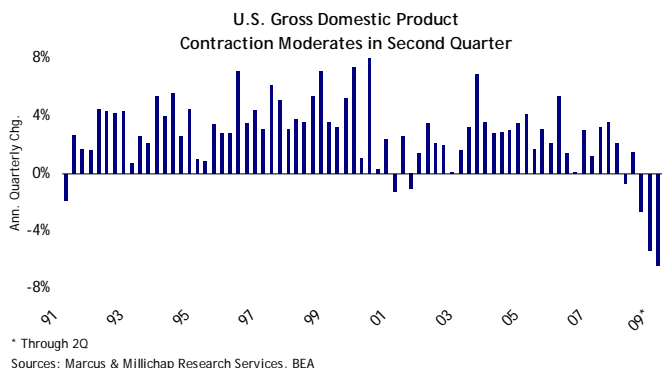




## Technical End to Recession Likely in Current Quarter, but Real Economic Growth Yet to Come

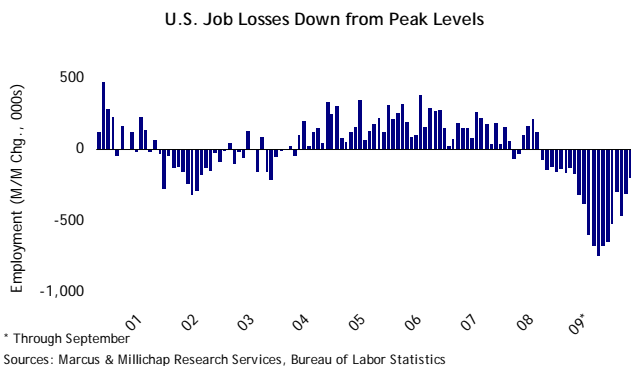
Several indicators offer cause for guarded optimism, though the economy has not yet cleared the woods. While U.S. GDP contracted for the fourth consecutive period in the second quarter, the rate of decline slowed dramatically. Government spending and net exports posted moderate growth during the quarter; however, personal consumption, which accounts for 70 percent of GDP, weakened further. Employment trends continue to reflect softening across industries, though job losses have decelerated.

Until meaningful and sustainable job growth resumes, which is unlikely until at least mid-2010, consumers will remain cautious. Since the U.S. economy is largely consumer-driven, this greatly reduces the chances of a snapback recovery, which has followed some recessions. Instead, the economy will likely stabilize and post only modest expansion starting in late 2009. The outlook for even mild GDP growth is based on assumptions that housing has touched bottom and the stimulus package has started contributing to growth.



**GDP Contraction Decelerates, Likely to Turn Positive in Current Quarter.** U.S. GDP contracted at an annualized rate of 0.7 percent in the second quarter, following a 6.4 percent drop in the previous quarter. The latest release suggests that the most severe recession since the Great Depression has finally begun to lose steam. Although businesses have yet to increase spending, they have stopped slashing expenditures at a double-digit pace. For perspective, business spending shaved just 1 percentage point from GDP during the second quarter, compared with 5.3 percentage points in the first quarter. There were a few true bright spots in the latest GDP release. Government spending, which lost ground earlier this year, added 1.3 percentage points to GDP in the second quarter, while net exports contributed 1.65 percentage points. Third quarter GDP is expected to reflect growth, mainly due to an end to inventory reductions.

**Job Losses Down from Extreme Levels.** In September, employment declined by 263,000 jobs, the second-lowest monthly loss reported since the global financial crisis began a year ago. Payroll cuts remain widespread and high by historical measures, however, with a record-setting 7.2 million positions lost since the start of the recession. During September, manufacturers shed 51,000 jobs, which is a substantial decrease, though it pales in comparison to the average elimination of 150,000 positions per month in the first half of the year. Similarly, office-using employment contracted for the 21<sup>st</sup> consecutive month in September, though the decline was the smallest recorded since late 2007. This may come as little consolation to office property owners who have lost tenants in recent months, though it appears to be a step in the right direction. Unemployment increased to 9.8 percent in September and is



forecast to surpass 10 percent by year end as those who suspended job searches begin to re-enter the labor pool. On a positive note, reduced staffing and other cost cuts have resulted in stronger corporate profit margins.

