Is this a *RECOVERY*?

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Is this a *RECOVERY*?

By Dr. Peter Linneman, PhD
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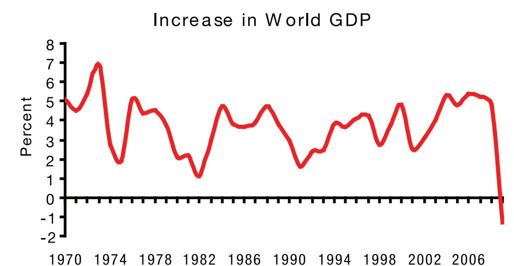
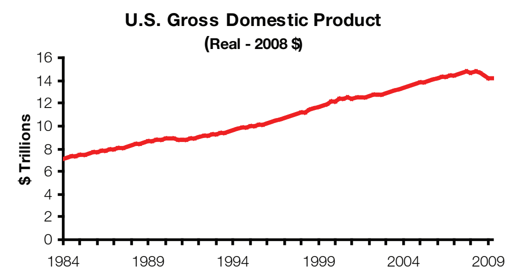
Several years ago, the question was asked whether the U.S. could continue to grow without widespread growth around the world. That question was answered with a resounding "yes" due to the strength of the U.S. economy, with its sustained, internally generated productivity growth and population growth of 3 million people annually.

As the recent U.S. decline began, the question was asked whether the rest of the world could maintain growth even as the U.S. stumbled. This question has been answered with a resounding "no." This is because too many countries lack internally generated growth in productivity and population. As a result, countries such as Germany, France and Japan are dependent on U.S. growth, as their internal growth dynamics are too anemic to overcome weak U.S. growth. The U.S. recession, combined with the global impact of high oil prices, is why most countries are struggling – with many declining by far more than the U.S.

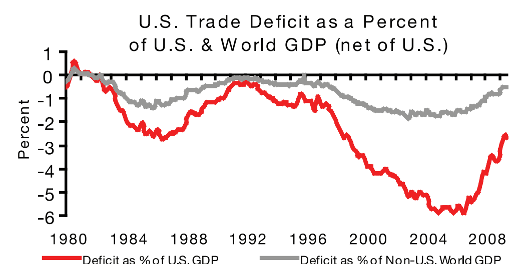


The good news is that despite the serial ineffectiveness of government interventions, the U.S. economy is beginning to stabilize and investors are slowly coming out of their tortoise shells. As the U.S. begins recovery, things will slowly begin to look brighter for the rest of the world. The current recession is the worst downturn in economic activity since the Great Depression, but barring more government "salvation" we have hit bottom.

And it should be noted that without this disastrous "salvation," we would have bottomed in January 2009. Contrary to the mythological rhetoric and our current media, government interventions both lengthened and massively deepened the current super recession.



Global real GDP growth has been negative since October 2008. U.S. GDP bottomed in the third quarter, and employment will lag by about a year. When the job declines end, there will be a net loss of about 7.5 million jobs. This is the equivalent to nearly four years of normal job growth. To put the situation in perspective, real U.S. GDP was about $14.7 trillion at the start of September 2008, falling by 2.8% through June 2009. At a 3% annual real GDP growth rate, it will take until April 2010 to get back to where we were a year ago.



The U.S. trade deficit has plunged, reflecting the horrific loss of global confidence in the integrity and productivity of U.S. capital markets. Our trade deficit has fallen to -2.7% of U.S. GDP, and -0.53% of rest-of-world GDP as of June

2009. Always remember that the U.S. trade deficit is not a reflection of the lack of competitiveness of our goods and services, but rather a reflection of our capital market superiority.

