Navigating the Fiscal Cliff and Global Economic Downshift

November 6, 2012

Macroeconomic Outlook - Global

- Relatively low volatility despite significant policy uncertainty throughout Europe, China and U.S.
- Ongoing concerns about Eurozone despite ECB initiatives
  - Conditions attached to ECB financial aid ➔ no takers yet, but has calmed the market
  - Greece still has not reached agreement with troika
  - Europe's troubled bank system and recession
  - Germany unwilling (and likely constitutionally unable) to consider Eurobonds
- Unknowns about China's new leader, slowing growth, and size/effectiveness of fiscal and monetary stimulus
- U.S. slowing job growth, private sector hesitancy, and uncertainty regarding 2013 fiscal cliff

IMF has downgraded outlook for global and U.S. economic growth for 2013

U.S. Treasury yields up from record lows, but close to zero real returns still reflects risk aversion

Market seemingly overly reliant on global monetary policy, whereas fiscal and regulatory policy are areas of greatest concern

Fiscal Cliff Downside

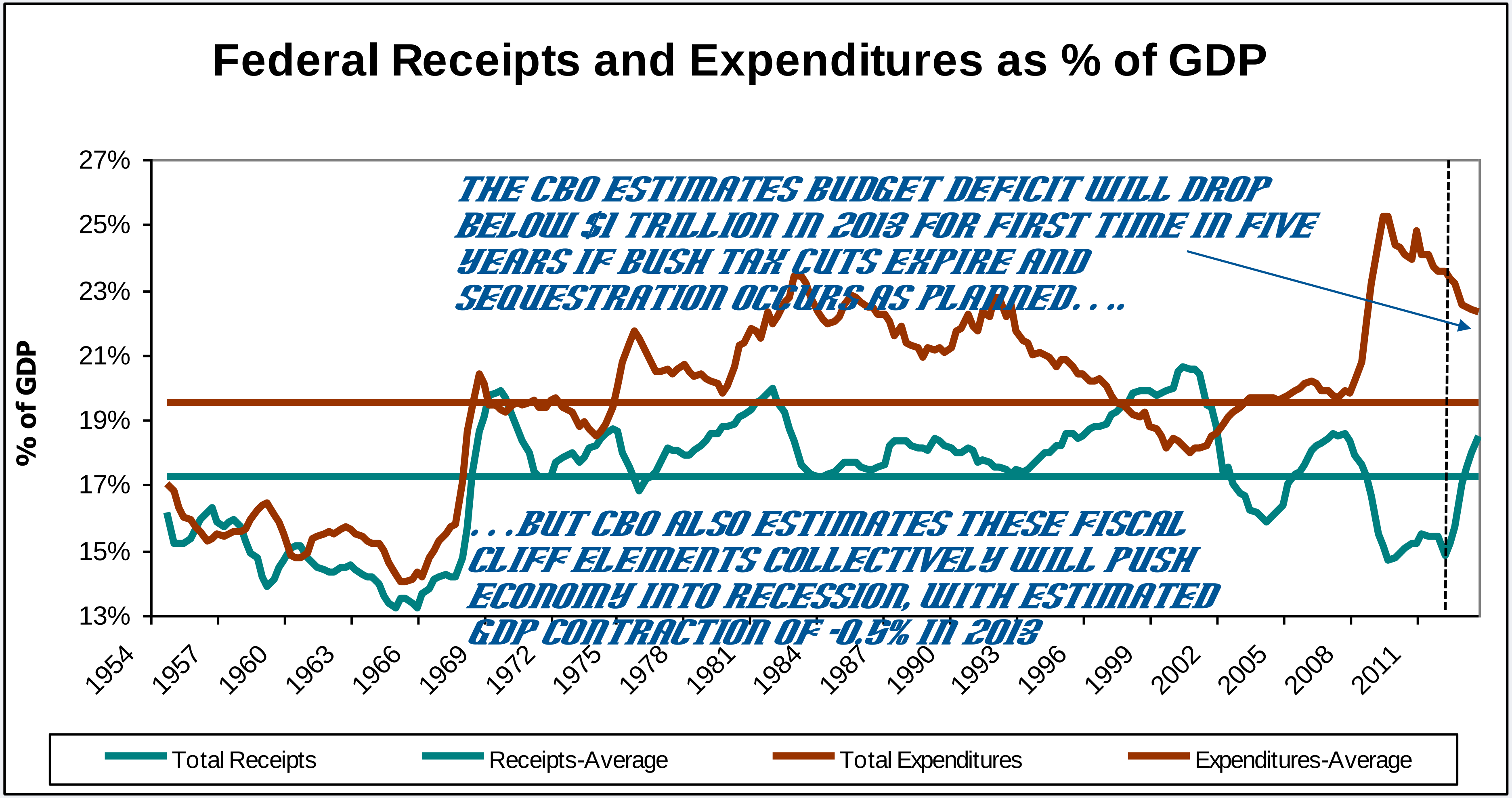
- Downside macroeconomic risks for 2013 have risen due to the year-end 2012 fiscal cliff
  - Scheduled end of payroll tax holiday and extended unemployment benefits
  - Expiration of Bush tax cuts
  - Sequestration (automatic government spending cut) measures

