



Capital Metes and Bounds

By James M. Murphy, CMB, CRI

The “Oughts” Are Behind Us Interest Rates Headed Higher

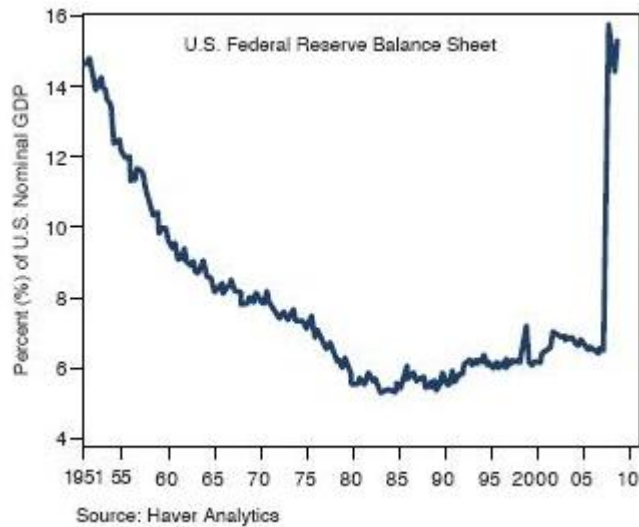
At long last, the years beginning with “Ought” are now behind us. The question remains how long the damage those years inflicted on our largest institutions, future generations and the capital markets will be with us.

The Economy

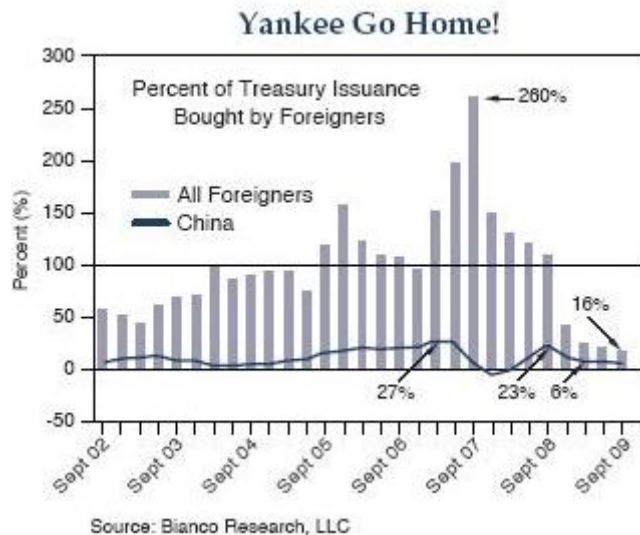
This newsletter is unabashedly free market oriented and will remain so in spite of the chaos caused by poorly regulated free market capitalism and resultant government intervention. This country was built on the power that it is unleashed when individuals are free to innovate, create and grow economically. The positive continues to outweigh the negative and while most of this letter will be devoted to that premise, a little perspective is in order. Unfortunately the “Oughts” saw the results of a failure to properly regulate the free markets.

The failure was endemic! It started with a misguided government policy that every American should own a home. This translated into Housing and Urban Development (HUD) policy that forced the GSE’s (Fannie and Freddie) to loosen proven underwriting standards for ownership. The private sector, motivated by profits, responded with innovative new products for mortgage lending. The no-docs, no income verification, adjustable rate and sub prime craze was born. The rating agencies put their imprimatur on the bonds that Fannie and Freddie sold as they bundled the mortgage loans without regard to the collateral since Fan and Fred had the “implied” backing of the Federal Government. Our House of Representatives and Senate committees charged with funding the Office of Federal Housing Enterprise Oversight (OFHEO) were compromised by millions of dollars in campaign contributions from the officers and friends of the very GSE’s that OFHEO was to regulate. OFHEO found itself a day late and millions short of doing its job. The Federal Reserve aided and abetted the process by driving interest rates to 40 year lows. Anyone protesting this malfeasance to our elected officials was branded as anti-housing and alarmist. The house of cards eventually had to collapse and did, dragging homeowners, GSE’s, bondholders (foreign and domestic) and the government along with it. The USA has always wanted a global capital market and when it finally occurred, we nearly collapsed it.

