



eF 303

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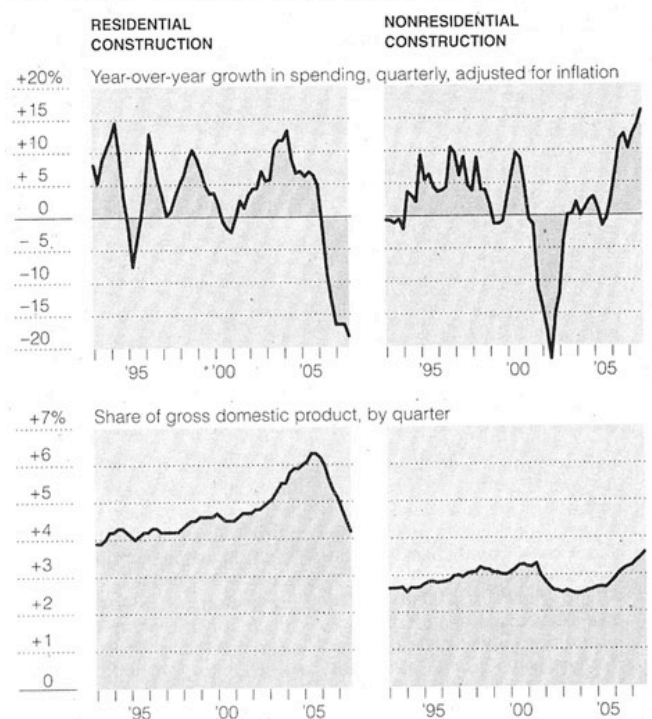
## Commercial Real Estate: An Economic Cornerstone At Risk

Cuts from corporate management will be an important contribution to any recession following the housing market decline. That has been our mantra in meetings with you since late 2005, and it is now taking place. The manias of the 1990s trained management to aggressively manage earnings to meet Wall Street expectations. Therefore, any signs of weakness would foretell a swift pullback in business spending designed to protect earnings. In addition to advertising, the topic of eF 218 (12/31/07), corporate real estate is the latest arena where we are witnessing such pullbacks.

Compared with the fourth quarter of 2006, the fourth quarter of 2007 saw U.S. office property sales volume fall 42 percent, retail property sales volume fall 30.1 percent and industrial real estate sales volume fall 22 percent. That 42 percent drop for office properties was the largest fall since the quarter of the September 11 terrorist attacks. Those decreases come amidst a jump in supply. The fourth quarter witnessed the biggest increase in commercial buildings completions in 5 years, from 12.5 million square feet to 20 million square feet. However, market absorption of property fell from 16.2 million square feet to 4.4 million square feet. (*Financial Times*, 1/26/08 & 2/6/08)

Numerous ripple effects may emerge from such a drastic shift in uptake. For one, banks have recently played by new rules in the commercial real estate market. While banks once made loans for no more than 80 percent of a commercial property's value, they have recently made loans for as much as 120 percent of the value. As a probable response to their unusual commercial mortgage exposure, 80 percent of U.S. banks tightened lending standards on commercial loans from October to January, the highest percent since 1990, when the Federal Reserve's survey of senior loan officers began. That change in standards suggests both recognition of untenable risk levels and a likely contraction in commercial real estate construction to come (see chart at right). Such a contraction

## As Home Building Fell, Other Construction Rose



Source: Bureau of Economic Analysis, via Haver Analytics

bodes badly for the construction and building materials industries, which have come to rely on commercial spending in the wake of decreased residential spending. (*CondéNast Portfolio*, 1/08; *International Herald Tribune*, 2/27/08)

Beyond focused ripples to banking and construction, a weak commercial property market would circle back to the U.S. economy as a whole. The share of the U.S. economy derived from nonresidential construction is at its highest level since 1988, as of the latest GDP statistics for 2007's fourth quarter. Moreover, 2007 was a record year for the issuance of commercial mortgage-backed securities, bringing the total outstanding to \$730 billion. Compared with previous cycles, a slowdown in these areas will have a disproportionately large effect on the overall economy. (*The New York Times*, 2/2/08)