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### COMMERCIAL REAL ESTATE OUTLOOK: ANOTHER LOOK AT FUNDAMENTALS

Several recent stories in the press have suggested that commercial real estate values have begun to weaken in response to the current turmoil in the financial markets. As commercial mortgage lenders have tightened standards, commercial real estate buyers have an increasingly difficult time borrowing funds. With fewer buyers bidding on properties, prices *on average* have dipped, and could dip further if credit remains tight. Concerns about the slowing economy and talk of a possible recession have also dampened the outlook for commercial real estate.

As we pointed out in our February 2007 Market Monitor, “Commercial Real Estate’s Day in the Sun,” commercial real estate market returns and values are driven primarily by supply/demand fundamentals. Prior commercial real estate downturns occurred at times when supply and demand were extremely mismatched. In 2001, for example, both the national recession and the bursting of the high tech bubble resulted in a marked decline in the demand for office space. At the same time, the construction cycle was peaking with 83 million sq. ft. being built, which came on the heels of 100 million and 90 million sq. ft. built in 1999 and 2000. This supply/demand combination caused vacancies to soar and rents to decline. Despite the upheaval, both overall commercial property returns and office property returns as measured by the NCREIF indexes remained positive overall, which is a testimony to the power of geographic and property type diversification. Given current economic and market conditions:

- How do supply/demand fundamentals look today?
- How might commercial real estate fare if the financial markets upheaval is prolonged?



Commercial real estate consists of office, industrial, retail, and apartment properties. Fundamentals in those areas have been favorable since mid-2004 when the national economy began to gain steam. Employment growth accelerated in 2005 and 2006 as construction remained modest. As a result, demand exceeded supply by a wide margin which pushed rents steadily higher. Job growth began to slow in the latter part of 2006, and while still positive, has slowed further still in 2007. Space demand has remained healthy in 2007, but is expected to weaken in the future as the U.S. economy slows. What about construction?

Fortunately, construction has been constrained, and largely in-line with demand. National office space demand during the first nine months of 2007 totaled 40 million square feet as compared with construction of 42 million square feet (Source: Torto Wheaton Research.) As Exhibit 1 shows, construction for all of 2007 is expected to total 72 million square feet, or 2.3% of existing stock. Not only is this well below the level of construction recorded in 1999–2001, but

it is a smaller share of the current stock, and 7 million jobs have been added since then. Note too that construction is expected to decline in 2008 and 2009.

Construction trends are generally similar for other property types. For example, as shown in Exhibit 2, industrial construction is expected to total 168 million sq. ft. in 2007, or 1.4% existing stock. This compares with an average of almost 250 million sq. ft., or 2.2% of stock, over the 1999–2001 period. Industrial space demand has also exceeded supply during the first nine months of 2007. (Source: Torto Wheaton Research.)

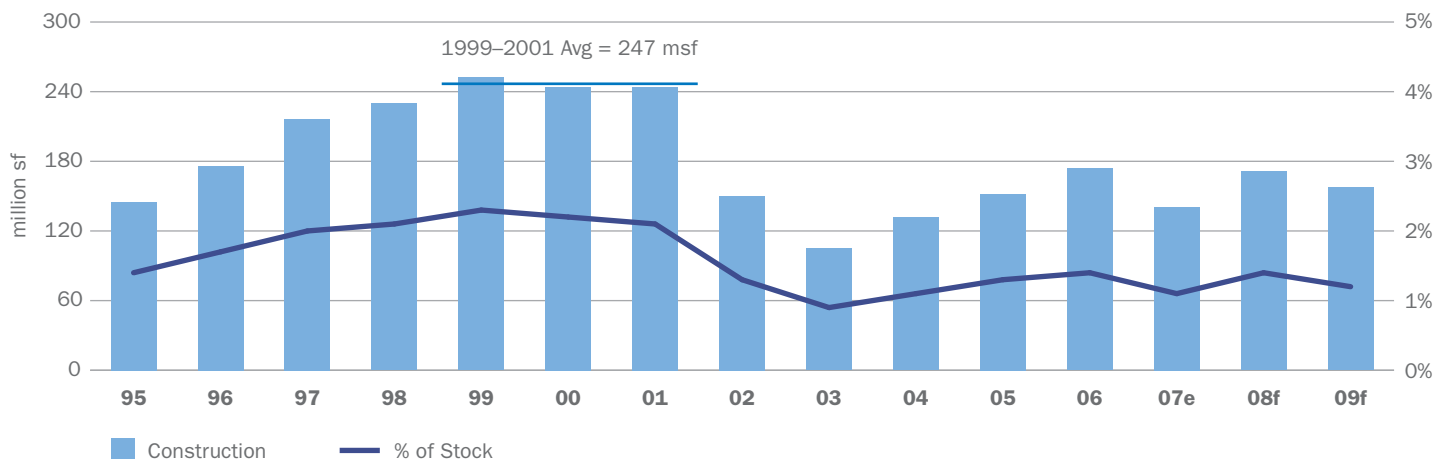
With supply seemingly in check, let's now look at prospects for demand. For the office market, job growth in the financial services sector is especially important as it, along with the "professional and business services" sector, are the primary generators of office space demand. Thus far in 2007, the financial services sector has added 37,000 jobs, which is well below the gains recorded for the comparable period in 2006; however,

