



THE 2005 NATIONAL ASSOCIATION OF REALTORS® PROFILE OF REAL ESTATE MARKETS: The United States of America

Prepared by the Research Division of

THE NATIONAL ASSOCIATION OF REALTORS®

December 2005



NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®



Executive Summary

This report reviews the economic and market conditions underlying the U.S. real estate market in the recent past and provide an outlook for the upcoming year. Major economic indicators are discussed in the first section. The housing market conditions are then examined, including housing stock, home sales and sales prices. Finally, the performance of the commercial real estate market is evaluated.

Following are the major findings:

- The U.S. economy continued to show remarkable resilience in 2005. GDP is expected to post a 3.5 percent growth rate in 2005 – a solid performance, especially in light of unprecedented oil price levels, vacillating consumer confidence, and a trio of devastating Hurricanes in the Gulf Coast, Texas and Florida.
- Residential real estate once again was the backbone of the U.S. economy. Home sales activity reached a fifth consecutive record year and home price appreciation in most markets was solid, if not astounding. Many metropolitan areas experienced home prices growth of better than 10 percent. Active homebuying has pushed up homeownership; the nation's homeownership rate was 69 percent. The health of the housing sector has helped propel job creation, especially in home construction.
- Job creation and healthy home price appreciation is continuing to fuel consumer spending. Home price appreciation increasing household wealth, thus giving homeowners financial comfort to spend on other items. Spending, in turn, is creating new jobs at the rate of around 200,000 per month.
- After several years of lackluster performance, the stock market has recovered nicely, with the S&P 500 approaching a 3-year high at the end of 2005. For Dow Jones Industrial Average is within close reach to cross the magic 11,000 for the first time in 5 years. The rising stock market reflects growing business confidence about the future. Furthermore, business spending has been increasing near double-digit pace. Corporate profits have increased significantly in the past three years, giving companies the resources to invest in properties and restock depleted inventory.
- Interest rates remained at 45-year lows in 2005, although by the end of the year they were starting to tick upwards. Still, the cost of borrowing is at historically low levels. Inflation, as well, remains under control. The Federal Reserve continued its measured approach to interest rates. A major drag to the economy in 2005 was oil, which surpassed the \$70 per barrel mark before showing signs of settling back to more comfortable levels.
- Commercial real estate market performance is improving, due to nearly 4 million jobs created during the past 2 years. The office sector showed real strength, primarily due to demand from an increase in professional and financial services employment. New international trade agreements will help propel demand for industrial real estate, particularly in Florida, Texas, Southern California. With vacancy rates in most key markets declining and rental rates have begun to accelerate.

- As mortgage interest rates tick up, housing affordability is likely to decrease, making it more difficult for households to purchase a home. That is likely to drive demand for multifamily housing, especially in those areas with high housing costs. In addition, rental demand by young adults aged 20-29 who are just forming households. This group of people will provide support for a healthy market for multifamily rental properties.

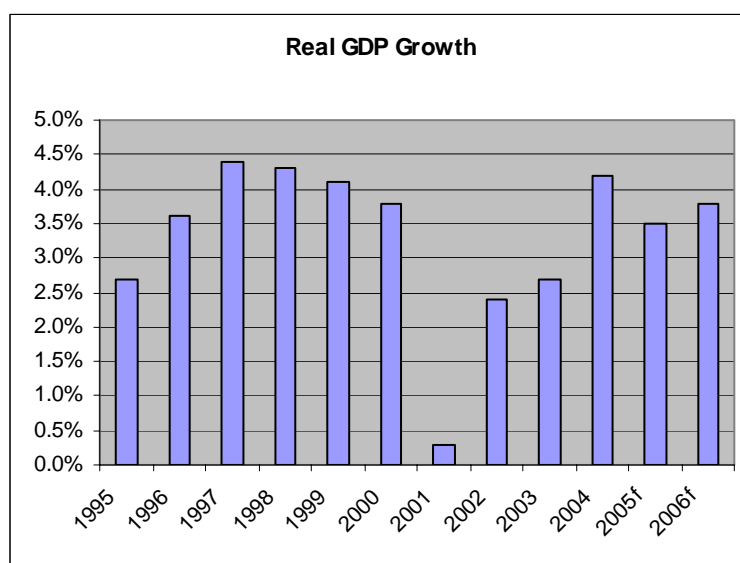
The U.S. Economy

GROSS DOMESTIC PRODUCT

The U.S. economy in 2005 showed remarkable strength. Gross Domestic Product (GDP), a measure of economic activity, is projected to post a 3.5 percent growth rate for the year. While that is a deceleration from the 4.2 percent growth rate in 2004, the better-than-three-percent rate for 2005 is despite several negative hits to the economy. Oil prices rose to unprecedented levels, at one point surpassing the \$70 per barrel mark. Consumer confidence vacillated back and forth throughout 2005 due in large part to those oil-price fluctuations. Changing opinions regarding the war in Iraq also contributed to uneven consumer confidence levels. Inflation also has been picking up, though not to alarming levels, prompting the Federal Reserve to take away its monetary stimulus by steadily raising the short-term lending rate. Add to all that the record number of hurricanes in 2005 that devastated many localities, including virtually wiping away a major U.S. city: employment in New Orleans alone declined by over 200,000 from the impact of Hurricane Katrina.

The respectable economic growth is being led by a surge in business spending and housing market activity. Businesses have increased spending for plants and equipments by 8.7 percent in the third quarter of 2005 and looks to rise at a double-digit growth pace for the remainder of the year. Significant rise in corporate profits in the past three years is providing the wherewithal for businesses to go out and spend. At the same time, 25-year high activity in new home construction and fifth straight record home sales (both new and existing) have pushed residential investment to grow 9.6 percent in the first three quarters of 2005.

Despite all the talk of overstretched wallets, consumer spending also made respectable gains with spending rising at better than 3 percent rate in the nine of the past ten quarters. The nearly 4 million job additions in the past two years have helped income to grow, thereby supporting spending. But undoubtedly, the significant rise in housing wealth has provided comfort level for consumers to go out and spend. 2005 Federal Reserve research paper (coauthored by Federal Reserve Chairman Alan Greenspan, along with James Kennedy) reports a more than \$400 billion annual boost to consumer spending directly as a result of rising home prices.



Source: U.S. Bureau of Economic Analysis, NAR forecast (f)

A recovering stock market, with the S&P 500 approaching a 4-year high at the end of 2005, has also provided the financial wherewithal to support consumer spending. The total net worth hit \$49.8 trillion in the second quarter of 2005, an increase of 9.5 percent from one year before. (A faster home price

appreciation and a strong rise in the stock market in the third quarter are likely to have accelerated the gains in total net worth for the quarter.)

