Great Expectations Translating to Economic Realizations

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.

Commentary

A lot has happened on the economic front since the summer issue of Financial Views while the real estate front has remained relatively stable. To catch up on the economy, this issue focuses more attention to economic conditions that will affect the real estate market over the long term. Once caught up, attention will shift to the real estate market as it comes more in alignment with the broader economy and real estate market and investor activity reverts to longer-term averages.

As noted in this column's title, improving economic conditions, bolstered by a string of strong job figures, have strengthened expectations that the long-awaited economic recovery is underway. One significant indicator that has been prescient of prior recovery periods is the widespread improvement of confidence levels and expectations of many key players. Of particular importance are the optimistic attitudes of small business owners, consumers, and investors. CEOs' confidence levels are fairly solid on the home front, but their attention is also appropriately focused on a number of global concerns that may especially affect multinational firms, such as the strengthening dollar and global weakness in key regions. While the domestic economic data contain some mixed figures, the upward trend is generally positive and appears to be sustainable. That said, the specter of geopolitical risk continues to lurk in the background and is a wild card that bears close monitoring during these challenging times.

The Economic Environment

Despite some disappointments toward the end of the 2014 fourth quarter, during the 2015 first quarter the US economy appeared to be building momentum and be on track to experience its best performance in the past decade. This optimistic outlook is fairly widespread, embraced by the White House, Congressional Budget Office, and Federal Reserve. Indeed, the president's budget released at the beginning of February predicted unemployment would fall below 5% by the end of 2016 on the heels of back-to-back 3% plus growth in gross domestic product (GDP). The major forces behind these predictions include improvement in unemployment, Federal Reserve policy, and an increase in retail sales as consumers gain more confidence. On the negative side are concerns regarding hangover from the credit crisis and global uncertainty, especially in Europe and Asia, and geopolitical hot-spot regions. While some discount White House predictions as being overly optimistic, a number of economists and other prognosticators are in the same camp.

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Several key economic indicators suggest the optimistic outlook may hold. The recent Federal Reserve Beige Book reveals that the economic recovery is widespread, with all districts reporting modest or moderate growth except the Kansas City district, which reported slight growth during the end of 2014. In terms of sectors, the results differed across the country. For example, financial service growth was generally moderate and mixed while manufacturing activity increased in most districts. At the national level, business and consumer credit activity increased as lenders' lending standards loosened up, especially for high-quality borrowers. The Conference Board Leading Indicators index increased modestly in December ahead of expectations and contributed to a string of fifteen out of seventeen months of gains. Durable goods activity, which was extremely volatile in mid-2014, slipped slightly at year-end but nowhere near the decline that occurred during late summer. Factory orders for manufactured goods exhibited the same pattern, although the declines at year-end were more pronounced and more widespread. GDP also slowed at 2014 year-end, slipping below 3%, which was somewhat disappointing although the trend was still positive. In general, the good news has outweighed the bad news for the economy, with the risk of recession continuing to trend downward despite some recent fluctuations.

The boom in US oil production has been a major factor in the trade deficit. When combined with falling prices, petroleum imports accounted for under 20% of the deficit, which is half of its share five years ago. Despite the decline in petroleum imports, the deficit continued to increase as imports for most other categories of goods. For 2014, export levels increased over the prior year but did not keep pace with the increase in imports, resulting in a deficit over $500 billion. The strengthening dollar is likely to place upward pressure on the deficit, with demand for imports continuing to rise amid a dampening of overseas demand for more expensive exports.

During 2014, the United States came in with its lowest budget deficit since 2007, including a $2 billion surplus in December. On a year-over basis, the deficit was some $72 billion lower than the prior year. This has set the stage for some interesting debates as President Obama and Republican leaders square off over the budget. The improvement has taken some of the pressure off crisis management that has characterized recent budget debates. Although ideological issues and political rancor will continue to cloud the scene, there are some signs that economic deals may be reached. For example, while the call for sweeping tax increases in the president's budget proposal that will not play well with Republicans, other elements may set the stage for more reasoned compromises than in the past. Of particular note are infrastructure spending, military spending, child care, and veterans support. The infrastructure issue will likely be the first major test as the current funding for highways and bridges expires at the end of May. The president has zeroed in on taxing corporate foreign earnings as a source of funding infrastructure, proposing a 14% tax on some $2 trillion of earnings and 19% going forward. How the issue plays out will be closely watched as a precursor of future issues that will come to a head later in the year.

Employment

Business leaders, consumers, government agencies, and economists have all focused on the employment situation as the most important leading indicator for this economic recovery cycle. Over the past several months, the employment scene has experienced a taste of Nirvana with "realizations outpacing the great expectations" of many pundits. The importance of employment to the economy was punctuated by in the president's budget proposal which calls for an increase in funding to allow the Bureau of Labor Statistics to release its "Jobs Openings and Labor Turnover Survey" (JOLTS) at the same time as it reports on total job growth. This boost in funding would provide more transparency and allow various parties to get a better handle on changes in the labor force, including employers' plans for adding new employees to their rosters. In the meantime, prognosticators will continue to use existing forecasting models.

The employment scene has experienced dramatic improvement with the United States adding 257,000 jobs in January. In addition, the Labor Department revised its combined November and December jobs figures

upward, resulting in a November total of 423,000 jobs, the highest figure since the dot-com days in 1997. Table 1 shows the improvement in employment indicators by sector of the economy.

On the unemployment front, the numbers weren't as strong, with January figures climbing to 5.7%, a tenth of a percent increase over December. Rather than a cause for concern, the slight increase is actually a positive sign as it reflected the reentry into the job market by some who had stopped looking for full-time employment. The jobless situation differs across the country as some areas recover faster than others. For example, 40% of metropolitan areas had jobless rates below 5% in December. In the case of larger metropolitan areas, six had unemployment rates below 4%. These included Minneapolis at 3.3%, followed by Austin, Oklahoma City, Columbus, San Antonio, and Denver. The six areas with the highest unemployment rates included some surprises: Memphis at 7.6%, followed by Riverside (CA), Las Vegas, Los Angeles, Detroit, and Atlanta.

Despite the gradual increase in re-entry activity, the labor force participation rate has languished around a 36-year low, with a 62.9% participation rate that has continued the downward trend that began during the recession. On the other hand, the employment-to-population level, which plummeted during the recession, has continued its very gradual increase, rising to 59.3% in mid-January. There are significant differences in unemployment rates by level of education. However, the dramatic widening of the gap that occurred during the height of the recession continues to decline, with the spread between those with "less than high school" and college graduates beginning to return to historical averages. The ranks of the long-term unemployed flattened out at 31.5% in January, a historically high figure but significantly better than the 45% share in the period lagging the recession.

