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V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

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11. "Analysis of Real Estate Market Conditions", Asset Manager Symposium, San Antonio, TX, February 9, 1986

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Analysis of Real Estate Market Conditions

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I. Introduction

A. Symposium managers have specified that I have 40 minutes to resolve the following questions:

1. What are the long-term trends in the real estate investment mart?

2. How does the changing economic pattern affect investment performance for the next five years? For the next ten years?

3. What tax changes can be expected and what impact will these changes have on real estate investment?

4. In light of the above, what sure-fire market strategies should you employ for success?

B. Wisconsin economists are instiutional economists rather than statistical We ask you to think in terms of the conceptual rather than the transactional.

1. Real estate success requires monopoly and spread to buy low, sell high.

2. Next five years will provide opportunity to buy low; the end of the century will provide opportunities to sell high.

3. The increase in value will depend on asset enhancement on managerial skill rather than systematic increases hyped with marketing skill·

II. Basic Reasons to invest in real estate continue to be true and limit down-side risk.

A. Real estate is the most significant investment in the ecohomy, enclosing all basic activity, and is largely invulnerable to external shocks. Life goes on.

B. Demographic pressures promis some continued growth in demand and experience shows small neighborhood shifts within the community are major factors in the marginal demand for new stocks real estate.

Table 1
Net Funds Raised in U.S. Credit Markets, 1983-1984 and Estimates for 1985 and 1986 ($ billions)

	1983	1984	1985^{E}	1986^{P}
Total Net Funds Raised	643.0	887.6	862.8	864.3
U.S. Treasury Issues	186.7	199.0	205.0	190.0
State and local government bonds	57.3	65.8	93.0	55.0
Corporate bonds	24.6	60.8	78.5	92.0
Single-family home mortgages	115.6	139.2	136.0	132.0
Multifamily residential mortgages	9.4	14.0	14.0	16.0
Commercial mortgages	47.6	58.8	48.5	52.0
Consumer credit	59.8	96.5	120.0	100.0
Business and other loans of banks*	26.7	79.4	12.5	52.0
Mortgage pool securities	66.4	44.4	75.0	65.0
Issues of U.S. Government-sponsored agencies**	1.4	30.4	28.0	30.0
Open-market paper and R.P.s	14.4	44.1	35.0	40.0
Loans from Federal Home Loan Banks	−7.0	15.7	12.0	10.0
All other credit	40.1	39.5	5.3	30.3

E—Estimated
P—Projected
*—Excludes mortgages and consumer loans
**—Federal National Mortgage Association and Federal farm credit agencies
Source: Flow-of-funds, Federal Reserve Board

Table 2
Net Funds Raised in U.S. Credit Markets, 1983-1984 and Estimates for 1985 and 1986 ($ billions)

	1983	1984	1985^{E}	1986^{P}
Total Net Funds Advanced	643.0	887.6	862.8	864.3
Households	70.9	118.0	99.6	74.3
Corporate business	20.4	22.2	−6.2	10.0
State and local governments	47.7	46.1	63.0	66.0
Foreign investors	27.1	43.4	58.0	52.0
U.S. Government	9.7	17.2	5.5	15.0
Financial Institutions:				
U.S. Government-sponsored credit agencies	3.4	28.8	29.0	30.0
Mortgage pools	66.4	44.4	75.0	65.0
Federal Reserve System	10.9	8.4	13.5	11.0
Commercial banking system	136.1	181.9	155.0	150.0
Savings and loan associations	105.4	119.8	65.0	70.0
Mutual savings banks	18.5	10.4	10.5	11.5
Life insurance companies	50.6	57.9	56.0	58.0
Other insurance companies	1.7	9.1	11.0	13.0
Uninsured private pension funds	25.9	24.9	26.0	27.0
State and local retirement funds	16.0	31.2	21.0	24.0
All Other Funds Advanced*	32.3	123.9	180.9	187.5

E—Estimated
P—Projected
*—Includes non-farm non-corporate business, finance companies, credit unions, REITS, mutual funds, money market funds, and security brokers and dealers.
Source: Flow-of-funds, Federal Reserve Board

C. Real estate provides competitive investment returns, portfolio diversification benefits, and sometimes a hedge against inflation.

