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Summer Cycle on Solid Ground

by James R. DeLisle, PhD

Commentary

In the summer of 2006, the United States is facing a number of interesting scenarios: the Southeast is still recovering from Hurricane Katrina and the carry-over effects of the subsequent storms; the new hurricane season has arrived with a prognostication for an active year; gasoline prices have spiked ahead of the peak summer driving period; the rapid inflation at the gas pumps has created some angst among retailers and other consumer-dependent sectors; and jet fuel prices have forced airlines to increase prices with premiums that are causing consternation among business and consumer travelers. As the war in Iraq drags on and the Iranian situation festers, there are few signs that the geopolitical situation will change for the positive, creating further doubts for consumers and business leaders.

The Economic Environment

Economic Growth

The U.S. economy has exhibited strong fundamentals, suggesting the economic recovery remains on solid ground. A number of positive signs for economic growth, including strong growth in gross domestic product (GDP) in the first quarter, stimulated by business investment, have helped accelerate the economic expansion. Consumer spending bounced back, with increased gasoline prices driving consumers to more efficient vehicles and helped bail out the auto industry. Consumers also helped bolster selected durable goods manufacturers, most notably the furniture and household industries. On the downside, investment in inventory was somewhat tempered, with declines in retail inventory leading the contraction. Growth in manufacturing output is expected to moderate as domestic and global growth decelerates, although business expansion and exports will help bolster the sector. At the same time, strong imports have deflected some of the gains in purchasing away from the domestic economy. The increase in first quarter GDP was also fueled by increases in federal government spending. Going forward, the outlook for GDP is for some moderation in growth, although the economic expansion is expected to continue.

The international frontier has continued to play an important role in the health of the U.S. economy, both in terms of financial support associated with investments and a willingness to fund the ever-increasing trade deficit. On a positive note, the current-account deficit narrowed in the first quarter, beating estimates and declining from the previous quarter. Despite this improvement, the sheer magnitude of the deficit remains a major cloud over the economy.

The delicate balance of the dollar on world markets depends on a continued infusion of foreign investment capital. A significant area of concern on the foreign exchange front is the continued diversification of central bank reserves away from the dollar. This trend has been attributed to a number of factors, including concern over the rising federal deficit and the continued emergence of the euro as an attractive alternative to the dollar. Shifting reserves away from the dollar has been particularly pronounced among emerging markets, many of which are flush with dollars as a result of surging oil exports. Of particular concern is China, with its large reserves and the central bank's stated intent to diversify its foreign exchange reserves. It should be noted that to this point, the pattern of rising interest rates in the United States has dampened defection away from the dollar. If the Federal Reserve (Fed) does pause and stop raising rates, the attractiveness of the dollar will be further eroded, encouraging other markets toward diversification and further weakening the dollar on the global market.

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Employment

Jobs have continued to expand, but at a lower rate than anticipated, although unemployment has shown some improvement, with a recent decline in the number of newly laid off workers. On a year-to-date basis, the unemployment rate has generally trended downward, although the improvement flattened out in May as employment growth stumbled and the number of workers continuing to file for benefits rose modestly. Over the near term, the anticipated deceleration in economic growth may ultimately lead to more layoffs during the summer although the process is expected to be orderly.

Rising health care costs remain a major source of concern, with little relief in site, as benefits continue to contribute to an increase in total labor costs, forcing companies to rethink benefit packages. Retirement programs also continue to receive more scrutiny as typified by Delta Airline's recent efforts to terminate its pension plan. The combination of these forces will lead to a more mobile, less loyal workforce that focuses on its own needs rather than that of its employer or industry sector. This trend will create new pressures on companies to recruit and retain skilled employees. Over the short term, this trend will place a damper on permanent hiring as companies look to the total cost of employment and consider alternatives ranging from technological innovation and productivity gains to offshoring and outsourcing.

