

It's Déjà Vu All Over Again

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Commentary

During these interesting times, it is useful to step back and see if we can draw on lessons learned from our great philosophers. After searching for some profound statement that would help put the situation in perspective, the inimitable words of the great Yogi Berra rose to the surface: given what we've seen in Washington, "it's déjà vu all over again" seems to be prescient. This is particularly true in light of the post-election bantering and yet another go-round of "kicking the can down the road."

The good news is that the situation is likely to change, although the consequences of delayed action will dampen any hopes of a resultant reversal of fortunes. Thus, the economy and capital markets will have to carry on in the face of significant headwinds and the absence of unified approaches to the complex challenges facing the country.

In spite of the turmoil, both the stock market and the commercial real estate market have been able to rise above the fray. Indeed, strong performance has triggered claims of a new bull phase and suggests that the markets have made a successful transition from hoping to coping—and coping very well at that. While it would be easy and somewhat tempting to try to ignore some of the uncertainty, the reality is that hard choices are going to have to be made and implemented before the recent market rally can be seen as more than a temporary phenomenon.

On the real estate front, the commercial market has continued to function under the new normal of low interest rates and low investor yield requirements despite a moderate slowdown. Some advocates contend that the continued demand for real estate investments represents a structural shift, one that will continue unabated. They cite the recent performance of the private and public real estate markets, which continued to rack up double-digit returns through the

end of 2012. Looking at this situation from a historical perspective suggests the recent state is more likely a temporary departure from the longer-term trend that will create a greater alignment between the real estate market and the economy.

Probing beneath the surface, it is clear that economic principles of supply of ready capital and demand for assets coming from the capital side of the market have helped the real estate asset class sail above the political and economic uncertainty that have buffeted other sectors. Granted, the moderate improvement in real estate fundamentals, on the spatial side, and the active management of distressed real estate have helped the cause. Unfortunately, the outlook for the spatial side and the expected lag between an economic recovery and a robust real estate market suggest the asset class may be vulnerable to a correction when the tide of low-risk capital flows back out as it inevitably will do. The fact that some players are cashing out and others are continuing to be more defensive suggests that such an inflexion point may be on the horizon. While the horizon may be further off than it appears, it's worth noting Yogi's words of wisdom—"You can observe a lot by watching"—because it is clear that it will take more than running on autopilot at this stage.

The Economic Environment

In addressing the economic environment, it is useful to discuss some of the most pressing issues that will ultimately define the outlook for the economy and the country. These include significant staff changes in the Obama administration, the budget ceiling, new taxes and cost-cutting measures, and health care reform implementation.

With respect to staff changes in the new Obama administration, executive appointment decisions were closely monitored by economists, businesses,

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investors, and consumers. One key staffing decision is the appointment of the new Secretary of the Treasury. Given the importance of this position in the upcoming budget battles and the vacuum left by the departure of Secretary Geithner, the stakes are high on both sides. The president's nomination of Jacob Lew sent a clear message that he is not going to back down in negotiations and intends to push his agendas for raising revenues and managing cuts.

Another contentious appointment relates to the head of the Securities and Exchange Commission (SEC). Wall Street reform is high on the list of action items for consumer advocates pushing for greater enforcement of Dodd-Frank, which has had limited effect as indicated by the failure of some 60% of the almost 240 deadlines built into the legislation.

With respect to the budget crisis, the political parties are preparing for the next round of contentious debates, which will affect consumer and business confidence levels. Indeed, it has become painfully clear that there are few, if any, options that will avoid the contentious discussions. The temporary nature of the current solutions is just one example of déjà vu—more than half of the previous 39 ceiling increases have lasted less than a year. Thus, the likelihood of a permanent settlement being approved is remote.

In addition to the debt ceiling, attention will be on the contentious question of how to get agreements on expense cuts and revenue increases to take pressure off the deficit over the long term. As President Obama's inaugural comments outlined, this agenda for America is one that will define his second term.

The implementation of the health care program reform also will be a bellwether for the Obama administration. The pressure on spending cuts will likely bring Medicare into the cost-cutting debate and will embed health care reform in the Affordable Care Act even more so than when the legislation was first passed. When the law kicks in on January 1, 2014 it will affect some 28 million additional Americans. The road to universal insurance for Americans will be more challenging than other initiatives due to its

sheer scale, the unwillingness of almost half of the states to set up health insurance exchanges, and the Supreme Court decision holding that states cannot be compelled to extend Medicaid by increasing the qualifying ceiling. In addition to the issue of coverage, the medical delivery system will have to undergo dramatic change including figuring out how to deliver “more affordable” health care—a challenge that has proven elusive in the past.

