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2007 U.S. Real Estate Investment Outlook and Market Perspective

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Overview

Stellar investment performance and improvements in property market fundamentals kept capital flowing to real estate in 2006, producing record high investment volume. The rebound in demand for most types of real estate last year has been remarkable, driving healthy net operating income (NOI) gains. Investors, unable to achieve better risk-adjusted yields from other asset classes, continued to increase their real estate exposure. The flood of capital continued to compress real estate yields, driving up values.

This year, however, may be the year of transition for real estate. The US economy is slowing with the housing market in recession, a slowing consumer market, and a troubled US auto industry. These events are expected to lead to an economic slowdown in 2007, which is forecast to be a mid-cycle correction, rather than a recession. The economy should rebound in 2008 and 2009.

A correction in 2007 is expected to result in a modest reduction in demand for space. At the same time, after years of subdued construction activity, development activity is clearly accelerating. New completions were up substantially in 2006 across all property sectors and markets. Despite elevated construction costs, 2007 will see a similar elevated supply of new space at the same time that demand is slowing. While overall, supply and demand are expected to remain in balance over the next few years, some markets may be at risk of over-supply. Supply is the biggest risk over the next couple of years.

Nonetheless, real estate fundamentals are expected to continue to improve in 2007 and over the next few years, but at a much more moderate pace. Effective rent gains should continue but will fail to match the strong pace of 2006.

Capitalization (cap) rates for privately-held real estate remain at historic lows. Pricing should remain firm for the best product in the best markets, However, a nascent slowdown in transaction volume for core assets implies some future moderation in pricing, with moderate upward pressure on cap rates for 2007. This is likely to be especially true in secondary markets and for retail product, given that the retail market has peaked and investors are concerned about a slowdown in consumer spending. Cap rates for apartments in markets that have seen substantial compression due to condominium conversion activity are also likely to feel some upward pressure, due to the declining appeal of for-sale product.

Total returns generated by existing "core-like" properties included in the NCREIF Property Index (NPI) ended 2006 at 16.6%. We expect some further tempering in appreciation returns this year with total returns generated by the NPI ranging between 10% and 12% for 2007. Yet lower returns are anticipated for 2008.

While investors have benefited greatly from strong demand and liquidity, which has produced high returns through significant appreciation over the past few years, they will need to rely much more heavily upon income growth to achieve desired yields in 2007 and beyond. Cap rates reached the end of their precipitous fall during 2006, and are unlikely to fall further. As a result, market and asset selection will remain critical going forward where income growth potential will be the focus. There will be much more differentiation across markets and individual deals. Investors should focus on actively managing their real estate portfolios in 2007 to improve leasing activity. Second tier market properties with little income growth potential might be considered for disposition, as they will be at risk for upward cap rate movement.

Investors are accepting lower returns on real estate investments from the much higher levels expected during the past few years. Nevertheless, on a risk-adjusted basis, real estate still remains a compelling investment relative to other asset classes within a diversified portfolio. Except for condo converters, investors remain enthusiastic about real estate, with substantial capital available for additional investment in 2007. Core assets, which provide long duration stable cash flows, remain highly sought after. Institutional investors, namely pension plans, are seeking long-dated assets with higher returns relative to today's bonds. This will keep core real estate assets in favor.

At the margin, many real estate investors seeking higher yields are shifting away from core to value-added and opportunistic strategies. Real estate investors are also actively investing abroad to seek enhanced yields. In 2007, more capital will flow to these and other high-yielding strategies as a way to boost returns and meet pension plan sponsors' actuarial requirements. Investors are willingly taking more risk in their real estate portfolios. Excess global liquidity has increased investor appetite for all kinds of risk. High rates of saving around the world, combined with open global financial markets, have created a flood of investment capital seeking higher returns. Value-added and opportunistic strategies are expected to comprise a significant portion of the investment market in 2007.

The following are our top predictions for the US real estate market in 2007:

- **Capital Flows.** Transaction volumes will fall from the historic highs achieved in 2005 and 2006. Declining real estate returns, along with the stronger than expected recovery in the broader equity markets, may restrain capital flows to the sector in 2007. Nevertheless, demand for long-duration stable cash flows generated by core real estate assets by institutional investors is here to stay, so volumes will not fall precipitously.

- **Pricing.** Pricing for the best assets in the best markets will remain firm. With cap rates now stabilizing at their current low levels, additional appreciation from cap rate compression is unlikely, and modest upward movement for some properties is probable. As a result, investors will shift their yield expectations to focus on income. Core product, with above-inflationary income growth potential, will continue to be highly sought after. A continued low interest rate environment expected in 2007 will still provide a boost for leveraged yields, and should stave off a significant increase in cap rates.

- **Private Equity Returns.** Total returns from the NPI should range between 10% and 12% in 2007 down from 16.7% in 2006, as appreciation gains ease.

- **Publicly Traded REITs**. The public REIT market, which has produced several years of very high returns, should perform more in line with private real estate in 2007, with total return expectations in the 5% to 10% range.

- **The Economy**. Real GDP growth will decline to a mid-cycle trough in 2007 to approximately 2.3%, well below trend for the US economy. Business capital spending and exports will support growth, but should not be sufficiently strong to offset the housing and consumer slowdowns.

- **Apartment Properties**. Strong operating performance should continue in 2007, with increased occupancy and rents, making apartments one of the strongest growth sectors. Completions nationwide are expected to remain below trend this year, allowing for additional improvement. Several markets are experiencing a strong ramp-up in development activity, however, including New York, Chicago, Seattle, Los Angeles, Atlanta, Orlando, Houston, Washington DC, Austin, and Las Vegas. Most of these markets remain attractive, but caution should be exerted.

- **Industrial Properties**. Industrial supply/demand fundamentals will strengthen further in 2007, making the industrial sector a solid income investment. Major land constrained port markets, such as Southern California, South Florida, the San Francisco Bay area, Seattle and New York/New Jersey will continue to outperform. Inland distribution markets, such as Dallas, Chicago and Atlanta are now strengthening at a later point in the cycle. In general, new development is being driven by large distribution users. As a result, in some of the major distribution markets where land is available and affordable, such as Atlanta, Chicago, Dallas/Ft. Worth, and the Inland Empire, big-box warehouse construction activity is approaching levels last seen in the late 1990s, so caution should be used in these markets.

- **Office Properties**. Office, similar to apartment, continues to be one of the strongest growth sectors, with further, albeit more modest, improvement expected. In general, construction remains restrained. New development will remain concentrated in a handful of metros— most notably Washington DC, New York, Seattle, Las Vegas, San Diego, and Orange County.

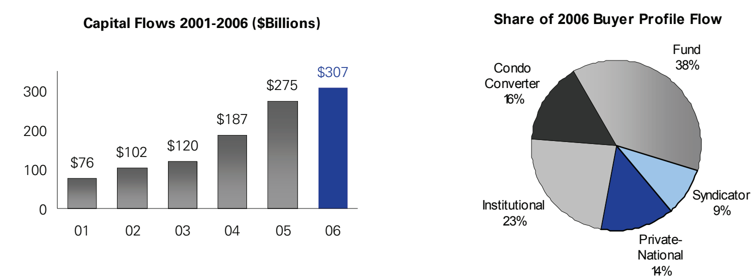
- **Retail Properties**. The retail property market, which has been one of the strongest sectors over the past several years, reached its market peak in 2006. As a result of historically high retail sales growth and retailer profitability over the past several years, retailers are aggressively expanding new store openings. Since retailers tend to drive new development, retail completions can be expected to be very strong during 2007. This expansion activity coincides with a de-escalating consumer market, so that retail center sales growth is expected to moderate. As a result, vacancies should increase and average rent growth for this sector should approximate or lag inflation.

- **Implications**. Real estate capital markets have reached an inflection point. Core properties are fully priced, and some sectors should experience a modest increase in cap rates during 2007. Even with reduced total return expectations, the best core properties will continue to be highly sought after. Value-added properties will attract even more capital in 2007 and should witness further yield compression as a result. Ten-year unleveraged IRRs should continue to range between 7% and 8% for core properties, with the high end of this range difficult to achieve. Leveraged returns of 11% to 15% are achievable from value-added strategies, with low mortgage rates expected to hold.

Capital, Pricing, and Returns: Return to Property Fundamentals

Capital In-Flows. US commercial real estate continued to attract record levels of capital in 2006. Between 2001 and 2005, capital flows to the four major property groups grew at an incredible average annual rate of 38%. In 2006, volume rose a further 4%. As shown in Exhibit 1, transactions totaled $307 billion in 2006.

Exhibit 1
Real Estate Transaction Volumes
2001-2006



Source: Real Capital Analytics, and RREEF Research

Institutional investors and private national buyers increased their acquisition activity over the previous year, while condominium converters and local investors pulled back. REITs were net sellers of property in 2006, as several publicly-traded REITs were acquired outright by private purchasers. REIT privatizations accounted for approximately $29 billion of total volume. On the debt side, aggressive competition for market share continued among banks, commercial mortgage-backed securities (CMBS) conduits, and mezzanine lenders.

