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“It’s far better to buy a wonderful asset at a fair price, than a fair asset at a wonderful price.”

-- Warren Buffet

Commercial Realty Markets Still Strong

Commercial Realty Markets Still Strong; Asset Pricing Bubbles a Risk. Avid Realty Partners continues to acquire properties in key commercial realty segments including the Multifamily Apartment and Hospitality sectors. We see no signs of a slowdown in these sectors at all, and in fact ongoing evidence that prices continue to rise. While the markets took a brief pause following Trump’s Presidential election, they have surged back to a state of appreciation as some of that political uncertainty settled and buyers got back to business. In fact, buying activity in the multifamily apartment and industrial spaces in particular continues to be aggressive, with prices following suit. Indeed, while others may be comfortable with prices in the multifamily apartment space, we see compressed yields and less opportunity for outsized investor returns. That said, we are deploying capital carefully into our key asset classes, and do find ongoing opportunities to earn substantial cash-on-cash returns on behalf of our equity investors...we just have to underwrite and bid on a lot more properties to find these *diamonds in the rough*.

Underlying Fundamentals Robust. One reason that Commercial Realty asset prices continue to rise is that underlying fundamentals remain so strong: 1) Vacancies are at or near all-time lows, despite new deliveries of Class A product; 2) Rent levels continue to rise robustly outside of the Retail space as housing gets more expensive, even if broader economic inflation is limited; 3) New housing supply is somewhat limited broadly (though with greater supply growth in Class A sub-segments), and is really only replacing

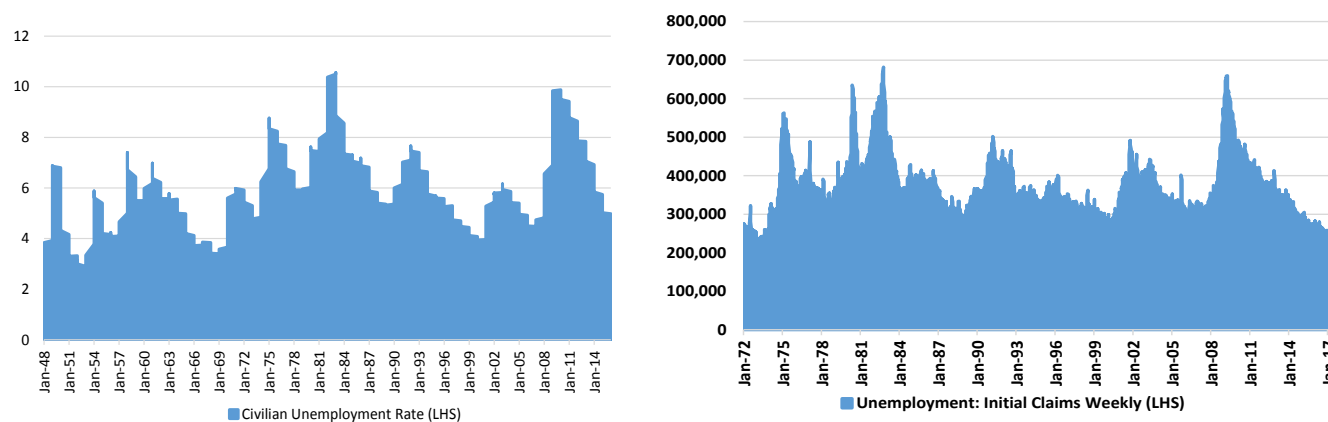
old and outdated supply across asset classes; and 4) Interest rates remain low with Fannie/Freddie mortgage rates hardly moving up despite the Fed increasing the Federal Funds rate multiple times over the past year.

Monitoring Key Economic Indicators...Which Generally Remain Strong. As Real Estate people, why are we monitoring key Economic Indicators? Well, we continue to deploy investor capital into Commercial Real Estate in what may be the 7th, 9th, or 11th inning of this economic cycle, and we firmly believe we have a duty to our investors to maintain a vigilant watch over these key macro-economic indicators. Our analysis suggests that most indicators remain robust, including those related to Employment, Banking, Construction, and Housing trends. One area of concern we have is seen in the Fed Balance Sheet, with its ‘Reverse Quantitative Easing’ program starting up soon as it sells assets back to the big banks and decreases liquidity out of the banking system. Nobody knows the real impacts from the Fed selling off its assets (though this action is probably long overdue), and it could throw a monkey-wrench into our economic system. Big picture, we do see ‘Cheap Money’ risks and Government Debt risks evident in the Fed balance sheet data, though other indicators remain healthy at this point in time.

U.S. Employment Indicators Robust

Strong Positive – US Labor Market is Robust. Overall, the US employment picture looks strong. While the BLS recently reported a 33,000 job decline in non-farm payroll employment for September, most of this can be attributed to Hurricanes Harvey (8/25) and Irma (9/10). The total US unemployment rate has fallen to 4.2% (solid), with an average 91,000 jobs created per month over the past three months, net of revisions. We also see below that Initial Weekly Unemployment Claims are essentially at modern-era lows.

