Real Estate Forefront

Emerging Developments in the NYC Marketplace, #10

New York City's Vicious Economic Cycle

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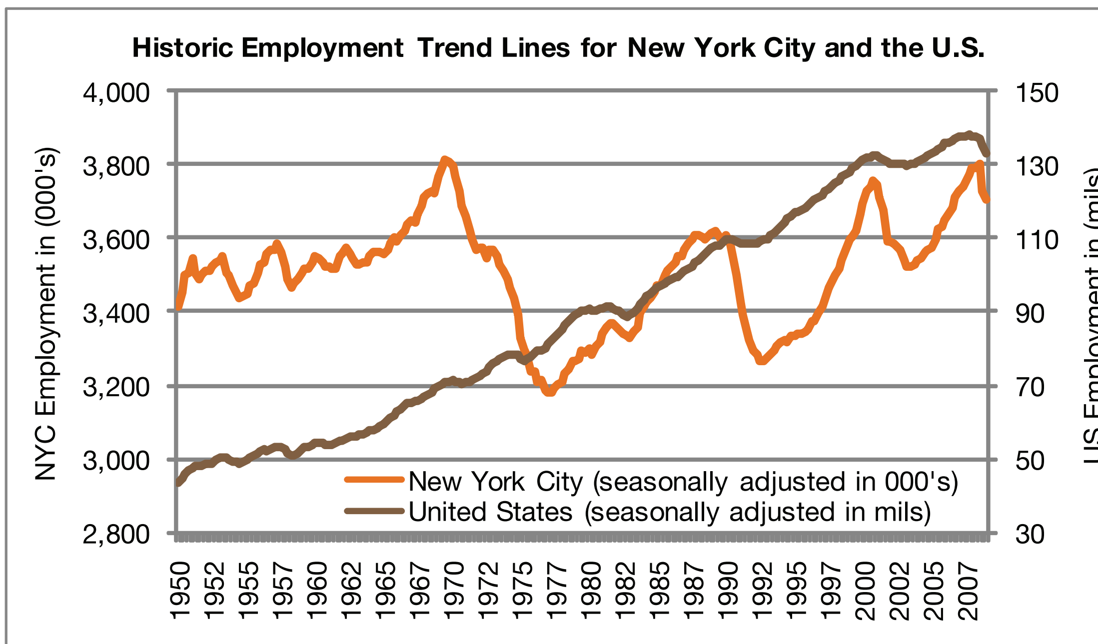
New York City's employment level last peaked in August 2008 with 3.81 million jobs, a level that nearly eclipsed the historic "high water mark," as the New York Times labeled it. That is, the jobs number climbed just shy of the historic peak level of employment. Some might guess that this historic peak was in 2000 at the end of the dotcom boom, but they would be wrong. Others might think the late 1980s produced the apex, it did not.

No, the peak employment level for New York City was in 1969. Yes, that is a six. Of course, much of the employment back then was in manufacturing (830,000 jobs vs. 82,000 today), and nearly half of that manufacturing employment was in the outer boroughs (vs. 57% in 2008). But this finding illustrates how cyclical New York City's economy has been over the last half-century.

Consider this: in the same 40-year period the United States employment base has nearly doubled from 71 million jobs to 133 million jobs. That is 62 million jobs, net, that were added elsewhere in the U.S.



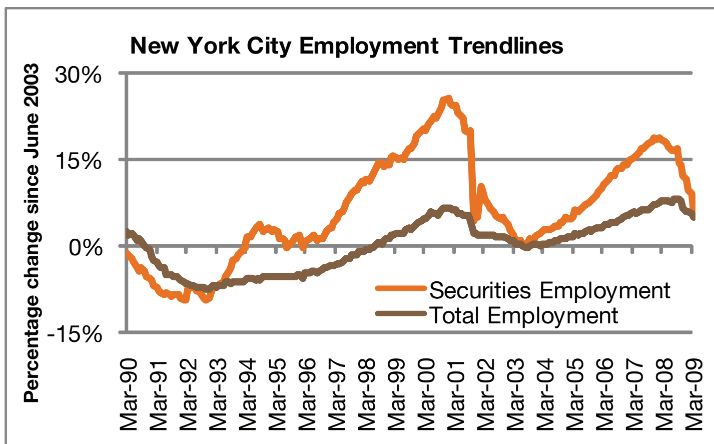
Source: Eastern Consolidated, NY State Department of Labor, Bureau of Labor Statistics

