

ECONOMIC PULSE

A MONTHLY REPORT ON THE U.S. ECONOMY
AND ITS IMPACT ON COMMERCIAL REAL ESTATE

LOW RATES = MORE GROWTH

LOW INTEREST RATES WILL CONTINUE TO SUPPORT
LEASING AND INVESTMENT ACTIVITY

BY KEN MCCARTHY

There is very little that is more important to the U.S. economic outlook and the commercial real estate industry than the trend in interest rates. Because so much economic activity, from consumer purchases of homes and cars to capital investment by businesses to construction of new buildings, depends on debt, the cost of capital is a critical factor in determining whether transactions take place. The current trend in U.S. interest rates is essentially flat following the Federal Reserve's decision to stop raising rates in June 2006. While we expect this trend to continue in 2007, there is a greater chance that interest rates will budge upwards than decline further.

THE FED'S OBJECTIVES AND RECENT TRENDS

The level of interest rates in the economy is primarily determined by the Federal Reserve's monetary policy. The Fed sets the federal funds rate (the interest rate for overnight funds) and participants in the financial markets set other interest rates for everything from Treasury notes to corporate bonds to mortgages based on the Fed funds rate. The Fed sets rates based on its view of the economy's expected performance. If the economy is expected to grow at a rate that is so strong it will cause shortages and

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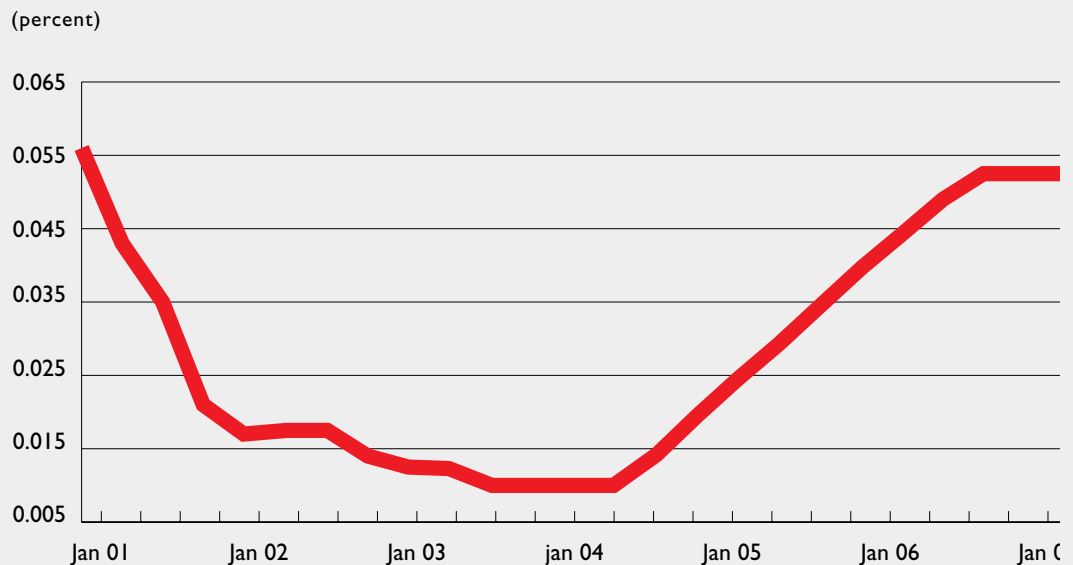
The low level of interest rates and availability of capital has been an important spur to the strong investment sales market – 2006 saw record investment sales in the U.S. and 2007 is starting out strongly.

prices to rise, thereby triggering inflation, the interest rates will be increased in an effort to slow the growth. If the Fed expects the economy to weaken and unemployment to increase, interest rates will be lowered in an effort to stimulate activity and boost growth.

The Fed was in tightening mode, raising interest rates from June 2004 through June 2006, taking the funds rate from its record low of 1% to the current 5.25%. This increase was prompted by the strong performance of the economy in 2004 and 2005, particularly in the housing sector, where sales reached record levels. Fed policy makers sought to reign in growth before the economy got so tight that it began to push up prices and increase inflation.

Markets indeed did get tighter – commodity prices surged (including oil and most metals) and unemployment fell, pushing up wages. The inflation rate, as measured by the consumer expenditures deflator excluding food and energy (the so-called core PCE deflator) began to rise. In August 2003, the core inflation rate was 1.3%; in November 2004, the rate had increased to 2.3%. That may not seem high, but the rate was accelerating, which was making the Fed uncomfortable, especially with the unemployment rate falling. So they continued to inexorably raise rates to the current level.

