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Economics Group

Special Commentary

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Commercial Real Estate Chartbook: Q2

Rising Interest Rates May Taper the Real Estate Recovery

Long-term interest rates have spiked over the past few months. Rising interest rates will test the viability of the recovery in property values. While operating fundamentals for income properties have improved, the bulk of the increase in prices has been driven by exceptionally low interest rates, which have made the income streams from rent more valuable. Higher interest rates will lead to a number of adjustments. Overall price appreciation will slow and demand will gravitate even further toward areas where operating fundamentals have improved the most and prospects remain the brightest. For now that still primarily means apartments, where demand has been strong and rents adjust relatively quickly. Industrial properties should also hold up relatively well, thanks to continued strong growth in online retailing, the energy boom and improving sentiment in the manufacturing area. Demand for well-located office and retail properties has turned the corner as well, but both areas have recovered much less and the improvement remains spotty.

Rising interest rates will test the viability of the recovery in property values.

Apartment fundamentals remain solidly in place, but the acceleration we have seen over the past couple of years is likely to moderate somewhat. After 12 consecutive quarters of vacancy rate declines, the apartment vacancy rate held steady at 4.3 percent in the second quarter. The rate of decline over the past year is also decelerating, although this is not necessarily concerning, as we would expect new construction to fall more in line with demand over time. A wave of new construction is coming on line later this year and, when combined with an improving single-family market, should take some of the steam out of the apartment boom. Based on projections from Reis, Inc., apartment completions should continue to pick up in 2014, and then fall back slightly as we reach the middle of the decade. The apartment vacancy rate declined 0.5 percentage points over the past year, compared to a 1.1 percentage point decline the year prior and a 1.9 percentage point drop two years ago. The markets benefiting from the energy and technology booms are performing the best, including Houston, Austin, San Francisco, Seattle and Denver.

Figure 1

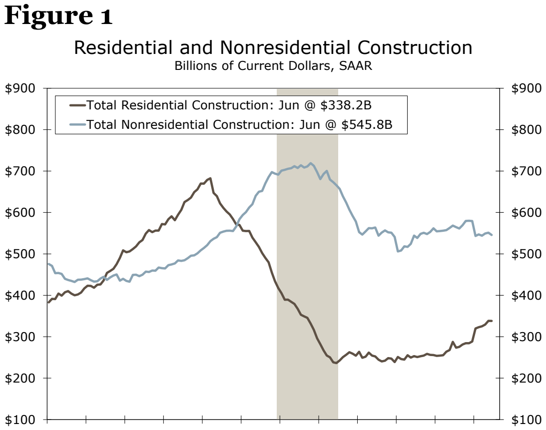
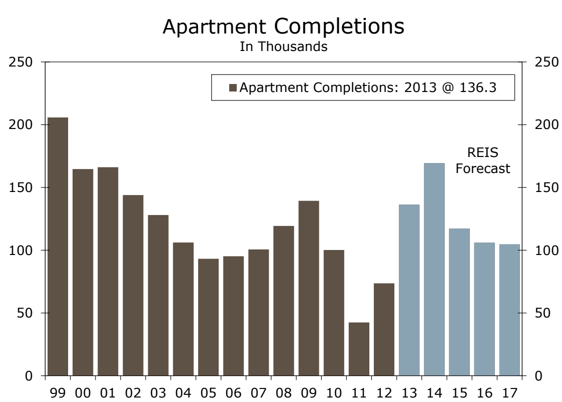


Figure 2



Source: U.S. Department of Commerce, Reis, Inc. and Wells Fargo Securities, LLC

Energy and Technology Are Still Leading the Way

Industrial vacancy rate declines have been pulled lower by growing demand for warehouse space as well as minimal new construction.

With overall economic fundamentals improving, including employment, income and consumer spending; demand for industrial space is increasing. Industrial vacancy rate declines have been pulled lower by growing demand for warehouse space and minimal new construction. E-commerce remains one of the driving influences on demand, as large Internet retailers build out their distribution network and traditional retail chains add online distribution channels as well. We suspect this trend has quite some way to go. Many firms are opting to build rather than lease existing space, as their location and building requirements are often unique. Demand from more traditional sources has slowed in recent quarters, reflecting weaker global economic growth and a greater desire by many firms to reduce raw materials and finished goods inventories. We expect global economic growth and international trade to improve during the second half of the year and into 2014, which should fuel demand for industrial space in major international trade gateways.

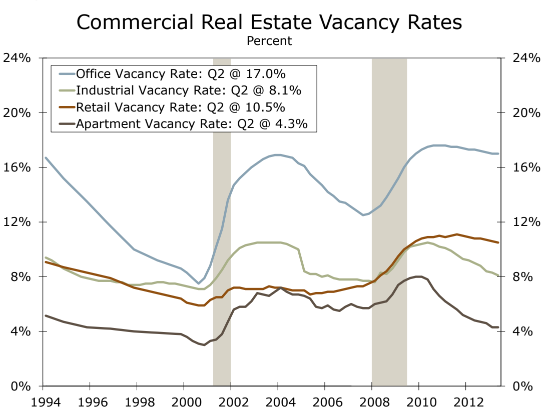
Many ports along the Gulf and East coasts have already been busy, as the ports and businesses prepare to handle increased trade volumes following the expansion of the Panama Canal, which is expected to be completed by the end of 2015. Growth is evident around several key areas but the greatest impacts have been in the South. The Gulf Coast has seen a huge influx of investment in its key energy and chemical sectors and has also landed a number of marquee industrial projects. Container traffic has increased at most major Gulf ports, many of which continue to expand. Ports along the East Coast are also preparing for the larger container ships. The additional capacity is driving demand for nearby warehouse and distribution space.

Demand for office space continues to slowly revive, as businesses have gradually ramped up hiring. Growth in professional and business services and part of the information industry have been the primary drivers. Hiring in the energy sector is a big driver in professional and business services, particularly in Houston, Dallas, Oklahoma City and Denver. The tech sector is driving much of the improvement in office demand in Manhattan and Atlanta. Employment in the financial services sector has also stabilized, although the sector still appears to be consolidating its space needs. Markets tied to the federal government have clearly felt the sting from sequestration. Vacancy rates have increased in Northern Virginia and Washington's Maryland suburbs.

Traditional retailers continue to battle increased competition from online merchants and value-oriented consumers.

The recovery in the retail sector has been slower to take shape. Traditional retailers continue to battle increased competition from online merchants and value-oriented consumers. Higher-end retailers are tending to hold up better than discount stores. Middle income households have been squeezed this past year between sluggish wage and salary growth, higher payroll taxes and increased food and gasoline prices. Sales are growing modestly, however, and gas prices have retreated in recent weeks. More chains are expanding. While the national vacancy rate has fallen 0.3 percentage points over the past year, it still stands at 10.5 percent. Prime locations are becoming scarce in many markets, leading to some selective new development.

