



## Other Recent Provocative Thoughts

### Provocative Thoughts #13

April 2005 - The financial investment community has recently undergone a profound change of outlook towards real estate. Rather than continuing to regard real properties as a highly speculative and marginal form of wealth, the world's major financial investors have in the past few years shifted to accepting real estate as a separate asset class in which they should keep a significant share of their total assets. This fundamental change of views has had profound impacts upon all real estate markets. It has essentially flooded those markets with tons of investment capital trying to buy good-quality real estate.

Why has this happened? The answer lies in the relative advantages of real estate - including real estate investment trusts (REITs) - in comparison with the major investment alternatives: other stocks, bonds, and cash. Back in the mid to late 1990s, when REITs and other real properties were doing very well in terms of profitable operations, investors ignored them because the surging internet boom made the stock market seem a lot more attractive. But then came the Crash of 2000, and stocks dropped through the floor. In response, the world's central banks lowered interest rates and increased liquidity in order to offset the impact of falling stock prices on sagging economic activity.

These changes made real property seem a lot more attractive, especially because it was not collapsing in price. And bonds were losing appeal because of falling yields as interest rates plunged. In short, real estate was clearly outperforming both stocks and bonds. So capital flooded into real estate markets, both residential and non-residential.

The impacts were two-fold. First, housing prices soared throughout the developed world, as more households rushed to buy homes at low interest rates and low down-payments. Housing production soared too. Second, non-residential markets experienced an atypical disconnect between worsening fundamental conditions in space markets (rising vacancies, falling rents) and strong demands in investment markets (rising prices for well-occupied properties). That drove cap rates to record low levels, partly in keeping with very low interest rates. Now that the recession has ended, space market conditions are improving, but demands by investors to buy well-occupied properties remain extraordinary.

There are several other reasons why real estate has gained so much more favor among investors than in the past. All those reasons have to do with the relative attraction of real property vs. the alternatives. One reason is that investors are heavily influenced by their recent past experiences - even though Wall Street likes to claim investment markets are "purely rational." Hence many investors remain leery of stocks, having been so badly burned from 2000 to 2002. Second, there is an unusually high degree of uncertainty about economic conditions around the world, thanks to terrorism, the Iraq war, North Korea, soaring oil prices, and Iran. This helps keep most stocks moving more sideways than upwards, making them less attractive as alternatives to REIT shares and direct ownership of real properties. Third, the threat of rising interest rates stemming from Federal Reserve policy and federal deficits makes bonds look risky too. And today investing in real properties is easier than ever because of greater transparency and more types of investment vehicles.

Finally, real properties and REIT shares provide larger dividends and cash flows than most other investment vehicles, and current income is becoming increasingly attractive to retiring baby-boomers and the pension funds who must support their retirement. That is one reason the appeal of real property is likely to remain strong.

True, the Federal Reserve has embarked on a policy of raising interest rates as part of its long-term anti-inflationary behavior. But there is still so much capital flowing into real property markets that the Fed's pushing short-term rates up has not had much of a similar impact on long-term real estate borrowing rates.

One implication of this "Niagra of capital" flooding into real property markets is that this is a great time to sell real estate. No one can know the exact moment when any property market hits its peak, but real estate markets are surely close to their peaks today. When investors are clamoring to pay record prices for even hum-drum properties, that is the best time to sell. True, if you own a property that pays terrific returns, and will continue to do so indefinitely, it might be unwise to sell. But if your property is near its peak earning capacity, or needs renovation, or is just run-of-the-mill, this is a terrific time to consider selling it. No, I don't know what you should do with the money you receive; I have no other high-paying alternatives in mind. Perhaps you should just sit on such funds until market conditions change and something else becomes attractive, as will surely happen.

How long will this flood of capital into real estate last? It would slow dramatically if the value of the U.S. dollar dropped sharply, or if some international disruption occurred, such as fundamentalist radicals taking over Saudi Arabia's oil supplies. Then U.S. interest rates would rise suddenly. The capital flood might also slow if true peace "broke out" in the Middle East between Israel and the Palestinians and in Iraq, which might cause uncertainties to fall and stocks to rise again at high speed. And in the long run, the impacts of soaring federal deficits and trade deficits will surely put upward pressure on interest rates.

