

# COLLIERS INTERNATIONAL VALUATION & ADVISORY SERVICES

## WEEKLY MARKET RECAP



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Compared to the previous few weeks, the flow of market moving data will be comparatively light.

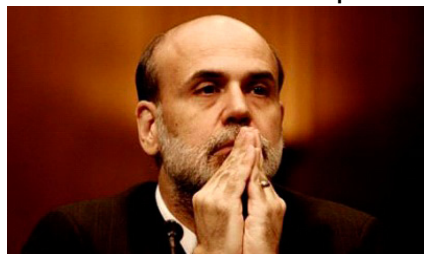
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## Macro Economic and Real Estate News

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

A common expression is that a picture is worth a thousand words. In the case of the past few weeks, four pictures are worth the thousands of words of frustration in the mind of the FED Chairman over the U.S. debt crisis and credit downgrade.

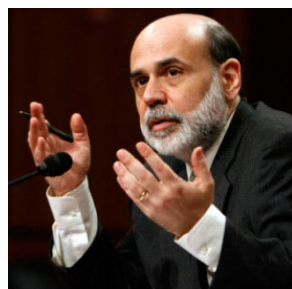
#### The faces of the FED Chairman the past 4 weeks.



FED Chairman monitoring Congress negotiating a solution to the Debt Ceiling.



(Left) FED Chairman after the Debt Ceiling vote  
(Right) FED Chairman after the Debt Downgrade



The FED Chairman after last week's FOMC meeting  
"So now what do you want me to do?"

Say what you will about the Federal Reserve Chairman. However, no one can make the claim that he didn't at least try. For the past four years, Federal Reserve Chairman Bernanke has rolled up his sleeves, and tried things never imagined by any central banker in efforts to prevent another 1929-1934 banking crisis and potential depression. He created facilities such as the Troubled Asset Relief Program (TARP) as a kind of firewall to alleviate an uncontrolled burn in our financial system following the demise of Lehman Brothers, Wachovia, and takeover of AIG. He designed Troubled Asset Loan Facility (TALF) to restart the capital markets and CMBS. He had the vision to initiate bank stress testing to avoid a 1933 bank holiday. Unfortunately, the quantitative easing may have just delayed and exacerbated the inevitable. As we watch unprecedented market volatility, and another capital market lock-up as debt investors search for a pricing floor, Congress has abdicated its responsibilities and our financial standing in the world continues to erode. The genesis of this situation has been more than a decade in the making. It all boils down to two simple principles that are tried and true - whether you are red or blue in your politics:

- Job growth is the foundation for economic growth.
- Fiat currency economies have failed since the Roman Empire and Song Dynasty when their rulers discovered the ability to print money and breach the only thing of value in a fiat currency: the promise and ability to pay.

Since last January, at 30 national events, CIVAS Analytics has emphasized 2 points to the respective industry and regulatory audiences:

- **Jobs:** What we did in America the past decade has handicapped us.

The 2000 to 2010 period was the first decade since the end of WW II in which the U.S. did not experience double-digit, 20% plus job growth. In fact, we had net negative job growth.

This week, a much simpler view of the U.S. debt situation comes to you compliments of one of my regulatory colleagues who prefers to remain anonymous – not just because of his Irish heritage.

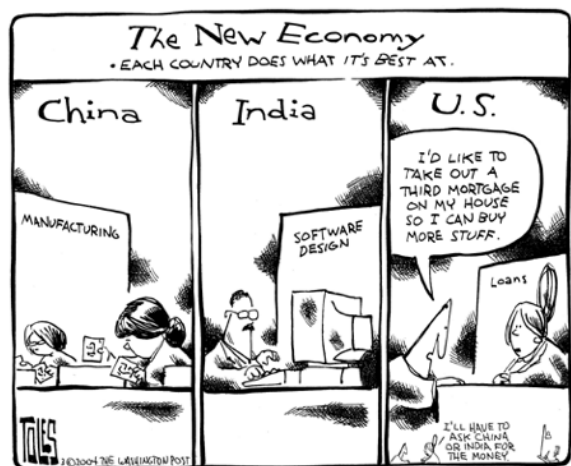
AMERICA'S LOST DECADE OF JOB GROWTH		
DECADE	JOB GROWTH (MILLIONS)	% CHANGE
1940's	11.927	38%
1950's	10.744	25%
1960's	16.902	31%
1970's	19.624	28%
1980's	18.351	20%
1990's	21.630	20%
2000's	-1.179	-1%

Source: BLS

**So where do we go from here?**

The founding fathers should have envisioned this debt scenario and structured a mechanism to call for new elections in the event of a credit downgrade. Recognizing we didn't have debt ceilings and credit reporting agencies at the "get-go" of America, we can't blame the absence of such a mechanism on the founding fathers.

The topic is merely being raised as a means of expressing the urgency of reigning-in uncontrolled spending. It's a concern whether the economy, debt markets, and nearly depleted state unemployment coffers can make it until November 2012 to install a new class of elected officials to begin the work of economic reconstruction.



The cartoon to the left, used in numerous Keynote Presentations, sums it up quite well:

- We sent our manufacturing to China;
- We subcontracted our computer programming to India; and
- Americans went into debt to buy the products produced by the rest of the world.

