



The Economy and Construction

September's Financial Market Turmoil

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The upheaval in the financial markets during September has altered the financial landscape, which will affect funding for construction projects and in turn construction activity.

The September Events

Since the onset of the credit crunch a year ago, there has been the sense that with each new wave of crisis, the situation had the potential to go from bad to worse, as financial institutions absorbed the mounting losses coming from mortgage-backed securities. The week of September 15 proved to be the breaking point. The investment banking firm Lehman Brothers went bankrupt, the insurance giant AIG required an \$85 billion cash infusion from the federal government to stay afloat, and investors pulled money out of money market mutual funds. Lending between banks came to a halt, essentially freezing the credit markets.

To keep the crisis from spiraling downward, Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke met with Congressional leaders on September 18 and throughout the weekend. The outcome was the Treasury proposal to buy up to \$700 billion of troubled assets from financial institutions for the purpose of promoting market stability. In Secretary Paulson's words, "these illiquid assets are clogging up our financial system, and undermining the strength of our otherwise sound financial institutions." The proposed purchase represents a change from dealing with the credit crisis on a case-by-case basis to one which goes after the root cause—the distressed mortgage-backed securities on the books of the nation's financial institutions.

What's the early take on this action? The proposal itself served to calm the financial markets, in showing that steps would now be directed at fixing the problem in a fundamental manner as opposed to piecemeal. In effect this was a financial "time-out," for at least a few days, averting the chance that a lending shutdown would begin to impact the U.S. economy on a broader level. The proposal is under consideration by Congress, and both Paulson and Bernanke urged quick approval before Congress goes on recess at the end of September.

As of September 24, it is widely believed that some form of the mortgage buyout program will be approved. Assuming this occurs, it sets the stage for the financial system to achieve firmer financial footing. However, it will take time to get there. Setting up the process by which mortgages are purchased with proper oversight will be complicated. This would involve a "reverse auction," in which the sellers would compete against one another to sell their securities to a single buyer, in this case the U.S. Treasury. The buyout program will also be in effect over a two-year period. The implementation of this program is not expected to have an immediate impact on lending standards; instead, it will probably be several quarters before the benefits become discernible.

The near meltdown of the financial sector in September, and the anxiety it has generated, means that banks will closely protect their capital positions through the end of this year and into 2009. The financial system will not collapse, but lending standards are not expected to ease much during this time—that will be more an event for late 2009 and 2010, after the capital positions of banks have shown improvement. With the push from last spring's stimulus bill having run its course, it is expected that GDP growth through the end of 2008 and into 2009 will be particularly weak, and probably negative. Not only will commercial building have to deal with tight lending standards, but the weak economy will cause such market fundamentals as occupancies to deteriorate further, making it even more difficult for projects to get financing.

Aside from tight lending conditions in general, there are other factors that in the near term that will dampen the prospects for commercial building. The bankruptcy of Lehman Brothers includes the expected liquidation of a \$30 billion commercial property portfolio, with about \$4 billion consisting of mortgage-backed securities. This has led to another selloff in the commercial mortgage-backed securities market, as holders of these securities have tried to stay ahead of the liquidation. According to a report in the Wall St. Journal, Goldman Sachs reduced its portfolio of commercial mortgages and securities by \$2 billion for its quarter that ended August 29, taking a \$325 million loss in the process. Lehman Brothers had also purchased the large multifamily company Archstone for \$22 billion, and unloading this acquisition will put downward pressure on property prices in those markets where Archstone has holdings. On a broad scale, commercial real estate prices over the next year are expected to sag, providing another reason why financing will remain difficult for commercial (and multifamily) projects.

An additional factor relates to the change in the banking system. When the current year began, there were five major investment banks. In March Bear Stearns was sold to JP Morgan Chase in a sale brokered by the Federal Reserve, then over the September 13-14 weekend Merrill Lynch agreed to be sold to Bank of America, and on September 15 Lehman Brothers filed for bankruptcy. The remaining two major investment banks, Goldman Sachs and Morgan Stanley requested on September 21 to be converted into traditional bank holding companies. With this change, the two firms will come under the close supervision of bank regulators, making them subject to stricter capital requirements and additional oversight. Both will gain the security provided by bank deposits that have kept large commercial banks like JP Morgan Chase and Bank of America relatively safe in the current turmoil. The conversion also means that both institutions will become more leverage-averse, with real estate investment probably taking a reduced role.

Preceding the Wall Street upheaval and the mortgage buyout proposal was the federal takeover of Fannie Mae and Freddie Mac, the government sponsored enterprises that own or guarantee about \$5.2 trillion of the nation's \$12 trillion in mortgages. On September 7, the U.S. Treasury announced that it would acquire \$1 billion in preferred shares in each company, and would provide as much as \$200 billion to the companies to help them deal with heavy losses from mortgage defaults. The two companies were put under a conservatorship, with management control assumed by their regulator, the Federal Housing Finance Agency. The move did have one short-term benefit—a decline in mortgage rates, given the positive reaction to the plan by the financial markets. During August, the 30-year fixed mortgage rate had hovered around 6.5%, but by mid-September it had retreated to 5.8%. In areas of the country where home prices have not fallen to an excessive degree, the lower cost of financing may help spur some activity from those homebuyers that are still able to get approval for mortgages.

The Broad Impact on Construction

The situation with the financial markets continues to be fluid, particularly regarding the shape of the \$700 billion mortgage buyout proposal. Given the sense of urgency coming from Treasury Secretary Paulson and Fed Chairman Bernanke, Congress is likely to pass some measure with revisions to the Treasury proposal, including oversight of the process by which the distressed mortgage securities are purchased. The expectation is that the purchased securities will increase in value as the housing market begins to improve in 2009 and beyond, which would allow them to be resold and decrease the potential cost of the bailout from

\$700 billion to something less. The key, of course, is that the decline in home prices comes to an end, and this is not expected until 2009 at the earliest.

The steps taken to provide stability to the financial markets will require time. The lending environment for commercial projects will probably grow even more difficult in the near term, before some credit easing begins to take hold, perhaps in the latter half of 2009. This means that the downturn in construction starts shown by the commercial building in 2008, particularly for stores and warehouses, will grow more widespread in 2009, dampening offices and hotels as well. This had been the expectation prior to this September's events—should these steps be successful it would allow for an earlier rebound in 2010 or 2011 than would have occurred otherwise.

The institutional structure types, such as schools and hospitals, respond in a lagged manner to shifts in the economy and lending conditions. A loss of momentum is expected for 2009, given the deterioration in state and local fiscal health, although funding already raised through the bond market should help the initial stage of a construction slowdown remain gradual. In other words, the response to September's financial turmoil is expected to be delayed and diffused. The same applies for public works, and a near term plus for that sector is that Congress recently transferred \$8 billion from the general fund to shore up the Highway Trust Fund. As for single family housing, the steps to stabilize the financial markets, if successful, should help to stabilize homebuilding in 2009, although at a very, very low level.