Assessing Real Estate & Financial Markets: A Macro Economic View

Prepared for

14th Annual UC Berkeley Fisher Center for Real Estate Conference – St. Francis Hotel, San Francisco

Prepared by

Lawrence Souza, CRE/RICS/CCIM

- ***Principal - Real Estate-Financial Economist / Advisor / Broker Johnson Souza Group, Inc.***
- ***Professor – Real Estate/Finance/Economics Golden Gate University***

Tue 04/14/09

Johnson Souza Group, Inc

- Over 20 years of real estate economic and financial research, and institutional due diligence underwriting. Specializes in apartment and commercial market research, valuation and brokerage services.

- Offering tax deferred vehicles: 1031 Exchanges, Tenants in Common (TIC), Deferred Sales Trusts (DST), etc.; and real estate related investments: partnerships, funds, REITs, etc.

Contact Information:

www.the-commercial-group.com

Lsouza@JohnsonSouzaGroup.com

Cell Direct: (415) 713-0213 Fax: (415) 826-2216

Introduction

- Introduction
- Business/Commercial Real Estate Cycles
- Commercial Capital Market Fundamentals
- Commercial Mortgage Lending
- Appendix

Introduction


IT'S IN MY CONTRACT THAT YOU HAVE TO TIP ME $165,000,000 FOR MY SERVICES.
AIG EXECS
I'M REALLY GOOD AT WHAT I DO.
TOLES
UNIVERSAL PRESS SYND.
© 2009 THE WASHINGTON POST

Tom Toles

MY NAME IS TIM GEITHNER AND I'LL BE YOUR SERVER.
Entrees
TOXIC ASSETS
WITH OLIVE OIL
TOXIC ASSETS
TERIYAKI
TOXIC ASSETS
WITH CHEESE
TOXIC ASSETS
OVER RICE
TOXIC ASSETS
WITH GRILLED VEGETABLES
TOXIC ASSETS
COUNTRY STYLE
TAXPAYER
TOLES
SOMEBODY ELSE GOT

Chronicle / Michael Macor

Business-Market Cycle Overview

- Economy in decline/trough phase, employment contraction bottoming: 36-to-60 month trough, decline from August 2007.
- Economic contraction - bottom 2/3Q 09’, moderate growth 10’.
- Next business-commercial real estate cycle peak 2015 - 2020, technology-employment cycle peak 2016 – 2018, potential rent spikes.
- Target markets for commercial real estate investment 2009-2010:

Downtown San Francisco/San Jose; I-680/880 Corridors-Walnut Creek/San Ramon/Pleasanton/Fremont; SF Peninsula-Redwood City/Palo Alto; Marin/Santa Cruz Counties

Institutional Foundations for Efficient Capital Markets

"Efficient real estate and securities capital markets require strong public and private sector cooperation, disclosure of government and corporate financial conditions, and institutional and individual investor confidence in financial and political institutions."

Lawrence Souza

US Budget Deficits

- **$11 trillion public debt outstanding, $55 billion in interest; Total Debt-to-GDP to reach ~100% by 2015**
  Crowding Out Effect ~ High Inflation Expectations and Interest Rates ~ Fiscal/Monetary Policy Ineffectiveness

- $1.2 trillion annual budget deficit, not including $600 billion for Iraq War 2004 – 2009; defense budget up 41% since 2001

- Administration to cut deficit in half by 2009, over optimistic assumptions for rising tax revenue, excluding cost of Iraq/Afghanistan wars ($100 + billion in 2008)

- Fed will spend $300 billion over 6 mths to buy L-T T-Bills/Bonds, total $1.2 trillion, already has $2 trillion on balance sheet

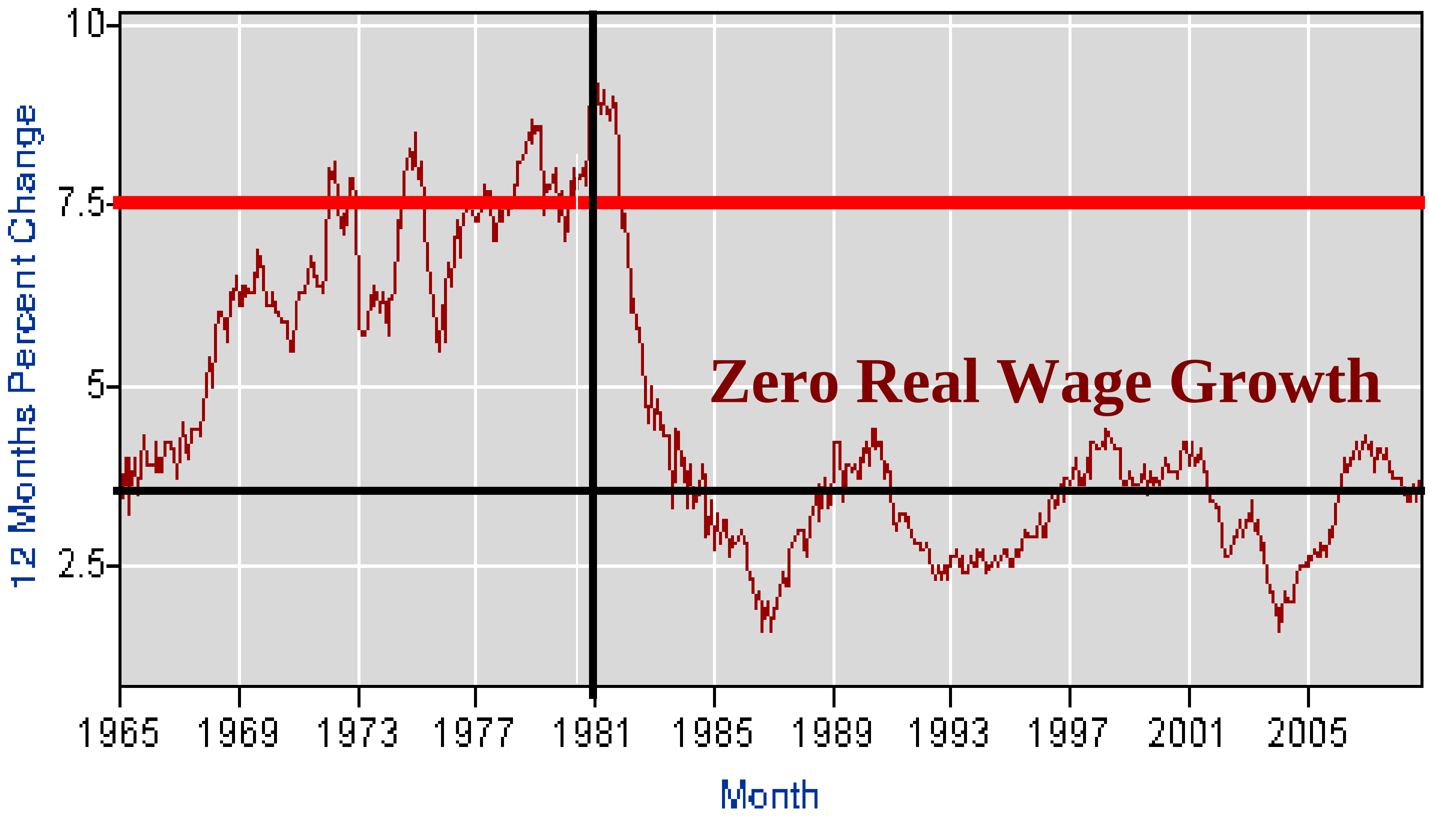
- Budget deficits to total $10 trillion over next 10 years.

- Foreigners currently own 47% of U.S. government debt (China/Japan)

Business and Commercial Real Estate Cycles

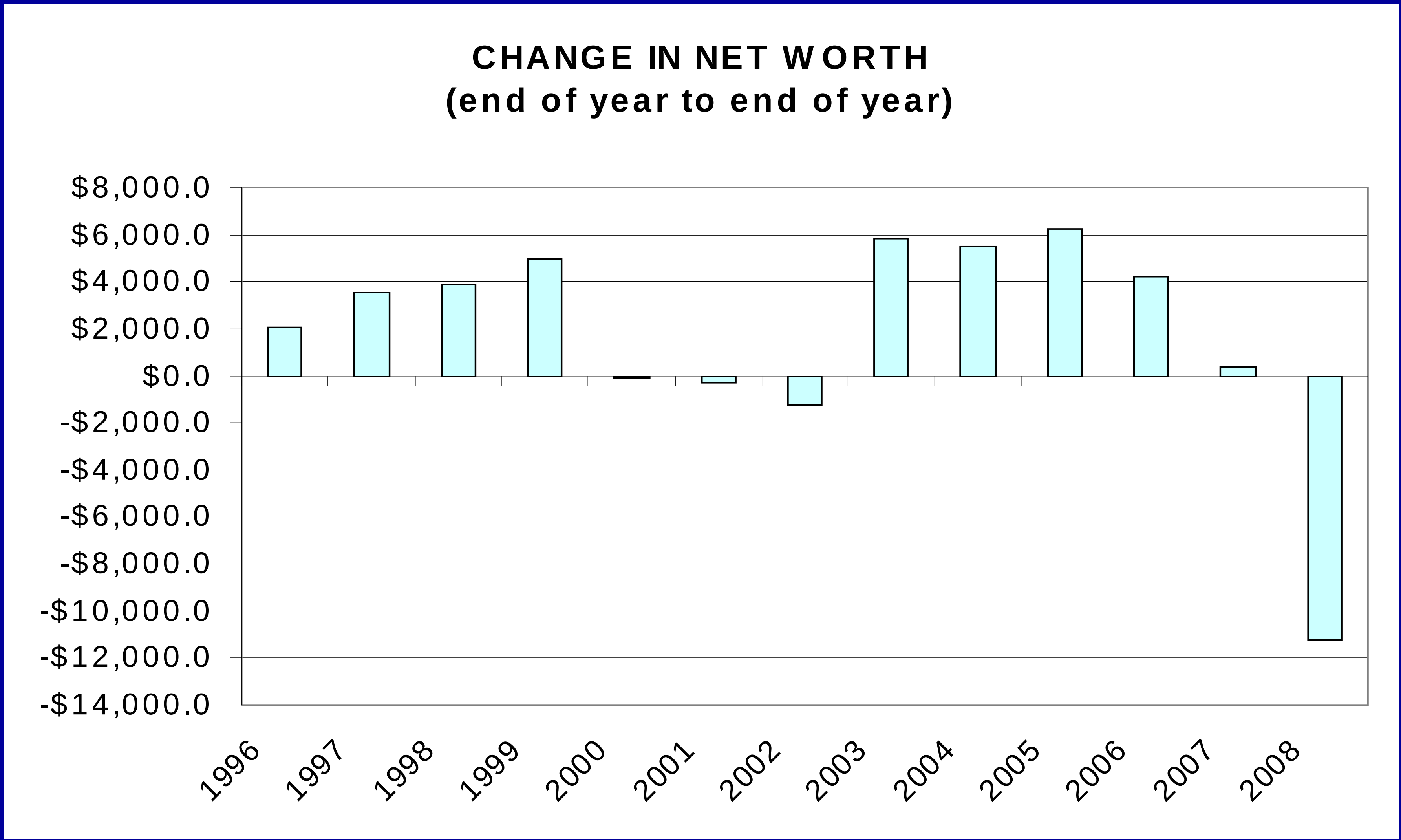
Income and Wages

Average Hourly Earnings of Production Workers



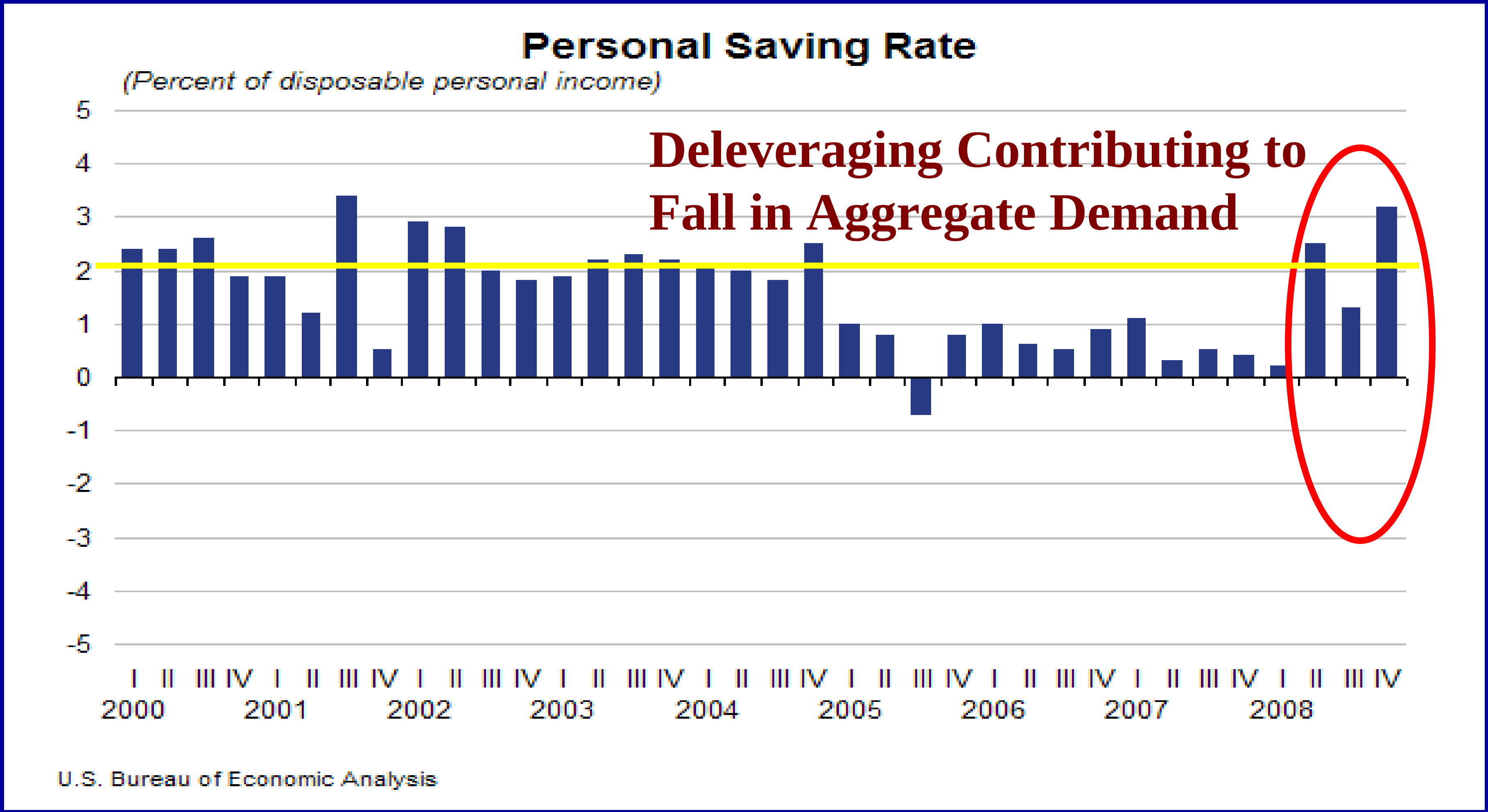
Source: Bureau of Labor Statistics. http://www.bls.gov

Change in Net Worth



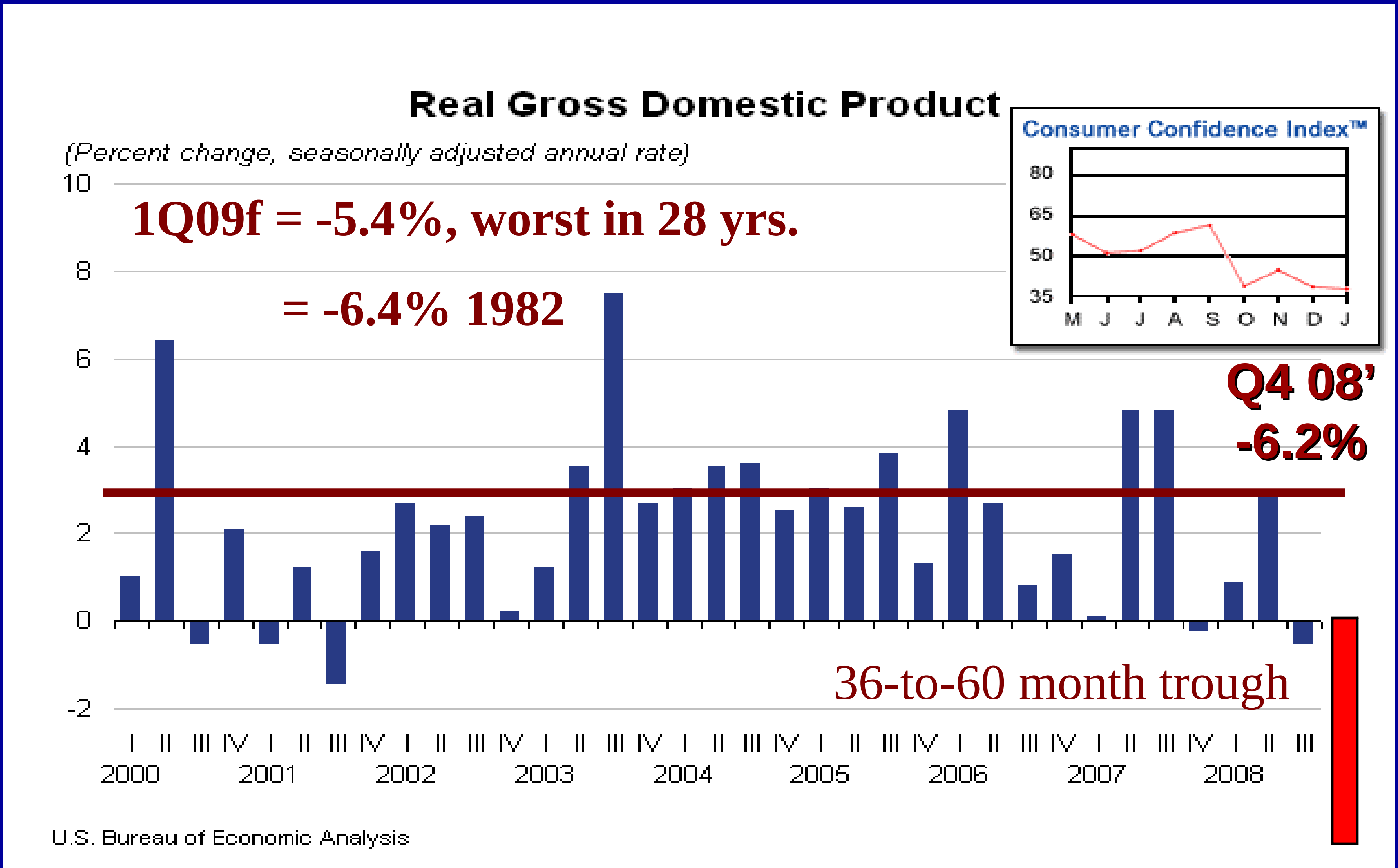
Martin Wolf, Associate Editor & Chief Economics Commentator, *Financial Times*

Personal Savings Rate



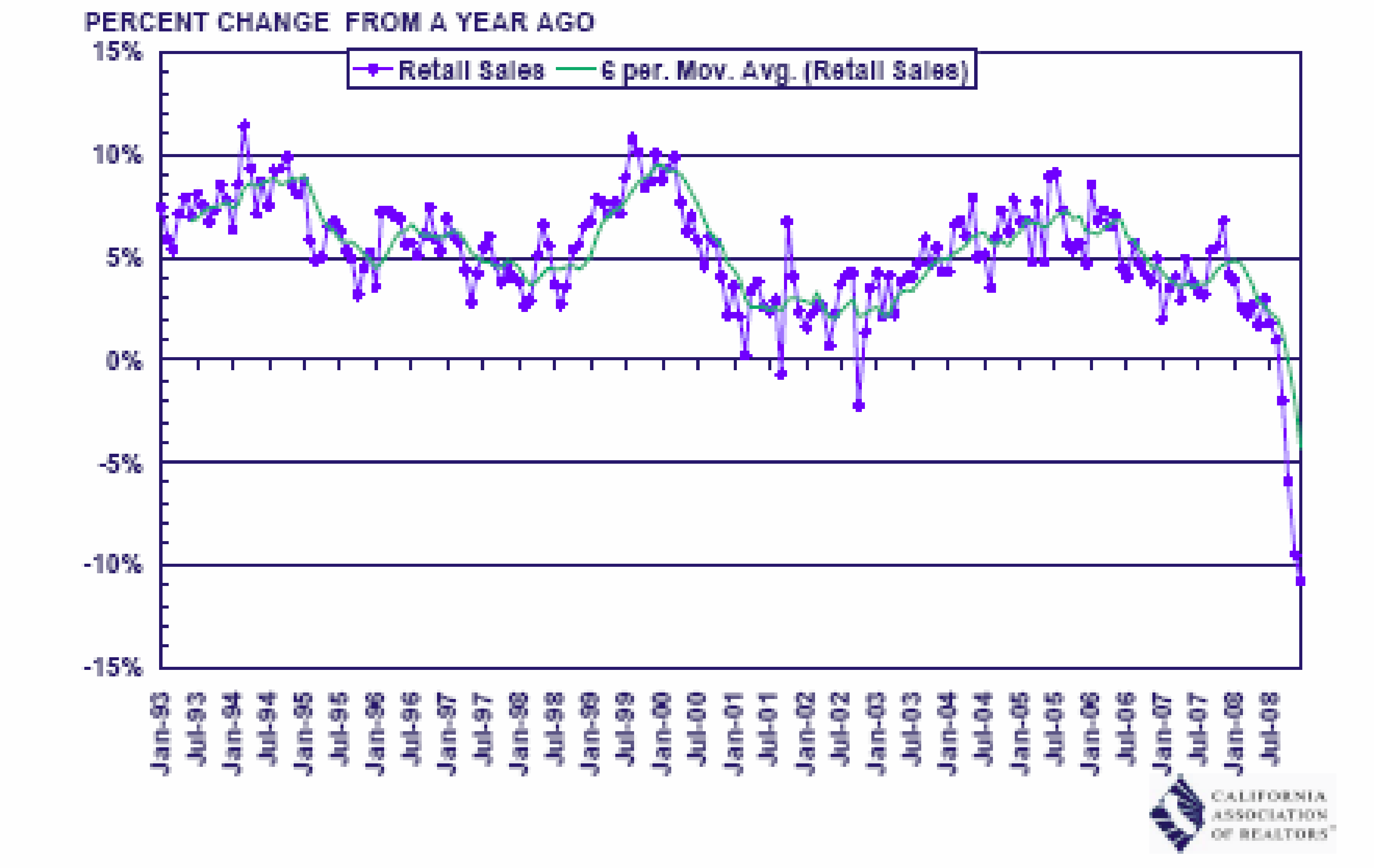
Source: Bureau of Economic Analysis. http://www.bea.gov/briefrm/saving.htm

