

The Wall Report

an economic commentary by Terrence R. Wall



OVERVIEW

The economy seems to be exactly on the track I predicted last summer; slowing growth to near zero, possibly in recession-lite as I called it, although maybe not quite there yet, with inflation heating up. Likewise, the subprime and housing crisis along with the stock market bear market (Dow down about 20% with the Nasdaq down about 50% from the peak in October) have unfolded exactly as I wrote about last summer and fall.

I hate to be a braggart, but even now the 'experts' are saying what I have been saying in print for almost three years now, that the Bush Administration's and the Fed's pushing down of the value of the dollar over the last few years would lead to exactly the kind of uncontrolled inflation we are now experiencing. The only thing that has interrupted (or should I say, distracted) the Fed from seeing the inflation that is on the horizon is the mess on Wall Street, which the Fed has seen fit (what choice does it have?) to step in and rescue those who have perpetrated this crisis.

I say perpetrated because the a number of the same people who brought us the Bear Sterns fiasco (64:1 leverage) are the same people who brought us the crisis at Long-Term Capital Management back in 1998. Remember that one? The Fed had to step in and bail them out then, and now a few of those same guys went on another leveraged gambling spree at Bear Sterns, knowing, just knowing, that if all else

fails, the Fed would rescue them again. (I wonder where they'll go now. Heaven help us if they are allowed to continue to be employed on Wall Street; if so, watch where they go.) Can you imagine going to Las Vegas and taking out a loan for \$64 of debt using \$1 of equity and then walking down to the casinos and placing continuous bets until you went broke? (The only difference is that the casinos aren't going to bail you out.)

So, what is happening now and where is all this headed?

Presently we have a very delicate situation in the economy, where certain sectors, like exports, are doing well, while others (like autos, residential housing, mortgages, financials, etc.) are reeling. You'll note an important difference in this downturn - as one Wall Street Journal editorial put it, the difficulties in the financial houses were not caused by the downturn, but rather the downturn was caused by the difficulties in the financial industry (just like what happened in credit crunch of 1998).

Jobs in the manufacturing, retail, and construction industries are down, while jobs in the service and government sectors are up. Unemployment is stable at plus or minus five percent, with temporary relief from lower interest rates having helped. The job numbers indicate that the economy is not entering a

deep downturn (probably because the shedding of fewer jobs is tied to the slower hiring that occurred during the prior recovery, leaving less excess employment). This stabilization of the jobs numbers evidences a shallower downturn.

I would expect the slow down to continue with slow or slightly negative GDP growth to continue through to fall with a possible pick up in economic activity late in the year depending on the outcome of the election. (Just eliminating the uncertainty associated with the election will help decision makers get off the dime and stop postponing needed decisions.)

All bets are off in 2009 until we see what Congress does with any new tax law changes. So we'll have to wait and see.

Beyond that, remember that while Madison may be recovering already, the rest of the nation won't really recover to normal from the subprime and housing crises until about summer 2010. It's always a three year rule of thumb to recover completely from the start of an economic crisis.

INFLATION

One thing is for sure; substantial inflation is "baked in". Inflation doesn't just happen over night and wringing it out of the economy won't happen over night either. The inflationary pressure we are seeing presently won't just disappear, in fact,



The election - and resulting new Congress - will determine tax law changes

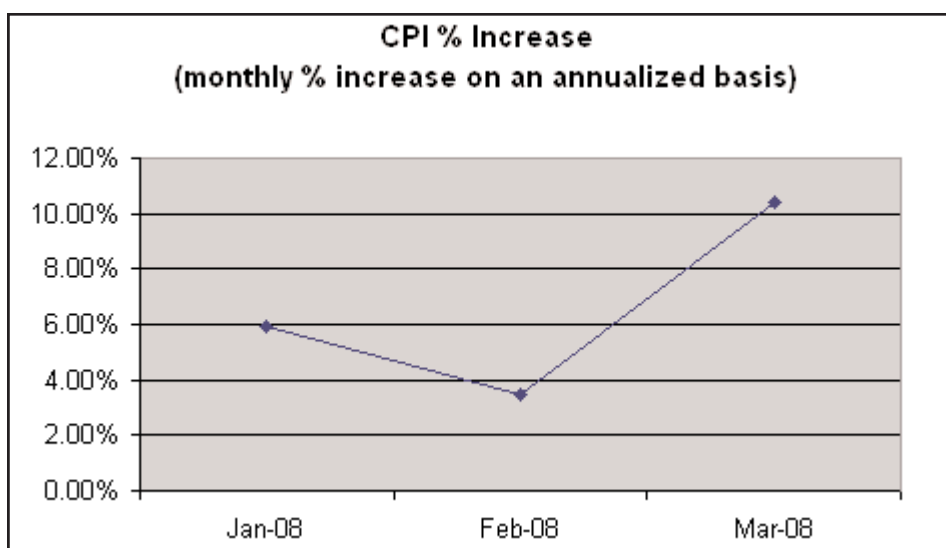
the opposite is true: the inflation we see today will only start to appear in the numbers this fall. Why? Because the government and the media like to report a trailing 12-month inflation, but if you look at the inflation rate over the last few months and then annualize that number, you have inflation over 10%, but no one is reporting that.

