FOCUS ON THE ECONOMY

THE POST-ATTACK ECONOMY: AN OUTLOOK ACROSS AMERICA

by Hugh F. Kelly, CRE

Literally, before the dust settled following the collapse of the World Trade Center from the terrorist attack of September 11, 2001, and throughout the month thereafter as the fires still burned at Ground Zero, economists have been attempting to analyze the immediate effects of the catastrophe and to estimate its implications for the future. By September 14, Bank of America's Chief Economist Mickey Levy had completed an economic brief, preparing clients for a mild recession with unemployment peaking at 5.5 percent near the end of this year. Economy.com prepared a preliminary analysis by September 17, and its CEO, Mark Zandi, offered some refinements at a Property and Portfolio Research client conference in Boston on September 20—21. Updates to the forecast were issued, for a while almost on a daily basis. On September 21, Bank One issued its economic interpretation, as did Morgan Stanley three days later. Their senior economists, Diane Swonk and Richard Berner, helped lead a September 28 conference call for members of the National Association of Business Economists. The initial consensus seems to center on a recessionary episode lasting perhaps into the spring of 2002, with Federal fiscal and monetary stimulus jump-starting a recovery that could see real GDP growth in the 3.5 percent to 5.5 percent range by the final quarter of 2002.

Macroeconomic trends such as the national growth rate, the movement of interest rates, patterns of job change measured by employment and unemployment, income, and consumer spending, all are important factors considered by real estate professionals. But since real estate quintessentially remains a local commodity, it is the array of economic impacts across the geographic reach of the U.S. that most significantly affects choices and decision-making in our industry. Over the years, analytical tools to assess such impacts have been developing and may help us to unpack the likely exposure of metropolitan areas to shifts on the demand side of the real estate equation.

More than a decade ago, researchers at Prudential Real Estate Investors, led by Charles Wurtzebach, proposed what they termed "the portfolio construction process." Their work offered a model they called "the Economic Location Matrix," which arrayed cities by two characteristics: the structure of the local economy, and its long-term growth trend. Over the past 10 or 12 years, I have extended and modified that research for institutional equity and debt investors, and for developer clients. This extended work has taken the initial concept and analyzed the local economic structure in finer levels of detail, and has shifted the focus from long-term trend lines toward the exposure of the MSAs to economic cycles. This is especially pertinent now, as the economy suddenly downshifts into a post-9/11/01 recession.

Exhibit 1 shows where 58 of the country's more than 300 MSAs are situated in these basic economic terms. The 58 selected urban areas include

Exhibit 1

Economic Location Matrix

	Boom/ Bust	Moderately Volatile	Avg. Cycle – High Growth	Avg. Cycle – Low Growth	Stable
Diversified		Los Angeles	Kansas City Indianapolis Middlesex Minneapolis	Chicago	Columbus Philadelphia St. Louis
Capital Goods Production	Seattle Detroit	Toledo	Ft. Worth	Cleveland Milwaukee Stamford Newark	Pittsburgh
Consumer Goods Production	Tacoma	Riverside	Cincinnati	Long Island Bergen, NJ	
Transportation & Trade	Laredo TX		Jacksonville		Oakland
Tourism & Entertainment	Las Vegas	Orlando	Reno		
Finance & Business Services	Tampa	Dallas Atlanta Boston Charlotte Denver Miami	Salt Lake	New York	S. Francisco
Government Administration & Education	Charlotteville,VA	Washington	Sacramento	Baltimore	Madison, WI
Military & Defense			Killeen, TX	New London	San Antonio
High Technology	Phoenix Austin Orange Co. San Jose	San Diego Portland	Albuquerque		
Energy	Houston	Baton Rouge	Bakersfield	New Orleans	

all 40 of the nation's largest MSAs, plus several (such as Las Vegas, New Orleans, Jacksonville, and Orlando) with claims on real estate industry attention beyond their relative city sizes. Finally, a number of smaller areas (*e.g.*, Bakersfield, Killeen, Tacoma, and Reno) are displayed to illustrate cells in the matrix not populated by the larger metro areas. Where cells (the boxes in the *Exhibit*) are empty, that means that *none* of the MSAs in the country fall into the statistical groupings defining the matrix. This illustrates some important relationships. For instance, there are no diversified or military/defense-based economies in the boom/bust category. Neither are there any stable economies with a high-technology or energy-based economic structure.

Understanding the structure of the local economic base and the historical propensity to swing to

Exhibit 2

RECESSION PROFILE	REPRESENTATIVE CITIES
Standard (S)	Chicago, Seattle, Ft. Lauderdale, San Antonio, Cleveland
Minimal (M)	Atlanta, Suburban New York area, Los Angeles, Dallas, Denver, Washington, DC
V-Recession (V)	Boston, Charlotte, Houston, Las Vegas, Oakland, Orlando, Phoenix, San Diego, San Francisco, San Jose
U-Recession (U)	New York City, Miami, Detroit, Kansas City, Philadelphia, St. Louis
Lagging Recovery (L)	Hartford, New Orleans, Oklahoma City

a greater or lesser degree in response to macroeconomic cycles is an important aid in assessing demand risk in the present circumstances. Still, every recession has its own fingerprints, and therefore, the *Economic Location Matrix* is not a mechanical tool to be blindly applied. Thus, in looking at the outlook for the 2002 – 2004 period, I have overlaid factors of particular immediate concern in evaluating the forecasts. Such factors include the relative exposure of each MSA to the global economic slowdown that began in 1998; the already existing trends in place as a result of the bursting of the NASDAQ bubble; and truly local effects, such as the dispersal of downtown Manhattan tenants into neighboring markets such as Long Island, New Jersey, and Connecticut.

