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US economy

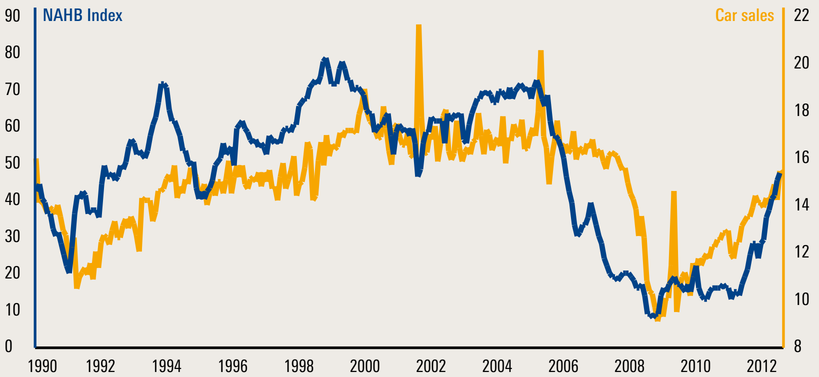
METZLER GERMANY PERSPECTIVE

The outlook for the US economy has meaningfully improved in recent months. It seems that monetary policy is gaining more traction in stimulating private demand amid increasing signs that deleveraging in the financial and private household sector has come to an end. Evidence of this can be seen in the strong recovery of the housing market and automobile sales. Both sectors are very interest rate sensitive and thus a reflection of effective monetary policy. The NAHB/Wells Fargo Housing Market Index has recently climbed to levels not seen since 2006 on the strength of rising single-family housing demand. This demand has a direct impact on growth in the form of new construction, remodeling, and related employment. In a further sign of improvement, automakers sold an estimated 14.5 million vehicles in 2012, a 13% improvement over 2011 and the highest sales year since 2007. With the average age of vehicles on the road just over eleven years, the need for replacements should drive further sales in 2013.

The US economy also benefits from low energy prices and attractive labor costs. The price of natural gas has declined by more than 75% since the 2008 peak and accounts for approximately 25% of total energy demand. The US workforce is becoming more competitive because domestic wages are increasing at a slower rate than many emerging markets. However, there are downside risks to the outlook – mainly from the political side. It is critical that the debt ceiling is lifted in time so that a partial default and shutdown of the government is avoided. All things considered, we expect 2013 to end with GDP growth accelerating to 3.0% as a result of a 4.0% contribution from private sector demand and a 1.0% contraction in public sector demand. The unemployment rate will likely decline to about 7.0%, but this drop may cause a substantial steepening of the yield curve once investors begin to price in the possibility of the Fed raising interest rates much sooner than expected.

USA: monetary policy stimulating demand in interest rate sensitive sectors

Car sales in million units and NAHB index



Sources: Thomson Reuters Datastream, Metzler; as of December 2012

METZLER US PERSPECTIVE

With so much focus on the elections and the fiscal cliff, other developments within the US economy have received relatively little attention. The S&P 500 stock market index has now recovered back to where it stood before the start of the recession in December 2007. Since hitting bottom in March of 2009, this index is up an incredible 120%. After several disastrous failures and near-failures in 2008 and 2009, the banking sector is now much healthier than just a few years ago. Toxic loans are finally being recognized and written-off in an orderly fashion. In addition, more banks are growing and fewer are failing. The number of quarterly bank failures has dropped to the lowest level since the fourth quarter of 2008.

For every positive economic indicator, there are equivalent challenges. Employment is improving, but at a pace that looks nothing like the S&P 500. There are approximately four million less people employed than five years ago, even though the US population has grown by nearly 12 million during the same time. With sluggish projected GDP growth, it is difficult to envision a near-term scenario where job growth outpaces population growth. The remainder of 2013 will likely be a mix of gradual recovery and volatility as lawmakers struggle to make hard, but necessary, decisions about debt burdens and the long-term viability of entitlement programs. Underneath it all, we believe there is a relatively healthy economy just waiting to be unleashed.

Editorial

Uncertainty is a pervasive theme in today's markets. For many, uncertainty has a negative perception and can be a reason to avoid investing opportunities altogether. The problem is that if you wait for certainty to arrive, you pay for it in the form of higher prices and lower returns on risky assets such as stocks, bonds, and commercial real estate. Another way to think about uncertainty is opportunity. Do periods of uncertainty provide opportunities for attractive returns that otherwise wouldn't be available? Metzler's view is that if you are patient, know where to look, and what to look for, the answer is a resounding yes.

