

A Double-Dip Recession and US Commercial Real Estate

July 2010

Table of Contents:

The US Economy in Perspective	1
Financial Markets in Perspective	2
Prospects for the US Economy	3
History of US Recessions and Double-Dips	5
Implications for Commercial Real Estate.....	6

The recent weakening in both financial conditions and headline economic data is questioning the durability of the US economic recovery which began in earnest starting in the second half of 2009. Against the backdrop of this nascent rebound, both the equity and bond markets appear to be discounting a “double-dip” recession in the US. Investors are also increasingly jittery about European sovereign debt issues, a perceived slowdown in China, and weakening indicators in the US.

True to form, the phrase “double-dip” is making headlines across the mainstream business media. The most common definition of a double-dip recession is an occurrence whereby the economy enters into recession within a period of less than 12 months following the end of the previous recession. In the event of a double-dip recession in the US, any hopes for improving commercial real estate market conditions will evaporate. The US commercial real estate market remains fragile. Despite the lack of speculative development and oversupply in this real estate down-cycle, the sharp contraction in demand for space has driven vacancy rates for most property sectors to record highs. A further exogenous shock that disrupts demand is sure to drive vacancy rates even higher, rents lower and place further downward pressure on real estate values.

What is the likelihood of a double-dip recession in the US? What would be the likely fall-out on commercial real estate? To provide insight, we first examine the recent evidence on US economic performance and financial market conditions. We will next update our latest thinking on the prospects for the US economy. This is followed by a historic retrospective on US recessions since the Great Depression with an assessment of the recurrence of double-dip recessions domestically. Implications for real estate investors will be presented at the end.

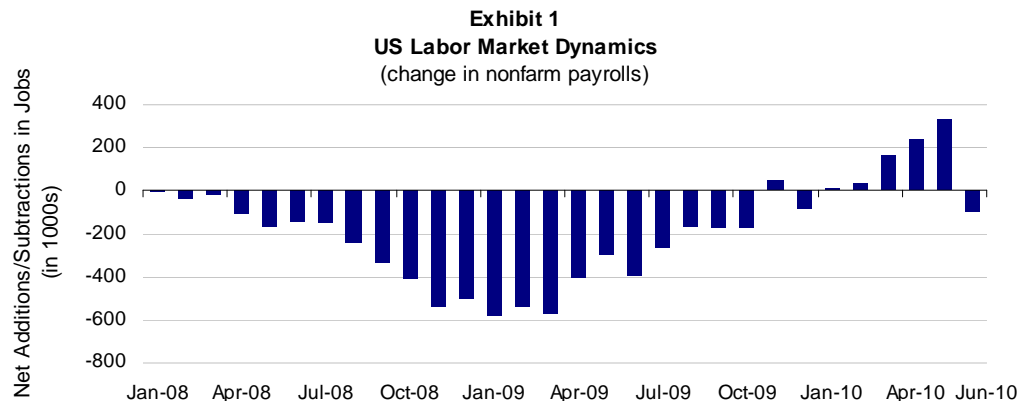
Prepared by:

Asieh Mansour, Ph.D.
 Managing Director
 San Francisco
 USA
 (415) 262-2044
 asieh.mansour@rreef.com

