A Temporary Pause: Time for a Reality Check

by James R. DeLisle, PhD

Abstract

This column explores the current status of the US real estate market. The column discusses the players and elements impacting various market segments, summarizes latest developments and figures, and offers analysis of recent trends in the real estate market.

The Economic Environment

The US economy got off to a disappointing start in 2015. The Bureau of Economic Analysis's advanced estimate indicated the economy eked out only marginally positive gross domestic product (GDP) growth for the first quarter. This was a major disappointment and came on the heels of a slowdown in the 2014 fourth quarter when GDP growth slipped to 2.2% after two solid quarters of 4%–5% growth. The biggest drags in GDP were declines in fixed investment (especially nonresidential), in net exports, and in government spending. Consumer spending was the strongest contributor to GDP, although it declined dramatically from the 3% pace of the fourth quarter of 2014. The Commerce Department suggested that the disappointing results for the first quarter might be related to a statistical anomaly that it refers to a "residual seaonality" and is considering recalibrating its models to compensate for statistical quirks that may be affecting initial forecasts of first quarter GDP growth.

A number of indicators have raised concern that the economic slowdown may be more than an anomaly. For example, the Manufacturers Alliance for Productivity and Innovation (MAPI) Composite Business Outlook fell during the 2015 first quarter, continuing the downward trend that began in spring 2014. Industrial production activity also fell in March, continuing a downward trend that began in November 2014. Production figures would have been down even more if not for the motor vehicle and parts sector, which recovered from February slippage. The Institute for Supply Management (ISM) Manufacturing Index leveled off in April, stopping a downward trend that began in September. Reflecting the mixed signals that the economy is giving off, the ISM Non-Manufacturing Index continued to improve. Business inventory levels have tapered off a bit but still remained positive through the first quarter. The inventory-to-sales ratio remained stable for both durable and nondurable goods. While the risk-of-recession barometer increased during the 2015 first quarter, that trend tapered off, resulting in moderate-risk readings that were an improvement from the year-over figures. The bottom line is the economic environment is triggering some concerns but reveals no major flags for the economic recovery over the near-to-intermediate term.

On a positive note, in a *Wall Street Journal* poll conducted in mid-May, economists projected the economy would pick up the pace of expansion for the balance of the year, estimating around a 3% annualized rate of increase. The rationale behind the increase was the expectation that consumers would increase their spending concomitant with improved employment prospects and wages, and increases in value for homes and stocks. The Conference Board's Leading Economic Index increased modestly in March and April, offsetting some of the decline that began in mid-January.

The Index rose modestly in May and remains above the year-ago figure. The inventory-to-sales ratio remained relatively stable during the first quarter, with retail at the highest level, followed by manufacturing and wholesale. The National Federation of Independent Business (NFIB) Small Business Optimism Index improved in April, reversing a five-month slide. On a similar note, Moody's Analytics Survey of Business Confidence continued its gradual upward trend with six-month expectations coming in particularly strong. Thus, while there are some concerns over the recent slowdown, there are also a number of signs that economic activity will pick up the second half of the year.

Employment

As in previous years, the employment scene is being closely watched as one of the harbingers of the economic recovery and thus bears in-depth discussion here.

During the 2015 first quarter the number of job openings trended downward but still remained relatively healthy. New hires increased modestly in March and were up 6.8% over the prior year. During April, 223,000 nonfarm jobs were added, which offset the disappointing 85,000 in March and brought job numbers back on par with the beginning of the year. However, new jobs figures remain below 2014 monthly averages.

The number of total layoffs has been relatively stable, but March figures came in some 6% ahead of the prior month's—the biggest increase since October 2014. In May, there were 1,301 mass layoffs, which was a slight increase over April but down from the levels over the past nine months. Total separations increased 10% over the prior March. However, as a sign of improving employment prospects, the number of voluntary quits or departures was up almost 50% over the prior year. Voluntary departures have been increasing in low-to-mid double-digits since August 2014, and the rate of departures is likely to increase as the employment market firms up and employees seek newly available opportunities.

During the 2015 first quarter, productivity fell almost 2% on an annualized basis, continuing the trend that began in the fourth quarter of 2014. These declines followed two strong quarters of productivity gains that had offset the declines in early 2014. There's no clear explanation for the most recent decline in productivity. Economists are split between structural changes (e.g., the aging population) and cyclical forces related to weak demand in the current economic environment. At the same time, unit labor costs rose 5% over the prior year with hourly wages up moderately. At an aggregate level, wages are expected to increase about 3% overall during 2015, with some demand sectors, such as technology, posting much-stronger figures. In a particularly strong position are high-skill/demand occupations, including mobile-applications developers, big-data engineers, wireless-network engineers, and business-intelligence and data-security analysts.

Initial unemployment claims increased slightly in April and then reverted to the downward trend that began in January. The four-week moving average, which is a better indicator of trends, has continued to decline and continuing claims also have declined modestly.

