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HITTING THE WALL

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In December 2015, market uncertainty was reaching a crescendo. Low crude oil prices, slowing economic growth in China and further destabilization in the Middle East had investors very concerned. The Dow Jones Industrial Average (DJIA) Index responded by dropping more than 1,000 points during the first week of trading, the worst start to a new year, ever.

Headlines such as "Stocks Sink as Investors Seek Safety," "Treasury Yields Plummet," "Gold Soars," "Economists Lower Growth Estimates," and "Why Low Rates Aren't Enough" that appeared in January 2016 suggested investors had hit the wall in this investment cycle. In fact, investors are backing away from risky assets and buying safe harbor investments a process that has increased interest in commercial real estate (CRE).

CRE is, possibly, the quintessential safe harbor investment as it's a hard asset with steady income and relatively stable pricing. However, when considering commercial property for value, it is important to examine gross value as well as the capital return. Commercial real estate gross values increased 77.2 % between the first quarter 2000 and the first quarter 2008. Then, gross value declined 29.3% in the 2009 trough, with a subsequent rebound in values of 62.6% from 2009 to 2015. From a capital return perspective (gross value change less capital costs), interest in CRE has increased, but not as dramatically. From 2000 to the first quarter 2009, the capital component appreciated 48.1% which was followed by a Great Depression trough of 31.7% in 2009. Since 2009, the capital component has appreciated 46.2%. The biggest reason behind the re-appreciation is not renewed interest in CRE, tremendous value or even flight to safety but rather capital improvement projects (including leasing activity).

As an investment, CRE has returned to most of its former glory and hasn't experienced the huge swings securities have, but is it the right play in these uncertain times? Situs' ValTrends experts expect that it will be hard to find core deals that will provide risk-adjusted returns in 2016 as good as they were in 2015. They also note that the wall of commercial mortgage-backed securities (CMBS) loans, originatin in 2006, may be difficult to refinance if underwriting standards tighten and less capital is available. They point out that possible interest rate increases, new construction, as well as economic and political instability will be among the biggest challenges to return performance.

Even so, most ValTrends experts believe that cap and discount rates are fully priced compared to long-term historical averages (the yield on 10-year Treasurys was 2.24 percent when surveyed). One respondent who felt cap and discount rates were not reasonable, noted that "when Treasury yields are no longer artificially contained, cap rates will rise." We agree with this statement; however, as noted above, the 10-Year Treasury is predicted to stay low for the next 12 months or possibly longer.

With respect to valuation over the next year, the majority of our ValTrends experts felt that commercial real estate value will see "minimal changes" in 2016. Another respondent stated that "values should hold steady or increase 5 percent or so, as net operating income (NOI) continues to increase in 2016 and there is plenty of capital available to invest." One ValTrends survey respondent forecasted that as cap rates increase, "values will continue to bump along the top, until a watershed event craters precarious valuations."

On a metro and regional basis, Situs RERC® ValTrends survey respondents noted the following trends:

- Commercial real estate values declined in the East region in fourth quarter 2015, and while commercial real estate was overpriced, the Boston market offered the most value compared to New York City, Washington, D.C., Philadelphia, and Charlotte.

- During fourth quarter 2015, commercial real estate values in the Chicago, Columbus, and Minneapolis markets were rated lower than those for the previous quarter. Commercial real estate value ratings for some other Midwest metros were higher, however, including those for Kansas City and St. Louis, where value was equal to, or outpaced, price.

- While the value vs. price rating for commercial real estate in the Houston market was higher in fourth quarter 2015, prices generally outweighed values for commercial real estate in the Atlanta, Austin, Dallas, and Miami metros of the South region, according to ValTrends experts.

- The value vs. price ratings in the West region declined for the majority of the metros surveyed, with the exception of the Denver market, during fourth quarter 2015. Although the value vs. price rating for commercial real estate in the Phoenix market declined, the rating indicated that value still outweighed price. In contrast, commercial real estate in the Los Angeles market was slightly overpriced, and the value vs. price ratings for the San Francisco and Seattle markets were among the lowest for the metros surveyed across all four regions.