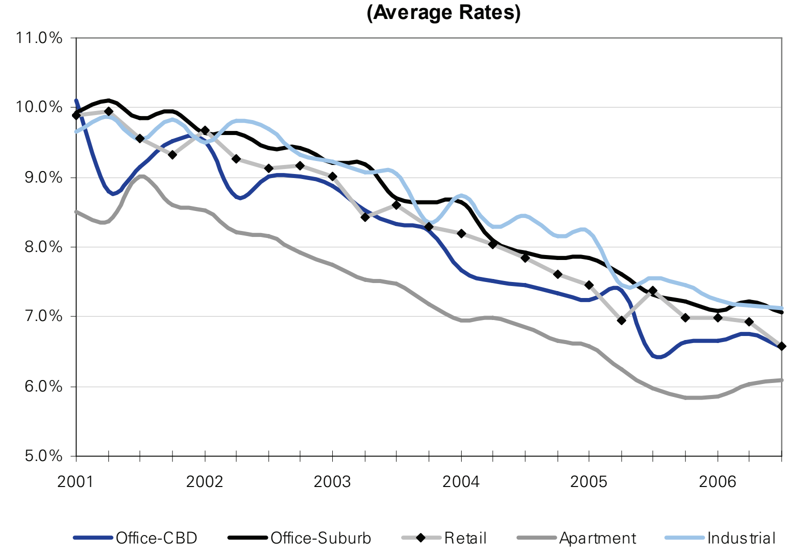
Office acquisitions generated most of the 2006 increase in transaction volume. $133 billion in 2006, compared with $101 billion in 2005. Industrial transactions increased modestly, while retail transactions fell due to declining investor enthusiasm for the sector and fewer properties that came to market. Apartment sales were nearly on par with last year. Condominium converters dramatically slowed their acquisition of apartments, but remained net buyers through the third quarter of 2006.

Capital in-flows to real estate are expected to remain steady in 2007. While 2006 may prove to be the peak of this real estate transaction cycle, several factors support continued strong capital in-flows over the short and long term. Billions of dollars are still queued up to enter the asset class. Pension plan sponsors in particular are underinvested relative to their allocation targets. Moreover, private real estate returns should remain highly competitive with other asset classes in 2007, given continued strong income growth for most sectors. The NCREIF Property Index (NPI) is likely to outperform the broad equity and bond indices on a total return basis next year. Among lenders, more stringent underwriting standards are expected in 2007, but the elevated volume of transactions should continue to generate lending opportunities. Strong operating fundamentals in 2007 should keep delinquency rates near their current lows.

Declining real estate returns over the medium term may constrain capital in-flows in 2007 and beyond. That said, real estate is increasingly viewed as an essential component of any diversified multi-asset portfolio. Growing acceptance of real estate as an asset class, on par with traditional investments like stocks and bonds, should put a floor under capital flows and head off any dramatic pullout from the asset class.

Pricing and Cap Rates. Despite the record level of real estate transactions in 2006, price appreciation for privately-held real estate has eased. Cap rates continued their multi-year decline in early 2006, but appear to have stabilized during the second half of the year, averaging between 6.6% and 6.8%. See Exhibit 2.

Exhibit 2
Capitalization Rate Trends
(Average Rates)



Source: Real Capital Analytics and RREEF Research

Cap rate decline appears to have ended across all property types. Apartments actually witnessed an uptick in cap rates in early 2006 as condo converters dropped out of the market, but declined again toward the end of the year. Outside of this effect, apartment cap rates are very low, the lowest of the four property sectors.

The spread between real estate cap rates and the benchmark interest rate stabilized during 2006, though the spread remains narrow. The yield on a 10-year Treasury hovered between 4.5% and 5.0% during most of 2006, for a rate spread of between 110 and 250 basis points for core real estate assets. The spread of core cap rates over the 10-year Treasury appears to have reached a low point mid-year 2006 when Treasuries also hit their peak, but have declined along with Treasury yields during the second half of the year. Core cap rates declined by a modest 20 basis point in the second half of 2006 as the 10-year Treasury shed 50 basis points.

Expectations for Cap Rates. With narrow cap rate spreads and low interest rates, cap rate compression seems to have run its course. Core cap rates are expected to remain stable or increase slightly during 2007. Any rise in the average core cap rate should be minimal, not exceeding 50 basis points for any property type. Cap rates for riskier real estate investments, including high quality value-added and development deals, should continue to see downward pressure.

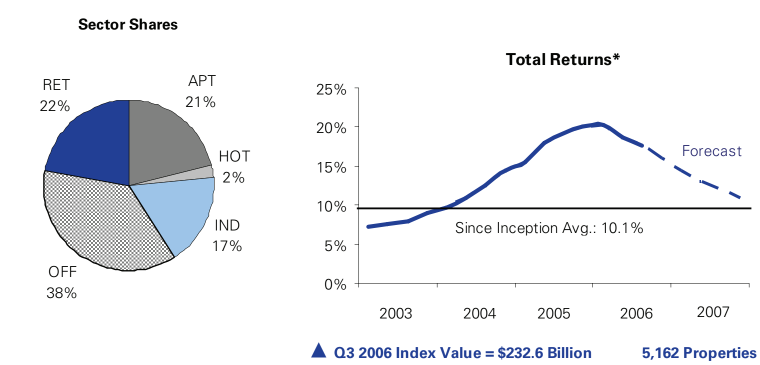
Benchmark interest rates are expected to remain low throughout 2007. The yield on a 10-year Treasury hovered near 4.6% at year-end 2006. Many have been concerned that rising interest rates could cause a painful correction in real estate cap rates. Fortunately, the factors that have kept interest rates low are expected to persist during the coming year. The Federal Reserve is expected to either remain neutral or lower short-term interest rates modestly during 2007, which should keep long-term rates low. Low benchmark interest rates should help forestall any significant run-up in cap rates. Fairly healthy real estate market fundamentals in 2007 should help contain a substantial widening of the spread of cap rates over benchmark interest rates.

Along the risk spectrum, core cap rates appear to have stabilized, but further cap rate compression is possible for riskier investments. Investors' pursuit of yield, paired with aggressive underwriting for value-added and development properties, could narrow the spread of riskier assets over core cap rates.

Aside from the benchmark interest rate, cap rate compression has also been driven by skyrocketing construction costs. Property pricing is influenced by the current cost of constructing a comparable building. Several years of sharply escalating commodity costs and a red-hot housing market drove up the cost of land, materials, and labor. At year-end 2006, construction costs remain elevated, but future price pressures are easing. Increases in the cost of materials should stabilize near inflation. Land values should readjust to reflect the slowdown in the housing market, especially in CBD areas with significant condo construction and in growth corridors on the fringe of metro areas. Price appreciation of both new and existing assets should reflect slowing replacement cost growth over the next year.

NPI Returns. Annual total returns for privately-held properties in the NCREIF Property Index came in at a healthy 16.6%, unleveraged, for 2006. Exhibit 3 shows that returns continue to greatly exceed the long-term average. Annual NPI appreciation peaked at 12.7% in 2007 and has since come down to 9.9% for 2006. The NPI income return equaled 6.2% for 2006 -- the lowest annual income return since the index's inception in 1978. The low income returns reflect falling cap rates, not operating income fundamentals. Growth in net operating income (NOI) was very strong in 2006 due to broad-based increases in occupancy and effective rent.

Exhibit 3
2006 NCREIF Property Index



*Unleveraged Rolling Four Quarter Returns

Source: NCREIF & RREEF Research.

The NPI should ease to between 10% and 12% in 2007. Income should once again take the lead from appreciation as the key driver of returns. Historically, about 8% of the NPI's 10% average return since inception has come from income, but in recent years appreciation has driven NPI total returns to new heights. In 2007, appreciation should cool as a result of stabilizing cap rates and replacement costs. There is still room for appreciation gains, however, as solid 2007 NOI growth gets capitalized into property value. It is also likely that carrying values will lag transaction prices for many NPI properties, implying some upside for booked appreciation as appraisals occur during 2007. Please see pages 11 to 22 for information on NPI returns by sector.

New Investments. Total returns for existing properties acquired this year should be lower than the 2007 NPI return. Projected unleveraged 10-year IRRs in the transaction market should range from 7% to 8% for core US properties. Between 100 and 200 basis points should be added for value-added properties, and between 300 and 400 basis points for development, all on an unleveraged basis.

Risks. Barring a jump in interest rates or an unexpected recession, 2007 should bring relative stability in cap rates and return performance that is above the historical average. The biggest risk to these returns will be how investors respond to a transition in the real estate cycle as it matures over the next few years.

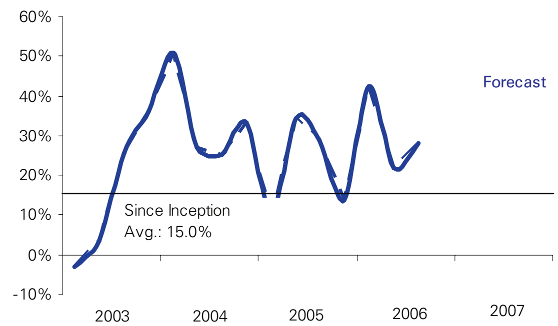
Real estate market fundamentals are currently accommodative of new supply. Several years of vacancy declines have led to significant effective rent growth across many markets and property types. Not only do real estate fundamentals encourage construction in many areas, but capital market factors also support new development. Many investors and developers perceive opportunities to build new product at a higher risk-adjusted yield than they could achieve in the transaction market for existing assets. Newfound stability in construction costs also reduces the risk of starting a project.

As this real estate cycle matures over the next few years, today's low cap rates will be tested. As supply begins to overtake demand in several markets, resulting in declining income growth, the degree of long-term investor commitment to the asset class should be revealed. The current development pipeline suggests that in 2007 and 2008, significant new supply will come online.

Publicly-Traded REITs

Performance Review. REITs outperformed the broader equity markets for an unprecedented seventh straight calendar year and once again far outpaced our expectations. For the year ended 2006, the Dow Jones Wilshire REIT Index posted a total return of 36.0% while the Dow Jones Industrial Average posted a total return of 19.0%, the Standard & Poor's 500 Index posted a total return of 15.8%, and the NASDAQ Composite Index posted a total return of 10.4%. Our 5% to 10% expected return was predicated on earnings growth of 9% to 10% plus the starting yield of 4.5% less an expectation of multiple contraction ranging from 5% to 10%. Our growth expectations were on target, but multiples did not cooperate. Instead private capital remained aggressive even in the face of a 10-year Treasury yield that reached as high as 5.2% in June. The Office, Storage, and Apartment sectors took the reigns this year as these more cyclical sectors were highly sought after by investors. More bond like asset classes specifically Retail and Industrial performed admirably, but underperformed their procyclical peers.

