Message from the Chairman:
The Bulls Versus the Bears
April, 2010

As we have progressed through the recent recession and entered recovery mode, I have observed an interesting change in participant's perspectives on where we are headed from here. Up until a couple of months ago, it seemed like there was consensus within the commercial real estate sector regarding the direction of things to come. We felt the effects of high unemployment and a degrading of our fundamentals. From late 2007 through the beginning of 2009, we knew things were going to be difficult with transparent downward pressure on rental rates and property values. The health and direction of these metrics have always been, and remain, linked to aspects of the broader economy.

Lately, it appears those who are optimistic (the Bulls) are becoming much more optimistic and those who are pessimistic (the Bears) are becoming much more pessimistic. Generally, participants in the market are relatively more optimistic than they were one year ago as evidenced by the many "investor surveys" that have been published since the beginning of the year. However, some optimists are seeing nothing but blue skies and some pessimists are now nearly guaranteeing that things will get much worse as our economy and our real estate market double-dip. Here are some key differences of opinion:

1) Inflation: The level of inflation in the economy is important to watch because, if inflation rises above the Fed's comfort level of 1% to 2%, Chairman Bernanke will likely raise interest rates in response. This increase in interest rates would likely translate into higher lending rates at banks which would exert downward pressure on commercial real estate values.

The Bulls: The bulls see inflation as being in-check with far too much deflationary pressure in the system for inflation to be a concern in the short to medium term. Unemployment remains high, consumer spending is moderate and demand for consumer credit is very low. The bulls are not concerned about inflation at all.

The Bears: The bears are concerned about inflation, not in the short-term, but definitely in the medium and long-term. With the U.S. government doubling our money supply in 2009 (which was higher in dollar amount than the aggregate of money supply increases over the prior 50 years!), the bears believe there is no way that inflation will not creep into the economy. If the bears are correct, rates will be increased which will exert downward pressure on values.

2) Housing: The U.S. housing market is important to watch because, for most Americans, homes represent their largest asset. As property values increase, there is a wealth effect which greatly impacts consumer spending which still represents about 70% of our Gross Domestic Product. As equity levels rise, homeowners can tap into this "savings" through mortgage equity withdrawal (MEW). MEW was a major reason (along with credit card usage) why the savings rate in this country dropped to -4% (yes, *negative* 4 percent) a few years ago. Even if MEW was not used, the wealth effect of large amounts of perceived equity encouraged consumers to spend more than they would have otherwise. Given the influence of the consumer on our economy, the performance of the housing market must not be overlooked.

The Bulls: The bulls believe that the housing market has bottomed and a recovery has begun. And I am not referring to the National Association of Realtors who have been publishing optimistic press releases consistently over the past 15 months (many based upon just one month's worth of a statistically insignificant data) insinuating that the market had bottomed even as values continued to drop like a stone. Chip Case, of Case-Shiller fame, recently stated that he believed the housing market had bottomed and that he expected values to rise throughout 2010. Others in the market, while having a self-interest to portray a recovering housing sector, have presented compelling data that foreclosures are down and values are rebounding. The bulls also point to the fact that we have been in a sustained environment of low housing starts for an unusually long period of time. For nearly two years, housing starts averaged about 450,000 on an annual basis, well below the stabilized long-term average of about 1.3 million. The interesting thing about the 450,000 number is that the U.S. market looses 300,000 to 500,000 homes each year due to natural disaster or obsolescence. This housing start data will bode well for supply / demand dynamics moving forward, the bulls say.

The Bears: The bears see a double-dip in housing on the horizon. They say foreclosure activity has been artificially curtailed by various government programs and pressure the government has placed on lenders to "go easy" on homeowners who are under water. This has kept foreclosure numbers well below their natural level and, without unemployment reversing and income levels rising, defaulting homeowners have little hope of reversing their fates. The loan-modification programs have been a disaster for the government as less than 200,000 mortgages have been permanently modified (as opposed to the 4 million target) and more than 70% of the loan temporarily modified fall back into default within 6 months. The bears also see a market completely propped up by the government. The first-time homebuyers tax credit (now expanded to include some non-first time homebuyers) gave an $8,000 credit to buyers when the 3.5% FHA down payment on the average U.S. home ($178,000 last month) is only $6,230. Here the government is handing the buyer a deed and a check for $1,770. The bears say this is what precipitated the problem in the first place. Between Fannie Mae, Freddie Mac and FHA, the government guarantees 92% of all home loans in the nation. As unemployment remains elevated, which most economists are predicting through 2011, the likelihood of further housing value declines seems inevitable to the bears.

