

U.S. Economy: Recovery is Underway, But Uncertainties Remain

Although there is good news to report, the economy still faces a number of headwinds. The good news is that the financial system has stabilized and job losses have decreased. The bad news is that consumers are not spending, businesses are not investing, and banks are not lending. Without these basic principles occurring, the economic recovery is not sustainable. Adding to these concerns, homebuyer incentives are set to expire in the spring. Federal Reserve purchases of mortgage-backed securities will end in March. The \$787 billion fiscal stimulus package will start to ramp down later this year. And, the Bush tax cuts are scheduled to expire at the end of the year. Pressure is mounting on Washington to fix the labor market, but policy makers and economists are concluding there is no magic bullet to boost job creation.

Unemployment – The U.S. Bureau of Labor Statistics reported that non-farm payroll employment edged down by 20,000 in January. At the same time, the unemployment rate fell from 10.0% to 9.7%. Employment fell in construction, transportation and warehousing, while temporary help services and retail trade added jobs. These mixed results do not match expectations as the market was looking for net job gains and no decline in the unemployment rate.

Manufacturing – The Institute for Supply Management reported that the manufacturing sector grew for the sixth consecutive month in January as the ISM's main index rose to 58.4, its highest reading since August 2004 when it registered 58.5. The report suggests that the manufacturing sector is in recovery mode. In January, 13 out of 18 industries reported growth, up from nine industries in December.

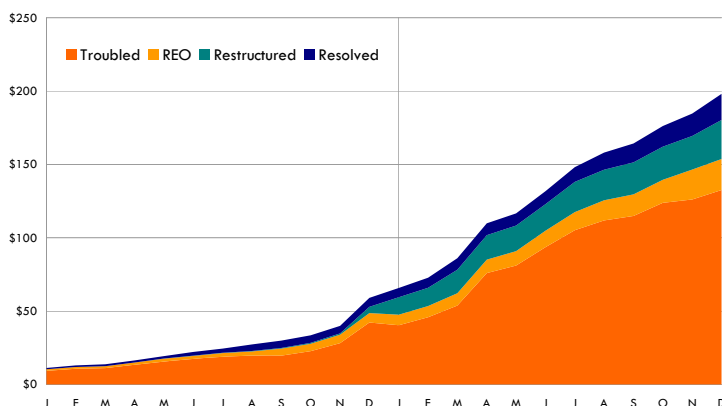
Housing – Home prices rose in more than a third of U.S. metropolitan areas in the fourth quarter, the National Association of Realtors said as it pointed to a "broad stabilization" in values. The median price for single-family home resales was up from a year earlier in 67 of the 151 U.S. metropolitan areas. But other housing analysts say the home-price trend depends heavily on any recovery in the job market and on the pace of foreclosures. U.S. foreclosure filings rose 15 percent in January from a year earlier according to RealtyTrac Inc.

Commercial Real Estate: Banks Starting to Fret

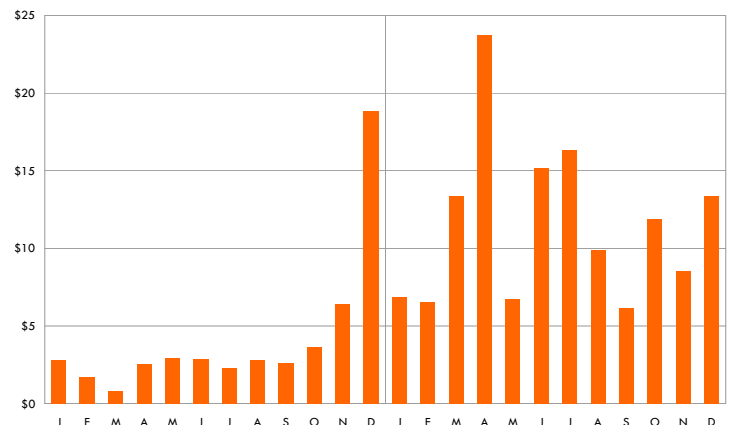
Industry analysts have issued dire warnings for more than a year, suggesting that lenders could incur billions of commercial real estate losses. But for all the ominous warnings, the impact has remained relatively modest to date. According to Foresight Analytics, banks have only recognized about \$50 billion in losses, or about 60% of the estimated cumulative losses. The problem, however, is that the volume of troubled assets is about to rise significantly. Between 2010 and 2014, about \$1.4 trillion in commercial real estate loans will reach the end of their terms and nearly half are "underwater," meaning the borrower owes more than the property is worth. With economic conditions expected to remain tepid and lending standards tight, borrowers will not be able to refinance. Hundreds, maybe thousands, of banks could fail and the broader economy could suffer. Small and mid-sized banks will likely carry the bulk of CRE losses. According to a recent report released by the TARP Congressional Oversight Panel, "...nearly 3,000 banks have concentrations in commercial real estate loans, including 2,115 banks with \$100 million to \$1 billion in total assets."

CMBS delinquencies climbed to about 6.5% this month, an all-time high, according to Trepp, a New York company that tracks the commercial property market. More trouble is looming for small-time property owners because much of the \$223 billion of CMBS debt coming due between now and 2013 is in the form of mortgages of less than \$50 million. According to New York-based Real Capital Analytics (RCA), there is nearly \$200 billion of outstanding distressed assets, including just \$21.2 billion of assets claimed by lenders as REO and \$26.7 of assets restructured. In contrast, only an additional \$17.7 billion in distressed situations have been resolved to date.

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: Flood Gates Starting to Break

TDC has established relationships with a number of banks for the purpose of tracking REO investment opportunities. Discussions with such lenders are now starting to take a different tone. Previously, they were unwilling to consider moving the REO assets at "new" market valuation levels. Now, they are willing to "discuss the possibility." This may be the beginning.