FOCUS ON THE ECONOMY

Watching the Tides

by Hugh F. Kelly, CRE

Apologists for the high stock market valuations that have so enthused Wall Street point to the huge worldwide capital pool that is keeping the economy buoyant. So long as we avoid a 1930s-style deflation that shrinks the real amount of wealth available for investment, they argue, the stock market has just about nowhere to go but up (little wrinkles and corrections aside). The happy talk is selling books about a possible Dow Jones Industrial Average at 30,000 points, and is the unspoken premise behind programs to set aside some Social Security withholding for personal investment accounts that would "have to" bring better yields than the present imputed returns.

No one seems to be watching either basic demographics or the advice, quite sound on its face, of virtually every fiduciary money manager. As workers by the millions have been shifted from defined benefit pension plans to defined contribution programs like 401(k)s, financial planners have laid out a simple and cogent strategy. Prior to age 55, it makes sense to have most retirement funds invested in common stocks. The objective is simple: seek aggressive capital growth. That's where we've been up to now. In years immediately preceding retirement, start shifting to a portfolio that emphasizes conservation of capital, mostly high-quality bonds. Right now, there are few if any analysts discussing what happens when the baby boomers begin to execute this strategy en masse, through the agency of mutual funds, as they surely will some time in the coming decade. It will be interesting to observe, to say the least.

Real estate is facing something of an analogous situation. As commercial property has climbed the steep slope of recovery from its collapse of a decade ago, investors have ridden a market up, based upon a strategy of capital growth. In this rising market, assets characterized by multiple leases, many of which face nearly certain upward adjustment upon expiration, have been the most sought after. Office buildings, in particular, have attracted the majority of capital. Apartments have been purchased at very aggressive prices, on the expectation that rents will rise sharply without much negative effect upon the occupancy rate of the property. Thus far, the strategy has worked brilliantly, as values have leapt from severe discounts to replacement costs to clear premiums in most markets.

Experience, and the economics of market equilibrium, suggest that this cannot go on indefinitely, though. Most professional real estate observers are still congratulating the industry on its ability to maintain development discipline. But even if construction lenders can keep building reined in over a long period of time, it is probable that the steep upward climb in rents and prices will not persist longer than another year or two. Tenants simply do not have infinitely elastic budgets, for one thing, and we are running out of the raw

material for 1990s-style absorption gains, viz., huge employment, and household increases across the entire market.

This means that shrewd real estate investors will be looking at conservation of capital strategies with increasing interest over the next few years. The quality and durability of the income stream will become of paramount importance. Investors will look less enthusiastically at tenant rolls with lots of near-term expirations, and will seek high-quality, long-term leases as the most sought-after feature in their prospective purchases. Industrial properties could see their market share growing under such as scenario, as will triple-net-leased shopping centers anchored by strong credits. Master-leased office buildings could become a more common feature, especially if lenders can get comfortable with appropriate underwriting standards and the securitized mortgage market can provide secondary liquidity for the collateral. Now that major urban areas, newly baptized as "24-hour cities," have regained credibility, we could even see the return of the long-term ground lease as a low-risk, predictable-return investment vehicle.

As we start to prepare for the year 2001, much attention is likely to be devoted to the immediate cross-currents affecting the markets: shifts in interest rates, the fate of the dot-coms, rent spikes, construction starts, and so forth. The wisest investors will be more concerned with the tidal forces that will be affecting capital for the coming five to 10 years. It won't pay to stick to "business as usual" if that means repeating the investment behaviors that paid off so handsomely during the Nineties.

While the relationship between the capital markets and the fundamental economy is often tricky to puzzle out, commercial real estate professionals need to think through the consequences of the shift from a capital growth to a capital preservation bias in the decade ahead. Absent any external trigger to higher inflation, a flood of capital into the bond markets is likely to have the effect of lowering interest rates, which move inversely to the price of bonds. As this column has noted previously, real interest rates are quite high and have been since 1995. Thinking globally, high real rates have contributed to the strong dollar (and conversely, to the weak yen and euro). If U.S. policy were to seek some reduction in the dollar, let us say to tackle our enormous trade deficit at some time, downward pressure on rates would be one of the key monetary policy levers.

Real estate counseling is all about choices. The range of choice is influenced in turn by the condition of the property markets as well as the underlying economy that supports all real estate. If the tides of capital flow are turning, so too will the array of options for real estate. Otis Redding, sitting on the dock of the bay, might be proposed to offer our theme song for the early 2000s. REI25

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