The pace of layoffs declined throughout the 2014 fourth quarter. The strengthening demand for employees translated to a 2.2% increase in wages that is historically modest but a dramatic improvement over the past several years and a continuation of a recent trend. For the year as a whole, layoffs were 483,171—which was the lowest figure since 1997. The pace of voluntary separations (i.e., quits) trended moderately upward during the year, led by some of the lower-paying sectors including accommodation and food services; leisure and hospitality; and retail trade. With improving job prospects, this trend is expected to continue as employees seek to move to new opportunities after having had to hang onto jobs to survive economically or to retain medical insurance. With both of these concerns less

Table 1 Employment Indicators

Sector	Number of Jobs*					
	Past Three Months			Rolling 12-Month Average **		
	Dec-15	Jan-15	Feb-15	2013	2014	Change
Private Jobs	118,690	118,927	119,215	114,938	117,692	2.4%
Goods Producing	19,489	19,553	19,582	18,803	19,315	2.7%
Service Producing	99,201	99,374	99,633	96,135	98,377	2.3%
Government	21,902	21,904	21,911	21,837	21,872	0.2%
Total Nonfarm Jobs	140,592	140,831	141,126	136,775	139,564	2.0%
	Change in Jobs*					
	Change over Prior Year			Rolling 12-Month Average **		
	Dec-15	Jan-15	Feb-15	2013	2014	Change
Private Jobs	3,042	3,096	3,209	191	267	39.9%
Goods Producing	595	569	551	31	46	48.5%
Service Producing	2,447	2,527	2,658	160	222	38.3%
Government	74	93	87	−6	7	−224.3%
Total Nonfarm Jobs	3,116	3,189	3,296	136,775	139,564	2.0%

Source: U.S. Bureau of Labor Statistics
* Number and change in jobs in 000s
**Through February 2015

important in the current environment, the pace of voluntary separations may outperform expectations and put human resources departments on the offensive as they attempt to hang on to employees. In this environment, businesses will have to pay more attention to two key stakeholders: customers who they serve, and the employees who serve them.

Inflation and Interest Rates

The January 28 press release from the Federal Reserve's Federal Open Market Committee (FOMC) began with a positive statement, recognizing that economic activity has been expanding at a solid pace. Of particular note was improvement on the labor front, citing strong job figures and declining unemployment rates. The statement noted that inflation remains below its 2% long-term target, attributing much of the decline to falling energy prices. At current levels, inflation is at its lowest level in the past five years. Going forward, the Federal Reserve (the Fed) expects inflation to fall even further over the near term before beginning to increase toward its long-term target. The Fed is facing a new challenge in satisfying its dual mandate to balance maximum employment, which appears to be on track, and price stability/inflation, which is off track. Over the near term, the Fed is likely to maintain its current target for the federal funds rate, holding interest rates at their historically low levels. However, if conditions change faster than expected then the Fed will move more quickly to raise the target rate. In the meantime, it is maintaining its current policy of reinvesting principal in agency mortgage-backed securities and maturing Treasury securities.

A number of Federal Reserve Bank presidents (e.g., Bullard of St. Louis, Lockhart of Atlanta, Mester of Cleveland) have called for increases in rates by mid-year, citing the lagged impact of Fed stimulus policies. Given growing calls for increases, the Fed's March meeting will be closely watched as will many of the signals that have become more common of late. Since behavioral responses based on expectations have become more recognized, the Fed might test the waters by changing its "patient" tone ahead of any action. Regardless of when the Fed acts on interest rates, there is some evidence that its recent monetary policy with its emphasis on managing the market's expectations via rhetoric will continue to boost the economy even after rates begin to increase. If current trends continue, it is likely that the much-anticipated but delayed rate hike will begin at mid-year or later. However, the increases will be modest to avoid disrupting the economic recovery.

Business Indicators

The recent trends in business indicators echo those of the economic indicators, as shown in Table 2. For example, the Manufacturers Alliance/MAPI composite index lost some momentum during the second half of 2014, although the longer-term trend remained positive due to improvements during the previous six quarters. Capacity utilization increased toward the end of the year, coming in much higher than the long-term average. As the same time, inventories declined, reducing the risk of oversupply.

In terms of types of inventories, the patterns differed with business inventories rising modestly. On the other hand, retail inventories declined modestly due to automobiles, while furniture, home furnishings, and electronics increased. The ISM Purchasing Managers Index continued the decline that began in mid-2014. The recent figures can be attributed to a number of factors, including global weakening and the strengthening dollar. The ISM Nonmanufacturing Index improved in January, leading to a leveling off that began in mid-2014 after a string of improving figures. Business activity and new orders, which accounts for half of the index, led the improvement, while the employment component slipped on mixed results across industry segments.

On a positive note, in late 2014 the NFIB Small Business Optimism Index rose to its highest level since October 2006. The improvement was broadly based and included the critical "expectation for higher sales," which had held back small business optimism during prior periods. Of particular note was the dramatic increase in the "plans to make capital outlays" component, with 60% reporting plans to make outlays, the strongest figures since December 2007. These factors help explain the increased sentiment that "now is a good time for expansion," with 29% expecting to make outlays in the next 3-6 months which is the strongest recent figure. This improvement coincides with the continued loosening of bank lending standards, which should make it easier for small businesses to fund expansion.

With respect to big business, CEO confidence levels reported by the Conference Board improved slightly during the 2014 fourth quarter, reading at 60-point level, which reflects a preponderance of positive responses

over negative responses. One of the differences between the attitudes of small versus big business leaders may be the greater attention the latter pay to the global scene as a potential source of problems. Of particular concern are Brazil, Japan, Europe, and China, which all are struggling with their economies.

The banking sector has been under siege for some time, and it is likely to trigger a new round of debates during early 2015. In addition to its monetary policies and interest rate policies, the Fed is receiving growing attention as a result of its new capital rule for big banks. The proposal will be phased in during 2016 and be fully implemented by 2019. December debates suggested the new capital requirements would apply to Bank of America Corp., Bank of New York Mellon Corp., Citigroup Inc., Goldman Sachs Group Inc., Morgan Stanley, State Street Corp, and Wells Fargo & Co. According to reports of the Big-8 banks, however, the proposed rules would only affect J. P. Morgan Chase & Co., which would have a projected $21 billion shortfall. The objective of the proposal is to reduce the likelihood of failure and avoid bailouts by making sure banks are adequately capitalized and by curtailing their reliance on riskier, short-term funding sources. Since the proposal was presented in December, the surging dollar has triggered a backlash from US banks who argue that the capital requirements, which exceed by 1.8 times the international targets set in the 2014 Basel III agreement, will favor international competitors. In addition to higher capital requirements, the proposal is more stringent regarding the range of assets that will qualify, the assumed rate of outflows of certain funding sources, and the shorter transition period. The recent surge in the dollar has created even more angst among the Big-8, leading to meetings with Fed officials and plans to file an official comment letter seeking relaxation of the rules.

