

# COLLIERS INTERNATIONAL VALUATION & ADVISORY SERVICES WEEKLY MARKET RECAP



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During periods of volatility and the absence of market direction, stepping back to obtain some perspective is necessary.

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## Macro Economic and Real Estate News

K.C. Conway, MAI, CRE, CIVAS Market Analytics

### Perspective – Analysis – Conviction

*It's back to one of my recipes:*

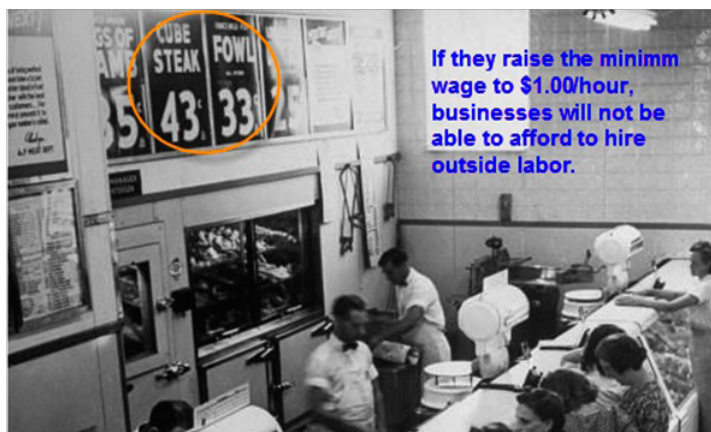
- 1 part perspective
- 1 part analysis
- 1 part conviction

During periods of volatility and the absence of market direction, stepping back to obtain some perspective, reassess all metrics from top to bottom, and develop a conviction about what to do is a solid investment strategy. This strategy applies whether one is focused on equities, commodities, or real estate. So, what specifically is meant by perspective, analysis, and conviction?

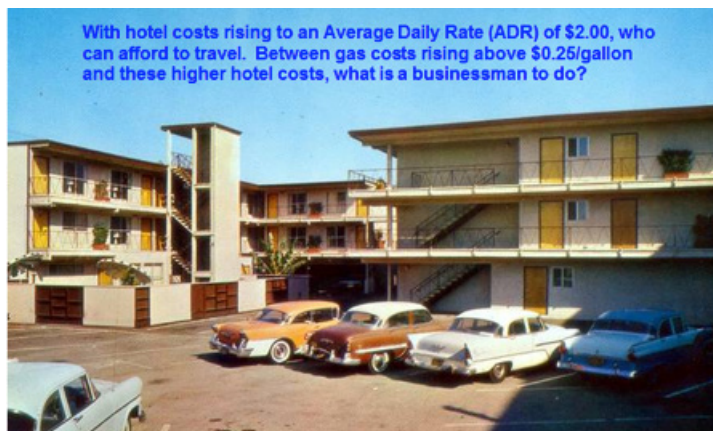
Perspective refers to filtering out the media hype and examining data from historical trends. Frequently, the issue at hand is that either something systemic is resurfacing, or there is a burgeoning risk that has been a long time coming. Taking a step back may clarify whether the hype is a rehash of a reoccurring risk, or a new risk that will adversely weigh on the market for an extended period of time.

As a result, regulators and politicians will do their best to deflect issues such as deficit spending. The market reaction will be quite different depending upon the outcome. The following are a couple of examples taken from news headlines in 1955 - complements of a real estate finance colleague in Florida (Bill Simms).

In the early to mid 1950s, inflation was as much of a concern as it became in the 1970s, 1990s, and these past few quarters. In 1955, the thought of raising the minimum wage to \$1.00 per hour, or hotel costs rising to an average daily rate (ADR) of \$2.00, were considered just as economically paralyzing as \$100 per barrel of oil in the present. **Looking back over the past 55 years, inflation is a systemic risk we should always have on our radar screen.** In the early days of my real estate career as an appraiser, the Appraisal Institute curriculum taught the principle of substitution to identify and measure inflation risk. In laymen's terms, the principle of substitution as applied to real estate simply says: **If rents or values rise too high, the market will respond by pursuing another alternative.**



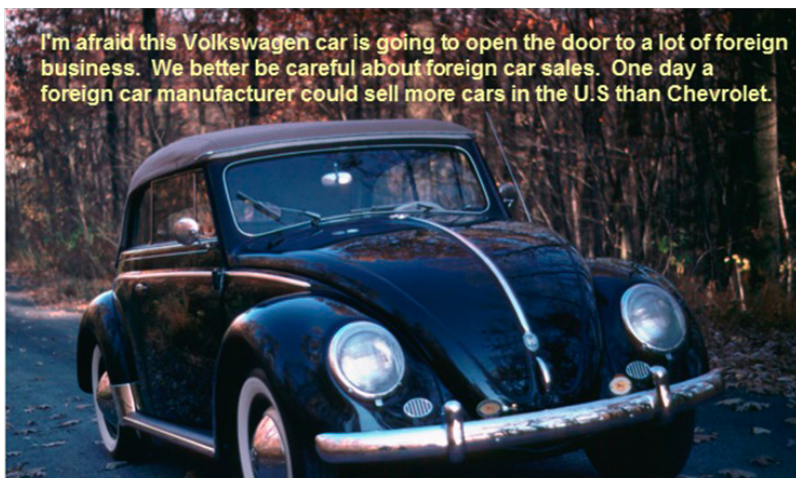
**If they raise the minimum wage to \$1.00/hour, businesses will not be able to afford to hire outside labor.**



**With hotel costs rising to an Average Daily Rate (ADR) of \$2.00, who can afford to travel. Between gas costs rising above \$0.25/gallon and these higher hotel costs, what is a businessman to do?**

That alternative in a supply-constrained and inflationary market is to build new product. In an overbuilt or declining market, like today, that alternative is to buy or rent distressed existing real estate at prices less than replacement cost. In other words, what I learned early in my career as an appraiser was:

- **Always have a refreshed perspective on inflation** as a systemic risk that will periodically rear its ugly head to differing degrees by market.
- **The market will respond to inflation via the principle of substitution.** Currently, capital is investing in commercial real estate because the values have declined 30% to 60% below replacement costs. With key construction commodity costs (cement, steel, and lumber) rising due to global demand for those construction commodities, the drive to buy distressed versus replacement cost differential will only be enhanced over the coming quarters or years.



