ORG Insights February 2013

Candid Real Estate Investment Industry Observations by ORG Professionals

Theatre of the Obvious

There's an old joke about two guys hiking in the woods. One guy asks the other: "What if we stumbled onto a hungry bear; do you think you could outrun him?" The other guy replies: "I wouldn't have to… I'd only have to outrun you." Now, let's give these two guys names. Let's call the first guy *Circuit City* and the second guy *Best Buy*. While we're at it, let's call the bear *Amazon*. The two guys' names could just as easily have been *Borders* and *Barnes and Noble*, but this isn't a discussion about problems in the retail sector, how the internet is affecting our use of space, or who will be the bear's next meal. It's about being blind to what—in retrospect—was patently obvious. There's no lack of examples of major businesses that have been blind-sided by environmental changes to which they failed to react: Kodak, Blockbuster, the US Postal Service, the list goes on and on.

For every example of a company that ignored what should have been obvious, there are examples of those that paid attention and reacted appropriately. Where Kodak chose to focus on maintaining its market share in a business that was quickly becoming an anachronism, Fujifilm chose to focus on the new direction in which imaging was moving. Where Blockbuster chose to fight Netflix with a business model that had become unsustainable, Redbox chose to create a new business model that addressed the major gap in the Netflix strategy. Where the US Postal Service chose to focus on the business it lost to email and online electronic payments, UPS chose to work with online retailers.

Looking around today's business landscape, there is at least one thing that should stand out as obvious to those of us working with investments. Today's low interest rates—while extremely attractive to real estate investors—are not sustainable. While none of us can predict with any certainty when, or by how much, interest rates will eventually rise. We have to be prepared for that moment.

Interest rates today are the lowest they've been since Dwight D. Eisenhower took office in 1953. Between 1953 and 1981—with just a few pauses—interest rates moved steadily higher, with 10-year constant maturity treasury securities peaking—and breaking through the 15% mark—in September 1981. Since that time, rates have—again, with just a few pauses—moved steadily lower, with 10-year constant maturity treasury securities hitting a monthly low of 1.53% in July 2012 (see Figure 1).

Since the mid-80's, we have enjoyed an economic environment characterized by ever declining interest rates, and inflation that, for the most part, remained at reasonable levels. The global economic melt-down we suffered in 2008 managed to put an end to the relative calm to which we had all become accustomed.

