

# **PUGET SOUND MARKET REPORT**

## **FIRST QUARTER, 2006**

Bill Parker, Consultant

This report presents information on a variety of factors which have an effect on the economy of the Puget Sound Region and on housing in particular. Individual readers may reach different conclusions than those presented here using the same data.

### **SUMMARY**

The strong local market for housing continued in 2005 but 2006 presents some uncertainty. Unemployment levels continue to improve, population trends are positive, housing sales remain brisk, office and industrial vacancy rates are improving and the state has its first budget surplus in several years. The effects of the Growth Management Act and the limitations that many local governments are placing on developers continue to restrict available housing sites and place upward pressure on the prices of both new and existing houses.

In addition to the limitation on developable land, there are other key factors which continue to support a positive of the housing market in the region. Certainly a major factor is jobs. The region did very well in recent years in spite of a much weaker jobs outlook. Today we see a much better picture, as the unemployment rate decreases while the number of people in the work force increases. Add to this the diversification of jobs we have today as compared to only a few years ago, when the region was much more dependent on only a few employers. And while there is always uncertainty about interest rates, mortgage rates are still at very low levels, historically, and the mortgage industry continues to concoct more products to try to get people into houses.

It must be said, though, that rising interest rates coupled with the extraordinary debt burden carried by many homeowner/consumers may well lead to serious problems for those who expect that the boom of the last few years will continue unabated. Lenders, builders, realtors, investors, suppliers and those who provide services to these industries should use ever increasing caution, particularly when committing resources for expansion. But there are definite signs that the market may slow to just "very good" from the red hot pace of the last few years.

## HOUSING REPORT

For the second month in a row, the Puget Sound Region saw pending sales for December decrease from the year before. The decrease in December, 2005 was 6.9% from the December, 2004 while November, 2005 was down less than 1% from November, 2004. Median prices, however, were up significantly, from 16.5% in Pierce County to 17.0%, 19.6% and 22.9% in King, Snohomish and Kitsap Counties, respectively. The decrease in Pending Sales from November to December, 2005 shown below, was greater than any comparable period in the last five years.

Res only	LISTINGS					PENDING SALES			CLOSED SALES			
	New-Dec05	* New-Dec04	Total Actv Dec05	* #Actv-Dec04	% chg, Total actv	Dec05	* Dec04	% chg	Dec05	* Dec04	Median \$, Dec05	* Median, Dec04
King	1,487	1,595	4,411	4,691	-5.97%	1,790	1,994	-10.23%	2,407	2,813	\$393,000	\$335,000
Snohomish	787	914	2,448	2,554	-4.15%	836	973	-14.08%	1,106	1,251	\$319,950	\$260,000
Pierce	1,032	936	3,375	2,851	18.38%	1,065	1,082	-1.57%	1,356	1,337	\$254,000	\$216,000
Kitsap	222	248	988	851	16.10%	265	296	-10.47%	346	425	\$272,250	\$209,950
Mason	66	73	330	323	2.17%	90	59	52.54%	102	82	\$195,000	\$142,200
Skagit	114	132	499	453	10.15%	125	125	0.00%	154	169	\$246,313	\$209,000
Grays Hrbr	102	88	468	376	24.47%	86	109	-21.10%	94	113	\$135,750	\$115,000
Lewis	68	87	355	361	-1.66%	89	64	39.06%	77	72	\$167,000	\$125,000
Cowlitz	80	73	360	363	-0.83%	116	91	27.47%	101	94	\$170,000	\$129,375
Grant	67	73	330	376	12.23%	50	50	0.00%	70	71	\$116,250	\$103,000
Thurston	329	318	1,013	706	43.48%	318	360	-11.67%	336	365	\$243,600	\$190,000
San Juan	15	18	165	160	3.13%	11	13	-15.38%	14	18	\$494,000	\$524,500
Island	94	96	517	468	10.47%	74	123	-39.84%	124	173	\$277,950	\$223,000
Kittitas	36	20	217	231	-6.06%	47	35	34.29%	57	51	\$193,500	\$204,000
Jefferson	22	28	235	222	5.86%	33	39	-15.38%	28	57	\$286,000	\$260,000
<b>Sub-total</b>	<b>315</b>	<b>222</b>	<b>1,290</b>	<b>765</b>	<b>68.63%</b>	<b>215</b>	<b>175</b>	<b>22.86%</b>	<b>213</b>	<b>238</b>	<b>\$242,000</b>	
Okanogan	4,836	4,921	17,001	15,751	7.94%	5,210	5,588	-6.76%	6,585	7,329		\$258,450
Whatcom	24	N/A	168	N/A		25	N/A		14	N/A	\$129,500	N/A
Others	228	N/A	921	N/A		172	N/A		202	N/A	\$275,000	N/A
<b>Total</b>	<b>5,088</b>		<b>18,090</b>			<b>5,407</b>			<b>6,801</b>		<b>\$301,000</b>	

