


THE PERFECT (FINANCIAL) STORM



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DePaul University




Components of the Storm

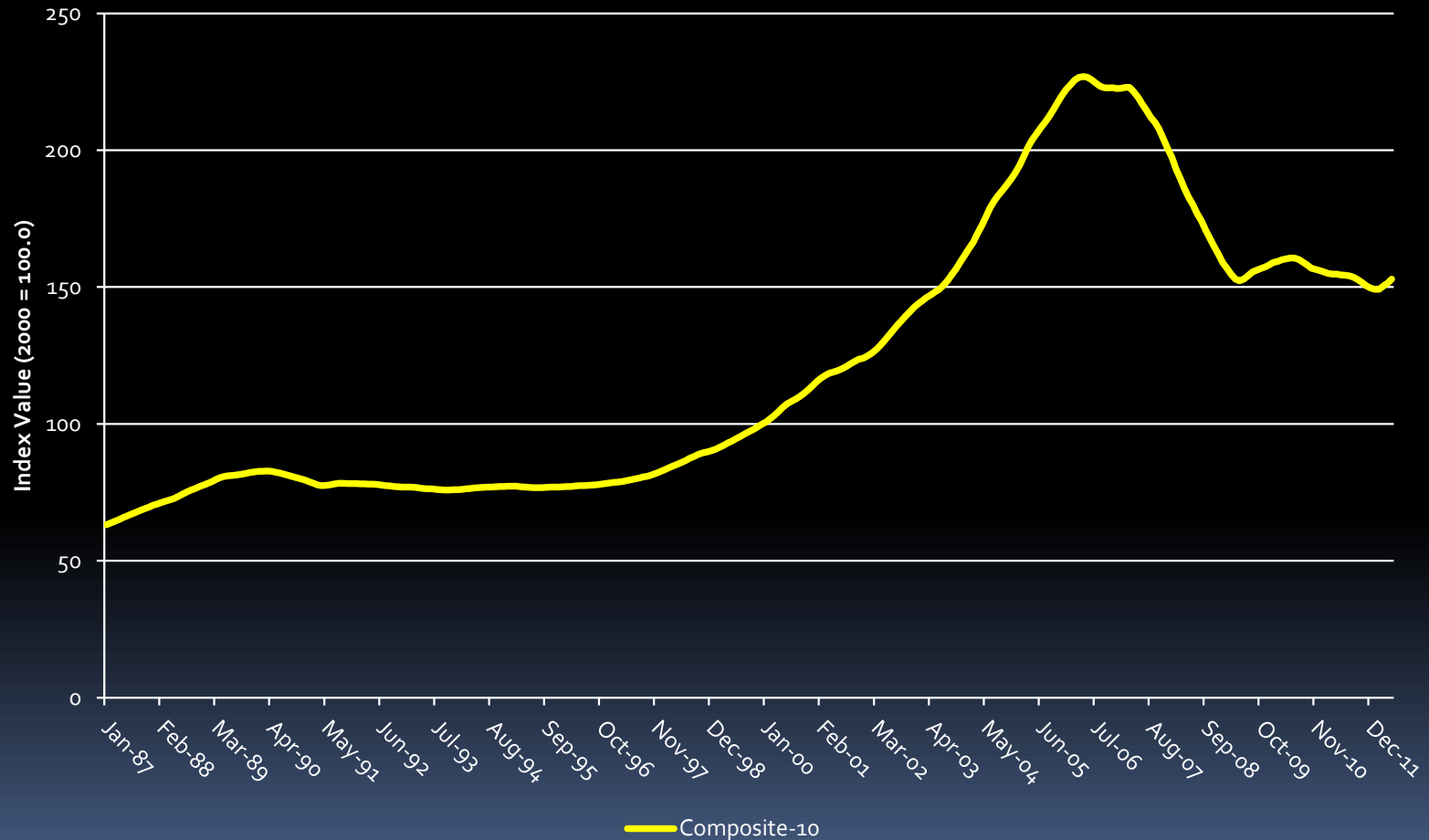
- **Housing Crisis:** \$7 Trillion in lost home equity
 - **Banking Crisis:** 350 (and counting) failed banks
 - **Employment Crisis:** 15 million out of work
 - **Euro Crisis:** Sovereign Bailout Mania
 - **Fiscal Crisis:** The looming “Fiscal Cliff”
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The Housing Crisis

- Since 2008, about 4 million families have lost their homes to foreclosure.
 - Another 4 million are likely to lose their homes in the next four years.
 - Another 6 million are “underwater,” owing more than the value of their home.
 - More than \$7 trillion in home equity has been destroyed. Home equity is the financial lifeblood of entrepreneurs, who create most U.S. jobs.
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The Housing Crisis: Home Prices 1987 - 2012



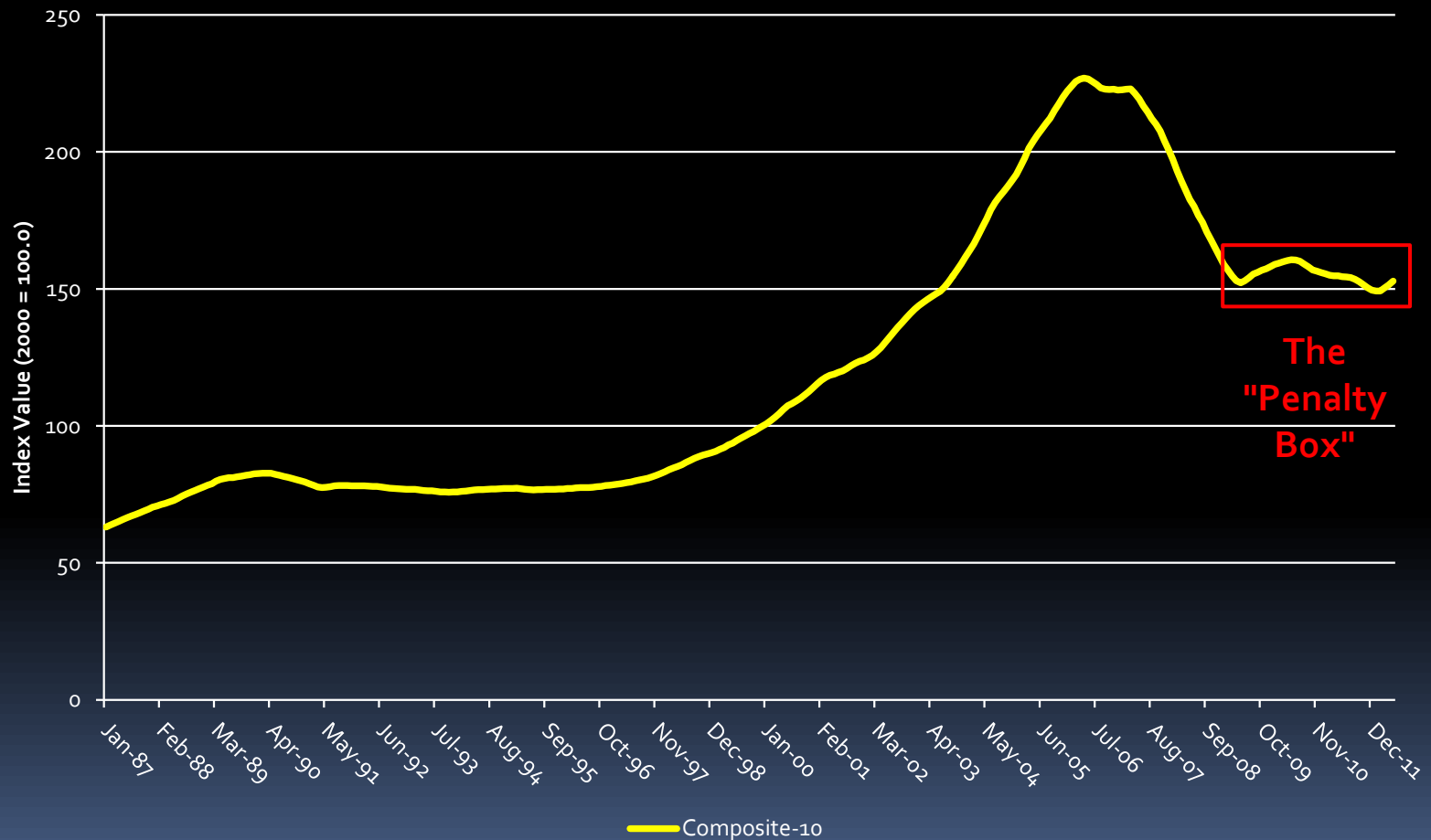
Source: Case-Shiller Composite 10-City Index (May 2012)

The Housing Crisis: Home Prices 1987 - 2012



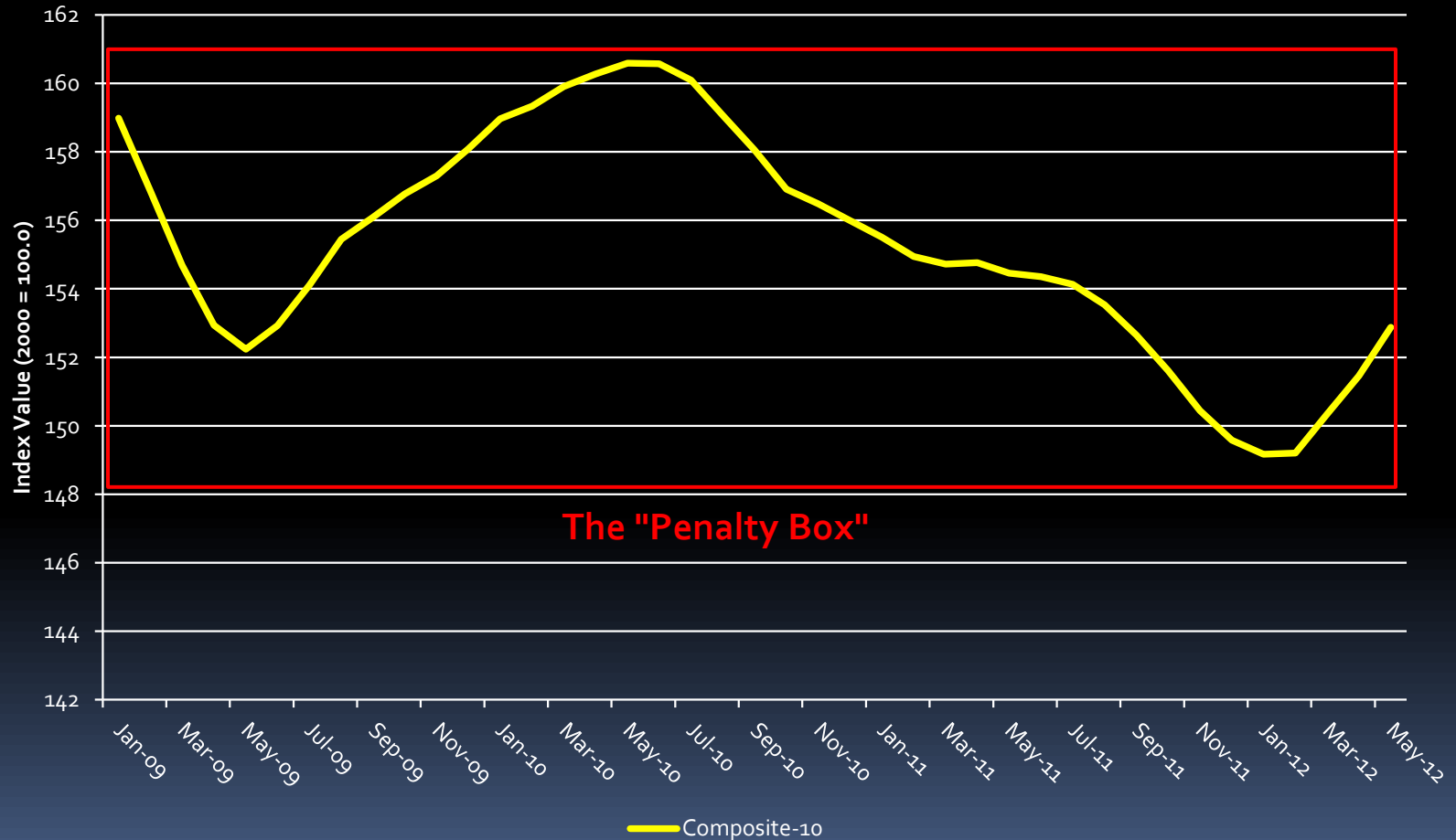
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The Housing Crisis: Home Prices 1987 - 2012



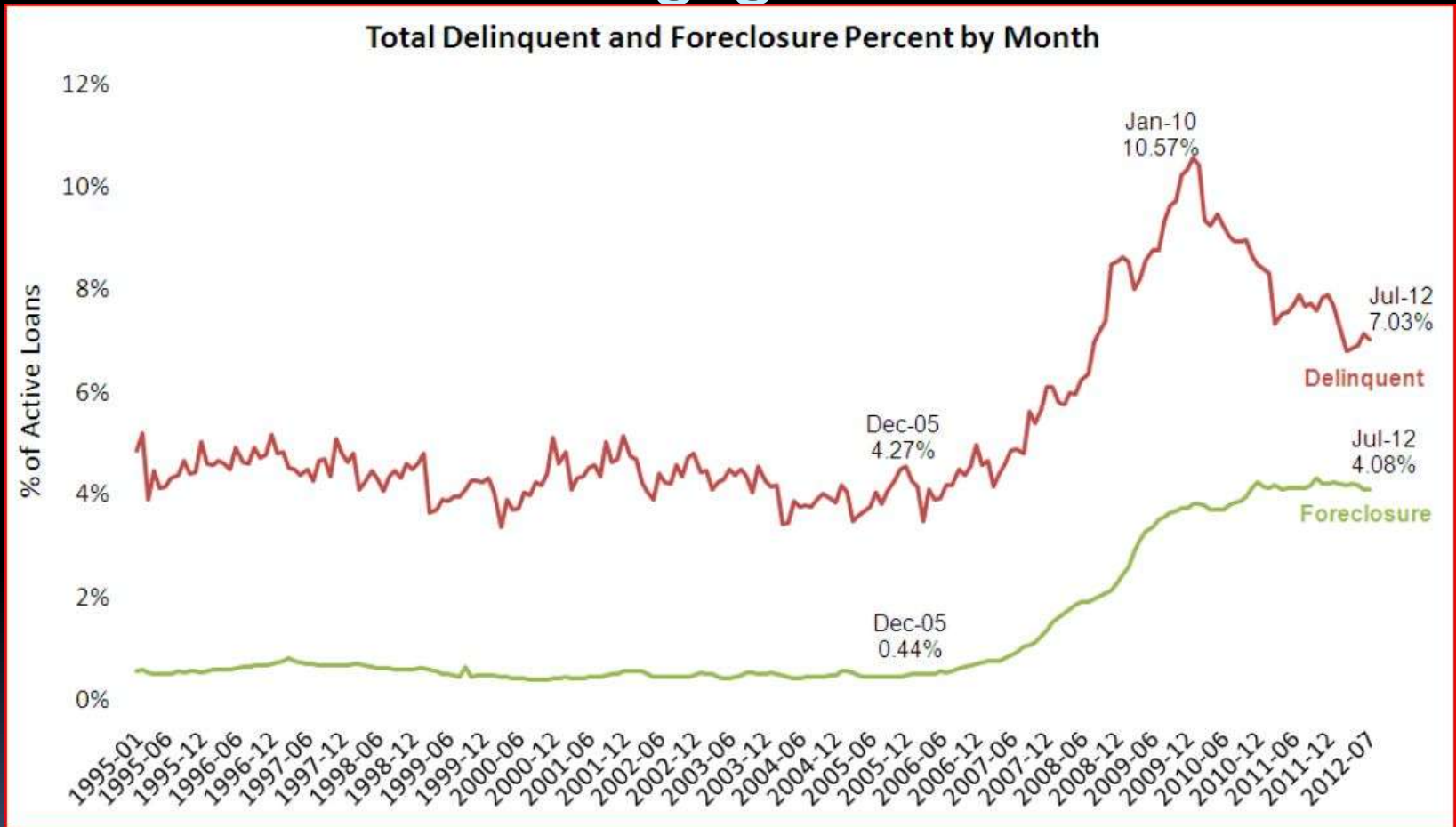
Source: Case-Shiller Composite 10-City Index (May 2012)

