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National Economy

By Gerard Mildner, Director, PSU Center for Real Estate

2006 was a year of robust growth for the U.S. and global economy. According to the latest estimates of *The Economist*, the U.S. economy has grown at a rate of 3.3 percent for the past 12 months, continuing its five-year long expansion. Economists are forecasting that the economy will slow to a rate, perhaps as low as 2.2 percent, for 2007, reflecting the tightening of monetary policy in recent years and a decline in consumer spending.¹

Nevertheless, 2006 economic growth within the U.S. remains higher than that of Japan (2.3 percent), Britain (2.6 percent) or the European nations of the Euro currency (2.7 percent). As has been true for several years, the fastest growing countries remain in the developing world, led by the economies of China (10.5 percent) and India (8.3 percent). The opening of China and India to the world economy in the last two decades has led to an effective doubling of the global market of labor, leading to an acceleration of world economic growth. That opening or “globalization” has been a positive factor for U.S. economic growth and a strong influence restraining inflation. However, globalization has also led to a reduction in the returns to labor relative to the returns to capital, leading many observers to worry about rising inequality.

Another important factor in the widening of incomes has been the adoption of new technology, notably the personal computer. In the language of economists, the innovations in computing technology has created a “skills-biased productivity advantage” to those workers with greater education and who are working in the service sector, as compared to less well-educated workers and those in the manufacturing sector. Since college-educated workers already receive higher pay, their productivity gains have widened an existing gap in wages and incomes.

Inflation has become a growing worry for the Federal Reserve. One year ago, inflation in the United States reached 3.5 percent, the highest rate for any major industrialized country with the exception of Spain. Most observers have blamed the rise in inflation on the Federal Reserve’s loose monetary policy over the last five years, as well as rising energy and raw material demand from Asia.

High U.S. inflation rates as well as rising federal spending and budget deficits have led to a decline in the dollar’s value against most major international currencies. The U.S. trade weighted exchange rate is down

1. *The Economist*, 2007



14.6 percent since 2005, the largest decline of any industrialized country except Japan (-17.7 percent). Only four of 21 leading industrialized countries experienced currency depreciation last year. This has been a great period for U.S. exporters, but a tough time to be traveling overseas. The Federal Reserve has responded by tightening the money supply and raising interest rates steadily in the past year. The current inflation estimate for the U.S. is 2.0 percent and *The Economist* forecast for 2007 is also 2.0 percent.

The U.S. continues to have a strong labor market with historically low unemployment rates. Over the past year, the unemployment rate has fallen from 4.9 percent to 4.5 percent. The tighter job market conditions have led to upward pressure on wages, which have risen by 3.2 percent in the past year.

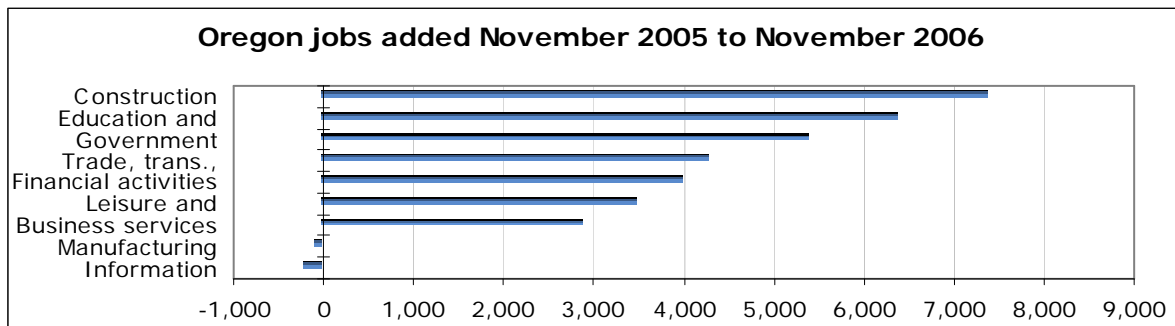
International comparison of labor markets is relatively complex, as each country has a national standard for measuring unemployment rates, labor force participation, and jobs. However, it's generally recognized that unemployment rates in the U.S. are lower than those in Europe and that job growth is faster here, due largely to more flexible (and less regulated) conditions of hiring and firing. For the past year, wage growth in the U.S. (3.2 percent) has exceeded that of Japan (2.7 percent) and the Euro-using countries (2.1 percent), but not that of Britain (3.4 percent)■



Local Economy

The Oregon economy has steadily rebounded with the unemployment rate decreasing from its peak of 8.5 percent in 2003 to 5.4 percent in December 2006. However, the rate is still almost one percentage point above the national rate.¹ Often high unemployment rates relative to the nation are common in states like Oregon that receive positive net migration, particularly of young adults searching for employment.

Oregon continues to experience a job growth recovery that began in 2002. Almost 31,600 non-farm jobs were added in 2006. Roughly 19,500 of these new jobs were created in the Portland metropolitan area. The following chart shows the jobs added statewide by industry in 2006.



Source: Oregon Employment Department. *Current Employment Statistics Survey, 2007*

Positive net growth occurred in all major economic sectors of the Oregon economy with the exception of information and manufacturing. Construction grew by 7,400 jobs for a 7.8 percent increase, the largest of any sector in the state economy. However, construction grew more slowly in 2006 than in 2005, when the sector saw a net gain of 10,000 jobs, representing an 11.0 percent increase. Thus, while construction remained strong in 2006, it was not as strong as 2005. Financial activities followed construction with the second highest percentage growth of 3.8 percent in 2006. Again that represents a slower growth rate than in 2005 when the number of jobs rose 4.6 percent.²

Oregon's real gross state product (GSP), a measure of the economic output of all industries within the state continued to increase at a faster rate than the U.S. economy as a whole. However, the recent growth was slower than previous years. The highest growth rate, 9.6 percent, occurred in 2004, while 2005 grew more slowly at a rate of 6.7 percent.³

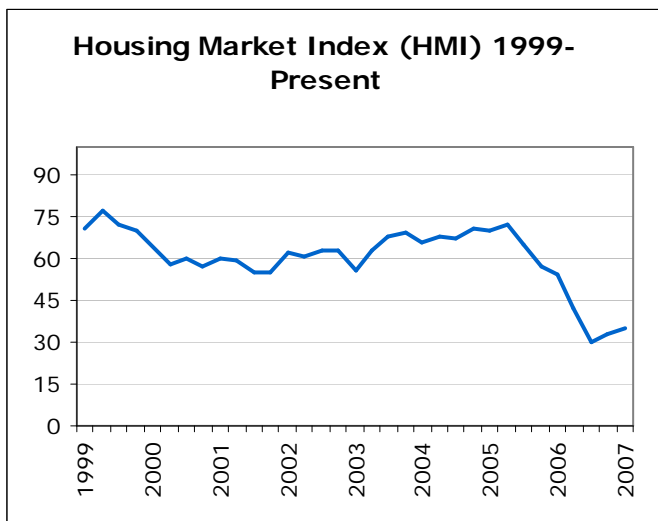
1. Oregon Employment Department, 2007a
 2. Oregon Employment Department, 2007b
 3. Bureau of Economic Analysis, 2006



Oregon’s real per capita income followed national trends closely, growing steadily in 2004 and 2005 after three years of declines. Since 2003, Oregon’s per-capita income has increased by 4.9 percent. However, Oregon remains at an income level that is more than 7 percent below the national average¹ ■

National Housing Market

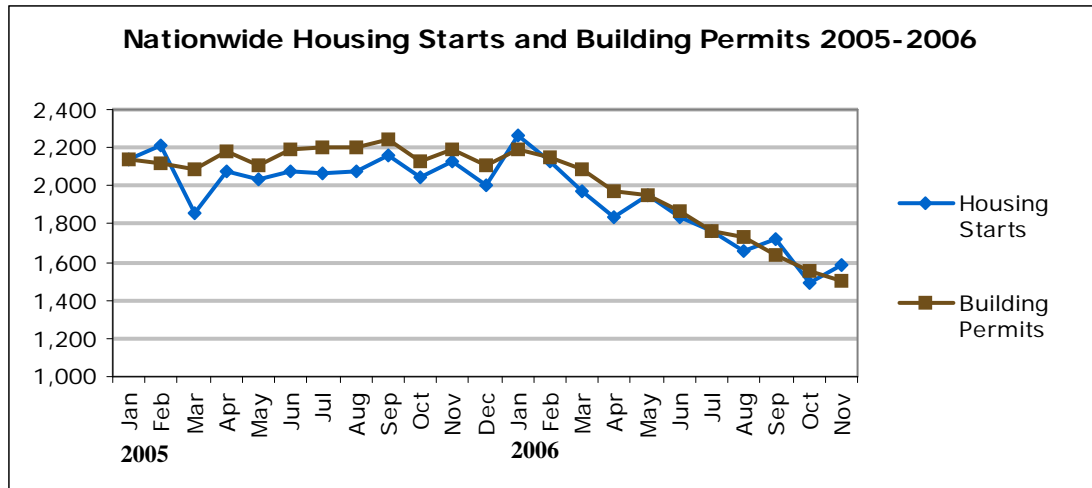
During the past year, news of the U.S. economy centered on the housing market and expectations for either a “hard” or “soft” landing for housing prices. The National Association of Realtors[®] (NAR) reports that the annual number of sales of existing homes (including attached homes) fell 8.4 percent to 6.48 million home sales in 2006 compared to 7.54 million in 2005. However, NAR points out that the number of home sales in 2006 are still high relative to historical numbers.² Furthermore, NAR forecasts existing home sales will “gradually rise” in 2007 and 2008 and that new home sales will rebound by summer.³