- The total impact of these measures amounts to roughly 4.5% of GDP

- Expiration of payroll tax holiday/extended unemployment benefits is likely, since neither political party is particularly supportive of extension

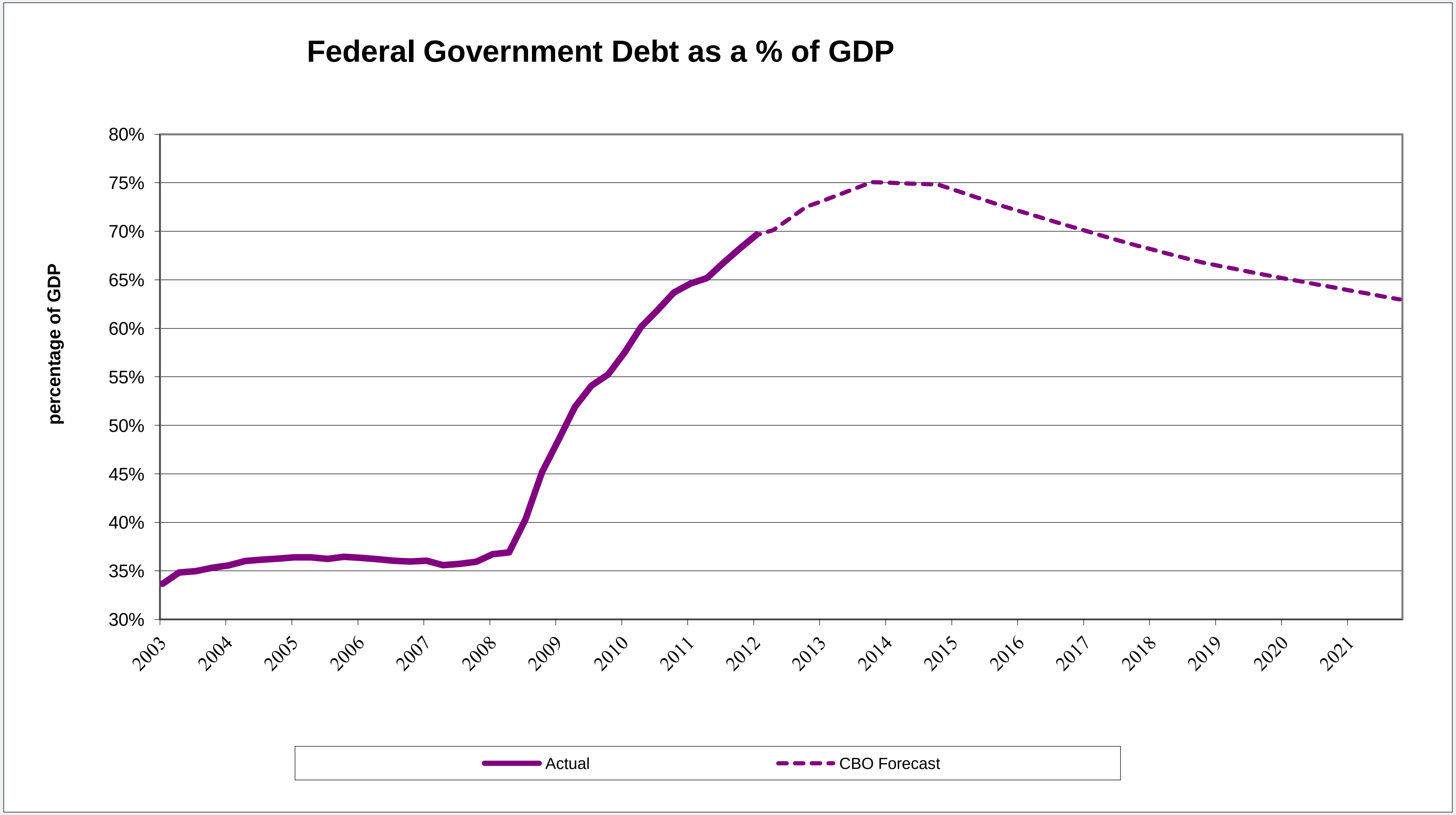
- Less certain is a) whether the Bush tax cuts will be amended and the federal government will delay sequestration and b) whether any such changes would be made by “lame duck” Congress or retroactively by new Congress

