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A Turning Point

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2010 is an inflection year for real estate. We will either see sustained growth, in which case the Fed will raise artificially low interest rates, or we will continue to languish economically, à la Japan over the past 20 years, in which case the Fed will keep rates low. The fact that real GDP has increased over the past three quarters (presuming the first quarter of 2010 will be positive), and that early signs of job growth are appearing, support our view that a recovery is underway. In this case, although job formation will lag GDP growth by 12-18 months, interest rates should be increased by June of this year, or we will risk repeating the 2002-2005 mistake of the Greenspan Fed.

Bear in mind that even if a robust recovery occurs, real estate NOIs will fall over the next two years, as leases expire into weaker supply-demand fundamentals than existed when they were signed 3-5 years ago. However, by late 2011, markets will improve as job formation and the complete absence of new supply will allow property markets to find bottom. The challenge will be that NOIs will not rise as rapidly as interest rates, squeezing borrowers who are staying alive via low short-term rates.

The risk of real estate demand today versus that perceived in 2006 is much like the general perception of national security on September 10, 2001, versus September 12, 2001. Objectively, demand fundamentals for the next five years are stronger today than in 2006, though they feel much riskier. The recession we foresaw for 2009 is now over, and a demand-driven recovery similar to that which followed previous super-recessions is underway. This recovery will not happen overnight, but we anticipate strong growth over the next three years.

The problem is that in 2006 and early 2007, investors underwrote real estate with a belief that 6 million jobs would be added to the economy by the end of 2010, while new real estate covering only 80% (5 million) of those jobs would be created. Instead, some 8.5 million jobs were lost, while approximately 1.5 million jobs' worth of new real estate was created. The result is that, versus the lofty aspirations of 2006 and early 2007, real estate has a pro forma shortfall of some 11 million jobs. Even if the U.S. economy adds 3 million jobs per year beginning in the middle of this year, it will take until mid-2013 to return to the rent and occupancy conditions that existed in mid-2008, and until the end of 2014 before the rent and occupancy expectations implicit in peak underwriting are achieved.

The greatest economic wild card is inflation, which could substantially increase replacement costs and NOIs, spurring real estate values. This is a very real possibility, given the extraordinary federal budget deficits