



RICE

JONES GRADUATE
SCHOOL OF BUSINESS

Economic Forecast Conference

ULI + Real Estate Center at
Texas A&M



National Outlook

Where are we going to?

Where have we come from?

Where have we come from?

- The American Economy showed an extraordinary level of resilience after the 1991 recession
 - The 1995 Peso Crisis, the 1997 Asian Crisis, LTCM default in 1998, the burst of the dot.com bubble, corporate scandals (e.g. WorldCom), September 11th 2001, war on terror, hurricane Katrina.
 - Real GDP growth close to 3.2% per year between 1992 and 2007
- How could the economy suffer only minor setbacks under such extreme set of conditions?



The American Consumer

- Took an unprecedented leverage helped by:
 - Cheap products from new entrants (BRIC) in the world economy kept inflation low
 - Currency pegging from Asian economies helped to keep long-term Treasury yields low
 - Securitization (credit tranching) allowed the creation of investment grade bonds from consumer loans with low credit quality increasing access to credit.



The Real Estate Bubbles

- Easy access to cheap credit contributed to extreme returns on residential real estate
 - Real home prices increased 85% between 1997 and 2006
- The resilience of the economy contributed to the notion that commercial real estate was riskless.
 - Average core property cap rates were around 6.5% in 2007

The Sub-prime Crisis

- In early 2007, it was clear that there were problems in the sub-prime mortgage universe
 - Residential real estate prices in central California and Florida started dropping.
- Investors start suspecting the securitization model
 - Securitization of non-GSE mortgages dropped to \$2 billion by March 2008 from \$105 billion in March 2007
 - CMBS issuance dropped to \$12 billion in 2008 from \$230 billion in 2007

The Banking Crisis

- Suspicion on the securitization model led to a crash in mortgage-backed securities and in asset-backed securities
- Real estate bubbles burst
- The crash corroded the solvency of many financial institutions
 - Highly leverage institutions suffered
 - Credit became tight and asset prices decreased
 - Investment decreased as a response
 - Unemployment increased feeding credit fears



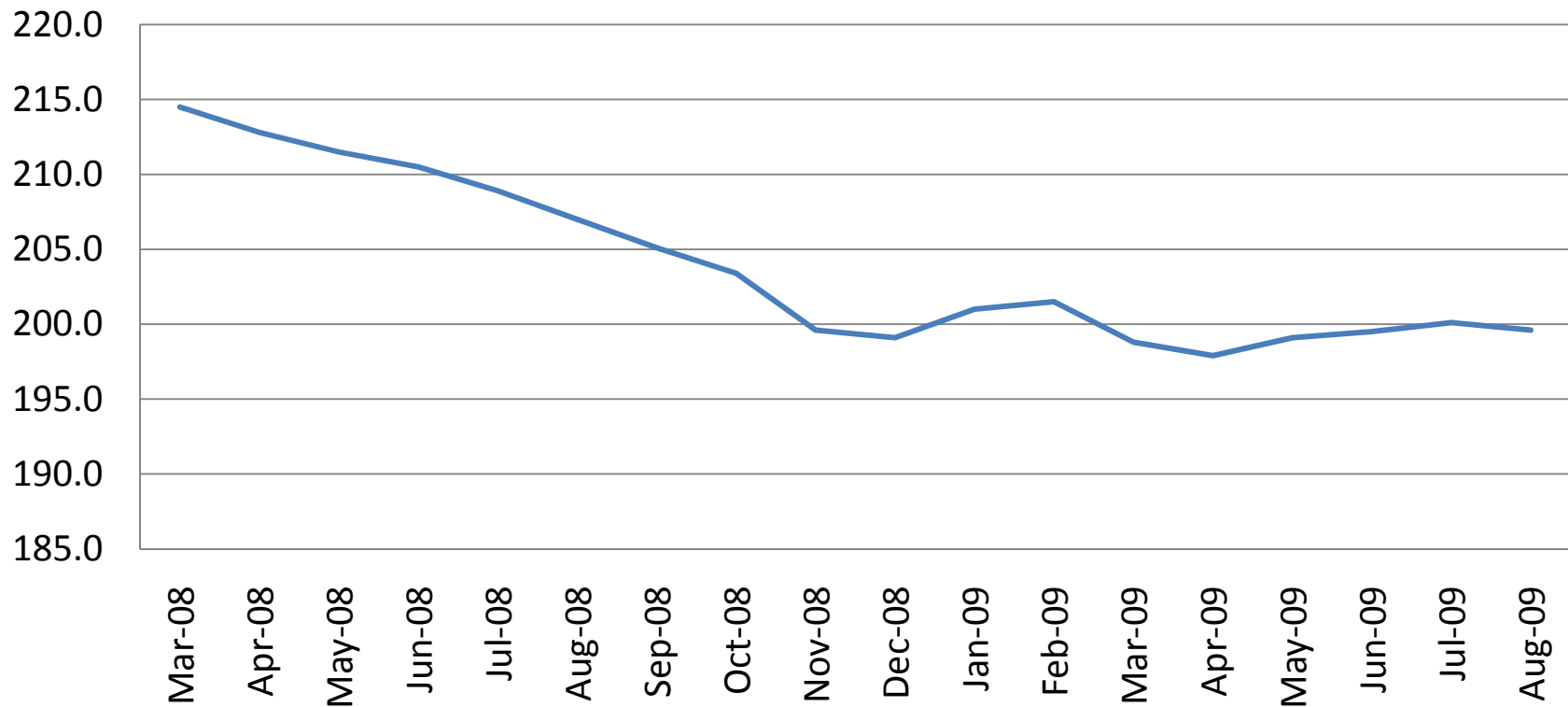
Where are we today, and where we go from here?