The Gap Closing Dilemma



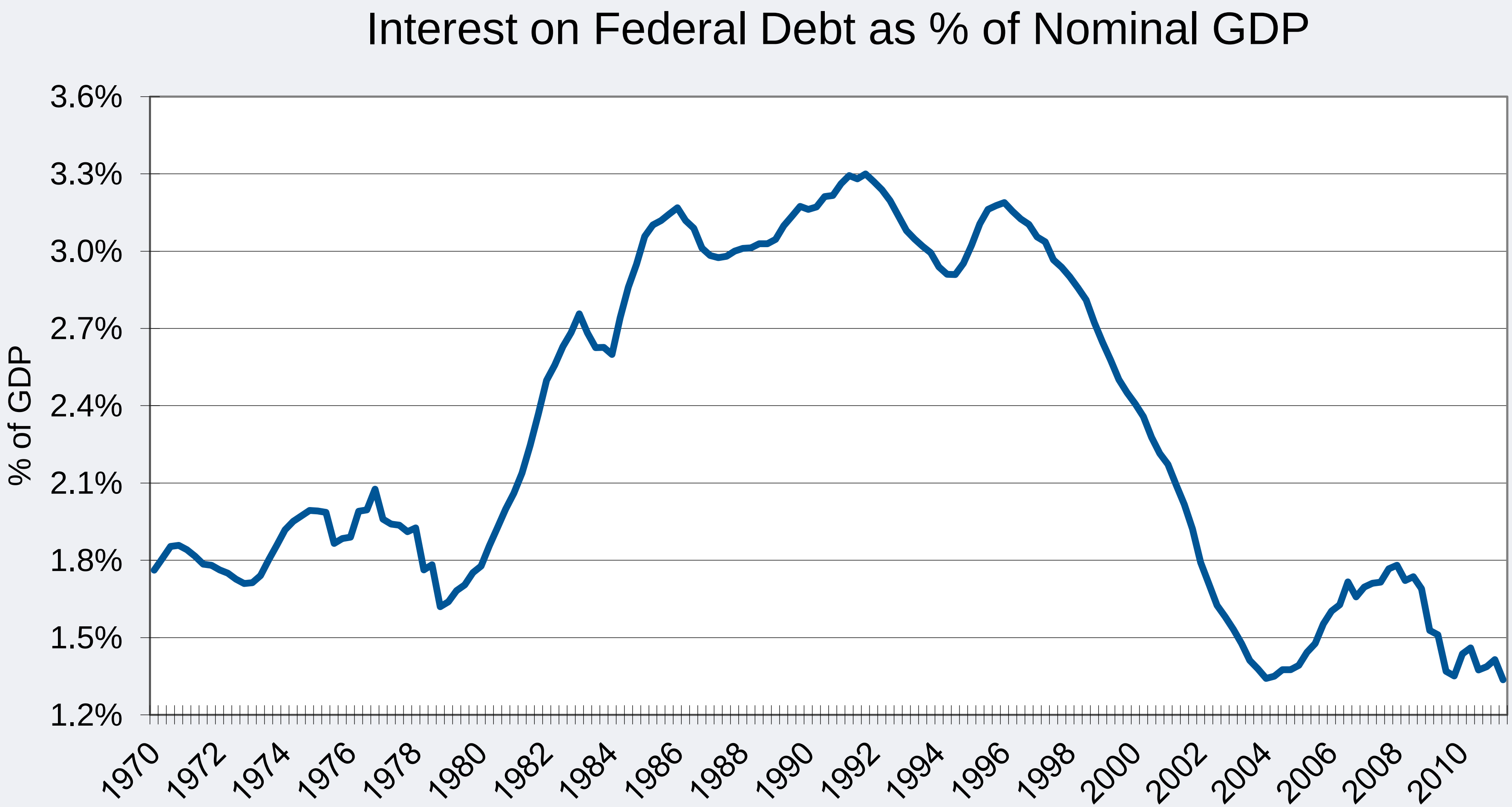
Sources: Bureau of Economic Analysis, US Treasury, Congressional Budget Office, August 2012

