The Battle for the Future of Investment Sales

Inflation, the Fed, de-leveraging and more! What will steer the market?

Now that a new decade has begun, many people question what is in store for the commercial real estate investment-sales market over the next few years. Clearly, 2009 was a challenging year, to say the least, with extraordinarily low sales volume and falling prices.

As 2009 ended, it was clear that, although the volume of sales would register the lowest totals we have seen going back to at least 1984, volume was trending upward with strong activity in the third and fourth quarters. Exact 2009 year-end numbers will be released by Massey Knakal before the end of this month. The direction of value, on the other hand, was still heading south as the year closed.

Robert Knakal
Columnist

Real estate fundamentals move in tandem, inversely, with unemployment. As unemployment rises, fundamentals weaken and vice versa. If this generally accepted hypothesis is correct, we can use unemployment as a predictor of the direction of prices of commercial investment properties. Most economists believe that unemployment will peak at some point during the first half of 2010. It will be at this peak that market fundamentals will be their weakest and property values will be at their lowest level.

What happens after property values bottom out? Will property values bounce along this bottom for a while? Will values bounce but trend upward or trend downward? The answers to these questions are dependent upon a battle that will take place among the following factors: the speed and extent of inflation; the de-leveraging process; the massive amount of capital on the sidelines; job growth; the state of fundamentals; the Fed's monetary policy (and how it sequences its exit); and good old-fashion supply and demand. We firmly believe that 2009's low volume of sales was more a function of constrained supply rather than a lack of demand, which remained healthy.

Inflation is important to watch, as a rise in this metric, above the Fed's comfort zone of 1 to 2 percent, will force it to raise interest rates, which will have a tangible impact on commercial real estate values. At present, it appears that inflation is likely to fall in the short term, at least as far as the "core" indexes are concerned (core inflation strips out volatile food and energy prices). In the U.S. economy, "slack" is the best predictor of inflation both at the aggregate level and in individual sectors of the economy. Slack is pervasive throughout the economy, not just in the frequently referenced data on unemployment and industrial capacity utilization but also in the service sector and our housing/real estate sector.

We have seen actual and imputed rents drop significantly during this recession, in the range of 20 percent (residential) to 50 percent (retail), depending upon the property type. The slack, or vacancy, in our market could further decrease inflation significantly. There is a clear inverse relationship between the rental vacancy rate and the pace of rent inflation. With rental vacancies approaching record levels and real unemployment hovering around 17 percent, there is a reasonable expectation of further declines in year-on-year rent inflation.

Most economists believe that a weak dollar is, generally, a threat to inflation. Under our current conditions, this threat is limited. In actuality, the dollar is really not that weak, and this was true even before the most recent round of risk reduction. The U.S. dollar clearly depreciated substantially in 2009; however, this could be considered a consequence of the normalization that has occurred in global financial markets. According to the Fed's broad trade-weighted index, the dollar is slightly stronger than the average of the past two years.

Additionally, currency has less impact on inflation in the United States than elsewhere given the relatively small size of the trade sector. In the U.S., the impact of currency changes on inflation, in particular, is nominal. The general rule of thumb is that a 10 percent depreciation in the trade-weighted dollar raises the level of the Consumer Price Index by just 25 basis points. Therefore, it would take a massive drop in the relative value of the dollar to create tangible concerns about imported inflation.

On the flip side, the U.S. money supply more than doubled in 2009, and this increase was greater than the increases in our money supply in aggregate over the past 50 years. This massive additional supply will eventually significantly raise inflation. When this occurs, it will impact the timing of the Fed's response.

The Federal Reserve has addressed the financial market turmoil of the past two years, in part, by greatly expanding its balance sheet and by supplying an unprecedented volume of reserves to the banking system. The Fed's balance sheet had grown to approximately $2.2 trillion as 2009 ended. Its total portfolio of loans and securities has more than doubled since the beginning of the financial crisis. The Fed's exit strategy will have profound implications for commercial real estate. In theory, the Fed has four strategies for "exiting" their current, highly accommodative stance.

