

## U.S. Macro Forecast: Tap it up, cautiously

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- Economic data is consistently surprising on the upside.
- Job creation is accelerating. Hiring is no longer an option, it is a must.
- Euro-zone policy, oil, and U.S. policy – all potential game changers.
- Assuming minimal shocks, the CRE recovery will accelerate in 2012.

All Consistently Better			
	Was	Is	Trend
DOW REIT Index <small>(Dec 2011 vs. Jan 2012)</small>	179	191	▲
Job Growth <small>(May 2011 vs. Jan 2012)</small>	54k	243k	▲
Jobless Claims <small>(Jan 2012 vs. Feb. 2012)</small>	402k	358k	▼
ISM Index <small>(Oct 2011 vs. Jan 2012)</small>	51.8	54.1	▲
10-YR AAA Swaps <small>(Oct 2011 vs. Feb. 2012)</small>	339	222	▼
Copper Prices <small>(Oct 2011 vs. Feb. 2012)</small>	\$354	\$406	▲
Auto Sales <small>(Aug. 2011 vs. Jan. 2012)</small>	12.1m	14.1m	▲

Recent economic data is simply too consistently positive not to tap up the commercial real estate forecast for 2012. Equity markets and REIT indices are rallying, new factory orders are rising, retail sales jumped up in January, copper prices are rebounding, and the January employment figures exceeded even the most optimistic expectations. The most recent data suggests even stronger momentum. On February 4th, the number of initial jobless claims fell to 358,000, just 30,000 away from a level that reflects a robust – think “2006-ish” – U.S. economy.

Even the policy environment is taking on a brighter tone. U.S. policy makers are close to agreeing to extend the payroll tax cut before it is scheduled to expire at the end of February. That should add nearly 1% more of GDP growth to the U.S. economy for 2012. On the other side of the Atlantic, the European Central Bank’s (ECB) Long-term Refinancing Operation (LTRO) – in which it provides unlimited funds to European banks for 36 months at a rate of 1% -- has, at least temporarily, stabilized the euro-zone. Italy’s 10-Yr government bond yields have fallen from an alarming 7.2% on January 9th to a far more comfortable 5.5% on February 9th.

As we remember from early-2011, things can easily go wrong. The most imminent threats include a deepening of the euro debt-crisis, a spike in oil prices related to rising tensions with Iran, and the impending federal fiscal drag in 2013. Nevertheless, the string of positive economic data has shifted the trajectory to the upside. U.S. Real GDP is expected to grow 2.6% in 2012. This level of growth will be enough to create 1.8 million net new jobs, which in turn will shave no less than 50 basis points (bps) off vacancy rates across all commercial real estate sectors.

### Jobs (hard blink!) - Yup, that’s a big number

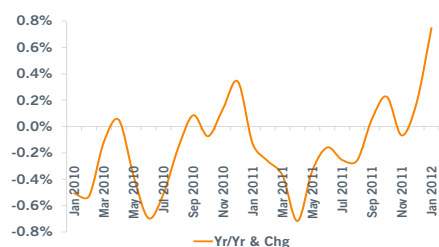
The January jobs report is the strongest indication that U.S. recovery is once again gaining momentum. According to the Bureau of Labor Statistics, 243,000 net new nonfarm payroll jobs were created in January of 2012. Both November and December job creation figures were revised upward, further validating that the uptrend in labor markets is clear and consistent. Since September of 2011, growth in nonfarm payrolls has averaged a respectable 183,000 per month. The jobs being created are those that drive demand for commercial real estate. Of the 243,000 jobs created in January, 70,000 were in the professional and business services sector (correlation to office net absorption .80), 50,000 were in the manufacturing sector (correlation to industrial absorption .82), and 10,500 were in the retail trade sector (correlation to retail space absorption .80).

There are indications that businesses will continue hiring at a healthy clip. Most notably, recent data shows that the labor force is growing again. Granted, the household survey data – from which the labor force data is derived -- was revised in January, so the trends may not be as solid as they appear. That said, the year-to-year comparison gives us a reasonably clean view. It shows that the labor force has expanded in four out of the last five employment reports. Given that a stronger recovery needs both job creation *and* labor force growth, this development is new, encouraging, and it signals that job prospects are finally improving enough to move the needle. The second encouraging factor – although it may seem a bit counterintuitive – is that both productivity and corporate profits

are now weakening. Businesses' output per hour has either declined or decelerated in three out of the last four quarters. Corporate profits, while still strong, have been increasing at a much slower rate since the fourth quarter of 2010. This combination suggests that businesses have reached the tipping point where they cannot grow their profit margins any longer without hiring more people. For many businesses, hiring is no longer an option, it is a must.

