



## Watershed Events



Success in long-term real estate investing requires a commitment to being something of a futurist – looking well ahead and doing one’s best to anticipate opportunities and risks long before they make headlines. Real estate investing strategies take time to implement, and even more time to realize. The headlines over the past three months have certainly been noteworthy, and recent events taken together with longer term trends certainly have long-term implications.

Near the end of the first quarter of 2008, JP Morgan Chase agreed to acquire Bear Stearns for \$240 million in a fire sale deal that allowed the venerable “Bear” to avoid bankruptcy - one year earlier Bear had been valued at over \$18 billion.<sup>1</sup> By mid March the financial markets were in full retreat: the dollar had tumbled to a 12-year low against the Yen, and the yield on 30-day Treasury bills had fallen as low as 0.625%, the lowest level since May 1958, when the U.S. was emerging from recession.

Since August 2007, when the collapse of U.S. subprime mortgages started to infect markets around the world, the Fed has lowered its benchmark overnight rate five times and the discount rate seven times. It has also taken the unprecedented step of opening the Discount Window to Prime Brokers.<sup>2</sup> As of May, 22 major Wall Street firms, according to Morgan Stanley, have absorbed \$230 billion<sup>3</sup> of the \$300 billion<sup>4</sup> in worldwide losses related to the “crisis”. Homebuilder activity continues to fall, consumer confidence is at the lowest point since 1980<sup>5</sup>, and the dollar has fallen to 1.55 to the Euro.

The full extent of the housing decline this cycle remains unknown. According to the Federal Reserve, a 15% decline in housing prices results in a \$3.2 trillion loss in value, a powerful negative to the wealth effect of rising asset values. Goldman Sachs projects a 25% drop in housing prices, erasing nearly \$6 trillion in homeowner wealth.<sup>6</sup> This factor alone will likely result in a slow and protracted economic recovery. The Levy Economics Institute of Bard College suggests that, if housing prices continue to fall, total credit losses from the subprime mortgage crisis to borrowers, creditors, and banks could approach \$900 billion – The International Monetary Fund projects \$845 billion. By contrast, the Japanese economic crisis of the

1990s resulted in \$750 billion in total losses. Not to be too depressing, but the Japanese economy faltered for 13 years before it began a tentative recovery...

In order to look forward and draw a few conclusions about the future, we have to look past the headlines, sift through a massive volume of available information, and try to develop our own actionable judgment. However, the volume of available information in the current era is amazing. As Barry Schwartz highlights in *The Paradox of Choice*, more information, and more investment options, do not always lead to better decision making – in fact, more information can lead to worse decisions, or the

<sup>1</sup> The sale was for \$2.00 per share; later increased to \$10.00. Approximately one year earlier, Bear Stearns shares traded at \$158 per share, an aggregate equity value in excess of \$18 billion.

<sup>2</sup> Heretofore, Discount Window lending was limited to commercial banks. Extending lending capacity to non-commercial banks represents a policy shift in the Fed’s 94-year history. The so-called “primary dealers,” who are now eligible borrowers, include firms that are units of commercial banks and several that aren’t, including Goldman Sachs Group Inc., Morgan Stanley and Merrill Lynch & Co.

<sup>3</sup> “Banks Still Seen to Have \$180 Billion in Writedowns,” Reuters, May 13, 2008.

<sup>4</sup> “Buffet Says Credit Crisis Ends for Wall Street Firms,” Bloomberg News, May 3, 2008.

<sup>5</sup> The Reuters/University of Michigan Index of Consumer Confidence was at 59.5 in May – the lowest level since June 1980. Source: The New York Times, May 17, 2008.

<sup>6</sup> “The Worst is Over,” Kiplinger’s Personal Finance Magazine, June 2008.

failure to make any decisions at all. I wonder whether even Alvin Tofler, who coined the term *information overload* in his 1970s book *Future Shock*, could have imagined the level of information overload experienced by investors today. How do we make sense of events and chart a future course? One way is to try to tease out the watershed events from the many cyclical sea changes, and keep a low risk profile with regard to recent trends whose sustainability is unsustainable.