Figure 3



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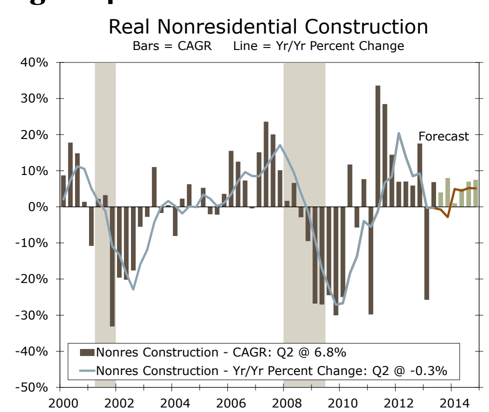
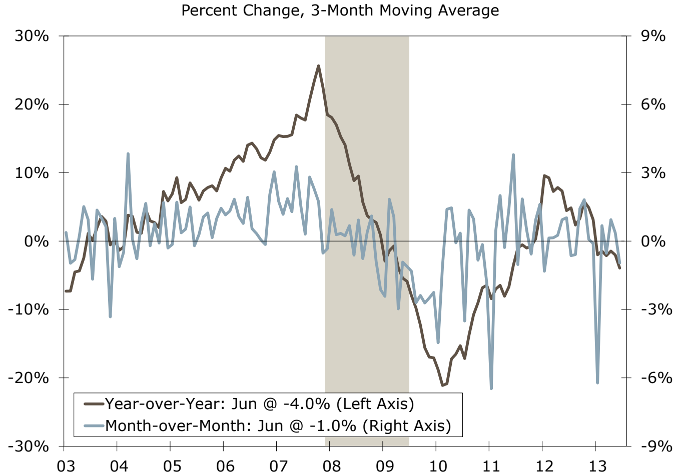


Source: PPR, Reis, Inc., U.S. Department of Commerce and Wells Fargo Securities, LLC

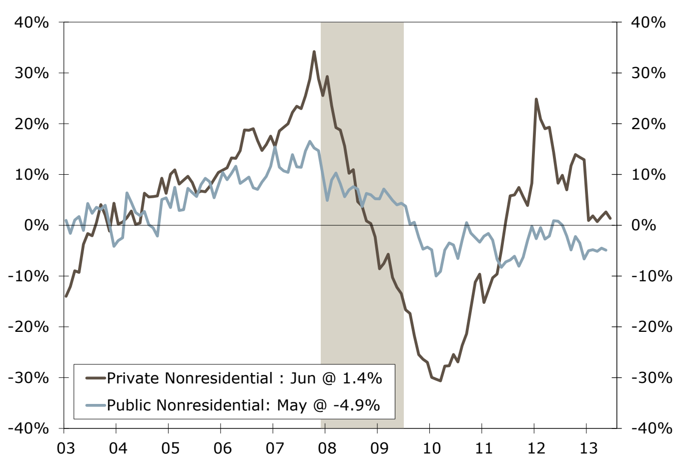
Nonresidential Construction Spending

- Following a sharp pullback in the first quarter private nonresidential construction spending rebounded in the second quarter led by an expected bounce in power. Power, which includes wind and solar construction, was weak in the first quarter as government incentives trailed off from the year end race. Lodging and transportation also made notable contributions. Moreover, with nonresidential construction jobs, starts and architectural billings showing gains, we expect to see continued modest improvement.
- Architectural billings, which tend to lead outlays by about a year, improved for the second month straight in June following a dip below the key threshold of 50 in April. Inquiries into new work and the value of new contracts also picked up.

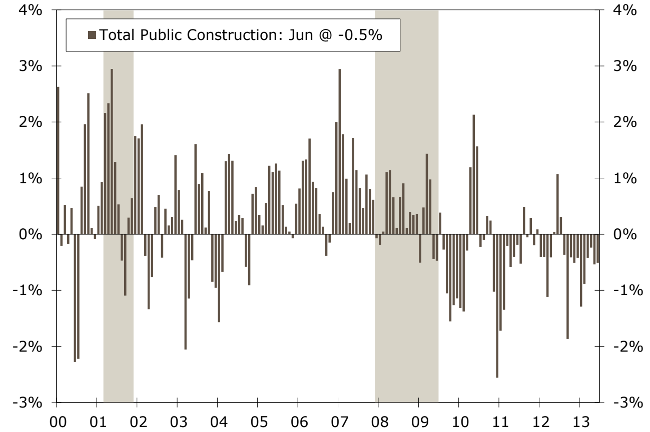
Total Nonresidential Construction
Percent Change, 3-Month Moving Average



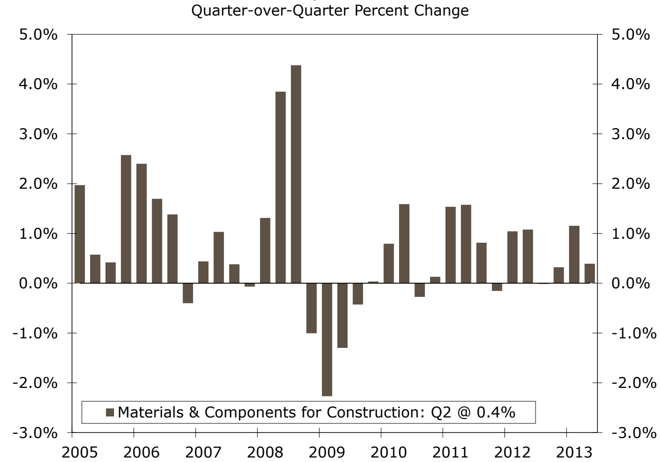
Public and Private Nonresidential Construction
Year-over-Year Percent Change



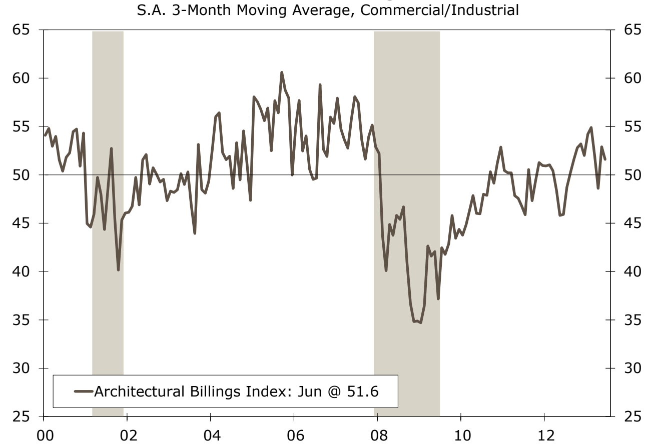
Public Nonresidential Construction
Month-over-Month Percentage Change, 3-Month Moving Average



PPI: Materials & Components for Construction
Quarter-over-Quarter Percent Change



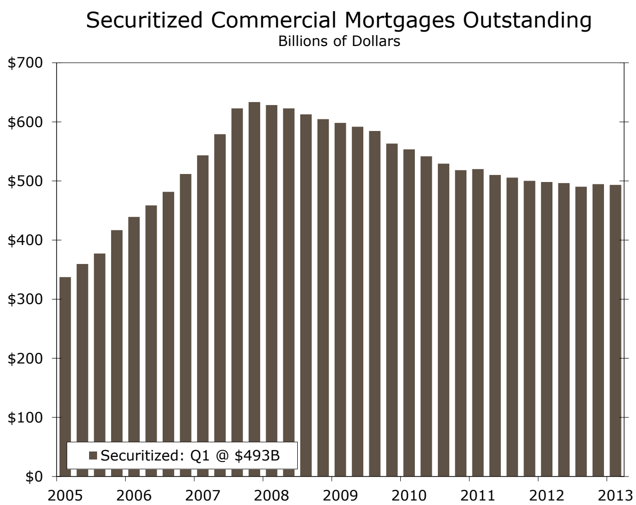
Architectural Billings Index
S.A. 3-Month Moving Average, Commercial/Industrial

