

**U.S. Economy: Momentum Stalls a Bit after Weak Jobs Report**

The U.S. economic recovery was set back modestly with the release of the December jobs report. The Bureau of Labor Statistics reported that U.S. employers cut 85,000 jobs in December. This number was in stark contrast to the November revised report, showing an increase of 4,000 jobs for that month. The November figure showed the first case of job creation in two years. Economists and the general public were hopeful that the economy had turned the corner. The popular sentiment, however, was a bit premature. Economists believe the multi-month jobs data does show a gradual bottoming out in the labor market deterioration. They believe that the economy is stabilizing, but the process will be slower than typical recovery periods.

As for consumer confidence, retailers reported strong holiday season sales. Chain stores' December revenue rose 2.9% overall compared with the prior year. This represented the best monthly showing since April 2008 according to Thomson Reuters index of 30 retailers. Total holiday-season sales grew 1.8% according to a similar index of 33 retailers by the International Council of Shopping Centers. Retail economists are now predicting solid growth for 2010. The International Council of Shopping Centers projects annual sales will increase 3% to 3.5%, the largest increase since 2006.

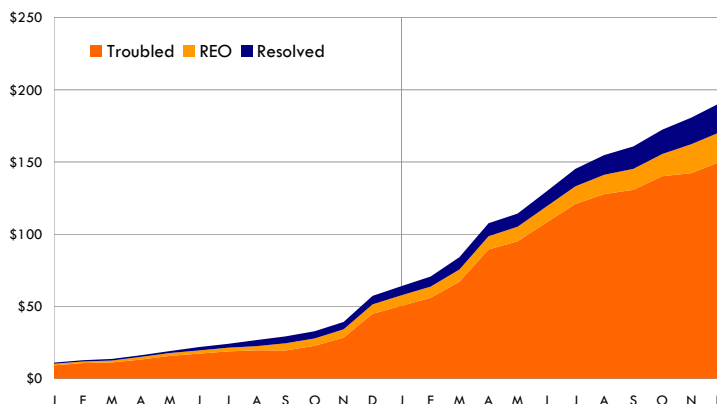
The Federal Reserve remains cautiously optimistic. Fed officials are expecting a recovery that produces "spotty" job growth in the early stages. The December jobs report diminished probability of an increase in the benchmark federal funds rate by midyear. According to futures contracts there was just a 22% chance of a rate hike by June. The Fed is confident that the layoffs are tapering off; however, they are unconvinced that employers are ready to start making permanent hires. The Fed believes that the spotty job growth will exert downward pressure on wages and inflation, enabling monetary policy to remain favorable.

**Commercial Real Estate: Biggest Risk to U.S. Banks**

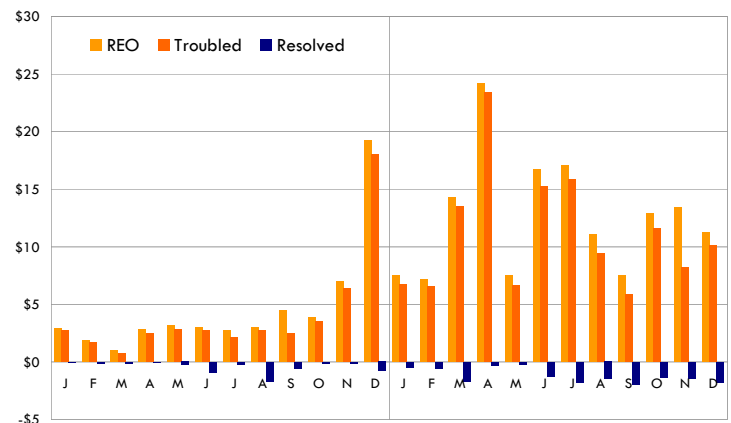
U.S. bank examiners warn that losses on commercial real estate loans pose "...the biggest risk to U.S. banks in 2010." According to Eugene Ludwig, a financial institution consultant with Promontory Financial Group, "Hundreds of banks will fail or will be resolved over the course of the cycle." U.S. bank examiners do not believe that the losses threaten the entire financial system; however, the troubles will impede U.S. economic recovery. Banks are reserving their capital to absorb potential losses from commercial real estate loans. The level of distress in commercial real properties continues to mount.

Banks and investors held about \$3.5 trillion of commercial real estate debt as of June 2009, with about \$1.7 trillion of that total on the books of banks and thrifts, according to Fed data. Regional banks are holding almost four times the level of commercial property loans as that held by the nation's largest lenders, according to Bloomberg. The default rate on commercial mortgages held by U.S. banks more than doubled to 3.4% in the third quarter, according to Real Estate Econometrics. Default rates in the first three quarters of 2009 were the highest since 1993. Fed officials estimate that approximately \$500 billion of the commercial loans will mature each year over the next few years. According to New York-based Real Capital Analytics (RCA), there is \$170.6 billion of outstanding distressed assets, including just \$20.6 billion of assets claimed by lenders as REO. In contrast, only an additional \$20.1 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: Distress Levels Climbing**

Deal activity was almost non-existent in 2009, because lenders were unwilling to unload debt at discounted prices. The year 2010, however, will likely be far different. Pressure is now mounting on banks to take action. Troubled assets continue to sink deeper with vacancies rising and net operating income falling. Lenders had hoped that the market would rebound in time to salvage their values; however, they are coming to the realization that they won't be doing so in the near future. The retail property sector remains the most deeply affected by distress, with approximately \$40 billion of assets. The hotel and casino sectors follow next with a combined \$32.7 billion of distressed assets. The office sector has approximately \$31.8 billion of troubled assets. The apartment sector has total distress of \$30.8 billion. Such distress will present significant opportunities in the future for investors with patience and access to capital.