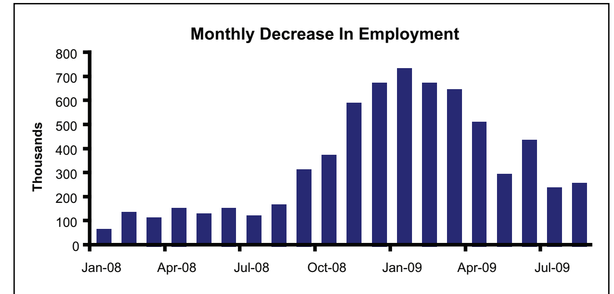
THE LINNEMAN LETTER

Volume 9 Issue 3

U.S. Economic and Real Estate Overview

By Dr. Peter Linneman, PhD
Chief Economist, NAI Global
Principal, Linneman Associates

The present recession is the worst downturn in economic activity since the Great Depression. Barring more government "salvation," we have hit bottom. Without this disastrous "salvation," we would have bottomed in January 2009. Contrary to mythological rhetoric, government interventions both lengthened and massively deepened the current super-recession. GDP bottomed in the third quarter, and employment will lag by about a year. When job declines end, there will be a net loss of about 7.5 million jobs. This is equivalent to nearly four years of normal job growth.



To put the situation in perspective, real GDP was about $14.7 trillion at the start of September 2008, falling by 2.8% over nine months through June 2009. At a 3% annual real GDP growth rate, the lower job base will take 10 months through April 2010 to get back to where we were a year ago.

The U.S. trade deficit has plunged, reflecting the horrific loss of global confidence in the integrity and productivity of U.S. capital markets. Our trade deficit has fallen to -2.7% of U.S. GDP, and -0.5% of rest-of-world GDP. Always remember that the U.S. trade deficit is not a reflection of the lack of competitiveness of our goods and services, but rather a reflection of our capital market superiority.

The fundamental problem remains: it is impossible to predict what will happen next, as every day brings new seemingly ad hoc rules. A perfect example occurred when the list of autos eligible for clunker tax rebates was suddenly revised on the eve of the program without any explanation. And tax, health care and regulatory proposals abound, with little clarity as to the ultimate outcomes.

Early in 2009, monthly job declines were wiping out 500,000-700,000 jobs. In July, that number had diminished to just under 250,000, but increased to 265,000 in August. Year-over-year through the second quarter of 2009, the U.S. lost 3.9% of all payroll jobs.

On a 12-month moving average basis through June, just 27% of industries are adding workers, versus the 8-year average of 50%. All sectors, except government, lost ground year-over-year through July 2009. On a percentage basis, construction (-14.2%), manufacturing (-12.1%), and

Table of Contents

Is This a Recovery Yet?
Inflation is Coming
Two Years Later: How Will Things Look?
Financial Market Invasion
Has Capitalism Failed?
The Linneman Letter Look-back: The Risk of Hedge Funds
Are Capital Markets Beginning to Work?
So Where is Commercial Real Estate Pricing?
Real Estate Debt Update
Construction Costs
The Linneman Letter Look-back: Construction Costs Predicted
It is Time to Build More Housing!
Homeownership: Changing Demographics Versus Ownership Propensities
A New Look at the Housing Price Increase
Show me the Money: TARP Funding Update
Market Close-up: Northern-Central N.J. Office
Market Close-up: Cleveland Industrial
Market Close-up: Houston Multifamily
Market Close-up: San Diego Hotel
Office Market Outlook
Industrial Market Outlook
Multifamily Market Outlook
Retail Market Outlook
Hotel Market Outlook
Seniors Housing and Care Market Outlook

NAI Global®
Commercial Real Estate Services, Worldwide.