The housing crisis was just the beginning as the impact rippled through the economy, the capital markets ceased to function. Investment banks, automobile companies and behemoth financial institutions began to fail. Ben Bernanke and the Federal Reserve intervened on an unprecedented scale and brought us back from the abyss. The balance sheet of the Federal Reserve ballooned as shown below.



The question now is how to unwind this intervention without collapsing the economy. The real fear is that if we don't get our house in order, the world markets will force us to. As you can see below foreigners and China are already reducing their investments in our treasuries which has forced the Treasury to buy our own debt. Some of this is in retaliation for protectionist trade policy which according to the Center for Economic Policy and Research includes tariffs against China on steel, tires, nylon and paper plus 437 additional protectionist moves across the globe. From an economist's perspective, higher taxes, deficit spending and protectionist trade spell disaster.

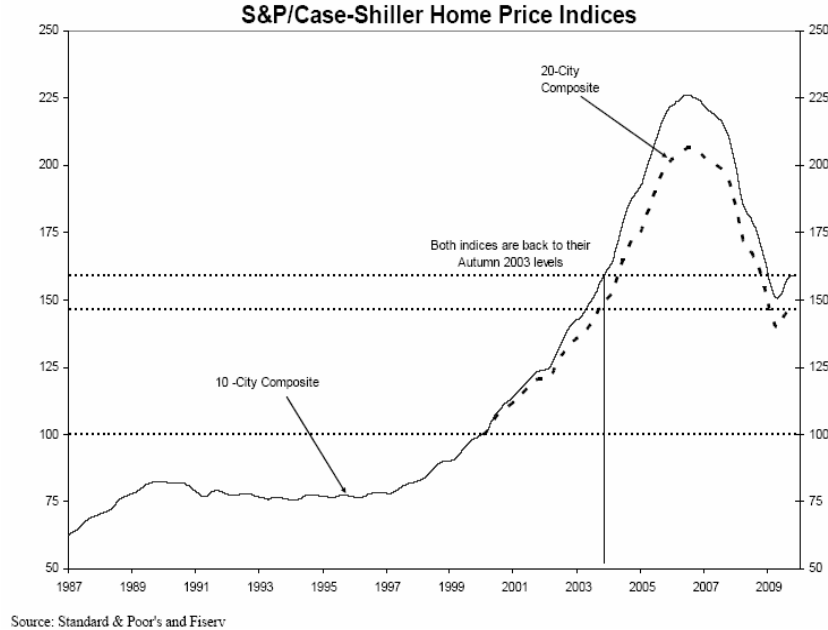


Yet all indications are that our government still doesn't get it. Deficits are now projected at over \$1 trillion for the next ten years. In spite of all the facts, the treasury just lifted its \$400 billion cap on losses for Freddie and Fannie, in the face of over \$100 billion in losses thus far and these two behemoths continue to buy apartment loans at interest rates a full percentage point below private sector rates. What sense does this make?

Investor's Business Daily just reported that the average annual wage for a federal worker is now \$71,206 as compared to \$40,331 for a private sector employee and worse still, one out of five federal workers gets paid more than \$100,000, a number that is up over 33% during this great recession.

Meanwhile the Tax Policy Center states that 47% of Americans pay no federal income tax. Someone needs to stop the madness! Some readers will take this as a political comment but the facts are the facts!

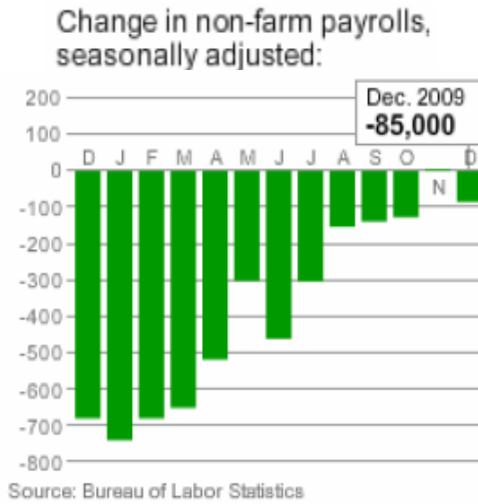
Enough said about the dark clouds that overcame us in the “Oughts” and on to positive news. Home prices appear to be recovering. The Case Schiller Index shows that home prices are now back to the levels of the fall of 2003 in both the 10 city and 20 city indices.