Zeb Bradford,
Chief Investment Officer

According to Prudential Real Estate Investors, more than 25% of the world's institutional-grade commercial real estate is located in the US. The US is also the world's third largest country and contains several metropolitan areas that uniquely contribute to both domestic and international commerce. Even in times of uncertainty, this geographic and economic diversity dictates there will be several submarkets likely to outperform macroeconomic averages due to differences in population growth, job growth, supply constraints, or industry specific advantages in sectors such as technology, education, healthcare, or natural resources.

Metzler has always believed and demonstrated that commercial real estate is a relatively inefficient asset class that can be exploited with careful asset selection, active asset management, and tactical market timing. These inefficiencies stem from the fact that no two properties can have exactly the same location, physical attributes, or cash flow generation potential. The combination of inefficiency and uncertain markets provides an opportunity to anticipate and uncover high quality, mispriced assets at a time when others are waiting for an entry point that will likely be too late and too expensive.

Commercial real estate fundamentals

On average, the office sector is continuing a trend of positive net absorption, decreasing vacancy, and gradually rising rents. However, more than two-thirds of the net absorption is occurring in Class A properties as tenants use the opportunity to upgrade into relatively inexpensive space at a time of relatively healthy corporate profits. As a result, Class B and C properties are struggling with elevated vacancies and flat rents. Going forward, office demand will be positive but challenged by increasingly productive and efficient tenants needing less space than before. Over the past ten years, the average lease size for new tenants has fallen by 20%. Relatively little new speculative construction should help balance out some of these challenges.

Property fundamentals continue to improve for the industrial sector. Vacancy rates have recently fallen to levels not seen since the end of 2008. One contributing trend towards improved fundamentals is the reduction in inventory as obsolescence and demolitions are occurring faster than new buildings are being delivered. On the demand side, newer and larger properties in major port and distribution markets are in high demand as traditional and e-commerce tenants look to maximize efficiencies associated with quickly processing large amounts of inventory. For the moment, new construction activity is still well below historical levels. Developers will likely begin seriously considering several new projects in 2013 if vacancies continue to fall.

The retail sector has undergone major structural changes that would not be accurately reflected by looking at average vacancy rates. Demand has been concentrated in a subset of properties that are healthy and productive. Beyond those locations, a wide variety of shopping centers are effectively obsolete. Estimates are that the nationwide retail vacancy rate would be 300 basis points lower if you excluded these "dead malls" with vacancy rates greater than 40%. One

Capital markets

According to Real Capital Analytics (RCA), approximately USD 283 billion of purchase and sale transaction activity occurred during 2012. This represents a 24% increase over 2011 and reflects the results of strong increases in sales of apartment, office, and retail properties. Transactions for industrial and hotel properties were largely flat when compared to 2011. Over USD 98 billion in sales took place in the fourth quarter alone, making it the most active quarter since the last quarter of 2007. Relative to just a few years ago, the growing participation of buyers and sellers is a positive overall trend and a vote of confidence in the future health of the commercial real estate sector. Not only is the number of property sales increasing, but pricing is also moving up. The extent of pricing movement depends on location and property type. Properties within major markets such as San Francisco, Los Angeles, Chicago, Boston, Washington DC, and New York City have drawn a disproportionately larger share of investor capital since the recession. As a result of this divergence, prices in major markets are only down 10–15% from pre-recession highs while non-major markets are still down 25–30%. In terms of property types, apartments are on average only down 7% from pre-recession highs while retail and hotel properties still remain 30–35% below.

With the exception of office, capitalization rates remained flat or moved down only slightly during 2012. This is in stark contrast to 2011 when industrial, retail, and apartment capitalization rates moved down anywhere from 25 to 60 basis points. Given how far average capitalization rates have already fallen since late 2009, this recent deceleration in capitalization rate compression suggests owners and investors will have to pursue other strategies for value creation going forward. Future appreciation returns will most likely need to be generated from growth in net operating incomes, lease-up of vacant space, and active asset management. Despite a flattening of capitalization rates and a persistent cloud of economic and political uncertainty, a growing consensus of debt and equity sources view US commercial real estate as an attractive asset class that offers inflation protection and above average risk-adjusted returns. The current capitalization rate spread over a risk-free alternative such as the 10-year US Treasury yield remains relatively wide and makes a compelling case for further investment activity.