Exhibit 4
Wilshire REIT Index Total Returns*
as of Third Quarter 2006



- **Q3 2006 Market Capitalization:**

*Rolling Four Quarter Returns

Source: Dow Jones Wilshire REIT Index & RREEF Research

Merger and acquisition activity again provided momentum to the group with the biggest announcement coming in November when the Blackstone Group announced its intention to purchase Equity Office Properties for $20 billion plus $16 billion in debt assumption. Equity Office is one of the largest REITs by market capitalization, comprising 4.7% of the Dow Jones Wilshire REIT Index, and this deal proved not only to be the largest REIT privatization, but also the largest leveraged buyout in history. Similar to 2005, a majority of the M&A activity this year was not public-to-public mergers, but public REIT privatizations, involving a substantial transfer of assets from public to private ownership. Exhibit 5 displays the large number of deals transacted in over the last 18 months.

Exhibit 5
Mergers and Acquisitions Summary

Announcement Date	Target Company	Property Type	Transaction Type	Total Value (Mil)	Equity Value (Mil)
6/6/05	O&Y Properties	Office	Privatization	$1,890	$1,080
6/6/05	Catellus	Industrial	Merger	$4,900	$3,900
6/7/05	Gables Residential	Multifamily	Privatization	$3,000	$1,800
6/17/05	Crocker Realty	Office	Privatization	$1,700	$937
9/6/05	Capital Automotive	Net Lease	Privatization	$3,400	$1,700
8/1/05	Shurgard Self Storage	Self Storage	Merger	$5,000	$3,200
10/3/05	Prentiss Properties	Office	Merger	$3,300	$1,900
10/24/05	AMLI Residential	Multifamily	Privatization	$2,100	$959
12/19/05	CenterPoint Properties	Industrial	Privatization	$3,400	$2,500
12/19/05	Town and Country Trust	Multifamily	Privatization	$1,300	$860
12/22/05	Arden Realty	Office	Privatization	$4,800	$3,200
1/30/06	Fairmont Hotels	Hotel	Privatization	$3,900	$3,390
2/13/06	Bedford Property	Flex/Industrial	Privatization	$875	$519
2/21/06	Meristar Hospitality	Hotel	Privatization	$2,600	$943
3/6/06	CarrAmerica Realty	Office	Privatization	$5,400	$3,100
6/5/06	Trizec Properties	Office	Privatization	$8,900	$4,712
7/9/06	Heritage Property	Retail	Merger	$3,200	$1,775
7/10/06	Pan Pacific	Retail	Merger	$4,000	$2,900
8/3/06	Reckson	Office	Merger/Privatization	$6,000	$4,000
8/21/06	Sizeler Property	Retail	Merger	$409	$324
8/21/06	Gleborough Realty	Office	Privatization	$1,900	$1,140
8/30/06	Summit REIT	Industrial	Privatization	$2,880	$1,980
8/31/06	BNP Residential	Multifamily	Privatization	$766	$313
9/13/06	Windrose Medical	Medical Office	Merger	$877	$451
9/20/06	Centracore	Prison	Merger	$396	$356
11/19/06	Equity Office Prop	Office	Privatization	$35,811	$18,857

Valuation. The volume of privatization activity has clearly validated underlying REIT share prices relative to underlying real estate. At the end of December, REITs were trading at an approximate 7% premium to NAV as measured by Green Street Advisors. This premium is in line with historical average premium to NAV which is nearly 7%, but we should caution this NAV is calculated based upon historically low cap rates in the private sector driven by continuing strong demand for real estate. Although REITs currently are trading at parity relative to their historical relationship with direct real estate, pricing relative to bonds yields and S&P multiples looks less compelling. Historically the majority of an investor's expected real estate return was generated by current cash flow with the balance being generated by appreciation. Although this remains the case for buyers using 100% equity (5% income + (2% to 3% Appreciation) = 7% to 8% IRR), leveraged buyers find themselves in an environment whereby going in cash flow from real estate is less than their borrowing cost. Therefore if we have a valuation concern it is that highly leveraged real estate plays are being made in many markets whereby the buyers' leveraged return hurdles can only be met through appreciation. To date most REITs have steered clear of these types of transactions and therefore we are comfortable with the current risk profile in the public market.

Performance Outlook. REIT prices continue to be driven by strong investor demand for real estate and strengthening fundamentals with merger and acquisition activity continuing across all property types. While over 20 REITs have been privatized or acquired in the past 18 months, with the largest transaction yet announced in November, we believe that the best run companies remain in the investment universe. Therefore, although we expect the sector to consolidate some of its gains over the intermediate term, the long term outlook for REIT returns remains compelling as the companies that have historically created the most excess value comprise an ever greater percentage of the REIT investment universe. Even as economic growth appears to slow, real estate fundamentals remain strong. This fundamental strength and the resulting growth will be the primary driver of returns going forward. Furthermore, although we are more cautious near term, we believe that meaningful downside risk is minimal given healthy demand for real estate and lack of compelling investment alternatives. With that backdrop, we continue to view the relative returns of real estate securities as attractive. Implied cap rates in the public market average in the mid 5% range on a cash basis and average net operating income growth should trend in the 2.5 to 3.5% for the foreseeable future implying unleveraged IRRs in the 7 to 8% range and high single to low double digit returns on a leveraged basis. Therefore for 2007 we are forecasting returns in the 5 to 10% range with a bias towards the high end.

General Economic Outlook

US economic performance is moderating with weakness permeating the nation's housing, retail and auto sectors as we enter 2007. GDP growth for 2006 was quite robust, however, estimated at 3.3%. Our expectation is that the current weakness in housing and consumer markets will be balanced by strong growth in other sectors. With corporate balance sheets flush with cash, business capital spending should support growth in the coming quarters. Nevertheless, on balance, we expect 2007 GDP growth of around 2.3%, which is considerably below trend.

The trade sector should also be less of a drag on output growth. Economic growth in the rest of the world has surprised on the upside. This, combined with a falling dollar, should encourage demand for US-produced goods. Support from business spending and exports, however, will not fully offset the slowdown in housing and its impact on consumer spending. Forecast highlights are presented in Exhibit 6.

Exhibit 6
Forecast Highlights: U.S. Economy 2006-2008
(annual percent change)

	2006	2007	2008		2006	2007	2008
Real GDP	3.3	2.3	3.2	Consumer Price Inflation	3.2	1.8	2.1
Consumption	3.2	2.8	2.8	Payroll Employment Growth	1.4	1.0	1.3
Business Fixed Investment	7.5	5.6	4.2	Unemployment Rate	4.6	4.9	4.9
Equipment & Software	6.8	4.6	5.8	Federal Funds (%)	4.96	4.86	4.50
Exports	8.7	8.6	9.3	Ten-Year Treasury (%)	4.79	4.53	4.79
Imports	5.9	3.0	4.0	30-Year Fixed Mortgage (%)	6.41	6.15	6.40

Source: Global Insight and RREEF Research

Although the housing downturn has been sharper than anticipated, the decline in oil prices from the high $70s to below $60 per barrel has made the soft landing scenario for the US economy a more viable base case. Lower oil prices, in addition to supporting growth, have reduced the upside risks to inflation in the near term. The Fed may help the softness in the economy by cutting the federal funds rate modestly during the second half of 2007.

There are several key trends underlying our sanguine view of prospects for the US economy.

- **Low inflation.** For the time being, inflation in the US and around the world remains restrained. Falling oil prices have driven down headline CPI inflation recently. There are also several structural forces that are supporting low inflation, including activist anti-inflationary policies by central banks, increased global competition, and continued excess capacity in many parts of the world. These forces have kept inflation tame. The slowing in US economic growth will further reduce inflationary pressures in the near term.

- **Low interest rates.** Interest rates remain low and as the economy weakens in 2007, and the Fed should either remain neutral or lower rates modestly.

- **Fiscal policies remain loose.** Many of the industrialized countries around the globe, including the US, are running sizable budget deficits. This suggests that government spending in the US will be a further source of support to the economy.

- **Low exchange rate volatility.** For most of the past two years, the US dollar had remained fairly stable relative to other currencies. This stability has supported the unrestricted flow of financial capital and maintained healthy growth in international trade. However, the dollar has declined in the past few months, and further declines are expected over the next few years. Fortunately, this decline is expected to be gradual and orderly. The US and most of the developed world have a strong interest in achieving a soft landing for the dollar, given that it remains the reserve currency around the world.

- **Tight labor markets.** US labor markets remain tight with the unemployment rate at 4.5% as of December 2006. Job growth averaged over 150,000 per month last year, a relatively healthy pace despite setbacks in the nation's housing and auto sectors. New labor force entrants will be readily absorbed into this market. A projected modest increase in the unemployment rate will ease inflationary concerns, but unemployment will remain low.

- **Healthy global economy.** Growth remains steady across the globe with no major country in recession. The latest OECD economic outlook forecasts slower world growth next year, with the major industrial countries converging to a still healthy 2.7% in 2007 from an average of 3.2% this year.

The slowdown in the economy may impact real estate markets in the near term. The continued expansion of the economy, at a slower pace in 2007 followed by recovery in 2008, will nevertheless continue to provide a solid backdrop for real estate markets going forward. The shift in the drivers of growth from the housing and consumer sectors to business spending and international trade will impact the four property sectors in differing ways, however. The industrial and office sectors, in particular, should benefit while the retail sector should be negatively impacted from this shift in growth dynamics.

Outlook for Regional Economies

All regions of the US have been impacted by the slowdown in the housing and consumer markets and the secular decline in the nation's auto industry. The greatest near-term risk to regional economies is the severity of their housing downturns and the magnitude of adjustment in local housing prices. Over the next several years, the regional outlook remains strongest for the West and South. Job growth in the West (1.7%) and South (1.5%) over the next five years will exceed the national average. By contrast, job growth in the Northeast (0.9%) will remain in line with the national average and the Midwest (0.7%) will lag the nation. The following is a breakdown of the economic outlook for the four main census regions.

