

THE NEW THREE D'S—DISTRUST, DELEVERAGING AND DEFLATION

by James Costello, Jon Southard and Raymond Torto¹

In the fall of 2007 when the financial crisis broke, we wrote a piece which we called “The New Three R’s—Re-trading, Repricing and Recession.” One year later, we’ve titled this current paper: “The New Three D’s—Distrust, Deleveraging and Deflation” as an adverse spiral of events have taken hold in the credit markets. How can we understand what has transpired given the increased complexity of our financial system? How does Congress’ initial rejection of the Emergency Economic Stabilization Act of 2008 (EESA) fit in to our present state?

Written in the middle of the daily unfolding financial and economic drama, this paper has a modest purpose. We hope to help our clients better understand and evaluate where this drama might end—and the implications for their business—by offering insight into how today’s problems developed and providing a context for understanding the present situation.

First, we present a metaphor for how the economy and financial system is integrated and operates together. While many factors contributed to the current mess, we identify some broad trends/truths that we think are integral to the development of this crisis.

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SUMMARY A successful Treasury intervention will clearly not reverse the decline in commercial real estate equity prices. To the extent that liquidity flows again, the prices revealed are likely to include higher cap rates than before the crisis. With this, values are likely to fall. However, any short-term price adjustment should be weighed against a scenario absent government action, which, at best, would be a multi-year period of constrained credit availability.

While the section on the Troubled Asset Relief Program (TARP) within EESA is still only known in broad terms and much definition is needed, we show how the plan might potentially play out from an economist’s viewpoint.

Finally, we present our best thinking on the expected impact on the economy and the leasing and pricing of commercial real estate.

MUCH LIKE THE HUMAN BODY

Metaphorically the economy runs like the human body. We both have our parts—feet (autos), hands (technology), mind (information), etc.—as well as a circulatory system. Without the circulatory system, neither the human body nor the economy can function.

The financial system is the economy’s circulatory system. Like the arteries that carry blood within the human body, the financial system circulates credit that nourishes our economy. For instance, retailers borrow to buy inventory to sell, manufacturers borrow to buy raw materials and other inputs, and families borrow via mortgages to buy homes, or loans to finance cars or higher education. If the circulatory system fails, so does the body, and if the circulatory system is slowing and pressure drops, the human body collapses. In the economy, a slowing or malfunctioning financial system leads to recession or worse. This is precisely what happened

in the Great Depression of the 1930s to which the current crisis is sometimes compared.

Public opinion polls indicate most Americans have greeted this financial crisis with skepticism and/or derision. It is extremely difficult to think of helping financial institutions that either initiated and/or distributed the disease into the global circulatory system. Particularly galling is the knowledge that some individuals made excessive income in the process.

It is also difficult to be sympathetic to these institutions when one sees hard-working neighbors about to lose their homes. It is not surprising then that across the political spectrum, there has been such a negative reaction to the TARP proposal, especially when many people do not see or feel the crisis in their industry or job or household. However, heart disease will kill the body if not addressed.

THE ROLE OF CONFIDENCE

The average American is not the only one who is skeptical and distrustful today. In fact, one of the reasons that economists and policy makers—if not the general public—support EESA is that the very institutions that comprise our financial system do not trust each other. To understand this, let's broadly trace the origins of this crisis.

The word credit is derived from the Latin "to trust." Lenders give funds to borrowers charging an interest fee, and trust that they will be paid back. This crisis started with issues in the housing mortgage market with subprime loans, and escalated when it became clear that these loans were made without regard to whether a borrower could meet his/her obligations. Rather the assumption was that housing prices would always rise and if the borrower couldn't pay, the house would be sold and the lender would be repaid.²

² It was not only bad decision-making but also sometimes fraud as we are discovering.

