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Quo Vadis Redux—Or “Where Are We Heading”

By Daniel Rose

At this first national conference of the Yale Alumni Real Estate Association, it seems appropriate to address two important questions: First, looking at the real estate field in perspective, we should ask where we have been, where we are and where we are going. Second, as individuals seeing ourselves in perspective, we should ask where we have been, where we are, and where we should be going.

To deal effectively with the first question, we must realize that real estate economics has micro and macro aspects. Local challenges of site acquisition, building design and construction, leasing, management and so forth are obviously crucial, and they are the fundamentals of our day-to-day activities. But the macro problems of real estate cycles and the financial conditions that determine a project's success are influenced by national and global factors not readily apparent.

Local market conditions and global capital flows must both be understood; and, in 2008, the macro economic question is more challenging.

No one has an unclouded crystal ball, and it is sobering to realize that, for example, the U.S. credit crunch of 2007 took virtually all economists by surprise. In 2006, the term “subprime mortgage” was unknown to the general public, and most economists (except for a few such as Yale's Professor Robert J. Shiller) seemed

unconcerned with housing finance practices.

Today, the current volatility of the stock market, with its three-digit surges and crashes, shows how nervous investors are; the fluctuating interbank lending rate shows how wary banks are of lending even to one another; and the conflicting signals we receive are bewildering.

On the same day that the Blackstone Group announced it had raised a fresh \$10.9 billion fund to invest in real estate opportunities ahead, JPMorgan Chase analysts predicted the U.S. commercial real estate market could decline by as much as 20% over the next five years. And at the moment when most observers anticipate a softening of the Manhattan office market because of an expected loss of 20,000 to 30,000 financial services jobs, the General Motors Building is rumored to be close to a sale at \$2.9 billion that would give its purchaser a negative cash flow.

On Friday, March 14, I heard President Bush tell the Economic Club of New York how strong and resilient the American economy was and how government should not over-react to current problems. As he spoke, Bear Stearns informed the government it was contemplating Chapter 11 protection, and Messrs. Bernanke and Paulson spent the weekend pulling rabbits out of their financial hats.

The President's relaxed reaction, then and since, recalls the comic version of Kipling's poem *If*—"If you can keep your head when all about you are losing theirs and blaming it on you, perhaps they know something you don't."

This week, Federal Reserve Chairman Bernanke told Congress that he expects the economy to grow in the second half of 2008 and to

be solid in 2009. Yet this same week's Michigan Consumer Confidence Survey showed public confidence (historically the best predictor of recession) had declined to its lowest level in 16 years; the Conference Board's index of leading indicators fell for the fifth consecutive month; and forecasts indicate that residential construction this year will fall below one million starts for the first time since 1991. Traditional economic forecasting signals—such as job loss/creation, home foreclosures, credit card delinquencies, bankruptcies—are negative.

Optimists, who want to believe in good times, but who contemplate grim fundamentals, feel like the fellow in the Tom Lehrer song who was “as nervous as a devout Christian Scientist with appendicitis.”

At this moment of financial turmoil it is useful to remember some basic economic “facts of life”:

- a) leverage works in both directions, with smiles on the way up and tears on the way down, and our financial institutions and vehicles are wildly over-leveraged in these difficult times;
- b) a “liquidity crisis” can easily be solved by the Federal Reserve (as lender of last resort) but a “solvency crisis” is a different problem entirely—monetary policy cannot make bad investments turn good;
- c) supply and demand are complex factors, with “demand” referring to those ready, able and willing to buy, and “supply” often varying with price. A public worried about falling home values, rising interest costs and possible unemployment may be reluctant to spend;

d) with national and international inflation rates clearly rising, we note that Jimmy Carter did not copyright the term “stagflation” in the 1970’s, so it will be available for use next year should conditions warrant it. It is difficult to understand why our economists continue to use the term “core inflation,” which does not include energy or food prices, since Joe Sixpack is fully aware of what he is paying at the gas pump and the supermarket;

e) and, finally, we should remember that Jack Kennedy noted not only that “the rising tide lifts all the boats,” but also, as he smirked privately to friends, “when the police raid a house, they take all the girls.”

Real estate practitioners sometimes forget how deeply their fortunes are tied to those of the general economy. A good place to begin such a discussion is with capitalization rates, or the ratio between a property’s income and its price.

A net cash flow as free and clear of \$100 with a cap rate of 10% gives a property a price of \$1,000. If the cap rate drops to 5%, the price of the same income flow rises to \$2,000. When cap rates “revert to their historic mean,” those prices will decline accordingly.

From 1987 to 2001, cap rates of U.S. office buildings, shopping centers and rental housing complexes generally were in the 8% to 9% range; by 2007, cap rates had plummeted (in some markets to 5% or less) and prices soared.

