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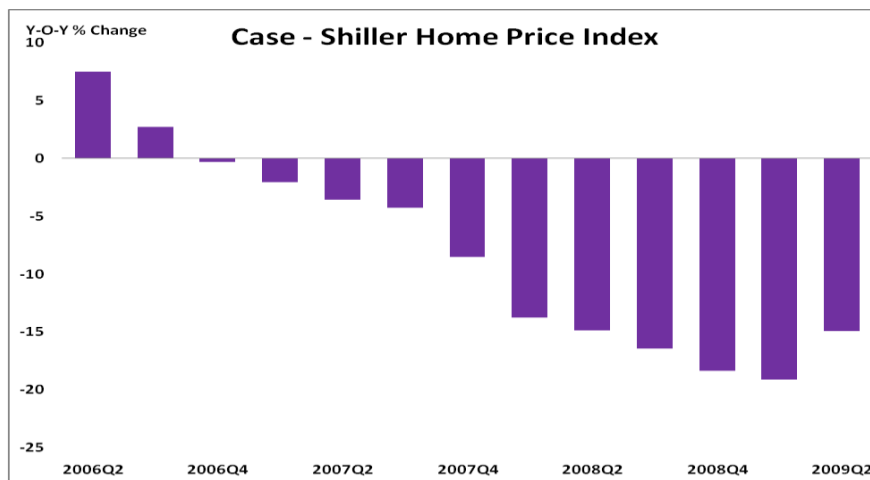
The recession continues to take a toll on all real estate markets across the United States. Home prices are still declining according to the Case-Shiller Index. The percent of homes in foreclosure is at a new high. The industrial vacancy rate exceeds 12.0 percent while the downtown office vacancy rate exceeds 13.0 percent. The percent of delinquent commercial real estate loans is about 8.0 percent.

To be sure, this news is depressing. Unfortunately, real estate markets in the United States are likely to remain in the doll-drums. Our model indicates a weak economy over the forecast horizon. This translates into more recessionary pressures in both the residential and commercial real estate markets.

Residential Real Estate

It is fair to say that the current decline in the residential real estate market is unprecedented in modern times. Regardless of the measure, residential real estate is showing signs of significant decline. The fall in prices has been severe and sustained. The rise in foreclosures has been exceedingly swift. At this time there is very little, if any, good news.

Home prices in the United States are still falling. The national Case-Shiller Index has fallen eleven consecutive quarters. Currently, the Index is approximately at the same level it was in Q2 2003. In other words, according to the Case-Shiller Index, home values are at their Q2 2003 level.

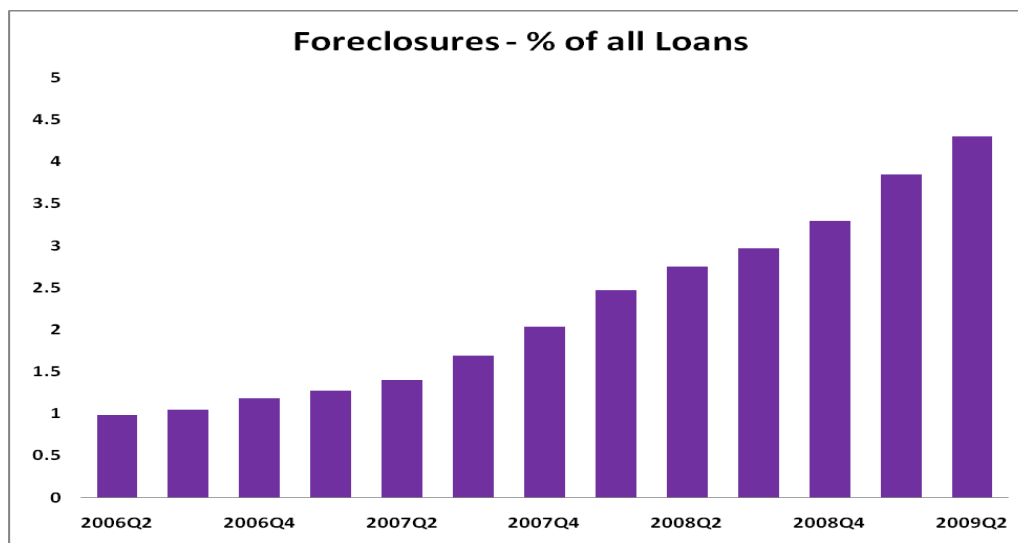


Source: Standard & Poor's and Fiserv, Inc.

