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Economics Group

Special Commentary

Mark Vitner, Senior Economist
mark.vitner@wachovia.com ● 704-383-5635
Anika Khan, Economist
anika.khan@wachovia.com ● 704-715-0575
Yasmine Kamaruddin, Economic Analyst
yasmine.kamaruddin@wachovia.com ● 704-374-2992

Commercial Real Estate Chartbook: Quarter 4

The Dust Hasn't Settled Just Yet

Despite robust economic growth, the outlook for commercial real estate has not materially improved.

Despite robust economic growth in the second half of last year and a more upbeat assessment for economic activity during the first part of 2010, the outlook for commercial real estate has not materially improved. Credit quality is still deteriorating as delinquencies and defaults increase. Operating fundamentals continue to decline. Vacancy rates across all property types have either already risen to record highs or appear set to. Lending standards remain exceptionally tight, and there has been very little progress made at clearing up the logjam of properties with maturing loans in the next few years, many of which are underwater or have seen loan-to-value (LTV) ratios skyrocket to levels that are difficult to refinance.

This list of problems is nothing new. There has been a persistent chatter about the impending dislocations that will unfold when large numbers of borrowers are unable to refinance commercial real estate loans coming due over the next two to three years. Many of these loans were made at the height of the real estate bubble, between 2005 and mid-2007, when valuations were stretched to the max. Economic conditions have proven to be much more difficult than the operating assumptions many of these projects expected, which means occupancy rates and rents never reached the levels needed to adequately service debt payments. As a result, values have tumbled and many properties are now worth less than the balance due on their loans.

The Moody's/REAL Commercial Property Price Index (CPPI) is currently down 42 percent from its 2007 peak. Values have fallen in every region, but appear to be most problematic in the South and West where there was a great deal of construction activity during the past decade. Declines are expected to continue and we expect the Moody's/REAL CPPI to ultimately fall by 50 percent.[1]

Figure 1

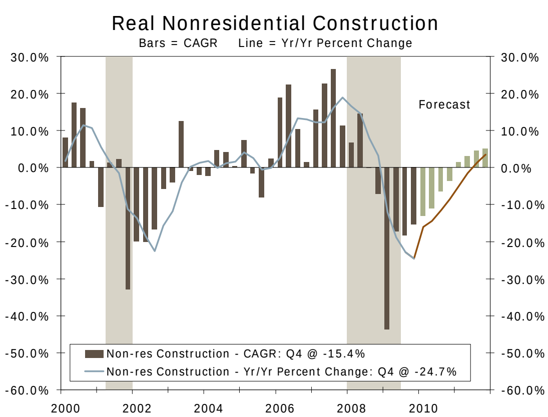
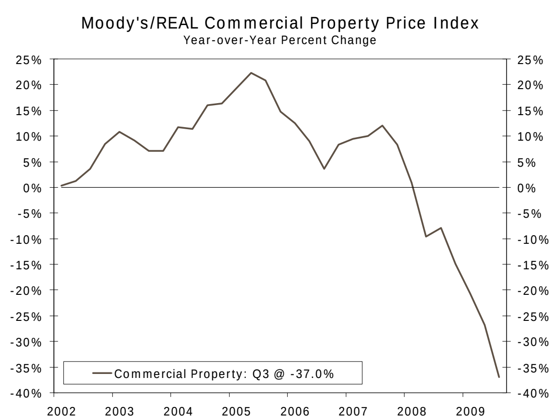


Figure 2



Source: U.S. Department of Commerce, Moody's and Wells Fargo Securities, LLC

[1] Other measures of commercial real estate peak-to-trough declines also project prices to fall by 50 percent. Please also see, *2010 CMBS Outlook*, Jan. 22, 2010, Wells Fargo Structured Products Research.

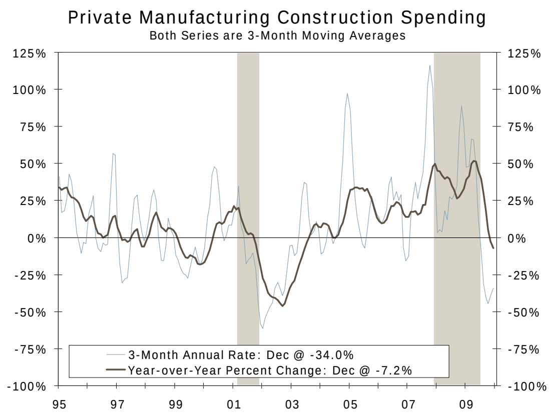
Private Nonresidential Construction Spending

Private nonresidential construction spending did not turn down until late 2008 and is currently down 22 percent from its peak. Overall construction spending was supported by the energy boom, which led to a surge in oil and gas exploration, refinery and pipeline expansions, and alternative energy projects. Construction of office, retail and warehouse projects topped out earlier and has fallen harder with outlays declining on average about 50 percent since peaking in October 2007.

The high vacancy rates confronting commercial properties today are more a product of job losses than they are overbuilding.

The pullback in private nonresidential construction is one of the necessary steps to bring the commercial real estate market back to balance, but in many ways this is the easiest part. We have stressed repeatedly, commercial real estate is less overbuilt in this cycle than in previous cycles. Only a handful of markets saw excessive commercial development during the past decade. The high vacancy rates confronting commercial properties today are more a product of job losses than overbuilding. Office employment has tumbled 8.5 percent from December 2007 until October 2009, producing a net loss of 2.5 million jobs. Overall employment fell 6.1 percent, wiping out 8.4 million jobs.

Figure 3



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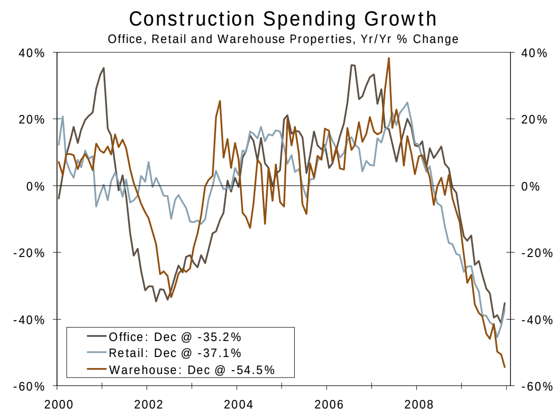


Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Commercial Real Estate Fundamentals

While commercial real estate may not have been as overbuilt as it was in past cycles, it was clearly more overbought. Low interest rates and an abundance of capital allowed property values to be bid up to unsustainable levels. When this rise in commercial property values collided with the unusually severe losses in employment, retail spending, inventory draw-downs and less travel, you got a perfect storm with unsustainably high values running up against sharply deteriorating operating fundamentals. The net result has been sharply rising vacancy rates, declining rents and a sharp increase in delinquencies and foreclosures.

