SIOR Index—Continuing Decline Prompted by National Economic Conditions

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By Lawrence Yun and George Ratiu

Despite concerns of a recession, the economy has kept a steady, albeit very slow pace. The GDP rose 1.0 percent in the first quarter of 2008, following similar lackluster activity in the prior quarter. The economy is clearly in a slowdown from its average 3.0 percent growth, but it is not in a recession. A recession would require two consecutive quarters of economic contraction. Looking forward to the next quarter, economic activity is likely to continue to be sluggish, but will remain positive.

Several factors are contributing to current economic conditions. The residential housing market has placed downward pressure on the overall economy, particularly affecting consumer confidence and spending. While sales volume and prices vary across the country, mortgage delinquencies and foreclosures continue to take a toll. The performance of these mortgages, particularly in the subprime sector, have led to large losses for banks that issued them, as well as for banks that originated securities backed by these loans. The financial credit situation has extended to Freddie and Fannie, moving the Treasury to intervene to settle the markets.

In response to these mounting losses, banks have tightened credit availability and requirements. Falling new home construction and soft home sales have further added downward pressures to the market. This action has spilled over into the commercial sector as well. Based on the SIOR Index survey, 44 percent of respondents indicated that construction activity is down, and 23 percent indicated that there is virtually no new construction in their markets. Along the same lines, construction employment is also taking a hit. Construction jobs in the second quarter of 2008 were down by 18,200 from the first quarter of the year. In the overall economy, the unemployment rate is also up, reaching 5.5 percent, and it is forecast to move up to 5.8 percent in the fourth quarter.

Consumer confidence has been eroded by the combination of these factors and is at its lowest level in the past 10 years. However, on the upside, the economic stimulus checks seem to be having an impact as consumer spending is still expanding, although at a slow rate—1.1 percent. Business spending increased slightly during the quarter but remains off the historical pace.

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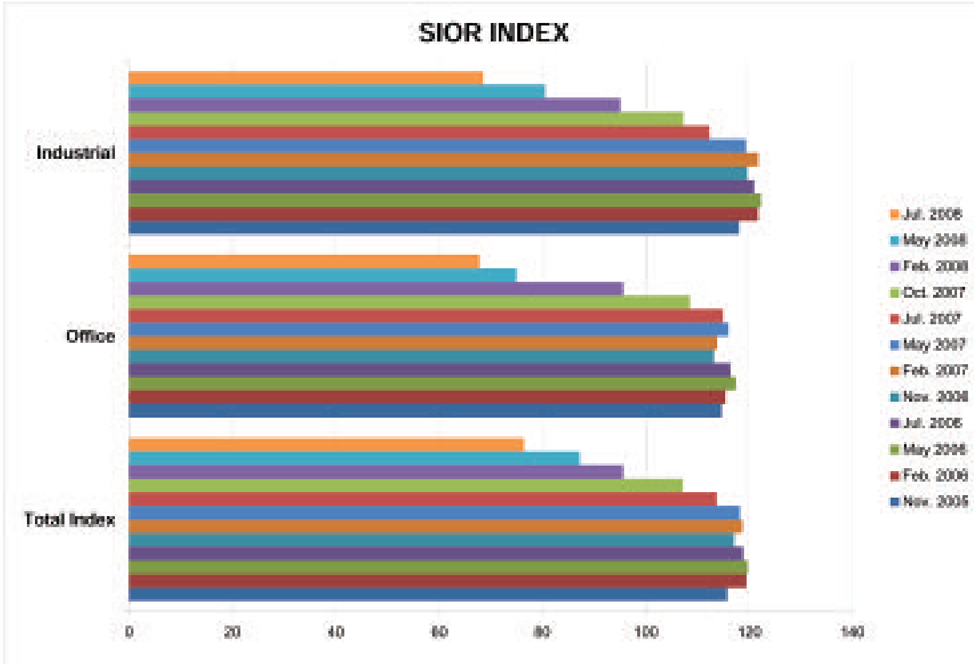
Fundamentally, the underlining components of GDP will continue to grow at a slow but steady pace. Exports have grown by 3.5 percent and will continue to provide a strong thrust to the GDP's forward momentum. The upside of a weak U.S. dollar is that U.S. products are priced competitively abroad. Consequently, net exports are adding nearly one full percentage point to the overall growth of the economy. In other words, without exports, we would be in a recession.

