The Threats to the Market in 2011

Inflation, devaluation, unemployment, the Fed and the feds—positive signs for real estate investment abound in the new year, but some things to watch

There's no doubt that the mood of participants in the commercial real estate market coming out of 2010 was significantly more positive than it was when we exited 2009. The capital markets for lending are in much better condition than they were a year ago, and underlying real estate fundamentals have firmed up. Rent concessions, in both the commercial and residential markets, are down significantly and vacancy rates have appeared to stabilize. These developments are all very positive.

When our 2010 building sales statistics come out in a couple of weeks, we will undoubtedly see at least a doubling of 2009 dollar volume levels. This increased volume will not tell the entire story of 2010 activity, as a significant component of last year's marketplace consisted of distressed-asset activity, which was mainly in the form of note sales. These note-sale transactions are not recorded publicly, so there is no way to know the actual magnitude of this activity; however, we estimate that roughly one-third of all 2010 investment sale activity took the form of note transactions. This would indicate that the true volume was at least triple what it was in 2009; though we were coming off an extraordinarily low base at the beginning of 2010, this level of activity was very welcomed by the marketplace.

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Columnist

Some of the questions we have heading into 2011 revolve around whether this positive activity will continue. We clearly see some very positive things from a real estate perspective; we also see some positive indications in the broader economy. In 2010, the Dow Jones increased by 11 percent, the S&P 500 increased by 13 percent, and we started to see some very positive activity with respect to start-ups and IPOs.

Notwithstanding these positive indicators, there remain several threats to what has been a very fragile recovery. Some of these threats could have a direct impact on commercial real estate; others are either macroeconomic or geopolitical in nature, and their impact on commercial real estate will be determined by how the dots are connected.

Interest Rates, QE2 and Cash for Clunkers

In 2011, perhaps nothing will have more impact on commercial real estate, and particularly values in the investment sales market, than interest rates. Because of what has been obviously a very sluggish recovery, the Fed's monetary policy has been focused around keeping interest rates low. Given below-trend gross domestic product growth and stubbornly high unemployment, the Fed recently implemented another round of quantitative easing, commonly referred to as QE2. Quantitative easing is nothing more than a fancy way of saying "printing money," and the presses are running to try to keep interest rates low.

Thus far, QE2 has had the reverse impact, as rates have increased, particularly at the long end of the curve. It is clear that treasuries are losing their appeal due to inflationary fears (more on inflation later), as evidenced by the recent two-year and five-year auctions, which produced lackluster results. This is not really surprising when you consider treasury debt is approaching $10 trillion, or approximately 70 percent of G.D.P. due to all of the government stimulus. This figure is expected to rise to $15 trillion, or 110 percent of G.D.P., by 2015. By then, the U.S. government will spend about 50 percent of the revenue it collects on servicing its debt. Recently, talk of QE3 has surfaced as control of interest rates remains in the cross hairs of Ben Bernanke.

With respect to the volume of sales, a big question heading into 2011 is whether the impact on the number of transactions due to the anticipated increase in capital gains rates will have the same stifling effect that other externalities have had on economic activity. In the latter half of 2010, many discretionary sellers placed properties on the market for sale due to the anticipated increase in the capital gains rate. As the tax-rate extensions were only approved at the very end of last year, many of these sale decisions were already made and committed to before the uncertainty was eliminated.

As we saw when both the "Cash for Clunkers" program and the first-time home buyers tax credit ended, activity in auto and home sales plummeted. We wonder whether the same impact will be experienced in the investment-sales arena. One factor that could offset this effect could be an increased flow in the distressed-asset sector as banks and special servicers continue to purge nonperforming and underperforming assets from their balance sheets.

Cuomo, the Unions and Real Estate Taxes

Real estate taxes are clearly something that impacts the market significantly. Significant increases in these taxes would certainly be harmful to the market moving forward. It will be very interesting for those of us in New York to see what Governor Cuomo's budget will look like when released on Feb. 1.

Given the massive budget deficits the state faces, his pledge of no new taxes and a cap on property taxes can only be achieved through unprecedented spending cuts. This will necessitate an iron will to endure a head-to-head battle with public-sector unions. All of the rhetoric we've heard thus far indicates that he is prepared to stand firm. To the extent he actually does, it would be positive from a real estate tax perspective.

The Lending Environment

In New York, our community and regional banks have performed far better than most throughout the country, and the availability of debt for real estate transactions has remained healthy. The Fed's highly accommodative monetary policy has allowed for recapitalization of the banking industry, and excess bank reserves are at an all-time high.

