From: "Sultan Bin Sulayem" <[redacted]>
To: "Jeffrey Epstein" <jeeproject@yahoo.com>
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accounts for about 50% of the stock in Dubai).
Here's a chart of who lived where in Dubai 2008: *(Click to enlarge)*

The point is that there are three markets, all going in different directions.

The main reason for the bubble was that 90% of the "foreigners" market is focused on rentals, and less than 20% of the residual are "high flyers" with a second home. In 2005, there was a huge demand for new accommodation because of economic growth,

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plus the start of the freehold construction boom; that had to be accommodated by new units, and the rents of those went through the roof.

Existing accommodation lagged, so you could find one apartment in a building renting for $25,000 (since it had been rented a few years before and there was implicit and later explicit rent control for incumbents), and a newly vacated one next door being rented for $75,000, and being snapped up.

So the buyers only saw the rents on the (new) stuff on offer, and they thought, "OK, I'll buy at a 7% gross yield or so, and that's not counting for the "fact" that in Dubai house prices will go on going up forever." Whoopee!

But that price wasn't a true reflection of market reality, and as soon as new units started coming on line (plus the economic slowdown), reality was restored. Yields didn't change, but rents went down.

The rate of development of "new" accommodation is on the right on the chart above. The current situation is that construction almost stopped (buildings under construction typically got finished, but a lot got cancelled although it's not clear how many did).

The consensus projection in 2008 was for 70,000 new units in 2010 (that's not hard, you just need to be able to count that far), some are projecting that figure will go down to 20,000.

How fast prices recover is an issue that depends mainly on the recovery of the Dubai economy, and that may depend on the second story in the newspapers.

Debt:

The second big story is that Dubai Inc. (i.e. the Government of Dubai plus "government-related issuers" (GSI)) owes between $80 billion and $160 billion of relatively short-term debt; depending on what newspaper stories you believe.

There are reports that they are having some complications rolling that debt over, thanks in part to the worldwide credit crunch (they got caught borrowing short and investing long).

Earlier in the year there were concerns that there would be defaults, although there was never any question that Dubai's "rich relations" in Abu Dhabi would make sure that the essential infrastructure of Dubai kept working.

There have been no defaults so far and Dubai has a long tradition of paying its debts, most of the development over the past thirty years was paid for with debt.

Of course, there's always a first time.

Some of the debt was recently downgraded from A3 to Baa1 by Moody's, this is what they said:

> "Following recent disclosures of increased conditionality around when support could be provided to the GRIs"

In other words, a divide is building between debt that has some semblance of a sovereign guarantee, i.e. implicitly or explicitly guaranteed by the UAE Federal Government via the Dubai Financial Support

Fund, and debt that has either a personal guarantee or that is collateralized by assets.

How much of the debt is in the "good debt" camp, and how much is in the "not so good" camp is not clear, although reports suggest thatperhaps the biggest debtor is the "state-owned" conglomerate Dubai World (which owns the developer Nakheel and Dubai Ports Authority (and which recently bought [redacted] Ports)), according to reports Dubai World owes between $40 billion and $60 billion.

The idea of "state-owned" is also an interesting concept; the latest twist that was noticed by Moody's seems to imply that that the "state" owns the assets, but not the liabilities.

What's also uncertain is how much of that was squandered buying assets outside of Dubai at the top of the market, possibly "double geared."

Starting in 2006, "Dubai Inc." went on a high profile shopping spree, investing in projects such as the MGM development in Las Vegas, which was a bit of a departure from the tried and tested business model of investing every penny in Dubai itself.

That "old idea" was the motto of Sheikh Rashid who is once reported to have remarked, "I will build the infrastructure (in Dubai); the rest will follow." It was a good idea, and "the rest" followed.

$1.3 trillion backstop?

Some estimates put the collateral backing up the $80 billion to $160 billion of debt, at $1.3 trillion, although there are no details on how that was calculated.

From the National Newspaper:

> It's mere speculation at this point, but according to SJS Markets, a Swiss brokerage, the new law could even cause Dubai's government-owned companies to sell assets in order to pay down debt and reduce its overall borrowings.
>
> The new law if enacted could limit Dubai's debt financed growth as the second largest emirate in the UAE has debt load of ~$70 bn while its GDP is ~$55 bn. However Dubai's assets are estimated at $1.3 trillion and we feel the government could sell assets to pay down debt.

