

The Three C's of Our Disconnect: Credit, Confidence, and Collateral

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Commentary

Going into the summer of 2008, we were concerned about the ripple effect of the stagnating economy on the heels of the housing market collapse and the emerging credit crunch. Much has changed in a short period of time. Indeed, we have entered new territory, with the financial crisis sending waves crashing across the economy in a manner that paralleled Hurricane Ike in terms of breadth and depth of impact.

Although hurricane season has wound down, the country has enjoyed no respite from the financial turbulence, with the rapidly deteriorating financial markets and broader economy taking center stage and dominating the news and election rhetoric. The speed and magnitude of the losses that began in the credit markets continue to emanate outward from the vortex. The credit crisis has touched so many sectors of the economy and rippled so far across the globe that it is difficult to see an end to the carnage.

Many were caught off guard, and many households and investors are underwater. Indeed, the impact has left few unscathed, regardless of the role they may have played. And like the captain and crew of the Andrea Gail caught in the infamous "Perfect Storm" of 1991, many are finding it impossible to ride out the storm regardless of their training and resolve. Individual businesses, consumers, and households have lost confidence in their ability to navigate through these troubled waters.

Even more troubling is the fact the broader market has come to the hard realization that a significant portion of the value of the underlying assets, which many looked to for safety that would collateralize their positions, has been eroded.

To help avoid a deep recession that could be triggered by a collapse of the financial sector, Congress and other governmental agencies have announced a number of interventions. While far from divine, the early reading is that these programs may be able to help keep the economic ship afloat. However, even if they work the ride will be rocky, and we will need to bail out a lot of water before we return to smooth sailing.

Assuming the interventions help avert an economic collapse, they will come at tremendous expense and are likely to trigger collateral damages and unanticipated consequences for generations to come. This is especially true since a number of fronts have required immediate attention. Of particular concern is the fact that the interventions are being implemented without the benefit of strategic planning and preemptive thinking. Rather, they are occurring in a reactive, crisis mode. Further complicating the solution is the fact that the proposals are being vetted in the political arena, where it is difficult to arrive at the optimal programs and policies.

There has been significant disagreement as to what—if anything—should be done, to smooth out the credit crisis and bail out the financial industry. However, the problem is so endemic that the voices of hardliners, who might be expected to argue the government should step back and let the crisis play out by letting those who benefitted pay the price, have been muted.

In spite of the prospects for additional interventions in the form of monetary and fiscal policy, the good-faith efforts of the federal government and Federal Reserve—coupled with those of their global counterparts—are likely to fall far short. This pessimism stems from the fact that the initial policies and pro-

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grams are dealing with visible symptoms, symptoms that point to the tip of the proverbial iceberg. At this point, the focus on the most immediate pressure points has prevented policy makers from taking a more comprehensive look at the broader implications of the easy credit and risk management by transfer practices that created this crisis. Furthermore, the lack of oversight and government regulation of some of the complex financial instruments and products, coupled with the absence of a clear accounting of the scale of such activities, suggests there are many more unrecognized challenges that will need to be addressed. However, it is doubtful that there will be anything left in the till to address these new challenges, or that elected officials have the resolve to de-lever the short-term debt of the credit market by placing long-term debt on the backs of taxpayers. Thus, the near-term outlook includes much more downside risk than upside potential. Businesses and consumers are expected to be hunkered down for some time, suggesting the economy is in for some hard times that will carry well into next year and beyond.

In this difficult and unprecedented situation, prognostication is much more complicated than in more normal times. The complex network of interdependencies woven among the financial markets and the economy, both domestic and global, renders even the most sophisticated econometric models unreliable. In this environment, economic axioms built on rational thinking that underpin most econometric models give way to a set of behavioral factors that rule the day. As such, it is difficult to predict what the broader market will do. The recent events have unfolded so quickly, decisively, and significantly that many players are simply shell-shocked and scratching their heads, pondering the question of what to do next. A further complication in calling the market is the fact that new challenges and proposed solutions are breaking on a daily basis. This is likely to continue for the near term.

Despite the challenges and uncertainty ahead, the objective of this column is to provide a prospective look at where we are headed and give some in-

sight into what it all means to the real estate market. Before delving into the current state and near-term prospects for the economy, capital markets, and real estate fundamentals, it is useful to review the events that led up to the current situation. Since the rules of engagement by which the market operates are also changing, it is important to explore the interventions that have been taken and proposed. Thus, we will first review how Congress and a number of federal agencies—including the Federal Reserve, the U.S. Treasury, the FDIC, and the newly created Federal Housing Finance Agency—are approaching the crisis. Since the crisis has rippled across the globe, responses from individual countries trying to salvage their financial institutions, and the call to action for coordinated global responses, should also be recognized. Readers are cautioned to stay tuned to the issues as policy makers introduce new programs, and the leadership in Washington and many states is turned over to new regimes.

