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The 4E-Clouds: Europe, Election, Employment, & Expectations

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Commentary

Election years are typically difficult periods for prognosticators since a changing of the guard can have significant impacts on the economic outlook, and on the policies and practices that affect the economy, capital, and real estate markets. The situation is even more challenging in the current environment, as the stakes are much higher with the US economy facing prospects of another recession.

A number of factors are creating uncertainty for the economic outlook; however, there are four major clouds hanging over the US economy, which for purposes of discussion will be labeled "E-clouds." The first and, not surprisingly, most important E-cloud is the situation in Europe. The importance of this offshore source of uncertainty and global drag is evidenced by recent headlines and stock market volatility as the world struggles with the implications of the failure of European leaders to stabilize the countries most at risk without jeopardizing the overall European Union.

The second E-cloud, and one that is certainly not a surprise on the domestic front, is the upcoming national election and the increasingly hard lines that are being drawn in the sand regarding critical economic and policy-level decisions. Unless there is a meaningful reconciliation of interests, the lack of action could have a devastating impact on the economy.

The third E-cloud is the continued disappointing picture on the employment front, which is a critical element to any sustainable economic recovery.

The fourth E-cloud relates to expectations. Nagging uncertainty has spilled over into the expectations of businesses, consumers, and offshore players who will ultimately determine the near-term economic outlook for the nation.

Since the intensities, paths, and convergence among the 4E-clouds cannot be predicted, forecasts should be continuously monitored to avoid getting caught off guard if the winds shift in some unexpected way. Unfortunately, the E-clouds are likely to remain nebulous and are unlikely to bring any respite. This outlook is somewhat ominous, as it is clear the country is in need of cool-headed thinking and collaborative action.

Election and European Clouds

The upcoming election is a significant cloud over the economic outlook. The political rancor that has been fermenting heightens the prospects for an election-related downturn. Unfortunately, the damaging heat waves across the country may be analogous to the heated debates and attack ads that are likely to accelerate as the election draws closer.

While some may discount the barrage of shopworn "I approved of this message" sound bites, they could provide a tipping point given the already tenuous nature of consumer and business confidence. This is particularly true since many voters are aware that the underlying issues have not been addressed, and the political parties have demonstrated they are willing to go to the mat over these issues. Although it is hoped that cooler heads will prevail, the stakes are very high and some of the key players have drawn a line in the sand. The ability of the Obama administration to push some jobs and other stimulus programs through Congress may be critical to the collective psyche of the nation. The various machinations and willingness to take on the grand challenges the country faces will also be closely watched here and abroad, especially by foreign investors whom the United States has come to depend on.

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In a rather bold attempt to focus Congress's attention, Federal Reserve Chair Bernanke in his July 17 opening statement before the Senate Committee on Banking, Housing, and Urban Affairs pointed out the US economy could fall off a "fiscal cliff" unless prompt action was taken. He identified a number of cliff-makers, including the expiration of tax cuts; loss of protection of middle-class taxpayers from the Alternative Minimum Tax; the expiration of some 50 temporary tax breaks for businesses and individuals; and the expiration of payroll tax cuts and long-term unemployment benefits.

Of even greater concern is the possibility of $1 trillion in automatic spending cuts, which could ripple across the economy and help plunge the already fragile economy into a full-blown recession. The fact Congress was willing to push the economy over the brink during its arguments over the debt ceiling in 2011 increases concerns regarding future budget moves. Indeed, the prospects of automatic cuts in US defense spending have already resulted in some defense contractor layoffs and other cutbacks in expenses.

In addition to domestic issues related to the election, the downside risk associated with the European cloud that hangs over the US and world economies cannot be overstated. It is rather ominous that in past downturns, when tracking US versus UK economic cycles, the United States has led with the exception of the most recent downturn in the United Kingdom, which has yet to be felt here.

The importance of arriving at a sustainable solution to the European debt crisis can be punctuated by a variety of evidence. This dependency should be clear to the legions of investors and consumers who have been watching the stock market on a daily basis over the past several months. With few exceptions, a decline in the Dow and the S&P has come on the heels of bad news across the euro zone, while increases have correlated with news that some solution, or commitment to find a solution, has been made.

Although a number of domestic forces will undoubtedly determine the fate of the US economy, the impact of offshore forces cannot be overstated. This high level of economic integration can be illustrated by the surge in the US stock market at the end of the last week in July. That uptick was largely attributable to the European Central Bank's (ECB) President Mario Draghi's pronouncement that the ECB would do whatever it takes to preserve the euro. His statement was noteworthy in the sense that it was much stronger than previous commitments. In addition to impacts on the US markets, the commitment to support the euro created global ripples from Europe to Asia. While lauded by many, the strategy of buying additional country bonds to bolster targeted economies is likely to come under scrutiny. This situation is punctuated by the reaction in Germany, where Chancellor Merkel joined French President Hollande to support efforts to protect the euro zone, while at the same time Germany's central bank announced that it would resist additional bond purchases. Thus, despite some signs of improvement, the situation remains far from over and could drag on past the US election and continue to hang over consumer psyche across Europe.

In other global news, the slowdown in China's frenetic growth, and the concomitant decline of economic growth in many countries, has placed a governor on economic recovery. This has manifested itself in an increase in the current account deficit that can be traced to an increase in the trade gap as exports fell off and net income receipts declined. This situation is likely to prevail until global uncertainty is resolved.

In the meantime, the domestic capital markets continue to enjoy an increase in net long-term capital inflows as international investors are attracted to US securities and bonds. In terms of currencies, the US dollar has held up compared to the euro, but has fallen when compared to other currencies such as the Japanese yen and the Aussie dollar. This trend could be amplified if the Federal Reserve (Fed) and the ECB pursue more monetary easing to stimulate their economies. The situation could erode further if US lawmakers fail to address the looming fiscal cliff by year-end.