Economic Growth

During all but the third quarter of 2012, growth in gross domestic product (GDP) was disappointing and trended downward. During the fourth quarter, GDP growth fell to 1.6%. This decline was disappointing, but not unexpected in light of growing uncertainty over the fiscal cliff and budget ceiling, which weighed heavily on business confidence levels. The outlook for 2013 remains guarded, especially with so many unresolved issues in Washington. Until agreements are reached, businesses and consumers are likely to remain anxious.

In addition to the problems onshore, global issues have continued to weigh heavily on the domestic economy. This was evidenced by the correlation between the domestic stock market and the twists and turns that occurred in Europe during the third quarter. This trend continued up until the turning point when attention to global issues was supplanted by the pressing domestic issues that took center stage during the debates leading up to the presidential election.

While US domestic issues dominated the news during the 2012 fourth quarter, the global economy continued to influence the US economy. Indeed, the integration achieved by globalization created widespread weakness that affected most economies. Some regions fared much worse than others, with much of Europe falling into recessionary downturns. Conditions were particularly challenging in Europe with the euro crisis, as temporary measures may not hold up if conditions deteriorate further. The situation is so dire that concern over a partial breakup of the euro zone is not out of the question and will loom over the region through much of 2013. In addition to the widespread drag that has rippled across Europe, growth in the previously robust Asia-Pacific and South American regions lost momentum.

Looking forward, weak economic conditions are likely to prevail across most developed nations, forcing those that have not already taken action

to invoke stimulus programs. At the same time, emerging markets that have adopted appropriate policies are likely to continue to outperform the broader global market. Of particular interest will be China, which may be one of the first Asian markets to regain some of the momentum recently lost. However, this improvement will hinge on gradual recovery or stabilization in other regions that support the export activity that China depends on to fuel domestic economic activity.

Once economic activity in developed nations begins to recover, emerging markets will likely outperform. In the meantime, they will depend on domestic activity to dampen the impact of the global downturn. For the United States, this translates to expected GDP growth around 2%—disappointing, but still ahead of European counterparts.

Employment

Looking back at 2012, the pace of 250,000 net employment growth during the first two months suggested that the economic recovery was finally on solid footing. However, this sense of optimism faded as employment growth slipped below the monthly average of 50,000 net job growth by mid-year. During the third quarter, employment growth experienced a moderate rebound and then settled down to 150,000 net job growth at 2012 year-end. Despite flattening out at year-end, the economy picked up some 2 million nonfarm jobs for the year as a whole. Other employment indicators were fairly stable during 2012, including labor force participation rates, average workweeks, and earnings.

Although the steady pace of job growth was welcomed, it was below the level needed to put a dent in unemployment rates, which hovered around 7.8% during the 2012 fourth quarter—a moderate improvement from the 8% plus rate during the first half of the year. In early January 2013, initial claims for unemployment increased and continued the trend that began four weeks earlier. On the other hand, the level of continuing claims declined at 2012 year-end, falling to 3.1 million employees—the lowest level since the recession caused employers to cut back on employment growth.

Of some concern on the labor front was the spike in mass layoffs in November 2012. However, a significant driver behind this was Hurricane Sandy, which made landfall in late October and triggered layoffs in the Northeast. Despite this late uptick, the number of layoffs on an annualized basis was the lowest in over five

years when the recession was at its peak. The biggest layoffs were in the computer and manufacturing sector, although some financial service firms announced layoffs toward the end of the year. Going forward, net job growth should exhibit moderate growth in line with general economic conditions.

Inflation and Interest Rates

As has been the case for some time now, one of the key calming factors helping bolster the fledgling economic recovery has been the low interest rate environment.

The continuation of the low interest rate environment has become a given that a lot of decisions have been based on. However, perpetually low rates have not supplanted the two real givens in life: death and taxes. Indeed, the contentious debates over the budget ceiling and the attention on the burgeoning deficit suggest that interest rates will start moving toward longer-term averages that reflect the underlying risk. This correction will not occur soon, however, as the Federal Reserve (Fed) has promised to hold rates low through 2015. Indeed, the Fed has indicated it will continue to maintain the low interest rate environment as part of its easing strategy until unemployment rates dip below 6.5%, which could prove to be an elusive goal.

The fact that 2012 inflation remained in the below 2% range has been one of the good signs for the economy and has empowered the Fed to continue its stimulus programs. The outlook for inflation remains positive in light of the recent economic slowdown and continued economic uncertainty. This situation has been bolstered by the global slowdown that has taken pressure off of commodity and import prices.

To the chagrin of many, the disappointing employment figures have kept wage pressure out of the equation—a situation that is likely to continue until some of the political uncertainty is resolved. Similarly, many of the proposed measures for addressing the fiscal cliff will be anti-inflationary, as punctuated by the recent expiration of the payroll tax relief.

While much economic uncertainty remains, it is likely that low interest rates and low inflation will continue for the short-to-intermediate term. After that, and after the Fed has played out its hand, natural forces will bring them back in line with historical averages. If that process is abrupt it could create a lot of unexpected waves.