The economy may once again begin to create jobs. The Bureau of Labor Statistics table below indicates that the number of unemployed has dropped over the last two months from 15.6 million to 15.27 million. The number is somewhat misleading as it fails to account for disillusioned workers who have ceased to look and those underemployed who are qualified for better jobs. For the number of unemployed to shrink, we must create more than 150,000 jobs per month to absorb new entries into the workforce.

	Jan.	Feb.	Mar.	Apr.	May.	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
TOTAL												
Population	234,739	234,913	235,086	235,271	235,452	235,655	235,870	236,087	236,322	236,550	236,743	236,924
Labor force	154,140	154,401	154,164	154,718	154,956	154,759	154,351	154,426	153,927	153,854	153,720	153,059
Employed	142,221	141,687	140,854	140,902	140,438	140,038	139,817	139,433	138,768	138,242	138,381	137,792
Unemployed	11,919	12,714	13,310	13,816	14,518	14,721	14,534	14,993	15,159	15,612	15,340	15,267

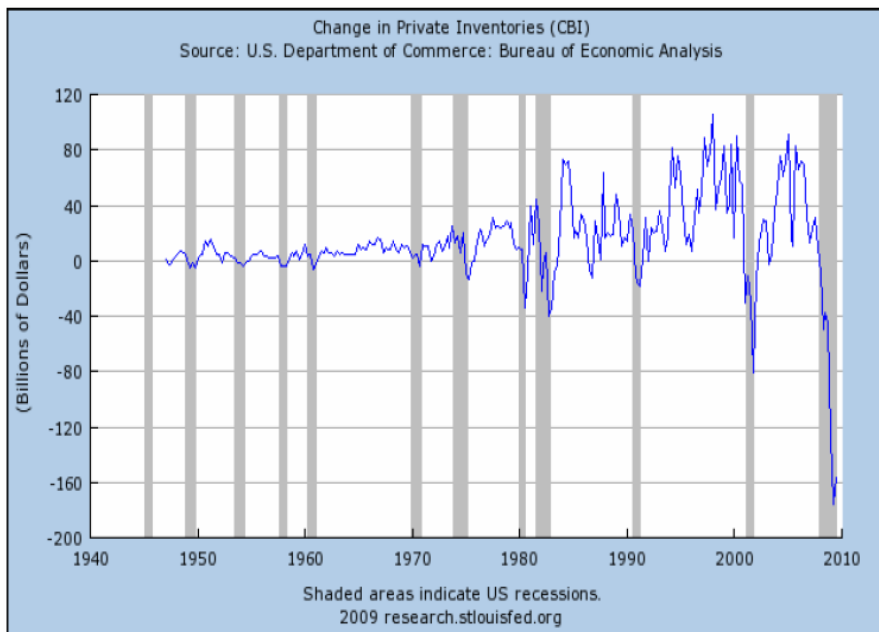
Nonetheless, the trend is improving as job losses mitigate. For the month of November, the economy actually added 11,000 jobs and this accounted for the one-tenth of one percent drop in unemployment from 10.1% to 10.0%.



