U.S. Outlook

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Executive Summary

National Economy

The economic recovery continued on a moderate course through the end of 2010, with GDP and corporate profits strengthening while labor markets recovered slowly and housing languished. Signs that the recovery has taken hold abound, but it remains moderate when compared to previous post-recession recoveries. RCG believes that the recovery is now self-sustaining, and we expect public policy supports such as QEII and stimulus programs to phase out by mid-year 2011. RCG forecasts a continued moderate recovery for the next three years. RCG expects employment growth to pick up during 2011 and 2012, reaching a 1.3% rate each year. This would mean a net gain of over 4 million jobs and get the unemployment rate down to 8.1% in 2012. GDP growth of 2.8% in 2011 and 3.0% in 2012 is expected, driven by strength in the technology, business services and health care sectors, with some support from a reviving manufacturing sector. We assign an 85% chance of a moderate to strong recovery continuing. We have reduced our probability of the economy slipping into a renewed recession to 15%.

Capital Markets

Real estate fundamentals are improving and net operating income is rising as economic growth improves. With the moderate macro-recovery that we anticipate, real estate capital markets are well-positioned to benefit from low interest rates and the quest for yield, particularly in 2011. While we expect interest rates to move up, we believe real estate yields will remain positive and continue to attract investors. Real estate is currently cheap relative to alternative investments. For investors worried about inflation, real estate serves as an inflation hedge. Investment options are expanding as the private market and CMBS return to life. The availability of capital coupled with our confidence in our positive economic outlook solidifies our belief that real estate will improve from here and not suffer another leg down.

Single Family Housing Market

In 2010, it was a great time to buy a house. House prices were at cyclical lows and the mortgage rate was under 4%. According to RCG's calculation, nearly 60% of households are able to purchase a median-priced home as of the third quarter of 2010, up from a house-price-boom low of 40.1% in 2005. The boost to affordability would be more meaningful if private lenders were more expansive in their credit provision. Just as we were frustrated by the inflated ease of credit in the 2004-2008 period, we are equally concerned now by the lack of credit for qualified borrowers. With a 20% down payment and a high credit score required, marginal home buyers are out of the market. As job growth gains and credit availability increases, demand will respond. From 2011–2014, we expect job growth, mortgage rates and supply conditions to be the critical factors in forecasting housing demand and prices. We expect the median price of a home to rise steadily, reaching $195,100 by the end of 2014. The growth rate will average 3.0% between 2011 and 2014. It will remain well below the pace of the boom era and trail the long-term 6.25% average.

Apartment Market

The multifamily sector has been the clear leader among commercial real estate types for quite some time, benefiting from reduced homeownership and the beginnings of a hiring resurgence. On both a capital market and income-producing basis, the outlook remains very bright. During the next few quarters, continued employment growth and the lease-up of formerly languishing, downturn-era deliveries will provide markets that are not struggling with heavy shadow condo supply with ample fuel for NOI increases. Because of the confluence of vacancy tightening and rent growth that occurred in the third quarter, the rental apartment market has crossed over from the overshooting phase, where it had been since the fourth quarter of 2009, to the growth phase, at 7:00.

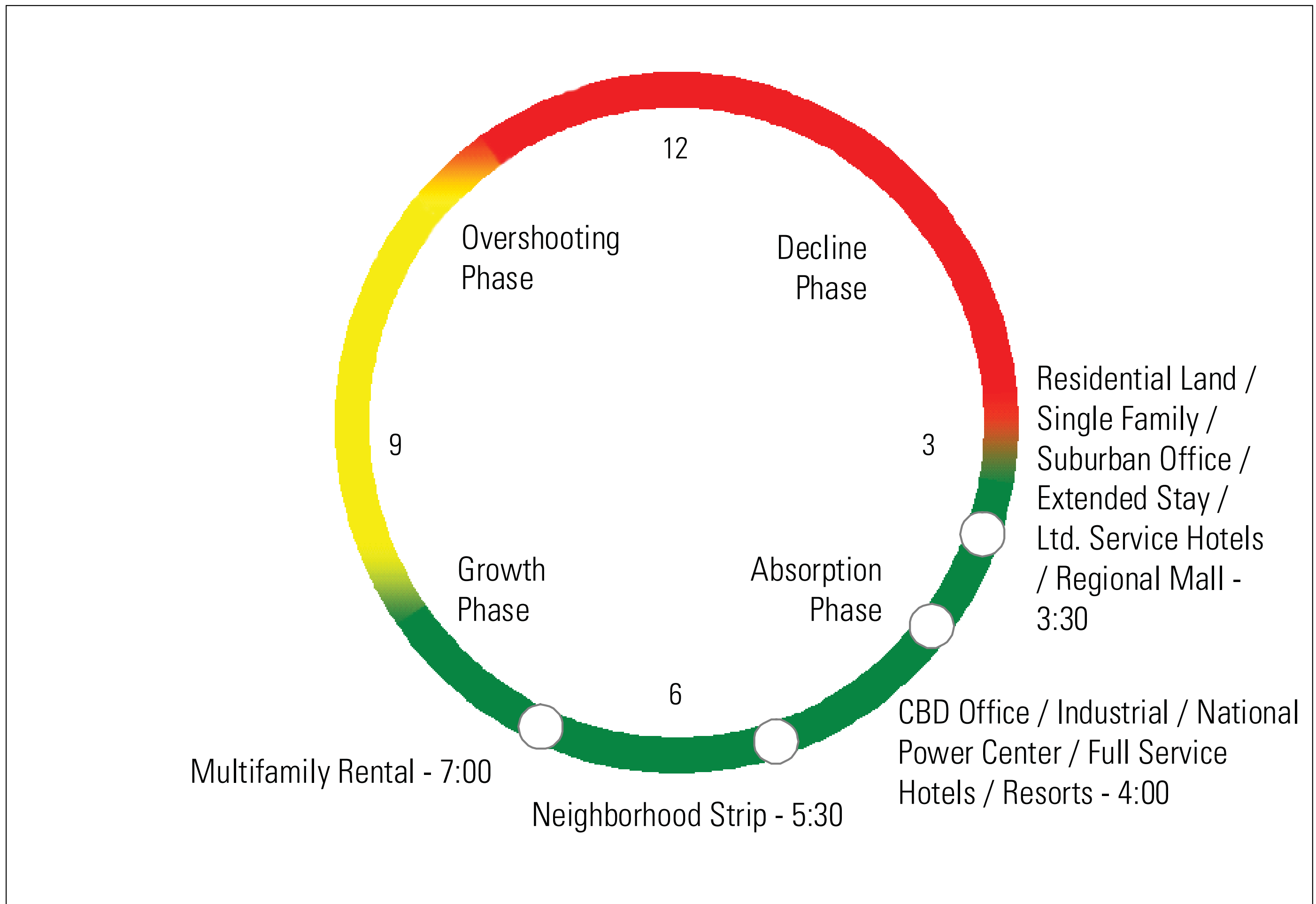
Office Market

The national office market reached bottom in 2010 and has begun the recovery process. Major financial centers and downtown areas are leading the recovery, while suburban submarkets with a large amount of construction in the last decade and tertiary markets are lagging. Overall, business confidence improved significantly, translating into a substantial increase in leasing activity. With vacant space slowly being absorbed, landlords began to curtail the value of concession packages and asking rents have appreciated in some markets. The improved operating conditions spurred a surge in investment activity, particularly for premier assets in gateway cities. The strengthening economic recovery will continue to drive a rebound in the national office market. In the near term, leasing activity should accelerate and, coupled with fewer subleases coming to market, the amount of vacant space will decrease steadily. However, it will take some time to absorb all of the space made available during the recession as well as for companies to fill under-utilized office space.

Industrial Market

The industrial market is in the early stages of recovery following several years of extremely poor conditions. In 2010, the improved economic conditions helped spur manufacturing and goods-

Real Estate Cycle – January 2011



movement hiring. Improved consumer and business sentiment, as well as economic growth in many parts of the world, prompted a resurgence in cargo flows last year. This optimism filtered into the industrial market, with businesses more willing to lease space or buy buildings for occupancy. The improving operating conditions provided the impetus for sales velocity to accelerate. Particularly within core markets, investment activity improved substantially at the end of 2010. The national industrial market should continue to recover in the near term before growing at a more robust pace. The recovery in tenant demand observed through 2010 will continue throughout 2011, with the national vacancy rate falling to 10.0%. The rate of absorption of vacant space should accelerate in 2012 and the vacancy rate should fall to 9.4%. In 2013, we expect the national economy to slow, though remain positive, and the industrial vacancy rate should stabilize. By 2014, leasing activity should pick up and the vacancy rate is forecasted to fall to 8.4%.

Retail Market

The retail market picture brightened during the second half of 2010, capped off by strong sales growth during the holiday shopping season. Job growth and pent-up demand for goods and services following an extended period of consumer frugality fueled retail sales, resulting in increased optimism regarding the sector's outlook among retailers, owners and potential investors. Following a dismal shopping season in 2008 and only modestly better sales numbers in 2009, consumer demand rebounded in November and December 2010. Improvement was broad-based, with many of the most beleaguered retail categories during the recession bouncing back, a positive sign for retail sales during the coming year. Stronger job growth and heightened consumer confidence are expected to yield higher retail sales in 2011, with improvement in market fundamentals continuing throughout the forecast period.

Hotel Market

The national hotel market rebounded quickly during the second half of 2010. The increase in business travel and tourism volume pushed occupancy levels higher throughout much of the country. While travelers remain sensitive to pricing, the growing demand for hotel rooms has offset the lowered room rates achievable in some markets. The improved operating fundamentals attracted

investment capital in recent months, a trend that should continue. With the hotel sector in the early stages of a moderate recovery cycle, operating conditions are set to improve for several years and capital should continue to flow into the sector to take advantage of pricing opportunities. The recovery in the hotel market is under way and operating conditions are expected to increase moderately during the next several years. In the near term, traveler demand should slowly increase as business and leisure travel volumes grow, in line with the recovering economy. This will translate into increased occupancy rates and RevPAR, though some operators will continue to offer reduced rates to maintain booking levels. We expect the occupancy rate to reach 59.5% in 2011 before crossing the 60.0% threshold in 2012. By 2014, the occupancy rate should reach 61.7%.

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The National Economic Outlook

The economic recovery continued on a moderate course through the end of 2010, with GDP and corporate profits strengthening while labor markets recovered slowly and housing languished. Signs that the recovery has taken hold abound, but it remains moderate when compared to previous post-recession recoveries.

Areas driving the recovery include:

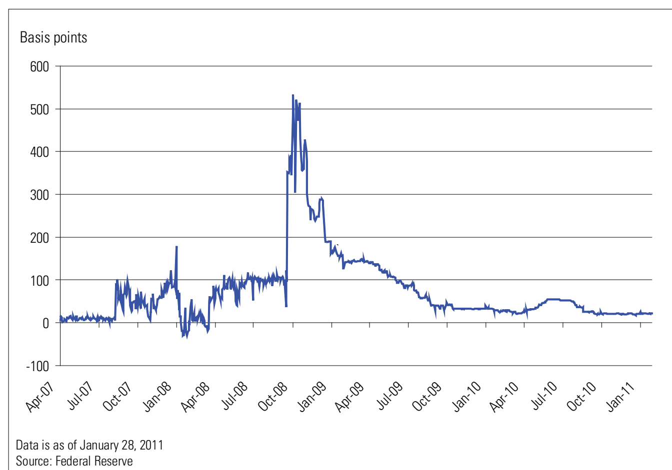
- <u>Employment growth as businesses recover.</u> At the depths of the Great Recession, companies large and small cut employee headcount deeply ---too deeply, it turned out. As most companies survived the downturn and business began to revive, companies began to add staff so as to run their businesses efficiently. Professional and business services have been the strongest areas to recover, and the health services sector –which actually added jobs during the downturn –has continued to grow. RCG expects employment growth to pick up during 2011 and 2012, reaching a 1.3% rate each year. This would mean a net gain of over 4 million jobs and get the unemployment rate down to 8.1% in 2012;
- <u>Low interest rates.</u> We believe that interest rates are artificially low, and that they will rise throughout the forecast period. Low interest rates have helped the recovery to this point. Fears that floating-rate debt (for real estate and also for business loans and consumer credit) would re-set at high levels and force defaults and foreclosures have –to this point –been unfounded. We have therefore been spared a tsunami of property foreclosures and business and personal bankruptcies that threatened any hope for recovery had interest rates risen sharply. This has given "breathing space" to borrowers and lenders alike, allowed many situations to resolve themselves as markets and employment improved, and facilitated a more measured resolution –which is still in process –of truly impaired loans;
- <u>Consumer spending.</u> Despite low levels of consumer confidence and tighter credit for consumers, the 90% of the labor force which is employed has resumed spending. This translates into recovery in both economic activity (inventory rebuilding and retail sales) and employment, and is important in driving the economy;

National Economic Outlook
Moderate Recovery 2010-2014 (60%)

	2002	2003	2004	2005	2006	2007	2008	2009	2010H1	2010H2	2010f	2011f	2012f	2013f	2014f
Real GDP Growth (Annual growth rate)	1.8%	2.5%	3.6%	3.1%	2.7%	1.9%	0.0%	-2.6%	3.5%	2.5%	2.9%	2.8%	3.0%	1.5%	2.0%
Year-over-year rate (4Q)*	1.9%	3.8%	3.1%	2.7%	2.4%	2.3%	-2.8%	0.2%	1.4%	1.4%	2.8%	2.2%	2.8%	1.5%	2.0%
Inflation--CPI, 4Q/4Q rate	2.3%	2.0%	3.4%	3.7%	1.9%	4.0%	1.6%	1.5%	0.2%	1.0%	1.2%	2.8%	3.5%	4.5%	4.5%
Interest Rates															
3-month T-Bill (average)	1.6%	1.0%	1.4%	3.2%	4.8%	4.5%	1.4%	0.2%	0.1%	0.1%	0.1%	0.3%	4.8%	4.0%	5.5%
Year-end (final trading day)	1.2%	1.0%	2.2%	4.1%	5.0%	3.4%	0.1%	0.1%	0.2%	0.1%	0.1%	2.0%	3.0%	4.2%	6.0%
3-month LIBOR (average)	1.8%	1.2%	1.6%	3.6%	5.2%	5.3%	2.9%	0.7%	0.3%	0.3%	0.3%	0.5%	5.0%	4.2%	5.8%
Year-end (final trading day)	1.4%	1.2%	2.6%	4.5%	5.4%	4.7%	1.4%	0.3%	0.5%	0.3%	0.3%	3.2%	5.2%	4.4%	6.1%
10-year T-Bond Yield (average)	4.6%	4.0%	4.3%	4.3%	4.8%	4.6%	3.7%	3.3%	3.6%	2.8%	3.2%	4.0%	6.0%	5.5%	6.0%
Year-end (final trading day)	3.8%	4.3%	4.2%	4.4%	4.7%	4.0%	2.3%	3.9%	3.0%	3.3%	3.3%	4.5%	5.5%	6.2%	6.3%
Conv. 30-year Mortgage Rate (average)	6.5%	5.8%	5.8%	5.9%	6.4%	6.3%	6.0%	5.0%	5.0%	4.4%	4.7%	5.1%	7.2%	6.7%	7.3%
Year-end (final week)	5.9%	5.9%	5.8%	6.2%	6.2%	6.2%	5.1%	5.1%	4.6%	4.9%	4.9%	6.4%	6.8%	7.5%	7.6%
Federal Budget Surplus/Deficit (NIA Basis)															
$Billions (CY)	-307	-415	-388	-257	-153	-215	-683	-1,244	-1,295	-1,400	-1,400	-1,300	-1,200	-1,400	-1,200
As % of Nominal GDP	-2.9%	-3.7%	-3.3%	-2.0%	-1.1%	-1.5%	-4.8%	-8.8%	-9.0%	-9.5%	-9.5%	-8.3%	-7.2%	-7.9%	-6.4%
Employment Growth, 4Q/4Q rate	-0.5%	-0.1%	1.6%	1.8%	1.6%	0.9%	-2.1%	-4.0%	0.6%	0.2%	0.8%	1.3%	1.3%	0.9%	1.5%
Unemployment Rate (4Q)	5.9%	5.8%	5.4%	5.0%	4.4%	4.8%	6.9%	10.0%	9.6%	9.6%	9.6%	8.9%	8.1%	7.5%	7.0%
Housing Starts (000)	1,705	1,848	1,956	2,068	1,801	1,355	906	554	613	563	588	739	910	1,195	1,380
Single Family	1,359	1,499	1,611	1,716	1,465	1,046	622	445	513	429	471	574	700	900	1,000
Multifamily	347	349	345	352	336	309	284	109	100	134	117	165	210	295	380
Sales of Existing Homes (inc. condos and coops)															
Units (000)	5,657	6,176	6,727	7,076	6,516	5,675	4,893	5,160	5,355	4,483	4,919	5,800	6,100	5,900	6,200
Non-Residential Construction															
$Billions	283	282	307	352	434	525	582	452	381	383	382	315	330	350	370
Retail Sales Ex. Autos, 4Q/4Q rate	3.9%	5.9%	7.7%	8.0%	3.8%	5.5%	-4.2%	1.0%	3.1%	3.4%	6.5%	2.3%	3.8%	1.9%	3.3%
Total Car and Truck Sales															
Millions of Units	16.8	16.6	16.9	17.0	16.5	16.2	13.2	10.4	11.2	12.0	11.6	12.5	14.0	13.5	14.0
CPI - Rental Component, 4Q/4Q Rate	3.3%	2.7%	2.8%	3.1%	4.1%	4.0%	3.6%	0.9%	0.1%	0.5%	0.6%	3.1%	4.4%	4.0%	4.5%
Median House Price Gain--US, 4Q/4Q rate	8.5%	6.9%	8.8%	13.6%	-2.8%	-6.1%	-12.4%	-5.5%	3.8%	-3.5%	0.2%	2.6%	3.5%	3.0%	3.0%
Consumer Confidence Index (average)	96.6	79.8	96.1	100.3	105.9	103.4	58.0	45.2	55.0	51.7	53.4	80.0	90.0	80.0	95.0
Real Disposable Personal Income, 4Q/4Q rate	3.1%	3.9%	3.5%	0.6%	4.6%	1.5%	1.0%	0.4%	1.7%	0.6%	2.4%	2.5%	2.9%	2.5%	3.0%
Inflation PPI 4Q/4Q Rate	1.0%	3.5%	4.6%	5.3%	0.2%	6.7%	1.4%	1.5%	1.9%	2.0%	4.0%	3.5%	4.0%	3.4%	4.0%
Industrial Production (average)	89.1	90.2	92.3	95.3	97.4	100.0	96.7	87.7	91.5	94.0	92.7	97.0	97.9	93.5	98.8
%change	2.8%	1.4%	2.9%	2.2%	2.5%	2.7%	-3.3%	-9.3%	3.5%	2.8%	5.7%	4.6%	0.9%	-4.5%	5.7%

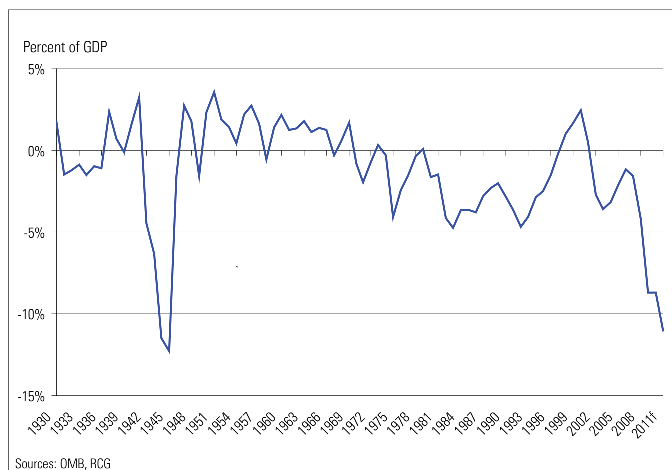
*Not Annualized
Note: For monthly data series, 4Q is average of months
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Census, Federal Reserve, National Association of Realtors, Bloomberg, RCG

3-Month LIBOR vs. Fed Funds



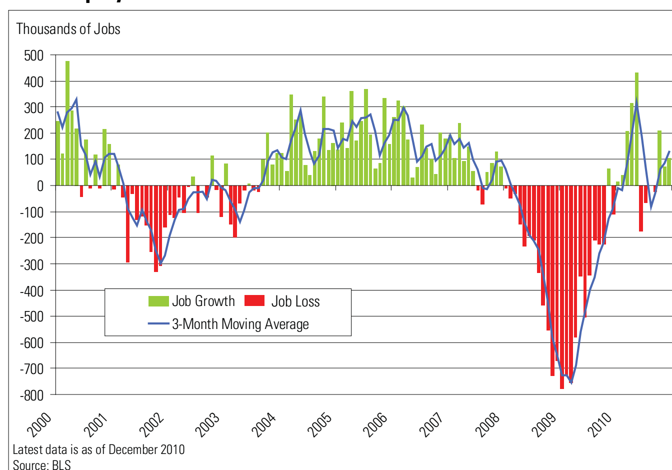
Data is as of January 28, 2011
Source: Federal Reserve

U.S. Budget Deficit to GDP



Sources: OMB, RCG

U.S. Employment Growth



Latest data is as of December 2010
Source: BLS

- Developing country growth. The U.S. economy is an integral part of the global system. Strong growth in developing countries has increased demand for U.S. goods, resources and services, and plays a significant part in increasing demand. In addition, as costs have risen in many of these countries, U.S. goods and commodities have become more competitive –both abroad and at home.

These factors have supported recovery, and RCG expects them to continue. Nevertheless, the recovery has been weaker than many policy makers had hoped. RCG believes the modest pace of recovery is the result of several negatives, including:

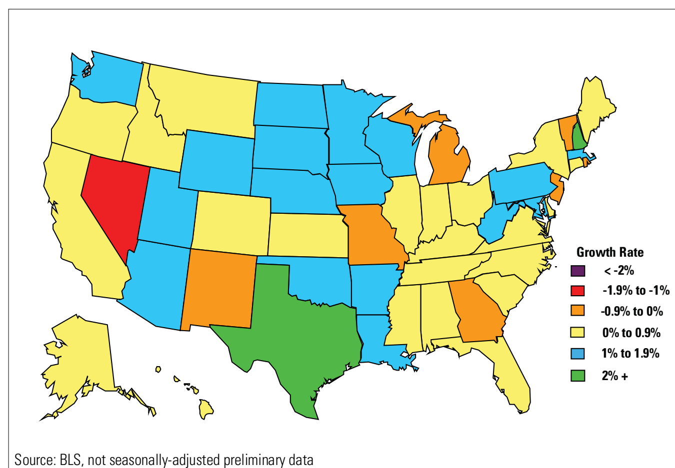
- State and local government budget problems. Warning signals over the past six months that state and local budget problems would hamper the recovery have started to show up in monthly statistics, as good private sector job creation is diluted by losses in the public sector;

- Continuing weakness in housing. Most economic recoveries since 1945 have been led by the housing sector, which generally adds more than 0.5% to 1.0% to GDP in an upturn. The Great Recession was caused in large part by excesses in the housing and housing finance sectors, which resulted in a massive oversupply of housing units. Despite low mortgage rates and high levels of housing affordability, the backlog of several million unsold existing homes (and condominium units) has been barely dented by demand. In fact, the overhang of foreclosed or potentially foreclosed houses means that supply will continue to outstrip demand for several years. This translates into weak demand for new housing construction, and therefore little contribution from the housing sector to either increasing GDP or lowering unemployment;

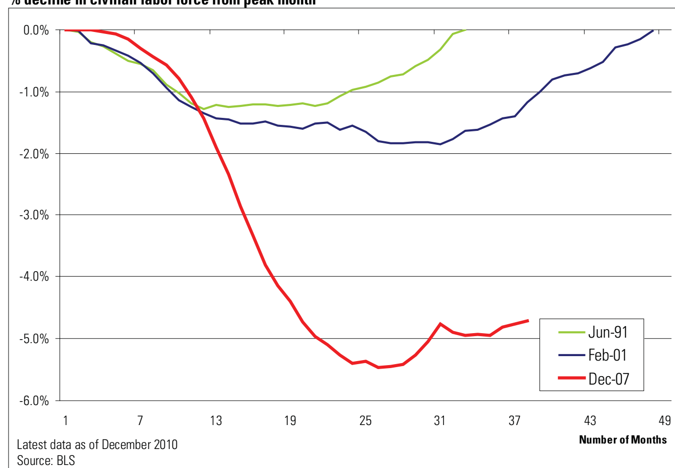
- Changes in the structure of the job market (technology and globalization). The past two decades have seen a remarkable shift in the labor market, driven by the interplay between globalization and technology. These twin drivers have allowed companies to increase productivity (produce more per unit of labor) and to locate many functions in areas where labor costs are low. In the workplace, we have seen machines replace workers while output increased. In the larger economy, we have seen jobs migrate –first to less expensive regions domestically, and lately overseas. The results: both corporate profits and GDP can increase rapidly while job creation stagnates;

- Changes in the structure of the job market (domestic labor demand patterns). The Great Recession extinguished more than 8.6 million jobs in the United States, and nearly half of them were in construction (mainly housing construction) and manufacturing. RCG believes that, of the nearly 2 million manufacturing jobs lost, only about a quarter will be recreated during the recovery as manufacturers use technology and globalization to increase productivity and lower labor costs –and domestic labor demand. In addition, the 1.7 million construction jobs that were lost in the recession will come

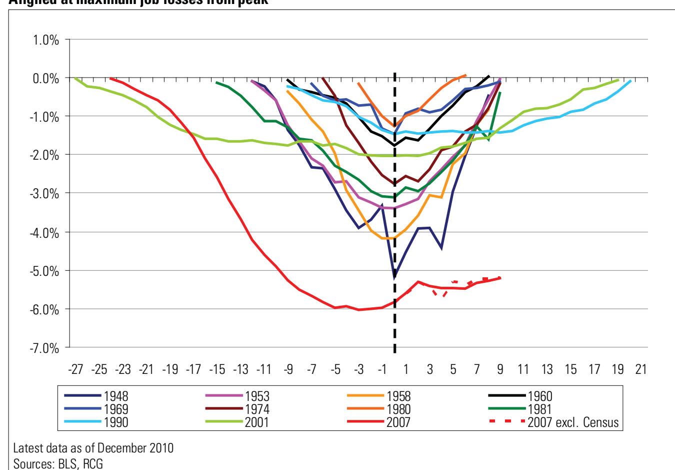
U.S. Employment Growth, December 2010 yr/yr



Labor Force Contractions in Past Recessions:
% decline in civilian labor force from peak month



Percent Job Losses in Post-WWII Recessions:
Aligned at maximum job losses from peak



back, but very slowly, due to the prospect of lower levels of single family housing starts and commercial construction for the next several years.

- Domestic government funding imbalances. All levels of government in the United States are awash in debt. The problems at the federal level are well known, but the difficulties at the state and local government levels are –in the short run –probably a greater drag on the economy. Unlike the national government, state and local jurisdictions generally must operate under a balanced budget. The sharp drops in revenue and the large increases in social service expenditures that have followed in the recession's wake have thrown the typical jurisdiction into a deficit, with the requirement to get finances balanced quickly. The result, which began to show up in fourth-quarter 2010 statistics, has been job losses in the public sector as governors and mayors attempt to cut expenses. Thus, while private sector job formation has been good, overall employment growth has been minimized and unemployment has remained higher than it otherwise would be. RCG expects this issue to get more severe in 2011, and is a major factor in our projections of modest overall job growth for the year;

- Global economic imbalances. These are nothing new, but they are persistent and a significant drag on any American recovery. Our balance of payments deficit remains much too high, in large part because of our trade relationship with China and our continued appetite for imported petroleum products (whose price is again rising toward $100/barrel as this is written because of instability in the Mideast). RCG does not see either of these problems being resolved in the short term, and so we expect the level of national debt (and its costs, as interest rates rise) as a headwind for the economy during the forecast period.

Because of the mixed economic picture on so many fronts, and the strong drags on domestic recovery from several directions, RCG forecasts a continued moderate recovery for the next three years. We assign an 85% chance of a moderate to strong recovery continuing. We have reduced our probability of the economy slipping into a renewed recession to 15%. Our specific forecast assumes:

- GDP growth of 2.8% in 2011 and 3.0% in 2012, driven by strength in the technology, business services and health care sectors, with some support from a reviving manufacturing sector We do not expect the 4% growth that many analysts project because of lingering unemployment, slow recoveries in manufacturing and construction, reductions in public sector employment, and continuing difficulties in the single family housing sector;

- Interest rates, which have been pushing up despite the efforts of the Federal Reserve to keep them low, will spring up once the quantitative easing program expires in mid-year. We expect a steady increase in the 10-year Treasury until it reaches at 6% in 2012.

- Home mortgage rates should also increase, to 6.4% in 2011 and reach 7.5% in 2013. These rising interest rates will dampen the housing recovery, with housing starts exceeding 765,000 in 2011 and 910,000 in 2012, but not reaching the "normal" level of 1.4 million until mid-decade. This delayed housing sector recovery will minimize employment growth from a resurgent housing construction sector, but will support increasing housing prices in the range of 2%-3% annually throughout the forecast period;

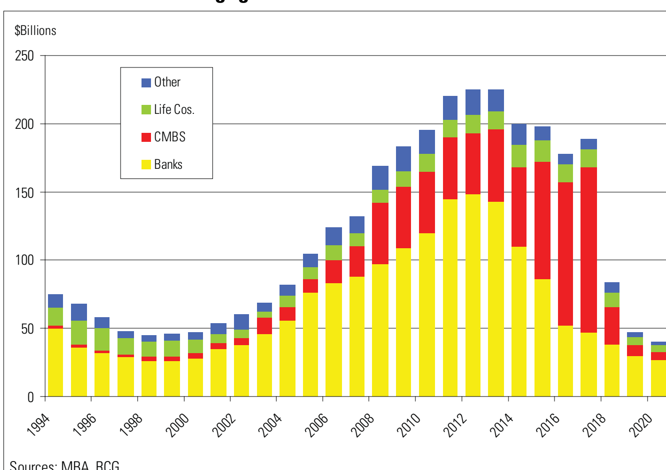
- Employment, which grew at 0.8% in 2010, should grow more quickly in 2011 and 2012 as the economy continues to recover. However, the drag from public sector layoffs will keep overall growth to about 1.3% annually, which should provide approximately 4 million new jobs and wipe out half the job loss incurred in the recession. As a result, unemployment will drop, but only to 8.1% in 2012 and 7.5% in 2013 because more under-employed Americans will return to the workforce as conditions improve;

- Inflation has been dormant during the recovery, but as 2011 begins, it is showing up in several places. Among the most important for consumers, but not counted in the "core" inflation index used by the Federal Reserve, are energy and food prices. But other areas which are part of the Fed-favored index are also seeing substantial increases in prices, such as the rental housing component of the CPI (which we expect to grow by 3.1% in 2011 and then rise between 4% and 4.5% for the rest of the forecast period) and the cost of imported goods. We expect inflation to more than double, to 2.8%, in 2011 and continue rising to 4.5% by 2013. While this is a large percentage increase from current inflation levels, RCG does not believe that inflation in the 3%-5% range poses a substantial danger to the economy, but we think policy makers may overreact to its reappearance.

- Corporate profits should continue to be strong, as stagnant wages and low costs of capital allow for expanded margins. We do, however, expect some slowdown in corporate earnings in 2011, because we believe that cost-cutting –a major factor in recent profitability –has run its course and energy and raw material inputs are skyrocketing and maybe hard to pass through to consumers, and that demand will return slowly and fitfully, thus restricting top-line revenue growth;

- Capital markets will, in our view, continue to improve. We expect banks to lend more aggressively in 2011 than they did in 2010 as their balance sheets improve. In real estate, we think that the property sector will join the rest of the asset-backed sectors in a revitalized securitization market. For property markets, this will not mean a fast return to the giddiness of 2007, but a CMBS volume of about $40 billion in 2011, increasing to perhaps $75 billion per year over the forecast period.

U.S. Commercial Mortgage Maturities



Sources: MBA, RCG

Conclusion

RCG believes that the recovery is now self-sustaining, and we expect public policy supports such as QEII and stimulus programs to phase out by mid-year 2011. Our forecast calls for only a 15% chance of a return to recession, and we believe that the next several years will be characterized by moderate growth. We do expect unemployment to fall, but to remain significantly higher than the experience of the past 20 years, with rates remaining greater than 7% throughout the forecast period. We forecast a higher inflation and interest-rate environment becoming apparent by late 2011. So, in our view, the growth will be moderate; but, barring an extraneous event such as a major terrorist attack or the unraveling of another regional economy, such as the Eurozone, we expect it to continue throughout the forecast period.

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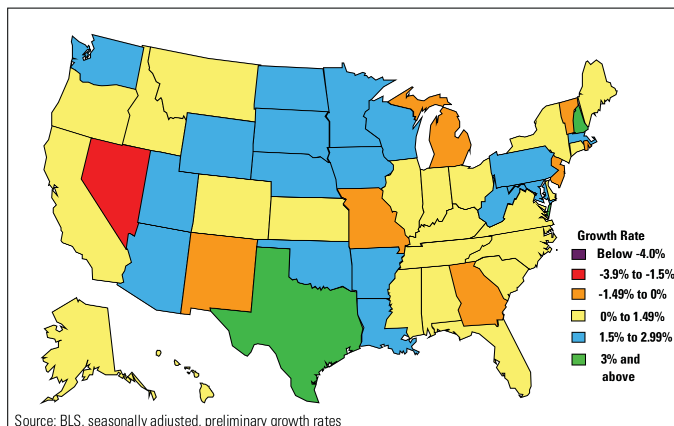
Regional Economic Overview

The economic recovery began in all four regions in 2010, with job creation due entirely to hiring in the private sector. As confidence in the sustainability of the economic recovery grows in 2011, we expect private companies to add jobs at a faster rate, driving job growth in most employment sectors.

- The South was the strongest region by far in absolute and percentage terms, adding around 490,000 jobs, or nearly half of all jobs created nationwide during 2010, for a 1.0% growth rate. The South accounts for slightly more than one-third of all U.S. jobs, and thus the region had a disproportionate positive increase on total employment growth.
- After 29 consecutive months of year-over-year job losses, annual employment growth turned positive in the West region in October 2010, the last of the regions to do so. The West added more than 181,000 positions during the 12-month period.
- The Northeast, which had the mildest recession among the four regions, added jobs at a 0.6% clip during 2010, resulting in a net gain of nearly 140,000 positions.
- The Midwest posted the slowest growth among the regions, with a 0.5% increase resulting in a gain of around 150,000 jobs.

U.S. Employment Growth
December 2010 vs. December 2009



A majority of sectors in each region added jobs during the year, boosting overall payroll levels.

- The professional and business services sector grew at a 2.3% or greater pace in each of the regions, as companies that slashed jobs during the recession added them back in response to stronger demand. The South led all regions with a 2.8% increase. We expect this sector to be a major contributor to job growth going forward, driving the recovery in office markets

Employment Growth by Region

Year	U.S.	Midwest	Northeast	South	West
1995	1.9%	2.1%	0.7%	2.4%	2.7%
1996	2.4%	1.7%	1.7%	2.4%	3.3%
1997	2.8%	2.2%	2.2%	3.2%	3.6%
1998	2.4%	1.9%	1.8%	2.8%	3.1%
1999	2.5%	1.7%	2.3%	2.3%	3.1%
2000	1.5%	0.4%	1.9%	1.8%	3.0%
2001	-1.3%	-2.1%	-1.8%	-1.5%	-1.7%
2002	-0.4%	-0.5%	-0.5%	0.0%	0.4%
2003	0.1%	-0.6%	-0.3%	0.3%	0.3%
2004	1.6%	0.9%	0.9%	2.4%	2.5%
2005	1.9%	0.9%	0.9%	1.8%	2.9%
2006	1.7%	0.6%	1.0%	2.0%	2.4%
2007	0.8%	0.2%	0.7%	1.0%	1.0%
2008	-2.6%	-2.3%	-1.5%	-2.1%	-3.2%
2009	-3.5%	-4.4%	-3.1%	-3.8%	-5.3%
2010	0.9%	0.5%	0.6%	1.0%	0.6%

Source: BLS, Seasonally Adjusted

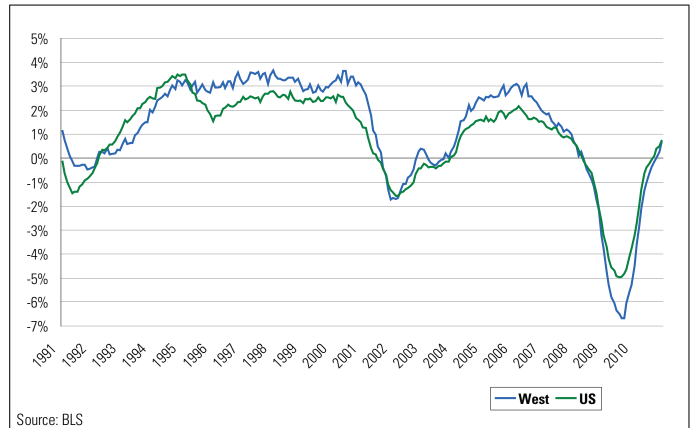
across the nation.

- The educational and health services sector, the lone bright spot during the recession, continued to add jobs in all of the regions. The West and the South, which posted the strongest growth rates of 2.7% and 2.6%, respectively, contain many of the nation's most attractive retirement destinations. Therefore, the aging baby-boom population will likely drive particularly strong growth in health services employment in these regions going forward.
- Higher consumer confidence levels drove growth in leisure and hospitality employment as well as the trade sector, nearly three-quarters of which is in the retail trade sub-sector at the national level.
  - Relatively strong job growth in most other sectors resulted in the South posting the highest growth in leisure and hospitality employment, of 2.0%. Stronger economic conditions enabled residents to dine out and attend entertainment and recreational events more frequently, boosting hiring in the sector. By the same token, the Midwest posted the slowest growth in leisure and hospitality employment of 0.8%.
  - Trade employment gains were more modest yet positive in all of the regions, led by a 0.9% gain in the West. In addition to stronger retail sales, cargo volumes increased through many West Coast ports, boosting wholesale trade activity. Like leisure and hospitality, the lagging Midwest region posted the slowest growth rate among the regions of 0.3%.

In most regions, the greatest drag on total employment continued to be the real estate-related sectors as well as government.

- The beleaguered construction sector shed jobs in all four regions in 2010, albeit at a much slower pace than in recent years. Sector declines were primarily attributable to the troubled housing sector during the recession, but continued as commercial construction projects already under way were completed and few new developments were started.
  - The West posted the largest decline, of 5.0% in 2010. Many metropolitan areas within the region that had some of the nation's largest housing bubbles are lagging the national economic recovery, resulting in sustained declines in development activity.
  - The rebounding South region posted the smallest contraction in construction employment, of just 0.9%, followed by the Northeast (-1.3%) and the Midwest (-3.5%).
  - Following a peak-to-trough contraction in construction employment of more than 40% nationwide, we believe that the sector is close to bottoming. However, the hardest-hit housing markets with high foreclosure rates and weak economic activity will likely continue to lag.

