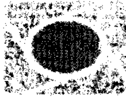

Real Estate Investor and Landlord Alert!

(January 2013)

We, in our industry, know of and anticipate systemic economic cycles. Under special circumstances there can be offshoots of these cycles that are the result of previous actions taken both on a fiscal and monetary basis by our governments (State and Federal) and the Federal Reserve, respectively.

Over the past 4 years there has been worldwide currency monetization (printing). In Europe, it was and is an attempt to boost economic job growth; In Asia (excluding China) it was and is an attempt to increase their manufactured exports through more competitive currency pricing; In the U.S., it was and is an attempt to foster employment and domestic growth. This monetization translates into a worldwide dilution in currency values and inflationary pressures. So, this is not just a local or regional issue to deal with. It's bigger than that and it will become an international issue as well. Please read on to see how this all may affect us in the Real Estate sector:

Inflation can be real estate's friend. This type of investment product, with it's uniqueness as a hard asset investment versus alternative soft asset investments (bonds and securities) draws benefits from a broad and flexible bandwidth. Investment and Commercial Real Estate serves to hedge the fluctuating future purchase value of the U.S. dollar in both low and high interest rate financial environments through the indexation of rents, mutual participations, preferred stock ownership, operating expense pass-thrus and properly structured tenant lease terms.

Some of you may not have been around or even involved in the real estate investment markets when the U.S. financial monetary system got off the gold standard and converted to the dollar backed standard in 1971. This served to destabilize the markets. You may have also missed the great inflation caused by dollar monetization in the late seventies and early eighties (1974-1981). At BFI, we were there and very involved in these markets of the 70s. "Nominal" (before inflation), short term interest rates rose to 16-20%. Long term loan rates were 13-14%. Hard money was achieving a 25-28% IRR! Cap Rates on core real estate rose, but not in linear correlation with real (after inflation) interest rates. Cap rates then rose on average to 7-8% from their prior 5 to 6% as rate of return expectations grew.

Think about this, you could sell a building at an 8% Cap Rate, take the proceeds and loan it back out at 25%. Speak about positive leverage!

Quality product for resale in the Bay Area became very hard to find for purchase let alone actually buying it, except for less desirable product and locations. Many of us sought and purchased out-of-state properties (Texas, Oklahoma, and Washington). Good quality product sold in less than a day with multiple bids. A quality core product could be bought and, if the leases were properly structured, be immediately resold for a 25% immediate profit, 30 day close, no questions asked.

The above is non-fiction fact and our strategies today will be testimony to the art of interpreting "behavioral finance". You might want to prepare and structure your leases, pass-thrus and financing right now for the events to follow.

For 2013, this is what exists based upon an empirical review of the facts.

For the best and well located commercial properties, national and regional cap rates are 325-375 basis points over the 10 year Treasury Note (about 5.5% to 6%). These rates are still higher than many corporate or private bond rates and equal to, or better than many credit loan rates.

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New government regulations are going to dramatically increase the cost of doing business for most of us. Over 5,800 Federal regulations (not even counting California State Regs) have come into play in the past 90 days alone that will directly affect our business, personal and financial lives. There are many more Federal and State regulations to follow and be put in place soon hereafter in early 2013. These increased costs of doing business are forcing us to modify our business and investment compliance processes and models wherein their requisite costs can and will be passed thru to the consumer and/or to end user businesses that we, as owners and consultants, deal with everyday. The mentality will soon be, "buy it now before the price goes up.... if you can". And remember, when the pie gets smaller, table manners go away.

Now, turn to the U.S. Federal Reserve (Central Bank).

Our Federal Government, along with the (obstensively) independent Federal Reserve have envisioned five steps to stabilize the U.S. economy in the face of our excessive $16.5 Trillion debt load which we have today.

> ***First:*** *Significantly raise government revenues through higher taxes.* ***(Fiscal)***
> ***Second:*** *Cut social benefits, programs and their costs.* ***(Fiscal)***
> ***Third:*** *Hold interest rates down to do whatever it can to get Gross Domestic Product (GDP) growth rates above long and intermediate interest rates in order to reduce our debt burden over time.* ***(Monetary)***
> ***Fourth:*** *Gradually unwind (buy back) loans it gave through its bond purchases (QE1, QE2, QE3)in order to reverse money back out of the U.S. financial system.* ***(Monetary)***
> ***Fifth:*** *Raise interest rates on the loans it currently pays to the U.S. banks for their $1.4 Trillion "Excess" they have in cash reserves currently being held by them. These interest payments are a Fed inducement to discourage the banks from lending out these excess reserves to the public in the form of new, longer term, higher interest rate spread loans.* ***(Monetary)***

Number three is where the Federal Reserve strategy is as of January 1st, 2013 and intends to comply with thru 2015 if necessary. Numbers four and five is what they will do if '74-'81 is any example.