One continuing area of disappointment in recent years has been the performance of net exports. The nation's trade deficit drastically deteriorated with import growth far outpacing export growth. The current international account plummeted to \$624 billion deficit in 2004, a substantial increase from the \$501 billion deficit registered in 2003. The deficit is expected to surpass \$700 billion in 2005 - about 6 percent of GDP. The large trade deficit partly reflects the fact that the U.S. economy has been stronger than elsewhere. Stronger economies spend more, including that for imports. A second important reason is due to generational low interest rates and easy financing afforded to U.S. consumers as foreign investors continue to pour record amount money into the U.S. financial markets. A high energy prices also necessitated spending more on imported oil.

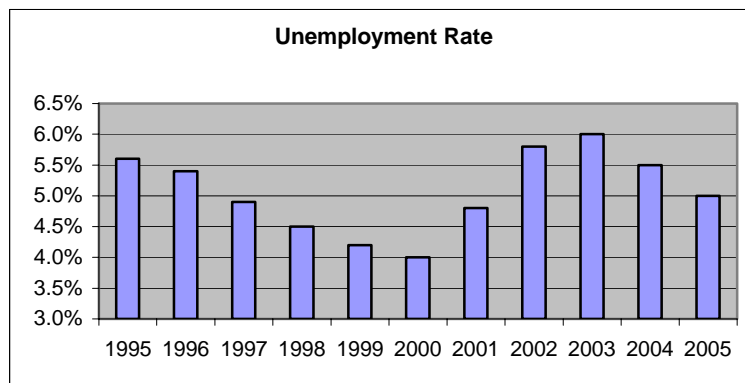
Overall, the positives far outweigh the negatives and the economy will likely accelerate faster in 2006. Companies have deep resources to expand. Income growth from job additions and the rising stock market, as well as increased housing market wealth, will provide support for consumer spending to march at a brisk pace. Rebuilding activity related to Hurricanes Katrina, Rita and Wilma will mean more construction-related spending and jobs. If anything, oil prices are expected to trend down modestly in 2006, adding back wind to push the economy forward. GDP growth will accelerate to 3.8% in 2006.

LABOR MARKET

After the devastation wrought by Hurricane Katrina, employment in New Orleans declined by more than 200,000. Job losses in Gulfport-Biloxi, Mississippi totaled 25,000. Claims for unemployment insurance shot up to their highest level in two years. Surprisingly though, the impact was very localized; the rest of the country moved ahead on the job front, with the economy creating about 200,000 net new jobs per month.

As of October 2005, there have been 4.1 million payroll job additions in the previous 24 months. The strong job gains came in spite of the job losses associated with the hurricanes. By a separate household measure (based on survey of households and not based on payroll data from companies) - which some analysts feel better reflect employment growth in new start-up companies and those of independent consultants - even more jobs were created. Household employment grew by a cool 5 million over the same time period.

Not all sectors of the economy have benefited equally from the job expansion. The construction sector, riding on the back of record home sales, added 533,000 jobs in two years. Employment in the financial activities sector (including that of mortgage lending) rose by 299,000. Jobs in professional business services - of which many are in high-tech consultancy - grew by 989,000. The weak sector was in manufacturing, where employment decreased by 84,000 jobs over the 24 months. The struggling manufacturing sector has been on a long-term decline for



Source: U. S. Bureau of Labor Statistics

quite some time. In 1960s, about one in five workers was employed in the sector. By the end of 2005 it was one in ten. Manufacturing took a brutal hit from 2000 to 2004 as 3 million jobs were lost. The only positive news, if it can be called that, is that the bleeding appeared to have stopped with no net major job losses in the sector in 2005.

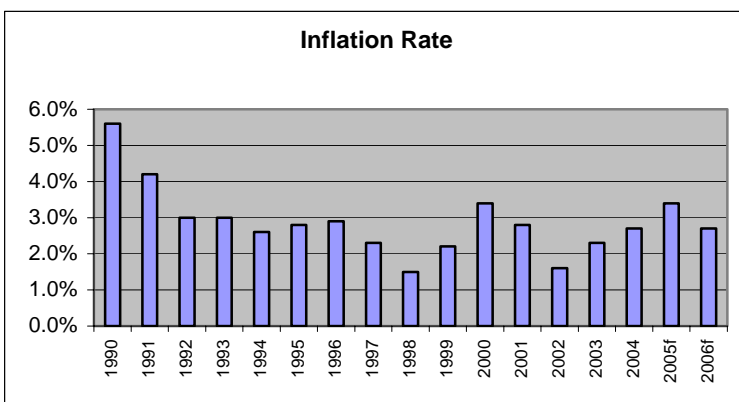
The job-creating economy has lowered the unemployment rate. The jobless rate was 5.0 percent in October compared to the cyclical peak rate of 6.3 percent in July 2003. The current unemployment rate, pretty much already at the natural rate and certainly unlike the double-digit rates in Germany and France, is projected to remain at this level in 2006.

INFLATION AND INTEREST RATES

Generally, any inflation rate below 3 percent is deemed “manageable.” But in 2005, there were some potentially unmanageable factors that helped drive prices upwards. The big culprit was oil. The price of a barrel of oil crossed the \$70 mark in the summer of 2005. It had been, believe it or not, \$11 per barrel in the winter of 1998. Rising oil prices are a huge drag to the economy because higher oil prices are equivalent to higher taxes in terms of consumer spending impact. Because the U.S. is a net importer of oil higher payment at gas stations mostly flow out of the country, leaving less available for spending in other items. NAR estimates that if the oil price had remained at 2004 prices of about \$45, then GDP would have expanded at a robust near 5 percent as opposed to 3.5 percent in 2005.

The oil price spike has been the principal reason for a much higher overall inflation rate in 2005, with the consumer price index being 4.3 percent higher over the 12 months from October 2004 to October 2005. The Federal Reserve prefers to see inflation at below 3 percent.

Fortunately, the “core” inflation rate, which excludes the volatile energy and food components, rose by 2.0 percent in that same 12 month period. It suggests that price increases have been confined primarily to the energy component which has yet to filter into the costs of other goods and services. Furthermore, oil prices measurably declined in November 2005 to about \$55 per barrel. Many oil analysts anticipate further declines in the price as more new production comes on line and from diminished speculative buying.

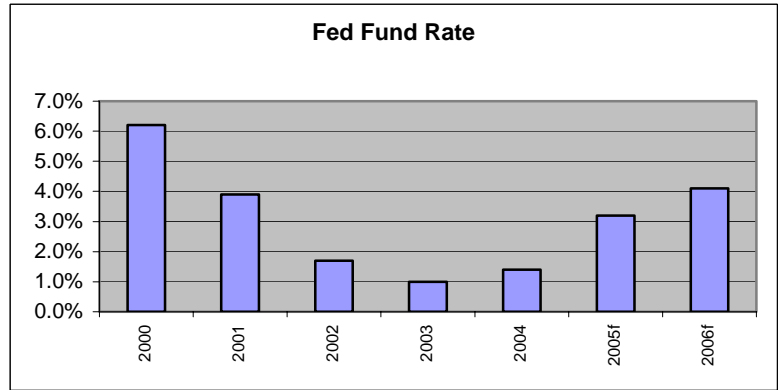


Source: Bureau of Labor Statistics, NAR forecast (f)

For 2006, inflation will sink back to below 3 percent. As happened with the *rise* in energy price, the anticipated *fall* in energy prices will be the primary reason for the overall decline in the consumer price index. The “core” inflation rate will make a modest gain to about 2.4 percent in 2006 due to the lagged impact of high oil prices in 2005 and from the overall strengthening in the economy.

