

## **2006 Economic Outlook: A Stellar Market by Any Measure** **by Robert Freedman**

The United States economy has displayed a powerful resiliency over the last several years, with home sales hitting records and commercial activity reaching robust levels despite a steady stream of big shocks like hurricanes Katrina and Rita. That same resiliency will keep real estate activity strong in 2006, handing practitioners in all property sectors another year of outstanding business opportunity.

“The real estate boom is showing signs of tiring,” says National Association of Realtors® Chief Economist David Lereah, “but because the fundamentals in our economy are so strong, what we’re calling a slowdown is really a stellar market by any definition.” NAR is forecasting total existing-home sales, including condos and cooperatives, of 6.86 million units in 2006, down 3.5 percent from the estimated all-time record of 7.11 million in 2005 and the second highest ever. New-home sales will reach 1.24 million, down 4.6 from a record 1.30 million in 2005, NAR forecasts.

Commercial activity will exhibit similar strength, thanks in large part to resurging business spending that’s helping to offset cooling spending by consumers. After years of retrenching after the tech bust, businesses are plowing a good chunk of their record profits back into investment, driving demand particularly in industrial markets riding the wave in Asian and Central American trading.

“Industrial strength is one of the commercial stories for 2006,” says Kenneth Riggs Jr., CEO of Real Estate Research Corp. in Chicago.

The rise in business spending comes at a crucial time, because consumers are showing signs of spending fatigue. Although job growth has picked up momentum after two years of weak gains and incomes are rising high and many households that want to tap the equity in their home have already done so. And even though conditions are relatively strong, worries about the economy remain high. Consumer confidence, as measured by the Conference Board Index, dropped to 85 just before Katrina hit from about 100 in mid-2005. A confidence level below 100 is considered weak. Although the index is expected to climb back to the 100-point mark before the end of 2006, it will likely stay below the 105 level that was typical in much of 2004 and early 2005.

### **Strong Fundamentals**

Despite lagging consumer confidence, the economic fundamentals are good. Continuing strong populations growth fueled in part by immigration and new household formation by boomer children, is keeping housing demand at peak levels. And housing inventories, while rising, remain out of balance with that demand. On a national basis, inventories were at a 4.7 month supply, up from a 3.8 month supply at the beginning of 2005, but still below the five to six-month supply that is associated with balanced market conditions.

The easing housing shortage will soften price appreciation as supply and demand move into better balance. NAR is forecasting national median price appreciation of 5.3% in 2006, down from 12.4 percent in 2005, so practitioners will need to start reducing sellers’ expectations of what their home can command and how long it will stay on the market.

Rising interest rates – led by the Federal Reserve’s policy of keeping inflation in check with quarter-point increases in its overnight rate for banks – will also help slow sales and appreciation. NAR expects the rate on a 30-year fixed rate mortgage to average 6.5% in 2006, about one percentage point higher than in 2003 and 2004, but not much above the expected average for 2005 of 5.9% - all extremely low by historical standards.

Signs that eased appreciation might help first-time buyers have yet to emerge, though, in part because of the rise in rates, which hurts affordability. NAR’s affordability index in September stood at about 120, down from an average of about 133 in 2004. An index of 120 means a

household earning the national median income earns 120 percent of what it needs to qualify for a mortgage on a house priced at the national median.

"Housing affordability will continue to be a very tough problem for California," says Leslie Appleton-Young, chief economist at the California Association of Realtors®. Even so, the most robust sales activity will be on the lower end of the market in 2006, economists say. Sales have started slowing on million-dollar homes, already a thin part of the market, but homes that list near the local median price will be snapped up. "Anything affordably priced will continue to sell well," says Frank Nothaft, chief economist for Freddie Mac.

#### Economic Shocks

Notwithstanding price jumps in oil and natural gas, particularly after Katrina and Rita disrupted supplies by damaging processing and transportation facilities on the Gulf Coast, inflation continues to be modest. The core inflation rate, which excludes volatile energy and food prices, has risen by only two percent in the 12 months ending September 30, 2005, and is expected to stay low through the first part of 2006.

Even oil prices, which surged to almost \$71 a barrel after the hurricanes from about \$50 a barrel at the beginning of 2005, are showing signs of coming back down to earth. A barrel of light, sweet crude had dropped to about \$57 by mid-November and, absent another catastrophic event to disrupt the supply, prices should continue easing. Some analysts are forecasting prices to ease even to \$30-\$40 range by the end of this year.

#### Investment Fuels Commercial

The strong balance sheets of U.S. businesses, which continue to tap tech-led productivity gains, will be a driving force in commercial market strength, analysts say.

Fixed business investment, which had plunged more than 10 percent annually after the tech bust, has been steadily climbing back. In early 2005, investment was growing at a 10 percent rate, federal Bureau of Economic Advisors data show. Huge public and private investment for rebuilding after the hurricanes will add to the trend.

With unemployment expected to shrink and core inflation remaining low, the stage is set for more strong capital inflows into commercial real estate, he says.

The number of sales transactions in all commercial sectors was up in 2005 and that trend is forecasted to continue.

Sales activity on industrial buildings was up 83 percent in the third quarter of last year and leading all other sectors. Industrial will continue to be an investor favorite in 2006. Massive trade with countries abroad, particularly in Asia, is a root of the sector's strength. "Economies with strong port and distribution bases will do well," says Riggs.

Good bets are southern California, the main hub for trade with China, and South Florida, the main hub for trade with Central America, which is expected to get a big boost from the Central American Free Trade Agreement (CAFTA).

Multifamily housing will benefit as interest rates move up, attracting immigrant and young households not ready to move into homeownership. However, this sector isn't expected to see rent growth as strong in other sectors, in part because multifamily was never hit as hard as others after the tech bust. At the same time, a rush by owners into condo conversions is taking inventory off the market.

"Growth will be at a contained rate," says Beth Lambert, vice president of the Archon Group in Dallas and 2006 president of the Council of Real Estate Women.

Multifamily vacancy rates have been heading down since before 2003, when they were at about 6.5%, and by the end of 2005 stood at just above 5%.

Retail markets, despite over-spent consumers, will stay strong, thanks in part to boomer household wealth. Vacancies are coming down, although not at the rate of other sectors. A drop to 7.1% in 2006 from 7.2% in 2005 is forecast.

The office market is a big beneficiary of the strong business investment, particularly in high-growth metro areas such as Washington, D.C. and southern California. Vacancies on a national basis are at their lowest since 2001. Job creation, which has been rising steadily since 2003 when companies were shedding office jobs, and discipline among developers not to overbuild markets have led to a healthy balance between space absorption and new units coming on line.

“The economy is stronger and more resilient than anyone had anticipated just a few years ago,” says Riggs. “Our economy has weathered the most destructive storm ever, the tech bust, the terrorist attack, wars abroad and accounting scandals. Despite all that, the state is set for healthy market growth, and real estate is a prime beneficiary of that.”

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