ON THE MONEY

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The road to growth in Washington is out of the exurbs

PEARLSTEIN FROM G1

areas in the eastern quadrants of the District and some of the region's older, closer-in suburbs.

It's not just smart-growth planners and anti-sprawl activists who think so; most developers I've spoken with in recent weeks agree. The models for the future, they say, can be found in Pentagon City rather than Dale City, along the Rosslyn-Ballston corridor rather than the far reaches of the Dulles corridor, in the NOMA area near Union Station and the downtowns of Bethesda and Silver Spring. The pressure of development now points inward toward the Capitol, not outward toward Germantown, Gainesville, Waldorf and Laurel.

Consider, for example, Crystal City, with its proximity to Reagan National Airport, spectacular views of the Potomac and the national monuments, its Metro stop and easy access to highways leading in all directions. If ever there was an ideal location for prime office and hotel space and high-end condos with all the amenities, this is it. And yet for years, legions of GS-13s and mid-level defense contractors toiled in its sterile office buildings and criss-crossed its warren of underground malls before driving home on streets devoid of interesting retail stores, restaurants or pedestrian life. It took the heavy hand of the Pentagon and its base closure commission to do what the market should have, forcing a redevelopment aimed at higher-paying, private-sector tenants.

The rationalization of land use in the region is now being driven by fundamental shifts in the economics of housing and commercial development.

The news that Bloomingdale's will close its White Flint store says less about the future of the department store or Rockville Pike than about enclosed malls. Shoppers no longer prefer them, retailers are abandoning them and developers are scrambling to tear them down or — as is the case of White Flint — turn them into suburban town centers. Even in a rejuvenated Georgetown, the once-elegant Georgetown Park mall sits mostly empty.

The same fate is in store for the suburban office park that, not so many years ago, was the bread and butter of the commercial real estate business in Washington. Workers no longer prefer to work in them, companies no longer want to occupy them, banks no longer will finance them, real estate investment trusts no longer want to own them and planning boards have become reluctant to approve them. In the future, developers say, offices will be part of mixed-used developments, with shops, restaurants, schools, day-care centers and doctors' offices, preferably within walking or biking distance of condos, townhouses and Metro stops.

JAHI CHIKWENDIU/THE WASHINGTON POST

The next phase of growth in the Washington area will likely be in places such as Anacostia, which has land to work with.

Changes in tastes are also conspiring with changing demographics to alter the economics of housing developments, particularly in the outer suburbs.

Across the region, a generation of baby boomers is getting ready to sell three-bedroom suburban colonials to Gen Xers who either don't want them or can't afford them. Add to that a wave of foreclosures and excess inventory left over from a speculative housing boom that has driven home prices in many submarkets to levels below the cost of new construction.

For exurban developers, the implication is pretty clear: The raw land they're holding isn't worth much and in any case, and there's not much point trying to build on it until the excess inventory is worked off. Perhaps that is why developments that were started during the boom but were never finished are selling at 35 cents on every dollar invested in land, roads, street lights, sewer and water lines and half-finished golf courses. Even when the market clears, exurban development is likely to focus on low-cost starter homes.

All that contrasts sharply with what is going on in the District and inner suburbs, where prices have held steady and a construction boom is under way for new and remodeled townhouses and apartments. Despite the absence of bank lending, speculative condo developments have even begun to spring up in the hotter neighborhoods, almost all of them equity financed. This market is driven by singles, young-marrieds and empty-nesters, plus a growing number of families with children, all looking for a more urban, less car-dependent lifestyle.

Accommodating this new demand, and these new economics, won't be easy.

Whereas exurban development was a matter of assembling a few large tracts of farmland or sparsely settled countryside, redevelopment of existing neighborhoods requires dealing with scores of owners of small parcels who may not want to sell, or like things the way they are and will use the political process to keep them that way.

Traditionally, one advantage of the "infill" development is that it can leverage existing infrastructure — roads, Metro, street lights, water, sewer, parks — without the need for new investment. But today, adding significant density in many instances may require expanding the capacity of that infrastructure, which can get pretty expensive and generate plenty of community opposition.

In those big exurban projects of the past, the developers were required to pay for most of the new infrastructure, including schools in some instances. But if increasing density of housing or commercial use requires the widening of Route 1 or putting a light-rail line down Columbia Pike, there is no one developer who can be required to foot the bill. Whatever is done must be a public expense agreed to by the voters and added to the tax bills of all landowners in the city, the county or the special taxing district. That alone can explain why development never happened.