- Today, the securitization market is broken
 - No new CMBS
 - 20% of the credit available to commercial properties
 - No new non-agency RMBS
 - 30% of the RMBS market
 - A government-dependent agency-MBS market
 - A TALF dependent ABS market
- The Financial Regulatory Reform aims to rebuild TRUST on the securitization model
- The sectors depending on securitization will be financially constrained in the next years.

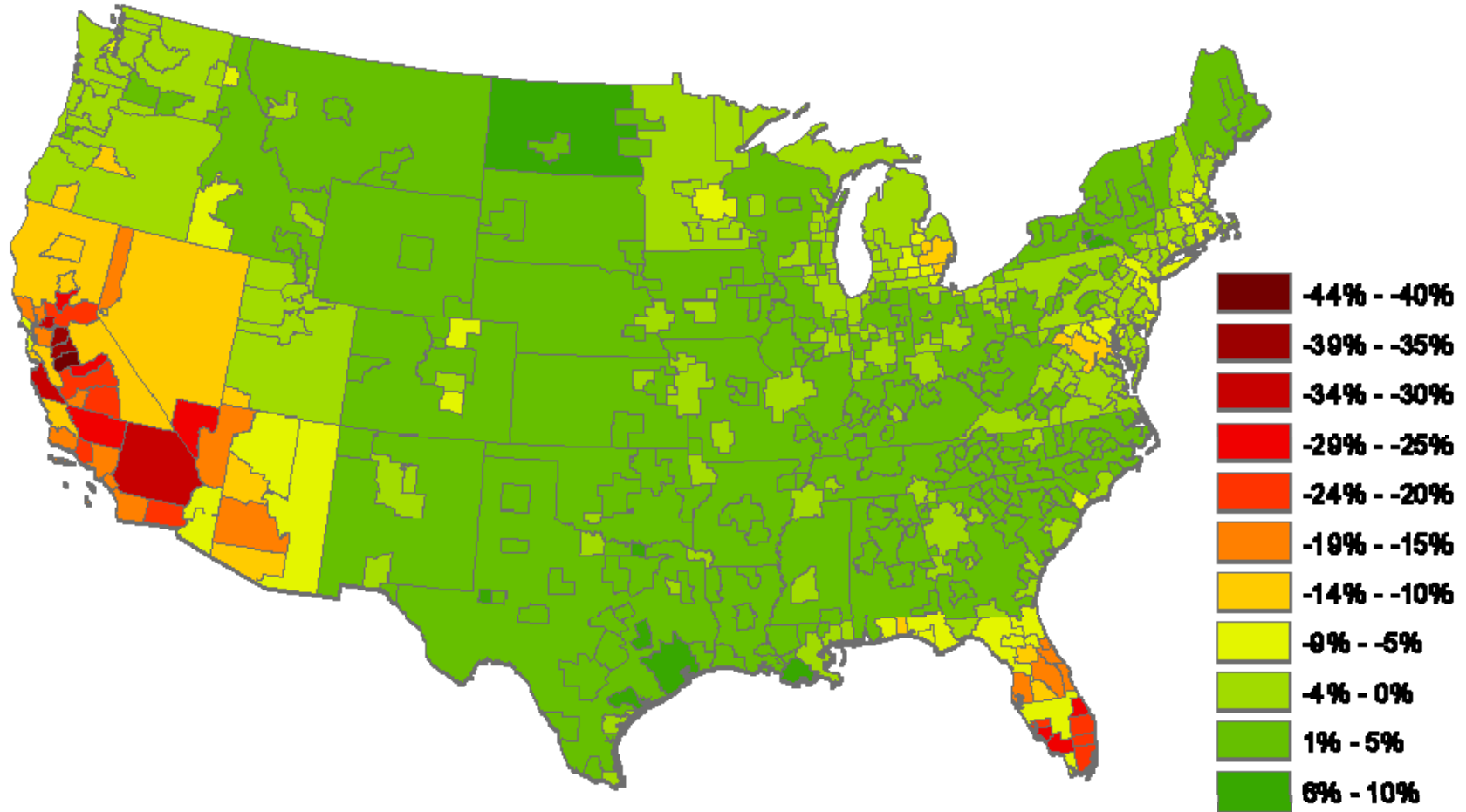


Where is the Residential Real Estate Market?