Figure 1. Unemployment Rates are Falling, Weekly Claims are Stable. Reflecting Strength in Job Market

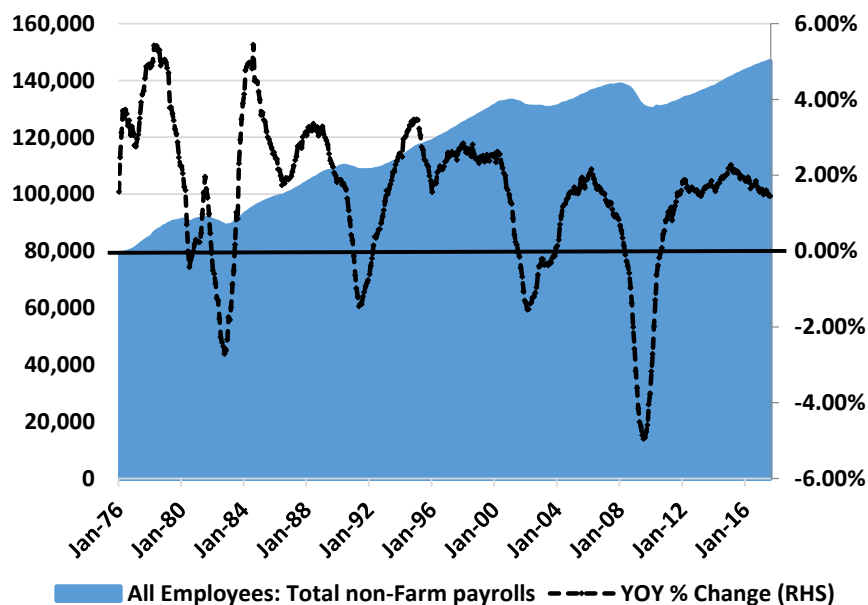


Source: BLS, Fred.StLouisFed.Org; Avid Realty Partners

Positive – Non-Farm Payroll Still Growing, But at a Declining Rate. Below we see that job gains have averaged nearly 150,000 per month over the past year, a plus, and job openings still hover near all-time highs. While non-farm payrolls do continue to grow, they are growing at a declining rate, not totally surprising given we are eight years into the economic expansion. Looking at this indicator for signals about the future, we note job growth on a year-over-year basis peaked in early 2006 and then spent 30 months

falling before waves of selling set in during mid-2008 as the US entered the Great Recession. This suggests we would see meaningful job weakness as an indicator of more weakness to come, or as an Effect of other economic weakness that has already begun occurring.

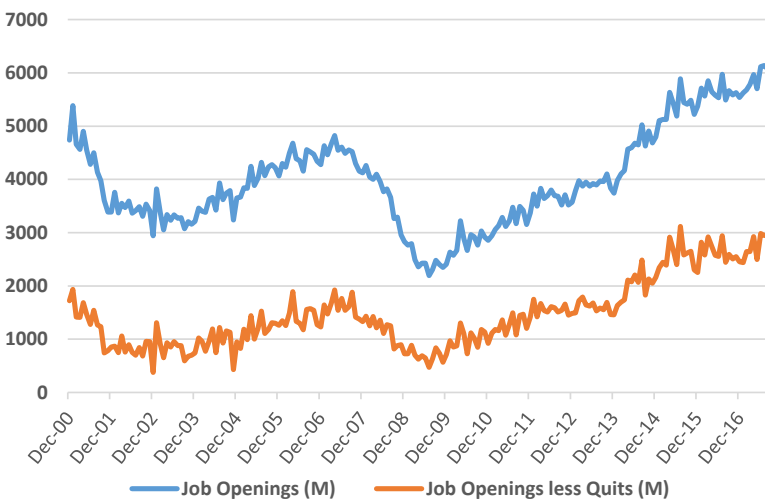
Figure 2. Total Non-Farm Payrolls are Declining; Reflects Weakness in Job Market



Source: Fred.StLouisFed.Org; Avid Realty Partners

Strong Positive – Job Openings and Quits are Both Strong. Various employment metrics have been robust over the past year. According to the BLS, the number of workers quitting jobs, presumably for higher pay, is also high. In fact, we see a high spread between Job Openings and Quits, indicating robust hiring activity, and also suggesting a mismatch in the skills of US workers versus available job openings. It seems our economy would benefit from some broad based Job retraining programs around the US.

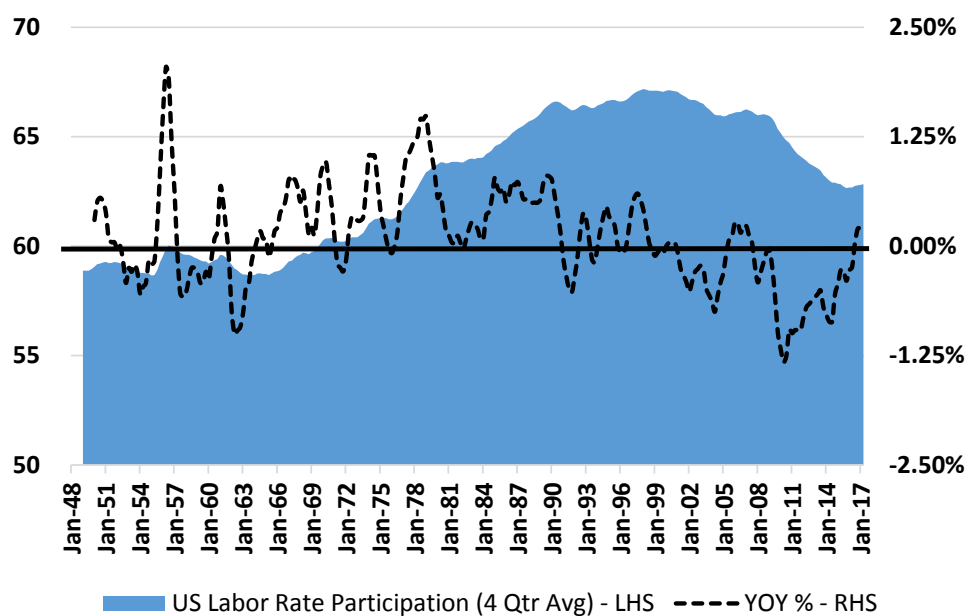
Figure 3. Job Openings and Quits are both Strong, Reflecting Strength in Job Market



