

## Real Estate Capital Markets Update – May 5, 2005

### Volume 7, Number 6

Welcome to the update of ULI's Real Estate Capital Markets Web site. Updates are divided into four sections: public real estate securities markets, public real estate debt markets, private real estate equity markets, and private real estate debt (mortgage) markets. In each section, we feature Real Estate Capital Markets Scoreboards detailing selected performance indices for each of the real estate capital markets.

To expand site users' knowledge and understanding of the real estate capital markets, we will publish "knowledge" papers describing underlying market mechanics. In addition, we have provided links to other Web sites that provide related and relevant information. [Click here for links to other Web sites.](#)

Frequently Asked Questions (FAQs): In addition to knowledge papers, we have published answers to FAQs about the real estate capital markets. To go to FAQs, [click here.](#)

Glossaries of frequently used terms are available for readers' use. To go to the glossary section, that includes selected Web sites that provide glossaries and/or real estate term search engines, [click here.](#)

We want this site to be both useful and responsive to users, and we encourage you to e-mail comments and suggestions. If you want to send me an e-mail, click [stephen@uli.org](mailto:stephen@uli.org), add your comments, and click "Send".

Key Rates			
	May 3, 2005	Year Ago	Increase/Decrease
Prime Rate	6.00%	4.00%	+2.00%
Federal Funds Rate	3.00%	1.00%	+2.00%
3-Month Libor	3.21%	1.18%	+2.03%
3-Month Treasury Bills	2.90%	0.98%	+1.92%
10-Year Treasury Bonds	4.16%	4.56%	-0.40%
30-Year Treasury Bonds	4.48%	5.34%	-0.86%
Telephone Bonds	5.78%	6.37%	-0.59%
Municipal Bonds	4.49%	5.10%	-0.61%

### **Special Comment: What Are the Key [Interest] Rates (Above) Trying to Tell Us, if Anything?**

Based upon our experience, when long rates appear artificially low compared to short rates as well as the indicated monetary policy initiatives of the Federal Reserve Board and the consensus projections of economists and analysts, it is a clear sign that the economy is not as robust as some would like to believe.

**Special Comment: John B. Levy, President of John B. Levy & Company, Inc. and author of the monthly *Barron's*/John B. Levy Company, Inc. National Mortgage Survey, to be Guest Speaker on 4th ULI Real Estate Capital Markets Conference Call**

We are pleased to announce that John B. Levy, President of John B. Levy Company, Inc. and author of the *Barron's*/John B. Levy National Mortgage Survey, will be the guest speaker on ULI's Real Estate Capital Markets conference call which will be held on Friday, September 23, 2005 from 11:00 am to Noon, Eastern Standard time.

Given the unique experience, perspective, and knowledge of our guest speaker, the discussion will focus exclusively on the conventional and securitized real estate mortgage capital markets.

If you would like submit a question, please e-mail: [blank@uli.org](mailto:blank@uli.org)

The call-in number will be 1-719-785-9359; the participant pass code will be 508131. The call will be recorded and available for playback for 30 days.

**Special Comment: No Surprise...Federal Reserve Board Increases Federal Funds Rate 25 Basis Points to 3.00%**

As expected, the Federal Reserve Board (FRB) increased the Federal Funds Rate 25 basis points (0.25%) to 3.00%. Simultaneously, the FRB increased the Discount Rate 25 basis points to 4.00% and major money center commercial banks increased their Prime lending rate to 6.00%. Importantly, the Federal Open Market Committee (FOMC) maintained its now famous language regarding the pace of tightening [of monetary policy] stating: "With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured."

The FRB also noted that "...the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability".

The Committee noted slower growth in spending and specifically cited higher energy prices as one of the causes. The Committee also expressed increased concern regarding inflation, noting that: "Pressures on inflation have picked up in recent months and pricing power is more evident."

Further, the Committee noted risks to growth and inflation are in "balance", indicating that the FRB is unlikely to stop tightening monetary policy (and raising interest rates) for some time.

The next FRB meeting is scheduled for June 29, 2005. Based upon the consensus predictions of economists, the FRB will continue to raise the Federal Funds Rate through mid-year 2006 with a target rate of 4.50%.

