The Storms Behind, the Markets Ahead

by James R. DeLisle, PhD

Commentary

Last fall, the devastation wrought by Hurricanes Katrina and Wilma took center stage, with many observers anticipating the aftershocks derailing the economic recovery. These catastrophic events had dramatic effects; however, the U.S. economy appears to have weathered the storms and is positioned to move forward on the road to recovery.

The economic recovery remains vulnerable to unexpected shocks and will not be as pronounced as some hoped, though the general prognostication is that it will remain on track. While this outlook is welcome relief for many, it should not signal that the United States can become complacent. Indeed, the record deficit, high energy prices, rising health care costs, underfunded pensions, erosion in the balance of trade, and the prolonged war in Iraq will have to be addressed.

The capital markets are poised to help the economy through the challenges it faces, while providing adequate funding for the real estate market to ensure it stays on track. The real estate market in turn is expected to continue to improve in terms of market fundamentals. These improvements will vary by property type and market, with a gradual movement toward more stratification of products in terms of winners and losers and less of an overall halo that will buoy products across the board. The bottom line is an increased understanding of market fundamentals to create, capture, and maintain values and to capture attractive, risk-adjusted returns.

The Economic Environment

Economic Growth

In the 2005 fourth quarter, prospects for economic growth were somewhat tempered due to a combination of factors ranging from slipping consumer confidence to rising energy prices. Despite the drag created by these and other factors, economic growth showed its resiliency by gaining momentum later in the quarter. Looking forward, growth in gross domestic product (GDP) is expected to pick up over the next six months before falling back with prospects generally stable but unspectacular.

Of particular note for the 2005 fourth quarter was the continued string of monthly record trade deficits, with growth in imports continuing to outpace exports in spite of the relatively cheap dollar. Toward year-end, the dollar gained some ground against the euro and yen. However, this improvement is unlikely to be enduring; the modest gains being more of a commentary on global economic conditions than on changing fortunes for the dollar. The consensus expectation is a further decline of the dollar in 2006. This decline may help the export side of the equation, although that depends on economic growth in U.S. trading partners rather than currency advantages. At the same time, the surge in imports most notably from China and Southeast Asia will continue to have a competitive advantage on prices. Going forward, the trade deficit is expected to continue to rise on its record pace. The end result will be a downward drag on growth, although prospects remain generally positive.

Employment

The employment scene has received modest employment gains, which has helped alleviate some concern over when the economy would finally begin to reward employees with new opportunities. Indeed, in 2005, over two million net payroll jobs were added. In terms of sectors, construction employment overall has gained some momentum attributable in part to hurricane recovery and to a strengthening in the commercial sector, while the residential sector has begun to lose some momentum. The manufactur-

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ing sector, which had material job losses over the past several years, also showed some moderate gains. However, the slowdown in the automotive industry, which was punctuated by the announced plant closings and layoffs at General Motors, has created some concern in terms of the potential ripple effect on other automobile companies and those in related sectors in the future.

The unemployment rate has been holding relatively stable with rates below those experienced since 9/11. The major exception to this pattern is in the areas affected by Hurricane Katrina where overall unemployment levels are over twenty percent, with returnees fairing better than evacuees. Overall, initial claims for unemployment declined in the 2005 fourth quarter, providing more evidence that the job situation may be stabilizing.

In terms of nominal wages, employees have experienced some modest gains, although real wages have been relatively flat. The prospects for wage gains are likely to remain tempered, with the exception of some high demand sectors (e.g., technology, biotechnology). Going forward, concerns over pension funding, benefit reductions, and qualifications can be expected to become a lightning rod for employees. In labor negotiations, employees' concerns may prove to be more problematic than disputes over wages.

Many employees are frustrated about the inability to cash in on improving economic conditions on the wage front. This is likely to continue as labor costs are expected to increase. As in the past several years, rising benefit costs will account for a significant portion of the increase in total compensation costs. At the same time, employers will continue cutting back on benefits, placing downward pressure on net disposable income for workers. This situation is even more dramatic when pension modifications are factored in, with employers cutting back on benefits or shifting to defined contribution plans. Although pension reform has been put on a back burner in Washington, DC, the debate is likely to pick up in 2006 as attention shifts back to Social Security reform and the record deficit hanging over the broader economy.