While much attention has been paid to the improving unemployment figures, the debate over whether the unemployment rate provides an accurate picture of the plight of American workers has been ongoing and will continue as the economy tries to gain much-needed momentum. In an opinion piece Jim Clifton, chairman and CEO of Gallup, argues that the official unemployment figures ignore the plight of some 30 million Americans who are either out of a job or are working but severely underemployed in terms of skill sets, compensation, and benefits.[1] When such factors are included in the calculations he and others argue that the *underemployment rate* may actually be 10% higher than the official unemployment rate suggests. While this is not embraced by policymakers and other pundits, the Labor Department does have a category for such employment status labeled "U-6," which suggests that there is some credence to Clifton's claim. The Labor Department defines U-6 as "the total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force." According to Federal Reserve Economic Data (FRED) compiled by the Federal Reserve Bank of St. Louis, the April 2015

1. "The Big Lie: 5.6% Unemployment," http://www.gallup.com/opinion/chairman/181469/big-lie-unemployment.aspx.

U-6 estimate indicated 10.8% of workers fell in the underemployment category.

Many caught in the U-6 or underemployment category would agree that the current unemployment figures do not reflect the real number of affected workers. Thus, while there has been some improvement in unemployment, at this point many potential workers have been "left behind." Figure 1 shows the trends in the unemployment and underemployment as well as the duration of unemployment as reported by the Bureau of Labor Statistics. Note that the duration of unemployment remains over 30 weeks, and remains stubbornly high by historical standards.

In addition to underemployment, another issue that is hanging over the employment scene is the question of the appropriate level of minimum wages. A related issue is the jurisdictional level at which minimum wages should be set. Interest in these issues has manifested itself in a spate of minimum wage legislation at state and local levels. Despite the appeal of such increases to employees and their advocates, the issue of whether it would be a net positive or negative for employees, companies, and economic conditions is far from resolved. On the one hand, many economists argue that an increase in minimum wage could lead to a decrease in jobs with the exact relationship not understood. The increasing interest in minimum wages will stimulate a new wave of research that explores the relationship between differential wage levels, employment levels, and worker migration patterns. While the jury is still out on the impact of increasing minimum wages, the pressure to act continues to increase. President Obama's 2014 State of the Union address called on Congress to raise the minimum wage to $10.10 an hour. Support for such action was lobbied for by a January 2014 letter to the president and Congress in which 600 economists advocated an increase in the minimum wage.

Although Congress was unable to pass minimum wage legislation in 2014, the president's call for a "year of action" in which he encouraged states, cities, counties, and businesses to take the initiative to raise wages did gain some traction. The president's advice on grassroots efforts to raise minimum wages was heeded on a number of fronts. The trend toward increased minimum wages accelerated in 2014, when lawmakers in Connecticut, Delaware, Hawaii, Maryland, Massachusetts, Michigan, Minnesota, Rhode Island, Vermont, West Virginia and D.C. enacted increases. During the same period, voters in Alaska, Arkansas, Nebraska, and South Dakota approved minimum wage increases through ballot

Figure 1 Unemployment, Underemployment, and Duration

Source: US Bureau of the Census

measures. Some cities have also jumped on the minimum wage issue, including Albuquerque, Chicago, Los Angeles, San Francisco, San Jose, and Seattle. The trend has carried into 2015 with additional cities proposing increases, including Portland (Maine) and New York, and a statewide increase proposed by New York Governor Cuomo. According to the National Conference of State Legislatures, as of February 24, 2015, twenty-nine states and Washington, DC, had minimum wages above the federal minimum wage.[2]

In the meantime, a growing number of retailers and other high-profile merchants depending on low-wage workers are likely to take some actions to increase wages to get ahead of the curve and earn much-needed goodwill. In 2014, the Gap (GPS) and IKEA led the charge by raising wages at the bottom of their pay scales. In February, Walmart US stores and Sam's Clubs announced minimum wages would be increased to at least $9 per hour, with another increase to $10 per hour by February 1, 2016. Walmart also promised to address other workers' concerns, including more flexible work hours, as it tries to retain workers in the face of improving employment conditions. While the National Retail Federation continues to fight against raising the minimum wage, other retailers are expected to join the movement on a voluntary basis. The minimum wage movement may well extend to other sectors, as illustrated by McDonald's announcement that it would increase wages $1 above the local legal minimum wage for employees in 1,500 company-owned stores. As with Walmart, McDonald's move was part of a broader program to improve its image and employee experience, and includes paid time off and educational benefits for all employees. The efficacy of these moves and the impact on company performance will be closely monitored as other companies ponder the question of what is the right thing to do in the current economic and competitive environment.

Inflation and Interest Rates

At the end of the first quarter, federal officials remained concerned about getting inflation back up to its 2% target rate. Indeed, the April figures for the Consumer Price Index from the Bureau of Labor Statistics reveal that disinflation remains an appropriate concern with -0.2% inflation on a trailing twelve-month basis. However, food and energy inflation has been relatively stable around 0.2% throughout the first quarter. The key driver to the moderation in inflation has been the energy index, which declined in April after regaining some lost ground in the prior two months. The index for fuel oil declined 8.4% in April, with natural gas falling at a 2.6% rate. On a year-over basis, the gasoline index was down 31.7%, with a 29.1% decline in fuel oil, and 16.3% for natural gas. The food index has remained relatively stable, with food away from home rising 2.9% annually and food at home increasing 1.3%. In addition, import prices continued to decline, albeit not at the levels at the beginning of the year. On a year-over basis, import prices declined 12% in April. Similarly, the Producer Price Index fell in April. The convergence of these indicators suggests the low inflationary cycle is likely to continue, with energy prices being the biggest risk although the global slowdown has mitigated some of that risk.

