IN A GLOBAL CREDIT CRUNCH IT'S BACK to BASICS

…lessons to be learned from tulip bulbs

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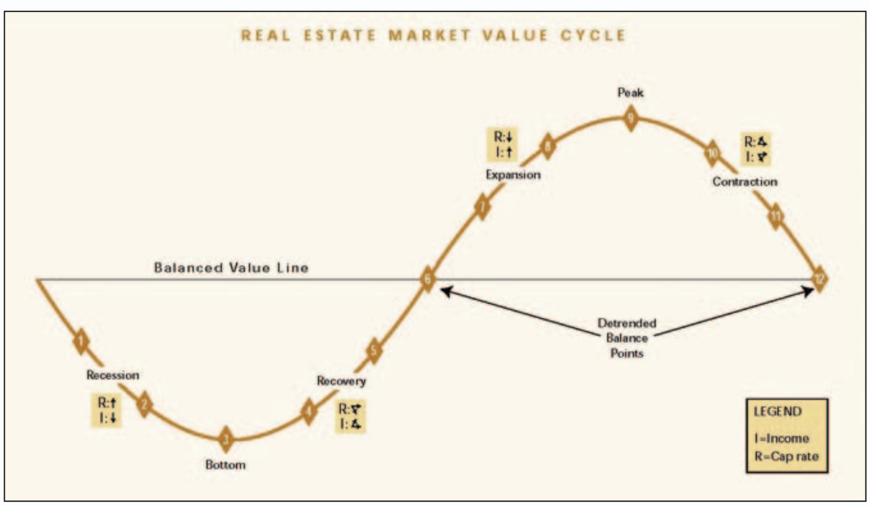
Over the last several decades, international property markets have accelerated faster than the ability of analysts, regulators, and advisors to maintain equilibrium for investors within inevitable cycles. In the finance, insurance, and real estate (FIRE) market sector, credit is the primary product. World markets are now experiencing an extreme contraction of credit following a speculative bubble, in the same way as markets for tulip bulbs, barrels of oil, and Internet stocks have seen extreme expansions and contractions in the past. What makes the FIRE contraction extraordinary is its broad scope—not only in the breadth of the economies, but also in the asset classes affected.

Tangible vs. Intangible Risks

Tulip bulbs, pork bellies and barrels of oil are tangibles. Credit and risk associated with tangibles, including land and buildings, have a long history. Credit and risk associated with intangibles such as pork belly futures and mortgage backed securities are less understood.

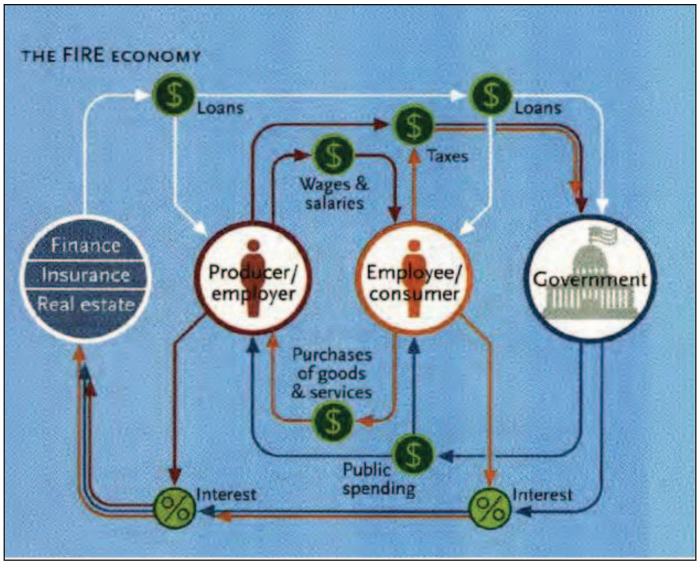
The first speculative futures bubble occurred in Holland with tulip bulbs in the 1630s. Profit from trade in the East Indies found its way into tulip bulbs. The basic economic principle of supply and demand was extrapolated into absurd prices for exotic new varieties of tulips. At the peak of the cycle, common, ordinary bulbs commanded high prices—even before they were dug out of the ground. The tulip bubble, however, unlike the recent U.S. housing bubble, was relatively contained to Holland and the tulip market.