Inflation and Interest Rates

Fear of inflation accelerated in the 2005 fourth quarter. It should be noted that while inflation has risen above average rates experienced during the first half of the decade, rates are still relatively moderate compared to historical patterns experienced over long-term cycles. Looking forward, as gasoline prices temper there is relatively limited risk of a broad-based surge in inflation through midyear. However, some elements of the economy (e.g., health care, material shortages, and energy and material costs) will continue to be problematic. This outlook is based in part on the assumption that the Federal Reserve (Fed) will continue to monitor inflation very carefully and that there will be a relatively smooth transition with the new regime.

The appointment of Ben Bernanke as the new Chairman of the Board of Governors of the Federal Reserve System was received as positive news in terms of continuity of recent policies. The market tried to discount the impact of possible changes in philosophy upon the retirement of Alan Greenspan. At the same time, the market welcomed signs that the Fed may take on a more open, transparent tone.

At its December meeting, the Fed raised the federal funds target rate once more. The financial markets are waiting to see if the Federal Open Market Committee is ready to alter its presiding accommodative term for level of rate raises, which would suggest that the series of increases may be coming to an end. However, there is no certainty as to the outlook for this modification since the Fed is cautious not to mislead the market. Thus, the outlook for short-term interest rates is for limited risk of major upward movement.

While short-term rates are likely to be flattening out in the future, there may be additional pressure on long-term rates. This economic environment, coupled with a softening in housing prices, will place upward pressure on mortgage rates. However, strong competition for mortgage investments on the commercial side of the industry, from both public and private capital sources, is likely to constrain rates. Similarly, excess capacity for deal flow on the residential side is likely to translate to easier credit terms and compressed spreads, also leading to reduced pressure on rates. Accordingly, as long as delinquency and foreclosure rates remain in check, there is limited risk of isolated increases in mortgage rates for the real estate sector. However, migration to the mean and the absence of some structural shift in capitalization of the real estate market argues that over the next several years, rates will be under some upward pressure.

Business Indicators

During the 2005 fourth quarter, business indicators were mixed, though generally positive. At a national level, most districts reported gains in manufacturing and service activity. Some of this improvement was attributable to plants returning to operation after the hurricanes. In the South where the devastation was the greatest, the demand for tool and heavy equipment picked up.

Manufacturing improvements were not isolated to the South. The manufacturing economy racked up its thirtieth consecutive month of expansion, albeit at moderate levels. New manufacturing orders also picked up in November 2005. However, due to tight supply chains in many sectors, deliveries of supplies to manufacturers actually fell. Demand for construction-related products has been particularly strong, despite rising prices for raw materials that have been driving up costs. Manufacturing inventory levels declined much of 2005, although inventory levels continued to exceed the threshold associated with economic expansion.

In the current environment, business attitudes remain guarded, despite overall improvements in market fundamentals. Some of the concerns in boardrooms are related to potential shortages in raw materials and rising prices in the energy sector. High energy and transportation costs are also creating a drag on confidence levels, with recent improvements providing little long-term relief.

In terms of commodities, price increases are widespread, with very limited price declines. Despite these challenges, industrial production is up moderately on a year-over basis, while capacity utilization remains below long-term rates. Given this cushion, increases in capacity utilization have a way to go before placing additional upward pressure on investment spending. That said, investment levels have been increasing, although some of that has leaked overseas as companies turn to foreign sourcing. In this environment, domestic capital spending is expected to remain moderate.

Stock Market

The stock market went through an interesting period in 2005, with corporate profits in the third quarter taking a beating as a result of the hurricanes. This temporary shock reversed healthy gains in profits from earlier in the year. The financial sector was hit particularly hard, while the nonfinancial sector was relatively steady. This domestic situation lagged the rest of the world, where corporate profits such as European stocks have continued to trend upward. Global stocks and emerging markets have come in around twice the domestic averages.

