The Rising Risk: Business as Unusual

by James R. DeLisle, PhD

Commentary

Over the past several years, one of the recurring themes has been the inability of policymakers and elected officials to get on the same page. Going into the second half of 2014, this situation had not abated, with the president facing the threat of a House of Representatives lawsuit and key decisions being stalled by political discord. The result has been widespread cynicism toward Washington, which has failed to act on a number of critical issues, ranging from immigration reform to funding for infrastructure investment. This inaction has exacerbated the "second-term curse," which similarly thwarted the efforts of prior presidencies even in the absence of political rancor.

Going forward, the list of unresolved critical issues will continue to grow, with little hope of resolution. This will force continuation of "government by decree," which has triggered its own backlash and further polarized the parties.

As if the lack of resolution of domestic issues was not enough to derail the economic recovery, the unexpected rise of geopolitical risk emanating from Russia and across the Middle East has created new economic uncertainty. Surprisingly, to date the rising number of disasters and increasing threat of terrorist activity have not thwarted the recovery, which continues to chug along as though all the turmoil will work its way out. Whether this is a case of denial or whether the downside risks are indeed manageable and will somehow be resolved remain to be seen. However, the resiliency of the recovery suggests that it is likely to continue in the absence of greater external shocks, and the economy will continue its gradual pace of improvement. That said, the sheer number of issues lurking in the backs of the minds of businesses and consumers could catapult to the frontal lobe and trigger a reaction that would throw things off track. During these particularly troubling times, some form of back-up plan or exit strategy is warranted, and strategic players have already developed response plans to various scenarios. Those who have not considered how to react in the face of unexpected shocks—which are becoming more expected—will find little solace in claiming that they "didn't see it coming."

Despite all these issues, the near-term outlook for the economy and real estate market is for continued moderate improvement. The question of whether this rather sanguine outlook will cool toward year-end (or earlier) depends on externalities that are plausible but cannot be predicted. Thus, the second half of 2014 will be characterized by business as *unusual* with a number of lessons to be learned on the horizon.

The Economic Environment

Economic Growth

During the first half of 2014, the US economy continued to expand, with moderate improvement reported in the May-June Beige Book for all twelve Federal Reserve districts.[1] Despite this widespread improvement, some regions outperformed while others made more modest gains.

In general, consumer spending, tourism, and nonfinancial and professional services expanded, with particular strength in the healthcare and technology sectors in several Federal Reserve districts. The advance estimate for gross domestic product (GDP) growth came in at 4% for the second

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1. Current and previous editions of the Beige Book are available at http://www.federalreserve.gov/monetarypolicy/beigebook/.

> "The Fed is struggling with how much slack remains in the economy."

quarter. This estimate was a welcomed reversal of the reported decline for the 2014 first quarter and was related to strengthening in inventory investment, consumer spending, and export activity. On the other hand, a decline in federal spending, which is expected to continue, placed a drag on economic growth. The Conference Board's Leading Economic Index slowed in June but was on par with the prior year and continued the streak of positive gains.

While there are a number of storm clouds hanging over the economy, the risk of recession continues to decline, falling in line with the prior year and at a marked improvement from the peak reached in early 2014. The outlook for the economy is for continued improvement, with downside risk related to geopolitical uncertainty and the escalating conflicts in Ukraine, Iraq, and the Gaza Strip that could spill over to the United States.

Employment

Despite some volatility, employment growth on a seasonally adjusted basis trended upward through the first half of 2014, peaking in April with an increase in over 300,000 nonfarm jobs. After a moderate slowdown in May, job growth outperformed expectations in June, with net job growth totaling 288,000. The private sector accounted for the vast majority of net employment increases, with a ten-fold advantage. This was not a surprise, as the pressure on government budgets continues to affect public employment.

The job gains were fairly evenly distributed across industry sectors, with the most significant gains in professional/business services, retail, education/healthcare, and leisure/hospitality. In addition to positive results across industries, employment gains were fairly widespread on a geographic basis, with some two-thirds of states reporting gains. While the improved employment figures were welcomed and overdue, the increase in part-time workers was a source of concern. Also, it is likely that job growth will be somewhat unsteady over the near term. However, absent external shocks, the prospects are positive for improved job growth during the second half of the year.

