2009: The Shape of the “New Normal”

By James W. Hughes and Joseph J. Seneca

On December 1, 2008, the Business Cycle Dating Committee of the National Bureau of Economic Research—the private, nonprofit, nonpartisan, research organization that decides when recessions and expansions begin and end—first reported that the United States entered a recession in December 2007. Thus, America was already one full year into a recession before the Committee had sufficient evidence to tell the nation that it was actually in one! So, one month later, on January 1, 2009, the United States was officially in the 2007–2009 recession, spanning all or part of three years. The hope is that this downturn does not ultimately become the 2007–2010 recession, although that is, unfortunately, a possibility.

The once great “American Job Creation Machine” fully expired in 2008. It was replaced by the great “American Job Destruction Machine.” The United States experienced private-sector payroll employment declines every month in 2008, and by year’s end nearly 2.8 million jobs were lost (figure 1). In terms of absolute private-sector job losses, 2008 was the worst year since 1939, the first year that payroll employment statistics were compiled in the United States. In terms of percentage loss, it was the fifth worst year.

Of the 2.8 million job decline of 2008, 1.9 million jobs, or 68 percent, were lost in the last four months of the year. Figure 1 vividly portrays a labor market falling completely out of bed in the September 2008 to December 2008 period. This reflects a serious national economic meltdown, with all major components of demand—with the exception of health care—in decline. And it appears that the worst is yet to come. (continued, page 2)

Change Coming to the 2009 Commercial Real Estate Market?

By Sachiyo Asakawa; Gregg Nowell, Senior Vice President; and Christopher Santoro, Assistant Vice President

The Northern and Central New Jersey office markets ended a year of economic chaos with an overall vacancy rate of 15.8 percent. Despite the fluctuations seen in other regional markets, along with the state’s highest unemployment rate (November 2008) since August 1996, the Northern and Central New Jersey markets maintained relative stability. The vacancy rate increased by a slight 0.3 percentage points from the previous quarter’s 15.5 percent, with only a 0.2 percentage point increase from the fourth quarter of 2007. The average asking rate was $26.92, which was a solid $1.15 rise from the previous quarter and a $1.13 rise from the same quarter in 2007. Thus, the market has shown some slowdown, but it appears that the negative influence remains minimal.

Sublease activity continues to be very strong. The vacancy rate of sublease space dropped to 1.9 percent from 2.1 percent in the third quarter (continued, page 6)
The New Normality

A key question is not: When will things return to normal? But rather: What will the new normal look like? And, rest assured, there will be a new normality, because the sources of our current economic difficulties took the form of unsustainable bubbles and trends. Four are of major importance: financial activities’ economic dominance, an unprecedented global credit surge, over-consumption, and a homeownership bubble.

The New “Reduced Scale” Financial World

High-end investment banking activities entered the first decade of the twenty-first century like economic lions. They may exit it like wounded economic lambs. The financial sector’s share of all corporate profits in America jumped from generally below 20 percent in the early 1980s to above 40 percent at its peak in the current decade. The global credit bubble led to an unsustainable lending and borrowing binge, and unprecedented wealth on Wall Street. This was a key engine of regional prosperity bolstering New Jersey. But this over-leveraged, debt-driven era is now history.

Wall Street as we knew it for 75 years—loosely regulated, daringly risky, and ultra-lavishly rewarded—was obliterated in a matter of weeks. The world’s financial system is now being remade at lightning speed, with deleveraging and recapitalization the words of the moment. Already, the economic crisis has resulted in the financial sector’s share of profits dropping to 30 percent, and it will probably go lower. Clearly, the platinum years of seemingly unrestrained financial activities propelling real estate markets to new heights are now history. This will reverberate throughout New Jersey. It is a new normality that requires adjustment.
The New Credit Reality

A seemingly inexhaustible mountain of cheap global credit, accompanied by risk amnesia, drove not only Wall Street but also the broader economy during the 2000 to 2006 period. Such credit abundance made many real estate, housing, and development projects possible that simply weren’t feasible before. However, they became doable because of easy credit, not underlying economic-market fundamentals. But the era of severely underpriced risk has rapidly receded into the distant past. The rediscovery of risk and tightened lending standards will make many projects infeasible again. Exuberance and excess, spawned by cheap credit, are making way for prudence and pragmatism.

