

The Wall Report

a quarterly economic commentary



T. Wall Properties appreciates this opportunity to provide you with a market and economic report, which includes information about national and global economic issues, local market and economic details, predictions for the future, and how these may affect the development of your company.

STEADY AS SHE GOES

Introduction

As we discussed in the last Wall Report, overall economic activity has slowed to a crawl, although there are sectors that are doing quite well in spite of the overall national numbers. The main theme of this report is “steady as she goes” for the overall economy, but at a slow and reduced pace as compared to the years 2003 through 2006. However, there are some significant new risks coming into play in 2009.

Overall the U.S. economic forecast remains slightly positive, capital continues to flow to new investments (and in fact, there is an over abundance of capital floating around the globe). The trade deficit widens, but as long as foreigners continue to buy U.S. bonds, we’ll be fine, and the dollar is weakening, which is helping to sustain export growth and therefore, overall growth, albeit at an anemic rate. Overall the strong global economy is helping the U.S., with China in particular experiencing extremely strong growth.

The commercial real estate market fundamentals remain strong and steady, while the residential real estate market fundamentals continue to weaken dramatically as we predicted last report. The two mar-

kets are a study in contrasts. Commercial vacancies are shrinking while residential vacancies are increasing. The commercial development pipeline is under control; experiencing steady absorption and increasing rents due to less new construction while the residential pipeline continues to oversupply the market, depressing prices.

With the flattening of returns (yields on investments) across all asset classes (frankly, to historical norms) and the aging Baby Boom generation, I am predicting that investments that produce dividends will become much more in demand than in the recent past, as those Baby Boomers seek a steady flow of income in their retirement years. (They won’t be looking for those super-high returns that they used to demand when they were in their 40’s and 50’s simply because they won’t have the time left in their lifespan to achieve those returns.) This is very much a return to historical normalcy ala the 1950’s, not some new paradigm.

I can already see the demand for dividends growing with a few limited partners in T. Wall Properties coming to me and saying, “in eight more years, I’ll be x years old and I don’t see myself re-committing (in 2015) to another five to ten years in an investment

that targets appreciation," the implication being that they will need income then.

One reason we research and compile all this information and write The Wall Report is to force us to take time to evaluate the market and the external factors that can have an impact on our business. And while we can't be right all the time, at least we'll have thought about what the local and worldwide situation around us is doing and how it might affect our business. Hopefully you do too.

What's the Data Saying?

- The unemployment rate stood at 4.5% in April; a slight increase. When you consider a slowly increasing unemployment rate going into spring when employment activity usually picks up, well - that's unusual. Actual jobless claims increased 0.6%. One contributing factor may be the housing industry not being ready to ramp up for summer construction given its continued weakness and over supply that still needs to be worked out of the system.

- Job growth was weaker at less than 1%, but the economy is still creating jobs overall. The strength was in small and medium firms that added jobs, while large firms continued to downsize.

- The first quarter GDP stood at 1.3%; exactly in the range we expected it to be, demonstrating the economy's overall weakness.

- Even inflation remained tame at less than 2%, evidencing a lack of pent-up demand, although the Fed's over concern about inflation means this economic slowdown won't have the benefit of the Fed lowering interest rates to stimulate growth.

- And lower long-term interest rates means there is still excess capital in the markets, which may mean capital can't find appropriate investments given the weakness in the economy, but that's just our interpretation.

- Sales of existing homes dropped considerably (the biggest drop in 18 years) according to the National Association of Realtors, which disclosed that sales dropped 8.4% just in March alone. As we discussed in the last Wall Report, there are too many real estate related professionals out there that continue to

underestimate the depth of the housing market debacle; the recent drop in sales was triple what the Realtors had expected.

