



Job Losses Accelerate; Economic Stimulus Reaches Unprecedented Levels, Likely to Support Stabilization by Late 2009, Recovery in 2010

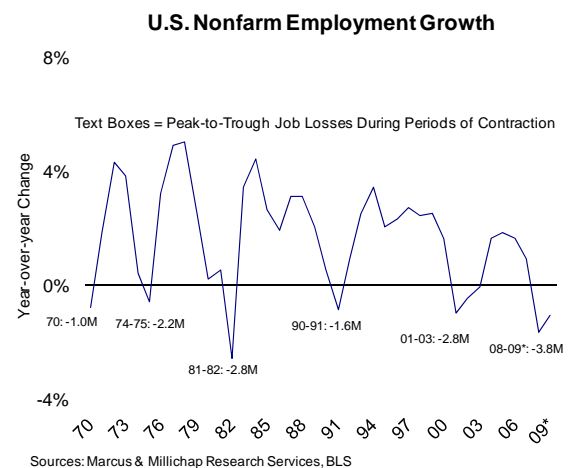
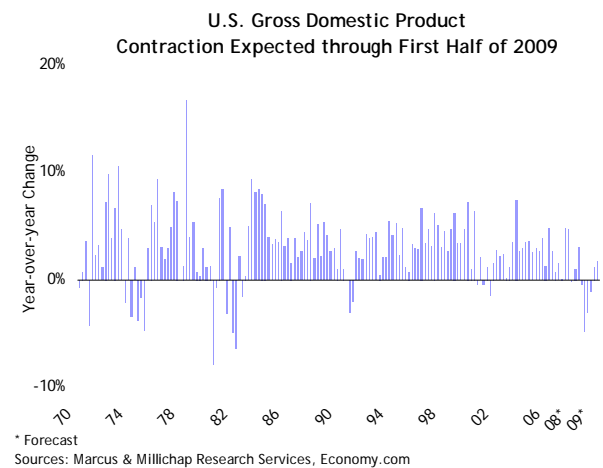
The U.S. economy was relatively resilient through the first half of 2008, which was marked by moderate GDP growth, below-trend job losses and rising consumer spending -- due in part to a temporary boost from economic stimulus checks. However, a crisis of confidence spurred by record financial sector losses, corporate bankruptcies and government takeovers led to an interbank lending freeze and near-standstill in the commercial paper market. The escalation of the credit crunch to a full-blow crisis has contributed to the broadening of the recession.

The economic situation is expected to worsen before showing signs of recovery. U.S. GDP figures for the fourth quarter of 2008 are expected to reflect the greatest contraction since the early 1980s, following a decline of 0.5 percent in the third quarter.

- U.S. GDP is forecast to decline by an annualized rate exceeding 4 percent during the fourth quarter due to the combination of housing market woes, tight credit markets, and a pullback in spending by consumers and businesses.
- Declining consumer expenditures subtracted 270 basis points from GDP during the third quarter of 2008, and spending is likely to continue detracting from growth through at least the first part of 2009.
- Based on preliminary estimates, retail sales (less auto and gas) during the 2008 holiday season were down approximately 2 percent from one year earlier.
- The current downturn is expected to be similar in magnitude to the 1974/75 recession, which was also global in nature and among the worst since WWII. GDP contraction is forecast to reach 2.5 to 3.0 percent from peak to trough.

Job losses are expected to continue at an accelerated pace in the near term. Employment has been declining since January 2008, with a total of 1.9 million jobs cut through November. The most significant reductions have been in the manufacturing, and professional and business services sectors; however, during the last three months, the trade sector, which includes retail, has shed a significant number of positions.

- From peak to trough, we expect losses to reach 3.8 million jobs, a loss of 2.8 percent - the greatest contraction registered since the early 1980s.
- There are downside risks to the employment outlook, including the potential for one or more of the major U.S. automakers to fail, even after the recent \$18 billion bailout provided by President Bush.





