September 6, 2012

Economics Group

Special Commentary

Mark Vitner, Senior Economist
mark.vitner@wellsfargo.com • (704) 383-5635
Anika Khan, Senior Economist
anika.khan@wellsfargo.com • (704) 715-0575

Commercial Real Estate Chartbook: Quarter 2

QE Twists Returns in Commercial Real Estate

With attention once again turning toward the prospects of additional quantitative easing by the Federal Reserve, this is a good time to look at what effect the Fed's past actions have had on the commercial real estate market. The huge mountain of commercial real estate loans maturing around the middle of the decade has been one of the motivating forces behind the Fed's monetary policy strategy, which has driven long-term interest rates down to historic lows and removed much of the near-term interest rate risk. Lower interest rates have also made it possible to refinance and restructure a larger proportion of maturing and potentially problematic loans maturing later in the decade. Moreover, the drop in Treasury yields has also pushed liquidity into other areas, including stocks and real estate. Furthermore, higher stock market valuations have allowed insurance companies and pension funds to allocate a larger portion of their investment portfolio to real estate. A healthier equity market has also made it easier for REITS to raise funds.

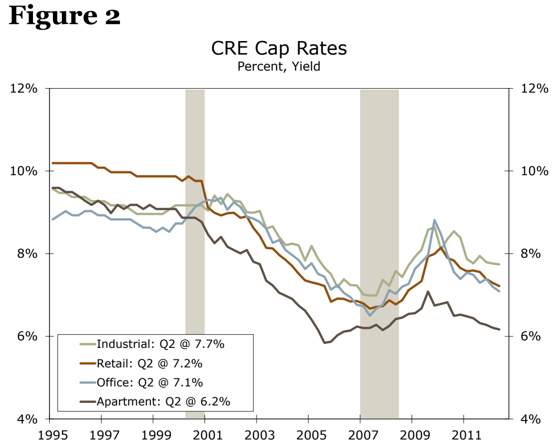
However, investors should remember that all magic comes with a price. Ben Bernanke outlined what he believed the costs of the Fed's asset purchase program have been and by his account they have been manageable. The yield curve has narrowed and inflation premiums, as measured by TIPS, have remained relatively low. This analysis misses one key point, which is the large increase in the demand for liquidity arising from the uncertainty surrounding the Fed's unprecedented policy moves. Investors' increased preference for liquidity has manifested in a number of ways, including significantly higher prices for assets with more certain cash flows. No cash flow is more certain than Treasuries, which means the Fed's measure of potential costs may be flawed.

The drive for liquidity is also affecting commercial real estate. Demand has soared for well-located properties with strong tenants in deep, liquid markets like New York and San Francisco. While that sounds perfectly logical, it means that the most significant gains in commercial real estate values have been limited to a relative handful of projects in a small number of markets.

Demand has soared for well located properties with strong tenants in deep, liquid market.

Figure 1

Figure 2



Source: IHS Global Insight, Real Capital Analytics and Wells Fargo Securities, LLC

Together we'll go far

This report is available on wellsfargo.com/economics and on Bloomberg WFEC

A Hit or Miss Recovery

Apartments have been the standout asset class so far in this recovery and demand from both renters and investors should remain strong for at least the next couple of years.

Apartments have been the standout asset class so far in this recovery, and demand from renters and investors should remain strong for at least the next couple of years. Nationwide, absorption has outpaced completions for the past nine quarters, which has pulled the vacancy rate down 3.3 percentage points to 4.7 percent and sent rents higher. Investor demand for apartments has nearly been insatiable, particularly for higher-end properties in technology hubs like Seattle, San Francisco, San Jose and Austin. Accessibility has been another key driver, particularly in major vehicle-dependent Sunbelt markets like Los Angeles, Dallas, Atlanta and Charlotte. Properties near key employment centers or assessable to viable transit links have been hot commodities and sold at huge premiums relative to suburban locations, where growth has largely remained tepid. New construction has largely followed this same pattern, with tech standouts like Seattle, Austin and San Francisco posting some of the largest gains over the past two years and a smattering of projects in other larger Sunbelt areas where job growth has turned, but there has been relatively little new development in most other areas.

The split nature of the apartment market typifies the overall commercial real estate recovery. Investors are paying up for solid but generally less risky returns, favoring large, established markets or are seeking out the best submarkets in rapidly growing metro areas driven by some sort of investable theme. In the industrial market, that theme has been growth in international trade, the resurgence of parts of the U.S. factory sector, and an even greater drive for efficiency in distributing consumer products. The primary beneficiaries have been large coastal markets near major container ports, including Los Angeles, the Inland Empire and Seattle on the West Coast, Houston on the Gulf Coast, and Central New Jersey and Philadelphia/Harrisburg on the East Coast. Demand for space and industrial properties has also picked up in key inland markets such as Chicago, Atlanta and Dallas. The slowing global economy and moderation in manufacturing activity may cool industrial demand somewhat in the second half of this year.

Improvement in the office market has been even spottier. Demand has picked up in a handful of West Coast markets, including San Francisco, San Jose, Seattle and Portland, driven by the social networking boom. Leasing has cooled off along the East Coast, where worries about the approaching fiscal cliff and cutbacks in financial services have restrained hiring. With the exception of energy-driven markets, like Houston, Dallas and Denver, most other major markets have seen less absorption in the first half of this year than was seen in 2011. Moreover, recent gains might actually be exaggerated by movements within the market by firms that are simply upgrading space. Despite modest gains in the fundamentals, investor demand for office properties remains fairly strong. While overall sales are down slightly from last year, nearly all the drop has been in Manhattan and Washington, D.C. Office sales have picked up in major tech centers, like San Francisco, Seattle and Portland, and also in the Central Business Districts of a handful of secondary markets, including Charlotte, San Diego and Minneapolis.

Figure 3

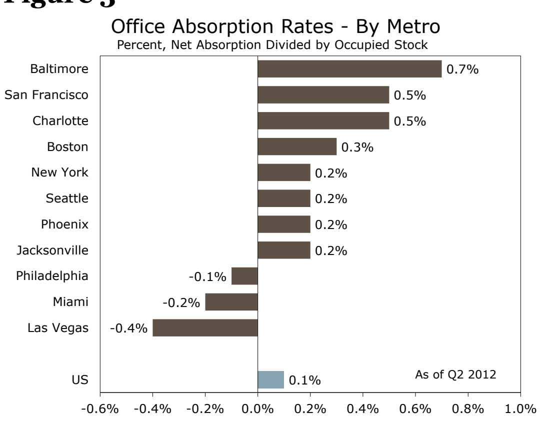
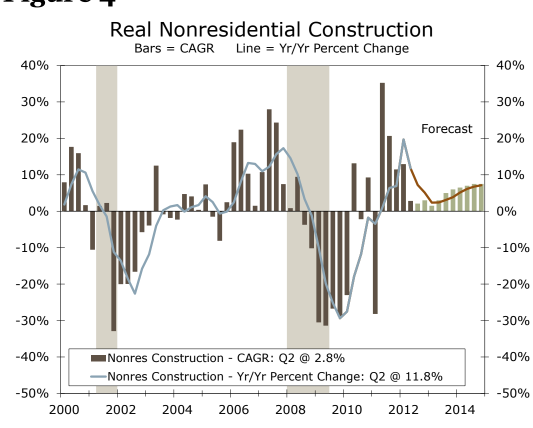