Source: National Association of Home Builders/Wells Fargo, 2007 (Seasonally adjusted)

The Housing Market Index (HMI) has recovered modestly in October and November from a September 2006 low. The HMI, also known as the Home Builders’ Sentiment index, is based on a monthly survey of members from the National Association of Home Builders (NAHB). The survey reflects respondents’ perceptions of present sales of new homes, sales of new homes expected in the next six months and traffic of prospective new home buyers. In September, the index reached its lowest point, 30, since February 1991, but has edged up to 33 in December and further to 35 in January.⁴ However, the Wall Street Journal reports increased discounts from builders, suggesting a weak outlook.⁵ While NAHB concedes that incentive programs have helped, they point to improved buying conditions such as lower energy costs, growth in employment and household incomes and recent reductions in mortgage interest rates.⁶

1. Oregon Employment Department, 2006, May
 2. Maloney, W., 2007, January 25
 3. Maloney, W., 2007, January 10
 4. National Association of Homebuilders, 2007, January 17
 5. Hagerty, J. & Wei, L. , 2007
 6. National Association of Homebuilders, 2007, January 17



Source: National Association of Home Builders, 2007 b and c. (Not seasonally adjusted)

When looking at these figures it is important to remember that building permits are not always exercised whereas a housing start is defined as the actual breaking of ground to begin laying the foundation. Building permits tend to be a leading indicator of future building activity. Housing starts, on the other hand, generally coincide with market perceptions. Both data series show an estimated 125 percent decrease in monthly activity from over 2 million housing units to roughly 1.5 million units in 2005 as shown in the above chart. However, in line with recent HMI figures, there has been a recent surge in housing starts. According to NAHB President David Pressly, “builders are responding to increased buyer interest at the end of 2006 and beginning of 2007.”¹ Housing starts increased even further in December, due to warmer than usual weather conditions.²

Looking at home sales, the median sales price of new homes and existing homes show diverging trends according to preliminary fourth quarter data as well as 2007 forecasts from NAR. Both new and existing homes saw a steep decline in median sales price from the second to third quarter of 2006. However, the median price of new homes, which experienced a steeper decline, have rebounded to \$244,000 in the fourth quarter according to preliminary data. This is still down from their second quarter high of \$246,100. The median price of new homes is expected to continue increasing in the first and second quarters of 2007 to a high of \$247,100.³ This projected increase runs counter to historical trends, which generally show slower sales in the first quarter and suggests that builders may be able to maintain prices without discounting. However, the appreciation in 2007 is expected to be much slower than in 2006. New homes are projected to increase by only 0.3 percent in the first quarter of 2007 compared to 2.0

1. National Association of Homebuilders, 2007, January 17

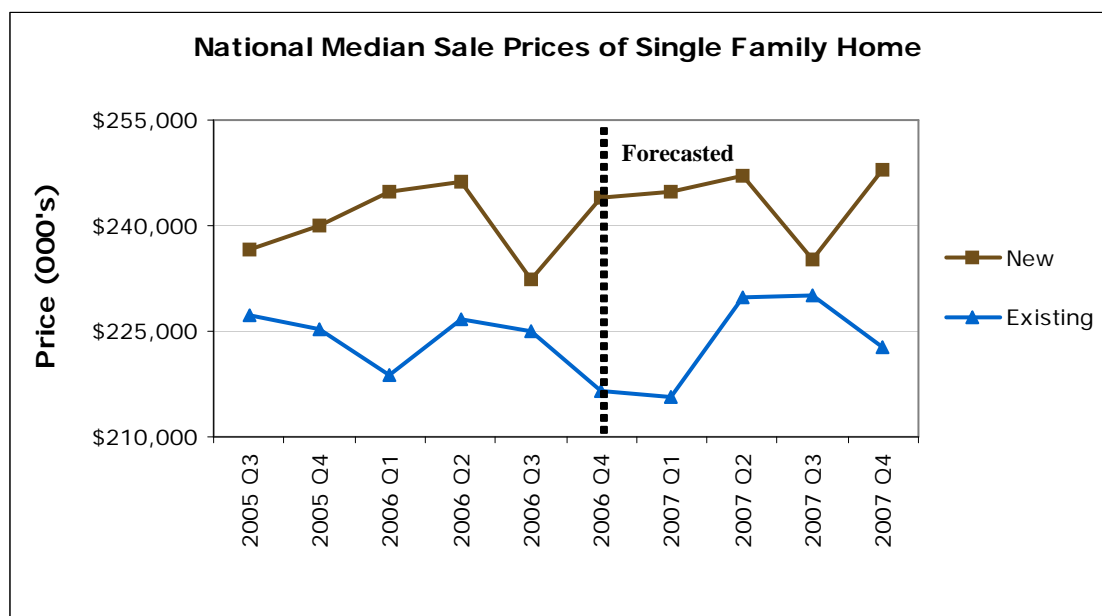
2. National Association of Homebuilders, 2007, January 18

3. National Association of Realtors®, 2007, January



percent in the first quarter of 2006.¹

The outlook for existing homes is less rosy. The median sales price for existing homes has been declining since the second quarter of 2006, but is projected to rebound to \$229,900 in the second quarter of 2007. The median price of existing homes is projected to decline by 0.3 percent in the first quarter of 2007, a less steep decline than in the first quarter of 2006, where the median price fell by 2.9 percent. In the second quarter of 2007, existing homes are projected to increase by 6.5 percent (compared to 3.7 percent in the second quarter of 2006) before stabilizing and then falling again in the fourth quarter.²



Source: National Association of Realtors®, 2007 (Seasonally adjusted; includes attached homes)

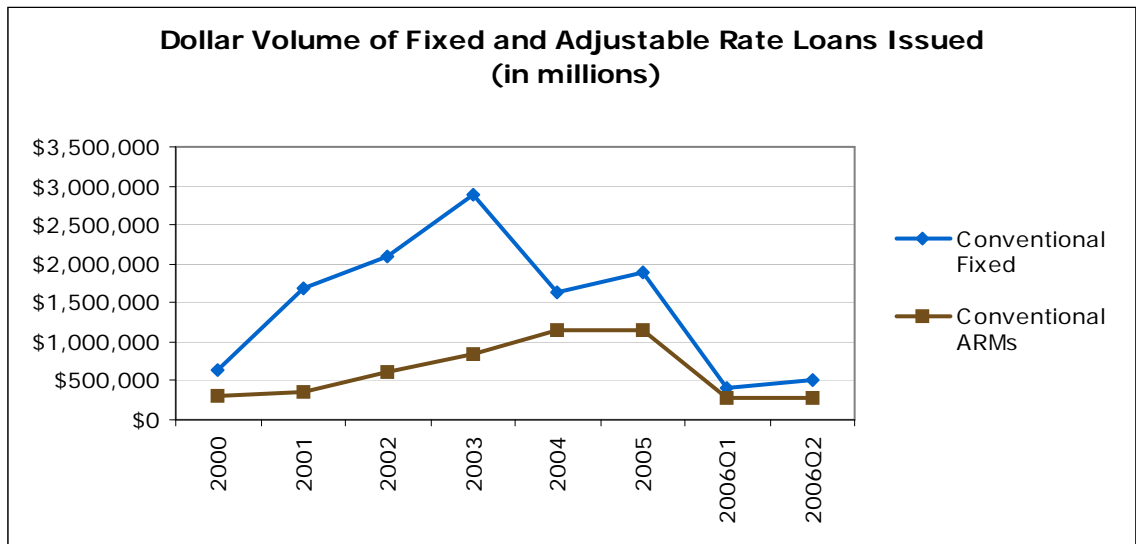
The flattening home price appreciation in 2006 has likely impacted the finance industry. However, the pace of conventional fixed rate loan originations remained strong as of the second quarter of 2006. Data on fixed-rate loan origination show that dollar volume in the first quarter of 2006 exceeded 2005 by 8.5 percent. However, volume in the second quarter of 2006 exceeded 2005 by only 2.6 percent.³ Dollar volume of loan origination is a reflection of appreciation of home prices as much as the number of sales within a given period.