Stepping back and obtaining this perspective helps explain why capital is still flowing into commercial real estate despite lackluster demand and job growth.

The U.S. government recognizes this same principle of substitution in its monthly calculation of the Consumer Price Index (CPI). In calculating CPI, the government uses a basket of goods methodology. This methodology assumes the consumer will substitute apples for oranges if prices for oranges rise sharply due to a freeze or other supply disruption.

- **Recognize the leading indicators that will provide a fresh perspective** on systemic issues, like inflation. The key here is focus on leading indicators such as the Producers Price Index (PPI), rent concessions, and net absorption. All too often, the lagging indicators, such as vacancy rates, garner the attention.

**Monitoring just the lagging indicators will cause one to miss the opportunity to apply substitution in time to mitigate losses or capitalize on opportunities.**

In contrast to the re-emergence of a systemic risk like inflation, the alternative perspective gained from stepping back can foster recognition of the emergence of something that, if not understood, could become a long-term concern that will adversely impact the market for an extended period of time. Typically, this type of concern is rooted in something benign that then develops over years - or even decades - and gradually becomes malignant. It's also an item the regulators and politicians will usually dismiss as immaterial until it becomes a systemic risk - like banks becoming over concentrated in commercial real estate lending, unfunded pension liabilities, and deficit spending. Two examples from 55 years ago that have come home to roost are: the impact of **shifting from a manufacturing economy to a service economy** and the evolution of double-income households in conjunction with a more mobile work force.

The image headlines to the left relating to the importation of the Volkswagen Beetle and whether McDonalds was a dining-out fad or effect from some yet-to-be-understood cause are good examples of watershed changes to the U.S. economy that commenced nearly 55 years ago and are just now being understood. Clearly, market participants did not take the time to gain perspective on the underlying causes for both these news headlines.

*THE PROBLEM IS THAT INFORMATION HAS BEEN SUBSTITUTED FOR ANALYSIS. TODAY WE ARE BOMBARDED WITH INFORMATION BUT STARVED FOR ANALYSIS.*

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In 1955, perspective was lacking as to what the importation of the VW Bug or advent of fast food restaurants meant to the U.S. economy. Both were the result of two fundamental changes occurring in the U.S. economy that have taken 55 years to fully mature. Those two fundamental changes are:

- **Evolution of the U.S. economy** to a service economy as global trade was in its infancy post WW II and pre North American Free Trade Agreement (NAFTA).
- **Evolution of the double-income household** as a result of women having entered the workforce out of necessity during WW II.

The discussion around the import of the VW car and whether or not fast food and dining out was a fad or sustainable new industry should have evolved from the perspective: **why are we importing manufactured goods; and why are people dining out?**

The answer to both questions then should have led to the development of two key perspectives that would have had profound implications for commercial real estate, investing in equities, and the value of the U.S. dollar. **Rebuilding war-torn countries means what to the U.S. economy?**

- As the world rebuilt in the aftermath of WW II, countries needed marketplaces to sell their goods in order to grow. This expansion of manufacturing capabilities outside the U.S to rebuild Europe and Japan would inevitably set the stage for global competition in which the low-cost producer would prevail.
- From the importation of the VW Bug to all that we import today from Asia and Europe, the perspective of the U.S. evolving into a service economy could have been discerned as far back as 1955. The wake-up calls were in the 1970s with our steel and auto industries, the 1980s with the loss of our textile industry, and the past decade with the move of technology manufacturing to Asia.

**How does the evolution of the double-income household impact the evolution of a service economy?**

As the U.S. household changed to a two-earner household, demand for services such as child daycare, dining out, dry cleaning, etc. increased.

Clearly, McDonalds and Ray Kroc had the right concept at the right time.

McDonalds tapped into the busier lifestyle from a double-income household that had less time to prepare meals at home. Daycare, dry cleaners, and eventually the Internet are all offshoots of this shift to a service economy **driven primarily by the growth of double-income households.**

**Analysis and Conviction**

Once perspective is obtained, robust analysis enables the development of investment conviction. The problem is that information has been substituted for analysis. Today we are bombarded with information but starved for analysis.

CNBC reports the breaking economic metrics each morning at 8:30 a.m. EST and has drawn conclusions by 8:35 a.m. The market responds to breaking news, like jobless claims rise, without understanding why. The weekly jobless claims rise during a number of weeks this past spring was solely due to weather (tornadoes in Alabama or Missouri), yet the market reacted without perspective from analysis.

Analysis enables the development of conviction or belief in why a course of action should be taken. During times of market volatility and the emergence of unprecedented events - like a U.S. debt downgrade, conviction can only be obtained after top-to-bottom analysis of all key metrics.

The current environment is one in which we all go back and ask the "why" questions. Without answers to the "why" questions, markets become besieged by fear and all head for a hasty exit. Those who can do analysis will have the conviction to invest.

A good example is Berkshire Hathaway and Warren Buffet. Look at his 2011 YTD returns and behind the incredible analysis that goes into his investment decisions and you will understand his conviction to go long when the rest come up short.

As we sort through the past week's *Bulls, Bears and Bewildered* and look ahead to the end of Q3, keep in mind PAC: Perspective – Analysis – Conviction. The year-end *Weekly Market Recap* will self evaluate the credibility of the perspectives, analysis, and convictions we offered up so you can score our reliability.



