Madison Harbor Capital, LLC

Our View

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Summary

As we turn the corner and head for year-end, the housing sector is falling and the economy is slowing. The stock market lacks conviction as the future direction of both inflation and interest rates is hotly debated. Following 17 consecutive interest rate increases over the past two years, the Fed took no action on rates at its most recent meeting. Domestic politics are signaling brewing voter dissatisfaction with incumbents and geopolitical risks abound.

Meanwhile, fundamentals for the commercial real estate market continue to improve on strengthening demand for space across all property sectors, although there are early hints that leasing demand in the industrial sector may be softening with slowing economic growth. Real estate capital flows remain robust, maintaining record sales volumes and historically high valuations for established properties. The low returns from increased valuations and higher interest rates have resulted in negative leverage (i.e., initial interest rates exceed initial equity returns, or cap rates[1]), potentially resulting in a squeeze-out of highly leveraged purchasers.

Our readers know that we have been expecting 2006 to be a transition year with a mid-recovery economic slowdown and an adjustment in commercial real estate valuations resulting from a combination of improved fundamentals and price softening. Although delayed as to its start, this is now beginning to unfold.

Moving forward we expect the GDP slowdown to become more evident. Inflation, which is currently problematic, will moderate eventually allowing the Fed to stop raising rates. Unless the Fed has already overdone the present tightening (and barring a major unforeseen economic accident) a recession does not appear likely. Once this mid-recovery slowdown has run its course, the economy can be expected to return to trendline growth with the recovery extended.

Overall, real estate should continue to experience a continuation of healthy leasing demand throughout this mid-course economic slowdown to justify some of the lofty valuations in the marketplace. We believe that income returns will revert to the mean and if property cash flows do not sufficiently improve, some price softening has to be expected. Accordingly, focus on cash flow growth is more imperative than ever.

The U.S. Economy

HISTORY

Following the most severe nominal recession in over 40 years at the beginning of the new millennium, this recovery, now in its fifth year, has been atypical. Unlike the more common V-shape initial phase, the ramp-up was a more gradual U-shape. Strong employment growth did not occur and business spending on new U.S. plant and equipment has been healthy yet relatively constrained. The driver has been the consumer-

[1] A capitalization rate, or "cap" rate, reflects the anticipated first year income yield from a property based on its purchase price expressed as a percentage – the higher the purchase price, the lower the cap rate.

buoyed by tax refunds, easy money, low interest rates and a booming for-sale residential market. Unlike the corporate sector that deleveraged and rebuilt its balance sheet, the consumer, using the value perceived in their ever-increasing home prices, borrowed heavily despite only modest and unevenly distributed increases in disposable income.

THE FED ACTS

In 2004 the Fed developed growing concerns over the emergence of a variety of imbalances. In their desire to preempt a reemergence of structural inflation, the Fed acted by instituting a more restrictive monetary policy. In doing so, the Fed understood their actions would induce a mid-recovery slowdown in GDP growth after which the economic recovery would resume and be extended for an indefinite number of years.

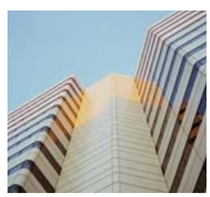
The Fed, charged by charter to maintain price stability, had successfully engineered similar strategies in the mid 1980's and again in the mid 1990's. Their plan was to persuade the bond market that following the horrors of stagflation[2] experienced in the 1970's, the Fed would remain steadfast in containing inflation and preventing a recurrence of those debilitating times. Although this current policy shift was initiated under Alan Greenspan, the market needed to test the resolve of new Chairman Ben Bernanke to stay the course and demonstrate that he too is a hawk on inflation.

BERNANKE STAYS THE COURSE

Since the start of 2006 the underlying strength of the economy has proven to be surprisingly resilient despite being challenged by the burn-off of fiscal stimuli and rising oil and commodity prices which produced a bout of cyclical inflationary pressures. To date, it is clear that early Fed initiatives and a solid productivity rate have combined to prevent a damaging wage/price inflation spiral from occurring.

At the August 2006 FOMC meeting the Fed voted to take no action on interest rates. Its statement was remarkable in *not* saying that it had stopped or even paused from raising rates. The Fed did say "inflation pressures seem likely to moderate over time, reflecting contained inflation expectations and the cumulative effects on monetary policy actions and other factors restraining aggregate demands." Importantly, the statement also emphasized "the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information." In short, the Fed is clearly saying that the 17 consecutive 25 basis point increases over the past two years and the unfolding mid-cycle slowdown should be enough to moderate recent inflation and return it to an acceptable range. If not, the Fed stands ready to tighten further if it does not see convincing data demonstrating slower GDP growth and moderating inflation.