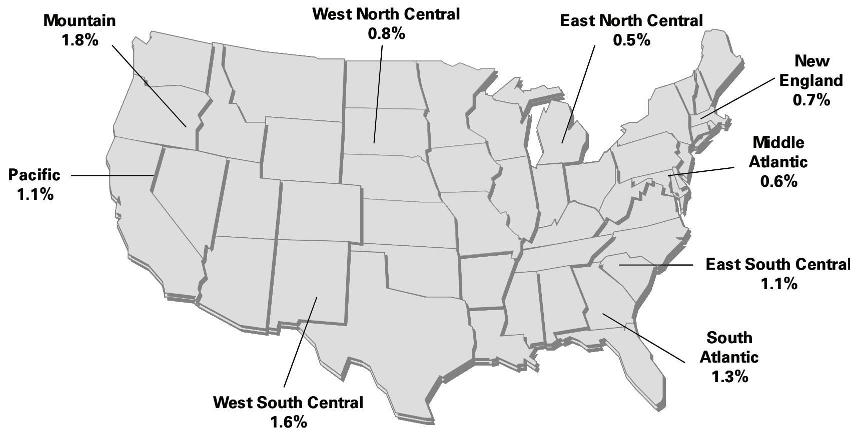
West: The West benefits from very strong demographic trends, with above average in-migration and a younger population distribution. Metro areas located in the Western region of the US benefit from the long-term cyclical upturn in the aerospace industry, technology, travel and tourism, international trade, and banking outside of mortgage services. Indeed, defense aerospace remains a steady component of the economy and commercial aerospace production is accelerating due to strong export and emerging domestic demand. The West is projected to remain a leader in international trade, technology, and financial services. With a weaker dollar and healthy global economic prospects, demand for technology products will support R&D activity in the region, even as low value-added tech manufacturing continues to move offshore.

South: The South also benefits from very strong population growth and low business costs relative to the US as a whole. Despite the contraction of old-line traditional manufacturing in the South, the region benefits from gains in business and financial services, leisure and travel, and international trade. Energy exploration and development favors Texas and the Southwest. New investments in auto and tech plants in the region have begun to revitalize metro areas in the South. Defense spending should remain high across the region in light of global conflicts and the demand for increased homeland security measures.

Northeast: Job growth in the Northeast is expected to be in line with the national average over the next several years. The region benefits from high education levels and the highest per capita income in the US. The Northeast also benefits from very strong global links and a large contingent of high-tech and research operations. The region remains the financial capital of the US. In fact, New York competes with London as the financial capital of the world. Over the long run, economic growth in the Northeast will be restrained by limited demographic trends, a declining industrial base and relatively high business costs.

Midwest: The Midwest remains the chronic underperformer, facing the weakest prospects, particularly as the US auto industry continues its long-term decline. Michigan is the one US state that remains in recession. The secular decline in manufacturing, a lack of strong economic alternatives, and migration of the baby boomers to warmer climates will all weigh on the region.

Map 1
Regional Job Growth in 2007
Percent Change



Source: Economy.com and RREEF Research

The strengths and weaknesses of these regional economies highlight the factors that will support the superior performance of certain metro areas over others in coming years. Metro areas that have exposure to high-tech industries including aerospace and defense should benefit from strong job growth. Those with the highest exposure to global linkages and international trade will benefit from globalization trends. Structurally, metro areas that possess low business costs and population growth will outperform over the longer run. Exhibit 7 summarizes the drivers shaping superior regional performance in the US in the age of globalization. The associated Map 2 highlights those metro areas that have the greatest prospects for job growth over the next several years.

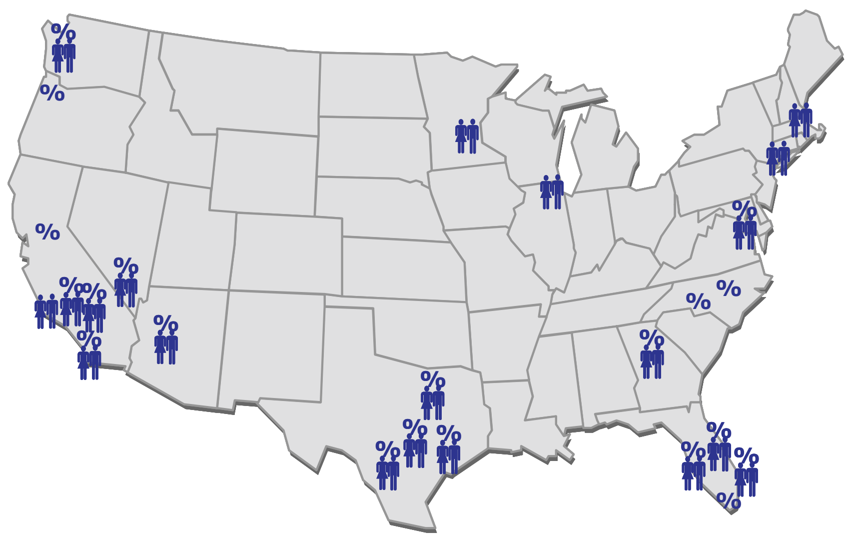
Exhibit 7
Key Drivers of Regional Performance

Industrial Linkages	Structural Characteristics
High-tech	Strong Demographic Flows
Global Trade	Low Business Costs
Financial Services	Availability of Skilled Labor
Leisure & Hospitality	Warm Climate
Health & Education	Pro-business Regulatory Environment

Source: RREEF Research

The metro areas with the best economic prospects, both in terms of job growth and absolute gains in jobs, are located across the tri-coastal regions of the US. Real estate portfolios should continue to overweight these markets as part of a focused regional strategy going forward. Job and income growth across these metro areas will outperform that of the nation and drive disproportionately higher demand for real estate. These are the metro areas that will benefit from increased global trade and the shift from the consumer- to the business-driven economy.

Map 2
Prospects for Regional Job Growth: 2007-2009



% Fastest Growing Metros

1. Las Vegas
2. Phoenix
3. Austin
4. San Antonio
5. Fort Lauderdale
6. Riverside
7. Orlando
8. Dallas/Fort Worth
9. Houston
10. Atlanta
11. Raleigh
12. Seattle
13. Charlotte
14. Portland
15. Tampa
16. Sacramento
17. Washington, DC
18. Miami
19. San Diego
20. Orange County

Largest Net Gain in Jobs

1. Phoenix
2. Dallas/Fort Worth
3. New York
4. Houston
5. Atlanta
6. Washington, DC
7. Seattle
8. Las Vegas
9. Chicago
10. Riverside
11. Boston
12. Orlando
13. Austin
14. Los Angeles
15. San Antonio
16. Fort Lauderdale
17. Tampa
18. Minneapolis
19. Orange County
20. San Diego

Source: Economy.com and RREEF Research

The Property Sectors: Supply May Start Catching Up to Demand

During much of 2006, the four major US property sectors have enjoyed healthy market fundamentals that have produced remarkable occupancy gains. Effective rental growth has been broad-based across property sectors and geographic regions. Apartment, office, and to a lesser extent, industrial properties, have attracted investor capital due to the strong earnings recovery in this phase of the economic and real estate cycle. At the same time, worries regarding the strength in consumer spending and modest readings on retail sales have made retail less appealing to investors than in recent years.

Exhibit 8
National Vacancy Rate Trends

	– Actual –				Trend
	2005	**3Q/2006**	**YE2006**	**YE2007**	**05-07**
Apartment	5.6%	5.4%	5.3%	5.2%	↓
Industrial	9.9%	9.6%	9.5%	9.3%	↓
Office	13.6%	12.9%	12.8%	12.3%	↓
Retail	6.5%	7.0%	6.7%	7.3%	↑

Source: REIS, CB Richard Ellis/Torto Wheaton, & RREEF Research

Since early 2005, the US **apartment** market has experienced a strong recovery due to a sustained decline in vacancy rates. Net absorption should continue to outpace supply. Two significant shifts in the US economy are redefining the apartment landscape. The first is the end of the US for-sale housing market boom, and the second is the momentous reversal of demographic trends in the prime renter-age cohort. With the US for-sale housing market in recession, the apartment market has enjoyed reinvigorated demand. Furthermore, the leading edge of the echo-boomers graduated from college this year and began their careers. This age group will provide significant support to the apartment market sector going forward.

After a stellar 2005, **industrial** market conditions stabilized in 2006, with only modest improvement forecast for 2007. The global gateway hubs continue to lead the overall industrial market recovery, with strong occupancy and rent growth. Speculative construction activity for warehouse/distribution space is increasing in the low barrier–to–entry markets, which are mostly in the South and Midwest. This could pose a supply problem for these markets in the next few years.

Of the four property sectors, the US **office** markets have experienced the most dramatic improvement during the past two years. Rental growth has been strong and widespread. US money centers will continue to be prime beneficiaries of the strong expansion in the financial services industry. The year ahead should deliver another round of steady growth to the office market. Although supply overall is expected to remain proportionate to demand, oversupply could become a risk in some markets beyond 2007.

The **retail** sector witnessed continued strong demand growth in 2006, reflecting strong retail sales growth in the first half of the year. However, relative to the other property sectors, its performance was less dramatic. Steady construction in the face of weakening retail sales and net absorption should result in rising vacancy rates in 2007. In general, vacancy rates will remain healthy by historical standards. However, some retail over-building is likely in low barrier to entry markets with low land costs. These tend to be focused in Southeastern and Southwestern metros. Overall, rent growth for the sector is expected to be modest.

Apartment Properties: Concession Burn Gives Way to Real Rent Growth

Market Highlights. Several factors contribute to a continued positive outlook for the apartment sector. These include employment gains, strong net absorption of apartment units, and limited new supply in the development pipeline. These factors have been proven in the past couple of years through effective rent increases and rising occupancy.