It is easy to point now to the fabulous success of the Rosslyn-Ballston corridor, or of downtown Bethesda and Silver Spring, but the reality is that it took more than a decade of determined effort by planning, zoning and elected officials before they overcame myriad practical and political obstacles.

Prince George's County offers the greatest gap between the potential for development and redevelopment in the inner ring and market realities. High crime rates, inferior schools, rampant corruption and sheer ineptitude on the part of local officials have scared away many developers. Racism has been a factor as well. At this point, however, what has long been considered a Prince George's problem is now a regional problem: If the Washington area is to grow, a lot of that growth is going to have to happen in Prince George's.

Given the strength of the market resistance so far, only the federal government has the clout to jump-start that development process. A study by the University of Maryland found that although the county accounts for a third of the land in the region and a fifth of the population, only 4 percent of the government's leased office space is within its borders — and that despite some of the region's lowest rents and land values. Although 26 percent of the region's federal workers live in the county, less than 8 percent of them work there.

The General Services Administration made a knuckle-headed decision last year when it extended a big lease for 3,000 federal workers at a building in Montgomery County rather than take up an offer to relocate the work to New Carrollton, Largo or Hyattsville, all with Metro stops nearby. The GSA cited lower cost as the key factor, reflecting a sizable subsidy that Montgomery County taxpayers provided to keep the jobs.

That kind of bidding war among local jurisdictions is just plain stupid, whether it is for Northrop's headquarters or a GSA lease. If GSA Regional Administrator Robert Peck is to be taken seriously on his promise to locate federal employment in Prince George's, he should be pressured to issue a rule discounting the effect of local subsidies in evaluating competing lease proposals. On a level playing field, Prince George's ought to win most of those competitions hands down.

Even that, however, probably won't be enough. Given the endemic corruption and favoritism surrounding development in Prince George's, it also will be necessary for Maryland to step in and create a Capital Region Redevelopment Authority whose director and board majority are appointed by the governor. Such an authority would need to have the power to borrow money, buy and assemble land (by taking if necessary), override local zoning in extraordinary circumstances, and provide an open and fair mechanism for private developers to compete for rights at Metro stops, highway exits and other prime locations. Because of the potential to raise land values and generate additional revenue for the state and its counties, such an authority could easily be self-financing.

Virginia and the District probably don't need such heavy-handed intervention, but they should consider the possibility of special taxing and redevelopment districts, such as the one used to finance the extension of Metro to Dulles International Airport. It is reasonable to ask landowners who will realize windfalls from infrastructure to help pay for these public investments, and in the current political environment it is folly to think that other taxpayers will agree to do so.

There are natural limits to how much a metropolitan region can expand its economy and its population by expanding its geographic footprint, and Washington is probably getting pretty close to them. The evidence can be found in the horrible commutes, in the divergent trends in land values at the core and at the periphery, and in the extraordinary cost of extending Metrorail to Loudoun County.

Older cities such as New York, Boston, San Francisco and Chicago reached similar limits a generation ago, and it is no coincidence that their recent economic revival has been accompanied by the gentrification of urban neighborhoods and the redevelopment of closer-in suburbs. Changes in lifestyles and market pressures are pushing the Washington region in a similar direction. Still missing, however, is the political and business leadership needed to accommodate, accelerate and manage that process. More on that next week.

What's your "big idea" for the future of the Washington regional economy? Send your thoughts to *pearlstein@washpost.com*. I'll include as many as I can in the series' final installment later this month.

The markets don't care how you vote

Barry Ritholtz

ON INVESTING

Just about this time every campaign cycle, the pundits get all excited about what Mr. Market is saying about the election: What does this candidate or that mean for the stock market returns? Will an incumbent victory bode well or poorly? Are stock prices telling voters which candidate will be friendlier to future market returns?

In a word, no. Markets do not rally or sell off because one candidate or the other is more likely to win. This might strike some as a bit radical, but here it is: Markets don't give a flying fig about any of this nonsense.

First, consider the classic "causation/correlation error" — one that pundits make all the time. This occurs when two factors happen at similar times, and an assumption is made that one is causing the other. Correlation errors confuse cause and effect. Typically, a more significant but overlooked factor is driving the outcome.

Here is a classic example: "The incumbent's poll numbers are rising, and the S&P 500 likes it. It has been rallying in response."

Not exactly. There is a third explanation, and understanding this requires thinking about what is common to both incumbent polls and stock markets. Instead of assuming that one is causing the other, we need to look for broader forces that are driving both elements.