Stock Market

The stock market continues to fluctuate with changes in economic indicators and global conditions affecting investor behavior. In the first week in February, the improvement in jobs and wages helped stock prices surge to the highest weekly gains in two years. This was welcomed news after a poor showing in January when both the Dow and the S&P 500 reported the greatest monthly declines in a year. The increase in the market in the face of strong jobs figures suggests that an inflection point might have been reached. That is, it appears investors believe the economic recovery has gained sufficient momentum to carry itself even if the Fed does raise rates. Additional evidence of the market's rising expectation of an increase in interest rates was provided by the rally in bank stocks, which would likely experience an increase in income from higher loan rates. At the same time, the expectation of rising rates would adversely utility stocks, which have benefited from moderate but steady dividends as was manifested in a recent decline in stock prices. The same fate was experienced by bonds and treasuries, with prices falling as yield requirements rose.

The strengthening dollar has affected a number of American multinational companies, putting those affected by exports at a disadvantage and forcing them to a more defensive posture. This pressure has forced a number of large firms to refocus on cost cutting, leading to a decline in capital spending and stock prices. Affected companies cover a wide range of business sectors with strong export sales, ranging from durable equipment manufacturers such as Caterpillar, to technology firms such as Apple and

Table 2 Economic Indicators

Indicator	2014			2013	Rolling 12-Month Average **		
	Oct	Nov	Dec	Dec	2013	2014	Change
US Leading Indicators	1.88	1.67	1.74	1.44	1.49	1.75	17.8%
Financial Stress Index	−1.11	−1.19	−1.01	−1.2	−1.18	−1.30	−10.1%
Business Inventories	$1,760	$1,763	$1,764	$1,698	1,658.7	1740.4	4.9%
Business Sales	$1,348	$1,343	$1,331	$1,303	1,291.7	1338.3	3.6%
Inventory/Sales Ratio	1.31	1.31	1.33	1.29	1.3	1.3	1.3%

Sources: Federal Reserve Bank of Philadelphia & St. Louis, US Bureau of the Census
* Inventories and sales in $ billions, end of period
** Through December 2014

Microsoft. In addition to the dollar, global weakness in the eurozone and Asia has placed a dampener on American multinational firms.

Global Scene

While the trend toward globalization is not new, the integration (i.e., correlation) among economic conditions across borders has dramatically increased in most economic and business sectors. This trend has created windfalls for those who can exploit the arbitrage opportunities by reading cross-border market signals, and wipeouts for those continuing to focus on local and national indicators.

Since the Great Recession with its global proportions, the ability to anticipate convergence and divergence across country boundaries has become more difficult. This is due, in large part, to uncertainty in how various countries will deal with an economic slowdown at home as well has how the market will react to interventions. The combination of these two factors has added more volatility to the global economy. For example, the Swiss National Bank caught the market off guard in mid-January when it removed the cap on the exchange rate of 1.2 Swiss francs per euro. The market reacted quickly to this unexpected move, leading to a 30% surge in the franc before falling back to a 15% premium against the euro. The Swiss stock market took an immediate dive and stock prices plunged as prospects for sales in the eurozone weakened.

The situation is a bit different in the eurozone, although the impact of interventions on market behavior is far from certain. For example, Mario Draghi, the president of the European Center Bank (ECB), is expected to take a page out of the Fed Reserve's playbook and launch a policy of quantitative easing. This will lead to further adjustments in the market that hopefully will be more moderate than in the case with Switzerland. However, the circumstances surrounding this intervention are different from what the Fed faced. Europe is struggling with a debt crisis, falling prices—manifested in a -0.2% fall in December, rising unemployment, and stagnant growth. The threat of the eurozone slipping back into a recession after its recent—albeit modest—recovery is pushing the ECB toward a crisis mode in which uncertainty can wreak havoc upon already vulnerable market expectations. The ECB has limited options, especially due to disagreements among members of the governing council and Germany's stance against quantitative easing.

At the other end of the spectrum, Greece has initiated procedures to undo some of the austerity measures that were a condition of its international bailout, including tax cuts and increases in minimum wages. In addition, Prime Minister Alexis Tsipras indicated Greece would try to get a bridge loan from international creditors instead of extending its current bailout. The severity of the financial crisis in Greece manifested itself in another downgrade in its sovereign credit rating by Standards & Poor's Ratings Services, plummeting it further into junk territory.

Greece's fate hung over the Group of 20 (G20) meeting of financial officials and policymakers in mid-February. Weakness across Europe and in Asia—particularly China—has led to a downward revision in global economic growth. At the same time, inconsistent monetary policies promise to create volatility on the global economic scene. Indeed, since some countries are moving in opposite directions on monetary policy and interest rates, economic volatility will likely amplify. For example, while the United States is winding down its quantitative easing and looking to raise interest rates, the eurozone is moving in the opposite direction.

The slowdown in China—the worst since 2009—has become more problematic for American multinational companies. Indeed, trade results for January caught many off guard, with a 3% drop in exports on a year-over basis compared to a 20% decline in imports. This imbalance translated to a record $60 billion surplus. The declines in China's export activities varied by geographic region, with Japan and Europe declining and the United States increasing. On the import side, the slowdown reveals a weakness in domestic demand that may prove difficult for American companies seeking to capitalize on China's growth. In addition to official numbers on trade activity, another indicator of economic conditions comes from UniGroup Relocation, which moves some 260,000 families worldwide for jobs. UniGroup has reported that in 2014 twice as many customers moved out of China as moved in. This is a dramatic change, although it can be attributed to a number of factors beyond economic activity, ranging from expiring work contracts, almost intolerable pollution levels, and high costs of living. Indeed, Mercer reported that a number of key cities in mainland China (e.g., Shanghi and

Beijing) rose into the top-eleven most-expensive cities for expatriates in the world, while Hong Kong rose to third place.

Consumer Confidence

In the United States, continued improvement in the economy—especially on the employment front—has bolstered consumer confidence levels. The Conference Board Consumer Confidence Index rose almost ten points in January, rising to the highest level since mid-2007. The improvement was widespread among components of the index, with "present conditions" experiencing the greatest increase. Although improving at a slower rate, the increase in "expectations" signaled a growing sense of optimism about the future. Despite this shift in morale, purchasing plans were dampened, as shown in Figure 1, which will keep retailers on their guard as they try to balance inventory levels with sales expectations.