But right now, real estate markets remain dominated by the huge inflows of financial capital into them looking for properties. So take advantage of these favorable conditions while you can.

### **Provocative Thought #12**

October 2004 - The U.S. economy is in the midst of a general expansion, but it is moderately weak so far. Real Gross Domestic Product grew at an annual rate of 4.5% in the first quarter and 3.3% in the second quarter, and job gains have been below those in previous recoveries. Our economy is being influenced by a major change in the long-run economic climate, plus several foreign developments.

This major change is a shift from continual and prolonged declines in interest rates to a period of rising interest rates. Interest rates were pushed sharply upward in the late 1970s and early 1980s to slow inflation. Freddie Mac's fixed 30-year rate peaked at 16.6% in 1981 and began a long decline to 5.8% in 2003. But the Fed has now decided to reverse this long-run decline and started to push rates up to check inflation. However, rates in money markets have not yet begun to move upward much in response, though I believe they will eventually do so.

Real estate in general has benefitted enormously from falling rates during this 23-year period. The latest result of falling rates has been a flood of financial capital into real estate markets. That capital came three sources: (1) a flight from the stock market after 2000, (2) investors' search for "decent" yields non-real-estate returns fell very low, and (3) the "carry trade" of borrowing at very low rates and re-investing in real estate.

The result of that capital flood was upward pressure on property prices, even though vacancy and rents were deteriorating, especially in office and industrial space. This pressure has lowered capitalization rates and stimulated speculation. But now the situation will change, though probably gradually.

Commercial property prices will stop rising and many will begin declining. I do not expect cap rates will rise as fast as short-term interest rates rise, or even as fast as long-term rates. And negative impacts of higher cap rates will be partly offset by lower vacancy as the economy expands. And because most commercial markets today are dominated by investors with low debt ratios, there will be no massive wave of defaults and bankruptcies as in 1990.

Also, some capital will shift out of real estate into other uses. These include commercial lending as business firms borrow more to finance their prosperity. This shift of capital will gradually diminish the overhang of capital in real property markets. That will also raise cap rates. But right now, there is plenty of debt capital looking for mortgages, so debt spreads on major commercial properties over Treasuries are remaining at low levels.

In housing markets, new construction and sales of existing units will decline and price appreciation will slow down. Fewer households will shift from renting into buying homes. And home mortgage lending will fall sharply. In some condominium markets, recent "bubbles" of soaring prices will collapse. This change in housing is important to retail too because rising wealth in homes has been a key stimulant to retail spending by American households.

Except for the condo "bubbles," these changes in real estate are likely to occur gradually, not in any dramatic collapse of prices or activity. Yet the shift from falling rates to rising rates is a fundamental change in conditions that is not terribly favorable to real estate in general.

The pace of this economic recovery has been slow partly because of uncertainty about global conditions. The war in Iraq and the general rise of terrorism worldwide have created generalized fears that are slowing down the enthusiasm of both investors and entrepreneurial firms for engaging in all-out expansion like that of the mid-1990s. This is clear from both rising oil prices, which spring from uncertainties about the availability of supply, and the lagging performance of the stock market, which has traditionally been a leading indicator of economic expansion.

This uncertainty has benefitted real estate, both as a direct investment and in real estate investment trusts, because real property has been seen as a safer place to put money than stocks in general, and especially high-tech stocks. Real estate stock yields have been much greater than those from most other stocks, and REITs have done better than the other major stock indices since 1999.

The American presidential election is also a source of uncertainty. Neither major candidate is facing up to the emerging problems from large federal deficits, huge future federal spending increases in retirement and medical costs, and defense. President Bush has asked Americans to assume more spending burdens than ever, including more defense, rebuilding Iraq, fighting terrorism, adding prescription drugs to Medicare, and improving education. But the only sacrifice he has asked for to pay for these new burdens is accepting lower taxes - not just right now to counteract a recession, but permanently!!