Date	Federal Funds Rate	Increase/Decrease	Discount Rate	Increase/Decrease
May 4, 2004	1.00%	-----	2.00%	-----
June 30, 2004	1.25%	+0.25%	2.25%	+0.25%
August 10, 2004	1.50%	+0.25%	2.50%	+0.25%
September 21, 2004	1.75%	+0.25%	2.75%	+0.25%
November 10, 2004	2.00%	+0.25%	3.00%	+0.25%
December 14, 2004	2.25%	+0.25%	3.25%	+0.25%
February 2, 2005	2.50%	+0.25%	3.50%	+0.25%
March 22, 2005	2.75%	+0.25%	3.75%	+0.25%
May 3, 2005	3.00%	+0.25%	4.00%	+0.25%
June 29, 2005				

**Special Comment: Greenspan Urges Action to Shrink Federal Budget Deficits; Predicts Tax Hikes Will Likely be Part of Eventual Compromise**

In Senate testimony on April 22, 2005, Federal Reserve Chairman Alan Greenspan urged Congress to act to control the federal budget deficit, which he noted was on “an unsustainable path” that could lead to higher interest rates and “economic stagnation”. In calling for “major” deficit-reducing actions Chairman Greenspan noted that the “economy is expanding at a reasonably good pace” but that “large deficits [will] result in rising interest rates and ever-growing interest payments that augment deficits in future years”.

Based upon reaction to Chairman Greenspan’s warning from Congress, it appears no one in the hearing room was focusing on his testimony.

**Special Comment: Federal Reserve Board Releases Beige Book**

The Federal Reserve Board recently released its Beige Book economic survey for the period late February through early April 2005. In the report, dated April 20, 2005, all 12 Federal Reserve Districts reported that business activity continued to expand. The following highlights of the report were compiled by *The Dismal Scientist*:

- More than half the districts reported retail activity up modestly to strongly;
- Service sector industries showed a moderate increase in activity across all Districts;
- 11 districts reported rising production or orders with only New York reporting a “loss of momentum”;
- Residential real estate markets continue very active in all Districts;
- Demand for loans increased across a range of categories; and
- Many districts reported that upward price pressures have strengthened due to energy costs.

## Special Comment: Notes and Quotes from “The PunchLine...

### “Clouds Gather”

“Several factors are cultivating heightened market uncertainty. Perceptions surrounding the outlook for energy prices seem to change from week to week. Risks emanate out of the likely shift in policy at the Federal Reserve to a more proactive stance against inflationary pressures. The sweet spot of robust growth and low inflation may have passed with recent data shifting back and forth. Tech remains a key pacesetter in the markets, and prospects have been running hot and cold, depending on the day. The balance between corporate financing needs and market demand and supply can not be ignored; corporate issuance seems to dry up quickly when markets get edgy. Substantial headlines reflect the heightened concerns over possible credit events, such as the storylines regarding increased leverage with the resurgence in LBO [leveraged buy-out] activity and the unprecedented developments surrounding GM and the auto market. If policymakers were focused on making the world safe against risk for the past three years, it also provided a seemingly free ride for risky assets and tended to override the true calibration of risk/return. Moving away from that comfort zone may turn out to be tougher going than many realize.”

### “Key Risk Parameters...Principal Risks to [Economic and Strategic] Forecasts Include...”

The following is a listing of principal risks to current business and economic forecasts mentioned by analysts and strategists:

- Sector and individual company dislocations;
- Difficulties in financial adjustments to rising [interest] rates;
- A faster than anticipated unraveling in the U.S. dollar with associated near-term negative implications for the current account balance;
- Sustained pressure in energy prices feeding through into inflation;
- Growth imbalances, including a still-fragile economic upturn (particularly in Europe and Japan); and
- Renewed geopolitical tensions, including terrorism.

<b>Real Estate Capital Markets Scoreboard: Money Rates</b>	<b>May 3, 2005</b>
Prime Rate	6.00%
Federal Funds Rate	3.00%
Discount Rate	4.00%
Dealer Commercial Paper	3.04% - 30 days 3.05% - 60 days 3.14% - 90 days
London Inter-bank Offered Rate (LIBOR)	3.01%- 1-month 3.22% - 3-months 3.43% - 6 months 3.71% - 1 year
U.S. Treasury Securities	4.16% - 10-year

## Public Real Estate Securities Capital Markets

It's earnings season! And as is the case in many sectors of the investment economy, the valuation race is on. As was clearly noted in *Emerging Trends in Real Estate 2005*, the race in the real estate industry is between growth in earnings (or net operating income) and increases in interest rates. So long as the pace of earnings growth is sufficient to offset the impact of increases in interest rates, real estate valuations will be maintained, and possibly even increase. If interest rates increase faster, then earnings will decline and valuations will be negatively impacted by investor's requirements for higher yields on investments.

According to a recent report published by Morgan Stanley, approximately 47% of the real estate investment trusts (in the Morgan Stanley REIT Index) reporting first quarter 2005 earnings have beaten analysts consensus estimates, with an additional 23% meeting analysts expectations, and the remaining 30% missing analysts predictions.

