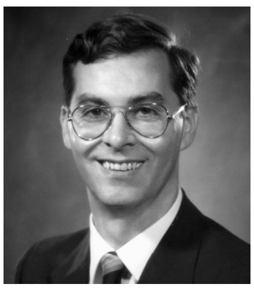
FOCUS ON THE ECONOMY

Expect Big Changes in the Next Five Years

BY HUGH F. KELLY, CRE



TO HEAR THE GENERAL RUN OF ECONOMIC COMMENTARY, you might think that its primary article of faith was penned by Sir Isaac Newton: "Objects in motion tend to remain in motion; objects at rest tend to remain at rest." Following Newton's law of inertia, we might expect that tomorrow will be like today, only more so.

For optimists, the governing expectations derive from the relatively high-growth, low-inflation economy the U.S. has enjoyed, with just a couple of interruptions, since the mid-1980s. Based on that experience, today's employment generation of more than 2 million jobs annually, an unemployment rate of less than 5 percent, sustainable real gross domestic product expansion of 3.5 percent or more, high productivity and vigorous consumption should frame our baseline for the coming years.

Not so fast, say more dour types. Look at trends in the national debt—now pushing toward $9 trillion—a trade deficit soaring past 6 percent of gross domestic product, looming shortfalls in Social Security, and the ever-growing debt of U.S. households. Factor those patterns into the future and abandon hope.

MAPPING THE ECONOMIC FUTURE

Rather than choose sides, I'd like to challenge myself to consider how the next five years will be different from the last five. Though all forecasting is fraught with uncertainty, I am quite confident that 2006–2010 will be different from 2001–2005. The issue, of course, is just how. I'd like to sketch several changes that seem highly probable to me, with the promise that I will provide greater detail about those changes in future columns.

Here goes:

1. **The later years of this decade will consist mostly of the expansion-to-peak phase of the business cycle.**

   The year 2001 marked the onset of a recession, the end of the great bull market of the 1980s and 1990s on Wall Street, and the catastrophic events of Sept. 11. Though GDP growth resumed with surprising swiftness, employment losses persisted, the technology sector remained depressed and stocks spent years declining or stagnant. Corporate strategies seemed driven more by anxiety than ambition.

   Real estate was one of the few bright spots, but even in our industry worry shadowed any sign of strength. Common portents of doom included the so-called

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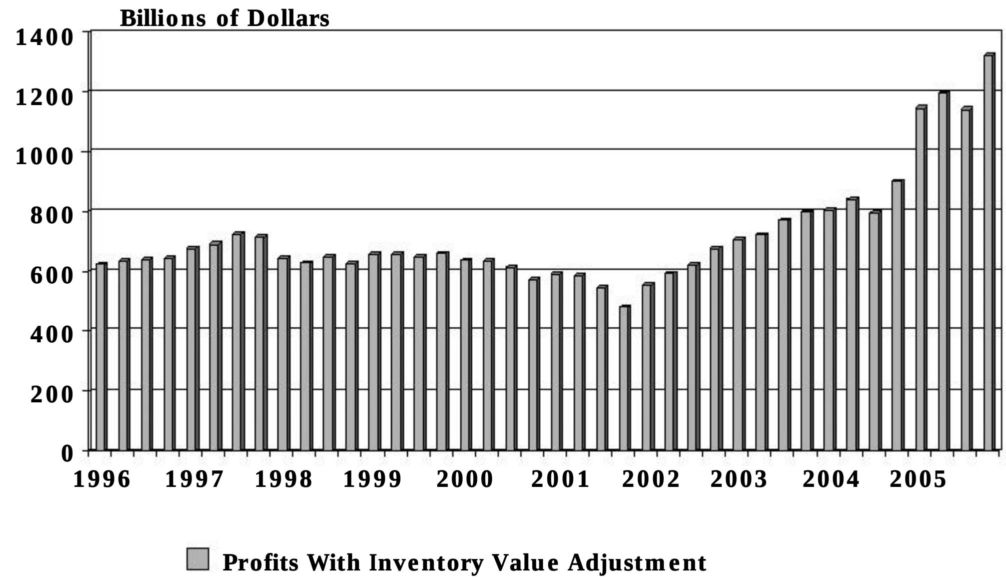
Table 1

U.S. Corporate Profits Have Enjoyed an Extraordinary Surge Since 2002



disconnect between capital appreciation and weak market fundamentals and the alleged bubble market.