1. National Association of Realtors®, 2007
 2. National Association of Realtors®, 2007
 3. Office of Federal Housing Enterprise Oversight, n.d.



The dollar volume of adjustable rate mortgages (ARM) experienced more volatile swings than that of fixed-rate. After an 11.2 percent surge in the first quarter of 2006 over the fourth quarter of 2005, the dollar volume of ARM loans fell 8.8 percent in the second quarter compared with the second quarter of 2005.¹

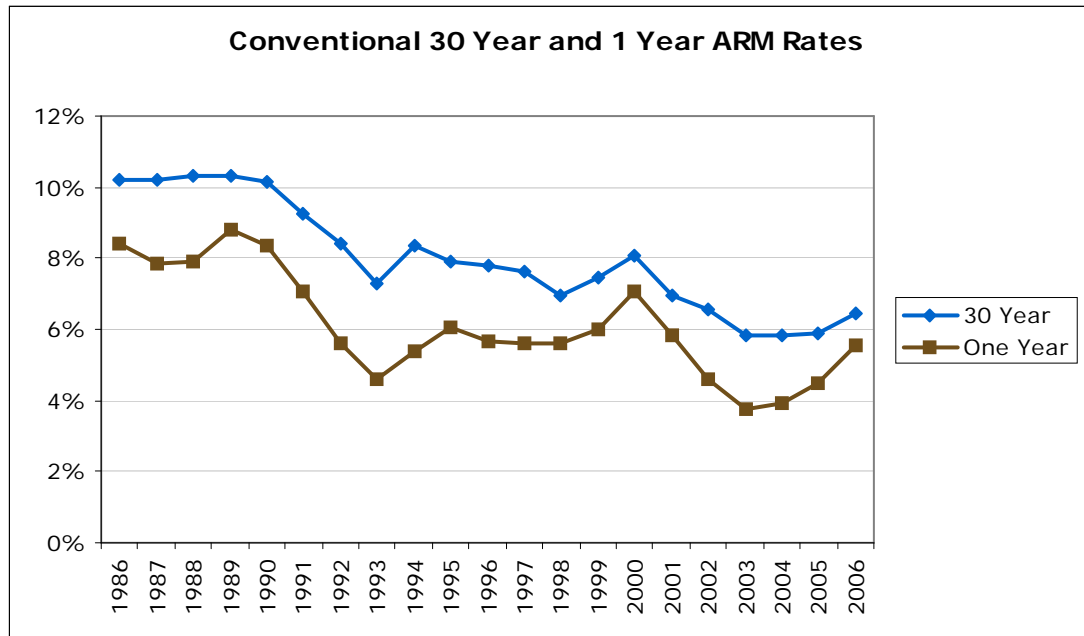
The following chart shows that the dollar volume of fixed-rate loans, as to be expected, has steadily risen from 2001 to its peak in 2003—a year that saw some of the lowest interest rates historically. However, there was significant delay before activity in adjustable rate loans picked up. It was not until 2004 that ARMS experienced a significant increase in dollar volume—37.3 percent over 2003—keeping pace with fixed-rate loans and highlighting the aggressiveness by lenders looking to stay competitive by offering more tailored loan packages to consumers.



Source: Office of Federal Housing Enterprise Oversight, n.d.

Although increasing, mortgage rates remain the lowest in several decades. In 2006, the average interest rate on conventional 30-year loan was 6.41 percent up from the 2005 low of 5.83 percent. 2006 saw 30-year rates climb as high as 6.76 percent, before dropping to 6.14 percent. The following shows rates for the one-year and the 30-year fixed and adjustable loans for the past two decades.²

1. Office of Federal Housing Enterprise Oversight, n.d.
 2. Freddie Mac, 2007



Source: Freddie Mac, 2007

As reflected in the previous two charts, mortgage rates have been a leading indicator for the dollar volume of loan originations. Dollar volume of loan originations may also reflect the willingness of lenders to increase the loan-to-value ratio in order to capture more consumer lending business. All of the above are indicative of a booming housing market. However, third and fourth quarter 2006 mortgage data will likely reveal a different story once they are released. Lenders are showing more reluctance in their underwriting as the housing market begins to lose steam. Current mortgage rates will be instrumental in determining continued growth or slackening of the single family housing market■

Local Housing Market Overview

The local housing market showed continued strength in 2006 in many areas, although indications of a cooling market are beginning to appear in some areas. The median price of both new and existing homes was higher in the fourth quarter of 2006 compared with that of 2005. The median price of new homes grew by 13.6 percent from \$295,000 to \$335,000 whereas existing homes grew by 8.0 percent from \$250,000 to \$270,000. The median sales price of existing homes fell by 0.9 percent to \$270,000 from the third to fourth quarter of 2006. New home prices, however, rose by 6.3 percent in the fourth quarter.



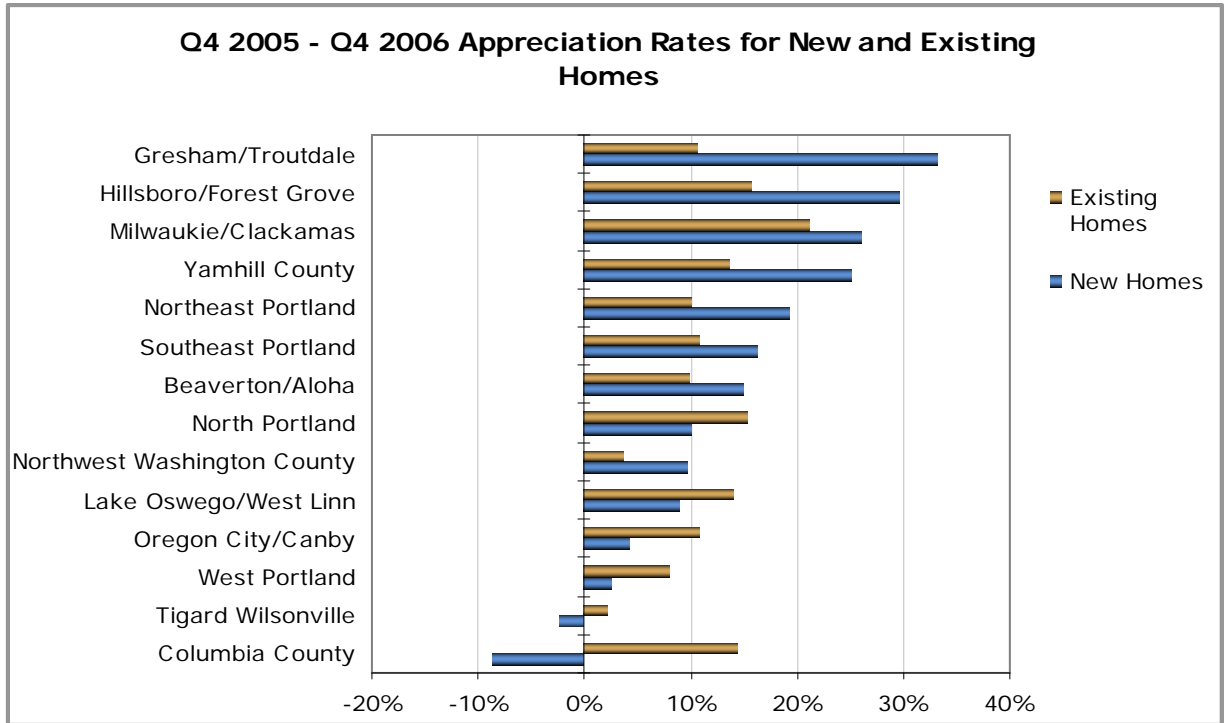
Note that these figures are based on sales of unattached single family homes only and include only areas where home sales were reported to RMLS™. Some of these results may not reflect sales in late December that have not yet been submitted to RMLS™. The following summarizes recent trends in appreciation, transactions and days on market in the single family housing market in the Portland metro region, Vancouver and selected outer areas.