Business Indicators

While businesses have been forced to cope with a number of challenges, the leading economic indicators remain stable to positive overall. This suggests the fledgling recovery might stay on track—although any near-term improvement will be gradual and accompanied with downside risk.

During the 2012 fourth quarter, the pace of business inventory growth slowed from its summer peak. Despite this moderation, the decline in business sales spilled over to a slight increase in the inventory-to-sales ratio as businesses pulled inventories in line with expectations. One of the major drags on expectations for small businesses was the dramatic decline in sentiment going into the election as owners focused on the fiscal cliff. This situation deteriorated even further after the election, when hardliners in both parties appeared to have dug in to let the chips fall where they may.

The spreading recession in Europe and the broad-based global slowdown created additional concerns for businesses. This led to a slowdown in factory orders, with November figures coming in below expectations—although still in slightly positive territory. The general consensus was that conditions had stabilized, a situation that was reassuring in light of all the downward pressure caused by political uncertainty.

On the production side of the equation, activity levels were surprisingly robust in late 2012—although the figures continued to bounce around leaving no clear indication of an upward trend that could carry into 2013. The December figures on the manufacturing front reveal some improvement, although the outlook remains rather flat in light of domestic and global conditions. On the non-manufacturing front, the sector seemed to gain some much-needed momentum in the fourth quarter, which may carry into early 2013. Whether these trends continue depends on the progress Congress makes in resolution of the budget-related issues.

Stock Market

As 2012 wound down, the stock market exhibited significant resiliency that carried into early 2013. For 2012 as a whole, the market performed surprisingly well, with returns in the solid double-digit range. This overall market performance benefited from a number of factors, including the lack of performance in fixed-income investments.

The improvement in the stock market is somewhat surprising since the recent advances have occurred in the face of significant downward risks that continue to hang over the economy and dampened business and consumer confidence. It is possible that some of the recent strength is a carryover from corporate behavior in which profits were taken in the post-election phase to avoid the risk of future increased tax rates. This might have triggered a flurry of activity that will ultimately place downside risk on the market as the economy slows or remains flat, which are the most likely scenarios at this point.

The combination of these factors has rendered many investment models at least temporarily invalid, making it more difficult to turn to quantitative models for insights—especially those that have not been recalibrated for the new world order and rely on static-state assumptions. Thus, some investors will seek additional cues as to where the market is headed, illustrated by the interest in transportation stocks as a bellwether of the markets. The good news is that as of mid-January they were signaling better times ahead. Assuming the market continues to power forward, this prognostication is consistent with the “January effect,” which suggests that as January goes, so goes the year. Such outlooks blend both the hoping and coping phases of the investor behavior.

Analysis of the increasing degree of integration that has occurred among stock markets in developed nations and, to a lesser extent, those in emerging markets suggests some leading indicators warrant close attention for investors seeking a clue as to when things might change.

For example, anecdotal evidence revealed that changes in the US market during summer 2012 were highly correlated with the European saga. While trending generally downward and ultimately leading to the recession that has spread across the region, news leaks created event-driven spikes in the domestic market. Similarly, when the Chinese economy slowed down, global markets (including the United States) became a bit more defensive. Going into the fall season, the key leading indicators of the US market turned back to domestic affairs, but the permanent resolution of the major challenges on both the domestic and global fronts will remain elusive. However, this might not place a governor on the stock market, especially if there is a secular rotation out of bond funds, which continue to produce less-than-stellar returns in the low interest rate

environment that will prevail over the next two years or so. Regardless of alternative investments, once the budget uncertainty in Congress is removed, attention will shift to more fundamental drivers of the market.

Consumer Confidence

Up to the election period, consumer confidence was surprisingly strong. Once the election was decided, consumers started to peek beneath the surface and began to focus attention on the fiscal cliff and the possibility of the country moving toward the brink of bankruptcy. The fact that politicians seemed willing to duel it out to the bitter end created significant angst among consumers. The general mood of consumers became more apprehensive as they joined the ranks of small businesses that had raised the cautionary flag long before the election.

Congress bought some time at 2012 year-end, leaving consumers hoping for a solution to the impending crisis. However, the 2013 expiration of the payroll tax relief and the resultant decline in take-home pay punctuated the fact that things were changing and that some of the changes could strike close to home. Although the 2% increase in payroll taxes seemed relatively minor on the margin, it will reduce household budgets by an estimated \$125 billion when it ripples through the economy. With this as background, consumers are likely to remain cautious and pay more attention to how the political wrangling will affect their livelihoods.

