 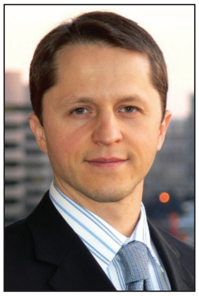

SIOR Index—Office and Industrial Markets Show Signs of Advance in First Quarter 2010

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NAR Economic Overview

The first quarter of 2010 offered positive signs that the economy is maintaining the growth pattern reignited in the latter half of 2009. Several economic indicators continue to point to a moderate but steady economic recovery. Housing is showing signs of stabilization, industrial production has been growing, and international trade activity has been advancing. There is evidence of optimism permeating the economy. However, there are still measures that are tempering that mood, especially for commercial real estate.

The Leading Indicators

The Conference Board Leading Economic Index rose 1.4 percent in March, on the heels of a 0.4 percent advance in February, and an additional 0.6 percent rise in January. Meanwhile, the Coincident Economic Index is inching up—0.1 percent in both February and March.

Wholesale Trade

Wholesale trade, another major indicator of economic activity, gained ground with February results showing moderate sales improvement having gained 9.8 percent from February 2009 and standing at $338.7 billion in February 2010. Durable goods sales increased 6.5 percent from February to February. Automotive products (vehicles and parts) led the list of goods with the largest increase in sales—up 2.4 percent from January. At the same time, sales of nondurable goods rose 12.6 percent on a year-over-year basis. Wholesale businesses have also increased their inventories in anticipation of continued growth in sales. The changes should translate into slightly higher demand for warehouse and industrial spaces, a fact that was picked up in the first quarter results of the SIOR Index.

International

International trade gained ground in the first quarter. Indicating a likely bump in consumer optimism, imports rose 1.7 percent in February—more than was expected. Exports of consumer goods increased at a slower 0.2 percent pace, leading to a widening of the trade deficit. February's trade deficit increased to $39.7 billion from a revised $37.0 billion in January. On a yearly basis, growth in February exports was 14.3 percent. At the same time, import growth increased 23.3 percent in the 12 months leading to February.

It is worth noting that both imports and exports posted growing prices, mostly driven by upward pressures from oil prices. While the increase in prices is not significant enough to suggest inflation concerns worldwide, inflation is one of the key indicators weighed by the U.S. Federal Reserve when deciding on short-term interest rates. Given the U.S. economy's moderate pace of improvement, inflation continues to remain subdued.

Employment

A major reason for the economy's tempered recovery is employment. Businesses have experienced a sharp increase in productivity over the past year. After a modest 0.9 percent rise in output per hour during the first quarter of 2009, productivity jumped by 7.6 percent in the second quarter, 8.0 percent in the third quarter, and 7.6 percent in the final quarter. Corporate profits have been rising robustly as a result. In light of these gains, businesses have increased their hiring, but at a slower pace.

Based on the latest data from the Bureau of Labor Statistics, payroll employment rose slightly with March posting a 1.5 percent advance. Goods-producing industries registered gains, with manufacturing adding 22,000 jobs in January, 6,000 jobs in February, and 17,000 jobs in March. Service-providing industries posted noticeable growth as well—46,000 jobs in January, 55,000 jobs in February, and 82,000 jobs in March.

However, the pace of employment does not match the pattern of growth normally associated with historic economic recoveries after recessions. Although the volume of unemployment insurance claims is still high, the number of initial claims has been steadily declining since March 2009, when it hit 643,000. In March 2010, initial claims totaled 450,000. Nonetheless, the number of people receiving unemployment insurance in March hovered around the 4.6 million mark.

Consumer Confidence

Given the uneven pace of recovery, consumers are feeling uncertain. Two measures of consumer confidence and sentiment illustrate the mixed mood. According to the University of Michigan Consumer Sentiment Index, consumer sentiment fell to its lowest level in four months—69.5 in the first half of April. While general economic conditions show signs of improvement, the high unemployment rate is evidently holding back consumers confidence about the economy. This survey generally questions individuals on financial wealth and the results tend to follow the stock market index. However, the decline in April suggests that most people are not participating in the stock market recovery; rather, they are very concerned about the job market conditions. During economic expansionary years, the index tends to be around 100 or higher. It was 89 in the 2001 recession, and following the dot-com bust, it fell into the 60s in 2008 and 2009. Today's figure of 69.5 suggests a long road ahead to fully regain consumer confidence.