The fallout in the residential market is still in its infancy, with falling prices just starting to come into play, mortgage defaults are now up to the highest point in ten years, with many markets having a three year or longer supply of housing (at the old absorption rates before the credit-tightening standards discussed below come into play). If you want a really good test of the market, look at the auction numbers. The Wall Street Journal reported Lennar's condo auction receiving bids that were about 42% below asking prices, which tells you where prices are headed in the worse markets - and not one unit sold in the auction. (Only after the auction and after the company negotiated directly with a few buyers did they secure a few contracts, but the lack of any bids reaching the company's reserve prices tells us that residential developers are still out of touch with the severity of this downturn.) Of course, housing is local so every market is different given the different circumstances and different levels of supply and demand.

But one thing is for sure, investment in new residential structures needs to experience further cutbacks before we see recovery, and recently we've started to see that on a national level as the residential investment levels dropped 22% in the fourth quarter last year and another 19% the first quarter this year.

- In spite of the slowing housing market, the CPI (inflation) has started to increase slightly after having dropped in the third quarter last year. I think this is why the Fed has not reduced interest rates in response to the slowing economy; they are afraid that inflation is creeping back into the economy. So what is causing this incremental inflation? I believe it is the strong global economy and a weak dollar. As I mentioned in the last Wall Report, the U.S. economy, for the first time, is not leading the world economy. In fact, the global economy may be what is keeping the U.S. economy from dipping into a recession; significant worldwide growth (over ten percent in China during the first quarter alone) is boosting U.S. exports, but at the same time, that growth is keeping the demand up for goods, which is why I think we're seeing inflation creep up (in addition to the overall skilled labor shortage). But with the dollar falling considerably, companies cannot keep absorbing the additional costs,

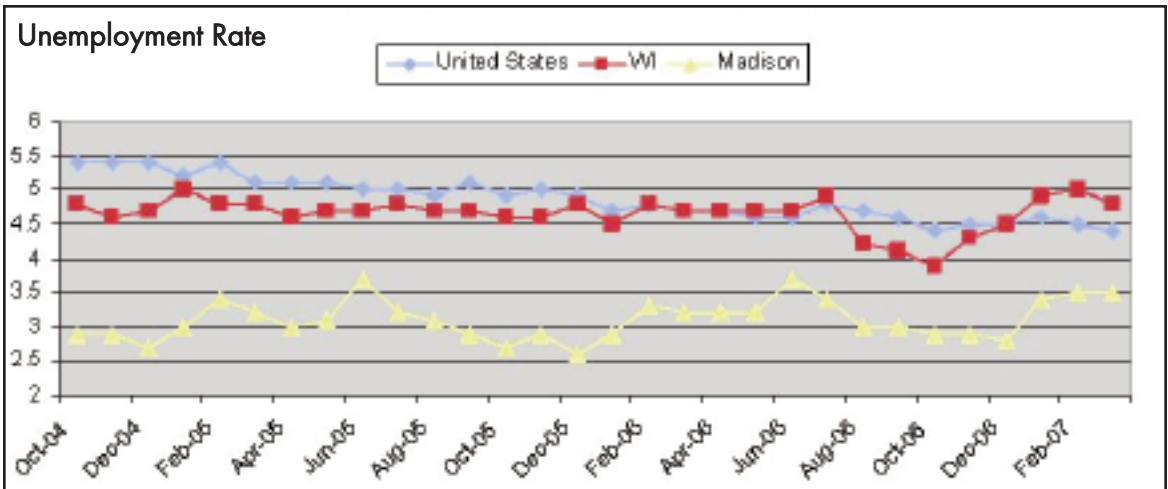
they must eventually pass along some of it in the form of higher prices.

But thank retailers like Wal-Mart for single handedly keeping downward pressure on prices on goods they import up to this point. With the dollar having dropped

so far in value in such a short time, we should have experienced far greater inflation than we have, but retailers are doing everything they can to hold the line on prices. If they hadn't, inflation would have come on strong and the Fed would have had to raise rates significantly, doing so during the housing downturn, which would have led to a recession.