Gross National Product (GDP)

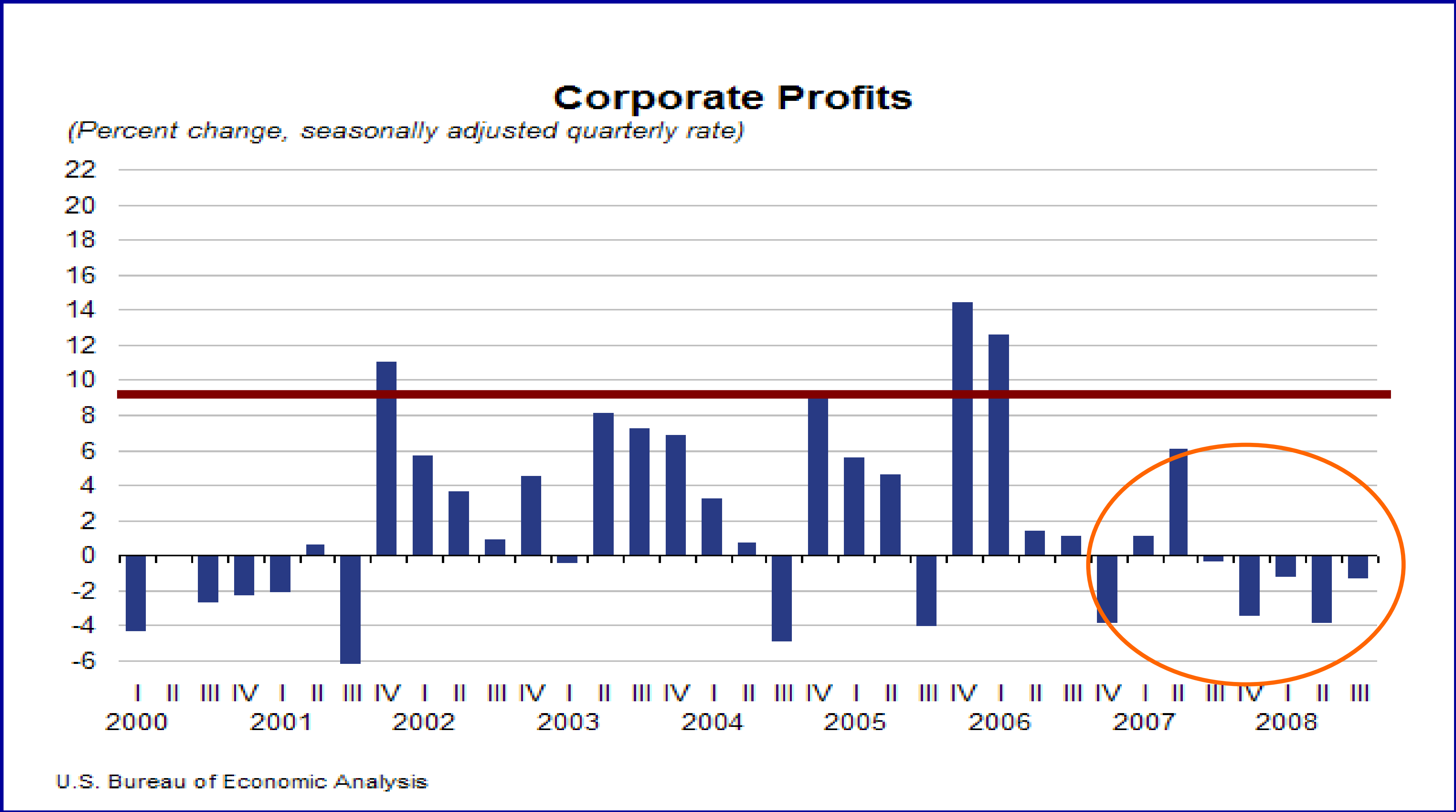


http://www.bea.doc.gov/bea/newsrel/gdp_glance.htm. http://www.conference-board.org/economics/ConsumerConfidence.cfm

Retail Sales

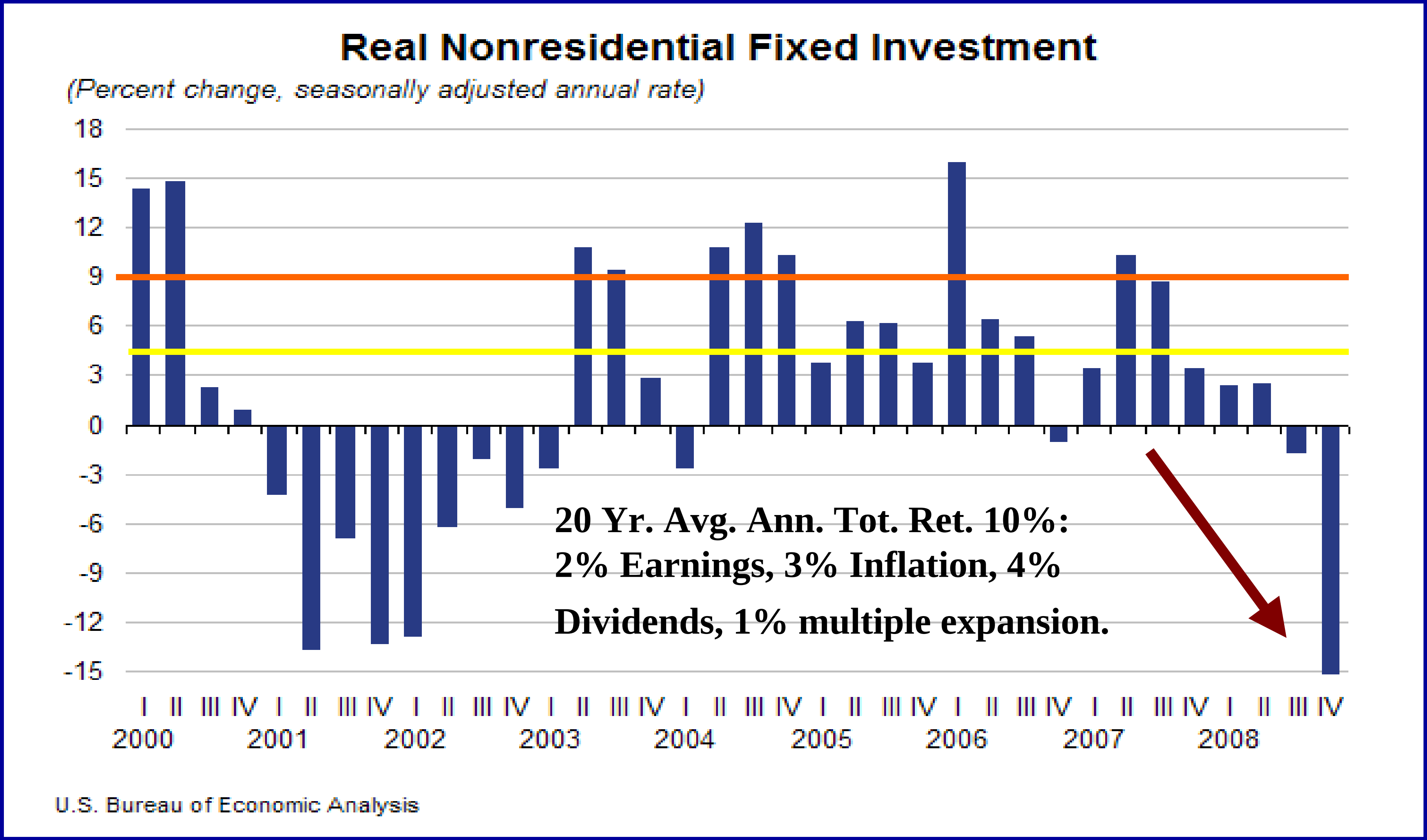


Corporate Profits



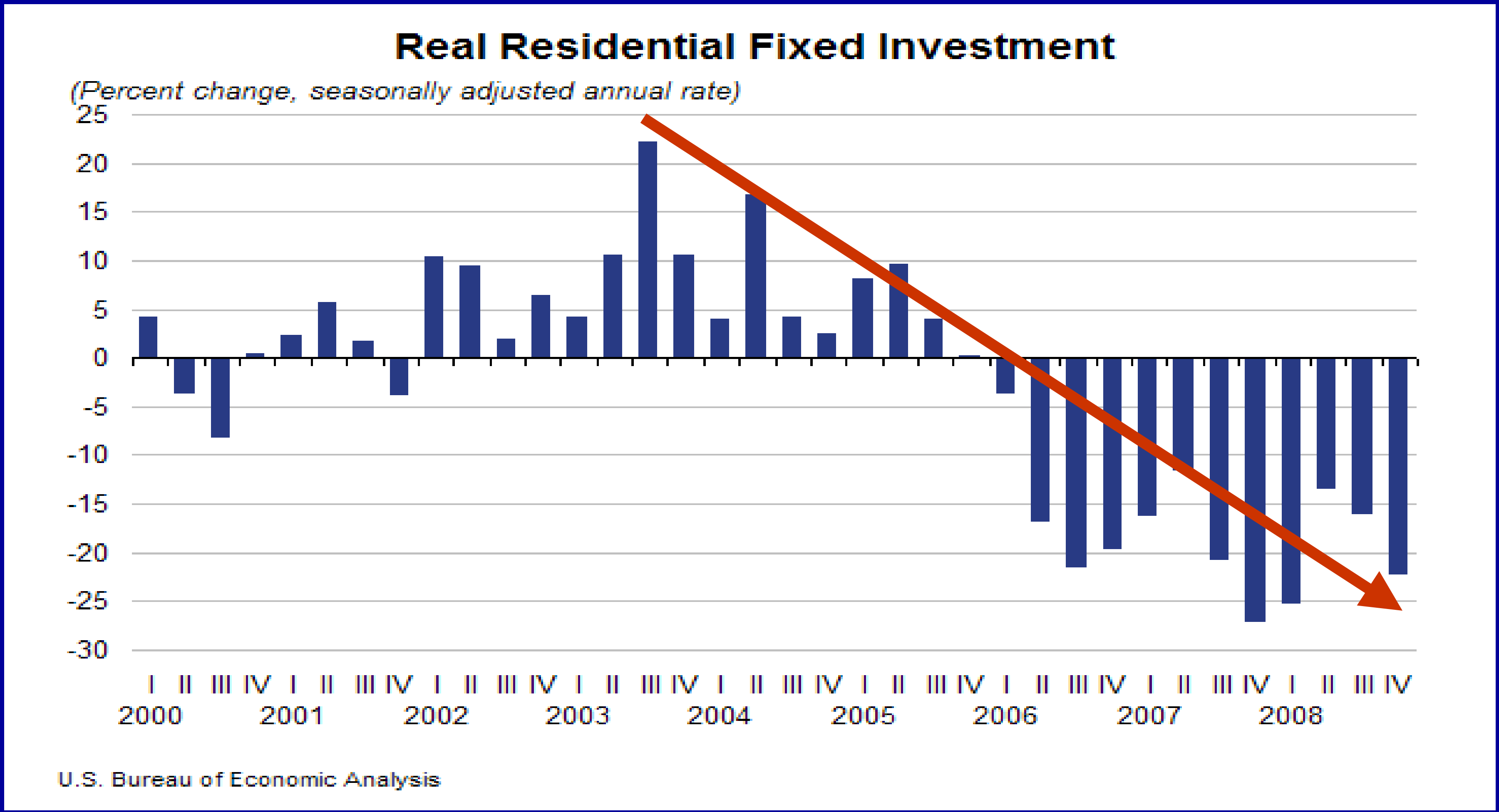
http://www.bea.gov/briefrm/corpprof.htm

Non-Residential Fixed Investment



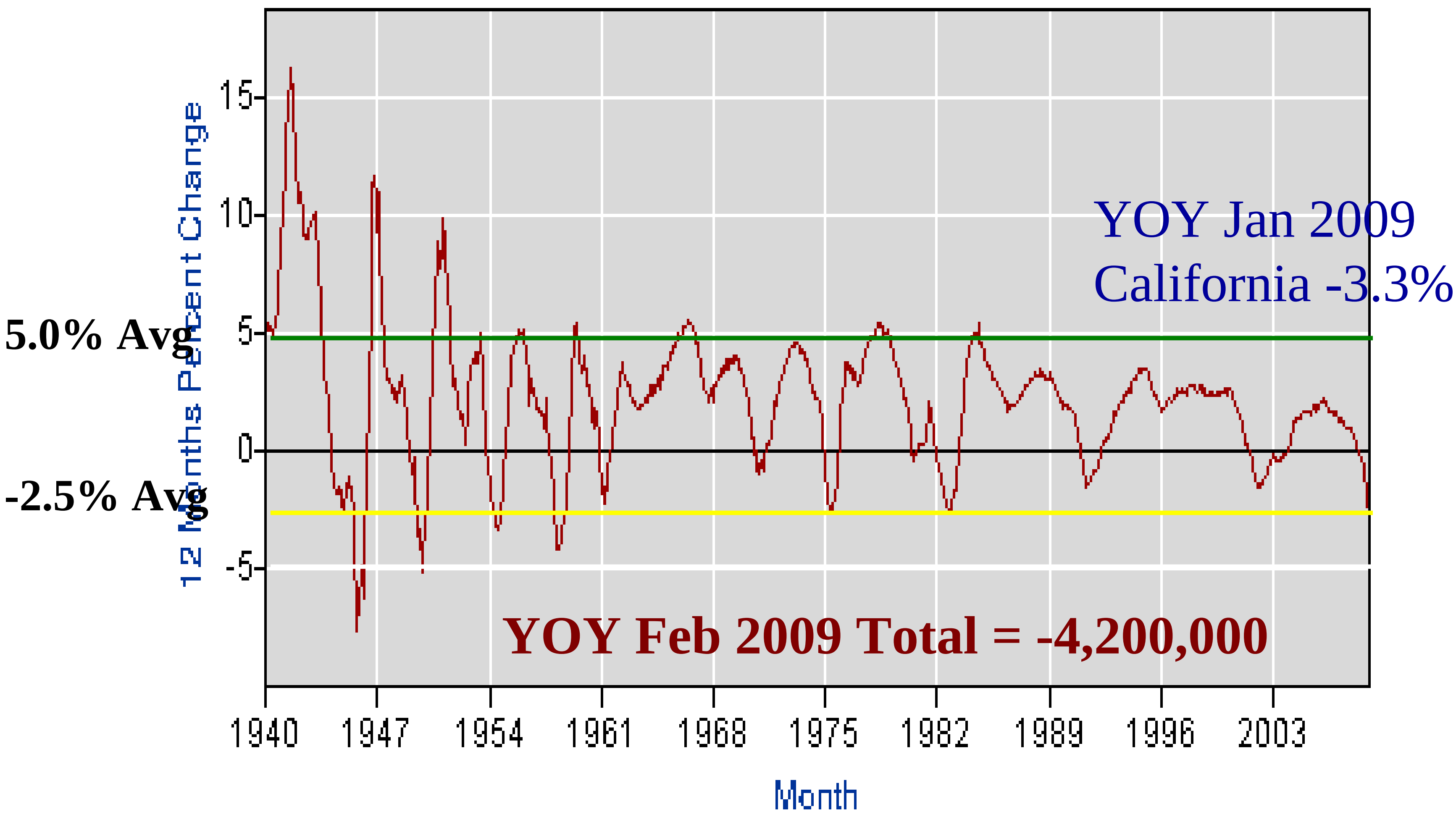
Source: Bureau of Economic Analysis. http://www.bea.gov/briefrm/nonresfi.htm

Real Residential Fixed Investment



http://www.bea.gov/briefrm/resfi.htm

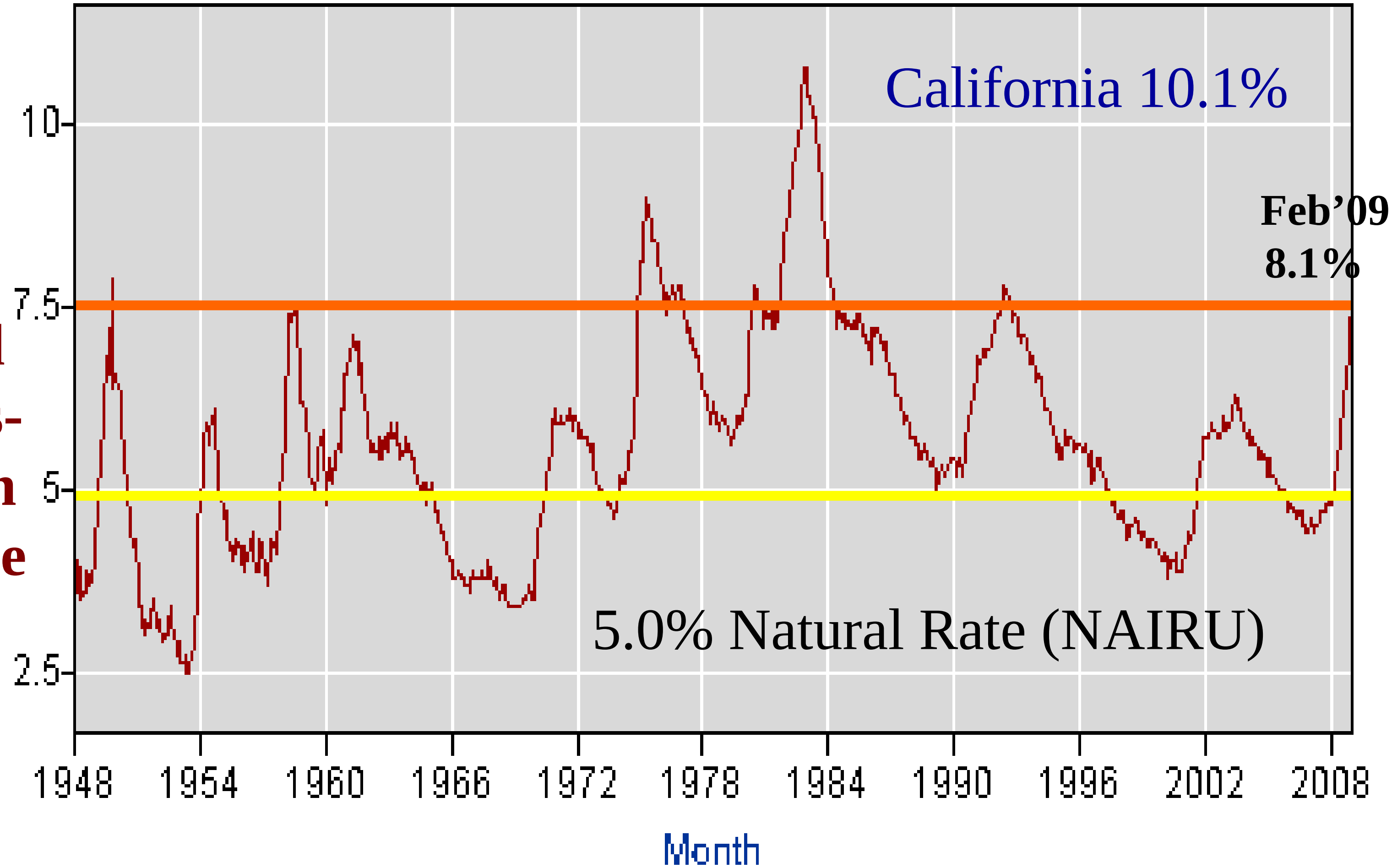
Non-Farm Payroll Employment



Source: Bureau of Labor Statistics.
http://www.bls.gov

U.S. Unemployment Rate

Well Above Natural rate, Dis-Inflation Exposure

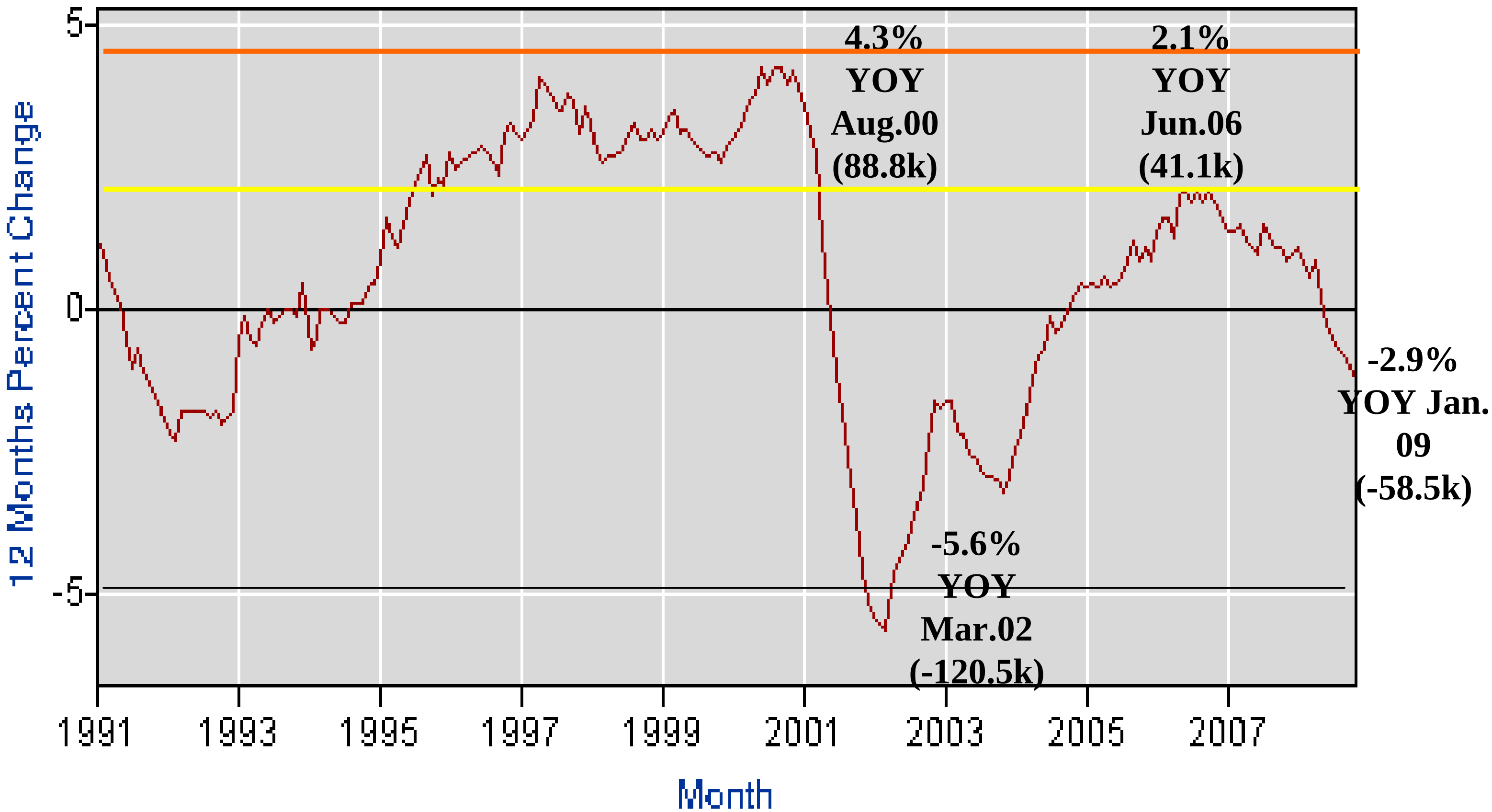


Source: Bureau of Labor Statistics.

