BALANCING REAL ESTATE BUBBLES,

National real estate trends have riveted consumers for the past two years, yet the mantra "location, location, location" still holds true. Home prices and sales rates can be so volatile even within local markets that wide variances can occur even with the same neighborhood. But, on a national scale the subprime mortgage meltdown morphed into tumbling home values, rising foreclosures, slowing sales, and a credit crunch extending into financial transactions unrelated to residential real estate. The commercial real estate market, while impacted by the changing economic climate, has managed to avoid the implosion experienced in the residential sector. **BY MICHELE LERNER**

BREAKDOWNS AND BOOMS

GOVERNMENT TO THE RESCUE

Government initiatives meant to stimulate the housing market and revitalize the economy are anticipated to have a positive effect on real estate markets, but opinions vary as to when the real estate market will improve. Real estate experts agree that areas that have been hit hardest by foreclosures and devalued homes will take the longest to recover.

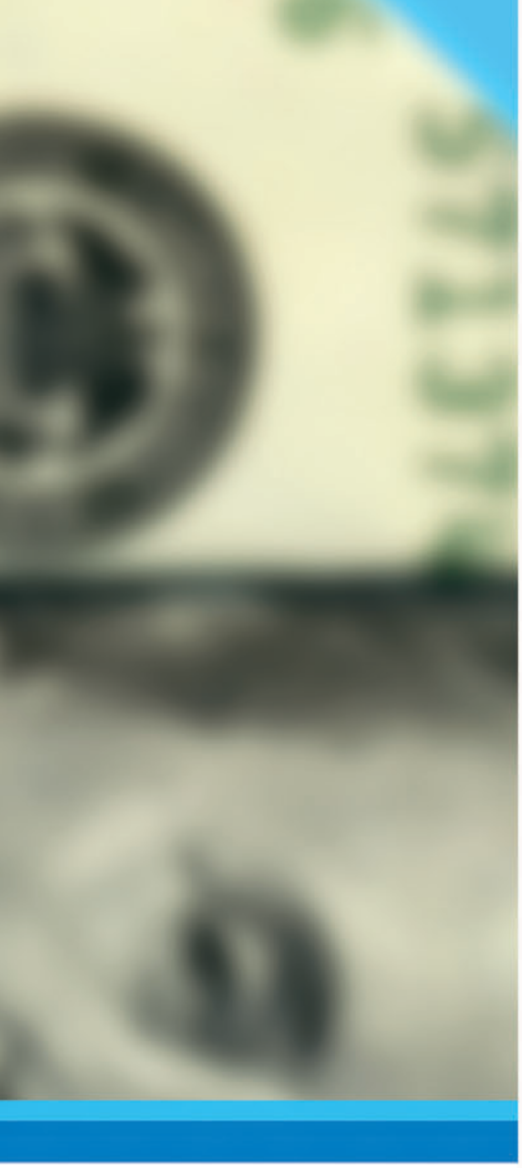
The Housing and Recovery Act of 2008, signed into law July 30, 2008 by President Bush, includes a variety of provisions meant to move residential real estate trends back on track. A key element which home builders and realtors think will stimulate the housing market is the homebuyer tax credit of up to $7,500 which will be given to first-time homebuyers. The tax credit can be used for homes purchased between April 9, 2008 and July 1, 2009.

Lawrence Yun, chief economist for the National Association of Realtors (NAR) said in his "Economist's Commentary" of July 28, 2008, "I am excited about the tax credit because it will have the biggest impact in getting the housing market moving again and in lessening the foreclosure pressure."

National Association of Home Builders' (NAHB) President Sandy Dunn, a home builder from Point Pleasant, W. Va., said in a statement, "The tax credit is the best stimulative measure. It will increase housing demand, get home buyers back into the marketplace and fight falling home prices, which threaten the economy as a whole."

Other elements of the housing bill include modernization of the Federal Housing Authority (FHA) by giving the organization additional authority to insure mortgages and refinance loans for homeowners facing foreclosure. A low-income housing tax credit will expand affordable rental housing and a mortgage revenue bond program will help states issue additional bonds, which can aid borrowers attempting to refinance their home loans.

Another section of the legislation focuses on government-sponsored enterprise (GSE) reorganization, which reforms the regulation of Fannie Mae and Freddie Mac and permanently increases the conforming loan limit which will help buyers in markets with expensive housing.



ECONOMIC AFTERMATH

Economists, many of whom predicted a housing bubble primed to burst, carefully study the factors which created the current real estate climate.

"The main impetus, what got us to where we are today, was easy credit," said Bernard Markstein, a senior economist and director of Economic Forecasting for the National Association of Home Builders (NAHB). "Lower interest rates and easier credit allowed more buyers into the market, which started the process of bidding up home prices. This worked as a feedback loop: as home prices rose, lenders saw the loans as less risky. They thought that even if the loans went belly-up, they would walk away with a profit and no one would be hurt."