Taking a longer-term viewpoint, employment growth over the next decade is projected to match that of the last decade. In the United States, the strongest growth will be in service-providing jobs, led by education, health, social assistance, and professional and business services. This distribution of anticipated job growth is somewhat bifurcated, focusing on two opposite ends of the income and educational attainment spectrum. This pattern is likely to put added pressure at the bottom end of the job market. Of concern is the weakening housing market, which could trigger a number of layoffs as homebuilders pull back on production. While there has been an increase in commercial construction, there is something of a mismatch between the skill sets of homebuilders and commercial construction workers, current location of such workers, and the increase in demand. The aging of the workforce will also be a concern; there is a decline in the concentration of workers in their prime earnings years from 25–54 years of age. At the same time, the percentage of workers over 55 years of age will grow by some 50%, five times the increase of the total workforce. The number of women in the labor force is projected to outpace growth in the number of males, leading to further parity in the employment mix. These changes, coupled with changes in ethnicity of workers, will have a number of implications for businesses. Companies will need to accommodate the more diverse workforce and households.

Inflation and Interest Rates

Inflation continues to put additional pressure on the Fed to continue to increase rates. While a number of economists had hoped the Fed was through with its pattern of increasing rates, most now believe that additional increases are likely at least over the next two meetings. The rise in interest rates has had a cooling effect on the broader markets, with a more pronounced impact on the housing market. The underlying causes behind the increase in inflation figures have triggered some arguments about what they really mean. Some contend that the rental component related to the cooling housing market has artificially amplified inflation. Regardless of how such arguments are resolved, the reality is that, despite upward pressure on prices, producers have not been able to pass increases on to consumers due to a combination of softening demand and strong competition. This situation should hold over the near term as plentiful imports and increasing domestic production bolster supply lines.

The dramatic increase in energy prices, especially at the gas pump, has been one of the major drags on the economy, affecting both business and consumer budgets. While the rising prices have created much consternation, they are not without historical precedent. Higher energy prices may not be a cyclical phenomenon that is driven by short-term factors or disruptions in supply, but instead may reflect a longer-term trend due to globalization and increased appetites for oil. The growth in demand has been particularly strong in the United States and China, India, and other emerging markets. On the supply side, the production of oil remains constrained by geopolitical forces, hurricanes, and capacity constraints including lack of investment in infrastructure as producers discounted a cyclical correction that would lead to price declines. While sustained high prices are likely to result in more capacity, the adjustment process will likely take some time and its impact on prices will be mitigated by additional global economic expansion.

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It will be necessary to pay close attention to this situation as energy is one of the key building blocks of the economic engine in the United States and in many other economies.

The recent slowdown in job growth should place more pressure on the Fed to balance inflation-fighting with the adverse economic consequences of continued increases in interest rates. However, over the near term, concern over inflation is likely to lead the Fed to favor a couple more increases with a likelihood that rates will settle in the 5.25%–5.5% range. Assuming interest rates begin to stabilize, the economic expansion should be able to regain some of the momentum it lost as a result of increasing interest rates and a surge in energy costs. This resiliency is especially likely on the business front, where strong balance sheets and earnings have provided companies with a cushion against deceleration of growth. Additionally, the yield curve is flat with periods of inversion as investors continue to accept low risk premiums for longer-term assets and foreign central bank appetites remain strong for U.S. treasuries.

Business Indicators

In general, business indicators have been mixed to positive, suggesting that the economic recovery will continue. Productivity levels, which slipped in the 2005 fourth quarter, have rebounded with output revised upward and real labor costs revised downward. Business inventories have continued to grow, albeit at a modest pace, as the economy has cooled down. The retail sector has been an exception, with much of the decline attributable to the automobile sector, which has reined in activity levels. Retailers are expected to watch consumer confidence and expenditure levels over the summer in order to position themselves for the holiday season. Capacity utilization has improved moderately, rising slightly above long-term averages and reflecting a significant recovery from the trough reached between 2001 and 2002. This improvement occurred across all three stages of production including the crude stage, primary and semifinished stages, and finished stage. While not near the highs achieved in the mid-1990s, the increase suggests further gains may lead to an expansion of plant and equipment expenditures to increase capacity and respond to anticipated increases in global demand. The increase in producer prices remains a concern, although much of the increases can be traced to the energy sector. Companies have been hard-pressed to pass price gains through to consumers. As the recovery spreads across the economy, there is some upside potential that can be captured–corporate balance sheets and earnings remain solid, suggesting the market is poised to capitalize on the improving economy and that companies will position themselves to take advantage of global opportunities.

