

FOCUS ON THE ECONOMY...

RECOVERY: ARE WE THERE YET?

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Economic recovery is much like the family auto outing across the country, as the children in the back seat frequently ask the parents: "Are we there yet?"

The issue remains: With regard to recovery of the real estate economy, real estate investors, experts in the fields of banking, real estate organizations, REITs, etc., and numerous financial advisors connected with commercial or residential real estate are also asking this perennial question: "Are we there, yet?" The aspirant seeks his or her answer to this continual question; and, the answers are affected by the local economy, as well as the broader economies of the United States and the world economy.

The issue as to whether the real estate recovery has "arrived" is compounded by the consistent inconsistencies that are faced in various real estate markets.

RESIDENTIAL

The housing market continues to set a record sales pace in many areas of the U.S.

The report by Ken Simonson, chief economist, Associated General Contractors of America, for July, 2003, indicated that home ownership numbers continued to remain very strong. Also noted in the Simonson report was the reference to the Census Bureau, indicating that the adjusted sales of new homes totaled \$1.16 billion, which was an increase of 4% from the revised total for May, 2003. This is an increase of 21% from the June, 2002 total.

Also showing strength is the pricing of the median home throughout the United States, which pricing is running at approximately \$187,000.

Although such numbers are favorable, even in the housing industry that has been showing record, positive positions, there is a decline in some areas, when contrasted with the prior year position. The report by the National Association of Realtors (NAR) indicated that the sale of existing houses was slightly down from sales of the prior year.

In general, the residential, single-family home market has had a fantastic run over the past few years. And, it continues with very strong numbers, even if somewhat reduced from the last several months.

As good as the residential real estate market has been, the market has shown some decline, and it will probably continue in this track if interest rates continue to increase.

However, without waiting for the issue of interest rates, it is very clear that many other sectors of the real estate market are adversely functioning from the standpoint of the investors' position, notwithstanding favorable interest rates and refinancing, which gives greater support for cash flow.

COMMERCIAL

Office rents have generally been declining throughout most of the U.S.A., over the past year. The vacancy rates have generally continued to increase, whether in Class A property or otherwise.

These are generalizations. However, as reported by Cushman & Wakefield, in their study undertaken by Gregory Bante, rental rates are falling in most major cities throughout the United States.

Twenty percent (20%) vacancy rates are quite common for office space throughout major cities in the United States. This is true in such cities as Denver, Phoenix, Austin, Chicago, and even in many places in California, such as San Francisco and the Silicon Valley.

Pockets of commercial real estate throughout the country continue to be fairly strong, such as mid-town New York City, which has gained strength as a result of a shifting of some of the office population to mid-town from the lower downtown, following the September 11, 2001 tragedies.

OTHER REAL ESTATE

In addition to a weak office market, other sectors of the real estate market are also suffering. Hotel and resort areas generally suffer from low occupancy and reduced rates.

Building permits are substantially down in the apartment sector, as reported by the Home Builders Association (HBA). Overbuilding in this area is especially prevalent in a number of major cities, such as Denver, which has vacancy rates for multi-family housing in the area of 15%.

Foreclosures are increasing in many parts of the country, whether the foreclosed property involves residential or commercial property. However, because of the lower interest rates, it is true that many property owners have been able to sustain what would have been a very negative cashflow position.

INTEREST RATES

The lower interest rates that have been present for several years, resulting, recently, in the lowest interest rates in the last 45 years, have been the saving grace in not only the residential markets, but also in commercial real estate markets, supporting a positive cash-flow position, even with higher vacancy rates.

The continued ability to acquire or hold property as a result of favorable, low interest rates cannot be over-stressed. The single, key factor of lower interest rates have kept alive many markets that would have otherwise been in dire straits.

It is quite easy to illustrate this impact on the residential marketplace. If the amount of debt in question for a residential property is, for example, \$200,000, with interest at 5% on \$200,000, this is \$10,000 in interest, per year. However, the interest at 8% is \$16,000. Therefore, the \$6,000 difference results in a payment differential, for only the interest factor, of \$500 per month.

