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since 2007, and the economy added slightly more than 900,000 new jobs in the 11 months ending November 2010; at that rate, eight years will pass before merely the jobs lost in the recession return. To make a meaningful dent in unemployment, the economy must add at least 250,000 jobs per month.

Given the depth and financial origin of the recent recession and subsequent slow recovery, no "silver bullet" will quickly drive down unemployment near term to even 7–8%, much less the 5% level enjoyed in 2005 and 2006.

To the contrary, the significant headwinds against reducing unemployment are both systemic and structural. Businesses of all sizes are reluctant to add costs and hire new employees until they have a clearer idea of final product demand, future tax policy, and the costs associated with the massive healthcare and financial reform legislation passed in 2010. Adding to this angst is the rapidly rising cost of providing unemployment insurance. Although employers traditionally cover state unemployment insurance up to 20 weeks, as unemployment has grown and the federal government has extended emergency unemployment benefits, states have had to borrow money to meet their unemployment benefit obligations, which businesses will ultimately have to repay, with interest, during the next five years. Increases in business unemployment insurance taxes are expected to rise from $36 billion in 2009 to more than $60 billion by 2015.

Chicken-and-Egg Dilemma

Given the outlook for modest economic growth, unemployment is likely to remain above 9% this year. The "chicken-and-egg" nature of rapidly reducing unemployment is compounded by several additional factors:

- Small companies, which account for approximately half of private sector job creation, have been slow to hire. Newly opened companies created a seasonally-adjusted total of 2.6 million jobs in the three quarters ending March 2010—15% less than the first three quarters following the prior recession, when investors and entrepreneurs were still trying to dig themselves out of the Internet bust.
  And while banks appear to have increased their commercial and industrial lending in the fourth quarter according to Moody's Analytics small businesses also face limited access to debt financing. Community and regional banks, historically the prime source of debt financing for small businesses, are saddled with huge potential losses on their commercial real estate loans and are reluctant or unable to lend. Until financing becomes more readily available, small business hiring is likely to continue to lag.

- With significant excess capacity (factory utilization is 75%), U.S. companies have little incentive to invest their record $1.9 trillion cash in new plant and equipment, except where the investment improves productivity and reduces the need to hire more workers.

  Companies weathered the worst recession since the Great Depression by cutting costs, laying off workers, and increasing productivity. Given the uncertain economic and political outlook, lack of strong final demand, and inability to raise prices, adding full-time employees is not a priority. When necessary, companies are adding temporary help, which can be quickly and inexpensively laid off if the economy falters. Twenty-six percent of all private sector jobs added in 2010 were temporary, compared to only 11% after the 1990 recession. While many of these temporary workers could become permanent as the economy recovers, long-term unemployment may increase if the recovery slows.

- Manufacturing, which has led the recovery, is not having the historically expected impact on employment. In the late 1970s the United States held almost 20 million manufacturing jobs among a population of 220 million; today 11.6 million manufacturing jobs are spread across a country of 303 million.

  Manufacturing is unlikely to rehire anywhere near the 2 million employees laid off in the past two to three years, much less replace the 6 million manufacturing jobs lost in the past 12 years.

- Job losses among state and municipalities could reach 900,000 in the next two years, according to the nonpartisan Center on Budget and Policy Priorities, negating any

growth in federal government jobs. Adding to the potential economic impact of the absolute loss of hundreds of thousands of state and municipality jobs is the generally high-paying nature of these government jobs. During the past 30 years, globalization has limited employee compensation in the private sector, resulting in relatively flat private sector employee purchasing power during the past decade, but municipal employees have been averaging 3% or more in salary increases and even greater hikes in benefits, according to economist A. Gary Shilling.

Last year, states and municipalities cut 258,000 jobs (1.3% of their 19.5 million workforce) to cope with growing deficits. This year states alone are facing budget shortfalls of $160 billion, which are expected to be $140 billion in fiscal 2012, according to the Center on Budget and Policy Priorities. Unlike the federal government, states and municipalities must balance their budgets annually, and so they have little choice but to reduce spending and/or raise taxes to fill their budget shortfalls.

Worse, $56 billion of federal stimulus money to help states balance their budgets in fiscal 2011 is likely to dry up this year. Additionally, the Build America Bond program, which since 2009 has allowed states and municipalities to borrow $167 billion with federal subsidies for interest costs, is ending and may not be extended. As a result, the once sanguine $2.7 trillion market for municipals is being roiled by investor concern about the strained finances and the lack of transparency regarding future pension payouts and healthcare obligations. In a recent study by Northwestern University's Kellogg School of Management, unfunded pension benefits for states could total $3 trillion and municipalities may be facing more than $570 billion of unfunded pension liabilities. The recent sell-off in the municipal bond market and the threat that several cities may default on their bond is raising fears of a systemic credit crisis in municipal bonds similar to the European sovereign debt crisis.

