

National Market Update: Q4 2009

UNITED STATES

RESEARCH AND STRATEGY
JANUARY 2010

Outlook for the U.S. Economy

The U.S. economic recovery gained additional strength during the fourth quarter, thanks to broad-based improvement across most business sectors and geographic regions. After rebounding by 2.2% in the third quarter of 2009, real gross domestic product (GDP) surged 5.7% during the last three months of the year.¹ Growth exceeded expectations mainly due to a jump in business spending and inventory restocking. Several significant challenges remain, however, including tight credit and high unemployment. Looking forward, we expect a slow recovery process with a few bumps in the road. We believe that the fiscal and monetary policies of the U.S. government and Federal Reserve will continue to be flexible and accommodating in 2010, supporting economic growth of 3.0% over the next twelve months.

Although the U.S. is technically out of recession, the labor market continues to struggle. Since the beginning of the recession through December 2009, a total of 7.2 million jobs were lost nationwide.² The national unemployment rate climbed to 10.1% in October, and though it has since receded to 10.0%, it remains at the highest level in 26 years.³ Despite these negative indicators, we now see early signs of recovery in the labor market. The four-week moving average of initial jobless claims continues to trend downward, pointing to a deceleration in the pace of layoffs. Average hourly earnings and the hiring of temporary workers are on the rise. With many firms reporting better-than-expected earnings and moderate sales increases over the past two quarters, we believe we will likely see job growth before mid-2010.

DAVID J. LYNN, PH D
Managing Director
Research & Investment Strategy
+1 212.883.2582
david.lynn@ingclarion.com

TIM WANG, PH D
Vice President
+1 212.883.2754
tim.wang@ingclarion.com

BOHDY HEDGCOCK
Associate
+1 212.808.2192
bohdy.hedgcock@ingclarion.com

JEFFREY ORGANISCIAK
Senior Analyst
+1.212.883.2525
jeffrey.organisciak@ingclarion.com

Consumer spending showed encouraging signs of improvement during the fourth quarter, with 2009 holiday sales rising by 2.3% over the depressed levels of the same period a year ago.⁴ However, U.S. consumers continued to increase savings and reduce household debt in the face of negative wealth effects. The personal savings rate rose to 4.7% in November 2009, up from 3.8% one year prior.⁵ We continue to believe that consumer spending will likely remain muted until the job and housing markets stabilize. The December Consumer Price Index (CPI) increased by only 0.1% over the previous month and by 2.7% year-over-year, primarily due to volatile energy prices.⁶ We believe that inflationary pressure should remain subdued over the next 12-18 months as a result of relatively weak demand and low capacity utilization.

The combination of a government tax credit for first-time buyers and historically low mortgage rates drove increased demand for residential housing over 2009. The U.S. housing market showed signs of stabilization with the S&P/Case-Shiller home price index climbing modestly for six straight months from June through November.⁷ However, both new and existing home sales declined larger-than-expected in December, suggesting a rather fragile housing recovery.⁸ There is a potential risk of additional home price decline in 2010 if the government stimulus assistance is withdrawn and mortgage rates increase substantially.

Capital Market Trends

At the Federal Open Market Committee (FOMC) meeting on January 27, 2010, the Federal Reserve pledged to keep interest rates near zero for an extended period and restated its plan to end the \$1.25 trillion mortgage debt purchase program by the end of March 2010.⁹ We do not expect any interest rate increase during the first half of 2010. We believe that the Federal Reserve and the U.S. government are facing a delicate balance today – they need to maintain adequate stimulus in the system to facilitate the on-going economic recovery while trying not to ignite inflationary pressures or significantly increase budget deficits. Any misstep in their exit strategies could pose a risk to the revival of the capital markets. On another front, the stock market continued its momentum from the March low with the S&P 500 gaining 6.0% during the fourth quarter of 2009.¹⁰ With access to both equity and debt markets, many U.S. public REITs continued to outperform the broader index. The NAREIT Equity REIT Index gained 9.3% during the fourth quarter and was up by 28.0% through 2009.¹¹

Several positive developments are emerging in the real estate capital markets, providing a glimpse of optimism as investor sentiment begins to rebound. As of December 2009, the average commercial mortgage rate was approximately 7.0-7.2%, with spreads over the 10-year Treasury narrowing to 360-420 bps from 430-500 bps in the third quarter 2009.¹² Mortgage spreads for core retail, warehouse, and office properties contracted by about 50 bps. Spreads for apartment and hotel properties remained essentially unchanged over the same period.¹³ On the CMBS front, all tranches have rallied appreciably. Spreads on the AAA CMBX index have narrowed by over 85 bps over the past three months.¹⁴ We believe that both mortgage and CMBS spreads will continue to drift downward, albeit at a slow pace, as real estate fundamentals continue to stabilize over the next twelve months.

