

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

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**- Professor – Real Estate/Finance/Economics
Golden Gate University**



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.

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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.



TOLES

UNIVERSAL PRESS SYND.
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I'M REALLY GOOD
AT WHAT I DO.

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
TOXIC ASSETS

TAXPAYER

SOMEBDDY ELSE GOT
THE DESSERT MENU

TUES

MA



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

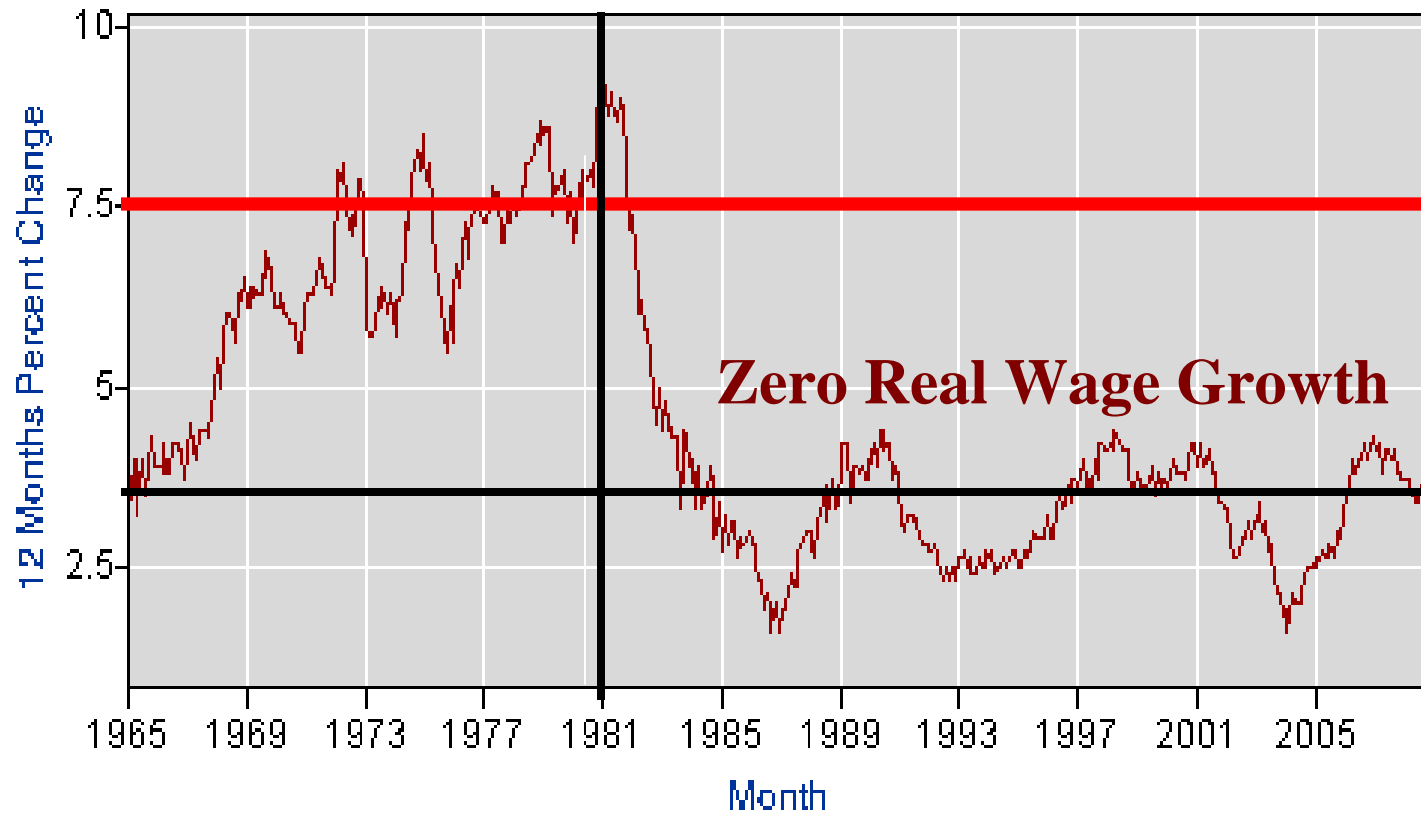
US Budget Deficits

- **\$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

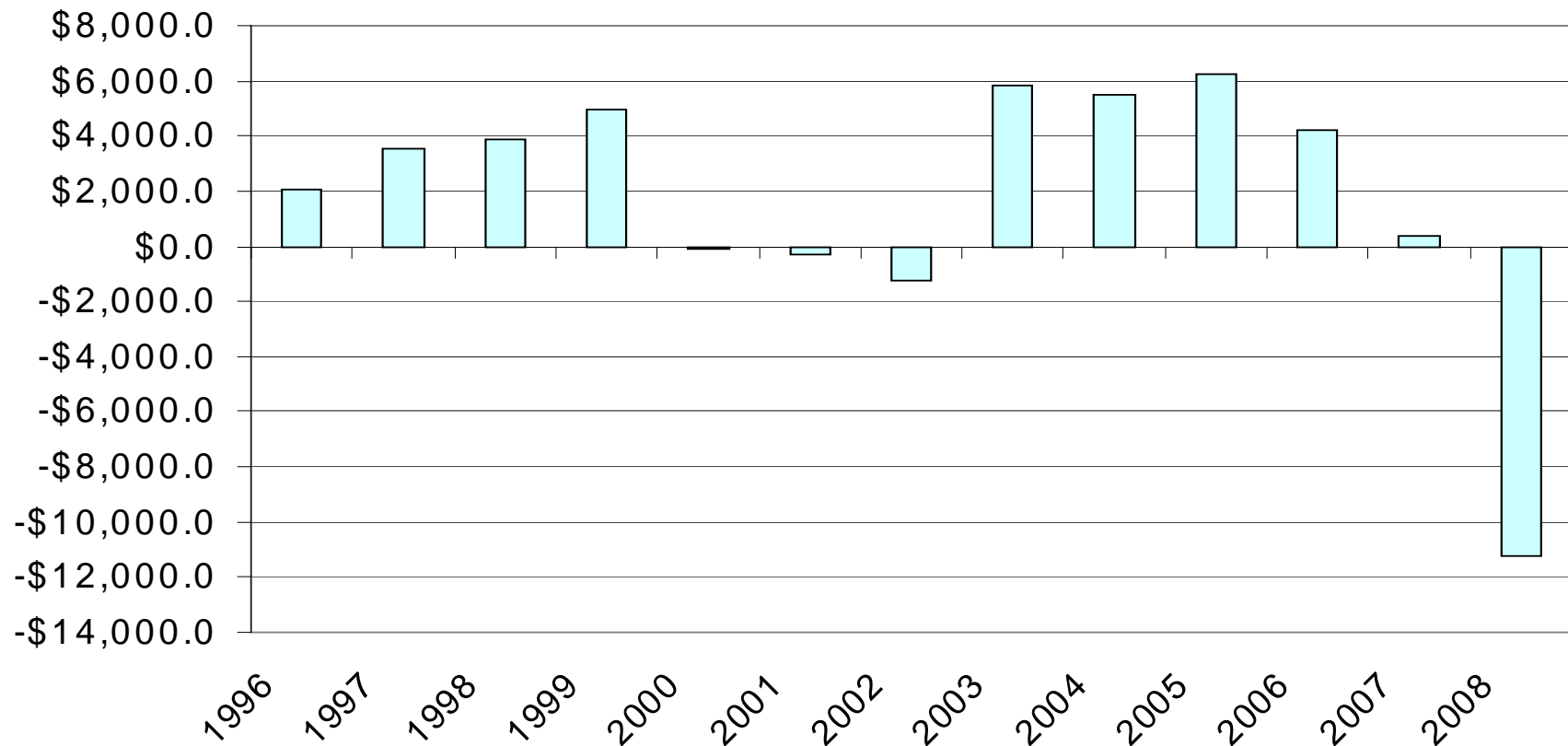
Average Hourly Earnings of Production Workers



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

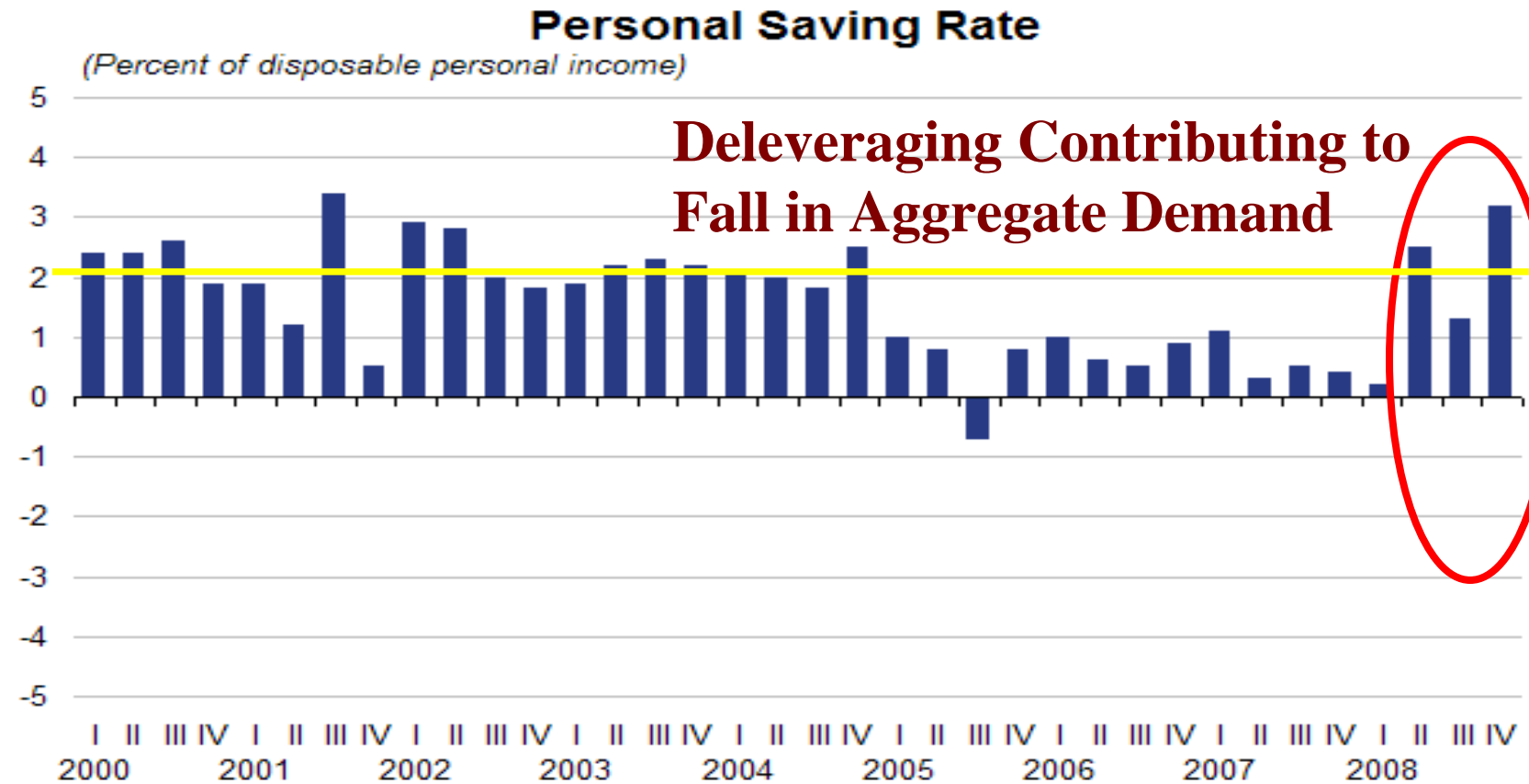
Change in Net Worth

CHANGE IN NET WORTH
(end of year to end of year)



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

Personal Savings Rate



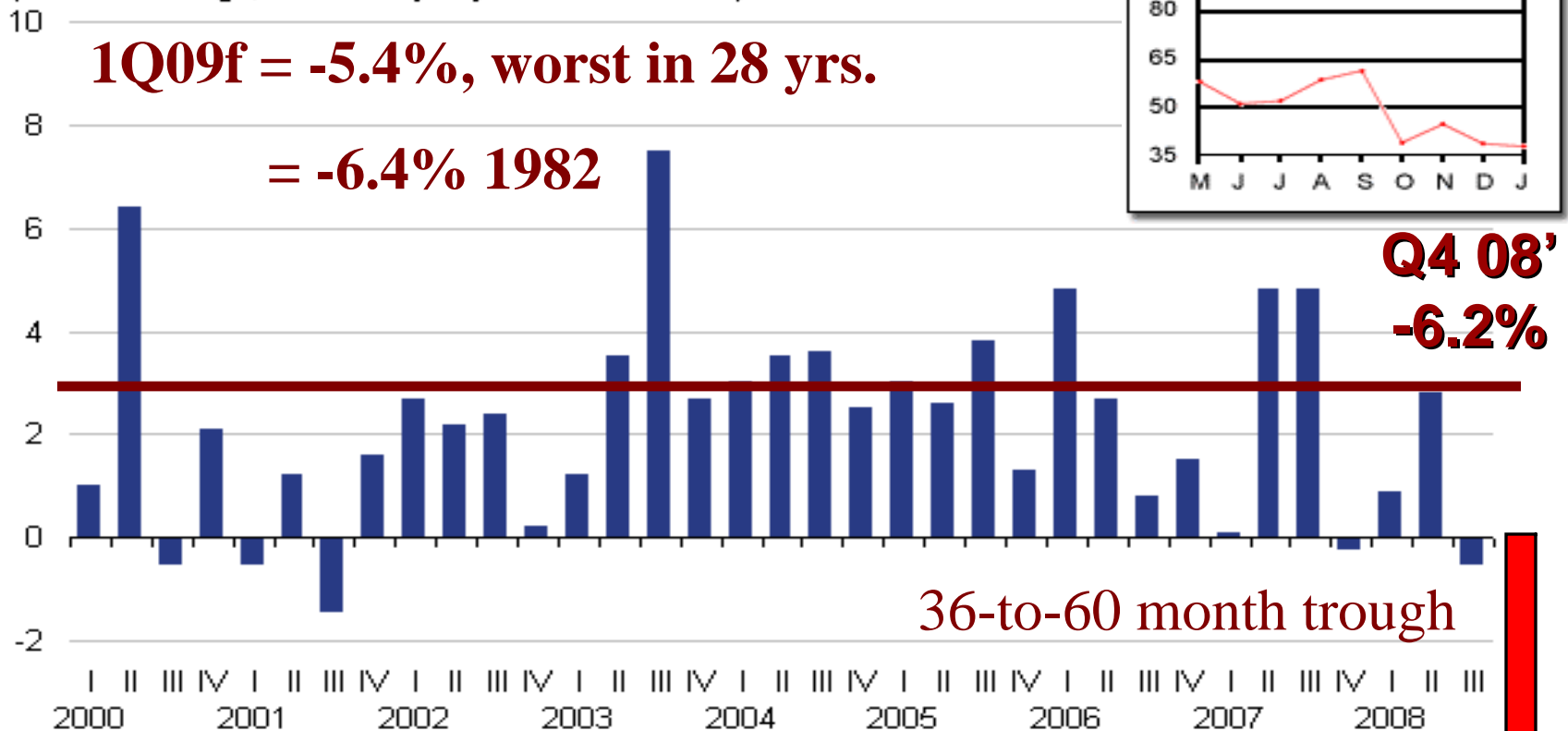
U.S. Bureau of Economic Analysis

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

Gross National Product (GDP)

Real Gross Domestic Product

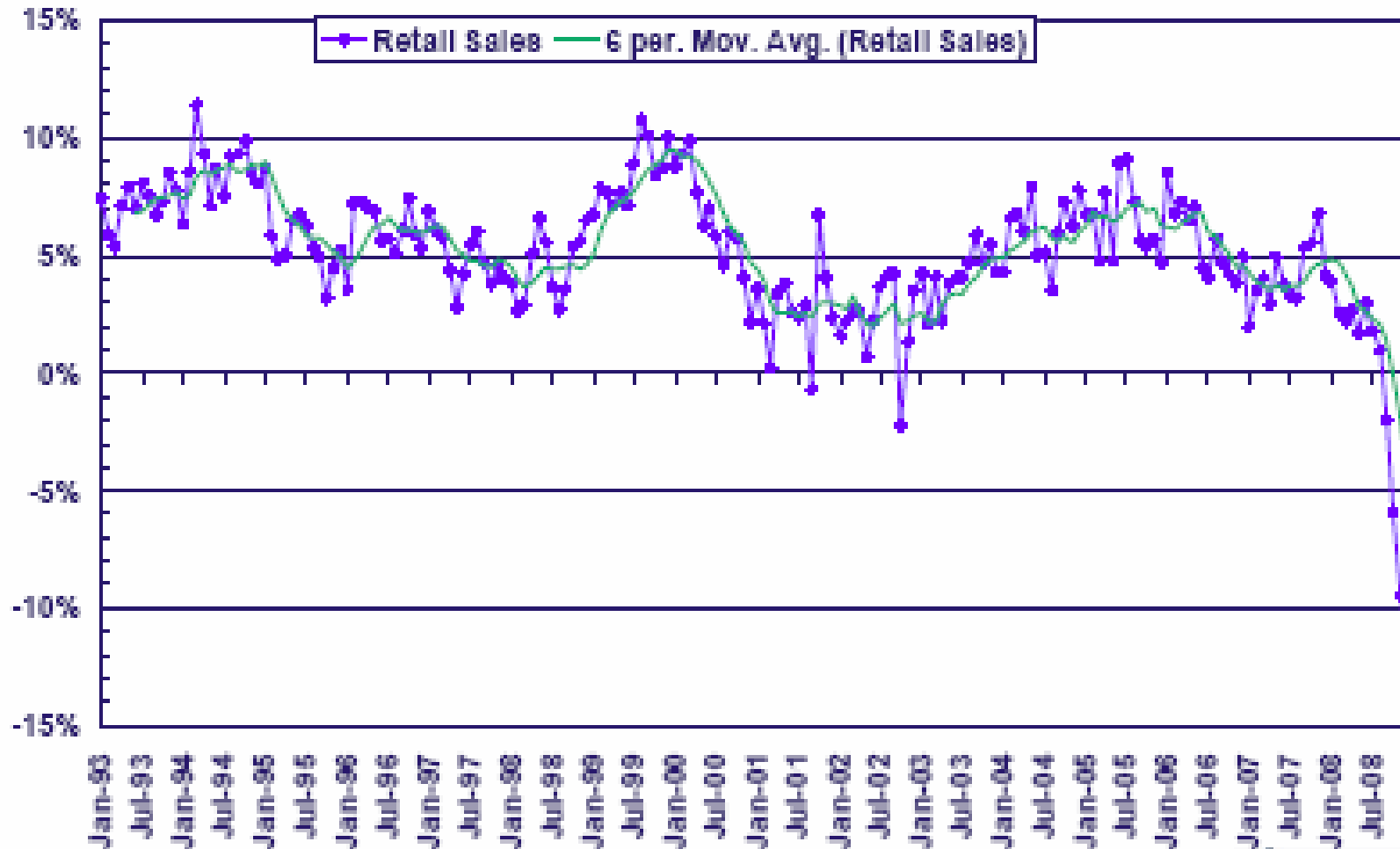
(Percent change, seasonally adjusted annual rate)



