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AHEAD OF THE TAPE

Chapter II: A Commercial Real-Estate Bust

 By **SCOTT PATTERSON**
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Investors are hoping the subprime-mortgage debacle will be a bad memory by the year's second half. Instead, they might have another mess to sort out in commercial real estate. If it were a movie, it might be called "Subprime II: Monster in Your Mall."

Work on everything from new malls to office parks helped to carry the construction industry as housing crumbled. While residential construction spending was down 20% in December from a year earlier, nonresidential construction was up 20%, according to the Census Bureau.



But clouds are forming over the sector. Commercial real estate probably didn't get as overheated as housing in this boom, but tight credit and a slowing economy are squeezing the sector.


The Federal Reserve's latest survey of senior loan officers showed 80% of domestic banks tightened lending standards on commercial real-estate loans in the past three months -- the highest level since the question was first asked in 1990.

"Mom and dad aren't buying the homes surrounding new commercial developments, so there's nobody to buy goods and services at those developments," says Jim McKillop, president of Independent Bankers' Bank of Florida.

In January, no commercial mortgage-backed securities -- pools of commercial real-estate loans -- were issued. That's the first time that's happened since October 1990, says Commercial Mortgage Alert, a newsletter.

Since the start of the year, the cost of protection against default on a basket of CMBS originated in 2005 and early 2006 has more than tripled, according to Markit Group's CMBX index.

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Goldman Sachs says the turning credit cycle could drive losses in commercial real-estate loans up to \$183 billion, compared with \$211 billion on subprime loans, and commercial real-estate prices could fall as much as 26%. While banks have recognized 91% of subprime losses, Goldman says they've come clean on only 17% of expected commercial real-estate losses.

This causes troubling feedback for the economy. Nonresidential building last year added a little less than half a percentage point to economic growth, and cushioned the decline in construction employment. If commercial construction stumbles, that cushion is gone.

Picking Market Bottoms With History as a Guide

It would be hard to dismiss the heightened risk of recession these days. What's less clear is whether financial markets, despite all of their woes of late, have fully priced it in.

Financials, home builders and retailers have tanked, but the broader stock market hasn't suffered as much as it has in the past in periods surrounding recessions. The S&P 500 is off 14.6% from its October peak. Since World War II, on average, the index has fallen 26% from its peak around the time of a recession. If history were bound to repeat itself, one might surmise the S&P needs to sink to about 1158 to fully price in a recession. It closed yesterday at 1336.91.

Of course, market downturns come in great variety. The 1990-91 recession, to which the current episode is often compared, resulted in an S&P decline of less than 20%. If this turns out to be a brief and mild recession or a midcycle slowdown, then the S&P's recent bottom of Jan. 22, which represented an 18.5% tumble from its peak, might have been the worst of it.

--Mark Gongloff

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