Source: NWMLS

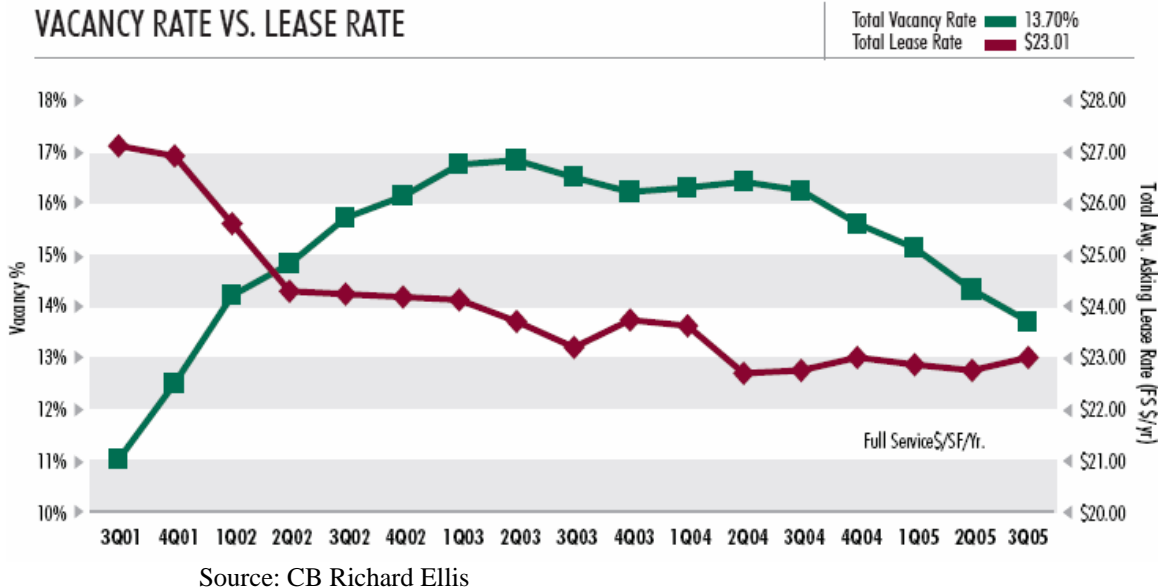
**4 -county Puget Sound Region Pending Sales (SFH + Condo combined)**  
(Totals include King, Snohomish, Pierce & Kitsap counties)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
<b>2000</b>	3706	4778	5903	5116	5490	5079	4928	5432	4569	4675	4126	3166
<b>2001</b>	4334	5056	5722	5399	5631	5568	5434	5544	4040	4387	4155	3430
<b>2002</b>	4293	4735	5569	5436	6131	5212	5525	6215	5394	5777	4966	4153
<b>2003</b>	4746	5290	6889	6837	7148	7202	7673	7135	6698	6552	4904	4454
<b>2004</b>	4521	6284	8073	7910	7888	8186	7583	7464	6984	6761	6228	5195
<b>2005</b>	5426	6833	8801	8420	8610	8896	8207	8784	7561	7157	6188	4837

NOTE: NWMLS had been reporting “Days on Market” in its published reports for many years. The data reflected current listings only and was found to be misleading as slow moving properties could be unlisted one day and re-listed the next day. NWMLS no longer provides this information but is implementing a new field, “Cumulative Days on Market”. This information is not yet available. It should be noted that the former report showed a consistently downward trend in marketing time in recent years. It should also be noted that many realtors are indicating that things are “slowing down” and that the sellers’ market of the last few years may be tailing off.

# COMMERCIAL REAL ESTATE

## OFFICE SPACE



In the third quarter of 2005, the Puget Sound office market had its 12<sup>th</sup> consecutive of positive gains in absorption. The area's vacancy rate declined by 0.61% to 13.7%, continuing its downward trend from nearly three years ago when it reached almost 17%. The annual absorption rate for 2005 is expected to exceed the ten year average.