Vacancy rates for office buildings have risen 2.5 percentage points over the past year to 17 percent. Industrial vacancy rates have climbed 2.7 percentage points to 13.2 percent, and vacancy rates for retail space have risen 1.7 percentage points to 10.6 percent. Occupancy rates and operating revenues for apartments and hotels have all declined in recent years, although recent months have seen the rate of decline moderate considerably.

The demand for commercial real estate conditions tends to lag behind economic activity.

While nearly all the news on commercial real estate continues to be negative, there are a few glimmers of sunshine. Office employment has risen during each of the past three months, and some of the leading indicators of employment, such as hours worked and hiring at temporary staffing firms, have turned positive in recent months. Unfortunately, the demand for commercial real estate conditions tends to lag behind economic activity. Vacancy rates are more likely to increase in coming months, as businesses consolidate operations to more closely match their smaller workforces.

Figure 5

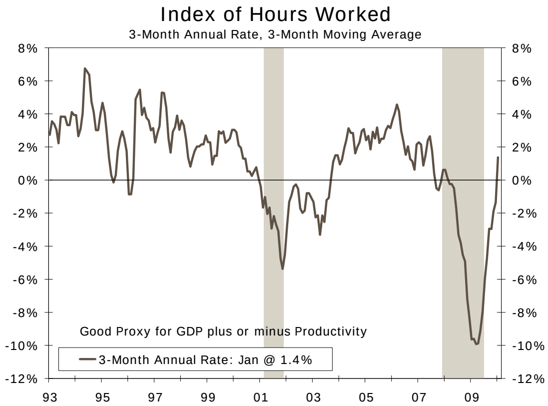
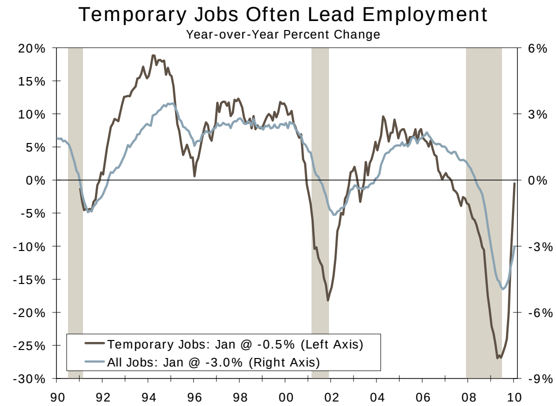


Figure 6



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Federal Reserve Exit Strategy

Higher interest rates look increasingly likely over the next few months.

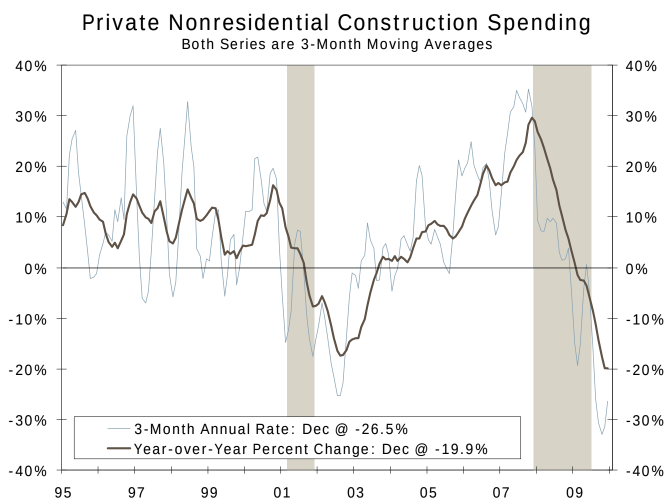
Another important dynamic is the Federal Reserve's exit strategy. The Fed is removing much of the quantitative easing that it put in place following the onset of the financial crisis. Quantitative measures, including direct purchases of $1.25 trillion in mortgage-backed securities helped contribute to a tightening in credit spreads.[2] In addition, Fed Chairman Ben Bernanke stated the Federal Open Market Committee would soon raise the discount, rate returning it to its one-percentage point pre-crisis spread versus the Federal Funds rate.[3] Higher interest rates look increasingly likely over the next few months, even if the Federal Funds rate remains unchanged. Higher rates may cause construction loan problems to surface sooner than they would otherwise and may place some additional downward pressure on property values, making it more difficult to refinance maturing loans.

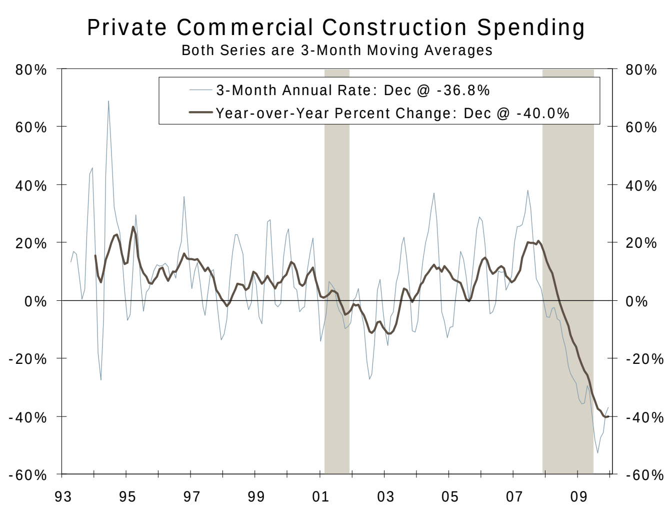
Given the uncertainty surrounding what awaits the financial markets, investors and lenders are more likely to treat any glimmer of light as an approaching freight train rather than the light at the end of the tunnel. We expect vacancy rates, operating fundamentals and prices to deteriorate in coming months and look for sales to gradually increase as investors become more comfortable and accustomed to the new economic and regulatory environment.

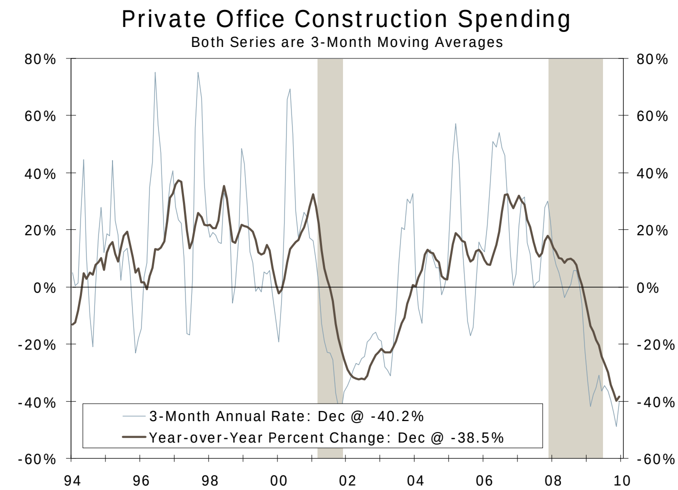
[2] The Term Asset-Backed Securities Loan Facility (TALF) has been less effective in reviving CMBS issuance. For more details, please see *Investing in the Changing Face of America*, December 2009, page 124.
[3] Chairman Ben S. Bernanke, *Federal Reserve's Exit Strategy*, prepared remarks for the Committee on Financial Services, U.S. House of Representatives, Feb. 10, 2010.