- On the other hand, many statistics are holding steady, such as the supply of money, the Fed Funds Rate and Prime Rate, which is the first time in a couple years when rates have held steady for many months at a time.

- And the lower-valued dollar should help with



exports and therefore help U.S. businesses compete.

- One area of positive news is factory orders, which edged up 1%.

- Likewise, durable goods orders were up 1.5%, but more interestingly is that durable goods excluding autos was up a strong 4.7%.

- And productivity was up 1.7%, which was unexpected and helped hold down inflation.

- As for Wisconsin, during April alone the plant closing notices show another 1573 jobs to be eliminated, although this time the closings are geographi-

Green, Green, Green

As one speaker at the Graaskamp Real Estate Center dedication ceremony said, "in ten years buildings that are not green could be considered functionally obsolete and therefore unleaseable by the vast majority of businesses." 'Functionally obsolete' is what the entire pre-1980 office building market became when technology came along (until wireless technology reversed that situation). Buildings that could not be retrofitted and rewired to accommodate a whole host of new technology dropped into the Class B and C category and lost customers and rent.

The same may become true in ten years or so of buildings that are not 'green', depending on how many businesses want to be located in green buildings. We are already starting to see some municipalities toying with the idea of mandating green construction.

So, what is T. Wall Properties doing about it? We're starting down the path of incorporating aspects of 'green' in all new construction we do, and we conducted an energy audit of existing buildings so that we can make upgrades to newer, energy efficient kinds of systems and components.

This 'green' trend could also present an opportunity for those embracing the idea before others do, possibly offering an opportunity for slightly higher rents for green buildings and at a minimum, certainly offering reduced energy costs for locating in a green building.

cally more disbursed than we normally see (with most normally being located in and around Milwaukee).

- Fortunately, the housing starts data shows that residential developers have finally begun to curtail development of more homes with Dane County starts at only 40% of the levels of May 2005 and Wisconsin on the whole at a similar figure.

- Now throw into the mix the long-term effect from a slower housing buying pool as a result of demographic trends; be aware that while we will have a small bulge of students graduating from college through 2009, after that and especially in 2017 there will be a number of years with a severe decrease in the graduating student head count, which will translate to fewer home buyers. Likewise, consider the impact of Generation X (age 42 on down) on the upper-priced housing market. I would expect now that Gen X is reaching the age where they would trade up in housing stock that we're going to see far slower sales of high priced homes along with price reductions becoming the long-term trend. We're talking about 15 years or so of very few people in the demographic age group combined with simply fewer numbers of people that will be able to afford a high-priced house as compared to when the Baby Boom generation flooded the market with demand for huge homes with three and four car garages. (Expect to see a trend towards homes of a smaller size than the McMansions that we saw the Baby Boomers build.)

- This demographic trend also means a labor shortage. We continue to expect a labor shortage through at least 2020, which will keep upward pressure on the cost of labor.

- The real labor shortage (which no one really has thought about) is that Generation X is just starting now to hit the managerial market, which means there will be a severe shortage of managerial talent age 42 or younger (and in seven years, age 50 and younger). This means firms looking for experienced managers are going to find it difficult to find them and the cost for those managers is also going to increase in portion to the shortage. How are firms going to replace their retiring managers? One answer we have in the commercial real estate industry is consolidation. Firms will merge or get bought out (and become larger as a result), and as those larger firms expand, they will have to both pay more to find talent (they can afford to given their larger size) as well as depend on younger managers to fill those positions. Possibly hiring retired managers part-time will also be another solution.

- The one big negative in the numbers is the dramatic jump up in the overall manufacturers' inventory to sales ratio during the first quarter, which had previously moved only incrementally over the last few years. Either sales dropped at a faster rate than managers expected or they ramped up inventory in anticipation of sales that didn't materialize. I suspect it was a combination of both, but either way, with this

The Auto Industry

Toyota passed GM in worldwide auto sales now making Toyota the topped selling auto manufacturer in the world. This displacement of GM from the #1 spot not only demonstrates the seriousness of GM's problems, but is also indicative of future trends. I predict that within ten years GM and Ford will either cease to exist or at least not exist in their present form (be merged or sold).