Production by:
 Michelle Woods

The US Economy in Perspective: Recent Evidence

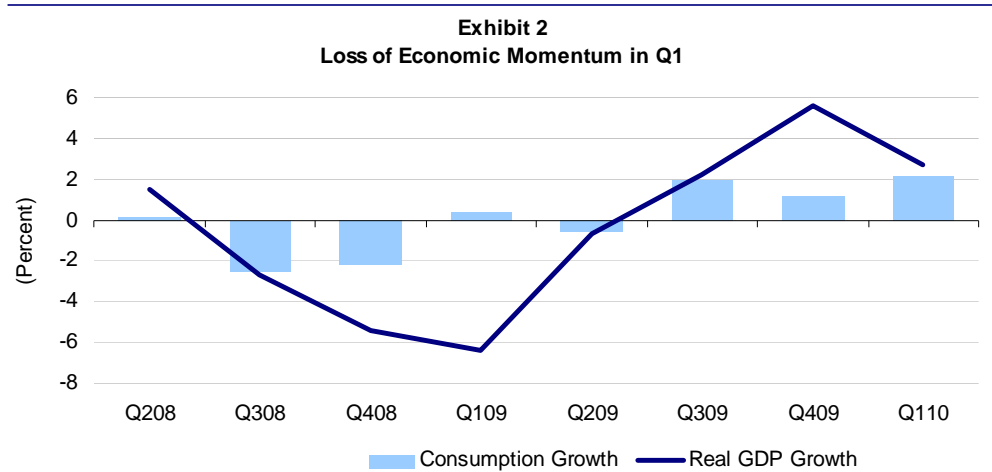
The most recent economic data and leading indicators are pointing to a soft-patch ahead. The labor market has disappointed given this phase of the business cycle. Exhibit 1 provides the trend in the change in nonfarm payroll employment.



The labor market has made only modest improvement in June. This is an anemic recovery by historical standards. After having lost almost 8.4 million jobs during 2008 and 2009, the labor market recovery has been tepid. Nonfarm payrolls fell by 125,000 last month as the Census Bureau laid off 225,000. The more important gauge of private sector payrolls increased by 83,000, below consensus expectations. By contrast, the unemployment rate fell to 9.5%, but this was mostly due to a decline in the number of people looking for work.

Analysts point to the relative weakening of the labor market as evidence supporting a double dip. There exist many downside risks to the labor market given still weak business and consumer confidence, lack of access to credit for small business, and the dampening impact on US growth from weakness in Europe and any slowdown in China.

The softer than expected labor market has also restrained consumer spending as reflected in the recently revised update to first quarter real GDP. Exhibit 2 provides a snapshot of output growth and growth in consumer spending since the second quarter of 2008.



First quarter real GDP growth was revised down to a 2.7% annualized rate. Much of the revision was due to weaker consumer spending data. The US economy continues to expand but not at a pace to drive consumption higher nor at a rate to create a healthier number of jobs.

Housing data over the past several weeks has also been disappointing. New and existing home sales and housing starts continue to weaken. This was not unexpected, however, given the elimination of the homebuyer tax credit. The manufacturing sector, as proxied by the ISM diffusion index, is also losing some momentum but still signals expansion. The fiscal boost from the Obama administration is also fading as even the non-manufacturing ISM is losing momentum.

Financial Markets in Perspective

Financial conditions have been under stress as well. The equity markets have been in a sharp decline since last May and volatility in the listed markets has increased significantly in recent weeks. The substantial surge in the exchange value of the dollar and fall in treasury yields are further indicators of massive risk aversion globally. We have also witnessed some growing stress in the interbank lending market. Exhibit 3 tracks movements in the TED spread. The TED spread spiked in the aftermath of the Lehman collapse to an all-time record. More recently, it had fallen back to a more normalized level. Recent events, however, have driven the TED spread slightly higher as investors have become more risk averse.

**Exhibit 3
TED Spread***



Source: Bloomberg and RREEF Research, as of July 2, 2010

*The TED spread is the difference between the interest rates on interbank loans and short-term US government debt ("T-bills"). In Exhibit 3, this specific TED spread is the difference between interest rates for three-month US treasuries and the three-month Eurodollar contract as represented by LIBOR. The TED spread marks RREEF Research's most favorite indicator of perceived credit risk in the general economy.

Prospects for the US Economy: 2010 and Beyond

Are conditions so dismal, however, to lead to a double-dip recession? We do not believe that the recent financial and economic evidence supports the dreaded double-dip, rather is consistent with much slower economic growth for the balance of 2010 as has been the original forecast of RREEF Research. The US economy entered the second quarter with great momentum and it is leaving it with none. The labor market is weak, consumers are restrained, the housing market remains under pressure, the inventory cycle is softening and both manufacturing and the service sector are reporting slower growth. The evidence, however, is not weak enough to support a double-dip recession and the probability of one occurring over the next 6 months is not more than 25%. The recent data on the economy and financial markets, however, is consistent with continuing, but slower expansion.

