NASHVILLE NOTES

A Strange Year Fades Into Another One

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I have an 80-year-old friend, who has worked in the investment business all his life and is known around Nashville as a value investor. At a dinner recently, he reminisced about attempting to buy real estate in the early 1980s when interest rates were near 20%. He said everyone knew real estate was a great buy, but no one could afford it. My retort was that everyone knew real estate was a terrible buy in 2021, but everyone could afford it because mortgage rates were so low.

Wall Street Journal reporter Nick Timiraos, who is known as the "Fed whisperer" by some, recently tweeted that "the U.S. housing market is going through a hard stop after a massive rate shock ended a 'bubble,' in [Federal Reserve] Chair Jay Powell's words." The commercial real estate market also appears to be going through a slump, although I do not think the bubble moniker applied to most CRE sectors at the beginning of the year, especially the office sector.

The comeuppance for a couple of years of free money and wild speculation is underway. But, for whom and how much is not clear, excluding individuals and businesses that do not owe much money or refinanced borrowings well into the future at generational lows during 2020 and 2021.

This is a strange year in which the river is flowing backward, so to speak. But so far, what may have broken has not rippled through the economy in a major way and may never do so. Nonetheless, this year's zeitgeist is interesting to compare with the monumental years from a market perspective of 1980, 2000 and 2007.

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The analogy to 2000 gets a lot of play when the tech bubble began to deflate. The Nasdaq Composite Index peaked in March of that year at 5,049 and then proceeded to fall 78% to a low of 1,114 on Oct. 9, 2002. In the current cycle, the Nasdaq peaked in November 2021 and is now down about 30% this year, as of Dec. 9. A comparable repeat of 2000 would have the Nasdaq bottom around 3,500 from its 2021 high of 16,057, but that seems a stretch.

Forgotten in the bear market of 2000-2002 was the performance of value stocks, including bank stocks in which the Nasdaq Bank index rose 50% over the same period the Nasdaq Composite fell 78%. The 2001 recession was mild with limited credit losses, in part because real estate values began to trend higher as the Fed pivot in late 2000 saw the federal funds target rate fall from 6.50% to 1.00% by June 2003.

The 2007 analogy relates to inflated asset values, illiquidity and leverage. While there were plenty of data points that the housing market was in trouble by late 2006, most date the beginning of the Great Financial Crisis to June 2007. Then, two Bear Stearns hedge funds that invested in subprime mortgages received margin calls that reverberated throughout financial markets because so many other market participants were levered to similar assets.

Today, we are witnessing the implosion of the crypto ecosphere. My inclination is that it will not matter much to financial markets just as the implosion in meme stocks, special purpose acquisition companies, NFTs and other pandemic speculative assets has not mattered, so far. That said, the recent news that Blackstone and Starwood Capital have halted capital redemptions from large private (non-traded) REITs may be one-offs. However, the parallels to the Bear Stearns funds have not been completely dismissed by institutional investors. Private credit funds, which have grown massively in the past decade, are another asset class to watch.

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The comparisons to 1980 are particularly interesting to me, though the amount of time that has lapsed may make comparisons haphazard. During the 1970s, interest rates trended higher in an uneven manner, then went parabolic in the early 1980s as the then newly appointed Fed Chairman Paul Volcker had a political mandate to crush inflation. One result was that thrifts, and some banks, had a disproportionate amount of long-duration assets (then residential and CRE mortgages) that were funded with much shorter-duration deposits and borrowings.

These institutions could not afford to sell their low coupon, long-life bonds, mortgages and other assets because it would create a capital loss. The issue festered and was then made worse in 1986 when tax reform hurt commercial real estate values. The market eventually cleared (my recollection is that the degree of pain and opportunity varied among regions) by the early 1990s, but it was a painful process.

As it relates to banks today, banks have a significant lever to deal with liquidity needs that cannot be met through selling underwater bonds and assets: raise deposit rates. Doing so will clip margins, but margins have widened a lot this year, profitability is good and the spread on assets that are funded with non-interest-

bearing deposits will remain wide. The second lever is to restrict lending, which is not a great outcome for the economy when liquidity is receding.

The setup for 2023 is interesting, and it may play out fine with or without a softish landing unless there is a lot of forced selling of real estate and other levered assets.

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