Going into the 2005 fourth quarter, the domestic stock market enjoyed a brief surge that lost some momentum as some investors took profits before the holidays. In terms of sectors, real estate investment trust (REIT) stocks outperformed other sectors on a rolling fifty-two month basis, with the exception of oil stocks. The Standard and Poor's 500 and the NASDAQ indexes have turned in some six percent gains over the year, while the Dow Jones Industrial Average has lagged at two percent but has remained positive. Despite generally favorable conditions and corporate balance sheets, there is no major driver suggesting a rally in the domestic stock market. However, overall market conditions remain fundamentally attractive with some upside potential.

Consumer Confidence

Consumer confidence dipped early in the 2005 third quarter as the spate of national disasters wore away at the resilience of consumers. Consumer angst and nagging concerns affected credit card balances, with monthly outstanding credit card receivables falling to their lowest levels in over three years.

During the 2005 fourth quarter, confidence levels rebounded somewhat, offsetting the three-month decline. This improvement was attributable in part to gasoline prices that fell from peak levels. While the increase in confidence was well received in most sectors, significant concern remains over the level of consumer debt, lack of savings, consumer vulnerability to rising energy costs, and increasing interest expenses. Consumer confidence levels may have some downside exposure, falling into line with long-term averages, because of signs of softening in the housing market, rising mortgage rates, and surging energy prices. The surge in energy prices may leave moderate, fixed-income households most vulnerable. Going forward, consumer confidence will be closely tied to the overall economy and in particular the employment situation.

Retail Sales

In the 2005 fourth quarter, retail sales were generally mixed, with high-end retailers continuing to outperform and value-oriented retailers struggling somewhat. Department stores and specialty clothing stores have faced a number of challenges, with sale levels slowing down in November. On the heels of this uncertainty, the holiday season once again turned into a promotional period, with retailers reluctantly giving greater discounts to consumers after disappointing results in the post-Thanksgiving season. Going into the final weekend, retailers pulled out all stops in an attempt to lure holiday shoppers. However, retailers have been walking an increasingly tight line in terms of inventory levels, raising prospects of spot shortages of some of the fashion and gift trends.

Internet shopping continued to exhibit improvement, although market share of online shopping remains miniscule in terms of total retail sales. That said, Internet sales in the late holiday season were up dramatically over 2004, continuing the string of improved activity stretching back a number of years. Free shipping continued to attract buyers. There were some reports that more mainstream customers turned to the Internet, with a significant increase in households shopping online. Gift card sales were also up, as were Internet searches for the phrase "gift cards," suggesting a convergence between the two nontraditional but growing shopping formats.

Housing Market

Over the past several years, the housing market has been one of the bright spots in the economy, with record sales and surging prices creating sufficient momentum to power through some of the uncertainty that could have otherwise derailed the economy. Although near-term activity levels remain high compared to historical levels, there are some signs that the housing market has peaked and may be slowing down.

At a national level, housing starts and permit activity have tempered, with completions beginning to lose some steam as builders reassess the overall market. On the other hand, homebuilders have been anticipating this stage of the cycle for a while. Thus, strong balance sheets and increased sophistication in the more consolidated homebuilding sector should allow it to weather the storm. In addition, a softening housing market may help take some of the pressure off of land prices, thereby allowing builders to bring finished product in at more sustainable levels than possible over the past several years.

Assuming a cyclical correction is in order, some of the larger builders will use the slowdown to implement expansion programs and tie up land for the next wave. Since Wall Street tends to take a shorter view of the real estate market, investors may find some opportunities as the market adjusts to activity levels that are more sustainable in light of long-term trends. The good news is that, if the Fed's cycle of increasing hikes is indeed near an end, and if historical trends hold, the homebuilding sector should enjoy some upside potential.