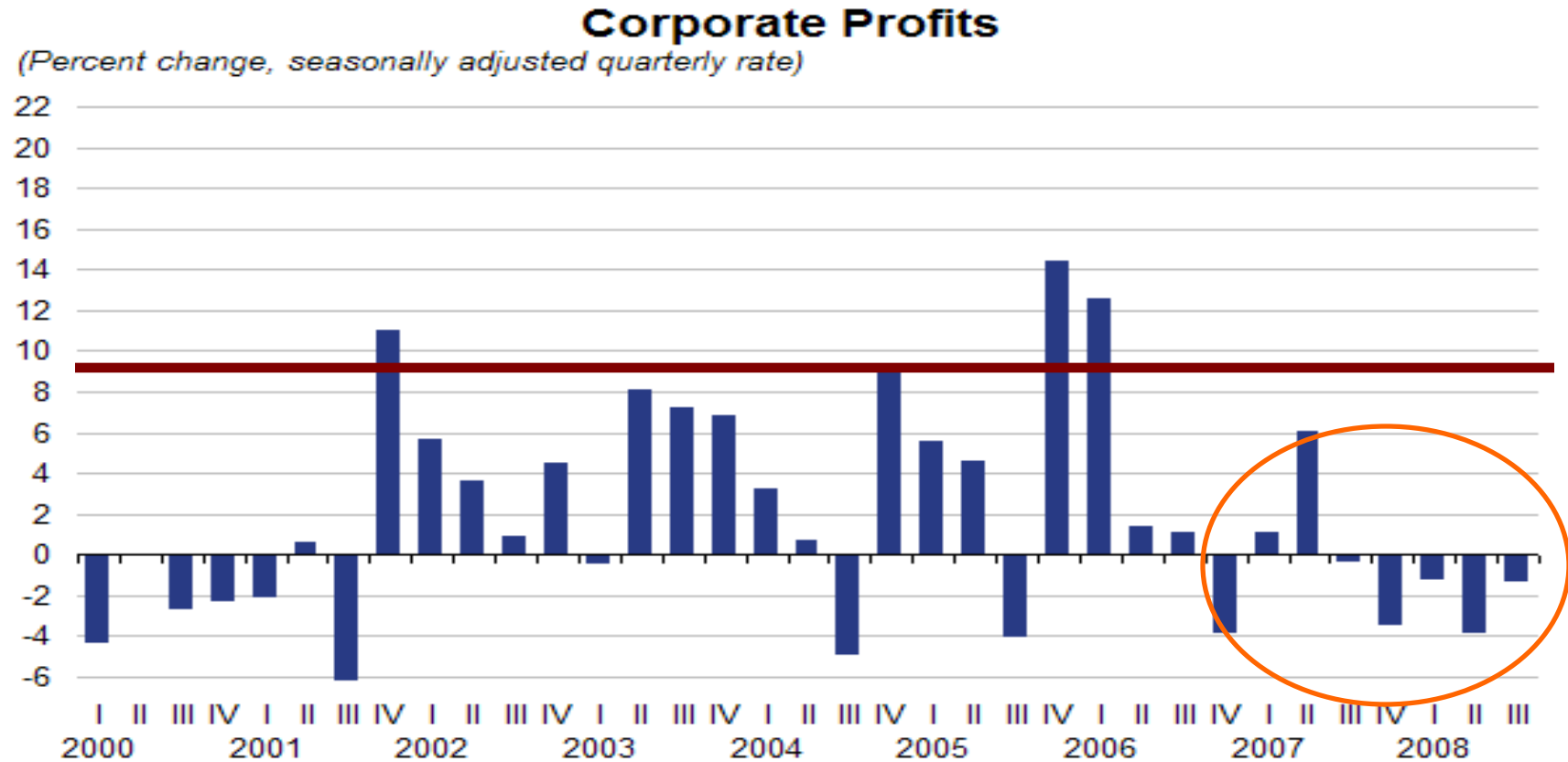
U.S. Bureau of Economic Analysis

Retail Sales

PERCENT CHANGE FROM A YEAR AGO



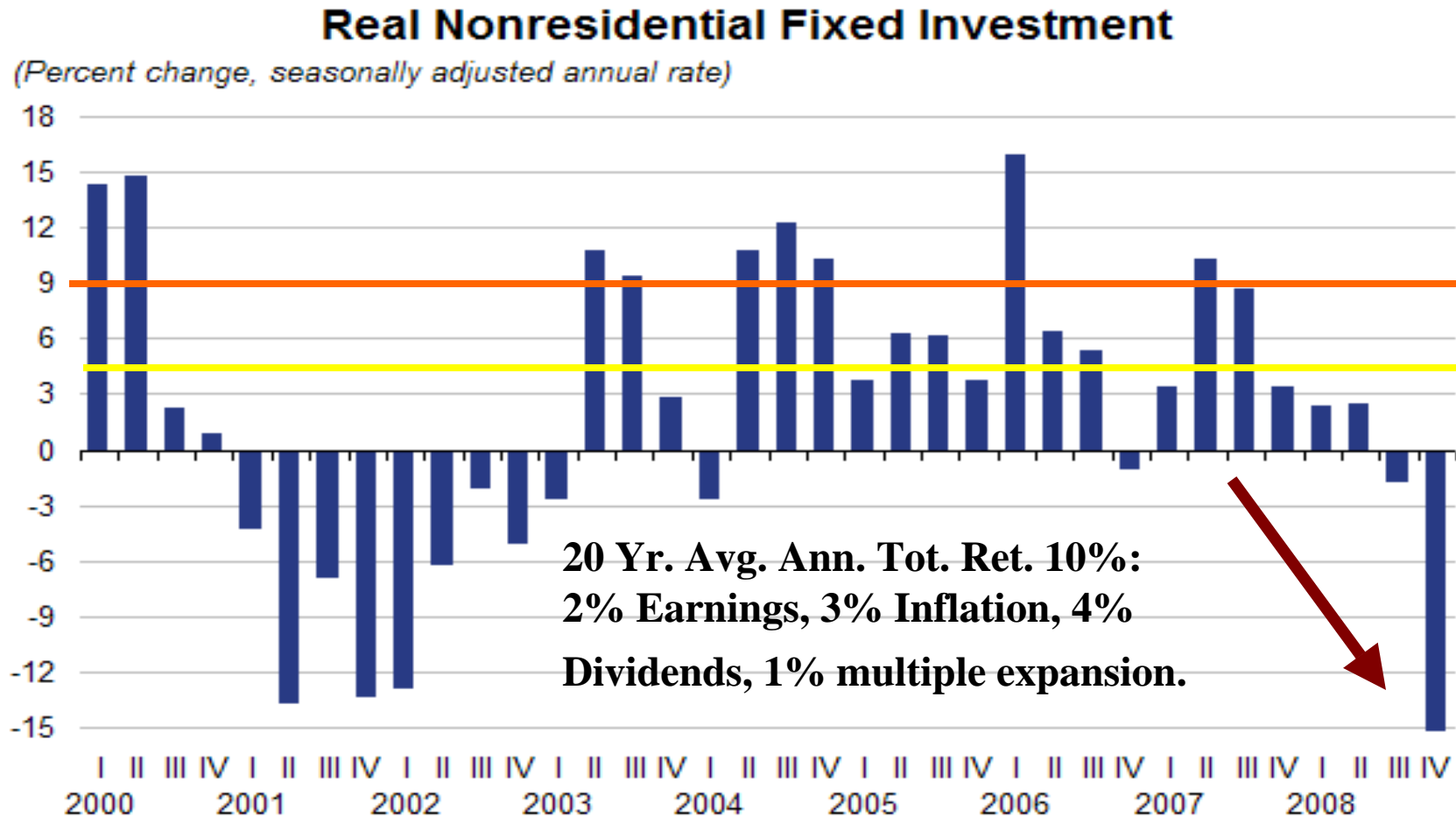
Corporate Profits



U.S. Bureau of Economic Analysis

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

Non-Residential Fixed Investment

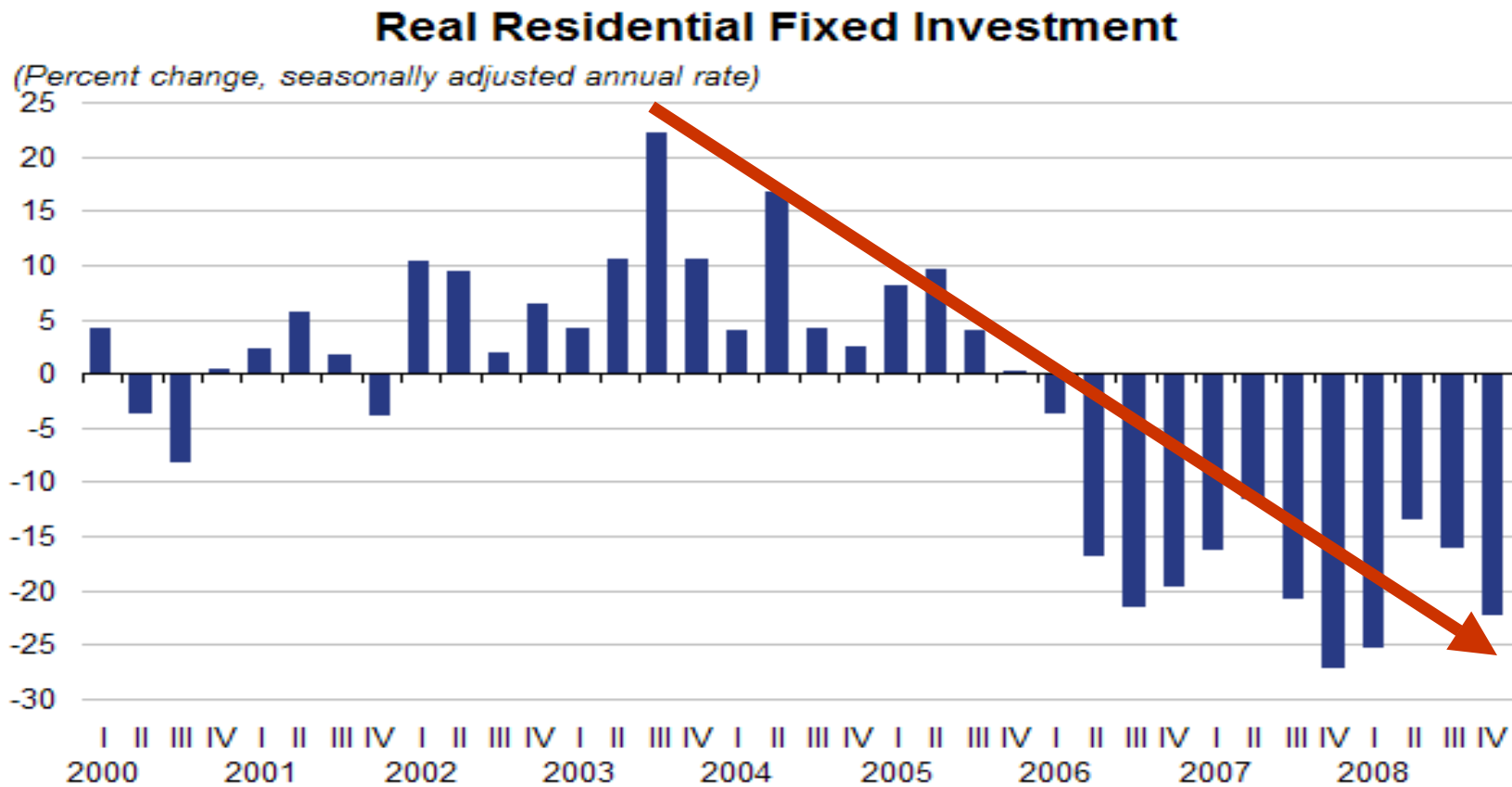


**20 Yr. Avg. Ann. Tot. Ret. 10%:
2% Earnings, 3% Inflation, 4%
Dividends, 1% multiple expansion.**

U.S. Bureau of Economic Analysis

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

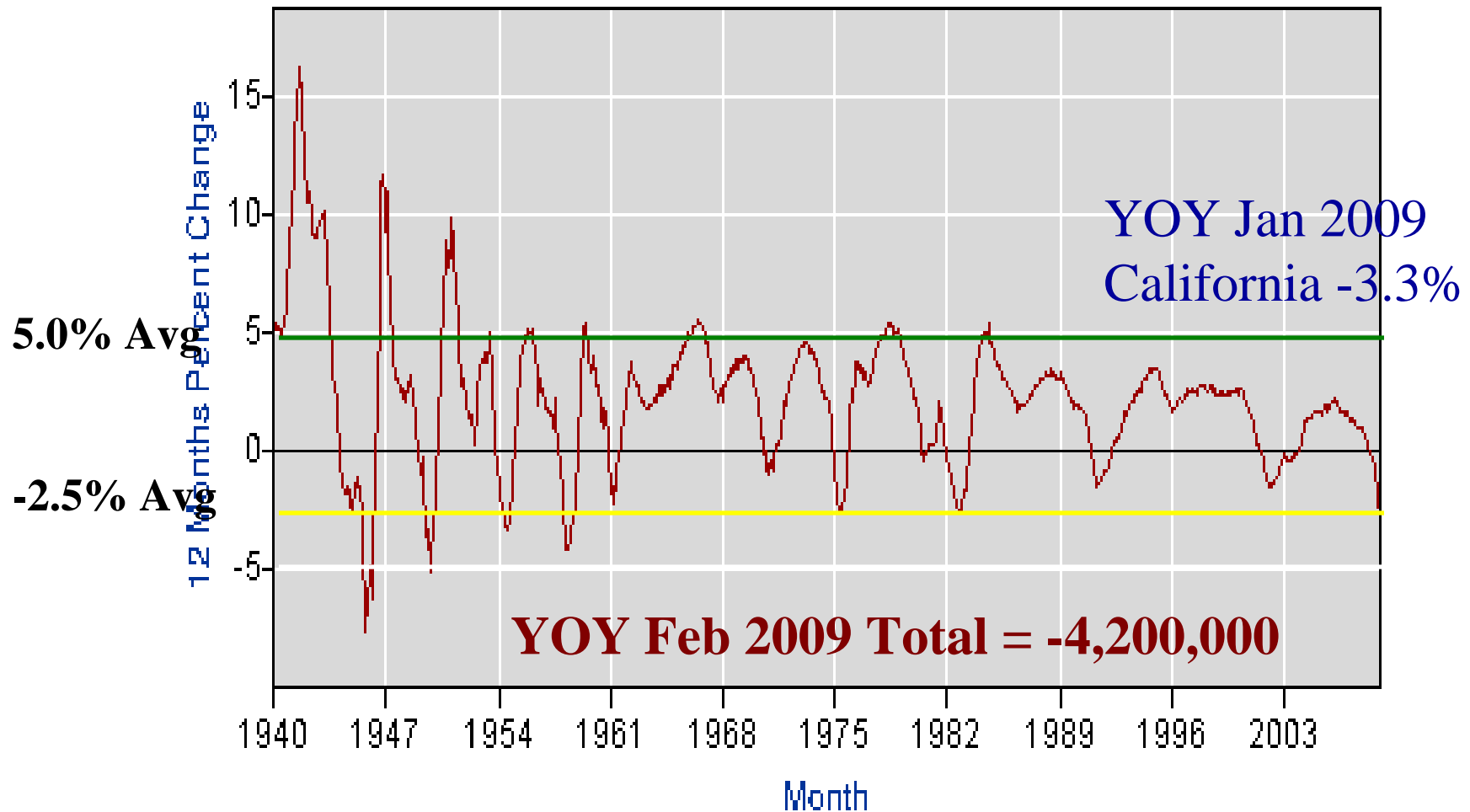
Real Residential Fixed Investment



U.S. Bureau of Economic Analysis

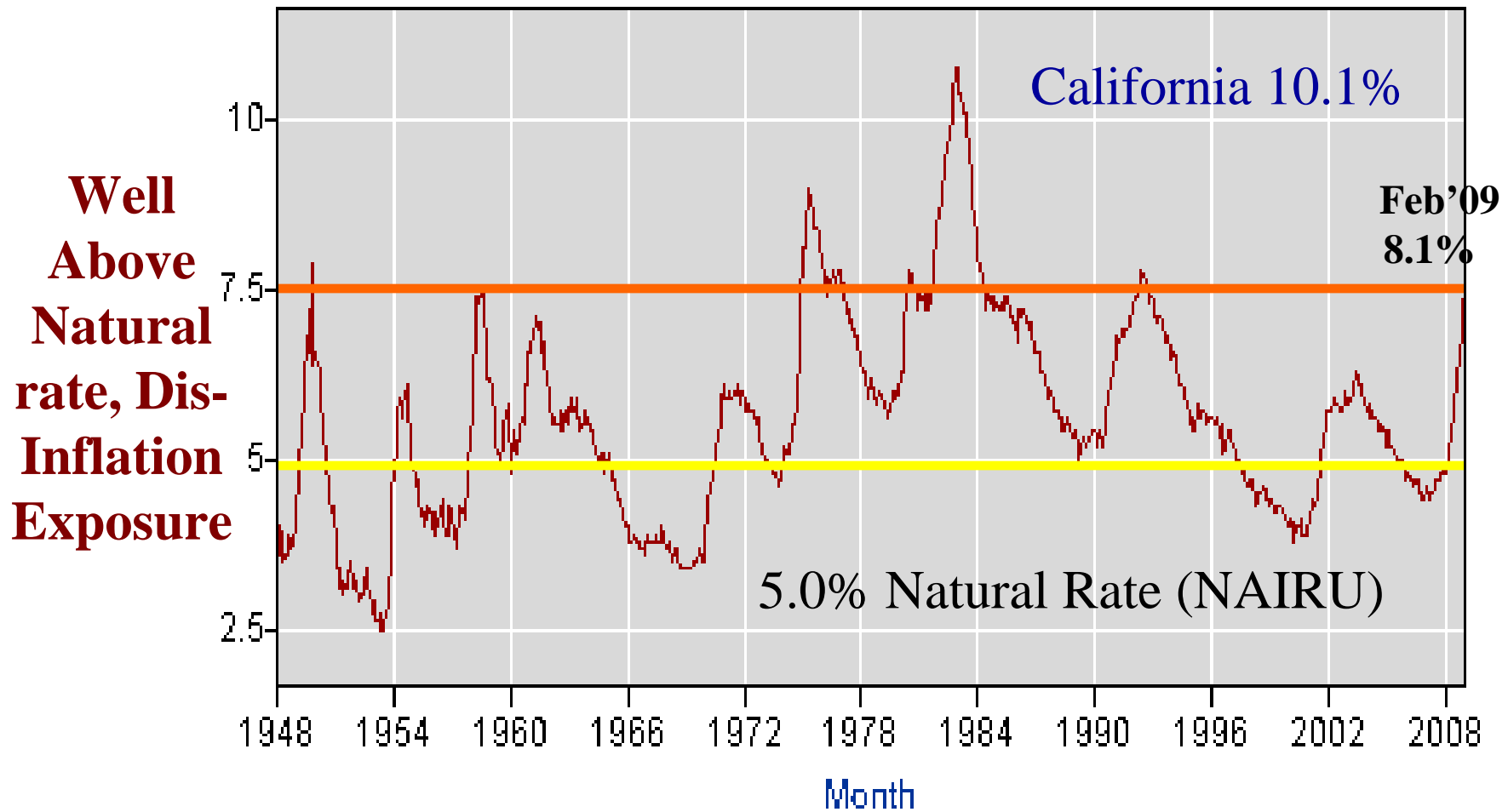
<http://www.bea.gov/briefmr/resfi.htm>

Non-Farm Payroll Employment



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

U.S. Unemployment Rate

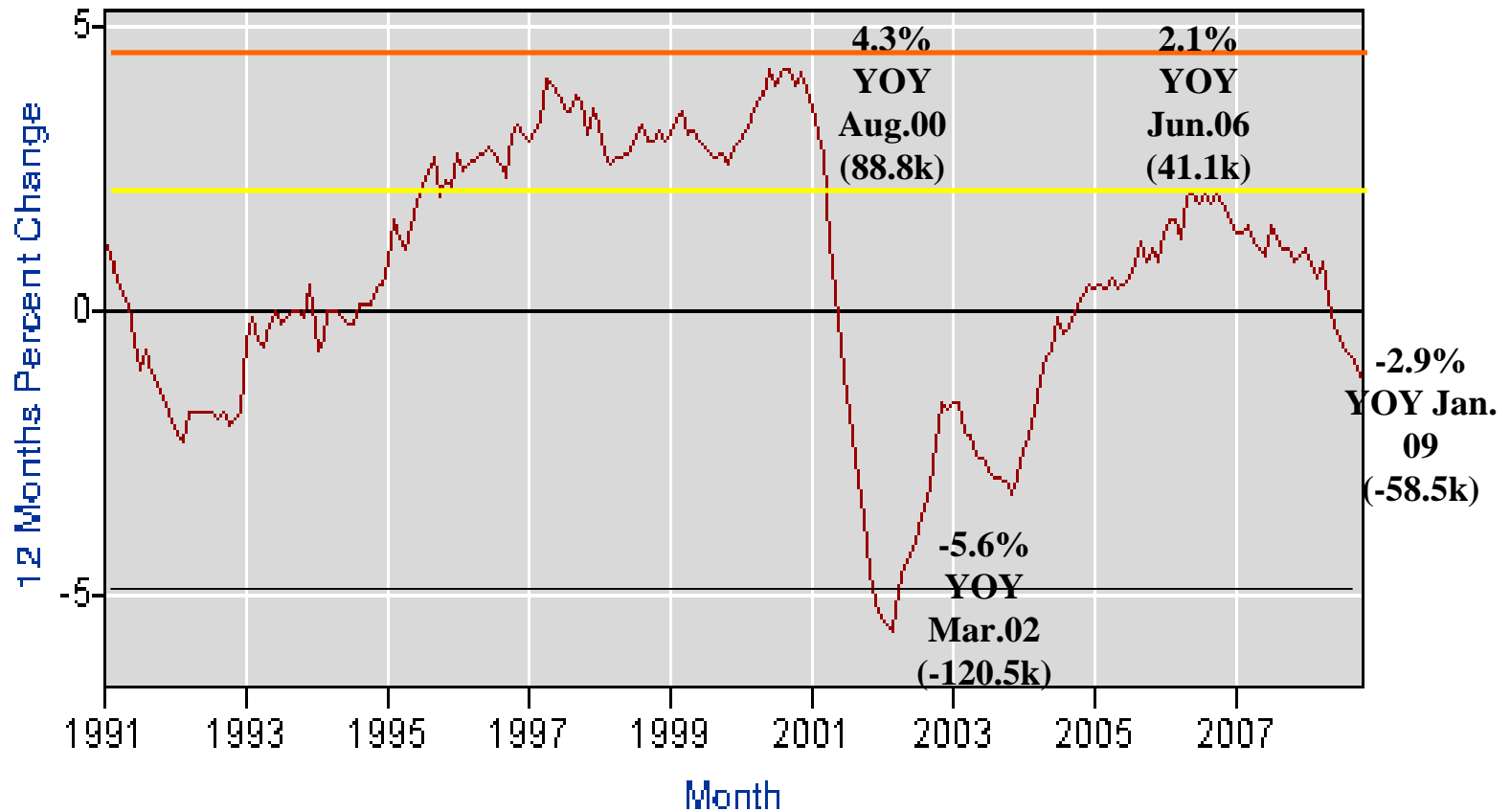


Source: Bureau of Labor Statistics.

