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Prospects for the US Economy and Real Estate Markets: The Return of Risk Aversion . . . At Last!

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Troubles brewing in the subprime sector of the residential mortgage market exploded into business news headlines as a crisis in the nation's debt markets this summer. It is apparent that the problem extends to the overall investment market, regardless of quality. In a global economy flush with cash seeking higher yields, leverage has been used excessively across all investment vehicles. In the residential market, all types of mortgages were frequently offered at very high loan-to-value ratios to buyers with poor or no credit. In the commercial property markets, mortgages were underwritten for core and even development deals at very high loan-to-value ratios on properties that in some instances were ill equipped to cover their loan payments. Loan securitizations fed this cheap debt, providing large quantities of supposedly investment grade paper. In addition, riskier tranches were offered at prices that reflected poor understanding of the underlying risk.

Such events were not confined to the property markets. Rapid growth of hedge funds has relied on inexpensive and extensive debt, often with an under-appreciation of risk. Private equity leveraged buyout (LBO) transactions, including a number of high profile public to private transactions, were facilitated by cheap and abundant debt. In many ways, this mirrored the LBO deals that were favored in a previous cycle.

The risk involved in heavily leveraged investments is now being realized by the markets. In fact, most leverage that is not very low risk, utilizing rigorous underwriting standards, is highly illiquid. The value of this leverage has greatly depreciated, but since a bottom has not been established, markets may have over-reacted and pricing remains highly uncertain.

Prepared By:

Alan Billingsley
Director
RREEF
San Francisco
USA
(415) 262-2017
alan.billingsley@rreef.com

Asieh Mansour
Chief Economist and Strategist
RREEF
San Francisco
USA
(415) 262-2044
asieh.mansour@rreef.com

The dust will settle, markets will establish pricing, and riskier debt will become marketable again. However, the unrealistically tight spreads between low and high risk investments will not narrow to their pre-July levels. Even low risk debt is likely to be more expensive than in the past, while higher risk debt will remain significantly more expensive.

These events, which are still unfolding, should impact the overall economy, the real estate markets and real estate pricing. The following discussion addresses these issues.

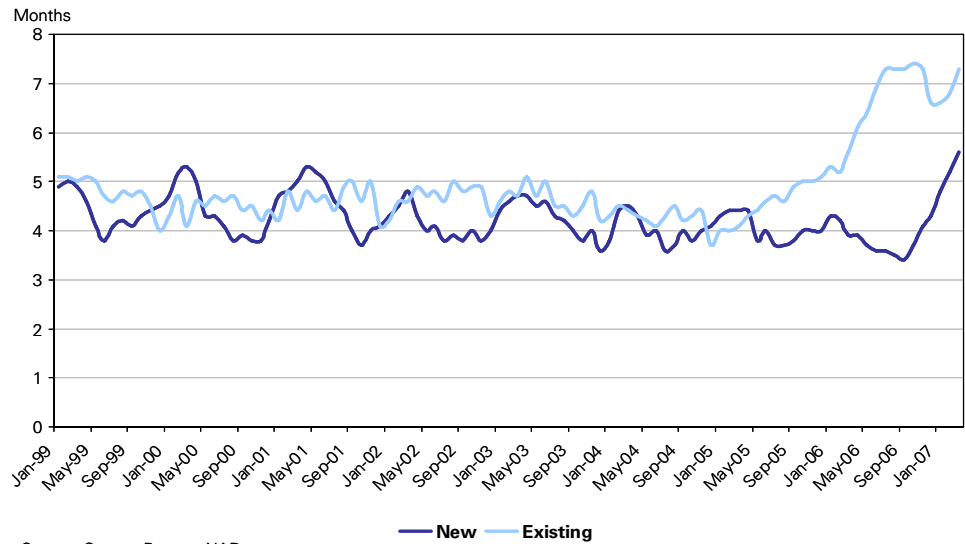
Impact on the Economy

The US economy was already on a softer trajectory leading up to the recent financial turmoil. The current credit and liquidity squeezes, however, have increased the downside risk to US economic performance going forward. Nevertheless, the underlying fundamentals of the economy are strong, with the notable exceptions of the housing and mortgage markets, and the riskier segments of the debt markets. The following highlights some of the key features of our outlook.

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- **Housing** remains the primary drag on the economy, subtracting roughly 100 basis points from growth over the past four quarters. The slowdown in housing in itself was no surprise but it came later and much sharper than expected. Lax credit standards and low interest rates inflated demand for housing, and home builders responded. The sharp tightening of lending standards for prime mortgages, and the tightening of cost and availability of sub-prime, Alt-A and jumbo prime mortgages has dramatically depressed home buying. As a result, the unsold inventory of new homes is escalating while builders try to ramp down construction activity. Home prices are continuing to decline. Excess housing inventory is not forecast to be absorbed until well into 2008. Housing construction will not return to healthy levels again until 2009.

