Making Sense of the Current **Capital Markets Disarray**

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Making Sense of the Current **Capital Markets Disarray**

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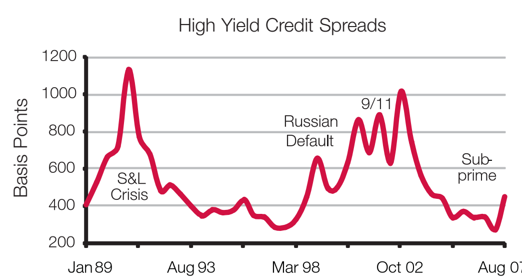
What is occurring today in global capital markets is the combination of two fundamental problems. The first is that most assets are long-term in nature, while most available capital is short-term. As a result, there is a fundamental bias toward asset-liability mismatches. As long as people believe in the rising values and liquidity of long-term assets, this is not a problem. However, when people lose faith this mismatch is exposed, causing short-term illiquidity and asset prices to tumble.

The second problem is that in the eternal struggle between fear and greed or pessimism and optimism, fear occasionally wins. Through March 2007, greed was winning hands down. It was one of the greatest victories of greed over fear, not just in real estate, but in almost every investment category. Credit spreads were very thin, the stock market was booming and pricey buy-outs were everywhere. Although an undercurrent of fear grew as each new height was achieved, optimism abounded and capital providers focused on the good things that could happen. Six months later, fear is routing greed. This has triggered a flight from risk, leaving mismatched investors drowning in a sea of losses.

It is fair to say it all started with sub-prime residential loans, which experienced egregiously poor underwriting from 2005-2006, fueled by capital sources with mismatched portfolios. Households who would have never qualified for a mortgage got one, with little money down and with minimal credit spreads. This generated a great wealth transfer from sub-prime lenders to the borrowers. The good news is that roughly 70% of sub-prime borrowers locked in their transfers via fixed-rate mortgages. But 30% did not.

For a while, most sub-prime lenders passed the hot potato before the poor underwriting came to light. They were aided and abetted by ratings agencies that did not understand what they were underwriting, and whose ignorance was salved by rating fees. And, as always, the rating agencies dropped ratings only well after the disaster, providing a lovely “early warning” system for investors! This not only increased spreads on sub-prime debt, but also caused investors to wonder what other credits have been poorly underwritten and overrated, starting the ball rolling of widespread widening of credit spreads and falling asset prices.



sub-prime causes credit crisis

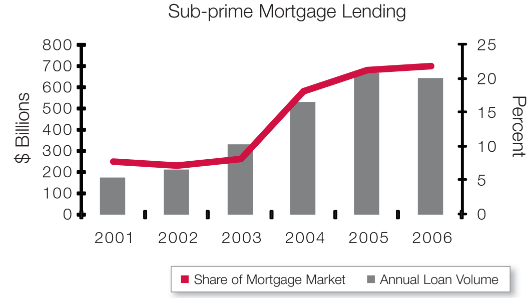
Asset prices fell as investors worried that they would lose money due to poor underwriting, and anyone who mismatched long assets with short-term liabilities were forced to meet margin calls. So to cover what will ultimately be about $90 billion of losses on sub-prime loans, mismatched owners had to sell assets. The more leveraged they were, the quicker and more dramatic were the margin calls. As they sold assets, (including other credit instruments and stocks) to cover margin calls, credits spreads widened further and stock prices fell. This triggered margin calls on more mismatched asset owners, causing another round of sales. And as fear widened, the knock-on effect broadened. This is what happens when fear wins out over greed.

This process will continue until assets are held by investors with strong enough balance sheets to take price hits without margin calls, and when asset prices fall to the point that they comfortably compensate for underwriting losses. We are nearing this turning point after four months of snowballing fear. As smart, liquid investors step up saying "at these prices these assets are a steal," greed begins its counterattack. From that point, it is just a matter of time until greed once again prevails.

IT ISN'T THE FIRST TIME

In the past 20 years there have been four other times when fear has defeated greed, triggering a capital markets crisis – the 1987 stock market crash, the S&L debacle of the early 1990s, the 1998 Russian ruble crisis, and the 9/11 2001 terrorist attack. We are now experiencing the fifth credit crisis in the past 20 years, with sub-prime debt as the trigger. As was the case in 1987 and 1998, this credit crisis is occurring in a strong economy and will not harm the general economy, except in New York. As in the past, it will take roughly 18 months for pricing and spreads to return to normal. In the meantime, it is a horrible time to have to borrow or sell. But such is life when fear defeats greed.