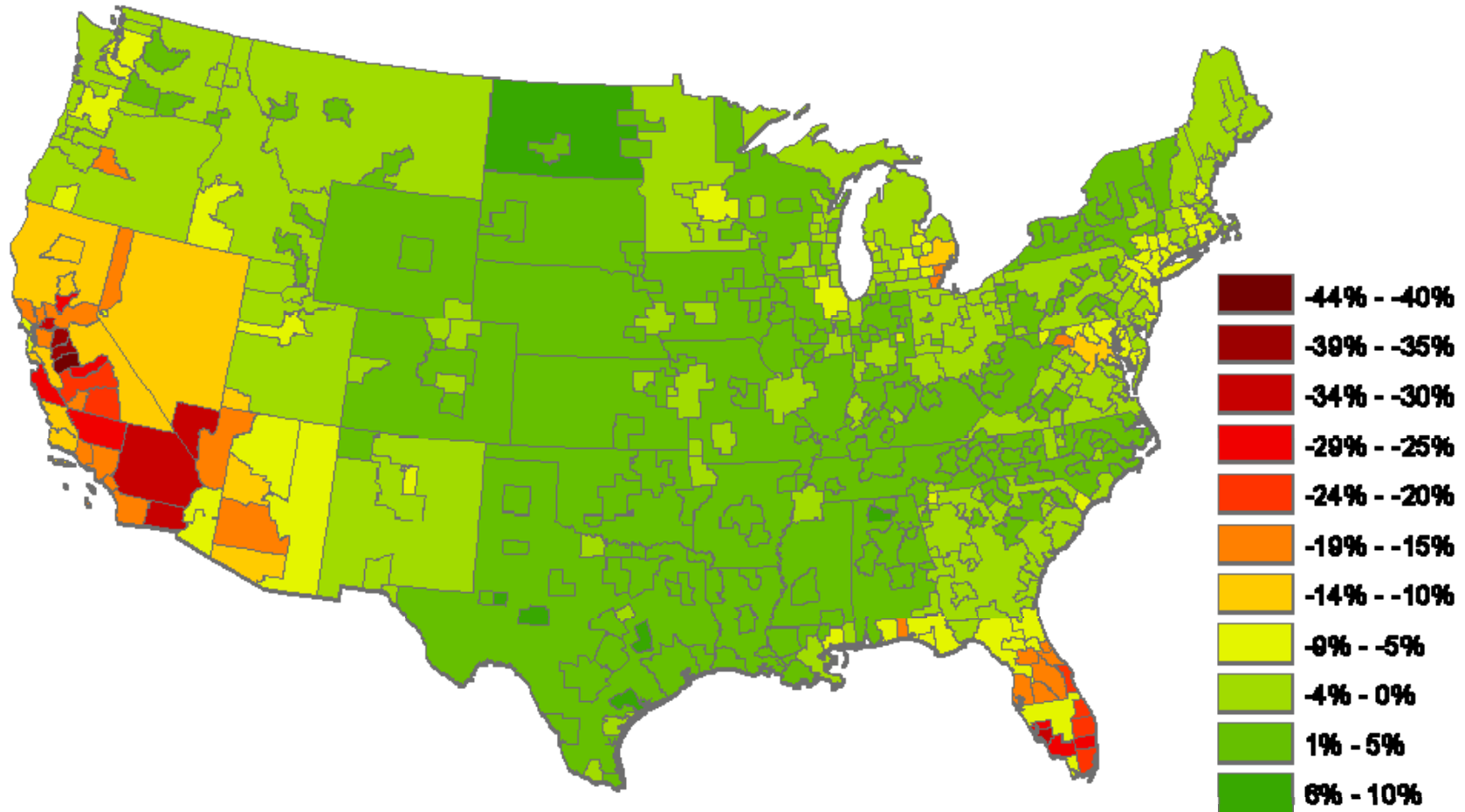
Federal Housing Finance Agency Purchase-Only Seasonally Adjusted Index for the US