The University of Michigan Index of Consumer Sentiment showed even stronger results and reached its highest point since 2004. Consumer sentiment improved as to both present conditions and future expectations, with a majority perceiving an improvement in business conditions. In addition to improved labor conditions and low gasoline prices, consumer sentiment was bolstered by an increase

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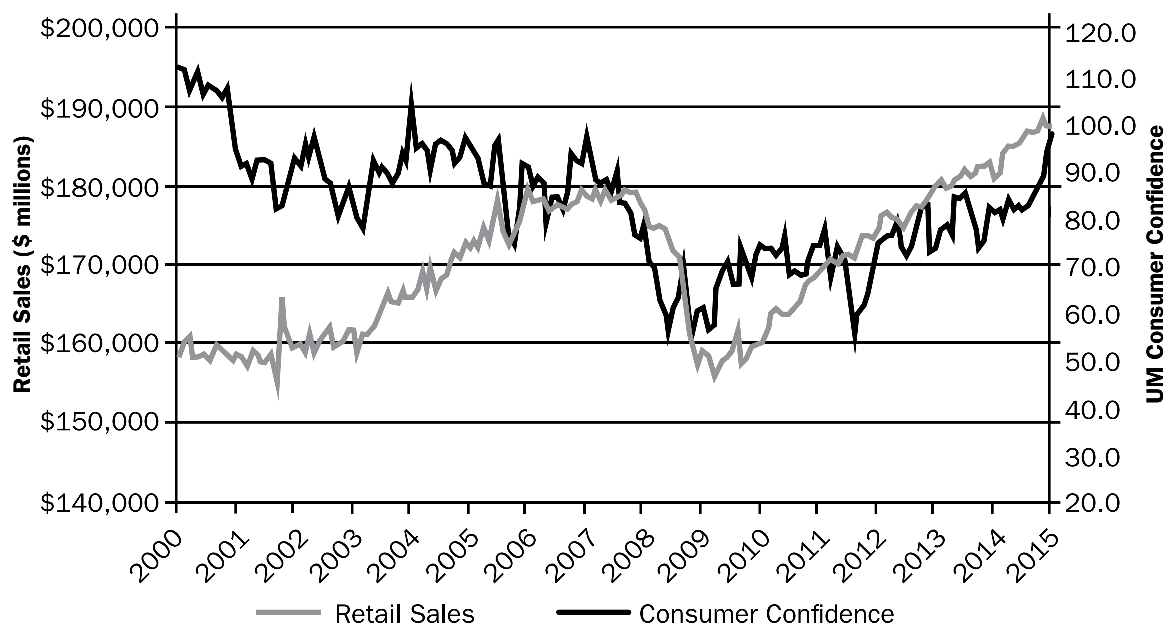
in earnings, reported by 40% of survey respondents, and an expectation of higher earnings in the year ahead, reported by over half for respondents. This perception is consistent with personal income growth, which was positive throughout 2014. Another sign of improved consumer confidence was the moderate increase in consumer credit combined with a decline in write-offs and bankruptcy filings from the prior year.

Retail Sales

According to the Federal Reserve Beige Book, during January consumer spending increased in most districts, leading to modest increases in year-over sales. Holiday sales were somewhat mixed, although mostly in line with expectations. The ICSC Chain Store Sales Index dropped at the end of the holiday season, with 2.2% year-over sales growth declining from the prior year. At an aggregate level, retail sales fell almost 1% in December, driven down by the

Figure 1 Consumer Confidence and Retail Sales Trend



Sources: Thomson Reuters/University of Michigan, Federal Reserve Bank of St. Louis

6.5% decline in gasoline sales. This dragged down total retail sales and led to a disappointing 3.2% year-over figure.

The decline in gas prices provided some respite for consumers and helped bolster other retail categories that otherwise would have had even more disappointing results. The decline in sales was fairly widespread; it included department, clothing, sporting goods and hobby, building supply, and electronics and appliance stores. A number of categories experienced flat to moderately positive sales growth at 2014 year-end, including food service and drinking; furniture and home furnishings; and food and beverage. Going forward, retail sales are expected to improve along with employment, earnings and consumer confidence.

Internet sales continued to increase ahead of overall retail sales, with a 4% increase during the 2014 third quarter, which was up over 16% from the prior year. Despite the increase in online sales, the industry still accounts for 6.6% of total retail sales. Main Street retailers have continued to adapt to advances in technology, growth in customer apps, and Internet shopping. For example, an increasing number of retailers have started accepting mobile smartphone gift cards for payments. The industry also continues to strengthen loyalty programs using data mining and other tools to reach customers. This trend is likely to continue, with Moody's Analytics reporting the results of a survey in which respondents indicated a third of purchases were made online.

During January, vehicle sales were strong, with some 16.7 million unit sales on a seasonally adjusted annual basis. The uptick over the prior month included a slight moderation in auto sales, while the decline in gas prices contributed to an increase in light truck sales. Manufacturer sales levels remained relatively stable, with imports and domestic manufacturers holding their own. Going forward, the rise in the dollar against the euro, Japanese yen, and South Korean won has increased the appeal of the US market. As a result, foreign carmakers are expected to increase exports, which in turn will place downward pressure on prices, cause a shift from options to standard equipment, and increase dealer incentives. Assuming that employment figures continue to hold up, disposable income increases, and credit remains readily available, the auto industry is in for a strong year. However, there are likely to be some shifts in market share, favoring foreign car manufacturers over domestic ones. Foreign companies with domestic manufacturing facilities—such as Germany's Daimler AG with its Mercedes-Benz USA, Toyota Motor Corporation, and Honda Motor Corporation—are expected to particularly benefit from the strengthened dollar that will bolster profits and provide a competitive advantage over its purely foreign counterparts. On the other hand, the opposite is expected for auto exports, which is a disappointment after a three-year string of record-level activity with 2.1 million car and truck exports. This was the first time exports exceeded 2 million and is up some 75% from a decade ago. In an ironic shift, the United States has become something of a low-cost auto producer benefiting from competitive labor rates and adoption of leaner manufacturing.

Housing Market

With the exception of employment, the housing market has remained the most closely monitored sector for those tracking the economy. Unfortunately, this economic sector has not lived up to the great expectations held by some. The sector has been problematic in terms of forecasting, with mixed signals on price gains, new construction, and shifts in housing preferences clouding the scene.

After strong gains over the prior two years, housing prices increases slowed during 2014. This downward trend was reported in a number of indices including the Black Knight Home Price Index, the S&P/Case-Shiller Home Price Index, the Core Logic Home Price Index, and the FHFA Purchase-Only Home Price Index, which unlike the others showed a slight uptick at year-end. Volume declined for both new and previously owned homes concomitant with the rise in interest rates, providing a forward look at what might occur when interest rates begin to return to more sustainable levels. When this occurs, housing prices will experience downward pressure especially if an increase in household incomes is not adequate to maintain effective demand for housing. On the new-housing front, 2014 was particularly volatile, with figures bouncing up and down but ending the year on a positive swing. Through the first three quarters of 2014, existing-home sales trended upward rather consistently before falling at the beginning of the fourth quarter and recovering somewhat at year-end.

