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Recovery Slowing in Mid 2011

Last quarter, we said that this recovery would be two steps forward, one step backwards, and these last few months were definitely steps backwards. GDP growth slowed considerably, as did the pace of new job creation; both strong indications that the recovery has flattened and partially stalled as of the second quarter of 2011. In fact, almost all measures of economic health have shown declines or outright flattening in the growth rate.

It is critical to draw a distinction between this stalling activity and a real decline or new recession. The numbers are still positive, just not robust in growth. There are several explanations for the slowdown in economic growth. First, dramatic increase in fuel prices during the first half of the year due to foreign war and strife put undue pressure on what were still relatively weak consumers. Second, pent-up demand from both consumers and businesses likely caused a type of “bubble” of spending and activity that crested around the holidays, thus part of the flattening is likely just a return to steadier growth levels. Third, and perhaps most troublesome, consumers have been reporting lower levels of confidence, thus risking a self-fulfilling slowdown prophecy.

There is yet to be any direct evidence or even strong rationale to believe we are at the beginning of another recession, the dreaded “double dip”. We believe it is possible for the slowdown to persist for several months or longer; however, it is equally likely, if not more likely, that modest or even robust

growth will resume by year’s end. Pure fundamental facts about the American economy and populous did not change over the past several months, thus there is no obvious reason for a prolonged slowdown.

Another issue that is plaguing the business environment is the implementation of new regulations as required by recently passed laws. Several aspects of the Dodd-Frank Act become effective this summer, and banks and other industries are having to learn to play by new rules. Implementation of any new regulations will cause at least some short-term adjustment pain, and we expect the same to come from implementation of the health care reform law. Once businesses learn to adapt and regulators iron out problems and ambiguities, we can expect the new “business as usual” to be more conducive to sustained growth.

“Income-producing real estate continues to gain attractiveness.”

The brightest indicator that we are just in a temporary stall and not on the verge of recession is the equity markets. The Dow Jones Industrials Index remains near 12,500 at the time of writing; close to recent highs and far from recession lows. The market has historically been a good predictor of future economic conditions, and right now it is not predicting failure. Nonetheless, income-producing real estate continues to gain attractiveness given uncertainty of the business cycle and possible inflation.

Current Economic Snapshot

- ↔ GDP Growth
- ↔ Employment
- ↑ Productivity
- ↔ Consumer Confidence
- ↑ Corporate Profits
- ↔ Interest Rates
- ↔ Inflation

Current Real Estate Snapshot

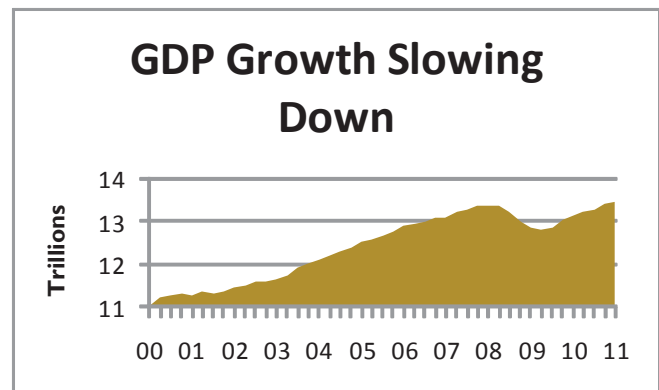
- ↔ Rental Rates
- ↑ Occupancy
- ↔ Prices
- ↓ New Construction
- ↔ Loan Distress
- ↑ Transactions

Note: Current economic snapshot and current real estate snapshot are intended to represent an overall sense of the current trend for the entire nation and across all property types. Neither is intended to represent an endorsement or recommendation of any investment or market.

