Markets Feel Effects of Subprime Loans, Downturn in Economy

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by Hugh F. Kelly, CRE

Note: Since performing the analysis and writing the narrative for the Summer SIOR Commercial Real Estate Index, the subprime and credit market turmoil has continued to deepen. The psychology of the market has become increasingly fearful, despite appropriate action on the part of the Fed to provide liquidity and lower its Discount Rate. Re-reading the text, I find its perspective one that I would still endorse—that we are seeing an example of a product failure, rather than an industry failure like the S&L crisis in the early nineties. The decline of employment in the most recent release, however, is worrisome, and the possibility of a wider economic downturn has increased. At best, we will see a much slower economy in the second half of the year than was previously thought, and I would now expect the Fall survey for this Index to be weaker than I anticipated just a month ago. But that's exactly the reason for evaluating the market conditions frequently. Let's hold on to our hats, since the ride is getting bumpier.

—Hugh F. Kelly, CRE (September 11, 2007)

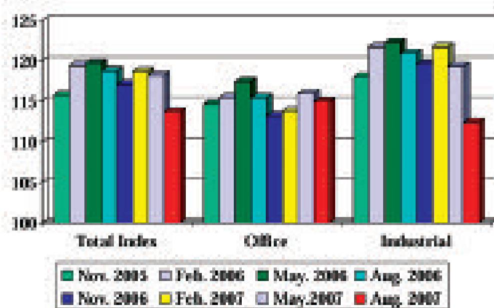
The Motown record label defined summer transistor radio listening for many in the Baby Boomer generation. Over the beach season of 2007, echoes of that playlist seemed to beam over the economy and the real estate markets. For many, Marvin Gaye's "What's Going on?" was the question of the hour. Experienced real estate professionals, alert to the industry's cyclicality, could be pardoned for singing The Four Tops', "It's the Same Old Song." On Wall Street, traders in the markets for CDOs (collateralized debt obligations) that repackaged subprime mortgages were discovering the truth of Martha and the Vandellas' "Nowhere to Run." And, for those investors sucked into spurious securities and hedge funds that were caught holding suddenly toxic products, the circus beat of Smokey Robinson's "The Tears of a Clown" thumped mockingly in the background.

Psychology, it must be said, has superseded dispassionate logic in all of this. The economist Ben Stein wrote a trenchant column in the *New York Times* Sunday Business section in August, citing the numerous ways in which the subprime "crisis" has been overblown, from the relative size of the expected losses in this area (perhaps $67 billion, in the

$10.6 trillion U.S. mortgage market) to the losses in the Dow Jones Industrial Average (30 huge companies who are hardly dependent upon exotic residential mortgages for their economic success). Stein's conclusion: "Fear can trump fact. The media will catastrophize anything they can."

Fact or fear, though, the spillover of the residential mortgage turmoil into the world of commercial real estate is having its effect.

Warning Flags in Summer 2007 SIOR Survey:
Economic Uncertainty Slams Industrials; Offices Look Solid

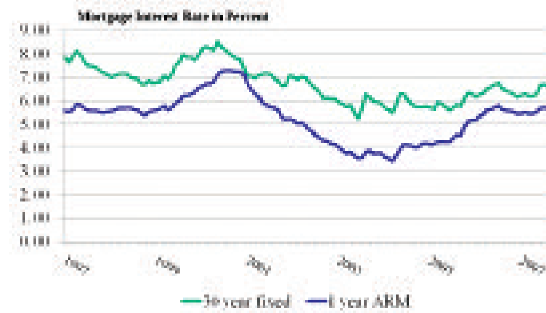


Source: Hugh F. Kelly Real Estate Economics for SIOR

The Summer 2007 Commercial Real Estate Index compiled by the SOCIETY OF INDUSTRIAL AND OFFICE REALTORS® posted the steepest quarterly decline since SIOR began its indexing project in late 2005. The national index, which measures 10 variables pertinent to the performance of U.S. industrial and office markets, dropped 4.49 points from the Spring survey's 118.19 to a Summer reading of just 113.70. This is the weakest score yet seen for SIOR's national index.

The SIOR Commercial Real Estate Index is a diffusion index (see Methodology under that heading in the newsroom on the SIOR Web site) where 100 represents markets in balance. Hence, the score of 113.70 still reflects positive conditions in the commercial real estate industry. But it is clear that the strong momentum enjoyed until recently has been broken, at least temporarily. The weakness was broad-based, with all 10 components of the index registering lower scores than in the spring. The index reflected slower leasing activity, and the SIOR survey respondents associated this with softening in both national and local economies. The index was based

Back to Basics: Home Mortgage Rates Still Excellent for Most Households



Source: Freddie Mac Primary Mortgage Survey

on questionnaires completed by 367 SIOR industry professionals in late July and early August.