http://data.bls.gov/PDQ/servlet/SurveyOutputServlet

San Francisco-Oakland-Fremont, CA

Monthly % Year-Over-Year Non-Farm Employment Growth Rates

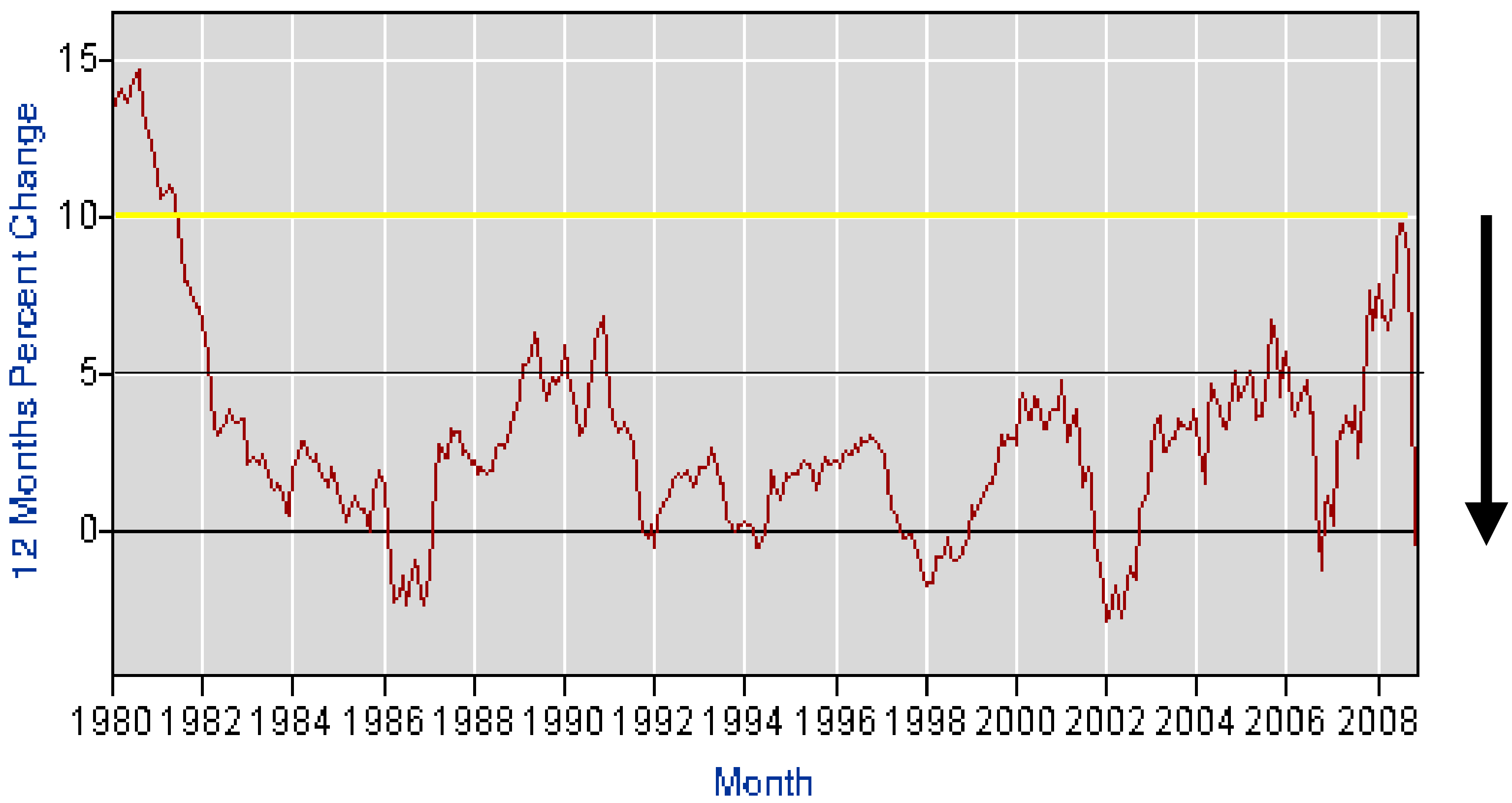


Source: Bureau of Labor Statistics.
http://data.bls.gov/PDQ/servlet/SurveyOutputServlet

Commercial Real Estate
Capital Market Fundamentals

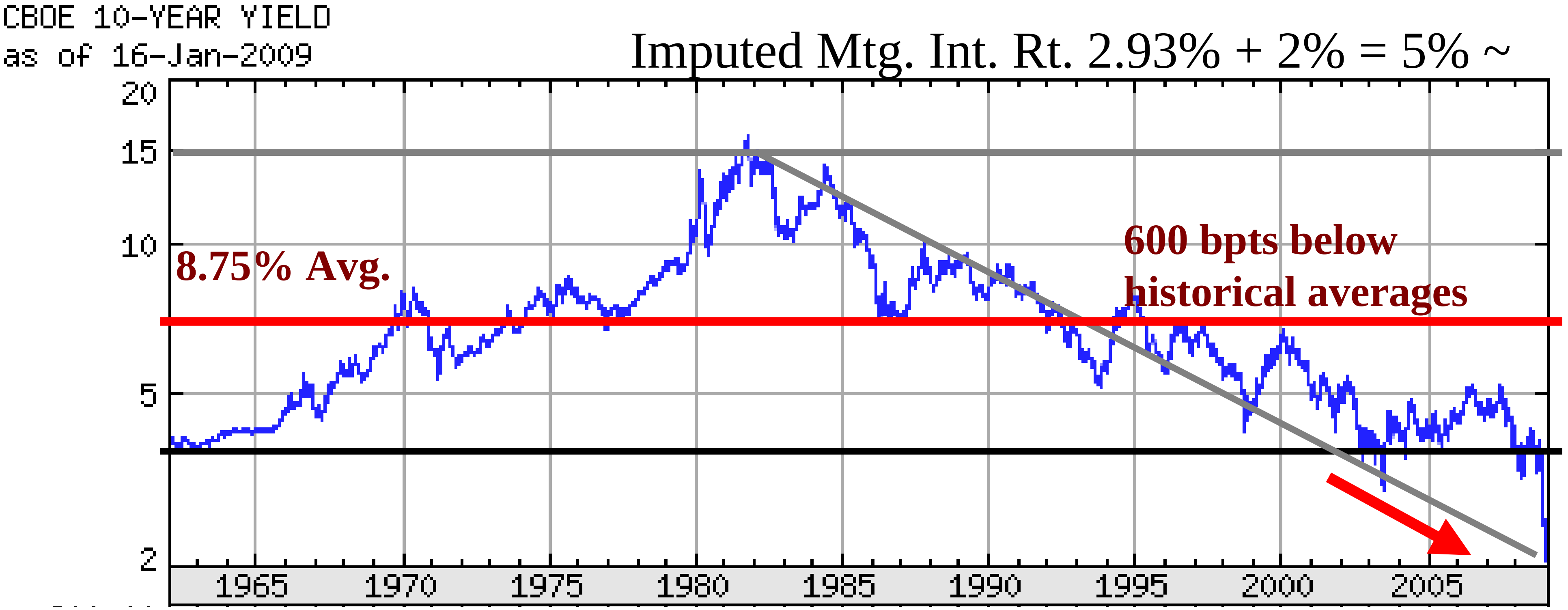
Inflation Expectations

U.S. Producer Price Index (PPI) – Finished Goods



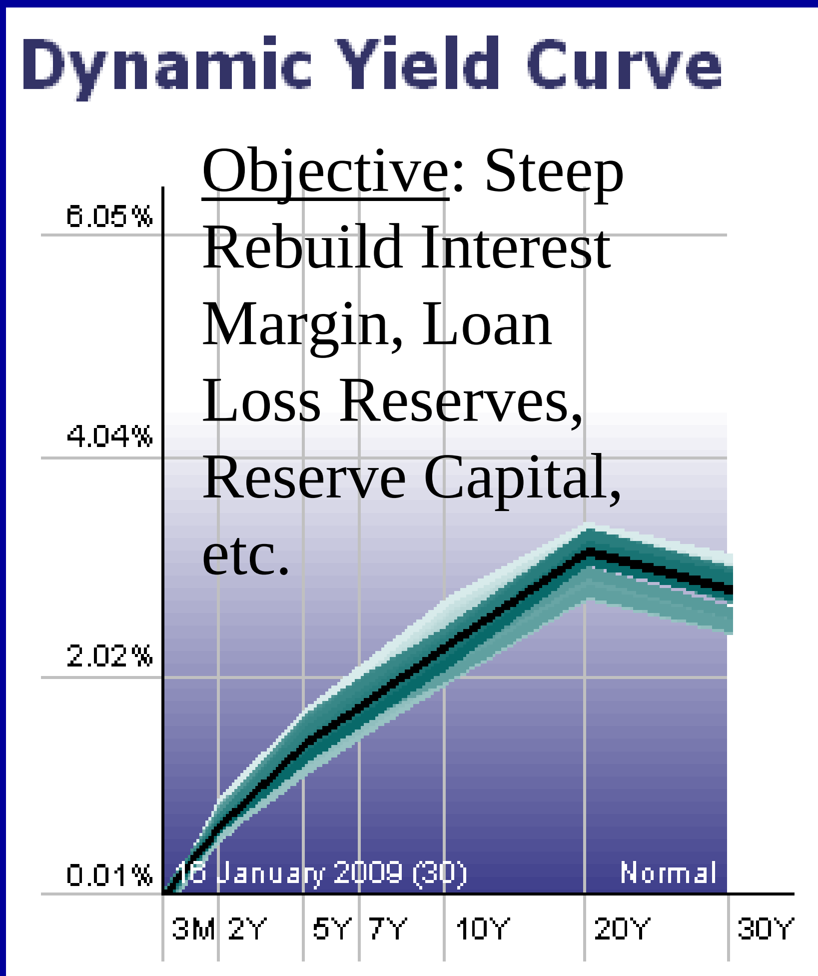
http://www.bls.gov/home.htm

Yield 10-Year Treasury

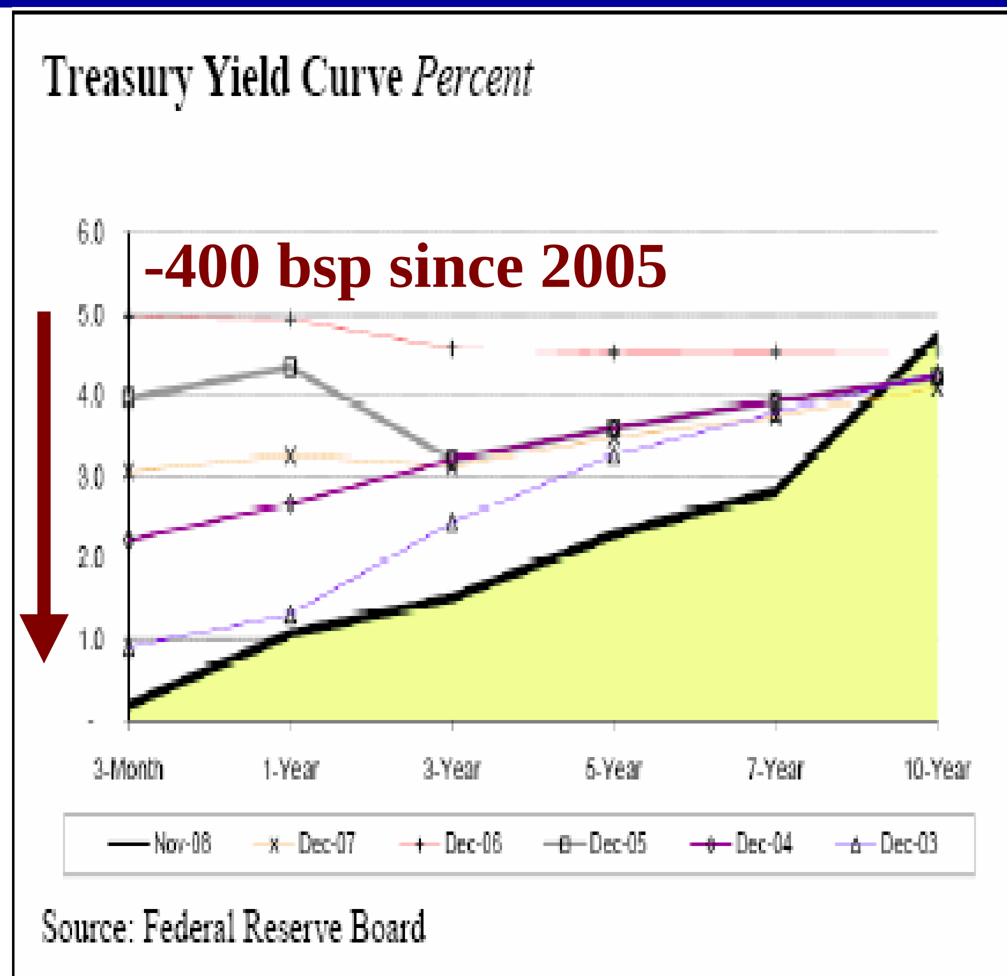


http://finance.yahoo.com

Yield Curve

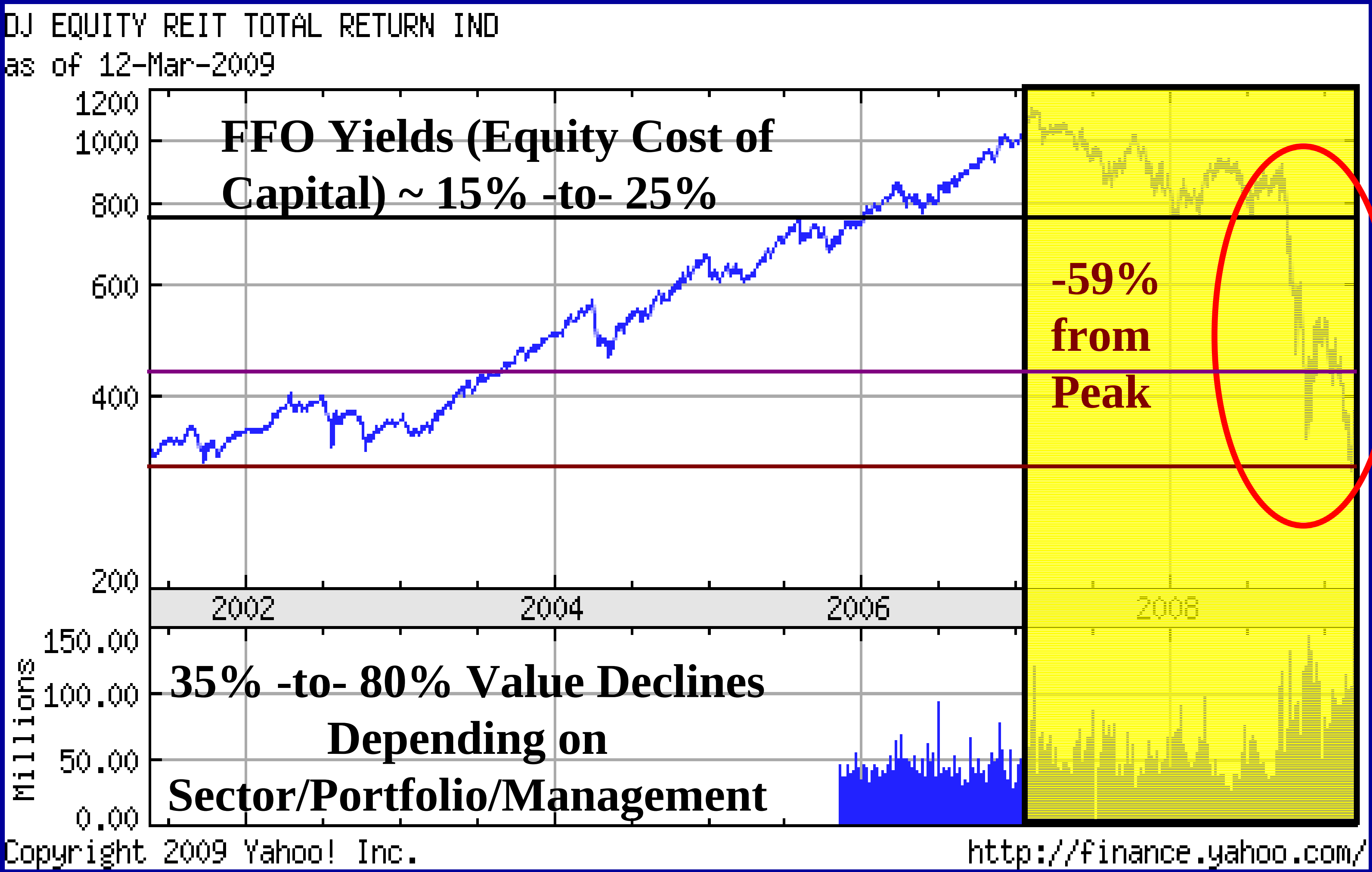


Objective: Steep Rebuild Interest Margin, Loan Loss Reserves, Reserve Capital, etc.



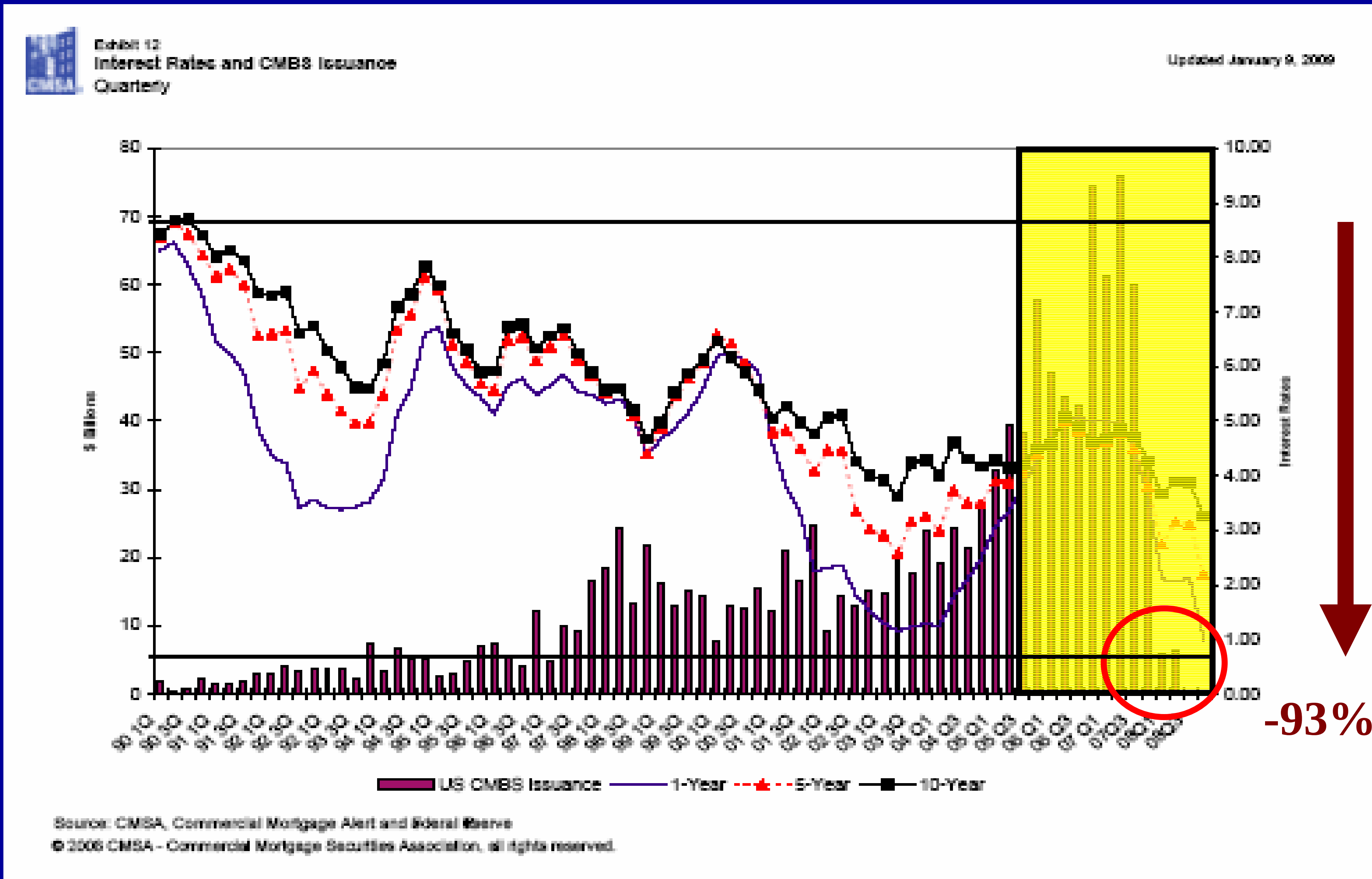
http://stockcharts.com/charts/YieldCurve.html