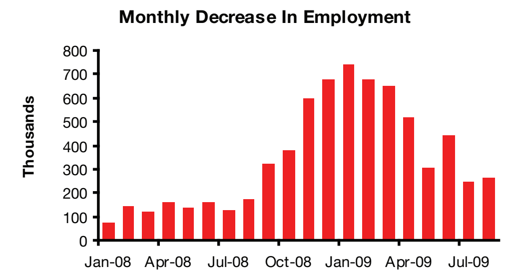
Employment is still falling, but at a declining rate. Early in 2009, monthly job declines were wiping out 500,000-700,000 jobs. In July, that number had diminished to about 250,000, but increased to 265,000 the next month. The unemployment rate stood at 9.7% in August, a year-over-year increase of 350 basis points. The brutal truth is that many more people are unemployed, and for longer, as a result of government interventions.

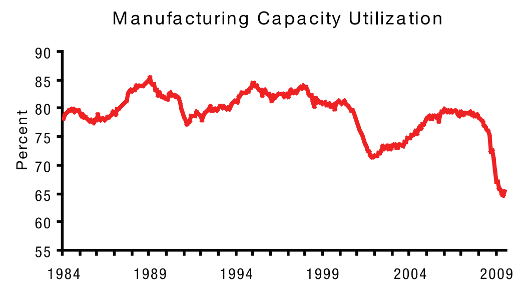
Since August 2008, capacity utilization has plummeted by 1,062 basis points to a stunningly low 64.7% in June, but then exhibited a very slight increase to 65.4% in July (compared to a 20-year average of 79%). This represents the first increase in capacity utilization since March 2007. Not surprisingly, business investment activity has fallen by an average of 20% year-over-year through the second quarter of 2009. Faced with staggering excess capacity, as well as economic and political uncertainty and scarce capital, firms chose to hoard cash rather than invest in an uncertain future.

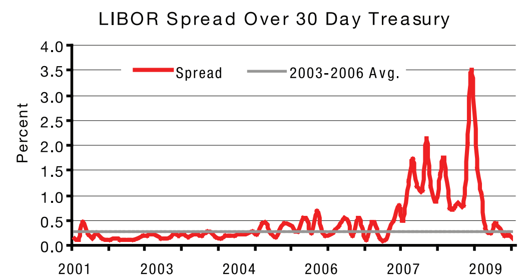
There are signs that capital markets are beginning to work. Quarter-over-quarter through the second quarter of 2009, yields on 10-year Treasuries have risen to 3.5%. We believe 10-year Treasury yields are still some 125 basis points too low. They have risen by 145 basis points as of mid-August 2009, from their low of 2.1% in December 2008. If all were normal, 10-year Treasury yields would be around 4.75-5%, where they hovered before October 2007. Nonetheless, we are reaching pre-TARP levels. The S&P 500 rose by 15% in the second quarter and by an estimated 12% in the third quarter. NAREIT's Equity REIT Total Index rose by 60% between March and August. We always believed that the logical progression for investors is short-term quality debt, long-term high grade bonds, high quality cash flow stocks, high quality cash flow real estate, lesser cash flow assets, and finally into non-cash flow assets such as construction and development loans, venture capital and the like.

The early signs of recovery are fragile because of the surge in oil prices back to about $70 per barrel. This erodes both our effective income and consumer confidence. The $20 per barrel rise since April has knocked about 90 basis points off GDP growth. At $70 per barrel, it will take much longer to rebuild consumer confidence, a pre-cursor for a recovery.

Recently, LIBOR and 30-day Treasuries have raced to zero. The LIBOR spreads over 30-day Treasuries in June were an average of 22 basis points, versus a peak of 351 basis points in October 2008. The average spread over the past month compares to the 286-basis-point average from 2003-2006. A low LIBOR has become the life blood for many borrowers with floating rate debt, and a rate spike has the potential to crush many borrowers.