Economic Headwinds to Remain Strong in Near Term, but Some Positive Forces Are at Work

The economic downturn has led to a dramatic reduction in oil prices, which are down more than 65 percent from their peak in the summer of 2008.

- Lower energy costs have taken some pressure off of household budgets and reduced inflationary concerns, providing the Fed with greater flexibility to cut rates. At its last meeting, the Federal Open Markets Committee (FOMC) cut the Fed funds rate by 75 basis points to 0.25 percent, the lowest rate on record.
- It must be noted that the potential for deflation is present and poses a new set of risks to the economy. During October and November, the headline rate of inflation declined by 1 percent and 1.8 percent, respectively.

Since the onset of the credit crunch, the U.S. government has dug deep into its arsenal of tools. Governments around the globe have also joined forces, injecting an unprecedented amount of liquidity into the banking system and economies worldwide in an attempt to hamper the pace of the current downturn and prop up confidence.

- Overall, the positive effects of most U.S. government measures have yet to take hold. As banks begin lending again and additional initiatives are implemented, they will ultimately work their way through the economy. The process, however, will take time, putting an expected economic stabilization at midyear.
- There has been some easing in the banking and credit markets, including the return of function to interbank lending operations and significant reductions in interest rates. The yield on the 10-year Treasury has fallen to record-low levels and is currently at just over 2.3 percent.
- Two of the more recent government stimulus programs, which were rolled out in late November, are showing some signs of early success. The measures are intended to help stabilize housing and increase the amount of credit available to U.S. households.
 - ◆ *Under its new Term Asset-Backed Securities Loan Facility (TALF), the Fed has made up to \$200 billion in loans available to help ease consumer and small business credit market conditions.* The debt underlying the asset-backed securities (ABS) must be recently originated auto, credit card, small business or student loans. At present, commercial real estate developers are asking to be included in this facility to help to stave off the potential for massive defaults as loans mature.
 - ◆ *The Fed will also purchase up to \$600 billion in debt backed by housing-related government-sponsored entities (GSEs), including Fannie Mae, Freddie Mac, Ginnie Mae and Federal Home Loan Banks.* Following the announcement of this program, the average 30-year residential mortgage rate dropped by approximately 50 basis points and has continued to slip. Furthermore, mortgage applications have posted a sizable gain, though much of it has been attributable to refinancing activity.



Fed/Treasury Extending Unprecedented Amounts of Credit

Average Monthly Balance by Facility

	<u>Jan 00 - Dec 02</u>	<u>Jul 07 - Sept 08</u>	<u>Oct 08 - Nov 08</u>
Discount Window Credit of Depository Institutions	\$302 Million	\$19.1 Billion	\$354.6 Billion
Asset-Backed Comm. Paper/Money Market Fund Facility	-	\$31.9 Billion	\$94.2 Billion
Credit Extended to AIG	-	\$22.2 Billion	\$77.6 Billion
Special Liquidity Facility	\$24 Million	-	-
Other Credit Extensions	-	\$1.2 Billion	-
Primary Borrowings of Depository Institutions	-	\$7.5 Billion	\$94.2 Billion
Secondary Borrowings of Depository Institutions	-	\$16.4 Million	\$77.5 Million
Primary Dealer and Other Broker-Dealer Credit	-	\$16.7 Billion	\$87.8 Billion
Seasonal Borrowings of Depository Institutions	\$138 Million	\$88.5 Million	\$18.0 Million
Term Auction Credit of Depository Institutions	-	\$101.9 Billion	\$318.9 Billion

**All figures above represent average monthly balance during time period (Federal Reserve Statistics - H3 Tables)*

Additional Stimulus Programs

Emergency Economic Stabilization Act (includes TARP)	-	\$700 Billion	-
<i>Capital Purchase Plan (Purchasing Stock in Banks)</i>	-	\$250 Billion	-
Term Asset-Backed Securities Loan Facility (TALF)	-	-	\$200 Billion
Fed Purchase of GSE-Held or Backed MBS	-	-	\$600 Billion
FDIC Increased Guarantee of Deposits to \$250,000	-	Unknown	-
Fed Provides Unlimited Currency Swap Lines for European Central Banks	-	Unknown	-

In addition to the vast liquidity measures already in place, the new administration is planning a large-scale economic stimulus package, which is expected to be rolled out soon after President-Elect Obama takes office.