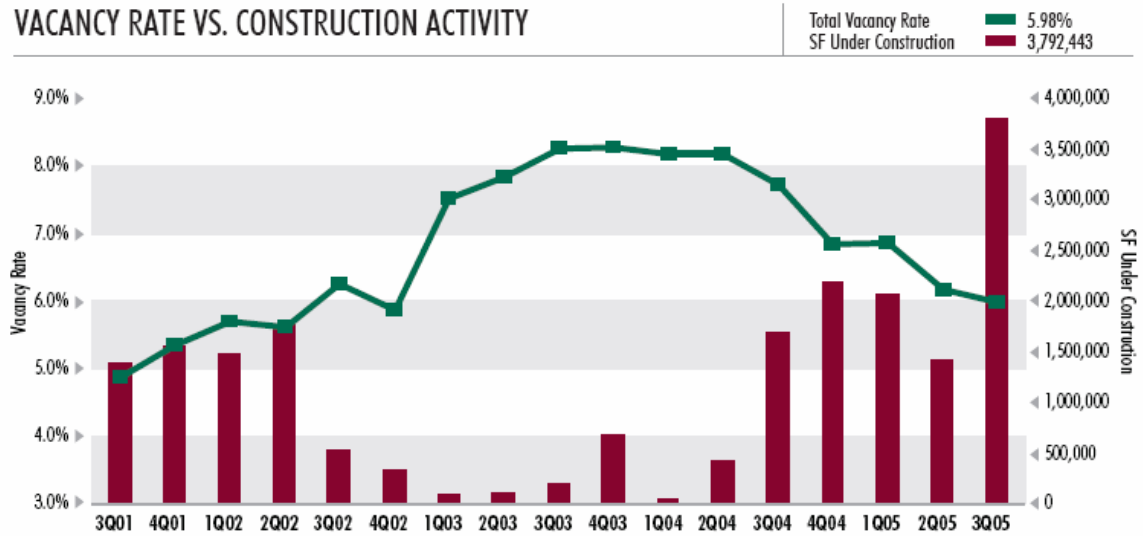
The Eastside showed the most improvement with its vacancy dropping to 10.61%. Snohomish County was considerably higher at 17.59% but it showed the greatest decline, 2.13%. The Southend, meanwhile, showed little improvement and was still relatively high at 21.15%. Downtown Seattle, which is 45% of the Puget Sound market, saw its vacancy rate fall to 13.65%. Fully serviced Class "A" lease rates for the region increased by \$.26 to \$23.01.

Looking ahead, steadily increasing job growth in the region indicates that the regional economy is continuing to recover and vacancy rates are expected to continue their moderate decline. While construction activity has picked up, developers may hold off on new projects until vacancy rates are in single digits and lease rates move closer to \$30.

Market	Net Rentable Area	Total Vacancy Rate %	Total Absorption SF	Under Construction SF	Direct Asking Rate, Class "A" (Fully Serviced SF/Yr)	Total Asking Rate, Class "A" (Fully Serviced SF/Yr)
Seattle CBD	18,645,453	13.29%				
Waterfront	2,430,733	17.95%				
Pioneer Square	3,451,790	9.47%				
Denny Regrade	5,507,463	16.55%				
Lower Queen Anne	2,587,998	15.07%				
Lake Union	2,953,512	13.76%				
Canal	1,229,447	5.96%				
<b>Downtown Seattle</b>	<b>36,806,396</b>	<b>13.65%</b>	<b>141,564</b>	<b>1,085,000</b>	<b>\$24.13</b>	<b>\$23.89</b>
<b>North Seattle</b>	<b>1,435,406</b>	<b>9.04%</b>	<b>-32,805</b>	<b>60,000</b>	<b>\$23.40</b>	<b>\$23.14</b>
South Seattle	1,256,928	15.74%				
Sea-Tac	807,452	12.87%				
Tukwila	1,853,246	21.17%				
Renton	3,290,552	32.82%				
Kent	1,707,945	23.54%				
Auburn	398,014	7.73%				
Federal Way	1,951,858	8.99%				
<b>Southend</b>	<b>11,265,995</b>	<b>21.15%</b>	<b>-11,332</b>	<b>-</b>	<b>\$19.92</b>	<b>\$19.64</b>
Bellevue CBD	5,458,023	10.29%				
I-405	5,421,507	15.84%				
SR-520	3,296,491	11.30%				
I-90	5,556,673	6.51%				
Bel-Red Road	1,037,880	9.65%				
Kirkland	1,544,220	6.35%				
Redmond	3,667,950	11.04%				
<b>Eastside</b>	<b>25,982,744</b>	<b>10.61%</b>	<b>539,342</b>	<b>26,112</b>	<b>\$23.62</b>	<b>\$23.30</b>
<b>Snohomish Co.</b>	<b>3,588,442</b>	<b>17.59%</b>	<b>76,444</b>	<b>111,261</b>	<b>\$23.48</b>	<b>\$23.14</b>
Tacoma	2,806,289	10.52%				
Fife	108,000	6.60%				
Puyallup	123,695	21.78%				
<b>Tacoma/Fife</b>	<b>3,037,984</b>	<b>10.84%</b>	<b>8,399</b>	<b>-</b>	<b>\$18.36</b>	<b>\$18.39</b>
<b>Market Total</b>	<b>82,116,967</b>	<b>13.70%</b>	<b>721,612</b>	<b>1,282,373</b>	<b>\$23.20</b>	<b>\$23.01</b>