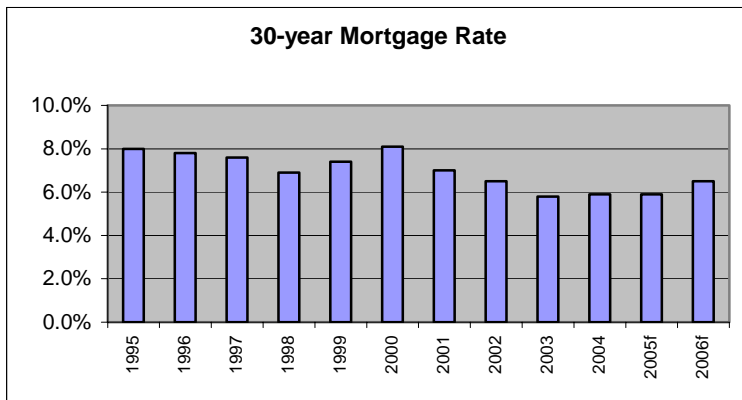
Finally, despite the falling unemployment rate, workers have not been aggressive in demanding higher wages. The average hourly wage rose by only 2.9 percent in the 12 month period October 2004 to October 2005. Historically, wages rise by 4 percent during an economic expansion. Therefore, there is minimal “cost-push” inflationary pressure from the labor market in the current economic expansion.

The Federal Reserve, wanting to err on the side of caution – i.e., not letting inflation get out of hand -- has drastically tightened its monetary policy. As of early December 2004, the fed fund rate is at 4 percent, compared to 1 percent in the spring of 2004. It is likely to be raised by another 50 basis points before the tightening cycle ends in mid 2006.



Source: Federal Reserve, NAR forecast (f)

Fortunately, the drastic hikes in the fed funds rate (the short term overnight borrowing rate between financial institutions) have not impacted long-term borrowing rates, including 30-year mortgage rates. The “conundrum” of the long-term rates not moving higher in spite of the short-term rate increases has been a godsend for the housing market and other interest-sensitive sectors.



Source: Freddie Mac, NAR forecast (f)

The major reason for this conundrum is the low inflationary expectation by lenders. Lenders tack on inflation premiums to their borrowing rates. If the outlook is for low inflation then lenders can lend at low rates. Many lenders (which include foreign banks and investors) evidently have viewed the Federal Reserve actions as inflation-fighting moves, giving them a comfort level. Ben Bernanke, the incoming chairman of the Federal Reserve, has mentioned another reason for

the conundrum. There is a global savings glut, particularly by China and Japan, with the U.S. being the only logical place to park the money. Similarly, the recent strong run-up in oil prices has fattened the coffers of oil-exporting countries. In spite of any political differences or public anti-American sentiments, those countries have used this money to invest in the U.S. So the savings glut contributes to keeping long-term rates at manageable levels.

The 10-year U.S. Treasury yields were 4.5 percent as of early December, which is not much different from rates in 2003 and 2004. Similarly, 30-year mortgage rates will average 5.9 percent for all of 2005 - essentially the same as in the prior two years.

For 2006, however, further short-term interest rate hikes by the Fed will push up long-term rates. The interest rate spread between the short and long term rates has greatly narrowed. The 10-year Treasury will average 4.9 percent and the 30-year mortgage rates will average 6.5 percent in 2006.

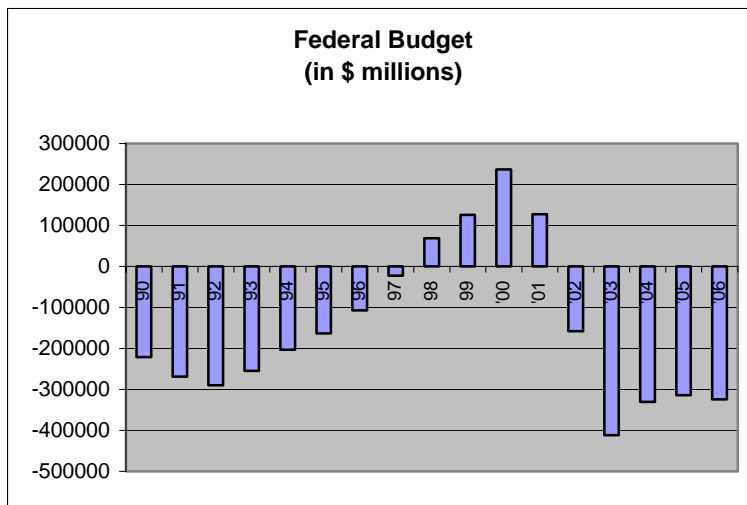
FEDERAL BUDGET/FISCAL POLICY

After posting a record budget deficit of \$413 billion in fiscal year 2004, the U.S. government budget improved a bit in 2005 as the deficit shrunk to \$318 billion. Solid economic growth raised tax revenue by 14.6 percent, easily outpacing government spending growth of 7.8 percent. That is good news in light of the previous budget years.

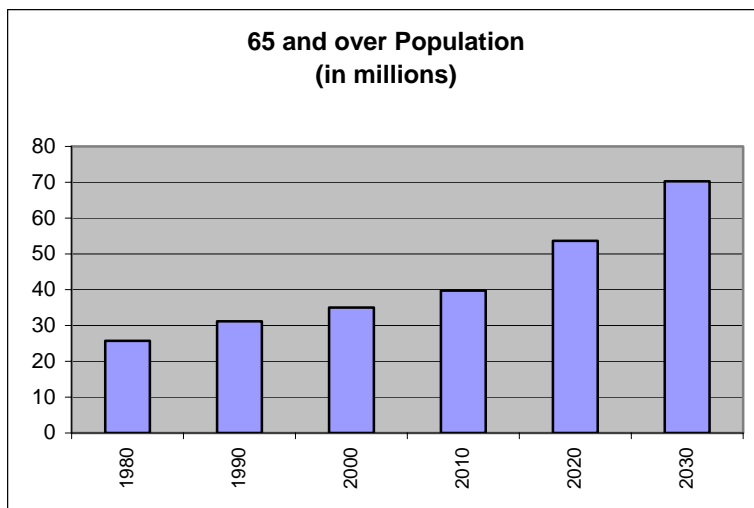
Though large, the size of the deficit relative to the nation's income – its ability to service the debt – was 3.0 percent in 2005, below the recent cyclical highs of 5 percent in 1992 and 6 percent in 1983. The 2005 deficit was also lower than what had been projected just a year prior by the Congressional Budget Office, Office of Budget and Management and many private analysts when a near \$500 billion deficit was forecasted.

