“Professor’s Comments”

(For the January 2009 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.

January saw biggest monthly drop so far…

The main headline in this month’s update of the Moody’s/REAL Indexes is the 5.5% drop in the National All-Property Index from December 2008 to January 2009. This is by far the biggest monthly drop since the inception of the index. (The previous record was negative 3.5% in May 2008.) The monthly index is now 21% below its October 2007 peak, and this takes the index down to a price level last seen (on the way up) in spring 2005. That’s in nominal terms. If we take out inflation, the index is now back to its level of early fall 2004 in real terms. Interestingly, the timing and magnitude of this drop is closely paralleled in the transactions price based version of the NCREIF Index published at the MIT Center for Real Estate (often referred to as the “TBI”), which dropped 22% from end of 2Q2007 through 4Q2008. The Moody’s/REAL Index tracks a much larger and broader commercial property population than NCREIF, but the agreement across these two indexes adds to the clarity surrounding the magnitude of the drop already realized in consummated transaction prices in the commercial property markets.

When we consider also the tremendous fall-off in sales volume in January (below already extremely low levels reached late last year), the magnitude of the pull-back on the demand side of the commercial property asset market appears awesome. Even with prices 21% below the peak, consummated deal volume in January was only 10% to 20% of the rate of sales during the peak years of 2005-07. There is money out there (witness the incredibly low T-bill yields – they’ve been driven down by cash being stashed there), but potential buyers are either afraid, or just biding their time waiting for signs of a bottom. As of January there were still relatively few distressed sales in commercial real estate (especially in comparison with housing). However, the number and value of commercial properties in distress increased noticeably in January, according to Real Capital Analytics (the data source for the Moody’s/REAL Index), which suggests that distressed selling may begin in earnest soon. This can only further drive down the prices observed in the transactions tracked by the index.

How low is too low?...

In short, this month’s index report suggests a considerable further worsening in the commercial property markets in January. Last month I went on record predicting that CY 2009 would see a further 15% decline in realized prices (equaling the drop in 2008). I did not expect more than one-third of that to be realized in the first month of 2009! Combined with other evidence, such as from the NCREIF swaps market and REIT prices, it now seems very likely that the current down-market will be more severe than that of the early 1990s as measured by the percentage magnitude of the peak-to-trough fall. It also seems that the current market fall is occurring more rapidly and precipitously than the earlier one. It is worth remembering that in the early 1990s the commercial property asset market fell too far, over-corrected. I say this with hind-sight in view of the fact that there was a subsequent strong and very long-lasting upsurge in real asset prices from the mid-1990s that still had enough momentum to carry the commercial asset markets largely unscathed through the 2001-02 recession. Arguably, commercial property asset prices didn't get back to their long-run equilibrium level until as recently as 2003, and even by 2006 prices had still not exceeded their mid-1980s peak in real terms.

Whether there will be such an over-correction this time, only time will tell. As I said, it looks like the percentage drop from peak will be even greater this time. However, the current downturn also follows a sharper peak in prices. The Moody's/REAL monthly index rose over 40% from the end of 2003 to 2006, and then another 10% from mid-2006 to mid-2007. So it is not necessarily the case (yet) that the bottom of this down-cycle will see commercial property asset prices that are as depressed in absolute terms as they were in the early-mid 1990s (measured, for example, by cap rates or by inflation-adjusted prices per square foot), even if the peak-to-trough drop is bigger than before. Of course, looming over (and under) everything is the question of how deep and long the current recession will be. Commercial real estate is a creature of the real economy, and the current recession is already far deeper and longer than that of the early 1990s which was associated with the previous property downturn. Stay tuned…

-David Geltner, March 2009.