Exhibit 1
Months Supply – Existing and New Homes



- **Consumer spending** has actually fared better than expected despite the slowdown in housing and elevated oil prices. The recent drop in auto sales is the major signal of weakening consumer spending so far. Consumer spending should decline over the next several quarters, coming in line with underlying growth in disposable income. Retail sales that typically correlate with home sales, such as home improvement and home furnishings stores, will suffer the most.
- **Business spending**, especially spending on equipment, has struggled lately despite the need to boost economic growth through productivity improvements. Capital orders seem to be reviving and recent surveys suggest that they should continue to climb. Nonresidential construction should also support GDP growth over the next couple of quarters as many projects remain in the pipeline.
- **Exports** are proving a critical support to the US economy due to strong growth fundamentals around the world. Outside of the US, growth fundamentals remain on firmer footing. A falling US dollar is further assisting export activity.
- **Risk aversion** has crept into all market segments. According to S&P, both the cost and availability of funds has deteriorated for even relatively safe assets, ranging from overnight commercial paper to "A" rated corporate bonds and prime mortgages. Our general expectation is that heightened risk aversion in the market should settle down, but

the long expected re-pricing of risk should keep spreads higher and volatility at more elevated levels.

- **Interest rates** are rising, also altering our forecasts. The more prolonged slowdown in the US economy and seize up of the credit markets are leading to rising interest rate spreads, particularly for higher risk deals. The Fed has acknowledged that the downside risks for growth have increased. In addition to the recent liquidity injections and the lowering of the discount rate, it is expected that if the economy continues to falter, the Fed may lower the benchmark fed funds rate later this year, which should soften the impact of rising rates.

It is still unclear how the current financial market turmoil will affect economies. Our economic outlook remains cautiously optimistic. Strong fundamentals should limit the downside from the recent financial crisis. The financial turmoil should, however, lower US growth trajectory for the balance of 2007 and 2008. (Please refer to Exhibit 2). With the housing and debt market corrections behind us, strong economic growth is forecast for 2009 and 2010.

Exhibit 2
Forecast Highlights: August 2007

(annual % change)	2007				2005	2006	2007*	2008*
	Q1	Q2	Q3*	Q4*				
Real GDP	0.6	3.4	2.3	1.5	3.1	2.9	1.8	2.0
Consumer Spending	3.7	1.3	2.4	2.3	3.2	3.1	2.8	2.3
Business Fixed Inv.	2.1	8.1	2.7	3.8	7.1	6.6	3.2	2.9
Exports	1.1	6.4	8.5	10.0	6.9	8.4	6.9	8.9
Imports	3.9	(2.6)	3.4	3.4	5.9	5.9	2.1	3.1
Unemployment Rate	4.5	4.5	4.7	4.8	5.1	4.6	4.6	5.1

Credit Market Conditions

	2007				2005	2006	2007*	2008*
	Q1	Q2	Q3*	Q4*				
Fed Funds Rate	5.3	5.3	5.1	4.6	3.2	5.0	5.0	4.5
10-Year Treasury	4.7	4.8	4.8	4.5	4.3	4.8	4.7	4.7
Mortgage Rate (30-Year Conventional)	6.2	6.3	6.6	6.8	5.9	6.4	6.5	6.9

*Projections

Source: Global Insight, Standard & Poor's and RREEF Research

Impact on Returns

Real estate returns have been bid down to historically low levels. From 2001 through mid-year 2007, capitalization (cap) rates have declined approximately 300 basis points to an average of around 6%. For the highest quality product in the best submarkets, cap rates are another 100 basis points lower. Several factors are responsible for this yield compression:

- Real estate has become a more accepted asset class for institutional and other investors. As a result, a substantial amount of investment dollars have poured into the sector.

- Real estate is cyclical, and has entered into the recovery and growth portion of the cycle following the recession of 2001. Over the subsequent years, the sector was an attractive growth vehicle, as investors appreciated the ability to achieve income growth as demand accelerated for all property sectors. This expected growth allowed for lower cap rates, while anticipating strong total returns over the hold period.
- Debt capital was abundant during this period. Rates were lower than historical standards and lending criteria were relaxed, allowing for highly leveraged transactions at low interest rates. These enhanced returns facilitated the bidding down of cap rates, and drew more buyers into the market.

The credit environment surrounding the real estate investment market has now changed:

- While real estate is expected to permanently play a strong role in institutional portfolios, return expectations from the sector are lower. As a result, allocations to the sector are likely to moderate.
- As the overall economy matures through this business cycle, and as most real estate product experiences strong income growth, the potential for robust future growth lessens. In many markets, new supply is starting to meet or exceed demand. With expectations of more moderate future income growth from real estate, investors will need to raise their cap rate assumptions in order to attain the desired total returns.
- As we have previously discussed, the debt markets are repricing. While we expect that overall interest rates will remain low, spreads have increased to levels that are more sustainable to lenders seeking a reasonable return. In addition, lenders have re-imposed judicious credit standards, making higher risk deals either difficult to get and/or more expensive. As a result, the downward bidding of cap rates due to leverage is likely to be reversed.

