FOCUS ON THE ECONOMY

Inflation Moderates as Mid-Recovery Slowdown Surfaces

BY RICHARD W. MAINE, CRE

"SO FAR, SO GOOD!" This statement is a simple, yet accurate summary of what is unfolding in the U.S. economy and commercial property market. Neither recession nor stagflation is probable; instead, evidence that we are in the early stages of a Fed-induced mid-recovery slowdown is gathering. Inflationary pressures are subsiding and, most important, commercial real estate fundamentals remain solid and improving across all property sectors.

Through midyear, the U.S. economy ran stronger than industry observers had expected, but a slowdown has begun. Third-quarter real gross domestic product growth came in at 1.6 percent, down from 2.6 percent in the previous quarter and 5.6 percent in the first quarter. Housing, which kept the economic recovery going longer and stronger, is clearly in decline. Major domestic automakers have announced production declines stretching well into 2007. Oil has dropped more than $20 a barrel since August, largely because of reduced demand signaling a possible cyclical peak in the economy. The yield curve remains flat to slightly inverted, which points to a slowdown; and through late 2006, the U.S. Leading Economic Indicator also continued to point toward a slowdown.

The consumer, who has driven this five-year-old recovery, continues to do so, assisted by reduced energy costs and continued high levels of home equity withdrawals from single home refinancings, but at a decelerating rate of growth. Warning signs of future retail spending declines are flashing; examples include the recent numbers and projections from Wal-Mart—an important proxy for low- to middle-income retail spending trends.

EXPECT HAWKISH FED DESPITE ENCOURAGING TRENDS

Understanding that cyclical inflation lags and always peaks after GDP peaks, the recent news about inflation is mixed, with a growing bias toward moderating inflation. Importantly, there is no evidence that inflation is baking itself into higher wages and benefits. This series within the economy commands the U.S. Federal System's greatest scrutiny as it fights to prevent cyclical inflation flare-ups from becoming structurally embedded via payrolls.

About the Author

Richard W. Maine, CRE., *is managing partner for Madison Harbor Capital, an independent investment firm serving institutional and high net worth investors with timely and distinctive real estate investment strategies through primary investments into newly formed real estate partnerships and secondary acquisitions of existing interests in real estate. The firm focuses on providing investors with a proper balance of risk and return through a high level of diversification.*

The Fed, following 17 consecutive 25-basis-point rate increases, stood down and took no action since June 2006. This Fed pattern continues with key leading technical indicators prompting Fed pronouncements regarding "moderating inflation" tempered with language that reminds the market the Fed can and will hike rates further if moderating inflation fails to continue. Also, remember that despite encouraging trends, the core inflation rate has not yet returned to within the Fed's desired 1 to 2 percent safe harbor. For the foreseeable future, the Fed should feel good about the economy while maintaining a hawkish posture on inflation.

SINGLE FAMILY HOUSING UNWINDS

The single family housing sector has peaked and is in rapid decline, but hasn't yet bottomed out. Following five years where home prices had a compounded annual growth rate of approximately 15 percent, we can look back and say it was the highest national rate of house price appreciation ever. A phenomenon of that magnitude will not be corrected in a few quarters. Most observers feel the correction has to play out in terms of duration and magnitude.

Nominal house prices are falling nationally for the first time in the post-World War II period. Though history shows the U.S. can unwind a housing bubble and avoid recession, the U.S. cannot avoid some meaningful consumer belt-tightening, which is still largely in the pipeline. This means the housing correction will be a significant contributor to below-trend GDP growth through at least 2007.

STOCKS FINALLY RESPOND

One very encouraging development has been recent stock market performance. It has overcome its stagflation obsession as demonstrated by the healthy year-to-date performances in the Dow Jones Industrial Average, S&P Indices, New York Stock Exchange, American Stock and Options Exchange and Russell 2000 Index—and even the NASDAQ Stock Market is now in positive territory.

The economy is downshifting, cyclical inflation fires are being dampened and, to date, the housing correction has proved manageable. However, the overall situation remains fragile with unforeseen accidents continuing to pose a threat to this scenario. Moving forward, it will be important to closely monitor job trends, the U.S. dollar and the continuing ramifications of the housing correction. If history is any guide and we continue on this mid-recovery slowdown path, the Fed should be in a position to consider reducing rates in late 2007, allowing the economy to return to trend-line GDP growth during 2008.

RENTS INCREASE IN U.S. COMMERCIAL PROPERTY MARKET

The picture for commercial real estate is very strong where it counts the most: the fundamentals. Despite the slowing general economy, demand for rental space across all property types remains strong. At the same time, the pipeline for new supply of space remains constrained in most local markets by high costs for land, entitlements and building materials.