The following chart summarizes Morgan Stanley's "Earnings Scoreboard" as of April 29, 2005:

Sector	# of Companies	# of Companies Reporting	% Beating Estimates	% Meeting Estimates	% Missing Estimates
Office	18	6	50%	17%	33%
Apartments	16	7	57%	29%	14%
Regional Malls	7	3	100%	0%	0%
Strip Centers	13	4	50%	50%	0%
Industrial	7	7	57%	14%	29%
Diversified	8	4	0%	50%	50%
Healthcare	9	3	33%	33%	33%
Mixed	7	5	40%	20%	40%
Hotel	11	2	100%	0%	0%
Triple Net Lease	8	3	0%	33%	67%
Self-Storage	3	0	---	---	---
Manuf. Housing	3	2	50%	0%	50%
Outlet Centers	1	1	0%	0%	100%
<b>Total/Average</b>	<b>111</b>	<b>47</b>	<b>47%</b>	<b>23%</b>	<b>30%</b>

Public Securities and Real Estate Performance Indices as of May 2, 2005						
	Dow Jones Industrial Average	S&P 500 Stock Index	NASDAQ Composite Index	Russell 2000 Index	Morgan Stanley REIT Index	NCREIF All Property Index
2005	-5.48%	-4.54%	-11.67%	-11.08%	-1.94%	+14.5%*

\* Trailing 12-months ended December 31, 2004.

Market Capitalization of REITs (number of shares multiplied by share price in \$ millions) as of May 4, 2005								
	# of REITs	Market Cap	Equity REITs	Market Cap	Mortgage REITs	Market Cap	Hybrid REITs	Market Cap
2005	191	325,325	151	295,159	34	24,176	7	5,999
Source: National Association of Real Estate Investment Trusts (NAREIT).								

Offerings of Securities by REITs (in \$ millions) as of March 31, 2005				
	2004		2005	
	# of Offerings	\$ Value	# of Offerings	\$ Value
Initial Public Offerings	29	\$8,271	2	\$794
Follow-on offerings-Common Shares	79	7,338	15	1,001
Follow-on Offerings-Preferred Shares	61	5,858	9	882
Unsecured Debt	97	17,306	20	4,164
Secured Debt	0	0	2	1,910
Source; National Association of Real Estate Investment Trusts.				

### Public Real Estate Debt Capital Markets

Issuance remains strong, trading spreads are literally unchanged from yearend 2004, capital is plentiful, and available at highly competitive rates. Without a “Bolt out of the Blue”, nothing seems to be able to derail the commercial mortgage-backed securities market.

Issuance of Commercial Mortgage-Backed Securities January 1, 2000 through April 29, 2005 (in \$ Millions)			
	U.S. Assets	Non-U.S Assets	Total Issuance
2000	46,849.4	12,116.4	59,010.8
2001	67,149.9	22,713.8	89,863.7
2002	52,073.3	28,705.9	80,779.1
2003	77,848.1	20,802.9	98,651.0
2004	93,838.2	33,746.0	127,584.2
2005	38,200.0	21,700.0	59,900.0
Source: <u>Commercial Mortgage Alert</u> .			

Commercial Mortgage-Backed Securities Trading Spreads above 10-Year Treasury Bonds (in Basis Points)			
	12/29/04	4/27/05	Year-to-Date
10-Year Treasury Bonds	4.32%	4.23%	-0.09
AAA	+70	+71	+1
AA	+77	+81	+4
A	+85	+92	+7
BBB	+127	+134	+7
BBB-	+167	+184	+17
BB	+325	+310	-15
B	+770	+750	-20
Source: Morgan Stanley.			

### Private Real Estate Equity Capital Market

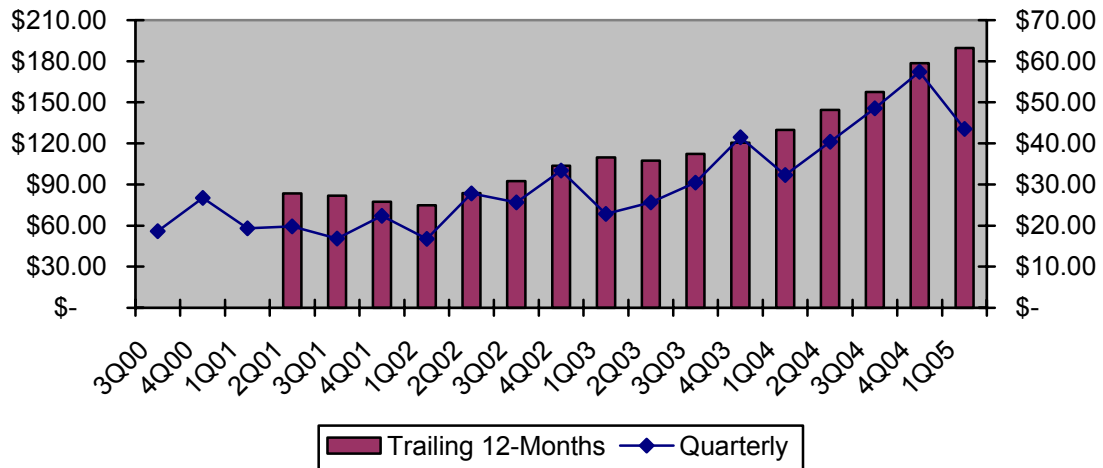
According to Real Capital Analytics, Inc., approximately \$43.5 billion of sales of income-producing properties were completed during the first quarter 2005. While sequentially lower as compared to the fourth quarter of 2004 in which sales equaled approximately \$57.4 billion, the number represents an approximately 35% increase as compared to the first quarter of 2004.

