will remain unanswered as we navigate unchartered waters.

Since this is an election year, debates about the economy and which candidate has the best solution are likely to move to center stage. These debates will be closely watched by households, consumers, businesses, and others who have a vested interest in the economic future. Unfortunately, the tide of optimism is now being washed downstream. Even

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those who have been able to stay on the sidelines are in danger of being caught up by the current of economic uncertainty nibbling away at our economic foundation. This will be an interesting time with more downside risk than upside potential through the balance of the year.

The Economic Environment

Economic Growth

Over the past several years, the economy has been able to find a number of bright spots to help it maintain respectable growth. This is no longer the case, with each passing week bringing more bad news and a growing sense of helplessness. The fact that Bernanke has acknowledged that a recession is possible may provide reassurance that the government does not have its head in the sand. Gross domestic product growth has continued to slow, with few prospects for any major near-term recovery. The slowdown in growth has been widespread, manifesting in a contraction in business investment in inventory, consumer spending, and federal government expenditures.

The economic slowdown and prospects for further declines have caused businesses to ratchet down expansion plans. This belt tightening has had spillover effects on employment, business investment, inventories, and bottom lines.

The anticipated decline in corporate profits will translate to lower income tax payments, pulling government into the fray. State and local governments are likely to feel some of the pressure, which could erode one of the few bright spots on the hiring front. Consumers’ reactions are leading to a softening in retail sales, which further hurts state and local coffers, which are dependent on sales tax revenues. Local governments are also staring at the prospects of even greater budget stress, as ad valorem tax systems begin to recognize the decline in property values, especially on the housing front.

The weak dollar continues to be a mixed bag, helping the export side of the equation but hurting on import prices. Unfortunately, the downturn affecting the U.S. economy is being mirrored in Europe and a number of other key global markets, lowering demand for U.S. exports. At the same time, softening demand on the global front has taken some pressure off of import prices, providing needed relief for consumers.

The dollar has recently strengthened somewhat against the euro and the yen, which suggests that offshore investors believe the Fed has played out its hand on interest rate cuts. The weak dollar has provided some relief for the residential and commercial real estate markets, with international capital flows increasing as investors and households look to the property markets for investments. On the balance, prospects for economic growth remain tempered, a condition that might well carry into next year. Fortunately, the United States is not alone in this outlook.

Employment

During the first three months of 2008, uncertainty and a slowdown in the economy led to a steady decline in employment totaling over 230,000 U.S. jobs. This figure would have been even greater if not for hiring in the government and education sectors. Manufacturing firms took the biggest hit, continuing its string of job losses. The turmoil in the housing market, and spill-over effects on commercial construction, led to losses in construction employment as well.

Despite losses in overall employment levels, some sectors have held up. For example, professional and business service employment have increased moderately as have government, education, and health services. While retail, leisure, and hospitality jobs have been stable, these sectors face some downside risk.

As might be expected, unemployment rates increased to 5.1%, the highest level since mid-2005. Jobless claims have also spiked, breaking the 400,000 barrier and creating worries as prospects for more cutbacks loom on the horizon. On a somewhat positive note, the softening of the employment has taken pressure off of wages, with average earnings up moderately. Going forward, the prospects of further erosion in employment should ensure no wage-driven inflation, although that is of little solace to consumers and businesses looking for a silver lining in the clouds.

Inflation and Interest Rates

Although not the lead story in the popular press, inflation continues to concern consumers who are feeling a budget squeeze. Of particular concern are energy costs, although consumer goods are experiencing widespread increases with few offsets. With respect to energy costs, denials of price-fixing and supply manipulation by oil company executives following a string of record profits have been met with cynicism, especially with low refinery utilization rates.

However, there seems to be little that can be done to forestall even higher prices looming on the horizon. Looking at seasonal patterns and recent trends, $4 per gallon gas prices are likely this year. The automobile industry is doing what it can to soften the blow by launching a wave of new hybrids.

Especially hard hit are working-class and moderate-income commuters who moved to the suburbs and opted for low down payment and adjustable mortgages. For such households, rising gasoline costs on top of rising mortgage payments and inflation in core goods and services have turned into a nightmare.