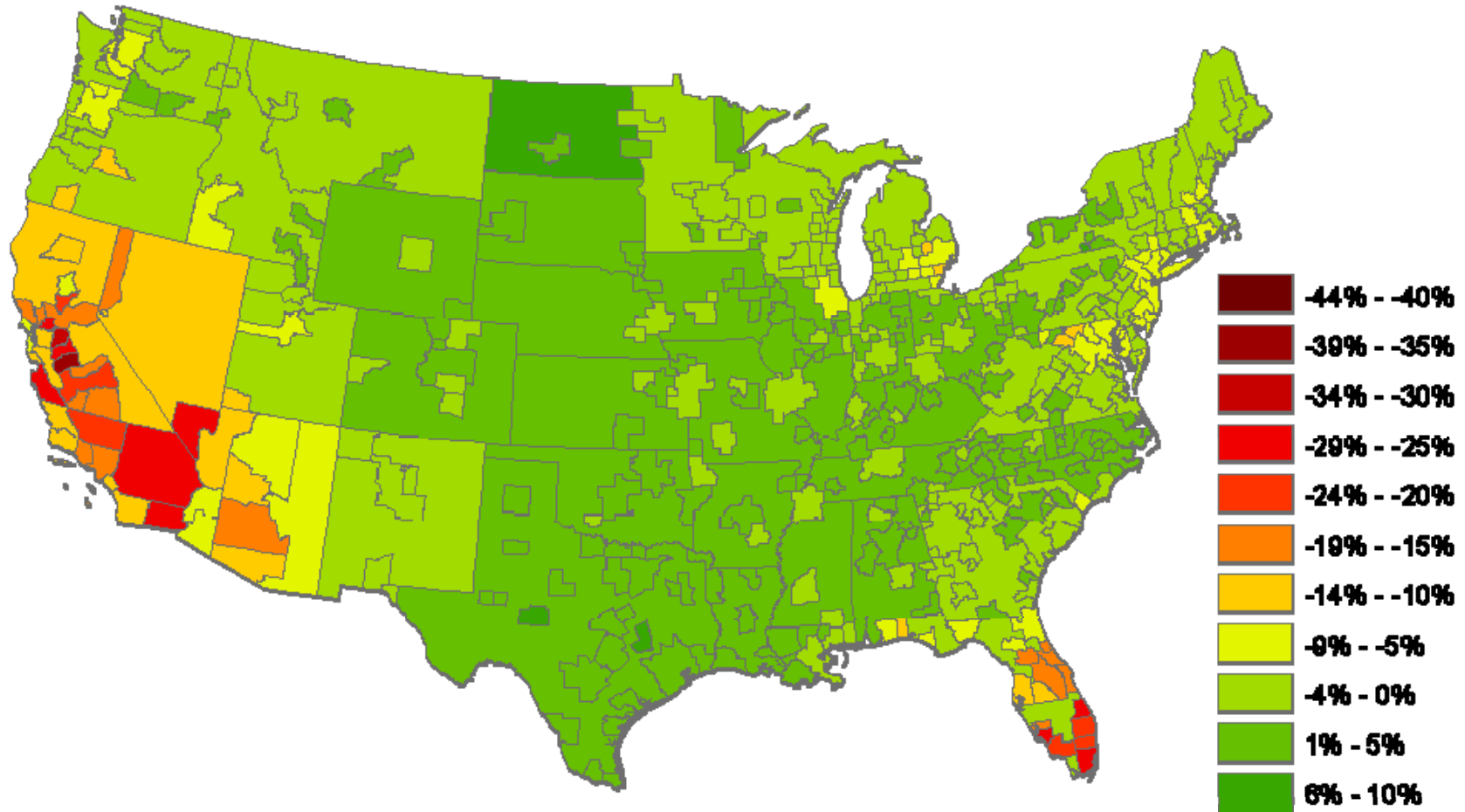
FHFA House Price Appreciation 07Q3-08Q3



FHFA House Price Appreciation 07Q4-08Q4



FHFA House Price Appreciation 08Q1-09Q1

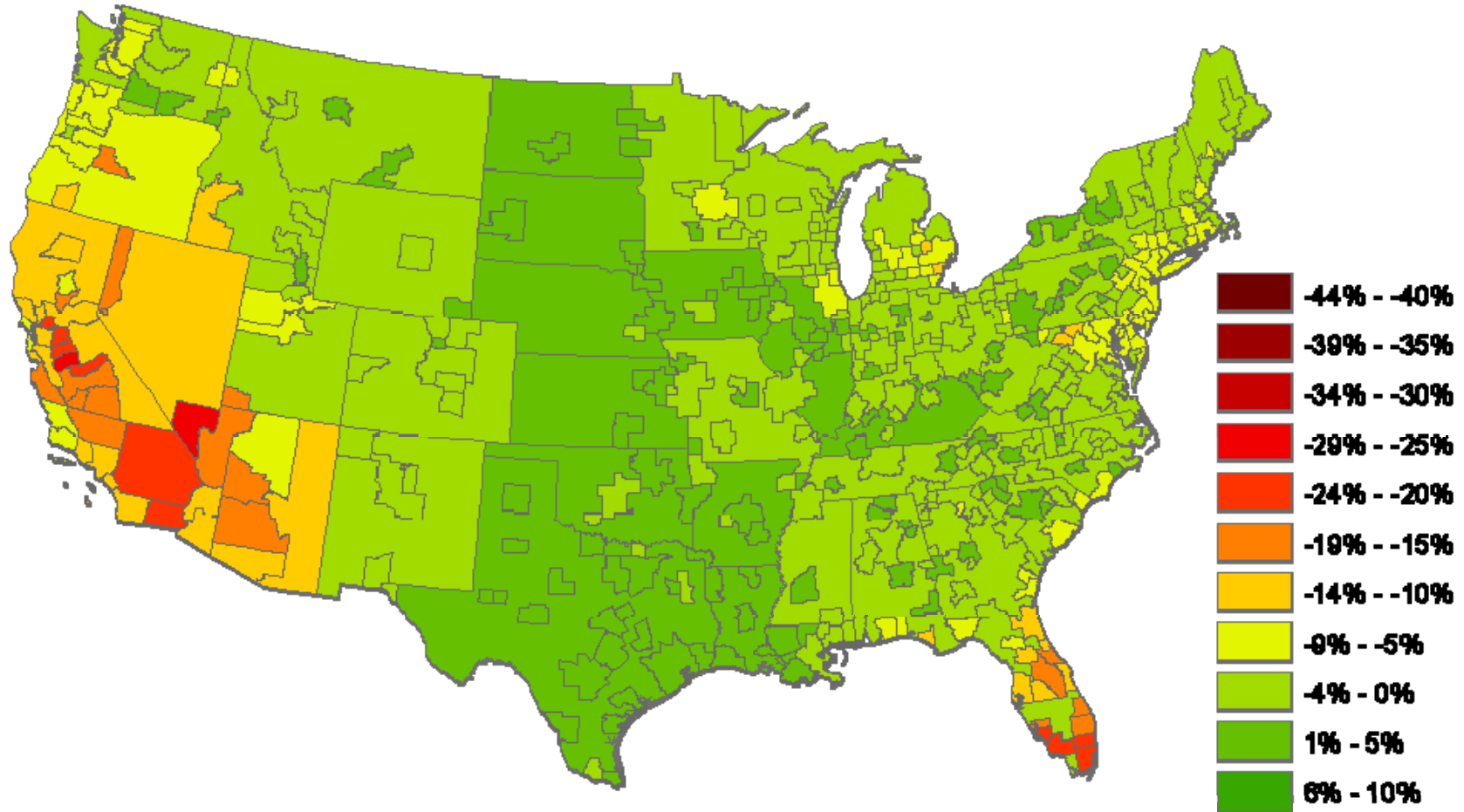




RICE

JONES GRADUATE
SCHOOL OF BUSINESS

FHFA House Price Appreciation 08Q2-09Q2



Source: FHFA

ULI & Texas A&M Conference

13

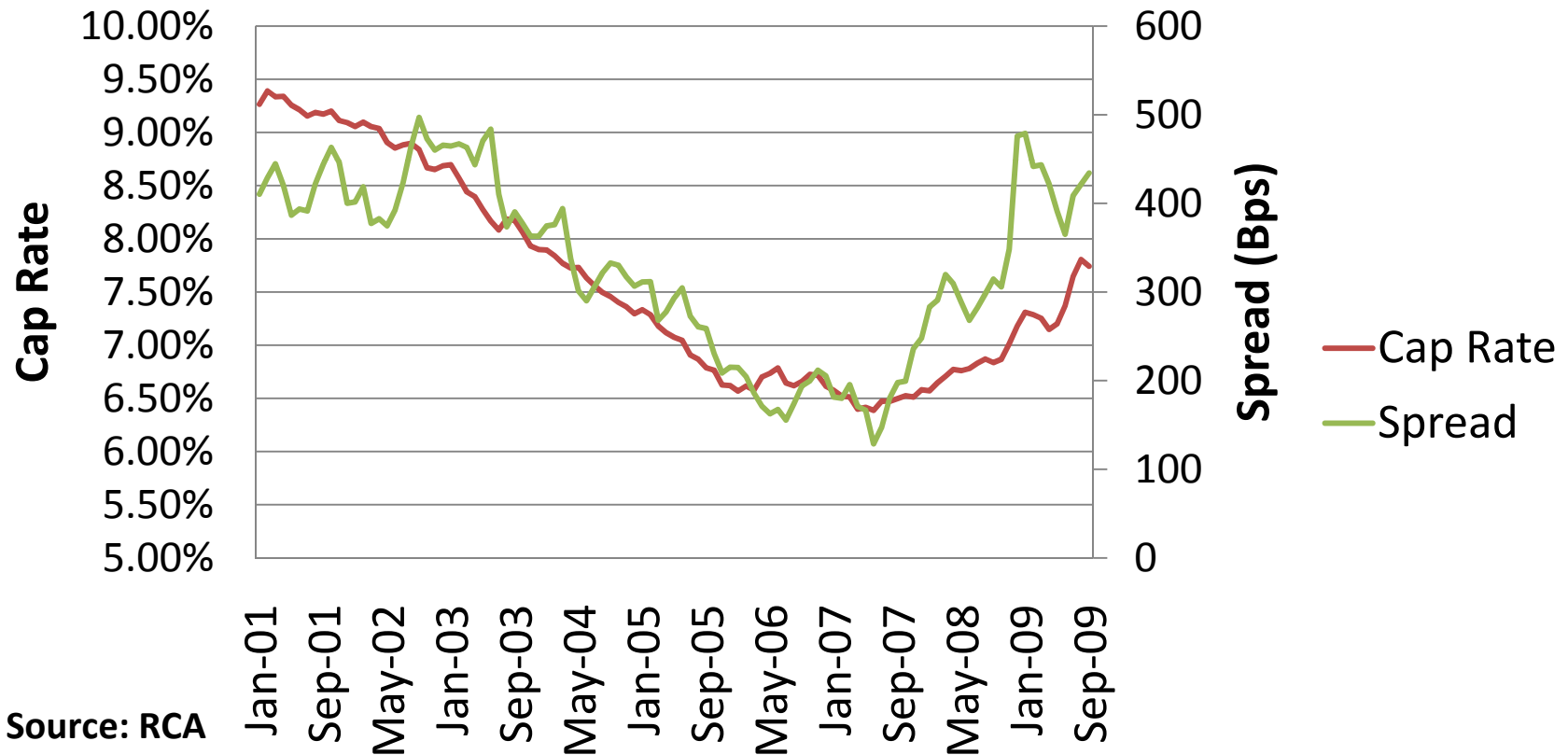


The State of the Housing Market

- The housing market is showing some signs of stability
 - House prices in California and Florida (the ground zero of the sub-prime crisis) are stabilizing
- However, the data do not indicate a strong recovery on the housing sector

Where is the commercial real estate market?

US All-Core Cap Rates and Spread to 10-year Treasury



Source: RCA



Where is Commercial Real Estate (CRE) Heading to?

- Further increase in cap rates is likely
 - Cap rates are still below pre-bubble level (9%)
 - The spread to 10-year Treasury is at the same level as in 2003, but the state of the economy is now worse
- Also, a 10% unemployment rate and raising vacancies will bring down the cash flows of CRE
- A drop of 10% to 20% on CRE is not unlikely
 - This drop will vary with location and property type



What Will Be The Engine of Growth?

- Domestic consumption
 - Domestic consumption is not a sustainable source of growth at the current level of consumer leverage
- Government spending and fiscal stimulus
 - Consistently high fiscal deficits will lead to high interest rates, weaker dollar, higher taxes and possibly inflation
- Exports
 - A global crisis curbs the possibility of growth through exports
- Business investments due to technological innovations
 - Technological innovations are random events
- There is no clear source of sustainable growth in the future, suggesting that we will have years of sluggish growth

Summarizing

- The securitization market will come back in some form, though it may take some time.
- Residential real estate is giving some signs of stability.
- Commercial real estate prices may drop by a further 10% to 20% on average.
- No clear engine of growth, which suggests sluggish growth in the next years.