Despite some improvements in the capital markets, commercial mortgage debt remains both expensive and difficult to obtain. We believe that the lending environment will continue to improve in 2010, including an increasing volume of CMBS originations. Those improvements will not, however, likely be enough to fully accommodate the \$1.1 trillion of commercial real estate debt that will mature in 2010-2012. With underwriting requirements remaining tight, traditional balance sheet lenders under stress and reluctant to lend, and regional bank failures rising, we expect a continuing financing gap in the market in 2010. According to Real Capital Analytics (RCA), distressed assets in the U.S. surged to \$203 billion as of December 2009.¹⁵ We expect the amount of distress to grow considerably as more loans mature over the next two to three years. There may be excellent opportunities for well-priced and/or distressed investments in 2010-2011.

The NCREIF Property Index (NPI) total return declined by 2.1% during the fourth quarter and by 16.8% for the year, the worst annual performance in the 32-year history of the index.¹⁶ This is slightly higher than the -17.5% projection that we made at the beginning of the year. The income portion of the return was resilient at 6.2%, but prices declined by 22.0%, a much steeper drop than during previous real estate downturns. National transaction volume across all five property sectors totaled \$18.1 billion in the fourth quarter of 2009, improving from \$13.0 billion in the third quarter but down from \$20.1 in the fourth quarter of 2008.¹⁷ The average transaction cap rate for all properties over \$5.0 million rose 20 bps to 8.1% in the fourth quarter of 2009, up 80 bps from the same period a year ago.¹⁸ Our review of a wide variety of market metrics suggests that commercial real estate transaction volume may be bottoming out. We expect to see more transactions over the next several months as an increasing number of investors look for distressed or undervalued opportunities in commercial real estate.

U.S. Real Estate Market Fundamentals

Industrial

Weak consumer spending, record low levels of business inventory, and reduced international trade continued to weigh on demand for industrial space. During the fourth quarter of 2009, the national average industrial vacancy rate increased by 40 bps to 13.9%, marking the ninth consecutive quarter of rising vacancy rates and the highest vacancy rate since 1989.¹⁹ All three sub-property types – warehouse, manufacturing, and R&D/flex – experienced increases in vacancy, though the rate of increase is clearly moderating. We expect national industrial vacancy to peak during the second half of 2010.

Industrial supply is constrained in most markets, which should help to counter-balance vacancy. We expect an average of 56.9 million square feet of warehouse space to enter the market annually from 2010 to 2012, which is less than one-third of the ten-year historical average.²⁰ Driven by inventory restocking and new orders, the manufacturing sector grew for the fifth consecutive month in December 2009 as the Purchasing Managers Index (PMI) rose to 55.9%, its highest reading since April 2006.²¹ Meanwhile, international trade continued to improve. November U.S. imports and exports expanded by 6.9% and 5.6% respectively compared to the monthly average of the third quarter. Both imports and exports are expected to recover by 2011-2012, benefiting U.S. warehouses.²² With the weak U.S. dollar and stronger economic growth overseas, U.S. exports should pick up strength. As such, demand for warehouse space is expected to accelerate in 2011. We continue to like coastal gateway markets and intermodal hubs serving the global supply chains that can capitalize on the improving volume of import and export goods.