3) The Fed's Exit: The Federal Reserve Bank has doubled its balance sheet in the past 18 months. At some point the Fed must withdraw its support and the implications of this on our commercial real estate market could be significant. The Fed's exit can occur in only four ways. 1) They can stop buying assets. Last year the Fed pledged to purchase $1.3 trillion of assets which were mostly in the form of mortgage backed securities and treasuries. The intent here was to exert downward pressure on interest rates. Most of the $1.3 trillion has been spent and this program is scheduled to cease at the end of this month. 2) They can sell the assets that they have purchased. Again, these were mostly mortgage backed securities and treasuries. 3) The Fed can raise the federal funds rate. 4) The Fed can drain excess bank reserves from the system. Numbers 1, 2 and 3 will exert upward pressure on interest rates while number 4 will reduce the pool of available capital that could be used to make commercial real estate loans. Whether the Fed will exit or not is not disputed. What is remains the timing of the withdrawal and its impact. This is where the bulls and the bears differ.

The Bulls: The bulls acknowledge that the Fed will exit and that it will cause upward pressure on interest rates. They believe that the increases in rates, however, will have minimal impact on commercial real estate values as the banking industry will be willing to compress spreads more quickly than they will be willing to pass along higher lending rates to borrowers. They also believe that the draining of excess bank reserves, which presently stand at about $800 billion, will have little impact as banks are not lending these reserves now anyway. "So what if they drain from a pool which is untouched" the bulls claim. They see this as tactical and not impactful on commercial real estate.

The Bears: The bears see the Fed's exit as putting significant pressure on interest rates to rise and they believe these increases will have a significant impact on mortgage rates. The Fed's highly accommodative monetary has allowed the banking industry to recapitalize itself as they are borrowing at close to zero and, if they are lending, spreads can be 600 or 700 basis points depending on the product. If banks choose not to lend, they can simply purchase risk-free treasuries and make 250 to 350 basis points depending upon term. Many bankers indicate that they will compress these spreads to absorb interest rate increases of 50 to 75 basis points but, above that, the increases will be passed along to borrowers. Higher commercial mortgage rates mean downward pressure on value. The bears also see the draining of excess reserves as a negative as lending volume will return at some point. When it does, commercial real estate will be competing with other asset classes for this debt and to the extent there is less capacity in the system, there will be less available for office buildings, retail properties and apartment complexes.

4) Deleveraging: During the bubble inflating years of 2005 to 2007, there were massive amounts of debt placed on investment properties. As values have fallen significantly from the peaks, there is far too much leverage in the system and most participants agree that deleveraging must take place. The opposing perspectives of the bulls and the bears relates to the extent to which this deleveraging will actually take place.

Using the New York City market as an example, we believe there are presently 15,000 properties (out of a total of 165,000) that currently have negative equity positions. On these assets, there is approximately $165 billion in leverage. If we take into consideration the reduction in value that we have seen in various product types and use today’s more conservative loan-to-value ratios, we believe there should only be $65 billion in leverage on these assets if the market were appropriately leveraged.

This means there is $100 billion too much leverage in the system. Of course, this will not all come out of the market in the form of losses. Some properties can still cash flow at 90, or 100, or even 110 percent loan-to-value ratios (thanks in large part to low interest rates). Other properties want to be held for the long-term by owners who have alternative sources of revenue to feed properties that are under water and others will be worked-out between the borrower and the lender. However, we believe that $30 to $40 billion will be absorbed, in the form of losses, before the dust settles in this cycle.

The Bulls: The bulls believe that interest rates will stay low for an extended period of time which will make the strategy of simply waiting, beneficial and will save many of the properties that are in negative equity positions They believe that the extent to which deleveraging will occur will be far less than anticipated (ie, many fewer distressed assets than most participants expected). They believe that fundamentals are becoming enhanced and the deleveraging projected in 2011 and 2012, based on the maturity of 2006 and 2007 vintage loans, will not be as significant as expected.

The Bears: The bears believe that there will be massive deleveraging, particularly during 2011 and 2012, as the 2006 and 2007 loans mature. They suggest that the 06 and 07 loans are the ones that are the most underwater as they were originated at a time when value was at its peak and loan-to-value ratios were at their maximum. They also have indicated that they feel ten-year CMBS loans, which will create significant maturities in 2016 and 2017, will cause a second wave of deleveraging. This would add more stress to the marketplace and indicates the “lost decade” conditions similar to those that Japan recently suffered.

5) Unemployment: If you are a frequent reader of StreetWise, you know that I view unemployment as the indicator which has the most profound affect on real estate fundamentals. During the recent recession, the U.S. has lost 8.5 million jobs. The importance of job losses to real estate fundamentals can be illustrated as follows: if someone has lost a job, or fears they may lose a job, they wont move out of mom and dad's home to set up their own household, they don't move from a smaller rental apartment to a larger one, they wont move from a rental unit to buy an apartment or a single family residence and companies that are letting people go, don't take more office space, they want less office space. In order for our real estate fundamentals to tangibly recover we need substantial job growth.