As to interest rates, in mid-March fifteen of the seventeen Federal Reserve (Fed) policymakers anticipated raising rates later in 2015. Given the increasing recognition of the importance of behavioral economics, federal officials were sending a strong signal to the market that the transition to a higher-interest rate environment would be moderate and would be conducted in an orderly manner.

The slow start to economic growth during the first quarter caused the Fed to ratchet back the expected increases in interest rates. Indeed, after the slow start to the year, projections for short-term interest rates were cut in half from the 1.125% forecast going into the year. At the end of April, the Federal Open Market Committee attributed the slowdown in part to transitory factors related to declines in energy and import prices, which contributed to moderating job growth and a slowdown in improvement in unemployment rates. Despite the slowdown, policymakers concluded that with appropriate accommodations economic activity would return to a pace of moderate expansion. As such, the committee indicated it would continue reinvesting the principal payments on agency debt and on mortgage-backed securities back into new mortgage-backed securities issued by GSEs and would continue rolling over the maturing treasuries it holds. It also stated that after target levels for employment and inflation were met, the target federal funds rate

2. For a comprehensive chart see http://www.ncsl.org/research/labor-and-employment/state-minimum-wage-chart.aspx#1.

may well remain below normal. That said, most economists believed the Fed would start raising interest rates in September although increases are likely to be moderate. This expectation was reinforced by a May 22 speech by Federal Reserve Chair Janet Yellen in which she stated the Fed was on track to raise rates later in the year but would do so cautiously. She also stated that it might be several years before the benchmark short-term rates was back to long-term normal levels, suggesting that rates are likely to stay in check over the intermediate term.

The Global Scene

Economic conditions on the European front, the plight of Greece, and the potential spillover effects across the eurozone continue to hang over the economic outlook. On a positive note, in mid-May Greece drew on International Monetary Fund (IMF) reserve currency holdings, or special drawing rights (SDRs), to buy some more time to work out an intermediate solution with creditors and avoid drawing on its scarce cash reserves. However, to maintain solvency through June, Greece will need another infusion of cash from creditors to cover debts and fund pensions and public wages expenses. This will add pressure to pass a set of economic reforms, including changes in government pension funding, increases in taxes, and privatizations—each of which would be politically untenable to citizens. There is some hope that the European Central Bank (ECB) will provide some short-term support but that would be a stop-gap measure at best.

Despite lingering concerns over Greece, economic growth in the eurozone in the first quarter beat out both the US and the UK growth rates. This performance was led by improvements in France and Italy, which helped propel overall growth to the highest level in the past two years. On the other hand, Germany, which is both the largest economy and has been the bellwether of growth, has had some recent troubles that have knocked it off stride. Going forward, the eurozone will have to address a number of issues to stay on track, including historically high debt levels for both the private and public sectors, high and sticky unemployment rates, increasing infrastructure issues, changing demographics in the form of an aging population and decline in birth rates, and potentially volatile levels of political risk with some of its neighbors to the east. The ECB is expected to continue to try to stimulate economic growth, although sustainable growth will depend on some economic reforms that are likely to be problematic since they would require reining in some of the stimulus plans that have helped bolster the recovery to this point in the cycle.

In other regions, economic growth levels still reflect some of the hangover from the global economic recession, although there are some signs that the recovery will remain on track albeit below the prerecession levels. For example, the Organisation for Economic Co-operation and Development (OECD) Composite Leading Indicators (MEI) has remained relatively stable, hovering slightly above the 100 level. This pattern was fairly consistent across regions, with China, India, Brazil, and Russia holding at slightly lower rates while Japan remained on par. In terms of economic growth, China is expected to come in at an annualized rate of 7% for 2015, which while laudatory to many countries is below recent levels and would be the lowest rate in twenty-five years. Thus, despite some concerns and risks associated with geopolitical factors, the global economic environment is poised for modest economic growth that is roughly in line with US prospects.

Consumer Confidence

Consumers remain a wild card in the economic recovery, with confidence levels seen as key to how they will behave at cash registers. After trending upward for the second half of 2014, the University of Michigan Index of Consumer Sentiment declined during the first two months of the year. Although there was some improvement in the April figures, confidence levels exhibited the largest monthly decline in two years and hit a six-month low. At the same time, inflation expectations also moderated and remain flat as noted by the 2.6% expected inflation for both the one- and five-year periods. The Conference Board Consumer Confidence Index rose in May, outpacing expectations and reversing the downward trend that began in January. Despite this improvement, the index remains at a five-month low with the expectations and present-conditions elements both showing some slippage. Inflation expectations reported by the Conference Board are significantly higher than those reported in the Michigan consumer survey but continue to hover around 5% inflation expectations, where they have been for much of the past year.