And the Fed's focus on Core Inflation (food and fuel inflationary numbers removed) is not fooling anyone. We all see the impact on our pocketbooks from substantially higher fuel and food costs. Does anyone believe that won't show up in the numbers later this year? Worse yet, the speculators have not taken hold of food commodities just like they did with oil futures and are starting to bid them up making matters worse.

I really don't see a way around CPI numbers in excess of 5%, possibly even higher than 10%. Of course, I

have to be careful how I couch those figures, because the government has, on occasion when it suits them, revised the definition of CPI. For example, if the government were using the CPI definition prior to revision in 1996, inflation would be more than 1% higher than that reported today. In fact, one report puts the unadjusted rate at over 7%!

Now take into account the fact that the downturn in the housing market is holding down the overall CPI numbers, you can begin to see the real rate of inflation in the overall economy (aside from falling



Looking at an annualized inflation you see higher numbers than the media and government report.

housing prices). That has to do with how the government manipulates the CPI numbers based upon hypothetical rental rates for single family homes. The point is that real inflation is much higher than reported inflation and we'll see that later this year.

Once the Fed gets through the crises on Wall Street, hopefully by this fall, they'll have to deal with inflation. They already know it's a problem (as evidenced by the repeated 'no' votes by two members of the Fed board on decreasing interest rates) and they'll deal with it by raising interest rates. Unfortunately, they should first withdraw liquidity from the market, given the record amounts of liquidity that the Fed has pumped into the financial markets over the last few months, which is why the economy won't dip into a deep recession – it's just impossible given the cash floating around after the Fed's actions and the upcoming tax rebate.

So this winter and into 2009 I would expect to see higher inflation numbers, and the Fed reacting to them in some manner. How and how fast the Fed reacts will determine the level of overall economic activity in

And while inflation is good for real estate, rising interest rates are not, because they lower returns. But these changing circumstances may present a heck of a buying opportunity for T. Wall Properties. We have seen a significant reduction in the number of buyers competing for properties with us, and in fact, we have seen a complete disappearance of the land speculators that annoyed us to no end in Phoenix as they bid up land prices. Now that they're gone, we are seeing better deals and higher returns as a result.

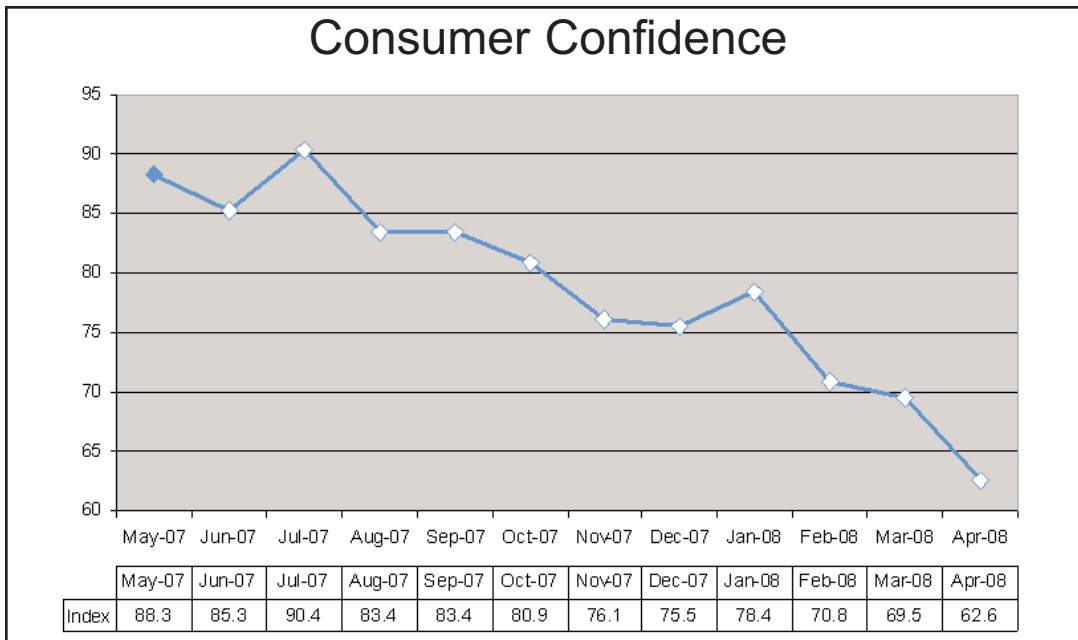
So we could see a multi-year buying opportunity with lower prices and higher returns, although the inverse would mean it won't be a sellers' market like it has been the last few years. The key, of course, is to have plenty of cash available to buy and not have to rely too heavily on leverage. Fortunately, we've positioned ourselves just right.

