



Capital Metes and Bounds

By James M. Murphy, CMB, CRI

DEBTOR NATION??

This newsletter has always maintained a positive outlook on the world of commercial real estate and mortgage finance. That is not to say that there is not cause for concern and some readers may disagree with what is said here but if so we are interested in any factual dispute. There is little debate today that we are reaping the benefits of loose lending policy in both the residential and commercial mortgage markets. The end result is forced de-leveraging across the entire capital market structure from borrowers to lenders to rating agencies to investment banks to servicers.

Given this backdrop, how is it a good idea for our government to become the largest debtor in the world? It has been said before here that unfunded liabilities for Medicare and Social Security now total over \$65 Trillion. The current budget projections are for the federal deficit to grow by over \$11 Trillion in the next ten years and that is based on what the General Accounting Office (GAO) says are unrealistic assumptions about growth in the economy. In ten years time, the Congressional Budget Office thinks the national debt will absorb 80% of the Gross Domestic Product. Our elected officials have demonstrated their inability to fiscally manage either Social Security or Medicaid and now they propose national health insurance. The Presidents budget contains \$650 Billion for this program but the GAO differs and says the number is \$1.2 Trillion. The United States now owes nearly \$3 Trillion to other nations through our treasury debt and this is about to grow exponentially.

The merits of government intervention in the banking, insurance and automobile industry can be argued either way but one thing is clear. If you take government money, caveat emptor. The deal you thought you made may not be the one with which you end. Executive compensation, product choices and even your ability to repay may be in question.

The single most troubling aspect of the GM bailout to the capital markets is the failure to give priority to bond holders. The end result must be skepticism from debt providers anywhere in the world. Why would any lender take the risk of lending to a U.S. corporation in need of capital, when the government can take centuries of contract law and abrogate it.

All of the stimulus is being sold on the basis of "saving or creating jobs". No economist in the world can tell us how to measure a "saved" job. The simple fact is that there continue to be signs that the economy is improving without the stimulus. Last months job losses declined to less than 350,000 and while it brings the total losses to over 6 million, more and more indicators are showing improvement. Of the \$800 plus billion approved by Congress, less than 6% of the money has been spent. The President's own Chair of the Economic Council, Christine Romer wrote in 1992 that it was not fiscal policy that brought us out of the Great Depression but rather monetary policy. What if the over \$2 Trillion in stimulus by the Federal Reserve as shown below is enough and we are putting ourselves into debt for naught? Why not take a breath and see whether Federal Reserve actions are enough before force feeding the country into debt and saddling future generations with over \$300,000 for every man woman and child in the country?

