FOCUS ON THE ECONOMY

A Potpourri of Economic Issues Impacting Real Estate and the Rest of the World

BY DR. MARK LEE LEVINE, CRE

I. INTRODUCTION

THIS TIME OF THE YEAR, INTO THE FAST START of the first quarter of 2005, we are flooded with a potpourri of interacting economic, cultural, political and social issues. Many of these issues are a "parry-and-thrust" position, arguing contrary positions which attempt to support diametrically opposed viewpoints.

In this short Note, it seems worthwhile to contrast several viewpoints which are often heard or seen in the media, especially around the first quarter of the year. When we reexamine such philosophical background, many issues previously thought as being on "solid ground" may cause one to revise thinking on important issues, as well as to laugh a bit, even at ourselves in the mirror. For the moment, consider some of the following issues and their implications as to whether the assumptions made are correct or incorrect.

II. POTPOURRI

The following areas are a collection of different positions that affect social, political and economic areas in which we often find ourselves in conflicting and/or disturbing positions. Each of the following areas is attributable to a number of individuals, cited in the following work. Their insight often gives us a chance to reflect on some of the areas indicated.

A. WHAT IF?

In an interesting short note by Byron Wien , U.S. Senior Investment Strategist at Morgan Stanley, in the book *Surprises of the New Year: 2004* http://www.morganstanley.com/ourviews, Mr. Wien considered surprises that might impact our thinking if these circumstances came into fruition. These "surprises" included:

1. Osama bin Laden is found.

2. The Federal Reserve ends up not raising rates (any more than it already has).

3. The stock market is strong.

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4. Improper practices by mutual funds are no longer in the news.

5. The question is whether the European Union will unravel.

6. Pharmaceuticals and certain other large-cap companies perform very well.

7. The positions of Saudi Arabia result in overall deteriorated political developments, such as the price of oil moves above $40 a barrel. (The $60 amount has already been exceeded!)

8. Silver gains an attractive position; gold moves to $500 per ounce. There is some question as to the value in the market for stocks, bonds and other currency.

9. The Japanese market picks up.

10. Republicans have important changes that take place, such as key folks in the Bush Administration resign, such as Secretary Rumsfeld.

Since this article was written, several events have taken place (eg, the upward movement on the price of oil). However, some projections and predictions are food for thought even though they may often be inconsistent with other positions.

B. IMPORTANCE OF CULTURE

In many of our classes, such as International Real Estate (at the Burns School of Real Estate and Construction Management, Daniels College of Business, University of Denver), we emphasize the importance of cultural aspects in making investments. Business and investment decisions are not normally made solely by examining financial issues. This is especially true when dealing on an international basis, as opposed to simply within the United States.

In an interesting article by Professor Dick Lamm, Executive Director at the Center for Public Policy and Contemporary Issues at the University of Denver, "The Elephant In the Room: How Culture Matters," Head-First Colorado, P. 47 (Fall 2003), Professor Lamm, three-term Governor in Colorado, emphasized the importance of cultural issues as to decision-making and life in general. Professor Lamm focused on what is important in educating our children.

Contrary to what many have learned in commercial real estate or other investment arenas, Internal Rates of Return (IRR) and Return On Investment (ROI) are not the only areas of focus. Many decisions are strongly influenced by non-financial considerations, such as the desire to own property, the desire to reside in a given location, ethical issues, safety of individuals (as opposed to simply safety of capital), and many other non-financial issues.

As the saying goes: "A starving man is not looking for gold." Some factors have more weight than the economic return.

C. ECONOMIC POSITION

One question raised in political circles, given the recent Federal Presidential election, is whether the "average" citizen in the United States is better off today as opposed to four (4) years ago—or eight (8) years ago.

In a study in September 2004, the Meyers Group Housing Market Key Indicator Alert (www.MeyersGroup.com), showed many factors which indicated that the U.S. economy is very strong. On the other hand, other reports have indicated that the economy is having a difficult time. Depending on the focus within the Study, comparing which of these factors is "correct" is sometimes difficult to determine. For example, in recent months, sales prices of some commercial properties have increased; yet, the Net Operating Incomes (NOI) have decreased. Financial indicators are "confused," to say the least. (The argument is that it is inconsistent to think that pricing would increase where the NOI is decreasing!)

