February 1, 2010

Forecaster: Fear Paving Way to Economic Recovery

U.S. policymakers' hasty comparisons of the unfolding recession to the Great Depression in 2008 triggered a panic that virtually halted discretionary spending by consumers and businesses alike, according to James Paulsen, chief investment strategist at Wells Capital Management. "This country developed a culture of the second coming of the Great Depression faster than I remember in any past recession," Paulsen told business leaders at a forecast gathering Jan. 21 in Austin, Texas. Paulsen keynoted the event, hosted by Austin-based economic development advisory firm AngelouEconomics. Too many bad loans, excessive consumer debt, unemployment and other economic factors did push the nation into recession, Paulsen says, but those occurrences were common to many previous downturns. What, then, made this recession so deep, with a contraction of nearly 6% in gross domestic product (GDP), more than 7.3 million job losses and, at 10%, the highest unemployment rate in 26 years? "At least half of [the reason] was just because we froze all economic players into paralysis with fear," Paulsen contends. "Our biggest issue in this recession was our healthy players and our healthy companies that just quit spending and quit hiring for awhile, simply to see where this Great Depression was going to go." Yet the steps taken to prepare for a crisis of 1930s magnitude are poised to propel a rapid recovery once easing fears turn to confidence, a trend Paulsen says is already evidenced by "green shoots" such as positive GDP growth and slowed job losses. He believes the nation will continue to benefit from reactive strategies prompted by anxiety that permeated both consumer households and the halls of government. Businesses and consumers have been stockpiling their buying power and together sit on a mountain of money equivalent to 70% of GDP or about $10 trillion, says Paulsen, who bases that figure on his own analysis of Federal Reserve Flow of Funds data. "That's a big asset, and it's only there because of the fear we created." Paulsen views the wave of stimulus measures enacted by Washington to counter the recession and credit crisis as an overreaction, but says the economy will certainly enjoy accelerated growth as the effects of massive deficit spending begin to show up later this year. In fact, he predicts that the Federal Open Market Committee will have to begin interest rate tightening this summer as the money supply and growing economy add to inflationary pressure. Joblessness will continue to be a problem for the next two years, Paulsen says, and the painful process of bank failures and writing off bad debt must run its course. Eventually, however, employers must increase hiring to meet demand for goods and services. Current business inventories are at their lowest point in a decade and orders for capital goods are rising. Paulsen didn't address commercial real estate's woes during his presentation on the national outlook, although his projection of a weak job market through 2011 suggests further softening in demand for commercial space and rising vacancy rates are ahead for most property types. A forecast published this week by commercial real estate service provider Jones Lang LaSalle calls for capitalization rates to reach a peak as early as the first quarter of 2010, but weak fundamentals mean asset values throughout the nation will continue to decline during the first half of the year before stabilizing in the third quarter. On average, commercial property values will have declined 50% from peak to trough, the company predicts. Retail landlords and tenants stand to gain this year if consumers revert to at least some of the consumption patterns that fueled growth in the sector earlier in this decade. Coupled with the trading benefits of a weakening dollar, Paulsen believes that conservative spending by U.S. consumers in the years ahead

will be offset by foreign consumers with an appetite for U.S. exports. Consumer spending in emerging markets such as China, India, and former Soviet states has skyrocketed in the past five years. In 2008, average private consumption expenditures in developing nations equated to an average of 91.7% of U.S. consumption, Paulsen says. If U.S. exports grow to contribute another 100 basis points to GDP, Paulsen says, then spending by savings-conscious U.S. consumers can hum along at 2% of GDP rather than returning to its historical level of 3%. "Trade is going to be an important part of our future growth," he says. **(National Real Estate Investor/Matt Hudgins)**

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Denver Hotel Occupancy, Prices Down in 2009

Metro Denver hotel occupancies plunged to a 19-year low in 2009 as a bad economy torpedoed business travel. Room rates also fell sharply from record levels in 2008, according to a report from Denver-based Horwath HTL/Montgomery & Associates. The 2009 occupancy rate of 60.6 percent was down from 66.6 percent in 2008 and the worst performance since 60 percent in 1990. After reaching an all-time high of $128 in 2008, average room rates dropped 11 percent to $114 in 2009. "The sector that really has been hurt is business travel," said John Montgomery, managing director of the hotel consulting firm. "Before, they would come to town for three or four days. Now they come maybe for one day or not at all." Leisure travel also was off but not as precipitously as business travel. Despite the poor annual performance in 2009, the market showed signs of recovery in the last quarter of the year, Montgomery said. "We think we've bottomed out here," he said. "Many hospitality-industry professionals believe that metro Denver will start to experience a growth in occupancy and average room rate by mid- to late 2010." For 2009, downtown Denver had the metro area's highest average room rate, $139, down from $156 in 2008. In a separate lodging report released this week, bookings at Rocky Mountain resorts for the coming six months were up slightly from last year's pace. Lodging reservations taken in December for 15 mountain destinations, including all of Colorado's major resorts, rose 1.4 percent, according to the Mountain Travel Research Program. December's occupancy rate at the mountain resorts fell to 40.3 percent, from 41.2 percent in December 2008. **(Denver Post)**

