

MARKET MONITOR

OCTOBER 13, 2008

MARTHA S. PEYTON

MANAGING DIRECTOR-STRATEGY & RESEARCH
GLOBAL REAL ESTATE

COMMERCIAL REAL ESTATE AND THE MACRO-ECONOMY

Investment performance of commercial real estate (CRE) is strongly influenced by the overall economy in both the best of times and the worst of times. Economic growth affects the demand for space; global inflation affects construction costs; the global debt markets influence the cost and availability of CRE financing; global capital costs influence the demand for property investments and their price. Reflecting these influences, CRE analysts and investors sometimes sound like economists.

In recent weeks, the wild gyrations in the United States and in global financial markets are defining a new environment for commercial real estate. A quick review of developments includes the following components.

- The generous supply of capital following the last recession in 2001 helped to support the recovery by keeping interest rates low; with capital plentiful, investors' appetite for risky investments pushed risk premiums lower and lower until mid-2007. The housing market was the particular beneficiary of capital abundance through innovative residential mortgage structures including a wide variety of subprime mortgages.
- In mid-2007, a **“regime shift” in risk pricing** took hold when credit deterioration in the subprime mortgage market became evident; rising defaults among subprime borrowers were propelled by re-sets in adjustable rate mortgages and by the increases in interest rates as the Federal Reserve slowly tightened monetary policy between mid-2004 and mid-2006, which put a lid on home price appreciation.



- The regime shift in risk pricing negatively affected the value of all investments except riskless U.S. Treasuries. Residential mortgage-backed securities, especially those containing subprime mortgages, were most drastically affected. Other structured securities especially commercial mortgage-backed instruments (CMBS) were also hard hit through **contagion** as confidence in the structuring imploded. As the value of these assets diminished, investors backed away, leaving these markets illiquid. With few, if any transactions, the market value of these investments has become unknowable. As a result, financial institutions that mark their portfolios to market are subject to extreme uncertainty as to the extent of their losses. This uncertainty, in turn, has beaten down their stock prices, worsening the erosion of capital. This process led to the collapse and subsequent bailout of Bear Stearns in March. More recently, capital erosion led to the federal takeover of Fannie and Freddie, and the bankruptcy of Lehman in September.
- The Lehman bankruptcy opened a flood gate of woes. Most importantly, contagion and loss of confidence mushroomed, both in the United States and globally. The collapse of trust **choked the willingness of lenders to supply credit to the economy**. Without credit, the capacity for economies to function is severely impaired. These unfortunate circumstances led up to the massive rescue legislation passed by Congress and signed by President Bush on October 3. The legislation allows the federal government to purchase assets from financial institutions and clean up the capital uncertainty that is at the root of the **credit crunch**.

OUTLOOK FOR COMMERCIAL REAL ESTATE

This mess has enormous implications for commercial real estate. Initially, the regime shift in risk pricing in mid-2007 set into motion a gradual process of re-pricing commercial real estate investments. This is most evident in the decline in the capital appreciation component of the NCREIF-NPI, which turned negative for the quarter ending June 30, 2008. Commercial real estate has been slow to respond to the risk re-pricing because the pace of transactions has declined dramatically as investors sit tight.

At the same time, the income generated by commercial real estate has continued to grow, thereby cushioning the negative impact of the risk re-pricing.

Since the regime shift in risk pricing in mid-2007, U.S. commercial real estate fundamentals have held up solidly. Vacancy rates for the four primary property types (apartment, industrial, office and retail) were holding near their long-term averages as of June 2008. At the same time, new construction underway and slated for delivery in late 2008 and 2009 is modest when compared with the last recession in 2001. In addition, rents have grown sharply since the last recession. As a result, as leases expire, renewals are coming in at generally higher rents thereby boosting net operating income (NOI) growth. Finally, credit quality for commercial real estate debt continues to hold up well with commercial mortgage delinquency rates near zero for life insurance companies and near the 0.5% mark for CMBS.

