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Howard Kline: Welcome everybody to CRE Radio and TV. This is an audio only podcast. Today, we're going to be talking about the Federal Reserve board who recently increased interest rates and my special guests is David Pascale. He's the senior vice president of George Smith Partners. David, welcome to the show.

David Pascale: Hello. Thanks for having me. I'm glad to be here.

Howard Kline: It's great. Glad to have you. I've been following you for quite some time and I'm really grateful that you're going to explain what just happened with the interest rates. Now, I understand that this is Janet Yellen's last board meeting as the … She's the chairman or chairwoman of the Federal Reserve board and-

David Pascale: That's right.

Howard Kline: … they recently, today, increased the federal interest rate that they charge to banks. Why don't you tell us what they did and then maybe talk a little bit about what the factors were that they considered?

David Pascale: The Federal Reserve has control of the short-term interest rate, the overnight rate that they charge to banks and that interest rate was put at basically zero percent in the wake of the financial crisis in 2008 and remained so all the way until December 2015 when they raised that rate a quarter percent and they felt that the time was right to start raising rates which is a twofold issue. One is it shows confidence in the economy that it doesn't need the ultra low accommodative policy of, like I said, the ultra low rates and it also is meant to show that they're trying to rein in inflation.

They then raised the rate one more time in 2016 and they raise it three times in 2017. Right now the rate stands at 1.5% because every time they raise it, they raise it a quarter percent. There have been five raises which is 1.5% worth of rate

raises and so we're now at a 1.5% on what they call the overnight rate. What's interesting is how it affects the ten year treasury which is, in our business which is where most of our loans are priced off of and, also how it affects LIBOR which is how many of the floating rate loans are priced off of and I would add that the ten year is for fixed rate loans and it is the standard term and index for fixed rate lending.

The fed rate absolutely affects LIBOR. LIBOR virtually moves in lockstep with the fed in normal conditions outside of a credit crisis and we've seen LIBOR move pretty much in lockstep. Sometimes it moves a little in anticipation of the move like today's move was highly telegraphed and the ten year treasury is more a prediction of where the markets think growth and inflation are going in the future. In fact the ten year actually dropped a little bit today from 2.40% to 2.34%

Howard Kline: Now, what does that all mean to someone who owns commercial real property or even someone who's looking to buy a home?

David Pascale: The long-term rates which affects most home mortgages because most home mortgages are fixed these days and stabilized properties are … Most of those borrowers watching the ten year treasury. Interestingly, the two year treasury moves more rapidly. It reacts more rapidly to the fed move. What the fed is also watching is where inflation is and where growth is. Also there's supply and demand dynamics with the treasury as far as how big our deficits are.

That doesn't seem to … I'll do a quick side here. The markets don't seem to be that concerned about the deficits and a lot of that has to do with the relative yield of a ten year treasury as opposed to a German bond or European bonds of the strong countries out there that are trading at much lower yields. I'll just leave that for a future podcast. We could talk more about that.

Howard Kline: Let me ask you this question. Let's say I'm looking to spend $20 million dollars to buy an income producing property. How might this affect me?

David Pascale: As of now, if you're buying a property that is stabilized, you're probably going to put ten year financing on it. It could be Fannie Mae, Freddie Mac. It could be a CMBS loan which is what we call a conduit loan or even a fixed rate bank loan. That index is tied more to inflation and inflation expectations. Today, it has been trading in a very tight range for months probably between about 220 and 240 and today it sits at 234 average spreads are maybe 200 over so call it 430 on a 10 year loan rate. That would be your rate on a ten year loan today and maybe a little lower in the 4% range for lower leverage and high quality.

Maybe a little higher for some higher leverage and maybe some lower quality stuff so you might be in the 450 range with a 30-year amortization. Going back to why the Fed is so concerned about inflation and watching it so closely is because the big fear that all central bankers have is deflation and so when inflation is very low, the feds preferred inflation target right now is about 1.4 to 1.6% annually.

That's called the personal consumption index and they … Because if we get into a deflation or a spiral, prices drop and people don't buy things on it because they believe that the price will drop more and our consumer based economy could go into a crisis and it's called the deflationary spiral.

The banks are very weary of keeping rates low enough to avoid deflation. Europe became very close to deflation in the last few years with some of their issues and their central bank has engaged in some very accommodative bond buying et cetera. The United States index was at one … During the early years of the recovery, sometimes hovered in the 1% range and there was some concern about deflation so that is why the fed wants inflation. Of course like you were saying, Howard is back in the '80s inflation was rampant and a complete nightmare where they hit, 15, 16, 17%.

Howard Kline: That whole bottom line is if there's inflation then your dollar doesn't buy as much.

David Pascale: Right. If there is price inflation and no wage inflation, then the standard or living for the average consumer citizen in America is in danger and the fed's mandate … This is something important to keep in mind. The fed's mandate is to keep economic conditions favorable to the average American and that is really something I believe Yellen was very, very clear on because her preferred gauge of prices was wage inflation and the lack of wage inflation over the past few years has really almost not bedeviled here but it has concerned her very much because the fed believes their mandate is to raise … Keep our economy strong but also make sure that the quality of life for the average American is getting better.