Investors have also become over-sensitized to conditions in financial markets and the mixed readings on the US economy. Event risk, especially as it relates to developments in Europe and a slowdown in China, are being given a great weight in investor expectations. We strongly believe that as European governments provide more decisive solutions to the sovereign debt crisis that is endemic across many member states, albeit at varying degrees, this heightened investor risk aversion should diminish and public market volatility should subside.

The US economy is also much different structurally than just a couple of years ago. Business and household discretionary spending on durable goods and structures (main drivers of recessions and expansions) has already been compressed to record low levels. There is, therefore, no massive slack in the system given the underlying base demographic net demand in the US economy. Moreover, corporations have made great strides in improving their balance sheets, having an estimated \$1.7 trillion of cash ready for new expenditures.

Consumer confidence in the US has also plunged but a large part of that can be tied back to the BP oil spill as the Gulf States continue to report the biggest drop in confidence. The University of Michigan gauge of consumer confidence has actually been rising recently, even though it remains at depressed levels.

The US economy also has one important growth driver that is being overlooked by the gloomy business media: exports. The strong growth in Asian and Latin American countries is a key driver of stronger US export growth going forward. China's recent decision to revalue the renminbi should also improve global rebalancing in favor of US growth longer term.

Additionally, lean inventories and the rebound in exports are buoying the US manufacturing sector. While the manufacturing ISM has retreated recently, it is still at a level that is signaling solid expansion of the US economy.

Forecast highlights for the US economy are presented in Table 1. We have now downwardly revised our real GDP outlook from 3.4% in 2010 to 3.1%, but still remain pretty consistent with our initial projection of US economic performance.

Table 1
Forecast Highlights: Still Expanding but More Slowly

	Quarterly				Annual				
	10:1	10:2	10:3	10:4	2009	2010	2011	2012	2013
Real GDP (Percent change)	2.7	3.8	2.3	2.6	-2.4	3.1	2.7	3.0	2.7
Federal Funds Rate (Percent)	0.13	0.19	0.16	0.16	0.16	0.16	0.23	2.28	3.50
Ten-Year Treasury Yield (Percent)	3.72	3.49	3.05	3.18	3.26	3.36	3.34	4.13	4.68
Oil Prices, WTI (Dollars/barrel)	79	78	72	75	62	76	83	89	93
Consumer Price Index (%change y/y)	2.4	1.8	1.1	0.8	-0.3	1.5	1.4	2.0	2.1
Housing Starts (Millions)	0.62	0.61	0.62	0.70	0.55	0.64	0.96	1.35	1.55
Consumer Sentiment (Univ. of Michigan)	74	74	72	74	66	73	78	78	79
Unemployment Rate (Percent)	9.7	9.7	9.7	9.6	9.3	9.7	9.2	8.5	7.9

Source: Global Insight, July 2010

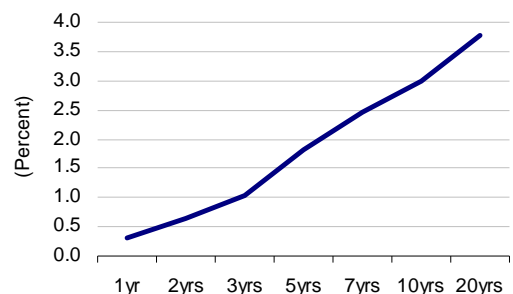
We have only made a slight downward adjustment to growth in 2010. US economic recovery will be restrained by historical standards for four reasons;

1. The fiscal drag as the effects of the stimulus package wear off
2. Growth slowdown in Europe and China may hurt US exports near term
3. Uncertainty regarding domestic policy (healthcare, taxes, financial regulation etc.)
4. Recoveries following financial shocks slower due to the “deleveraging” phenomenon

Given the relatively mild US economic recovery, consensus forecasts (as reflected in Table 1) project tame inflationary pressures over the next few years. We are less confident about the medium term inflation predictions. Even though inflation is viewed as bottoming and beginning to trend up again as the economic recovery continues, the inflation outlook remains mild. RREEF Research maintains that there is significant upside risk for inflation ahead that is not currently being underwritten by the market. We believe inflation may rise at a much faster pace as the economy gains traction and the unemployment rate trends lower. The expansion in the Fed balance sheet and the eventual monetization of the escalating US government budget deficit are the primary drivers of any upside risk to inflation.