There is confusion as to whether unemployment has decreased or increased, given questions as to types of jobs, seasonally adjusted issues, outsourcing of jobs (including to other countries), what is included in job levels and job descriptions, and so forth.

In grading what had performed well, the Meyers Study (noted above) showed that the real Gross Domestic Product Growth (GDP) would be rated, in their view, with a C+ grade. (Many politicians would disagree with this position.) On the other hand, that same Study showed that employment growth is at B-, indicating a not-so-favorable position. (However, politically, certainly, the Republican position would argue that is an incorrect assessment.)

Very few would argue that mortgage rates are at a level other than A or A+, given low interest rates for residential property today, when compared with the last 45 years, despite a recent slight rise in interest rates.

The Meyers Study also stated concern with affordability for housing, giving it a rating of B-, notwithstanding somewhat encouraging economic data, such as employment numbers.

D. MARKET TRENDS:

In "Notes," *Commercial Investment Real Estate Journal*, P. 6 (August, 2004), it was stated that, statistically, there has been a substantial increase in pricing for building materials, such as steel and lumber. Is this good or bad news? Obviously, to a supplier of such goods, this may be very favorable news. On the other hand, to a builder, this might be bad news.

The causes for differences in pricing are disputed within many circles. Arguments that much demand for goods has come from Asia, and, in particular, China and India, might be viewed as favorable or unfavorable, depending on one's economic position. If one supplies the goods and receives an economic benefit from increased pricing, obviously such increased prices would be favorable.

The lack of supply of raw materials, such as to the housing market which depends on such goods, was noted in the article by David Lereah, "Prices: Still About Supply," *Realtor* Magazine 20 (September, 2004).

E. INTEREST RATES:

What are implications of higher interest rates? Some might argue that higher interest rates are good news in that it preventing the economy from overheating and creating a larger "bubble." The practical point is that interest rates have been increasing, slightly, in recent months.

In an article by Anthony Downs, CRE, "Six Ramifications of Higher Interest Rates," *NREI* 56 (August 2004), Dr. Downs asserted six (6) key impacts from the increased interest rates. He noted:

1. Commercial property prices will probably not continue increasing, and in fact will begin to decline, in all likelihood.

2. Some capital will shift or be moved elsewhere, given changes in interest rates.

3. Home ownership will decline or slow; certainly sales of existing homes will also decline or slow. Appreciation will be slower; it may even stop, or drop in pricing of homes.

4. The amount of residential mortgage activity will certainly be reduced, as well as the activity in refinancing. Thus, the era of refinancing and "pulling" money by refinancing for tax-free, tax-deferred use may have seen its best days, at least for now.

5. There will be some decline in residential pricing, especially when supply is down in condominium markets, which were overheated. Dr. Downs specifically noted certain condominium markets, such as those in southern Florida and Las Vegas, where the condo "bubble" may burst.

6. In most cases, aside from the "bubble" bursting, as noted, many of the changes noted by Dr. Downs will probably occur on a gradual basis, as opposed to a sudden event.

What does this mean, relative to future planning? Some prognosticators would differ with Dr. Downs and argue that many bubbles will break, and there should be concern with refinancing and defaults, because of sudden changes in interest rates, as opposed to gradual changes as indicated by Dr. Downs.

F. WILL REAL ESTATE VALUES DECLINE?

With a bubble in some residential housing, if Dr. Downs is right, we may see a decline in housing values.

On the commercial side, in "Report," 5 *RCA* 3 (Realtors Commercial Alliance) (Summer 2004), a statement was made citing Torto Wheaton Research that office values will probably decline by 7.4%, and retail values will decline by 6.5% in 2005. This statement was made "even if interest rates only increase moderately."

Whether this statement would be agreed to by most real estate brokers and other real estate professionals is open to question. However, one could ask what the implications of such decline would be in the marketplace on not only specific buildings, but also on the commercial market and the general economic market in the U.S. This is an important issue, as several markets outside the U.S. follow U.S. positions.