Now, why aren't wages increasing? A lot of it has to do with technology, aging workforce, demographic trends and the decreasing influence of trade unions that we remember were so powerful in the '70s and '80s and they've lost their way. The new economy is very much a gig economy and with companies having trouble raising prices on their goods we're not seeing a lot of wage inflation. When wage inflation does tick up, you will definitely see the fed move quickly maybe quicker than we have seen before on rates.

Howard Kline: Yes. One of the things that she was talking about was she had indicated that the job market remains strong and they anticipated to remain strong for years ahead but for wages was just going to be a modest upward crasher. What did she mean by that?

David Pascale: What she means is that we're … The issue that she's talking about is really interesting because people her age, maybe my age remember that the old model was when employment was full and full employment is considered a 4% unemployment rate. When you're at a 3% unemployment rate, it's almost overheated because there's always a group that is not in the workforce or not efficiently searching for jobs. In the old days, when there was that much employment, supply demand dynamics would take over and wages would start to shoot up.

In this case, the fed has kept rates low. Employment is at a maximum at 4.1, 4.0 by some measures and wages are stubbornly flat. It shows what we are in, what a … One of the great thinkers or our time, a gentleman by the name of Muhammad El-Erian who now works for Allianz and was PIMCO's chief strategist for many years and he's on Bloomberg and CNBC all the time. He has actually talked about it as a future fed governor himself. He has called our post crisis economy as the new normal where the old rules don't apply.

What some analyst are talking about, in fact I saw a JP Morgan report today that was fascinating is that the fed is concentrating on the wrong thing. Instead of watching for wage inflation and waiting to raise rates when wages go up, they should be watching asset inflation which is bubble danger in housing, treasury, corporate bonds, stocks, equities, et cetera, but the old school thinking of the fed is they don’t want to raise rates too quickly and nip wage inflation in the butt.

Howard Kline: The way I perceive the way that the fed act is that they are looking for modest changes. They're looking for balance, nothing too drastic because that affects people's lives a little bit too much so I think that's the way that they look at it.

David Pascale: They raise rates three times this year and what's an interesting … What you're talking about is what a lot of people call the Goldilocks effect, not too hot and not too cold. You don't want to overheat the economy and you don't want to stop the economy. There's always many opinions out there, as I said that some people think that assets are becoming overheated and the feds should move quicker. Some say that the feds shouldn't move at all.

In fact, two governors today including Kashkari who's a gaming theorist and a real forward thinker. He actually worked some of the models on the tarp for the tarp legislation 2008. He was a protégée of Tim Geithner. They voted for no increase today so they wanted to see wages move up a little. The question is where are we going? Where we're going is in the new normal is what's the neutral rate. That's what the term is. Yellen has said that the neutral rate is about 2.75 to 2.8.

Now, keep in mind couple of years ago, they thought that the neutral rate was 3.25 meaning that that's where they're headed to and going above that would be foolish of course unless we saw rapid inflation and they would go above that. What does that mean? We're predicting four or five more increases and they have said that there's maybe three increases untapped for 2018 and the markets, the future's markets think there are two. Then they think maybe two or three the following year and we'll see at that point the neutral rate is the ultimate Goldilocks moment.

That's when the fed will say, "We're at where we should be after the crisis." A lot of it is learning what the lasting effects of the crisis are and to digress a little bit but to talk about something that everyone in our audience knows who orders from Amazon out there, everyone. I'm sure that you know my son is 12 years old. He knows how to order from Amazon, of course using my account. 40 cents of

every dollar online shopping goes to Amazon. Amazon has one of the most sophisticated pricing systems out there and they will undercut brick and mortar stores in order to grow their business effectively.

Again, guys my age and I'll say how old I am, I'm 58 years old, I remember my dad or my mom looking in the newspaper and comparing prices and I remember my dad buying tires and driving the one store and then driving to the other store and asking the price. You think about how inefficient that was. Now, people are seeing … There are price programs on every one smartphone. Why do I bring this up? It is holding down inflation. Manufacturers, sellers, do not have the pricing power that they did.

This Amazon effect is keeping inflation down. There's no doubt about that and central bankers that were raised and when these people went to college in the '70s or '60s at the University of Chicago or some of the great thinkers are rethinking the model now, what do we do? When if ever will these manufacturers be able to raise prices? Not only is it the Amazon effect but there's so many goods and services providers know that people have access to and of course when you grew up in a regular town in America, maybe there was six department stores within driving distance. It's now a thousand within online distance. There's a lot of changes, technology based that are affecting inflation and central bank policy.

Howard Kline: Let me ask another question because someone asked her a question about tax policy. Within just the last hour-and-a-half, two hours maximum, it was announced that both the senate and house had come to putting much an agreement on a tax proposal where they worked out their differences and Janet Yellen was asked a question about how tax policy is going to affect the federal funds rate. Her statement was that at this point in time, it's highly uncertain what the tax policy will have on the economy. Do you have any comments with regard to that and how any of that may … I don't think you need to know specifically what the terms of the tax bill will be other than the fact that there is some concern that the tax policy will have an effect on the economy.

