Are We Out of Recession?

Economics and Real Estate in 2010

BY DONALD J. SHERWOOD, MAI, SR/WA, FRICS AND DALTON D. VANN, MRE

Commercial real estate has suffered in the recession as a result of underlying shifts in fundamentals, and despite government efforts, the economic fundamentals have not shown many signs of improvement.

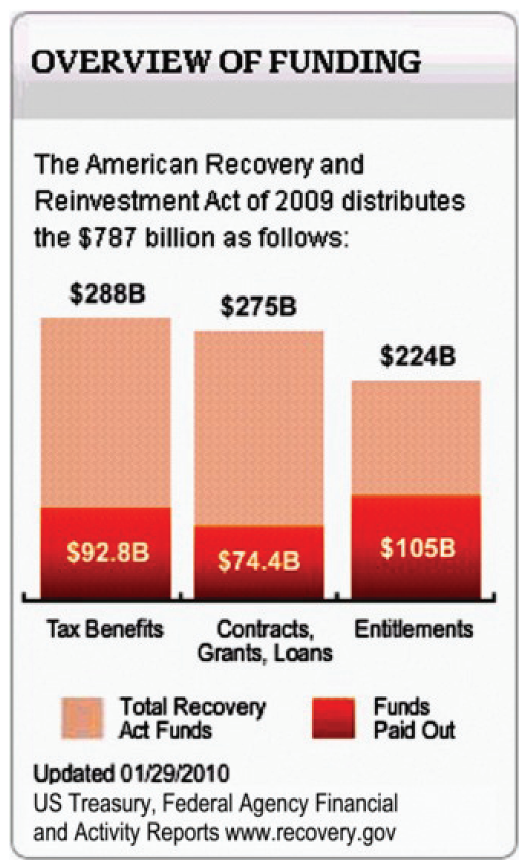
Are we out of recession? Federal Reserve Chairman Ben Bernanke believes that we are. However, the rate of decline has only stabilized. The Federal Government continues to pursue control of our financial system, the national debt is at an all time high and much uncertainty remains in the air.

EFFECTS OF GOVERNMENT PROGRAMS

In October 2008, the U.S. Government sponsored a $700 billion dollar financial rescue package known as The Troubled Asset Relief Program, or TARP. The program was intended to provide liquidity to cash-strapped banks and keep properties out of foreclosure. While it enabled many banks to stay in business, it failed to restore investor confidence in stock markets, and lending institutions did not continue lending funds as they had done in recent history. The government efforts were also unable to prevent bank failures. According to the FDIC, there were 26 national bank failures in 2008 and another 140 in 2009.

Other government programs have been met with mixed results. In December 2008, the U.S. Congress approved a $17.4 billion emergency bailout for three U.S. automakers, and the country took equity positions in these companies in exchange for the cash infusion. Despite the effort, two still declared bankruptcy and one was bought out by another automaker.

The American Recovery and Reinvestment Act of 2009 was designed to inject almost $800 billion into the U.S. economy through government grants, entitlements, tax credits, and infrastructure projects. The Act was passed in February 2009, and as of the February of 2010, only 35% of the funds have been distributed.



SIGNS OF LIFE

New York Federal Reserve Board released the following economic indicators.

Slowing Job Losses: While the unemployment rate is still rising, it may have peaked. Most economists expect job losses to continue in the first half of 2010.

Improving Corporate Profits: As corporate coffers recover, employers will be ready to expand and rehire as economic stability becomes more evident.

Declining Commercial Construction: As construction jobs are lost, excess inventory has time to be absorbed, mitigating oversupply.

Declining Sales: Sales of durable and nondurable goods are on the decline, which points toward future difficulties for retailers and manufacturers.

Rate of Retail Sales: While real sales volume is still off, the rate of retail transactions are generally positive and much improved over 2008.

Stabilized Capital Goods Shipments: The rate of purchasing has stopped declining and appears to have leveled off.

