Real Estate After the Stock Market Collapse

Summary and Conclusions

• The effect of the stock market collapse on real estate depends on whether investors adopt the view that the drop in stock prices signals a pause in economic growth or a recession.

• A pause would have modest impact on the real estate market, with the exception of those areas directly affected by the securities industry. Office space absorption in Manhattan, Chicago, Boston, Los Angeles, and San Francisco will slow, for example. A national recession could negatively affect real estate markets and asset prices.

• Rents for industrial buildings would do better if economic growth simply pauses, because the lower value of the dollar helps the trade-sensitive Midwest.

• The higher perceived volatility of stocks may offset the improvement of relative prices that stocks achieved through the fall, thus increasing the weight of real estate in asset allocation models.

• If economic growth pauses, real estate values will not reflect the compression of stock values. Furthermore, the easing of credit induced by the stock market debacle may cause investors to seek inflation-sensitive assets, which will improve the tone of the real estate asset market. Several significant transactions closed after October 19, 1987, that had been negotiated prior to that date, indicating that institutional investors expect long-run real estate fundamentals to remain intact.

Introduction

The October drop in stock prices has caused economists to revise forecasts for the U.S. economy and investors to reevaluate asset allocation decisions for portfolios. Although no ticker tape exists for real estate prices, real estate assets have been affected because the relative price of real estate compared with other assets has changed, and the supply and demand for real estate in the product market is directly affected by changes in the overall economy.

There are two broad schools of thought on the impact of the drop in stock prices on the overall economy: one optimistic and the other pessimistic. This difference is important to the value of real estate. The optimists believe that stock market drops do not necessarily lead to recessions. They cite the experience of 1962 in particular, when a 25% drop in stock prices was hardly noticed in the subsequent national economic statistics. In this view, the economy is headed only for a mild slowdown in the next two to three quarters and, thereafter, economic growth will accelerate.
The pessimistic school argues that the decline in stock prices signals a full-blown recession — and one that probably has already begun. The performance of real estate depends upon which view prevails. If the economy is just slowing temporarily, then after some initial uncertainty real estate assets should perform relatively better than they have in the recent past. However, if a recession occurs, real estate markets will receive the full brunt of it.

Real Estate Supply and Demand: Space Market

The slower economic growth induced by the drop in stock prices will adversely affect the demand for all real estate space. Although certain effects will be felt in all markets, some property types will suffer more:

Office Sector

The reduction in demand will be concentrated in the office sector in the major financial centers of New York, Boston, and to a lesser extent, Chicago, Los Angeles, and San Francisco. Nationally, employment in the securities, brokerage and investment banking areas has grown at a 10% annual rate over the past eight years. About one fourth of the growth in employment and demand for office space in Manhattan has come from this sector. Before the events of the past three weeks, demand already slowed noticeably. We now anticipate a 5%-15% contraction in employment in the securities industry and at best a 3% growth in overall office employment over the next year, compared with nearly 5% over the past 12 months.

Although this forecast represents a substantial downturn in the levels of office space absorption, it represents an inevitable correction to an unsustainable trend. The lower level of absorption will be reflected in rising vacancy rates, lower effective rents and the postponement of new projects in affected markets. Only if we see continued serious declines in financial markets and a corresponding deep recession will real estate markets suffer a setback in excess of the already anticipated slowdown in demand and new construction. In the deep recession scenario, the office vacancy rate could rise by two percentage points nationally, with vacancy rates in the New York metropolitan area showing a 3%-5% increase. Mitigating the rise in vacancy rates would be a sharp rise in canceled projects.

Residential Sector

The upper-end residential market in the financial center cities is also likely to be hurt. Reduced wealth, lower incomes and layoffs leave the financial center cities and especially the New York metropolitan area vulnerable to a decline in demand and values. The Northeast is particularly susceptible to price declines because of the doubling of housing values in the past four years. We anticipate a 10%-15% decline in nominal housing values in the Boston and New York metropolitan areas over the next year.

For the middle and lower end of the residential market, the impact of the new financial environment will be less noticeable. In the short run, some households will refrain from purchases until they gain a better understanding of the future course of the economy, interest rates and home values in local markets. This uncertainty should assist the rental housing market even though lower mortgage interest rates would normally stimulate home ownership. Uncertainty and lower economic growth will offset the beneficial effects of increased affordability of owner-occupied housing.
Retail Sector
The slowing of economic growth is expected to hamper already weak retail sales. The major impact will be on upscale and big-ticket items. General merchandise sales and grocery sales tend to hold up better during a slowdown; however, a recession would reduce real nonautomobile retail sales by about 5%.

Industrial Sector
A weakening dollar is offsetting a slowdown in domestic growth. This is aiding the recovery of the traditional industrial sector, especially in the Midwest. However, a severe recession would crimp automobile sales and the demand for capital goods and abort the recent improvement there.

Hotel Sector
In a modestly weakened economy, tourist and business travel will fall off, leading to lower occupancy rates. Business travelers may trade down in an attempt to economize, increasing the demand for less expensive hotel rooms. On the other hand, a weaker dollar will increase tourism in gateway cities, continuing the trend toward highly diverse geographic performance within the hotel sector.