When GDP growth starts to exceed real interest rates, the Fed will turn to monetary tightening (extracting cash) out of our U.S. money supply. We expect the Fed to tighten as early as 2013-2014...... Not 2015-2016! This is strategy #4 and #5 above. Technically, this strategy sounds proper and good, however, anecdotal "Behavioral Finance" experience says the banks will choose instead to loan out their $1.4 Trillion of excess reserves they currently have on hand to the investing public. Just like in 1974. Why shouldn't they? They will experience much higher margins and higher profits.

THIS STRATEGY ALMOST ALWAYS GUARANTEES INFLATION

The question is not if, but when and to what extent will they raise rates to tighten credit demand and curtail or reduce inflationary pressures. It is a fact that there is currently a strong relationship and "correlation" between Federal Reserve driven Monetary Policy, and politically driven Fiscal Policy. However, there currently is *no political will* to cut government spending.

Looking for alternatives, the Fed will have to de-leverage and buyback bonds which are

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in the form of bank excess reserves totaling $1.4 Trillion and that are currently held on our banking institution's balance sheets as mentioned above.

The new bank loans to investors, real estate borrowers and corporate bond holders at these higher interest rate spreads will trigger commodity and employment prices and related costs to rise. The Fed will then again attempt to raise interest rates it currently pays banks for their reserves in order to reduce or minimize the bank's desire and motivation to alternatively create this avalanche of new credit creation. This is the Fed's main exit strategy to prevent or minimize inflation caused by the banks otherwise flooding the market with $1.4 Trillion dollars of excess reserves they currently have on hand. In '74, the banks did in fact choose to lend at higher nominal rates vs. sitting on their reserves and receiving higher Fed interest rates to not loan. It shouldn't be any different this time around. The Feds financial chips are now all in for their deflationary or mitigating monetary bet (see #5 above).

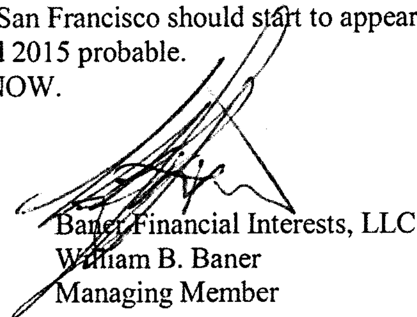
If navigated by the Fed in a timely and pre-emptive manner, and even though inflation will come, it may not nor does it have to be, as destructive as 1974. By that I mean nominal interest rates may not have to go to 16-20% as before to break the back of inflation by restricting and reducing excess money supply in circulation and credit as was previously done by Paul Volker in 1980-1982 (As a side note, Gold Increased only 10.2% from '74-'81; Real Estate increased 25-35% per year).

Because of the 3.25% to3.75% spread of Cap Rates over the 10 year treasury, Real Estate Cap Rates still offer a good interest rate safety buffer over treasuries for your investment dollar placement going forward. However, as inflation ensues starting in 2013 to 2014, this interest rate buffer will shrink but Cap Rates will continue to remain steady on good real estate product until loan interest rates exceed 7.5% -8%. Then San Francisco Cap Rates will slightly rise locally from 5%-6% to 6.5 to 7%.

A leading indicator of coming inflationary warning trends lie with the currency traders in Wall Street and Chicago. Traders now are starting to think more seriously and focus more on monetary versus fiscal policy financial controls and their underlying fundamentals. This trading shift was cemented on January 3rd when minutes from the Federal Reserve December meeting showed several Federal Board members advocating an early end to the Central Banks bond buying that churned $85 Billion per month into financial markets and weakened the dollar (Monetary easing= weaker currency= lower interest rates= less attractive for investors to hold $ versus other currencies=interest rates going up).

As a future look forward, inflation signs in San Francisco should start to appear in 2nd half of 2013 and be in full swing in 2014 earliest and 2015 probable.

MAKE YOUR PREPARATIONS NOW.



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Sources: Real Capital Annuities; Kollberg, Kravis, Roberts; Bloomberg; Martin Feldstein, Harvard; William B. Baner, Baner Financial Interests, LLC; World Gold Council.

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