Source: Marcus and Millichap; Avid Realty Partners

Modest Positive – Labor force participation rate rising slightly and now positive year-over-year. In the below graph we see that the US Labor Participation Rate has fallen since roughly 1999. While some of this has been driven by demographics – an aging number of Baby Boomers – we think other causes are driven by socio-economic issues, greater availability of different welfare programs, a mismatch between available jobs and skills, increasing use of robots to replace human workers, higher labor and related insurance/litigation costs, and more peoples’ desires to just not work. However, we see that labor participation started slightly increasing over the past 18 months and is now in positive year-over-year territory, a plus. We assume a stabilizing long-term US Labor Participation Rate would be a positive, and the data looks like it might increase further. A longer-term risk is robots and machines replacing humans for jobs like truckers, taxicab drivers, check-out register employees, factory workers, packers/pickers in distribution facilities, and others. This could be a real impact over time.

Figure 4. Labor Participation Rate Rises Slightly and is Now in Positive Territory



Source: Fred.StLouisFed.org; Avid Realty Partners

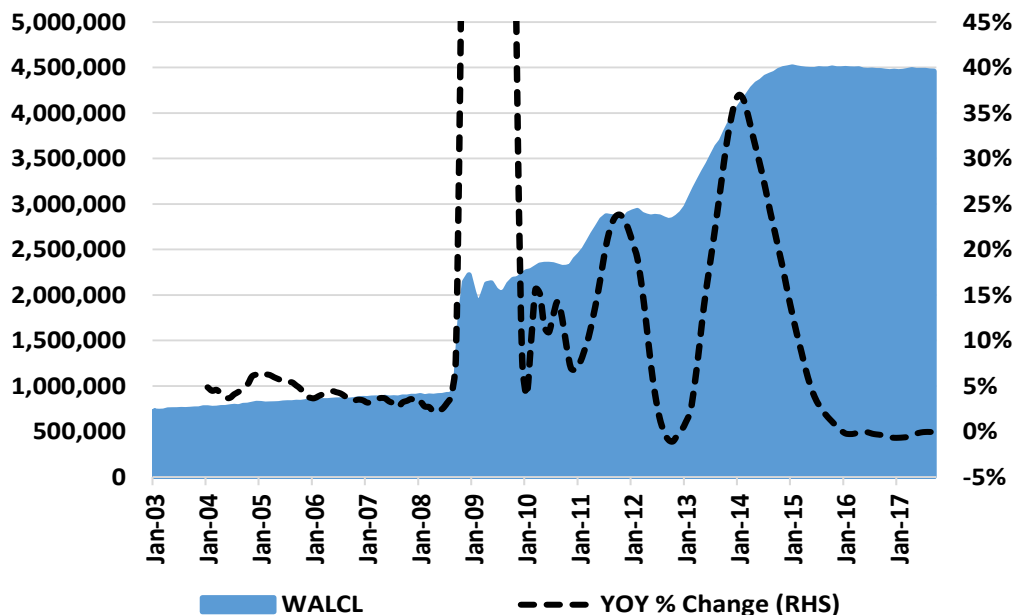
Key Conclusions regarding Employment Data: Net, this data looks strong and it seems like the domestic economy is on stable footing for now, though we recognize a downturn could begin to occur at any time, driven by a variety of Global economic factors, excessive cheap money, excessive government debt, or asset pricing bubbles. In a ‘Self Fulfilling Prophecy’ downturn scenario, employment reductions could be the effect of softness, and not the cause of it. Thus, we need to keep looking at other indicators to maintain vigilance.

Fed Balance Sheet, Asset Bubbles a Big Risk

Strong Negative – Fed Assets have Ballooned to \$4.5 Trillion since 2008, a Major Risk Factor. Looking at the chart below, we see that Total Fed Assets rose from \$725 Billion at the start of 2003 to \$1.0 Trillion in September 2008, and then skyrocketed to \$4.5 Trillion (yes with a T) by year-end 2014. A relative silver lining, Fed Assets have held steady since year-end 2014. Wow, this is a lot of assets on the Fed's balance sheet that did not exist before, introducing considerable risks into the US financial system! As the Fed 'buys' these assets from private sector financial and banking institutions, it pays for them with cash (that did not exist before), and these financial institutions can then turn around and directly lend this new found money to Borrowers. This paradigm shift in how the Fed operates can only be viewed as eye-raising, and a long-term negative that meaningfully increases bubble risks and inflation risks, and lessens the Fed's ability to fight future recessions using this tool as it has no 'dry powder' left here.