Despite the improvement in the latest year, the federal budget deficit is not expected to see major improvement and remain near the \$300 billion level for another 5 years. A balanced budget looks unlikely given the political reluctance to measurably reduce government spending. And there are some big ticket items coming due soon. The bill for Medicaid and pension payments – Social Security -- looms large as baby boomers begin retiring in the upcoming years. The number of people aged 65 and over is expected to double and reach 70 million by 2030. By 2050, there will be only 2.6 persons of working age per each retiree compared to today's 4.5 workers per retiree.

The budget deficit can impact the real estate market because government borrowing “crowds out” private sector borrowing. When a government enters the capital market to borrow, it is essentially first in line to get loans since it can offer to borrow at the lowest market rate due to its creditworthiness. That means the private sector will be competing over a smaller pool of funds, which naturally drives up interest rates. Currently, this negative crowding out impact is being mitigated from a large inflow of foreign capital into the U.S. has neutralized the impact of high budget deficits. Many companies, flooded with cash from



Source: Congressional Budget Office



Source: Census

sharply increased profits, did not resort to borrowing to fund capital expenditure in the past two years , thereby, alleviating pressure for interest rates to rise. Low inflationary expectations, as discussed, also helped to keep interest rates low.

Owner-Occupied Housing

Owner-occupied housing is driven by demand, the type and size of housing available for purchase and the price of those homes. Several factors are contributing to the fifth-consecutive record-setting housing market in 2005.

DEMOGRAPHICS

There is an old adage: demographics is destiny. That is certainly true for housing. Long-term housing demand is driven predominantly by demographic factors. The U.S. population has been growing at 1.0 to 1.2 percent per year in each of the past 10 years. That is very unlike many other industrialized countries whose population growth is either crawling or will soon be shrinking. The population in Japan and Russia is said to be already declining. As of December 2005, the total U.S. population reached 298 million. It is projected to rise to 420 million by 2050. One major reason for the ever increasing population figures is due to the newly arriving immigrants into the U.S. Since 1990s, nearly half of the increase in population was due to new immigrants.

Population Projections (in millions)

	U.K.	France	Germany	Italy	Spain	Poland	Japan	Russia	U.S.
2000	59.5	59.4	82.2	57.7	40	38.6	127	145	283
2050	64	61	73	50	35	34	110	102	420

Source: The Economist

What matters more from the standpoint of the real estate market is the number of households. Though both population growth and household growth are highly correlated over the long run, there may be short term differences in growth due to economic and other reasons. One household, whether representing a single person or a group of people, occupies one housing unit. Therefore, household growth (demand) necessitates building more homes (supply). The number of households increased by 1.6 million in the third quarter of 2005 from the third quarter of 2004. With improved economic conditions, more people have been forming their own independent households (i.e., grown-up children leaving parent's home).

The number of households in the United States is forecasted to increase by 1.2 to 1.5 million per year over the next ten years, assuming recent immigrant trends. (But ,the number of immigrants coming into the country, particularly in light of the post-September 11 era will be a major wildcard going forward.) The 1.2 to 1.5 million household additions require housing production to the tune of 1.9 to 2.2 million per year after accounting for about 400,000 housing units demolished annually and a growth in second home purchases.

U.S. HOUSING STOCK

The U.S. housing stock expanded at a strong pace in 2005. New home construction was at a 25-year high. There were 124.1 million housing units as of the third quarter of 2005 compared to 122.4 units in the third quarter of 2004. Of that housing stock, 108.4 million were occupied units. Of the occupied units, 74.6 million units were owner-occupied while 33.8 million were renter-occupied. Owner occupancy rose by 2.4 million during a two-year period from 2004 and 2005, while renter occupancy increased only by 500,000. Certainly, low mortgage rates enlarged the homebuying population, inspiring many households to choose homeownership over renting.

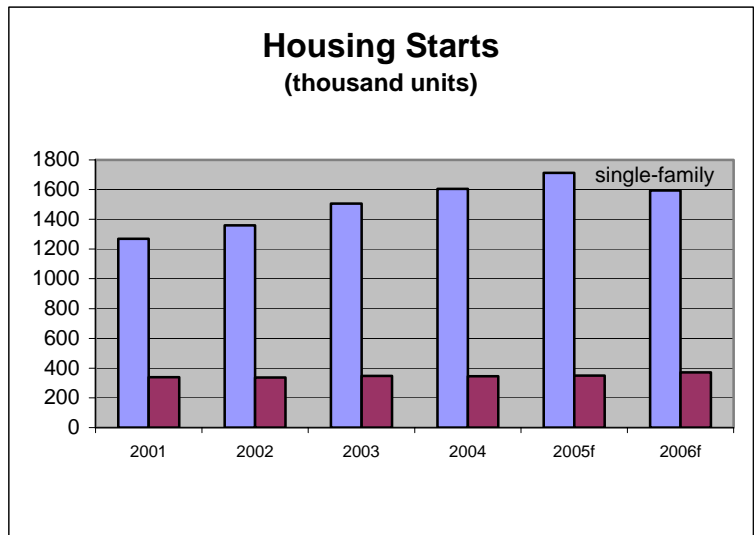
A typical U.S. owner-occupied existing home is three bedrooms, two baths, 1,740 square feet of livable space on a 0.38 acre lot. But the size of new homes has been increasing over the years. The median size of a newly built home was 1,905 square feet in 1990 and 1,595 in 1980. In 1990, new homes were typically 2,060 square feet .

The increasing housing stock, coupled with strong home price appreciation, has caused aggregate residential real estate valuation to increase to \$18.4 trillion as of the second quarter of 2005, an increase of \$2.5 trillion in one year.

HOUSING STARTS

Homebuilders have been busy during the past five years. Housing starts, which had been less than 1.5 million units for most of the 1990s, is on track in 2005 to surpass the 2 million mark for the first time since 1978. The surge in starts was the result of record home sales and strong increases in home prices. Despite the sizable increase in new home production, many parts of the country continue to have low levels of inventory in comparison to the ever-growing demand for homes. The nationwide price increase of 12 percent in 2005 and near or more than 30 percent in many Florida markets, Phoenix, and Washington D.C. reflect the sizable housing shortage conditions across many parts of the country.

The increase in housing starts was predominantly from the construction of single-family units. The projected 1.7 million single-family starts in 2005 will be the highest ever. Multifamily construction has been fairly flat for the past four years at around 350,000 annual units. The trend is not surprising, given the switch to homeownership for many households as evidenced by the rise in the homeownership rate and a rise in the multiunit vacancy rate. Single-family units now account for 83 percent of new residential construction.