- The growing number of people who have been unemployed longer than six months is an increasing impediment to reducing unemployment. More than 6.3 million people—more than 40% of those unemployed—have been out of work for longer than six months. According to U.S. Department of Labor data, people out of work for only five weeks or fewer were more than three times as likely to find a job in a few months than people who have been out of work for one year.

  While the recently enacted extension of unemployment insurance to up to 99 weeks will help consumer spending this year and the economic recovery, a recent study by the Federal Reserve Bank of San Francisco estimated the unemployment rate at the end of 2009 at a half percentage point lower if jobless benefits had not been extended beyond their 26 weeks. Putting aside the $56 billion in costs, extending unemployment insurance could create a situation similar to that in Europe, which suffers from 9–10% chronic unemployment.

Combined with the generally slow economic recovery, the systemic and structural problems are likely to result in the U.S. experiencing a prolonged period of chronic high unemployment near 8%.

Housing Market Undervalued but Declining

The housing market must stabilize before the economy can return to solid footing. Unfortunately, despite record-low mortgage rates and home prices 17% undervalued relative to disposable per capita income, according to the Case-Shiller Index, people are not buying houses. Existing home sales declined 2.2% in October to an annually-adjusted 4.43 million units—26% below the 5.98 million unit level achieved in October 2009, when sales were surging prior to the expiration of the first-time buyer tax credit. Residential construction, which accounted for approximately 55% of total U.S. construction in 2006, has plummeted. During the twelve months ending June 2006, Americans spent $643 billion on building homes and apartments, but residential construction dropped 60% to around $260 billion in the twelve months ending June 2010.

While this drop will bring supply and demand into balance more quickly it is increasing unemployment and dampening demand for housing near term.

Home prices saw a short-lived recovery in the second quarter of 2010, only to fall 3.6% in the third quarter. Home values are expected to fall another $1.7 trillion in 2010, according to a report by the research firm Zillow. In total, home values have reduced personal net worth by close to $8 trillion since the housing bubble burst in 2007. With more than 10 months' inventory of unsold homes, a foreclosure pipeline bulging at 4.6 million homes, plus another 2 million of unsold homes held by banks, the housing market appears to be "double dipping."

Economists are forecasting that home prices will drop between 5% and 12% in the next twelve months, adding to the more than 11 million mortgages already underwater and increasing the potential for more foreclosures. Federal Reserve Chairman Ben Bernanke recently highlighted the danger which further declines in home prices pose, noting that "33% of home borrowers have equity cushions of only 10% or less, putting them at risk if home prices decline much further."

The latest crisis to hit housing is the so-called robo-signing of foreclosure documents by loan servicers, which has launched a series of new challenges likely to further delay a housing market recovery—probably until 2012. Reacting to new lawsuits and ongoing investigations by the 50 state attorney generals, several banks have sharply curtailed home seizures, which fell 9% from September to October—the biggest decline in a year—as they sort out and, where necessary, refine their document review and foreclosure notification process. The time required to foreclose a property is now approaching 500 days; some may argue that the more than one million people living "free" provide an additional stimulus to the economy, but the much-needed recovery in housing is being delayed.

The "robo crisis" has further pressured home sales, as buyers, particularly investors who purchased foreclosed homes, are stepping to the sidelines until the uncertainties surrounding the legal documentation of foreclosed homes are resolved. Approximately 30% of home sales last year were foreclosed homes, according to RealTrac. Not only is the inventory of unsold homes held by banks increasing; future home prices will likely be depressed once documentation issues are resolved and banks begin dumping the homes they own onto the market.

Most recently, rising interest rates are hitting home sales. Ten-year Treasury rates have jumped to higher than 3.3% from a low of about 2.3% in early October as investors react to the Fed's Q2 program and the extension of the Bush tax cuts. As a result, 30-year mortgage rates—which hit a record low of 4.12% in the fall—have shot up to higher than 4.6% in mid-December. Combined with tighter bank lending standards, the increase in rates will likely further drag on home buying.

The housing market continues to suffer from excess inventory, foreclosures, and declining prices, yet many of these problems could be overcome if unemployment declined to 7–8%. Between 2002 and 2006, close to 50% of all new jobs created in the economy were in one way or another driven by the housing boom. Unfortunately without a recovery in housing, reducing unemployment will be that much more difficult.

Consumers Try to Rally

Never let it be said that the U.S. consumer isn't willing to give spending the "old college try" even when burdened with high unemployment, stagnant wages, heavy debt, and tight credit. November was the sixth month of rising consumer spending, pointing to a strong rebound as consumer confidence hit a five-month high in the fourth quarter. Real annualized consumption growth was 2.8% in the third quarter—the strongest performance since the fourth quarter of 2006. Economists expect consumer spending to grow at an annualized rate of close to 4% in the fourth quarter.