Six-County Portland Metro Region

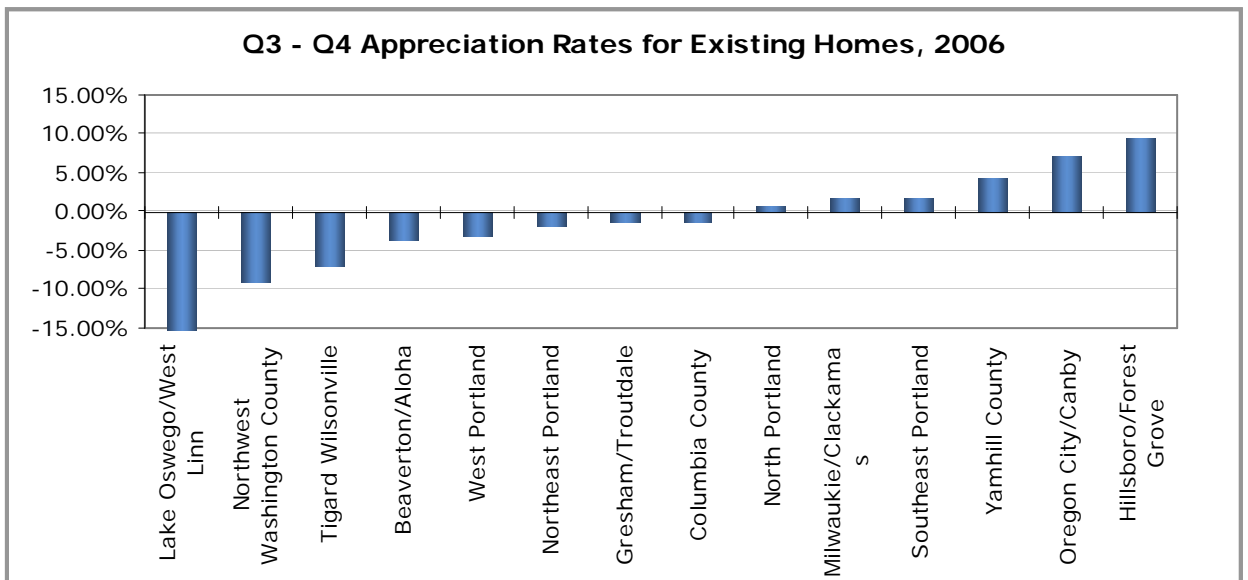
Home prices in the Portland metropolitan area tend to be higher and appreciate faster than homes in other parts of Oregon. The median sales price for existing homes in the six-county metro region (Clackamas, Clark, Columbia, Multnomah, Washington, Yamhill) appreciated in the fourth quarter of 2006 by 11.2 percent to \$289,000 compared to the fourth quarter of 2005. The median sales price of new and proposed homes appreciated by 16.4 percent ending at \$365,423. Among existing homes, those in the Milwaukie/Clackamas area experienced the highest growth in sales price with a fourth quarter-over-quarter appreciation rate of almost 21.27 percent. The Tigard Wilsonville area saw the lowest appreciation rate of 2.2 percent from fourth quarter 2005 to fourth quarter 2006.

The median sales price of new homes appreciated the most in the Gresham/Troutdale area in 2006, where the median sales price grew 33.2 percent to \$318,787. Some areas experienced price declines among new homes. The median price of new homes in Tigard/Wilsonville fell by 2.2 percent and in Columbia County they fell by 8.8 percent. New home appreciation rates are often impacted by construction costs, migration patterns and consumer preferences for the latest in home-building quality. Moreover, the new home market is much smaller than existing homes, and is therefore subject to greater volatility in median and average sales price. By comparison, the pool of existing homes is much larger and more stable than that for newer homes. Since the pool of existing homes does not change significantly from year to year, appreciation of existing homes is not based on increasing home-building quality. The key exception to this pattern would be a large number of remodeled homes.

As in the case of the national housing market, local RMLS data suggests that appreciation rates have slowed and, in some areas, reversed in the latter part of the year. The following graphs show appreciation rates for each of the different RMLS areas in the Portland region. The top graph shows the growth in median sales price of new and existing homes from the fourth quarter of 2005 to the fourth quarter of 2006. The bottom graph compares third to fourth quarter growth in existing homes for 2006. Several areas experienced third to fourth quarter depreciation in 2006 (even though several of these areas such as West Portland, experienced appreciation in the same period in 2005.)



Source: RMLS™ (Appreciation based on median price of home sales. Sample sizes under 25 are not shown. Figures are not seasonally adjusted.)



Source: RMLS™



EXISTING HOMES	2006 Median Home Price	1-Year Appreciation	3-Year Appreciation
Lake Oswego/West Linn	\$519,900	21.2%	65.6%
West Portland	\$460,000	21.1%	63.1%
Northwest Washington County	\$396,000	13.7%	49.5%
Tigard Wilsonville	\$351,000	11.4%	47.9%
Milwaukie/Clackamas	\$314,700	24.6%	70.1%
Beaverton/Aloha	\$282,000	12.8%	53.3%
Oregon City/Canby	\$277,225	6.6%	38.7%
Northeast Portland	\$277,185	16.0%	50.2%
Hillsboro/Forest Grove	\$269,950	15.4%	48.6%
Gresham/Troutdale	\$259,950	18.2%	47.5%
North Portland	\$243,650	21.8%	57.7%
Southeast Portland	\$237,000	16.7%	45.4%
Yamhill County	\$225,000	15.4%	51.0%
Columbia County	\$202,950	9.9%	40.0%

For much of the 1990's, home price appreciation rates in Portland's central city greatly exceeded that of its suburbs. The appreciation rates in each RMLS area in the past one to three years, however, are fairly evenly distributed across the region.

Over the past three years, existing homes in neighborhoods closest to downtown (North, Northeast, Southeast and West) appreciated by 50.0 percent, whereas the median price of new homes appreciated by 52.6 percent.

NEW HOMES	2006 Median Home Price	1-Year Appreciation	3-Year Appreciation
Lake Oswego/West Linn	\$796,108	17.9%	69.4%
West Portland	\$585,000	3.5%	23.3%
Milwaukie/Clackamas	\$502,750	35.9%	74.9%
Northwest Washington County	\$481,000	17.6%	26.6%
Tigard Wilsonville	\$440,000	14.7%	46.7%
Beaverton/Aloha	\$390,000	16.1%	98.3%
Oregon City/Canby	\$355,000	22.2%	42.6%
Yamhill County	\$316,780	33.4%	73.6%
Hillsboro/Forest Grove	\$295,000	13.8%	52.3%
Southeast Portland	\$278,650	22.2%	65.1%
Gresham/Troutdale	\$275,900	13.6%	57.5%
Northeast Portland	\$269,900	17.3%	44.3%
Columbia County	\$251,000	1.4%	61.0%
North Portland	\$240,000	14.3%	65.7%

In the suburbs, the median sales price of existing homes grew by approximately 50.3 percent whereas for new homes it grew by almost 54.2 percent.

New homes in the Beaverton/Aloha area experienced inordinate rates of appreciation over the past three years at just under 100 percent.

While not appreciating as rapidly, the Lake Oswego/West Linn area shows the highest median sales price among new and existing homes. The greatest growth in sales price in the one-year period from

Source: RMLS™

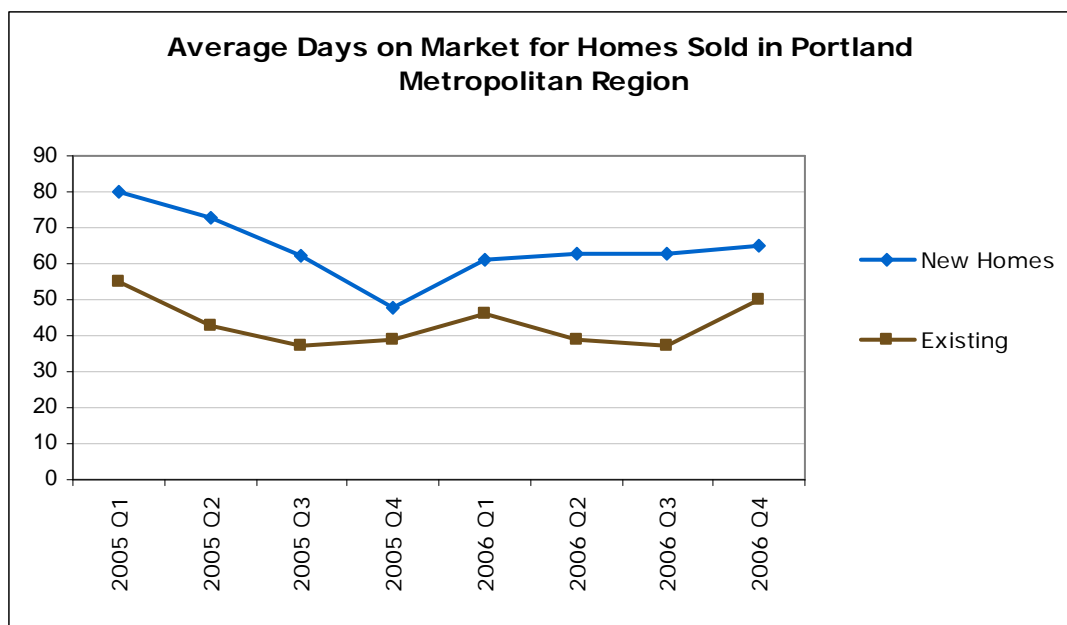


2005 to 2006 has taken place in the Milwaukie/Clackamas area in both new and existing homes.