Figures in Millions

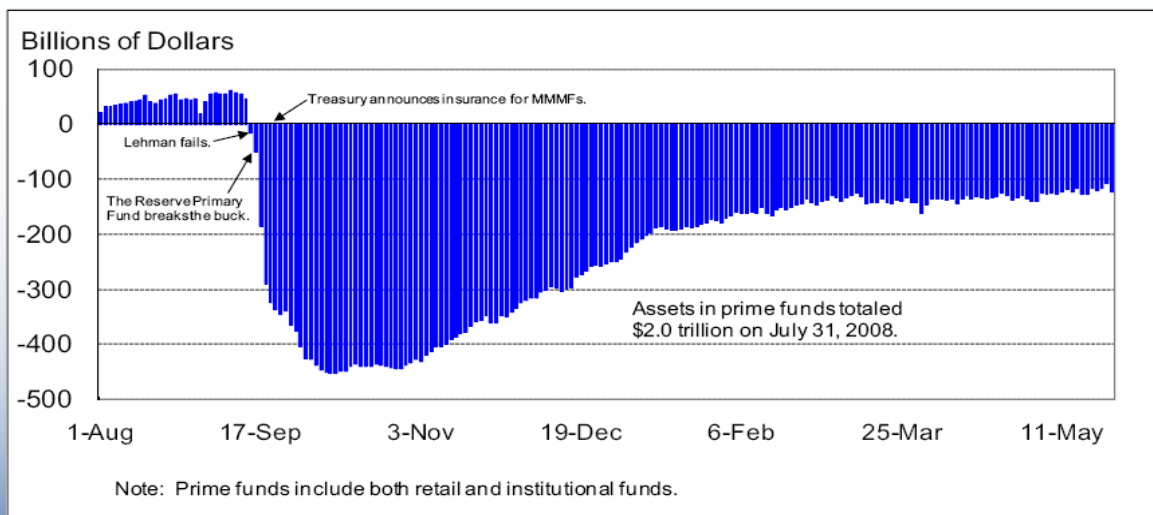
Reserve Bank credit	2,066,244
Securities held outright	1,114,473
U.S. Treasury securities ¹	606,158
Bills ²	18,423
Notes and bonds, nominal	540,022
Notes and bonds, inflation-indexed ²	42,803
Inflation compensation ³	4,910
Federal agency debt securities ²	80,704
Mortgage-backed securities ⁴	427,612
Repurchase agreements ⁵	0
Term auction credit	372,540
Other loans	126,054
Primary credit	41,930
Secondary credit	1
Seasonal credit	12
Primary dealer and other broker-dealer credit ⁶	0
Asset-Backed Commercial Paper Money	
Market Mutual Fund Liquidity Facility	25,093
Credit extended to American International Group, Inc. ⁷	43,578
Term Asset-Backed Securities Loan Facility	15,440
Other credit extensions	0
Net portfolio holdings of Commercial Paper Funding Facility LLC ⁸	145,139
Net portfolio holdings of LLCs funded through the Money Market Investor Funding Facility ⁹	0
Net portfolio holdings of Maiden Lane LLC ¹⁰	25,772
Net portfolio holdings of Maiden Lane II LLC ¹¹	16,260
Net portfolio holdings of Maiden Lane III LLC ¹²	20,395
Float	-1,857
Central bank liquidity swaps ¹³	176,833
Other Federal Reserve assets ¹⁴	70,634
Gold stock	11,041
Special drawing rights certificate account	2,200
Treasury currency outstanding ¹⁵	42,387
Total factors supplying reserve funds	2,121,872

Moving back to the capital markets and the ability of commercial real estate to access debt, what will the effect of all this borrowing on availability of capital. Is it possible that the private sector may be crowded out of access to capital. This is once again being talked about in economic circles.

Take a look at positives. Money is slowly moving out of short term instruments into other investment alternatives.

Cumulative Change in Money Market Fund Assets in Prime Funds

August 1, 2008 - May 26, 2009



The economic scorecard is improving without the stimulus.

Recession/Recovery Scorecard

Indicator	Peak Value	Peak Date	Low Value	Low Date	Current Value	Typical Range Entering A Recession	Improvement from Low?	Comments
LEI*	9.4	Mar. 04	-4.0	Dec. 08	-3.0	-3% to -4%	Yes	Up in Apr. on financial mkt. improvement.
Consumer sentiment	96.9	Jan. 07	55.3	Nov. 08	67.9	60 to 80	Yes	May sees further rise.
Real retail sales*	7.7	Jun. 05	-7.5	Apr. 09	-7.5	+1% to +2%	No	Still weak.
Payroll employment**	239	Mar. 06	-437	Apr. 09	-437	+100K to -100K	No	No longer deteriorating; still-large declines.
Initial claims***	291	Feb. 06	658	Mar. 09	626	375K to 400K	Yes	Needs to ease further to indicate recession end.
Housing Starts	2273	Jan. 06	458	Apr. 09	458	1200K to 1400K	No	Single family starts steady in recent months.
ISM	61.4	May. 04	32.9	Dec. 08	40.1	38 to 43	Yes	Contraction easing, but still weak.
Yield curve****	-3.72	Jun. 04	0.69	Dec. 06	-3.0	+0.00 to +3.00	Yes	Steepening on recovery or surge in supply?
Corp. quality spread*****	21.70	Dec. 08	2.66	Jun. 07	11.6	+6.50 plus	Yes	Spread easing significantly.
Stock prices (S&P500)	1540	Oct. 07	757	Mar. 09	890(-43%)	-10% plus	Yes	Likely will not re-visit lows.
Oil prices (WTI)	134	Jun. 08	15	Feb. 99	61	\$30 to \$75	Yes	Well off lows, along with other commodities.