Sub-prime Mortgage Lending



Sources: Bloomberg, Mortgage Bankers Association

Fortunately, most people and most firms do not have to access capital markets during this window. But firms in the capital business, such as commercial and investment banks have no choice, and their suffering will harm New York (and London). The good news is that both London and New York have very little construction under way and have low vacancy rates. But they will experience near-term weakness. Given time, optimism always wins. In fact, over the last 20 years, greed's record is 15 wins and five losses.

the fed bears responsibility

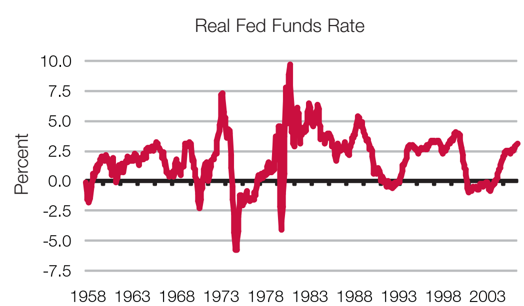
THE FED DID IT

The Fed bears considerable responsibility for the current capital market crisis. During the period 2002-2004, they kept the Fed Funds rate at a ridiculously low level. This low rate guaranteed a negative real return for anyone who invested short and safe, artificially encouraging investors to invest long and risky in an attempt to avoid guaranteed real losses. At the same time, the Fed's excessively low rate encouraged borrowers to borrow short-term using floating rates, taking advantage of the excessively steep yield curve. The Fed's 1.00-1.25% interest rate, essentially for a short-term loan to the U.S. government, when inflation was about 2%, guaranteed a pre-tax negative real return of roughly 1.00%. This is hardly an attractive or natural proposition.

Long-term asset values rose across the board as capital providers went long because of this strange and prolonged incentive created by the Fed. Better to possibly lose later on an overpriced long asset than to lose for sure immediately on a safe short investment. Finally, the Fed realized they had kept the rate too low for too long and rapidly raised it, changing the real short-term rate from roughly -1.00%, to about 2.75% in just 18 months. The Fed raised the Fed Funds rate to 5.25% in an attempt to soak up some liquidity, but even as inflation fell, the Fed kept interest rates at that absurdly high level. And if you don't believe it was too high, ask why someone deserves a 2.75% real return to effectively lend the U.S. government money for six months. The answer is: "They don't."

Now, three to four months too late, the Fed did admit their error with a grudging drop of 50 basis points on September 18. Though, we believe it is still too high by 75 basis points.

But when the Fed Funds rate was 5.25%, capital markets reacted in dramatic fashion, abandoning long assets and moving into short-term safe investments. And as they have switched, asset prices have been whipsawed. So in the same way the Fed artificially encouraged capital sources to go long and risky in 2002-2004, they then encouraged them to go short and safe.



The Fed's errors have created a serious problem for anyone who borrowed short-term floating rate money to fund long investments, including many sub-prime borrowers and debt holders. The Fed had kept the short rate at least 125 basis points higher than borrowers should have reasonably expected. By keeping the short rate high, the Fed was punishing these borrowers (and their lenders), creating more delinquencies and defaults than necessary.

fed fueling a recession

The Fed should have cut rates to 4.00-4.50% months ago. It is not a matter of "bailing them out," but rather creating a neutral capital market environment. Even at the current rate of 4.75%, anyone who says that it is now correct must explain why, when inflation is only about 2%, investors deserve a 2.75% real return for effectively holding short-term government paper. It makes no sense, and seriously distorts capital markets.

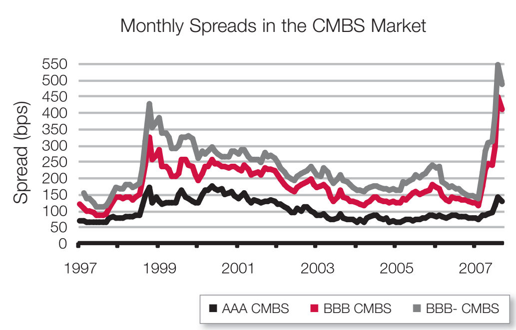
Unfortunately, the Fed doesn't seem to "get it." They seem more worried about "moral hazard" bailout risk, rather than creating a neutral capital market environment. They continue to talk as if there is a trade-off between low unemployment and rising inflation. But some 40 years ago, Nobel Prize winners Milton Friedman and Edmund Phelps proved that inflation does not rise as the unemployment rate falls. Yet the Fed seems to cling to this long debunked idea.