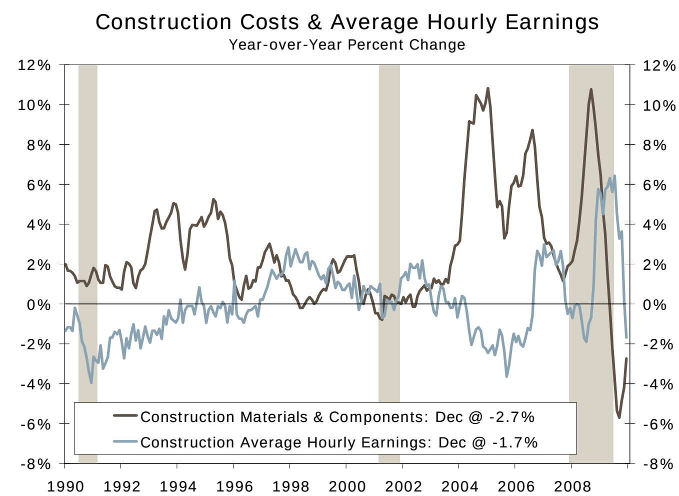
Nonresidential Construction Spending

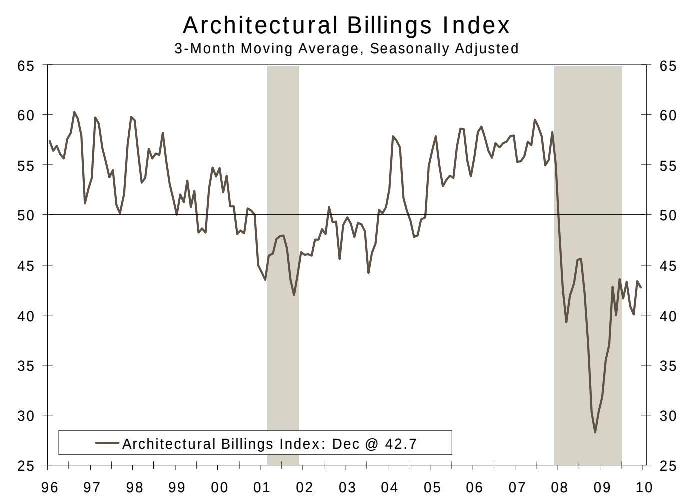
- While economic growth is now solidly in positive territory, structure outlays will likely continue to decline well into 2010.
- Private nonresidential construction spending dropped 7.4 percent in the fourth quarter and is expected to contract at a 12.8 percent annual rate in 2010 before regaining its footing in 2011.
- Construction spending for office and commercial, which includes retail and wholesale structures, continued to contract with declines of about 40 percent year over year.
- Construction material costs are now down 6 percent from their peak, but recent increases in commodity prices, particularly metals, will put some upward pressure on costs.







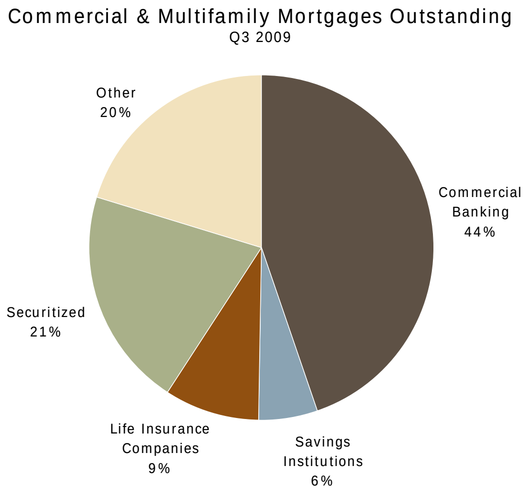


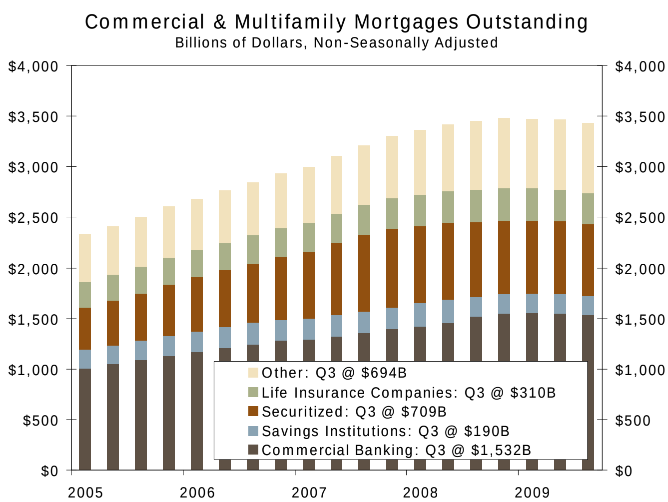


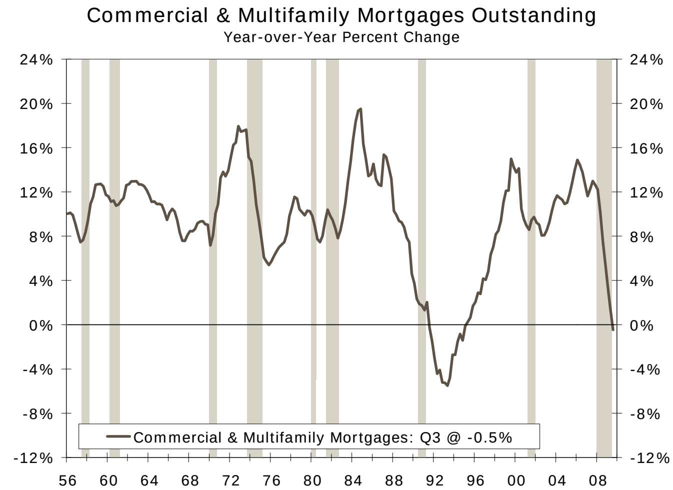
Source: The American Institute of Architects, Dept. of Commerce, Dept. of Labor and Wells Fargo Securities, LLC

