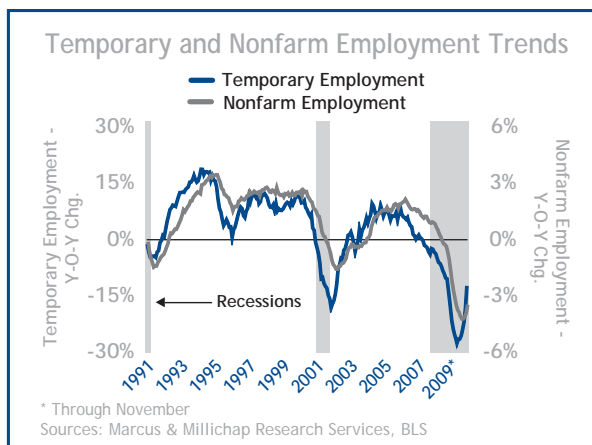


Positive Reading on Labor Market Indicators Point to a Bottom in Job Losses; Subdued, Choppy Recovery Expected in 2010

Unprecedented government stimulus and intervention prevented the worst-case scenario for the U.S. economy and helped bring the Great Recession to an end. Housing market weakness and job losses, albeit at drastically reduced levels, however, continue to challenge the onset of a sustainable expansion cycle. Economic headwinds, including elevated unemployment and high levels of consumer and public debt, will persist through the first half of 2010. Tight credit markets also dampen the possibility of a surge in spending this year, even if consumer sentiment steadily increased. Risks of another recession will linger as a result, but a growing number of indicators point to a choppy, muted recovery as the most likely scenario.



GDP Turns Positive; Slow Recovery Starts. Following four consecutive quarters of contraction, GDP expanded at an annualized rate of 2.2 percent in the third quarter of 2009, signaling a technical end to the recession. The resumption of growth marks an important turning point; however, the increase is attributable to government spending and incentives such as the “Cash for Clunkers” program and the first-time homebuyer tax credit. With only \$234 billion of the \$787 billion stimulus package paid out to date, government spending should support modest economic growth through most of 2010. A more vigorous, self-sustaining expansion is unlikely to gain traction until the second half of the year, when renewed business and consumer confidence will translate into increased demand, replacing the stimulus as the primary driver of economic growth.

Employment Trends Hint at Bottoming. First-time unemployment claims fell in December to their lowest point since the onset of the financial crisis in September 2008. In addition, only 11,000 jobs were lost in November, the lightest month of cuts since the recession began. Reductions were concentrated in the manufacturing, construction and information sectors and were almost offset by growth in healthcare and the professional and business services sector. The gain in professional and businesses services hiring was driven mostly by a surge in temporary staffing, which rose for the fourth consecutive month in November after a prolonged period of contraction. This trend suggests that staffing needs at many companies have begun to increase as a leading indicator of eventual payroll hiring when companies enter an expansion mode. The recession has claimed nearly 7.2 million jobs so far, including 4.1 million positions in 2009.

Inflation Tame – For Now. The doubling of the Fed’s balance sheet since late 2008 provides cause for inflation concerns; however, elevated unemployment and low capacity utilization should minimize the risks through at least the first half of 2010.

- Since the start of the recession, reported unemployment has more than doubled to 15.2 million persons, or 10 percent of the labor force, removing upward pressure on wages. Even after employment growth resumes in 2010, significant slack will persist as individuals who discontinued job searches during the downturn re-enter the work force.
- Capacity utilization recently slipped to 70.7 percent, the lowest level in at least 45 years and down from over 80 percent in 2007. When economic growth gains traction, manufacturers will be able to utilize excess capacity at fairly low variable costs, limiting the impact of higher demand on prices.

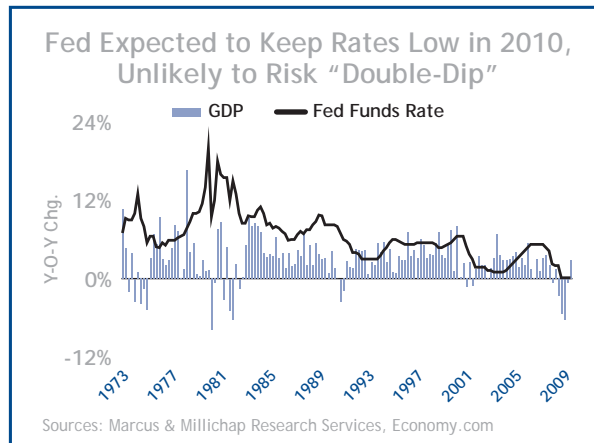


Fed Maintains Accommodative Stance. Through the recession, the Fed committed billions of dollars to providing liquidity to the credit markets and dropped interest rates to nearly zero. In 2010, the central bank must carefully monitor conditions to determine when, and by how much, to withdraw support without causing another recession. Mild inflation this year will likely allow the Fed to delay an aggressive tightening campaign until after a recovery gains traction. This should prevent a “double-dip” recession, which, in previous instances, was attributed to the Fed raising rates too far, too fast.