If the Fed keeps the rate too high much longer, it will adversely impact long-term investment activity. This will not hurt the economy during the next quarter or two, but will hurt two years from now, as we will not have put sufficient productive capital in place. That is, we will not have planted enough seeds for future growth. In short, the Fed is fueling a recession in 2009-2010.

CDOs AS A STABILIZER

Collateralized Debt Obligations get a bad rap, but they have been an enormous stabilizer during this crisis, as they allowed better asset-liability matching. Thanks to CDOs, CMBS holders have not seen runs, as investors did a decent job matching their long-term CMBS and mortgage positions with non-mark-to-market long-term CDO debt. Hence, CDOs have prevented a CRIMIE Mae meltdown, such as transpired in 1998 when spreads widened.

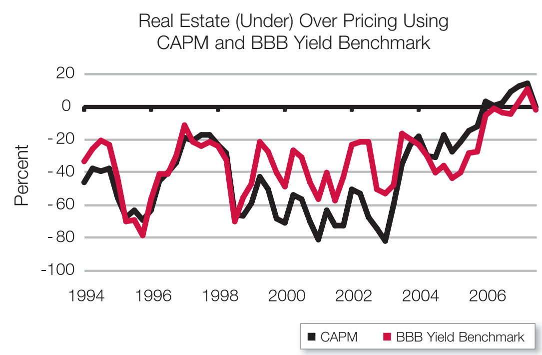
Due to extraordinary spread volatility, no one believes they can profitably issue a CDO today. As a result, fixed rate CMBS issuance is currently dead. This will resolve only as the CDO market recovers over the 12-18 months as markets stabilize. The current credit crisis has had a lesser impact on floating rate CMBS issues. For example, a BBB floater is about 210 basis points over LIBOR, versus a 2007 low of 65 basis points and a 52-week average of 97 bps. In contrast, the BBB fixed-rate spread today is 380-450 basis points higher than in February. This enormous swing reflects the fact that matched financing is near impossible in times of great volatility.



IMPACT

Like most companies (and households), commercial real estate players will simply avoid the capital markets until things stabilize. If they must borrow, they will borrow short and refinance when credit markets calm.

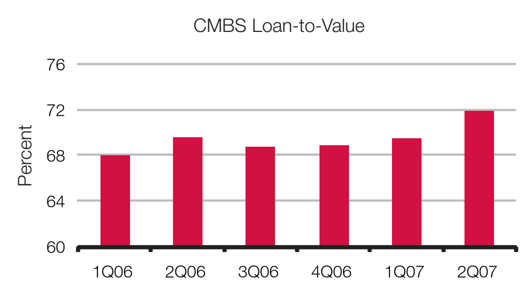
Most sub-prime borrowers took fixed rate mortgages, locking in cheap money. But floating rate borrowers, who purchased some 300,000 excess homes as speculative investments, will suffer as these investments sit empty for the next two years (or decades in the case of Miami condos)! Society's real sub-prime loss is that the capital that built these properties could have been used for something more productive.



As for the idiots who lent (often without down payments or documents) to the idiots who bought speculative homes, they deserve to lose. People must understand this simple fact. We owe many thanks to German taxpayers for bailing out our idiots through the bail-outs of German institutions holding U.S. sub-prime paper.

Many hedge funds with high water marks will shut down because their assets (not just sub-prime paper) have fallen to the point where their high water marks are unreachable in the near-term. They will shut down and reopen under a new name. This could create some additional selling pressure in the near-term.

In terms of commercial real estate pricing, through most of 2006 pricing was about right in both public and private markets. But by late 2006 real estate pricing was beyond anything explainable by using CAPM or compared to BBB credit spreads. And by March 2007, the overpricing reached 15-20%. That changed very rapidly in April and early May in the REIT market, as REIT pricing reacted very quickly to widening credit spreads and reduced LTVs. REITs re-priced, going from 15-20% overpriced in June to 5-10% under-priced in August to fairly priced in late September after the stock market run-up.



In April, May and early June, the private real estate market continued as if nothing had changed, even though credit spreads were widening and LTVs were falling. Hence, deals made in April, May, and June, which had 90-180 days to close, are now struggling. Wider spreads and higher LTVs are decimating original pro forma coverage ratios, effectively killing super-leveraged deals. In today's environment, if you have to borrow you probably should float, hoping to refinance when markets stabilize. But that's risky.