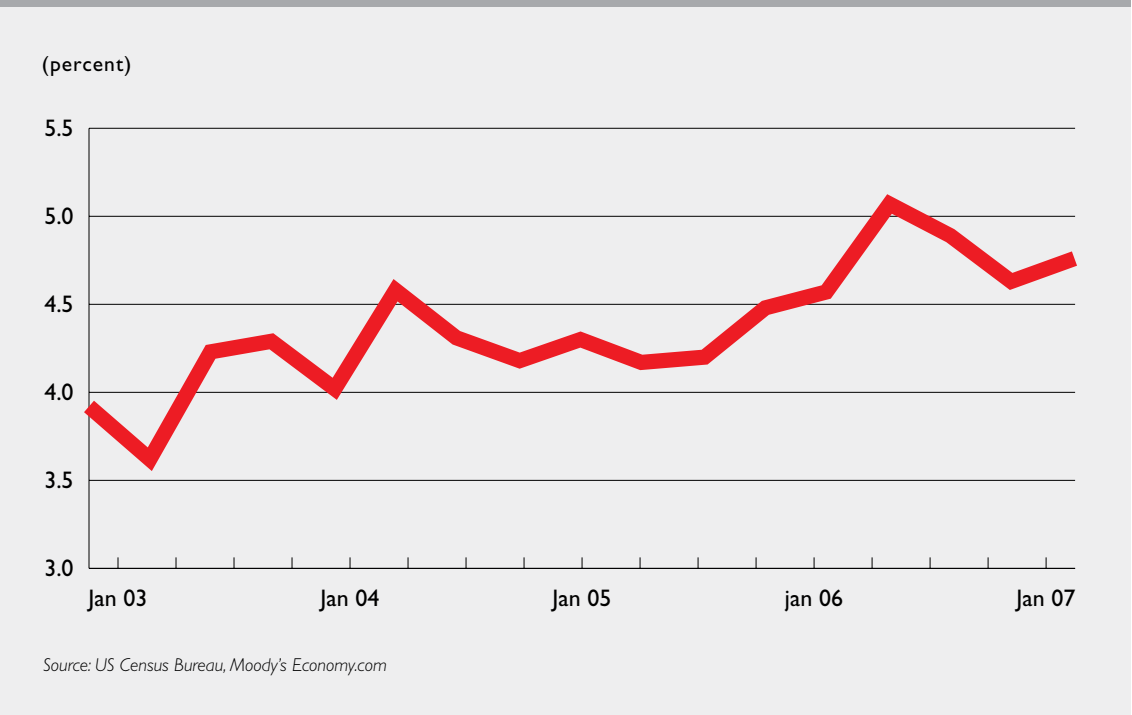
Chart I | FEDERAL FUNDS RATE



Source: Federal Reserve Board, Moody's Economy.com, Shaded areas are recession periods

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Chart 2 | 10-YEAR TREASURY NOTE RATE



By mid-2006, the economy was slowing and the Fed's concern shifted from worries about inflation to worries about growth as home sales fell.

The Fed's policy eventually had the desired effect of containing the housing sector, although it took a long time because rates had been at or near record lows for more than a year. Long-term interest rates entered an uptrend in late 2005 with the 10-year Treasury note climbing from 4.05% in early September 2005 to 5.25% in June 2006. This pushed up mortgage rates to almost 7% and took the steam out of the housing market. By mid-2006, the economy was slowing and the Fed's concern shifted from worries about inflation to worries about growth as home sales fell. Worries that the housing decline would curtail consumer spending at a time of rising oil prices began to weigh on financial markets even as the Fed stopped raising the funds rate. Long term interest rates, which peaked at 5.25% eased back to the current level of about 4.75%.

As it turned out, the economy didn't weaken substantially and appears on a path to expand by about 3% in 2007, following a 3.4% rate in 2006. In addition, inflation has moderated slightly from the oil-driven increase of early 2006 back to 2.2% at year-end. That's still higher than the Fed would like it. The stronger growth has kept the 10-year Treasury rate between 4.7% and 5% during early 2007.

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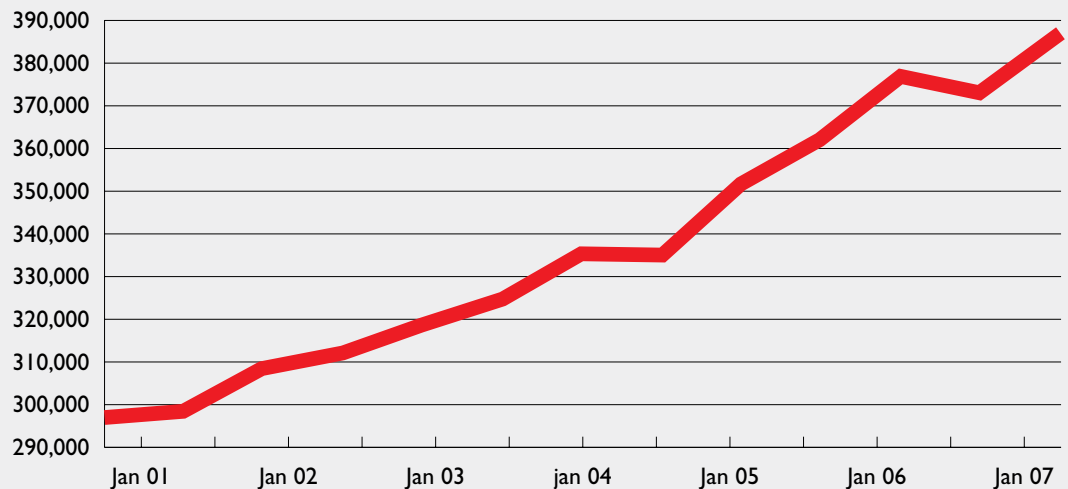
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THE OUTLOOK

