Real Estate Capital Markets Update – May 21, 2004

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Welcome to the update of ULI's Real Estate Capital Markets Web site. Updates are divided into four sections: public real estate securities markets, public real estate debt markets, private real estate equity markets, and private real estate debt (mortgage) markets. In each section, we feature Real Estate Capital Markets Scoreboards detailing selected performance indices for each of the real estate capital markets.

To expand site users' knowledge and understanding of the real estate capital markets, we will publish "knowledge" papers describing underlying market mechanics. In addition, we have provided links to other Web sites that provide related and relevant information. Click here for links to other Web sites.

Frequently Asked Questions (FAQs): In addition to knowledge papers, we have published answers to FAQs about the real estate capital markets. To go to FAQs, click here.

Glossaries of frequently used terms are available for readers' use. To go to the glossary section, which includes selected Web sites that provide glossaries and/or real estate term search engines, click here.

We want this site to be both useful and responsive to users, and we encourage you to e-mail comments and suggestions. If you want to send me an e-mail, click stephen@uli.org, add your comments, and click "Send".

Special Comment: When, Not If, Interest Rates Increase

We seem to be reaching an inflection point. Our nascent economic recovery is gaining traction and we appear to have turned a corner, maybe not the corner (defined as the point where productivity gains can only be achieved by more workers working rather than continued increases in technological innovation), but a corner nevertheless.

Now the tough part—the management of the increase in interest rates in a manner which both allows as well as promotes economic growth, both domestically as well as on a global basis—begins for the Federal Reserve Board (FRB). The results of the FRB's actions will have a marked impact on a wide array of interest-sensitive businesses such as finance, investment, banking, and real estate and every participant in every phase of the real estate industry—acquisitions, construction, development, and financing as well as every property sector—will be affected.

The consensus of opinion, as of mid-May, is that the FRB will increase the Federal Funds Rate 25 basis points (0.25%), from 1.00% to 1.25%, at its next regularly scheduled meeting on June 29th and 30th. It is likely that the FRB will simultaneously increase the Discount Rate 25 basis points, from 2.00% to 2.25%. The Discount Rate, which is often referred to as "largely symbolic" due to the fact that it affects only financial institutions borrowing directly from the FRB, is something financial institutions are loath to do as it is a serious sign of financial weakness when one must turn to the FRB, rather than another financial institution, for an overnight loan. Next, major money center banks will most likely increase their Prime Rate, the rate charged their most creditworthy borrowers, 25 basis points, from 4.00% to 4.25%.

It appears that the June 30th, 25 basis point rate increase is already, as they say on Wall Street, "baked into the cake", as interest rates have increased at least 25 basis points since the FRB's most recent meeting. One could attempt to make the case that as the market may be anticipating that the FRB will increase the Federal Funds Rate 50 basis points (0.50%) as evidenced by the fact that yields on 10-year Treasury securities are within striking distance of 5.00%, and if they remain so on June 30th, the FRB may "accept the market's wisdom", take advantage of the market's "anticipation" of the FRB's next action, and increase the Federal Funds Rate 50 basis points (0.50%) to 1.50% from 1.00%. Simultaneously, the FRB would raise the Discount Rate from 2.00% to 2.50% and commercial banks would increase their Prime Rate to 4.50% from 4.00%.

While this latter scenario is deeply appealing in a Machiavellian sense, it neglects the implicit promise of gradualism and patience contained in the announcement which accompanied the FRB's most recent meeting.

All things being equal, and no "Bolts out of the Blue" (as discussed below), we agree with the consensus that the most likely scenario is a 25 basis point increase in the Federal

Funds Rate on June 30th (from 1.00% to 1.25%), followed by a 25 basis point increase (from 1.25% to 1.50%) on August 10, followed by a hiatus in FRB activity until immediately after the Presidential Election (November 1st) and then a 25 basis point increase (from 1.50% to 1.75%) on November 10. Simultaneous with the increase in the Federal Funds Rate, the Discount Rate will increase from 2.00% to 2.25% on June 30th, from 2.25% to 2.50% on August 10, and from 2.50% to 2.75% on November 10. Likewise, commercial banks will increase their Prime Rate from 4.00% to 4.25% on June 30th, from 4.25% to 4.50% on August 10, and from 4.50% to 4.75% on November 10.

10-year Treasury bonds, which are currently priced to yield 4.75%+/-, will most likely trade in the 5.00 to 5.10% range by yearend 2004.