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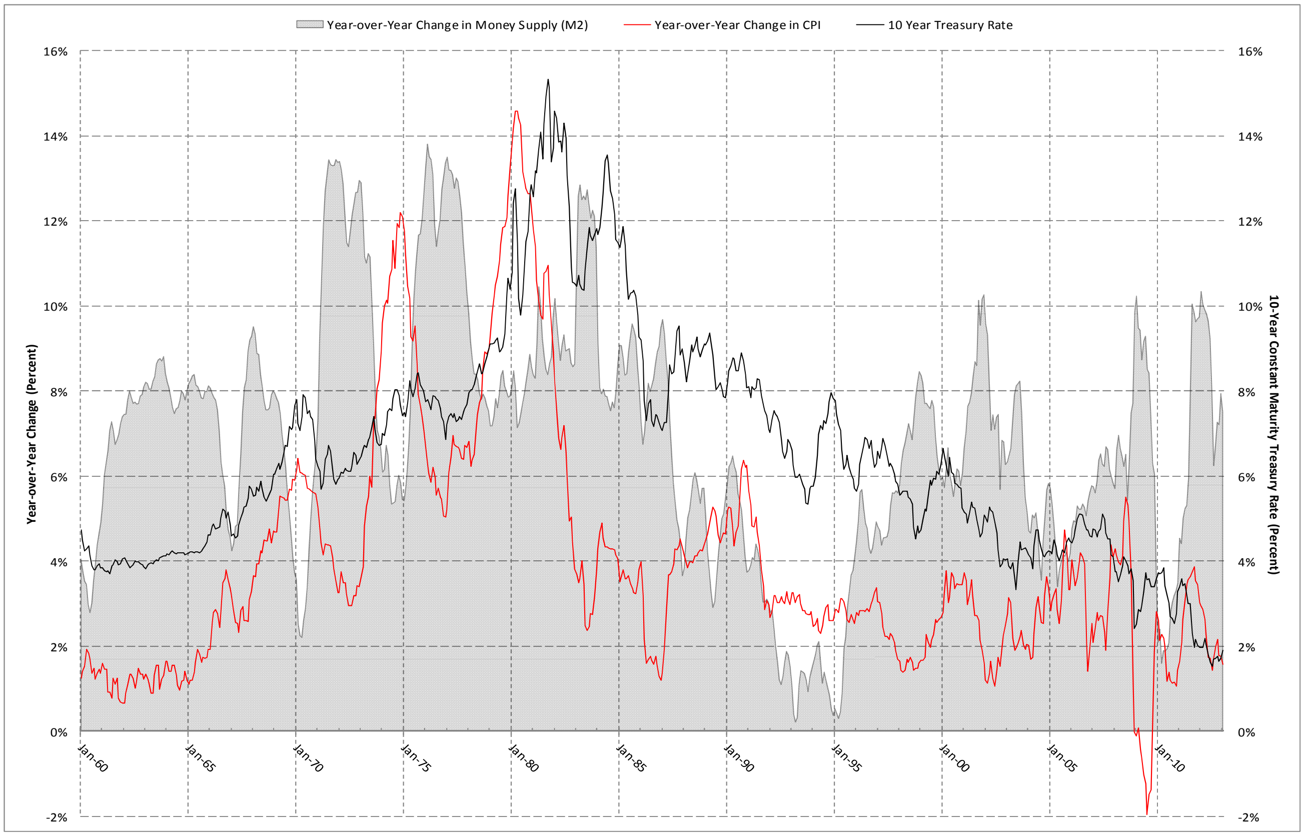
Figure 1: Money Supply, Interest Rates, and Inflation (January 1960—January 2013)

Source: Board of Governors of the Federal Reserve System (as of 2/21/2013); U.S. Bureau of Labor Statistics (as of 2/21/2013)