The Housing Crisis: Home Prices 2009 - 2012



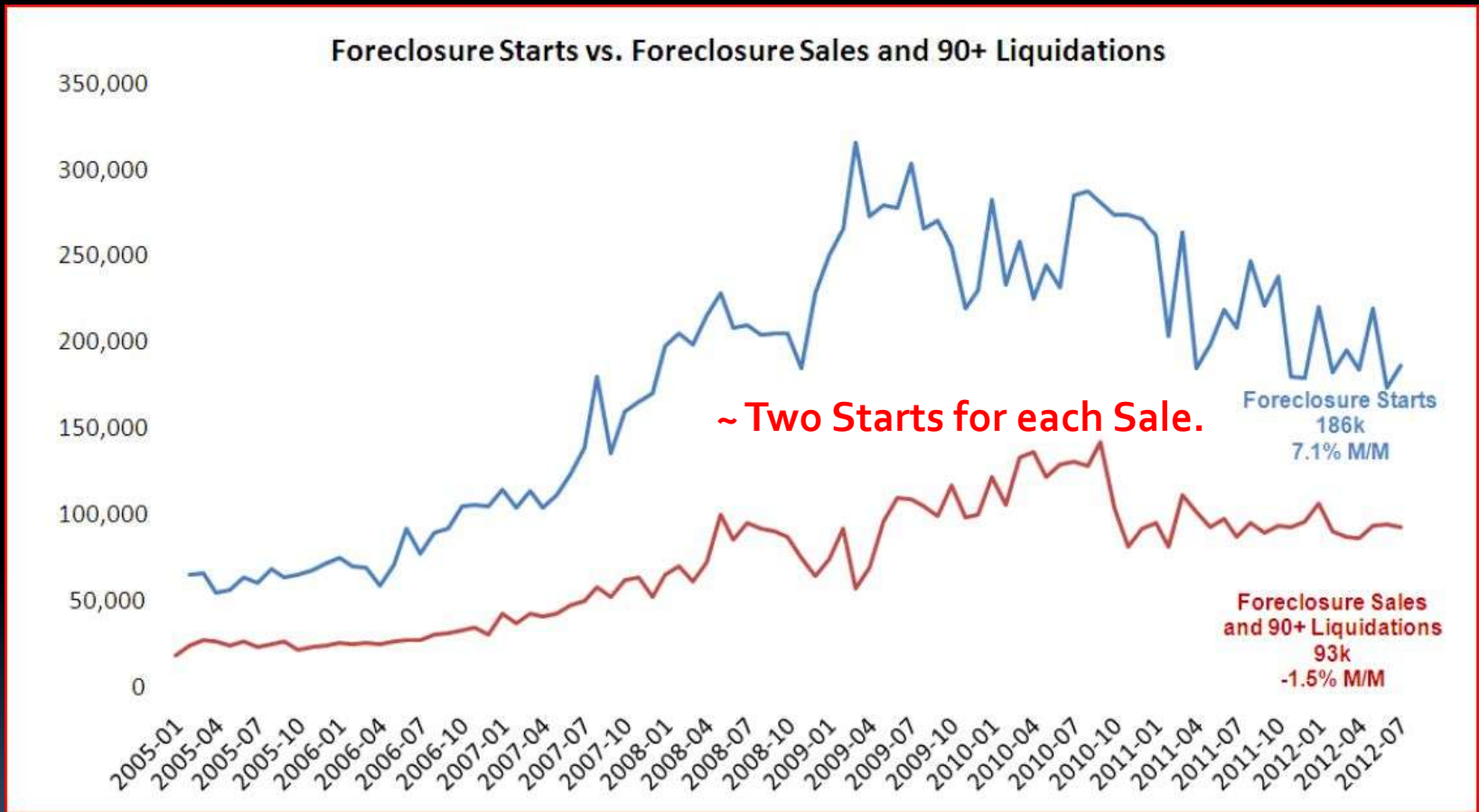
Source: Case-Shiller Composite 10-City Index (May 2012)

The Housing Crisis: Non-Current Mortgages



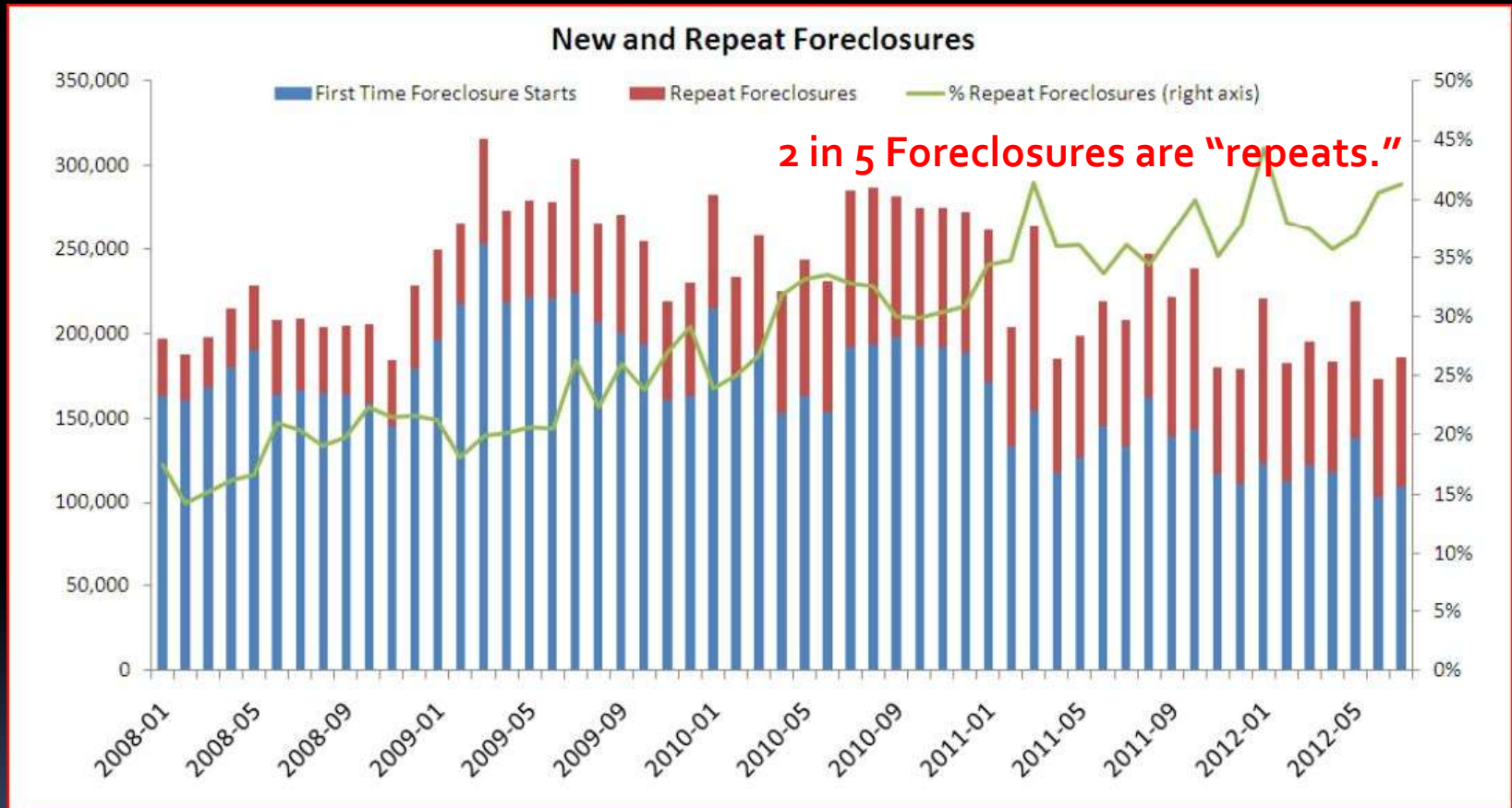
Source: Lender Processing Services (July 2012)

The Housing Crisis: Foreclosure Starts vs. Sales



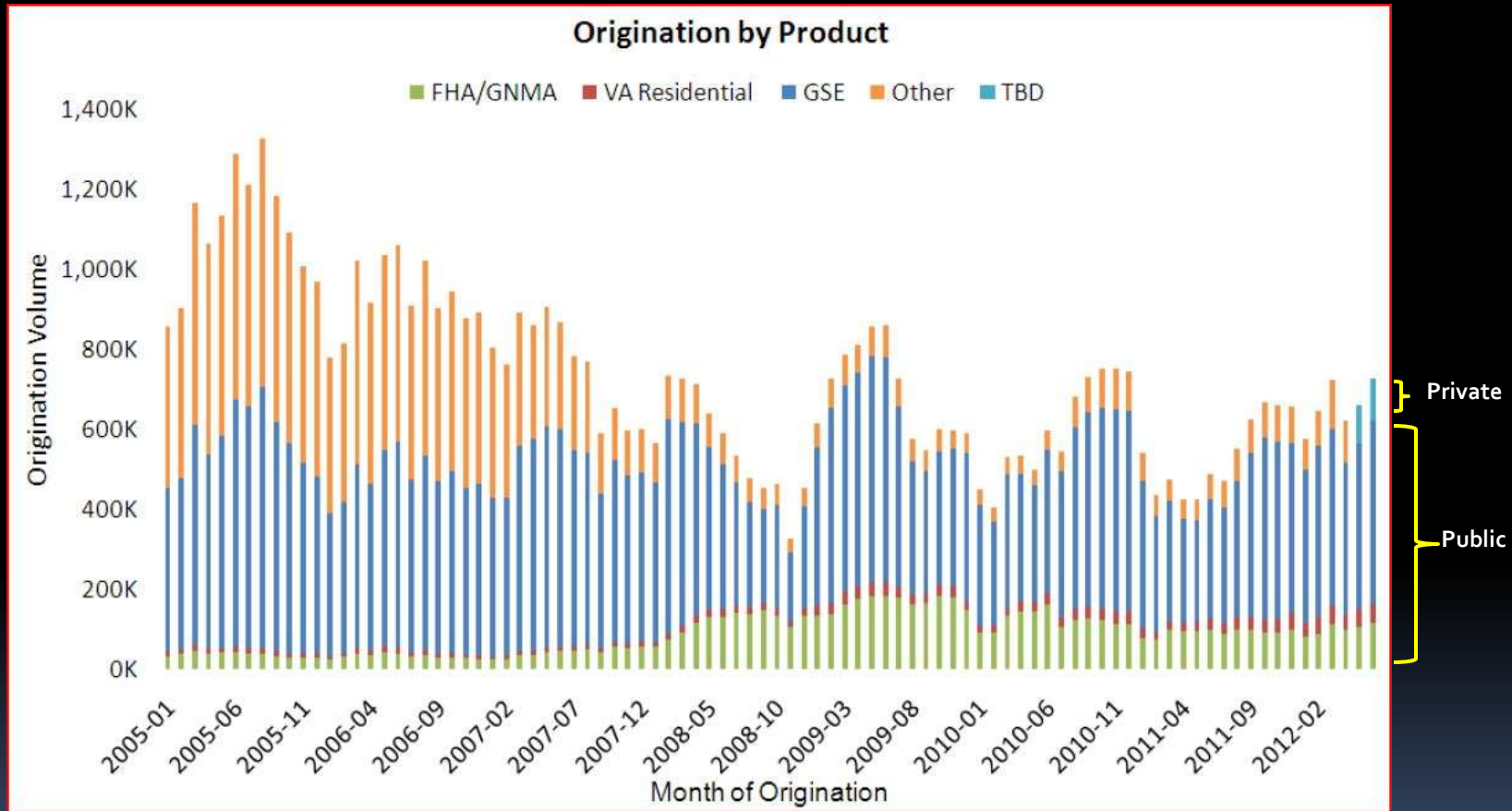
Source: Lender Processing Services (July 2012)

The Housing Crisis: “Repeat” Foreclosures




Source: Lender Processing Services (July 2012)


The Housing Crisis: Where is the private sector?



