The Battle Between Fear and Greed

And what it means for the investment sales market going forward—reasons for optimism and pessimism in 2011

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Last week, I reviewed New York's investment sales market in 2010. Its performance demonstrated a significant 131 percent increase in the dollar volume of sales, rising to $14.5 billion from just $6.3 billion in 2009. With regard to the number of buildings sold, we saw an increase of just 16 percent as 1,667 properties sold versus the 1,436 properties sold in 2009.

These figures were somewhat expected, as the general trend in volume has been positive since 2Q09, which was obviously the bottom of the market in terms of sales activity. On the downside, the relatively small increase in the number of properties sold did surprise, but, based upon the relative strength of the financing markets, it was not surprising to see the dollar volume shoot up the way it did. Quarterly volatility exists in these figures, but the trend line is clearly positive, and we expect sales volumes to continue to rise in 2011.

What was most surprising were the statistics relative to value. The general perception in the market was that values were rising, as many of the headline-grabbing transactions indicated pricing levels well above 2009 levels. Unfortunately, this dynamic existed mainly in the core or institutional-quality property sector, as the supply-demand imbalance was particularly acute in that sector. This sector represented less than 5 percent of sales in terms of number of properties sold in 2010, and, when all sales are taken into consideration, average values, on a price-per-square-foot basis, dropped by 8.4 percent from 2009 levels.

This tells us that the market is still trying to find firm footing, and we believe that values will appreciate before the end of 2011.

The remarkable reduction in sales volume from the peak of the market in 2007 to 2009 was astounding. A 90 percent drop occurred, as a 2007 total of $63 billion in sales shrank to just $6.3 billion in 2009. The fact that values were still falling in 2010, and are currently at levels about 38 percent below the 2007 peak, is indicative of the fact that the real estate market, like all markets, is cyclical. Sometimes people forget the cyclical nature of our market.

I recently read a report from a research analyst at a national firm who wrote, "The underlying hope is for a return to fundamentals-based capital flows leading to less volatility and a more orderly creation of value in the markets." These dynamics might occur over a very short term but will never exist over a long term, as our market is shaped by a constant battle between fear and greed. As conditions get better and participants make money, greed kicks in and all participants up the ante until a bubble is created and the market corrects. As the correction occurs, fear sets in and becomes contagious until someone has the guts to jump in. That party makes money, and then the greed dynamic kicks in again. And so on and so on ...

The cyclical nature of our market reminds us of some historically proven truths:

- When financing is available for everything from every source, soon thereafter there will be no financing available from any source for anything.
- When money is easily accessed by borrowers, sellers are those who receive the benefits, not the buyers.
- Even if your intended holding period is short, real estate is a long-term asset that requires substantial amounts of equity in order to provide an appropriate asset-liability match.
- Financial models never incorporate recessions and capital shortages, but reality often does.
- When everyone believes a "paradigm shift" has occurred and the market will never fall, it is about to.
- When everyone believes a 'paradigm shift" has occurred and the market will never rise, it is about to.
- Any rapid change in market conditions that is attributed to demographic changes must be wrong, as these changes move through the market at glacial speed.
- The real risk of using short-term financing is debt rollover renewal, not increases in interest rates.
- Leverage is wonderful when all goes well, but extremely punishing when things go wrong.

So, remaining cognizant of these truths, where are we in this cycle? Interestingly, many people I speak to who are active in our sales market say, "2010 was a great year, but I am pessimistic about 2011." There are many mixed messages coming out of recent economic data. Some of this data portends a very optimistic forecast. However, there is also a pessimistic perspective that may temper this optimism. We must, therefore, answer the question: Is the glass half-full or half-empty?

The reasons for optimism are many.

As discussed, the volume of sales, while up significantly from last year, still has a long way to go to approach the long-term trend line. We expect distressed selling in 2011 to occur at a very healthy pace and have already seen signs that indicate discretionary selling will return in a significant way this year. Our forecast for 2011 sales volume includes an expectation that the dollar volume of sales will be in the $22 billion to $25 billion range. If this level is attained, it would reflect approximately a 55 percent increase in the dollar volume of sales. With respect to the number of properties sold, we anticipate citywide sales volume reaching 1.2 percent to 1.3 percent, or an approximate increase of 25 percent over 2010 levels.

With regard to property values, we expect average prices per square foot to increase in 2011 over 2010 levels. If this occurs, it will allow us to retrospectively call the bottom of the market, in terms of value, at some point in 2011.

Underlying real estate fundamentals appear to be firming as rent concessions, in both the commercial and residential markets, have been evaporating, and, for the first time in this cycle, we are beginning to read reports about increases in rental rates. As employment growth accelerates, it will impact these fundamentals positively, and all expectations are that job growth will gain traction throughout 2011.

Businesses are highly profitable today. Productivity is up and balance sheets are healthier than they have been in years. With record amounts of capital on corporate balance sheets, it is clear that businesses have refrained from strong hiring based upon sentiment and strategic decision-making rather than an inability to hire. Uncertainty regarding health care costs and the implications of financial regulation seem to be holding companies back. The financial strength of businesses today bodes well for future space utilization, which will further enhance real estate fundamentals.