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

San Francisco-Oakland-Fremont, CA

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



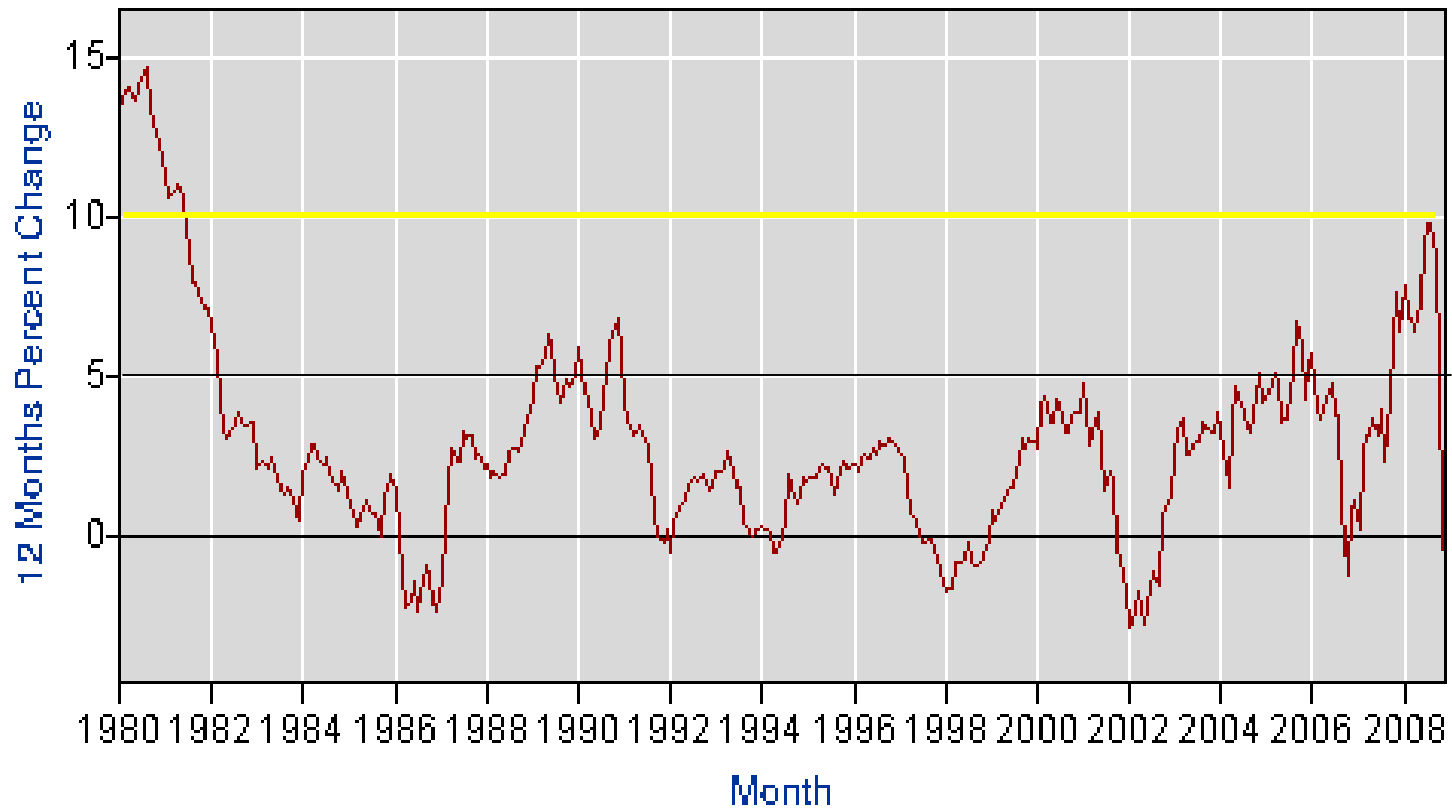
Source: Bureau of Labor Statistics.

<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

CBOE 10-YEAR YIELD
as of 16-Jan-2009

Imputed Mtg. Int. Rt. $2.93\% + 2\% = 5\% \sim$

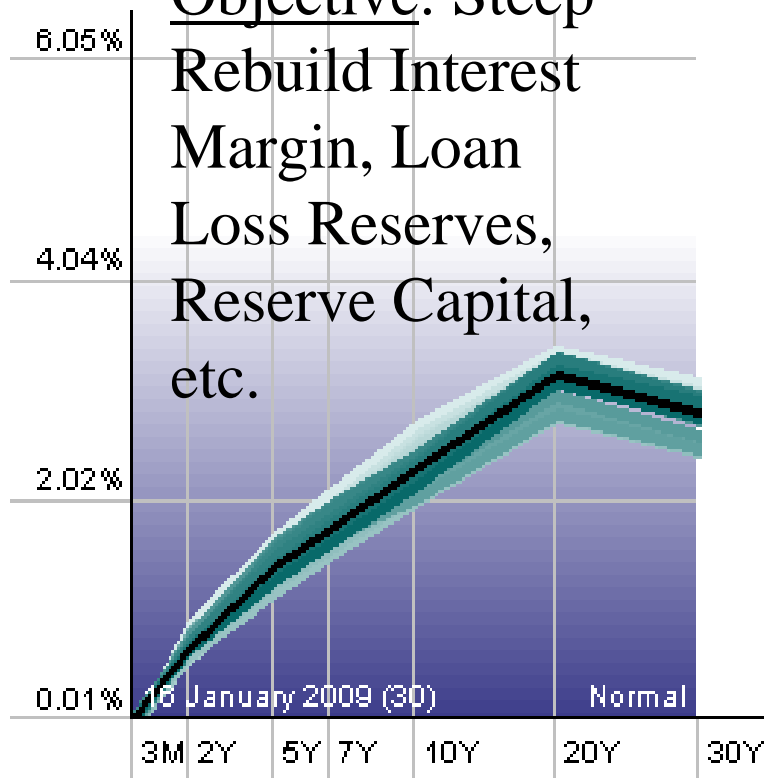


<http://finance.yahoo.com>

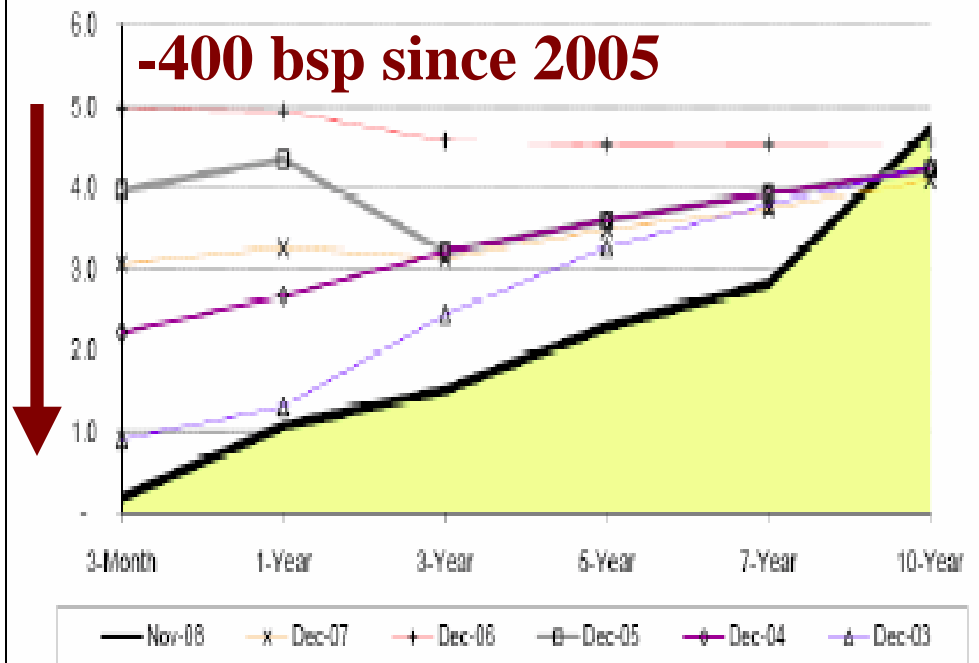
Yield Curve

Dynamic Yield Curve

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



Treasury Yield Curve Percent

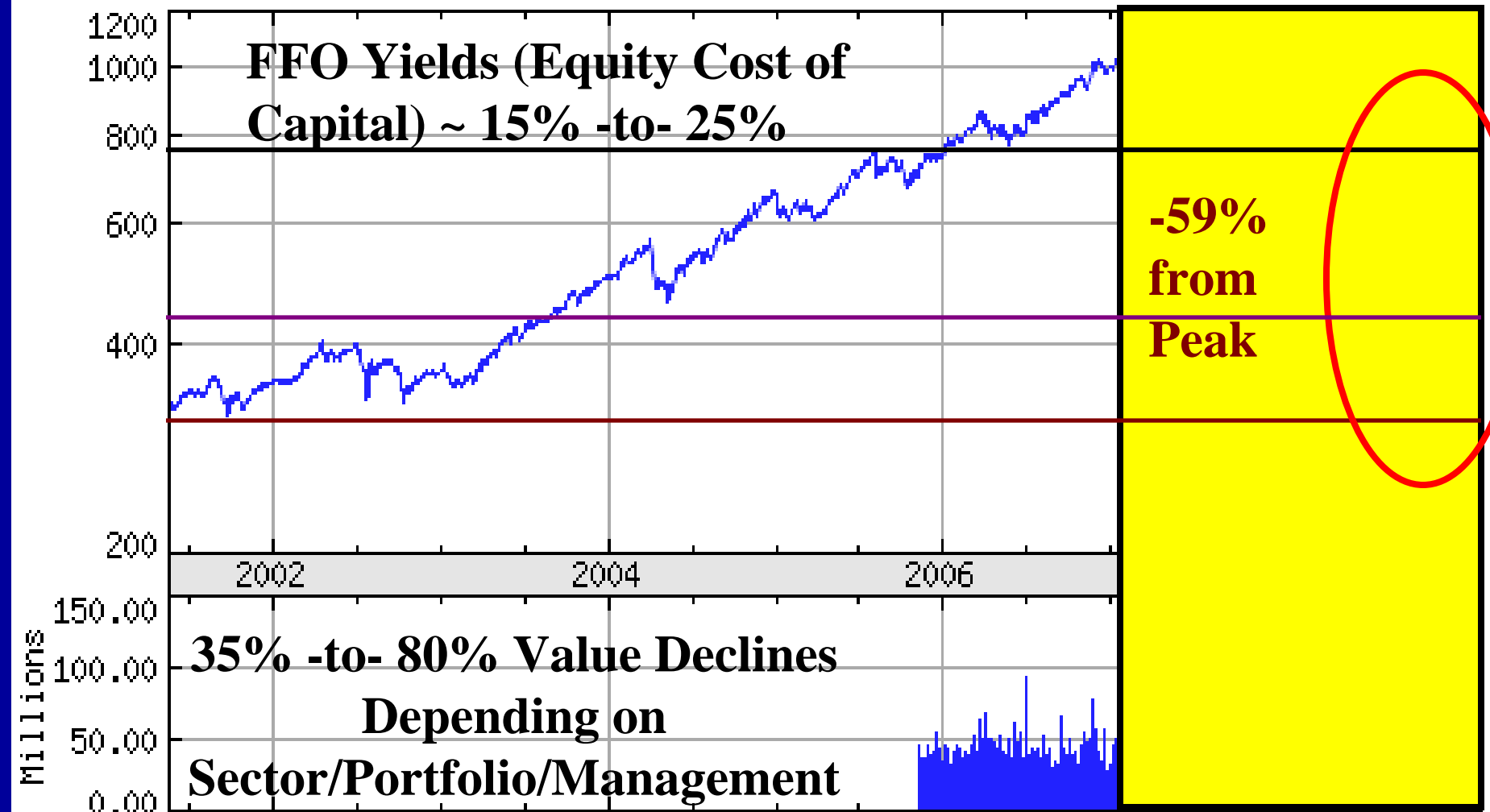


Source: Federal Reserve Board

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

REIT Equity Stock Index Performance – Dow Jones

DJ EQUITY REIT TOTAL RETURN IND
as of 12-Mar-2009



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<http://finance.yahoo.com/>

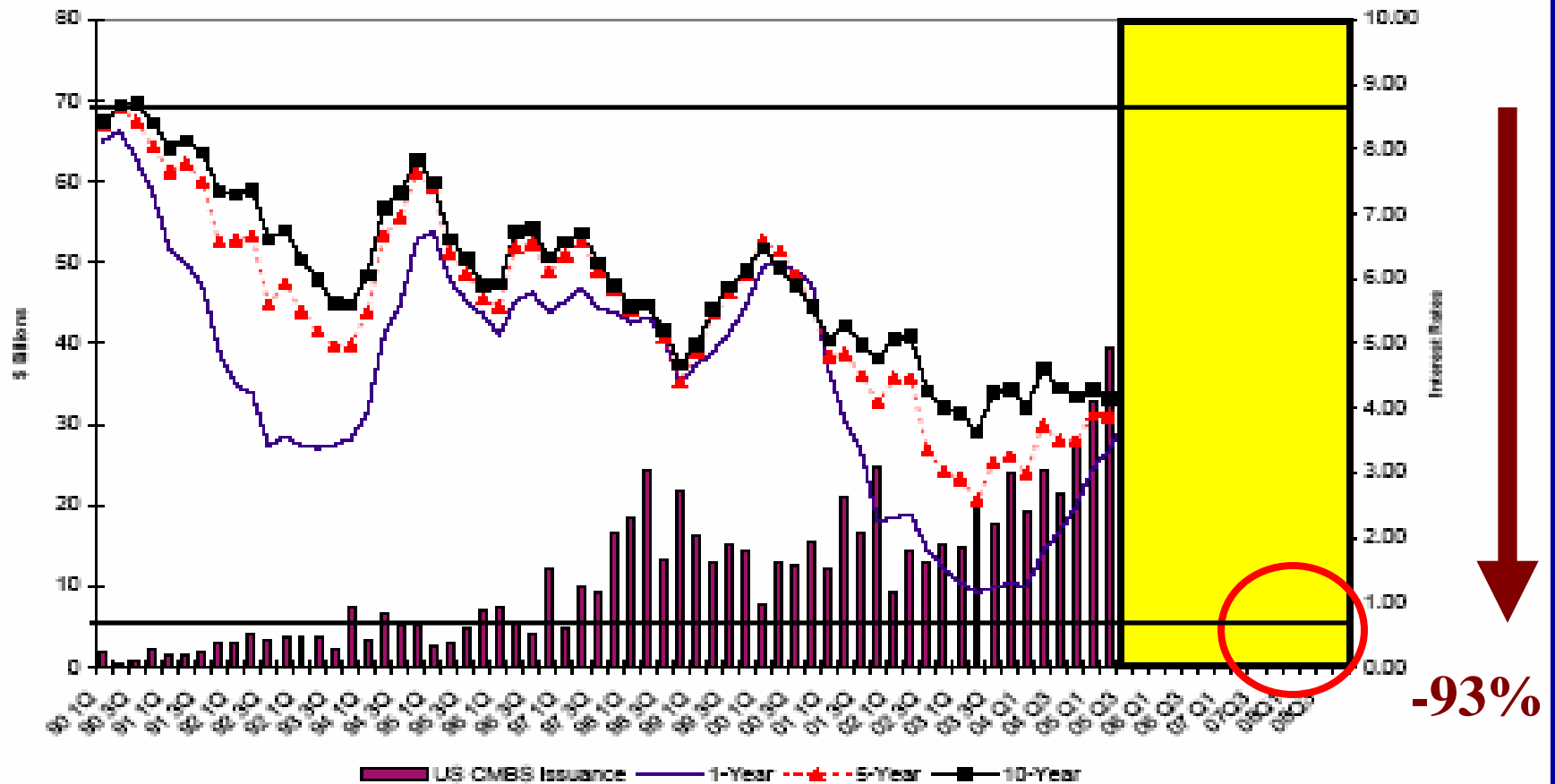
<http://finance.yahoo.com/q/bc?s=REIT&t=my>

Commercial Mortgage Back Securities (CMBS) Issuance



Exhibit 12
Interest Rates and CMBS Issuance
Quarterly

Updated January 9, 2009



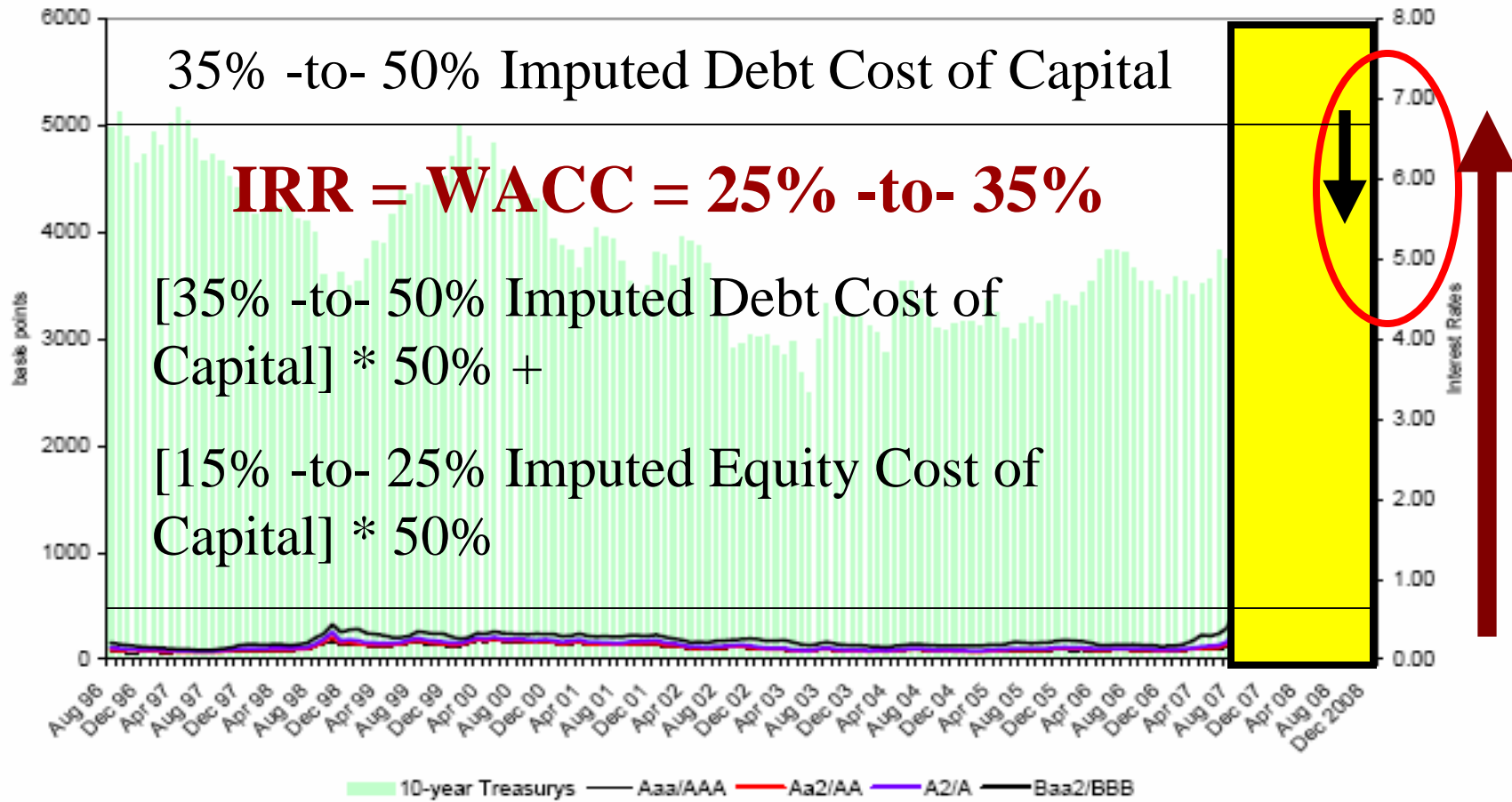
Source: CMSA, Commercial Mortgage Alert and Federal Reserve
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CMBS Spreads – Investment Grade vs. 10 Yr. Treasury