COMBINATION OF FACTORS AFFECTING GROWTH PROSPECTS

But these solid fundamentals cannot continue unscathed unless economic growth prospects hold up over the next several months. Pressure points include the elimination of financial sector jobs as a result of the restructuring that is now well underway. Since the beginning of September, Fannie and Freddie have been taken over by the federal government; AIG temporarily bailed out and is trying to raise capital; Lehman went bankrupt; Merrill Lynch, WaMu, and Wachovia merged with suitors; Morgan Stanley and Goldman Sachs turned into bank holding companies with lower capacity for leverage. These negative changes, balanced against the increase in office activities as massive federal rescue activities are mobilized, will change the dimensions of office space use and demand in many localities.

Retail space demand is another pressure point. Over and beyond the home value deterioration and the high energy and food prices that have been roiling consumers, job losses are mounting. Between January and mid-September, over 760,000 jobs disappeared, bringing the unemployment

rate to 6.1%. The tumult of recent weeks and its aftermath have not yet hit job losses, but they have hit consumers' willingness to spend. Vehicle sales have plummeted along with discretionary spending in general, but grocery store sales are strong as consumers replace restaurant meals with home cooking. If prolonged, retail space will suffer, especially if the holiday season is dismally weak. Industrial space will suffer as well as the flow of goods through the economy diminishes. Industrial space demand and rents are deriving some benefit from the tumult because the value of the dollar has declined, increasing the flow of our exports. The apartment sector is also in line for some positive and negative impacts. With home values and credit availability uncertain, renting is now economically preferable. However, on the negative side, the excess supply of condos and single family homes is keeping a lid on rent growth in selected markets.

REAL ESTATE HOLDS STEADY IN DOWNTURN

These mounting pressures on commercial real estate will be cushioned by the in-place cash flows and long-term lease structure that characterize investment quality, core properties. These qualities are quantifiable and transparent. Moreover, the appraisal-based pricing methodology used for institutional commercial real estate serves to dampen the impact of gyrations in sentiment and confidence that are so damaging in publicly traded markets. Finally, ongoing solid credit quality means few distressed sales of commercial real estate, which in turn constrains downward pressure on valuations.

In summary, for the next few months, the story is the macro-economy; commercial real estate performance is well-positioned but not invulnerable.

You should consider the investment objectives, risks, charges and expenses carefully before investing. Please call 877 518-9161, or go to tiaa-cref.org for a current prospectus that contains this and other information. Please read the prospectus carefully before investing.

Market Monitor is prepared by TIAA-CREF Asset Management and represents the views of TIAA-CREF's Investment Strategy and Client Solutions Group. These views may change in response to changing economic and market conditions. Past performance is not indicative of future results. The material is for informational purposes only and should not be regarded as a recommendation or an offer to buy or sell any product or service to which this information may relate.

TIAA-CREF is a national financial services organization and the leading provider of retirement services in the academic, research, medical and cultural fields with over \$420 billion in combined assets under management (as of June 30, 2008). Further information can be found at tiaa-cref.org.

TIAA-CREF Asset Management is a division of Teachers Advisors, Inc., a registered investment advisor and wholly owned subsidiary of Teachers Insurance and Annuity Association (TIAA). TIAA-CREF personnel in its investment management area provide investment advice and portfolio management services through the following entities: Teachers Advisors, Inc., TIAA-CREF Investment Management, LLC, and Teachers Insurance and Annuity Association. TIAA-CREF Individual & Institutional Services, LLC, distributes securities, member FINRA. Annuity products issued by TIAA (Teachers Insurance and Annuity Association), New York, NY. TIAA, TIAA-CREF, Teachers Insurance and Annuity Association, TIAA-CREF Asset Management and FINANCIAL SERVICES FOR THE GREATER GOOD are registered trademarks of Teachers Insurance and Annuity Association.

Martha Peyton is available to comment on real estate related issues. If you wish to speak with her, please contact Chad Peterson, Media Relations, 212 916-4808 or e-mail cpeterson@tiaa-cref.org.

©2008 Teachers Insurance and Annuity Association—College Retirement Equities Fund (TIAA-CREF), New York, NY 10017.

C43031 (0004)