**Housing Near Bottom.** Low residential mortgage rates and attractive pricing have moved many prospective homebuyers off of the sidelines, leading to reduced for-sale inventory and increased sales in four of the past five months. The \$8,000 tax credit available to first-time buyers has also encouraged purchases ahead of the program's deadline of Nov. 30. Although sales have improved, 25 percent of activity involves bank-owned homes, which typically sell at deep discounts. With roughly 13 percent of homeowners with a mortgage behind on payments or in foreclosure, further price reductions may occur in some markets, even as transactions increase. Nationwide, housing affordability has risen dramatically, and the overhang of for-sale homes could be steadily absorbed once job growth resumes.

**"U"-Shaped Recovery Likely.** With additional losses expected in the fourth quarter of 2009, employment forecasts call for a 4.5 million contraction this year, bringing the total lost during the recession to 7.6 million positions. Aside from the recent rise in auto sales spurred by the now-expired "Cash for Clunkers" program, consumers and businesses will continue to limit spending until clear signs of an economic recovery emerge. Government stimulus will help to offset the consumption gap in the near term; however, the full effects of legislative action may not be felt until mid-2010, as only a fraction of the available funding through the stimulus package has been spent to date. The recovery will require several months to gather momentum.

**Maturing Debt Remains Key Challenge for Commercial Real Estate.** An estimated \$535 billion of commercial mortgage debt will mature over the next two years. Due to declining NOIs and values, as well as tighter lending criteria, a large share of these mortgages may not qualify for refinancing without significant equity contributions from owners. After witnessing the devastating impact of foreclosures on residential property values, portfolio lenders have become increasingly willing to work with commercial borrowers to avoid foreclosures. Borrowers with CMBS debt are in a more challenging position, since delinquent loans are transferred to special servicers, which have tighter regulations on the modifications they can offer.

**Government Programs Aimed at Unlocking Credit Markets Show Promise.** The complexity of financial sector challenges caused the Term Asset-Backed Securities Loan Facility (TALF) and the Public-Private Investment Program (PPIP) to get off to a slow start. A scaled-down version of PPIP has begun moving forward, however, and the component of TALF focused on commercial mortgage-backed securities (CMBS) is gaining momentum. At least two major REITs are close to completing new-issue, TALF-eligible CMBS deals, and more could follow. Much of the capital raised will likely be used to pay down maturing mortgage debt, which has become increasingly difficult to refinance through traditional lending channels. The legacy CMBS component of TALF is already operational, with approximately \$3.5 billion in loans funded to date. These programs, designed to help restart the CMBS market, will increase lending for new property acquisitions and the refinancing of maturing debt.

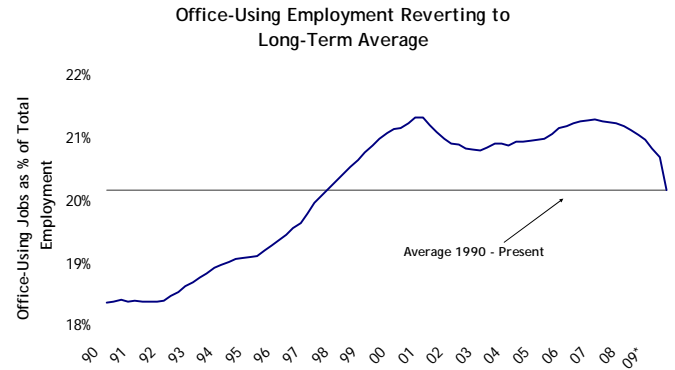
**Opportunities Emerging for Commercial Real Estate Investors.** Economic recovery will require several quarters to gain momentum; therefore, investors awaiting the return of strong economic expansion to redeploy capital into commercial real estate are at risk of missing attractive acquisition opportunities. A tremendous amount of capital waiting for well-priced, quality assets to be offered for sale has been accumulated, and many investors have begun to move off of the sidelines.