SAVING THE WORLD FROM ECONOMIC ARMAGEDDON

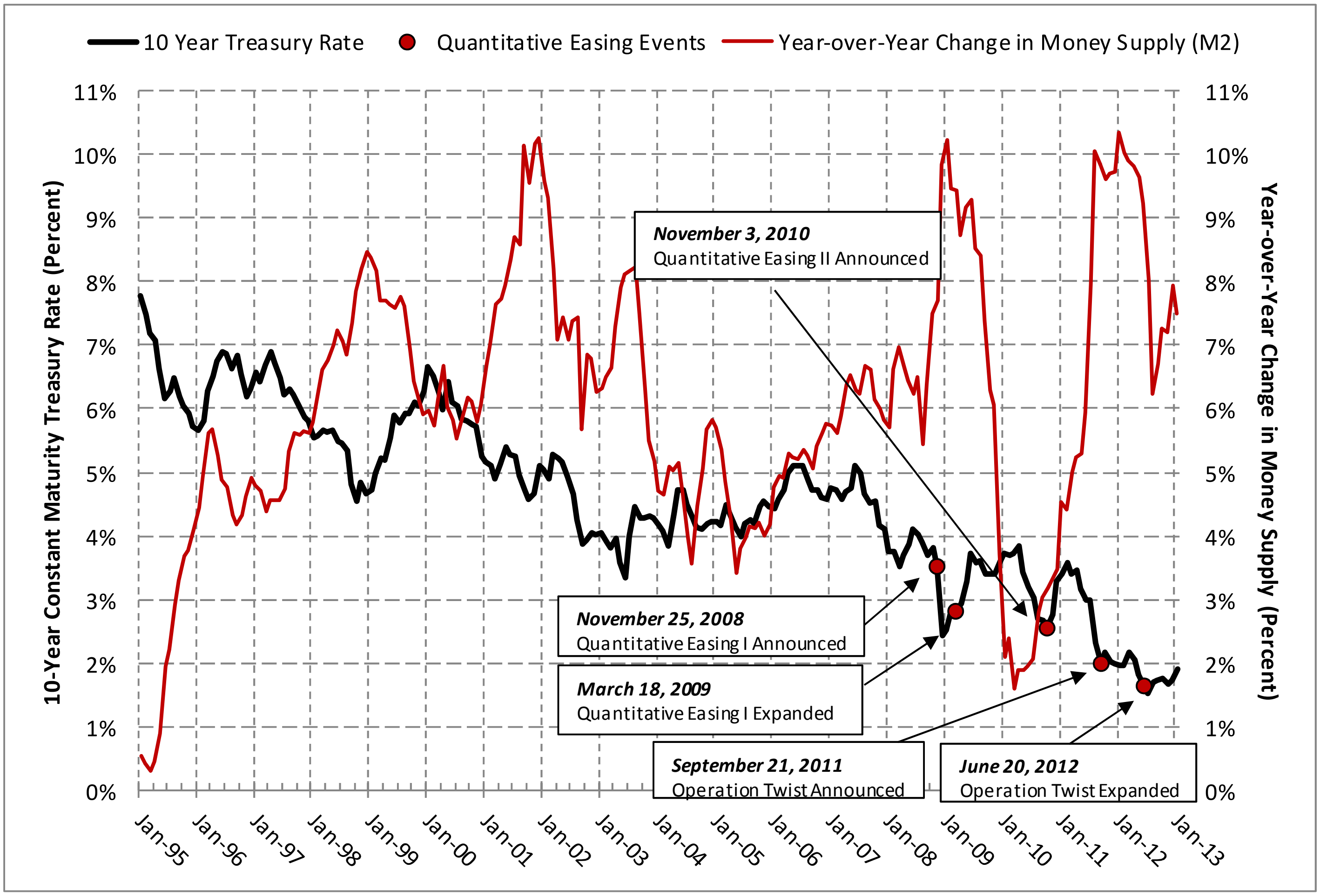
On that memorable Monday morning in September 2008, when we all learned that Lehman Brothers had filed for bankruptcy, AIG was on the verge of bankruptcy, and Merrill Lynch—one of the oldest, and best known, brokerage firms on Wall Street—sold itself to avert bankruptcy, things looked pretty bleak. As we all know, the US Government—acting through the Treasury Department and the Federal Reserve—took aggressive measures to keep the banking system from imploding.

On November 25, 2008, the Federal Reserve announced the first step in a program designed to keep interest rates low—in an attempt to spur lending activity—that came to be known as Quantitative Easing (see Figure 2). The first round of quantitative easing announced in 2008 was followed in 2010 by QE II (for Quantitative Easing II) and in 2011 by Operation Twist. While these programs were successful in keeping interest rates down, they did have a cost. Money supply, as measured by M2, expanded quickly and dramatically.

Historically, significant increases in money supply have been followed by periods of rising inflation as well as rising interest rates. As we see in Figure 1, surges in money supply preceded spikes in inflation and rising interest rates through the 1960s and 1970s. Slowing growth in money supply from the early-1980s to the mid-1990s preceded falling interest rates and lower inflation. The paradox of quantitative easing is that we are increasing money supply to keep interest rates low.