Figure 4

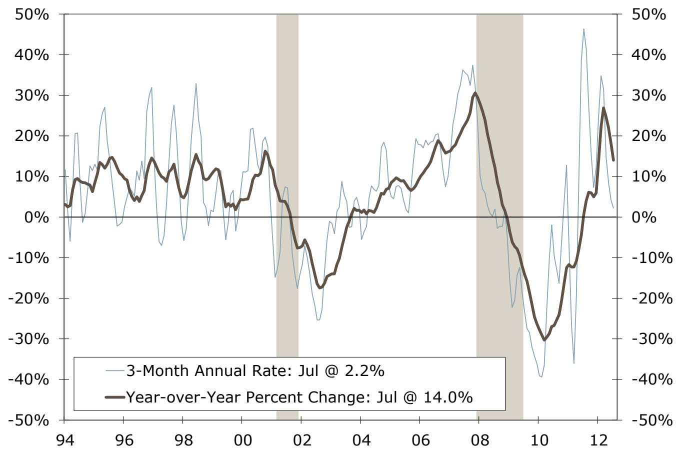


Source: Reis, Inc., U.S. Department of Commerce and Wells Fargo Securities, LLC

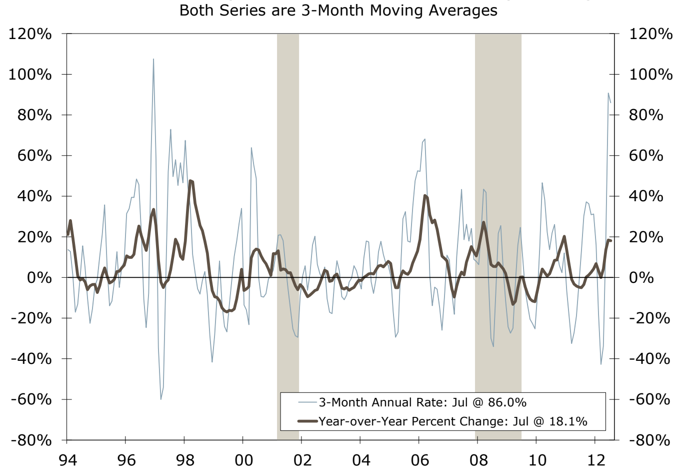
Nonresidential Construction Spending

- Nonresidential construction spending is improving with power outlays still shinning brightest. Much of the growth has been in wind and solar technologies, natural gas generating facilities and upgrades to existing plants, pipelines and transmission lines. Growth in manufacturing has moderated.
- Architectural billings, which have long provided clues to construction activity one year ahead, are now showing some weakness. Institutional billings, which include communication, healthcare, and transportation, have retreated back into negative territory suggesting slower growth ahead.
- Lower energy prices in Q2 gave builders a bit of a reprieve for some building materials. The recent increase in crude oil prices, however, will once again push material costs higher.

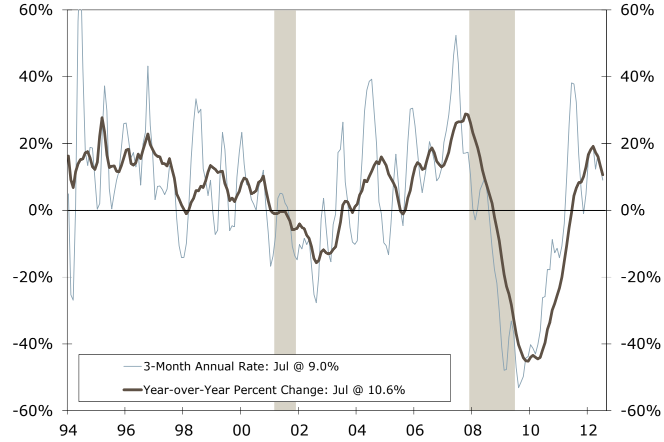
Private Nonresidential Construction Spending
Both Series are 3-Month Moving Averages



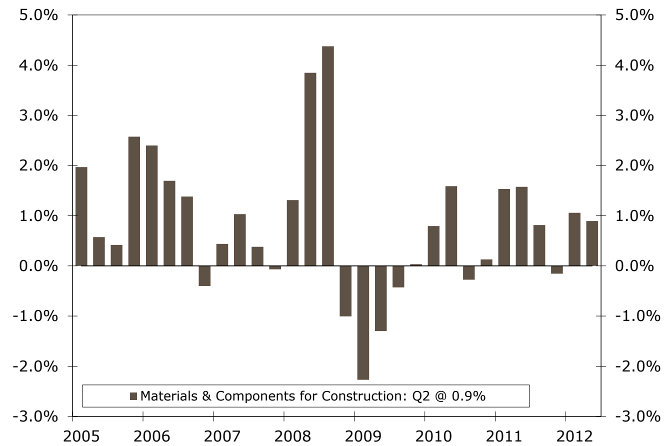
Private Transportation Construction Spending
Both Series are 3-Month Moving Averages



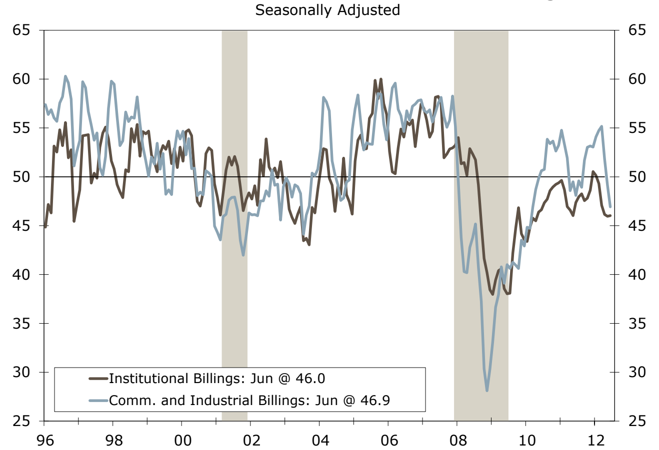
Priv. Commercial and Lodging Cons. Spending
Both Series are 3-Month Moving Averages



PPI: Materials & Components for Construction
Quarter-over-Quarter Percent Change



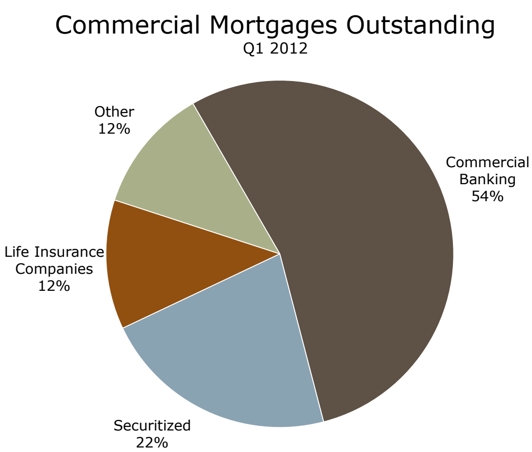
Institutional and C&I Architecture Billings
Seasonally Adjusted