**Where we go from here is uncharted territory.**

All the economic metrics from last week that showed the Bulls charging ahead are now backward looking and precede the debt downgrade. The dip in jobless claims below 400,000, for example, does not account for the forward guidance on job cuts now being revealed by private employers (such as Cisco) noted in the August *Challenger Employment Report*.

**• An Uncontrollable Deficit**

The second point has been our uncontrollable deficit spending. It extends far beyond the \$14.3 trillion federal debt highlighted in the media to the \$98.141 trillion total U.S. debt obligation - including all federal, state, municipal, unfunded pension, consumer, and mortgage debt. The mid-2011 per capita debt obligation for America is approximately \$320,000 – or 100% of household income. Over the past few weeks, we've provided you with this tally in a tabular format.

It also doesn't factor in 120,000 postal worker job cuts, or the likelihood of more state job cuts at the end of 2011, as states face mid-year budget readjustments based on revenue collections.

The same is true for retail sales data. Last week's figures preceded the debt downgrade - and likely reflected early back-to-school spending. For some forward perspective, focus on metrics like Consumer Confidence. It hit a 30-year low last week.

**Hunker-down is likely where we go through the end of 2011.**

Recall the economic forecast for 2H 2011 that pre-dates the debt ceiling debacle and U.S. credit downgrade from June:

**"No growth while government can't act."**



"GUESS I OVER DID IT A LITTLE....."



## THE SCORE BOARD

WEEK ENDING	BULLS	BEARS	BEWILDERED
August 12	5 ★	4	4
August 5	3	4	5 ★
July 29	2	5 ★	3
July 22	3	4	5 ★
<b>4-Week Avg.</b>	3.3	4.3	4.3 ★



## The Score Board

### "THE BULLS STRIKE BACK"

The resiliency of the market came to the rescue last week and sent the Bears back to their caves – at least temporarily. After a week of dizzying market volatility with 400-point daily moves in the DOW, and a pall of consumer and business pessimism, the DOW closed down for the week a mere 1.5%, the S&P down 1.7%, and the NASDAQ down less than 1.0%. Furthermore, weekly jobless claims surprisingly were less than the 400,000 claims level. Retail sales indicated the consumer was still spending in July. The substantial drop in oil prices to below \$90 per barrel may factor into some back-to-school retail sales for the month of August. Even more surprising, was that a

*THROUGH THE HEAVY HAND OF REGULATION, THE U.S. IS DISMANTLING ITS BANKING AND FINANCIAL SERVICES INDUSTRY.*

### STATISTIC(S) & HEADLINE(S) FOR THE WEEK AUGUST 8 - 12

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

This week, there are two statistics. Both statistics are aimed at reorienting our attention to a couple of leading indicators not typically considered in forecasts of the U.S. economy. However, both these items will provide investors with more insight into the likely direction of the U.S. economy in the coming quarters than most traditional metrics. The two statistical indicators are:

- Hong Kong GDP – a bell-weather indicator of global growth due to its export-driven economy.
- Money Market flows – an alternate measure of consumer sentiment and a temperature gauge for investor risk.

#### Hong Kong GDP

In Q2, Hong Kong's GDP contracted 0.5% (first negative reading since Q1 2009 and the depth of the U.S. financial crisis), and its merchandise

new CMBS transaction made it over the goal line by Deutsche Bank, and mortgage rates fell to their lowest levels of the year. The 15-year fixed mortgage rate dropped below 4.0% to 3.89%. This kind of market performance in the face of the category 4 hurricane headwinds warrants a *Bullish* rating for last week. The 4-week moving average score remains tied as *Bearish* and *Bewildering* with a score of 4.3. The scoreboard reflects the volatility of the market whereby investors and capital sources seem to be vacillating between a "flight or fight" response. Last week, the market decided to fight. Next week is a whole different story – especially as we receive new readings on:

- Industrial Production
- Producer Price Index (PPI)
- Consumer Price Index (CPI)
- Retail guidance from Wal-Mart & Home Depot
- Housing Starts and Existing Home Sales, and
- Leading Economic Indicators.

The market in the week ahead will have tangible evidence as to the damage done to the economy by the debt ceiling fiasco, S&P U.S. credit downgrade, and debt crisis in Europe. The market will begin to chart its own course assuming Congress remains A.W.O.L.

exports declined 11.0%. Hong Kong's export-led economy is a reliable bell-weather gauge of global growth.

What the GDP and merchandise export data are signaling out of Hong Kong is that global demand is declining abruptly as a result of the debt crises in both Europe and the U.S.

Begin to pay as much attention to GDP measures for non-U.S. countries, like Hong Kong, India, and Germany. As goes their GDP, so too will U.S. manufacturing activity given its dependency on global demand. The economic indicators section will be revised in September to update for these types of economic indicators.

#### Flow of Funds into Money Markets

According to EPFR, last week, global equity funds had more money pulled out of them than at any time since early 2008.

Investors moved faster out of risky junk-rated bonds than at any time since records began in 2005. Money markets attracted net inflows of \$49.8 billion of that money. David Shairp, global strategist at JP Morgan Asset Management, summed it up best with the following comments in interviews with Bloomberg and CNBC:

- Investors have spent the week worrying about anemic economic growth in developed countries and hoping that central banks will intervene to prop up markets.
- Extraordinary is the very least you can say, the degree of the movements shows that the markets are pricing in something really apocalyptic.

