A Positive State of Mind

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Commentary

The collective psyche among investors has turned bullish, creating a positive state of mind that has affected the economic outlook and a number of asset classes. This is most visible in the stock market, which has surged to record levels catching many off guard. The surprisingly strong stock market can be explained, in part, by the combination of solid balance sheets and improving economic prospects for a number of industry sectors. However, the recent improvement can also be attributed to the low interest rate environment that has permeated the economic and capital markets. Indeed, the impact of low interest rates on economic and investment activity cannot be overstated. This situation is not confined to the domestic market, as evidenced by the recent decisions by the European Central Bank (ECB) and other countries to reduce interest rates.

While artificially low interest rates have provided a temporary respite to the economic doldrums and have helped bolster prices for hard assets, they are no cure for weak market fundamentals. When combined with increasing access to debt, however, the continuation of low interest rates might just be sufficient to help jump-start overall economic activity. If this occurs, the fledgling recovery might gain added momentum and strengthen the positive state of mind. At some point interest rates and inflation will return to long-term averages, which will create a downward drag on the economy and asset values. For now, the market seems to be either ignoring the day of reckoning or assuming that economic growth will be sufficiently strong to offset the transition to more normal interest rates.

While an economic slowdown is anticipated for the second half of the year, there are some signs that activity will regain momentum after a temporary pause and might be able to move into a sustainable expansion mode. Given the record run in the stock market and in commercial real estate, it is clear that many players are discounting such a scenario. Hopefully, improvement in economic and market fundamentals will create a convergence between expectations and realizations. If this alignment does not occur, the economy will be in for a rough ride.

The Economic Environment

As 2012 wound down, gross domestic product (GDP) growth experienced a sharp decline, raising concerns that the economic recovery had lost momentum. Fortunately, this situation was short-lived, with real GDP bouncing back during the 2013 first quarter to a respectable, but somewhat disappointing, 2.5% rate of growth. The economic growth was attributable to a number of factors, including increased consumer consumption as well as positive inventory investment as businesses became more optimistic. On the downside, net exports were a drag on growth, as the global slowdown dampened demand for US products. Similarly, government spending continued to decline, although cuts in defense were not as severe as in the prior quarter.

During the 2013 second quarter, the economy appeared to be on track, maintaining a moderate rate of improvement, with consumers and businesses helping support economic activity. However, economic activity is expected to slow during the second half of 2013, as government spending cuts and tax increases hamper activity. The global economic slowdown is also expected to place a dampener on the economy.

On the domestic scene, the Federal Reserve (the Fed) is talking as though it will start unwinding its stimulus efforts, including its record-setting $85 billion monthly bond-buying program. Given the support that the program has provided to the financial markets, the timing and level of deceleration is being closely monitored. This attention has not been lost on the Fed, which is struggling with how to manage the withdrawal without creating excessive shocks to the market. The inclusion of mortgage-backed securities along with Treasury bonds is of particular note since the capital infusion is partly behind the stabilization of the mortgage market. While the easing out of the stimulus program is inevitable, the tenuous state of the economy as well as its ability to withstand cutbacks in government spending have created heated debates over the exit strategy. Indeed, there are some signs that the program could be amended to provide additional short-term stimulus if the economy loses ground. The lack of clear direction as to the timing and magnitude of changes in the Fed's policies has created a corollary level of exit risk for investors. This is especially true for those holding positions in real assets whose prices have been bolstered by the temporary infusion of capital.

On the budget front, Washington has done little to resolve the standoff as the two parties continue to defend the lines they have drawn in the sand. The failure to resolve the standoff triggered sequestration, which was presented as an automatic program that would force some type of agreement on both the revenue and expense sides of the equation. Some of the across-the-board cuts did not pan out that way, as in the case of the Federal Aviation Administration (FAA), where public outrage over widespread flight delays forced the FAA to reverse cutbacks by transferring funds from construction projects and less essential areas.

The FAA situation was seen as a test case and appeared to open the door to a spate of piecemeal fixes that would mute the impact of across-the-board cuts and take pressure off Congress to come up with a permanent solution. Of particular concern was the potential to shift funds from longer-term needs to cover short-term problems, which would exacerbate the budget crunch down the road. A case in point was the FAA reallocation of capital funds to operating funds, which could lead to a significant increase in flight delays and congestion in the future. Congress is likely to continue looking for ways to dampen the impact of sequestration and defer the pain.

At an aggregate level, sequestration is estimated to cut some $85 billion from the federal budget in the current fiscal year and a total of some $1 trillion over the next ten years. Real estate veterans are likely to see the cuts as analogous to the underfunding of routine maintenance and deferred capital expenditures that typically snowball and can create a budget time. Ironically, the sequestration budget impact for the entire fiscal year—$85 billion—matches the Fed's monthly bond-buying program that has been used to bolster the economy.

Regardless of the obvious lack of financial acumen emanating from Washington, there has been some good news on the deficit front. In a recent report, the Congressional Budget Office cut its deficit projection for fiscal 2013 by some 20%, putting it at 4% of GDP. This improvement came from a combination of factors, including higher revenues associated with recent tax increases and lower expenses associated with entitlement programs. With respect to the balance of trade, the foreign deficit declined during the first quarter, with exports relatively flat and imports declining moderately. Much of the challenge with exports can be attributed to the global economic slowdown—especially in Europe. With respect to China, the trade deficit declined due to a significant decline in imports and a moderate increase in exports.