*Percent change year-ago

**Average monthly change over 12 months

***Avg. of weekly data; series low is cyclical peak

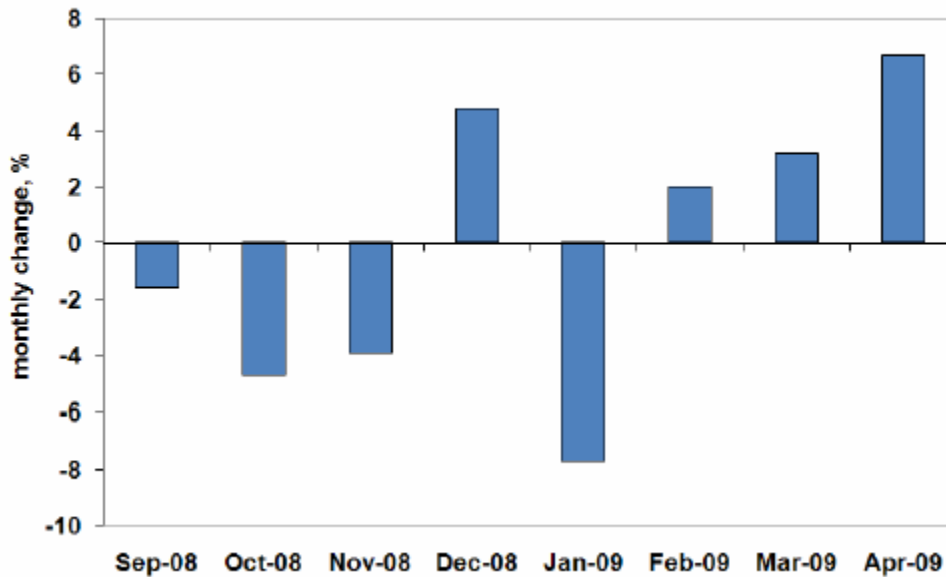
****Fed funds less 10-yr. T-notes

*****ML high yield index less 10-yr. T-notes

Source: Decision Economics, Inc.

Housing is improving.

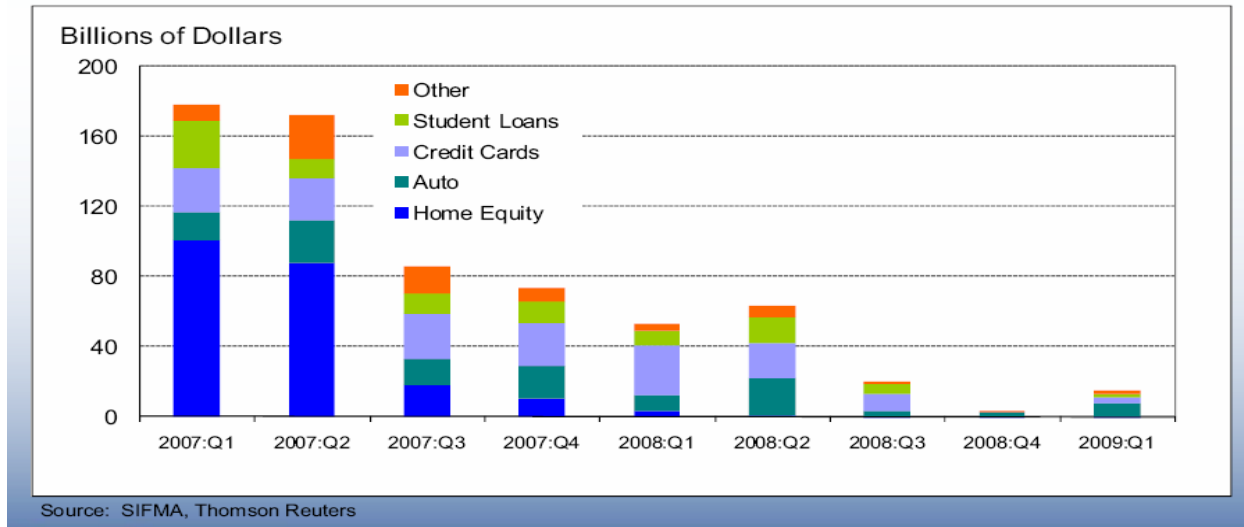
Pending Home Sales



But the capital markets are still frozen.