More telling in our view is an analysis of property sales on a trailing 12-month basis, which shows that sales increased approximately 6.25% during the 12-months ended March 31, 2005 as compared to the 12-months ended December 31, 2004. The flow of capital into real estate remains “flood-like” in size.

Where did pension funds invest their real estate allocations in 2004? According to the Pension Real Estate Association’s (PREA) *Plan Sponsor Report*, which surveyed 68 institutional investors including private and public pension plans, endowments, and foundations, investors in 2004 allocated approximately 70% of their real estate investment funds to core investment strategies as compared to 65% in 2003. Allocations to value-added investment strategies remained relatively static in 2004 as compared to 2003, increasing from approximately 17.3% of allocations to approximately 18.0% in 2004. Investment in opportunity funds declined moderately, from 13.9% of allocations in 2003 to 11.0% in 2004, continuing a trend begun in 2002 when allocations to opportunistic investing equaled approximately 17.2% of allocations.

Interestingly, a majority of all investors surveyed (69%) noted that they did not expect to increase their real estate allocations in 2005. In 2004, overall allocations to real estate equaled 3.3% of total invested funds as compared to 58.7% allocated to the public stock markets.

**Sales of Office, Industrial, Retail, and Apartments**  
(in \$ Billions)



Source: Real Capital Analytics Inc. ([www.realcapitalanalytics.com](http://www.realcapitalanalytics.com)).

Real Estate Capital Markets Scoreboard: Survey of Initial Capitalization Rates								
	Multi-Family	CBD Office	Suburban Office	Retail-Mall	Retail-Neighborhood	Retail-Power	Industrial-Warehouse	Industrial-R & D
2Q98	8.5%	8.5%	8.6%	8.3%	9.1%	9.2%	8.7%	8.8%
4Q98	8.8%	8.7%	8.9%	8.6%	9.5%	9.6%	8.9%	9.1%
4Q99	8.8%	8.9%	9.0%	8.5%	9.2%	9.6%	9.0%	9.3%
4Q00	8.7%	8.6%	9.3%	8.9%	9.4%	10.1%	8.9%	9.3%
4Q01	8.6%	9.2%	9.8%	8.9%	9.5%	10.2%	9.1%	9.7%
4Q02	8.0%	9.0%	9.7%	8.7%	9.2%	9.5%	8.9%	9.7%
4Q03	7.6%	8.4%	9.0%	7.9%	8.2%	8.4%	8.4%	9.2%
4Q04	7.2%	8.1%	8.5%	7.6%	7.7%	8.0%	8.0%	8.9%
1Q05	6.9%	7.8%	8.3%	7.3%	7.5%	7.7%	7.8%	8.6%
<b>YTD</b>	<b>-0.3%</b>	<b>-0.3%</b>	<b>-0.2%</b>	<b>-0.3%</b>	<b>-0.2%</b>	<b>-0.3%</b>	<b>-0.2%</b>	<b>-0.3%</b>

Source: Real Estate Research Corp. ([www.rerc.com](http://www.rerc.com)).

## Private Real Estate Debt (Mortgage) Capital Markets

Spreads remain attractive as lenders continue to compete for business.

Real Estate Capital Markets Scoreboard: "Prime" 10-Year Commercial Mortgages						
	12/31/01	12/31/02	12/31/03	12/31/04	4/17/05	Year-to-Date
Prime Mortgages	7.33%	6.05%	5.80%	5.51%	5.52%	+0.01%
10-Year Treasuries	5.05%	3.81%	4.25%	4.22%	4.23%	+0.01%
Spread	2.28%	2.23%	1.65%	1.29%	1.29%	0.00%
Source: Barron's/John B. Levy and Company Survey.						