Exhibit 14
CMBS Spreads Over 10-Year Treasuries: Investment Grade
 Monthly

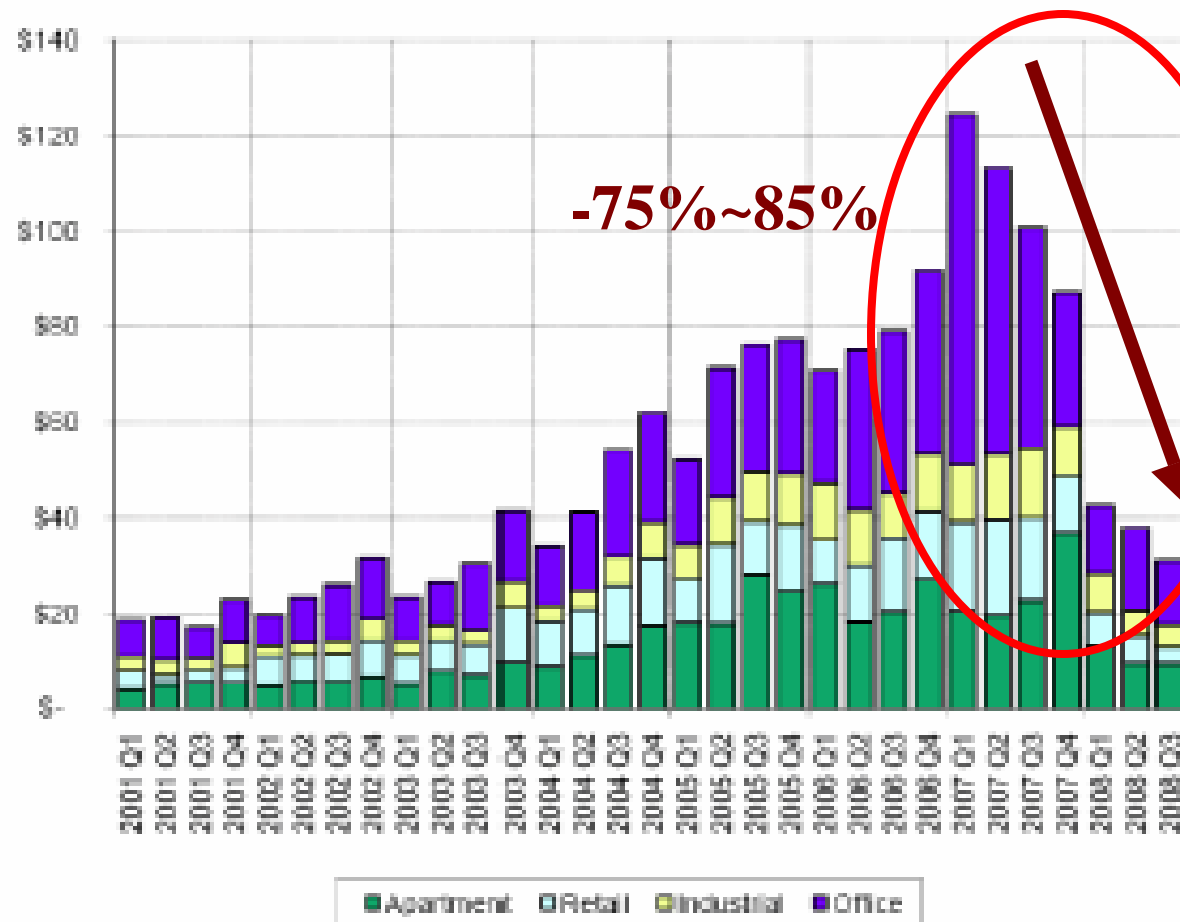
Updated January 20, 2009



Source: Morgan Stanley. Generic AAA spreads from August 1996 to December 2004; Super Senior AAA from January 2005 to present.
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Commercial Property Sales Volume (From 2001 to 2008)

Commercial/Multifamily Property Sales \$Billions



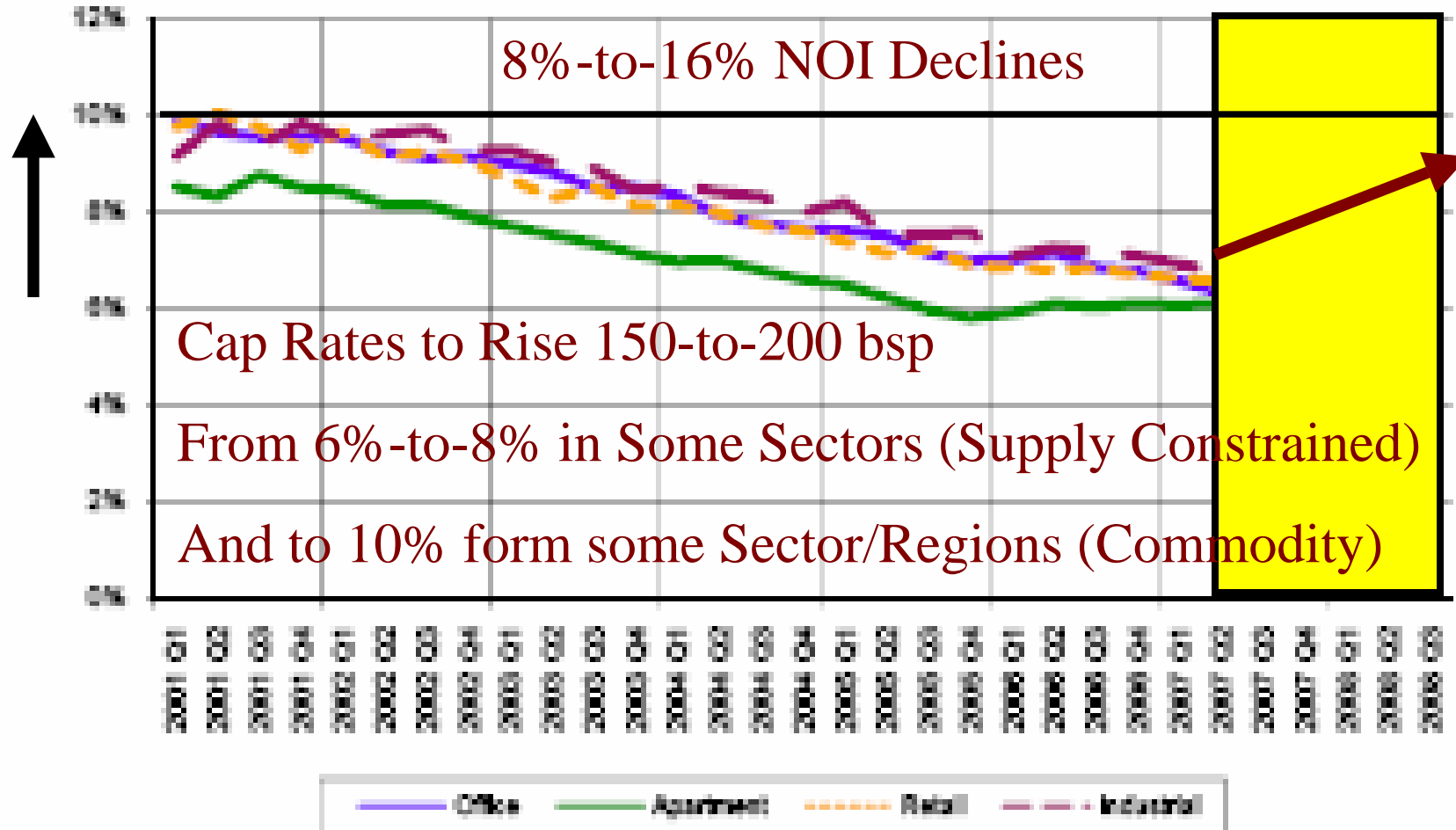
Source: Real Capital Analytics

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

Commercial Property – Capitalization Rates (2001-2008)

Capitalization rate

Potential Intrinsic Devaluation = 30%-to-50%*



Source: Real Capital Analytics. * Assumes 16% drop NOI, Cap rates to 10%

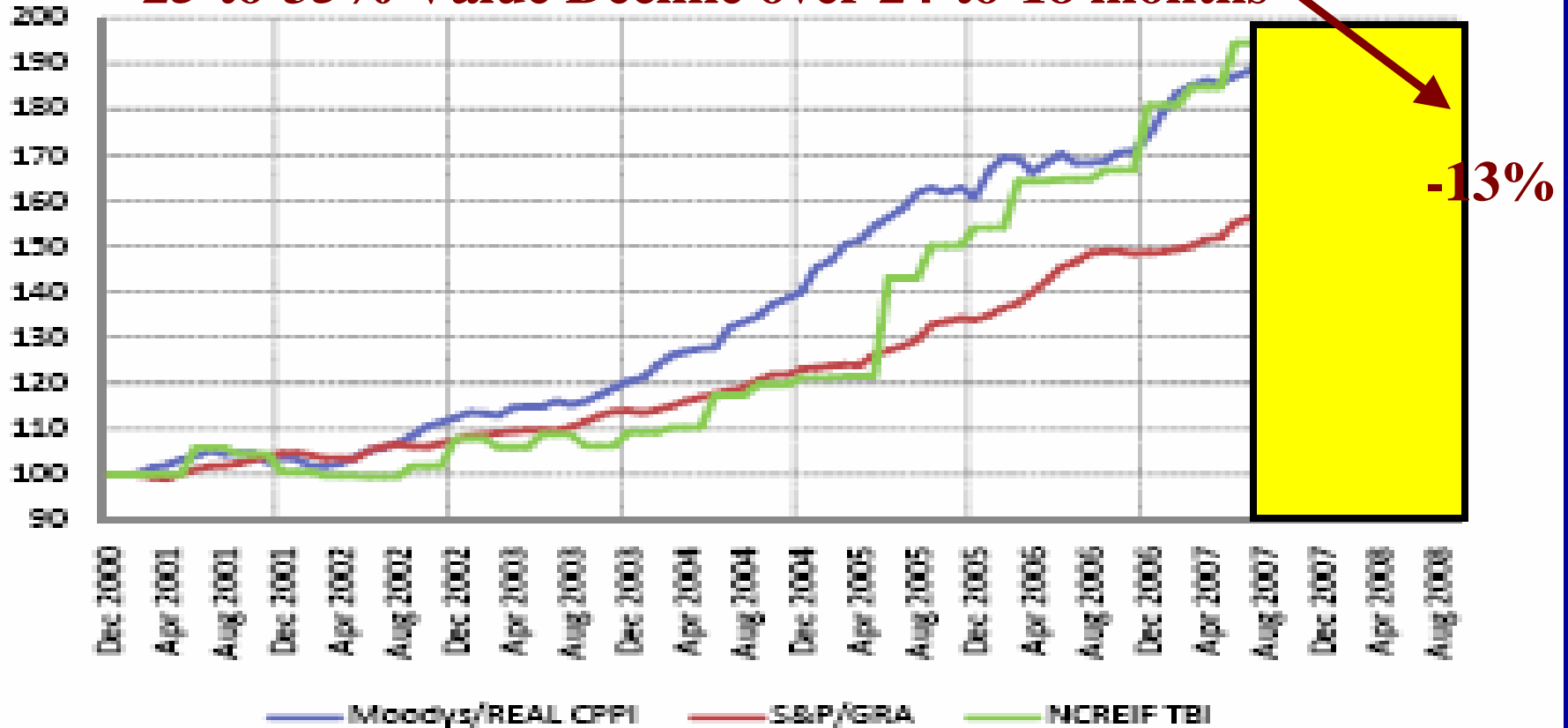
Commercial Property Value Indices (From 2000 to 2008)

COMMERCIAL/MULTIFAMILY PROPERTY PRICES AS REFLECTED
IN SELECTED INDICES

Re-indexed Values of the Moody's/REAL CPPI, Standard and Poor's/GRA and
NCREIF Transaction Based Index

December 2000 = 100

25-to-35% Value Decline over 24-to-18 months



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

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

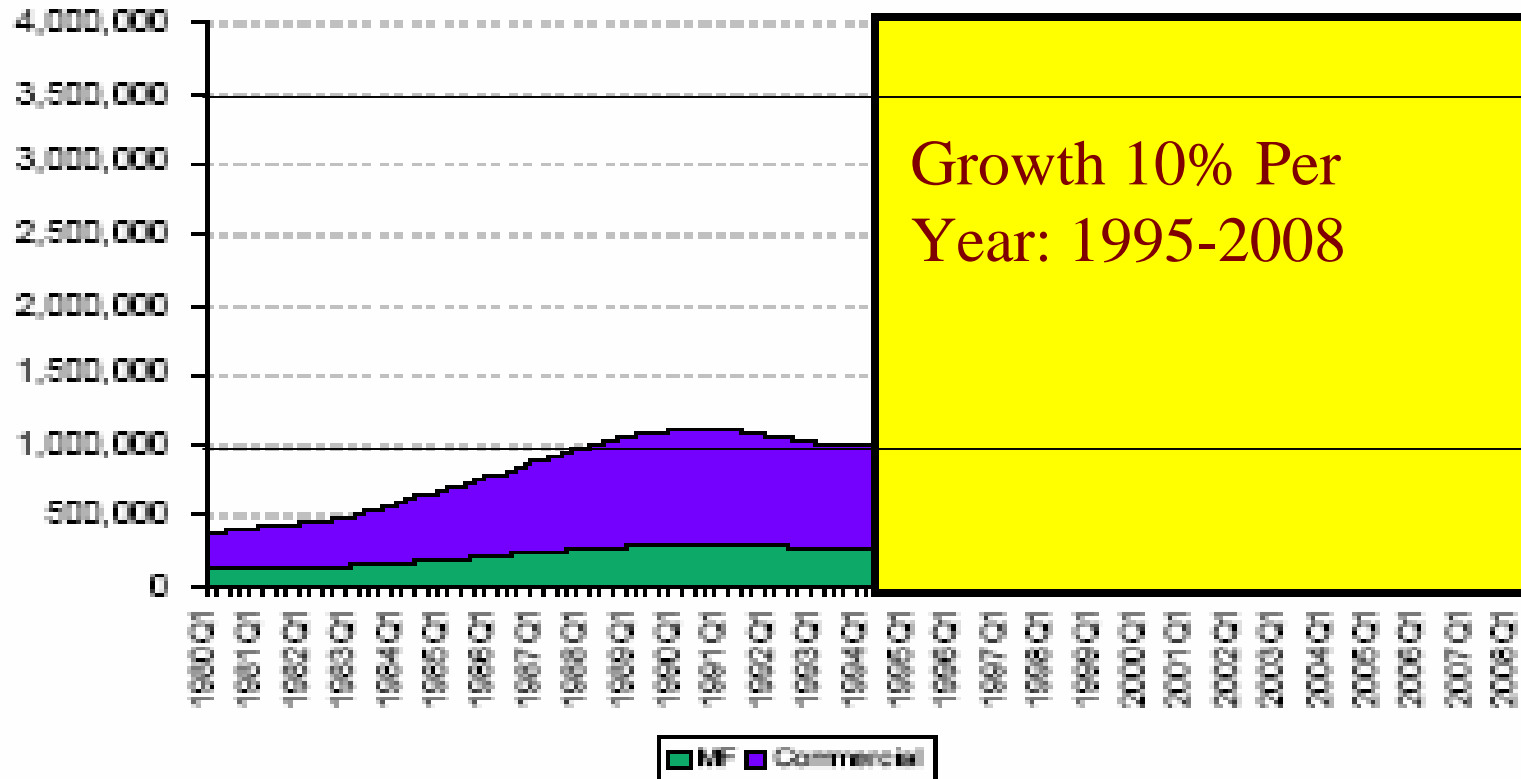
http://www.aia.org/aiarchitect/thisweek09/0116/0116n_consensus.cfm

Commercial Mortgage Lending

Commercial Mortgage Debt Outstanding – (From 1980 to 2008)

COMMERCIAL AND MULTIFAMILY MORTGAGE DEBT OUTSTANDING

Total Commercial and Multifamily Mortgage Debt Outstanding, by Quarter
(\$millions)



Source: Flow of Funds Accounts, Federal Reserve Board of Governors

Commercial Mortgage Debt Exposure

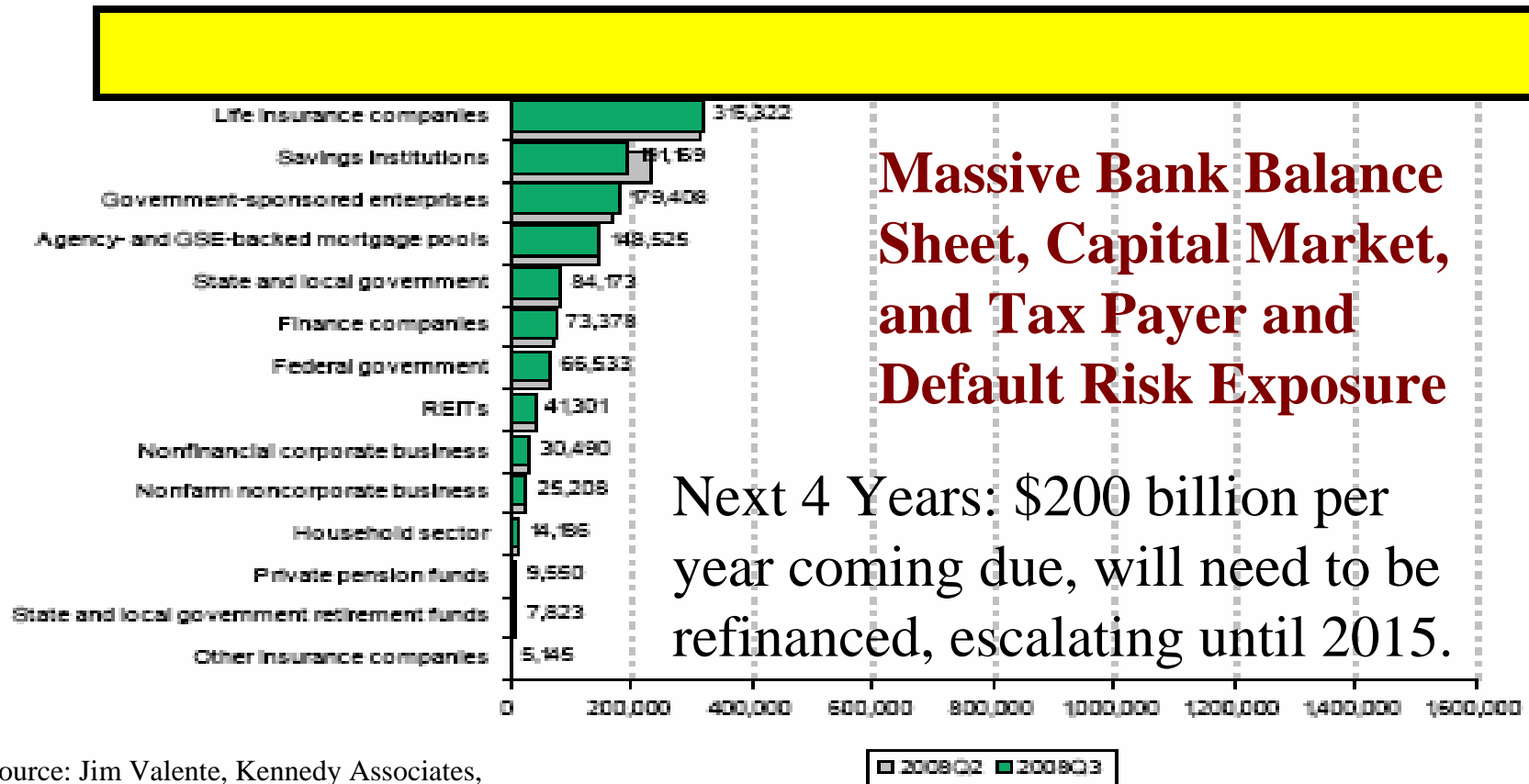
COMMERCIAL AND MULTIFAMILY MORTGAGE DEBT OUTSTANDING

Total Commercial and Multifamily Mortgage Debt Outstanding, by Sector

(\$millions)



\$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.