In addition to the drag on consumer confidence emanating from the wrangling in Congress, the erosion of retirement savings is becoming a more incipient problem. In particular, a recent report reveals that over 25% of workers are either dipping into their 401(k)s and other retirement plans or borrowing against them to cover current financial obligations. At an aggregate level, this form of “retirement calls” is pulling almost \$75 billion a year out of retirement accounts. This trend is symptomatic of an overall personal budget crisis, as workers must forfeit a 10% penalty and pay income taxes on early withdrawals. The consternation faced by workers who have reduced their retirement accounts will be heightened as policymakers flirt with cuts in Social Security and Medicare. This retirement income uncertainty will hang over consumers like a sword of Damocles, especially for those who have already dipped into their retirement accounts. This is likely to continue until the economy turns the

corner enough to rack up bona fide improvements in income levels, reversing the slippage that has pulled many workers away from retirement security.

Retail Sales

Retail sales are a key driver in the US economy, accounting for roughly 75% of overall economic activity. Thus, economic prognosticators focus significant attention on the consumer psyche in terms of what consumers are likely to do in terms of spending. The details of who captures the retail dollars are usually left up to retailers who aggressively compete with each other through a variety of traditional and nontraditional channels.

In periods of economic expansion, consumers are less selective about how they spend their hard-earned money, opening their wallets for the latest must-have items. That scenario has not been seen for some time. In the post-recessionary era, consumers have placed emphasis on higher-order needs of economic survival rather than conspicuous consumption. During 2012, this emphasis on value continued to reign supreme. Late in the year, the reality of the impending fiscal cliff and the potential derailing of the economic recovery hung over consumers as they headed into the important holiday season. Consequently, the result was on par with expectations—moderate, but tempered, growth in retail sales.

Unfortunately, in late 2012 sales growth slipped into negative territory before eking back into slightly positive levels at the end of the year. In terms of retail sectors, durable auto and furniture sales were relatively strong, along with drugstores and restaurants. For the year as a whole, monthly retail sales growth on a comp store basis were in the 4% to 5% range. As in recent years, retail sales growth rates were the highest for non-store retailers, which racked up double-digit gains. When expansion of Internet sales initiatives by traditional retailers are factored into the mix, the increase in online sales growth rates was even more dramatic. Despite this trend, online sales remained below 5% of total retail sales activity. Going forward, retail sales activity levels will be governed by economic growth and consumers’ willingness and ability to pay, neither of which can be taken as a given in the current environment.

Housing Market

The housing market has been closely watched as a harbinger of times to come. A recent study cited in

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the *Wall Street Journal* argues that the housing market may be even more important to the economy than previously thought due to its impact on household wealth and consumption. The research suggests the relationship is more accretive on the upside of an improving housing market than it is dilutive on the downside. Thus, on the heels of disappointing retail sales figures at year-end, the nascent recovery in the housing market was welcomed news. It is far too early to assume the improvement in a number of key housing indicators has built enough momentum to catapult the sector out of the at-risk category. However, by acting on consumer sentiment, a strengthening housing market could offset some of the angst caused by political uncertainty and moderate job growth.

At this point in the cycle, it is useful to explore some of the direct and indirect market indicators that can help determine if a major rally is on the horizon. At one level, important bellwethers for the housing sector come from the capital side of the market, which at various stages of the cycle can lead or lag spatial fundamentals of supply and demand for housing. A look at the surge in homebuilder stock prices in the 2012 fourth quarter suggests that a significant number of investors have bought into the recovery scenario and have built further earnings growth and price spikes into their corporate pro forma expectations.

Another capital market indicator for the housing market is the burgeoning market for initial public offerings (IPOs), which are on the drawing boards and are likely to lead other sectors in terms of new issuances. In addition to positive investor sentiment deduced from homebuilder stock prices and imminent IPO activity, there have been increases in median housing prices and in demand for new product. This has led to an increase on the supply side of the market wherein positive homebuilder sentiment and increasing access to capital has fueled an increase in housing starts.

Although housing starts have increased, housing inventory levels have been declining with listed inventory levels at the end of 2012 over 20% lower than the year-over. In addition, median prices for

existing housing in December were up some 12% from 2011. This figure added to the ten-month string of increasing prices that last occurred in the heyday period leading up to the 2006 market collapse. The good news is that the 2006 run-up was to the top of the market cycle, while this one is a recovery from what might well be the bottom. In December 2012, the pace of total housing sales moderated a bit. Despite this deceleration, total sales for the year as a whole were at the highest pace in the last five years. On the demand side, first-time buyers accounted for some 30% of housing sales at 2012 year-end. This suggests that for an increasing share of households, the rent-versus-own equation is tilting in favor of ownership.

The market share of existing home sales in the short sale or distressed category declined significantly during 2012, although they still accounted for a third of transactions. This decline would have been even more dramatic if not for the fact lenders increased the pace of short sales to cut inventory levels and recapture more on troubled loans than they could through foreclosure proceedings. Through the remainder of 2013, upward pressure on the pace of short sales is likely to increase.