It appears to me that the "shape" of the local outlooks can be described as following one of five basic patterns. Those scenarios are termed "Recessionary Profiles," and are coded by letter: **S** for a standard MSA that is expected to mirror national trends; **M** for an MSA that is expected to have a "minimal" response to the recession, outperforming the U.S. trends; **V** for a local economy expected to have an immediate and steep contraction into 2002, with a sharp rebound in 2003 and good growth prospects in 2004 (a so-called "V-shaped recession"); **U** indicating a more lasting contraction, where the local economy does not recover to its 2001 level of employment until 2004 (which the economists are terming a "U-shaped cyclical contraction"); and **L** representing a sharp dip in employment in 2002, and a failure to return to 2001 employment levels in the three-year forecast horizon. Salt Lake City is the only exception to these scenarios, as the 2002 Olympic Games introduce unique local influences into this MSA's forecast. *Exhibit 2* lists some representative cities for each outlook.

As might be expected, many of the boom/bust and moderately volatile local economies are anticipated to have ***V-shaped*** cycles, with a steep drop and sharp rebounds. These include travel and tourism cities like Las Vegas and Orlando and high-tech localities including Austin, San Jose, San Diego, and Portland. Boston, which appears to be holding up fairly well so far, has some short-term exposure because of its financial industry cluster, as do Charlotte and Tampa. But even a few economies that have had less-than-average exposure to U.S. cycles in the past 20 years are at risk in 2002. San Francisco and the Oakland-East Bay areas, the beneficiaries of the 1990's boom, now face contractions beyond the bounds for which immediate historical experience has prepared them.

New York City faces a ***U-shaped*** recession, and will suffer the loss of more than 100,000 office jobs and perhaps as many jobs lost in the retail, hotel, air transportation, and certain blue collar sectors. This will, however, be balanced somewhat by full employment in the construction trades as infrastructure repair goes forward and damaged buildings in the vicinity of the World Trade Center are prepared to go back into service. MSAs with significant import/export exposure or ties to manufacturing industries will also see ***U-shaped*** cycles, cities including Detroit, St. Louis, Kansas City, and Miami.

Suburban areas surrounding New York, however, have minimal exposure to the national recession, though they must be wary of a downdraft if corporate decisions prompt an exodus of companies from the larger metropolitan region to other parts of the country. That does not appear probable at this juncture. More likely, New Jersey, Long Island, and southwestern Connecticut will benefit from large firms such as Merrill Lynch and American Express moving operations into available office space where rents are substantially below Manhattan standards. Some of those moves will prove permanent additions to the economic base structure of Newark, Middlesex, Nassau-Suffolk, and Stamford. Likewise, I expect Orange County, CA, sunbelt markets like Dallas and Atlanta, and government-based economies like Washington, DC, and Sacramento, to have minimal effects (or ***M-recessions***).

One might think that the default scenario would be the ***S-recession***, in which the local area is expected to follow the pattern of the nation in its slowdown and eventual recovery. But actually the "national average" is just that, and reflects the range of local economic experiences. Local economies "summing up" produce the national profile much more than U.S. trends "trickling down." Nevertheless several MSAs, especially in the Midwest, are anticipated to mirror nationwide trends: these include Chicago, Indianapolis, Cleveland, and Pittsburgh. Seattle works out to an ***S-recession*** outlook as well, because the Boeing manufacturing effect (a negative) is offset by Microsoft and related technology companies rebounding within the forecast horizon.

The most dire outlooks are the ***L-shaped*** outlooks for Hartford, New Orleans, and Oklahoma City. These were in fragile shape prior to September 11, and will find it difficult to re-establish their momentum before mid-decade. Hartford's insurance exposure has yet to be fully quantified, but the news for the property-casualty end of that business can't be considered good at the present time. New Orleans, with a combination of energy, trade, and tourism in its economic base, faces a triple-whammy in this recession. And Oklahoma City, still struggling with the aftereffects of its own terrorism experience (of the domestic variety, let us remember), has no growth trigger that I can identify that would haul it into recovery until a real robust national economic expansion comes along.

Real estate professionals will naturally be keeping up with the basic economic data flowing on a near daily basis from the federal government and from key industry groups. But we need to filter this information through the screens of our local markets. From the demand side, I have found analytical tools like the *Economic Location Matrix* extremely helpful in measuring distributed effects and in sorting the range of probable consequences. At minimum, it helps me and my clients think through the circumstances and sharpens our sense of the probabilities and the choices available in the real estate decision-making process. REI

ABOUT OUR FEATURED COLUMNIST

Hugh F. Kelly, CRE, *is the principal of an independent counseling practice, specializing in applied real estate economics for clients with domestic and international commercial property interests. Kelly is based in Brooklyn, NY, and is well-known as a writer and public speaker. Formerly, he was chief economist for Landauer Realty Group and author of the Landauer* Forecast *from 1986 to 2000. Kelly was a 2000 national vice president of The Counselors of Real Estate, chair of its New York Metropolitan Chapter in 1999 and 2000, and editor in chief of "The Counselor" newsletter from 1997-1999.* [redacted]