

MESSAGE FROM THE CHAIRMAN



Mixed signals are coming from the NY Metropolitan area's building sales market. Market segments are, indeed, moving in different directions. **The hotel and office segments are increasing in value while land and conversion properties are seeing reductions in value. Income producing properties' values are holding steady.** We have discussed in past issues that the hotel and office components would be the hottest product segments for the next two to three quarters. **This prediction is being fully borne out.** The reduction in the supply of hotel rooms (due to condominium conversion) and the continuing drop in the strength of the dollar which has caused an increase in tourism, has resulted in hotel occupancy figures rising along with room rates, creating a booming hotel market. We expect these trends to continue as planned hotel developments (in response to current conditions) will take 12-18 months to come online and a peak tourism season upon us.

In the office segment a virtual lack of speculative office construction over the past several years, has resulted in a lowering of vacancy rates and an increase in rental rates. According to the GVA Williams' 1st quarter 2006 report, average rents in midtown Manhattan are \$49.28 up from \$46.42 in the 4th quarter of 2005. This represents a 6% increase in a single quarter. We would not be surprised to see office rents increase 15-20% in 2006. The vacancy rate is presently running at 7.8% clearly representing a landlord's market.

Land and conversion properties are being adversely affected by the slow down in the consumer condominium market. All data presented from residential real estate firms for the first quarter, show that prices of condominiums are holding steady. This has been the focus of all the media coverage for that market segment as well. **However, the most telling factor is that the velocity of sales is slowing which is typically a precursor to a reduction in price.** Increasing pressure on developers to lower prices to get sales velocity to an acceptable level should be setting in shortly. **In all but the most prime locations, land appears to continue to be off its peak anywhere from 5-15% and existing multi-family buildings for conversion to condominium appear to be off by 5% and, more importantly, many are languishing on the market at unattainable prices.**

Occupied incoming producing properties continue to be the most highly sought after product type. The proliferation of 1031 tax deferred exchanges continues to pump significant demand into the market and new capital from first time buyers wanting to get their piece of the pie, continues to drive this market. **As discussed last month, we continue to see tremendous capital inflows from China, Mexico and India, continuing the globalization of the small to mid-size building sales market.** The dollar continues to weaken creating even more incentive for offshore investors to park money in NYC Real Estate. There is so much capital actively looking for a home here, and an additional tremendous reserve of capital sitting on the sidelines, that **if income producing properties prices were to fall by 10%, it would be perceived as such a buying opportunity that the patient capital would sweep into the market and buoy prices** back up near their present levels. We, therefore, over the short term, do not see any vulnerability in the marketplace.

The yield expectation on behalf of investors continues to be at relatively low levels. If we take a look at interest rate dynamics an interesting conclusion is drawn. **As predicted, at the May 10th meeting of the Fed, the target rate was increased 25 basis points to 5% which was the 16th consecutive quarter point increase.** This increased the federal funds rate to 5%. A year ago it was 3%. The prime rate was increased to 8% which was 6% a year ago, so base rates have increased 2% over the past 12 months. However, mortgage rates have only increased about 1% during the same period. Today the 30 year rate is 6.21% which was 5.28% a year ago. This dynamic is compressing lender's margins as they continue to be more competitive for financing product. The interesting thing is to see that cap rates during the same 12 month period have remained virtually unchanged. **This means that over the last 12 months there has been approximately a 60 basis point (assuming 75% LTV) reduction in the yield expectation on behalf of the investment community.**

We believe that at the June 29th meeting of the Fed, rates will not be increased again. Fed officials seem to expect that inflation and growth will soften in the short term. If this proves correct, they are likely to stop the tightening at the current 5% Federal Funds target rate. Growth does seem to be slowing to a trend pace in the second quarter of 06. We believe that this slow down will continue pro-

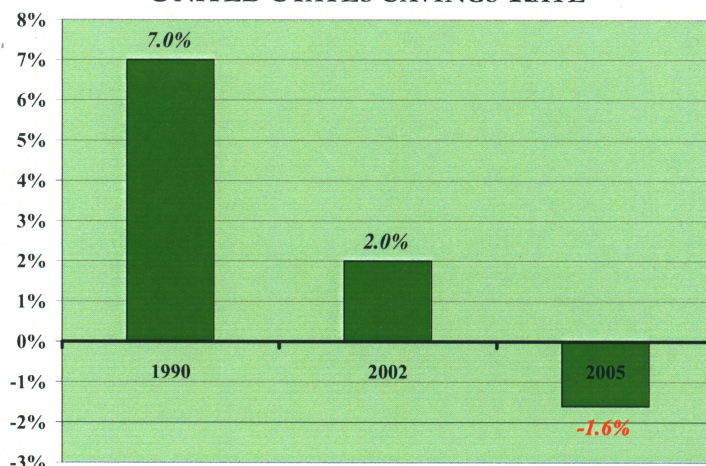
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ducing below trend growth in late 2006 and early 2007. As this is likely to cap core inflation, the Fed will not need to tighten any further. **However, inflation data is not consistent (as evidenced by the data released on May 17th) and further surprises could exert upward pressure on inflation expectations.** The biggest factor affecting these could be energy prices.

The recent consumer data suggests that a pause in June is likely. Retail sales rose less than expected in April. As real consumer spending is on an extremely modest course, consumer confidence has tumbled in recent weeks. Fed Chairman Bernanke has a forward looking approach which has important implications for the near term policy outlook. Strong recent growth data do not appear to have changed his viewpoint that a significant slowdown lies ahead. A gradual cooling of the housing market and the lag effects of increases in interest rates and energy prices are likely to moderate a more sustainable pace. **We expect consumer spending to slow significantly in the coming quarters due to an average lag of 1-2 quarters between home price inflation and mortgage equity withdrawal (MEW) and another lag of 1-2 quarters between changes in MEW and changes in consumer spending.**

Insight can be drawn from the U.S. savings rate. In 1990 the savings rate was 7%, in 2002 it was 2% and in 2005 it was -1.6%. This was due to the rise in housing value encouraging many homeowners to access equity through MEW. Most of this equity was spent on consumer goods creating negative savings. To put this in perspective the average savings rate in China is 50%! As interest rates have risen there

UNITED STATES SAVINGS RATE



longer refinancing opportunities and the savings rate, by definition, will go up causing a reduction in consumer spending, the economy will slow down, and this will put a drag on demand. For these reasons we do not see growth accelerating and we believe that the Fed will, in the short term, stop increasing rates. Positive news for our market indeed...stay tuned...

Very truly yours,

Robert A. Knakal
 Chairman
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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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