

# “WHY THE PARTY ISN’T OVER”

*COMMENTARY ON THE REAL ESTATE MARKET IN 2006*

*SEC Registered Real Estate Investment Manager  
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FIRST QUARTER 2006



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## **“Why the Party Isn’t Over”**

### ***Commentary on the Real Estate Market in 2006***

The United States is likely to experience a mid-cycle growth pause for two or three quarters through mid-2006. Serious issues, including the trade and fiscal deficits, a slowdown in housing, and the lingering consequences of the hurricane-related disruptions of 2005, will lower the results of both business and consumer confidence surveys, and raise concerns about the expansion’s sustainability.

The real estate investment community will not be immune from the effects of the gathering uncertainty. We can expect to hear – for the fourth year now – that a real estate bubble exists and that the “smart money” will exit the sector ahead of its bursting. Already, a spirit of caution can be detected in widely-read surveys of the commercial property industry.

***Will the Fed . . . “take away the punch bowl just when the party gets going”? For reasons to be examined below, we don’t believe so.***

A careful reading of economic and market conditions, however, suggests that a timid, much less negative, view of the short and mid-range prospects for real estate could not be more incorrect. A variety of fundamental factors are displaying signs of vigorous growth. For structural reasons, capital conditions for commercial property investment will remain favorable this year and next. Meanwhile, user-market conditions are rapidly improving. Sharp rising in construction costs will set the stage for steep and rapid commercial rent increases as building volumes recover.

Taken together, these factors reduce the probability of a “bursting bubble” in commercial real estate close to zero. As the overly cautious move to the sidelines, this year should be one when the selective,

long-term-oriented real estate investor can execute deals and strategically enhance portfolios.

#### ***What More Could We Wish For?***

Suppose that a 1990’s crystal ball had revealed that, at the start of 2006, the ten-year Treasury note would have a coupon rate just under 4.4% and that the outlook for this benchmark security was a ceiling of 5% for the balance of the year. Most real estate investors would have said “Bottle that, and I’ll take as much as you can provide.” As usual, though, the headline news concentrates on short-run volatility. As such, we tend to lose perspective about where we stand economically and in the condition of real estate markets.

Even those whose only exposure to business news is the Money section of *USA Today* can recite the trends of Federal Reserve interest rate management since 2001. Alan Greenspan and his colleagues first drove the Fed Funds rate down to historic lows, prompting a massive infusion of credit into the economy and unlocking trillions of dollars in home equity. This sustained consumption through a prolonged period of weak employment statistics, and enabled the 2001 recession to be characterized as “short and shallow” by the broad measure of Gross Domestic Product, and has brought us through to 17 consecutive quarters of economic expansion.

#### ***Interest Rates in 2006 – Low, and Stable for the First Time in Years***

Observers of rate trends are well aware that 30-day to one-year Treasuries have risen about 325 basis points in two years. The level of consumer education has improved, too, as the increasing number homeowners needing to make choices among the panoply of mortgage products now available. Those with adjustable rate mortgages clearly took advantage of the wide spread between

ARMs and fixed rate mortgages during the early 2000s. At the beginning of 2004, one-year ARMs had a 220 basis point advantage over 30-year fixed mortgage rates. That spread has been cut in half and, unsurprisingly, consumers have been shifting their preferences to hybrid ARMs, where they can lock in a low initial rate for 3, 5, or 7 years.

If the ordinary homeowner is making relatively sophisticated risk-reward calculations in a shifting interest rate environment, even more are institutional investors and others active in the commercial real estate markets watching the movement of the Yield Curve. When the Fed began to signal its intentions to snug up rates, it was widely anticipated that long-rates would nudge upward in response to the Fed's pressure at the short end of the market. The Liquidity Preference theory of the Yield Curve says that, because lenders will prefer to be paid back quickly while at the same

down: will the Fed, in former Chairman William McChesney Martin's memorable phrase, "take away the punch bowl just when the party gets going." For reasons to be examined below, we don't believe so.