Markstein said that default rates fell for years as real estate prices rose, which encouraged lenders to make even riskier loans. At the same time, Wall Street was buying mortgages and selling securities backed by pools of mortgages, all predicated on rising home prices.

"As prices rose and it was easy to get a loan, people became fearful that if they did not buy something, they would be priced out of the real estate market forever," Markstein said. "This led people to take risks and to overbid on homes. Investors jumped in, thinking they would get rich by buying and selling houses."

Markstein said that rising interest rates at the end of 2005 and concern among buyers that prices for homes were getting too high contributed to the crash of the residential real estate market.

"As soon as prices stopped rising and the market turned south, people started canceling contracts on new homes," Markstein said. "The market went almost immediately from having not enough supply to having an oversupply of homes. The downward spiral continued as buyers dropped out of the market, and then more and more people found themselves underwater, owing more on their loan than their house was worth."

Markstein said there are pockets of concentration in which the real estate market fell hardest, such as Phoenix, Las Vegas, South Florida, California and suburban areas around major cities such as Washington, D.C. and New York City, all of which were overbuilt during the housing boom. He said Michigan and some other areas of the upper Midwest such as Ohio, Indiana and Illinois have been hit hard because of economic

distress, particularly in the auto industry. A third area which has been hurt is the second home market, primarily in coastal areas such as Florida, North Carolina and South Carolina.

"As home prices dropped, the distress spread into the financial markets, and, in September 2006, the subprime loan market meltdown began," said Markstein. "The problems in the financial markets then spread back into the mortgage market. Credit used to be too easy to obtain, but now it may be too hard. The result is that now sometimes people cannot obtain the mortgage they want, and they need a larger down payment, which also slows home buying."

Markstein predicts home sales to stabilize by the end of 2008 and expects housing starts to rise in early 2009, after more of the foreclosures have been purchased and supply lessens.

"Each local market is different," said Markstein. "In some parts of the country home prices have stayed flat or are even rising. Nationally, I expect prices to stop falling by the middle of 2009."

Yun, in an online market forecast in July 2008, said the residential real estate market is still a buyer's market, and he anticipates a recovery in home sales during the second half of 2008. He points out that location matters more than ever in the current market.

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"Look at the pending home sales index for the West [NAR's July Pending Home Sales Index based on contracts signed in May]," wrote Yun. "While it's true the index slipped 1.3 percent to 97.5 in May in that region, it was 2.0 percent higher than it was in May of 2007. Indeed, some markets have seen a doubling in home sales from a year ago, while others are seeing contract signings cut in half. For instance, double-digit pending sales gains in May from a year ago were noted in Colorado Springs, Colo.; Sacramento, Calif.; and Spartanburg, S.C. In addition, price conditions vary tremendously, even within a locality, depending upon a neighborhood's exposure to subprime loans."

The Mortgage Bankers Association (MBA) in a Financial Commentary dated July 10, 2008, projects total existing home sales for 2008 to decline approximately 14 percent from 2007 sales to 4.88 million units. Existing home sales are anticipated to increase by 7 percent in both 2009 and 2010.

The new residential construction market has been hit harder than the existing home market. New home sales are predicted by the MBA to decline about 35 percent from 2007 to 508,000 units by the end of 2008. The MBA expects new home sales to increase about six percent in 2009 and about 19 percent in 2010.

Yun points out, "Current real estate market conditions are positive for most buyers: still-attractive interest rates, a large inventory of homes available for sale, and many sellers willing to negotiate their prices – sometimes significantly."

Markstein anticipates that the Housing Stimulus Bill will break what he terms the "cycle of fear," which stops many potential buyers from purchasing a home.

"Consumers need to think about not just falling home prices, but also rising interest rates," said Markstein. "Mortgage interest rates have risen one-half percent since April. In some cases, this means that someone who bought a home in April would have a lower monthly payment than if they bought the same home in June for a slightly lower price."

Yun states that based on current indicators, the 30-year fixed-rate mortgage is forecast to rise gradually to 6.5 percent by the end of 2008 and then hold at that level for most of 2009.

Ultimately, Markstein said, everyone should think about why they want to buy a home.

"A home should be a true, long-term investment in a family and a community," said Markstein. "Historically, home values rise as long as you stay in the property for five to seven years. In the meantime, you have the stability of living in the same place and control over your own property."

The PNC Economic Outlook, a twice-yearly national survey of small and middle-market business owners, found that business owners surveyed in April 2008 shared a concern about the possibility of the U.S. heading into a recession that could impact their business. Both the credit squeeze and the housing slump are affecting the outlook of these owners, according to the survey. Nearly half (48 percent) expect housing prices in their area to decrease over the next six to 12 months, compared with 43 percent expecting declining prices during the fall 2007 survey.

COMMERCIAL REAL ESTATE REPERCUSSIONS

Media attention has primarily focused on the residential real estate market, but the effects of the credit crunch engendered by drooping home values and rising foreclosures are beginning to be felt in the commercial real estate market. According to the NAR Commercial Real Estate Outlook in June 2008, commercial real estate vacancies are up slightly and investment has dropped sharply.

