STRATEGAS

# Economic Impact of the Real Estate Crisis:

# Size and Scope of the Current Problems

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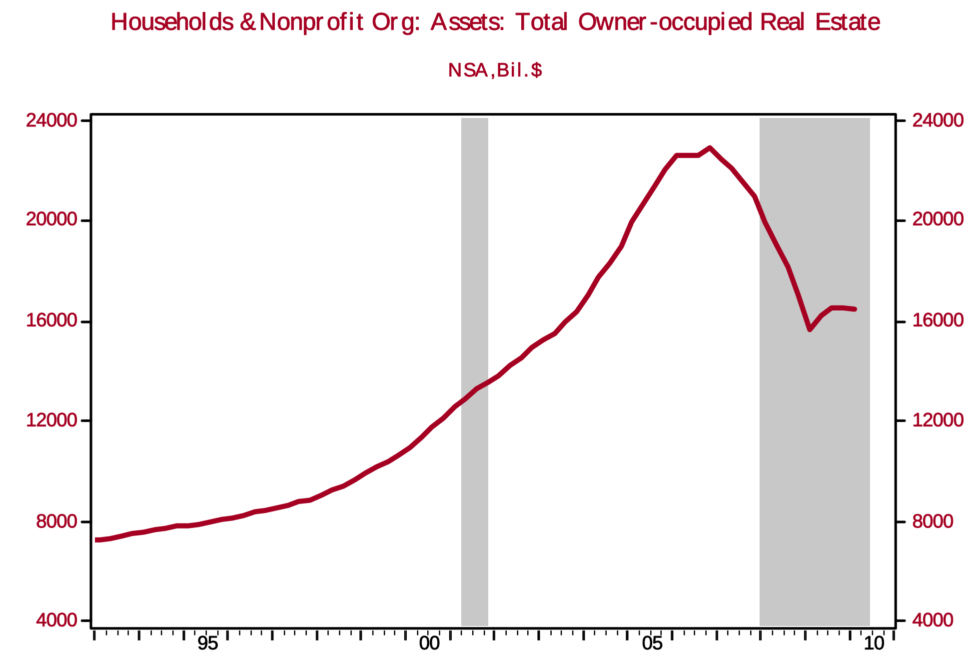
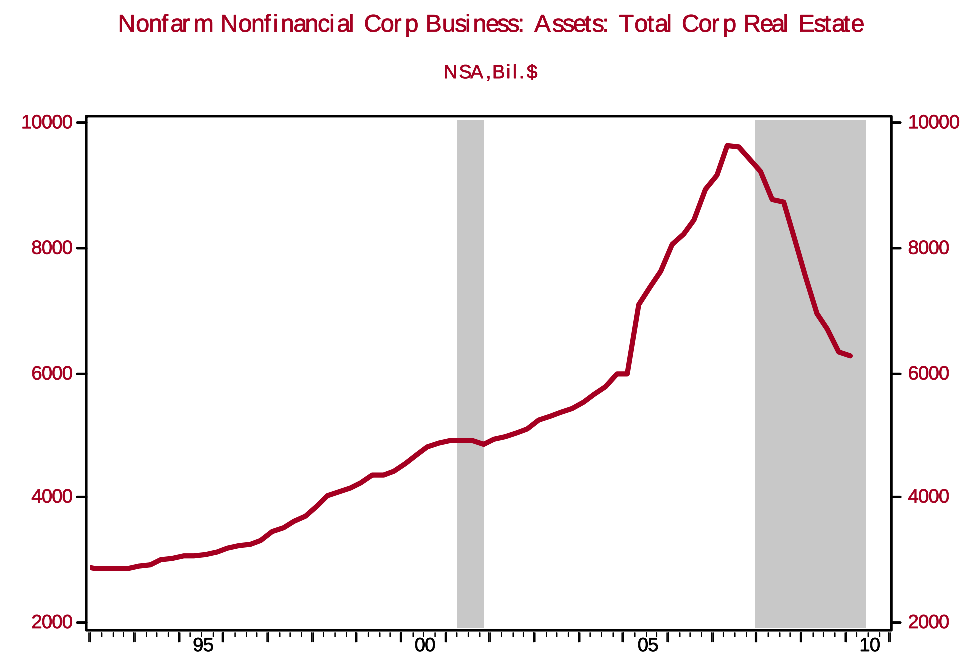
# OVER $30 TRILLION IN RESIDENTIAL & NONRESIDENTIAL REAL ESTATE VALUE IN PLAY

Given how large the real estate issues are, it's not surprising that "cushion the blow" strategies have developed. The issue is that many of these policies, including tax credits and Fed liquidity actions, are temporary by construction.