### Recognizing a Watershed Event



A watershed event is an event marking a unique or important historical change of course or one on which important developments depend. A watershed, being a land ridge, may have steep slopes on either side or only slight changes in gradient from positive to negative. Accordingly, although you may be standing on a watershed, you may not even know it.

One could imagine rain falling on that ridge beginning to move down one side of the ridge or the other; its movement is now fixed and irreversible, barring intervention by an outside agent. Hence, any given raindrop experiences a “watershed event.” Two such watersheds are worth reviewing: the first is an inevitable long-term trend, and the second is a reaction to recent credit excess.

Probably the most significant watershed event still in play is the evolution from an American dominated world to a more level global playing field, resulting from a number of factors including the introduction of China and India into the global labor, commerce and financial markets as well as U.S. policies that have likely accelerated the transition. The problem for the U.S., and possibly for the world, is that as a nation the U.S. will face new international opportunities hampered by massive fiscal imbalances.

The most recent watershed event happened that fateful weekend in March, when the Federal Reserve guaranteed \$30 billion in securities held by Bear Stearns, effectively transferring the performance risk of Bear’s portfolio to U.S. taxpayers. In America, we have experienced a number of legislative watershed events in real estate during our careers, including the tax acts enacted in 1981 and 1986, the FIRREA<sup>7</sup> act in 1989 as well as the formation of the first UP-REIT in 1992. After each of those events, the real estate investing world had changed. As Nouriel Roubeni notes, recent Fed actions “imply that the lender of last resort support of the Fed has been now extended to systemically important non-bank institutions. This is the most radical change in monetary policy and in the role of the Fed since the great depression as the Fed is not supposed to lend to non-banks.”<sup>8</sup>

These two watershed events will significantly transform the playing field for investors in commercial real estate.

### FACING THE DAWN OF THE POST-U.S. CENTURY – HAMPERED BY A MASSIVE FISCAL IMBALANCE

Since the early 1990s, three prominent countries have reemerged onto the world economic stage: China, India and Russia. Much has been written about the incorporation of 3 billion new capitalists, nearly half the world population, into the global market. But there likely remains a lack of understanding, and in some cases a lack of predictability, as to what this means for the average investor. At the very least, the relative position of the largest economies will be altered, perhaps forever. The chart below drives the message home: by 2050, China and India will represent two of the three largest world economies. The U.S. will only be second. As will become evidently clear, we are at the dawn of the post-U.S. century.

<sup>7</sup> The Financial Institutions Reform Recovery and Enforcement Act, which created the Resolution Trust Corporation in 1989, mandated the liquidation of assets (primarily real estate) held by savings and loan associations declared insolvent by the Office of Thrift Supervision.

<sup>8</sup> Roubeni, Nouriel. Ten Fundamental Issues in Reforming Financial Regulation and Supervision in a World of Financial Innovation and Globalization. March 31, 2008.

**The World's Largest Economies**



Source: A Maddison (Historic). Goldman Sachs (Projected)

It's not that the U.S. has grown weaker; it's that others have grown stronger. The massive new supply of available labor (alone a major event) together with the massive transfer of wealth to oil producing countries has resulted in the declining relative influence of the U.S., presenting new risks to the real estate investor.