Review of Events

The first real signals of impending doom emerged in the residential market, which went into a deep tailspin in 2006. The initial debates about the problem focused on subprime mortgages that were blamed for the rise in delinquency and foreclosure rates. However, it quickly became obvious that the problem was not contained to a small segment of unqualified and marginal borrowers with exotic deals. Rather, the market began to realize the housing market was facing a maelstrom of epic proportions as a result of the cumulative effects of easy credit, reliance on financial engineering, lack of transparency, absence of regulation, and limited accountability that had driven the bull housing run. After the housing market went into freefall, the role of Fannie Mae and Freddie Mac came into question as policy makers struggled with the issue of what to do to turn things around.

Once attention was drawn on festering problems in the residential market, some began to worry about whether this was an isolated problem, or whether it was a symptom of a broader problem. Those who explored how widespread the credit practices were in other sectors realized that the market was a house of cards. In the broader economy the credit crisis quickly turned into a crisis of confidence. At first, some of the players who experienced problems blamed the press for creating a sense of paranoia that could become a self-fulfilling prophesy. Un-

fortunately, it soon became clear that the problems were both real and widespread, going far beyond the residential sector. Indeed, while the numbers are still coming in, financial institutions have taken some \$600 billion in write-downs on bad credit. Over half of these realized losses were incurred by banks, along with mortgage brokers, mortgage finance companies, and insurance companies.

The fallout was dramatic and spread quickly. While many of the losses were associated with residential securities, commercial and other asset-backed securities were also hit hard. Attention then focused on the dependency of the capital markets on credit swaps, an unregulated industry for which no systematic data is compiled and it became apparent the credit crisis extended far beyond the residential sector.

By mid-2008, the government realized that significant and unprecedented intervention was mandated and that failure to act would expose the economy to a downturn that could rival the Great Depression. Once the magnitude of realized losses hit the street and earnings and stock prices were hit, questions about the survival of some major players began to surface. In September, the government watched Lehman Brothers file bankruptcy, but stepped in to facilitate the sale of Bear Stearns to JP Morgan Chase. In mid-September, the government seized control of American International Group (AIG) and made an \$85 billion infusion to try to avoid the negative fallout if it failed. The Federal Reserve (Fed) provided Morgan Stanley and Goldman Sachs with a credit agreement, placed them under supervision by bank regulators, and allowed them to give up their status as investment banks and become traditional bank holding companies. Then, the Bank of America acquired Merrill Lynch and received a similar credit agreement from the Fed to assist in the acquisition. Further, the turmoil on Wall Street was not confined to New York, as evidenced by the acquisition of Washington Mutual by Wells Fargo & Co.

Despite the spate of mergers and the Fed's efforts to restore confidence, the situation continued to deteriorate rapidly and showed the potential to bring the economy to its knees. To help avoid a complete meltdown and quash the waves of fear, the government approved a \$700 billion bail-out package to shore up financial institutions and return the credit markets to a semblance of balance. In mid-October, the Fed provided some direction as to how it would deploy the \$700 billion that capitalized its Troubled Asset Relief

Program (TARP). In one of the first clarifications, Fed Chairman Bernanke announced that he had received approval to accelerate the date at which the Fed can pay interest on depository institutions' required and excess reserves, which had been set for 2011. At the same meeting, Treasury Secretary Paulson announced a \$200 billion capital purchase program to infuse equity in the top financial institutions (and other eligible institutions that apply) through investments in preferred stock. However, the Treasury is able to use some discretion—and leverage—in picking eligible institutions, focusing on those that are healthy and likely to pass the funds through to borrowers.

One of the challenges the Treasury recognized was the importance of ensuring banks would deploy capital and ease the credit crunch, rather than hoard it to shore up their balance sheets. To qualify for the equity infusion, participating banks would have to provide more transparency and submit to greater regulation than nonparticipating institutions. Also, in approving the relief, Congress made it clear that it would apply pressure to ensure that homeowners would have greater access to affordable debt to help forestall foreclosures. This concern put additional pressure on financial institutions to work with borrowers.

The Economic Environment

Economic Growth

Given all the turmoil and anxiety focused on the plight of the capital and credit markets, it is easy to lose focus on the fundamentals of the broader economy. While much of the news is negative, the upward revision of gross domestic product (GDP) for the second quarter provided some much-needed good news. While unsustainable due to eroding fundamentals, the stronger-than-expected growth suggested that the previous tax stimulus plan had something of a positive effect on consumers and the broader economy. Despite this brief improvement, the prospects are for further deceleration in economic growth, with the downside risk of a full-blown recession. On October 19, Fed Chairman Bernanke testified before Congress about the wisdom of passing a second stimulus package aimed at businesses and consumers to forestall a deep recession. The reception was generally positive and supported by a range of economists, suggesting additional action may be on the horizon.

The global contagion of the U.S. credit and financial market turmoil has dampened the prospects

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for export activity to help stimulate the economy and allow it to emerge from the doldrums. Indeed, many other economies and financial markets have stumbled as well, leading to wave of interventions rippling across Western Europe, Asia, and most emerging markets, and contributing to a softening of global demand for U.S. products and services. In addition to government interventions, concern over the plight of the financial and credit markets has forced global investors to step back and take a hard look at investments. This has made it difficult for solid domestic, multinational, and global companies to hold share prices and access capital to maintain operations and support economic expansion.

