CONCRETE THOUGHTS

Where Are We Headed?

Will the boom continue or is another bust right around the corner?

Without a doubt, December 2012 will be remembered as an epic month in the history of property sales in New York City.

In December alone, there were 984 properties sold totaling $11.8 billion. This monthly total is nearly double the entire year's dollar volume in 2009. It is also the highest monthly total, in both number of properties sold and dollar volume, since we began tracking the market in 1984.

The market's performance in the fourth quarter was no surprise. We knew it would be extraordinarily active as the pending increase in the capital gains tax rate catalyzed many transactions that either might not have happened or would have happened in 2013 that were accelerated to take advantage of 2012's capital gains rate.

The natural assumption we made was that this externality would affect behavior and there would be a natural slowdown at the beginning of 2013, as is normal after the externality comes to pass.

In January, there were 253 properties sold, which is the lowest monthly total going back to April 2012. Monthly dollar volume was $1.75 billion, also the lowest total going back to April. However, this activity is still relatively strong compared with monthly totals seen in 2010 and 2011.

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The question becomes: Will volume continue to be muted, or will we see a pickup?

At the end of the year, we projected a reduction in the number of buildings sold this year by 20 to 25 percent but, counter-intuitively, an increase in the dollar volume due to an anticipated increase in sales of large office buildings. Typically, the office buildings sold in the city, at very high prices, affect the total dollar volume much more than the number of buildings sold.

We also projected that values would increase by 15 to 20 percent this year as buyers fight over a smaller supply of available properties. Thus far, it appears that our projections are holding.

The activity in the market has been extraordinary as our historically low interest rates have provided the rocket fuel for sale prices to take off. The upward pressure being exerted on property values is tangible as sales are hitting record levels on seemingly successive transactions. The length of time assets are on the market has been reduced, leaving market participants scratching their heads at the prices being paid for assets, yet these assets continue to trade.

So, are we in a commercial real estate bubble? History teaches us that low interest rates, for extended periods of time, create asset bubbles. Last year, average prices per square foot citywide increased by 13 percent. This year we are expecting even higher increases, and these increases are not occurring because underlying fundamentals have gotten significantly better. More than anything else, low rates are the reason.

Currently, the economy is trending upward, fundamentals are improving (albeit slowly), and most economic metrics are so far below their long-term trend lines that we must assume a natural regression toward the norms will occur at some point. We have also had so little new product added to the market in the last several years that pent-up demand is imbedded in the system. Will these positive dynamics trump those that normally create quintessential asset bubbles?

Low interest rates during much of Alan Greenspan's tenure as Fed chairman directly affected the housing bubble which led to the Great Recession. As William Shakespeare's real estate broker brother said, "To repeat, or not to repeat, that is the question."

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THE LEAD INDICATOR

The Housing Finance Reform Debate

The apartment market can manage without its subsidy.

The debate over housing finance reform has taken place largely behind closed doors, with public discourse limited to speculation. Since the collapse of Fannie Mae and Freddie Mac into effective insolvency in September 2008, the public has been shielded from serious discussion about their future. At least for the time being, weakness in the housing market has encouraged the status quo; policymakers have sidestepped the question of the government's long-term role in shepherding homeownership outcomes.

The beneficiaries of the prevailing market structure, in ownership and rental markets alike, have held sway in warning of dire consequences absent continued, large-scale public support of housing. They're right in some cases and just well incentivized in others. Among their ranks, you will find at least a few ratings agencies and industry groups that—until it was a matter of fact—argued that conservatorship in some form was entirely improbable.

The enterprises themselves rebuked their critics in the days and weeks leading up to conservatorship, in one case stating emphatically that "we are well capitalized and positioned to continue to serve our vital housing mission." Assuaging skeptics, reassurances depended on the implicit guarantee that was a contributor to the housing crisis. During the summer of 2008, one industry spokesperson offered, "just given the size of the two companies, surely the government would not stand aside." The message: Don't worry, we're too big to fail.

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Approaching the five-year anniversary of conservatorship, the enterprises have become increasingly conventional tools of policy. Any illusion to the contrary was shattered in late 2011, when Congress extended the payroll tax holiday and unemployment benefits. Ever frugal, Congress paid for these measures by increasing fees the enterprises charge lenders for home loan guarantees and the premium the Federal Housing Administration charges homeowners for mortgage insurance. Revenues generated by the enterprises were now fungible with every other public dollar.

With housing on the mend, the enterprises are in the black once again. Their profitability should underscore that a public debate over the government's long-term role in subsidizing housing—by definition and design, a distortion of market outcomes—is increasingly overdue. Under the current structure, the risks taken by the agencies in generating their profits imply off balance sheet liabilities held by the public. With billions of dollars of draws on the Treasury, that relationship is tangible, even if the enterprises are now in a position to remit.

When the conservatorship was first announced, then-Secretary of the Treasury Henry Paulson assigned blame to "the inherent conflict and flawed business model embedded in the GSE structure, and to the ongoing housing correction." In some circles, that view is softening now that the enterprises are turning a profit. Absent anything approaching a long-term plan from Congress or the administration, the initiative in housing finance reform has been taken by the Federal Housing Finance Agency. Its leadership is in flux, in part because of the steps it is taking. In early March, Acting Director Edward DeMarco announced plans for new risk-sharing arrangements, higher guarantee fees and a new, shared platform for the issuance of mortgage-backed securities. The enterprises' dominance in the multifamily market will be reduced in 2013 by at least 10 percent, in part by tightening underwriting standards.

The multifamily market can stomach the change, even if it protests. In the most hotly contested markets, we can argue credibly that competition from nonagency lenders has converged on the enterprises' subsidized capital to crowd out banks and strain underwriting quality. In these markets, a measured adjustment to a more limited role for the enterprises is consonant with long-term market stability.

The field is uneven; not every market is Manhattan or waterfront Brooklyn. While some markets are flush with liquidity, there are many others where credit needs would be undeserved if the enterprises pulled back abruptly. There is a legitimate policy rationale for the participation of quasi-public institutions in these cases, which at least for now can be found in abundance.

The challenge is that a drawdown of the enterprises' activities may see them pull back from underserved markets and not the markets where banks and life companies are actively engaged. To address that potential, the FHFA needs to do more than set a volume target. In the public interest, it should define clearly when a subsidy is appropriate and when it is not.

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