Source: Lender Processing Services (July 2012)




The Housing Crisis: Bottom Line

- Housing market will be weak until foreclosure inventory works through the system. (2016?)
 - Without housing, the jobs market will remain weak. Also, many workers can't move to take a new job because of underwater mortgages.
 - Foreclosures mean there will be millions of new renters who will not be able to buy until their credit histories heal.
 - Bernanke's Fed will continue ZIRP in attempt to fix housing. QE₃ is coming . . . later today?
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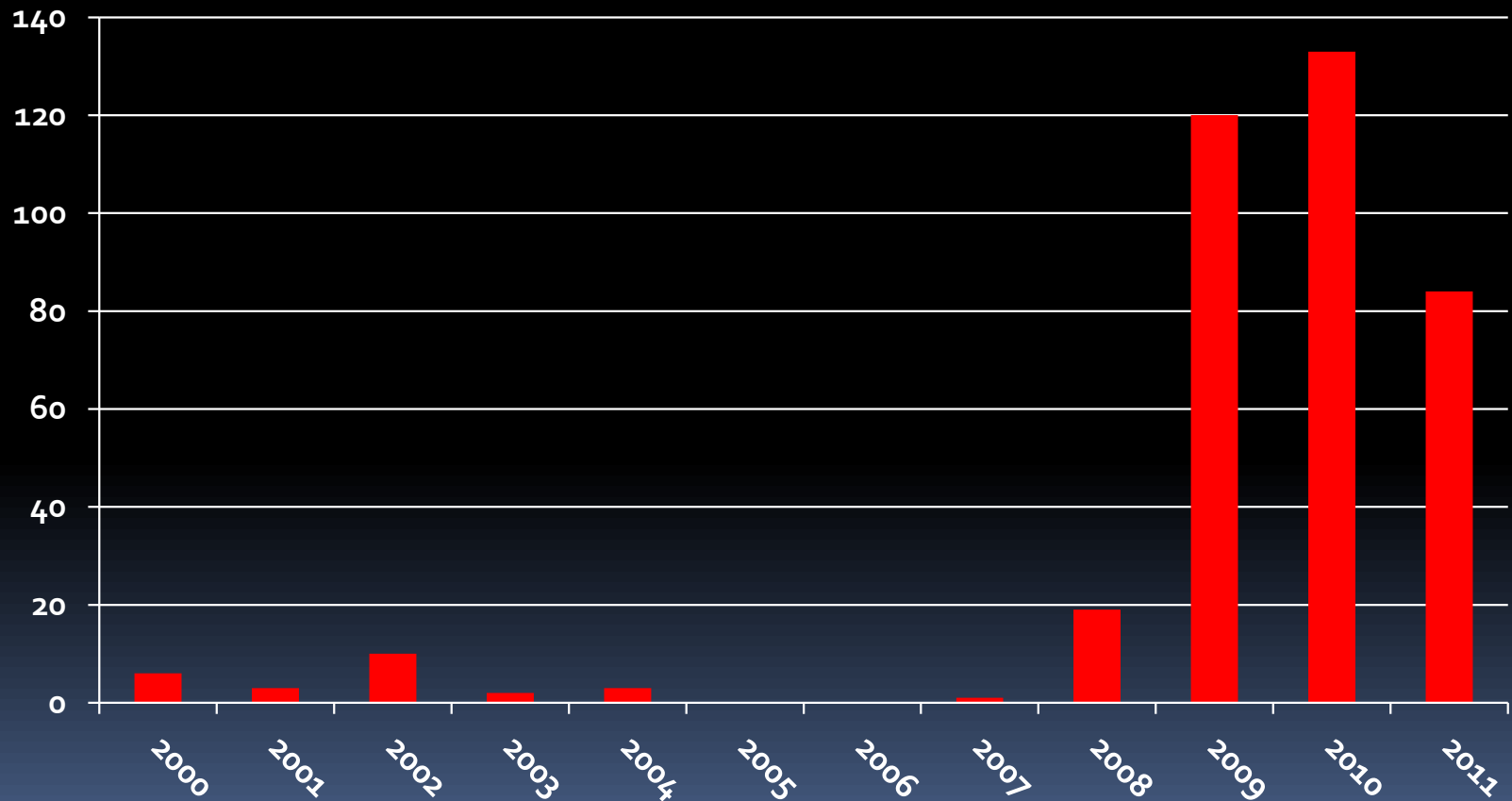


The Banking Crisis:

- In 2008, Feds were forced to rescue most of the largest U.S. bank holding companies.
 - \$700 billion TARP (of which only \$200 billion went to banks) was dwarfed by \$7 trillion in secret Fed loans.
 - Since 2008, more than 350 smaller banks have failed.
 - More than 700 banks remain on FDIC's "Problem Bank" list.
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The Banking Crisis: Number of Failures 2000 - 2011

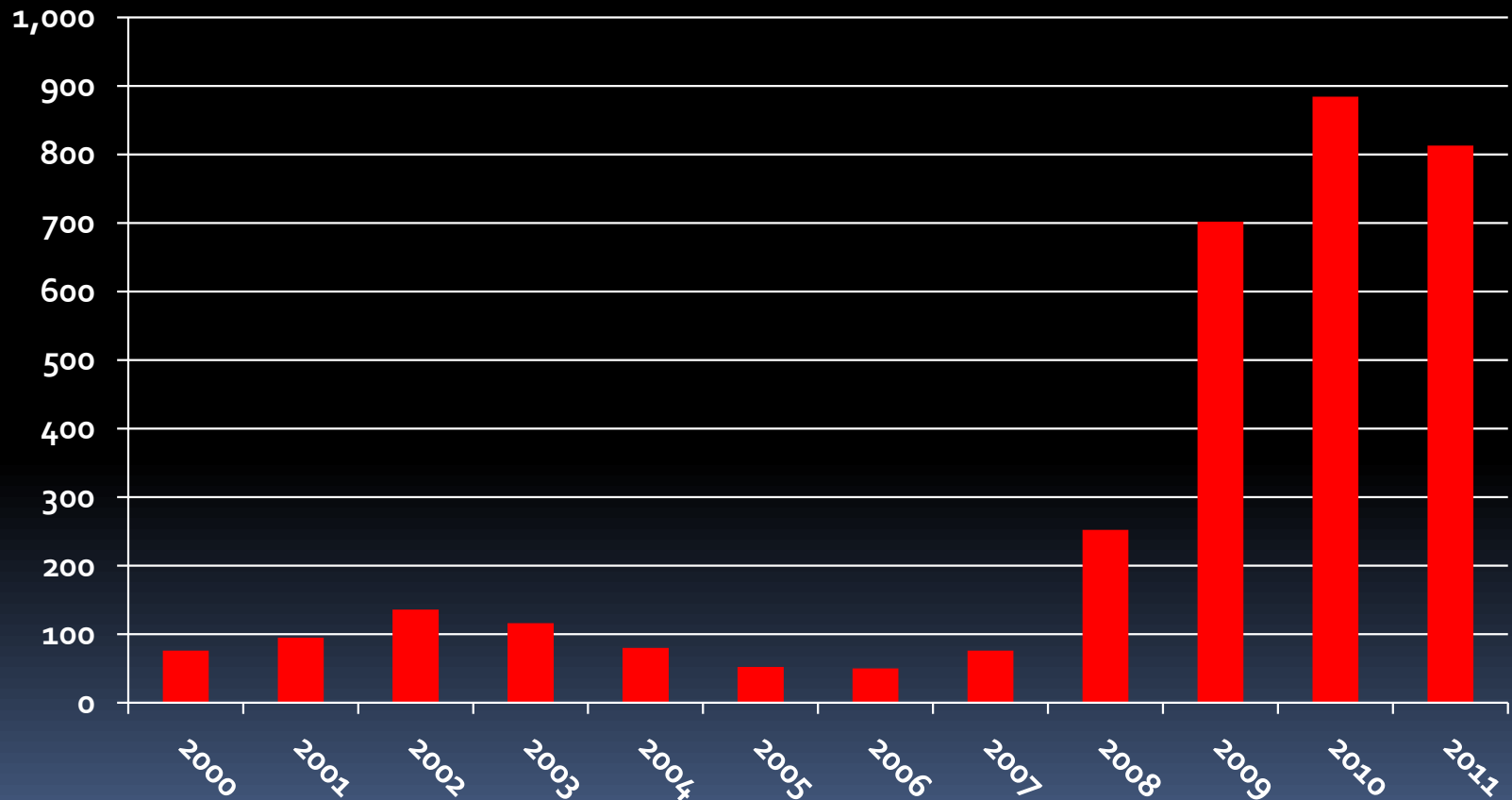
Bank Failures: 2000 - 2011



Source: FDIC Historical Statistics on Banking

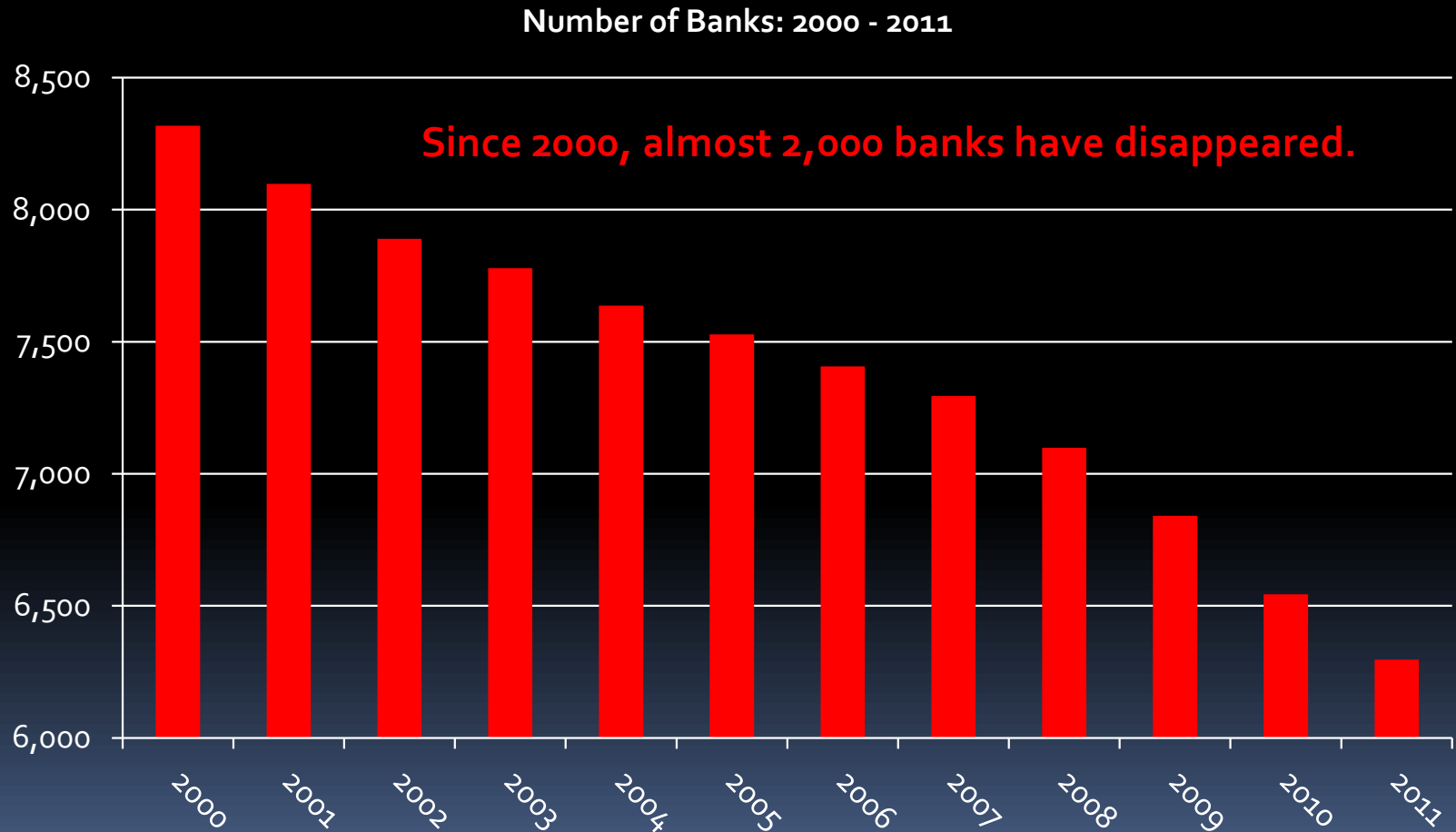
The Banking Crisis: Number of Problem Banks 2000 - 2011

Number of FDIC Problem Banks: 2000 - 2011



Source: FDIC Quarterly Bank Profiles

The Banking Crisis: Number of Banks 2000 - 2011




Source: FDIC Historical Statistics on Banking

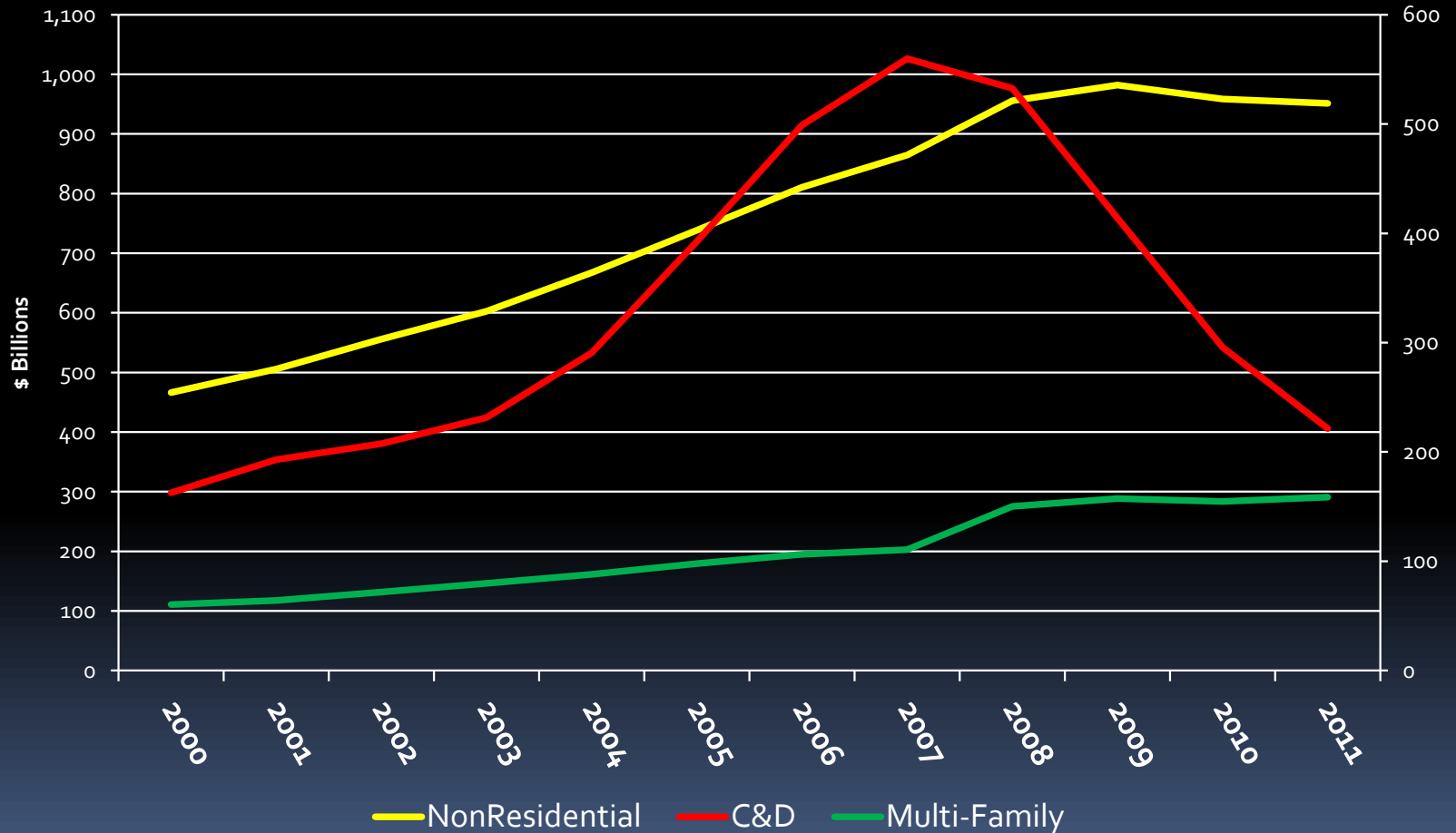


The Banking Crisis:

Subprime, CDOs, CDSs and C&D loans

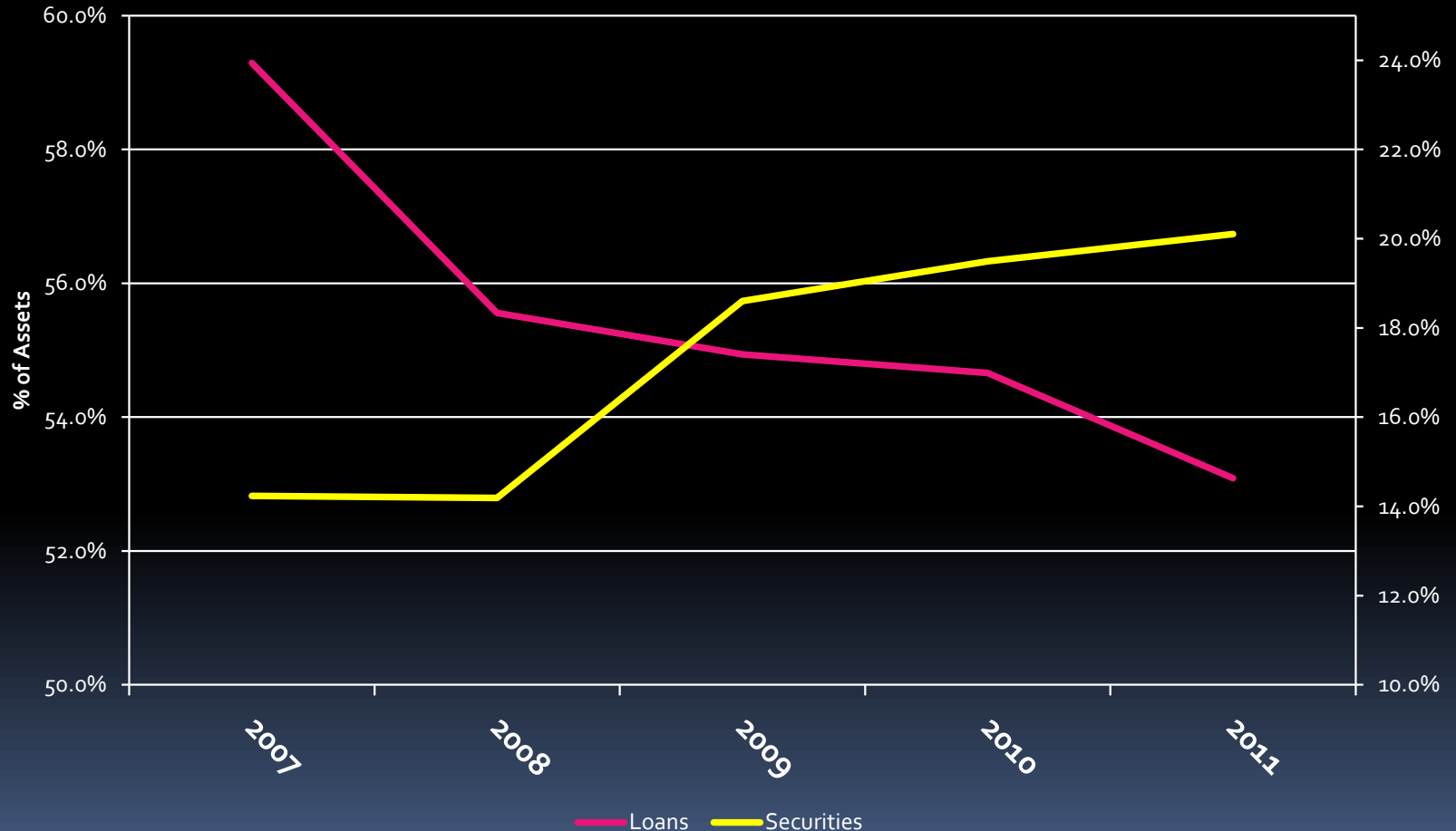
- “Subprime” mortgages are widely blamed for the crisis, but it was Collateralized Debt Obligations (CDOs) and Credit Default Swaps (CDSs) that did the real damage to Wall Street banks.
 - \$70 Trillion in opaque OTC CDSs meant that no one knew who was solvent and who was not.
 - Main Street banks are another story: they were funding construction loans to developers that went south as the housing market crashed.
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The Banking Crisis: Commercial Real Estate Lending



Source: FDIC Historical Statistics on Banking

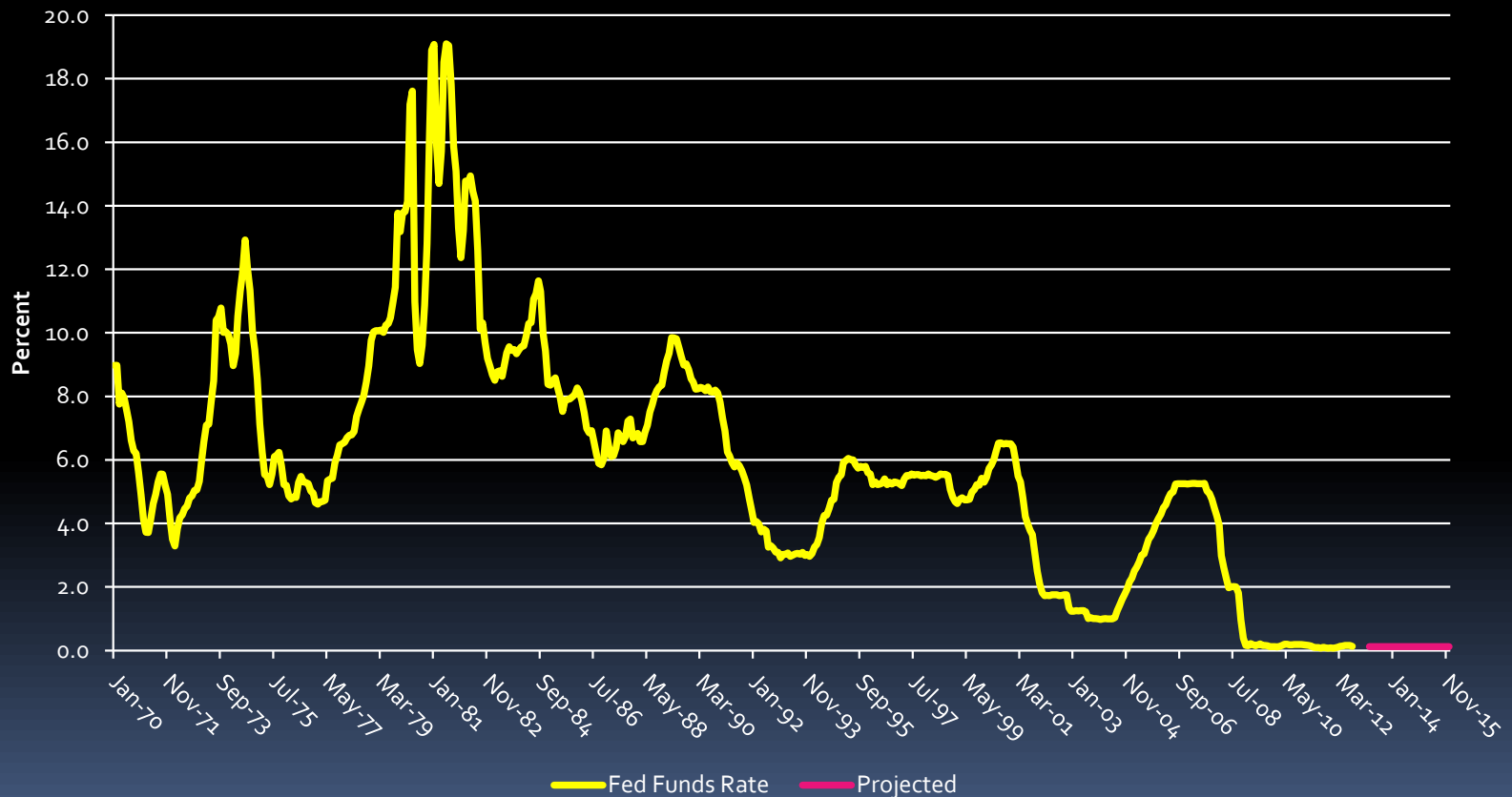
The Banking Crisis: Banks slowed lending, bought securities



Source: FDIC Historical Statistics on Banking

The Banking Crisis: Fed's Response--ZIRP

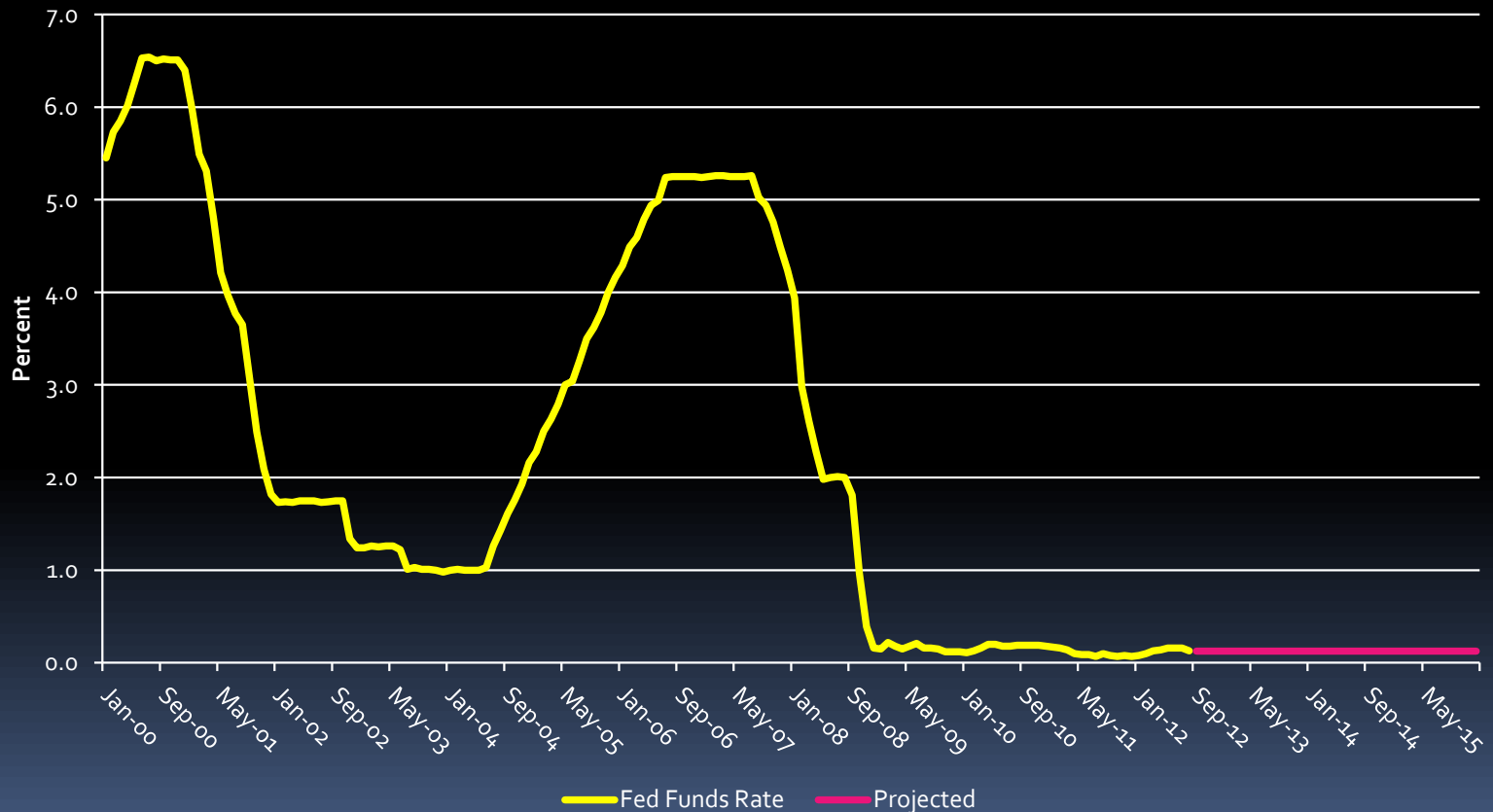
Federal Funds Rate 1970 - 2012



Source: Federal Reserve Economic Data (FRED)

The Banking Crisis: Fed's Response--ZIRP

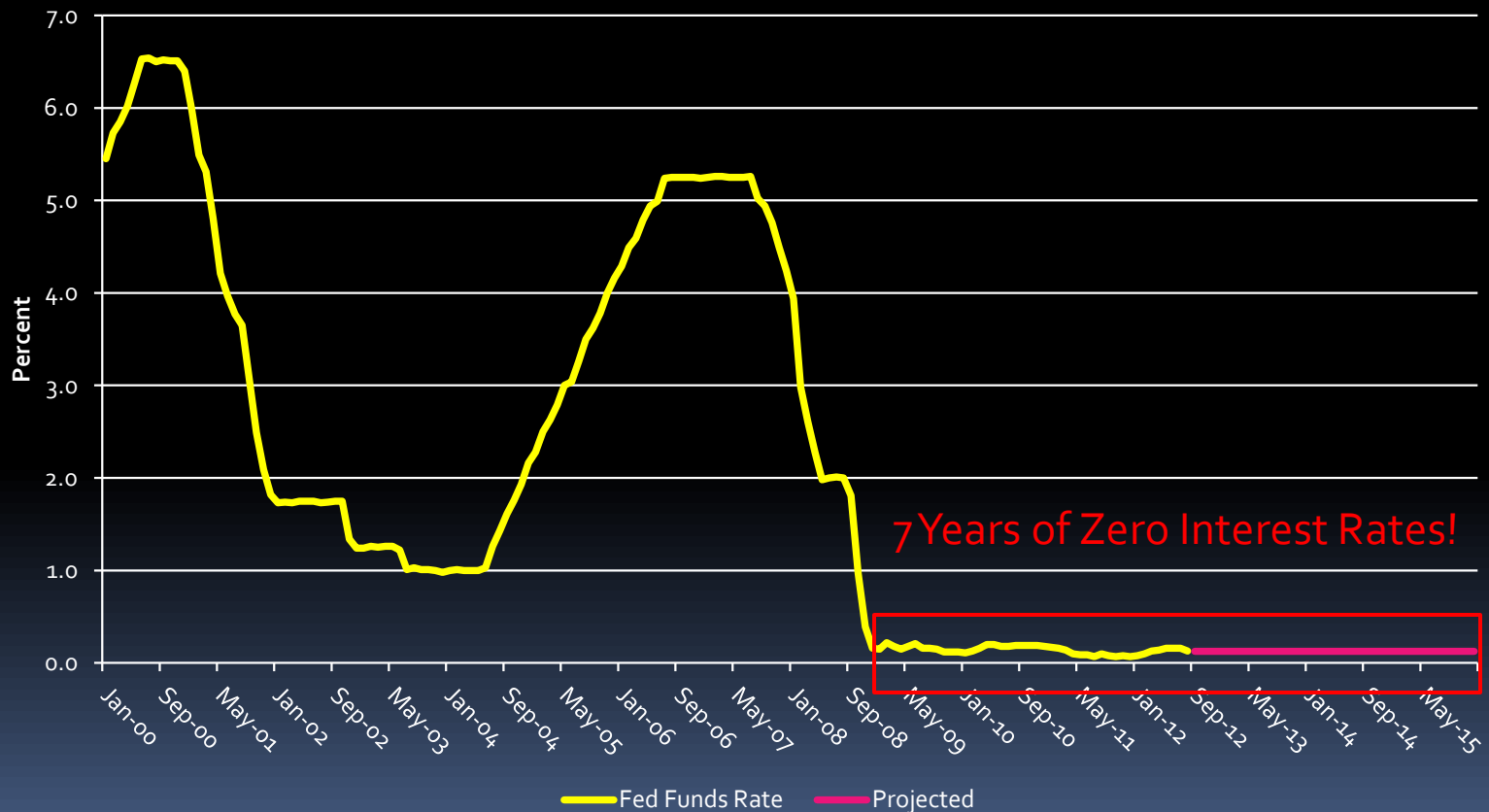
Federal Funds Rate 2000 - 2012



Source: Federal Reserve Economic Data (FRED)

