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The Next Real Estate Shoe to Drop

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Falling prices and rising delinquency rates on loans -- sounds like we're about to talk about home mortgages and residential real estate, right? Wrong. The area to watch now is commercial real estate where falling prices and rising delinquencies are the story that many banks are trying to keep under wraps. See these two eye-opening charts from Bob Prechter's recent *Elliott Wave Theorist*, in which he discusses why this trend of commercial loans going bad is only just beginning.

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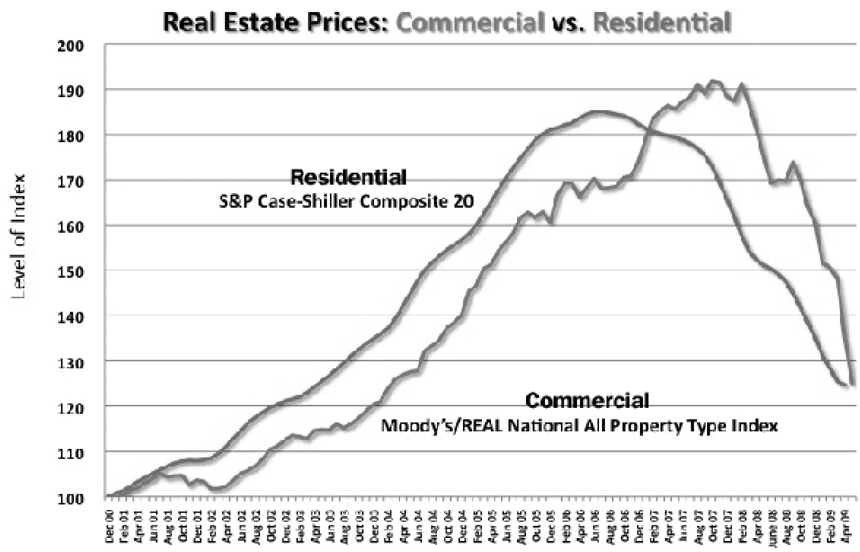
Excerpted from The Elliott Wave Theorist, by Robert Prechter, published September 15, 2009

Real Estate and the Comeback Fantasy

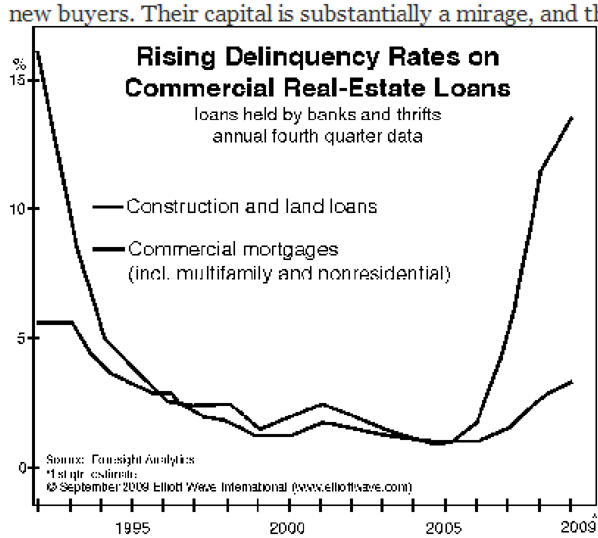
I had the good fortune of starting on Wall Street under the auspices of Robert J. Farrell, head of the Merrill Lynch Market Analysis Department. One of Bob's great nuggets of wisdom was the observation that stocks enjoying inordinate focus at the end of one cycle will tend to underperform significantly in the next cycle. His prime example at the time was the famous "Nifty Fifty" "growth stocks," to which institutional investors directed their attention in 1970-1973. When the stock market overall ended its bear market in the fourth quarter of 1974, the Nifty Fifty had fallen substantially from their highs, and many investors continued to hold them under the belief that they would come roaring back. But they underperformed most other groups of stocks throughout the rest of the 1970s and into the 1980s as the S&P and secondary indexes moved up. Investors in these big-name stocks were stuck in so many shares they wanted to sell that they created an "overhang" that kept prices dampened for years after their glory days ended in 1973....

Like the investors in Nifty-Fifty shares in the mid and late 1970s, investors in residential real estate now think that the old upside excitement will return. But it won't, and before the final long, drawn-out, exhausting bottom arrives, they will be selling out for 10 cents or less on peak-value dollars.

Meanwhile, commercial real estate is not attracting buyers at all. On the contrary, after levitating for two years through 2007, prices are finally catching up to the residential market, as you can see in Figure 11. According to a recent report in Bloomberg (8/18), "Manhattan office sales came to a near standstill in the first half, with less than one-tenth the average number of transactions seen during the same period in the previous five years....Three office buildings valued at more than $30 million sold from January to June, down from an average of 32 in the first six months of the prior five years."....



Despite bankers' desperate attempts to keep their borrowers afloat, the default rate on commercial property is rising, as shown in Figure 12. Most people think this situation is bad for banks, and they're right. But consider also how bad it is for prospects for new mortgage lending and therefore, ultimately, for real estate prices. With collateral melting before their eyes, bankers are losing the wherewithal to lend to new buyers. Their capital is substantially a mirage, and they know it.



The continued selling in commercial real estate today can be considered a technical "non-confirmation" of the recent buying in the residential market. When only one sector rallies, it's a bad sign for the market as a whole.

Conquer the Crash made this forecast:

> In a depression, buyers just go away. Mom and Pop move in with the kids, or the kids move in with Mom and Pop. People start living in their offices or moving their offices into their living quarters. Businesses close down. In time, there is a massive glut of real estate. (p.151)

This is exactly what is happening. Here is a recent report:

> Eighty-eight percent of property owners who participated in a recent Rent.com survey said that job losses are contributing to vacancy rates. Fifty percent said would-be tenants can't afford rent or are trying to save, and 45% said that the trend of more people doubling up with roommates is causing units to sit vacant. (MarketWatch, 8/13)

This trend is not temporary. It is only beginning.