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Dr. Sohn

Economic Forecast, November 2009

Craig Lieberman attended an economic and real estate forecast at the Smith Business School located at the California State University – Channel Islands, where, the speaker, Dr. Sohn, teaches and chairs the business and economics department. Dr. Sohn was the former Chief Economic Officer at Wells Fargo Bank, and has a wealth of knowledge, some of which he offered at the conference.

The economic conference was titled “Exit Strategy” (from the current recession). Dr. Sohn addressed how we might manage an exit strategy from the current economic downturn so we can enter a stable economy in the future. He warned that if we do not, we could enter into a “double-dip” downturn.

The hardest hit economic sectors have been in manufacturing and housing. In manufacturing, inventories are being reduced because of less production, but as the standing inventories are purchased by consumers, there will be a need to hire more people. In doing so, the intense unemployment rates will begin to improve, and then you will have an uptick in consumption, making the need to manufacture that much greater (and rehiring to begin). Especially notable was the improvement in the car manufacturing industry, fostered primarily by the recent “cash for clunkers” federal program. Inventories of new cars dramatically decreased, causing the trend of laying off workers to reverse.

It is interesting to note one out of eight jobs are directly or indirectly involved in the housing/construction industry. The last housing boom we recently had was clearly the highest in U.S. history – that boom has now hit bottom (we have seen a direct correlation between how high a boom goes with how low the bust is).

We are now seeing housing rebound to some extent, with the affordability index at an historical high, especially as first-time home buyers enter the market – facilitated by the combination of the following:

- The lower prices of homes, as most areas have seen 40-50% price decreases from the high
- 30-year mortgage rates are at historic lows

- And, to a lesser extent, the first-time home buyer federal tax credit

For the first time in decades, out-of-state buyers are able to afford California housing – this permits this population to work in California, and allows employers to recruit (if needed) out-of-state skilled workers.

The housing market is definitely seeing signs of improvement. At the bottom, 50% of sales transactions were considered distressed (short sales, auctions or foreclosed (REO) properties) – currently, only 30% of sales are considered distressed.

Gross Domestic Product (GDP), the primary measure of the country's economy and productivity, saw the growth rates in 2008 at 0.4%; in 2009, minus 2.6%; and is forecast to be 2% in 2010, as jobs are still being lost. A 3.5% growth in GDP is required to have stabilization in employment and the economy. To foster improvement in the economy, the Fed has provided so far \$787 Billion in spending and tax cuts – the economic downturn has bottomed, but no marked improvement will occur until the employment picture improves.

Dr. Sohn opined we are “not out of the woods yet” – there may still be much pain to be inflicted.

In 1983, a very dismal period in the country's economic history had an unemployment rate of 10.8% -- the country currently has a 10.2% unemployment rate. Even these rates do not count the “discouraged unemployed”, those that have informally dropped out of the work force or become under-employed as part-time workers. If those discouraged unemployed were counted, the figure would be closer to 17.5% (or, almost one out of every five available workers are un- or under-employed). “We are still seeing more firings than hirings.”

A very obvious problem of the current downturn is the credit squeeze (Wall Street to Main Street). While the biggest banks have stabilized through such stimulus packages as TALF, regional and local banks are still having a hard time because small businesses all over are failing. The Federal Deposit Insurance Corporation (FDIC) have already closed and taken over 100 banks, and have placed over 400 others on its problem bank list. Banks are struggling because their customers are struggling. And, the economy cannot improve without lending occurring – and banks are not lending. The problem is, from a statistical basis, a bank needs to make 77 good loans to make up for one bad loan.

The recovery could be shaped in a quick “V”, a slower “U”, or a double-dipped “W” – with the latter able to occur because of the dismal employment picture – it is hard to argue we are in an economic recovery when there is little hiring. As mentioned above, normal recoveries take on the same speed as the speed of the downturn – in this case, we could be subject to a double-dip recession because of the anemic employment market. Employers, in a downturn, will “hoard” their good workers, even if under-utilized because of the uncomfortable and expensive problem of rehiring once production and the recovery occurs.

The bulk of the federal stimulus spending is occurring this year, with most of the remainder of the spending to occur the first half of 2010 – after that, it is expected things could slow once again. Fed chairman, Ben Bernanke, has put out \$1 Trillion, and there money supply is more liquid, but, because lenders are not lending, we are not seeing the second part of the required equation, velocity – the money needs to move before there is improvement in the overall economy.

Although long-term interest rates will remain stable, at least, until the jobless rate peaks (not until mid 2010), but short-term rates (including the federal funds rate which is currently at “0”) are expected to begin inching up.

In terms of consumer spending (which represents 2/3 of the total economy), this sector has been lethargic – the second strongest retail period, that of “back to school” was weak, and that is thought to be a leading indicator to the strongest retail holiday period, the upcoming “Christmas” shopping days, which is expected to be very weak. This is consumer confidence is way down, and is not expected to improve until the employment picture improves – it is human instinct to limit spending and be more cautious when one does not know how long a job will last, with knowing how difficult it is to secure a new one. The natural inclination is for consumers to save “for a rainy day”. Moreover, credit availability is difficult to secure, especially when homeowners can no longer easily finance their spending habits through home equity loans.

The imminent distress in the commercial real estate sector is expected to be the “next shoe to drop” after the housing sector saw its industry turn upside down. This sector is known as a lagging economic indicator, as this sector is the last to feel economic downturns because business problems will be manifested in higher office and industrial vacancies, and weak consumer spending will hurt the retail and lodging real estate sectors.

In terms of inflation, Fed. Chairman Bernanke is watching very intently the signs of pending inflation, but does not really see an issue as long as there is what is known as an “output gap” when GDP growth is lower than the normalized 3.5% growth rate. Dr. Sohn expected there to be problems in employment through 2014 to 2015, so he does not expect inflation to hit until then.

The stock market is stabilized as inflation and the S&P multiples are balanced. Market multiples remain lower during periods of low inflation. The stock market, however, has seen a steep rise in value, with the Dow Industrial Average having increased an average of 0.31% per day since March – we are definitely out of the “Bear” market. But, we could be in for a secular (longer) downturn in the stock market – when the market is oriented downward for a protracted period of time based on the underlying economic principles.

These are the three other secular downturns in the stock market we have seen in our history:

- 1906, lasted 15 years
- 1933, lasted 12 years
- 1966, lasted 16 years

And, our recent, overall bear market started since the “dot com” burst in 2001 – it is difficult to determine which way it will go.

In Ventura County, the unemployment rate is slightly worse off than the national unemployment rate (closer to 11%), with real estate and construction industry sectors more hard hit than the rest of the country. The office vacancy is about equal to the rest of the country. The manufacturing sector nationally is showing signs of improvement, but the recent troubles at Amgen, the largest private company in Ventura County, is dragging down that sector in our region.

The plusses for the county include Healthcare; Agriculture and Military

The minuses for the county include Amgen/Countrywide employment losses; Port Hueneme; and Commercial Real Estate