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The role and importance of the commercial real estate sector as an asset class

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One outcome of a slow (retracting?) economy is that it provides more time to read. This past week I read The Ascent of Money: A Financial History of the World by Niall Ferguson. This 358 page book is an easy read incorporating the role of money in establishing credit and the history of foreign exchange, international trade and most recently financialization tools.
It is important to look at the big picture in order to grasp the role and importance of commercial real estate sector as an asset class. Let's face it, real estate is a market and markets rise and fall. A local broker is fond of saying that he makes his commissions selling the same buildings over and over again. For those of us in our middle years, we vividly remember the run up of prices in the mid 1980s (following a long slog through the 1960s and 1970s). Then the walls came tumbling down in the early 1990s with the bank failures and the Feds coming in to clean house.
With hind sight, we now realize we emerged from that downturn by 1994 with the dot com and telecomm booms. But the bounce back was quick enough and fast enough that the lessons were not learned. A rising tide floats all boats. Two quick blips in 2000 and 2002 had folks feeling that the economy was on auto pilot and that globalization was establishing the new paradigm!

Long Term Capital Management (LTCM), remember them, thought they could hedge all risk with sophisticated economic models. Alas, they chocked on their own success, they created so much profit for reinvestment they had to reach further and further for bonds and derivatives to invest in and when the Russian government defaulted on its bonds, it started a cascade of events that wiped out LTCM in about a year, despite a $3.6 billion bailout forced by the Fed. But even here we bounced back quickly and again the lessons were not learned.
Ferguson poses the question, "It might be assumed that after the catastrophic failure of LTCM, quantative hedge funds would have vanished from the financial scene." Not so. In fact the reverse happened. Since then the number and type of hedge funds mushroomed to over 7,000 in 2008.

To this frothy stew must be added zillions of dollars of liquidity around the globe. Much of it was debt financed by our imports of foreign oil ($80+ billion per year). The oil countries invested those dollars in US treasuries and other securitized debt (conduits of residential mortgages, credit card loans, student loans and commercial mortgage backed securities). Oh yes, China is the biggest player in the arena, with nearly $1 trillion of our debt. They were enabling us to be way over leveraged. The music stopped in December, 2008 and now it is time to deleverage. Now in July 2009, the pundits suggest this could take several years.

Returning to one of Ferguson's central themes, ". . . financial history is a roller coaster ride of ups and downs, bubbles and bursts, mania and panics, shocks and crashes. Since 1870 there have been 148 crises in which a country experienced a cumulative decline of GDP of at least 10%. It seems that for all our ingenuity we are doomed to be 'fooled by randomness' and surprised by 'black swans'. It may even be that we are living through the deflation of a multi decade 'super bubble'."

Beyond the rising chorus of concern about the specter of inflation is that government bail outs can lead to "moral hazard" where there are no consequences for taking risks which result in failures. Again to quote Ferguson, "The experiences of Japan in the 1990s stands as a warning to legislators and regulators that an entire banking sector can become a kind of economic dead hand if institutions are propped up despite under performance and bad debts are not written off."

That is what we need to do in both the US and globally, we need to flush out the toxic assets, deleverage, stabilize markets and then we can start creating jobs, which will begin to lease up apartments, offices and stores. Until then we real estate folks will have time on our hands to read more books!

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