

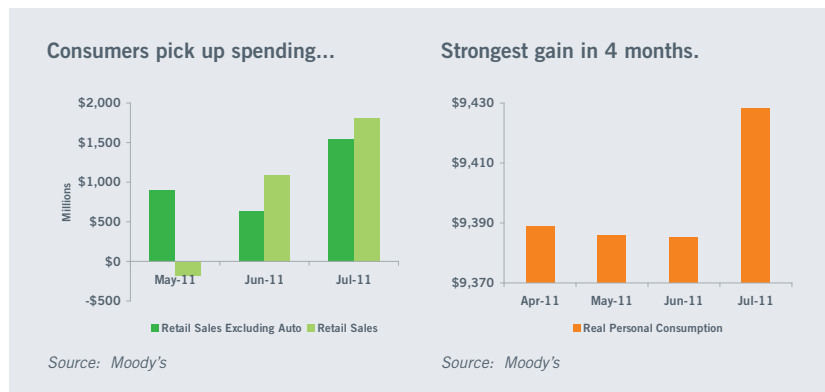
Retail Sector: Getting a Second Wind?

The US retail sector is suddenly exhibiting a few flashes of positive economic data; it is subtle, but the picture is improving. Retail sales are rising, wages are rising, and household financials are in a better position – thus enabling consumers to spend slightly more aggressively. The sudden improvement affirms the notion that at least part of the economic slowdown in the first six months of 2011 was due to temporary disruptions. Further, it suggests the underlying strength of the consumer remains intact. Confidence remains at depressed levels, but assuming there are no additional shocks to the economy or to the financial markets, then consumers should continue to modestly increase their spending, and the retail sector will see improving demand.

To be clear, the recovery has lost a tremendous amount of steam. Real GDP was extremely anemic in the first half of 2011 – growing by less than 1% compared to the 3% growth rate for all of 2010. Consumer confidence has dropped back to pre-QE2 levels, and financial markets have declined by approximately 15%, from the first week of July to the first week of August. The odds of a double-dip recession rest at an uncomfortably high 30% probability. Still, that is mostly semantics: a double-dip wouldn't necessarily be meaningfully different than the slow growth experienced in the first six months of this year. Several one-time events dragged down economic growth. Most notably, surging gasoline prices, caused in large part by the turmoil in the Middle East and North Africa in the beginning of the year, essentially stopped the recovery in its tracks – particularly for the retail sector. The price of unleaded fuel rose from \$3 per gallon in May of 2010 to nearly \$4 a gallon in May of 2011. It is no coincidence that personal consumption expenditures dropped from 3% to 0.4% over the same time period.

The dust is now settling, and the consumer data is looking brighter. According to the US Census Bureau, retail sales rose 0.5% in July of 2011 - the largest gain in four months. Consumers increased their spending on electronics, clothing, appliances, furniture, and motor vehicles. It is also worth noting that the retail sales figures were revised upwards in June to 0.3%. The improvement was also corroborated by the latest data released by the Bureau of Economic Analysis (BEA) showing real consumer spending rose 0.5% in July - the largest increase since December of 2009. The BEA also reported that both wages and disposable income grew 0.4% - their strongest growth rates since April of 2011. Moreover, gas prices are currently down 40 cents per gallon since mid-May. With prices down at the pump, consumers suddenly have approximately \$55 billion more in their pockets that can they can spend on things other than fuel.

The underlying fundamentals still point to continued improvement. The clearest indication of this comes from household balance sheets, which are in much better shape. After more than three years of deleveraging, the household debt-to-service ratio is down to 11.5% - right at trend. The question is not whether consumers have the financial wherewithal to unleash demand, but rather, when will they have the full confidence to do so. Job growth is far from robust, but it is far closer to reflecting a recovery than it is to a second recession. Although the retail sector cut 8,000 jobs in August, prior to that, it had added 105,000 new jobs from April to July – the strongest 4-month period of job gains since the recovery began. One of largest risks to the retail recovery lies in the equity markets. There is a strong correlation between stock prices and consumer spending, commonly known as the wealth effect. A prolonged slide in stocks would surely derail the recovery.

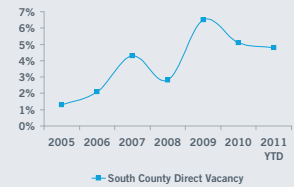


Outlook

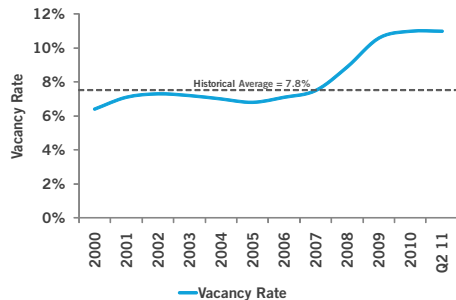
Prior to the string of unfortunate events, the retail sector was experiencing a modest recovery. Net demand had turned positive for three straight quarters (2010Q3 to 2011Q1), vacancy had stabilized, and rents were beginning to appreciate in most first-tier locations. The second quarter saw a clear setback, as fundamentals turned negative again. Given the latest economic data, there is reason to be optimistic that consumer spending is returning to healthier levels. But once again, resilient equity markets are the key to keeping the positive momentum going.

Spotlight:

San Diego's South County is a good example of a retail sector that is experiencing improving fundamentals. Demand for retail space has remained on a mostly positive trajectory since the second half of 2010, and vacancy has consistently trended downwards for the last year and a half. The improvement can also be seen in the slight uptrend in San Diego's retail job figures in 2011 (+800 new jobs y/y). Rents are still flat-to-falling, but like the rest of the country, those drops are helping to spur increased tenant demand.



