

## **Real Estate Capital Markets Update – January 11, 2008**

### **Volume 10, Number 1**

Welcome to the 10<sup>th</sup> year of ULI's Real Estate Capital Markets Update.

#### **The Economy**

On January 9<sup>th</sup>, William Gross who manages what is arguably the world's largest bond fund for PIMCO Advisors (and who has long expressed the conviction that the U.S. economy will be subject to a recession) predicted that the Federal Reserve Board would cut the Federal Funds rate from its current 4.25% to 3.00% by mid-year.

The same day, Moody's Economy.com lowered its forecast for the Federal Funds Rate, stating that it thought the Federal Open Market Committee would lower the rate by 50 basis points to 3.75% at its next meeting (January 29-30) and would decrease the rate an additional 25 basis points (to 3.50%) at its March 18<sup>th</sup> meeting.

Bolstering the above, Federal Reserve Chairman Bernanke said on January 11 that the Fed was prepared to take "substantive additional actions" which many analysts read as a 50 basis point cut in the Federal Funds Rate on January 30 and additional cuts at future meetings.

Lastly, a survey by the Wall Street Journal of 54 economists put the odds of a recession at 42%, an increase of 4% from December's 38%. Best quote in the article: Stuart G. Hoffman of PNC Financial Services Group who stated, "The U.S. economy in 2008 will be like a cat on a hot tin roof that has already used up eight of its nine lives."

#### **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.)

#### **Fresh Starts – More Challenges in Disorderly Times**

"The world economy starts the New Year with much less confidence in its momentum and mindful of a myriad of risks that are combining to challenge households and businesses in 2008...the load of pressures even at the start of a new year can easily fill any top 10 listing.

These include challenges emanating out of the series of miss-steps in the mortgage and housing fiasco, the likely weakening of household spending in the U.S., the breakdown in money markets across several major financial centers, the pressures in the buyout business, the serious distortions in the currency markets, the stubbornly high commodity prices, the reemergence of geopolitical concerns, the added uncertainties of an election that includes no incumbents, the overheating China economy and the struggling recovery in Japan".

## Real Estate Investment Trusts

Why are real estate investment trusts (REITs) in the investment dog house? Try one or a combination of the following:

1. Few catalysts to reverse discounts to net asset value; even continued strength in fundamentals doesn't seem to work.
2. Despite strong fundamentals, wide array of macroeconomic concerns.
3. Even though REITs employ low overall leverage, growth constrained and limited by conditions in the debt markets.
4. Investors "rotating" to perceived higher "relative value" sectors.
5. Era of privatizations has come and gone.
6. REITs are being lumped with financial stocks.
7. Analysts are predicting a wide array of returns ranging from (10.0%) to +5.0%.

Our take for 2008: think dividends - 5%+/- - with no appreciation in value.

## Conventional and Securitized Mortgages (Commercial Mortgage-Backed Securities)

According to the Mortgage Bankers Association's Third Quarter 2007 Commercial Real Estate Quarterly Data Book, overall mortgage originations in 3Q2007 were 30% lower than in 2Q2007.

The following chart details who (which lenders) did and didn't do business, i.e., whose production increased or decreased, on a quarter-over-quarter basis:

Lender Type	3Q2007 V. 2Q2007
Conduit (securitized) Lenders	-66%
Life Insurance Companies	+27%
Government Sponsored Entities	+61%
Commercial Banks	+ 9%
Total Originations	-30%

The disconnect between buyers and sellers continues (and therefore pricing of securitized mortgages remains "uncertain"). Probably the most important topic discussed around the beverage coolers at the recent Commercial Mortgage Securitization Association's annual investor conference was the lack of investment (or sale) activity for loans originated for securitization during the pre-August 2007 period, but now trapped in inventory due to buyer's lack of interest in product with perceived higher loan-to-value ratios and lower risk premiums over Treasuries (or LIBOR). The buyer's strike (or seller's strike, depending on where you are sitting) is expected to continue for a while as neither side seems (at present) "compelled to sell" (or buy). The originators seem to have made it past year end accounting worries and the buyer's...well it's only early January and the money is not burning a hole in their pockets. We understand some originators have tried to sell loans from their inventory via the whole loan market, apparently with little success (to date).

## Private Equity

According to the most recent Real Estate Research Corporation (RERC) investor survey, sentiment seems to have shifted markedly to “Hold” or “uncertainty” with the exception of the multifamily sector as the following chart indicates:

	Buy	Sell	Hold
Office-CBD	24%	12%	64%
Office-Suburban	24%	14%	62%
Industrial-Warehouse	39%	6%	55%
Industrial-R & D	20%	13%	67%
Industrial-Flex	8%	15%	77%
Retail-Regional Mall	0%	42%	58%
Retail-Power Center	0%	31%	69%
Retail-Neighborhood	6%	39%	55%
Multifamily	41%	5%	54%
Hospitality	0%	40%	60%

Again, according to RERC’s most recent survey, changes in capitalization rates during the fourth quarter were modest. But, we do not think you can take this as indicative of anything as volume was down significantly and so the real impact on buyer and seller behavior of the credit crises and the looming recession has yet to be seen. Given the number of deals that were reportedly re-sized or abandoned, measurable change is on the way.

Period	All Property	Multifamily	Office-CBD	Office-Suburban	Retail-Mall	Retail-Neighborhood	Retail-Power	Industrial-Warehouse	Industrial-R & D	Industrial-Flex
3Q07	6.51%	5.80%	6.00%	6.50%	6.60%	6.50%	6.50%	6.30%	6.80%	6.90%
4Q07	6.58%	5.90%	6.10%	6.60%	6.40%	6.50%	6.40%	6.60%	7.00%	6.80%
	+0.07%	+0.10%	+0.10%	+0.10%	-0.20%	0.00%	-0.10%	+0.30%	+0.20%	-0.10%