Source: Bureau of Census, NAR forecast (f)

The outlook for 2005 is for a modest decline in home sales and housing starts. The higher anticipated mortgage rates will pull back builders' enthusiasm. Furthermore, the inventory of new homes for sale has risen by 20 percent in the past 12 months. Therefore, housing starts are expected to decline by 5 percent to 1.96 million units from 2.06 million in 2005. Single-family starts will fall by 7 percent, while the multifamily starts will increase by 6 percent from stronger than expected new household formation in the past year.

TOTAL HOME SALES (NEW AND EXISTING)

Defying expectations, home sales will set new record in 2005 for the fifth straight year. Generational low mortgage rates of under 6 percent in the past two years combined with over 4 million job additions have fueled housing demand. Existing single-family home sales are projected to hit 7.1 million in 2005, an increase of 5 percent from a year ago, while new home sales will reach 1.3 million, an 8 percent jump.

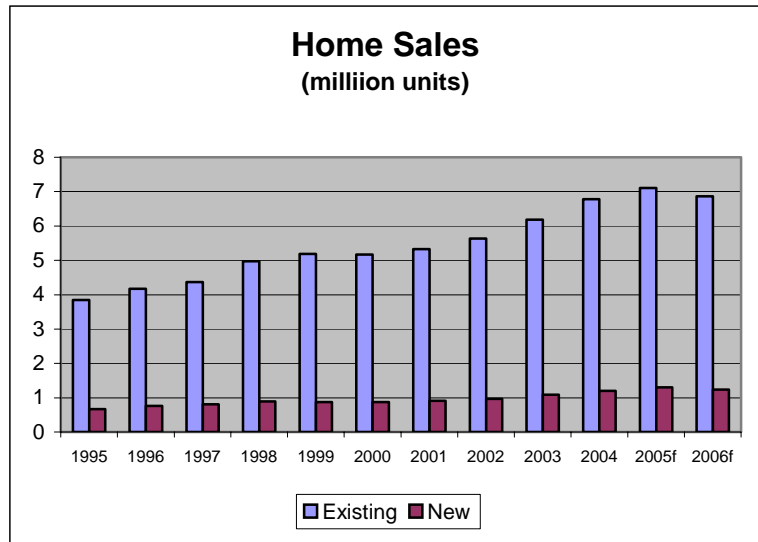
Second home purchases have been particularly strong. In 2004, 36 percent of all home sales were for second homes (23 percent as investment homes and 13 percent as vacation homes). The magic of low rates has allowed Americans to not only buy primary homes but also second, third, and perhaps even fourth and fifth homes.

The outlook is for a modest reduction in sales activity. Higher mortgage rates will be the primary culprit. Existing home sales will decline by 3.5 percent while the more cyclical new homes will drop by 4.5 percent.

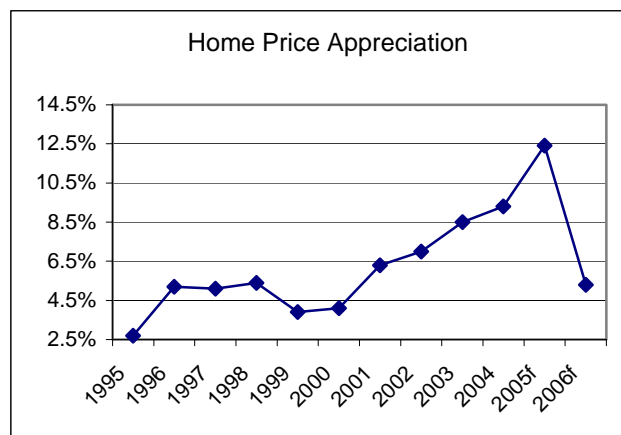
HOME PRICE APPRECIATION

The combination of a spectacular sales pace and tight inventory conditions has pushed home prices up remarkably. The median price of an existing home rose by 17 percent from October 2004 to October 2005 and is projected to finish the year with a 13 percent gain. That would be the highest gain since the late 1970s and the highest gain in real terms (after subtracting away consumer price inflation) since the National Association of REALTORS® began tracking home prices in 1968.

There were wide variances in price growth across the country. Prices in Phoenix rose by 55 percent, while several Florida markets experienced price growth of better than 40 percent. Many markets in the middle part of the country where new home construction -- hence, new housing supply -- has been active, registered price gains in the single digits. There were also great differences in home



Source: Bureau of Census, NAR forecast (f)



Source: NAR

price differentials with San Francisco continuing to top the list of metropolitan areas with a median price of \$721,900 in the third quarter of 2005. Homes in Danville, Illinois were only one-tenth of the highest priced market. (A full up-to-date listing of home prices and price appreciations can be found on www.realtor.org/research)

In the past three years (2002 to 2005), the national existing median home price rose by 33 percent. That translates into a \$51,900 gain for a typical homeowner during that same time period. In some markets, like Phoenix, Las Vegas, and San Diego, gains of better than \$50,000 were realized in just a one year time span.

HOMEOWNERSHIP RATE

The homeownership rate in the U.S. has steadily increased over time. From a 40 percent ownership rate during the height of the Great Depression, it has generally trended upward ever since. It stood at 68.7 percent as of the third quarter of 2005. The magical 70 percent homeownership will be reached within the next three years.

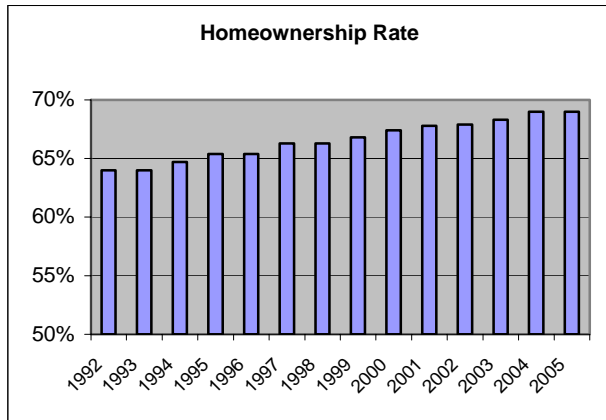
The fastest growing segment of homeowners was the population under the age of 25. While these young households comprise a small fraction of total homebuyers, they experienced the biggest gain in homeownership. During the 10-year period from 1994 to 2004, the homeownership rate for the under-25 age group increased from 14.9 percent to 25.2 percent, or by 10.3 percentage points. By contrast, the overall homeownership rate increased by 5 percentage points over the same 10 year period.

Minorities have also made marked progress in homeownership in recent years. In fact, the growth in minority homeownership has outpaced that of whites. But even with the gains, the homeownership rate among minorities still lags significantly behind that of non-Hispanic white households. In the third quarter of 2005, slightly less than half of African-American and Hispanic households owned their homes, with homeownership rates of 49.1 percent and 48.1 percent, respectively. The homeownership rate among Asians stood at 60 percent. By contrast, 76 percent of whites were homeowners.

