



U.S. commercial real estate outlook

The return of volatility

By Martha Peyton, Ph.D., and Edward F. Pierzak, Ph.D.

Investors in U.S. commercial real estate (CRE) have a lot to celebrate as results for 2014 are posted. According to the National Council of Real Estate Investment Fiduciaries (NCREIF), total return amounted to 11.8 percent for the year, making 2014 the fifth consecutive calendar year of double-digit performance. Prospects for 2015 are bright based on strengthening economic growth, solid job creation, low interest rates, declining vacancy rates, rising rents and modest new construction. It bears recognizing, however, that 2015 would mark the sixth year of positive CRE performance after the Great Recession. That milestone means nothing in and of itself because cycles have no schedule — they do not expire and they do not die of old age. But, historically, all cycles have ended in a downturn.

In this report, we review the splendid performance of U.S. CRE through the recent recovery and examine the foundation for performance in the year ahead. As thoughtful real estate investors, we look beyond the obvious metrics to factors that might eventually undermine property performance. Investors who recognize these vulnerabilities can adjust their decisions to benefit not only from the ongoing good times that are forecasted, but also from opportunity to hedge potential dangers that are lurking out of sight.

On a roll

The institutional-quality U.S. CRE represented by the NCREIF Property Index (NPI) delivered another very strong year of performance in 2014 with total return of 11.8 percent. This performance represents a continuation of the positive and steady path that the U.S. CRE cycle has followed in the aftermath of the Great Recession. While the recent path of returns is satisfying, history tells us that past periods of strong returns have each ended with downturns associated with macroeconomic recessions. The last U.S. CRE downturn in 2009 was profound, but short-lived. In contrast, the 2001 downturn was barely detectable, while the 1991 downturn was both severe and prolonged. The mes-

sage for investors is: (1) celebrate the good times, (2) examine the likelihood of the good times continuing and (3) identify the vulnerabilities that will determine the shape of the next downturn.

Examining the good times is easy. As noted earlier, 2014 was the fifth consecutive calendar year of double-digit total returns. As the recent recovery has matured, the growth in four-quarter net operating income (NOI) has been strengthening. NPI properties posted NOI growth of 6.6 percent in the past year; the strongest four-quarter growth in NOI since the beginning of the recovery. Earlier in the recovery, total return was driven more by cap rate compression as illustrated in the relatively weaker NOI growth and strong total returns, especially in 2010 and 2011. Looking forward, the annual benefit of cap rate compression is expected to continue to wane and NOI growth is anticipated to become the primary driver of total return performance.

However, strong total returns and the rising property values embedded in them have resulted in lower yields. Among the four major property types, only the apartment sector is now priced above its 2008 record low yield. Office is roughly in line with its historical low yield. Retail is slightly below and industrial is significantly below their all-time low yields. But, before deeming industrial to be “overpriced,” it is important to recognize that the 2008 low in yields occurred with a 10-year Treasury yield roughly 100 basis points higher than its 2.3 percent average in fourth quarter 2014. Recognizing that Treasury yields have been hovering around the 2 percent mark, today’s cap rate spreads support the conclusion that current property pricing is not only sustainable, but offers the potential for some further yield compression.

Future looks bright

The pace of U.S. economic growth since the Great Recession has been modest with annual GDP growth rates reaching no higher than the 2.5 percent bounce

realized in 2010, the first full year of recovery. But, growth has been strong enough to replace all of the jobs lost during the recession and, as of January 2015, add 2.5 million more jobs. As a result, the unemployment rate that peaked at 10.0 percent in October 2009 now rests at 5.7 percent in January 2015.

The more important backdrop for 2015 prospects is the strengthening in growth and employment during the second half of 2014. The GDP growth rate surged to 5.0 percent in third quarter 2014 before easing back to 2.6 percent in the fourth quarter. The strengthening in growth propelled average job creation of 280,000 jobs per month during the second half of 2014, well ahead of the 212,000 jobs per month average during the prior 18 months. Moreover, the underemployment rate, which is a wider definition of labor market slack, has dropped to 11.3 percent, down from its 17.1 percent recession peak. The improvement in the underemployment rate is notable because it is occurring with a stable labor force participation rate, meaning that the underemployed are not simply disappearing out of the labor force. The stronger tone of U.S. growth is a reflection of strengthening consumer spending in the second half of 2014 combined with a lessening in the drag on growth from cutbacks in the federal government sector. Rising confidence among consumers, corporate CEOs and small business owners has also contributed to these improvements and the high level of confidence bodes well for 2015 growth.