Source: Flow of Funds Accounts, Federal Reserve Board of Governors

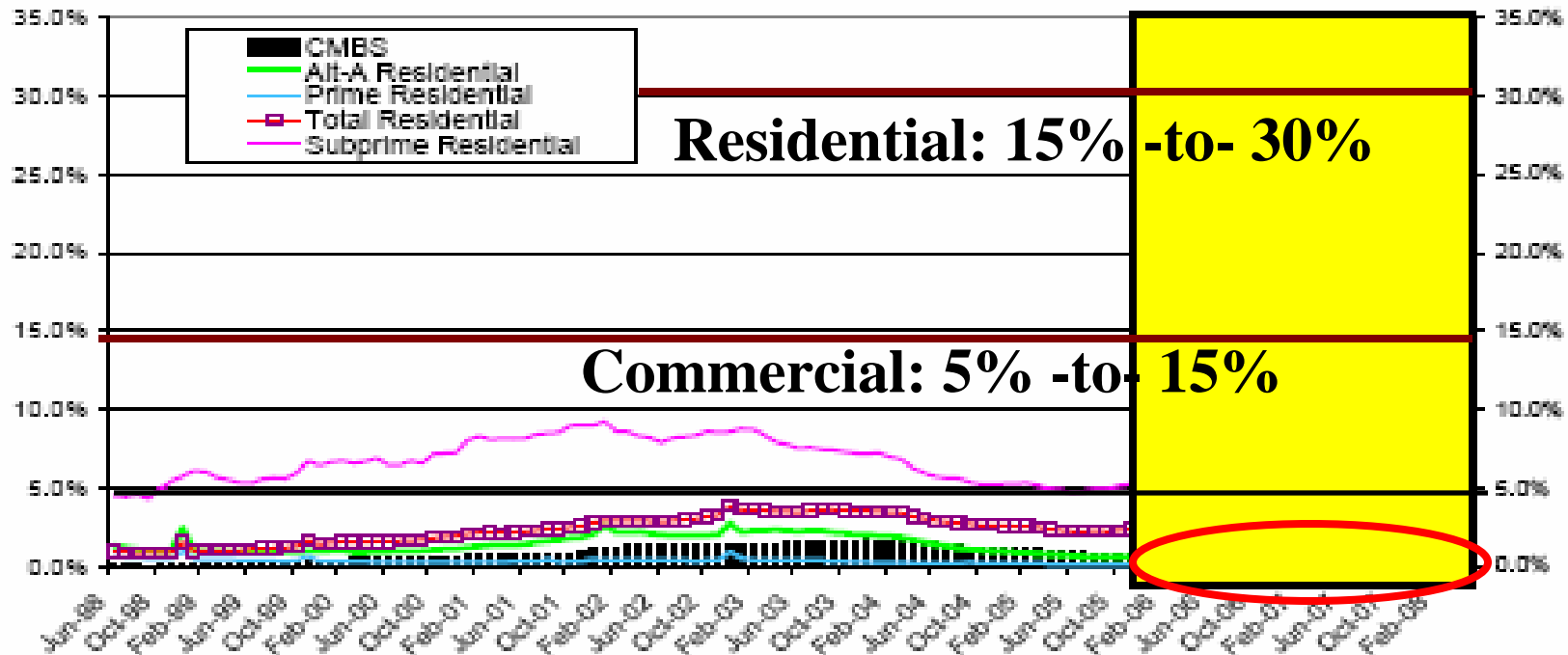
Commercial Mortgage Back Securities (CMBS) Delinquency



Exhibit A
CMBS vs. RMBS Delinquencies

Updated July 9, 2008

Securitized Mortgages: Residential vs. Commercial (60+ day)
by dollar securitized



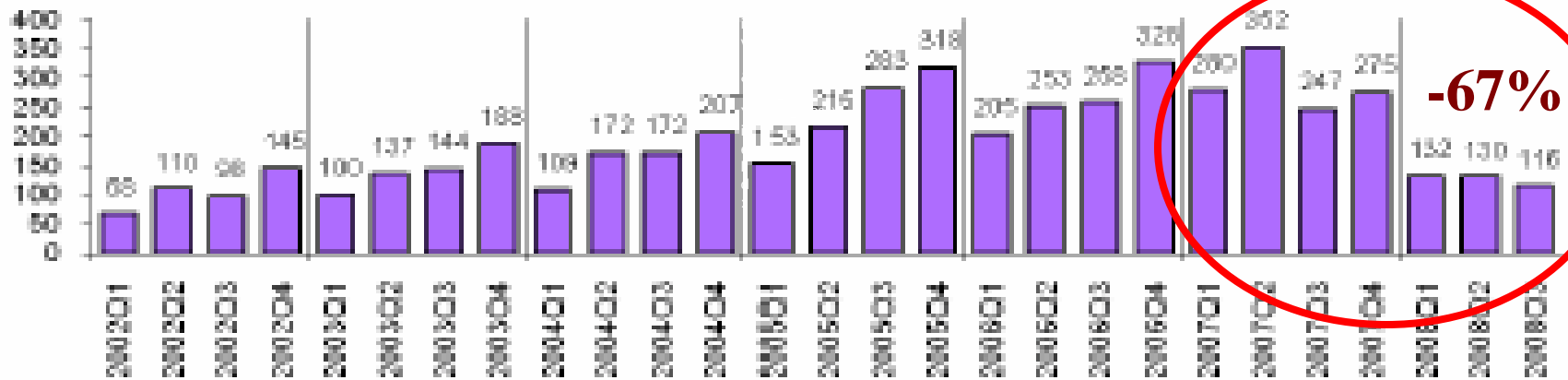
Source: CMSA, JPMorgan, LoanPerformance, Trigg, Inc.

Delinquency figures are dollar based (not loan count) and includes loans that are 60+, 90-day delinquent in addition to loans in process of foreclosure and REO. Residential includes loans on residential investment properties, manufactured housing and a limited amount of multifamily holdings. CMBS are commercial mortgages, all properties types, securitized as commercial mortgage backed securities. Historical data subject to quarterly revisions.

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Commercial Mortgage Origination Index – (From 2002 to 2008)

Commercial/Multifamily Mortgage Bankers Originations Index
2001 quarterly average = 100



Net Change Commercial Mortgage Debt (1980-2008)

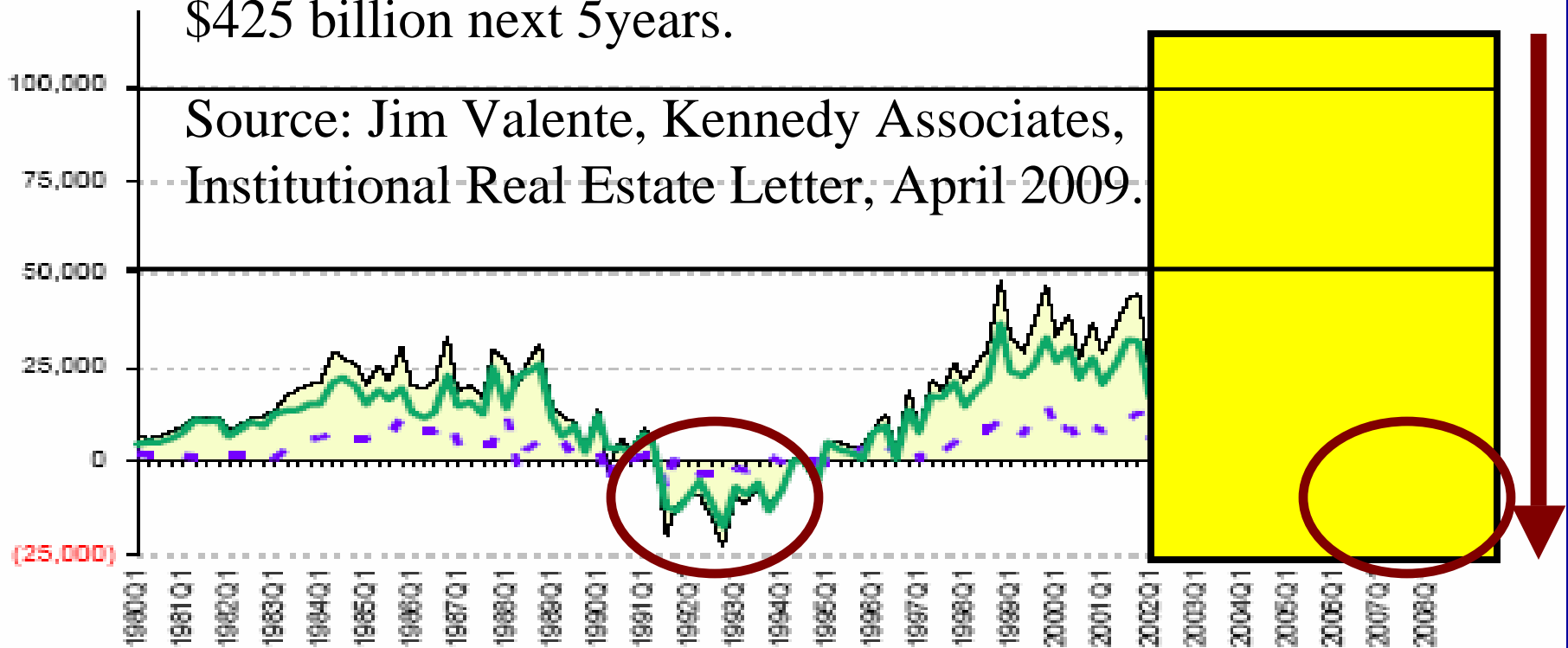
COMMERCIAL AND MULTIFAMILY MORTGAGE FLOWS

Net Change in Commercial and Multifamily Mortgage Debt Outstanding, by Quarter
(\$millions)



Falling values/deleveraging: Equity Shortfall
\$425 billion next 5 years.

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

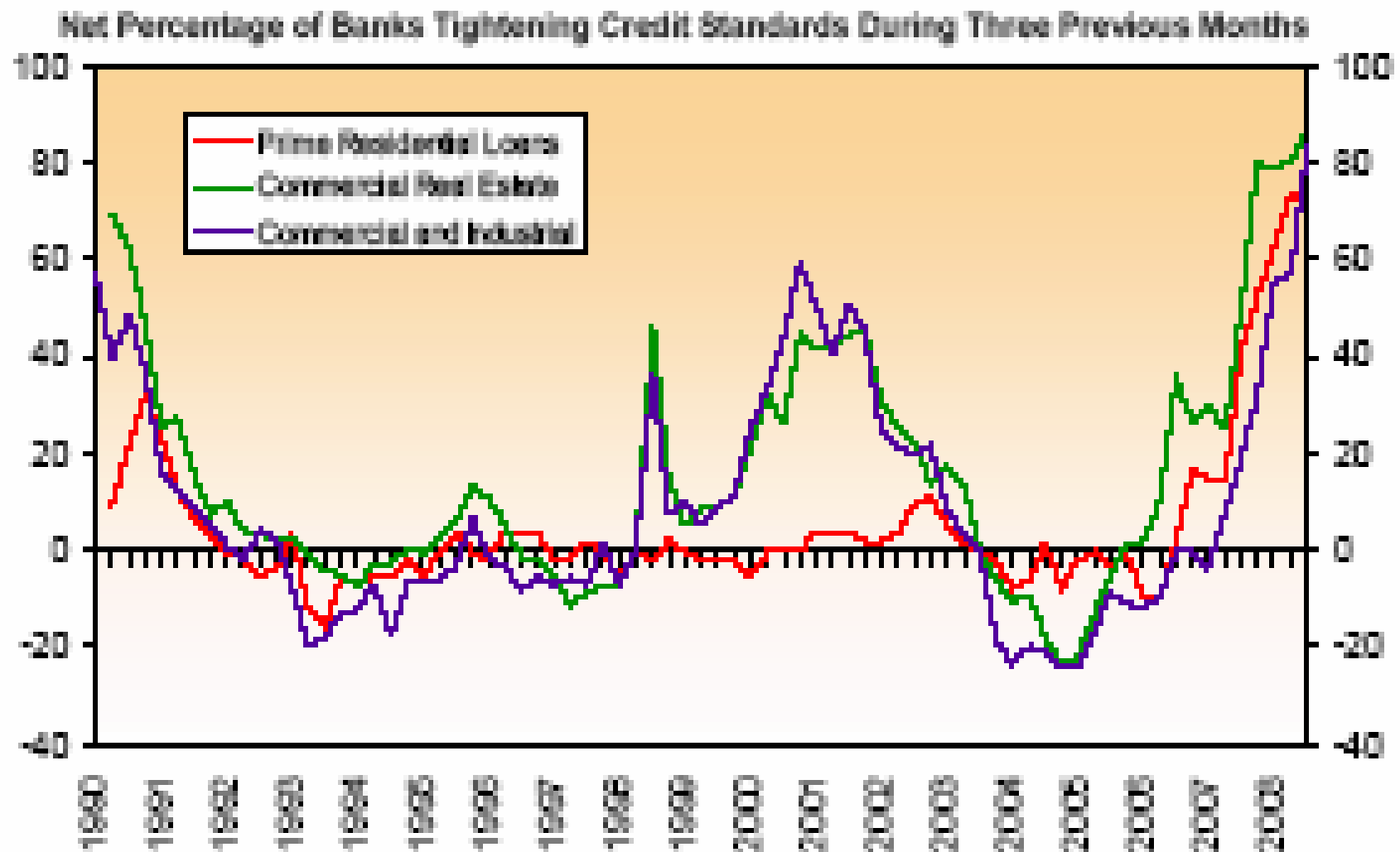


Source: Jim Valente, Kennedy Associates,
Institutional Real Estate Letter, April 2009.



Source: Flow of Funds Accounts, Federal Reserve Board of Governors

Housing Market – Tight Credit Standards

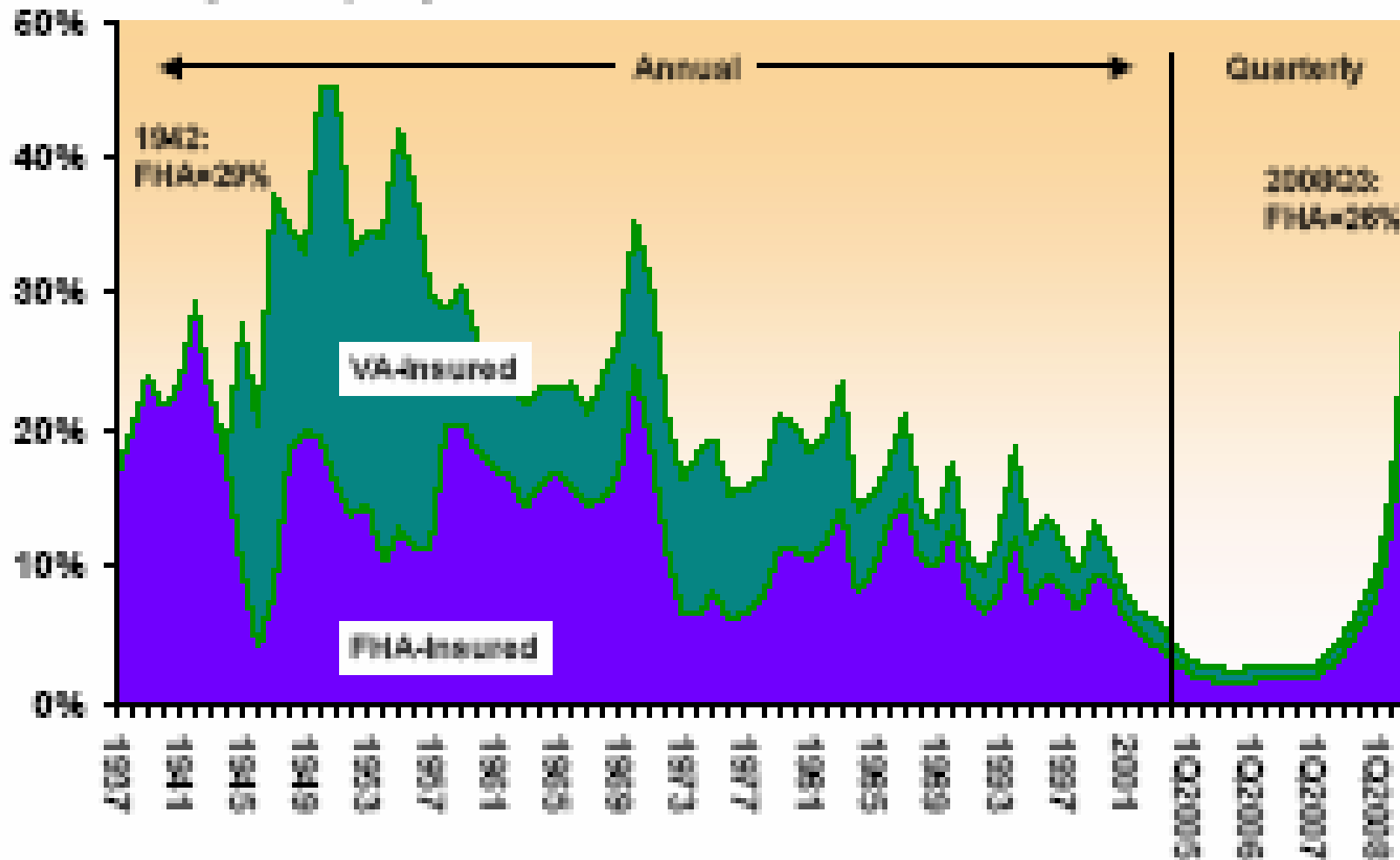


Source: Federal Reserve Board's Senior Loan Officer Survey (all residential loans through 2007Q1, prime residential starting 2007Q2; C&I loans to large and middle-market firms).
Last update: November 3, 2008

Office of the Chief Economist

Housing Market – FHA Originations

Share of Single-Family Originations



Sources: HUD (1937-1997), Freddie Mac & Inside Mortgage Finance (1998 - Present)

Office of the Chief Economist

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, Friedrich 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

REDWOOD TRUST INC
as of 12-Mar-2009



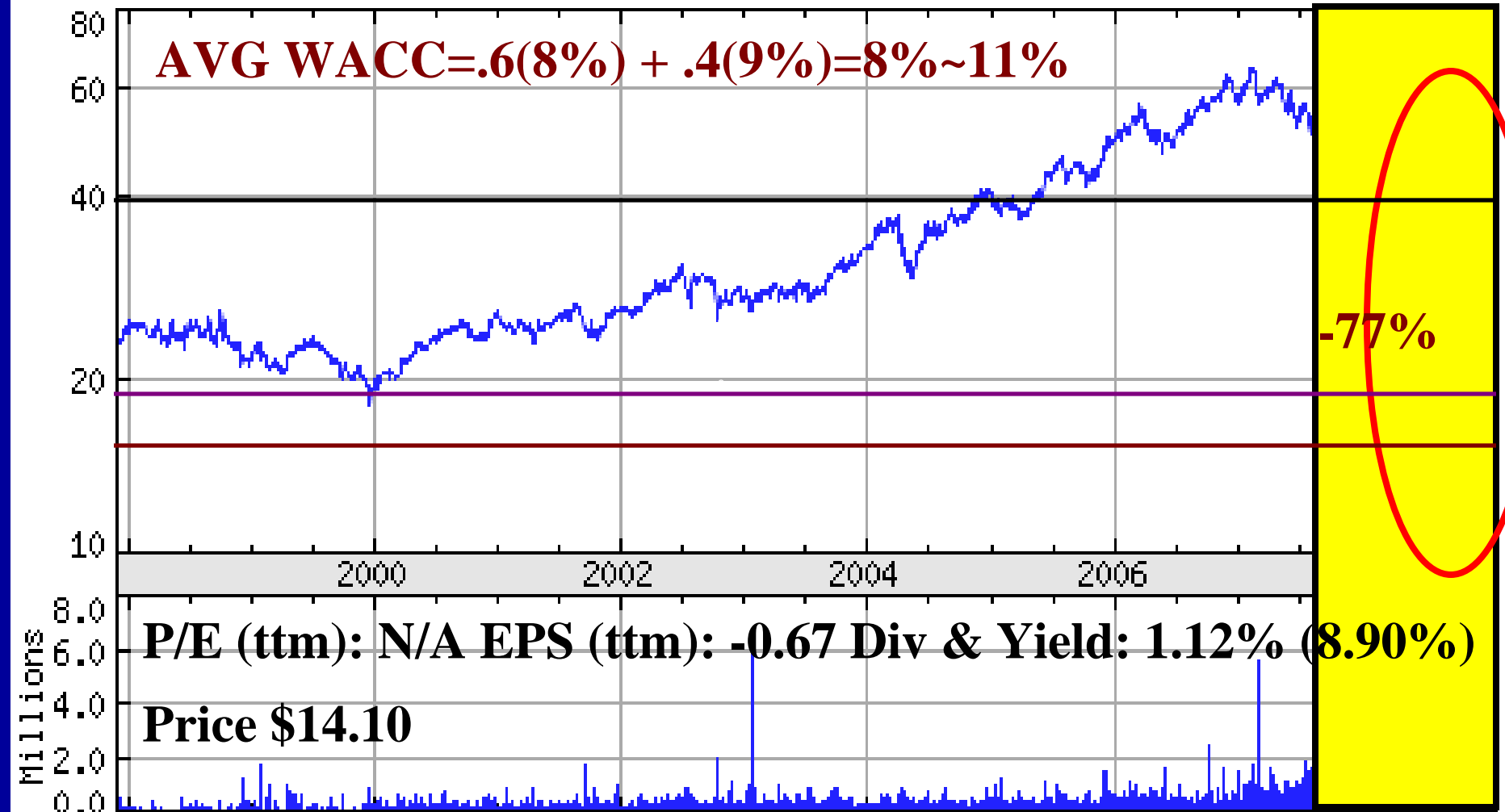
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<http://finance.yahoo.com/>