After a slow start to the year, consumer credit picked up and trended upward throughout the 2015 first quarter. The biggest change was in revolving debt, which after two straight months of increases was up 6.1% in March on a year-over basis. During the same period non-revolving debt grew at a steady pace, accounting for the bulk of consumer debt and reflecting an 8.2% year-over increase. Automobile lending was strong during the first quarter, with a solid 10% year-over increase. Reflecting improvement in borrowers' conditions, delinquency rates for automobile and mortgage loans declined on both month-to-month and year-over bases. Over the same period, bankcard delinquency rates were stable and trailed other categories. These data suggest consumers may be well positioned for a growth phase that would translate to higher earnings expectations and confidence levels, and suggests they should be able to withstand moderate setbacks and tempered interest rate increases.

Retail Sales

Through April of this year consumers continued to exhibit restraint in spite of some improvement in economic conditions. Retail sales were flat in April as they had been for much of the previous five months. Disappointing sales earlier in the year were attributed, in part, to extreme weather conditions, but the spring thaw did little to bolster consumer activity. While some of the overall sales decline was due to falling gasoline prices, consumers did not transfer saved dollars to other consumer products. Rather, consumers used their extra money to pay off debt and increase savings. Indeed, the personal savings rate in the first quarter was the highest it's been in several years. Given recent declines in confidence levels, the outlook for retail sales is fairly guarded; unless conditions improve, this will place a dampener on overall economic activity. However, there are some signs of hope, including the increase in early May reported by the Johnson Redbook Retail Sales Index, which came in at 2.1% and beat expectations. Whether this sense of optimism holds will be closely watched as retailers try to position themselves and manage inventories for the balance of the year.

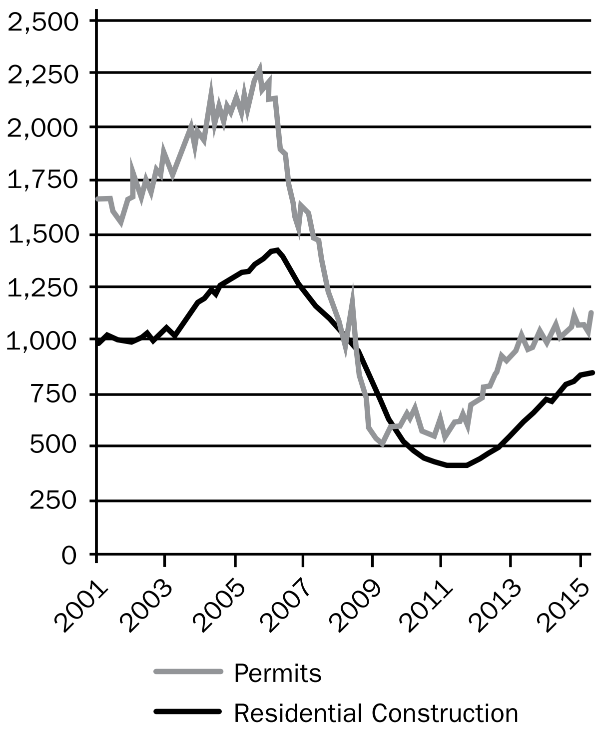
Housing Market

The housing market provided mixed signals during the first quarter of 2015. The year got off to a slow start in terms of existing-home sales, continuing the downward trend that began in October 2014. Toward the end of the first quarter, existing-home sales picked up, coming in at slightly over 10% over the prior year on a seasonally adjusted basis. The National Association of Realtors (NAR) reported that the inventory of existing-home sales continued to tighten with some 4.6 months of supply on the market as of the end of March. On the other hand, the seasonally adjusted rate of new-home sales declined in March, reversing a generally upward trend that began in July 2014. Although disappointing, on a year-over basis home sales were still almost 20% above the prior March. Pending home sales levels were relatively strong through the first quarter and were up around 11% over the prior year.

In terms of housing appreciation rates the S&P/Case Shiller Home Price Index continued to reflect a moderate increase which has hovered around 4% annualized since the market began cooling off in August 2014. The story was a bit more optimistic from the Federal Housing Finance Agency (FHFA) Purchase-Only House Price Index, which continued to rise to 5.5% annualized since hitting a trough in October 2014. Despite only gradual increases, the FHFA House Price Index is down just 3% from its March 2007 peak, while the S&P/Case Shiller Index remains about 10% below its peak in July 2006. Looking at appreciation rates with respect to price levels, less-expensive housing has been increasing at a faster rate than higher-end housing.

Homeownership rates have continued to trend downward, falling to 63.7% by the end of the first quarter. This trend has fueled heated debates over whether the change in tenure choice is a cyclical reaction to the collapse of the housing market and the weak economic recovery, or whether it is a structural shift as millennials and other segments opt for rental as a lifestyle choice. The National Association of Home Builder's NAHB/Wells Fargo Housing Market Index improved modestly in April, the first monthly increase for the year. This improvement suggests that members believe in the future of homeownership. However, both builders and homebuyers are paying close attention to the economic recovery, confidence levels, and behavioral responses of the key players. According to NAHB, during March new-home sales were up 8% over February, while inventory levels declined with "Month's Supply" falling to 4.7 from 5.1 months. Housing starts increased in April on a month-over basis. In terms of market share by type, single-family starts doubled between 2010 and 2015, while multifamily starts tripled over the same period. Despite continued interest in multifamily this shift in market share may have started leveling off. For example, single-family starts had the highest monthly and year-over gains coming in at 1,135,000 units for April, while multifamily starts were flat at around 400,000 units. Figure 2 shows the trends in new-home construction.