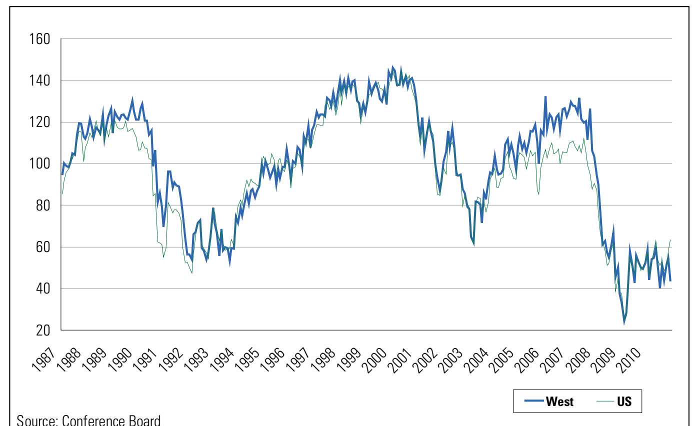
Western Region
Employment Growth, 1991 – December 2010



Source: BLS

- Financial activities employment declined in most regions in 2010, although like construction, at a much slower rate than in recent years.
  - The Northeast was the only region to post an increase, as stronger hiring on Wall Street and at other financial firms in the region drove a 0.2% gain.
  - Contractions in the South (-0.6%) and West (-0.7%) were minimal, indicating that the sector is close to bottoming and should begin to add jobs in those regions in 2011. The Midwest trailed the other regions, with a 2.2% decline.
- Government employment continued to contract, as layoffs at the state and local level offset federal government hiring in most regions.
  - The Northeast posted the largest decline of 1.6%, while the South's government sector was the healthiest, with sector employment unchanged from 2009.
  - States with particularly severe budget crises, such as California, Arizona and Nevada, will likely require additional layoffs in order to address projected budgetary shortfalls through at least fiscal year 2013. Government employment in fiscally stronger states should benefit from increases in

Western Region
Consumer Confidence Index (SA), 1987 – Dec. 2010



Source: Conference Board

Lowest Unemployment Rates, December 2010

Rank	State	Unemployment Rate	Rank	State	Unemployment Rate
1.	North Dakota	3.8%	9.	Kansas	6.8%
2.	Nebraska	4.4%	10.	Minnesota	7.0%
3.	South Dakota	4.6%	11.	Montana	7.2%
4.	New Hampshire	5.5%	12.	Maine	7.3%
5.	Vermont	5.8%	13.	Maryland	7.4%
6.	Iowa	6.3%	14.	Wisconsin	7.5%
7.	Wyoming	6.4%	14.	Utah	7.5%
7.	Hawaii	6.4%	15.	Arkansas	7.9%
8.	Virginia	6.7%	16.	Louisiana	8%
9.	Oklahoma	6.8%	17.	Alaska	8.1%

Sources: BLS, RCG

consumer spending and business activity.

The Western Region

Although parts of the Western Region most impacted by the housing market correction continued to struggle in 2010, the region as a whole improved, posting 0.6% growth in total employment.

- Despite ongoing budget issues, California, the nation's largest economy, managed 0.6% growth in employment, with 8 of 11 sectors expanding.
  - o Professional and business services was the strongest driver of job growth, expanding at a 3.4% clip, as business confidence and hiring by technology companies in the region increased. Leisure and hospitality (1.9%) and educational and health services (1.8%) also expanded at healthy rates, driven by higher consumer spending levels and demographics trends, respectively.
  - o Construction posted the largest decline, of 5.8%, as the large amount of foreclosures and high commercial vacancy rates throughout the state deterred developers from breaking ground on new projects. Government employment contracted by 0.8%, as the state government and local jurisdictions continued to grapple with budgetary problems.

Foreclosure Filing Rates By State, January 2011

Rank	State	Total	# Per Household	% Change from Dec. 10	% Change from Jan. 10
1.	Nevada	12,263	93	-8.97%	3.45%
2.	Florida	21,671	409	-15.48%	-53.96%
3.	Arizona	15,757	175	16.19%	-25.14%
4.	California	67,072	200	1.76%	-6.61%
5.	Michigan	16,716	272	4.08%	-4.88%
6.	Utah	3,601	265	8.11%	-11.89%
7.	Georgia	12,772	318	15.67%	13.29%
8.	Idaho	2,686	241	29.38%	3.19%
9.	Illinois	13,164	402	-6.25%	-27.35%
10.	Colorado	4,946	438	-3.46%	-1.65%

Source: RealtyTrac

- Arizona and Las Vegas, epicenters of the housing bust, are recovering at different rates. Employment in Arizona increased by 1.0%, one of the fastest growth rates among states included in our regional coverage, while employment in Nevada contracted by 1.5%, by far the largest decline among the states in our regional coverage.
  - o The important tourism and gaming industries have yet to rebound significantly in Nevada, with flat levels of leisure and hospitality employment in December compared with one year earlier. Because of the dependence of other sectors on this industry, weakness in tourism activity had a ripple effect throughout the rest of the economy. The construction (-18.9%), financial services (-4.4%), manufacturing (-2.6%), transportation and utilities (-2.3%), and government (-1.5%) sectors all posted substantial

Percent Change in State Employment by Sector - West
Dec 2010 Year-over-Year

Sector	West	AZ	CA	CO	NV	OR	WA	UT
Total	**0.6%**	1.4%	0.6%	0.2%	-1.5%	0.7%	1.2%	1.1%
Construction*	**-5.0%**	-0.6%	-5.8%	-4.9%	-18.9%	-4.1%	-2.5%	-1.6%
Manufacturing	**0.8%**	1.5%	1.1%	-2.2%	-2.6%	-1.4%	-0.2%	2.4%
Trade	**0.9%**	3.3%	0.2%	1.3%	1.2%	1.3%	4.4%	-0.8%
TPU	**-1.3%**	1.2%	-1.9%	-3.9%	-2.3%	0.6%	-4.3%	2.2%
Information Svcs.	**0.1%**	-3.2%	0.4%	-4.7%	-0.8%	7.6%	2.5%	-2.0%
Financial Svcs.	**-0.7%**	-1.8%	0.4%	-2.0%	-4.4%	-1.1%	-2.8%	-1.9%
Prof. & Bus. Svcs.	**2.6%**	3.5%	3.4%	1.2%	-0.3%	4.2%	3.9%	2.5%
Edu & Hlth Svc	**2.7%**	4.1%	1.8%	3.7%	0.7%	1.0%	3.5%	4.5%
Leisure & Hosp. Svcs.	**1.6%**	1.4%	1.9%	2.5%	0.0%	1.6%	2.0%	1.9%
Other Svcs.	**0.4%**	-3.8%	1.1%	-0.1%	3.4%	2.2%	-4.0%	3.6%
Government	**-0.6%**	-1.2%	-0.8%	-0.1%	-1.5%	-0.4%	-0.1%	0.3%

*Regional construction data are based on available state employment figures
Source: BLS, Seasonally Adjusted

declines. Also, the state had the highest foreclosure rate in the nation in 2010, with one filing for every 11 households, according to RealtyTrac. We expect the state to continue to lag the national economic recovery, as the record levels of gaming and tourism spending fueled by easy credit during the housing boom are unlikely to return for the foreseeable future.

- Despite having the nation's second-highest foreclosure rate in 2010, Arizona posted a surprisingly strong economic rebound, driven by gains in the educational and health services (4.1%), professional and business services (3.5%) and trade (3.3%) sectors. The state's large retiree population drove demand for health services, a trend we expect to continue as the baby-boom population ages.

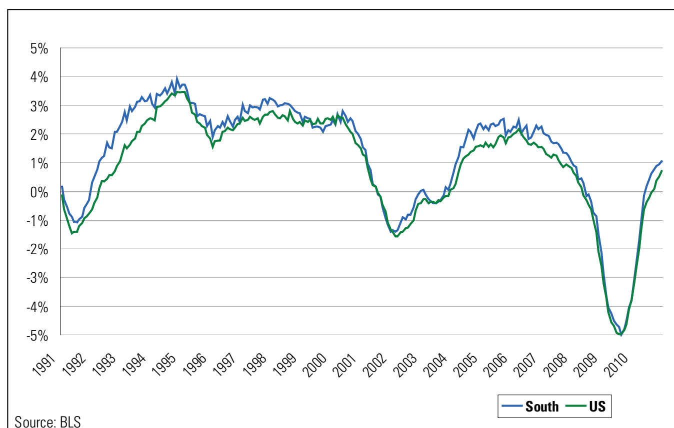
- The Mountain and Pacific Northwest states, which entered the recession later than the former housing-bubble states, continued to rebound, with job growth rates ranging from 0.2% in Colorado to 1.2% in Washington. Strong growth in educational and health services, leisure and hospitality, and professional and business services employment drove overall gains in each state, offsetting continued losses in construction, manufacturing, financial activities and government.
- The foreclosure problem continued to plague the region in 2010. According to RealtyTrac, six of the top ten states in the nation in terms of foreclosure rate were in the West, including four of the top five (Nevada, Arizona, California and Utah). Although we expect employment gains to continue in the region in 2011, the large number of foreclosures is likely to remain a drag on growth.

The Southern Region

The Southern Region bounced back strongly in 2010, driven by particularly strong growth in Texas, which had one of the nation's mildest recessions.

- Total employment in Texas increased by 2.3% year-over-year in December with the addition of 230,800 jobs, accounting for more than one-fifth of jobs created nationwide.
  - Other than a 6.4% decline in the small information services sector and a 0.3% decrease in trade employment, all sectors added jobs.
  - We expect the state's low costs of living and doing business to drive continued population and job growth going forward.
- Louisiana and Virginia posted relatively strong job growth of 1.4% and 1.0%, respectively.
  - Rebuilding efforts continued in Louisiana, while strong federal government hiring and growth in industries associated with it, such as consulting and legal firms, drove employment growth in Virginia.

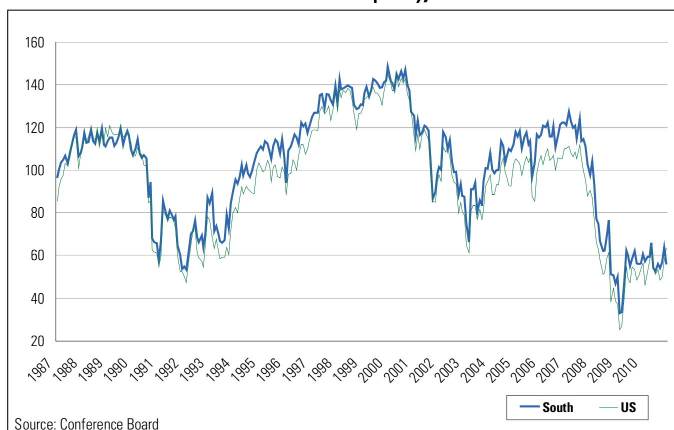
Southern Region
Employment Growth, 1991 – December 2010



Source: BLS

  - Along with Texas, we expect these states to continue to lead the South Region's recovery.
- Florida and North Carolina added jobs in 2010 but at a slower rate than Texas, Louisiana and Virginia, while Georgia posted a small decline.
  - Florida, North Carolina and Goergia continued to recover from steep contractions in housing-related and manufacturing employment. Florida and Georgia posted the third- and sixth-highest foreclosure rates in the nation in 2010, according to RealtyTrac.
  - Despite these challenges, these states offer low costs of living and doing business, which should continue to attract residents and business as economic growth and population mobility accelerate.
  - Foreclosures were a much less significant problem in major metropolitan areas in other Southern states such as Texas, Louisiana and North Carolina.
- Unemployment remains a problem in many parts of the region. As of December, six of the nation's top-ten highest unemploy-

Southern Region
Consumer Confidence Index (SA), 1987 – Dec. 2010



Source: Conference Board

Percent Change in State Employment by Sector - South
Dec 2010 Year-over-Year

Sector	South	FL	GA	LA	NC	TX	VA
Total	**1.0%**	0.6%	-0.2%	1.4%	0.3%	2.3%	1.0%
Construction*	**-0.9%**	-5.5%	-7.5%	1.7%	-6.4%	5.9%	-4.3%
Manufacturing	**0.8%**	-1.5%	-1.3%	1.8%	0.7%	3.5%	-1.3%
Trade	**0.7%**	0.8%	-0.7%	2.2%	0.8%	-0.3%	1.5%
TPU	**0.1%**	0.1%	0.2%	2.6%	-1.6%	0.8%	2.7%
Information Svcs.	**-2.7%**	-3.8%	-1.7%	5.3%	4.1%	-6.4%	-4.8%
Financial Svcs.	**-0.6%**	-1.6%	-5.1%	-0.1%	0.3%	0.8%	-1.3%
Prof. & Bus. Svcs.	**2.8%**	-0.1%	1.9%	1.4%	4.5%	5.3%	3.3%
Edu & Hlth Svc	**2.6%**	3.3%	3.1%	3.3%	0.7%	3.4%	2.3%
Leisure & Hosp. Svcs.	**2.0%**	3.8%	0.7%	1.0%	-1.9%	2.5%	2.0%
Other Svcs.	**1.0%**	3.1%	2.0%	-0.2%	-1.6%	3.4%	-0.8%
Government	**0.0%**	-0.3%	-0.5%	-0.8%	0.0%	0.3%	1.1%

*Regional construction data are based on available state employment figures
Source: BLS, Seasonally Adjusted

ment rates were in the region, including third-ranked Florida (12.0%) and sixth-ranked South Carolina (10.7%). Despite year-over-year declines in all of the states except Florida, unemployment is likely to remain high in the region going forward as previously discouraged workers reenter the labor force.

The Northeast Region

Year-over-year job growth continued in the Northeast region, which was the least impacted by the recession, but the last region to post annual job growth during the recovery. In contrast to other regions, the Northeast did not have a major housing bubble or suffer from the structural decline of any of the region's employment sectors, limiting employment declines. Because the job losses were shallower during the downturn, the bounce-back in employment has been less pronounced than in some regions with steeper job losses, a trend that is likely to continue.

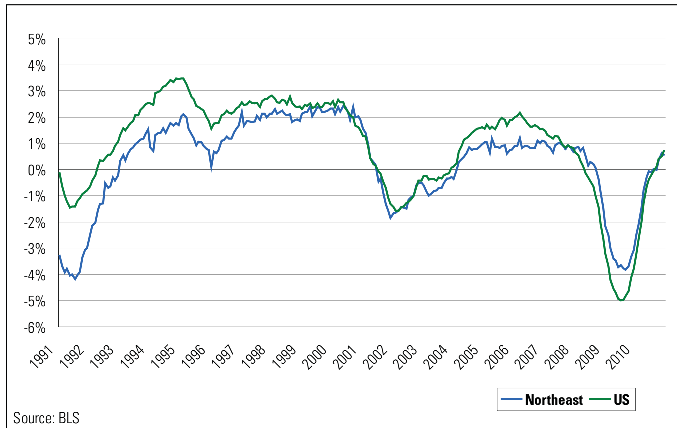
Highest Unemployment Rates, December 2010

Rank	State	Unemployment Rate	Rank	State	Unemployment Rate
1.	Nevada	14.5%	10.	North Carolina	9.8%
2.	California	12.5%	12.	District of Columbia	9.7%
3.	Florida	12%	13.	West Virginia	9.6%
4.	Michigan	11.7%	13.	Ohio	9.6%
5.	Rhode Island	11.5%	14.	Idaho	9.5%
6.	South Carolina	10.7%	14.	Missouri	9.5%
7.	Oregon	10.6%	14.	Indiana	9.5%
8.	Kentucky	10.3%	15.	Arizona	9.4%
8.	Georgia	10.2%	15.	Tennessee	9.4%
10.	Mississippi	10.1%	16.	Washington	9.3%

Sources: BLS, RCG

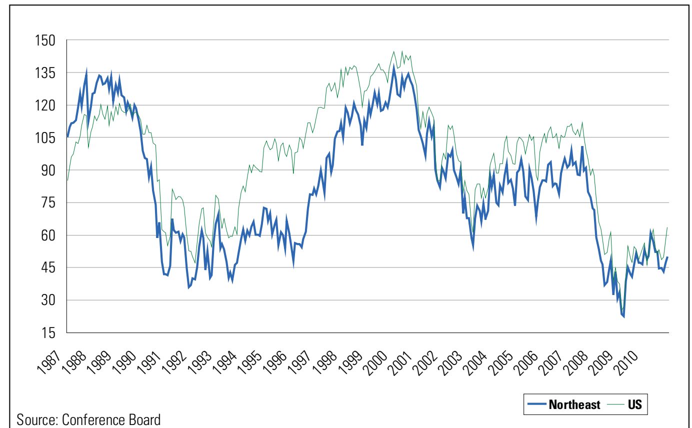
- Massachusetts (1.5%) and Pennsylvania (1.2%) led job growth in 2010, followed by New York (0.4%) and Connecticut (0.3%). New Jersey posted the largest decline among states included in our regional coverage (-0.8%), and total employment also contracted in Rhode Island (-0.5%).
- Eight out of eleven employment sectors added jobs during 2010, led by professional and business services (2.3%), a positive sign for office absorption. The catchall other services sector (1.6%), educational and health services (1.5%) and leisure and hospitality (1.2%) also posted gains of more than 1.0%.
- The only three employment sectors to decline in the Northeast region in 2010 were government (-1.6%), construction (-1.3%) and information services (-0.8%). Job losses abated in the latter two sectors, but increased in the government sector as budget problems forced layoffs at the state and local levels.
- Increased hiring in the banking and securities industries boosted financial activities sector employment in Massachusetts (1.7%), New Jersey (1.4%) and New York (-0.3%).
- Leisure and hospitality and trade employment rebounded in most states as job creation fueled consumer spending. Consequently, growth in these sectors was generally strongest in the states with the largest increases in total employment.
- Unemployment rates in December 2010 illustrated the region's relatively strong economy.
  - o The only Northeast state with an unemployment rate higher than the U.S. unemployment rate was Rhode Island (11.5%), which was hit hard by the housing market correction and decline in demand for manufactured goods. The next-highest unemployment rate posted by a state in

Northeastern Region
Employment Growth, 1991 – December 2010



Source: BLS

Northeastern Region
Consumer Confidence Index (SA), 1987 – Dec. 2010



Source: Conference Board

the Northeast region was 9.1% in New Jersey, compared with a 9.4% unemployment rate nationally.

- o Unemployment rates in New Hampshire (5.5%) and Vermont (5.8%) were among the lowest in the nation.

- Continuing a trend that has persisted during the last few years, foreclosure rates remained relatively low in the Northeast in 2010. No Northeast states ranked among the top ten in terms of foreclosure rate during the year, according to RealtyTrac.

- We expect steady improvement in the Northeast economy to continue going forward, driven by continued gains in educational and health services, professional and business services, trade, and leisure and hospitality employment.

The Midwest Region

Despite a bounce-back in the region's important manufacturing sector in 2010, the Midwest posted the slowest growth in total employment among the four regions, with its job base increasing at a 0.5% clip. Similar to most regions, losses in the real estate-related sectors as well as government were the main reasons for the slow rate of growth.

- Construction and financial activities employment contracted by 3.5% and 2.2%, respectively, in 2010, as housing market conditions generally remained weak.
  - o According to RealtyTrac, Michigan and Illinois had the seventh- and ninth-highest foreclosure rates in the nation in 2010. One out of every 33 households received a foreclosure notice in Michigan, and one out of every 35 households in Illinois received a filing, compared with one out of every 45 households nationwide.

Percent Change in State Employment by Sector - Northeast
Dec 2010 Year-over-Year

Sector	Northeast	CT	MA	NJ	NY	PA	RI
Total	**0.6%**	0.3%	1.5%	-0.8%	0.4%	1.2%	-0.5%
Construction*	**-1.3%**	-6.4%	1.2%	-4.2%	-1.3%	-0.1%	-7.1%
Manufacturing	**0.6%**	-0.6%	0.3%	-0.7%	-0.1%	1.5%	-0.5%
Trade	**0.5%**	0.1%	1.7%	-0.2%	0.2%	0.9%	-0.9%
TPU	**0.3%**	-3.1%	1.2%	-0.1%	-0.9%	2.1%	4.8%
Information Svcs.	**-0.8%**	-1.7%	2.4%	-1.7%	-1.5%	-1.2%	3.1%
Financial Svcs.	**0.2%**	-1.2%	1.7%	1.4%	0.3%	-1.1%	-1.3%
Prof. & Bus. Svcs.	**2.3%**	4.3%	2.6%	2.2%	2.2%	2.1%	-0.1%
Edu & Hlth Svc	**1.5%**	2.1%	1.9%	-0.2%	1.9%	1.9%	-0.6%
Leisure & Hosp. Svcs.	**1.2%**	2.1%	1.8%	-1.1%	1.4%	2.3%	-0.8%
Other Svcs.	**1.6%**	-0.3%	0.8%	-0.7%	4.1%	0.2%	2.4%
Government	**-1.6%**	-1.1%	0.2%	-4.3%	-2.2%	0.2%	-0.3%

*Regional construction data are based on available state employment figures
Source: BLS, Seasonally Adjusted

Highest Concentration of Financial Activities Employment

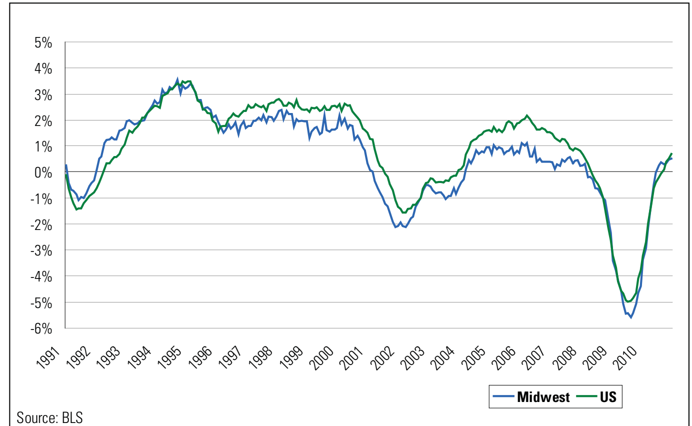
Metropolitan Area	% of Jobs
Hartford, CT	11.2%
Stamford, CT	10.6%
New York, NY	10.6%
Philadelphia, PA	7.5%
Boston, MA	7.3%
U.S.	**5.8%**

Note: as of December 2010
Sources: BLS, RCG

- Home prices have yet to rebound significantly in the region given weak job creation. According to the National Association of Realtors, the median single family home price increased by 0.5% in the fourth quarter of 2010, compared with a 0.2% increase nationally. The median condo price declined by 10.9% during the same period, compared with a 6.4% drop in the U.S. median condo price.

- The Midwest region's economy remained bifurcated.
  - The unemployment rate of the East North Central Census Division, which is composed of Wisconsin, Michigan, Illinois, Indiana and Ohio, was 9.6% in December 2010. Many of these rustbelt states will likely continue to post elevated unemployment rates as they undergo a painful structural shift from goods-producing to services-producing and knowledge-based economies.
  - The West North Central Census Division, composed of Minnesota, Missouri, Iowa, Kansas, Nebraska, North Dakota and South Dakota, posted an unemployment rate of 7.1% in December. Strong demand for raw materials and agricultural products and a lack of a housing bubble in this region were the primary reasons for the continued low unemployment rate. The economy of this Census Division should improve further going forward as the national and global economic recoveries increase demand for the area's natural resources.

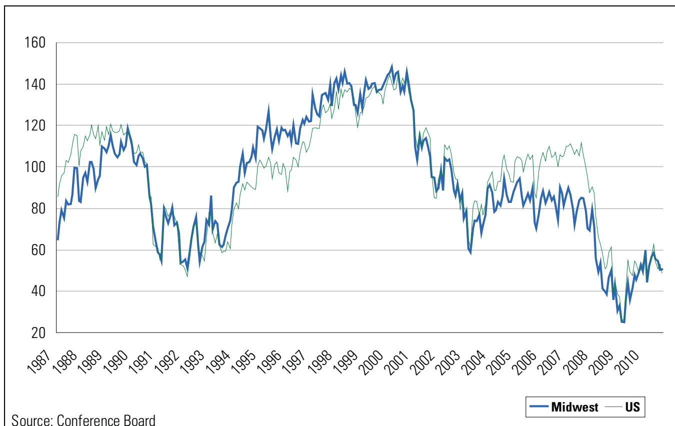
Midwestern Region
Employment Growth, 1991 – December 2010



Source: BLS

- The weakest state among those included in our regional coverage was once again Michigan, which posted a 0.6% year-over-year decline in employment in December 2010. Most employment sectors shed jobs, with the largest decline in construction employment (-4.2%).
- The strongest Midwestern state in our regional coverage was Wisconsin, with a 1.2% increase in total jobs. Like most states in the region, increased hiring in the manufacturing sector, which expanded by 3.3% on the year, was a major reason for stronger overall job growth.
- Despite the 2.2% year-over-year increase in manufacturing sector employment in the Midwest in December 2010, the sector recovered only a small fraction or jobs lost during the recession. We believe that these gains were temporary, and we expect the long-term, structural decline of this sector to continue to plague the region. States and cities that are unable to retrain their workers with the skills necessary to succeed in the 21st-century global economy will be hit particularly hard.

Midwestern Region
Consumer Confidence Index (SA), 1987 – Dec. 2010



Source: Conference Board

Highest Underemployment Rates, 4Q 2010

Rank	State	U-6 Rate, 4Q10	Rank	State	U-6 Rate, 4Q10
1.	Nevada	24.7%	11.	Arizona	17.3%
2.	California	21.9%	12.	North Carolina	17.1%
3.	Florida	19.8%	13.	Mississippi	17.0%
4.	Rhode Island	19.3%	14.	Hawaii	16.8%
5.	Washington	19.1%	15.	Idaho	16.6%
6.	Michigan	18.8%	16.	New Mexico	16.4%
7.	Oregon	18.6%	17.	Illinois	15.8%
8.	Georgia	18.4%	17.	Kentucky	15.8%
9.	South Carolina	17.9%	18.	Colorado	15.7%
10.	Alabama	17.4%	19.	Indiana	15.6%

Note: The U-6 unemployment rate includes marginally attached, involuntary part-time, and unemployed members of the labor force.

Sources: BLS, RCG

Percent Change in State Employment by Sector - Midwest
Dec 2010 Year-over-Year

Sector	Midwest	IL	IN	MI	MO	OH	WI
Total	**0.5%**	0.8%	0.9%	-0.3%	-0.6%	0.1%	1.2%
Construction*	**-3.5%**	-0.6%	-7.3%	-1.4%	-9.4%	-4.6%	-5.9%
Manufacturing	**2.2%**	1.7%	2.9%	2.4%	-0.4%	2.0%	3.3%
Trade	**0.3%**	0.6%	0.8%	0.7%	-0.4%	-0.6%	0.9%
TPU	**-0.3%**	0.8%	1.2%	-4.0%	-2.9%	-1.3%	-0.3%
Information Svcs.	**-0.8%**	2.0%	-0.8%	-5.4%	-1.2%	-4.4%	-0.6%
Financial Svcs.	**-2.2%**	-1.6%	0.5%	-2.4%	-3.2%	-3.6%	-2.7%
Prof. & Bus. Svcs.	**2.5%**	1.8%	8.8%	-0.1%	-0.8%	2.5%	4.2%
Edu & Hlth Svc	**1.3%**	1.7%	1.7%	0.2%	0.7%	1.2%	2.1%
Leisure & Hosp. Svcs.	**0.8%**	-0.1%	-0.7%	-0.2%	1.1%	1.3%	0.8%
Other Svcs.	**1.1%**	2.3%	-0.6%	0.4%	1.7%	-0.9%	3.1%
Government	**-0.8%**	0.3%	-2.4%	-2.4%	0.5%	-1.0%	0.3%

*Regional construction data are based on available state employment figures
Source: BLS, Seasonally Adjusted

Conclusion

We expect the economic recovery to continue across the United States in 2011, with higher business and consumer confidence levels spurring job creation in all four regions. However, the pace of recovery will vary significantly between regions and even within regions. For example, in the South, Texas and Virginia are anticipated to be among the leaders in job growth nationally, while Florida and Georgia's recoveries will likely be stunted by high foreclosure rates and state and local budgetary issues. Likewise, as Washington and the Mountain states rebound in the West, California and Nevada are likely to trail the region and nation in recovery. The Northeast region should continue to post steady job growth going forward, driven by expansion in the educational and health services and financial activities sectors, both of which account for a larger share of total employment in the region than in the United States as a whole. The structural decline of the manufacturing sector is expected to continue, disproportionately impacting the Rust Belt states and weighing on overall job growth in the Midwest.

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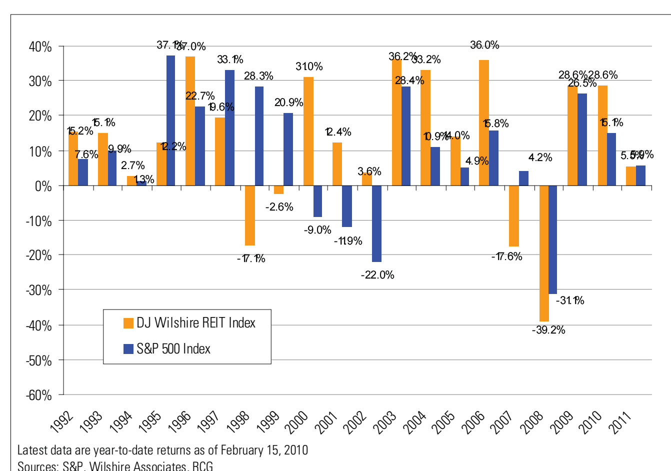
The Real Estate Capital Markets

Real estate fundamentals are improving and net operating income is rising as economic growth improves. With the moderate macro-recovery that we anticipate, real estate capital markets are well-positioned to benefit from low interest rates and the quest for yield, particularly in 2011. While we expect interest rates to move up, we believe real estate yields will remain positive and continue to attract investors. Real estate is currently cheap relative to alternative investments. For investors worried about inflation, real estate serves as an inflation hedge. Investment options are expanding as the private market and CMBS return to life. The availability of capital coupled with our confidence in our positive economic outlook solidifies our belief that real estate will improve from here and not suffer another leg down.

REITs are outperforming the broader stock market and private real estate investment.

- For 2010 as a whole, the DJ Wilshire REIT index gained 28.6% versus 15.1% for the S&P 500. As of January 8th, the S&P index had moved ahead of REITS at 5.03% versus 4.42%.
- Despite this advantage, REITs are running in close correlation with the S&P 500. Financial market liquidity reversed the long-standing low correlation between real estate and broader market stocks. Since 2005, correlation has increased and is now 83% compared with the long-term average of 41%.
- REITs are also outperforming private real estate. According to Green Street Advisors, REITs are trading at a 20% premium to the underlying value of private real estate as of February 1st, up from a recent low of 10% in July 2010, but below the new high of 29% reached in April 2010. We caution that the private market is less liquid and the premium may not prove to be this high.
- AFFO multiples have returned to recent highs at 22.6 as of January 21st. Multiples peaked at 27.3 in February of 2007 before dropping to the recent low of 9.3 in February of 2009. Pricing remains above the long-term average of 14.0.

Investment Performance - REITs vs. S&P 500 Index



Latest data are year-to-date returns as of February 15, 2010
Sources: S&P, Wilshire Associates, RCG

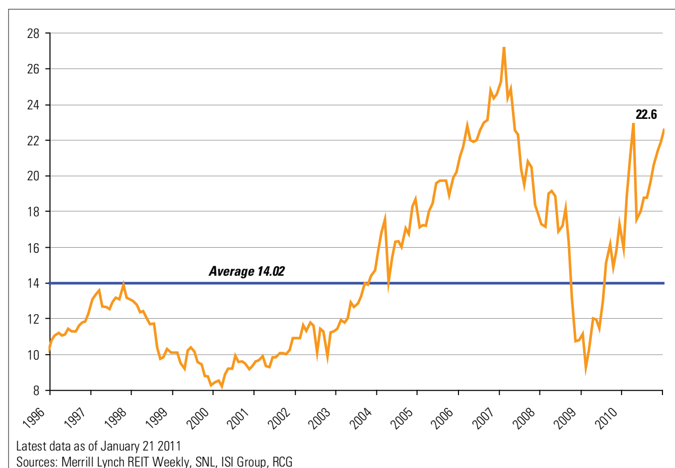
Real Estate Capital Market Overview

		2003	2004	2005	2006	2007	2008	2009	4Q09	1Q10	2Q10	3Q10	2010f	2011f
Debt Market														
Commercial Lending Volume [1]														
Construction Loans Outstanding	($ Bill.)	272.2	336.8	448.7	564.9	628.9	592.2	451.6	451.6	417.9	383.3	353.9	375.1	365.1
Net Dollar Growth	($ Bill.)	27.4	64.6	111.9	116.2	64.0	-36.7	-140.6	-40.6	-33.7	-34.6	-29.4	-76.5	-10.0
Long Term Mtg. Loans Outstanding	($ Bill.)	2054.1	2272.8	2583.3	2898.8	3245.1	3413.3	3330.4	3330.4	3296.4	3244.2	3202.5	3311.5	3306.5
Net Dollar Growth (Qtrs are SAAR)	($ Bill.)	199.3	218.7	310.5	314.4	346.1	177.0	-89.2	-224.2	-136.0	-208.8	-166.8	-75.0	-5.0
Domestic CMBS Issuance [2]	($ Bill.)	77.8	97.9	169.2	205.6	230.2	12.1	3.0	2.2	2.3	0.1	2.1	11.6	50.0
10-Year Treasury Rate		4.0%	4.3%	4.3%	4.8%	4.6%	3.7%	3.3%	3.5%	3.7%	3.5%	2.8%	3.3%	4.5%
10-Year Commercial Mortgage Rate		5.8%	5.5%	5.5%	5.9%	6.2%	6.7%	6.9%	6.9%	6.6%	6.0%	5.2%	5.4%	5.0%
Spreads vs. Treasury (bps) - Legacy														
10-Year Commercial Mortgage		153	123	92	118	251	394	315	315	315	322	237	205	50
Super Sr AAA		n/a	69	83	72	153	887	440	440	266	291	259	275	110
BBB- CMBS		129	127	180	123	790	5362	9515	9515	9191	8306	8204	8500	400
Equity Market														
Equity REIT Issuance [2]	($ Bill.)	13.3	21.5	15.4	22.2	17.9	12.8	24.2	2.3	2.7	8.3	6.1	20.0	35.0
Returns for Period														
NCREIF - Total [3]	(yoy)	9.0%	14.5%	20.1%	16.6%	15.8%	-6.5%	-16.8%	-16.8%	0.8%	4.1%	8.1%	11.6%	12.9%
Wilshire REIT Index		36.2%	33.2%	14.0%	36.1%	-17.6%	-39.2%	28.6%	28.6%	9.8%	5.2%	19.2%	22.0%	10.0%
REIT Yield		5.5%	4.7%	4.6%	3.7%	4.9%	7.6%	3.7%	3.7%	3.9%	4.2%	3.8%	3.9%	4.3%

[1] *Includes multifamily lending*
[2] *Quarterly figures are not annualized.*
[3] *Quarterly figures are returns from the previous period*
Note: Interest rates and spreads are end of period

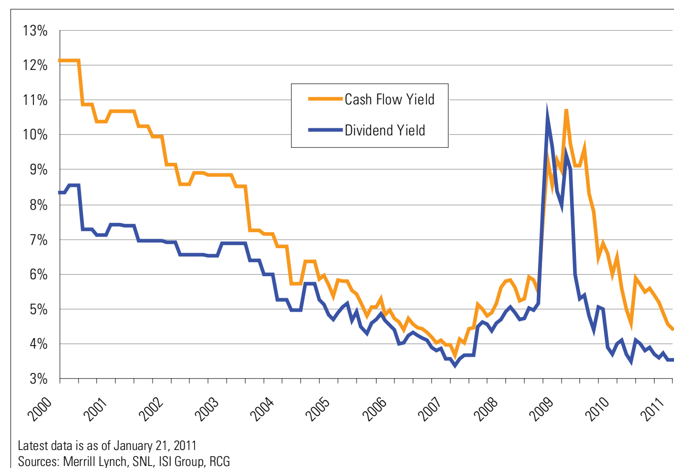
Sources: Federal Reserve, FDIC, Commercial Mortgage Alert, Morgan Stanley, Merril Lynch, NAREIT, Wilshire Associates, ULI, NCREIF, Real Capital Analytics, ACLI, RCG

REIT AFFO Multiple



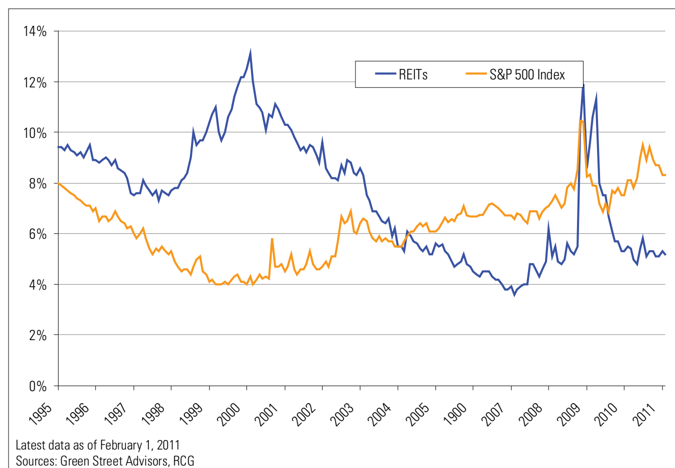
Latest data as of January 21 2011
Sources: Merrill Lynch REIT Weekly, SNL, ISI Group, RCG

REIT Yield Comparison- REIT Cash Flow Yield vs. Dividend Yield



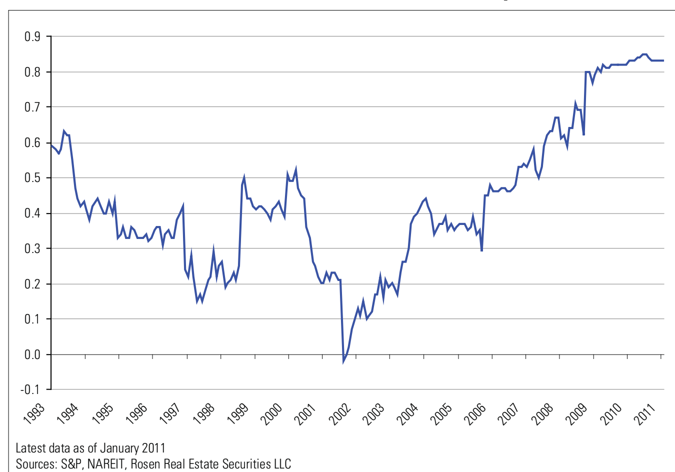
Latest data is as of January 21, 2011
Sources: Merrill Lynch, SNL, ISI Group, RCG

Forward Earnings Yield - REITs vs. S&P 500



Latest data as of February 1, 2011
Sources: Green Street Advisors, RCG

36-Month Rolling Correlation - S&P 500 vs. NAREIT Equity Index



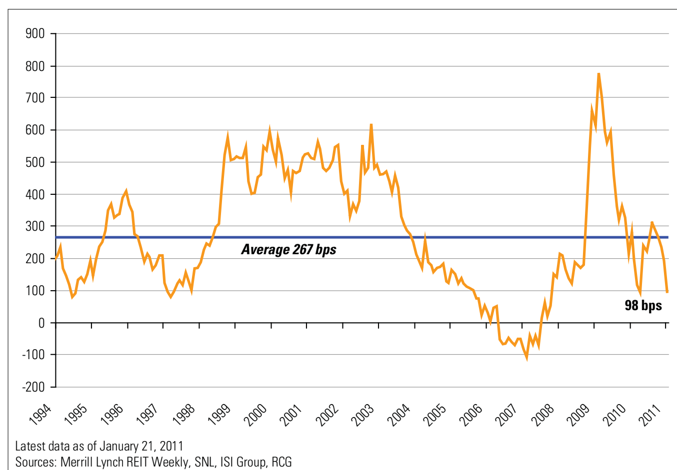
Latest data as of January 2011
Sources: S&P, NAREIT, Rosen Real Estate Securities LLC

- REITs are still trading at a much lower earnings yield of 5.1% than the S&P 500 at 8.7% as of December 2010.
- The REIT cash-flow yield spread to treasuries dropped back down to 98 as of January 21st from 311 in August 2010 as the 10-year Treasury rate moved up.
- As of January 21st, REITs are trading at a 3.6% dividend yield and a 4.4% cash flow yield. With 10-year Treasury rates near 3.4%, REITs will be under pressure to increase dividends.
- REITs have been actively raising capital through a combination of equity and debt offerings. Through December of 2010, IPO issuance totaled near $2 billion and secondary equity offerings totaled $23.6 billion. In contrast, a total of $24.2 billion of equity was raised in 2009. Unsecured debt issuance year-to-date through December at $19.2 billion is nearly twice the $10.4 billion issued in all of 2009.
- Capital infused, REITs are ready to buy assets, whether core, opportunistic or broken.