Such payment differential makes it clear that many "prospective buyers" would not be able to purchase, as they would be disqualified from this level of home ownership, because of increased monthly payments due to the higher interest rate.

If this same concept is pervasive throughout the residential, single-family home market, with an increase of interest rates from 5% to 8%, as illustrated, this 3% difference would be a disaster for many residential real estate markets, especially for purchases of homes, refinancing, new furnishings for the home, possible home renovation and improvements, and other support activities.

If we extrapolated from the above example, by assuming that there is a debt of \$2 million on the property, as opposed to \$200,000, the 3% differential, the increase in the interest rate, results in a \$60,000 per year increase, or \$5,000 per month.

This example becomes further compounded, when extrapolating, if we assume the given debt is \$200 million, as opposed to \$2 million. Applying this same 3% differential on interest rates makes it quickly apparent that there is a huge and adverse impact by this 3% adjustment. Thus, at any level, the 3% increase had an enormous, adverse impact.

Knowing this interest rate differential, the implicit question is: "When will such rates increase?" The most recent indicators show that interest rates have been increasing, although there have been some blips, up and down. Implications of such movement is magnified, on the negative side, by considering that the slight movement in interest rates from July and August, 2003, resulted in an approximate 25% to 33% decline in refinancing.

As reported in Freddie Mac's *Primary Mortgage Market Survey*, the 30-year fixed rate increased at the end of July to the first part of August, 2003. This dampened the refinancing market.

As reported in the survey by the Mortgage Bankers Association of America, their Real Estate Center online news, August 1, 2003 report, mortgage loan applications for purchases and for refinancing for the end of July, 2003 decreased by almost 25%.

Although the Federal Reserve Chairman, Alan Greenspan, noted in his testimony before the Committee on Financial Services in Congress on July 16, 2003, that the market was somewhat "positive," and that interest rates would remain low, to help the economy recovery, concern continues in many areas. This is especially true considering the higher unemployment rate of over 6%, an increased deficit, increased strain on the economy because of war and terrorism, and other negative positions, such as the decline in high-paying jobs as a result of outsourcing many of these jobs by some companies in hiring employees from outside the United States.

Chairman Greenspan stated that we may be on the verge of an economic growth; but, that is the concern: We are on the verge: We are not "in" a substantial growth position.

It was reported in an article by Adam Shell in *USA Today* (July 15, 2003), that the economy, as seen by Chairman Greenspan, was "poised" for a rebound. The concern is to determine "when" such rebound will occur, and what negative factors may defer such recovery.

"WHEN" DO WE GET THERE?

In the earlier-noted testimony by Chairman Greenspan, made to Congress at the end of July, 2003, many questions have been raised as to how we can have a recovery if unemployment contin-

ues to be high, and the nature of the jobs that we are losing, such as high-tech and other well-paying employment positions, are lost to new hires from outside of the United States. This issue was also recently raised by Representative Michael Castle of Delaware. This issue has been raised by many others, who still seek the answer to the issues as to "when" and "what" will cause the U.S.A. to reach the recovery stage.

As reported by Sue Kirchhoff, in *USA Today* (July 16, 2003), Chairman Greenspan stated, before Congress, that the support for the lower interest rates will remain "for as long as it takes" for the market to recover.

There continues to be concern with the Federal tax cuts, and whether the tax-cut decision by Congress and President Bush will provide an impetus for improvement in the economy, or provide a larger and bigger deficit that will be that much more difficult to overcome. This issue was discussed by Chairman Greenspan in his testimony on July 15, 2003, before Congress and, specifically, before the House Financial Services Committee. The article by David Firestone, in the *New York Times* (July 16, 2003), detailed the concern with these issues and the increased deficit that will further strain the economy.