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Institutions Once Bitten, But Not So Shy

Institutional investors are making big plans to invest more heavily in commercial properties in 2010, despite major write-downs that have left some portfolios worth half of their value since the market peak in 2007. Leading the way as one of the pension fund bellwethers is the California Public Employees' Retirement System (CalPERS), with $206 billion in total assets under management. Its chief investment officer, Joseph Dear, says he is not afraid to jump back into the steaming cauldron that is the commercial real estate investment market, even after being badly burned in the last two years. "Real estate has been tough for us, but opportunities are going to be developing and we'd like to take advantage of the distress in 2010," says Dear. Surprisingly, this statement comes after CalPERS' real estate portfolio lost an astounding 50% of its value in the year ended Sept. 30, 2009, dropping to $13.5 billion. "We took a huge hit in real estate," admits Dear. "It's a hugely painful lesson." He also notes that there is lingering concern over the health of commercial

real estate. “The fundamentals still aren’t good and there may be further write-downs, but our write-down in the portfolio was as realistic as we could possibly make it.” The flaws of CalPERS’ previous investment strategy are well documented, including overly aggressive leverage and poor underwriting coupled with ill market timing. The fund’s board of directors has made moves to right its past mistakes. It recently fired several of its advisors and instituted strict new oversight guidelines on new investments, along with hiring Dear to lead the charge. In the short term at least, Dear, who joined the fund in March 2009 fresh from his stint as executive director at the Washington State Investment Board, inherited a portfolio that is expected to rack up further losses. Pension Consulting Alliance, the fund’s lead real estate advisor, predicts that the value of CalPERS’ real estate portfolio will continue to decline for at least the next 12 months. Dear would not specify how much CalPERS might plow into real estate, but the fund could invest $6 billion in the sector, based on its target of 10% of total fund assets. Jumping back into the fray seems logical to some. “It’s the only way to take advantage of a bad situation,” says Hessam Nadji, managing director of research services at Marcus & Millichap. “Having written [the portfolio] down, now it’s really important to write it back up. The only way to do that is to take a position in the market and make new investments.” Among pension funds, CalPERS is not alone in returning to the real estate markets. In January 2010, the Ohio Public Employees Retirement System approved new commitments totaling $600 million into funds run by JP Morgan and UBS. These commitments follow previous investments of $200 million in the same funds in 2004 and 2007, respectively. Meanwhile, the Teacher Retirement System of Texas and USAA Real Estate Co. have entered into a joint venture that plans to invest more than $300 million in commercial real estate across the country. Making commitments is one thing, but finding deals is another, as competition has become fierce. Private equity players alone have amassed some $173 billion in dry powder waiting for the “right opportunities” in distressed assets or problem loans along with everyone else. Still, Nadji believes institutional investors will be among the buyers at the front of the line. “We’re seeing them come out of defensive mode, come out of write-down mode and try to position the capital that’s been raised for more opportunistic investments going forward.” Real estate investment trusts (REITs) also are aggressively scouting deals, after raising some $32 billion of equity and debt in 2009. “They are in an optimal position now that their stock prices have rebounded, and we’re seeing them bid a lot more on assets that we’re marketing versus six months ago,” says Nadji. “They’re in the hunt. They’re not coming in as the top or second buyer, but they’re becoming more aggressive.” In the near term, core investments, including downtown office properties in established, stable markets like Washington, D.C. and New York, will likely be at the top of the institutional investors’ shopping lists. “There already has been an increasing emphasis on the pursuit of core assets in major markets,” says Steve Pumper, executive managing director at Transwestern Commercial in Dallas. “This trend will continue to increase as core prices stabilize.” Recent evidence suggests that price declines may have bottomed. The latest Moody’s/REAL commercial property index registered a 1.0% increase in property prices in November, the first in more than a year. **(National Real Estate Investor/Ben Johnson)**