The first is terminating the cur-

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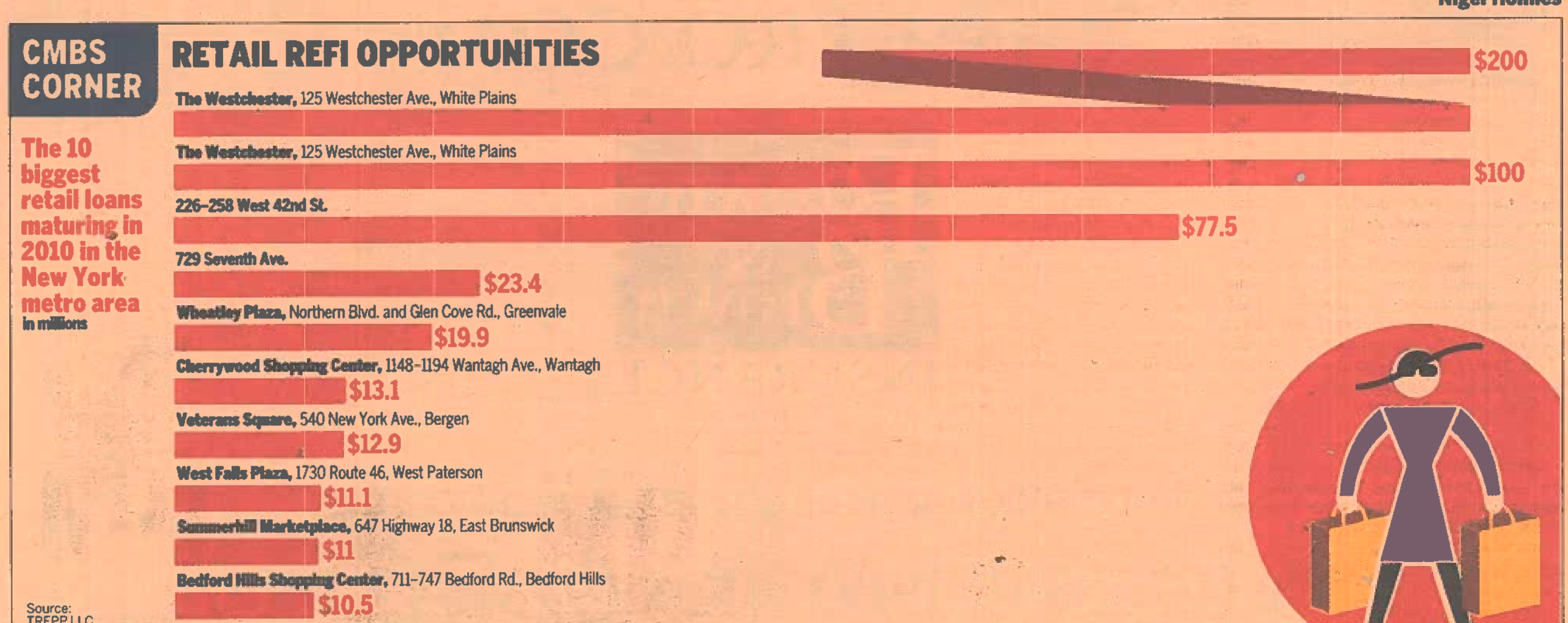

CONCRETE THOUGHTS

rent program of asset purchases. The Fed now holds $910.43 billion in mortgage-backed securities and is on its way toward a goal of $1.25 trillion, which was part of the central bank's efforts to fight the downturn. This program is scheduled to end in March.

The second is draining excess bank reserves through reverse repos and/or term-deposit facilities. The Fed is already testing this strategy of reverse repurchase agreements, in which the central bank sells securities from its portfolio with an agreement to buy them back later. Under this arrangement, the buyers move cash from banks to the Fed, removing reserves from the system. Term deposits are roughly analogous to the certificates of deposit that banks offer to their customers. Under this strategy, the Fed would issue term deposits to banks, potentially at several maturities up to one year. This would encourage banks to park reserves at the Fed rather than lending them out. This remov-

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al of money from the lending stream has obvious implications for commercial real estate.