While short sale activity is expected to increase, the pace of overall distressed sales is also likely to increase as a result of the agreement between the Fed and the Comptroller of the Currency and the ten largest mortgage services. This agreement, which included an \$8.5 billion settlement, put an end to the prolonged review process for mortgages foreclosed on during the 2009–2010 period. It is likely that agreements will be made with other lenders as well, further speeding up the overall foreclosure process. Despite this cleansing of the backlog of contested foreclosures, the pace of new foreclosures has been declining, especially in some of the hardest hit markets.

Regarding the intermediate-term outlook for single-family sales, transaction activity is likely to pick up ahead of anticipated interest rate increases. In the meantime, the housing sector might be finally shifting from being a drag on the economy to helping bolster growth. Going forward, new rules adopted by the Consumer Financial Protection Bureau are expected to force lenders to adhere to origination and underwriting standards and costs that were the rule rather than the exception before the lax standards that dominated the market and led to the 2006 collapse. This is clearly another case of *déjà vu*—coupled with a dose of common sense and prudent business practices—two

attributes that were somehow forgotten in the last cycle. Hopefully the memories and lessons learned will hang around for a while this time, although attention spans in the real estate and capital markets tend to be relatively short.

Construction Activity

Through November 2012, the value of construction put in place exhibited a modest upward trend, with year-over total construction activity up some 8% on a seasonally adjusted basis. On the private side of the market, the increase in new permit activity was led by the residential sector, which was up 28% on a year-over basis. This reflected a consistent upward trend in monthly permit activity throughout the year. Of the over 900,000 housing permits issued in December, over a third were for buildings with five or more units, which was significantly above long-term averages. With respect to completions, the trend was similar although the widening gap between permits and completions suggests a significant increase in construction activity is built into the current pipeline.

On the commercial front, lodging in 2012 experienced the highest percentage change, although the aggregate level of construction was still moderate compared to other sectors. The office and general commercial categories were up modestly. It should be noted that some of this increased activity was attributable to the restarting of projects that had been put on hold when the market collapsed.

Infrastructure construction activity was strongly led by communications, highways and streets, and power, which reported double-digit increases. However, public construction activity continued to trend downward through the year due in large part to tight local, state, and federal budget constraints. Despite the increase in private construction levels, construction activity overall has remained significantly below long-term averages.

Real Estate Market

Office Market

In 2012, intra-urban central business districts (CBDs) attracted the greatest tenant activity, especially in cities that offered vibrant, livable, and dynamic centers. During this phase of the cycle, such areas became magnets for commercial and residential activity. This urban preference was particularly prominent in urban markets that lacked a multi-nucleated structure with linkages that provided a variety of locational options

for those interested in more connected spaces. On the other hand, suburban markets characterized by non-descript, commoditized sectors struggled with inertia.

Office transaction activity levels were fairly strong in 2012, especially at year-end when the typical market slowdown did not occur. According to transaction data reported by Real Capital Analytics (RCA), office sales through November outpaced all property types, with the exception of apartments, with over \$61 billion of verified sales. The Northeast and West regions were the most active in office sales. Of the major markets in the Northeast, New York reported the greatest transaction volume through November, with Boston coming in a distant second. Office sales were fairly equally balanced in the West, with San Francisco, Los Angeles, and Seattle dominating the region as investors focused on coastal markets.

In terms of asset preferences, office sales activity was particularly robust for larger, core assets to the chagrin of smaller, more commodity-like space. As on the spatial side of the market, investors exhibited strong preferences for CBD properties, especially those in major markets where downtowns offered a mix of office, retail, and housing options. Despite this preference and the price premiums offered in CBDs, suburban office transaction levels were also fairly solid, especially when compared on a year-to-year basis.

Capitalization rates were relatively flat for both CBD and suburban properties in the top asset-quality tiers. However, capitalization rate spreads began to widen as investors focused more attention on relative risk/return at an investment level. This investment targeting and preference is juxtaposed to the previous activity, which measured success by the ability to source product rather than long-term investment performance.

With respect to performance, during 2012 the office sector provided competitive returns on both the private and public sides of the market. However, office returns in the NCREIF Property Index sector trailed the public office sector, with annual returns of 9.5% for 2012. These returns also lagged other property sectors, with the exception of hotels, and had the lowest income returns, with the exception of apartments. In terms of subsectors, CBD properties outperformed their suburban counterparts in terms of total returns—10.4% and 8.6%, respectively. However, it should be noted that a significant share of this advantage was attributable to strong investor interest in CBD properties that drove capitalization rates down under 5.2% for the year.

During 2012, office real estate investment trusts (REITs) recovered from slightly negative performance in the prior year, with returns in the mid-teens. While lagging the overall index, returns were in line with market fundamentals, which exhibited moderate improvement as companies continued to hold the line on spatial consumption due to economic uncertainty.

Going forward, the national outlook for the office market mirrors that of the broader economy: moderate growth with some downside risk. However, this pattern will differ across markets, as evidenced by the fact some markets are beginning to see speculative office construction. Whether these bets pay off or are déjà vu exuberance will be closely monitored.