Chairman Greenspan has supported the position that, with tax cuts, there also needed to be spending restraints by Congress to allow the tax cuts to be effective for the economy to recover. Whether those restraints will come about remains to be seen.

What should be very disconcerting to many investors, lenders and others involved in the financial market, and with particular focus on real estate, is the impact that a strong and continues spike in interest rates will have on the real estate markets.

On the negative side, for whatever reasons the interest rates spike, it is clear that this could be very damaging to the economy. Concern with inflation, deflation, outsourcing of jobs, unemployment, terrorism, an increase in the Federal and state deficits, etc., will seriously impact much of the rental real estate market. Such negative items may produce a concomitant hold-back on expansion by many companies. Vacancy rates would continue to

increase. Home sales would slow. Refinancing would, for most intents and purposes, mostly end, whether for residential or commercial property, and there would be continued pressure for financial positions that involve variable rates, adjustable rates, construction loans and other short-term interest rates, where the newer, current rates would be substantially higher than the rates for the first few years in 2000. This scenario would, in turn, cause additional foreclosures, a slowing of activity in the general economy, and a time interval for regrouping within the marketplace.

There is the hope that such spiking of interest rates would not come about. However, the implications of such spiking should at least be considered and substantially weighed by those who are facing debt positions.

Under the current setting, there are certainly favorable performance grades that could be issued for the marketplace. For example, the residential real estate market would continue to receive an "A" grade, as activity in the residential real estate market, and particularly the single-family home market, continues to be strong. Pricing of homes remains strong. (Prior articles and commentaries have discussed the reasons for such positions, including a lack of other alternatives to place monies, the comfort level with "bricks and sticks" as opposed to intangible positions, a reduced desire to enter the bond market because of low rates, the uncertainty and volatility of the stock market, and prior-year losses, among other issues.)

The Consumer Confidence Index (CCI) continues to drop. Should it sustain further losses, this, concomitant position, with the potential increase in interest rates, spells a very negative scenario for the marketplace.

Although home sales for new property generally continue to increase, existing home inventory sales have slowed in many areas; and, the inventory of homes on the market continues to grow in many areas.

Home affordability for home purchasers continues to be favorable, given the lower interest rates. However, the recent increase of interest rates at the end of July, and the first part of August, slightly reduced the affordability ratio.

Vacancy rates in office space continue to rise. Therefore, in many markets, existing vacancy rates would receive a "C" grade, at best.

Motels, hotels and resort properties have also experienced higher vacancy rates and lower rental rates, thereby producing a lower rate or grade of a "C" to "C-" in many markets.

Favorable financing continues to be the key factor. Although financing might have received an "A+" grade over the past year, recent events might reduce that to an "A" under the current scenario.

Other types of commercial property have various grades that might be assigned for performance, but generally would be in the "C+" to "B+" grade range, depending on the type of property and location throughout the country.

Industrial space remains fairly strong in many parts of the country. However, retail space is showing signs of overbuilding in many areas. As reported in the Wall Street Journal (July, 2003), shopping center vacancy rates have increased. (However, occupancy rates are still fairly favorable.)

CONCLUSION

To the question, "ARE WE THERE, YET?" the conclusion is that we are not there yet.

But to the question, "WHEN WILL WE GET THERE?": This answer depends, in part, upon job growth, stimulus in the economy to gain a sustained position for more jobs, and a more positive attitude for the consumer confidence level to be sustained at a higher rate for a number of quarters.

It is unlikely that there is much stimulus in the economy to turn the corner and produce a "quick-fix" to "get us there." Although the tax rate cuts have been made, it is unlikely that they, alone, will provide the stimulus necessary to "jump-start" the activity of the economic engine for the real estate market as well as the economic market in general.

Even if we assume that interest rates remain fairly low, that much of the vacancy in multi-family units and office space is absorbed because of reasonable expansion, a positive attitude, and lack of terrorist activities, the likelihood is that arrival of a strong economy will not occur, until, at best, later in 2004.