Daimler's (Mercedes Benz) purchase of Chrysler has resulted in a \$27.74 billion loss in market value for Chrysler (as determined by comparing Daimler-Benz's purchase value in 1998 of \$37 billion vs. last week's deal for Chrysler valuing the company at \$9.26 billion. Daimler learned very quickly that the pension fund liabilities exceed the value of the company, which is one reason they were quick to off load it.) What does that say about the auto industry and consolidation? Very few big bureaucracies (corporations) can buy a weak or failing company and turn it around; that takes an innovator or a change master and those don't typically exist at large corporations. (GE may be the exception.)



On the Plaza at City Center West

out of the ordinary jump I see companies cutting back on manufacturing more product given their higher than normal inventory levels, which means there won't be strength in the economy going through the remainder of this year. That is why our theme for this report is "steady as she goes, but at a slow pace".

■ And in that context, the commercial market is continuing along this theme with nice, steady but incremental growth and no excess supply to have to work through (as measured by commercial bank loan activity). The commercial industry never experienced the over-building that the residential industry suffered, so while overall economic growth is slower, the commercial real estate industry is extremely healthy and

will continue to be.

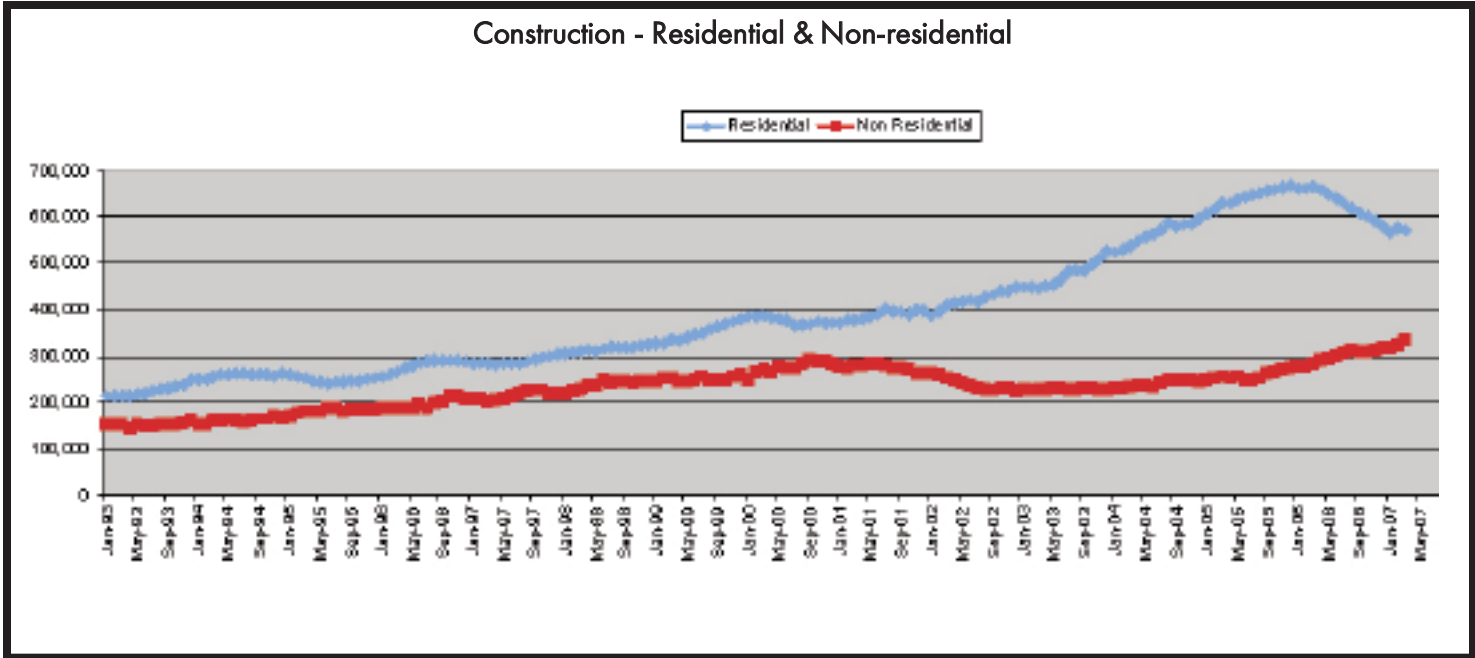
■ The only disadvantage in the commercial industry is the continuing increase in the cost of materials like steel and concrete. In January suppliers passed through a 10% increase in concrete. In April a 10% increase in copper came through as well as an 8% increase in steel. I am still hoping for a slow down in material pricing as China curtails its construction activity in preparation for the Olympics, but that won't probably occur until the 4th quarter of this year and the first quarter of 2008. Surprisingly, China's fast growth of about 9% a year jumped to ten percent in just the first quarter of this year, which is incredible. So the faster growth and demand in materials worldwide is offsetting the slack that is being created in the residential market in the U.S.