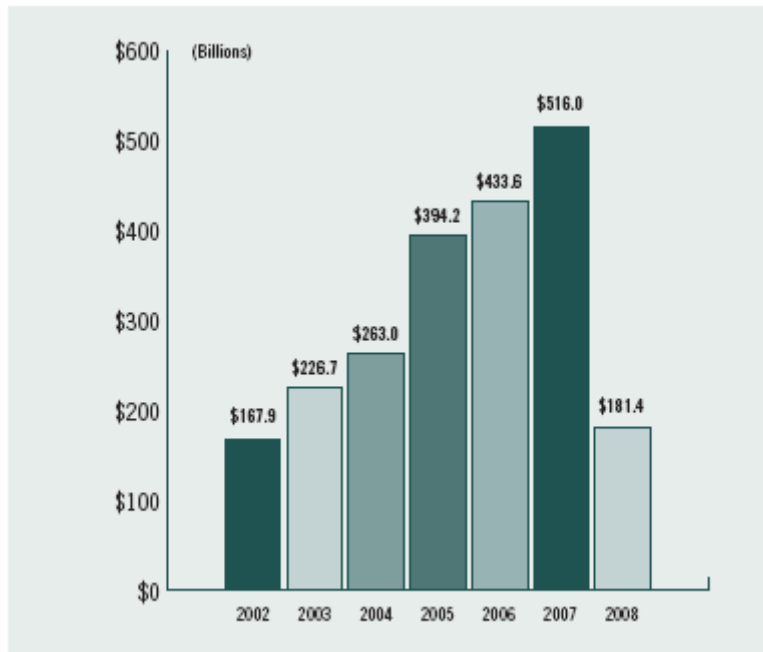
Asset-Backed Securities Issuance by Type

2007:Q1 - 2009:Q1



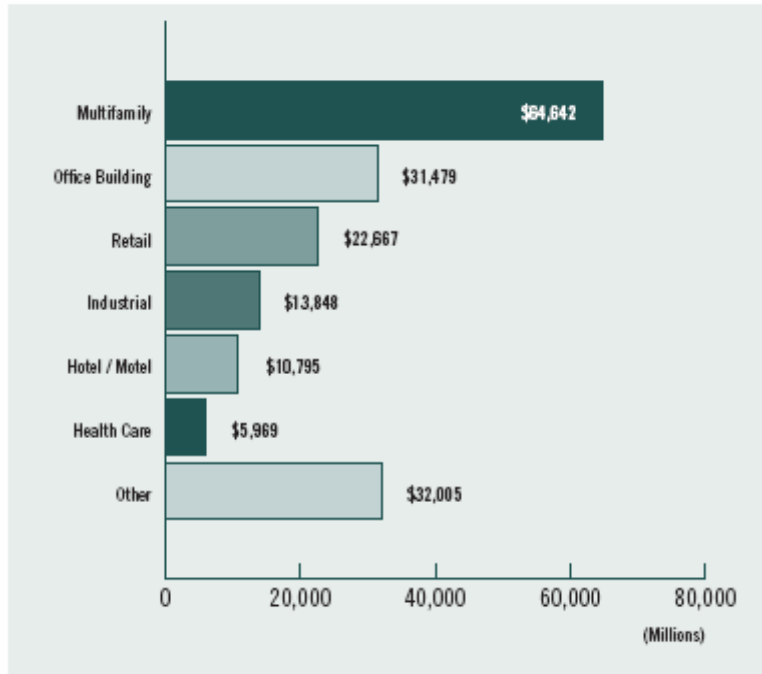
Commercial Real Estate is faring no better.