On a separate note, the inflation rate is uncomfortably high. But due to the weak economy, the Federal Reserve will refrain from raising rates. A rate hike should be expected in December. The Fed Funds rate could well reach as high as 3.5 percent by the end of 2009 from current 1.0 percent.

SIOR Index Survey Results

The results of the Summer 2008 SIOR Index survey, reflecting 2nd quarter conditions, suggest continuing deterioration of the economy and commercial real estate in the view of SIOR members. The Commercial Real Estate Index, compiled by SIOR and evaluated by the NATIONAL ASSOCIATION OF REALTORS® (NAR), reached the lowest point since SIOR began the project in Fall 2005. The national index, which measures 10 variables pertinent to the performance of U.S. industrial and office markets, dropped 10.8 points to a summer reading of just 76.4.

The SIOR Commercial Real Estate Index is a diffusion index (see Methodology at the conclusion of this article) where a score of 100 indicates markets in balance. Therefore, a score of 76.4 reflects negative conditions in the commercial real estate industry for landlords and sellers. This is also the third consecutive quarter with values below 100, pointing to a difficult environment for commercial real estate activity.



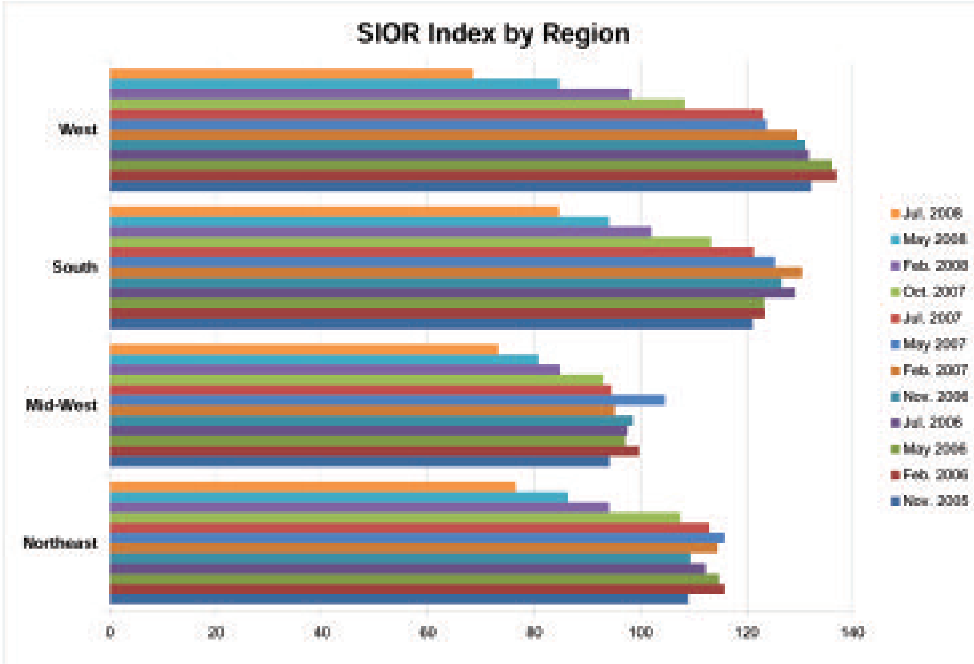
Index results reflect a struggling national economy that is affecting local industrial and office markets. Concerns about where the national economy is headed are clearly causing firms to delay or completely halt expansions or relocations. Of the two sectors of the survey, the Industrial Index is declining at a faster rate (12-point drop) than the Office Index (7.2 point decrease). The South continues to be resilient, while the Midwest and West are seeing much worse market conditions than last quarter.