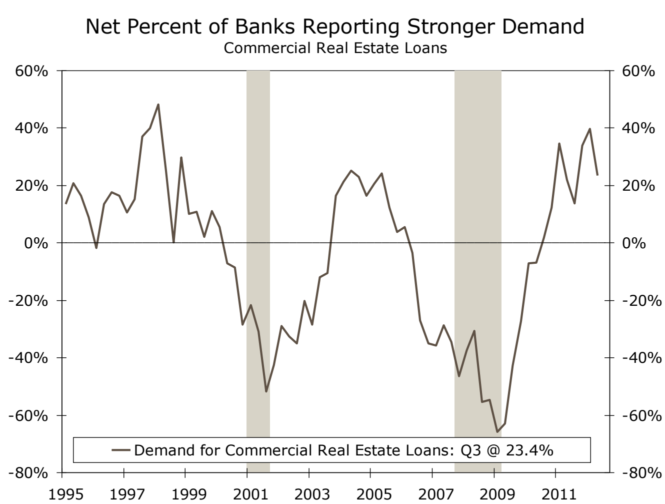


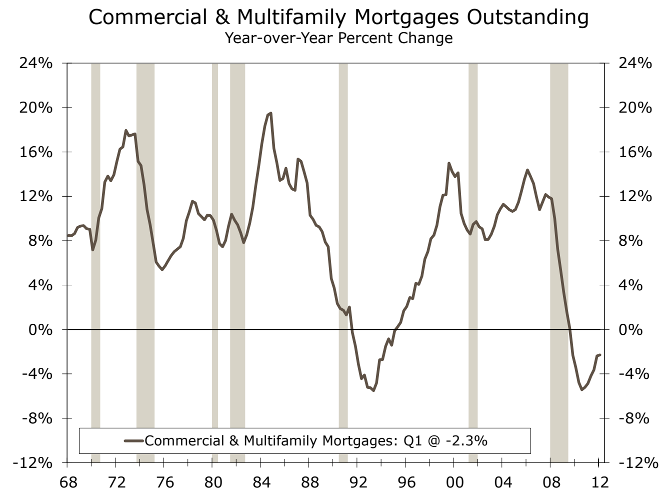
Source: American Institute of Architects, U.S. Dept. of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

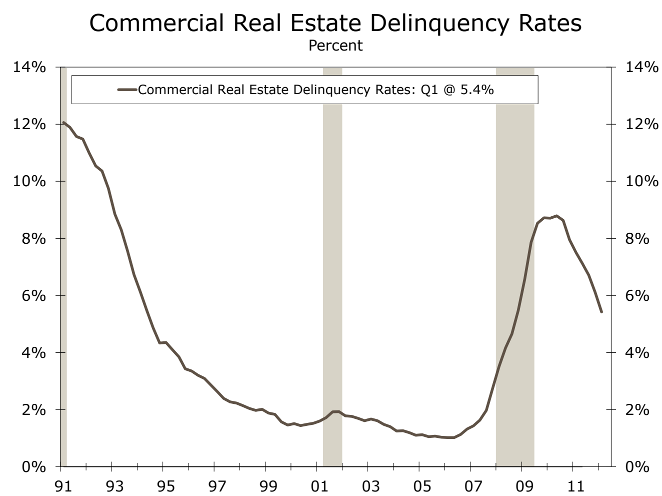
Commercial Mortgages Outstanding

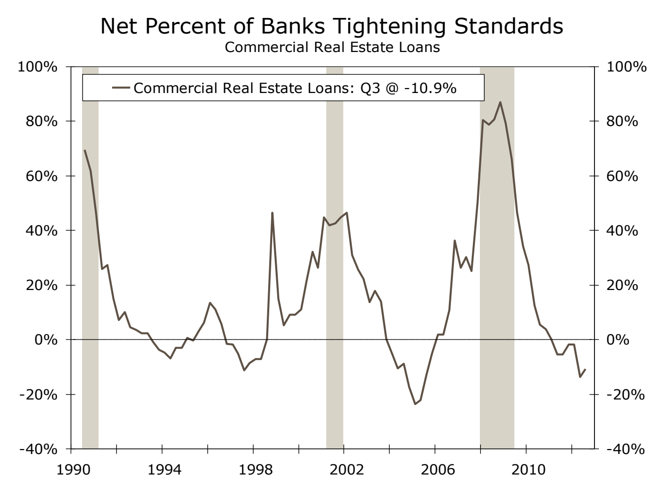
- Commercial/multifamily mortgage debt outstanding increased $8.1 billion in Q1 2012. Banks, GSEs and life insurance companies all increased their holdings of commercial and multifamily mortgages while securitized mortgages continued to decline.
- The latest Senior Loan Officer Survey showed a modest fraction of domestic banks reported having eased standards on CRE loans over the past three months, while a relatively sizeable fraction continued to indicate having experienced stronger demand for such loans.
- Commercial real estate delinquency rates including construction, land development, and multifamily loans continued to decline in Q1 and are now 3.4 percentage points lower than their peak.









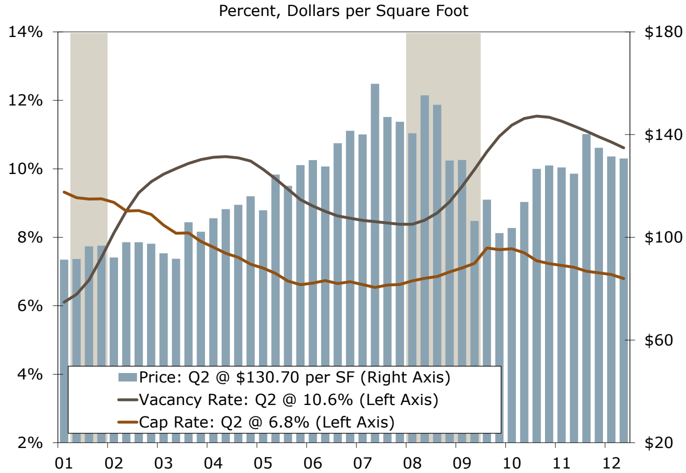


Source: Federal Reserve Board and Wells Fargo Securities, LLC

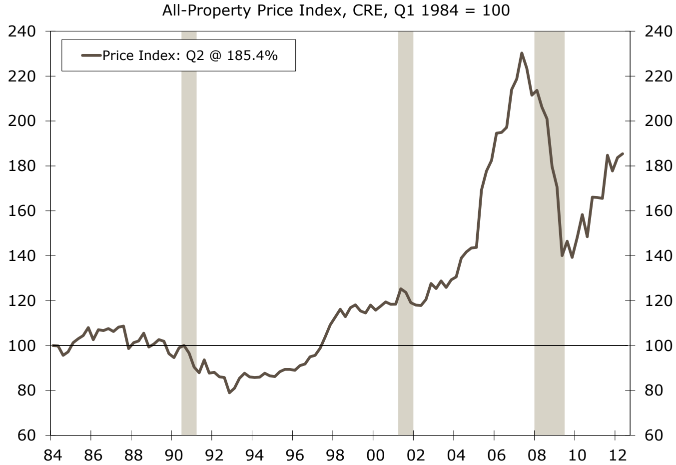
CRE Property Fundamentals

- Operating fundamentals for all major property types improved in the second quarter with demand for apartments and industrial remaining solid. The vacancy rate for apartments, retail and industrial trended lower in the second quarter, while office remained unchanged. The retail market is still struggling, however, with several big-box chains reporting disappointing earnings and a few chains electing to close underperforming stores.
- Sales for all property types totaled $108.8 billion involving 7,590 properties in the first half of the year. The increase in sales transactions, helped lower cap rates for all property types. Markets that continue to outperform across all property types include major technology markets such as Seattle, San Jose and Austin and major energy hubs.

