# FOCUS ON THE ECONOMY

## THE END ISN'T NEAR . . . BUT REPENT ANYWAY!

*by Hugh F. Kelly, CRE*

Well, we have gotten through Y2K without needing to draw on all that bottled water and canned food. The survivalists have come back from the mountains. The confetti is cleaned up from Times Square. Airplanes didn't fall from the sky. At last report, ATMs had not cycled back to the year "00" and were still dispensing dollars, not wampum. Even the hangovers have gone away by now.

When I was growing up, magazine cartoonists had clipart of a bearded, rumpled old man carrying a sign saying, "The End is Near!" The punch line would vary, depending on the news of the day. But the comedy was always the same: the out-of-touch doomsayer with the millenarian message versus the go-getters who made the world revolve. We, the readers, always knew something that the local Nostradamus couldn't see and our laughter never involved adopting his perspective. The end *wasn't* near; the party was destined to go on. That was the point of the joke.

By the time this edition of *Real Estate Issues* is in your hands, we will have passed another significant event on the calendar. The present economic expansion will have set a new record for longevity. Young people who were in grade school at the time of the last recession will be preparing for their college graduations. Their fortunate older brothers and sisters, who were given a few shares of Microsoft as a graduation present in 1991, are now gazillionaires if they have had the sense to hold on to their grub-stake. When will the party end? Even for those of us who still cling to a belief in the business cycle, there is no date fixed for the ball to drop, signaling the end of this extraordinary period of growth. Our economic times are worth reflecting upon, as they have been exceptional not only in length, but in the magnitude and the character of their vigorous gains.

First, it should be said that no expansion dies of old age. Typically, recessions are the result of either economic suicide or homicide. The "suicide" scenario involves death from overdose, too much of the high life that overheats some critical economic sectors until a reaction sets in. Such recessions are, in effect, corrective measures in our economic system. "Suicide" is probably too final a term, as the mechanism of a recession in fact serves to slow down the economic pulse, rather than arrest the heartbeat entirely. The "homicide" recessions are those either deliberately induced (such as the inflation-killing recessions of the early '80s, engineered by the Fed under Paul Volker) or those that are triggered by hostile maneuvering (including the oil crisis downturn of the mid-'70s and the Gulf War recession of nine years ago). Again, "homicide" overstates the case since we have, up to now, always been able to rebound from the crisis.

Second, and notwithstanding the frequency with which we see real GDP growth soaring above four percent, this economy has not been hitting on all

cylinders. We have been congratulating ourselves about the breadth of the American economic revival, most notably seen in a three-month skein of 4.1 percent national unemployment, the best jobless rate in 30 years. But we actually have had many soft spots in the past year or two. A simple list would include:

- A manufacturing sector which has seen recent employment losses in all industries except for automobiles
- A capacity utilization rate that was 80.7 percent in October, an indication that our production chain is relatively slack given the duration of this expansion and that the surge of investment in plant and equipment during the '90s is seeing sub-optimal returns
- A negative trade balance of historic proportions, with each quarter's dip in the current account creating a drag, now approaching $100 billion every three months, on total GDP
- An absolute drop in exports (not just a lag relative to high import volumes) from approximately $680 billion in 1997 to $660 billion in 1999
- Federal belt-tightening that has seen government spending growth slip behind real GDP increases, not only in social programs but in defense (0.9 percent nominal growth in Fiscal 2000, or a loss in constant dollar spending) and in net interest payments to the private sector (one of the consequences of a budget surplus that lets us retire high-yield Treasury debt)
- An agricultural economy that is truly distressed, with net farm income at its lowest level in a decade
- We shall probably never know the extent of the productivity wasted in the obsessive attempt to exterminate the Y2K computer bug, but it cost at least a couple of decimal points in GDP during 1998 and 1999.

In the face of such measures, it is all the most stunning that we have not only kept growing for so long, but have continued to expand robustly. The list immediately above, however, does not exhaust the sources of concern. Socially, we have to worry about our incredible shrinking savings rate, the persistence of the underclass in the midst of general prosperity, and the question of why – for all our wealth– we find large swaths of the population unable to find decent housing, medical care, or quality public education. And, with the Japanese model squarely before us, we need to consider the helium-powered stock market and the potential consequences of Wall Street running out of gas in the near future.

Real estate professionals do well to attend to the total economic picture, good and bad. Real estate is best conceived as a residual product of economic activity, receiving its value from the ability to provide functional, well-located, pleasing, and economically appropriate facilities. Real estate exists to house people and their interactions at work and play, to provide a place to fabricate, store, distribute, and sell goods. The very term "economy" comes from the Greek *oikos*, meaning "house." I have found that real estate, with all its tangibility, is an excellent vantage point from which to view the economy as a whole, since property value so intimately reflects economic demand stemming from every conceivable sector.

If I have my reservations about the current good feelings about the economy – based upon the factors I've listed – I still do not see any immediate stumbling block that would end the successful run of GDP gains in the near future. We have too much momentum thus far in 2000 for any sudden contraction to be likely. Industrial production figures started to improve last summer and the National Association of Purchasing Managers Index for November was solidly positive. Real personal income is advancing smartly and consumer confidence is high. Thus, we have just had the best holiday sales season in more than a decade, both in stores and on-line. After-tax corporate profits have doubled since 1990 and are up 5.5 percent in the past year. We have a Federal Budget in surplus, giving the government plenty of ammunition for economic stimulation should it be needed. And we already have a high real interest rate – the spread of short-term rates over the CPI – that gives the Federal Reserve tremendous monetary flexibility should it be needed, as it was in late 1998.

No wonder that there is snickering at any suggestion that "the end is near" for this cycle. Our biggest danger might be complacency, the optimistic belief that growth will go on forever. Real estate analysts know what this unrealistic faith looks like: revenue projections that grow faster than inflation throughout the cash flow projection, coupled with an aggressive discount rate to calculate Net Present Value.

In fact, we don't know which of the numerous economic risks lurking out there might tip the economy into recession. It is important, though, to recognize that the risks are real. During the long and very impressive cycle of the '90s we dodged a couple of exceptionally serious troubles, including the threat of a commercial banking collapse in the U.S. between 1990 and 1993 and the potential for a severe global decline in 1998. Our hope in continued expansion is the likelihood that many of the weaknesses listed above are already in the process of correction. But the economy gives us no guarantees.

Don't be too dismissive of that old gentleman or his sign. As is so often the case, there is great practical benefit in a biblical injunction: Be watchful. You do not know the day or the hour. The best insurance against the ill effects of a recession, after all, is to anticipate that you will one day need to cope with the downturn. The best time to start that planning is now. REI

## ABOUT OUR FEATURED COLUMNIST

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