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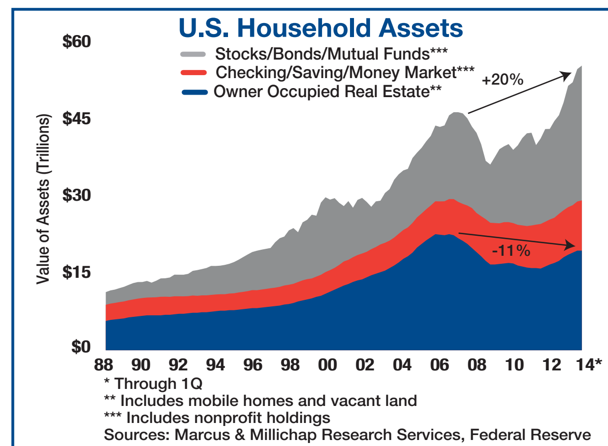
Third Quarter 2014

A Respite for Housing, But Payrolls Fully Regain Jobs Lost in Recession

Now in its fifth year of expansion, the subtle pace of growth that has characterized the U.S. economic recovery continued into the second quarter of 2014. Economic data remains mixed but skewed to the upside, particularly forward-looking macro trends. The unemployment rate touched a five-year low this year, with employment surpassing the prior 2007 peak, while consumer spending has proved resilient despite higher taxes and dire weather. In addition, bank lending has risen, prompted by growing consumer and business demand. Other positive economic trends include low inflation, expanded consumer credit and improved job and wage growth together with sustained demand for housing and durable goods.



Downward revisions to first-quarter GDP captured the effects of the harsh winter, noting weakness reported in housing, manufacturing and retail sales. Exports and government spending declined as well, further contributing to a contraction in first-quarter productivity. The much anticipated but disappointing spring sales season for new and existing single-family homes lagged 2013 levels, although condo sales posted healthy gains in both volume and median price. As noted, many of the setbacks tie directly or indirectly to severe weather conditions that disrupted activity and shut down businesses and factories while sidelining consumers.

Demand Drivers Poised for Growth. From a broader perspective on economic momentum, recovered equity markets along with rising home prices and lower levels of mortgage debt helped push U.S. household wealth to a record high of $81.8 trillion in the first quarter of 2014. Additionally, consumer and business debt grew at a 6.6 and 7.3 percent annualized rate, respectively. The expansion of consumer and business balance sheets presages a rebound in the housing market, increased private business investment and more robust consumer spending. The rise in imports further suggests underlying strength in domestic consumer spending. The tepid housing recovery presents a challenge to the broader economy, however. Mortgage applications have continued to trend downward while the percentage of first-time buyers remains below trend at 28 percent. Stringent credit requirements, downpayment hurdles and student loan burdens have been key factors in restraining housing demand, but policy initiatives that would lift home sales and new home construction are now under discussion.

Monthly job growth this year has averaged 230,000. Expansion remains broad-based across sectors and regions, thereby reducing and stabilizing the unemployment rate. Private-sector payrolls expanded by 198,000 positions in July; government job losses have bottomed, with the sector contributing 11,000 jobs, supporting a year-over-year gain of nearly 2.6 million positions. Initial unemployment claims have approached a five-year low and the unemployment rate improved by 110 basis points to 6.2 percent over the year.

Sales of existing single-family homes remain near their long-term norm at an annualized 4.4 million units as of June, although sales activity has fallen 2.9 percent from last year. The median home price increased 4.4 percent to $207,800, losing some momentum from the blistering 9.0 percent appreciation of 2012 and 2013 when investor and foreclosure activity boosted demand. The rising inventory of homes for sale has expanded choices for homebuyers while demonstrating sellers' emerging confidence in the market, which should combine to push sales momentum this summer. Federal housing agencies and the Federal Reserve are watching the housing market carefully. Should sales not build momentum over the summer, it's likely that federal housing agencies will take action to stimulate sales activity while the Federal Reserve will continue its accommodative fiscal policies.