Another basic economic principle ignored in speculative price distortions is market cycles—what goes up must come down.[1] Just like other markets, real estate markets go through periods of expansion, contraction, recession, and recovery. Many people within the FIRE sector—from some brokers in local communities to investment banks and insurers on Wall Street—based their advice on the idea that home prices would rise forever. This led to speculation not only



Source: Pricewaterhouse Coopers

[1] Emerging Trends in Real Estate Value Cycles, PricewaterhouseCoopers, Year-end 1999 www.pwcreval.com/survey/cyclesspecial.pdf



Source: *Harper's Magazine*, May 2006

on home prices in many areas of the country, but on the intangible securities, insurance contracts and other derivatives based on those home prices and mortgages.

In an article for *Harper's* May 2006 issue, Michael Hudson warned of the consequences of the current collapse in the U.S. housing market: "The FIRE sector's other advantage is that interest payments can quickly be recycled into more debt. The more interest paid, the more banks lend. And those new loans in turn can further drive up the demand for real estate—thereby allowing homeowners to take out even more loans in anticipation of future capital gains. Some call this perpetual-motion machine a "post industrial economy." It might, however, be more accurately be called a *rentier*[2] economy. The dream is that the FIRE sector will expand to embrace the fortune of every American—that we need not work or produce anything, or, for that matter, invest in new technology or infrastructure for the nation. We certainly need not pay taxes. We need only participate in the boom itself. The miracle of compound interest will allow every one of us to be a *rentier*, feasting on interest, dividends, and capital gains."

Hudson goes on to predict that the dream will become a nightmare when the business cycle turns down. Millions of home owners will have negative equity and nations will be awash in bankruptcies. Unlike speculative bubbles in the past, however, the growth and international expansion of the FIRE sector over the last 20 years has facilitated the spread of this contraction far beyond U.S. housing prices.

Global Credit Market Reforms

Like the expansion of the production-consumer economy into world trade and the joining of national governments into regional trading zones, securitization has taken local mortgages to an integrated international market. As real estate continued to outperform stocks and bonds, investors increasingly bought real estate derived stocks. Insurance companies using models based on corporate bonds began to sell derivatives based on mortgage-backed securities—again with the belief that the only way the market would go is up.

The current downturn proves that credit markets have become not only more global, but inexorably intertwined with housing and real estate markets. The outward extension of credit from the production economy, through the Keynesian economy of government and taxation, to the FIRE economy is now retracting as corrections in the FIRE economy effect all asset classes and sectors.

It is important for you, as an international real estate practitioner, to remember that, just as the tulip markets in Holland survived and remain a model for the world, U.S. real estate markets will recover and lead a rebound in worldwide credit markets. And, just as the market collapse brought about reforms in market entry and settlement for tulip futures, we will see real estate credit market reforms around the world.

The Way Forward

First, there can be no substitute for the "three Cs of credit"—character, capacity and capital. Credit decisions must be made on the borrower's credit history, verification of income, and a full evaluation of the market risks associated with the capital put up for a loan. Current sub-prime default rates in the U.S. are a clear reminder that when banks stray from these basics, all citizens pay the price.

Now that markets are international, the ability to analyze the character, capacity, and capital of borrowers around the world needs to be improved. Although public and private credit bureaus, income verification methods, and trained and ethical asset valuers and brokers exist in the developed world, these critical tools and skills are still lacking in many markets. U.S. practitioners and organizations can play a role in building this capacity by sharing experience and expertise with their colleagues around the world.

Additionally, understanding market cycles means understanding where investments flow in each segment of the cycle. As we have seen, when the market is expanding, capital flows into second homes in such areas as Costa Rica and Panama and, also, into exotic regions like Dubai. Market contraction, however, is inevitable. At such times capital will flow into the basics of affordable housing, healthcare, and education facilities and other critical infrastructure projects. Medical tourism in Mexico, for example, is a growing new development. In addition projects related to energy efficiency and sustainability are attracting investors and will see continued growth.

Right now, rather than focus on the real estate investment market, shift your focus to individual and institutional clients with basic needs. Some businesses are expanding both nationally and internationally. Down the block an immigrant family is welcoming a new member and seeking to move on from a small rental apartment.

Finally, as a savvy real estate professional, take the long-term view. The current contraction is a natural and needed return to the basic economic principles that have ruled markets since the 17th century. Markets have become more integrated and more international. The market for intangibles, including financial interests, lease analysis, and futures options will see renewed focus as the lessons from this correction are absorbed into the operating procedures of the future.

The need for ethical, highly trained and adaptable international real estate advisors is greater than ever. Use this time to increase your skills, broaden your horizons, and refresh your understand of basic economic principles.

And, buy some tulips! gp

[2] www.krugman.blogs.nytimes.com/2007/10/05?return-of-the-rentier-city/