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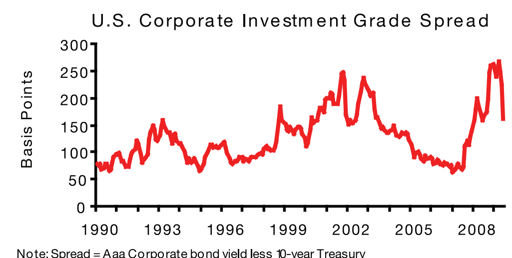


Note: Spread = Aaa Corporate bond yield less 10-year Treasury

Long-term Treasury Inflated-Protected Securities (TIPS) returns have been remarkably narrow even as inflationary threats are rising. They experienced a yield increase to 3.09% in November 2008, and stood at 2.31% in July 2009.

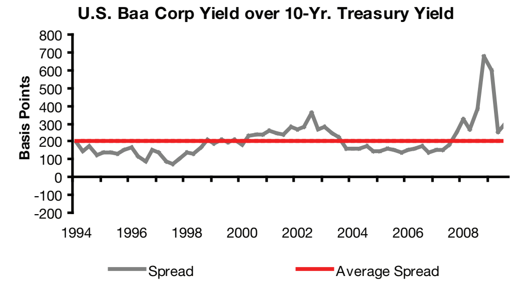
Spreads have narrowed on corporate debt, providing more evidence that investor jitters are subsiding. In February 2007, 10-year AAA corporate spreads over Treasury were 67 basis points, before exploding to 268 basis points in March 2009. They have since declined to 178 basis points over 10-year Treasuries as of September, though still slightly above the 10-year average of 142 basis points.

BBB/Baa (S&P/Moody's) corporate bond yield spreads over 10-year Treasuries have followed a similar trend. The spread peaked in December 2008 at 675 basis points and then dropped to 250 basis points in June 2009, compared to the 15-year average of 206 basis points. As of August, the BBB spread over Treasuries stood at 312 basis points. We use BBB corporate bond yields as a proxy for the average credit of commercial tenants, thus providing a relative benchmark for real estate pricing.

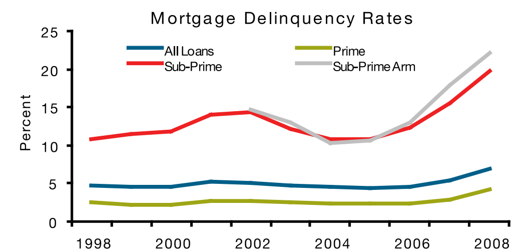
Residential mortgage delinquencies have risen among all products since lows in late 2005. "Sub-prime" mortgages experienced the sharpest increase in delinquencies over the past year, reaching more than double their 2006 levels, followed by sub-prime ARM and prime. Sub-prime ARM experienced a more modest 23% year-over-year increase in delinquency rates. Prime mortgage delinquency rates increased 45% over 2007 levels but moved only from 2.92%, to 4.26%. However, these delinquencies are highly concentrated in recession torn greater Ohio (Ohio plus 100 miles beyond the Ohio border) and the boom markets of south/central Florida, Arizona, Nevada and California. They remain at cyclical norms in the remainder of the country. It is difficult to assess how much of delinquencies today reflect a "why pay?" attitude versus hopelessly negative equity versus lost employment. Recent research suggests that all three forces are at work.

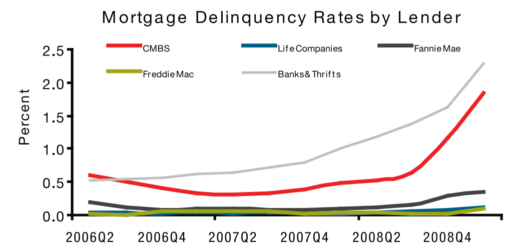
Commercial mortgage delinquency rates have risen across the board, most visibly at banks and thrifts, and CMBS. Fannie Mae delinquencies rose from a mere 0.1%, to its current peak of 0.34%. Freddie Mac and Life Companies experienced increases, but remain low at 0.09% and 0.12%, respectively. Bank and thrifts delinquencies are much higher at 2.28% while CMBS reached 2.35% in August 2009. The increase in CMBS delinquencies partially reflects the rigid structure of these instruments, whereby the borrower must default in order to have services transferred to a special servicer who is empowered to negotiate.