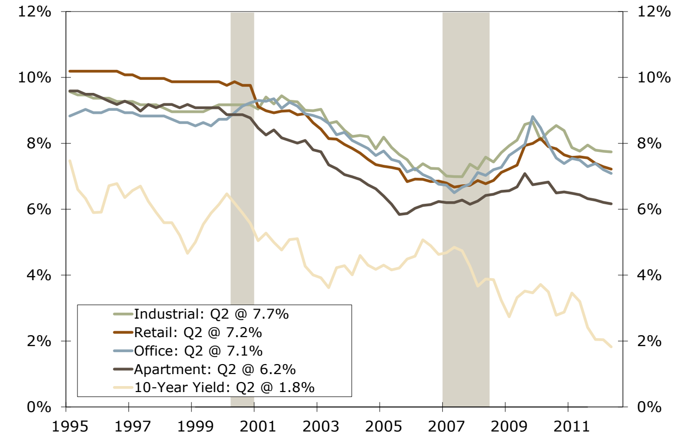
Commercial Real Estate
Percent, Dollars per Square Foot



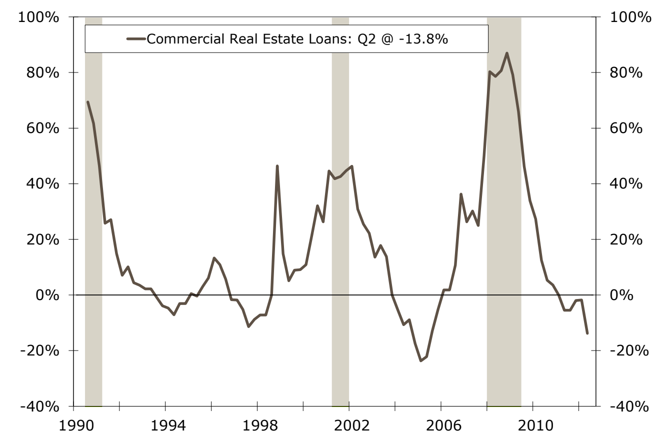
NCREIF Transactions-Based Index
All-Property Price Index, CRE, Q1 1984 = 100



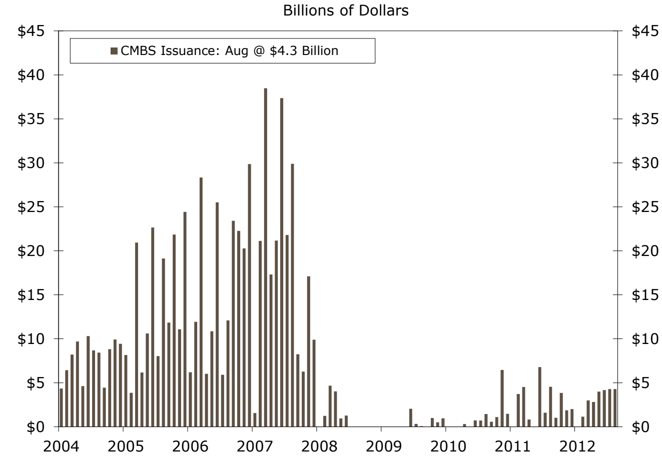
CRE Cap Rates vs. 10-Year Treasury Yields
Percent, Yield



Net Percent of Banks Tightening Standards
Commercial Real Estate Loans



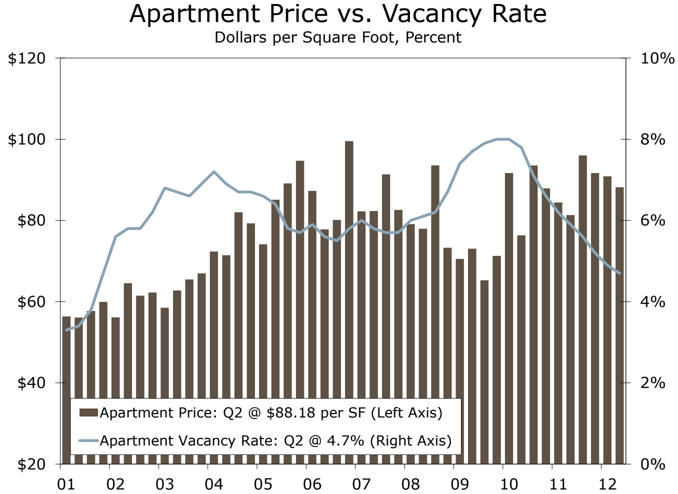
U.S. CMBS Issuance
Billions of Dollars

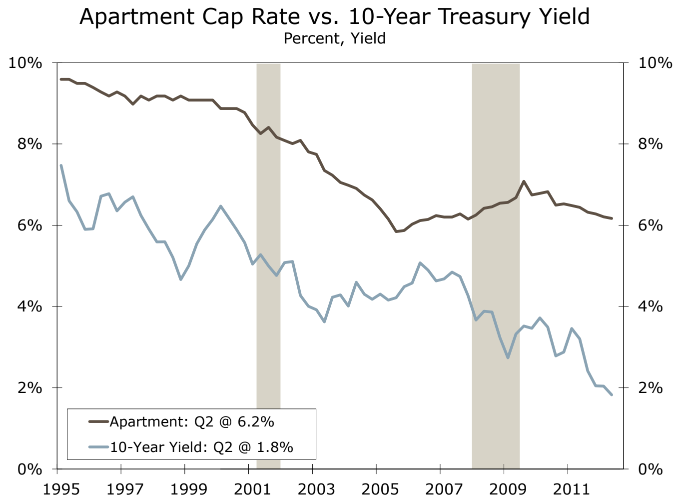


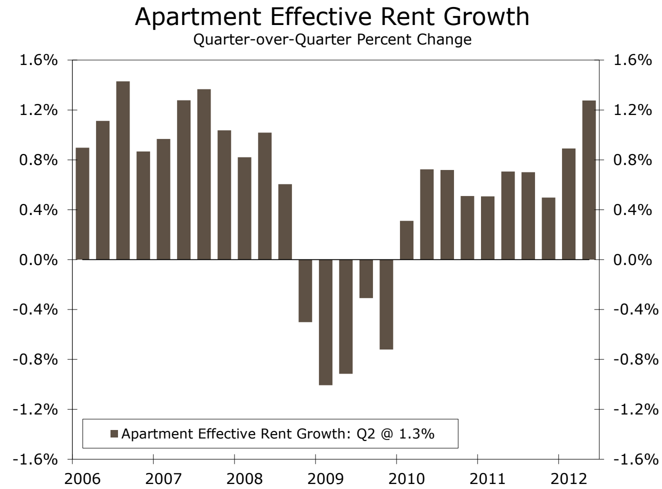
Source: Federal Reserve Board, PPR, RCA, Reis, Inc., NCREIF, IHS Global Insight and Wells Fargo Securities, LLC