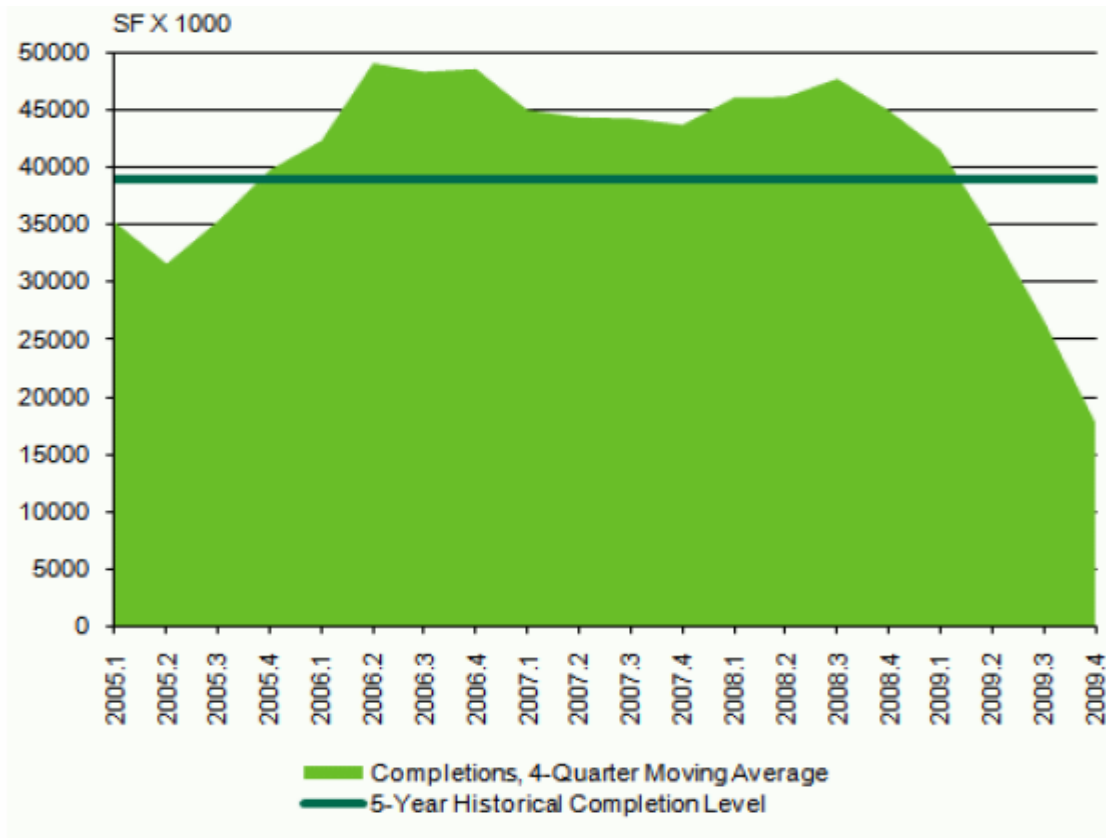
Other good news comes from the U.S. manufacturing industry which grew at its fastest pace in four years with December being the fifth consecutive month of expansion. Supply Management’s national factory index rose to 55.9 in December and any number above 50 indicates expansion. The Consumer Confidence Index also rose to 52.9 in December, a two year high. Lastly, according to the International Council of Shopping Centers sales index, retail sales rose 2.8% over December one year ago.

Commercial Real Estate

Under the no news category is the fact that fundamentals in the market continue to deteriorate with virtually every product type experiencing increased vacancy, rent compression and rising capitalization rates. Even in the bad news there is hope for industrial as inventories replenish.

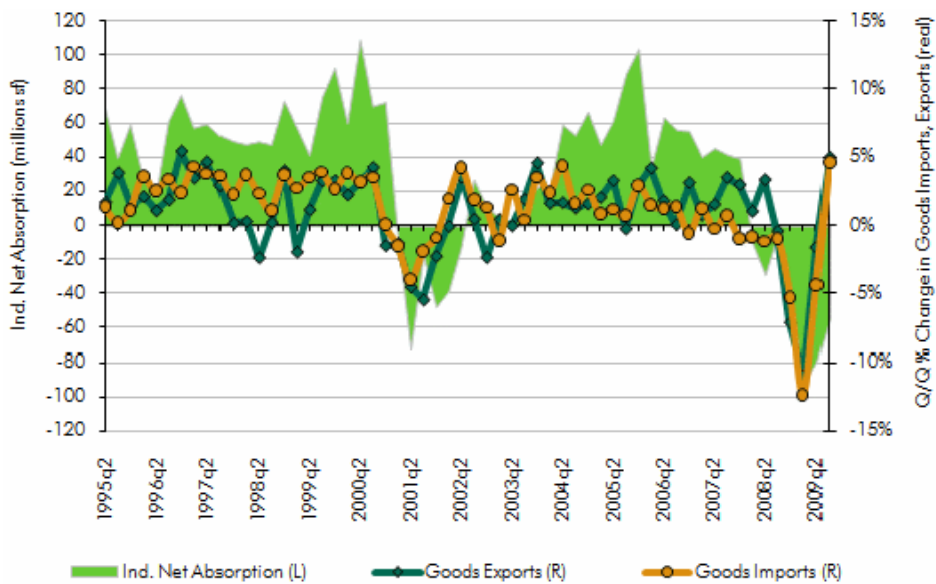


As is often said, warehouse space is the first to adjust to imbalances and completions have dropped to less than half the normal level. This bodes well for the product as business is forced to replenish supply with the economic recovery.