G. WILL THE ECONOMY RECOVER? HAS IT RECOVERED?

At what rate would the economy recover? In the last few months, there have been many questions raised as to whether the general economy is in stages of recovery, whether this will be sustained, and the force and impact of such overall recovery on many markets.

In an article by Thomas, Craig, "A Modest Economic Recovery Will Be Sustainable, But Disappointing," *Real Estate Forum* 22 (August, 2004), Mr. Thomas argued that the economy is recovering at a slow recovery.

Mr. Thomas also argued that, although we are gaining some jobs and are seeing some improvement in the overall market, there are also unfavorable areas. He noted the pressure for more inflation, rising of interest rates and other negative economic signs which are now apparent in the marketplace and which will cause the recovery to be somewhat disappointing. Mr. Thomas said: "Moreover, expect higher borrowing costs to create a few new troubles of their own in the quarters ahead."

If Mr. Thomas is right, then other prognosticators projecting a favorable and immediate recovery, with strong impetus, are certainly wrong.

What implications there are to either view should be seriously examined. In *The Economist*, p. 90 (July 24, 2004), in summarizing their data, it was noted that Chairman Alan Greenspan, Chairman of the Federal Reserve, was very positive and upbeat in his assessment of the American economy during his 2004 testimony before Congress. Contrary to what Mr. Thomas seems to be saying, Mr. Greenspan said that the recovery was "broad based," and even with some offsets in consumer spending the recovery would be forthcoming and "broad" in its nature.

H. WHERE DO YOU WANT TO LIVE?

Many issues impact our daily activities. In this light, consider the review in *The Economist*, p.92 (July 24, 2004), that listed the most favorable places to live based on the "Human Development Index" (HDI).

Under this HDI, The Economist found that the top five (5) most favorable countries were: Norway, Sweden, Australia, Canada, and The Netherlands, in that order. The United States placed #8. Cuba was #52. Sierra Leone was #177, the lowest showing on the rankings. What, if anything, does this say about the U.S. economy? It may provide some insight into how others view the U.S.

I. HEDGING TIME:

Most economists and prognosticators have a caveat, justifiably so, to qualify their comments. Whatever conclusion is reached (that the overall economy will do okay, be "great," have a "bubble," or face reasonable employment or rising unemployment), there are always qualifiers.

In projecting whether or not the economy will have strong improvement and recovery, Dr. James DeLisle, in his article "The Three Rs of Election Year Economics: Recovery, Rhetoric and 'Rithmetic," *The Appraisal Journal* 101 (Spring 2004), noted his qualifications or exceptions where the economy may be adversely affected. These risk factors included rising gas prices, terrorism and threats of terrorism, and concerns with consumer confidence.

There is little doubt that the items noted by Dr. DeLisle are very important. How strong an act of terrorism might need to be to have a strong impact on the economy remains an uncertainty. Certainly no one would doubt that 9/11/2001 had a strong impact on people and economies. More recently, the Tsunami in Asia continues to have devastating impacts on various world economies.

J. MIXED MESSAGES:

Probably one of the more favorable and honest views of the economy was captured in an article by Locke, Tom, "Hearing Mixed Messages? Deciphering the Economy," *Denver Business Journal* A9 (March 12-18, 2004). In this article, the caption discloses that there are mixed messages. There are increases and decreases in employment. Bankruptcies are up, yet some businesses are flourishing. Tourism may be up in some locales and down in other areas. Recent violent storms have caused major damage to housing, businesses and tourism in many areas. (Of course, the Tsunami in Asia has created a renewed appreciation of the tremendous power and impact on lives and economies via natural events.)

More home ownership opportunities have existed for potential home owners, given lower interest rates. However, increasing housing prices have limited the ability for some individuals to purchase homes. Thus, as indicated by Mr. Locke, we do have mixed messages. Which mes-

sages are correct will be the determining factor in many instances as to how the economy goes and how we all move in various directions.

K. IRRATIONAL EXUBERANCE AND RATIONAL EXUBERANCE:

"Irrational" exuberance language has been quoted subsequent to the comment made by Mr. Alan Greenspan when he previously asserted that possibly because the market was doing so well, there is an overconfidence level.