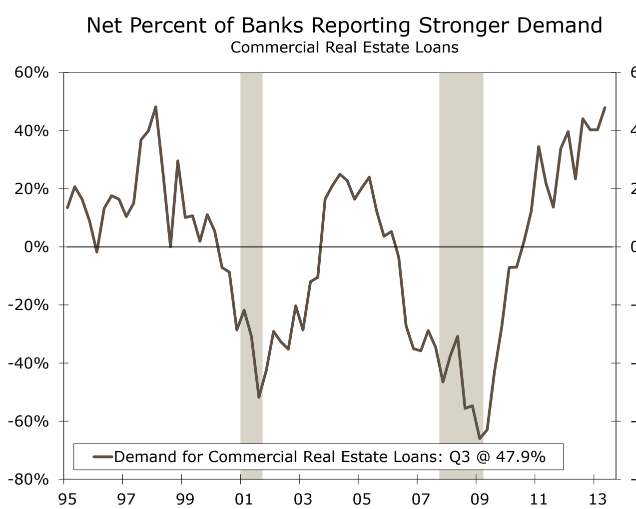


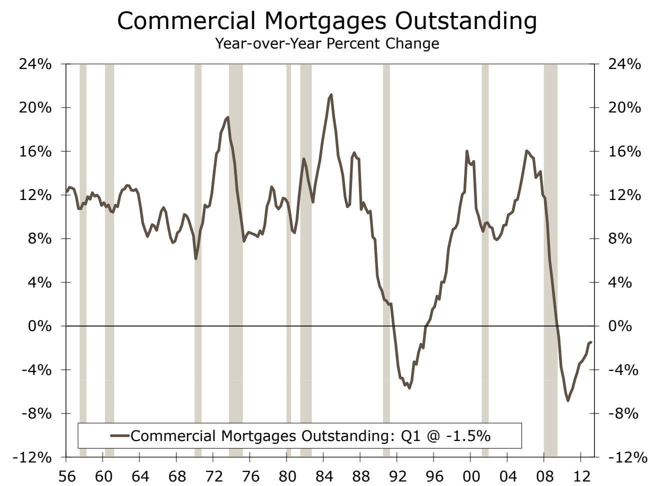
Source: U.S. Dept. of Commerce, U.S. Dept. of Labor, American Institute of Architects and Wells Fargo Securities, LLC

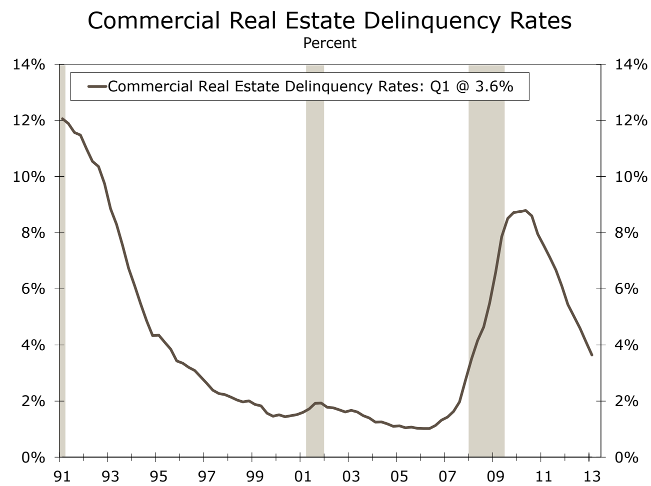
Commercial Mortgages Outstanding

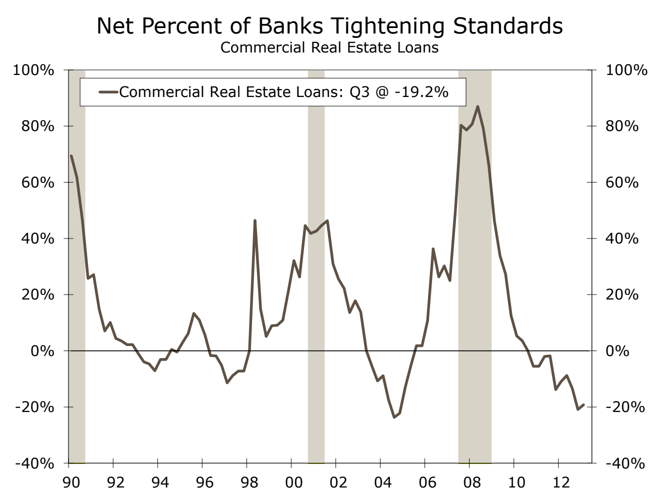
- Commercial/multifamily debt outstanding fell 0.2 percent in the first quarter, a decline of $4.9 billion. The pullback marks the first decrease since the third quarter of 2011. Much of the weakness continues to be concentrated in securitized mortgages, which remained at a low level for the first quarter.
- Showing a consistent downward trend, commercial mortgage delinquencies (includes land development loans), fell nearly half a percentage point in the first quarter to 4.1 percent but remained above pre-recession levels.
- Lending standards for commercial mortgages continued to ease and demand is strengthening according to the Senior Loan Officer Survey.