## INDUSTRIAL SPACE

### VACANCY RATE VS. CONSTRUCTION ACTIVITY



Source: CB Richard Ellis

The overall vacancy rate dropped below 6% in spite of a slowdown in the absorption rate. All of the markets reported improved absorption rates except for the Kent Valley (the region's largest market), where the vacancy rate stands at 5.04%. The Port of Tacoma/Fife market remains the tightest with a vacancy rate of 1.83%.

Developers continue to move projects to the construction phase as the market continues to tighten and the regional economy continues to improve. This is particularly true in the Kent Valley and Tacoma/Fife markets, which represent more than 91% of new construction in the region.

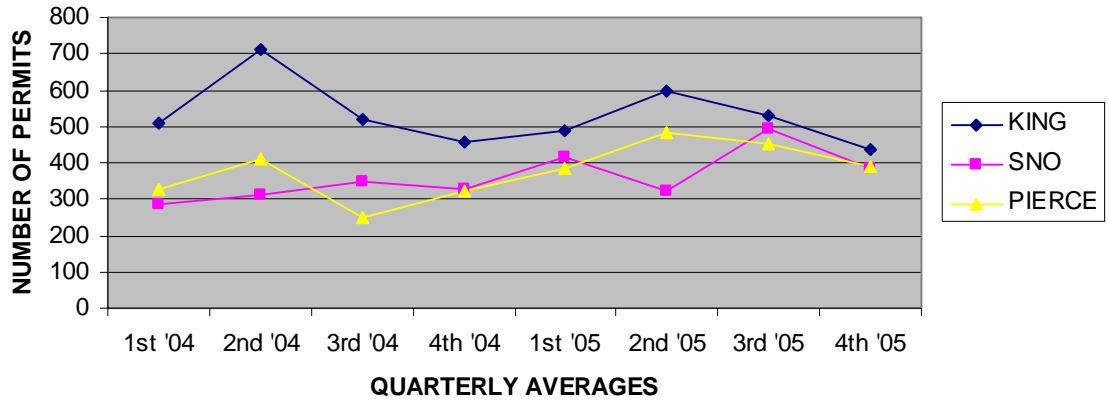
## BUILDING PERMITS

While we have experienced considerable upward price pressure and fast marketing times, the number of building permits has remained fairly level and has even been decreasing in recent months. The month of December, 2005, saw King County actually fall below both Snohomish and Pierce Counties in the number of permits issued.

Permits are a key measure in the future number of new homes that will be in inventory as 2006 moves along. It does not appear that this inventory level will be any higher than it has been.

<b>BUILDING PERMITS - SFR (\$000)</b>						
	<b>KING</b>		<b>SNO</b>		<b>PIERCE</b>	
	#	\$	#	\$	#	\$
<b>2004</b>						
Jan	483	253	251	174	288	156
Feb	446	262	269	178	268	149
Mar	603	252	339	185	418	152
Apr	662	260	418	178	407	148
May	625	264	331	181	346	165
Jun	848	253	481	181	474	156
Jul	532	269	404	185	234	176
Aug	535	266	337	194	209	176
Sep	500	301	303	196	309	158
Oct	548	259	358	192	317	184
Nov	407	258	286	188	314	162
Dec	415	284	344	205	333	168
<b>2005</b>						
Jan	428	275	352	197	466	165
Feb	417	284	413	199	350	192
Mar	615	276	477	193	329	193
Apr	545	285	457	192	383	198
May	649	283	400	199	506	186
Jun	594	285	526	197	53	175
Jul	508	293	480	185	432	178
Aug	521	299	568	199	525	184
Sep	558	282	440	207	396	175
Oct	574	288	370	199	410	180
Nov	417	299	376	198	385	173
Dec	324	286	407	205	374	174