One of the standard measures for tightness in the local housing market is the amount of marketing time for home sales. When supply is high and buyers cannot get their asking price, homes remain on the market longer. The average number of days on market for homes sold in the Portland region decreased from 65 days in 2001 to a low of 40 in 2005 during the housing boom. However, the trend may be reversing as the average number of days on market in 2006 was 42 days. Looking at fourth quarter only, the average days on market was 49 in 2006 compared to 37 in 2005. As a result, many observers see this as a sign of a softening housing market.

On average, new homes are on the market longer than existing homes since they are often marketed during the construction period. Therefore, it helps to look at each category separately. In the fourth quarter of 2006, new homes were on the market an average of 63 days compared to 66 days in 2005. Existing homes were on the market an average of 42 days in both periods.

The following graph shows the average days on market per quarter for new homes as well as existing homes during the past two years. Existing homes saw a steep rise in the average number of days on market in the fourth quarter of 2006, while new homes saw only a steady increase. Neither new or existing homes are seeing the short marketing periods experienced in the fourth quarter of 2005.



Source: RMLS™



In summary, while existing home prices have appreciated by 11.2 percent from fourth quarter 2005 to fourth quarter 2006 throughout the Portland region, the rate of appreciation is beginning to slow, especially when comparing third to fourth quarter growth for each of the two years, which shows slower activity in 2006 than in 2005. The average number of days on market is increasing among both new and existing homes, which often indicates a negative shift in the market's outlook. Furthermore, the number of transactions of existing homes has decreased by 19.6 percent from 16,440 in 2005 to 13,221 in 2006. New home transactions on the other hand increased slightly from 2,138 in 2005 to 2,258 in 2006. In fact, sales of new homes saw greater appreciation from the fourth quarter of 2005 to 2006 than seen among existing homes. In addition, new homes saw an appreciation of 5.79 percent from the third to fourth quarter of 2006 whereas the median sales price actually depreciated in the last two quarters of 2005.

Vancouver

Home prices in Vancouver and Clark County tend to be priced lower than houses in Portland and most of its suburban areas. The median sales price for existing homes sold in the fourth quarter of 2006 was \$258,000, up 3.2 percent from 2005. For new homes the 2006 median home price was \$306,000, an increase of only 2 percent from 2005.

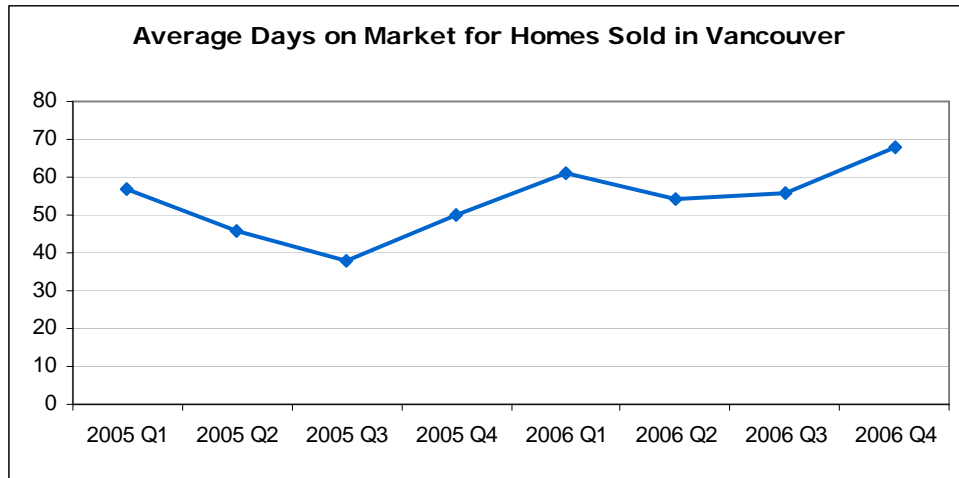
When looking at full-year data, the median price of new homes sold appreciated by 9.5 percent compared with existing homes, which saw an increase of 10.6 percent. Ridgefield saw the greatest appreciation of existing home prices, from \$178,500 to \$355,000, a rate of almost 100 percent, which was greater than any seen in the Portland area. East Clark County saw the greatest appreciation of new home prices, at a rate of 50 percent, as luxury home developers have focused on that area.

Several markets experienced depreciation in the median home price from 2005 to 2006. The median price of new homes fell in La Center and the median price of existing homes fell in East Orchards and North Felida.

Like the Portland market, the average days on market for existing homes has steadily increased since the second quarter of 2006. As following graph shows, the number of days on market in the fourth quarter of this year surpassed the average number in the fourth quarter of last year by 18 days.



We should expect to see even longer marketing periods in early 2007 as the first quarter is often the slowest for home purchases.

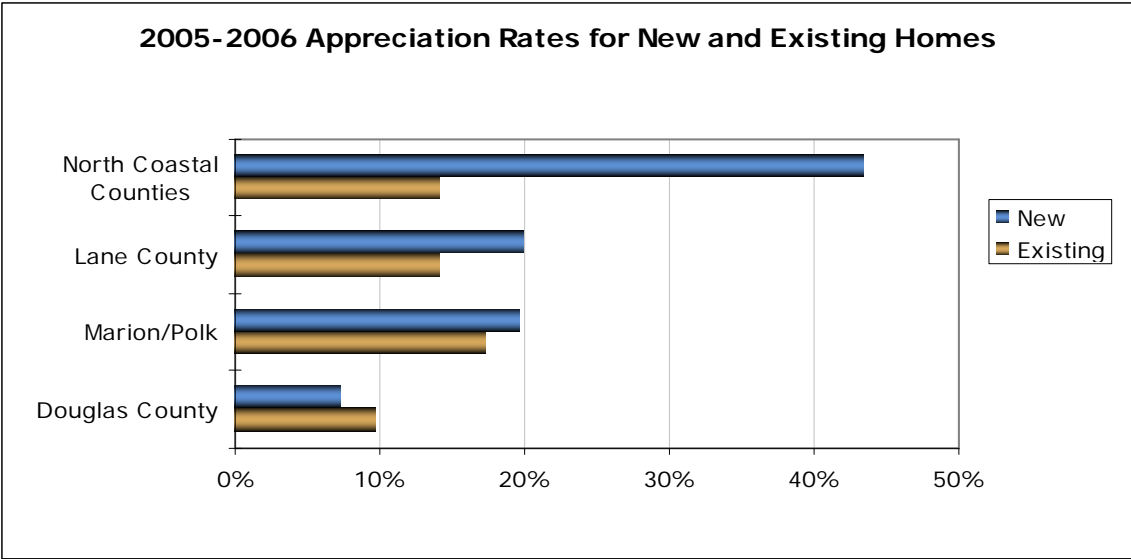


Source: RMLS™

Oregon Outside of Portland

Both new and existing homes outside of Portland experienced appreciation in 2006, with the highest prices and appreciation occurring in those areas closest to Portland. New homes appreciated the most in North Coastal counties (Clatsop, Tillamook and Lincoln) while existing homes appreciated most in Marion and Polk counties. The North Coastal counties also have the highest median price of new and existing home sales in 2006 among the areas included in this analysis, \$393,000 and \$284,000 respectively. Douglas County, which has the lowest median home price in both categories (\$251,000 new and \$185,000 existing) appreciated the least, with rates remaining under 10 percent.

The following chart shows appreciation of the median sales price from 2005 to 2006 for both new and existing homes. This analysis uses full year data given the small sample sizes available in quarterly data for these RMLS areas. New homes in North Coastal counties appreciated the most with a 2006 median sales price of almost \$393,000, a 41.3 percent change over 2005. In looking only at existing homes, Marion and Polk counties saw the greatest appreciation, 17.3 percent, with a 2006 median sales price of \$210,000.