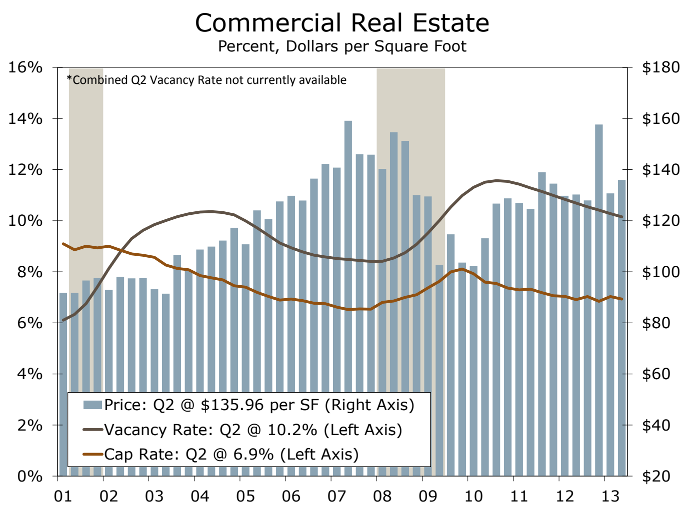


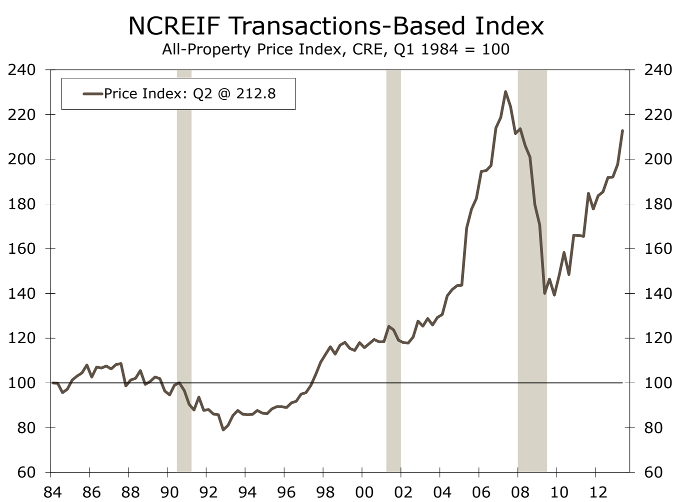


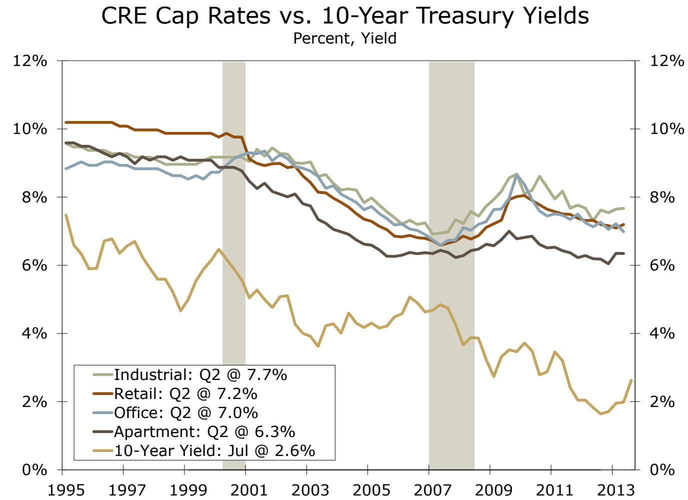
Source: Federal Reserve Board and Wells Fargo Securities, LLC

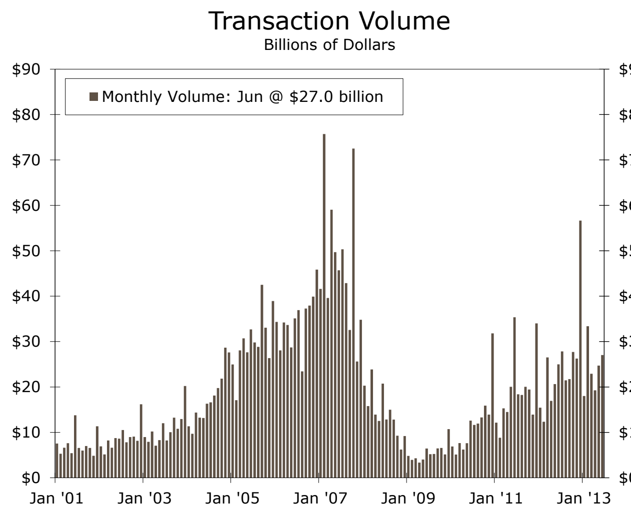
CRE Property Fundamentals

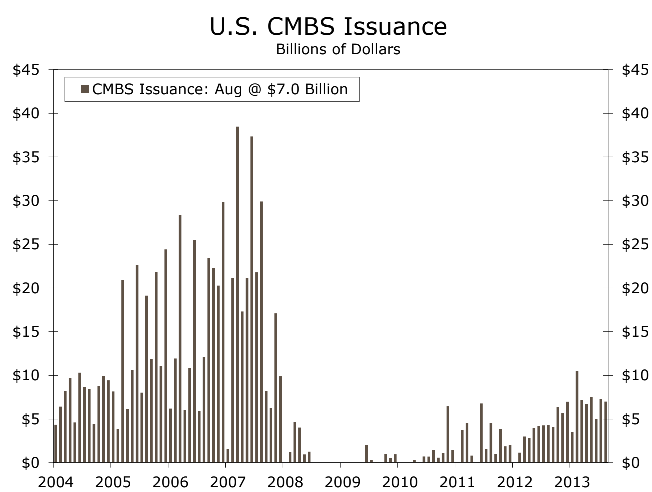
- Operating fundamentals have improved only modestly across all key property types outside of the apartment sector. However, the rapid surge in apartment fundamentals is slowing with vacancies bottoming at 4.3 percent in the second quarter and net absorption (change in occupied space) falling for the second consecutive quarter.
- Total transaction volume increased more than 25 percent over the year, with office and industrial showing double-digit gains. However, apartment activity has started to moderate as investors become wary of rising interest rates.
- Suburban office has outperformed CBD and unanchored retail had the most positive trends in retail. Properties in markets tied to the energy and technology sectors remain in high demand.









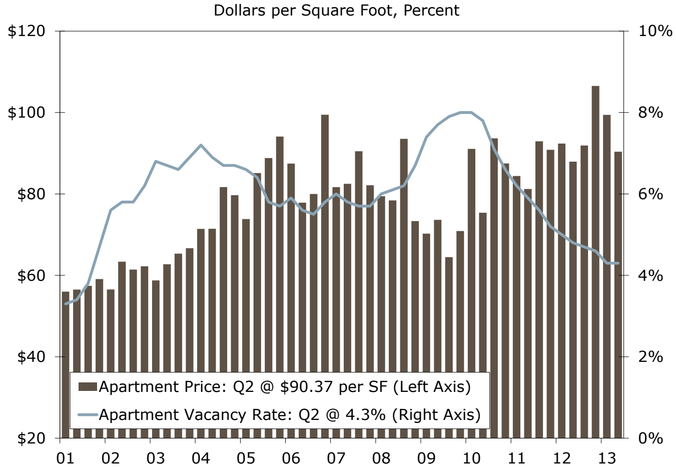


Source: Reis, Inc., PPR,RCA Analytics, NCRIEF, IHS Global Insight, Commercial Mortgage Alert, Intex and Wells Fargo Securities, LLC

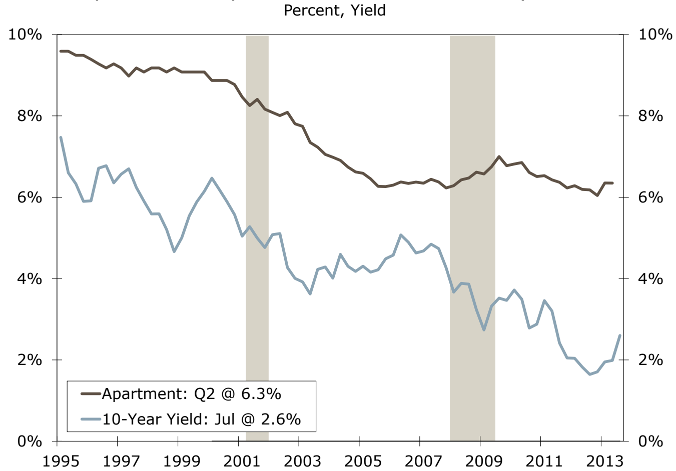
Apartments

- Apartment demand remained strong in the second quarter, with net absorption of nearly 32,000 units. Builders continue to plan new projects, and while we believe this market will gradually begin to cool off somewhat, overbuilding is not yet a major concern.
- Apartment vacancy rates were unchanged at 4.3 percent in the second quarter, which may signal a bottoming for this cycle. The gap between net absorption and net completions narrowed significantly in the second quarter to 5,300 units.
- Deliveries will increase during the second half of this year, possibly pushing vacancy rates slightly higher. Demand should remain strong, however, reflecting improving employment conditions.