Major Economic Factors

Gross Domestic Product (GDP): Slow yet Positive Growth

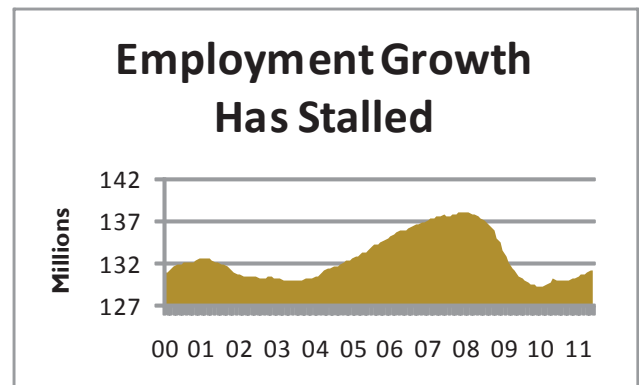
The only thing to say about a 1.9% annualized rate of GDP growth as seen in the first quarter of 2011 is at least it was not negative! After achieving relatively robust growth during most of 2010, we have seen a substantial pullback in economic activity advancement. The declines in economic activity come primarily from slower growth of personal consumption and federal government spending. To the positive, a notable upturn in private inventory investment was detected indicating that the business sector still holds positive expectations of demand. Unfortunately, it is the consumer that ultimately holds the power in determining the direction of the American economy. Fuel prices have a direct impact on the consumers' propensity to spend, especially on discretionary goods and services. If we can see fuel price pressure ease, it is likely that the consumer can resume higher spending levels.



Source: U.S. Bureau of Economic Analysis

Employment: Growth Maintains but at Disappointing Levels

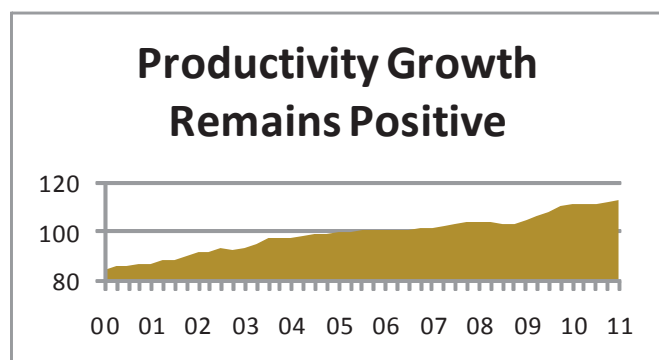
The last several months have seen slow, tepid employment growth raising the unemployment rate to 9.2%. This represents a marked turn from growth seen at the end of 2010 and early parts of 2011. This has largely been due to stagnation in private sector employment and declines in government employment. This trend was largely unexpected by most economists who believed that we had resumed steady growth. We believe the weakness in the consumer sector has caused many business leaders to become more cautious in their expectations of future demand and, as such, have delayed new hiring. Bright spots in employment include professional and technical services, health care, mining, and leisure and hospitality. Government is the only sector to show actual losses, the rest have been essentially flat for the year. We have said repeatedly that robust job growth would be slow to take hold, and sadly, we have been correct.



Source: U.S. Bureau of Labor Statistics

Leading Economic Indicators: Mixed Readings of the Future

According to The Conference Board, consumer confidence has been trending down for several months and consumers are increasingly reporting lower expectations for the future. Rising fuel prices, job market stagnation, and the ever-hurting housing market are all likely causes for this finding. On the other hand, The Conference Board Leading Economic Index continues to increase and predicts slow growth for the remainder of the year. Further, productivity, as measured and reported by the U.S. Bureau of Labor Statistics, continues to gain which means employers are better utilizing workers and may need to increase hiring at some point. In summation, we believe the consumer is capable of healthy spending and growth, but faces headwinds of fear at the moment. Thus, the economy should remain growing, but it is prudent to note that the risk of decline has certainly increased.



Source: U.S. Bureau of Labor Statistics

Property Sector Analysis

Multifamily Sector Outlook

Apartments continued a positive absorption trend through the second quarter, although at a slower rate than before. The U.S. Census Bureau data shows a slight negative trend in household formation, no doubt due to the lack of job creation in recent months. Demographic trends will keep apartment demand robust in many markets for some time, thus we expect continued improvement in rental rates and occupancy for the foreseeable future. The asset market for multifamily is likely to offer more favorable pricing to new buyers as the speculative rush to buy trophy properties subsides. Overall, assuming we do not have significant job losses, multifamily will likely remain the strongest sector of real estate for investment.

