

C&W POSITION SUMMARY

THE ECONOMY

1. There is a general and growing consensus that the economy is strengthening and that 2011 will be a much stronger year than 2010 in terms of economic growth. The current projection from Moody's Analytics calls for GDP growth in 2011 of 3.9% following the 2.9% increase in 2010. We think this is likely to be low and GDP growth is likely come in over 4%.
 - a. Consumer spending is accelerating. After increasing at a 2.2% annual rate in the first three quarters of 2010, spending growth doubled to a 4.4% annual rate in Q4 which was the strongest growth rate since the first quarter of 2006, nearly five years ago.
 - b. Investment is booming. In 2010 spending on equipment and software increased 15.1%, the strongest single year since 1978.
 - c. Exports are up, reaching a record high in the fourth quarter.

2. Employment growth is set to soar. After adding 1.1 million jobs in 2010, we expect the economy to add between 3.0 million and 3.5 million jobs in 2011.
 - a. Corporate profits which historically lead employment growth by roughly three quarters, increased strongly in 2010. Now corporations will need to add employees to maintain revenue growth.
 - b. Businesses will shift from being concerned about costs to being concerned about losing revenues. As that shift occurs, employment growth is expected to accelerate sharply.

3. Interest rates will rise. Strong growth, the threat of inflation and a large budget deficit will cause treasury rates to increase substantially. The Fed will be raising interest rates by the fourth quarter.
 - a. As the economy accelerates, the Federal Reserve will shift from concerns about the strength of the recovery to concern about the possibility of inflation and will shift its monetary policy stance from accommodation to tightening.
 - b. This pattern is already emerging in other areas of the world where the recovery is much further along. In many Asian countries including Australia and China, the central bank has already begun to increase interest rates to cool economic growth.

4. The unexpectedly strong growth will lead to improved revenues for many states and localities causing layoffs to be trimmed. At the Federal level, the drive to cut spending will stall. Addressing the budget deficit will become a campaign issue for 2012.
 - a. While confrontations are now occurring in several states across the nation, some states and localities that have seen stronger economic and employment growth are already seeing improvement. New York City for example, recently announced that the budget deficit for the coming year will be smaller than earlier projected.

LEASING MARKETS

5. The strong economy and limited construction will cause vacancy to decline sharply in 2011.
 - a. The national CBD vacancy rate reached a peak of 15.0% in the first quarter of 2010. Remarkably, this is lower than the 15.5% peak reached in the third quarter of 2003 at the end of the last market downturn despite the fact that the total number of jobs lost in this recession was more than three times as large as in the early 2000's.
 - i. The main driver has been limited construction. In the three years prior to the recession the US added a total of 4.0% to our national inventory, compared with 8.6% in the three years prior to the 2001 recession and nearly 13% in the three years prior to the 1990 recession.
 - ii. The low level of construction means that as employment growth accelerates vacancy will fall sharply.
 - b. Absorption which turned positive in 2010 will reach the highest level since 2005.
 - i. Major 24-hour CBDs will experience the highest absorption. In 2010, Manhattan, Denver and Washington DC accounted for more than the total positive absorption in the US (offset by declines in other cities). With employment rising more strongly in more locations, occupancy will increase in most major metropolitan areas and more cities will record positive absorption in 2011.
6. Leasing activity will be strong throughout the nation, not just in select pockets as in 2010. As the economic growth accelerates employment increases will lead to more expansion in occupancy in cities throughout the country.
 - a. For the first time in several years, leasing will be driven by growth as much as by expirations.
 - b. The last year in which the US economy added more than 2 million jobs was 2006 and new US leasing in that year totaled 254 million square feet, roughly 35% higher than the 2010 level.
7. The industrial sector will recover much more strongly in 2011 and beyond as rising employment and demand lead to both higher manufacturing output and faster growth in good shipments. As of January, manufactures shipments of goods were 9% above the level of a year ago and imports of goods were up 22%. This strong growth will lead to a further reduction in the overall national industrial vacancy rate from the 10.3% of the end of 2010 back into single digits by the end of 2011 or early 2012.
8. Rents will rise sooner rather than later. Although this always varies from market to market, the bulk of US CBD markets will be experiencing rising asking rents by the end of 2011. The 24-hour gateway CBDs are likely to experience rental increases first followed by the stronger secondary markets.
 - a. Net effective rents are likely to rise more quickly and sooner. In some markets they are already starting to move.
 - b. In the major gateway cities there is already evidence of improving rents. At the end of 2010 Manhattan rents are modestly higher than at mid-2010 and Midtown class A rents were up 2.5% from a year ago. Rents are also rising in Washington DC, Dallas, San Francisco and Miami, among others.
 - c. Tightening markets will make these increases more widespread over the coming year.
 - d. Industrial rents will turn higher by mid-2011 and increase in the second half of the year.