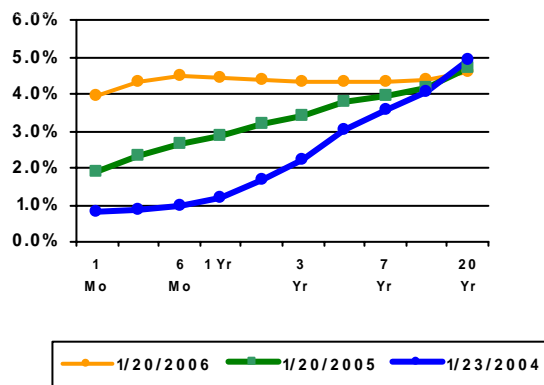
### ***Market Is Confident That Inflation Will Be Controlled***

Essentially, the market has made up its own mind about the economy and the implications of monetary policy. The disciplined approach of the Fed in re-adjusting rates upward once employment began to recover confirmed the market's confidence in the Fed's inflation vigilance, and suggested that long-rates in the 4% - 5% range represented realistic returns (a real risk-free rate plus an inflation premium) that were sustainable. For structural reasons (discussed in our essay "Is Real Estate Liquidity 'Excessive?'" last summer), there is tremendous ongoing demand for longer-maturity instruments, keeping prices at the long end high and rates low. The Treasury could attempt to manage this by increasing the supply of long bonds, but that does not appear to be in the cards.

The Bond Market Association's January 2006 forecast anticipates \$22 billion in 10-year Treasury issuance for the first quarter of this year, compared with \$23 billion in 10-year notes in the final quarter of 2005. The BMA therefore predicts a consistently flat yield curve deep into 2006. Their median projection (based upon a members' survey) is a 5 basis point spread between 2-year and 10-year treasury yields at the end of 1Q2006, and an even thinner 2 bp spread at the end of the second quarter. The vast majority of the \$169 billion in Treasury product in the first quarter will be at the short end of the market, although a \$15 billion sale of 30-year bonds is anticipated in February. If there is a risk of accelerating inflation pushing rates up, the survey respondents see counter-balancing downside pressure from a slowing housing sector and softer consumer demand.

So the most probable path ahead is established by an interest rate environment that is low and stable. After the roller coaster of the past five years, investors will like the idea of stability, and real estate investors will like the stabilization of rates at such modest levels even more.

**Treasury Yield Curve Shift**  
**Market makes up its own mind on Fed Policy**



Source: Federal Reserve H.15 weekly reports

time, borrowers want to hold on to loans for as long as they can, longer duration instruments should bear higher rates than shorter maturities. And the "normal" shape of the yield curve – upwardly sloping and concave – reflects this.

When current inflation is very high and/or the Fed otherwise considers the economy in danger of overheating, monetary policy may invert the yield curve – usually signaling a recession ahead. The flattening of the yield curve over the course of the past quarter or so would typically be interpreted as a sign that the Fed is ready to slow the economy

### ***A “Mid-Cycle Growth Pause” is Likely***

That is not to say that there will not be voices seeking to ratchet up anxiety. Indeed, we expect that there will be at least a few Nostradamus-like predictions of recession on the horizon. The preliminary GDP numbers for the final quarter of 2005 have already set the pessimists to their keyboards.

Compared with the 4.1% growth rate in the 3Q05, the 1.1% gain in real GDP for the final three months of the year was a marked change. Although the figures released on January 27<sup>th</sup> were preliminary, and subject to revision when more complete data are available, the statistical causes for the slowdown were broadly based. Personal consumption expenditure growth dropped exactly the same as GDP as a whole, from 4.1% to 1.1% - understandably, since consumption now represents 70.6% of GDP.

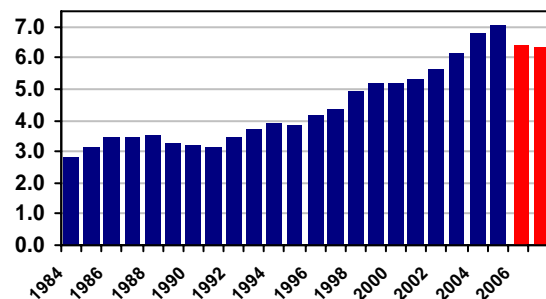
Imports rose by nearly \$40 billion, and the trade deficit of \$650 billion reduced GDP by 1.2%. Fixed investment showed sharply reduced growth, mainly in the transportation equipment category, swinging from \$5.6 billion in expansion in 3Q05 to a \$7.7 billion contraction in 4Q05. Many were astonished by the puzzling \$17.4 billion reduction in defense spending in 4Q05, and, on the heels of the President’s State of the Union address, expect that to reverse sharply. Lastly, residential investment growth slowed to \$14.4 billion, compared to \$36.8 billion in the previous quarter.