Hoping to keep consumers spending during the all-important Christmas season, retailers have been aggressively slashing prices and the strategy is working. More Americans—an estimated 212 million—shopped during Thanksgiving weekend (approximately 9% of Christmas season sales, according to the National Retail Federation) than ever before, and online shopping accounted for the highest share of the weekend's sales ever. In-store sales increased approximately 3% from 2009 and online sales were up close to 30% year over

year. Even if sales growth slows in December, annualized real consumption could accelerate to 3.5–4.0% in the fourth quarter, from 2.8% in the third quarter, according to Capital Economics. The International Council of Shopping Centers is predicting 6–8% year over year growth in holiday retail sales.

The outlook for consumer spending in 2011 is cautiously optimistic, especially since the Bush tax cuts have been extended for two years and a one-year extension of long-term unemployment benefits and the payroll tax cut were enacted, giving consumers $550 billion to spend in 2011 and another $350 billion in 2012. Partially offsetting the positive impact of these actions is expected higher fuel and food prices and rising state and city taxes and fees as they struggle with ballooning deficits. Consumer spending is expected to grow 2.4–2.7% this year.

While consumer spending growth of 2.4–2.7%will keep the recovery on track, it is below the 3.5% annual growth in consumer spending which drove economic growth prior to the recession. Consumer spending will continue to be weighed down by tougher lending standards, high unemployment, limited growth in personal income, and the need to reduce debt. Since 2007, annual wage growth has been cut in half, from 3.2% to 1.6%, and with unemployment running 9.8%+, personal income is expected to grow 2.2–2.4% this year.

Beyond 2011, consumers are unlikely to return to their pre-recession, free-spending ways as they grapple with the depressed housing market; an onerous level of household debt, which at 122% of disposable income needs to be reduced to a more manageable level of 100%; and close to $11 trillion of lost household net worth and the tepid outlook for income growth. Overshadowing these challenges is the trillions of dollars of government deficits (the government is currently spending $1.60 for each $1.00 of tax revenue it takes in) that must be reduced through a combination of tax increases and painful, draconian spending cuts, which will only add to consumer angst, reduce disposable income, and limit future spending.

Given these realities, consumer spending will unlikely become the "knight in shining armor" returning GDP growth to 4.5–5.5% and reducing unemployment to 6–7% by 2013–2014.

Lots of Liquidity yet Financing Tough for Small Businesses

Corporate bonds, particularly below investment-grade junk bonds, have been selling like hotcakes as investors seek yield and perceive risk as manageable because corporate default rates have plummeted below pre-recession levels of less than 3%.

In the first nine months of 2010, investment-grade corporations issued more than $300 billion of debt, according to Thomson Reuters, and junk bond issuance was a record $172 billion. Yields on investment-grade corporate bonds are now averaging about 2% over 10-year Treasuries, and so-called junk bonds (below investment grade) are yielding around 6.0–6.5% over Treasuries, according to Barclay's Capital.

While access to cheap debt financing is generally positive for the economy—enabling companies to invest in plants and equipment and create jobs—unfortunately large companies are choosing to build their cash reserves, totaling approximately $1.9 trillion,(7.4% of total assets, the highest level since 1959) or raise capital to repay high-cost debt (S&P estimates that approximately 50% of new junk bond issues were used to refinance leveraged loans and/or make distributions to private equity owners), increase dividends, or make acquisitions—none of which materially add jobs to the economy. In a recent *Financial Times* interview, former Chairman of the Federal Reserve Bank Alan Greenspan attributed the lack of capital investment by companies to "the massive and growing government deficits which are causing uncertainties about future tax policy and the costs and uncertainties coming out of the frenetic pace of new government regulations which are impacting all aspects of corporate operations." It is unlikely that these issues will be resolved anytime soon.

At the other end of the corporate spectrum, small companies continue to struggle to obtain bank financing as community and regional banks, the primary source of small company loans, grapple with soaring residential and commercial real estate loans. The Congressional Oversight Panel found that nearly 3,000 small U.S. banks had CRE exposure exceeding 300% of their total capital. With loan losses rising, 60% of U.S. banks increased their reserves in the third quarter, which reduced funds

available for lending. Compounding the problem for smaller banks is the government bank auditors' aggressive monitoring of their lending and reserves for bad loans, and in many cases forcing them to tighten lending standards not only for business loans but also for home equity and mortgage loans, which entrepreneurs often use to finance new ventures.

