Real Estate Capital Markets Update – June 28, 2007

Volume 9, Number 7

Special Comment: Federal Reserve Board Leaves Rates Unchanged

The Federal Reserve Board kept the Federal Funds Rate at 5.25%, expressing a positive view toward lower inflation and economic growth.

Inflation appears a principal concern as expressed in its statement where the Federal Open Market Committee noted that its greatest concern was that inflation would not moderate as expected.

There appears near universal agreement that rates will remain unchanged through the summer and possibly through yearend.

Lloyd's "Wall of Worry"—"It's the counterintuitive indicator: many worries, buy; few worries, sell"

"Long a part of Wall Street lore, Lloyd's Wall of Worry (a trademark of Khaner Capital Management) is a quick, handy way to gauge the emotions of investors. As interpreted by money manager Lloyd Khaner, a low wall, with seven or fewer blocks, indicates a complacent, even overconfident market: Time to take profits. A high all, with 15 or more blocks, suggests a squeamish market: Look to buy at bargain prices. In the middle range, reading the wall gets tricky; knowing not only where the wall stands but whether it's headed up or down is the key."

June 2007's Wall: 10 Ways to Worry

What goes down comes back up. With the Dow and the S & P 500 in record-setting territory, and the NASDAQ fighting its way higher, the trend is skyward. As money pours into the Megacap Club—today's version of the Nifty 50—the Wall stands at 10 worries. Some complacency is creeping back into the market, so keep a wary eye on potential upsetters of the applecart, such as the slowing pace of small-business spending in the U.S. and rising interest rates in Europe, Japan, and China. For now there's not a lot of deep value around, so individual stock drops may provide the only bargains. Happy hunting.

U.S. economy: When was the last time the U.S. had a recession in the year before a presidential election? But let's not claim "mission accomplished" just yet.

Inflation: After disco and Watergate, it's the most reviled thing about he 1970s. Nobody wants to see it come back.

Consumer Spending: What's causing the current retail slowdown? Bad weather, bad gas prices, bad consumer balance sheets or just some short-term bad karma—it's a toss up.

Carry Trade: Average home in Manhattan: $1.3 million. Personal chauffer: $75,000. Private school tuition: $25,000. Keeping the yen weak to support the carry trade: priceless.

U.S. Mortgages: Now that the sub-primes are officially blown out, all eyes are trained on Alt-A and adjustable-rate delinquencies and defaults. Tick, tick, tick…

Interest Rates: A slight increase would put some people out of their homes; a cut would reignite and inflationary spiral in commodities. Holding steady creates a comfort zone—albeit a narrow one.

Oil Prices: If the choice is between building refineries and suffering through a recession, I'm for grabbing a hammer and nails.

Housing Prices: Pundits have found myriad ways to describe today's housing prices—flat, holding steady, stabilizing, soft, weak, showing some give and more accommodating. Or we could say they're dropping but haven't hit the air pocket yet.

Iran: With a nice chunk of the world's oil supply and a huge helping of its natural gas reserves, this nuclear contender continues to develop its technology while major economic players watch—and worry.

Greenspan: Talking the markets up—and down—more often than Big Ben. But relief is on the way now that he's signed on with bond behemoth Pimco. From here on out he'll be talking his book like the rest of us.

Special Comment: Federal Reserve Board Beige Book

The recently released Federal Reserve Board Beige Book economic survey of conditions in the 12 Federal Reserve districts can be characterized as sort of positive with 7 of 12 districts reporting modest to moderate growth. While housing and housing-related industries are clearly under pressure, consumer spending was noted as generally rising moderately. Overall, travel and tourism remained strong notwithstanding increased energy costs. Manufacturing except as noted above was considered strong. Commercial lending picked up some of the slack from the downturn in residential lending. Labor markets remain strong while wage increases remain modest.