The recent decline in oil prices, which have fallen some 50% from the 2007 peak, provides some solace, although many companies had already pulled back to cut energy and fuel costs. The reduction in energy prices should take some pressure off prices and corporate bottom lines, but the meltdown in the stock market has wiped out any upside potential. This has manifested itself in lower profit margins that have slipped over the past year. Tight and expensive credit has also forced companies to rein in investments in plant and equipment, with capacity utilization rates slipping and belt-tightening becoming the norm. Even the high-powered technology industry has recently pulled back, with some of the leading firms suggesting they are rationalizing further expansion plans and slowing down operations.

Employment

Employment continues to weaken in many sectors, although the damage to the residential sector has largely played out. Unfortunately, the related subprime mortgage debacle and spillover into the credit and financial sectors has placed tremendous downward pressure on jobs. Retailers have already reined in their forces, cutting back in anticipation of a particularly weak holiday period with consumers, sales and inventory levels all pointing down.

The automobile industry has suffered despite efforts to ratchet up demand on the backs of hybrids and more fuel-efficient vehicles. The automobile sector is likely to continue to struggle, as evidenced by the recent talks of a merger between GM and Chrysler, and pleas for government support and interventions. Such a merger would lead to further employment cuts in this beleaguered sector as the combined company would lay off employees to capture potential economies of scale.

The slowing economy and credit issues are spilling over into the commercial sector, with employment levels declining as developers slow down or abandon proposed projects and construction activity moderates. Until recently, the technology sector and state and local government employment have provided some stimulus to employment figures. However, softening business investment and budget deficits due to significant declines in property, retail, and income taxes have placed a drag on these sectors as well.

All told, some 600,000 jobs have been lost in 2008, with prospects for additional losses as the economy stumbles. Unemployment rates have increased, both for new claims and for longer-term unemployed. This situation is unlikely to change over the near-to-intermediate term, with companies pulling back and focusing on bottom lines until well into 2009.

Inflation and Interest Rates

The deterioration of the employment picture has taken some of the pressure off wages, removing the near-term risk of stimulating inflation. The recent decline in energy prices has also helped, although many consumers had already curtailed driving to deal with record prices. The core inflation levels have flattened out in the face of weakening demand on the domestic and global fronts. Health care remains an area of concern, with companies cutting back on benefits and the cost of insurance, treatment, and medication all rising. The Fed is likely to remain concerned about inflation, although the fears of a deep recession, the near-collapse of the financial sector, and prospects for a global slowdown have taken some of the pressure off inflation.

On the interest front, the news has been somewhat mixed. The Fed has been very aggressive with monetary policy, lowering base rates in hopes of stimulating growth. Unfortunately, in these unusual times, the rates themselves are not as problematic for borrowers as the tightened credit standards, which are making it increasingly difficult to tap into available debt.

Rates for commercial loans and business expansion have spiked, with lenders pulling back to help shore up balance sheets and deal with much-anticipated credit losses. LIBOR rates have recently come down somewhat, although they remain above rates during much of 2007 before the credit crisis rippled across the globe.

On the mortgage front, spreads widened as attention turned to individual loan risks versus transaction volumes, resulting in upward pressure on mortgage rates. Until the market stabilizes and starts to return to some semblance of balance, spreads on conventional mortgages are likely to remain wide.

Business Indicators

In general, business indicators are neutral to negative with few positive signs for a near-term correction. Although balance sheets are relatively healthy, the slowdown in activity has caused a moderate decline in corporate profits. At the same time, turmoil in the stock market has created significant losses in shareholder wealth, with few companies and sectors avoiding the downturn. New factory orders and backlogs have declined as companies caught up with demand in a slowing environment. Inventory levels have risen, while shipments have tapered off. Manufacturing levels have declined moderately, while inventories have increased and shipments have slipped.

Business confidence levels have plummeted, with a dramatic contraction. Interest rates and access to credit have been problematic, although the curtailment of demand has taken attention off of expansion plans. In late October, the Fed announced it would provide up to \$540 billion to shore up the \$3.5 trillion money market fund industry, which had been decimated by withdrawals. On a telling note with respect to the risk to the economy, the Fed had to revert to Depression-era emergency powers to justify the intervention. The Fed hoped the infusion of capital would take some pressure off of commercial paper and make it easier and more affordable for companies to satisfy their credit needs.

On something of a positive note, small business optimism has increased despite nagging concern over weak sales, inflation, insurance, and taxes. However, the credit markets will have to loosen up and the economic outlook will have to improve before business indicators turn the corner in a sustainable manner.