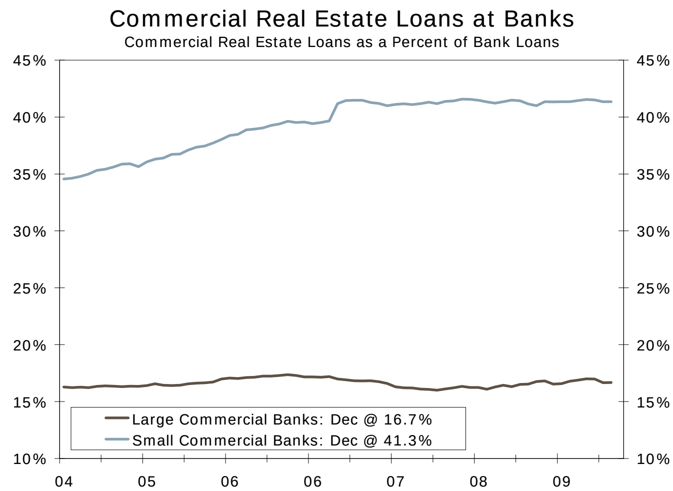
Commercial Mortgages Outstanding

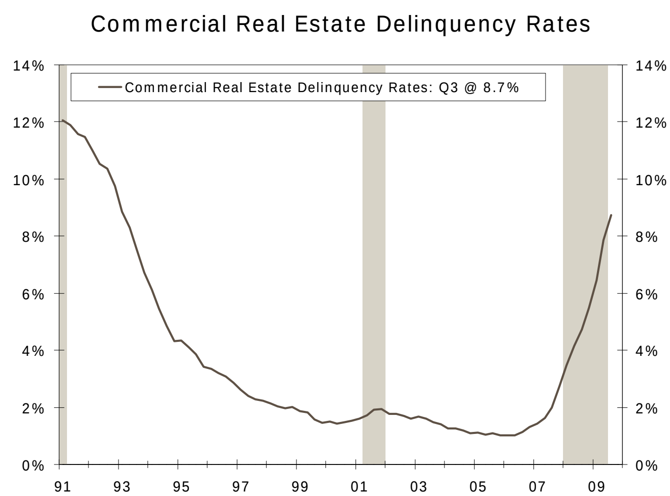
- Commercial and multifamily mortgages outstanding fell by $28 billion in the third quarter, the third straight quarterly decline. By comparison, mortgages declined nearly one year after the 1990-1991 recession ended, falling almost 12 percent from its peak.
- Commercial banks continue to hold the majority of commercial mortgages at 41 percent. CMBS, CDO and other ABS issuers are the second-largest holders with 21 percent of the market.
- Small banks continue to have more exposure to commercial real estate with 41 percent of their bank loans tied up in that sector.
- Delinquency rates have risen nearly 8 percentage points since early 2006 and should continue to increase in coming quarters.









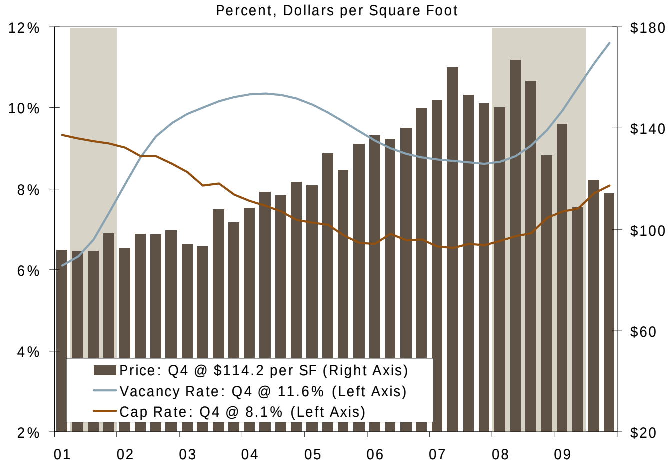


Source: Federal Reserve Board and Wells Fargo Securities, LLC

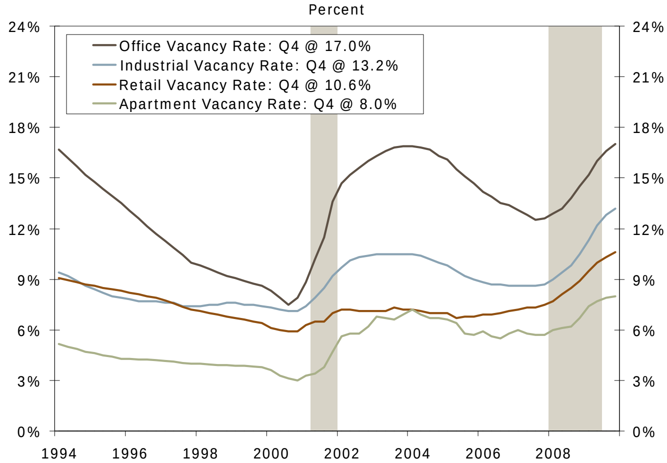
CRE Property Fundamentals

- Property fundamentals remain weak as vacancy rates continue to rise amid a weak labor market. Office vacancy rates are now at 17 percent, the highest level in 16 years. Office employment has declined 8 percent from its mid-2007 peak. Even when employment starts rising again, vacancy rates will continue to move higher as businesses consolidate operations. Cap rates are back near levels seen a decade ago.
- Commercial real estate lending standards remain tight but have improved considerably since the collapse of Lehman Brothers.
- Commercial mortgage-backed security issuance remains at record low levels but is showing a faint heartbeat as a handful of new deals are scheduled to come to market in 2010.

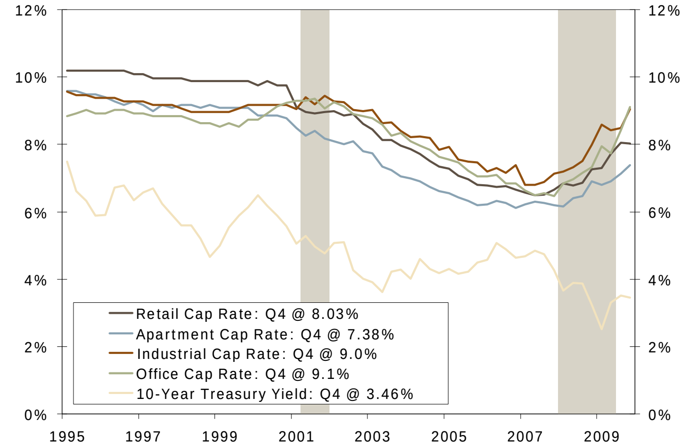
Commercial Real Estate
Percent, Dollars per Square Foot



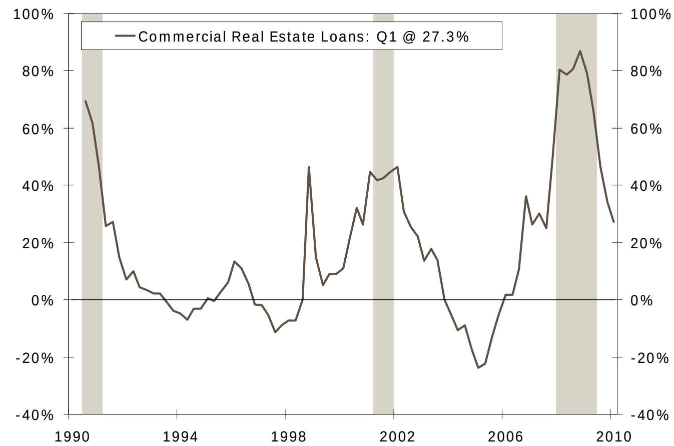
Commercial Real Estate Vacancy Rates
Percent