During the fourth quarter of 2009, industrial transaction volume was \$2.6 billion, up from \$1.7 billion in the third quarter but still down from \$3.1 billion during the same period a year ago.²³ Average industrial transaction cap rates increased by 50 bps to 9.0% during the fourth quarter of 2009.²⁴ Dragged down by significant depreciation, the NCREIF industrial sector realized total returns of -2.6% during the quarter and -17.9% for the year, underperforming the overall NPI total returns of -2.1% and -16.8%, respectively.²⁵

Multifamily

Multifamily vacancy rates reached a record high during the fourth quarter of 2009 as rising unemployment continued to reduce rental demand. The unemployment rate for workers aged 19-35 years old, who are more likely to rent than own, is almost twice as high as the national average. During the fourth quarter, net absorption was mildly positive at 10,000 units, while 28,000 newly completed units were delivered to the market.²⁶ As a result, the national average apartment vacancy rate rose 20 bps to 8.0%, which is 140 bps high than the same period a year ago.²⁷ Both asking and effective rents declined by 0.7% over the quarter as landlords were forced to offer concessions and lower asking rents to compete for tenants.²⁸ We expect multifamily vacancy to bottom out during the second half of 2010, responding to stabilization in the labor market.

Government sponsored enterprises (GSEs) including Freddie Mac, Fannie Mae, and to a lesser extent the U.S. Department of Housing and Urban Development (HUD), continue to dominate the multifamily financing market. During the first ten months of 2009, GSEs originated almost 60% of all multifamily financing according to Real Capital Analytics.²⁹ The agency apartment mortgage rate is 5.5-5.8%, approximately 150 bps lower than that of other core property sectors.³⁰ These attractive financing terms are a key reason that multifamily deals accounted for almost 30% of all property transactions during the fourth quarter of 2009. Developers can still obtain construction loans if projects meet the GSE's conservative underwriting criteria.

Multifamily transaction volume improved to \$5.0 billion during the fourth quarter, up from \$3.6 billion during the third quarter.³¹ The average transaction cap rate increased 20 bps to 7.4% during the quarter, 50 bps higher than the same period a year ago.³² During the fourth quarter of 2009, NCREIF reported a total return of -1.8% for the multifamily sector, outperforming the overall NPI. For the year, the multifamily sector posted a total return of -17.5%, underperforming the overall NPI.³³

Office

The U.S. has lost 2.0 million office-using jobs since the beginning of this downturn, with additional losses expected in the first two quarters of 2010. Preliminary data showed a surprising gain of 48,000 office-using jobs in December.³⁴ Nonetheless, the number of jobs lost in this downturn is nearly twice the amount lost during the downturn in 2001-2003.³⁵ With a deeper hole to dig out of, this recovery cycle is likely to be longer than the last one. Office fundamentals continued to weaken in the fourth quarter of 2009, though at a slower pace, as fewer companies are downsizing and returning sublease office space to the market. New sublease space listings have slowed down significantly since the summer of 2009 with a total of 76.7 million square feet of vacant sublease space currently available, representing approximately 0.9% of total stock.³⁶

During the fourth quarter of 2009, the national average office vacancy rate rose 20 bps to 16.3%, a 15-year high.³⁷ This marks the eighth consecutive quarterly vacancy increase since the beginning of 2008. We expect weakened fundamentals and limited financing availability to continue to deter development projects, with an average of just 22 million square feet of office space delivering annually from 2010-2013, less than half of the annual average rate over the past ten years. We believe this should help mitigate the overall effect on vacancies over the next few years. National asking rents and effective rents fell by 1.1% and 1.9% respectively during the quarter as landlords increased concessions in an attempt to maintain building occupancy.³⁸

In the fourth quarter of 2009, office transaction volume declined to \$4.5 billion, compared to \$4.7 billion in the third quarter and well below the \$7.7 billion during the same period of 2008.³⁹ The ongoing bid-ask gap and limited financing are the two biggest hurdles in closing large office transactions. The average transaction cap rate rose 50 bps to 9.1%, which is 180 bps higher than the same period a year ago.⁴⁰ The NCREIF office sector posted a total return of -2.8% for the fourth quarter, slightly underperforming the overall NPI. For 2009, the office sector posted a total return of -19.1%, 230 bps below the overall NPI. The annual appreciation decline in the office sector was the steepest of the five property sectors at -24.3%.⁴¹

Retail

U.S. retailers experienced a better-than-expected Christmas season as consumers let loose some pent-up demand and retailers carefully managed inventories and promotions. Retail sales rose 3.4% in December compared to a very weak December in 2008. Combined with a 0.9% gain in November, holiday retail sales rose 2.3% year-over-year to \$509.3 billion for the two-month holiday period.⁴² Nonetheless, U.S. consumers are still facing several significant headwinds, including high unemployment, modest income growth, deleveraging, and reduced household wealth. We believe that the worst period for retail sales is probably over, but do not expect a

quick rebound. We believe that consumer spending will likely remain constrained in the near future and retail fundamentals could continue to weaken, albeit at a slower pace, into 2011.