Stock Market

During the third quarter, the stock market was a roller coaster, plummeting significantly as investors lost confidence in the economy and the reality of a recession settled in. The Dow Jones Industrial Average plummeted from its November 2007 peak of almost 14,000 to its October 2008 bottom of some 7,780. October 2008 experienced the highest monthly loss in stock value since the crash in October 1987. However, while the previous crash was rapid and decisive, this one was rapid but indecisive.

In addition to this decline, the compressions between daily highs and lows have increased as have trading volumes, suggesting greater uncertainty and angst among investors. The Dow is likely to bounce around a bit, although many hope it has bottomed out. The recent volatility can be explained by the fact investors have been forced to focus on the likely impacts of government intervention programs on top of their normal attention to economic and corporate indicators. Since new programs and policies are being announced almost daily, this volatility is likely to continue, with the market turning up on good news and down on bad news. Given the unprecedented times, the stock market is likely to remain more volatile than normal, with some downside risk and prospects for a gradual but unsteady recovery until the direction of the economy becomes clearer.

Consumer Confidence

During the summer, consumer confidence levels showed a slight upturn due in part to a decline in prices at the pump. However, this uptick proved short-lived with confidence levels once again turning down as consumers opened their 401(k) statements and began to pay more attention to financial news, most of which was bad.

The outlook for confidence levels is expected to remain tempered and volatile with consumers listening to arguments over how to bail out the financial sector. Going forward, rising concerns over the weak employment prospects, across-the-board pressure on inflation, and tightened credit should weigh heavily on consumer psyche. This situation should continue until consumers get a sense of where the country is headed.

The recent talks of a second stimulus package could provide some upside potential to consumers. Similarly, signs that government interventions could be effective in helping homeowners avoid

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foreclosure, and tax credits for new buyers and other forms of mortgage assistance that suggest the housing market is starting to turn the corner would be much welcomed. However, a significant turnaround is likely to carry well into 2009, if not beyond.

Stimulus checks from last spring provided some catalyst to retail sales, but as expected, did not have an enduring impact. Consumers who remained in the game, continued to search out bargains, favoring discounters and off-price retailers over middle-market players. Indeed, the dramatic declines in the stock market and rising concern over the plight of retirement funds have caused upscale shoppers—who in the past seemed to sail above the economic reality that dragged down other shoppers—to step back and rein in spending plans. This situation is likely to worsen across the board, with little positive news to stimulate sales. Indeed, the probability of further declines in sales is becoming discounted in the market, with retailers pulling back on holiday orders to avoid creating another hangover of inventory. Thus, even if consumers decided to make a last hurrah for the holidays, shelves are likely to be thinly stocked, with early promotions rapidly depleting supplies of goods that hit the right cord with consumers in terms of value.

Housing Market

In addition to the data on individual homeowners facing mortgage pressure, the industry statistics continue to be gruesome. Homebuilders are struggling to hang on, with sales lagging and land values plummeting. Indeed, in some overbuilt markets, raw land values have plummeted by 60%–70% with few takers at those depressed prices. Current sales also have plummeted, with buyer traffic and future sales following suit. New construction starts and completions are below levels of the early 1990s with few prospects for a turnaround. At this point, some reminisce about the “It’ll be fine in 2009,” and are now resigned to “But then again, it could be 2010.” Unfortunately, the longer timetable may be realistic, depending on how long it takes the market to bottom out, and how effective new interventions and incentives are in stimulating demand.

The data surrounding the housing market is bleak, with few signs that the market has bottomed out. Housing permits and starts are at the lowest levels in over 20 years. While inventories have been declining, sales levels and traffic remain low as potential buyers sit on the sidelines, waiting for the market to bottom out or for the economy to improve. Delinquency rates continue to rise at an accelerating pace. In the absence of meaningful intervention, this trend is likely to continue, especially with estimates that some 50% of households who bought in the last five years are underwater, with principal balances greater than market values. This situation will put more pressure on the government and private parties to step in to prevent an even greater crisis than has already occurred.

The creation of the new independent regulator, the Federal Housing Finance Agency (FHFA) in July 2008, showed the federal government’s commitment to turning the housing market around. The subsequent placing of the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac under conservatorship was designed to rein in the two entities, and make them more responsible and accountable. Congress approved the infusion of some \$200 billion in new capital into the two entities. In September, Treasury Secretary Paulson and the director of FHFA provided some details as to how they will work together. They noted that the objectives of takeover of the two entities were to (1) provide stability to the volatile residential mortgage market, (2) increase access to mortgages, and (3) protect taxpayer interests. The primary mission of the two enterprises is to increase availability of mortgage finance while attempting to address the affordability issue.

In many respects, the initial efforts of the FHFA are to forestall more downturns, rather than stimulate an upturn. While disappointing to many, the current situation argues for some immediate help. Delinquency and foreclosure rates have started to spike, with the potential for additional increases as variable rate loans reset from low teaser rates. In addition, many homeowners who have hung on in hopes of a near-term bailout are now facing the realization that any help may be too little, too late. Similarly, homeowners who have lost their jobs may be forced to walk, while those who find themselves upside down on their mortgages (i.e., principal balances are greater than values) may just decide to pull the plug on their American Dream.