The rate of inflation has crept up to uncomfortable levels, with more upside pressure continuing to percolate. The rising costs of transporting goods will place even more upward pressure on prices, piling on top of rising costs of production, especially in industries dependent on fossil fuels for energy. Import prices are expected to rise as shipping and logistics place upward pressure on prices.

Despite this risk, it is likely that the Fed has played out its hand on interest rates, with the possibility of one final minor adjustment on the horizon. This would bring the total downward revisions to some 300 basis points over the past year, which due to lagged effects, should provide some relief.

At the same time, the credit crunch that is manifesting itself in tighter credit, rising standards, and higher risk premiums will continue to offset the effects of the recent declines. Consumers are likely to struggle to manage current debt loads. These challenges are likely to move up the income chain as moderate- and upper-income homeowners realize the home equity cushion is no longer viable.

Mortgage rates, both residential and commercial, are likely to face upward pressure as institutions, either voluntarily or involuntarily, are forced to deal with embedded problems in their current portfolios. This phenomenon has already emerged, as adjustable mortgage commitment rates have been sticky and have not matched declines in either the Fed funds rate or short-term rates.

On the other hand, holders of existing adjustable rate mortgages that are automatically indexed to such rates should benefit from the declines, assuming they can hold on until the resets kick in. In terms of construction loans, the residential pipeline will tighten even further, as lenders shift underwriting attention to the viability of homebuilders. Clearly, residential credit will be harder to get and costlier, with lenders more selective in who they do business with on new originations.

In addition to its traditional roles, the Fed has been forced to shift its attention to more pressing issues in an effort to forestall a collapse of the financial system. The bailout of Bear Stearns, which the Fed steadfastly claims was a preemptive move rather than a bailout, speaks to the fragile nature of the economic system.

While the debate around the $30 billion assistance package is likely to carry on for some time, it has raised questions over how far the Fed should go to protect private institutions. The full scope of the subprime debacle and the extent to which easy credit permeated other sectors of the financial system suggest that more difficulty may well lie ahead.

Business Indicators

The manufacturing sector struggled in the first quarter, with new orders suffering from the slowing economy and declining business confidence levels. New orders for manufactured goods have continued to decline, with shipments also falling, especially for computers and electronic products. Unfilled orders for manufactured durable goods have risen, led by transportation equipment. Wholesale inventory levels rose during the quarter, benefiting from the buildup in agricultural inventories. On the other hand, the inventory/sales ratio declined, reversing the slight rebound at year end as businesses tightened up on overhead in anticipation of slowing sales.

Productivity levels remained on par, with business productivity holding steady. Manufacturing productivity gains were also positive, but were off the pace of the past several years despite a moderate decrease in hours worked. In the nonmanufacturing sector, overall economic activity levels are hovering between expansion and contraction. However, the ratio of expanding to contracting industries was 2:1.

On a positive note, business activity has trended up in the first quarter but is still behind par.

Signaling some of the underlying concern regarding inflation, commodity prices have risen across the board, placing upward pressure on prices for finished goods. Capacity utilization rates have softened a bit, but are still significantly above those at the beginning of the decade and moderately below long-term averages. In light of economic uncertainty and falling profits, business investment in plant and equipment is expected to moderate over the near term. The good news is that, despite some belt tightening and deferral of new investment and expansion activity, there are no signs a major business contraction is on the horizon.

Stock Market

One of the more dramatic events surrounding the stock market in 2008 was the near collapse of Bear Stearns due to its subprime exposure. To avoid a collapse and possible ripple effects associated with a loss of confidence in the integrity of the banking system, the Federal Reserve Bank of New York backstopped a loan to JPMorgan Chase of some $30 billion, with $29 billion of that at risk to the government and the $1 billion first loss exposure to JPMorgan Chase.

