

“Professor’s Comments”

(For the November 2008 Moody’s/REAL Index returns.)

This is a periodic commentary which will generally be posted monthly on the “RealIndices” web site, offering the perspective on the indexes of Professor David Geltner (or occasional guest commentators). Geltner was a leader of the team at MIT that developed the methodology for the Moody’s/REAL Indexes.

Let’s Put the Downturn in Perspective...

I am pleased to commence what we intend will be a monthly commentary on the Moody’s/REAL Index returns shortly after they are released each month. While these are challenging times in all of the capital markets, not just real estate, they are also times of great opportunity, and for those of us who are dedicated to improving the quality of information in the real estate capital markets, these are actually very exciting times.

What I like about the Moody’s/REAL indexes is the kind of narrative their return numbers tell. I don’t mean I’m happy about falling prices, but I find markets fascinating, so I love instruments that enable me to observe markets carefully, and that’s what the Moody’s/REAL indexes do, better than any previous tool that we have had for peering at the U.S. commercial property markets. Sometimes I feel a little like Galileo, when he built his telescope and turned it onto Jupiter and Saturn. The previously-available instrument for viewing planets (the naked eye) allowed people to see a single dot for each of those planets. Galileo’s new tool showed there were moons around Jupiter and rings around Saturn. Who knew?

Of course commercial property markets aren’t quite as unknown as Jupiter and Saturn. Plenty of people have a feeling about what is going on in them. But feelings are one thing and data is another. And the Moody’s/REAL Indexes give us greater resolution, a finer focus, than we have ever had before. And now this “telescope” is being focused on the greatest commercial real estate market turning point in at least 20 years. It allows me to tell a narrative like the following...

For the month of November the national all-property Moody’s/REAL price index declined 3.4% compared to the previous month. This was the second largest monthly decline in the history of the index (commencing in 2001), just barely less than the 3.5% decline last May. During the first two months of the fourth quarter the index is down 5.7%, coming off of a plateau last summer during which the index actually slightly increased for the third quarter. But that plateau followed a drastic fall of 11.5% in the four months from February through June. That sharp decline followed several months of volatile but slightly down-trending realized prices which marked the end of the last gasp of the great bull market, which added 11.9% to prices between November 2006 and August 2007. That last hurrah followed something of a plateau between February and November 2006 in which the index was essentially flat as the markets digested higher interest rates and the bust of the condo conversion boom. But that plateau came after two

full years of uninterrupted growth in which property prices climbed 41% between August 2003 and September 2005, probably the strongest two years in U.S. commercial market history.

The quantitative price history narrative in the previous paragraph correlates to historical events that we all know were happening in the markets at each of those times. We know 2004 and 2005 were the golden years of low interest rates combined with strong economic growth and unprecedented capital flows into real estate via both public and private equity as well as the mushrooming of the CMBS industry. We know there was a pause in that heady growth in late 2005 and much of 2006 as interest rates blipped up sharply and the condo-conversion boom busted. We know there was a distinct last wild frothy splash of ridiculously aggressive mortgage lending and equity buyouts beginning in late 2006 and going through the first half of 2007. It was that last binge that added some 12% to prices which many experts hoped we could get away with just a “correction” of that excess, a price drop of only about 10% or so from the peak. Through last summer it seemed like we might just get away with that, as there was still reason to believe the worst had been avoided in the financial markets and we might skirt a severe recession. That relative optimism (or at least calm) explains the plateau in the Moody’s/REAL Index through last September (which reflects closing of deals whose prices were agreed to during the summer). The optimism of last summer is forgotten now, but the plateau in the Moody’s/REAL is testament to the fact that it existed. And now we are in the midst of reporting the commercial property price effects of the traumatic and economically devastating events of last autumn.

I don’t know how far property prices will fall. You don’t have to be a genius to understand that it depends on the magnitude, length, and nature of the recession (or depression) into which the U.S. (and world) economy has plunged. But I do know that however far the prices fall, and whenever they fall, the Moody’s/REAL Index will track that decline accurately, in its magnitude and in its timing. I look forward to sharing with you my thoughts each month as this future history unfolds.

-David Geltner, January 2009.