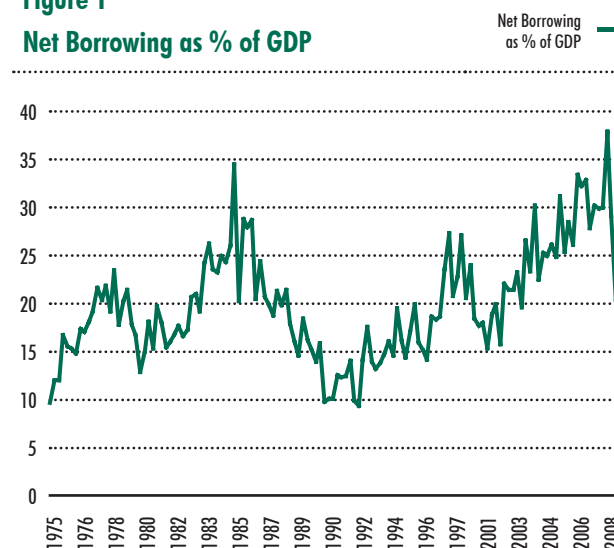
But the original lender didn't hold the loan. Rather he/she packaged and sold it to investors all over the world, which in turn trusted the institutions in the United States, especially when the securities were rated AAA. Recently, the subprime distrust has evolved into counterparty distrust (Bear Stearns) to inter-bank distrust (yawning LIBOR spreads), to money markets distrust ("breaking the buck"), even to distrust that an insurance company can pay on the insurance contract. Each of these has eroded trust in the financial system and the arteries of the circulatory system are clogging...with grave implications for the economic body.

This distrust is a contagion and EESA is attempting to deal not only with the actual flow of credit, but also the lack of confidence in the system. Unfortunately it is only an important first step and not a panacea!

IT'S ALL ABOUT MAIN STREET

Evidence that credit is drying up is reflected in figure 1, which shows that in the second quarter we had the biggest half-year decline in net lending in the last 30+ years. A decline from the excessive borrowings of the last three years is expected and warranted, of course, but this chart shows that we are dropping to levels seen in past recessions—early 2000s, 1990s, and 1980s. It is the implications of this decline in debt activity for our economy that has policy makers so concerned.

Figure 1
Net Borrowing as % of GDP



The severity of the decline in net lending activity (new loans less expiring loans as a percentage of GDP) means that U.S. businesses will find it increasingly difficult to finance their day-to-day activity, buy new equipment and invest in their own futures. As businesses pull back, jobs are lost and these losses impact commercial real estate through less lending activity, reduced investment performance and lower leasing volumes.

The biggest risk we face today is in doing nothing. The issue is not Wall Street, but Main Street. The financial markets are not working and if nothing is done, the economy will not work, either. With so much damage already done, no longer will there be a debate about whether or not we are in recession. There will be a recession with the only question being how deep and how long.

WHY ARE THE FINANCIAL MARKETS NOT WORKING?

Ben Bernanke rhetorically asked in his testimony to Congress: “Why are financial markets not working?” It’s because there are lots of mortgage securities out there with a real fire-sale price and a theoretical hold-to-maturity price. If banks value all those assets at the fire-sale price, they’ll be more or less insolvent. What EESA would try to do would be to establish ‘reasonable hold-to-maturity prices’ for asset-backed securities.”

What does this mean? The financial crisis has two components. First, heavy losses from bad mortgages have hit many lenders that leveraged their balance sheets to the point that they now do not have enough capital to survive the degree of downturn in housing prices. They are out of business and we have seen the list grow. Second, the insolvency problem in some companies has boiled over to a general lack of confidence in financial institutions, which has exacerbated the problem as prices of many asset-backed securities reflect extreme risk premiums.

Prices for mortgage-related paper in today’s market are severely depressed and reflect three key factors: 1) the discounted present value of the loss of asset value; 2) the risk of further loss; and 3) the “panic” discount. It is the “panic” discount—which stems from fears of the effects of financial bankruptcies and lack of confidence—that is causing the paralysis in the financial markets. TARP seeks to eliminate the “panic” discount, helping to bring stability to the financial markets. Until confidence in the system has been restored, trust between lenders and borrowers will remain broken, as will trust in many financial markets. Without the credit circulating, the economy will sputter for as long as it takes to recharge the financial system. In Japan back in the 1990s, the process took at least 10 years.