On the construction front, multifamily activity has returned to pre-crisis levels, while single-family rates have lagged. In some markets, the

shift in market share to multifamily units from single-family units has been dramatic. Although not a major problem in most markets, if this shift in supply continues it should be closely monitored. According the National Association of Home Builders (NAHB), developers' sentiment about the multifamily market cooled off toward the end of 2014 but remained positive. The NAHB/Wells Fargo Housing Market Index (HMI) improved during the second half of 2014, offsetting some of the slippage that occurred earlier in the year. This was consistent with the NAHB/First American Improving Markets Index (IMI), which demonstrated widespread improvement in September. At 2014 year-end, 63 of the 350 national metropolitan areas exceeded their prior normal levels of economic and housing activity, with the national average running at 90% levels.

One of the more interesting debates that is yet to be resolved is whether the shift in tenure choice among some demographic segments is a cyclical phenomenon or is a structural shift as some apartment aficionados have argued. Bolstering the case for a structural shift is the decline in homeownership rates, which the Commerce Department reported as under 64% at year-end, the lowest rate in some twenty years. This decline accelerated during 2014, due in part to the overall increase in the number of household formations, which was at a ten-year record level. This increase in households was attributed, in part, to improving economic conditions and employment levels, which likely encouraged those who had moved back home to strike out on their own. However, homeownership statistics for households headed by those under 35 years fell to 35% in 2014, down from the peak of 44% in 2004 prior to the dramatic run-up in housing prices. This situation is unlikely to change due, in large part, to the average $33,000 in student debt that hangs over college graduates, which is up a third since the housing market collapsed. At an aggregate level, student debt totals a staggering $1.1 trillion, nearly double the level in 2007 during the Great Recession.

Rising student debt is not the only factor behind the decline in homeownership rates by younger households. An uptick in housing prices that outpaced income growth during a stagnant job market also contributed to the trend. Lenders have also contributed to the issue through strict underwriting standards that focus on total debt, credit ratings, and other risk factors, making it difficult for many younger households to afford home ownership. A recent report released by Trulia offers some useful insights into the prospects for homeownership among younger households. The report suggests that demographic changes in terms of delayed marriage and parenthood are a major factor in low homeownership rates among younger households. The report also contends that there really hasn't been a major change in preference of millennials toward homeownership but rather a deferral of ownership. While continued improvement in the economy may help bolster homeownership for younger households, some stimulus or incentive programs are likely to be necessary to allow ownership levels for this segment to rise to their long-term averages.

> "Commercial real estate investors continue to flock to core assets, driving prices up and yields down to record levels."

Real Estate Market

Overview

The year 2014 was one in which "great expectations were met with realizations" for the commercial real estate market. Commercial real estate enjoyed a solid 2014 as measured by improving fundamentals, transaction volume, and pricing trends. According to Real Capital Analytics (RCA), sales of significant commercial property came in at $424 billion dollars. This continued a six-year trend in increasing activity levels and reflected a 17% increase over the prior year. In terms of records, sales volume approached the 2006 figures, which were only exceeded by the 2007 peak that pushed $600 billion before the bottom fell out of the market. Indeed, if portfolio transactions, which were prolific in 2007, are held out of the mix, the recent figures are greater than they were when the market last peaked. Transaction levels should remain robust, at least over the near term, given improvement in economic conditions and the continued turmoil offshore that is driving interest in US assets among foreign investors.

> "Brokers report office leasing activity was on an upward pace going into 2015."

The positive outlook for transaction volume is bolstered by the fact some owners are likely to cash out core assets ahead of a rise in interest rates and yield requirements. This phenomenon may be most pronounced for stable, core assets that owners feel are fully priced and thus have limited upside potential in terms of pricing. This dampening on appreciation will make such assets revert to long-term trends, functioning more as fixed-income investments than as the growth investments they have become of late, with returns attributable to appreciation rather than income. Indeed, the $409 billion NCREIF Property Index (NPI) reveals that appreciation outpaced income returns in 2014, continuing a trend that has held for the five years since the market recovered from the downturn. In terms of magnitude, of the 11.8% total return for 2014, 52.5% was attributable to appreciation (Table 3). This compares to an 18% attribution from inception of the NPI in 1978. If the data for the past five years—a period during which appreciation came in ahead of income—were held out of the historical averages, the differences would be even more dramatic.

In many respects, the commercial real estate market has entered into a new regime in terms of pricing and yields for core assets. Indeed, recent shifts suggest that commercial real estate investors continue to flock to core assets, driving prices up and yields down to record levels not seen in modern history. While this situation may hold over the near term, at some point an eventual sell-off is likely to occur once the market steps back and objectively evaluates the current situation. This behavioral response would be consistent with the recent rotation out of bonds and other fixed-income investments in the face of rising prospects that the Fed will raise rates by mid-year or shortly thereafter.

Interestingly, a number of investors appear to be focusing more attention on risk, a concept that appeared to have faded during the recent heyday period. This tendency may explain the slowdown in transaction activity during the 2014 fourth quarter, which RCA reported came in at a ten-quarter low. Ironically, rising concern over risk may be having the opposite affect that it should, especially with economic improvement spreading across the country. That is, at the same time investors are willing to pay even higher record prices for core assets, they are turning attention away from perceived higher-risk investments in secondary and tertiary markets. When flawed exit strategies for potentially over-priced investments are factored into yield calculations, these core assets may actually prove to be riskier than non-core assets when considered on a total return basis.

Some argue that this trend toward over-priced core assets is justified for long-term investors, who plan to hold assets through any repricing. However, such behavior is unlikely to work for mark-to-market accounts, including pension funds and other investment vehicles managed in a fiduciary capacity. Such investors will have to recognize unrealized losses (i.e., declines in appraised values) that would be associated with an increase in yield requirements. While this might be uncharted territory for many, for others it is strikingly similar to the late-1980s real

Table 3 NCREIF Property Index 2014 Profile

Property Type	Number of Properties		Market Value*		Average* Value	2014 Annual Returns		
	Total	Share	Total	Share		Income	Appreciation	Total
Office	1,414	20%	$152,565	62%	$107.9	5.2%	6.1%	11.5%
Retail	1,118	16%	$95,129	38%	$85.1	5.6%	7.3%	13.1%
Apartment	1,503	21%	$99,816	40%	$66.4	4.9%	5.2%	10.3%
Industrial	2,862	41%	$55,389	22%	$19.4	5.8%	7.3%	13.4%
Hotel	165	2%	$6,354	3%	$38.5	8.2%	2.8%	11.1%
Total	7,062	100%	$247,695	100%	$35.1	5.4%	6.2%	11.8%

Source: NCREIF Property Index (NPI): Quarterly Detail Report
* $ millions

estate recession. Unlike the more recent downturn, which was short-lived and reflected shifts in short-term pricing, the 1980s experience was much more prolonged, with a lack of liquidity that spread across the industry, including assets which to that point had been in the greatest demand. Therefore, how the current trend plays out over the next several years will be interesting to watch and argues that investors and owners should pay close attention to changes in investor expectations and, ultimately, behavior.

