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# The real estate cycle: What inning are we in?

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In the big game of real estate, everyone is asking the same thing: What inning are we in? Is it time to bring in the closer? After all, memories of the Great Recession are not far from the mind.

Next month will mark six full years of the current U.S. economic cycle, making the current recovery longer than the average and on par with the expansion that began after the dot-com crash and ended with the 2008 financial crisis. Real estate values are considered by many to be rich and there is debate about how much higher they can go. Is it time for the smart money to make the call to the bullpen?

The answer, of course, is maybe. While everyone wants to sell high, if you are too conservative, you could miss an opportunity to profit from continued economic expansion. Employment is healthy, with a 5.4% unemployment rate. However, incomes aren't rising fast enough to provoke inflation, which is down 0.1% year-over-year through mid-2015. This has allowed Fed Chairman Janet Yellen to remain patient.

## WORD ON THE STREET

"Many of our clients believe commercial real estate prices have become too expensive," said Brad Dubeck, New York/New Jersey Market Executive for Bank of America Merrill Lynch. "A significant number have been selling assets over the past 18 months, taking advantage of historically low cap rates. Sponsors who remain in acquisition mode tend to be attracted to the larger gateway markets, which are benefiting the most from capital investment and job growth.

"They admit we might be in the later innings of this cycle but remain convinced many opportunities still exist for prudent real estate investments. Moreover, there are certain players, in particular foreign investors, who remain very bullish and see the game in its early innings. In particular, they believe low interest rates will prevail for the foreseeable future."

Any rapid or aggressive tightening of the money supply by the Federal Reserve would be a surprise to many, Dubeck noted. Rates must rise, but the real question is when and whether the downside impact can be managed. He added that the real estate economy has become accustomed to low interest rates and rate increases will change capital flows and cause some disruption.

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For now that disruption seems a ways off—but for how many innings? Most key indicators point to a mid- rather than late-stage cycle. Multi-family and residential housing markets are hot and new supply of other asset classes is modest.

"The Federal Reserve's first rate hike is likely to occur at the same time primary elections and budget negotiations are in full swing," U.S. Trust's May 26 issue of *Capital Markets Outlook* said. "For investors, the Fed's independence is most important and inflation forecasts should mostly reflect its credibility. Barring legislation that interferes with this, the dispersion of inflation forecasts should not be overly disruptive to markets."

Despite signs of froth, such as the influx of capital flooding the market, mainly from non-regulated lenders and foreign investors, real estate investors evince a guarded optimism.

## WHEN TO SEND IN THE CLOSER

Savvy investors look for indicators of the top of the cycle such as speculative, high-leverage financing and development; or paying richly for land despite facing large risks to develop it. But nobody really knows where the shock is going to come from.

The *Capital Markets Outlook* issue stated that a strong U.S. economy should remain a tailwind for the world economy:

*"There are, of course, a wide range of variables to consider here, from inflation and commodity prices to trade exposures, balance-of-payments positions, sector composition, government policy and political risk. But for each market, three directly comparable factors that we think will be important to watch are: 1. Delivered economic performance versus consensus expectations 2. Starting equity market valuation multiples 3. The outlook for local monetary policy."*

Regardless of the point of the real estate cycle, Bank of America Merrill Lynch will be an industry-leading provider of capital, market intelligence and advice to clients.