The Banking Crisis: Fed's Response--ZIRP


Federal Funds Rate 2000 - 2012



Source: Federal Reserve Economic Data (FRED)

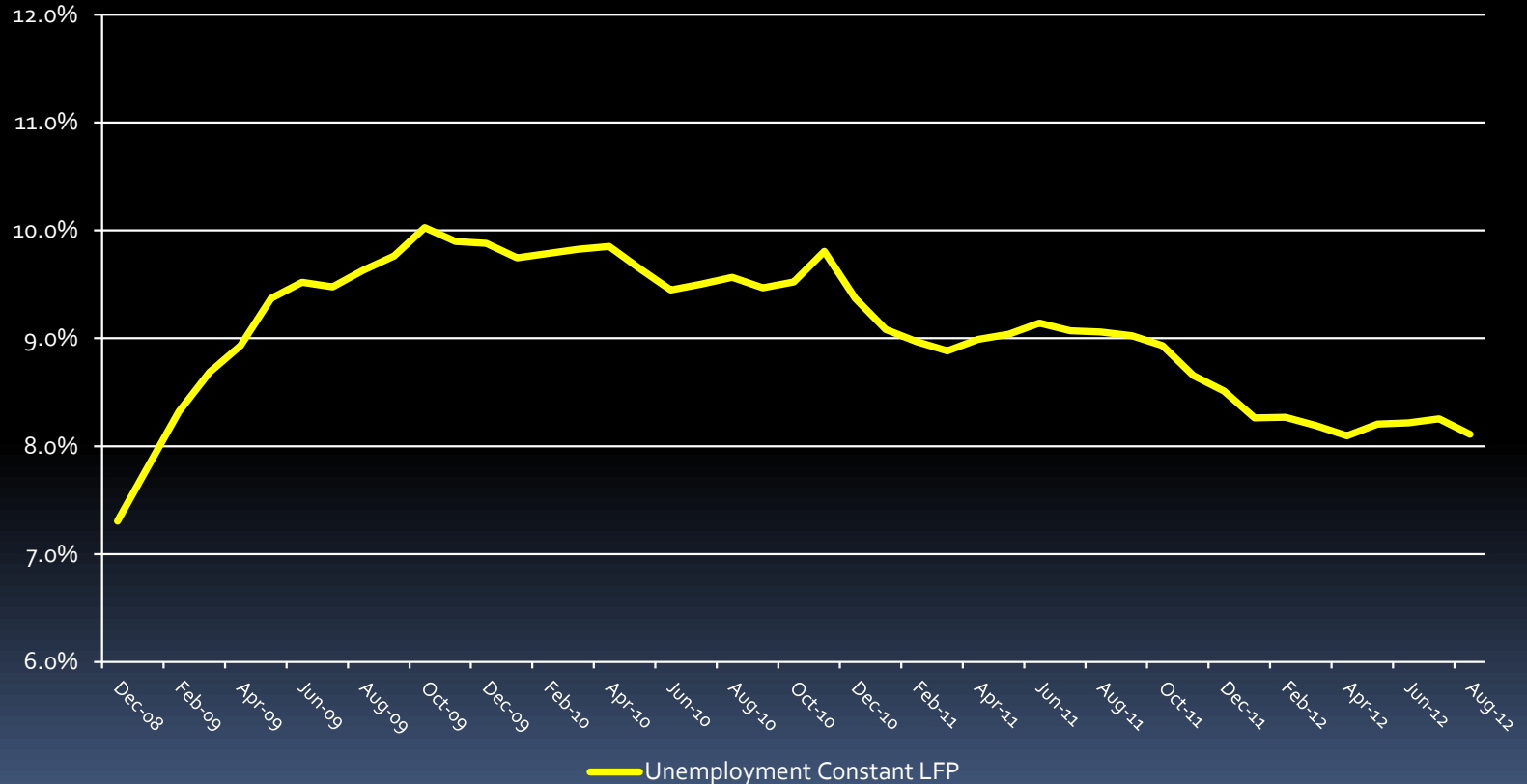


The Banking Crisis: The Bottom Line

- The mega-banks are earning their way back to financial health, but still aren't lending.
 - Community banks remain in crisis.
 - Look for another 300 – 500 community banks to fail or disappear in “shotgun” weddings.
 - Look for the Fed to continue ZIRP until the problem bank list drops below 100.
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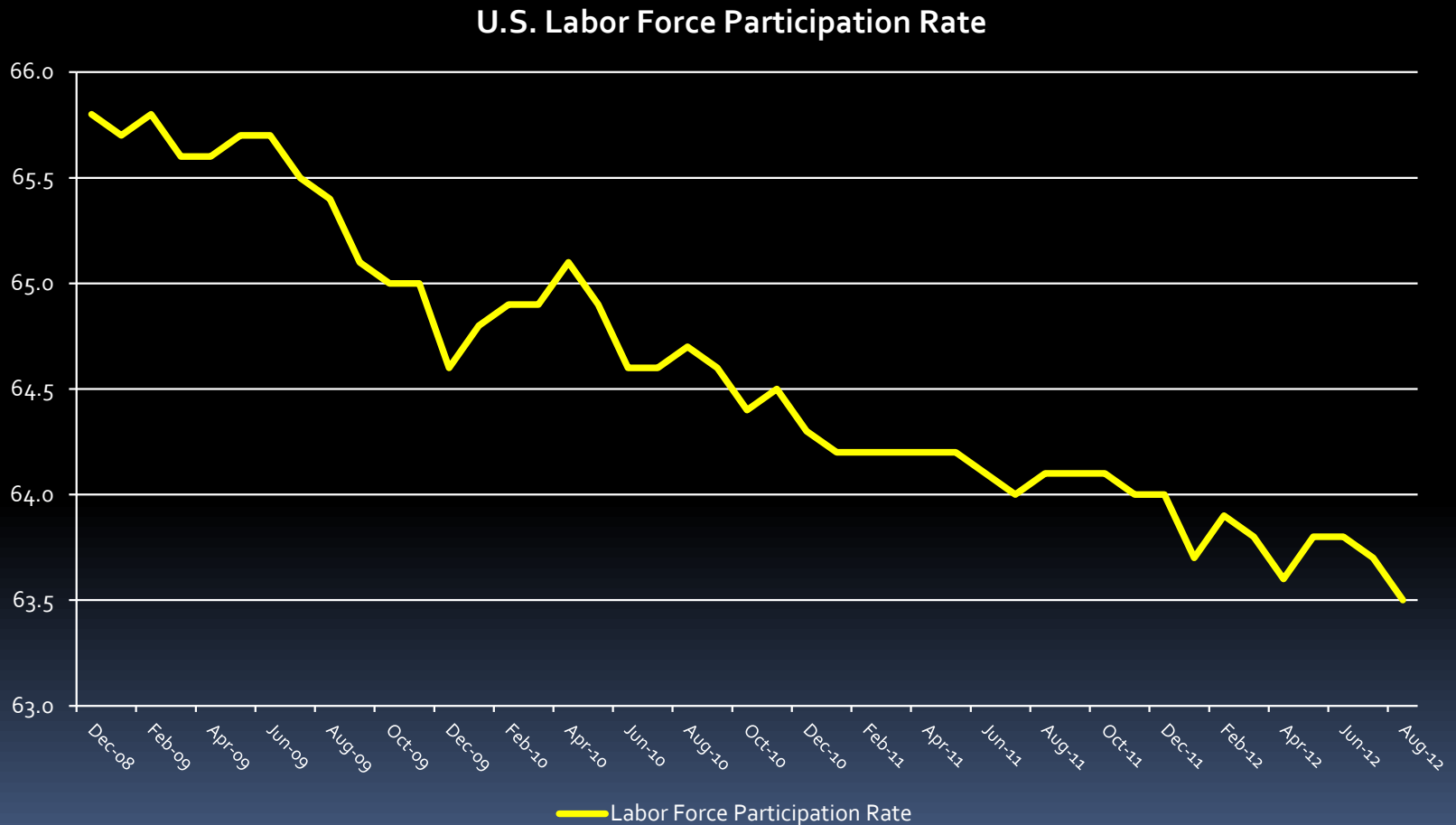
The Jobs Crisis: Unemployment Rate

U.S. Unemployment Rate:
As Reported



Source: Federal Reserve Economic Data (FRED)

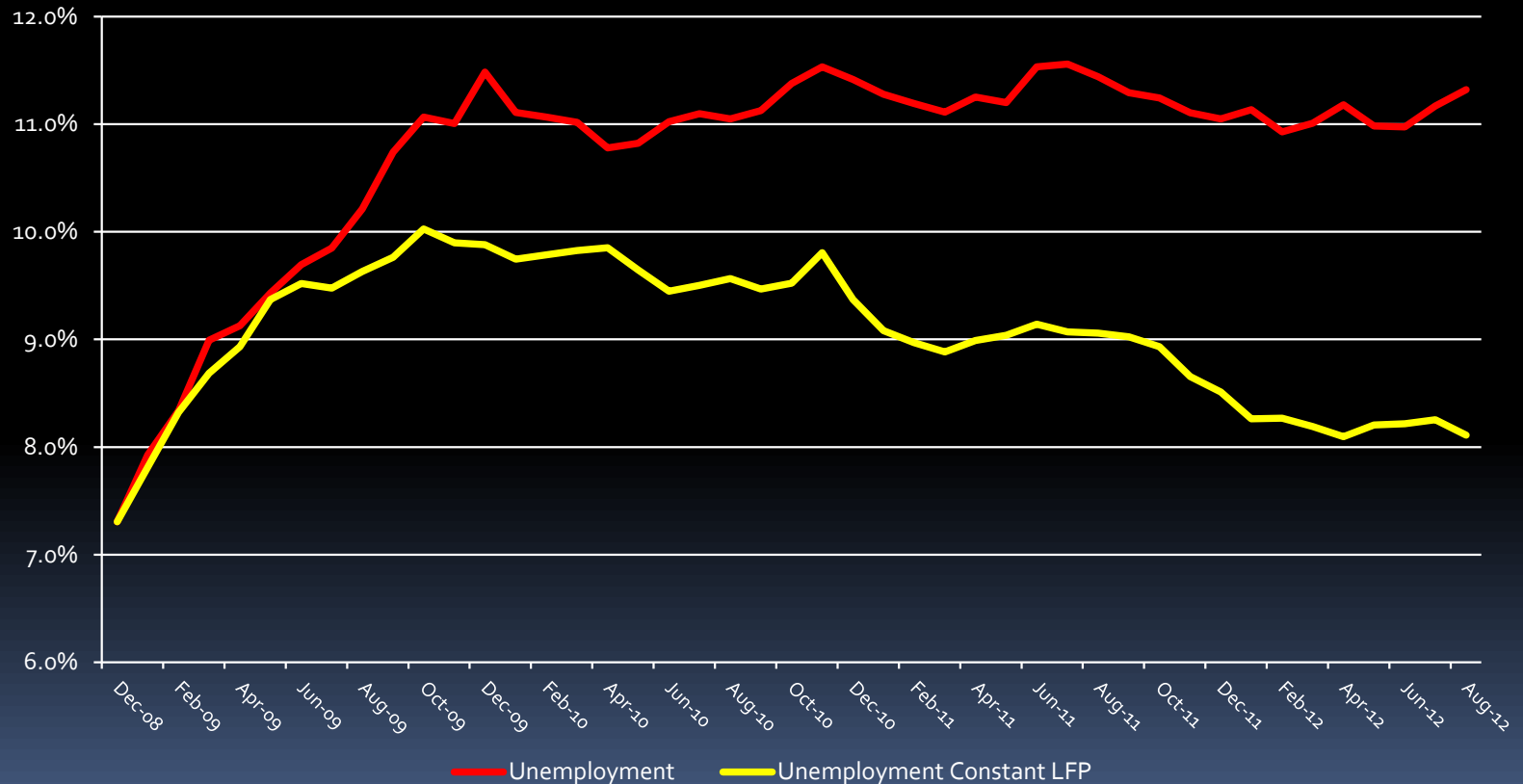
The Jobs Crisis: Labor Force Participation Rate



Source: Federal Reserve Economic Data (FRED)