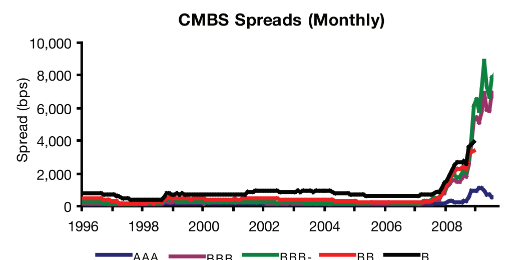
CMBS issuance in the U.S. remains nearly comatose, with no new issues from July 2008-May 2009 or in August 2009. In June and July 2009, the CMBS market showed signs of life with new issues of a meager $600 million and $300 million, respectively. Ten-year AAA tranche spreads peaked at an incredible 1,400 basis points in November 2008, but have since reverted to about 550



The return of unfettered greed will take another five to seven years to run its course, but it will definitely return.







basis points as of September 2009. Since tightening began in late March, the AAAs have been bouncing around in the 400-700 basis point range, indicative of 7-10% yield.

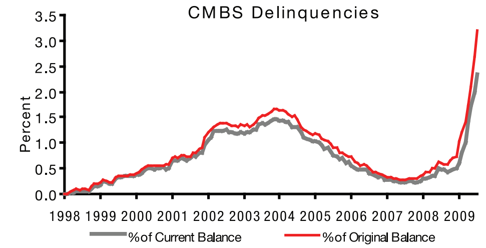
BBB- tranche spreads peaked at an incomprehensible 9,000 basis points in April 2009, dropped to about 5,000 basis points in May, but stood above 8,500 basis points in September. However, the pricing for tranches below AAA are meaningless as there are no trades.

Equity markets have rebounded, with five straight months of S&P 500 gains. Since bottoming at 676 in March, it has risen by 54%, and stood at 1,400 in early September, 33% below its peak in October 2007. Three-, two-, and one-year average P/E ratios for the S&P 500 have steadily grown from 22.8x and 25.2x to 31x. This reflects both improved prices and cyclically low earning levels. This rebound in equity pricing is good news for the property sector as it will slowly work its way through to commercial real estate. While evidence of improved real estate pricing will lag public markets, the rebound should serve to re-equitize many properties crushed by the collapse in late 2008 and early 2009.

CAPM analysis indicates that real estate pricing has improved dramatically relative to its long-term risk during the past six months. In particular, the underpricing has gone from 230% in March to about 24% in September. This under-pricing reflects the fact that the beta for real estate has gone from 0.5 or less to in excess of 1 during the height of the financial crisis. Some argue that ETFs are the culprit for this counterintuitive and excessive beta. In any case, what historically serves as a diversifier has heightened portfolio risk. In fact, the CAPM model results indicate an implied beta of roughly 0.7 in September. We believe that in time the beta will revert to approximately 0.5 as real estate fundamentals are not perfectly correlated with the broader market due to lease maturities and differing supply demand cycles.

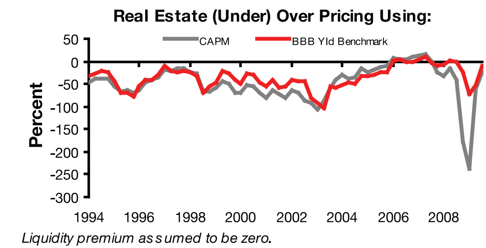
The ITLC ("it tastes like chicken") model suggests that the under-pricing of real estate has gone from almost 70% to about 10% over the past quarter, reflecting the strong rebound in REIT prices. This model still shows substantial under-pricing of both BBB bonds and commercial real estate based on their long-term risk characteristics, reflective of a lost faith in "risk" in the face of investor fear. However, recent signs of renewed greed have improved pricing for "risk," as evident in the rise of the broad stock and bond markets. The return of unfettered greed will take another five to seven years to run its course, but it will definitely return.

