What in the Hell is Going on Here Anyway?: A SWOT Analysis of the Financial Recovery

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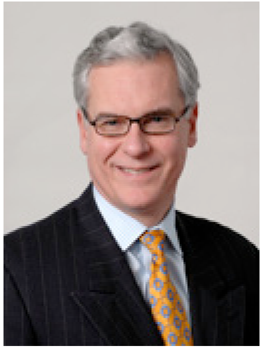

What the hell is going on here? I've got a business to run, and it's really annoying that I can't sort out whether we're in the early stages of recovery or on the cusp of another train wreck. When Dad taught me to drive, he had to keep saying "Don't look at where you are but where you're going." Good advice. Yet only as long as I look at the road right in front of me do I feel OK. If my eyes wander to the horizon, I get really itchy.

This recovery feels very brittle. Oh, sure, transactional activity is way up. If Dechert's practice is the first derivative of the broader capital markets (and I think it is), then things have been getting progressively more robust for the better part of a year now. We're growing, we're hiring, deals are coming in at a goodly pace. Yet, everyone I know with the slightest capacity for reflection is touchy, to say the least.

So let's do a S.W.O.T. analysis of where we sit.

First, our Strengths and Opportunities:

- We're coming out of the deepest and most torturous recession in 70 years. The financial markets came close to collapsing, credit evaporated, the U.S. housing market went into a tailspin and commercial real estate values dropped between 30% and 40%. But things are demonstrably getting better. All downturns end and are followed by sustained periods of recovery, right?
- Interest rates are at insanely low levels. I'm still trying to wrap my brain around a one-month LIBOR of 20 bps and ten-year Treasury below three percent.
- Bank balance sheets have repaired (some), the financial market has crept back from the edge of oblivion. There's money to be lent.
- Cap rates have dropped like a rock from '08 and '09 and higher valuations resulted. In some CBDs, prices are within single digits of pre-fall highs.

- The GSEs might be in conservatorship, but for dead people, the Twins are pretty damn active market participants. They should have a recurring role on True Blood.
- The housing market must be near its bottom. It just must! The experts have been predicting the bottom for 24 months and eventually they have to be right. When the bottom's reached, the consumers will find their courage and the consumer sector of the economy, some 70% of GDP, should start to perform more like normal.
- The stock market's going great guns, there's trillions of dollars on the balance sheets of corporate America.
- With a little luck, we won't spend more lives and treasure on more wars and wacky governmental recovery initiatives.

So, that's all good and, voila, a functioning commercial real estate mortgage market and a growing economy result. I'm feeling good, so far.

But hold on, let's look at the Weaknesses and Threats:

- While some parts of the banking sector and the financial services sector are well on their way to health, not all is well. There still are a lot of outstanding questions about what lurks on the balance sheets of institutions large and small, and whether the full story of repair has been played out.
- We can't seem to get to a budget. Yet it seems that, at some point, this Ponzi scheme of continuing to borrow and spend must stop. Could you imagine what would happen if the Treasury's borrowing costs went up 500 bps really quickly? Portugal, anyone?
- Commercial real estate is increasing in value not because more butts are in seats and more sales are happening (although there's some of that), but because of the changes in cap rates. When one lives by cap rate moves, one can die by cap rate moves. What happens if we stop believing an optimistic narrative that things will continue to get better? If that narrative is disrupted, it could turn ugly in a hurry.
- Interest rates are extremely low. Where are they going to go? How long can they actually stay at these historically anomalous levels? At some point, they have to go up. We've certainly seen commercial real estate markets operating robustly with an eight handle on the ten year, but how do you go from three to eight? Maybe if that happens over a decade, all's good. If it happens over a quarter, it's bad.
- Europe is a disaster. We shot right by Spain on the road to Italy. Europeans are playing world class kick the can and as long as a common currency is off the table, there's no way out. Europe's Hotel California contagion moves from sovereign to sovereign and then from major international bank to major international bank. It will be hard to keep all this away from the shores of this economy.

- The government seems to be, or at least is perceived by market players as being, hostile to capital formation. That, by itself, creates a miasma of doubt and uncertainty which chokes off momentum. Add to that our new and as yet untested regulatory burden and one wonders if growth can win out. Oh sure, there are some good reasons behind the current regulatory transformation, but for every safeguard there is a cost. For every provision designed to prevent something bad in the future, there is a drag on capital formation now. Dodd-Frank and its progeny will have an enormous and yet not fully appreciated impact on the ability of all markets to grow and innovate in a way critical to the successful re-acceleration of our economy. Risk retention is, perhaps, the most visible current face of Dodd-Frank. No matter how the final regulations turn out, they will, with a moral certainty, decrease the availability of affordable credit to the commercial real estate market and to the broader economy.

So throw all of that onto the scales and try to get comfortable about the sustainability of this recovery. As long as they play music, I'm going to dance. Just don't make me tell you when the band's going to take a break.