The unemployment rate improved throughout the first half of 2014, falling to 6.1% in June. During early July, initial unemployment claims continued to decline, falling to the lowest levels in over eight years. While the pace of mass layoffs increased toward the end of the first quarter, the figures were still markedly lower than the peak at year-end 2013. Similarly, at an overall level the total number of layoffs declined in June, an improvement over the pace maintained during the first five months of the year. Despite the decline in the number of layoffs, the number of affected employees increased; however, on a positive note, long-term unemployment fell to a post-recession low.

Looking forward, employment growth is likely to lead to moderate improvements in the unemployment rate, although employment growth may draw more people back into the workforce. Regardless, the recent improvements should provide additional stimulus to the overall economy.

Inflation and Interest Rates

Although the minutes from the recent Federal Open Market Committee (FOMC) meeting reflect differing opinions among members, it is likely that monetary policy will continue to hold steady over the near term.[2] As such, any increase in the federal funds rate is likely to be postponed until 2015. Even then, any increases are likely to be moderate, as policymakers try to avoid disrupting recent improvement in economic indicators. This is especially true in the face of the rising geopolitical risk, which could place a dramatic and unexpected dampener on economic activity. With respect to quantitative easing, the Federal Reserve (the Fed) is expected to continue its steady pullback on bond purchases, resulting in a decline of some $10 billion per month over the near term.

One key question the Fed is struggling with is how much slack remains in the economy. The answer to this question is fundamental to determining the cushion that exists between increased interest rates and upward pressure on prices that could lead to inflation. There are four key indicators of

2. FOMC meeting minutes are available at http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

the level of slack in the economy: two related to employment and two related to capacity utilization in the manufacturing and real estate sectors. At this point in the cycle, the Fed continues to focus on the employment indicators, where the improvement in employment growth and decline in unemployment are still below inflationary levels. This interpretation is attested to by the relatively weak gains in wages. With respect to capacity utilization, manufacturers have ratcheted up toward long-term averages of 80%. On the other hand, indicators of real estate utilization are somewhat mixed, with office vacancy rates above long-term averages and apartment vacancy rates below. Gradual improvement in economic conditions should return both indicators to more normal levels, with office employment burning off excess supply, and new additions to apartment stock and renewed interest in homeownership bringing apartment occupancy rates to more normal levels. These adjustments will take some time, and assuming they occur in an orderly manner (as appears to be the case) this gives the Fed some breathing room to ponder an increase in interest rates.

On the price front, recent indicators reveal that the absence of upward pressure on prices is relatively widespread, including employment cost, producer prices, and import and export prices. The increase in agriculture prices during the 2014 first quarter cooled off during the second quarter, providing some respite from the upward pressure on food prices that had caught consumers' attention. During June, the Consumer Price Index (CPI) declined after increasing in May, with higher gasoline prices putting upward pressure on inflation but food price increases tapering off. The result was an increase in CPI slightly under 2%, which is the Fed's target rate in the current environment.

Based on the combination of improving economic conditions and signals from the FOMC, it is likely that interest rates will begin rising in 2015, although a major spike is not anticipated.

Business Indicators

As with economic indicators, business indicators have been generally positive and echo a moderately improved outlook. Business inventories have continued to grow throughout the year and are significantly higher than a year ago. Despite a recent slowdown in business sales, the inventory-to-sales ratio has been relatively stable. Going forward, the moderate decline in sales is expected to trigger a slowdown in inventory investment as businesses seek to maintain a balanced posture in line with long-term averages.

Despite some improvement in the economic and business conditions, rising concern over geopolitical risk has weighed on the collective psyche of small business owners and has led to a moderate decline in business optimism. Despite this downward pressure, confidence levels still are above those of year ago, although down from the recent 96.6 highpoint, which was a seven-year record. At the same time, banks have continued to ease lending standards, helping satisfy growing demand for business loans and setting the stage for additional expansion.

Industrial production activity remained positive through the first half of the year. Of particular note was manufacturing activity, which peaked early in the second quarter, although it lost some momentum at the end of the quarter. This was reflected in the Institute for Supply Management (ISM) PMI (previously called the Purchasing Managers Index), which flattened out in June but maintained the upward trend it has exhibited since the beginning of the year, with a 6.7% annualized increase, the highest level in two and a half years. The same situation held for the ISM nonmanufacturing index, according to the Report on Business. Both ISM indexes signaled an expansionary mode. Factory orders, however, lost some momentum toward the end of the second quarter, dipping into slightly negative territory before rebounding in June.[3]

Stock Market

During much of the first half of 2014, the stock market experienced strong performance, closing at a number of record highs. This reflected rising confidence in the economic outlook despite some concerns that kept various investors on the fence and caused a flight to quality. Indeed, certain investors have begun to question whether the buoyant market has boosted stock prices for smaller companies and riskier assets beyond sustainable levels and have acted accordingly.

