SEPTEMBER 11TH: THE AFTERMATH (Newsletter Summer 2001)

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The economic effects of September 11th on this region, pale into insignificance when measured against the pain suffered by those personally effected by the terrorist attacks in New York, Washington and rural Pennsylvania. But, coupled with the recession and the all too recent memory of the 1990 property meltdown, they do raise the spectre of the latter again. How real is that possibility?

The effect of the terrorist attacks in the United States was felt immediately in Atlantic Canada as air traffic destined for American airspace was diverted to airports around the region. The second wave occurred shortly thereafter as cross border traffic slowed to a crawl impeding exports; as cruise ship passengers cancelled trips during the busy Fall season; as tourists stayed at home; and as the airline industry struggled to adjust to the new reality. We are now experiencing the third wave as industries not directly impacted by the cutbacks in air travel, tourism and cross border trade, experience the knock-on effect. Businesses have placed expansion plans on hold and some have started to lay off staff. Some of this decline in economic activity was coming anyway, but the events of September 11th have escalated the downturn and will deepen it. The anthrax contamination in the United States continues to dampen economic activity in this region too, often to the point of absurdity. Buildings in Halifax have been evacuated because of dust on a civil servant's computer keyboard, in a workman's boot, on a laundry room floor. Are we now facing economic Armageddon? We think not. Indeed we venture to suggest that such unremarkable events as dusty civil servants, dirty boots and soapy floors will shortly command little attention. What will endure is the jolt to the economy as the economic downturn continues.

Economists, ever accommodating, offer us two scenarios for the American (and hence the Canadian) economy: (1) a short V shaped recession lasting through the third and fourth quarters of this year, followed by a relatively flat first quarter in 2002 and then a strong recovery (3% - 4%) in the second half of the year or, (2) a recession which is deeper and more prolonged. Arguments in favour of the former are based on the fact that inventories have already been cut back, oil prices are falling, monetary and fiscal policy has been loosened. The counter arguments are that there is substantial overcapacity world-wide, the entire world is in recession, people save instead of spending in times of uncertainty so monetary and fiscal policy is ineffective. It would perhaps, be prudent to hope for the best and prepare for the worst.

Property déjà-vu

Is the 1990 market meltdown about to repeat itself? We believe not. A collapse in property values is due to (1) a sharp fall in demand, or (2) a rapid increase in supply, or (3) both of the foregoing. The Wharton School, University of Pennsylvania research paper on the subject (Newsletter Vol. 2 Nos. 65, 66, 67) discovered that the property crisis of a decade ago was due to a rapid increase in supply fuelled by easy credit from a banking system, which continued long after rising vacancy rates should have signalled an over expansion. There has been only modest expansion in the hotel, industrial and office markets in the Atlantic Region during the past ten years and prior to September 11th, occupancy rates were high. The apartment market has expanded due to financing guarantees by CMHC, but vacancy rates are generally low. The retail sector has expanded, particularly big box retailers which have taken trade from Community Shopping Centres. During the early 1990's pension funds and insurance companies divested themselves of real estate, financing dried up and the lack of liquidity reduced demand, further exacerbating the situation. In the late 1990's the Real Estate Investment Trusts (REITs) injected some badly needed liquidity into the markets and pension funds returned as purchasers. Market rents and room rates have recovered the ground they lost and are close to, or above, 1989 levels. In addition mortgage money is available at figures not seen since 1960 and may go lower. Inflation is falling world-wide and is expected to continue given that American industrial capacity utilisation is 75.5%, its lowest since 1983. The danger is that nominal GDP growth in the G7 economies could fall to 1% early next year at which point monetary policy becomes an ineffective tool for boosting growth and we may slip into deflation. Interesting times. Fools rush in where angels fear to tread. These are our predictions:

1. Hotels and motels are the most vulnerable market and have been hit during the busy fall season. Property values will fall as investors discount revenue per available room (RevPAR) over the next 24 months and demand higher return on investment (ROI) to compensate for the extra risk.

2. Retail, particularly Community Shopping Centres will fall in value as shoppers focus on big box retailers during the economic downturn.

3. The industrial markets will generally hold their value. Some specialist types of industrial property such as airport facilities will experience declines in value.

4. The office markets will hold their own but rental growth will be flat for the next 24 months. Trophy buildings will no longer be able to claim the same rental premium and rents will soften slightly.

5. Apartment rents will be flat for the next 24 months but demand for apartment buildings will increase and prices will rise as purchasers take advantage of low mortgage rates to leverage their return on equity.

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