The only comforting fact that can be taken from the chart above is that the decline in home values slowed in Q2 2009. The year-over-year decline in Q2 2009 is the smallest in a year. To be sure, a one quarter improvement in the rate of decline is not a trend. However, any positive sign in the residential market must be noted.

Foreclosures continue to plague the market, particularly in California, Nevada, and Florida. Initially, foreclosures were limited to over-extended consumers who purchase homes with sub-prime loans. As the recession continued and deepened, borrowers with prime loans began to default.

The rise in foreclosures has been dramatic. In three short years the foreclosure rate has risen four-fold. In Q2 2006 approximately 1.0 percent of all loans were in foreclosure. By Q2 2009 that rate had risen to 4.3 percent.



Perhaps the most striking feature of this graph is the increase in the last three quarters. From Q3 2008 to Q2 2009 the foreclosure rate increased from 3.0 percent to 4.3 percent. This increase occurred during a period of foreclosure moratoriums. During the period in question, Fannie Mae and Freddie Mac instituted foreclosure moratoriums in an effort to slowdown the rate of foreclosures. Several large, financial institutions followed suit and issued their own moratoriums. Unfortunately, their efforts were in vain.

On a positive note, home sales appear to be increasing. On a year-over-year basis, home sales have increased in each of the last two quarters. While the gains have been modest, in the 3.0 to 5.0 range, the news is certainly welcome.

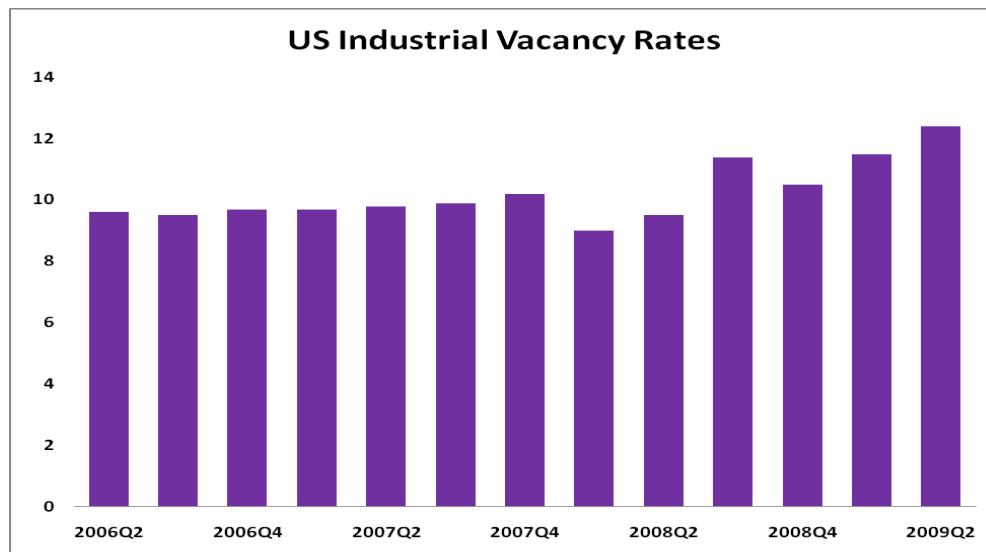
Going forward we can expect much of the same. Mounting job losses, over leveraged consumers and tight credit markets will continue to put downward pressure on residential real estate. We expect home values to fall further over our forecast horizon. Although, the rate of decline will diminish as we move forward. Our forecast also indicates that the foreclosure rate will decrease but stay well above the long-run average.

Commercial Real Estate

Commercial real estate markets are also under duress. Vacancy rate are increasing and lease rates are falling across the country. Few, if any, markets have been spared this fate. The decline in consumer spending caused a pull back in retail markets. The decline in economic output has devastated the industrial market. The near collapse of the financial industry has negatively impacted core downtown office markets.