Monitoring the flow of funds is a reliable indicator of risk aversion by investors. Until we see these flows revert back out along the risk curve, capital for activities germane to real estate – like CMBS – will remain constrained.

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

This week's quote relates to a series of comments made in relation to a Kingwood, Texas community bank's decision to close – not because of any regulatory action or deterioration relative to key capital ratios, but because of the paralyzing bank regulatory environment. Prior WMRs have addressed this item, but a bank calling it quits voluntarily is a first in my career. Last week, the following statements were made by Tom Depping (Main Street Bank of Kingwood, Texas' CEO) and Paul Merski (chief economist for the Independent Community Bankers Association), respectively:

- **The regulatory environment makes it very difficult to do what we do.**  
– Tom Depping, CEO of Main Street Bank
- **I blame this move to close the bank on a tightening regulatory noose. Bankers have long complained about their overseers, but it is rare for a bank to basically close its doors aside from an acquisition or failure. Maybe this move will call some attention to the regulatory problem faced by community banks.**  
– Mr. Depping, CEO of Main Street Bank
- **The No. 1 complaint we hear from community bankers is that they feel regulators have gone one step too far and are choking off lending**  
– Paul Merski, chief economist, Independent Community Bankers Assoc.

The 27-year-old Main Street bank – which survived the downturn of the oil-patch, S&L crisis of the late 1980s, and 1991-1994 commercial real estate recession – will surrender its banking charter and sell its four branches. Mr. Depping plans to set up a new “lender” that will operate beyond the reach of banking regulators—and the deposit-insurance safety net. Backed by the private investment firm of Microsoft Corp. co-founder Paul Allen, the company won't be able to call itself a bank, but it will be able to do business the way Tom Depping wants. Look for the mother of all capital markets disruption later this fall when the Federal Reserve announces whom it will deem as “systemically important” and begin to regulate. Dodd-Frank requires the FED to write rules that hold systemically important companies – both banks and nonbanks – to standards that are “more stringent” than those applied to other financial firms. These “enhanced prudential” standards will cover everything from risk-based capital rules and a leverage ratio to liquidity requirements and concentration limits. They will dictate risk management practices, resolution plans, and credit exposure reports.

The law also gives the FED the option of imposing standards on contingent capital, enhanced public disclosures, short-term debt limits, and any other factors the central bank “determines are appropriate.” The statutory deadline for these rules is Jan. 1, 2012, so the FED has less than five months to propose, collect comments, and adopt a final rule. FED officials have said little about the proposal other than noting it will be released before summer's end. The rule is rumored to run 1,500 pages, and most sources expect the central bank to fully flex its new powers and expanded regulatory authority to entities that frustrated it during the 2008-2009 financial crisis. Tom Depping and Main Street Bank of Kingwood, Texas may just well be getting out from under the heavy regulatory hand in the nick of time.

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

In last week's *Economic Calendar for the Week*, the FOMC meeting and Chairman Bernanke's press conference was identified as the event that would overshadow all other market news. As it turns out, the Chairman's comments did overshadow all. The Federal Reserve's statement addressing further FED monetary easing made the headline of the week: **FED's Message to Markets: “Stand on Your Own”**

*THE LAW GIVES THE FED THE OPTION OF IMPOSING STANDARDS ON CONTINGENT CAPITAL; ENHANCED PUBLIC DISCLOSURES; SHORT-TERM DEBT LIMITS; AND ANY OTHER FACTORS THE CENTRAL BANK “DETERMINES ARE APPROPRIATE.”*

*IF ONLY WE COULD ALL BE AS OPTIMISTIC AS MR. PAULSEN AND BELIEVE THAT THE FED IS GOING TO LET THE MARKETS FUNCTION ON THEIR OWN TWO FEET.*

This headline resulted from a CNBC interview with James Paulsen, chief market strategist at Wells Capital Management. In the interview, Paulsen cut to the heart of the Federal Reserve's statement by noting that the FED was essentially saying:

**We'll keep interest rates low as long as you want, but outside of that you're on your own.**

Mr. Paulsen went on to note:

- "Since the 2008 crisis, the market has developed this thought that if we crash the FED will spend \$740 billion on you, and they'll keep dropping rates too. That's an unhealthy environment for investors."
- "To the extent that the FED is getting away from that and saying, "stand on your own," that's a very healthy development and new position for the FED."

If only we could all be as optimistic as Paulsen and believe that the FED is going to let the markets function on their own two feet. The FED has tinkered to such a degree, and ballooned its balance sheet in a way that the

FED is now a market force of its own. It can't just walk away. Have they forgotten the lessons learned from 2009? Such as:

- It's more complex than just low interest rates. If it were just about low interest rates the housing crisis would be over by now.
- It's hard to restart capital markets and key credit facilities, like CMBS, when they lock-up and shut down. Extraordinary efforts are needed to free-up debt capital when it all seizes up. The TALF program and its extension to CMBS is just one such example.
- It's about confidence, liquidity, trust between financial institutions and the ripple effect on jobs and GDP.