Going forward, the fate of the deficit will depend in large part on the relative pace of economic recovery in the United States compared to that of its major trading partners. Regardless of cyclical adjustments, the United States remains dependent on global partners for both trade and capital flows. This situation is likely to become more pronounced as global forces play a more prominent role in domestic economic conditions.

Employment

The employment scene has been closely watched as a harbinger of economic recovery. Accurate estimates of job creation rates have proven to be somewhat elusive, however, triggering relatively significant revisions. Fortunately, these revisions have been to the upside, indicating that employment growth was stronger than initially reported. Thus, when April job reports came in above expectations, prognosticators and investors had some unexpected positive news to digest. While the news helped contribute to the positive state of mind, it also set the stage for disappointment when weekly jobless claims exploded over tenfold to 360,000 workers. Despite this setback, some observers dismissed it as an anomaly and a temporary pause. But, it was a red flag for those bears whose ranks have been gradually eroded by the fact the economy seems to have stabilized.

Setting aside the recent figures, the increase in jobs through April put downward pressure on unemployment, which fell to 7.5%—the lowest level since the Great Recession. Despite this improvement, by the end of the first quarter the labor force participation rate fell to its lowest level since the recession of the early 1980s. While a sign of concern regarding shadow unemployment, the participation rates across the country were correlated with job losses, suggesting it reflects a cyclical phenomenon rather than a structural shift. This will make it more difficult to get unemployment rates under control as improving prospects are likely to draw more employees back into the labor pool. At the same time, older employees with jobs are likely to hang on as long as possible, creating an additional drag on the correction. Also, a significant number of employees—especially seasoned workers whose skills were not valued during the early stages of recovery—remain underemployed.

While employment growth generally improved, some sectors lagged. This was especially true with respect to government employment, although the impacts of sequestration were not as pronounced as some had feared. Similarly, manufacturing employment declined due to impending cutbacks in defense spending. The lack of manufacturing employment growth in other economic sectors reflected nagging concerns by businesses regarding the demand side of the equation, especially when factoring in the global economic slowdown. In addition to softness in some economic sectors, weather-related forces created a drag on employment, creating a modest decline in average workweeks and a temporary increase in part-time employment figures. On a positive note, temporary employment levels, which typically precede an increase in permanent employment, have improved.

It should be noted that continued improvement on the employment front will stimulate an increase in voluntary job separations as employees decide to look for new jobs. Such a trend is evidenced by a number of studies that report record-low levels of job satisfaction. Employees may feel trapped in their jobs by a number of forces, including a prolonged weak job market after the Great Recession. Those who did hang on to their jobs have been expected to pick up the slack and produce more with less. Also, frustration with the lack of wage growth has increased, especially in companies with wealth created in the recent stock market run. In addition, rising health care costs and lack of access to low cost, portable insurance tied many employees to existing jobs. Finally, the collapse of the housing market eliminated mobility for many employees who could not take the economic hit by selling houses at historically low prices.

As the economy moves forward, the result may be new employment opportunities. That is, there may be an increase in employment turnover as employees begin to search for new opportunities. While job-related moves have historically affected interstate migration rates, a number of employees may change jobs without changing location. The degree to which voluntary separations occurs depends, in part, on whether the economy picks up some lost momentum in the second half of the year as anticipated, as well as on the efficacy of proactive efforts of companies to reengage employees. Given strong balance sheets and record stock prices, many will have the financial wherewithal to invest in their employees, although it is not clear if leadership from human resources can supplant the corporate cost-cutting mantra of the past several years. The choice may well be compromised by analysts and investors who focus on quarterly earnings and punish companies that make strategic, long-term decisions geared toward improving forward earnings and the long-term bottom line.

The lessons learned from this reengaging of employees will be telling in terms of how effective companies are in dealing with a new labor force of young millennials. In this new world, job turnover rates can be expected to increase with a new structural level replacing old norms, at least until the new rules of engagement between companies and workers are codified. Unfortunately for some younger employees, this debate will be postponed until the economy picks up enough momentum to let aging workers retire and free up jobs.

Despite longer-term structural concerns, improving near-term employment figures have made a material contribution to the positive state of mind. This helped bolster stock prices, and placed upward pressure on business and consumer confidence levels.

Inflation and Interest Rate

During the second quarter, the annual rate of inflation slipped toward 1%, which was significantly below the Federal Reserve's target of 2%. Expectations for future inflation suggest the low

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inflationary environment should continue for the near term. Inflation rates will be dampened by the lack of wage increases and by increases in payroll taxes. The global slowdown, which has reached recessionary levels in some countries, has also taken pressure off commodity and import prices and should help maintain low inflationary rates. This will allow the Fed to ease into its transition period as it begins to wean the market from its aggressive, prolonged effort to stimulate the economic recovery.

The Federal Reserve has continued its commitment to hold interest rates at historically low levels. This policy has been fully discounted in the market, which has internalized low interest rates. The Fed is well aware of the economy's dependence on low interest rates and the need for a gradual transition as it begins to plan its pullback. At the same time, a growing number of countries have cut interest rates to stimulate economic activity in the face of weak demand. This was evidenced by the European Central Bank (ECB) decision to reduce its benchmark rate to a record low in early May 2013. However, China has been a notable exception, signaling it believes the moderate contraction in its economic growth is manageable and that its domestic demand and global competitive advantage can insulate it from the global slowdown. Given the degree of contagion with respect to low interest rate policies, the adjustment to a higher interest rate environment will be a global phenomenon that will bear close monitoring.