Neighborhood and community shopping centers experienced negative 3.5 million square feet of net absorption during the fourth quarter of 2009 with vacancy rising to 10.6%.⁴³ Both asking rents and effective rents for neighborhood and community shopping centers continued to decline as landlords faced vacant space and less favorable lease negotiations.⁴⁴ Deterioration in fundamentals was also pervasive in regional and super regional malls, with vacancy rising 20 bps to 8.8% and asking rents falling by 0.4% over the fourth quarter.⁴⁵ Value centers, neighborhood/necessity retail, and high productivity malls in high income and high growth markets continue to outperform the overall retail market.

Investors showed elevated interests in retail assets in the fourth quarter of 2009, with transaction volume rising to \$5.5 billion, compared to \$4.2 billion in the same period in 2008.⁴⁶ The average transaction cap rate remained unchanged at 8.1% during the quarter, but was still 80 bps higher than a year ago.⁴⁷ The sector achieved a total return of -0.9% over the fourth quarter, the best performing sector within the NPI. The sector also significantly outperformed the overall NPI over the year, posting a total return of -10.9%.⁴⁸

Hotel

The U.S. Hotel Industry Leading Indicator, a composite indicator that leads the lodging industry's business activity by four to five months, increased 1.8% in December 2009, the ninth consecutive monthly increase.⁴⁹ The industry has shown positive signs of stabilization with 11 of 25 top hotel markets experiencing gains in occupancy during the fourth quarter.⁵⁰ The Luxury segment in particular reported increases in all three key performance metrics (Occupancy, ADR and RevPAR). Nonetheless, compared to the same period a year ago all three metrics remained weak, as room supply still substantially outweighed room demand. In year-over-year measurements, the industry's occupancy dropped 4.4% to 50.6%, ADR fell 7.6% to \$95.8, and RevPAR decreased 11.7% to \$48.5.⁵¹

Looking forward into 2010, we believe the lodging industry should face easier year-over-year comparisons, and improving economic conditions may increase the propensity for both business and leisure travel. As RevPAR starts to accelerate, we expect hotel owners will benefit from positive operating leverage due to significant cost containment actions implemented over the past 18 months. With supply growth slowing in 2010-2011, room demand should also bounce back with the broader economic recovery.

During the fourth quarter of 2009, hotel transaction volume remained bleak as investors continued to avoid hotel assets. Only \$450.9 million of hotel assets were traded, compared to \$694.3 million traded in the third quarter of 2009 and well below the same period in 2008.⁵² The average transaction cap rate rose 110 bps to 9.2% over the quarter.⁵³ Hit by significant depreciation, the NCREIF hotel sector achieved a total return of -3.6% in the fourth quarter, the worst performing sector within the NPI. For the year, the hotel sector posted a total return of -20.4%.⁵⁴

Important Information

This publication has been prepared on behalf of ING Real Estate ("ING") solely for informational purposes. It is not investment advice or an offer or solicitation for the purchase or sale of any financial instrument. While reasonable care has been taken to ensure that the information contained herein is not untrue or misleading at the time of publication, ING makes no representation that it is accurate or complete. The assumptions used in making forecasts rely on a number of economic and financial variables. These variables are subject to change and may affect the likely outcome of the forecasts. The information contained herein is subject to change without notice. ING and any of its officers or employees may, to the extent permitted by law, have a position or otherwise be interested in any transactions, in any investments (including derivatives) referred to in this publication. ING may provide banking or other services (including acting as adviser, manager, lender or liquidity provider) for, or solicit banking or other business from, any company referred to in this publication. Neither ING nor any of its officers or employees accepts any liability for any direct or consequential loss arising from any use of this publication or its contents. Copyright and database rights protection exists in this publication and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. Any investments referred to herein may involve significant risk, are not necessarily available in all jurisdictions, may be illiquid and may not be suitable for all investors. The value of, or income from, any investments referred to herein may fluctuate and/or be affected by changes in exchange rates. Past performance is not indicative of future results. Investors should make their own investment decisions without relying on this publication. Only investors with sufficient knowledge and experience in financial matters to evaluate the merits and risks should consider an investment in any issuer or market discussed herein and other persons should not take any action on the basis of this publication. Additional information is available on request. At the date hereof, the author, and/or the ING Group may be buying, selling, or holding significant long or short positions; acting as investment and/or commercial bankers; be represented on the board of the issuer; and/or engaging in market making in securities mentioned herein.

