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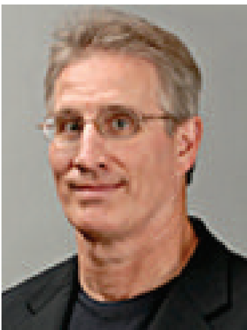
Economic Outlook—the Good, the Bad, and the Ugly 2009



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By Dr. Peter Linneman

We are in a minefield of losses, but these losses are finite. The mines the economy faces are the future losses associated with poorly underwritten investments made from 2004 through early 2007. The trouble is that we do not know how big these losses are, when they will occur, which firms hold these assets, or if these losses will wipe out their equity. Strangely, each time a "loss" mine explodes (Bear Stearns, Fannie/Freddie, AIG, Lehman, Wachovia, Washington Mutual), we become a bit safer, as there is one fewer mine to be inadvertently stepped on (this is true in spite of collateral damage to those near the detonation). Yet psychologically, seeing old friends blown to bits erodes confidence, makes us feel more endangered, stops us dead in our tracks, and creates panic among the citizenry.

Our political leadership panicked in the last five months of 2008, substituting deals for policy. This panic quickly spilled over onto both Wall Street and Main Street, and worse, we still do not know who holds the losses. Instead, we have seen finger-pointing about which party is to blame and who gets paid how much (and by whom) if blown up. Until the location of the losses is revealed, the economy and capital will largely stand around in a worried state, rather than moving forward.

When the U.S. economy stands still, per capita income declines because no one is investing, taking on new opportunities, expanding their products, or transacting. Jobs are not created for the three million people entering the economy, and those who die, retire, or go back to school

are not being replaced. Thus, U.S. job losses increase. We expect the U.S. to lose another 900,000 jobs over the first half of 2009. In addition to declining per capita GDP, we also expect a 3.0 to 4.0 percent decline in total real GDP. This is going to be a recession rivaling 1973-1975, and it is going to take time to work our way through it.

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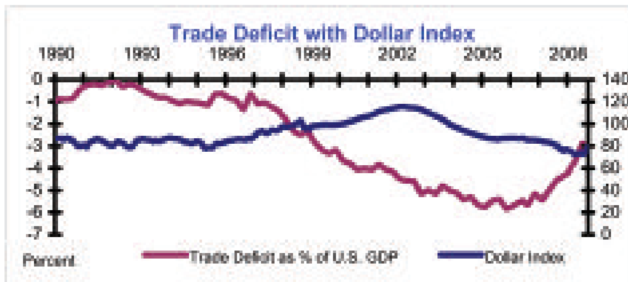
Bad news abounds as the economy shuts down in the face of capricious government policy. Real GDP fell in the third quarter by 0.5 percent; real per capita disposable income fell year-over-year by 0.4 percent and by 9.6 percent on an annualized basis in the third quarter of 2008. Unemployment rates were up across the board, rising to 7.2 percent nationally. For 16- to 19-year-olds, the rate soared to 20.4 percent from 15.4 percent in late 2006 (prior to minimum wage legislation to "help" low-wage workers). Durable goods output declined by 2.5 percent in September and October, and by 4.6 percent year-over-year, with the greatest declines in the auto sector, which suffered from high gasoline prices, tight credit, and low consumer confidence. The S&P 500 fell 32 percent from the start of September through December 15; and consumer confidence was a modern record low of 56.4.