The volume of transactions gained in the second half of the year with investors focused on high-quality core assets. Lenders are gradually bringing distressed assets to market, keeping the bulk of problems in workout. Broken deals – so-called "Zombie buildings" – requiring equity infusions to become competitive are on the sidelines. As volume rises, however, investor interest will expand from core assets to more challenging opportunities.

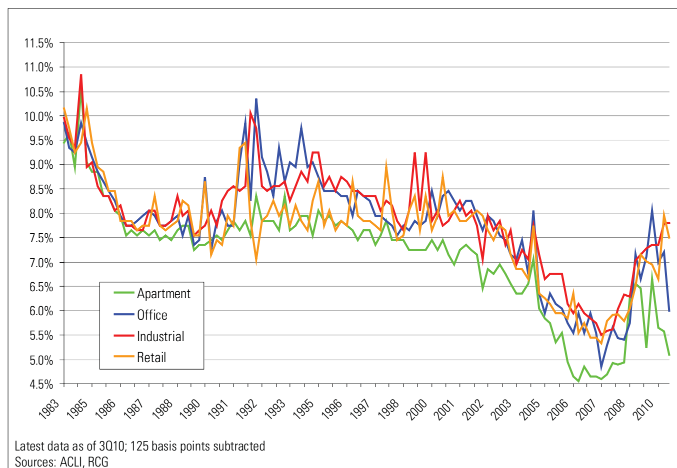
- According to Real Capital Analytics, sales volume in 2010 totaled $134 billion compared with $54.2 billion in 2009.
    - Office deals totaled $41.2 with a preponderance of central business district transations.
    - Apartment deals accounted for the next highest volume at $33.6 billion.
    - Retail transactions totaled $22.6.
    - Hotels added up to $13.8 billion in sales.

REIT Cash Flow Yield vs. 10-Year U.S. Treasury Bond



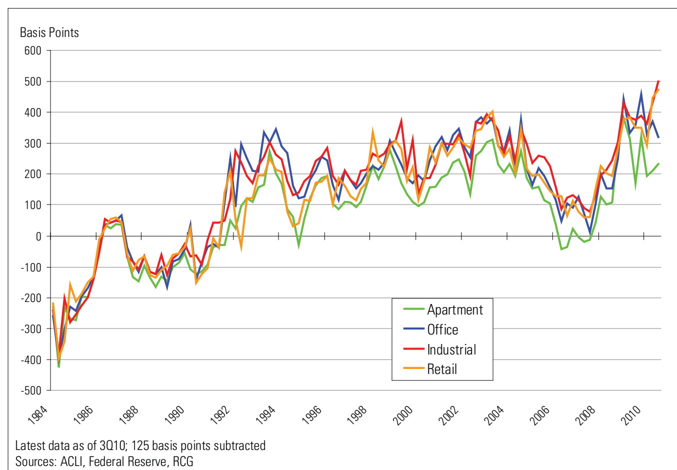
Latest data as of January 21, 2011
Sources: Merrill Lynch REIT Weekly, SNL, ISI Group, RCG

Cap Rates by Product Type



Latest data as of 3Q10; 125 basis points subtracted
Sources: ACLI, RCG

Cap Rate Spreads vs. 10-Year Treasury Yield



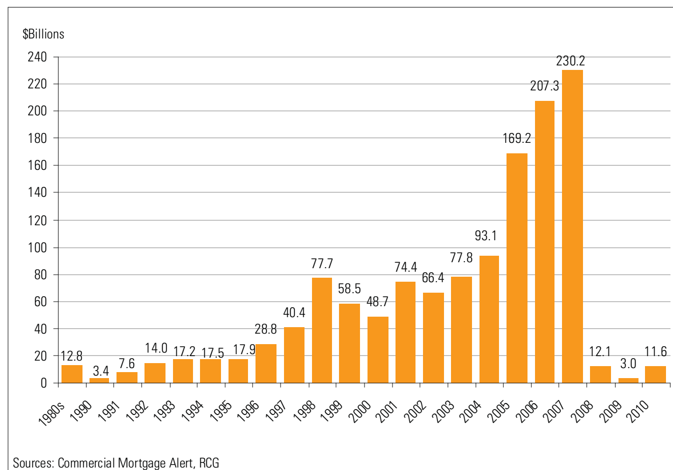
Latest data as of 3Q10; 125 basis points subtracted
Sources: ACLI, Federal Reserve, RCG

- The size of deals increased to $18 million from $11 million the year before. Moreover the amount of portfolio sales increased to more than $31 billion in 2010.
- There appears to be a wide differential in pricing across class and location. Investor interest in core properties in particular is lowering the cap rate on high-quality, well-located assets in primary markets. Core office and apartment properties in top-ranked markets are trading at less than a 5% cap rate.
- Cap rates are in the 5.1% to 7.8% range today with apartments at the low end and industrial at the high end. We adjust American Council of Life Insurance data to better reflect purchase market conditions since the ACLI data is solely from life insurance company mortgage originations.
- We caution that transaction volume is still relatively light, making it more difficult to pinpoint cap rate levels. More significantly, cap rates do not have the same level of reliability when net operating income is shifting. As net operating income bottoms and turns positive, we prefer measures such as price per square foot and replacement cost in a declining income environment.
- Real estate is cheap relative to alternative investments. With the exception of the office market, the spread between cap rates and ultra-low Treasury rates widened in the third quarter. The cap rate spread ranges between 234 basis points for apartments and 500 basis points for industrial.
- Reflecting improving fundamentals and rising transaction volume, the NCREIF property index increased by 8.1% in the third quarter of 2010 year-to-date. Capital appreciation picked up, after turning positive for the first time in the second quarter, gaining near 3%. Income returns improved to 5.1% year-to-date.

The volume of commercial and multifamily mortgages is down, but by all reports, activity is increasing. The CMBS market is gearing up for 2011. Both public and private players are positioned for portfolio and securitized lending despite ongoing workouts and regulatory uncertainty.

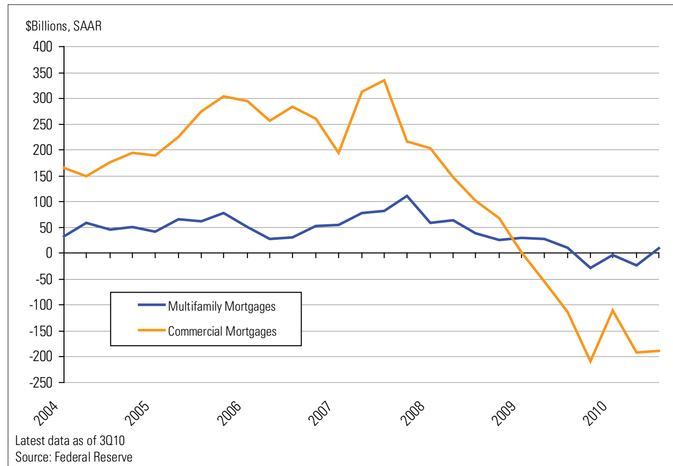
- Commercial mortgage outstandings fell by $172.8 billion on a seasonally adjusted annual rate in the third quarter as lenders wrote down existing debt and added little to portfolios.
- Commercial banks tightened outstandings by $91.9 billion.
- ABS issuers' outstandings fell by $53.5 billion.
- Multifamily mortgage flows decreased by $11.2 billion (seasonally adjusted annual rate). The troubled GSEs increased flows by $48.3 billion in the third quarter.
- The reemerging CMBS market issued $11.6 billion in 2010 versus $3 billion in 2009.
- Commercial Mortgage Alert reported total volume of $11.6 bil-

Domestic Commercial MBS Gross Amount Issued



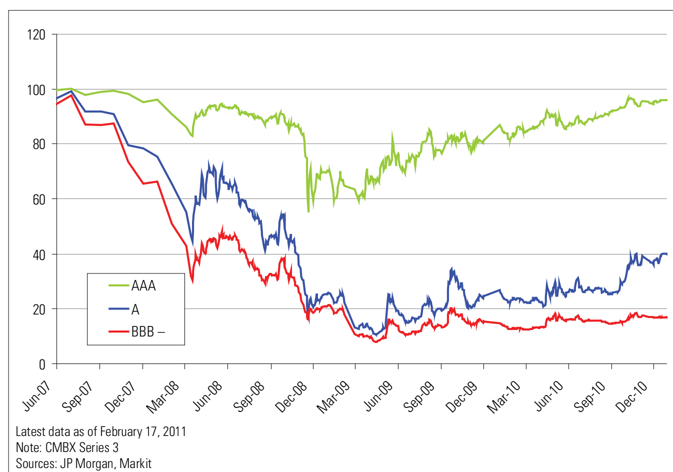
Sources: Commercial Mortgage Alert, RCG

Net New Commercial and Multifamily Mortgages



Latest data as of 3Q10
Source: Federal Reserve

CMBX Price Summary



Latest data as of February 17, 2011
Note: CMBX Series 3
Sources: JP Morgan, Markit

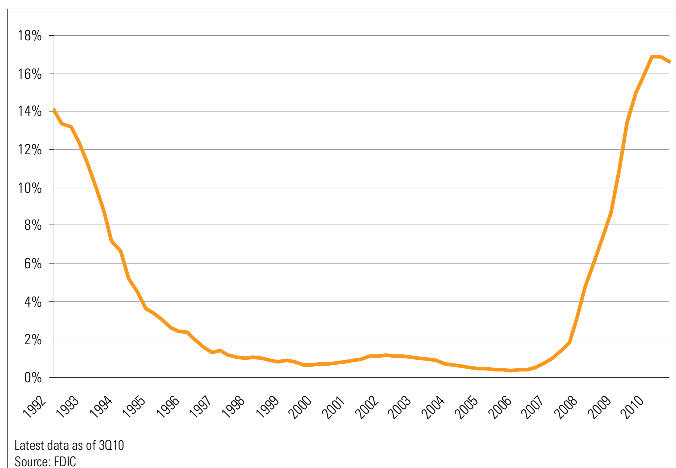
lion in 2010 versus $2.7 billion in 2009. Year-to-date in 2011, $3.9 billion has closed versus $0.8 billion in 2010.

- Most of the major banks announced that they reopened their CMBS shops and have begun originating. Commercial Mortgage Alert reports that securitization programs are targeting originations of $68.6 billion in 2011.
- Legacy commercial mortgage spreads have narrowed to near 250 since widening to 322 in May of 2010. Despite some choppiness, spreads are well-in from the distress-period high of 1,426 basis points in November of 2008.
- The AAA CMBX index is approaching par at 96.7 as of February 17th, having gradually improved from crisis lows of 55 in November 2008. While, the lower-rated instruments are still trading below par, Single A has improved to 55.61 in recent months. The BBB- remains low at 18.6. The lows for these instruments had been near 10.

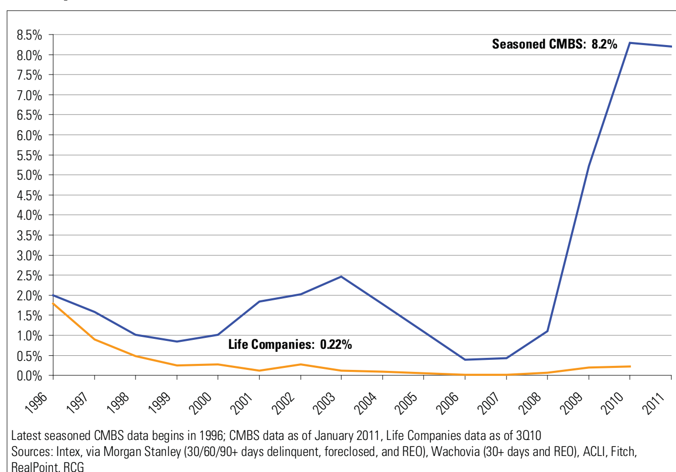
Delinquencies are rising for both legacy primary loans and CMBS. The only exceptions are life insurance portfolio loans where there was only a modest uptick in problems. Lenders and servicers are tending to modify and extend, keeping loans in the delinquent category for a longer period.

- Construction and development loans held by regional banks are causing the highest volume of problems. According to the FDIC, the delinquency rate leveled off in the second quarter and trended modestly down to 16.6% in the third quarter. The delinquency rate peaked at near 17.5% in March from 11% a year earlier. The delinquency rate was a low .04% in 2005.
- According to Realpoint, 8.2% of CMBS securities were delinquent on a trailing three-month basis as of January 2011. Delinquencies climbed to $62.09 billion.
- The average loss severity for loan workouts and liquidations year-to-date in 2010 through December was 56.7% according to Realpoint.
- Trepp reports that 13.4% of CMBS loans are in special servicing as of the end of January.
  - Office loans in special servicing remained near $23 billion in January or 30% of all loans in special servicing. As of the end of January, 11.5% of office mortgages were in special servicing, up from 5.5% at the end of 2009.
  - Retail CMBS in special servicing ticked up to 9.2%, accounting for 29.5% of all CMBS loans.
  - Including Stuyvesant, 19.7% of multifamily CMBS are in special servicing or 14.5% of all CMBS loans.
  - Hotel CMBS in special servicing improved to 21.8% of hotel loans or 9.4% of all CMBS loans. Extended Stay hotels was resolved in October.
  - Industrial CMBS has the lowest percentage of loans in special serving at 10.3% or 4.9% of all CMBS loans.

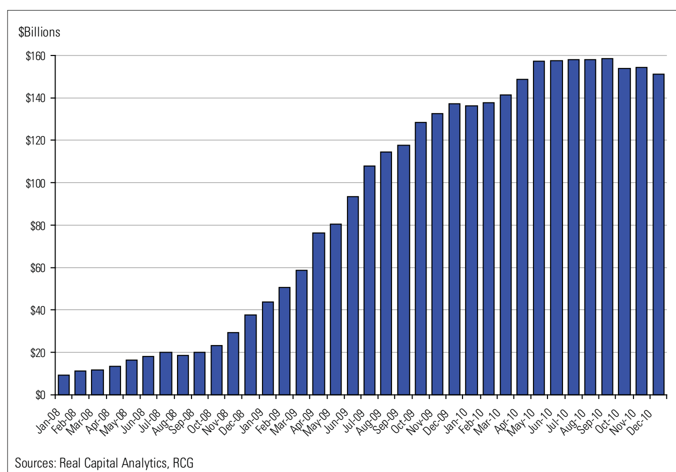
Delinquency Rate on Real Estate Construction and Development Loans



Delinquency Rates



U.S. Commercial Real Estate Troubled Assets



- According to Real Capital Analytics, the volume of distressed assets declined to $190 billion in December. Inflows have slowed while the volume of sales and workouts has increased. Distressed assets accounted for 22% of all sales in 2010, with the majority selling in the fourth quarter.
- Low Libor rates are allowing borrowers to stay current and lenders to adjust loan terms despite weakened net operating income in a phenomenon termed "Libor life support."

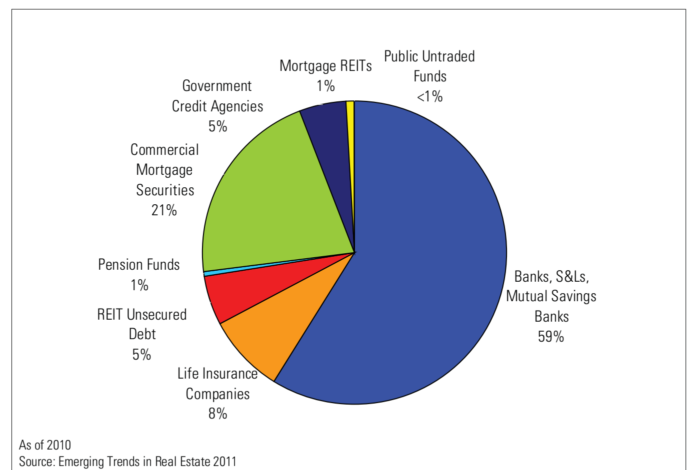
The Outlook

Unlike in the housing market, the overhang of troubled loans is not accompanied by excess inventory. While the drop-off in demand during the recession pushed vacancy rates up, construction pipelines were shut down fairly quickly, preventing overbuilding. Absorption gains have occurred as the job market has improved, lifting rents and net operating incomes. Additionally, it is less likely that disposition of problem loans will have a broad impact on property values because of the size and diversity of the real estate market. In fact, investors are already bidding up the price of high-quality office and apartments in the top ten markets. We expect investors to widen their scope as market fundamentals improve. We believe investors who venture into secondary markets, and assets, will be compensated for the added risk both in discount pricing and the opportunity to improve performance in a limited construction environment. Many of the loans in the wave of maturities across the forecast horizon will remain challenged by over-leveraging and cash flow impairment, even as fundamentals improve. Fresh equity and debt capital will be required and we expect to see increasingly sophisticated structures employed to isolate problems and to compensate risk. Time is running out, however, on low interest rates, and new capitalization will have to account for the rising cost of debt.

- Conservative choices by both developers and construction lenders are curtailing new construction, allowing time for existing supply to be absorbed. We expect construction loans outstanding to decline through 2011.
- In 2010, we expect write-downs and limited new originations will cause commercial mortgages outstanding to contract by $75 billion. Although we expect a pick-up in new activity in 2011, the overhang of problems will push outstandings down by an additional $5 billion.
- We expect the commercial mortgage rate spread to narrow from 205 basis points in 2010 to 50 basis points in 2011. With Treasuries at 4.5%, the mortgage rate will reach 5.0% by the end of 2011.
- REITS are vulnerable to an increase in long-term interest rates as the search for yield could come to an abrupt halt if the 10-year Treasury yield moves back to the 4%-5% range by 2012. We expect REITs to increase their dividends in the next year.

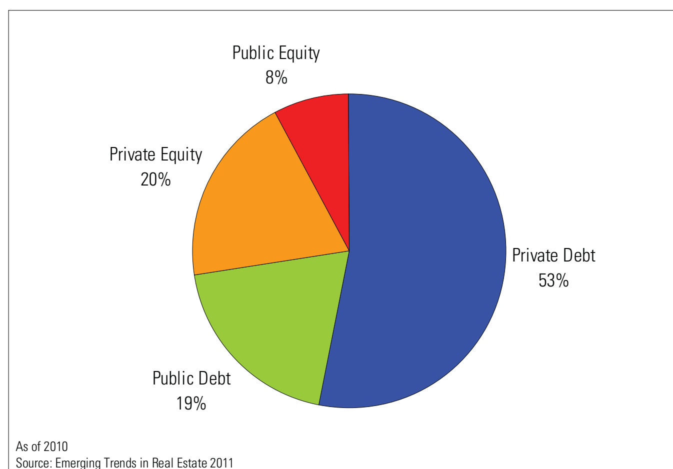
- There will be a wave of challenging maturities from this year through 2017. According to the Mortgage Bankers Association, the volume of commercial loan maturities will peak at $225 billion in 2012 and continue at the $150+ billion level through 2017. The challenge will come from value deterioration, impaired cash flows and high loan-to-value ratios of the maturing loans. While improving market fundamentals will help, a combination of fresh equity, lender write-downs and foreclosure or borrower bankruptcy will likely be required to close the equity gap.
- Equity capital will begin to bring "Zombie Buildings" back into service. It will be important, however, for lenders and equity investors to be aware of the status of such potentially competitive buildings as loan problems are abated.
- We expect CMBS issuance to elevate to $50 billion, well below the peak $230 billion volume in 2007.
- We expect both new whole loans and CMBS originations to be more conservative than during the boom period. The cap-rate pricing distinction we expect across the deal/asset quality spectrum will be reflected as well in loan pricing and underwriting standards.
- We expect equity REIT issuance to pick up to $35 billion by 2011 as investors favor the sector. REIT returns will moderate to 10% in 2011.
- NCREIF property index returns will return to double digits at 11.6% in 2010 and 12.9% in 2011 as capital appreciation gains.
- As a result of the Dodd-Frank bill, the FDIC, SEC, and the European Union, there will be more regulation on securitization. The FDIC will be the first to set guidelines for banks on January 1st. Other regulations will be put in place during the next two years. Risk retention of at least 5% is likely to be required. Details vary on the form risk retention must take. In addition, the National Association of Insurance Commissioners has issued new risk-based capital requirements for commercial mortgages and CMBS that are now in effect. Banks will also get expanded capital reserve requirements in the coming year from U.S. regulators and under Basel 3 rules. The potential impact of the Volcker Rule on securitization and securities trading is also not yet finalized.

U.S. Debt Capital: $2153.7 Billion



As of 2010
Source: Emerging Trends in Real Estate 2011

U.S. Real Estate Capital: $4058.9 Billion



As of 2010
Source: Emerging Trends in Real Estate 2011

Conclusion

Real estate is in an excellent position to perform well as the economy recovers. Real estate is cheap relative to alternative investments. Cash flow is rising as rents and occupancies improve. Although rising interest rates will add to costs, improving fundamentals, cash flow and pricing will gradually facilitate the resolution of lingering problems during the next five years. We believe opportunities are so compelling that the investment market is likely to get competitive by mid-2011. For core investing, we recommend:

- REIT portfolios hedged with out-of-the-money put options or call writing against long positions;
- Buy office, industrial, apartments at 5%-7% or above cap rates, 80% replacement cost or less;
- Lock in debt now;
- Defensive portfolios with modest leverage.

For opportunistic investments, we recommend:

- Public real estate strategies targeting opportunistic companies;
- Buy hotels at 50% of replacement cost;
- Single family land / housing / broken condos;

- Buy vacancy in strategic markets;
- Use mezzanine debt to fill capital gap;
- Development deals for apartments;
- Over-leveraged portfolios that need equity restructuring;
- LIFO or other structured equity programs.

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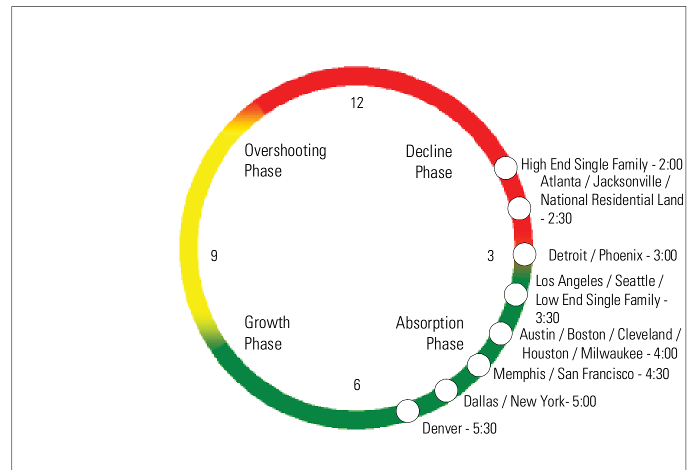
The National Single Family Housing Market

In 2010, it was a great time to buy a house. House prices were at cyclical lows and the mortgage rate was under 4%. The boost to affordability would be more meaningful if private lenders were more expansive in their credit provision. Just as we were frustrated by the inflated ease of credit in the 2004-2008 period, we are equally concerned now by the lack of credit for qualified borrowers. With a 20% down payment and a high credit score required, marginal home buyers are out of the market. Most underwater mortgages cannot be refinanced. The majority of mortgage credit is coming from the federal agencies and the Federal Housing Authority (FHA) either directly or through private lenders underwriting to meet FHA terms. Under the new Dodd-Frank bill signed into law in July of 2010, the mortgage industry will come under stronger regulation than it has historically. From origination to servicing to securitization, the eye of the regulators will be on establishing best practices.

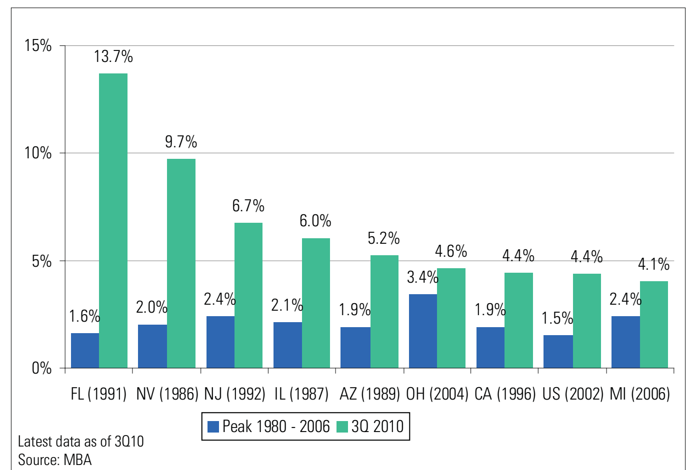
- As of January 28th, the 30-year fixed mortgage rate was 4.8% - up from nearly 80 basis points from last fall, reflecting rising Treasury rates.
- With Treasury rates plunging to artificial lows, the spread between the 30-year-fixed agency mortgage rate and the 10-year Treasury bond widened to 196 basis points in August before narrowing to 138 basis points by the end of January of 2011. Under the Federal Reserve mortgage-backed securities buying program, the spread had narrowed to near 100 basis points in March. The long-term average is 164 basis points.
- While the total amount of mortgages outstanding declined to $10.6 trillion in the third quarter of 2010, the GSEs including mortgage pools added $139 billion and now account for 54% of mortgages outstanding.

The housing market will continue to languish without an infusion of liquidity. Adding to the uncertainty are the foreclosure errors that came to light in September. The halt in foreclosures is a mixed blessing to the market. On the one hand, it will help households struggling to keep their homes. On the other hand, it will delay resolution of situations where the house is unoccupied. Many neighborhoods across the country are languishing because of a pile-up of vacant homes. Overall, the inventory of unsold homes remains high. An effective loan modification program is needed

Real Estate Cycle – Single Family



Mortgage Foreclosures in Process by State



Outlook for the National Single Family Home Market

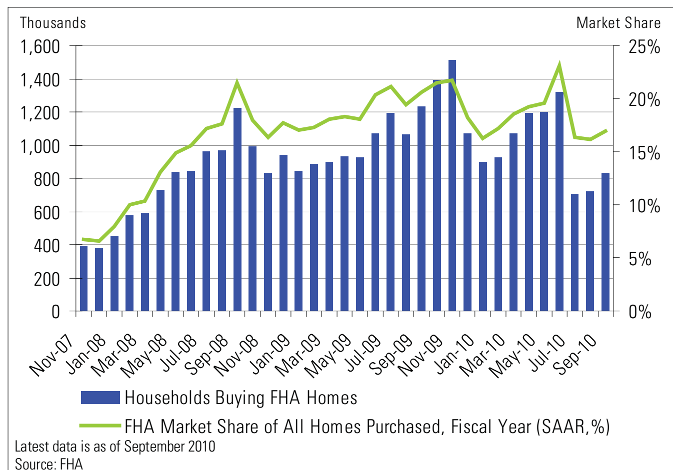
	2002	2003	2004	2005	2006	2007	2008	2009	3Q10	2010f	2011f	2012f	2013f	2014f
New Construction (000 Starts, Annual Rate)	1,359	1,499	1,611	1,716	1,465	1,046	622	445	476	471	574	700	900	1,000
Sales (000)**	5,657	6,176	6,727	7,076	6,516	5,675	4,893	5,160	4,163	4,919	5,800	6,100	5,900	6,200
Median Exist. Home Price (000)	$ 170.7	$ 182.4	$ 198.4	$ 225.3	$ 219.0	$ 205.7	$ 180.2	$ 170.3	$ 177.8	$ 170.6	$ 175.0	$ 181.1	$ 186.6	$ 192.2
Price Appreciation (4Q/4Q Rate)	8.5%	6.9%	8.8%	13.6%	-2.8%	-6.1%	-12.4%	-5.5%	-0.2%	0.2%	2.6%	3.5%	3.0%	3.0%
Affordability Index	131.0	129.0	123.4	107.6	110.5	125.7	154.1	173.7	173.1	187.9	179.1	142.5	149.1	140.4
Prime Delinquency Rate	2.6%	2.4%	2.2%	2.5%	2.6%	3.2%	5.1%	6.7%	6.3%	7.0%	6.5%	4.5%	2.5%	2.0%
Subprime Delinquency Rate	13.2%	11.5%	10.3%	11.6%	13.3%	17.3%	21.9%	25.3%	26.2%	27.0%	20.0%	13.0%	12.0%	11.5%
Foreclosure Rate	1.5%	1.3%	1.2%	1.0%	1.2%	2.0%	3.3%	4.6%	4.4%	4.6%	4.0%	3.0%	1.2%	1.0%
Subprime Foreclosure Rate	8.0%	5.6%	3.8%	3.3%	4.5%	8.7%	13.7%	15.6%	13.7%	14.5%	10.0%	5.5%	3.0%	3.0%
Alt-A Delinquency Rate	3.4%	3.0%	1.4%	1.2%	1.2%	6.4%	15.3%	20.4%	19.9%	21.0%	10.3%	3.0%	2.0%	1.5%
Interest Rate (90-Day T-Bill)*	1.2%	1.0%	2.2%	4.1%	5.0%	3.4%	0.1%	0.1%	0.2%	0.1%	2.0%	3.0%	4.2%	6.0%
Conventional 30-Yr. Mort. Rate*	5.9%	5.9%	5.8%	6.2%	6.2%	6.2%	5.1%	5.1%	4.3%	4.7%	5.1%	7.2%	6.7%	7.3%

*End of Period

**Sales of Existing Homes (inc. condos and coops)

Sources: Census, Federal Reserve, MBA, NAR, RCG

Increased FHA Mortgage Activity



Latest data is as of September 2010
Source: FHA

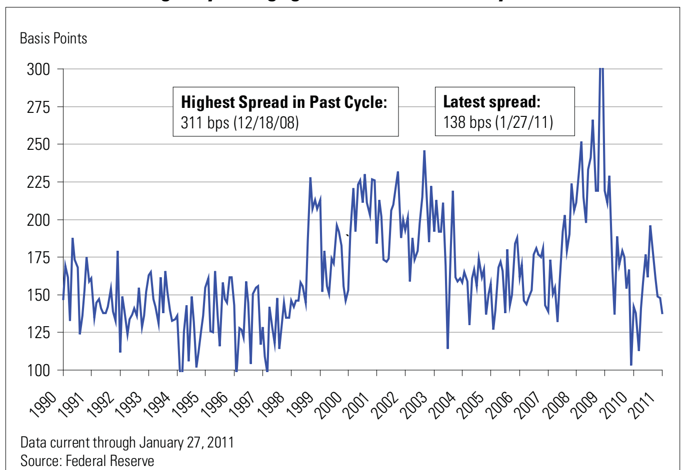
to help those homeowners who potentially could afford to stay in their home at reduced mortgage rates or balances.

Existing home sales totaled 4.9 million units in 2010, down from 5.2 million units in 2009 and matching the 2008 pace.

- The tax credit front-loaded sales in the fourth quarter of 2009 and first two quarters of 2010.
- The inventory level has trended down in the last two months and is currently 3.6 million units. At the current pace of sales, there is an 8.1-month supply of existing homes.
- Focusing on the existing single family market, there are 3.0 million homes on the market as of December of 2010, a 7.8-month supply.
- According to the National Association of Realtors, first-time buyers increased to 50% of buyers in 2010, from 36% of buyers in 2006. Reduced or negative equity is limiting the ability move-up buyers to enter the market.
- The mortgage crisis has trapped households in homes, limiting their ability to move for job, education, retirement or other purposes.
- The pace of new home sales slowed to 329,000 units (seasonally adjusted annual rate) in December, 7.6% lower than one year earlier when new homes sales had also been boosted by the tax credit. There is a 7.9-month supply of new homes based on the current pace of sales down from a peak of 14.4 months in March 2010.
- As of October, there were 191,000 new homes for sale, with 42% that were finished.

After posting the first year-over-year positive growth since the second quarter of 2006 in June, the median home price was virtually flat at a 0.2% gain fourth quarter of 2010 over fourth quarter of 2009. Although the foreclosure moratorium and reduction in for-sale foreclosure inventory has reduced downward pressure on prices, the lack of available credit and uncertainty has slowed sales curbing price growth. At the market level, data is only available

30-Year Fixed Agency Mortgage vs. 10-Year Treasury

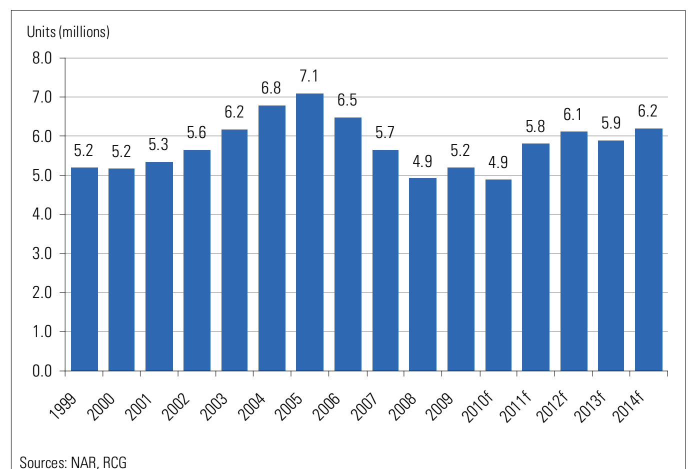


Data current through January 27, 2011
Source: Federal Reserve

through the third quarter.

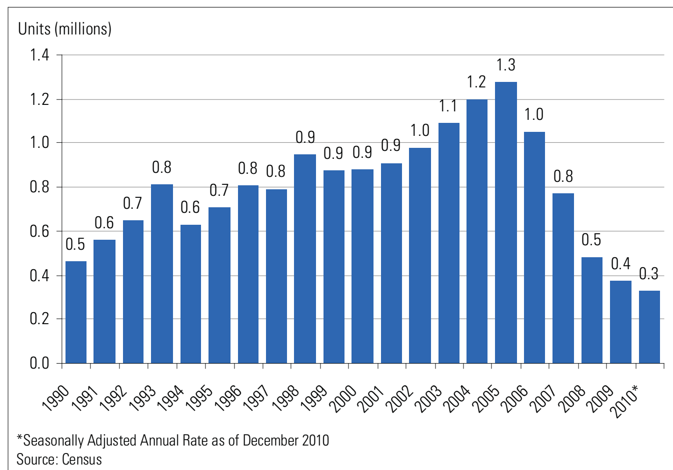
- Of the 75 markets we cover, only 16 posted negative price appreciation year-to-date through the third quarter. Only 6 of these markets posted declines of 5% or more. These prices are not seasonally adjusted and, therefore, a portion of the price increase is reflective of seasonal differences.
- Of the 75 markets we cover, 42 had positive year-over-year price increases in the third quarter of 2010.
- Thirty-three markets posted year-over-year declines in the third quarter including the usual suspects, Miami, Las Vegas and Phoenix.
- Of these, 17 markets declined after posting year-over-years gains in the second quarter of 2010 including: Cincinnati, Cleveland, Columbus, Fort Lauderdale, Kansas City, Modesto, Memphis, Sacramento, St. Louis, Vallejo and Ventura.
- In the latest report for December of 2010, the median existing home price slipped to $68,800. Note that the monthly price data are not seasonally adjusted.
- The S&P/Case Shiller 10-city index was nearly flat at negative 0.4% year-over-year as of November 2010 while the 20-city

U.S. Total Existing Home Sales (including condos and co-ops)



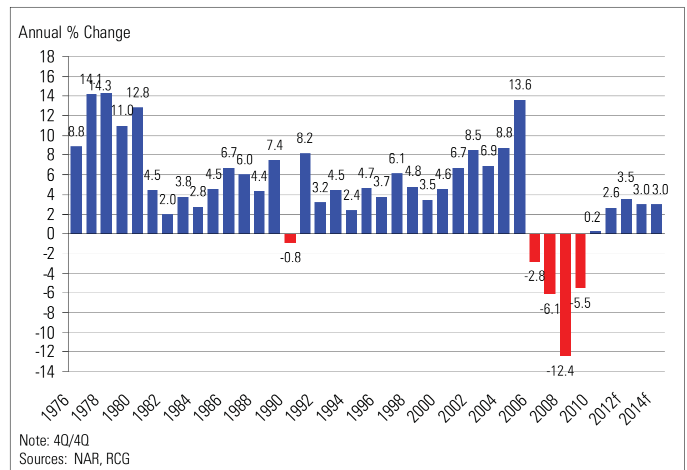
Sources: NAR, RCG

U.S. Total New Home Sales



*Seasonally Adjusted Annual Rate as of December 2010
Source: Census

Existing Median Home Price Appreciation - United States



Note: 4Q/4Q
Sources: NAR, RCG

index dipped by 1.6% on a seasonally adjusted basis year-over-year. As indicated by the overall index values, gains were sharply muted and 16 markets posted negative growth.