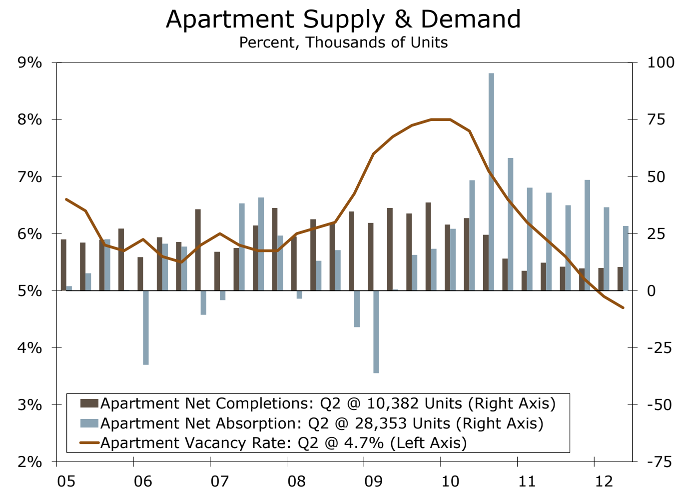
Apartments

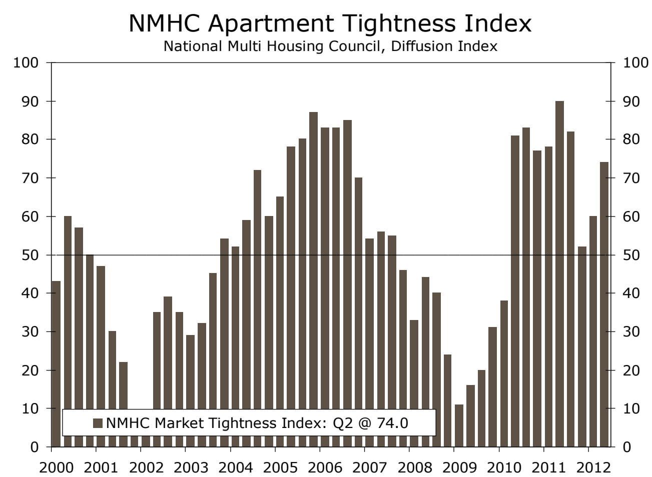
- Demand for apartments remains exceptionally strong across most of the country. Apartment vacancy rates are now the lowest they have been in a more than a decade at 4.7 percent and the low level of completions means rent growth will remain strong. Moreover, landlords are less inclined to offer concessions and continue to raise asking rents to boost revenue. The pace of completions is beginning to pick up, however, as developers continue to ramp up construction activity to meet the growing apartment demand.
- According to RCA, developers acquired more than $2 billion of significant multifamily development sites in the first half of 2012, almost double the volume of last year. At this point in the cycle, developers are concentrating on core locations.







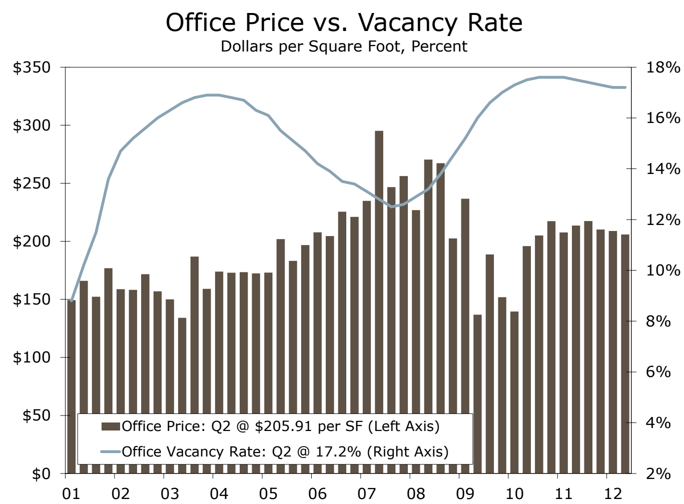


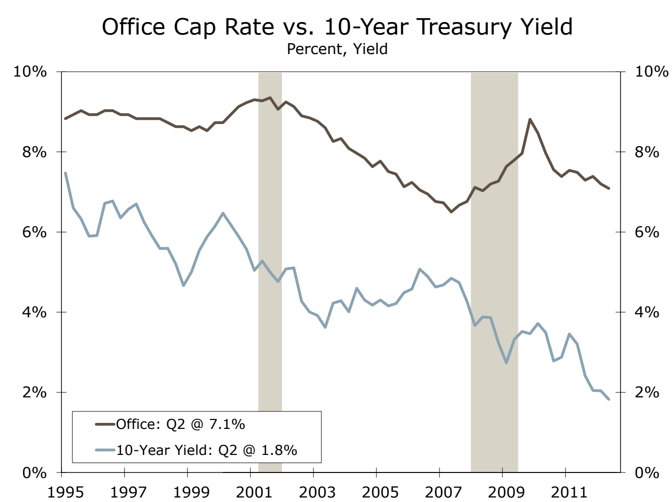


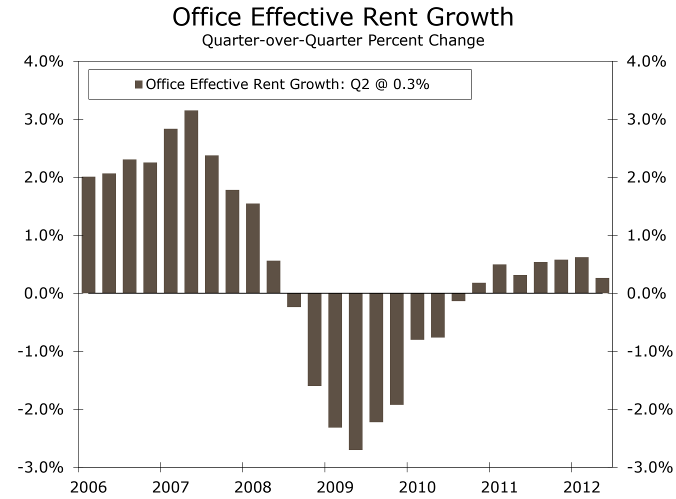
Source: IHS Global Insight, NMHC, Reis, Inc. and Wells Fargo Securities, LLC