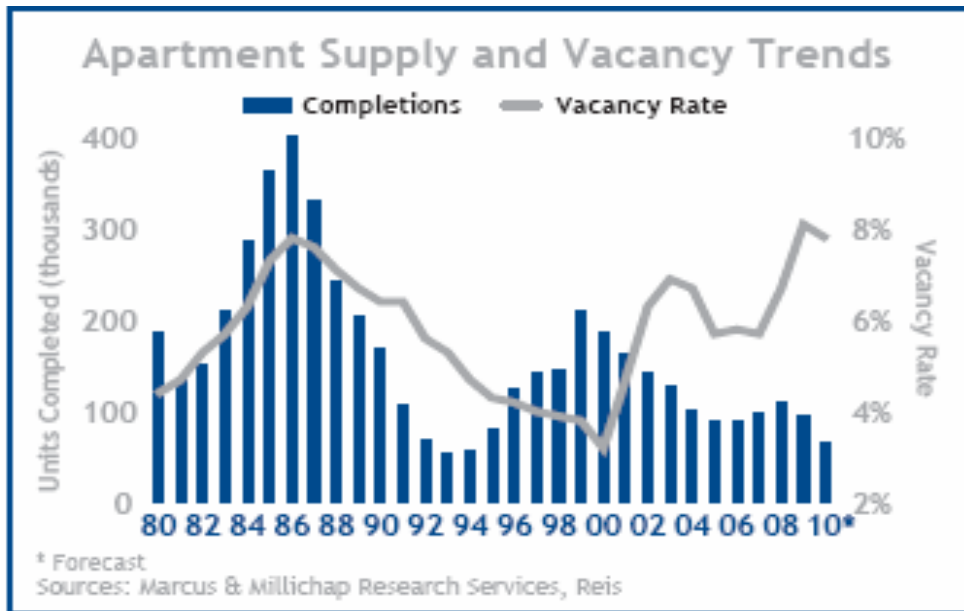
Source: CBRE-EA Industrial Outlook, Winter 2010.

Both imports and exports are on the rise, and firms with a port strategy should fare well when absorption turns positive. This is probably a buying opportunity not seen in decades if one has cash.