- Washington led with a gain of 3.5% versus 7.4% year-over-year in July. San Francisco had led in July with double-digit year-over-year gains. As of November, San Francisco prices were only 0.4% year-over-year. Prices also gained in San Diego (2.6%) and Los Angeles (2.1%).
- Chicago posted the sharpest price decline of 7.6% followed by Detroit with a year-over-year decline of 7.1%.

- In contrast to the other two series, the Federal Housing Finance Agency (FHFA) purchase-only house price index declined by 3.4% in the 12 months ending in October. The FHFA monthly index is calculated using purchase prices of houses backing mortgages sold to or guaranteed by Fannie Mae or Freddie Mac.

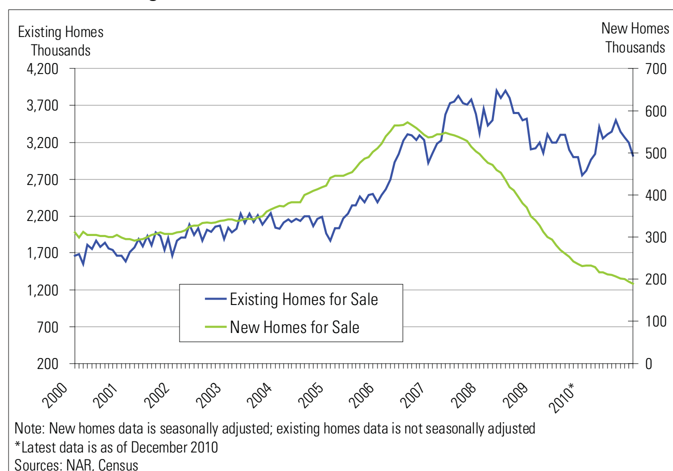
Affordability is at the highest level in decades. According to RCG's calculation, nearly 60% of households are able to purchase a median-priced home as of the third quarter of 2010, up from a house-price-boom low of 40.1% in 2005.

- The affordability index produced by NAR is 187.9 in the fourth quarter of 2010, well above the long-term average of 130.
- At 100, the index shows that a family earning the median income has exactly the amount of income necessary to qualify for a conventional mortgage and purchase a median-priced home given current mortgage rates. An index value this high above 100 illustrates that the pool of potential buyers is large.
- The proportion of owner households had gradually decreased since 2006 with the wave of delinquencies and foreclosures. The rate just slipped under 67% in the third quarter of 2010.

Home builders are pacing new construction to match demand resurgence and the hangover of existing inventory and foreclosures. From a 50-year low (based on available records), the pace of housing starts ticked up in the first half of 2010 before pulling back in the second half. Relative to the volume of new home sales, construction is far lower than both short-term and long-term historical averages.

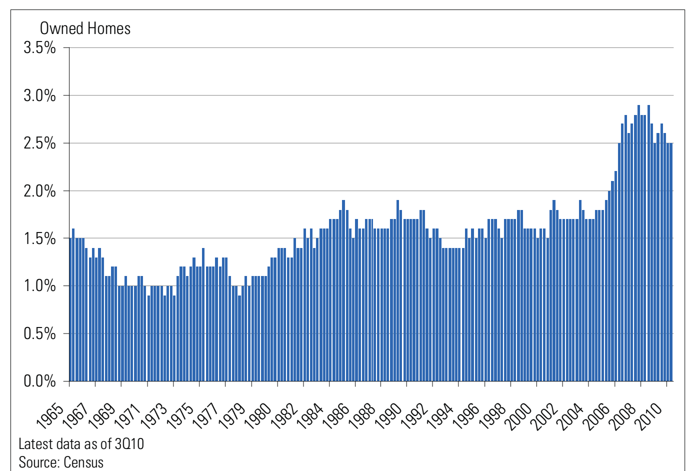
- For 2010 as a whole, single family starts decreased to 471,000 units on a seasonally adjusted annualized basis from 486,000 in 2009.
  - As of November, the South had the highest level of starts of all regions at 117,000. Despite the high volume, the

New & Existing Homes Available For Sale



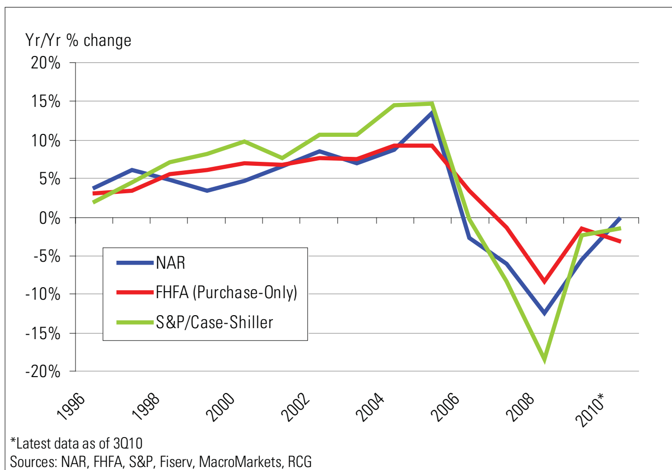
Note: New homes data is seasonally adjusted; existing homes data is not seasonally adjusted
*Latest data is as of December 2010
Sources: NAR, Census

Percentage of Housing Stock Vacant



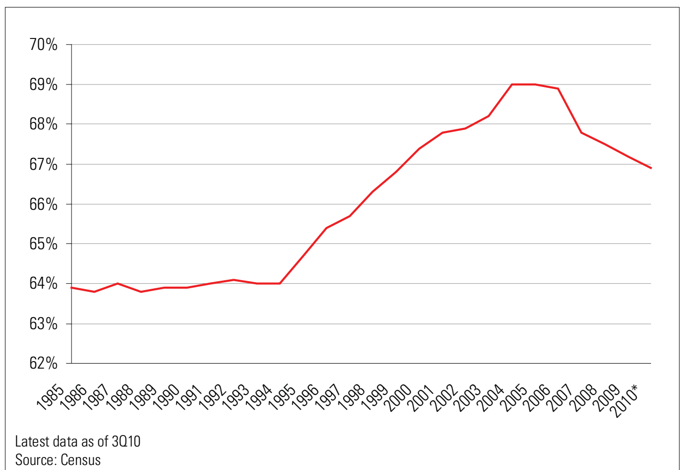
Latest data as of 3Q10
Source: Census

Home Price Indices



*Latest data as of 3Q10
Sources: NAR, FHFA, S&P, Fiserv, MacroMarkets, RCG

Homeowner Households - Proportion of Total Households



Latest data as of 3Q10
Source: Census

pace of construction was off by 10% from a year earlier.

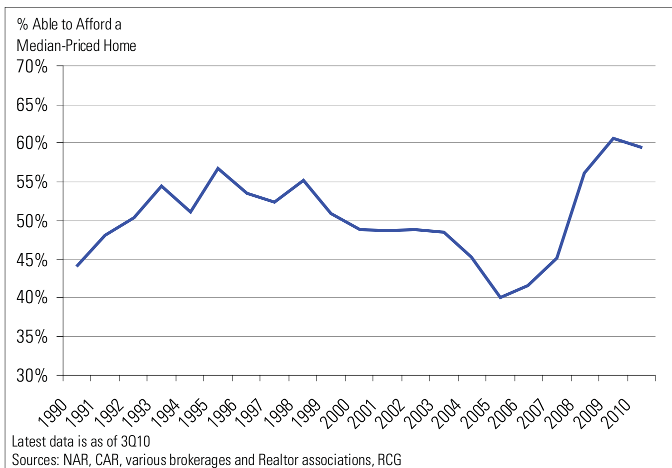
- Starts in the West totaled 56,000 in November, a 17.6% drop from a year earlier.
- The Midwest and Northeast typically produce lower levels of starts. At 48,000 units, starts in the Midwest are down by 12.7% year-over-year. Construction in the Northeast totaled 40,000 units, down by 11.% from a year earlier.

- Builders are taking advantage of cheap land opportunities to assemble lots. The net operating loss carryback provision signed into law in November of 2009 was a big positive for homebuilders in 2010.

Delinquencies and foreclosures began to decline for the first time in the second quarter. Further improvement was noted in the third quarter, supporting our belief that 2010 will mark the peak of the problems and improvements will follow. The only exception was a slight increase in foreclosures for prime fixed-rate mortgages.

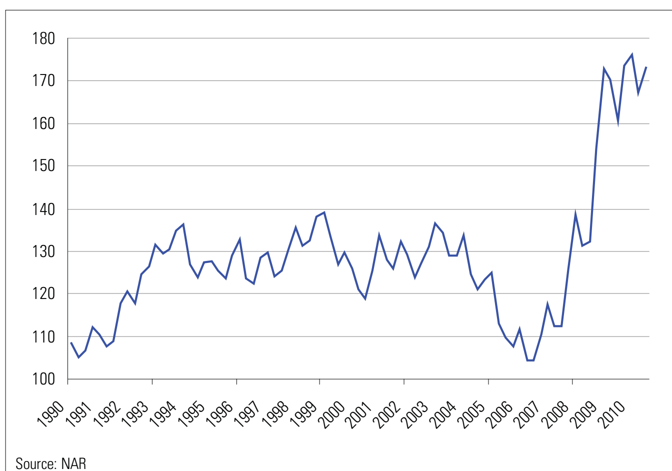
- According to First American Core Logic, the number of borrowers holding underwater mortgages declined, for the most part due to foreclosure, to 10.8 million or 22.5% of all mortgage properties as of the end of the third quarter. This level has

Affordability, United States



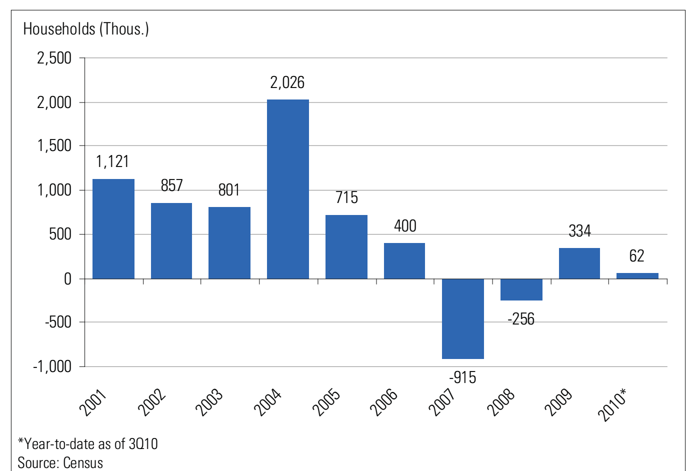
Latest data is as of 3Q10
Sources: NAR, CAR, various brokerages and Realtor associations, RCG

Composite Housing Affordability Index – United States



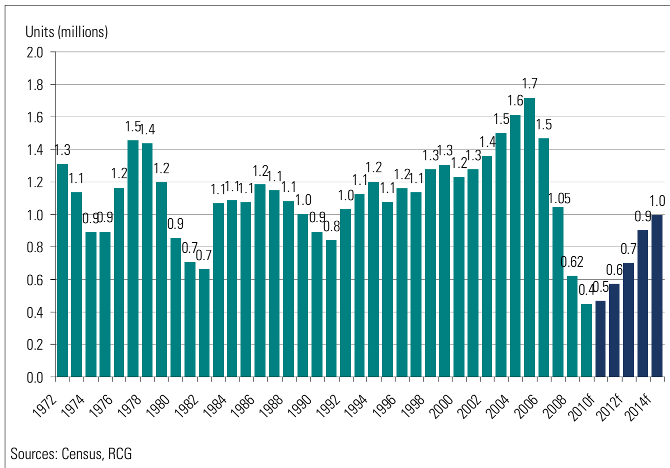
Source: NAR

Annual Change in Homeowner Households



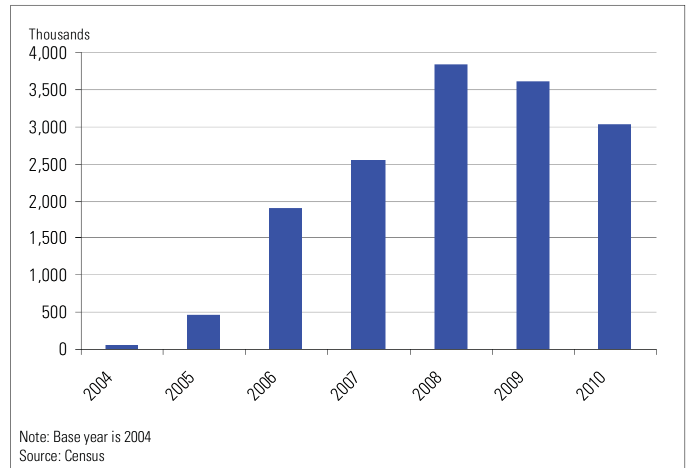
*Year-to-date as of 3Q10
Source: Census

U.S. Single Family Housing Starts



Sources: Census, RCG

Cumulative Excess Supply – Total Starts vs. Total Households



Note: Base year is 2004
Source: Census

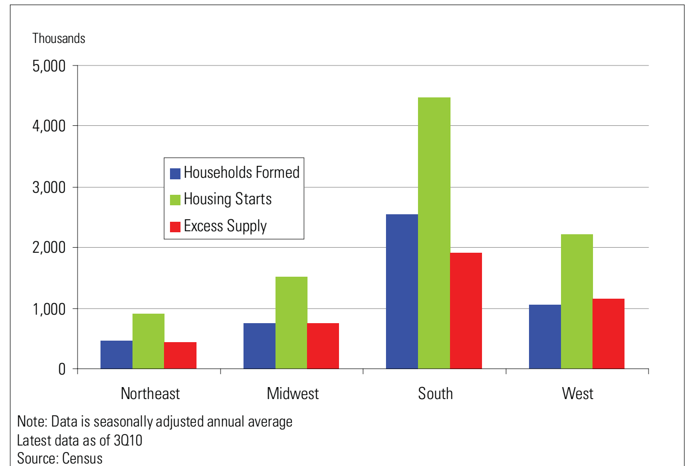
been stable since September of 2009, signaling that the pace of new problems is slowing.

- The problem states again showed modest improvements, indicating that although troubles are deep, they are not worsening. Nevada has the largest share with 67% of all loans underwater. Arizona has 49% underwater; Florida, 46%; Michigan, 38%; and California, 32%.

- Reflecting problems for high-end borrowers, the rate of delinquencies and foreclosures for prime loans remains high, particularly for the riskiest adjustable-rate segment. Many within this category are in the jumbo category, exceeding the Federal agencies' loan size limit, and therefore dependent on private mortgage sources for relief.
  - 6.3% of all conventional prime loans are past due in the third quarter of 2010 versus 7.1% in the second quarter and 6.8% a year earlier.
  - The rate of delinquency in prime fixed-rate mortgages improved to 5.2% in the third quarter, down from 6.0% in the second quarter and 5.7% a year earlier.
  - Prime ARM mortgages past due improved to 13.3%, from a high of 13.8% in the second quarter. The rate remains above the 12.4% of a year earlier.
  - The rate of foreclosure ticked up for fixed-rate prime mortgages to 2.5% in the third quarter from near 2.0% a year earlier. Foreclosures for ARM prime mortgages decreased to 10.1%, near the year-ago level. from a high of 10.4% in the first quarter.

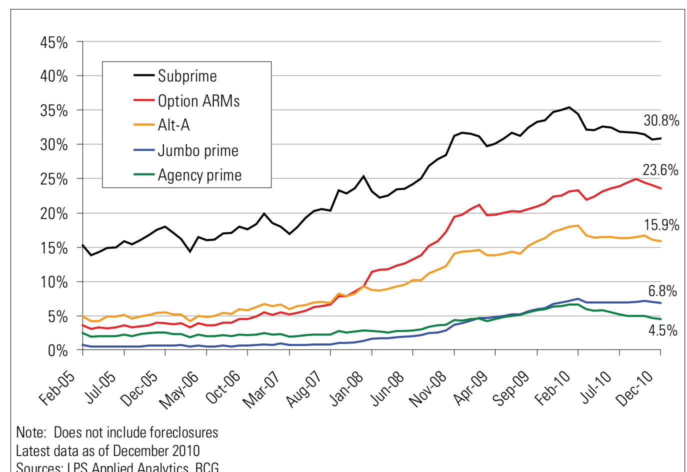
- The deterioration of prime mortgages is unprecedented. In the 2001 recession, prime fixed-rate loan delinquencies peaked at 2.6% and prime ARM loans peaked at 4.1%. Data changes by the Mortgage Bankers Association made earlier time periods not directly comparable, but in the earlier series, total delinquencies peaked near an estimated 5% in the 1990-1991 recession.

Regional Excess Supply, 2004 – 3Q 2010



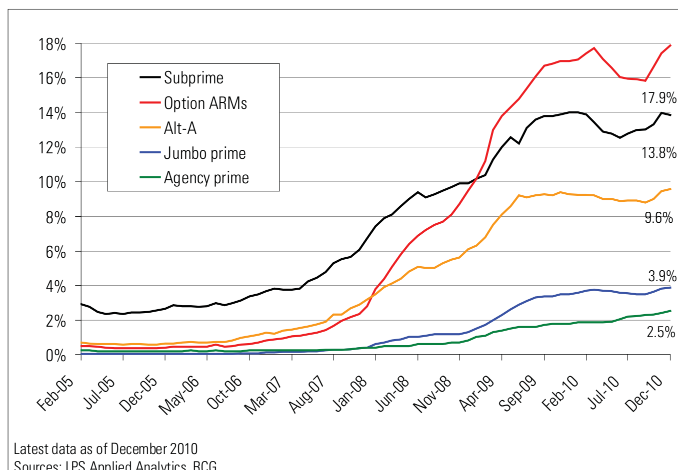
Note: Data is seasonally adjusted annual average
Latest data as of 3Q10
Source: Census

Total Loans Past Due 30+ Days

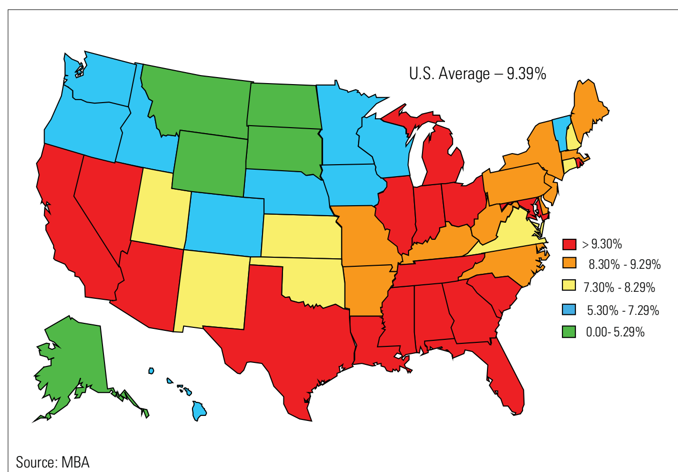


Note: Does not include foreclosures
Latest data as of December 2010
Sources: LPS Applied Analytics, RCG

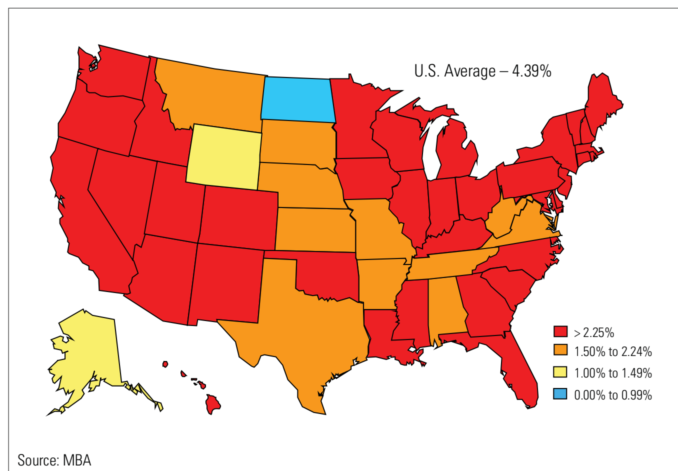
Mortgage Foreclosures in Process by Loan Type



Delinquencies - Total Loans Past Due By State for 3Q10



Foreclosure Inventory Rates by State for 3Q10



- Subprime delinquencies improved to 26.2% in the third quarter from 27.0% in the second quarter and 26.4% a year earlier. The rate of delinquencies is still well above the near-15% peak rate of the 2001 recession. At best, the subprime business is never less than 10% delinquent. Subprime foreclosures ticked down to 13.7% in the third quarter from a high of 15.6% in the fourth quarter of 2009.
- Foreclosure filings increased only 1.7% in 2010 from 2009 due to the moratorium. A total of 2.87 million foreclosures were filed in 2010 according to RealtyTrac.
  - Problems are concentrated in five states where 51% of foreclosure filings occurred in 2010: California, Florida, Arizona, Illinois and Michigan.
  - Despite the concentration, foreclosures were down year-over-year in California by nearly 14%, Florida by 6% and Arizona down 4% from 2009.

We have re-consolidated the low-end and high-end of the residential market finding the market as a whole to have progressed to 3:30 in the recovery phase. The pace of recovery from here will vary widely by locality with markets with stronger job growth improving more rapidly than markets lagging national growth. Additionally, the pace of improvement will be slower for markets with higher levels of vacant and foreclosure inventory. The graphic on the first page of this section shows clock times for selected metropolitan markets.

The Outlook

We have lowered our house price appreciation expectations, but remain positive. Gains will be dampened by the overhang of excess inventory and the ongoing lack of resolution for the 4.1 million households with delinquent mortgages and the 11.3 million homes with negative equity (whether currently delinquent or not). Despite the inventory weight, we believe momentum will be sufficient, particularly for low- to mid-priced homes, provided:

- The mortgage rate remains below 6%;
- Credit becomes more widely available for qualified borrowers;
- Employment continues to rise; and
- A better plan for dealing with troubled loans is put into place by the Federal Government and servicers.

We expect house price appreciation to pick up from there in all markets beginning in 2011. We have, however, lowered the pace of price gains to reflect the extended overhang of troubled loans. Value increases will be driven by a combination of rising demand and, in markets that have had high levels of foreclosure sales, a bounce-back from distressed pricing. These markets also correspond to where we anticipate strong long-term growth. From 2011–2014, we expect job growth, mortgage rates and supply conditions to be the critical factors in forecasting housing demand and prices.

- We expect the median price of a home to rise steadily, reaching $195,100 by the end of 2014.
- The growth rate will average 3.0% between 2011 and 2014. It will remain well below the pace of the boom era and trail the long-term 6.25% average.

Under our base case, the economic conditions will hold. We are hopeful that a better plan will be put into place soon.

- Affordability will be strongest during the next 12 months. As house price appreciation returns and mortgage rates move up, affordability will decrease, but remain above the long-term average and well above the housing-boom lows.
- The mortgage market will gradually recover over the forecast horizon. There will be a transition period between the current public-dominated market to one with a rising share of privately originated and held mortgages.
- The impact of new financial services reform on the lending business is not yet known. The new regulations will impact origination, servicing and the reemergence of private-labeled residential mortgage-backed securities. We expect private volume to gradually increase as the new regulations are clarified and as the economy improves.
- It looks like 2010 will be the last year of the sub-5% mortgage. Rising Treasury rates will push the rate on a conventional 30-year loan to 7.3% by year-end 2014.
- The majority of mortgages will be conventional fixed-rate with fully amortized monthly principal and interest payments.
- Borrowers will be required to have cash for down payments and supporting documents for income verification under the new Qualified Residential Mortgage requirements.
- The new regulations along with lenders' inclinations will exclude those households that are not qualified to buy and will keep the percentage of homeowners declining perhaps to below 66%. We find the previous peak of 69% homeownership to be unrealistic, dependent as it was on unstable aggressive loans.
- We expect the lowest level of existing home sales in 2010. Thereafter, despite rising mortgage rates and the return of healthy home-price appreciation, sales will climb to 6.1 million units in 2012. By the end of the forecast period in 2014, we expect sales to total 6.2 million. This level is near 2003s sales figure, but below 2004-2007s boom pace.

Given the scale of foreclosure problems, it will take time for troubled mortgages to be resolved or terminated. Even with the positive house-price appreciation we expect, deeply underwater mortgages will remain with negative equity at the end of the forecast period. The higher end of the market will lag behind the low to moderate end during the recovery period.

- We believe delinquencies for all loan categories will peak in 2010. The pace of improvement will be gradual, however, over the next 12 to 18 months. Beginning in 2012, delinquencies in all categories should approach historically normal levels.
- RCG believes that the overall foreclosure rate will peak in 2010 at 4.6% even with the moratorium. It will take another two to three years for the foreclosure process to complete and for this inventory to clear.

There are wide regional differences in housing market performance. Please refer to our market spotlights for specific market detail. Of our 75 markets, 30 markets will outperform our forecasted national increase in 2011 with house price appreciation ranging from 2.6% to 5.7%, including:

- The large California markets of San Jose, Inland Empire, Orange County and San Diego along with Santa Barbara and Stockton, and in the rest of the West, Denver, Honolulu, Portland, Salt Lake City and Tucson will outperform the nation as a whole. San Francisco will match the national average.
- In the East, New York and the surrounding markets of Stamford, Nassau-Suffolk, Central New Jersey and Newark, Boston, Washington D.C., and Philadelphia, will outperform the nation as a whole. Hartford will match the national average.
- In the Midwest, only Minneapolis at a growth rate of 3.3% will outperform the national average. Boise will match the national average.
- Finally, in the South, Houston and Austin as well as Norfolk, Greensboro, Raleigh-Durham and Richmond will outperform the national appreciation rate. Dallas will perform near the national average.

There are 45 markets that will underperform the national gain in 2011.

- Oakland, Los Angeles, Sacramento, Fresno and other smaller California markets are in this category. Also underperforming

California Median Prices by Metropolitan Statistical Area

Ranked by 3Q10 Median Price Growth

		3Q 2009		3Q 2010	
California	Peak-Trough Decline	Median Price	Annual Change	Median Price	Annual Change
Santa Barbara	-52.8%	$391,836	-4.3%	$459,391	17.2%
Salinas	-56.3%	$296,576	-13.6%	$346,670	16.9%
Inland Empire	-56.5%	$168,100	-26.0%	$190,100	13.1%
San Jose	-37.3%	$565,000	-8.9%	$627,750	11.1%
Oakland	-30.2%	$517,250	-10.8%	$573,771	10.9%
Bakersfield	-52.7%	$131,991	-27.2%	$139,414	5.6%
Stockton	-60.5%	$157,012	-21.7%	$164,836	5.0%
San Francisco	-23.9%	$716,513	-11.5%	$747,503	4.3%
Santa Rosa	-44.9%	$360,245	-5.3%	$373,077	3.6%
San Diego	-45.2%	$378,100	0.2%	$387,600	2.5%
Orange County	-33.6%	$498,800	-3.3%	$508,400	1.9%
Fresno	-49.5%	$148,865	-21.4%	$151,617	1.8%
Los Angeles	-41.6%	$343,697	-10.3%	$348,019	1.3%
Sacramento	-50.7%	$186,600	-12.0%	$185,000	-0.9%
Modesto	-61.1%	$139,365	-22.8%	$137,970	-1.0%
Ventura	-41.8%	$454,754	1.9%	$443,967	-2.4%
Vallejo	-66.2%	$179,111	-29.5%	$171,011	-4.5%
Regional Average	**-47.3%**		**-13.3%**		**5.1%**

Sources: CAR, RCG

Northeast Median Prices by Metropolitan Statistical Area
Ranked by 3Q10 Median Price Growth

Northeast	Peak-Trough Decline	3Q 2009 Median Price	3Q 2009 Annual Change	3Q 2010 Median Price	3Q 2010 Annual Change
Stamford	-19.0%	$398,200	-15.6%	$451,200	13.3%
Boston	-16.4%	$348,000	-7.0%	$366,500	5.3%
New York	-16.5%	$450,700	-13.8%	$470,100	4.3%
Washington	-31.8%	$324,700	-2.5%	$338,600	4.3%
Newark	-21.7%	$385,400	-14.8%	$398,900	3.5%
Central New Jersey	-14.4%	$343,800	-8.9%	$355,800	3.5%
Hartford	-12.2%	$237,500	-4.7%	$244,100	2.8%
Philadelphia	-6.3%	$227,500	-5.6%	$231,000	1.5%
Rochester	-7.2%	$121,500	-1.7%	$121,700	0.2%
Nassau-Suffolk	-19.3%	$384,900	-9.2%	$385,500	0.2%
Baltimore	-12.2%	$261,100	-6.5%	$257,100	-1.5%
Pittsburgh	-6.7%	$124,600	1.5%	n/a	n/a
Regional Average	**-15.3%**		**-7.4%**		**3.4%**

Sources: NAR, RCG

Midwest Median Prices by Metropolitan Statistical Area
Ranked by 3Q10 Median Price Growth

Midwest	Peak-Trough Decline	3Q 2009 Median Price	3Q 2009 Annual Change	3Q 2010 Median Price	3Q 2010 Annual Change
Detroit	-52.7%	$65,168	-37.2%	$75,750	16.2%
Milwaukee	-14.2%	$199,500	-8.0%	$209,300	4.9%
Indianapolis	-17.9%	$120,200	2.0%	$123,300	2.6%
St. Louis	-20.8%	$135,600	-5.0%	$135,400	-0.1%
Cleveland	-35.5%	$115,800	-0.5%	$114,500	-1.1%
Cincinnati	-19.3%	$131,700	-3.2%	$129,300	-1.8%
Kansas City	-16.3%	$146,200	-0.7%	$141,400	-3.3%
Columbus	-14.5%	$142,600	-1.0%	$135,100	-5.3%
Chicago	-28.6%	$210,100	-16.2%	$196,600	-6.4%
Minneapolis	-27.3%	$184,800	-9.9%	$171,400	-7.3%
Regional Average	**-24.7%**		**-8.0%**		**-0.2%**

Sources: NAR, RCG

West (excluding CA) Median Prices by Metropolitan Statistical Area
Ranked by 3Q10 Median Price Growth

West (excluding CA)	Peak-Trough Decline	3Q 2009 Median Price	3Q 2009 Annual Change	3Q 2010 Median Price	3Q 2010 Annual Change
Honolulu	-2.4%	$587,139	-4.5%	$628,100	7.0%
Denver	-18.9%	$229,100	1.8%	$238,500	4.1%
Colorado Springs	-14.8%	$195,100	-6.2%	$201,400	3.2%
Spokane	-12.4%	$177,600	-7.1%	$181,000	1.9%
Albuquerque	-10.4%	$183,500	-5.1%	$185,100	0.9%
Las Vegas	-56.9%	$138,500	-34.5%	$138,100	-0.3%
Seattle	-16.0%	$356,943	-11.6%	$353,486	-1.0%
Portland	-17.6%	$244,500	-12.2%	$242,100	-1.0%
Salt Lake City	-9.3%	$218,900	-4.9%	$215,600	-1.5%
Tacoma	-20.2%	$229,849	-9.6%	$224,681	-2.2%
Phoenix	-49.1%	$142,700	-22.9%	$138,000	-3.3%
Boise	-35.7%	$153,400	-18.1%	$131,800	-14.1%
Tucson	-38.4%	$174,000	-12.7%	$148,100	-14.9%
Regional Average	**-23.2%**		**-11.4%**		**-1.6%**

Sources: NAR, RCG

South Median Prices by Metropolitan Statistical Area
Ranked by 3Q10 Median Price Growth

South	Peak-Trough Decline	3Q 2009 Median Price	3Q 2009 Annual Change	3Q 2010 Median Price	3Q 2010 Annual Change
Richmond	-13.8%	$202,322	-7.1%	$220,600	9.0%
Austin	-1.2%	$189,100	-0.9%	$205,000	8.4%
Nashville	-12.0%	$163,700	-6.9%	$175,773	7.4%
El Paso	-5.5%	$132,800	-2.6%	$139,200	4.8%
Tulsa	-4.6%	$132,100	-5.5%	$136,600	3.4%
San Antonio	-5.5%	$152,800	-1.0%	$158,000	3.4%
Dallas	-4.9%	$159,839	1.1%	$164,434	2.9%
Louisville	-9.9%	$135,600	0.1%	$138,500	2.1%
Raleigh-Durham	-7.2%	$202,277	-4.4%	$202,898	0.3%
Charlotte	-9.4%	$199,600	-5.4%	$200,100	0.3%
Norfolk	-15.3%	$215,000	-5.7%	$215,000	0.0%
Houston	-5.5%	$160,600	0.2%	$158,900	-1.1%
Fort Worth	-5.9%	$116,334	-2.5%	$114,805	-1.3%
Fort Lauderdale	-43.6%	$212,329	-23.4%	$209,409	-1.4%
Greensboro/Winston-Salem	-15.1%	$131,700	-9.5%	$129,800	-1.4%
Miami	-49.7%	$192,745	-33.5%	$189,905	-1.5%
Tampa	-42.4%	$137,400	-20.8%	$131,300	-4.4%
Birmingham	-16.3%	$153,300	-1.8%	$146,000	-4.8%
Jacksonville	-24.8%	$145,700	-17.0%	$137,000	-6.0%
West Palm Beach	-45.1%	$244,632	-19.2%	$226,562	-7.4%
Memphis	-30.5%	$129,300	2.2%	$119,600	-7.5%
Orlando	-48.7%	$157,900	-26.0%	$140,500	-11.0%
Atlanta	-31.8%	$129,400	-14.5%	$113,500	-12.3%
Regional Average	**-19.5%**		**-8.9%**		**-0.8%**

Sources: FAR, NAR, TAMU, RCG

in the rest of the West are Seattle, Las Vegas and Tacoma. House prices in Phoenix and Albuquerque are projected to gain by 2.3%.

- The major Florida cities of Miami, Tampa, West Palm Beach, and Jacksonville also will produce positive gains, but less than the 2.7% we expect nationally. Orlando and Fort Lauderdale will perform the strongest with projected growth of 2.4% and 2.3%, respectively. Memphis, Nashville, Louisville, Atlanta, Fort Worth, and San Antonio are also in this category.
- In the East, New York and Baltimore will underperform.
- In the Midwest, Detroit, Indianapolis, Columbus, St. Louis, Chicago, Cleveland, Cincinnati, and Kansas City will also underperform.

In response to rising demand, homebuilders will gradually add new supply in areas of population growth.

- Single family starts will slowly recover to 1.0 million units by 2014. The limited new supply will allow for gradual absorption of the overhang of existing home inventory.

Conclusion

High affordability makes today an excellent time to buy. As job growth gains and credit availability increases, demand will respond. We are concerned about the overhang of troubled loans and think it is long past time that these households were helped. We believe a new loan modification program is needed along with the regulations coming under Dodd-Frank to both resolve problems and guide the mortgage industry going forward. Stricter underwriting will be required by both federal agencies and private participants, but we advise that these restrictions must allow truly qualified households to become homeowners. At the same time, we recognize, given the recent boom-bust market trend, some qualified households may choose to rent rather than buy. We are confident that rising demand will lift house prices back to near 2007 levels by the end of the forecast period.

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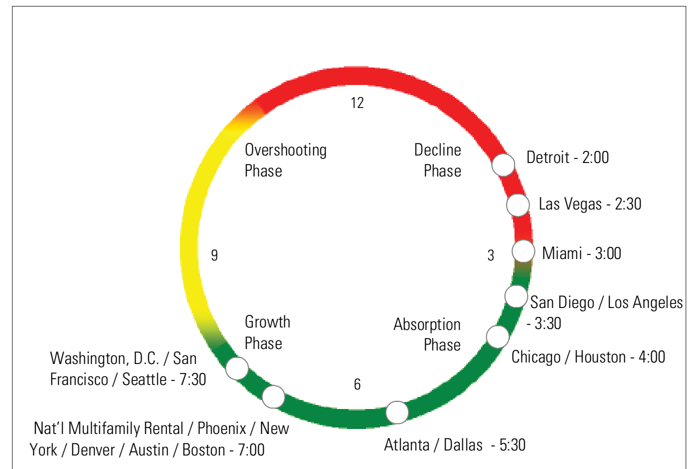
The National Apartment Market

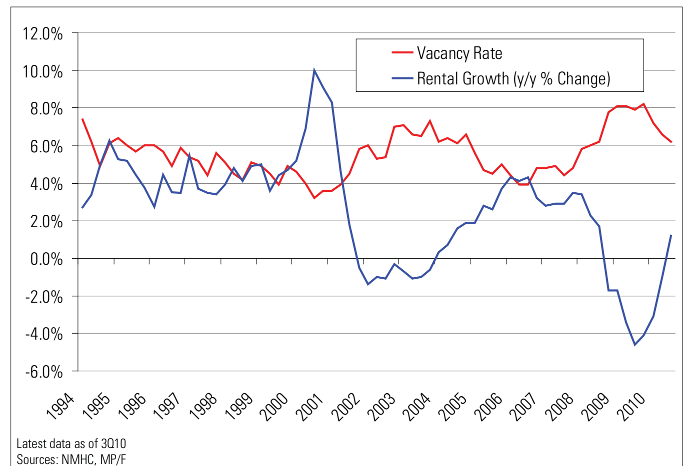
In the third quarter, assisted by the positive trends of new household formation and tightening occupancy, the long-predicted increase in rent finally occurred, particularly for professionally managed stock. Though some markets performed better than others, the national trend was strongly positive; the NMHC Market Tightness Index, a national indicator for which a reading greater than 50 indicates contracting dynamics, shot up from 31 in October of 2009 to 77 in October of 2010. The growing roster of players in the investment market has provided a surge of capital and extended the scope of sales beyond the trophy assets that characterized the beginning of the investment revival. Given the national reach of the apartment recovery, NOI growth is expected to proceed across markets. Though at first it will be more pronounced in markets with a lack of competition from foreclosed homes and excessive condo supply, the post tax-credit uptick in condo sales that began at the end of 2010 should help NOI growth to spread quickly. The current below-average level of construction, which should last through the beginning of the forecast period, will augment NOI growth potential.

- The investment-grade rental market, where rents are still comparatively affordable, continues to benefit from strengthening demand. Between the second and third quarters, the investment-grade (professionally managed) apartment vacancy rate dropped by 40 basis points to 6.2%, as reported by M/PF YieldStar (published by NMHC), representing a nine-quarter low. In comparison, the vacancy rate in the third quarter of 2009 was 7.9%.
- The vacancy rate for all buildings with five or more units has also begun to improve. Though this vacancy rate rose by 10 basis points between the first and second quarters, it fell by 40 basis points between the second and third quarters to 11.8%, representing a seven-quarter low. The overall vacancy rate dropped by 30 basis points in the third quarter to 10.3%.