Figure 2 Housing Permits and Units under Construction*



* In thounsands
Source: US Bureau of the Census

On the foreclosure front, despite a slight increase at the beginning of 2015 foreclosure activity was down from the prior year. There has been a slight uptick in the category of real estate owned (REO) due to the lag caused by judicial foreclosure laws in a number of states. During the first quarter, the Mortgage Bankers Association reported a decline in residential delinquency and foreclosure rates. Mortgage interest rates have increased modestly although not enough to have a significant impact on transaction levels.

Going forward, the resolution of two key questions will have a significant impact on the continued recovery of the housing market. The first is the fate of the Dodd-Frank Wall Street Reform and Consumer Protection Act requiring banks to determine if borrowers can afford a mortgage. This manifested itself in the creation of a category of "qualified mortgages" that receive legal protections if they satisfy pre-established standards that render them safe or affordable for borrowers. A regulatory reform bill introduced by Senate Banking Committee Chairman Richard Shelby in mid-May would relax this standard as long as the lender would keep the loan on their own books. The theory is that lenders would be more careful if they had skin in the game. While affording more flexibility for banks, the legislation could have a significant impact on the risk profile of portfolio loans as well as limit the liquidity of assets. On the other hand, relaxation of standards could make homeownership possible for individuals who are too financially stretched to obtain a mortgage. This includes the legions of recent college graduates whose mortgage capture potential has been—and will be for some time—severely constrained by the economic hangover of student loans. While the proposed bill may not be the solution for this and other demographic segments, some interventions may well be required to move homeownership rates to long-term averages.

The second key question that will affect the housing market is the future of Fannie Mae and Freddie Mac. After heated debates in 2014, no action was taken despite increasing claims that the two taxpayer-funded entities that have been under government conservatorship play too large of a role in the housing market. Going into 2015, President Obama apparently abandoned efforts to eliminate these two government-sponsored enterprises (GSEs) through legislative actions. The situation is complicated by the critical role the GSEs played in carrying out the Home Affordable Refinance Program (HARP) and the Home Affordable Modification Program (HAMP) that were launched to help the housing market and beleaguered homeowners get back on their feet. Thus, some policymakers are reluctant to make changes as it appears the residential mortgage system is working and is helping get the housing market back on track. Proponents of reform argue that the private sector is better suited for funding the residential mortgage market. The debates are likely to continue during 2015 with limited prospects for major reform while the housing market remains vulnerable. However, some improvements are occurring through the efforts of FHFA to streamline the operations of the GSEs and lay off some of the risk they face to the private sector. Going forward, the fate of the GSAs will be closely watched as policymakers debate their proper role in the housing market and attention shifts to the 2016 election, which will bring this and other unresolved issues to the forefront.

Stock Market

The stock market continues to enjoy a bull run, benefiting from the economic recovery and the strengthening dollar. At this point, valuations are above historical averages and are relatively high, suggesting the outlook for the market will depend on growth in earnings, coupled with continued restraint on the expense side of corporate balance sheets. Small cap stocks have trended upward since October, recovering from some of the declines experienced in the first half of 2014. Cyclical stocks have led defensive stocks, benefiting from a number of trends including the stronger dollar, lower energy drags, and better access to capital as credit standards have eased. On the mergers and acquisitions front, activity levels declined in April after three months of increases in aggregate volume. Of the twenty-one sectors followed by FactSet Research Systems Inc., eleven reported increases led by technology services, finance, consumer services, distribution services, and communications.

Private equity activity fell 17.0% in April, dropping to 88 deals for an aggregate $20 billion in monthly activity. Through late May, the dollar was up 25% over the euro, 20% against the Japanese yen, and 10% against the pound over the past year. When coupled with strong cash reserves, ready access to debt and high confidence in the US economy led to a surge in foreign investment activity. On the other hand, during 2014, US companies reportedly made some $250 billion in cross-border acquisitions. This was the highest level in over twenty years and continued into 2015 with a number of large transactions grabbing the headlines including FedEx, XPO Logistics Inc., Prologis.

Tempering the outlook for stocks is the continued pressure that companies are feeling from activist investors to return capital to shareholders. As a result, a number of companies have pulled back on long-term spending in favor of increases in dividends. Indeed, according to Moody's Investors Service, the median share of cash to dividends increased to 12% of earnings before interest, taxes, depreciation and amortization (EBITDA), the highest percent in over a decade. On the other hand, some companies have emphasized stock buybacks including such notables as DuPont, Apple and General Motors. This trend has been bolstered by the fact that many companies have excess cash that can be distributed without cannibalizing growth, while others have access to cheap capital, creating arbitrage opportunities to drive stock prices by buying back shares.