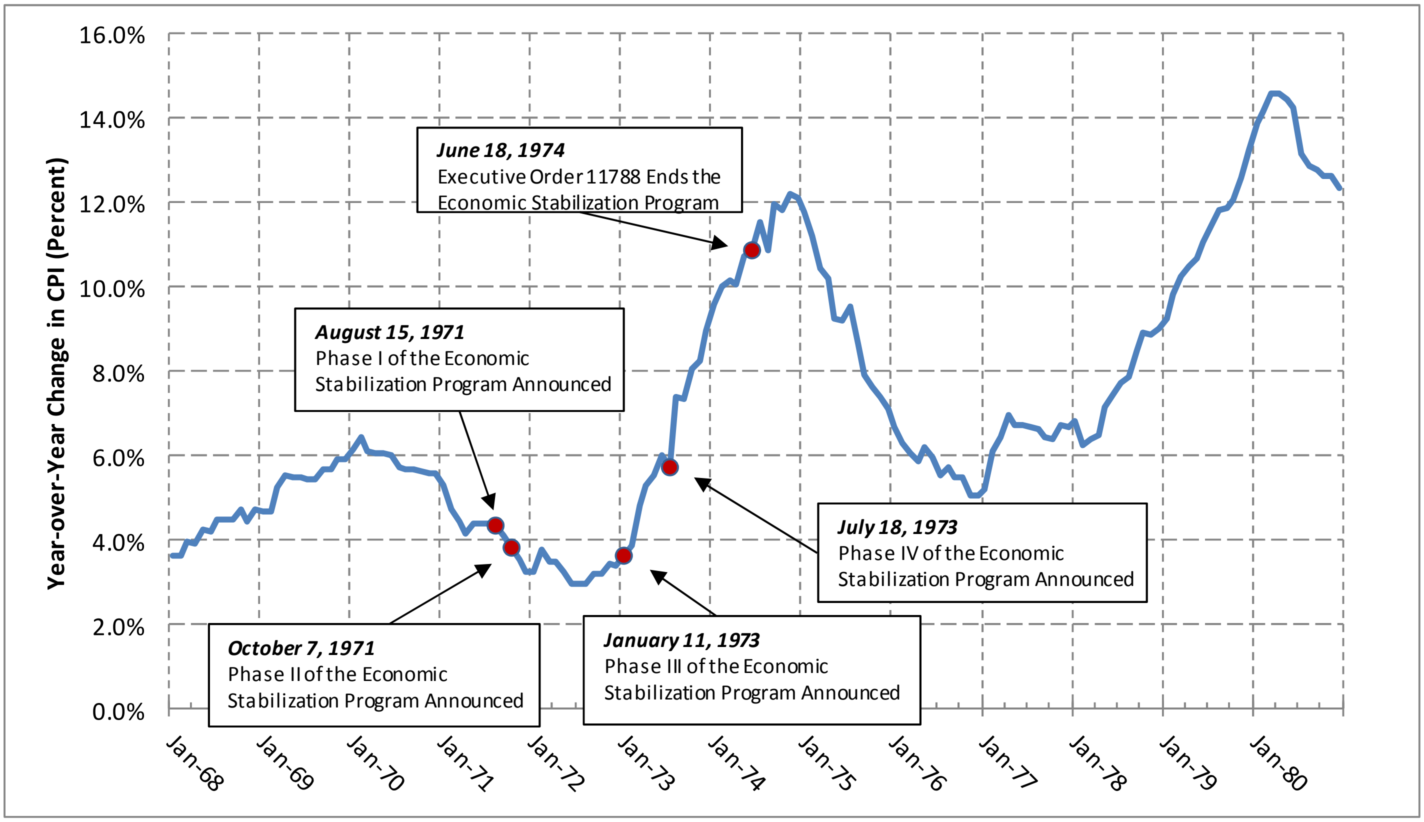
Figure 2: Ten-Year Constant Maturity Treasury Rate and Money Supply (January 1995—January 2013)

Source: Board of Governors of the Federal Reserve System (as of 2/21/2013); The New York Times



Because of the similarities between our most recent recession and the Great Depression, current Federal Reserve policies are usually compared to the policies during the presidencies of either Herbert Hoover, the Depression having started during his term in office, or Franklin D. Roosevelt, whose policies are credited with ending the Depression. But, perhaps a better comparison would be with the policies of Richard Nixon, who instituted wage and price freezes in 1971 in an attempt to contain what was then viewed as unacceptably high inflation. The similarity between Nixon's policies and Bernanke's being the artificial constraint that was placed on the economy via governmental action.