Bottom line, growth will slow, but we are not underwriting a double-dip. The low probability of a double-dip recession in the US is also a function of Fed monetary policy. Despite the recent gyrations in the financial markets, the Fed remains ultra-accommodating with the yield curve very steep. Exhibit 4 displays the yield curve for the US. The yield curve has been a relatively solid barometer of investor expectations. A steep yield curve implies that market participants collectively expect stronger growth in the future.

Exhibit 4
US Treasury Securities Yield Curve for July 2, 2010



Source: Economy.com

The relatively steep yield curve has benefited the banks significantly, permitting them to profitably recapitalize their balance sheets. In turn, banks have become less reluctant to lend to consumers. According to the Fed's latest Senior Loan Officer Survey, commercial banks' willingness to provide consumer loans continues to expand. Last quarter, the net percentage of banks reporting an increased willingness to make consumer installment loans totaled 14%, up from 9.6% in Q1 2009 and up sharply from the cyclical low of -47.2% in Q4 2008. The current willingness to extend credit is the highest since Q2 2006 and is consistent with solid (3%) consumer spending growth.

History of US Recessions and Double-Dips

In this section, we take a closer look at US recessions since the Great Depression. Table 2 tracks 14 recessions in US economic history since the late-1920s as dated by the NBER (National Bureau of Economic Research) cycling committee. Among the 14 recessions, we have also included the most recent recession of 2007 to 2009. In each case we have comparative statistics such as duration in months, peak to trough decline in real GDP, the maximum value of the unemployment rate, and the change in the inflation rate. The recession of 2007-2009 was somewhat longer in duration and somewhat deeper than the post-war average. It was precipitated by a major financial crisis and a bust in the housing market.

Table 2
Key Macro Performance Measures Across U.S. Recessions

Recession	Duration (months)	Real GDP: Decline peak to trough (%)	Unemployment: Maximum value during recession (%)	CPI: Change peak to trough (%)
1929-33	43	-36.21	25.36	-27.17
1937-38	13	-10.04	20.00	-2.08
1945-45	8	-14.48	3.40	1.69
1948-49	11	-1.58	7.90	-2.07
1953-54	10	-2.53	5.90	0.37
1957-58	8	-3.14	7.40	2.12
1960-61	10	-0.53	6.90	1.02
1969-70	11	-0.16	5.90	5.04
1973-75	16	-3.19	8.60	14.81
1980	6	-2.23	7.80	6.30
1981-82	16	-2.64	10.80	6.99
1990-91	8	-1.36	6.80	3.53
2001	8	0.73	5.50	0.68
2007-09	20*	-3.66	10.00	2.76

The current recession end date has not yet been determined by the NBER; data is through 2009:Q2. We have determined the end of the current recession as June 2009 but will need to await confirmation from the NBER.

Source: The Federal Reserve of St. Louis Review, March/April 2010, Volume 92, Number 2, page 90.

Indeed, the financial crisis of 2007 to 2009 is widely viewed as the worst financial disruption since the Great Depression. But the actual recession was much milder in magnitude as compared with the Great Depression but severe as compared to postwar recessions. The peak-to-trough decline in real GDP in the current recession was 3.7%, higher than any in the postwar era but smaller than the 36.2% decline recorded during the Great Depression. Aggressive monetary policy this time limited the impact of the financial crisis on the real economy.

Table 2 also highlights another observation, namely that recessions are rare and no two are alike. Certain business cycle indicators, however, do behave similarly leading up to recessions. On average, these include:

- Declining stock prices
- Softening housing markets
- Declining consumer confidence
- Tightening monetary policy
- Weakening labor market
- Widening TED spreads
- Flattening/inverted yield curves

None of these variables, however, in isolation can accurately forecast a recession.