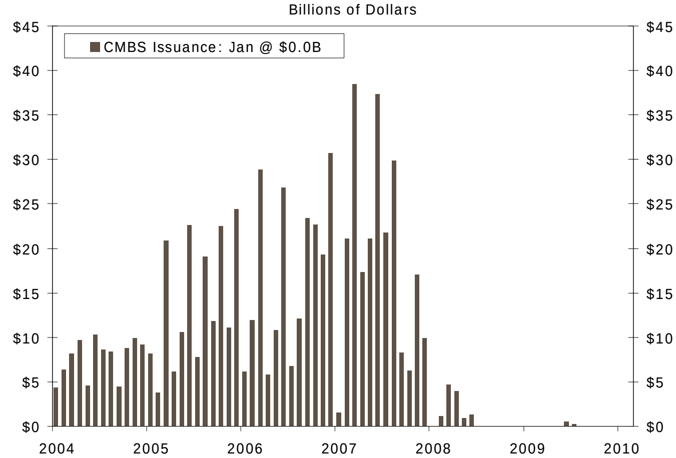
Cap Rates vs. 10-Year Treasury Yield
Percent, Yield



Net Percent of Banks Tightening Standards
Commercial Real Estate Loans



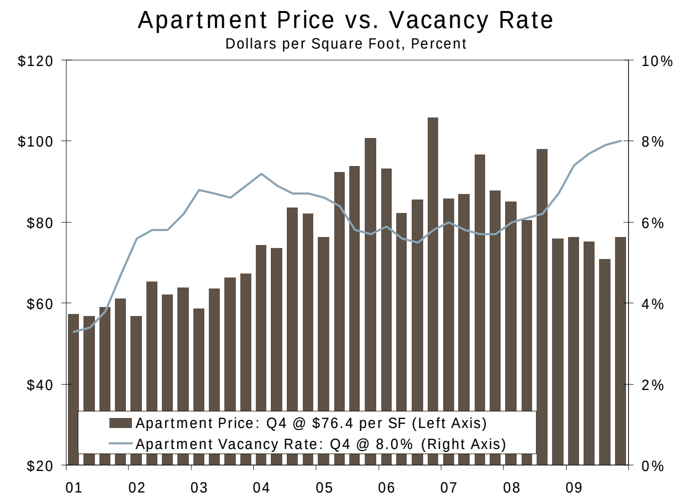
U.S. CMBS Issuance
Billions of Dollars

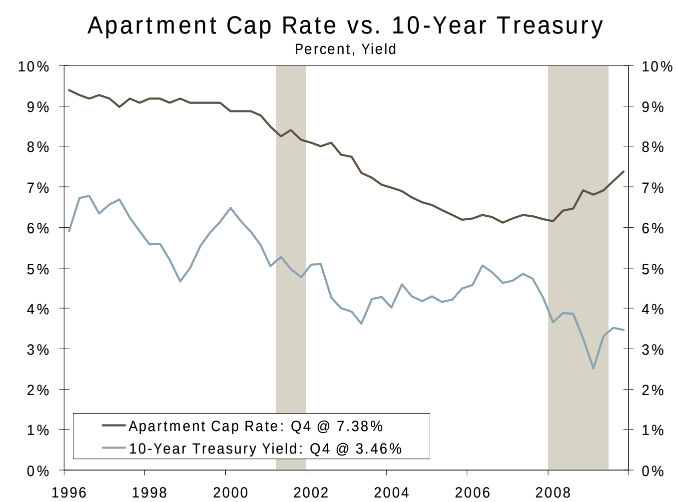


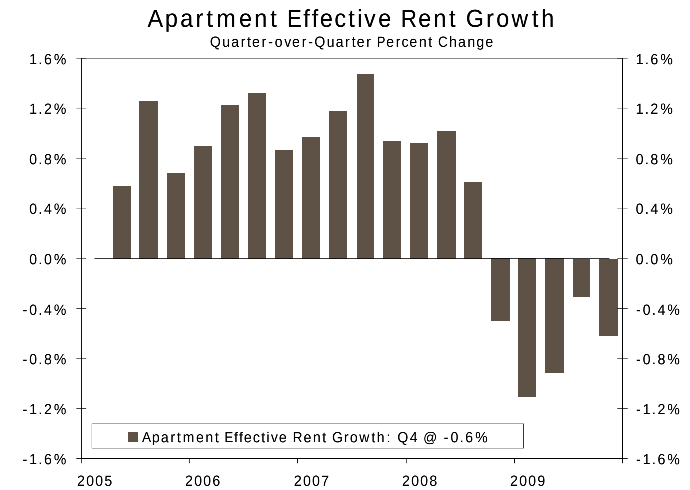
Source: Federal Reserve Board, Property & Portfolio Research, Real Capital Analytics, Reis, Inc. and Wells Fargo Securities, LLC