THE DOWNSIDE



One should be careful in reading the discussion above about the Federal Reserve and inflation and avoid inferring a preciseness and certainty that clearly does not exist. History is replete with examples of how policy makers have underplayed or overplayed their hand in policy actions or in timing. At best, the Fed's tools are crude instruments lagged as to timing of impact and, increasingly in a more synchronized global financial environment, subject to unexpected events or unintended consequences.

This raises the possibility of either recession, where GDP turns negative for two or more consecutive quarters, or stagflation, where growth slows but inflation rates continue to rise. Neither alternative can be ruled out, but there does not appear to be a strong probability of

[2] Stagflation occurs when economic growth becomes sluggish while inflation and interest rates remain high.

either right now because:

- The Fed has acted in a well telegraphed and measured way by pre-emptively shifting policy beginning in 2004.
- There is no evidence of a wage/price spiral having taken hold.
- Current Fed Funds of 5.25% only exceed the ten-year Treasury rate by 35 basis points, much less than the usually high spreads that have existed at similar times.
- Corporate balance sheets, which include large cash balances, are sound and profit margins are high allowing business investment growth to continue.
- The consumer is leveraged and balance sheet net worth is still growing at an 8% annual rate, although the latter is likely to change as home prices moderate downward.
- Employment levels are lean, reducing the threat of large-scale layoffs.

One sobering thought is that the Fed has never ended a restrictive period without an accident occurring. Rising oil prices and the unfolding housing correction increase the probability this time that an accident may occur. We therefore should not be surprised if one materializes, even if it eventually does prove to be manageable.

HOUSING: A SPECIAL RISK

Regular readers of *Our View* know we monitor the for-sale residential sector because of the extraordinary and outsized role housing was allowed to play during this recovery. Restoring the housing sector and home prices to sounder and more sustainable levels is a special task the Fed must manage while at the same time attempting to minimize its negative impact on the larger economy. This will prove to be a challenge.

Housing took on a disproportionate role and prices came to be driven by rampant speculation during this recovery. It turbocharged a virulent consumer spending spree in a variety of ways. It provided the fuel to fund purchases of goods and services at a volume that far outstripped consumers' ability to afford based on growth in wages and disposable income. It has left the consumer overleveraged.

From the peak in January 2006, the National Association of Home Builders' housing index has plunged 40 points to 32, the lowest reading since the 1990 recession. Home permits for new construction have now declined a cumulative -25.9% including -6.5% in July. According to *ISI*, "the biggest year-to-year declines in home prices are in the Midwest and smaller coastal markets, which probably increases the odds we're seeing a national, not a regional, weakening in the housing sector."

Even though Australia and the U.K. experienced somewhat similar overheating in their respective housing markets, their readjustment periods, which lead the U.S. by two years, are continuing in an orderly, contained fashion. Neither market, however, turned down with the amount of unsold inventory that existed at the start of the U.S. correction. Neither market was as badly overextended in the degree of leverage utilized. The vulnerability for the U.S. is in the way this was all financed. While we have not experienced a significant and sustained year-to-year national decline in the price of homes since the Depression, we will be challenged to avoid it in this wind down because of the outsized role of housing and because of the degree to which marginal borrowers were permitted to finance their house purchases. In addition, there are negative implications for employment and consumer spending.

THE MARKETS' PERCEPTION

Coming off the stock market corrections five years ago, the equity markets are understandably reluctant to reprise another down market cycle. They clearly see the glass as being half empty, fearing a decline in economic growth rates and rising inflation (i.e., stagflation). This is despite strong corporate balance sheets, large cash positions, high profit margins and relatively attractive P/E ratios. They extrapolate the unfolding mid-recovery slowdown into a prolonged period of below trendline growth. This sentiment is shown in yet another period of lackluster year-to-date performance across the various equity markets.

The bond market, on the other hand, sees a glass half full. It sees improved corporate balance sheets, large cash balances and strong profits. It is impressed with the Fed's hard preemptive strike and is slowly becoming more confident in the newly elected Fed Chairman's resolve to contain inflation. Based on the evidence to date, the bond market is building its nerve to rally if the Fed, in fact, does stop raising rates this year because of a cooling economy. It sees the prospect that historically 5 to 7 months after the Fed stops raising rates, the Fed typically acts to start lowering interest rates.