The prospects of a slowdown in the residential sector have led to more aggressive lending and an emergence of new products and underwriting standards aimed at prolonging the market cycle. Since caution flags have been increasingly raised in the popular press, these efforts are unlikely to have much of an impact. Indeed, as the housing market softens, marginal buyers are likely to back off, creating downward pressure on activity levels and appreciation rates, which will be amplified by rising mortgage rates. While no major surge in rates is anticipated over the near term, even modest increases will be felt by households with adjustable rate mortgages. While this effect will be most pronounced for moderate-income households, ripple effects are likely to be felt at higher price points, especially those that were fueled by investment-driven buyers drawn to the market to capture high appreciation rates. The extent of market churning and price/inflation adjustments will vary by market and segment, creating a mosaic of winners and losers.

Real Estate Outlook

Office Market

At a national level, the office market has benefited from the combination of moderate increases in demand and constrained activity on the construction front. Despite tempered job growth as companies hold the line and rely on increased productivity levels, new absorption has been modest, but positive. In general, office vacancy rates have continued to decline, although rates remain in the mid-teens. While this situation characterizes most markets, it should be noted that new office construction activity has begun to pick up in markets with improving fundamentals. Indeed, a number of projects that were delayed during the downturn are now being launched. At the same time, strong investor demand, and increasing access to construction financing have triggered a number of proposals for new products, especially in urban markets.

In terms of submarkets, at a national level, urban markets are ahead of their suburban counterparts in terms of vacancy rates, although suburban markets have been gaining ground. On a related note, absorption rates in suburban markets have dramatically outpaced urban markets. At the same time, much of the office construction that has occurred has been in suburban markets, although activity in both sectors remains below historical levels. In general, space available for sublease has contracted since peaking in 2002, although suburban markets with a higher initial base have been burning off such space at a much faster rate.

The outlook for the office sector is for more of the same, with its fate tied to the broader economy and especially jobs. As such, investor interest in the sector should remain strong, although few hold hopes for a major rebound.

Retail Market

As noted over the past several quarters, the retail sector has had a fairly strong run, with consumers helping bolster the economy. The retail real estate market has directly benefited from consumers' collective exuberance, with market fundamentals generally leading other property sectors. To a certain extent, the strong consumer market can be traced back to the housing market and the increasing willingness of homeowners to refinance and tap into their built-up equity. While the housing market is not near a collapse, it is unlikely that such a scenario will repeat over the near term. It is more likely that as mortgage rates creep up, housing values will flatten or decline moderately. Growing recognition of this scenario has already filtered over to consumer confidence levels. However, the overall robustness of the retail market can be affirmed by its outperform rating in both public and private investment performance. Furthermore, this relatively strong performance occurred during a period in which competition dramatically increased from an increased supply of traditional store formats and from online shopping. Based on this track record, institutional capital is still expected to surge into the retail sector, with some investors drawn to funding new development including mixed-use projects with a significant retail component. Within the retail sector, neighborhood centers are favored by institutional lenders, although investors are becoming enamored of lifestyle centers and urban centers that are sweeping the country in both large urban and small suburban settings.

Industrial/Warehouse Market

The industrial sector has enjoyed some improvement, much of which can be associated with moderate strengthening in the manufacturing and wholesale/distribution sectors.

In the wholesale/distribution sector, the real estate market has benefited from increased activity on both the export and import fronts. However, technological innovations in inventory management and supply-chain management have dampened some of that improvement, as companies and distributors developed more efficient models for getting product through the manufacturing cycle and into stores or consumers' homes. The industry continues to become more stratified, with growing recognition of the different risk/return profiles and drivers of value of various components. Despite this added precision, bulk warehouse space that meets contemporary standards for modern logistics systems remains the focal point of institutional capital. This situation is likely to continue, explaining part of the upward trend in total returns exhibited in the National Council of Real Estate Investment Fiduciaries (NCREIF) Industrial Index, which is somewhat ahead of market fundamentals and a dramatic improvement over the trough in yields hit in 2002. Thus, the industrial sector remains fully priced, with some risk as eager investors and developers get poised to respond to anticipated improvements in the broader economy.