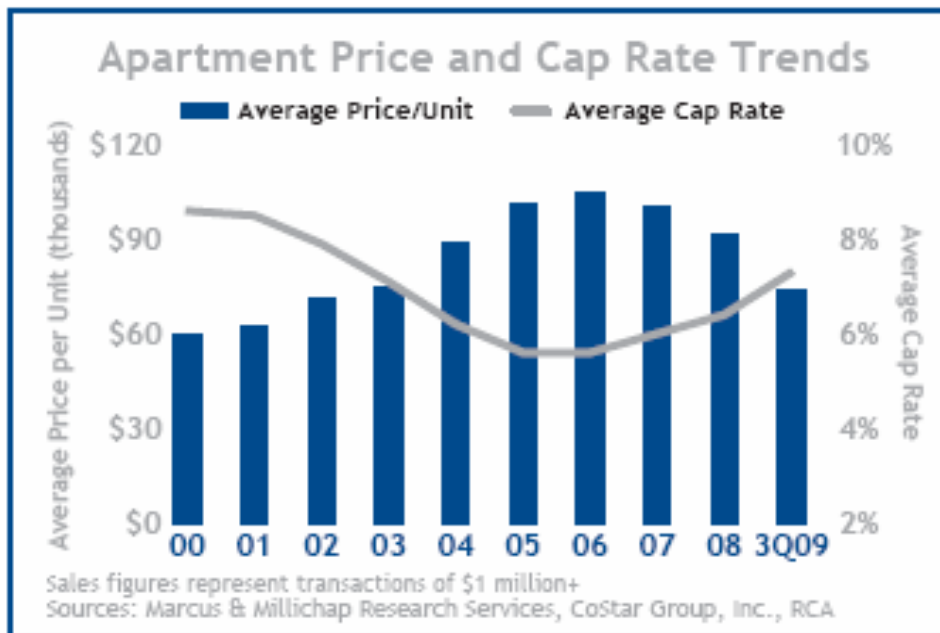


Source: CBRE Econometrics

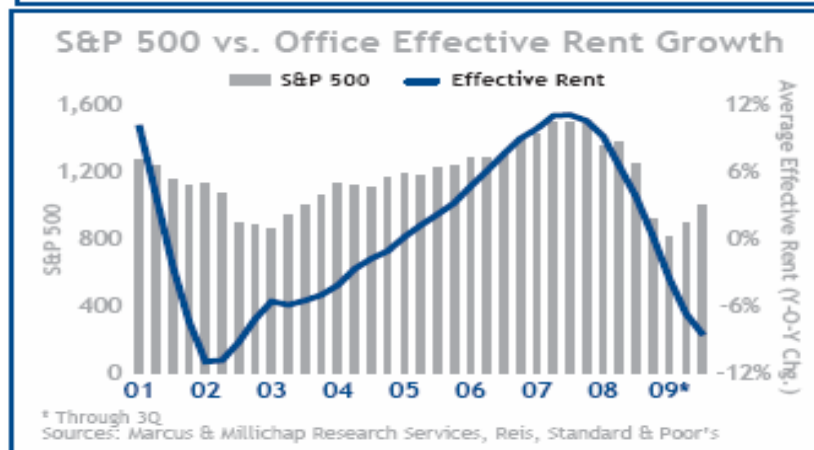
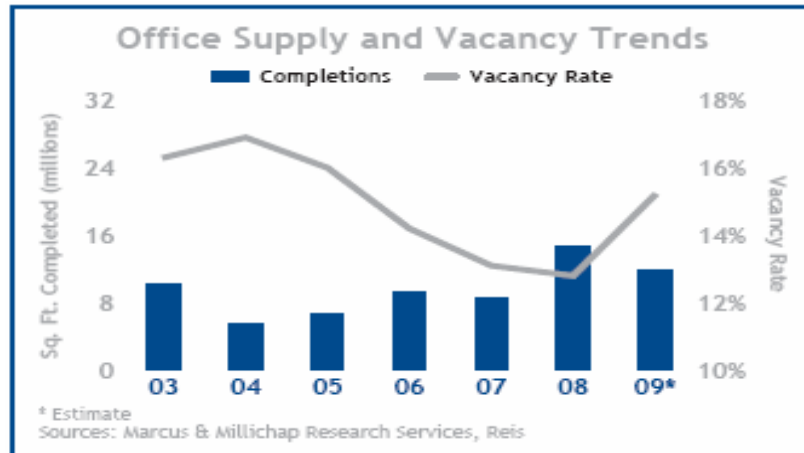
The apartment market may have also seen a turn in vacancy as new supply moderates.



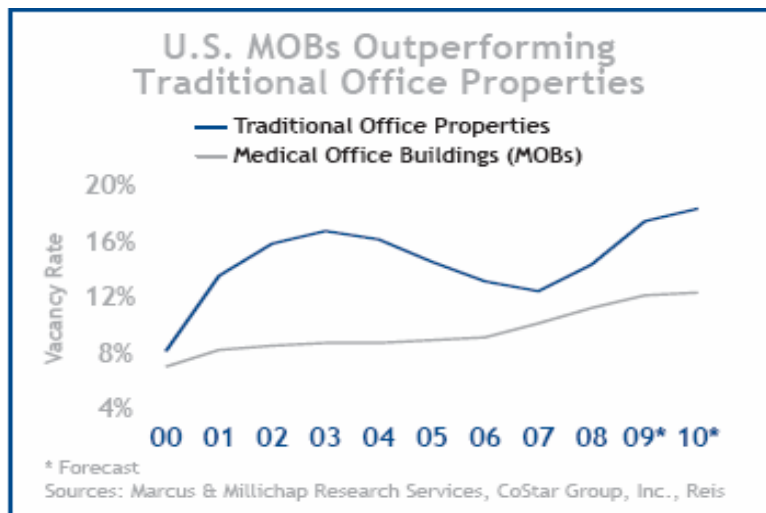
With the condominium conversion craze over, capitalization rates are regressing to the historic mean.