This bailout, which was designed to avoid a collapse of Bear Stearns, created a barrage of press. Opponents argued that insulating the institution from risk set a bad precedent. Proponents argued it was for the broader good and protected those who would have suffered in the wake of a collapse. While the move was bold and decisive, it underscored the severity of the problem and the Fed's resolve to avoid a system-wide collapse. Indeed, while financial institutions have written off significant losses, some estimates suggest losses might actually double or triple the current level before the correction plays out.

Reductions in consumer spending have hit retailer stocks fairly hard, with share prices falling as investors discount anticipated softness on the retail front. Declines in orders for capital equipment and additional softening on the employment front suggest the stock market will remain volatile, with more downward pressure than near-term upside potential.

Again, some sectors will outperform, but capital is likely to be fairly fluid and finicky, resulting in more volatility than normal. Tepid earnings rates on savings may provide some solace, although marginal investors who cannot afford the risk and are troubled by erosions in retirement and investment programs are likely to pull back to avoid additional losses.

Consumer Confidence

Over the years, consumer confidence has been a good indicator of the true state of the economy. This is especially true on the downside since consumers feel the angst at the cash register and unemployment lines before the official numbers come in. As such, the dramatic collapses in consumer confidence levels that occurred during the first quarter are an ominous sign for the economy. The decline in expectations suggests consumers are likely to pull back even more.

Of particular concern to consumers are anticipated declines in housing prices, rising foreclosure rates, and erosion in retirement savings associated with falling stock prices and lower yields on savings. Weakening employment figures and prospects for limited wage gains will also nag away at consumers, leading to further declines in confidence ratings. Continued increases in delinquency rates for consumer credit, including bank cards, automobile loans, home equity loans, and second mortgages are symptomatic of decreased consumer confidence. Consumers are likely to move toward, and remain on, the sidelines in the near term although additional stimulus programs may provide sufficient relief to entice some consumers back into the game.

Retail Sales

In January, retail sales enjoyed a surge as consumers cashed in holiday gift cards and took advantage of seasonal clearances. This improvement proved to be short-lived, as the erosion in consumer confidence reined in consumer spending, resulting in disappointing sales growth. This situation has been exacerbated by higher prices for necessities, which has placed even more downward pressure on nonessential goods.

Retailers were caught off guard by the slowdown in sales, causing a temporary increase in inventory/sales ratios. Hardest hit were clothing and accessory stores, followed by department stores and general merchandisers. Despite rising interest in hybrids, automobile sales have fallen off. Some of this downturn is self-inflicted and speaks to the success of previous stimulus plans to boost unit sales. In the current environment, surging consumer debt loads and other economic pressures have forced many potential buyers to the sidelines, focusing on paying off current automobile loans without taking on new debt.

The trend toward weaker retail sales has spread up the food chain, with higher-end retailers also experiencing a pull-back from consumers. This erosion is symptomatic of the widespread nature of the housing and credit crunches, which, along with other factors, have caused a crisis of confidence that is likely to hang over the sector until conditions begin to improve.

The home goods and home improvement segments have had particularly difficult times, with many owners seemingly pulling back on additional investments in existing housing and others simply not in a position to afford upgrades. Electronics sales have also struggled, in spite of the ticking clock on analog televisions and falling unit prices on many electronic goods.

Retail sales are likely to remain in check over the near term, with lower than normal growth in general merchandise sales, especially department stores, which are seeing sales cannibalized by discount merchants. Looking forward, sales of discretionary goods are expected to languish as consumers are forced to pay even more attention to their budgets in the face of rising costs.

The fact that some 130 million Americans will receive government stimulus checks of $300 to $600 per capita may provide some temporary respite for retailers. However, those checks are not expected to last long and for some, may go toward much-needed summer vacations as consumers seek some relief from all the national stress. Thus, until the economy begins to stabilize or recover, the outlook for retail sales is guarded, with retailers pulling back on new openings and tightening up on inventory levels.

Housing Market

The plight of the housing market has become daily news, with more and more markets and submarkets being forced to recognize that they were not really that different after all. The realities of the market, coupled with a barrage of negative press, continue to drag on the sector and on the broader economy. While the early discussions on the subprime debacle suggested that the turmoil could be contained on the residential front, it has become strikingly clear that the underlying problems have spilled over into the broader economy.