By 2005, most Americans understood that we had truly dug out of the hole we entered in 2001, and were not about to fall right back in. At mid-decade, we could talk comfortably about an economy in recovery.

We can expect several transitions as that recovery matures. Consumption no longer will be the sole driver of growth, and may indeed give up a couple of points in its share of GDP as business-fixed investment increases. Strong corporate profits—now at their highest rate in 40 years as a percent of national income—can readily fund those investments. But more important, businesses will have a strong motivation to make those investments.

Businesses will realize that making investments that drive stock prices upward through earnings growth can no longer be primarily about expense control, but instead should spur improved output and increased market share. That dynamic is very different from the first half of the decade. It implies investments in plants and equipment, surely, and suggests personnel increases as well. Price-earnings ratios, in the stratosphere in the late 1990s, have come back to more normal levels, so companies will need to be aggressive in pursuing earnings opportunities and will spend money to make more money—until we hit the next peak.

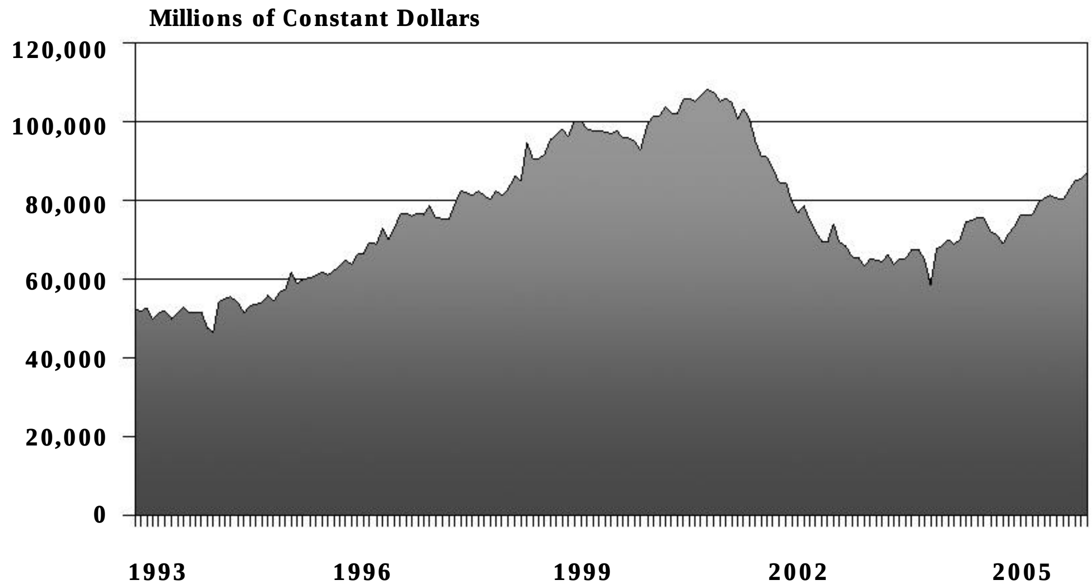
2. **Commercial construction slacked quickly in the early 2000s and stayed down for years. The later years of the decade will see an acceleration in construction.**

The so-called weak fundamentals for commercial real estate came about for the usual reason: Demand contracted suddenly, but the supply chain could not shift gears quickly enough. Vacancy, consequently, skyrocketed and rents plummeted. This was especially true in offices and hotels, but industrial properties were affected as well—especially research and development and flex space. Of the nonresidential property types, only retail avoided a steep development contraction because consumer spending remained high thanks to a stimulating monetary policy.