REIT Equity Stock Index Performance – Dow Jones



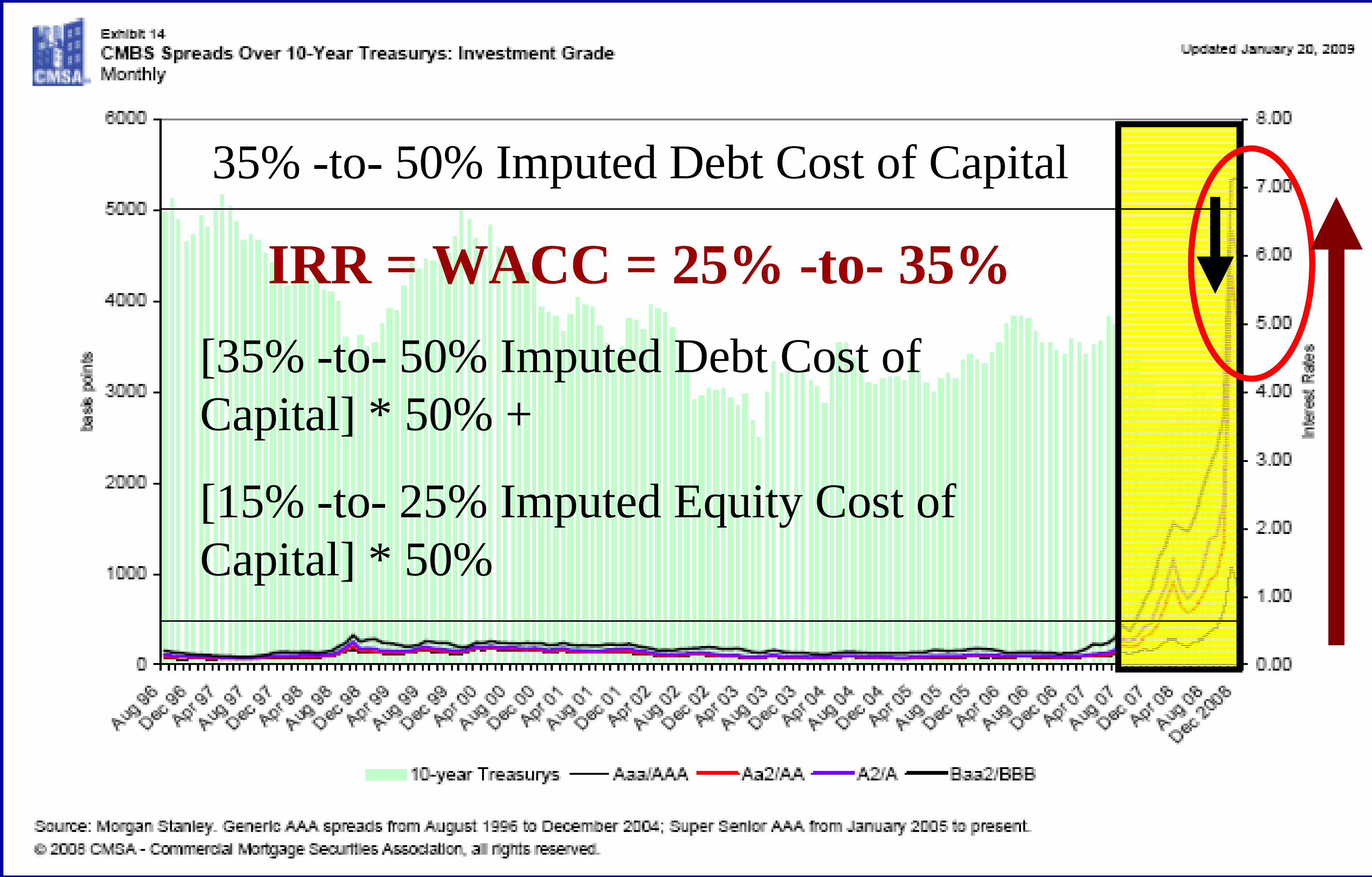
http://finance.yahoo.com/q/bc?s=REIT&t=my

Commercial Mortgage Back Securities (CMBS) Issuance



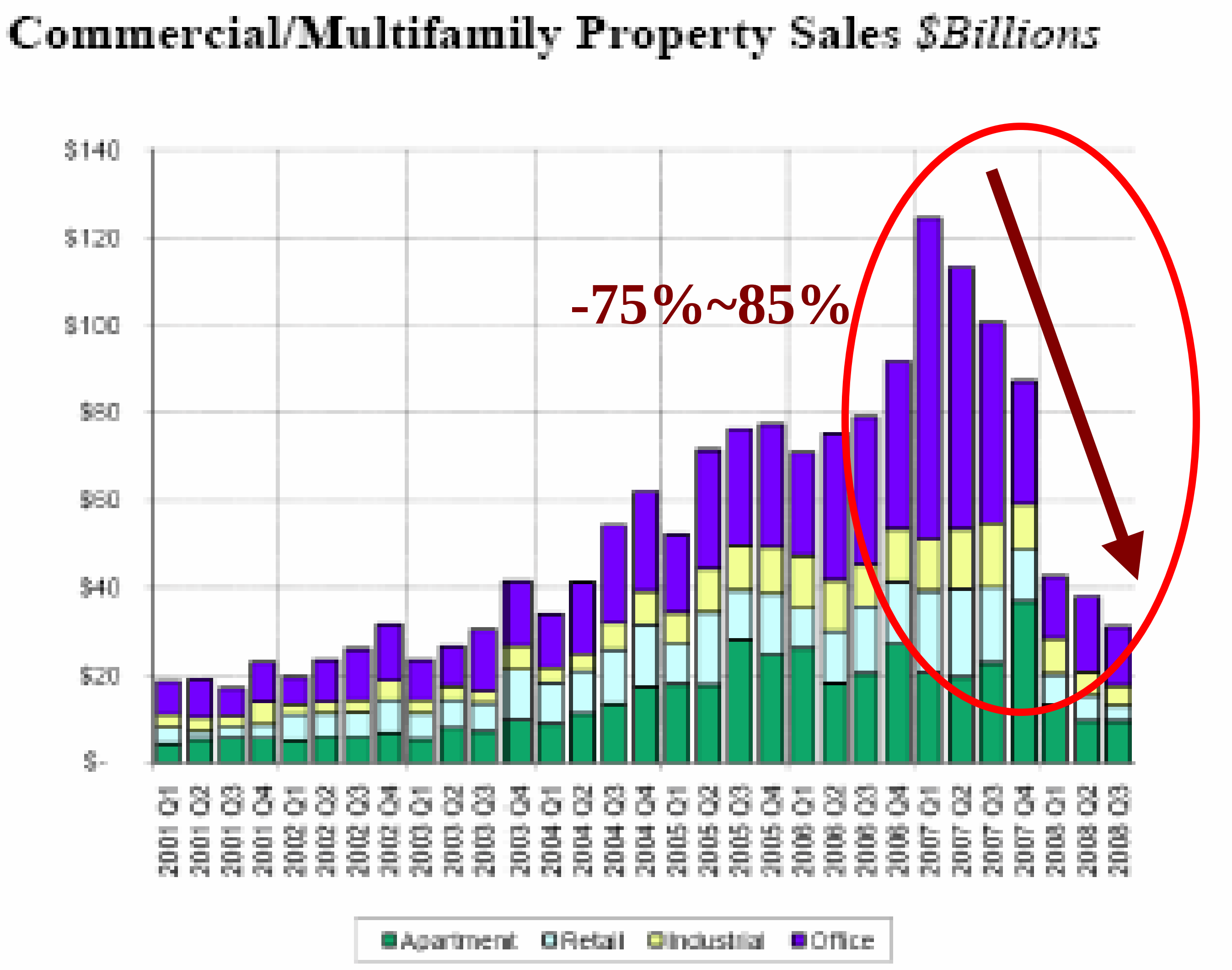
http://www.cmsaglobal.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Statistics/CMSA_Compendium.pdf

CMBS Spreads – Investment Grade vs. 10 Yr. Treasury



http://www.cmsaglobal.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Statistics/CMSA_Compendium.pdf

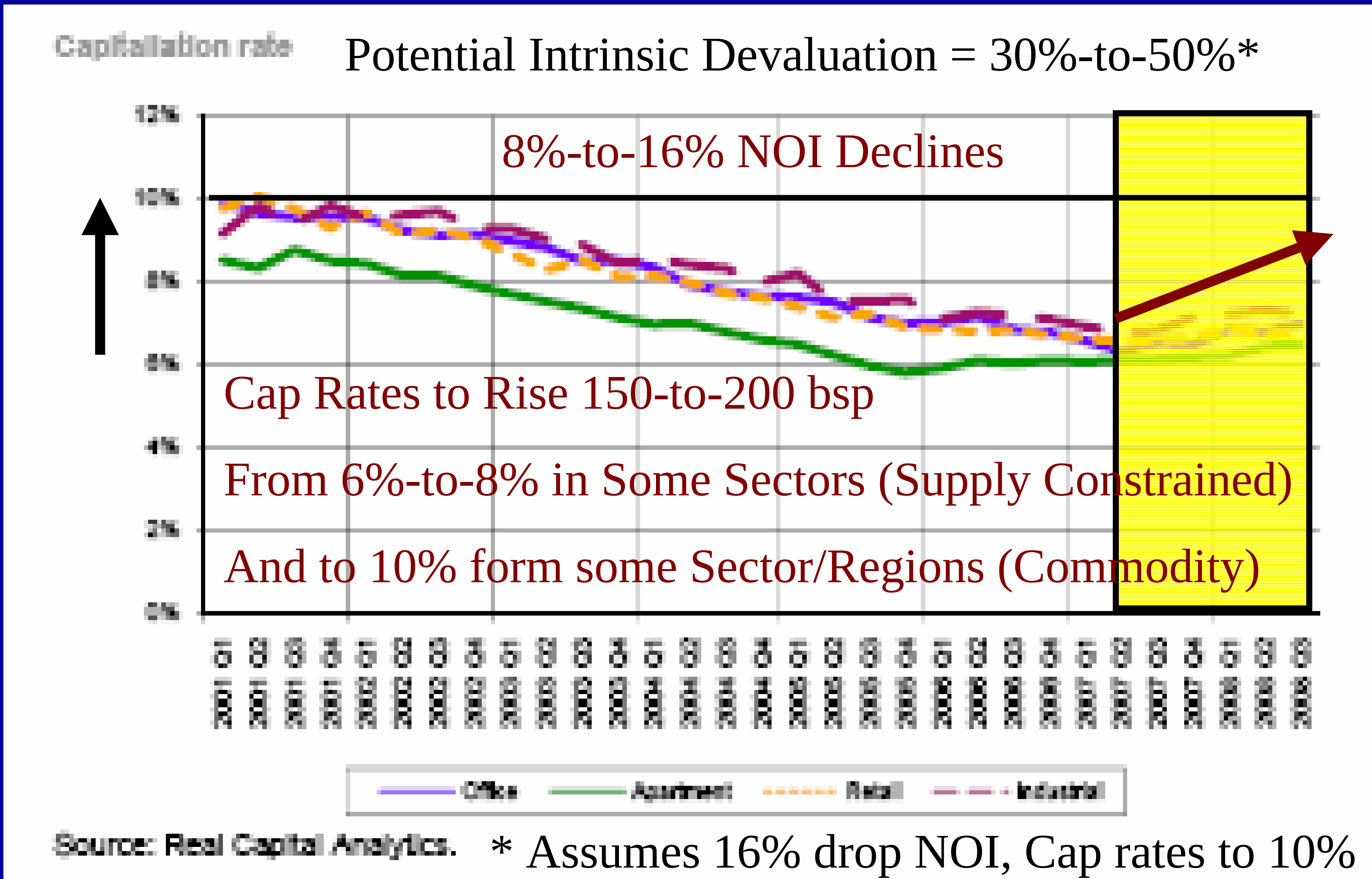
Commercial Property Sales Volume (From 2001 to 2008)



Source: Real Capital Analytics

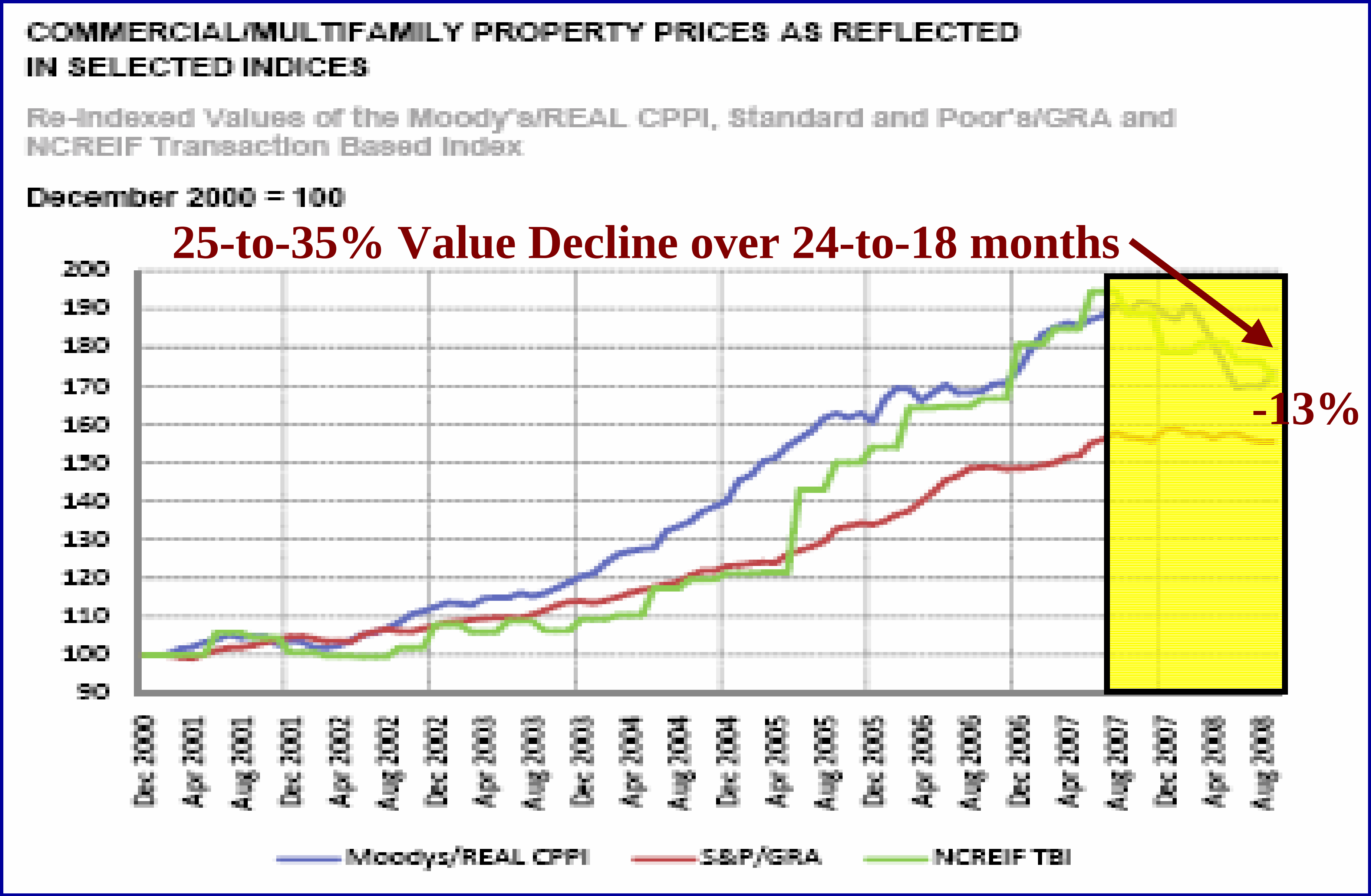
http://www.mbaa.org/files/Research/DataBooks/3Q08QuarterlyDataBook.pdf

Commercial Property – Capitalization Rates (2001-2008)



http://www.mbaa.org/files/Research/DataBooks/3Q08QuarterlyDataBook.pdf

Commercial Property Value Indices (From 2000 to 2008)



http://www.mbaa.org/files/Research/DataBooks/3Q08QuarterlyDataBook.pdf

Non-Residential Commercial Construction Spending Forecast – Decrease by 11% in 2009

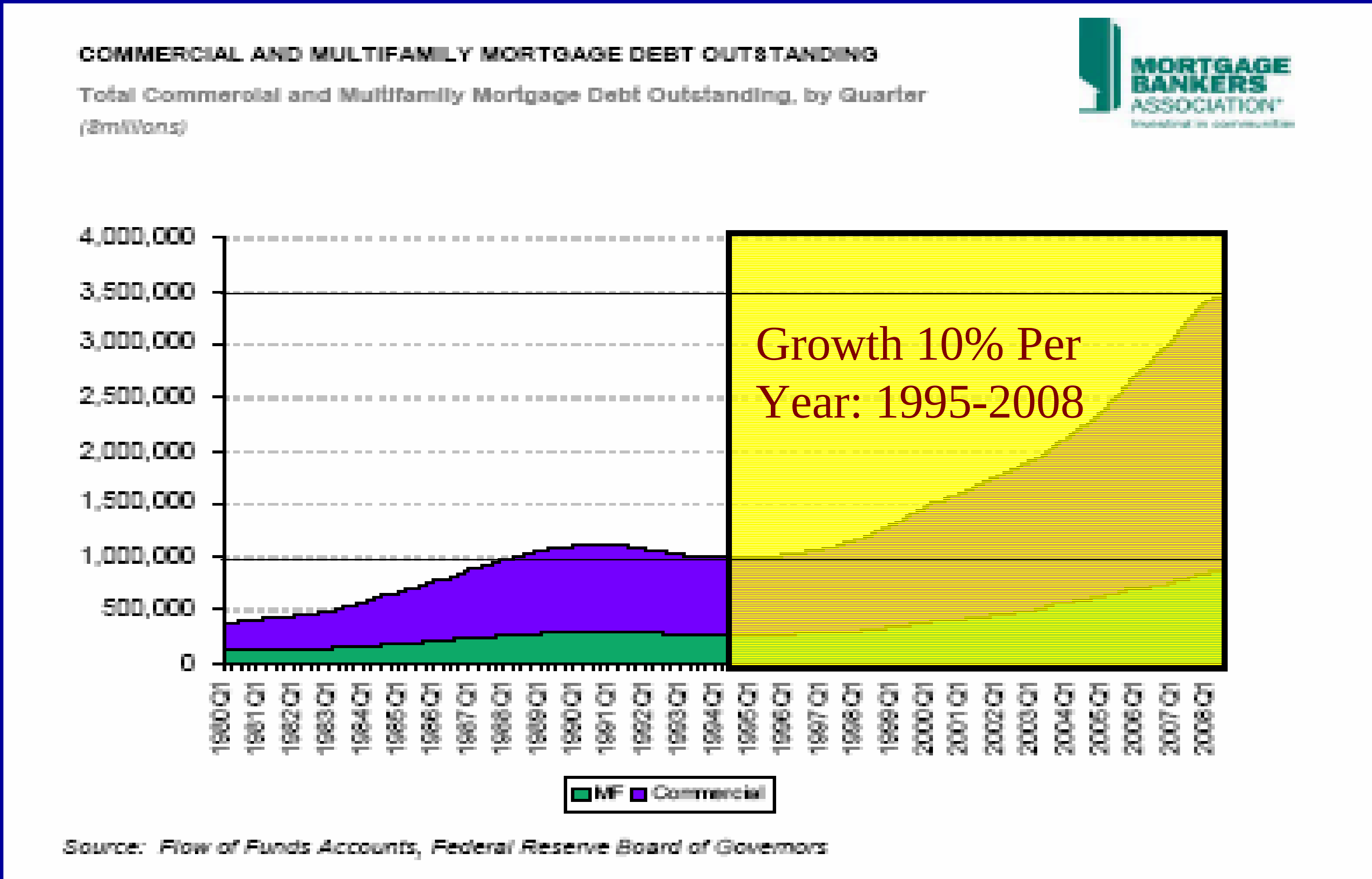
Commercial / industrial	2009	2010
• Hotels	-20.2%	-12.2%
• Retail	-19.2%	-6.6%
• Office buildings	-17.5%	-11.1%
• Industrial facilities	-11.2%	-8.4%