Retail Market

During much of 2012, retail market fundamentals were relatively stable as developers reined in their activity and retailers continued to cull their operations. In the modest growth economy, both investors and retailers focused their attention on retail facilities that were profitable and economically viable at the individual outlet level. While some construction activity was reported, in most markets that was the exception rather than the rule. Indeed, instead of growing through expansion, developers and retailers alike focused on renovations and expansions that could capitalize on solid market fundamentals and increase sales-capture ratios in existing trade areas.

In some cases, retailers took advantage of store closings to expand into new markets or increase market penetration and leverage existing operations. However, this activity tended to be very selective and based on an underlying strategic plan rather than tactical approaches based on a more transactional model of growth. This increased selectivity made it difficult to backfill big-box space and other space abandoned by users, especially in locations that had struggled before the economic slowdown due to poor fundamentals.

Transaction levels for retail properties were fairly strong, with \$41 billion in sales through November 2012. From a regional perspective, the West experienced the highest volume of retail sales. Retail transaction volumes were the highest in Los Angeles, followed by properties located in the tertiary West outside of major urban centers. This reflected a preference for higher-growth markets in which retail prospects were more favorable than in large,

mature markets. This interpretation is bolstered by the fact that the Southeast was the second most active region in terms of retail property sales. While the greater Miami area and Atlanta experienced the greatest transaction volume for urban areas, sales in the tertiary areas outpaced their urban counterparts on a combined basis.

In 2012, retail REITs led all property sectors in terms of total performance with the exception of the industrial sector. The strong stock performance was widespread across retail subsectors. This was a dramatic change from the previous year, when regional malls had returns over 20%, but smaller shopping centers and freestanding properties were flat-to-negative. For the sector as a whole, 2012 returns were over 26%, with malls leading and freestanding properties bringing up the pack with returns of over 22%, which include the highest dividend yield of all subsectors except for mixed office/industrial properties.

Industrial/Warehouse Market

Industrial market fundamentals gradually improved last year but manufacturing and exports softened in the fourth quarter. However, for 2012 as a whole, industrial fundamentals were stable-to-positive, with overall vacancy rates trending downward before flattening out. As with other property types, market fundamentals became more of a differentiator; tenants and investors showed preference for larger, state-of-the-art facilities that provide a competitive advantage in the global market. The global economic slowdown suggests this situation will continue well into 2013, and this may place a dampener on the overall sector.

Advances in supply-chain management, changes in logistical models, and technological innovations are expected to have a significant impact on this sector. New infrastructure investment, like the widening of the Panama Canal, and efforts to relieve the gridlock in port markets will create opportunities for tenants, developers, and savvy investors. The result may be renewed interest in facilities that provide high throughput with emphasis on location and capacity rather than building design. Tenants will seek out such facilities and may try to go long on leases to take advantage of current market conditions, but, more importantly, to control space that will provide a competitive advantage in both a down and an up market.

On the transaction side of the market, through November 2012 industrial sales levels lagged other core property types, with institutional-grade sales coming in around \$28 billion. As might be expected, industrial sales were less concentrated in major urban centers than most other property types, with investors favoring port cities and major distribution hubs. In terms of market share, the West accounted for over a quarter of all industrial sales; the greatest activity was in urban centers with working ports, including Los Angeles, Seattle, and to a lesser extent, San Diego.

Industrial returns for institutional-grade properties were fairly competitive during 2012. On the private market front, the NCREIF Property Index reported 10.7% total industrial property returns, with income returns of 6.3% leading all property types with the exception of hotels. This situation reflected the greater integration between the industrial sector and the broader economy. In general, larger industrial facilities outperformed their smaller counterparts, although differences varied by market and the underlying drivers of value. Research and development properties led all industrial property segments, with 12.4% returns for the year followed by warehouse properties, which trailed by 115 basis points (bps).

Industrial REITs led all property sectors during 2012, with total returns over 30% for the year as a whole. This stellar performance came on the heels of negative returns in 2011 when economic uncertainty spilled over to the sector. It should be noted that the industry-leading returns were built on price gains, signaled by the fact industrial REITs provided the lowest dividend yields of all major property sectors.

Apartment Market

Last year, the apartment market continued to enjoy an increase in demand and positive absorption. This growth on the demand side of the spatial market prolonged the trend that began in early 2009, as households continued to eschew homeownership.

There is some danger that the apartment market could be overheating and could be slowing. Although net absorption was positive in 2012, on a year-over basis the pace of growth actually slowed from the peak post-recessionary levels. On the supply side, the market continues to accelerate, with developers, investors, and lenders preferring the sector over other property types. The result has been an increase in the pace of multifamily completions with even more units in the pipeline. While strong tenant

demand has generally kept pace with additions to stock, there is some danger that new additions might begin to outpace demand. This caveat is especially true in light of changing perceptions of the single-family market and renewed calls for households to revisit the “rent versus own” decision.