The results to-date of the global transformation are most evident in the current account balance. In our view, investors would be wise to understand this macro-economic issue as the unwinding of current imbalances is likely to be a primary theme throughout the coming decade.<sup>9</sup>

The formula below, which breaks out the components of Gross Domestic Product, needs to be understood by investors, and hopefully our political leaders. Gross Domestic Product is the term used for our national output, and as David Moss points out in *A Concise Guide to*

**Components of U.S. GDP – Expenditure Method - 2007**

<i>Gross Domestic Product</i>	=	<i>Consumption</i>	+	<i>Investment</i>	+	<i>Government Spending</i>	+	<i>(Exports - Imports)</i>
\$13.8 t		\$9.7t		\$2.1t		\$2.6t		\$1.6 t    \$2.3 t
100%		70.3%		15.4%		19.4%		17.4%    21.7%
								<i>Net Imports (roughly equivalent to the current account deficit)</i>
								\$708 billion <sup>10</sup> -5.1%

*Macro Economics*, large volumes of output are what make nations prosperous. Using the expenditure method of calculation we can come to understand that the national output (GDP) equals total expenditure on final goods and services, excluding imports.

When a country exports more than it imports, it inevitably lends an equivalent amount of funds abroad, which allows foreigners to purchase its surplus production. Conversely, when a country imports more than it exports, it must borrow from foreigners to finance the difference. Over the past 10 years, U.S. imports have dwarfed exports. There are a few potential, interrelated causes that are worth noting, including:

- The lower labor cost resulting from the massive supply of people (particularly Asians) entering the workforce.
- American appetite for goods and services and a willingness to spend on current consumption.
- Government spending in excess of tax receipts, resulting in a budget deficit.
- Financial policies on the part of the Chinese to maintain a weak currency (as a way to stimulate their own economy and create jobs).
- Foreign willingness to lend to the U.S., as the size of the U.S. military alone reinforces confidence that America will endure to honor its debts.

In many ways, this current account deficit is an indication that we are living beyond our means, increasing consumption unsustainably.<sup>11</sup> As the figures above demonstrate, in 2007, consumption investment and government spending

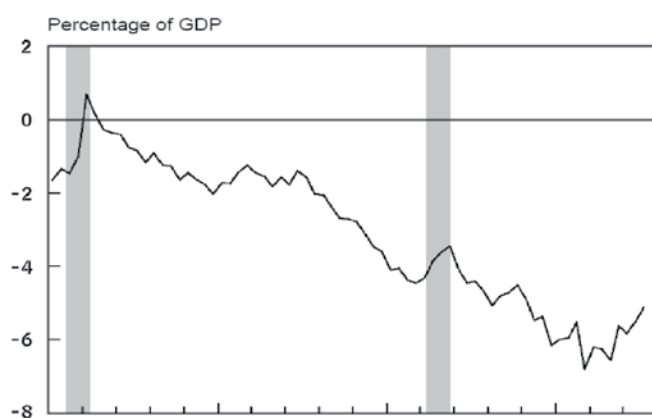
<sup>9</sup> An excellent primer on macro economics can be found in *A Concise Guide to Macro Economics* by Harvard Business School professor David A. Moss. The current account (one of the two components of the balance of payments – the other being the capital account) is the sum of the balance of trade (exports minus imports of goods and services) net factor incomes (such as interest and dividends) and net transfers (payments such as foreign aid). Both government and private payments are included in the calculation.

<sup>10</sup> Includes Unilateral Current Transfers, net. Source: Bureau of Economic Analysis

<sup>11</sup> A current account deficit can also occur as a result of excess investment, which may result in improved output in the future. This does not appear to be the case with the US in recent past.

equaled 105.1% of output, or GDP – with the excess financed by borrowing from abroad. The repeated annual deficits (which in this cycle began in 1992) have also resulted in a massive stockpiling of foreign reserves (in the form of U.S. Treasury securities) primarily by the Japanese and Chinese, and increasingly the oil-producing countries. In effect, these countries now possess claims on the future output of the United States.

### The U.S. Current Account Deficit



So, is the increasingly level playing field a problem for U.S. or international investors? In our view, not in the long run. World economic integration will likely lead to a more interconnected and safer world, as constituencies have interrelated financial, political and security interests. However, in the medium term, the resultant financial imbalances have potentially dangerous repercussions. How we as investors, and as citizens, anticipate and react will have a profound affect on our investment performance as well as our overall financial wellbeing.