<http://finance.yahoo.com/q/bc?s=RWT&t=my&l=on&z=m&q=1&c=>

REIT Equity Stock Index Performance – AMB

AMB PROPERTY CORP
as of 29-Jan-2009



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<http://finance.yahoo.com/>

REIT Equity Stock Index Performance – BRE

BRE PROPERTIES INC

Splits: ▼

as of 5-Mar-2009



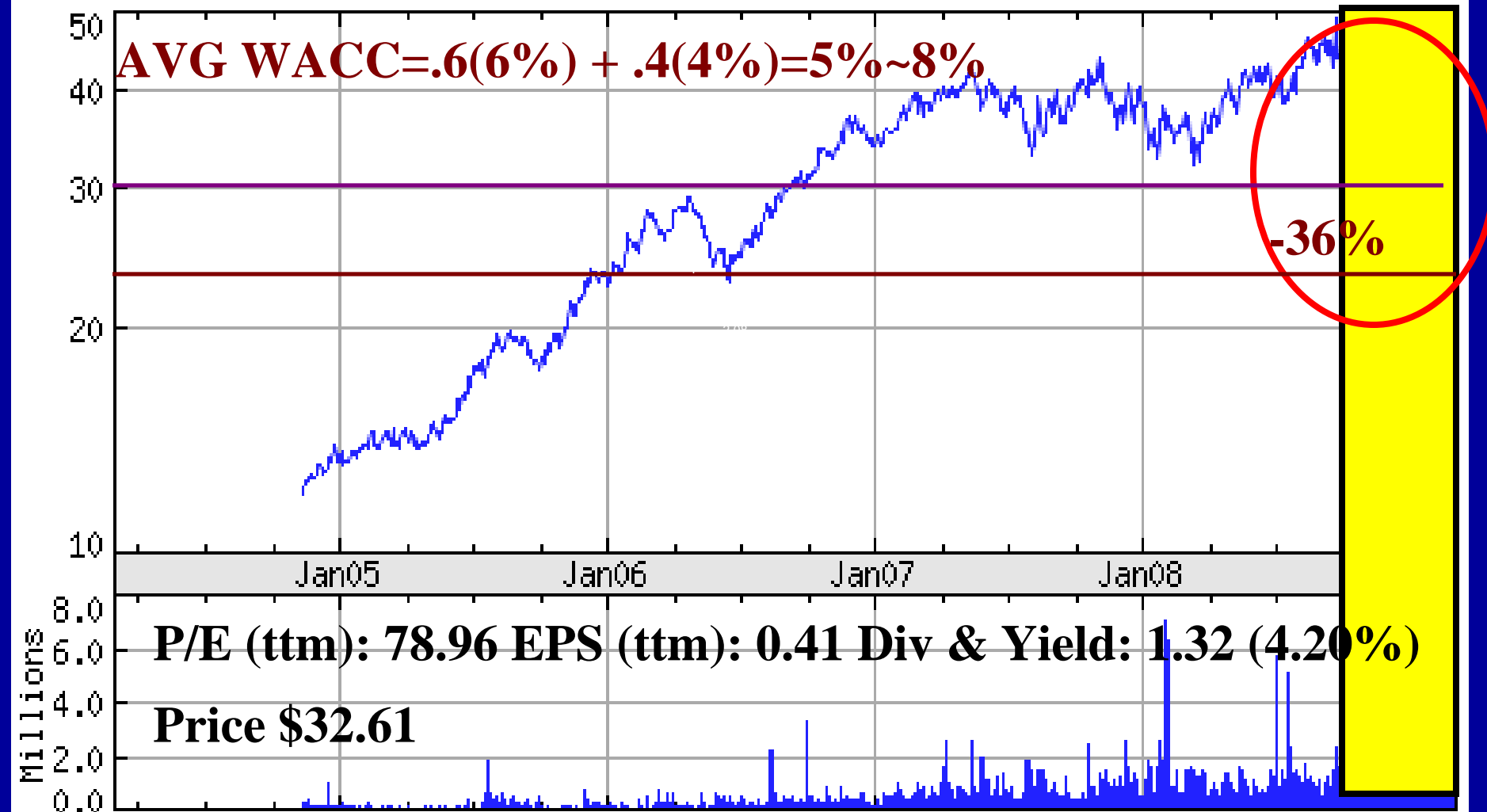
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<http://finance.yahoo.com/>

REIT Equity Stock Index Performance – Digital Realty Trust

DIGITAL REALTY TRUST INC

as of 25-Feb-2009



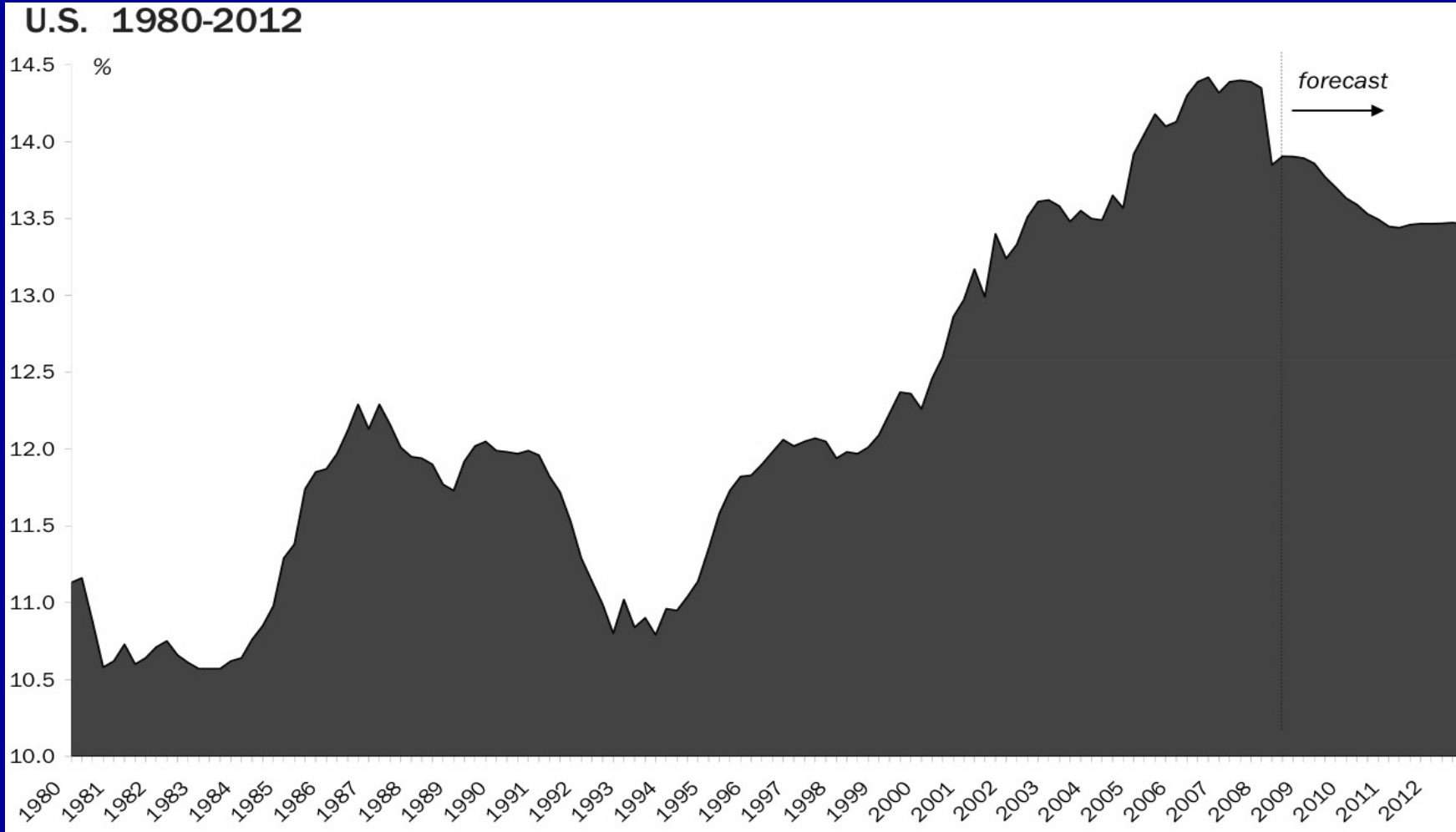
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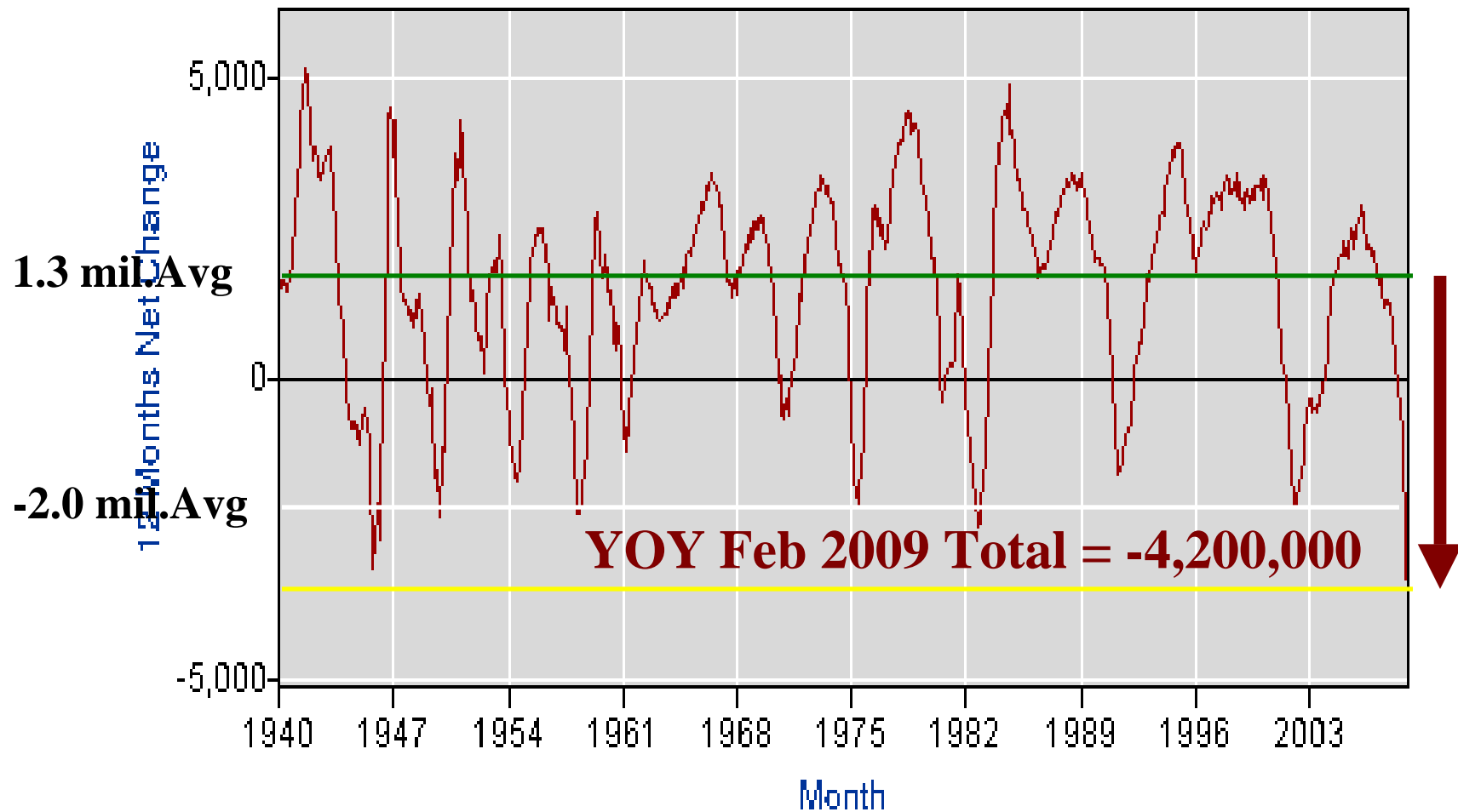
<http://finance.yahoo.com/q/bc?s=DLR&t=5y>

Increasing Debt of Consumers

Source: Economy.com

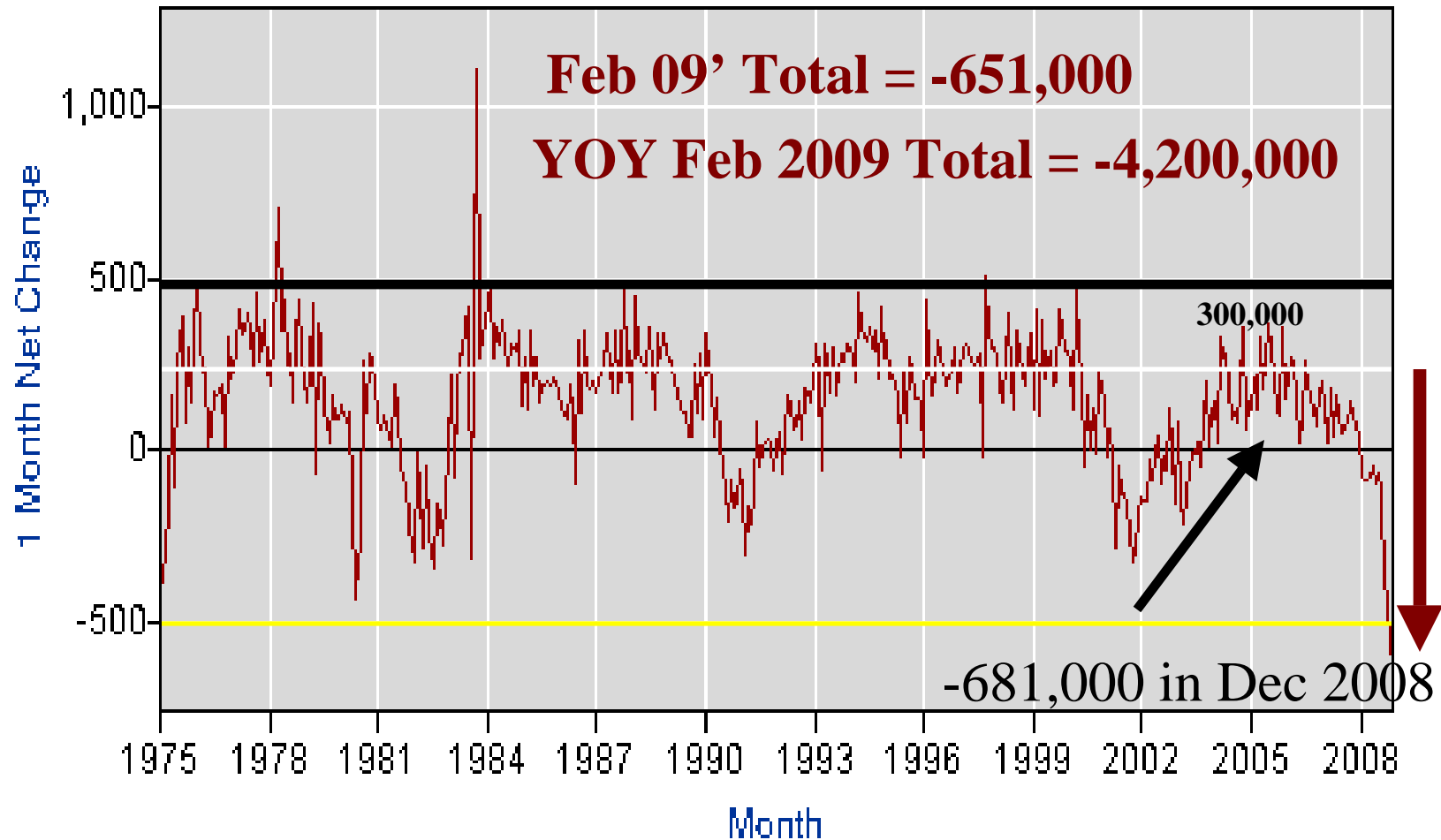


Non-Farm Payroll Employment



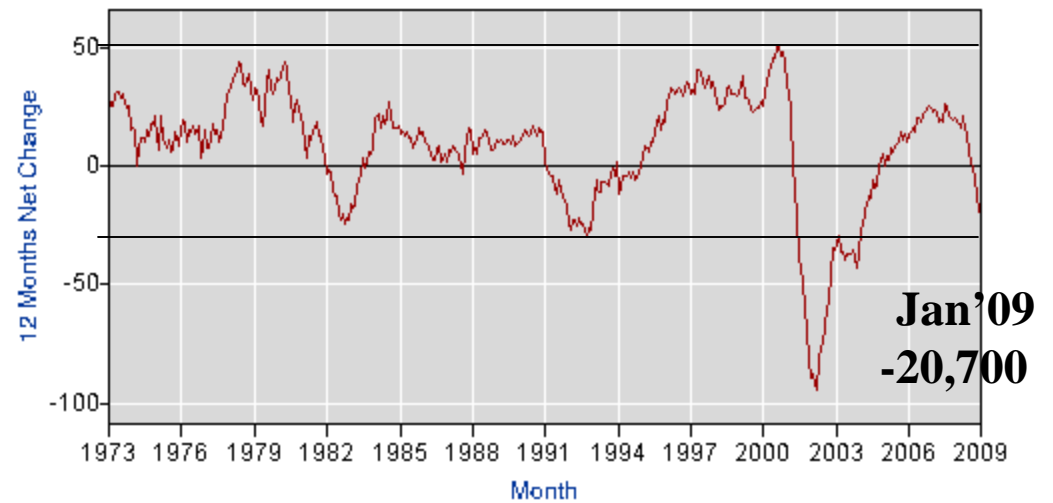
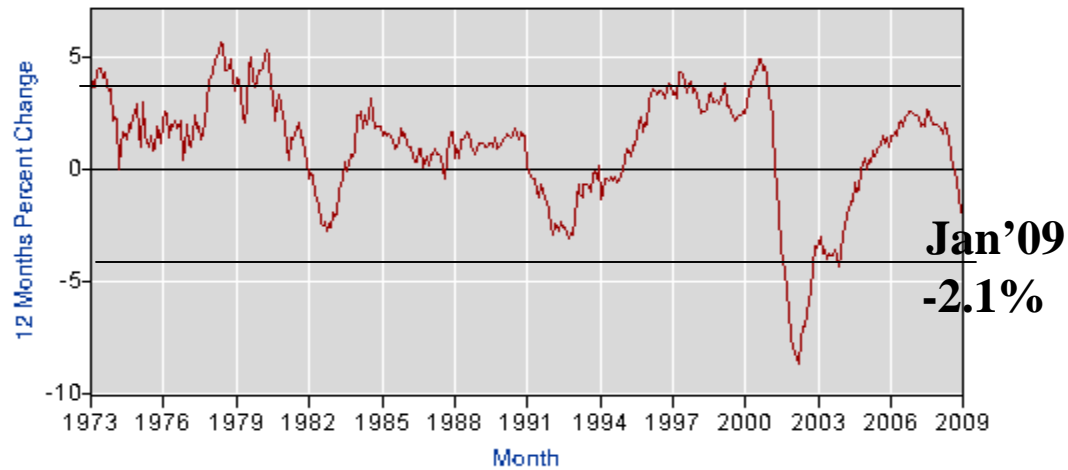
Source: Bureau of Labor Statistics.
<http://www.bls.gov>

Non-Farm Payroll Employment



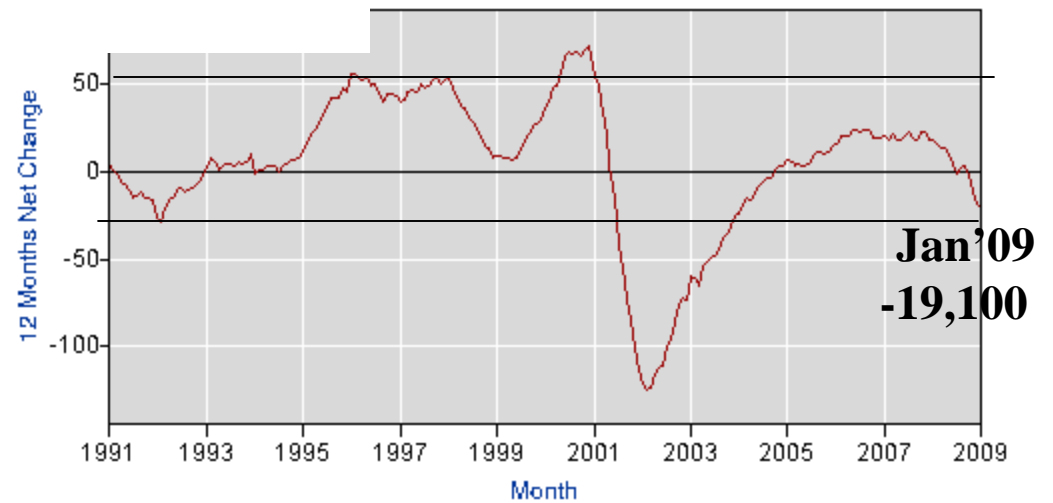
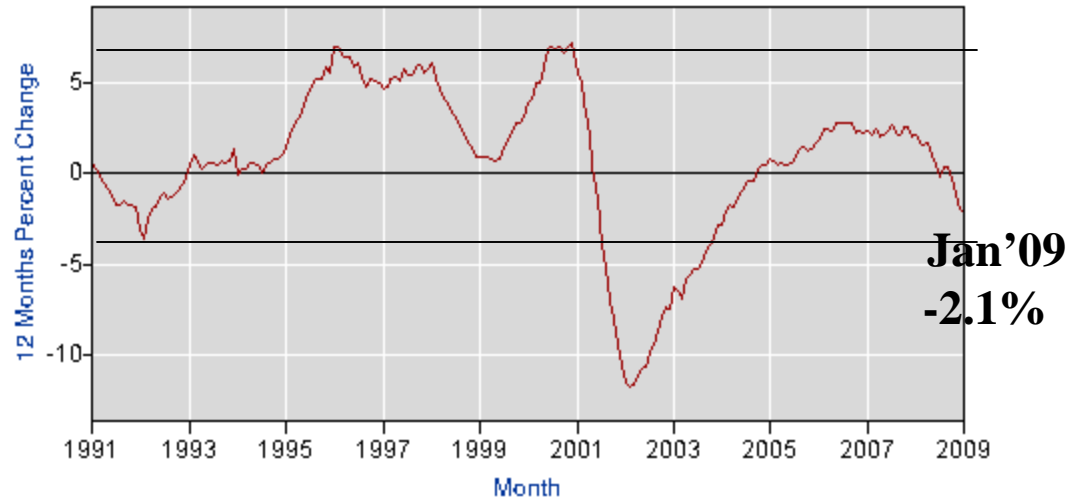
Source: Bureau of Labor Statistics.
<http://www.bls.gov>

San Francisco PMSA Non-Farm Employment Growth (YOY)



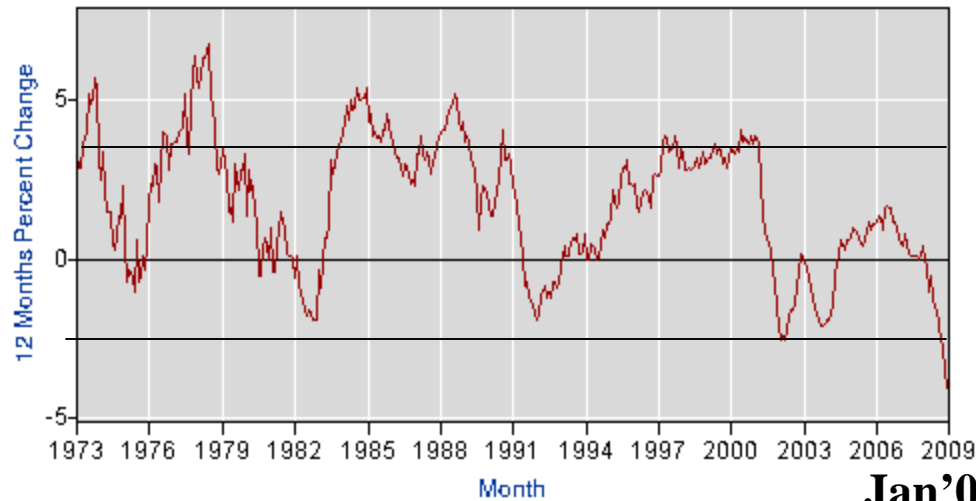
Source: Department of Labor Statistics.