U.S. Retail Vacancy



Source: Reis; Cassidy Turley Research

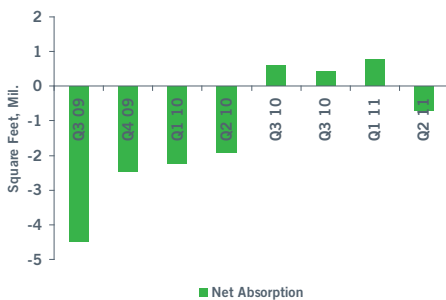
Personal Income vs. Sales

Current Dollar



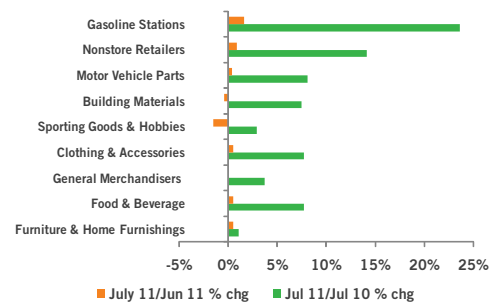
Source: BEA; US Census Bureau

Net Demand

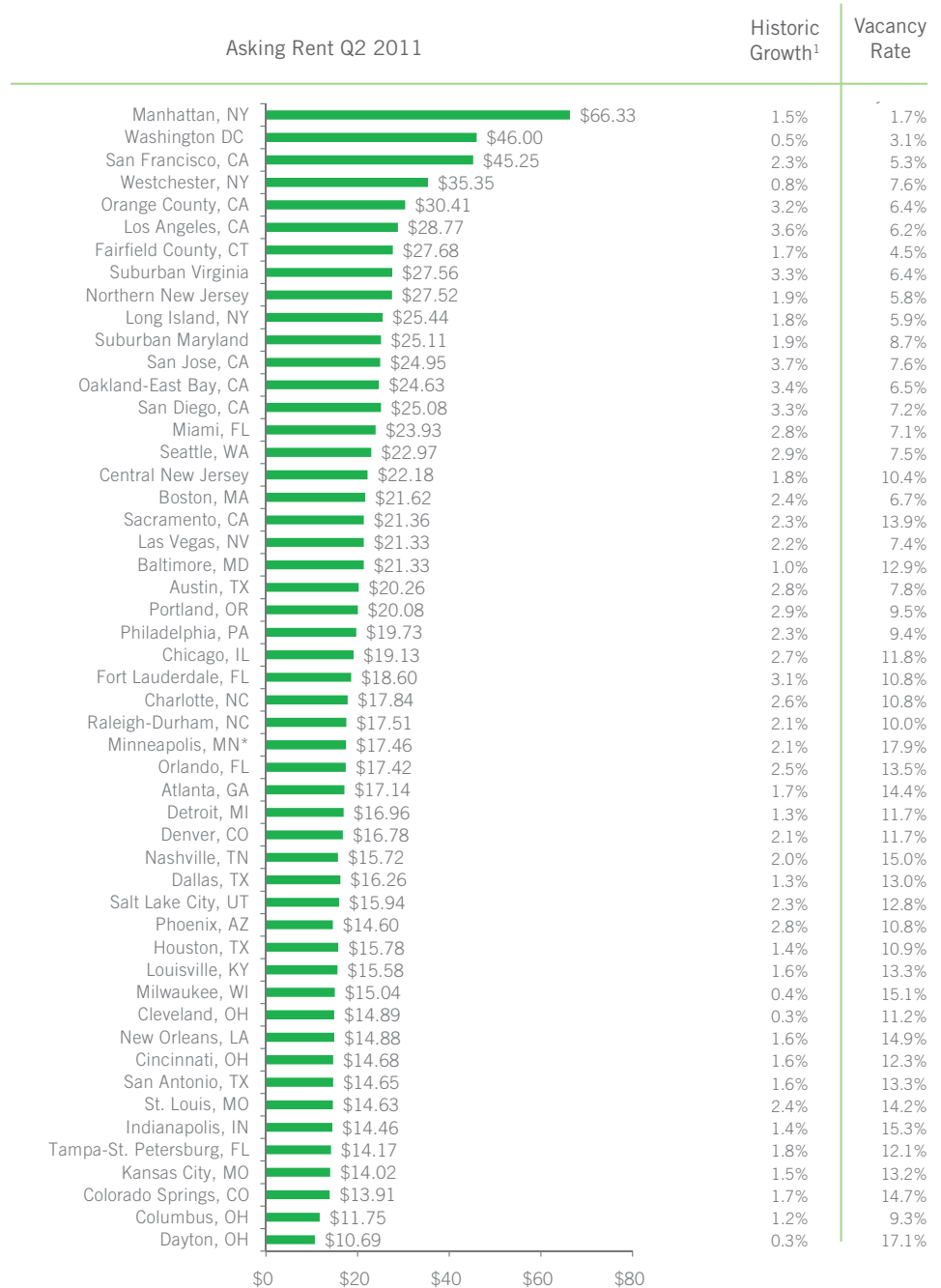


Source: BLS

Retail Sales Components



Source: US Census Bureau



SOURCE: Reis; Cassidy Turley Research
¹ = Historical average annual rent growth
 NNN Asking Rent
 *Q1 2011 vacancy rate

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U.S. Research

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