Institutional	2009	2010
• Religious	-9.4%	1.4%
• Education	-7.4%	-1.9%
• Amusement / recreation	-5.9%	1.0%
• Health care facilities	-3.6%	-1.9%
• Public safety	-3.5%	-1.9%

http://www.aia.org/aiarchitect/thisweek09/0116/0116n_consensus.cfm

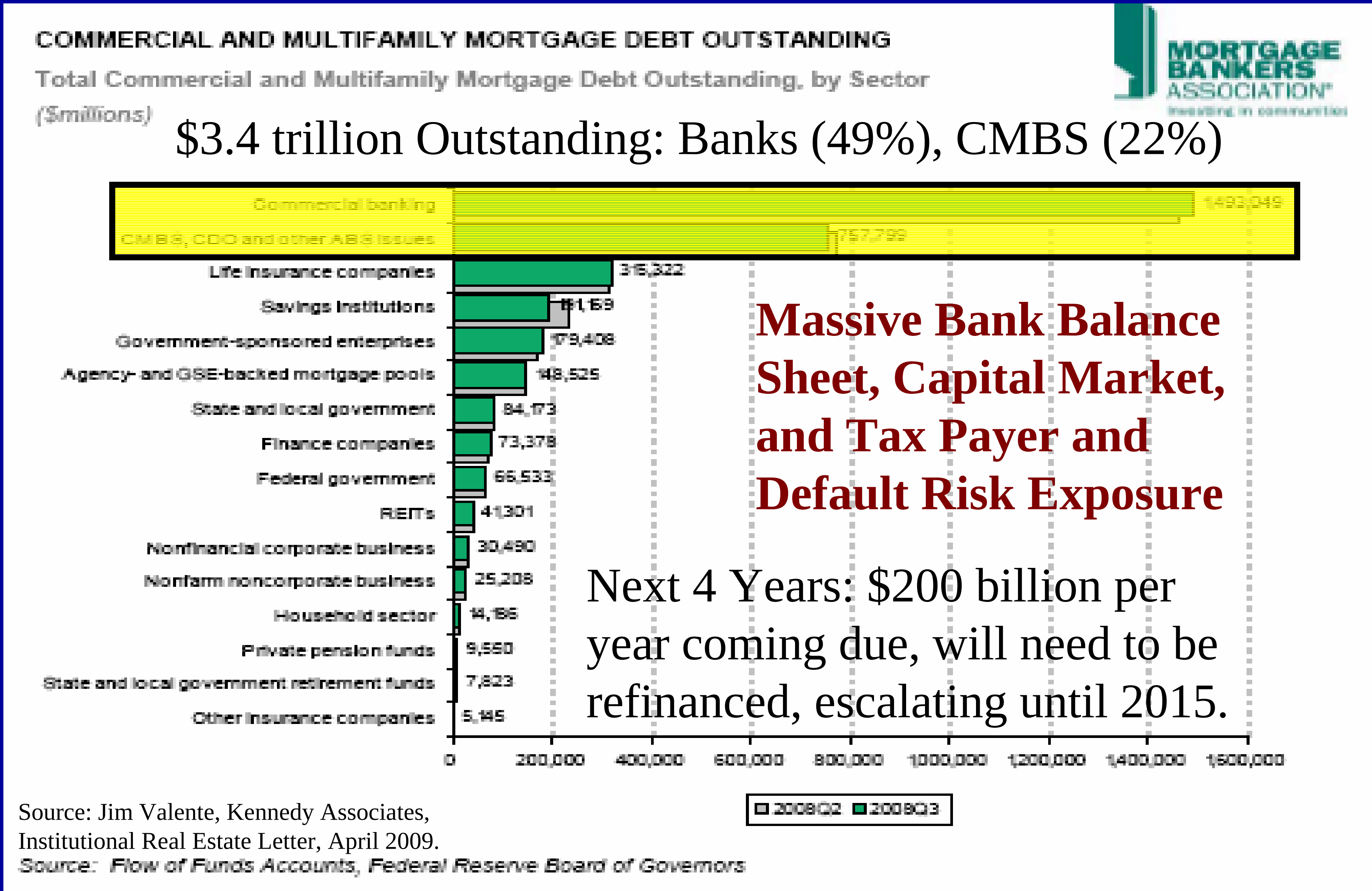
Commercial Mortgage Lending

Commercial Mortgage Debt Outstanding – (From 1980 to 2008)



http://www.mbaa.org/files/Research/DataBooks/3Q08QuarterlyDataBook.pdf

Commercial Mortgage Debt Exposure



$3.4 trillion Outstanding: Banks (49%), CMBS (22%)

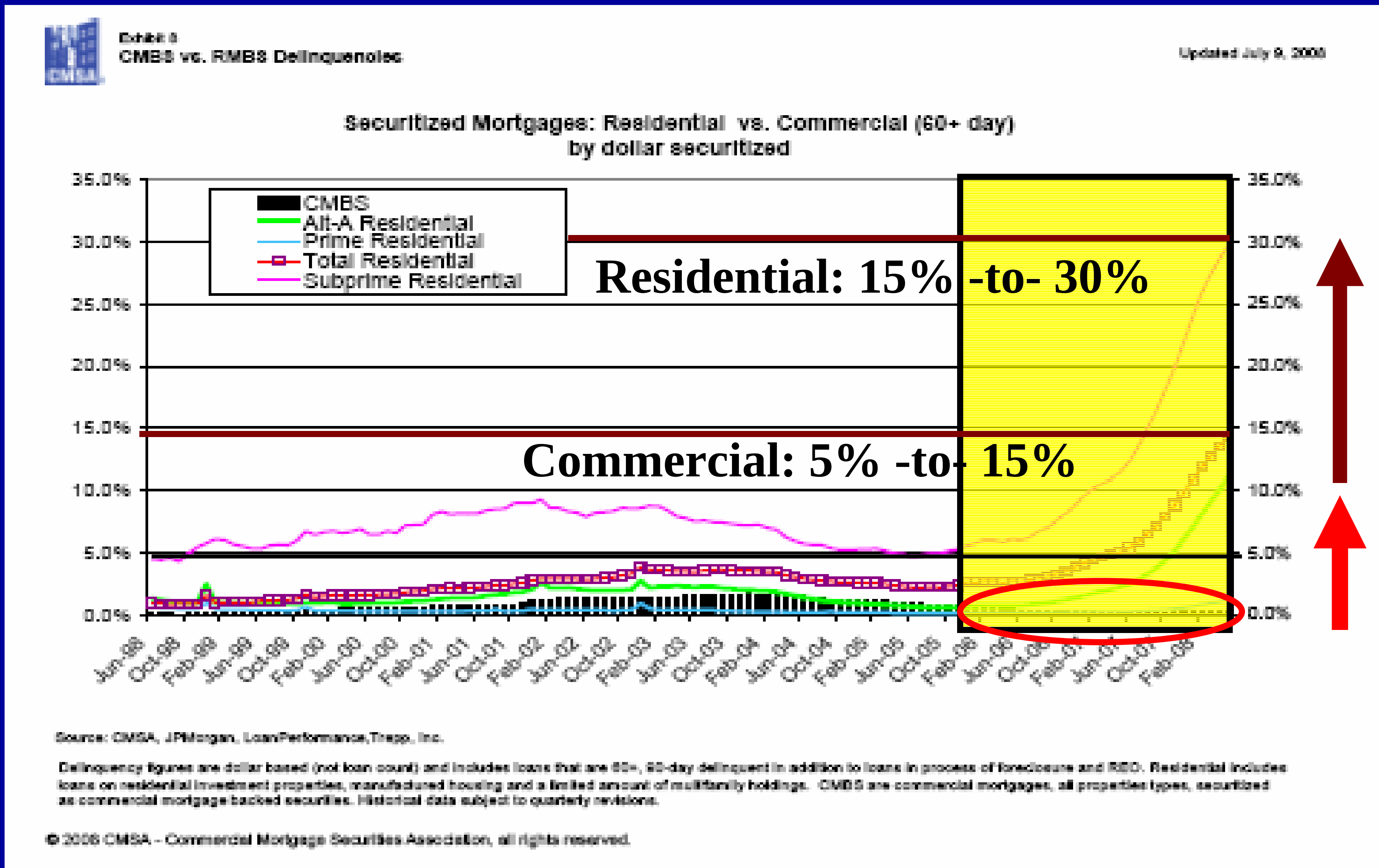
Massive Bank Balance Sheet, Capital Market, and Tax Payer and Default Risk Exposure

Next 4 Years: $200 billion per year coming due, will need to be refinanced, escalating until 2015.

Source: Jim Valente, Kennedy Associates, Institutional Real Estate Letter, April 2009.

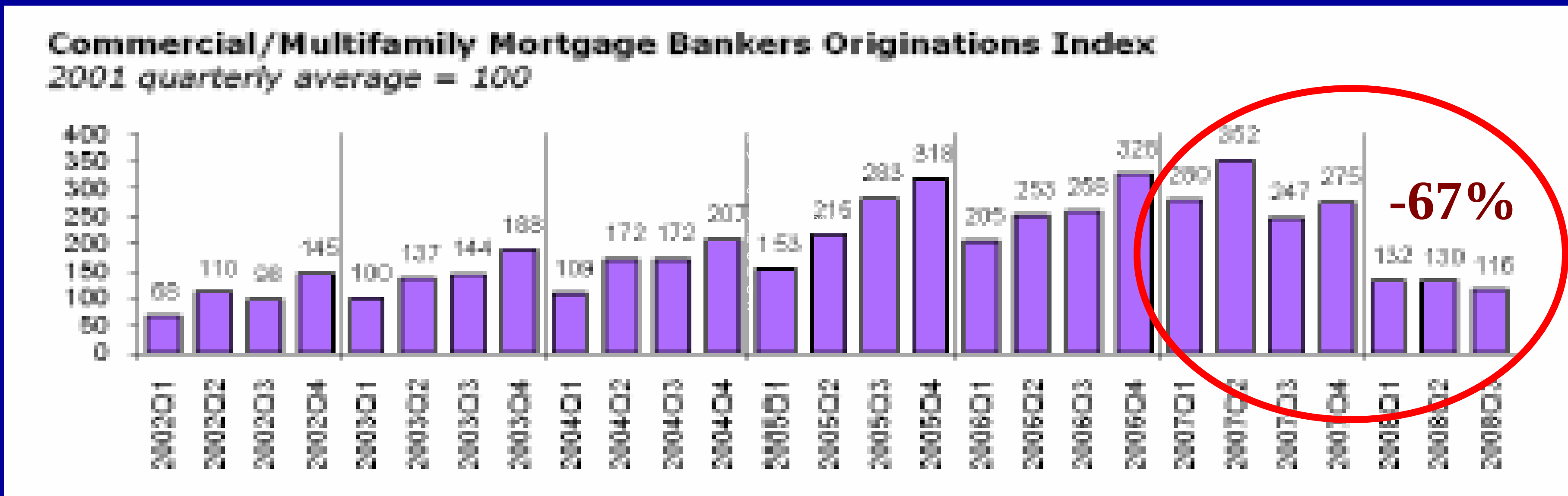
http://www.mbaa.org/files/Research/DataBooks/3Q08QuarterlyDataBook.pdf

Commercial Mortgage Back Securities (CMBS) Delinquency



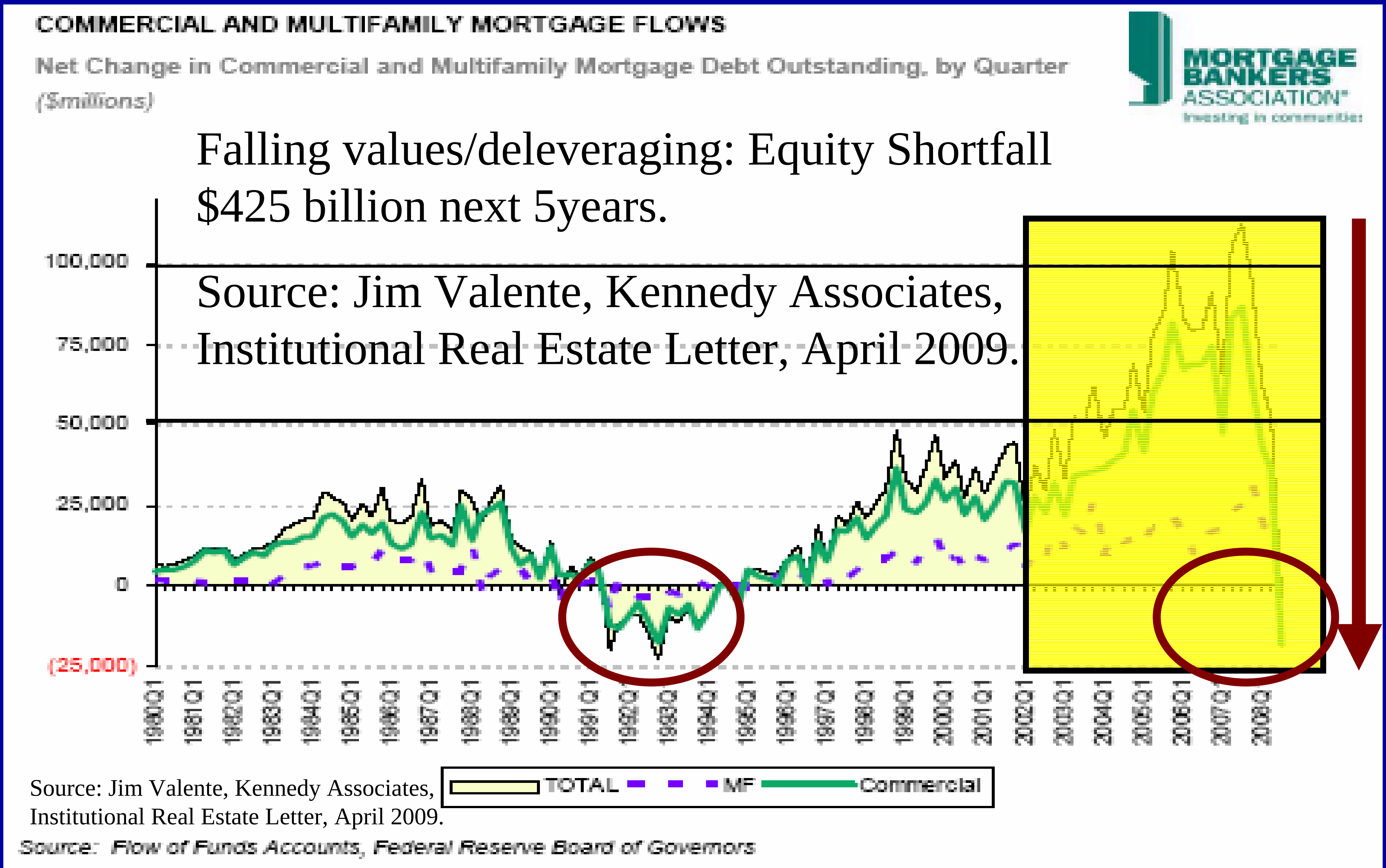
http://www.cmsaglobal.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Statistics/CMSA_Compendium.pdf

Commercial Mortgage Origination Index – (From 2002 to 2008)



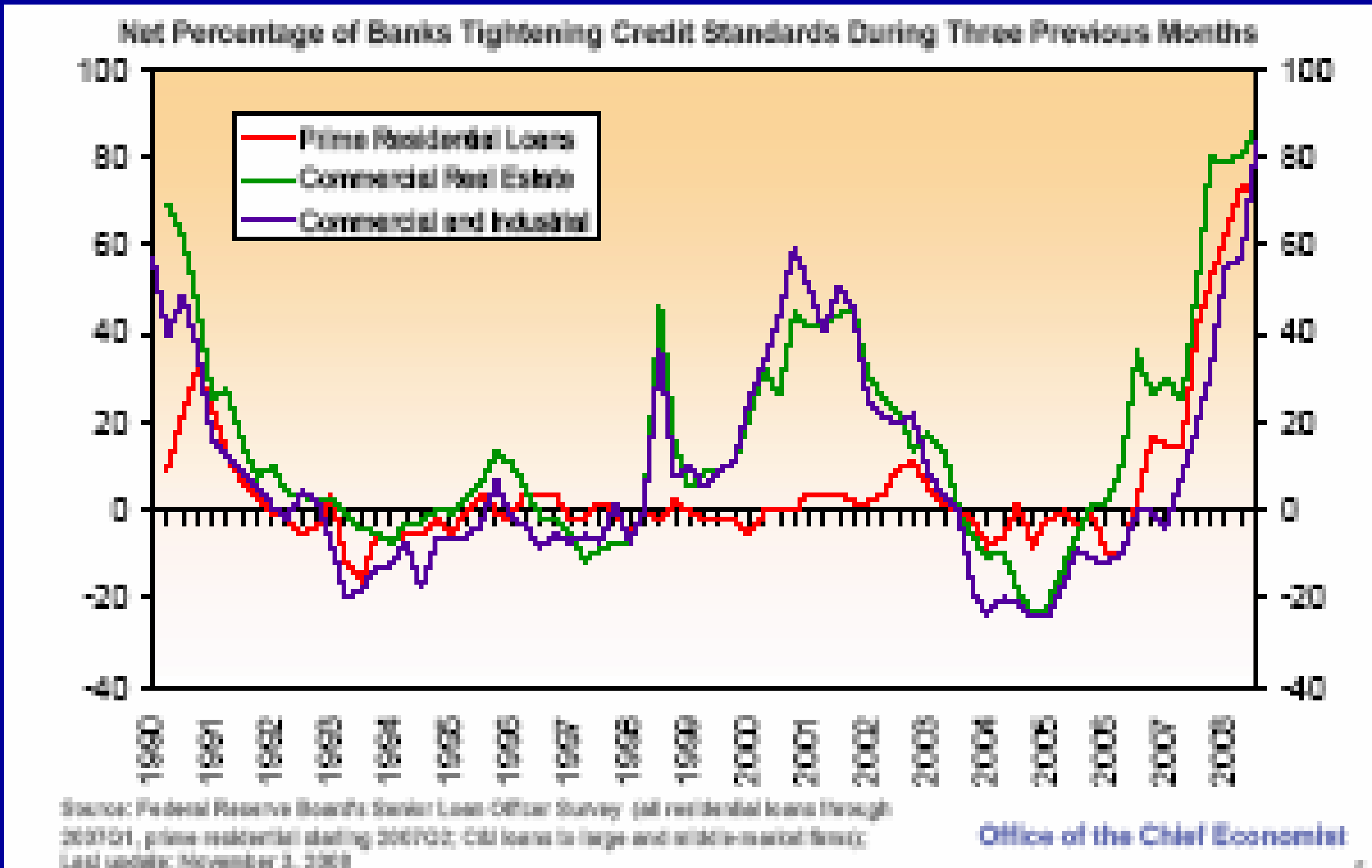
http://www.mortgagebankers.org/files/Research/CommercialOriginations/3Q08CMFOriginationsSurvey.pdf

Net Change Commercial Mortgage Debt (1980-2008)

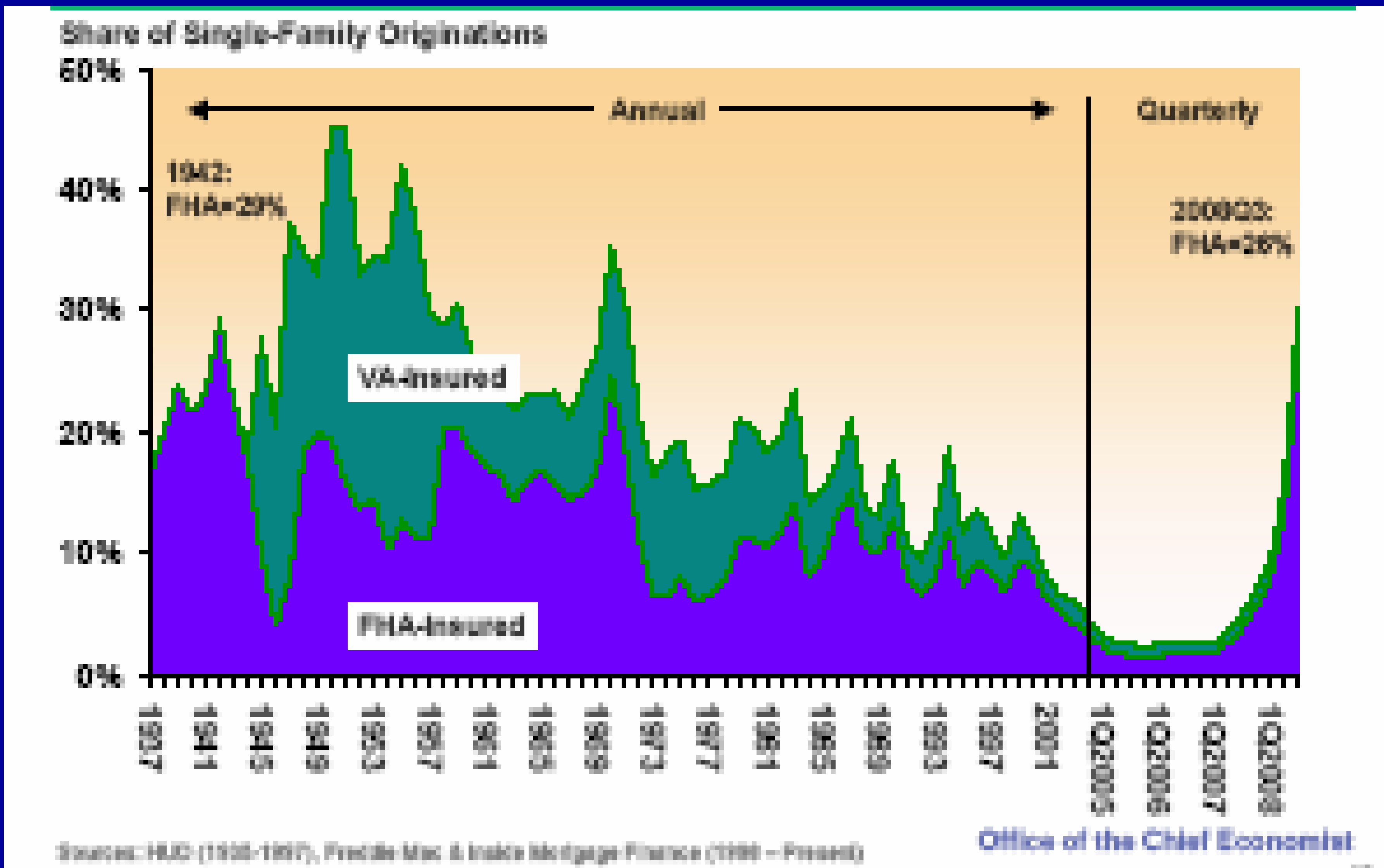


http://www.mbaa.org/files/Research/DataBooks/3Q08QuarterlyDataBook.pdf

Housing Market – Tight Credit Standards



Housing Market – FHA Originations



Appendix

Institutional Deconstruction

- **Loss of Civil Liberties - Personal/Individual/Property Rights**
- **Lack of Governmental Transparency and Accountability**
- **Dismantling of Social Welfare State and Safety Net**
- **Direct Input into Policy Development by Special Interests**
- **Redistribution and Concentration of Wealth (Privatization)**
- **Lack of Access to Democratic Institutions and Legal System**
- **Freedom of Speech and Press Limitations (Censorship)**
- **Unification of Church and State, attack on science**

"Institutional deconstruction is the dismantling of pluralistic and democratic institutions by powerful interests within society. The goal is to "deconstruct" these institutions, and replace them with new authoritarian institutions that enforce and redistribute private property rights to privileged interests, at any cost."

Jacques Derrida, Martin Heidegger, Friedreich Nietzsche, Et.Al.