The Long Road to Government Deleveraging



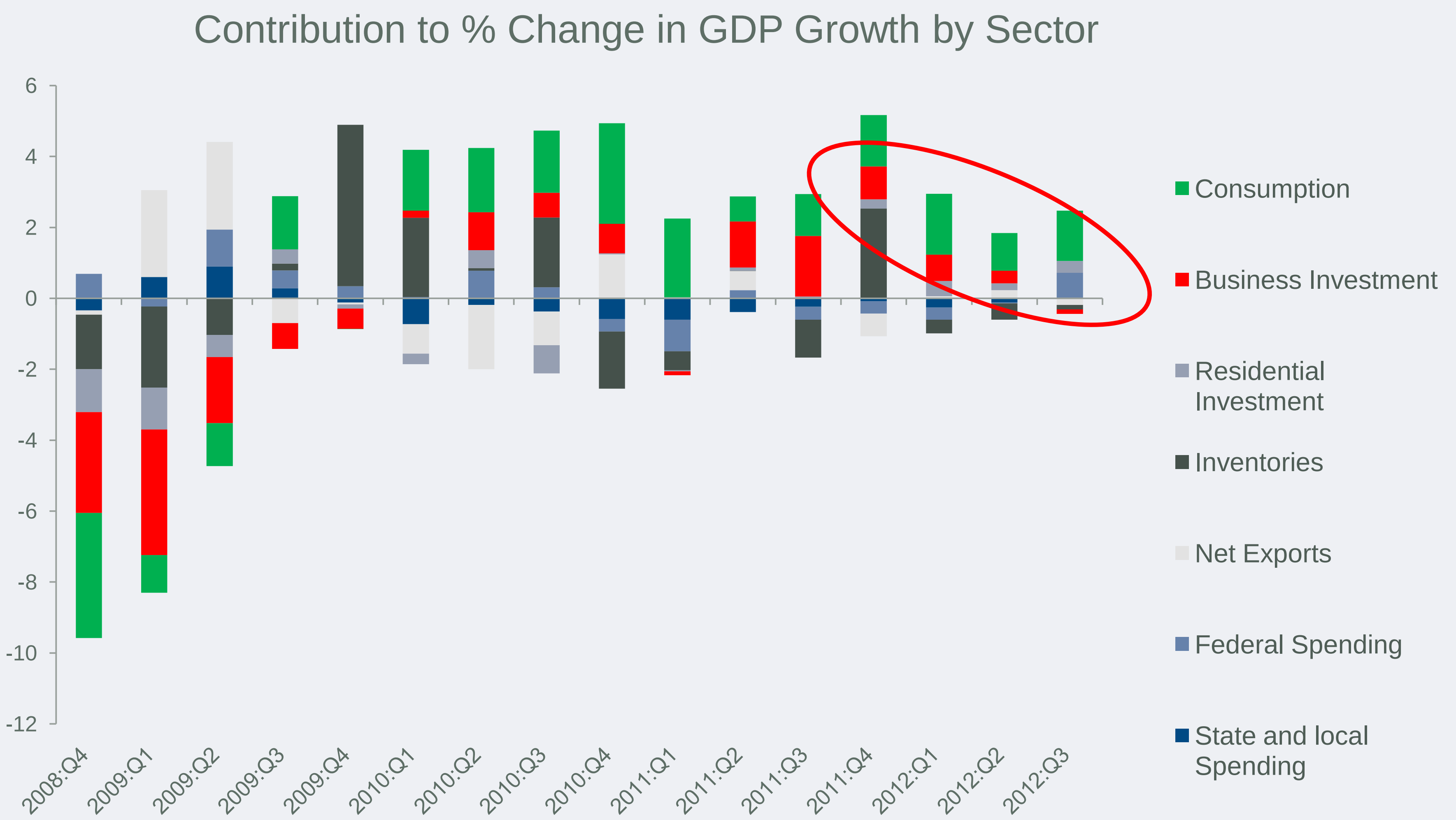
Source: Congressional Budget Office, Bureau of Economic Analysis, August 2012
Note: CBO Baseline which assumes fiscal cliff is left unaddressed

Low Interest Rates Reduce Government Cost of Servicing its Debt (and Sense of Urgency to Deleverage)



