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Commercial Real Estate: *The Next Shoe to Drop?*

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We are all concerned about the economy. Almost everyone reading this article has been affected by the downturn in the markets. Many have lost substantial amounts of money while others were prepared to capitalize on the trends ahead of the crowd. Those folks have protected their hard earned assets through the economic malaise. The question both parties are asking is, what is next and how do we either profit from it, or at the very least, get out of the way of the train? As usual we are going to be blunt.

Now before the detractors (of which, every columnist has his share) go crazy about "doom and gloom" preaching, let me say that knowing what is around the corner and preparing for it is the opposite of doom and gloom. Like the founding father Patrick Henry once noted, "As for me and my family I prefer to know the worst and prepare for it." A conscientious doctor would give you the full skinny on your health, and I will attempt to do so here with regard to the economy.

The Federal Reserve, along with most of the developed nations' central banks, have pumped incredible and historic amounts of new money into the economy—the results of which have not yet begun to impact the economy. But this irresponsible action set us up for some potentially ferocious inflation in the coming months. It typically takes anywhere from 12 to 18 months for those effects to be felt in the broader market. In turn, this means our dollars purchase fewer goods and services.

We discussed this in an earlier column entitled, "Inflation: The Invisible Tax." Investments likewise feel the pressure as they are paid back to you in the form of paper currencies such as the dollar. In order to prepare for this and mitigate the effects of inflation, we advise diversifying part of your portfolio in the "ultimate currency": precious metals. Inflation is an unintended consequence of the Fed and other central banks that are insinuating themselves deeply into the markets.

The other unintended consequence on the near horizon is that this infusion has put off the inevitable liquidation of malinvestment. Simply put, bad investments must always be liquidated. One man's foreclosure is another's discount dream home—a tough analogy for sure, but a reality in any downturn. When the government or central banks pump all of this new capital into the market, it actually slows down the natural healing of the economy; it's much like giving a drunk another drink instead of letting him get through the pain of sobering up. The end result of such delaying action will kill the patient—or at the very least, it will make the recovery that much more difficult.

The meddling in the markets by the Fed, the Congress and the White House (both Bush and Obama) has had just such an effect. Banks have not been able to properly liquidate poor investments; and investors, anticipating more government intervention, have not been as likely to pick up the pieces as they might have done in prior years. You see, government intervention is one of those things that, more often than not, scares investors away from making immediate decisions.

Commercial real estate is suffering from both 1) the economic doldrums of the broader economy, and 2) the banks' uneasiness about lending, given the overt meddling of the government. Why should this matter for those in commercial real estate? Commercial real estate loans typically range from five to seven years, with a balloon payment that must be refinanced at the end of the term. In previous times this would not have been a problem; but with the intense scrutiny and the unsure footing on which many banks find themselves, they are looking for bulletproof loans. When you

add in high vacancy rates in retail strip malls and many office complexes, and when the diminished profitability of commercial property starts to come into question, this further shrinks the pool of banks willing to finance new loans. Of course, the banks don't want to be left holding the bag on an empty building.

It is estimated that in 2010 some \$5.1-\$5.5 trillion in commercial real estate loans are coming up for refinancing. An additional \$750 billion must be refinanced by the end of this year. Who is going to refinance all of this debt? Consider also how this affects the value of even those commercial properties that are doing well, and the effect on investors in REIT's. A lot of insurance companies (annuities) are also heavily invested in commercial real estate. Keeping all of this in mind, you can begin to see the potential magnitude of the problem facing the economy in the coming months.

It's not a pretty picture, but at least you can get out of the way of the next train!