FOCUS ON THE ECONOMY

REAL ESTATE IS DOWN: LET THE GAMES BEGIN!

by Dr. Mark Lee Levine, CRE

There is no question that the real estate market, for residential and commercial properties, is down in many sectors throughout the United States, with some exceptions. In the commercial area of most markets the real estate trend for the last half of 2002 has moved downward, and will continue to decrease, when compared to performance over the past several years. This is true whether the grouping of properties involves office space, industrial, retail, multi-family use, and most special purpose properties (such as hotels and golf courses).

Studies throughout the United States show a decline in the marketplace for these groupings of properties, with only a few exceptions throughout the U.S.

Nothing realistically appears on the horizon in 2003 for the general U.S. market to think that it will do other than continue to decline. The level of decline will vary in the markets, but few markets can hope to retain the posture which existed in 2001. Markets will go down.

The residential market has been strong for 5 years, but a recent article in *Inside Mortgage Finance* (January, 2003) noted the position by the FANNIE MAE economist which projects a drop in the market.

In the same edition, many industry experts noted their conclusions which seem to focus on a major reduction in activity of mortgage loans in 2004.

In this same edition of Inside Mortgage Finance, David Lereah, Chief Economist for the National Association of Realtors (NAR), noted that for 2003 there will be a drop of about 4% in home sales, even if the dollar volume remains fairly strong because of increased pricing of those homes.

Also noted in that same edition was a comment through the National Association of Homebuilders (NAHB) by Chief Economist David Seiders. Seiders noted that the question is "sustainability" relative to housing activity. It is clear to many economists that sustainability will not be present, given a number of factors existing in today's market. Those factors include increasing unemployment, with recent figures noting around the 5.5% level in many jurisdictions of the United States. Although interest rates are the lowest in 45 years, they are certainly postured to rise, whether in 2004 or in 2005. Such increase in interest rates reduces the incentive for some lenders to extend themselves as far as they might have extended in recent vintage.

Economic Prognostication
As noted in *Economic Outlook Summary* (February, 2003), published by AMG Guarantee Trust, and particularly noting its economist, Michael Bergmann, the economy is weak. Bergmann noted: "Economic output experienced little growth in the fourth quarter (of 2002). The anemic .7% growth rate for real GDP was a reflection of consumer spending on cars and trucks, which decreased after last summer's surge."

Unemployment
The unemployment position continues to be of great concern, notwithstanding that there have been some blips within the lines of unemployment. One looking through optimistic glasses might conclude that the economy is "out of the woods" relative to job losses. However, many other sources, economically speaking, support the position that unemployment will continue to be around the 5.5% level throughout 2003.

The *Meyers Group Report* for April, 2003, certainly noted this type of position as well. The implications of such outlooks are clear, as stated in this *Report*, when it noted: "Therefore, with continued negative readings for our demand/supply and employment/permit ratios combined with dampened income growth, we expect a far more moderate level of homebuilding activity in 2003 than seen last year."

Interest Rates
With interest rates remaining the lowest in 45 years, whether under the *Meyers Group Report*, as noted above, or other sources, the thought is that the housing market will continue to be strong.

However, rising unemployment, concern with consumer confidence, and the fear that interest rates will rise in the not too distant future, have led many to speculate that interest rates alone are not going to support continued strength in the residential real estate market.

With strains on the economy, reduction in the GDP growth rate, and other pressures for spending faced by the U.S. government, whether from the rebuilding of Afghanistan, rebuilding of Iraq, support for other foreign policies, additional credits and tax incentives approved by Congress within the United States to stimulate the U.S. economy, among other items, it is fairly certain that interest rates face a potential increase. One cannot simply assume that interest rates will remain at low levels.

What About Other Market Aspects?
As noted in the *Cushman & Wakefield Market Beat Report* (year end 2002), there continues to be concerns with nonresidential markets as well.

The above-noted *Market Beat Report* cited, on Page 3, the *Moody's Report*, which concluded that the overall commercial position on industrial real estate is not strong.

This *Market Beat Report* also noted that many metropolitan areas have weakening economic conditions; therefore, average rent rates have been dropping, while vacancy rates are increasing.

Consumer Confidence
Consumer spending has declined. Consumer confidence continues to be a major question, and the confidence level also seems to be decreasing. The University of Michigan publishes the "Consumer Confidence Index." It noted in *The Economist* (February 22, 2003) that such confidence level has fallen in February, down to 79.2%, which represents the lowest level since 1993.

Consumers have been a key factor in the growth of economic activity within the United States. When the consumer confidence level continues to drop, this supports additional concern in the marketplace and delays the recovery. Such recovery was projected by many to be at the end of 2002. Many prognosticators have moved this forecast to 2003. (As noted in the conclusion of this Note, it is the Author's opinion that recovery will not take place in the general real estate market in 2003.)