In 2006, office, industrial and hotel occupancies are improving steadily. Rents are beginning to creep

Table 2

Nonresidential Building Construction Already in Substantial Rebound



Source: U.S. Census Bureau; constant dollar adjustment by Hugh Kelly, CRE

upward. But in most market areas, construction has not yet hit its stride. The most powerful reason for this hesitancy is that market rents do not yet stand at the level where developers can pencil out "feasibility" when they run construction cost numbers.

Rents are one problem, but the explosion in cost for building materials and, to a lesser extent, labor, keep raising the feasibility bar. Most markets are not prepared for the likely result: several years of double-digit rent increases once vacancy rates drop below frictional levels. That reality is coming, though, and faster than many expect. It will be a huge difference from the recent past, and even the present, but I believe we can count on such a phenomenon in most major markets.

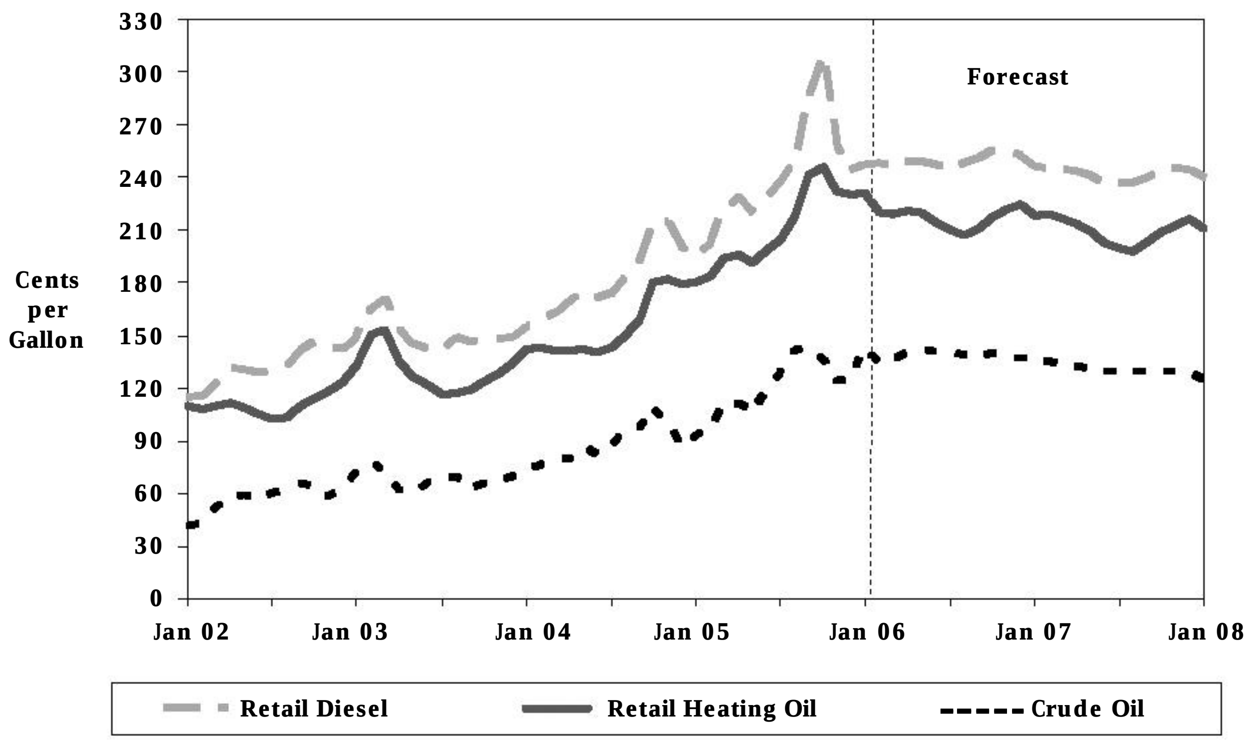
3. **The extreme volatility of early-decade interest rates will give way to much narrower fluctuations.**

Though the Federal Reserve System's management of interest rates following the tech wreck and especially in the aftermath of the Sept. 11 terrorist attacks was especially dramatic, it applied well-established remedies for recession and recovery. The Fed lowered interest rates until it was well assured that the contraction in the economy had been halted, then it began to hit the brakes to forestall any threat of overheating.