First, there has been, and for the foreseeable future there will continue to be, a massive wealth transfer from the West to China, Russia and the energy producing countries, as the world has been unable to reduce its dependence on carbon-based energy sources, particularly oil and natural gas, resulting in major increases in global energy prices. According to Richard Haas at the Council on Foreign Relations, since the 1970's oil shock, U.S. oil consumption



has grown by some 20%, and, more importantly, U.S. imports of petroleum products have more than doubled in volume and nearly doubled as a percentage of consumption. Some of the excess capital being accumulated by energy consuming countries has found its way into so-called "Sovereign Wealth Funds," which have been set up by national governments as a way to seek higher returns for their foreign reserve holdings. Until recently, these pools, whose total value may equal as much as \$3.5 trillion,<sup>12</sup> have been invested in low risk government assets; however, more recently, some have taken steps to acquire stakes in foreign companies as a way to earn higher yields. It is as yet unclear how the huge increase in the assets managed by these potentially non-economic agents will affect the efficiency of the global capital market and the allocation of risk and resources.

Second, and perhaps more dangerously, the fiscal imbalances present significant risk with regard to the U.S. dollar, future trade and the world economy. The current account deficit was financed with a massive financial account surplus, resulting in lower interest rates in the U.S. than would otherwise have been the case. As Peter Goodman points out,<sup>13</sup> with debts spiraling higher, a trade deficit exceeding \$700 billion a year, and its currency in a multi-year plunge, if the U.S. were any other country it would be forced to cut spending and jack-up interest rates in a frantic bid to attract investment. The U.S. faces new and mounting pressures on public finance, which it must confront from a position of fiscal weakness. Even now, the U.S. spends more per head on healthcare than Britain. But baby boomer retirement will severely strain finances without a major change. Does the U.S. have the will to make hard choices if the excess financial capital isn't available?

This has not yet been the case, as foreigners have steadfastly purchased U.S. Treasuries, either because

<sup>12</sup> "Russia Wealth Fund Battles West" The Wall Street Journal, May 7, 2008

<sup>13</sup> Almglyt - The Dollar: Shrinkable But (So Far) Unsinkable, Peter S. Goodman, The New York Times, May 11, 2008

they view the U.S. as a secure place to invest, or, as in the case of China, because they are trying to keep their currencies from appreciating. However, there are signs that Russia and the Middle Eastern countries have begun to diversify away from the U.S. dollar, as is evidenced by the decline of the dollar against the Euro. According to the International Monetary Fund, between 2001 and the end of 2007, the dollar's share of the world's total foreign exchange reserves shrank from about 73% to 64%, while the Euro expanded from about 18% to 25%. But much of this has resulted from an adjustment in currency values rather than active diversification. As of yet, the figures are not conclusive.



Going forward, in our view it is likely that the dollar decline will improve U.S. exports, but it will also result in diversification away from the dollar, particularly to the currencies of Asian and oil producing countries, as well as potentially higher interest rates. These factors have some predictability. However, a truly precarious situation will transpire if the unwinding of global imbalances happens chaotically rather than orderly. While, one can argue that global capital suppliers are incentivized to forestall a dollar freefall, one has to remember that this situation resembles a “multi-party game,” in game theory parlance, where it is beneficial for one party to act before others do, if the move of the others is perceived as inevitable.

## **THE COMING REGULATORY TRANSFORMATION**

This is the first time we're facing a financial crisis with a global financial market in place – exacerbated by the fact that the shadow financial system has been out of the Fed's control. As noted below, with the credit markets now globally interconnected, some financial institutions (notably Bear Stearns) are considered so pivotal and systemically important that public policy requires that they be supported through government intervention when negative events occur. While this consideration may be debated, in our view it is clear that significant changes to

the U.S financial system's regulatory regime are imminent, and that despite Alan Greenspan's admonitions to the contrary financial self regulation, the fundamental balance mechanism for global finance, will be a casualty of this credit crisis, the most profound since 1907.