The Economic Outlook

Economic Growth

While much of the nation struggled with record-high temperatures, the economy cooled off, with growth coming in below expectations. During the first half of the year, growth in real gross domestic product (GDP) was a tepid 1.5%–2%, which was significantly below expectations. This was a major disappointment to many who had hoped the 2011 fourth-quarter surge would be sustainable and set the stage for the long-awaited recovery. Unfortunately, the economy is likely to remain mired in what has been the slowest post-recessionary recovery since WWII.

Of particular concern are the recent pullback in consumer spending, and the curtailment in hiring

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and investment in plant and equipment as companies have become more cautious. Given the tenuous nature of the economic growth, some prognosticators have noted the economy faces an increased risk of a recession. In addition to the weak economic growth, the downside scenario is driven by disappointing employment growth that has kept wages in check and employees locked into current jobs.

In this environment, there is growing concern that in the absence of some good news, fears of an economic downturn could become a self-fulfilling prophecy. The outlook for GDP growth remains tepid, with some potential for moderate improvement in the second half of 2012. However, the economy faces a number of downside risks and is extremely vulnerable to unexpected events that could create a shock to the system. Going forward, consumer and business expectations, which will be informed by what happens in Europe and on the election road, will play a significant role in determining the economic outlook.

Employment

The disappointing employment environment has continued to hang over the economy. However, some pundits have pointed out that the situation is not as bad as it could be in light of the slowing global economy and festering domestic issues.

In terms of numbers, during May and June employment growth averaged a disappointing 80,000 jobs. In July, employment growth came in at a seasonally adjusted 163,000, which created an immediate surge on Wall Street and eased some recession fears. The soft employment-growth figures help explain the slowdown in total compensation and the cost of benefits. Productivity levels are somewhat mixed, with overall productivity slipping a bit, suggesting pressure on current employees. However, manufacturing productivity continued to increase at the same time demand softened on both the domestic and international fronts.

Despite the disappointing employment-growth statistics, there have been some positive signs that the employment situation is flattening out. These included an increase in the hours worked by current employees as well as an increase in temporary hires, which may mean employers will be under pressure to add new workers to boost output when demand begins to firm up. On another positive note, the pace of planned layoffs declined in May, suggesting that companies have not pushed the panic button. In addition, the pace of mass layoffs continues to trend downward, although there was a slight increase in the number of affected employees in the middle of the 2012 second quarter. The number of firms that indicated they were planning to hire improved somewhat toward the end of the quarter. Despite this posturing, however, few firms were willing to pull the trigger in light of growing uncertainty regarding the fate of the economy.

The unemployment rate has remained stubbornly high, and there are doubts about whether the Obama administration's sub-7% target can be reached by year-end. The prospects that the target will prove elusive are attributable to a combination of the slowing economy and the inability of a divided Congress to arrive at a compromise on additional job-creating legislation.

In the absence of an unexpected turnaround in the global scene and meaningful interventions in Washington, the employment situation is likely to continue to languish through the balance of 2012. It is uncertain whether the situation will improve in 2013 in the absence of some catalyst or economic recovery, and the employment outlook remains rather flat with isolated areas of improvement emerging. It is hoped that such improvement will eventually give way to a more generalized recovery. However, the situation is likely to remain frustrating unless the mismatch between employer needs and employee skills and expectations is resolved.

Inflation and Interest Rates

The low inflationary environment, which has been discounted into the economy, is likely to continue through the end of the year with little sign of a surge of inflation on the horizon. Indeed, price indexes are consistently below the Fed's 2% target rate, with personal consumption price increases coming in around 1.6% for the year. When food and energy components are held out, inflation rates remain below target.

Despite some concern over inflation over the longer-term, the softening economic and employment outlook is likely to keep inflation in check over the near-to-intermediate term. This outlook has been bolstered by the global economic slowdown, which has taken pressure off prices for imported goods and for raw materials.

During the first two quarters, producer prices were relatively flat, falling off the increase reported at the beginning of 2012. On a similarly positive note, import prices declined, falling more than expected on the heels of the global economic slowdown. Going forward,

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there may be some unexpected pressure on consumer budgets as the record heat wave and associated drought across much of the country put upward pressure on food prices, which had been declining before a brief uptick in June. Lower energy prices attributable to the global slowdown should offset some of that pressure on consumer budgets. However, many households will also face near-term pressure from higher energy costs related to the record heat that lingered through the summer.

The tenuous nature of the US economic recovery and the absence of positive forces from offshore have turned attention back to the Fed. The importance of having clear signals that the Fed will step up to the plate was noted by the pullback in the stock market after the ECB's pronouncement in late July provided a brief respite from the concern over global issues.

While offshore forces remain significant, investors are still looking for positive signals from Washington. Thus, the Fed's Open Market Committee at the end of July took on added significance. This importance was amplified by the fact that in its previous meeting the Fed acknowledged that the economy is facing a number of headwinds but failed to make a major move toward further quantitative easing. While there are growing calls for a third round of quantitative easing (QE3), it is likely that the Fed will hold off until the next jobs report comes in and then make a move in September. To appease investors and bolster expectations the Fed is expected to extend its commitment to keep interest rates low through mid-2015. Regardless of what the Fed does, moderate economic growth is expected to continue through the balance of 2012. In this environment, inflationary pressures should remain tempered.

On the interest rate front, the Fed extended Operation Twist, which was designed to hold long-term rates down by purchasing Treasuries with six- to thirty-year maturities through the end of 2012. The impact on the $44 billion per month program on the overall economy will be muted by the Fed's efforts directed at flattening the yield curve by selling an equivalent amount of short-term securities. While this decision will help hold long-term rates down, its impact will be lessened because this action has already been discounted in the market. In terms of the outlook for interest rates, the cost of debt is likely to remain favorable, although appetites for debt may vary among various classes of borrowers depending on their relative expectations for the economy.

