# Musings on CRE Prices and Differing Market States

November 16, 2015

## Construction cranes, trophy deals and soaring asset values in some big cities can hoodwink us about the overall circumstances of CRE prices.

Questions have increasingly been aired over the trajectory of CRE asset prices and, in particular, whether we're closing in on bubble territory. Most recently in a speech to a local Rhode Island Chamber of Commerce, President Rosengren of the Federal Reserve Bank of Boston cited that prices had "grown quite rapidly" and the trend warranted scrutiny going forward.

This type of discourse is a recurring theme through real estate cycles and a prudent one at that. However, we also tend to reflexively conflate the price performance of assets in high-profile or "gateway" cities with what's happening in other places like Dallas or even Dubuque. This parochial view is reminiscent of the famous *The New Yorker* magazine cover depicting Manhattan's 9th and 10th avenues and the Hudson River in the foreground and foreshortened images of the rest of the country—and beyond—as if an afterthought .

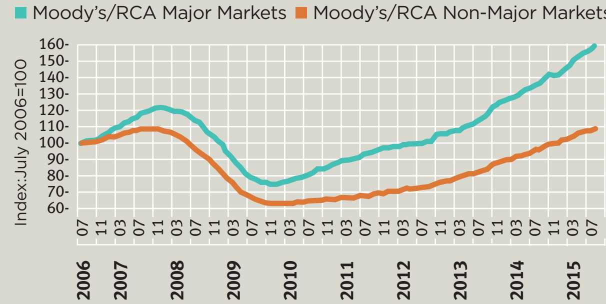

True, CRE prices in New York and Mr. Rosengren's Boston among several other locations have been on fire. But like *The New Yorker* cover, there's more than meets the eye. Employing Boxwood's proprietary data on small cap CRE prices as well as price data from our friends at Real Capital Analytics who jointly produce the Moody's/RCA price indices, we can draw a more nuanced picture of national CRE price trends that include the following observations:

- **Asset prices in top-tier cities are through the roof.** Yep, these magnets for global investment capital have pulled out all stops on price appreciation. The Moody's/RCA Major Markets (MM) Index that includes commercial/multi-family transactions (principally above $2.5 million) for the six gateway cities of New York, Los Angeles, San Francisco, Chicago, Boston and Washington, DC have recovered 115.1% from its trough and, as of August, floated a grandiose 32.5% above the pre-crisis peak level of December, 2007. Also with a whopping annual return of 17.9%, the MM trend shows little indication of slowing with 29 consecutive months of year-over-year gains ranging roughly between 10% - 19%. See the nearby graph.

**BUBBLE TERRITORY?**

Large Cap CRE Price Trends for Market Segments

Moody's/RCA Major Markets ■ Moody's/RCA Non-Major Markets

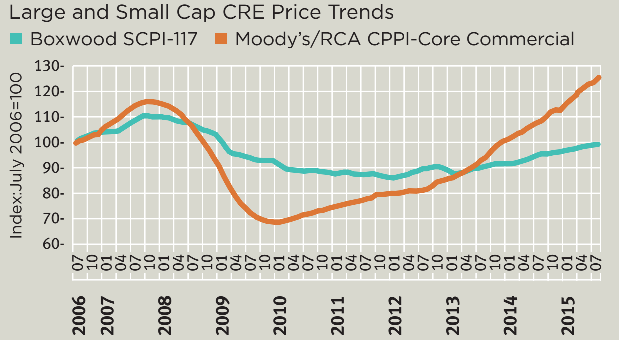



Source: Moody's/RCA; Boxwood Means, LLC;

▶ **More balanced price growth reigns elsewhere.** The Non-Major Markets (NMM) Index from Moody's/RCA suggests that asset prices in secondary and tertiary cities are recovering at a more reasonable rate. Let's call them the Goldilocks group—not too hot nor cold—about right in light of strong national space market fundamentals. The NMM Index increased a solid 12.9% year over year during August and has cumulatively retraced 72.5% of its losses since its nadir to reach near parity (-0.1%) with its pre-crisis peak. This equivalence says a lot about prices for the majority of the country when compared with the lofty peak-to-current status of the MM Index cited above. Moreover, the price spread between major and non-major markets has only been expanding: i.e., by our reckoning asset prices in the former exceed the latter by 56.7%—the biggest gap on record and, for point of comparison, is way more than double the spread between the two indices at the market's previous 2007 peak. Clearly, this collection of cities has lacked the luster (and capital inflow) relative to the gateway cities and, as Moody's recently reported, trails the major market recovery by about two years.

▶ **Price recovery is a longer-term proposition for small cap CRE.** We've always maintained that small cap CRE prices have more in common with residential housing prices than they do with institutionally-oriented or large cap CRE trends. Boxwood's national commercial composite index of 117 markets, or SCPI-117 (that excludes multi-family), has advanced by only 4.4% year over year and recovered 55.1% of its losses since hitting bottom during January, 2012—a full two years after the trough for the equivalent Moody's/RCA's Core Commercial Index involving larger-sized assets (see the nearby graph). SCPI-117's peak-to-current gap stands at 10.0%. (Residential housing prices are similarly 11.6% below peak based on S&P/Case-Shiller price data.) Needless to say, this domain's price recovery has followed a much more gradual path. And although substantial

**MOVING, FAST AND SLOW**




Source: Boxwood Means, LLC; Moody's/RCA

price gains have been posted for small cap CRE in some info-tech centers and typical boom-bust cities, a majority of the 117 cities tracked by Boxwood have eked out price increases of just 3% or less over the last 12 months.

The contrasting volatility in the price trends for SCPI-117 and the separate Moody's/RCA MM and NMM indices couldn't be more striking. In particular, the increasing resemblance of the MM Index trend to the classic "hockey stick" shape (associated with rapid change in a data series) may be consequential and cannot be ignored. But, also, the tendency among some observers to conclude that the major-market phenomena of construction cranes, trophy deals and soaring prices are ubiquitous is to grossly distort the national picture—just like *The New Yorker* cover.