A final salient observation from Table 2 is the infrequency of double-dip recessions. Double-dip recessions are highly rare but you would not know it from the business chatter of recent weeks. Since the Great Depression, the US economy has experienced only one double-dip recession and that occurred in the early 1980s. The 1980-82 double-dip recession occurred when the initial contraction was rather mild. In other words, there is no historic example of a double-dip recession after a severe downturn or financial crisis similar to what we experienced in 2007-2009. Back in 1980, a softening economy was hit by another exogenous shock and a second recession occurred. In that period, policy makers also erred on the side of tightening too soon, a very different policy mind set than what we have today. The Fed was also facing inflation rates in the teens, much higher than what we are experiencing today. The quick ramping up of interest rates by the Fed back in the early 1980s was directly responsible for the double-dip recession. Such a scenario is unlikely in 2010 since inflationary pressures are at bay and the Fed under Chairman Bernanke is very well-versed in past policy mistakes.

Implications for Commercial Real Estate

Based on our analysis of recent economic and financial data and a retrospective on the advent of double-dip recessions historically, we conclude that recent developments do warrant a moderate and temporary marking down of US economic growth prospects over the coming quarters, but not a substantial delay of the economic recovery which we still think is underway. This is consistent with RREEF Research's initial projections. There is no question, however, that risks have shifted considerably to the downside with a prolonged slowdown a possibility.

The outlook for US economic growth is a main driver of demand-side fundamentals across property markets. A full-blown double-dip recession or a moderate economic recovery will imply different demand trajectories for space use across US markets. We believe that a moderate economic recovery is the most likely. Regardless of either outcome, however, real estate market fundamentals remain challenging. We continue to project a further rise in vacancy rates this year and erosion in rent dynamics. The recovery in NOI in this up-cycle will take longer to achieve. Investors should underwrite any new acquisitions accordingly. We may not be calling for a double-dip but the recovery in economic growth, jobs and space absorption will take much longer this time around. Our vacancy rated projections by property sector are presented in Table 3. We have not materially altered our projections of real estate fundamentals given the recent bearish economic headline news. Our outlook for real estate market conditions continues to underwrite a sluggish economic recovery.

Table 3
Real Estate Fundamentals Remain Under Stress
Vacancy Rates (Percent)

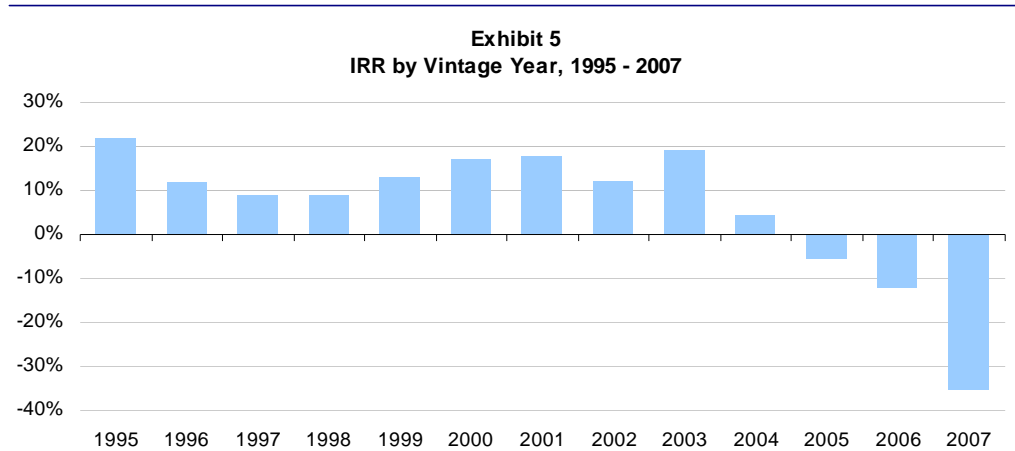
	Forecast					
	2007	2008	2009	2010	2011	2012
Apartment	5.7	6.8	8.1	8.4	7.4	6.1
Industrial	9.5	11.4	13.9	14.2	13.2	11.7
Office	12.6	14.0	16.3	17.2	16.7	16.2
Retail	7.2	8.9	10.3	10.9	10.5	9.8