In terms of access to debt, banks and other lenders have been easing lending standards on selected types of loans. This easing has been necessitated by increasing competition from other lenders, which has made it easier for borrowers to access capital. Unfortunately, the recent spate of bad news and lingering uncertainty has kept small businesses on the sidelines as they have pulled back to see which direction the economy is likely to head before turning to the credit markets to support new investment.

To this point, consumers have done a fairly good job of staying on top of credit requirements, with some weakness in auto loan repayments offset by improvement in credit payments and student loans. The outlook for student loan payments was improved by the extension of the student loan interest program and by changes to the federal Income-Based Repayment Plan, which will drop the cap on student loan payments from 15% of discretionary income to 10% for eligible borrowers in 2014.

In the absence of a recession, consumers and businesses should continue to enjoy access to debt. The question is whether they will have the confidence to increase credit obligations or will they be forced to in the face of an economic slowdown.

Business Indicators

In general, business indicators are somewhat mixed, which is not unusual given the recent bad news that caught many off guard. During the first half of the year, the Conference Board's leading indicators exhibited a moderately downward slope, characterized by a sawtooth pattern representing periods of ups and downs as the economic environment gradually deteriorated.

In the most recent figures, downward pressure of leading indicators emanated from a decline in orders throughout the supply chain and the erosion in consumer expectations. Additional negative news came from the declines in the stock market and disappointment on the employment front. Business inventory levels have increased modestly due to the decline in consumer and business sales. Thus, the supply chain quickly contracted in light of disappointing economic news. The result has been a slight increase in the inventory-to-sales ratio, but one that remains below the peak ratio reached at the end of the recession.

At an aggregate level, business productivity levels declined modestly during the 2012 first

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> "In the 2012 second quarter, industrial production activity declined significantly."

quarter, reversing some of the gains at the end of the last year. The exception to this pattern was in the manufacturing sector where overall productivity levels rose over 5% and durable manufacturing productivity to almost twice that level. As a result, manufacturing and labor costs experienced a comparable decline due to soft wage rates.

In the 2012 second quarter, industrial production activity declined significantly with an annualized rate falling below 2% after pushing a 10% level during the first quarter. This dramatic decline was reflected in the Manufacturers Alliance for Productivity and Innovation's outlook, which continued to trend downward but remained above the expansionary threshold. The Institute for Supply Management's manufacturing index trended downward during the first half of the year, slipping even further than expected on the disappointing economic news both domestically and abroad. During the same period, the nonmanufacturing index also declined as the economy slowed across the board and dragged the service sector down.

In terms of capacity utilization, the number of manufacturing firms that reported operating above 85% fell to 35% during the second quarter. Given this situation, a significant number of firms have excess capacity that will allow them to increase output without requiring additional plant and equipment. When coupled with ready access to credit, manufacturers are well positioned to take on additional workers to respond to improving economic conditions. However, until some of the uncertainty is removed from the equation, tempered expectations will continue to hang over business activity and moderate business indicators.

Stock Market

Despite the advanced quantitative models that some investors rely on in allocating to equities, a significant share of market movement and resultant volatility continues to be driven by investors' expectations. Specifically, expectations for future earnings have become an increasingly critical factor in stock market valuations.

During the first half of 2012, analysts significantly ratcheted back their expectations for earnings, which have fallen by over 75% from 2010 and 2011 projections. In hindsight, some have wondered how forecasts could have been so strong in light of the rather tempered rate of the economic recovery that belied such outcomes. Granted, the ratcheting down of earnings forecasts has allowed 80% of the 300 companies reporting earnings to match or beat expectations. However, rather than looking back, attention has been focused on the future.

While in normal times matching expectations can be an important achievement for corporate management, today few investors take solace in that achievement if the earnings results are disappointing. Even when companies are able to exceed the expectations hurdle, the fact the hurdle has been lowered has decreased the tolerance of investors. For example, even though Starbucks Corporation was able to hit its expected earnings hurdle after stock prices had already fallen some 10%, prices slipped as investors focused on tempered outlooks for earnings projections. At the same time, the bloom has come off the rose of some of the most touted IPOs, including Facebook and Zinga—both of which turned out to be real zingers for investors who tried to catch the social networking wave.

In addition to more tempered outlooks across many industry sectors, the banking sector has come under particularly intense scrutiny. Banks have been subject to criticism for some time and have been on the defensive after the "too big to fail" bailouts; however, recent events such as the $6+ billion losses on derivatives at JP Morgan and the LIBOR manipulation scandal have exacerbated the situation.

When the LIBOR scandal first emerged, it appeared the fallout would be confined to Europe. More recent events suggest, however, that it is likely to have global, if not epic, implications. For example, although Chairman Bernanke indicated he was powerless to stop the manipulation when he learned about it in 2008, his defense has not resonated with many. Similarly, Timothy Geithner—who was the former president of the New York Fed when the manipulations first emerged and has been Treasury Secretary since 2009—received much criticism for not intervening or bringing it to light so it could be addressed by the proper authorities. This criticism came from a number of sources, including the House of Representatives' Financial Services Committee,

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which chastised Geithner for not raising a flag in his various appearances.

The LIBOR scandal is far from over. Regulators and policy makers are trying to understand the scope of the problem, and pressure is mounting to take some action. Indeed, Sandy Weill, the former chair and CEO of Citigroup, has argued that it is time to break up the big banks to split investment banking from traditional banking functions. Some have questioned his motives, including former Senator Chris Dodd and others who sponsored the Dodd-Frank bill, and they have argued breaking up big banks is too simplistic. Rather than focusing on the size of the institution, Weill has argued that the questionable activities and risk taking are key issues that should be addressed in future bank reforms.

While these debates are likely to rage on past the election, the courts are also likely to step in and play a key role in determining the consequences that the perpetrators will face. These lawsuits will be widespread in the United Kingdom, where the bulk of the crimes were committed, as well as in the United States and other countries where borrowers were adversely affected by the fraud.