COMMODITY PRICING

Sure, a slow down in economic activity could result in a temporary pull back of oil prices and other commodity prices, but federal laws such as the ethanol legislation do "bake in" increased demand beyond available supply. Therefore there will be higher prices for corn and since corn is in just about everything, general food inflation will continue. Likewise, with oil.

If you applied the U.S. per capita's oil consumption rate to China's population, China would be consuming over 90 million bbl/day, which compares to the U.S. daily consumption of 20.7 million bbl/day. You read that right; 3.5 times the U.S. consumption. Now add in

India, expanding Eastern Europe, etc. Wow! Even if China's population doesn't consume at the same rate as the U.S., it would have to consume at only a rate about one-fourth of the U.S. per capita rate. Did you catch that? Regardless of the annual ups and downs of the oil market, China's consumption at a rate one-fourth of the U.S.'s per capita rate would result in the



The Consumer Confidence Index reached a five-year low in April.

2009. If those constraining actions are combined with increased government regulation and taxation with a new tax bill, expect a big downturn in 2009, but if Congress and the new President don't go overboard, maybe we can squeak through with a little bit of Jimmy Carter malaise. Who knows at this point?

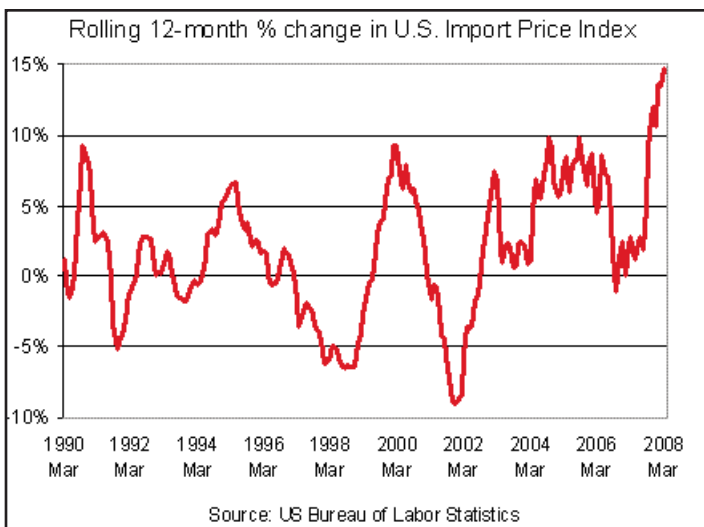
same overall consumption of 20.7 bbl/day. That alone would put tremendous pressure on oil pricing.

I wouldn't hesitate to bet that China knows this and that China will eventually make political and economic moves to get closer to the Middle East over the next twenty years, just as China has made direct purchases of iron ore mines in Minnesota. They're no dummies. They know what resources they need and they'll go after them in order to maintain their growth rate. If they don't they'll risk rising political unrest, because the equivalent of the entire population of the U.S. is moving right now from the farmlands in the west to the major east coast cities in order to find higher paying jobs. China must keep their job creation engine going or they're out of business. Expect an overall trend towards higher oil prices over the next twenty years (unless maybe, if the U.S. reduces its dependency on foreign oil, it'll instead be a race between higher prices and our ability to change over to new technologies.)

But oil isn't everything. Import prices are at their highest 12-month range in the US Labor Department's archives which go back to 1982. Even pulling oil out of the equation with the assumption that energy prices will eventually right themselves, non-petroleum import prices are still soaring well beyond the rate of general inflation and the growth of the GDP.

POSSIBLE RISK FACTORS

Heads up! I am told that the FDIC issued a "guidance" letter in the last year informing all banks



nationwide to limit lending to commercial real estate to 300% of the bank's capital. Presently, I'm told, there are few banks in the county that satisfy that ratio. What does this mean? While this is a 'guidance', when the regulators come in once every 18 months to conduct their audits of the banks and they start looking at how high the ratio is, they're going to put pressure on the banks to cut back on commercial lending.

The purpose of the guidance is to reduce the concentration in commercial lending, but of course, after small business lending (and the now defunct residential lending) there's not much of a market left for smaller and community banks to lend to except commercial real estate. This could lead to tighter lending terms and less lending, leading to commercial developers and small businesses (who use their real estate as their primary asset on their balance sheet) being put in a bind when their loans come up for refinancing, creating the same crisis in commercial real estate markets as presently exists in the residential markets.