Despite these concerns, the stock market has stabilized, with the Dow Jones Industrial Average (DJIA) hovering around the 16,500 level after

3. Institute for Supply Management reports are available at http://www.ism.ws/news/?navItemNumber=22305

peaking at over 17,000 in June. This is a significant improvement over three years ago when the DJIA was around 11,000. The same pattern has held for the NASDAQ and the S&P 500. This suggested investors were focused on key economic indicators instead of the rising geopolitical risk. By early July, however, rising concern over geopolitical risk created a surge in demand for bonds, driving yields on ten-year treasuries below 2.4%—a low for the year. Given the escalating international conflicts, the bond market may experience additional upward price pressure that will continue until the international scene settles down.

Unfortunately, there are no clear solutions to the international conflicts, with further escalation threatening to expand the risk beyond the current focal points of unrest. The conflicts have kept investors on edge, although they have taken some solace from the fact that the US economy continues to improve. Whether this sense of resiliency will hold depends on how the various risks play out. The outlook also depends on whether investors and businesses continue to ignore the politics in Washington that have placed a dampener on economic growth and created additional downside risks. Regardless of politicians' ability to defer meaningful reforms and market interventions, at some point in the near future hard decisions will have to be made and permanent solutions will have to be implemented. In the meantime, a lot of money remains to be made, although the attendant cyclical risks have undoubtedly increased and eventually will be reflected in prices and yields.

Consumer Confidence

During the first half of this year, the consumer segment was a positive surprise for the economy. Consumer behavior reflected improving confidence levels that have been on an upward trend since early in the fourth quarter of 2013. The recent improvement reflected consumers' reported optimism for both their present situation and future outlook. The University of Michigan's consumer sentiment survey has trended upward since last October, although the figures flattened out for July. Consumer expectations for inflation outpaced the Fed's target rate, suggesting there is some room for maneuvering before consumer confidence levels are impacted by an inflation increase.

For some consumers, the recently announced change in FICO scoring will decrease the impact of medical expenses, and consequently improve the credit scores of affected consumers and improve their access to affordable credit. This change was in response to the release of a federal regulator's report in May 2014 that concluded that credit-scoring systems placed too much emphasis on medical debt, which is not voluntary in nature. In a relatively speedy response to the report, in August the Fair Isaac Corporation, which publishes FICO scores, announced it would make changes to its rating model that would favor households facing debt collectors for medical expenses but otherwise having clean credit histories. According to the release, households falling in this category will experience a 25-point increase in their FICO scores. Given the importance of FICO scores in setting interest rates, this change could result in significant improvement in costs of the credit. For consumers who are not saddled with nonmedical debt this could reflect a significant reduction in interest rates. For example, a 30-point improvement in FICO scores could make a 130 basis point difference in interest rates on automobile loans at the top of the spectrum and almost 400 basis points in the middle tranches. The impact of such changes on consumption functions is not clear at this point, although some consumers on the fence for new cars or other durables might accelerate their purchases. That said, consumer responses to the changes will be somewhat muted by the fact that collection agencies will not pull back in their efforts to collect.

Retail Sales

The improvement in the employment situation, GDP growth, and other economic indicators that have helped bolster consumer confidence levels have translated to an increase in retail sales. Despite this increase in sales, the pattern of growth was inconsistent during the first half of the year, with a decline in January offset by a rebound in February and March. The increase in sales proved to be unsustainable, however, and tapered off to more modest gains that were in line with the state of the economy. During June, retail sales increased over 4% from the prior year, with gains in a variety of stores, ranging from general merchandise to apparel stores. Chain-store sales were moderately positive through the first half of the year, although again the figures were unstable on a month-to-month basis. When compared to 2013,

chain-store sales were up 4.6% through mid-July. Despite some volatility in traditional retail sales levels, Internet sales activity has continued its upward track, approaching 6.2% of total sales through the 2014 first quarter. On the negative side of the equation were automobile sales, which flattened out, and building supplies, which registered moderate declines in June. Despite the recent slowdown in automobile sales, the industry exhibited an upward trend and was significantly up over the prior year. For some potential auto buyers, revisions in FICO scores and interest rates are likely to stimulate a temporary increase in auto sales. The outlook for retail sales for the balance of year is moderately positive, with hopes for strong back-to-school sales and holiday sales potentially increasing some 4% on a comparable sales basis. However, this outlook depends on continued improvement in employment, consumer confidence, and some stabilization on the geopolitical front.