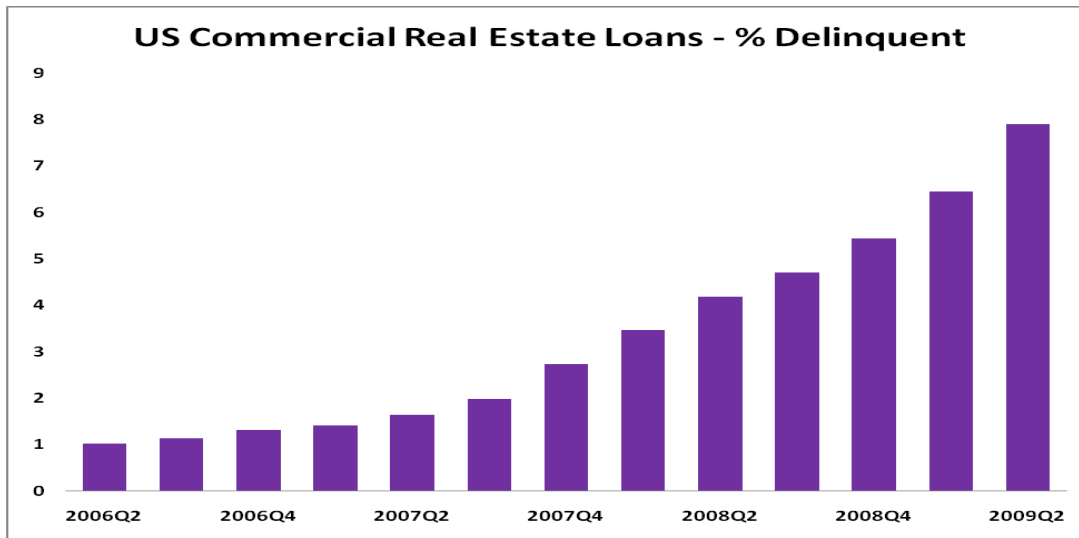
The increase in vacancy rates is best exemplified in the industrial market. Vacancy rates in this market have essentially increased for five consecutive quarters. The exception being Q4 2008 when vacancy rates fell relative to the previous quarter but were higher than Q2 2008.

The vacancy rate in Q2 2009 was 12.4 percent. This is the highest reading we have dating back to Q2 1977. In other words, this is the highest vacancy rate in at least 32 years. This includes the recession of the early 1980s when Reagan was elected President and the recession in the early 1990s when defense spending was significantly reduced.



Source: CB Commercial

Another measure of the weakness in commercial markets is the rate of delinquency on commercial loans. This rate has risen much faster than the foreclosure rate. Since Q2 2006 it has risen nearly eight-fold. Approximately 7.9 percent of all commercial real estate loans were delinquent at the end of Q2 2009. The rate has not been this high since the recession of the early 1990s.



Source: Federal Reserve Board

One of our major concerns is the impact of this rate on the health of the financial industry. Banks and other lending institutions are currently coping with significant losses related to poor residential loans. They may once again teeter on the brink of insolvency if a significant portion of delinquent commercial real estate loans are written off.

The outlook for commercial real estate is bleak over our forecast horizon. In general, we expect vacancy rates to rise and lease rates to fall as the United States economy continues to shrink. This will reduce the cash flow generated from commercial property. This in turn will lead to higher delinquency rates as owners are unable to meet their loan obligations.

Over leveraged consumers will continue to scale back their spending. We anticipate a very weak 2009 holiday season. Retailers, who rely on holiday sales for a significant portion of their sales, are likely to experience even more duress. We expect retail vacancy rates will increase in Q1 2010 and remain high throughout the forecast horizon.

Industrial real estate that caters to car manufacturing and related industries is a serious concern going forward. Although the “Cash for Clunkers” program temporarily increased car sales, this level of demand is not expected to continue. We expect further cuts in car manufacturing during the forecast horizon. In fact, we are already seeing them. Toyota recently announced that it is closing its joint venture plant in Fremont, California.

The rising unemployment rate suggests that companies remain in survival mode rather than expansion mode. This does not bode well for the office market. We expect few new companies to enter the market. There are likely to be some in the emerging “Green Industry” but not enough to offset losses in other industries. As a result, we anticipate further deterioration in the office market.