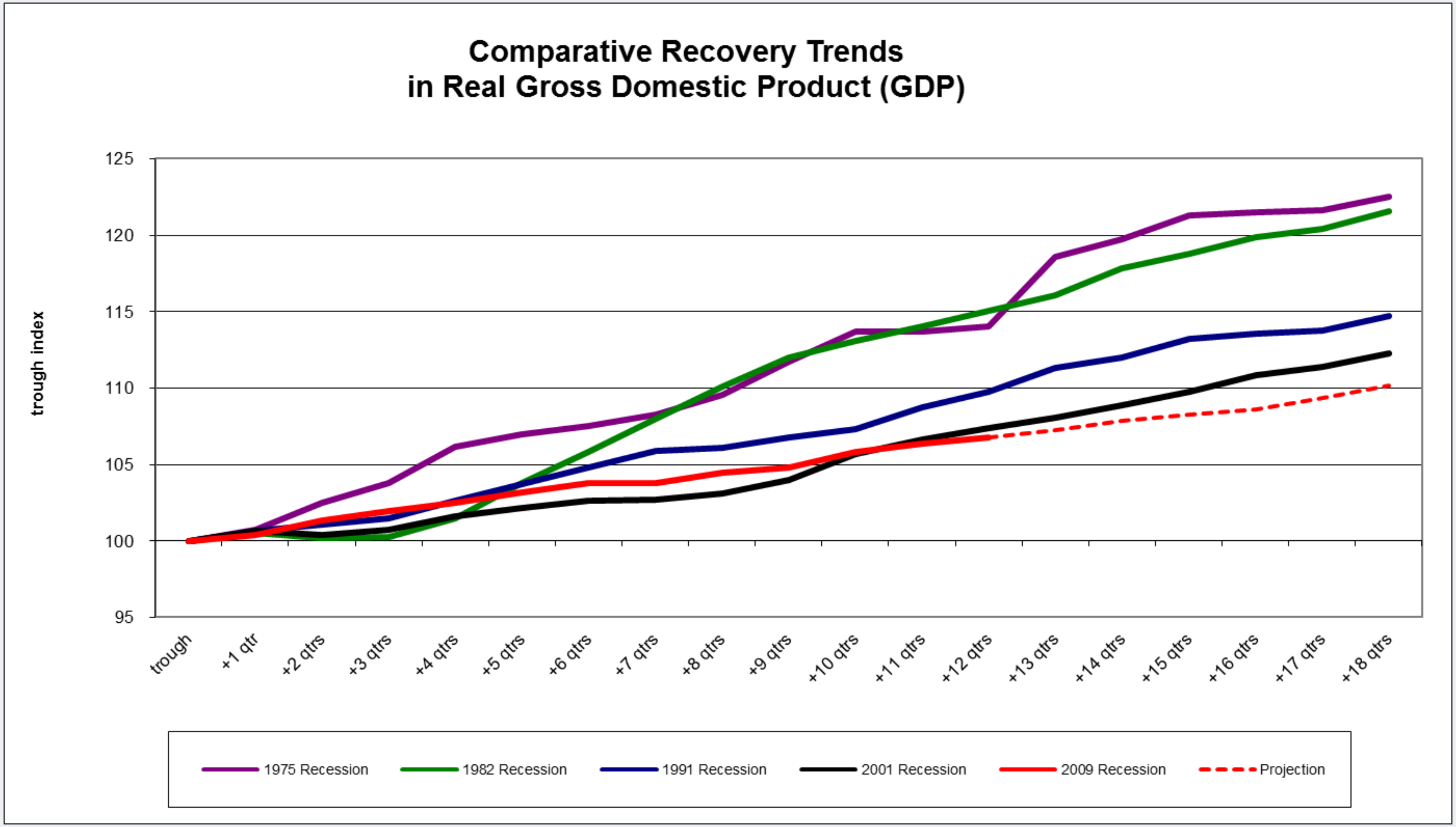
Sources: Bureau of Economic Analysis, U.S. Treasury, August 2012

