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State of the Market 48: The undiscovered country

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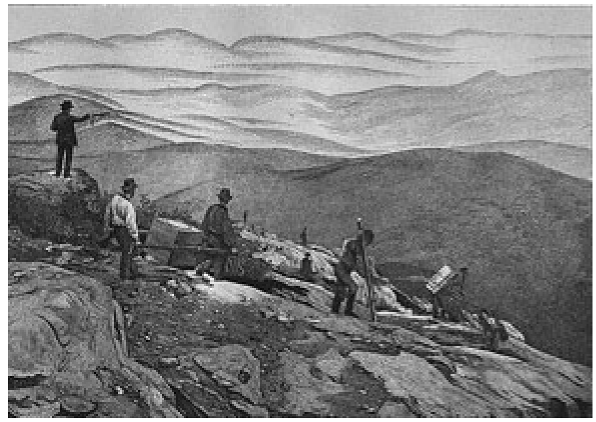
The future is an undiscovered country, from whose bourn no traveler returns – and sometimes it differs strikingly from the past. It includes event horizons – potential discontinuities where the future could suddenly angle away from the past. As 2012 ends, we confront many more than our normal share, of which the 'fiscal cliff' is only the first. It seems certain to make 2013's marketplace for affordable housing and for residential capital quite different from the years we have just passed through.

1. Going over the 'fiscal cliff'

This already-overused term has been a misnomer from the start. It is a purely political cliff, not a fiscal one, because the idea that a federal government which has expanded roughly 31% since President Obama took office (and which is now 24% of US GDP, higher than any level since 1946) cannot contract by 3% without economic convulsion is laughable. The skirmishing now taking place in Washington is political battle-space preparation, based on who believes their side will be less blamed for failure to reach agreement, and therefore who theoretically gains negotiating advantage for the compromise that may be struck.

While the elected officials shadowbox, the capital markets are already pricing in the expected demise of current tax brackets: shrewd asset-holders are dividending sooner, selling to lock in lower capital gains rates, or gifting to beneficiaries. By the time the cliff arrives, many of those most affected may care much less about it.

What to plan for. Plan for us to 'go over the fiscal cliff'. An automatic, across-the-board cut is inherently no less unfair than a painfully negotiated redistribution of the



Behind that cliff, there lies ... another cliff?

pain, and finger-pointing is politically so much easier than being finger-pointed at. So the likely consequences are:

- *Apparent recurrence or deepening of the recession*. I've never believed we were out of it; now others will agree.
- *Outrage over the Alternative Minimum Tax and clamors for tax reform*. A great many people who voted for higher taxes on the rich will find that they themselves are defined as rich for the AMT, and there will be renewed clamor to trim *all* the tax preferences – starting with the heretofore-sacrosanct mortgage interest deduction, and moving right down the line, to LIHTC and beyond.

2. Deficit standoff

The fiscal cliff is only the beginning of our adventures, which indeed are much more like a series of nasty rapids than a single Niagara Falls, because today's Federal government spends $3 for every $2 it takes in. To bring spending down, out will go anything that can be presented as a loophole, and that means:

- *The Alternative Minimum tax will continue expanding*. It's the ultimate 'do nothing' tax hike, and indeed, more than one third of the fiscal cliff, $220 billion, is due to the AMT alone.

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- *The Mortgage Interest Deduction will be cut …* especially for second homes, vacation homes, possibly investment properties, and possibly for loans above a certain size. This is hugely ironic: It will eventually dawn on both parties that the states suffering most from cutting the MID will be predominantly those that voted Democratic, so the politics and the economics of this issue will be at odds with one another.
- *… Savings from cutting the MID will not go into housing*. Whatever they may be, they'll be used to cut the deficit, because, sad to relate, in the Big Picture, we're invisible.
- *The capital markets will remain risk-averse*. If you were the CEO of a large US company, would you make a bet that, having survived the fiscal rapids, you will be in smooth water thereafter? A political stump speech about making corporations pay their 'fair share' is a gift that self-renews for at least the next two years.

What to plan for. Figure on:

- LIHTC price declines. Actually, LIHTC prices appear already in decline; the so-called 'economic investors' are largely gone now, and only those with an ongoing CRA appetite will need to buy credits. Low interest rates will be the main source of LIHTC price support.
- New Markets Tax Credits expiration. Reauthorization is sailing totally against the wind.
- Carbon taxes. I've written about this before. Direct or indirect, it's taxable, so it will be taxed.

3. State 'shadow bankruptcy'

If US states were corporations, virtually none of them would be able to secure clean opinion letters from their auditors; all would have red-flag 'going concern' warnings.

This would have come as a shock to their founders, who wrote into their state constitutions requirements for budget-balancing, but if the last decade taught us nothing, it revealed all the myriad ways we can keep liabilities off-balance-sheet and perform on-balance-sheet flummery with assumptions about investment yields (high!) and actuarial obligations (low!).

When it comes to unfunded state pension liabilities, for example, the *least* insolvent (North Carolina) has a 37% shortfall (that is, 63¢ on hand for every dollar of net present liability); the most insolvent (Illinois) is 72% underfunded, a number that beggars the imagination.
All this was disguised for the last couple of years, as the Federal ARRA legislation gave the states over $150 billion of Federal money, which bought them three years to take decisive action (which most did not). Now that subsidy is done. Bills are due that states cannot pay.