Regardless of how the scandal plays out, the future of big banking is likely to change, with limited prospects of returning to business as usual when all is said and done. How the imminent changes will affect future global capital flows remains to be seen. In the meantime, downward pressure on the overall banking sector is likely due to the expected winding down of the mortgage refinancing boom and the end of cost-cutting measures that have bolstered earnings.

Consumer Confidence

Consumer confidence levels have trended downward over the past several months as consumers focused more attention on future conditions. This downward trend is not unexpected in light of the deterioration in general economic conditions and continued softness on the employment front.

In this environment, consumers seem resigned to the fact that employment income increases will be elusive over the near-to-intermediate term. They are also somewhat sanguine over the outlook for business conditions and appear to be expecting downward pressure through the end of 2012 and into 2013. The rocky stock market and downward trend through much of the first half of 2012 was also a concern.

Consumer confidence measures indicate that consumers have discounted low inflation expectations and are banking on the assumption inflation will remain moderate or even decline over the intermediate term. Despite widespread concern over the plight of the economy, not all consumers share the same reaction. For example, respondents over thirty-five years old were more pessimistic than their younger counterparts. Given the vulnerable nature of consumer confidence levels, the election debates and news from offshore are likely to play an important role in determining the collective consumer psyche of the balance of the year.

Retail Sales

The retail sector plays a critical role in the US economy, accounting for some 70% or more of economic activity. As such, the improvement in retail sales during the 2012 first quarter was seen as a bellwether of good things to come. However, earlier predictions that consumers would not lead the economic recovery came true during the second quarter as consumers began to ratchet back their buying.

This pullback was in line with the stumbling economic outlook as well as the trend in personal income growth, which has continued to decelerate. It is also consistent with the recent revisions to the savings rates that indicate consumer saving is lower than reported for 2011. Given the declines in personal income, savings rates are likely to face additional pressure as consumers shift their buying patterns from wants to needs and face purchases of replacement goods that can no longer be deferred. The tepid outlook for the economy and income growth is likely to push such a shift into next year when some of the election-related uncertainty may be taken out of the equation.

The recent erosion in consumer confidence levels is likely to lead to further declines in consumer spending. Retailers will have to redouble efforts to attract consumers back to the registers or to their keyboards.

The weak spot in retail sales has been in the durable goods category, which consumers have eschewed in light of pessimistic reads on the intermediate-term economy and their own financial situations. On the other hand, the temporary decline in fuel prices allowed consumers to shift scarce dollars to other goods and services and thus bolstered

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sales of non-durable goods. However, this shifting did not spill over to the durable goods side of the equation. Based on recent experience with volatile energy costs, it was understandable that energy price declines would not be sufficient in magnitude and durability to convince consumers to shift consumption to more capital-intensive durable goods.

As has occurred over much of the past several years, Internet sales have continued to increase, belying the fate of traditional in-store purchases. While growing at a solid 15% plus rate, Internet sales as a percent of total retail sales still remain slightly below 5% overall. This picture may not provide an accurate assessment of the full impact of the Internet on retail shopping due to the fact that the Internet, technological innovations, and social networking have become important tools of the trade of consumers and traditional retailers alike.

On the consumer front, a growing number of potential buyers are using traditional stores to preview merchandise, only to go back to their keyboards to pull the trigger and order for in-home delivery. On the retailer front, merchants are redoubling their efforts to make their stores more Internet and social network friendly, hoping to attract more buyers and convert them to customers. At the same time, retailers have beefed up their own websites and have tried to attract virtual customers through a combination of price matching, delivery, and personal service before and after the purchase. Merchants are increasing use of technology to help with replenishment and distribution to provide a competitive edge over pure virtual retailers. These efforts of traditional retailers to compete with virtual competitors may receive some much-needed help in the form of the imposition of sales taxes on Internet purchases outside of states in which the retailer has a physical operation.

Going into the important back-to-school season and leading up to the holidays, the outlook for retail sales remains tempered both on a comparative and absolute level. While consumers will focus on essentials and nondurables, some will likely want to return to fashion-based purchases again. In this environment, retailers will be scrambling to figure out how to attract consumers and how to ensure they have adequate supplies at the appropriate price points and quality levels. As in recent years, they may err on the conservative side and go short on inventory at the risk of losing potential sales. At the same time, they will struggle with the message they want to convey to consumers, especially regarding the need for early and deep discounts to generate traffic and compete in what is likely to be a generally soft buying season with significant downside risk.

Housing Market

The housing market has been closely watched as a harbinger of times to come in the real estate and broader economic markets. While still struggling on a number of fronts, there has been some positive news on the state of the housing industry. For example, during the first half of the year, housing starts continued a moderately upward trend with 760,000 annualized starts at the end of the second quarter. Despite this uptick, residential starts remained significantly below long-term averages but above the post-recessionary period once the pipeline was burned off.

Although the bulk of total housing starts were single-family properties, about a third of the activity was in the multifamily sector. While single-family starts trended upward though much of the first half of 2012, multifamily starts were more volatile, racking up low double-digit month-over increases in three of the first five months. On the single-family front, new housing supplies are relatively low while housing prices have stabilized, which may entice some new home buyers into the market.

There was some disappointment in the level of housing sales as a decline in sales ended the upward trend that had carried through much of the first half of the year. Pending home sales also turned down in June, although the moderate decline was not as steep as in April before an uptick in May. This pattern of oscillation is not unusual given the downside economic signals that potential buyers have to overcome.

Since interest rates are likely to stay at historically low levels well into next year, buyers feel little pressure to pull the trigger. In some markets, however, low inventories have resulted in bidding wars, a phenomenon that many have been waiting to see. Unfortunately, these situations are isolated to select markets and submarkets where the increase in demand is related to local economies or other externalities.

In terms of prices, trends during the first half of the year suggest the market may have bottomed out, with price declines moderating and actually giving way to price increases in some markets (e.g., Chicago, Denver, Houston, Miami).

