

U.S. Economy: Positive Signs of Recovery, But Needs More Time to Heal

Despite the vast amount of data supporting U.S. economic recovery, much debate still exists. Some economists believe that the worst is behind us, and we are on the road to recovery, albeit a long, slow trek back. Other economists believe that more trouble lies ahead and that we may even experience a double-dip recession. The primary concerns for the naysayers are the rising unemployment rate, the lackluster consumer spending, and the health of U.S. banks. History would suggest that the pessimists concerns can be overstated. The last double-dip recession occurred in the early 1980s when the country was faced with “stagflation”. The Federal Reserve used a heavy-handed monetary policy, jolting federal funds rate to and fro. Between 1978 and 1980, the federal fund rate skyrocketed from 7% to 17%. Then in 1980 the Fed cut rates to 9%, allowing a brief recovery, and then abruptly raised it back to 19% in 1981, resulting in the double-dip. Ben Bernanke and the Fed are not expected to act with such erratic or unpredictable actions. One wildcard for the Fed, however, is the banking industry’s exposure to commercial real estate. Please see attached Wall Street Journal article, “Fed Frets about Commercial Real Estate” (published Oct 7, 2009).

A summary of recent economic indicators is as follows:

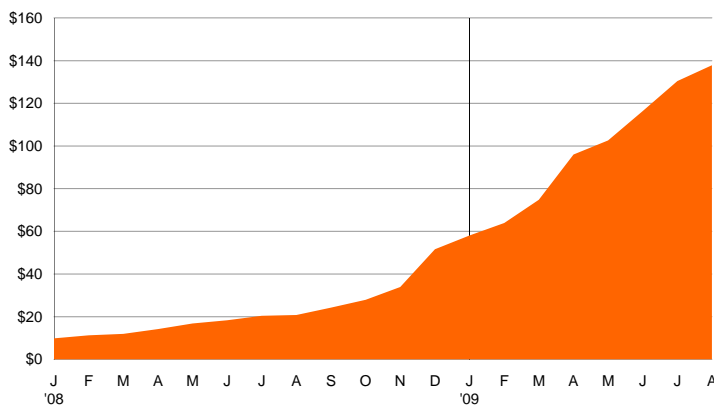
- Unemployment rate increased to 9.8% in September, up 0.1 point from July’s 9.7% and up 3.6 points from September 2008.
- Manufacturing purchasing sentiment in U.S. was 52.6 in September, down from 52.9 in August according to the Institute for Supply Management. This measurement indicates expansion for second consecutive month. Any reading above 50 points to growth.
- Housing starts increased 0.5% in September to a 590,000 seasonally adjusted annual rate, showing the market is slowly stabilizing with help from low prices and government tax credits (\$8,000 first-time home buyer credit expires in November).
- Inventories index increased to 42.5 from 34.4. This represents a contraction, but a sign that manufacturers may soon be restocking their shelves if orders continue to grow.
- Consumer prices jumped 0.2% in September, down from 0.4% rise in August. Producer prices are down 4.8% from a year ago as a result of increased price competition and worker productivity.

Commercial Real Estate: Growing Concern for Federal Reserve

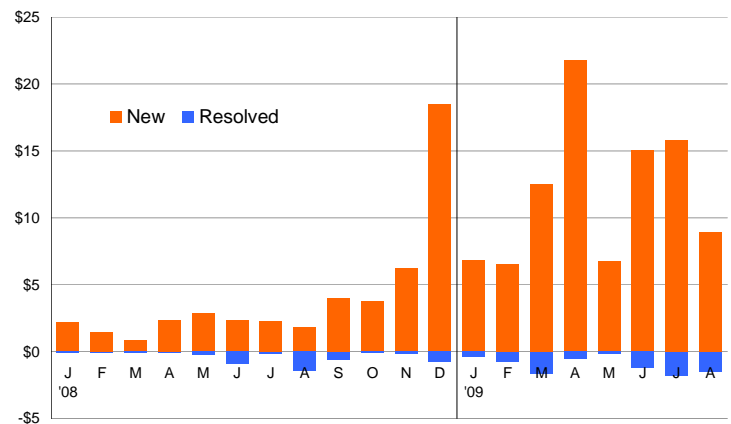
The Federal Reserve is growing increasingly concerned with the banking industry’s exposure to commercial real estate. The worry is that banks are “too slow” to recognize losses, just as they did with residential. Regulators believe that banks are overlooking the dramatic drop in property values (30 – 45%) and the deteriorating operating performance of assets in order to renew or extend loans, rather than evaluating the risk based upon current underwriting standards. To address this issue, bank examiners are increasing their scrutiny of commercial real estate portfolios at U.S. banks.

On the one hand, regulators are committed to having U.S. banks clean up their commercial real estate portfolios. On the other hand, however, regulators are worried of starting a mass liquidation of troubled real estate assets, similar to the fire sales seen on foreclosed houses in the residential sector. Currently FDIC and PPIP are not prepared to handle the volume of potentially troubled assets. As such, regulators plan to issue guidelines on when/how U.S. banks should restructure (“workout”) some of their commercial real estate loans. According to data released by Real Capital Analytics through August 2009, there is \$138 billion of debt on distressed properties in the U.S. This number is expected to increase as more loans come to maturity, and the regulators increase their scrutiny of U.S. bank portfolios.

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



Monthly Changes to Distress
(volume of all U.S. property types in \$Billions)



Investment Outlook: Still Waiting for Looming Opportunities

Although there is a lot of discussion about looming opportunities, investors remain in a holding pattern. They are in no hurry to commit capital to new investment vehicles. According to research firm Prequin, there are 363 real estate funds now being marketed by private equity shops. Although the number of funds is just off the all time high, these active funds raised just \$4.9 billion in the third quarter of 2009, compared to \$40 billion raised in the third quarter of 2008. The tipping point for investors may come when banks are forced to address writing down the value of their real estate portfolios. That day is coming, and with it will come buying opportunities.