Stock Market

The stock market has had something of a tumultuous year. The major indices exhibited a jagged upward pattern that peaked in early May. Since that time, the Dow, S&P, and NASDAQ indices have all trended downward, albeit in a choppy manner. It should be noted that the recent corrections have made valuations more compelling, which may attract foreign capital and prevent markets from tumbling down much further. At the same time, companies are pouring a record $400 billion into stock buyback plans in an effort to bolster share prices. While generally well received by investors, the recent wave of buybacks is something of a two-edged sword. While it should bolster share prices, it represents a cannibalization of assets that could otherwise be spent on economic expansion. This suggests that companies are hedging the future, waiting for further evidence that the Fed can succeed in reining in inflation without disrupting the broader economic recovery.

In the current environment, the recent volatility in the stock market is likely to continue while the market turns on the latest economic news, rumors, or comments by Chairman of the Federal Reserve Ben Bernanke. Indeed, some observers are hoping that Bernanke and his colleagues can be a bit more reticent and introspective rather than opining openly on a broad range of topics that give mixed signals to the market. In the meantime, investors will be seeking to stabilize their portfolios to provide cushion against unexpected news, especially downside risks.

Commodity markets, which have been relatively strong, are showing some signs of softening as the specter of global inflation, rising interest rates, and slowing economic growth looms over the sector. Thus, there is some risk that the recent surge of capital flow to commodities from investors who sought to tap into high returns will reverse, putting some downward pressure on prices. While a major collapse is not anticipated, pricing levels should revert to more sustainable levels tied to the prospects of supply and demand rather than speculation.

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Consumer Confidence

Consumer confidence levels are expected to increase as job growth expands and inflation remains in check. However, the combination of rising interest rates and the dramatic rise in gasoline prices in the peak travel season have begun to hit home. Gasoline prices stabilized somewhat in June, which tempered consumer fears, but confidence levels are likely to remain volatile until employment and job gains are sufficient to allay fears of inflation. Despite this cautionary note, consumer attitudes remain rather sanguine with respect to current conditions. It will be important to watch the widening gap between present and expected conditions. Consumers appear to be tuned into the economic recovery and will likely pick up on further advances. While that is good news for retailers over the near term, the cumulative impact of the rhetoric surrounding the fate of pension plans and the importance of retirement planning is likely to begin nagging at the aging workforce that makes up the bulk of consumers.

Retail Sales

Retail sales, which have provided much of the support for the broader economy over the past several years, have shown some signs of weakening, especially at the lower end of the market, as energy prices wreak havoc with household budgets. High levels of consumer debt and growing concern over rising interest rates also are placing downward pressure on retail sales. Despite these negative forces and other concerns hanging over consumers, retail sales have proven to be fairly robust with year-to-year sales growth figures continuing to increase at a respectable rate. The strengthening job market and some increases in wages have played a major role in bolstering retail sales, although the recent slowdown in employment has created some concern. The pace of consumer sales has been supported by record-high levels of wealth, much of which can be attributed to the run-up in housing prices, which have boosted gains for many homeowners. Since the pace of equity extraction from increasing housing values has begun to slow down with the rise in interest rates and the decline in refinancing activity, consumer sales will hinge on the overall health of the housing market and the orderliness of any price adjustments. Given the fact that mortgage balances have crept up, a widespread correction in housing prices could have a dramatic impact on consumer confidence levels and budgets. Thus, the fates of the housing market and the retail sector have converged, creating the potential for greater swings on the upside or downside. Despite this potential volatility, the improving economy is likely to spill over to a healthy retail market. However, given record levels of debt and rising interest rates, there is more downside risk than upside potential in this outlook.

Housing Market

The housing market, which has generally outperformed expectations and held onto the boom period longer than many thought possible, has begun to show signs of cooling off. Housing starts and permits have both declined since peaking at the beginning of the year with the most dramatic declines in the South and the West. This trend is expected to continue, although it does not appear that a major correction is on the near-term horizon. Despite the declines in housing starts and permits, it should be noted that the current levels remain elevated over historical averages, suggesting that the boom was not sustainable and a slowdown was inevitable. New home sales have generally trended downward, although there was a brief rally in April. The inventory of unsold houses has also declined as builders began to rein in their activity, although the inventory remains elevated over the prior year when the market was at its peak. Continued increases in interest rates and withdrawal of speculative investment have created a downside risk to the outlook.