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Improving fundamentals—or rather an end to further erosion—has provided homebuilders with some much-needed confidence as reflected in the upward trend in the NAHB Housing Market Index. This improvement was fairly widespread, although few homebuilders felt anything close to the euphoria that led to the 2006 collapse. Indeed, after a shakeout in the industry and a wave of consolidations, homebuilder optimism is expected to continue to be guarded and help ensure that supply does not get ahead of demand. At the same time, there is a significant overhang of entitled sites that have been sitting idle for several years. These sites were acquired by investors and builders at attractive prices, and give them a competitive cost advantage over product built during the heyday period of the mid-2000s.

The recovering housing market should be supported by adequate debt capital, with a number of lenders competing for business. The refinancing cycle should play out over the near term and lenders will seek to continue to originate mortgages to prop up their revenue streams, which are facing downward pressure on a number of fronts.

Although there has been a decline in mortgage delinquency rates, outstanding mortgages that are underwater or held by distressed homeowners remain a major concern. Thus, while sale prices for nondistressed properties may remain firm as owners opt to wait for a recovery, the same is not true for distressed assets that must be liquidated over the near term. Lenders are expected to continue to expand access to mortgages moving down the food chain but draw the line above where it had slipped before the market collapsed. As a recent headline in *The Wall Street Journal* noted, "Housing Isn't a Horror Show Anymore."[1] However, it's far from a romantic movie and will offer some of the excitement of the new wave of blockbuster movies.

Real Estate Market

Overview

During the recession, it was generally believed that real estate would lag the overall recovery, as space users would absorb excess capacity before turning to additional space. The good news in the real estate market has been that, despite the collapse of commercial values, the correction was not due to a surge of overbuilding as was the case in the late-1980s. As a result, the capital market side of the real estate industry has actually recovered ahead of the broader market. On the spatial side, there also has been some improvement in fundamentals of supply and demand, although certainly not outpacing the general economic recovery. This disconnect is due to a number of factors, including the prolonged low interest rate environment and the lack of viable alternative investments. The sector has continued to attract investors to the asset class despite historically low implicit capitalization (cap) rates around 5.76% for the full spectrum of private properties.

At an overall level, during the first half of 2012 institutional real estate had a relatively strong run compared to other asset classes. On the private market side through June, the NCREIF Property Index provided a 5.3% average total return. During the same period, the FTSE NAREIT Equity Return Index racked up almost 15% in total returns. On a trailing twelve-month basis, NCREIF Property Index returns came in at 12%, while real estate investment trusts (REITs) came in around 50 basis points higher. This suggests a shift in momentum, with private property cooling off a bit and public property picking up momentum as investors clamor for returns in light of the volatile equity market.

The low cap rates at which prime properties have traded have continued to spill over to other properties, reflecting commoditization of pricing and/or valuation. This trend is likely to continue until market activity picks up across the board and investors once again tie pricing to individual property fundamentals as opposed to overall asset class halos.

Similarly, the average payout ratio (i.e., dividends as a percentage of funds from operations) averaged 71% through midyear, which was an improvement over 2011 but below long-term historical averages that were last exceeded in 2006. REITs continued to use leverage in a strategic manner, with average debt ratios of 36% and strong fixed-debt coverage ratios of 2.6% overall.

Office Market

During the 2012 second quarter, office market fundamentals continued modest improvement in spite of the economic downturn that undercut business confidence levels. However, the improvement in office fundamentals represented a tale of two cities.

1. "Housing Isn't a Horror Show Anymore," WSJ.com, July 27, 2012.

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Central business district (CBD) space in selected markets with strong technology and knowledge industries led the way, while suburban space and spaces in other markets struggled to gain momentum. In general, vacancy rates continued to decline moderately, moving into the lower teens for CBDs and the mid-upper teens for suburban offices.

The overall improvement that has occurred is attributable to a combination of tempered but positive demand for new space and the lack of new construction in most markets. Absorption levels have outpaced delivery of new space, and this is likely to continue with the recent pullback in construction activity. Tenants have been taking advantage of higher vacancy rates by continuing their flight to quality. This has created a bifurcated market that has placed upward pressure on top-end properties while leaving non-core assets struggling for tenants.

Going forward, the moderate economic slowdown is likely to forestall significant improvement in office market fundamentals. But on a positive note, the firming up of supply and demand is likely to help the sector avoid significant erosion in fundamentals. If the economy slips into another recession, however, this situation could change dramatically, and this concern is likely to keep investors on the defensive.

With respect to transaction volume, office property sales increased moderately during the 2012 second quarter but were off a bit from the prior year. Office cap rates averaged 7.1% overall, which continued the downward trend that began in late 2009 when transaction cap rates pushed 9%. Despite edging down, the rate of decline continues to flatten out as the market reaches a balance point between supply and demand for assets. According to Real Capital Analytics, the decline in cap rates was attributable to CBD transactions, while suburban cap rates edged upward.

In the second quarter, office transactions totaled $14.8 billion, bringing the dollar total for the first half of the year to some $29 billion. Interestingly, despite an increase in volume, the average deal size declined by 24%, indicating investors have expanded their horizons beyond the large, core trophy office properties that have become more than fully priced. In addition, transaction volume increased the most in secondary and tertiary markets as investors were willing to expand their investment horizons in search of better deals.

With respect to distressed office properties, some $43.6 billion were outstanding at the end of the second quarter. Of these properties, the majority were held by CMBSs ($28 billion) followed by domestic banks ($6 billion), other lenders, international banks and life companies. In terms of market share, distressed office sales trended downward, averaging under 10% for the first half of 2012. At an overall level, 57% of distressed office loans were worked out at an average recovery rate of 67%. In terms of changes to distressed assets, the pace continued to slow, falling to the lowest rate since the market collapse became more visible in late 2008.

On the private market side of the institutional real estate asset class, office properties represented some 35% of the total $310 billion in the NCREIF Property Index at the end of the 2012 second quarter. For the first half of the year, office returns totaled some 4.8%, representing something of a slowdown compared to a one-year trailing return of slightly over 10%. While attractive relative to other asset classes, one-year office returns lagged other property types, which averaged 12% for the major property sectors.