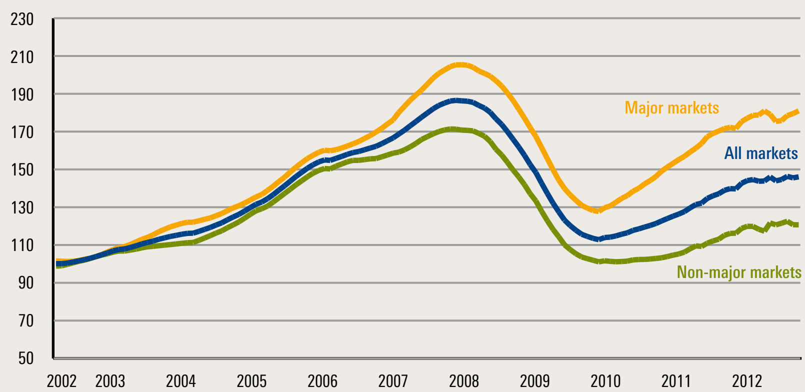
fundamentals continued

contributor is e-commerce sales, growing at three times the rate of traditional retail stores. Fortunately, the threat of speculative new construction is extremely low and expected to remain that way through at least 2013.

Multifamily has had the best recovery of all property types following the end of the recession. The multifamily vacancy rate has dropped by 200 basis points since the end of 2009 (90% of that during 2010 and 2011). When you combine strong demand due to favorable demographics with relatively little new supply, it should come as no surprise that less than 10% of apartment properties with 50 or more units have a vacancy rate greater than 10%. However, significant amounts of new construction are currently underway. The rate of improvement in rent and vacancy fundamentals has already slowed and future movements should more closely follow the pace of job creation.

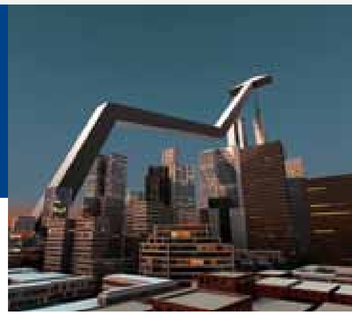
Property values have rebounded for some markets more than others

Moody's/RCA Commercial Property Price Index



Sources: Real Capital Analytics (RCA) and Moody's Investors Service

Index Value, December 2000 = 100



Topic in focus: commercial real estate & the fiscal cliff

When the congressional "super committee" failed to reach an agreement regarding deficit reduction in late 2011, the year-end 2012 fiscal cliff drama was officially set in motion. Unfortunately, the self-imposed deadline of tax hikes and automatic spending cuts 13 months later did very little to force meaningful progress towards deficit reduction, tax reform, and long-term fiscal sustainability. A last minute legislative agreement was patched together to mitigate the tax impact of the fiscal cliff, but some tax and almost all spending and debt reduction decisions were simply delayed and pushed into what could be a very volatile 2013. How has the weight of this uncertainty affected commercial real estate, and what can we expect going forward?

Looking back at 2012, the fear of uncertain political and fiscal policies arguably caused more economic damage than an inevitably controversial, but at least definitive, set of known policies. The potential impact on consumer confidence and consumer spending was reflected in advance by pullbacks in business confidence and business spending. Some decision makers in real estate, particularly corporate tenants, took a wait and see approach to expansions, renewals, and other major investment decisions. This did not mean that 2012 was a step backwards for commercial real estate. In fact, it proved to be a relatively resilient asset class. Net absorption for all major sectors was higher than 2011. Purchase and sale transaction activity was also modestly higher. However, the cautious mood going into the second half of the year likely weakened what could have been a strong period of growth if not for self-inflicted political paralysis.

As we work our way through 2013, the broader commercial real estate markets will hopefully turn from fear of uncertain policies to dealing with actual policies. This is assuming meaningful decisions can and will be made in Washington, DC. The impacts of proposed cuts to the Federal Government, for example, could have significant effects on real estate demand across the country. Cassidy Turley estimates that Federal agencies lease 167 million square feet and major government contractors lease another 208 million square feet. Another concern is the possible upward pressure on long-term interest rates as a result of continued deficit spending and unsustainable debt levels. While we wait for politicians to work out their differences, select industries and submarkets around the country are not waiting around. These strong pockets of growth are expected to persevere and provide relatively attractive returns, despite the volatility of the current political and fiscal environment.

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Sources – Images by istock, panthermedia and fotolia; statistics within commercial real estate fundamentals provided by Property & Portfolio Research (PPR).

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