Total Originations



Source: Mortgage Bankers Association of America

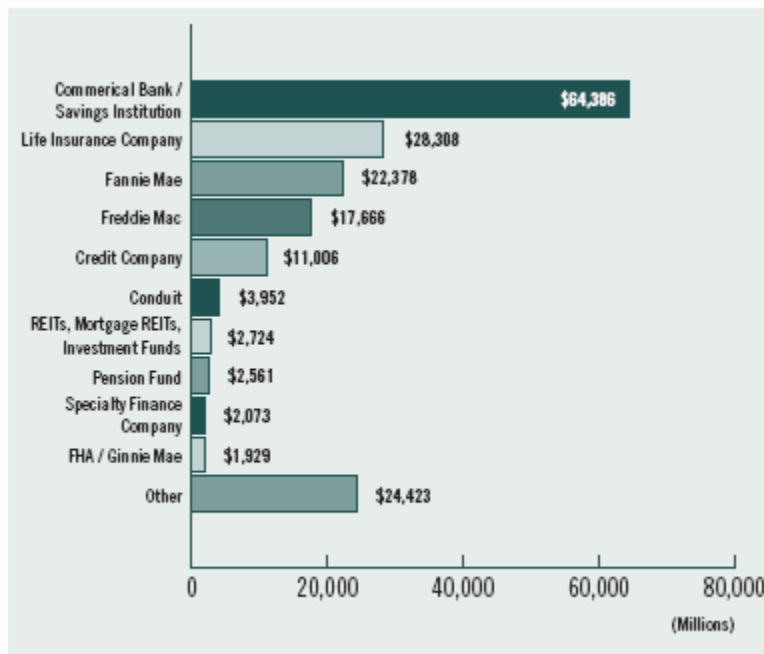
Commercial Mortgage Origination By Property Type



Source: Mortgage Bankers Association of America

The Life Insurance Industry continues as a major player for long term debt while short term lending is dominated by the banks.

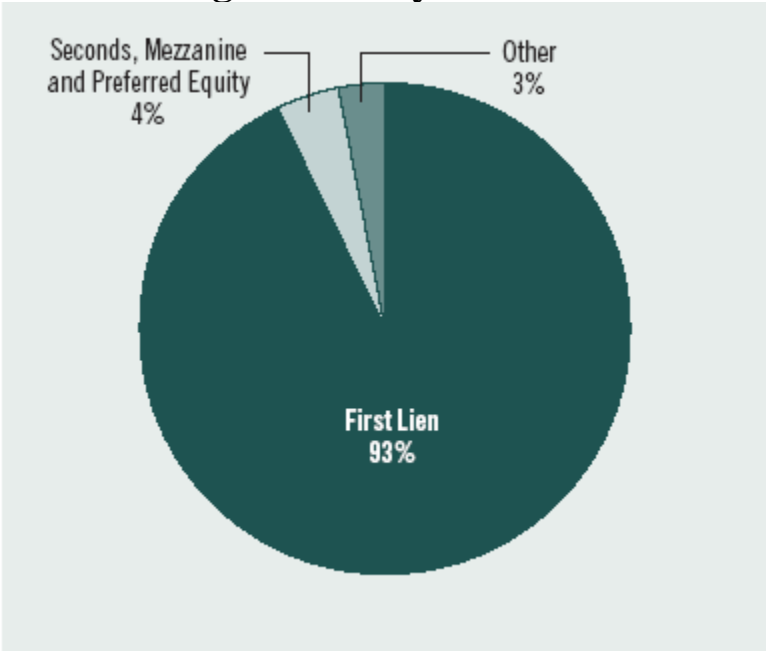
Commercial Mortgage Volume By Capital Source



Source: Mortgage Bankers Association of America

First liens are dominant.

