MAI VIEW

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Wall Street Checkout

We have wondered for a while how the Managing Director who bought a 3/2 apartment on Park Avenue for $4 million would get out whole. Who could purchase it from him? Certainly not a person of equal rank in publishing. The financial industry deals in scale. It makes its own credit and no one bills by the hour. So, home prices (and most everything else) in the financial capital of the world are distorted higher.

Equity and credit bull markets boosted income along the wage scale in New York and surrounding suburbs. Five years of bonuses allowed securities analysts who did not generate direct revenues to afford luxury apartments that displaced senior management in other industries experiencing deflation, like advertising and retail. Those in sales and trading could afford larger apartments in better buildings. Masters of the universe at private equity firms, hedge funds and banks raised top-end home prices even further.

Property taxes and fees, school tuitions and donations, beach home mortgage payments and upkeep, golf memberships, vacations, cars, parking and forty-dollar entrees twelve times a week (per family) boosted annual overhead to the point where the run-of-the-mill millionaire needs a million dollar pre-tax income simply to make ends meet.

The typical Wall Streeter is rich on all metrics, but tends to be long real estate and company stock and is very dependent on current cash flow, which is to say keeping his or her job. They are all correlated.

Residential real estate in and around New York has begun to weaken. Should New York homeowners be concerned that bank revenues have been stagnant and front-office headcounts have been declining? Should investors be concerned that a shrinking financial sector might imply a reduction in the ability to gear the economy and markets? How are output growth and jobs supposed to be goosed when people in the animal spirits business are losing their mojo?

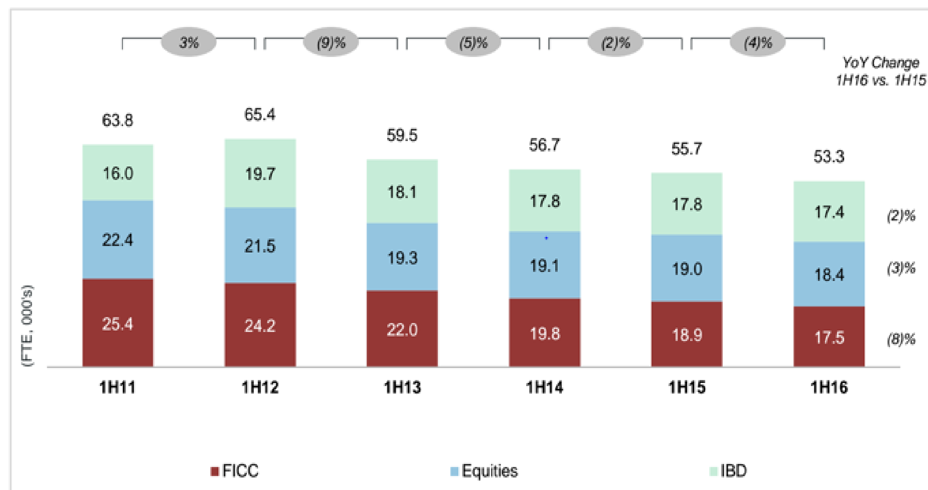
According to Bloomberg: "The portion of new leases signed with concessions, such as a free month or payment of broker fees, reached a new high for the fourth straight month. In January, 31 percent of contracts came with landlord incentives, the biggest share in more than six years of data-keeping by appraiser Miller Samuel Inc. and brokerage

Douglas Elliman Real Estate. The previous record, set in December was 26 percent, which topped November's high-water mark of 25 percent."[1]

While a weak Manhattan rental market may be attributed to a cyclical increase in inventory, it does not explain the building inventory of homes for sale in the city and its suburbs. Rising housing inventory is a high frequency indicator that tends to foreshadow falling prices. And like higher interest rates, falling real estate prices would have an economic impact far greater than past cyclical slowdowns. It is particularly interesting that the real estate market is getting softer when the dollar has been strengthening on a global purchasing power parity basis. Worried oligarchs and South Americans? Been there, done that.

Against this backdrop, Wall Street net revenues have been flat over the last five years, and so, unsurprisingly, the New York City financial sector front office producer headcount has dropped 15% since 2011. It is interesting to note that the steady decline in employment has occurred in a period when total equity trade volume *declined* almost 30% but mergers and acquisitions activity *increased* over 60%. Clearly, client relationships have driven earnings as the financial industry architecture has shrunk. Equity prices may be at all-time nominal highs, but there certainly has not been a bull market in in the business of floating, pricing and overseeing financial assets. How curious.

Figure 5. Coalition Index – Front Office Producer Headcount FTE



Note: Numbers may not add up due to rounding. Percentages are based on unrounded numbers

One may be tempted to blame trade automation and burdensome regulations for stagnant bank revenues and the decline of front office employment. Fair enough. But are either of these two dynamics cyclical? Certainly not. A recent article on ZeroHedge points out that there were 600 cash equity traders at Goldman Sachs in 2000, and now there are two. As for regulations, it is fair to suggest that the prop traders have been replaced with lawyers since 2008. Will this reverse? It is unclear. Mergers and acquisitions may continue apace, but reorganizations will be increasingly challenged by historically high valuations. Our sense is that real estate weakness cannot be explained away by cyclicality.

[1] Bloomberg; https://www.bloomberg.com/news/articles/2017-02-09/manhattan-landlords-can-t-stop-setting-new-records-for-giveaways.

The capital market ecosystem has changed. Wall Street broker/dealers formerly used to control and dominate the investing zeitgeist, but they are being replaced with buy-side fee-based asset managers. Innovation, flatter geographic expertise and the abundance of competent outsourced service providers allow a small front office investment group to open and operate a first-rate fund anywhere in the world. The participation in, and influence of, securities firms over markets has been reduced. Investors that place money directly with buy-side asset managers effectively pay low prime brokerage fees to investment banks. Wall Street revenues are also limited by investors that direct sell-side investment advisors and wealth managers to invest through approved independent asset managers.

Effect on Asset Prices

This disintermediation is not benign for asset prices. The steady migration from dealer to broker (as well as post-financial crisis regulations) has reduced the incentive of Wall Street firms to profit directly in the markets. (It is curious that market volatility has consistently fallen in this environment. Does it imply higher market volatility of the past was, in large part, produced by shifting sell-side risk capital?)

Higher capital requirements have further diminished the incentive of broker/dealers to make deep markets in assets not held by the firm's best clients. As a result, buy-side asset managers requiring liquidity have incentive to gather more and more around popular assets. (For most fiduciaries, asset valuation has become secondary to liquidity.) Market cap weighted equity indexes have benefitted. Very few investors have incentive to force asset prices towards sustainable value.

The reduction of demand for housing in and around New York reflects a reality that 1) asset prices are not sustainable, and 2) everyone knows it, but few care.

There are a couple of constituencies that come to mind that care (or should care) deeply about this state of affairs: investment bankers being disintermediated and economic policy makers left to carry the water for the markets. The market leveraging function that Wall Street historically filled has been replaced by monetary authorities. Central banks do not care about falling earnings, they just care that nominal prices do not fall.

Wall Street has checked out. Investors looking to match nominal liabilities should succeed as long as central banks retain control over markets. Those that care about true wealth creation will be left holding the bag in real terms.

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