Business Sector Wary of Fiscal Cliff



Sources: Bureau of Economic Analysis, October 2012

Drifting into Slowest Recovery in Past 40 Years

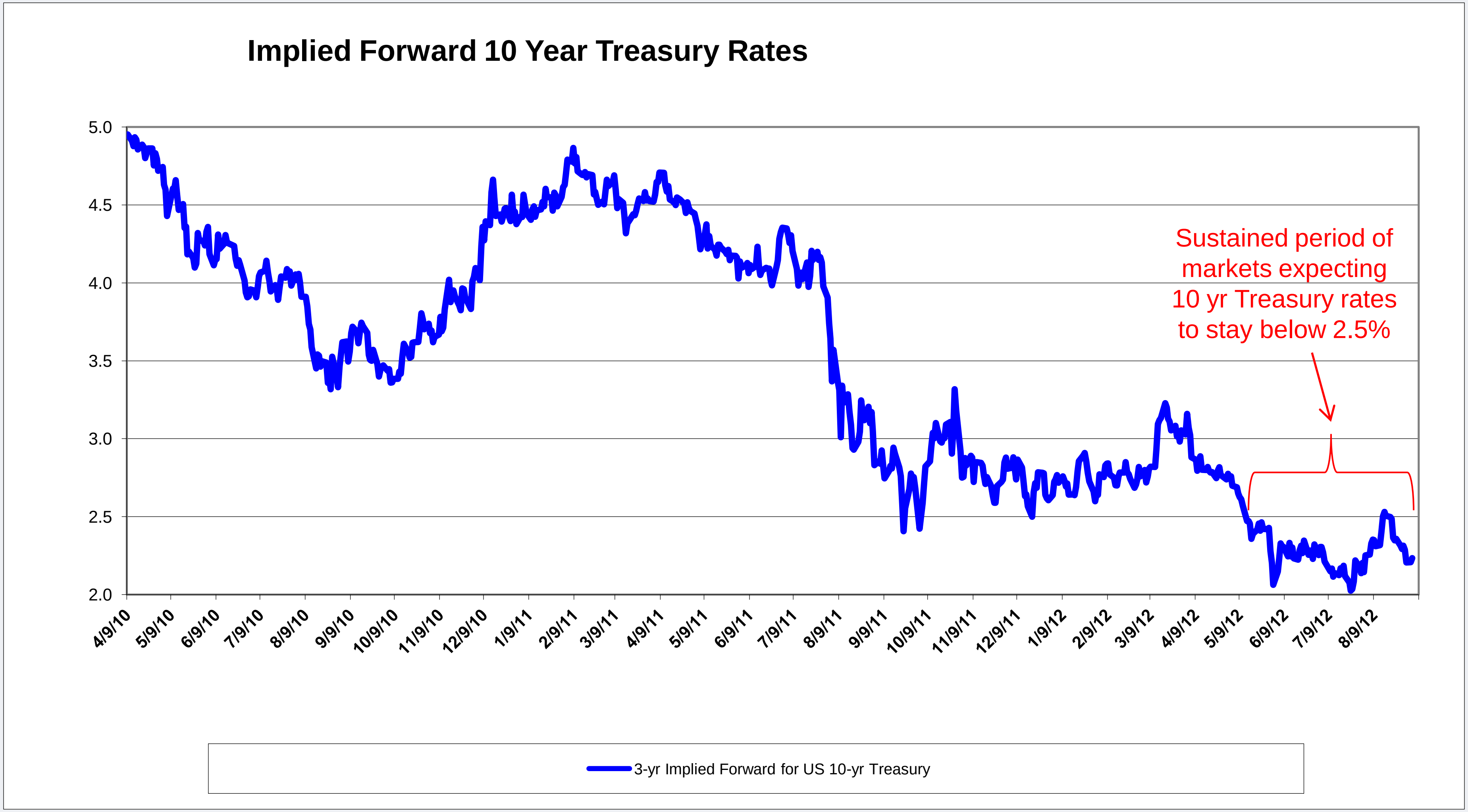


Sources: Bureau of Economic Analysis, Principal Global Investors, November 2012

U.S. Real Estate Space and Capital Markets

- Crosswinds
  - Capital markets tailwinds as investors seek yield-oriented asset classes like real estate
  - Space market headwinds (ex-multifamily) as global economy slows and weak small business sentiment impacts the pace of job formation
- Fiscal cliff, if left unaddressed, likely to exacerbate these trends
- Payroll employment barely back to 50% recovery of peak-to-trough loss --- and fiscal cliff setback would further delay recovery, possibly into 2017…
- …hurting those property types that are not yet at equilibrium by hampering net absorption and landlord pricing power
  - Multifamily space markets likely to be least impacted
  - Office, industrial, retail and hotel space markets more adversely impacted
- And Fed likely to maintain ultra-accommodative monetary policy for a year or two longer