The survey, which measures practitioner sentiment and is based on anecdotal evidence from SIOR members across the country, provided several insights. A substantial 83 percent of respondents feel that the national economy is having a negative impact on their local market. Thirty-six percent of respondents feel that their local economy is performing normally, while 52 percent feel the situation is much worse, with the local economy slowing the real estate market.

A significant 75 percent of respondents state that leasing activity in their market is below historic levels. Fundamentals are beginning to be affected by the economic slowdown as 50 percent of respondents think that vacancy rates are higher than normal. However, in terms of rents, 59 percent of respondents feel that asking rents are at or above where they were one year ago.

Respondents feel that currently they are in a tenant's market when it comes to concessions—55 percent feel that tenants are benefiting from moderate levels of concessions, seven percent consider that deep discounts from asking rents are available, and 28 percent of respondents think that concessions are in balance.

Not surprisingly, when asked what the next three months hold in store, only 17 percent of respondents indicate that business is going to be up from current levels. A total of 48 percent feel that their market will be down during the next three months.



Regional Breakdown

West

Regionally, the most pessimistic sentiment about the market comes from the West. The SIOR Index for the West dropped 16.2 points, to 68.4, the first time any region dropped below the 70 mark. Respondents there are the most pessimistic about the low level of leasing activity, pointing to the housing downturn as a main factor. Continuing high rates of mortgage foreclosures in Arizona, California, and Nevada are taking a toll on consumer confidence. The West also registered higher vacancy rates, with an increase in moderate to deep tenant concessions. The weak dollar has resulted in a lower volume of imports, leading to slow demand for warehouse and distribution space both on the coast and in the Mountain states. Practitioners in the West are not overly positive about the economic conditions over the next three months.

South

In the South, the SIOR Index declined 9.4 points to 84.6, currently the highest index of the four regions. Unlike the other regions, respondents in the South find that leasing activity is a little higher than average. The sentiment is carried over to asking rents, where the Southern practitioners feel that rents are up slightly. They find vacancy rates somewhat higher, but not significantly. They also report that their investment markets are in balance.

Northeast

The Northeast SIOR Index has fallen from 86.3 in May to 76.4 in July. Leasing activity is lower, accompanied by slightly lower rents. The Northeast respondents also noted that sublease space is a more significant issue than it is in the other regions. The major financial losses on Wall Street are probably affecting SIOR members' sentiment about economic activity. More respondents from the Northeast Region felt prices were below replacement costs than any other region.

Midwest

The Midwest Index recorded the smallest decline—7.6 points, from 80.7 in May to 73.1 in July. However, most respondents in the region feel that their local market is performing below normal levels. The region is experiencing higher availability rates, along with lower rents. Sublease space availability is also a more notable issue in the Midwest than in the West and the South. Respondents also indicate that tenants are obtaining more moderate to deep concessions than in other regions. In terms of investment markets, the Midwest echoes the West, with practitioners considering that they are in a buyer's market.

Outlook

The SIOR Index for July 2008 is clearly indicating a downslide in office and industrial leasing and sales activity. The national economy is weighing on respondents' minds and affecting both local economies and the real estate markets. Adding to that, lenders are tightening credit availability, causing tenants and investors to postpone major decisions related to real estate.

SIOR Members

Your participation is important to the SIOR Commercial Real Estate Index. As ***the*** market experts in your local market, your sense of what is happening in your marketplace is essential in developing the Index as ***the*** commercial gauge to look at for a true sense of what is happening in commercial real estate throughout the United States. Look for your opportunity to participate September 16 and complete the 5-minute survey on trends in your area.

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 measure 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, corres-ponding 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 since 1989.