The apartment sector moved beyond recovery squarely into the growth phase of the real estate cycle in 2006. Apartments posted a 5.4% third quarter 2006 vacancy rate, representing a year-over-year decline of 40 basis points. With reduced competition from the for-sale housing market, limited new apartment supply, and stabilized occupancies, property managers enjoyed increased leverage in reducing concessions and pushing modest asking rent increases. Current market dynamics suggest strong operating performance will continue into 2007, with a shift toward higher contract rents as concessions burn off. With improved overall occupancy, only those markets with above average vacancy will continue to benefit from significantly stronger unit absorption.

Traditional apartment demand drivers, such as population, household formation, employment and immigration growth are currently strong. Demographic trends will favor apartments in the second half of this decade much more than in the first half. The “echo boom” generation is estimated to comprise more than 76 million people. Growth in the prime renter-age cohort of 20 to 24 year olds is expected to total nearly 900,000 between 2005 and 2010, peaking in 2009 and 2010. This should benefit both coastal high cost housing markets as well as the Sunbelt, where strong demographic flows and attractive job markets will stimulate demand.

The US is projected to add 14.6 million new households between 2005 and 2015, an average of roughly 1.5 million new households each year. Comparatively, the US has added about 1.3 million new households each year since 2001. The 15% acceleration in new household formation will be driven by echo-boomers coming of age and from strong immigration. The top ten markets expected to gain Echo Boom households over the next five years include Southern California, excluding Orange County, Washington, DC, Atlanta, Charlotte, Raleigh, West Palm Beach and Orlando, and the Texas metros of Dallas, Austin and Houston.

The US has always accommodated strong immigration, in spite of changing and inconsistent governmental policies. In recent years, immigration has been a major national political issue, and US policy questions remain unresolved. While policy is likely to restrict future immigration somewhat, it is unlikely to have a major impact. Immigration is crucial to the health and balance of the apartment sector as evidenced in a 2002 study by the National Multi-Housing Council. The study found that 44% of recent immigrants rent apartments versus 13% of natives. Based upon Census Bureau projections, immigrants will contribute an additional 1.1 million renter households by the year 2010. After netting out the immigrants who arrived in earlier decades and are likely to move into homeownership, immigrants still add nearly 500,000 renter households.

On the supply side, multi-family starts weakened overall in 2006. Completions nationwide in 2007 are expected to remain below trend at less than 90,000 units. This represents nearly 1.0% of stock, well below the 1.4% historical trend. Regionally, though, several markets have had a strong up-tick in development. The top markets nationwide for new apartment construction include New York, Chicago, Seattle, Los Angeles, Atlanta, Orlando, Houston, Washington DC, Austin and Las Vegas. Construction figures include both rental and condominium development, and these markets were particularly targeted for condominium development. Fortunately, these markets are some of the highest demand markets so that excess supply should be absorbed relatively quickly. This accelerated supply will remove some of the pricing leverage, however, except in premier markets for exceptional product.

With today's premium pricing for apartments, acquisition of high quality assets at attractive yields will be difficult. Asset selection and strong property management will be especially important in this sector, where attractive deals will be highly opportunistic. The following are likely to be some of the more promising strategy for apartment acquisitions in the coming year:

- Apartments in high-barrier-to-entry markets where returns are likely to be above average over a long term hold, in spite of a low going-in yield;

- Properties in markets that are still in early stages of recovery, where several years of strong rent growth are forecast;

- Older Class B properties in strong growth markets, where rents can be increased substantially through renovation and market repositioning;

- New development in urban or inner suburban infill locations where prospects are excellent for growth, but new supply is restricted;

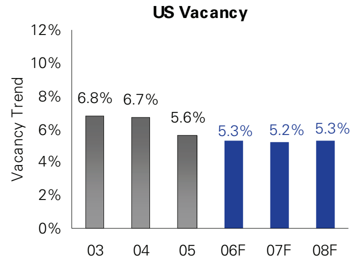
- New mixed-use apartment and retail development in excellent infill locations, since consumers have proven a preference for this more exciting and convenient product;

- Market-timing acquisitions in second tier markets or locations where growth is expected to be strong, but price is significantly below replacement cost, requiring a carefully timed exit before supply can ramp up; and

- Acquisition of failed condominium developments from troubled developers or converters.

There is no single optimal acquisition strategy, so the door should remain open for opportunities in varying markets and submarkets. The demographic shifts clearly favor the Sunbelt states, like Georgia, Florida, the Carolinas, Texas and Arizona, but many of these tend to be low-barrier-to-entry markets, and will require market timing skill. On the other hand, high-barrier-to-entry markets offer more supply protection for long term hold. Conversely, they often require an especially low going-in yield, making acceptable long-term yields difficult. The dynamics going forward suggest a healthy diversification, geographically by product type and strategy. We expect vacancy to range between 5.3% and 5.6% over the next five years and construction volumes to increase in 2009 and 2010.

Exhibit 9
Apartment Snapshot



Metro Outlook: 2006-2007

Leaders		Laggards
Austin	Oakland/East Bay	Boston
Dallas	Orange County	Charlotte
Ft. Lauderdale	Riverside/SB	Kansas City
Los Angeles	San Diego (suburban)	Raleigh
Mami	Washington, DC	Philadelphia
New York	West Palm Beach	St. Louis
No. New Jersey		

Source: REIS and RREEF Research

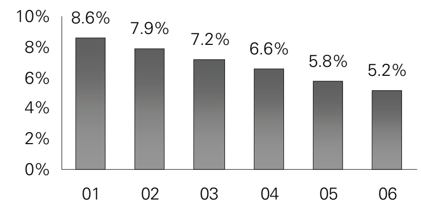
Risks associated with apartment investment at this point in the cycle include:

- The high level of interest in apartment investments and subsequent high capital flows have bid cap rates to historic lows. In some markets, future projected rent growth is already imbedded in these low cap rates. As a result, the buyer is not being compensated for the risk to future rent growth.
- Employment growth is requisite to balanced space market fundamentals and a muted job outlook may result in less demand;.
- More restrictive immigration policies could diminish a vital component of apartment demand.
- Higher replacement costs are driving up pro forma rents for new development, but the last recession proved that apartments are not immune to recession. High-end apartments are particularly vulnerable to economic malaise. Further, rental demand will increasingly depend upon echo boomers and immigrants, who tend to be younger and earning less money than other target renter markets.
- High condominium and entry level single family foreclosure rates, along with excessive levels of new construction, may result in a competitive challenge to rentals in the form of shadow rentals or as a lower cost of entry into homeownership.
- Continued low interest rates and the plateau or even reversal of home price appreciation may take some renters off the sidelines in 2007 as they move in to pick up "deals" in single family homes and condominiums.

Transaction Market. Sales of apartment properties picked up after the second half of 2006, when interest rates stabilized. According to Real Capital Analytics (RCA), apartment prices were remarkably resilient despite the pullback in apartment acquisition activity by condominium converters. Sales volume in 2006 was off 3.0% from 2005, closing last year at an estimated $85.9 billion. RCA further reports that 4,103 properties were exchanged for a weighted average price per unit of just less than $98,000, relatively flat compared to 2005. The weighted average cap rate was a low 5.2% compared to last year's 5.8%. Cap rates in the top tier markets are holding firm, while secondary markets appear to be at risk for some adjustment for lesser quality assets.

Performance. The NCREIF Apartment Index finished the year ending third quarter 2006 with a total return of 17.0%, trailing office and industrial properties. A 170 basis point drop in appreciation contributed to a lower overall return. The income return notably was the weakest of all the property types. High-rise and garden properties posted total returns of 17.8 and 16.6%, respectively. Regionally, properties in the West and South led total returns, posting 19.2 and 17.5%, respectively, boosted by appreciation.

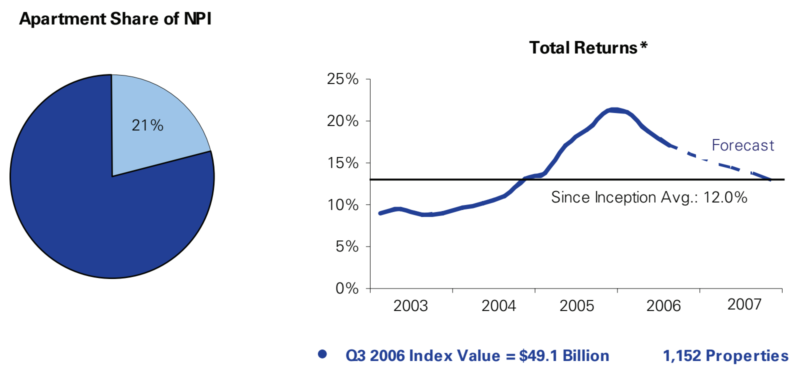
Exhibit 10
Average Apartment Cap Rates
Year-End 2001-2006



Source: Real Capital Analytics & RREEF Research

We expect total returns for apartment properties as measured by the NPI to range between 12% and 14%. Further improvement in market fundamentals should shore up values in the face of slower rates of appreciation.

Exhibit 11
NCREIF Apartment Index
as of Third Quarter 2006



*Unleveraged Rolling Four Quarter Returns
Source: NCREIF & RREEF Research.