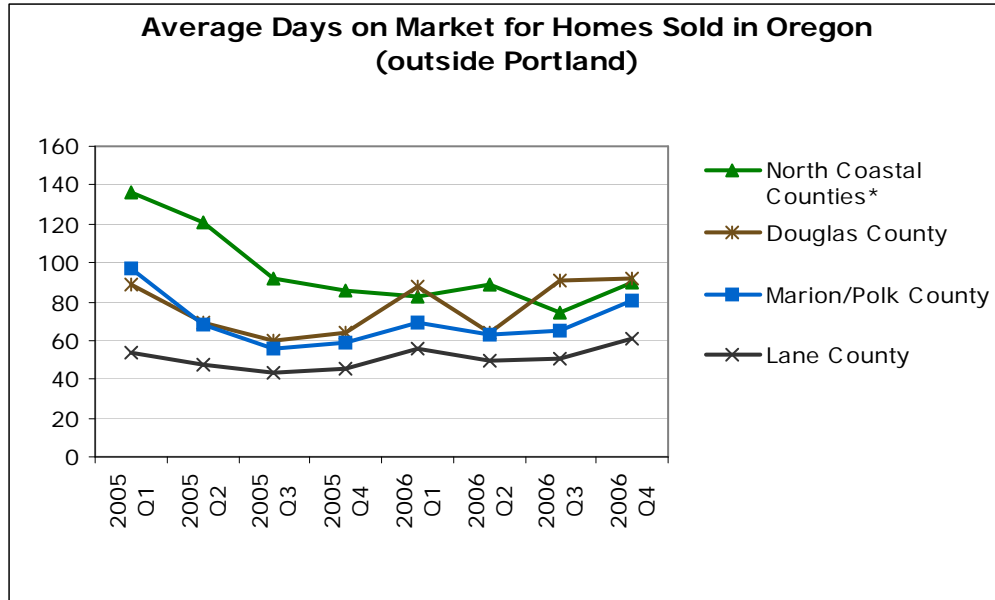


EXISTING HOMES	2006 Median Home Price	1-Year Appreciation	NEW HOMES	2006 Median Home Price	1-Year Appreciation
North Coastal Counties	\$284,250	13.9%	North Coastal Counties	\$392,750	41.3%
Lane County	\$222,900	14.3%	Lane County	\$269,900	20.0%
Marion/Polk	\$210,000	17.3%	Marion/Polk	\$262,815	23.9%
Douglas County	\$185,000	8.8%	Douglas County	\$251,000	5.0%

Source: RMLS™ (Appreciation based on median price of home sales. * Sample sizes under 25 are not included.)

Similar to areas in Portland, Marion and Polk, Douglas and the North Coastal counties saw a decrease in the number of days on market since the first quarter of 2005. The North Coastal counties have seen the most significant decline, while Lane County has not seen any lengthening in the average marketing period of their home sales from the first quarter of 2005.

The average days on market for existing homes is the highest in Douglas County among the four areas reported. The marketing period lengthened considerably for Douglas county in the third quarter of 2006, after seeing short marketing periods, an average of 64 days, in the second quarter. The average days on



Source: RMLS™ (*Sample size for the North Coastal County transactions in the first quarter of 2005 is below 25.)

market for Douglas County has since stabilized. The remaining areas reported above have all seen increases in the number of days on market during the fourth quarter of 2006. The average marketing period for the North Coastal counties in the fourth quarter reached 90 days, almost as high as Douglas County. This may be a reflection of buyers' reluctance to pay the higher prices in this area relative to the other areas outside of Portland. Again, we should expect to see even longer marketing periods during this quarter, as the first quarter is often the slowest for home purchases ■



Local Housing Market Forecast

By Jerry Johnson, Johnson Gardner, LLC



The Portland metropolitan region's owner-occupied housing market is in the midst of a correction, as increased inventories have reduced pricing power for both new homes as well as re-sales. While median sales prices continue to increase in the new home market, well above the rate for existing homes, these rates of appreciation will not be sustainable in 2007. New home cost increases have been driven by the underlying economics of new construction, with rapidly rising costs associated with land, fees and construction. While rising costs increase the pricing necessary to deliver targeted yields, the increased level of inventory will prevent builders from fully passing on these costs.

Over the next year, we are projecting a decline in demand for new housing between 10 percent and 15 percent. The owner-occupied residential market has been bolstered over the last decade by steadily increasing rates of homeownership, a trend not expected to continue in 2007. The implications of this vary depending upon the response of the homebuilding industry. The likely outcome of this decline will be an increase in days on market, particularly for new product, as industry production outpaces demand. This is the typical phenomenon we see in a cooling market, with real reductions in new supply not occurring until late 2007 and early 2008. Assuming continued economic growth, and associated residential demand, the market will tighten again for another run in 2008.

With the supply and demand balance expected to favor buyers in the next year, a key issue will be the market's ability to sustain pricing. A year ago we felt that the market was in good shape, but some of the recent pricing gains may be given back in 2007. The level of condominium supply in the pipeline, particularly urban condominiums at \$400 per square foot or greater, is expected to lead to softening in that market. Single family homes priced above \$500,000 are becoming the norm for new construction, but the level of market depth for this product remains limited. While the cost side of the equation is pushing builders into that price point, the market is expected to lag supply, which will lead to discounting of those units.



Market speculators will begin to abandon the market if asset values don't continue to appreciate significantly, but this may be a poor long-term position. Properties bought for speculative purposes in the last year may not look good in the next year, but the market will recover. We strongly feel that the pricing problems reflect a short-term issue, and the fundamentals look strong assuming continued economic growth. Over the long term, pricing will reflect replacement cost, and we don't anticipate that those costs will get substantively cheaper. Portland remains the low-cost residential location on the West Coast, a somewhat dubious distinction but significant nonetheless.

In summary, we expect demand to decline substantially in the next year. This will be reflected in overall market activity as well as net new demand. The development community is expected to reduce the rate of new construction, but not rapidly enough to prevent a significant rise in standing inventories and a loss of pricing power. Pricing will see modest appreciation on average over the next years, with effective drops in pricing for some market products and geographic areas. The market is entering a more volatile period, in which general market inflation can no longer be counted upon to rescue poorly-conceived projects ■



National Commercial Market

In 2006, commercial real estate experienced another banner year. According to NAR, \$236 billion in transactions were recorded in 2006, excluding properties valued under \$5 million.¹ The National Association of Real Estate Investment Trusts[®] (NAREIT) reports 2006 as the seventh consecutive year in which the primary U.S. REIT index outperformed all other major indices. The U.S. REIT index yielded a 34.35 percent return compared to 15.79 percent for the S&P 500 and 16.29 percent for the Dow Jones Industrials.²

According to NAREIT, a portion of this success is attributed to apartment REITS, which grew in value due to the lagging housing boom. However, growth in the office and industrial sectors also played a role. In fact, office REITs in the index provided the highest return—45.22 percent. Industrial REITs returned the third highest at 28.92 percent.

This growth should be of no surprise given the strengthening of market fundamentals such as the employment growth in sectors known for using office and industrial space. Employment growth often leads to lower vacancy rates and thus higher rents. According the Bureau of Labor and Statistics, office-using employment in the information, financial activities and business services sectors grew by 578,000 jobs or 2.0 percent from December 2005 to December 2006, which was less than the 2.2 percent rate of growth seen from 2004 and 2005³. Yet, vacancy rates still fell nationwide from 15.1 percent in the third quarter of 2005 to 13.5 percent in the third quarter of 2006.⁴ The lower vacancy rates contributed to the 2 percent increase in rents nationwide, which, according to NAR, occurred in the third quarter.⁵ NAR further notes that high construction costs have kept speculative construction to a minimum, thereby reducing competition among property owners for tenants in the market.

The industrial market has seen similar strong market conditions, led by the transportation and warehousing sector. Employment in transportation and warehousing grew by 106,000 jobs, an improvement of 2.4 percent from December 2005 to December 2006. By comparison, the previous twelve-month period, from December 2004 to 2005, saw only an increase of 73,000 jobs or 1.7 percent.

