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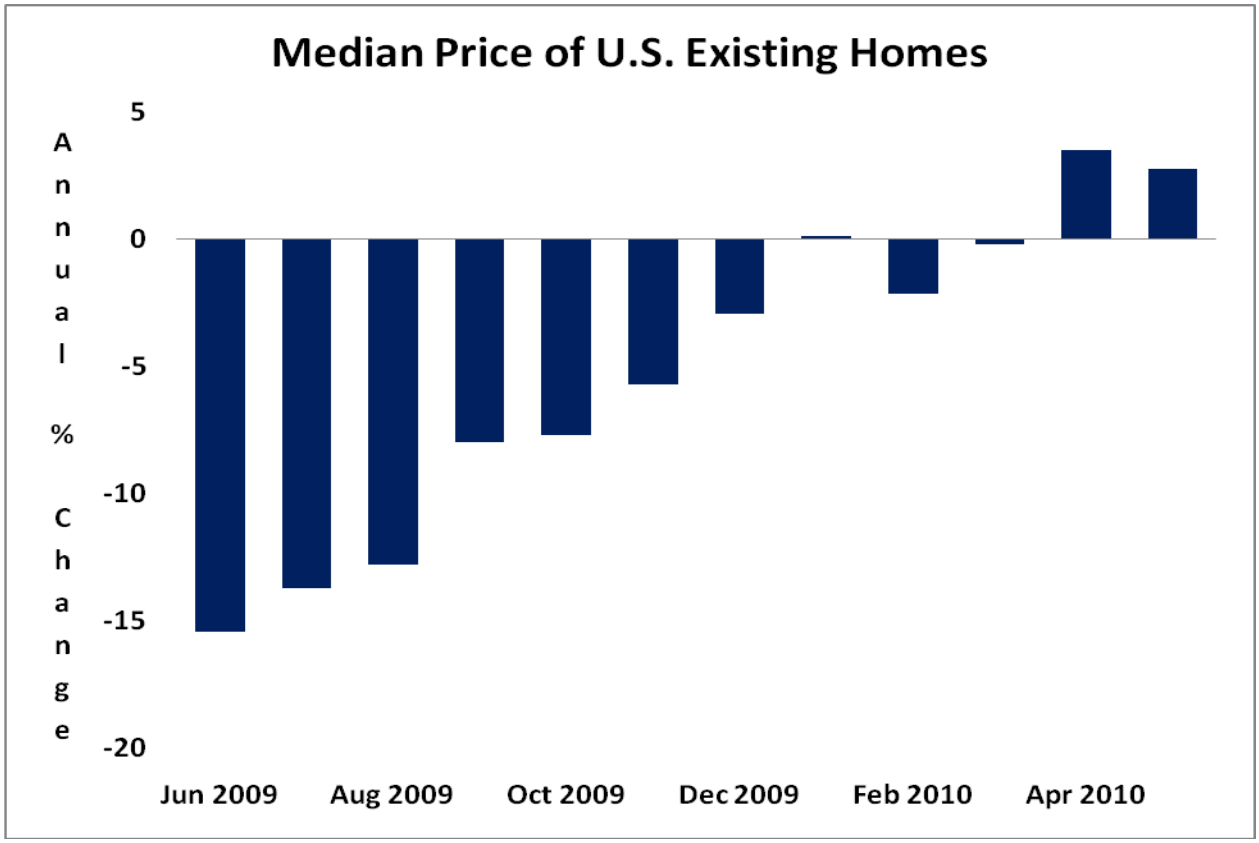
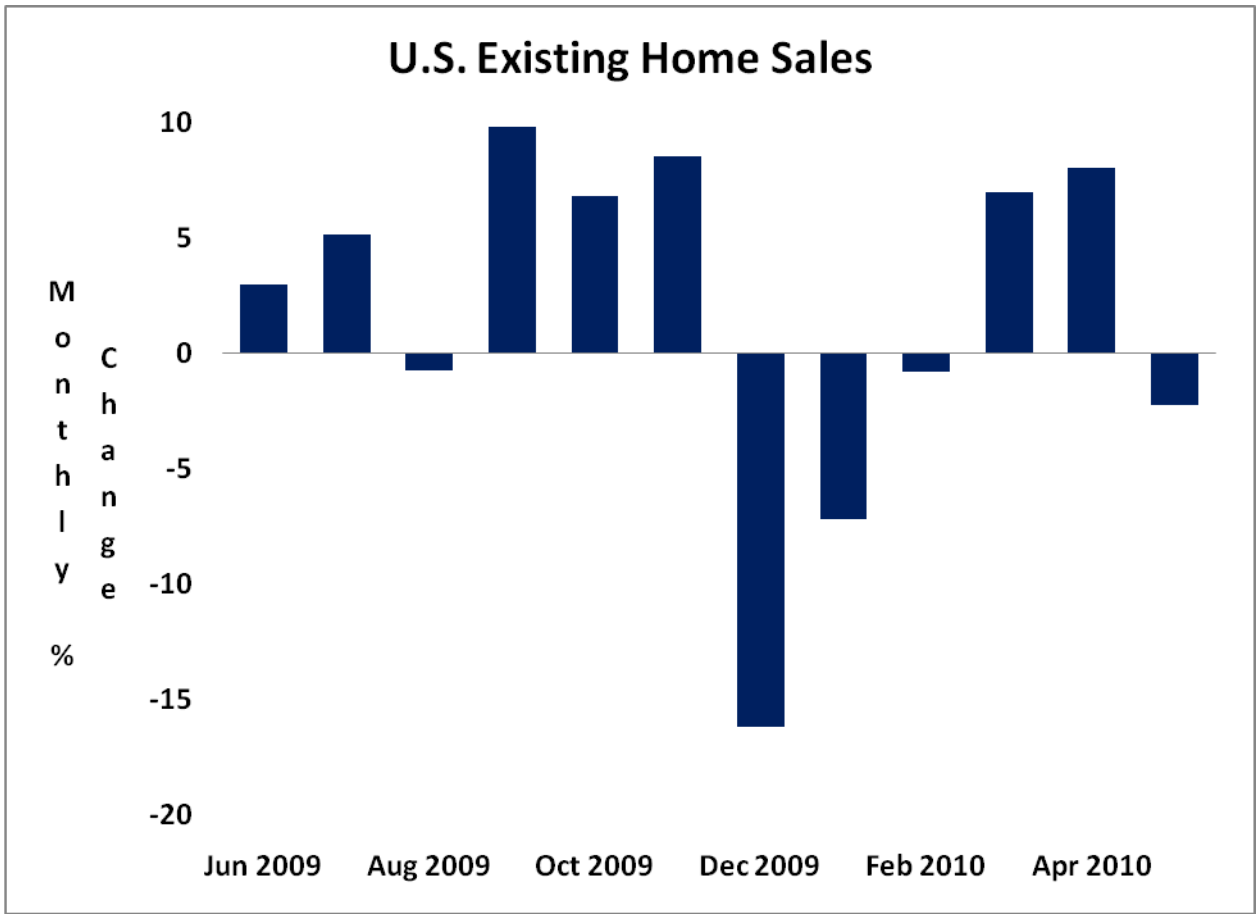
Finally we have some good news to report regarding the U. S. housing market. Recent data suggest that the worst is behind us. Nationally, the median price of an existing home increased for two consecutive months. That has not happened since June and July 2006. The decline in May home sales is, we believe, solely due to the expiration of tax credits. Even with the decline May 2009 home sales are 19.2 percent higher compared to May 2008. Foreclosure rates, while high, have started to decline. Taken together we view this as positive momentum for the housing market.

