Our November 2009 report, “Inside the Global Supply Chain,” predicted that a rebound from unsustainably low levels of production and trade would be the catalyst to an inventory rebuild and positive net absorption in the second half of 2010. As expected, the recovery has led to an increase in global inventories, sparking positive net absorption for the first time in three years. Exhibit 1 outlines the decline and recovery of trade, consumption and real output in the U.S. through September 30, 2010.

Our current findings conclude that despite record drops in the leading indicators of industrial demand in 2008 and 2009, no structural or secular change has occurred in the relationship between production, trade and inventories (see Appendix A). This report examines our theory more closely by providing an update on these variables, and suggests that the inventory rebuilding process is not in the final stage, as some have suggested, but actually still in an early stage.

EXHIBIT 1: Leading Industrial Indicators Peak to Trough to Current

1. AMB Research, Bureau of Economic Analysis: National Income and Product Accounts, Federal Reserve Board
Significant surge in positive net absorption on the horizon

While the recovery and the shift to positive absorption have been directionally consistent with our forecast, the bottom of the cycle extended longer than we originally anticipated. The pace of the recovery moderated in the late spring due to a dip in confidence and slight softening of fundamentals prompted by economic uncertainty in Europe and the United States. As markets and confidence appear to have stabilized, and as the economic recovery gains momentum, we expect net absorption to accelerate in the fourth quarter and into 2011.

Consensus production and trade forecasts imply 2011 net absorption of more than 165 million square feet in the U.S. and 400 million square feet globally. The global forecast is driven by rapid growth in emerging markets, as production and trade numbers in these areas indicate that much higher levels of absorption are warranted. These markets have relatively small bases of modern logistics facilities, and older, less functional product cannot meet all of the demand. Therefore, we expect demand for new Class A product to easily outstrip supply in the next few years, specifically in emerging markets such as China and Brazil, and more selectively in supply-constrained developed markets with pent-up demand for modern product.

Inventories and net absorption are accelerating

While the initial recovery in inventories during the first half of 2010 was tepid, it has since accelerated. In fact, inventories grew by a rate of 1.7% in the third quarter, the fastest rate since the first quarter of 1998. Exhibit 2 illustrates the long-term growth in real inventories relative to GDP.

1. AMB Research, Bureau of Economic Analysis and CBRE-EA
The panic that ensued the economic crisis led to instantaneous and unprecedented double-digit declines in real production and trade, and more than an 8% drop in real inventories. As the recovery gained momentum, and consumption resumed, it became more apparent that the inventory draw-down was too severe; the 60-year record low inventory-to-sales ratio registered in the fourth quarter of 2009 helped substantiate this notion.

For the past three quarters, inventory levels have been rising incrementally, but customers are tightly managing inventory levels until there is greater visibility into the trajectory of economic growth. As such, some of our customers are running too lean and have been employing unconventional inventory management and transportation strategies. This means they are ordering smaller quantities of product, which translates to more frequent and costly orders as well as an increase of deliveries via air cargo, which surpassed its previous monthly peak earlier this year. Therefore, while inventories are rebuilding, the surge in production and trade is actually clogging up the transportation network.

We view these substitute transportation strategies as temporary measures because the added expenses they represent will quickly become cost prohibitive. It is worth noting that customer sentiment is improving and the fourth quarter could be a significant turning point, depending on the strength of the holiday season.

Real GDP grew by 2% in the third quarter at an annualized rate and real inventory growth accounted for almost 3/4 of that total. Real inventories jumped 1.7% in the third quarter, equaling what we saw in the first and second quarters combined. While we do not expect inventories to continue to grow at this rate, we do expect them to grow faster than consumption in the coming quarters until the two become more aligned with the long-term trend.

Supply-constrained coastal markets expected to outperform

After 12 consecutive quarters of unprecedented rising vacancy, net absorption in the U.S. turned positive at about 11 million square feet during the third quarter of 2010. This important milestone was predicted by our proprietary demand model introduced in our November 2009 research. While demand has reached an inflection point, there is substantial square footage to absorb before single-digit availability rates are achieved.

As the recovery continues to gain traction, we expect the U.S. availability rate to fall faster than in previous recoveries as record low deliveries of new space have fallen below the rate of obsolescence; there has not been enough new space to replace that which is no longer usable by tenants today. Over the last four quarters, only 31.4 million square feet have been delivered—a negligible amount of the existing stock and just 17% of the average annual deliveries over the previous 10 years.

We expect these dynamics to be even more pronounced in our supply-constrained, infill markets. Our data supports that these markets have been in recovery mode for three consecutive quarters. Increasing demand and limited new supply will drive vacancy rates down and lead to rent growth in some submarkets in 2011. As the economic recovery progresses and availability rates continue to fall, rent growth will become more broad-based and, in many markets, we expect spikes that are consistent with replacement costs and new construction.
Conclusion: Demand for distribution and logistics space to improve in 2011

Demand for industrial real estate reflects the long-term relationship between global trade and global GDP. For more than 50 years, trade has outpaced GDP growth by a factor of four, a trend likely to increase as supply chains continue to lengthen and as the world produces and consumes more. Consensus forecasts for U.S. and global GDP, production and trade continue to drive our models and indicate an ongoing economic recovery. With trade expected to grow by more than 9% in the U.S., our model indicates that demand will be much stronger in 2011 and beyond, as shown in Exhibit 3.

In summary, the data supporting our position that the drivers of industrial real estate are intact is stronger than ever today. The correction we have been experiencing as it relates to output, consumption, inventories and demand is simply part of the market cycle, although it has been a deep correction by historical standards, as was the severity of the financial crisis that caused it. As production, trade and inventories continue to rebound, demand for industrial real estate will continue to grow.

EXHIBIT 3: U.S. Industrial Market on the Road to Recovery(1)

1. AMB Research, Bureau of Economic Analysis and CBRE-EA
2. Reflects AMB’s forecast for net absorption introduced in November 2009
Appendix A: The Leading Indicators of Demand

The components of the supply chain are interconnected globally. All products are produced somewhere and are then transported/traded, whether across the street or across the world, usually ending up somewhere as inventory or eventually finished product.

When inventory levels are too high, orders and manufacturing are curtailed and when inventory is too low orders and production increase, once again leading to more trade and transportation.

All three variables—production, trade and inventories—are inherently interconnected globally. Not only does the model make simple intuitive sense, but there is a very strong correlation between each of the drivers. More importantly, all three are highly correlated and exhibit statistical causation with the demand for industrial real estate (see Exhibit 4 below).

About the Author

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