"What a (Little) Difference a Year Makes"

Key Rates			
	June 22, 2007	Year Ago	Increase/Decrease
Prime Rate	8.25%	8.25%	0.00%
Federal Funds Rate	5.25%	5.25%	0.00%
3-Month Libor	5.36%	5.51%	-0.15%
3-Month Treasury Bills	4.73%	4.99%	-0.26%
10-Year Treasury Bonds	5.20%	5.19%	+0.01%
30-Year Treasury Bonds	5.32%	5.23%	+0.09%

Special Comments: Notes from "The Punch Line…", published by Abraham Gulkowitz

(Headlines and data in The Punch Line come from widely available publications including national and international newspapers, trade journals, economic and industrial bulletins and websites.)

Time to Recalibrate?

A consensus is emerging that cov-lite (covenant lite) loans – well under way in funding U.S. buyouts and rapidly emerging in Europe – are a symptom of a credit bubble, with too many lenders chasing too few borrowers. In other words, smart private equity houses are exploiting dumb money [lenders] to weaken creditors' oversight of their operations.

Carry Trade Concerns Grow

Domestic and international concern is growing over the potential dangers arising from yen carry trades. Financial derivative positions linked to such transactions may be far larger than previously suggested, the OECD has warned, while Bank of Japan Governor Toshihiko Fukui has spoken of a possible disruption of global capital flows associated with the carry trade phenomenon.

The waves of debt feeding today's buyout deluge will eventually recede. Now's the time to figure out what will make this happen. This has become the essential question on Wall Street, where even the cocksure ranks of banks, hedge funds, and private equity firms have begun to doubt lenient standards for lending and deal-making. As Bank of America's own chief, Ken Lewis, admitted recently, "we are close to a time when we will look back and say we did some stupid things."

Risk appetite is high as investors are willing to assume more risks buying companies without solid fundamentals in the hope of a turnaround or purely based on unfounded rumors.

World Competitiveness Rankings

Of the 55 countries followed by the Institute for Management Development, the U.S. still ranks No. 1 in 2007, closely followed by Singapore and Hong Kong. The results of the 2007 edition of the IMD's World Competitiveness Yearbook highlight a big shakeout in economic and business power.

- China, Russia, India, the Slovak Republic, Estonia, Sweden, Austria, Australia, Denmark, Switzerland, and Hong Kong have displayed a strong improvement in their competitiveness performance in recent years. This does not imply that all of these nations are already at the top of the competitiveness league.
- However, they are catching up quickly. On the other hand, Indonesia, Italy, Argentina, Brazil, Turkey, the Philippines and France have tended to lose ground compared to the top league. Despite some real and specific competitive advantages, these nations, will sooner or later, lose their standing in the world competitiveness if they do not improve their overall performance.

Country	2007	2006	2000	1990	1980
USA	1	1	1	3	2
Sweden	9	14	14	--	--
Canada	10	7	8	--	--
Australia	12	6	11	--	--
Germany	16	26	13	4	4
Taiwan	18	18	17	--	--
U.K.	20	21	15	--	--
France	28	35	22	--	--
Japan	24	17	21	1	1
Korea	29	38	29	--	--
China	15*	19	24	--	--
Source: Institute for Management Development, Switzerland.					

* Given the weak legal system [in China], many question this high ranking.

Credit Concerns – Realty Programming

Fed could tighten lending rules…The U.S. Federal reserve could tighten regulatory constraints on buyout lending after it warned last month of the risks posed by bank bridging loans to private equity sponsors. Sponsors have exploited their borrowing power over the past few years and benign credit market conditions sustained by deep global liquidity, low interest rates, and low corporate default rates. Banks' willingness to lend and the emergence of powerful institutional investors, composed of credit hedge funds and structured credit investors, have been fundamental to the rise of sponsors' borrowing power.

"There are some significant risks associated with financing of private equity, including bridge loans, [and] we are looking at that," Federal Reserve Chairman Ben Bernanke said in response to questions at a [recent] Chicago conference. "I urge banks to closely evaluate the risks they are taking not only in the context of a highly liquid, benign financial environment, but in one that might conceivably be less liquid and benign."