Long-Term Consumer Retrenchment

The once all-powerful economic locomotive of consumer spending has run out of steam. For two decades, Americans became unrepentant shopaholics—became the most overextended consumers in world history—by maxing out on plastic credit and using their houses as ATM machines. Figure 2, which has two parts, provides the evidence. At the top is the savings rate—personal savings as a percentage of disposable income—in the United States for the 1970 to 2008 period. For the first 16 years—1970 to 1986—America was relatively virtuous as a society, with the savings rate averaging roughly 10 percent. Then, the long sustained slide began, reaching zero percent by 2005. Obviously, a zero savings rate is not sustainable. (continued, page 4)
Households now have too little savings, too much debt, and their balance sheets are stretched to the limit.

Not surprisingly, at the same time, personal consumption as a percentage of Gross Domestic Product (GDP) soared. This is shown on the bottom half of figure 2. In the 1970 to 1982 period, personal consumption accounted for roughly 63 percent of GDP. By 2002, it exceeded 70 percent. Consider that the start of America’s great consumption bubble. We went on the greatest spending spree in the history of the planet. But that level of consumption is not sustainable. It was achieved only by spending every dollar of the paycheck, by depleting home equity, and overdosing on credit. Households now have too little savings, too much debt, and their balance sheets are stretched to the limit at a time when home prices and financial assets are still declining, and labor markets are continuing to weaken.

The bottom line is that an era of significant consumer retrenchment is upon us. Just like financial institutions, households are being forced to deleverage and recapitalize. The broad New York metropolitan region has been one of America’s most potent consumer markets—a virtual retail and distribution paradise.

However, change is taking place. The new post-spending-spree normality will be defined by a new sustainable lifestyle, with consumption as a share of GDP declining and savings rates rising. This will ripple through the economy.

**Homeownership Retreat**

The home price and homeownership rate corrections have unfortunately not run their courses. Since the size of the national housing bubble was unprecedented, its rectification will be a multi-year phenomenon. We are starting to see a retreat to sustainable homeownership rates. As shown in figure 3, the national homeownership rate was 64 percent in 1994. That was roughly the long-term average rate of preceding decades. However, it soared to the 69 percent level by 2004, before starting to retreat. The increase of 5 percentage points—from 64 percent to 69 percent—may not have been sustainable and probably represented a homeownership bubble. Many households in that 5 percentage points probably shouldn’t have become homeowners. And they may not be homeowners in the years to come. In any case,
a new homeownership reality is on the horizon. The homeownership rate in the third quarter of 2008 fell to 67.9 percent, the same level as 2002.

Eventually, the current downturn will end, and both the United States and New Jersey will move into a post-recession future. Success in that future will be based on understanding the new normality that will emerge. Key elements of this new economic landscape will be:

- A high-frequency financial industry makeover, yielding a reduced-scale, less-potent economic sector;
- A new constrained global credit reality defined by prudence and pragmatism;
- Sustained consumer retrenchment, defined by rising savings rates, reduced levels of consumption, and more sustainable life-styles;
- Decelerating homeownership and a restructured housing industry; and
- A chastened commercial real estate sector that will be fundamentally reshaped.

Consequently, the “old normal” of business as usual is not a viable option going forward; a “new normal” will prevail.

New Jersey: The Final 2008 Accounts

While re-benchmarked employment numbers for 2008 will be released in March, the “preliminary” final job counts of January 2009 paint a picture of a year that is best forgotten. According to the New Jersey Department of Labor and Workforce Development, the state lost 63,000 total payroll jobs between December 2007 and December 2008, with 59,800 of the losses occurring in the private sector (table 1). The total employment decline in 2008 was the greatest since 1991, when 80,800 jobs were lost. The private-sector employment decrease last year was also the worst since 1991, when 74,900 private-sector jobs were lost. The public sector was also in full retreat (–3,200 jobs) in 2008, following steady growth in every previous year of the current decade. In fact, 2008 broke a string of 11 straight years of public-sector job growth (since 1996).

Private-sector job losses for 2008 were led by trade, transportation, and utilities (–18,100 jobs), manufacturing (–15,900 jobs), construction (–9,200 jobs), financial activities (7,500 jobs), professional and business services (–7,300 jobs), leisure and hospitality (–5,000 jobs), information (–1,200 jobs), and other services (–700 jobs). Only education and health services showed growth for the year (+5,100 jobs). However, even this sector lost employment in December (–1,900 jobs).

Thus, all of the state’s major employment sectors are now in decline or are weakening.