The goal of TARP is to create liquidity and promote price discovery. Its success will hinge on how well the purchasing process creates asset prices that reflect the markdown from the actual distress, but not the additional markdown related to distrust of the financial institutions’ balance sheets.

HOW WOULD A REVERSE AUCTION WORK?

The proposed purchasing process is a reverse Dutch auction system, which economists regard highly for its ability to arrive upon efficient prices. With few details available, we will reserve judgment on whether the price-setting mechanism will work. Instead, we will look at the distinct scenarios that could emerge, depending on how the price-setting mechanism is executed. There are three possibilities: resulting prices that are low, those that are high, and those that achieve a balance.

Functionally, buyers in a reverse auction invite a large number of potential sellers to make offers in one stage of the auction, and then invite fewer and fewer of those sellers back for new rounds throughout some pre-defined timeframe. In the process a price is discovered for the assets, in this case, asset-backed paper held by the financial institutions. The problem right now is that the prices in the marketplace include the panic discount we

mentioned above, i.e., they are fire sale prices. What is needed to clear the market, unclog the credit arteries, is a hold-to-maturity price.

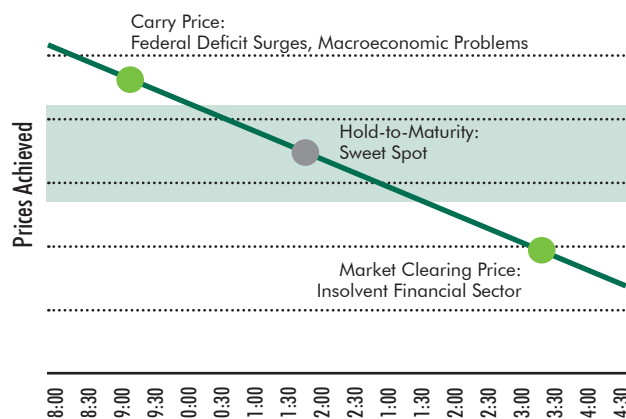
Here is an example. Suppose you bought a 5-year bond for \$1,000 paying \$50 a year in interest. If the next day, the market changed and similar bonds were paying \$100 in interest, your bond has a market value of close to \$810 if you were to sell it.³ An individual can hold this bond to maturity and receive \$50 a year in interest and their principal back at maturity. A financial institution will also receive \$50 per year, but would need to mark the asset to market, i.e., to \$810. This would require them to come up with \$190 in fresh capital to cover the loss.

Institutions that do not have the capital (Lehman Brothers, Washington Mutual, etc.) have gone bankrupt or have been bought by others at distressed prices. Other institutions have the capital, but if they use it to offset their losses, they cannot lend it to businesses and consumers. In turn, the economy stalls and sputters.

TARP will accelerate the clearing process with a reverse auction. It will work if it can eliminate the panic discount in the market and in the process, speed up the pace at which financial institutions come clean with the true asset values they are carrying on their books.⁴

Figure 2 provides a schematic on how prices are achieved in such auctions and the impact these would have on financial institutions and the broader U.S. economy.

Figure 2 - Auction Timeline through Business Day



The goal is to find the sweet spot in the market, or the hold-to-maturity price. If the Treasury achieved this via the auction, holders of the asset-backed paper would pay for their poor investment choices because they will record losses, but they would not be excessively punished by the irrational crisis of confidence in the financial system overall. By removing the additional discount in prices that is being required by “the run on the shadow banking system,” financial companies would be able to put their write-downs behind them and resume lending.

However, if the auction produces prices that are too low, many more financial companies will be faced with insolvency. There would be a series of quick and brutal bankruptcies. The financial system would remain impaired, and financial companies would still be unable to lend.