John Kerry is promising he will spend more to help every group and pay for it solely by taxing the rich more heavily, while easing taxes on everyone else. Neither candidate is talking about huge future federal spending increases that will come from Baby Boomers retiring soon, and how to pay for them.

Even after the election is over, a lot of uncertainty will remain because neither candidate has really shown the electorate what he would do if he wins. However, if the situation in Iraq should become markedly more favorable, that will help reduce American uncertainties about the outlook, and speed growth.

In this election, a lot has been said about the impacts of our losing manufacturing jobs overseas, with Kerry claiming this is very bad for America. Yet the expanded employment in China and India that we have heard condemned have had extremely beneficial impacts upon U.S. real estate markets - both commercial and residential.

U.S. manufacturing has been losing jobs for the past 25 years. Our manufacturing jobs peaked in 1979 at 21.0 million. From then until the end of 2003, total jobs in manufacturing

fell in 16 years and rose in only 8, for a net loss of 7.1 million jobs, or 33.8%, down to 14.3 million. Most of this large job loss came from improved productivity in U.S. factories, but some involved shifts of low-wage jobs overseas.

China's and India's relatively recent entry into the world's industrialized labor force has had enormous impacts upon worldwide wages. There are about 6.4 billion people in the entire world, of whom 1.2 billion are in China and another 1.0 billion in India - or one third of the whole world's population in both combined. If one-fourth of the Chinese and one-fifth of the Indians are in the modern labor force, that is 500 million workers. Among the other 4.2 billion people in the world, about 800 million are in Africa, which is mostly outside the modern global economy. That leaves 3.4 billion world residents excluding China, India, and Africa. If half of those residents are in the modern world labor force, that is 1.7 billion workers, in this very rough calculation.

When China's and India's 500 million workers entered this labor force over the past decade or so, that was a 29 percent increase in the world's whole modern work force - and these newcomers were at relatively low wages.

This giant increase in the world's industrialized labor force has kept world wages down and prevented manufacturing firms from being able to raise prices. In other words, it has been a major force keeping world inflation at very low levels. This is best illustrated by Walmart, the world's largest retail firm. Walmart gets a lot of its merchandise from China, and Walmart has kept American retail prices low.

Low and falling inflation has permitted the central banks in modern nations to generate declining interest rates over the past 22 years. And falling interest rates have been the foundation for a worldwide boom in housing markets in industrialized nations - including the United States. True, we lost 2.7 million manufacturing jobs since 1994, many to China. But since 1994, we also added 1.8 million jobs in construction, 1.1 million in finance, plus 2.2 million in leisure and hospitality and 1.5 million in retail trade - all gainers from low inflation. And commercial real estate has benefitted enormously from low interest rates.

Thus, the impact of low Chinese wages and expanded Chinese manufacturing employment upon world financial conditions through lower inflation has greatly benefitted American households because it increased the values of their homes. And home values are the biggest source of wealth for most American households. True, stock values are larger in total, but they are not as widely distributed as the values of homes. And rising home values have been a key source of purchasing power for American households that they have spent in shopping centers.

In the future, the beneficial impact of China on world economic and monetary conditions will moderate. The Chinese economy has been growing so fast it has begun absorbing large amounts of food and raw materials, putting upward pressure on some world prices, including oil. Even so, the huge Chinese labor force has still not been fully absorbed into the world economy. So its downward pressure on wage rates will continue to be a check on rising inflation. That means we are not likely to get the kind of strong inflationary pressures that pushed interest rates so high in the United States in the late 1970s and early 1980s - at least not for quite a while.

A second major implication of low-wage foreign labor is that we need to improve our performance in educating young people in big city school systems. Our African-Americans and Hispanics are concentrated in those systems, and both are not doing well enough to remain fully competitive in the global high-tech economy. Yet those two groups form large majorities in most big-city school systems and will be key parts of our future labor force. By 2020, our population will grow by about 30 million. Over 80 percent of our future labor-force growth will consist of ethnic minority members. We cannot afford not to have this large fraction of our future workers getting properly educated. This may require encouraging movement of many more such Americans into suburbs for better schools.