That was the precise period, of course, when the debt markets unraveled as speculation in subprime mortgage securities came back to haunt Wall Street investment banks and hedge funds. Most of the analysts were telling the story as a housing market collapse spilling over into the credit market. In fact, residential real estate has fundamentally performed quite well as we will see later in this article. Construction did drop in consonance with retrenching sales, but most indicators (including mortgage rates) stayed strong by historical standards. The serious troubles—again—were in the Wall Street "genius" models. In a pattern strikingly reminiscent of the Long-Term Capital Management turmoil of 1998, exotic and untested investment products promised "high yields and low risks," and precious few financial engineers and supposedly-sophisticated investors said, "That can't be right."

"Where Did Our Love Go?"

Of the two property types covered, industrials were hard hit. They scored 112.34 in the summer survey, down from a high of 121.71 as recently as six months ago. Warehouse and distribution centers experienced a significant slowdown in demand, translating into a stall in the improving vacancy trend that this sector has enjoyed since the economy emerged from recession. While some modest upward movement in rental rates still occurred, the strength of rental growth moderated. No doubt, the contraction in the homebuilding industry and the ripple effects in durable goods spending are responsible for much of the weakness.

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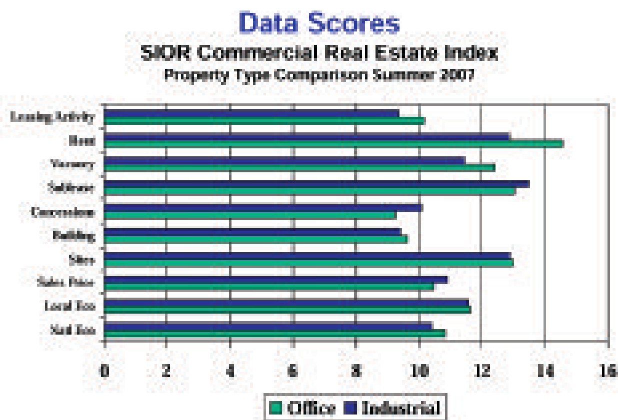


Considering the 10 variables making up the index, leasing activity and development both came in below the 10-point norm reflecting market balance. Leasing activity slipped to 9.35—1.25 points from its May score of 10.60, while development activity slid 0.13 points to 9.40. For industrials, the strongest score (13.49) was posted in subleasing conditions. Site acquisition was still seen favoring sellers over buyers, with a score of 12.88. Rental rates reflected a continuing advantage for landlords over tenants, with this variable posting a 12.87 score.

Major interstate hubs and gateway ports all appear to be doing well. Positive commentary accompanied the statistical survey submissions from Atlanta, Chicago, and Dallas/Ft. Worth, as well as the Los Angeles and San Francisco areas and Delaware, Florida, Jacksonville, Miami, and northern New Jersey. Many of these markets continue to report scarcity issues, high land costs, and restricted building volumes as contributing factors to strong lease and sales prices. Baltimore also falls into the "upbeat" column, with several submissions mentioning military base closures as positive events for their industrial markets.

The booming housing markets, now feeling a chill, prompted more caution from the SIOR survey respondents in Las Vegas, Nashville, Orlando, and Phoenix. Los Angeles also generated a comment that "it is too soon to tell the effect of a possible credit crunch, but it could be significant." Auto industry markets in the Midwest, especially in Michigan and northern Ohio, and are concerned about employment issues, of course, but these also spill into the housing market. It is not clear how much of the residential troubles in these two states are just traditional economic weakness and how much are special difficulties stemming from the mortgage squeeze. All in all, the weakening industrial index nationwide signals at least a yellow caution light for this property type.

“You Keep Me Hanging On”

Offices seem to be in better shape. Summer’s score of 114.95 showed only a modest loss of 0.98 points. Leasing activity in offices was actually up slightly, with rent and vacancy measures improving. Investment values were also rated as strengthening. However, the SIOR respondents indicated that local and national economic conditions are weakening and that this is likely to translate into a less robust office market later in the year.