IPO issuance fell from $56 billion in 2007 to $28 billion in 2008, and was only $10 billion through the second quarter of 2009. Of the 100 IPOs over the last three years, technology firms account for the greatest share, including seven in the first half of 2009. Consumer services firms are second with 17, but only two in the first half of 2009. Financial services firms represent 14 of the most recent 100 IPOs, with three transactions in the first half of 2009. The recent rebound in equity pricing should faster renew IPO interest.

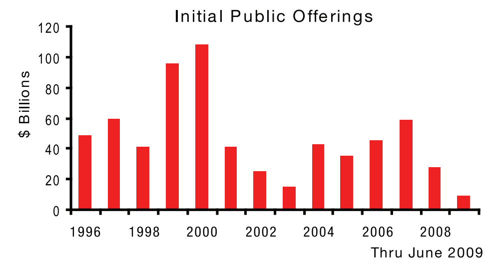


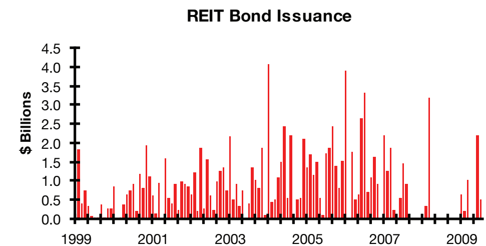
Real Estate (Under) Pricing as of Sept. 11, 2009

		Long-Term Annual Dividend Growth			
		2.0%	2.5%	3.0%	3.5%
BETA	0.3	-52.1%	-83.4%	-131.0%	-211.9%
	0.4	-30.5%	-53.0%	-84.7%	-133.1%
	0.5	-14.4%	-31.2%	-53.9%	-86.1%
	0.6	-1.8%	-14.9%	-31.9%	-54.9%



Liquidity premium assumed to be zero.





REIT equity offerings fell by 23% in 2007 and a further 34% in 2008. However, the $16.2 billion offered in the first half of 2009 indicates an 80% increase over the first half of 2008. Second quarter 2009 REIT equity proceeds skyrocketed to an all-time quarterly high of $13.9 billion. Improved equity pricing is sparking renewed interest in REIT offerings.

Sales by retail stores have fallen year-over-year by 7.5% since the end of August 2008. Real auto-related sales have fallen by nearly 5.9% over the same period, buffered in part by the cash-for-clunkers program.

Manufacturing activity has been crushed, with durable goods production down 22% and non-durables down 8% year-over-year through July 2009. Autos were down by 50% and energy was down by 5% for the same period.

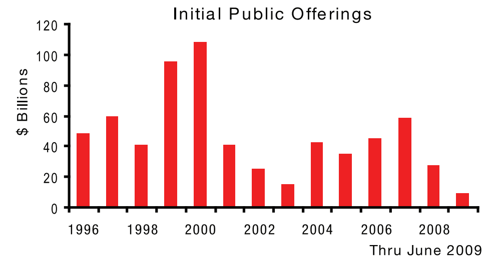
Corporate profits and cash flows have fallen by 13.5% since the second quarter of 2008, even as productivity per hour grew by 2% over the same period. Given massive lay-offs, the remaining workers are being pushed to produce more than they were required to just a year ago, yet profits are still down. Not surprisingly, the greatest profitability drops have occurred in the manufacturing (32%) and financial services sectors (12%).

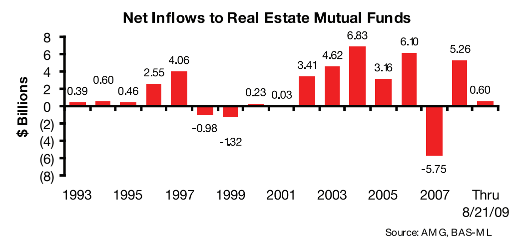
Real disposable personal income has risen by a mere 1% between September 2008 and July 2009. Real wage income has fallen 3.4%, while interest/dividend income is down by 10% over this period. Real personal consumption expenditures are down by about 2% year-over-year through the second quarter of 2009. Real housing expenditures have been flat, while auto expenditures fell 15.3% over this period.