## THE SCORE BOARD

WEEK ENDING	BULLS	BEARS	BEWILDERED
August 19	3	6★	5
August 12	5★	4	4
August 5	3	4	5★
July 29	2	5★	3
<b>4-Week Avg.</b>	3.3	4.8	4.3★



## The Score Board

### "THE BEARS ARE BACK IN TOWN"

More bank failures, elevated readings on inflation from both a consumer and producer

### STATISTIC(S) & HEADLINE(S) FOR THE WEEK AUGUST 15-19

#### The Statistic(s) of the Week

As in prior weeks, it was difficult to settle on just one statistic. This week's statistic is a pair of related statistics tied to our perennial Bear subject – housing. The two related statistics are:

- Million-dollar-and-up homes are the fastest-growing segment of the U.S. foreclosure market, with banks seizing some 335% more such properties last year than they did in 2007 (RealtyTrac).
- RealtyTrac's latest figures show that homes with \$1 million or higher mortgages represented 2.3% of houses in foreclosure during 2010 – and that percentage is approximately double the number in 2007.

On October 1, 2011, the maximum residential mortgage for an FHA, Fannie Mae, or Freddie Mac loan drops to \$625,000 from the current level of \$729,750. In recognition of the lead time to underwrite, package, and sell these types of residential mortgages, those without commitments as of Friday, August 19th will find the deadline has come and gone.

Wells Fargo, Bank of America, and the other top national mortgage lenders announced last week that they are no longer accepting applications for loan requests in excess of \$625,000.

What both these statistics tell us is that all is not well even in the ultra high-end housing market – and it will likely get worse with the reduction in the maximum FHA, Fannie Mae and Freddie Mac loan limit to \$625,000.

perspective, atrocious existing home sales data, slowing manufacturing beyond autos, and revised GDP growth forecasts - on top of the European sovereign debt crisis - sent the Bulls fleeing from Madrid, Spain and Madrid, Illinois.

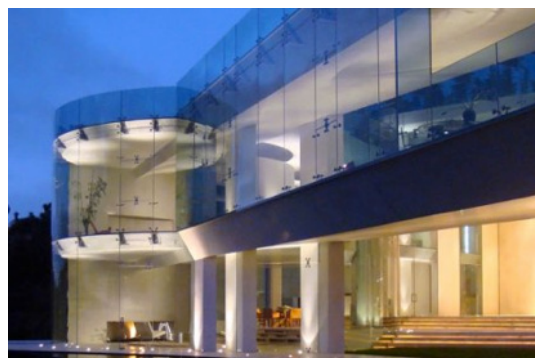
No running of the bulls this year, but Bear sightings have increased literally and figuratively from Georgia to California as investors seek shelter from the heat of this market meltdown.

Recall that the WMR has previously warned that the two most down months of the year in the history of U.S. stock markets have been June and August.

**"Play just until May or join the crowd of those explaining why September is rarely something to remember if you stay long past May."**

Even those vilified millionaires and billionaires are impacted by this housing and financial crisis. How will they pay their higher tax rates sought by the current administration if they are homeless?

To put a picture on the face of this story, below are images of the two most expensive residential foreclosures listed for sale, according to Realtor.com:



A final interesting note on this statistic of the week is that 60% of the residential foreclosures listed for sale with a price in excess of \$5.0 million are located in Arizona, California, or Florida (Source: Realtor.com).

### The Quote(s) of the Week

This week's quote is derived from an excellent article in an August 16th edition of American Banker entitled: **Big Banks Fear Retention Rule Will Destroy Securitization Market**, by Donna Borak. The article addressed an item highlighted in previous WMRs – the detriment of the Dodd-Frank legislation to our banking industry and credit markets. The two quotes in this article worth emphasizing are:

- “We believe the rules as currently proposed in response to the Dodd-Frank legislation by the regulators embed in the regulatory framework excessive cost and complexity that could impede the revitalization of healthy securitization and housing markets, and potentially unduly restrict credit availability for a majority of consumers, contravening stated policy goals of both Congress and the White House.” – Tom Hamilton, managing director, head of securitized products trading at Barclays Capital Inc.
- **“If regulators set risk retention requirements at an inappropriate level, or design them in an inappropriate manner, the cost in terms of lost long-term output could outweigh the benefits of the regulations.”** – Jeffery Perlowitz, managing director and co-head of Global Securitized Markets for Citigroup.

As this sovereign debt crisis unfolds, and the regulatory regime is increasingly punitive on the banking industry and credit markets, we're discovering the resulting impact on credit to consumers, businesses, and real estate. Essentially, the regulatory regime is saying “No Credit for Nobody in America” (NCNBIA), except the Federal Reserve. I made presentations on this NCNBIA point to the chagrin of the Federal Reserve in 2009 and 2010.

The Federal Reserve, as we have learned from the recent GAO report on its 13-3 emergency lending authority during the 2008-2009 financial crisis, does not document the circumstances by which it lends; **it simply declares “exigent circumstances.”** Let's face it, the regulatory regime is destroying the banking industry and capital markets in this country.

We now have banks closing on their own accord due to onerous and expensive regulation (Main Street Bank in Texas); last week we even had a bank in Colorado (Colorado Community Bank) sell its name to raise capital to stave off a “cease and desist” order. It's time to be outraged and understand the perspective that Dodd-Frank has on America's banking and capital markets industries before both go the way of the U.S. auto, steel, and textile industries – offshore!

### The Headline(s) of the Week

I noted in last week's WMR that I was going to be in Las Vegas on August 17th speaking at the annual Appraisal Institute (MAIs) conference. Although there was an abundance of major headlines to choose from for the week, I opted to pick something from Las Vegas that sheds light on a material systemic real estate problem in the banks that is continuing to rise: **Construction mismanagement**. The headline of the week is complements of the local Las Vegas business newspaper and reads: **Ill-fated Harmon's story might end with a bang**.

The Harmon Hotel was to be the latest of the glitzy new hotels on the Las Vegas strip and at the heart of the massive City Center project at the corner of Harmon Avenue and Las Vegas Boulevard. However, the hotel has sat empty since the opening of the City Center project in 2009 because of construction defects that render the hotel structurally unsafe. At the heart of the issue is: who in the construction process was at fault for not catching a problem that rendered the building structurally unsound and not capable of meeting the City's earthquake standards.