These "distressed buyers" need more equity, and many are purchasing at prices 15-20% above values today. But if they walk, they lose their deposits. Those trying to re-trade find sellers who say "the only reason I was selling the property was because of the outrageous price you agreed to pay."

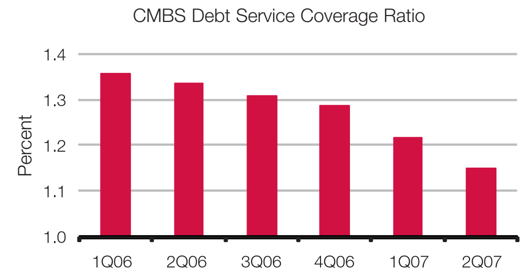
Most funds in this situation have sufficient capital to infuse the required equity, and will close rather than walk from deposits. That is, most will prefer to face the music of

the economy is strong

less-than-expected returns in five or six years than guaranteed zero returns on those earnest dollars today (especially as they pitch raising the next fund).

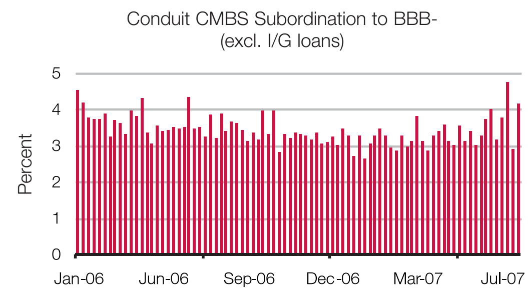
It is smart to pursue this strategy. Even if it's not a spectacular deal today on paper, they have the option of hanging on until greed makes its triumphant return. And greed can turn marginal investments into stellar performers. So it makes sense to stay alive to 2013.

Deals in the pipeline that were bridged by investment banks will be interesting to watch. Three times in my career I have watched Wall Street get aggressive and guarantee bridges. All three times, bridges are enormously profitable–right up until they almost bankrupt the firm. We are witnessing the same thing as in 1987 and 1992 with bridges. Specifically, bridge makers who thought they would place the paper at a quick profit are stuck holding bridge commitments that challenge their balance sheets. There are banks that have bridges that I do not know how they can bridge, as they do not have enough capital. And no one is going to take the bridge out in the near-term, except at a huge discount. This is more prevalent with big buyout deals than in real estate.



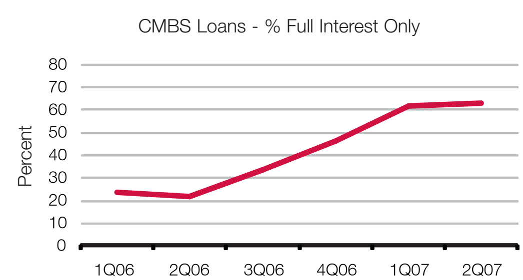
IT'S GOING TO BE ALL RIGHT

The economy is strong, job growth is solid and most people rarely tap capital markets. While some of us are in the capital market regularly, if you go to the people running companies around the country, they're not terribly sensitive to capital market events. They rarely tap capital markets, and do not really focus on this "Wall Street stuff." They do not have Bloombergs, and they do not read *The Wall Street Journal* or the *Financial Times*. They read their local newspaper, *USA Today* and trade magazines. If credit spreads stay wide and the Fed keeps the rate high for more than 18 months, it will hurt them, as eventually they use capital markets, but not in the short-term. And this is even truer of consumers.



Housing is obviously a weak sector. But it should be a weak sector. They built 400,000-500,000 homes (about 0.3% of the existing housing stock) that they should not have built. And now they have to burn-off this excess inventory, which will take until late 2008.

These kinds of adjustments are healthy in that they re-introduce underwriting discipline. Like jogging, it's painful, but healthy. Now is a great time to buy credit spread. But buy it with long-term money, as it could get worse before it stabilizes.



I anticipate few new transactions through the end of the year. But by the latter half of 2008, and certainly in '09, transaction velocity will resume at cap rates that are 40-60 basis points higher than prevailed in early 2007. In the meantime, don't panic. Just avoid capital markets. Corporate America has a very strong balance sheet and large cash balances. We are just living through another case of fear conquering greed. But count on greed to be back on the scene sooner than you think.

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