The cause was detailed in Tony Downs’ perceptive book, *Niagara of Capital*, which describes the massive flow of capital into real estate after Alan Greenspan in 2003 dropped interest rates to 1%

and kept them there. For 31 consecutive months, the base inflation-adjusted short-term interest rate was below zero. The result was, in Downs' words, "an unprecedented disconnect between conditions in commercial space markets, where rents and occupancies were falling, and conditions in commercial property finance, where prices soared on well-occupied buildings with good cash flow."

To compound matters, just as a global savings glut, particularly in Asia, poured foreign funds into the U.S., Wall Street's huge increase in securitization of debt of all kinds gave lenders an unrealistic sense of confidence in the very real risks they were facing; and rating agencies' AAA approval of subprime packages added fuel to the fire.

These reinforcing factors pushed cap rates to their recent lows which history tells us cannot be sustained. Last year when Harry Macklowe bought a package of office buildings from Blackstone for \$7 billion, with a \$5.8 billion short-term loan from Deutsche Bank and \$1.2 billion from the Fortress Investment Group, his \$50 million on top controlled a lot of bricks and mortar. Today, with Deutsche Bank pressing for return of its loan and no buyers in sight for the package at \$6 billion, life looks different for all concerned.

At the moment, U.S. real estate markets are all but frozen, but most observers believe it will probably take about 18 months for them to return to normal fluidity. At what cap rates, and at what sales prices, one can only guess.

U.S. housing markets present a similar picture, with a universal feeling that they are over-priced and over-mortgaged.

As Professor Shiller documents in his thought-provoking book, *Irrational Exuberance*, real U.S. home prices, which traditionally rise at the rate of inflation, increased 52% between 1997 and 2004, much faster than incomes rose. From 1985 to 2002, he points out, “the median price of an American home rose from 4.9 years’ per capita income to 7.7 years’ per capita income.”

Nationally, home prices have dropped about 10% since last Spring, and Professor Shiller said recently that he thinks we could see home prices in gradual decline for five years or more. An authority on the psychology of financial decision-making, he is a firm believer in business cycles.

Some observers believe that during the next three to five years, house prices could fall as low as their 2001 levels, which in some regions would show huge losses. Goldman Sachs recently proclaimed that home prices in California are overvalued by 35% to 40%. Once home prices in a region fall by more than 20%, even borrowers with solid credit and mainstream mortgages face serious problems. Subprime borrowers will have long since been in extremis, with their mortgagees in trauma.

Government assistance efforts to date have focused on lenders; homeowners present a more difficult problem. Widespread home ownership is a desirable goal, but not all purchasers can afford to own houses; and no one feels much sympathy for speculators who bought condos or second homes hoping only for a quick and profitable flip.

Some economists fear that the subprime problem may be the earliest manifestation of a deeper credit bubble involving high yield bonds, commercial mortgages, leveraged loans, credit card and student loan debts and—the big unknown—credit default

swaps. These instruments, meant to insure bond holders against default, currently cover some \$45 trillion, yes trillion, in investment portfolios, up from \$1 trillion in 2001.

If the Bernanke/Paulson team can maintain stability and confidence in the integrity of our financial system, these challenges can be met. Otherwise, the possible scenarios are too painful to contemplate.

When I recently asked Larry Summers, former Secretary of the Treasury and former head of “that other place,” if he was worried about credit default swaps and the other huge, opaque financial vehicles, he replied, “Yes, worried, but not panicky,” by which I assume he thought they could be dealt with in due course.

At some point, the world’s increasingly complex financial structure—with an estimated \$500 trillion dollars in opaque derivatives that are unanalyzed, unregulated and barely understood, and recently created multi-billion dollar Sovereign Wealth Funds—that can be applied to political as well as economic goals—must be subjected to mature and thoughtful discussion and prudent regulation.

Eventually, when we come through our current cyclical problem, the next U.S. President can then face our zero national savings rate, large and continuing domestic and foreign account deficits, weakening dollar, huge and pressing infrastructure needs, our unfunded Social Security obligations, painful dependence on foreign oil, and national income inequality at its highest level since 1929. (I assume health care and environmental problems will be tackled first.)

Just as a heroic Paul Volcker faced up to the ramifications of the

“cheap money” policies of Arthur Burns, so a new Paul Volcker will in turn have to face up to the problems left by Alan Greenspan; and life will resume.

In time, the world will right itself; and the real estate economy will revert to its historic “means,” that is, house prices rising by roughly the rate of inflation, and income-producing real estate with cap rates reflecting the risk/reward ratios of medium quality bonds.

In the long run, the sound strategies of thoughtful investment managers like Yale’s incredible David Swenson and of “value” investors like Warren Buffet will be proved correct, of course. But in the long run, too, new financial bubbles will eventually arise and will eventually burst.

Robert Shiller, who more than any other economist writing today understands the impact on business cycles of herd psychology and “animal spirits,” writes admiringly of his mentor, Prof. Charles Kindleberger, author of the classic, *Manias, Panics and Crashes: A History of Financial Crises.*” Kindleberger, in turn, admires and cites Charles Mackay’s *Popular Delusions and the Madness of Crowds,*” which describes the South Sea Bubble, The Dutch Tulip Craze, John Law’s Mississippi Schemes and similar explosions.