***All things considered, it looks like we are going to be experiencing a “mid-cycle pause” in GDP growth over the next two or three quarters.***

This last figure was seized upon as evidence that the housing boom is over. Although, it is likely that the peak has passed, an honest look at the numbers will show that 2006 should be a good year for housing at least by most historical standards. Fannie Mae projects starts and existing sales in 2006 to dip, but to remain higher than any of the years between 1983 and 2003 – hardly a collapse of the residential

sector. Total housing starts are anticipated at about 1.9 million units, and existing home sales at 6.4 million houses.

**Existing Home Sales**  
**A New Record in 2005, But Down in 2006**



Source: National Association of Realtors, Fannie Mae forecast

### ***Regional/Industry Performance: A Closer Look***

Lurking behind the economic performance in the fourth quarter were the lingering effects of the storms of 2005. Population dislocation and workplace disruptions rippled through the economy. As the map of Statewide Employment Change clearly illustrates, Louisiana and Mississippi showed year-over-year job declines of 196,700 and 24,300, respectively. Exacerbating the picture, troubles in the domestic automobile industry caused Michigan to lose 25,100 jobs over the year and drove Ohio down to zero growth (a 1,800 job gain in a 5.5 million job state these two regional stories dampened what would have been a strong year of job gains nationally, and mask the acceleration of growth in several other parts of the country, especially in the Pacific Northwest (Washington and Oregon) and the Intermountain West (Arizona, Utah, and Idaho). Nevada still leads the nation with a 5.8% growth rate in jobs, while Florida and California set the pace with employment gains of 250,400 and 234,100, respectively.

With the exception of the transportation sector, we should find business fixed investment accelerating at a double-digit pace in 2006. The Industrial Production Index rose 2.8% in the twelve months ending December 2005, with the Business Equipment component soaring 10.1%. Total capacity utilization is at 80.7%, virtually identical to

the 1972 – 2004 average of 81.0%. Typically, investment picks up at this stage, picking up some of the slack from the consumer side of the economy.

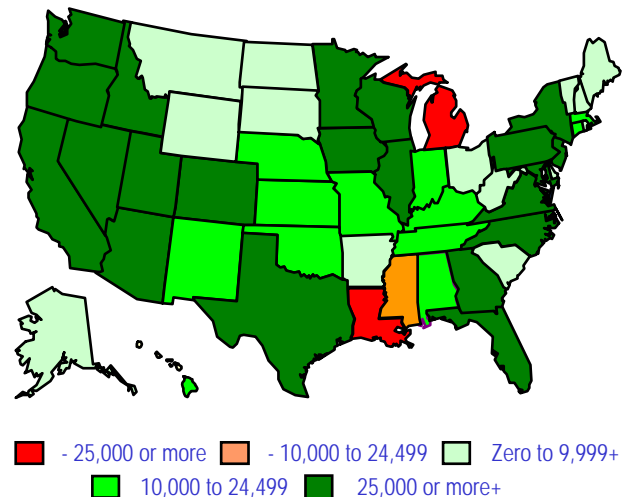
Revenues have been up in the Services sector of the economy, with year-over-year gains of 5.0% in the Information cluster and 8.9% in the Professional/Scientific/Technical category. Many of the key office-using industries have been growing revenues more than 10% in the past year – including Architecture and Engineering (14.7%); Management Consulting (12.2%); Information Services (11.5%); and Advertising (10.9%). Such revenue trends should lead to further hiring in these sectors during 2006, driving the economy forward. Hospitality is another area showing solid growth, a 13.2% increase in revenues for the year.

Finally, the financial industry is doing very well. Mergers and acquisition volume has spurred the Investment Banking segment to a level where bonus payouts are estimated to be \$25 billion by the Securities Industry Association. All told, the nation's major office markets ought to see excellent demand in the coming year. In addition, bonuses will fuel spending on luxury goods, including high-end resorts and high-priced housing.

So there are definitely mixed economic signals for the year ahead. Some of the bad news won't go away soon. Both the trade deficit and the Federal budget deficit will get worse before they get better. The stimulus of the housing boom is easing. The auto industry will lay-off tens of thousands of workers. New Orleans, like New York before it, will find that promises of Federal disaster aid are quickly made and slowly kept, if at all. Consumers will be more cautious as a rule.