A return to normal levels of tenure choice will take some time to reestablish and will depend on a strengthening economy, improved prospects for employment growth, and ultimately, increases in wages. In the meantime, analysts and investors should start taking a hard look at their underwriting models that include strong rent growth and/or rent spikes to help bolster expected holding period yields above going-in capitalization rates.

The news surrounding several large portfolio-level sales provides additional insight into the fact the apartment sector might be peaking on the asset side of the market.

For example, Equity Residential (EQR) announced the sale of \$1.5 billion of assets to a joint venture between Goldman Sachs Group Inc. and Greystar Real Estate Partners LLC. The move was related to the acquisition of part of Archstone Inc. from Lehman and was explained as a strategic move to increase holdings in targeted core markets. When completed, this restructuring may involve additional sales totaling \$4 billion. Another transaction of note is the announced \$1 billion sale of a portfolio of repositioned assets acquired from Corus Bank offered by ST Residential.

The emergence of larger apartment-portfolio sales may reveal a profit-taking strategy that portends a peaking of the cycle, although that message appears clearly lost on—or ignored by—institutional investors. Through November 2012, apartment transactions reported by RCA led all property types at \$68 billion dollars. This represented over 30% of all transactions, which is significantly greater than the apartment sector’s share of the market basket investible assets.

As might be expected, investor appetites followed the demographics, with the combined Southeast, Southwest, and West accounting for almost two-thirds of reported apartment transactions. Within those regions, the greatest volume of sales was in the traditional Sunbelt markets (Atlanta, Dallas, Houston, and Phoenix) and gateway markets (Los Angeles, Seattle, Denver, San Francisco, and San Diego). In addition to these urban centers, tertiary

“The emergence of larger apartment-portfolio sales may reveal a profit-taking strategy.”

markets were also active, with those in the Southeast leading all other regions combined.

While apartments dominated other property types in terms of transaction volume, the field was more balanced on the performance side of the equation. This was true on the private front—due in large part to low capitalization rates—but was much more dramatic on the public side where investors seem to have pulled back ahead of the market peak. Total performance for private investments slipped at year-end, dipping to 11.2%, which fell behind the retail sector. Looking back at the cycle, the one-year figures were around 120 bps lower than the three-year figures, suggesting the sector had peaked in terms of relative performance.

Other signs that the bull run for the apartment sector may have played out include the income returns, which fell to 5.4% and were lower than all other property types. In terms of subtypes, low-rise apartments led in terms of total returns, which approached 13% for the year. On the other hand, strong investor interest in urban properties drove income returns below 4.8%, over 65 bps below urban and 100 bps below garden apartments.

On the public side of the market, apartment REIT performance during 2012 was the most disappointing. For the year as a whole, apartment returns were under 7%, which was less than half of returns racked up in the prior year. This performance was particularly interesting in light of all the positive hype for the much-ballyhooed apartment sector.

Real Estate and Capital Markets Overview

Going into 2013, the capital markets continue to drive the spatial markets, with investor appetites outpacing product availability. This is especially true for preferred real estate assets in preferred markets and submarkets. In terms of major players, the usual players remain active with a spate of new players stepping into the fray. These patterns have occurred on both the buy and sell sides of the market.

For example, pension funds and advisory firms continue to reposition their portfolios, with many trying to make a strategic shift from higher-risk opportunistic investments to lower-risk core investments. At the same time, foreign investors are active players, with some taking profits, others seeking safety in income-generating assets, and still others focusing on growth assets in which the real play is in the potential for appreciation. In all cases, rising confidence levels and an appetite for higher returns are likely to push investors into some secondary and tertiary markets that to this point have been an anathema for institutional investors.

Opportunistic investors are also working both sides of the market, with some selling to lock in profits on repositioned assets, while others are moving out on the risk spectrum ahead of the institutional players who remain risk averse. The bottom line is there is no shortage of equity capital to support current and anticipated near-term levels of market activity. This situation could change dramatically if the economy encounters a major setback. On the other hand, if the stock market continues to rally, a denominator effect—in which real estate exposures fall relative to asset allocations—could spur another round of net institutional real estate investment activity.

Recent performance in the private and public markets suggests that capital flows to real estate should stay positive. For example, results for NCREIF's Open End Diversified Core Equity index fund (NFI-ODCE) reveal that private sector property performance tapered off toward the end of 2012. This reflected a continuation of the trend toward moderation in returns that began earlier in the year. Despite the slowdown, annualized returns for private investments were in the low double-digit range. However, returns continued downward, closer to historical averages and more in line with underlying property fundamentals.