With respect to subtypes, CBD office investments outperformed suburban investments, with one-year returns of 11.5% and 9.7%, respectively. In terms of implicit cap rates, the overall office sector was priced at a 5.8% overall cap rate for the twelve months. At a subtype level, CBD offices were trading at a premium to their suburban counterparts with a one-year income return of 5.29%. CBD income returns continued to hold at record lows during the first half of the year, reflecting strong investor appetites for core properties.

Office REITs experienced strong returns during the first half of 2012, slightly lagging the overall averages, which came in slightly under 15% on a year-to-date basis. However, office REITs showed some signs of strengthening on a relative basis, with June returns outperforming the other major property-type sectors.

In terms of market capitalization, pure office REITs accounted for only 15% of total REIT market capitalization when compared to the major property types (e.g., retail, industrial, apartment, and diversified). This basis provides a more consistent benchmark compared to the NCREIF Property Index and focuses on the property types generally considered core asset sectors by institutional investors. While office properties are also included in some of the mixed (i.e., office/industrial) and diversified REITs, the allocation to the office sector reflects an underweighting relative to office market share of institutional-grade office properties.

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Retail Market

Improvement in retail market fundamentals has continued to lag other property types, especially in light of the recent declines in consumer confidence and quick contraction in retail sales.

The supply side of the retail market remains largely inactive. Retail vacancy rates failed to improve as retailers rationalized their stores and focused on repositioning strategies and investment in technology in an attempt to recoup lost market share. As the overall retail sector struggles, properties in solid locations with strong tenancy matched to the trade-area demographics continued to do well. This trend toward product differentiation and value maintenance is likely to continue past the ultimate economic recovery as consumers adjust their shopping patterns to reflect their changing situations and lifestyles.

Despite no significant increase in retail space, a number of retailers continue to explore urban formats to complement existing suburban stores, as evidenced by new Target and Walmart stores in urban cores. The challenges these and other traditionally suburban retailers and big-box stores face in moving into urban cores will tend to inhibit the trend, but retailers seeking to retain or increase market share are likely to continue to push for such outlets.

In the second quarter, retail transaction volume reported by Real Capital Analytics totaled some $11.6 billion. While significant in absolute terms, volume was off from the prior quarter and the prior year, reflecting a slowdown in market activity. Of total retail transactions, sales of strip centers outpaced other segments, exceeding $5 billion in volume. Despite this market share, sales of regional malls and other formats grew at a faster rate.

At an overall level, retail cap rates have continued to decline, falling some 100 basis points from a peak in early 2010 to 7.2% in the current market. Due to market forces for retail assets, prices have remained relatively flat.

In terms of distressed sales, 10% of total retail sales volume fell in this category, although it accounted for only about 14% of activity due to smaller average values. The good news is that some 60% of distressed retail assets have been cleared out of the queue after a wave of restructurings and loan extensions. When large portfolio sales in 2011 are held out, retail sales in the first half of 2012 showed an increase of over 21%.

At the end of the 2012 second quarter, about $27 billion of distressed retail assets remained outstanding. In a sign that the worst may be behind the sector, the additions to the ranks of distressed assets were at the lowest level over the past four years. As with other property types, the bulk of distressed retail properties were in CMBS pools, followed by domestic banks and other capital providers.

In terms of workouts, 58% of distressed retail properties were resolved with an average recovery rate of 63%, with insurance companies outperforming other lenders. In terms of market share, distressed retail sales accounted for slightly under 10% of total retail transactions, reflecting a brief uptick in the second quarter.

On a trailing twelve-month basis, private retail investments led other institutional categories with overall returns of 13.4%. Retail investments continued to provide strong returns during the first half of the year, leading other property types in the second quarter. Retail investment generated a 56.4% overall implicit cap rate, leading the overall average of 5.9%, but trailing long-term averages. Retail investments represented 22.7% of the NCREIF Property Index, below market share of the investable universe representing moderate underweighting to the sector.

In terms of subtypes, super-regional malls led all retail categories with trailing returns of 15.2% on an implicit cap rate of 6.2% annualized. Regional malls experienced slightly lower returns, followed by community and neighborhood centers. Retail fashion/specialty centers were somewhat disappointing, with returns around 10% on low cap rates that have trended downward to an annualized 5.5% as investors pursued the sector.

On the public market side of the industry, retail REITs were one of the leading property sectors through the first half of 2012, with total returns over 21%. These figures were fairly widespread, with regional malls taking the lead and shopping centers slightly under average. The durability of regional mall REITs was evidenced by the strong sector performance in both 2011 and 2012. The smaller shopping center sector was up dramatically from a slightly negative return in 2011. In terms of implied market capitalization, retail REITs accounted for over 28% of the index, leading all other property types. The retail market share of the major property types was even more significant, coming in at 42%

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of total REIT assets; of that total, regional malls accounted for two-thirds of the retail holdings.

Industrial/Warehouse Market

Industrial market fundamentals remained relatively stable during the first half of 2012 despite softening of the economy and disappointment on the export front. Even with the economic slowdown, industrial vacancy rates have continued to trend downward, especially in major distribution hubs that benefit from changes in logistical models. In some markets, tenants have continued to upgrade space and take advantage of higher-than-normal vacancy rates. This trend is likely to continue and create problems for the functionally or logistically challenged spaces left behind; however, the available supply of upgrade space is relatively limited.

Despite a moderation in the outlook for warehouse demand, a number of trends may create additional opportunities. These trends include the Panama Canal project, which will affect the south and southeast ports; the reconfiguration of supply chains, which is an ongoing proposition as companies seek to improve throughput and achieve other efficiencies; and the growing reliance on technological innovations. These changes will affect the location, design, and configuration of contemporary warehouse facilities.

