

U.S. Office Market First Look: 2011-Q3

- Defying the economic headwinds, the office market turned in a reasonably strong performance in the third quarter. The vacancy rate ended the quarter at 17.0 percent, down 30 basis points from the second quarter. The decline of 70 bps in the last two quarters, while encouraging, is on the low side of what might be expected in a normal recovery cycle. Moreover, the recovery is in the early innings with vacancy just 90 bps below the peak, still well above the 12-14 percent range that represents a balanced market.
- Although vacancy has been consistently lower in CBD markets, both CBD and suburban markets are recovering at a comparable pace. CBD vacancy fell from 14.7 percent in Q2 to 14.4 percent in Q3 while suburban vacancy declined from 18.7 percent to 18.4 percent during this period.
- Third quarter absorption totaled 11.8 million square feet, just shy of the 12.0 million square feet absorbed in the second quarter. Class A properties captured nearly all of the demand – typical for the early stages of a recovery when tenants take advantage of depressed rents to move up from Class B properties.
- Space under construction remained extremely low, which is a driving force behind the market's recovery. Construction activity did pick up slightly, however, ending Q3 at 22.8 million square feet compared with 19.5 million square feet in Q2. Both spec and build-to-suit activity moved higher with spec accounting for about two-thirds of the total. Over half of the new space is located in New York and Washington, D.C.
- Space completions in Q3 totaled just 1.8 million square feet, far below absorption, and this mismatch was responsible for the decline in the vacancy rate. About a third of that total was in Washington, D.C. and its environs.
- Space offered for sublease continued to drop, ending the quarter at 77.6 million square feet – back within a normal range.
- Average rental rates fluctuated little at the national level. The average Class A asking rate for space available at the end of the third quarter was \$31.12 per square foot per year, full service gross, up six cents (0.2 percent) from the second quarter. Class A rates were pushed higher by tightening conditions in a handful of supply-constrained CBD markets including New York Midtown, Boston, the District of Columbia and San Francisco. The average Class B rate of \$22.84 was 7 cents (0.3 percent) below the second quarter.

Forecast

The economic outlook deteriorated substantially over the past quarter due to flagging consumer and business confidence. The debt ceiling debate in the U.S. and the worsening sovereign debt crisis in Europe combined to torpedo confidence in the ability of policymakers to stabilize the economy and financial markets. About half of economists, including the highly respected Economic Cycle Research Institute, think the U.S. economy is headed into a near-term recession. This group is divided on the severity with some expecting a mild recession since businesses remain thinly staffed – less potential for layoffs – and others saying it could be severe if the credit markets seize up as they did in 2008 following the collapse of Lehman Brothers. Despite all of this, the office market performed surprisingly well in the second and third quarters – not great, but a bona fide recovery cycle. This could be a result of economic strength earlier in the year since the office market typically lags the economy. On the other hand, it could be a sign that underlying business confidence is stronger than the economic data suggest. Expect the recovery to continue over the next few quarters but at a slower pace until at least early next year.