Greenspan Critique: Labor vs. Capital

- Greenspan developed a New Business Cycle that privileges financial-capital markets over labor markets.
- Major shift to ***preemptive monetary policy strikes*** toward ***inflation targeting***, and away from ***full employment-real wage growth targeting*** (Paul Volcker -> Ben Bernanke).
- Foundation of monetary policy was deregulation, a financial boom in the stock and real estate markets and free trade, driving up consumer consumption and debt levels.
- **Results:** Cycle marked by deindustrialization, growing trade deficits, financial-asset market price bubbles, dollar overvaluation, L-T decline real wage growth, growing household debt levels, under investment by business in capital stock
- **Risks:** Fragile economy-recovery, high debt levels, under performing labor markets, exposure to financial market corrections, moral hazard – Fed intervention to rescue markets

Thomas Palley, Challenge, Nov.-Dec. 2005.

REIT Equity Stock Index Performance – Redwood Trust

http://finance.yahoo.com/q/bc?s=RWT&t=my&l=on&z=m&q=l&c=

REIT Equity Stock Index Performance – AMB

http://finance.yahoo.com/q/bc?s=AMB&t=my&l=on&z=m&q=l&c=

REIT Equity Stock Index Performance – BRE

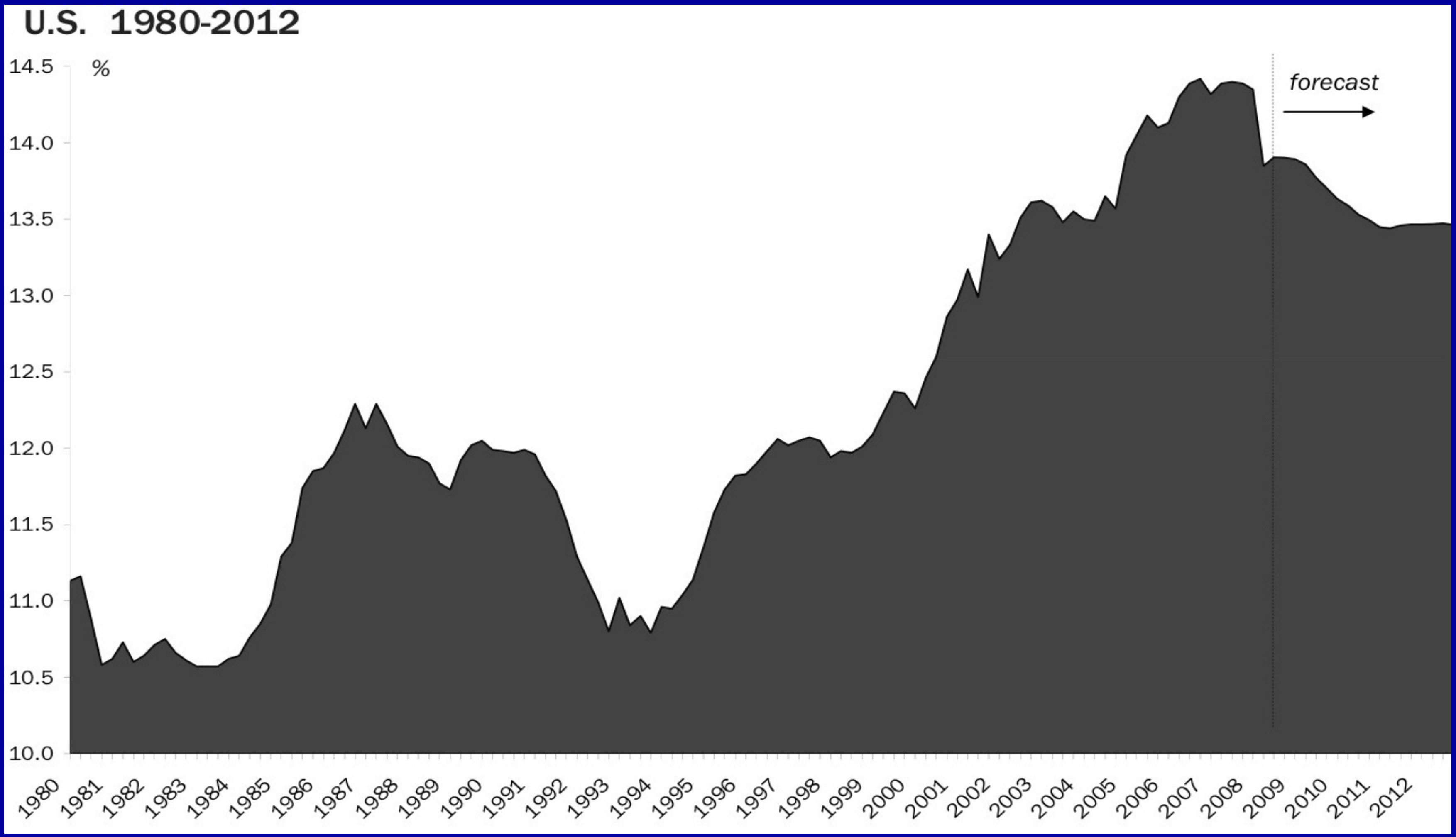
http://finance.yahoo.com/q/bc?s=BRE&t=my&l=on&z=m&q=l&c=

REIT Equity Stock Index Performance – Digital Realty Trust

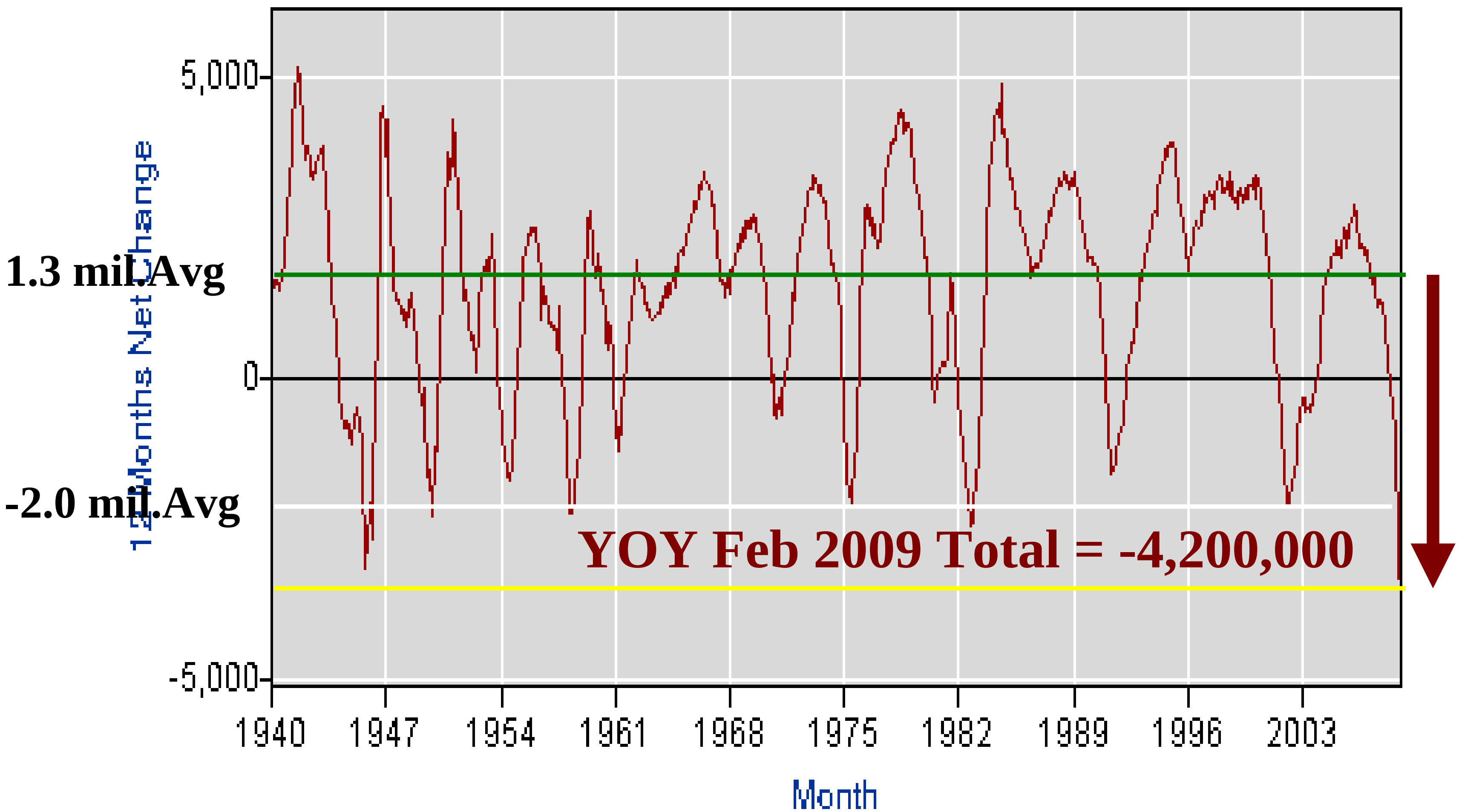
http://finance.yahoo.com/q/bc?s=DLR&t=5y

Increasing Debt of Consumers

Source: Economy.com

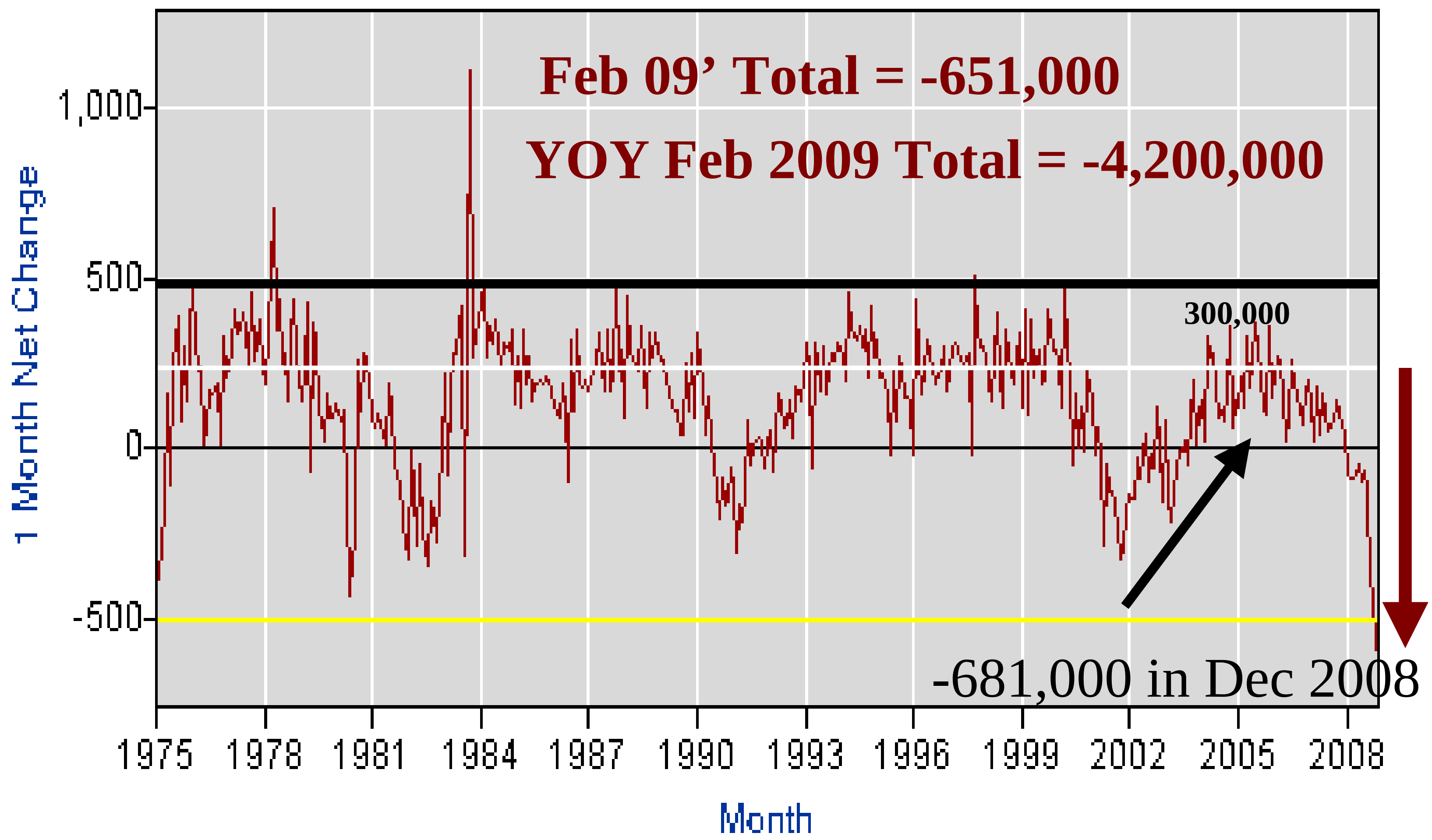


Non-Farm Payroll Employment



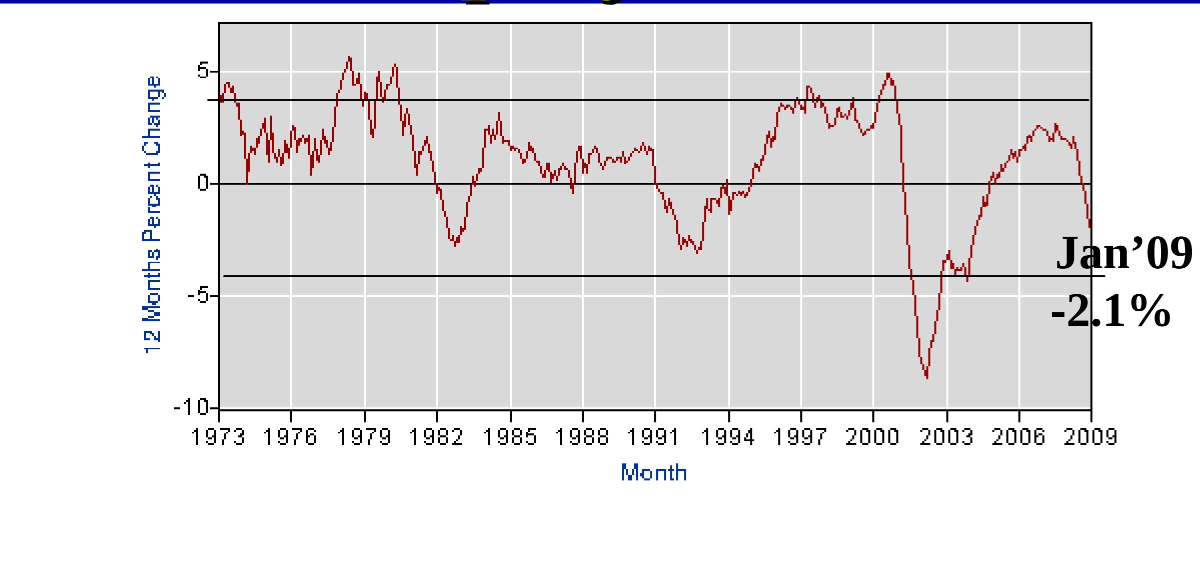
Source: Bureau of Labor Statistics.
http://www.bls.gov

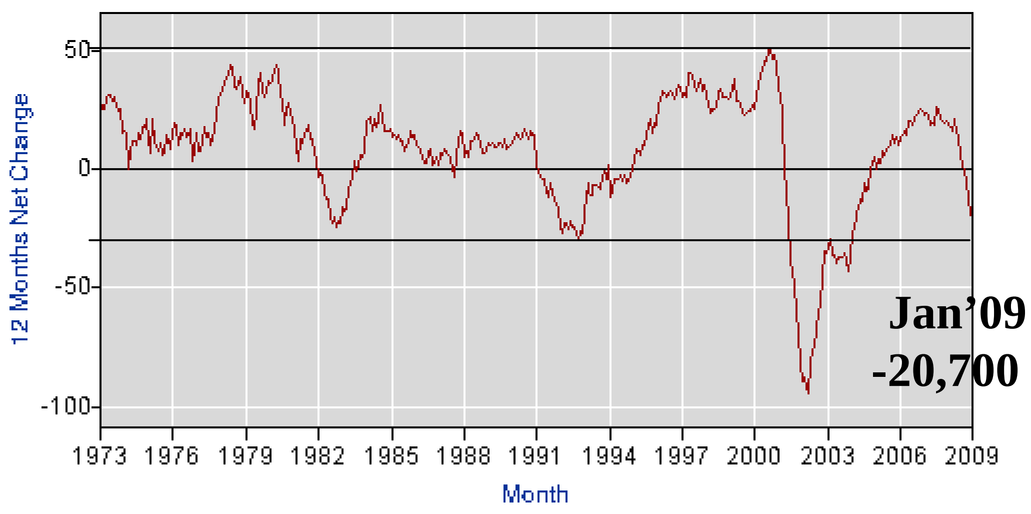
Non-Farm Payroll Employment



Source: Bureau of Labor Statistics.
http://www.bls.gov

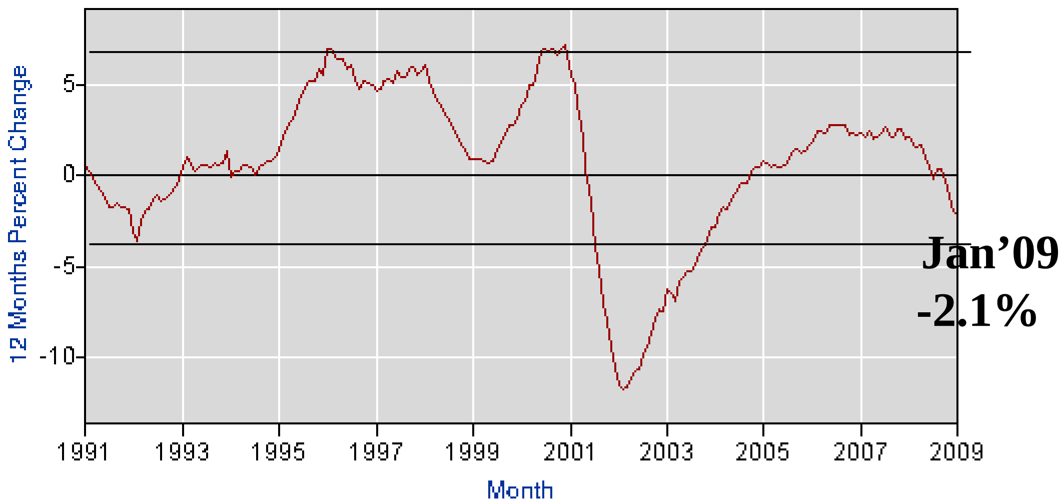
San Francisco PMSA Non-Farm Employment Growth (YOY)

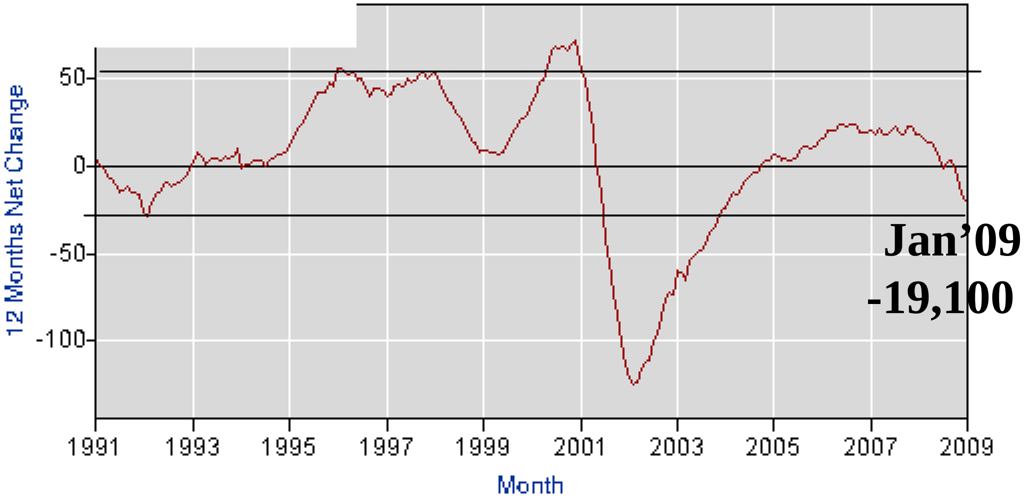




Source: Department of Labor Statistics.

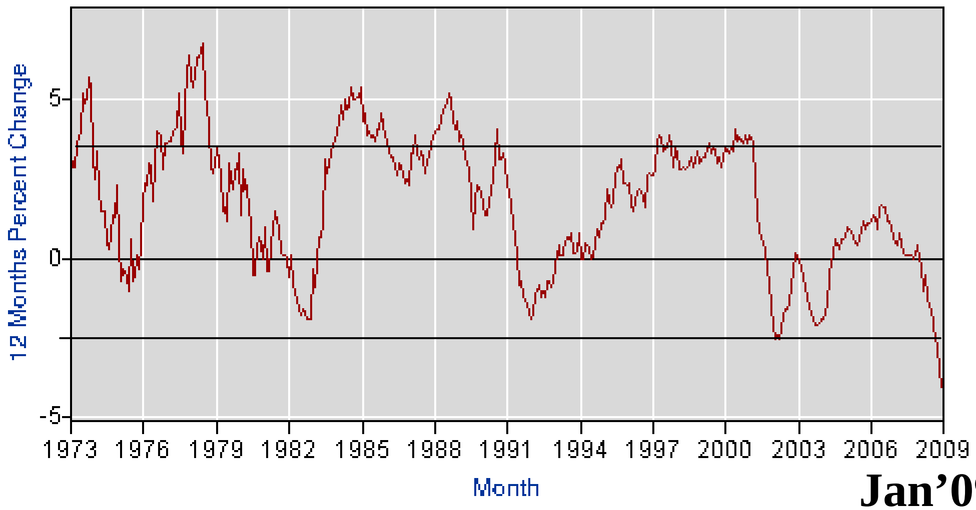
San Jose PMSA Non-Farm Employment Growth (YOY)



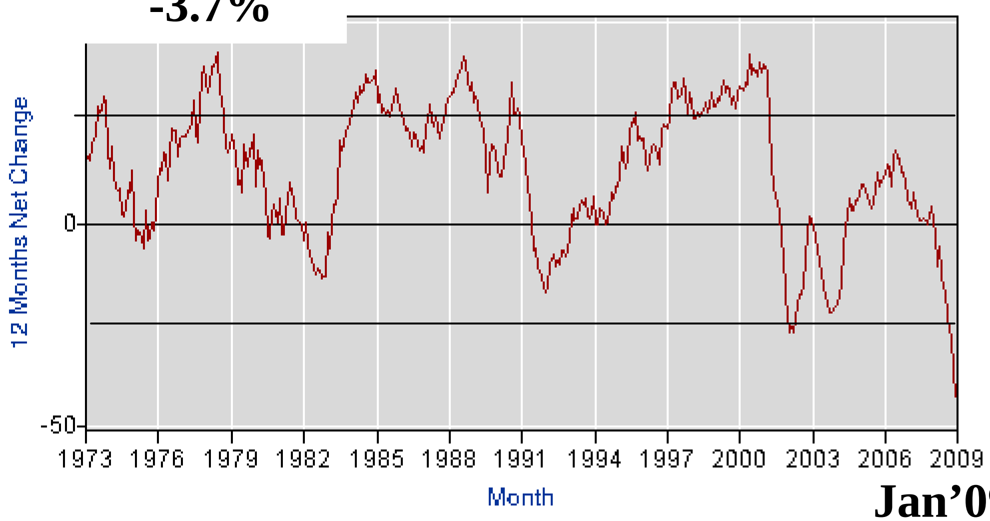


Source: Department of Labor Statistics.

