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Fed Rate Cut: Disaster Averted Or Simply Delayed?

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Tuesday's half-percentage point interest rate cut sparked a sizeable rally that drove the Dow Jones Industrial Average up by 335.97 points. And in the embattled credit markets, pricing for the riskiest bonds roundly shot up as bankers exploited the interest rate cut to refinance debt or sell junk bonds.

It's tough to deny that the Fed breathed some life back into the equity and debt markets yesterday. But apart from this market surge, what should commercial real estate investors really expect this steep rate cut to accomplish on a longer-term basis?

To be sure, many skeptics doubt that yesterday's rate reduction will ultimately win over investors who have largely shunned both the commercial mortgage-backed security (CMBS) and commercial real estate collateralized debt obligation (CDO) markets in recent months. Two thorny issues — the challenge of unwinding complex debt instruments while boosting investor confidence — may stand in the way of any longer-term benefit from the Fed's latest effort.

"Securitization allowed risk to be sliced and diced. Then the banks simply unloaded the credit risk onto investors after deluging them with structured products," said John Plender, senior editorial writer and columnist at the Financial Times.

Plender, who also serves as chairman of British-based property firm Quintain, addressed the Association of Foreign Investors in Real Estate (AFIRE) fall conference in Washington, D.C. earlier this week. The conference drew more than 200 of the largest offshore investors in U.S. commercial real estate.

"We'll get the rate cut this week," he projected, "but there are so many ironies here: Greenspan and others welcomed innovation in the securitization market because they felt it would reduce the risk of a systemic shock. We ended up with a rip-roaring credit bubble."

As Plender noted, carefree borrowing terms and complex innovations such as commercial real estate CDOs actually did little to diversify risk. While these vehicles "generated fantastic fee incomes" for the bankers issuing them, the overall credit quality of these instruments was deplorable.

Plender expects some demand to return for securitized real estate debt. But he was quick to add that the riskiest and most complex debt products will be challenged to find buyers amid such a "freakish economic cycle."

"The degree of disillusionment with more exotic products may not come back at all," he said. "We've never had a crisis like this where we've had so much trouble just determining where the problems are."

Aside from the confusion of unwinding such complex financial instruments, much of the underlying problem is also widespread fear of any leveraged investment. That's why Richard Moody, chief economist and research director at apartment investment firm Mission Residential, wrote in a recent report that a lower fed funds rate may not be the cure-all that many believe it to be.

"Neither the price of credit nor the availability of credit is the issue. What we are facing now is more a crisis of confidence taking place amidst a badly needed and long overdue repricing of risk in the credit markets," writes Moody.

So what measures — aside from a strong tranquilizer — will calm the global credit markets? Moody of Mission Residential may not have the answer, but he's not convinced it's the lower interest rates that triggered the bubble to begin with. "The remedies to the excesses seen in housing and credit markets in recent years lie beyond the reach of the Fed . . . no matter how low they take the Fed funds rate."