Figure 3: Inflation and the Economic Stabilization Act of 1970 (January 1968—December 1980)
Source: U.S. Bureau of Labor Statistics (as of 2/21/2013); The American Presidency Project (americanpresidency.org)



THE BEST LAID PLANS…

On August 15, 1971, Richard M. Nixon signed Executive Order 11615[1], freezing prices in the United States. Authority to put those price controls in place was granted by the Economic Stabilization Act of 1970 (P.L. 91-379, 84 Stat. 799). As with the current Fed policies, Phase I of the Economic Stabilization Program was intended to be a short term solution, as shown by the text of Section 1 of the Executive Order:

> "SECTION 1. (a) Prices, rents, wages, and salaries shall be stabilized for a period of 90 days from the date hereof at levels not greater than the highest of those pertaining to a substantial volume of actual transactions by each individual, business, firm or other entity of any kind during the 30-day period ending August 14, 1971, for like or similar commodities or services. If no transactions occurred in that period, the ceiling will be the highest price, rent, salary or wage in the nearest preceding 30-day period in which transactions did occur. No person shall charge, assess, or receive, directly or indirectly in any transaction prices or rents in any form higher than those permitted hereunder, and no person shall, directly or indirectly, pay or agree to pay in any transaction wages or salaries in any form, or to use any means to obtain payment of wages and salaries in any form, higher than those permitted hereunder, whether by retroactive increase or otherwise."

In July 1971, the month before E.O. 11615 was issued; inflation in the U.S. was running at a year-over-year rate of 4.4%. By the end of September, inflation was running at a rate of 4.1%. It looked like the price controls were having the desired effect—so, on October 7, 1971; President Nixon went on national television to address the country. In that address he announced that:

> "On the inflation front, I can report to you tonight that the wage-price freeze has been remarkably successful. As

[1]Richard Nixon: "Executive Order 11615 - Providing for Stabilization of Prices, Rents, Wages, and Salaries," August 15, 1971. Online by Gerhard Peters and John T. Woolley, The American Presidency Project. http://www.presidency.ucsb.edu/ws/?pid=60492.

> you heard on your evening news, the figures bear out that statement. Wholesale prices in September posted the biggest decline in 5 years. And the price of industrial commodities has gone down for the first time in 7 years."

President Nixon went on to state:

> "And consequently, I am announcing tonight that when the 90-day freeze is over on November 13, we shall continue our program of wage and price restraint. We began this battle against inflation for the purpose of winning it, and we are going to stay in it till we do win it."

Phase II of the Economic Stabilization Program was now in effect. The inflation rate continued to drop until August 1972, when it hit an annual rate of 2.9%. Unfortunately, the inflation rate did not stay there. By December of 1972, inflation was running at an annual rate of 3.4%—prompting President Nixon, on January 11, 1973, to announce Phase III of the Economic Stabilization Program. In six months, inflation hit an annual rate of 6.0%, prompting another round of price controls. On July 18, 1973, President Nixon announced Phase IV of the Economic Stabilization Program. By June of 1974, inflation was running at an annual rate of 10.9%. On June 18, 1974, Richard Nixon signed Executive Order 11788, putting an end to the price controls that he originally put in place nearly three years earlier. Over this time the annual rate of inflation went from 4.4% to 10.9%—not a screaming success if your intent was to hold down inflation.

