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EDITORIAL by Geoffrey Dohrmann

Hope Springs Eternal, Despite Economy

Just in case you haven't been paying attention, there do appear to be some signs of weakening in the economy on the horizon. Consumer debt service payments as a percent of disposable personal income have risen from a low of 6 percent in 1992 to well above 7.5 percent since 1997, and continue to rise. Consumer spending, while robust, has moved almost in lockstep since 1972 with the movements in the Nasdaq.

Apparently spending increases today only when people feel wealthier. And despite occasional recoveries in what has proven to be an almost frighteningly volatile market, Nasdaq has been more down than up since the middle of 2000, which means consumers haven't felt wealthier for a while.

Meanwhile, profits of non-financial corporations as a share of output have fallen since they peaked in late 1997, diminished in part by slowing sales growth but also by rising wages and by rising costs of facilities, energy, transportation, lodging and occupancy. (After all, real estate's good news of continually rising rents spells bad news for tenants.)

These rising costs are not yet fully reflected in the inflation indices, but they're beginning to be. They're certainly beginning to be felt in the credit markets, where defaults on "B" and "BB" paper are at 1991 levels. Most economists expect those default rates to rise.

Yet hope springs eternal in investor land, where, despite overfunded allocations to venture capital and private equity, money continues to flow. More than $57 billion was raised by venture capitalists in 1999 on the strength of posting a whopping 149 percent IRR for the year. That's an unprecedented amount of capital; billion dollar funds — now common — were all but unheard of when we entered the previous decade.

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The mode of investing has changed dramatically too. In the early part of the decade, and throughout most of the history of venture capital, venture capitalists made relatively small early- or late-stage investments in fairly tiny but promising growth companies. With few exceptions, the expectation was that capitalists would work side by side with entrepreneurs for six to seven years to create an enterprise of lasting value that would be worthy of spinning out to the public markets at high multiples.

Ever since Netscape went public in 1995, however, the model has changed to one of funding startups as pure financial plays, with the expectation of unloading far from profitable companies onto the hot, hot technology and Internet-focused IPO markets of the mid- to late-1990s. Unfortunately, the IPO window slammed shut in 2000, dropping from a peak of 150 IPOs completed in May to

Continued on page 24

Editorial

Continued from page 3

fewer than 20 completed in September — an 86 percent decline in activity. And with the IPO window shut, the promise of many of these new high-tech companies is proving to be as false as that of a gender illusionist.

Even if the "tech wreck" currently under way has no impact on the economy, the four largest costs of running a business are all moving up — real wages and benefits, facilities, energy/transportation and technology.

Real interest rates also are relatively high, and if the economy doesn't cool down, they almost certainly will continue to move up for a while.

There is a bright spot, however. The Asian fusion reactor appears to be humming again, and if the growth rates of the past should reappear, it just might be enough to keep the engine in our own economy spinning.

Meanwhile, however, U.S. lenders are tightening — nearly 35 percent of large bank lenders are demanding tougher terms for large borrowers; nearly 25 percent report tougher terms for smaller borrowers. FDIC reports are sending up red flags about potential trouble brewing in several targeted real estate markets, where regulators believe pipelines could drive property markets into an overbuilt state if the flow of funds to new development is not stemmed by lenders.

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All of this boils down to a cooling off of our red-hot economy. According to the National Association of Realtors (NAR), while real GDP growth was more than 4 percent in 2000, this is expected to moderate to 3.3 percent in 2001, eventually creeping back up to 3.5 percent by 2002. Nothing catastrophic here, unless investors panic.

But NAR also is concerned about several potential threats that have wormed their way into the economy — higher oil prices, a possible stock market correction, unforeseen international problems, a potential credit crunch should the Fed tighten too quickly or too severely, and tight labor markets.

So be careful. Be very, very careful out there. As always, it's a whacky world. ❖

Geoffrey Dohrmann is publisher and editor-in-chief of **Institutional Real Estate, Inc.**

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