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A look at signs of economic recovery from National Association of Realtors

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A look at the economy from George Ratiu, NAR Research Economis : The third quarter of 2009 brought signs of relief to a U.S. economy fighting to emerge from what has been coined the Great Recession. Most measures of economic activity moved in upward trendsâ€”gross domestic product turned positive after four quarters of decline; industrial production gained; stock market indices have been surging.

However, commercial real estate did not find its footing in the constantly shifting terrain of weak fundamentals and timid transaction activity. Demand for commercial properties continued on a downward path, adding pressure on prices and rents. Moreover, credit conditions continued to tighten as banks moved to strengthen their balance sheets. As a result, vacancy rates have been rising and the volume of distressed properties has grown. Nonetheless, it is worth noting that the pace of decline in fundamentals is slowing, and sales transactions are posting positive growth.

Following four consecutive negative quarters, gross domestic product (GDP) rose 2.8% in the third quarter of 2009. The increase was prompted by improvements in all GDP components. Consumer spending moved up 2.9%, driven by strong activity in durable goods consumption. In particular, motor vehicles and parts spending jumped 43.4% during the quarter. The spike was a direct result of the 'cash for clunkers' program.

Investments posted a solid 8.4% gain, mostly due to contributions from equipment and software (up 2.3%) and transportation and related equipment purchases (up 26.5%). More pertinent to commercial real estateâ€”nonresidential investment was down 4.1%, with investment in commercial structures declining 15.2%. Government spending also provided additional boost to the GDP figures with a 3.1% increase in spending, mostly at the federal level. While both export and import activity was up for the quarter, the net exports figure made a negative contribution to GDP.

Underlying these positive changes are several factors. Industrial production was up 5.6% during the third quarter, after five consecutive quarters in negative territory. Manufacturing activity posted a 7.6% gain, while mining rose 4.0%. Production of raw materials was also up, with coal production rising 17.4% and primary energy materials increasing 1.4%. Moreover, retail sales gained 7.1% - attributable in large part to auto sales. However, even when excluding auto sales, retail sales advanced 4%.

Yet, while the economy is slowly coming back to life, several issues continue to cast long shadows over prospects of recovery in general and commercial real estate, in particular. At the heart of these issues lies employment. Payroll employment has been on a steep decline for the past 22 months. Over this period, 7.3 million jobs have been lost. The unemployment rate jumped from 7.2% in December 2007 to 10.2% in October of this year. And while the rate declined slightly to 10% in

November, the near-term expectations point to a continued rise in the unemployment rate.
In addition, consumers and businesses are wary of the impact that current legislation packages being considered in Congress coupled with mounting state budget deficits will have upon the economy.

How are these factors impacting the commercial real estate outlook? In brief, the next quarters will likely be a difficult march toward stabilization, punctuated by modest signs of improvement. The experience is not likely to be spread evenly across property types or geographical markets. Whereas office properties struggle with high vacancies, declines in rents for industrial space are expected to grow. And while demand for apartments is projected to rise in 2010, challenges continue to mount for distressed hotel and retail properties.
For the fourth quarter 2009, net absorption is expected to decline 18.7 million square feet for office space and 74.9 million square feet for industrial properties. Retail space is likely to post 4.4 million square feet of negative net absorption. Even apartments are expected to witness a quarterly decline of 44.7 thousand units in net absorption. In tandem with the decline in demand, available space is growing across all property types. Vacancy rates for the fourth quarter are expected to hit 17.0% for office properties, 14.2% for the industrial sector, 12.6% for retail and 7.8% for multi-family. In order to attract or retain tenants, landlords are reducing rents. By the end of 2009, rent rates are expected to be down 12.1% for office properties, 10.8% for industrial, 1.3% for retail and 4.1% for apartments.
On the transaction side, sales activity has been positive, but slow and stuck in a vicious cycle where lack of credit is maintaining a negative spiral. Based on the latest Quarterly Banking Profile from the Federal Deposit Insurance Corporation (FDIC), the banking industry continues to be fully engaged in the deleveraging process.
During the third quarter of 2009, loan balances at commercial banks declined 2.8% from the previous quarter, the largest percentage drop in 25 years. Lending contracted mostly sharply for construction and development loans, which were down 8.1% from the second quarter, to $492 billion. At a volume of $1.27 trillion, commercial and industrial loans posted the next largest declineâ€”6.5%. Banks increased their holdings of conservative assetsâ€”Federal Reserve banks' balances gained 36.7%, to $531 billion, and Treasuries advanced 49%, to $86.6 billion. These moves have strengthened banks' capital levels and vaulted them into profitability. Equity capital increased 2.9%, to $1.46 trillion and the FDIC stated that regulatory capital ratios have hit the highest levels in 19 years. For the third quarter, banks posted earnings of $2.8 billion, a dramatic change from the second quarter's $4.3 billion loss.
Nonetheless, in an encouraging sign for commercial real estate, the commercial mortgage backed securities (CMBS) market regained a pulse around midyear, sparked in part by the government's TALF program, with over $1.2 billion issued during the third quarter. The Federal Reserve also extended funding for the TALF program into 2010 for both new and legacy CMBS issues. In addition, the Fed also issued a policy statement in support of commercial real estate loan modifications, given declines in cash flow, asset prices and low transaction volume.
Additionally, recoveries in global economies and rising international cash reserves are prompting investors to start looking for deals. Transaction activity during the third quarter of 2009 rose 27.4%, with 677 major properties exchanging hands for a total of $13.1 billion. The advance in commercial property sales was driven by an 85% jump in office sales. The volume of retail and hotel sales also increased noticeably, by 46% and 40%, respectively. Apartment transactions were up 12%, while

industrial sales declined 32%.

Deriving from these factors, it becomes apparent that commercial real estate is facing a quick-changing landscape where maturing debt, loan modifications, lower prices and private investment currently vie for a foothold. Central to any market stabilization and sustained recovery is the issue of employment and credit availability. More to the point, a positive shift in employment and financing activity are both needed to place commercial real estate on solid ground.

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