In terms of housing values, the general consensus is that the frenetic pace of appreciation has come to a stop. There are still pockets of housing shortages where values are likely to continue to increase as employment improves but rising interest rates will impact moderate-income buyers the most. In markets in which appreciation was fueled by speculative buying and the use of creative financing, price declines could be dramatic.

A similar phenomenon could cut across markets for marginal homebuyers who turned to subprime loans, including variable rate mortgages, with low teaser rates. While these instruments were written with lockout periods that prevented adjustments, a significant number of such mortgages are scheduled to pass their anniversary date and to bump to market rates. According to some estimates, these subprime mortgages have crept up to almost 10% of the total mortgage market, suggesting that the im-

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plications of rising rates could be fairly pronounced. While some homeowners will be able to absorb the dramatic increase in payments, it is likely that a number will be caught off guard and be forced to sell to avoid onerous payments. In some market segments and housing developments, the use of such creative financing has been widespread, setting the stage for a surge in inventory that will have limited demand since the most marginal buyers will be similarly priced out of the market.

The good news is that in the absence of a major spike in mortgage rates, such corrections are likely to be limited. At the same time, speculative housing investors are likely to try to tap into unrealized gains. Depending on the magnitude of such activity, the withdrawal of speculative buyers will place additional downward pressure on price gains. While taking some of the steam off of prices, this shift will depend on more durable drivers of value than vagaries of the capital markets and cyclically low interest rates. The bottom line for the housing market is that price gains are likely to be more stable but moderate with increases tied to gains in income.

Real Estate Outlook

Office Market

At a national level, the office market continues to show signs of improvement, with vacancy rates declining and absorption picking up. This improvement has been attributed in large part to increasing demand as businesses began to add employees and the pace of layoffs slowed. Improvements have been noted in both commercial business districts and suburban markets. Revitalization of urban cores and the addition of housing has shored up demand. The gradual but significant improvement in fundamentals has finally reached the point where some markets are beginning to experience rising rents. Indeed, in some markets that were the first to benefit from the economic recovery, developers are beginning to talk about building rent spikes into pro forma investment models to support higher current prices and help new developments pencil out. While such adjustments were common during the recovery phase in the 1990s, the phenomenon had all but slipped out of mind for many investors who were content to invest in real estate at moderate but stable yields.

Despite increasing demand for office space, construction activity has been generally tempered. However, the pace of new construction and anticipation of further expansion of the economy is beginning to heat up. Although rising construction activity should be closely monitored, the economic recovery is expected to help sustain the recent improvement in market fundamentals. The exuberance of developers with ready access to debt and joint venture partners is likely to lead to overheating of some markets, especially markets without a proven track record and sufficient scale to withstand cyclical downturns.

Retail Market

The retail market continues to experience growth, although a potential softening in consumer sales has begun to raise concerns. In terms of new construction, the development of traditional regional and super-regional malls remains at a standstill, while mixed use and lifestyle center development continues to accelerate. Retailers continue to look more closely at urban formats to respond to the densification trend that is occurring in many healthier downtown markets. Despite new construction activity and the prospects for slower sales growth, the retail industry remains healthy with low vacancy rates, plentiful debt and equity capital, and expansion-minded tenants driving the sector.

On the real estate investment trust (REIT) front, the retail sector has lost some of its momentum relative to other property types, continuing a trend that started in 2005. Through the first five months of 2006, smaller shopping centers led the sector but still lagged the overall REIT universe. Regional malls were flat and freestanding REITs lost ground. The private market has also experienced strong returns, with low cap rates and a ready supply of investors supporting an active market.