Yun said economic weakness is impacting commercial real estate.

"Although the supply-demand fundamentals are broadly favorable in most commercial real estate markets, vacancy rates are rising modestly and rent gains are slowing," said Yun in an online statement. "Slow economic growth is lowering demand for commercial space, mostly in the office and industrial sectors. Despite the slowdown, commercial real estate is in much better shape compared to conditions during the 2001 slowdown."

Henry Chamberlain, Building Owners and Managers Association (BOMA) president and COO commented during his annual "State of the Industry" address at the 2008 BOMA International Convention that even though vacancy rates are beginning to creep up, downtown office properties continue to thrive. Rental rates have slowed somewhat overall, but they continue to rise in urban office buildings.

Total income in downtown office buildings increased by 5 percent, while rental rates increased by 4.8 percent, according to BOMA's 2008 Experience Exchange Report. However, total net absorption for 2007 was 53.4 million square feet, down from 79.8 million in 2006, according to Divided Capital Research.

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GREEN INITIATIVES

A major trend in commercial real estate, now extending into residential buildings, is "green building," a term which refers to a variety of practices including the installation of energy efficient products, using renewable resources, conserving water and recycling construction materials. The LEED (Leadership in Energy and Environmental Design) certification program, developed by the U.S. Green Building Council (USGBC), now involves over 3.6 billion square feet of commercial building space which have achieved or are in the process of achieving various levels of certification. LEED for homes was launched in December 2007.

"The relative stability of utilities expenses in office buildings, according to the 2008 Experience Exchange Report, despite the rise in energy costs, tells us that low-cost energy efficiency strategies are working," said Chamberlain. "In a survey by BOMA, USGBC and Real Estate Media, 82 percent of property professionals said greening their portfolios was a priority. Nearly two-thirds of the survey respondents have allocated funds to green initiatives."

According to the Green Building Alliance, the green building products market is projected to be worth $30 to $40 billion annually by 2010. McGraw Hill Construction's Greening of Corporate America Smart Market Report in 2007 predicts that by 2009, 80 percent of corporate America is expected to be engaged in green efforts at least 16 percent of the time, and 20 percent will be engaged in green 60 percent of the time.

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GLOBAL REAL ESTATE IMPLICATIONS

Financial factors may have the strongest immediate influence on both commercial and residential real estate trends, but demographics, both nationally and globally, play an important role in the long-term real estate market. The Urban Land Institute (ULI) recently published Global Demographics 2008: Shaping Real Estate's Future, written by M. Leanne Lachman, president of Lachman Associates, LLC in New York City and Deborah L. Brett of Deborah L. Brett & Associates in Plainsboro, N.J., a study which looks at the real estate market implications of population patterns, aging, migration, urbanization and tourism.

Perhaps the most significant demographic trend worldwide is aging. The Global Demographics report said that by 2030, one in eight of the earth's population will be over 65. The most dramatic growth, expected to drive demand for assisted living and nursing homes, is among seniors over 80 years of age, anticipated to increase from 80 million in 2005 to 197 million in 2030. In the United States, the aging baby boomers and the "coming of age" of echo boomers will lead to an increase in single-person households, driving demand for more multifamily housing in retirement and workforce developments.

Immigration also accounts for rising demand for housing. The report said that half of U.S. population growth by 2030 will be the result of immigrants, their children or grandchildren.

Globally, demand for real estate development and infrastructure investments will be highest in the developing regions of Asia, Africa and the Middle East, which will experience the fastest population growth. "Demand for modern real estate is overwhelming in these rapidly emerging markets," the report said. The Global Demographics report was sponsored in part by Deloitte LLP.

"Over the next 20 years, demographic mega trends, and their variations by continent, present the real estate industry with tremendous opportunity to not only grow its business, but to better serve the people real estate is designed for," said David Jacobstein, senior advisor to Deloitte's real estate practice. "Mature economies, especially growing ones, offer attractive investment opportunities, but emerging markets require vast quantities of residential, retail, office and hotel properties to support their burgeoning populations."

As an example, commercial and residential real estate investment is on the rise in both Mexico and Brazil, two countries which are attractive to U.S. investors because of their current political stability and the scale of their economies.

"Mexico has 110 million people and Brazil has 200 million people, but beyond just the numbers is the important fact that these are youthful populations," said Gary Garrabrant, CEO of Equity International.

"The larger percentage of youthful people compared with developed countries means that both consumerism and the growth of a middle class are expected to accelerate in the coming years."

In contrast to the oversupply of housing in many areas of the United States, Mexico currently has a shortfall of four to six million homes. Brazil has a shortfall of six to eight million homes. Builders in these countries are growing their businesses at a rate of 100 percent per year, with the majority of homes sold before they are built.

Expectations of a slowly improving North American residential and commercial real estate market in the coming years may not match the excitement of working in emerging markets, but economists do anticipate some welcome stability in the U.S. market.

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