Housing Market

The housing market, which had been viewed as a harbinger of economic recovery for the past several years, failed to live up to that role during the 2014 first quarter. On a positive note, the pace of existing-home sales accelerated during the second quarter, coming in slightly over 5 million units. In general, the existing-home market is relatively stable, with 5.5 months of supply at current activity levels. Despite the increase in activity, housing appreciation rates slowed but remained positive at slightly over 4% on a year-to-year basis. This stabilization can be attributed to a number of factors, including the maturing of the price-correction phase of the cycle and a dramatic decline in investor purchases of single-family homes. The index of pending home sales slipped into negative territory during June, wiping out some of the optimism that been created with the strong, but unsustainable, May figures.

New-home sales activity was disappointing in June, reversing the upward trend for the prior two months and approaching the trough reached in March. These results were over 10% below the prior year's figures and were a significant disappointment for homebuilders. The slowdown in new-home sales activity triggered an increase in the inventory, pushing the months of supply to the highest level in almost three years. This increase in inventory led to a decline in new residential construction that affected both single-family and multifamily starts. Although new construction activity declined throughout the second quarter, the figures were still above those for the first quarter of 2013. The vacillation in residential construction activity was illustrated by the surge during the 2013 fourth quarter followed by weakening growth in the 2014 first quarter. This pattern reflects the latent desire of homebuilders to ratchet up activity while facing uncertainty on the demand side of the equation. As might be expected, housing construction activity has been mixed across the country, with the West and South experiencing a decline while the Midwest and Northeast regions racked up increases. Despite the downward trend in units sold during the second quarter, the median house price was up over 5% from the same period in 2013.

While residential transaction volume and construction activity have been disappointing, there has been some improvement in the delinquency and foreclosure side of the market. According to the Mortgage Bankers Association, the delinquency rate has fallen to the lowest level since the bottom of the market at the end of 2007. At the same time, the rate of new foreclosure activity has also declined to its lowest level in over eight years. The good news for the industry is that the improvement in delinquencies and foreclosures is fairly widespread. although transaction levels and construction activity have been somewhat mixed across the country.

The good news for the single-family sector is in homeownership rates, which had pushed 70% in 2003, but then declined, are approaching long-term averages in the low– to mid-60% range. At this point in the cycle, it is likely that improved economic conditions and stabilization in the housing market may start to reverse the rent-versus-own equation that has kept many households out of the market. This migration toward the mean is likely to trigger heated debates among apartment aficionados who have argued that the decline in ownership rates among millennials and other market segments is a structural shift. While the overexuberance that led to the market collapse and the Great Recession is likely to receive significant attention from potential homebuyers for some time, history suggests that it is a cyclical reaction that will fade over time as have memories of other excesses in the real estate industry.

Real Estate Market

Overview

Unlike the residential market's volatility, the commercial real estate market was relatively stable during the first half of the year. At an aggregate level, the commercial market experienced some improvement in both the spatial and capital sides of the equation.

On the public front, commercial real estate showed strong performance on a year-to-date basis through July 2014, with 16.2% total returns for the FTSE NAREIT All Equity REITs Index. This performance included a 3.76% dividend yield that continued to attract investors in the low-interest rate and low-yield environment. As of July 2104, the implied market capitalization of the FTSE NAREIT All Equity REITs Index was around $770 billion. The bulk of the NAREIT universe is held in property-focused REITs, with diversified REITs accounting for 9% of total market capitalization. Despite this relatively low market share, diversified REITs outperformed the broader index, with 17% total returns through July and above-par dividend yields that exceeded industry averages by 66 basis points.