Two major events were precursors to the current financial crisis. First, the major reform of U.S. banking regulation in 1999 – the Gramm-Leach-Bliley (Financial Services Modernization) Act – allowed the creation of bank-holding companies to carry out virtually all types of financial activities. Second, the extensive application of the Basel minimum capital standards in 2004 encouraged banks to continue to increase their fee and commission incomes by moving lending to unrelated off-balance sheet affiliates. These events supported the “originate and distribute” financial system, which emerged from the 1980s real estate crisis, was facilitated by the modernization of financial services and has generated significant profits for the banks' underwriting departments and proprietary trading desks.



Over the past years, credit rating agencies have replaced bank loan officers and credit committees in determining appropriate safety margins. Unfortunately, now those who bear the risk of receiving principal and interest payments are no longer evaluating the creditworthiness of borrowers. Because those that were assessing the creditworthiness were not those who would ultimately hold the credit, and profit was based on volume of production, the result was a severe overestimation of creditworthiness and mispricing of risk – having the net effect of making credit too cheap, leading to the assumption of excessive risk in order to provide higher returns. As markets continued to rise, cushions of safety, which might have provided protection for the inevitable decline, were too thin.

The increasingly decentralized system of financial product distribution also resulted in the creation of a capital market vastly larger than the Federal Reserve's sphere

of influence. (See: Madison Harbor Capital, *Our View* 2/28/08) As Paul Volker, former Chairman of the Federal Reserve, has stated “We have moved from a commercial bank-centered highly regulated financial system, to an enormously more complicated and highly engineered system.” As Roubeni notes, during the past years we have experienced a significant regulatory arbitrage, i.e., the transfer of a large fraction of financial intermediation to non-bank financial institutions such as broker dealers, hedge funds, money market funds, SIVs, conduits, etc. However, because these institutions are financed short-term and are subject to “runs on the bank,” the Fed has recently taken the following unprecedented actions:

- Allowing primary dealers to borrow at the discount rate in exchange for a “broad range” of investment-grade collateral;
- Extending the maximum term of discount-window loans to 90 days from 30 days;
- Swapping \$200 billion in Treasuries with its 20 primary dealers for debt, including AAA mortgage-backed and asset-backed securities;
- Increasing the amount auctioned to eligible depository institutions under its Term Auction Facility from \$50 billion to \$75 billion, increasing the amounts outstanding to \$150 billion;
- Extending swap lines to the ECB and Swiss National Bank, allowing them to offer dollars to commercial banks in their jurisdiction; and, most notably
- Providing a \$29 billion loan to support the sale of Bear Stearns.

### Potential Regulatory Options

The Fed, the SEC and Congress are reviewing causes and effects of the financial seizure, and soon the Draghi Commission, within the Financial Stability Forum, will report its conclusions and proposals for reform of the financial system to the G7 Finance Ministers.



Nouriel Roubeni has provided a thorough analysis of the issues faced in reforming financial regulation.<sup>14</sup> In addition to addressing compensation structures, which lead to mis-alignment of interests and other flaws of the originate and distribute financing model, Roubeni points out the problems of selective regulation, suggesting that regulation must be extended to the investment banks and off-balance sheet subsidiaries. We note that extending the Fed’s purview as lender of last resort to include investment banks is a proposition supported by Volker. Such a relationship is particularly important because “the recent Bear Stearns episode as well as the run on and collapse of other members of the shadow financial system suggest bank-like runs on non-banks can occur and are likely to occur more often if such institutions do not properly manage their liquidity and credit risks.” In Roubeni’s view, and ours as well, the regulatory and supervisory framework should be similar for banks and non-bank financial institutions: regulatory capital, type of supervision, liquidity ratios, compliance and disclosure standards, etc. Otherwise, regulatory arbitrage will shift financial intermediation and risks to other more lightly regulated institutions.