However, on the plus side, jobs are on the rise in 47 of the 50 states – with 21 states posting gains of 25,000 per year or more. The Technology Sector is recovering smartly. Manufacturing output is up, and goods exports rose \$55 billion in 2005, a 6.9% gain with room still to improve. Corporate profitability is high and the stock market finally looks like it will respond to earnings growth. The outlook for business investment is positive under these circumstances, especially in an environment of low and stable interest rates.

### Job gain/loss For the year 2005



Source: U.S. Department of Labor

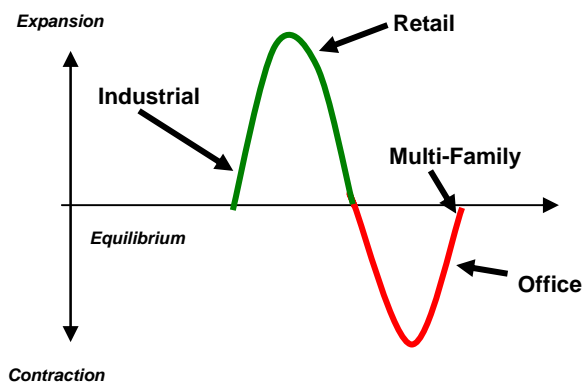
All things considered, it looks like we are going to be experiencing a “mid-cycle pause” in GDP growth over the next two or three quarters. Growth should be positive, but attenuated. It is possible that we will see the percentage gains in employment be higher than the percentage gains for real GDP – something that many have forgotten can happen! But a review of not-too-ancient history shows that this occurred in several quarters between 1992 and 1996, before the late-decade boom that had GDP expanding at 4% and jobs growing at 2% until early 2000.

### *Implications for the Real Estate Sector*

According to the 2006 edition of *Emerging Trends in Real Estate* (jointly published by the Urban Land Institute and PricewaterhouseCoopers), the size of the investable real estate market is approximately \$3.5 trillion. Obviously, in an asset class of such magnitude, strategic objectives will vary from investor to investor. Even more so, tactical choices that fit one risk-reward profile may not suit some others. The spectrum of opportunities is, in fact, one of the great strengths of the real estate field. Both investors seeking high and steady income returns as well as those primarily seeking growth via turn-around opportunities can find assets matching their needs.

From the standpoint of fundamental market conditions, most property types are at favorable places in the vacancy cycle. Grubb & Ellis' research head, Robert Bach, prepared the accompanying graph to illustrate the situation as of January 2006. Retail is near its peak, consistent with our observation of slowing consumption in the year ahead. But office, industrial, and multifamily are on the upslope leg of the cycle. This predicts higher levels of occupancy and upward pressure on rent as the background music for the industry over the next two to three years.

### Property Type Cycles as of January 2006



Source: Grubb & Ellis

With “core” properties in top cities so richly priced, yield-oriented investors will have to cast a wider net, with a consideration of the full range of U.S. economic geography, a sensitivity to market timing in still-oversupplied areas, an openness to development and redevelopment opportunities, and an eye for acquisitions that can be enhanced by skilled hands-on management. Cap rates have likely bottomed out, though they are not under any pressure to rise appreciably. User markets are firming, the capital pool remains deep, and the cost of funds is predicted to stay steady. Solid assets can be held, especially if Net Operating Income levels will be rising as early 2000s leases expire and occupancy tightens. Institutions still under-allocated to real estate will derive portfolio benefits by adding to their real estate “core” even at high prices. Contrary to many popular alarms, pricing risk for high-quality commercial real estate assets is actually quite low at the present time.

Many assets, though, harbor significant unrealized capital gains. Investors should be examining portfolios for properties that have matured to a point where they have met or exceeded their going-in investment objective, and reaping the profits. The point should be to emerge in the next year or two with the highest quality mix of assets in the core, and have some redeployment of capital into real estate’s growth sectors.

Where might one look for such opportunities? In the office sector, one can look at a matrix of markets where vacancy is already below 14% and absorption is running a million square feet or more annually. These markets will be approaching equilibrium sooner than later, and should have the greatest acceleration in property net income. Beyond the already soaring markets like Manhattan, Washington DC, and southern California, such characteristics can be found in northern California’s Silicon Valley and East Bay areas, in Seattle and Phoenix, and in the south Florida markets of Miami and Ft. Lauderdale.