At a minimum, the FED will need to become the buyer of last resort again for the debt instruments linked to our fiat currency. If they let the CMBS market implode again and completely shut down, "Houston, we have a problem."

## The Bulls, The Bears & The Bewildering

Unlike last week, we did not need to enlist the assistance of an NCIS (Navy Criminal Investigative Service) team to locate some *Bullish* news. The market's resiliency came to the forefront and produced:

- **A drop in weekly jobless claims to 395,000** claims with no states reporting an increase of 1,000 claims.
- **A 0.5% increase in July retail sales** – best performance since March 2011 and post the Sendai earthquake.
- **Dow, S&P 500 and NASDAQ stock indices recovering nearly all of the 400 point declines** during the earlier part of the week to close down a modest 1.5%, 1.7% and 0.9%, respectively.
- **Execution of a \$1.4 billion CMBS transaction** by Deutsche Bank and UBS in which 85% of the assets were office, retail, and hotel properties.
- **A decline in oil prices** back below \$90 per barrel to \$85 per barrel.

Don't mistake this *Bullish* news for a change in the WMR outlook for 2H 2011. Market volatility will remain - and likely intensify - as the

"Congressional Deficit Dream Team" nears its November deadline to develop real spending cuts mandated by the latest debt ceiling increase agreement. This past week also gave us plenty to be anxious about, including:

- Declining consumer sentiment
- Loss of confidence by small businesses in the latest NFIB small business optimism index.
- More bank failures, closings, and ominous news on the bank regulation front – especially for credit unions and potential SIFIs – Systemically Important Financial Institutions.
- Contracting GDP for global bell-weather markets like Hong Kong.

There is still plenty about which to be bewildered about. Bank regulations to come from Dodd-Frank, the evolution of CMBS 3.0 in the aftermath of the S&P debt downgrade, the validity of the Federal Reserve's new "stand on your own" policy, and bank's closing on their own accord without regulatory enforcement action all stand out as bewildering. **For now, let's relish a rare week of *Bullish* dominance.**



As previously noted, the *Bullish* items for the week ending with August 12th were:

- A drop in weekly jobless claims
- A 0.5% increase in July retail sales
- Dow, S&P 500 and NASDAQ stock indices recovering nearly all of the 400 point declines
- Execution of a \$1.4 billion CMBS transaction
- A decline in oil prices

Because of the media coverage of item 3 (stock market volatility), and the fickle nature of oil prices based on the value of the dollar and outlook for global GDP growth, this week's analysis of the *Bullish* news focuses on jobless claims, retail sales, and the first CMBS 3.0 transaction.

**Weekly Jobless Claims**

There have been a number of weeks since March in which we have seen jobless claims drop one week to then be followed by an increase. The decline in jobless claims appears to be the result of fewer state and municipal government cuts, and recovery in auto manufacturing that was disrupted by the Sendai earthquake.

Recognizing the announced job cuts from the Challenger employment report last week, the post office and other large corporations, such as Cisco, this decline should be viewed with some skepticism.

As a result, the cuts being announced here in Q3 will not appear in the jobless claims data until the end of Q4 or early 1H 2012.

The most encouraging aspect of the jobless claims data is that last week represented the second consecutive week in which no states reported an increase of 1,000 or more claims. If this trend holds, the claims data would suggest that the large layoffs feared as fallout from the debt crisis are not yet materializing. Monitoring this aspect of the jobless claims may be the most insightful indicator of future claims.

Also, keep in mind that as weak as job growth is across the U.S., August will constitute the 11th consecutive month of job growth if claims remain at or below the 400,000 levels.

**Retail Sales**

According to the Commerce Department, retail sales climbed 0.5% in July. That was the largest increase since March, and it follows on the heels of a revised 0.3% gain in June.

In other words, the consumer didn't quit spending in July despite the debt-ceiling spectacle by Congress. The two dominant explanations for this surprise increase are:

- Falling gasoline prices enabled the consumer to regain back some purchasing power that was lost to above \$4.00 per gallon gas prices in the spring; and
- Consumers took advantage of early back-to-school sales by retailers. There is concern that some of the August back-to-school sales were advanced into July due to both sales and lower gas prices.

The notable categories where retail sales contracted in the following table produced by the Commerce Department are:

- Building Materials – this decline is consistent with the latest Lowe's earnings. Next week, Home Depot reports its earnings and we will see if there is any difference in these two home improvement and contractor retailers.
- Department Store Sales – apparel sales are strong, but the discounting and sales suggest underlying weakness.
- Food Services and Bars – the consumer is spending more at the grocery store than eating out.

ACCORDING TO THE COMMERCE DEPARTMENT, RETAIL SALES CLIMBED 0.5% IN JULY - THE LARGEST INCREASE SINCE MARCH.

UNEMPLOYMENT INSURANCE DATA FOR REGULAR STATE PROGRAMS					
WEEK ENDING	ADVANCE AUGUST 6	JULY 30	CHANGE	JULY 23	PRIOR YEAR
Initial Claims (SA)	395,000	402,000	-7,000	401,000	478,000
Initial Claims (NSA)	351,370	341,103	+10,267	369,207	425,471
4 WK Moving Avg. (SA)	405,000	408,250	-3,250	414,500	468,750

All indications are that jobless claims are more likely to increase in Q4 than remain subdued. It is also important to keep in mind the lag between when job cuts are announced and ultimately counted by the BLS. Until all severance benefits are depleted, laid off workers are not officially counted as unemployed and eligible for unemployment benefits.