Now let us consider what can go wrong with our idyllic masterpiece of logical thought. While not attempting to play the Cassandra, we note the following issues and concerns, anyone one of which could have a significant impact on the current economic recovery, our future economic well-being, and FRB actions and reactions.

The FRB's gradualism predicted by many is borne of experience gained by the FRB during 1994 when the Federal Funds Rate was, in hindsight, increased too rapidly, leading some believe to the Orange County, California bankruptcy and Mexico's currency devaluation. While we are sympathetic to this view, we are probably more persuaded by the clear and absolute fact that the U.S. economy is currently very highly leveraged, and possibly too highly leveraged to absorb any hits or shocks to the interest rate environment.

From where we sit, there are any number of potential "Bolts out of the Blue"—some independent of each other, some interconnected with each other—that the FRB is attempting to manage or avoid. As in most things economic, many of the pitfalls forecast or postulated may be both unavoidable and as well as outside of the FRB's reasonable span of control.

In no particular order, a rapid increase in interest rates could precipitate any number of crises' including:

- Disruption of the credit derivative products, leveraged commodity investment, and "Carry Trades" markets, leading to a 1998-type financial crises.

According to ING Investment Management, leverage in the bond markets, as measured by primary dealer net borrowings, has increased from $300 billion in 2000 to more than $750 billion today. While we are all aware of the activities of the numerous hedge funds active in the credit markets, we seem willing to ignore the fact that ordinary corporations (as well as real estate borrowers)—anyone who is currently employing floating rate debt—routinely utilize some form of financial engineering through structured debt derivative instruments such as a swaps, caps, collars, etc. and that the markets has grown exponentially in recent years The carry trade—where banks and brokers borrow short (at the lowest cost on the yield curve) and invest long (at the highest return on the yield curve)—has been immensely profitable. During the past 18 months, a carry trade involving borrowing short term at say 1.00% and buying 10-year Treasury bonds has yielded an approximately 3.00% net spread. Multiple 3.00% by the hundreds and hundreds of millions involved in the carry trade and the returns become serious. The 3.00% spread in our example has been significantly increased by some investors bold enough to invest in emerging market debt and mortgage-backed securities. No one knows how big the carry trade actually is! Further. surging commodity prices have spawned speculative, highly leveraged investment models that are clearly susceptible to interest rate risk in the form of margin calls that must be answered or the underlying position is immediately liquidated.

- High levels of consumer debt caused by serial mortgage refinancing combined with the use of home equity lines of credit as personal ATM machines.

According to the Mortgage Bankers Association, household debt now amounts to 110% of after-tax income as compared to 80% in 1993.With owner's equity in single-family homes down to about 55%, what happens if interest rate skyrocket or housing prices plateau or even decline, or both.

- Oil price increases continue to shock the U.S. economy.

Isn't $41.50 per barrel shocking enough?

- Continued financing of the U.S. deficit by foreign investors purchasing U.S. Treasury securities.

- Short-term and/or persistent budget deficits.

- Continued decline in the value of the dollar vis-à-vis our major trading partner's currencies.

- Inflation

Hopefully, inflation remains under control with core inflation anticipated in the 1.75% to 2.00% range.

As interest rates increase, average capitalization rates are expected to …increase as real estate yields inexorably follow the cost of funds. While it is "OK" to characterize the above shift as a relative value "thing", where real estate investment yields must increase if real estate investment is to remain competitive with investment alternatives, 75% of all real estate transactions involve debt, so the absolute level of interest rates may be more dispositive than any other factor in determining trends in capitalization rates. It should also be noted that increases in real estate yields may also affect near-term demand for investment properties as the highly leveraged buyer set moves on to other markets.

What will happen to the value of properties will also be measured by changes in net operating income. While vacancy rates will certainly be reduced as the economy gains traction, the real estate industry has recently experienced declining rents and the use of concessions is back in some sectors and markets. So, when leases rollover, a serious number will do so at rents lower that existing contract rents, thereby reducing net operating income and value.

Many believe 2004 will be the first credit test for the modern real estate industry since the late 1980s-early 1990s debacle. While we believe the current credit climate reflects an extended period of safe lending by the vast majority of participants in the debt capital markets, the combination of higher interest rates, reduced levels of net operating income, and mezzanine financing that needs to be repaid or rolled-over, will provide some agile investors with an opportunistic play.

We suspect as interest rates increase conventional and securitized lenders will use this as an opportunity to widen spreads to more normal (and profitable) levels as a means of offsetting reduced origination volume and recent rate-aggressive lending practices.

The balance of 2004 will be a challenging period for our industry!