

Slow in 2010, Slow in 2011, a Pop will come in 2012

Kevin Thorpe, Chief Economist

Summary

- Real GDP appears to be growing at meager rate of 1.6% – well below the 2.5% to 3% GDP growth rate needed to keep unemployment stable.
- Demand for commercial real estate space remains low, but is gradually improving in all sectors except retail.
- Investor demand for core assets is surging; cap rates for high-quality product in major metros have dropped 100 – 150 bps from where they were just 9 months ago.
- Vacancy remains at near-peak levels, but is not likely to rise much higher.
- Property markets will face low rents for the next 2 years, but the sharp declines are likely over.

Forecast Analysis

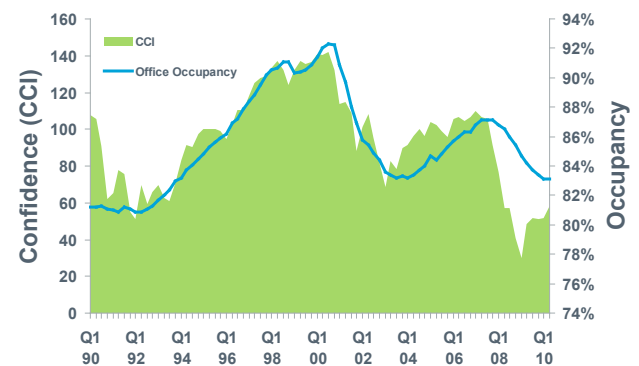
The U.S. economy has clearly lost whatever momentum we thought it originally had coming out of the recession. Many of the economic drivers that were propelling growth (home sales, retail sales, exports) have all declined significantly from the levels recorded just 3 months ago. Real GDP is now on pace to grow at a meager rate of 1.6% in the third quarter of 2010, and will remain below 3% for all of 2011. For perspective, the last strong recovery in the U.S. occurred in the early 1980s, when GDP ranged between 4% and 7% immediately following that decade's economic downturn. With the current recovery tracking much slower, unemployment is now expected remain elevated above 9.5% through 2011. It should be noted that if the latest "call it anything but stimulus" proposals from the White House were to pass, then they will give the U.S. economy an additional lift in 2011. In particular, one such proposal that would allow businesses to deduct the full cost of investment against their taxes next year – as opposed to spreading them out over a few years – could add as much as \$100 billion, or 0.7%, to GDP growth in 2011. However, given the current political climate and time constraints before the midterm elections, we are not including passage of such proposals in our assumptions in generating the latest forecast (pg.2). As policy changes are made, we will revise our predictions accordingly.

A subpar economy will translate into a subpar recovery for the property markets. Nevertheless, with the exception of retail, demand for commercial real estate space has improved across the board. For the first time in 2 years, demand for office, industrial, and apartment units all registered levels in positive territory in the second quarter of 2010. Although the current pace of hiring (averaging 90,000 new jobs per month in 2010) has not been

enough to cause the unemployment rate to drop measurably, it has been sufficient to keep vacancy rates generally even. In looking at the 80 major metros tracked, 48 have reported an improvement in office demand since the beginning of the year. Nevertheless, with vacancy running between 200 & 400 bps above the historical average for all commercial real estate sectors, rents will remain largely flat for at least the next two years. Class A and trophy space will benefit from a flight to quality and a tenant base that is more inelastic (willing to stay no matter what) than the rest of the market; thus, rent growth in high-quality assets will continue to outperform market rates by a wide margin. The same can be said for investment sales, where quality assets in major markets are dominating sales activity. Through August, investment sales in major metros accounted for 62% of total sales in the country, compared to just 51% in a typical year. Moreover, core/stabilized assets in markets such as Washington DC and New York City are fetching prices very similar to pre-recession levels.

Corporate profits are a clear silver lining in this recovery, up 40% compared to a year ago. Historically, corporate profits would translate into healthy job creation 6-9 quarters later. However, small businesses are still struggling, and they typically account for 60% of total job creation. Moreover, given the elevated risks in the economy, lack of confidence, and lack of clarity on numerous legislative issues (healthcare, energy, financial regulatory reform, and taxes), we anticipate 2011 to be another year of lackluster hiring. The pop in the labor markets will come in 2012. By then, the economy will be growing at much stronger clip (between 4% and 6%), and business leaders and banks will have greater clarity on policy issues. Given the record levels of cash that currently exists on balance sheets (large banks and other financial institutions with cash exceeding \$1 trillion), they should have plenty to lend and invest, that should spark an economic rally.