Office Market

In general, office market fundamentals have continued to improve due to a combination of tempered construction and increasing demand. Indeed, some brokers report office leasing activity was on an upward pace going into 2015. During 2014, absorption activity remained solid, leading to a gradual increase in asking rents and a decline in vacancy rates. The increase in asking rents is a continuation of a trend that began in early 2012. While improving fundamentals have been fairly widespread, a number of markets have led the trend in terms of total absorption; these markets include Houston, Dallas, Boston, Chicago, New York City, Atlanta, Los Angeles, and Seattle.

Going forward, near-term prospects for office demand continue to be positive as the market adjusts to changing preferences of office users and as tenants rationalize their current holdings and leases in the face of improvement in the economic outlook. At the same time, renewed commitment to revitalizing urban cores will benefit some office markets more than others, especially those that have been able to attract new residents and achieve critical mass. Cities that have strong technology and knowledge-industry sectors and a thriving business services component will continue to outperform national averages.

With respect to investment performance, in 2014 the office sub-index of the private NCREIF Property Index (NPI) showed solid 11.5% annualized return with appreciation edging out income returns by 83 basis points. The office sector accounted for 37% of the value of the NPI leading all property types. In terms of number of investments, the sector had a 20% market share with an average size of $108 million, which led all property types. At a subtype level, suburban properties enjoyed something of a renaissance with 12.3% returns compared to 10.9% for central business district (CBD) holdings. Some of the strength in the suburban numbers can be attributed to risk-taking with suburban assets providing 5.8% income yields, which was 104 basis points over CBD properties.

On the public front, office REITs had a stellar year during 2014, with 25.7% total returns. Despite these returns, office REITS trailed the overall industry average of 30% on equity REITs. In terms of market share, office REITs accounted for 11% of the $783.6 billion FTSE NAREIT Equity REIT universe. However, health care REITs, which have a solid office component, accounted for another $105 billion of investments, while mixed industrial/office REITs added another $18.8 billion to the mix.

In terms of transaction volume, the office sector had a solid year, with total sales pushing $120 billion, a 15% increase over the prior year. Reflecting the herd mentality of investors and the penchant for perceived core assets, this increase in activity levels was concentrated in the top-six major metro markets: Boston, Chicago, Washington DC, Los Angeles, New York City, and San Francisco. This concentration was especially true for CBD investments although suburban investments in these markets were also relatively strong compared to secondary markets.

With respect to the secondary markets, average sales volumes for the year were up only slightly. Interestingly, office sales in Atlanta, Dallas, Denver, Houston, and Seattle tapered off, as they did in Austin, which seemed to have been on everyone's radar screen earlier in the cycle. In terms of subtypes, CBD sales outpaced suburban sales although both sectors exhibited a comparable decline in cap rates. Toward the end of 2014, the two sectors also experienced a slowdown in sales volume. Medical office properties were much sought after during the year, with volume increasing 24% along with 20% increases in average prices.

Retail Market

Retail market fundamentals of supply and demand continued to improve during 2014 although there were more than a few trouble spots. For example, retail store closings continued to garner news, including RadioShack, which filed for bankruptcy and announced the closing of almost 1,800 stores, most of which are leased facilities. While the closings may create some opportunities for releasing, the closures will fall hard on smaller investors who own less than stellar properties as well as REITs that reportedly own

some 25% of locations. A number of other retailers are rationalizing store holdings including some voluntary and involuntary moves. For example, several large retail chains announced store closings, including some that are exiting the business (e.g., Bottom Dollar Food, Deb Shops, Body Central, and Target, which is closing all 133 stores in Canada) as well as those that are downsizing to improve bottom-line performance. These include such brands as Abercrombie & Fitch, Aeropostale, American Eagle, Barnes & Noble, Coach, Express, JC Penney, Jones Group, Office Depot/Office Max, Staples, and Wet Seal.

Another recent retail move that caught the attention of shopping center investors is the Staples/Office Depot deal. This deal was initiated by Staples with some encouragement from Starboard Value LP, which held significant positions in both companies. While subject to antitrust approval, the proposed deal sheds some light on some of the machinations going on in the retail industry. It is also reminiscent of the feeding frenzy over Family Dollar Stores Inc. (FDO), which was being pursued by Dollar General (DG) and Dollar Tree (DLTR). On January 22, some 90% of Family Dollar shareholders voted to back the $8.5 billion merger with Dollar Tree. Rather than economics, antitrust issues weighed heavily on the decision, with the Dollar Tree deal resulting in only an estimated 310 store closures under antitrust regulations compared to 4,000 store closings if the deal with Dollar General was concluded.

With respect to investment performance, the retail sub-index of the private NPI came in at a solid 13.1%, leading all property types with the exception of industrial. In terms of attribution, the appreciation component outperformed the income component by a solid 167 basis points. With respect to market share, retail accounted for 23% of the NPI, with 16% of properties and an $85 million average value trailing only the office sector. At a subsector level, single-tenant properties, which were a relatively minor portion of total retail holdings, racked up as strong 18.4% return. However, evidence that this was the result of a surge in demand for fixed-income real estate can be gleaned from the fact that the subsector had 4.5% income returns and some 13.5% appreciation, which outpaced all other property types and subtypes. Super-regional malls came in with solid 15.2% total returns, with appreciation accounting for a surprising 9.6% of the total. Performance of regional centers and neighborhood centers were on par, with returns around 13.4% with neighborhood centers generating higher income returns of 5.9% although income returns for both subsectors were outpaced by appreciation.

On the public front, retail REITs dominated other property types in terms of market share claiming 29% of the total equity REIT universe. In addition, for 2104 retail sector performance was on par with industry averages with 27.6% total returns. As on the private front, regional mall REITs led the overall sector. On the other hand, freestanding REITs lagged all property sectors with disappointing total returns of 9.7% annualized.

Despite some of the turmoil in the retail sector, retail transaction volume racked up a solid 31% year-over increase in sales volumes, which led all commercial sectors and translated to $82.6 billion in activity for the year. In an interesting trend, sales of strip centers and single-tenant properties declined in terms of market share, falling 7% to 46% of retail transactions for 2014 as a whole. During the fourth quarter, sales of strip centers regained momentum, racking up a 37% increase over the prior year.

Despite recent gains in prices, the retail sector is something of an outlier with the greatest gap between current prices and prerecessionary levels. As with the office sector, interest in retail properties in secondary markets seemed to wane during 2014, reversing a trend that had begun earlier in the cycle. At the same time, retail transactions in urban/high street locations surged by 60% over 2013, with investors clearly buying into the vision of urban revitalization in top-tier markets. The flight to quality is also evident in premium prices for top-tier assets.