The allegations are flying between the hotel's owner (MGM Resorts International) and the building contractor (Perini Building Company), but the following statement from Richard Rizzo (Perini's Vice Chairman) sums the situation up best: **who is at fault is “very blurred,” and “everybody's a part of it.”** While I was in Las Vegas, MGM announced that: **“City Center has decided that to abate the potential for structural collapse in case of a code level earthquake, City Center will demolish the Harmon Hotel Building.”**

In my estimation, after the past 5 years at the Federal Reserve as the Commercial Real Estate Risk Specialty Officer, **one in four construction loans have construction mismanagement problems** to such a degree that the value impairment from these defects exceeds the project costs.

*ESSENTIALLY, THE REGULATORY REGIME IS SAYING “NO CREDIT FOR NOBODY IN AMERICA” (NCNBIA), EXCEPT THE FEDERAL RESERVE.*

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# The Bulls, The Bears & The Bewildering

Bulls are getting as hard to find as common sense in Washington D.C. However, I found a number of *Bullish* items from last week, and I didn't have to stretch to "Net Zero Energy Utilization" (NZEU) or new natural gas pipelines to be *Bullish*.



23 STATES CREATING JOBS		
STATE	RANGE	JOB GROWTH JULY '10-'11
Texas	3 States	269,500
California	>100,000	189,000
New York		106,600
Ohio		74,100
Pennsylvania		70,500
Michigan	5 States >50,000	60,000
Mass.		58,800
Illinois		51,100
Washington		38,300
Oklahoma		34,000
Wisconsin		29,900
Utah	8 States	29,700
Kentucky	>20,000	27,900
Louisiana		26,300
Oregon		25,300
Arizona		21,800
North Dakota		19,700
Iowa	3 States >10,000	18,300
Nebraska		13,400
Hawaii		9,900
N. Hampshire	4 States	9,600
Rhode Island	<10,000	6,900
Wyoming		6,300

Source: U.S. Department of Labor

In keeping with this week's theme, Perspective – Analysis – Conviction, the lead Bull story is some perspective on employment derived from some good old-fashioned subterranean analysis. The lead *Bullish* news was:

- More states are creating jobs than not; and
- Half the U.S. states have an unemployment rate below the national 9.1% rate – and 12 states have unemployment rates below 7.0%.

Taking last week's media headlines on employment at face value, the average American would think we are losing one-half million jobs per month again. While our job growth is insufficient to both absorb new workers entering the work place and employ the millions laid off over the past thirty-six months, we do have job growth.

### Many parts of Europe would gladly exchange their contracting employment for our growth.

The table to the left may provide you with a different perspective on U.S. employment growth, and some conviction on where it is plenty safe to be putting one's toe in the water to invest in U.S. real estate, businesses, and households. Aside from Texas, two other states are creating more than 100,000 jobs on a trailing 12-month basis: California and New York. Arizona, unlike Georgia, is producing jobs again. Additionally, two key midwestern states, Illinois and Michigan, are producing more than 50,000 jobs a year again. **Where is this kind of analysis and perspective in the business media right now?**

With respect to unemployment, only nine states have unemployment rates worse than the 9.1% national average. Half the states have an unemployment rate below 9.1%, and 12 states have unemployment rates below 7.0%.

However, credit to homebuyers, businesses and real estate investors is just as restrictive in these low unemployment states as it is in Nevada, California, and Michigan with unemployment rates nearly double those found in North Dakota, Nebraska, South Dakota, New Hampshire, Oklahoma, Vermont, and Wyoming. If you are looking for a different perspective on unemployment in the U.S. based on subterranean analysis to give you some conviction to invest, this analysis may be just the thing.

UNEMPLOYMENT BY STATE		
STATE	RANGE	UNEMPL. RATE
Nevada		12.9%
California		12.0%
Michigan		10.9%
South Carolina		10.9%
Wash. D.C.	>U.S. AVERAGE 9.1%	10.8%
Rhode Island		10.8%
Florida		10.7%
Georgia		10.1%
North Carolina		10.1%
<b>U.S. AVERAGE - (AUGUST 2011)</b>		<b>9.1%</b>
Texas		8.4%
Delaware		8.1%
New York		8.0%
Pennsylvania		7.8%
Wisconsin		7.8%
Alaska		7.7%
Maine		7.7%
Montana		7.7%
Louisiana		7.6%
Massachusetts		7.6%
Utah		7.6%
Maryland		7.2%
Minnesota	<U.S. AVERAGE 9.1%	7.2%
New Mexico		6.7%
Kansas		6.5%
Hawaii		6.1%
Virginia		6.1%
Iowa		6.0%
Wyoming		5.8%
Vermont		5.7%
Oklahoma		5.5%
New Hampshire		5.2%
South Dakota		4.7%
Nebraska		4.1%
North Dakota		3.3%
<b>16 STATES WITH UNEMPL. RATES 9.1% +/- 0.5%</b>		

Source: U.S. Department of Labor

**WHAT CONCERNS THE MARKET IS THAT THE FED APPEARS TO BE PURSUING AN INFLATIONARY MONETARY POLICY TO WEAKEN THE U.S. DOLLAR IN HOPES IT LIFTS U.S. EXPORTS, MANUFACTURING, AND ULTIMATELY HIRING.**

Aside from this employment profile, oil prices below \$85 per barrel of WTI (\$82.26 close Friday, Aug 19th), declining Treasury and mortgage rates, increasing multifamily real estate lending (for only the second time in history, FHA will surpass \$10 billion in new multifamily loan commitments in fiscal year 2011), and Fitch breaking ranks with S&P and reaffirming the triple-A credit rating of the U.S., there was a lot of *Bullish* news last week - if one had taken the time to do the analysis to gain a contrarian perspective.



**THE BEARS**

Where to begin? Whether it was the decline in Empire State Manufacturing Index, elevated readings on producer and consumer prices, another month of atrocious existing home sales, or more bank failures, there was plenty to be *Bearish* about last week before we even ventured into the news from Europe – our largest trading partner excluding OPEC. Rather than belabor the *Bearish* news we all are familiar with, this week I am just providing the numbers and charts regarding the key PPI, CPI, housing sales, and bank failure metrics.