1. National Association of Realtors®, 2006, December
2. National Association of Real Estate Investment Trusts®, 2007
3. U.S. Department of Labor, 2007
4. Chittum, R., & Frangos, A., January 2007
5. National Association of Realtors®, 2006, December

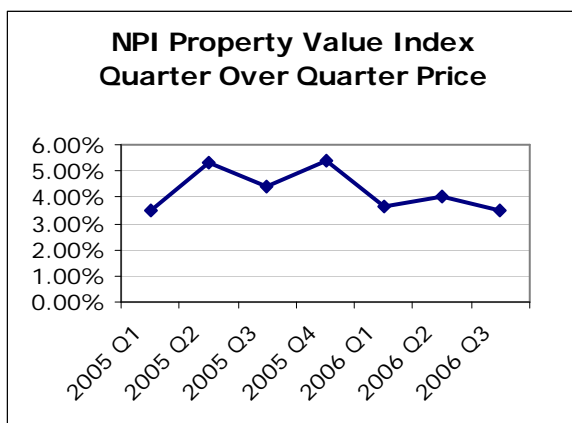


The main laggard in the industrial sector has been manufacturing, which saw a decrease of 72,000 jobs for the second year in a row. However, this was not enough to offset gains seen elsewhere in the industrial sector. Employment in trade and transportation was able to pick up the slack since this sector has seen huge gains attributable to increased trade from Asia particularly China. This has increased the need for warehousing both at ports in Los Angeles and Long Beach, California, as well as at major inland distribution hubs such as Memphis, Tennessee.¹

In addition to market fundamentals such as falling vacancy rates and rising rents, the value of real estate assets has grown considerably due to historically low interest rates and the large amounts of capital flowing into the market. In a January 10, 2006 press release, the Federal Reserve expressed concern about increased lending for commercial properties with loan repayment primarily dependant on rental income or unrealized appreciation.²

NAR, however, argues that large amounts of capital are coming not from increasingly risky commercial loans but rather from pension funds, foreign investors and other institutional investors.³ NAREIT also reports that each year over the past five years, pension funds have increased their investments in commercial real estate. Additionally, 401(k) investments in commercial real estate have also risen during the same period. According to NAREIT President and Chief Executive, Steven Wechsler, “Investors of all

types are realizing the benefits of portfolio diversification, strong and reliable income generation, long-term performance, liquidity and transparency that REITs and other listed real estate provide.”⁴



Source: National Council of Real Estate Investment

However, some early indications of a slowdown in commercial real estate are beginning to show. In its third quarter report on their National Property Index (NPI), the National Council of Real Estate Investment Fiduciaries (NCREIF) shows lower quarter-over-quarter figures for all three

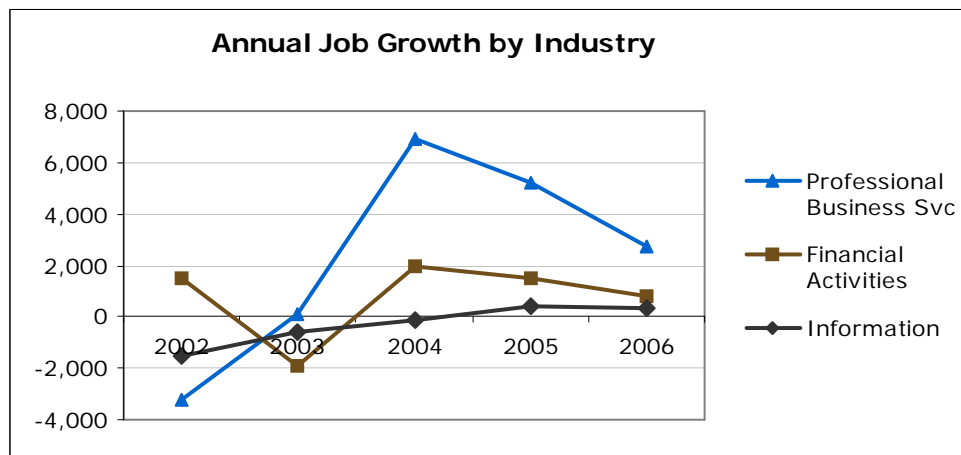
1. Sicola, M. T., & Williams, M. J., 2006
 2. The Federal Reserve Board January, 2007
 3. National Association of Realtors®, 2006, December
 4. National Association of Real Estate Investment Trusts®, 2007



2006 quarters when compared with the first three quarters of 2005.¹ The NPI is an appraisal-based index where members of NCREIF, comprised of institutional investors, provide quarterly rates of return based on the appraised market value of properties in their portfolio. The NPI thus does not report transactional data. The graph shows quarter over quarter differences for total returns based on both appraised values and net operating income for 2005 to 2006. Future growth in commercial real estate will depend on the availability of capital in both debt and equity markets, especially if market fundamentals begin to falter. In fact, many economists predict job growth will slacken in 2007, which will negatively impact rental income. For now, the record flow of investment capital into commercial real estate has kept values high. However, this investment capital will not be enough to sustain the commercial market in the long run without being accompanied by continued job growth■

Portland Office Market

In 2006, the Portland metropolitan region saw a net gain of 3,800 jobs in office-using sectors (information, financial activities and business services fields).² At an estimated 200 square feet (sf) per worker this growth in employment implies an additional 760,000 sf of office space required by employers within the metropolitan area for 2006. The actual net absorption of office space for 2006 was reported by brokerage firms to be in the range of 726,000 and 887,000 sf.³



Source: Oregon Labor Management Information System

1. National Council Real Estate Investment Fiduciaries, 2006

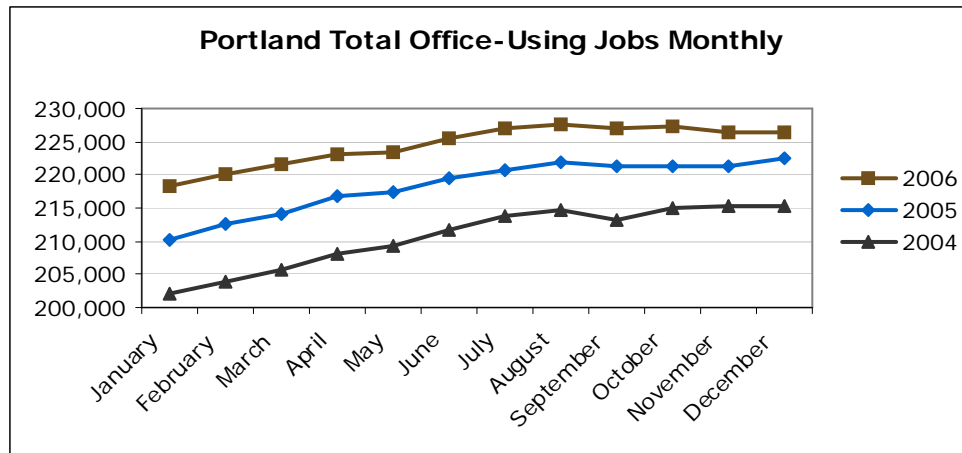
2. Oregon Employment Department, 2007b

3. This section and the following on the Portland Industrial Market utilize real estate data reported by brokerage firms Cushman & Wakefield, Grubb & Ellis and Norris, Beggs and Simpson. Ranges of reported data reflect the information from among these firms.



This net gain of employment in the Portland metropolitan region, however, fell short of growth levels seen in 2005 when 7,100 jobs in the office-using sector were added. The following chart shows the yearly job growth in these sectors for the past five years. Employment growth slowed in 2006 but remained above levels seen 2002 to 2003, when all three sectors saw a net loss in jobs.

The following chart shows the total number of jobs on a monthly basis in office-using sectors for the years 2004 to 2006. In November and December 2006, Portland lost 200 jobs, whereas in December 2005, Portland gained 1,100 jobs. All three years experienced a dip in the number of jobs in the month of January, due to the seasonality industries such as the real estate industry and temporary service agencies.



Source: Oregon Labor Management Information System

Of the jobs added in 2006, the majority were within the business and service sector, a category that includes professional and technical services, administrative and support services and company management. Historically, the business service category is the largest category of the three office-using sectors. In 2006, 2,700 of these jobs were added, compared with 5,200 added in 2005. The financial activities sector received a net gain of 800 jobs compared with 1,500 in 2005. This sector traditionally concentrates in the downtown central business district (CBD). The information sector received a net gain of 300 jobs for 2006 regaining its footing after the number of jobs fell by 300 from August to October. Companies in this sector traditionally seek suburban office locations.



