 

SIOR Index – Office and Industrial Conditions Continue to Improve in Second Quarter 2010

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NAR Economic Overview

Economic activity continued on a positive growth trend during the second quarter of this year, but at a slightly slower pace. Based on the Bureau of Economic Analysis's first estimate, all major components of gross domestic product (GDP)—except net exports—registered advances. Following growth in manufacturing activity, employment also gained during the quarter. At the same time, commercial real estate is seeking a platform for recovery. While vacancy rates remain elevated and rents continue to decline, leasing activity has picked up.

However, concerns over the direction of the economic recovery remain. Capital markets continue to be tight, even as private sources of financing have been growing. And the slowdown in the housing markets has been clouding the economic horizon.

While at a slower pace than the first quarter, GDP rose 2.4 percent in the second quarter of 2010. The growth was underpinned by solid advances in business investments, along with positive private and government consumption. Mirrored by positive earnings reports, businesses stepped up their spending. Business investments jumped 28.8 percent in the second quarter, the second highest rate since the second quarter of 2000. The investments were particularly evident in industrial equipment (up 50.4 percent) and transportation equipment (up 57.4 percent), as well as computers and peripherals (up 33.6 percent). Reversing the negative trend of the past two years, business spending on commercial buildings turned positive in the second quarter, growing 5.1 percent.

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As the summer season approached, consumers maintained a cautious-yet-positive approach to spending. Personal consumption expenditures increased 1.6 percent in the second quarter. Spending rose for goods (up 3.4 percent) and services (up 0.8 percent). Consumers increased their spending on durable goods—both motor vehicle and furniture purchases advanced 9.6 percent, while purchases of recreational goods and vehicles increased 7.9 percent. In the nondurables category, consumers chose to spend more on clothing and shoes (up 6.5 percent) then food and beverages (down 2.6 percent), or gasoline and other energy goods (up 0.7 percent).

Meanwhile, spending on services posted a more muted rise of 0.8 percent. Consumer spending on health care, transportation, and financial products, as well as lodging and restaurants, increased during the quarter. Spending on household, utilities, and recreation declined.

The gain in business and consumer spending was also reflected in the level of international trade activity. While the balance of trade was negative in the second quarter, both exports and imports registered growth. Exports increased 10.4 percent in the second quarter, driven by a 14.1 percent advance in goods and a 2.2 percent gain in services. Meanwhile, imports jumped 28.8 percent on a wave of incoming goods.

Government spending—the other major GDP component—rose 4.4 percent in the second quarter. The growth was motivated by stimulus spending at the federal level (up 9.1 percent) coupled with a moderate increase in spending at the state and local levels (up 1.3 percent).

With the pace of economic recovery moderating, the upward employment trends have tempered. It is worth noting that over the first six months of this year, the economy added nearly a million new jobs. But even without the Census-related government hiring, nearly 600,000 private sector jobs have been added in the first six months. The job creation pace is welcomed but frustratingly slow. At this pace, it will take five or six years to bring the unemployment rate back down to the normal range of 5 to 6 percent.

In the private sector, the bulk of new jobs were created in service industries. During the second quarter, service-providing industries added 285,000 jobs compared with 72,000 in goods-producing industries. Looking across industry sectors, the employment gains were unevenly distributed.

Professional and business services added a robust net 121,000 payroll jobs in the second quarter in addition to 111,000 added during the first quarter. The trade, transportation and utilities sectors also added 58,000 workers to payrolls. On the other hand, information industries lost 16,000 jobs and finance, insurance and real estate shed 26,000 jobs, marking the fourteenth consecutive quarter of negative growth. However, there were a few more positive developments. In tandem with the traditional travel season, leisure and hospitality industries gained 66,000 net jobs. And the education and health

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sectors maintained the long-term trend, adding 91,000 jobs.

The employment figures are a crucial component of a sustained economic recovery. Yet the growth in jobs remains slower than expected. Unemployment insurance claims have risen from 450,000 in March of this year to 466,000 in June. In addition, although the number of people receiving unemployment insurance has been declining, it has yet to drop below 4.5 million. The unemployment rate declined from 10.6 in January to 9.5 in June 2010, but it is likely to remain elevated for the remainder of the year.

With the economy providing mixed signals, consumers continue to maintain a cautious outlook. Both main measures of consumer confidence and sentiment are pointing downward. Based on the University of Michigan Consumer Sentiment Index, consumer sentiment fell to 67.8 in July—the lowest level in eight months. The index tends to be at around 100 or higher during economic expansionary years. In addition, the consumer confidence index compiled by the Conference Board, also declined from a high of 62.7 in May to 50.4 in July of this year. This measure looks at respondents' general feelings about the job market and their finances. These indicators illustrate areas of concern regarding the economy and overall direction of the recovery.