## Labor Force is Growing

Civilian Labor Force, SA



Source: Moody's

## Productivity is falling, so must hire workers

Nonfarm Business, Output per hour

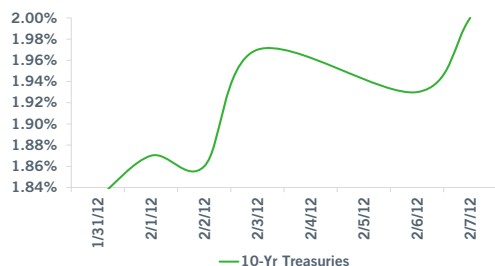


Source: Moody's

## Interest Rates & Inflation

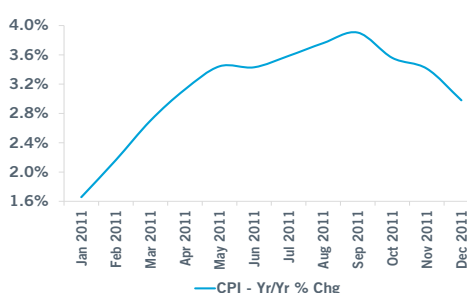
Firmer economic data also has interest rates rising. The yield on 10-Year U.S. Treasuries rose from 1.83% on January 31st to 1.98% on February 10th. This signifies that investors are slowly shifting away from risk-free government bonds and towards assets that offer higher yields. More often than not, a rise in interest rates is a healthy dynamic for property markets. For every 75-100 bps increase in long-term Treasury yields, U.S. office rents increase by 50 cents six months later. However, inflation, or more precisely disinflation, is sending a different message. The top-line CPI inflation for urban consumers has been trending downward since September of 2011. According to the most recent data in December 2011, energy prices fell, commodity prices inched down, and wage inflation remained flat. Moreover, based on the latest statements from the Federal Reserve, there is a better than 50% probability that the Fed will embark on another round of monetary stimulus in early 2012. This, in combination with the downside risks related to the euro-crisis – a dynamic that will keep investors heavily invested in U.S. government bonds – suggests the yield on 10-year Treasuries will stick very close to 2% for most of 2012.

## Interest Rates are Rising



Source: Moody's

## But Inflation Trending Down - Rates will stay low



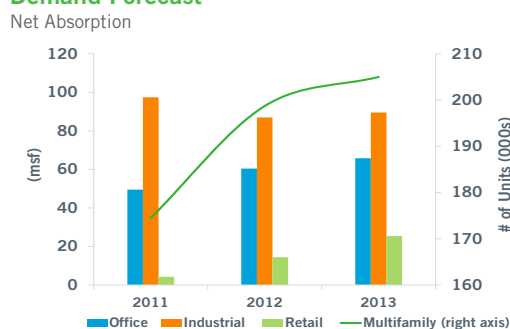
Source: Moody's

## Commercial Real Estate Outlook

### Leasing

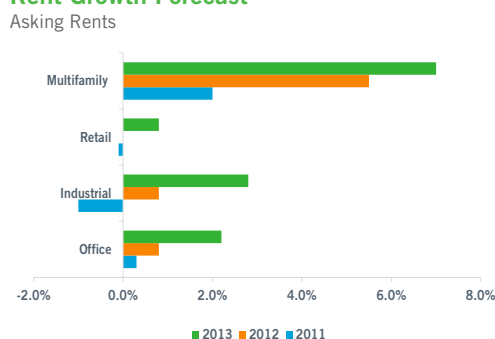
For context, it is worth reviewing how the property markets performed during 2011 – a slow economic recovery year. In 2011, real GDP grew by just 1.7%, and the U.S. economy created 1.5 million jobs. Under this economic backdrop, the U.S. office sector absorbed 49.5 million square feet (msf), the industrial sector absorbed 97.4 msf, the apartment sector absorbed 174,500 units, and the retail sector absorbed 4.3 msf. Vacancy tightened by 50 bps in both the office and industrial sectors, by 140 bps in the multi-family sector and remained flat in the retail sector. Thus, given the stronger economic trajectory for 2012 – a year during which GDP grows by 2.6% and creates 1.8 million jobs – the CRE recovery is expected to accelerate across all sectors. Lack of new development will help. For most property sectors, new construction is about two-thirds below its historical trend. In our baseline scenario for 2012, vacancy will fall by 90 bps for office product, 60 bps for industrial, 10 bps for retail, and by 130 bps for multi-family. Despite the erosion in empty space, vacancy still remains approximately 200 bps above the threshold needed to push rents upward. Consequently, outside of the multi-family sector, rents will generally remain flat in 2012, but will see more noticeable upward movement in 2013. The multi-family sector, with a vacancy rate expected to fall below 4%, will see rent growth of 5.5% in 2012, followed by 7% in 2013.