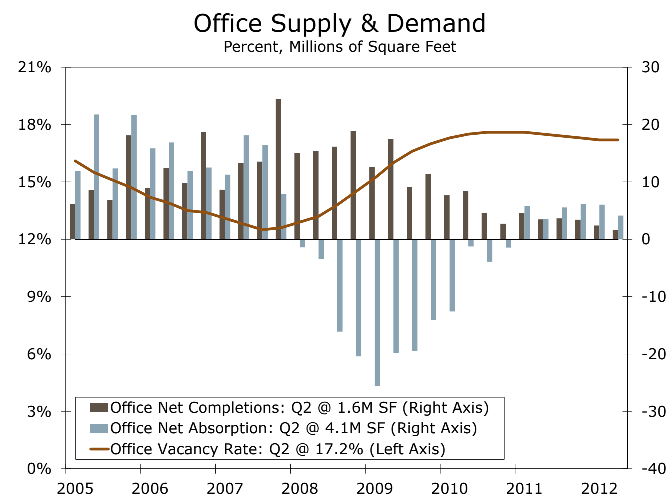
Office

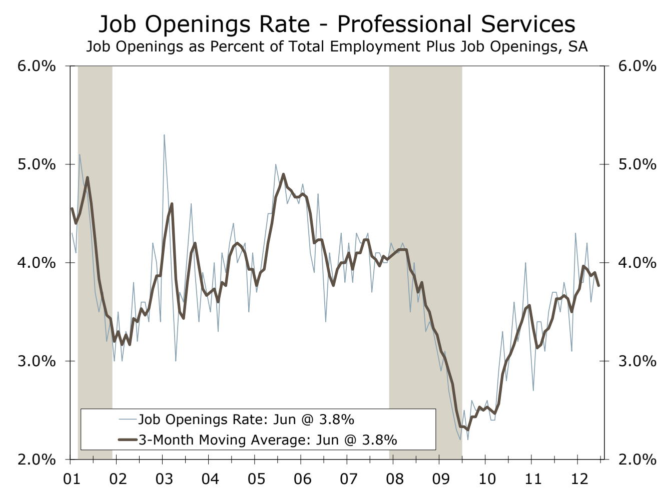
- Despite an elevated vacancy rate, office markets are showing improvement. Net absorption has risen in each of the past six quarters, but demand has not been sufficient enough to increase rent in a meaningful way. By most measures, growth is modest by past standards. Leasing activity trended higher in the second quarter with much of the activity concentrated in the energy and technology areas. The pace will likely slow in coming quarters as many tenants signed longer-term leases as far out as 2016. Tenants in the market for office space continue to trade up into newer Class A properties.
- Transaction volume increased in the second quarter to $14.8 billion, but is down 10 percent on a year-ago basis. Impending mortgage maturities continue to drive a significant amount of sales.







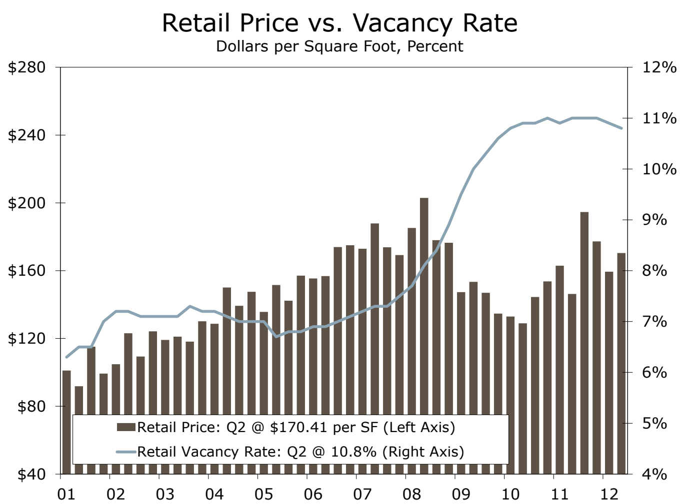


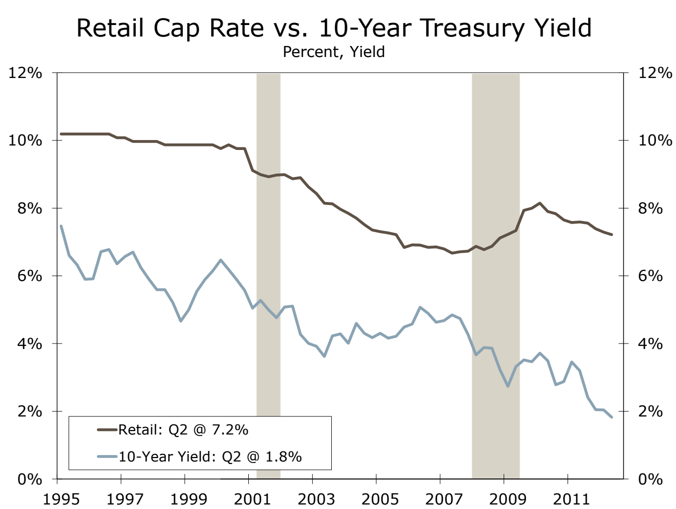


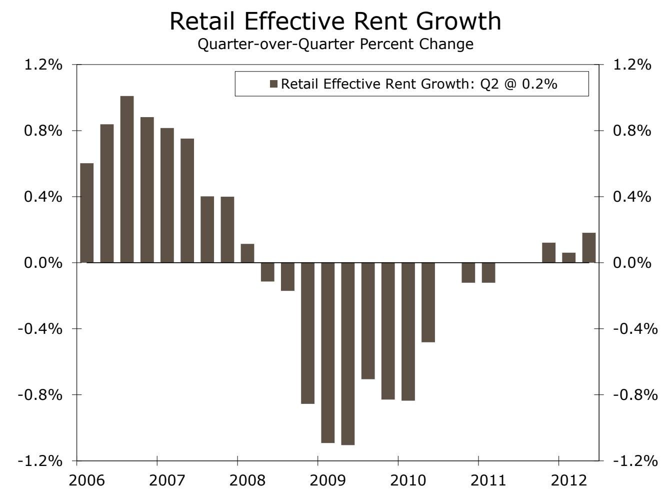
Source: IHS Global Insight, Real Capital Analytics, Reis, Inc, U.S. Department of Labor and Wells Fargo Securities, LLC

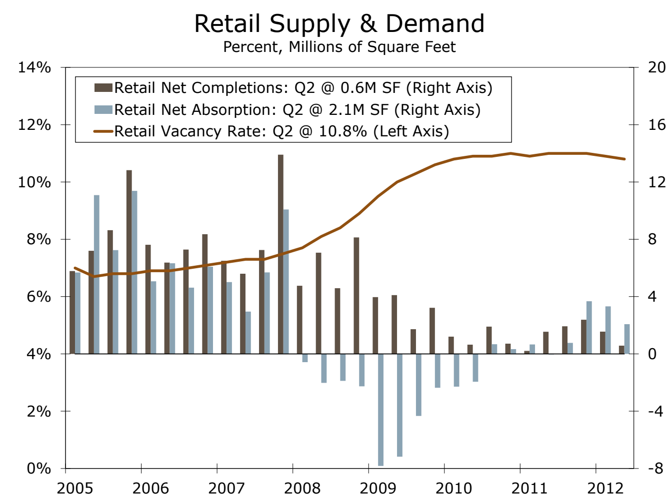
Retail

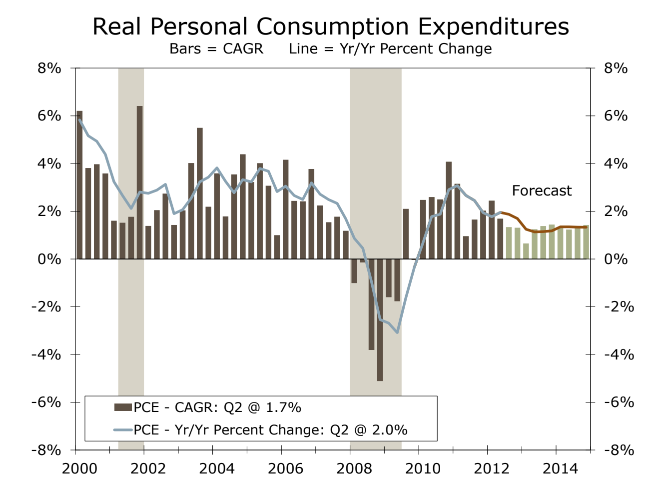
- The retail recovery is underway, but the momentum is tenuous. Modest consumer spending growth and the growing market share shifting to E-commerce are contributing to the slower pace of growth. Regional malls are doing surprisingly well with many developing a sustainable competitive strategy to deal with online competitors.
- Big-box retailers like Kmart, Sears, Best Buy, the Gap and Office Max, are closing underperforming stores, as they have effectively become show rooms for future online purchases.
- Retail property prices, as measured by the Moody's/ Real CPPI, reflect only a modest increase this year. Retail prices are being weighed down by the liquidation of distressed assets.