By contrast, nine out of the ten largest financial institutions sharply reduced their reserves in the third and fourth quarters and are again lending. Unfortunately, the "big ten" tend to be focused on providing credit to large, well-established companies that also generate investment banking and other fees.

In an effort to kick-start small-business lending, the Administration has signed a bill to provide $30 billion of new capital to community banks. However, FDIC bank auditors are forcing banks to reduce risk exposure; thus small and regional banks will unlikely loosen their lending standards enough to increase credit availability significantly to small companies near term.

Challenging Expectations for Corporate Profits

For corporate earnings, 2010 was a banner year, with a more than 11% increase in the S&P 500 Stock Index. Versus 2009, earnings for S&P 500 companies were up 26% in the third quarter—the fourth consecutive quarterly increase—and profits are expected to grow in the fourth quarter. U.S. corporate profits rose in the third quarter to an annual rate of $1.66 trillion, the highest on record, according to the U.S. Department of Commerce. S&P 500 companies' 2010 profit per share is estimated to be $82,and analysts are forecasting growth to more than $95 per share next year.

The impressive growth in 2010 corporate profits has come almost entirely from cost reductions and efficiency improvements. As of the second week of November, earnings from S&P 500 companies on a trailing 12-month basis have rebounded 23% since the fourth quarter of 2007—yet sales have declined 9% during the same period.
Companies have cut more than 8.5 million jobs, meeting demand through productivity gains. Normally at this point in an economic recovery, productivity growth is on the decline, forcing companies to hire. Although having declined in 2010, productivity growth remains positive, rising 2.3% in the third quarter; as a result, companies can minimize hiring. Since labor accounts for approximately two-thirds of the cost of producing goods and services, companies have been able to more than offset a weak pricing environment and rising raw material costs by not hiring.

However, companies will unlikely be able to grow or even maintain earnings in 2011 solely through cost-cutting, especially since many commodities, such as oil and copper, are experiencing price increases of 20-25% in the past six months and states and cities are raising taxes and fees. To achieve analysts' projections for a 15% increase in the earnings of the S&P 500 companies this year, demand and sales must show solid improvement. Given the modest outlook for economic growth and continued low inflation, this forecast appears optimistic. Should corporate earnings fall short, any strong recovery in the equity markets will be hindered, which in turn could undercut the expected growth in consumer spending, particularly for high-end retail sales, which have an 82% correlation to stock prices, according to David Rosenberg, chief economist and strategist at Gluskin Sheff + Associates Inc..

New Fed Q2 Program: Potential for Unintended Consequences

In September, the Federal Reserve announced a new program of Quantitative Easing (Q2), aimed at further lowering long-term interest rates; driving investors into higher risk investments, such as equities; increasing inflation expectations to encourage the public to buy now; and stimulating exports by lowering the value of the U.S. dollar.

Under the Q2 program, the Fed plans to buy up to $900 billion of Treasury bonds during the next nine months—essentially financing the majority of the government's capital-raising needs for fiscal 2011. This program follows Q1, when the Fed purchased more than $1.5 trillion in government and mortgage-backed securities to provide liquidity to the financial system, which in 2008 was poised on the brink of a meltdown. While Q1 helped stabilize the financial markets, the jury is out on whether Q2 will accomplish its goals.

On the one hand, the announcement of Q2 has helped drive stock prices up since September. On the other hand, rates have jumped from about 2.9% for 10-year Treasuries to over 3.3%, as investors

questioned the Fed's ability to control the yield curve and shape public and market expectations regarding inflation without inadvertently sowing the seeds for future inflation, which could be difficult to control, given the economy's fragile recovery. The extension of the Bush tax cuts and unemployment insurance benefits have added to these concerns.

In addition, several other red flags are being raised about Q2. Specifically:

- With cheap, easy money, historically investors take outsized risks, creating asset bubbles that eventually burst. The tech boom and most recently the housing crisis were largely created by such cheap, easy money. Today the economy is not suffering from a liquidity problem—banks and corporations have plenty of cash—but missing is demand growth, and Q2 does little to stimulate that. Ironically, with no growth in demand lowering borrowing costs, it may encourage businesses to continue to invest in equipment to improve productivity and avoid hiring more employees.

- Increasing liquidity will likely neither ease credit conditions for small businesses dependent on loans from small banks with heavy exposure to CRE risk nor slow home foreclosures and mortgage defaults, since these result from falling home prices.

- Internationally, Q2 is drawing sharp criticism, particularly from emerging economies that fear that a cheaper dollar and low U.S. interest rates will drive up inflation in their countries and result in a war of competitive devaluations, ultimately leading to a trade war.

While Q2 is a creative new strategy to sustain the recovery with fiscal spending likely severely curtailed in the future, the approach is not without risk, particularly it if stokes the flames of inflation at a time when the Fed has limited ability to control inflation without raising rates, curtailing liquidity, and derailing the economic recovery.

