

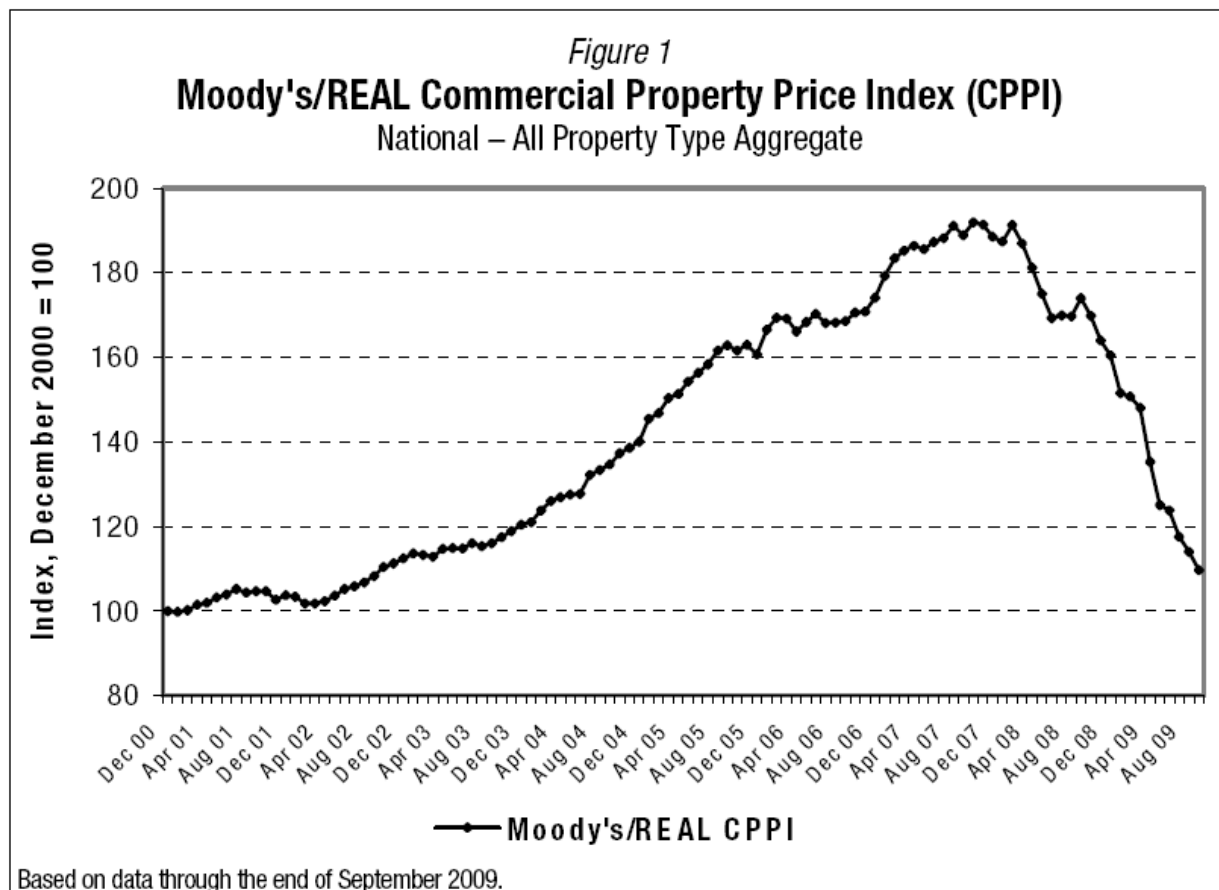
The Economy — From a Real Estate Perspective

Headlines lately have been “cautiously optimistic”. Residential real estate is – at least briefly – on an uptick, and the stock market looks, for all the world, like it’s on a bull run. Without sounding too much like the “glass is half empty” crowd, Greenfield would put more emphasis on cautiously and just a slight bit less on optimistic.

Why, you might ask? Three things continue to bug us about the long-term sustainability of any post-recession economic rally: commercial real estate, the consumption/productivity relationship, and the overall health of the nation’s banking structure.