Going forward, vacancy rates are expected to remain low, supporting rising rents and additional development activity. However, the wealth effect, in which rising housing prices have buoyed consumer activity, is fairly well played out, suggesting that the sector's fate will depend on improving economic conditions and increasing disposable income. Assuming the economy stays on track and wages begin to pick up, the retail sector offers investors solid prospects with some inflation-hedging potential in the form of percentage rents. However, the dramatic increases in new, untested retail formats with limited performance histories and unproven staying power bear close watching as developers, retailers, and investors experiment with new offerings.

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Industrial/Warehouse Market

During early 2006, improved prospects for the manufacturing and warehousing sectors boded well for the industry. The increase in construction levels was somewhat ahead of the market, creating a modest downward drag on rents. However, positive absorption levels have led to a decline in vacancy levels, thus providing a stable environment for investors.

Going forward, increasing capacity utilization rates have set the stage for expanded demand that should help on the revenue front. Indeed, some market prognosticators argue that the industrial sector has turned the corner, moving from the recovery stage to the expansion stage. While such an outlook may be a bit rosy, the sector is fairly well positioned to benefit from additional improvement in market fundamentals associated with a strengthening economy. This outlook is particularly appropriate in major distribution centers that can benefit from strong international trade. However, rising energy costs and interest rates may place a damper on the sector if the market is forced to contract in the face of a global decline in economic growth.

Apartment Market

The cooling off of the single-family housing market has created some positive momentum for the apartment market as overall housing demand continues to expand along with the economic recovery. At the same time, the condominium market, which has been extremely active in a number of major markets, is beginning to show signs of losing steam. This is especially true in markets that were fueled by rapid increases in prices due to the emergence of speculative buyers, low mortgage rates, and easy credit. While the condominium boom continues to play out and more projects come off the drawing board, the softening home ownership market is likely to place a governor on the sector.

Until the condominium market corrects and land prices back off a bit, apartment development will be somewhat constrained. This constraint, coupled with growing tenant demand and moderation of new supply, suggests that the apartment market is well positioned. Additional interest in the sector is being fueled by increasing occupancy rates as well as rental increases associated with rising demand and lagged supply. Thus, investor expectations have begun to be ratcheted up as evidenced by apartment REITs whose 2006 performance through May exceeded 15% and has more than doubled the overall REIT index. The outlook for the apartment sector remains relatively healthy with some upside potential as the economic expansion helps fuel a growth in demand.

Real Estate and Capital Markets

Capital Market Overview

Going into the summer, the real estate capital markets are exhibiting robust activity levels, extending the streak that has characterized the recent market. These overall activity levels have benefited from a combination of patient capital and growing anticipation of further improvements in market fundamentals. The market has been able to absorb modest increases in mortgage rates. It should also be noted that mortgage rates have been held down by strong capital flows, taking some of the pressure off commercial mortgage rates, which may not reflect the underlying risks. However, to this point in the current cycle, investors in domestic real estate–either debt or equity–have had little reason to think about risk. Increasingly, prices and low mortgage rates have provided ample exit strategies for owners of troubled properties, which has forestalled delinquencies and defaults.

In the face of such performance, lenders have become even more aggressive in sourcing new product, turning to the use of creative financing that has helped current market prices. This situation has fueled growing debates over the sustainability of the current market with focus on the potential of a correction if cap rates should return to long-term averages. On the other side of the debate, some are arguing that interest rates and cap rates are locked into a long-term pattern and are unlikely to significantly change. While there is some evidence that current rates might hold for some time, it is more likely that the market will return to long-term averages. The good news is that since current pricing has been institutionalized (i.e., built into the NCREIF Index) such changes are likely to be gradual. Furthermore, if economic recovery stays on track, improving rental rates and declining vacancy levels could cushion the adjustment. Thus, over the near term, real estate capital markets should remain relatively stable.

Construction Activity

As the second quarter unfolded, there was a surge in multifamily housing starts as the ownership market began to cool off and investors began to anticipate improvement in rental market conditions. The multifamily rental market was spurred by the ready availability

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of debt and equity capital as investors continued to aggressively pour money into the asset class. Currently, this improvement in starts appears to be a temporary phenomenon with homebuilders responding to rising mortgage rates and a softening in housing prices.