Going forward, it is likely a number of new programs and policies will be developed to help stabilize the housing market. Some of these policies will be included in the proposed stimulus package, while others will be targeted to home buyers, including a first-time buyers' tax credit. On a complementary note, the Treasury and the Fed will also place pressure on financial institutions to restructure loans, reduce principals, and lower interest rates to help troubled homeowners. Recently, the FDIC announced it is working "closely and creatively" with the Treasury to create incentives for loan servicers to work with individual borrowers to help avoid foreclosure and place them in more sustainable mortgages. These incentives could take a number of forms, including the creation of standards and loan guarantees for lower-rate, fixed-rate loans that replaced unaffordable and/or adjustable loans. The GSEs are also likely to explore insurance and guarantee programs that could reduce risks to the private sector and leverage investment of additional taxpayer funds.

Real Estate and Capital Markets

Real Estate Capital Markets

On several occasions over the past five years, we have expressed concern over the capital/spatial market divide. This concern was triggered by the realization that the real estate market had gotten out of balance when there was a disconnect between capital flows and underlying real estate fundamentals. The current crisis affecting the real estate markets is a harsh reminder of the end result of such a disconnect.

While there are many complex explanations as to how we wound up in the current mess, it all boils down to a relatively simple chain of events. It began with easy credit that led to excess capital flows to real estate and other targeted sectors. This distorted the market, creating a surge in prices that led to additional supply, which was supported by buyers eager to get into the game. As credit eased even more, prices continued to surge leading to a seemingly endless rising tide in which some buyers and capital providers got swept away. Once the market recognized that the inflated prices were not sustainable, attention shifted to the risk side of the equation, and capital flows slowed down, especially on the credit side of the market.

In 2007, the real estate market began to understand it was in a contraction mode, and that the

wave of record pricing was behind it and some corrections would occur. Since that time, commercial values have come down in a rather orderly fashion with adjustments in the range of 10%–20% not uncommon. Despite some pullbacks, the prospects for the commercial sector seemed manageable, with fundamentals fairly solid and new supply generally in line with demand. Assuming business as usual continued, the outlook was fairly sanguine with investors and lenders accepting lower-than-average returns that were commensurate with perceived risk. However, once the credit crisis began to unfold, it became clear the commercial market had been caught up in the same easy credit and risk-transfer mechanisms that were common in the residential market. That explains in part why prices soared to record levels, with the tide rising on the waves of capital flows, easy credit, relaxed underwriting standards, low equity yields, high leveraging, and the pervasive use of financial engineering, including securitization and bullet loans.

Even if the economy picks up in the second half of 2009, as some are predicting, the commercial market is in for a rocky ride. This is especially true for weaker product in second- and third-tier markets that benefited from commoditized pricing in the prior phase of the cycle, when the disconnect between the spatial and capital markets made fundamentals less important to pricing.

Regardless of how the market conditions play out, the days of commoditized pricing and low yields are behind us. This argues that some components of the commercial market are in for further price compression. While this will attract opportunistic capital and eventually help turn things around, it will provide little solace to those left holding the bag and squeezed out of their positions. Those who are sitting on core properties that are insulated from the downturn, have patient capital, and can absorb the unrealized losses that are on the horizon should be able to weather the downturn.

Construction Activity

The credit crisis and slowing economy have contributed to a decline in construction activity, both in the residential and commercial sectors. Residential construction activity remains tepid, with annualized starts under one million units. On the commercial side, activity was moderately higher in the summer, but declined in the fall as developers pulled back.

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The manufacturing and warehouse sectors reported the greatest percentage declines, although the drop in dollar value was not as pronounced since activity levels were much lower than other property types. The retail sector experienced the greatest decline in both percentage and dollars as developers reacted to tenants' defensive contraction in anticipation of a decline in retail sales and market fundamentals.

Going forward, the prospects are for additional slowing in construction activity as demand for new space dries up and employment losses translate to higher vacancies. On the public side, construction levels have held, although the decline in state and local coffers associated with lower sales, income, and property taxes will create budget deficits that may force a slowdown in proposed projects.

In addition to concerns related to the credit crisis, construction costs rose some 10% during the first half of 2008, putting pressure on new construction activity. However, the recent slowdown in construction activity has provided a brief respite from these inflating costs, as speculators in commodity markets cashed out. Material shipping costs have benefited from the moderate decline in fuel prices, while the shortage of cranes that drove up prices are expected to burn off. Construction labor costs were less elastic, although the slowdown is putting downward pressure on bid prices as contractors and subcontractors compete for fewer deals.

Given the global economic slowdown, construction costs should remain flat into 2009. While this might help some marginal projects pencil out, the weakening demand, tightened credit, and higher hurdle rates for capital will likely offset any gains. With the exception of build-to-suit properties and preleased space where credit tenants are motivated and committed, the pace of construction activity should continue to abate. This situation is likely to continue until the economy begins showing signs of improvement and the underlying market fundamentals improve both here and abroad. At that point, costs should rebound and continue the upward pace of the past several years.