Real Estate Cycle – Multifamily



Professionally Managed Apartments



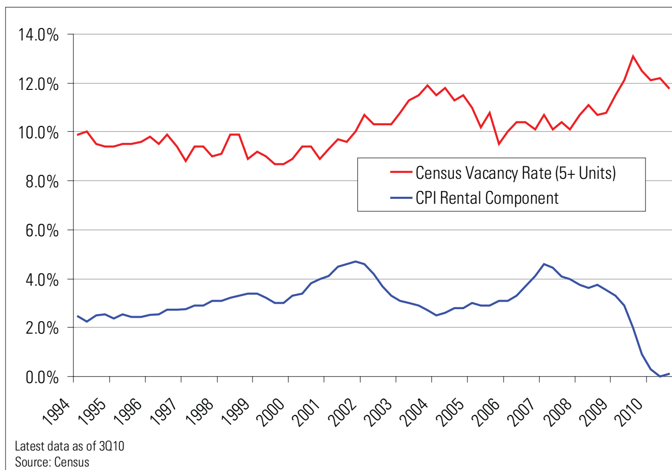
Latest data as of 3Q10
Sources: NMHC, MP/F

Outlook for the National Apartment Market

	2002	2003	2004	2005	2006	2007	2008	2009	3Q10	2010f	2011f	2012f	2013f	2014f
Total Multifamily Construction (Starts, Ann., 000)*	347	349	345	352	336	309	284	109	121	117	165	210	295	380
Rental Apartment Const. (Starts, Ann., 000)*	274	264	225	200	185	189	217	91	103	97	135	175	250	325
Condominium Const. (Starts, Ann., 000)*	73	85	120	152	151	120	67	18	19	20	30	35	45	55
Overall Vacancy Rate	9.0%	9.8%	10.2%	9.9%	9.7%	9.8%	10.0%	10.6%	10.3%	10.1%	9.2%	8.2%	8.0%	8.1%
Vacancy Rate, 5+ Units	10.4%	11.4%	11.5%	10.4%	10.2%	10.3%	10.8%	12.3%	11.8%	11.2%	9.0%	8.8%	8.3%	8.4%
Gross Rent (SF/Yr.)	$13.44	$13.81	$14.20	$14.64	$15.24	$15.85	$16.42	$16.57	$16.61	$16.66	$17.18	$17.93	$18.65	$19.49
Rent Growth - CPI Component	3.3%	2.7%	2.8%	3.1%	4.1%	4.0%	3.6%	0.9%	0.1%	0.6%	3.1%	4.4%	4.0%	4.5%
Rent Growth- Professionally Managed Properties	-0.3%	-0.6%	1.9%	3.7%	3.2%	3.5%	-1.7%	-4.1%	1.2%	1.4%	4.2%	5.5%	7.0%	6.5%
Cap Rate	6.8%	6.7%	6.5%	5.6%	4.8%	4.7%	5.3%	6.2%	5.1%	5.3%	5.1%	5.6%	6.0%	5.6%
NCREIF Return	8.8%	8.9%	13.0%	21.2%	14.6%	11.4%	-7.3%	-17.5%	11.2%	25.4%	15.5%	1.3%	5.8%	19.0%
Capital Return	1.6%	2.4%	6.7%	14.8%	8.9%	6.4%	-11.4%	-21.9%	6.6%	20.7%	11.0%	-3.7%	0.4%	14.0%
Income Return	7.1%	6.3%	6.1%	5.7%	5.4%	4.7%	4.5%	5.3%	4.4%	4.7%	4.5%	5.0%	5.3%	5.0%
Delinquency Rate	0.16%	0.08%	0.07%	0.02%	0.02%	0.05%	0.04%	0.04%	0.23%	0.25%	0.10%	0.04%	0.02%	0.01%

* Numbers in quarterly columns are annualized.
Sources: Census, ACLI, NCREIF, RCG

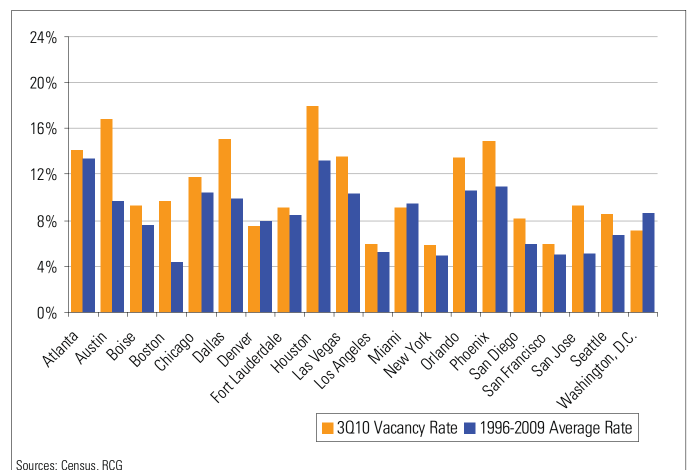
Overall Rental Market



- In the third quarter, healthy conditions in the professionally managed sector allowed for concurrent vacancy decreases and rent increases on a year-over-year basis in all four regions.
  - The smallest year-over-year rent increase among regions was in the West, which posted the largest rent decline in the second quarter. Western professionally managed rents increased by 0.4% year-over-year in the third quarter. However, after remaining at 6.1% for the first two quarters of 2010, the vacancy rate in the West fell by 40 basis points to 5.7% in the third quarter.
  - At 2.8%, the greatest third-quarter, year-over-year increase in professionally managed rents was in the Northeast, the only region to grow rents year-over-year in the second quarter. The Northeast also registered the lowest vacancy rate among regions in the third quarter at 3.9%. These results indicate that the Northeast is moving from stabilization toward solid rental market growth.
  - The greatest improvement in year-over-year rent growth between the second and third quarters was in the Midwest. After a 0.9% year-over-year drop in rents in the second quarter, the Midwest posted a 1.7% year-over-year gain in the third quarter. During this time, the vacancy rate fell by 30 basis points to reach 6.1%, impressive given the rent growth that occurred.
  - After shedding 120 basis points between the first and second quarters, the vacancy rate in the South declined a more modest 30 basis points between the second and third quarters. However, in contrast to their 1.1% year-over-year loss in the second quarter, professionally managed rents gained 1.2% year-over-year in the third quarter. M/PF YieldStar reports that in contrast to the other regions where major markets played a key role in vacancy reduction, many of the largest vacancy declines in the South occurred in smaller markets such as Birmingham, El Paso and Greenville.
- The momentum provided to the apartment market by continued job growth had heretofore been apparent only in diminishing vacancy rates, but in the third quarter this momentum was strong enough to push rent growth back into positive territory. Same-store rents grew by 1.2% year-over-year in the third quarter, a positive progression from the 1.0% year-over-year rent loss in the second quarter, and a remarkable change from the 4.6% year-over-year rent loss in the third quarter of 2009.
- The 0.1% year-over-year growth in the CPI rent index, which is inclusive of all rental housing, represented progress from its second-quarter year-over-year drop of 0.02%, the first drop recorded since 1947.
- Most markets continue to prioritize firming occupancy over increasing rent; in the 63 markets for which year-over-year rent growth data was available in the third quarter, 45 registered declines. Most of these declines were very modest, but select markets experienced significant year-over-year rent losses, including:
  - Atlanta: 4.5% decrease;
  - Dallas-Fort Worth: 2.7% decrease;
  - Seattle: 2.4% decrease.
- Markets at the forefront of the rising year-over-year rent growth trend include:
  - New York: 2.6% increase; New York is at the beginning of what RCG believes will be a robust recovery as the employment base strengthens and diversifies;
  - Houston: 1.5%;
  - Washington, D.C. and Baltimore: each 1.2%.

The increase in professionally managed rents and decrease in vacancy rates was apparent in December year-over-year changes in revenue per available unit; several major REITs, including Post Properties, AIMCO, and Home Properties surpassed third-quarter earnings estimates. The absorption of some of the downtown condo overhang spurred by the tax credit earlier this year has enabled the

3Q10 Vacancy Rate vs. 1996-2009 Average



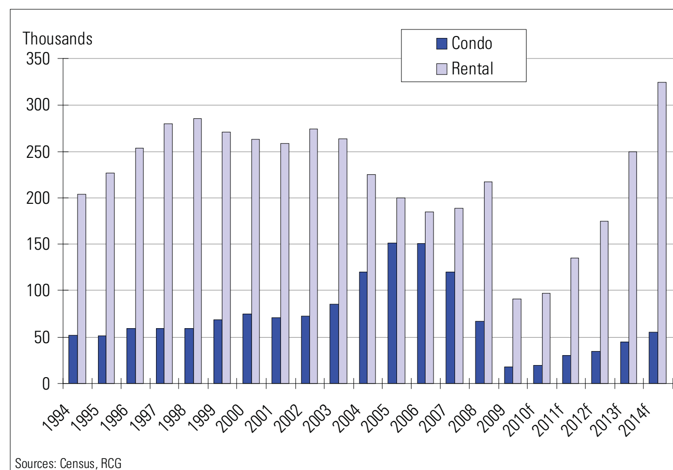
long-awaited lease-up of downtown, high-rise, rental stock, much of which delivered into the downturn and competed heavily against unsold, rented-out condos. By the end of 2010, year-over-year growth in revenue per available unit was vigorous in many major markets. As improvements in rent growth and vacancy become more widespread, market leaders are expected to vary, depending on where they are in the recovery process.

- In December, year-over-year growth in revenue per available unit was led by the following markets:
  - Phoenix: 9.5%;
  - Denver: 9.2%;
  - Austin: 9.1%;
  - Washington, D.C.: 8.9%; and
  - Boston, 8.3%.
- Many of the Southern California markets were still relatively weak due in part to their continued oversupply of housing. However, just one market, Las Vegas, posted a year-over-year decline.

Construction has been minimal by historical standards since multifamily fundamentals began to falter in 2008. However, during the past two quarters, evidence of a construction revival has been mounting. Rising rents, tightening vacancy rates, compressing cap rates, and a more accommodating lending environment have whetted developers' appetites.

- Throughout 2010, rental housing starts have ramped up at a consistent pace. In the third quarter, rental starts totaled 103,000 (seasonally adjusted annual rate), up from 84,000 in the second quarter and 64,000 in the first. The 2010 year-end seasonally adjusted annual rental start-rate is estimated at 97,000 units, up moderately from the 2009 total of 91,000, as starts are believed to have leveled off during the fourth quarter.

Multifamily Starts



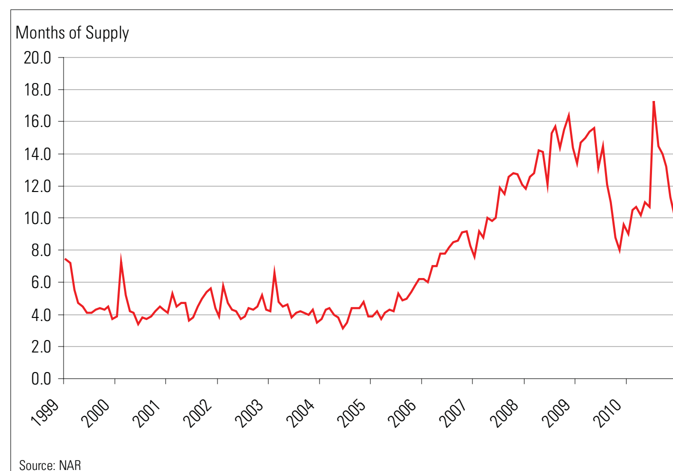
- Markets expected to have a notable uptick in permitting activity between 2009 and 2010 include:
  - Miami and Seattle, 1,600 units;
  - Central New Jersey and Los Angeles, 1,300 units;
  - El Paso, 1,200 units.
- Given the propitious environment for rentership during the next few years, as households un-double from the recession and echo boomers constitute a large presence in overall housing demand, rental construction should be highly favored over condo construction. On average between 2011 and 2014, rental starts are expected to constitute roughly 98.0% of all multifamily starts.
- RCG believes that this new rental construction will be digested by the surge of demand that is already being observed and projected to continue through the forecast period. However, there is a risk of oversupply toward the outer years, especially in non-gateway cities.

Year-over-year Change in Apartment Fundamentals, December 2010

	Year-over-year Change in Revenue per Available Unit	Year-over-year Change in Occupancy	Year-over-year Change in Effective Rent
Phoenix	9.5%	3.1%	5.8%
Denver	9.2%	1.5%	7.5%
Austin	9.1%	2.1%	6.7%
Washington, D.C.	8.9%	1.1%	7.6%
Boston	8.3%	0.9%	7.3%
Chicago	8.3%	1.4%	6.7%
San Francisco	8.1%	0.8%	7.1%
Seattle	7.0%	1.0%	5.9%
NYC Metro	6.7%	0.7%	6.0%
Dallas/Ft. Worth	6.6%	2.2%	4.1%
Charlotte	6.4%	2.2%	3.8%
Tampa	5.0%	1.4%	3.5%
Orlando	4.7%	1.5%	3.1%
Atlanta	4.3%	0.5%	3.7%
Riverside	3.0%	0.6%	2.4%
Houston	2.6%	1.3%	1.1%
Orange County	2.4%	1.2%	1.1%
Los Angeles	2.0%	-0.2%	2.2%
San Diego	0.7%	-0.1%	0.8%
Las Vegas	-1.7%	0.8%	-2.6%

Sources: Axiometrics and Bank of America Merrill Lynch

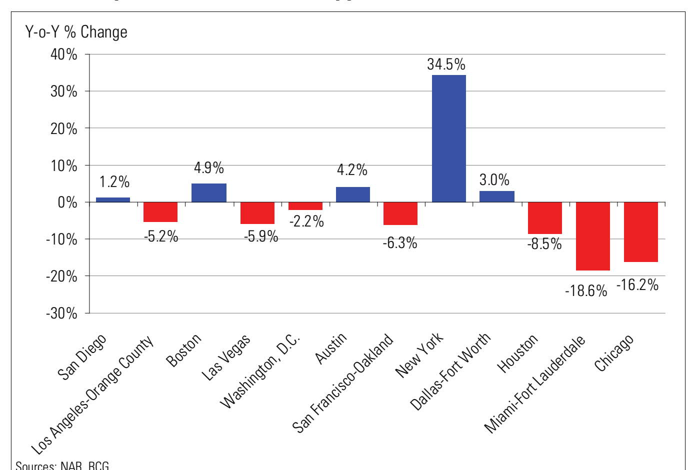
U.S. Condos and Co-ops Housing Inventory



Condominium Market

- The forward demand pull of the federal home buyer tax credit, which boosted sales through the final closing deadline of September 30, dampened median prices and sales in the wake of its expiration. However, by the end of 2010, the build-up of employment and the continued low level of interest rates had generated an encouraging pick-up in sales, albeit at the expense of traction in prices. As employment growth builds and near-term interest rates remain comparatively low for those with good credit, this demand is expected to slowly but steadily regenerate. The final tally for 2010 total condo starts is expected to come in at 20,000, a mild increase over the 2009 total, but a far cry from the 67,000 starts in 2008 and the 152,000 starts at the peak in 2005. Condo starts are expected to increase moderately in the early part of the forecast period while the market is still healing before accelerating as recovery progresses, to reach 55,000 starts by 2014.
- According to the National Association of Realtors' preliminary report, existing condo/co-op seasonally-adjusted sales swelled by 16.4% month-over-month in December following a 1.9% month-over-month drop in November. Sales were down by 5.2% year-over-year and 12.3% from the 2010 April peak, revealing that current demand is still weaker than it was in the absence of the tax credit.
- The months' supply of units stood at 10.0 in November, the lowest level since January 2010, and another sign that the condo market is heading toward stabilization.
- After a freefall of 6.0% between July and November, the national median condo price was flat in December. However, at $165,000, it is still down by 7.4% year-over-year.
- The West was the region that best exemplified the national trend of higher sales at lower prices. In the West, December sales shot up by 71.4% to 120,000, the highest level since May of 2010, but the median price fell by 1.6% month-over-month to reach the lowest level in more than a year.
- Outperforming Western markets included:
    - o Boulder, CO, 5.7% quarter-over-quarter median price growth;
    - o Honolulu, 2.8% quarter-over-quarter median price growth;
    - o Austin, 1.3% quarter-over-quarter median price growth.
- Western underperformers included:
    - o Phoenix, 16.2% quarter-over-quarter median price decline;
    - o Houston, 10.5% quarter-over-quarter median price decline;
    - o Sacramento, 8.9% quarter-over-quarter median price decline.
- Sales in the Midwest were flat between September and November, but finally perked up in December, increasing by 10,000 or 12.5% month-over-month. The sales increase came at the expense of a median month-over-month price drop of 2.9%.
- Outperforming Midwestern markets included:
    - o Milwaukee, 4.3% quarter-over-quarter median price growth;
    - o Louisville, 2.9% quarter-over-quarter median price growth;
    - o Indianapolis, 0.3% quarter-over-quarter median price growth.
- Midwestern underperformers included:
    - o Chicago, 10.2% quarter-over-quarter median price decline;
    - o Columbus, 7.5% quarter-over-quarter median price decline;
    - o Sacramento, 8.9% quarter-over-quarter median price decline.
- The Northeast was the only region to post both sales and median price growth. Month-over-month, Northeastern condo sales grew by 4.8% in December while median price also increased by 4.8%. Low unemployment and significant job creation in major markets such as New York, Boston, and Washington, D.C. have facilitated recovery in the Northeast.
- Outperforming Northeastern markets included:
    - o New York-Wayne-White Plains, 57.2% quarter-over-quarter median price growth (34.5% year-over-year growth). Though RCG believes New York will continue to outperform the nation handily over the forecast period, the massive size of this growth is not likely to be matched in the quarters to follow; local sources such as Corcoran suggest that in the low mortgage rate environment, buyers seized the rare chance to purchase large units in the greater New York market, inflating the median price. In

Condo-Coop Median Home Price Appreciation for Select MSAs, 3Q 2010



Manhattan alone, the median price was up by 15.0% year-over-year and 9.0% quarter-over-quarter, according to the Corcoran Report.

  - Baltimore, 6.6% quarter-over-quarter median price growth;
  - Boston, 6.2% quarter-over-quarter median price growth.

- Northeastern underperformers included:
  - Washington, D.C., 3.8% quarter-over-quarter median price decline;
  - Stamford, 3.1% quarter-over-quarter median price decline;
  - Philadelphia, 0.5% quarter-over-quarter median price decline.
- In the South, after dipping through the fall, sales increased by 10.5% month-over-month in December, reaching the spring 2010 level. Median price in the South declined by 4.3% month-over-month and 17.2% year-over-year, reflecting the national trend.
- Just one Southern market in the RCG universe, Norfolk, posted a quarter-over-quarter price gain at 4.1%. Quarter-over-quarter price declines were led by Tampa, with a 21.6% drop, and Miami's 14.5% decline.

Increasing home prices and continued foreclosures have kept homeownership on a downward trend.

- Nationally, the ratio of home prices to rents fell to 16.7% in the third quarter from 17.4% in the second as rents strengthened. The healthy pace of rent growth forecasted for the coming years should keep this ratio moving toward its long-run average of 16.4%.
- Due to a variety of factors such as the challenging mortgage financing environment as well as the heavy preference among newly employed young people to rent rather than buy, homeownership declined to 66.9% in the third quarter, nearly 100 basis points from its third quarter 2006 peak of 69.0%.

Ratio of Home Prices to Rents

Note: Ratio of median sales price for vacant for-sale-only units to median annual asking rent for vacant housing units
Sources: Census, RCG

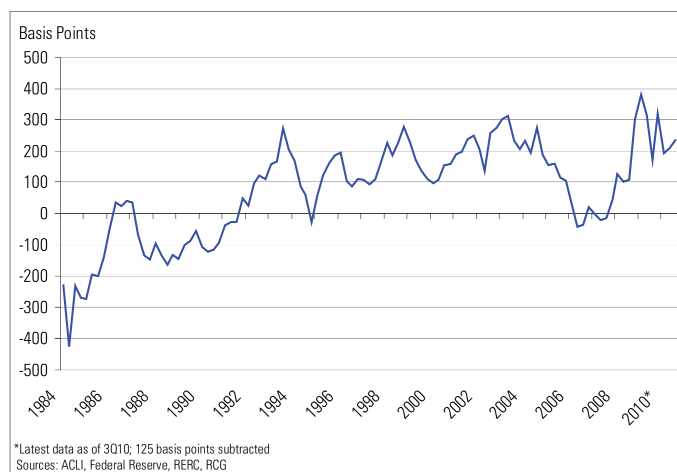
Because of the confluence of vacancy tightening and rent growth that occurred in the third quarter, the rental apartment market has crossed over from the overshooting phase, where it had been since the fourth quarter of 2009, to the growth phase, at 7:00.

Investment Market

Similar to rent and vacancy dynamics, the investment climate reached a highly favorable point in the third quarter of 2010, as capital availability increased amid a profusion of appealing deals across the apartment spectrum. As the credit markets have loosened and the recovery of the multifamily sector has progressed, lending activity is no longer as dominated by the GSEs. As reported by Real Capital Analytics, 60.0% of lending by volume was done by GSEs in the first ten months of 2010 compared to 78.0% in 2009. Regional and local banks have picked up most of the slack, rising from 8.0% to 13.0%, as the defaults that hampered their lending ability over the past year begin to taper off. Apartment sales volume is burgeoning as buyers begin to look outside the increasingly expensive trophy-asset category. However, because trophy assets are still selling at a discount relative to their pricing during the peak, they are expected to capture most of demand, particularly in the near term. As investor appetite escalates, deals across the full risk spectrum will be more hotly pursued.

- At $8.9 billion, apartment transaction volume in the third quarter of 2010 increased dramatically from the $5.3 billion in the second quarter, according to Real Capital Analytics. As a result of heavy investor interest in highly favorable comparative risk-return ratio of apartments, the average cap rate dropped from 7.0% to 6.7%, and price per unit escalated to $117,032 from $99,126 as more capital entered the market. Increased participation and preference for larger deals was also reflected in the ratio of closed to offered, which rose from 0.73 per month on average in the second quarter to 0.86 per month on average in the third quarter.
- As new investors chased yield, they turned to garden properties. The ratio of closed to offered prices for garden apartments was 1.0 on average per month, up from 0.9 per month on average during the second quarter, suggesting that garden demand and supply are becoming more synchronized.
- Whereas cap rates for both garden and mid-/high-rise properties changed notably between the first and second quarters of 2010, reflecting the surge of activity that was just beginning to hit capital markets, they were relatively static between the second and third quarters. The garden property average cap rate for closed deals ticked up slightly from 6.9% to 7.0%, while the mid-/high-rise cap rate ticked up from 6.2% to 6.4%.
- Default rates for multifamily loans are still rising but at a decelerating rate. The year-over-year default growth was 1.07% in the third quarter of 2010, down from 2.13% in the third quarter of 2009. Resolutions averaged $12.5 billion per month

Apartment Cap Rate vs. 10-Year Treasury Yield



*Latest data as of 3Q10; 125 basis points subtracted
Sources: ACLI, Federal Reserve, RERC, RCG

in the third quarter, up from $10.0 billion in the second quarter. Thus, at $1.2 billion, new distressed properties were down by 80.8% year-over-year in November. Workouts continued on their heightened pace, totaling $1.6 billion in November and bringing the overall distress level down to $37.8 billion, the lowest amount since May 2010.

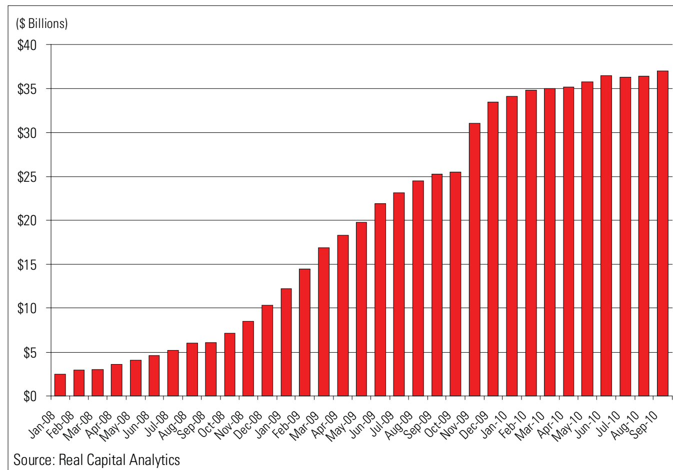
- Looking at year-to-date closed/offered ratios through November as calculated by Real Capital Analytics on both a region and market level yields a more detailed analysis of current multifamily dynamics. This ratio represents the volume of all properties that closed between January and November 2010 to the volume brought to market during this time. Though not a perfect metric since some of the closings may have come to market in 2009 or been off-market deals, it still gives a sense of where various locations stand in the investment cycle.
- Closed cap rates were lower than offered cap rates in the Southwest, Southeast, and Mid-Atlantic, suggestive of a flight to quality.
- Following the 1.9% capital return in the second quarter, the first positive quarterly return in two years, capital appreciation shot up to 6.6%, a result of continued cap rate compression. Income return also improved by 140 basis points to 4.4%, launching total return to 11.2%, the highest number since the fourth quarter of 2007.

The Outlook

The multifamily sector has been the clear leader among commercial real estate types for quite some time, benefiting from reduced homeownership and the beginnings of a hiring resurgence. On both a capital market and income-producing basis, the outlook remains very bright. During the next few quarters, continued employment growth and the lease-up of formerly languishing, downturn-era deliveries will provide markets that are not struggling with heavy shadow condo supply with ample fuel for NOI increases.

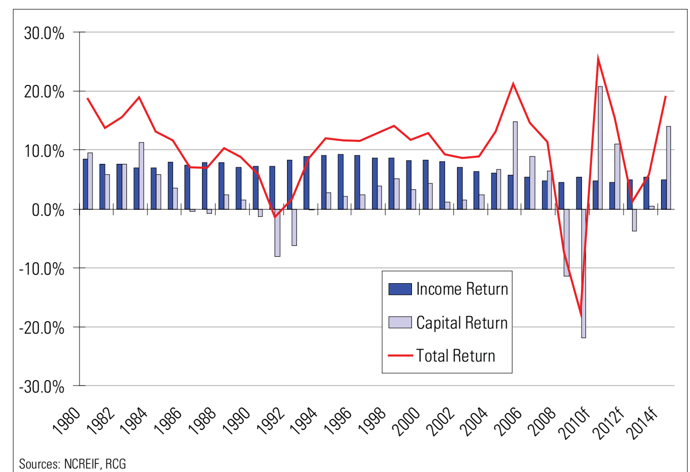
- Employment growth among the 20-34 year-old cohort, which comprises the heart of the renter pool, has consistently outperformed overall growth. The ensuing renewal in confidence has encouraged this cohort to move from roommate or family living situations into their own apartments, filling institutional properties that have been struggling since the beginning of the downturn and thus invigorating NOI growth.
- The build-up of confidence over time, which should start somewhat modestly but accelerate once the recovery is well under way by 2012, will promote household formation and shrink the vacancy rate.
  - The overall vacancy rate, which includes rental homes, will decrease slowly at first as foreclosures are still working through the system, but by 2012, the vacancy rate should reach 8.2%, on par with late-1990s levels.
  - The 5+ units' vacancy rate should follow the same trend as the overall multifamily market, but drop more quickly in the near term, as rental homes do not pose as much of a threat in this category.
- Rent growth, which finally turned the corner in the third quarter, will accelerate as confidence builds.
  - Professionally managed apartment rent growth turned positive in the third quarter as occupancy firmed enough for operators to feel comfortable pushing rents. Still, the recovery is likely to remain choppy for awhile, so growth should be modest at first, at 1.4% year-over-year in the fourth quarter of 2010. However, as households un-double and apply more demand to the market, fourth-quarter, year-over-year rent growth should reach 4.2% in 2011, 5.5% in 2012, 7.0% in 2013 and 6.5% in 2014.
  - CPI rent growth is typically less prone to major upswings and downswings than professionally managed apartment rent growth for a variety of reasons, including the fact that concession build-up and burn-off play less of a role. Thus, after modest growth of 0.6% in 2010, CPI rent growth is expected to grow steadily at an average of 4.0% throughout the forecast period alongside general inflation growth trends, but will not reach the heights of professionally-managed rent growth in the later years of the forecast.
- The flood of investor capital and the major positive shift in apartment market dynamics that occurred in 2010 is clearly illustrated by the estimated spike in the year-end NCREIF total return at 25.4%. Following this turning-point, we project more moderate but still healthy returns over the forecast period, averaging 10.4%, as fundamentals firm. However, cap rates could face upward pressure if the downside of oversupply is realized, which would moderate outer year total returns.
- The budding recovery has begun to encourage development. New deliveries will be modest for the first two years of the

Total Distressed Assets - Apartment



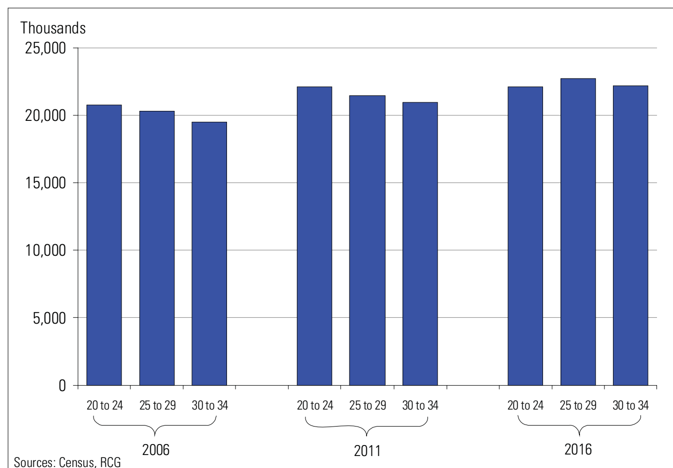
Source: Real Capital Analytics

Total Rates of Return for Multifamily Properties



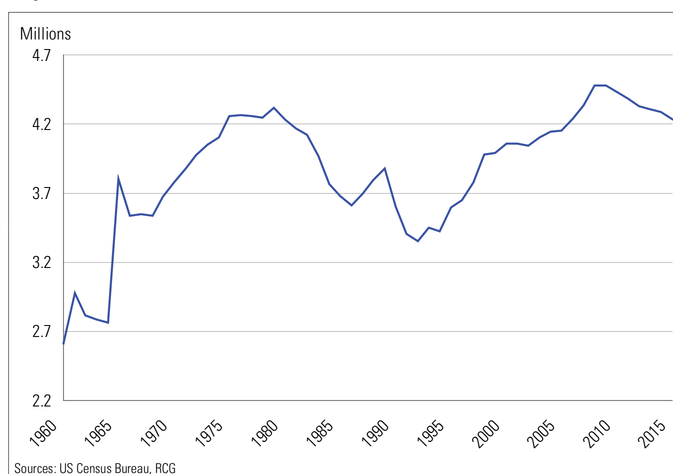
Sources: NCREIF, RCG

Echo Boom Demographics: Projections Based on Year of Birth



Sources: Census, RCG

Population Turning 18, 1960 - 2015



Sources: US Census Bureau, RCG

forecast as plans are laid. By 2013, deliveries should tick up notably, particularly for rentals. Because of robust demand trends, rental deliveries should reach 250,000 by 2013, the highest level since 2005, and condo deliveries should reach 45,000.

- We expect condo starts to total roughly 185,000 between 2010 and 2014, compared with 152,000 in 2005 alone. As for rentals, we expect 885,000 during the forecast period, heavily weighted toward the later years. Though this forecast is similar to the 882,000 between 2005 and 2009, it is expected to be coincident with strong demand from echo boomers, baby boomers, and those unqualified for or uninterested in home purchase.
- The wave of new units should coincide with the rise of the echo-boom generation. This group, which in 2009 caused the population turning 18 years-old to reach an all-time high of 4.5 million, is widely expected to generate extraordinary demand for apartments for years to come. As the average age at first marriage continues to rise, so does the likelihood of rentership for echo boomers through their 20s and 30s.
- In addition to the echo boomers, the 12 million people expected to immigrate to the United States over the coming decade should augment rental demand considerably; historically, immigrants have been highly likely to rent, with rentership in this group averaging around 45.0% over the past several years.
- Though defaults and new distress continue to compile, both are doing so at a decelerating pace. Overall, investor sentiment is optimistic. As the investment market continues to heat up, investors in search of yield will increasingly pursue non-trophy assets.
- Continued active management among institutional operators, who had been prioritizing occupancy over rent growth for most of the year, helped them recognize that demand was sufficient to allow for rent increases.

Conclusion

Apartment market dynamics are stronger than ever. The third quarter saw the return of professionally managed apartments' rent growth as well as occupancy growth overall as young households continued to un-double and choose still-affordable institutional-grade apartments. CPI rent growth, which includes rented-out single family homes, is lagging, but will catch up as foreclosed homes are eliminated. Unlike the recovery after the 2001 recession, when many young professionals bought homes rather than renting, short credit histories, no down payment funds, and fresh memories of the foreclosure crisis will discourage many young professionals from home purchase. This should mitigate the challenge to rent growth posed by affordable home prices. The echo boomers and retiring baby boomers will emerge into an appropriately-supplied new construction environment and swell the renter ranks across property types.

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The National Office Market

The national office market reached bottom in 2010 and has begun the recovery process. Major financial centers and downtown areas are leading the recovery, while suburban submarkets with a large amount of construction in the last decade and tertiary markets are lagging. Overall, business confidence improved significantly, translating into a substantial increase in leasing activity. With vacant space slowly being absorbed, landlords began to curtail the value of concession packages and asking rents have appreciated in some markets. The improved operating conditions spurred a surge in investment activity, particularly for premier assets in gateway cities.

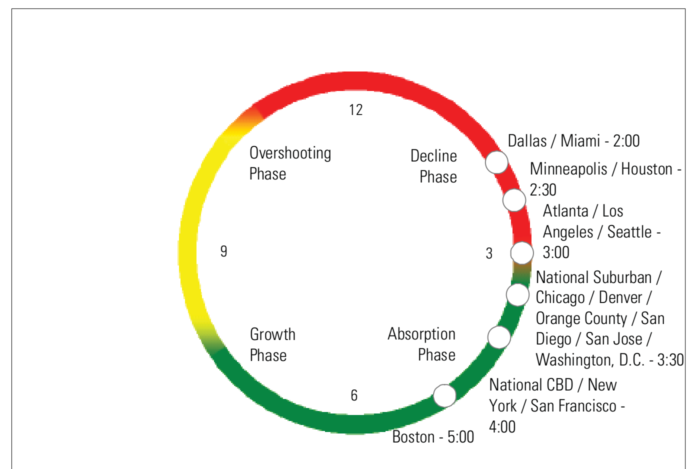
The office-using employment sectors expanded in the third quarter, with more than 33,000 jobs added. While many more jobs than this were lost during the recession and it will take some time to return to pre-recession employment levels, the fact that office-using employment expanded for four consecutive quarters is a positive indication that the recovery is under way.

- Year-over-year, employment growth totaled 0.7% in the third quarter. This was the first year-over-year increase in office-using payrolls since 2007.
- Since the fourth quarter of 2009, more than 190,000 office-using jobs were created.
- The professional and business services sector is the driving force behind office-using job creation.

As the economy continued to recover, tenant demand also increased and lease transactions began to outweigh move-outs in the second half of 2010. The national vacancy rate reached 17.9% in the third quarter and is expected to have trended slightly lower by the end of the year.

- Through the third quarter, several local markets improved significantly over the previous year. Selected markets with lower vacancy rates than year-end 2009 included:
    - Fort Worth: 2.6 percentage-point decrease;
    - Silicon Valley: 2.0 percentage-point decrease;
    - Austin: 1.5 percentage-point decrease;
    - San Diego: 1.4 percentage-point decrease;
    - Denver: 1.2 percentage-point decrease.
- The amount of vacant space remained high, or rose in a limited number of markets, through the third quarter. These metropolitan areas with extremely high vacancy rates were among the hardest-hit employment centers during the recession. The highest vacancy rates during the third quarter included:
    - Phoenix: 27.1%;
    - Detroit: 26.6%;
    - Inland Empire: 25.0%;
    - West Palm Beach: 24.9%;
    - Dallas: 24.8%.
    - In all, 22 markets tracked by RCG had vacancy rates in excess of 20.0%.

Real Estate Cycle – Office

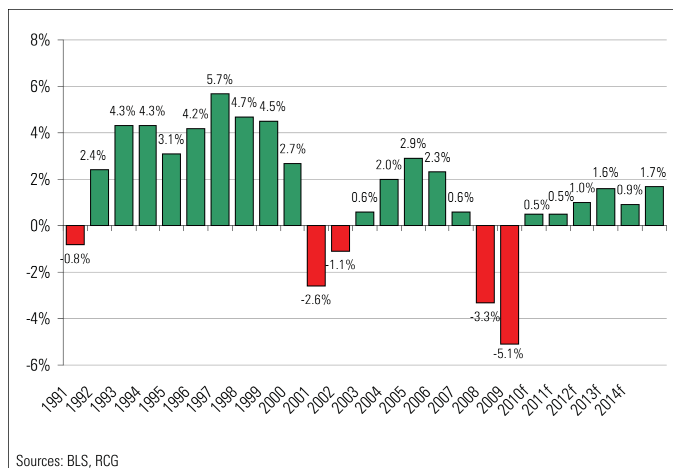


Outlook for the National Office Market

	2002	2003	2004	2005	2006	2007	2008	2009	3Q10	2010f	2011f	2012f	2013f	2014f
New Construction* (Put-in-place, 2005 $ Bill.)	44.7	37.2	37.1	37.4	40.4	44.9	44.2	31.1	18.8	18.5	17.0	20.0	23.0	30.0
Office Employment Growth	-1.1%	0.6%	2.0%	2.9%	2.3%	0.6%	-3.3%	-5.1%	0.7%	0.5%	1.0%	1.6%	0.9%	1.7%
Office Vacancy Rate	18.3%	18.7%	17.3%	15.1%	13.1%	12.6%	14.4%	17.7%	17.9%	17.7%	17.1%	16.6%	16.2%	15.2%
Downtown Vacancy Rate	14.8%	15.2%	14.5%	12.5%	10.6%	9.7%	11.2%	14.7%	14.7%	14.6%	14.0%	13.3%	13.0%	11.9%
Suburban Vacancy Rate	20.5%	20.8%	19.0%	16.7%	14.5%	14.3%	16.2%	19.3%	19.6%	19.4%	18.8%	18.3%	17.9%	17.0%
Downtown Rent Growth	-5.7%	-2.6%	-3.1%	2.1%	13.2%	15.5%	8.5%	-11.5%	-3.0%	0.1%	1.8%	3.7%	3.6%	4.3%
Suburban Rent Growth	-6.1%	-5.9%	-0.2%	2.4%	7.2%	9.1%	2.2%	-7.3%	-2.1%	0.2%	1.0%	2.5%	2.9%	3.4%
Cap Rate	7.8%	7.3%	7.2%	6.1%	5.7%	5.4%	5.6%	7.2%	6.0%	6.5%	6.7%	6.6%	6.4%	6.1%
NCREIF Total Return	2.8%	5.7%	12.0%	19.5%	19.2%	20.5%	-7.3%	-19.1%	7.5%	14.5%	10.8%	14.1%	12.2%	17.5%
Capital Return	-5.6%	-2.5%	4.0%	12.0%	12.3%	14.4%	-11.8%	-24.3%	2.2%	8.4%	4.8%	8.4%	6.7%	12.3%
Income Return	8.8%	8.3%	7.8%	6.9%	6.3%	5.5%	4.9%	6.4%	5.3%	6.1%	5.9%	5.7%	5.5%	5.1%
Delinquency Rate	0.28%	0.30%	0.18%	0.22%	0.04%	0.01%	0.03%	0.15%	0.16%	0.70%	0.90%	0.80%	0.50%	0.30%

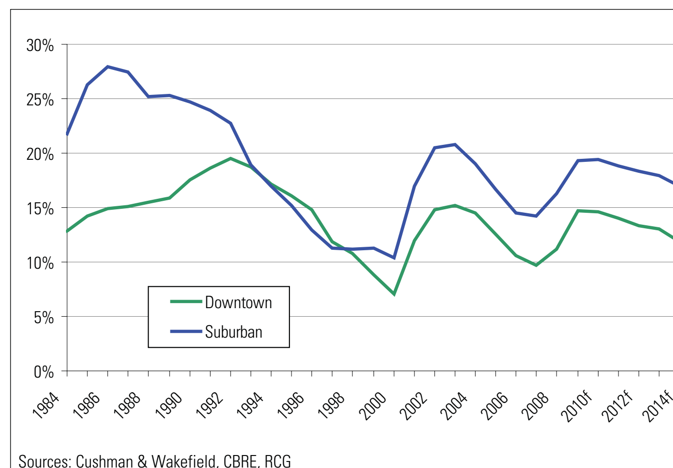
* Numbers in quarterly columns are annualized.
Sources: Cushman & Wakefield, CBRE, ACLI, BLS, NCREIF, RCG

Office Employment - Annual Percent Change in Jobs



Sources: BLS, RCG

Office Vacancy Rates - Downtown and Suburban



Sources: Cushman & Wakefield, CBRE, RCG

- Even in the worst-performing markets, the office market has generally reached or passed the bottom of the cycle. We expect that the vacancy rate reached its peak in most local markets.

