

## **RCLCO ON THE ECONOMY AND THE REAL ESTATE MARKET**

### **Recovery Continues to Be Lumpy**

*Summer 2011*

#### **ECONOMIC OVERVIEW**

It is our view that the recent negative sentiments about the U.S. economy are driven by temporary, short-term events (weather, energy prices, natural disasters), rather than by fundamental issues. These events are serving to slow the rate of the recovery, but are not expected to reverse the course from recovery to a second recession. The U.S. economy should continue to grow at a modest pace, picking up momentum in the second half of 2011, and improving further into 2012 and 2013.

Indeed, in October 2010 we predicted in this space that the U.S. economy was likely to experience slow, uneven recovery climbing out of the Great Recession. Further, we predicted that there will be periodic disruptions to the recovery, as global capital markets and political events “spook” both consumers and investors. And that is what appears to be happening, as concerns about the pace of growth and rising fuel prices, fears about the instability of the faltering economies in Europe, and global political concerns lead businesses to push off hiring and investing for as long as possible.

It is therefore not surprising to us that mid-year 2011 finds the U.S. economy and real estate market in an uncomfortable state of dissonance. Economic growth and the much needed job growth it was expected to create have been slower and less stable than hoped for. Two years after the official end of the Great Recession, we are still experiencing a pattern of fitful, uneven growth, which we believe may continue for 12 to 24 months as the economy shakes off the recession’s lingering after-effects.

The housing market and the Federal Government stimulus programs were expected to help pull the American economy out of the recession. However, the persistent weakness of the housing sector, traditionally a leading sector of past recoveries, is one of the factors delaying the recovery of the U.S. economy. With the housing sector continuing to slug through the foreclosure overhang for the next two to three years, house prices will remain relatively flat and new home construction activity will remain well below levels experienced during past recoveries (stay tuned for RCLCO’s housing market outlook, to be issued in the near future).

The government, which has already played many of its cards in helping prevent the economy from an even deeper decline during the downturn, is not likely to intervene unless the economy slips into a recessionary “double dip” – another downturn akin to the 2006-2009 correction.

In addition to the weak housing sector and the limited role the Federal Government will likely play in inducing the economic recovery, the deleveraging of U.S. personal and corporate balance sheets is diverting money to savings and away from economically stimulative consumption and investment activities. Finally, a string of unforeseen temporary events such as bad weather, natural disasters in Japan and in the U.S., and high energy prices driven by a speculative fervor, are not helping the economy gather the much needed steam.

There is much reason for optimism, in spite of the current relatively gloomy conditions. In our view, odds are that the U.S. economy will not slip into a double dip recession. Rather, we expect that economic growth will perk up in the second half of 2011 as the main causes of the recent slowdown – high oil prices and manufacturing delays because of the tsunami in Japan and other natural disasters in the U.S. – have started to fade. Indeed, production capacity is expanding to catch up with the demand that pent up while supply-chain interruptions from Japan slowed economic activity, falling gas prices free up more of households budget for consumption of other goods and services, and the reconstruction of the flood

damaged areas in the South and the Midwest cause significant and unexpected boost to the construction industry.

The momentum that began to gather since the recession technically ended is about to start accelerating. American households have been feeling increasingly more comfortable with their personal balance sheets for the last year or more, and the resulting increase in personal consumption has already triggered significant corporate investment and increased production, both reflected in the continued run up of the equities markets, where investors see fundamental growth. Until now this increase in demand has been mostly accommodated by improved productivity rather than expansion of the workforce, but all evidence is that we are nearing a tipping point, and that far more substantial hiring will be needed to serve this growing demand for goods and services. With corporate and bank balance sheets loaded with cash ready to be deployed the level of investment and hiring will eventually move up much more quickly, there is no reason to expect anything but improving economic conditions for the remainder of 2011 and beyond.

Indeed, private sector job growth is already gathering steam, as more and more sectors of the economy complete their restructuring, shed inefficiencies and redeploy slack capacity productively, ultimately leading to net new jobs and net new investment at accelerating rates. Eventually, the bleeding will stop and all sectors will become stable or growing, allowing the economy to grow more freely. This will continue to be a painfully slow process at least through 2012. The housing sector, one of the last to regain its health, will begin to create jobs as demand for new homes picks up, starting with select high-growth, high-barrier to entry markets where the overhang is not as significant as in other markets, and spreading across the nation over time as the foreclosure overhang clears the various markets over time.

As to the government sector, the appetite for mounting debt and current deficits is not what it used to be, leading to slow growth of government spending and job growth rates. Eventually, governments at all levels will begin to address the structural deficit and the need to reduce debt, further cutting services and/or increasing taxes, which will likely have a dilatory effect on economic recovery. By then, we hope, the private sector will have gained sufficient momentum to be able to carry the economy and maintain reasonable growth rates.

## **REAL ESTATE MARKET OVERVIEW**

Perhaps the best way to describe the conditions in the real estate market at this time is as “bumping along the bottom.” The operating fundamentals of real estate assets – prices (lease rates and home prices), occupancy, absorption paces, etc. – have thus far remained weak, showing modest if any improvement, and are yet to rise to levels that would justify new construction, even with current depressed land prices.