### SFR BUILDING PERMITS



## INTEREST RATE OUTLOOK

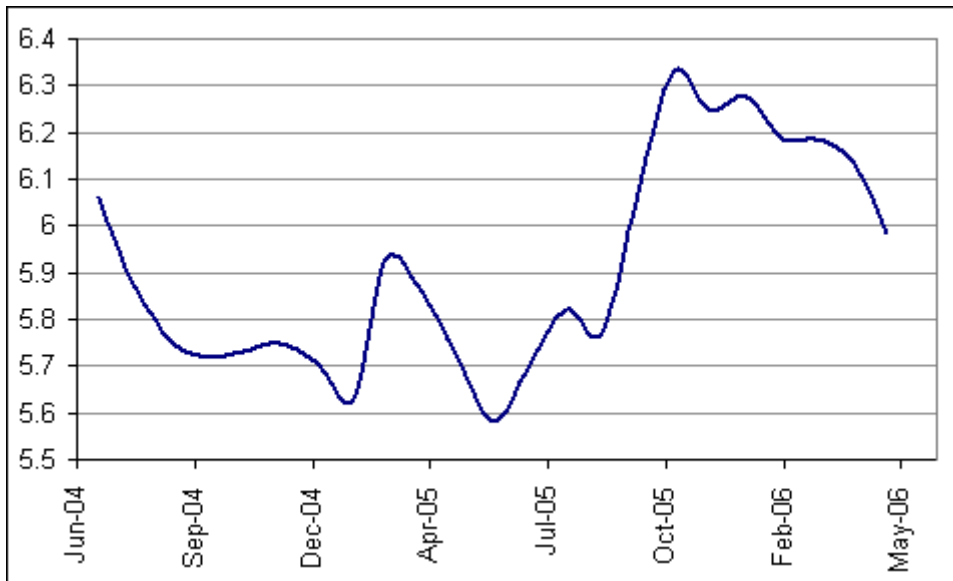
Information on interest rates and several other factors affecting the economy are presented from four different sources. It is important to note that not all agree with the direction of long-term mortgages nor do they agree on the level of rates even out as far as six months. All of the forecasts for housing starts predict a downward trend. None of these forecasts anticipate any severe upward trend in rates.

	2003	2004	2005	2006	2007
Total Starts (000)	1,854	1,950	2,060	1,940	1,883
Single-family (000)	1,505	1,604	1,706	1,590	1,533
Multifamily (000)	349	345	354	350	350
New Single-Family Home Sales (000)	1,091	1,200	1,273	1,190	1,148
Existing Home Sales (000)	5,441	5,913	6,233	5,894	5,707
<b>Interest Rates (Freddie Mac Commitment)</b>					
30-Year Fixed-rate	5.8%	5.8%	5.9%	6.6%	6.7%
1-Year ARMs	3.8%	3.9%	4.5%	5.4%	5.5%
Prime Rate	4.1%	4.3%	6.2%	7.5%	7.5%

\*\* Annual data are averages of seasonally adjusted quarterly data and may not match annual data published elsewhere.

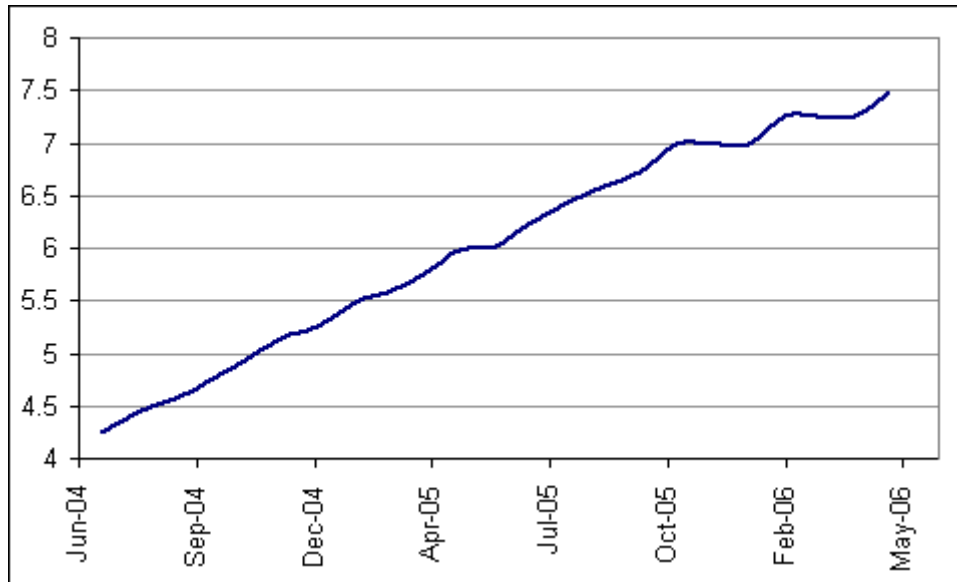
Source: National Association of Homebuilders