The slower pace of activity should take some pressure off of prices although such an adjustment should be short-lived as the domestic and global economies weather the recent storm.

Private Equity Market

Up until this point in the cycle, the private equity market has held up fairly well, with pent-up demand helping sustain activity levels. More recently, however, equity players have not been immune to the turmoil and have been forced to take a hard look at the risk side of their real estate investments. This is especially true in the face of value losses as the credit crisis, higher yield requirements, and erosion in net income outlooks are factored into the appraisal process. This situation is likely to continue to play out over the near term, as some investors have pulled back to wait for things to sort themselves out.

Also, some of the more active players have been forced out of the game due to the denominator effect, with losses in other asset classes pushing real estate allocations above targeted levels. This compression has come at a particularly unfortunate time for some of the more savvy players who sold real estate holdings before the market peaked to take advantage of record prices and increase liquidity. If the markets had continued to operate in an orderly fashion, these investors were positioned to take advantage of the repricing and capital shortages that were likely to occur as the market moved into a downward cycle.

Another, more troubling concern in the private equity market is the fact that many of the properties that traded or were financed over the past several years depend on high leverage and financial engineering, including 3-, 5-, and 7-year bullet loans. Further, many of these properties were financed with little equity and were acquired at the peak of market prices. Over the next several years, these investments will need to be recapitalized with a combination of debt and equity. Unless there is a dramatic reversal in the debt markets, these investors will find it much more difficult to refinance maturing loans. Even if they can come up with a loan commitment, they are likely to face much more stringent underwriting than when the properties were originally acquired or financed, including higher equity requirements, higher rates, and more recourse debt. Recapitalizing properties will be even more difficult if the economic slowdown, rising cap rates, and lower capital flows to real estate lead to further declines in collateral values. Hopefully, before that scenario occurs

on a widespread basis, the economy will have turned around to help calm the waters.

On the acquisition side of the private market, many credit-worthy borrowers will struggle to find financing and will be forced to come up with higher equity contributions and/or assume recourse on new acquisitions. In this environment, cash will be king for core assets. At the same time, opportunistic investors and bottom-fishers are expected to be active, looking for distressed deals, both debt and equity. However, these investors will be in no immediate hurry on the equity side and will be willing to let the market bottom out before jumping in. Some of them will resort to "channel sourcing," prospecting for deals in the form of real estate owned (REO) that defaults to the balance sheet of lenders.

Thus, the market will be somewhat bifurcated, with conservative players sitting it out and waiting for the dust to settle, and opportunistic investors jumping into the fray in hopes of landing some real deals. On the other hand, value investors will be somewhat stymied, waiting for prices to correct even further before taking on the risks of creating value in a soft economic environment at a time in which costs of capital are increasing.

Public Equity Market

On the public front, REITs have struggled over the past 18 months. But despite some disappointments, REITs have outperformed the broader market and avoided some of the recent meltdown. Through September 2008, equity REITs eked out a modest positive return after coming off a 16% negative return in 2007. On the other hand, hybrid REITs and mortgage REITs suffered the same fate as the broader commercial market, with back-to-back negative total returns. Through September, the loss on the hybrid REITs accelerated over the previous year, while erosion in mortgage REITs decelerated. The slowing economy is likely to place downward pressure on returns, although the quality of REIT holdings should provide some cushion.

In terms of equity market capital, REITs have lost some ground due to declining stock values, tighter credit markets, and a dramatic drop in security offerings. Indeed, total capital raised through IPOs, secondary offerings, and secondary debt plummeted some 50% over the prior year and stand almost one-third lower than the peak in 2006. In addition, the ability to access capital through revolving credit lines is coming into question, as evidenced by rating agency warnings

that they are taking a hard look at the ability to extend maturities of such facilities in light of the current credit crisis. Despite these concerns, analysts contend there is no major risk and that REITs have the ability to satisfy short-term capital needs. To bolster balance sheets, REITs have pulled back on stock buybacks, development activities, and acquisitions.

The industry faces a challenge in rolling over unsecured debt that will be maturing over the next two years in a significantly different market than when negotiated previously. In anticipation of these challenges, management is expected to step back and spend some time on corporate strategy, developing plans to deal with downside scenarios and identifying opportunities to participate in the upside potential as market fundamentals ultimately improve.

Mortgage Market

As noted earlier, the commercial mortgage market is in for some challenges. On the public front, the credit crisis has effectively taken the commercial mortgage-backed securities (CMBS) component out of the picture. Indeed, CMBS issuance has collapsed to 10% or so of year-to-date levels in 2007. At the same time, the ratio of downgrades to upgrades of existing product has dramatically increased, putting pressure on outstanding issues. The end result has been a significant withdrawal of capital from the mortgage sector and an attendant increase in spreads for various tranches of investments. This situation is unlikely to change, calling into question the very role and function of the CMBS industry. Indeed, rather than pondering when the sector will rebound, questions have focused on how it would reemerge and what form it will take if and when the flow of securitized debt returned.