Households are de-leveraging, which creates optimism for the pace of future consumption. Two-thirds of our annual G.D.P. is driven by consumer spending, so the health of consumers is critical. Approximately 18 months ago, total household liabilities were approximately $13 trillion; today, this figure stands at approximately $12 trillion. The amount of consumer credit is shrinking as well. At the peak, there were 435 million credit cards in the hands of Americans; that figure is now down to 320 million. In early 2009, there were about 19 million consumer loans outstanding in the form of mortgages, auto loans and student loans. This figure has dropped to 13 million, its lowest level since 1998. These dynamics are putting consumers in a much better position to fuel consumption as we move forward.

The banking industry is in much better condition than it has been in many years. The Fed's highly accommodative monetary policy has allowed for a recapitalization of the banking industry. Unfortunately, this recapitalization is occurring at the larger banks more so than the smaller community and regional banks across the nation. The 20 largest banks appear to be overcapitalized and are continuing to lend. Credit card lending, car loans and home equity loans are now increasing for the first time in this cycle. We remain hopeful that this increase in lending trickles down to the commercial real estate industry.

Another reason for optimism: Our current level of economic activity is not keeping pace with demographic trends in the United States. Pent-up demand from consumers will create additional economic activity out of necessity, which will push up G.D.P. growth. The consensus among economists six months ago was that G.D.P. growth in 2011 would be approximately 3 percent to 3.5 percent. Today that consensus is closer to 4 percent. Fourth-quarter 2010 G.D.P. growth was 3.3 percent, well ahead of many economists' projections. While this is relatively positive, G.D.P. growth should be more like 6 percent to 8 percent at this point in a recovery.

There are, however, factors that could throw some cold water on the optimistic perspective of some market participants. Unemployment is a key factor. Thus far, we have regained only a small percentage of the 8.5 million jobs that were lost during the recession. Given that we need 100,000 to 150,000 jobs created per month just to keep up with population growth, we really need to see 300,000 to 400,000 jobs created per month to have a tangible impact on recapturing the jobs that were lost. In New York, we are fortunate that the negative impact on employment has been much less severe than in other parts of the nation.

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The national housing market is something we need to keep a close eye on. Given that a home is generally the largest asset for most Americans, the value of housing will impact consumer spending moving forward. Due to the massive and unprecedented government intervention in the housing market, the market was never allowed to clear its inventory, which created the potential for a double dip in housing. It appears that we are in the midst of that double dip now, as for several months in a row, average home prices have once again declined.

It will also be important to see how politicians deal with deficit-reduction activities. At present, the U.S. deficit stands at about 11 percent of G.D.P. U.S. debt is hovering around 100 percent of G.D.P. Even with realistic projections for revenue growth, both of these percentages are far too high. The potential impact of budget pressures on real estate tax burdens is significant. If elected officials cannot cut spending and fundamentally reform entitlements and pensions, real estate taxes will mushroom, exerting negative pressure on property values.

Additionally, potential municipal defaults are a big concern. In 2009, there were 10 bankruptcies, and there were six last year. Some analysts are warning of a potential calamity, as state governments are facing about $130 billion in budget deficits in 2011. Exerting substantial pressure on municipal budgets are pension obligations, which appear to be exploding and are unsustainable. In Detroit, there are three pension funds that just happen to manufacture cars. Across the U.S., there are pension funds that just happen to run police and fire departments, schools and hospitals. Additionally, the financial stability of Medicare and Social Security are in question, as present conditions are unsustainable and must be fundamentally reformed. Population trends exacerbate these problems. The U.S. once had four workers for every person over 65 years of age. In 2010, this number dipped to three and, by 2020, it is projected to hit 2.5. With less people to "foot the bill," something must change.

The importance of these issues on the commercial real estate market is that if municipal defaults occur in growing numbers, upward pressure will be placed on interest rates, as the bond market will have to provide higher yields to compensate investors for the additional risks undertaken. Anything that exerts upward pressure on rates hurts the market.

Lastly, there are three things that we need to monitor that will have a direct impact on the health of the building sales market in 2011. The acute supply-demand imbalance that we have had, with thousands of investors chasing after relatively few available properties, has exerted upward pressure on property values and has been one of the main reasons why value per square foot is decreasing at a swiftly declining rate. We believe that distressed assets, particularly distressed notes, will continue to come to the market in substantial numbers in 2011. However, this increased supply should be absorbed rather easily by the market's excessive demand. To the extent supply is increased more significantly than anticipated, it could exert downward pressure on value, but we believe the downside is limited here. The extraordinarily low interest-rate environment has also helped to exert upward pressure on value. Most economists believe that we will be in a low-interest-rate environment for much of 2011. At some point, however, interest rates will increase, and this will exert downward pressure on value.

There is a good argument to be made for cautious optimism as we move into 2011. Sales volume has clearly passed its low point and continues to climb toward its trend line. More importantly, it is anticipated that values will begin their correction this year. Just how good the year will be is dependent upon the many factors we have discussed here. Given the momentum going into 2011, it is more likely that we will be pleasantly surprised 12 months from now rather than the reverse. Of all of the factors we have addressed (other than employment, which is always the most important one), interest rates could have the biggest impact.

Time will tell how these various factors will play out, but one thing remains constant, we should all be glad we are in New York and not elsewhere.

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