

Interest Rates - How Much Higher?

Since the beginning of 2006, interest rates have moved sharply higher, with both long- and short-term yields climbing by 70 to 80 basis points. Higher interest rates have increased real estate borrowing costs and have the potential to negatively impact valuations through higher cap rates. Investors, developers and lenders are all concerned about the prospect for even higher rates ahead.

Based on our analysis of recent and long-term trends, including the likelihood of various interest rate movements, we expect interest rates to head moderately higher during the next 6 to 12 months. We believe the Fed is nearing the end of its interest rate hikes, causing short-term rates to level off in the near term. Long-term yields will likely increase by another 20 to 50 basis points, putting the 10-Year Treasury yield in the 5.3% to 5.6% range.

Recent Trends

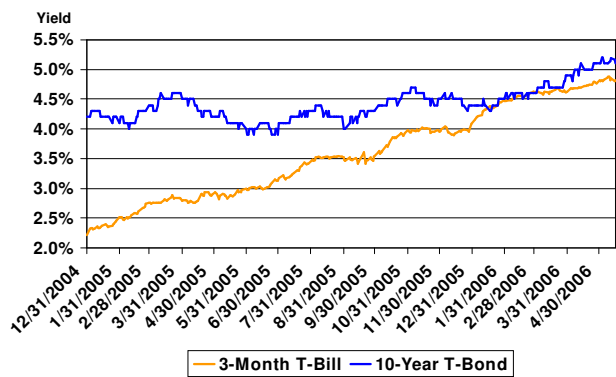
The recent increases highlight two different patterns for short- and long-term rates: short-term rates have been steadily increasing since mid-2004, while long-term rates have broken out of the 4.0% to 4.5% trading range that prevailed during most of 2004 and 2005. Fears of higher inflation, driven by energy prices, have been the main impetus behind the recent increases in both short- and long-term rates. The Federal Reserve's steady increases in the federal funds rate have provided the underpinning for higher short-term rates, while the bond market resisted higher long-term rates until the end of January, when long-term rates began their move up from 4.4%.

Currently, the yield curve is flat, with only a 30 basis point difference between 3-Month and 10-Year Treasury yields. To some extent, the narrow spread represents a clash of perspectives on inflation: the Fed's concern with recent price trends and the bond market's perspective that long-term inflation will be muted. Of the 80 basis point increase in 10-Year yields since 2005, only 20 basis points of the increase is due to an increase in expected long-term inflation, with the remaining 60 basis points accounted for by higher real yields.

Inflation and the Fed

At its May 10 meeting, the Federal Reserve raised the benchmark federal funds rate another 25 basis points, to 5%, the 16th consecutive increase since the Fed began to tighten monetary policy in June 2004. Since the Fed began to increase rates, the federal funds rate has risen by 400 bp, removing the negative real short-term rates that were in place for most of 2002 to 2004.

Treasury Yields
Since 12/31/2004



Source: Federal Reserve

Recent Interest Rates and Inflation

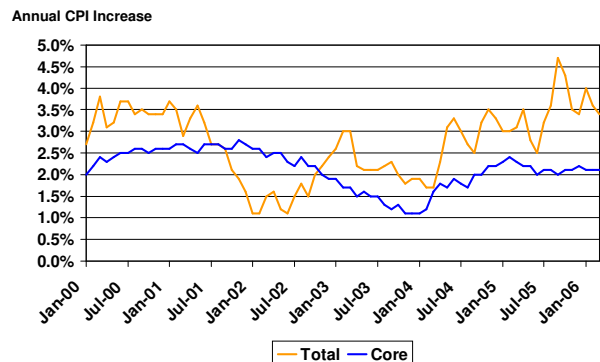
	Interest Rates			Inflation	
	3-Mo T-Bill	10-Yr T-Bond Nominal	10-Yr T-Bond Real	1-Year	Long-term**
2003	1.0%	4.0%	2.1%	2.3%	2.0%
2004	1.4%	4.3%	1.9%	2.7%	2.4%
2005	3.2%	4.3%	1.8%	3.4%	2.5%
2006*	4.6%	4.7%	2.2%	3.7%	2.5%
5/16/2006	4.8%	5.1%	2.4%	3.4%	2.7%

* Year-to-date average.