The fourth quarter will be even worse than the third, as the government-created consumer and business panic will continue until the new administration replaces ad hoc deal making with economic policy. Inflation will be muted in the very near term, and perhaps even negative, as the massive declines in oil prices work their way through the economy. However, core inflation remains at 2.1 percent, while service sector inflation has crept up to 3.5 percent from 3.0 percent. In the longer term, the huge financial injections made around the world, combined with low central bank rates, create a greater long-term inflationary bias than has existed since the early 1980s. Yet short-term Treasury rates hover near zero, while 10-year Treasury yields are 2.6 percent, as people seek absolute safety. Eventually, capital will have to seek a real return. The U.S. trade deficit as a percent of U.S. GDP has fallen to -3.2 percent, while

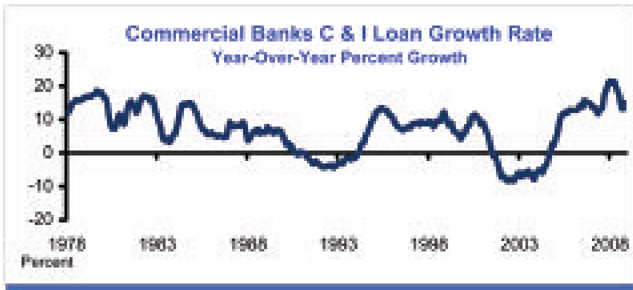
as a percentage of world (other than U.S.) GDP, it has fallen to 0.6 percent. The good news is that this decline will reverse in the near term, due to the global flight to safe investments (U.S. Treasuries).

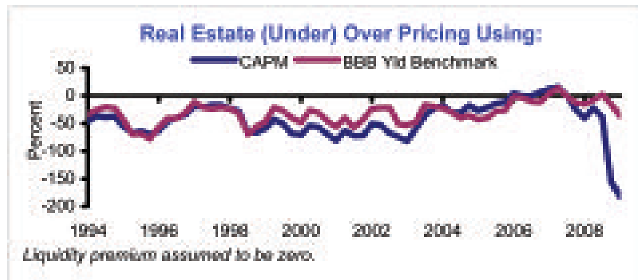


Better news is that the dollar has notably strengthened in spite of U.S. economic weakness because, while the U.S. economy may be weak, most other economies are even weaker. The dollar is now only about 10 percent undervalued on a purchasing power parity basis. And contrary to rhetoric, banks are lending. Total bank credit at the end of October was up more than $620 billion, or 6.9 percent year-over-year. And bank lending to commercial real estate rose to $1.7 trillion, up $215 billion year-over-year (13.8 percent). While some of this reflects construction draws and loan extensions, the fact is that banks are lending. However, their loan expansions are insufficient to make up for the complete vaporization of CMBS lending, which averaged nearly $220 billion annually in 2006 and 2007. As a result, net real estate lending was down in total by perhaps $100 billion in 2008.

Bank securities holdings have fallen by nearly 4.0 percent from their March 2008 peak, as banks have sold some of their hung securitizations. Commercial and industrial loans (primarily lines of credit) have risen nearly $190 billion (13.3 percent) year-over-year through November 2008. The properties facing the most distress are the "transitional" projects: land, re-development, construction, or anything lacking an identifiable cash flow. Discounts on these properties will be extraordinary, and investors must be willing to go in on these transitional developments on an all-equity basis in order to move forward. They will have to underwrite returns assuming a long-term hold. And for developers with a great site, our advice is to mothball it.

Turning to commercial real estate pricing, private transactions are almost non-existent. When they do occur, cap rates appear to be 15-20 percent above first quarter 2007 levels. REIT prices remain absurdly low and imply that cap rates are still 20 percent to 30 percent higher than in