Within the housing sector itself, concern over the market is weighing heavily on consumers, creating a downward pull that is far from over. Those homeowners who do not have the ability to pay their mortgages have few options and are facing imminent foreclosures. While congressional initiatives to help contain such losses are being debated, interventions will provide limited relief and will be restricted to those who qualify for the proposed programs.

Even more symptomatic of the breadth and depth of the problem is the fact that many with the will to pay, are opting to walk away from houses with negative or marginal equity. This is especially true in markets in which further declines are likely and near-term recovery is unlikely.

The housing market downslide is likely to continue this spring as the country moves into the peak selling season. In this environment, sellers will face several challenges. First, they must find a buyer who has confidence in the underlying value of their real estate and believe it is fairly priced relative to the competition. Second, the prospective buyers must be able to close on the loan.

This latter criterion is important, as will become clear to those facing higher down payments, stricter underwriting standards, and higher mortgage rates. These caveats will be particularly true for buyers with lower credit scores, the ranks of which are expected to soar as more and more consumers fall behind on consumer debt and employment prospects weaken across the economy.

Searching for positive news on the housing front is a daunting task. The statistics are particularly sobering, but even then, may not underscore the depth of the problem. As many realize, the housing boom was supported by a number of factors (e.g., low interest rates, creative financing, low down payments, easy credit), which led to a self-fulfilling prophesy.

In the past, the good news in housing evangelized that buyers could not fail, and those who failed to buy were missing the biggest gravy train in history. Buyers bought the hype and placed themselves in deals that were dubious at best. Thus, to a great extent the housing market bubble was a byproduct of human behavior, behavior fueled by hype and expectations.

Now that expectations have been pulled in, market behavior may lead to contraction far beyond the correction that econometric models might predict. There is some risk that on the housing front, the bottom might indeed fall out much as it did in the commercial market some twenty years ago. This potential is likely to lead to several waves of stimu-

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lus as the government pulls out all stops to forestall a complete collapse of the housing market. While attractive on a number of fronts, the stimulus packages could ripple across the economy and trigger a deep recession.

Real Estate Outlook

Office Market

Net absorption in the office market has been uneven but positive, with the suburbs experiencing the most volatility. In terms of new construction, central business district (CBD) activity has been tempered, while suburban construction has continued to climb in anticipation of improving demand and the need for new product. The improvement in fundamentals has been strongest in CBDs where the vacancy rate has gradually fallen toward the single-digit range.

On the other hand, suburban vacancy rates held steady in the midteens, with new supply keeping up with the growth in demand. On the private side of the market, during 2007 the office sector led other property types, with total returns breaking 20%, attributable largely to appreciation, with income returns at cyclical lows. On the public front, the office sector has failed to reverse itself, with returns remaining in negative territory.

The stringent underwriting that began to manifest last year has helped take some of the steam out of the office sector. As a result, the slowdown in business expansion should result in moderate increases in vacancy levels. Thus, some of the rent gains enjoyed over the past several years may continue, although much depends on how deep and long the recession is. The fate of the office sector will vary by market, with some areas facing challenges as tenant demand contracts at the same time new products come online.

However, the fact that a significant share of the new construction has been concentrated in some of the urban centers that have the healthiest demand should prevent a major correction. Due to the size of the pipeline, office construction should continue to expand, but prospects for the next year will be tied to the economy. Speculative development will be significantly curtailed as lenders tighten standards and investors focus on risk. Thus, the office sector should remain relatively stable although there may be some uptick in vacancy levels.

Retail Market

During the first quarter, the downslide of the housing market along with turmoil in the credit markets and the slowing economy undercut the retail sector. Especially hard hit were local retailers and smaller operators who lacked the liquid capital reserves or access to credit necessary to work through the largely unanticipated declines in retail sales. In this environment, retailers have pulled back on expansion plans. Retailers have become more defensive, looking at unit profitability and bottom-line performance.