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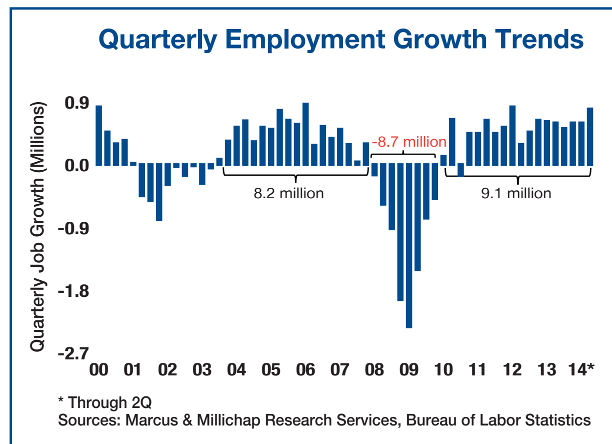
• Total retail sales posted a solid 4.3 percent annualized increase in June, with broad-based support from all sectors. Core retail sales, excluding autos and gasoline, were in alignment, advancing 4.2 percent. Annualized sales remain robust, reaching 3.8 percent growth and outpacing the long-term average of 3.4 percent, with only a few sectors reflecting negative trends. Not surprisingly, receipts in housing-related segments grew at a decelerated pace, with building materials and supplies, and furniture and home furnishing stores up 3.7 and 1.9 percent, respectively. Non-store retail sales, which includes e-commerce, grew 8.1 percent, with particular strength in electronics. In net, consumption has continued to escalate, supporting economic growth and lifting corporate performance.

Forecast:

The technology, energy and trade sectors will remain powerful supports to the economy through the remainder of the year. The cost of capital remains historically low and credit access will boost economic performance. Commercial and industrial loans will continue to expand, aiding recovery momentum and hiring for smaller and regional employment establishments. In addition, healthier consumer balance sheets will enhance credit access, benefiting from low inflation and interest rates, which will support cautiously higher levels of debt and spending.



* Through 2Q
Sources: Marcus & Millichap Research Services, Bureau of Labor Statistics

• Economy well-positioned for growth in remainder of 2014. Favorable outlooks for rising consumption, wages and incomes, trade, and private residential and business investment are forecast to set a much more robust pace for GDP performance for the remainder of 2014, with annualized increases of 3.0 to 3.5 percent forecast in each of the remaining quarters. In addition, fiscal drag should reverse with an upswing in government spending. Pent-up housing demand and still-high affordability suggest housing and housing-related activities will spur a significantly higher contribution to GDP going forward.

• Small-business optimism continues to accelerate, lifting prospects for broadening growth. Over the last three months, small-business optimism has steadily increased, reaching its highest level since late 2007. The rising sales and earnings of these smaller companies enhance prospects of increased hiring and investment. Businesses with fewer than 500 employees comprise nearly half of the private-sector employment, so they could significantly lift job creation this year.

• Payrolls will add nearly 3 million jobs in 2014, further tightening the unemployment rate. Home building and commercial construction will gain momentum and lift hiring in areas that have been slower to recover than other industries, such as construction, finance and insurance.

• The forecast for global economic growth is now cautiously positive with steady headwinds. Chilly relations between Europe and Russia will exacerbate risks of retaliatory trade policies that could rein in global economic growth this year. Nonetheless, second quarter positive momentum in the U.S., Britain and China will support economic stability on the world stage. Rising tensions in Ukraine and the Middle East will remain significant risks to the economy as geopolitical tensions play out.

The Federal Open Market Committee (FOMC) has reduced the pace of asset purchases by $10 billion four times since December 2013 and appears likely to maintain a gradual pace with no rate hike expected until early 2015. Despite recent improvement in the labor market, structural issues persist, indicating that it has not fully recovered. Further, U.S. interest rates have actually declined since tapering began and the global capital market response continues to be favorable.