The U.S. Property Market

Apologies for the over-weighting of this discussion of the economy. However, as most domestic commercial real estate markets are relatively healthy from a supply/demand standpoint, the state and future direction of the economy have a particularly profound impact on the future health of the commercial real estate market and its potential returns. With new employment creation uncharacteristically weak in this recovery and with the economy moving into a critical and sensitive transition phase, a close watch on macro trends is essential.

We are pleased to report that nearly all aspects of commercial property fundamentals are showing continuing improvement. Vacancy rates have declined in nearly all sectors as new development (e.g., new supply) remains constrained by high land costs and premium prices for construction materials and skilled labor. Absorption has been good although second quarter net absorption slowed somewhat from first quarter levels in all property types except apartments, according to *Property & Portfolio Research*. We note however that even with the improvement of the past 12 to 15 months, vacancy levels must still be lowered further for significant pricing power to emerge in the office, retail, industrial and, to a lesser extent, rental apartment sectors. Further, as reported earlier, great care must be taken in carefully underwriting local markets due to greater than ever differentials between healthy vibrant markets and markets still struggling to mount necessary growth in population and employment.

MARKET HIGHLIGHTS

Demand for office rentals, where national vacancy still exceeds 13%, remains steady and should continue in that mode even as the economy moves through its mid-recovery slowdown. Being the last property sector to experience the restoration of demand for space, the office sector is projected to make the most significant improvement in reducing vacancy to deliver the best relative fundamentals over the next several years.

Industrial rents have been increasing through the past 12 months. However, early anecdotal reports of stepped up new industrial supply, while not unusual due to the nature of industrial lease patterns, will bear close monitoring going forward.

The multi-family rental sector has an improved near-term outlook as higher interest rates and high home prices make home ownership less achievable. This is reducing vacancy and allowing for rent increases. There is a moderate increase in supply based on new construction and unsold condominium inventory being rented, but not enough to create significant supply issues. This is especially true after the significant reduction of supply over the prior four years with rental projects being converted for sale as condominiums. Longer term, the demographics for the Echo Boom compare favorably with the demands for rental apartments experienced by the Baby Boom generation.

NEGATIVE LEVERAGE TAKES HOLD

Probably the most significant recent change in the real estate market over the past quarter has resulted from the increase in interest rates. In the meantime, prices for stabilized property have continued to be bid-up, with capitalization rates across property types at all time lows – a phenomenon which is not considered either healthy or sustainable for the market.

This “negative leverage” (i.e., interest rates exceeding cap rates) situation hasn’t taken place for a sustained period in over 20 years. This time however the negative leverage is a relatively healthy development in that it is causing leverage-dependent purchasers of core leased properties to re-evaluate whether current purchase prices can be justified and whether their exit valuation assumptions are justifiable. We believe that the current market dynamics should dampen further increases in property prices which are not supported by a commensurate increase in cash flow.

Eventually we believe cap rates will increase to a level which will create positive returns for the leveraged equity buyer and that valuations and returns for stabilized properties will undergo a reversion to their mean over the next several years. Depending on local dynamics and property type, this will likely involve a mix of rising returns and/or lower prices to get back to sustainable valuations in a normalized interest rate environment. Until then, investors in value-added and opportunistic real estate strategies will be well served to build in a pricing cushion into their cash flow projections in order to take into account expected cap rate increases.

Wrap-Up

We see the glass half full with respect to the way events are playing out with a mid-recovery slowdown. We share the bond market’s perception that a recovery to solid, sustainable GDP growth of 3 to 3½% will be achievable once we have successfully allowed the slowdown to navigate its one to (possibly) two year course. Commercial real estate fundamentals will do well but not spectacularly as prices and returns are brought back into more traditional alignments – and the post slowdown scenario is very positive given the U.S.’s demographics and economic growth potential.

The interim is filled with risks that are measured and promising opportunities, if carefully underwritten and managed in a disciplined fashion, are also present. There will be many near term bumps over the next year but, barring a major accident, these should prove to be manageable. In times like these it is constructive to communicate frequently. If you have questions about our outlook, don’t hesitate to contact us through your adviser.

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 and Richard W. Maine as Co-Managing Partners, as well as Russell H. Bates, Partner in charge of real estate underwriting. The firm focuses on providing investors with a proper balance of risk and return through a high level of diversification. Madison Harbor’s principals collectively have over 125 years in commercial real estate and capital markets experience. For more information, please visit **www.madison-harbor.com**.