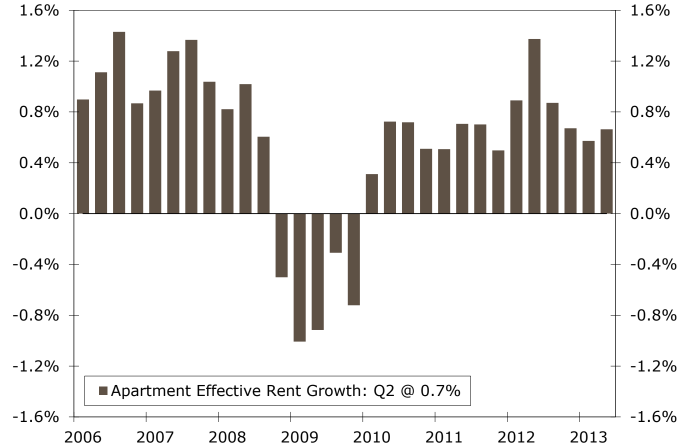
Apartment Price vs. Vacancy Rate
Dollars per Square Foot, Percent



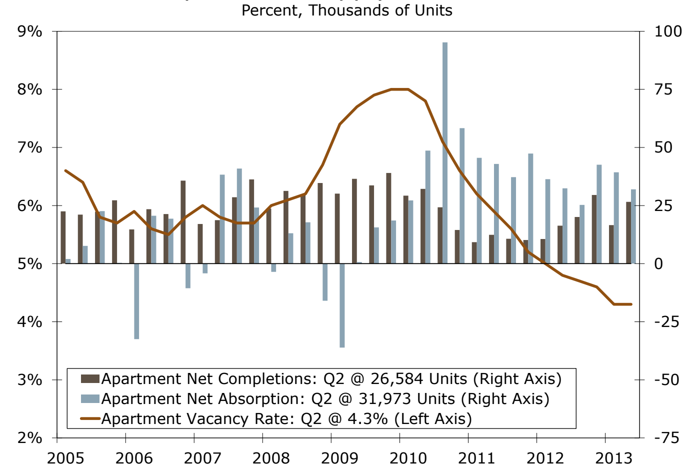
Apartment Cap Rate vs. 10-Year Treasury Yield
Percent, Yield



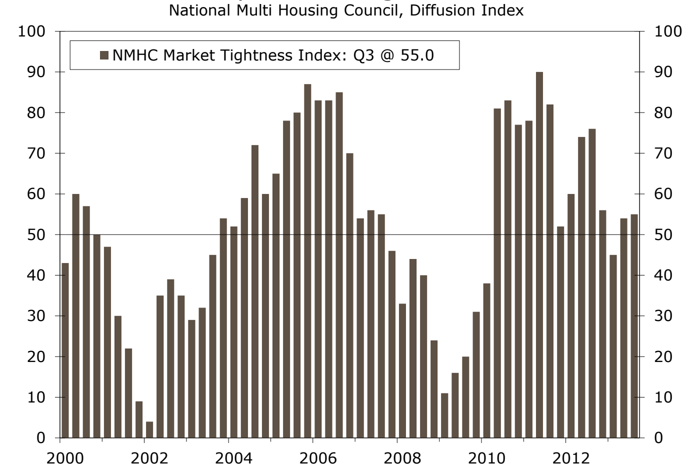
Apartment Effective Rent Growth
Quarter-over-Quarter Percent Change



Apartment Supply & Demand
Percent, Thousands of Units



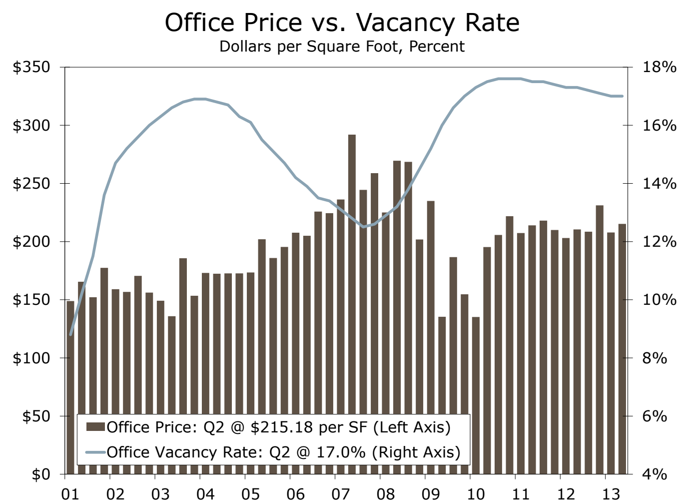
NMHC Apartment Tightness Index
National Multi Housing Council, Diffusion Index

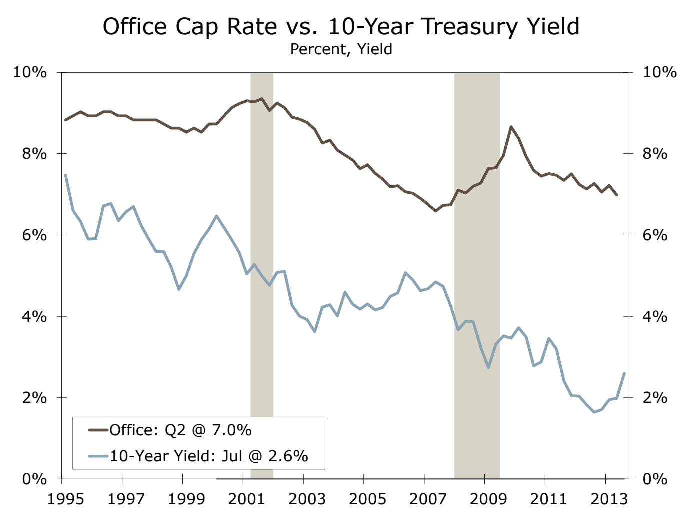


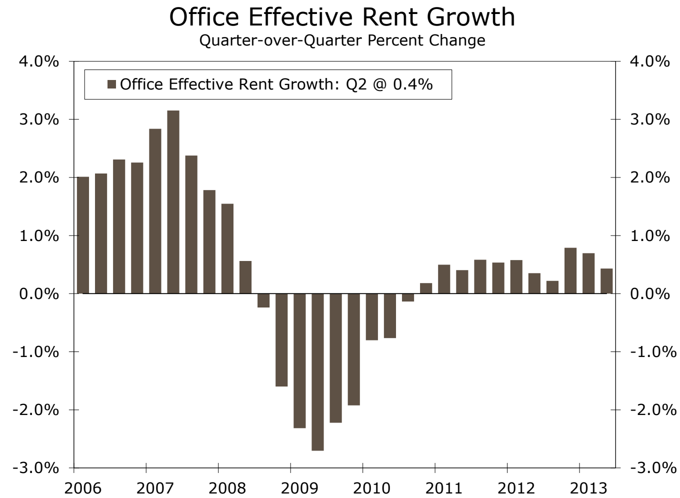
Source: Reis, Inc., RCA Analytics, IHS Global Insight, NMHC and Wells Fargo Securities, LLC