Predictions

■ The Sarbanes Oxley law will cause a dramatic shift in the public vs. private markets for companies – while companies in prior years wanted to 'go public' to cash out, we predict more and more public companies will 'go private' instead as a way of saving millions of dollars in Sarbanes Oxley compliance costs and risks, which when combined with cheap debt can make a huge difference in the bottom line results of a company, public vs. private.

Risks

■ The potential pulling of American troops out of



Iraq (assuming this followed a January 2009 inauguration of a new President and Congress) could have a destabilizing impact on the supply and pricing of oil. We are not making a political statement; we're just saying that a power vacuum in Iraq will lead to an unstable environment there that could make Iraq ripe for civil war - a fight for filling that vacuum between the Middle Eastern nations adjacent Iraq could result in the price of oil skyrocketing, and such a price increase and the shortages that caused it could have a significant negative impact on the U.S. economy in 2009 and into 2010 if it were to occur, simply because Iraq is accountable for billions of barrels of oil delivered to the market daily and without that supply, prices would shoot up. Advice: Keep an eye on this situation.

■ Hedge Fund risk. Hedge funds have increased their investment in the stock market to \$60 billion from \$35 billion just a few years ago (compare that huge figure with the size of China's funds), which combined with the fact that hedge funds typically don't invest for the long-term means that there will be a huge rush for the exit doors in any market downturn.

Just one example is a hedge fund (which shall remain unnamed) that is responsible for 3% of the average trading volume on the top three trading exchanges, 15% of the Options market and 10% of the Treasury bond market. This hedge firm does quant trading, which means they don't invest in companies as an investment, but rather this fund buys and sells like crazy based upon computerized models and comparisons. That means that when the market does turn south, these computerized models will force lightning fast selling so as to exit the market before you and I hear about it on CNBC that night, and by that time, it will be too late for us to exit. Now, throw on top of that the fact that this same fund leverages at a rate of 7.8 times its asset base (the equivalent of 87% leverage in real estate terms) and you have a recipe for disaster. Why? Because when the market moves down, the first money lost is this hedge fund's razor-thin slice of equity (just \$13 billion on a \$100 billion investment in the market), which means the fund will have to move quickly to protect its equity base or risk losing all of its equity, since the debt obviously has to be paid back no matter what.

