MESSAGE FROM THE CHAIRMAN

MASSEY KNAKAL Realty Services

In my last Message from the Chairman I indicated that I believed the second quarter of 2005 would be reflected upon as the top of the bell curve for this investment property cycle. I also indicated that a question of how flat the top of the bell curve would be was critical. **It appears the top of the bell curve is going to be very flat.** Conditions still exist in the market place where there are fewer bidders making offers on properties of all types. However, **the reduced number of prospects** (about 50% of the bidders that existed 9 months ago) **are still paying the same elevated prices that have been with us for four quarters now.** It appears that the strength of prices is directly related to the enormous amount of capital that is available on both a debt and equity basis.

I believe that there has been **a fundamental shift in the perspective on real estate by the average American.** The Enron, WorldCom and other corporate scandals have actually helped our market considerably. Because a growing percentage of people do not want to invest in stocks and bonds, they are looking at real estate investments very favorably. This is driving yields down, keeping prices up and keeping tremendous capital reserves pouring into the marketplace. **There is an over abundance of capital being deployed and we do not see this trend shifting in the short term.** Clearly, interest rates have a significant impact on our market. Presently, five year fixed money is at 5.75% up 1.25% from the 4 ½% that it was about one year ago. The prime rate is currently at 7 ½% and it was 5.25% a year ago. The biggest increase in rates has been in LIBOR floating rate financing which one year ago was at 2.75% and presently is at 6.75%. We assume that most of the LIBOR floating rate debt in the marketplace has been refinanced. While a 5 year fixed rate of 5.75% may seem reasonable there is something that has happened with interest rates that causes concern. **The two year note yield recently rose above the 30 year yield for the first time since December of 2000.** This 2-10 spread currently stands inverted by 6 basis points. **Since 1956 this curve has inverted 10 times leading to a recession in 8 of those cases.** The average time from the beginning of the inversion to the onset of the recession in those 8 cases was slightly over 14 months.

In new Fed Chairman Ben Bernanke's February address to the House Financial Services Committee, he stated that "The economic expansion remains on track." He also stated that increases in demand could put upward pressure on prices leaving the door open for future rate increases. **Federal Funds Futures place a 90% probability on another 25 basis point increase by March and also place a 35% chance on yet another by May. These are major reversals from the beginning of the year, when they predicted a 50% probability of a hike in March and no chance of an increase in the second quarter.** Consequently, Treasury prices fell sharply across the curve particularly after positive employment data was released.

The U.S. economy steamrolled through its 4th year of expansion in 2005 despite looming hazards. Soaring energy prices, increasing global imbalances, a super heated housing market and rising interest rates were just a few of the obstacles faced by the economy last year. Slower consumer spending in the fourth quarter provided a drag on growth when GDP expanded at a 1.1% rate; for all of 2005 GDP grew 3.5%. **Unemployment statistics were positive as the unemployment rate averaged 5.1% in 2005 (in January 2006 it was 4.7%) down from the 5.5% rate experienced in 2004.** In 2005, the economy added about 2 million jobs. Many economists believe that the economy must create around 1.8 million jobs per year in order to keep pace with population growth. There were many reasons to believe that the circumstances in 2005 would make the U.S. consumer over stretched. Energy prices climbed making gasoline and home heating more expensive, personal savings levels dwindled and rising interest rates made credit card debt more expensive to service. **A big concern is that companies will start to pass along the increase in these costs to the consumer adding upward pressure on inflation.** Consumer confidence began 2005 in excellent condition but, confidence plummeted after the batterings the U.S. encountered by hurricanes Rita, Wilma and Katrina.

It appears many Americans are taking a wait and see approach to calendar year 2006, with the housing market wobbling and interest rates climbing. **The end user**

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has recently appeared to be sluggish. The statistics vary depending upon whom you speak to. But it is generally considered that the very best product, positioned properly, with market-expected amenity packages is selling well, while anything less is experiencing a slower sales process. This sluggishness has already affected land prices which, as reported last quarter, are down about 5-10%. Tougher underwriting by banks will continue to put downward pressure on land prices.

In my third quarter 2005 message, I predicted concern of a wild ride through the end of the year. The ride has been anything but. It has been extremely smooth and **if the market is to go through a correction, we do not see more than a 10% market wide reduction in price given the overwhelming amount of capital available to the markets today. We are currently working with 1031 exchange buyers who have over $2 billion in aggregate equity to place into transactions!** This is by far the largest amount of 1031 demand we have ever seen. We believe the market will experience mild fluctuations through the balance of 2006. The anticipated strengthening of both the commercial and residential rental markets will offset factors creating downward pressure on prices. **We know that the first half of 2006 will be excellent in terms of transaction volume, given contract executions in the fourth quarter of 2005. Contract executions in January were at record pace for our firm which is making us feel very bullish.** All of the other externalities that could affect our market are worth looking at. Question marks come into play for the second half of 2006. As market conditions are changing rapidly, I will be updating these messages for you on a monthly basis. I look forward to speaking with you again soon.

Very truly yours,

Robert A. Knakal
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Proud Member REBNY Real Estate Board of New York

During Mr. Knakal's 22 year career, he had sold over 850 buildings having an aggregate market value of over $3.35 Billion. He was the top salesman, with partner Paul Massey, at Coldwell Banker Commercial(now CB Richard Ellis) in New York in 1986, 1987, and 1988 prior to forming Massey Knakal. In 1999 he was awarded Crain's New York Business "40 Under 40" awarded annually to 40 business people under forty years of age for outstanding achievement in the New York business community. In 2001 Mr. Knakal was named one of "The Top Dealmakers" by Real Estate New York Magazine. He has twice been the recipient of the Robert T. Lawrence Award in the Real Estate Board of New York's Most Ingenious Deal of the Year Contest. First in 2002, for the assemblage of the easterly blockfront of Second Avenue betweeen 54th and 55th Streets. Then again in 2004 for the sale of the historic Gotham Book Mart at 41 West 47th Street. Please give a call if you have questions about your property or the market in general.

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