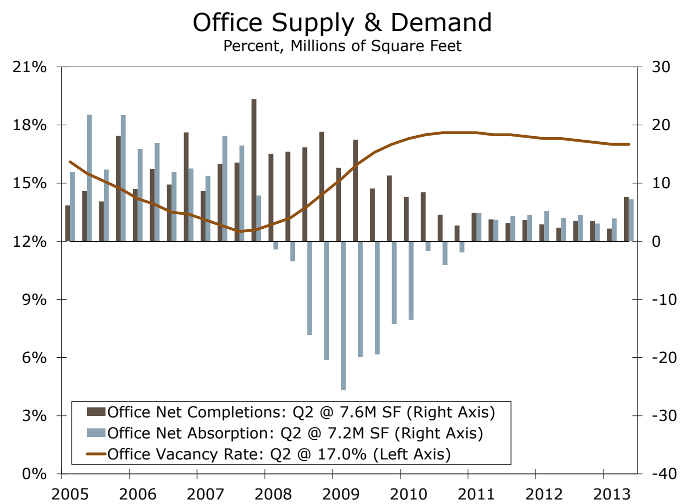
Office

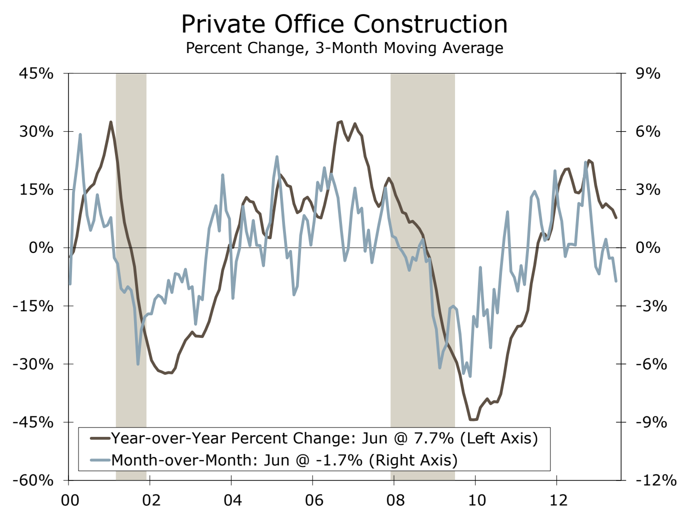
- The office market continues to see only modest improvement. Private construction has slowed recently, although it remains up 7.7 percent from its exceptionally low year ago levels. By contrast, the weakness in public building has been unrelenting. The office market is unlikely to pick up without any substantial increase in office employment. The vacancy rate remains elevated at 17.0 percent in the second quarter.
- Office net absorption and completions picked up in tandem in the second quarter. While growth continued to be driven by hiring in the IT sector, conditions also improved modestly in financial services. Rising mortgage rates may cut back into these gains, however, due to slower demand during the second half of the year.







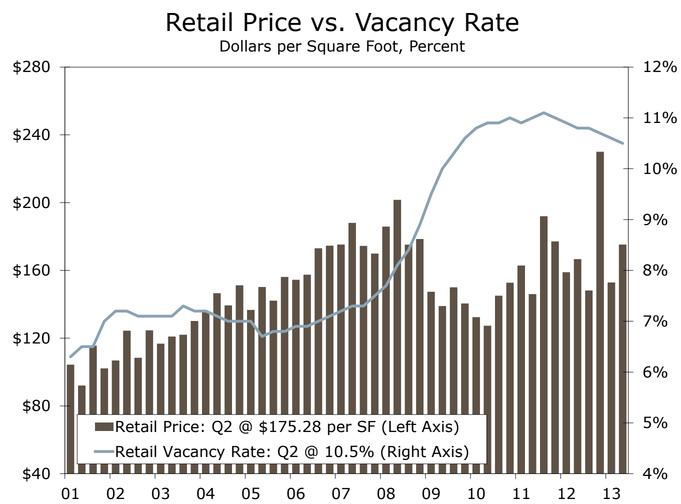


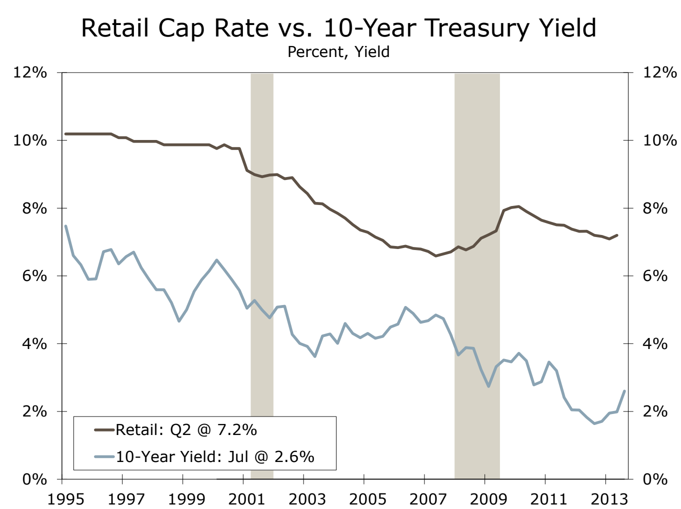


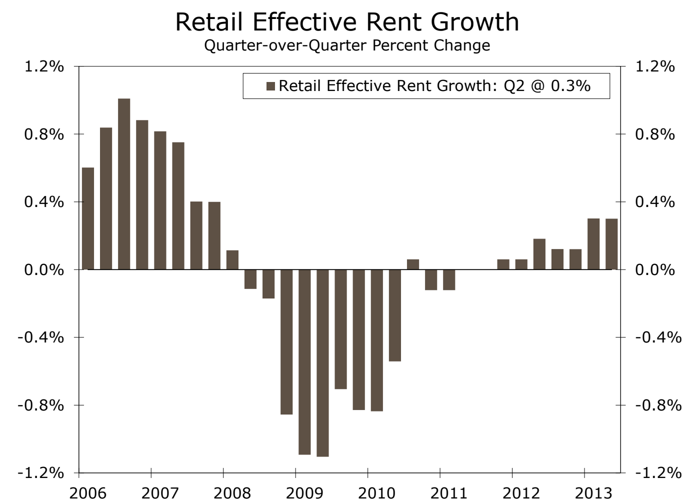
Source: Reis, Inc., RCA Analytics, IHS Global Insight, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