David Pascale: Yes. It's a very large bill and it affects all swaths of the economy. For example, you're going to have big corporate tax cuts. What are corporations going to do with that money? It really comes down to some existential questions like how does tax policy affect corporate behavior and an individual behavior. People aren't robots that you can just move a lever and watch in and everyone does this.

Different companies might repatriate overseas money and they might do stock buybacks. Some might invest in robots. That's not going to help the average Joe, if I can use that term the average person but some might hire more and some might raise wages. That's what the hope is and so it might have some stimulative effects and so we're looking for those effects. On a side note, we noticed there was some issues with California, New York and New Jersey and this is very important where there was going to be less deductions for state and local taxes.

The battle effect to bottom line spendable income of a lot of the higher earners in the country and nobody said these named three states but California has about a 10th of the entire country's population when you add New York and New Jersey and I don't have the numbers in front of me. It's a significant amount of the population, a significant amount of the high earners and a lot of the drivers of our economy so we're watching that and I heard that they just … I just noticed that they put in a $10,000 deduction over property taxes and income taxes combined to soften that blow.

Then what Janet Yellen, Chair Yellen, Fed Chair Yellen, that's we usually refer to her as, her official title, what she also noted is supply and demand of treasuries. Now, there's been a lot of controversy. Will this pay for itself, this tax cut using something called dynamic scoring and there is a consensus among the cold and the analytics that it will drive the deficit up about a trillion. There's some political … And I don't want to get into politics here but some of the tax cut champions are saying, "No. It'll be revenue neutral." We'll see. If it isn't and there's more treasuries being sold because of higher deficits, aging baby boomers, more Medicare dollars having to go out.

We always know the defense always goes up. We're talking about the three biggest pieces of the economy if I say social security Medicare defense, interest on the debt and if there's more treasuries out there, interest rates might go up, then you'll see the ten yearreally move up. All this is TBD, to be determined and it'll be very, very interesting. If inflation picks up because of this, you'll see them slow down the rate increases.

If inflation shoots way up, you might even see rate decreases. What I say in my column a lot that ever since the crisis, we're in uncharted territory. We've never seen an economy with zero percent rates worldwide for seven years and anemic growth compared to pre-crash of 1 to 2% worldwide. Our administration is now predicting 2.9 to 3% GDP for the next five years. Let's see how that goes.

Howard Kline: Interestingly enough and one of the questions that was asked of right at the end of the comment period was that there some people expecting or suggesting that there's going to be a 4% growth with the tax cuts and her comment was that that would be challenging to achieve. Do you have any comments on that?

David Pascale: I agree with her. 4% growth is not been seen since some of our heydays of the late '90s, one or two years and I don't have the stats in front of me but that's like … When we talk about the modern economy, we start with World War 2 as a defining moment, post-World War 2, that's when all the Roosevelt policy went into effect and the American economy really turned on. That was the … If you talk about the heyday, you call it 1946 to 1973 the great era of American expansion and infrastructure, there was some 4% growth then.

It would be very difficult to see that now in an era where we just, like I say, had a huge stimulus bond buying, zero percent rates, accommodative policy, tax cuts

still remaining from the Bush era and growth, GDP at 1.1, 1.5%. To see it go up to four would be amazing and I think it would be quite unexpected.

Howard Kline: One last question. If you had a crystal ball over the next two years, what do you expect?

David Pascale: I would expect my prediction to be, and maybe you and I will play this in two years, Howard, just we'll mark the day. Maybe we'll laugh, maybe we'll cry. I see two increases next year. I see not much wage inflation and maybe … I see growth rates, 2.2 to 2.4% at best. We don't know if there will be, as we always say a black swan event that like the Chinese [inaudible 00:29:10] crisis a couple of years ago.

I see pretty steady growth one or two fed increases per year and a theme of couple more years of what I call Goldilocks but I don't see any rapid growth or rapid inflation. I watch oil prices very closely and no one sees oil hitting $100 a barrel. There's just so much supply out there in changing dynamics in that market and I think it's a major component of inflation. That's what I see. I'm watching the end of LIBOR.

That would be another podcast as we're winding down LIBOR which by the way is the benchmark for a quarter quadrillion, that's about $300 trillion worth of derivatives out there and LIBOR is going to end in 2021 and we're going to transition over the next few years to some new benchmarks and it won't be a worldwide benchmark. I think this is a major crystal ball speculation that what will be the effect as we get to 2020 as Britain is going to have their own index called SONIA, the US is going to use a fed funds overnight rate. That will be interesting to watch.

Howard Kline: Right. We're going to have to wrap this up, David. Thank you very much. We will provide on our podcast how to get a hold of David at George Smith Partners.

David Pascale: Okay.

Howard Kline: Thank you very much. This is Howard Kline with CRE Radio and TV. Thank you very much, David.

David Pascale: Thank you, Howard.

Howard Kline: That's a wrap.

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