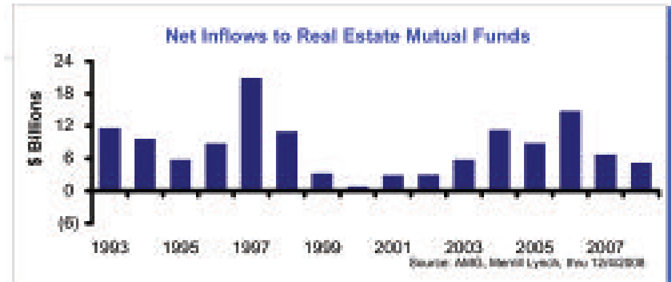




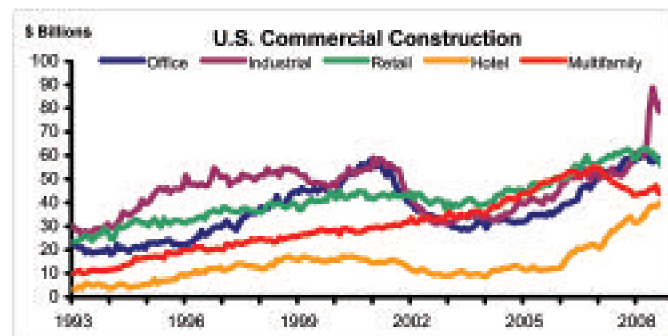
early 2007. REIT implied NOI cap rates were a staggering 600 basis points above 10-year Treasury yields in mid-December. As economies weaken, leasing activity and rental rates in the retail, office, and industrial property sectors will generate flat to declining NOI. By mid-2009, most markets will witness a decline in rental rates and an increase in vacancies as tenants increasingly focus on consolidation and cost-efficiency rather than expansion.

If you look at housing prices on a broader basis, they are down year-over-year by 4.0 percent for the nation, based on the OFHEO housing price index. In some parts of the country that were not overbuilt, prices are still up. By mid-2009, you will see the housing market start to shift from an excess supply to the very early stages of an excess demand.

Demand for office space will soften dramatically for the next 12 to18 months. There will be a halt in leasing activity, and shadow space will gradually rise, sided by the occasional bankruptcy. As the economy picks up slowly in late 2009-early 2010, tenants will first fill empty desks before



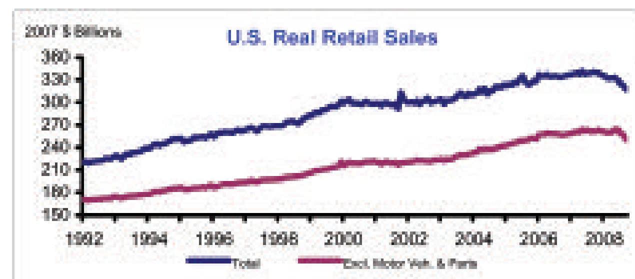
making new space commitments. According to CB Richard Ellis, the third quarter 2008 national office vacancy rate rose to 14.1 percent, up 50 basis points from the previous quarter and 150 basis points from the same time last year.



We believe the warehouse sector will hold up the best, as boxes still have to be stored and construction lead times are relatively short. But demand will be off. According to CBRE, the industrial vacancy rate rose slightly to 11.4 percent in the third quarter of 2008.

The Census Bureau's quarterly Housing Vacancy Survey indicates that the U.S. multifamily vacancy rate declined by 10 basis points to 9.9 percent in the third quarter of 2008. This series has generally been hovering around 10 percent since late 2003.

We are also seeing an acceleration in retail store closings. The problem today is that there will be fewer store openings in the near term to offset those closings, as retailers hoard their capital.



The retail sector will skew toward groceries and non-durable goods, as well as lower price points, and away from anything capital-intensive. NCREIF reported that the national retail vacancy rate jumped to 7.5 percent, and new retail construction has been declining steadily on a monthly annualized basis, reaching approximately $55 billion in October 2008.

U.S. hotel markets dramatically weakened in the third quarter of 2008, because of escalating supply and collapsing demand. As of October 2008, RevPAR stood at $65.46, according to STR and the 12-month rolling average dropped to 61.3 percent. Consumers are cautious, making fewer visits to Disney World and relatives. Advance bookings stopped, and many events that have already been booked will be cancelled. After a strong five-year run, we expect RevPAR to decline, though with the odd exception.

The best news for real estate is that new construction financings were virtually non-existent in late 2007 and 2008. This will continue into 2009, meaning that weakening demand fundamentals will meet limited supply expansion, rather than the exploding supply which usually appears at the end of an economic cycle.