SIOR Index Results

The results of the July 2010 SIOR Index reflect commercial real estate conditions which follow the moderate upswing of the economic recovery. Fundamentals in office and industrial markets remain challenged—new construction is still nonexistent, vacancies remain elevated, and prices are very low. However, respondents in several areas indicate that declines are slowing and some local economic environments are improving.

The Commercial Real Estate Index, representing second quarter 2010 data, advanced 2.8 points. The national index, based on 10 variables pertinent to the performance of U.S. industrial and office markets, moved up to 41.0. The index reveals improvements in the office and industrial sectors—the office index rose 2.9 points while the industrial index gained 2.4 points. The pace of recovery in the national economy remains a major concern, especially in light of the employment situation. Geographically, all four regions recorded growth.

SIOR Commercial Markets

July's SIOR Index data represents the third consecutive quarterly advance, pointing to the likelihood that SIOR markets have hit bottom and are stabilizing. While office and industrial fundamentals remain weak, with soft demand for space, high vacancies, and low rents, the same environment provides increased opportunities for tenants and investors.

Leasing activity remains tentative but is showing signs of life in parts of the country. Practitioners reported that traffic has picked up and businesses have been searching for better rates or for upgraded space at the same rates. The level of tenant concessions mirrored this trend. SIOR members mentioned that landlords continued to offer generous incentives to attract or retain occupancy.

While investment activity was moderate during the second quarter, the overall level was unchanged from the first quarter. For some respondents, that meant no transactions, even though, based on prices, the market favors buyers. Tight credit conditions and the reluctance of banks to lend are cited as the main

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reasons for the current environment. Construction of commercial space is still practically nonexistent. With vacancy rates in the double digits and no credit available, the expectations for new construction remain subdued.

Notably, the survey results pointed to improving conditions in local economies. However, the upticks were not evenly spread. The office and industrial markets in the Northeast posted comparatively stronger fundamentals. In an encouraging sign, the Midwest recorded the largest point advance of all regions during the second quarter. And while the markets still have a long way to go towards recovery, SIOR members' expectations remain cautiously optimistic—57 percent expect the market to improve.

SIOR Outlook

The second quarter survey confirms that commercial real estate is still in a weakened state. The economy has been growing, but the pace slowed at the half-year mark. Employment remains a major concern despite positive corporate earnings reports and profits. The banking sector has regained its poise, yet credit availability has not followed. In addition, major legislative initiatives whose impact has yet to be quantified are sounding a note of caution for businesses and investors. Barring an unexpected downturn in the broader economy, SIOR members expect another modest uptick for the next quarter.

METHODOLOGY

The SIOR Commercial Real Estate Index is constructed as a "diffusion index," a very common and familiar indexing technique for economic measures. Other examples of diffusion indexes include the Index of Leading Economic Indicators, the Consumer Confidence Index, and the Institute of Supply Management's Purchasing Managers' Index. In the SIOR Commercial Real Estate Index, a value of 100 represents a well-balanced market for industrial and office property. Values significantly lower than 100 indicate weak market conditions; values significantly higher than 100 indicate strong market conditions. The theoretical limits of this Index are a low of zero, and a high of 200, though it is unlikely that such limits would be approached as long as the property markets are operating efficiently.

The Index is based on a survey questionnaire with ten topics. The topics covered are (1) recent leasing activity; (2) trends in asking rents; (3) trends in vacancy rates; (4) subleasing conditions; (5) levels of concession packages in leases; (6) development activity; (7) site acquisition activity; (8) investment pricing levels; (9) the impact of the local economy on the property market; and, (10) the effect of the national economy on the property market. Survey respondents are given five choices. For each topic, five choices are provided, corresponding to conditions that are very weak, moderately weak, well-balanced, moderately strong, or very strong.

For each question, answers are tallied and the percentage of responses for each of the five choices is calculated. If survey panelists indicate "very weak" conditions (the "a" choices in the questionnaire), the answer is assigned 0 (zero) points; "moderately weak" ("b" answers) earn 5 points; an indication of "market balance" ("c") receives 10 points; "moderately strong" indications ("d") score 15 points; and "very strong" ("e") responses receive a maximum 20 points. Thus a score of 10 for a given question can be earned if responses are evenly distributed across all five choices, if all responses were "c", or if the answers form a "bell-shaped curve" centered around the "c" choice. The total index value is derived by summing the scores for all ten questions. Index values for each of the two property types are similarly calculated.

The survey was developed by Hugh F. Kelly, CRE, clinical professor at New York University, who worked with SIOR on research projects from 1989.