If only our bankers, brokers and hedge fund types had read those books!

As for today’s second question, that of our individual careers and the lives we lead, I would like to recommend two books that should be required reading for everyone in our field. The first, by Buzz McCoy, is called *Living Into Leadership—A Journey in Ethics.* The second is by William J. Poorvu and is entitled *Creating and Growing Real Estate Wealth—The 4 Stages to a*

Lifetime of Success.

These two volumes are by men of character and competence who are giants in our field and whose wisdom is widely admired and respected. They discuss the importance not only of deals but of relationships, of investment not only in one's financial capital but also in one's human capital through appropriate training and experience; and they discuss your role in your career field and in your community.

In pragmatic terms and by practical examples, they echo the ancient Roman Tertullian, who said, "Any calling is noble if nobly pursued."

Study these books and—along with a good sense of values, a happy family and a Yale education—they will help you not only to make a living but to make a life.

Thank you.

Replies to Questions:

- 1) When is the economy likely to revive? No one knows for sure. Larry Summers is probably correct when he guesses that we "are in the third or fourth inning" of a recovery.

If we act wisely, the present recession will probably be like our other post WWII recessions, or perhaps just a little worse. In Japan in the 1990's they acted unwisely and their problems lasted for years.

- 2) Most observers applauded the Fed's recent moves, because a

Bear Stearns bankruptcy would have had a fearful “domino” effect on the financial world. A few, however, claimed that it was a case of “private profits, socialized losses”; and others raised the cry of “moral hazard,” which means that risk-taking is encouraged by knowledge of a prospective bail out.

On balance, it is crucial to maintain public confidence in the system. The term “credit” stems from the Latin “credere”—to believe—and lenders won’t extend credit if they don’t believe they will be repaid.

- 3) The \$500 trillion estimate of world derivatives comes from the Bank for International Settlements. To give a sense of scale, the U.S. national debt is now \$9.5 trillion, the U.S. GNP is about \$13 trillion and our federal budget is about \$3 trillion.

The key problem here is not only the size of these derivative exposures but the inability to price derivatives accurately in a hysterical down market, when everyone wants to sell but there are no buyers.

The originators of the widely-used Black-Scholes pricing model for derivatives won a Nobel Prize but lost a fortune, because what works in normal times does not work in a panic, when “mark-to-market” valuations are not possible.

- 4) Steps to prevent even more serious problems in the future are a daunting challenge.

Keynsians think government should do everything; Milton Friedmanites think the government should do nothing but adjust the money supply; the Delphic Oracle said, “Nothing

in excess”; and I am a Delphian.

William McChesney Martin, a former head of the Fed and another Delphian, believed government should “lean against the wind” in the early stages of a runaway boom or a destructive bust. The mind-boggling problem is to determine the proper timing.

However, as Kindleberger and Mackay point out, human euphoria, greed and hysteria will always be with us; and so will bubbles.

Regulatory changes, such as requiring increased disclosure of derivative holdings and “off balance sheet” risks and requiring appropriate capital adequacy standards, will most likely be enacted in time. Risk management decisions, however, should be dictated by the free market; and economic fluctuations are part of life.

- 5) Rose Walk, the street closing in front of the Yale library, was first suggested years ago by the example of Columbia University’s closing of 116th Street in front of their library. The next best thing to having a good idea is to recognize someone else’s good idea.
- 6) The term “core inflation” is meaningless today. It recalls Abraham Lincoln’s favorite riddle: if you call the tail a leg, how many legs does a sheep have? Answer: four, because calling it a leg doesn’t make it one.
- 7) What the coming “hot” areas in the economy will be is anyone’s guess. My own hunch is that in time we will revert from a system that currently over-emphasizes borrowing and

consumption to one that again values savings, investment and production.

In the real estate field, I believe infrastructure will be the new buzzword; and Jane Jacobs, the current icon of neighborhood preservation, will soon be overshadowed by a newly-rediscovered Robert Moses. You will recall that it was Moses who built the infrastructure for our transportation systems, parks, playgrounds and so forth.

High density city life will be for those who can afford it. Post WWII suburban sprawl—with single family houses, lawns and two-car garages—will be less fashionable than high rise, high density development at suburban mass transit nodes.

Regional malls will add high rise housing, office, hotel and recreational and civic facilities to become new town centers, much like our Pentagon City development of twenty years ago.

In the business world, bio-medical engineering and pharmaceutical facilities, alternative energy, health, education and recreation will be continuing areas of growth.

Those are my guesses.

- 8) How should real estate investors approach new involvements in this challenging climate? Well, think of how porcupines make love—very, very carefully!

Thank you.

Daniel Rose talks can be found on: www.danielrose.org