



with Bob Knakal

Debt ceiling dilemma

Q. With the presently apparent impasse on the debt ceiling negotiations, what impacts, if any, do you think this issue could have on our real estate capital markets?

A. I believe that the biggest potential land mine in our real estate market recovery is the question of when interest rates will rise and how significantly they will do so.

One of the main reasons why the building sales market has recovered to the extent it has, is due to the extraordinarily low interest rate environment that we have been operating within.

The debt ceiling issue, and the resultant spotlight which has been shined on America's fiscal position, has led some of the rating agencies to indicate a downgrade of the US's AAA

credit rating may be warranted.

Through all the rhetoric which has been thrown about, by both parties, I am shocked that no one has broken the issue of the debt ceiling debate down to its most elementary form, which would be understandable to everyone in America.

Here is a basic analogy; Assume that you have maxed-out your only credit card and have no money in the bank. Your monthly paycheck is \$3,000 after withholdings and your monthly expenses are \$3,500. In this case you are faced with three options.

The first is to call your credit card company and ask them to increase your limit so that you can pay your bills (raising the debt ceiling). This is something that your bank is not likely to do given that you don't earn enough to pay

your obligations.

The second option is to go to your employer and ask them to pay you more (increasing taxes and other "revenues"). Many economists believe that given the fragile economic recovery, this strategy is not prudent.

This realistically leaves only one option, and that is to reduce the amount you spend by \$500 per month. This can be done either by reducing the number of magazine subscriptions you have, leasing a less expensive car, or a host of other expense-reducing measures.

This third option is precisely what most American people and American companies have had to do over the past several years given the realities of our economy. Unfortunately, many politicians do not see things so simply and, for mainly ideological reasons, will not agree to simply cut spending.

The deficits that we have presently, while massive, don't even reflect the reality of our position. One of the fundamental problems that we have as a nation is our fuzzy understanding of the true US fiscal picture. This is created by the government's arcane "cash basis" budget methodology.

The government budget only records long term liabilities, such as entitlements, when they are paid, whereas private sector corporations must reflect the net present value of liabilities as they occur.

This leads to a complete misunderstanding of the short term picture, leaving politicians and citizens believing the country is in much better financial condition than it really is. This leads to an assumption that taking on even greater obligations is okay.

The immense magnitude of Obamacare has not been accurately reflected in projections moving forward, nor could it be as there is not a single person in the US who accurately can predict the new law's financial implications. While the program hasn't even kicked in yet, most of its double-counting and projected savings have already been exposed as pure fiction

and it is expected that the program will end up costing many times what was originally anticipated.

Consider that cumulative Medicare spending has exceeded \$1.4 trillion, or 10 times the original political forecast in 1965.

If you compare the debt the country has relative to its GDP, and include off-balance-sheets liabilities such as Fannie Mae and Freddie Mac obligations, our debt-to-GDP ratio far exceeds that of Greece.

Furthermore, if the government was to account for our national finances the way corporate America does, some estimates show that, for fiscal year 2010, the U.S. would show a negative net worth of \$44 trillion, an operating loss of \$817 billion and \$1.3 trillion of negative cash flow.

In addition to the poor financial condition of the country, the Fed's announced end of QE2 will also exert significant upward pressure on interest rates. During the last several Treasury auctions, the Fed has purchased approximately 70% of all bonds. If the Fed doesn't show up at the table, the price of bonds will likely drop, which will increase the imputed interest rates.

This entire scenario could mean that interest rates rise more quickly and to a greater extent than most economists are predicting. To the extent interest rates rise, mortgage rates will rise and, as mortgage rates rise, so will cap rates.

This dynamic will exert negative pressure on commercial real estate values and could create a host of problems for the hundreds of properties in New York City with negative equity positions yet positive cash flow based on such low interest rates.

Let's hope that true leadership is demonstrated in Washington to overcome the extraordinary partisanship that pervades Congress, the extent to which hasn't been seen in over 100 years. Our real estate market is depending on it.