Source: REIS Reports, CBRE-EA, RREEF Research, as of April 2010

In this environment, core assets may command even a higher premium than at other times. The high occupancy of core assets with credit tenants and limited lease rollovers by definition can protect investors in the near-term from any significant fall-out from the economy. Core assets should be given priority in any investor portfolio given this phase of the business cycle.

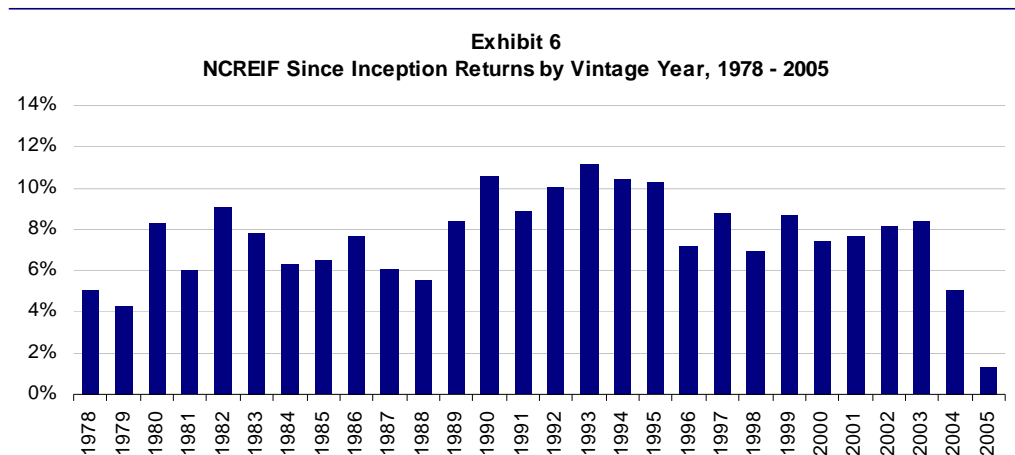
Data on acquisitions by vintage year also provide some insight. In Exhibit 5, we display returns by vintage year from the Preqin data base. In Exhibit 6, we provide since inception returns based on NCREIF data by vintage year as well. What is obvious from both sets of data is that investments during the bottom of an economic cycle provide some of the best vintage year returns.

According to the Preqin private equity real estate returns data, as measured by IRRs, the best vintage years for profitable investments coincided with bottoms of the real estate and business cycles (2000 – 2002). The worst vintage years were during booms and real estate pricing bubbles (2005 – 2007).



Source: Preqin

Exhibit 6 displays NCREIF time-weighted since-inception returns by vintage year. The data corroborates the Preqin data. On a NCREIF basis, best returns occurred during the early 1980s and 1990s, periods marked by significant economic disruptions and dysfunctional real estate markets. In the last decade, early 2000 returns were also among the best. Opportunistic timing of real estate investments is one key driver of outsized gains. Investors take note.



Source: NCREIF

Important disclosure

© 2010. All rights reserved. RREEF is the brand name of the real estate division for the asset management activities of Deutsche Bank AG. In the US this relates to the asset management activities of RREEF America L.L.C.; in Germany: RREEF Investment GmbH, RREEF Management GmbH, and RREEF Spezial Invest GmbH; in Australia: Deutsche Asset Management (Australia) Limited (ABN 63 116 232 154) Australian financial services license holder; in Japan: Deutsche Securities Inc. (For DSI, financial advisory (not investment advisory) and distribution services only.); in Singapore, Deutsche Asset Management (Asia) Limited (Company Reg. No. 198701485N) and in the United Kingdom, RREEF Limited, RREEF Global Advisers Limited, and Deutsche Asset Management (UK) Limited; in addition to other regional entities in the Deutsche Bank Group.