An Unknown – 'Reverse Quantitative Easing' to Begin. In recent months the Fed announced that it is going to reverse its buying pattern, and will begin selling off the assets on its balance sheet. Its 'Reverse Quantitative Easing' program will begin at \$10B per month (446 months to get Fed Assets to zero) and grow to as much as \$30B per month (149 months to get Fed Assets to zero), taking somewhere between 12 and 37 years to complete. Nobody knows the real impacts from the Fed selling off its assets (though this action is probably long overdue), and it could throw a monkey-wrench into our economic system. Big picture, we do see 'Cheap Money' risks and Government Debt risks evident in the Fed balance sheet data and in a variety of other financial and interest rate metrics.

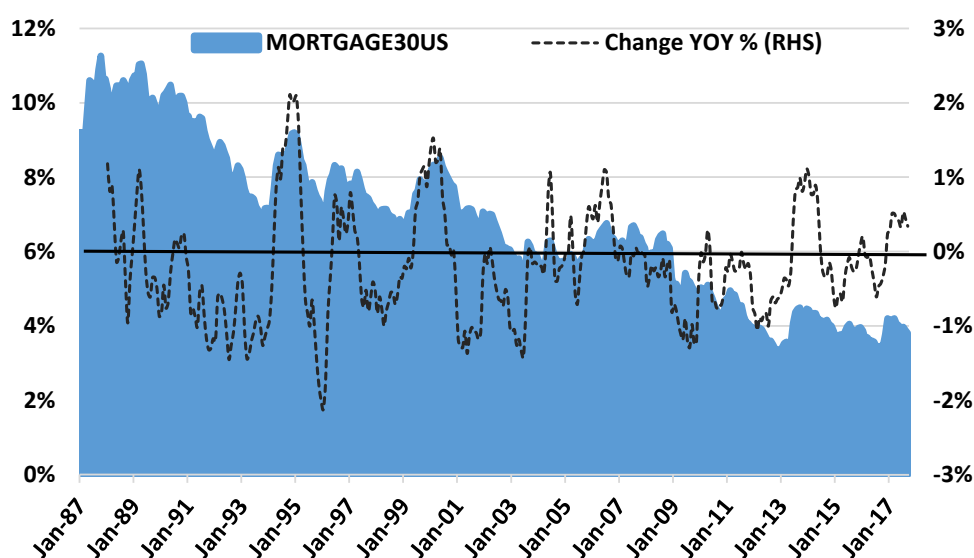
Figure 5. Fed Assets have Ballooned since 2008, a Major Risk Factor



Source: Fred.StLouisFed.org; Avid Realty Partners

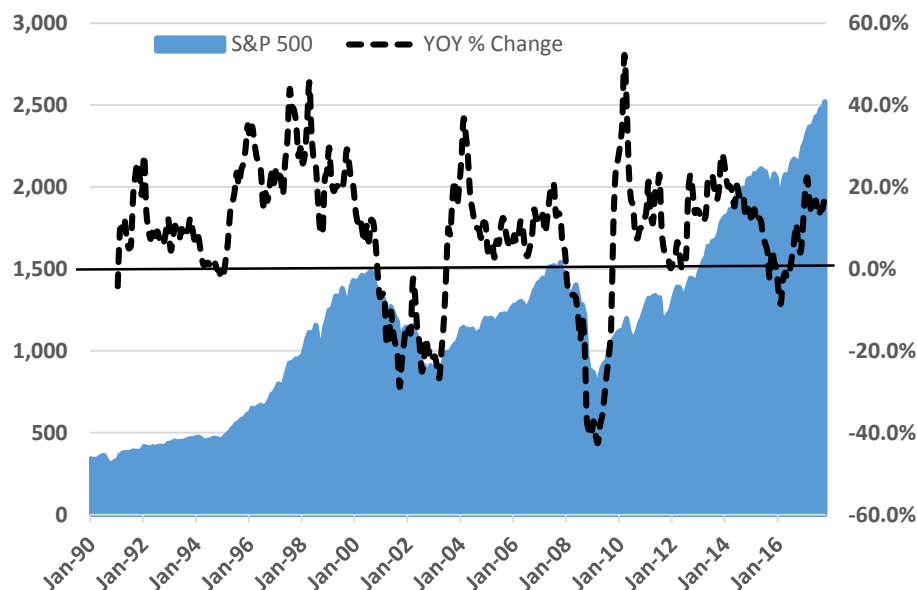
Mixed to Negative – 30-year US Mortgage Rates are stable at low levels; continuing to juice the housing market. 30-year mortgage rates remain near all-time prior lows achieved in late 2012 and early 2013. Clearly, low 30-year Mortgage Rates have improved housing affordability for purchasers in both the residential and commercial markets, driving strength to the overall US realty market. Very low rates are definitely ‘juicing’ the housing and commercial realty markets, and we think this is a longer-term risk. How low can rates go? With negative Central Bank deposit rates in Japan, it seems that US markets still have a little further to go until we are in that situation, though most or all of the declines in interest rates are now likely behind us with the Fed several rate increases into its tightening process. If mortgage rates were to materially rise from here, both the Residential and Commercial realty markets would take a hit, prices would soften, and wealth would disappear, leading to some level of economic weakness. Given this, we expect the Fed will continue to walk rates up slowly.

Figure 6. 30-Year Fixed Rate Mortgage Average in the United States



Source: *Fred.StLouisFed.org; Avid Realty Partners*

Mixed to Negative – Asset Bubble Risks are Somewhat High. Looking below we see that the S&P 500 index has had one heck of a run, more than tripling off the lows of March 2009, and now up 18% on a year-over-year basis. This is another symptom of cheap Fed money, and does suggest that there is some asset price bubble risks not just in equities, but across asset classes as very low interest rates drive lower return thresholds, and drive up asset prices in sync. This is one of the key risks in the economy right now as the wealth created here has been substantial, and could cause some real pain if the equities were to pull back in a meaningful way like they did in 2008-2009.