## RETAIL SALES BY THE COMMERCE DEPARTMENT FOR JULY 2011

KIND OF BUSINESS	JULY 2011 ADVANCE % CHANGE		JUNE 2011 PRELIM. % CHANGE	
	JUNE 2011	JULY 2010	MAY 2011	JUNE 2010
Retail & Food Services	0.5	8.5	0.3	8.3
Total (Excluding Motor Vehicle & Parts)	0.5	8.6	0.2	8.2
Retail	0.5	8.9	0.3	8.6
Motor Vehicle & Parts Dealers	0.4	8.1	0.7	9.0
Auto & Other Motor Vehicle Dealers	0.5	8.3	0.5	9.3
Furniture & Home Stores	0.5	1.1	-0.5	0.7
Electronics & Appliance Stores	1.4	0.4	-0.1	-2.2
Building Material & Garden Equipment	-0.4	7.5	1.6	8.1
Food & Beverage Stores	0.5	7.8	0.5	6.6
Grocery Stores	0.6	8.2	0.4	6.9
Health & Personal Care Stores	0.1	4.1	0.0	4.4
Gasoline Stations	1.6	23.6	-1.7	22.8
Clothing & Clothing Accessories Stores	0.5	7.7	1.2	7.7
Sporting Goods, Hobby, Book & Music Stores	-1.5	2.9	0.2	5.1
General Merchandise Stores	0.0	3.7	0.5	4.1
Department Stores	-0.8	0.4	1.2	0.6
Miscellaneous Store Retailers	2.4	9.4	0.3	5.9
Nonstore Retailers	0.9	14.1	0.4	12.5
Food Service & Drinking Places	-0.1	5.6	0.4	5.9

Source: Commerce Department

### Execution of a CMBS transaction: 1st CMBS 3.0 issuance

The final *Bullish* item was the execution of the first transaction of CMBS 3.0. As noted in prior WMRs, the underwriting and structures of CMBS (those deals completed after Q3 2009 when TALF was used to restart CMBS - aka CMBS 2.0) had deteriorated substantially. Industry colleagues addressed this observation in a June 29th NY Times article titled: *Commercial Lenders Take Steps Into Riskier Deals* by Julie Satow. The S&P downgrade of the U.S. credit rating and refusal to issue a rating to a Goldman/Citi securitization last month while it reviews its method for DSCR calculations was the end of CMBS 2.0 and beginning of CMBS 3.0. This Deutsche bank securitization reflects the change to:

- Increased creditor enhancements to the 30% range from the high-teens to 20% level;
- Increased yields to reflect the increased liquidity risk of CMBS bonds and non-cash investments in the midst of this debt crisis;
- Increased investor selectivity whereby bond buyers are returning to issuances in

which the asset mix is core property types in first-tier MSAs (purge the specialty property types that were creeping back into issuances, such as RV parks and self-storage).

In other words, this most recent Deutsche Bank transaction restricts the risk appetite to less than 1,000 calories of risk per issuance. **It's a return to risk aversion. The gains made in 1H 2010 to expand CMBS activity to a broader spectrum of commercial real estate assets with higher LTVs and lower DSCRs has reversed course.**



THE BEARS

Of the four major *Bearish* news items of the past week, the two with the most forward-looking implications are:

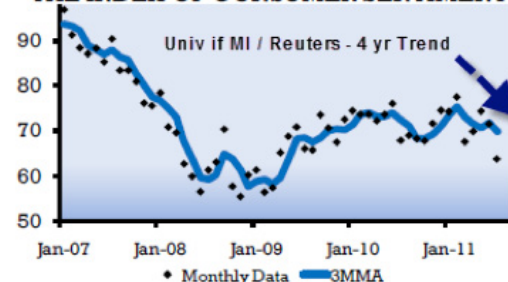
- Declining consumer sentiment
- Loss of confidence by small businesses in the latest NFIB small business optimism index.

### Declining Consumer Sentiment

According to the Thomson Reuters/University of Michigan Index of Consumer Sentiment (the most widely recognized private industry measure of consumer confidence) released this past week, consumer sentiment dropped like a rock in August to a preliminary reading of 54.9.

**This reading below 55 was the third-worst score since the index began in 1952.** The only lower scores came in May 1980 (51.7) and April 1980 (52.7) during the 1977-1981 recessions in which inflation soared and the PRIME-lending rate peaked at a record 21%. The other low reading was in 2008 (55.3) at the beginning of the financial crisis. This sharp decline in consumer sentiment and its historic correlation to periods of recession adds fuel to those suggesting the U.S. is entering a second, double-dip recession. This item is the focus of this week's Discussion Item at the end of the WMR.

### THE INDEX OF CONSUMER SENTIMENT



Paralleling the decline in consumer sentiment is the decline in small business optimism. According to the NFIB's latest survey for July, the monthly Small-Business Optimism Index fell for the fifth consecutive month dropping 0.9 points. This decline for July was a larger decline than in each of the previous three months; and it brought the Index down to 89.9. A reading of less than 90 is below the average Index reading of 90.2 for the last two-year recovery period. Expectations for future real sales growth and improved business conditions were the major contributors to the decline in optimism.