Looking ahead, the Blue Chip Economic Indicator survey shows a 3.2 percent average GDP growth expected for 2015. This would constitute the strongest annual performance in this cycle.¹ To achieve this pace of growth, forecasters are expecting stronger wage growth

in 2015 than the paltry 2 percent inflation-like pace of 2014. This assumption is supported by the strengthening in job gains and leveling out of the unemployment rate during the latter half of 2014. If the labor market continues to strengthen as expected, the U.S. economy will be less vulnerable to short-term shocks that have repeatedly derailed growth to date since the beginning of the recovery.

The policy environment is also supportive of good prospects for 2015. The Federal Reserve succeeded in tapering and then turning off its quantitative easing activities without disrupting financial markets. The next step to normalizing monetary policy is the initiation of tightening in the federal funds target rate which has been kept at essentially zero since December 2008. More than 90 percent of forecasters expect the first tightening to come no sooner than June of this year with a consensus mid-point of 0.95 percent expected by year-end.² With this minor tightening,

money will continue to be cheap and available in 2015, supporting solid economic growth.

Unfortunately, fiscal policy is not as clear. On a positive note, state and local governments are no longer a drag on GDP growth as tax revenues continue to recover. The federal contribution to growth is less certain. It is unlikely that Congress will boost non-defense spending in 2015, so the best that can be expected is a steady path that will not compromise growth. In contrast, defense spending has become a volatile component of growth and is unlikely to settle down soon

“Just enough” for prosperity

The path of the U.S. economy has provided “just enough” fuel for the CRE sector to produce five consecutive years of double-digit returns. “Just enough” is the critical point. Growth was just strong enough to reduce vacancy rates across property types toward their long-term averages and ignite rent growth. Both powered the strong NOI

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**According to Pensions & Investments, Real Estate Managers ranking, October 27, 2014*

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growth in 2014 mentioned earlier in this report. Growth, however, has also not been strong enough to propel material construction activity, with the exception of the apartment sector, which bodes well for continuing solid NOI growth ahead. In addition, there has been just enough debt availability to support commercial property transactions, but not so much to create pervasive pricing or debt bubbles.

The positive foundation for U.S. commercial real estate in 2015 includes factors representing the cost and availability of capital, macroeconomic strength and CRE fundamentals. Our research has shown that each of the eight indicators is a statistically significant predictor of investment performance. As of fourth quarter 2014, each indicator is in the “green” zone, signaling that conditions are supportive of solid operational performance (NOI growth). Forecasters are affirming such positive prospects, with the latest consensus survey by PREA showing a 9.8 percent total return expectation for the year.³

However, with a real estate environment characterized by solid performance, strong capital flows and expanding debt availability, conditions are also ripe for new supply. New construction is expected to be the key differentiator of market performance in the next phase of the CRE cycle.

Among the sectors, apartments are the furthest along in their cycle. This is evident in prices and rents that both significantly exceed past peak values, as well as the substantial pace of construction now underway. Retail appears to be on the other end of the spectrum with very little new construction and comparatively weaker fundamentals. It bears mentioning, however, that retail sector total returns have lead the other three major sectors during the past 15 years largely due

to the strength in investment performance of super-regional malls. Despite their very strong total return performance, mall construction is almost non-existent due to the difficulty in assembling sites, approvals and anchor tenants.

Office and industrial property sectors are in earlier phases of recovery. For industrial, the national vacancy rate is now in line with its long-term historical average and operational performance has been consistently strengthening. The office sector has had an experience similar to that of the industrial sector, but with a vacancy rate at 14 percent, conditions still do not warrant a material increase in supply on a national basis.