**EXHIBIT 1: COMPARATIVE OFFICE CONSTRUCTION AND EMPLOYMENT DATA**

	1999	2000	2001	2007e	2008f	2009f
Construction	101,964	89,912	83,637	71,884	61,707	55,113
Existing Stock (million sf)	2,918.2	3,008.1	3,091.7	3,398.0	3,459.7	3,514.8
Construction as a % of Existing Stock	3.5%	3.0%	2.7%	2.1%	1.8%	1.6%
U.S. Employment (millions)	129.0	131.8	131.8	138.0	139.4	140.9

Sources: Torto Wheaton Research and Economy.com.

**EXHIBIT 2: U.S. INDUSTRIAL CONSTRUCTION**



this is not surprising given the significant job losses in the subprime mortgage industry. Growth in professional and business services sector employment has more than compensated for the tepid gains in financial services jobs. The professional and business services sector added 65,000 jobs in October and has generated 378,000 new jobs thus far in 2007. The technology sector is another source of office space demand, and it too is growing at a healthy pace. While layoffs in the financial services sector are occurring and more are likely to come, the technology and professional and business services sectors continue to drive demand.

For the industrial market, employment growth in the “transportation and warehousing sector,” which is a good proxy for space demand, has grown by roughly 70,000 jobs, or 1.5% over the first ten months of 2007. Similarly, the ongoing growth in global trade flows bode well for future space demand.

Looking ahead, most economists expect employment growth to slow further in 2008 but to rebound subsequently, perhaps even by the second half of next year. A summary of economic projections for the remainder of 2007, as well as 2008, 2009, and 2010 that are used by the Federal Reserve Board to guide policy decisions were published in the minutes to their October 30–31,

2007 meeting. Based on current market conditions, Federal Reserve Board members expected real GDP growth to dip to the 1.8–2.5% range in 2008, followed by an uptick in GDP growth to the 2.3–2.7% range in 2009, and 2.5–2.6% in 2010. Employment growth projections were not provided, but steady job growth would be expected under such a scenario. Though the outlook is for weaker job growth in 2008, employment growth is not expected to turn negative. Weaker demand for office and industrial space can therefore be expected in 2008, but the level of supply appears to be on par or only slightly greater than anticipated demand. While prior commercial real estate market downturns were due to a mismatch of supply and demand, supply/demand fundamentals in 2008 do not appear to be grossly mismatched. Indeed, prospects for 2009 and 2010 may be stronger since the financial markets turmoil has made construction loans more difficult to obtain, which could cause construction to drop sharply in 2009 and 2010.

In summary, supply/demand fundamentals continue to look favorable over the next 12+ months, and that bodes well for commercial property returns and values. We expect the U.S. economy to moderate over the coming quarters, and with it overall demand for commercial space, but with 2008 construction expected to be below 2007 levels, supply and demand should remain roughly in balance.

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