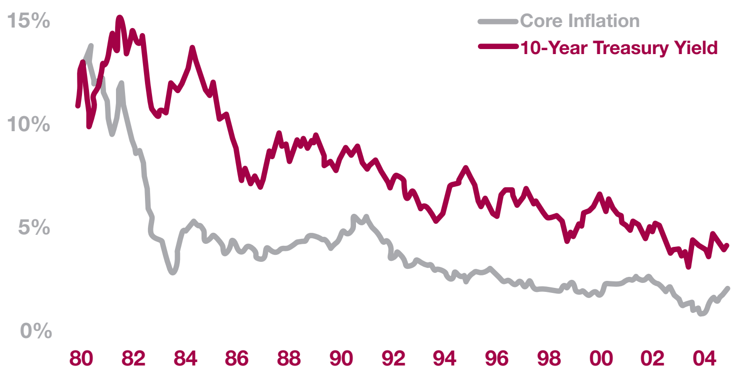
10-Year Treasury Yield and Core Inflation



- Yields Flat. Foreign and domestic bond buyers held long-term rates in the low-4 percent range over the past year. The 10-year Treasury came in at approximately 4.2 percent at year end and was only about 200 basis points above the two-year note yield, an unusually narrow spread.
- Competitive Environment. Conduits and life insurance companies each booked high loan volumes last year. Lenders were willing to compete intensely on terms and proceeds.
- Improved Pricing. Spreads on office loans tightened in 2004, signaling intense competition among lenders and high investor demand for mortgage-backed securities. Lending volume also suggested lenders were becoming more confident that an office market recovery was evolving.
- Tightening Began. As widely expected, the Fed began to raise short-term rates. The Fed Funds rate ended 2004 at 2.25 percent and was increased to 2.5 percent in early 2005.

Capital Markets: Lenders Gain Interest in Office Deals

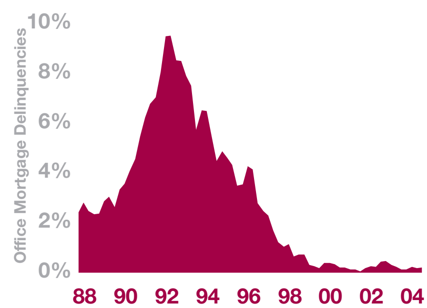
The prolonged slump in the nation's office market was the main story leading into 2004, yet the usual providers of capital for office properties were quite busy during the year. A low number of office completions, an economic recovery that found its legs in 2004 and the evaporation of sublease space helped brighten the outlook of conduits and life insurance companies. Each recorded high loan volumes and remained the go-to sources of capital for office property owners and investors. Over the past several years, conduits and life companies have sharpened their expertise in assessing risk, underwriting office assets and supporting an increasingly liquid mortgage-backed securities market. Additionally, delinquencies on loans secured by office properties remain low. At the same time, with net absorption improving, the prospect of rapidly rising delinquencies seems to have passed. This development should encourage lenders to be more competitive and active in 2005.

Spreads on office loans tightened by approximately 50 basis points in 2004. At year end, large, low-leverage (65 percent LTV, 1.25x DSC) loans were being issued at 115 basis points over the 10-year U.S. Treasury, while higher leverage (75 percent LTV, 1.35x DSC) were being priced at 150 basis points over. Additional tightening is expected through the early part of the year as 10-year rates remain low, the office recovery builds steam and more capital pours into mortgage-backed securities. Borrowers should expect conduits and life companies to step up activity, with conduits competing aggressively to increase market share. Rising short-term rates, meanwhile, might be a signal for borrowers with LIBOR-based debt to lock in fixed rates.

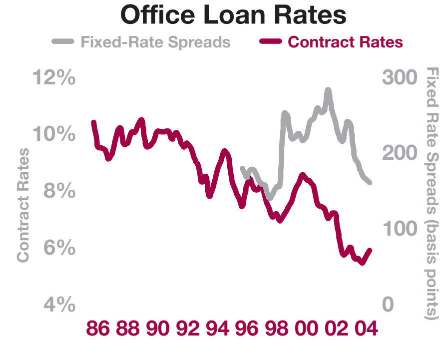
Forecast

- Rising Rates. Contract rates on loans will increase as economic growth gains traction and Treasury yields rise. According to consensus, a 50 to 80 basis point increase in the 10-year Treasury to the mid- to high-4 percent range is expected.
- Rate Spike Unlikely. Exogenous events such as a large-scale unwinding of foreign positions in U.S. Treasury securities could send rates soaring from current low levels, but such an occurrence is considered unlikely.
- Fed Maintains Course. Gradual increases in the Fed Funds rate are expected throughout the year. The Fed will be keeping a vigilant eye on the buildup of inflationary pressures.

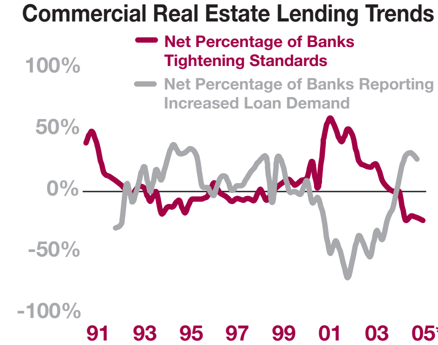
Office Mortgage Delinquencies



Office Loan Rates



Commercial Real Estate Lending Trends



*Forecast