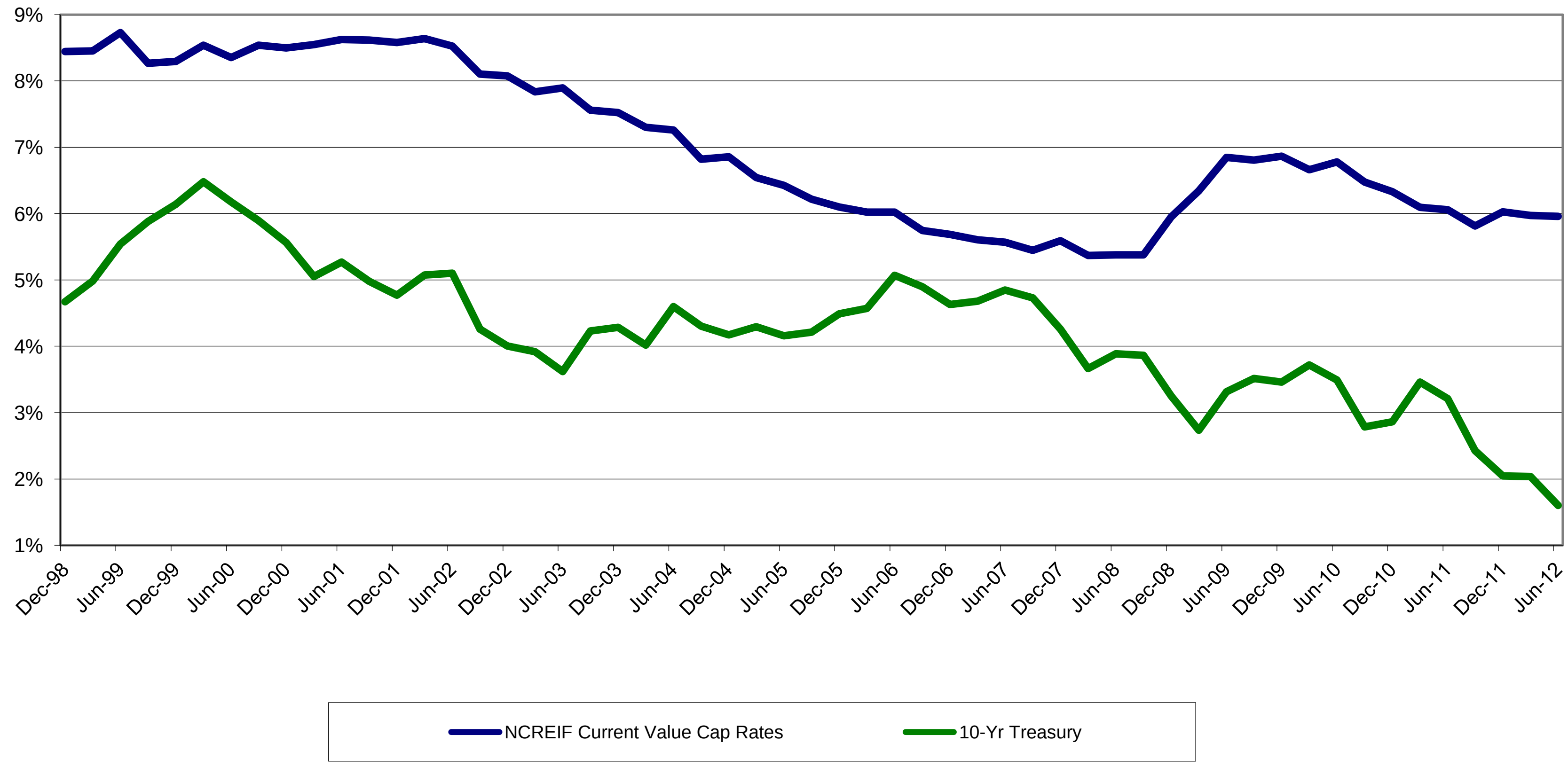
Market Expecting Low Rates to Last



Source: Bloomberg, September 2012

Even Lower Treasury Rates from Fiscal Cliff Could Support Further Cap Rate Compression