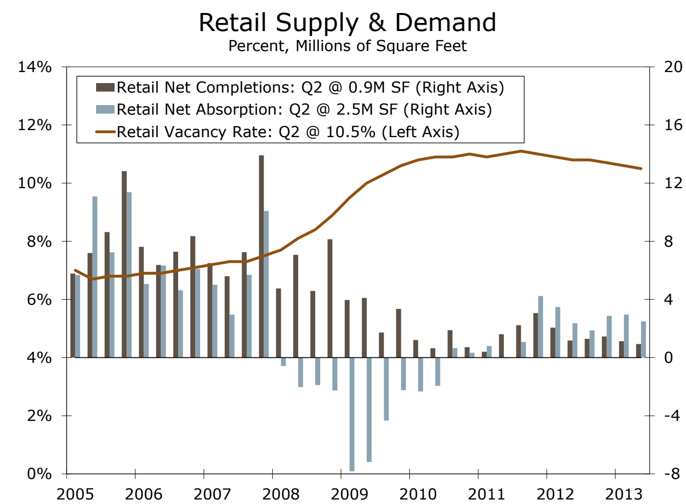
Retail

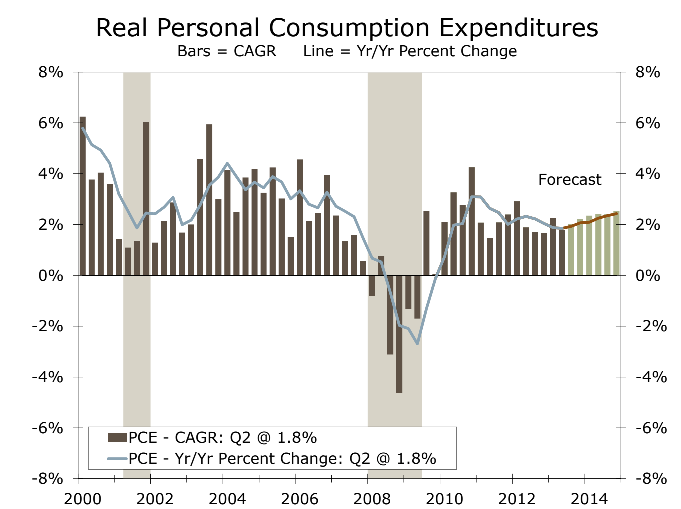
- The retail market continued to see modest improvement, as consumer spending gradually recovers. The overall retail vacancy rate declined 0.1 percentage point to 10.5 percent, and has declined just 0.3 percentage points over the past year. Growth in the retail sector remains spotty, with a handful higher-end chains and specialty retailers posting solid gains.
- We suspect the retail market has turned the corner. Rent growth strengthened in the first half of the year, rising 0.3 percent in the first and second quarters. Still, there likely remains an oversupply of available space, much of which is in B and C locations. The better-performing retailers are moving past these locations, which is helping support new development.







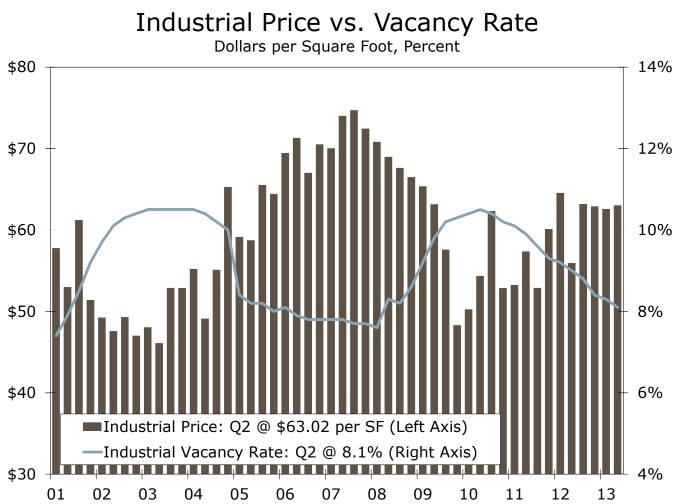


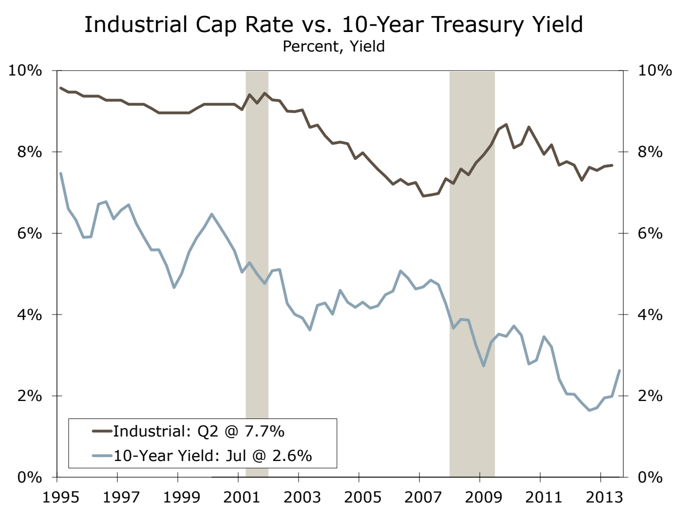


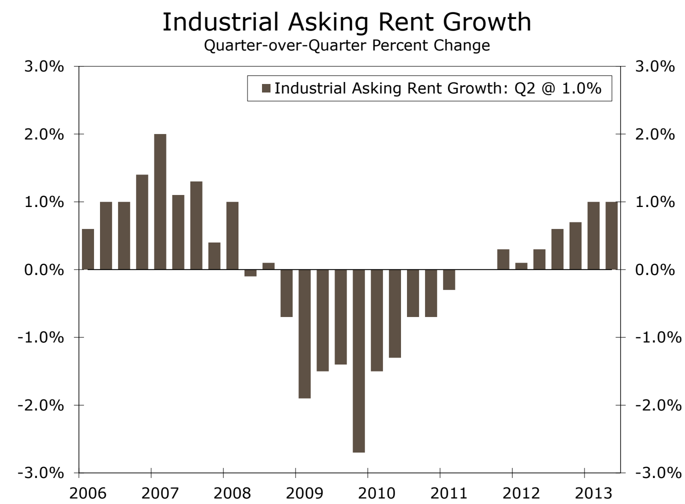
Source: Reis, Inc., RCA Analytics, IHS Global Insight, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