Another potential action is the forced listing of derivative indices such as the CMBX, which trades in a dealer’s market and whose volumes are therefore unknown. As Roubeni notes, “Instruments that are exchange traded through a clearing house would have much lower counter party risk, would be subject to appropriate margin requirements and would be appropriately marked to market on a daily basis.” Requiring standardization of other exotic and complex securities may also be required as financial markets have become less transparent and more opaque in many different dimensions. In our view it is likely that this step will be required before the CMBS market returns to anything resembling its former size.

Lastly, but no less importantly, international coordination of financial policies, regulation and supervision would

<sup>14</sup> Ten Fundamental Issues in Reforming Financial Regulation and Supervision in a World of Financial Innovation and Globalization, Nouriel Roubeni, March 31, 2008

be beneficial over time, although, in the near term, such activity would likely take place only in the Eurozone.

While increased regulation is likely in the cards, the process may take time to implement, due to the many existing U.S. regulatory entities (e.g., the Fed, the SEC, the Controller of the Currency, the NASD, state regulatory agencies, etc.). While we may not move to a UK-style single-regulator model (the FSA), a streamlining and concentration of regulatory and supervisory activity would be beneficial.

## A FEW LESSONS



Common sense is often the best – and least frequently used – tool. Hence, during the age of computational capability and sophisticated financial models, the opportunity to enter into derivative contracts, the dependence on statistical analysis can overpower experience and logic. As Alan Greenspan has noted, the essential problem is that both risk and econometric models – as complex as they have become – are still too simple to capture the full array of variables driving the global economy. Two personal examples come to mind.

First, eighteen months ago, a university professor of real estate and I had a discussion about housing prices, with him arguing that they were in line, as I argued that they were unsustainable. His repeated argument was that housing prices had never experienced a national decline in the U.S. Without then understanding that housing had in fact declined in the history of the US, just not since World War I, I asked myself a simple question to arrive at my own conclusion: could the majority of people in my neighborhood afford, given their current incomes, to purchase the home in which they currently live using a traditional mortgage? The answer is generally no. Something had to give.

The second example took place just recently when some extremely smart investors outlined their projections for

purchaser defaults on condominium deposits in South Florida. They projected 15%, which was about double the recent historical rate. This sounds aggressive, until you realize that recent construction has been unprecedented – except, of course, for the last time condo construction was unprecedented, in 1976–1980. By looking back a few years to the last Brickel Avenue construction boom, one would have realized that a 15% default rate was not nearly aggressive enough. The recent experience: approximately a 50% default rate.

By-and-large, investors are not very good at predicting future events; they typically follow the herd. Blame it on human emotion (behavioral economics) or on pattern reading (fooled by randomness). In any event, those with vision are in and out long before the mass market catches on. A few other areas that are worth noting as you make investment decisions include alignment of interest, understanding the effects of financial leverage, asset/liability mismatching, liquidity, and the importance of a global view.

### Alignment of interest

Business people will behave as they are financially incentivized. Alan Greenspan<sup>15</sup> correctly noted: “much of the dubious financial-market behavior that chronically emerges during the expansion phase is the result not of ignorance of badly under priced risk, but of the concern that unless firms participate in a current euphoria, they will irretrievably lose market share.” An example is the commercial banks and securitization. The interest of the banks in these structures was not only the release of capital when the loans were removed from the banks’ balance sheets, but also the various sizable fees that accrued to them from loan origination and underwriting, Special Purpose Entity management and loan servicing. So long as agents are compensated for loan production, rather than loan performance, problems are inevitable.