Housing Starts to Stabilize: While well below norms for the last decade, the number of housing starts has stopped declining.

Personal Savings Up: Although increased savings rate is historically a precursor to increased spending, American's today are saving but not spending.

Consumer Confidence Improving: Stabilized to slightly improving consumer sentiment from surveys show that Americans are less fearful about the future.

Real GDP Up: The third quarter of 2009 saw the first positive change in Gross Domestic Product in one year.

Positive Industrial Production: With orders for durables and nondurables declining, positive industrial production figures indicate a potential rebound.

Low Interest Rates: Money may be cheap to borrow but strict lending requirements mean that deals are not being financed. Banks can pay less on savings accounts.

Inverted Yield Curve: Wary about the future, investors are still more willing to make short-term investments than to invest in the future.

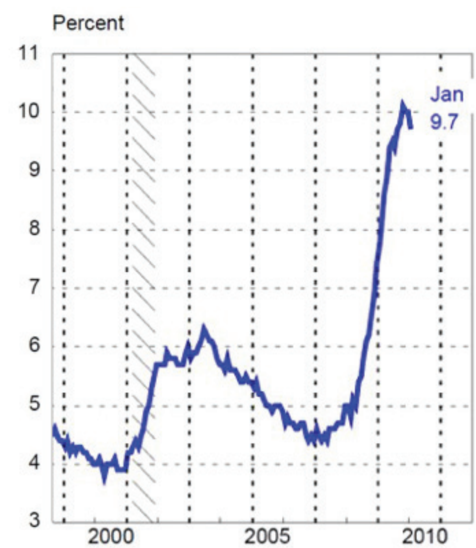
Stock Market Rebound: Gains mean that investors are at least willing to invest in highly liquid assets like stocks and near-term economic expectations are improving.

When residential foreclosures put additional strain on the economy, Congress approved a $275 billion "homeowner bailout," which slated $200 billion for Fannie Mae and Freddie Mac to spur lending, while the remaining $75 billion was intended to aid refinancing and write-downs.

Other government programs, such as "Cash for Clunkers" and the first-time homebuyer tax credit have been met with mixed sentiments. Cash for clunkers created an artificial market for new cars, and, many believe an artificial market for housing is also being created. A decline in volume once the credit ends in June 2010 could have the unintended consequence of a housing slump relapse.

The most challenging figure is the unemployment rate, which crossed the 10% mark in October 2009. Poor retail sales, slowing industrial production and a sluggish business climate have all resulted in layoffs. Economic uncertainty is keeping employers from expanding and rehiring. Much uncertainty remains in the market with regard to future taxation, especially the capital gains tax and mandatory healthcare costs relating to the highly-debated healthcare reform bills before the House and Senate. Talk is also under way to introduce a finance reform bill that will regulate derivatives and is intended to protect consumers.

UNEMPLOYMENT RATE (SEASONALLY ADJUSTED)



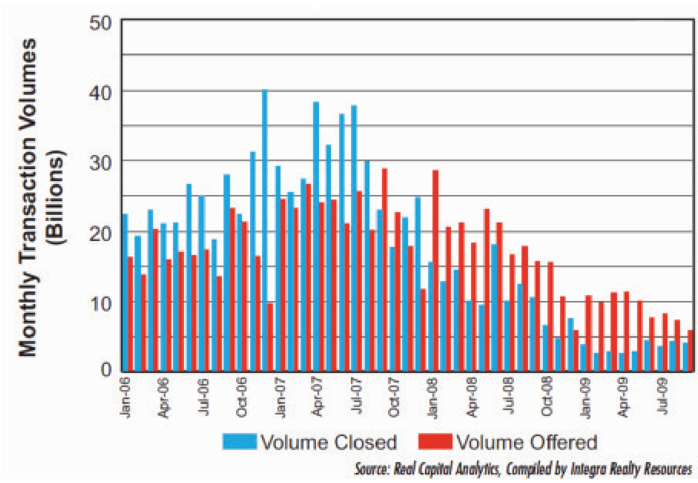
COMMERCIAL PROPERTY TRANSACTION VOLUMES

Commercial real estate has suffered in the recession as a result of underlying shifts in fundamentals. Poor retail sales led many retailers to close their doors or renegotiate rental rates. Retail vacancies are probably the highest of any sector, but all property types have been affected.