### 30 Year Conventional Mortgage Interest Rate Past Trend, Present Value & Future Projection



Source: Financial Forecast Center, LLC

## Prime Loan Interest Rate Past Trend, Present Value & Future Projection



Source: Financial Forecast Center, LLC

## MBA Mortgage Finance Forecast

January 10, 2006

	2005				2006				2004	2005	2006
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
<b>Housing Measures (Thous)</b>											
Housing Starts	2,083	2,044	2,101	2,058	2,019	1,977	1,951	1,932	1,956	2,072	1,970
Single-Family	1,709	1,693	1,747	1,751	1,698	1,642	1,609	1,591	1,611	1,725	1,635
Two or More	374	351	354	308	321	335	342	341	345	347	335
<b>Home Sales</b>											
Total Existing Homes	6,837	7,223	7,240	6,937	6,858	6,701	6,640	6,623	6,784	7,059	6,706
New Homes	1,249	1,287	1,302	1,289	1,274	1,235	1,218	1,207	1,203	1,282	1,234
Median Price of Total Existing Homes (Thous \$)	190.3	209.3	216.3	215.2	216.9	222.6	223.0	221.4	185.2	207.8	221.0
Median Price of New Homes (Thous \$)	229.9	230.2	235.1	232.8	240.5	245.3	244.8	242.9	221.0	232.0	243.4
<b>Interest Rates (%)</b>											
30-Year Fixed Rate Mortgage	5.8	5.7	5.8	6.2	6.2	6.3	6.4	6.6	5.8	5.9	6.4
10-Year Treasury Yield	4.3	4.2	4.2	4.5	4.5	4.9	5.0	5.1	4.3	4.3	4.9
1-Year Treasury ARM	4.2	4.2	4.5	5.1	5.2	5.5	5.5	5.5	3.9	4.5	5.4
1-Year Treasury Yield	3.1	3.3	3.8	4.3	4.5	4.9	4.9	5.0	1.9	3.6	4.8
<b>Mortgage Originations</b>											
Total 1- to 4-Family (Bill \$)	620	771	763	633	499	634	606	498	2,772	2,787	2,236
Purchase	292	424	427	349	309	412	400	333	1,309	1,492	1,455
Refinance	329	347	336	284	189	222	206	164	1,463	1,295	782
Refinance Share (%)	53	45	44	45	38	35	34	33	53	47	35
ARM Share (%)	32	33	28	29	26	25	27	28	34	31	26

Source: Mortgage Bankers Association

*Dr. Sohn's Economic Forecast: 12/31/05*

Economic Data	History				Forecast				Annual Average							
	2004.1	2004.2	2004.3	2004.4	2005.1	2005.2	2005.3	2005.4	2006.1	2006.2	2006.3	2006.4	2003	2004	2005	2006
Real GDP*	4.3	3.5	4	3.3	3.8	3.3	4.1	3.75	3.25	3.2	3.1	3.1	4	3.8	3.7	3.2
Personal Consumption Expenditures*	4.7	1.9	4.4	4.3	3.5	3.4	4.1	3	3	3	3.1	3	3.8	3.8	3.5	3.0
Private Housing Starts (000s units)	1929	1923	1974	1973	2083	2038	2101	1985	1935	1850	1760	1690	1853	1950	2051.8	1808.8
Vehicle Sales (mill. units)	16.5	16.5	17.1	17.2	16.4	17.2	17.9	16.25	16.25	16.2	16.2	16.2	16.6	16.8	16.9	16.2
Nonfarm Payroll Employment (mill.)	130.5	131.3	131.7	132.3	132.8	133.4	133.7	134.5	135.1	135.3	135.6	136.3	130	131.5	133.6	135.6
Unemployment Rate	5.7	5.6	5.4	5.4	5.3	5.1	5.1	5.1	5.1	5.1	5.1	5.1	6	5.5	5.2	5.1
CPI*	3.9	4.4	1.6	3.6	2.4	4.2	5.1	4.0	3.5	3.2	3.0	3.0	1.9	3.4	3.9	3.2
PPI*	2.8	5.8	1.6	8.5	2.8	3	7.5	6.0	4.0	3.0	2.8	2.8	3.6	4.6	4.8	3.2
Compensation per Hour*	2.1	6	5.5	10.2	5.6	4.4	4.1	3.3	4.2	4.0	3.8	3.7	5.4	5.9	4.4	3.9
Productivity*	3.8	4.1	0.9	2.3	3.2	1.9	4.6	3.0	2.8	2.6	2.5	2.5	5.6	2.8	3.2	2.6