The vacancy rate for the CBD edged downward in 2006, indicating an increase in occupancy, to a reported range of 9.3 percent to 10.7 percent compared to 10.8 percent to 12.5 percent in 2005. Looking only at class A, the reported range plunged from 8.2 percent to 8.8 percent in 2005 to a range of 5.9 percent to 6.3 percent in 2006. Furthermore, Norris, Beggs & Simpson report that only ten class A full floors remain vacant in the CBD with an additional five in the Lloyd District, supporting the argument that prime space downtown has dwindled leaving few remaining choices for tenants.¹

The reduction in prime space downtown boosted the average direct asking rental rate in the CBD among all classes of office space. Class A increased from \$22.04 annually per square foot (psf) at the end of 2005 to \$23.87 psf. Class B moved from \$17.54 psf to \$18.94 psf and class C from \$16.35 psf to \$18.36. The hike in the average class C rental rate further showcases the decline in premium space in downtown. As premium space is absorbed, tenants turn to class B and C driving up rates in these two categories of space.²

The decreased vacancy in the suburbs managed to boost the average direct asking rental rate in all classes of office space as in the CBD. The average rental rate of class A space grew \$1.31 psf \$22.80 by the end of 2006.³ The suburban market also showed signs of improvement with a slight decline in its vacancy rate from 2005 to 2006. In 2005, the vacancy rate was reported to be between 13.4 percent to 15.7 percent. In 2006, the high end of that ranged dropped to 14.6 percent. While the market tightened, Grubb & Ellis notes that major Portland technology companies such as InFocus and Planar Systems are showing signs of struggle, which may lead to job cuts. Pixelworks, which has already cut jobs, recently put approximately 50,000 sf of space back on the market in Tualatin.⁴ The future of the suburban office market will rest heavily on the success of Portland-based technology firms in their competition against Asian firms in the global economy.

Looking ahead, office-related employment sectors are projected to grow by 5,100 or 1.5 percent state-wide.⁵ While growth in these sectors will diminish somewhat from last year's addition of 12,600 jobs or 3.9 percent, the continued but stable growth should foster the expansion of office-related employment in the Portland region. This will translate into slow and steady tightening of the Portland office market. While available space disappear, rental rates will rise. As Cushman & Wakefield states, "trends are strengthening the landlords' position in the market. Tenants restructuring leases—a tactic used to cap-

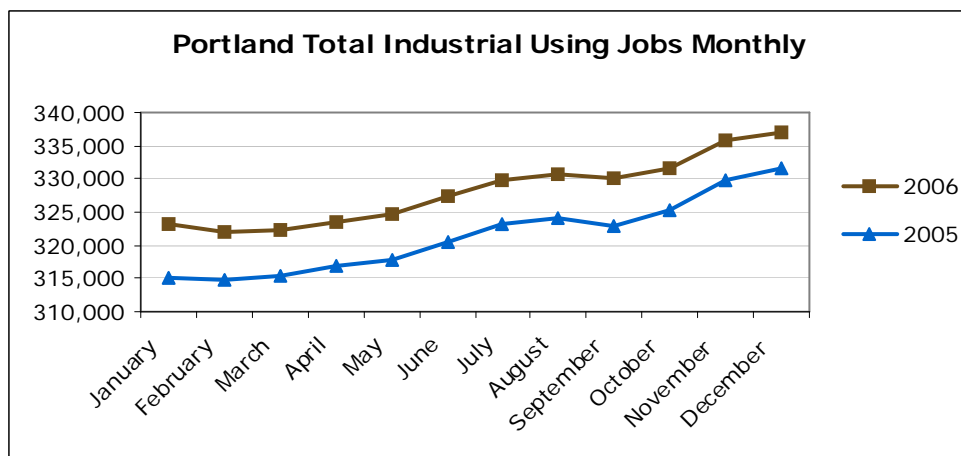
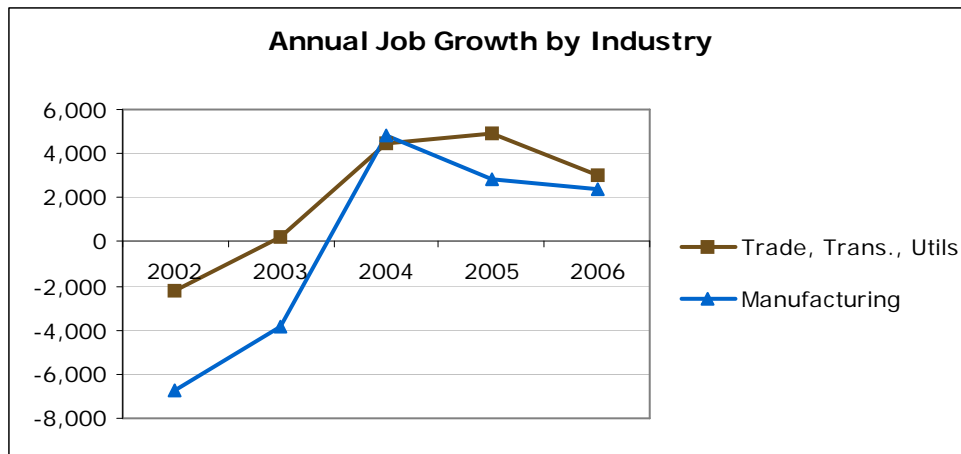
1. 1. NAI Norris, Beggs & Simpson, 2007b
2. Cushman & Wakefield, 2007e
3. Cushman & Wakefield, 2007d
4. Grubb & Ellis, 2007b
5. Oregon Office of Economic Analysis, 2006



ture lower rental rates in a down market—less frequently and fewer landlords are offering concessions.”¹
 The duration of the landlord’s advantageous position will depend on whether future job growth meets expectations or whether the recent November and December slump in employment marks the start of a longer downward trend■

Portland Industrial Market

The industrial economy in the Portland region continued to grow in 2006, although at a slower pace than 2005. The region received a net gain of 5,400 traditional industrial sector jobs (trade, transportation and utilities as well as manufacturing) in 2006 compared with 7,100 jobs in 2005. Trade, transportation and utilities gained only 3,000 jobs in 2006 bringing the total number of jobs to 209,700, compared with



Source: Oregon Labor Management Information System

1. Cushman & Wakefield, 2007e



4,900 jobs gained in 2005. Manufacturing gained 2,400 jobs bringing the total number to 127,400, compared with 2,800 jobs gained in the previous year. The numbers reflect a market that is still growing but losing some of the steam it had in 2005. The previous charts show the yearly growth in jobs by industry and the total number of jobs monthly in industrial sectors for the years 2005 to 2006 respectively.

Contributing to much of this growth is record activity at the Port of Portland. Already the 15th largest volume container port in the U.S. as well as the second largest export tonnage port on the U.S. West Coast as of 2004,¹ the Port saw a 34 percent increase over 2005 in container shipment from its seven shipping lines. The Port further saw a 31 percent leap in auto imports to 463,515 autos.² Moreover, the Port of Portland anticipates that trade volume will double by 2035 in the Portland/Vancouver region.³

This increased activity likely contributed to the more than 3.4 million square feet of industrial space which was absorbed in the Portland region in 2006 particularly, space absorbed in the Rivergate and Airport Way submarkets. Region-wide, the industrial market vacancy rate fell to almost 6.0 percent from close to 7.0 percent in 2005. Looking only at warehouse/distribution space, which comprises roughly 70 percent of the entire industrial inventory, the vacancy has dipped below 6.0 percent.

The flex market, bolstered by a thriving office market, experienced a drop in vacancy for the fifth consecutive quarter by the end of 2006.⁴ The reported range by the brokerage firms varies the most for flex space given the difference in criteria used to identify space as flex versus office. However all three firms are showing a year-over-year decrease in the vacancy rate ending at a range between 9.0 and 16.4 percent.

While, in 2007 flex space may be hurt by the job outlook in the technology sector, the warehouse/distribution market shows signs of positive growth. In addition to modest state-wide growth of 1.7 percent in trade, transportation and utilities employment, increased investments at the Port of Portland should further attract import trade and thus increase warehousing needs. For example, the Port received its third Post-Panamax container crane in 2006 and is due to purchase a fourth in 2008. The Post-Panamax cranes are so named for their ability to unload containers from ships that are too large to navigate the Panama Canal. These cranes increase the speed at which cargo can be unloaded and are therefore integral in attracting shipping lines to Portland's docks. The Port is also investing in rail infrastructure to increase rail access to the Port.⁵

1. Port of Portland

2. Port of Portland, 2007, January 22

3. Port of Portland, 2006

4. NAI Norris, Beggs & Simpson, 2007a

5. Port of Portland, 2007, January 22



The Port expects that burgeoning Asian economies as well as our own region's growth will greatly increase trade into and out of the Portland as the region is one of four key international ports on the US West Coast. Furthermore, as a key access point for consumer markets throughout the northwest, the Port of Portland will benefit from projected local population increases, which will lead to increased demand for domestic and international goods.¹ All of the above, should help sustain a moderate level of occupancy growth in the industrial market even if the technology, manufacturing and construction employment sectors begin to wane■

1. Port of Portland, 2006



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