This situation and downward pressure on rents for new space has forced developers to revisit their own plans. Leasing programs will also face new challenges as retailers become more selective in renewals and new openings, looking for near-term gains rather than longer-term positions. Looking forward, retail performance is likely to remain tempered.

Industrial/Warehouse Market

Given the relative balance in market fundamentals, the industrial sector is well positioned with respect to the anticipated slowdown in economic growth and weakness in the manufacturing sector. While some expected the weak dollar to create a surge in exports, cooling of the global economy has tempered that demand. On the other hand, it has provided some insulation from rising import prices, helping maintain the status quo with respect to warehousing and distribution functions. The energy crisis and record diesel costs are likely to create some changes in supply chains and logistics, although no major disruptions are anticipated.

In terms of investment performance, the industrial sector has held its own relative to other property types. Indeed, in REITs, the industrial sector was the only property type to avoid negative returns for 2007, but returns have slipped somewhat in 2008. In the private sector, industrial returns came in the middle of the pack, although income returns outpaced other core property types. Going forward, stable market fundamentals bode well for the sector, with some moderate upside potential as trade activities gain traction. Rents are likely to demonstrate some gains, with vacancy rates relatively flat in spite of the global slowdown. Investors are expected to continue to be drawn to the sector, with lenders willing to participate in moderate-risk, core asset opportunities.

Apartment Market

The strong linkages between the rental apartment market and the owned-housing market created a drag during the recent bull run of the broader sector. Many apartments struggled with softening of demand as renters were enticed into ownership by easy, cheap credit that seemed to make owning cheaper than renting, at least over the short term. At this point, the fallacy of that belief has become clear, especially as homeowners begin to realize that real estate is an illiquid asset for which an exit strategy is a paramount element of investment decision making.

While legions of marginalized homeowners struggle under the weight of homeownership and try to hang on in hopes some bailout will come out of Washington, others are simply throwing in the towel and walking away. This will cause a shift in tenure choice, placing upward pressure on the apartment market. Due to lags in construction, especially in supply-constrained markets favored by many investors, this surge in demand will lead to declining vacancy rates and rising rents. This situation has already begun playing out in the first quarter, with apartment rents rising nationwide.

The conversion of single-family homes to rentals and the reconversion of stalled condominium projects back to rentals will take some pressure off of rents. Over the intermediate term, the likelihood that Congress will pass temporary programs to stimulate homeownership and help work through the rising tide of foreclosures will relieve some of the pressure. However, there will be some lags before those programs kick in, and many targeted buyers will likely stay on the sidelines after experiencing the pain of losing houses themselves, or watching family and friends forced to deal with the market's collapse.

While apartment construction levels have remained modest, rising demand is likely to lead to new construction activity. However, tighter credit standards will place a governor on such expansion, helping boost investor interest in apartments. Thus, the sector may be able to avoid some of the price corrections that will affect other property types, with returns becoming more competitive.

Real Estate and Capital Markets

Capital Market Overview

During this tumultuous period, the commercial real estate market will not be immune to downside risks. Indeed, just as the residential market floated upward on the cyclical wave of easy credit and strong capital flows, the commercial market has also risen to record levels. While attention has not yet shifted to the commercial sector, the run-up in values and declining yields suggest the commercial market is also at a cyclical peak. Thus, the tightening of credit and renewed emphasis on risk warrants close attention to market fundamentals.

The expected erosion in the demand side associated with a slowdown in the business sector should be offset in part by tightening of credit, which will place a dampener on new construction. In particular, construction lenders are expected to pull back on loan-to-value ratios even further, requiring developers to invest more capital and assume more up-front risk. Some current projects that seemed immune from capital market contraction may also struggle as lenders look for more preleasing and the slowing economy hits some tenants in the pocketbooks.

The good news is that the supply side has not gotten out of control as in some past recessions, and capital flows should remain adequate to support the market and help avoid a recurrence of the debacle of the early 1990s. Unfortunately, the outlook for the housing market is not as sanguine and the bottom is likely to be a ways off yet before the homebuilding sector can get back to business as usual, especially since the volume of business they had internalized was unusual and unsustainable.