Commercial Real Estate

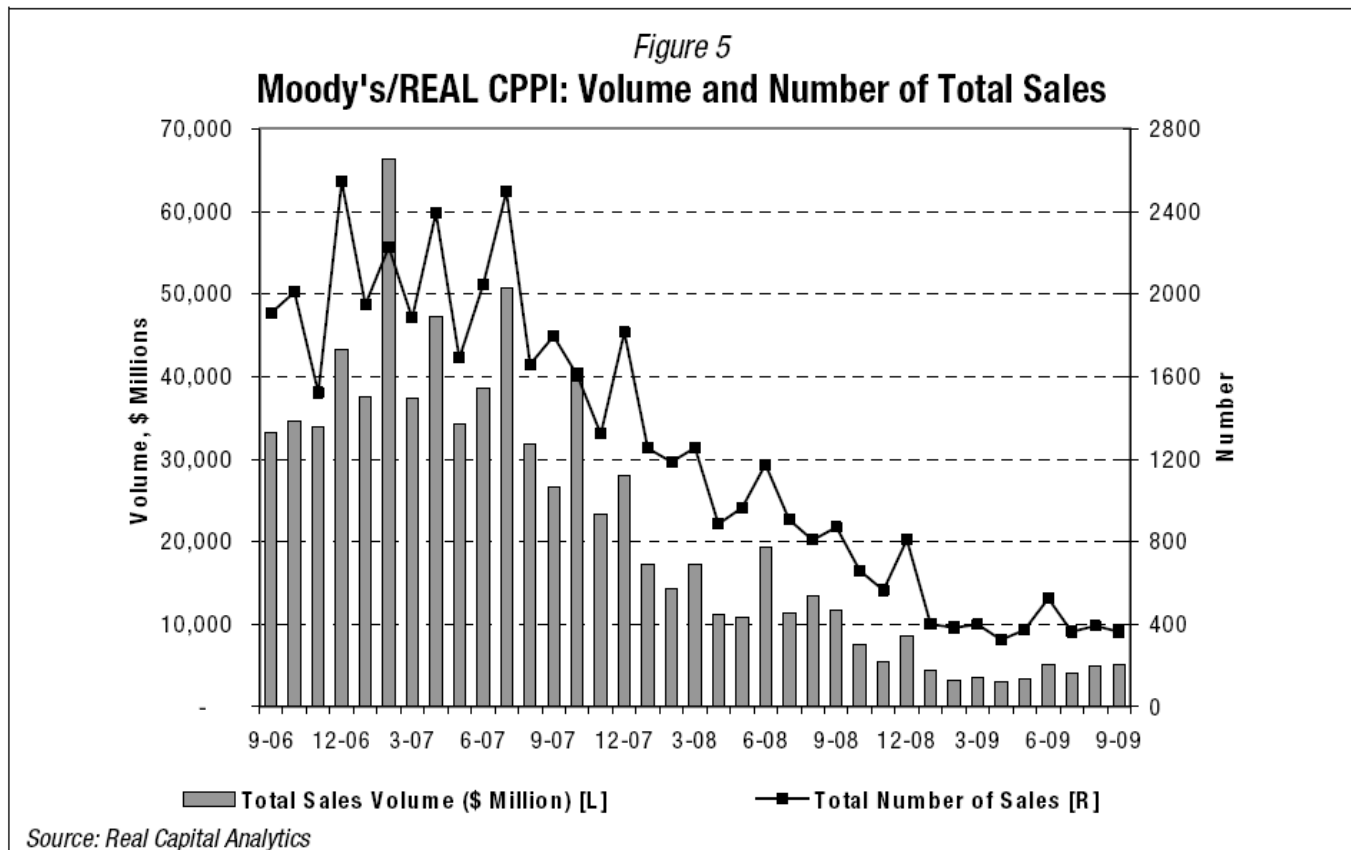
In last month’s newsletter, we commented briefly on the commercial real estate problem and particularly on collateralized mortgage obligation balloons which are coming due during the next few years. The latter of these two problems may hurt the most – with the melt-down in equity, even for great properties, it is hard to imagine that all of these notes will simply be renewed. More on this later...