## Office Investors Beginning to Move Off Sidelines; Smaller Deals Driving Increase in Transaction Velocity

### Vacancy Continues to Rise but Remains Below Previous Cyclical Peak, For Now.

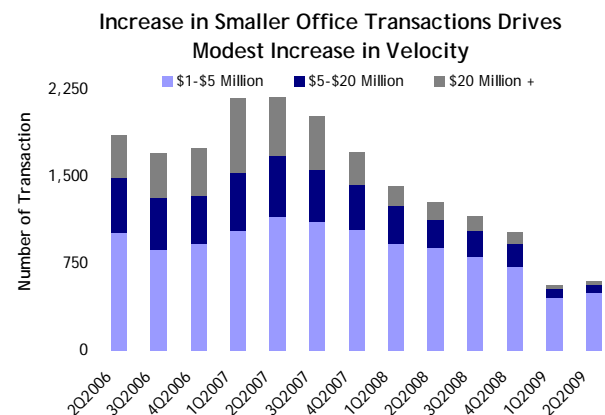
U.S. office vacancy increased 70 basis points in each of the first two quarters of 2009, reaching 15.9 percent by midyear. During the last downturn, vacancy peaked at 16.9 percent, but continuing job losses will likely drive vacancy above this level by year-end 2009. Since the start of the recession, office-using employment has declined by 2.3 million positions, accounting for one-third of all nonfarm jobs lost. Prior to the freezing of interbank lending and the commercial paper market last fall – the transition point of the credit crunch to a full-fledged global crisis – the office market was showing resilience, with vacancy only 120 basis points above its cyclical low set one year earlier. The rapid acceleration of job losses at the time, however, contributed to a 120 basis point increase in vacancy during the fourth quarter alone. Although the pace of vacancy increases has slowed, weakening will continue through the first half of 2010, as new supply slated for delivery over this period is currently less than half pre-leased.



**Effective Rents Slip as Sublease Availability Rises.** Effective rents have fallen 6.7 percent during the last year, with the majority of decline recorded in the first half of 2009. Asking rents also retreated, but to a lesser degree of 2.7 percent. Significant office-using job losses over the past 12 months have translated into approximately 80 million square feet of negative net absorption and a dramatic rise in sublease availability. In order to remain competitive, owners with direct vacancies have increased concessions substantially. Some historically tight, supply-constrained markets have been hardest hit, with owners in New York City, Boston and San Francisco cutting effective rents by 9.0 percent to 11.5 percent so far this year.

### Financing Constraints Persist; Buyer/Seller Disconnect Narrowing.

The gap between buyers' and sellers' price expectations remains wide, but a few indicators suggest it has begun to narrow. To start, while dollar volume continued to decline in the second quarter, the number of transactions increased for the first time in two years. The uptick in activity was driven by deals between \$1 million and \$5 million, a price range favored by local and regional banks, which have become the primary source of financing in the marketplace. Increased activity in the lower price tier also reflects renewed interest among private investors, many of whom planned to wait for clear signs of a bottom before deploying





capital into commercial real estate. Despite expectations for further weakening in office fundamentals into 2010, however, these investors have already started to move off of the sidelines, unwilling to risk missing attractive deals available today. The average cap rate for closed traditional office properties during the first half of 2009 was 8.3 percent, up 150 basis points from the low set in 2007. Cap rate increases among new listings have accelerated recently, suggesting owners have become more accepting of market realities. Cap rates for medical office assets also have ticked up in recent years, but to a lesser degree than traditional properties; year to date, the average cap rate for closed medical office properties is approximately 7.8 percent.