If the prices are too high, the costs to the Treasury would reach the \$700 billion cap as eventual losses result in markdowns over time. This would have adverse consequences on long-term Treasury rates, the dollar and likely oil prices, too. The good news is that it would likely get borrowing moving again, but only through providing financial institutions with a taxpayer-subsidized windfall. Real estate would be a beneficiary

³ We are rounding for simplicity here. Buying at \$810 gives the buyer the \$50 a year plus the capital gains of \$190 at maturity.

⁴ A key assumption of the plan is that the panic discount is large. It might be that the underlying assets are deteriorating in value and the market has it right and there is no panic element in the pricing. However, we in commercial real estate have seen that some perfectly good income producing assets are being sold at fire price sales. The goal is not to see such fire sales accelerate.

in the short run as, in effect, valuations are supported by the taxpayers. However, the costs weighing down the government would eventually be a drag on the whole economy, including real estate.

One little-mentioned aspect of TARP is that additional financial institution bankruptcies are still expected even if things go according to plan. The difference from the last few weeks is that the “who’s next” atmosphere would dissipate for the institutions still standing, as prices would already have been forced to lower levels.

IMPLICATIONS FOR THE ECONOMY

We see TARP as a plan to assist Main Street, not Wall Street. New regulations, investigations for fraud, restructuring of the financial system—all these will be addressed once the crisis has been quieted.⁵ However, TARP will not stem the expected job losses in the financial services industry and economy in general. Its three successes will be in 1) reducing the number of job losses that otherwise would have occurred; 2) shortening the adjustment period to recovery; and 3) doing away with the adverse feedback loop that currently is threatening to spin out of control.

The U.S. will still face a recession, with a glut of homes on the market, and many option ARM mortgages coming due in the next few years. The spiral of falling home prices, foreclosures, and more falling prices will continue for several more years.

We expect the recession will further hobble the leasing market, but unlike the single family market, there is currently not a glut of excess space in the commercial real estate market and the development pipeline is modest. We will have to watch for sublease space coming into the market, which was a big factor in the deterioration of the 2001 downturn. Overall, the commercial real estate market is in a position to take the forthcoming pain from a position of general strength.

Of course, this statement is not universally true. Some regions are already weak and a recession will cause serious dislocations in some markets.

One final point, the U.S. has been borrowing from foreign governments and investors to finance its government and current account deficits and will need to continue to do so. Hopefully these foreign entities will lend to the U.S. Of concern are reports from China reflecting public dissatisfaction with the Chinese government buying U.S. dollar denominated securities, which pay 3-4% in interest per annum, but are losing 10% in currency value.⁶

The other concern is the severely tarnished reputation of U.S. financial institutions in the eyes of the Asian public. Some Hong Kong investors lost funds on Lehman Brothers Bonds, which were not protected under the rules of the Hong Kong Securities Exchange Commission.

Even with the passage of the EESA and successful price discovery, we expect short-term pain for the commercial real estate market as well as the economy. While we believe that prices on the secondary market for CMBS are destined to rise from their current levels, a successful Treasury intervention will clearly not reverse the decline in commercial real estate equity prices. To the extent that liquidity flows again in the real estate sector, the prices revealed are likely to include higher cap rates in comparison to what they were before the crisis started. With this, values are likely to fall as sellers are forced to accept the new rate reality.

As with the economy as a whole, any short-term price adjustment resulting from TARP should be weighed against a scenario absent government action. Without TARP, the best case scenario would be a multi-year period of constrained credit availability; at worst, we would be threatened by persistent capital shortages that could ignite commercial real estate’s own vicious cycle of less lending and lower prices.

⁵ Of course, sometimes when a crisis is over the energy to tackle the structural issues dissipates. Hopefully this will not be the case.

⁶ We are grateful to our colleague Andrew Ness, Executive Director of Research, Asia, for forwarding material on the Asian reaction.

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