Apartment Market

The apartment market showed some signs of improvement during 2005, although the overhang of space, fueled by the last wave of investment, continued to plague the sector. This situation was exacerbated by the shift in tenure choice that swept the country over the past several years as low interest rates reduced the cost to own relative to the cost to rent. In addition, the prolonged bull housing market and aggressive lending combined to make housing an attractive and affordable investment, even after prices had run up in many markets. During the latter half of 2005, the apartment sector benefited from a moderate slowdown in the single-family market and rising concerns of a housing bubble.

Going forward, several factors point to improving apartment fundamentals. First, demographics are beginning to favor rentals, with "echo boomers" beginning to graduate and enter the workforce with limited ability to jump into homeownership. Second, a spate of condominium conversions has occurred in many markets. While this has created windfall profits for developers and investors, conversions have also helped apartment investors by taking rental product out of the market. Third, softening appreciation rates in the single-family sector and the possibility of a housing bubble are beginning to dampen housing investment. Finally, the push toward infill development is increasing rental housing or mixed-use development. While this trend will add more products, it will also create more interest in urban living and help focus attention on the amenities and services that will attract various demographic groups. This added precision should allow the market to create more effective apartment solutions that attract and retain tenants drawn by lifestyle choice rather than an inability to afford homeownership.

Real Estate and Capital Markets

Capital Market Overview

On the commercial side, real estate capital markets have been so robust that they have been largely immune to negative signals, with both investors and lenders focused on sourcing product. While pricing levels have never been more aggressive, there are no signs that any capital market source has retrenched. Accordingly, investors have been scrambling for product, although some owners have begun to take profits as rates show some signs of creeping up. This situation has continued to push active investors with higher return requirements out on the risk spectrum in search of returns that are currently not achievable with buy and hold strategies for new core properties. Some investors, who are focused on acquiring core assets, are turning to rental spikes and other market cures to generate pro formas that support current pricing. On the other hand, a significant share of players seem resolved to accept lower returns, including longer-term institutional investors and foreign investors, focusing on the advantage of the cheap dollar and relatively higher returns.

In addition to a robust domestic capital market, the international scene heated up last year. Indeed, U.S. capital sources and real estate professionals have been looking overseas in search of higher returns. Southeast Asia, in particular China, has captured tremendous interest from a range of domestic players–REITs, retailers, and private investors–seeking to cash in on the burgeoning real estate market. On the other hand, foreign capital flows into the domestic real estate market have continued to accelerate as investors seek to capitalize on the weak dollar and market fundamentals. On both sides of the equation, attention is focused on how to develop effective market entry and penetration strategies that benefit from the combination of globalization and local market knowledge, insights, and networks.

Construction Activity

In early 2005, domestic construction activity was up, with residential construction providing the primary boost. Although the housing market remained strong at the beginning of 2005, total private construction activity fluctuated in the summer before beginning to pick up again. Additionally, Hurricanes Katrina and Wilma put some dampers on construction activity, though activity levels began to pick up even before the post-hurricane rebuilding gained momentum. This trend is likely to continue, with improving market fundamentals in a number of markets and strong capital flows triggering an increase in commercial construction levels.

Shortages of materials continued to place upward pressure on construction costs during 2005. While some of these shortages and rising costs were attributed to spot shortages associated with the hurricanes, a number of them were due to global demand (e.g., steel, concrete, and petroleum-related products). Despite the rising costs, commercial construction activity trended upward in some markets, characterized either by a flurry of activity, improved fundamentals, or developers jumping in to capitalize on the potential for early recovery. While this activity is expected to continue, the prospects of a major surge in speculative building is unlikely. However, increased supply may dampen the potential for rent spikes and market cures that some investors have built into their pro forma pricing models.