**Inflation**

Producer price Index: PPI for July, 2011

**Table A. Monthly and 12-month percent changes in selected stage-of-processing price indexes, seasonally adjusted**

Month	Finished goods				Change in finished goods from 12 months ago (unadj.)	Intermediate goods	Crude goods
	Total	Foods	Energy	Except foods and energy			
<b>2010</b>							
July.....	0.1	0.7	-1.0	0.2	4.1	-0.4	1.5
Aug.....	0.6	-0.1	2.5	0.1	3.3	0.6	3.3
Sept.....	0.3	0.9	0.0	0.2	3.9	0.4	0.6
Oct.....	0.6	0.5	3.0	-0.3	4.3	1.0	4.8
Nov.....	0.5	0.8	1.6	0.0	3.4 <sup>f</sup>	0.9	1.4
Dec.....	0.9	0.8	2.5	0.2	3.8	1.1	6.9
<b>2011</b>							
Jan.....	1.0	0.4	2.8	0.5	3.6	1.6	3.5
Feb.....	1.5	3.5	2.9	0.2	5.4	1.9	3.1
Mar. <sup>1</sup> .....	0.7	-0.4	2.8	0.3	5.6	1.4	-0.8
Apr. <sup>1</sup> .....	0.9	0.8	2.7	0.3	6.8	1.1	3.8
May.....	0.2	-1.4	1.5	0.2	7.3	0.9	-4.1
June.....	-0.4	0.6	-2.8	0.3	7.0	0.0	-0.6
July.....	0.2	0.6	-0.6	0.4	7.2	0.2	-1.2

PPI for Finished Goods has been rising since Jan 2011.

Although the Producer Price Index for finished goods rose just 0.2% in July, seasonally adjusted, it's up an alarming 7.2% for finished goods for the 12-month period ending July 2011. The important perspective that rattled the

markets – as seen in the preceding table from the PPI – is that the prices for finished goods on a trailing 12-month basis has been rising since June of last year. It has doubled from +3.6% to +7.2%.

**Manufacturing**

The week started off with a thud when the NY FED reported on Monday, August 15th that manufacturing activity in the NY region (second largest in the U.S) contracted for a third consecutive month. The New York FED's "Empire State" general business conditions index fell to negative 7.72 from negative 3.76 the month before. New orders worsened to negative 7.82 from negative 5.45, while inventories fell to negative 7.61 from negative 5.56.

This survey of manufacturing plants in the NY region is one of the earliest monthly guideposts to U.S. factory conditions. It should be of particular concern right now as the manufacturing activity in the NY region is not impacted by supply disruptions from the Sendai earthquake; rather it is weakening demand for our goods in Europe and the rest of the U.S. Keep an eye out for the upcoming Durable Goods report next week and Institute for Supply management (ISM) report after that.

**Consumer Price Index – CPI**

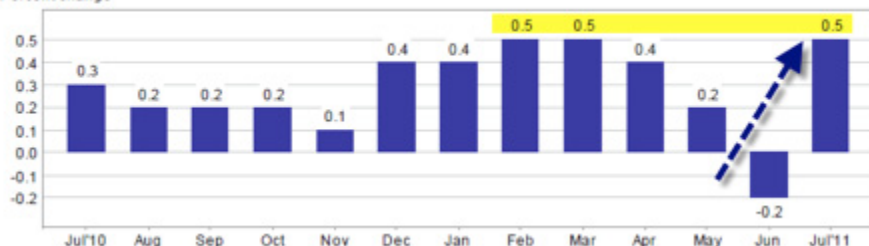
On the heels of the PPI data, the market received additional data confirming inflation concerns at the consumer level. Despite lower gasoline prices and early back-to-school sales by retailers, consumer prices spiked back to their highest levels over the past year. Inflation is one of those systemic risks that rears its ugly head at the most inopportune times.

What concerns the market is that the FED appears to be pursuing an inflationary monetary policy to weaken the U.S. dollar in hopes it lifts U.S. exports, manufacturing, and ultimately hiring.

The flaw in the FED policy is twofold: global demand, which is collapsing, not the price of the U.S. dollar, drives manufacturing activity; and inflation is not that easy to control once it gets embedded.

While it may devalue the dollar and ultimately outstanding U.S. debt, it also acts as a drain on consumer spending in much the same way as higher gasoline prices because the consumer's buying power is diminished by higher prices on food and all basic non-core things consumers spend money on every day.

Chart 1. One-month percent change in CPI for All Urban Consumers (CPI-U), seasonally adjusted, July 2010 - July 2011  
Percent change



**Existing Home Sales by the National Association of Realtors**

The latest data from NAR shows investors are buying up homes priced below \$250,000 for rental and investment opportunity. Demand for the higher-end price points remains weak. Adding the previously presented data on high-end foreclosures rising over 300% since 2007, the decline in the max FHA, Fannie, and Freddie residential loan amount to \$625,000 and the news for the higher-end housing market is not encouraging. For my banking colleagues with high-end or jumbo mortgage portfolio exposure, plan for more ALLL (allowance for loan and lease losses). For my cash-flush and opportunistic colleagues, there may never have been such a good time to buy a high-end or luxury home – as long as you have the cash.