Construction Activity

New residential construction starts peaked in early 2007, with little warning that the prolonged run was about to come to an end. After holding steady for a couple of months, starts began to drop rather dramatically, contracting some 40% or so since that period. The declines were largely confined to the single-family market, with multifamily starts holding up fairly well due in large part to the condominium market, which continued to power as part of the urban renaissance occurring in a number of cities.

In terms of regions, the contraction was widespread, attesting to the fact that some of the forces that had boosted the bull run in housing emanated from capital flows at the national level rather than local market fundamentals. That said, until recently some housing markets and submarkets continued to move forward belying the national trend. Where there are still some pockets of opportunity today, these are the exceptions.

During the early throws of the retrenchment in construction, commercial spending continued to trend upward, benefiting from a fairly stable economic environment, plentiful credit, and moderate increases in demand. That situation changed as the economy began to show signs of weakening and business confidence levels eroded. More importantly, access to credit began to tighten as concerns rose that the commercial market run had been partly fueled by the easy credit that was one of the forces that had set the residential market up for a collapse. This translated to rapid contraction in construction lending standards, which dramatically reduced loan-to-cost ratios and caused a tightening in underwriting standards.

Due to the large size of some of the commercial projects in the pipeline and the lack of a major trigger, the pullback has not been as dramatic as in the residential sector. That said, commercial activity had begun to lose steam even before the economic signals began to point to a recession. Even developers who tend to be optimistic recognized that credit standards would tighten even more as lenders and investors turned attention to the risk side of the equation.

The widespread nature of the slowdown is likely to continue to play out in the commercial sector as the market goes on the defensive and takes a hard look at where we are in the cycle. Unfortunately, the answer to that question will remain murky for some time, suggesting a more conservative outlook for construction–private and public, residential and commercial. Projects that do go forward will tend to be at the top of the market, with significant forward sales, preleasing, or unique market positions with a proven track record. Projects that reflect innovation and risk taking will be placed on the back burner.

Commercial Mortgage Market

The wave of capital flowing into the mortgage market via the commercial mortgage-backed securities (CMBS) activity has hit a headwind, with concerns over the credit worthiness of existing issues creating a tremendous backflow of capital. Investors were sensitized to this tightening last year as rating agencies warned that the sector would be in for some tough times. Symptomatic of the logjam is the fact that for the first time since the early 1990s, no new deals were priced in January. Spreads to treasuries have spiked dramatically. This is especially true for lower-rated tranches, although spreads on higher-rated pieces have also increased.

To this point, commercial delinquency rates have not surged. Indeed, delinquency rates could double or triple from their low base and still remain at, or below, long-term averages. The recent slowdown in the economy has come at a bad time for the sector, causing many investors to step back and revisit real estate market fundamentals.

Unfortunately, few investors have focused on underlying real estate and capital flows, deferring to rating agencies to sort out the fundamental side of the equation. Thus, if risks start manifesting themselves in rising delinquencies or investors lose confidence in rating agencies, access to securitized debt, could be amplified by a herd response from investors. These forces would place additional downward pressure on the economy and add to the severity of the contraction in the real estate sector.

While public debt markets are likely to remain in a freefall for some time, the private mortgage market is in much better shape. That said, construction, permanent and mezzanine lenders are all likely to be more cautious since their individual and collective actions are likely to receive greater scrutiny as regulators seek to limit any widespread, credit-related collapse on the commercial side of the market.

This will translate to higher equity requirements, preferences for credit-deals, and more attention to underlying market fundamentals. At the same time, the transition away from commoditized pricing that characterized the recent market will create more price differentiation. In general, this renewed interest in the underlying market will be healthy and help align capital markets with spatial markets. However, those stuck with real estate with poor fundamentals are likely to take it on the chin.

Private Equity Market

At this point, the recent economic uncertainty, along with the pullback in tenant demand and easy credit, points to further contraction in the private equity market. The pent-up capital for institutional-grade real estate, combined with growing interest by foreign investors seeking to cash in on the cheap dollar should forestall any major contraction. However, the days of double-digit appreciation that had become commonplace over the past several years are clearly over.