Quite a few markets seem to be more than holding their own. That is to be expected with the national index still scoring greater than 113 points. The drop since the spring survey, while significant, finds the index still solidly above the “equilibrium” value of 100. The summer’s turmoil on Wall Street notwithstanding, we are finding solid real estate market performance in Manhattan as well as in markets close to New York. One respondent noted that it has been several years since brokers had to break a sweat to market properties. Tenants and buyers are lined up, checkbooks in hand. In part, the relatively steady performance in both the Northeast regional index and the office index reflect the bellwether Manhattan office market, but nearby markets—whether over the bridge in Brooklyn or in northern New Jersey— report solid conditions as well.

Silicon Valley is also maintaining its upward market trajectory, as the once-battered high-tech sector again takes wing. Silicon Valley was only one of many areas energized by the enormous Blackstone acquisition of the Equity Office Properties portfolio, a $39 billion transaction. Blackstone rapidly repackaged the portfolio into local asset groupings in Austin, Denver, Manhattan, San Francisco, Seattle, Stamford, and Washington, D.C.

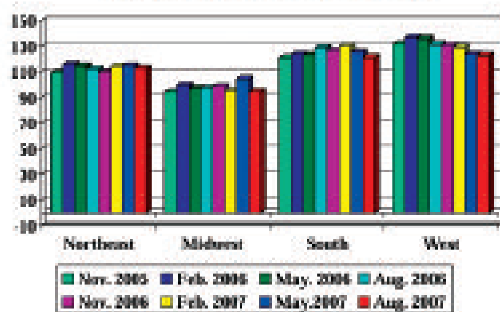
Among smaller office markets, Charleston, Charlotte, and Louisville all indicated improvements in occupancy into the summer months, with the expectations of a strong 2007 finish. Even in markets that might look especially risky at the moment, it is wise not to jump to conclusions. Certainly, based on the headlines of the past few months, one would think that the cluster of hedge funds in Fairfield County, Connecticut should be reeling, if the losses in the Bear Stearns’ funds are

typical of the market. But while some of the Wall Street giants bet absolutely wrong on subprime mortgage securitizations, others "short-sold" the subprime CDOs (collateralized debt obligations) and "went long" on more conventional mortgage securities. At least one of these funds is privately reporting a 70 percent gain on its residential securities investments, worth billions to its investors and to its managing partners.

"Do You Know Where You're Going To?"

SIOR Index Dips in All Regions

Midwest and South Take Brunt of Slowdown, Subprime Issue Partly to Blame



Source: Hugh F. Kelly Real Estate Economics for SIOR

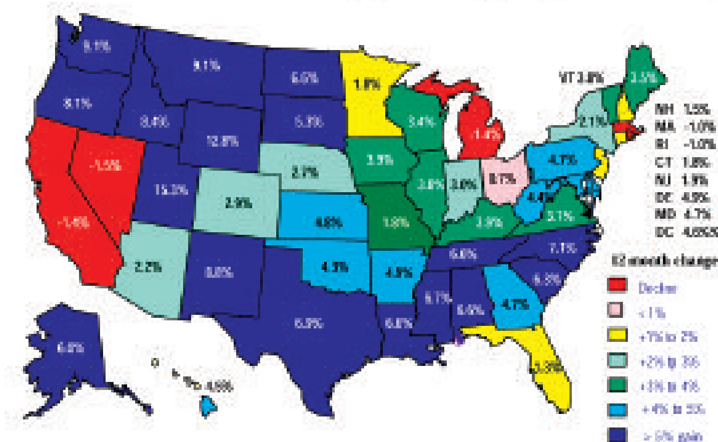
All four major regions of the country saw their index scores slip, with the West and South reaching new lows. That said, the Sunbelt and the West remained marginally stronger than the Northeast, and much stronger than the troubled Midwest.

West

The West led all regions with a score of 122.99, down 0.76 points from the Spring and 13.91 points from its peak of 136.90 in the Winter of 2006—when housing markets were booming, retail sales were robust, and international trade was flowing copiously. Summer 2007 marked the sixth consecutive quarter of decline in the West's index score.

Survey respondents from many formerly high-flying residential markets indicate significant commercial property effects as the homebuilding slowdown enters its second full year. Many Sunbelt markets, such as Las Vegas and Phoenix, find their economies directly related to the pace of demographic growth. The slowdown in housing, therefore, creates a ripple effect affecting employment, retailing, and warehousing. Boise and Reno are other market areas that reported similar spillover from the housing and subprime mortgage market turmoil. Tucson, however, seems to have sidestepped difficulty until now.