On the R&D, flex, and light manufacturing end of the market, improvement in fundamentals will be tied to improvement in economic conditions as well as absorption of excess capacity.

Industrial property sales in the 2012 second quarter totaled $8.4 billion, which was materially lower than the previous year. However, that comparison was distorted by the mammoth AMB/ProLogis merger. Industrial cap rates continued to flatten out during the first half of the year, averaging 7.7% by midyear.

The transaction volume in the second quarter benefited from a number of portfolio sales, although nowhere near the AMB/ProLogis merger. Distressed industrial sales were not insignificant, and comprised only 6% of total transactions, a figure that came in lower than any other major property type. Sales of flex properties led the sector due to a surge in such activity, although aggregate warehouse transactions were not far behind. In terms of tenancy, single-tenant properties dominated industrial sales, accounting for some 28% of all transaction volume and up over 40% on a year-over basis.

The industrial/warehouse component of the private real estate market represented around 14% of the total NCREIF Property Index market capitalization, which was generally in line with the market share of institutional real estate. On a trailing twelve-month basis, private industrial properties provided competitive returns, slightly above the overall averages. This relative performance improved during the second quarter, with industrial returns leading the overall index with the exception of retail properties.

In terms of pricing, industrial properties exhibited an implicit cap rate of 6.4%, which was ahead of the overall figures but below long-term averages. In terms of subclasses, warehouse properties provided the highest total returns at 12.9%, followed by R&D and manufacturing. Flex industrial space provided disappointing total returns of 6.7% despite having the highest cap rates among other industrial sectors.

Industrial REITs outperformed the overall NAREIT Index for the first half of the year, although relative performance slipped a bit in June. The increased strength in the industrial sector was noteworthy on the heels of weak performance in 2011, when the industrial sector fell over 5% and trailed all property sectors except lodging. Focused industrial REITs comprised only 6% of the traditional property-type allocations. Although industrial components of the office/industrial and the diversified categories increase the concentration of industrial properties, the aggregate figures still represent significant underweighting to the sector.

Apartment Market

On the demand side of the equation, apartment market fundamentals continued to improve during the first half of 2012, with prospects positive for the near term. Due to delays in the production element, the supply side has remained relatively in check although that situation is likely to change. This shift is likely to occur as developers ratchet up activity to take advantage of the anticipated surge in demand due to changing demographics; rising immigration and net in-migration that is occurring in some markets; increases in household formations; and shifting lifestyle preferences.

While the list of positive demand-side factors is long, there is a growing danger that apartment developers empowered by investors seeking product will saturate the market. However, there is a more

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significant risk that some strata of the apartment market will become oversaturated while other strata will be underserved. This caveat is based on recognition that the demand side of the housing market requires a segmented approach. That is, developers and investors should focus on the needs and wants of distinct clusters of renters. While this approach is known to veteran apartment developers, lenders and developers new to the sector may take a less precise look at the market. The end result will be pockets of overbuilding dominated by redundant product that targets an attractive but finite band of demand. At the same time, other segments that may provide more enduring demand and deliver better value may languish.

Apartment transactions led most other major property types during the first half of 2012, trailing only office properties, which have a greater market capitalization. Overall, Real Capital Analytics reported $16.2 billion of apartments traded hands in the second quarter, leading all property types. This increase in volume was a testament to the favored status of the sector among institutional investors and the compelling story that they have been sold.

Not surprisingly, apartment cap rates were lower than other property types, trending down to 6.2% by midyear. Despite some flattening, apartment prices continued to trend upward, a pattern that is likely to continue over the near term. Developers acquired a record level of $2 billion in apartment sites, providing further evidence of the apartment demand.

On the distressed front, apartments benefited from strong investor demand, with additions to the distressed segment trending down and lenders resolving some $4.4 billion of distressed assets. This surge in activity increased the market share of distressed sales to 18% and likely contributed to the slowdown in the decline in reported cap rates.

Garden properties were the most active component of the transaction market, comprising roughly two-thirds of total volume. As with office properties, average deal sizes for apartments declined and investors expanded their horizon to include smaller secondary and tertiary markets.

On the private market front, apartment properties comprised over 25% of the NCREIF Property Index universe, a figure that is somewhat above overall market share of the investible universe. For the trailing twelve months, apartment investment led the overall index by some 120 basis points, trailing

> "There is a growing danger that apartment developers empowered by investors will saturate the market."

only retail properties. However, apartment properties were more aggressively priced than other property sectors, with an implicit cap rate of 5.4%. This figure trended downward in the first half of the year, reflecting strong investor interest in the sector.

With respect to subclasses, low-rise apartments provided the highest trailing one-year returns at 14.8%, followed by high-rise and garden apartments. Reflecting strong investor demand and preferences for urban infill, high-rise apartments traded for 4.8% cap rates for the year and have held firm in spite of increasing construction activity in the sector.

The public apartment sector experienced below-par performance during the first half of 2012, with total returns coming in under 10% and lagging the overall REIT Index by a third. In addition to disappointing performance relative to other property types, the performance was significantly below 2011 returns, which led the other major property types with the exception of regional malls. In terms of market share, apartments comprised some 22% of the major property types, a figure that represents an overweighting relative to private market holdings of institutional-grade properties.

Real Estate Capital Markets

Transaction Volume and Pricing

Real estate transaction volume was relatively strong during the first half of 2012, although slipping somewhat from the second half of 2011. According to Real Capital Analytics, this slowdown is an anomaly that can be attributed, in part, to the fact the 2011 figures were inflated by a number of large merger and acquisition transactions.

During the first half of the year, Real Capital Analytics tracked some $108.8 billion of transactions spread among some 7,600 properties. In terms of pricing, the overall cap rate on significant commercial transactions was 6.9%, which is not 18 basis points over the prior year. Apartments, which have been the darling of investors for some time, had a 6.2% cap rate, while industrial and hotel cap rates

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of 7.8% were at the top end of the range. Office and retail rates came in at the low 7% range.