Commercial Mortgage Market

During the first three quarters of 2005, both the commercial and residential mortgage markets were strong, with plentiful capital to support the market. Despite the Fed's impact on short-term rates, mortgage rates remained relatively low, especially in light of historical averages. During the fall, residential mortgage rates trended up a bit before falling back somewhat toward year-end. By mid-December, fixed rate residential mortgages were up some 60 basis points over the prior year, while adjustable rates were up almost a full percent from the year-over number. The end result was a reduction in the spread between fixed and adjustable rate loans. Despite this compression, the market share of adjustable loans edged up as marginal buyers struggled to qualify for homeownership and jumped into the fray before rate increases could price them out of the market. At the same time, in the face of the recent decline in refinancing, and signs of a slower transactions market, lenders were becoming more aggressive in terms of originations and mortgage products. Assuming the market remains relatively disciplined, delinquency rates may continue to improve. However, lenders will face some difficult situations in the hurricane zones as those who were granted temporary forbearance are forced to seek longer-term solutions. Despite these challenges, and those in some of the markets in which the housing prices overheated, the overall residential mortgage market should be able to sustain and adjust to a cyclical slowdown in the housing market.

With the exception of the markets directly affected by the hurricanes, the commercial mortgage market has remained active. Lenders are struggling to place capital and hold underwriting standards in the face of strong competition. This competitive arena has translated to low spreads between mortgages and similar term securities. Reflecting the flat yield curve on interest rates, the spread for five- and ten-year mortgages has remained relatively tight, creating a number of opportunities for borrowers to match debt terms with expected holding periods.

Commercial delinquency and foreclosure rates have remained low, despite some increases in the hurricane zones, taking some of the concern over credit quality out of the equation. This situation should hold and perhaps improve as real estate fundamentals of supply and demand improve with the broader economy.

Going forward, from the private side of the market, the supply of mortgage capital will continue to expand and provide more than adequate capital flows to support the institutional real estate market as it expands to capitalize on improving fundamentals. Similarly, smaller investors, including tenants-in-common investors, are expected to be met with open arms, thereby setting the stage for an active market that should carry well into 2006.

The commercial mortgage-backed securities (CMBS) market has remained strong, with a record $4.3 billion issuance from Goldman Sachs in October 2005. While market fundamentals remain solid, and spreads compressed, there is some concern over the aggressive underwriting in many pools and the use of interest-only and high loan-to-value ratio mortgages. Increased attention to such issues should bring some constraint, although investors have ignored concerns to this point. Indeed, a two billion dollar securitization in September had an effective LV ratio over 100%, with some individual properties carrying even higher total debt than the portion allocated to the issue. Despite such concerns, the CMBS market continues to expand as new products are being created to increase capital flows. For example, the market has created a new tier of product–collateralized debt obligations–which allows originators to securitize a range of new debt, including construction loans, which had been the purview of commercial banks. The trend in new products is expected to continue to evolve and provide plentiful capital to finance the full spectrum of investment opportunities in the commercial market.

Private Equity Market

The private equity market has continued its strong showing. Record prices are drawing even more product to the market, as owners seek to lock in unrealized gains before the capital sources begin to focus on absolute levels of return. This situation has attracted some investors who had previously drawn the line on low returns for commodity product. Despite increased deal flows, the pent-up volume of private equity capital seeking real estate has held yields at historical lows, with limited upside potential. While many observers remain concerned over the commercial real estate values, the fact that lower yields have been priced into the market has provided some reassurance. For example, several years ago the NCREIF Index was expected to slip into singledigit total returns. Due to a confluence of events, and the emergence of commercial real estate as a safe haven, this situation has yet to unfold, with NCREIF returns continuing in the low double-digit range. However, it should be noted that a significant portion of this performance could be attributed to unrealized capital gains, which could quickly evaporate if return requirements are ratcheted back up to long-term averages. Despite this caveat, the pent-up demand for product, and the willingness of investors to accept lower current returns, should carry the industry over the near-to-intermediate term.

