July 14, 2022

The State of the Market and the State of the Art

James E. Bishop, J.D.

As we look forward, the possibility of a recession looms ominously and the Federal Reserve's latest indication of another rate hike by 50 to 100 basis points (with more to come) almost guarantees it. Is recession always bad news? As with most things, it depends on one's perspective and the direct impact.

WhiteStar is poised to help its clients weather these economic uncertainties in the months to come and to take advantage of opportunities that may arise in connection with an economic slowdown. The average length of recessions going back to 1857 has been less than 17.5 months. For the period since World War II, recessions have lasted an average of 11.1 months[1]. Each recession is different, and this one is different in that it is largely self-induced as opposed to being triggered by exogenous factors (think of the oil crisis of the early 1970s v. the gasoline crisis of today). Recessions are officially tracked and proclaimed by the Business Cycle Dating Committee of the National Bureau of Economic Research, an organization most people have never heard of, based on a dozen or so indicators that only an economist could love. In the real world, a recession generally is defined as two consecutive quarters of negative growth in the country's Gross Domestic Product or more bluntly, a period of substantial job losses and a painful decline in economic activity.

The groundwork for this inflation - recession cycle was laid with the lock-down of the economy upon the advent of the COVID pandemic and the Federal Reserve, together with the Federal Government, pushing over five

---

[1] Recession: 10 Facts You Must Know. Dan Burrows, John Waggoner, April 21, 2022

trillion dollars in the form of stimulus checks to millions of individuals and businesses in an economy that had no place to spend it. The classic definition of inflation is too much money chasing too few goods, a formula guaranteed to increase prices. There are two ways to check inflation: by increasing the supply of the desired goods or by dampening demand. For a variety of reasons, supply, particularly related to gasoline and diesel fuel, continues to be seriously constrained (almost paradoxically, a recession may inhibit demand and result in reduced prices). When the economy started opening up in late 2021 and early 2022, the demand for goods exploded, but the ramp up of production continues to lag and the failure of the global supply chain has exacerbated the problem. Some supply constraints (again fuel in particular) will continue for the near future to cause pain at the gas pump and continue to exert inflationary pressures notwithstanding anything the Fed can do on the monetary front. Despite this, most markets eventually will adapt and stabilize in other respects and in their own good time. The reduced economic growth emblematic of recessions is not permanent and should be seen as an opportunity while the economy sorts itself out. There actually is little the Federal Reserve or the Federal Government can do. They both have abysmal records when it comes to fine tuning the economy and feathering the runway for a soft landing, which would result more from luck than skill.

With inflation baked into the economic cake, even though the Fed initially refused to acknowledge its complicity, calling 40-year high inflation "transitory", prices were sure to rise out of control. The impact of our energy policies and the apparent unwillingness of anyone in Washington to acknowledge that or to take steps to rectify it played a significant role, but the result is the same, higher prices. Faced with a couple of years of pent up demand, supply constraints, guaranteed rising prices and, real interest rates hovering around zero, the Fed, as part of its self-stated dual mission to assure job growth and target inflation at approximately 2% annually, has no choice but to raise interest rates dramatically, albeit probably too much too late, to dampen demand. Stimulating production across the board would have been a better approach, but the Fed has no ability to do that as those are largely supply and regulatory not monetary decisions.

What should we do and how is WhiteStar ready to help clients navigate these waters? Move ahead confidently with rigorous underwriting and stress testing and supporting real estate and related projects with experienced sponsor/partners in viable markets and asset classes. The fact that the economy may be undergoing fundamental challenges does not change the economy's fundamental needs. Recessions do not happen equally throughout the country or throughout investment markets. Interstate population movements and the resulting boom in some areas invariably leads to hard times in others, ask those who have spent decades rebuilding key cities in the so-called rust belt. That is not to say we should avoid investments in the affected areas. In fact, while the new economic growth, particularly in the Sunbelt is attractive, those very areas showing the greatest sensitivity to a recession still offer opportunities for investors willing to put in the work. The need for additional rental and workforce housing and the continued need for modernized industrial development in particular provides development opportunities nation-wide.

Additionally, with changing global alliances and geopolitics being what they are, some industrial and agricultural products that until recently have come out of Russia and Ukraine (fertilizer and oil are good examples) are unlikely to resume at their pre-invasion quantities. Likewise, the vast majority of the highest quality computer chips are produced in Taiwan, with a substantial portion of the remainder coming from mainland China. Uncertainties in those relationships bode well for increased domestic production and the infrastructure required to support it. These factors coupled with increased domestic production of rare earth minerals, essential for virtually all electronics and our defense industry, offer opportunities and necessary growth industries that were not seriously contemplated a few years ago, yet are good examples of the types of products that will be needed in both the short term and longer term for our economy to become more self-sufficient and to attain and maintain a strong economic growth curve.

As a nation-wide investor, focused on real asset development, WhiteStar has the ability to identify and benefit from these dynamic challenges. Recessions often provide new opportunities for smart investors. While the country is legitimately worried about potential short-term job losses and other dislocations, savvy investors have a number of avenues by which to

profit. Higher interest rates and even further restrictions on bank underwriting result in lower loan-to-cost construction loans and lower loan-to-value acquisition loans from traditional lenders. Non-bank lenders, such as WhiteStar and its pension fund clients, find themselves in the position of improved leverage when it comes to negotiating investment terms and loans for the construction as well as acquisition of real assets.
In the recent past, developers often looked at non-bank lenders as providers of temporary capital at rates higher than traditional sources but less than they would have to pay for permanent capital in the form of additional equity. Today, and over the next few years, the participation of non-bank investors will be the deciding factor in whether many projects are built at all and will have an impact on job creation as well as the depth and length of any forthcoming economic slowdown.

As WhiteStar has propounded for over two decades, "Good Investments = Good Jobs." Today, we should add "and a strong economy."