Retail Sector Outlook

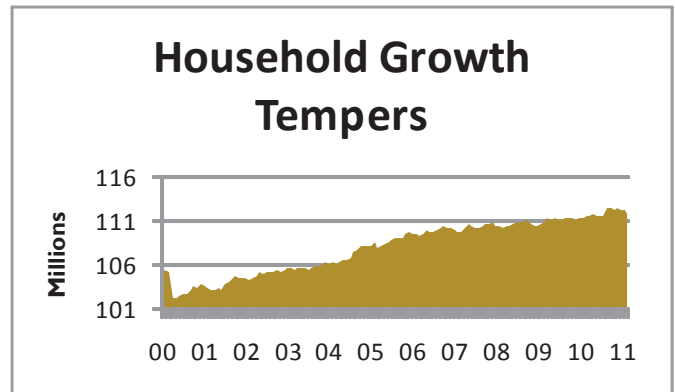
Vacancy rates moved higher this past quarter nationwide as the consumer faced new pressures due to high gasoline costs. Retailers have recovered a great deal as seen in the level of retail sales, but are facing challenges in sustaining growth (especially in discretionary and luxury goods). More troublesome to the retail real estate sector is the fact that traditional “big box” space users, such as Best Buy, are opting to open smaller stores when they do expand and thus aggregate space demand may be slow for some time. Retail real estate fundamentals will face challenges until job growth resumes and/or fuel prices subside. Still, look for markets with job growth to perform quite well.

Office Sector Outlook

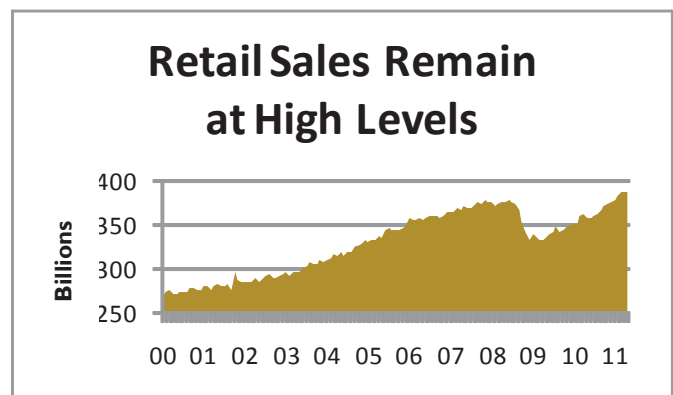
The national office market continued to absorb space during the second quarter but at a slower rate than earlier in the year. The slowdown in the pace of hiring will likely cause a flattening in the demand for office space and hinder improvements in rental rates and overall occupancy. On the positive side, new supply will likely be delayed further and thus rental rate increases will be far more likely once the economic growth resumes in earnest. The asset market for trophy office buildings has been exceedingly hot due to supply constraints; we expect this trend to moderate as fears of the macro economy cause office investors to slow down and rethink their acquisition criteria.

Industrial Sector Outlook

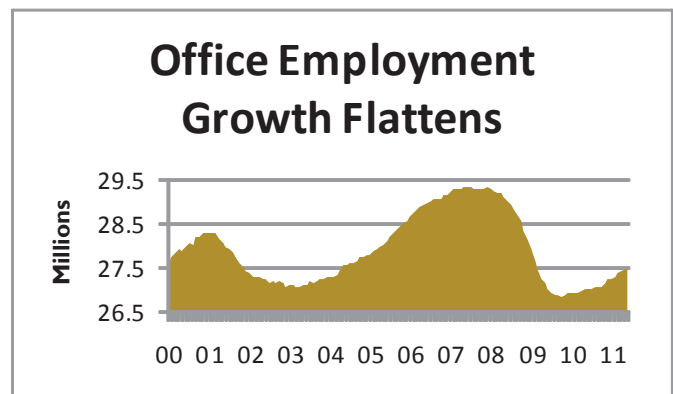
The industrial market continued to show improvement in occupancy nationwide as many private sector firms expanded inventories and continued to resume more normal levels of production. The flattening in the growth rate of new manufacturing orders along with the overall economic sluggishness will likely cause a flattening of industrial space demand as well. However, many markets, especially those along key trade corridors, are facing new supply constraints and thus are likely to see continued improvement in rental rates and occupancy even if the economy remains essentially flat.