Real Estate Market

Overview

At a national level, the real estate market is showing some signs of improvement in fundamentals of supply and demand. This generalized situation differs by market, with some gateway cities outperforming while others continue to languish along with their local economies. Investor attitudes remain bullish, with no shortage of appetite for core assets and an increasing number willing to move into secondary and tertiary markets to capture higher returns. Relatively stable conditions and downward pressure on capitalization rates associated with strong capital flows continue to skew attention away from the risk side of the equation and the fact that real estate is a cyclical industry. At this point it appears the market is fully priced, with some assets trading at and being valued above long-term sustainable levels due to the combination of historically low interest rates and capitalization rates.

The private real estate market, as reflected by the NCREIF Property Index began 2015 on a positive note with total returns of 3.57% for the first quarter. These figures compared favorably on a year-over basis with an increase of some 66 basis points over the same period. Interestingly, with strong capital flows and aggressive appraisal assumptions, income returns fell to 1.24% for the quarter and 4.96% on an annualized basis. This continued the downward trend that occurred during 2014, which led to trailing 5.3% income returns on a rolling twelve-month basis. On the other hand, appreciation returns rose 111 basis points on a year-over basis, leading to the increase in total returns. With respect to total market capitalization, the NCREIF Property Index logged in at $426 billion at the end of the quarter. This included 6,863 properties which translated to a $62 million average value. Figures 3 and 4 provide detail on the

NCREIF Property Index composition and implicit capitalization rate.

Going into 2015, REIT balance sheets were relatively healthy with an average debt ratio of 31% and debt coverage ratio of 4.0 for equity REITs. During 2014, REITs raised $63.6 billion in capital, with $31 billion was unsecured debt and another $24 billion in secondary offerings common shares. This activity was off the pace of 2013 when $77 billion of capital was raised by REITs. By the end of April 2015, the 221 REITs in the FTSE All-REITs universe hit $926 billion in market capitalization. During the first quarter, REITs raised some $22 billion in capital, which was almost double the total in the 2014 first quarter. Of that total, $11 billion was raised in secondary equity issuances of common shares along with $8.6 billion in unsecured debt. In terms of assets, REITs owned approximately $1.7 trillion in commercial real estate held in various formats, including stock exchange-listed and public non-listed REITs.

During 2015, the REIT market has become increasingly active, with April 2015 reporting average daily trading volume of $6.2 billion. With respect to returns, the first four months of 2015 have been somewhat volatile with total returns shifting from positive to negative levels during each of the four months. This pattern was most pronounced for equity REITs with total returns slightly negative on a year-to-date basis. This was a significant reversal from 2014 when the All-Equity REIT returns were over 11% through April.

On the debt side of the equation, there are no shortages of capital that would rein in the market over the near term. As lenders seek to hit their quotas, pressure will remain on doing deals. This will filter over to secondary and tertiary assets, although much of that segment of the market is likely to be served by commercial mortgage-backed securities (CMBS), with other lenders continuing to focus on core assets.

With respect to interest rates, the Federal Reserve has signaled that rates are likely to remain in check with few signs of a major increase. At this point the market has discounted the continued availability of low-cost, accessible debt financing and is anticipating no disruption to capital flows. Given the Fed's efforts to balance inflation and interest rates to stimulate growth, this situation is likely to hold for the balance of the year and provide a relatively stable capital market environment.

Figure 3 Property Type Mix, NCREIF Property Index

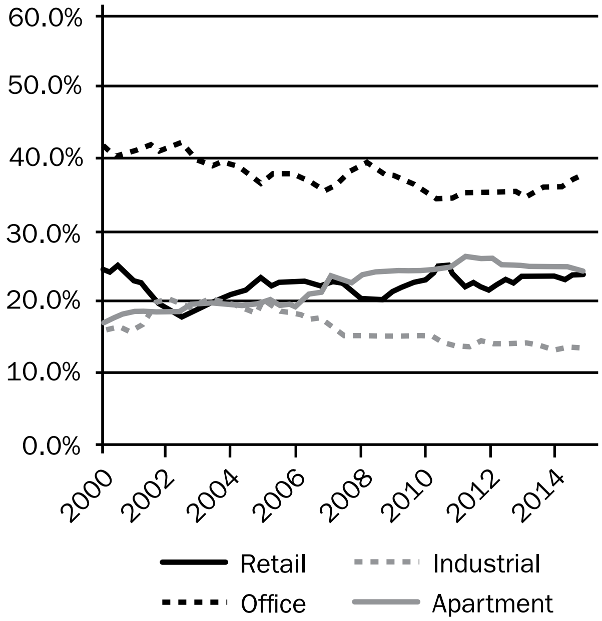
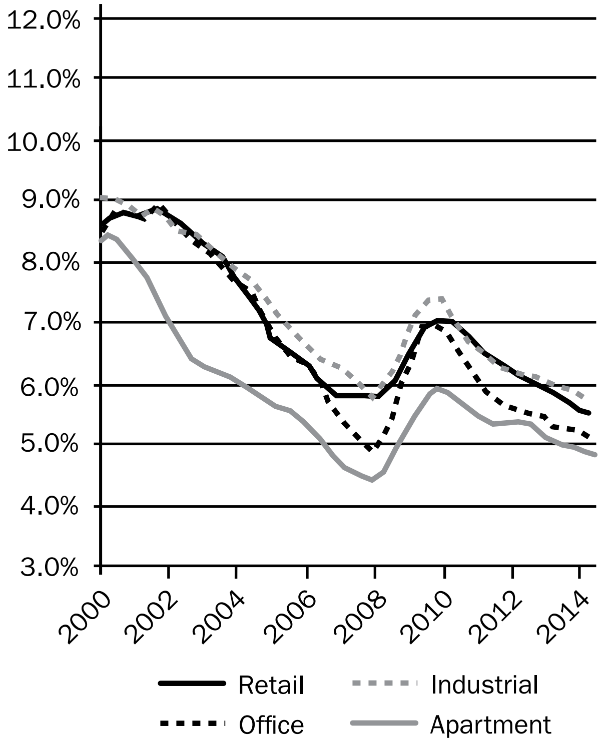