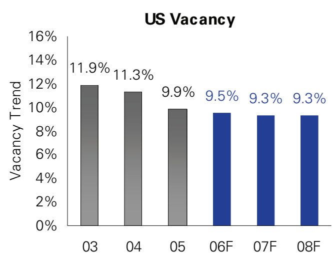
Industrial Properties: Steady Gains

Market Highlights. Coming off a stellar 2005, industrial market fundamentals continued to improve in 2006. The industrial sector's availability rate fell by 140 basis points in 2005, enjoying the best year-over-year decline on record. With a recovery that began in 2004 well underway, the industrial sector's availability rate is now approaching its 15-year historical average of 9.3%. The warehouse segment leads the overall industrial sector recovery, while conditions for the R&D/flex segment are tracking a typical cycle pattern and are finally gaining traction with availability now down to the low 13% range, a drop of more than 150 basis points from 2005. After taking a breather during the first quarter, net absorption should still post a healthy 200 million square feet for 2006. Ample capital and improving market conditions have spurred a more active construction pipeline, with deliveries expected to reach almost 180 million square feet by the close of 2006 – up 20% from 2005.

Although the US economy slowed during the second half of 2006, factors that drive industrial demand remained resilient during the year. The consumer did not go away and strong balance sheets allowed businesses to continue to invest, while an expanding global economy and a weakening US dollar grew exports at an accelerating pace. While the gateway markets on both coasts have led the current industrial recovery, market conditions in most US metros continued to strengthen in 2006 producing a more broad-based and diverse recovery.

Leading indicators for industrial demand provided a mixed picture for 2007. Rising inventory levels and slowing import growth point to weakness during the first half, but the US economy is expected to regain its momentum by the close of the year. Speculative construction activity is increasing in the low barrier-to-entry metros, which could pose a supply problem if demand does unexpectedly waver. Political efforts to expand global free trade have stalled, while increasing protectionist rhetoric out of Washington is a growing concern. Political risk aside, moderate economic growth is expected to keep the industrial sector on track for another positive, albeit steady year in 2007. Here's our view for the year ahead:

Exhibit 12
Industrial Snapshot



Metro Outlook: 2006-2007

Leaders		Laggards	
Austin	Orange County	Boston	Memphis
Fort Lauderdale	Orlando	Charlotte	St. Louis
Los Angeles	Riverside/SB	Columbus	Trenton
Miami	San Diego	Detroit	
Minneapolis	San Jose	Hartford	
Oakland/East Bay	Seattle	Indianapolis	

Source: REIS and RREEF Research

- Supply/demand fundamentals should strengthen further, although at a slower pace as decelerating net absorption (forecast of 165 million square feet) will slightly outpace a projected 155 million square feet of new supply. The national vacancy rate falls to 9.3% by year's end (see Exhibit 12).
- Net absorption is decelerating due to weakness in housing and a slowing consumer sector. However, increased capital spending, along with rising export growth, continues to support industrial space demand.
- The current cycle of industrial development is being driven by large distribution users looking for large floor plates, more doors, and increased outside storage capacity for trailers and containers. In the major distribution markets of Atlanta, Chicago, Dallas/Ft Worth, and Southern California's Inland Empire, big-box warehouse construction activity is approaching levels last seen in the late 1990s.
- The rapidly improving R&D/flex segment should continue its recovery as the tech hubs of San Jose, Austin and Raleigh, along with Atlanta, Dallas and Phoenix benefit from increased capital investment by US companies. The national vacancy rate is expected to reach low double-digits in 2007.
- Although the global gateway hubs of Southern California, South Florida, San Francisco Bay Area, Seattle, and New York/Northern New Jersey will continue to outperform,

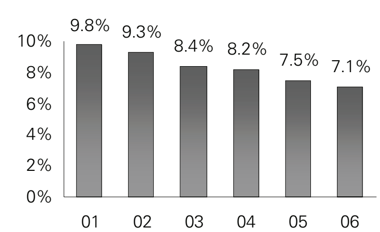
strengthening market conditions have moved to an increasing number of metro markets in the Midwest and the South.

- Effective rents should continue to post steady increases in markets with single-digit vacancy rates, with an average rent increase of 4.5% in 2007. Providing the most upside, R&D/flex space in rapidly improving tech markets could see above-average gains in effective rents in the 5% to 6% range, as free rent decreases and occupancies improve.

Transaction Market. Investors are still bullish on the industrial sector, despite the current market's elevated prices and depressed yields. Industrial property sales reached $38 billion in 2006, up approximately 10% from 2005. Much of that gain is attributed to a strong appetite for warehouse properties and several high-profile REIT privatizations. Although the buyer composition for industrial remains broad, institutional investors, including pension funds, have remained the top buyers of warehouse properties. Private local investors continue to lead acquisitions in R&D/flex space.

Average cap rates for warehouse and flex properties continue to trend down, but the pace of compression appears to be stabilizing. The average industrial cap rate dropped 40 basis points from the close of 2005 to 7.1% by the end of 2006 (see Exhibit 13). While the average US industrial cap rate is about 7%, rates in the spot market range as low as 4.5%. Newer warehouse buildings in the leading distribution markets are priced at or above replacement cost, protected to some extent by long-term leases to credit tenants.

Exhibit 13
Average Industrial Cap Rates
Year-End 2001-2006



Source: Real Capital Analytics & RREEF Research

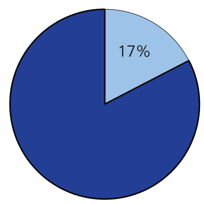
Industrial property pricing in 2007 is expected to witness little change. Our expectations are as follows:

- The desirability of industrial properties as a core holding in institutional property portfolios keeps pricing strong.
- Persistent investor demand and strong market fundamentals hold warehouse pricing and cap rates at their current levels.
- Sustained competitiveness in the transaction market and improving occupancies support stronger pricing and lower cap rates for R&D space.
- Potential value declines are restricted to lesser quality properties in over-supplied markets.

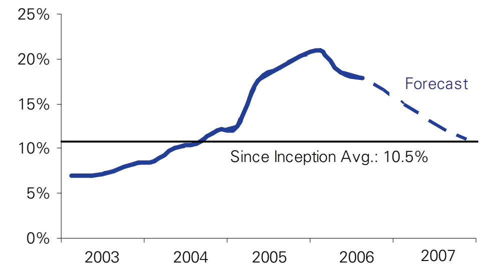
Performance. The NCREIF Industrial Index posted a total return of 17.9% for the year ending in third quarter 2006, 30 basis points above the NPI composite return (see Exhibit 14). Warehouse properties remain the most stable industrial performer, posting total returns of 18.2%, while the total returns for the flex and R&D segments slipped to 17.3% and 15.2%, respectively.

Exhibit 14
NCREIF Industrial Index
as of Third Quarter 2006

Industrial Share of NPI



Total Returns*



- **Q3 2006 Index Value = $40.5 Billion** **1,939 Properties**

*Unleveraged Rolling Four Quarter Returns

Source: NCREIF & RREEF Research.

After posting several years of exceptional growth, we expect total returns for the industrial sector to trend down in 2007 towards the sector's historical average return of 10.5%. Essentially tracking the NPI composite return during 2007, we anticipate total NPI returns for the industrial sector to range between 10% and 12%. Continued robust demand from institutional investors for warehouse product and overall healthy market conditions should produce a steady year of returns from the industrial sector.

Office Properties: Standing at the Crossroads

Market Highlights. The US office market is at a critical point in the cycle. The past three years have seen solid occupancy gains on a national basis. At best, there has been strong, double-digit rental growth for Class A space in the leading metros. At worst, the lagging markets have seen their availability rates stabilize and net absorption turn positive.

The US office market's performance remained positive in 2006, although the pace of recovery was less robust than in 2005. The office sector produced 53 million square feet of net absorption through the third quarter and an estimated 72 million square feet for the year overall – down from a five-year high of 89 million square feet in 2005.

Sustained office job growth, forecast at 2.2% for 2006, also helped the national office availability rate to decline to 12.8%, a fall of 80 basis points over the year compared to an 180 basis point fall in 2005. Currently, downtown markets post a 10.9% availability rate compared to 14.0% in the suburbs.

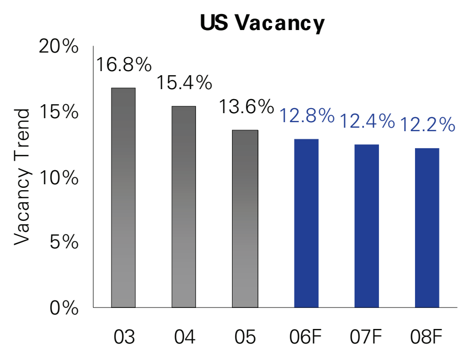
The supply-side has started to gear up again. After six straight years of decline, national multi-tenant office completions rose by 14 million square feet in 2006 to approximately 52 million square feet. This is in line with the long-term (1988 to 2005) historic average of 54 million square feet per year.

On a geographic basis, the office sector's performance remains far from even. On a broad basis, the leading markets – those with low availability levels and strong upward movement in Class A rents – are clustered in the East (Manhattan, Washington, DC, Miami and Fort Lauderdale) and the West (Los Angeles, Orange County, San Diego, San Francisco and Seattle). Midwestern markets have now stabilized but the supply-rich markets of Dallas and Atlanta continue to lag, as do the slow-moving economies of Philadelphia and Central New Jersey.

The year ahead should deliver another round of steady growth to the office market. The major risk facing the sector rests with the demand side, at least in the near term. As long as the employment pipeline is working the market should continue witnessing positive conditions. Office construction starts are increasing but deliveries should be containable, on a national basis, for another 12 months. Here's our take on the sector during 2007:

- Sector fundamentals show further, if more modest, improvement, as net absorption again outpaces new supply - 54 million square feet compared to 47 million square feet. The national availability rate falls by 40 basis points to 12.4% by the close of 2007 (see Exhibit 15).

Exhibit 15
Office Snapshot



Metro Outlook: 2007

Leaders	Laggar
Los Angeles	Atlanta
Mami	Dallas
New York	Mnneapolis
San Francisco	Central NJ
Seattle	Philadelphia
Washington DC	

Source: REIS and RREEF Research

- Office employment growth will slow to 1.2% in 2007, resulting in the addition of 600,000 new jobs and accounting for the slowdown in absorption to around the long-term average of 52 million square feet per year.