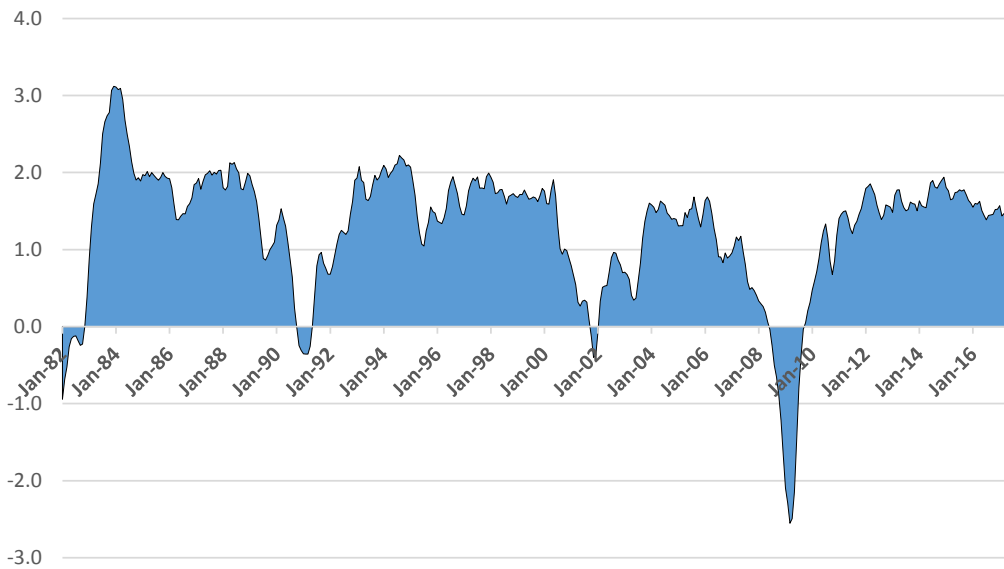
Figure 7. Equities Are Surging, Suggesting Asset Bubble Prices are a Risk

Source: *Fred.StLouisFed.org; Avid Realty Partners*

Key Production Indicators Healthy

Positive – Leading Economic Indicators Remain Solid; No Evidence of Weakening Economy. Leading Economic Indicators indexes remain solid, as seen below. While this metric has deteriorated somewhat from peak levels in 2014, some of that activity was likely inventory replenishment across the supply chain, and this indicator solidly remains above 1.0. We see no evidence yet of weakening indexes here the way we saw throughout late 2006 and 2007, and with these indexes actually inflecting negative in early 2008. That said, we note the obvious that this metric has been cyclical since our data begins in the early 1980s, and its probably only a matter of time before we have another recessionary dip...the only questions are when, and how severe will the dip be? ISM, Production, and Leading Economic Indexes are key to watch and so far remain solid.

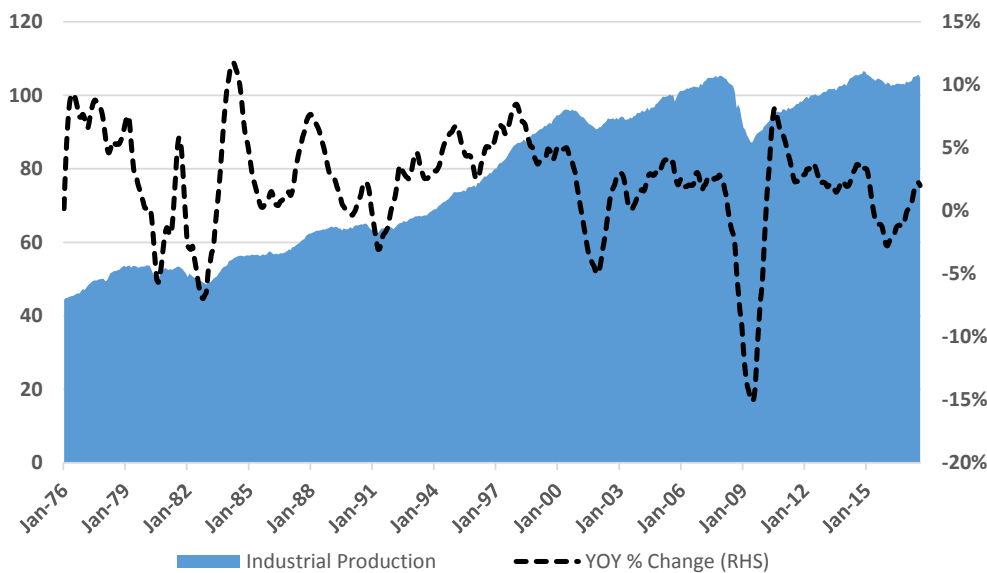
Figure 8. Leading Economic Index Remains Solid, Though Off Peak Levels



Source: Fred.StLouisFed.org; Avid Realty Partners

Stable to Positive – Industrial Production has Normalized and is Now Back in Positive Territory. Below we see that Industrial Production, a major measure of broadbased manufacturing activity, eased off peak levels achieved in late 2014, stabilized (likely as downstream inventories were digested following a huge run off the bottom of the Great Recession), and have now ticked up into positive growth territory. This suggests the US Economy is healthy, stabilizing, and has normalized following a steep recovery in what could be considered a ‘Goldilocks’ scenario for the US economy broadly.