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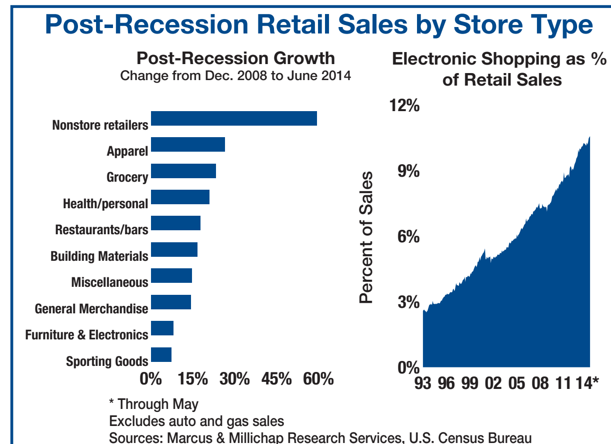
Consumer Spending and Modest Inventory Growth Push Gradual Performance Gains



Escalating job gains and rising consumer confidence have supported retail spending, but weak income growth constrains core retail sales. The U.S. population increased by 9.0 million residents over the past four years, supporting an accelerated pace of retail sales growth despite the slower pace of job growth and net absorption throughout the recovery. Consumer confidence for the first half of the year improved 12 percent, with expansion in both the present situation and expectations indexes. Going forward, wage growth and the housing market recovery become paramount to continued improvement in consumer spending and thus overall demand for retail space. In addition, a significant shift in the distribution of income and wealth has created a pronounced change in the retail landscape, squeezing out middle-market department stores and mid-priced restaurants, concurrent with rapid growth in luxury or specialty retail stores, grocers and restaurants, as well as discount stores and value-oriented outlets. The bifurcated spending pattern represented at the discount and luxury ends of the spectrum underscores that the recovery remains uneven and segments of the population continue to struggle.

Retailers have adapted to different locales and consumer preferences using varied store prototypes and multichannel platforms. The changing face of retail has made additional facets of the business as relevant as competitive price points, quality products and convenience. Evolving mobile technology and rapidly growing e-commerce transactions have resulted in downsized existing retail footprints and an increase in quasi-distribution centers for expedited delivery. This adaptation may drive retail sales but has constrained demand for traditional retail space. The number of retail establishment closings announced in the first quarter of this year soared to 2,444, but the 27.1 million square feet affected, while a little high, does align with typical first quarter space reductions. Radio Shack accounted for approximately 45 percent of the store closures, and the rest were spread between department stores, Sears, J.C. Penney, Macy's and Nordstrom (4.8 million square feet); office supplies, Staples (4.3 million square feet); and discount department stores, Kmart and Target (3.3 million square feet). Grocers announced closures that totaled 2.7 million square feet as the segment evolves into smaller formats with targeted offerings, such as organics, ethnic cuisine, gourmet and limited-service discount. Discount and dollar stores accounted for more than 54 percent of retailer expansion announcements with the remainder primarily split between fast food, auto parts and apparel.

E-commerce continues to challenge net absorption of existing space, but retail space fundamentals remain on a clear path to recovery. Net absorption over the past four quarters totaled nearly 60 million square feet, the strongest pace in six years, but was still less than half of the total averaged from 2000 to 2007. Although e-commerce has likely placed retail on a path toward a "new normal" for space demand, pure e-retailers now seek to open brick and mortar stores to compete for consumers desiring a personalized, in-store experience as well as the entertainment and social aspect of shopping. The emergence of fresh retail concepts and the addition of entertainment and restaurant venues will help well-located, well-conceived existing shopping centers thrive. Recovery in strip and neighborhood centers continues to lag malls and power centers, but the national vacancy rate for all retail properties decreased 40 basis points over the year to 6.9 percent as of first quarter.