In the United Kingdom, this report is approved and distributed by ING Real Estate Investment Management (UK Funds) Limited which is Authorised and Regulated by the Financial Services Authority. Interested parties are advised to contact the ING entity they currently deal with, or the ING entity that has distributed this report to them. Transactions should be executed through an ING entity in the client's home jurisdiction unless otherwise permitted by law. This publication is intended to provide information to assist investors in making their own investment decisions, not to provide investment advice to any specific investor. Investments discussed and recommendations made herein may not be suitable for all investors: readers must exercise their own independent judgement as to the suitability of such investments and recommendations in light of their own investment objectives, experience, taxation status and financial position. Past performance is not necessarily indicative of future performance: the value, price or income from investments may fall as well as rise. It is not intended for use by Retail Clients as defined by The Financial Services and Markets Act 2000. You should not deal in derivatives unless you understand the nature of the contract that you are entering into and the extent of your exposure risk.

-
- ¹ Bureau of Economic Analysis, January 2010.
 - ² Bureau of Labor Statistics, January 2010.
 - ³ Ibid.
 - ⁴ Moody's Economy.com, January 2010
 - ⁵ Bureau of Economic Analysis, December 2009
 - ⁶ Moody's Economy.com, January 2010.
 - ⁷ S&P Case-Shiller Home Price Index, January 2010.
 - ⁸ Moody's Economy.com, January 2010.
 - ⁹ Bloomberg News, January 27, 2010.
 - ¹⁰ Standard & Poor's, January 2010.
 - ¹¹ NAREIT, January 2010.
 - ¹² Kearny Capital Partners, December 2009.
 - ¹³ Ibid.
 - ¹⁴ ING Clarion Capital, January 2010.
 - ¹⁵ Real Capital Analytics Troubled Assets Radar, October 2009.
 - ¹⁶ NCREIF, October 2009.
 - ¹⁷ Real Capital Analytics, Capital Trends Monthly, September 2009.
 - ¹⁸ Ibid.
 - ¹⁹ CBRE-EA, December 2009.
 - ²⁰ CBRE-EA, December 2010.
 - ²¹ Institute of Supply Management, January 2010.
 - ²² Moody's Economy.com, January 2010.
 - ²³ Real Capital Analytics, Capital Trends Monthly, December 2009.
 - ²⁴ Ibid.
 - ²⁵ NCREIF, January 2010.
 - ²⁶ REIS, January 2010.
 - ²⁷ Ibid.
 - ²⁸ Ibid.
 - ²⁹ Real Capital Analytics, Capital Trends Monthly, December 2009.
 - ³⁰ Kearny Capital Partners, December 2009.
 - ³¹ Ibid.
 - ³² Ibid.
 - ³³ NCREIF, January 2010.
 - ³⁴ Bureau of Labor Statistics, January 2010.
 - ³⁵ Moody's Economy.com, January 2010.
 - ³⁶ CoStar, January 2010
 - ³⁷ CBRE-EA, December 2009.
 - ³⁸ Ibid.
 - ³⁹ Real Capital Analytics, Capital Trends Monthly, December 2009.
 - ⁴⁰ Ibid.
 - ⁴¹ NCREIF, January 2010.
 - ⁴² Moody's Economy.com, January 2010.
 - ⁴³ REIS, January 2010.
 - ⁴⁴ Ibid.
 - ⁴⁵ Ibid.
 - ⁴⁶ Real Capital Analytics, Capital Trends Monthly, December 2009.
 - ⁴⁷ Ibid.
 - ⁴⁸ NCREIF, January 2010.
 - ⁴⁹ Smith Travel Research, January 2010.
 - ⁵⁰ Ibid.
 - ⁵¹ Ibid.
 - ⁵² Real Capital Analytics, Capital Trends Monthly, December 2009.
 - ⁵³ Ibid.
 - ⁵⁴ NCREIF, January 2010.