Figure 9. Industrial Production Eased off Peak Levels but Now Back in Positive Territory

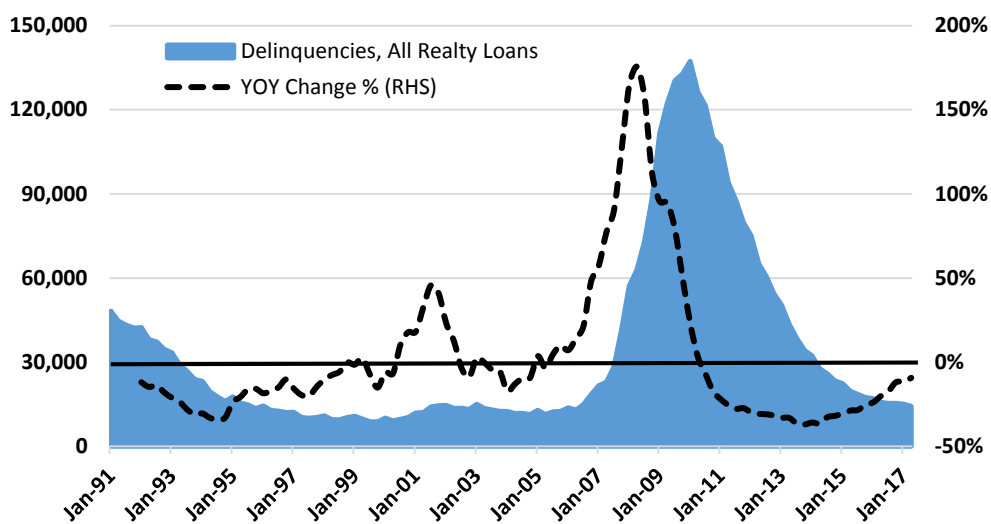


Source: Fred.StLouisFed.org; Avid Realty Partners

Key Banking & Realty Indicators Healthy

Strong Positive – Commercial realty-backed Loan Delinquencies Remain Low; are at Typical Levels Seen from 1999-2002. Looking at the below graph, we see that during past few years Commercial Realty-backed loans have been near all-time low levels and remain there today, a positive. And when looking back at the last cycle we see that Commercial Realty-backed loan delinquencies began to rise as early as 2005, and rose throughout 2006-2008 before the Great Recession engaged fully. While Loan Delinquencies are not yet growing, we do see that the rate of decline is falling and approaching zero (parity), as one would expect eight years after the Great Recession.

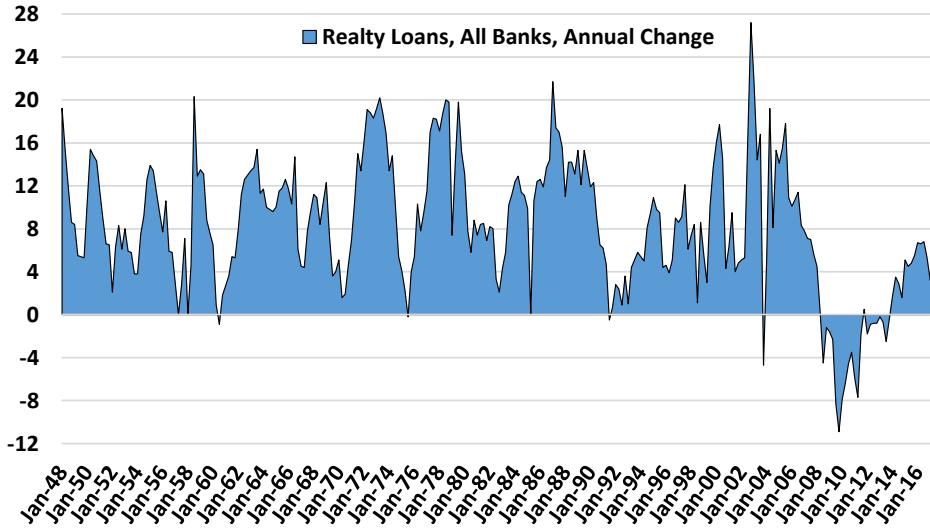
Figure 10. Delinquencies on Commercial Realty Loans Remain Low; No Sign of Late Cycle Surge



Source: Fred.StLouisFed.org; Avid Realty Partners

Positive – Total Real Estate Loans Remain in Control. Looking at the below graph, we see that total real estate loans from all banks remain in control, in stark contrast to levels seen in 2004-2006. In fact, this is some of the lowest rate of loan growth in modern era history, possibly due to lower home ownership rates during the past eight years following the Great Recession. Nevertheless, this gives us some comfort that realty loan levels have not spiraled out of control, and remain in check.