**Provocative Thought #11**

January 2004 - When the stock market internet and telecommunications "bubble" burst in early 2000, a radical realignment of investor opinions about what types of assets were the most desirable occurred within a relatively short period. Stocks in general were devalued in the eyes of both institutional and individual investors as share prices plunged. In contrast, the relative attraction of owning real estate in any one of several forms soared. Those forms of ownership included direct equity investments, REIT shares, and commercial mortgage backed securities. Investors quickly switched a lot of the current cash flows they have available for investment from stocks in general to one or more of these forms of real estate.

This change of relative desirability ironically occurred precisely at the moment when real estate space markets themselves were sharply deteriorating in profitability and accelerating in riskiness. The collapse of internet and telecommunications firms caused a severe shrinkage in the demand for space in many office and research and development markets. That was especially true in regions that had specialized in those industries, such as Silicon Valley, San Francisco, Boston, Seattle, and Austin. Vacancies soared in those regions and rents declined sharply. Yet those conditions did not dent the rising popularity of real estate investments - at least not in properties that had low vacancies and leases not likely to turn over in the near future.

Another result was a remarkable rise in the share values of REIT stocks. The National Association of Real Estate Investment Trusts (NAREIT) index rose over 100 percent from early 2000 to late 2003 - a marked contrast to the immense declines that occurred in the other major indices from 2000 to early 2003. Similarly, the market values of low-vacancy properties actually rose because of intense bidding from investors trying to shift money out of the stock and bond markets - even though rents in general were falling and vacancies rising. These paradoxical results reflected the flight of investment capital out of stocks in general and into what seemed a much better and safer asset class - commercial real estate.

But as the American economy in general began to recover in 2003, general stock values started moving upward again. As of December 2003, they had by no means recovered their peaks in 1999 and early 2000, but they had risen sharply. This raises the question of whether a lot of the money that investors had put into commercial real estate since 2000 through fear of other stocks would now pull out of real estate and move back into the general stock market. If that happened at a large scale, prices of REIT shares and individual properties might decline notably.

I believe investor interest in low-vacancy, good quality properties will remain high enough to maintain current price levels, at least through most of 2004. For one thing, there is already a huge amount of capital in investment funds committed to buy such properties that has not yet been expended because sensible acquisition has been so difficult. This capital will continue propping up property prices for quite a while. Also, interest rates will not rise as fast as many people believe, in spite of spreading general prosperity, unless there is a massive decline in the value of the U.S. dollar. If interest rates remain low, real estate will still look attractive and existing owners will not be squeezed between rising rates and low cash flows enough to accept much lower prices. Another factor is that many investors need high current income, either for their pension fund accounts or just because they are retiring individuals who need income, and real estate provides much better current income than almost all alternative stocks. Finally, the sheer volume of money looking for someplace to go will remain high.

REIT share prices are more vulnerable to at least some downward adjustments in the near future. They are much more liquid than the investment funds dedicated to real estate, so their current owners can move out of them more rapidly. Also, it is unlikely that most REIT shares can maintain the rapid appreciation in value they have experienced over the past three years; hence the total returns from owning them will surely be lower in 2004 than in the recent past. In contrast, the total return from owning most other stocks may improve in 2004 - certainly over the period 2000 through 2002, and perhaps even over 2003. Even so, REIT shares as a whole will still pay higher dividends than most other stocks, so investors focused on current income will maintain a lot of ownership interest in REITs. So it is unlikely that any massive decline in REIT share prices will occur like that which plagued most other shares from 2000 through 2002.

**Provocative Thought #10**

June 2003 - Since September 11, Americans have discovered they can get along without many activities they formerly carried out regularly. The most obvious is air travel, especially abroad and on vacations, but also for business. Related to that is patronizing hotels and resorts instead of spending vacation and leisure times close to home. This discovery was initially inspired by fear of terrorism, but has since become motivated by other factors too.

The result has been an economically devastating slump in air travel and hotel and resort bookings, both here and abroad. Even local restaurants and theaters have suffered. That slump has been aggravated by the worldwide economic slowdown since 2000. Recently, these industries have been further depressed by the SARS epidemic in Asia, especially in Hong Kong and China, and by war in the Middle East.