Forecast:

Muted Recovery in 2010 Expected; Upside Surprise Likely in Second Half and 2011.

In 2010, GDP growth of 2.5 percent to 3.0 percent, in line with the long-term average, will be accompanied by below-trend job creation. Employers will increase payrolls by 0.75 percent to 1.0 percent, falling approximately 50 basis points to 75 basis points short of the 25-year average. These trends fall well below typical recovery years after steep downturns due to consumer debt levels and constrained credit. Until employers regain confidence and attribute economic expansion to sustainable growth drivers, not just short-term stimulus, hiring will remain limited. The extreme job cuts of the past two years should result in a shortage of workers in many industries as early as 2011, however, leading to more robust job creation.



Distress Rising, but Visions of High-Quality REO Wave Fading. More distress will come to market, but the quality will be mixed as lenders avert further losses by avoiding foreclosure on performing assets and those with reasonable prospects for stabilization. Reduced NOIs and values, combined with tighter lending criteria, will make it difficult for many owners to refinance maturing debt. From 2010 to 2012, more than \$830 billion in commercial mortgage debt is due to mature, a portion of which was originated between 2005 to 2007, when prices were at or near peak levels and lax underwriting and high-leverage loans were commonplace. In addition to maturity risk, many owners also face difficulties meeting debt-service obligations due to reduced rents and occupancy levels. This trend will likely contribute to further distress this year as occupancy and rents continue to weaken in many major markets.

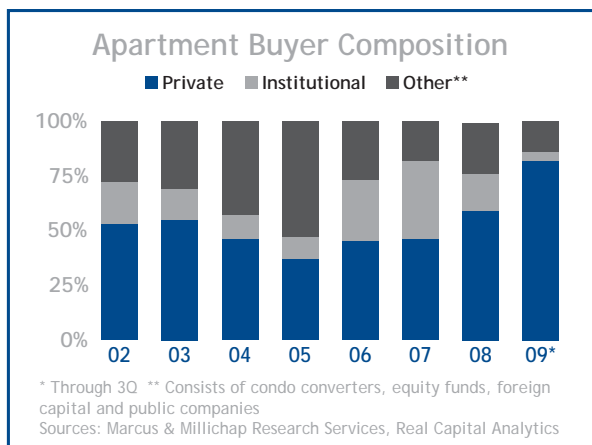
Lenders Remain Cautious, but Encouraging Signs Emerge. Banks will remain the primary source of financing for commercial real estate, with the exception of apartments, which will continue to benefit from agency lending. Life insurance companies are showing renewed interest in lending, but a 2010 surge is unlikely due to capacity limitations. While traditional CMBS is not expected to become a major source of financing in the near term, the first TALF-eligible CMBS issuance was met with strong demand and paved the way for a few non-TALF deals in the weeks that followed.

Rising Interest Rates a Potential Risk. One of the biggest risks to the economic recovery and commercial real estate is rising interest rates ahead of a recovery in end demand. In the last few weeks of 2009, the 10-year Treasury yield moved up 60 basis points to 3.8 percent. This move largely reflected a capital shift toward equity markets as risk tolerance rose but also illustrates inflation concerns and volatility in the U.S. dollar. This recent rise in long-term rates may not last, as geopolitical concerns and a choppy economic recovery pattern may create a flight to safety, but the prospects of a jump in interest rates above and beyond the sustainable 3.5 percent to 4.0 percent range poses a risk to the housing recovery and places additional pressure on commercial real estate values.



Apartment Sales Volume Remains Well Below “Normal” but Rises for Second Consecutive Quarter

Sales Edge Upward. In retrospect, the first quarter of 2009 will likely be considered the bottom of the downturn in apartment sales volume. Nationally, \$4.5 billion of properties changed hands in the third quarter, up slightly from the preceding quarter but a 40 percent jump from the first quarter. Credit availability has barely improved since the most severe phase of the credit crunch late last year, but the gap between buyers’ and sellers’ expectations has narrowed considerably in many instances. Contrary to investors’ expectations, distressed property sales remain limited, accounting for only 14 percent of total dollar volume in recent months.