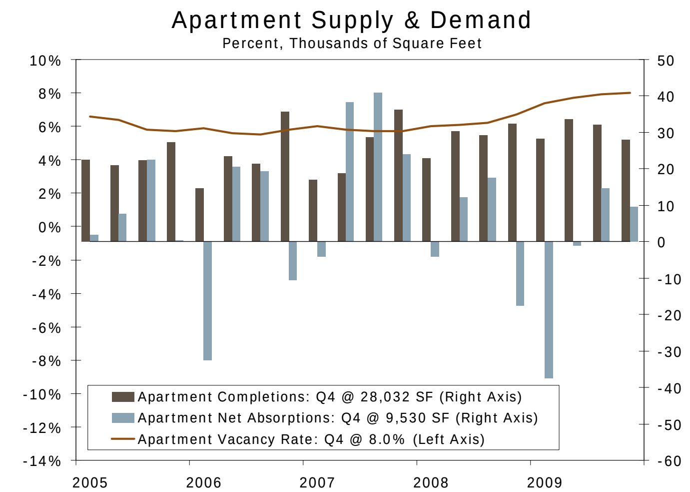
Apartment

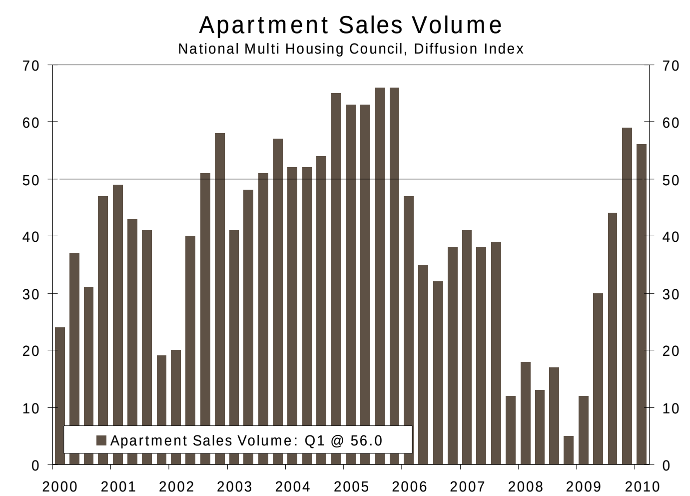
- The apartment market remains extremely challenged as the vacancy rate rose 10 bps to 8.0 percent in the fourth quarter. Demand is still weak due to a rising unemployment rate and excess inventory. Household formation still remains quite sluggish. The glut of rental apartments and weak demand will continue to push vacancy rates higher.
- Effective rent growth has been negative for the past five quarters with further declines likely as landlords continue to offer concessions.
- While the pace of apartment completions continues to slow, according to REIS, newly completed buildings that did come on line, did so at around 50 to 60 percent vacant.







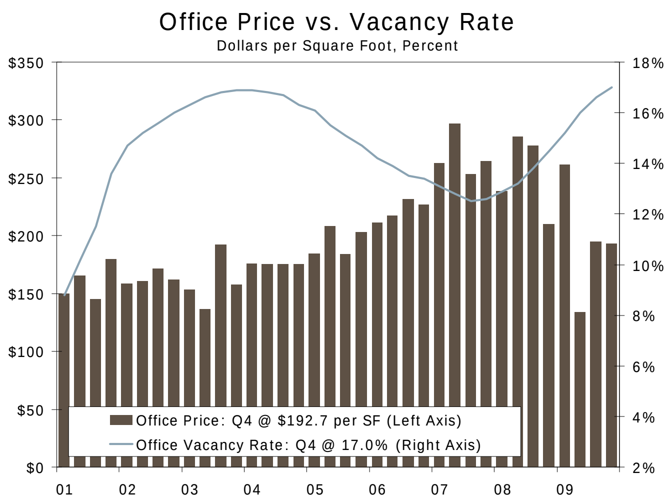


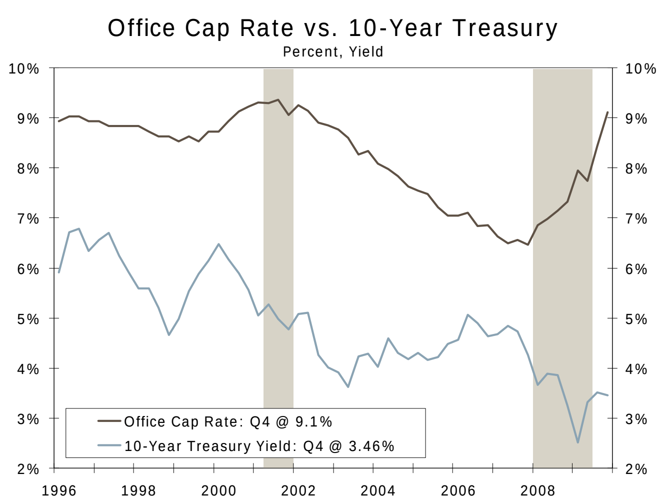


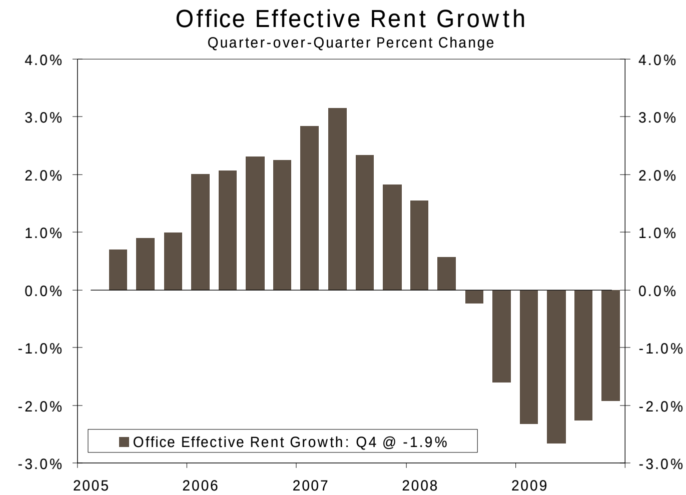
Source: Federal Reserve Board, NMHC, Real Capital Analytics, Reis, Inc. and Wells Fargo Securities, LLC

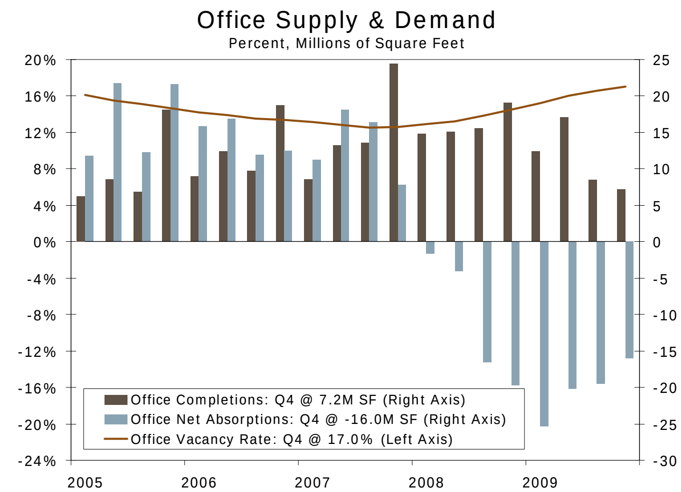
Office

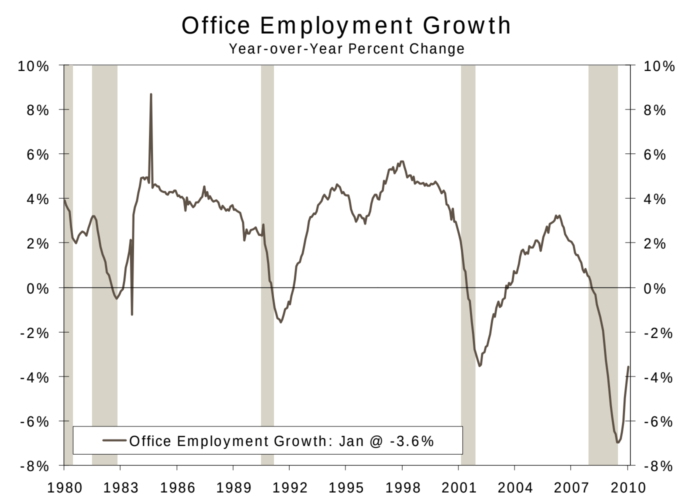
- With mounting job losses in financial, business and professional services, net absorption has now been negative for eight consecutive quarters. Declines are moderating, however.
- Office employment has fallen 8 percent from its peak, and several major metro areas have seen double-digit declines.
- While completions slowed in the fourth quarter, roughly 7 million square feet were delivered. When combined with the continued drop in demand, vacancy rates moved significantly higher, to 17 percent.
- Reported vacancy rates likely understate the extent of oversupply as a great deal of space remains underutilized.