Oakland PMSA Non-Farm Employment Growth (YOY)



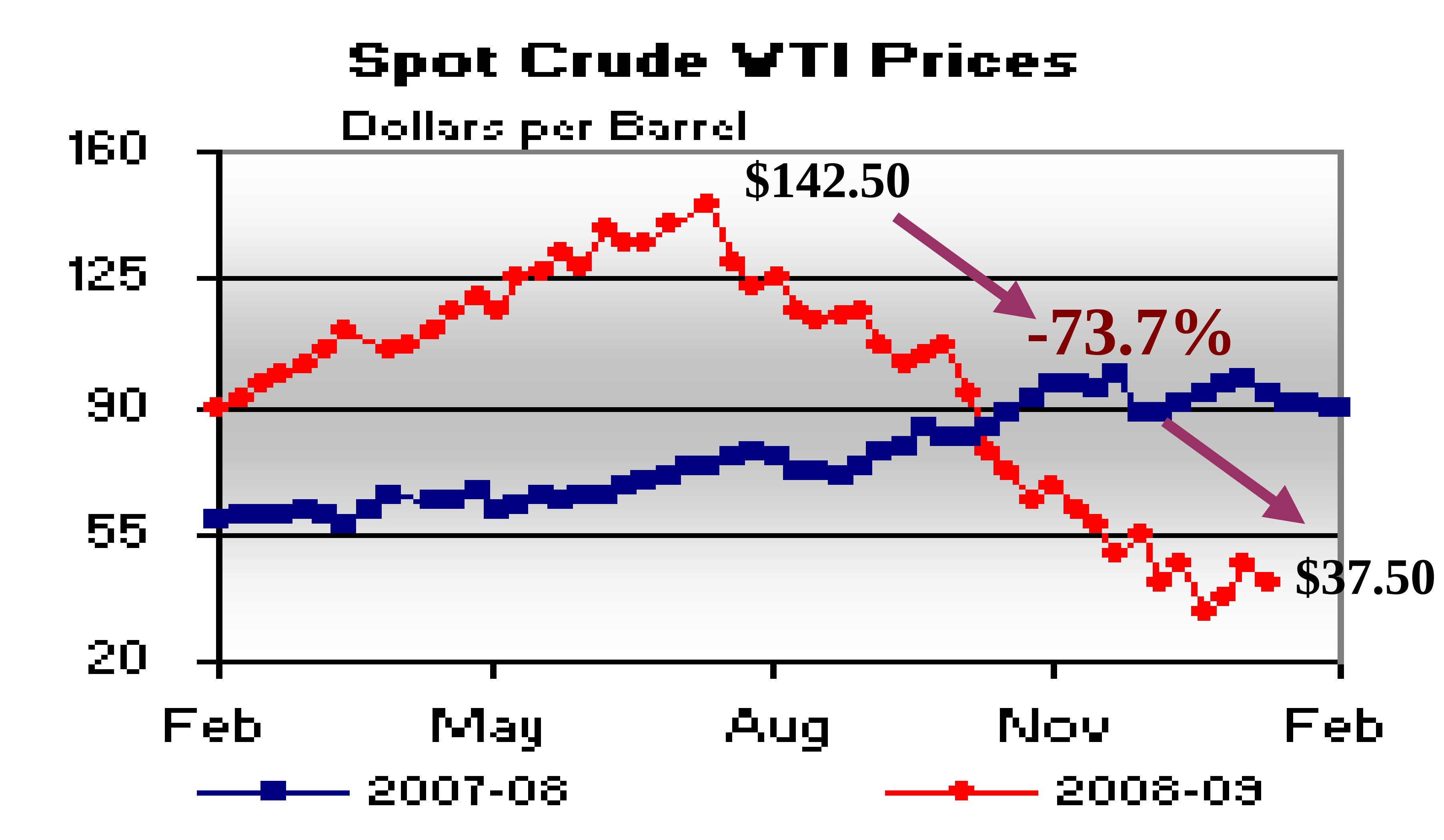
Jan'09
-3.7%



Jan'09
-37,800

Source: Department of Labor Statistics.

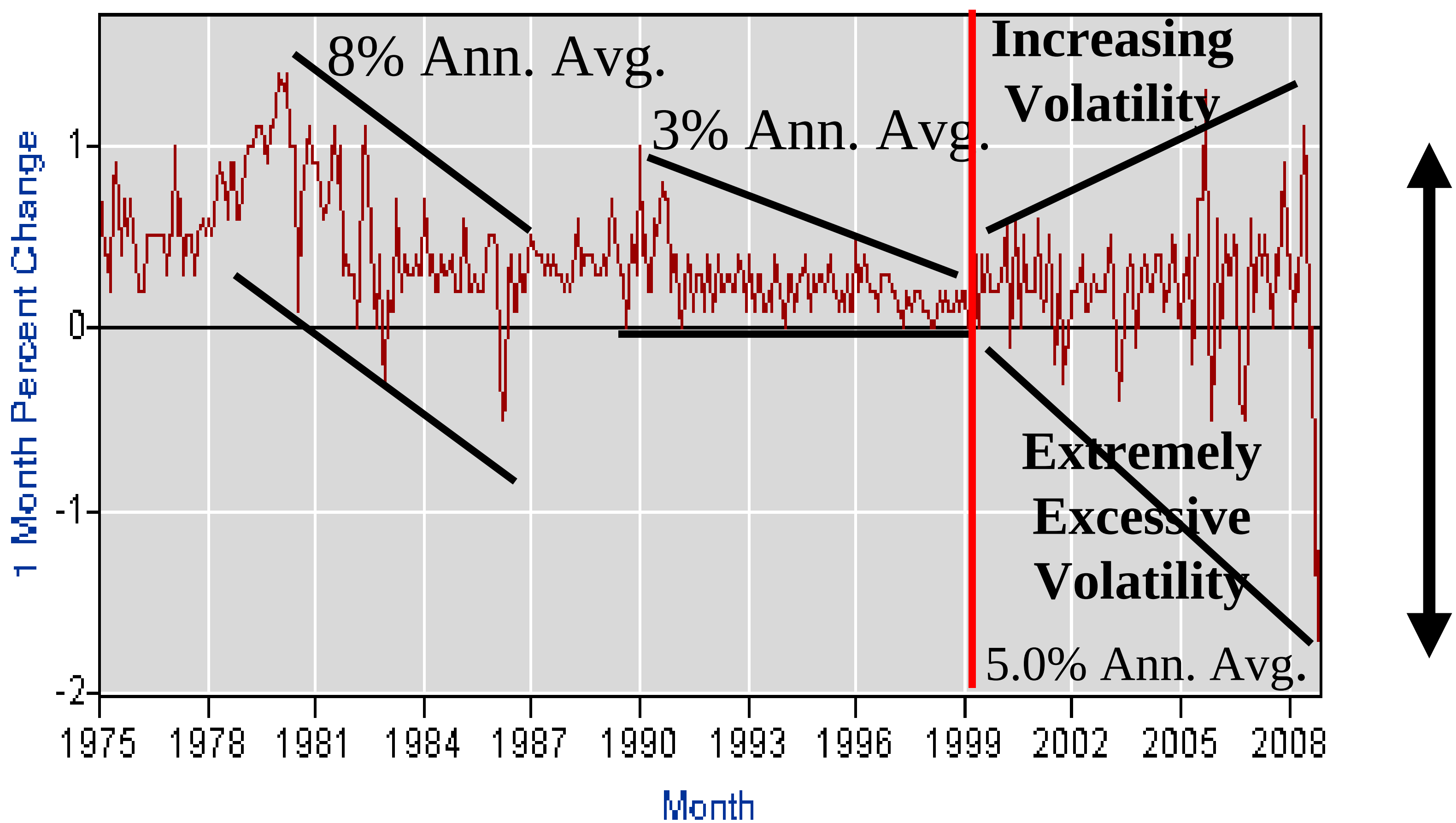
Inflation Expectations



Source: Energy Information Administration (http://eia.doe.gov/)

Inflation Expectations - Volatility

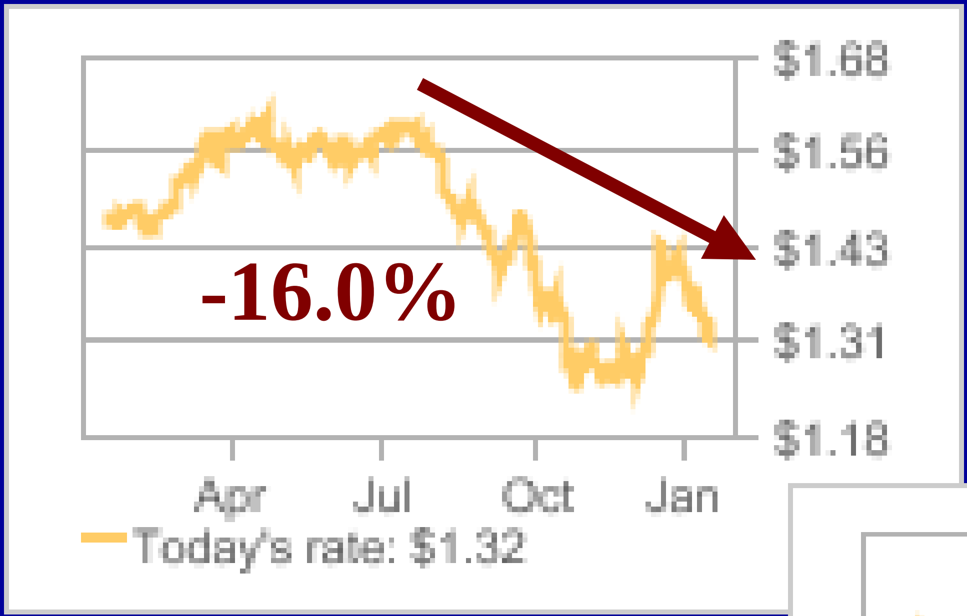
U.S. Consumer Price Index – All Items (U.S. City Average)



Source: Bureau of Labor Statistics.

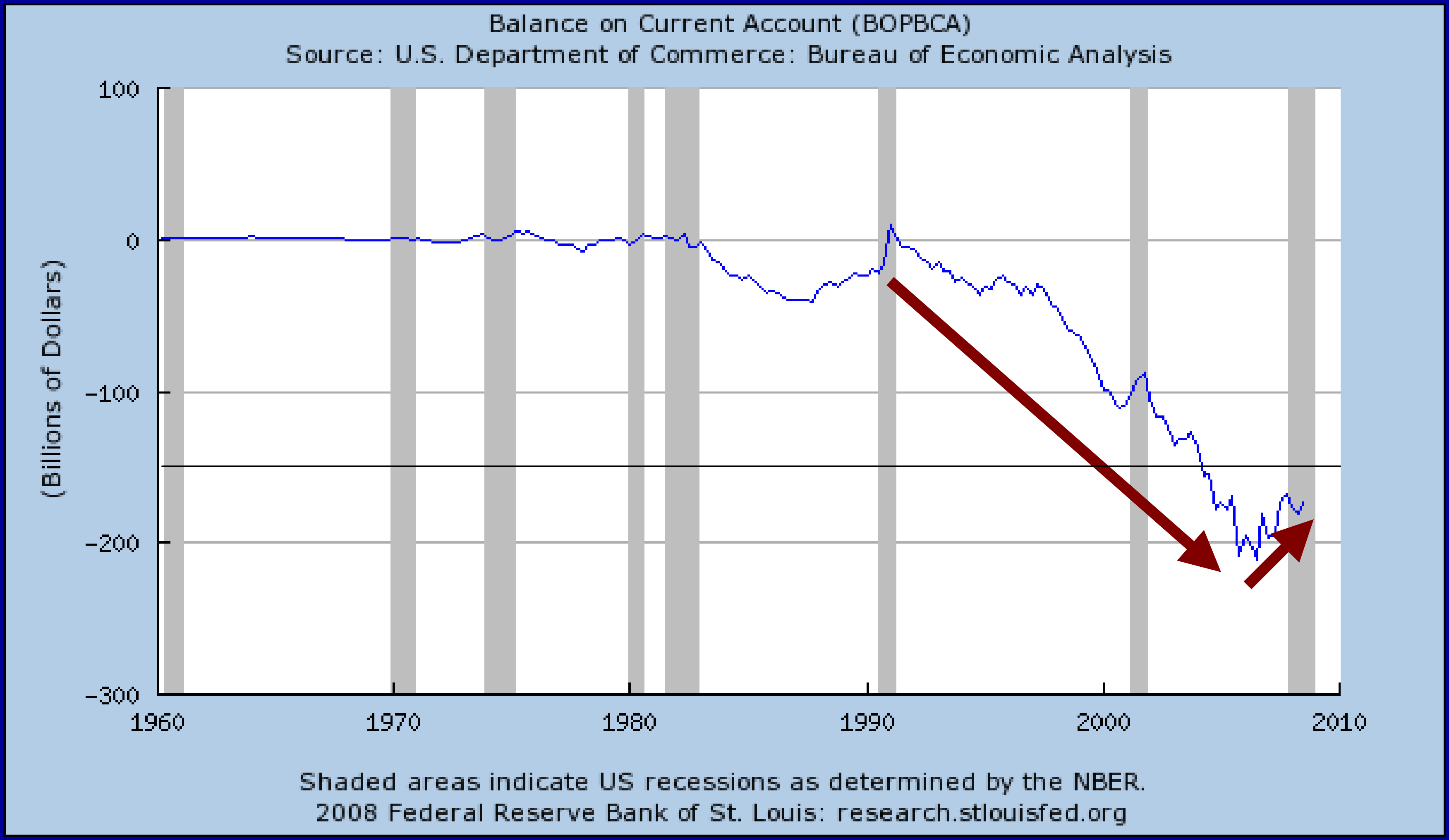
http://www.bls.gov/home.htm

Euro/Yen Exchange Rates 2008-2009



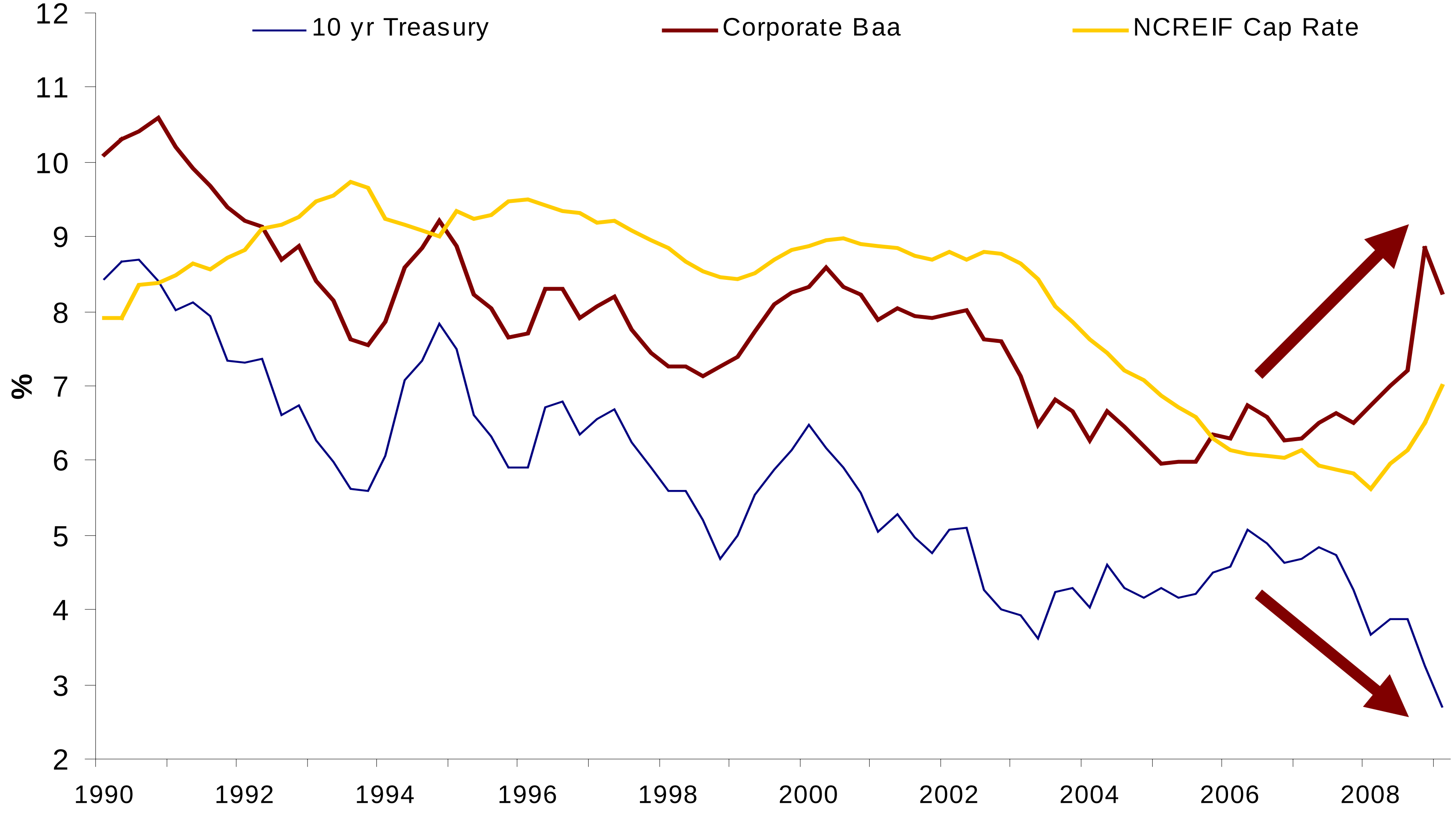
Source: New York Federal Reserve Bank. http://www.ny.frb.org/markets/foreignex.html

Balance of Trade



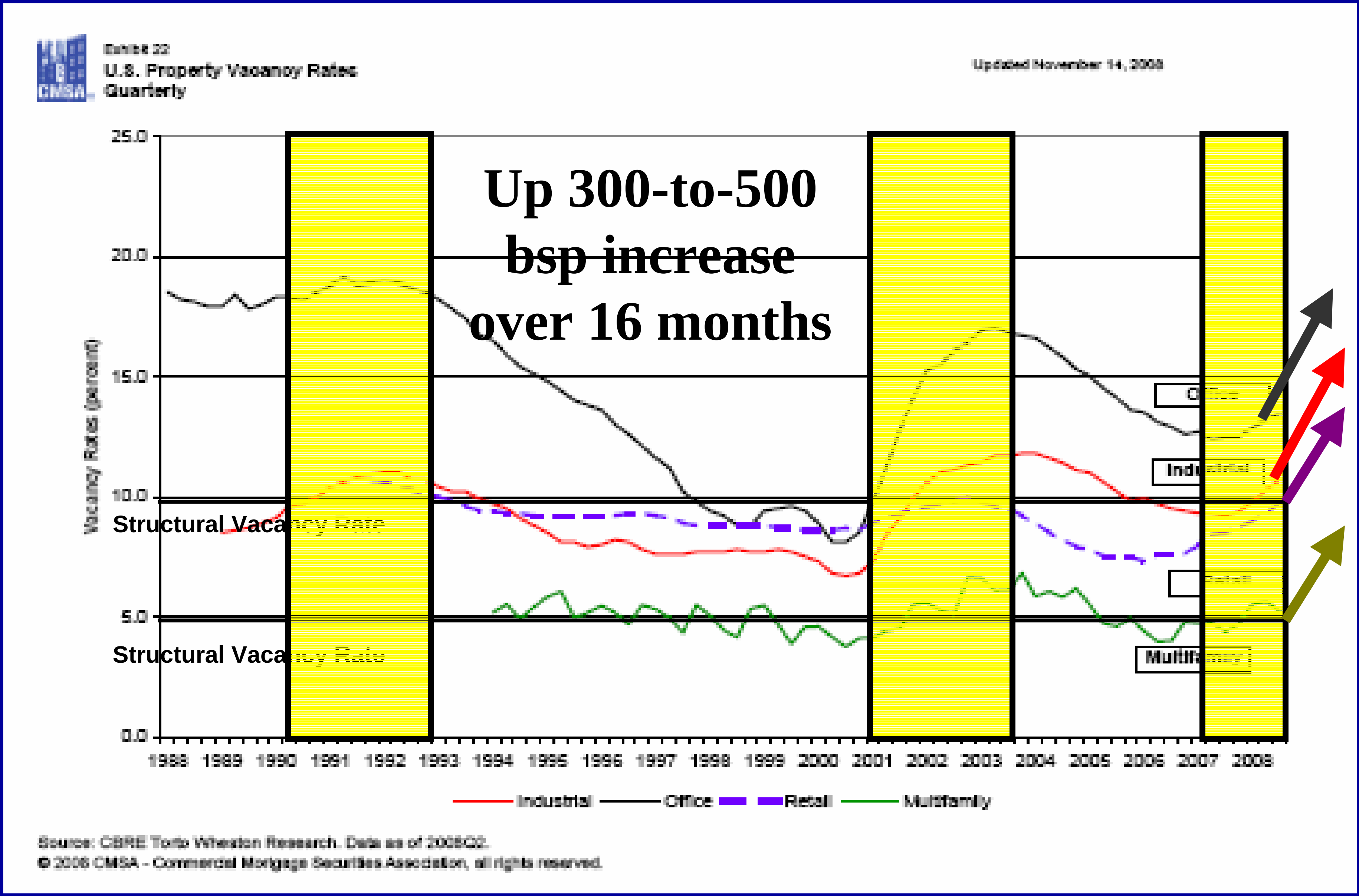
Sources: U.S. Department of Commerce: Bureau of Economic Analysis
http://research.stlouisfed.org/fred2/series/BOPBCA/13