Now that the Federal Reserve appears to have achieved its goal of slowing the housing sector and damping inflation, the key to the future level of interest rates will be the performance of the economy. Stronger growth will boost demand for debt and likely prompt further monetary tightening by the Fed, but a slowdown would lead to lower interest rates. Continuing growth in the current range of about 3% would allow interest rates to stay roughly where they are today with the Fed maintaining a steady stance. This is the scenario we expect.

Chart 3 | REAL RETAIL SALES

(millions of 2000 dollars)



Source: US Department of Commerce, Bureau of the Census, Moody's Economy.com

Economic growth currently remains healthy, although slower than at this time last year. In the fourth quarter, real GDP increased at a 3.5% annual rate, and the economy's performance in January and early February suggests that growth continues apace. Retail sales adjusted for inflation rose only modestly in January as declining gasoline prices and a drop in auto sales offset increases in sales at department and clothing stores. Excluding gasoline and autos, sales rose at a 6% annual rate in January. Payroll employment increased 111,000 jobs in January, below the roughly 170,000-per-month average of the previous six months, but still healthy enough to boost income and support future consumer spending growth.

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The weak sectors of the economy are motor vehicles and housing. Auto sales and home sales have both declined from the very high levels of 2005 and are currently treading water. For the national economy, the key to growth in 2007 will be the extent to which these two sectors influence the rest of the economy. If housing and autos weaken further, they would likely slow economic growth to about 2% to 2.5%, but if those sectors remain stable at or near current levels, the economy will continue to perform well, reaching growth in the 3.0% range. This will be supported by continuing income and employment growth, along with rising business investment.

We expect the growth constraining impact of weaker housing and autos to be offset by continuing gains in consumer outlays, maintaining overall GDP growth. As the year progresses economic conditions are expected to improve, as rising employment supports stronger consumer spending, particularly if oil prices remain stable. In addition, business investment, which has thus far lagged in the current expansion, is more likely to accelerate in the coming year as businesses face low unemployment and the need to continuously boost productivity. That's why we think the risk in the current forecast is that the economy will be stronger than expected, not weaker. If the economy does accelerate, the pressure on interest rates in the second half will be upward.

Thus, our baseline forecast calls for interest rates to remain relatively flat this year with the Fed on hold, but if there is a risk, it is more likely that rates will increase from current levels by year end.

REAL ESTATE IMPLICATIONS

It's very important to keep the recent trends in interest rates in perspective. Although long-term rates have increased over the past two years, they are still low by historical standards and in terms of their impact on the economy.

Over the 36 years between 1966 and 2002, the yield on the 10-year Treasury note fell to 4.5% or lower twice (in 1998 following the collapse of Long Term Capital and in the weeks following the 9/11 attack). Thus, the current level of long-term interest rates is only high relative to the levels of the past four years. At 4.5% to 5%, the rates are still at a level that tends to support growth in borrowing. The returns needed to justify an investment are not high in this interest rate environment and thus, funds are available for business and individuals to increase purchases.

For the real estate industry, interest rates influence all aspects of the market. They reflect the level of economic activity and, therefore, demand. They influence the cost of development, or supply. And they influence the availability of capital for investment. Trends to watch out for include:

- The likelihood of stable interest rates in 2007 in a solid economic growth environment should perpetuate growth in demand for new space.

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- With ample funds available, development of new space should continue to increase. At the end of 2006, construction spending on commercial buildings was 28% above the level of a year led by strong increases in commercial office (+22%) and hotels (+60%). Construction activity is likely to remain strong as long as interest rates remain relatively attractive to developers.
- Finally, the low level of interest rates and availability of capital has been an important spur to the strong investment sales market – 2006 saw record investment sales in the U.S. and 2007 is starting out strongly. If we are correct and interest rates remain stable, the investment market will continue to increase and values for properties will continue to rise.

CONCLUSION

The U.S. is expected to see stable interest rates in 2007, as growth is healthy but not excessive while inflation remains tame. The risks lean toward the possibility of higher not lower rates. This is a positive environment for leasing and investment. It means continuing healthy demand growth and ample capital will be available to fund new construction and investment.

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For more information about C&W Research, please contact:

Kenneth J. McCarthy
Managing Director – Research
212-698-2502
Ken.McCarthy@cushwake.com

Maria T. Sicola
Executive Managing Director – Research
212-841-7781
Maria.Sicola@cushwake.com

For additional copies of Economic Pulse e-mail Corporate Communications:

corpcomm@cushwake.com

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51 West 52nd Street New York, NY 10019-6178

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