The key difference in former Fed Chairman Alan Greenspan's approach, as opposed to his predecessors, was that he signaled boldly to the markets what he intended to do and had the courage to bring rates down to uncharted lows—prolonged negative real interest rates (i.e., rates below the concurrent consumer price index)—to deal with the dangerous combination of a stock market collapse, a nation anxious about the disruption of terrorism and a deep dislocation in the labor markets. Then, he showed real discipline in introducing a regime of rate increases that was steady, predictable and significant in overall magnitude, while looking past short-run fluctuations in the economic data. Rarely have I seen a policy-maker execute strategy so skillfully, insightfully and purposefully. It was a tour de force.

Table 3

U.S. Distillate Fuel Prices



Source: U.S. Department of Energy, chart gallery for March 2006

We stand in early 2006 at a very different place for monetary policy. Fed Chairman Ben Bernanke, thankfully, is working within the context of less volatile economic times. The yield curve is exceptionally flat, but likely will not remain so for an extended period of time. The Fed can now entertain a *laissez-faire* rate period, allowing market forces in the treasury arena direct the price of risk-free assets.

Absent serious shocks, I would expect the yield curve to return to a moderately upward slope within the next year. Within two years, I suspect we will find short rates dropping again of their own accord, and long rates stepping up 100–125 basis points. From there, I would not be surprised to experience little change in rates for a year or more. Any significant upward movement in rates in the last years of the decade could be a precursor to the next recession.

4. Increases in energy costs, tempered by the low cost of consumer imports, have fueled inflation. That relationship will reverse in the years ahead.

Just a decade ago, the Organization of the Petroleum Exporting Countries, or OPEC, was worried that overproduction had created an oil glut that virtually robbed the energy industry of pricing power in the market. I can recall, in late spring 2000, driving up to a gas pump in eastern Indiana where unleaded regular was 99 cents a gallon and thinking that I was paying substantially more for a bottle of water in the service station's convenience store. Iraq and Hurricane Katrina changed that picture in a hurry. But, the finite supply of oil in the ground notwithstanding, energy prices through 2010 could decrease.

The U.S. Department of Energy's most recent projections show 2010 crude prices at about $50 per barrel and natural gas prices approximately 20 percent below 2006 levels. Remember that volatility could prompt significant price swings, and the direction of change can be down as well as up. Consumers waiting in long lines to pay $2 for a gallon of gasoline in 1979 probably never imagined that price would be cut in half two decades later, but that's what happened. It can happen again.

Meanwhile, a flood of imported goods has held down consumer prices—the positive side of our enormous and unsustainable trade deficit. The CPI sub-index for shoes, for example, was 128 in 1996 and is 124 as of the first quarter of 2006. Declines in apparel prices have been even more dramatic, dropping from 132 in early 1996 to 119 this spring. Recreational products such as toys and video games also have dropped steeply in price, from a CPI sub-index of 125 a decade ago to 75 today.

Even if we don't see the coordinated effort to bring down the current account deficit that the G-7 central bankers managed in the Plaza Accord of 1985, expect some adjustment in exchange rates and targeted trade agreements designed to make a dent in the trade imbalance. Such moves will put upward pressure on the import prices for many consumer goods, counterbalancing the anticipated drop in energy prices. The net effect on the CPI is that inflation should fluctuate in the 2 percent to 3.5 percent range, giving interest rates the opportunity to shift to the yield curve described previously.

Economic dynamics, and their implications for real estate, are endlessly fascinating. They also are complex and almost always can shift in unexpected ways. Nevertheless, I find it important to think about the economic future in concrete ways to anticipate specific changes. Otherwise, how can we make rational decisions? I'm sure some readers will find my perspective highly debatable, and others will agree with me. In future columns, I will explain in greater detail the data on which I base my arguments. ■