On the other hand, businesses that cater to home and family activities have been booming. Home furnishings, gardening, outdoor recreation, home entertainment systems, appliances, and even cooking programs on television are doing well. People are "nesting": focusing on their close-to-home lives rather than on other uses of disposable incomes. That is one reason why home sales have soared - also aided by low interest rates and a flight of capital from the stock market. This new focus on one's personal life also helps explain why so many hotels and resorts have opened health, beauty, and fitness spas to attract new business in this environment.

When the U.S. economy starts recovering strongly, airlines, travel businesses, meeting planners, and hotels and resorts are hoping their usual activities will return to something like pre-9-11 levels. But I seriously doubt this will happen. The truth is that Americans previously were preoccupied with activities that are in reality easily dispensed with. Vacation travel to exotic destinations is the most obvious example. After all, there are plenty of interesting places to visit within the United States, and many can be reached by car at less expense than by air. In the same way, foreign tourists can just as easily stay in their own countries as visit America. Tourism is the single largest industry in the world; so when it suffers a major decline, economies the world over are hurt. Some regions like Hawaii and the Caribbean are heavily dependent on tourism, and thus especially vulnerable. This is one way in which terrorism has already seriously injured myriad economies all over the world.

Lots of other "normal" activities are also dispensable. Many business trips can be replaced by phone calls, e-mails, or video conferences. Whole industries are dominated by the sale of goods and services that can hardly be considered necessities. A lot of goods, gadgets, fashion items, and trinkets that people buy during periods of prosperity can easily be done without. People can also hold onto their existing cars, clothes, computers, televisions, and appliances a little longer than they have in the past, thereby reducing annual sales levels in those industries. Billions of dollars are spent each year in advertising aimed at persuading people they ought to buy something new right now that they could easily postpone indefinitely, or just forget about.

As a result, the world economy is vulnerable to prolonged slumps in specific activities that are highly dispensable. Moreover, once people have discovered that they can do without certain activities, there is a strong chance that many will not resume the former levels of spending, even when prosperity returns. I believe that is the situation facing airlines and the hospitality business, and many producers of luxury goods and services. Hence investors contemplating putting money into those businesses should be extremely cautious. They surely do not want to become additional victims of the huge negative impact that terrorism has already had on the world's prosperity.

### **Provocative Thought #9**

December 2002 - 2002 was not a bad year from the viewpoint of real gross domestic product (GDP) growth, since that indicator of overall economic performance increased by more than three percent. That is not far off the average gain from 1992 through 2002 of 3.3 percent. Yet most Americans felt very bad about our economy in 2002 for at least five reasons - several of which will continue to affect us in 2003.

First, the stock market took another nose dive. From the start of 2002 until Nov. 27, the NASDAQ composite index was down 25 percent, in spite of a recent rally. The S & P 500 fell 19 percent in that same period. Millions of owners of stock thus suffered large equity losses.

Second, job formation was very weak. Unemployment rose to 6 percent in April and again in November, and total job growth was less than one-half of one percent – compared to an average of 1.7 percent from 1992 through 2000.

Third, certain key sectors of the economy were in the tank economically. These include the airlines, hotels and resorts, the telecom and internet industries, and state governments – which are suffering from enormous fiscal deficits. Fourth, commercial real estate markets deteriorated greatly and are experiencing a true recession, even though the overall economy is not. Office and industrial vacancy rates shot upward because of an unprecedented withdrawal of demands for space, plus huge surpluses in sub-leasing and rented-but-not-used space. Rents fell, but property values for well-occupied buildings and for most real estate investment trust shares were held up by strong demands from investors fleeing out of stocks.

Finally, there was – and still is – a tremendous amount of general uncertainty and insecurity because of the war on terrorism in general, and the possibility of war in Iraq in particular. The resulting malaise was intensified by the episode of the Washington-area snipers, who showed that any part of the nation could easily be terrified and upset for weeks by just two renegades.