In addition to a trend toward longer-term average interest rates and the eventual ending of the Fed's stimulus program, the financial system will face additional stressors as efforts are redoubled to avoid future banking crises. As noted by Chairman Bernanke, these efforts could take a number of forms, including increased capital requirements in general and for certain higher-risk activities in particular. In addition, as the economic recovery continues, regulators and policy makers are expected to refocus energy on controlling the "too big to fail" phenomenon that many believe has yet to be resolved. These efforts will come on top of pressure to enforce provisions built into the Dodd-Frank law, many of which have taken a back burner during the height and aftermath of the financial crisis. Domestic banks will have to adopt additional policies and practices to comply with the Basel III accord that seeks to stabilize the global financial system. While compliance is voluntary, the increasing integration and interconnectedness at the global level will force larger banks to adhere to added capital requirements designed to manage liquidity risks and help ensure they are able to survive foreseeable stresses.

The cumulative effect of these efforts will place a dampener on bank activities to help forestall future financial crisis that could threaten the domestic and global economies. Unfortunately, there is no guarantee the combination of voluntary and mandatory standards will work over the long term, although the added scrutiny and resultant transparency may monitor emerging risks and signal the need for additional interventions or corrections. In the meantime, interest rates a likely to remain at historically low levels with upward pressure over the intermediate to longer term.

Business Indicators

Business indicators were mixed to positive during the 2013 first quarter with some slippage in the second quarter. For example, in January, the growth rate in business inventories was at the highest level since shifting into positive territory, but the rate of growth slowed in February. While inconsistent, the growth rate was generally in line with expectations for sales. The positive trend was led by retailers who were anticipating continued growth in retail sales. Inventory growth surged in January, but then remained generally flat as businesses paid close attention to demand and focused on improved supply chain management to manage costs. In terms of sectors, wholesale inventory levels contracted a bit and lagged growth in the retail and manufacturing sectors. During the second half of the year, businesses are likely to continue to keep a close eye on inventory levels in the face of a potential slowdown in economic growth.

On the production front, industrial production levels through the first quarter rose at a respectable 5% annualized, although activity slipped after that point. Advance orders for durable goods have continued to exhibit a volatile pattern, with expectations for moderate improvement in line with the overall economic recovery. Factory orders have exhibited a similar pattern, with downward revisions indicating activity has been weaker than initially thought. Fortunately, the magnitude of these adjustments and the range of volatility have not been sufficient to alter the generally positive state of mind among manufacturers. One wild card that will bear watching will be defense-related spending, which will be under negative pressure.

On the export front, the global slowdown and the inability to jump-start economic activity among key trading partners is likely to place an additional dampener on manufacturing. The uptick in the housing market and improved outlook for the commercial sector might bolster the construction sector, although public-sector demand is likely to continue to soften. The result will be added delays in much-needed infrastructure investment, setting the stage for a surge in activity when the domestic and global economies pick up momentum.

On a positive note, confidence levels among small business owners increased during the second quarter of 2013, continuing an upward trend that began in the 2012 third quarter. Despite this improvement, confidence remains below par with respect to historical levels and is based on a belief that near-term conditions will be stable rather than expectation of a significant recovery. However, access to credit for small businesses has improved as lenders have relaxed standards although they remain relatively tight compared to long-term standards.

With respect to big business, CEO confidence levels have shown some gains, bolstered by solid balance sheets and strong stock prices as well as improvement in economic conditions. In general, CEOs recognize the challenges ahead but are shifting more attention to the opportunities that may be emerging as the domestic economy improves. According to a recent Conference Board CEO Challenge survey, the most critical challenges they face are related to human capital and achieving operational excellence. The top strategies for addressing human capital concerns focus on growing talent internally through training and development, which bodes well for current employees. Not surprisingly, these efforts carry over to the operational excellence side of the ledger for which the top strategies relate to improved employee engagement and productivity, as well as to further reduction in baseline costs. Whether these two approaches will work at the same time will be interesting to watch, especially since there is generally a lag in the return on investment in human capital. This may bode well for some of experienced workers who can make an immediate contribution. Going forward, business indicators will be characterized by a period of gradual improvement with some near-term adjustments in response to economic conditions on the domestic and global fronts.

Stock Market

The stock market has enjoyed an unexpectedly strong run with 18 straight weeks of positive Tuesdays (which is something of a bellwether for investor expectations), helping the market recover and set new records for the Dow and S&P indices. Despite record index levels, the underlying price/earnings ratios remain below record levels. This provides fuel to the positive thinkers who contend the market may not be as overheated or over exuberant as the entrenched bears continue to argue. In addition to the generally positive state of mind, stock prices can be attributed to positive financial conditions, with many companies sitting on healthy reserves and strong earnings growth. However, it should be noted that a number of companies increased earnings through cost-cutting measures and austerity programs rather than an increase in top-line sales. The ability to squeeze more out of less has played out for most companies, suggesting that further improvements will have to come from revenue growth that depends on the economic recovery or on outperforming the overall economy. The fact that corporate balance sheets are strong and earnings growth rates in a number of sectors are coming in above expectations are positive indicators that the stock rally may continue.