Now consider that there are now 8,000 hedge funds in operations, many of them operating with high leverage or even in some cases greater than 100%



575 D'Onofrio Drive in the High Point Office Park

leverage (i.e. more than a 10 to 1 ratio of debt to equity). There's a reason why the government has restrictions and prohibitions on individual investors being able to invest in the market 'on margin' or using borrowed funds, because doing so increases the inherent risk in the overall market to all investors. The volatility we're witnessing in the market lately is just a symptom. The end result of any downturn is going to be much more dramatic than in the past and much bloodier. I don't try to predict where the stock market is going, all I am saying is that when a downturn does materialize, there is significantly more risk that the fall will be faster and greater than in the past due to hedge fund risk. Individual investors are the ones that are going to get left holding the bag simply because we don't have the information on the same timeframe as the professionals do and also because we can't act as quickly to access the risk and issue trading orders as compared to those whose full time job it is to monitor the market. Think about it; in the past, as individual investors we competed against other individual investors and until fairly recently, did so without the benefit of computerized trading. Today however, the entire market can move in the blink of an eye because of computerized trading.

■ Subprime Lending Market: Subprime lending for home mortgages increased dramatically over the last few years and now we're just starting to see the fallout with a number of subprime lenders now having financial difficulty. Likewise, the mortgage backed securities market tripled to almost \$600 billion from \$200 billion between 2002 and 2006. While we're seeing the fall out in the subprime market, we really haven't see the fallout in the mortgage-backed securities market yet, but Freddie Mac recently announced

changes in their mortgage underwriting standards that, come October, will impact their ability to underwrite, and therefore, purchase mortgages that are considered subprime.

What this means is that fewer subprime loans will be made in the future, which in turn will reduce the number of single family and condominium homes that can be purchased by buyers who are considered risky. This means that a reasonable portion of the home buying market that existed in the past, will not exist in the future. In other words, the buying pool will decline this year, permanently, which will further reduce demand for all those homes on the market. In turn, this means a longer recovery period for the home (and condo) market as compared to if Freddie Mac continued to underwrite that sector of the market. That means that residential developers would be advised not to estimate future absorption of their residential projects at the same rate as in the past, because there simply won't be as many buyers. We can expect at least a five to ten percent reduction in the number of buyers just from this one factor.

■ China, Again. A new risk has just developed due to China's decision last month to establish its first investment advisory arm based upon the Singapore model. This model is basically a government run investment company, much like the State of Wisconsin Investment Board (SWIB) that will evaluate alternative investments and make investment decisions. Currently China has been simply buying U.S. Treasuries without considering the alternatives. I would anticipate this investment company will begin to invest some of China's one trillion U.S. dollars (that China holds) in assets other than Treasuries within one to two years. What does this mean for you? Even if China shifted only 20% of its foreign currency reserves that would mean about \$200 billion (that's *billion*) moving out of the bond market, thereby causing a trend towards higher long term rates due to less demand for Treasuries. Now some may speculate that those funds would then go into the U.S. stock market, but I wouldn't be so sure. I think China will

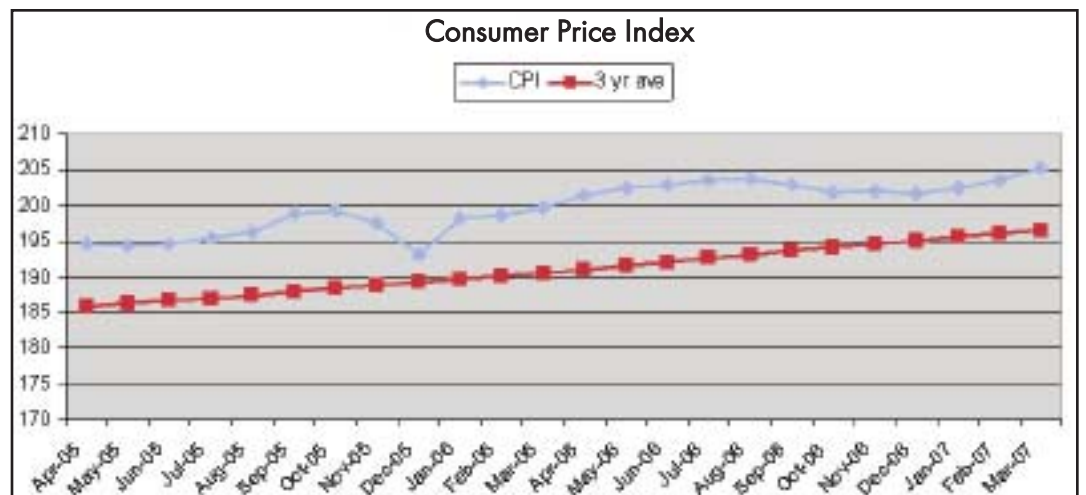
spread those dollars around into different asset classes as well as into other foreign nations' stock and bond and currency markets.