Figure 4 NCREIF Property Index Implicit Cap Rates*



* Value-weighted capitalization rates

Source: NCREIF detail file

Office Market

At a national level, the office market showed some signs of improvement during the 2015 first quarter. This improvement was due to an expansion in office-oriented employment that translated to an increase in net absorption rates. At the same time, construction of office space during the first quarter remained on par with 2014 and show no major signs of a surge in construction. Vacancy rates have declined to 14% overall, with the suburban rates slightly over 15% and downtown vacancy rates around 11%, which reflected a slight uptick.

In terms of transaction volume, investor activity remains strong with transaction volume up and cap rates down. According to Real Capital Analytics (RCA), there were $33.5 billion in office sales in the first quarter, which was up 43% from the prior year. The sales volume was bolstered by entity-level and portfolio transactions that accounted for roughly a third of total sales. Due to strong investor demand, capitalization rates on transactions fell to 6.5%, which is around the rate offices traded at prior to the market collapse in 2007. Office prices on transactions were up 16% during the quarter, which was solid but still around half the price increases in the prior year.

With respect to investment performance, on a rolling twelve-month basis the private office sector reported solid 12.7% annualized total returns. Reflecting strong investor interest and corresponding valuation assumptions, office income returns fell to 1.2% for the quarter, which translated to a somewhat surprising 4.7% annualized returns. While this was on par with the apartment sector, it is significantly below long-term averages. The decline in income returns continued the downward trend through the year and is lower than the 5.1% rolling twelve-month income returns.

Office REITs racked up solid performance during 2014 and ended the year with a 25.9% annualized total return. This pattern held during January, with office REITs reporting 5.6% total returns. Unfortunately, as with the broader REIT segment, office REIT returns later declined to the point of only a slightly positive year-to-date total returns through April. While disappointing when compared to the private sector, office REITs still outperformed the overall index, which came in with a negative 1.2% for the All-Equity REITs benchmark.

Retail Market

Retail market fundamentals showed some improvement in the first quarter of 2015 due to a combination of improving economic conditions and tempered additions to supply. Despite limited construction activity, more retail space has come on the market as a number of retailers pulled back to rationalize their operations and renew focus on unit profitability versus market share.

Investor demand for retail properties remained strong, with 2015 first quarter sales at $24 billion, which was on par with the prior year. A significant difference from a year ago was the decline in entity-level and portfolio transactions. Transaction prices rose some 13% for the year although retail prices remain below prerecession levels. Capitalization rates continued to decline, falling to 6.4%. Capitalization rates for malls in other retail investments were 6%, which was 50 basis points below the prior trough. Prices remained more aggressive for urban retail assets as investors were drawn by demographic trends, with particular attention to millennials and the wave of knowledge workers being drawn back to the central urban areas.

On the investment performance front, the overall retail component of the NCREIF Property Index experienced a dramatic increase during the first quarter, with annualized total returns of 13.81%, which included 5.5% income returns. Compared to the 2014 fourth quarter, total returns were almost double, with the appreciation component up 229 basis points, reflecting aggressive pricing assumptions. As with other property types, income returns for the retail sector have continued to trend downward.

Retail REITS led most other property types during 2014, coming in with annualized returns of 27.6%, led by regional mall REITs with 32.6% total returns. After a strong January in which freestanding retail REITs led the pack, retail REITs began to stumble, with total returns falling to -1.8% through April. This negative performance was fairly widespread, let by smaller shopping center REITs but also extending to regional mall REITs.

Industrial/Warehouse Market

The industrial market benefited from strong leasing during the 2015 first quarter. Although leasing slipped from 2014 year-end figures it remained above the pace set in the prior year. Unlike other property types, new industrial construction remains strong with slightly under thirty million square feet delivered in the first quarter and another ninety million square feet in the pipeline. However, construction activity remains below long-term averages and below the increase in demand. The result has been a decline in vacancy rates that has continued some twenty quarters, and vacancy rates around 7% at the end of the quarter. Indeed, vacancy rates have fallen below 5% in key distribution markets such as Los Angeles, Orange County, Denver, Salt Lake City, and Houston.

