

US Real Estate Capital Market Commentary: August 5, 2009

"There is no such thing as a free lunch." -Milton Friedman

Overview

We are painfully aware of the current deflationary environment ravishing the capital markets and its potential long-term impact on the economy and therefore recognize the need for the US government to intervene, backstop and stimulate the financial system during the past year in order to prevent a complete meltdown of the economy. We therefore applaud the many creative monetary policy-driven solutions to the current credit and economic crises put forth by the Fed, Treasury, and FDIC. While the delivery of the message has been somewhat erratic, the intention has been on-target.

However, we have become increasingly concerned by the aggressive use of fiscal policy to stimulate the economy and cure the near-term problems of the financial system. Not because we think many of these projects are not without merit, but rather we are concerned about the law of unintended consequences and the rising specter of inflation.

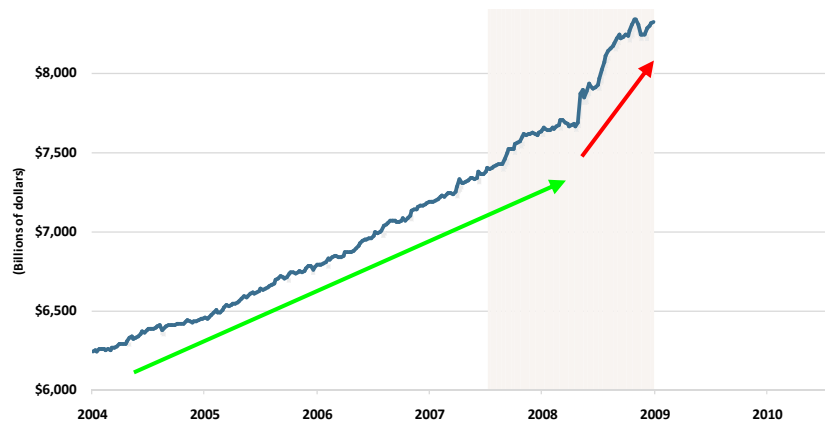
Cadence Capital believes that a period of high inflation could bode well for real estate values.

Monetary policy and increased liquidity...

The US economy has been in an economic recession since late 2007 and this has since spread across the globe. The United States, as the largest affected economy, has taken the lead in stimulating economic recovery, in an attempt to "jump-start" growth. The unprecedented level of stimulus comes in two forms, namely lowering interest rates and dramatically increasing fiscal spending. The first effort is the traditional and familiar method of promoting economic expansion through credit expansion. The second effort is less common and thus has a less known longer-term outcome. Essentially the government is trying to increase money supply with the intention of stabilizing the financial markets and ultimately increasing asset price levels. This has become the collective objective of government since the private market has been aggressively pursuing asset devaluation as a driver to de-leveraging.

Based on the quantity theory of money developed by Irving Fisher and updated for the modern economy by Milton Friedman, the expected inflation rate is primarily a function of the growth rate of the money supply. Inflation is the general term for the situation where money buys less goods and services over time. Clearly if there is plenty of capital available, but not enough goods and services to purchase, prices rise in an inflationary fashion.

As we stated in the first paragraph, money supply has grown. In fact, recently it has grown exponentially, compared with the long-term trend, as the following graph from the St. Louis Federal Reserve Bank shows.



Source: Cadence Capital Group, LLC; Federal Reserve Bank of St. Louis

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Increased liquidity and the law of unintended consequences...

In addition to the real and immediate increase in money supply there is a high *potential* for further increases to the money supply, since interest rates are extremely low and the Federal Reserve has been historically slow in raising interest rates during an economic recovery when inflation begins to develop. In the current economic and fiscal climate, a tepid anti-inflationary response could be problematic, since consumers may have an unusually deep pent-up demand for goods. This pent-up demand, combined with the availability of cheap government-sponsored credit and unprecedented levels of fiscal stimuli, could lead to a significant imbalance if supply for these goods and services is not available.

If supply of available goods and services can be rapidly ramped up, then the risk of inflation is low. However, the longer the recession, the harder it will be to quickly ramp-up production, due to idled plants, the lay-off of skilled workers, and the reduced capacity of transportation, to name just a few impediments to increased production. Additionally, the global supply chain for many goods has grown to be very complex and is not flexible enough to allow for a rapid increase of the movement of goods. This is especially the case for more complex, value-add goods, which have an outsized impact on the various inflation indices.

Stimulus-driven inflation: will commercial real estate values rise?

According to widely accepted business cycle theories, artificially low interest rates, the associated increase in the money supply and increased government spending will lead to excess borrowing. This increase in available investment funds will lead to the acquisition of marginally profitable assets, inflating their value. Indeed, commercial real estate has historically risen during inflationary periods for a number of reasons, leading to a belief that it is a good hedge against inflation. Cash flow from commercial real estate is typically linked to inflation through contractual rental rate increases and the “pass-through” nature of some operating expenses (stipulated in most lease contracts). Additionally, commercial real estate is typically purchased with debt, or “leverage”, which could become more plentiful during a period of artificially low interest rates. Therefore, past economic cycles have shown that real estate investing is more profitable during economic recoveries when inflation is increasing.

Outlook

Cadence Capital believes that the current monetary and fiscal policies being pursued by the US government are potentially laying the foundation for a post-recovery inflationary environment. Commercial real estate investments should fare well during an economic recovery, with indirect investments (securities) outperforming in early-stages and direct investments (property) outperforming as the recovery continues.

Cadence Capital therefore believes a well-diversified investment portfolio should contain a balance of real estate-related assets.

Cadence Capital acknowledges the constructive input of Dr. Beate Klingenberg, Assistant Professor of Management at Marist College.

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