Separately, the Consumer Confidence Index compiled by the Conference Board, showed an increase in April. This measure looks at respondents' general feelings about the job market and their finances. The index rose 11.0 percent in April, compared with the prior month. However, the increase is from very depressed levels, and the index is still far below what can be considered as normal. These indicators point to the fact that we are not yet fully out of the woods. The job market is still on the edge. The likely contributors to the increase in consumer confidence are the huge jumps in the stock market and the recent stabilizing of the housing market.

SIOR Index Results

In tandem with an economy improving at a moderate pace, the results of the April 2010 SIOR Index show a commercial real estate market that has found bottom and that is looking up. It does not mean that the sector is out of the woods—SIOR practitioners indicate that fundamentals of vacancy and rents continue to be extremely weak. But conditions related to credit availability and transactions are improving incrementally. In addition, SIOR members' expectations for the next quarter are more positive, a trend that has been rising for the past three quarters.

The Commercial Real Estate Index, representing first quarter 2010 data, advanced 2.7 points. This national index, based on 10 variables pertinent to the performance of U.S. industrial and office markets, moved up to 38.2 (A score of 100 indicates a balanced market.). The index highlights slight improvements in both the office and the industrial sectors—the office index was up 2.7 points while the industrial index rose 2.9 points. The pace of recovery in the national economy remains a major concern, especially in light of the employment situation. Geographically, three of the four regions posted growth with the Midwest declining 0.4 points during the first quarter.

SIOR Commercial Markets

As indicated by the rise in the index value, SIOR markets are stabilizing from the deep slide of the past three years. The advance does not hide the reality that market conditions continue to be challenging. Office and industrial fundamentals remain soft, distinguished by weak demand for space, elevated vacancy rates, and rents still trending downward.

Although leasing activity remains muted, traffic has picked up and practitioners are reporting increased interest from tenants looking for better rates. The trend is not surprising, given the high vacancy rates and rent values that continued to slide in the first quarter. Moreover, sublease space remains abundant, placing tenants in an advantageous negotiating position. SIOR members mentioned that significant concessions are still needed to either attract new tenants or retain existing ones.

Investment activity remained low in the first quarter, with many respondents reporting no sales activity. The lack of transactions comes in spite of dropping asset prices, as credit availability is still scarce and the wave of distressed properties that was expected to hit the markets has failed to substantially materialize. Banks have been modifying or restructuring the loan terms on performing properties, rather than foreclosing.

Given the stark conditions in the market, construction of commercial space is practically nonexistent. SIOR respondents indicate that development conditions favor buyers, with almost 90 percent of markets characterized by acquisition prices lower than construction costs. With elevated vacancy rates and virtually no credit for building available, the expectations for new construction remain subdued.

The results of the first quarter survey show that commercial real estate still faces a challenging environment. However, respondents are reporting an end to the decline. While the markets are obviously not in the clear, SIOR members are expecting improving conditions for the next quarter—65 percent expect the market to improve, compared with 55 percent in the previous quarter and 47 percent in the third quarter of 2009. The percentage of respondents expecting declines in business activity continues to shrink—it was 13 percent in the first quarter of this year, compared with 66 percent a year ago.

SIOR Outlook

The results of the first quarter of 2010 highlighted the continued challenges facing commercial real estate. While the economic environment is improving, major issues remain—employment, credit availability, maturing debt, and current legislative initiatives. Member comments indicate that there are areas of the country where commercial activity is gathering steam. In addition, practitioners' expectations for the next quarter are on the upswing. The second quarter results are likely to provide a better measure of the overall direction of the economy and of commercial real estate.

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.