- New office development, at 47 million square feet, will remain at a containable level on a national basis in 2007. Although construction costs remain high and there is still a gap (in most locations) between market and replacement cost rents, the desire to generate higher returns through new construction is rising. Supply is, therefore, a risk.

- Growth in Class A effective rents should remain healthy. Average Class A effective rental growth across the 24 metros tracked in RREEF Research's US Office Market Book is forecast at 5.3% for 2007.

- NOI growth will be assisted by the expiration of leases struck on five-year terms that were undertaken at the bottom of the rental market in 2002.

- New development will remain concentrated in a handful of metros – most notably Washington DC, New York, Seattle, Las Vegas, San Diego and Orange County. In the latter two Southern California markets, while they remain strategic long-term locations, we anticipate a rise in availability in 2007 as new speculative construction outpaces short-term demand.

- Construction activity will gear up again in the land-rich, volatile markets of Phoenix, Dallas and Atlanta.

- Among the major markets, the following metros will close out 2007 with an availability rate of 10% or below: Los Angeles, Miami, New York, San Francisco, Seattle and Washington DC.

- While there will be significant submarket-level variations, in broad terms, the strongest appreciation in Class A rents is expected in Boston, Denver, New York, San Francisco, San Jose and Seattle.

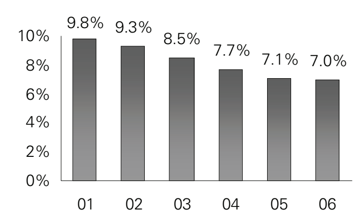
Transaction Market. Further rises in pricing characterized the office sector in 2006. Increasing values for core office assets have made it virtually impossible to acquire well-leased properties at a discount to replacement cost.

New records were set in 2006 with capital values breaking through the $1,000 per square foot barrier in Midtown Manhattan. Office buyers paid over $700 per square foot in the District of Columbia and $600 per square foot in Downtown San Francisco. While this has limited the pool of potential buyers for such trophy assets, the demand for office properties remains unabated. This demand is evidenced by the high profile private equity acquisitions of office REITs such as Crescent, Reckson and Trizec and the on-going battle for the acquisition of Equity Office Properties.

The most significant change in investor strategy is the shift to a value-added approach. Investors are becoming more willing to take on leasing risk, undertake capital improvements, consider secondary markets or create value through new construction.

Average cap rates for office properties fell by 10 basis points from 7.1% at the end of 2005 to 7.0% at year-end 2006 (see Exhibit 16). Cap ra tes in the spot market, while only holding steady in the second half of the year, still remain as low as 5% for Class A properties in CBD markets like New York, Washington DC, and San Francisco. Cap rates in the leading suburban markets can range as low as 6%.

Exhibit 16
Average Office Cap Rates
Year-End 2001-2006



Source: Real Capital Analytics & RREEF Research

Office property pricing is expected to witness only slight change in 2007. Our expectations for the transaction market are as follows:

- Steady investor demand and rising rents keep office pricing and cap rates at or close to current low levels for most institutional quality product.

- High prices for core properties will encourage even more investors to undertake value added acquisitions.

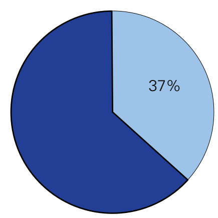
- The flow of capital to new development will increase.

- As the rate of improvement in market fundamentals slows, cap rates on some lesser quality assets may increase by 25 to 50 basis points by the end of the year.

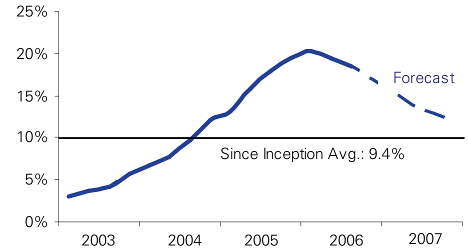
Performance. The NCREIF Office Index posted an 18.4% total return for the year ending third quarter 2006, 80 basis points above the NPI composite return (see Exhibit 17). CBD properties registered a 21.0% total return while the suburban segment returned 16.8%.

Exhibit 17
NCREIF Office Index
as of Third Quarter 2006

Office Share of NPI



Total Returns*



Q3 2006 Index Value = $85.3 Billion **1,271 Properties**

*Unleveraged Rolling Four Quarter Returns

Source: NCREIF & RREEF Research.

We expect total returns for office properties as measured by the NPI to range between 11% and 13% during 2007, slightly outdistancing the projected total NPI return of 10% to 12%. Steady buyer interest and a modest further improvement in market fundamentals should support sound performance from the office sector.

Retail Properties: At their Peak

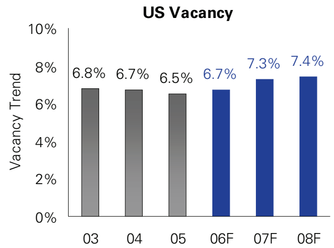
Market Highlights. A sharp slowdown in consumer spending, which has long been predicted, began in late 2006. American consumers have been on a tear for the past four years, with retail sales and food services, excluding automobiles, producing growth which has averaged over 7% annually since the end of 2002. The past two years, 2005 and 2006, have been the strongest, with retail sales growth averaging over 8% annually, reflecting particularly strong growth during the first half of 2006. Consumers remained confident even in the face of high energy prices, rising short-term interest rates, and a slowing housing market. Despite a brief contraction in spending when oil prices approached $80 per barrel, consumer spending resumed after prices settled back into the $60 range. Long-term interest rates have also remained low, a further support to consumer spending.

Retail sales growth is expected to continue to moderate in 2007. The national for-sale housing market, which peaked in 2006, has slowed considerably, with reductions in home values in many markets. With a slowing overall economy, we expect retail sales growth to moderate considerably in 2007 to between 4% and 5%.

The retail property market has peaked as well. Net absorption of retail space has been very strong the past three years, achieving levels similar to those achieved during the 1997 through 2000 economic boom. New construction was restrained during the past several years, but it ramped up in 2006. With strong absorption, vacancy rates have remained healthy, ranging between 6.5% and 6.7% during the past three years (see Exhibit 18).

After several years of strong retail sales growth, most retailers are financially strong by historical standards. As a result, they are expanding through aggressive new store openings, including their traditional stores as well as the introduction of new concepts. Since retailers tend to drive new development, retail completions can be expected to be strong during 2007, maintaining a level similar to that achieved in 2006. We forecast that this new construction will exceed demand, driving vacancy rates upward by approximately 60 basis points to 7.3% by year-end 2007. While this shift in supply and

Exhibit 18
Retail Snapshot



Metro Outlook: 2006-2007

Leaders		Laggards	
Baltimore	Orange County	Charlotte	Indianapolis
Boston	San Diego	Cincinnati	Memphis
Los Angeles	San Jose	Columbus	San Antonio
Miami	Seattle	Dallas	St. Louis
No. New Jersey	Washington, DC	Fort Worth	
Oakland/East Bay		Houston	

Source: REIS and RREEF Research

demand dynamics is an indication that the retail market has peaked, this vacancy rate is still quite healthy by historical standards. By contrast, as a result of significant overbuilding, vacancy rates remained above 10% between 1987 and 1992. In 2008, new construction is projected to decline to a level only slightly exceeding net absorption, producing a modest 10 basis point increase in the vacancy rate. With a slowing in retail sales growth, most retailers are placing renewed focus on profitability over growth. As a result, we expect new store openings to be more muted in 2008 and 2009.

New retail construction activity is largely focused on two markets: (1) value retailing; and (2) lifestyle retailing. Relatively few grocery anchored neighborhood or community retail centers or super-regional malls are being developed. Value-retailing, or **power center retail**, is being driven by major retailers who are in an aggressive expansion mode. Wal-Mart leads this group, with the most ambitious expansion plans, with plans to open over 300 stores in the coming year within the US. However, the world's largest retailer has stumbled in the past year, producing disappointing sales growth. Expansion has been too rapid, resulting in cannibalization of existing store sales. As a result, the retailer's expansion plans are more restrained than previously planned. Many successful value retailers are also expanding, including Target and other power center retailers. The value retail sector is now quite concentrated, so that most are bottom-line rather than market share focused. Thus, if over-expansion produces declining sales, they are likely to adjust their growth plans.

Lifestyle retail centers are also expanding at a rapid pace. These centers range from unanchored centers of 100,000 square feet or less to centers nearly as large as regional malls. An increasing number include one or two down-sized department stores. In nearly all cases, they are open air formats. The convenience and ambience of these centers has proven quite popular, particularly with time-pressed affluent households. Department stores are still refining their prototypes, but are finding these centers to be desirable venues. Several upscale apparel retailers find these formats especially appealing to their customers. These retailers tend to focus on the baby boom generation market. In addition, restaurants and home furnishings retailers perform well in these centers. Lifestyle centers have been wildly popular and successful, with broad acceptance from both shoppers and retailers.

Enthusiasm for lifestyle centers may result in over-building. A few centers have opened in the past year in locations where support has been weak, thereby providing some caution to retailers. Many long-planned projects have been delayed as major retailers and anchors reconsider their expansion plans. Nevertheless, we expect to see some weak centers open in the next couple years.

Grocery anchored **neighborhood or community retail** centers are currently in a position of strength. The traditional grocer is emerging from a period of consolidation and redefinition, and is once again a strong anchor in appropriate markets. Once mass market retailers, grocers have been challenged by lower cost operations, led by Wal-Mart, with their Super Centers and Neighborhood Markets. As a result, the grocers have repositioned themselves to target affluent markets. Although sensitive to cost, they are also sensitive to the shopping experience and quality of the offerings. The industry is now dominated by national and a few strong regional operators. Neighborhood and community retail centers anchored by the more successful operators in strong demographic locations will continue to be robust, and are unlikely to face major new competitive development.