The aggressive pricing of private equity investors has led to a number of coinvestment ventures with private and public sources of capital. For example, several pension funds have partnered with REITs in new ventures, providing REITs with the flexibility to take on risks not embraced by public investors, and enabling private investors to access deals and expertise they might not possess internally. The success of these ventures, some of which can be traced back to the mid-1990s, should set the stage for more of these relationships. As other asset classes improve with the economy, it is likely that private real estate will be under more pressure to provide competitive returns, which will be juxtaposed against a higher market standard. To some extent, public-private relationships may create more opportunities to capture value in the commercial market, allow private investors to outperform passive buy-and-hold investing strategies, and allow public investors to shift attention from quarterly earnings to more long-term wealth creation.

Public Equity Market

After a weak start, the Composite REIT Index had a relatively strong year in 2005 compared to other asset classes. In the second half of the year, returns fluctuated, with a series of moderate loses before the sector recovered in the fourth quarter.

REIT mutual funds had a challenging time in the fourth quarter, losing ground over the prior three months. This downturn raised eyebrows and caused passive investors relying on funds versus stock selection to step back and revisit the sector. The overall consensus is that returns will be tempered compared to the thirty percent plus racked up in 2003–2004, but will continue to provide competitive turns and stable dividends. This outlook is based in part on signs that the economy will continue to expand, spilling over to improvement in real estate fundamentals upon which REIT values are partially predicated.

The potential for increases in mortgage rates, and increasing dependence of the overall commercial estate market, has had some REIT investors on edge. However, strong equity capital flows and competition among lenders are expected to continue to place upward pressure on asset prices. Thus, investors seeking diversification benefits to enhance risk-adjusted portfolio returns are expected to maintain REIT allocations, while those chasing absolute returns and making bets may rotate out of the sector.

In addition to overall performance, the REIT industry is undergoing some changes that are noteworthy. For example, during 2005, a number of REITs went private, with institutional investment funds on the buy side. This trend can be attributed to a number of factors, including the aggressive pricing in the private market, which outpaces the tolerance levels of stock market investors. This spread is exemplified in the transaction between AMLI Residential Properties Trust and Morgan Stanley Real Estate's Prime Property Fund, which reportedly paid a twenty percent premium over share value. Another factor is the surplus of private equity capital, both domestic and international, chasing real estate and the lack of access to quality assets. Given the concentration of REITs in rather narrow property types or markets, larger institutional players can upgrade the quality of a portfolio by adding assets that complement existing holdings and provide access to new markets. Finally, under current pricing, REITs are trading at par with net asset values and are providing some upside potential for shareholders seeking to cash out and catch a wave at the end of the REIT cycle.

The trend toward privatization is expected to continue, especially as private capital sources get more aggressive and seek to bolster current holdings. Some of these efforts can be attributed to a desire to expand current holdings to broaden the foundation of income-generating property and spread the marginal risk associated with new development opportunities. The end result of these returns will be an upward pressure on REIT values as the market contracts and current values are reaffirmed.

Conclusion

As 2006 begins, one can sit back and marvel at how the economy has weathered the storms of the past year. These storms came in a number of forms, ranging from continued geopolitical risk to the hurricanes that devastated the South to the record deficit. There is little respite in sight on the trade front as the global economy suffers and demand is dampened for weak dollar goods and services. China and other low-cost competitors continue to flood the United States with imports that consumers cannot seem to resist. In spite of these and other challenges, the gross domestic product continues to improve, with prospects that the economy will continue to expand over the near term.

Capital flows remain strong overall, with low interest rates helping fuel a supply of debt and equity capital that is more than adequate to support the current real estate market. The residential market remains relatively strong, although it is likely that the bull run in single-family housing has played out. Despite low yields that have emerged over the past several years, the real estate market seems to be fairly priced in terms of investor demands. While it is likely that prices will soften over the next several years, improving market fundamentals might be adequate to sustain current prices and avoid the "bubble" that some have predicted would burst both the residential and commercial markets.

In terms of real estate fundamentals, the general outlook is for gradual improvement. Strong investor demand is sufficient to withstand periodic setbacks as the industry adjusts to a more competitive capital arena and attention shifts back to pricing risk.

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