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A recent report from Moody's, using studies from our good friends at Real Capital Analytics, really underscores the problem. Commercial real estate values have been in free-fall since mid-2007, and there is nothing on the horizon to turn that trend around. Indeed, and as we reported last month, we're hearing rumblings that cap rates may still be 75 to 100 basis points too high. In short, it's difficult to imagine a scenario in which values and prices aren't back to pre-2000 levels (or worse!) before things turn around.

To underscore this, note Figure 5 from that same Moody's report.



The number of transactions has collapsed by about 80% since 2007, and the dollar volume of transactions has suffered even worse – from a peak of \$65 Billion/month in early 2007, and a “typical” month in the mid-\$30 Billion range throughout that period, to less than \$5 billion/month throughout this year.

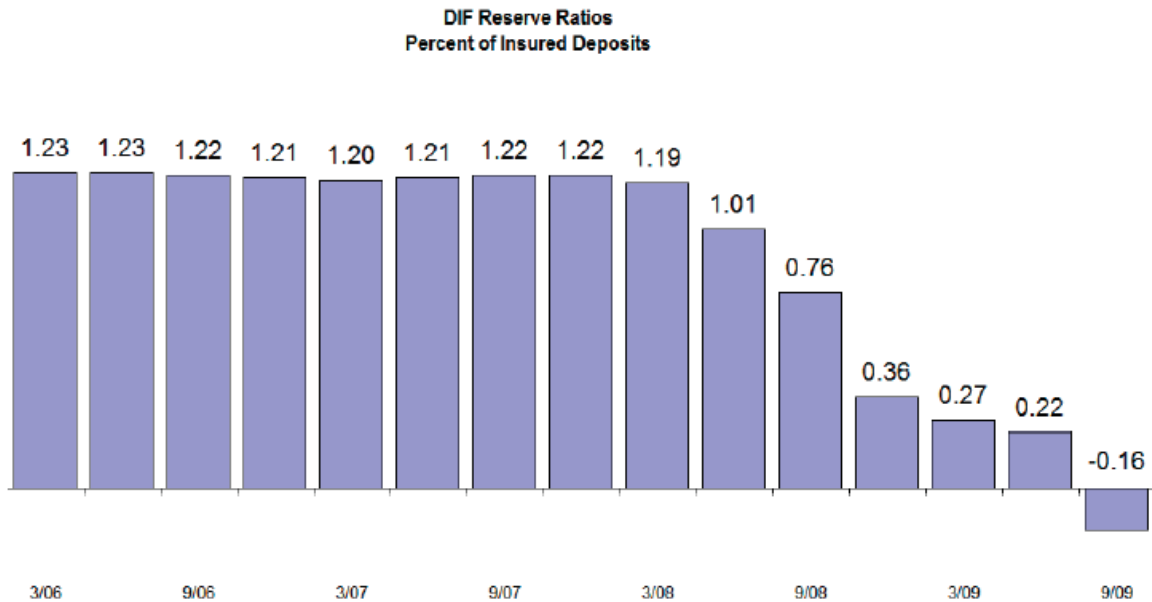
Picking out the details will take more time. We know that there is a significant amount of “darkness” in the retail, office, and hotel sectors. How many of these transactions are “distress” and how many are not remains to be seen. The overwhelming suspicion is that a lot of underwater properties simply haven't flushed through the system yet. When appraisals fail to support refinances of maturing balloons over the next few years, it is hard to picture this scenario getting better.

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Banking

The real crisis last year was the potential for a credit/banking collapse. Notwithstanding the many very large institutions that went by the wayside, the system itself stayed afloat, albeit with a tremendous amount of Federal liquidity. None-the-less, the patients generally aren't ready to go home from the hospitals yet, or even stray very far from the intensive care units.

First, according to the most recent reports from the FDIC, the percentage of unprofitable banks has soared from about 8% in 2006 to over 28% today (see below), and the number of banks on the FDIC's "Problem Institutions" list as of September was 552 – about 11 TIMES as many as 2006.