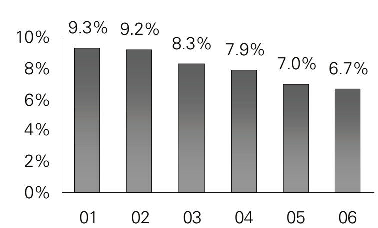
Few new **super-regional malls** are being developed. Using a strict definition of a minimum of three department stores (or at least two full-sized department stores), no new malls opened in 2006 and none are on track for opening in 2007. Large lifestyle centers, as described above, with one or two downsized department stores, have taken their place in the construction pipeline. With a dramatically consolidated department store industry, and the difficulty and cost of developing full-sized super-regional malls, few are likely to be developed in the future. Nevertheless, many of the strongest established malls are in the midst of renovation and/or expansion, indicating that this segment is alive and well.

In addition to the trend toward outdoor venues, other formats are emerging in the shopping center industry. Perhaps the hottest product is the **mixed-use town center**, generally incorporating residential, and sometimes office and/or hotel, into the development. Consumers seem to prefer these visually exciting active environments, and the higher density allows for development in costly infill locations that are often under-retailed. In other cases, existing super-regional malls are being retro-fitted with mixed-use development. Another popular concept is the hybrid of a lifestyle and power retail center in a single development. This allows for maximum shopping flexibility within a single trip.

Retail over-building will be most pronounced in low barrier-to-entry markets with low land costs. These tend to be focused in Southeastern (excluding Southern Florida) and Southwestern metros. Higher density infill markets, with strong incomes, high land costs, and restrictive planning controls, will generally be insulated from excess supply. Northeastern and West Coast metros provide the greatest concentration of favorable markets.

Transaction Market. Retail properties continued to appreciate in 2006, with further cap rate compression. Although the retail sector had experienced healthy income growth over the past five years, most price appreciation has come from a fall in cap rates from 9.3% at year-end 2001 to 6.7% at end of 2006 (see Exhibit 19).

Exhibit 19
Average Retail Cap Rates
Year-End 2001-2006



Source: Real Capital Analytics & RREEF Research

Sales volume of retail properties increased at a rapid pace through 2005, growing from approximately $12 billion in 2001 to $50 billion in 2005, a faster rate of growth than that experienced by office and industrial sales, but slightly below that for apartments. Overall, sales for retail properties increased by an average of 43% annually, compared to 37% for the four property types in total.

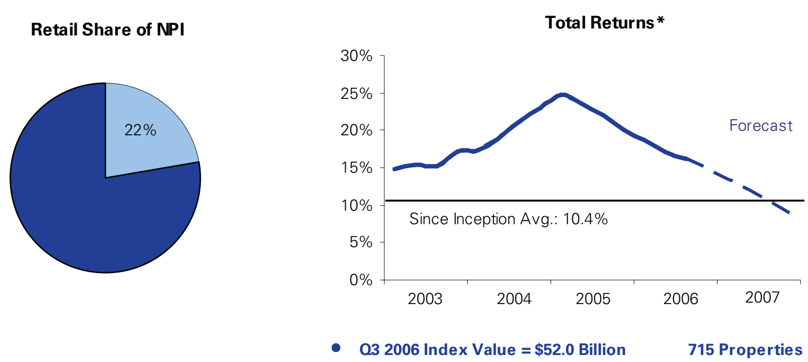
Retail's preferred status appears to have taken a hit in 2006. Whereas overall property sales increased by over 10% during the year, retail property sales were up only 3%.

Retail pricing appears to have peaked. Cap rates reached a low of 6.6% in the third quarter of 2006, rising by a modest 10 basis points in the final quarter of the year. With slowing growth in consumer sales and modestly rising vacancy rates, there will be little pressure to produce NOI growth above an inflationary 2% to 4% annually. As a result, cap rates will need to rise to reach investor hurdle rates for total returns in the transaction market.

We expect modest upward movement in cap rates over the next year of between 20 and 30 basis points. Sales will evidence an increasing divergence between commodity or second-tier shopping centers and those which are market dominant. Class A malls, centers anchored by dominant grocers in affluent markets, power centers in strategic locations with strong anchors and well-conceived lifestyle centers will continue to hold their value. Lesser quality assets could experience greater cap rate increases.

Performance. The NCREIF Retail Index finished the year ending third quarter 2006 with a total return of 16.2% (see Exhibit 20), lagging the composite NPI by 140 basis points. Between 2002 and 2004, the retail index beat the composite by a substantial margin. In 2005, the two indices approximated each other. This past year has been the first year during this cycle in which retail lagged the composite. Fashion/specialty (lifestyle) led this sector substantially, producing a total return of 24.4%. Regional and super-regional malls have led the retail sector by a modest margin, while neighborhood and community retail have lagged somewhat. Power centers have trailed in performance by a wider margin, with a 14.0% total return.

Exhibit 20
NCREIF Retail Index
as of Third Quarter 2006



*Unleveraged Rolling Four Quarter Returns

Source: NCREIF & RREEF Research.

We expect total returns for retail properties as measured by the NPI to range between 8% and 10% during 2007. This reflects our expectation that retail sales grwoth will moderate over the coming year and that appreciation in the retail property sector has reached its peak.

Implications for Investors

Real estate is nearing an inflection point, but should continue to attract capital flows in 2007. Pricing for the best product in primary markets will hold its value. Investors with core strategies are accepting the higher prices and associated lower returns. Cap rate compression for core product, however, appears to have ended. As a result, total returns will no longer receive a boost from declining cap rates. In fact, investments could be in danger of moderately increasing cap rates. This will be especially true for secondary assets, retail and apartment (in formerly frothy condominium conversion markets) properties. Asset selection will be key in this environment. A focus on active property management and leasing will also be required to generate healthy returns on acquisitions.

At the margin, more capital is flowing to higher-yielding strategies such as value-added, opportunistic, or international investments. Given strong market fundamentals, real estate investors are taking more risk to achieve higher yields. The increased capital flowing to these strategies is bidding down returns, though in this current dynamic investment setting, investors need to consider the following when implementing a real estate program.

Core Strategies. High prices and lower yields have characterized core product. Investors are recognizing that core product reflects rich pricing. The best product in the best markets remains highly sought after, with below replacement cost pricing being eliminated. Still, real estate investors want exposure to core product for its stable cash flow, especially in this relatively benign space market environment. Strategies to consider across regions and product types are as follows:

- **Geographies**. Buy the best product in the leading markets. These include the tri-coastal markets that will continue to generate jobs and attract population flows in an era of globalization. These tri-coastal markets have exposure to those industries that will benefit from globalization trends this decade.

- **Apartments**. Core multifamily investors should stick to supply constrained markets. High-barrier-to-entry markets with high housing costs include New York, Washington DC, Seattle, California in general, and most other coastal and mountain markets. The buy back of unsuccessful condominium projects and leasing as apartments is also an emerging opportunity.

- **Industrial**. Industrial remains a popular core asset due to its low rental volatility and modest NOI leakage from turnover. It is more recession proof relative to other property sectors as well. Acquire industrial warehouses around major ports and airports. Port congestion around Los Angeles and the East Coast may create opportunities in secondary ports, such as Oakland, Savannah, and Tacoma.

- **Office**. Acquire Class A CBD product in the nation’s money centers to take advantage of the expanding financial services industry in the US. Buy the best office product in recovering tech markets to take advantage of strong business spending, both domestically and globally.

- **Retail.** The retail sector has peaked and should be the first to show a supply/demand imbalance in 2007. Some retail opportunities still exist, including mixed-use retail, urban infill retail, and Hispanic retail that caters to the changing US demographics.

- **Mixed-use**. Mixed-use properties in dense infill settings are becoming popular with consumers, and evidence suggests that they can produce superior income returns over comparable single-use properties. Typically, mixed-use combines retail with apartment or office uses, which provide synergistic benefits. For new development, or existing product for a long-term hold, mixed-use investments have the potential to generate superior returns.

- **Asset-specific investing**. With historically low cap rates and a slowing economy, acquisitions will need to be highly opportunistic in 2007. While all acquisitions are asset-specific, acquisition officers will be particularly challenged during the next year to find those opportunities that afford an attractive price and/or growth prospects in order to achieve desired risk adjusted returns.

- **Late cyle markets**. Since going-in yields are low in prime markets nationally, opportunities could present themselves in markets that are in the early phases of their growth cycle. With several years of strong income growth projected, properties in these markets have the potential to yield the desired long-term total returns.

Value-Added Strategies. The wave of capital committed to value-added and opportunistic strategies is exerting downward pressure on returns. Prices, however, remain less frothy than for core deals, generating a significant premium of 100 to 200 basis points on total return, unleveraged. Given that we are in the growth phase of the real estate cycle, value-added investment is appealing. In this low-interest rate environment, leverage will remain a key component of value-added returns.

Development. As with value-added, a development strategy makes sense during the growth phase of the real estate cycle, particularly in high growth supply constrained markets. A premium of approximately 300 to 400 basis points should be expected for new development, with additional returns provided by favorable leverage.

Disposition Strategies. With demand for real estate assets at a high point, investors should accelerate the pruning of their portfolio. In particular, portfolio managers should take advantage of the surge in investor demand for value-added and opportunistic properties. Investors can sell assets that have leasing challenges at highly competitive pricing in 2007. Similarly, properties that are nearing their cyclical peak in their income producing potential might be sold today, with the funds redeployed for higher-growth opportunities.

Publicly-Traded REITS. Publicly-traded REITs ourperformed both equities and bonds for the seventh consecutive year. Expectations are that the Wilshire REIT should deliver a total return of between 5% to 10% this year. Although we are cautious near term, we believe that REITs will continue to enjoy healthy demand given the lack of compelling alternatives. With that backdrop, we continue to view the relative returns of real estate securities attractive in 2007.

ANALYST CERTIFICATION

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst. In addition, the undersigned lead analyst has not and will not receive any compensation for providing a specific recommendation or view in this report.

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