CORRELATION AMONG GEOGRAPHIES AND ASSET CLASSES GROWING, ERODING SOME OF THE DIVERSIFICAION BENEFITS TRADERS PREVIOUSLY ENJOYED.

This one's important as the lack of correlation (i.e., the assumption that the dots were not connected between performance of various asset classes—like real estate returns do their thing and common stocks returns do their thing and their not connected or interdependent or interrelated or inter-anything) is one of the important tenants underlying institutional asset allocation and therefore investment in real estate. If this premise proves to be false, a lot of re-thinking of investment strategies and allocations could occur.

Watch the Money Flow

[Single family] mortgagees in foreclosure rose 62% in April and the number of Americans falling behind on home loans will climb this year as home prices fall and lending standards are tightened, RealtyTrac said. There were 147,708 notices of default, scheduled auctions, and bank repossessions last month, led by [those in the states of] California, Florida, and Ohio, the

Irvine, California-based seller of foreclosure data said [today]. The median U.S. home price fell 1.8% in the fourth quarter, according to a separate report by the National Association of Realtors. Foreclosures are being “fueled by a combustible mix of risky loans taken out in the last few years –many in the sub-prime market—and slowing home price appreciation.”

Public Real Estate Debt Capital Markets

Speaking at the Commercial Mortgage Securitization Association’s 13th Annual Convention, Michael Fascitelli, President of Vornado Real Trust, and one person known not to mince his words stated (in reference to the debt capital markets): “There’s too much stupid money in the market”. He also noted (as we have on many occasions) that many investors and lenders are “taking a lot of risk for not a lot of money”. Hopefully, this is clear enough for everyone to understand.

It’s hard not to believe we are approaching some sort of an inflection point; according to the Federal Reserve, we’re certainly in record territory with commercial mortgage volume at its highest level in the post-World War II era—equal to 16% of gross domestic product. For comparison purposes, the previous record was 14% of GDP which occurred during the mid-1980’ construction orgy.

Why should you at least be attuned to where we are? Because as they say on Wall Street, no one ever rings a bell at the top or bottom of the market. While no one was watching carefully (or at least not broadcasting it from the roof tops), spreads recently widened between 25 and 50 basis points and leverage turned from positive to negative literally overnight. Some more building blocks of our “Wall of Worry”:

1. Record volume of issuance in both the conventional and securitized mortgage sectors;
2. Until very recently, spreads at their lowest levels in 40 years or so;
3. According to the Federal Deposit Insurance Corporation, the value of commercial mortgages (including construction and permanent loans) equals 55% of risked-based capital at banks overall versus 38% in 2004.
4. Delinquencies continue to decline, setting new record “lows” month with both conventional as well as CMBS delinquencies well below 1.0% of outstanding balances.

You don’t get record volume and record low spreads without piles of money freely flowing through the system and very few roadblocks to its being dispersed by lenders to borrowers.

But it would appear that someone actually was listening and heard the tree fall in the forest. All of sudden, the CMBS lending community is professing that it has found religion and that all the “leaks” in its boat—high loan-to-value ratios, low debt service coverage ratios, interminable periods of interest-only/non-amortization, and covenant-lite, covenant-loose, and covenant-non-existent structures—are being plugged.

What caused this religious revival? It began a few months ago with the rating agencies expressing their concern about underwriting standards by increasing transaction subordination levels, thereby reducing originator/underwriting profit levels (which were already razor thin and stretched to the breaking point by relentless industry-wide competition). The rating agency’s actions caused the markets to back-up some as a number of investors pulled back to the sidelines to analyze and assess the impact of the change in subordination levels. When markets back-up, either dealers hold securities in inventory and wait it out, or increase spreads to make inventory more attractive to buyers (which is what happened). Next, the B-piece buyers began to exercise renewed care and diligence, thereby increasing the volume of loans they "kicked-out", i.e., rejected from proposed securitized offerings.