A large part of the gap in homeownership rates between minorities and whites can be attributed to the existing divergence in economic situations and the age composition of those groups. Income and wealth holdings among minorities are significantly lower than that of whites. Furthermore, there is a disproportionately higher share of younger households – who are less likely to be homeowners – among minorities. Finally, a large number of minorities, particularly Asians, live in high-priced less affordable regions of the country such as Hawaii, California and New York. A study by the Harvard Joint Center shows that adjustments for income, age, and family type reduce the gap in homeownership rates between whites and minorities from 25 percentage points to about 10 percentage points. The existence of the gap even after adjusting for financial and demographic factors implies that similarly situated minorities would have lower homeownership rates.

Homeownership rates also differ by region of the country. The homeownership rates in the Midwest and the South have consistently been higher than those in the West and the Northeast. The primary reason for the differences is affordability conditions. States with higher home prices typically have lower homeownership rates. Hawaii, California, New York, and Rhode Island generally have the lowest homeownership rate in the country. These are also the states with the high home prices.

Finally, it is worth noting the impact of the recent surge in immigration. The number of newly arriving immigrants to the U.S. has significantly risen in the past two decades. Whereas only 2.5 million immigrants arrived during the 1950s, 7.3 million and 9.3 million arrived in the two recent decades,



Source: U.S. Bureau of the Census

respectively. Because homeownership tends to increase with length of residence in the U.S., the important role of the immigrant population in supporting the housing market will grow over the next 10 years and beyond. The homeownership rate of foreign-born households who came to the U.S. in the past four years is only 16 percent. However, among households who entered the country more than 30 years ago, the homeownership rate surpasses the national average with 78 percent owning a home.

The large pool of immigrants that arrived over the last few decades will steadily look to become homeowners. Furthermore, U.S.

Census estimates that the foreign-born population will continue to grow at a strong rate. It projects an annual average growth rate of 2.0 percent from 2004 through 2010 before tapering off to 1.3 percent for the period from 2011 through 2020. Therefore, the prospects of home purchases by foreign-born population in the U.S. will remain strong for the next two or three decades.

RETURN ON INVESTMENT

Home prices have appreciated rapidly during the past 5 years. Consequently, homeowners have begun to view their homes not only as a place to live and raise a family, but also as an investment through which wealth can be built for retirement or to purchase other homes. However, price appreciation is not the only component of wealth building. The amount one must pledge for a down payment and the mortgage rate play important roles.

Consider: if one pays 20 percent of the cost of a \$200,000 home and borrows the rest, and the price of the home increases 10 percent during the first year to \$220,000, the return on investment after one year is 50 percent. The \$40,000 down payment yielded \$20,000 in housing equity gain. If one had paid the full \$200,000 up front, the return on the investment after one year would only be 10 percent. Down payments of less than 20 percent have been more common in recent years as lower mortgage rates have allowed lenders to lower loan qualifying requirements. Lower down payments push up the return on investment.

HOUSING BUBBLE

Homeownership pays great dividends. In the past three years, more than 74 million U.S. households accumulated sizable wealth from just owning their homes. But are the gains real and lasting? Or will they go the way of Internet stocks -- hyper-euphoria followed by harsh pain? Those who are convinced that there will be a housing bubble burst point to the fact that income growth has not kept up with home price growth. After all, the nation went through a recession with sizable job losses in 2001, 2002, and the first half of 2003. Therefore, either income has to grow at a rapid pace or home price has to deflate.

But there are sound counterarguments. First, home price growth lagged markedly behind income growth for most of the 1980s and 1990s. So the recent reversal in that trend could be interpreted as nothing more than home prices catching up to those income gains. From 1980 to 2004, income is projected to have grown by 150% while home prices are likely to have increased 180%. The difference is not as dramatic as some would paint over the shorter-term horizon (for example: saying home price growth of 12 percent in 2005 is more than three times the income growth). It is also worth noting that the U.S. home prices have risen far less compared to other industrialized countries. U.K., France, Spain, and Australia have all seen their home prices rise much faster in recent years.

A second and more powerful argument against a housing bubble is related to a household's ability to service its housing payment. What matters is not home price *per se* but monthly mortgage payments. Interest rates are at 45 year lows (i.e., once in a lifetime opportunity). Compare that to the average 8 percent mortgage rate in 2000 -- or even the 18 percent rate in the early 1980s. Recent homebuyers could buy a more expensive or larger home for the same or even lower monthly payments. A two-percentage point drop in mortgage rates, as has happened since 2000, translates into 23 percent larger loan a homebuyer can take out for the same monthly payment. Even assuming no income growth, it should not be at all surprising that people are bidding up home prices given the opportunities provided by the low rates.

Also consider that most homeowners will not feel the sting of rising interest rates because they have 15-year or 30-year fixed rates. According to an analysis by Mortgage Bankers Association, 35 percent of the homeowners owned their home free and clear. Another 50 percent had either 15 or 30 year fixed rate mortgages. That means only 15 percent of the homeowners have some form of adjustable rate mortgages. In the U.S. many of the adjustable mortgages are of hybrid kind with fixed 3 to 7 year terms, unlike that of say U.K. where adjustable mortgages change with the changes in the rate changes by the Bank of England. Furthermore, homes are not pure financial assets. Unlike Wall Street assets, there are no massive panic selling arising from taking short positions, unwinding of derivative holdings, computer generated trades and such. Homes provide shelter -- a "housing service." If the market was to turn softer than is anticipated, homeowners will just wait it out while still having a home and shelter. It is possible that prolonged job losses could force involuntary home selling. But this risk is not present in the current job creating economy.

Commercial Real Estate Market

The commercial real estate market is generally the last sector to recover after an economic downturn. Not surprisingly, this sector underwent major adjustment from the onset of the recession in 2001 to 2003. For example, vacancy rates for office spaces essentially doubled and rents fell by more than 20 percent. However, the market has steadily improved over the past 18 months to October 2005. The momentum is building with net absorption remaining positive in most markets, thereby, lowering vacancy rates. Rents have also turned positive.

The office sector experienced the largest decline in vacancy rates among all commercial property types in 2005. The office vacancy rate fell from 15.4 percent to 13.0 percent. This trend will continue in 2006 with the office vacancy rate projected to decline by another 2 percentage points. The multifamily and retail sectors will see only modest declines in vacancy rates because the available space conditions are relatively low to begin with.

Rent growth in 2005 was also the strongest in the office sector, posting a 4.4 percent gain. A similar gain is expected for 2006. The gains in office rents, however, should be viewed as a recovery after a more than 20 percent decline in rents from 2001 to 2003. A sector-by-sector analysis and forecast is discussed more fully below.