As the graph below shows, median home prices in the U.S. have increased for two consecutive months. To be sure the increases are not significant. Median home prices increased 3.5 percent in April and 2.7 percent in May. What is important here is not the magnitude of the increase. Rather it is the fact that home prices have increased for two consecutive months. This suggests to us that prices are beginning to stabilize.



Home sales paint an even better picture of the market. It is true that existing and new home sales fell in May. However, we believe that the decline is solely due to the expiration of home buyer tax credits. The same phenomenon occurred at the end of 2009 when the original home buyer tax credits expired. We expect home sales to recover in the coming months.

If we take a broader view we see that home sales, even after the May decline, are up 19.2 percent compared to last year. On a year-over-year basis, home sales have increased every month since July 2009. This is certainly good news. It should be noted that while home sales are increasing they are well below their 2005 – 2006 levels.



Foreclosures remain problematic in some areas of the country. In total, the percent of all loans in foreclosure continues to increase. Nearly five percent of all home loans in the U.S. were in foreclosure at the end of Q1 2010. While tragic and well above historical norms, foreclosures are not affecting all markets equally.

For the most part, foreclosures are a problem for the so called "Sunshine" states of California, Arizona, Nevada, and Florida. Together these states have the bulk of all foreclosures in the U.S. Areas that experienced a significant building spurt during the boom, like the Sunshine states, are the most suspectible to the foreclosure problem. Too many homes were built and sold at elevated prices in these markets.