FRAGILE SETTING
Newspapers throughout the United States have a plethora of commentaries by economists and others regarding implications to the market as a result of deficits that the United States faces, and additional deficits that it will face as a result of new tax laws designed to create incentives and to energize the marketplace.

Whether incentives such as earned income credits - or additional refunds, elimination of the dividend tax, a reduction of the Alternative Minimum Tax (AMT), reduction of capital gains tax rates, increased depreciation allowances, increased expending allowances, additional credits, additional deductions allowed above-line or below-line, for Federal income tax purposes -- or other incentives are present, there is concern that such positions will increase the deficit, which will damage the country, overall, and will not produce the anticipated incentives. Rather, many argue, such positions create a general negative impact on the marketplace and potentially increase interest rates.

The single factor of an increase in interest rates will substantially and negatively impact the entire U.S. market, and, in turn, other countries that tie their positions to the United States.

Given that the level of interest rates, historically, has peaks and valleys, coupled with the fact that the rates are the lowest in 45 years, such levels create great consternation for planning purposes, even if one anticipates an increased interest rate of only 100 basis points.

It is likely, in the opinion of many economists, that interest rates will rise in 2004 or 2005. It appears that interest rates will hold to their current range for 2003, and possibly until the Presidential election in 2004, although many economists and other prognosticators question even this assumption. The snowball impact of such change in interest rates could devastate the economy. It could further reduce consumer confidence, increase vacancies, cause corporations and other businesses to reduce or halt expansion activities, most likely raise unemployment levels and create other major economic concerns within the entire United States.

The costs to undertake business in the U.S. is relatively low, compared to other countries. There is concern with economic sustainability of growth in the United States, given the factors noted.

According to a DTZ Research Study, 6th Edition (2003), global "Class A" office rates in U.S. dollars is much higher in London, West End ($146.70), or in Tokyo ($91.90) or in Paris ($81.40), as compared to the U.S. (Of course, it is of little comfort to consumers in midtown Manhattan that "Class A" U.S. lease rates are lower in the U.S. [$62.80 per square foot per year].)

The U.S. is in a fairly fragile economic position, given strains on the purse strings of the U.S., after facing an elimination of the prior surplus within the government. A deficit now exists within the U.S. government. Dependency on the marketplace to continue its growth position in many areas, or at least sustain close to its prior position, is very much aligned to the favorable interest rate position, since unemployment has been rising.

It is fairly clear in the view of many U.S. economists that if there is an additional spike upward on unemployment, or an increase in interest rates that is substantial (often defined as 200 basis points or more), the same would be devastating to the economic position in the U.S.

As mentioned, consumer confidence has continued to deteriorate. As reported in *The Economist* (February 1, 2003), such consumer confidence level fell to a 9-year low in January, 2003.

OTHER CONCERNS

Office space continues to be in an oversupply position throughout most of the United States. Vacancy rates have increased in most jurisdictions for office space, and rates have decreased. Concessions offered, through additional tenant finish, waivers of certain monthly rents, inclusion of parking benefits and other incentives have further distorted rent rates. This indicates that actual rents are certainly below those of stated rents in many leases for office space throughout the United States.

For additional comments on these same points, see the Studley Report for the Fourth Quarter (2002), which can be found at:
http://www.studleyreport.com

The office market continues with a high vacancy level, given negative absorption and the concern with additional supply of space in many markets, with some companies consolidating. Such vacancy increases are common in many markets throughout the United States.

In the Colliers International Report (January, 2003), which can be found at the web site at: http://www.colliers.com, the office market has continued to have problems in the U.S., as well as in many other markets. Collers International Report stated: "Over two-thirds of global office markets registered rising vacancy levels in the second half of 2002." Many markets internationally were cited for additional vacancy, including London, Frankfurt, Paris, Hong Kong, Tokyo, and New York.

The office market generally has felt strong downturns throughout most of the world; therefore, the United States cannot assume that there will be stronger economic positions in other countries which will embolden the U.S. position. This is especially true when one considers terrorism issues, SARS, the prior war in Iraq, notwithstanding the "conclusion" of the same, the rebuilding processes necessary in especially Afghanistan and Iraq, and concerns in other countries that have faced internal wars or neighboring wars, among other issues.

THE MARKET IS DOWN: LET THE GAMES BEGIN

Historically, when many economic indicators are negatively inclined (such as increased unemployment rates, increased cost of doing business, reduction in consumer confidence, growth in vacancies, and so forth), there are many economic "games" or "adjustments" that seem to be generated. Some of these attempt to continue the image of positive positions and growth; others seem to generate outright fraud and perpetuate individual benefits.

Some of the Games . . .