Industrial/Warehouse Market

On the spatial side of the equation, market fundamentals in the industrial sector wrapped up 2014 on a positive note with momentum carrying into the 2015. Industrial vacancy rates continued to decline at a national level, falling to the lowest level in fourteen years. This improvement in market fundamentals occurred despite an increase in construction activity, which testified to solid improvement in net absorption levels. Due to improving market conditions, average asking rents increased by some 4% on a year-over basis in the 2014 fourth quarter. A number of markets experienced double-digit increases in rent, with Denver leading the pack followed by several other Western US markets. Assuming the economic recovery remains on track, recent trends should continue. However,

weakness in exports related to the strong dollar and global slowdown will be a risk factor for some markets.

In terms of investment performance, the industrial sub-index of the NPI led all property types during 2014, with a 13.42% annualized total return. As with most other property types, appreciation rose ahead of income with a 148 basis point advantage. The industrial sector accounted of 14% of the NPI, trailing other property types with the exception of hotels, which came in with a 2% share. As might be expected, the industrial sector had the smallest average market value in the NPI at $19.4 million while accounting for 41% of all properties in the NPI.

With respect to industrial subtypes, warehouse investments constituted the bulk of private institutional holdings and racked up sector-leading performance of 13.6 % with a strong appreciation component attesting to growing investor appetites. R&D properties came in second place, with 12.1% returns and, given their higher-risk profiles, relatively disappointing income returns. Industrial REITs finished 2014 with 21% total returns, which while strong compared to private holdings, lagged other REIT sectors and accounted for only 4% of the NAREIT equity universe.

On the transaction front, during 2014 industrial sales volumes approached $54 billion, which was a solid 13% increase over 2013. Despite relatively robust sales activity for the year, industrial transaction volume slowed in the fourth quarter. As in the recent past, investor activity remained focused on large national and regional distribution hubs. As such, cap rates have fallen in the major distribution markets, pushing some investors to consider secondary markets. In terms of subtypes, warehouse investments constitute the largest share of industrial investments, accounting for some two-thirds of all activity. While the warehouse sector has cooled off in terms of transaction volume, the flex sector has gain momentum, with sales up 24% over the prior year. Unlike some other property types, industrial investors have demonstrated an appetite for deals in secondary markets although still willing to pay a premium for assets in top-tier markets.

Apartment Market

At a national level, apartment market fundamentals have continued to improve in spite of an increase in construction activity. Improvements in economic activity and jobs bodes well for the sector over the near term as new household formations will lead to an increase in apartment demand. In a number of markets, millennials will continue to fuel the demand for apartments due to their increasing numbers and propensity to prefer rent over ownership.

One debate related to apartment market fundamentals that warrants close attention is the struggle between downtowns and suburbs. Some have prematurely claimed a fate accompli in favor of downtowns. A number of factors appear to support this claim, including recent trends in many cities. Indeed, a number of cities have experienced a renaissance of growth fueled in part by households seeking an urban environment. While this trend is likely to continue in cities that are able to create a critical mass and achieve lifestyle, 24-hour status, it is not going to occur across the board. This is especially true in cities in which budget limitations have restricted expenditures for infrastructure, services, schools, crime prevention, and other amenities necessary to make more dense environments livable in a sustainable manner.

A recent report released by NYU's Furman Center and Capital One Financial Corporation indicates renters have become a majority in nine of the largest US cities. This was a dramatic increase since 2006, when only five of the cities fell into that category. The recent list includes the five carryovers—Boston, Los Angeles, Miami, New York City and San Francisco—as well as newcomers Chicago, Dallas, Houston, and Washington DC. Philadelphia, which missed the list, experienced the highest growth rate with a 28% grow rate in the number of renters. Despite increases in construction in these cities, vacant and available-for-rent housing fell in all but two cities. Somewhat reminiscent of the spike in housing prices that led up the collapse of the single-family market, rental increases in several of the markets outpaced gross income change. The spread was widest in Los Angeles (11% rent increase; -4% gross income change) and New York City (12% rent increase; 0% gross income change). On the other hand, three of the markets saw growth in gross income outpacing rents, led by Boston with a 4% increase in rent and 15% increase in gross income.

At an aggregate level, the trend in these two indicators resulted in a spike in rent-burdened households in which low-income households pay more than 50% of income on housing. In addition, in five of the eleven largest US housing markets,

moderate-income households pay over a third of their income on housing, with New York topping the list at 43% of income. This situation was even more challenging for low-income renters, which face a dramatic shortage of affordable housing units. Apartment developers are demonstrating a herd behavior with their penchant for building at the top-end of the market. Consequently, less than 11% of new stock in the top US cities has been affordable to low-income housing. This situation is not confined to the larger markets and is unlikely to change over the near term in the absence of more targeted stimulus programs.

On the performance front, the apartment sector was somewhat disappointing compare to other property types although the 10.3% total return in the NPI Apartment sub-index remained attractive relative to other asset classes. The sector has peaked in performance while fundamentals continue to improve, as reflected in the income returns that lag appreciation by only 23 basis points but slipped below 5% and trailed all other property types. The apartment sector accounted for 24% of the NPI, with an average value of $66.4 million.

Within the apartment sector, garden apartments had the highest total returns for 2014, coming in at 11.3% with income returns slightly beating out appreciation. Low-rise apartments came in with slightly lower returns while high-rise apartments slipped into the single-digit range. This subsector, which had been aggressively pursued by institutional investors, remains fully priced as noted by the low 4.49% annualized income returns.

In terms of transaction volume, the apartment sector showed no signs of slowing in 2014, with total sales volumes reported by RCA reaching record levels of $112 billion, which was a 9% increase over the previous year. While transaction activity in some property types tapered off at the end of 2014, apartment sales continue to increase, approaching quarterly record levels. Reflecting growing interest in urban assets, prices for mid-high rise apartments outpaced overall averages for the sector. Indeed, by year-end prices for such sought-after assets were up almost 50% from the prior peak. Individual property sales were also up, while portfolio sales trended downward. In a departure from some other property sectors, apartment investors continued to search for assets in secondary markets as they sought higher yields. Apartment investors also appeared to be more willing to take on risk, with an increase in value-add investments. In terms of niches, investors continued to seek student housing although demand outpaced supply. The same was true for senior housing, with sales volume increasing 23% and drawn by relatively high 7.5% cap rates.

Infrastructure

Infrastructure investment continues to garner much attention as noted by President Obama's recent $4 trillion budget proposal that included significant funding for infrastructure. While taxing overseas earnings to fund infrastructure will be hotly debated, there is little debate that something needs to be done to fund infrastructure, especially with federal road and highway funding expiring in May. To this point, domestic pension funds have been somewhat reluctant to include infrastructure investments as an asset class or as an investment sector. This has opened to door for Canadian pension funds, other foreign investors, and other capital sources that have moved into infrastructure investment. For example, Preqin data points out the while 90% of public Canadian pension funds and 99% of US pension funds invest in commingled infrastructure funds, 45% of Canadian funds invested in funds directly committed to infrastructure compared to only 16% of US funds. Further, in terms of asset allocation to infrastructure, Canadian funds were 6% invested on 8% targets, compared to US funds with 2% investment on 4% targets.