Nor do the insolvent states have a revenue tap they can easily turn. California, New Jersey, Rhode Island, Illinois, Arizona and Connecticut are all in parlous situations, and of these only Arizona has any intermediate-term prospects for improved revenues (as its foreclosure-battered economy recovers). The other states have already taxed their citizens to the point of revenue counter-productivity: for instance, if you're a higher-income resident of Hawaii, New York, or California, the governments (federal and state) combine to take more than 50% of your marginal income dollar.

Under current law, states cannot actually go bankrupt, and it will literally take an act of Congress for that to happen. However, states can enter the netherworld of shadow bankruptcy in several ways: they can run out of money (as California did a few years back when it briefly issued IOU's to pay its bills), or they can default on their obligations (as Mississippi did in the 1840s, in precedents that are still not overturned 170 years later).

What to plan for. Broke entities do desperate things, and too many states are broke. So plan on:

- *Sales taxes up and excise taxes up*. They will be packaged or justified as 'user fees,' with glossy studies trotted out as required, but you can expect that anything a state provides will cost the taxpayer something more in 2013 than it did in 2012.

- *Marijuana legalized and taxed*. Whether with the fig-leaf of 'medical marijuana' (which can be described for anxiety and depression, a prescription that should be available to anyone who finishes reading this *State of the Market*), as Massachusetts just did, or legalized outright (as Colorado and Washington did), legalizing marijuana gets a state a new revenue source, new sales taxes, and licensing fees galore.
- *State-level soft-money programs dry up*. They'll be too visible to allow unscathed while public-employee pensions are being cut.

4. Municipal bankruptcies

While states can't go bankrupt, cities and counties can, via Chapter 9 of the bankruptcy code. Until three years ago, we thought they wouldn't. Now Prichard AL, Vallejo, Stockton, San Bernardino, Scranton, Jefferson County AL, and Central Falls RI, have all passed into their own undiscovered country, mainly to break public-sector employee pension obligations. (Harrisburg PA and Hamtramck MI both filed, but had their filings opposed by their states; the situation is in flux and in any case they're both insolvent.) Chicago, Paterson NJ, Camden NJ, and Joliet IL, are severely wounded, with filings imminent.

As with states, insolvency breeds political radicalism. San Bernardino is suing Calpers, the city's pension advisor/ manager and also its largest creditor. Camden is laying off half its police force and hiring contractors as a means of cutting unionized costs. Detroit has stated it will stop maintaining streetlights in some neighborhoods.

What to plan for. Though the cities will be pleading for state-level support via revenue-sharing or otherwise, few states will help them, because the broke cities are mainly in broke states. With balanced-budget requirements are even more stringent than states, cities will be scraping revenue wherever they can, and that includes:

- *Challenges to real estate tax abatement agreements*. While housing advocates like tax abatements, county and city assessors hate them. If you have a tax abatement, be prepared to defend it. Old documents will be scrutinized to see if in fact that syndicated LIHTC partnership with a non-profit as minority general partner really meets the statutory definition of 'non-profit affordable housing.'
- *Infrastructure water/ sewer costs up*, both in capital charges and ongoing rates.
- *Disappearance of new soft debt*. Unless it's use-it-or-lose it (as in HOME or CDBG), cities will no longer be handing out soft debt as an affordable housing gap-filling source.
- *Higher commuting costs*. Whether in public-transportation costs or gas taxes (and throw in higher parking charges), getting from home to work and back will cost more. This hits and hurts housing affordability, because as a general matter, people pay 60% of household income for the combination of housing and transportation, so when one goes up in the household budget, the other has to go down. That will further push up the location premium – proximity to employment centers and transportation nodes will translate into higher rent and home prices.
- *New local taxes*. Everything from taxi rates to hotel occupancy charges and city sales taxes will be going up.
- *Significantly lower new affordable housing production*. We're going to be building few affordable apartments, with shallower affordability levels.

- *Price declines in development land* as the market readjusts to the higher local costs.

5. Capital flying into America

For all our economic slowdown, America is still the destination of choice for people's children (especially their education), people's career development, and people's safe-haven capital. Then too, currency weakness and recession (the Eurozone), high taxation (France's 75% top bracket), capital controls (China), and political instability (South America, the Middle East, and much of Africa) are all creating anxiety among the world's wealthier and more successful people, and when it comes to capital, few asset classes are more appealing than US residential property.

What to plan for. About the only thing that won't be expensive is money: it'll stay cheap.

- *Continuing foreign interest in US real estate*. Foreigners will keep buying high-end properties in America's gateway cities – the ones everyone knows without asking which state they're in.
- *More price discrimination by location and trophy-dom*. Real estate investment from abroad always starts at the top and works its way downward.
- *Low interest rates for a few years*. We won't reach the stage of Switzerland, whose banks have announced they will pay negative interest on large deposits, but we'll still have the cheapest capital around … for a while. So borrow long while you still can.

Conclusion

Those who crafted the fiscal cliff compromise outfoxed themselves with their cleverness: an election that many hoped would bring clarity to American economic policy ended with a refresh of the status quo, the one outcome that neither party wanted. Now that it is here, what lies beyond is undiscovered country, and after each horizon is passed, another one will loom. This is a great time to own apartments, a difficult time to develop them, and a bad time to own pre-development land.

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