

Real Estate Capital Markets Update – August 31, 2005

Volume 7, Number 10

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, add your comments, and click "Send".

Key Rates			
	August 29, 2005	Year Ago	Increase/Decrease
Prime Rate	6.50%	4.00%	+2.25%
Federal Funds Rate	3.50%	1.00%	+2.25%
3-Month Libor	3.86%	1.69%	+2.00%
3-Month Treasury Bills	3.49%	1.44%	+1.95%
10-Year Treasury Bonds	4.17%	4.57%	-0.38%
30-Year Treasury Bonds	4.36%	5.30%	-0.90%
Telephone Bonds	5.73%	6.42%	-0.68%
Municipal Bonds	4.34%	5.15%	-0.79%

Special Comment: No Surprise...Federal Reserve Board Increase Rates for the 10th Time

The Federal Reserve Board (FRB), as expected, raised the Federal Funds Rate 25 basis points (0.25%) to 3.50% at its regularly scheduled meeting held on August 9. The FRB also increased the Discount Rate 25 basis points (from 4.25% to 4.50%). Simultaneously, major money center commercial banks increased their Prime Rate from 6.25% to 6.50%. In response to the FRB's action, the equity and debt markets "yawned".

The FRB's statement continued to contain the now familiar language that "the [Federal Open Market] Committee believes that policy accommodation can be removed at a pace that is likely to be measured" effectively stating that the Committee continues to view monetary

policy as “accommodative” and supportive to the economy. The statement noted that “labor market conditions continue to improve gradually” and “core inflation has been relatively low in recent months and longer-term inflation expectations remain well contained...”

All in all, no surprises here. The FRB’s next meeting is scheduled for September 20 at which time it is expected that the FRB will increase the Federal Funds Rate and the Discount Rate 0.25% respectively.

Base upon trading in the Federal Funds Futures market, it is anticipated two additional 25 basis point increases appear to be “baked” into the numbers for September and November respectively which would bring the Federal Funds Rate to 4.00% by yearend 2005. The futures market currently rate the probability of the Federal Funds Rate reaching 4.25% by December 2005 at 50%.

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

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: Notes and Quotes from “The PunchLine...”

Conundrums, Distortions, Excesses...

Markets have been buoyed this summer by renewed growth prospects and a steady hand at the Federal Reserve. But stubbornly high energy prices represent a major threat to US and global economic growth and to the relatively benign outlook priced into financial markets. The most recent price levels in both oil and natural gas markets are significantly higher than widely anticipated levels just a few months ago. We have argued consistently that one of the most troubling aspects of these energy markets is the inability to clearly pin down forecasts. While some factors have seemingly offset the loss of income from higher energy prices, such supports may be on the wane. Fed policy, for one, has not passed through to bond market yields; as a result, mortgage rates and housing markets have not only held their own but have flourished. Excesses such as these are not easy to navigate. The unprecedented, pace-setting role of U.S. consumer spending and the awkward role of the energy sector deserve constant attention and will be central to the outlook even in 2006.

Prof Paul Krugman Summarizes the US Economy in a Single Sentence:

“...these days, Americans make a living selling each other houses, paid for with money borrowed from the Chinese.”

Be Warned: Mr. Bubble's Worried Again

Professor Robert J. Shiller is arguing that the housing craze is another bubble destined to end badly, just as every other real-estate boom on record has.”

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 30, 2005	3.25%	+0.25%	4.25%	+0.25%
August 9, 2005	3.50%	+0.25%	4.50%	+0.25%
September 20, 2005 (P)	3.75%	+0.25%	4.75%	+0.25%
November 1, 2005 (P)	4.00%	+0.25%	5.00%	+0.25%
December 13, 2005 (P*)	4.25%	+0.25%	5.25%	+0.25%

*Based upon trading in the financial futures market, there is a 50% probability of the Federal Funds Rate reaching 4.25% on December 13, 2005.

Beware...

A few years ago, collateralized debt obligation (CDO) investors who sold mezzanine protection on a portfolio of investment grade names including the likes of WorldCom, Railtrack, Xerox, and Enron—all of which subsequently experienced credit events—were hurt. The situation that current mezzanine investors find themselves in is, in essence, similar. However, the greater volumes, complexity, and longer maturity of contemporary CDO structures suggest investors' troubles this time will be more serious.

Commercial Mortgage Securities Boom; Some Fear Property Price Increases

Commercial mortgage-backed securities are having a record year as investors pour funds into real estate. The investments are bundled and sold off as bonds to investors, but some bankers caution that [the] influx [of capital] could cause lending standards to loosen, thereby driving up property prices.”