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CONSTRUCTION

9. As markets move, developers will start getting out the shovels. There is currently 7.3 million square feet of construction across the US set for completion this year (down from 16.9 million in 2010 and 40.6 million in 2009), and 6.0 million in each of the following two years.
 - a. As vacancy declines and rents increase, new construction will become attractive once again.
 - b. However, how fast construction actually ramps up will depend on the availability of financing. Despite the improvement in capital markets, it is still difficult to get financing, particularly for speculative construction.
 - c. This means the first buildings likely to come out of the ground will be those where the developer already has a tenant and those where the developer is well capitalized and does not need to tap debt markets.

CAPITAL MARKETS

10. Markets are moving. They will get significantly stronger in 2011 and beyond.
 - a. 2010 was the year of the “gateway Cities” revival. Washington, New York, Boston, San Francisco all saw a substantial increase in investment activity.
 - i. This led to significant increases in prices in those cities in 2010 with corresponding drops in cap rates. According to Real capital Analytics, cap rates in Manhattan averaged 5.5% in 2010 and Washington DC averaged 6.3%.
 - b. 2011 will see a broadening of that revival as investors begin to reach for yield.
 - i. As we are seeing in fixed income markets, where junk bond yields have fallen sharply, we expect to see a similar drive on the part of real estate investor.
 - ii. As cap rates in the major gateway cities fall, investors will reach into secondary markets to get higher yields.
11. The dreaded avalanche of CMBS foreclosures will be a ripple in the pond.
 - a. Workouts are occurring, debt is being purchased. In fact, the discount being applied to debt is declining, suggesting that there is little worry about rising supply.
 - b. Real estate is staying in the hands of real estate people retaining value.

POTENTIAL HEADWINDS

While we believe this optimistic scenario to be the most likely outcome for the US economy and real estate market in 2011, there are stresses that could slow growth.

1. Oil prices and the Middle East Political Environment. With popular uprisings in first Tunisia, then Egypt and now Libya, Qatar and Bahrain, the political environment throughout the Middle East and North Africa (MENA) has become less stable. The instability has the potential to threaten oil production and supplies from the MENA countries which together account for approximately 36% of the world’s oil production. The response to this uncertainty has been a surge in world oil prices which has the potential to slow the US and global economies.

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- a. Since the beginning of the year, the price of West Texas Intermediate crude oil has increased by more than 10% climbing from roughly \$90 per barrel to about \$105 in mid-March. A further substantial increase would have a negative impact on the US economy.
 - b. Rising oil prices act as a tax on consumers. Since 1986, after the 80s oil crisis, consumer spending on energy products and services accounted for, on average 4.9% of after tax income. In 2008 when oil prices rose to nearly \$150 per barrel, that ration climbed to 6.4%. By the first quarter of 2009 as the recession hit and oil prices plunged, it fell to 4.3%. Today, it is back up to 5.4% and likely to go higher. That increase means there is less money available for consumers to spend. Fortunately income is growing more rapidly, so the economy is able to absorb this price increase more readily than in 2008. Nevertheless a spike in oil prices would put a crimp on consumer budgets and ratchet down the economy's growth rate leading to slower employment growth and less robust real estate markets.
2. Japan's crisis. The earthquake and subsequent tsunami in Japan have devastated the third largest economy in the world. The nation is now facing challenges due to the partial meltdown of at least one and possibly three nuclear reactors. While the economic damage from these meltdowns will not be substantial, it may have an impact on confidence particularly in the near term. In addition, the disruption caused by the earthquake and its aftermath will cause a temporary slowdown in output. That slowdown is likely to be made up in the second half of the year as the nation begins to rebuild.
 3. Inflation. Inflation is not an immediate problem, but it is clear that rising commodity prices are having an impact on consumers and business. If these trends continue, the economy could experience rising inflation sooner than is expected. This would lead to reduced confidence, rising spending on necessities and higher interest rates, all of which would slow the economy.

CONCLUSIONS

After three of the most difficult years in our nation's economic history, the US is poised to make a strong recovery over the coming year. The real estate sector, because of its strong ties to all sectors of the economy and because of the relatively healthy underlying fundamentals (most notably the lack of construction), is likely to participate fully in the robust recovery. If the headwinds are not too great, we could be looking back a year from now and saying that 2011 was one of the best years for real estate in a long time.