Regardless of such capital flows and how the government addresses the issue, it is clear that infrastructure funding will fall short of needs. This will increase pressure on public-private partnerships and other structured arrangements to help governmental bodies respond to growing demand for a wide range of infrastructure projects. There are some signs that the attention being paid to infrastructure investment on the global front is beginning to filter over to domestic investors. For example, although limited in scope and numbers, infrastructure REITs experienced competitive returns of 20% during 2014. The market cap of infrastructure REITs also increased to $67 billion, above longer-term niche sectors such as timber, self-storage, lodging/resorts, mixed industrial/office, freestanding retail, and manufactured homes. More telling is the fact that the 2015 issue of "Emerging Trends in Real Estate," published by PwC and the Urban Land Institute, included a discussion of

infrastructure investment in its list of hot topics and opportunities for 2015. While this might have been related to the fact the discussion was aimed at both US and Canadian market participants, the result remains there is an increased awareness of infrastructure as a potential real estate play.

While some domestic pension funds have moved into the infrastructure arena, there is a lot of ambiguity over how that should be done. One of the challenges has been figuring out where it should be housed. In some cases it has been embedded with alternative investments, while in others it has been treated as a subset of real estate and even as a distinct asset class. The answer to this fundamental question depends on a number of factors, including the type of infrastructure under consideration. The fact that "Emerging Trends," which is primarily a real estate publication for institutional investors, focused on infrastructure may be somewhat prescient. Even more noteworthy is that California State Teachers' Retirement System (CalSTRS) met in early February this year to explore modifications to its investment policy that would allow CalSTRS to "invest alongside with other like-minded investors" pursuing "consortium investment opportunities." This would open the door to direct investment in larger infrastructure projects as well as attract other pension funds to the arena and help expand its infrastructure portfolio to $3 billion over the long term.

Real Estate and Capital Markets

Overview

At a national level, the real estate capital markets have proven to be robust and more than adequate to support the recent increase in commercial transactions levels. This situation personifies the great expectations of many players and is readily apparent on the commercial side of the market where investors and lenders continue to compete for business. This competition has led to a decline in yield requirements for both debt and equity.

On the equity buy side of the market, transaction volumes have been bolstered by strong demand from a number of investors such as private equity and opportunity funds, pension funds, offshore investors and sovereign wealth funds. Based on strong performance during 2014, REITs have been active players, benefiting from investors seeking dividend payments that have been below cap rates for new acquisitions. When combined with judicious use of low-cost debt, the market has allowed REITs to acquire properties accretive to earnings and help boost the momentum in stock prices. While REITs are expected to remain active, they are unlikely to be as aggressive in 2015 and it will be difficult to stay on par with the prior year.

Private equity investors have also been active with hedge funds and are expected to continue to be active going forward. Foreign investors have also been active in the equity side of the market, with increased capital flowing from China as well as a number of sovereign wealth funds. While the strengthening dollar will make such investments more expensive, the upward trend in foreign investment is expected to continue with investors expanding their investment horizons in search of product.

On the mortgage front, traditional lenders continue to prefer high-quality assets in top-tier markets. Commercial banks have resolved a number of portfolio problems, which had limited commercial mortgage lending, and have eased lending standards, which is important for construction activity that has been one of the bastions of banks. Insurance companies, which have tended to be the most conservative lenders, are expected to increase commercial loan volume during 2015. They will continue to be disciplined in terms of underwriting, in part, because they tend to be portfolio lenders and must deal with problem loans. Mortgage REITs had a relatively strong performance in 2014 with 17.9% total returns although the early going this year has been moderately negative. On the mezzanine loan side of the mortgage market, a number of players have been active, including nonbank banks that offer limited financial services, hedge funds, private equity funds, and a variety of other lenders. Although borrowers will continue to pay high rates for such debt, in some cases it will be necessary to get the deals done that depend on financial engineering for short-term viability.

Since the bulk of commercial mortgage lenders remain somewhat conservative, the door has been opened for commercial mortgage-backed securities (CMBS) issuers to take a larger share of activity in secondary and tertiary markets as well as in lower-quality assets that previously would have struggled for capital. Funding for CMBS issuances has been bolstered by continued improvement in delinquency rates, which ended the year below 6% as part of a gradual downward trend. At an aggregate level, CMBS delinquencies fell toward $30 billion in November 2014, a 26% decline from the prior year. Liquidations came in at $776 million on 70 loans, with an average severity of loss of 41%; this was an

improvement over last October when the volume as $1.3 billion with almost a 50% severity level.

In terms of vintage, the deals that originated as the market peaked in 2005–2007 period accounted for 86% of delinquencies. This included the record level of $1.23 trillion in 2007 vintage loans that moved into special servicing, which translated to 72% of transfer volumes of issuances stretching back to 1999. With respect to property types, Morningstar's Watch List was led by the office (39%), retail (26%), and apartment (13%)sectors. The metropolitan areas with the highest share of watch-list properties included the larger markets, with the top-ten accounting for 30% of the total value.

For 2014, CMBS volume increased to $90 billion and continued the five-year upward trend, including almost doubling between 2012 and 2013. With respect to property types, CMBS current balances include 30% retail, 27% office, 17% multifamily, and 13% hotel. While improvements in the CMBS market are likely to continue through 2015, there is some concern about the next tranche of maturing loans.

The outlook for capital flows to commercial real estate remains positive with the recent momentum carrying on in spite of low yields. However, with the prospect of increasing interest rates in the second half of 2015, cap rate compression may have fully played out and may be facing some upward pressure for spread rate investors as well as mark-to-market accounts. It remains to be seen whether economic activity and business expansion will pick up enough to drive net operating income up sufficiently to offset this migration toward the mean in yield requirements.

Conclusion

The year is off to an interesting start with great expectations characterizing the general attitude among many key players in the economy. The recent improvement on the jobs front has been one of the drivers of this mood shift that, if carried over the near term, may become a self-fulfilling prophecy. While the actual realization might differ in some respects, there are enough positive signals to suggest the economic recovery will prove sustainable and may finally break away from the below-par improvements that have dominated over the past several years.

Over the near term there is little risk of a disruption of business as usual, with the Fed expected to take a disciplined approach to raising interest rates and the market already discounting increases during the second half of the year. Although there are some concerns on the domestic scene, the biggest risks to the economic recovery and continued improvement come from offshore. Of particular concern is the economic turmoil that has rippled across the eurozone, and the unexpected slowdown in China. These forces have led to a strengthening of the dollar, which will place a dampener on exports and put pressure on the gap in trade. Assuming no major economic or geopolitical disasters occur, and Washington finally focuses in finding solutions for the long-term issues at home, 2015 might just be the year that lives up to the great expectations that many hoped it would deliver. In this environment, real estate is expected to continue to exhibit improvement in underlying market fundamentals despite some pricing pressure in the face of rising interest rates and yield requirements.

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