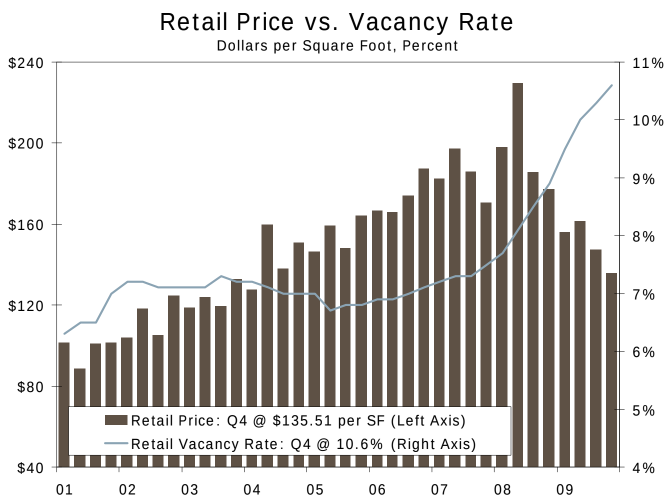


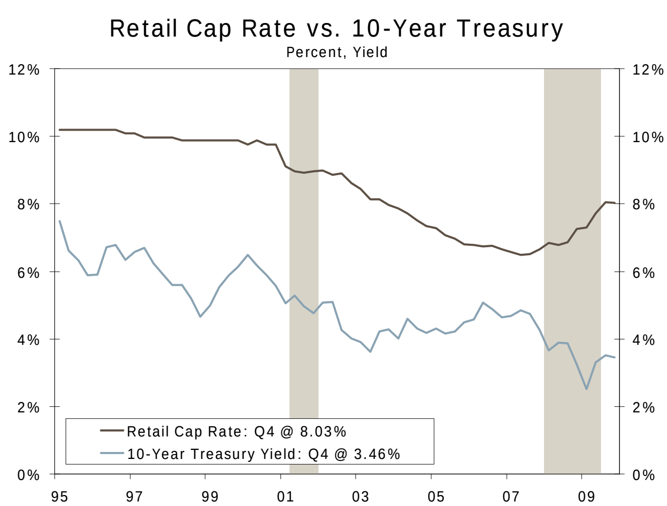


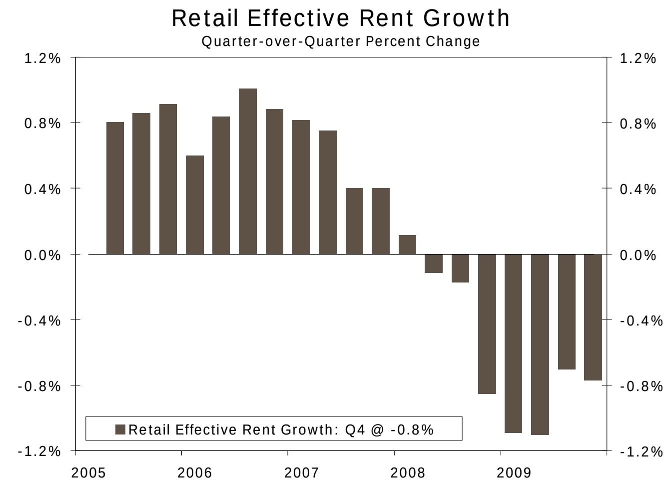
Source: Federal Reserve Board, Real Capital Analytics, Reis, Inc, U.S. Department of Labor and Wells Fargo Securities, LLC

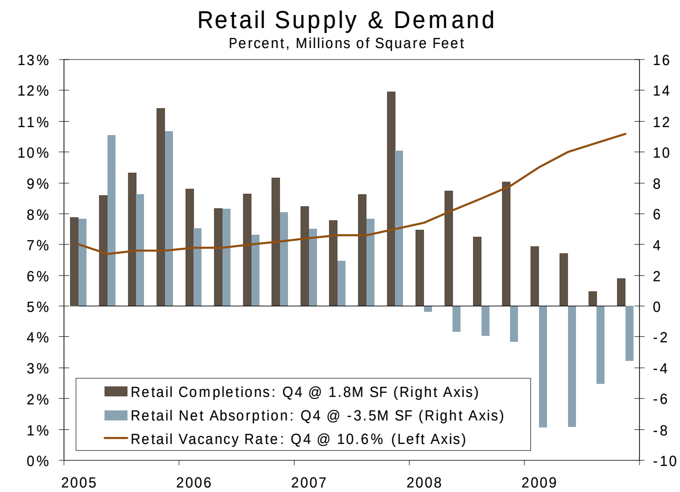
Retail

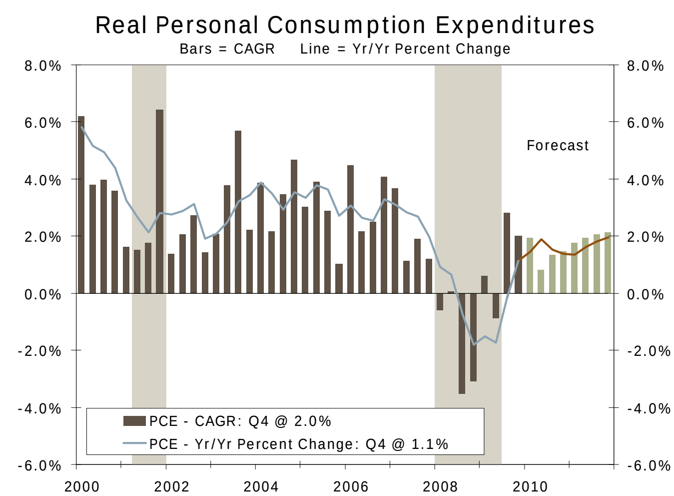
- Demand for retail space has weakened dramatically, as tepid employment conditions and falling home prices cut into discretionary spending. Personal consumption is expected to grow a modest 1.6 percent in 2010.
- Effective rent growth has been negative for seven consecutive quarters as landlords continue to contend with space returned from bankruptcies and store closures. A few strong chains are using this as an opportunity to trade up.
- Retail completions continue to hit the market, but the pace has slowed significantly. Even with less new space coming on line, vacancy rates will still likely trend higher.