European Sovereign Debt Crisis Is Looming Risk

The reemergence of a sovereign debt crisis in Europe poses yet another new risk for the U.S. economic recovery.

Plagued by large deficits and looming bank losses, Ireland finally agreed to a $110 billion bailout from the European Union (EU) and International Monetary Fund (IMF). Unfortunately, the bailout plan for Ireland has done little to contain the spreading fear that Portugal, Spain, Belgium, and even Italy will not be able to economically finance their ballooning deficits and potential bank loan losses without massive bailouts. The cost of financing these countries' debts has soared and is attracting "bond vigilantes," who exacerbate the problem by betting against the currencies and debts of countries perceived to be in trouble.

Further, unlike the U.S., Europe never required its banks to undergo in-depth stress tests. Many major European banks are saddled with illiquid assets with little value, and until investors have a clearer picture of the potential write-offs and losses facing European banks, the threat of a major financial crisis in Europe, which could spread to the rest of the world, remains a very real possibility.

The danger for the United States is threefold:

- U.S financial institutions and money market funds have invested in European sovereign debt and securities of European banks, which may have to be written off, thus pressuring U.S. financial institution reserves, profits, and, ultimately, lending. J.P. Morgan estimates that U.S. money market funds hold about $400 billion of their assets in foreign banks with sovereign debt exposure. Major U.S. banks' exposure to Greece, Ireland, Portugal, and Spain was $146 billion in the second quarter.

- A prolonged financial crisis in Europe will hurt Europe's recovery and U.S. exports.

- If the debt crisis spreads to several countries and requires massive bailouts, financially sound countries such as Germany and France may balk at providing aid, which ultimately could cause the collapse of the Euro. This major shock to the world financial system would threaten the global economic recovery and capital markets.

Capital and Low Rates Breathe Life into Commercial Real Estate (CRE) Markets

Despite high unemployment and lagging economic growth, CRE is attracting capital, transaction volume is growing, and cap rates are beginning to tighten. As a result, the mood among major CRE investors has shifted from a defensive/survival mindset to one of cautious optimism and growth. However, the market remains fragile and far from recovering from the 30-35% decline from pre-recession values. In addition, the industry must navigate through the $1.5 trillion of mortgage debt, which will come due between now and 2014.

CRE markets are expected to continue to recover this year, although the recovery will be tempered by lower return expectations, limited development, and tough lender underwriting.

According to the CoStar Group, approximately 1,460 companies and funds raised close to $80 billion for CRE investments and financing during the first nine months of 2010. In October, sixteen funds and firms reported raising another $8.3 billion of real estate-related capital.

Although credit markets remain tight, public REITs' access to the public markets is an important reason why many CRE markets have bottomed out and are recuperating. Public REITs raised $35 billion in new capital, including $20 billion of new equity in the first ten months of 2010, according to Debra Cafaro, chairman of the National Association of Real Estate Investment Trusts (NAREIT). And $35 billion was already raised in 2009, as a wave of recapitalizations helped REITs clean up their balance sheets. As a result, the REITs' average debt ratio has declined to close to 40% of total enterprise value, down significantly from the 66% at the trough of the downcycle in March 2009, and enabled them to resume growth through acquisitions, particularly during the second half of 2010.

With construction financing remaining scarce, the lack of new CRE construction combined with the economic recovery has helped stabilize property fundamentals and restore a tighter balance between supply and demand. At the same time, low interest rates are providing price support for CRE by lowering the cost of financing—financing costs for well-located, high-quality, stabilized CRE now ranges 5–6%—and supporting transaction returns. For example, the gap between average office property cap rates and the 10-year Treasury yield averaged approximately 250 bps between 2005 and 2007. The average cap rate/Treasury yield gap for office properties between 2009 and 2010 has widened to more than 450 bps. Partially offsetting the positive effect of the gap between borrowing costs and purchase price is the tighter underwriting standards lenders have adopted, which require borrowers to have lower leverage, more equity, and tougher loan covenants.

Transaction volume for office, retail, and industrial CRE properties is expected to hit $47–50 billion in 2010, up from $36.8 billion in 2009, according to Real Capital Analytics. While well below the $220 billion annual average volume for these property types between 2005 and 2007, the tone of the market and transaction volume continued to improve through the second half of the year and this momentum is expected to carry into 2011. Transaction volume for office, retail, and industrial CRE could grow to $100–120 billion with distressed properties, representing 20% or more of total CRE sales, as marginal properties facing refinancing increase. Average cap rates may tighten somewhat, perhaps by 5–10 bps, for high-quality, well-located, stabilized properties, with this tightening driven by strong institutional demand for quality assets. Cap rates for lesser quality properties and distressed assets are also expected to tighten, perhaps in the range of 35–75 bps, as confidence in the economic recovery grows and investors seek to deploy 2010 capital.