While the outlook for stocks over the long term will depend on the economic recovery, there are some short-term phenomena that might explain the prolonged bull run as well as why it might continue. A major factor is the absence of viable options for returns from other asset classes. The search for yield in what is expected to be a low interest rate environment over the near-to-intermediate term has led a growing cadre of investors to stay on the offensive in search of yield. Even some investors who had stayed out of the market are being drawn back in to see if they can recover the money they left on the table when they got defensive and pulled out of the market.

When the Fed signals it will start backing off on its stimulus programs, investors are expected to rotate portfolios away from assets that will lose value in a rising interest rate environment and seek out stocks and other investments with more "offense" that can benefit from economic expansion. An additional stimulus to the stock market could come from asset allocators who find their portfolios under-allocated to stocks compared to long-term averages; this is the case for a number of institutional players that have adopted defensive portfolio positions. Finally, the global decline in interest rates that has recently accelerated has put the United States at something of an advantage as it is ahead of the pack. Until the global economy stabilizes, US assets might be seen through a positive lens in terms of investment performance. Regardless of how the domestic and global scenes play out, recent momentum in the stock market and investor remorse by those who missed out on the correction coupled with new players trying to rebuild wealth in a low-yield world will make for interesting headlines.

Consumer Confidence

Consumer confidence has continued to bounce around, although the general trend is upward and came in above expectations for April. Despite this improvement, confidence levels have not recovered from the peak in early Fall 2012 before the budget debacle played out. Of significance in the recent figures is the fact that consumer expectations leapt ahead of present conditions, echoing the positive state of mind exhibited by other players in the market. Going forward, consumer confidence levels are expected to become more aligned with economic activity levels, especially those that are likely to affect their personal situations. Thus, reports of strong economic growth or bull stock markets that are achieving records highs are not expected to offer significant solace to consumers who feel left behind and do not benefit from the economic recovery.

Consumers have worked at addressing their credit woes, resulting in a decline of over $110 billion in outstanding credit during the first quarter. At the same time, delinquency rates for mortgages and for lines of credit, credit cards, and automobile loans all declined moderately. This improvement included a decline in delinquency rates on student loans although rising tuition and college attendance levels pushed outstanding student debt levels upward. Indeed, during the first quarter student loan balances increased by some $20 billion pushing the total outstanding balance toward $1 trillion. This debt represents a future drag on consumer spending and economic activity.

Overall, the outlook for consumer confidence is stable to positive, with consumers paying close attention to how Washington deals with unresolved conflicts as well as news related to how the economy is actually performing. However, the real acid test will be how their pocketbooks and wealth are likely to fair.

Retail Sales

The volatility in retail sales growth is somewhat understandable given the uncertain economic, budgetary, and political environment that has characterized much of the first half of the year. Retail sales started off 2013 at a slow pace before racking up an unexpected increase in February. While the economy continued to gain momentum during the first quarter, retail sales growth slipped again into negative territory. The pattern was generally negative across categories, with lower gas prices contributing to the decline along with automobile sales as interest in new models waned. This pattern was broken in April, with sales growth outperforming expectations. Despite a relatively volatile pattern of retail sales and some disappointing monthly figures, on a year-over basis sales were up. It should be noted, however, that the rate of increase was the lowest in over three years. These figures were dragged down by revisions to sales earlier in the quarter, which suggest consumers were more tentative than reported.

In a recent Gallup poll, around 40% of consumers reported they are spending less money than in the past; this is a substantial change from 2010, when almost 60% were in a contraction mode on spending. Despite this improvement, only 25% of consumers are in an expansionary mode in terms of consumer expenditures. This attitude is likely to create a drag on retail sales growth until consumers develop more confidence in their personal economic situations.

Of some concern is the fact that of those Americans reporting they are spending less, some 75% indicate they believe this will become a new pattern rather than being a cyclical phenomenon. This response is likely tempered by the increasing attention on the fact most Americans have nowhere near the savings needed to fund comfortable retirement living. For the surge in baby boomers, the fact that time is running out to make up for past spending will likely continue to place a drag on consumer expenditures. While rising housing values and an improving economy may provide some respite, not all will benefit from such forces.

During the first half of 2013, online retailers enjoyed an increase in market share. Although this trend is not new, the rate of compound growth has been impressive. Pure online sales continue to be a relatively small share of total retail sales, but the low market share understates the importance of online sales, and the Internet in general, since many traditional retailers are placing increased attention to Internet sales. Additional advances in technology and improvements in supply-chain management are likely to help increase throughput for traditional retailers and improve margins. The proposed Marketplace Fairness Act may create a more level playing field, and the fact that Amazon has signed on as a supporter of the bill suggests that sales tax reform for Internet transactions is on the horizon. That said, a number of details must be worked out, including how to protect smaller retailers who may not have the infrastructure or systems to address the myriad tax jurisdictions that would have to be paid if the legislation passes.

The volatility in retail sales has not been experienced across the board, especially with upper-end retailers whose core customers benefited most from the recovery in the housing market and the bull stock market. However, the middle class continues to be eroded and has been losing significant ground. Indeed, going into summer, the impacts of government cutbacks and lost jobs are likely to create a drag on overall retail sales; however, the upper end of the market may continue to outperform.