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Economy Grows at 5.7 pct Pace, Fastest Since 2003

The economy's faster-than-expected growth at the end of last year, fueled by companies boosting output to keep stockpiles up, is likely to weaken as consumers

keep a lid on spending. The 5.7 percent annual growth rate in the fourth quarter was the fastest pace since 2003. It marked two straight quarters of growth after four quarters of decline. Growth exceeded expectations mainly because business spending on equipment and software jumped much more than forecast. Still, economists expect growth to slow this year as companies finish restocking inventories and as government stimulus efforts fade. Many estimate the nation's gross domestic product will grow 2.5 percent to 3 percent in the current quarter and about 2.5 percent or less for the full year. That won't be fast enough to significantly reduce the unemployment rate, now 10 percent. Most analysts expect the rate to keep rising for several months and remain close to 10 percent through the end of the year. High unemployment and stagnant wage growth will likely keep consumers cautious about spending. Wages and benefits paid to U.S. workers posted a scant gain in the fourth quarter. And for all of last year, workers' compensation rose by the smallest amount on records going back more than a quarter-century. The economic recovery could falter if consumers, who account for 70 percent of economic activity, lack the income to ramp up spending. "That's why there's so much hand-wringing right now," said Brian Bethune, chief U.S. financial economist for IHS Global Insight. "Can the economy really sustain this? That's the big question mark sitting out there." With hiring still weak, President Barack Obama has stepped up his focus on job creation. On Friday, he urged Congress to embrace his call for tax incentives to create jobs. Obama wants to give companies a $5,000 tax credit for each net new worker they hire in 2010. Also, businesses that increase wages or hours for existing workers in 2010 would be reimbursed for the extra Social Security payroll taxes they would pay. "It's time to put America back to work," the president told workers at the Chesapeake Machine Company in Baltimore. But he acknowledged that "while these proposals will create jobs all across America, we've got a long way to go to make up for the millions of jobs that we lost in this recession." About 60 percent of the fourth quarter's growth resulted from a sharp slowdown in the reduction of inventories as firms began to rebuild stockpiles depleted by the recession. Changes to inventories added 3.4 percentage points to the fourth-quarter growth, the Commerce Department said in its report Friday. Excluding inventories, the economy would have grown at a 2.2 percent clip, the government said. That's an improvement from 1.5 percent in the third quarter. Consumer spending rose 2 percent, down from a 2.8 percent rise in the third quarter. It added 1.4 percentage points to GDP growth. A steep increase in exports also helped boost growth last quarter. The shipment of goods overseas rose 18.1 percent, far outpacing a 10.5 percent rise in imports. Net exports added 0.5 percentage point to GDP. Government spending was actually a slight drag on growth in the fourth quarter: A small increase in federal spending was outweighed by a drop in state and local spending. Still, federal government spending is likely to pick up and add to growth in the first quarter, Bethune said. Business spending will likely boost economic growth for several quarters, Bethune said, though not likely enough to make up for sluggish consumer spending. Many companies are upgrading computers, cell phones and machinery as their equipment needs to be replaced just to maintain current levels of production. In addition, many businesses have healthy balance sheets and don't need to pay off the large debts that households are struggling with, Bethune added. For now, the growing economy is benefiting companies up and down the supply chain. Ford Motor Co. this week reported higher fourth-quarter sales and its first annual profit in four years, as it recovers from the devastating downturn the auto industry. Ford's "recent success has benefited us," said Tom Schumann, general manager of EC Kitzel & Sons Inc., a small cutting tool fabricator based in Cleveland, Ohio. The

company, which has 30 employees, bought a new machine tool in December and hired a new worker to run it, the company's first hire since last spring. Still, many of the company's suppliers are struggling. "I'm not totally convinced we're out of the woods yet," Schumann said, referring to the economy. Friday's report is the first of the government's three estimates of gross domestic product and is likely to be revised. The government initially estimated third quarter growth was 3.5 percent, which was later revised down to 2.2 percent. The next estimate will be released Feb. 26. The report provided an upbeat end to an otherwise dismal year: The nation's economy declined 2.4 percent in 2009, the largest drop since 1946. That's the first annual decline since 1991. **(Denver Post)**

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	CURRENT	1 MONTH PRIOR	1 YEAR PRIOR
FED FUNDS RATE	.25	.25	.25
3 MONTH LIBOR	.25	.25	1.17
PRIME RATE	3.25	3.25	3.25
10 YEAR TREASURY	3.63	3.79	2.82
30 YEAR TREASURY	4.51	4.61	3.58