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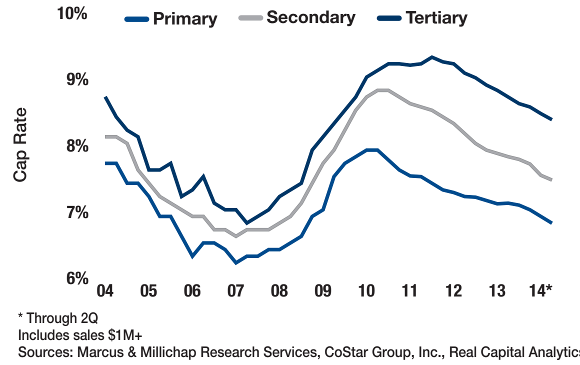
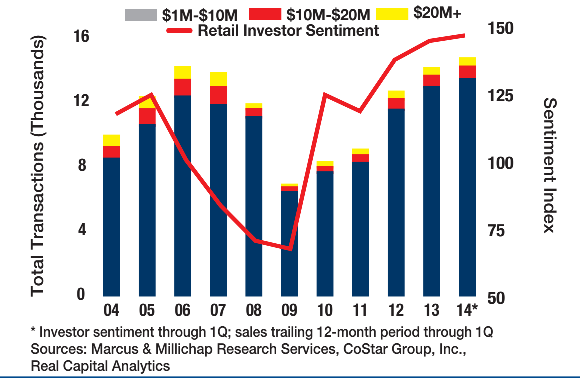
Individual property sales, portfolio transactions and momentum in urban/storefront property sales all propelled total retail property sales. First-half retail sales totaled $38.1 billion, more than 20 percent above last year's first-half volume. Sales of retail properties rose 13 percent on a year-over-year basis. Strip centers accounted for $14.6 billion, or 38 percent, of sales volume, but the mall category carried the momentum as sales volume jumped 75 percent. Not surprisingly, this category garnered premium pricing. The average price per square foot increased 49 percent to $298 at an average cap rate of 6.3 percent. Across all retail categories, investors paid an average of $163 per square foot, 4 percent higher than the prior year, and the average cap rate declined 20 basis points to 6.9 percent. The average cap rate fell 10 basis points to 7.3 percent for strip centers, although prices increased 14 percent to $156 per square foot. Major and secondary metros continue to capture the lion's share of total transactions for the quarter, posting superior transaction momentum, but sales volume in tertiary markets also grew a healthy 22 percent. At 8.4 percent, the cap-rate spread for tertiary markets has widened to an average of 90 basis points relative to secondary markets and 150 basis points with respect to major metros.



* Through 2Q
Includes sales $1M+
Sources: Marcus & Millichap Research Services, CoStar Group, Inc., Real Capital Analytics



* Investor sentiment through 1Q; sales trailing 12-month period through 1Q
Sources: Marcus & Millichap Research Services, CoStar Group, Inc., Real Capital Analytics

Forecast:

Accelerating job growth should ultimately produce stronger income growth and release pent-up household formations and retail spending. More than 1.4 million new households are forecast to be created in the U.S. this year as the pace of hiring accelerates. Metros with strong demographic trends and above-average job growth should see continued operational improvement. Tightening availability in some markets may prompt new construction if retailers are unable to find suitable space and the rents are high enough to justify new development. Power centers, grocery-anchored centers and upscale outlets will be the focus of ground-up development. Approximately 51 million square feet of new supply is forecast in 2014, well short of net demand for retail space totaling 76 million square feet. Forecast supply represents a 42 percent increase, but demand appears to be growing faster, a dynamic that should bring down the national vacancy rate another 70 basis points to 6.5 percent. Nationally, effective rents are forecast to grow 2.0-2.5 percent to $18.00 per square foot.

Minimal supply growth and continued vacancy declines will support rent growth and operational performance, enhancing investor demand and capital availability for retail assets. Retail mortgage originations across all lender segments accelerated over the past year. CMBS financing, which doubled in volume last year, was anticipated to lead the charge in the retail arena, but instead lost market share to regional and local banks. Life companies also lost market share. Robust capital has created a competitive financing arena, with tighter spreads and improved terms, while maintaining cautious underwriting criteria. In addition, the assets financed over the past year closed with an average vacancy rate of 4.0 percent. Going forward, the arbitrage in pricing and cap rates in secondary and tertiary markets will attract more investor interest.