Housing Market

The housing market has been closely watched as a sign of things to come. Thus, the generally positive housing figures have been a major contributing factor behind the positive state of mind. Through February, the housing market continued to deliver, with single-family prices reported in the S&P/Case-Shiller Index pushing double-digit increases over the trailing twelve months. The improvement was fairly widespread, with the biggest gains in the markets that were the hardest hit during the housing crisis. While the increase in home prices is good news, the percentages benefited from the low base of valuations that was a carryover from the collapsed housing market. In addition, the increase in median prices has benefited from a shift in the quality of product, with sellers of higher-priced homes testing the market and foreclosed sales declining. At the same time, potential buyers have been lured back into the market by the combination of improved economic outlook and low interest rates that have made ownership more attractive than renting in some markets.

With respect to housing starts, the pattern of recovery has been somewhat mixed although still generally on the upside. After a string of generally positive news, housing starts slipped at the end of the second quarter with two straight months of declining figures. This pattern mirrored the decline in homebuilder confidence as measured by the NAHB Housing Market Index, which by the end of April had slipped for the third month in a row. The biggest negative drag on the index was the decline in homebuyer traffic. In addition, builders are struggling with rising costs for labor and materials that are putting upward pressure on prices. In some cases, builders have been struggling to find laborers since many skilled workers walked away from the industry or were sent home during the collapse of the housing market.

While the decline in housing starts and builder confidence levels created some angst among housing observers, much of that concern was assuaged by the fact that building permit activity exhibited double-digit increases during the same period. The divergence of these two indicators suggests the recent slowdown in starts is a temporary pause. Indeed, the fact the decline in starts was led by the multifamily sector may actually be a healthy sign of a pullback from the excess exuberance that has led to record prices for existing assets and a spike in new development.

The pace of existing home sales grew in early 2013. Indeed, the annualized pace of sales through February came in at the highest level since the stimulus created by the homebuyer tax credit program in 2009. With respect to closings, pending home sales levels were up only moderately during the first quarter. In general, this lack of activity was a reflection of the lack of product on the market rather than a lack of demand. In terms of inventory, the reported supply of houses for sale was around 20% below the six-month average in a normal market.

In terms of distressed housing, the April foreclosure activity was at the lowest level since the collapse of the housing market, suggesting the worst may be over. Indeed, on a year-over basis residential foreclosures are off a third, with even more improvement in the recent figures. While generally healthy, the improvement in involuntary

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repossessions is likely to face some headwinds in the second half of 2013, as many who tried to hang on realize they have run out of time for values to rebound. This is especially true if the economy slows down in the second half of the year as expected.

Regardless of economic and housing market conditions, distressed homeowners are likely to start focusing more attention on the impending expiration of the IRS's temporary abeyance on treating mortgage forgiveness as a taxable form of income. This provision, which was already extended another year, expires at the end of 2013. This might lead to a wave of short sales that could dampen recent price gains. Similarly, banks may decide it is time to more aggressively thin their holdings of foreclosed properties and take advantage of improving market conditions. All in all, the second half of the year is likely to see an increase in housing activity, with a number of builders continuing to gear up in anticipation of continued improvement. Whether that optimism is warranted will depend on the fate of the overall economy and rising confidence among potential buyers.

Real Estate Market

Overview

It is well known that real estate is a cyclical industry, one that is at times out of sync with the rest of economy and other leading indicators. Since capital flows to real estate can be driven by factors outside of the real estate market, assets often trade at premiums or discounts relative to the values that would otherwise be supported by underlying fundamentals. This situation is clearly the case in the current real estate market, where access to low-cost, non-recourse debt and the lack of viable investment options for income-producing assets have driven capitalization rates to historical lows.

Although trophy building sales on flipped transactions are not capturing the headlines as they did at the peak of the market, many commercial transactions are still occurring at record-low cap rates. To understand how some investors are justifying such prices, it is useful to look at a simple example. Assume a value-add investor is looking at acquiring a $10 million property at a 5% cap rate, which translates to $500,000 per year in stabilized income. If the buyer is qualified and can get a 70% loan-to-value mortgage with a 3% interest-only loan for seven years, the effective cash throw-off is over 10%, which is extremely attractive relative to other fixed-income options that are not collateralized by hard assets.

While the typical investor might be accepting some risk in terms of exit values and foreclosure, those with strong track records have been able to get loans that have some assumption options as well as non-recourse features. This scenario is currently playing out in some segments of the market, putting upward pressure on values as investors use leverage to amplify returns. As long as low-cost financing is available and investors' options are limited, prices may hold up. However, this situation could rapidly change in the face of rising interest rates, higher yield requirements, and/or renewed interest in the risk side of the equation by both lenders and investors. In the meantime, the market is likely to remain very competitive in terms of pricing, with growing optimism on the economic front putting additional pressure on prices as investors pencil in rent increases into discounted cash flow models.

While recent pricing levels for real estate have kept some investors on the sidelines, other investors have expanded their horizons, moving beyond gateway cities and core assets in search of higher yields. In addition to increased activity supported by expanded deal sourcing, market activity is likely to increase further as a growing number of investors, lenders, developers and many other industry professionals begin to discount the economic recovery. The fact that tenants and space users have not quite gotten caught up in the same sense of optimism seems somewhat irrelevant with respect to increasing transaction volume.

Given recent market momentum, it is likely that real estate transaction activity will continue to increase over the near term. Whether the increase in market activity is sustainable depends on solid improvement in underlying market fundamentals. This improvement will have to be rather broad based to allow the market to absorb the distressed assets that lenders ultimately have to dispose of to clear their portfolios.

Office Market

The office market has exhibited some improvement in underlying fundamentals, benefiting from a lack of new product and moderate increases in demand.