LINNEMAN ASSOCIATES

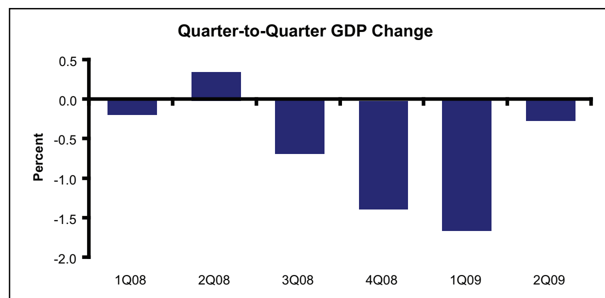
professional and business services (-6.4%) continue to suffer the most. The largest absolute job losses were in manufacturing (1.64 million), trade, transportation and utilities (1.24 million), and professional and business services (1.16 million). However, it is important to note that the decline in manufacturing employment is exactly on trend with a 50-year pattern, and thus is not driven solely by today's recession. The government sector added 33,000 jobs (0.2%) over the trailing 12 months through July. It is ironic, though not surprising, that the government's efforts to save the economy and weed out wasteful practices on Wall Street have only served to fatten its own ranks.

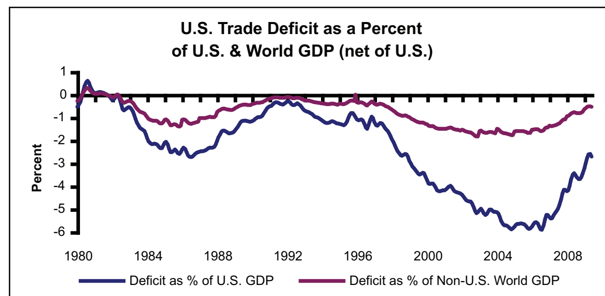
In August 2009, the unemployment rate stood at 9.7%, a year-over-year increase of 350 basis points. Over the same period, the median unemployment duration has risen by 5.1 weeks, to 15.4 weeks (a nearly 50% rise), with the percent unemployed more than 27 weeks rising from 22.8% to 33.4% since the Obama administration confidently announced in January 2009 that their actions would save us. At the same time, short-term (five weeks or less) unemployment spells have fallen to 2%, from 2.4% in January. The brutal truth is that many more people are unemployed, and for longer, as a result of rule-destroying government interventions.

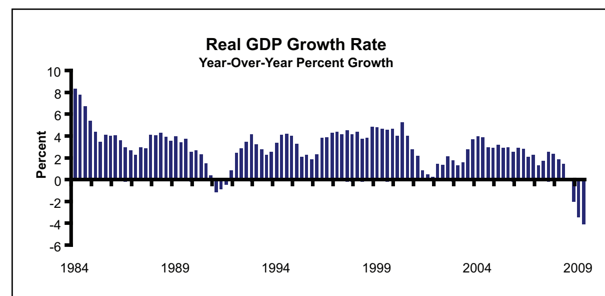
Teen workers accounted for about 15% of the nearly 5.4 million jobs lost between August 2008 and August 2009. Thank you, Congress, for the minimum wage increase. Job losses continue to be extraordinarily male-centric, with 3.5 million of the 5.4 million total lost jobs concentrated among males older than 19, and only 1.3 million among women older than 19. This reflects the high concentration of males in manufacturing, construction and finance, while women are disproportionately employed in the less adversely impacted health care and education sectors.

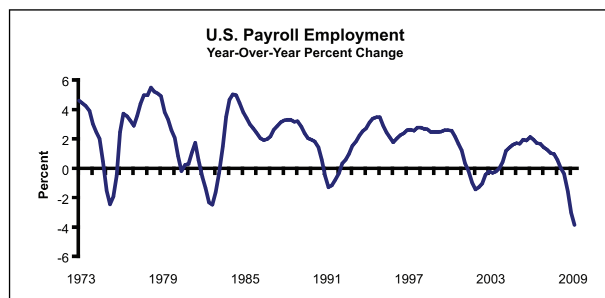
The biggest uncertainty is not the capital markets; it is the Capitol markets. Despite the serial ineffectiveness of government interventions, investors are slowly coming out of their tortoise shells. The early signs of recovery are fragile because of the surge in oil prices back to $70 per barrel. At $70 per barrel, it will take much longer to rebuild consumer confidence, a pre-cursor for a recovery. GDP bottomed in the third quarter, and employment will lag by about a year.

In early September 2009, yields on 10-year Treasuries have risen to 3.48%. We believe 10-year Treasury yields are still some 125 bps too low. If all were normal, 10-year Treasury yields would be around 4.75-5%, where they hovered before October 2007.









NAI Global®
Commercial Real Estate Services, Worldwide.