The downtown office markets, primarily in top-tier cities, were the first office markets to begin the recovery process. By the third quarter, the national CBD vacancy rate fell to 14.7%, down from 15.0% in the first quarter of 2010.

- Many tenants took advantage of relatively-affordable rental rates to lease space in trophy and Class A assets during 2010. Leasing demand in many downtown areas rebounded from the previous year; however, much of the demand focused on higher-quality properties, creating a significant spread between the vacancy rates for top-tier properties and Class B assets. The third quarter vacancy rate in major CBD submarkets included:
    - Midtown Manhattan: 11.0%;
    - Downtown Manhattan: 12.1%;
    - San Francisco: 12.9%;
    - Washington, D.C.: 13.3%;
    - Chicago: 16.6%;
    - Los Angeles: 17.8%.
- The vacancy rate improved in nearly half of the downtown markets tracked by RCG through the first three quarters of 2010. Markets with a significant decrease in the vacancy rate included:
    - Ft. Worth: 5.2 percentage-point decrease;
    - Salt Lake City: 3.1 percentage-point decrease;
    - Denver: 1.7 percentage-point decrease:
    - Brooklyn: 1.7 percentage-point decrease;
    - Pittsburgh: 1.4 percentage-point decrease.

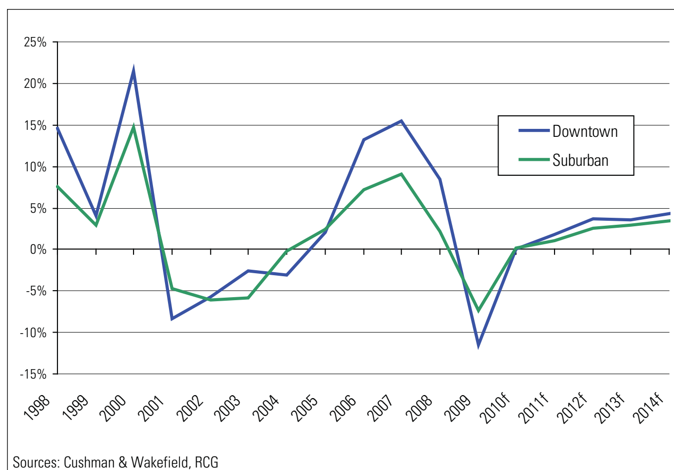
The national suburban market lagged the CBD market, but the amount of space vacated appeared to peak in the third quarter of 2010. The suburban vacancy rate increased slightly to 19.6% and increased 10 basis points during each of the first three quarters of 2010.

- Markets with substantial decreases in the vacancy rate through the third quarter of 2010 included:
    - San Jose: 2.7 percentage-point decrease;
    - San Antonio: 2.3 percentage-point decrease;
    - Colorado Springs: 2.2 percentage-point decrease;
    - San Francisco Peninsula: 2.1 percentage-point decrease.
- Many tenants that sought to lease space in 2010 targeted downtown areas rather than suburban environments. This focus on urban core submarkets produced a higher suburban vacancy rate in several metropolitan regions.
- The suburban vacancy rate increased by more than 100 basis points for 20 markets tracked by RCG, led by Cincinnati, Detroit and Alameda County in the Oakland MSA.
- Metropolitan areas with the highest suburban vacancy rates in the third quarter included:
    - Phoenix: 28.4%;
    - Detroit: 27.4%;
    - Cincinnati: 25.6%;
    - West Palm Beach: 24.9%;
    - Las Vegas: 24.7%.

The recovering economy prompted an increase in lease transactions in 2010. Through the third quarter, leasing activity totaled more than 162.5 million square feet, a 27.2% increase from the previous year.

- Improved business confidence, an abundance of space options and relatively affordable rents spurred the increase in new leases.
- Many tenants are taking advantage of market conditions to lease higher-quality space. Leasing activity for Class A properties accounted for 57.3% of the square footage leased

Office Rent Growth – Downtown and Suburban



Sources: Cushman & Wakefield, RCG

through the third quarter. This was an over-sized share of lease transactions as the Class A inventory accounts for less than half of the total office market.

- Tenants are displaying continued interest in minimizing occupancy costs by focusing on more efficient properties such as LEED-certified buildings that reduce expenses.

As leasing activity rebounded, landlords cautiously began to hold asking rents steady. Additionally, the dollar value of concession packages began to fall; however, in most markets it remains a significant share of total consideration. With tenants focused on higher-quality space, rents for premier properties and view space are already on the rise while achievable rents for commodity space are still weak.

- Through the third quarter, the average CBD asking rent was only 0.5% lower than at the end of 2009. The average rent increased minimally from the second quarter as rent gains in trophy assets were offset by weakness in rents for commodity space.
- Local downtown submarkets with the most significant asking rent increases through the third quarter of 2010 included:
  - Washington, D.C.: 8.8% increase;
  - Oakland: 8.1% increase;
  - Philadelphia: 6.7% increase.
- The average suburban asking rent reached $27.80 per square foot in the third quarter, on par with year-end 2009.
- The largest gains in the average asking rent in the suburban markets occurred in:
  - Philadelphia: 14.4% increase;
  - Kansas City: 8.1% increase;
  - San Antonio: 6.4% increase.
- While contract rents have stabilized and the value of concessions began to decrease, the average effective rent is still approximately 25% lower than in 2008.

New office construction continued to fall and reached a historical low. During the third quarter, the value of put-in-place construction declined to $18.8 billion, a 7.4% decrease from the previous quarter.

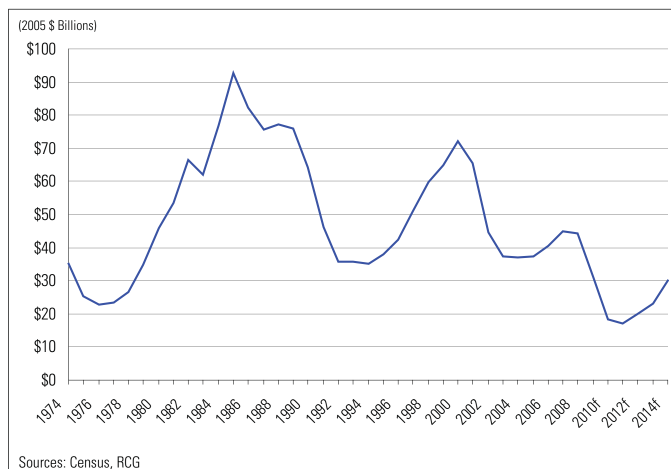
- The value of put-in-place construction fell for the 11th consecutive quarter, and with near-term development unlikely, this trend will continue.
- Among markets tracked by RCG, new construction totaled slightly more than 21.0 million square feet through the third quarter. This was a decrease of more than 60% from the amount of new product delivered in 2009.
- New deliveries were concentrated in a handful of office markets during 2010. Several high-rise developments begun prior to or at the beginning of the recession were finally delivered to the market. Cities with the greatest amount of construction activity included:
  - Washington, D.C.: 2.9 million square feet;
  - Charlotte: 2.2 million square feet;
  - Boston: 1.6 million square feet;
  - Atlanta: 1.6 million square feet;
  - Miami: 1.5 million square feet.

The national office market is in the early stages of recovery. Office tenants are increasingly absorbing space, placing downward pressure on the vacancy rates. As occupancy levels increase, landlords will regain some leverage and effective rents will increase further. With the office market past the bottom of the cycle and moving in a positive direction, we place the CBD market at 4:00 and the suburban market at 3:30 on the RCG Real Estate Cycle Clock.

Investment Market

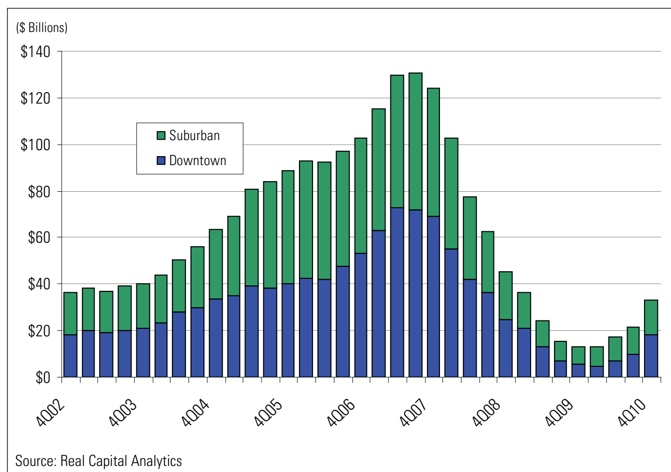
The investment market continued to accelerate with a large amount of capital focused on core markets. The improved operating conditions have moved capital off the sidelines, and the search for yield has pushed some investors to secondary markets.

Office Construction Put in Place



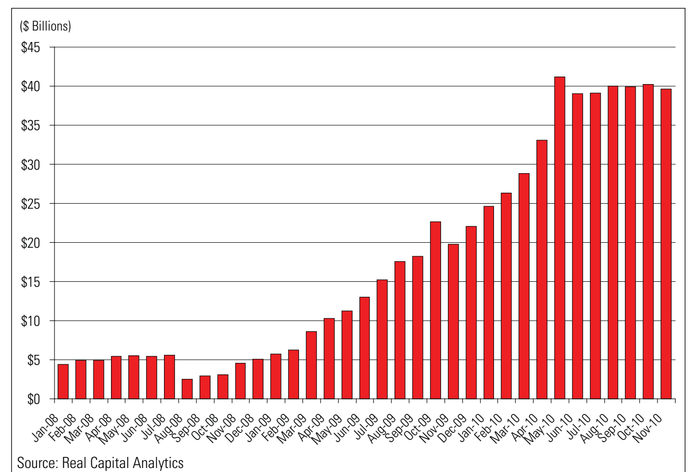
Sources: Census, RCG

Quarterly Transaction Volume



Source: Real Capital Analytics

Total Distressed Assets - Office



Source: Real Capital Analytics

- Investment activity trended higher. In the 12 months ending in November, total transaction volume reached $32.8 billion, according to Real Capital Analytics.
- Sales activity accelerated in the second half of the year. From September through November, nearly $9.6 billion of office properties traded.
- Transactional cap rates continued to fall. By November, the average cap rate decreased to 7.7%, an 80 basis-point decrease from April. With sales concentrated in larger office markets, these transactions are bringing the average cap rate lower.
  - Increased interest for quality properties in core markets drove the cap rate lower in these cities. In secondary markets or for properties with vacancy risk, cap rates are estimated to be at least 100 to 150 basis points higher.
- The ACLI cap rate, which generally reflects the highest-quality properties, fell to 6.0% in the third quarter. Intense bidding activity for the limited number of quality assets drove up prices and compressed cap rates.
- Through October 2010, national banks, life companies and international banks accounted for 78.0% of lending volume. While life companies maintained a large share of originations, national banks led in terms of dollar volume primarily because of a large amount of refinancing activity.
- The CMBS market opened in 2010, but new issuance remained small. The increased lending activity by financial institutions can be expected to provide loans for securitization in the near term. We expect a sharp uptick in securitization in 2011.
- Regional or local banks continued to curtail lending activity as existing loans continued to fall into distress. In 2010, lending volume at these smaller institutions fell by almost half compared with the previous year.
- The ACLI delinquency rate remained low at 0.16% in the third quarter. Some lenders are still focused on amending debt obligations rather than recognizing losses; however, this trend is slowing.
- The office CMBS delinquency rate increased to nearly 7.0% in November, more than double the rate of one year ago, according to Trepp.
  - It will likely take significantly longer to resolve these distressed assets because of the complexities of unwinding securitized loans.
- In November, cumulative distress totaled nearly $39.7 billion of office properties.
  - Since 2007, nearly $28.6 billion of office assets were restructured or resolved.
  - The net change was negative in November as resolutions exceeded new distress. Many special servicers are able to operate more effectively, resolving or restructuring loans more quickly as compared with during the recession, when many firms were overwhelmed by the volume of distressed assets.
  - More than $8.6 billion of office properties are lender-owned, according to Real Capital Analytics. As operating conditions have improved, some lenders are slowly limiting refinancing opportunities and are becoming less hesitant to repossess assets.
- Private market returns rebounded in 2010. Through the third quarter, the office component of the NCREIF index produced a 7.5% total return and will soon return to double-digit territory.

The Outlook

The strengthening economic recovery will continue to drive a rebound in the national office market. In the near term, leasing activity should accelerate and, coupled with fewer subleases coming to market, the amount of vacant space will decrease steadily. However, it will take some time to absorb all of the space made available during the recession as well as for companies to fill

under-utilized office space.

- In 2011, the CBD vacancy rate should fall to 14.0% as tenant interest for Class A space remains elevated. The most significant decreases in the vacancy rate from the third quarter of 2010 through the end of 2011 are forecasted to occur in:
  - Nashville: 2.7 percentage-point decrease;
  - Denver: 1.5 percentage-point decrease;
  - Midtown Manhattan: 1.3 percentage-point decrease;
  - San Diego: 1.3 percentage-point decrease;
  - Salt Lake City: 1.2 percentage-point decrease.
- In a handful of markets, we expect the CBD vacancy rate to increase. The vacancy rate should increase by 0.2 to 0.4 percentage points in Cincinnati, Charlotte, Detroit, and Las Vegas. In Houston, the vacancy rate should increase by 1.3 percentage points due to a construction delivery. With the exception of Houston, these markets have significant near-term risk in their economies.
- Our forecast calls for the national suburban vacancy rate to fall to 18.8% in 2011. In nearly all metropolitan areas tracked by RCG, the vacancy rate should decrease this year. The most significant improvements in the vacancy rate include:
  - Austin: 2.7 percentage-point decrease;
  - Portland: 2.3 percentage-point decrease;
  - San Diego: 2.3 percentage-point decrease;
  - Indianapolis: 2.1 percentage-point decrease;
  - San Francisco City Suburban: 1.9 percentage-point decrease.
- New leasing activity will continue to accelerate through the remainder of the year. We expect leases to total more than 230 million square feet in 2011.
- The improved tenant demand and absorption of excess vacant space will cause asking rents to stabilize in the first half of the year and slowly increase in the second half. Rent growth in downtown areas will outpace suburban submarkets. We expect the CBD asking rent to increase by 1.8% compared with 1.0% in the suburban regions. In 2011, the most significant forecasted rent increases include:
  - San Francisco: 3.5%;
  - Houston: 3.4%;
  - Austin: 2.3%;
  - Silicon Valley: 2.3%;
  - Oakland: 1.9%.
- Throughout the year, large concession packages will become much more limited. We expect effective rents to increase more than asking rents in the near term.
- Once contract rents display a solid upward trend, tenants that focused on short-term renewals will attempt to lock-in current market rents with longer terms.
- The abundance of space options will constrain construction for the next year. Until achievable rents increase high enough to justify building, we expect few office developments to break ground. In 2011, the value of put-in-place construction should decrease further to $17.0 billion.
  - Within markets tracked by RCG, new construction is expected to total only 9.8 million square feet.

Moving forward, the office market recovery will accelerate in 2012. The vacancy rate should fall to 16.6% in 2012 and to 16.2% in 2013. In 2013, while we expect a slight economic slowdown, the office market should continue to trend in a positive direction. In 2014, we expect tenant demand to drive the vacancy rate to 15.2%.

- Between 2012 and 2014, a significant amount of vacant space will be absorbed throughout the country. Regions where the vacancy rate spiked significantly due to the housing crash will lag the recovery in the next year, but will improve substantially by 2014. Local markets with the largest decrease in the vacancy rate by 2014 include:
  - Inland Empire: 10.6 percentage-point decrease;
  - San Diego: 8.0 percentage-point decrease;
  - West Palm Beach: 6.9 percentage-point decrease;
  - Phoenix: 6.2 percentage-point decrease;
  - Las Vegas: 5.8 percentage-point decrease.
- The national CBD vacancy rate will continue lower through the end of the forecast period, reaching 11.9% by 2014. The improvement in the vacancy rate from 2012 through 2014 for selected downtown markets is forecasted to be:
  - Washington, D.C.: 5.4 percentage-point decrease;
  - Chicago: 3.7 percentage-point decrease;
  - Boston: 3.4 percentage-point decrease;
  - Midtown Manhattan: 2.8 percentage-point decrease;
  - San Francisco: 2.4 percentage-point decrease.
- The absorption of space will be slower in the suburbs as tenants focus on urban properties in the near term. Additionally, the suburban markets had the majority of construction activity in the last decade and it will take some time to absorb this recently built space. The suburban vacancy rate should decrease to 18.3% in 2012 and slowly trend lower to 17.0% by 2014.
- Many leases signed in 2007 and 2008 at top-of-the-market rents roll in the next several years. These tenants will seek to reduce occupancy costs, if they have not already renegotiated their leases. With achievable rents in the near term expected to be less than the in-place rents on these leases, and if landlords are unable to secure renewals, a larger wave of tenant

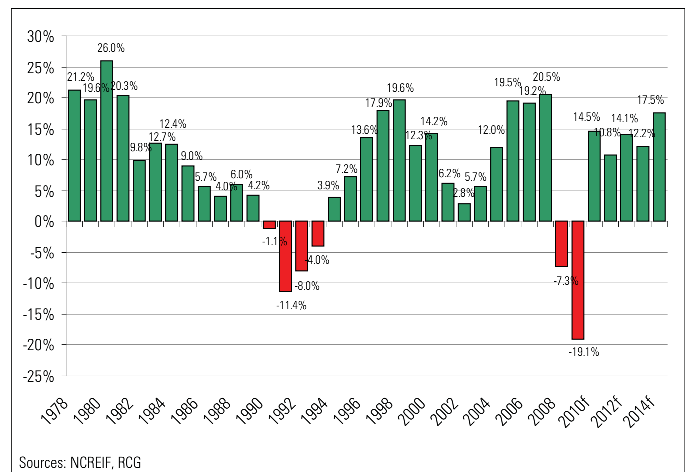
relocations may occur than was expected.

- Beginning in 2012, we expect rent growth to increase quickly as vacant space is absorbed and tenant activity expands. Through at least 2012, rent expectations will be much more robust for premier assets or view space.
  - In downtown markets, the average asking rent is forecasted to increase by 3.7% in 2012, 3.6% in 2013 and 4.3% in 2014.
  - Rent growth in the suburbs will be somewhat constrained by the slower pace of absorption. The average suburban rent should increase by 2.5% in 2012, 2.9% in 2013 and 3.4% in 2014.
- Throughout the forecast period, we expect construction to be constrained. The value of put-in-place office construction should reach $20.0 billion in 2012. As operating conditions improve and rents justify new development, put-in-place construction should increase to $30.0 billion in 2014.
  - Though construction activity is expected to accelerate, it should not come close to the large amount of development that occurred during the last decade. In fact, the $30.0 billion forecasted in 2014 is lower than the amount of put-in-place construction in each year of the 2000s.

The improved operating conditions will continue to attract capital. Many investors will remain focused on core markets in the near term, but a shift will occur as pricing appreciates for trophy assets and investors seek greater returns in non-core markets.

- The spread between buyer and seller expectations has narrowed, which has helped drive the accelerated sales volume.
- In the next 12 to 18 months, we expect much of the sales activity to occur in the larger office markets. This will result in multiple bids and higher pricing for quality assets.
  - Investor risk appetite will spread beyond trophy assets in core markets. As investors chase yield, capital should become more active in suburban and secondary office markets. As this occurs, the cap rate spread between prime and secondary markets will begin to compress.
- As operating conditions improve, investment capital that shunned commercial real estate during the recession should return as investors seek quality real estate assets as part of inflation hedging strategies.
- The focus on quality underwriting will remain. Well-capitalized borrowers able to acquire properties with reduced leverage will find relatively attractive debt opportunities while financing will remain expensive for borrowers seeking higher LTVs.
- A significant portion of the office stock requires recapitalization during the next several years. The large backlog of distressed assets will provide acquisition opportunities for some time.

Total Rates of Return – Office Properties



Sources: NCREIF, RCG

- The delinquency rate should rise further as highly leveraged owners face maturing debt and lower operating revenue. As leases roll and are marked to market, gross revenue may be lower than current in-place leases. This will place more owners at risk of default even as tenant demand increases.
- CMBS originations will accelerate in 2011, providing a capital source that had been virtually non-existent since 2007.
  - While new CMBS will have more solid underwriting characteristics, legacy CMBS will remain under duress and defaults elevated through the near term. The maturing securitized loans that require refinancing, as well as the large wave of bank loans, will contribute to the increase in new CMBS issuance.
- The adjusted ACLI cap rate should reach the mid-6% range in 2011. We expect the cap rate to slowly trend lower to the low-6% range by 2014.
  - In the near term, a wide spread will exist between cap rates on stabilized assets or properties in core markets as compared with transactions for buildings with vacancy risk or in non-supply-constrained tertiary markets.
- We expect the NCREIF index to produce double-digit returns through at least 2014. From 2011 through 2014, the average annual return should reach 13.6%.

Conclusion

The national office market is in the early stages of a moderate recovery. The near-term economic expansion will create new jobs in the office-using employment sectors helping to absorb space vacated during the recession. During the next several quarters, tenants will continue to have leverage during lease or renewal negotiations; however, landlords will slowly regain momentum as fewer space options will exist, particularly for large blocks of

contiguous space and within trophy assets. Although the amount of space will decrease and achievable rents will appreciate, construction is expected to remain minimal in the near term. Despite development activity accelerating through the end of the forecast period, the amount of new product delivered per year will be much lower than during the previous decade. The strengthened operating conditions will entice available capital and achievable pricing will appreciate, particularly in core markets. The gateway cities will continue to lead the office market recovery in the near term. Secondary markets will lag the trend somewhat, but continue along an upward trajectory.

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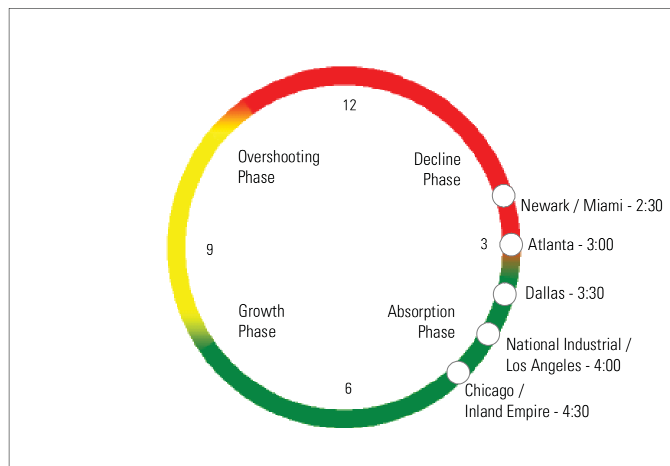
The National Industrial Market

The industrial market is in the early stages of recovery following several years of extremely poor conditions. In 2010, the improved economic conditions helped spur manufacturing and goods-movement hiring. Improved consumer and business sentiment, as well as economic growth in many parts of the world, prompted a resurgence in cargo flows last year. This optimism filtered into the industrial market, with businesses more willing to lease space or buy buildings for occupancy. The improving operating conditions provided the impetus for sales velocity to accelerate. Particularly within core markets, investment activity improved substantially at the end of 2010. The national industrial market should continue to recover in the near term before growing at a more robust pace.

The moderate economic recovery continued in 2010. In the first half of the year, inventory replenishment and an increase in export activity boosted manufacturing, wholesale trade and transportation employment.

- The manufacturing sector added approximately 64,000 jobs in 2010, reaching approximately 11.6 million workers by the fourth quarter. This was the first year-over-year net increase in payroll since 1998.
    - The durable goods subsector fueled the job gains in manufacturing. Last year, the subsector expanded payrolls by 106,000.
- The transportation and warehousing employment subsector also expanded in 2010. Approximately 54,800 jobs were added last year.
    - Within the transportation subsector, rail transportation employment increased significantly. In 2010, payrolls expanded by 7,800 jobs or an annual growth rate of 3.7%.
    - The trucking industry, which lost 14.9% of its jobs during the recession, began to rebound as cargo flows recovered. In 2010, truck transportation employment expanded by 0.8% or 10,500 jobs.
    - Also signaling recovery in the logistics industry, the warehousing and storage subsector grew by 0.9% in 2010.
- Large-scale plant shutdowns and layoffs slowed significantly in 2010. By year-end, there were slightly more than 2,000 mass layoffs in the manufacturing, wholesale trade, and transportation and warehousing industries. This was a decrease of 58.1% from 2009.
    - Within the manufacturing sector, mass layoff events fell by 63.7% to less than 1,400 in 2010. The majority of layoffs were within the non-durable goods manufacturing categories.

Real Estate Cycle – Industrial



The industrial production index increased to 94.4 in the fourth quarter, an increase of nearly 6.0% from 2009. In the second half of 2010, the index trended higher each month.

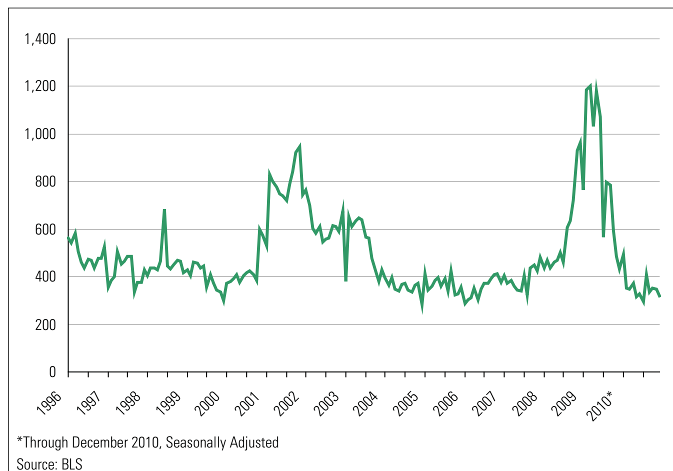
- Within the manufacturing categories, the index improved for both durable and non-durable goods.

Outlook for the National Industrial Market

	2002	2003	2004	2005	2006	2007	2008	2009	3Q10	2010f	2011f	2012f	2013f	2014f
New Construction* (Put-in-place, 2005 $ Bill.)	13.9	13.4	12.2	11.5	11.9	13.0	12.4	7.1	3.5	3.3	4.0	6.9	8.5	10.5
Manufacturing Empl. Growth	-5.4%	-4.5%	-0.1%	-0.8%	-1.1%	-2.1%	-5.5%	-11.0%	0.0%	0.3%	0.2%	0.1%	0.1%	0.1%
Trade Employment Growth	-1.1%	-0.4%	1.4%	1.5%	0.9%	1.2%	-3.6%	-4.2%	-0.1%	0.6%	0.8%	1.1%	0.7%	1.0%
Transport. & Utilities Empl. Growth	-0.9%	-1.3%	1.9%	2.1%	2.2%	1.0%	-2.3%	-5.2%	-0.1%	0.8%	0.9%	1.2%	0.8%	1.0%
Indust. Production ('07=100)	89.1	90.2	92.3	95.3	97.4	100.0	96.7	87.7	93.4	94.4	97.0	97.9	93.5	98.8
Indust. Production Percent Change	2.8%	1.4%	2.9%	2.2%	2.5%	2.7%	-3.3%	-9.3%	6.6%	7.6%	2.8%	0.9%	-4.5%	5.7%
Vacancy Rate	10.1%	10.3%	9.7%	8.3%	7.3%	7.2%	8.3%	10.4%	10.6%	10.3%	10.0%	9.4%	9.3%	8.4%
Rent Growth	1.2%	1.3%	3.9%	3.8%	10.3%	4.1%	0.8%	-21.9%	-8.7%	-5.5%	2.1%	3.1%	2.7%	3.8%
Cap Rate	7.6%	7.5%	7.3%	6.7%	6.0%	5.7%	6.1%	7.2%	7.8%	7.1%	7.0%	6.9%	7.0%	6.8%
NCREIF Total Industrial Return	6.7%	8.2%	12.1%	20.3%	17.0%	14.9%	-5.8%	-17.9%	5.8%	6.7%	11.8%	12.4%	8.5%	14.9%
Capital Return	-1.8%	-0.2%	3.9%	12.3%	9.8%	8.3%	-11.1%	-23.5%	0.3%	0.0%	5.3%	6.0%	2.0%	8.6%
Income Return	8.7%	8.4%	7.9%	7.3%	6.6%	6.3%	5.9%	6.9%	5.5%	6.7%	6.5%	6.4%	6.4%	6.2%
Delinquency Rate	0.17%	0.16%	0.11%	0.09%	0.01%	0.01%	0.03%	0.08%	0.30%	0.45%	0.22%	0.17%	0.15%	0.14%

* Numbers in quarterly columns are annualized.
Sources: Cushman & Wakefield, CB Richard Ellis, ACLI, Korpacz, BLS, Census, Federal Reserve, NCREIF, RCG

Mass Layoffs: Manufacturing



*Through December 2010, Seasonally Adjusted
Source: BLS

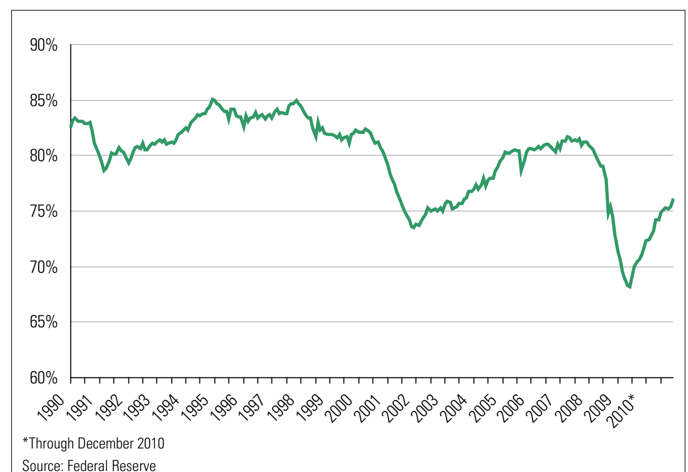
- The business equipment subcategory increased by 11.6% from the previous year. This market group accelerated in late 2010 as business confidence improved.
- The consumer goods market group plateaued in the second half of the year. The category remained at the 95% level throughout the second half of the year.

Utilization of production capacity continued to increase throughout 2010, reaching 75.6% in the fourth quarter. While capacity utilization rebounded substantially from the historical lows during the recession, underutilization continues, with the index much lower than the long-term average of 80.6%.

- Raw materials processing accelerated throughout the year, with much of the goods destined for low-cost overseas manufacturing facilities. By the fourth quarter, the crude stage-of-process category reached 88.8% capacity utilization, more than ten percentage-points higher than the trough in 2009.

The national industrial vacancy rate remained at 10.6% through the third quarter, 20 basis points off the peak earlier in the year. With businesses still cautious about overstocking inventories and a stronger focus on creating efficiencies in the supply chain, a slow pace of absorption was expected.

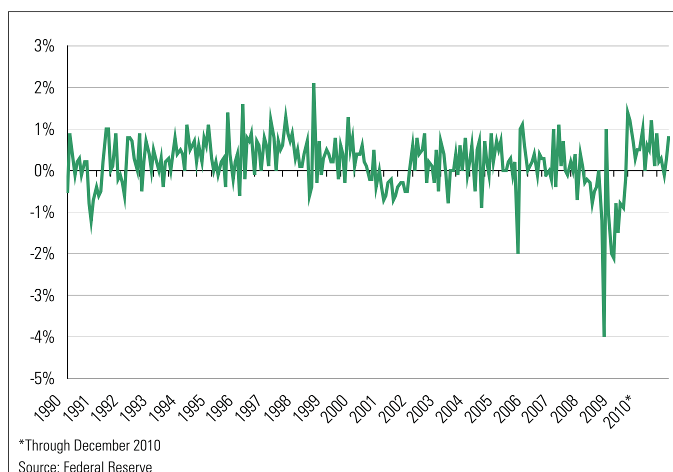
Index of Industrial Capacity Utilization



*Through December 2010
Source: Federal Reserve

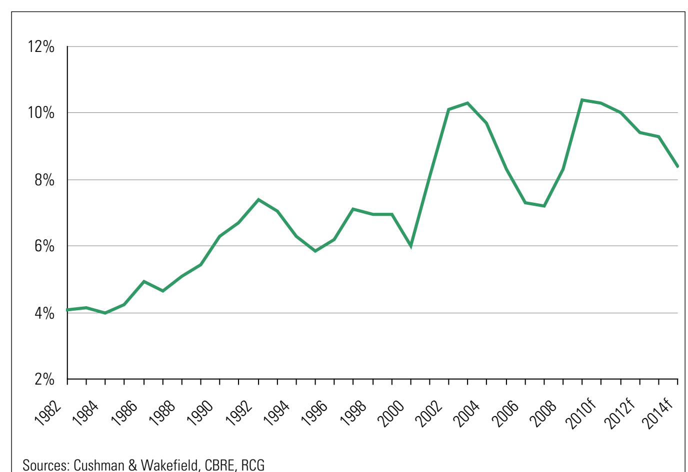
- The top-tier distribution markets are generally at the forefront of the recovery. Selected vacancy rates for major industrial markets included:
  - Los Angeles: 5.2%;
  - Chicago: 11.3%;
  - Inland Empire: 11.7%;
  - Atlanta: 11.7%;
  - Dallas: 14.5%.
- The industrial markets with the most significant improvements in vacancy rates from year-end 2009 through the third quarter included:
  - Memphis: 3.4 percentage-point decrease;
  - Tacoma: 2.5 percentage-point decrease;
  - Baltimore: 2.3 percentage-point decrease;
  - Inland Empire: 1.7 percentage-point decrease;
  - Portland: 1.4 percentage-point decrease.

Index of Industrial Production: Percent Change



*Through December 2010
Source: Federal Reserve

Industrial Vacancy Rate



Sources: Cushman & Wakefield, CBRE, RCG

- Industrial markets focused on technology, life sciences or R&D were generally more stable through the recession but have yet to improve significantly. Selected vacancy rates in these markets included:
    - Seattle: 11.3%;
    - San Jose: 13.2%;
    - Washington, D.C.: 14.3%;
    - Boston: 18.8%.

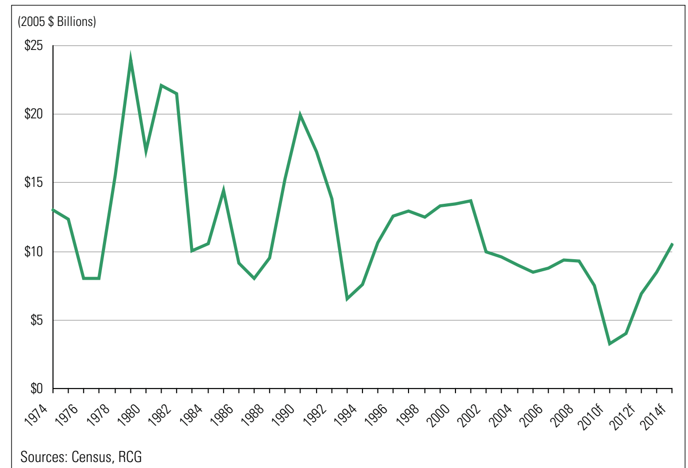
Leasing activity was often at opposite ends of the spectrum for some local industrial markets in 2010. In cities with access to deepwater ports or primary rail lines, leasing activity generally accelerated; however, markets with industrial product geared towards local distribution or tertiary markets that attracted logistics professionals prior to the recession seeking to diversify distribution centers had little improvement in transaction volume.

- Through the first three quarters of 2010, nearly 244.1 million square feet of leases were consummated. This was a 15.0% increase from the previous year.
- Metropolitan regions with the most substantial improvements in leasing activity from the previous year included:
    - Los Angeles: 6.8 million square feet greater;
    - Atlanta: 2.9 million square feet greater;
    - Orange County: 2.5 million square feet greater;
    - Portland: 2.3 million square feet greater;
    - Inland Empire: 2.1 million square feet greater.
- Much of the improved leasing demand thus far was from large distribution tenants. Many of these companies sought to consolidate facilities or take advantage of lower rental rates for sites closer to ports or with direct rail access.

With a large amount of available space in most markets, downward pressure on asking rents continued. Year-to-date through the third quarter, the average asking rent contracted by 6.3%. On a positive note, the pace of contraction slowed from the first half of the year.

- Through the first three quarters of 2010, several markets produced rent growth. These included:
    - Pittsburgh: 6.9% rent growth;
    - Columbus: 6.2% rent growth;
    - Birmingham: 5.6% rent growth;
    - Kansas City: 3.5% rent growth;
    - Indianapolis: 2.8%.
- The abundance of availabilities continues to prevent landlords from increasing asking rents to a significant degree; however, in many cases landlords have already begun to curtail the usage of leasing concessions. With the industrial market poised for improvement, some landlords have become unwilling to gain occupancy in the near term by offering extremely generous incentives.

Industrial Construction Put-in-Place



Sources: Census, RCG

- The spread between achievable rents for state-of-the-art properties or port-adjacent submarkets and less efficient spaces continued to widen. Tenants in the market are generally very aware of the efficiency gains afforded by first-generation space and tend to be willing to pay more for the right location.
- Some tenants are focused on longer-term leases, attempting to lock-in current rents for an extended period. This is a reversal from several quarters ago when most tenants sought short-term deals due to the downward direction of rental rates. While average rents have yet to turn upward, this trend is an indication that tenants are expecting rent increases to materialize in the near term.