Real Estate Capital Markets Scoreboard: Money Rates	August 29, 2005
Prime Rate	6.50%
Federal Funds Rate	3.50%
Discount Rate	4.50%
Dealer Commercial Paper	3.60% - 30 days 3.69% - 60 days 3.77% - 90 days
London Inter-bank Offered Rate (LIBOR)	3.67% - 1-month 3.86% - 3-months 4.06% - 6 months 4.27% - 1 year
U.S. Treasury Securities	4.17% - 10-year

Greenspan Warns on Dangers of Growing Acceptance of Risk

In a speech on August 26 at an annual conference of central bankers, Federal Reserve Board Chairman Alan Greenspan pointedly warned of the “dangers of [the] growing acceptance of risk”, stating that recent increases in stock and housing prices is reflective of a growing inclination and willingness on investors parts to accept risk, an inclination and willingness that could end badly. Chairman Greenspan noted: “What they [investors and homeowners] perceive as newly abundant liquidity can readily disappear...Any onset of increased investors caution” could cause prices to decline and force leveraged investors and homeowners to have to liquidate assets to repay debts. “This is the reason history has not dealt kindly with the aftermath of protracted periods of low-risk premiums”, i.e., periods of low interest rates and low capitalization rates and/or high price earnings ratios.

Public Real Estate Securities Capital Markets

While real estate investment trust (REIT) performance year-to-date leads all market indicators, there is clearly a nervous tone to the market. It’s not that investors are exactly anxious about the prospects for the REIT and/or real estate industry, but there is clearly a yet-to-fully-surface series of concerns about low capitalization rates and high asset prices, lofty REIT valuations, the potential for too many secondary share offerings, the recent (and short-lived) series of hostile REIT-to-REIT merger offers, increases in interest rates, the impact of increased oil prices on the economy, etc. Maybe it’s just the “August effect”, with the markets looking for direction and waiting for September.

Public Securities and Real Estate Performance Indices as of August 26, 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	-2.4%	-0.6%	-2.5%	-0.5%	+7.2%	+18.0%*

* Trailing 12-months ended June 30, 2005.

Market Capitalization of REITs (number of shares multiplied by share price in \$ millions) as of August 29, 2005								
	# of REITs	Market Cap	Equity REITs	Market Cap	Mortgage REITs	Market Cap	Hybrid REITs	Market Cap
2005	197	332,876	153	293,542	37	25,212	7	6,121
Source: National Association of Real Estate Investment Trusts (NAREIT).								

Offerings of Securities by REITs (in \$ millions) as of June 30, 2005				
	2004		2005	
	# of Offerings	\$ Value	# of Offerings	\$ Value
Initial Public Offerings	29	\$8,271	6	\$2,728
Follow-on offerings-Common Shares	79	7,338	30	3,123
Follow-on Offerings-Preferred Shares	61	5,858	21	1,850
Unsecured Debt	97	17,306	48	7,997
Secured Debt	0	0	2	1,910
Source; National Association of Real Estate Investment Trusts.				

Public Real Estate Debt Capital Markets

While there is continuing discussion (without anyone reaching a conclusion) among investors, rating agencies, and originators regarding supposed weakening in the application of underwriting standards due to higher loan-to-value and lower debt-service coverage ratios, the increased propensity to interest-only, non-amortizing loans, weakening of loan carve-out provisions, declines in required reserves, and the use of master leases by borrowers, the commercial mortgage-backed securities (CMBS) markets just keeps rolling along.

On a year-to-date basis, issuance volume has surpassed all of calendar year 2004's (see chart that follows) while trading spreads remain at extremely competitive levels. Capital remains, as it has all year, readily available and very effective cost.

According to a recent report by Morgan Stanley Fixed Income Research, delinquency rates for seasoned CMBS increased 1 basis point (0.01%) in July, from 1.41% to 1.42%. The states with the highest percentage of delinquencies were: Texas, Illinois, and Massachusetts. The product sectors with the highest percentage of delinquencies were: senior housing, hospitality, and multifamily.