** Long-term inflation as implied by the spread between nominal and real 10-Yr T-Bond rates.

Sources: Federal Reserve, Bureau of Labor Statistics, Foresight Analytics

Inflation Since 2000
Total vs. Core CPI



Source: Bureau of Labor Statistics

The Fed is worried about inflation and the booming housing market, and is trying to contain both by setting higher interest rates. The concern about inflation is centered around higher energy and commodity prices. Oil is currently above \$70 per barrel and gasoline is above \$3 per gallon in many parts of the nation. The energy component of CPI has grown at double-digit rates since 2002, including a 17% rise in the last 12 months. As a result, overall CPI inflation has increased, reaching 4.7% in September 2005, before moderating to 3.4% in March 2006.

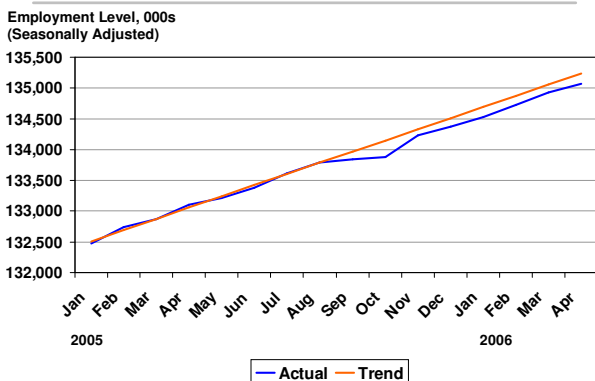
However, the acceleration in overall CPI has not yet translated to higher core CPI,¹ which is up only 2.1% in the last 12 months. The bond market is clearly paying close attention to the low rate of core inflation. Bond market expectations of long-term inflation have increased — from 2.0% in 2003, to 2.5% in 2005, to 2.7% currently —, but less than the acceleration in total CPI and the Fed's interest rate hikes might suggest.

Fundamentals - Firm, but not Robust

While U.S. economic fundamentals are firm, they are not robust. As a result, we believe the Fed is near the end of its tightening of monetary policy. In its May 10th FOMC statement, the Fed left the door open to further rate increases, citing concerns about capacity utilization and energy and other commodity prices.

However, one of the broadest measures of economic health — the employment growth rate — is off its pre-Katrina pace. During 2004 and 2005 (through August), U.S. job growth averaged about 175,000 jobs per month, an annualized growth rate of nearly 1.6%. After Hurricane Katrina struck, growth stumbled during September and October 2005,² then resumed, but remains off the pre-Katrina pace. Since September 2005, employers have added fewer than 160,000 jobs per month, for a growth rate of 1.5%. As of April 2006, Foresight Analytics estimates a “job deficit” of 170,000 jobs between trend and actual.

U.S. Job Growth Trend



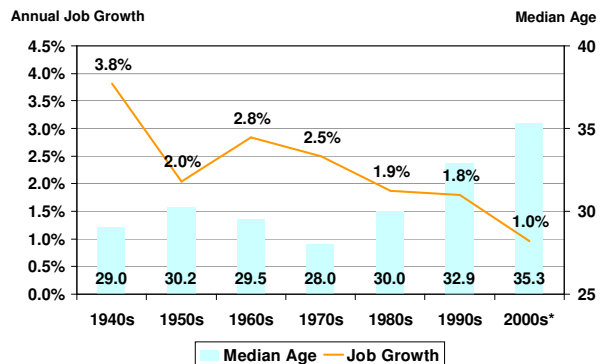
Source: Bureau of Labor Statistics, Foresight Analytics

Long-term Employment Growth Trends

Over the last 40 to 50 years, employment growth in the United States has decelerated, while the population has aged. Average annual employment growth has slowed from 2.8% in the 1960s, to 1.8% in the 1990s and a forecasted 1.0% in the present decade.³ During the same period, the median age in the U.S. has increased from just below 30 to just over 35. As the U.S. population ages, fewer new entrants will join the labor force, removing some of the dynamism of the U.S. economy.

