

My Most Frequently Asked Question: When Will This Market Get Back on Track?

I am asked at least 10 times per day how long the present negative market conditions will last. That is a question that no one can accurately answer because no one knows. There are a number of things to consider when attempting to articulate an answer. **I thought I would take this opportunity to share with you some indicators I am watching which will likely let us know when we have turned the corner.** Notwithstanding the content of this commentary, I remain optimistic about our market and I don't let today's facts alter my perspective on the future. Let us first take a look at where we are today.

The investment sales market for properties under \$50,000,000 is not performing nearly as poorly as one might think. In the first half of 2008, the volume of sales was down only 31% from the first half of 2007. I used the word "only" because the institutional quality sales market for properties over \$100,000,000 has seen volume shrink by 60% (the most bullish estimate) to 85% (the most bearish estimate). Additionally, prices were down by only 5% in the under \$50 sector while larger properties are off 25% - 35%. The main reason for this relatively good performance is the significant amount of debt that is available for middle market properties. From July 1st through today, the market has softened slightly but transactions are still happening regularly. I will provide a complete breakdown of the market's performance in next week's commentary.

Based upon today's market conditions, many people are also asking me how this market compares with the market of the early 1990s. Here is a comparison: In the early '90s times were tough as volume was down and prices plummeted. We sold elevated apartment buildings for 13 - 14 times the rent roll in the late '80s for conversion to cooperative ownership (condos were for Floridians in the '80s) and sold those same properties in the early '90s for 3 to 4 times the rent. This was the sector which was hit the hardest. Average prices were down 35% in the '90s; thus far we are down about 10%. In the early '90s the Fed was tightening monetary policy (raising interest rates up to 8% and subsequently dropping them to 2.5%) and heading into today's market (which we will define as July of 2007 through today), the Fed was easing monetary policy (lowering interest rates from a starting point of 5.25% down to 2%). The Federal Funds Rate is expected to remain at 2% well into 2009 with current expectations leaning toward more easing as opposed to a tightening. The Fed meets Tuesday.

In the present cycle, unemployment has increased from 4.5% to 6.1%. In the early '90s unemployment increased from 5.5% up to 7.8%. It is generally expected that we have quite a way to go before unemployment levels out. This is a key economic indicator to watch as it will greatly affect the fundamentals of our market such as residential rental unit

and for-sale unit demand and commercial office space occupancy levels. Going into the early '90s, these fundamentals were in much worse shape as residential vacancy was almost 5% and heading into the present cycle they were just slightly over 1%. Office vacancy was in double digits 17 years ago and was approximately 6% heading into this cycle. We were on much better footing this time around.



This article, and all other Commentaries by Bob Knakal, can be found on [The Massey Knakal Reel](http://www.masseyknakal.com/blog) – a blog for breaking sales, listing and neighborhood real estate news – at www.masseyknakal.com/blog

In the early 1990s, land for development had virtually zero value. You couldn't give a development site away because the rents that were achievable did not justify the construction costs even if you paid nothing for the land. (In fact, we did one of the first development site sales coming out of the "zero land value market" in 1992 when we sold the Phillips Auction House property at 406 East 79th street for \$35 per buildable square foot.) Today, land value is falling in all but the best of locations, and certainly financing for new construction is very challenging, but it is still high enough that construction for rental housing is not possible. In the early '90s, oil prices were relatively low (notwithstanding the short spike experience during the Gulf war) and today oil prices are relatively high at today's \$102 per barrel (we also had a spike recently when the price hit \$147).

In the early '90s, the Savings and Loan crisis was a \$250 million problem in what was a \$7 trillion economy. Today, the credit crisis is estimated to be a \$1 trillion problem in what is a \$12 trillion economy. By this measure, today's crisis is a much bigger problem.



During Mr. Knakal's 24-year career, he has sold over 1,000 buildings having an aggregate market value of over \$5.8 billion. He was the top salesman, with partner Paul Massey, at Coldwell Banker Commercial (now CB Richard Ellis) in New York in 1986, 1987, and 1988 prior to forming Massey Knakal. In 1990, he was awarded Crain's New York Business "40 Under 40" awarded annually to 40 business people under

forty years of age for outstanding achievement in the New York business community. In 2001, Mr. Knakal was named one of "The Top Dealmakers" by Real Estate New York Magazine. He has twice been the recipient of the Robert T. Lawrence Award in the Real Estate Board of New York's Most Ingenious Deal of the Year Contest. First in 2002, for the assemblage of the easterly blockfront of Second Avenue between 54th and 55th Streets. Then again in 2004 for the sale of the historic Gotham Book Mart at 41 West 47th Street.

Please give a call if you have questions about your property or the market in general.

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We have been in the current cycle for 15 months and we have a long way to go before we are out of the woods. History tells us that there have been 10 economic cycles since 1945 with the average expansion lasting 57 months and the average contraction lasting 10 months. Clearly, this contraction will not be average. **There are still three issues that need to be dealt with:**

- 1) Financial institutions need to be stabilized.** The Fed addressed Bear Stearns, Fannie Mae and Freddie Mac. They may still have to address the FDIC which has indicated a probably need to borrow to address a slew of banks failures which they anticipate. Home Loan banks are GSEs (like Fannie and Freddie) also and, so far, look healthy but may require intervention. Lehman Brothers has indicated it will file for Chapter 11 Protection, Bank of America intends to buy Merrill Lynch, and AIG, WaMu and a host of others need to be stabilized. It is likely the Fed will not intervene further unless systemic risk presents itself.
- 2) Housing prices need to bottom out.** 39% of all banking assets are related to housing and the hangover of inventory is substantial. It is expected that housing will not hit bottom until the cost of homeownership equals market rent levels. We got into this current economy through the housing market and it is through the housing market that we will get out of it.
- 3) Banks need to be recapitalized and regain their appetite to lend money.** Banks will still have to deal with large write-offs from Fannie Mae and Freddie Mac preferred stock holdings. They also must refinance floating rate note securities which will amount to \$780 billion maturing before 12/31/09. Also ahead is the construction loan issue. 6,900 banks made construction loans and 2,100 of those have almost 100% of their risk based capital tied up in construction loans. Delinquency rates have been rising and will continue to do so.

Clearly, banks have some heavy lifting ahead of them. **So how will we know when the market has turned the corner? Here are three metrics to watch that will give us that answer:**

- 1) Bank capital.** We would like to see 2 or 3 quarters where banks are not forced to actively raise capital.
- 2) Leveraged loan spreads.** These spreads have been very high and are increasing. The spread is a reflection of bank's willingness to lend. The spread and willingness to lend are in inverse proportion.
- 3) Credit default swap premiums.** These premiums have also been inflated. They indicate what peers of the banks and financial institutions think of their creditworthiness. As these premiums fall, it will indicate that optimism is coming back to the market.

No one knows when the "bad market" will end. We remain optimistic that transaction volume will remain well above our baseline level of 1.6% of the total stock of properties (annualizing the first half of 2008 resulted in a turnover of 2.2%). This was the level experienced in 1990 and 1991 when the only people who sold property, had to. Even if volume reverted to this baseline, that still would result in 2,000 properties being sold each year, enough to keep us all very busy. I look forward to sharing our first half 2008 market analysis with you next week as the results are quite interesting. Have a great week.

- Bob