It's hard to figure out where that number came from seeing as the total amount of GDP declared for the whole of Dubai added up over the past twenty years was under $500 billion.

In a rare report on Dubai and Dubai Inc's finances done in 2003 by the National Bank of Dubai, the assets were rather more modest. Of course, perhaps most of that $1.3 trillion was made over the past five years?

Oh well, perhaps the people in the know have a different way to do valuations than the "old fashioned" methods, that might explain why I read in the newspaper that RBS is in town "helping out", they of course know all about doing valuations.

Where Next?

Dubai is either an economic anomaly or a free-marketer's fantasy land, depending on your perspective.

Twenty years ago the economy was 15% the size of Singapore; in 2008 it was 45% ($US 80 billion). And Singapore is no slouch when it comes to economic growth. Dubai's nominal GDP growth averaged 15% since 1988, and that growth was not driven (directly) by oil.

Why or how, or how much of that was inflation, are questions economists can argue about, but the question of inflation is rather academic considering that 90% of the labor force are foreigners on temporary work visas.

In any case it's hard to explain that growth away by inflation since the currency is tied to the dollar and freely exchanged; and there are effectively no constraints on imports, of anything, including brains and brawn; Dubai can shop the world for the best deals on both of those commodities.

Details aside, the business model hardly changed since the then Ruler((s)) of Dubai signed the Perpetual Maritime Treaty in 1835 and declared Dubai a "Free Port" in 1901 making Dubai one of the first Special Economic Zones (SEZ); although arguably the Square Mile City of London and Venice preceded Dubai in that regard.

That's a formula that China adopted so successfully when it embraced the "dangerous" path to capitalism, although it kept those ideas well segregated from the "mother-land"; currently 80% of China's exports are manufactured in such zones; often in factories owned by foreigners.

Regardless, the SEZ idea clearly works and the fact that Dubai (which hardly has any oil (left) to speak of), is located where it is, is not the secret to its success, that's just geography – what's fairly unique is the business model; and the main difference from the China model is that in China the labor is from the mainland, whereas in Dubai the labor is from foreign countries. (And laborers are treated much better in Dubai; don't believe what you read in the newspapers).

Whatever happens, the core business model of Dubai is driven mainly by foreigners providing local and international goods and services, and it's likely that will carry on.

That's what made Dubai work in the first place; and without that Dubai will have not very much but a load of empty real estate; Dubai came to be what it is by being an open place and safe place with good infrastructure and transportation, to do business; that's where the money and the demand for real estate comes from.

So regardless of what happens to the debt that is not explicitly or implicitly guaranteed by the sovereign state of Dubai, or whatever steps the bond-holders take to liquidate whatever assets they collateralized that debt with, (in the event that it defaults); it's likely that the essential and very efficient infrastructure of Dubai will keep running, and will be kept running.

In which case there will still be demand for real estate.

Property Prices:

This is the "BubbleOmics" estimate of what happened and a projection of what's probably in store:

By way of explanation:

1: In 2004 freehold property was sold too cheap, that helped fuel the bubble because people saw a disproportionate rise in prices – the "pebble."

2: From 2006 to 2007 prices were at about the equilibrium.

3: Then there was a bubble; it was short; (18 to 24 months), but intense, 40% mispricing about by my reckoning.

4: Then a bust, accompanied by a drop in nominal GDP and an increase in inventory (that's why the equilibrium line goes down).

5: Then the "overshoot" drop below the equilibrium which was right on target (28% 1-1/1.4))

6: The exposed debt is now out of the market, anyone who had to run away, has (that's what all the cars at the airport were); likely therefore the time for "overshoot" will be about the same time-span as the previous mis-pricing; that's what normally happens.

7: So by that logic, perhaps a 40% bounce from the lows until the equilibrium is regained in 18 to 24 months from now, i.e. perhaps about another 30% from here.

8: The path of the equilibrium line assumes oil (the main driver of the Dubai economy, which has no oil but services a region that has), will stay above $70.

One other factor that might hasten a recovery is the carry trade in US dollars since the UAE currency is (and likely will be for some time), denominated in US dollars, and it's fully convertible.

Perhaps there will be another bubble in Dubai...thanks to the US Fed?

Disclosure: *No positions*

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