The most common theme across all markets is not that values are falling, but that transactions are not closing. "Nothing is happening" is a common phrase heard from commercial real estate investors and brokers alike. Inactivity is largely due to conservative lending practices on the part of lenders who are either cash-strapped or are fearful in the face of uncertainty.

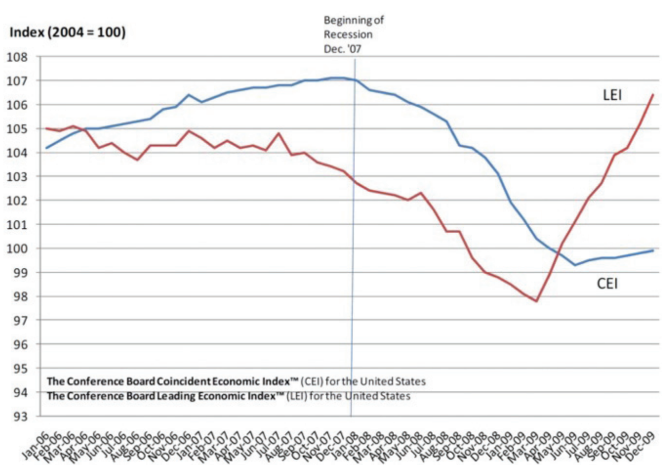
Low loan-to-value ratios mean that buyers must bring more equity to the table. Effective loan-to-value ratios of 50% are not uncommon in the current market. Debt coverage ratios are also more conservative, edging up from 1.1:1 in 2007 to 1.3 or more today. Lending institutions also require more personal liability and full recourse in order to get a loan. Despite lower interest rates, few deals are transacting because financing cannot be acquired for projects that would have been considered conservative only two years ago. Real estate indexes and commercial real estate funds indicate that property values have suffered losses upwards of 40%, however, little data is available to support such drastic declines.

COMMERCIAL PROPERTY TRANSACTION VOLUMES



Commercial real estate pricing is a lagging indicator of economic health. Job growth, corporate profits, industrial production, and consumer spending are some of the economic fundamentals that must improve before real estate values are affected through occupancy, lease rates, and transaction volume. Generally speaking, commercial real estate lags about 18 months to two years behind coincident economic indicators.

LEADING ECONOMIC INDICATORS INDEX



LEADING ECONOMIC INDICATORS INDEX

The leading economic indicator index, as tracked by The Conference Board, points toward improving fundamentals in the near-term. Coincident indicators, which generally track the current economy, lag about two quarters behind.

SUMMARY

Overall, economic signs point to an economy that has stabilized. Some figures like stock market indices show improving conditions, but most documented changes indicate positive rates of changes while others indicate stabilization. An accurate assessment for economic recovery will take time. In our opinion, the national economy appears to be in the early stages of stabilization, not recovery as stated by many. Nevertheless, economists warn that the possibility of a "double-dip" recession is still a concern.

Since commercial real estate lags several years behind the national economy, property values may still be in jeopardy of decline and are certainly several years away from escalating. Looking forward, no one can be certain of how this economic situation will play out.

Dr. Mark Dotzour, Chief Economist at the Real Estate Center at Texas A&M University points to four major effects our economy will face in 2010.

1. States and cities will experience budget deficits due to declining sales tax, property tax and income tax revenues.
2. Interest rates will fluctuate as the Federal Reserve stops buying up mortgages.
3. Businesses and consumers will continue to face a credit squeeze.
4. The political risk to business owners and investors will remain elevated.

The bottom line for commercial real estate is this – with real estate always lagging the economy, even if the indices are looking better, don't look for improvement any time soon.

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