When you consider that one primary reason the U.S. has experienced a period of low long-term interest rates is because of the large trade deficits with China, which then reinvests those funds into Treasuries to ensure a stable balance of capital flows. When one side or the other gets out of balance, that's when we experience trouble.

Political

■ We talked about political risk in the last Wall Report, but that discussion was speculative. We now have some definitive information to base our risk statement on. We're not trying to pick on the Democrats, heaven knows the Republicans have made their fair share of mistakes, but the Senate Democrats recently wrote a spending and taxing plan (their first since taking control of Congress) that calls for a \$900 billion increase in taxes over the next five years and \$3.3 trillion over ten years and this comes on top of Bush's huge spending increases to instill democracy in Iraq. (That's the equivalent of a \$2,641 per household increase annually according to the Heritage Foundation.) And as I had mentioned before, the Democrats have already stated their preference for raising the capital gains tax too, potentially more than doubling the rate back to 35% from the current 15%. If either or both a significant income tax rate increase and a capital gains tax rate increase is passed into law in 2009, we can count on the economy shutting down in 2009 and 2010.

■ On the reverse side, the Republicans are squeez-





City Center West

ing the immigration market with new and tighter laws that discourage companies from taking the risk of hiring immigrant labor. Immigration has historically been a hallmark of this country, and without a continued inflow of new labor, U.S. growth will grind to a halt. Why? First, take California as an example. Without the influx of immigrants, California's population would have actually declined, and it's impossible to grow the overall economy without population growth, because all that is left is a battle over the remaining customer pool. It becomes a zero-sum game. Second, companies need the low-priced labor to grow. Look at what happens to maturing industries with a maturing labor force like the domestic auto industry; the combination of the two has led to an unsustainable domestic industry and significant financial losses.

■ Protectionism is what led to the Great Depression; huge tariff increases passed by Congress severely limited trade and resulted in job losses and decreased velocity of money. It's not a coincidence that the 1990's growth came at a time following significant reduction in barriers to free trade under Reagan, Bush and Clinton. There seems to be an air of protectionism out there that we must guard against and we must continue to try to break down the barriers to free trade overseas and particularly in China.

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Conclusion

In conclusion, the remainder of 2007 should look a lot like the first four months of the year. Come 2008 we may continue the same, but hopefully experience reduced material pricing; certainly I can't imagine the Fed increasing rates during the six months leading up to the election in 2008, nor can I see Congress trying to pass new tax increases then either, which means some semblance of stability as compared to years when those factors do not come into play.

But come 2009, all bets are off. At worst, we could see either an administration that increases taxes significantly or at best, an administration that has to deal with whatever the situation in Iraq is at that time. And the Iranian issue may have come to a head by then too, requiring action. So there are many national concerns during and following 2009, yet locally the picture could look brighter.

While Wisconsin continues to lose traditional manufacturing jobs, hopefully the bio-tech and stem cell industries that are developing currently in the Madison metro area will lead the state and the nation in new job creation, opportunities and growth, which will in turn generate increasing demand for commercial real estate space. The greater Madison metro area (the 'MSA'), in particular, looks like it has a particularly bright future ahead.

And certainly, none of us will have to worry about finding a good paying job!

T. Wall Properties is relocating. Effective June 1, 2007:

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