Key RREEF research personnel, including Asieh Mansour, Head of Americas Research and Peter Hobbs, Head of EMEA Real Estate Research are voting members of the investment committee of certain of the RREEF Alternative Investment Funds. Members of the investment committees vote with respect to underlying investments and/or transactions and certain other matters subjected to a vote of such investment committee. Additionally, research personnel receive, and may in the future receive incentive compensation based on the performance of a certain investment accounts and investment vehicles managed by RREEF and its affiliates.

This material is intended for informational purposes only and it is not intended that it be relied on to make any investment decision. It does not constitute investment advice or a recommendation or an offer or solicitation and is not the basis for any contract to purchase or sell any security or other instrument, or for Deutsche Bank AG and its affiliates to enter into or arrange any type of transaction as a consequence of any information contained herein. Neither Deutsche Bank AG nor any of its affiliates, gives any warranty as to the accuracy, reliability or completeness of information which is contained in this document. Except insofar as liability under any statute cannot be excluded, no member of the Deutsche Bank Group, the Issuer or any officer, employee or associate of them accepts any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this document or for any resulting loss or damage whether direct, indirect, consequential or otherwise suffered by the recipient of this document or any other person.

The views expressed in this document constitute Deutsche Bank AG or its affiliates' judgment at the time of issue and are subject to change. This document is only for professional investors. This document was prepared without regard to the specific objectives, financial situation or needs of any particular person who may receive it. No further distribution is allowed without prior written consent of the Issuer.

An investment in real estate involves a high degree of risk and is suitable only for sophisticated investors who can bear substantial investment losses. The value of shares/units and their derived income may fall as well as rise. Past performance or any prediction or forecast is not indicative of future results.

The forecasts provided are based upon our opinion of the market as at this date and are subject to change, dependent on future changes in the market. Any prediction, projection or forecast on the economy, stock market, bond market or the economic trends of the markets is not necessarily indicative of the future or likely performance.

Main Offices

Frankfurt

Alfred-Herrhausen-Allee 16-24
65760 Eschborn
Tel: +49 69 71704 906

Hong Kong

48/F Cheung Kong Centre
2 Queen's Road Central
Hong Kong
Tel: +852 2203 8888

London

1 Appold Street
Broadgate
London
EC2A 2UU
United Kingdom
Tel: +44 20 7545 8000

New York

280 Park Avenue
23W Floor
New York
NY10017-1270
United States
Tel: +1 212 454 3900

San Francisco

101 California Street
26th Floor
San Francisco
CA 94111
United States
Tel: +1 415 781 3300

Tokyo

Floor 17
Sanno Park Tower
2-11-1 Nagata-cho
Chiyoda-Ku
Japan
Tel: +81 3 5156 6000

RREEF Research

Peter Hobbs
Head of EMEA Research
+44 20 7547 4855

Asieh Mansour
Head of Americas Research
+1 415 262 2044

Europe

Maren Väh
Vice President
+49 69 717 04 466

Justin Curlow
Assistant Vice President
+44 20 7545 9682

Jarek Morawski
Assistant Vice President
+49 69 717 04 204

Henry Stratton
Associate
+44 20 7547 3305

Asia Pacific

Koichiro Obu
Director
+81 3 5156 6522

Tan Yen Keng
Vice President
+852 2203 8062

Edward Huang
Assistant Vice President
+852 2203 7993

North America

Alan Billingsley
Director
+1 415 262 2017

Andrew J. Nelson
Director
+1 415 262 7735

Brooks Wells
Director
+1 212 454 6437

Ross Adams
Vice President
+1 415 262 2097

Bill Hersler
Vice President
+1 415 262 2075

Jaimala Patel
Vice President
+1 212 454 1752

Terence Callahan
Assistant Vice President
+1 415 262 6432

Alex Symes
Assistant Vice President
+1 415 262 7746

Stella Yun Xu
Assistant Vice President
+1 415 262 7715

Publication Address:

RREEF
101 California Street
26th Floor
San Francisco, CA 94111
USA

Website:

www.rreef.com

Additional information is
available upon request

I-018225-1.1