At a national level, office vacancy rates have continued to improve at a gradual rate falling toward 15% overall. The pattern of vacancy rates differed by market and submarket, with some outperforming the averages and others languishing.

In terms of cycle stage, the office sector has not yet shifted into the recovery stage, although it is postured for additional improvement when hiring activity picks up along with the broader economic recovery. The modest improvement in occupancy rates has supported some increases in leasing rates. Some gateway markets with strong technology, biotechnology, and energy activity have experienced greater improvement. Nationally, rental rates are still significantly below levels needed to support new construction, which has constrained development activity. This scenario is expected to continue at the national level, although some markets are beginning to see speculative construction.

In terms of market share, the office component of the NCREIF Property Index accounted for some 35% of the $329 billion total market cap. Despite this dominance relative to other property types, office performance lagged overall returns, with a rather disappointing 9% total annualized returns through the end of the 2013 first quarter. Despite these trailing figures, the income component was relatively competitive, falling 20 bps off the overall pace.

With respect to office subtypes, CBD properties generated higher total returns than their suburban counterparts with annualized returns slightly under 10% for CBD and suburban trailing by a significant 182 bps. Reflecting strong investor demand and favorable comparable sales for properties that actually traded, CBD offices generated slightly over 5% income returns compared to suburban properties that generated over 100 bps. With respect to market share, CBD offices held a moderate advantage with end of period market cap of $60.4 billion compared to $54.5 billion for suburban holdings. On the public side, pure office REITs account for some 10% of the market. Through April 30, although slightly lagging the overall index office REITs generated solid total returns over 13% on a year-to-date basis including 3% dividend yields.

During the first quarter, Real Capital Analytics reported a moderate increase in the value of office transactions and a significant increase in the number of sales. The difference between these two figures suggests investors have been moving down the size spectrum in search of higher returns. Associated with a decline in deal size, suburban transaction volume outpaced CBD transactions. Similarly, activity continued to pick up in secondary and tertiary markets, which is a major shift from the dominance of the larger markets. Capitalization rates remained relatively flat at slightly over 7% overall, with CBDs around 6% compared to 7.5% for suburban. Major metros still remain priced at lower cap rates, running some 120–150 bps below the mid-7% range for smaller markets. Specialty and niche office products continued to command higher yields, with 7.6% cap rates for single-tenant and medical office space reflecting their higher-risk profiles.

On the distressed asset front, workouts on office loans outpaced new distressed activity, thus continuing the downward trend in outstanding volume. Lenders are selling the more marketable properties, and the residual holdings are declining in size and quality, which might lead to higher returns for value-add or risk-tolerant investors.

Retail Market

Retail market fundamentals have experienced some improvement as the uptick in consumer sales helped bolster the demand side of the market. At a national level, retail vacancy rates improved during the first quarter, with positive net absorption benefiting from the lack of new construction.

The renewed interest in retail is likely to continue to grow as the economy picks up and attention shifts to differences in the inflation-hedging potential of various property types where retail has an advantage. However, the ability to grow net operating income will require added expertise as owners figure out how to increase overall mall productivity. In some respects, the collapse of General Growth Properties ahead of the commercial market collapse, and JC Penney's woes at the end of the cycle provide bookend lessons. That is, over the long term no amount of financial engineering or visioneering can supplant the importance of retail acumen, customer orientation, value creation and real estate fundamentals. This renewed interest in market fundamentals, and an appreciation for the upside potential in the retail sector, may explain the increased attendance at the International Council of Shopping Centers' annual convention, which is on track to attract over 33,000 attendees in 2013.

Retail investments accounted for some 24% of the NCREIF Property Index at the end of the first quarter.

Overall, private retail holdings generated 12.6% total annualized returns through the first quarter. These returns benefited from higher income returns that exceeded the overall averages by some 35 bps on an annualized basis. With respect to subtypes, large retail assets outperformed smaller assets, with regional malls and super-regional malls racking up annualized total returns of 13.6% and 15.3%, respectively. At the same time, larger properties generated around 6% annualized income returns. Other retail properties provided generally solid total returns, with neighborhood centers, fashion/specialty, community, power, and single-tenant properties all generating low double-digit returns. From a risk/return perspective, community, neighborhood, and power centers were all valued at higher yields, with income returns around 6.5% annualized.

In terms of public holdings, retail equity REITs have dominated other property sectors, accounting for almost 25% of the total market cap of all REITs. On a year-to-date basis, retail REITs led the overall index with total returns over 17%, including 3% dividend yields. Freestanding properties led all retail categories and were above overall averages as were shopping centers although regional malls lagged slightly.

On the transaction front, retail sales volume in the 2013 first quarter declined over 2012, although those figures were skewed by two major transactions. Setting those aside, transaction volume of non-portfolio sales were up some 10% on a year-over basis. Retail pricing has been fairly stable, with cap rates plateauing at slightly over 7%. In general, cap rates have been lower for stabilized properties, which might be benefiting from better access to low-rate debt. Average cap rates differ by subtype, reflecting differences in investor demand. Interestingly, the market is fairly bifurcated, with small strip and regional malls trading at almost 8% cap rates, while single-tenant properties are 100 bps lower. Reflecting renewed investor demand for infill properties, urban/high street retail properties are trading at 6.5% cap rates.

