Current Developments in the Markets and Implications for the Real Estate Recovery

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Outline:

1. What drives a healthy real estate market?
2. Where do we stand now? Current conditions and trends
   - The macro-economy
   - The housing market
   - The commercial market
3. An assessment of intervention policies: past, present, and future
4. How can politics/policy play a constructive role in the real estate market recovery?
What drives a healthy real estate market?
Back to fundamentals: The housing market…

- Healthy growth in population/number of households
- High and increasing real incomes and wealth
- Household characteristics and “tastes”
- Presence/absence of “locational amenities”
- Presence/absence of nearby employment
- Price (rent) of available stock and rent vs. own “user cost”
- Optimal level of supply restrictions
- Broad availability of affordable financing and terms
- Good supply-demand balance (e.g., vacancies, time-on-market)
- Market not excessively volatile
Back to fundamentals: The commercial market

- Healthy growth in demand drivers (e.g., employment, retail sales, GDP, population, incomes and wealth, etc.)
- Competitive cost structure relative to outsourcing, offshoring
- Competitive labor costs relative to technological substitution
- Competitive land, construction, development costs
- Availability of construction, permanent financing at reasonable terms
- No supply/demand imbalances
- Reasonable restrictions on new supply
- Markets not excessively volatile
Where do we stand now? The macro-economy
GDP growth has been weaker than expected

Real GDP growth is measured at seasonally adjusted annual rates.

U.S. Bureau of Economic Analysis
Employment recovery has “whip-sawed,” but is not significantly different from last cycle.

Source: Bureau of Labor Statistics
Construction employment still remains “in the tank”
The unemployment rate is dropping at a rate comparable to past recoveries...

Source: Bureau of Labor Statistics
...but long-term unemployment is a problem
The deficit (as a percent of GDP) still remains high (though it is projected to drop)
...while the national debt as a percent of GDP is even higher (and rising)
Credit and lending are still constrained...though banking is coming back

F.1 Total Credit Market Borrowing and Lending (1)
Billions of dollars; quarterly figures are seasonally adjusted annual rates

<table>
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<tr>
<th>30 Financial sectors</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
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<th>2011</th>
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<td>50 Brokers and dealers</td>
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<td>387.9</td>
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The financial crisis severely eroded household net worth.

Figure 1. Household sector net worth

Shaded area represents the range of the 2007 and 2009 surveys discussed (2007-Q3 to 2009-Q3)
…especially at the low end
Where do we stand now? Housing
Homebuilding stopped dead...annual housing starts dropped from about 2.2MM to 500K over 3 years and have stayed there with only a recent blip upwards (Is this really bad news?)
Mortgage credit availability and terms remain strict and elusive, but some recent indications of a “thaw”

- Volume of lending low by historical standards, but recent increases under low interest rates
- Terms (LTV, debt-to-income, rates, balloon payments, ARM restrictions, teaser rates, seconds, non-Agency issues, appraisals, credit ratings) remain strict
- “Jumbo” and other spreads, though declining from peaks, remain high. But funds are available.
- Secondary market essentially exists only for Agency issues (FHA, Freddie, Fannie)
Though the jumbo spread has narrowed, it is still high by historical standards. But loans are being made
The MBA Purchase Applications Index has begun to stabilize
And home sales are starting to pick up
And the apartment market is clearly rebounding
Though home ownership rates have been dropping since 2004.
The foreclosure crisis: Has it peaked?
Delinquency and foreclosure “overhang” are gradually dropping

• High concentrations, creating “zombie” properties, households, and neighborhoods, are now primarily in the outer fringe

• Subprime mostly resolved, and alt-A, pay-option ARM, investor loans are slowly running off

• Delays still persist in cleaning up banks balance sheets, but “extend and pretend” is abating

• The result? Demand for new homes, multifamily is starting to pick up
An example: Laguna Beach homes in trouble 2010 vs. 2011

Source: RealtyTrac
Although homeowner vacancy rates remain high, they are starting to drop.
...and existing home inventory is also declining
Shadow inventory is starting to decline
The result? House prices are beginning to stabilize.
…but the CBO does not expect peak-to-peak house price recovery until 2020
Where do we stand now? The commercial markets
Market balance returning: Supply still ahead of demand, but within normal relationship for an equilibrium market.
Sales volume started to recover slowly in Q2 2009 and is accelerating.

Source: Real Capital Analytics.
…and vacancies are stable or declining, especially in multifamily
Rents are stabilized in retail as of the end of 2011 and are increasing in office and (especially) apartment

Source: REIS
… and cap rates are continuing their downward trend (low costs of capital and growing expectations of market improvement). A BIFURCATED MARKET!

Source: Real Capital Analytics.
The result? Prices began to stabilize by year end 2009 and have been increasing since 2010

Source: MIT Center for Real Estate
…and across all metro areas (e.g., office outlook 2010 Q1)

United States office clock

Source: Jones Lang LaSalle 2010 Q1 Office Outlook
vs. office outlook 2012 Q1

Peaking market
San Francisco
Silicon Valley
Austin, Houston
Pittsburgh
Seattle
Dallas, Indianapolis, San Francisco Peninsula
Boston
Denver, New York
Baltimore, Minneapolis, Richmond, San Antonio, United States

Falling market
Detroit, West Palm Beach
Fort Lauderdale, Jacksonville, New Jersey, Phoenix, Sacramento, San Diego, St. Louis, Westchester County
Cincinnati, Cleveland, Fairfield County, Hampton Roads, Orange County, Washington, DC
Atlanta, Charlotte, Chicago, Los Angeles, Miami, Oakland-East Bay, Orlando, Philadelphia, Portland, Raleigh-Durham, Tampa

Rising market

Bottoming market

Source: Jones Lang LaSalle 2012 Q1 Office Outlook
This is in (very small) part because the CMBS market has begun to reawaken (though slowly).