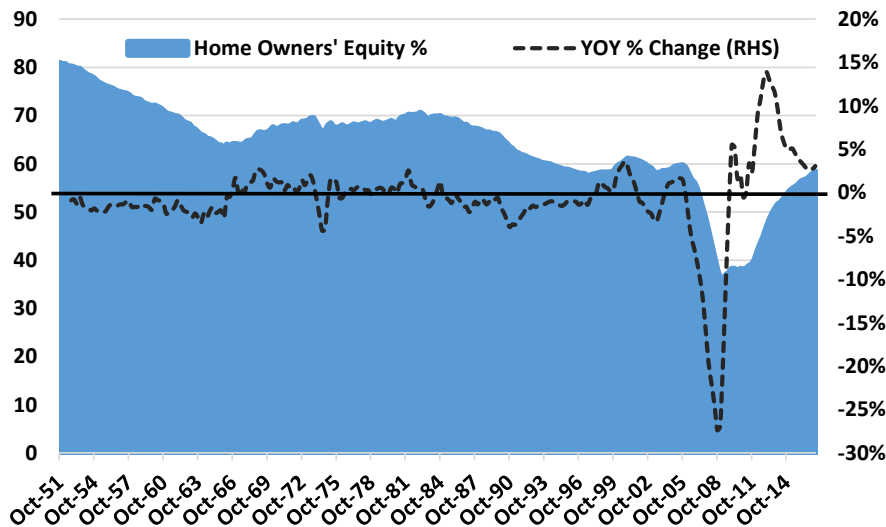
Figure 11. Year-over-Year Real Estate Loans from All Commercial Banks Remain Low



Source: Fred.StLouisFed.org; Avid Realty Partners

Positive – US Homeowner’s Equity is Again Rising; Almost back to Normal Levels. This interesting graph shows US Homeowners' home equity as a percentage of total home value, or how much of the average homeowner's home value is equity versus debt. What we see is that Homeowners Equity fell from 70% in the mid-1980s to 60% by the mid-1990s as Americans took on more debt and as higher loan-to-value mortgages became available. Then, by 2005 Homeowners' Equity started falling again as consumer credit standards loosened, and also due to declining home prices, and fell all the way down to 38% in 2009. Homeowner’s Equity has since recovered to 58.4% for as of April 2017 almost reaching the low end of historically typical ranges. We expect that with modest or inflationary increases in home prices over the next 12 months, homeowners will have even more equity in their homes, and this figure should rise toward that 60% level seen in years past.

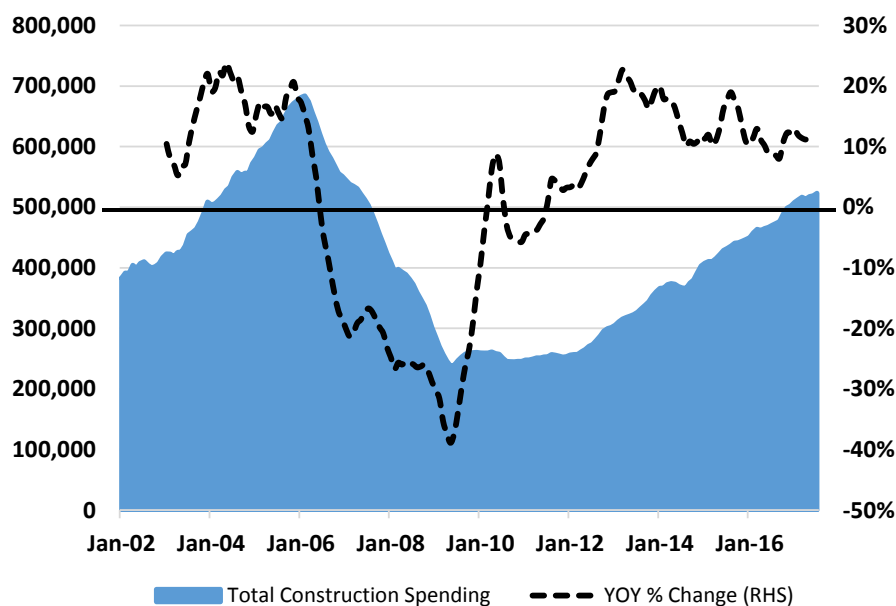
Figure 12. Owners' Equity in Real Estate Rising as a Percentage of Total, a Plus



Source: Fred.StLouisFed.org; Avid Realty Partners

Slight Positive – Total US Construction Spending Has Only Recovered About Halfway. Looking at Total US Construction Spending below, we see that monthly spending fell from a peak of \$700 billion per month in early 2006 to roughly \$250 billion per month by mid-2009, a 65% peak-to-trough decline. Since that time, spending has recovered roughly halfway back, towards \$500 billion per month. While clearly activity has picked up off the lows, we see that total Construction Spending has only rallied back to 2004 levels, and with growth rates that have begun to rationalize over the past year (still growing strongly at +10% YOY, but this is reasonable given the huge declines seen during the Great Recession).

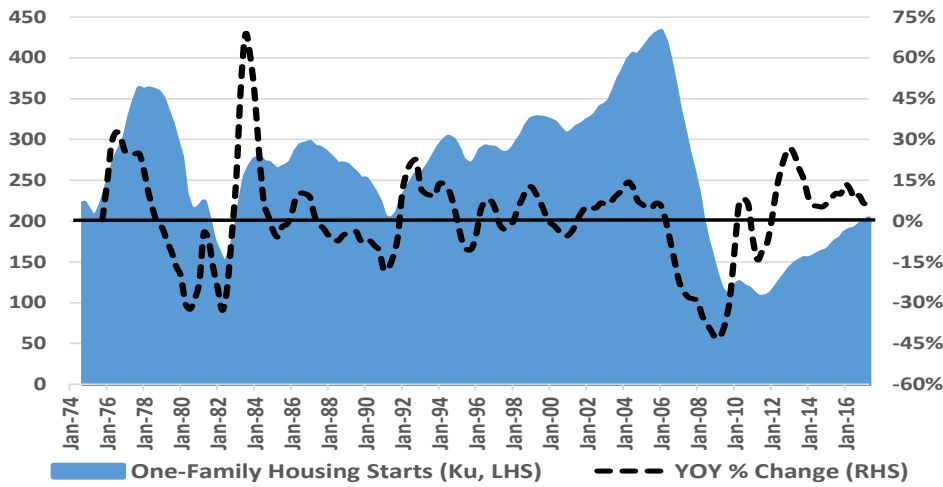
Figure 13. Total Construction Spending Still Well Below 2005-2006 Levels



