

Real Estate Capital Markets Update – January 25, 2008

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

A quote from “Investment Postcards from Cape Tow”, Prieur du Plessis's investment blog:

“The Year of the Rat: How to Invest”

“The Chinese calendar proclaims this as the *Year of the Rat*. Based on the behavior of economies and financial markets over the past few months, investors would be forgiven for thinking that a plague had descended upon the financial system”.

The Economy

The Federal Reserve Board (FRB) strikes back. Will they strike again?

In a rare inter-meeting “meeting”, the FRB reduced both the Federal Funds Rate and the Discount Rate by 75 basis points to 3.50% and 4.00 %, respectively. The FRB statement noted the rate cut was in “view of a weakening of the economic outlook and increasing downside risk to growth” as well as the fact that “broader financial market conditions have continued to deteriorate and credit has tightened further...”

Now for next week's meeting on January 29-30. While some postulate that the FRB will cut rates again, the majority view is that the FRB's bold move this week put it ahead of market expectations and provides some breathing room before the mid-March meeting.

In other economic news, the FRB recently released its Beige Book economic survey for the of late November through December 2007. Given the financial markets turmoil and the FRB's action this week, it's rather obvious what the Beige Book had to say for itself. According to Moody's Economy.com, the report “outlines a slowing economy...with retailing and housing markets remain[ing] the largest concerns...This report is not quite as negative as expected, but paints a picture of an economy that is rapid decelerating.”

Lloyd's Wall of Worry (a trademark of Khaner Capital Management”

“It's the counterintuitive indicator: many worries, buy; few worries, sell.

“Patience and other resolutions: December left the stock market wanting. No Santa rally, and an interest rate cut that had many fearing the fed is way behind the curve in its effort to unlock credit markets and stimulate economic growth. The wall hits 19 worries. Its future dimensions are especially tough to call—some worries should ease while others, such as the U.S. presidential election, will appear. Opportunity abounds, but so does volatility. Pick your spots carefully in this new year”. [The “block” of the wall follow].

Inflation: The ultimate iceberg, inflation has been building slowly for years but only recently poked itself above the waterline and into the economic numbers. Brrrrr...

Oil Prices: At some point they will reflect the reality of the slowing world economies. Don't hold your breath.

Consumer Spending: A little less here, a little trading-down here. The beat is slower but thankfully still going.

U.S. Dollar: Weak, but not the time for the wheelbarrow just year.

Write-offs: More to come. The key is that they not be too big to be damaging or too small to be believable.

European Economies: Europeans may be leaders in fashion, but their economies follow U.S. trends—up and, like now, down.

Pakistan: Unlike Afghanistan, it's too critical for the world's powers to ignore.

U.S. Economy: The mid-cycle slowdown crowd is grudgingly giving way to a growing horde of recessionistas.

Credit Crunch: Banks must figure out if they can trust their own balance sheets before they put money on the books of other banks, businesses, and individuals.

Terrorism: Activity seems to be rising along with the world's vulnerability to shocks.

Interest rates: Going lower. Should stimulate growth, may stoke inflation. Comforting, huh?

Housing Prices; Takin' a beating' like a county fair junker you get to bash with a sledgehammer for a buck.

Unemployment: Now at 5.0%, and that's before you tack on a few tenths for all the steroid-tainted baseball players who may be out of work.

U.S. Mortgages; It's now easier to walk away from one than tpo get one.

Emerging Markets: The clear drivers of global economic growth. Let's hope they got the memo to keep up the good work.

Structured Investment Vehicles: Still a mystery. Who's working on this case, Columbo or Inspector Clouseau?

Mergers & Acquisitions: The art of the deal is rapidly becoming the art of unraveling the deal.

Dividends: The bigger they are, the harder they may fall.

What I Heard While Moderating the Capital Markets Panel at the ULI Trustees Meeting his Week

The panel, which consisted on a global real estate investment manager, a representative of a commercial bank, a U.K. based global investor, and a global opportunistic investor noted that the commercial real estate industry “got the wake up-call we needed” and that the resulting “tightening was long overdue”. Then they got serious. The following summarizes my notes from the podium:

1. The problem is global, not local.
2. Re-pricing of equity and debt and everything “in-between” is occurring; renegotiation of sales and financings, common; withdrawals of deals from the market, common.
3. 2008—1st test of the “Credit Culture” since the early 1990s; finding out that lots of the people did not do their jobs, i.e., due diligence.
4. “Diversification does not offset systemic risk”; unfortunately, it never did before too.
5. Sales and financing volume will be down as much as 50% from 2007.
6. “Revenge of the low leverage buyers—REITs, pension funds, and foreign investors; portfolio/balance sheet lenders have their “pick of the litter”.
7. Federal Reserve Board action this week—more symbolic than meaningful.
8. Information remains hard to come-by; markets are “opaque”; holders of debt securities are guarding data; hard to estimate size and width of problems.
9. Markets are waiting for the next shoe to drop—will it be credit cards, auto loans, home equity loans, commercial CDOs, credit default swaps, etc.
10. How long will it last—12 months, maybe longer.
11. It’s a “liquidity problem, not [real estate] fundamentals problem”.
12. Financial institutions are working to “repair their balance sheets” which are currently “capacity constrained”; credit will be “rationed/restricted”; underwriting will be more stringent.
13. Buyer’s strike continues in the debt market; “You can price risk, but you can’t price uncertainty”.
14. Seller’s strike continues in the equity market; “Why should I reduce the price because you can’t get ‘super-sized’ financing”.
15. Short-term opportunities—home builder lots, real estate investment trusts; long-term opportunities—owners needing to refinance properties whose debt was originated during the past 5 years.

Indications of Interest

Based upon a recent survey of conduit lenders (assuming there really are any left) by CohenFinancial, spreads continue to widen with commercial real estate loans being quoted on the following basis:

5-Year Term: Treasuries (2.54%) plus 417 basis points, or 6.71%
10-year Term: Treasuries (3.42%) plus 321 basis points, or 6.63%