In terms of sales volume, transactions for offices eked out apartments with both sectors at around $30 billion. Sales volume in the retail sector followed at $24 billion, industrial at $14 billion, and retail at $7.5 billion. Reflecting the increased optimism among developers, sales of development sites pushed $5 billion, which was a 67% surge in transaction volume over the prior year.

A significant portion of institutional-grade sales were initiated by motivated sellers facing mortgage maturities. However, distressed sales as a percent of total fell to 12% compared to the 15% average for the prior year. As investors sought higher return opportunities, attention shifted to the secondary and tertiary markets that were overlooked during the early stages of the recovery. Sales in major markets were moderately down, but this was based on an absence of available product rather than the lack of investor interest. The hottest markets across the country were those whose economic base was tilted toward technology, entrepreneurship, innovation, and knowledge transfer.

Distressed Assets

On the distressed asset front, Real Capital Analytics reported that commercial mortgage defaults in transfers to special servicers continued to decline, although still over $26 billion in the first half of 2012 and with increased volume in the second quarter. The office sector led the pack with $43.6 billion, followed by the apartment sector at $33 billion, retail sector at $27 billion, hotel sector at $22 billion, and industrial sector at $12.5 billion. At an aggregate level, 55% of distressed properties were worked out with an average rate of recovery of 67%. The lowest rates of recovery were in the land and the other property categories, with land providing the lowest rate of recovery at 55%.

In terms of lenders, CMBS led all categories with $82 billion in outstanding distressed loans, followed by domestic banks at $40 billion, other sources of capital at $34 billion, international banks at $10.6 billion, and insurance companies at a rather surprisingly low $3 billion. Interestingly, international banks had the highest workout rate eking out insurance companies at 66%, while insurance companies had the highest recovery rate of 77%.

Equity Capital Flows

The increase in equity transaction activity in the first half of 2012 was bolstered by an array of investors: private capital; public pension funds; listed and unlisted REITs; domestic advisory firms; local and regional investment firms; development firms; partnerships; and foreign investors. This potpourri of investors reflects the widespread interest in commercial real estate in the United States.

While some investors are taking advantage of low interest rates to increase leverage returns, a significant share of investors are all equity players focusing on core properties in established markets. On the other hand, opportunistic investors and advisors are finding an increasing array of properties available for which value can be created through a number of sources. Some of the larger market-timing players appear to be ready to exit the market before it peaks, including some larger opportunity funds with short-to-intermediate term investment horizons.

While the global slowdown and the deteriorating economic outlook for the United States are of concern to investors, the lack of viable options continues to benefit institutional-grade real estate. Some of the players are long-term investors and are not concerned with mark-to-market fluctuations. But, there is a downside risk that investors who have not developed appropriate exit strategies and pricing models may be faced with realized returns that are significantly below pro forma forecasts generated at acquisition.

Mortgage Capital Flows

On the commercial mortgage front, a number of players remained active during the first half of 2012 and are expected to do so going forward. These include traditional sources such as domestic and international banks as well as insurance companies, mortgage funds, pension funds, advisory firms, and the CMBS industry.

In terms of transaction volume, life insurance companies and commercial banks are expected to be a major source of capital, while the CMBS market will still struggle to gain traction. According to Fitch Ratings, some $570 billion in CMBS loans were outstanding at the end of the second quarter of 2012. With respect to vintage (i.e., year of issuance), the bulk of the CMBS loans in default originated in the 2005–2007 period leading up to the collapse of the industry.

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In terms of property types, health care properties had the highest default rate at 26%; followed by hotels at 23%; multifamily at 18%; and the trio of industrial, retail, and office slightly over 10%.

The push back of maturing bullet loans that has occurred through various restructuring, extensions, or other workout programs still looms over the commercial market with some $12.3 trillion of property in need of recapitalization over the next three to five years. While this overhang will be problematic and may take some government intervention before all is said and done, the private and public sides of the market are likely to have the capacity and desire to help support normal transaction volume.

The spillover effects of Operation Twist and the continued low interest rate environment will help make loans affordable for those borrowers and properties that qualify under competitive underwriting guidelines. It should be noted that this situation could change dramatically if the economy struggles and/or capital providers focus more attention on the long-term sustainability of current values.

Conclusion

The summer of 2012 with its record-breaking heat and drought created considerable stress for those who ventured outside or worked outdoors. In addition to this physical stress, however, residents and businesses have been dealing with a spate of stress emanating from the E-clouds hanging over the country. These clouds include the continued drama associated with the financial crisis in Europe; the specter of a cantankerous national election; the prospect of soft employment growth; and the downward pressure on expectations of businesses, consumers, and investors faced with the downside risks hanging over the economy.

Despite these potential shocks to the system and a disappointing economic outlook, it is possible that the United States will be able to avoid slipping into another painful recession or falling off of the fiscal cliff.

On the spatial side of the equation, commercial real estate market fundamentals are likely to be moderate. Indeed, significant improvement in spatial fundamentals can be expected to lag the broader economic recovery, which is consistent with the conventional wisdom that has carried through much of the recovery phase. On the asset or capital market side of the equation, the dynamics have been somewhat different, with real estate investment performance continuing to surprise on the upside. This dichotomy reflects another period of disconnect between the spatial and capital sides of the market and bears close monitoring.

There are a number of externalities that have bolstered the capital side of the equation: low interest rates, strong investor appetites, tolerance for low risk-adjusted returns, emphasis on long-term holds, lack of attention on the illiquidity of real estate, and a willingness to ignore mark-to-market metrics. While it is likely some of these forces will continue in the short-to-intermediate term, they are not sustainable over the long term. The real question is whether the spatial side will catch up in time to offset the downward pressure that withdrawal of such a support system entails, or whether new interventions will be introduced to change the rules of engagement. The outcome will be interesting to watch and will create a new (or renewed) batch of lessons learned. So at this point, the key rule is to stay cool.

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