**NAR'S REGIONAL SALES BY PRICE RANGE: EXISTING SINGLE FAMILY HOMES SOLD, JULY 2011**

REGION	\$0-100K	\$100-250K	\$250-500K	\$500-750K	\$750K-1M	\$1M+
Northeast	14.0%	32.5%	14.1%	14.9%	-3.8%	-8.4%
Midwest	24.9%	37.0%	28.2%	3.5%	16.1%	13.2%
South	16.0%	18.0%	9.4%	-0.1%	12.6%	11.6%
West	59.7%	15.9%	3.1%	-10.7%	-7.9%	0.1%
U.S.	24.6%	24.2%	11.5%	1.4%	-0.6%	0.3%

**SALES DISTRIBUTION**

Region	\$0-100K	\$100-250K	\$250-500K	\$500-750K	\$750-1M	\$1M+
U.S.	22.8%	43.7%	23.4%	6.4%	1.9%	1.9%

Source: NAR

**UNEMPLOYMENT INSURANCE DATA FOR REGULAR STATE PROGRAMS**

WEEK ENDING	ADVANCE AUGUST 13	AUG 6	CHANGE	JULY 30
Initial Claims (SA)	408,000	399,000	9,000	402,000
Initial Claims (NSA)	342,669	354,408	-11,739	341,103
4 WK Moving Avg. (SA)	402,500	406,000	-3,500	408,250

Weekly Jobless Claims rose by nearly 10,000, but only 3 states reported an increase of more than 1,000 claims. This report was on the heels of a decline in claims the prior week and two consecutive weeks in which no states reported an increase in claims.

The perspective to have, though, is on what is ahead in Q4 and Q1 2012 given the job cut announcements (Bank of America, Cisco, Caterpillar, etc.). Your leading indicator here is the monthly Challenger employment report. It will guide you forward 1-3 quarters.

**Bank Failures**

Bank closings did not end with the end of former FDIC chair Sheila Bair's tenure as head of the FDIC last month. Interim acting chair Martin Gruenberg is chipping away at the 888 banks on the FDIC watch list. Next week, the FDIC will release an updated watch-list report on the banks. It'll be interesting to see if that list continues to grow. The four bank failures from last week bringing the 2011 tally to 68 were:

- **Palm Beach, FL-based Lydian Private Bank**, whose assets were acquired by Miami-based Sabadell United Bank NA. As of June 30, Lydian Private Bank had approximately \$1.70 billion in total assets, \$907.1 million of which are covered by a loss-share transaction entered into by Sabadell United Bank and the FDIC.
- **The OCC also closed Statesboro, GA-based First Southern National Bank.** Albany, GA-based Heritage Bank of the South agreed to assume the deposits and purchase essentially all of the assets of the failed bank. The FDIC and Heritage Bank of the South's loss-share agreement covers \$115.7 million of assets.
- **State regulators in Illinois closed Geneva, IL-based First Choice Bank.** The FDIC entered into a purchase-and-assumption agreement with Oak Brook, IL-headquartered Inland Bank and Trust. First Choice Bank had approximately \$141 million total assets as of the end of the second quarter.
- **The Pennsylvania Department of Banking closed Huntingdon Valley, PA-based Public Savings Bank**, whose assets were purchased by Rockville, MD-based Capital Bank NA.

**Nonperforming commercial real estate loans were a key driver behind all four banking institutions' demise.** For in depth analysis of these watch list financial institutions, refer to TREPP Bank Navigator data and reports. TREPP, the industry gold standard for CMBS intelligence, has nearly mimicked the CAMEL banks rating system used by the respective bank regulators and does a better job analyzing banks than the regulatory community.

AS PROFFERED IN THE WMR THE WEEK PRECEDING THE U.S. DEBT DOWNGRADE, WE NEED TO CHANGE OUR CONCEPTION OF RATING AGENCIES INSTEAD TO RATING COMPANIES, AS IT IS NOT POSSIBLE TO RATE THE DEBT OF GOVERNMENTS GIVEN THE ACCOUNTING GIMMICKRY.

TREPP Bank Navigator is a top banking and real estate industry intelligence recommendation. It's "bottom-up" analysis that is unparalleled.

### Growth Forecasts being revised downward

My final *Bearish* item to note for last week was the plethora of growth forecasts to the downside by the likes of JP Morgan, Citi, and chief economists at FBOs (Foreign Banks Operating in the U.S). As these "Johnny come lately" forecasters revise their GDP estimates downward to 2.0% or less, recall the WMR GDP forecast in Q1 for 2011: **Slow growth (<2.0% GDP) as we cut government debt.**

Recall that the WMR was the first to suggest maybe a less than 1.0% GDP for 2011 at the beginning of Q2: **"No growth while government can't act."**

Analysis after the fact doesn't help you know when to deploy the principle of substitution in time to mitigate losses or capitalize on opportunities. The goal of the WMR is to give you the "before the event" analysis to deploy the principle of substitution. Hopefully, the WMR can provide you with the conviction of fully developed perspectives derived from robust analysis.



### THE BEWILDERED

The market is telling us it is *Bewildered* by adopting a "short everything" investment strategy. The short investing strategy is so pervasive by hedge funds and other money managers that one has to track the covering of short-positions to understand the wild swings in trading from day-to-day. Increasingly, the volatility in the market is attributable to shorting strategies rather than any underlying performance or belief in a particular stock or sector. After what we've observed with the U.S. based rating agencies, one might conclude the same with respect to rating analyses.

Two weeks ago S&P downgraded the U.S. debt despite making self-admitted trillion-dollar errors in its calculations; and last week Fitch reaffirmed the U.S. triple-A credit rating despite evidence that the U.S. now needs to apply 100% of its household income to retire its \$98.141 trillion in total debt (federal, state, municipal, consumer, mortgage, and pension liabilities) if it were to amortize it all via a 30-year, fixed-rate mortgage at 5.0%. It would seem S&P got the downgrade right

by accidental incompetence, and Fitch has it wrong due to fear of political reprisal like that being enacted on S&P by U.S. authorities (the Justice Department Treasury and the SEC) and European governments (Italian raid of S&P's Milan offices the day preceding its U.S. debt downgrade).

Therefore, it should be of no surprise that my top *Bewildering* news item of last week was Fitch's reaffirmation of the U.S. triple-A rating. If the U.S. is a triple-A credit rating, gold should be selling for half its current price. It appears our creditors and the marketplace have a different assessment of the U.S. fiscal situation.