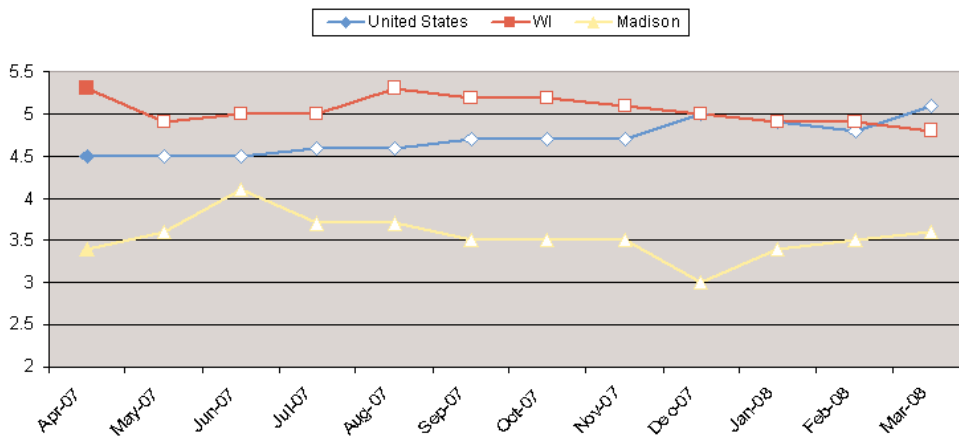
If you think I am kidding, ask your banker. This guidance comes in the form of a Memo of Understanding, which is one step away from a cease and desist order from the FDIC. Pretty scary!

The FDIC's idea is to create diversification of income down at the tenant level – in other words, this policy would promote multi-tenant buildings over single-tenant buildings. How ironic, because in the real estate industry a single-tenant building is usually sold for a higher price than a multi-tenant building. In our case, this policy would favor our company since all of our buildings (except one) are multi-tenant. However, I can assure you that if this policy goes into enforcement, it will mean serious trouble for many commercial real estate borrowers who don't have alternative sources of capital.

Additionally, the Quarterly Survey of Bank Loan Officers recently released by the Federal Reserve showed a significant increase in the number of banks tightening up their standards for commercial and industrial loans and commercial real estate loans.

Changing standards for these types of loans usually leads to changes in order rates on capital goods and

Unemployment Rate



	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08
United States	4.5	4.5	4.5	4.6	4.6	4.7	4.7	4.7	5	4.9	4.8	5.1
WI	5.3	4.9	5	5	5.3	5.2	5.2	5.1	5	4.9	4.9	4.8
Madison	3.4	3.6	4.1	3.7	3.7	3.5	3.5	3.5	3	3.4	3.5	3.6

Despite economic concerns, Madison's unemployment rate remains low compared to the state and the U.S.

commercial construction activity. Just another indication of where things are heading.

CONCLUSION

Overreaction by Congress in 2009 through over-regulation or new taxes could throw the economy into a tailspin. Generally I don't think Wall Street should be regulated but in my opinion if the investment banks want a bail-out insurance policy to fund their gambling habit, then they should subject themselves to government oversight. On the other hand, I would almost prefer prohibiting the investment banks from acting like and competing with regular banks because then the government could let them fail when they behave as they have.

The mess we're in now could have been avoided. But now that we're in it, the Fed had to act. Let's face it, the Fed probably called up all the investment banks and asked them to confidentially disclose their true exposure. The fact that many of them probably answered with an initial "we don't know" probably scared the heck out of Bernanke and forced him to take the action he did. And while I don't like bailing

out a bunch of whining investment bankers at taxpayer expense, the Fed didn't have much of a choice given the evidence of the freezing up of the auction rate market and other market problems we've seen over the last few months.

But the result will be even more exaggerated inflation (stoked by the extreme amounts of liquidity the Fed is pumping in right now; another \$150 billion the other week). The

result will be higher inflation that will require reverse action next year.

Keep your eye on the ball and like we do at T. Wall Properties, look for opportunities tied to these changing circumstances. Stay nimble and flexible and be willing to shift gears on a moment's notice to not avoid taking a hit, but also to take advantage of the situation to your own benefit.

Please note our new physical address and phone number effective May 16 :

T. Wall Properties
8215 Greenway Boulevard
Suite 500
Middleton, WI 53562
(608) 830-6300

Mailing Address of PO Box 7700, Madison, WI 53707 will remain the same.

INFORMATION IN THIS REPORT IS THE PERSONAL VIEW OF THE WRITER, NOT NECESSARILY REFLECTING T. WALL PROPERTIES. IT IS FOR YOUR PERSONAL USE. THE WRITER DOES NOT REPRESENT THAT IT IS ACCURATE OR COMPLETE. NOTHING IS GUARANTEED.

P.O. Box 7700, Madison, WI 53707-7700
Phone: 608-241-2100
Fax: 608-662-0500
twall@twallproperties.com



T. Wall Properties®
Creating Places Where People Interact