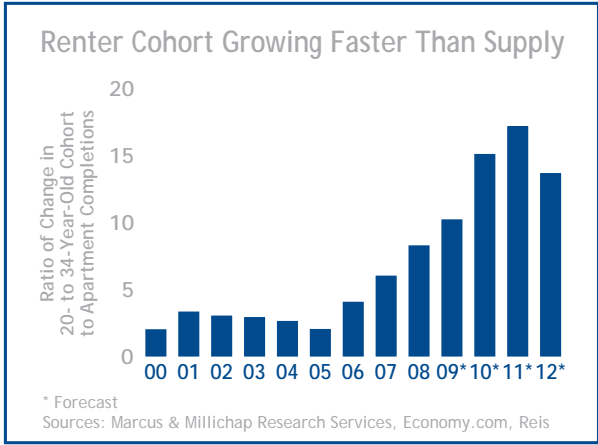


Private, Local Buyers Lead Acquisitions. In the middle of this decade, many private, local investors took advantage of the unprecedented jump in prices and vigorous competition among buyers to liquidate holdings. At the peak, they accounted for about 70 percent of all sellers, but now they are re-entering many markets. Private investors have accounted for 82 percent of the dollar value of acquisitions, compared with just 37 percent at the peak of the market four years ago. The re-emergence of private, local buyers may represent the clearest signal yet that prices have adjusted to levels that can be sustained by current operations. Motivated by lower prices, these investors will continue to re-evaluate portfolios, using local knowledge and a hands-on approach to acquire properties with the potential to increase in value as a recovery accelerates. With other buyer groups less active, private, local investors are likely to conduct transactions on highly favorable terms, especially with motivated sellers.

Institutional Investors Shifting Strategies. Deals in excess of \$40 million stirred to life in the third quarter of 2009, after laying dormant for the first half of the year. The cautious return of large investors may signal a shift in strategies from wait-and-see to bargain-hunting. Values have dropped sufficiently to encourage these investors to resume acquisitions rather than risk missed opportunities by attempting to time the absolute bottom of the market. Activity by institutions remains subdued, though, representing only 4 percent of the dollar volume of properties purchased in 2009. As recently as 2007, institutions accounted for 36 percent of the acquisition volume, but they have since moved to the sidelines in response to the credit market freeze and concerns over deteriorating property performance. While they have not been highly active purchasers, institutions and REITs have been the predominant sellers in the past year, participating in nearly half of all dispositions over \$5 million. This activity has largely been driven by institutions’ need to cull properties in markets where they lack a critical mass to generate economies of scale and by their need to strengthen balance sheets. The re-evaluation of institutional portfolios will continue this year, with capital expected to shift to markets where institutional investors have significant concentrations of assets and operational efficiencies already exist.



Apartment Fundamentals Stabilizing. The national vacancy rate has risen 210 basis points to 7.8 percent since the start of the recession, reflecting the extreme levels of job cuts and shadow market competition. The market appears to be stabilizing, with third quarter 2009 net absorption turning positive and vacancy only pushing up 10 basis points, the lowest uptick since the recession began. The vacancy rise has been fueled by increasing unemployment among the prime renter demographic of individuals aged 20 to 34 to 12.1 percent. The jump has been triggered by a significant surge in manufacturing, construction, leisure and hospitality, and retail sector employment cuts, which collectively account for more than 70 percent of the jobs lost during the recession. For many workers in these sectors, apartments are the most viable and affordable housing option. In 2010, though, vacancies will flatten as the employment market stabilizes.