2010 Trends Endure

During 2010, several trends emerged and are expected to impact the market in 2011 and beyond, specifically:

- Demand for investment-grade, well-located, high-quality CRE is expected to remain strong as institutional investors seek acceptable risk-adjusted returns from stabilized, well-located properties with predictable cash flows. Further cap rate compression for high-credit, quality, stabilized properties is likely to be limited as prices for these types of properties have recovered to close to 2007 levels;

- Distressed office, industrial, and retail asset sales during the first half of 2010 were 6–10% of total CRE sales, according to Real Capital Analytics. At the end of the third quarter, approximately $68 billion of distressed office, industrial, and retail properties were in workout with servicers, excluding another $14 billion of these types of lender-held properties that will eventually have to be sold.

  Distress property sale volumes are expected to grow as approximately $500 billion of CRE mortgages come due in 2011 and 2012. Many of these loans were underwritten in 2005 and 2006 and will require significant additional equity to refinance. Although banks have been willing to "extend and pretend" to avoid write-offs, foreclosures will increase as more marginal properties fail to cover debt service.

  Investors have raised more than $200 billion to acquire distressed properties, according to Dr. Norm Miller, CoStar's vice president of analytics, but have been frustrated by the lack of available distressed properties. Many buyers have lowered their return target from 25–30% to a more realistic 15–20% in order to win deals.

- In 2010, private buyers dominating the weak CRE market in 2009 gave way to large institutional investors with access to capital—particularly public REITs, insurance companies, pension funds, and, to a lesser extent, foreign investors and non-traded REITs—a shift resulting in the increased average size of transactions. Large institutional investors are likely to continue as primary buyers of CRE, and large transactions should dominate CRE volume in 2011.

- The institutional buyer mix, which emerged last year, is also impacting pricing and demand for different property types. For example, Real Capital Analytics found that, although publically traded REITs bought office properties across a range of markets, central business districts (CBDs), and suburban markets in the third quarter, they were not the most aggressive bidders for trophy properties in Tier 1 cities such as New York, DC, San Francisco, and Chicago. In these cities, foreign buyers were aggressive, in some cases driving cap rates below 5%.

CMBS Market Revival Supports CRE Recovery

Supporting the recovery in CRE has been the reopening of the commercial mortgage-backed securities market. After essentially shutting down in 2009, its volume grew to more than $12 billion in 2010, driven by three factors:

- Underwriting standards were significantly tightened, greatly improving the quality of the loans being securitized. Also, the rating agencies increased subordination levels, thus making the highly rated tranches attractive to investors.

- Loan covenants and investor protections were greatly enhanced to reduce risk of recovery should problems occur.

- CMBS spreads tightened substantially from their peaks in 2009. Generic AAA bonds with 30% subordination are trading at roughly 250 bps over swaps—down from roughly 500 bps over swaps at the beginning of 2010 and 1100 bps over swaps in early 2009.

With Treasuries hovering around 3.3%, borrowers can finance stable properties at 5.25–6.00%.

The revival of the CMBS market has led several major investment banks and conduit lenders to staff up and again originate new loans for securitization. Assuming interest rates remain low, S&P expects conduit volume to grow to $25–30 billion in 2011–assuming no major increase in Treasury rates. Others are more optimistic, forecasting volume approaching $50 billion. While a far cry from 2007's more than $270 billion, the reopening of the CMBS market does provide borrowers with another source of capital. With $40 billion of CMBS conduit and $450 billion of other CRE mortgages and loans

maturing in 2011, every source of new capital supports the recovery in CRE.

The recovery of the CMBS market still faces strong headwinds beyond general economic conditions:

- CMBS loans 60 or more days delinquent continue to increase and are approaching a level close to 8%, according to the Fitch Ratings agency. So-called pro forma loans, which were underwritten in 2005–2007 and based on projected rather than in-place property cash flows, are encountering problems at an accelerating rate. At the end of September, 22.6% of pro forma loans, by balance, were delinquent and 31.1% were in special servicing, versus 13.0% for CMBS loans in general, according to Trepp.

- A maze of new, evolving, and at times conflicting government regulations is creating uncertainties for lenders. For example, lenders are facing conflicting risk retention mandates from the European Union, the FDIC and, by way of the Dodd-Frank Act, the SEC, which is also planning new sweeping disclosure and collateral reporting rules for securitizations, which will likely place onerous and costly reporting obligations on lenders.