#### Demand Forecast



Source: Cassidy Turley Research

#### Rent Growth Forecast



Source: Cassidy Turley Research

### Investment Sales

From a capital markets perspective, debt is what makes the commercial real estate world go round. Debt was flowing in 2007; U.S. office sales volume was \$206 billion. Compare that to 2011 when lenders had turned the spigot off more than on; U.S. office sales volume was just \$63 billion. Thus, to a large extent gauging the outlook for investment sales volume and pricing comes down to what will be the availability of financial leverage in 2012.

The three primary lenders for commercial real estate include banks and thrifts (accounting for ~33% of all lending), the CMBS market (accounting for ~25%), and life companies (accounting for ~13%). Of the three groups, life companies were the only group that resumed normal lending patterns in 2011. Given life companies' solid balance-sheets, we expect more of the same in 2012. The CMBS market was spotty in 2011, but nevertheless did manage to create \$30 billion in CMBS issuance. Most analysts expect CMBS issuance in 2012 to range between \$30 and \$50 billion. The big wild card is commercial banks. Cash is not the problem. By the end of 2011, commercial banks had \$1.5 trillion in cash assets. This is five times the norm. The problem is that this money is not being lent, on net, for commercial real estate. In 2011, U.S. banks decreased their loan volume for commercial real estate by \$200 billion. The primary reason for that ties back to Europe. According to some estimates, nearly 77% of all existing U.S. bank capital is, in some way, exposed to European debt.

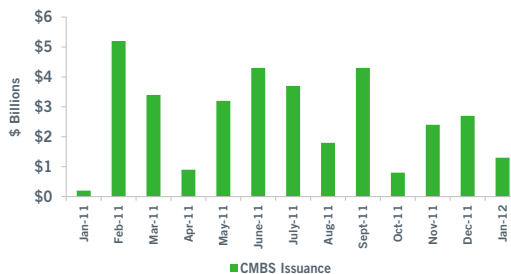
## Banks: Little Appetite for CRE

Commercial Banks: Domestic Loans Secured, NSA



Source: FDIC, Federal Reserve

## And CMBS is Struggling



Source: Commercial Real Estate Alert

In other words, until European policymakers arrive at a plan to address the euro-zone's debt and liquidity issues, U.S. banks will continue to sit on their cash reserves to protect themselves from the potential of huge losses. On the upside, at the recent Brussels Summit in February, leaders of the European Union governments agreed on important measures that move the region closer to a stronger fiscal union. Moreover, the Greek parliament approved a further round of budget cuts, a requirement before it could receive its second bailout (\$171 billion).

Given that prospects are slowly improving in Europe, we anticipate lending conditions will slowly loosen and investment sales will build on their momentum from 2011. Nevertheless, over the next 12 to 18 months, the majority of the sales activity will stay in core to core plus properties.

## Bank Liquidity is Tremendous

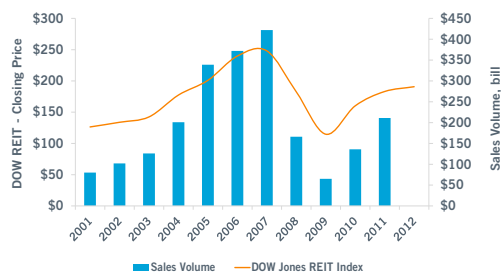
Commercial Banks: Cash Assets, \$billions



Source: Federal Reserve

## REITS Point to Momentum

REITS vs. Sales Volume (all property types)



Source: Moody's

## A Better Year

The economic trajectory is shifting in a positive direction. In October of 2011, the worst case scenario was that the U.S. would follow Europe into another recession; the best-case scenario was that the U.S. economy would experience minimal growth. Fast-forward to today, and the expectation is that the U.S. will experience moderate growth in 2012, and at its worse, slow growth. Double-dip rhetoric is suddenly a million miles away.

Given the depth of the recent recession, and the painfully slow recovery that followed, it is easy to focus on all the things that can go wrong. To be clear, the downside risks remain large. Then again, "luck" doesn't always need to be a negative in the economic equation. If nothing else, the recent bright spots in the economic data remind us of what the U.S. economy is capable of when there is slightly less global chaos. Last year, the property markets proved that fundamentals can strengthen even against a difficult economic backdrop. Just imagine the progress we may observe with a small dose of good luck.