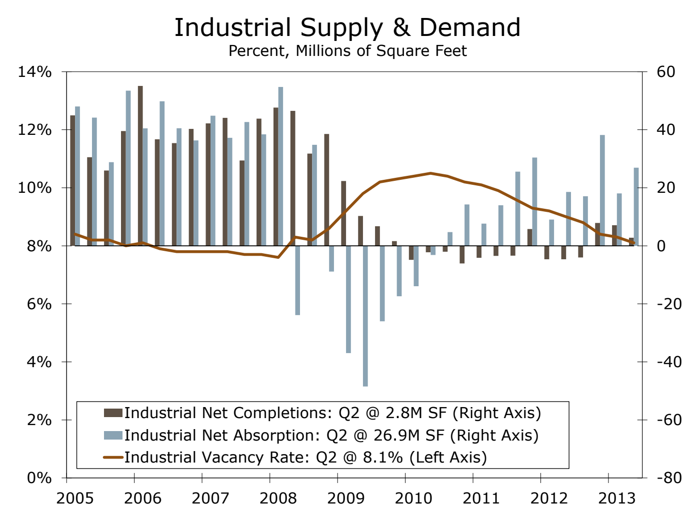
Industrial

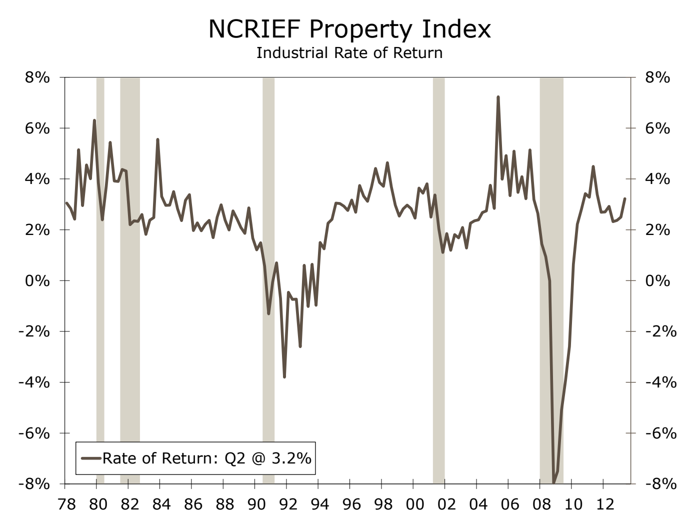
- The demand for warehouse and distribution space continued to improve, but at a steady pace. Competition for Class A properties in large gateway markets remained active in Q2 due to tight supply. However, flex properties, which comprise one-third of the market (specifically in many mid-tier metro areas), are holding back more robust activity. According to Moody's/RCA CPPI, industrial prices remained weak in the second quarter, but operating fundamentals and prices are improving modestly.
- E-commerce continues to be a growing trend with tenants opting for build-to-suit developments. According to CB Richard Ellis, markets near large couriers are likely to enjoy robust demand.







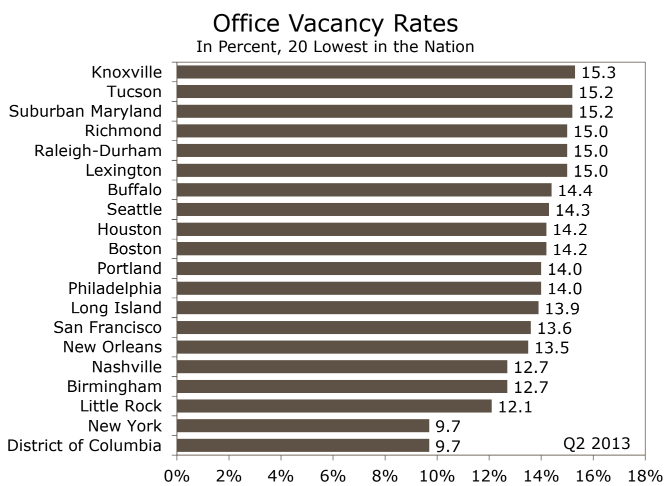


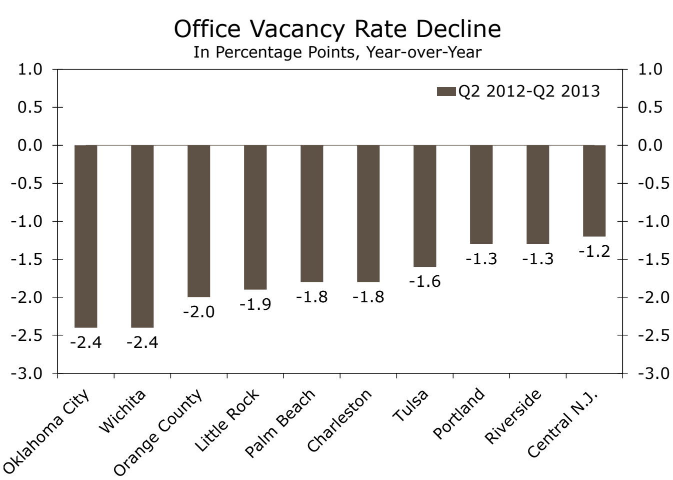


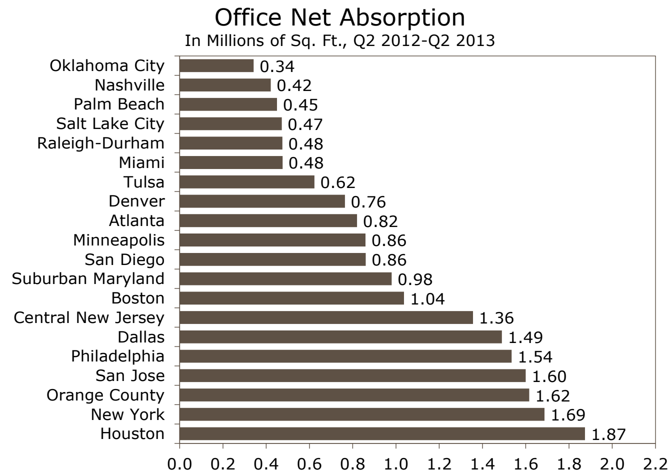
Source: PPR, RCA Analytics, IHS Global Insight and Wells Fargo Securities, LLC

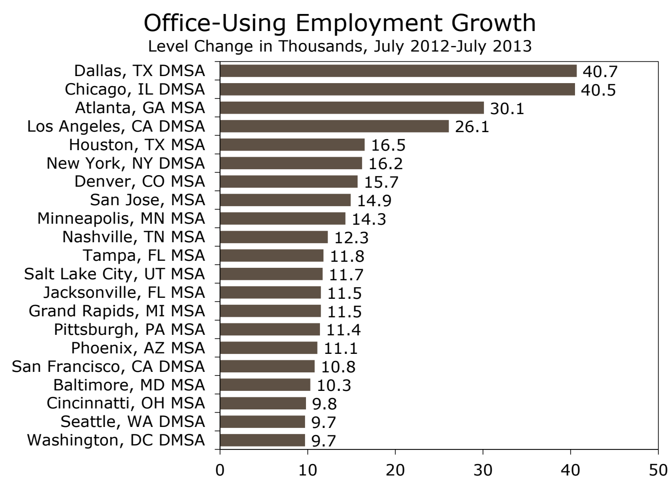
Regional Market Overview

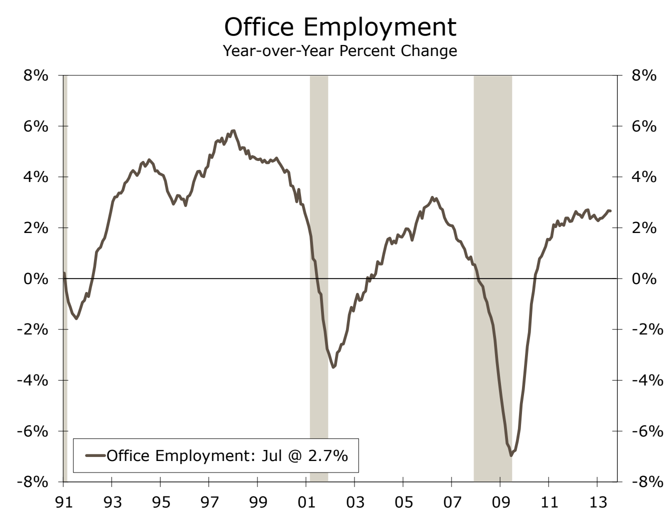
- Office employment growth has accelerated slightly over the past year, led by gains in the technology sector, energy business and some stabilization in financial services. Major energy market and tech centers have posted some of the strongest absorption gains. Tech employment is also fueling much of the growth in more diverse markets such as New York City and Atlanta.
- Rising interest rates will present some near-term challenges. The modest recovery in financial services will come under pressures from declines in refinancing activity. Property price appreciation should also slow, which would disproportionately affect B and C properties in the slower growing markets and submarkets.











Source: Reis, Inc., U.S. Department of Labor and Wells Fargo Securities, LLC

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