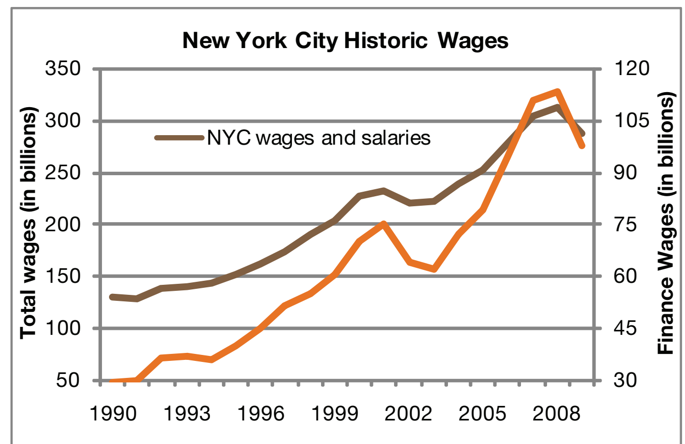
Those too young to remember the 1970s may be surprised to learn this, but the City lost 650,000 jobs from 1969 through 1977. That is eight years of deteriorating conditions. Another 400,000 jobs were lost from 1989 through 1992. The recession following the dotcom bust, amplified by 9/11, was relatively mild, taking out 230,000 jobs. This current recession has already removed 101,000 jobs and will likely strip another 100,000+ jobs which would put the job count at 3.6 million, the same that we had in mid 2005, 1999, early 1990, 1986 and 1971.

So why is New York City so cyclical, and will this cyclical pattern ever end? The answer to the first question is best answered by focusing on the last 25 years since the 1970s was hopefully an anomaly. But the second question is more complicated and truly subject to debate.

New York's economy is cyclical because the economy revolves around Wall Street and Wall Street is a volatile industry. Not only is the S&P 500 cyclical, but Wall Street firms hire and fire more frequently than most industries as shown below. Although the industry employs 5% of the City workers, Wall Street drives significant ancillary business for the accounting, legal and advertising industries not to mention real estate. These indirect business beneficiaries live and die by Wall Street's fortunes.

Moreover, Wall Street workers are paid significantly more than the average employee ($400,000 average salary in 2007 compared to $55,000 per annum outside of the industry) which makes them significant consumers in local restaurants, retail and, of course, real estate. Ironically, Wall Street pay is less volatile than Wall Street employment -- lucky for these employees, pay has been more on an upward trajectory for 20 years. But the local consumer-oriented industries in New York definitely suffer when Wall Street is down.





Source: Eastern Consolidated, NY State Department of Labor

So the answer to the first question at least narrows the discussion on the second question. Will the booms and busts on Wall Street end with the recent crisis, or will Wall Street invent something new to entice investors that not only earn them sizable fees but allow them to circumvent regulators? Or will regulators boost their efforts to stay in step with Wall Street?

The Obama administration recently announced new reporting requirements for derivatives trading, requiring all trades to go through a clearinghouse, giving this so-called shadow banking system more transparency. Derivatives, used effectively, are very good for hedging risk, but traders can also use derivatives to speculate on the direction of the market. When the market moves against the direction underwritten in the derivatives instrument, not only can the derivatives holder lose money but the instrument for which the derivative is written to insure stands to lose value as well creating systemic risk in the capital markets.[1]

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[1] AIG has been salvaged with $180 billion in capital infusions from the Treasury over a six-month period because institutions like Goldman Sachs have called on AIG to put up collateral to honor its $500 billion in credit default swaps for asset-backed securities (collateral debt obligations and mortgage backed securities) that had plummeted in value. Without these infusions, not only would AIG have failed but Goldman and many others would have suffered a critical loss in capital, beyond what they already had lost, and many may not have survived.

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Because the current flawed system for trading derivatives does not currently require any capital reserves, or "cushion" for bad trades as regular bank lending does, financial institutions have had no limits in how much they could issue, hold or trade in derivatives. This first step should go a long way in reducing rampant risk taking in the future but more needs to be done. Some suggestions include the following:

- Government regulators should extend reporting requirements to hedge funds.
- The Commodity Futures Trading Commission – the regulatory agency assigned to oversee the derivatives | market – should expand and reconcile all turf battles with the SEC.
- The Federal Reserve should keep tighter reins on interest rates and the money supply once the economy starts to grow to contain the growth in capital.

If these reforms are implemented than the cycles that we have lived with for 25 years could come to an end, but these tasks are herculean. Regulators will still have a hard time tracking off-market deals, and Wall Street is very clever. It will always find new ways to circumvent regulations and lending controls. It will always find new products that at first appear to hedge risk but ultimately lead to speculative activity, and it will always fund lobbyists to fight the toughest of legislation brewing in Washington.

We may be reassured in the coming months as new legislation evolves but nothing has changed in the last year that suggests that New York City's cyclical economy will ever end.

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FOR ADDITIONAL INFORMATION CONTACT:

Barbara Byrne Denham
Chief Economist
Eastern Consolidated
355 Lexington Avenue
New York, NY 10017
T: 646.658.7363
F: 212.499.7718
bdenham@easternconsolidated.com

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