The slow deterioration in market fundamentals associated with the slowing economy, falling values of existing collateral associated with repricing, and dearth of capital to refinance projects and support the transactions market are all troubling signs for which there are few answers. This situation bears close attention, especially if the sector begins to experience additional losses that could further erode confidence, which is already in question.

While the plight of the securitized mortgage market might bode well for private sources of debt, credit losses absorbed by the private sector on other fronts have forced many commercial lenders to the sidelines. As the effects of the credit crisis ripple through their portfolios and stock prices fall, private lenders are

expected to pull back. This is especially true for the larger players who were forced into mergers or acquisitions that will take place some time to rationalize and achieve hoped-for economies of scale.

While the Fed is infusing capital into the banking system, access to capital is expected to remain restricted. This is especially true on the commercial front where policy makers have yet to focus on the need to encourage lenders to put money into the market. This situation is expected to hold well into 2009, with lenders being increasingly picky and with underwriting receiving additional scrutiny.

In the current state of turmoil in the capital markets, creative behavior and aggressive lending will not be rewarded, suggesting upward pressure on rates resulting in higher weighted costs of capital. This trend will put additional pressure on repricing, which will fall especially hard on marginal properties. Of particular concern will be the fate of properties held by highly leveraged investors who relied on financial engineering to acquire property at the peak of the market and who face the prospects of maturing bullet loans. This situation may be more pervasive than thought, creating problems reminiscent of the residential market. Unfortunately, taxpayers and regulators are unlikely to feel compelled to step in and help bail out commercial owners, letting them fend for themselves and letting the market cycle play out.

Real Estate Outlook

Office Market

During 2008, the office market has shown some signs of weakening, with increases in vacancy rates and softening rents occurring in many markets. For the most part, this moderate contraction has been related to the slowing of the overall economy and rising unemployment rates. The crisis in the credit markets and financial sector also has factored into the equation, especially in markets that depended heavily on financial services and related businesses.

As the scope of the credit and financial crisis has become clearer, the ripple effects of the contractions have spilled over to a number of markets. Although rental rates held up through the early phases of this correction, the market is beginning to experience some downward pressure. This is especially pronounced in markets facing major job cuts, resulting in tenant givebacks and a rise in subleasing activity.

During the first half of 2008, total returns on institutional office investments slipped as property

values declined. That adjustment is likely to continue, especially with implicit cap rates lagging other property types with the exception of apartments. The pace of unrealized value losses will accelerate as market fundamentals deteriorate even more over the near term and comparable sales begin to reflect the repricing of the sector. While these downward pressures may not change institutional appetites for larger product that is unleveraged, it may force owners of marginal or commoditized product to make hard choices. This is especially true with respect to highly leveraged owners who will have to refinance projects that will be held to strict underwriting guidelines and that will require an infusion of additional equity and/or acceptance of recourse debt.

On the construction front, developers are finishing out their current pipelines, which will put more upward pressure on vacancy rates. They have put new projects on hold, especially speculative projects that can be shelved until conditions improve. Even when the market begins to turn, the recent tightening of credit standards is likely to preempt developers from going forward with new speculative projects. This governor on activity levels will be driven by investors facing the prospects of higher equity infusions and greater reliance on recourse debt. At the same time, construction lenders are likely to balk at deals where their exit strategies are unclear and a permanent takeout has not been secured. Thus, the office market should be able to maintain its current position and benefit from a rising economy and increased demand for space. In the meantime, the rising cost of capital and a decline in pro forma incomes should create downward pressure on values.

Retail Market

The retail market has been more dramatically affected by the economic contraction than the other major property types. The rising unemployment levels and the housing market collapse have combined to eat away at the confidence levels of consumers. Since the housing market is unlikely to correct over the near term, retail sales growth should remain off for some time.

In anticipation of declining retail sales, retailers have turned defensive, putting the brakes on new store openings. This unexpected contraction has caught a number of developers off guard and left them scrambling to lease space that has not yet come on the market. Particularly hard hit are some mixed-use projects and lifestyle centers that may have been a bit ahead of the

market. In the current economic environment, characterized by slow sales growth and higher operating and credit costs, few retailers are willing to take positions that need time to mature in order to support rents.

The decline in consumer spending is fairly widespread, affecting retailers across the price/value spectrum, including upper-end retailers who had been able to weather the economic storm, but not the credit crunch. In addition to cutting back on new stores, retailers are also closing existing operations, especially noncore locations that are not profitable.

From an investment perspective, retail properties have faced some of the repricing that is now hitting other property types. In terms of cap rates, retail hurdle rates have moved up somewhat in anticipation of a weakening of fundamentals. Despite these recent adjustments, additional pressure on pricing is expected to continue. Further erosion in prices is likely as buyers become more selective and investors seek higher yields to compensate for risk. This cyclical trend will be amplified for smaller retail properties that lose tenants in the contraction of the sector and are faced with refinancing in the face of lower occupancy rates and declining revenues.