- The rating agencies continue to play catch-up by downgrading bonds of past CMBS and adding to investor angst; for example, in October, Moody's surprised investors by announcing a review for downgrading close to 700 classes of past CMBS deals. These bonds totaled $50 billion from 49 transactions, mostly underwritten in 2006–2007.

Given investor and lender skittishness, these types of issues add to the challenge of rebuilding the CMBS market, but, barring some unforeseen disruption, the CMBS market should provide CRE investors a growing source of capital.

Uneven Recovery of Office Market Begins

As with most commercial real estate, "all properties are not created equal" – and that is certainly the case in the office sector, where trophy office properties in New York City, DC, San Francisco, and a handful of other 24-hour downturn core cities, are trading at pre-recession cap rates of 4.7–5.5% as foreign buyers and cash-flush, high net-worth investors bid aggressively for these properties. At the other end of the spectrum demand and pricing for suburban office properties is weak.

The office sector continues to suffer from corporate cost-cutting and lack of hiring. Office employment dropped 2.5 million during the recession, and since October 2009, companies have hired about 300,000 office workers— not close to the minimum to reduce office vacancies and stabilize net operating incomes (NOIs).

Overall office vacancies crept up to 17.6% in the third quarter from 17.4% in the second quarter, according to REIS, Inc. Faring better than the close to 19% of the suburban office market, CBD vacancies were approximately 14.9%. Construction of new office buildings remains negligible, which should help reduce vacancies and tighten the market during the next 12 to 18 months.

Given the cost-conscious culture engulfing corporate America and the bleak overall outlook for employment in general, rents are likely to remain under pressure, particularly for suburban office space in 2011. CoStar reports that quoted rents per square foot for both CBD and suburban office space declined in the third quarter. The average annual quoted rent was $26.64 per square foot for CBD office space, versus $20.51 for suburban office.

Year-to-date through the third quarter of 2010, approximately $20.6 billion of office properties traded, representing an 83% increase over the first nine months of 2009, according to Real Capital Analytics. Distressed property sales in the second and third quarters of 2010 represented approximately 15% of total sales by dollar volume and 20% of total transactions. At the end of the third quarter, Real Capital Analytics reports, approximately $48 billion in distressed office properties were in some form of workout. Distressed office sales are likely to remain a major component of office sales this year and next, given the volume of maturing office property mortgages. Overall

office transaction volume is expected to more than double during the next year to $45–50 billion.

Retail Retrenches, Waits for Consumers

During Thanksgiving weekend, holiday retail kindled a feeling of optimism that the worst may be behind us and that consumers will be returning to the stores this year. Since expectations for retail real estate were abysmally low as the recession deepened, retailers sharply retrenched, closing weak stores and downsizing others, enhancing inventory management, and laying off one million employees. While a large chunk of gross leasable retail space is likely to remain empty (5–10%, according to the Urban Land Institute), the retail CRE market seems to have stabilized and is positioned to benefit from the expected growth in consumer spending. As with most CRE sectors, retail real estate will also benefit from the lack of new construction. According to the Urban Land Institute, for the first time since the early 1950s no regional malls are under construction, and CoStar Group reports that there are only 31.8 million square feet of retail space under construction—less than 0.2% of total retail space. While this is good news, the U.S. has 40 square feet of retail space for each person – the most per person in the world. With Web sales growing (Web sales grew 15.5% during the holiday season) further reductions in retail space is likely even as the economy recovers.

By historical standards, retail vacancies remain high, but varying between regional/super malls and neighborhood community shopping centers. Mall vacancies are 8.8%, consistent with 2009, according to REIS, but, prior to the recession, in 2005 and 2006 mall vacancies were approximately 5.5%, despite significant new construction. Vacancies have been creeping up in neighborhood/community centers and were approaching 11% in the third quarter, according to REIS, up from approximately 10.3% the third quarter of 2009, and under 7% in 2005 and 2006.

Community/neighborhood centers are likely to continue to suffer in 2011 as malls and power centers lure supermarkets out of weak community centers, many of which are already under the gun from lenders unwilling to refinance them. Simultaneously, strong malls are poaching tenants, forcing weaker malls to cut rents to retain them, find new tenants, or simply shut down.

During the past two years, tenants have been pushing landlords for rent reductions and other concessions. REIS reports average annual asking rents for regional/super malls decreased to $38.72 per square foot in the third quarter of 2010, compared to $39.03 in the fourth quarter of 2009. Average annual asking rents for neighborhood and community centers were $19.01 in the third quarter of 2010, versus $19.13 in the fourth quarter of 2009. Effective rents after concessions were lower, at $16.53 in the third quarter of 2010.

