Message from the Chairman

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So much for my career as an economist. In last months message I predicted that the June 29th meeting of the FOMC would not produce a 17th consecutive quarter point increase. **However, it appears almost certainly that the Fed will raise rates on June 29th another quarter of a point to make the Federal Funds rate 5.25%. It appears this action has already been taken into consideration by lenders as last week 5 year fixed rate money increased a quarter of a point from 6.25 to 6.5%.** It appears that Fed Chairman Bernanke is concerned about "unwelcome developments" on the inflation front. Last week's consumer price report and other signs that growth may be firming, have some economists calling for the Fed Funds rate to reach 6% later this year. We still do not believe this is likely, as we believe that the economy is simply not growing fast enough and expect a softening by the fall. There has been quite a bit of tightening already which the marketplace has not yet experienced and Fed officials need to be wary of not making their policy to restrictive. **Unemployment seems to be steady at 4.6% and does not appear to be volatile.** The recent pick up in inflation indicators has been concentrated in rental components, which in turn reflect evolving weaknesses in the housing sector. Labor costs remain stable and inflation expectations here have retreated. Fed officials can also continue to characterize inflation expectations as "contained" while recognizing that inflation itself has picked up in recent months.

The predicted June 29th rate increase and subsequent rate increases will continue to put pressure on cap rates. **The segments of the market that have been most adversely affected in recent months have been land and condo conversion properties. Depending upon location, land values have been off anywhere from 5-20%.** The increasing rates will have the effect of changing the underwriting for end user condo prices. As interest rates increase, the amount the consumer condominium market can support, has to be affected. We should, therefore, see additional price adjustments in this sector. **However, we are still amazed by the fact that the most well located properties are not seeing any tangible reduction in value.**

The office building and hotel sectors continue to increase in value at a steady rate. As predicted, two months ago, the hotel market has been on fire. **Last year 41 million tourists visited New York and this year 43 million are projected to visit. Both of these are record numbers and, in tandem with the thousands of hotel rooms that have been removed from the stock of rooms by condominium conversions, the market is currently experiencing occupancy rates at 35 year highs and the average room rate is also at a record level.** The proliferation of boutique hotels that have sprung up all over the city has been notable but has really not added a significant number of rooms to the stock. **Large scale hotel projects that are now planned or are just beginning are still 18-24 months from delivery, meaning that the next two years for the hotel market should be fantastic.** Since mentioning this at our Market Makers Breakfast on May 25th, we have been contacted by almost two dozen developers that are actively looking for hotel development sites. This market should be very interesting to watch.

Similarly, the office sector is looking very healthy as rents continue to climb and concessions continue to evaporate. **Based upon this, some projects that were slated for conversion to condomini-**

um are now being re-thought as potential office candidates. It is also no longer an automatic that a site zoned for both residential and commercial will absolutely be a residential development. We expect to see the supply of available office buildings for sale in the city increase as demand for this asset class continues to escalate.

On the income producing front, prices have held steady until now. But with the recent increase in mortgage rates, and the expected increase in the Federal Funds rate on June 29th, we expect there to be more upward pressure on cap rates than we have seen in several years. The underlying fact about the market that gives us some comfort is the abundance of capital that is presently in the marketplace. **We believe that if there were to be a 10% decline in prices, it would be viewed as such a buying opportunity that the capital would swoop into the market and booey up the prices.** Allocations at leading institutions in the country have been increasing toward real estate and hedge funds continue to raise record amounts of dollars, much of which is slated for real estate investment.

Notwithstanding an externality, we are expecting a healthy building sales market for the next couple of years.

In our opinion, the most interesting Fed development will take place in the August meeting. Another rate hike then could have significant implications for our market. The yield curve is already projecting a reasonable probability that his could happen.

I will resume the message in September and wish you all a happy, healthy summer spent with family and friends.

Very truly yours,

Bob

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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 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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