NFIB's chief economist Bill Dunkelberg summarized the results of the latest survey quite well in his press release dated August 9, 2011 stating:

- "Given the current political climate, the protracted debate over how to handle the nation's debt and spending, and now this latest development of the debt downgrade, expectations for growth are low and uncertainty is great,"
- "At the two year anniversary of the expansion, the Index is only 3.4 points higher than it was in July 2009. Considering the confidence-draining performance of policy makers, there is little hope that Washington will stop hemorrhaging money and put spending back on a sustainable course. Perhaps we might begin referring to the 'Small-Business Pessimism Index' from now on."
- The July survey anticipates slow growth for the remainder of the year, high unemployment rates, inflation rates that are too high, and little job creation.

Aggregating the 3rd worst consumer sentiment reading since 1952, a fifth consecutive month of decline in the NFIB small business optimism index, and the first contraction in global growth bell-weather Hong Kong's GDP in 2 years. The *Bullish* readings regarding weekly jobless claims and retail sales are not reflective of a forward looking view of what is ahead. A lot more has to play out regarding U.S. and European sovereign debt in Q4, and the consumer and small business have gone into hibernation. If the FED has also joined the consumer and small business in that cave with all our hopes residing on the shoulders of Congress, "Houston, we have a problem."



### THE BEWILDERED

400-point swings in market indices, the weekly volley between the *Bewildered* and the *Bears* in the WMR scoreboard, Congress remaining in recess during a period of self-inflicted national crisis, and now a bank closing its doors voluntarily due to the heavy hand of regulation are all consistent with an economy operating without a compass. This past week, the *Bulls* narrowly edged out the *Bewildered* and *Bears* by a score of 5 to 4. Last week, the *Bewildered* edged out the *Bears* by the same score. In this kind of market, there is almost a daily flow of stomach-churning data. The number to focus on with respect to almost all these economic measures is the moving average. Whether it's a four-week, 12-week, or 52-week period, the moving average will yield a better perspective of direction. With that said, the 4-week moving average for the WMR Scoreboard is now tied with the *Bears* at 4.3.

Because the already addressed *Bullish* and *Bearish* items could have easily been classified as *Bewildering*, the following three *Bewildering* items warrant some expanded discussion.

- **SIFIs** – The scariest part of Dodd-Frank has yet to come. Why would we entrust the most authority for our financial system in the entity that failed at its job leading up to this financial crisis?
- The future of CMBS and debt capital for commercial real estate.
- Recession or not, risk or reward – where is the market?

*THE DODD-FRANK LEGISLATION IS A FAST-GROWING CANCER IN OUR FINANCIAL SERVICES INDUSTRY WITH A PROFOUND IMPACT ON CAPITAL FOR REAL ESTATE.*

## SIFIs

In prior editions of the WMR, SIFIs have been mentioned in the context of the Dodd-Frank legislation. **What is it; and why should those of us in banking, capital markets, or real estate industries care about it?**

SIFI is an acronym for **Systemically Important Financial Institution** and was birthed by the Dodd-Frank legislation to appease the excuse used by the Federal Reserve to deflect criticism as to why they didn't intervene and rescue Lehman Brothers. The excuse was that the FED lacked the authority to act. In fact, the FED went on to argue it didn't have access to specific information related to non-bank entities that were systemically important to the banking system. In other words, SIFI is Congress's response to the FED's argument that it needed more authority despite its atrocious failing at bank supervision. In essence, SIFI stipulates to the FED: "Congress is going to give you expanded authority into areas of the financial services industry to prevent another Lehman and AIG situation despite the fact that you failed to manage the **most obvious risks in banking – a buildup of real estate concentration risk.**"

SIFI gives the FED expanded authority, but authority to do what? Last week, the American Banker published a story (*Get Set for 1,500 More Tiny Cuts Complements of Dodd-Frank* – by Barbara Rehm) in which the former head of supervision at the FED – Rich Spillenkothen was interviewed about SIFIs. While you're encouraged to read the entire piece, below are a few key excerpts from the American Banker article/interview:

- Section 165 of the Dodd-Frank legislation requires the FED to write rules that hold systemically important companies (both banks and nonbanks) **to standards that are "more stringent" than those applied to other financial firms.** These enhanced "prudential standards" will cover everything from risk-based capital rules and a leverage ratio to liquidity requirements and concentration limits. They will dictate risk management practices, resolution plans and credit exposure reports.

**Translation:** The FED can create more stringent regulations for whoever is deemed a SIFI.

- The law also gives the Fed the option of imposing standards on any of the following topics: contingent capital, enhanced public disclosures, and short-term debt limits.

**Translation:** The FED can decide that anything is appropriate and go after it. There are no checks & balances on the FED in this legislation. For those who had an issue with Dr. Elizabeth Warren, the creation of the Consumer Finance Protection Bureau should give you real heartburn. Congress has essentially relinquished complete authority and discretion to oversee the financial service industry to the FED with no accountability. Its authority now extends to any entity it wants to supervise – bank, insurance company, hedge fund, etc.