Need Confidence to Improve or we go nowhere



Source: Conference Board, Cassidy Turley

	2009			2010				2011		Annual		
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2009	2010	2011
U.S. Economy												
Real GDP (AR%)	-0.7	1.6	5.0	3.7	1.6	1.6	2.3	2.0	2.4	-2.6	2.7	2.5
Non-Farm Employment (q)	-1,702	-1,035	-438	58	694	-40	240	300	500	-5,918	952*	1,900
Office-using Employment (q)	-494	-257	26	73	95	25	45	56	93	-1,545	238*	353
Industrial Employment (q)	-638	-320	-170	-19	121	23	40	50	83	-1,115	165*	315
Retail Employment (q)	-147	-104	-99	55	23	5	27	33	56	-754	110*	211
CCI	48.3	51.8	51.0	51.7	58.2	53.0	57.0	59.0	70.2	45.2	55.0	69.2
CPI Inflation (AR%)	1.9	3.7	2.6	1.5	-0.7	1.1	1.4	2.0	2.5	-0.3	0.8	2.4
Unemployment (%)	9.3	9.6	10.0	9.7	9.7	9.7	9.9	9.8	9.7	9.3	9.7	9.7
ISM Manufacturing Index	43.0	51.4	54.6	58.2	58.8	56.2	57.2	57.9	58.2	46.2	57.6	58.5
Retail Sales (AR%)	-0.1	7.5	7.4	8.2	4.6	2.5	4.6	5.5	5.9	-6.3	5.0	6.2
Existing Home Sales (k)	4,780	5,280	5,970	5,137	5,570	4,610	5,300	5,500	5,540	5,156	5,154	5,600
Existing Home Prices (k)	174.4	178.1	170.8	166.4	176.6	178.4	169	173	177.5	172.5	172.6	177
Housing Starts (k)	537	586	565	617	601	560	610	670	750	554	597	800
Interest Rates												
Fed Funds Rate	0.2	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.5	0.2	0.2	1.0
3 Month Tbill	0.2	0.2	0.1	0.1	0.2	0.3	0.4	0.4	0.8	0.2	0.3	1.4
Corporate AAA Bond	5.5	5.3	5.2	5.3	5.1	4.9	5.0	5.1	5.0	5.3	5.1	5.1
10-year Gov't Bond	3.3	3.5	3.4	3.7	3.5	3.0	3.2	3.5	3.6	3.2	3.4	3.9
30 year Gov't Bond	4.2	4.3	4.3	4.6	4.4	4.0	4.2	4.4	4.5	4.0	4.3	4.7
30-year Mortgage Rates	5.0	5.2	4.9	5.0	4.9	4.5	4.7	4.9	5.0	5.0	4.8	5.3
Office Sector												
Net Absorption (m)	-19.1	-14.2	-7.0	-3.7	8.8	7.1	2.5	4.5	14.0	-62.6	6.0	39.9
Vacancy	15.8%	16.3%	16.6%	16.9%	16.9%	16.8%	16.8%	16.8%	16.5%	16.0%	16.8%	16.5%
New Deliveries (m)	16.7	8.5	6.7	11.9	10.9	N/A	N/A	N/A	N/A	44.0	28.0	17.3
Asking Rents	\$22.14	\$21.92	\$21.69	\$21.79	\$21.35	\$21.25	\$21.66	\$21.73	\$21.69	\$22.03	\$21.62	\$21.78
Effective Rents	\$18.24	\$17.88	\$17.62	\$17.64	\$17.65	\$17.34	\$17.45	\$17.55	\$17.65	\$18.09	\$17.52	\$17.69
Investment Sales (\$vol, bil)	\$2.8	\$4.8	\$4.5	\$4.5	\$8.1	\$4.8	\$12.0	\$11.0	\$12.5	\$15.8	\$33.8	\$42.0
Cap Rates (CBD)	7.4%	7.7%	8.2%	8.0%	6.9%	6.7%	6.6%	6.4%	6.6%	7.7%	7.0%	6.6%
Cap Rates (Suburban)	8.0%	8.4%	8.9%	8.8%	8.4%	8.4%	9.1%	8.8%	8.5%	8.3%	8.7%	8.5%
Industrial Sector												
Net Absorption (m)	-35.4	-43.1	-22.6	-30.8	6.2	2.1	-5.2	3.1	3.8	-136.5	-31.1	29.2
Vacancy	9.2%	9.5%	9.6%	9.8%	9.9%	9.9%	10.0%	10.1%	10.0%	9.2%	9.9%	9.5%
New Deliveries (m)	N/A	N/A	N/A	4.4	5.0	3.8	5.0	N/A	N/A	15.3	18.2	17.5
Asking Rents	\$5.41	\$5.32	\$5.21	\$5.16	\$5.15	\$5.12	\$5.15	\$5.19	\$5.19	\$5.36	\$5.14	\$5.19
Investment Sales (\$vol, bil)	\$0.8	\$0.7	\$0.8	\$1.9	\$1.1	\$1.2	\$2.6	\$4.2	\$4.4	\$2.8	\$11.4	\$12.0
Cap Rates	8.0%	8.6%	8.3%	8.5%	8.3%	8.2%	8.4%	8.5%	8.3%	8.2%	8.4%	8.5%

q = qtr/qtr chg, 000s

(k) = measured in thousands

AR = annualized rate

q% = qtr/qtr % chg

(m) = millions, sq. ft.

* Dec2010 over Dec2009

*Sources for economic indicators include: US Census Bureau, BLS, BEA, Dismal, The Conference Board, NAR, Department of the Treasury and the Federal Reserve; all forecasts generated by Cassidy Turley Research.

*updated October 22, 2010