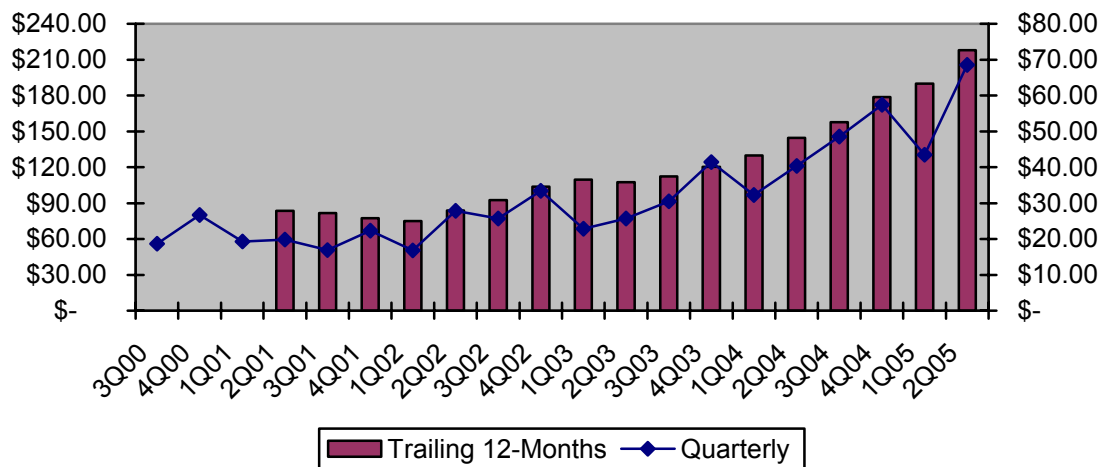
Issuance of Commercial Mortgage-Backed Securities January 1, 2000 through August 29, 2005 (in \$ Millions)			
	U.S. Assets	Non-U.S Assets	Total Issuance
2000	46,849.4	12,116.4	59,010.8
2001	67,149.9	22,713.8	89,863.7
2002	52,073.3	28,705.9	80,779.1
2003	77,848.1	20,802.9	98,651.0
2004	93,838.2	33,746.0	127,584.2
2005	98,600.0	40,900.0	139,500.0
Source: <u>Commercial Mortgage Alert</u> .			

Commercial Mortgage-Backed Securities Trading Spreads above 10-Year Treasury Bonds (in Basis Points)			
	12/29/04	8/16/05	Year-to-Date
10-Year Treasury Bonds	4.32%	4.21%	-0.11%
AAA	+70	+73	+3
AA	+77	+89	+12
A	+85	+99	+14
BBB	+127	+150	+23
BBB-	+167	+200	+33
BB	+325	+290	-35
B	+770	+700	-70

Source: Morgan Stanley.

Private Real Estate Equity Capital Market

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



Source: Real Capital Analytics Inc. (www.realcapitalanalytics.com)

Capitalization rate compression continues unabated. As the following “mini-scoreboard” indicates, capitalization rates declined by at least 50 basis points (0.50%) between year end 2004 and June 30, 2005. Depending on your perspective, it remains an excellent time to sell, but a difficult time to buy as no one want to find themselves having been the last buyer at the highest price and lowest yield when the music stops. Someone recently noted that when the music stops this time, they may not be taking away just one chair; more likely, they will be taking away “an entire row!”

	Multi-Family	CBD Office	Suburban Office	Retail-Mall	Retail-Neighborhood	Retail-Power	Industrial-Warehouse	Industrial-R & D
4Q04	7.2%	8.1%	8.5%	7.6%	7.7%	8.0%	8.0%	8.9%
2Q05	6.7%	7.3%	7.8%	7.0%	7.2%	7.3%	7.5%	8.0%
	-0.5%	-0.8%	-0.7%	-0.6%	-0.5%	-0.7%	-0.5%	-0.9%

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%
2Q05	6.7%	7.3%	7.8%	7.0%	7.2%	7.3%	7.5%	8.0%
YTD	-0.3%	-0.3%	-0.2%	-0.3%	-0.2%	-0.3%	-0.2%	-0.3%

Source: Real Estate Research Corp. (www.nerc.com).

Private Real Estate Debt (Mortgage) Capital Markets

According to the Federal Reserve Board's July Senior Loan Officer survey, commercial banks reported continued easing in terms and lending standards for commercial and industrial loans as well as commercial and multifamily real estate loans.

Capital remains abundant and available at highly competitive terms.

Real Estate Capital Markets Scoreboard: "Prime" 10-Year Commercial Mortgages						
	12/31/01	12/31/02	12/31/03	12/31/04	7/31/05	Year-to-Date
Prime Mortgages	7.33%	6.05%	5.80%	5.51%	5.45%	-0.06%
10-Year Treasuries	5.05%	3.81%	4.25%	4.22%	4.20%	-0.02%
Spread	2.28%	2.23%	1.65%	1.29%	1.25%	-0.04%

Source: Barron's/John B. Levy and Company Survey.