- The statutory deadline for writing the SIFI rules and identifying whom will be deemed a SIFI is January 1, 2012. The FED has less than five months to propose, collect comments, and adopt a final rule. The final SIFI rule is rumored to run 1,500 pages. Most sources expect the central bank to fully flex its authority.

**Translation:** A quote in the article sums it up best: "It's 1,500 more tiny cuts when we are already bleeding."

The Dodd-Frank legislation is a fast-growing cancer in our financial services industry with a profound impact on capital for real estate. The regulatory regime does not view real estate as an asset class financed by regulated financial institutions. It will finally have the authority under section 165 of Dodd-Frank to rewrite the rules of real estate finance. It's not going to be a situation where the real estate industry can respond to onerous bank rules pertaining to real estate by shifting to life companies, securitization, hedge funds, or REITs to access debt. The FED can name those entities a SIFI and put them under the same or more onerous rules as banks. **The publication of the Federal Reserve's final SIFI rule in response to section 165 of Dodd-Frank later this summer will be the market moving event for the financial services industry in 2011. For this reason, a short-strategy may be the safe bet until this uncertainty clears.**

The apparent fear is that the FED will over-reach and name hedge-funds, life companies, REITs as systemically important and under their purview. **Where will that leave access to debt capital for the real estate industry?** Consequently, the risk to real estate value is more to the downside if capital is restricted further by the FED. What will the resulting impact be to cap rates if the FED restricts the max DSCR to 60% or requires a bank to hold substantially more capital for having a commercial real estate concentration?

## The Future of CMBS

This item is included in the discussion of the Deutsche Bank/UBS securitization in the *Bulls* section of this WMR. The question is: where are we heading with respect to the CMBS markets?

The CMBS was created by the Resolution Trust Corporation in 1991 to liquidate the remaining assets from the S&L crisis. Since its inception, there have been 3 distinct disruptive periods. Those three periods are highlighted below:

- August of 1998 – Russian default that highlighted the problematic hedging strategies of the day.
- Fall of 2008 and onset of the financial crisis which ultimately saw the CMBS market grind to a halt for nearly 18 months. The TALF program was used to restart CMBS and enable price discovery again in Q4, 2009 with the DDR-I issuance.
- August 2011 with the S&P debt downgrade of the U.S.

We've entered a new period of CMBS activity that will become known as CMBS 3.0 with this latest Deutsche Bank/UBS issuance. It's justifiably a new era for CMBS because it comes in the aftermath of the S&P downgrade. It unwinds most of the progress to advance liquidity to a broader array of income producing property types – as we had seen in the May issuances from JP Morgan and Wells Fargo.

Investors are clearly back in control and they want enhanced credit protection and wider spreads to compensate for liquidity and economic risk. They also want a return to core property types in core markets.

The good news is that a CMBS issuance did occur post the S&P downgrade. The market received some guidance as to the kind of credit enhancements and pricing investors will require to return to this debt product. However, the looming SIFI issue emanating from the Dodd-Frank legislation may make CMBS 3.0 the shortest lived vintage of securitization to date.

### Recession or Not, Risk or Reward?

There is no official definition of recession, and no official body to decree that one has begun or ended. Determination of the U.S. economy having entered a recession comes months later. Regardless, most periods of economic contractions are labeled as a recession when there has been at least **two consecutive quarters of a declining GDP.**

That unofficial definition, is not used by the National Bureau of Economic Research, a private and non-partisan group based in Cambridge. Their findings related to the business cycle have come to be generally accepted as the definitive dates for recessions and expansions. The NBER's official definition of recession is: **"a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."** The NBER's definition essentially says: If it walks like a recession, talks like a recession and smells like a recession- it's a recession.

As the NBER points out, a decline in GDP is not necessarily the key determinant. Therefore, we can see very modest GDP growth of less than 1.0% and be in recession as long as unemployment remains elevated (above 9%), consumer spending is declining netting-out food and energy due to the higher cost for each, and industrial production is anemic to declining. Also, the market is now recognizing this scenario and is voting that we are in recession via market volatility as money flows back to safe and liquid havens. What is *bewildering* is how the politicians and economists play a game of semantics to avoid acknowledging that we are in recession. Q1 GDP was revised down to an anemic 0.4%. Q2 GDP will be revised to less than 1.0% by the end of Q3. The question then for us in the real estate finance and valuation industry is **how does the perception of recession impact value?** It has a substantial impact in areas, such as:

- Debt underwriting terms like LTV and DSCR. In a contracting economic environment, lenders want credit enhancements to protect against the downside. Credit enhancements like lower LTV, higher DSCR and higher interest rate spreads. What did the first post U.S. debt downgrade CMBS issuance demand? It demanded a 50% increase in credit enhancements from <20% to 30%, and higher spreads.
- DCF (Discounted Cash Flow) assumptions ranging from the growth rate for rents (0% to maybe contracting for 1-2 years) and expenses (rising due to higher energy and property tax costs as rates rise) to the probability of tenant renewal for maturing near-term leases.