# *LOCAL BANK* PROBLEMS STILL LIKELY AHEAD, AS THE REAL ESTATE ISSUE HAS NOT BEEN FIXED

# (STILL THE EARLY INNINGS)

## Smaller banks have a disproportionate exposure to CRE

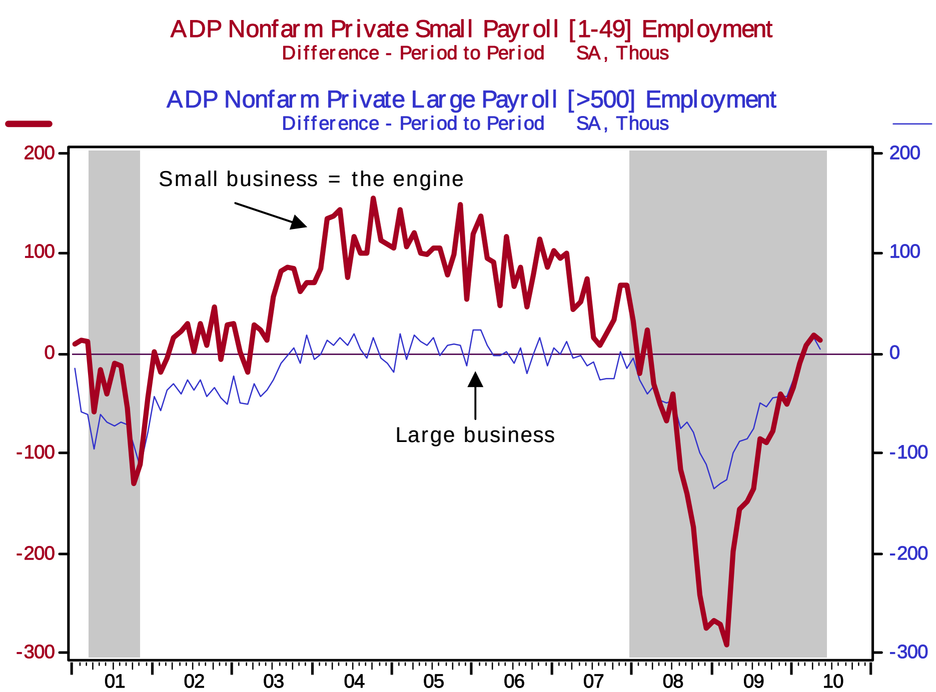
| | Total assets ($bn) | % of Total | CRE exposure ($bn) | % of Total | CRE Loans/ Total Loans |
|---|---|---|---|---|---|
| Global banks | 7,415 | 42% | 331 | 18% | 10.2% |
| Large regional banks | 4,849 | 28% | 260 | 14% | 18.8% |
| Medium sized regional banks | 1,837 | 10% | 272 | 15% | 24.5% |
| Smaller regional and larger community banks | 706 | 4% | 168 | 9% | **33.8%** |
| Community banks | 2,772 | 16% | 787 | 44% | **40.0%** |
| Total | 17,579 | 100% | 1,808 | 100% | 21.9% |

# REAL ESTATE PROBLEM: <u>HOW WE GOT HERE</u>

- **"Fallacy of composition"**: a logical flaw in assuming that rules that apply to individual units necessarily apply to the whole.

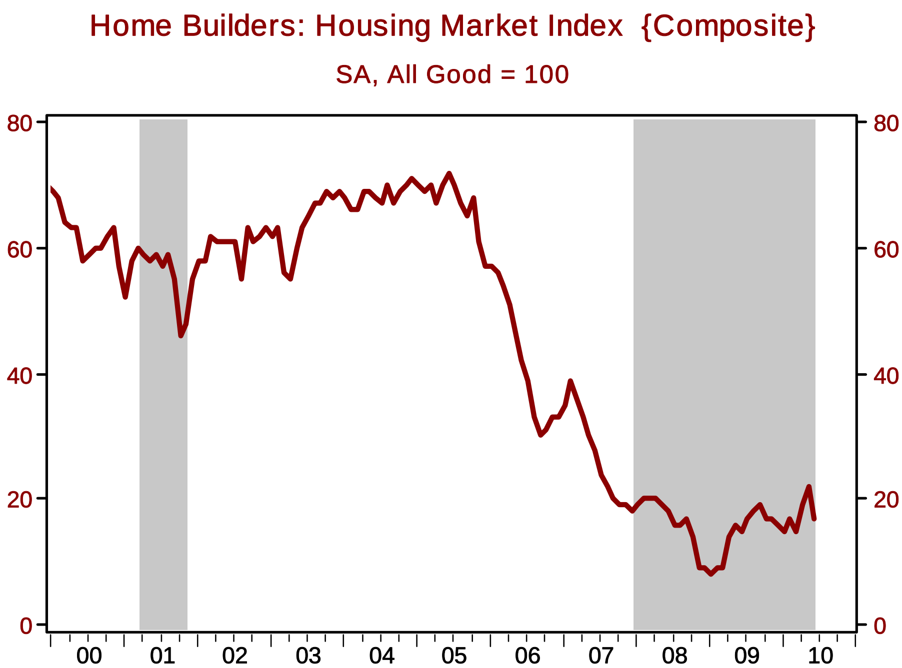
The locomotive for U.S. growth in expansions has been small business job creation. The <u>engine of this locomotive (small business) has been local</u> **<u>real estate credit,</u>** which was:

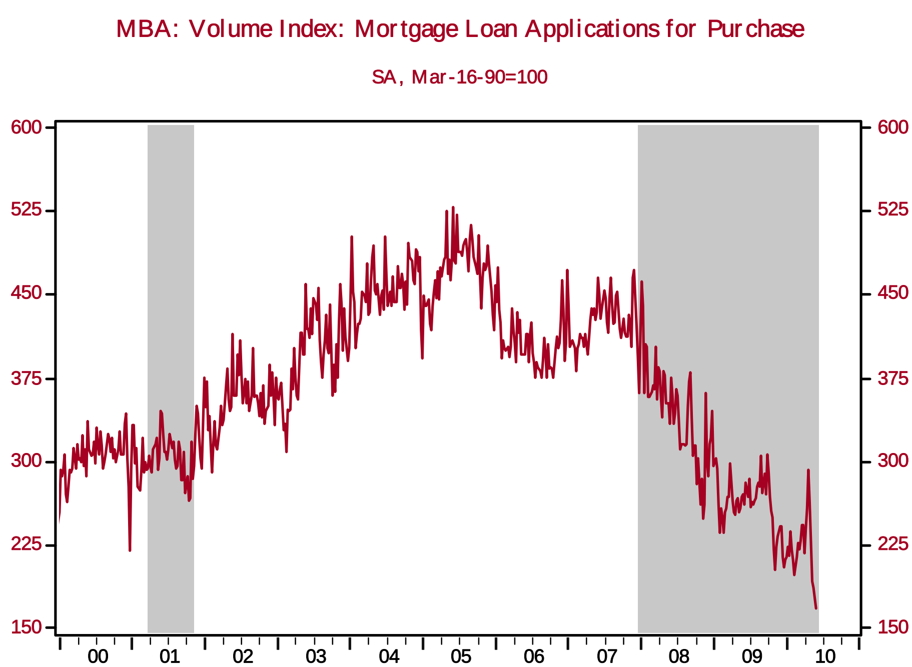
1) **Tax advantaged** – real estate interest was tax deductible;
2) **Legally advantaged** – home mortgage debt was non-recourse;
3) **Price advantaged** – mortgage rates have been low given a glut of global saving;
4) **Politically advantaged** – as the push for homeownership provided cover for, in retrospect, questionable lending.
5) **Innovation advantaged** – Securitization proved profitable for Wall Street.




It was *rational* for consumers and small business owners to move as much credit as they could into their home, as long as they could. **<u>At least it was individually rational – at the end of the day, the worst that could happen was that you would have to mail in the keys to the bank</u>**.