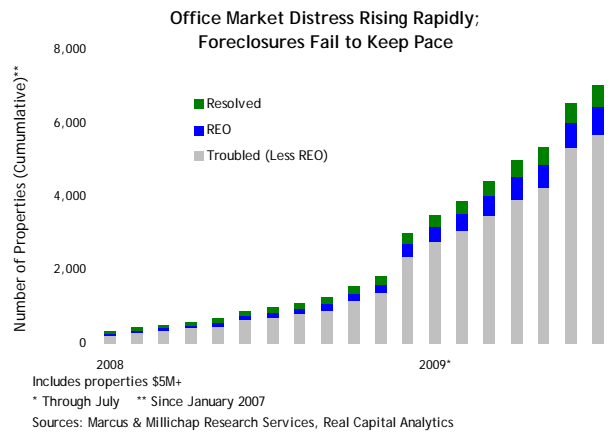
**Investors Turn to Assumable or Seller Financing.** Since tapping into traditional sources of financing can be difficult, assumable and seller-financed deals have become more prevalent. This segment of the market now accounts for roughly half of all closed dollar volume, compared with just 11 percent prior to the onset of the credit crunch. Nonetheless, growth in seller and assumed financing has done little to offset the void created by the stalled commercial-backed mortgage securities (CMBS) market, which was responsible for roughly 40 percent of the commercial mortgage debt originated at the market's peak. The government's TALF program is showing promise and is expected to encourage a handful of new CMBS issues in the near term. These deals may be a crucial turning point for the CMBS market, and could lead to more lending in the sector as early as next year; however, a return to previous levels is not anticipated.

**Forecast:**

**Construction Pullback Should Drive Stronger Recovery Cycle.** Developers are expected to deliver just over 50 million square feet of new office space in 2009, down from 62 million square feet in 2008 and well below the 10-year annual average of 75 million square feet. Starts have declined dramatically in recent quarters, as fewer projects are entering the planning phase and the volume of deferred/abandoned space is rising. During the second quarter of 2009, abandoned or deferred office projects totaled 35 million square feet, up 75 percent from the same period in 2008. Reduced construction should support a comparatively swift recovery once moderate job creation resumes; however, weakening demand will offset the benefits in the near term, causing vacancy to reach 17.6 percent by year-end 2009. Effective rents are forecast to decline by an average of 6.5 percent this year, though more significant increases have already been recorded in a handful of the nation's hardest-hit markets.

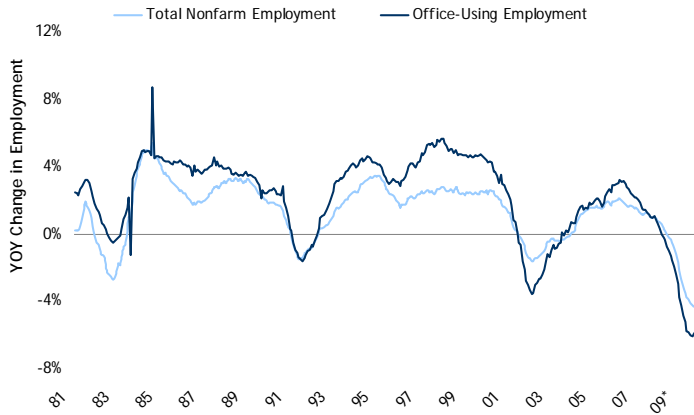
**High-Quality Foreclosures Limited; Competition Stiff.**

Despite rising delinquency rates and expectations for mounting distress due to maturing debt, investors waiting for a surge in high-quality, deeply discounted, bank-owned properties are likely to be disappointed. Most lenders are working closely with at-risk borrowers, extending loans or modifying other terms, to prevent near-term foreclosure-related losses. Furthermore, even if commercial foreclosures rise in the near term, investors are likely to face elevated competition for high-quality properties that come to market. There is already a tremendous amount of capital circling the market for distress sales, and several funds continue to raise capital for this purpose. As a result, price discounting could be limited, and a repeat of conditions in the early 1990s is unlikely.