On the private market side of the industry, the $336 billion NCREIF Property Index (NPI) showed an 11.2% total return through the 2014 first quarter. The rolling twelve-month return was fairly equally split between income and appreciation, with annualized income returns eking out appreciation by 10 basis points. During the first quarter, the $367-billion index generated competitive returns due, in large part, to strong appreciation rates that outpaced income returns. This pattern is significantly below the long-term averages. For example, when measured from inception of the NPI, total annual returns averaged 9.16%, with income returns outpacing appreciation by an almost five-fold advantage (i.e., 7.5% versus 1.6%). The dependence of double-digit NCREIF returns on the appreciation component has held over the prior three years, with income returns averaging 5.78% and appreciation returns averaging 5.68%. While the investment behavior of some players suggests this pricing represents a structural shift, when it is compared to longer-term averages it is clear this is a cyclical anomaly. For example, on a five-year basis the income/appreciation mix is 6.08%/1.72%, which is a more sustainable mix across the real estate and business cycles. Over the near term, the low-interest rate environment and moderate improvement in real estate fundamentals may help support total returns for commercial real estate. However, absent a dramatic and unexpected surge in the demand side of the spatial market, there is an intermediate-term risk of repricing attendant with an eventual return to more normal return patterns.

Office Market

Office market fundamentals improved during the first half of 2014, with vacancy rates declining moderately due to an uptick in demand combined with limited construction activity. The improvement has been dampened by the fact that tenants continue to rationalize their space utilization, focusing on efficiencies that can be achieved by reducing square feet per employee. Despite this contraction among some classes of office tenants, net absorption remained positive, with central business district (CBD) markets outperforming their suburban counterparts. This relationship held for rents, although CBD and suburban Class A properties benefited from moderate increases. In terms of regions, the Sun Belt experienced the strongest absorption and subsequent improvement in market fundamentals of supply and demand. Markets with a preponderance of jobs in professional and business services and strong technology and health sectors have seen the greatest improvement in underlying fundamentals. On the other hand, markets with strong financial employment levels have enjoyed a limited recovery as financial institutions continue to rationalize their activity levels. Going forward, tenants are expected to continue to remain cautious and focus on reducing expenses, and this will place a damper on the office sector. On an overall level, the office sector is also expected to maintain its focus on flexibility to accommodate changing needs as the economic recovery continues to unfold.

At the end of the first quarter, the office sector accounted for some 36% of the total NPI. Office market investment performance during the first quarter of 2014 came in at 2.2%, which was on par with apartments but lagged the retail and industrial sectors. On a trailing twelve-month basis, office returns were slightly over 10%, which translated to a third-place finish among major property types. In terms of subproperty types, CBD office properties led the sector with a 55% market share in terms of value compared to suburban properties. Due

to the smaller size of suburban investments, the sector accounted for over three-quarters of office investments, with an average value of $56 million compared to $221 million for CBD investments. With respect to performance, CBD properties underperformed suburban properties on both a quarterly and annualized basis. In terms of pricing, CBD investments were more aggressively valued with annualized income returns around 4.8%, which came in 108 basis points lower than suburban offices.

On the public side of the market, apartments rebounded from negative performance during 2013 and led among property types in terms of total returns, followed by office REITs, which reported 17.7% year-to-date returns through July 2014.

Despite strong total returns, office REITs provided the lowest dividend yields (2.96%) among all major property types. With respect to market share, pure office REITs accounted for 11% of the REIT universe. The mixed office/industrial REIT sector also enjoyed double-digit returns but lagged the broader index and other property types with 12.5% total returns and above-par 4.6% dividend yields. At an overall level, mixed industrial/office properties accounted for a rather minor 2% market share of REITs.

Retail Market

The retail property sector continued to undergo transformation during the first half of the year, resulting in continued improvement in spatial market fundamentals of supply and demand. The situation was somewhat uneven, however, with markets that have a stronger economic base and more vibrant employment conditions seeing positive spillovers into the retail sector.

Technology and the Internet continue to play a major role in the retail market as traditional in-store retailers ratchet up their use of online sales to complement and enhance productivity. Despite this general trend, a number of retailers still struggle to regain their niche and the loyalty of their core customers, which have been tested by mission or vision drift (in the case of JC Penney) or breach of confidentiality (in the case of Target and other retailers). Assuming recent trends hold, rising consumer confidence levels will provide some stimulus to the retail sector although the industry will remain hypercompetitive.

"Retail REITs experienced competitive 15.9% year-to-date total returns through July."

The modest improvement in spatial market fundamentals for the retail sector has carried over to the investment side of the industry. On the private front, retail returns led all property types during the first quarter, with the NPI retail sector racking up 4.3% total returns, which helped boost trailing twelve-month returns of 13.5% ahead of other property types. Despite this track record, which held for the one-, three-, five- and ten-year bases, retail investments accounted for only 24% of the NPI. Reflecting conservative valuations, income returns for retail investments also outperformed the overall universe over the near term as well as the intermediate to ten-year terms. In terms of subproperty types, super-regional malls dominated the retail sector, accounting for 35% of the market with regional malls, community centers and neighborhood centers each accounting for 14%–16% of the total. Power centers accounted for another 12% of total retail investments, followed by 6% fashion/specialty, and other shopping-center formats making up the balance. The pattern of retail returns fairly echoed the market share with super-regional malls racking up the highest first-quarter returns (6.8%) and annualized returns (16.4%). This pattern held for the intermediate- to long-term although on a longer term basis the premium was not has high as it has been for the one-to-three year horizons.