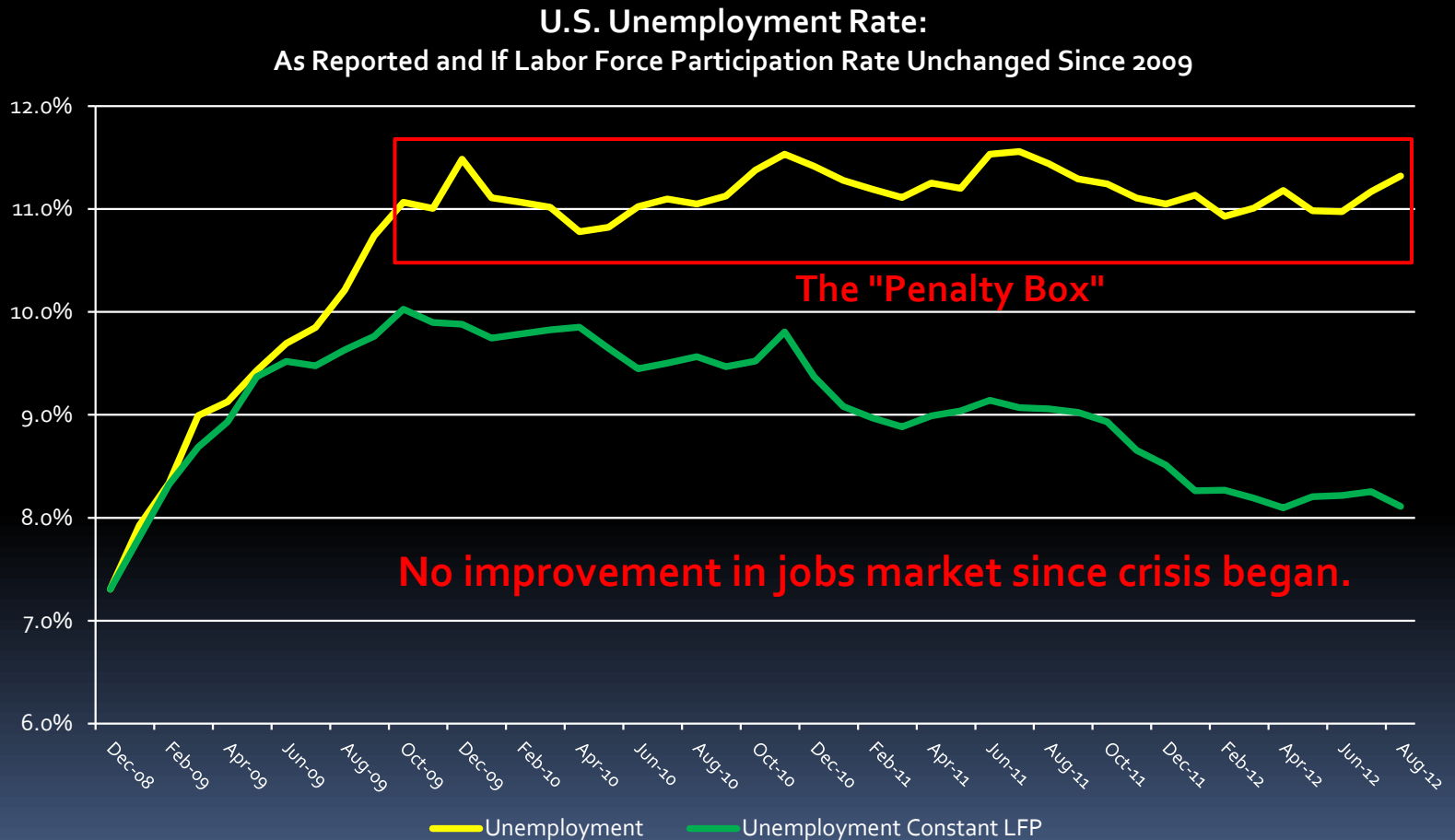
The Jobs Crisis: Unemployment Rate

U.S. Unemployment Rate:
As Reported and If Labor Force Participation Rate Unchanged Since 2009



Source: Federal Reserve Economic Data (FRED)

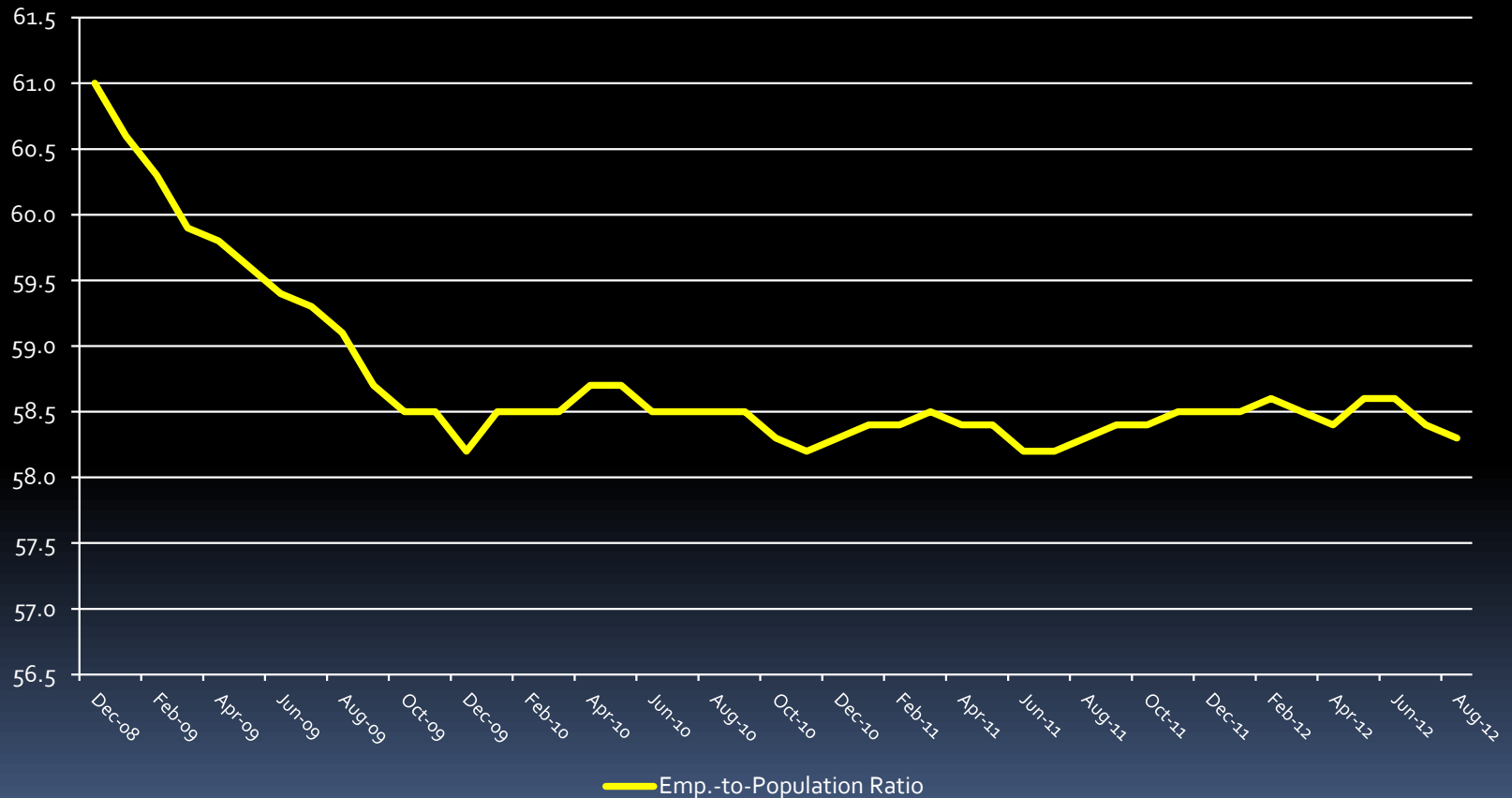
The Jobs Crisis: Unemployment Rate



Source: Federal Reserve Economic Data (FRED)

The Jobs Crisis: Employment-to-Population Ratio

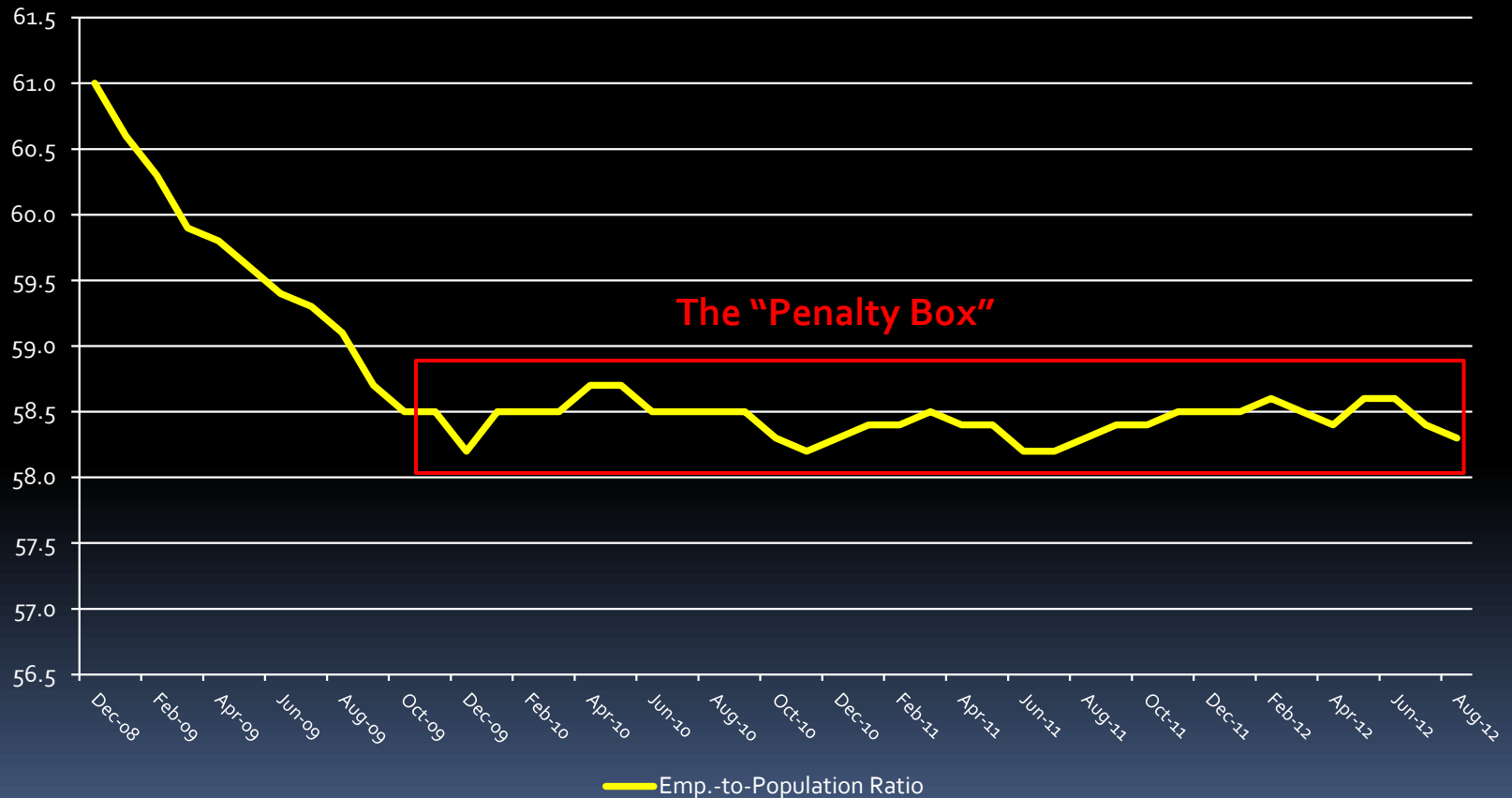
U.S. Employment-to-Population Ratio



Source: Federal Reserve Economic Data (FRED)

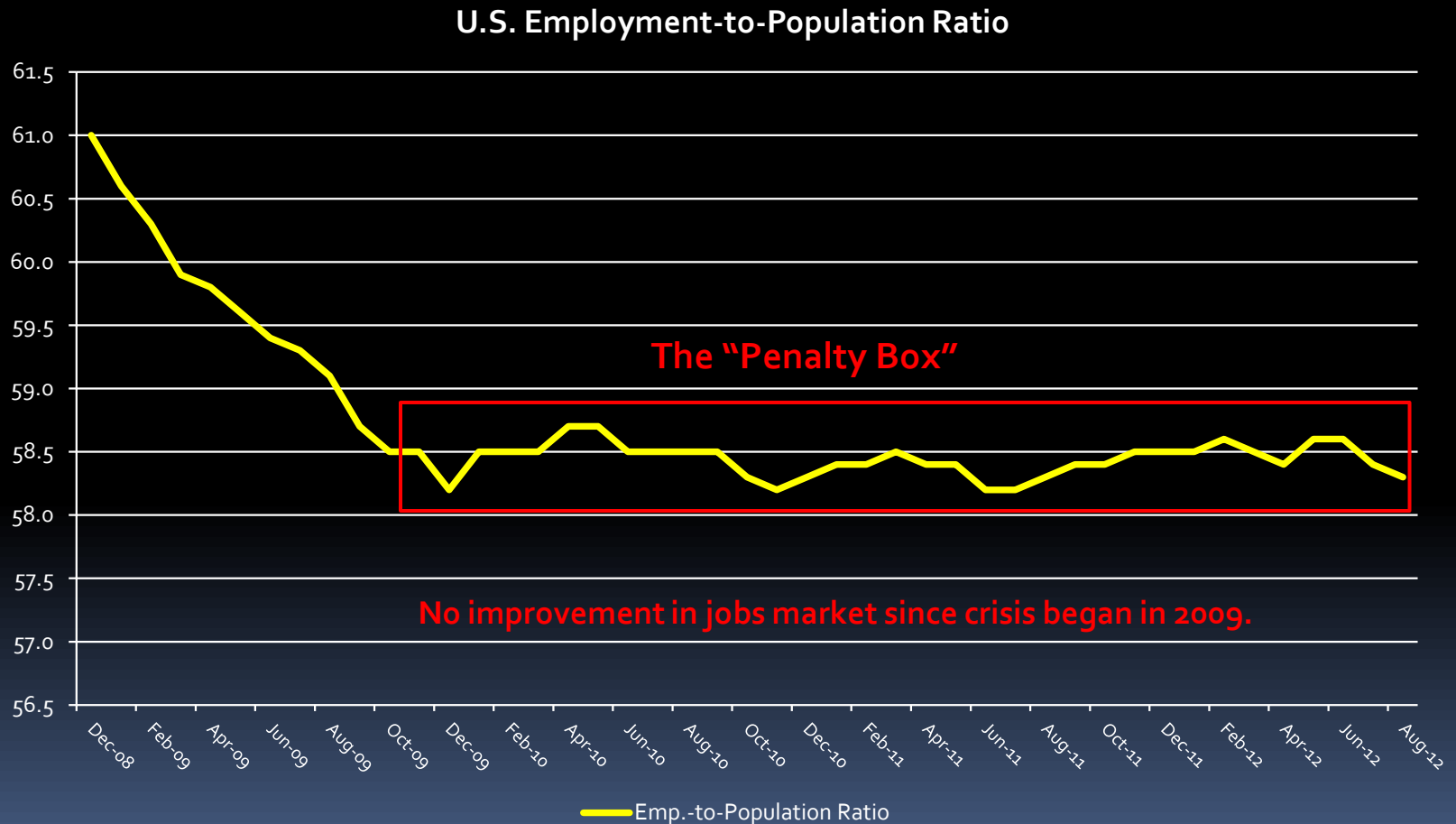
The Jobs Crisis: Employment-to-Population Ratio

U.S. Employment-to-Population Ratio




Source: Federal Reserve Economic Data (FRED)

The Jobs Crisis: Employment-to-Population Ratio



Source: Federal Reserve Economic Data (FRED)



The Jobs Crisis: Bottom Line

- Improvement in Unemployment Rate is “smoke and mirrors:”
- Attributable to millions of unemployed workers who have given up hope and left the work force for early retirement or long-term disability.
- There has been no measurable improvement in the U.S. labor market since Oct. 2009.
- By this measure, the Great Recession has not ended.
- Bernanke has stated that he will pursue the “full employment” part of the Fed’s “dual mandate.”