Real personal expenditures on gasoline rose by 1.1%, as reduced gasoline prices have encouraged greater auto usage. Service consumption has remained flat, with medical expenditures increasing by 1.7% year-over-year through the second quarter of 2009.

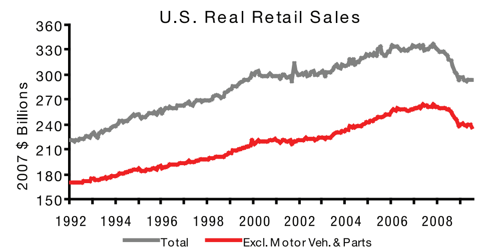
Meanwhile, consumer credit has fallen by roughly 1.8% as consumers have reduced durable goods consumption, paid down some debt and hoarded cash in the face of uncertainty.

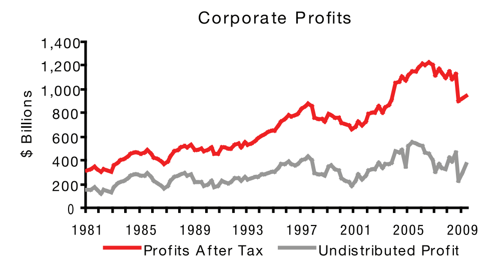
The best news for the economy is that the U.S. housing market bottomed in February. Single family starts hit a very low bottom of roughly 355,000 units in January and February, increasing to 490,000. The inventory of homes held by builders for sale has fallen to 270,000 as new home production over the past year has been insufficient to replace the nearly 350,000 units destroyed each year. MLS home prices (which exclude sheriff sales) have risen nationally, and in almost every MSA, for the past six months. Thus, while many foreclosure sales in the weakest markets continue to drag down the Case-Shiller index, the preponderance of homes sold by resident owners has seen price rebounds. This sector's rebound over the next three to four years will be a powerful growth engine.



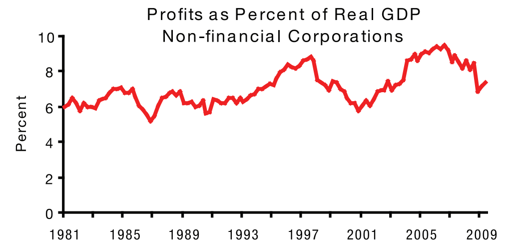


The rebound in equity pricing is good news for the property sector as it will slowly work its way through to commercial real estate.

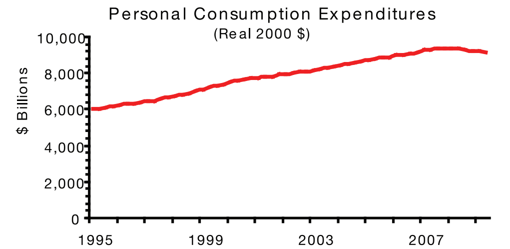




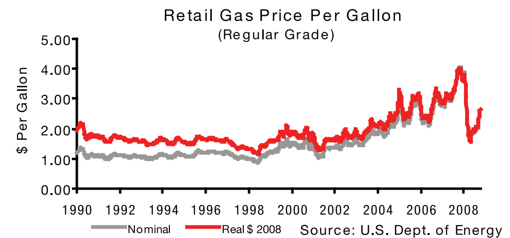
Multifamily starts (5+ units) have come to a virtual standstill at a mere 80,000 units in July, versus 20- and 40-year averages of about 260,000 and 368,000 units, respectively. This reflects the confluence of weak recessionary demand (as people double-up) and the shortage of construction financing. We anticipate that multifamily starts will remain weak until early 2010 in the face of continuing weak demand and little construction debt.