New construction remained at a minimal level throughout 2010. With a multitude of space options and achievable rents not at a level to justify new construction, speculative development activity has been rare for the last several years.

- The value of private put-in-place construction fell to $3.5 billion in the third quarter. This was a 20.5% decrease from the previous quarter and less than half of the activity in 2009.
- In the metropolitan areas tracked by RCG, only 14.9 million square feet of industrial product were delivered through the first three quarters. The cities with the most completions included:
    - Atlanta: 2.5 million square feet;
    - Chicago: 1.4 million square feet;
    - Cincinnati: 1.3 million square feet;
    - Phoenix: 1.1 million square feet.
- An additional 13.0 million square feet were under construction. Although this is a large amount of space compared with recent deliveries, approximately 22.5% of the new product is accounted for by a 1.8 million square-foot building in the Inland

Empire and a 1.1 million square-foot building in Atlanta. Both of these projects are build-to-suit developments and will be fully occupied upon completion.

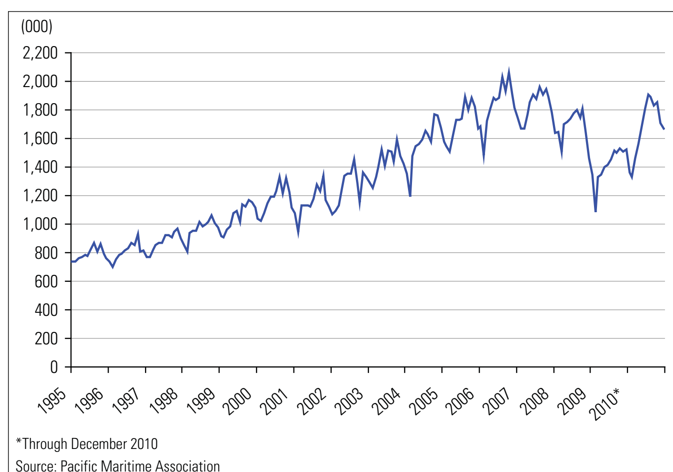
The industrial market continued along the path to recovery in the second half of 2010 as tenant demand increased in prime distribution markets and for state-of-the art facilities. Outside of these core markets, leasing demand was still soft and asking rents displayed further weakness. However, we believe that the national industrial market is poised for a slow recovery and will trend in a positive direction. As the industrial market is in the early stages of recovery, we have moved the position forward on the RCG Real Estate Cycle Clock to 4:00.

Cargo Trends

Global cargo flows rebounded in 2010 due to inventory replenishment in the first half of the year and stronger purchasing activity by businesses and consumers in the second half. Although the peak shipping season was somewhat muted, the increase in demand and reduction in capacity for sea, highway and rail movement created tightened conditions and stabilized rates.

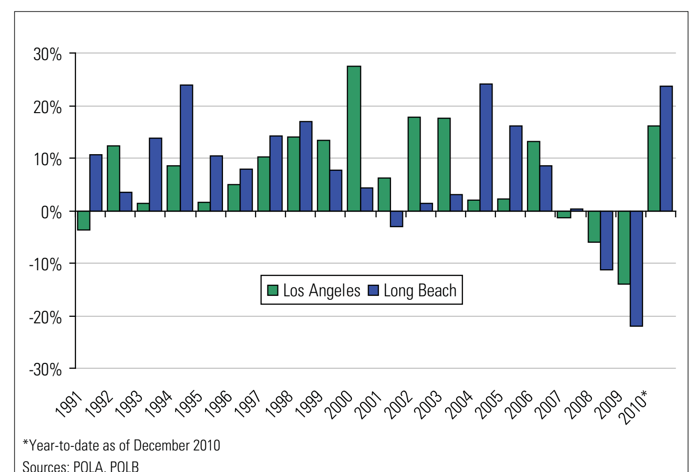
- In 2010, more than 20.0 million TEUs transited through West Coast ports, according to the Pacific Maritime Association. Container handling increased by more than 18.3% compared with 2009.
- In Southern California, container traffic also rebounded significantly from the low totals of 2009. At the Port of Los Angeles, more than 7.8 million TEUs moved through port facilities, an increase of more than 16.0% compared to 2009. Activity at the Port of Long Beach increased even more with TEU movement growing by 23.6% to total nearly 6.3 million TEUs.
- Traffic along the Europe to North America shipping lines did not increase as much as did traffic from Asia to the West Coast. In 2010, TEU volume from Europe to North America increased by 12.3% and totaled approximately 3.2 million TEUs.
- As cargo activity rebounded, many container lines reactivated portions of the idled fleet. In 2010, the major liners increased cellular capacity by approximately 9.1%, according to AXS-Alphaliner.
    - While container traffic is expected to increase throughout the next several years, overcapacity concerns will linger.
    - NYK Line forecasted cargo growth of between 7% and 8% in 2011, though it expected global capacity to increase by 10% during the same period.
- Some liners are focusing on deploying the largest ships that are most profitable by providing greater energy efficiency and economies of scale. This is causing a ripple effect as larger ships now ply coastal and short-haul routes previously dominated by the smaller handy and feeder classes of containerships.
    - These ships that can carry up to 18,000 TEUs will focus cargo flows on primary deepwater ports.
- Although containerized cargo volume increased substantially in 2010, it should be remembered that the growth rates are off of extremely low 2009 figures. Although liners instituted peak season surcharges from early January through the Lunar New Year, cargo traffic remains much lower than prior to the recession and contract rates are still relatively low.
    - The trans-Pacific benchmark rate jumped by approximately 10% at the end of 2010. Following the Lunar New Year holidays and annual contract negotiations, the spot rate should fall below $2,000 per 40-foot container.
    - Even with an expected increase in cargo flows in 2011, spot rates are likely to be on par or lower than in 2010 as carriers continue to battle overcapacity issues.
- The rebound in rail freight volume continued through the end of 2010. In December, the number of freight cars in storage fell to 20.8% of the total fleet, the 18th-consecutive monthly decrease

TEUs Handled by Month – West Coast



*Through December 2010
Source: Pacific Maritime Association

TEU Growth: Ports of Los Angeles & Long Beach



*Year-to-date as of December 2010
Sources: POLA, POLB

in the idled car fleet. While in 2010 more than 132,000 freight cars returned to the active fleet, the Association of American Railroads estimates that during good economic conditions, the share of idled cars would fall to between 2% and 3% of the domestic fleet.

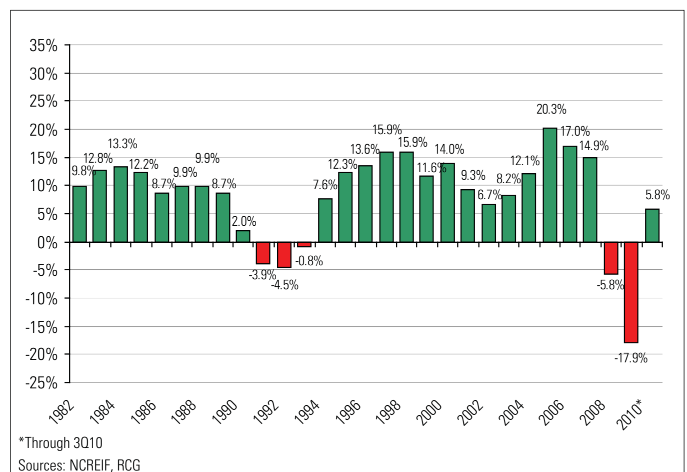
- After reducing capacity significantly in 2008 and 2009, demand for trucking services created tight conditions and boosted revenue per truck in 2010. Expectations for 2011 trucking volume are between 5% and 10% growth.
  - The increased demand and tight supply conditions will translate into higher rates in the first half of 2011.
  - The spot price of diesel increased by 12.9% in the fourth quarter and events early in 2011 indicate that fuel prices will increase further. Not only will this contribute to higher trucking costs and potentially add to fuel surcharges, but the growing cost of trucking will continue to focus demand on rail when possible.

Investment Market

Investment activity continued its upward trend in 2010 after bottoming at the end of 2009. High-quality assets in prime markets and well-managed portfolios attracted a great amount of interest throughout the year. As sales volume increased, price discovery established floors early in the year. By the second half of the year, price appreciation already occurred for quality assets in core markets. With asset pricing beyond the trough and operating conditions improving, investment capital is moving off the sidelines and will be deployed this year.

- Industrial investment volume increased to $12.2 billion in November, nearly double the value of activity in the previous year.
  - Capital remained focused on prime distribution cities throughout 2010. Additionally, pricing was strongest for assets near deepwater ports and state-of-the-art facilities with rail access.
  - Thus far in the recovery, much of the investment interest has been biased towards large-scale distribution centers and warehouse portfolios rather than flex properties.
- The average transactional cap rate fell to 8.1% in November, down 40 basis points from the end of 2009.
  - Average cap rates for secondary markets or assets with significant vacancy risk are at least 150 basis points higher.
- The ACLI cap rate remained stable at 7.8% in the third quarter. Since early 2009, the ACLI cap rate moved less than 40 basis points.
- Private market investment returns continued to rebound in 2010. The NCREIF index accelerated to 5.8% total returns in the third quarter.

Total Rates of Return: Industrial Properties



*Through 3Q10
Sources: NCREIF, RCG

  - The R&D subcomponent of the NCREIF index rebounded quickly and is outpacing the warehouse component. In the third quarter, R&D returns accelerated to 8.7%, compared to 5.9% for the warehouse component.
- While a large amount of distress exists for industrial real estate, the sector has fared better than other property types.
  - The ACLI delinquency rate increased minimally to 0.3% in the third quarter. With the ACLI portfolio focused on quality assets, and continued willingness to amend terms on loans, the delinquency rate remained low.
  - The CMBS delinquency rate increased to nearly 9.0%, according to Trepp. At the end of 2010, the industrial delinquency rate spiked due to two issuances totaling approximately $622.5 million.
  - At the end of December 2010, more than $2.1 billion of industrial CMBS were delinquent, according to Standard & Poor's.
  - In November, the cumulative total of distressed assets was $7.3 billion, according to Real Capital Analytics. An additional $1.8 billion of properties were lender-owned. In all, since 2007, nearly $3.2 billion of industrial loans were restructured or resolved.

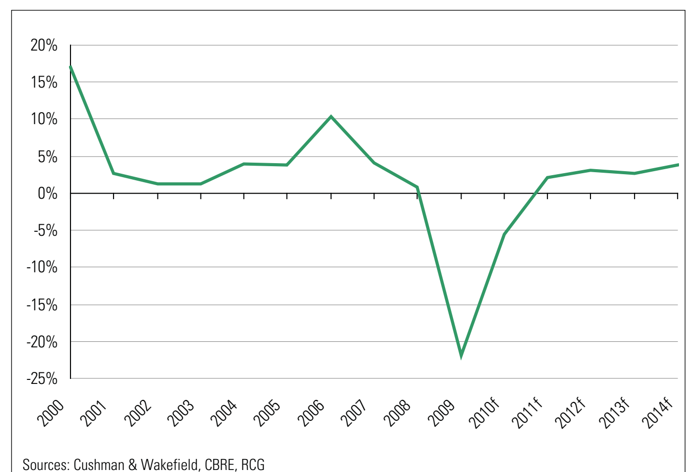
The Outlook

The national industrial market will continue to recover in the near term, before accelerating in line with improved economic conditions next year. Tenant demand increased in recent months and will grow; however, landlords are not expected to obtain significant leverage during lease negotiations until much of the excess vacant space is absorbed. Construction activity will be curtailed for the next several years as operating conditions improve slowly and achievable rents do not justify widespread building. Investment capital will focus primarily on core markets and quality assets with credit tenants in

the near term. As investors seek yield, we expect the investment outlook for secondary markets to improve over the medium term. The recovery in tenant demand will continue throughout 2011, with the national vacancy rate falling to 10.0%. The rate of absorption of vacant space should accelerate in 2012 and the vacancy rate should fall to 9.4%. In 2013, we expect the national economy to slow, though remain positive, and the industrial vacancy rate should stabilize. By 2014, leasing activity should pick up and the vacancy rate is forecasted to fall to 8.4%.

- In the near term, core markets will likely outperform secondary distribution cities. The forecasted 2011 vacancy rates for prime distribution cities include:
  - Los Angeles: 5.1%;
  - Chicago: 10.9%;
  - Inland Empire: 10.9%;
  - Atlanta: 11.6%;
  - Dallas: 13.6%.
- From 2012 through 2014, a significant amount of industrial space should be absorbed. Selected local markets with the greatest reduction in the vacancy rate during this period include:
  - Washington, D.C.: 4.6 percentage-point decrease;
  - Inland Empire: 4.4 percentage-point decrease;
  - Phoenix: 4.4 percentage-point decrease;
  - Boston: 4.2 percentage-point decrease;
  - Minneapolis: 3.0 percentage-point decrease.
- As excess vacant space is slowly absorbed, asking rents should stabilize in the first half of 2011 and increase by the end of the year. We expect the average asking rent to increase by 2.1% in 2011 before accelerating to 3.1%. Rent growth should remain positive in 2013, even with a slight economic slowdown, and accelerate to 3.8% in 2014.
- In 2011, the greatest expected rent growth will occur in:
  - Oakland: 4.0%;
  - San Francisco: 3.6%;
  - San Diego: 3.3%;
  - Los Angeles: 3.0%;
  - Atlanta: 3.0%.
- As available space diminishes, moderate rent growth should occur in most markets. Between 2012 and 2014, average annual rent growth in selected markets includes:
  - Inland Empire: 5.2%;
  - San Jose: 4.4%;
  - Portland: 4.3%;
  - Chicago: 3.4%;

Industrial Rent Growth



Sources: Cushman & Wakefield, CBRE, RCG

  - Seattle: 3.4%
- Through the forecast period occupancy demand as well as rent growth will be strongest in submarkets nearest to port complexes or with excellent access to transportation infrastructure. While the slow to moderate pace of absorption will prevent a significant spike in rental rates across the board, these submarkets adjacent to major port complexes could be the exception.
- As leases roll, distribution tenants will remain committed to improving efficiency within supply chains. We do not expect the trend of supply chain diversification to return in the medium term; ports and shipping routes will not return to maximum capacity levels for some time.
- Many tenants will achieve cost savings by consolidating facilities or leasing state-of-the-art properties with increased clear heights and more efficient floor plans.
- The rise in diesel costs and highway congestion will continue to place a premium on industrial properties with direct rail access.
- Construction activity will remain muted throughout the entire forecast period. In 2011, the value of put-in-place construction should reach only $4.0 billion. While development activity will increase, by 2014 we expect only $10.5 billion of new industrial construction, significantly less than the construction levels produced during the first half of the 2000s.
  - We forecast only 17.7 million square feet of industrial construction in 2011. Approximately half of this amount will occur in the Inland Empire, Atlanta, Los Angeles and Chicago. Each of these cities is a prime distribution market and the new construction will account for a small fraction of existing stock.
  - Moving forward, we expect more than 220.0 million square feet of new construction from 2012 through 2014,

or an average of less than 74.0 million per year. A large portion of the development activity will occur in Chicago, Dallas, Houston, Inland Empire and Los Angeles.

  - While a rate of 74 million square feet per year is a rapid acceleration from the current low pace of development, it is still less than half the amount of new construction delivered per year from 2005 through 2008.

- Global cargo flows will continue to expand in 2011, though pricing should remain volatile because a large amount of capacity exists among most modes of transportation, placing downward pressure on rates. Concurrently, increasing fuel prices are causing operators to impose surcharges.
  - Supply chain diversification is over for at least the next several years. Logistics professionals will focus on cost-saving measures including consolidating facilities and ports of entry.
  - Retailers and manufacturers will focus on just-in-time practices rather than just-in-case, though the tone of contract negotiations for the ILA and East Coast ports in 2012 and ILWU and West Coast ports in 2014 could alter the trend.
  - The spike in global commodities prices will help export activity, boosting intermodal traffic and outbound containers from domestic ports. This may help boost industrial real estate surrounding smaller ports that focus on bulk rather than containerized cargo.
- Investment activity will continue to increase in the near term as capital moves off the sidelines and distressed assets are recapitalized.
  - Delinquencies will continue in the near term as NOI growth is likely to be lackluster for the next several quarters.
  - The ACLI cap rate should decrease to the 7% range as pricing recovers for prime assets.
  - Properties with credit tenants locked into long-term leases will continue to garner multiple bids as they come to market.
  - Opportunistic investors seeking more aggressive rates of return may find attractive opportunities in assets with a high level of vacancy. These new owners may be able to attract tenants from the large roster of leases rolling in the near term that have in-place rents at above-market rates. If properties are purchased at a relatively low cost basis, these assets have the potential to be positioned for an exit strategy coinciding with a heightened inflation environment, which could place greater emphasis on real estate as an inflation hedge.
- The NCREIF index will accelerate further as valuations increase and operating conditions improve. In 2011, we expect the index to return to double-digit territory. Between 2012 and 2014, the industrial component of the NCREIF index should appreciate by approximately 11.9% per year.

Conclusion

The national industrial market will continue to recover slowly in the near term before accelerating beyond this year. The trend of import activity providing much of the goods sold by retailers is not expected to reverse, placing continued focus on the major deepwater ports and Class 1 railroad trunk lines. Although some markets will be weak in the near term as local distribution trends reflect the high unemployment rates, the primary distribution markets are poised for a period of balanced recovery. While tenant demand will rise, the vacancy rate will not fall dramatically, as users learned to operate at lean levels during the recession and will continue to focus on efficiency throughout the supply chain. Even with operating conditions improved, we do not expect a large amount of construction to occur for at least the next several years. With the risk of oversupply contained and absorption turning positive, investment activity will continue to trend higher. In the near term, investors will focus on gateway cities, bidding-up values on premier assets. As capital chases yield, investment activity should spillover into the secondary markets. Overall, we have a positive view of the industrial market and the sector should return to its traditional place as a supplier of stable returns relative to other property types.

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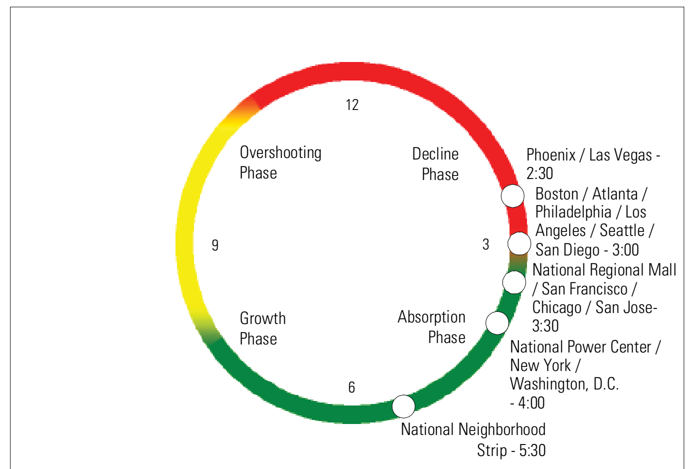
The National Retail Market

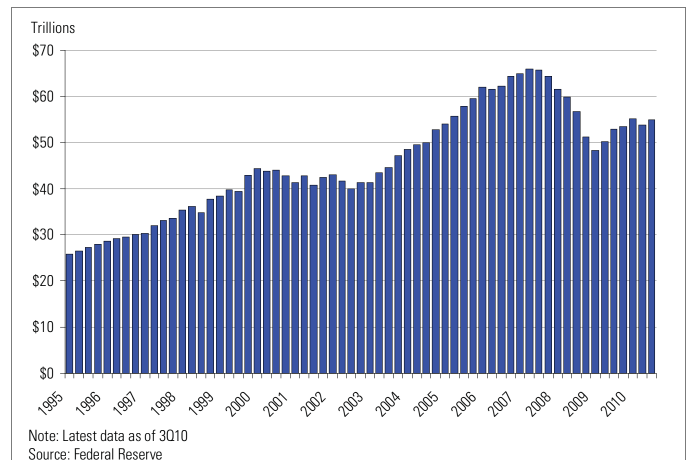
The retail market picture brightened during the second half of 2010, capped off by strong sales growth during the holiday shopping season. Job growth and pent-up demand for goods and services following an extended period of consumer frugality fueled retail sales, resulting in increased optimism regarding the sector's outlook among retailers, owners and potential investors.

- The economy added over 900,000 jobs during 2010, including more than 1.1 million in the private sector, and layoffs declined sharply between the cyclical peak in early 2009 and year-end 2010. Improving labor market conditions had a financial impact on consumers by increasing overall earnings as well as a psychological impact of consumers becoming less fearful regarding spending, particularly on discretionary items.
- Household net worth was elevated through the first three quarters of the year compared with the cyclical low in the first quarter of 2009, driven by the strong rebound in the equity markets. Total net worth stood at $54.9 trillion in the third quarter of 2010, a 12.2% increase from the first quarter of 2009.
- The Conference Board's consumer confidence index bounced around the 45-60 range throughout the year, reflecting an increase in confidence compared with the depths of the recession, but also some uncertainty regarding the recovery's traction amid still-high unemployment.
    - Consumer confidence fell slightly to 52.5 in December 2010 from 54.3 the previous month and 53.6 in December 2009. A reading of 90, last observed in late 2007, is indicative of a healthy economy. Thus, the consumer remained wary of the current state of and future prospects for the economy and job market
    - The present situation component of the index remained at recessionary levels during the last two years, ending 2010 at 23.5, while the expectations component fluctuated between 65 and 80 throughout the year, compared with a

Real Estate Cycle – Retail



Total Household & Non-Profit Net Worth



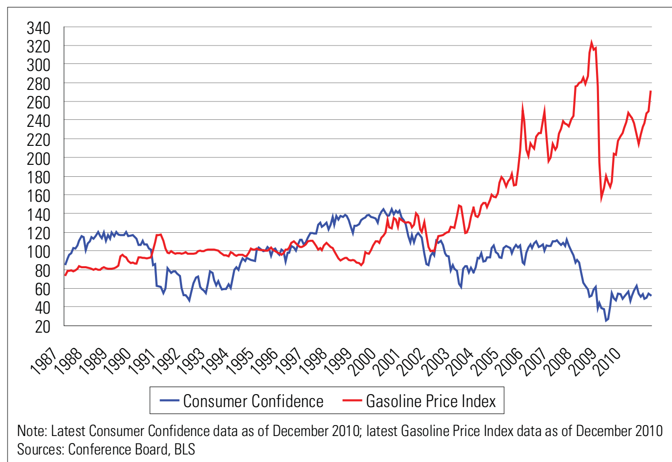
Note: Latest data as of 3Q10
Source: Federal Reserve

Outlook for the National Retail Market

	2002	2003	2004	2005	2006	2007	2008	2009	3Q10	2010f	2011f	2012f	2013f	2014f
New Construction (Put in Place, 2005 $ Bill.)	45.0	42.6	45.6	42.3	42.1	46.8	41.7	24.6	18.2	18.0	16.5	19.5	23.0	30.0
Retail Sales Excl. Autos ($ Bill.)	670.8	710.1	764.8	826.0	857.2	903.9	866.1	876.4	908.1	933.6	955.1	991.4	1,010.2	1,043.5
% Change (Yr./Yr.)	3.9%	5.9%	7.7%	8.0%	3.8%	5.5%	-4.2%	1.2%	5.3%	6.5%	2.3%	3.8%	1.9%	3.3%
Real Per Capita Disp. Income Growth	3.1%	3.9%	3.5%	0.6%	4.6%	1.5%	1.0%	0.4%	1.9%	2.4%	2.5%	2.9%	2.5%	3.0%
Consumer Confidence	96.6	79.8	96.1	100.3	105.9	103.4	58.0	45.2	50.9	53.4	80.0	90.0	80.0	95.0
Vacancy Rate	7.8%	7.6%	7.3%	7.2%	6.9%	7.3%	7.6%	8.7%	n/a	9.2%	8.8%	8.5%	8.3%	8.0%
Neighborhood Strip: Rent Growth	2.2%	2.2%	2.6%	2.6%	2.8%	2.9%	2.3%	0.7%	0.6%	0.5%	1.7%	2.4%	2.6%	2.9%
Power Center: Rent Growth	2.9%	2.4%	2.5%	2.6%	3.0%	2.9%	1.4%	-1.7%	-0.7%	-0.9%	1.5%	2.1%	2.4%	3.0%
Regional Mall: Rent Growth	2.8%	2.5%	2.5%	2.8%	2.9%	2.9%	1.9%	0.3%	0.6%	0.7%	1.9%	2.5%	2.7%	3.0%
Cap Rate	7.8%	7.4%	6.9%	6.1%	5.9%	5.5%	5.9%	6.9%	7.5%	6.9%	6.6%	6.6%	6.5%	6.4%
NCREIF Return	13.7%	17.1%	23.0%	20.0%	13.4%	13.5%	-4.1%	-10.9%	7.5%	5.2%	13.1%	9.0%	10.6%	8.1%
Capital Return	4.7%	8.2%	14.4%	12.6%	6.8%	7.3%	-9.5%	-16.6%	2.2%	-1.5%	6.8%	2.7%	4.4%	1.9%
Income Return	8.8%	8.5%	7.7%	6.8%	6.3%	5.9%	5.7%	6.5%	5.2%	6.6%	6.4%	6.4%	6.3%	6.2%
Delinquency Rate	0.47%	0.20%	0.07%	0.07%	0.06%	0.02%	0.00%	0.25%	0.03%	0.30%	1.80%	1.30%	0.80%	0.60%

Sources: U.S. Commerce Dept., ABA, ACLI, BEA, Korpacz, The Conference Board, NCREIF, Viewpoint, RCG

Consumer Confidence and Gasoline Price Index



Note: Latest Consumer Confidence data as of December 2010; latest Gasoline Price Index data as of December 2010
Sources: Conference Board, BLS

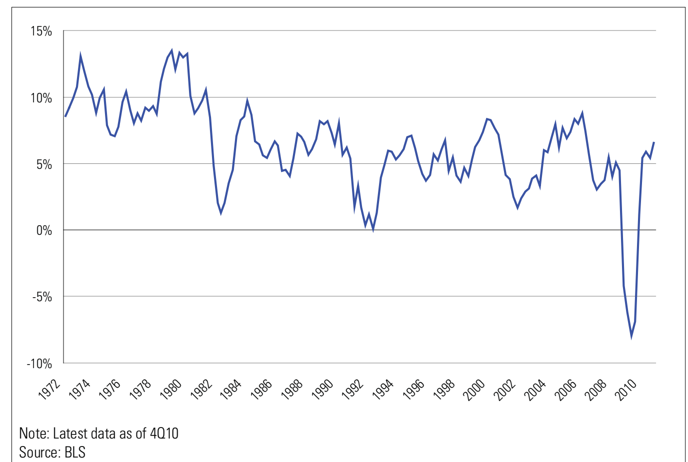
recent low of 27.3 in February 2009. Both measures should improve in 2011 as stronger job growth takes hold.

Following a dismal shopping season in 2008 and only modestly better sales numbers in 2009, consumer demand rebounded in November and December 2010. Improvement was broad-based, with many of the most beleaguered retail categories during the recession bouncing back, a positive sign for retail sales during the coming year.

- Year-over-year growth in the International Council of Shopping Centers' (ICSC) chain store sales index, which measures sales at chain store locations open for at least one year, decelerated from 5.4% in November to 3.1% in December. However, the slowdown was partially because of the blizzard that hit the East Coast on December 26th, one of the busiest shopping days of the year, and continued for several more days. The storm postponed an estimated $1 billion of anticipated post-Christmas retail sales, part of which will be carried forward into the January 2011 statistics.

- Unlike recent years, when discounters and warehouse stores were the lone bright spots, other categories posted strong increases compared with 2009.
  - The luxury segment continued its robust rebound, with sales increasing by 5.2% and 8.1% in November and December, respectively. The stock market rally was a key reason for improvement in demand in this sector this year. Because an estimated 40% of retail sales come from the wealthiest 20% of households, improvement in this demand segment is important for the retail market.
  - Apparel sales lost momentum in December, increasing by 0.8%, but increased by a strong 6.3% annual rate in November. This sector faces cost pressures that could intensify as the global economic rebound continues. Higher prices for raw materials such as cotton are squeezing profits, while rising gasoline prices could limit demand from a consumer base still hampered by high unemployment.

Retail Sales (excl. autos) Year-over-Year % Change (SAAR)



Note: Latest data as of 4Q10
Source: BLS

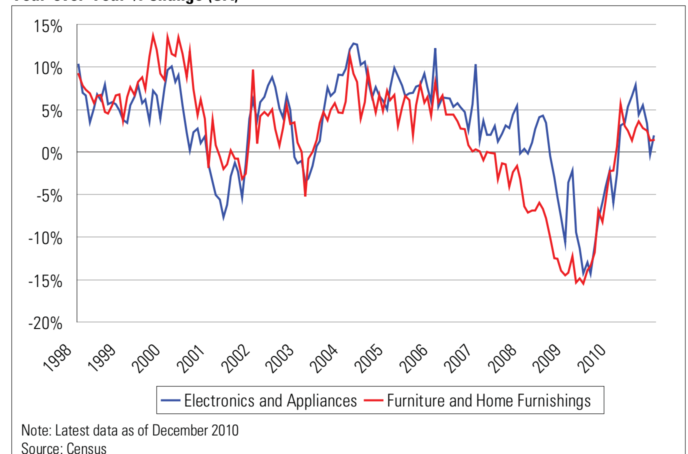
  - Wholesale clubs remained popular with consumers, posting 5.7% and 3.7% year-over-year sales increases (excluding fuel sales) in November and December, respectively, while discounter sales increased by more modest rates of 4.9% and 1.2%, respectively. Growth rates for both categories trailed previously beleaguered segments such as luxury and department store sales. However, sales at wholesale and discount stores declined much less during the recession and therefore will likely continue to increase at a slower rate going forward as the discretionary-oriented retailers recover from depressed sales volumes.

- Higher sales volumes, measured discounting and effective inventory controls limited the amount of end-of-year "blow-out" sales, helping to preserve margins.

- In addition to the strong holiday sales figures, other positive signs for the retail industry emerged in 2010.

- Steady year-over-year sales growth throughout 2010, coupled with effective inventory and cost management by retailers resulted in a lower level of year-to-date store closings compared with the recession.

Retail Sales by Store Type: Electronics and Appliances, Furniture and Home Furnishings Year-over-Year % Change (SA)



Note: Latest data as of December 2010
Source: Census

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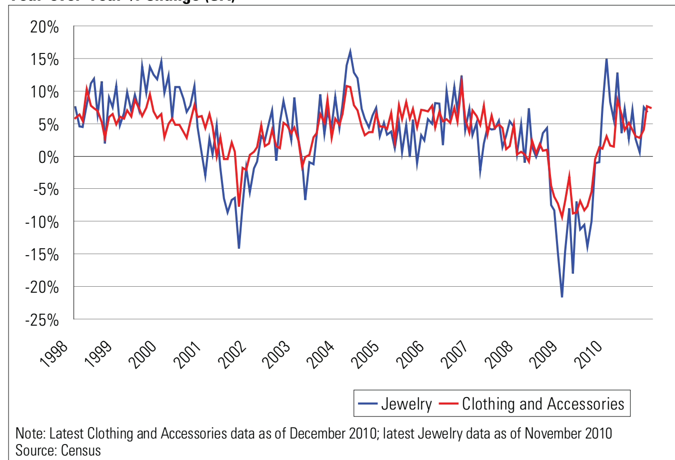
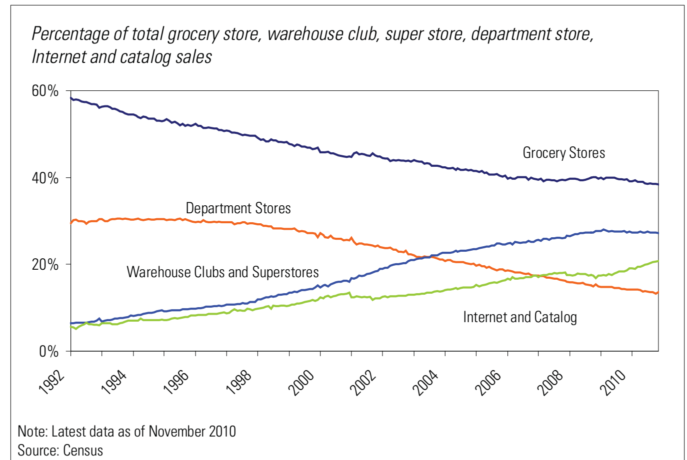
Retail Sales by Store Type: Jewelry, Clothing and Accessories
Year-over-Year % Change (SA)



Note: Latest Clothing and Accessories data as of December 2010; latest Jewelry data as of November 2010
Source: Census

Superstores' Sales Cannibalization

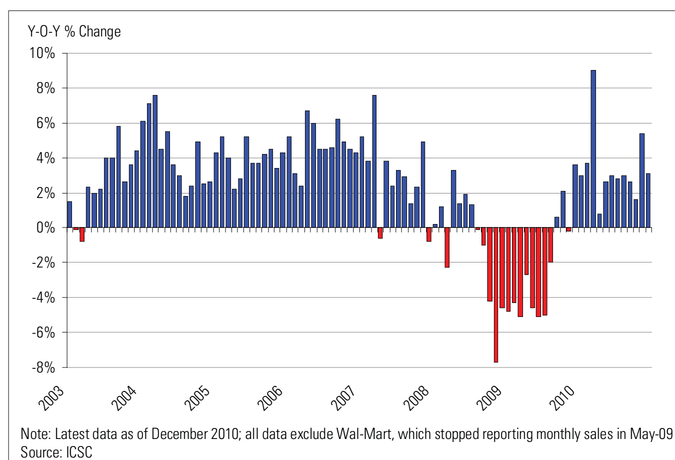


Note: Latest data as of November 2010
Source: Census

- o According to the International Council of Shopping Centers (ICSC), store closing announcements by major retailers totaled 4,680 through the first three quarters of 2010, slightly less than the total of 4,811 for all of 2009. Retailers closed just 350 stores during the third quarter.
- o Although the 2010 closings total will likely surpass 2009s total, it will likely be far below the total of 6,913 in 2008 in the wake of a slew of big-box and other major retailer closings and bankruptcies.
- o In contrast with the recession, when closings spanned a range of retailers hit hard by the recession, many of the recent store closing announcements have come from companies such as Barnes & Noble and Blockbuster that are losing market share to less expensive, more efficient online competitors like Amazon.com and Netflix. This secular trend is likely to continue, even as overall economic growth improves.

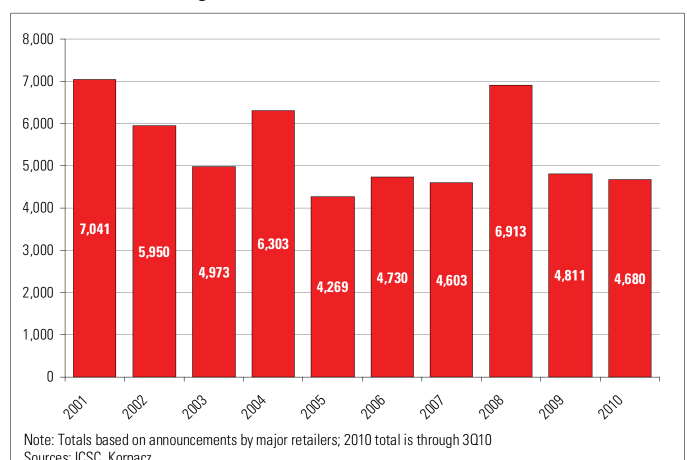
- As market conditions improve, retailers are slowly picking up the pace of store openings, which will boost absorption in 2011 and beyond.
  - o As of November, retailers tracked by RBC Capital Markets and Retail Lease Trac planned to open more than 66,500 stores during the next 24 months, up from around 65,700 the previous month.
  - o Quick service restaurants including Quiznos Sub, Five Guys Famous Burgers and Fries, and A&W Restaurants and dollar stores including Dollar General, Dollar Tree and Family Dollar are among the retailers planning to open the most locations during the next two years.
  - o Other retailers with aggressive expansion plans include discounters such as Ross Stores, TJX and Kohl's, and retailers continuing to seek to capitalize on the bankruptcies of major rivals several years ago, such as Best Buy in the wake of Circuit City's filing and Bed Bath & Beyond following the closure of Linens 'n Things.
- ICSC's Shopping Center Executive Opinion Survey indicated improvements in business conditions in November and December, with readings of 57.0 and 54.0, respectively. (A level of 50.0 or higher indicates improvement.) Executives held positive views regarding both the current and future state of retail market conditions.

Comparable Store Sales



Note: Latest data as of December 2010; all data exclude Wal-Mart, which stopped reporting monthly sales in May-09
Source: ICSC

Annual Store Closings



Note: Totals based on announcements by major retailers; 2010 total is through 3Q10
Sources: ICSC, Korpacz

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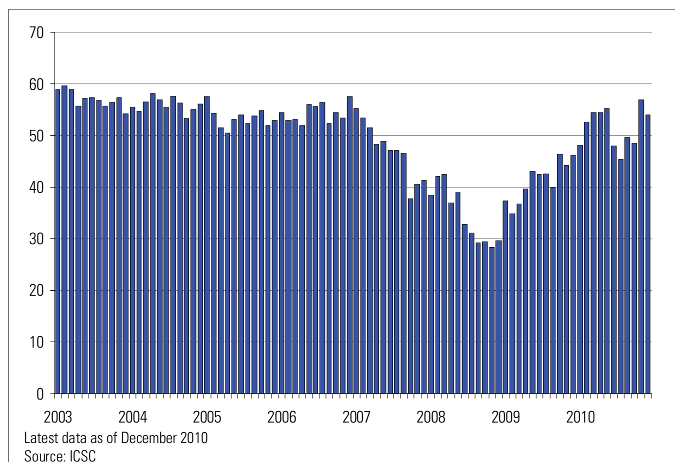
Shopping Center Executive Business Barometer



With improving retail conditions, all of the retail property types moved into the absorption phase of the RCG clock. The regional mall, power center and neighborhood strip center property types now stand at 3:30, 4:00 and 5:30, respectively.