Home Price Change Through 2Q 2007



Source: Office of Federal Housing Enterprise Oversight (OFHEO): Index release of August 30, 2007

As a matter of fact, the housing price data released by OFHEO (the Office of Federal Housing Enterprise Oversight—the monitor for Fannie Mae, Freddie Mac, and Ginnie Mae) provides much food for thought. The nation as a whole posted a 12-month gain in house prices of 3.2 percent. As the accompanying map shows, many of the Western States far exceeded this, with double-digit

increases still registering in Utah and Wyoming. But the "headline states" of California and Nevada fell into negative territory, with Arizona and Colorado suddenly chugging below the national average. Arizona, California, and Nevada still stand with 90 percent appreciation of their home prices since 2002—but that makes the current dip an even more arresting phenomenon. SIOR's survey respondents clearly see it translating into greater risk on the commercial property side.

South

After two quarters as the nation's leading regional score, the South saw its index slip 4.06 points to 121.32, significantly below its excellent 130.45 value just six months ago. The Sunbelt's reliance on vigorous home building as a component of its economy turns out to be a two-edged sword, now cutting into its commercial markets in a measurable way.

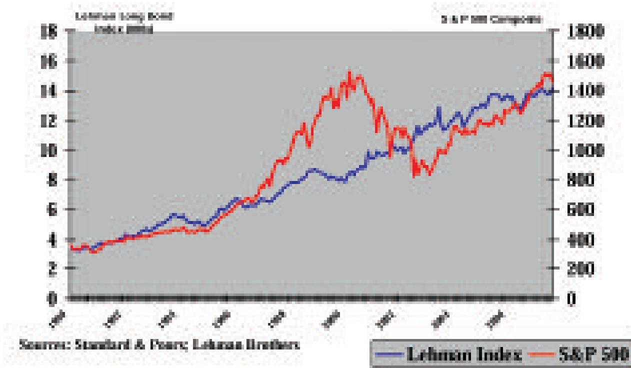
Turning points in the real estate cycle are notoriously difficult to pinpoint when they are occurring. And there is some question about the relationship between the cycle in the space-use market, where rents and vacancies are key variables, and the cycle in investments, where capital flows are critical. Many respondents indicated no relaxation in the pressure of capital and its consequent effects on prices and capitalization rates. Others were less certain, feeling that the potential for tightening commercial mortgage standards—and even a possible liquidity squeeze—may stall values in their tracks before the year is out. Several responses—from markets as different as Austin, Nashville, and Orlando—raised the possibility that we are not seeing a turning point or reversal of trend, but a temporary bump in the road toward even tougher landlord-dominated markets.

Houston has such strength in the oil and natural gas industries that it currently appears insulated from the housing downturn. According to one participating SIOR member, Charlotte's office market is seeing record low vacancy and record high rents. Developers are becoming more bullish around the Dallas/Ft. Worth metroplex. So it would be an irresponsible exaggeration to maintain that the wind is entirely out of the commercial real estate industry's sails.

Northeast

Despite falling 2.16 points from the Spring index, the Northeast index of 112.95 was slightly above the mid-point of its historical range. This densely populated quadrant of the country is more demographically mature, and it features some of the largest and healthiest office markets in the country, while being comparatively less dependent upon the industrial sector of the commercial real estate market. While it appears that the subprime lending and resultant credit market turmoil will affect financial industry employment before this year is out, such demand-side effects were not yet evident in the summer 2007 results. Even in the New York metro area, where much of the credit trouble originated, the numbers have to be put into perspective. Market monitors such as Challenger Gray & Christmas have counted 14,000 lost jobs in the New York region directly due to subprime-related layoffs. But it should be remembered that this is less than one-half of one percent of the Tri-State area's office employment base of three million workers.

Markets such as Philadelphia are still quite solid. Other markets, including the Albany, New York, and Delaware industrial sectors, cite development discipline as a fundamental explanation for rising prices and falling vacancies, even in the face of recent economic uncertainty. Providence is sufficiently confident that speculative office development has returned to the scene.



The performance of the financial markets was exceptionally bullish through the first seven months of the year (see the graph of stock and bond indexes above). Even with August's sell-off, it is not clear that we are headed for a financial bear market. The summer months are notorious for nervous behavior on Wall Street, and frequently dislocations such as the one we've seen recently give way to a second leg of a bull market. No guarantees can be issued, of course. But there are those who are thinking current values represent a buying opportunity. Real estate professionals will be watching such sentiment closely, since it will surely give a strong hint about the performance of the Northeast commercial property markets into 2008.