The Bulls: The bulls currently point to the fact that we are losing *only* tens of thousands of jobs per month today while we were losing 600,000 and 700,000 jobs per month in the first quarter of 2009. They believe this losing-jobs trend will soon reverse and that we will have positive job growth beginning within the next few months. The Department of Labor has projected that in 2010 our economy will grow by an average of 90,000 jobs per month. The bulls view this as very positive news.

The Bears: The bears point out that, simply based on population growth, we need 100,000 jobs created per month. They claim that if we had 100,000 jobs created per month throughout the year we would still not gain back any of the 8.5 million jobs that were lost to the recession. The bears claim that, in order to have a sustainable recovery, we need 300,000 to 400,000 jobs created per month and that, even at this rate, it would take several years to regain the 8.5 million jobs that were lost.

6) Interest rates: The Federal Reserve Bank's interest rate policy has been keeping rates at historical low levels. The direction of these rates and the timing of rate increases will have a significant impact on our marketplace moving forward. Rate increases could cause many transactions which are hanging on by a fingernail to crater. Interestingly, floating rate borrowers turned out to be smart (as opposed to fixed-rate borrowers who are paying higher rates) as low rates are saving some operating statements. An increase in interest rates could change this dynamic significantly. How much they increase, and when, should be on the minds of every floating rate borrower in the market (and also on the minds of anyone with mortgages maturing in the short-term).

The Bulls: The bulls believe that the Fed will keep interest rates artificially low for the foreseeable future. They do not believe that the likelihood of inflation is real in the short- to medium-term and they believe that the Fed's exit from the marketplace will not be impactful on our interest rate environment. While it is expected the Federal Funds Rate will increase by year's end into the range of 1.25% to 1.5%, the bulls believe that lenders will allow the spreads to compress to absorb this increase, which will not increase mortgage rates to any significant degree. If commercial mortgage rates remain steady, values will not be negatively impacted.

The Bears: The bears believe that inflation is indeed on the horizon which will exert upward pressure on interest rates and that the Fed's exit from the marketplace will cause rates to climb. To the extent that the Federal Funds Rate is increased (and most economists believe that it will be in the 1.25% to 1.5% range by year's end), mortgage rates will be driven up significantly. Increasing interest rates will have a dampening impact on commercial real estate values.

7) Gross Domestic Product (GDP) Growth: During this crisis we have gone through an unprecedented reduction in GDP growth. 70% of U.S. output is consumer driven and we have seen consumer confidence and consumer spending at near-record lows during the past couple of years. With housing values down significantly from the peak (homes are the major asset for an overwhelming majority of U.S. citizens), Americans are feeling less wealthy and are, therefore, spending much less. They are also unable to use home equity lines of credit to gain access to whatever equity they may have had. Mortgage equity withdrawal was a major contributing factor to a -4% U.S. savings rate a few years ago. Consumer spending drives our economy and provides the fuel for GDP growth.

The Bulls: The bulls believe that we will see GDP growth in the 5 to 6 percent range which, while still below typical GDP growth coming out of a recession, is significantly above what the consensus is among U.S. economists. They believe that consumer confidence (and therefore spending) will rebound and, moreover, the stimulus will start to tangibly take hold and that the output of the U.S. will grow on a healthy path out of our current position.

The Bears: The bears believe that fourth quarter GDP growth, at 5.9%, was created mainly by government intervention and that the economy does not have the wherewithal to sustain growth levels at these rates without government support. The bears believe that consumers are uncertain about their economic futures, particularly given the uncertainty of the U.S. tax outlook moving forward, given all of the government spending and massive deficits being observed on federal, state and local levels. With an apparent unwillingness for politicians to cut spending (except in New Jersey and Virginia), Americans see the only possible outcome as increased taxes across the board. The bears expect GDP growth to be a sluggish 2 to 3 percent for the balance of 2010 and into 2011.

8) Corporate earnings: Corporate earnings are important as the more profitable companies are; the more likely it is that they will hire employees to grow their businesses. Growing business need more office space and growing retailers absorb vacant storefronts. The more employees that are hired, the better for our economy as output will grow and, most importantly, consumers will have more disposable income and, presumably, they will spend most of it. The recent stock market rally portents a more positive perspective on future earnings. Why the rally has been so strong is due to different factors depending upon whom you ask; the bulls or the bears.

