# RED CAPITAL RESEARCH

## Mideast Regional Report

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FOURTH QUARTER 2007

## EXECUTIVE SUMMARY

***National Economic Trends***

- The pace of economic expansion was considerably weaker in the fourth quarter 2007. Real gross domestic product advanced at a 0.6% seasonally-adjusted annual rate, significantly below trend and comprehensively slower than the 4.9% surge recorded in the third quarter. The housing downturn was largely to blame: residential fixed investment fell 25.2%, as developers cut production in order to stem a sharp rise in unsold home inventories. Personal consumption advanced at a 1.9% rate, down from 2.8% in 3Q07, and import levels fell 1.9% on sluggish domestic demand. The decline in spending was felt most acutely at retailers exposed to the housing industry, especially building supply, home furnishings and department stores, which registered declining sales year-over-year. Even export growth, which ignited the economy in the third quarter, decelerated significantly, dropping from a 19.1% burst in 3Q07 to a more modest 4.8% advance.

- January and February payroll data suggest that the economy continued to decelerate in 2008 and raised the prospect that GDP growth will be negative in the first quarter. Establishments trimmed 22,000 and 63,000 jobs, respectively, in January and February, the first seasonally adjusted losses recorded since August 2003. On a year-over-year basis, payroll employment rose 0.6% in February, the slowest annual comparison observed in 48 months. New orders for manufactured goods fell 2.5% in January, following a 2.0% increase in December. This decline was primarily attributable to reduced demand for cars, trucks and other transportation equipment, which fell 13.0% following a 10.1% gain posted in December.

- National City Bank economist Dr. Richard DeKaser forecasts GDP growth to decelerate to 1.9% in 2008 but rebound to 2.5% in 2009. Similarly, the rate of payroll growth is expected to fall to 0.6% this year, and accelerate to 1.1% in 2009.

***Mideast Region Economic Trends***

- Conditions in the Mideast Region economy deteriorated in the second half of 2007, in large part due to the downward spiral of the domestic automobile industry. Transportation equipment manufacturing headcounts fell by an aggregate of 37,700 (-6.7%) in 2007, the worst performance since 2001. Sub-sector job losses accelerated in 4Q07 to a 38,100-job pace, as layoffs in the state of Michigan surged from a year-over-year rate of 9,700 (-4.7%) jobs in 3Q to 20,600 (-9.5%) jobs. Further cuts in the construction and retail trade sectors also contributed to the regional decline.

- In aggregate, Four-state region payrolls declined 39,500 (-0.3%) jobs, tripling 2006's net loss of 13,300. Conditions were marginally stronger in 3Q07, when attrition slowed from a -54,700-job pace in the first half to a –14,800-job, -0.1% rate in the three months ended in September. Trends took a turn for the worse in the fourth quarter, however, with losses reaccelerating to -35,800. Net job losses were confined to Michigan and Ohio; payroll aggregates s in Indiana and Kentucky were higher by 14,400 (0.5%) and 23,100 (1.3%), respectively in 2007. Kentucky exhibited some degree of slowing in 4Q07, again due to automobile industry issues, but Indiana headcount growth accelerated, rising to a 25,000-job annual pace from 23,100 in the previous quarter.

- **RED CAPITAL Research** expect 2008 to be another challenging year for the region. **RCR**'s econometric payroll model foresees net job losses totaling 23,000 (-0.2%) in 2008, but a return to the black in 2009 with a net gain of 69,000 (0.6%) jobs.

***Total Return Analysis***

- Aided by the highest acquisition cap rates in the **RED 50** and low levels of occupancy and rent volatility**,** assets in this region offer above average expected 5-year holding period total returns and some of the best risk-adjusted returns available. Three Mideast markets offer expected returns of 8% or more, and each metro promises greater returns than the 6.2% **RED 50** average. Louisville sports the highest risk-adjusted index in the **RED 50,** and only two metros, Indianapolis and Columbus, generate RAI below 4%.

***Investment Rankings***

- Each of the metro markets in this group offers compelling value to yield-driven investors. But in only three cases do yields reach the level necessary to overcome structural economic, demographic and property market liquidity weaknesses: Cleveland, Pittsburgh and Louisville. We rank each an ***Accumulate*** market. While we have dismissed Indianapolis and Columbus as supply prone commodity markets in the past, improving economic fundamentals and developer capitulation now elevate them to the cusp of the ***Accumulate*** ranks. Detroit offers interesting risk-adjusted returns, but we aren't comfortable with the Reis rent forecast; Cincinnati is improving on all fronts, but asset prices remain too rich to recommend it: invest ***Opportunistically*** in both.

RED CAPITAL GROUP • 800-830-5100 • www.redcapitalgroup.com