We expect cap rates to rise but the amount of this increase is difficult to determine. Looking at current on-going transactions, it appears evident that cap rates have already adjusted upward. Assuming a continued favorable inflation and interest rate environment, we are expecting a 50 basis point upward adjustment in cap rates by the end of 2007, with a further 25 to 50 basis point upward adjustment in 2008. Cap rates will rise more for properties in weaker markets and submarkets, while those in strong primary markets will experience less of an increase.

Impact on Real Estate Fundamentals

RREEF Research anticipates relatively modest impact on real estate fundamentals due to the housing and debt market correction. The following outlines our expectations:

- The slowdown in new home construction, which we expect to impact the overall economy and employment levels, is not expected to have a significant impact on institutional real estate markets. Home building has become highly concentrated in large publicly owned companies. While some of these may reduce their office space needs over the course of the next year, most are likely to ride out the downturn, with plans to ramp up construction again in 2009. For subcontractors and suppliers to home builders, which are frequently smaller companies, **industrial** markets will feel some impact, as some companies go out of business and others down-size. These impacts will be the most pronounced in the most overbuilt markets, such as South Florida, Phoenix, Las Vegas and San Diego. However, nearly all markets will experience some modest impact.

- Mortgage companies and mortgage brokers are experiencing very significant down-sizing. National estimates of jobs lost in this sector total about 40,000. This number is likely to double over the next year. Nevertheless, this is not a significant portion of office-using employment, and so will have a muted overall effect on the national **office** market. However, a few markets that house substantial concentrations of this industry will be hurt. Orange County, for example, has already experienced a visible decline in its office occupancy. Other markets, such as San Diego, Phoenix, Sacramento and Washington DC, will see some visible reductions. Overall, however, the robust national office market is expected to weather this impact.
- Investment firms that rely heavily upon the use of leverage will experience some down-sizing. A major portion of the hedge fund and private equity businesses are currently feeling heavily impacted by the difficulty and cost of extensive use of debt. For the most part, these businesses are concentrated in Manhattan and Stamford, Connecticut. Others are scattered in major metros. This down-sizing in the financial services industry will be felt by varying degrees by the nation's **office** markets.
- In metro areas that have experienced substantial over-building of the for-sale housing sector, rental **apartment** properties may be hurt. Excess homes and condos are entering the rental market, and will provide some competition with apartment properties. To some extent, this should be offset by a larger renter pool due to positive demographic trends and the increased difficulty of lower income households to afford homes.
- In metros and submarkets that are not over-supplied with for-sale housing, **apartment** markets are likely to benefit from current trends, with increasing number of households relying upon the rental market.
- **Retail** markets should expect more muted impacts from changes in the debt market. Retail sales growth, which was already declining from unsustainably high levels from 2003 through 2006, had been forecast at roughly inflationary levels over the next few years. With the on-going negative impacts on the housing and debt markets, consumers may pull back further to sub-inflationary retail sales growth. Impacts will be strongest on sector related to housing, including home improvement and home furnishing retailers.
- The **lodging** sector, more than any other property sector, is tied to the cycles of the economy. As a result, with the expected slowing of GDP growth through 2008, hotel revenue growth as expected to slow significantly from the extraordinary levels that have been achieved since 2003. As a result of an economy that is now expected to slow further relative to prior forecasts, the lodging sector will also slow further, with particularly anemic income growth expected during the second half of 2007 through 2008. With anticipated restraint in new supply, however, the longer term prospects for US hotel markets are quite favorable.
- The **construction pipeline** for all property sectors is likely to slow from that which was previously anticipated for the next couple years. With debt more expensive and underwriting more stringent, some planned projects will be either delayed or abandoned.

In summary, we expect that current conditions in the housing and debt markets will have muted impacts on real estate market fundamentals. These impacts have been taken into account in RREEF Research's current market forecasts.

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.

Asieh Mansour
Chief Economist and Strategist

Alan Billingsley
Director

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Main Offices

Frankfurt

Mergenthalerallee 73-75
65760 Eschborn
Germany
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
40th 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

Asieh Mansour
Chief Economist and Strategist
+1 415 262 2044

Peter Hobbs
Head, Global Real Estate Research
+44 20 7547 4855

North America

Alan Billingsley
Director
+1 415 262 2017

Brook Wells
Director
+1 212 454 6437

Hope Nadji
Director
+1 415 262 2022

Andrew Nelson
Vice President
+1 415 262 1135

Bill Hersler
Vice President
+1 415 262 2075

Stephen Newbold
Vice President
+1 415 262 2040

Asia Pacific

Koichiro Obu
Vice President
+81 3 5156 6000

Tan Yen Keng
Vice President
+852 2203 8062

Europe

Brenna O'Roarty
Director
+44 20 7545 6099

Maren Våth
Vice President
+49 69 717 04 204

Ermina Topintzi
Assistant Vice President
+44 20 7545 6674

Henry (Wei) Chin
Assistant Vice President
+44 20 7545 6611

Lonneke Löwik
Assistant Vice President
+44 20 7545 6328

Susannah Hunter
Assistant Vice President
+44 20 7547 3305

Publication Address:

RREEF Limited
1 Appold Street
Broadgate
London EC2A 2UU

Website:

www.rreef.com

Additional information is
available upon request

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