The Bulls: The bulls believe that corporate earnings have performed well above expectations at this point in the cycle and that this is reflected in a rallying stock market. They believe that these earnings are sustainable and will lead to new hiring initiatives. These earnings will lead to corporate growth which will enhance real estate fundamentals, leading to a substantial and sustainable recovery.

The Bears: The bears believe that much of the corporate earnings which have exceeded expectations were due, mainly, to massive cost cutting and that top-line revenue growth has not resumed to levels which are needed to promote substantial new hiring. The bears want to see top-line revenue growth continue for a quarter or two before they believe corporate earnings are solid. The rallying stock market, they claim, is based simply on future expectations, not solid earnings today which would precipitate job creation.

9) Capital on the sidelines: We have heard, and continue to hear, about the massive amount of capital that is sitting on the sidelines seeking opportunities to purchase distressed assets and core commercial real estate properties which need to be sold. Each day we hear about another fund or another investor that has entered the market and is looking to buy. At this point in the cycle, it appears the demand drivers are substantial, but, is this perception reality?

The Bulls: The bulls believe that everyone who says they have $5 million, or $50 million, or $500 million to invest in real estate, have it. And they believe it is mostly from unique sources indicating that there really are billions and billions of dollars sitting on the sidelines waiting for an opportunity to buy. Clearly, the demand is out there in the marketplace as we see a significant number of bidders on each of the properties being sold today. On our income producing properties dozens of offers are obtained and on the notes we have sold, which were collateralized by New York City properties, we have received over 50 offers on every one. A combination of high net worth individuals, families, institutional capital and foreign investors have created demand unlike anything we have seen in recent times. The bulls believe that this overwhelming demand, which exerts upward pressure on value, will dominate the factors in the market which exert downward pressure on value.

The Bears: The bears believe that, of the people claiming to have capital waiting to invest in commercial real estate, many are representing the same pools of equity. Many of the funds have not been raised with cash sitting in accounts. They merely have verbal representations that money is available “for the right deal”. It is very likely that equity sources have many “scouts” in the market claiming to represent the same pools of equity. If this is the case, the bears believe that the amounts of capital claimed to be looking for opportunities is grossly overstated. They also believe that, while there may be a lot of capital available for "good deals", the expectations of what a good deal is, is unrealistic and, therefore, this demand is artificial.

10) Financing: Clearly, debt availability is a significant driver in our investment sales marketplace. Community and regional banks across the country have invested much of their risk based capital in construction and development projects and the result of this is that 124 banks failed in 2009 and is why today there are 720 banks on the FDIC’s watch list of potentially troubled institutions. Fortunately, for those of us in New York, our community and regional banks have invested primarily in cash-flowing properties and they have maintained very healthy portfolios. Because of this, they have continued to lend throughout this crisis. The commercial and money center banks have, however, for the most part, withdrawn from the real estate lending scene. Moreover, construction financing is extraordinarily challenging to find today. This is true particularly for any asset class other than residential rental properties. Even for residential rental construction financing, low loan-to-value ratios exist and recourse is generally included for, at least, part of the indebtedness.

The Bulls: The bulls believe the financing picture is thawing significantly and expectations are that the commercial and money center banks will be back in the game shortly, if they have not already begun to make loans. The bulls say that the CMBS market is on the road to recovery as evidenced by the recent transactions which began late last year. They believe that, although loan-to-values are low and recourse is required, construction financing is available and that there are lenders which are looking for strategic opportunities. If this level of availability existed, it would be extremely positive for the commercial real estate market.

The Bears: The bears see the lending environment as still very limited. Capital availability is low and most real estate loans are being made on only the most conservative terms. The bears also view the CMBS market as still in a relative state of inertia. They point out that CMBS transactions which have occurred thus far in the cycle have helped only a very narrow slice of the marketplace as loan-to-values are around 50 percent (one transaction was closed at 75% LTV) and loans that are being made are more in the form of personal loans based on the strength of the borrower as opposed to the viability of the real estate project. This is not only true for CMBS loans but also for traditional loans made by portfolio lenders. The bears believe it will be many years before construction financing comes back anywhere close to what its normal trend has been.

The times we are living in are truly interesting. If you were a member of a debating team and were assigned to be on the side of the Bulls or the Bears, very strong arguments could be made for each perspective. Are we really on the road to recovery with blue skies ahead or are we sitting in the calm in the eye of the storm about to be smashed by the tail? To some degree your perspective might be influenced by your political tendencies, your economic slant or perhaps what you are seeing out there in the commercial real estate market. The divergence of opinions in the marketplace has been palpable and time will tell whose inclinations were more correct.

Sincerely,
Bob

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You can also read Mr. Knakal's weekly article in The Commercial Observer entitled "Concrete Thoughts" at www.observer.com/commercial.