As we look ahead into 2003, several of these factors will continue to make many Americans feel bad, but others probably will not. We hope the stock market has bottomed out and therefore will not take another nosedive – though no one can be certain. The heavily depressed sectors are likely to stay depressed, unfortunately, and job growth will probably be low again too. Commercial property markets are not going to get much better, but perhaps they will not get much worse either. Uncertainty caused by terrorism and Iraq are still with us as 2003 begins, and surely the former type will remain even if war either is accomplished or becomes less likely. So we will probably feel slightly better in 2003 than in 2002 – but not a whole lot better – even if real GDP again grows in the three percent range, which seems likely.

### **Provocative Thought #8**

August 2002 - After stock prices in general plunged in the Fall of 1998, the technology and telecom sectors led most stocks back upward in the spectacular bubble year of 1999. But Real Estate Investment Trust (REIT) shares, which had done well prior to 1998, went nowhere as capital poured into more speculative, "hot" growth sectors. From Fall 1998 through mid-January 2000, the Dow-Jones Industrial average soared over 55 percent to a high of 11,722. And the NASDAQ Composite index went from about 1,500 in September 1999 to 5,000 in early 2000 – a gain of 233 percent! During about the same period, the National Association of Real Estate Investment Trusts (NAREIT) Equity REIT Index declined about 12 percent.

But in 2000, these trends reversed themselves. The Dow-Jones Industrial average began a steep but highly volatile decline to its level at the end of July 2002 of about 8,500 – an overall fall of 27.5 percent from its high in January 2000. The NASDAQ Composite index fell even more spectacularly from 5,000 to 1,280 – a collapse of 74 percent! Yet the NAREIT Equity REIT index climbed steadily to a peak of 3,889 at the end of June 2002 – a rise of 77 percent. Then the NAREIT index suddenly plunged 17 percent in July 2002, but it bounced back up again at the same time that the Dow-Jones Industrial index and the NASDAQ Composite were continuing to fall.

What was causing REIT shares to move in the opposite direction from broader stock prices? Why were REIT share prices rising precisely when the economy was slowing down and conditions in real estate space markets were deteriorating? The basic answer is that investment capital was fleeing from corporate activities into real estate, which had two fundamental advantages over other types of stocks – especially high-tech and internet stocks. First, real properties that were well occupied enjoyed steady cash flows much more immune to cyclically collapsing earnings than many corporate activities. Unlike the developers who owned commercial real estate in the late 1980s, REITs were not heavily leveraged with debt. So they could stand considerable cuts in their cash incomes without jeopardizing their solvency, or even restricting their ability to pay significant dividends. Those dividends were the second big advantage REITs had over other types of stocks that were paying almost no income to their owners. When the appreciation advantages of owning

those miniscule-dividend-paying stocks disappeared and became negative, the dividends from REITs began to look awfully good – even if REIT share prices did not rise much.

Pension funds were especially attracted to REITs because their heavy losses on other stocks were forcing their overall yields below their yield target rates. That meant they might have to start siphoning off reportable earnings from their parent companies to fund pension liabilities, instead of adding to corporate profits from investment yields above those target rates, as in the late 1990s. Pension funds were desperate to get yields from somewhere, and REIT dividends looked like a good source. So they poured capital into REIT shares, raising their overall allocations in real estate to do so. They could also rationalize that allocation shift because placing more capital into real estate conformed to modern portfolio theory's praise of diversification to reduce overall risk.

The Big Question now is: what effect will the apparently slower-than-expected economic recovery in 2002 revealed by the latest Gross Domestic Product statistics have upon these capital flows? Clearly, the news of that slowdown initially depressed stock prices generally, judging from the events of July 2002. Even REIT shares plunged in price in July 2002.

REIT share prices are being affected by several conflicting forces. On the positive side, pension funds need yields more than ever as the stock market in general continues to slide. If the economic recovery is slow enough to restrict gains in corporate earnings generally, stocks will have a hard time rising much soon. That will keep pension funds interested in REIT dividends as a source of yields, even if the capital values of REITs do not appreciate much, if any. Another positive factor is that more and more retiring citizens, hurt by stock declines, also need cash dividends to support themselves. Hence individuals too will be attracted to REITs, which are still paying over 6 percent in most cases.