Retail REITs experienced competitive 15.9% year-to-date total returns through July, with slightly higher dividend rates than the overall industry averages. Due in part to a track record of relatively strong performance in the public markets, retail REITs made up a larger share of the total industry, accounting for 30% of total market capitalization. Regional malls, which accounted for over half of the retail REIT market, outperformed other retail categories with 16.6% returns. This solid performance was a welcomed recovery from the slightly negative returns experienced in 2013. As with larger office properties, the dividend yield for larger regional malls was lower than other retail

subsectors and the overall average with a 3.1% yield. Freestanding retail lagged the overall sector but, due to the long-term bond-like nature of leases, generated 6.1% dividend yields, which exceeded other property types and the overall industry averages.

Industrial/Warehouse Market

Industrial market fundamentals improved during the first half of the year, with positive net absorption leading to the decline in vacancy and some improvement in rental levels in a number of key distribution nodes. As might be expected, coastal markets with active ports (e.g., Los Angeles, Seattle) and interior markets that play a vital role in the global supply chain (e.g., Atlanta, Dallas, and Chicago) outperformed other markets in terms of absorption and experienced improved occupancy levels in spite of new construction activity. Assuming the domestic and global economies continue to improve, this trend will spill over to other markets that have strong logistical and/or consumption functions built into the local economy.

During the first quarter of 2014, the industrial sector outperformed other property types in the private market, with industrial properties in the NPI generating 2.75% returns. This relatively strong performance held up on a trailing twelve-month basis with 12.6% total returns, which lagged retail but significantly outperformed other property types. Despite the increase in performance relative to other property types, industrial properties accounted for only 14% of the NPI. The bulk of industrial properties were warehouses (87%), followed by flex and R&D properties at 7.5% and 2.1%, respectively. At a subproperty level, R&D properties led other industrial sectors during the first quarter although warehouses led on a twelve-month trailing basis, with 12.9% total returns and almost 6% income returns.

Industrial REITs outpaced other property types in 2013, with total returns of 7.4%, but have lost some ground in 2014, with year-to-date total returns of 11.5% that lag the overall REIT index and other property types. Despite this disappointing performance, industrial REITs were fairly competitive in terms of dividends, lagging the overall averages by only 16 basis points. However, pure industrial REITs accounted for only 4% of the total market capitalization for REITs, with another 2% in the mixed industrial/office sector.

Apartment Market

The apartment market was fairly strong during the first half of 2014, with strong demand leading to sub-5% vacancy levels at a national level. Apartment market fundamentals are expected to remain tight over the near term, although the surge in new construction activity and a growing pipeline are likely to soften spatial market fundamentals in the intermediate term. The situation will be exacerbated in some of the hotter urban markets where additions to supply have outpaced the growth in demand. This is particularly true in markets where developers, lenders, and investors have focused on a band of top-end apartments targeted toward millennials, and technology and healthcare workers. While many of these properties will work, the fact that additions the stock have been relatively homogeneous may backfire and created a glut of expensive product that exceeds demand. On the other hand, in markets where developers have addressed the full array of demand apartments will fare much better with respect to the supply/demand balance.

In terms of investment performance, the private apartment market in the 2014 first quarter was on par with office investments with 2.2% total returns, which was respectable but lagged the retail and industrial property sectors. This pattern carried for the prior four quarters and barely eked out 10% plus returns for the trailing twelve months.

Some observers argue that the recent weakness in apartment returns doesn't reflect weakness in fundamentals or a shift in investor demand, but rather is a consequence of the strengthening of other property sectors. While this explanation resonates with some investors, it is more likely that apartments are falling in line with underlying fundamentals after a period of the excessive exuberance among investors, lenders, and developers. This explanation is bolstered by the fact that income returns for apartments came in under the overall index and approached historical lows of 5% for the trailing twelve months. Despite moderating interest in apartments, the sector accounted for 25% of the NPI. In terms of subproperty types, total returns for low-rise apartments led the sector followed by high-rise and garden apartments. However, income returns for high-rise units lagged the overall sector and came in at aggressive pricing and valuation levels of 4.6% income returns on an annualized basis.