The Euro Crisis: Germany and France to the Rescue!




The Euro Crisis: The PIIGS





The Euro Crisis: Origins

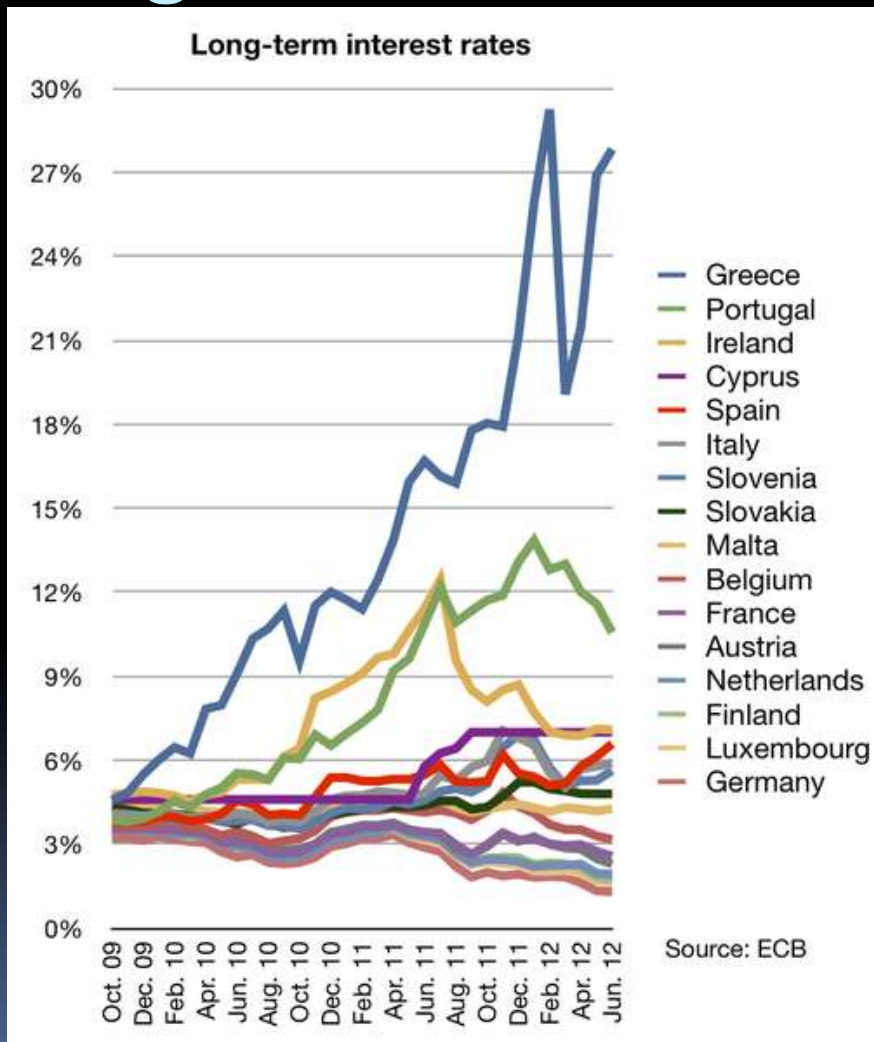
- The Euro crisis really began in 1999, when the Euro currency began trading. A monetary union simply cannot exist in the absence of a fiscal union.
 - Greece' entry in 2001 was a second key date, as we now know that Goldman Sachs helped Greece hide the size of its national debt through a currency swap transaction.
 - In 2010, under a new government, the depths of Greece's problems became public.
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The Euro Crisis:

Greece Bailouts I, II (and III)

- Fears of default led EuroZone countries to approve a US\$145 billion bailout in May 2010, in exchange for Greece agreeing to austerity measures designed to cut the government deficit.
- By early-2012, it was clear that the original bailout was too small, and another US\$170 billion bailout was approved in February.
- Most analysts think that even this will not be sufficient, so a third bailout is being discussed.

The Euro Crisis: Long-Term Rates on Government Bonds



- As shown in this graph, Greece was followed by Ireland and Portugal, each of which was bailed out.
- Now, we see Spain (in red) as the next crisis, with Italy expected to follow.

The Euro Crisis: Italy: “Too Big to Bail”



Germany Says Italy's



**2.5 Trillion Dollar Debt
Is Too High To Bailout**


The Euro Crisis: Bottom Line

- Options:
 - **Good**: None.
 - **Bad**: ECB bails out the PIIGS with Euro-Bonds. *
 - **Worse**: One or more of the PIIGS leaves the Euro.
 - **Worst**: Germany leaves the Euro.

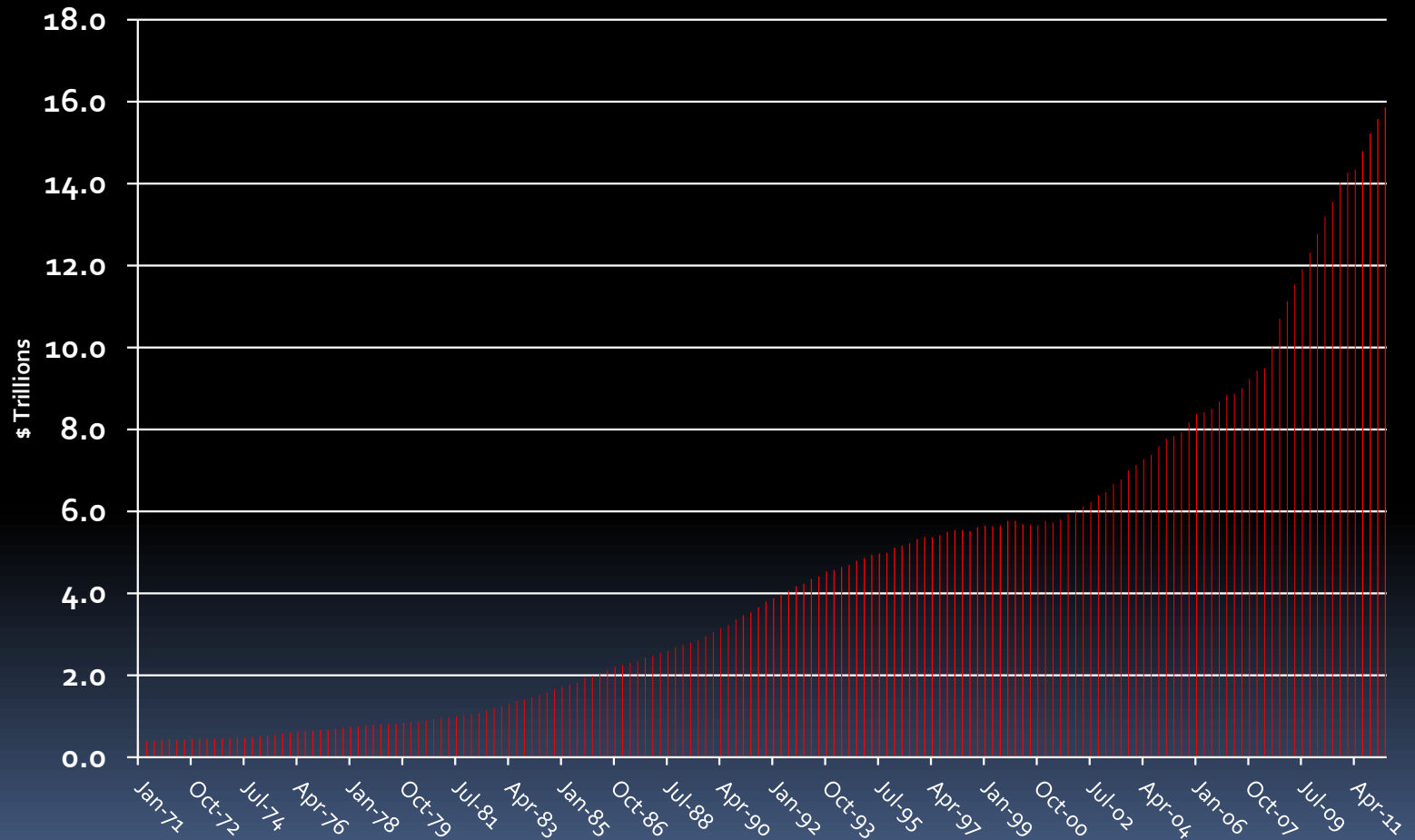
* Consensus forecast



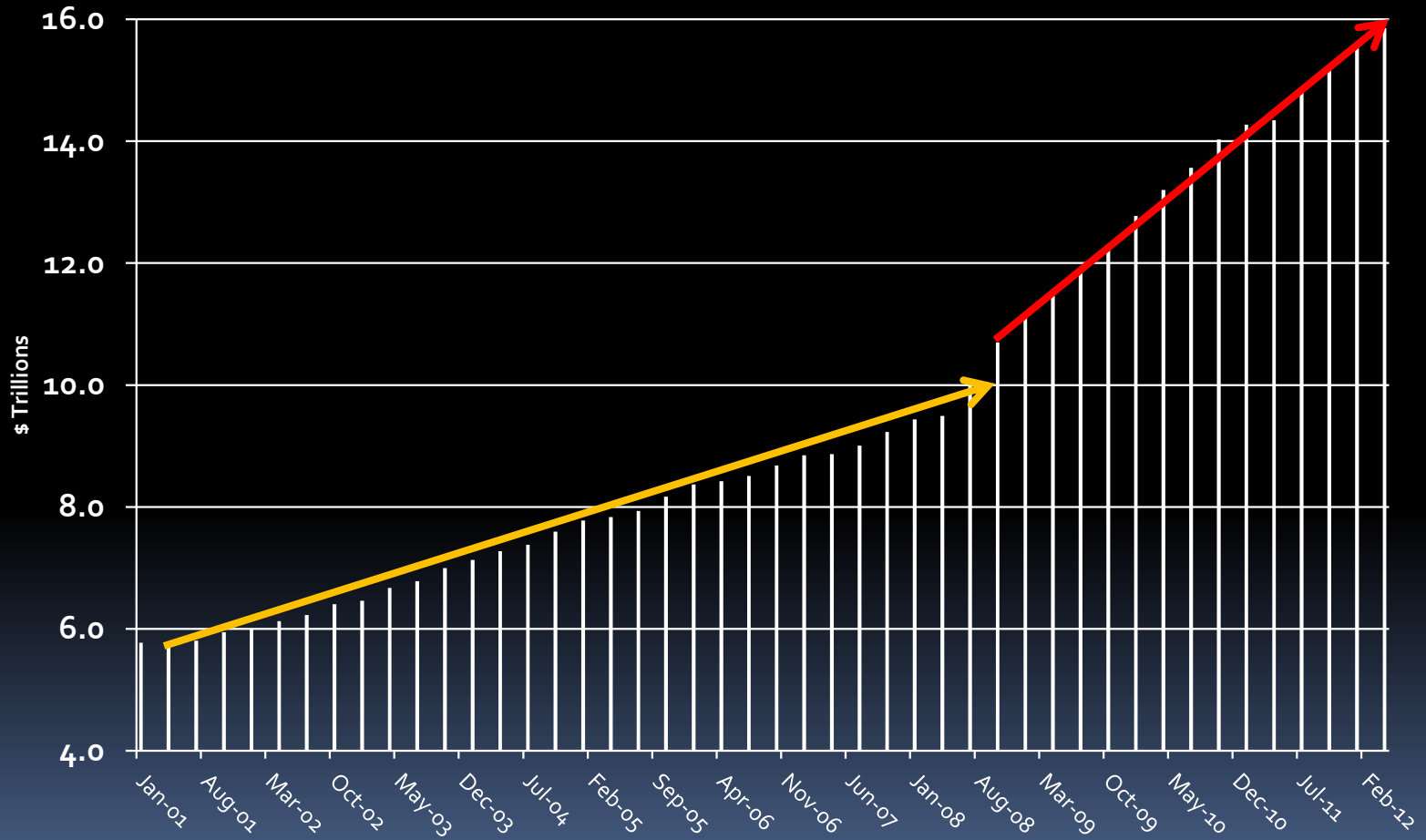
The Fiscal Crisis: Summary

- U.S. Federal Gov't has now amassed more than \$16 Trillion in debt.
 - Annual deficits have averaged > \$1 Trillion since 2009, with no end in sight.
 - “Fiscal Cliff” looms in Jan. 2013 if Congress does not act.
- 