\* Annualized Quarterly Growth Rate

Financial Data	History				Forecast				Current 12/29/05	Forecast (monthly)						
	Mar-05	Apr-05	May-05	Jun-05	Jul-05	Aug-05	Sep-05	Oct-05		Nov-05	Jan-06	Feb-06	Mar-06	Apr-06	May-06	Jun-06
S&P 500	1,195	1,164	1,178	1,202	1,222	1,227	1,225	1,219	1,239	1,260						
DJIA	10,682	10,263	10,377	10,486	10,545	10,579	10,525	10,531	10,700	10,819						
NASDAQ	2,022	1,957	2,008	2,074	2,145	2,163	2,144	2,165	2,205	2,230						
Fed. Funds Rate	2.83	2.79	3.00	3.04	3.26	3.51	3.83	3.98	3.99	4.25	4.50	4.50	4.75	4.75	4.75	4.75
3mo Treasury Bills	2.80	2.84	2.90	3.04	3.29	3.51	3.49	3.97	3.96	3.96	4.43	4.46	4.65	4.68	4.70	4.71
10yr Treasury Notes	4.50	4.34	4.14	4.00	4.18	4.29	4.18	4.63	4.53	4.37	4.60	4.70	4.70	4.90	5.00	5.10
Prime Rate	5.58	5.75	5.98	6.01	6.25	6.49	6.65	7.00	7.00	7.25	7.50	7.50	7.75	7.75	7.75	7.75
3 mo LIBOR (USD)	2.90	3.08	3.20	3.34	3.52	3.71	3.56	3.94	4.00	4.48	4.80	4.82	5.10	5.10	5.10	5.10
15 yr Mortgage	5.41	5.46	5.30	5.18	5.29	5.40	5.33	5.79	5.84	5.76	5.80	5.90	6.00	6.00	6.10	6.10
30 yr Mortgage	5.87	5.91	5.74	5.60	5.64	5.81	5.74	6.25	6.31	6.22	6.40	6.60	6.70	6.75	6.75	6.75
Adj. Rate Mortgage	4.14	4.14	4.17	4.26	4.35	4.53	4.42	5.18	5.22	5.15	5.65	5.72	5.80	5.85	5.90	5.90
GNMA	4.60	4.55	4.61	4.64	4.69	4.84	4.96	5.50	5.56	5.69	5.45	5.55	5.55	5.75	5.85	5.95
BAA Corporate	6.06	6.05	6.01	5.86	5.95	5.99	6.00	6.45	6.40	6.20	6.60	6.70	6.70	6.73	6.73	6.75

Sources: BEA, BLS, Federal Reserve, Bloomberg

Sung Won Sohn, PhD, was with Norwest Bank/Wells Fargo Bank from 1974 until 2005, most recently as EVP and Chief Economic Officer. He is currently President and CEO of Hanmi Bank, based in California.

It should be noted that, while mortgage rates are still at relatively low levels historically, they are moving closer to 8%. For many years, the 8% level for the fixed 30 year mortgage was a turning point for housing. When rates moved above that level, housing slowed down as people could no longer fit the mortgage into their budget. With the ever increasing availability of ARM's, however, the old "rule of thumb" may no longer have the same significance.

## HOUSING BUBBLE

The question of a “housing bubble” is on the mind of nearly everyone associated with the housing industry. Nationally there are areas where house prices have increased annually well into double digits while in other areas the increases have been far more modest. Certainly no one can reasonably expect that housing prices (values) will continue to increase at double digit rates forever, as they have for the last several years. Nor should anyone have expected that long term mortgage rates would stay at the 5-6% level forever.

The Fed, in an effort to move the economy ahead, caused rates to fall beginning in early 2001. The terrorist attacks later that year gave more impetus to continued lowering of rates and we found ourselves with mortgage rates at levels not experienced in forty years. Further, we found mortgage products (ARMs of all sorts and aggressively marketed home equity loans) that made the 20% down, 30 year fixed mortgage seem passé.