Real Estate Relative to Bond Prices …



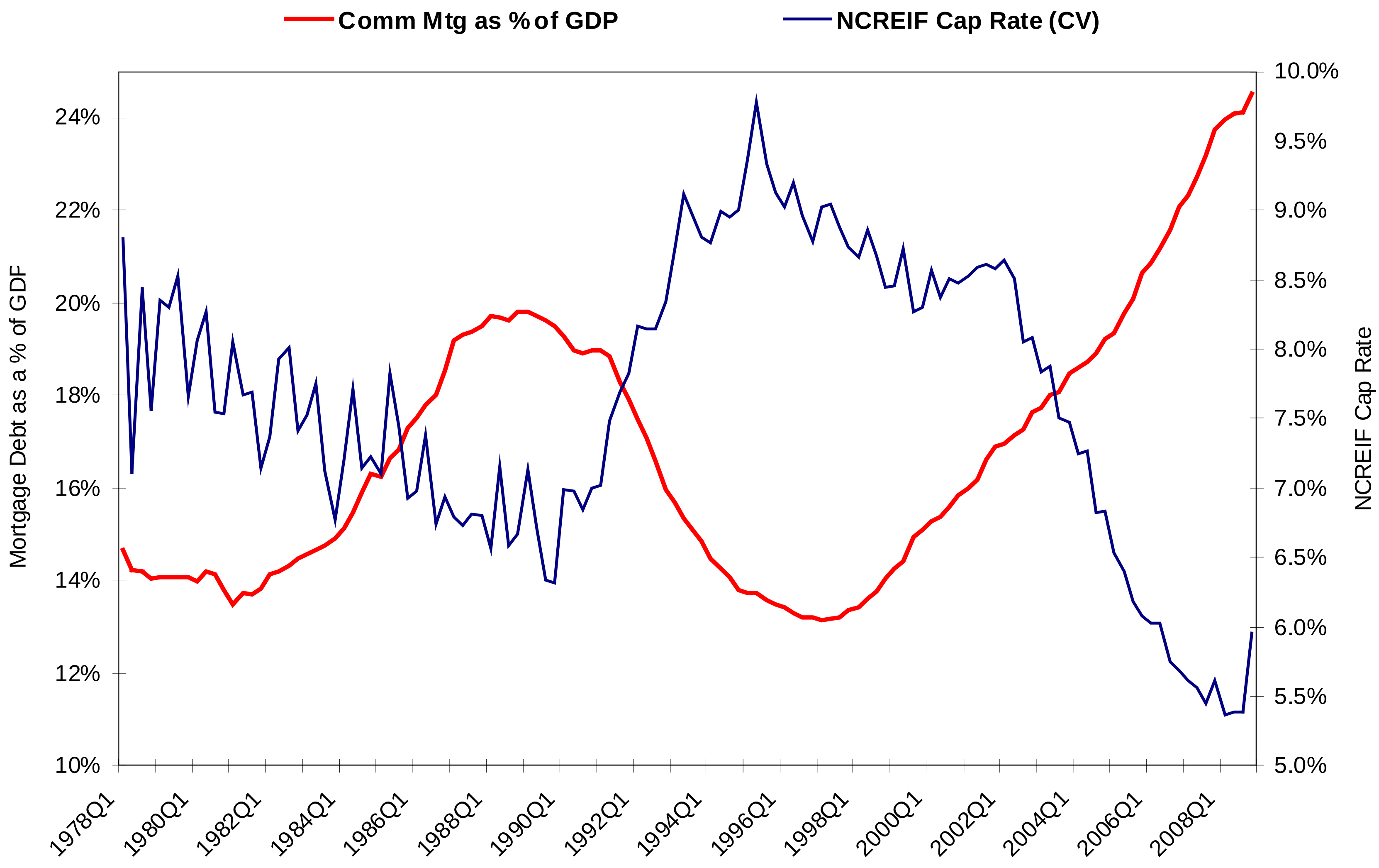
Source: Federal Reserve, NCREIF and Cornerstone Research.

Commercial Vacancy Rates (From 1988 to 2010)



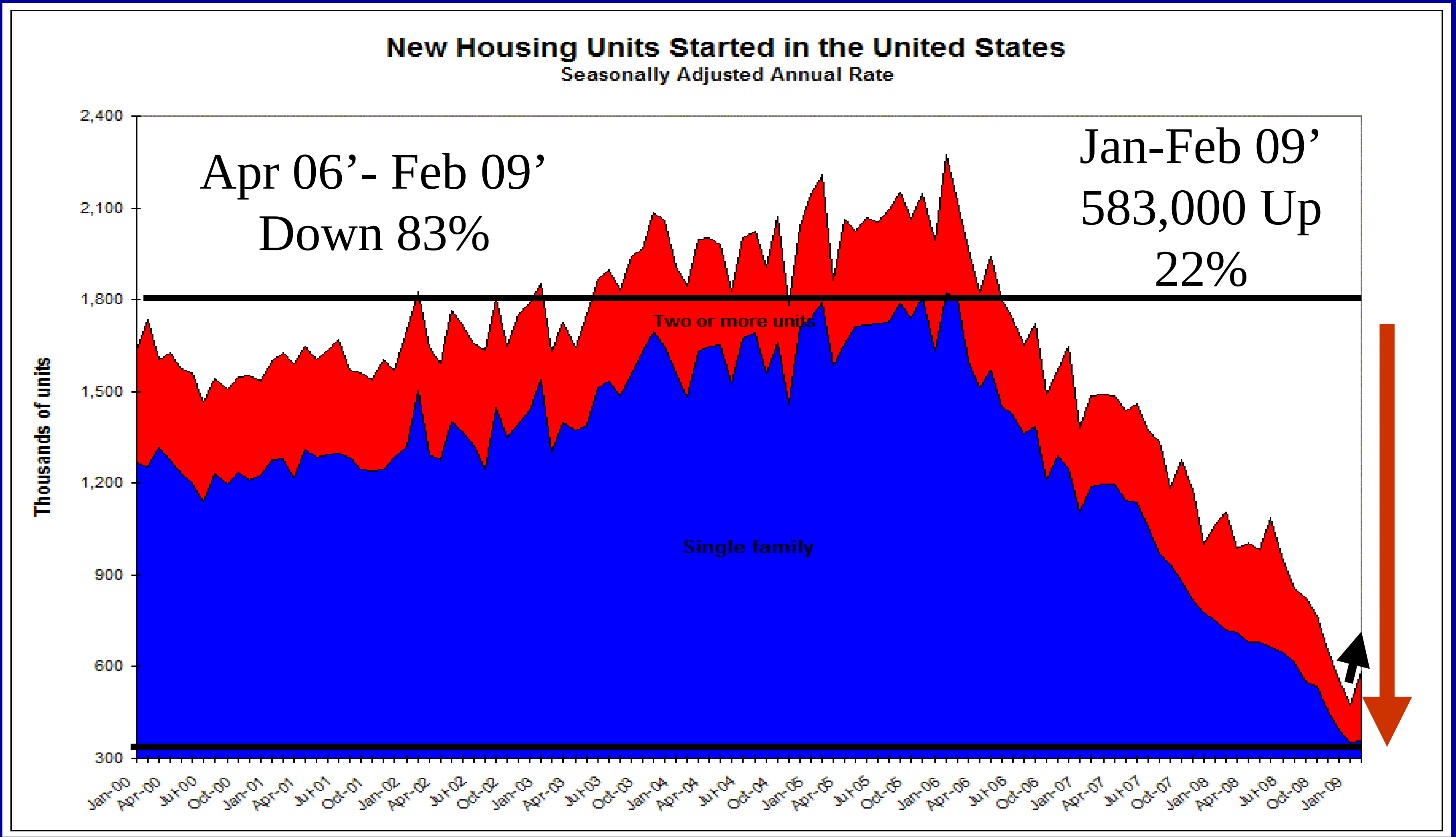
http://www.cmsaglobal.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Statistics/CMSA_Compendium.pdf

Mortgage Debt and NCREIF Cap Rates



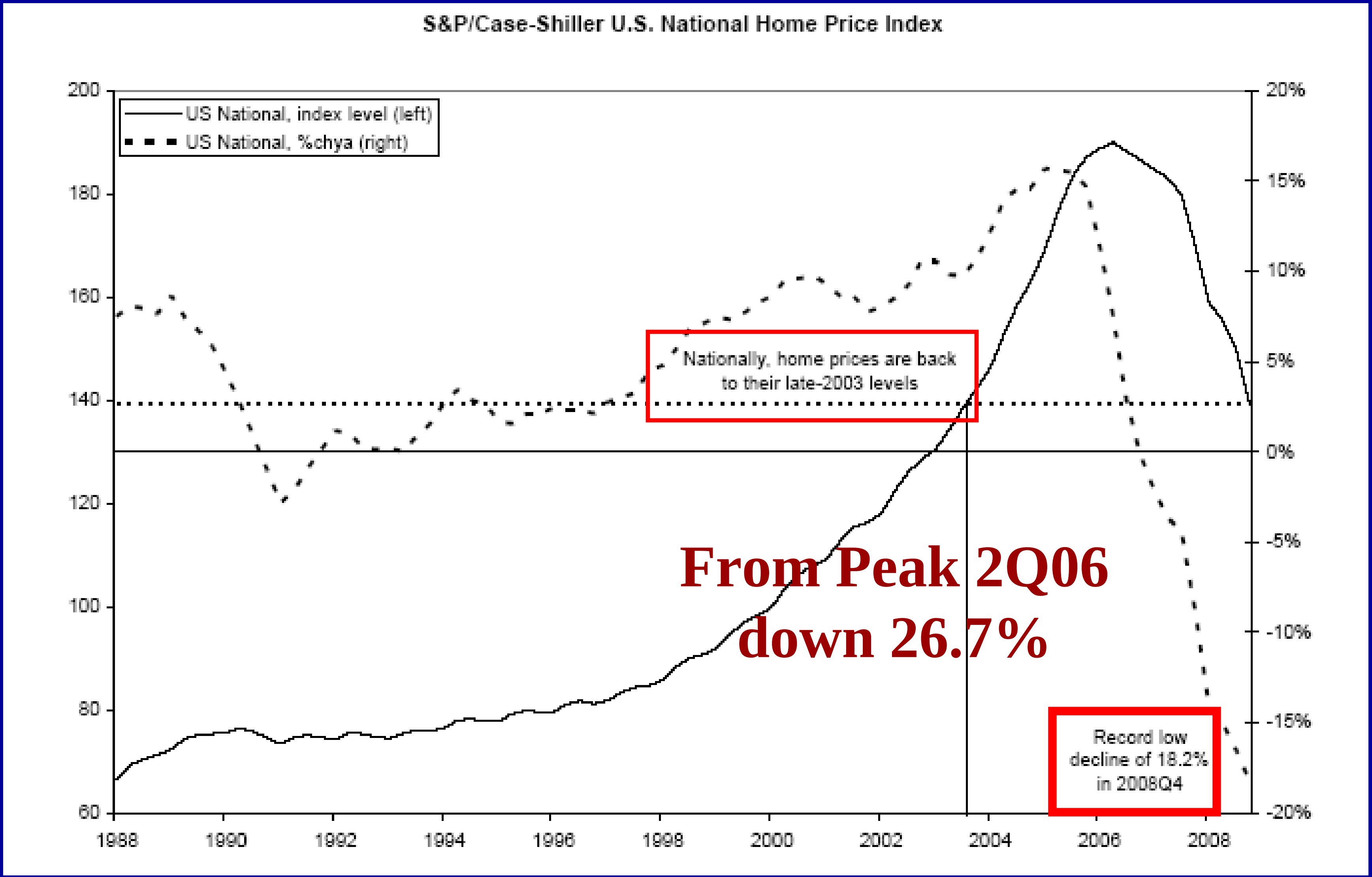
Source: Based on data from NCREIF, Bureau of Economic Analysis and the Federal Reserve

New Housing Starts



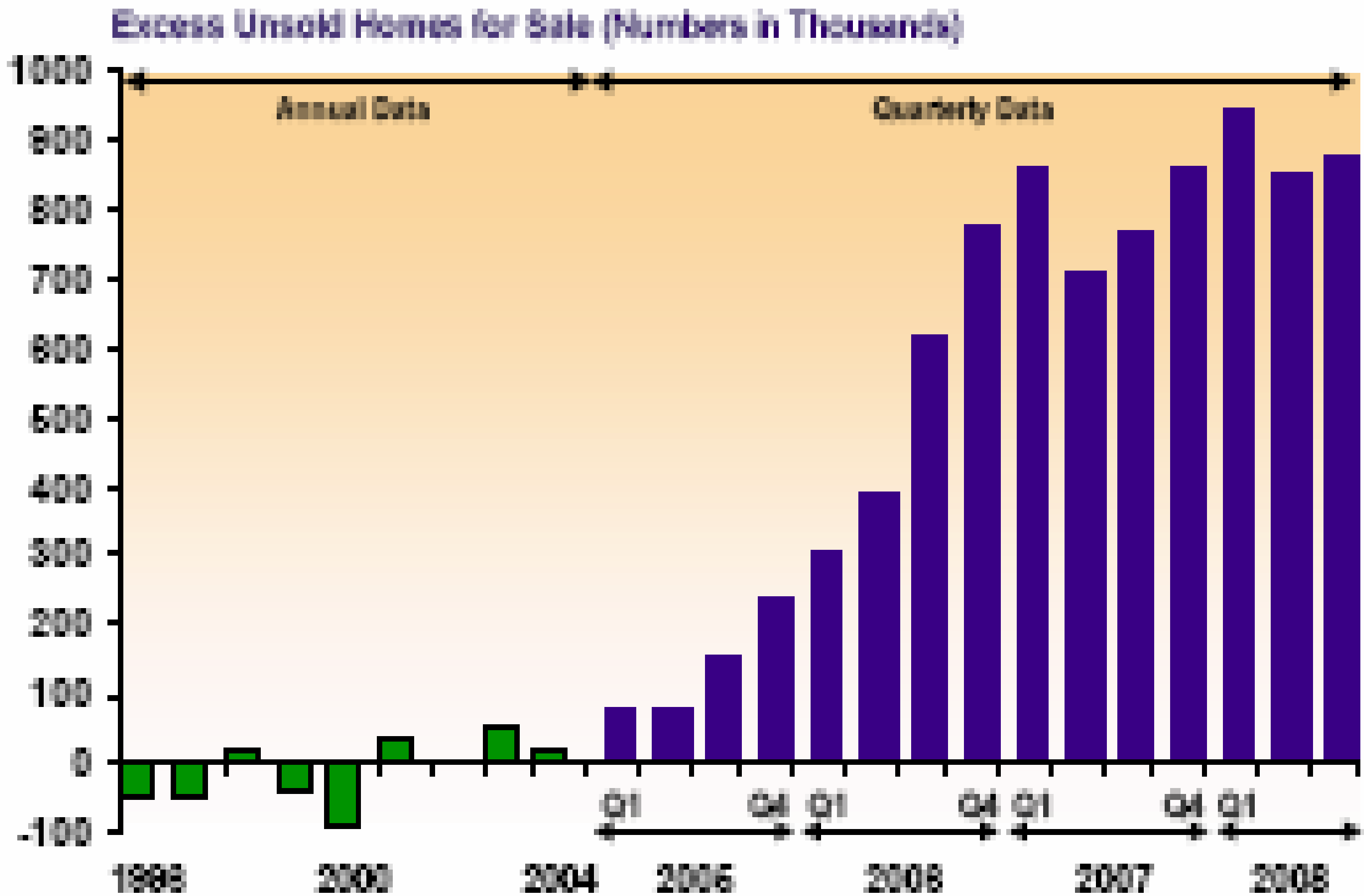
Source. United States Census Bureau. http://www.census.gov/briefrm/esbr/www/esbr020.html

Housing Market – Price Declines



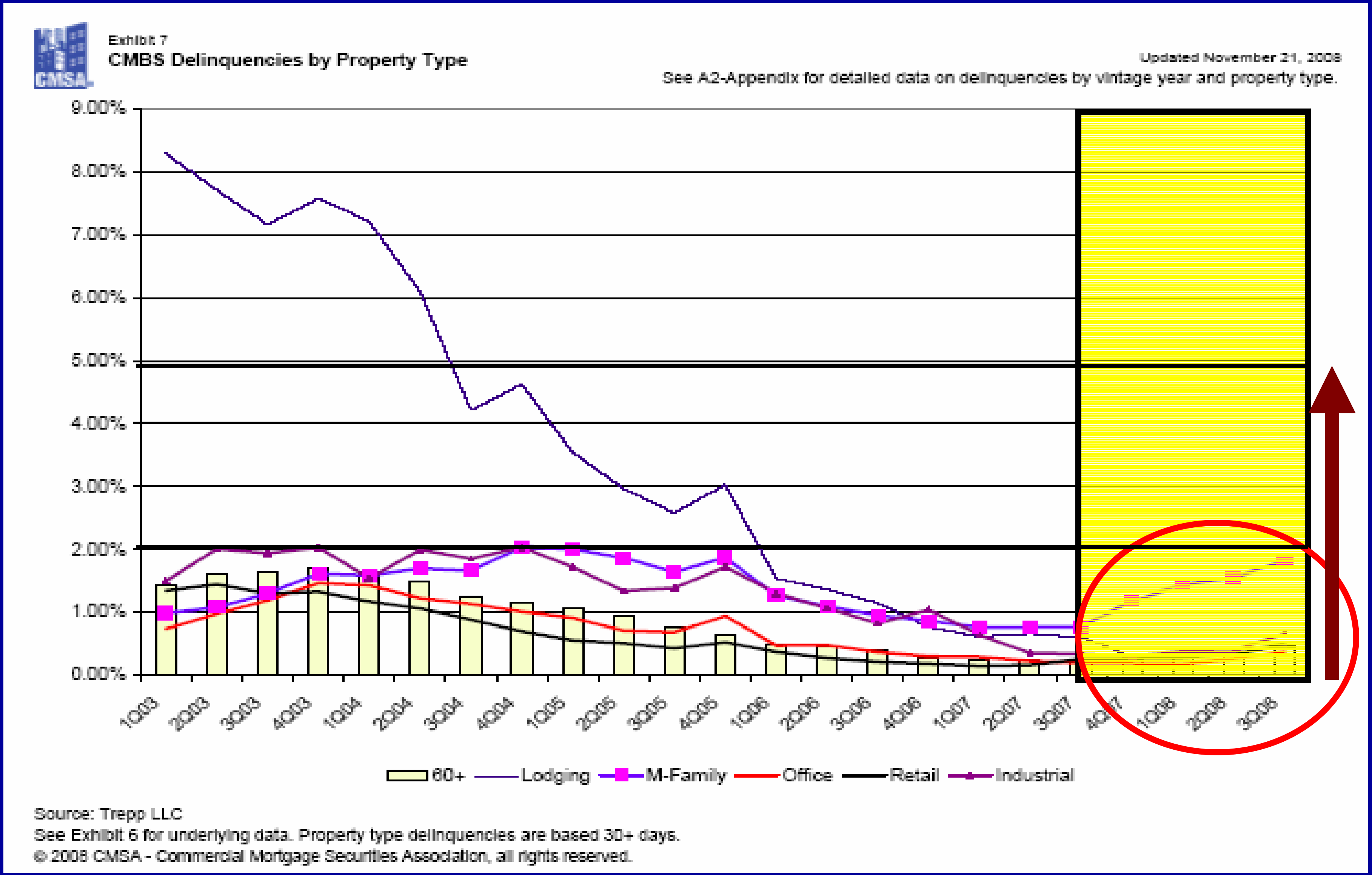
http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_022445.pdf

Housing Market - Excess Inventory



Office of the Chief Economist

CMBS Delinquency Rates by Type (From 2003 to 2008)



http://www.cmsaglobal.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Statistics/CMSA_Compendium.pdf

Lawrence Souza (**lsouza@Johnson/SouzaGroup.com**) brings to Johnson Souza Group, Inc. (**Direct: (415-713-0213**) over 20 years of experience in real estate economic and financial research. As Managing Director-Index Services, Charles Schwab Investment Management (CSIM); Chief Real Estate Economist and Director of Index Services, Global Real Analytics (GRA); Director of Research for BRE Properties, Inc. (REIT) in San Francisco and holding Senior Market/Research Analyst positions at Metric Institutional Realty Advisors and Mellon-McMahan/MacFarlane Realty Advisors, and market research positions at Norris, Beggs and Simpson and Grubb & Ellis commercial brokerage. Mr. Souza combines traditional fundamental real estate economic and market research with fundamental and technical financial and capital market research. This combined approach allows for the tracking and forecasting of economic, real estate and financial cycles and efficient portfolio construction, optimization and risk management.

Mr. Souza is also a licensed California Real Estate Broker (Realtor), specializing in urban-infill residential, commercial property transactions, and 1031 Exchanges in the San Francisco Bay Area and Western Region.

Mr. Souza has undergraduate degrees in Economics (BA) and Business Administration (BS) with concentrations in Accounting, Finance, Banking and Real Estate; and holds master's degrees in Applied Economics (MA), Finance/Investments (MS), Public Administration (MPA), and Information Systems (MSIS). Mr. Souza has been teaching Modern Real Estate Principles and Finance since 1996 with an emphasis on real estate in a modern portfolio and capital markets context; and the institutionalization, securitization, internationalization and technologization of real estate markets and products.