Recent statistics show that bank lending is rising, and to the extent that the commercial and money-center banks get back to aggressively lending on real estate, it would provide a shot in the arm to the marketplace. It is also anticipated that CMBS activity will increase substantially in 2011, which would also be very positive.

Jobs, G.D.P., Health Care and Regs

If you are a regular reader of Concrete Thoughts, you know that I'm constantly drawing parallels between the dynamics within the employment market and the underlying fundamentals of real estate. Given our stubbornly high level of unemployment, and the uncertainties that still exist within the economy, it is difficult, at this point, to see where the job creation will be derived, though most economists look at the technology sector for an employment solution. To date, job creation has been far below expectations, and we have managed to put only a dent into the 8.4 million jobs that were lost during this recession. The consensus among economists is that unemployment will stay around 9 percent for much of the year. If unemployment continues to stay at these elevated levels, it will likely continue to dampen real estate fundamentals.

Thus far in our recovery, G.D.P. growth has been well below expectations given what is normally seen coming out of a recession. Generally, G.D.P. growth at this stage should be 5 to 6 percent; bullish economists are projecting 3 to 3.5 percent for 2011. The uncertainties in our economy significantly impacted this rate of growth in 2010.

While uncertainties revolving around tax policy have been temporarily eliminated, the true financial impact of national health care and financial regulation could take years to determine. These massive initiatives have significant unintended consequences associated with them, and a lack of clarity with respect to their impact on businesses is creating inertia among corporate decision makers.

Housing and the Dreaded Double Dip?

Perhaps one of the biggest threats to our economy, and therefore our real estate market, is the health of

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the U.S. housing market. Based on the recent Case-Shiller Index and other indices, it appears that a double dip in the housing market is becoming more likely. In 2009, the housing market was experiencing a foreclosure every 13 seconds. This led to a massive amount of government intervention and has created significant stresses on Fannie Mae and Freddie Mac, which were both put into conservatorship (interestingly, financial regulation did not come close to addressing these government-sponsored enterprises).

The erosion of home equity has had a profound negative impact on consumer confidence and consumer spending. As home equity is the key wealth driver for the majority of U.S. consumers, and consumption makes up approximately 70 percent of our G.D.P., a double dip in housing could have significant negative implications for the broader economy.

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Inflation and Devaluation

While core inflation has been relatively modest, it is anticipated that energy and food prices will rise significantly in 2011. Based upon the devalued dollar, many analysts are projecting that oil will hit $100 per barrel and stay around that level for most of the year. If this happens, it could drive the price of gasoline to around $6 per gallon. The impact of this gasoline cost increase on consumers is clear. A report from the Wharton School at the University of Pennsylvania indicates that for every $10 increase in the price of oil, the U.S. G.D.P. shrinks by .25 percent.

Devaluation of the dollar will also lead to higher commodity prices, with many analysts projecting that gold will hit $1,700 per ounce this year. In 2010, producer prices rose but were not passed on to consumers at the grocery store. It is expected that, moving forward, margins will be protected by raising prices in the aisles.

Municipal Debt Defaults and Keeping Confidence Up

Another potential threat to our economy is the potential for a confidence-collapsing event. This could take the form of municipal debt defaults. Many municipalities, including states and cities, are projecting massive budget deficits in 2011.

It is likely that states will ask the federal government for assistance, and given the massive federal budget deficits coupled with the results of last November's midterm elections, it is unlikely that this assistance will be forthcoming. Defaults of this type would have significant repercussions within the bond market and would exert significant upward pressure on interest rates.

There is no doubt that our economic recovery is fragile, and we have a long way to go before market participants will feel truly comfortable. However, we should all feel fortunate that we are in New York, which has demand drivers unlike anywhere else in the country (with the possible exception of Washington, D.C.). New York is consistently at or near the top of the list in terms of a destination for foreign capital when it comes to real estate investments. If a real estate market is going to do well anywhere, it is here.

Based upon historic trends, it is easy to predict that sale volume trends will continue to increase, as they remain well below trend even considering how relatively good 2010 was compared to 2009. Most of the threats and dynamics mentioned in this column have more ramifications for the value of properties rather than the volume of sales.

Here's to hoping that the threats are minimized and real estate values continue to gain traction.

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Robert Knakal is the chairman and founding partner of Massey Knakal Realty services and in his career has brokered the sale of more than 1,125 properties, having a market value in excess of $7 billion.