In a reflection of this trend, GDP growth since 2000 has resulted mainly from productivity growth, rather than labor force expansion. This lower rate of growth implies reduced price pressures over the long-term outlook, in turn supporting bond market expectations for relatively low inflation.

**Long-term Economic Trends
Job Growth vs. Median Age**



Source: Bureau of Labor Statistics, Census Bureau, Foresight Analytics

¹ Core inflation excludes food and energy.

² See our report “The Impact of Hurricane Katrina - A Look at Initial Employment Data for New Orleans.”

³ Our estimate assumes 1.5% growth for the rest of the decade, which we believe to be rather optimistic. Average growth so far during the decade has only been 0.6%.

Long-term Interest Rate Perspective

Recent increases in short- and long-term interest rates have put nominal and real rates nearly on par with long-term averages. By contrast, the prevailing nominal and real rates during 2002 to 2005 were low by historical standards.

- In nominal terms, current short-term interest rates are above the average for the last 10 years, and essentially even with the average of the last 20 years.
- In real terms, current short-term rates are above the 10-year average and slightly below the average of the last 20 years.
- Nominal long-term rates are even with the 10-year average and below the 20-year average.
- In real terms, long-term rates are somewhat below the average of the last 10 years, and significantly below the 20-year average. It should be noted that high real rates prevailed for the mid- and late-1980s, following bouts of high inflation from the mid-1970s to the early-1980s. As a result, investors demanded higher real rates as protection against potential increases in inflation.

Future Rate Movements - A Probabilistic View

To gain additional perspective on the likelihood of future movements in long-term yields, we analyzed 12-month changes in the 10-Year Treasury yield for two sets of starting points, which correspond to current rates: nominal yields in the 4.5% to 5.5% range and real yields in the 2% to 3% range. When long-term interest rates have been in these ranges, there has been an upward bias in future movements, though the median increases have been modest, at 16 and 19 basis points, respectively.

When nominal rates have been in the 4.5% to 5.5% range, rate movements have mainly been stable, with approximately 70% likelihood that rates 12 months in the future would be within 100 basis points of prevailing rates.

- Rates have increased by 0 to 50 basis points 23.6% of the time, with relatively high likelihoods of a drop of 0 to 50 basis points (17.3%), or an increase of 50 to 100 basis points (14.4%).
- The risks of a greater than 100 bp increase (22.0%) or a more than 100 bp decrease (10.2%) from current rates are still meaningful.

When the starting real rate has been in the 2% to 3% range, the likelihood for large 12-month movements has been low, indicating that this is generally a stable range for interest rates.

Long-Term Yield Summary Nominal and Real Treasury Rates Since 1962

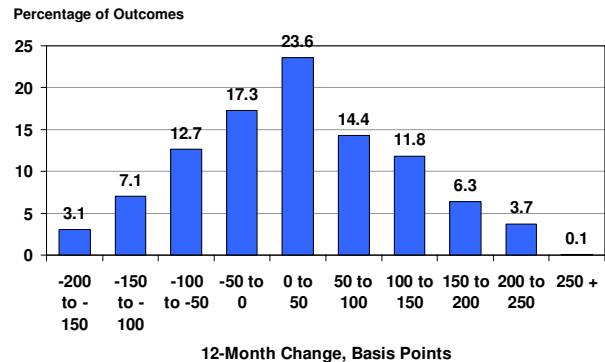
	3-Month		10-Year	
	Nominal	Real**	Nominal	Real**
Average*	5.5%	2.2%	7.1%	2.6%
20-Year Average	4.7%	1.6%	6.4%	3.3%
10-Year Average	3.7%	1.1%	5.1%	2.7%
Current (5/16/06)	4.8%	1.4%	5.1%	2.4%

* 3-Month series begins Jan 1982; 10-Year series begins Jan 1962.

