

MESSAGE FROM THE CHAIRMAN



It appears that our prediction of this market cycle bell curve topping out in the second quarter/third quarter of 2005 is on track. Price appreciation across the board has halted and while this is viewed as a negative by some participants in the market, it is actually a positive thing given our relative pricing levels compared with 6 or 12 months ago. Land prices are declining and multi-family conversion properties are also losing value, but on a relative basis are far ahead of where these prices were one year ago. The number of people bidding at these elevated levels continues to be reduced. Today the brokerage business is more difficult as, there are a number of first time buyers wanting to get into the game that are effectively "learning on the job" and this learning process is taking place between the time that a transaction is agreed to and a contract is executed. Often these purchasers are being hit with a dose of reality during this period and many contracts are not being executed. Even if these purchasers can substantiate they have the funds, getting them to execute is challenging. There is certainly downward pressure on pricing across the board as Federal Reserve Chairman Bernanke increased rates another quarter of a point in the March session. This 15th consecutive quarter point move left the federal funds rate at 4.75% its highest level since April 2001. So where are rates headed? The front end of the yield curve is now pricing more than a 70% chance that the FOMC will not only raise its federal funds rate target to 5% at the May 10th meeting, but will go to 5.25% by the fall. We believe that it is more likely that this target rate will top out at 5%.

Look at some key economic factors which we believe substantiate our position. Labor statistics would indicate a booming economy. Labor market data for March shows a new unemployment cyclical low of 4.65%. This data hurts our prediction of a "5%-and-done" Fed tightening policy. However, the factors that offset the labor statistics consist of three main points: 1) Key parts of the economy seem to be decelerating. This is mainly in consumption. 2) Inflation seems to be in check at 1.8% and 3) Some Federal bank presidents have been dropping hints that the increases may be over after the 5% target is met. With regard to deceleration, there are early and tentative signs of this on the industrial side of the economy. Among others, auto makers reported no change in unit sales in the first quarter and it is widely known that production will decline in the second quarter. Real spending growth, according to the

March 30th report, was revised downward to 0.9% from an already weak 1.2%. It also appears that GDP growth is slowing as well at a rate of 4.5% annually. Residential construction activity is projected to decline at annual rate of 2% during the second quarter of 2006. This decline in construction activity will be the first recorded since the fourth quarter of 2001. Other impacts that could affect the health of the economy and consequently rates are that net exports should add to second quarter growth, government spending growth is likely to slow, and inventories will probably continue to be a drag on overall GDP. Presently the prime rate stands at 7.75% up two full points from its 5.75% level one year ago. The Federal Reserve target rate is presently 4.75% up two percent from one year ago and, as stated earlier, we expect this target to increase to the 5% level.

Currently, five year fixed money is at 6.25% for residential properties and approximately 6.5% for commercial and retail product. These rate increases have started to effect the market as yield expectation is increasing by the arena of purchasers. The increasing yield expectations, however has not kept pace with the increase rates, it is lagging behind. This is because there is an inversion of the real risk vs. perceived risk relationship. Buyers presently perceive lower risk than the real risk of owning real estate. This is keeping pressure on yields down and, coupled with the availability of debt, is continuing to keep rates of return at low levels. We are seeing capital reserve continue to pour into the market. A noticeable influence is the constant capital flows from Mexico, India and China into our market. Of the 579 properties that Massey Knakal sold last year a growing percentage have come from these rapidly expanding markets. This is leading to more and more of a globalization of the small to midsize building sales market in the New York City metropolitan area. These capital flows have strengthened the market for solid incoming producing properties. These are the most highly sought after today and prices have been holding firm. Softness in pricing has affected the land market where prices are presently off 5-15%. A combination of a slowing consumer condominium market in conjunction with increasing development costs has significantly impacted land value. Labor costs currently make up approximately 65% of development costs and labor costs have been increasing significantly. Costs of steel and energy are also adding to these costs. The market for existing multi-family properties positioned for

conversion to condominium ownership has also seen negative pricing trends. These properties are off approximately 5% in their value from six months ago.

As you will see in the next edition of the Massey Knakal Building Sales Journal, the final 2005 statistics on volume of sales are in. **The volume reached 3.3% in 2005, the highest level in the past 16 years with the exception of 1998 which registered a 3.5% volume of sales. This increase in volume was up 27% from the 2.6% turnover level in 2004. We are anticipating a drop in the volume of sales back to the 2004 levels of 2.6% in 2006. We are also anticipating a market wide decrease in value of about 3.5%.** In the first quarter of 2006, Massey Knakal sold 119 properties a reduction of 18% from our 2005 average. We believe that the market volume will continue to slow as the discretionary sellers are unable to obtain continually increasing price levels. **For the next two quarters we expect the hottest product types to be hotel and office properties.** The hotel market is as strong as it has ever been, as the elimination of thousands of hotel rooms has created upward pressure on occupancy levels and room rates. Investor confidence is extremely high. The elimination of more than 20 hotels has added to the health of this market. Major hotels such as the Mayflower, Plaza, Mark, Stanhope, Drake and Sheridan Russell have been completely or partially converted to condominium ownership. We also believe that the office component of the market will be excellent in the coming quarters as leasing activity increases are causing reductions in availability. This tightening of inventory across all classes, will affect midtown, midtown south and downtown. Presently the vacancy rate in midtown Manhattan is 7.7% and the average rent has increased to approximately

\$47 per square foot up 8.2% for the year. This trend coupled with a lack of speculative office construction will put significant upward pressure on rental rates which is already being underwritten into office building pricing.

The market itself has shown tremendous resilience with regard to contract executions. Our company projections are based upon the flow of contract executions. After a very slow October; November, December and January were three of the strongest months we have ever experienced. February was average and March was slow, however, the first half of April is back on record pace as investors scurry to acquire properties while still being able to acquire financing at relatively low rates.

Congressional negotiations broke down on multiple fronts last week. Legislation to extend expiring tax cuts faltered. Despite some recent progress, GOP law makers are mostly agreed on a plan to extend the lower 15% capital gains and dividend tax rate for two years through 2010 and both parties favor provisions to hold the alternative minimum tax at bay for one additional year through 2006. Despite these recent set backs a deal looks likely in late April or May after Congress returns from recess. The market is in need of constant observation as uncertainty prevails.... Stay tuned....

Very truly yours,



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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 between 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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