Will it take? It's too soon to tell if the pain and suffering had the desired affect. We'll leave you with two quotes from a recent issue of *Commercial Mortgage Alert*:

Mortgage broker: "We have been telling our borrowers that they're going to have to revise their expectations pretty drastically fro what they were a few weeks ago…And we're telling them they may have to revise them again next week."

Real estate lawyer: "People say they have to tighten their belts, but they are not ready to lose a loan over something like that."

Issuance of Commercial Mortgage-Backed Securities January 1, 2000 through June 21, 2007 (in Millions)			
	U.S. Assets	Non-U.S Assets	Total Issuance
2001	67,149.9	22,713.8	89,863.7
2002	52,073.3	28,705.9	80,779.1
2003	77,848.1	20,802.9	98,651.0
2004	93,838.2	33,746.0	127,584.2
2005	169,169.5	69,376.1	238,545.6
2006	185,700.0	81,100.0	266,800.0
2007	93,100.0	28,600.0	121,700.0
Source: *Commercial Mortgage Alert*.			

Commercial Mortgage-Backed Securities Trading Spreads To U.S. Treasury Bonds (in Basis Points)		
Rating	Term	Spread
AAA	5 years	+75 basis points
AAA	10 years	+91 basis points
AA	10 years	+106 basis points
A	10 years	+127 basis points
BBB	10 years	+201 basis points
BBB-	10 years	+281 basis points

Private Real Estate Debt (Mortgage) Capital Markets

Indicated Spreads for Securitized Commercial Mortgages (as of June 12, 2007)

CohenFinancial Commercial Mortgage Markets Survey

"In May and early June, commercial mortgage-backed securities (CMBS) spreads widened due to a continuation of defaults in the sub-prime market, a large amount of securitizations [in the pipeline], and a decrease in demand from B-piece buyers. In the wake of the sub-prime meltdown, approximately 15% of the major B-piece buyers are sitting on the sidelines as the market continues its flight to quality. Some B-piece buyers had been placing their notes into collateralized debt obligations (Dos), which removed their risk exposure and ultimately caused a lack of quality control. Now, CDOs are cutting out the overly risky B-piece notes, forcing B-piece buyers to become more conservative.   This passed to borrowers in the form of higher spreads and tighter underwriting standards such as limiting interest-only periods and underwriting in-place cash flows instead of prospective cash flows based on speculation."

"Of the five lenders surveyed [by CohenFinancial], the average 10-year fixed rate CMBS spreads increased by 14 basis points to 1.22% and 5-year spreads by 23 basis points to 1.49%. At the same time, strength in the economy (and foreign economies) has caused Treasury yields to jump approximately 20 basis points on 10-year notes and 30 basis points on 5-year notes. The increase in effective interest rates and tighter underwriting standards has created a sudden change in borrower's capabilities, but the stubborn commercial real estate market is proving slow to adjust."

5-Year Treasury	Spread	Effective Rate
4.97%	1.49%	6.46%
10-Year Treasury	Spread	Effective rate
5.00%	1.22%	6.22%
Source: CohenFinancial.		

Indicative Spreads for Conventional Commercial Mortgages (as of May 31, 2007)

Conventional Mortgage Matrix	**<65% LTV (in Basis Points over Treasuries)**		**>65% LTV (in Basis Points over Treasuries)**	
Multifamily	95 – 105		105 – 115	
Regional Malls	90 – 110		105 – 115	
Strip/Power centers	95 – 115		110 – 125	
Multi-tenant Industrial	100 – 110		105 – 115	
CBD Office	105 – 115		115 – 125	
Suburban Office	110 – 120		120 – 130	
Mezzanine Financing Matrix	**Rate**	**Term (Years)**	**LTV Range**	**Fee**
Hedge/Opportunity Funds	10%-14%	1-5	>75%	1%-2%
Investment Banks	10%-14%	1-5	>75%	1%-2%
Insurance Companies	8%-10%	1-5	>75%	1%-2%
Private Sources	12%-18%	6 months-3 years	>75%	1%-3%
Source: Sonnenblick-Goldman, LLC.				