Going forward, the private market is expected to continue to hold its own, although there may be something of a pause as sellers readjust expectations in the new reality. With respect to the new construction side, the decline in loan-to-value ratios will force some developers to turn to seek out equity partners to avoid having to turn to more expensive mezzanine financing to complete deals in the pipeline. This should open the door to joint venture opportunities and attract institutional investors in search of core product.

Over the near term, the private equity market is likely to remain fairly stable. However, cap rates are likely to rise, moving back toward longer-term, historical averages. This will place some downward pressure on returns and result in some short-term investors looking for a quick flip or facing loan resets to get caught in the credit squeeze. While capital will remain available, there will be greater swings in strike prices, as market timing becomes more problematic for both sides of the transaction. With the tightening of credit and renewed attention on risk, cash will be king especially with respect to larger, more complex transactions.

Public Equity Market

After falling back last year on the early throws of the credit crisis, REITs enjoyed a rally in the first quarter, eking out a modest gain as opposed to the losses racked up by the S&P 500 Index. During the first week of April, REITs led all stock groups, both domestic and international.

This rally has been led by the apartment sector, which runs countercyclical to the single-family market. Apartment REITs enjoy additional insulation because of access to loans from Fannie Mae and Freddie Mac, which will them to avoid some of the credit crunch that other sectors face.

Despite recent gains, REITs continue to trade at a discount to net asset value, in contrast to typically trading at a slight premium. This situation has led some to argue they are a value in the current market.

While this argument might have attracted significant interest in the past, the specter of rising cap rates and softening of tenant demand associated with the slowing economy clouds the prospects for the asset class. However, declining earnings rates and the fact that REITs still pay dividends may increase their appeal to individual investors seeking some form of income, as well as attract the confidence that can spill over to institutional capital markets.

> "This renewed interest in the underlying market will be healthy and help align capital."

Conclusion

This is one of the more complex points in the economic cycle, with a number of forces adding to uncertainty. The U.S. economy is in the early stages of a recession, one that faces more downside risk as the ripple effects caused by the collapse of the housing market, subprime debacle, and expanding credit crunch continue to unfold. The Fed has largely played out its hand on interest-rate cuts and may be forced to step into the fray to forestall more problems in the financial sector lurking beneath the horizon. These interventions are unlikely to include a repeat of the bailout of Bear Stearns.

The federal government, along with its counterparts at the state and local levels, is expected to launch a number of initiatives to stimulate the economy and work through the housing-market collapse. While any such interventions will be welcomed, there will be no magic formula that can stop the process as it unfolds, and no magic elixir that can erase the pain that it will cause. Until things settle down a bit and the outlook for the economy becomes clearer, consumer and business confidence levels will remain shaky.

This will create tough times for retailers and manufacturers who depend on forward thinking and optimism to propel demand. While these factors suggest there is additional downside risk to the economy, with the right nurturing and support, the recession may be moderate and begin turning around after the election. However, there are no guarantees and the economy will remain in a fragile state.

In terms of the real estate market, the housing crisis will continue to unfold, with ripple effects carrying it into next year or beyond. Housing prices are likely to continue to fall, creating a drag on the broader sector as well as the economy. Programs to bail out the residential sector will be welcomed, but will not be sufficient by themselves to turn the market around. While there will be some opportunities, the process will be extremely painful for those caught in the melee.

On the commercial front, values are likely to slip as the market begins to focus on the risk side of the equation and lenders and investors take a hard look at risk/adjusted returns. The slowing economy poses some downside risk to the sector, although pent-up demand for investments should provide a cushion.

Commercial loans will be harder to find and may create some additional opportunities for investors, especially as bullet loans reset in the face of rising rates, more stringent underwriting, and softening demand. This contraction will place a natural governor on the sector and help the market avoid even greater corrections. This will, indeed, be one of the more interesting summers, especially with an election looming on the horizon and voters looking for leadership to guide them through troubled waters.

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