The relatively high foreclosure rate in parts of the country continues to put pressure on new construction. In April 2010, the last month for which we have data, the seasonally adjusted annual number of single family permits was a mere 502,000. For comparison, over one million permits are usually awarded in the U.S. during normal times. Although low, this does represent an increase from the depths of the housing crisis, when permits bottomed out at 350,000.

The dearth of new construction is closely related to foreclosures. Markets that are experiencing high foreclosure rates are also experiencing historically low new construction. The abundance of empty, recently constructed homes has negated the need for more homes.

What can we expect over the next twelve months? First, we expect prices to remain flat. We envision a scenario where prices bounce around their current levels. Some months prices may rise a bit while in other months prices may fall a little. Sales are likely to continue their slow upward trend. We do not expect to see large increases in home sales. Instead, we expect sales to rise slowly and gradually over the next twelve months.

Foreclosures are likely to remain high in the "Sunshine" states. Recent data point to a disturbing trend in these markets. It appears that consumers who purchased homes at the peak are now walking away from those homes, even if they can afford them. The loss in equity is just too great. These consumers are looking at the prospect of paying for an asset that will take years to recover.

Markets that experienced a gradual build up during the boom are likely to recover much faster than areas that built up rapidly. Communities with smart growth strategies have not felt the tremendous pressure of the foreclosure crisis. This is not to say that these communities will experience a rapid and robust recovery. Instead, we believe these areas will emerge first from the housing crisis.

New construction is likely to remain low for the next twelve months. This is particularly true in areas with high foreclosure rates. In these markets housing supply exceeds demand. Even areas with manageable foreclosure rates will not see a significant increase in new construction. Weak demand and tight credit markets will likely keep new construction subdued in these markets.

Commercial Real Estate

Weak economic conditions continue to negatively impact commercial real estate. Commercial real estate is intricately tied to the overall economy. During prosperous periods commercial real estate performs well. These periods are characterized by low vacancy rates, high lease rates, rising prices and new construction. Of course, the opposite is true as well. Commercial real estate performs poorly during economic downturns.

Additionally, commercial real estate metrics are lagging economic variables. When the economy moves from boom to bust vacancy rates, lease rates, and other commercial real metrics do not fall right away. It takes time for the downturn in economic activity to affect commercial real estate. The same is true when the economy switches from bust to boom. It takes time for a healthy economy to affect commercial real estate. We are currently dealing with this phenomenon, especially so since the economy is arguably not that "healthy" yet.

Economic activity is increasing in the U.S. Unfortunately, commercial real estate has yet to reap any benefits. Some of this is due to the lagging nature of commercial real estate. More importantly, the recovery has been weak and this tends to delay improvements in commercial real estate. Companies remain hesitant to expand and take on additional risk. Instead, they are waiting for more positive signs of economic recovery.

According to the Institute of Supply Management, the manufacturing sector expanded in May 2010. This was the tenth consecutive month of expansion. This bodes well for the industrial sector. A growing manufacturing sector will begin to absorb unused industrial space. Over time this will translate into lower vacancy rates and higher lease rates.

Consumer consumption is increasing. In fact, consumer consumption has increased for three consecutive quarters. This is good news for the retail segment as this segment has really been hurt by the decline in consumer spending. Most retailers, the exception being discount retailers like Wal-Mart, have seen sales fall dangerously low. Increasing consumer consumption will help to alleviate this problem.

A word of caution is necessary. Internet sales continue to compete with traditional retailers. The retailers most susceptible to this shift are video and music stores. The internet continues to play a larger role in these products. The advent of Netflix and iTunes are just two examples of internet retailers who have gained market share at the expense of traditional retailers. Traditional brick and mortar retailers in these industries are likely to face more competition from their internet competitors.

The office market is likely to remain weak during the next twelve months. High unemployment caused by a jobless recovery does not bode well for the office market. Instead of hiring new workers and expanding, companies are squeezing more productivity out of their current workforce. As a result, we expect the office market to remain weak.

Weak conditions throughout the commercial sector have negatively impacted construction. The American Institute of Architects billing index remains below 50. Any reading below 50 indicates a decline in billings. This leading indicator suggests that construction remains weak. Considering the amount of vacant space across all commercial segments we are not surprised by this reading. At the moment supply is greater than demand. When this occurs there is little need for new supply.

Prices for commercial real estate subdued. High vacancy rates and low lease are not attractive to most investors. A lack of available credit is also at work. Prospective buyers have found it difficult to secure funding. Considering that banks remain weak we expect this condition to prevail through 2010.

In general, commercial real estate markets continue to suffer. While there are some bright spots, the news is not overly optimistic. We expect all segments in the commercial segment to underperform in the final two quarters of 2010.