LINNEMAN ASSOCIATES

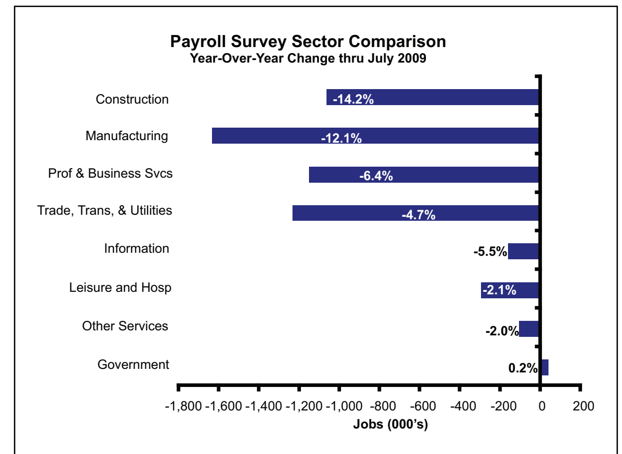
Recently, LIBOR and 30-day Treasuries have raced to zero. A low LIBOR has become the life blood for many borrowers with floating rate debt, and a rate spike has the potential to crush many borrowers. Long-term treasury Inflated-Protected Securities (TIPS) returns have narrowed remarkably, even as inflationary threats loom. They experienced a yield increase to 3.09% in November 2008, and stood at 2.25% in August 2009.

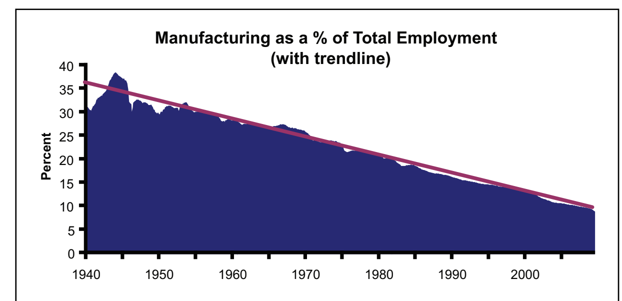
Residential mortgage delinquencies have risen among all products since hitting lows in late 2005. However, these delinquencies are highly concentrated in recession torn greater-Ohio (Ohio plus 100 miles beyond the Ohio border) and the boom markets of south/central Florida, Arizona, Nevada, and California. Elsewhere in the U.S., delinquencies remain at cyclical norms.

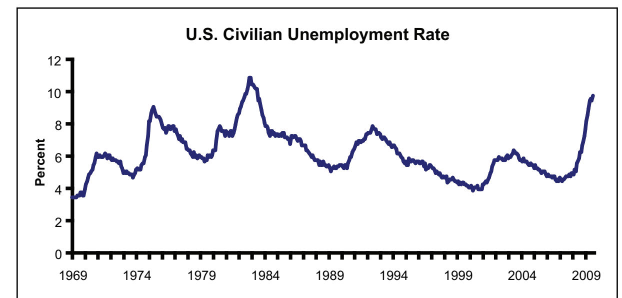
Commercial mortgage delinquency rates have risen across the board, most visibly at banks and thrifts, and CMBS. CMBS issuance in the U.S. remains nearly comatose, with no new issues from July 2008-May 2009 or in August 2009. The only positive glimmer was that the CMBS market managed to eke out a handful of deals in June ($600 million) and July 2009 ($300 million).

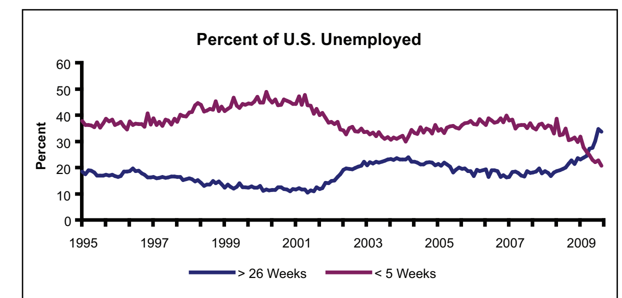
The best news for the economy is that the U.S. housing market bottomed in February. Single family starts hit a very low bottom of roughly 355,000 units in January and February, increasing to 490,000 by July. The inventory of homes held by builders for sale has fallen to 270,000, as new home production over the past year has been insufficient to replace the nearly 350,000 units destroyed each year. MLS home prices (which exclude sheriff sales) have risen nationally, and in almost every MSA, for the past six months. Thus, while many foreclosure sales in the weakest markets continue to drag down the Case-Shiller and NAR indices, the preponderance of homes sold by resident owners has seen price rebounds. This sector's rebound over the next 3-4 years will be a powerful growth engine.