On the negative side, conditions in space markets will get even worse if the economy in general recovers very slowly, and business in general stays weak. That will increase vacancies, put downward pressure on rents, and reduce REIT cash flows. Some REITs may have to reduce their dividends, thereby weakening their greatest attraction to investors. Yet most REITs will still be able to keep their dividend yields far above those of most alternatives – thereby retaining some of their attraction for both pension funds and retired or retiring individuals. And for once, real estate in general seems likely to do better in this recession than most corporations.

My guess is that the recent shift of capital into REITs from other types of stocks by both institutional and individual investors represents a significant long-range change as well as a bigger short-range one. True, if the general stock market should start a rapid rise in prices, a lot of capital now parked in REITs will move elsewhere. But even then, some investors will stick with real estate because of its high dividends and its diversification in relation to stocks in general. And such a general economic recovery will improve conditions in space markets too, though that will take a while. So REIT shares are still going to look good to a lot of investors until the economy and the stock market in general do a whole lot better than seems likely in the near future.

### **Provocative Thought #7**

April 2002 - In spring 2002, U.S. commercial office, industrial, and research property markets are experiencing paradoxical conditions. The balance of supply and demand for space is extremely unfavorable. Especially in high-tech markets like Silicon Valley, vacancy rates have soared to 15 percent or more in early 2002. Few leases are being signed because almost no firms need more space, and thousands that need less are flooding markets with sublease space. Yet for properties fully leased at good rents, market demand has been strong and property prices rising. The stock prices of real estate investment trusts (REITs) have also been driven upward while the rest of the stock market stagnated.

The main reason for this paradox is that investment yields have recently been so low on stocks and bonds. Therefore, the steady positive yields on real properties that are well occupied or on well-run REITs look very attractive to yield-hungry investors. So they have shifted a lot of money from stocks and bonds into commercial real estate, which often produces yields of 8 to 9 percent. This has stabilized or raised prices on many well-occupied properties in spite of adverse conditions in space markets.

This paradoxical situation only applies to properties well enough occupied to produce steady net incomes, not those with high vacancy rates. This situation is occurring within property markets experiencing unusually low levels of both leasing and sales transactions. Leasing activity is low because so few firms want additional space. Some sales are occurring, but many fewer than in a normally sound market. Buyers are deterred from making offers because of uncertainty about the true value of properties in a market where few leasing transactions establish likely future rent levels. Property owners are deterred from selling by similar uncertainty, and by the fact that many are large corporations that own commercial properties they have been using themselves. Also, institutional owners like pension funds have been reluctant to sell because they don't know what they would do with the money.

How long will this paradoxical situation last? One way it could end is by the return of strong general prosperity. Yet vacancy rates are now high enough so that even expanding space demand will not create much upward pressure on rents and prices for at least two years, and perhaps longer. This means entrepreneurial owners of older, relatively obsolete buildings with strong occupancy and yields should consider selling them now, before a return of general prosperity sucks yield-hungry money back into stocks and bonds.

### **Provocative Thought #6**

January 2002 - Many economists are predicting that the U.S. economy will start into the next expansion by the third quarter of 2002 at the latest, and that real gross domestic product will be growing smartly by the end of 2002. Even if these predictions come true, I do not believe commercial real estate will move out of the current OVERBUILT PHASE of its three-phase real estate cycle until past the end of 2002. I believe the real estate cycle ended its preceding DEVELOPMENT BOOM PHASE, which began in early 1997, in about mid-2000, when it then entered the current OVERBUILT PHASE. But the typical OVERBUILT PHASE lasts until well after the general economy has begun expanding upwards from the bottom of a recession. Though such a general expansion raises demands for space, at first there is enough available supply left over from the preceding DEVELOPMENT BOOM so that rents do not rise enough to justify new development. This is the third or GRADUAL ABSORPTION PHASE of the real estate cycle. During this phase, rents rise and vacancies decline as the general economy grows, but little new construction begins. Eventually, rents rise high enough, and vacancies fall low enough, so developers start building new projects again in the next DEVELOPMENT BOOM PHASE. But that will certainly not occur in 2002 and probably not in 2003 either. True, the current OVERBUILT PHASE will not be nearly as long or as difficult as the one from 1990 through 1993, because existing space surpluses are much smaller than those in the early 1990s. But 2002 is sure to be a year of coping with rising vacancies and downward pressure on rents and property prices, at least in most office, industrial, and retail markets.