Despite the slowing general economy, demand for rental space across all property types remains strong. At the same time, the pipeline for new supply of space remains constrained in most local markets by high costs for land, entitlements and building materials.

The result is rising occupancies, increasing rents, sharp declines in the need for concessions, and improving net operating income to fund maintenance and replacements as well as investor cash distributions.

The 2006 year-end numbers included many firsts and records, but the most compelling story is about rent increases. According to third-quarter 2006 data compiled by Global Real Analytics, nationwide commercial rents have increased 6 percent on a trailing 12-month basis. Tracked by quarter over the previous year, each property type except retail achieved an accelerating rate of rental growth. Even retail properties maintained a steady and respectable 5.2 percent average rent increase.

Obviously, there was a broad range across regions led by the Pacific Coast states' 8.2 percent growth with even the lowest regions recording a positive 2 percent growth. By property type, rent growth experienced a tighter range spanned from retail's 5.2 percent, to 6.7 percent for Class A central business district office properties and class A apartments.

REAL ESTATE REMAINS WELL POSITIONED

Remembering that private real estate equity's historical returns are composed mainly of current income, the fundamentals indeed look solid—even going into a mid-recovery economic slowdown—given the equilibrium existing between demand and supply for space. With strong liquidity and ample capital for debt and especially already mobilized private equity, commercial real estate is well positioned for the next several years.

Total returns are likely to moderate as the rate of appreciation slows. Even if real estate reverts back to its historical unleveraged NCREIF 9.5 percent to 10 percent total returns, it still represents a solid diversification with attractive absolute and relative returns.

PUBLIC REITs ARE TOP PERFORMERS

The third iteration of public REITs that began in 1993 has enjoyed a strong performance run for its investors. REITs represent roughly 20 percent of U.S. commercial real estate equity capital, and the public REIT structure is now being replicated in other countries, with the UK being the latest to introduce public REITs on Jan. 1, 2007.

The REIT performance in the U.S. has been well chronicled and needs no repeating except to say that 2003 – 2005 produced continuous annual returns of more than 30 percent, with 2006 returning more than 34 percent—well ahead of major stock indices and the seventh consecutive year that REITs have outperformed the indices.

Yet behind the headline performance numbers are other important REIT trends that draw private real estate equity into play. At an accelerating pace over the past 12 to 18 months, REITs are experiencing consolidation as well as public-to-private conversions. According to Prudential Real Estate Investors, approximately $44 billion in REIT merger-and-acquisition transactions have closed through the first three quarters of 2006, including $24 billion in transactions first announced in 2005. At least $65 billion in additional deals were announced in 2006, but not yet closed.

Though some of the activity involves public-to-public mergers, the majority are privatizations of either the entities or the underlying asset portfolios. As share prices have appreciated, investors who were ostensibly drawn to REITs for their dividends have seen their yields cut in half. Many REITs that continue to be publicly owned are making ample use of private real estate equity capital to form joint ventures for the purpose of purchasing portfolios of core properties.

Capital market activity for the public REITs as of third quarter 2006 vs. full year 2005 is:

- Two IPOs totalling $267 million vs. 17 for $6.5 billion in 2005
- 61 Secondary Equity Offerings for $9.5 billion vs. 75 for $8.9 billion in 2005
- 31 Preferred Stock Offerings for $3.4 billion vs. 35 for $3.0 billion in 2005
- 66 Unsecured Debt Offerings for $19.4 billion* vs. 104 for $16 billion in 2005
  **Includes 34 deals for $8.4 billion completed in third quarter 2006*

There are some fascinating trends behind the headline performance numbers that are very different from what occurred with REITs between 1993 and 2004. Right now, despite the returns, REITs cannot be considered a growth market. Instead, REIT IPO issuance is nonexistent and the volume of unsecured leveraging is increasing as the entire sector is being rationalized through consolidation and public-to-private conversion.

SUMMARY

The investment environment remains fragile and risky. The Fed's preemptive move to tighten in mid-2004 seems to be working in engineering a mid-recovery slowdown to defuse an inflationary flare-up and prick the bubble in home prices. Implementation is proceeding in an orderly fashion but can still be sabotaged by the fallout from the housing correction or an unforeseen accident.

Threats of either a recession or a stagflation scenario have receded, and a resumption to trend-line GDP growth is probable within 12 to 24 months. Commercial real estate fundamentals are sound, still improving and positioned to perform well, albeit at somewhat lower appreciation rates as we move through the slowdown phase of this economic cycle.

So far, so good. But it's early, so stay tuned. ■