



Economic Growth to Continue but Drivers Shifting

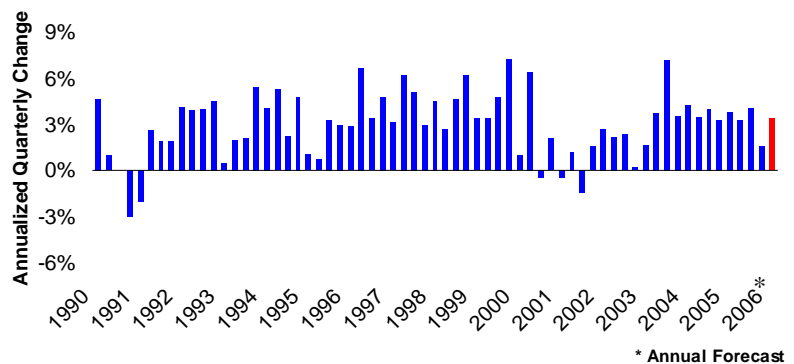
GDP growth is expected to snap back to the 4.0 percent to 4.5 percent range during the first quarter of 2006. Fourth quarter growth came in at just 1.6 percent, but several of the factors that led to the dramatic slowdown were caused by extraordinary circumstances and timing issues, and are not expected to hinder economic expansion this year.

- Growth in personal consumption expenditures declined significantly during the final quarter of 2005, but the data is somewhat misleading. While overall spending decreased to an annualized rate of only 1.2 percent, down from 4.1 percent in the third quarter of 2005, the deceleration was caused almost entirely by a drastic dropoff in auto sales in the month of October. Auto sales have since returned to more normalized levels. We do expect some slowing in consumer spending this year but not to the degree registered in the fourth quarter of last year.
- Last year's devastating hurricane season led to a prolonged disruption in U.S. energy production and also impacted Gulf Coast port activity. The combination of decreased exports and increased oil imports led to a greater trade imbalance during the fourth quarter. In addition, elevated energy prices affected many industries. While oil prices are still a concern, Gulf Coast oil production has been steadily recovering.
- A decline in defense spending cut into overall fourth quarter growth, but this was largely the result of timing issues related to legislation and contract delays. GDP growth in the first quarter of 2006 is expected to reflect a rebound in government spending, as rebuilding in the Southeast is gaining momentum and military operations in the Middle East continue.

Cooling in the housing market is expected to reduce growth after the first quarter of this year. Rising mortgage rates will, however, lend support to apartment demand. The FOMC continues to maintain its stance on inflation and is expected to raise the Fed funds rate by another 25 to 50 basis points by midyear. Adjustable-rate mortgages and home equity lines are typically tied to short-term indexes, making them sensitive to changes in monetary policy.

- Rising short-term rates will lead to stronger renter demand, as more potential home buyers are priced out of the market. This is the basis for our 2006 rent growth forecast, which calls for the greatest gain since 2000.
- The downside of a cooling housing market is expected to be a decline in the number of properties purchased for conversion to condos. There are growing concerns of oversupply in some of the most active condo markets, particularly at the higher end of the market. However, conversions will not disappear this year. While new condos are typically geared toward luxury buyers, converted apartments are often the most affordable for-sale option in the market, and will continue to benefit from a broader mix of buyers.

U.S. Gross Domestic Product



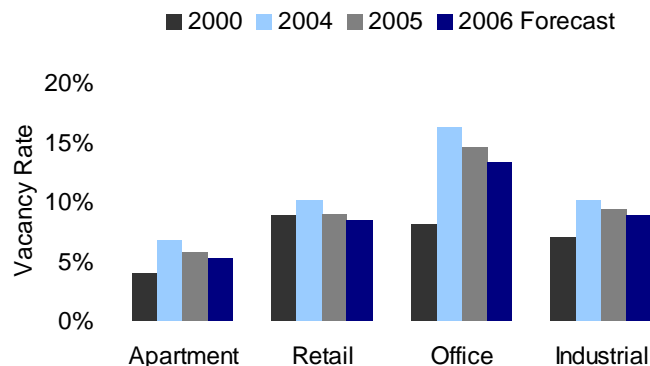
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Sources: Marcus & Millichap Research Services, Economy.com, U.S. Bureau of Economic Analysis



A shift in economic growth drivers is expected this year, with strong business spending and inventory buildup forecast to help offset the effects of slower growth in the housing and consumer sectors. Business confidence is high and corporate profits have been robust, suggesting that firms should be stepping up investment in plants and equipment, not cutting back.

- Demand for office space increased in the latter half of 2005 as businesses began to lease more space in anticipation of increased hiring this year. Office-using employment sectors are expanding at an above-average pace, which will support further increases in absorption this year.
- Office market fundamentals in nearly all major metro areas have registered improvement over the past few years, but the most significant gains in operations are still to come. As more investors take note of the opportunity in the sector, we expect investment activity to accelerate.

U.S. Property Fundamentals Improving Vacancy Trends by Sector



It is widely presumed that consumer spending will increase at a slower rate in 2006 than recently recorded, but a rapid dropoff is not anticipated. Consumer spending accounts for approximately two-thirds of GDP and has underpinned a respectable level of economic growth during the past several years. While a reduction in cash-out refinancing activity and elevated energy prices will weigh down retail sales growth, a drastic deceleration is not anticipated, due to steady job gains and corresponding wage pressure.

- Retail development has been largely tenant driven, which will continue to keep supply/demand fundamentals in check. While consumer spending is expected to stay at relatively healthy levels, most major retailers continue to move forward with expansion plans.
- Overall, stability will continue to draw investors to the retail sector. Single-tenant retail cap rates have declined considerably over the past few years but, on average, are still above returns for apartment properties. As baby boomers move toward retirement, we expect a strong flow of exchange capital to shift from apartments into the no-maintenance single-tenant sector. We do, however, expect cap rates to stabilize as mortgage rates edge up.

The 10-year Treasury yield is forecast to rise only moderately to the 4.8 percent to 5.2 percent range this year. The still-favorable interest rate environment will continue to support strong activity in the investment real estate market. Overall, market fundamentals are improving across real estate sectors, which will offset the effects that higher debt-service will have on cap rates this year.

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