While the retail sector will face some challenges and will have to deal with downward pressure on values, the longer-term prospects are generally positive. This outlook assumes the federal interventions are effective and the costs of business credit are reined in to allow smaller tenants access to much-needed capital to stock shelves and attract customers. Given the fragile nature of consumer confidence and the continued drags from the sagging housing market, record debt, and eroding retirement accounts, any major improvements in the retail sector will lag the overall economy.

Industrial Market

The industrial market has continued its trend of slowing activity throughout 2008. This easing is related to the softening economic picture in the United States and lower demand for space as manufacturers pulled back on operations and capacity utilization declined.

The moderate weakening in fundamentals has been exacerbated by the unexpected global recession that dampened demand for exports, thus eliminating one of the anticipated drivers for the sector. For port markets and those along the primary distribution routes, the end result has been negative absorption, which has not occurred for over five years, and a

“The apartment market is one of the brighter spots.”

moderate increase in vacancy rates. Due to the short pipeline for production of new space relative to other property types, development of new industrial space was scaled back, helping keep supply and demand in relative balance. Despite the modest increase in vacancy rates, the current levels are consistent with long-term averages and should benefit from a pickup in economic activity at the national or global levels.

On the investment front, industrial returns are on fairly solid ground, with implicit cap rates in the NCREIF subindex leading other property types with the exception of higher risk hotels. Industrial properties have also held their ground, with moderate erosion in year-to-date figures. While cap rates overall have some upward adjustments on the horizon, industrial product should not be a major drag on portfolio returns, assuming investors are holding solid properties with good fundamentals. Thus, investor demand is expected to lead most other property types, with cap rates creeping up slower than other, more dynamic, property types.

Apartment Market

The apartment market is one of the brighter spots, with a number of markets experiencing a decline in vacancy rates and rising rents. This situation is a stark contrast to the single-family and condominium markets, which are faced with significant excess capacity.

The prospect of record home foreclosures promises some upside potential for the apartment sector. However, the interventions and incentive programs that are being launched to provide relief for homeowners, allowing them to stay in their homes, may dampen this potential surge in apartment demand.

On the other hand, the slowing economy and prolonged recovery of the single-family market should bolster the ranks of renters and help hold rental rates. Indeed, despite the economic slowdown and pressure on consumers, some markets have experienced a decline in vacancy rates and rising apartment rents. Going forward, the occupancy side of the equation should hold up, although the ability to raise prices may be dampened by inflationary forces that put added strain on already stressed household budgets.

With respect to returns, the apartment market is fully priced, as evidenced by the low, implicit cap rates embedded in the NCREIF apartment subindex. While there have been some price adjustments, the sector lags others as investors hold onto product in anticipation of improving fundamentals.

Going forward, apartment values will be under pressure as overall cap rates rise. However, apartments will continue to be a favored sector for institutional investors, helping to hold up values. Investors with value-added strategies will be looking for distressed product where an infusion of equity capital may help create value. This is especially true for well-located product that has a competitive market advantage but suffers from a capital shortage. On the other hand, properties in markets with high barriers to entry and strong household growth rates will hold value as investors become more selective and focus on market fundamentals.

Conclusion

As 2008 winds down, there are few signs that the economic maelstrom in which we are embroiled will settle down over the near term. Despite the valiant efforts of the government, the credit crisis continues to drag the economy down, forcing many households and businesses on the defensive. At the current time, it is difficult to see the end of the tunnel. This is especially true since new problems seem to be surfacing each day. Unfortunately, none of the problems are trivial or isolated, but are complex and intertwined.

At this point, it appears that government interventions and stimulus packages may do some good. However, rather than catapult us on a new path of growth and prosperity, in a best case scenario, over the near term these actions will help put a bottom on the cyclical phase. This outlook is frustrating, especially in the context of the hundreds of billions of dollars that are being expended to keep us afloat. However, the downside risk to the U.S. and global economies is so high that such actions are warranted.

While it would be nice to think that the problems will be resolved with the infusion of well over \$1 trillion of taxpayers' money, the reality is that we simply do not have a handle on how deep the hole is, much

less what's on the horizon. The fate of the commercial real estate market and questions as to how it extracts itself from the combination of easy credit, a lack of confidence, and erosion in collateral values remains an unknown. While the near-term prospects are somewhat sobering, the ultimate reconnect between the spatial and capital markets will be healthy for the industry. In the meantime, the industry will bounce around a bit as it seeks a bottom and the market is recapitalized.

Once the market begins to show signs of improvement, the changes are likely to be moderate, mirroring the recovery of the broader economy. In the meantime, savvy investors will be poised to pounce on the various opportunities that will emerge as the market moves toward recapitalization. The market is also likely to benefit from a renewed appreciation for market fundamentals of supply and demand rather than financial engineering, and the smoke and mirrors of easy credit that created the disconnect between the capital and spatial markets. This should lead to a renewed sense of confidence as well as put a solid foundation under collateral values.

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