With respect to distressed retail assets, the volume of outstanding loans increased moderately but remained significantly lower than the peak of the downturn. The pace of workouts has accelerated as lenders try to liquidate their holdings while interest rates are low and investor demand is increasing. The residual portfolio of distressed retail contains smaller properties as well as those with weaker fundamentals, which will be more difficult to liquidate and involve higher risk in terms of fundamentals.

Industrial/Warehouse Market

On the spatial front, the market fundamentals improved during 2012 with a surge of leasing activity in the fourth quarter. During the 2013 first quarter, leasing activity cooled as growth in the related manufacturing and distribution sectors slowed. However, CoStar still reported over 35 million square feet of net positive absorption despite the fact activity was off in two-thirds of the markets. When coupled with a dearth of new space, the cumulative positive absorption that has occurred has pushed vacancy rates down overall. This tightening has supported rent increases in some markets.

Demand has been particularly strong for mid-size product in the 100,000 to 250,000-square-foot range that can accommodate the logistical needs of shippers. As economic activity picks up, demand for light manufacturing and distribution facilities is likely to continue to grow, setting the stage for additional improvement in the sector. However, some markets are expected to benefit more than others, making market and product selection an important component of investment success.

In terms of transactions, the industrial market was relatively active during the first quarter, with a double-digit increase over 2012. This trend differed by subtype, with warehouse sales up over 40% and flex sales declining by almost 20%. In terms of pricing, industrial cap rates rose moderately, averaging 7.7% overall for the quarter. Flex properties averaged 8% in the face of slowing investor demand for higher-risk properties. Portfolio sales were relatively active, accounting for almost a third of transaction volume.

As with other property types, investment activity continued to move beyond core distribution markets as investors sought higher returns. In terms of market size, primary and secondary markets experienced similar pricing, while tertiary markets were priced to yield 150–170 bp cap rate premiums. In terms of distressed assets, the industrial sector experienced net improvement in the first quarter, with an increase in workouts outpacing the moderate increase in new distressed assets in the 2012 fourth quarter. Due in part to underlying fundamentals, lenders that have disposed of distressed industrial assets have experienced higher recovery rates than for most other property types.

On the private market front, industrial investments had a significantly higher share than their public counterparts, with a 14% share that is around three times the size of the public holdings. On an annualized basis, private market industrial properties mirrored the overall index with 10.5% total returns. For the same period, the income returns were almost 50 bps above the overall average, reflecting a moderate decline on a year-over basis. At a subtype level, industrial R&D space generated the highest total returns, coming in over 12.2%. At the same time, investors recognized the higher risk associated with such assets, which translated to above-par income returns near 7% on an annualize basis. On the other hand, industrial flex space generated income returns that lagged by 45 bps while generating negative appreciation—the only property subtype among all investment categories falling into negative territory on values. Industrial warehouse properties generated low double-digit returns, with a solid 6.2% coming from income. Industrial REITs generated above-par total returns of slightly more than 17% through April.

Apartment Market

The apartment market has been a leading force in the recovery of the housing market but shows some signs of peaking. Apartment fundamentals continued to improve over the near term, extending the four year bull run. Despite an increase in development activity, vacancy rates should remain tight through the balance of 2013, supporting additional increases in effective rent. Some markets are likely to experience softening, however, due to increases in new supply stimulated by capital providers' emphasis on apartments over other property types. This is especially true in markets where development activity focused on narrow segments of demand, such as homogenized urban projects targeting a finite portion of the market. Going forward, once lessons about the importance of market segmentation and product stratification are learned, development activity is likely to spread out to match demand, which will favor overlooked suburban areas.

Apartment transaction activity continued to lead other property types during the first quarter, extending the upward trend that began in early 2010. Indeed, total transaction volume reached a record level. In the face of strong investor demand, cap rates continued to fall toward 6%, although the pace of declines slowed as the sector exhibited signs of being fully priced. Student housing continues to attract interest, but the sector may be getting overcrowded and in danger of some softening.

In terms of market size, major markets appear to have peaked in terms of pricing, with cap rates hovering above 5% as they have for more than a year and overall cap rates experiencing some declines as demand shifts to secondary and tertiary markets. With respect to subtypes, garden apartments traded at 70 bps cap rate premiums over mid/high rise apartments. Tertiary markets' cap rates averaged over 220 bps over major metro areas, although there should be some compression going forward. As might be expected, strong investor demand and the search for returns helped clear out some of the backlog of distressed assets and led to a net decline in outstanding value.

On the private side of the market, apartments accounted for a robust 25% of the total NCREIF Property Index. While in line with some asset allocation studies, this market share is high by historical standards and reflects some of the herd mentality that institutional capital often demonstrates. In terms of private market returns, the overall apartment component of the NCREIF Property Index through the first quarter continued to outperform the overall index, with 11% annualized total returns. With respect to income yield, apartments lagged the overall average with 5.36% annualized returns. The fact that income returns have been relatively stable suggests that the apartment sector is fully priced. When combined with the aggregate allocation, the data provide anecdotal information that private market apartment sector's bull run may well have played out.

With respect to subtypes, apartment market holdings are led by high-rise assets, which account for some 55% of private market apartment holdings. This market dominance reflects the recent interest in high-density, urban holdings. The market is somewhat bifurcated with high-rise and low-rise properties at the upper end of the total return spectrum and garden apartments lagging by some 30 bps annualized. On the other hand, the almost frenetic pace of demand for assets has yielded significant differences on the income side, with high-rise assets generating 4.9% annualized income that trails garden apartments by 100 bps annualized. Apartment REITs represent a significant share of the total REIT universe, with market cap constituting some 15% of the total. Interestingly, apartment REITs lagged all property types in terms of year-to-date returns, which fell below 3.8% and for which all but 50 bps were in the form of dividends.