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THE LOBBY

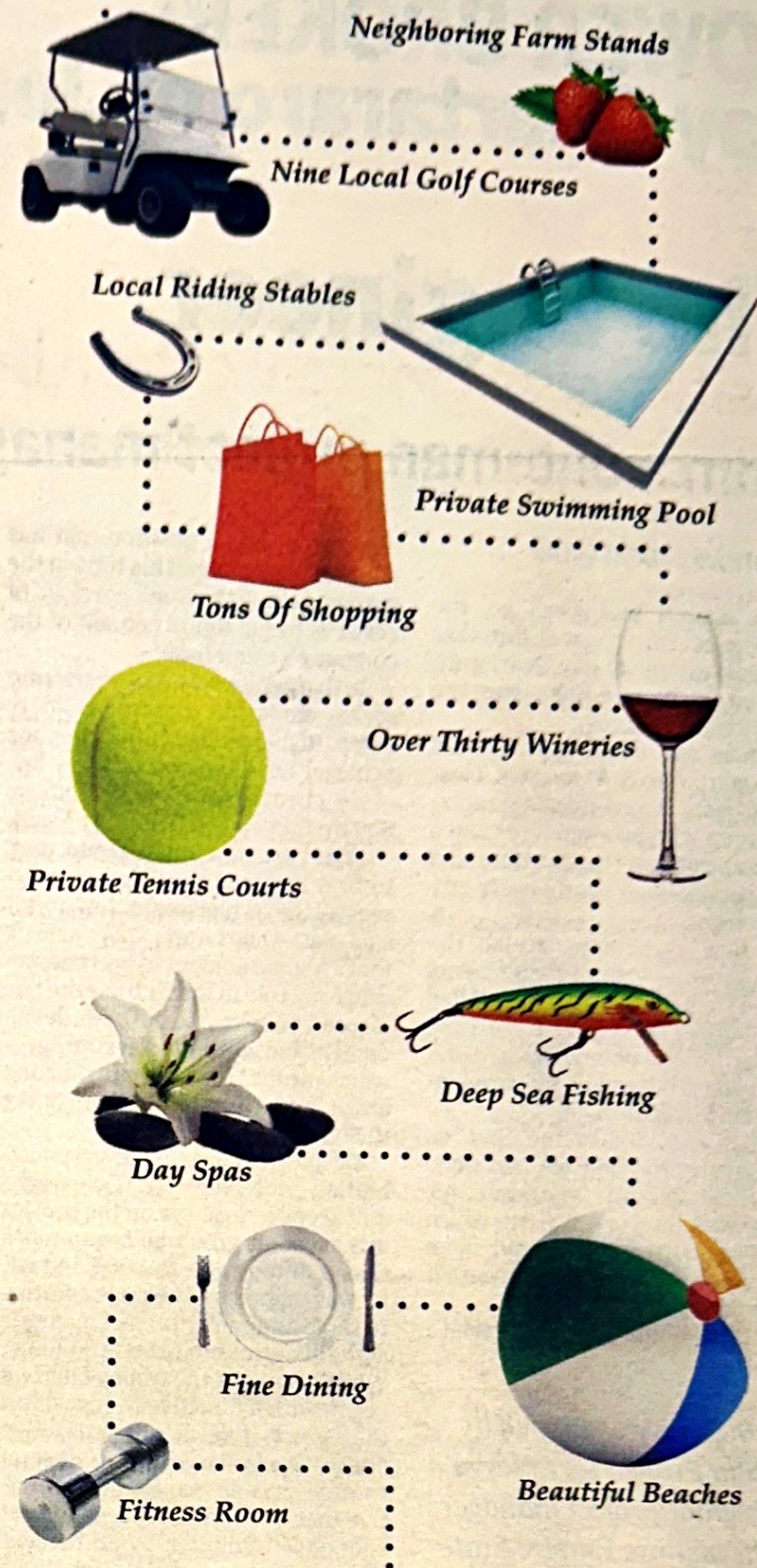
BY JOTHAM SEDERSTROM

U.S. Energy's Biz Developer

Bruce Kafenbaum, an owner, operator and developer of multifamily homes and office buildings in the New York area, has been tapped to join the U.S. Energy Group

Mr. Kafenbaum will serve as the senior vice president of business development for the New York-based company, which develops and integrates energy control, monitoring and analysis hardware systems for large-scale commercial properties.

Job moves, appointments, honors? Email Jotham Sederstrom at jsederstrom@observer.com.



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