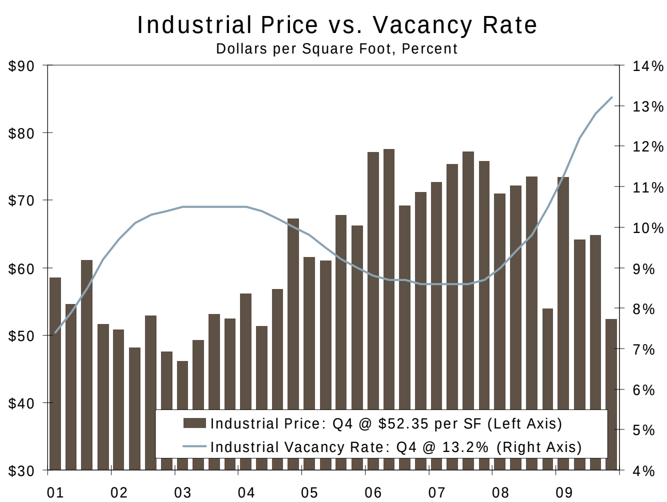


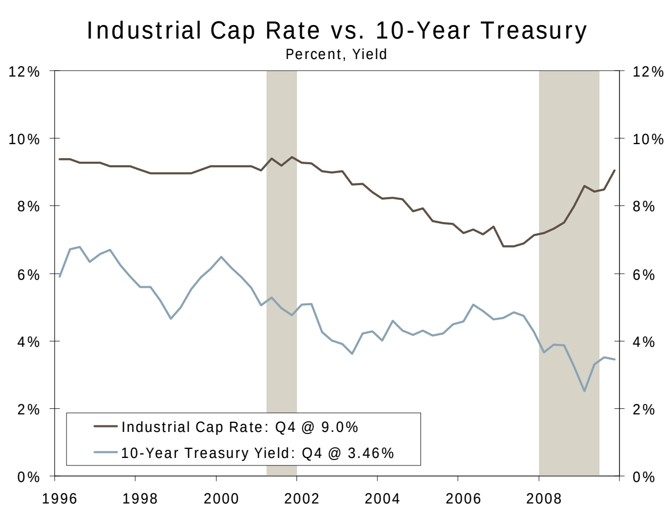


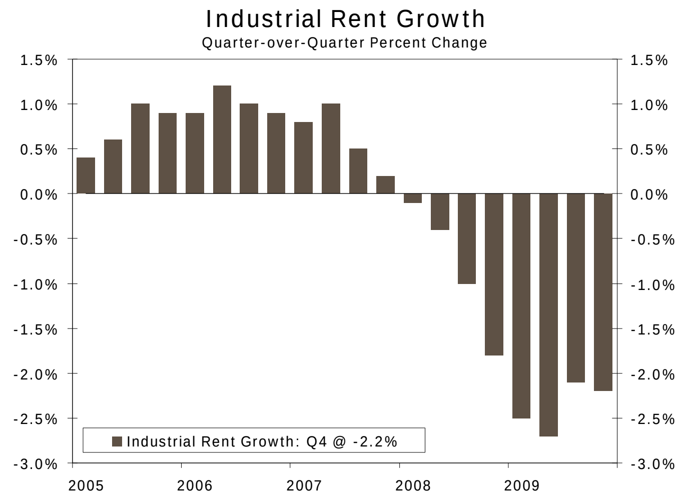
Source: Federal Reserve Board, Real Capital Analytics, Reis, Inc, U.S. Department of Commerce and Wells Fargo Securities, LLC

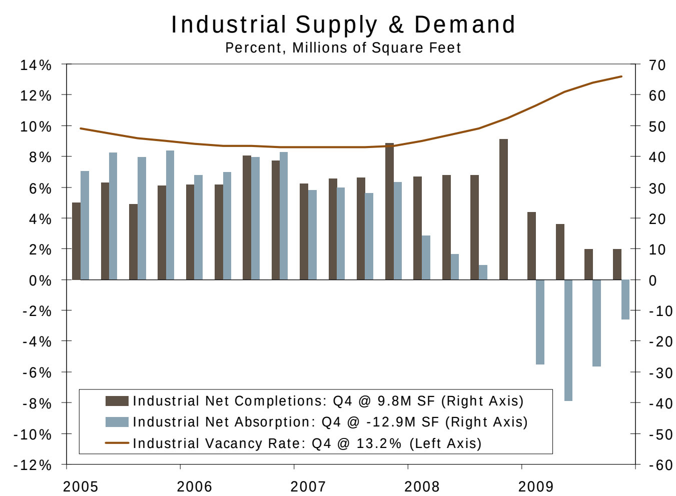
Industrial

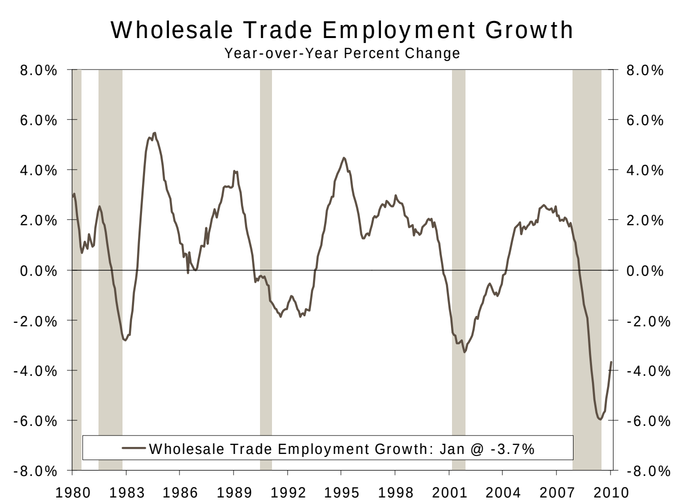
- Prices for industrial properties declined 19 percent in the fourth quarter, and the vacancy rate rose to 13.2 percent.
- Demand for industrial space remains weak as businesses continue to reduce inventories. Inventories were cut by $33.5 billion in the fourth quarter, a much smaller decline than in previous quarters. Inventories should rise in coming quarters, which should provide at least a modest lift to demand for warehouse space.
- Wholesale trade employment is declining at a slower pace but is still down a cumulative 8.2 percent since its November 2007 peak. Hiring is expected to rise modestly in 2010.











Source: Federal Reserve Board, Property & Portfolio Research, RCA, U.S. Department of Labor and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wachovia.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wachovia.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wachovia.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wachovia.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(612) 667-0168	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Economist	(704) 383-7372	sam.bullard@wachovia.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wachovia.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wachovia.com
Adam G. York	Economist	(704) 715-9660	adam.york@wachovia.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economic Analyst	(704) 374-4407	tim.quinlan@wachovia.com
Kim Whelan	Economic Analyst	(704) 715-8457	kim.whelan@wachovia.com
Yasmine Kamaruddin	Economic Analyst	(704) 374-2992	yasmine.kamaruddin@wachovia.com

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