### Higher levels of financial leverage increase financial risk

It would be wise for investors to review their introductory corporate finance textbooks to understand the primary

<sup>15</sup> Alan Greenspan, Financial Times, March 18, 2008.

attributes of risk and leverage: increased leverage may increase near-term cash flow, but it also increases financial risk. Specifically, review the Modigliani-Miller Theorem, also known as the capital structure irrelevance principle, which postulates that the value of a firm, or asset, is unaffected by how that asset is financed. In our view, it is a common mistake of real estate investors to justify paying higher prices for an asset when higher levels of (relatively low cost) debt financing are available. What is not often understood by purchasers is that higher leverage results in higher volatility (and importantly, higher risk) of the resultant cash flows to equity. Therefore, the value of the asset should be the same to a purchaser who purchases an asset utilizing all equity as to one utilizing a highly leveraged capital structure. Clearly, over the past five years, pricing has betrayed this principle. Those who misunderstood this basic principle will now understand its unforgiving consequences.

#### **Asset / liability mismatching**

As is often the case, bankruptcies often occur not because of insolvency but rather as a result of illiquidity and mismatched assets and liabilities. In order to sustain the increase in originations, banks created structured investment vehicles, or SIVs, to ease distribution: the SIVs acted as buyers of the senior securities of collateralized mortgage obligations. The SIVs financed themselves largely with commercial paper, which was backed by investment-grade senior securities of collateralized loan instruments and therefore also received investment-grade ratings. This commercial paper provided an attractive investment option for short-term money market mutual funds offered by most financial institutions. For these structured vehicles, income was determined by the difference between the short-term money market borrowing rate and the higher interest rates on the senior collateralized mortgage securities. However, this, in effect, represented borrowing short and lending long – a classic mistake. SIVs held not only credit risk but also liquidity and interest rate risk; in particular, as the Federal Reserve tightened, the spread narrowed and the sporadic inversion of the yield curve created the possibility of negative spreads.

#### **The need for liquidity**

In a crisis, investment performance of heretofore disparate assets can go to a correlation of 1. While the models may claim that your investment portfolio is perfectly diversified, in panic situations investors act indiscriminately and perhaps irrationally. Importantly, forecasters' concerns should not be whether human response is rational or irrational, only that it is observable and systematic. Accordingly, maintaining liquidity in an investment portfolio may reduce short term performance but has important long term value implications.

#### **The importance of a global view**



While local sharpshooters often win the day, in a steady investing environment, it is often those closest to the situations that fail to see the risk before their eyes. Two notable examples include

(a) New York 1977 – while local operators and developers felt the pain as New York real estate faltered, Olympia & York, a Canadian firm, seized the opportunity and bought eight midtown towers for \$334 million, approximately \$30 per square foot; and, (b) Japan in the 1980's – after the Japanese financial institutions saw their real estate valuations collapse by over 80%, numerous American real estate funds began investing in the late 1990s and seized the day. In both cases it took an outsider's view to realize markets were about to rebound sharply.

#### **CHALLENGES AHEAD**

Taking into account our premise of a more level global playing field, a fiscally weakening U.S., which has been the global growth engine for the past century, and the expectation of additional global financial regulation, what do we expect going forward and what actions should we take?

#### **Re-examine**

Certainly, now would be a good time to reexamine your own financial objectives and risk tolerance. You might be surprised that careful review may lead you to accept greater uncertainty in the interest of greater portfolio diversification

and potentially higher returns. For example, by making an international allocation in your portfolio, diversification by currency and industry as well as political and geographic exposure is obtainable. Diversification remains an important risk mitigation technique that too many smart people fail to adhere to – just ask a Bear Stearns employee who held too much Bear stock.

### Have patience



As real estate investors focused on fundamentals, we breathe a collective sigh of relief that speculative excess is rapidly declining. Real estate opportunities will improve because values will likely fall, not only to more rational levels, but, in the short term, prices may fall farther than is justified by declines in property cash flow. Further, in the long run, development will slow as a result of lender's imposing more stringent underwriting standards. This will significantly improve the supply/demand equilibrium on the part of owners – down the line.