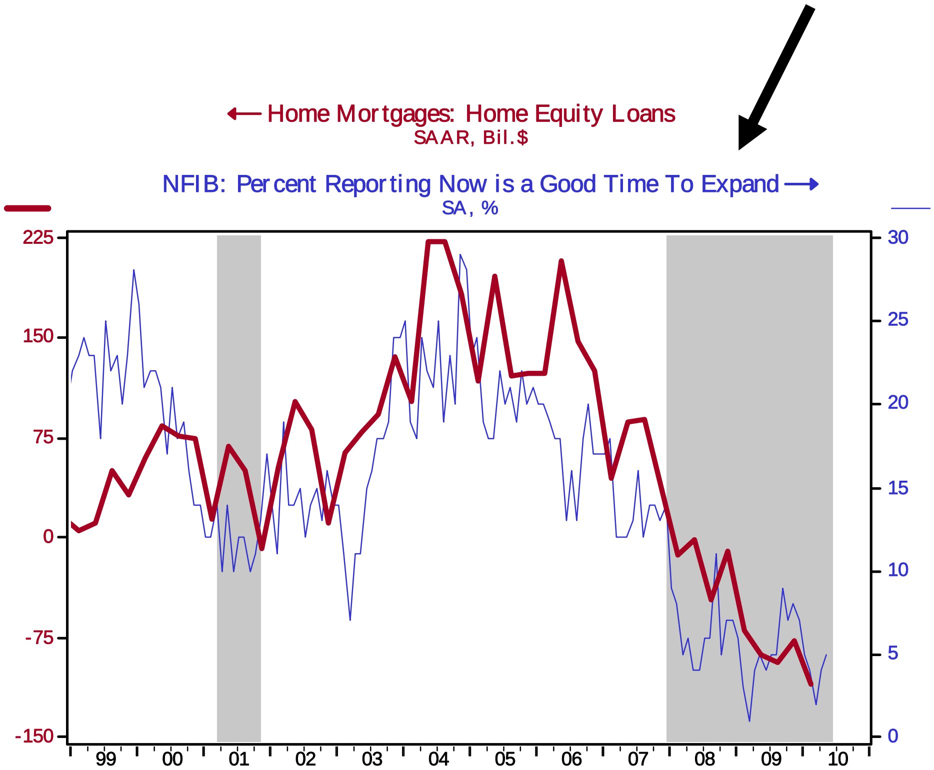
# NAHB INDEX SUGGESTS HOUSING REMAINS IMPAIRED AS THE TAX CREDIT EXPIRES




Housing would likely be forming one of the sharpest "V" bounces of all time, if it weren't for the structural overbuild seen in the past decade. The fade in housing permits and mtg apps for purchase in recent weeks suggests that the floor in housing still remains tentative in 2010, and the National Association of Home Builders (NAHB) index dropped to 17 in June versus 22 in May. **We continue to expect an "L"-shaped bottom in home sales and prices generally.**

# SMALL BUSINESS AND REAL ESTATE CREDIT HAVE BEEN LINKED CLOSELY




Solving the real estate credit problem should now free up more capital for other uses, **<u>including small business lending</u>**.

Early attempts to address the financial crisis included plans that appeared aimed at fixing the core problem of too much debt (eg, TARP). What we've had more success with over time, however, are programs aimed at "cushioning the blow" of the real estate overhang. **<u>The issue is that the core problem of too much debt has not been solved</u>**.