Originations by Structure

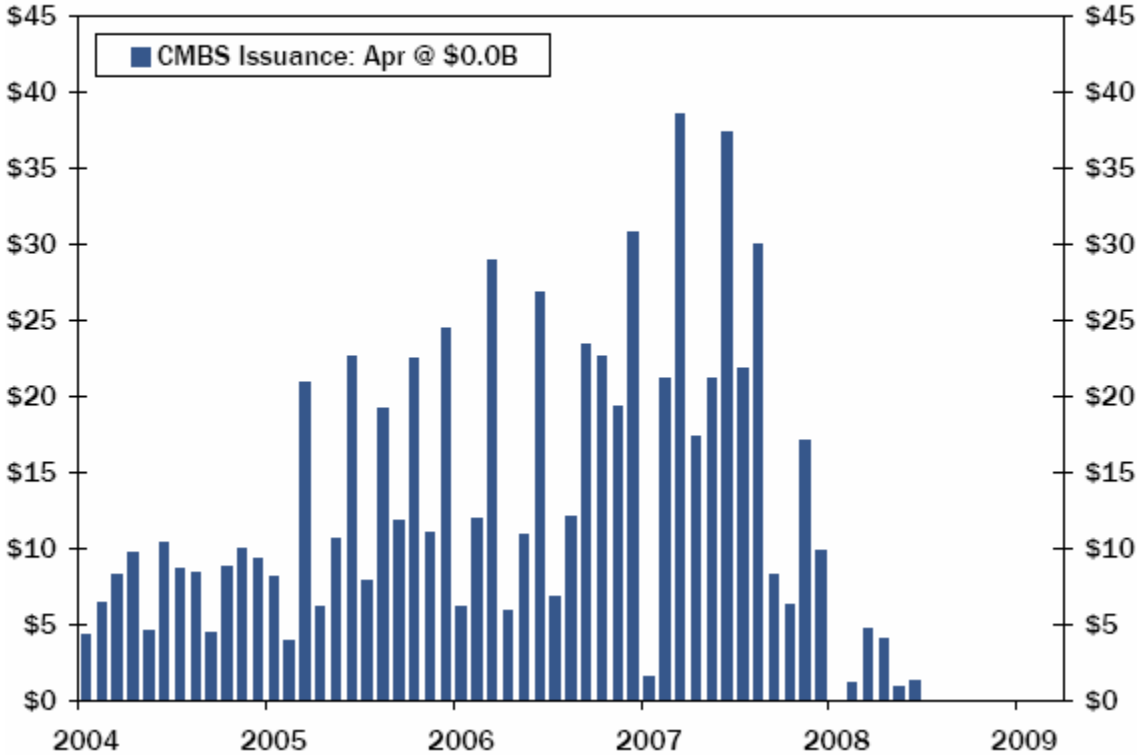


Source: Mortgage Bankers Association of America

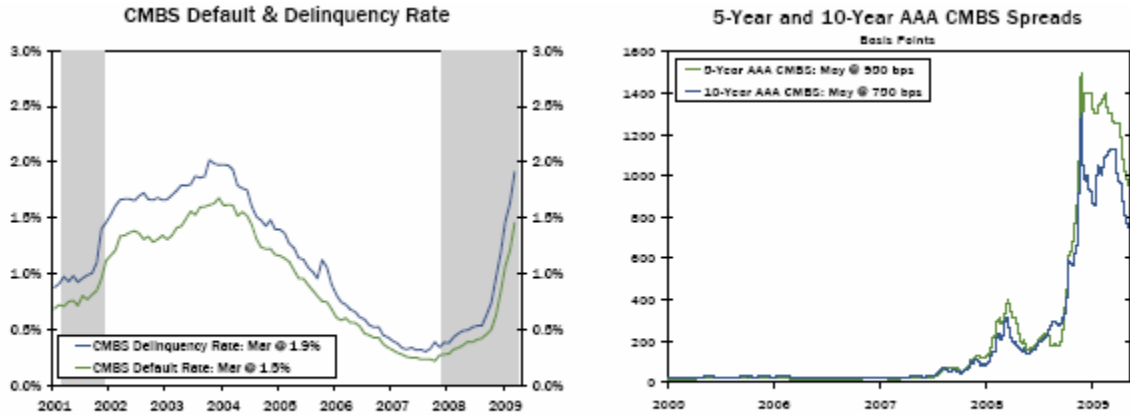
Mortgage Backed Security Issuance is still non-existent.