Consider some of the following games or positions that seem to be generated once the market has negative indicators which arise following a positive growth phase.

Market Image—The market image of a company having positive earnings, growth, and a position of a bright future, was only one example of the "dot.com" (."com") companies that are now "dot.gone" (."gone"). These are good examples of an attempt to project positive positions, notwithstanding that such companies were often never productive, economically; however, they had the "image" of "potential" growth. With stocks skyrocketing, "potential" was the key synonym in the days of the late 1900s and early 2000s.

Creative Accounting—Which adjectives that might be used with various accounting schemes allow one's imagination to wander. "New" accounting, "informative" accounting, "industry specific" accounting, and so forth, are only several examples of labels that were employed for presenting positions, such as those of Global Crossing, Enron, WorldCom and other companies which took positions that were not transparent. They often distorted positions of understanding for potential investors (assuming investors read financial reports and other financial information supplied to them).

Off-Balance Sheet—The approach to exclude some items from the balance sheet (because the given company was, arguably, not liable on a position, or was involved in a partnership and showed a net number, or for other reasons), exemplifies concern that the balance sheets presented by many companies were distortions. They did not reflect debt positions or potential surety positions that many companies faced if an investment or business which they undertook went south and resulted in losses. These accounting "irregularities" are now giving rise to bankruptcy positions and charges of liability and exposure for many executives in these companies.

"Nothing Down" Syndrome—Another indicator for the economic position of real estate, along with other major purchases, are acquisitions where the consumer is encouraged to buy property with "nothing down" or "very little down." That is, the purchaser invests very little of his or her own equity. In such circumstances, there is clear evidence that where the consumer has very little or nothing invested to buy, except as to payments over time, there is a much greater foreclosure or default rate. The investor/purchaser/consumer has very little of his or her own money involved in the transaction.

Pull Equity—Encouraging investors, consumers, and homeowners to "pull out" equity from their realty to utilize cash in other ventures (whether investing in the stock market, or for purchase of other real estate), further exemplifies concern within the marketplace. It is also an alarm that should encourage the cautious lender to review financial positions and consider whether there is the potential of a negative result which is forecast because of such alarms, such as the "highly leveraged" purchase. (Often the concept of "leverage" is taught in university classes, in finance, real estate, etc. Such concept is that the return can be increased in many circumstances, where the return on such borrowed money is greater than the cost of borrowing said funds ["positive leverage"]. This simplified statement also emphasizes that such leverage position may prove to be very beneficial in some settings.)

However, if such positive posture changes, whereby the cost of said funds is greater than what those funds can produce, there is "negative leverage." In such event, disaster, financially speaking, will often not be far behind. Such result can easily take place where interest rates are projected, for purposes of the investment, to be at current low levels. If, in fact, they increase, for example, by a one-third amount of the anticipated interest rate, such increase can spell disaster for the entire investment position.

Artificial Rents—As indicated earlier, many concessions are being given by landlords to tenants to thereby encourage tenants to undertake leasing arrangements with the landlord.

Such concessions, or benefits, to the tenants can occur in the simple leasing of an apartment or home, as well as in nonresidential areas, such as with office leasing circumstances and retail leases. Certainly hotels and other special use properties utilize such approaches. These incentives produce a distorted rent figure. When one considers the cost of such concessions in reducing the "stated" rent to an "effective" rent, the reality of the rent being charged must be examined. Such artificial rents and rent concession positions must be carefully reviewed. These are often good prognosticators of a weakening market; they can be potential indicators for reduced property market values, or even a collapsing market.

Swaps and Other Arrangements—Swaps, or transactions between or among related parties, related entities, or actions involving a quid pro quo between or among entities, often arise when entities attempt to paint a better picture than reality would dictate. Transactions between related entities, such as lease payments between a parent and a subsidiary, or a controlled entity of another type, are only basic examples of this type of artificial, and thus distorted, rent positions which are often reported in financial statements to indicate a positive earning position.

Many types of arrangements between related parties, whether by swaps or otherwise, are at the heart of some transactions being questioned today by the Securities and Exchange Commission (SEC) and state securities commissioners, among others, when examining companies that have entered bankruptcy over the last year or so because of a collapsed financial position that often distort and hide the true financial position.

Implications of the Games—The games noted above are played, or represented, to investors, governmental officials and other regulators as only a small sample of those that have been utilized within the marketplace. Lack of transparency, or lack of proper transparency, as to what has actually transpired within a given entity, through the use of games, cover-ups, "creative accounting," or accounting irregularities, to use some of the euphemisms, only illustrate some concerns in these areas.

This often means that a company could have been placed into bankruptcy, or it should have been terminated many years before its formal demise. However, because of the cover-ups or distortions, many companies continue down a path that causes actual damage to investors, employees, governments, and other companies that rely on what appears to be strong financial positions, only to learn, too late, that such companies had substantially negative financial positions for many years.