**ATTEMPTS TO "FIX" THE PROBLEM:**

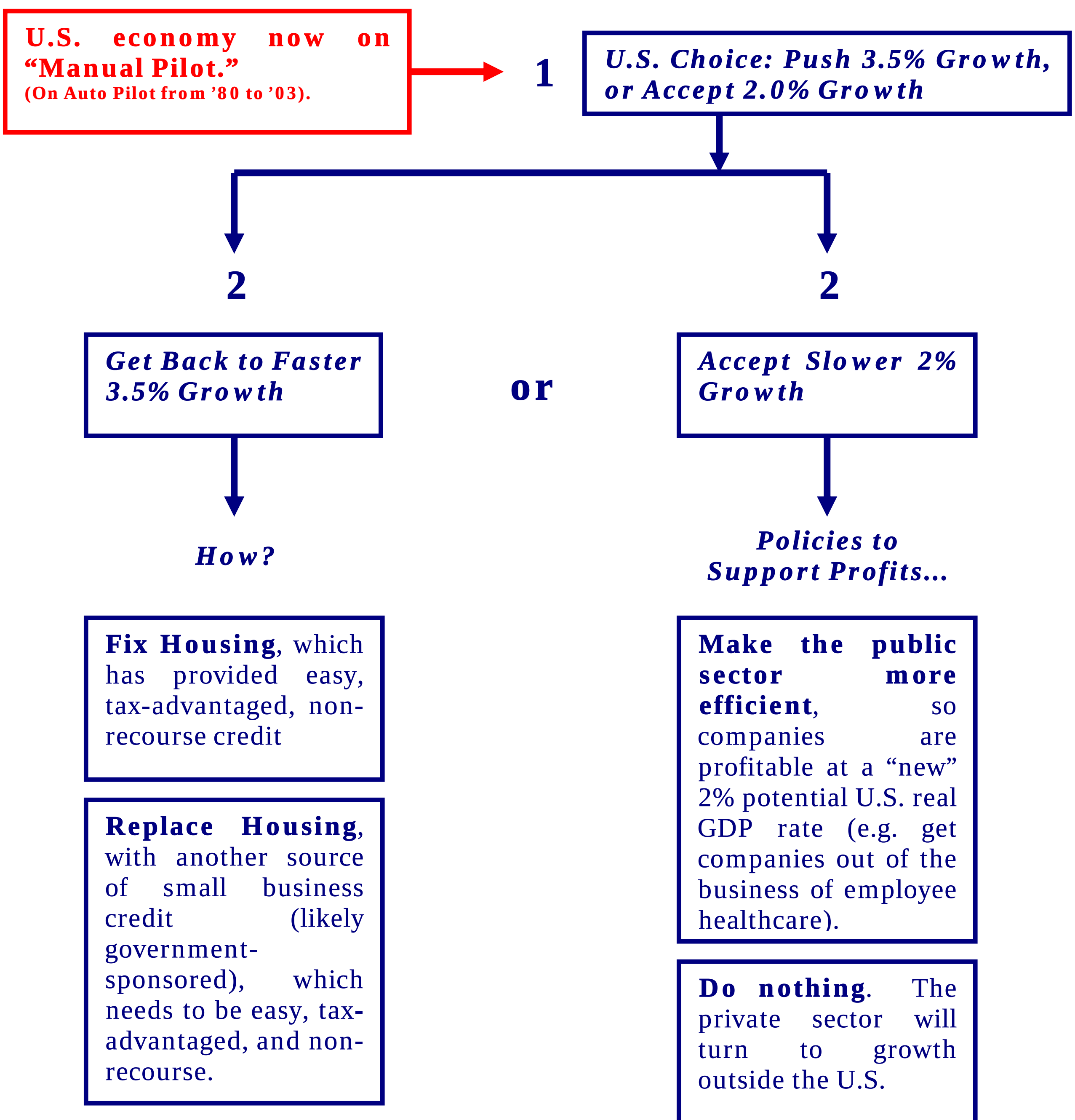
- TARP, Stress Tests & PPIP

**ATTEMPTS TO CUSHION THE BLOW (temporary by construction):**

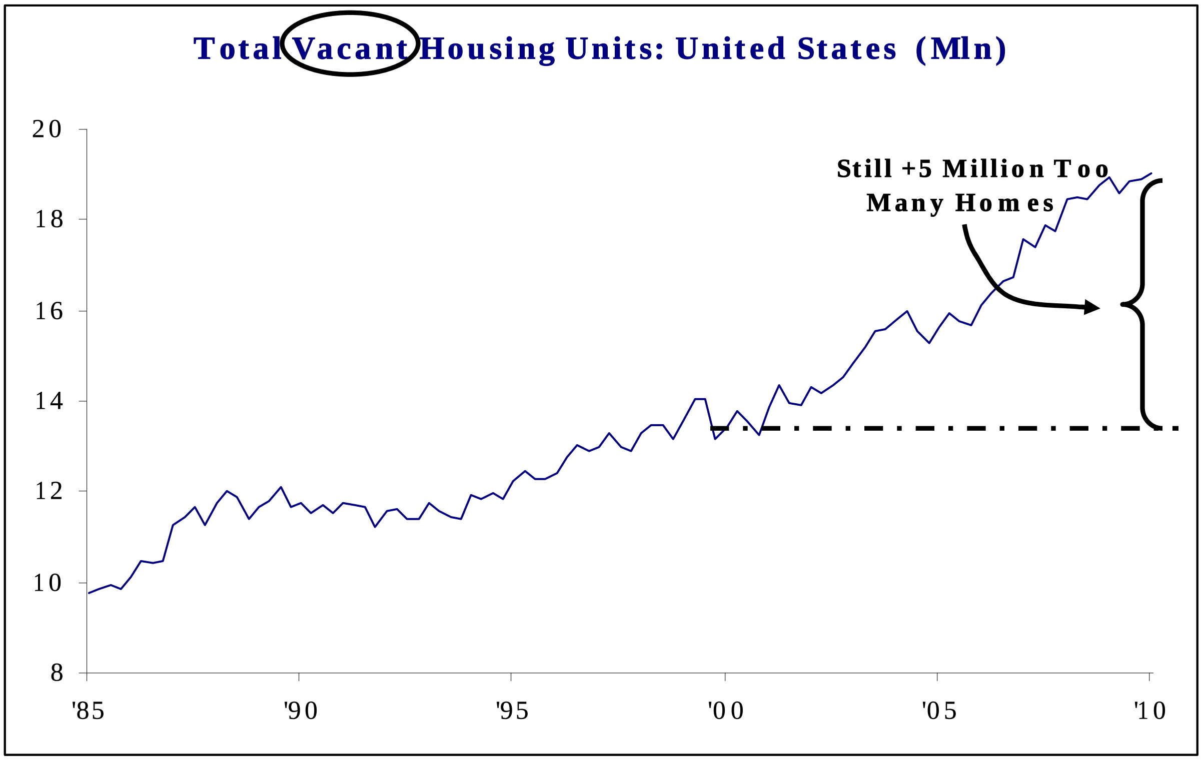
- Tax credit for homeownership
- Foreclosure relief plan
- Balance sheet action to reduce mortgage spreads
- Cash for clunkers
- Cash for appliances
- Cash for caulkers
- FASB Mark to Market Guidance
- FDIC bank takeovers & wind-downs