Real Estate and Capital Markets

Equity Market

The equity side of the commercial real estate market has continued to pick up speed as investors pour capital into the asset class. This activity was some 35% higher during the 2013 first quarter than in 2012. As transaction volume picked up, investors continued to move down the food chain in terms of risk and into secondary and tertiary levels in a search for returns. It is noteworthy that in the current environment competition is so strong that investors are focused more on the adequacy of returns as spread investors rather than the level of returns. This subtle shift in emphasis has had a profound impact on pricing as investors seem willing to support the aggressive pricing of the recent past that has pushed cap rates down to historically low levels for individual transactions.

The search for product has led to a growing number of portfolio sales as REITs (e.g., Equity Residential, Avalon Bay, American Realty Capital Trust) and private sources of capital seek to satiate their investment appetites. These larger, nonrecurring transactions dominated first quarter activity, but even after they are taken out of the equation, transaction activity was significantly up on a year-over basis. This trend of net positive equity capital flows to real estate is likely to continue although cap rates have been pushed about as far as they can. When interest rates ultimately rise, cap rates are likely to follow as the leverage subsidy that is supporting some segments of the market is taken out of the pricing proposition.

Mortgage Market

The commercial mortgage market has become more competitive, providing adequate capital flows to support transaction activity. Indeed, commercial banks have begun to increase new loan activity, joining the ranks of other capital sources that have allocated capital to the commercial mortgage markets. Competition for product has forced lenders to expand their investments by expanding the type and quality of properties. Lenders also have been forced to combine low interest rates with easier access through relaxed underwriting standards.

The market has also benefited from the orderly burn off of the supply of distressed loans. However, the residual pool of distressed assets will be more difficult to work out without a decrease in recovery rates. The increasing competition for mortgage investments on the demand side, coupled with improving market fundamentals, will help lenders move some of these more troubled assets off balance sheets without incurring severe losses. At some point in the cycle, however, lenders will have to bite the bullet to clear out inventory and make room for growth as the real estate markets pick up momentum.

The commercial mortgage-backed securities (CMBS) market has continued to show improvement, with new delinquencies falling below $1 billion for March, which according to Fitch Ratings is the lowest monthly pace in over four years. When combined with resolutions of distressed debt, the overall delinquency rate slipped below 7.5%, the lowest rate since the 2008 third quarter. In terms of property types, industrial and hotel delinquency rates rose moderately, coming in around 10% and 8%, respectively. Apartment delinquency rates showed the most improvement, with a moderate decline in office rates putting the two sectors on par. Retail delinquencies were flat as improving market conditions allowed lenders to avoid a net increase in distressed assets.

In terms of market activity, CMBS issuances gained momentum during the 2012 fourth quarter. This trend continued during the 2013 first quarter, with increased competition forcing issuers to relax underwriting standards to source product. As a result, estimates suggest total CMBS originations increased by more than 25% for the first quarter. For 2013 as a whole, projections are for issuances over $70 billion. While significantly below the heyday prior to the market's collapse, the CMBS sector has come back stronger than expected and is again a significant player in the commercial debt market. It should be noted, however, that the market has benefited from the Fed's quantitative easing program that allocated a portion of its funds to mortgage-backed securities. This has led to an increase in the share of assets on the Fed's balance sheet and has contributed to some of the growth on the commercial side of the market. As the Fed winds down its buying program, there is some risk that CMBS activity will face headwinds. The good news is that the Fed is very mindful of the tenuous nature of the economic recovery and the close scrutiny financial markets are paying to its ultimate exit strategy. The result is that there will be sufficient capital flows to support the forecasted increase in transaction volume at an overall level. That said, overall capital flows will be tempered, with credit worthiness of borrowers and underlying property fundamentals continuing to be a concern to lenders.

Conclusion

The US economy entered 2013 on a strong note in the face of number of headwinds, some of which were self-imposed (Washington's inertia) while others were external (global economic slowdown). Although there were no clear breakout moments or economic sectors, leading indicators trended moderately upward. GDP growth increased, creating a positive outlook despite the slow post-recession recovery. The positive mindset became a self-fulfilling prophecy as it spilled over into the stock market.

The commercial real estate market, which had been projected to lag the economic recovery, continued to outperform expectations on the capital side of the equation. Indeed, the willingness of investors to accept lower returns for real estate and the increased availability of low-cost mortgage capital have driven capitalization rates down to historical lows. Going into the second half of 2013, economic growth is expected to slow before kicking back into higher gear in 2014.

On the commercial real estate front, the near-term lack of viable higher-return investments is likely to continue to support aggressive pricing and valuations, providing some stability to the asset class. However, as the Fed implements its exit strategy from quantitative easing and backs off its low interest rate policy, commercial real estate values will face some downward pressure. Depending on the speed of the economic recovery, this pressure on values could be offset by an increase in net operating income that appears to be embedded in current transaction prices. In the absence of an unexpected shock to the system, the sense of positivism may help carry the day, at least over the near term. However, at some point the positive state of mind must be based on reality rather expectations. Hopefully the economy will be able to deliver on the promise that is being discounted in the current market.

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