Source: Commercial Real Estate Direct
But CMBS is not where it once was
... but in a larger part due to the re-entry of life insurance companies into the commercial mortgage market.
Winners and losers: Property value declines and loan calls have resulted in a significant increase in delinquencies among CMBS and banks. But, these have peaked...
Another bright spot: REIT returns (as in the early 1990’s) are ahead of property fundamentals

Source: NAREIT
Economic and policy issues of concern
The overall picture: What should keep real estate professionals awake at night?

• Government gridlock, adverse fiscal policy
• Faltering foreign economies: China, the Euro Zone
• Tepid real GDP growth
• A “jobless” recovery
• Income/wealth declines among the middle class
• Inadequate physical capital (infrastructure) and human capital (education) investments
• Irresponsible fiscal and/or monetary policy
• Excessive or inadequate regulatory policy
• Distortionary/inefficient tax policy
• Increased ambiguity/uncertainty in the future (including economic conditions, property rights, taxation, regulation, etc.)
• Extended delay in recapitalization of commercial/residential markets
• Lack of adequate recognition or control of windfall gains and losses created by public policies
Current federal foreclosure intervention policies

• Making Home Affordable (MHA) Program
  – Hope for Homeowners Program (H4H)
  – Home Affordable Modification Program (HAMP)
  – Principal Reduction Alternative (PRA)
  – Second Lien Modification Program (2MP)
  – Treasury/FHA Second Lien Program (FHA2LP)
  – Home Affordable Refinance Program (HARP)
  – Home Affordable Unemployment Program (UP)
  – Emergency Homeowners’ Loan Program (EHLP)
  – FHA Forbearance for Unemployed Homeowners
  – Home Affordable Foreclosure Alternatives (HAFA)
  – “Redemption”
  – FHA NSC Loss Mitigation Programs
  – HOPE NOW Alliance
  – State-run Hardest Hit Fund from $25 billion bank settlement
  – FHA Streamline Refinance Program
Some additional policies/initiatives to recapitalize the mortgage and housing sectors

- PPIP
- Fannie/Freddie bulk Sell-to-Rent Program
- Bank or Freddie/Fannie write-downs with equity-sharing features
- Investor bulk/one-off purchases of homes/mortgages for sale or rent
- Single-family rental REIT
The “ideal” foreclosure intervention policy

- Allocates costs to those at blame and/or who stand to benefit
- Allocates benefits to those who have been adversely affected
- Is efficient, transparent, and simple to understand
- Does not create “adverse incentives” or “moral hazard” or “unforeseen consequences”
- Has no or few “spillover” effects
Why can’t we achieve the “ideal” policy?

• Much of problem was result of well-intentioned, but misguided policies
• Blame costly to identify, especially for borrowers & mortgage brokers
• FDIC inadequately funded
• Past government policies deserve a substantial share of the blame
• Politically impossible in current climate
What to do with Freddie and Fannie?

- Most agree they are needed currently to maintain stability and liquidity
- Most agree the “dual mission” of safety/soundness and supporting affordable housing must be eliminated
- Most agree they should not hold in portfolio but simply issue securities with the guarantee
- Most agree their cost of capital should not be subsidized
Freddie and Fannie (continued)

• They should become fully privatized through a “utility-type” structure
• Originators should hold first loss position
• Their liquidity support should kick-in during long-cycle down markets
• The liquidity/reserve fund should be like the FDIC fund – Federal Mortgage Insurance Corporation
• The traditional FRM should be retained
Sequestration: A bad idea whose time has come

• Would cause automatic expiration of all the Bush Tax Cuts and automatic triggering of across-the-board federal budget cuts effective January 13
• Congress’ dithering is already being felt because of necessary contingency plans and expectations in the market
• It is agreed its triggering would cause the U.S. to go into recession in 2013
• A classic example of “adverse fiscal policy”
Dodd-Frank and the real estate market: Throwing the baby out with the bath water?

- All originators qualified, licensed, registered
- 5% retention on securities, unless Qualified Residential Mortgages (QRM)
- Bureau of Consumer Financial Protection
- Prohibition on steering and loan officer compensation
- New appraisal rules: Home Valuation Code of Conduct (HVCC)
- The Volker Rule
- Stricter requirements for ratings agencies
What about resolving the commercial market crisis?

• Recovery from recession/depression similar to recovery from war:
  – New infrastructure – older facilities obsolete
  – Change product lines
  – Reduce labor costs
    • Substitute technology for labor
    • Outsource
    • Offshore (encouraged by NAFTA, Globalization)
    • Renegotiate union contracts
  – Seek cheaper land/ construction costs in better current locations
Results/implications for recent recovery relative to past

- Recent crisis deeper, implies can dig deeper to find longer-term and greater increases in efficiencies
- Recent recessions increasingly affected by globalization, implies slower job recovery
- Certain areas especially affected by cuts: lower-skilled/educated, manufacturing, certain services
- Thus, have to recognize (1) previous peak was not “real”, was illusory (2) we cannot expect to come back even to previous real peak in short order
What can we do?

- Understand where our comparative advantage lies
- What does this imply with respect to GDP grow and employment in various sectors?
- Where do we stand in terms of supply in those sectors?
- How can we encourage “sustainable” growth?
  - Taxes
  - Infrastructure
  - Workforce
  - Amenities
Thank you!