After disappointing performance for 2013 with -6.2% total returns, the apartment REIT sector rebounded with industry-leading 26.6% total returns through July 2014. Due in part to a disappointing performance for the prior year, apartment REITs accounted for only 12% of total market capitalization. While still significant in terms of total dollars, the market share of apartment investments in the public sector was about half of that in the private sector, which remained more bullish on the sector despite recent declines in relative performance.

Infrastructure

Infrastructure investments warrant coverage as an emerging asset class. However, at this point in the diffusion of innovation process, infrastructure investments are not generally considered as real estate plays and are not represented separately in the NCREIF Index. Interestingly, this dearth of private-market performance indicators is reminiscent of the lack of data that throttled pension investment in the late 1970s and led to the formation of NCREIF. Going forward, the fledgling growth in pension investment in infrastructure is expected to eventually lead to the introduction of a new property series in NCREIF. In the meantime, however, infrastructure investment among pension funds is likely to continue to be relegated to a subset of the alternative investments where it is currently housed in most domestic portfolios.

On the public market front, infrastructure REITs have grown to an 8% share of the implied market capitalization. While this suggests that infrastructure REITs are being embraced by Wall Street investors, it should be noted that the nature of holdings in such REITs is fairly narrow relative to the broad universe of potential investments. For example, as of the end of July there were only four infrastructure REITs including two major players, American Tower Corp. (AMT) and Crown Castle International Corp. (CCI), with a combined 99.6% of the total infrastructure REIT industry market capitalization. Going forward, significant growth is anticipated for both private and public infrastructure investments that are considered real estate plays. Despite the long-term outlook, growth will be relatively tempered over the near term until the domestic industry gears up to manage infrastructure investments and institutional investors modify their investment policy statements to incorporate this complex, massive, and rapidly growing industry. Thus, the United States is expected to lag its global counterparts in terms of public and private infrastructure investment. This situation is expected to dramatically change over the next three to five years, however, as components of the infrastructure industry become absorbed as part of the real estate asset class.

> "Infrastructure REITs are being embraced by Wall Street investors."

Real Estate Capital Markets

Commercial Investment Activity

The commercial real estate market enjoyed robust transaction activity during the first half of 2014. According to Real Capital Analytics, transactions of properties over $2.5 million have totaled over $184 billion during the year-to-date. These figures included 13,270 transactions with an average transaction size of slightly under $14 million. Capitalization rates remained relatively stable in the second quarter with respect to property types, with hotels trading at the highest rate (8.2%), and CBD and apartment properties at around 6%. On a year-over basis, hotel capitalization rates were generally on par with industrial rates, down 46 basis points to 7.1%, and apartment and retail rates were down around 20 basis points.

In terms of regions, investor appetites were bicoastal; the West and the Northeast were the most active regions, accounting for almost half of the transaction volume. Due to larger transaction size, the two regions accounted for 40% of deals. In California (which dominates the West region) momentum shifted to Northern California, although it still lags in the greater Los Angeles area. In the Northeast, Manhattan remained the leading target for investors, with activity also accelerating in the suburbs.

As a leading indicator of development activity, land sales continued to trend upward, with slightly under $40 billion in sales on a year-to-date basis through June, which was about a 25% increase in the value and number of transactions over the prior year.

In terms of property types, developers have shifted their interest beyond the multifamily sector. For example, in the suburbs, mixed-use land led

other categories while multifamily and mixed-use led CBD sales.

The pool of investors in US commercial real estate has remained fairly diverse, with the top buyers ranging from public and private institutional players to private equity groups. As a sign of continued global interest in US real estate, the top buyers included a number of international players, including sovereign wealth funds. Nonetheless, most of the top sellers were domestic players, suggesting that international capital players have remained consistent in their long-term profiles. This situation is likely to hold, especially with the rising geopolitical risk and global slowdowns that have created a cloud over a number of countries. While the United States is not immune to the geopolitical problems, and indeed is facing heightened risks, the sheer size of the country and the geographic dispersion of the larger markets may provide some solace to international investors seeking a safe haven. This outlook is especially true if the domestic economy can continue to improve and the supply side remains in check as it is likely to do over the near term.