## Office Market Vital Signs

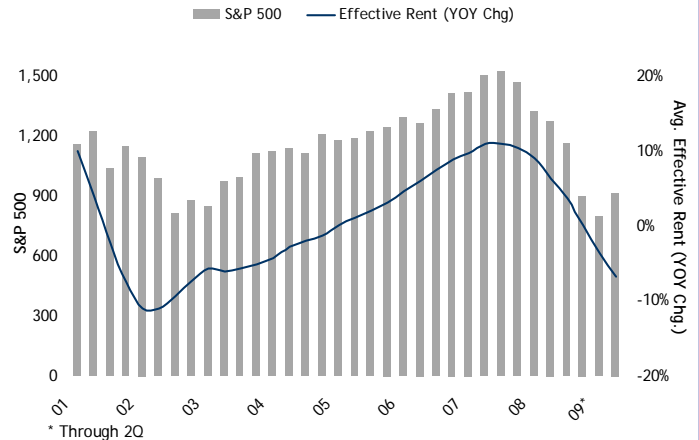
Employment Change



\* Through September

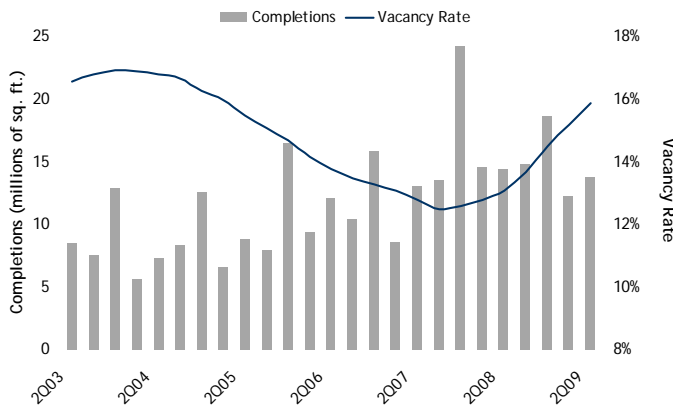
Sources: Marcus & Millichap Research Services, Economy.com

Office Effective Rent Growth vs. S&P 500



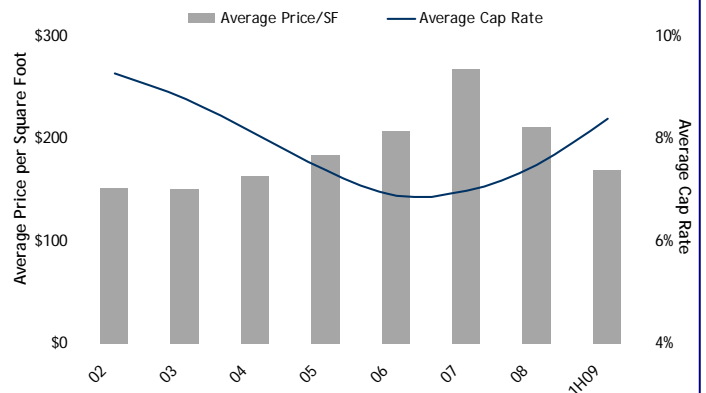
\* Through 2Q  
Sources: Marcus & Millichap Research Services, Reis, Standard & Poor's

Office Supply and Vacancy Trends



Sources: Marcus & Millichap Research Services, Reis

Office Price and Cap Rate Trends



Sales figures include \$1 Million+ transactions

Sources: Marcus & Millichap Research Services, Real Capital Analytics

### 2Q 2008 to 2Q 2009 Change in Office Vacancy

Markets by Least Change in Vacancy

Metro	2Q 2009	YOY Chg. (bps)
Cincinnati	18.8%	0
Louisville	14.5%	100
Columbus	18.7%	110
Kansas City	16.3%	110
Philadelphia	12.9%	120
Chicago	17.1%	140
Atlanta	17.4%	160
Raleigh-Durham	14.6%	160
Charlotte	13.3%	180
Houston	14.1%	190
U.S. Metro Average	15.9%	270

Markets by Greatest Change in Vacancy

Metro	2Q 2009	YOY Chg. (bps)
Oakland	18.0%	420
San Francisco	13.5%	420
San Diego	17.7%	430
Tampa	17.8%	460
Miami	15.1%	470
New York City	10.8%	470
Orange County	17.3%	490
Phoenix	21.5%	550
San Jose	20.0%	600
Riverside-San Bernardino	22.8%	700
U.S. Metro Average	15.9%	270

Sources: Marcus & Millichap Research Services, Reis

The information in this report is deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, expressed or implied, may be made as to the accuracy or reliability of the information contained herein. Sources: Marcus & Millichap Research Services, CoStar Group, Inc., DataQuick, Deutsche Bank, Economy.com, Federal Reserve, MBAA, NAR, Real Capital Analytics (RCA), Reis, U.S. Census Bureau.

Written by Erica Linn

September 2009

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