San Jose PMSA Non-Farm Employment Growth (YOY)

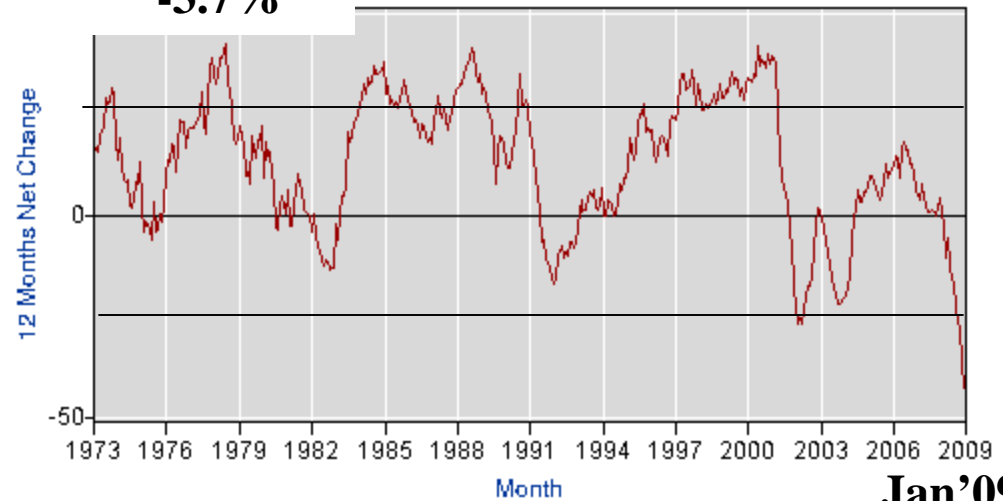


Source: Department of Labor Statistics.

Oakland PMSA Non-Farm Employment Growth (YOY)



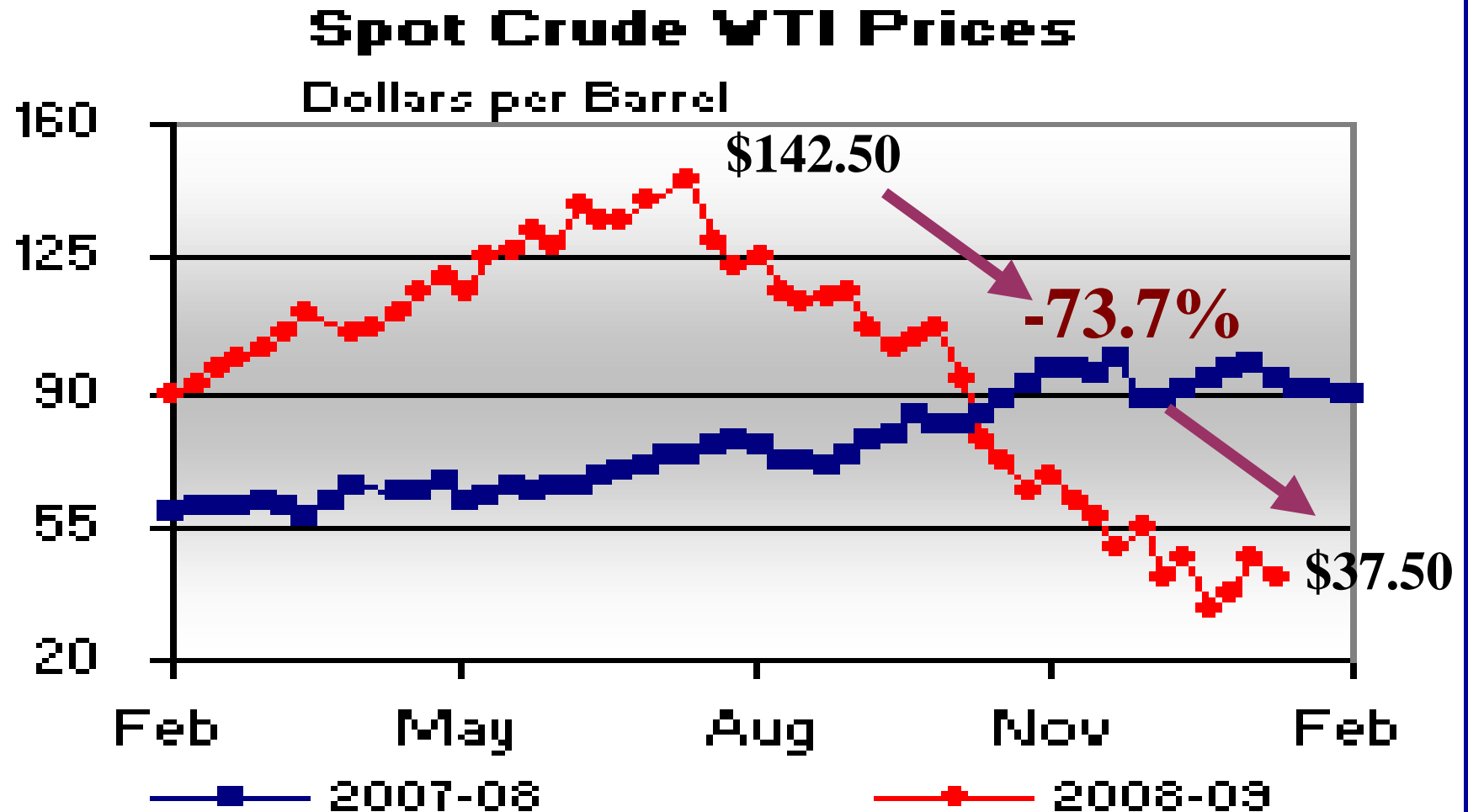
Jan'09
-3.7%



Jan'09
-37,800

Source: Department of Labor Statistics.

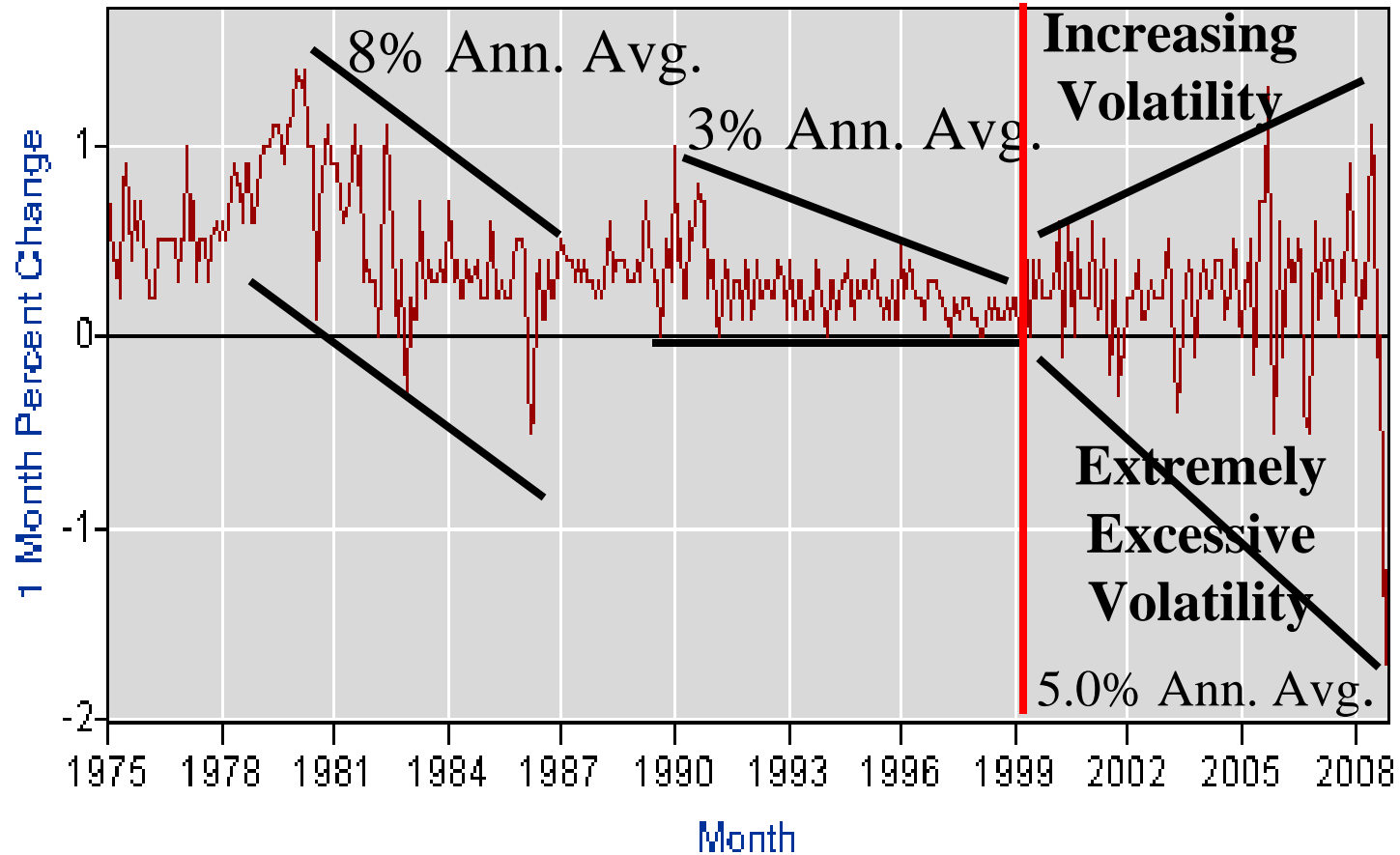
Inflation Expectations



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.

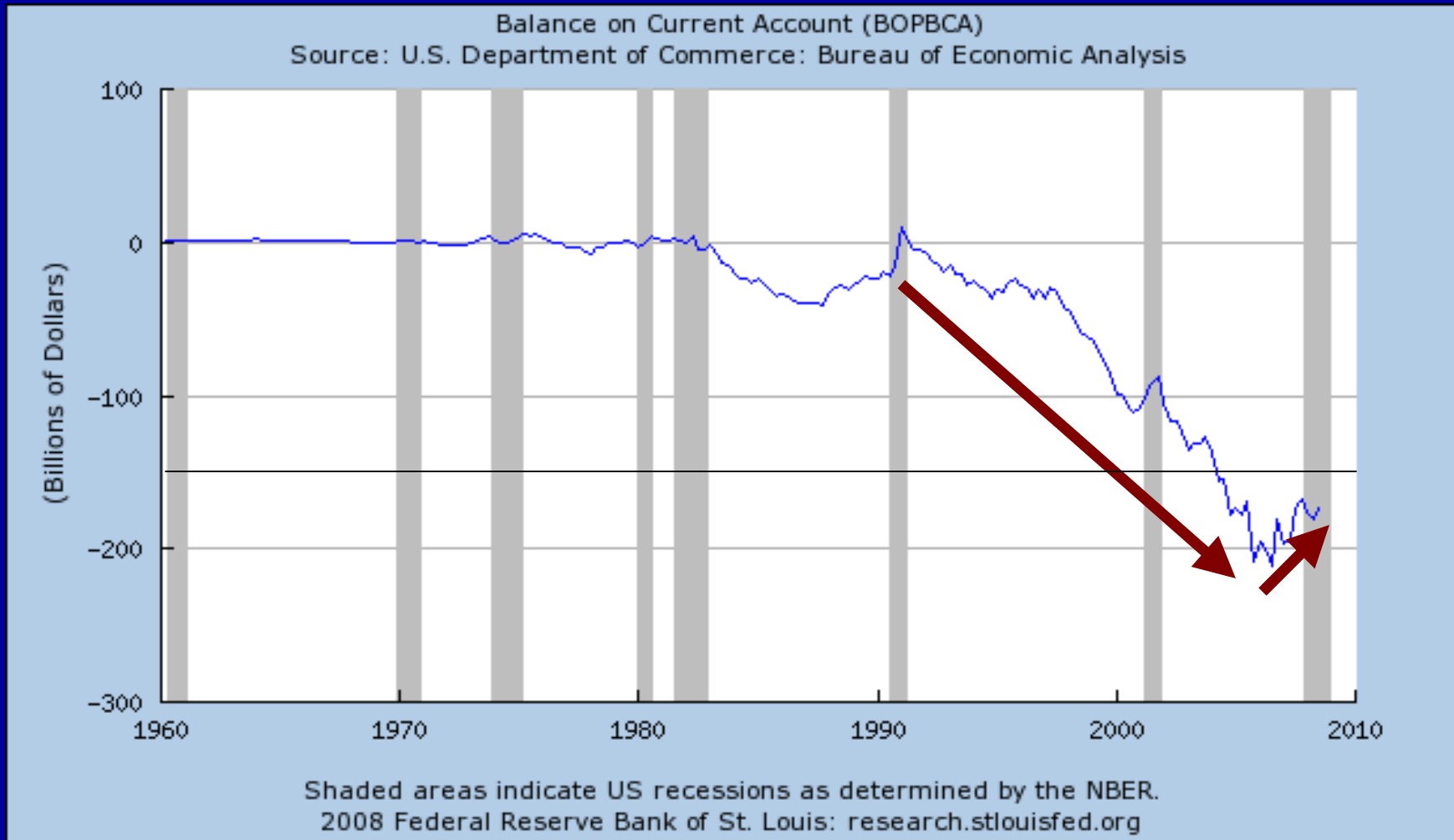
<http://www.bls.gov/home.htm>

Euro/Yen Exchange Rates 2008-2009



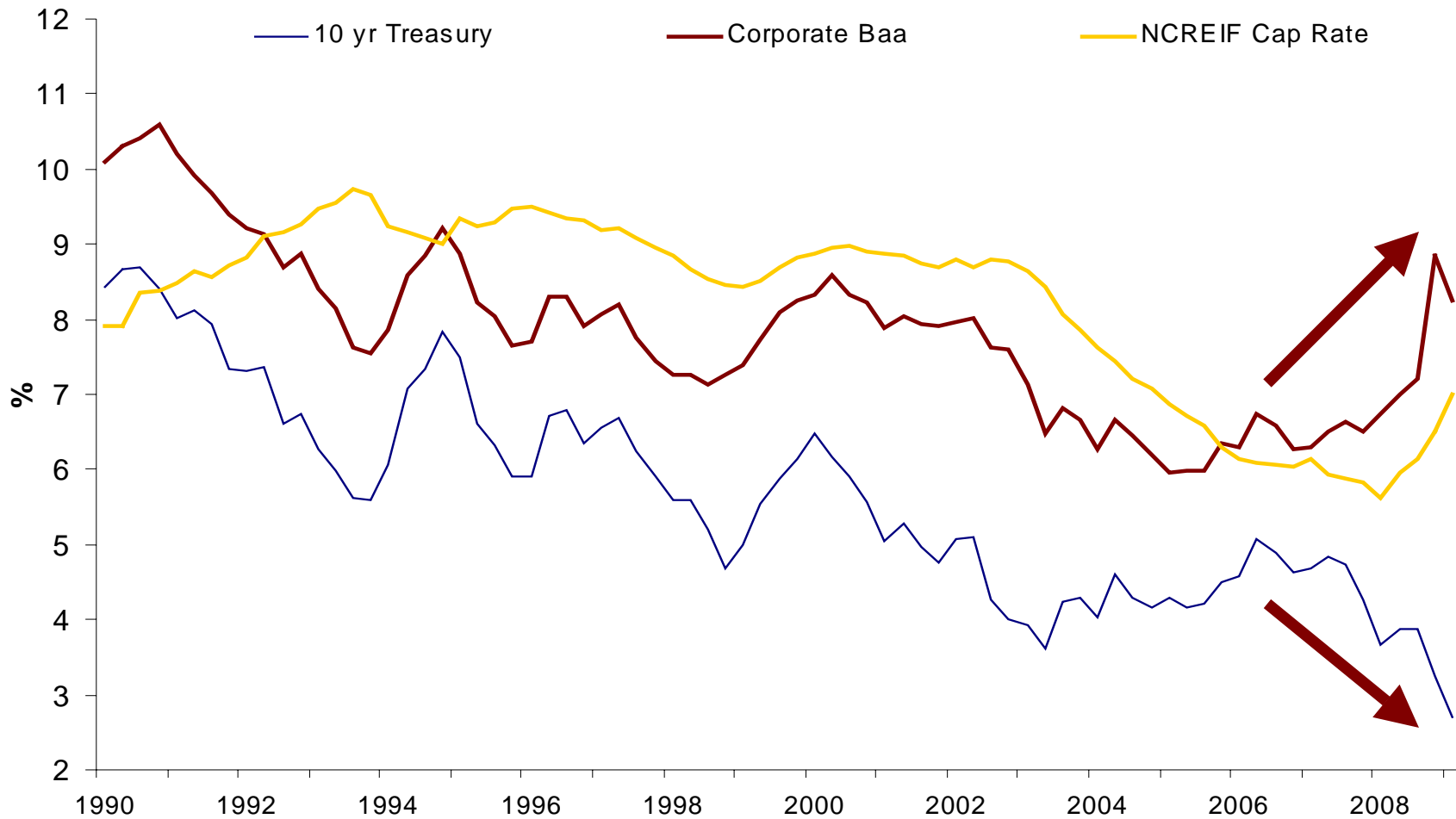
Source: New York Federal Reserve Bank. <http://www.ny.frb.org/markets/foreignex.html>

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 ...



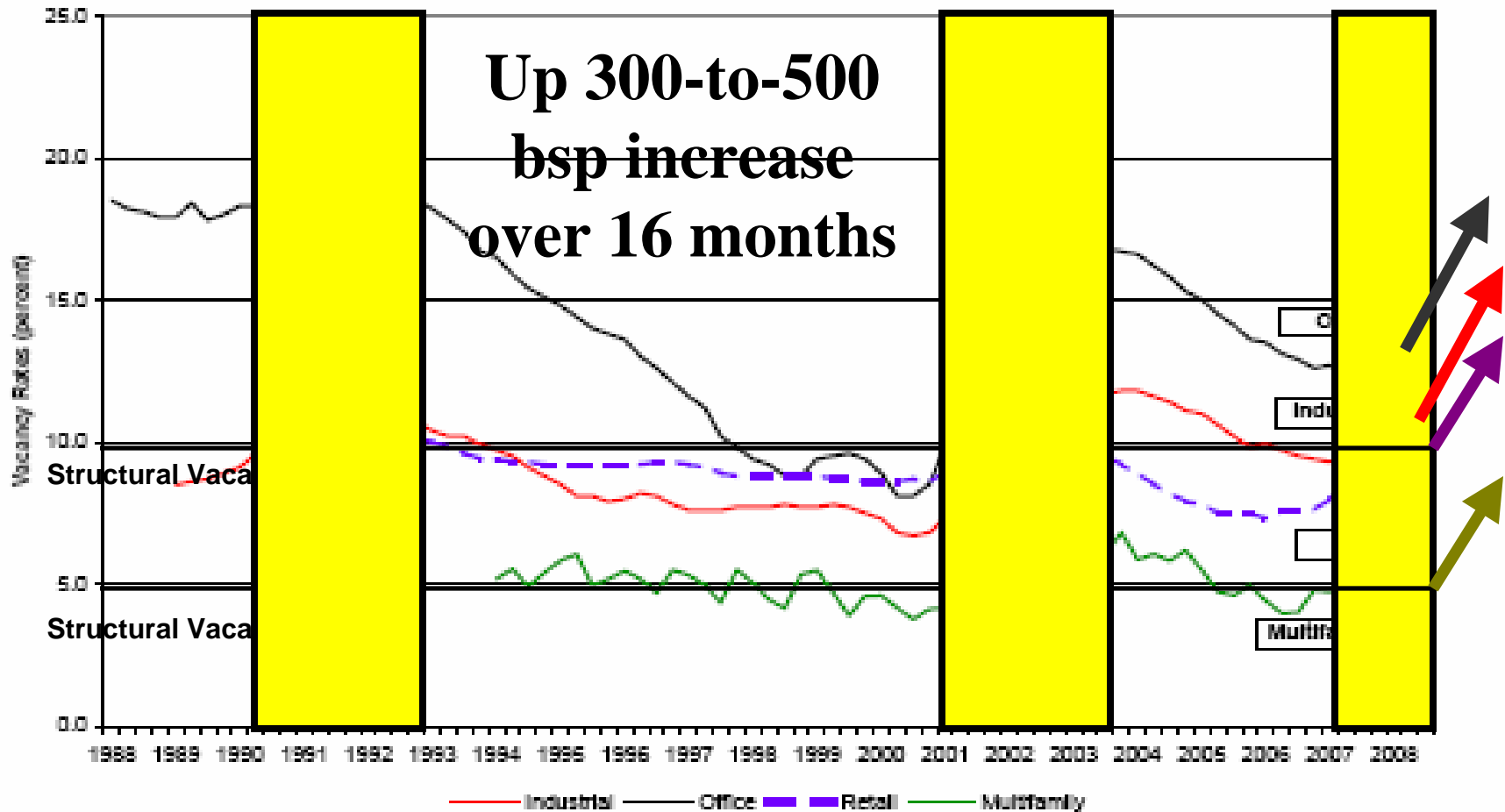
Source: Federal Reserve, NCREIF and Cornerstone Research.