However, one might also argue that there is a "rational" exuberance. This term was utilized in the book by Thomas Friedman, *The Lexus and the Olive Tree: Understanding Globalization*, when Mr. Friedman commented on a number of settings in the economy and the global interaction of various countries.

One might argue that there is a little bit of both: rational and irrational exuberance as to our economy. This same point was made by DeLisle, James, "Real Estate and the Economy: The Train Has Left the Station," *The Appraisal Journal* 5 (Winter 2004). In that article, Dr. DeLisle concluded: "After struggling through 15-19 months of cyclical bottoming out, the commercial real estate market is finally showing signs of improvement. However, this improvement will not be a near-term phenomenon. It will be a lagged event that will depend on a continuation of the fledgling economic recovery."

L. FORECASTS: BUT "WHAT IF ....?":

Many forecasts have been made by economists and experts in financial markets. Another question might be to ask: "What will happen to some markets that are substantially impacted by a number of negative events?" Such events include terrorist activities referred to earlier, negative trade balances, oil considerations, occupation positions by the United States and others, wars, SARS and other medical dilemmas, consumer confidence (or lack thereof), inability to refinance because of prior refinancing and rising interest rates, financial scandals, increased energy costs, natural disasters (e.g., Tsunami), and many other issues.

Some of these points were noted in a recent article by John Fenoglio, "Capital Markets Overview, January, 2004." (jKirkpatrick@liveOakCapital.net).

It is not "if," but "when" the economy will change. As mentioned, many prognosticators on the economy agree that the economy is changing, mostly to the positive. However, how long it will take for these changes to take place, and the timing of those changes within various markets remain uncertain.

In an article by Brian Miller, "More Challenges Ahead," *Real Estate Forum* 30 (December 2003), Mr. Miller noted that the jobless recovery, the India factor (outsourcing jobs, etc.), and the growing presence of high net worth investors, are only a few issues addressed which will be impacted as to recovery.

M. BANKRUPTCIES ARE UP:

If the market is up so favorably, another question is: "Why are bankruptcies up so drastically?" For example, in the state of Colorado, bankruptcies are setting a record high. Some argue that bankruptcies are just a means of doing business or working out of business problems. (This has been well illustrated in the airlines industry, as well as other major industries.)

However, in a general sense, bankruptcies indicate a failure. Financially speaking, if bankruptcy indicates financial failure, then there is great concern that rising bankruptcies, though a lagging indicator, imply that the economy is not doing quite as well as some might predict.

Notwithstanding favorable statements made by economists that the economy is improving, there is continued concern with the clearly demonstrable number of increasing bankruptcies which belie the representation that the economy is greatly improving.

N. TAX RATES AND TAXES IN GENERAL:

If the economy is doing better, one argues that, therefore, there will be more monies available for the Treasury, and one need not increase tax revenues through increased taxed rates.

Vying positions as to tax rates indicate that the general Republican posture will attempt to hold Federal income tax rates to the current tax position. The general Democratic position on a national basis is that tax rates should be increased.

The broad economic question may be to ask what the implications will be on various economies as to raising

Federal tax rates, as well as state and local tax increases, in coming months and years.

The tax rate issue goes hand-in-hand with the tax deficit issue. This will continue to be of great concern in the U.S. economy. It will have implications on a global basis, too.

O. BUDGET DEFICITS:

The U.S. budget deficit is enormous. Many states also face great deficits. There are concerns as to how these deficits can be serviced, and how deficits can be reduced, assuming that is the desire by governmental leaders.

Numerous economists have raised questions as to implications of tax cuts regarding the existing Federal deficit. For example, in the article by David Lereah, "The Trillion-Dollar Question," *REALTOR* 18 (April, 2004), Mr. Lereah raised the issue as to what will happen now that tax cuts and Federal spending (which increased the budget deficit) wear off? What will be the price that the U.S. economy must pay for the positions taken by the Federal government as to tax cuts?

As Mr. Lereah indicated in his article, if the economy picks up speed and jobs continue to be generated, we might work our way out of some of these economic concerns. However, if the deficit continues to remain high, and we are not able to adequately service all of the needs of the deficit, as well as other needs to be met by the government, this means, as Mr. Lereah noted: "... prolonged joblessness, flattening profits and capital spending, and curtailed consumer spending."