Broad equity markets have rebounded, with 6 straight months of increasing S&P 500. This reflects both improved prices and cyclically low earning levels. Since bottoming at 676 in March, the S&P 500 has risen by 54%, and stood at 1,400 in early September, though still 33% below its peak in October 2007.This rebound in broad equity pricing is good news for commercial real estate, as it will slowly work its way through to real estate. While real estate pricing will lag public markets, the rebound should serve to re-equitize many properties crushed by the collapse in late 2008 and early 2009. After steadily declining since the end of 2006, REIT FFO multiples







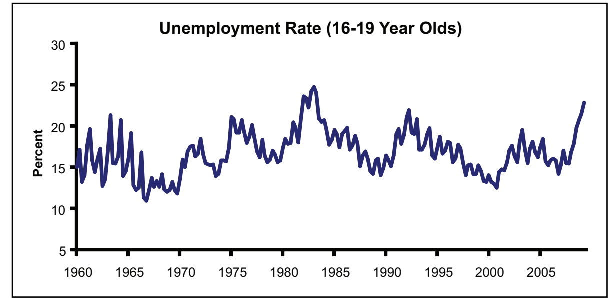


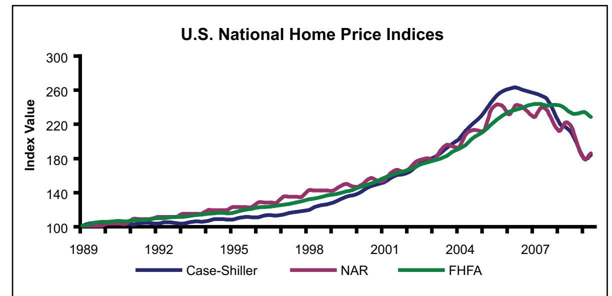
NAI Global®
Commercial Real Estate Services, Worldwide.

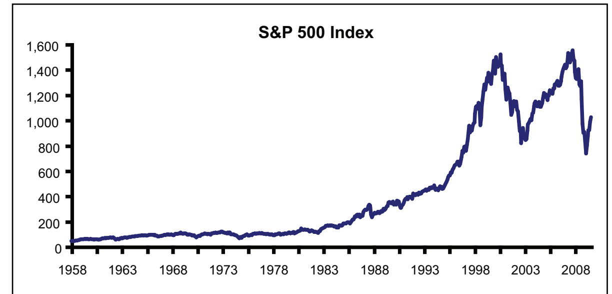
LINNEMAN ASSOCIATES

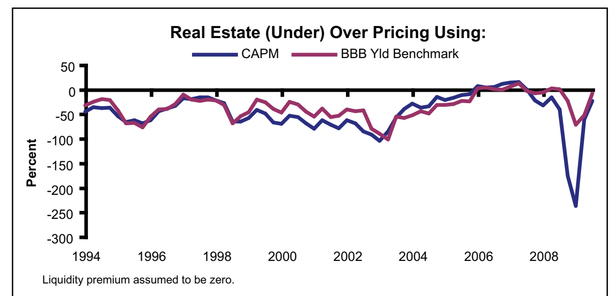
showed the first sign of changing course in the third quarter of 2009. In September, the overall REIT FFO multiple rose to approximately 12.8x, compared to the long-term average of 11.9x.

The Capital Asset Pricing Model (CAPM) indicates that public real estate pricing has improved dramatically relative to its long-term risk during the past 6 months. In particular, the under-pricing of REITs has gone from 230% in March, to 24% in September. A comparative risk analysis, which assumes that the ownership of the perpetuity lease claim should generate approximately the same expected return as the perpetuity BBB debt claim, suggests that the under-pricing of real estate has gone from almost 70% to less than 10%. Research indicates that public pricing leads private pricing by roughly 18 months. This suggests a rebound in private pricing remains about a year away.









NAI Global®
Commercial Real Estate Services, Worldwide.

LINNEMAN ASSOCIATES