All four major sectors are coping with structural challenges related in part to the emergence of the enormous “millennial” generation and the aging of the smaller “baby boom” generation. Millennials are propelling apartment demand, changing the nature of office space and innovating the meaning of shopping and with it the management of inventories and delivery processes. The impact of the generational shift is seen as one factor influencing strong apartment construction and weak construction in both office and retail sectors, along with the geographic rearrangement of warehouse space to accommodate millennial superstar retailers like Amazon.

No end in sight?

With all of these positives in place for 2015, it is easy to lose sight of the constraints on U.S. CRE performance that are also in play. Most importantly, while the data supports expectations for further cap rate compression, the potential is limited especially for higher-quality properties in more desirable locations. This leaves performance more dependent on NOI growth.

The “just enough” economic growth and limited construction in 2014 delivered very strong NOI growth across sectors. It must continue this year to support expectations for ongoing strong CRE performance. The economic outlook described above seems to assure that outcome, but the real world might not cooperate. In particular, economic growth outside of the United States weakened in 2014, with the slowdown in the euro zone and China of most concern. The United States has been withstanding the drag, and forecasters assume that will continue, but the drag leaves the U.S. economy more vulnerable to shocks.

If the U.S. economy is more vulnerable, so is U.S. CRE. The commercial real estate cycle has no expiration date and does not die of old age. It typically ends when external shocks crash into imbalances that have accumulated slowly over time. Overbuilding, overlending, overbuying, and overleasing are CRE imbalances that have characterized past downturns. When external shocks collide with CRE imbalances, property values and NOI growth suffer. We monitor for such imbalances in the context of the leading indicators previously described and our current analysis offers no reason for worry. The concern is more indirect in that shocks to the U.S. economy could compromise U.S. CRE performance rather than derail it.

Shocks and volatility

The vulnerability of the U.S. economy to shocks is implied in the pattern of volatility across various sectors and markets. Phases of high volatility are associated with heightened vulnerability because volatility creates big winners and big losers. While the macroeconomic impact should be a wash, the losers sometimes do enormous damage.

Volatility turned up sharply in the latter part of 2014 in a number of areas. Some examples are highlighted below.

1. Euro zone economic growth slipped toward recession, deflation risk increased, and the value of the euro nosedived.
2. Investor appetite for emerging markets sovereign debt plummeted and spreads ballooned.
3. Oil supply glut caused prices to plunge by more than half.
4. Investor appetite for U.S. high-yield bonds plummeted and spreads swelled.

The last item, U.S. high-yield bond spreads, is strongly associated with CRE pricing. Our cap rate spread model views the uptick in U.S. junk bond spreads as another indicator that prospects for further cap rate compression are limited for 2015.

Investment strategies for 2015

The 2015 U.S. commercial real estate investing environment is expected to be dominated by two factors: the advanced state of its cycle and the global macroeconomic backdrop, which is funneling capital into U.S. assets. Investors with more modest risk appetite will evaluate these factors and likely conclude that 2015 is a good time to double-down on high-quality core property with predictable cash flows. This market segment will



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benefit from the inflow of hungry capital, the potential for incremental cap rate compression and protection from the macroeconomic risk associated with intensified volatility. Investors with more aggressive risk appetite are anticipated to gravitate toward obvious cycle timing bets that include loading up on leasing risk and quick-fix value-add opportunities as vacancy rates slip below their long-term averages and employment growth drives absorption. Such risks should be comparatively well-rewarded, but investors need to recognize the advanced

stage of the cycle in their investment decision-making processes.

In sum, we posit that "the return of volatility" will be the theme of both macroeconomic and CRE developments for 2015. Volatility itself is not a threat to the solid U.S. commercial real estate performance expected for 2015. It is rather a catalyst that could ignite disturbances in real economic growth or financial market liquidity that would affect real estate later. The return of volatility is therefore a signal for real estate investors to examine their taste for risk and prepare for eventualities.

¹ Blue Chip Economic Indicators®, Volume 40, Number 1, January 10, 2015. ² Blue Chip Economic Indicators®, Volume 40, Number 1, January 10, 2015. ³ Pension Real Estate Association Consensus Forecast Survey of the NCREIF Property Index, 1st Quarter 2015.

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