Industrial transaction levels were surprisingly strong in the first quarter of 2015, with RCA reporting $21 billion in industrial transactions. Driven in part by entity-level and portfolio sales, this reflected almost 100% increase over the prior year and accounted for some 50% of all industrial transactions. In face of this demand, capitalization rates fell some 30 basis points but still came in at 6.9%, which was higher than other major property types. In terms of pricing, industrial transaction values were up 12% for the year and approach the levels leading up to the financial collapse in 2007. Due to strong demand cap rates fell across the board, including in the higher-risk flex sector, which declined to 7.3%, and in the warehouse segment, where rates fell to their 2007 era floor levels.

In terms of investment performance, the private industrial sector outperformed other property types during the first quarter, with a total return of 3.5%, which trailed only the retail sector. On a rolling twelve-month basis, industrial properties came in at 14.2% leading all major property types. Implicit cap rates for industrial properties continued to trend downward as did other property types, falling to 1.4% for the quarter. During 2014, industrial REITs were fairly competitive compared to the private sector but still lagged most other major property sectors, with 21% annualized total returns. After a strong start in 2015, total returns for industrial properties were volatile, echoing the overall REIT universe and coming in with -5.7% total returns through April. Mixed office-industrial REITs had a similar experience, although total returns were about 200 basis points higher than the pure industrial sector.

Apartment Market

At a national level, the apartment market remains the darling of many investors and developers, fueling record levels of construction activity and creating a robust pipeline that is likely to peak in 2015. At a national level vacancy rates appeared to flatten out at the end of 2014, falling to around 4.2%. Rates are expected to increase moderately over the next several years while remaining below the 6.6% level experienced in 2010. A number of markets continue to expect strong growth, although not the double-digit growth racked up in such markets as Denver, Oakland, and San Francisco in the first quarter. Similarly, if there is a hiccup in local economic conditions, markets that are on track to add the greatest number of units might experience some intermediate corrections; this includes such hotspots as Houston, Dallas, New York, Washington DC, and Seattle.

Although there are some signs that the apartment market may be near its peak in terms of fundamentals of supply and demand, that concern has not tempered investor appetites for product. During the first quarter, RCA reported $33 billion in apartment transactions, which was up 68% over the prior year. Unlike other property types, only about a quarter of such sales occurred in entity-level or portfolio transactions, attesting to the widespread interest in apartments. This pattern may also signal the desire of current holders to cash out in an orderly manner. Apartment prices were up 10% in the first quarter and on an aggregate basis were over 20% above the peak reached before the market collapsed in 2007. Whether such values are sustainable over the long term will be interesting to watch and will depend on the ability to push rents and retain tenants in what will likely be a more competitive environment than it has been for the past several years.

On the performance front, the apartment sector showed signs of moderation during the first quarter, with total returns only slightly up at 2.9% and income returns stabilizing at 1.2%. This translated to 11% and 4.9%, respectively, on a trailing twelve-month basis, which was lower on a total return basis than any other of the major property types. With the exception of the office sector, for which implicit capitalization rates have fallen, apartments remain the lowest income-yielding assets in the NCREIF Property Index.

Apartment REITs outperformed all other property sectors during 2014, ending the year with slightly over 40% total returns. While somewhat disappointing on a year-over basis, through the first four months of 2015 apartment REITs outperformed all other property types and were the only sector reporting positive performance, coming in at 3.8% total returns.

Conclusion

The year got off to an interesting start with an unexpected slowdown in GDP creating some cause for concern. While there are some signs that a degree of caution is indeed warranted, most prognosticators and the Federal Reserve believe the economy will pick up speed during the second half of the year. With the employment scene and housing market showing some signs of stabilization and improvement, attention shifts to consumers. While there has been improvement in confidence levels here and there over the past year, consumers are still somewhat on the fence and are likely to remain somewhat guarded. That said, consumers will need some guidance to help strengthen confidence levels to the point it can translate to action and show up at the cash register.

On the real estate front, the spatial market fundamentals of supply and demand appear relatively balanced on a national level. This perception is fairly widespread although some markets are ahead of the pack while others languish. On the capital side of the market, investors continue to exude a sense of confidence that can only be described as a sense of exuberance. Whether it turns out to be overexuberance will depend on whether capital sources continue to accept historically low yields going into the next stage of the cycle. Indeed, when the next inflection point is reached, it will be more than interesting to see whether the market acts in as orderly a manner on the downside of the curve as it has on the upside. This will be a genuine reality check—interesting to watch from the sidelines and exciting for those on the field of play.

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

Contact: delislej@umkc.edu

Web Connections

Internet resources for additional reading

Conference Board—Business Cycle Indicators
https://www.conference-board.org/data/bci.cfm

Federal Reserve Bank of St. Louis—Federal Reserve Economic Data (FRED)
https://research.stlouisfed.org/fred2/

Institute for Supply Management (ISM)—Report on Business
https://www.instituteforsupplymanagement.org/ISMReport/

Manufacturers Alliance for Productivity and Innovation
https://www.mapi.net/

National Association of Home Builders (NAHB)—Housing Economics
http://www.nahb.org/en/research/housing-economics.aspx

National Council of Real Estate Investment Fiduciaries (NCREIF)
—Data and Products
https://www.ncreif.org/data.aspx

—Resources (papers and minutes)
https://www.ncreif.org/resources.aspx

National Federation of Independent Business (NFIB)—Economic Trends
http://www.nfib.com/surveys/small-business-economic-trends/