As proffered in the WMR the week preceding the U.S. debt downgrade, we need to change our conception of rating agencies instead to rating companies, as it is not possible to rate the debt of governments given the accounting gimmickry, absence of fiscal discipline by politicians facing re-election, and all global currencies operating as fiat currency – not backed by anything of value but a promise to pay. **Rating agencies should stick to rating companies, not governments.**

The other *Bewildering* items of the week were:

- The rise in housing starts despite weak existing and new home sales data. Keep in mind that multifamily is driving this measure and banks and builders are not so crazy as to be starting a material amount of new single-family homes.
- Congress's sudden inquiry into the impact of Dodd-Frank after the legislation was passed and is devastating the U.S. banking industry, versus before it voted on the legislation. Increasingly, community bankers are having the fortitude to speak up about the atrocities of Dodd-Frank despite the risk of regulatory reprisal. Last week, American Banker published an interview with Paul Reed, president and chief executive of the \$256 million-asset Farmers Bank and Savings Company in Pomeroy, Ohio. Highlights include:
  - Reed testified at a Senate Banking subcommittee hearing in April on the "opportunities and challenges" facing community banks despite fear of regulatory reprisal.
  - Regulators are keeping his bank and most community banks from making loans to qualified borrowers through tactics that threaten banks with requiring more ALLL and capital if they make any kind of real estate or business loan.

*AS GOES THE EUROPEAN DEBT CRISIS THROUGH THE END OF THE YEAR, SO TOO GOES THE U.S. ECONOMY. EUROPE IS OUR LARGEST TRADING PARTNER OUTSIDE OPEC, AND IS INEXTRICABLY LINKED TO OUR FINANCIAL MARKETS.*

- Reed provided detailed examples of what he referred to as overzealous regulation. During his recent 2011 bank exam, Reed said, the examiner in charge for his bank exam had dressed down Farmers' CFO for not depreciating wallpaper fast enough and harassed the chief lending officer over a \$323 loan. But those were merely annoyances. Reed's main gripe was the examiners' insistence that Farmers further downgrade a loan to a longtime customer, a move that ended up choking off credit to its community.
- Reed went onto to testify that: "Federal examiners are exercising too much control over lending decisions." He went onto to elaborate on the loan downgrade that ended up choking off credit to a vital business in its community..."That \$150,000 that we had to beef up our loan reserve for a very solid customer equates to \$1.5 million of loans. As a result, our board members now ask the question: "What will the regulators think of this loan?" The regulators have now entered into our decisions on what is best for our communities. Banks now make loans based on what they think the regulators will do versus whether the loan is a properly underwritten credit decision.

What's *Bewildering* is that Congress is just now - a year after the passage of Dodd-Frank - interested in the legislation's impact on community banks. Aren't legislators supposed to conduct this kind of inquiry before they pass legislation? Now, as the final details of the rules to implement Dodd-Frank are written, community banks realize how adversely they are impacted. For community bankers, like Paul Reed, to speak up, things are bad. They are so bad that we now know banks are calling it quits voluntarily, and some are having to hock everything including their name (Community Banks of Colorado) to raise capital in response to arbitrary and inconsistent bank examiner practices.

**THE ECONOMIC CALENDAR FOR THE WEEK AHEAD: AUGUST 22-26**

There is no safe time to take a vacation in this kind of market. Despite the comparatively light flow of economic data and earnings releases, the market was not - as I had suggested - "a safe time to escape before Congress returns and we get new employment reports after Labor Day." Europe is the thorn in the global economy, and its sovereign debt problems are

taking on an "insurmountable" perspective by investors. It's amazing that there is so much uncertainty around U.S. bank exposure to Europe after all the bank stress tests by the Federal Reserve. I would love for the GAO to audit the bank stress testing process and share with you what I know about the bank stress tests. Until the market understands the ripple effects, the European debt crisis will be a dominating drain on the market psychology.

As goes the European debt crisis through the end of the year, so too goes the U.S. economy. Europe is our largest trading partner outside OPEC, and is inextricably linked to our financial markets. Aside from monitoring the European debt crisis, the likely market moving events for next week will be:

- Durable Goods on Wednesday
- Another weekly jobless claims report on Thursday
- GDP on Friday
- Bernanke speech from Jackson Hole, Wyoming on Friday where the market is expecting another QE program announcement, and
- Natural Disasters - we are in hurricane season and have a storm named Irene that has all the makings of a hurricane that will impact the U.S. East coast.

## DISCUSSION ITEM

This week's discussion item relates to a speech delivered by Bob Nielsen, chairman of the board of the National Association of Home Builders, at the Appraisal Institute's annual conference in Las Vegas last week. AKA "Bob the Builder," Mr. Nielsen used this event as a platform to blame all that ails the new home industry on "bad appraisals." Forget the massive overbuilding of homes 2004-2007 (to the tune of approximately 1.0 million more homes than the 800,000 needed/supported by organic growth during this same period), and forget the explosion of subprime and NINJA (No Income, No Job, and No Ability to pay) mortgage products to unsuspecting first-time homebuyers; and forget the speculative run-up in home prices by investors in markets like Florida, California and Las Vegas, it was all bad appraisals that derailed the housing industry. "Bob the Builder's" solution to what ails the housing industry is to promote a piece of proposed legislation that will abolish the use of distressed and short sales as comparables for all new home appraisals.

*MEMBERS OF THE APPRAISAL INSTITUTE ARE AMONG THE MOST EDUCATED AND EXPERIENCED IN THE FIELD OF REAL PROPERTY VALUATION, BUT WE HAVE TO COMPETE FOR A LIVING.*

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Ignore the principle of substitution that was laid out earlier in this WMR, and forget the fact that the market may consist of only foreclosure and short-sales in many MSAs today, let's make up a new kind of value just for new homes that excludes any comparables that suggest a new home is not worth its cost to build. Rather than recognize the real causes at the heart of this housing crisis:

- Overbuilding
- Speculative investing
- Subprime mortgage products and mortgage fraud
- Freddie and Fannie being exempt from FIRREA and the USPAP appraisal regulations
- Promulgation of a "fast and cheap" appraisal process by the regulators, which encourages lenders to hire the least qualified and competent appraiser

Nielsen told an audience, comprised of members of the one appraisal industry association which has been the leader and outspoken voice on appraisal competency and education (the Appraisal Institute), that we were the scourge on the new home industry.