Sales of retail properties in the first three quarters of 2010 totaled close to $12 billion, according to Real Capital Analytics, and could grow to $18 billion by year-end. The market for retail properties is stabilizing as the number of retail properties falling into distress has dropped sharply to $29.3 billion at the end of the third quarter, according to Real Capital Analytics. Distressed sales accounted for approximately 13% of dollar retail CRE sales and 16% of the sales of retail properties in the second and third quarters of 2010.

The retail CRE market is expected to begin recovering this year, as REITs and cash buyers seek fully leased, quality retail properties. Assuming that interest rates remain low, cap rates for these quality properties should tighten further. Retail properties in secondary locations will remain under pressure as buyers look for "steals." While transaction volume is expected to grow to $30–35 billion this year, rents are likely to remain under pressure until vacancy rates drop below 10%, likely sometime in 2012.

Industrial Benefits from Exports and Inventory Rebuild

Despite 2009's most severe drop in occupancy ever recorded by REIS, when net absorption of industrial space was a negative 72.7 million square feet, the industrial CRE market snapped back in 2010 as businesses rebuilt inventories and demand for U.S. exports increased. As a result, investors continued to have strong appetites for industrial properties despite declining rents and vacancies close to 11.4%, according to REIS.

Third quarter sales of industrial properties totaled $4 billion— the highest quarterly sales volume in two years and 25% higher than sales in the second quarter, according to Real Capital Analytics. For the year, industrial property sales were

approximately $13.5 billion, up from $8 billion in 2009 and could reach $18-20 billion in 2011.

Rents declined in 2010, although concessions were reduced as the year progressed. REIS reports that ask levels for annual average rents for industrial properties were $4.58 per square foot in 2010. Effective rent was $4.19 per square foot, down from $4.70 in 2007. Rents are not likely to recover quickly, even as the vacancy rate declines in 2011, since a number of rolling five-year leases will be coming off peak rents in the next two years, putting a damper on overall rents and net operating income.

Only approximately $2.5 billion worth of industrial properties were distressed at the end of the third quarter, representing only 5% of third quarter sales, according to Real Capital Analytics.

The industrial market is facing significant changes likely to impact property values in this sector during the next ten years. New distribution models, driven by Internet shopping and domestic point-to-point shipping, will impact warehouse locations and configurations. Also, the widening of the Panama Canal, whose completion is due in 2015, is already impacting deep water ports and distribution facilities on the west coast and is likely to result in increased rail transport from expanding Mexican ports to locations in the United States and result in the need for more pre-sort export capabilities. Against this background, industrial properties along the coasts and those served by rail will likely be in more demand than industrial properties located in the middle of the country.

Summing Up

The economy is expected to continue its modest recovery in 2011, but will remain fragile as high unemployment, a depressed housing market, excess manufacturing capacity, heavy consumer debt, and tight credit increases the chances of some unforeseen shock, such as a default by a major municipality, further worsening of the European Sovereign debt crisis, a jump in interest rates, or a military conflict in the Mideast or Korean peninsula, which could derail the recovery. Unlike housing, the CRE market appears to have bottomed out and is beginning to recover, particularly for well-located, high-quality properties where institutional and REIT demand is likely to remain strong. Lesser quality, non-stabilized properties and those in distress are likely to remain under price pressures, especially given the growing volume of CRE loans which will be maturing during the next five years and will be difficult to refinance, given the 30–35% decline in CRE property values and the new, tougher underwriting standards.

Sustaining and building on the CRE markets' early signs of recovery in 2010 depends on not only the economy's continued growth but also interest rates remaining low and an increasing flow of capital available to finance transactions. These requirements for growth seem to be in place as we enter 2011.

CapLease Resumes Growth

CapLease closed over $40 million in property acquisitions and construction-to-acquisition projects in the second half of 2010 as the CRE market in general and the net lease market in particular began to recover.

"We expect to see transaction volume grow in 2011. Our pipeline of potential property acquisitions continues to grow. At the same time, the popularity of our construction to acquisition program is growing as we are partnering with additional developer to bid on build-to-suit transactions," noted Paul McDowell, CapLease's Chairman and CEO.

We believe the Company's approximately $35 million cash on hand, $140 million revolving credit agreement with Wells Fargo Bank, puts CapLease in a strong position to take advantage of market opportunities as they arise" noted Mr. McDowell.

Dividend Raised 8%

CapLease's Board of Directors announced an increase in the company's quarterly dividend of 8% beginning with the fourth quarter of 2010 to $.065 per share. The increase reflects the Company's significant progress on its business plan which saw approximately $90 million reduction in debt and the restart of portfolio grow during 2010.

Paul McDowell, stated, "We are pleased to announce the increase in our dividend which reflects the Company's progress and achievements in 2010. Our dividend is well covered by existing operations and further by the Company's recently announced investment transactions. We are optimistic that we will continue to grow the portfolio and generate strong cash flows in 2011."