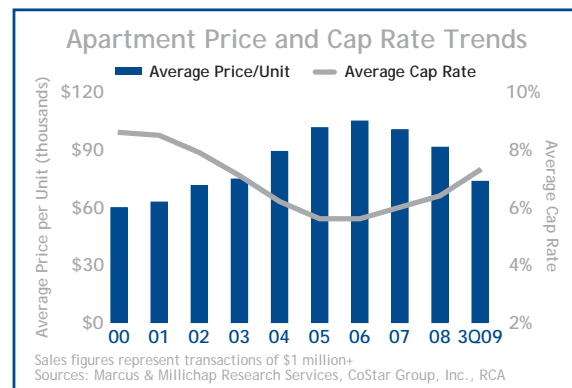
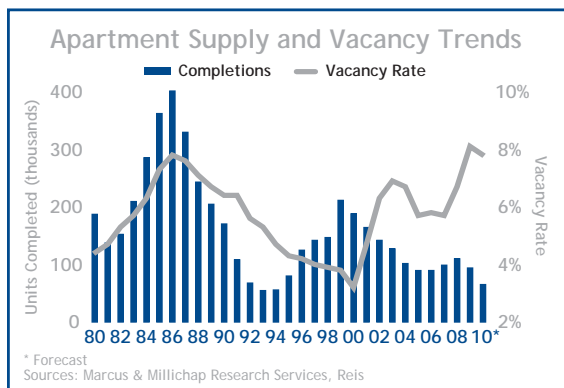
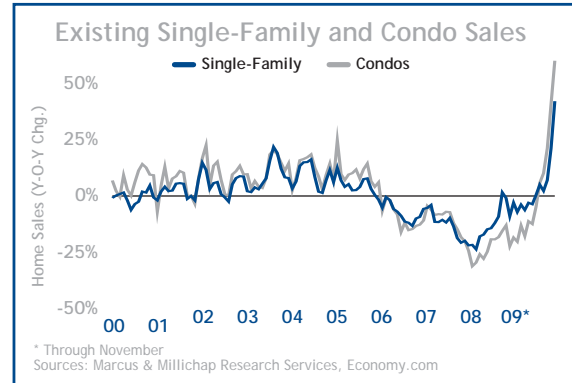
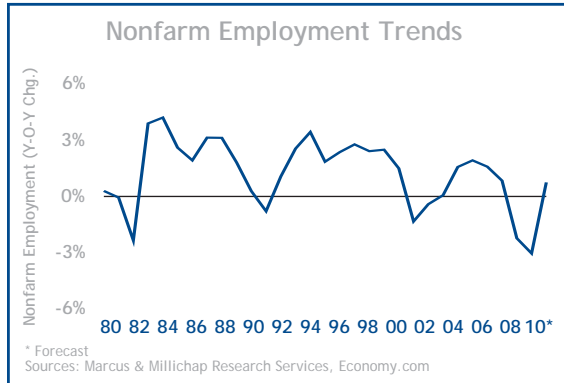
Worst of Rent Declines over for Most Markets. Rising unemployment has dampened rental housing demand and contributed to a 3.4 percent decline in asking rents in 2009 to \$1,016 per month. Effective rents decreased 5.8 percent to \$937 per month, yielding concessions equal to 7.8 percent of asking rents, up from 5.1 percent of asking rents at the start of the recession. Apartment owners' response to the economic crisis was swift, registering sharp declines in rents in the first half of 2009. Rents are now falling modestly as the market stabilizes. Concessions have climbed in formerly torrid housing markets, possibly reflecting increased competition from shadow stock. Concessions in Fort Lauderdale, Las Vegas, Miami, Orlando, Phoenix, Riverside-San Bernardino, Sacramento and Tampa-St. Petersburg collectively were on course to exceed 8 percent of asking rents by year-end 2009.

Forecast:

Opportunities on the Horizon. Approximately 94,000 units were delivered in 2009, with development expected to drop to 65,000 units in 2010, the lowest level since 1995. Falling net operating incomes and property prices have made development economically impractical. In many markets, this has created the potential for a favorable imbalance of supply to demand in the near term. In 2010, only one apartment will be built for every 15 people entering the prime renter demographic aged 20 to 34, compared with an average ratio of 2.6 people for every new apartment in the first half of this decade. A pause in construction and a population surge among prime renters over the next three years will drive vacancies lower and offer the opportunity to raise rents. Adding to the strength, recession-stalled households that would have been created in 2008 and 2009 will begin to form in 2011 and 2012 as the economy builds momentum.

Long-Term Trends Remain Favorable. Nationally, approximately 1 million jobs will be added in 2010, primarily in the second half, with a more vigorous rate of growth expected in 2011 and 2012. Vacancy will edge lower to the high-7 percent range, but asking rents will recede 1.7 percent, accompanied by a 3 percent drop in effective rents. The decrease in rents is primarily attributable to continuing weakness in metros hardest hit by the housing crash. Significant rent growth will not resume in most markets until early 2011 as improvements in demand accelerate.

Apartment Market Vital Signs



3Q 2008 to 3Q 2009 Change in Apartment Vacancy

Top 10 Markets by Least Change in Vacancy

Metro	3Q 2009	Y-O-Y Chg. (bps)
New Haven	4.4%	0
Boston	6.3%	20
New York City	2.9%	80
Miami	5.9%	80
Washington, D.C.	6.2%	90
Raleigh-Durham	8.3%	90
Columbus	8.5%	90
San Francisco	4.7%	100
Minneapolis-St. Paul	4.9%	100
Detroit	7.6%	100
U.S. Metro Average	7.8%	160

Top 10 Markets by Greatest Change in Vacancy

Metro	3Q 2009	Y-O-Y Chg. (bps)
Inland Empire	8.3%	180
Indianapolis	9.2%	180
Atlanta	11.1%	180
Dallas/Fort Worth	8.6%	190
St. Louis	8.9%	200
Oakland-East Bay	6.4%	210
San Antonio	10.3%	210
Jacksonville	13.3%	210
Seattle-Tacoma	7.3%	220
Tampa-St. Petersburg	9.9%	220
U.S. Metro Average	7.8%	160

Sources: Marcus & Millichap Research Services, Reis

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