*WE'VE ENTERED A NEW PERIOD OF CMBS ACTIVITY THAT WILL BECOME KNOWN AS CMBS 3.0 WITH THIS LATEST DEUTSCHE BANK/UBS ISSUANCE.*

*MONITORING MONEY  
MARKET FLOWS  
AND COMMERCIAL  
REAL ESTATE  
TRANSACTION  
ACTIVITY BY MSA IS  
CRITICAL.*

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In the coming weeks, debate over whether the U.S. is in or near a double-dip recession will surface. Forget the informal definition of two consecutive quarters of contracting GDP and consider the NBER formal definition that, in essence, says: If enough material economic measures are contracting and it walks, talks, and smells like a recession, it's a recession.

Ask yourself if the conditions are deteriorating similarly across all markets. What you'll likely find is that a number of markets, such as the education center MSAs (Boston, Raleigh, Denver, Austin, etc.) with returning intellectual property manufacturing are not in recession.

As real estate appraisers, lenders, and investors, these periods of transition and volatility require market-by-market analysis. Just as all real estate is not created equal, neither are all markets. The market is hungry for analysis in these volatile periods as they are searching for the answers.

Investors are voting recession or no recession via asset allocations. That's why monitoring money market flows and commercial real estate transaction activity by MSA is so critical. Cross-pollinating metrics, like vacancy, absorption or vacancy, and new supply still underway is the most effective technique to identify the good from the bad.

**Not all appraisers and lenders can accomplish this kind of analysis. Those that can will be the ones that the market turns to.**

## Economic Calendar

AUGUST 15 – AUGUST 19

Compared to the previous few weeks, the flow of market moving data will be comparatively light. Earnings season for Q2 is nearly played-out, and the only major economic data to be released relates to manufacturing activity and inflation. Updated readings on producer and consumer prices report on Wednesday and Thursday, respectively.

On the earnings front, Wal-Mart, Lowes, and Home Depot will report Q2 results. If you deferred vacation because of recent events surrounding the debt ceiling or downgrade, the next two weeks may be a safe time to escape before Congress returns and we get new employment reports after Labor Day.

## DISCUSSION ITEM

On Wednesday, August 10th, Colliers held a client conference call with approximately 50 of our largest real estate finance clients to obtain their insights into the following questions:

- How are you thinking about commercial real estate as an investment post the downgrade, and are you re-thinking items like cap rates?
- Is there any change in your investment behavior as a result of the U.S. debt downgrade?
- How are you looking at the existing valuations of your real estate assets as a result of this debt downgrade?
- What is the impact on CMBS – short term and long term?

Because we promised anonymity to the call participants to encourage as much candid exchange as possible, we're only able to provide an abbreviated summary of key points without citation to any individual or organization. The key comments and observations that we identified were:

- Lenders are honoring all commitments.
- Pricing was a challenge because of the inability to establish a floor due to the decline in the 10-year Treasury. A number of participants noted that while spreads had widened because of this compression in the 10-Year Treasury, the absolute rate in most cases was actually 5-10 basis points less than it was 2 weeks ago. The point was to focus on the all-in rate versus the hysteria regarding widening spreads.
- Lenders are back in control and still looking at real estate opportunities, but only those in core markets. The stretch to secondary markets and non-core assets that were in the May issuances by JP Morgan and Wells Fargo have been retracted. Most participants agreed that the bifurcation between the financeable core property types in core markets and the assets in secondary markets would widen. Investors and lenders are clearly retrenching to a more conservative position until the dust settles.
- The capital needed to refinance maturing CMBS over the next few years is in excess of \$100 billion per annum. The CMBS market will satisfy less than \$40 billion of 2011's \$80 billion in CMBS refinancing.

## 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 6th)	395,000
Initial (Prior Wk)	402,000
4-Wk Average	405,000

### 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%

### TREASURY RATES (JULY 29):

2-Year Tr (Down 18 BPS)	0.18%
10-Year Tr (Down 54 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:

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

### 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 12)	\$1,738
Gold (high: 5/4/11)	\$1,541
Oil (WTI) July 15' 11	\$85.00
Oil (High) Jun 13' 08	\$135.00

## DISCUSSION ITEM CONTINUED

Regulator trepidation is holding the banks back. The uncertainty of still to be written Dodd-Frank rules will keep the banks from being active CRE lenders for the time being.

Life Companies are not likely to come to the rescue in this liquidity crisis as approximately 80% of their 2011 allocated capital for CRE lending has been placed.

- With banks on the sidelines due to regulatory trepidation, life companies having allocated most of their 2011 capital for CRE lending, and CMBS issuance in time-out mode, there is almost a perfect-storm setting up for Q4 in terms of an absence of capital for commercial real estate refinance and transaction activity.
- Finally, most participants thought the impact on cap rates would be nominal. The bigger impact on value would result from lenders and investors placing more emphasis on discounted cash flow analyses and scrutinizing the assumptions. Lenders and investors are laser beam focused on the details of leases and tenant renewal assumptions. Fee simple values are expected along-side leased fee values to better assess the downside risk from market rents falling below contract rents in most markets.

Colliers will hold more of these calls through the end of 2011 on a monthly basis. If you have interest in participating on future calls, there is no cost. Please send an email to KC Conway, MAI, CRE or Jason Lund and your name will be added to the list for future calls.

The purpose of these calls is to stay in touch with our clients and market participants to better understand the valuation, capital availability, and underwriting implications resulting from the current market turmoil and U.S. debt downgrade.

- Jason Lund, MAI - Regional and International Valuation Managing Director  
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