Commercial Vacancy Rates (From 1988 to 2010)



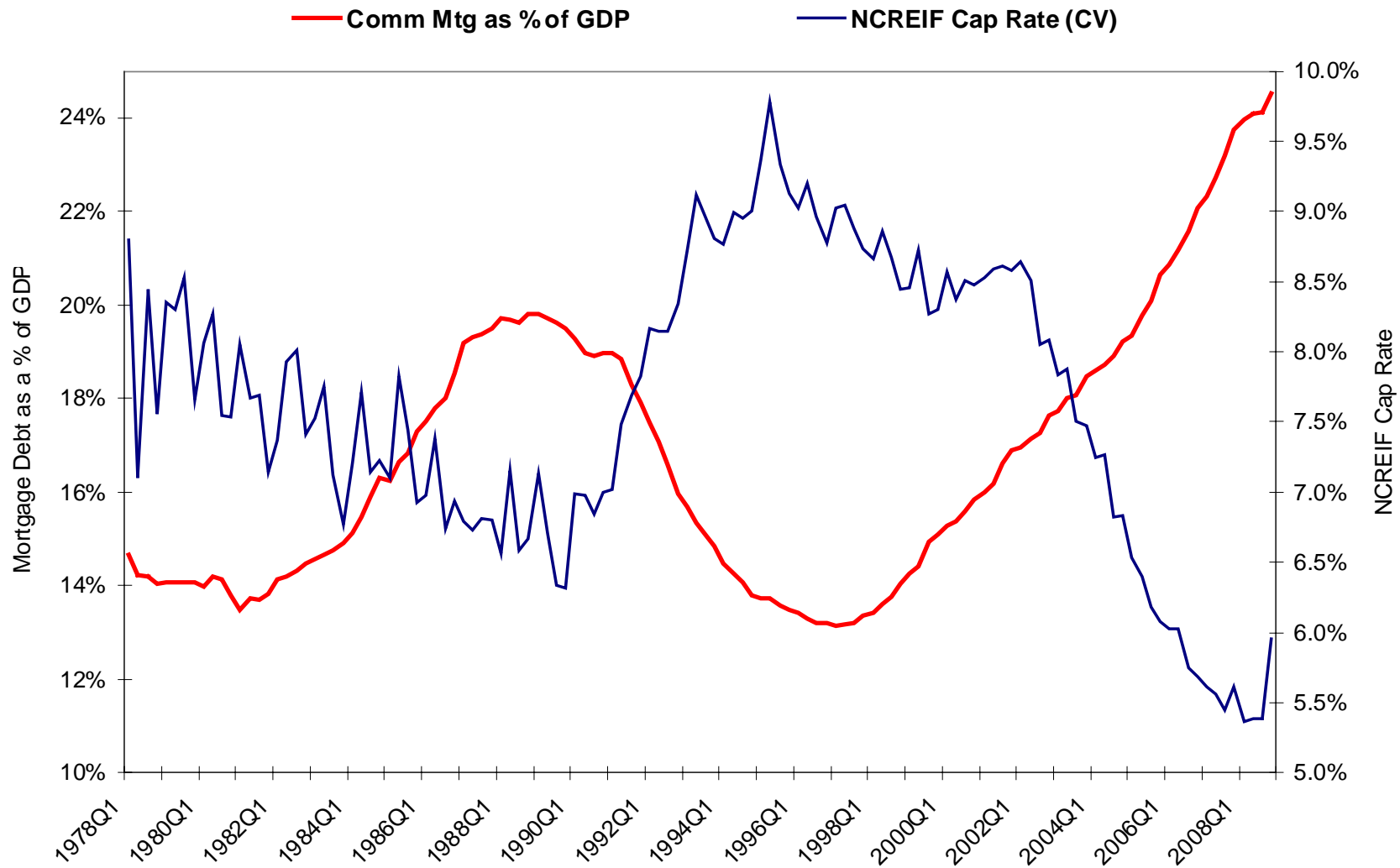
Exhibit 23
U.S. Property Vacancy Rates
Quarterly

Updated November 14, 2008



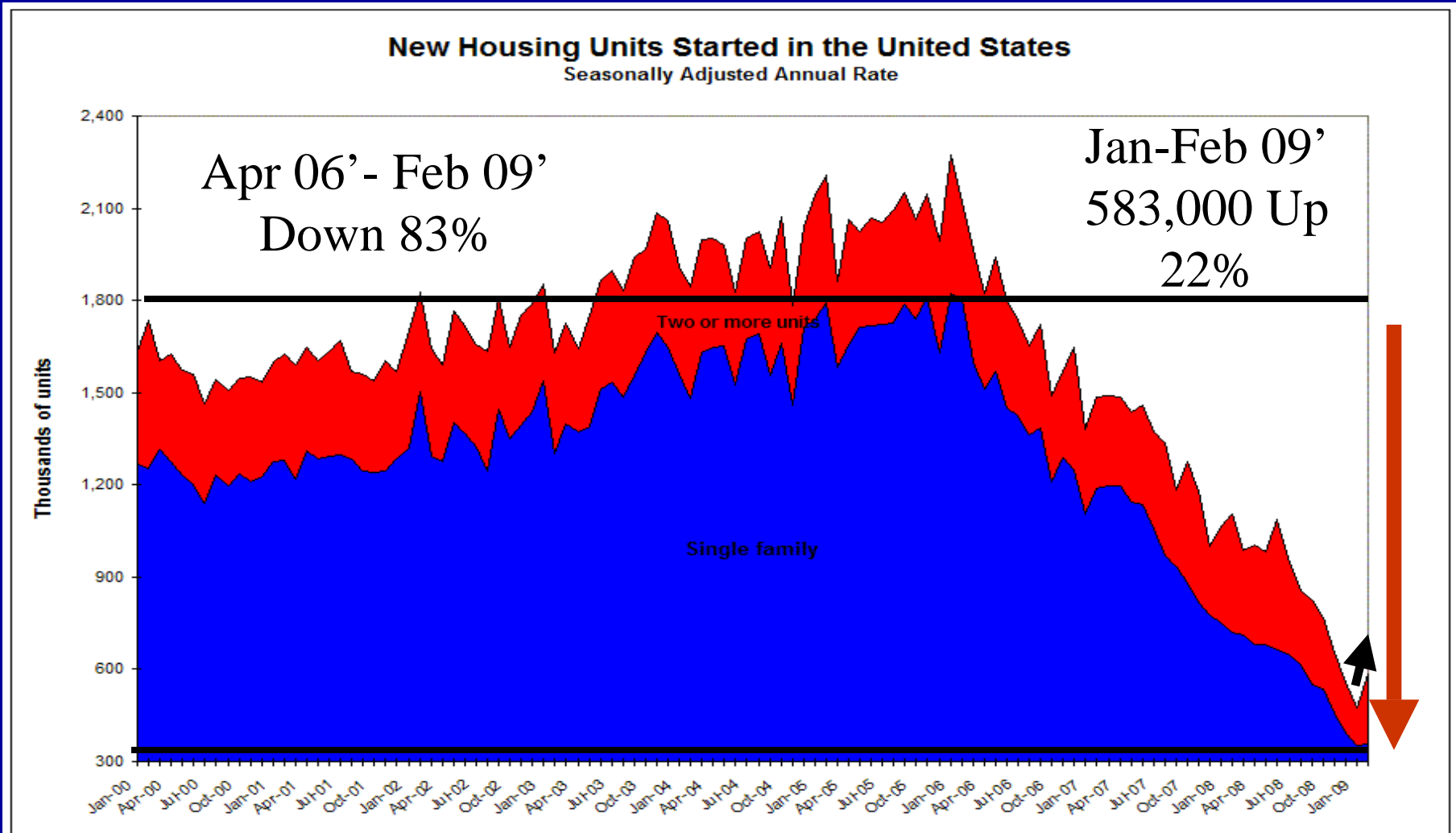
Source: CBRE Toro Wheaton Research. Data as of 2008Q2.
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Mortgage Debt and NCREIF Cap Rates



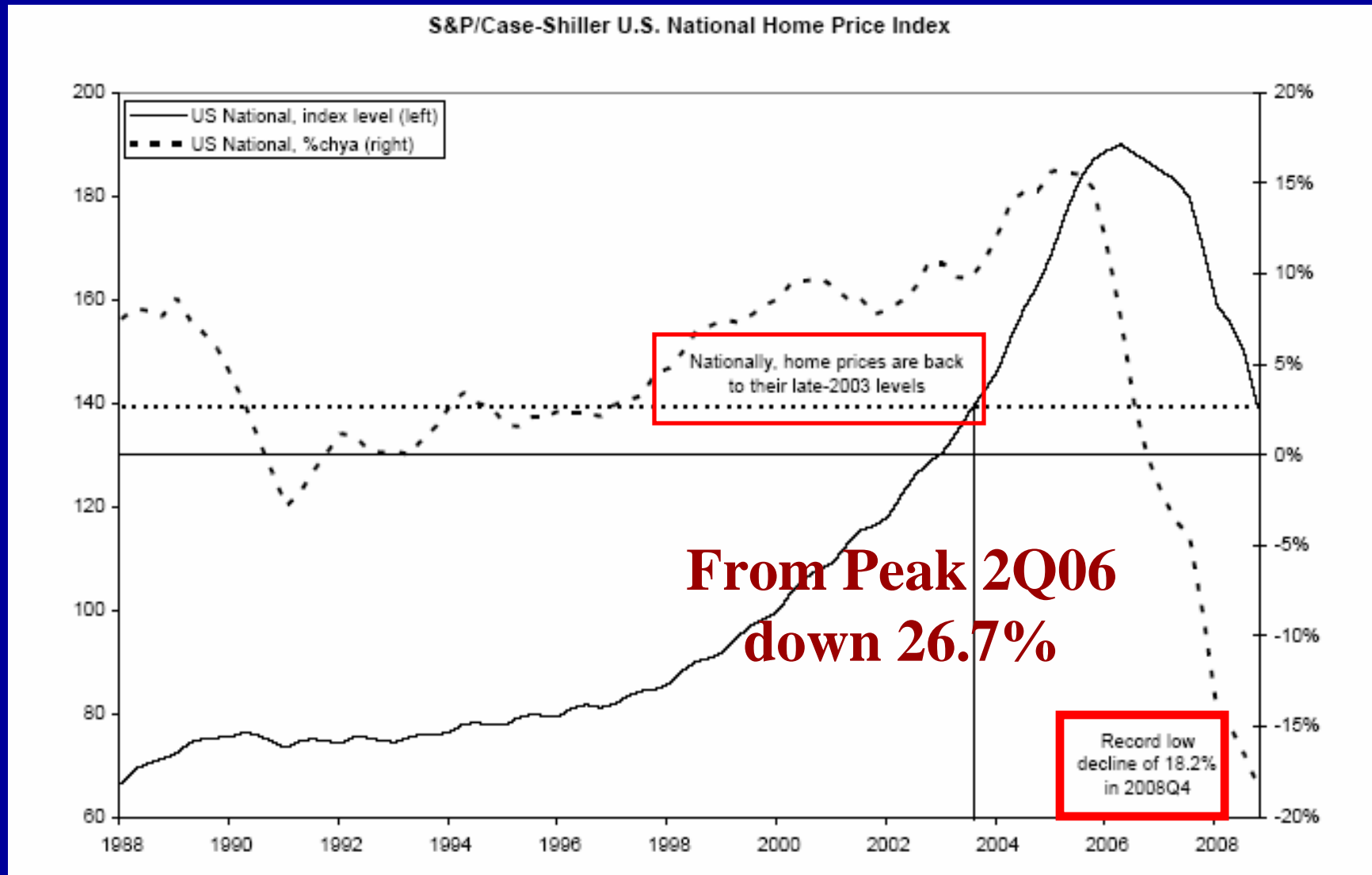
Source: Based on data from NCREIF, Bureau of Economic Analysis and the Federal Reserve

New Housing Starts

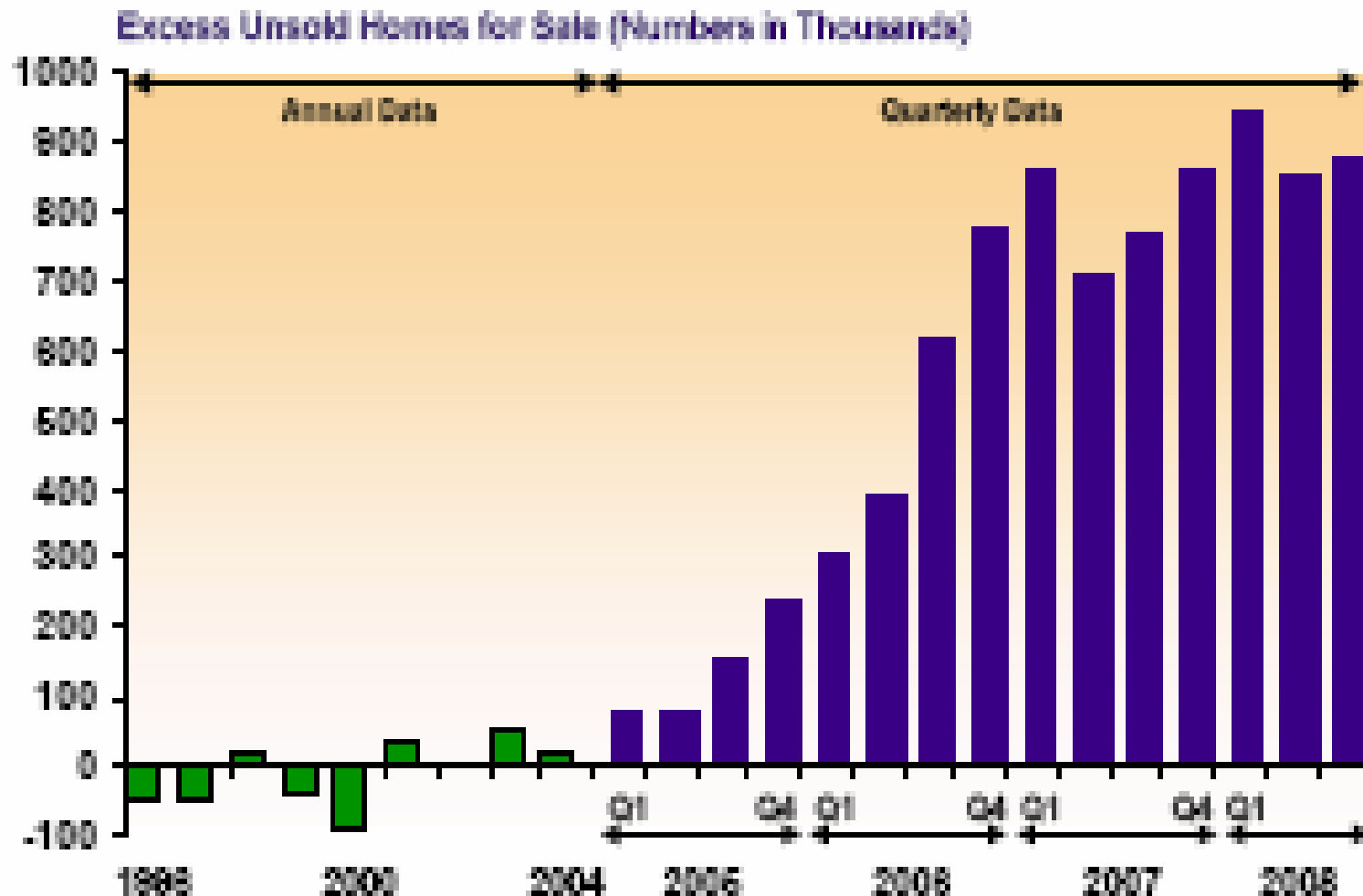


Source. United States Census Bureau. <http://www.census.gov/briefrm/esbr/www/esbr020.html>

Housing Market – Price Declines



Housing Market - Excess Inventory



Source: Bureau of Census (1998-2004 Annual Data, 2005Q1-2009Q2 Quarterly Data)
 Note: The excess unsold homes were calculated based on the average vacancy rate from 1999Q1 to 2009Q4 (1.7%).

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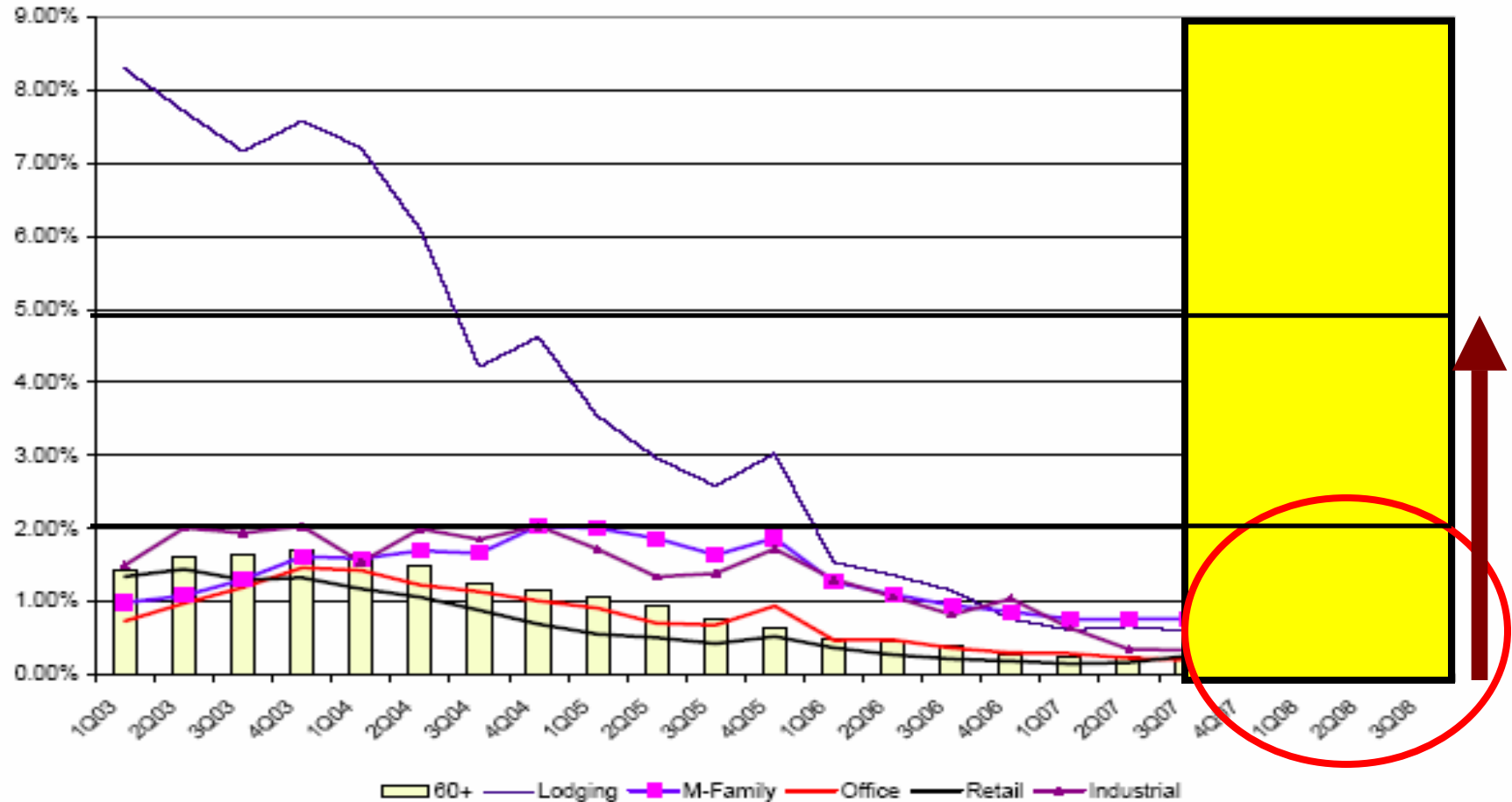
CMBS Delinquency Rates by Type (From 2003 to 2008)



Exhibit 7
CMBS Delinquencies by Property Type

Updated November 21, 2008

See A2-Appendix for detailed data on delinquencies by vintage year and property type.



Source: Trepp LLC

See Exhibit 6 for underlying data. Property type delinquencies are based 30+ days.

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Lawrence Souza (lsouza@JohnsonSouzaGroup.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.**

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