- As opposed to issuing stimulus checks to households, which provided a very short-term boost to the economy in the first half of 2008, the package is expected to be centered around near- and long-term measures that would ultimately help create jobs.
- The two-year plan is expected to cost upwards of \$750 billion. Discussions have been centered around tax cuts for U.S. households, tax incentives for businesses, and major infrastructure improvements to the nation's aging roads and bridges, and high-tech communications networks.



Economy a Drag on Commercial Real Estate Market; Focus on Quality to Prevail

- ***As businesses cut spending and payrolls due to reduced credit availability and economic uncertainty, office space needs will continue to slide.*** Further cutbacks in the financial sector, in particular, pushed office vacancy to an estimated 15 percent in 2008, up 240 basis points from one year earlier. Conditions will soften further this year as sublease space is added to the market. Many businesses that need additional space now are avoiding new commitments in light of the weakening economic situation, which could lead to some pent up demand in 2010.
- ***Job losses and reduced consumer spending increase risks for retail.*** Several retailers have already fallen prey to the weak economy, and more will follow. Consumers, concerned about the economy and feeling the impact of reduced credit availability, have cut back on spending. During the last year, retail vacancy increased 130 basis points to 8.5 percent, its highest level in 15 years. Fortunately, construction will drop in 2009, slipping from 130 million square feet in 2008 to 90 million square feet.
- ***Reduced export activity and waning retail trade has pushed industrial vacancy back into the double digits.*** At the end of 2008, vacancy in the sector had reached an estimated 11 percent, up from 9.5 percent one year earlier. Since industrial construction is comparatively quick compared to other property types, developers are able to react more quickly to changes in the economy and tenant demand. As a result, we expect construction in 2009 to fall by more than 50 percent.
- ***Of the core commercial real estate sectors, apartments will fare best, although job losses will lower occupancy.*** The combination of declining household credit quality, rising residential foreclosures and tougher mortgage standards are providing a boost to the renter pool and helping offset the impact of shadow rentals on vacancy. During the third quarter of 2008, vacancy ticked up just 10 basis points to 6.1 percent, but the employment market has since deteriorated. Fourth quarter results are expected to reflect this weakening, with year-end vacancy estimated at 6.7 percent. On the investment front, apartments are benefiting from continued lending by Fannie Mae and Freddie Mac, as multi-family loans remain a bright spot in the agencies' portfolios.
- ***Credit markets will remain tight and lender spreads will continue to fluctuate in a wide band, but financing will remain available for quality deals that are priced realistically.*** The CMBS sector, which was a major source of funding up until late last year, has dried up almost entirely. At the same time, a large share of life insurance companies have reached or are nearing capacity limitations, and maximum leverage from these sources has dipped to around 50 to 55 percent. Most commercial real estate investors are relying on assumable and seller financing or local/regional banks. Maximum leverage on new bank loans is around 60 to 70 percent, which is in line with historical averages but down from 80 to 90 percent as recently as the first half of 2007.
- ***Commercial mortgage delinquency will rise as fundamentals deteriorate and household formation slows, causing greater distress in the marketplace.*** Investors awaiting large-scale price discounting across markets and asset classes will be disappointed, as price and cap rate correction is heavily based on quality and location. For sellers faced with operational challenges or maturing debt, however, price adjustments will be necessary to clear the market. Cap rates for lower-quality properties in secondary/tertiary markets may need to be adjusted by as much as 200 basis points from one year ago, while those for high-quality assets in primary markets may need to rise by 75 to 100 basis points. Overall, sellers who are not in need of an immediate sale are likely to hold properties until credit markets ease somewhat and buyers' expectations stabilize.

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, BEA, BLS, Economy.com, Federal Reserve, Mortgage Bankers Association of America.

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