The argument that CEOs of many companies may be responsible for continuing to mislead employees, trusts, and others in these types of settings was illustrated in the article by Dugas, Christine, "CEOs May Be Liable For Losses In 408(k)s - Enron Lawsuit Sheds Light On Feds' Position," *USA Today* (September 30, 2002). This article noted potential exposure and some of the distortions that were present within Enron, and, in turn, the damage that was generated to retirement plans of employees within Enron, among other places.

In summary, these games that are played, these distortions and lack of proper transparency, and results that were taking place, clearly reflect circumstances that cannot go on without correction.

The damage to employees within companies, investors, the marketplace, governments, and taxpayers, to fund many of the bail-outs that resulted from such activities, are important issues to be addressed. The impact on the world economies must also be evaluated for countries and entities that follow the lead of the United States.

The SEC, the U.S. Senate, U.S. House of Representatives, and the President of the United States are attempting to address some of these issues, as are states and other regulatory bodies.

"THE RESULTS ...."

Some economists continue to suggest that the economic position in the United States will improve at the end of 2003; some suggest that such improvement will be at the end of 2004. For example, see the positive outlook on the economy, as written by Thredgold, Jeff, "Economic News of the Nation," *Insight* (Spring, 2003).

However, many other economists disagree with such projections, given the increase in unemployment, concern that interest rates may increase, problems with the global economies, potential of additional world conflicts between countries, lack of resolution of the Mid-East crises, continued concern with Iraq, terrorism, and uncertainty on many other issues, such as SARS.

When Will the Economy Recover

Certainly the economy will recover. The question is: "WHEN" will it recover? To what LEVEL will it recover? The more realistic position seems to be, in my opinion, that it will not occur, at the earliest, until sometime in 2004. Even then, it should not recover unless certain concerns, such as the potential of rising interest rates and increased unemployment are addressed in a way that is positive for the growth position.

Consumers need to feel a level of confidence. What issues are seen as impacting that confidence?

See "Trends" in *Development* (Winter, 2002), located at: http://www.naiop.org. Some trends that should be considered in the current marketplace, per this article, are:

"1. The economy has no momentum, and the real estate business is dragging.
2. The economy is going nowhere.
3. Like the economy, business is stagnant.
4.Rents are down and aren't going anywhere fast.
5.Development profits are getting squeezed.
6.Building security remains a concern.
7.Mold is a big problem.
8.Recovery is a moving target."
See the comments by Doug Herzbrun, Managing Director, C.B. Richard Ellis Investors, Page 9, Development (2003).

This short list illustrates a concern with today's market and why it is unlikely that the market will change to the positive position in 2003. And, there are additional hurdles for 2004.

Market Projections

Obviously it is difficult to project what various markets will do. Jessica Roe addressed this in her article, "Deflating Expectations: A Pessimist's Guide To the 2003 Real Estate Economy," Page 1, *Commercial Property News* (January 1, 2003). (See also http://www.cpnonline.com.)

Ms. Roe stated in the article: "Perhaps there is no surer sign that commercial real estate will hit bottom this year and linger for a while than the near total refusal by industry insiders to volunteer forecasts on when the recovery will begin."

Ms. Roe continued to note that because of the sluggish job growth, and limits on business spending, there is probably no recovery reasonably in sight for the real estate marketplace.

See the comments by President Harvey Green, and Managing Director, Hessam, Nadji, in National Research Report - Apartment Report, Marcus & Millichap (First Quarter, 2003). They noted in the introductory comments to this Report that: "The economic recovery has fallen disappointingly short of historical post-often recession trends due to the absence of pent-up demand." "We cannot ignore risks posed by geo-political turmoil, increased layoff announcements, and evidence of potential cooling in retail and home sales."

CONCLUSION

The increase in the unemployment rate, and decrease in consumer confidence, among other items, bode well for the position that the 2003 market will not readily improve. It is likely that additional accounting "irregularities" and other distortions in reports coming forth in the last couple of years will continue to be publicized and will continue to create uncertainty within the marketplace.

Concern with many earlier-mentioned items (including the current U.S. deficit, questions on the recently passed Federal tax changes, economic strain in the economy because of commitments to rebuild Iraq, other global financial commitments, and overall, an increase in supply and lack of proportionate demand) are indicators that 2003 will not see a major recovery in almost all real estate markets throughout the United States. It is likely that such recovery and improvement in real estate cycles will not occur until 2004, at the earliest. AND, should any of the "indicators of concern" (such as rising interest rates, and unemployment, along with decreasing consumer confidence) not be favorable, such recovery could be even further postponed in the economic cycle.