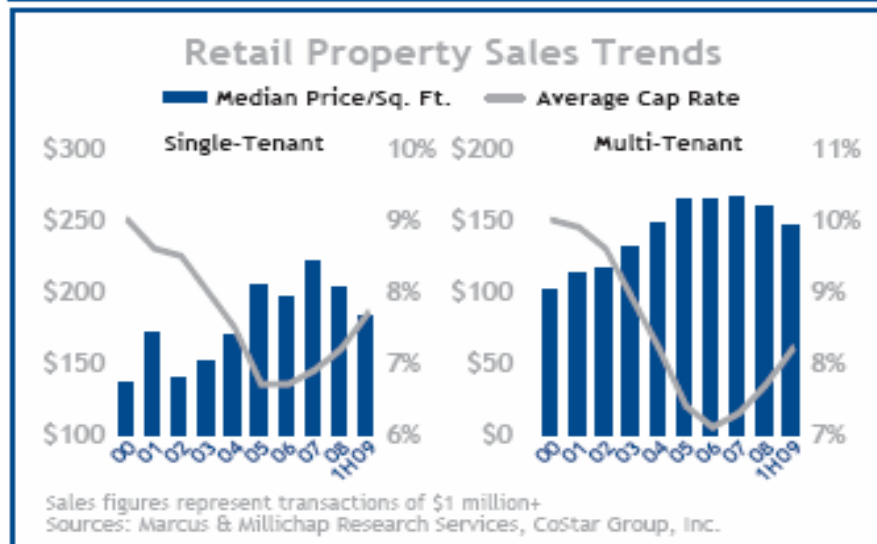
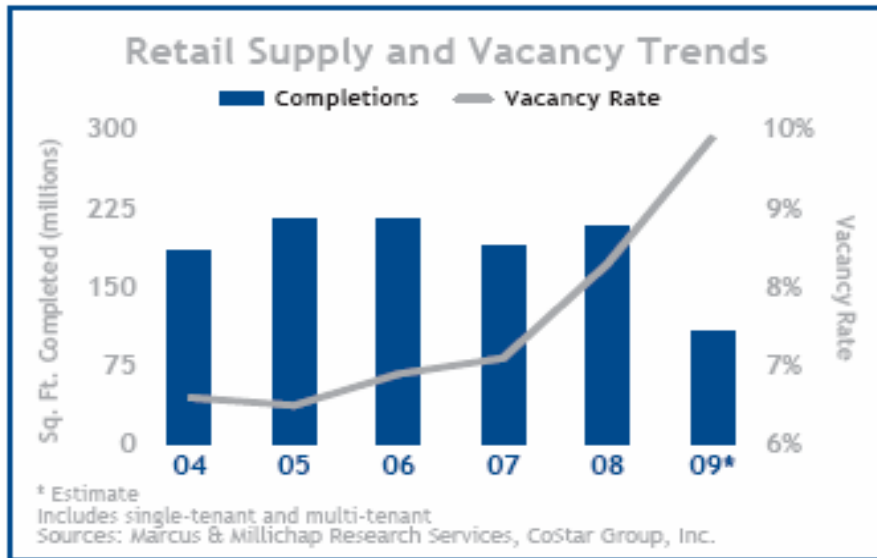
Office looks to be a horse of a different color with both vacancy and rents in disequilibrium. Second only to retail, office is impacted by unemployment and until the economy begins creating jobs, the future remains uncertain.



Medical office seems to be bucking the trend, however and while vacancy is rising, the imbalance is less pronounced.