D. Real estate markets are relatively inefficient and generate large fees for those who can exploit theinefficiency.

E. Real estate investment has a large, emotional attraction magnified by a positive stimulus from the international community.

F. Supply of investment quality property is delcining or is gradually redefined as institutions buy and hold.

G. Super Keynesianism makes a significant recession or depression with a $250 billion federal deficit virtually impossible.

H. The Federal reserve Board has lost its power to increase interest rates, trapped by Third World debts to U.S. banks, our negative foreign trade balance, and the need to monetize the defense budget.

III. Threat of economic roller coaster will reappear in'87 and'88, but the bad news is longer term.

A. As a society, we are unwilling to address curtailment of debt for personal, industrial, of public sectors. (See Tables 1 and 2 for following discussion).

B. Inflation lags debt increases by 4 or 5 years when the economy is operating below capacity.

C. Public deficit means that U.S. will lose out relative to Europe and Japan in terms of long term standard of living.

D. Tax reform efforts are a fraud. Only honest answer is to raise federal taxes and improve productivity of white collar employment.

IV. Missed opportunity to reduce deficit through increased taxes.

A. Gasoline tax

B. The Gramm-Rudman Act applies brutal budget cuts to all programs that benefit development and real estate.

1. Loss of federal rebates to states, counties, and cities and education means real estate taxes will rise from 1% of asset value to 5% of asset value.

2. Result will be taxpayer rebellion, not unlike Proposition 13 which will shift burden to commercial property.

3. Public services will be shifted to user fees directed toward commercial income property.

4. State real estate laws will be further modified to permit differential ratios to equalize values by property class to shift the tax burden toward investment properties other than apartments.

5. New sales taxes will be extended to leases, construction materials, and real estate transactions.

C. Short term increases in the income tax may be passed through to tenant but at the time of renegotiation, net effective rental will be reduced or flattened. The 6% escalators on income in 1985 appraisals will prove to be a lie.

1. Lease provisions will have to be modified to anticipate taxes on leases, financial transactions, or security values.

2. Some real estate taxes may be avoided where tenants own office interiors in industrial type spaces in suburbs which have escaped welfare burdens and redeveopment costs.

D. Productivity increases will require a reduction in white collar employment, i.e., office tenants, and a reduction in the costs of housing white collar employees.

VI. Any adjustments to the tax law will be cosmetic or temporary. The losss of investment tax credits and ome tax except financing will be damaging to new products but will help vacant projects by reducing the new supply.

A. Federal tax rules may explain less than 10% of real estate values, according to Roulac and others.

B. The need to eventually raise federal income taxes will strengthen the argument for tax neutrality and taxpayer revolt will crush the real estate lobbies.

C. In the future one will make their money when they buy and how they manage rather than how the political system can be manipulated to create arbitrage values through tax favortism or non-market inverest rates. The National Association of Realtors may win concessions in 1986 but ultimately will be shown to be on the wrong side of the issues.

VII. A suggested investment strategy to buy well as a basis for resale spread, manage well for operating spread, and market well for a monopoly spread might be to:

A. Choose existing properties in firmly established neighborhood trade areas which can be modernized or expanded rather than new properties without momentum or intertia as a stabilizing factor for marketing.

B. Invest in areas that have the most sophisticated land use controls to block new supplies and a history of political power structures to facilitate public/private cooperation on economic development priorities.

C. Develop internal organization capacity for management and leasing to maintain monopoly, minimize marketing eees, and maximize spread.

D. Greatly reduce debt ratios of well-positioned income real estate with capacity for enhancement.

E. Select market areas as a contrarian, relating to long-term trands and economic base, discretionary inceome, and quality or urban government.