To my surprise, my fellow colleagues and I sat politely and gave him his air time; and then we adjourned for a break to take an extra dose of our blood pressure medication. I raise this item for discussion not just because it hits close to home being a third-generation MAI and member of the leading global organization with the highest professional, education and ethics standards, but to highlight the pervasive tendency among our leaders in government and industry to:

- Avoid responsibility
- Look for the expedient "fast and cheap" solution, and
- Ignore the tough aspects of the problems we face to heal our economy and real estate industry.

It all goes back to leadership. The issue at hand that "Bob the Builder" refused to acknowledge is competency. We don't need legislation to develop a new type of value just for new homes, or to tell appraisers when they can or can't use foreclosure and short sales as comparables. We need the bar on appraisal competency raised so that the appraiser knows how to adjust a foreclosure or short sale for things like "conditions of sale."

Members of the Appraisal Institute are among the most educated and experienced in the field of real property valuation, but we have to compete for a living based on fees paid to the least competent and trained in the appraisal industry – a state licensed appraiser. State licensing is a minimum bar to become an appraiser and does not assure a bank, borrower or investor of any kind of competence. Do you want the minimum of competence working on your car, representing you in court, or treating an illness? On this subject, I typically ask the audience the following questions and hope they get the point that Nielsen does not: it's about competency!

Q. What are the two most important things to get right in any real estate transaction?

R. Title or ownership and value or price.

Q. What is the least compensated professional in a real estate transaction?

R. The appraiser.

Q. What is the minimum credential to appraise real property in all 50 states and for any federally regulated transaction (loan by a bank)?

R. A state licensed appraiser with typically less than 100 hours of education and experience.

Q. What is the most rigorous and difficult appraisal credential to obtain in the field of real property appraisal that rivals the education and experience requirements to become a CPA or CFA?

R. An MAI (Member of the Appraisal Institute) or SRA (the other professional designation issued by the Appraisal Institute for individuals specializing in residential valuations).

Q. What was the standard appraisal competency requirement mandated by banks prior to the FIRREA legislation following the S&L crisis?

R. Holding the MAI or SRA designation.

The regulatory regime has undermined the reliability of real property valuations over a 20 year process. It started by exempting the GSEs (Freddie Mac and Fannie Mae) from FIRREA and the USPAP appraisal regulations, and it deteriorated as:

- The bank regulators adopted Interagency Appraisal Guidance that mandated only compliance with minimum standards (i.e., having a state license).

## KEY ECONOMIC FINANCE RATES

### US UNEMPLOYMENT (AUG):

U-3 (official rate)	9.3%
U-6 (total rate)	16.3%

Note: Just Updated Aug 5

### JOBLESS CLAIMS: (AUG)

Initial (Aug 13th)	408,000
Initial (Prior Wk)	399,000
4-Wk Average	402,500

### HOME FORECLOSURES:

CY 2011	1,100,000
CY 2010	1,005,000
CY 2009	918,000
Dec 2010	69,847

### GROSS DOMESTIC PRODUCT:

Q2 2011(Advanced)	+1.3%
Q1 2011 (Revised)	+0.4%
Q4 2010	+2.8%
Q3 2010	+2.6%
CY 2010	+2.9%

New Readings Next Week.

### TREASURY RATES (JULY 29):

2-Year Tr (Up 1 BPS)	0.19%
10-Year Tr (Down 13 BPS)	2.26%

### LIBOR

6-Month	0.45%
3-Month	0.28%
1-year	0.76%
PRIME % (US)	3.25%

(Fed FOMC Mtg Sep. 20)

### MORTGAGE RATES (JULY 29):

30-yr Fixed	4.67% (-11 bps)
15-yr Fixed	3.89% (-12 bps)

### CONSUMER PRICE INDEX:

July	+0.5%
June 2011	-0.2%
May 2011	+0.2%
April 2011	+0.4%

### CMBS DELINQUENCY:

(Source: TREPP)	
9.88% - July 2011	up 51 bps
9.37% - June 2011	down 23 bps
9.60% - May 2011	down 5 bps
9.65% - Apr 2011	up 23 bps
9.42% - Mar 2011	up 3 bps
9.39% - Feb 2011	up 5 bps
9.34% - Jan 2011	up 32 bps

### COMMODITIES:

Gold (\$/oz Aug 19)	\$1,852
Gold ( prior low: 1/2006)	\$ 540

Oil (WTI) July 15' 11	\$82.26
Oil (High) Jun 13' 08	\$135.00
Oil (Low) Jan 09/09	\$40.83

## DISCUSSION ITEM CONTINUED

- Bank regulators failed to update the Interagency Appraisal Guidance once since 1994, and the advent of securitization, subprime mortgage lending and non-bank entity CRE lending.
- Bank regulators, like the Federal Reserve, minimized the importance of real estate appraisals by not even having a chief appraiser or a single MAI or state certified appraiser on staff in the past decade until I was hired in 2005. Between 2005 and 2010, I was the only credentialed appraiser in the entire Federal Reserve system. I was aghast at how little real estate training examiners were provided, and yet was represented to the public and banks as possessing in their roles as bank examiners for a banking industry that was becoming increasingly concentrated in commercial real estate. The Federal Reserve remains the only primary regulator without a chief appraiser or dedicated function area focused solely on real estate valuation. Real Estate valuations are just not a priority at the Federal Reserve.
- The respective bank regulatory agencies adopted CRE Workout Guidance to "extend and pretend" bank CRE problems; and
- The Federal Reserve conducted "CRE stress testing on the banks" with little to no valuation expertise.

If we are going to get beyond this real estate and financial crisis, we need leadership to address the real problems and not chase the shadows.

If borrowers, investors and lenders don't believe in the reliability of valuations, capital will remain at bay for the real estate industry. Competency is the issue, not new definitions of value that exclude foreclosures and short sales.

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