Over the next 18 months however, we expect that the U.S. will experience a long and protracted recovery from the confluence of negative events. In the near term, Fed and Congress anti-recession measures will facilitate demand. However, a weaker 2009 will likely result from government stimulus policies. The only good news on the local front is manufacturing demand, which is benefitting from a weak dollar. Unfortunately, manufacturing represents but a sliver of the larger U.S. economy, and positive activity in this sector is unlikely to fully counterbalance the negative wealth effects from housing price declines and financial market deleveraging.

Past this time period, one must accept that the past decade's financial engineering likely added significantly to GDP growth, and therefore job formation and real estate rental demand – but the wind for that sail is no longer blowing. Looking even farther forward, we must remain

wary of potential global fiscal imbalances created over the past decade unwinding. As discussed above, China's maintenance of a creeping peg against the dollar will not last indefinitely. Of particular importance is recognition that the sale of Yuan to purchase Dollars is inherently inflationary in China, the effects of which are now only beginning to be appreciated.

**Housing** - The lost wealth effect from the housing decline, which, as noted above, will range in the multiple *trillions*, will be anti-stimulative. It's impossible to envision how the American consumer can maintain current levels of consumption in the face of this headwind, which has further to run. The level of home prices will probably stabilize as soon as the rate of inventory liquidation peaks, perhaps well before the ultimate elimination of excess inventory but still far in the future.

**Deleveraging** - The current global financial crisis has little to do with the mortgage market (or subprime mortgages per se), but rather with the basic structure of a financial system that distributes risk recklessly – by overestimating if not outrightly ignoring creditworthiness. In our view, the system has been structured to make credit too inexpensive, leading to the assumption of excessive risk in order to provide higher returns. Now this system is undergoing deconstruction – job losses in New York, London and elsewhere will be significant and are but one component demonstrating financial institutions' reduced appetite for risk. For the commercial real estate industry, replacing securitization will be a long, arduous process, as no medium readily exists to replace the volume of securitized financing transacted annually over the past five years.

To add a little perspective, understand that the \$230 billion of losses sustained by investment banks has been replaced with perhaps \$180 billion of capital from Sovereign Wealth Funds and equity offerings, according to Lehman Brothers.<sup>16</sup> This leaves a shortfall of approximately \$50 billion in reduced equity capital in the financial

<sup>16</sup> "Capital Raising by Financial Institutions." Reuters. April 17, 2008.

system, which implies as much as a \$1 trillion in reduced debt financing capacity based on banks' maintaining their capital adequacy ratios at last year's levels. And the problem is likely to get worse, at least for a short period of time, until home prices stabilize and with them the value of equity in homes supporting troubled mortgage securities held by financial institutions.

### **Take advantage of dislocations**

It may be difficult to discern through financial chaos but opportunities for the real estate investor are generally improving from a fundamental standpoint. Clearly, in the near term three factors will exert downward pressures on commercial property valuations worldwide: (1) forced selling of real estate assets by distressed owners, (2) elimination of

irrational highly-leveraged investors – at least temporarily, and (3) an increasing appreciation of risk throughout the system. We must recall that in hindsight some of the best real estate purchases in history have been made just after substantial market corrections. We note that the credit problems, along with concern about the future state of the economy are already having a direct effect on future supply of commercial real estate. For example, the Architecture Billing Index, an excellent leading indicator of future construction activity dropped to its lowest level since the survey's inception in 1995. This is not the time to run away from real estate – it's a time to take a thoughtful approach toward real estate investment strategies that make sense, and are financed sensibly.

### **For More Information**

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### **About Madison Harbor**

Madison Harbor Capital is an independent investment firm serving institutional and high net worth investors with timely and distinctive real estate investment strategies through primary investments into newly formed real estate partnerships and secondary acquisitions of existing interests in real estate. The firm is led by real estate industry veterans Edward M. Casal, Chief Executive Officer and Russell H. Bates, Managing Director. For more information, please visit [www.madison-harbor.com](http://www.madison-harbor.com).

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