Most of the time when an incumbent is doing well in the polls, it is because the economy is doing well enough (or improving fast enough) that it is generating solid corporate earnings, strong hiring and positive consumer spending. That not only drives stocks and markets higher, but also makes voters feel economically secure. This works to the advantage of the sitting president. Note that the opposite is also true: Markets do not do poorly because the challenger is polling well; rather, the conditions that help a presidential challenger obtain victory — weak job availability, unhappiness with the economic conditions, desire for change — are negatives for earnings and the markets.

Don't expect to hear this straightforward reasoning from the punditry. During the silly season, politicos and cranks push all manner of sophistry and ignorance onto an unsuspecting public. We've seen it in the editorial pages, from guests on my pal Larry Kudlow's show, and all over the intertubes. Too many folks blame every twitch of the market as a reaction to the politician they like or dislike the most.

The shorter-term swings are especially nonsense.

Let's consider what is driving day-to-day stock prices: It's not expectations about changing capital gains taxes or broad shifts in health-care spending — issues that arguably can be game-changers in elections.

Rather, large hedge funds and high-frequency traders are the biggest participants short-term. The machine-driven mathematical traders have no interest in politics; their stock purchases are held for milliseconds, and their buying is driven by quantitative formulas that have nothing to do with any candidate. Hedge-fund managers certainly are not making bets dependent on the outcome of elections 10 months hence. They are more concerned with monthly, weekly and even daily performance. The technical factors driving what they do are far removed from whatever is happening on the campaign trail.

These simple facts never seem to get in the way of the op-ed writers at various journals who seem to favor arguments along these lines: "Worries about possible policy changes are weighing on markets ahead of the year's presidential elections. Candidate X's rise in the polls is a risk that is giving the stock market jitters. Stock prices are wobbling, all leading to uncertainty. (And the markets hate uncertainty.)"

This analysis — to use the word loosely — is misleading and flawed. Investors should avoid misconstruing information from polling and extrapolating it toward markets. Here are some other arguments to watch out for:

Misplaced credit and blame: Presidential blame and credit for the markets is greatly exaggerated. The U.S. chief executives get far more credit than they deserve for good markets, economies and business cycles. They also get more blame when the economy is weak than is reasonable or fair. This is true regardless of which party wins the White House, or where the economy is in its cycle.

The Obama bull market: Perhaps you don't buy my arguments. Then you must obviously be rooting for an incumbent victory. Why is it that? Consider how the markets did under George W. Bush, the most recent "pro-business president." Then imagine how markets probably reacted to the anti-business socialist from Kenya.

I have some disappointing news those of you who believe in such utter silliness: The S&P started at 850 the day Obama was sworn in; last week it hit 1292 — a better than 50 percent gain over three years. (If that's anti-market, I'll have some more, please.) In 2001, when Bush was sworn in, the S&P stood at 1343. He left at 850 — a decline of about 37 percent.

If you buy into the foolishness that presidents drive markets, than given his giant stock gains, Obama is your guy.

Anthropomorphizing markets: Politicos make another analytical error in the language they use: Markets "prefer" one candidate over another; polls are validated by short-term rallies; a disliked candidate's latest stump speech is what drove the last sell-off. It is a trick used to frame issues, and it is disingenuous at best. Indeed, with these silly claims, pundits manage to combine all of the analytical errors discussed above.

Perhaps it helps to think of markets as future discounting mechanisms. Whenever an economy is slowing, markets price in the possibility of worse profits and sales. (My experience is this occurs three to six months in advance.) Markets are imperfect, subject to excesses of crowd behavior, but they get the big picture correct eventually. When the economy is improving, you will see that reflected in improving stock prices, often in advance of the stronger economic data.

Weak job creation and slow sales both affect equity prices, the electorate and the incumbent party's election fortunes. When folks are content with the status quo and feel secure in their financial futures, they vote for more of the same; when they are not, they vote for change. Thus, the cause is the weakening economy and its discontents thereto. The effect is the rise of candidates claiming to be change agents — and the fall of those representing the status quo.

The underlying conditions that lead to strong equity markets — robust growth, job creation, brisk consumer spending, income gains, tame inflation, etc. — also work to aid the incumbent. It is not that markets like incumbents, it is that both markets and incumbents do better when the overall economy is doing well.

Putting the day-to-day noise into the larger context of quarters and years will help make you a better, smarter investor.

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