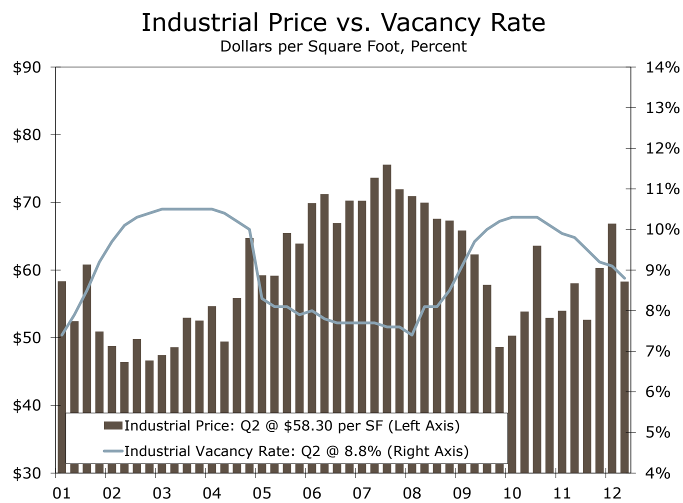


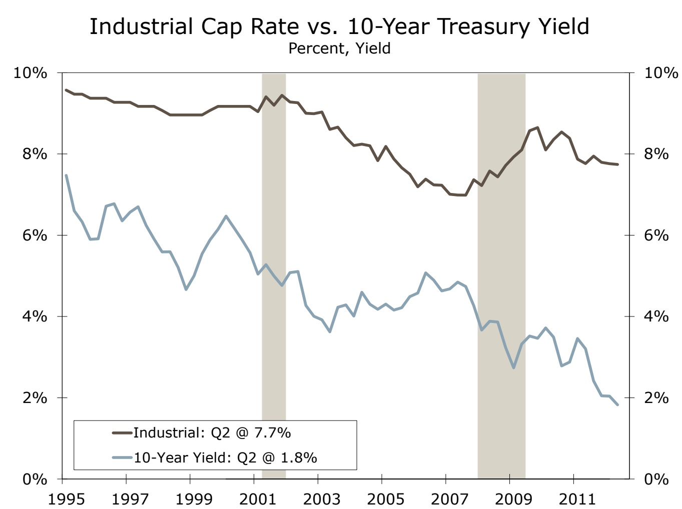


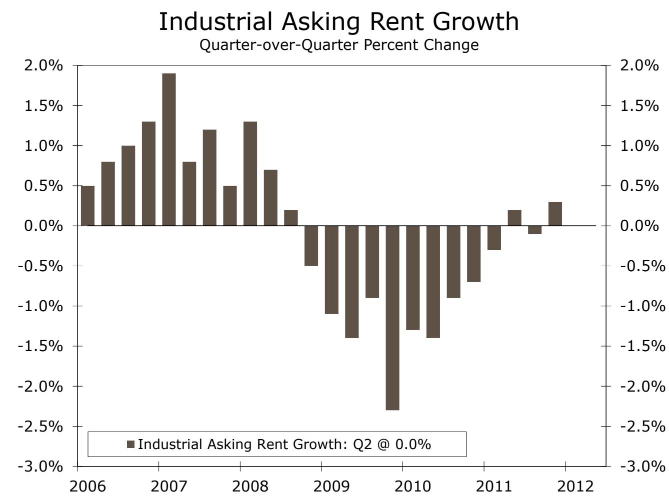
Source: IHS Global Insight, Real Capital Analytics, Reis, Inc, U.S. Department of Commerce and Wells Fargo Securities, LLC

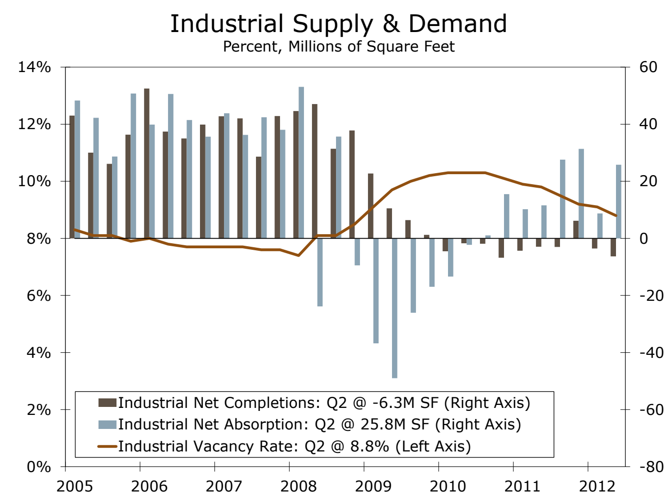
Industrial

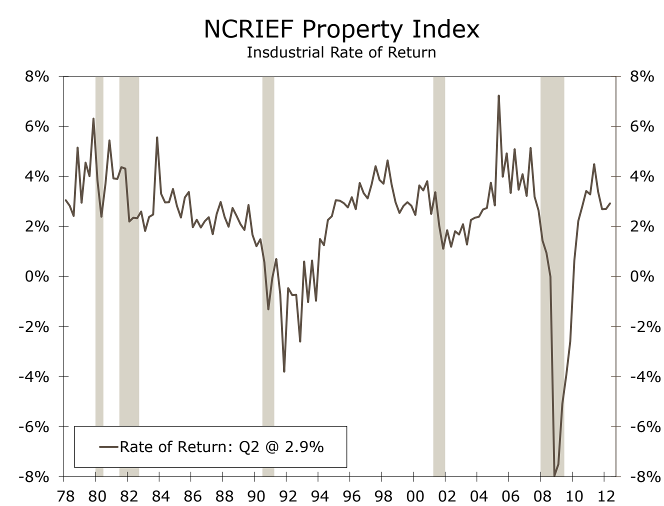
- According to RCA, industrial sales totaled $14.2 billion in the first half of the year, which was down 26 percent from the same period last year. Much of the weakness can be attributed to a decline in warehouse transactions, while flex-space transactions surged. Volume for single-tenant properties inched higher and data centers and R&D also increased. Tenants continue to upgrade to Class A space, but the supply is limited. Low interest rates and limited Class A industrial space for sales should continue to drive cap rates lower. Based on the NCREIF Property Index, industrial real estate returns increased 2.92 percent in the second quarter-the second consecutive quarterly increase. Overall activity should slow in the coming quarters due to the slowdown in manufacturing and trade.