On the commercial front, construction activity has continued to increase as developers capitalize on plentiful capital flows and signs of a lagged recovery on the demand side of the market. This improvement has resulted in healthy growth in year-over figures, a trend that should continue as the market anticipates further improvements in market fundamentals. Government spending has been somewhat flat, although continuing to trend up moderately over the prior year.

At an overall level, declines in the residential component will continue to drag down total construction activity, although private nonresidential and government spending, coupled with rebuilding after Katrina, will dampen the declines. In a number of markets, construction seems to be ahead of demand. This is particularly true in urban centers, as developers respond to increasing tenant demand and development policies designed to encourage denser, more compact development. There are few signs, however, of massive overbuilding that could undercut the fledgling recovery. Indeed, surging rising costs and a shortage of building materials are likely to place a damper on new construction activity. The market could also be adversely affected by changes in immigration policies and treatment of undocumented workers, which could lead to labor shortages and place additional upward pressure on prices. Thus, while the construction industry will remain busy and is likely to exhibit generally positive growth, with the exception of the single-family market, there is some downside risk to the outlook.

Commercial Mortgage Market

The commercial mortgage market continues to provide strong capital support for real estate, with plentiful supplies of private and public mortgages, mezzanine debt, and other capital products. The shortage of investable product has forced lenders to take a more aggressive stance with respect to underwriting, creating some downside risk for the industry. While this has raised some concerns, there are few signs of an impending crisis, with delinquency and foreclosure rates remaining low by historical standards. However, the current pricing and industry activity has been supported by increasing reliance on structured financing in the form of interest-only loans and bullet loans (e.g., long-term amortization periods and shorter-term lump payments). These and other financial structures have allowed lenders to manage debt-coverage ratios that indicate the spread between net income and required mortgage payments in spite of weak market fundamentals. Despite these efforts, debt-coverage ratios have declined from 1.2 long-term averages to 1.15 or 1.10, providing little financial cushion for required mortgage payments and eroding equity residuals. In terms of volume, the commercial mortgage-backed securities (CMBS) industry continues to expand, with issuances trending upward.

The trend toward the establishment of new CMBS product created by enabling legislation in a number of European and Asian countries has had far-reaching consequences on global capitalization of commercial mortgages. On the domestic front, the maturing of the U.S. industry has attracted the interest of foreign investors who have helped fuel the market by funding the higher risk ventures. On the global front, securitization of mortgage product has helped attract additional capital to support transactions and new development in both emerging and developed nations.

These trends are expected to continue, increasing options for investors and expanding the pool of capital to support the industry. While generally healthy, there is some risk that yield-driven investors in securitized product may not focus on local real estate fundamentals increasing the risk of overheating markets. This is especially plausible in light of the relative safety that U.S. product has provided despite relatively weak real estate fundamentals that have shifted investors' attention away from the risk side of the equation.

Private Equity Market

On the private side of the equity market, strong capital flows continue to fuel the market and hold down cap rates. The signs of an early recovery in some of the commercial sectors have created additional downward pressure on current cap rates as buyers begin to build rental spikes into their pricing models. However, many investors continue to remain comfortable with cyclically low income returns, looking toward total returns to justify investments. This response is somewhat understandable, as the NCREIF Index continues to outperform historical averages, racking up some 20% total returns.

While there is some pressure to liquidate assets to capitalize on strong current pricing, the inability to place capital in replacement assets with incremen-

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tal returns has dampened such activity. With real estate on a tear, many investors are reluctant to opt out of the sector and risk missing out on strong performances, many of which are in the form of unrealized gains. This situation is likely to continue as institutional allocations to the asset class rise while investors chase recent returns and provide additional fuel to the already overheated market.

The tightness of the domestic market has caused institutional investors to look offshore in search of higher returns. While much has been written about the need for transparency to justify such capital flows, surprisingly little has been published on the actual outcomes of early investments. Financial innovations pioneered in the United States in terms of REITs and CMBSs are spreading globally, opening the doors for investors to allocate capital offshore in both direct and indirect investment structures. This interest has been met with a ready pool of real estate talent as domestic players expand their international outreach and multinational and global service and advisory firms step up activity levels.