### **Provocative Thought #5**

September 2001 - In the Housing Act of 1949, Congress established a national goal of "Providing a decent home and a suitable living environment for every American family." However, this has never been a realistic goal. Throughout American history, millions of poor households – particularly recent immigrants from abroad – have lived in overcrowded and often deteriorated slums because they could not afford "decent" dwelling units, as defined by prevailing middle-class quality standards. Congress has never provided the financial means of achieving that goal for all poor American families who cannot afford to achieve it on their own, since doing so would be very expensive to middle-class taxpayers. This is just as true today as it was in the late 19th Century or the early 20th Century. We depend upon overcrowding to shelter millions of our low-wage workers and their families, whose efforts are vital to the operation of our economy. We will not permit anyone to build units small and simple enough to house them without crowding because nearby homeowners think such units would devalue their own homes, which are their major assets. In order to protect their interests, we condemn the poorest households to live in overcrowded and often deteriorated dwellings. Recent influxes of many poor immigrants from Latin America, combined with soaring housing prices – especially in California – have greatly expanded our reliance upon such slum housing. Yet resistance to building even "decent" multi-family housing for low-income households is intensifying everywhere, thanks to NIMBYism and increased dominance of local policies by parochial homeowners. Let's face it: maintaining slums is an unspoken but crucial part of American housing policy likely to expand even more in importance in the near future. It is the price we compel our poorest households to pay to

allow middle- and upper-income homeowners to gain significant increases in wealth from rising home values.

#### **Provocative Thought #4**

Many suburbs use "fiscal zoning" to decide what types of housing they will allow within their boundaries. If a certain type of housing does not produce more in local taxes than it costs the city government in local spending - including schools - the community designs building codes and zoning rules that keep that type of housing out. Since low-cost housing and multi-family housing are such "fiscal losers," this approach prohibits such units. But the affluent residents in that community need the workers who can only afford such housing to mow their lawns, run their cleaners and laundries, staff their hospitals, even run their police and fire departments and teach in their schools. Yet if every suburb adopts such "fiscal zoning," there will be no place for those low-and-middle-wage workers to live - except doubled up in illegally overcrowded units. That is why every community should be legally required by its state legislature to permit a certain fraction of its housing to be low-cost and multi-family units. And every consultant who does a "fiscal impact" study of proposed new housing ought to point out to the city concerned that excluding all residential "fiscal losers" is an irresponsible and unfair policy.

#### **Provocative Thought # 3**

Stocks of Real Estate Investment Trusts did poorly when the high-tech sector was booming even though real estate markets themselves were strong. That happened because REIT stocks seemed to offer far lower potential returns than high-tech stocks. When stocks of much of the high-tech sector tanked at least temporarily, REIT shares did much better because real estate markets have remained strong. So REITs looked better relatively. That improved REIT performance will probably last as long as (1) real estate markets remain strong, which they will in 2001 though market prices and rents will soften somewhat, and (2) high-tech stocks do not stage another spectacular rally, which seems unlikely for at least a while.

#### **Provocative Thought # 2**

Many people claim we are now in the "information age," so old-fashioned activities like agriculture and manufacturing do not matter much anymore. Nonsense. The information age wouldn't survive for a minute without an immense amount of manufactured equipment, and eating is still a nice idea. True, those sectors are not growing as rapidly as the information sector, but innovations in the older sectors still present great economic opportunities.

#### **Provocative Thought # 1**

"Smart Growth" is a code word for whatever the user of this term wants to achieve concerning metropolitan development. Yet different users of the term have totally different goals, so "smart growth" can mean almost anything. In spite of its diverse and often conflicting meanings, all parties superficially endorse "smart growth" because it is clearly superior to the alternative: "dumb growth."