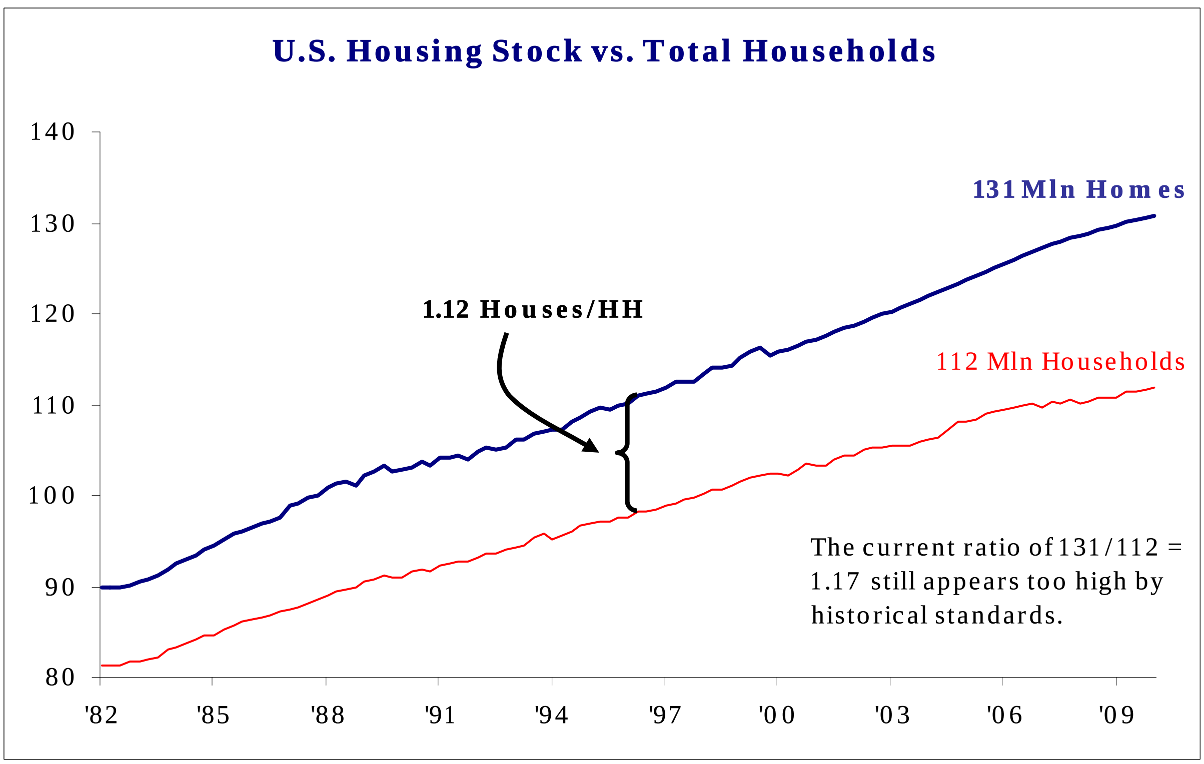
# U.S. ECONOMY NOW ON MANUAL PILOT VERSUS AUTO PILOT OF REFINANCING

While attempts to "cushion the blow" of real estate debt excesses have worked (in the sense that they have allowed a cyclical recovery in manufacturing to play out) we continue to believe that we are seeing a sub-par ("square-root" shaped) recovery, a slower trend for U.S. economic growth (ie, 2% versus 3.5% previously), likely a higher natural rate of U.S. unemployment (7% versus 5.5% previously), and a shorter U.S. business cycle (3-4 years versus 6-10 years in the past several cycles). **We still are lacking the credit creation mechanisms, as debt service burdens remain elevated, that have helped create the longer business cycles of the past several decades**.