Commercial Real Estate Market Trend and Forecast								
	Rental Rate Change				Vacancy Rates			
	<i>Office</i>	<i>Industrial</i>	<i>Multi-Family</i>	<i>Retail</i>	<i>Office</i>	<i>Industrial</i>	<i>Multi-Family</i>	<i>Retail</i>
2000	13.8%	9.8%	7.4%	4.9%	8.6%	6.6%	4.2%	N/A
2001	-7.2%	-0.7%	3.5%	1.9%	14.2%	9.8%	4.6%	N/A
2002	-8.3%	-4.1%	0.5%	1.4%	16.5%	11.0%	5.5%	N/A
2003	-6.7%	-4.1%	-0.3%	2.3%	16.8%	11.6%	6.4%	8.1%
2004	0.4%	-0.6%	1.5%	3.3%	15.4%	10.9%	6.2%	7.5%
2005	4.4%	2.2%	2.7%	4.0%	13.0%	10.0%	5.1%	7.2%
2006	4.4%	2.7%	3.0%	4.0%	11.3%	9.3%	5.0%	7.1%

Source: NAR, Torto Wheaton Research

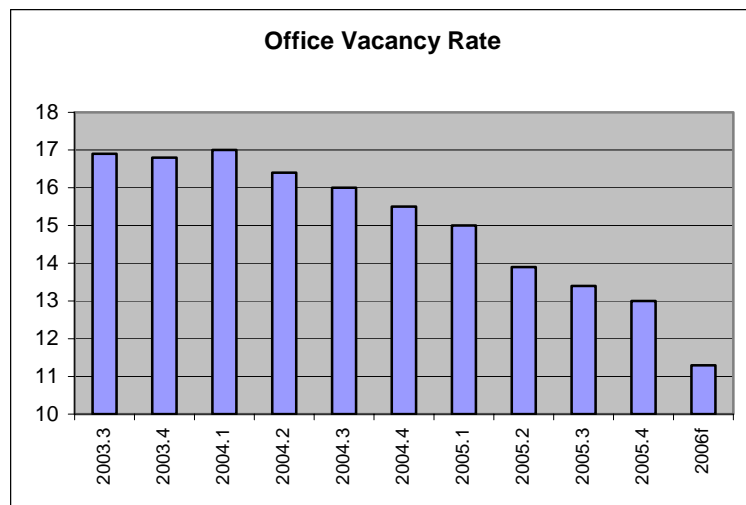
Office Sector

With increased demand in many markets for office space, the national office vacancy situation is looking considerably brighter. Job growth in the sectors of the economy that requires office space has picked up nicely. The number of workers in the professional and business services rose by 425,000 in 2004 and looks to finish 2005 with over 500,000 job gains.

While the demand has been rising, the supply has remained subdued. Many new constructions were of build-to-suit (i.e., already pre-leased). There was a marked slowdown in new speculative construction in 2005, which bodes well for reducing office vacancy rates. In most markets, the issue is not how quickly the new space will be absorbed, but rather the length of time it will take to back-fill space left by tenants who have upgraded. In Dallas, for example, where the existing vacancy rate is over 24 percent -- almost double the national average -- much of the current vacant space is due to the addition of 1.1 million square feet of new supply.

Markets that have low single-digit vacancy rates are primarily located in the West or Northeast. Washington, DC had the lowest vacancy rate thanks to the 80,000 job gains in the past 12 months. With demand coming from office tenants displaced by Hurricane Katrina, the office vacancy rate in the markets near the Gulf Coast is anticipated to decline. Markets like Dallas, Houston and Atlanta will have some attractiveness for tenants given the proximity to New Orleans.

Due to declining vacancy, property owners have been able to raise rents. Of the 57 markets tracked in this report 24 had rent growth above the national average of 3.9 percent. The biggest jump in rents this year is likely to be in San Francisco with a nearly 11 percent gain. Orange County, California and Washington, DC will closely follow with about a 10 percent rise in the rental rate. There are still some markets experiencing a decline in rent, primarily those located in the Midwest including Pittsburgh, Cleveland and Columbus. Even though rents are still declining in these markets, the rate of decline is slowing and rents are expected to turn positive in 2006.



Source: Torto-Wheaton, NAR Forecast

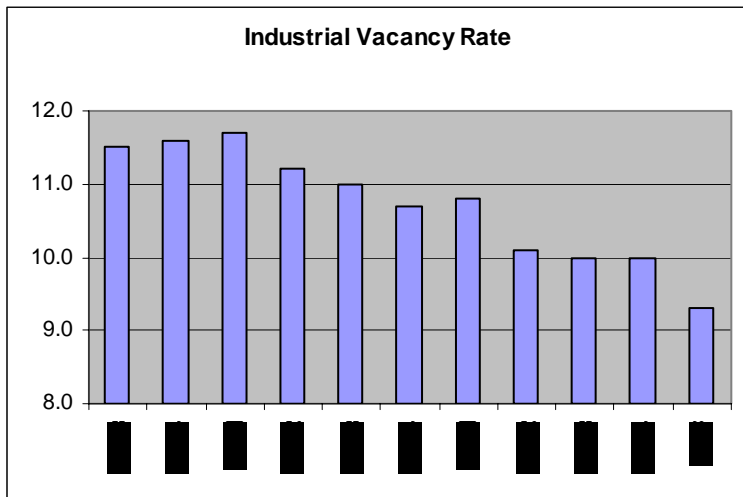
Meanwhile, low interest rates have allowed investors to bid up property prices, thereby lowering cap rates. Office building transaction volume reached a new record in the second quarter. Cap rates continue to fall for both suburban office buildings and those located in Central Business Districts (CBD). At the beginning of 2004, cap rates for suburban office buildings were averaging close to 9 percent. In late 2005, they were 7.4 percent. For buildings located in the CBD, cap rates have fallen to 6.7 percent.

Looking ahead to 2006, the office vacancy rate will decline to 11 percent by this time next year. Absorption is forecast to be in excess of 1.4 million square feet for each of the next six quarters. Average rents will climb by 4.4 percent in 2006.

Industrial Sector

Global trade continues to play a significant role in shaping the U.S. industrial market. Exports to and imports from China have resulted in high demand for warehouse and distribution space in Southern California and inland ports/distribution hubs such as Las Vegas and Albuquerque. The recent ratification of the Central American Free Trade Agreement (CAFTA) is also expected to increase demand for warehouse and distribution space in many markets in South Florida, Texas, and perhaps even as far north as the Port of Charleston. Some estimates suggest that up to 36,000 new jobs could be created in Florida as a direct result of CAFTA.

Industrial markets in South Florida are already experiencing some of the lowest vacancy rates in the country. For example, West Palm Beach has the lowest vacancy in the nation at only 5 percent. Another positive sign of the health of the industrial market is the fact that institutional investors have returned to this sector, primarily through sale-leaseback transactions. Rent growth for industrial real estate is expected to average 2.2% in 2005 and at a slightly higher 2.7% in 2006.



Source: Torto-Wheaton, NAR forecast

By the end of 2005, the national vacancy rate for industrial properties will be 9.3 percent, which is down from the current 10.1 percent. The disaster in New Orleans destroyed or damaged an estimated 54 million square feet of industrial space. As a result, some operations will likely shift to the Ports of Houston, Tampa/Lakeland and Miami.

Job growth in the manufacturing sector is down significantly, particularly within the transportation sector. Over the last 5 years, almost 3

million jobs have been lost in the manufacturing sector.

