

U.S. Economy: Will the Recovery Depend on Consumer Spending Again?

The encouraging economic data released in December has fueled new debate about when and how the Federal Reserve will rein in its support of the U.S. economy. The Fed Chairman, Ben Bernanke, has focused to date on doing whatever is necessary to revive the economy. Now that the economy is showing signs of life, critics are turning their attention to the federal deficit and rising risk of inflation. Ben Bernanke has firmly held his position that “short-term interest rates will remain low for an **extended period.**” Ben Bernanke needs more evidence that a recovery will be sustainable before unwinding government support programs and raising overnight bank lending rates from near zero. With the unemployment rate still so high at 10% and consumer confidence rebounding slowly, Ben Bernanke does not feel rushed to make any sudden moves. The Fed has certainly become more upbeat in its assessment of the economy; however, it waits with cautious optimism for the December consumer spending reports.

The strength of retail performance will likely indicate whether the economic recovery is sustainable. Sales during the holiday season typically account for about 20% of retailers’ annual income, and consumer spending makes up about 70% of all U.S. economic activity. If the December retail data is weak, the recovery is expected to limp along slowly. Conversely, if the data is strong, the recovery will likely build momentum in the economy. Early reports on consumer spending are favorable and the stock market has responded with a small rally in December. According to the U.S. Commerce Department, retail sales rose 1.3% in November, nearly double the market expectations. Further supporting the trend, the University of Michigan/Reuters consumer sentiment index moved to 73.4 in December from 67.4 in November. This marked its highest level since September.

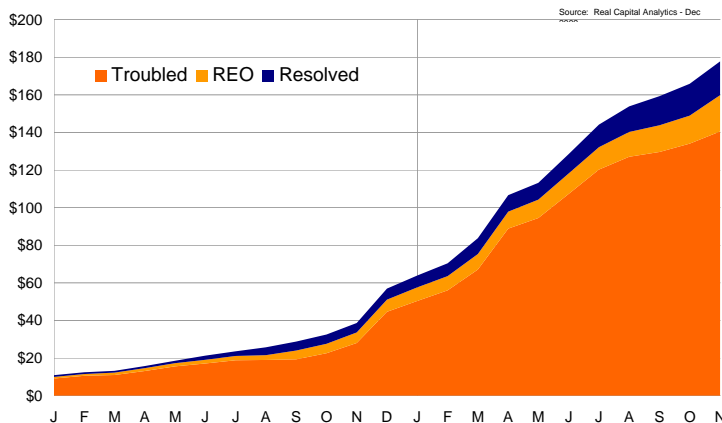
The clearest indication of economic stabilization is job creation. Job creation, however, does not come until employers have proof that consumers are buying again. In the November jobs report the Labor Department said employers shed 11,000 jobs, the fewest since the recession began in December 2007. The pull back in layoffs was enough to cut the jobless rate from 10.2% in October to 10.0% in November. Economists still predict unemployment to peak in the first-quarter of 2010 near 10.5%.

Commercial Real Estate: Rising Vacancy Rates and Downward Pressure on Rents

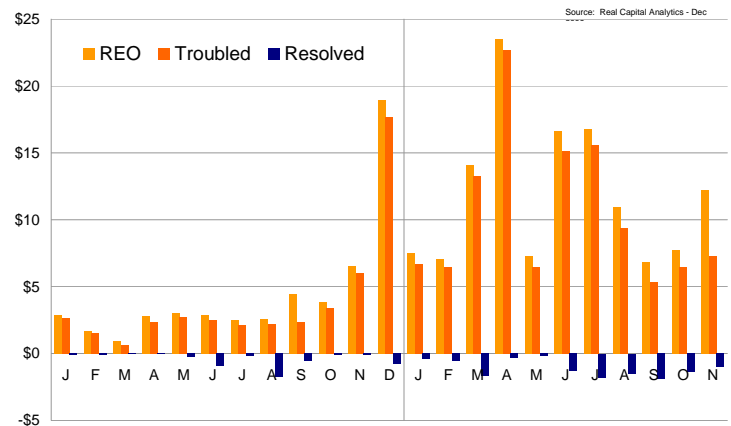
Bad news continues to dominate the industry. According to a December report issued by the Wells Fargo Economics Group, commercial vacancy rates are up dramatically year-over-year for all property types, including office vacancy rates at 12.0%, apartments at 7.8%, retail at 8.7%, and industrial at 13.0%. Rents are estimated to have declined 10 – 15% across all property types in 2009 vs. 2008. The CMBS market, a critical source of real estate financing, remains shut down. Financing from this source has reduced from \$197 billion in 2007 to less than \$1 billion in 2009. Commercial real estate loan delinquency rates are now at 7.9%, the highest they have been since 1993. Several high profile real estate firms have filed for bankruptcy including, General Growth, Extended Stay Hotels, and Capmark.

On the positive side, transaction activity in the U.S. has improved modestly. According to New York-based Real Capital Analytics (RCA), there were \$37.9 billion (in deals of \$5 million or more) closed through the end of October. However, some \$160 billion were still in distress at the end of November with just \$17.9 billion resolved according to RCA (see graphs below).

Distressed U.S. Properties
(cumulative of all property types in \$billions)



Monthly Changes to U.S. Distress
(for all property types in \$billions)



Investment Outlook: Buyers Beginning to Circle Opportunities

Real estate buyers are circling once again. Foreign investors, insurance companies, hedge funds and sovereign wealth funds are searching for real estate investments. Numerous hedge funds have started distressed asset funds. Vornado Realty Trust, one of the most respected and innovative REITs, with a market cap of \$11.5 billion, recently announced the formation of a \$1 billion private equity fund to invest in distressed real estate. Vornado expects returns in excess of 20 percent from the fund. Further highlighting the positive outlook on real estate investing, REITs have raised \$30 billion in new equity and unsecured debt in 2009. Real estate remains a viable and attractive asset class. Those investors with healthy balance sheets that can take advantage of the market dislocations will be the winners. We believe the savvy investors are beginning to awaken from their two-year hiatus. The allure of distressed deals and opportunities are calling them back into the marketplace.