Real Estate Values and Portfolio Allocation Decisions
Despite the relatively weak performance of real estate in the leasing markets, there remains a strong demand for real estate as an asset class for institutional investors. This stems from the perceived notions that real estate offers an inflation hedge and that diversification exists because real estate and financial asset returns move separately. The recent completion of the Cadillac-Fairview transaction and the Allegis Corporation's sale of Westin Hotels, negotiated prior to October 19, indicates that investors believe that the long-run fundamentals of real estate have not changed.\(^1\)

Given current vacancy rates, real estate values could rise under our economic-pause scenario. If, however, the recession scenario occurs, real estate values would fall markedly.

Relative Performance
At the end of 1986, the two hundred largest pension funds held approximately 3.6% of their portfolios in real estate equities. At the height of the bull stock market in August 1987, this percentage had fallen to approximately 3%. Even with October's drop in the stock market, the percentage has probably only inched back to the level where the year started, or approximately 3.6%. Therefore, pension funds are currently at the low end of their real estate portfolio allocation ranges, which we believe to range from 3% to 11%.\(^2\)

As inputs to the allocation decision, expected returns, volatilities and correlation among the returns earned by the various asset classes play an important role in determining both benchmark and strategic allocation decisions. Perhaps the most important effect of the recent extreme drop in stock prices is on expected stock volatility, which has jumped from pre-plunge levels. Under the pause scenario, stock prices would rise after a short lull, when investors realized that a recession is not forthcoming. However, the effect of an increase in expected volatility may diminish allocations to stocks. Because some inflationary pressure is inherent in the pause scenario, bond returns are expected to suffer once the short-term effects of recession fears subside. Again, because real estate has historically provided an inflation hedge and may well do so again after (or if) the leasing markets adjust to slowing construction levels, the value of real estate relative to financial assets should improve. At the current low allocations for real estate, pension funds have some room to add the asset class to portfolios.

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\(^1\) However, a recent press report indicated that a major Japanese investor withdrew from three real estate transactions involving two office buildings in Chicago and one in Boston.

Earlier this year, we provided evidence that stock and bond values were extremely high relative to real estate values, and that any expectation regarding weakness in either of the financial asset sectors would indicate a switch into real estate. As shown in Figure 1, the case can still be made, although not as strongly as before, that the terms of trade between real estate and stocks indicate that real estate represents good value. In particular, since the end of September, stock values have dropped by nearly 25% and real estate values have remained flat. In the pause scenario, stock prices are expected to rebound, but with greater expected volatility. Certain types of real estate are expected to perform well, indicating that there may still be opportunities in the asset class. The ultimate impact on real estate investment depends on investors' attitudes toward stock volatility as well as if expected returns adequately compensate for the increased risk.

Therefore we expect many institutional investors to make a marginal switch out of financial assets, largely from two different effects: First, a return to inflation increases the attractiveness of real estate, historically an inflation-sensitive asset. Second, given increased perceptions of stock volatility, real estate values are perceived to be more stable, thereby providing somewhat of a safe haven for times of potentially turbulent relative value shifts. Because real estate values tend to lag in response to other values, the recessionary expectation generated by the fall of the stock market will not be reflected in real estate values under the pause scenario, so that relative value will be retained. Therefore, to avoid large future losses, there may be stronger interest in real estate.

If the expectation is for a full-blown recession, then all equity markets (stock and real estate) will suffer. The stock market will continue to fall, although the magnitude of the fall is difficult to assess. Unlike the 1982 recession, which occurred when real estate markets were in relative supply-demand equilibrium, this recession will occur under conditions of fundamentally weak realty markets. In this case, it will be difficult to achieve targeted rates of return from investment in real estate as values fall.

If Relative Values are Higher, Where Will the Money Go?

The sudden increase in stock volatilities and the lower relative risk expectations for real estate in the pause scenario indicate that there may be an increased flow of funds to the real estate sector. This will occur despite the fact that retail markets are currently fully valued, with capitalization rates for regional malls as low as 5%, and that the office sector is weak in many major markets. Although opportunities exist in certain office and retail markets, the demand for quality space by institutional and international investors will continue to drive yields lower. At this time, with the outlook for single-family housing uncertain and with the dollar weakening, apartments and industrial real estate offer the best opportunities within the real estate asset class. Industrial markets will benefit from the improved export situation in the pause scenario, and apartment buildings will remain attractive because of higher relative yields. However, given large potential levels of investable funds, these markets are traditionally considered as difficult for placing significant amounts of funds because of the relatively small size of the average property.

Another sector that may exhibit strength under both possible economic scenarios is real estate debt. As with other markets, a flight to quality has led investors to seek relatively conservatively underwritten commercial mortgages and mortgage-backed securities at the quality end of the market, which in turn has led to a firming and narrowing of those yield spreads relative to Treasuries.

The Impact of the Collapse on the Foreign Investor

The greatest risk facing the foreign investor is the continued depreciation of the exchange value of the dollar. Under both scenarios, foreign investors might be tempted to postpone investments in U.S. real estate until exchange rates stabilize or at least until the depreciation of the dollar becomes more predictable. Otherwise, foreign investors will behave very much like their U.S. counterparts, by being more aggressive buyers under the pause scenario and more cautious in the event of a recession.

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