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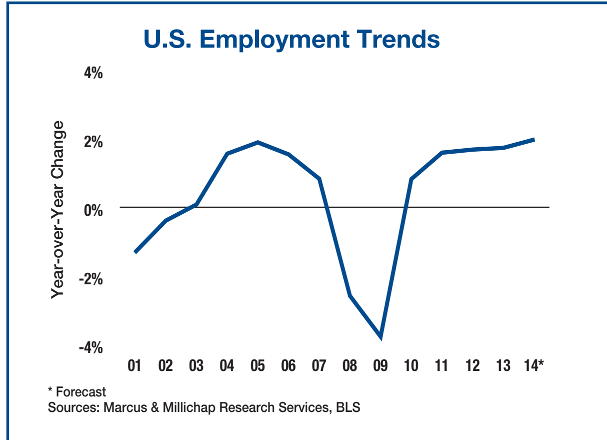
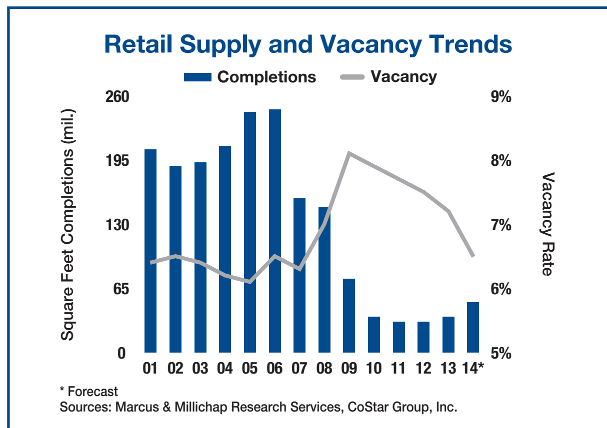
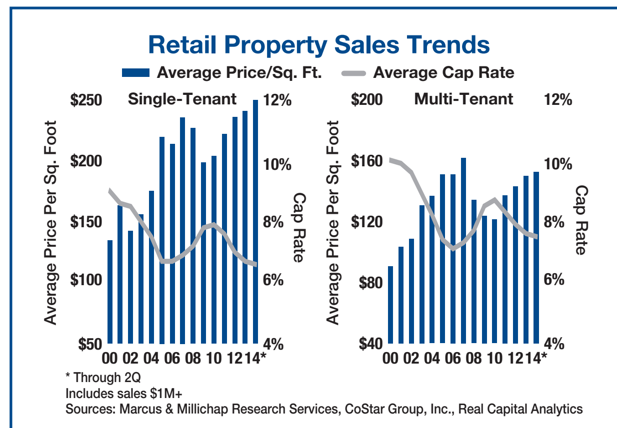
Retail Market Vital Signs







1Q 2013 to 1Q 2014 Change in Retail Vacancy

Markets by Greatest Decrease in Vacancy

Metro	1Q 2014	Y-O-Y Chg. (bps)
Atlanta	9.8%	-110
Cincinnati	8.3%	-90
Columbus	7.7%	-80
Phoenix	11.1%	-80
Denver	6.4%	-70
Los Angeles	5.3%	-70
Oakland	4.9%	-70
Sacramento	9.6%	-70
Austin	5.3%	-60
Detroit	9.9%	-60
U.S. Metro Average	**7.1%**	**-30**

Markets by Greatest Increase in Vacancy

Metro	1Q 2014	Y-O-Y Chg. (bps)
Chicago	9.0%	50
Houston	7.5%	30
Seattle	6.0%	30
West Palm Beach	6.8%	10
Miami	4.2%	0
Salt Lake City	5.0%	0
San Diego	4.8%	0
Portland	5.6%	-10
San Antonio	6.0%	-10
Boston	4.6%	-20
U.S. Metro Average	**7.1%**	**-30**

Sources: Marcus & Millichap Research Services, CoStar Group, Inc.

The information in this report is deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, expressed or implied, may be made as to the accuracy or reliability of the information contained herein. Sources: Marcus & Millichap Research Services, CoStar Group, Inc., DataQuick, Deutsche Bank, Economy.com, Federal Reserve, MBAA, NAR, Real Capital Analytics (RCA), Reis, U.S. Census Bureau.

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