P. DEBT: THE JOY OF SPENDING:

As mentioned, there is great concern with the various deficits in the U.S. economy, and great concern with the ability to service the debt, especially the Federal debt, based on a huge needs for increased Federal spending, tax cuts, and failure of the economy to generate a level of taxes to cover the Federal FISC.

Consumers have also kept the economy moving, as evidenced by many studies on the economy over the last year. One reason the economy has been buoyed is because of confidence that consumers have had, in large part, from the refinancing binge where homeowners, without paying income tax, have been able to withdraw part or all of their "equity" by refinancing, at very favorable interest rates, their principal residence.

Additionally, consumer spending from credit card activity has resulted in trillions of dollars of debt.

With the increased credit card debt, increasing mortgage debt, increases of debt in other areas, such as educational commitments for college, these lead to concern with the possible inability of consumers to service the debt, especially coupled with rising interest rates, where the amount of debt service on any of the above-noted items is also increased.

Even if one does not readily see the amount of leverage or debt that has been present in the marketplace, it takes only a momentary glance at the real estate market to see that are many opportunities for taxpayers and consumers to acquire home ownership or even automobiles with "nothing down." That is, the taxpayer has no equity in the property and is either financing it 100% through the lending institution, or through other entities or groups that facilitate such 100%, "no down" financing.

Congress has also played in this ballpark. Congress introduced House Bill 3755, which supported the position to allow FHA to provide for "no down payment" and also to support the position that closing costs can also be included within the financing for a single-family home.

Various programs exist within the marketplace to "lend" or "grant" the homeowner a down payment, emphasizing that there is no equity placed in the property by the homeowner.

Even if there is no visible "bubble" in the marketplace, and if the housing market simply declines by 5%, this may nevertheless be a sufficient decline to encourage the homeowner, who has no equity in the property, to simply consider leaving the property and going elsewhere. This might especially be true in a marketplace where the homeowner has found that his or her job was lost and a new opportunity exists in another state or location.

One argument for this favorable leverage is that as house prices increase, then equity is created. Historically, based on the past few years, this has been the case. However, this pattern may not continue for the near future. This point was made in a note entitled: "Cracks In the Brickwork?" *The Economist* 51 (January 3, 2004). The note indicated that, although pricing of housing has increased dramatically in many countries over the last few years, such increase is unlikely in the next few years, not only in the

U.S., but also in other countries, such as in Ireland, Britain and Spain.

There is a great deal of controversy as to whether there will be additional increased housing prices in the next few years. In an article addressing this issue, as to whether there will or will not be a crash in the housing market, see Jim Carlton, "Boom vs. Bust," *Wall Street Journal* 8 (Monday, June 14, 2004), Mr. Carlton stated that there were conflicting positions by experts. One argument was that inflated housing values will not last; this position was supported by John Talbott, the author of *The Coming Crash of the Housing Market*. The contrary position was also presented, which was supported by Mr. David Lereah, Chief Economist by the National Association of Realtors (NAR).

What is clear is that we are not clear. No one is quite certain of the ultimate position as to the housing market. The implications to a crash (or no crash) in the housing market are massive for the entire U.S. economy.

III. CONCLUSION:

What is certain is that many factors in a very complicated economy will influence the economy; and, the view remains cloudy. The economy, being bearish—and bullish—is much akin to the warning that has been given to patients by doctors: "Do not take a sleeping pill at the same time you take a stimulant! Sometimes the systems fight each other!"

Given such uncertainty, there is continued advice to consumers, the government acting for the public, and various economies, to be somewhat balanced or conservative. There is also the basic point of diversification, and to recognize that there is tremendous uncertainty within the marketplace today. The uncertainty caused by many factors listed (i.e., cost of medical care, terrorism, war, political instability, natural disasters, and much more), emphasizes that we have only a limited amount of "control" as to where the economy will go and when it will move to a given point. This should portend for all reasonable planners to allow for reasonable diversification and balance within the economic markets. ■