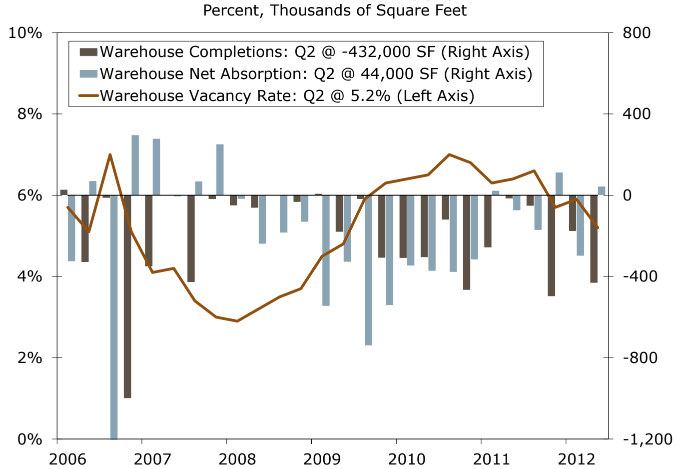


Source: PPR, Real Capital Analytics, NCRIEF and Wells Fargo Securities, LLC

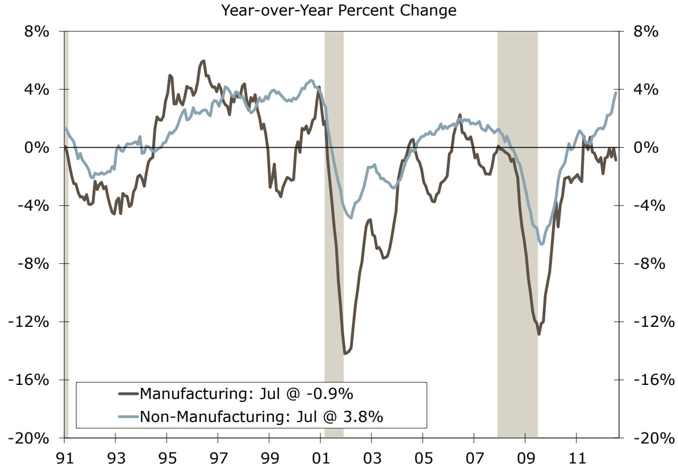
Regional Office Market Overview

- Office demand is sluggish, but areas benefitting from growth in technology and energy production are showing the most improvement. Seven of the top ten markets in these sectors have the strongest rent growth – San Francisco, San Jose, Boston, Austin, Seattle, Denver and Houston. Growth in hand-held computing devices and social networking is driving the biggest office-leasing boom since the dot.com era in Silicon Valley and San Francisco.
- Prices for office properties in Boston, Chicago, DC, Los Angeles, New York and San Francisco continue to rise at a faster rate than in other markets. Cap rates in these major metros also continue to compress, but sales activity is modest. The moderation in sales along with improvement prices suggests a lack of offerings.

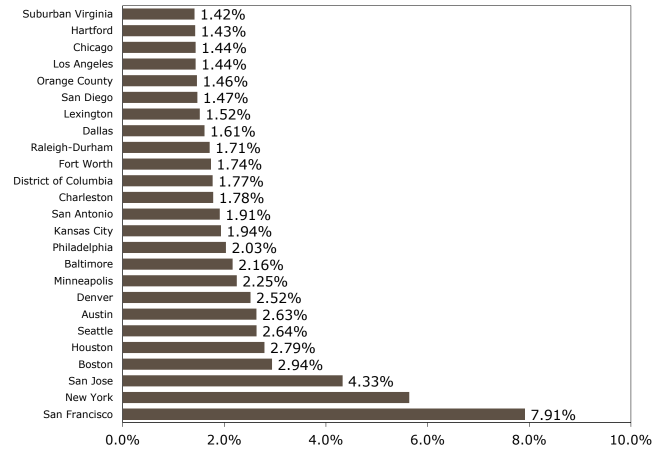
San Francisco Warehouse Supply & Demand
Percent, Thousands of Square Feet



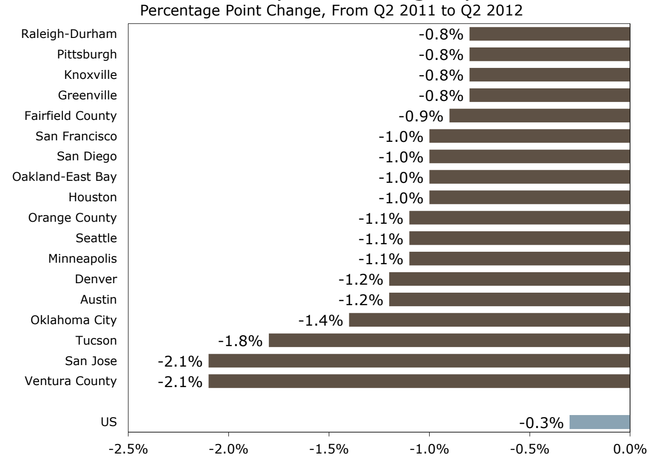
San Francisco MSA Employment
Year-over-Year Percent Change



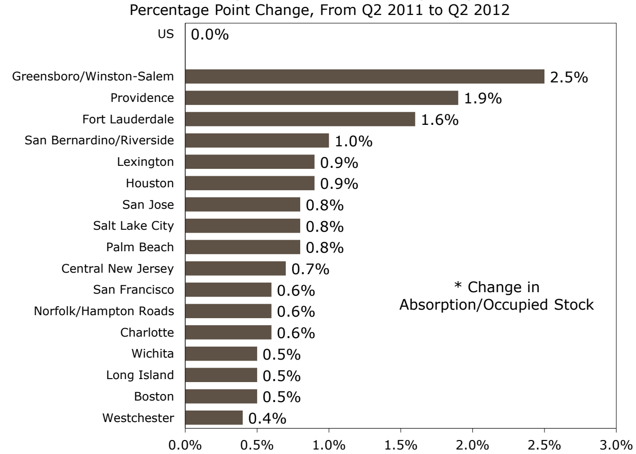
Office Effective Rent Growth by Metro
Year over Year Percent Change, From Q2 2011 to Q2 2012



Office Vacancy Rate Change by Metro
Percentage Point Change, From Q2 2011 to Q2 2012



Office Absorption Rate Change by Metro
Percentage Point Change, From Q2 2011 to Q2 2012



Source: Reis, Inc., U.S. Department of Labor, PPR and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 715-0314	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Senior Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Tim Quinlan	Economist	(704) 374-4407	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 715-0569	michael.a.brown@wellsfargo.com
Sarah Watt	Economic Analyst	(704) 374-7142	sarah.watt@wellsfargo.com
Kaylyn Swankoski	Economic Analyst	(704) 715-0526	kaylyn.swankoski@wellsfargo.com
Peg Gavin	Executive Assistant	(704) 383-9613	peg.gavin@wellsfargo.com
Cyndi Flowe	Administrative Assistant	(704) 715-3985	cyndi.h.flowe@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Advisors, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2012 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Services Authority. The content of this report has been approved by WFSIL a regulated person under the Act. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. The FSA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, not will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients. This document and any other materials accompanying this document (collectively, the "Materials") are provided for general informational purposes only.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

WELLS FARGO SECURITIES