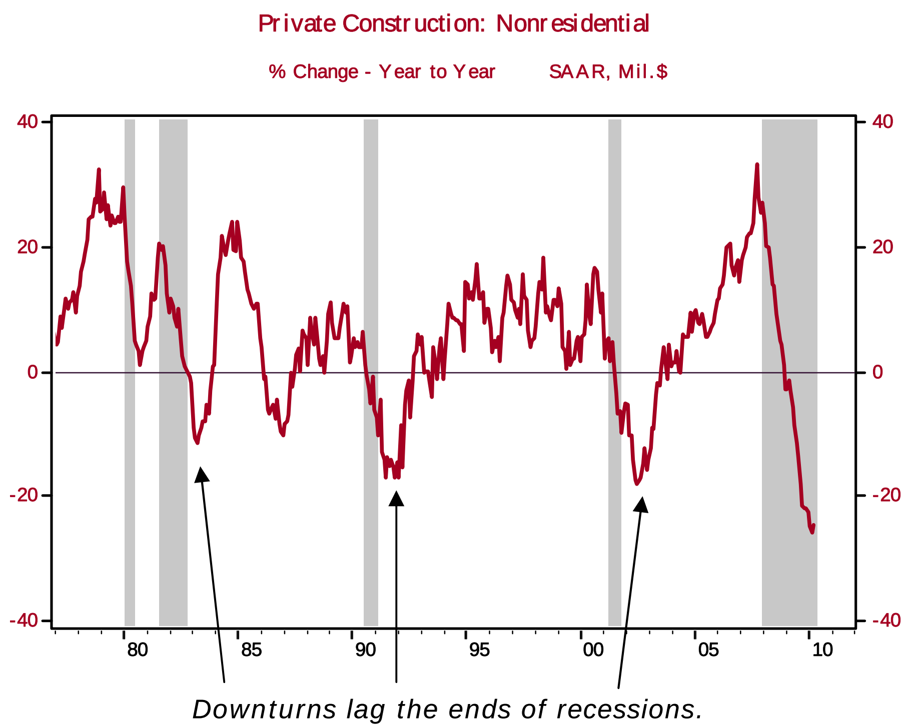
# SIZE OF THE PROBLEM: Residential



# SIZE OF THE PROBLEM: Nonresidential

- Residential real estate is a classic leading indicator, and nonresidential real estate is a classic lagging indicator (ie, nonres weakness *should* still be present, and it is).
- The Fed Beige Book continues to indicate problems around the country in commercial real estate.




"Commercial real estate activity generally remained weak. Office, industrial, and retail vacancy rates continued to drift upward in many Districts putting downward pressure on rents. However, lower rents were said to have led to an increase in leasing activity in New York, Philadelphia, Richmond, Kansas City, Dallas, and San Francisco. The elevated inventory of existing properties for sale or rent continued to weigh on new private nonresidential construction."

*Fed Beige Book*, **6/9/2010**

- Retail, office, and industrial vacancy rates still rising (many over 10%).
- Architectural surveys are recovering some, but remain depressed (eg, the AIA survey data).
- Structural change could potentially be creating further issues – with internet shopping, how many stores do we need?

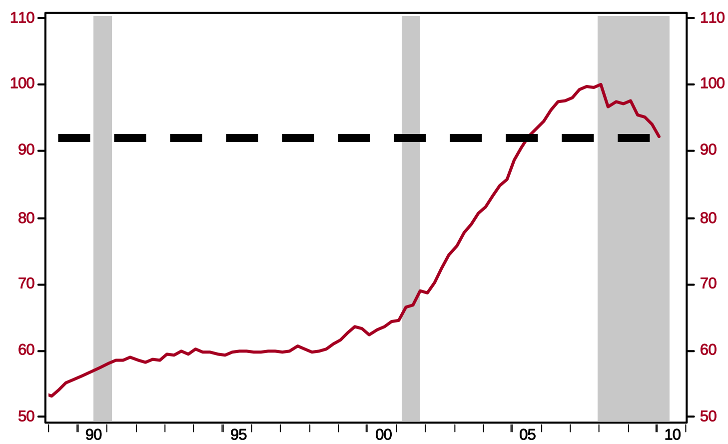
# SECURITIZATION HELPED DRIVE THE OVERBUILDING

Moving debt off financial company balance sheets worked fine as long as consumer balance sheets could expand, and home prices went up. Consumer credit not secured by real estate stands at roughly 22% of income, and has been roughly range-bound over the past decade. Home mortgage credit, however, is still over 92% of disposable income, versus 70% nearly a decade ago – which is *still* a roughly $2.5 trillion gap that has not yet been repaired (U.S. disposable personal income is over $11tr).

**There has still been no significant debt write-down to help solve the elevated mortgage debt problem**. Real estate is still the sector that has been left holding the bag – our incentive structure has left the U.S. economy with too many houses and mortgages.