As the spatial and capital markets came into greater alignment at the overall level, returns among property types and local markets have begun to diverge. This pattern suggests that some of the commoditized pricing, which has carried weaker properties along with stronger assets, may be waning. This is a natural correction as investors start paying more attention to the risk/return relationship.

At an overall level, REITs had a relatively strong year in 2012 and provided a total return slightly over 20%. This was a dramatic improvement over 2011

when returns slipped to the single digits, but was still down from the 2009–2010 recovery when REITs racked up consecutive returns over 25%.

In early 2013, REITs continued the upward trend in performance, although as in the case of the private sector the results differed by property type and REIT emphasis. Going into 2013, REIT advocates were arguing that the public real estate market was positioned to take advantage of a recovering market on the upside, while providing downside risk protection through built-in liquidity features. Whether that claim holds up depends on a number of factors, some of which are internal to the market and some of which are externalities that are beyond control of the real estate industry.

Mortgage Market

Throughout 2012 the commercial mortgage market was able to provide sufficient capital to support the market, both in terms of private and public or securitized capital. That said, in much of 2012 the available capital concentrated on performing assets held by borrowers with strong balance sheets and track records. This situation changed some during the year as lenders became more aggressive and cast a wider net in search of investment opportunities. Despite increased appetites for commercial mortgages, private lenders continued to hold the line on underwriting, making it difficult to get financing on marginal deals and distressed assets in which collateral values are not adequate to support capital needs to close deals. In terms of mortgage originators on the private side of the market, life insurance companies remain the dominant source of capital.

For commercial mortgage-backed securities (CMBSs) 2012 was an interesting year, with about \$16 billion in new issuances in the fourth quarter. While these volumes pale in comparison to activity levels before the 2008 collapse, they were more than welcomed by an industry segment seeking to regain lost ground. For the year as a whole, estimates were for slightly under \$50 billion—a far cry from the pre-2008 peaks, but considerably above the tepid pace since the market collapsed.

Looking forward, expectations are for moderate increases in CMBS issuances. This outlook depends on a number of factors, including performance of outstanding shares, improvement in delinquency rates, and strengthening of real estate fundamentals upon which the market is based. It also depends on

the low interest rate environment, which has skewed investors toward riskier asset classes that can be used to increase total portfolio-level returns without a commensurate increase in risk. This is especially true for the higher-risk tranches upon which the structure of CMBSs ultimately depends. However, the search for yields has compressed the spread at the lower-risk end of the market, which has fallen to around 100 bps or less over Treasuries.

Despite growing concerns over the plight of the economy, it appears that the demand for higher-yielding assets may be sufficient to continue momentum in the CMBS market in 2013. Indeed, early estimates were that Wall Street originated some \$8 billion of CMBS in January. If this claim is correct, it would constitute the highest monthly volume since the market abruptly shut down in late 2007 when new volume exceeded \$250 billion. On the originators side of the equation, the fact that banks have been able to dispose of commercial mortgages to yield-hungry investors indeed suggests the recent momentum may continue over the near term.

Despite what appears to be an adequate supply of mortgage capital to support business as usual in the commercial real estate market, a significant cloud hangs over the market. Namely, there are no obvious solutions for the \$1.5 trillion or so of bullet loans that were originated during the time leading up to the market peak. These loans have been restructured, extended, or otherwise pretended into temporary obscurity. However, the capital markets cannot continue to forestall a day of reckoning, especially if regulators get serious about risk-based capital requirements.

Efforts to delay or dilute imposition of the Basel Accord on global bank reserve requirements suggest the industry might be able to forestall new policies and practices, allowing it to operate on the basis of business as usual. While potentially attractive in the short term, the latent risk to which the capital side of the real estate market is exposed cannot be ignored. How it all plays out remains to be seen; one thing is sure, it will be an interesting journey.

Conclusion

Going into 2013, it was clear there are no simple questions, much less simple answers. In the face of considerable uncertainty as to how things will unfold, it is important to avoid either the euphoria that some advocate or the paranoia that recent history suggests.

Reflecting on the past and focusing on the future, the one thing that is clear is that the fate of the economy and the real estate market cannot be taken for granted. While we would like to believe the positive rhetoric that suggests the market is on the road to recovery, there are enough warning signals to suggest that such an outcome cannot be assumed. To protect against downside risk, it is important to reflect on lessons learned and not ignore the long-term forces that will ultimately prevail. This will help us cope with the many challenges ahead and develop the fortitude and flexibility necessary to work through the myriad problems that may surface.

The good news is that if we can hang in there, if Congress can get its act together, and if we can avoid a major economic setback, the future will be relatively bright. That said, during this period of economic and political uncertainty, the best advice is to stay on guard and make sure you have a back-up plan until the environment returns to a more balanced state of affairs. We are in for some interesting times ahead. The good news is we've been there before, which ultimately brings us back to our déjà vu theme. Enjoy the current state of affairs, but make sure you are ready for the unexpected.

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