Based on data from 2000 to 2005, Las Vegas, Nevada was the only major market that experienced an increase in manufacturing jobs. Much of this is due to the rapid population growth in Las Vegas, which in itself created new opportunities in this sector.

One industrial market that is making a significant comeback is San Francisco. By the end of this year, rent growth in San Francisco is anticipated too be the highest at 7.1 percent. Over a two year forecast period, rent growth in San Francisco is expected to be over 12 percent.

As of September 2005, the volume of industrial buildings trading hands had increased by 83 percent compared with the same period in 2004. This increase represents the largest jump in volume for any of the commercial sectors. There is expected to be another \$4.5 billion in the pipeline between recently closed deals and industrial properties that have recently been put on the market. As with the office sector, cap rates for industrial properties continue to decline. For flex industrial buildings, the cap rates have

gone from 9.0 percent in 2004 to 7.9 percent in late 2005, while for general industrial properties the decline has been from 8.4 percent to 7.1 percent.

Retail Sector

Retail properties have generally withstood the recent business cycle better than other commercial sectors. Rents have increased in each of the past five years. This is not surprising given the resiliency of consumer spending in light of substantial wealth gains from housing equity. In October 2005 retail sales increased by a solid 4.4 percent.

It is not anticipated that there will be a major shift in availability of vacant spaces on a national basis in 2006. The national vacancy rate for retail properties will slip from 7.2 percent in 2005 to 7.1 percent by the end of 2006. However, in some specific markets the Federated-May

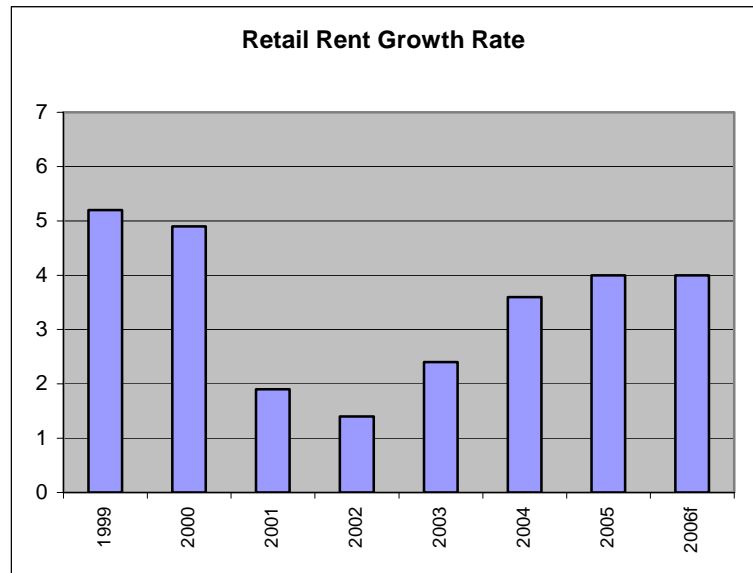
Department Store merger could result in store closings, particularly where stores from the two chains were going “head-to-head.” Retail properties are being targeted by foreign investors, particularly from Australia (Westfield and Macquarie). Foreign investors have tended to focus on the acquisition of regional shopping centers and larger strip plazas rather than free-standing or “street-front” types of retail properties.

Regionally, California markets dominate the list of markets with the highest average retail rent growth and average asking rental rates. New retailing concepts seem to develop on the West coast first and spread to other regions. Perhaps innovative retailers are also risk takers and are willing to pay more in rent.

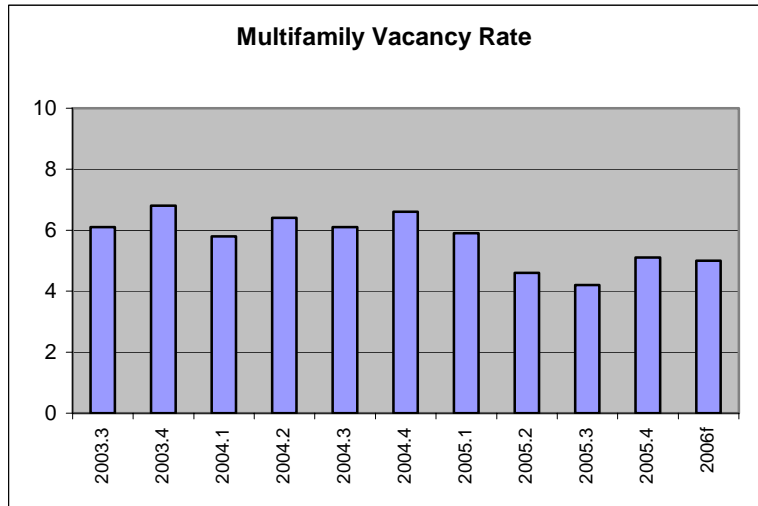
The volume of retail properties that traded hands in 2005 was up by 14 percent from 2004. The sale of free-standing and store-front properties jumped by a whopping 57 percent. Free-standing retail (drug stores in particular) has been particularly popular with investors using the tenant-in-common transaction.

Multi-family Sector

Housing affordability trends will help revive multifamily housing fundamentals. The National Association of REALTORS® housing affordability index recorded a 13-year low in 2005, suggesting that fewer households have the income necessary to purchase a median priced existing home. A regional analysis clearly indicates that areas with relatively high levels of homeownership also have high multi-family availability rates and vice versa. Housing costs are higher than average in the West and, therefore, one would expect to see lower levels of homeownership and higher demand for multi-family rental accommodations.



Furthermore, over the longer term, expect steady rental demand from the “Y Generation.” They are the 40 million U.S. residents aged 20 to 29 and are the dominant users of multi-family units across the country. This is the age when young adults leave the nest to either pursue further education or to begin a career. People in this age bracket normally rent while saving for the down payment on a home.



Source: Torto-Wheaton, NAR forecast

On the supply side, one major trend in the multi-family market has been the acquisition of rental apartment properties by condo-converters, who then sell the individual units as condominiums. Real Capital Analytics estimates that at least 120,000 rental apartments have been removed from the rental property inventory over the past 12 months. While this may seem to be a modest number given the fact that there are 13.6 million rental units within multi-family properties, condo conversions are significant because they remove rental units from the active stock. .

Markets like Los Angeles, Washington, and Miami are the top condo-conversion markets; they are also the markets with the lowest multi-family vacancy rates. In addition, home prices in these markets have gone through the roof. These and similar cities can expect a much high rent growth in 2006.

As to investment transactions, through the first half of 2005, there was a 64 percent increase in multifamily transactions compared with 2004. The volume of multi-family properties that traded hands was just over \$33 billion compared with \$20 billion for the first six months of 2004. .

In 2006, due to already low vacancy level, the multifamily sector will experience only a modest reduction in the vacancy rate to 5.0 percent from 5.1 percent in 2005. The rent growth will be marginally higher at 3 percent in 2006 from 2.7 percent in 2005.