The unemployment rate for December was equally grim. It jumped to 7.1 percent, up from 4.2 percent at the start of the year. As this issue goes to press, the state’s unemployment rate is approaching the national unemployment rate of 7.2 percent, after being significantly below it for most of 2008. So, the only good economic news is that 2008 is now history. The bad news is that the worst is probably yet to come: 2009 has the potential to be an even more difficult year economically. It hasn’t been pretty, and it’s not likely to get pretty any time soon. All hopes are now placed on the federal stimulus program to blunt the severity and duration of the still-unfolding recession.
Vacant space available for sublease fell dramatically, by 500,000 square feet, from the previous quarter. This is the smallest square footage of inventory space available for sublease since 2001. As more tenants sublease their portions of existing space, increasingly more tenants are also seeking sublease space for short-term commitment.

Leasing activities totaled 1.9 million square feet, 500,000 square feet less than the third quarter of 2008 and 1.3 million square feet less than 2007 at this time. Although leasing activity was slowing down, the largest three new leases in terms of square footage occurred during the fourth quarter of 2008. InVentiv Health, an information-technology and medical-consulting solutions firm, signed a 155,962-square-foot lease at 500 Atrium Drive in Somerset. In the Northern market, Verizon took a 153,000-square-foot-lease at 290 West Mount Pleasant Avenue in Livingston, and MLB Productions, major league baseball’s cable television station, leased 142,271 square feet at 40 Hartz Way in Secaucus.

After some consecutive slow quarters, Bergen County, the largest market in the state in terms of total inventory size, leased 420,342 square feet of Class A space during the fourth quarter, a jump from 221,078 square feet from the previous quarter and also a 200,000-square-foot rise from the first quarter of 2008. A couple of well-credited large corporations decided to call Bergen County home during the fourth quarter. Kumon North America, a worldwide tutoring company headquartered in Japan, took 41,000 square feet at
300 Frank W. Burr Boulevard in Teaneck, and Whole Foods signed a 10-year lease for 38,000 square feet at 930 Sylvan Avenue in Englewood Cliffs. As a result of the active new leases occurring in the fourth quarter of 2008, the total vacancy for Bergen County dropped to 15.7 percent from 16.9 percent in the previous quarter. Tenants were drawn to this market by dropping rental rates for the quality spaces that the Bergen County market offers. Class A rates dropped to $29.23 from $29.55 in the third quarter of 2008 and $30.17 in the first quarter.

Somerset County witnessed the lowest total vacancy rate—18.9 percent—since the third quarter of 2006. This market had been struggling with rising vacancy rates and large blocks of space available. InVentiv Health’s new lease in Somerset, mentioned above, helped a bit to bolster this market’s confidence. Year-to-date total net absorption was a positive 150,648 square feet. The Somerset County market offers a large inventory of high-quality products in corporate settings with highly competitive rates. Attracting large, well-credited corporations to the market in this economic climate will be key to the county’s economic success.

Renewal activities continue to be strong for those tenants taking advantage of declining rental rates for renewal of long-term leases. Conversely, other tenants prefer a “wait and see” approach, taking short-term (one- to two-year) renewals and thereby saving some capital. In Mercer County, Thomson Licensing, Inc., renewed 62,543 square feet at
Two Independence Way in Princeton. The Hudson Group, a travel retailer, renewed 62,000 square feet at Metropolitan Center in Bergen County.

The economic slump is expected to continue through 2009. During these challenging times, however, there are still opportunities for the commercial real estate market to hold steady and even turn things around. To achieve this, government, landlords, and real estate brokers must work together. Governor Jon S. Corzine has created a New Jersey Real Estate Advisory Board, a 29-member panel comprising leaders from academe, banking and lending, commercial real estate brokerage and investment, construction management, housing, industry, law, office/retail, and risk management. The Board will advise the Governor on ways to encourage economic development, thereby enhancing the state’s attractiveness to investors and the business community.

As the market maintained its strength during the fourth quarter of 2008, real estate brokers witnessed increased activity in terms of tenants starting to think about current and future requirements. Some of this new activity is due to pent-up demand as companies likely put their requirements on hold until after the holidays. Additionally, there is some optimism that, with a new administration in Washington, business sectors will improve or at least recover some long-overdue stability. While there is no quick fix for the nation’s economy, there is guarded optimism for the “change” that may come.

| Sitar-Rutgers Regional Report is published by the Edward J. Bloustein School of Planning and Public Policy and Sitar Company • ONCOR International. |
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