WHAT'S HAPPENING IN THE FINANCIAL MARKETS

By Patrick Niland

HAS ALL HELL BROKEN LOOSE?

My wife, who recently had been on an extended business trip to Europe, convinced me to join her for a long weekend. The prospect of leaving the country (and my clients) with the financial markets in such turmoil gave me more than a bad case of nerves. But I am very glad that I took the trip. First of all, nothing terrible happened while I was away. And, second, a few days of reading the European financial press gave me a broader perspective on the U.S. market. I now see five major truths.

1. <u>Rates aren't so bad.</u>

The 30-year Treasury (also called the "long bond") bottomed out last October at 5.79%, the lowest level in 30 years. Today, it's trading around 7.50% - more than 170 basis points higher. But, if one ignores the last six months, today's rates are still as low as they've been during the last 20 years! Therefore, it still makes sense to refinance those 10%, 11%, and 12% mortgages at 8.50% - or even 9.00%. And many people are. Most of the complaining you now hear about "high" rates comes from those "optimists" who wish they had acted six months ago.

The next six to nine months will see a gradual decline in rates, with the long bond possibly dipping below 7.00%. As most of the hysteria over recent Fed tightening evaporates, interest rates should return to their historical neighborhood of a 3.0% - 3.5% real return plus inflation (now about 3.5% - 4.0%). Longer term, however, rates will increase gradually as the improving economy slowly rekindles inflation.

2. <u>Lender criteria are changing.</u>

As lenders recover from the excesses of the '80s, they are taking a more reasoned approach to real estate lending. Loan criteria are changing, and most of this evolution is favorable. Perhaps the most publicized change occurred last November, when Fannie Mae loosened its criteria for certain types of multifamily property. This modification has had a ripple effect throughout the lending community as other institutions made similar changes.

This trend means that a property which essentially was unfinanceable a year ago, became financeable with great difficulty by six months ago, and today is financeable on tough but tolerable terms. This process will continue as lenders experiment with new loan products, higher loan-to-value ratios, and more flexible pricing formulas. As loan officers gain experience, structures will change and processing time will shorten. Further, as lender pipelines drain down, other terms should become more competitive as well.

3. <u>More money is available.</u>

When you are the one being turned down, it is natural to complain that the loan market has dried up. But the fact is that more money is available today than at any time in recent years. New lenders are entering the market. Old lenders are returning to the market. And many existing lenders are dedicating more of their capital to real estate lending.

But the biggest boost to liquidity is the development and growth of a commercial secondary market. To see where this trend is headed, you need look no further than the residential market. In the ‘50’s and ‘60’s, virtually all residential loans were portfolio loans, i.e., made by a local lender and kept in portfolio until the loan either was refinanced or paid off at maturity. By the early ‘80s, virtually all residential loans were sold into the secondary market as collateral for bonds issued on Wall Street. “Pools” of these loans now provide the “back” in the mortgage-backed securities traded worldwide. The size of this market has exploded to a level measured in the trillions of dollars.

A much smaller, but rapidly growing, market (measured in billions) now exists for commercial mortgage loans. Consequently, many lenders - even portfolio lenders - have begun to structure all of their loans for future sale. This practice initially will cause a few bottlenecks in the market, as all of the players maneuver to impose their underwriting criteria on the market. But, eventually, a standard will emerge and unleash a flurry of new loan products.

4. <u>The market will suffer increased volatility.</u>
Whether we Americans like it or not, the global market is a reality. Our parochial - even chauvinistic - view of our financial markets is no longer justified. After all, the Japanese stock market is now the world’s largest. Trading in most securities and currencies continues around the clock, around the world.

This means that U.S. interest rates increasingly will be influenced by global forces - forces which seem to have a mind of their own. For example, the “market” felt that Greenspan’s February rate increases were inadequate to forestall inflation. Therefore, the “market” traded up to the level that it viewed as more appropriate. Similar adjustments recently were forced on both the Canadian dollar and British pound. Such volatility is relatively new and, understandably, quite disconcerting. But we live in a world of accelerating change. As long as that is the case, we should get used to unsettled markets.

5. <u>More loan risk will pass to the borrower.</u>
All of this market volatility has not gone unnoticed by lenders. Nor has the avalanche of refinancing, spawned by low interest rates. The result of this “double whammy” on many commercial mortgage portfolios has been dramatically lower yields. To solve that problem, many lenders are trying to transfer more of the interest rate risk to the borrower. From now on, more lenders will employ indexed-based pricing (e.g., the 10-year Treasury rate plus some spread) and yield maintenance prepayment penalties. These tools help lenders maintain operating margins and, hence, their income. Expect to see more such changes.

What does all of this mean for those of you who need to refinance now? Four things.

(a) Now is better than later. No one can predict with certainty where rates will be in 9, 12, or 24 months. But it is more likely that they’ll be higher. So why take a chance?

(b) Once you start the refinancing process, keep moving. The sooner you close, the sooner you'll know exactly what you've got. This is one case when time really is money.

(c) Make sure you borrow enough. Enough to pay off your existing loan, cover all closing costs, and establish a fund for future repairs -- plus enough to cover possible rate jumps between application and closing.

(d) Get professional help. Involve your attorney, accountant, property manager, and mortgage broker from the very beginning. They will help you get the job done right - and on schedule. Don't be penny-wise and dollar-foolish. To get a good loan, prevent headaches, and save money, get the very best advice.

Good luck!