## Baseline Scenario:

	2011				2012				Annual			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2010	2011	2012	2013
<b>US Economy</b>												
Real GDP (a)	0.4	1.3	1.8	2.8	2.0	2.3	2.9	3.3	3.0	1.7	2.6	3.1
Nonfarm Employment (b)	459	552	294	447	543	430	431	390	-931	1,501	1,794	2,100
Office-using Employment (b)	185	171	73	154	177	140	141	127	-62	587	585	685
Unemployment Rate	9.0	9.0	9.1	8.7	8.3	8.3	8.2	8.2	9.6	9.0	8.3	7.9
Retail Sales	10.9	4.7	4.7	7.9	4.1	4.5	4.7	8.1	6.4	7.8	5.4	7.0
CPI Inflation (a)	2.2	3.3	3.8	3.3	2.5	2.5	2.8	3.0	1.7	3.1	2.7	3.3
CCI	67	62	50	54	69	72	74	69	54	58	71	80
Fed Funds Rate	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1
10-year Gov't Bond	3.5	3.2	2.4	2.1	2.0	2.0	2.2	2.4	3.2	2.8	2.2	3.2
ISM Manufacturing Index	59.8	56.6	52.1	52.4	55.0	54.1	55.0	58.0	57.3	55.2	55.5	58.0
West Texas Intermediate	94	103	90	94	100	99	93	95	79	95	97	98
<b>Office Sector</b>												
Net Absorption (c)	10.1	12.3	15.7	11.4	12.2	16.4	16.0	15.8	19.5	49.5	60.4	65.8
Vacancy	16.7%	16.6%	16.3%	16.0%	15.8%	15.6%	15.4%	15.1%	16.9%	16.4%	15.5%	14.3%
New Deliveries (c)	6.1	4.7	4.9	2.4	--	--	--	--	33.3	18.0	20.2	27.2
Asking Rents	\$21.36	\$21.36	\$21.43	\$21.50	\$21.51	\$21.58	\$21.60	\$21.65	\$21.34	\$21.41	\$21.59	\$22.07
Investment Sales (d)	\$10.7	\$16.6	\$16.5	\$19.7	\$10.3	\$17.2	\$18.4	\$22.0	\$46.3	\$63.5	\$67.9	\$71.2
<b>Industrial Sector</b>												
Net Absorption (c)	24.5	22.3	23.6	27.0	21.4	19.8	21.2	24.6	(8.7)	97.4	87.0	89.5
Vacancy	9.5%	9.3%	9.2%	9.1%	8.9%	8.8%	8.6%	8.5%	9.8%	9.3%	8.7%	8.0%
New Deliveries (c)	7.2	5.9	7.4	9.7	--	--	--	--	15.0	30.3	24.0	37.8
Asking Rents	\$5.05	\$5.09	\$5.11	\$5.05	\$5.09	\$5.09	\$5.11	\$5.18	\$5.13	\$5.08	\$5.12	\$5.26
Investment Sales (d)	\$4.3	\$15.1	\$7.2	\$7.9	\$5.2	\$9.8	\$14.4	\$8.3	\$16.6	\$34.5	\$37.7	\$38.0
<b>Retail Sector**</b>												
Net Absorption (c)	0.7	-0.1	0.5	3.2	2.8	2.5	3.0	6.1	-3.2	4.3	14.4	25.4
Vacancy	10.9%	11.0%	11.0%	11.1%	11.0%	10.9%	10.9%	10.7%	11.0%	11.0%	10.9%	10.3%
New Deliveries (c)	0.2	1.0	0.8	--	--	--	--	--	4.5	4.9	9.3	20.3
Asking Rents	\$18.97	\$18.97	\$18.97	\$18.95	\$18.95	\$18.96	\$18.95	\$18.97	\$18.99	\$18.97	\$18.96	\$19.11
Investment Sales (d)	\$6.6	\$16.3	\$8.6	\$10.9	\$6.0	\$9.5	\$8.0	\$8.6	\$22.3	\$42.4	\$32.1	\$45.0
<b>Apartment Sector**</b>												
Net Absorption (e)	44.7	42.4	36.8	50.6	48.4	49.3	50.6	50.4	228.0	174.5	198.7	205.0
Vacancy	6.2%	5.9%	5.6%	5.2%	4.9%	4.6%	4.2%	3.9%	6.6%	5.2%	3.9%	3.2%
New Deliveries (e)	7.5	10.5	8.2	8.9	--	--	--	--	99.1	37.7	75.3	137.4
Asking Rents	\$1,047	\$1,053	\$1,060	\$1,064	\$1,084	\$1,090	\$1,100	\$1,114	\$1,043	\$1,064	\$1,122	\$1,200
Investment Sales (d)	\$9.1	\$14.0	\$14.2	\$16.6	\$9.8	\$13.8	\$15.7	\$18.8	\$34.9	\$53.9	\$58.1	\$65.7

(a) - Annualized Growth Rate, Quarter-over-Quarter  
(b) - Thousands, SA, Quarterly Chg.

(c) - Millions square feet  
(d) - Quarterly Sum, Billions

(e) -Thousands  
\*December 2010 over Dec 2009

\*\*Reis & RCA Historical data; Cassidy Turley Forecasts