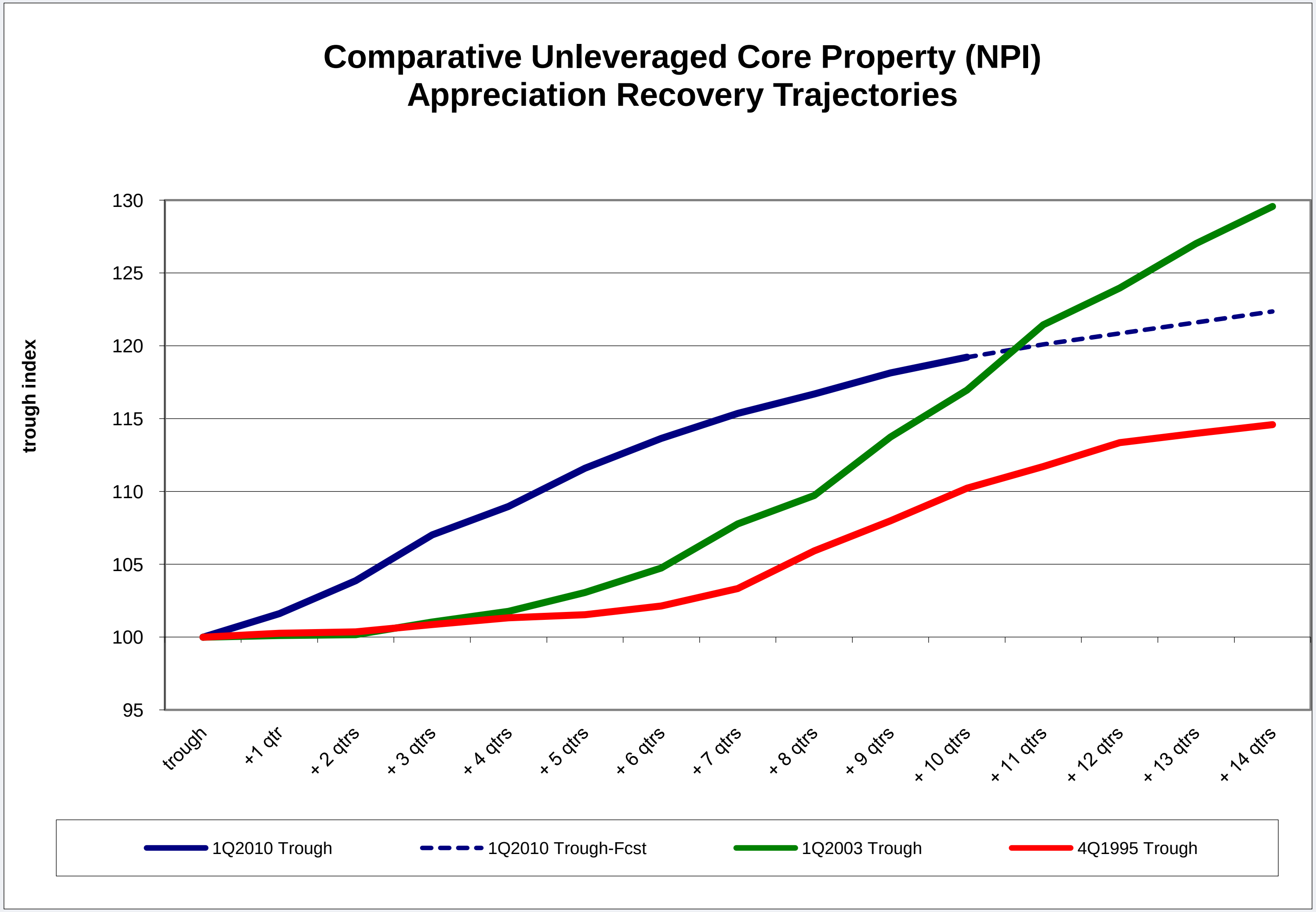
Cap Rate Spread to Treasury Rate



Sources: NCREIF, U.S. Treasury July 2012

Pace of Value Recovery is Slowing

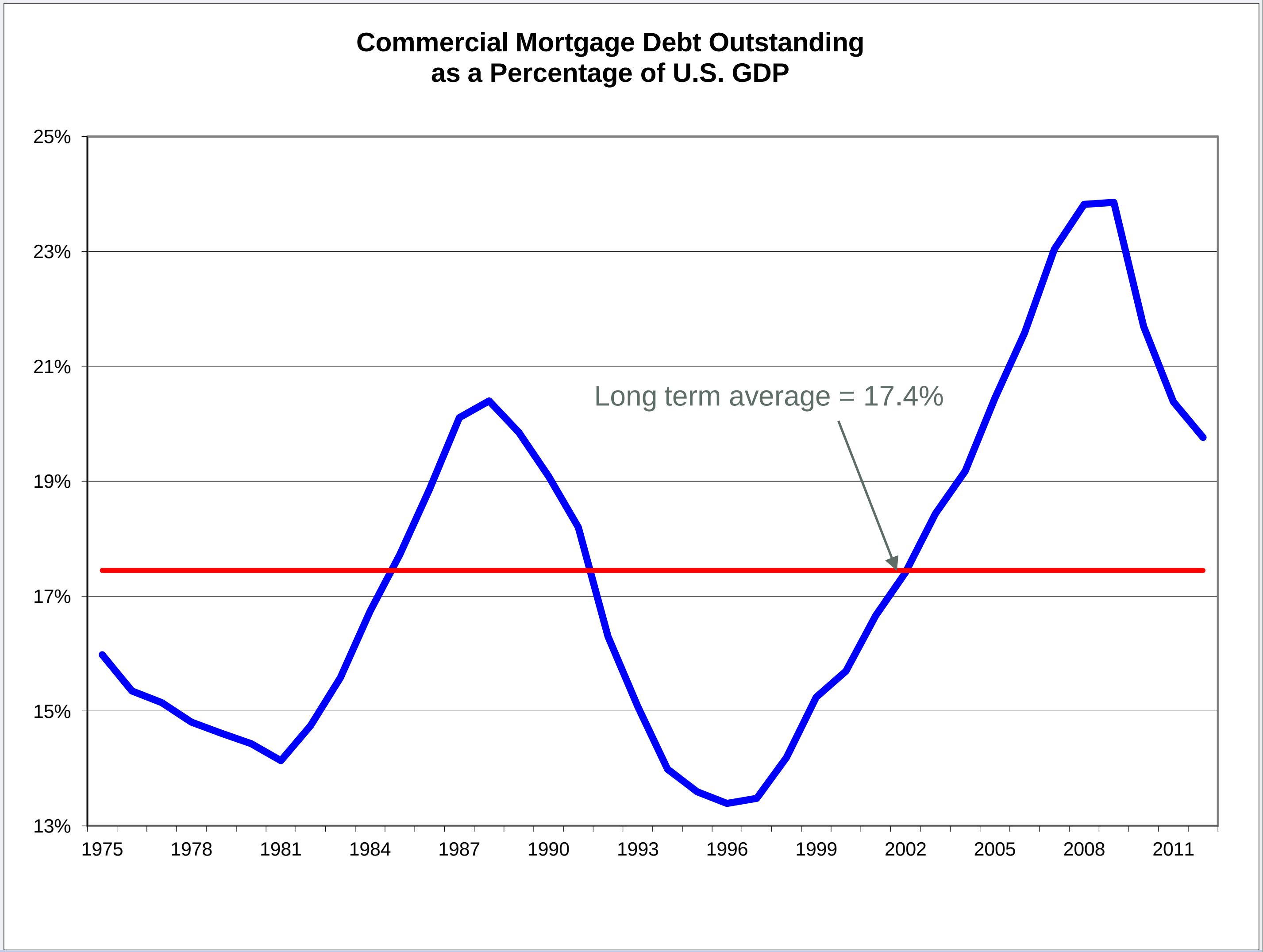
- Capital markets forces have thus far been primary driver of recovery in property values (NPI net appreciation up 19% over past 10 quarters)
- PREA surveys contain expectation that appreciation will continue, but at a slowing trajectory



Sources: NCREIF, PREA, October 2012

Deleveraging Well Underway

- Deleveraging underway, but leverage still well above long-term historical average
- And is still close to the peak level of the late 1980s S&L debacle, but less challenging to meet debt service today, given low interest rates
- Biggest risk is thus balloon default (as opposed to term default)



Sources: Bureau of Economic Analysis, Federal Reserve Flow of Funds, May 2012

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