While the skewing of real estate investment allocations offshore has taken some pressure off the domestic market, the cheap dollar and strong global capital flows have more than offset the trend. At the same time, tenancy-in-common (TIC) investment activity continues to surge. While still relatively small as a portion of total market cap, the pooling of TIC investments has helped move them into the institutional arena.

During this phase of the cycle, TIC investors are active on both sides of the market, bringing product to market to lock in capital gains and seeking out reinvestment opportunities to protect tax-deferred status in a rather narrow time frame to avoid capital gains. This time pressure and the emerging nature of the industry has helped contribute to the hefty fee structures, with sponsors getting healthy acquisition fees on top of sales commissions and marketing and organizational expenses. At current levels, front-end fees can exceed 10% of equity with another 4% of income for ongoing property management.

The lack of regulatory oversight and the cumbersome ownership and decision-making processes raise a cautionary flag. In some cases, TIC investors focus more on the capital gains elements of a deal rather than market fundamentals, suggesting the potential for making bad investment decisions.

Despite these concerns, investors continue to flock to TICs, including an influx of new investors who are not involved in 1031 exchanges but are turning to the structure to access the hot property market. The outlook is for continued increase in TIC activity levels, exacerbating the challenges associated with pent-up investor demand stemming from strong capital flows into the asset class.

Public Equity Market

The public equity market has enjoyed a relatively strong year compared to other asset classes despite an across-the-board decline in May. The year-to-date performance through the end of May came in at a respectable 7% plus range, led by apartment and office sectors.

A number of REITs have developed joint venture relationships with major capital partners in order to thwart privatizations, mergers, and consolidations of REITs by public companies. Such activities are increasingly becoming an explicit component of business strategies.

Joint ventures have a number of attractions for managers of existing REITs, allowing them to expand the scope of operations; provide additional sources of revenue; capture greater economies of scale; and retain their independence without having to drive up debt to unacceptable levels. The risk sharing also allows REITs to move into new territory, including international ventures, without taking on excessive risk exposures.

The increase in the yield on 10-year treasuries will make it hard for REITs with annual dividend yields under 4.5% to maintain their positive spread as they have for the past decade. While improving market fundamentals and increasing income streams may allow REITs to reestablish their spreads and attract investors, there are some clouds on the horizon. The continuation of strong interest in commercial real estate suggests that REITs should be able to hold their own relative to alternative investments, which have also slowed down at this point.

On the international front, the spread of REIT-like legislation to European and Asian markets and the search for higher returns in markets with stronger fundamentals and growth prospects has created more interest in global REIT investing. This interest is typified by the recent announcement that the California Public Employees Retirement System will be setting up an internal unit to invest some $1 billion in global REIT stocks. This move will likely spread to other pension plans and fuel a surge in

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capital allocations to REIT managers and advisors who are expected to ramp up their international activities to serve this relatively new market.

Conclusion

During the summer of 2006, the recovery of the domestic economy appears to remain on track, although economic growth is expected to moderate somewhat. Rising interest rates, high energy costs, and the trade deficit remain major question marks. Fortunately, these trends are not new and to this point, the economy has been able to navigate through them.

The housing market is expected to slow down, both in terms of new starts and price gains. However, improving economic conditions should provide a cushion that forestalls a major correction in pricing levels.

Real estate capital flows are expected to continue to support the market, although the string of record prices and declining cap rates is likely over. The commercial mortgage market should remain heated with lenders aggressively placing capital and supporting existing prices. Equity capital flows will continue to fuel a frenetic pace of activity while investors compete for scarce product. Joint venture activity is expected to increase as investors seek higher returns that depend on tapping into the development side of the industry. This trend is likely to be somewhat short-lived; once the market recovery kicks in, developers will be reluctant to share entrepreneurial profits with passive capital providers. The exception will be in cases in which such ventures open new doors, as in the case of global investing and more exotic product classes.

Real estate fundamentals should continue to improve, especially if construction remains in check. However, the built up momentum and investor interest may lead to a long, hot summer in which selected markets and property types bear the risk of getting overheated. Fortunately, there is little near-term risk that such conditions will be widespread and reminiscent of prior down cycles. Over the longer term, a correction in pricing levels and cap rates remains a distinct possibility as the market returns to more normal times and conditions return to long-term averages.

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