

Market Forecasting and Your Goals

By Greg Marderian, Senior Investment Broker

Many experienced real estate professionals and investors are confounded by the never before seen prices now being achieved for multi-family properties throughout Southern California. With the benefit of hindsight, perhaps we should not be too surprised. Consider: 1. Emergency interest rates at forty-six year lows and 2. extraordinary high occupancy levels and rising rents. *The best of two opposite worlds – depression level interest rates with boomtown rent levels coexisting as never before.* Southern California multi-family property is widely recognized as the hottest market in the United States – trustworthy with prospects for growth in a low return world.

To understand what may be ahead, we **must** understand how we arrived here in the first place and the prospects for interest rates and occupancy/rents.

Interest Rates: To understand the direction of rates, it is necessary to understand the Federal Reserve Policy over the past three and a half years. Prior to 9/11, the U.S. economy had experienced the tech crash and softening in several business sectors. The effects of 9/11 cannot be overstated. Estimates of million jobs lost, over a trillion dollars lost overnight in property damage and securities, consumer confidence deeply wounded. The Federal Reserve Policy of easy money/low rates was decisive and ultimately effective.

“...the Fed has already begun the “measured” rate increases alluded to by Mr. Greenspan...”

Despite occasionally mixed reports for Leading Economic Indicators Index, Institute of Supply Management Index, job growth, consumer confidence and construction /housing spending, the overall trend for the U.S. economy is clearly decidedly positive.

The Federal Reserve forecasts for the coming year are close to those of fifty-five leading economists surveyed by the Wall Street Journal: GDP growth – 4 to 4.5%, unemployment, 5.25 to 5.5%, and acceptable inflation in the range of 2 to 3%.

With the belief that the recovery is sustainable but not too vigorous, the Fed has already begun the “measured” rate increases alluded to by Mr. Greenspan on July 20th before Congress. Three .25% increases, starting in June and the last in September, have surprised absolutely no one, and were in fact “the most widely anticipated rate increases in history.” It is essential to note that in Mr. Greenspan’s July comments, he provided the important caveat: the measured increases are subject to inflation, the Fed “*was ready to raise rates more quickly than its current measured pace if inflation worsens.*” Mr. Greenspan stated that inflation is under control and price increases in food and energy are “transitory.” Productivity will be the prevailing inflation fighter.

Credible individuals point to various commodities with rising prices, which could impact core consumer products. Reasons given for price increases are the demands of an emerging China economy and the U.S. recovery. Currently, Europe could be described as stagnant. Yet at this time, present conditions and good evidence (10 year T-bills about 4%) indicate that the markets expect no sudden increases in inflation or the necessity for dramatic rate increases near term.

High Occupancy, Rising Rents: These are built upon the foundation of limited supply and consistent demand. Except in the high-end markets, rarely has this equation been more favorable to landlords. With the lack of available land, the costly entitlement processes, and an expensive single-family home market, this imbalance is highly unlikely to change.

Because of strong immigration levels that show no signs of abating and normal population growth of the nation’s second largest metropolitan area, the USC/Carden Real Estate Forecast estimates 2004 rent increases of 6 to 8%, marginally less than previous years, but still strong. Because of these prospects, several commercial properties, particularly in downtown Los Angeles, are looking to convert to multi-family.

With its diverse economy and location on the Pacific Rim, which cannot be replicated, the supply demand imbalance is so great that only a major event or dramatic economic downturn would significantly change the equation. Investors flying first class, as well and undocumented immigrants will arrive for their individual reasons.

In conclusion, what should we make of an improving national economy and continued demand for apartment housing? One would be wise to consider recent opinions from three superior real estate sources.

Milken Institute Global Conference – to summarize, 1) real estate has changed a great deal – much having to do with financing, 2) low interest rates have allowed people to stretch in to deals, many of which have heightened their risk when rates rise and 3) there has been heavy foreign investment and buying of U.S. real estate.

Sanford Goodkin – “Rates to continue rising in small jumps. Marginal buyers who have bought using adjustable rates will be at risk.” (August 2004)

UCLA Anderson Business School – “We could very well be entering a long period of rising interest rates”, “we have emergency interest rates in a non-emergency economy” and “increasing short term rates could make the bubble burst.”

Limited and steady incremental interest rate increases coupled with strong occupancy should not cause the collapse of prices. On the other hand, it is very difficult to imagine continued rising property values when financing costs rise slowly and steadily for the foreseeable future. Debt service goes straight to the bottom line. Furthermore, rate increases may disproportionately affect the Southern California multi-family market because so many deals have been made with a variety of Adjustable Rate Mortgages (ARMs). One Real Estate CEO stated, “It’s a great time to be a borrower; I have never seen so many lenders and products.” *Many ARMs have low attractive start rates but are fixed for only one to three years.* Los Angeles rent control stipulates 3% annual increases; market rents are only achieved when vacancies arise. Properties under rent control or with upper limit rents could have difficulty meeting increasing debt service if rates rise rapidly due to potential unacceptable inflation levels.

Inflation has historically been a friend to property owners. Most of yesterday’s owners who survived the previous cycles were not overly leveraged – they had more cash flow with the ability to meet contingencies along with fixed rate loans. Investors who have bought deals with thin cash flows using ARMs tied to the money markets may not welcome *possibly* higher inflation and the ensuing faster rate adjustments. Buildings in the red are eventually brought to the market, and many buildings offered create a buyer’s market.

If you believe that you will be a seller in then next one to three years, or even five years, you may want to look closely at potential market risk. This is a personal decision made for any number of reasons; moving, kids don’t want it, health, changing neighborhoods, etc. On the other hand, you may be a long-term hold – you know that cycles come and go and that Southern California real estate, as of late, is very good; you expect to work through the next down cycle whenever it occurs and will hopefully enjoy the following up cycle. Hold or sell, always a uniquely personal decision driven by goals in a never before seen market.

Greg Marderian is a Senior Investment Broker with AOA Commercial Brokerage. He may be reached by calling (818) 235-1133 or email to greg@aoausa.com.