Commercial Mortgage Market

The private and public commercial mortgage markets were active and competitive through the first half of 2014. On the commercial mortgage-backed securities (CMBS) front, loan activity continued an upward trend of 2013 when CMBS issuance rose to some $80 billion, almost double the prior year but still significantly below the $230 billion peak in 2007. In terms of market share, the Commercial Real Estate Finance Council (CREFC) reports that the CMBS industry has been accounting for about a quarter of all commercial transactions and over a third of loans in tertiary markets.[4]

Delinquency rates for the commercial mortgage market continued to improve during the first half of the year. On the CMBS side, rates fell to less than 4.6% through the end of the first quarter. This continued an almost twelve-month rate of decline and marked a significant improvement on a year-over basis. The improvement was attributable to loan resolutions, which have continued to outpace new delinquencies. Prepayment activity also has been strong along with an increase in refinance activity involving defeasance, where borrowers substitute collateral to release mortgage claims against individual loans. This activity has been bolstered by the low-interest rates and available debt along with improving incomes and values. These factors have allowed borrowers to absorb prepayment costs and reduce debt burdens via new financings. When coupled with the private debt, the commercial real estate market remains competitive, with sufficient capital flows to support the current pace of transaction activity.

In addition to access to low-cost, permanent financing, investors and property owners have been able to tap into an increasing supply of short-term variable rate loans. Some financing has come from the increase in commercial real estate collateralized loan obligations (CRE CLOs). These and other sources of flexible financing have helped support investment in nonstabilized properties and the repositioning of troubled loans as well as loans for properties in tertiary markets. At this point in the cycle the industry is facing a wave of commercial mortgages maturing with outstanding debt levels ahead of improvement in fundamentals. Therefore, the increase in flexible financing will play an important role in helping support the overall commercial real estate market. In the absence of an external shock to the system, the outlook for commercial mortgages for the balance of the year is positive, benefiting from continued improvement in market fundamentals and strong equity and debt capital flows.

Conclusion

The summer of 2014 is likely to be remembered as a period when the storm clouds, catastrophic events, political stalemates, and rising geopolitical risk created an environment of uncertainty that can best be characterized as one of "business as unusual." During this period, television and newspapers have reported a number of unusual events including the disappearance of the plane into the depths of the ocean (or some other unknown location) and the shooting down of a passenger plane over the Ukraine. As the world has imposed sanctions on Russia for its incursions into the Ukraine, reflections of the Cold War have resurfaced. The more recent conflicts in Iraq and the Gaza Strip have been grim reminders that peace can be an elusive proposition.

4. The CREFC is a good source of CMBS information; go to http://www.crefc.org/compendium/ or http://www.crefc.org/IndustryResources.aspx for more information.

Interestingly, the dramatic and devastating externalities caused by these events has turned some attention away from the domestic dysfunctional politics that has plagued the United States for several years. While some of these issues will eventually be resolved, the country and its economy will be facing unusual times that may well be unparalleled in an historical context.

Despite all these issues, business, consumers, stock markets, capital markets, real estate markets, and the economy in general all seem to be showing signs of improvement. The key question is whether this period of business as unusual can continue or will succumb to the downside risks. These interesting times argue for backup plans in case the unexpected or unfathomable occurs. This period will go down in history as a transitional period in which hopes are that the transition will be toward better times.

James R. DeLisle, PhD, is associate professor of real estate and director of the Lewis White Real Estate Center at the University of Missouri–Kansas City Bloch School of Management. His charge is to help build a preeminent real estate program that strikes a balance between academic rigor and state-of-the art industry practices. Drawing on this foundation, students are trained in critical thinking and the spirit of entrepreneurship necessary to take on the complex real estate problems that the next generation of industry leaders must be able to solve. He comes to the Bloch School from the University of Washington where he was Runstad Professor of Real Estate and director of the graduate real estate studies. DeLisle has spent almost half of his forty-year career in real estate as a professional with specializations in applied investment research and strategic portfolio management. Before returning to academia in 1999, he was an executive vice president and head of strategic planning for Lend Lease Real Estate Investments, a global company and the successor firm to Equitable Real Estate, where he founded the Investment Research Department. He has published widely in academic and professional journals. DeLisle received his BBA in real estate and MS in marketing from the University of Wisconsin. He received his PhD in real estate and urban land economics from the University of Wisconsin under his mentor, the late Dr. James A. Graaskamp, one of the leading academic proponents of applied real estate research. To increase industry connections, DeLisle has created a personal website, http://jrdelisle.com.

Contact: delislej@umkc.edu