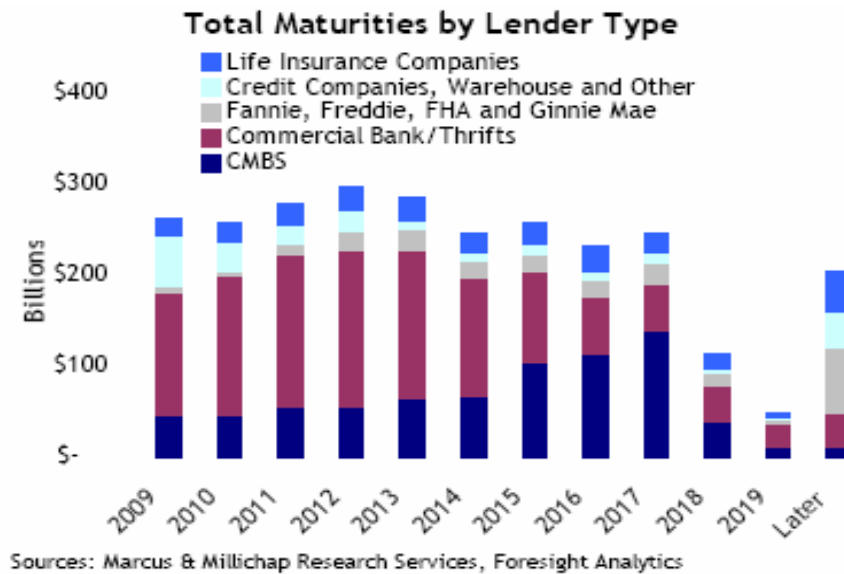


While the Christmas season apparently went well for retailers, vacancy continues to rise as do capitalization rates. While location, location, location is critical without jobs, jobs, jobs, the consumer is reluctant to open the wallet.



Capital Markets – Empirical Evidence as to Why Rates will Rise in 2010

The elephant in the room continues to be the tsunami of debt about to crest on the capital markets. Signs of life are emerging in the CMBS market with the use of the Term Asset-Backed Securities Loan Facility (TALF) money from Uncle Sam. Loans are even being quoted on a one-off basis by a few remaining conduits. For example, we have recently been quoted on \$15 million retail deal that is shadow anchored at a spread that would yield a 6.90% interest rate for a 10 year term with a 30 year amortization. Delinquency continues to rise in existing CMBS and this will impact pricing going forward. December brought a new high for defaults with over 6% of outstanding CMBS delinquent by 30 days or more.



The life insurance industry has recapitalized its balance sheet and we are getting commitments at the 6% level. Underwriting remains conservative with loan to value staying in the 60% to 65% range for most of the industry, but a few have broken from the herd and are offering up to 75% of value for preferred property. The 75% level is critical given that value has now reset. Much more will be revealed at the Mortgage Bankers Association Convention during the first week of February in Las Vegas. We will get a bulletin out to all after the convention.

Where are rates headed?

The laws of supply and demand are inescapable even in the treasury market. The magnitude of Chinese treasury holdings now stands at over \$1.5 trillion and if agency debt is added in, the total exceeds \$2 trillion and the Chinese are reluctant to go higher. At the same time China has begun to curtail trade with us from \$268 billion in 2008 to an estimated \$188 billion in 2009. The reduction in trade means less money to buy our debt. Thus far the Treasury has filled the gap as shown earlier by ballooning its balance sheet to over \$2 trillion dollars. It has done so by buying \$300 billion of treasury debt, over \$1 trillion of toxic mortgage backed securities and hundreds of billions more of debt guaranteed by the Treasury including Fannie Mae and Freddie Mac paper. The chart below shows the effect that China's Dollar Reserves can and will have on interest rates. Imagine what the green bar chart will look like when updated to reflect the current \$2.2 trillion in 2009 and the potential impact on rates. If China decides to reduce its exposure to our debt or is simply unable to keep up with our borrowing and therefore demand is reduced, the Fed will have to move rates to attract buyers. Does anyone really believe that rates will stay at 40 year lows much longer? Let's put \$1 trillion into perspective. U. S. farmland sells for somewhere around \$1,000 per acre. One trillion could buy all the farmland Kansas, Nebraska, the Dakotas, Oklahoma, Wyoming, Arkansas, Colorado, New Mexico, Montana, and Louisiana and maybe even Texas as well. The total capitalization of the Dow 30 Industrial is around \$3 trillion, so China could buy easily one-third to one-half of the Dow companies. If there was ever a time to lock an interest rate, it is now.

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10-year bond yield, 1962-2004 **China's Dollar Reserves 1977 - 2007**



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