The Fiscal Crisis: U.S. Federal Debt 1971 - 2012



The Fiscal Crisis: U.S. Federal Debt 2000 - 2012



The Fiscal Crisis: Annual Deficit/Surplus 1980 - 2012

Annual U.S. Federal Deficit/Surplus



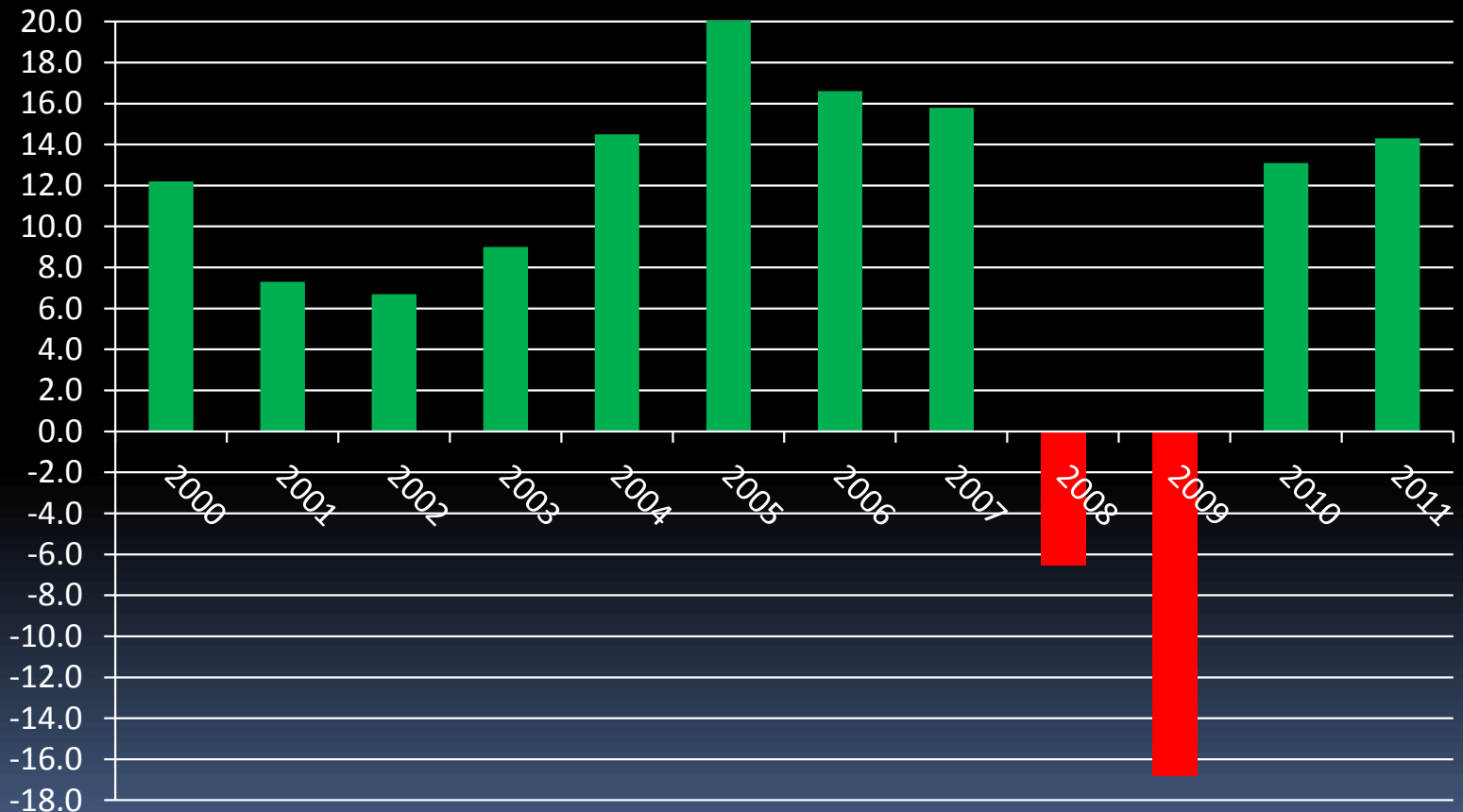
The Fiscal Crisis: The “Fiscal Cliff”

- If Congress does not act by year-end:
 - Bush tax cuts “expire,” meaning that tax rates rise.
 - Automatic spending cuts kick in, creating negative fiscal stimulus.
 - CBO estimates 2 million jobs will be lost, economy will fall back into recession (Actually, 1.0 percentage point drop in GDP, from +0.5 to -0.5).
 - In other words, best economic scenario is bad, but falling off cliff is worse.

Impact on Commercial Real Estate

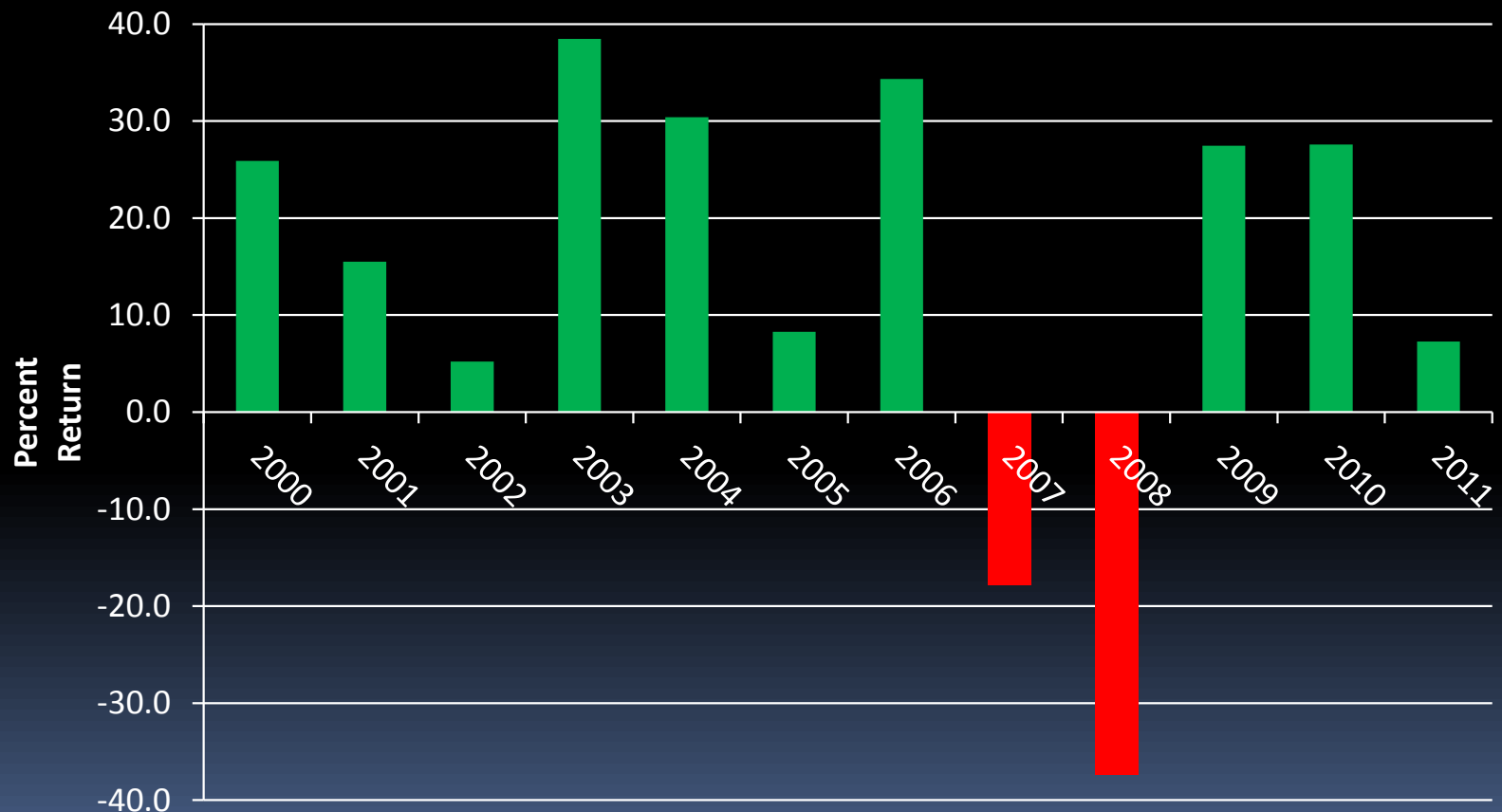
- The “perfect storm” has taken a toll on commercial real estate.
- NCREIF total returns were negative for 2008 and 2009 before rebounding strongly in 2010 and 2011.
- REIT stocks were hammered during 2008-2009 but recovered during 2010-2011.
- CMBS delinquency rates shot up into double digits in 2012.
- CMBS issuance essentially shut down in 2008.

Impact on Commercial Real Estate: NCREIF Total Returns 2000 - 2010



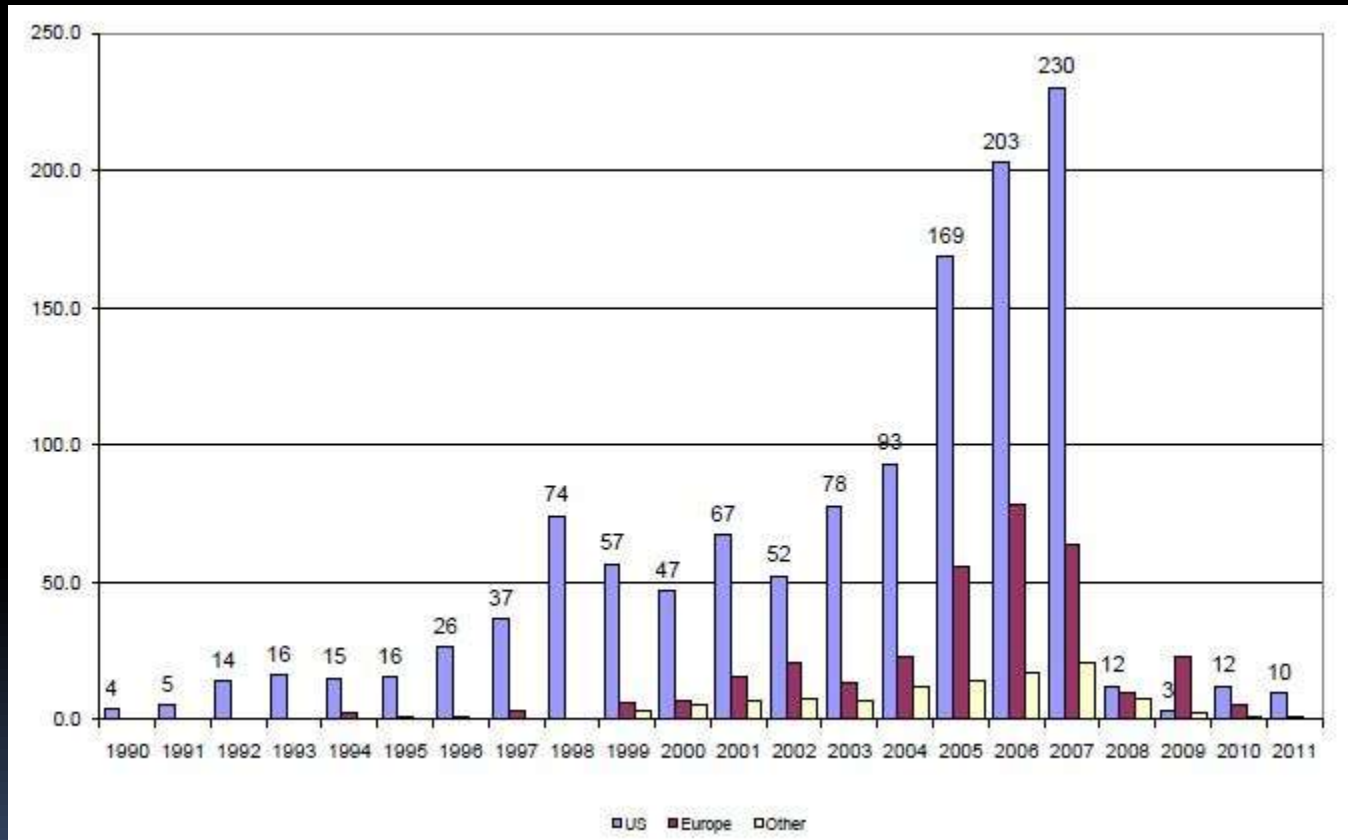
Source: NCREIF Total Return Index

Impact on Commercial Real Estate: REIT Annual Returns 2000 - 2010



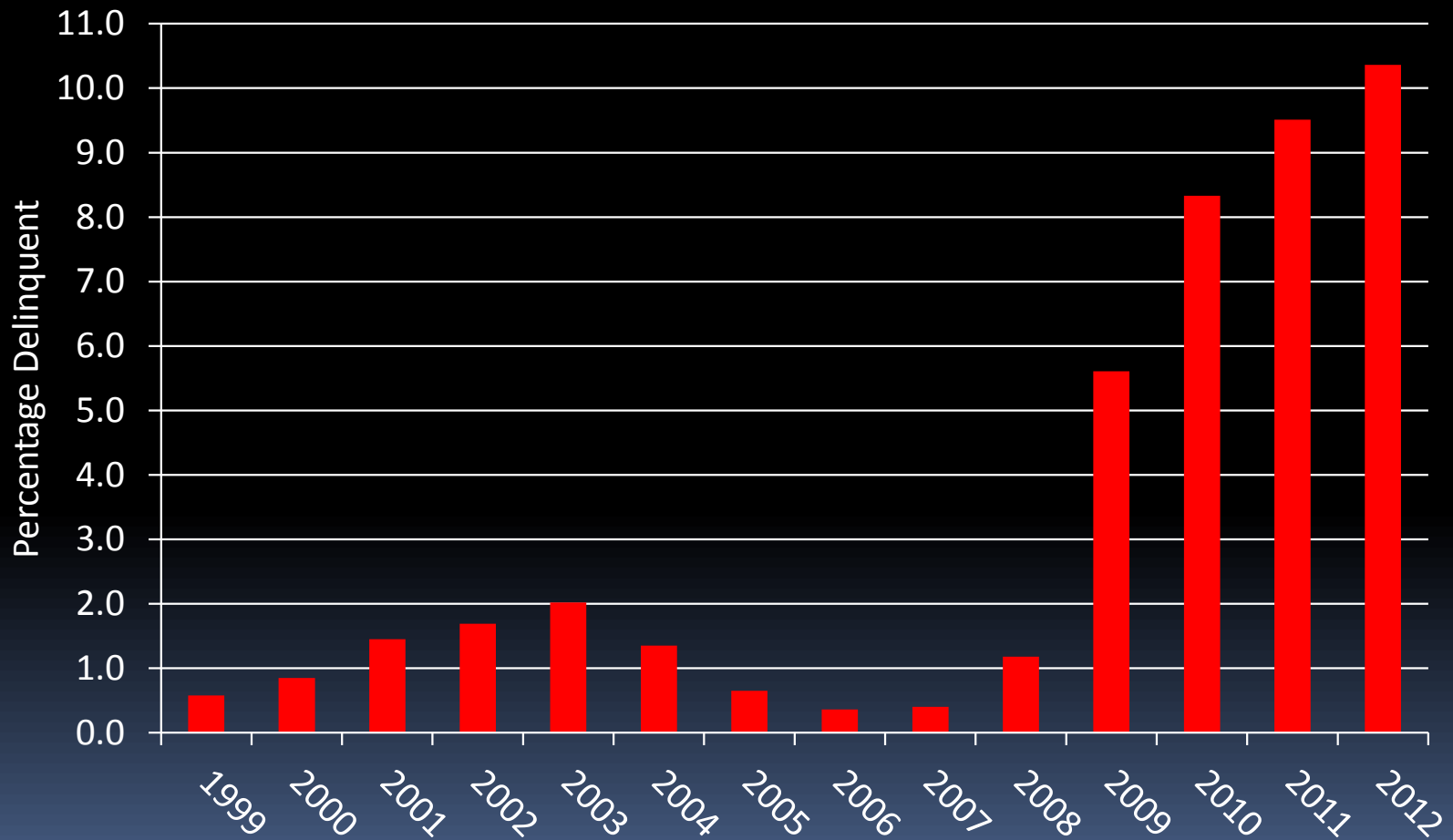
Source: FTSE NAREIT Total Return Index

Impact on Commercial Real Estate: CMBS Issuance Volume 1990 - 2011



Source: PRIA Compendium of Statistics

Impact on Commercial Real Estate: CMBS Delinquency Rates 1999 - 2012



Source: Trepp CMBS Analytics



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PERFECT STORM