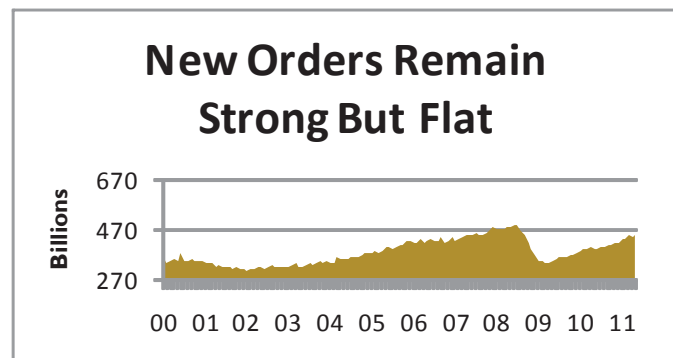
Source: U.S. Census Bureau



Source: U.S. Census Bureau



Source: U.S. Bureau of Labor Statistics



Source: U.S. Census Bureau

Capital Market Outlook

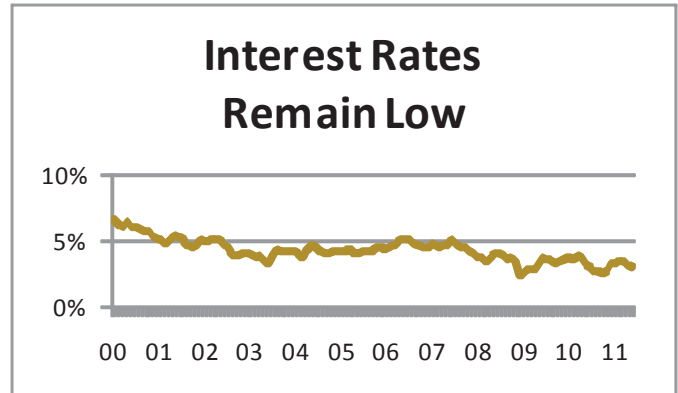
Despite the perceived weakness in the overall economy and slowing fundamental growth in occupancy and rental rates, investors continued to purchase investment properties at an increasing rate throughout the first half of the year. Thus, the “smart money” continues to believe and invest in real estate. Banks, life insurance companies, and Commercial Mortgage Backed Securities (CMBS) issuers all continued to increase the pace of lending, albeit still far from pre-bubble levels.

Last quarter we opined that rising interest rates could negatively impact mortgage rates. Presently, interest rates have fallen back to recent lows and thus we expect the asset market to remain well fueled; however, new fears may slow transaction volume despite capital availability. Interest rates are not likely to rise until the economic situation is healthier. Further, unrest in Europe due to the Greek debt problem will likely make U.S. Treasury debt more attractive in the short term. Thus, we are likely to continue to enjoy a low interest rate environment, even if it is for all of the wrong reasons.

Investment Horizon

Given the uncertainty of the speed of recovery or even the direction of the economy, combined with the real potential of long-run inflation due to rising federal deficits, we believe income-producing real estate may be one of the best investments available today.

Assuming well positioned assets in the right markets are purchased, income levels are likely to remain at least stable as new supply is constrained across the board. We believe that the space markets have likely experienced the bulk of the pain they needed to following the recent recession. Even if a “double dip” recession occurs, we do not expect income-producing real estate to feel the majority of the impact.



Source: Federal Reserve (Rates reflect 10-Year Treasury Securities)

The most interesting conversations at the large financial institutions today revolve around the impact of the newly enacted Dodd-Frank Act. There are likely to be significant changes in bank lending, investment, and trading operations that will affect commercial real estate. Unfortunately, exactly how is still unknown.

Thus, earning cash flow today from real estate may make more sense than betting on appreciation in the stock market which requires strong economic growth to persist.

If investors cannot be sure of the direction of the market, then current income is maybe one of the best features an investment can offer. Prices will always fluctuate in good markets and bad, but recurring cash flow is more valuable in uncertain times as you do not need to sell the asset to receive the cash. We believe it is wise that investors seek to increase the current yield of their overall portfolio and correctly purchased income-producing real estate is one such asset that can accomplish that.



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