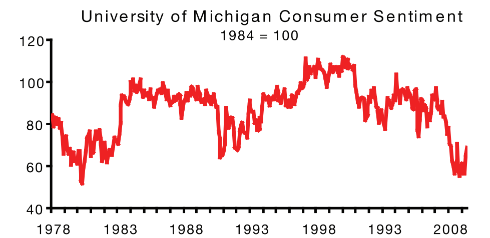
Since consumer confidence and household formations remain low, people continue doubling up with friends and family. Consumer confidence has nudged downward, largely due to increasing gasoline prices and government irregularity. The biggest negative in our forecast today versus last quarter is that oil prices have risen $20 per barrel since April 2009. That translates into a loss of about 0.67% of GDP growth, or about 335,000 jobs that we anticipated being created but did not materialize as money was shipped abroad due to high oil prices. If oil prices stabilize or decline, we expect consumer confidence to improve throughout the year as the housing market improves.



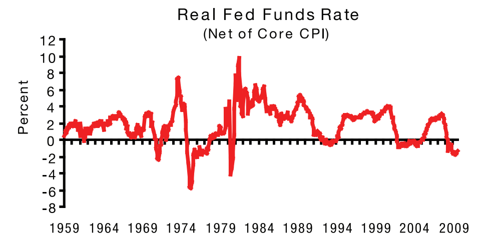
The eight-year accumulated deficit incurred by the Bush administration was less than $1.1 trillion (based on year-end data). In comparison, the projected federal deficit for 2009 and 2010 is $1.6 trillion and $1.4 trillion, respectively. The Congressional Budget Office estimates an increase of nearly $1.2 trillion in privately held federal debt in 2010 (not counting off-balance sheet obligations to Freddie/Fannie and others). This is a complete disaster, sapping as much as 0.5% from annual GDP growth for years to come. It also raises the spectre of the Fed accommodating federal budget deficits, which will lead to inflation and higher long-term interest rates, and hence higher cap rates.



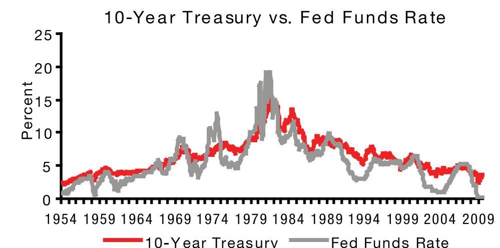
By late 2010, we expect the Fed Funds rate to be as high as 5% as part of the reversal of loose monetary policy. On the long end, we expect the 10-year Treasury to be 4.5-6% in 2010, going as high as 8% with the fear of inflation in 2011.



Although most of the facts reveal bad news, the economy has bottomed and is on the road to recovery. Historically, the U.S. economy has rebounded in ways that were unimaginable at the time and usually within two years of a recession. In the 24 months following the other two super-recessions, 1973-1975 and 1980-1982, uniform (not annualized) growth was registered: Real GDP grew by 10% and 14%, respectively; employment grew by 6% and 8%; automobile sales rebounded by 49% and 15%; industrial output grew by 19% in both cases; construction increased by 33% and 66%; housing starts had rebounded by 100% and 25%; the unemployment rate fell by 250 basis points in both instances; and real wealth rose by roughly 9.1% and 8.2%, respectively.



The point is that when we do hit bottom (and we believe we were there in July 2009), there will be a far more robust pick-up than any of us can credibly forecast. And we will rebound even in the absence of rules, though GDP and employment growth will be weaker than need be because the government continues to toss rules out the window.



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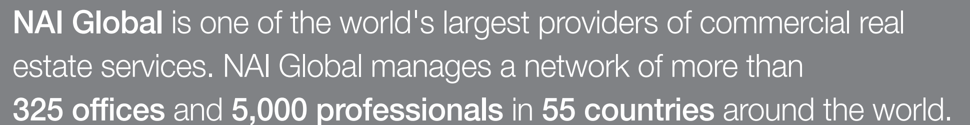

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