Consumers found themselves able to afford much more home than ever thought possible. It all got down to the monthly payment and, with available rates at extraordinarily low levels, consumers could easily meet the 40% debt to income requirement of most lenders. Cars, boats, vacations and even groceries got ultimately rolled into a 30 year amortization or maybe into “interest only”. The problem is that few seem to appreciate that the first word in ARM is “adjustable”. A consumer who started with a 4% ARM and finds his adjustment rate is “only” 1% more, will have a 25% increase in his payment. If he was stretching things going in to the purchase, he could find himself in real trouble.

In our region we are anything but immune to this potential problem. A study presented in “Business Week” showed that of all mortgages nationwide in 2004, the most recent year then available, almost 23% were “interest-only”. Washington, however, was eighth on the list of states at 34.6% and the Seattle-Everett-Bellevue area was eighth on the list of cities at 37.2%. One must assume that the results in 2005 will be close to the same.

Further complicating the matter was the fact that real estate took the place of tech stocks in the minds of many investors. Not only were home owners clamoring for too little housing inventory as they tried to “move up”, investors looking for a quick return jumped in as well. In many areas of the country reports estimated that over 25% of sales were to non-owners, who often rented the house for far less than the financial carrying costs but planned to sell it in relatively few months at a much inflated price. A leveling of housing prices could add to the amount of inventory as these investors try to bale out.

It is generally expected that the new Fed chairman will continue the course of periodic rate increases over the near term. As these increases translate into higher indexes, we could see an increase in default rates for both first mortgage and equity loans, which could lead to a dumping of homes (many fairly new) as homeowners seek to get out from under their mortgages and still come out with some cash. This could, in turn, have a negative impact on some contractors and their lenders. Those who have gotten

comfortable (and even complacent) with seeing a recently completed house sell for considerably more than its pre-construction appraisal may be in for rude awakening.

There are also those who see our current flat to inverted yield as a harbinger of recession, something it has been in the past including as recently as 2000. Many economists say the latest inversion won't lead to recession because short term interest rates are relatively low compared with past inversions, meaning consumers and businesses can still get credit at historically attractive terms. And some economists, including those at the Fed, argue that long-term yields have been artificially depressed by foreign investors, who have been heavy buyers of longer term bonds. Without the foreign buying, they say, long-term rates would be far higher. But the foreign investors are not going away and, since one of the most commonly used indexes is U.S. Treasuries, the effect on ARMs is already being felt with one year ARM's moving ever closer to the fixed 30 year mortgage.

It seems far more probable that, on a national basis, housing will slow and we will see the "bubble" deflating, not bursting. Real estate is inherently different from stock. Stock (for the most part) is national in scope. Real estate is local. It should be expected that some of the regions that experienced extraordinary housing price inflation will probably see a far more dramatic slowdown and, in some areas, prices may even decrease. In spite of the increases we have seen here, however, we are not among the national leaders in year over price increases. Accordingly, when all the other positive regional factors are considered, the Puget Sound Region should experience a slowdown but the housing market should still be very good.

## CONCLUSIONS

**Housing Sales:** Pending sales experienced a typical seasonal decrease in December but there appears to be a slight softening of the market in recent months, although empirical data is not currently available. Nonetheless, the housing market is very strong by recent historical measures and inventory levels are remaining fairly constant.

**Commercial Real Estate:** Office vacancy rates continue to show marked improvement, although the Southend has been slower to recover. Lease rates, however, have not shown any appreciable increase. Industrial vacancy rates are likewise showing steady improvement. Construction activity has picked up considerably, particularly in the Kent/Tacoma area.

**Single Family Building Permits:** The number of permits being issued in the tri-county area has been relatively constant for the last two years and shows no sign that builders are rushing to bring new product to the market. Based on the number of permits currently being issued, the inventory of new homes should be about the same as it has been but marketing time may be extended.

**Interest Rate Outlook:** There should be a continued increase in rates over the near term, as the Fed is expected to continue its policy of regular but modest increases. Long term mortgages will probably increase by 50bp over the next six to twelve months. Prime is also expected to be up 50bp by mid to late 2006. These gradual increases give credence to a slowing of the real estate market as opposed to a collapse.

**Housing Bubble:** In recent years housing prices increased by vastly different percentages in different parts of the country. While increases in interest rates may cause some price changes, there is no reason to believe that it will be universal across the country. Double digit annual increases, however, will not be as common and we may even see some decreases in different areas. Frenzied markets, be they stock, real estate, gold or otherwise, usually result in rather dramatic decreases when the market changes. Since real estate frenzy is much more of a local/regional phenomenon, we expect that any decreases will be felt accordingly.