The third strategy is hiking short-term interest rates via parallel increases in the federal-funds rate and the interest rate on reserves. This is the most commonly used monetary policy lever utilized by the Fed.

The fourth is simply the outright selling of assets.

The Fed has indicated that the testing of, and discussion about, these strategies has no implications for monetary policy decisions in the near term. This year, the main form of exit is likely to be an end to asset purchases. Fed officials will likely drain some excess reserves, mainly to prove to market participants that the Fed is capable of doing so. When it decides to tighten in earnest, it would probably use the term-deposits program ahead of or in conjunction with its traditional policy tool, the target for the federal-funds rate at which banks lend to each other overnight.

Draining reserves from the system has clear implications for the commercial real estate debt market, as the cash available for mortgages will shrink, further constraining an already dry market. Additionally, the cost of real estate debt available will likely increase as the federal-funds rate increases. This will be a key mechanism to watch when tightening occurs.

How will lenders react when their borrowing rates are increased? Present monetary policy is allowing for the recapitalization of the banking industry, as banks are borrowing at close to zero and are lending or investing at rates significantly higher. The Fed's accommodative policy is actually reducing incentives for banks to lend, as they can invest borrowed money in risk-free treasuries, making substantial spreads (profits), rather than make risky loans. An increase in the federal-funds rate might, therefore, actually increase the supply of dollars available to the debt market.

Conversely, banks have been enjoying wide spreads for quite a while, and an increase in the funds rate would eat into these comfortable cushions. How much will banks allow their spreads to compress before passing along the increase to borrowers in the form of higher mortgage rates? Many bankers I have spoken to indicate that they may absorb 50 to 75 basis points before opting to pass along the increase to borrowers. This would mean higher mortgage rates for borrowers, and lower commercial real estate asset value.

Another factor that would exert downward pressure on the value of assets is the impact of the massive de-leveraging process that our commercial real estate market must work through. We estimate that based on the sale and refinancing transactions closed in the bubble years of 2005 to 2007, and on pricing trends, approximately 15,000 commercial properties in New York City have negative equity. Based upon today's value levels and current bank underwriting standards, we estimate that there is $100 billion of excess leverage on city properties.

Clearly, not all of this leverage will be extracted from the market. Some properties will be held for the long term by owners who can afford to feed them out of cash flow from other sources. Some properties will be worked out between the lender and the borrower. We believe, however, that at the end of the day, $30 billion to $40 billion will be extracted in the form of losses based upon the recycling of assets. This dynamic will be especially acute in 2011 and 2012, as 2006 and 2007 vintage loans mature. These are the loans that are the most underwater.

Distressed assets have been slow to come to the market; everything that has occurred legislatively has created a disincentive for lenders to deal with their troubled real estate assets. Fed monetary policy is allowing banks to make tremendous profits that can be used to write down the value of known-to-be-toxic assets. The Making Home Affordable program; changes to FASB mark-to-market accounting rules; and bank regulators' allowing lenders to hold loans on their books at par even though they know the value of the collateral is far below that level—these have all served to allow lenders to kick the can down the street. This strategy only makes sense if enhanced fundamentals in the short term allow lenders to appreciate their way out of their problems. We do not see this as a likely outcome in the short term.

The recycling process that will need to occur will add significantly to the supply of properties for sale. As supply increases, value decreases.

To counter these factors, all of which will lower value, is the massive amount of capital available to acquire commercial real estate assets. Billions and billions have been raised to purchase both distressed and core assets. The REIT industry has raised more than $20 billion from public markets to pay down debt and create war chests to enable it to pounce on opportunities to buy. Foreign capital is very visible in the market, from both institutional buyers and, particularly, from high-net-worth individuals who are in the market in numbers not seen since the mid-1980s. And we can't forget about the locally based high-net-worth individuals and old-line families that have been gobbling up New York City properties for decades.

To a large extent, how our commercial real estate investment-sales market performs over the next two to three years will be dependent upon which of these factors prevail after an apparent bottom is reached.

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