Midwest

Finally we turn to the Midwest, where the troubled U.S. auto industry is centered. This region has emerged as one of the most intense housing foreclosure clusters in the nation, effectively ending what appeared to be an encouraging commercial property revival just three months ago. The Midwest, which had scored an index value of 104.58 in the spring, plunged to 94.49, a loss of more than 10 points. Such a precipitous drop is the steepest in any property type or any region in the eight quarters in which the SIOR Commercial Real Estate Index survey has been conducted.

It certainly seems that the industrial heart of this region is having more than a slight arrhythmia. Cleveland, Detroit, and the heavy-industrial belt from Gary to Toledo are struggling. Indianapolis,

a crossroads for the nation's interstate highway system and a distribution hub, noted that the flow of building goods through its warehouses has contracted noticeably.

Nonetheless, some Midwest markets, while noting the housing situation, pointed to overriding local economic strengths that have trumped the residential troubles. Minneapolis-St. Paul reports that a new and higher level of asking rents is being established in its office suburbs. Downtown Kansas City is seeing $3 billion in construction activity. Chicago's Loop is reported to have solid current conditions, though there are some concerns about potential excessive building in the metropolitan area.

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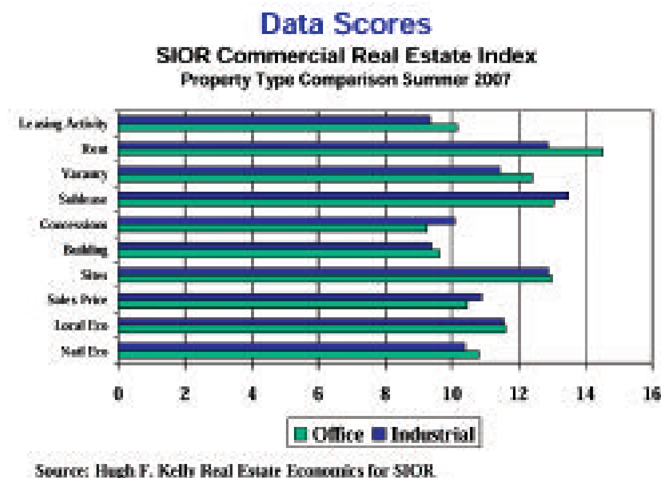
"Mountain High, Valley Low"

Although quarterly variation is a feature of the SIOR Index, and a rebound later in the year cannot be ruled out, there is obviously cause for concern that so many of the regions are at or near their two-year lows, and that both the overall index and the industrial property index posted



Source: Hugh F. Kelly Real Estate Economics for SIOR.

their lowest scores since our survey was initiated. While real estate is less volatile than investment markets like stocks and bonds, commercial property is cyclical and prone to swings in concert with the local and national economies. The SIOR Commercial Property Index warrants close and careful attention through the remainder of the year.

Such mixed opinion often leads to a wait-and-see attitude, not only among investors but among corporate decision makers and developers as well. If that is the case, we can make a lot of sense out of the Index numbers, which are showing much slower leasing activity and weak building for this point in the cycle. Investment pricing, meanwhile, remains not much higher than replacement cost.

If we can step back and take a longer view, we might hope that the financial markets will regain some perspective as the weather turns cooler. Looking at current residential mortgage rates (as of late August 2007), conventional mortgages still seem very affordable, even by the standards of the past 10 years, much less the peaks of the '80s and early '90s. Even ARMs don't look alarmingly expensive, with rates similar to what they were in the strong economy of 1997–1999. The Federal Reserve has already taken its first steps in accommodating market concerns by lowering its discount rate and injecting funds into the banking system. However, Chairman Ben Bernanke rightly says that the professional investors who speculated in risky mortgage securities should just take their lumps. James Grant, the noted expert on interest rates, has remarked, "Maybe he [Bernanke] is seeing the light that capitalism without financial failure is not capitalism at all, but a kind of socialism for the rich."

From my own perspective, looking into the latter part of 2007 and into 2008, I think that the credit troubles of the summer of 2007 more resemble the derivatives and currency problems of 1998 than they do the S&L crisis and resulting liquidity crunch of the early nineties. One way of distinguishing the two is to see that the S&L crisis was an industry-level meltdown, while the 1998 difficulties were largely a product failure. What we are seeing now, in my opinion, is a product failure that is being hyped as a structural fault in the financial industry. If, as seems likely, it turns out that the financial system is structurally sound but guilty of selling a lemon of a product in its subprime securities, I'd guess that the SIOR Indexes will be bouncing back over the course of the year ahead.