Retail assets are especially nuanced. Nationally, income disparities have widened and mid-market malls are threatened at both extremes – by discount centers and by luxury goods purveyors. Markets with strong population growth, a higher-than-average net worth profile, and regional barriers to entry have the best prospects. The exceptional bonuses on Wall Street this year will add \$21.5 billion to the New York regional income pool, and New York has added 160,000 new residents – in the City alone, not the metro area – so centers surrounding Manhattan fit the profile. For neighborhood centers, some of the Sunbelt metros are regaining their luster and places like Dallas, Houston, and Atlanta are worth an examination for those who understand that new competition will always be emerging on the horizon.

In the industrial sector, core investment in the major import/export markets on both coasts maintains the advantage of excellent fundamentals and, as trade volumes increase, so too will basic demand for warehouse space serving the logistical firms. As some of the large shippers begin to stage their overseas distribution at the places of origin, particularly in China, industrials will see some demand leakage in the years ahead. But this is a

problem of abundance, not a sign of weakness for U.S. warehouse properties.

The opportunities in industrials lie in the volatile R&D/flex sector. Technology is once again in the ascendancy as an economic force, and as office markets tighten we will once again be seeing spillover demand from conventional office buildings into flex space. Attributes of well-landscaped parks with excellent automobile access and separation from heavy truck traffic will be sought by those prospecting this industrial subgroup. Continued development in excess of 300,000 units per year has limited the potential for rental apartments to increase revenues significantly. That is not likely to change in the near future. Cap rates for apartments are exceptionally low, averaging 6% for garden apartments and nearly 5% for mid-and high-rise projects, according to Real Capital Analytics data. The high end of the market, particularly, looks vulnerable as most of the development has been targeted there. Meanwhile, with condo activity (conversions and new construction) superheating that market, investors should be aware that the fall-back position for speculators is dumping units back onto the rental market, so caution is urged.

***This year could provide a wonderful opportunity for selective investors to glean assets from a market less overheated and nearer to the next upward valuation.***

### ***Revival of Commercial Construction the Major Change after 2006***

The critical feature of the century's first real estate cycle has been continued low levels of construction for office, retail, and industrial properties. Reasonable as it may be given the sharp increase in vacancy after 2000, this stands in sharp contrast to the behaviors of developers and their financiers in the vacancy run-up of the late 1980s. Lenders learned the hard lesson of discipline in the face of weak occupancy, and have not allowed speculative building despite the enormous capital pressure for product. In its first real test of the industry "reforms" of the post-RTC era, commercial development has passed with flying colors.

When space become scarcer, however, and user-demand higher for new facilities, price shocks will appear. Building costs have increased tremendously during the construction lull, with *Engineering News-Record's* Building Cost Index rising more than 20% during a time when commercial rents are still working their way back to late 1990s levels. Once development returns, rents will need to adjust sharply upward to meet the feasibility requirements in construction pro formas, triggering the next wave of appreciation. Only market conditions passing the threshold where existing inventory is not sufficient to accommodate user demand is necessary. We will not have to wait until the end of this decade to see that day dawn.

### ***2006 – A Year to Separate from the Herd***

Most of the industry-wide prognostications, such as *Emerging Trends*, have been counseling an investment pull-back. Sentiment favors selling over buying, and a "hold" recommendation is considered the optimist's position. Frankly, it is to be hoped that many, many investors will blindly follow this advice in 2006, even if it is wrong-headed. As the herd takes the counsel of timidity, this year could provide a wonderful opportunity for selective investors to glean assets from a market less overheated and nearer to the next upward valuation.

A mid-cycle pause in GDP growth will encourage the conservative investors to adopt the "wait and see attitude." A chorus of concern can be expected as a couple of weak quarters of economic news are reported. None of this will negate the very powerful realignment of forces that define the late-decade market: a deep capital pool available for real estate investment, cap rates that will be sticky upwards, occupancy rates better than in the first half of the decade, and a sea-change in rents as construction cost increases are priced into building operating economics.

For investors who are committed to the asset class for the long-haul, and who are convinced that cyclical change is an embedded feature of the property markets, this is not the time to go to the sidelines. It may be a very smart time to be attentive, active, and even acquisition-minded.