Source: Fred.StLouisFed.org; Avid Realty Partners

Positive – Housing Starts are now in their sixth year of growth, but have only rallied back to prior cycle troughs. Looking at Total US Residential Housing Starts above we see that starts have only now rallied back to all time modern lows achieved in the recessions of 1982 and 1991. This suggests that housing starts fell well below consumption levels, and likely stayed there for much of 2009-2014, and are now heading back towards housing consumption levels. While lower homeownership rates (and more renters) have likely changed this dynamic somewhat, housing starts do seem to still be ‘in control’, with only modestly growing supply risks at this point in the cycle.

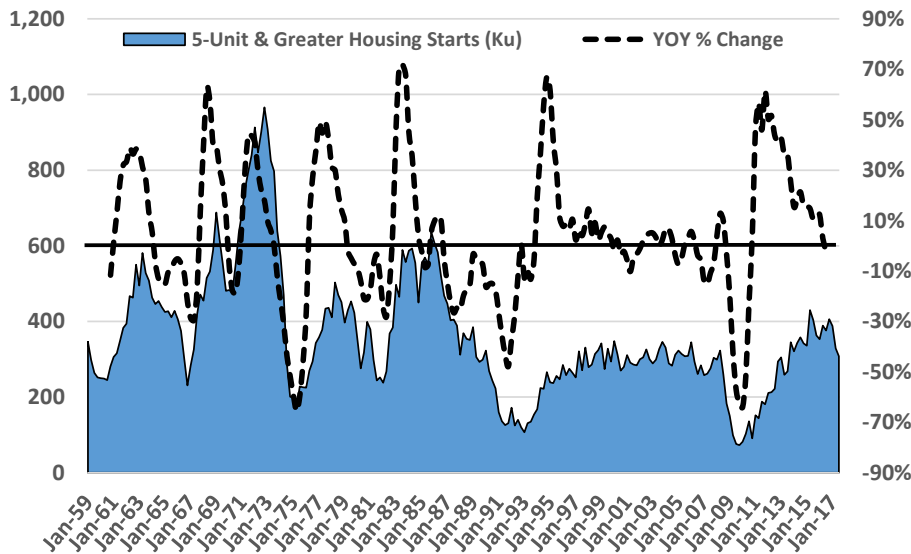
Figure 14. Total US Housing Starts (Single Family) Still Well Below 2005-2006 Levels



Source: Fred.StLouisFed.org; Avid Realty Partners

Modest Negative – MFU Apartment Starts have Rallied Back to Levels Last Seen in the 1980s. Looking at Total US Apartment Starts (Five Units or more) below, we see that starts have rallied back above prior cycle peaks, increasing supply risks to this market, and up to levels last seen in the mid-1980s. Yes this is somewhat concerning as an apartment owner and investor, but we note that Single Family housing starts have fallen meaningfully, and that a demographic shift is taking place as more young people rent, and as more elderly people move into apartment-style senior or assisted living facilities. This is a key metric for us to continue to observe, and we note encouragingly that year-over-year growth rates are moderating back down to normal levels after the impacts of the Great Recession and subsequent recovery.

Figure 15. Total US Apartment Starts (Five Units or More) Have Rallied Back



Source: Fred.StLouisFed.org; Avid Realty Partners

Overall Net Conclusions – The US economy seems reasonably healthy based on some of these key metrics, but significant risks remain. There are pluses and minuses in the economy, as usual. Some pluses: A) Employment data is strong and jobs are available in the workplace today as evidenced by a rising number of openings and quits; B) Leading Economic Indicators and Industrial Production are still in positive territory and show no signs of major degradation; C) We think the commercial banking sector is much healthier than a decade ago, with key metrics here in control; and D) Construction spending metrics, housing start metrics, home equity metrics, and others are more or less rational and appropriate. In some ways the US economy is flashing a ‘Goldilocks just right’ scenario. But, minuses and risks do exist including: E) Government Debt and the Fed balance sheet assets remain high, and, there are unknown impacts from the Fed’s soon-to-begin ‘Reverse Quantitative Easing Program’; F) All of this inexpensive Fed money is driving elevated Asset-Bubble risks in Equities and other real assets; G) there are non-quantifiable long-term risks of more and more jobs replaced with robots (a major impact to come) driving down the Labor Participation Rate over time; and H) The obvious risk that it has been eight years since the last downturn, and downturns do cyclically occur (though businesses are getting better at managing through them). So, while we see some risks with the Fed and Government Debt levels, and Asset Pricing risks, other key fundamental data from the corporate and private sector seems pretty healthy at this time, especially in the realty and banking sectors, flashing us green lights still for now. We will continue to monitor additional metrics in coming months ahead.

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