In spite of the spotty and anemic economic recovery thus far, investors have been eagerly deploying capital and chasing investment opportunities, driving property valuation metrics for property and real estate backed financial instruments up to levels approaching pre-recession prices. With property values racing ahead of the fundamentals, investors are displaying significant confidence in real estate, betting that the operating fundamentals will catch up in the not too distant future, perhaps as a result of economic growth, perhaps as a result of inflation, perhaps as a result of a combination of both. These conditions could develop into a bubble, with short-term corrections similar to the occasional corrections in the equity markets as a result of equity prices having gotten ahead of the recovery or political uncertainty spooking investors and causing a selloff.

But current prices are not explained solely by speculative investing. There is in fact structural demand for real estate of all types in the U.S., albeit in select markets and for select property types. There is also evidence of pent-up demand for some types of development, particularly multifamily rental apartments. Further, after almost five years of little new home construction activity, demand for new housing is accumulating, creating what will ultimately present itself as pent-up demand for new homes, as homebuyers seek the “new new thing” and the latest in design and features.

A trend to watch is the introduction of GenY into the economy. Some 4 million members of this generation turn 25 each year, playing an increasing role in the economy as workers and as consumers. The most profound impact is in the housing market, where already GenY is fueling occupancy levels and pushing rents up in the multifamily rental sector. As the recession abates and more GenYers find gainful employment, their impact on the housing market will grow even further, first as renters and then as homeowners as they enter their 30s.

As employers begin to hire less cautiously and consumers and businesses alike stop deferring large expenditures, the recovery in demand for real estate will transition from its current “lumpy” state, and property operating fundamentals will continue to improve. Indeed, there is a fair amount of excess inventory of commercial space and partially if not fully developed land that need to be absorbed before large-scale new development activity will be justified. As such, the level of new construction activity will likely remain low for the next several years, picking up gradually at times and rates that will range widely from market to market, and from sector to sector.

The above notwithstanding, a “double dip” in the real estate markets is unlikely. Even in the for-sale housing market. As long as the U.S. economy continues on the course discussed above, the currently anemic yet relatively stable fundamental supply and demand conditions should improve over the next several years as the economy picks up and the excess inventory is absorbed over time.

## **REAL ESTATE CAPITAL MARKETS**

The real estate sector is attracting investors seeking diversification and protection from inflation and currency risks, which may insulate it from a widespread selloff. Even at current very low cap rates, the low interest rates offer positive spread to the equity, juicing up investor returns for prime borrowers. And with interest rates as low as they are, even a modest rate of return produced by real estate appears an attractive investment compared with a risk-free investment in, say, a 10-year Treasury bond. Finally, a real estate investment offers appreciation potential as a hedge against inflation as well as an enhancement to the investment’s total return profile, something fixed-income alternatives do not offer.

The increasing availability and low cost of debt capital is a most encouraging macroeconomic condition. Bankers are gradually easing underwriting standards and considering a broader array of activities, including construction lending in some situations. Distressed assets and debt continue to be traded into the market in an orderly fashion, and the capital markets continue to thaw as balance sheets are shorn up.

Equity is being metered into the market at an accelerating pace, albeit disproportionately targeted to the most stable markets and the asset classes that seem best poised for continued recovery, leading to widely divergent real estate market conditions, with the best real estate values in the gateway markets firming more rapidly and other sectors continuing to lag.

REIT pricing and implied cap rates, a good measure of investor appetite for real estate, have regained a significant portion of the loss in value experienced since the early-2007 peak. For-sale housing prices, despite media doom and gloom after the precipitous fall of the bubble bursting, have essentially stabilized, particularly for non-distressed sales. However, some continued price declines are certainly possible.

The development community is also getting back to business, albeit cautiously and disproportionately, in strong submarkets in the metropolitan areas with the healthiest economies. While new construction will be constrained in most sectors for some time to come, niche players are advancing selected projects and finding eager capital partners.

The investment property sectors (office, retail, hotel, multifamily rental, etc.) saw transaction volume increase considerably since mid/late 2010, with prices rebounding more quickly than many investors expected—particularly in the most desirable metro areas. Investor appetite is quickly spreading into secondary markets and relatively lower quality assets, as few compelling investment alternatives exist,

driving investors to bid up the few available options and pricing many “opportunistic investors” out of the bidding. These conditions are created in large measure by the volume of global capital coming into the U.S. property market and with modest return expectations.

## **FINAL THOUGHTS**

The recent negative sentiments about the U.S. economy and real estate markets are driven by temporary, short-term events, rather than by fundamental issues. The U.S. economy should continue to grow at an accelerating pace during the second half of 2011, and improving further into 2012 and beyond.

Past real estate recessions tell us that the recovery typically gains strength slowly as fundamentals are reset, but when they gain traction they can “snap” back rather quickly as consumers of commercial real estate users rush back into the market, fearing that the buyer’s market is closing. This is already happening in some sectors of the commercial markets and in some geographic markets. While the rate of recovery may seem frustratingly slow to spread across sectors and to the most hard-hit markets, the tide is moving in the right direction.

The smart money uses the downturn to increase market share, and the up-cycle to increase volume and scale. Those who will prove to have been the most successful in the next cycle will move now in anticipation of it.

And finally, while it is too early to envision the next economic and market downturn, all players would be well advised to keep in mind that cycles are inevitable, and that those who fail to plan for such cycles are doomed to lose control of their assets, especially if they use leverage liberally. Our advice is to move cautiously, but to move forward. Good luck!