Credit Markets, Budget Deficits and Government Spending and Their Affect on Our Real Estate Market

It is no wonder that there has not been much talk recently about the massive budget deficits that we are facing on a city, state and federal basis. Of course, there have been other things on our minds and on the minds of politicians. The Investment in America Plan (aka The Bailout Plan, aka The Emergency Economic Stabilization Act of 2008 (EESA)) has been front and center. It appears this Act will be voted on within the next day or two and this, if passed, should provide a necessary boost to the flow of credit in the marketplace. The tightening of credit has been gaining momentum during the last two months as the crisis is becoming more problematic in some areas.

The housing market continues to take its lumps as 6.6% of all mortgages were at least 30 days past due at the end of August. Signaling that things are not improving, this delinquency rate was 5.8% at the end of June and was 4.5% one year ago. **This rise in delinquent loans has been driven by mortgages originated in 2006 and 2007 when lending standards were the least restrictive.** Mortgage delinquencies have been on the rise for three years which has led to substantial losses for banks and institutions holding securities backed by mortgages. Moody's Economy.com estimates that from 2004 through 2007 banks made risky mortgage loans (subprime, Alt-a and Ninja loans) on 15 million homes and as many as 10 million may go into default. These defaults will force home prices lower and have the effect of making lenders more conservative. As lenders lose their appetite to lend, those actions, along with the weakening economy, are creating a downward spiral and are exacerbating an already troubled market.

Short term money markets also remained in turmoil demonstrating that credit tightening may harm the broader economy, hence the importance of the EESA. These short term markets afford companies with ample cash reserves the opportunity to access extra dollars by investing in securities with short life spans of just days or weeks. All of this capital helps keep the economy lubricated by making those funds available to other firms needing to buy inventory, meet payroll, etc. **These short term markets are all but hidden from the general public and include the floating-rate municipal bond market, the overnight Treasury repo market and the short term commercial-paper market.** Last week the commercial paper market contracted by $61 billion, its largest decline in over a year.

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

There is such a lack of confidence in the markets that banks and funds aren't extending credit to customers even for a few hours during the day, as they typically do. Companies are continually monitoring the debt markets, where rates on any debt that matures in more than one day remain elevated. These elevated rates are the result of increased demand for safe Treasury bill type assets. In fact, the benchmark 10-year note yield fell to 3.862% last week.

With credit tough to come by and confidence low, it is critical that EESA gets approved. We need credit availability to get the economy moving. This Act will not be a solution by itself but it is a needed component of the solution. We have been fortunate that debt has been available from portfolio lenders for our moderately priced investment properties in New York. In fact, it is interesting to see that the commercial mortgage lending unit of WaMu was a highly profitable division of the failed bank. We were working on two transactions where WaMu was in the process of providing the debt and these transactions are right on track with the only change being the bankers now have different phone numbers. **It has been our contention that the high profitability and low risk nature of today's loans are providing incentive to the lending community to deploy capital into our market sector.** Access to debt on a larger scale

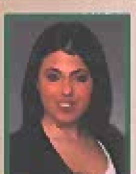
During Mr. Knakal's almost 25 year career, he has sold over 1,000 buildings having an aggregate market value of over $5.8 billion. He was the top salesman, with partner Paul Massey, at Coldwell Banker Commercial (now CB Richard Ellis) in New York in 1986, 1987, and 1988 prior to forming Massey Knakal. 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.

212.696.2500 x7777

Robert Knakal's Transactional Support Team

Jonathan Hageman
Sales Team Manager
212.696.2500 x7773
JHageman@masseyknakal.com



Elysa Berlin
Associate
212.696.2500 x7764
EBerlin@masseyknakal.com

J.J. Stanton
Associate
212.696.2500 x7775
JStanton@masseyknakal.com

Thomas Willoughby
Associate
212.696.2500 x7730
TWilloughby@masseyknakal.com

Kevin Gleason
Associate
212.696.2500 x7750
KGleason@masseyknakal.com

is still a challenge and perhaps EESA will help jumpstart that sector. These are positive developments for our building sales market where we are thirsting for positive news.

In addition to the current credit crisis, we have to be concerned with the massive deficits that are projected in various budgets. For 2009 the New York City budget is expected to have a deficit of $2.6 billion, the New York State budget deficit is forecast to be $5-6 billion and the Federal deficit was estimated at about $500 billion BEFORE the bailout plan was contemplated. The concern we have is that the bridging of these deficits will be effectuated by large, across-the-board tax increases. But tax increases are not the solution. **The need has never been greater to reduce government spending.** To his credit, Governor Paterson has been one of the few politicians who have been speaking out about cutting government spending. Budget gaps must be balanced with a combination of spending reductions and tax increases (as opposed to tax increases alone). I find it interesting that no one wants to talk about spending cuts. But after all, reductions are controversial as voters don't like to think that sectors which are important to them may receive funding cuts. In the debate last Thursday, it was interesting to see how both presidential candidates sidestepped the issue. Senator Obama, when asked what specific spending cuts he would endorse, simply said he would cut wasteful programs and then spent the rest of his allotted time discussing what he wouldn't cut. Senator McCain, when asked the same question, said he would consider a spending freeze and would also look to cut wasteful spending without mentioning any specifics. The cuts that are required are not just dollars spent on wasteful programs. Some real pain will be felt and should be spread across the board. If you have the ear of a politician in the coming weeks, remind them that spending cuts are necessary and are likely to be more acceptable to the public based upon the upheaval in our economy.

Regardless of who wins in November, it is very likely that our taxes will increase, and on all levels, city, state and Federal. The New York City economy will be adversely affected on a disproportional basis due to the high concentration of high income earners here. **An even bigger concern is the status of the capital gains tax. An increase in this tax slows building sale transaction volume as the costs of selling become prohibitive.** In a market where our volumes are already challenged, another incentive not to sell is the last thing we need. We should learn from experience. When the Cuomo tax went into effect in the 1980s, transaction volume dried up and tax revenue did not increase as much as projected. I vividly remember hundreds of conversations I had with potential sellers during the Cuomo tax years who liked the valuation we came up with for their property but who ultimately decided not to sell based upon the high costs associated with a sale. When the law was eliminated, the market reaction was so positive that tax revenue jumped significantly based upon the unclogging of the pent up demand to sell. Let's hope Washington can provide some much needed relief while not relying on taxing us to death to accomplish their objectives.

Have a great week,

Bob

275 Madison Avenue, Third Floor
New York, NY 10016
Phone: 212.696.2500 • Fax: 212.696.0333