** For all 3-Month and 10-Year data prior to 2003, calculated by subtracting trailing annualized inflation.

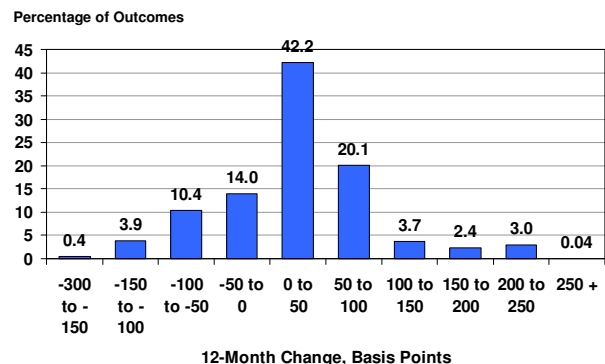
Sources: Federal Reserve, Bureau of Labor Statistics, Foresight Analytics

Interest Rate Movements 1-Year Ahead, Current Rate 4.5% to 5.5%



Source: Federal Reserve, Foresight Analytics

Interest Rate Movements 1-Year Ahead, Current Real Rate 2% to 3%



Source: Federal Reserve, Bureau of Labor Statistics, Foresight Analytics

**12-Month Change in Interest Rates
Given Current Rate, Since 1962**
Change in Basis Points

Change (in Basis Points)	Real Rate 2%	Nominal Rate
	to 3%	4.5% to 5.5%
Median	19	16
0% Min	-291	-187
10% Min	-72	-101
90% Max	96	151
100% Max	254	254
Number of Observations	2500	1261

Sources: Federal Reserve, Bureau of Labor Statistics, Foresight Analytics

- Modest increases of 0 to 50 basis points (in the nominal rate) have occurred 42.2% of the time. Increases of 50 to 100 bp have occurred 20.1% of the time, as compared to a 14.0% occurrence of a drop of 0 to 50 bp.
- Large movements of more than 100 bp up or down have been relatively rare, with higher than 100 bp increases occurring with a 9.1% likelihood compared to a 4.3% occurrence of larger than 100 bp drops.

Extreme movements have been relatively rare. The most extreme drops were -291 basis points (between November 1981 and 1982) when real rates were in the 2% to 3% range, and -187 basis points (between June 2002 and 2003) when nominal rates were in the 4.5% to 5.5% range. The largest increase in interest rates was 254 basis points between October 1993 and 1994. There has been a 10% occurrence of a drop greater than 70 to 100 basis points, and a 10% occurrence of an increase of 100 to 150 basis points or more.

Summary

Current interest rates are in line with historical averages, with the result that future increases are expected to be moderate.

- After two years of steady increases, short-term rates are close to the 20-year average, in both nominal and real terms.
- A sharp increase since January 2006 has put long-term rates — both nominal and real — essentially even with the average for the last 10 years.
- We expect 10-year yields to climb another 20 to 50 basis points, to approximately the 5.3% to 5.6% range, during the next 6 to 12 months. Higher inflation re-

mains a concern in the near term and economic growth is healthy, albeit not robust. As a result, we expect a leveling off of short-term rates and modest increase in long-term rates.

- We do not expect a further surge in interest rates, unless overall inflation picks up from the current 3% to 3.5% range, or core inflation accelerates from the 2% to 2.5% range. We estimate a 10% risk of an increase in long-term rates exceeding 100 basis points during the next 12 months.
- There is a chance that rates will decline, with the long-term rate falling below 5%. We estimate a 20% chance of a drop in rates below 5% within the next 6 to 12 months. Substantially weaker economic growth and declining inflation, most notably energy prices, could precipitate a decline in rates.

Risks to our outlook include:

- The large share of foreign investment in U.S. Treasury notes — Foreign central banks and investors hold close to half of U.S. Treasury securities, with the implication that a decline in foreign buying could cause a precipitous rise in rates. By some estimates, a drop-off in foreign buying would result in a 100 to 150 basis point increase in long-term rates.
- An oil price spike — Global demand is strong, with especially rapid growth occurring in China and India. As a result, a moderation in U.S. demand may not have a large impact on prices. Furthermore, supply margins are very tight, so any disruption to supply could cause demand to outstrip supply, thereby bringing on a price spike. An oil price spike could fuel inflation fears and spur higher interest rates.
- A substantially weaker dollar — The dollar has fallen by 8% against other major currencies since November 2005, nearing the lows reached in March 2005. A lower dollar makes imports more expensive, which adds to inflation, especially with the large U.S. trade deficit. If the dollar were to fall precipitously, both short-term and long-term interest rates would likely rise significantly.

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