

U.S. Economy: Fed Warns of Weakened Rebound

After spending months reassuring the public of a steady economic recovery, the Federal Reserve chairman Ben Bernanke offered a sobering assessment on market conditions. Ben Bernanke, speaking to a group of economists and Wall Street analysts on Monday, November 16th, warned of “some important headwinds” that could potentially stall the rebound. The chairman was referring specifically to the weak job market and the tight lending standards of banks. Neither is expected to improve significantly in the short-term. As such, the Chairman reaffirmed his intent to keep interest rates, “exceptionally low for an extended period.” Ben Bernanke also commented that the Fed was closely watching the weakness of the U.S. dollar and its implications on inflation. To combat future bubbles and the threat of inflation, the Chairman indicated that they were wary but not opposed to raising interest rates.

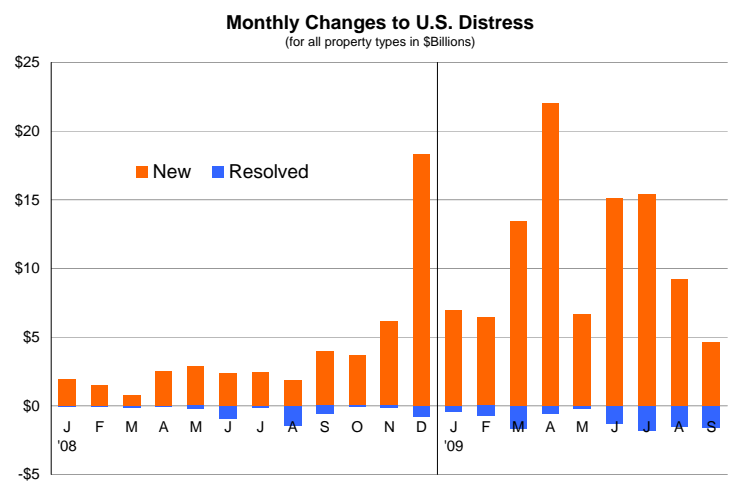
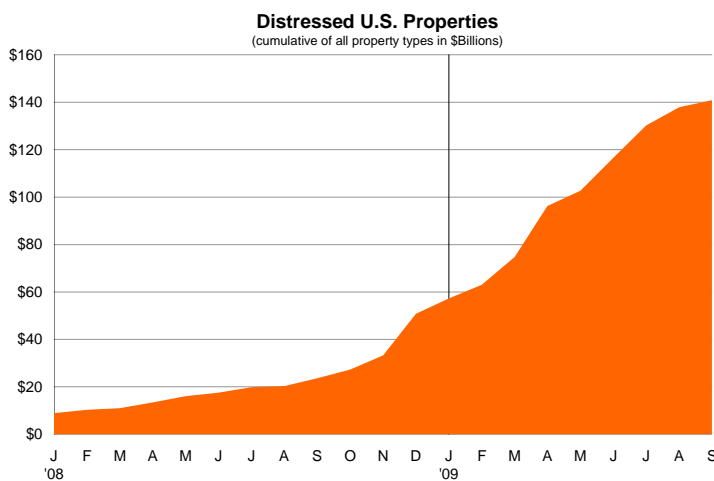
A summary of recent economic indicators is as follows:

- Home construction fell sharply in October, decreasing 10.6% to a seasonally adjusted 529,000 annual rate.
- Unemployment rate as of October stood at 10.2%, the highest since April 1983. The percentage of those who are unemployed, marginally attached to the labor force or working part-time because they have no other option, stood at 17.5%.
- Core CPI increased 0.2% in October, the same increase seen in the previous month. Food prices rose 0.1% last month, after a 0.1% decline in September. Energy prices rose by 1.5% in October, accelerating from the 0.6% increase in September.
- Residential mortgage delinquencies rose to 6.25% in the third-quarter from 3.96% a year earlier and 5.81% in the previous quarter. This marked the 11th consecutive increase according to credit information company TransUnion.
- Fixed rate CMBS delinquency rate reached 5.5% in September, nearly 3-times March level and 9-times September 2008 level.
- Leading Economic Index (LEI) for the U.S., as reported by the Conference Board, increased 0.3 percent in October, following a 1.0 percent gain in September, and a 0.4 percent rise in August. Data suggests economic recovery is finally setting in.

Commercial Real Estate: Pace of Deterioration Quickening

The volume of troubled commercial real estate loans continues to climb. In order to stem the tide, Federal bank regulators issued guidelines on October 30th allowing banks to keep loans on their books as “performing” even if the value of the asset has fallen below the loan amount. These new guidelines will encourage banks to restructure distressed commercial mortgages with borrowers rather than foreclose on them. Ultimately, this will enable banks to absorb fewer losses and to preserve their capital. In the next five years \$1.4 trillion of commercial mortgages will mature. According to Foresight Analytics, \$770 billion of the \$1.4 trillion is “underwater”, meaning the loan is higher than the property value. The new guidelines will help banks to extend terms for \$110 to \$130 billion of these commercial loans. The remainder will fall into a workout category.

The new U.S. guidelines are being met with some resistance. Critics believe the move only prolongs the financial crisis by not forcing borrowers and lenders to address the inevitable problems. Regional and small banks are expected to benefit the most from these guidelines. Regulators insist that the policy change is not an opportunity for leniency, but rather a prudent way of prioritizing higher risk assets. Some critics are advocating the formation of an entity similar to the Resolution Trust Corp (RTC) formed in the early 1990s during the last commercial real estate crash. RTC enabled the U.S. banking system to flush out quickly a significant amount of toxic mortgages. Critics argue that the banks must purge the bad debt from their books. The sooner losses are written-off, the sooner assets will begin to trade and the sooner the CRE market will begin to normalize.



Investment Outlook: Burden of Bad Debts Mounting

Delinquency rates will continue to rise in the next 12-24 months, driven by billions of dollars of pro forma loans that never stabilized and resetting IO loans. Commercial banks and CMBS special servicers will soon be overwhelmed with delinquent borrowers. As much as the Federal regulators will strive to control the fallout, eventually the volume of distressed assets will overwhelm the system. Banks will then concede and begin to write-off bad debts. Private equity will then enter the market and establish asset valuations. Only then will the recovery begin. Stress within the banking system will continue to mount for the next 4-6 months before giving way.