DEJA VU PLUS SOMETHING NEW

By Patrick Niland

A financial market update

As I look at today's financial markets, I see striking patterns with past trends. However, I also see the emergence of new factors that will permanently alter the lending landscape.

Remember 1993? Treasury rates fell throughout the year, with the 30-year Treasury (known on Wall Street as the "long bond") dropping to a 30-year low in late October. Commercial mortgage rates, which usually are pegged to the corresponding Treasury security, dropped as well. Lenders were buried in a wave of refinancings. Some skeptics and bottom-fishers foolishly held out for even *lower* rates. Imagine their shock as rates jumped 170 basis points over the following six months! So much for market-timing.

In February 1994, Alan Greenspan imposed the first of six increases in the discount rate (what the Fed charges banks for overnight loans) in his determined crusade against inflation. Those increases boosted the Federal Funds rate (what banks charge *each other* for overnight loans) by 3.00% which, in turn, hiked loan rates throughout the economy. Greenspan continued his fight for almost two years until he felt that inflation was retreating. Since January 1996, the Fed has held steady and, by the end of 1997, inflation had fallen to an all-but-nonexistent 1.70%. Therefore, most experts now expect the Fed to hold its course for the foreseeable future.

Back in early February 1995, I suggested the likelihood of a final 0.25% to 0.50% increase in rates. The Fed made me an "expert" (someone who makes a 50/50 guess and is "proven" right) by increasing the discount rate by 0.50% in late February to 5.25%. I also predicted that 30-year Treasuries would retreat to the 7.00% to 7.50% range by mid-year (the long bond traded around 6.60% in June and July), and that short-term rates would fall by 1.50% - 2.00%. One-year Treasuries actually fell 1.30% to the 5.70% range. I then suggested that all rates would "waddle sideways" until late 1996. The long bond dropped another half point, then rose back above 7.00%, then dropped back down to 6.00% by year-end 1997. In early 1998, 30-year Treasuries hit a new intra-day low of 5.66%, and they now are trading around 5.85%. Not bad work for a "guesspert."

So, what does my crystal ball tell me now? Continued corporate downsizings, lackluster housing starts, erratic retail sales, and unusually low inflation all seem to say that our economy is just out for a Sunday drive. But increasing producer prices, healthy GDP growth, rising industrial production, robust capacity utilization, an abnormally tight labor market, critical commodity shortages, and a confident consumer outlook all suggest that things might be rolling along a lot faster than we think. Now mix in a little Asian credit crisis, a falling Canadian dollar, a pending war in the Middle East, persistent instability in Russia and the Balkans, the possibility of trade sanctions against China or even Japan, and reduced Treasury auctions. My crystal ball is getting very cloudy.

Eh, clouds be damned! I predict a gradual, downward trend in rates. To be sure, the domestic market will suffer increased sensitivity to external shocks from a volatile global economy.

Hence, the overall climate will be quite favorable, but the *timing* of individual transactions will be crucial. In short, a *very* good time for borrowers.

The downward trend will be somewhat stronger in the commercial mortgage market due to significant changes happening there. First, the overall supply of borrowers has been reduced by all those wise (or lucky) souls who refinanced back in late 1993, January/February 1996, or in January 1998. Second, consolidation among banks paired with the birth of a host of new conduit lenders has intensified the demand for borrowers. Finally, the falling Federal deficit has reduced the Treasury's issuance of new securities just as foreign turmoil is increasing the offshore demand for such "flight to safety" investments.

This tightening of supply is causing great anxiety among money managers and institutional investors. Since these folks *must* invest to justify their six- and seven-figure salaries (*anyone* can hold cash), they are responding in the only way they know how: by reducing spreads! But don't get too giddy. Rates have loosened, true, but terms have *tightened*. Yield maintenance prepayment terms are now the norm rather than the exception, engineering inspections are more thorough, and environmental assessments are more detailed. Underwriting is more intense, in part because market pressures have compressed processing schedules. Now, more than ever, it *really* pays to use all of your professional advisors (property manager, attorney, accountant, mortgage broker) to capture the best deal -- and then get it *closed*.