Investment Market

- Transaction volume rebounded in concert with higher investor confidence in the economic recovery's sustainability. According to Real Capital Analytics, 12-month trailing retail investment volume in November more than doubled compared with the year-earlier period, reaching $17.9 billion. The average price-per-square-foot paid increased by 15.2% during the same period to $167.
- As of early December, retail was the third-most distressed property type, with troubled assets totaling $24.1 billion, behind office and apartment and ahead of hotel, development site and industrial, according to Real Capital Analytics.
  - Strip properties accounted for a larger volume of distress; although adjusted for sector size, regional malls were more distressed.
  - Regionally, the West continued to lead the way with 610 troubled assets totaling nearly $6.8 billion, while the Northeast had the smallest volume and total of $1.8 billion in 116 properties.
- According to the Association of Foreign Investors in Real Estate's (AFIRE) 19th annual survey, conducted in the fourth quarter of 2010, foreign investors were more optimistic regarding the prospects for the U.S. economy and real estate compared with the previous year as fears regarding a double-dip recession abated. Among the five major commercial property types, retail was the second-most preferred, behind multifamily, but ahead of hotel, office and industrial.
- Retail REIT stocks recorded a strong 2010.
  - According to NAREIT, total returns for the 27 retail REITs surged 33.4% in 2010, the largest gain since 2004 and ahead of the 28.0% return in the FTSE NAREIT All Equity REITs Index and the 15.1% return for the S&P 500.
  - As share prices rebounded, some retail owners, including Macerich, Simon Property Group, and Excel Trust, filed IPOs or secondary offerings, with many using the additional capital to pay down debt.
- Like other property sectors, investors were primarily focused on high-quality, well-located assets during the last few years. However, a fourth-quarter Pricewaterhouse Coopers survey found that investors are becoming comfortable assuming more risk, and therefore are more willing to consider value-add Class A and Class B assets, as well as properties in less desirable locations.
- Acquisition activity should pick up in 2011 as the economic recovery gains steam. After aggressively raising capital, retail REITs have a total of $17 billion in cash, according to Jones Lang LaSalle, which, along with growing demand from other types of buyers, should fuel transaction volume going forward.
- The fate of giant Australian mall owner Centro, including its 600 U.S. shopping centers, remains uncertain, as the company continues to struggle to pay off debt amassed for a buying binge earlier this decade. The disposition of some of the firm's assets is likely, and the acquisition of the entire firm is possible.
- Owner-users emerged as active players in the big-box space, purchasing distressed assets from banks or owners. Retailers such as Target, Kohl's, Wal-Mart and Ashley Furniture were willing to pay 20% to 30% more for boxes than investors because of the lack of occupancy risk for owner-users. The most active segment of the market is for stores totaling 60,000 square feet or more, and many transactions are occurring in Western states such as California, Arizona and Nevada where there are large concentrations of distressed retail assets.

The Outlook

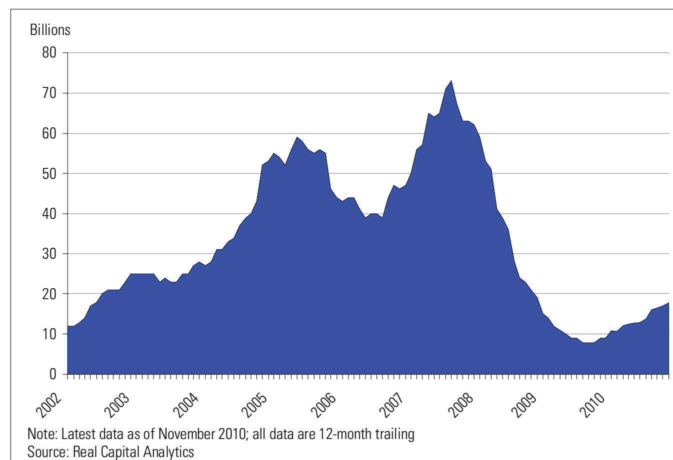
Stronger job growth and heightened consumer confidence are expected to yield higher retail sales in 2011, with improvement in market fundamentals continuing throughout the forecast period.

- The improving economy and lessening fears regarding the possibility of a double-dip recession should drive up the consumer confidence index to 80.0 in 2011 and a healthy level of 90.0 in 2012. With an economic slowdown forecasted for 2013, we expect the index to retreat slightly to 80.0, before increasing to 95.0 in 2014 as stronger job growth resumes. Although these levels are less than recent peaks of more than 100 between 2005 and 2007, they are indicative of the more modest, more sustainable economic expansion that we expect to occur through 2014.
- We expect annual real per capita disposable income growth to mirror overall job and economic growth, accelerating to

2.9% in 2012, followed by a slowdown to 2.5% in 2013 and an increase to 3.0% in 2014. After anemic real income growth averaging less than 1.0% annually between 2007 and 2009, stronger income growth going forward will be a key driver of the retail market's rebound.

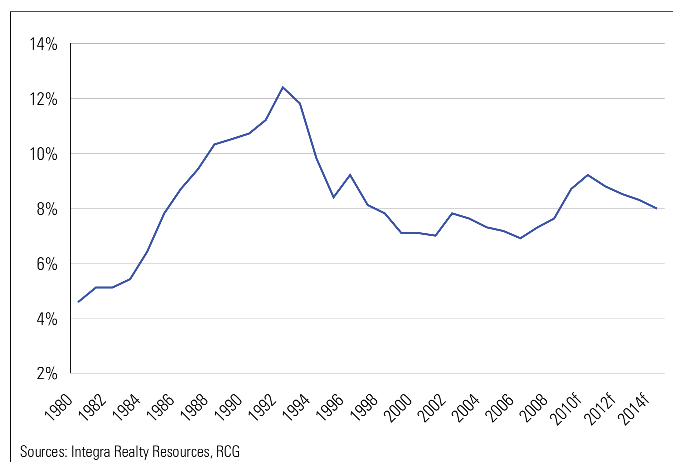
- Increased consumer demand should drive stronger retail sales growth, although we expect the increases to remain muted compared with the liquidity-fueled boom.
    - We forecast accelerating retail sales growth from 2.1% in 2010 to 3.8% in 2012, with a brief deceleration to 1.9% in 2013 as job creation slows. By 2014, retail sales growth should hit 3.3%.
    - These rates pale in comparison with 7.2% average annual growth between 2003 and 2005 because of our expectations for a persistently elevated unemployment rate and consumer caution in the wake of the Great Recession. Also, fewer consumers are using credit cards because of tighter lending standards or a personal choice not to accumulate debt – a positive for household balance sheets, but a negative for potential retail sales.
    - With stability among discounters and renewed strength among luxury retailers, discretionary retailers targeting the middle of the market are likely to face the longest road to recovery going forward.
- Retail fundamentals should mirror the improvement in consumer demand.
    - We expect the vacancy rate to peak at 9.2% in 2010, the highest level since 1994, when the vacancy rate reached 9.8%. Thereafter, more aggressive retail expansion activity in response to stronger retail sales and lower rents than a few years ago should drive down the vacancy rate steadily to 8.0% by 2014.
    - Because of the modest economic recovery, the vacancy rate is unlikely to return to the recent cyclical low of 6.9% in 2006 until well beyond the end of the forecast period.
- Rent trends should improve beginning in 2011 as retailer demand strengthens. Because of the importance of location for retail, rental trends will vary significantly by location, with high-quality, well-located assets in the strongest markets, such as Washington, D.C. and New York, outperforming lower-quality, poorly located properties in former housing-bubble markets such as Phoenix and Las Vegas and other economically weak metropolitan areas such as Detroit.
    - Regional malls should post the strongest rent growth going forward as apparel and department store sales continued to rebound. Our forecast calls for rent growth to accelerate from 0.7% in 2010 to 3.0% in 2014.
    - The neighborhood strip property type, the least impacted by the recession because of its concentration of non-discretionary retailers such as supermarkets and drugstores, should recover well also beginning in 2011. Rent growth is expected to accelerate from 0.5% in 2010 to nearly 3.0% in 2014. Unanchored strip properties in tertiary locations, particularly those with a large number of foreclosures and vacant homes, will take substantially longer to recover.
    - Power centers posted the weakest rent growth in 2008 and were the only property type to record a decline in rents in 2009, primarily because of the large number of big-box stores vacated by bankrupt and troubled retailers. However, leasing activity by former rivals of bankrupt companies as well as by healthy retailers seeking well-located space at discounted rents is growing and should drive the recovery in this segment. Following a rent decline of 0.9% in 2010, we expect rent growth to turn positive in 2011, accelerating to 3.0% in 2014, on par with regional malls and neighborhood strip properties.
- Construction activity, as measured by the inflation-adjusted value of put-in-place construction, remains extremely low and will likely remain muted throughout the forecast period

Total U.S. Retail Sales Volume



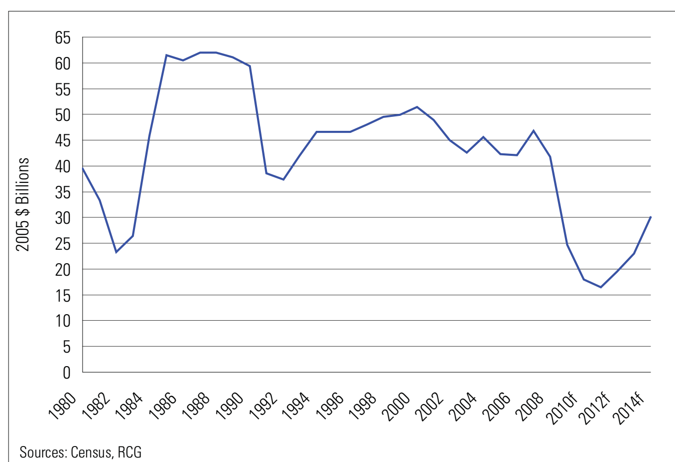
Note: Latest data as of November 2010; all data are 12-month trailing
Source: Real Capital Analytics

Retail Vacancy Rate



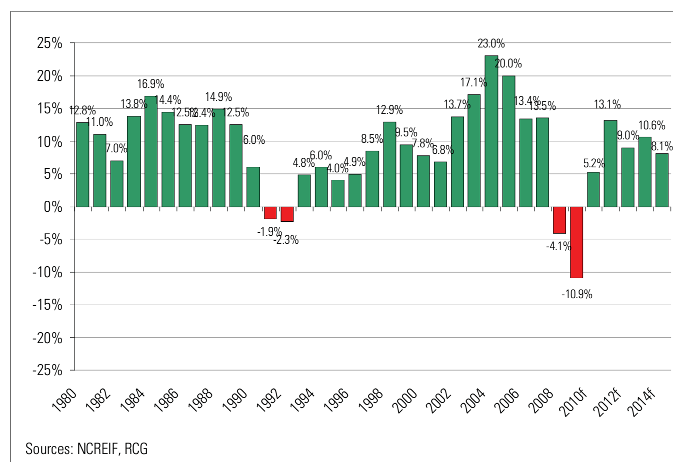
Sources: Integra Realty Resources, RCG

Retail Construction Put-in-Place



Sources: Census, RCG

Total Rates of Return - Retail Properties



Sources: NCREIF, RCG

compared with recent years.

- We expect the annual value of construction to fall from $18.2 billion in the third quarter to $18.0 billion by year-end 2010, followed by an additional decline to $16.5 billion in 2011. An increase in the availability of financing, coupled with improving market fundamentals should spur construction activity thereafter, with put-in-place construction reaching $30.0 billion in 2014.
- Forecasted construction, expected to total $107 billion between 2010 and 2014, pales in comparison with the nearly $220 billion completed between 2003 and 2007 at the height of the housing boom. Given the expected slow increase in consumer demand, the lack of new space will be a key supply-side driver of the retail market's recovery.

- Cap rates declined to 7.5% in the third quarter from 8.0% in the second quarter, and should continue this downward trend as investor demand increases. Our forecast calls for cap rates to fall from 6.9% in 2010 to 6.4% in 2014, higher than the recent fourth-quarter cyclical low of 5.5%, but reflective of investors' lower perceived risk of retail investment, and the current large amount of capital set to be deployed.
- According to NCREIF data, both capital and income returns improved during the third quarter, resulting in a 7.5% increase in total return for institutionally-held private real estate. Following two years of declines in 2008 and 2009, returns should turn positive in 2010 and increase to an average of around 10% annually between 2011 and 2014.
- Despite remaining very low in the third quarter, at 0.03%, we expect the delinquency rate to increase during the next few years, as more loans originated at inflated values during the peak of the real estate boom mature. Our forecast calls for the delinquency rate to rise to 1.8% in 2011, declining to 0.6% by the end of the forecast period.

Conclusion

Although headwinds remain for retail, the positive trends that emerged during 2010 are likely to continue in 2011, marking the beginning of a sustainable recovery for the property type. Improving economic and labor market conditions should have a positive financial and psychological impact on consumers, driving stronger retail sales, particularly in discretionary categories such as apparel, jewelry and luxury. In turn, increased sales and confidence regarding the recovery's momentum should drive more aggressive expansion by retailers, boosting shopping center occupancy rates. Given the measured pace of the economic and consumer recovery, the current and forecasted low levels of new construction activity will be a critical factor in restoring the health of the retail market.

Higher confidence levels in the economy are also impacting the investment market, where transaction activity is beginning to increase. Sales volumes should continue to grow going forward as investors' risk tolerance increases, resulting in more sales of properties in less desirable locations and of lesser quality than during the recession, when many investors were targeting trophy properties in the strongest markets. Also, the rising delinquency rate should result in a higher volume of transactions involving distressed assets. In addition, as the economy strengthens, stronger interest in U.S. retail by foreign buyers should drive the rebound in transaction volume as well.

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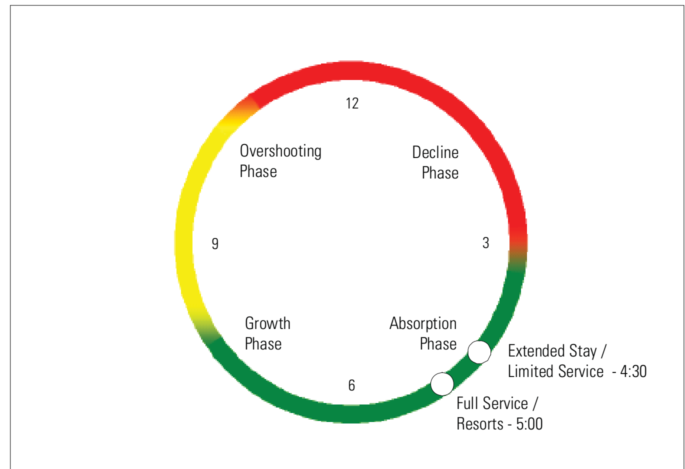
The National Hotel Market

The national hotel market rebounded quickly during the second half of 2010. The increase in business travel and tourism volume pushed occupancy levels higher throughout much of the country. While travelers remain sensitive to pricing, the growing demand for hotel rooms has offset the lowered room rates achievable in some markets. The improved operating fundamentals attracted investment capital in recent months, a trend that should continue. With the hotel sector in the early stages of a moderate recovery cycle, operating conditions are set to improve for several years and capital should continue to flow into the sector to take advantage of pricing opportunities.

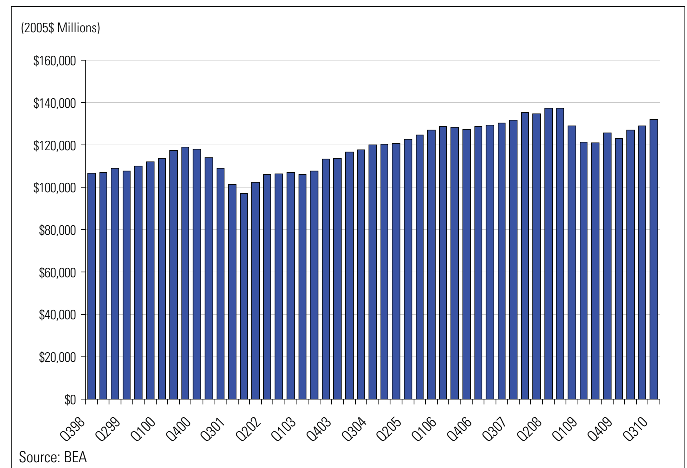
The economic recovery has stabilized the job outlook and improved business and consumer sentiment. The improved mood of the nation helped to increase travel activity and bolstered demand for hotel rooms.

- Real tourism spending accelerated in the latter half of 2010. In the third quarter, seasonally adjusted annual spending totaled $695.9 billion, an increase of 1.9% from the previous quarter and 3.6% from one year ago.
- Spending on accommodations increased at a greater pace than total tourism spending. During the third quarter, spending totaled $131.9 billion on a seasonally adjusted annual basis. This was a 2.3% increase from the second quarter of 2010 and 4.9% greater than the third quarter of 2009.
- Year-to-date through October, domestic enplanements reached nearly 529.3 million passengers, an increase of 1.4% from the same period in 2009.
    - International passenger travel also increased, reaching 130.1 million enplanements year-to-date through October. This was a 3.6% increase from the previous year.
- Employment in the leisure and hospitality sector increased to nearly 13.2 million workers in November, an increase of 1.2% from November 2009.
    - Within the accommodation employment sub-sector, there were nearly 1.8 million employed in November. This was an increase of 0.9% from the previous year, though month-to-month figures were volatile even after adjusting for seasonality.

Real Estate Cycle – Hotel



Total U.S. Tourism-Related Spending on Accommodations



Source: BEA

Outlook for the National Hotel Market

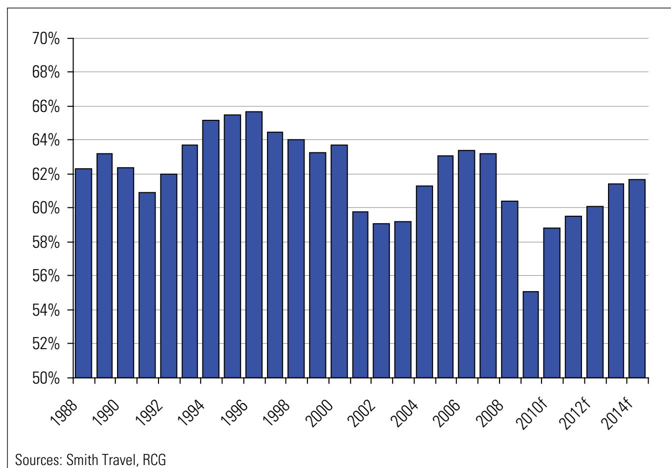
	2003	2004	2005	2006	2007	2008	2009	3Q10	2010f	2011f	2012f	2013f	2014f
Occupancy	59.2%	61.3%	63.1%	63.4%	63.2%	60.4%	55.1%	58.9%	58.8%	59.5%	60.1%	61.4%	61.7%
Avg. Daily Room Rate (ADR)	$83.28	$85.97	$90.84	$97.31	$103.64	$106.55	$97.51	$97.89	$98.49	$99.37	$100.56	$101.82	$103.65
RevPAR Growth	0.1%	7.7%	8.8%	7.5%	5.7%	-1.9%	-16.7%	4.5%	7.8%	2.1%	2.2%	3.4%	2.3%
Construction (Put-in-place, 2005 $Bill.)*	12.1	13.5	12.7	15.6	22.9	28.2	20.7	8.8	8.1	9.4	10.0	11.0	12.5
Cap Rate	7.9%	8.0%	6.7%	6.5%	5.9%	7.0%	9.5%	5.5%	7.0%	6.9%	6.5%	7.0%	6.5%
Delinquency Rate (ACLI)	0.57%	0.2%	0.0%	0.0%	0.1%	0.1%	0.1%	0.3%	0.8%	0.9%	0.6%	0.6%	0.5%
NCREIF Total Return	6.1%	10.2%	19.0%	23.6%	18.1%	-9.4%	-20.4%	5.4%	10.9%	18.9%	15.8%	5.9%	13.8%
Capital Return	-1.7%	2.0%	9.5%	14.0%	9.9%	-14.3%	-24.0%	0.7%	6.2%	14.7%	12.0%	2.1%	10.2%
Income Return	7.8%	8.0%	8.9%	8.6%	7.6%	5.6%	4.4%	4.7%	4.7%	4.2%	3.8%	3.9%	3.6%

* Numbers in quarterly columns are annualized.

Notes: Figures in quarterly columns represent year-to-date activity.

Sources: Smith Travel Research, ACLI, NCREIF, U.S. Census Bureau, RCG

Hotel Occupancy Rate



With travel on the rise, the lodging sector continued to show steady improvement. The occupancy rate reached 57.6% year-to-date in December, according to Smith Travel Research. This was a 3.1 percentage-point improvement from the same period in 2009. Year-to-date in December, revenue per available room (RevPAR) increased to $56.47, a 5.5% increase compared with one year ago.

- The average daily room (ADR) rate remained volatile as operators sacrificed rates for occupancy in order to attract budget-minded travelers. The national ADR fell slightly from the summer months to $98.08, approximately on par with 2009.
- The number of rooms sold year-to-date through December increased by 7.7% compared with the previous year.
- Primary markets continued to outperform secondary and tertiary lodging markets. The occupancy rate for the 25-largest markets was 63.8% year-to-date in December, compared with only 54.8% occupancy for other markets.
    - The ADR in large markets increased by 0.4% compared with 2009, while other markets produced a 0.6% contraction in the average rate.
    - As travelers focused on large markets, operators in these cities were able to hold ground on rates and increased RevPAR to $75.54, an increase of 7.2% from 2009.
- While bookings have rebounded well throughout all chain types, the luxury, upper-upscale and upscale segments continued to lead the recovery. The occupancy rates were 66.2% for luxury, 67.7% for upper-upscale and 65.4% for upscale year-to-date in December. Compared with the previous year, the occupancy rate improved by 4.8 percentage-points, 4.1 percentage-points and 4.5 percentage-points, respectively.
    - The number of rooms sold among these three chain types improved significantly in 2010. Through December, rooms sold increased by 11.6% for luxury, 8.5% for upper-upscale and 14.2% for upscale chains.
    - Similarly, RevPAR increased significantly more than other chain types. Year-to-date through December, RevPAR increased by 10.1% for luxury, 5.7% for upper-upscale and 5.7% for upscale hotels.

Performance by Chain Scale

	Occupancy YTD		*RevPAR YTD*		
	Dec-10	**Dec-09**	**Dec-10**	**Dec-09**	**% change**
Luxury	66.2%	61.4%	$165.29	$150.18	10.1%
Upper Upscale	67.7%	63.6%	$96.19	$90.97	5.7%
Upscale	65.4%	60.9%	$69.97	$66.20	5.7%
Midscale w/ F&B	51.1%	49.0%	$42.16	$40.82	3.3%
Midscale w/o F&B	58.3%	55.5%	$49.44	$47.39	4.3%
Economy	51.3%	48.9%	$25.35	$24.89	1.8%
Independents	55.0%	52.4%	$52.46	$49.88	5.2%

Source: Smith Travel Research

- In addition to chain type, the location of the hotel was an important factor in the pace of the rebound in 2010. Assets in urban and airport locations both increased occupancy in 2010 to greater than 60%.
- The urban and airport locations benefited significantly from the rebound in business travel. RevPAR increased by 8.8% and 4.0%, respectively, year-to-date through December.
- Hotels located along interstate highways and in smaller towns produced occupancy rates of 51.4% and 51.6%, respectively, the lowest among the location types.
- The ADR for suburban hotels fell by 1.6% compared with the previous year.
- While significant differences in performance exist based upon location of the property, the entire hotel sector rebounded well for much of 2010. The number of rooms sold and RevPAR increased for all hotels regardless of location.

As noted earlier, the top hotel markets led the market recovery in 2010. The return of business travel last year sent many travelers to the larger cities for meetings and sales pitches. The upturn in consumer confidence prompted more leisure travel, even if tourists remained cost-conscious.

- In New York, the occupancy rate spiked to 80.9% year-to-date in December, an increase of 3.9 percentage points compared

Performance by Location

	Occupancy YTD		*RevPAR YTD*		
	Dec-10	**Dec-09**	**Dec-10**	**Dec-09**	**% change**
Urban	65.7%	61.8%	$89.37	$82.74	8.8%
Suburban	57.3%	53.7%	$48.99	$47.38	5.0%
Airport	63.7%	59.8%	$57.45	$56.11	4.0%
Interstate	51.4%	49.5%	$36.71	$35.76	4.6%
Resort	59.4%	56.8%	$81.44	$79.58	4.2%

Source: Smith Travel Research

Recent Performance in Key Markets

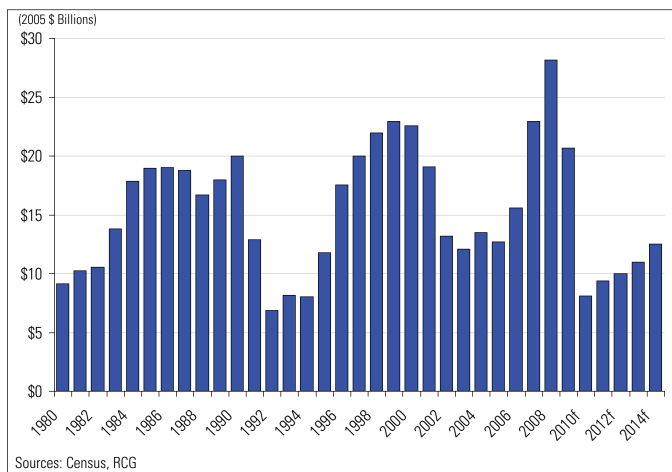
	Occupancy YTD		RevPAR YTD		
	Dec-10	**Dec-09**	**Dec-10**	**Dec-09**	**% change**
Business Travel Markets					
Atlanta	57.5%	52.5%	$47.66	$43.80	8.8%
Boston	68.7%	62.2%	$97.19	$85.97	13.0%
Chicago	61.8%	56.3%	$69.66	$63.82	9.1%
Dallas	54.6%	51.0%	$45.77	$44.02	4.0%
Denver	62.9%	57.5%	$59.25	$53.59	10.5%
Houston	55.1%	55.2%	$48.78	$50.90	-4.2%
Los Angeles/Lg. Beach	68.0%	64.0%	$79.06	$73.30	7.9%
New York	80.9%	77.0%	$187.93	$166.44	12.9%
San Francisco	75.2%	71.2%	$102.31	$95.02	7.7%
Washington, D.C.	67.0%	64.6%	$96.12	$93.76	2.5%
Leisure Travel Markets					
Anaheim-Santa Ana	68.1%	63.6%	$73.84	$69.35	6.5%
Miami	70.2%	65.1%	$101.19	$91.28	10.9%
Oahu Island	78.2%	72.3%	$117.02	$108.50	7.9%
Orlando	63.2%	59.5%	$58.15	$55.53	4.7%
Phoenix	55.8%	52.1%	$56.34	$55.42	1.7%
San Diego	66.7%	62.9%	$81.36	$78.59	3.5%

Source: Smith Travel Research

with 2009. The number of rooms sold increased by 10.0% and RevPAR was 12.9% higher than during the previous year. The average daily rate increased by 7.5%, the largest increase among the top hotel markets.

- The occupancy rate reached 67.0% in Washington, D.C., an increase of 2.4 percentage points from the previous year. RevPAR increased by 2.5% and the number of rooms sold was 6.8% higher than in 2009.
- In the Boston region, the occupancy rate increased to 68.7% in December, an increase of 6.5 percentage points. Year-to-date through December, RevPAR increased by 13.0% and the number of rooms sold grew by 10.2%.
- The occupancy rate in Chicago hit 61.8%, an increase of 5.5 percentage points from 2009. The number of rooms sold increased by 9.8%, though the ADR contracted slightly, by 0.6%.
- The occupancy rate increased to 68.0% in Los Angeles. The ADR increased by 1.4%, helping to spur a 7.9% increase in RevPAR.
- In the San Francisco Bay Area, occupancy increased by four percentage points to 75.2% in December.

Hotel Construction Put-in-Place



Sources: Census, RCG

- Markets that benefited from business and tourism travel fared the best in 2010. Hotel markets primarily driven by tourism typically increased occupancy, but ADR remained soft or fell as operators continued to trade rates for occupancy.
  - On Oahu, the occupancy rate reached 78.2%, an increase of 5.9 percentage points. The occupancy rate for the state of Hawaii was 70.7% year-to-date in December. The average daily rate declined for both Oahu and the rest of the state, a sign that resorts continued to offer economical rates in order to attract tourists.
  - Hotel operators sold more rooms in San Diego and the occupancy rate reached 66.7%; however, ADR fell by 2.4%.
  - In Orange County, the occupancy rate increased to 68.1%. RevPAR increased by 6.5% while ADR fell by 0.6%.
  - The occupancy rate for Nevada only increased to 58.0%, 2.1 percentage points higher than during the previous year. Though rooms sold increased by 7.8%, ADR fell by 3.2%.
  - The occupancy rate in Miami increased to 70.2% and RevPAR increased by 10.9%. In Orlando, the occupancy rate reached 63.2%, but ADR fell by 1.5%. While in Tampa, the occupancy rate increased to 55.3% and ADR fell by 7.2%.
  - New Orleans produced one of the largest gains in 2010, with the occupancy rate reaching 64.7% year-to-date in December, an increase of 7.3 percentage points from last year. The number of rooms sold increased by 15.1% and RevPAR increased by 14.7%.

While operating performance improved significantly, construction activity still trended lower as developers remain hesitant to build and construction financing is still restrictive. Hotel development activity is approaching an all-time low.

- The value of private put-in-place construction fell to $8.7 billion in the third quarter, a decrease of 6.5% from the previous quarter and a 19.6% decrease from one year ago.
- Through the first three quarters of 2010, about 52,000 rooms were delivered. During the third quarter, only 62,000 rooms were under construction, according to Lodging Econometrics. This was the lowest total recorded by the construction-tracking firm.
- The low volume of under construction projects will mean that a limited amount of new supply will be developed in the near term.

The recovery in the hotel market continued through the second half of 2010. Operating performance should continue to improve as business and leisure travel conditions strengthen; however, the remainder of the recovery is expected to be moderate as compared with the rebound in 2010. The full-service hotel segment is leading

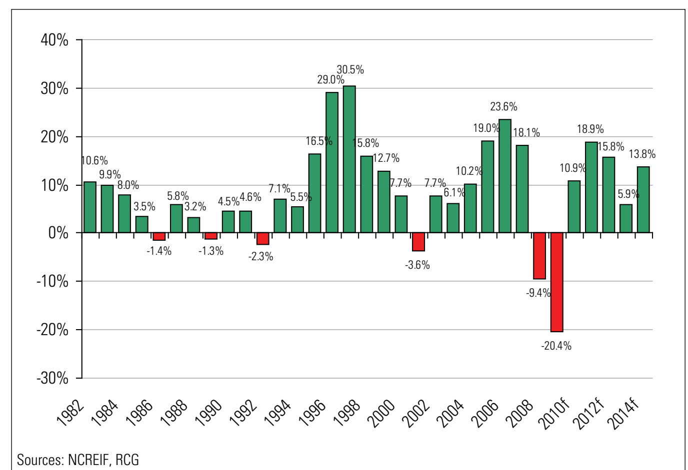
the recovery and remains at 3:30 on the RCG Real Estate Cycle Clock. The overbuilt limited-service and extended-stay categories remain at 2:30.

Investment Market

Improving operating conditions have spurred investors into action. Investors are becoming more active and the volume of closed sales spiked at the end of the year. Both public and private capital have focused on assets in prime markets, bidding prices up and cap rates down in the process. However, a lack of demand for properties located in tertiary markets or flags at the more economical end of the spectrum exists.

- Sales volume accelerated to $12.1 billion in the 12 months ending in November, according to Real Capital Analytics. This more than doubled the sales volume in the 12-month period ending in August.
- Through the first three quarters of the year, full-service hotels accounted for approximately 85% of all transactions.
- Investor focus on higher-quality or well-located assets, in addition to multiple bids on available properties, pushed the average price paid higher. In November, the average price per key was $168,400, nearly 36.0% higher than at the end of 2009.
    - Pricing in primary markets and for high-end hotels led the recovery.
    - Sales volume was concentrated in New York, Los Angeles, Boston, San Francisco and Chicago.
- A large amount of equity still exists on the sidelines and there are signs that some capital is beginning to move. Though there is still uncertainty about the pace of the recovery, many investors are concluding that asset pricing has already bottomed.
    - Investment interest will continue to manifest in primary gateway markets.
- REITs were the largest net buyers of hotels in 2010. Public and non-listed REITs acquired approximately $2.65 billion of hotel assets.
    - Most REITs purchased stable assets with little or no leverage.
- Lenders were the second-largest net acquirers of lodging assets, reflecting the level of distress in the market.
- The amount of distress fell at the end of 2010, due to the resolution of the Extended Stay Hotels loan. In 2010, cumulative hotel distress totaled approximately $22.3 billion with an additional $11.3 billion of casino properties facing distress.
    - The elevated level of distressed assets will continue in the near term as debt obligations approach maturity with refinancing options limited.

Total Rates of Return: Hotel Properties



Sources: NCREIF, RCG

- The hotel CMBS delinquency rate fell in the latter part of 2010, reaching 14.3% in December, as the Extended Stay Hotels loan was resolved, according to Trepp.
    - Special servicers have ramped up capacity and are better able to process delinquent CMBS loans, another factor in the decreasing delinquency rate.
- The average cap rate has been bid lower as investors focused on the limited number of well-positioned assets available during 2010.
    - The average transactional cap rate was 7.5% in November, 200 basis points less than at the end of 2009. The majority of transactions were within the largest hotel markets or for full-service hotels, helping to lower the average cap rate.
    - The ACLI cap rated fell to 5.5% in the third quarter, highlighting the quarter-to-quarter volatility that should be expected given the limited volume of completed transactions.
- Private market returns moved further into positive territory in the third quarter. Annualized NCREIF returns totaled 5.4% in the third quarter, more than double the results of the previous quarter.

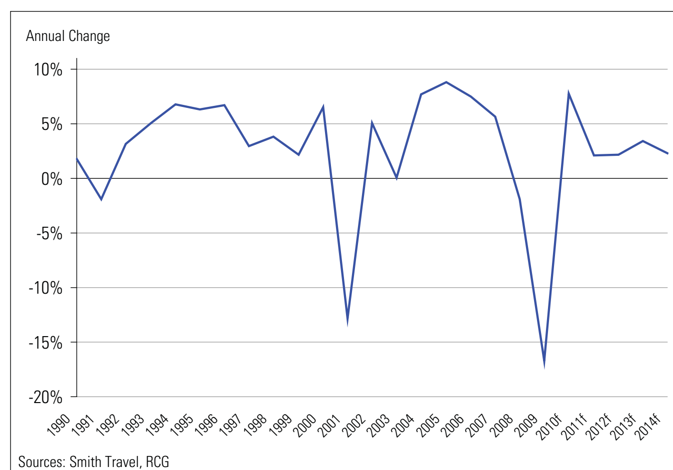
The Outlook

The recovery in the hotel market is under way and operating conditions are expected to increase moderately during the next several years. In the near term, traveler demand should slowly increase as business and leisure travel volumes grow, in line with the recovering economy. This will translate into increased occupancy rates and RevPAR, though some operators will continue to offer reduced rates to maintain booking levels. Following 2011, improved economic conditions will cause business and leisure travelers to become somewhat less cost-conscious, and the increased demand will result in accelerating rates of growth for ADR and RevPAR. Throughout the next several years, the number of new keys will

be extremely low as developers remain cautious even as operating conditions improve.

- The occupancy rate is expected to increase further in 2011, though at a slightly lower rate than in 2010. We expect the occupancy rate to reach 59.5% in 2011 before crossing the 60.0% threshold in 2012. By 2014, the occupancy rate should reach 61.7%.
- The ADR should continue trending upward, increasing by 0.9% in 2011 and approaching the $100 threshold. As the increase in travel activity becomes more sustainable, operators will no longer need to offer reduced room rates to maintain occupancy levels. In 2012, ADR should increase by 1.2% and an additional 1.3% in 2013. By 2014, a strengthened travel market will prompt an increase in ADR of 1.8%.
- After two years of declines, RevPar is expected to end 2010 in positive territory. In 2011, RevPAR is forecasted to increase by 2.1% and a similar 2.2% in 2012. In 2013 and 2014, with occupancy and ADR on the rise, RevPAR is expected to average nearly 2.9% per year.
- The strengthening economic recovery should continue to provide a boost to business travel in the near term. As such, properties located in major cities and within or with access to central business districts should continue to lead the recovery in the hotel market. Airport locations should also benefit from increased travel activity.
- Consumers continue to become more confident in the recovery and those with stable job outlooks are returning to resort destinations. While many resorts continue to offer discounted rates to attract visitors, the upward trend in the occupancy rate should continue.
- In the near term, interstate highway properties and suburban properties should lag assets in other locations. Although leisure travel is on the upswing, consumers remain hesitant to increase discretionary spending substantially.
    - The recent rise in the cost of gasoline could prove troublesome to these types of properties as well. Should gas rise to more than $4 per gallon once again, leisure travel will be impacted and fewer travelers will stay at interstate locations.
- Operators will continue to focus on NOI and restraining costs, particularly labor costs. Additionally, capital improvements and other maintenance projects halted during the recession will need funding in the near term. As such, we do not expect a significant hiring spike in the sector even as traveler demand increases.
- New development activity should remain muted in the near term. The value of put-in-place construction should slow further into the first half of 2011 before picking up slightly towards the end of the year. In 2011, we expect put-in-place construction to total $9.4 billion before increasing slightly to $10.0 billion in 2012. Construction activity should slowly accelerate and reach $12.5 billion by 2014.
    - While the development pipeline will open, construction activity will not even approach half of that produced during the peak building period in 2008.
    - Oversupplied segments of the market such as extended-stay hotels will see little new construction during the forecast period.
- In the near term, cap rates will likely remain volatile and highly dependent upon the type of properties selling in the limited-transaction environment. A significant spread between cap rates for luxury hotels or properties located in the largest markets and economy chains or properties in tertiary cities will remain for at least the next 12 to 18 months.
- The recent acceleration in sales should prompt existing owners to bring more assets to market. In addition to the resolution of troubled properties, this influx of available properties should help satiate some of the increasing investment demand expected in the near term.
- The volume of delinquent assets should continue to increase in the near term. The practice of amending debt obligations in lieu of transferring debt to special servicers or repossessing seems to be ending. As operating conditions improve, lenders will begin to place more value on the underlying asset and become less likely to extend existing mortgages.
- Many sales during 2006 and 2007 were financed with short-term debt that was intended to be securitized. With the market for new CMBS issuance closed beginning in 2008, many of these loans remain on lenders' books. While some of the debt has been restructured, much of it likely remains on balance sheets.
- Private market returns should accelerate into 2011, reaching 18.9%. For the next several years, as operating conditions improve further, return rates should remain in positive territory.

RevPAR Growth



Sources: Smith Travel, RCG

Conclusion

The economic recovery spurred business and leisure travel activity. With consumer confidence improving and businesses once again sending salespeople on the road and holding off-site meetings, demand for rooms has increased steadily in top-tier cities. As occupancy levels rose, some operators have begun to increase room rates and grow RevPAR; however, most travelers remain budget-minded and some operators have had to keep rates low in order to grow occupancy. While additional economic weakness could hamper growth in the lodging sector, the recovery process should continue at a moderate pace. Operating conditions should continue to improve in the near term before accelerating later in the forecast period. Properties in large cities and resorts should lead the recovery during the next year. The improved fundamentals will continue to attract investment interest; sales volume and pricing should continue moving higher. While risks to the recovery exist, we expect a moderate recovery in the hotel market to continue for the next several years.

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