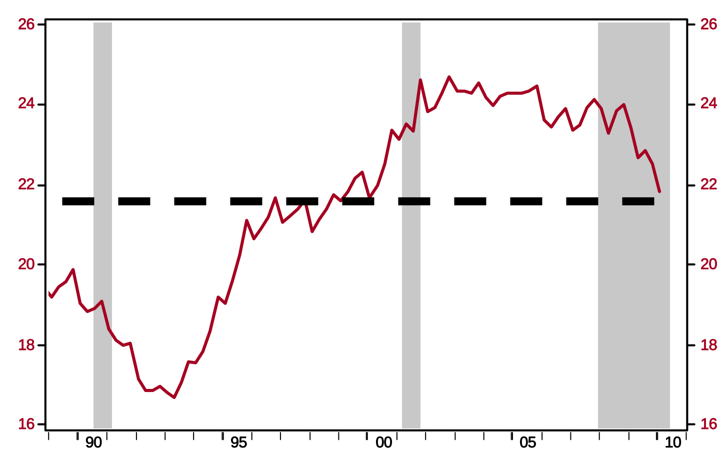
U.S. Mortgage Debt % Disp Personal Income

**Still very elevated …**




U.S. Consumer Credit % Disp Personal Income

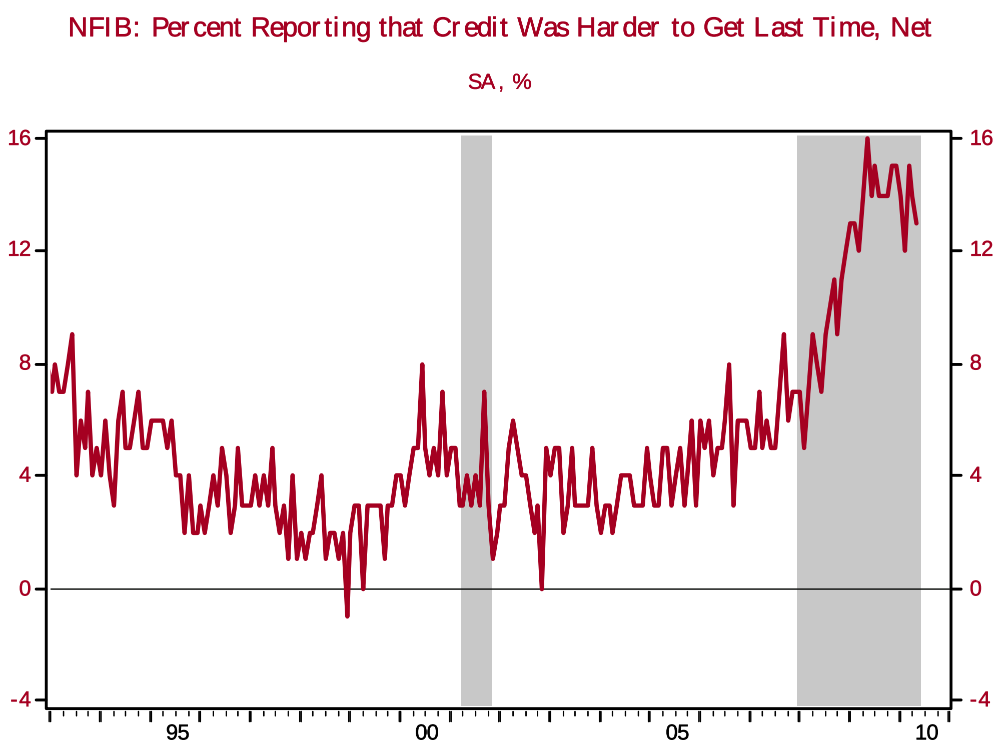
**… vs more mid-range**



## SIZE OF THE REAL ESTATE SOLUTION

- As banks have tightened *real estate* lending standards, *small businesses* have found it harder to get access to credit, since real-estate assets and home equity are often important collateral for these loans.
- The National Federation of Independent Business (NFIB) small business survey, for instance, has continued to show respondents saying credit was harder to get. This has been a restraint on typical business activities – hiring, capital spending, advertising, travel, etc.
- While there have been notable boosts to personal income in 2009/10 because of government transfers, underlying wage & salary income has been restrained.

**Indeed, the fact that the U.S. has needed sizeable tax incentives for housing (an \$8,000 first-time homebuyer credit) and autos (\$4,500 Cash for Clunkers) after the longest recession since the Great Depression[1], suggests that the normal playbook of looking for pent-up demand in consumer and business durables is hardly "working" yet.**




[1] See: www.nber.org/cycles