Taking Pause to Reflect

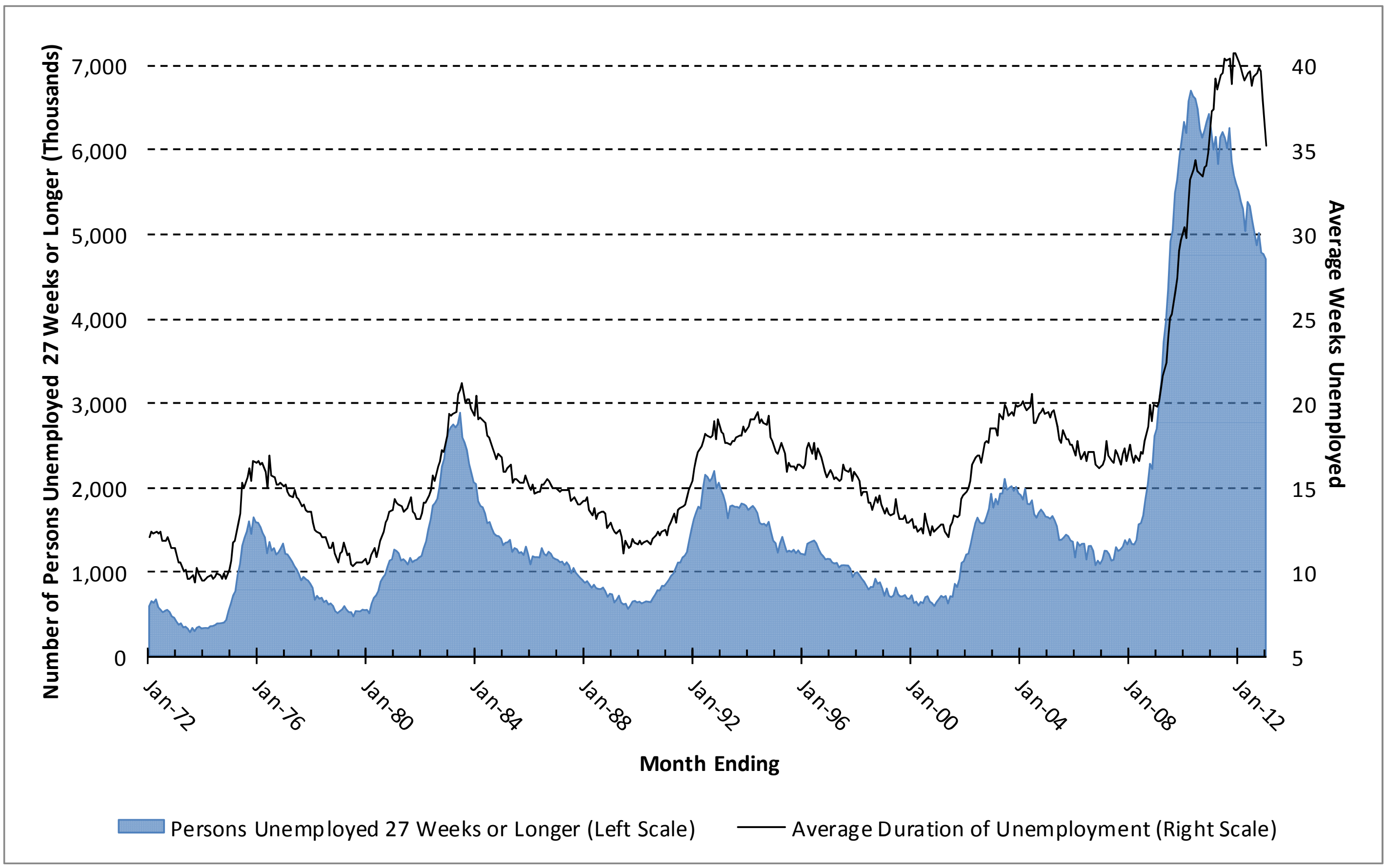
By comparing the price control policies put in place by President Nixon to the interest rate policies put in place by the Federal Reserve Bank we are not suggesting the current policies are destined for failure. Based upon the evidence, current policies appear to have worked quite well. What we can take away from this comparison though, is that any time you place artificial constraints on something, the results can be pretty predictable. Sometimes, we ignore the obvious at our own peril.

February 2013 Data Points

Long-Term Unemployment

The latest data from the U.S. Bureau of Labor Statistics, released on February 1, 2013, show that the level of long-term unemployment (those unemployed 27 weeks or longer) stood at 4.708 million at the end of January 2013. This is down from 4.766 million at the end of December and 5.522 million at the end of January 2012. The average duration of unemployment in the U.S. fell to 35.3 weeks in January, down from 38.1 weeks in December and 40.2 weeks in January 2012.

Level and Duration of Long-Term Unemployment (January 1972—January 2013)
Source: U.S. Bureau of Labor Statistics (as of 2/1/2013)



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