U.S. CMBS Issuance

Billions of Dollars

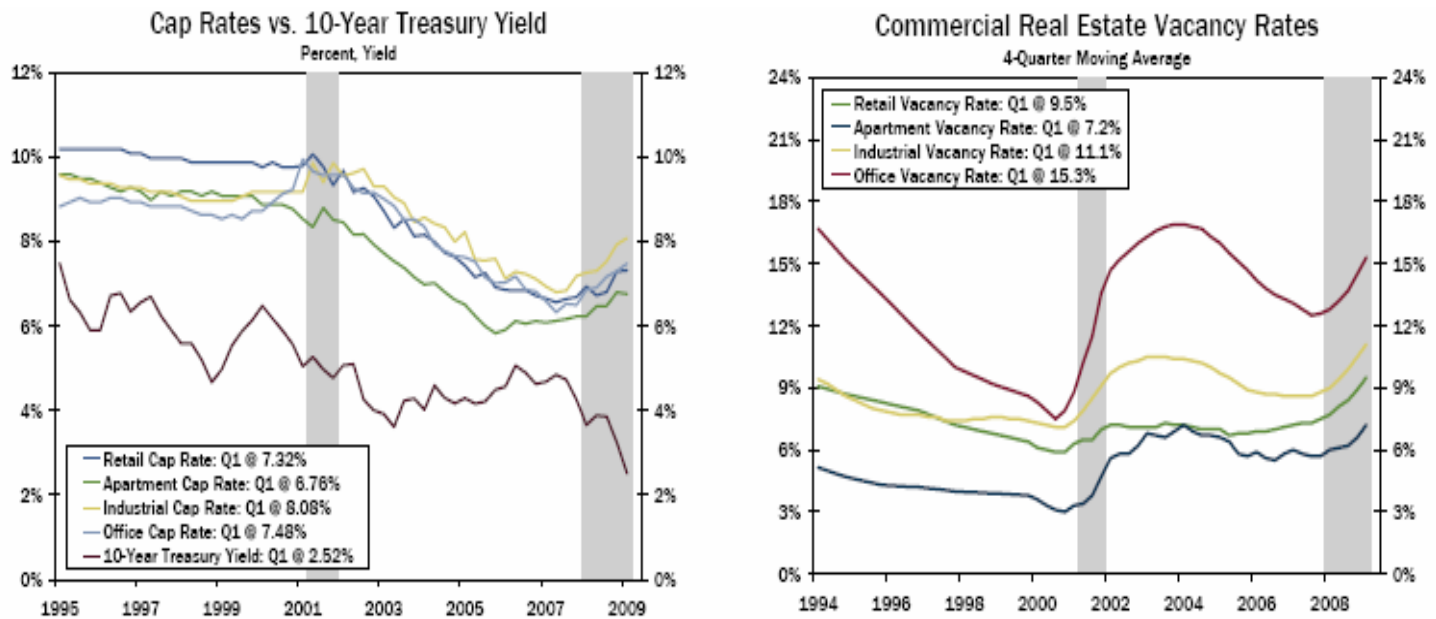


As predicted here, delinquencies are rising in the CMBS market and yet spreads have narrowed.



Source: Commercial Mortgage Alert, Wachovia Securities and Wachovia

Capitalization rates continue to rise to historic means and vacancy increases across all property types but as the economy improves and job losses mitigate the long term future is brightening with short term pain in the offing.



Source: Federal Reserve Board, PPR, Real Capital Analytics, Reis, Inc. and Wachovia

In spite of all the doom forecasts, Q10 capital remains a force in the market and captured over 10% of Life Insurance volume in 2008. We continue to have money for short and long term commercial mortgages as well as bridge and mezzanine financing. For the right deal, there is also joint venture capital available. In addition, we have a client looking to buy \$100 million in discounted notes. Please call your Q10 Capital loan officer at Q10 New England Realty for solutions to your commercial real estate capital needs.