Not surprisingly then, the FDIC's Deposit Insurance Fund, which has historically maintained at about 1.2% to 1.3% of deposits insured, is now at *negative* 0.16%. At a talk I recently gave to a civic club, one person in the audience asked if this meant we should pull our money out of banks. I replied no – that the full faith and credit of the U.S. is still behind your deposits, but there aren't many I'd want to own stock in right now.

Productivity

It's hard to turn on the TV without hearing some commentator wail about our "consumption economy" — indeed, we revel in conspicuous consumption this time of year, and a significant part of our economy, and our real estate, depends on a consumer spending. The confusing side of consumer spending is that so much of what we consume is made abroad. Is globalization a good thing? Unquestionably, globalization leads to boosting third-world economies, and in the long run, the world is a lot safer when countries are run by thriving middle-class citizens.

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On the other hand, has the U.S. benefitted from globalization? We seem to have maintained, and even advanced a standard of living which is the envy of the rest of the world, but at a “cost” of sending billions of dollars (actually, a couple of trillion) to countries that produce the stuff we consume. (A tip of my hat to readers in other countries — I know this sounds like a terribly parochial way of looking at things... but please bear with me for one more paragraph).

Indeed, the economic Law of Comparative Advantage suggests its to everyone’s benefit (yes, even Americans) to import goods from countries with a lower relative cost of production, and then export things (both goods and services) only when we have a comparative advantage to do so. Naturally, there are problems in today’s world — China, for example, keeps their currency linked to the dollar, and as such the normal free-float among currencies which would equalize China’s cheaper labor doesn’t function properly. (Quid pro quo, though — China has to use its dollar supply to import a lot of its food and raw materials, so what goes around eventually comes around.)

The biggest problem in the U.S. is one of productivity, particularly in the long-term. Our population is aging, and without some sort of logical reform of our immigration laws, we will demographically, and thus economically, resemble Europe or Japan by the middle of the century. (Hint — that’s not a good thing.) More importantly, we fail to focus on the things we do remarkably well here in the U.S.

Why is All of This Important?

Ultimately, this recession will be over, but the quality of the recovery will depend in no small part in the way our economy is structured going forward. Since WW-II, the U.S. has emerged from every recession with GDP growth in the 3+% range, and often well over 4%. The most recent survey of forecasting economists by the Philly FED finds a consensus GDP growth going forward in the range of 2.5%. Why? Many — indeed most — economic forecasters fear that the structural support (technology, investment, credit, etc.) needed for the “next big thing” simply isn’t there. Think about the S&L crisis of the late 1980’s and early 1990’s. We emerged from that with the dot-com boom. Admittedly, that ended with a bust a few years later, but the technology structure created in the 1990’s still remains, and few people can imagine the technology world we had prior to 1990. (Hint — there were only 50 “web sites” in 1993).

I don’t mean to be a doom-sayer. Indeed, we have a bit of a joke around here at Greenfield that I’m the chair of the “glass is half full” committee. And, I am very optimistic about the inventiveness of the human race and our ability to fix problems, including economic problems. Nonetheless, the economic challenges moving forward are significant indeed.

Some News from Greenfield

As noted last month, I spoke last month at the Chinese Drywall Litigation Conference in New Orleans, sponsored by [HB Litigation Conferences](#) (formerly Mealey’s Conferences). We’d really like to compliment the folks at HB. We’ve had the opportunity to participate in quite a few CLE presentations over the years, and this is our second one run by HB. They seem to do the best job we’ve seen of any of the CLE providers. I’d encourage our readers to track their offerings.

We’d very much like to welcome Tanya Bake to our team, who’s filling the all-important role of Executive Assistant to the management team here (mainly me, because I need the most assisting!). Contacting Ms. Bake is usually a better way to contact me!

And, as always, if you would like for Greenfield to provide a speaker on real estate topics, please contact our Client Services Manager, John Casker, either by phone or via e-mail at jcasker@greenfieldadvisors.com.

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