

Dear Investors and Friends:

In our July 2009 newsletter, we commented that to that point in time there was no strong quarter-over-quarter empirical data to suggest the U.S. economy was at a recessionary bottom. Recently, however, data suggests we reached bottom in mid-2009 as several macro indicators have turned positive. The most notable among them is the stock market, with the S&P 500 up over 65% from its low in March 2009. Global Gross Domestic Product (GDP) started its rebound in mid-2009 fueled in great part by economic growth in China, India and Brazil. U.S. GDP grew at a slower pace, booking a 2.2% annualized rate in the third quarter of 2009, a rate that is expected for the fourth quarter as well.

While all this is good news, two other leading indicators, job loss and consumer confidence, are still of great concern. The unemployment rate is anticipated to peak at about 10.5%, resulting in approximately 7.3 million jobs lost during this recession, a total that equates to approximately four years of normal job growth in non-recessionary times. At this point, most firms have made their personnel cuts, frozen new hiring and offered early retirement packages to meet the expense cuts necessary to offset reduced income projections. When demand for durable and non-durable goods grows, new hiring will begin, yet even at a healthy pace of 250,000 new jobs per quarter, it will take several years to reach equilibrium of 5% unemployment. Consumer confidence will also play a key role in how quickly our economy will recover. As of November 2009, the consumer confidence index stood at 67.4 based on an index value of 100.

At this point, we see two issues that could potentially stall or derail the recovery: 1) the impact of a growing deficit on interest rates and inflation; and 2) the unpredictable war on terror. As our economy begins to recover, it is likely that the Federal Reserve will have to raise interest rates to continue to entice investors to finance our deficit, which could lead to a period of inflation, and in turn higher interest rates. The last time we experienced this phenomena was in the late 1970's – early 1980's when the prime interest rate rose to 21% and inflation peaked at more than 14%. We expect the final numbers for 2009 will show deflation of around -2%, versus the long-term historical average in the 3-4% range. The Federal Reserve and our policy makers have a tough job in the coming years balancing monetary and fiscal policies so as not to inhibit long-term economic recovery.

As a lagging asset class relative to the economy, real estate fundamentals continued to decline throughout all of 2009. Rents and values fell another 10-15% suggesting a total decline of 40-45% since the peak in mid-2007. According to year-end reports from national commercial brokerage firms, the vacancy rate for major office markets now stands at 18.3%, up almost 2% from the prior year. Apartment vacancy rates are higher overall, but especially so in markets in the Southeast-Southwest markets. The industrial sector was weakest in areas like Southern California and the Midwest, while the retail sector experienced contraction in all regions of the country due to bankruptcies and downsizing of major national chains as well as regional and local operators.

Commercial real estate sale transaction volume remained exceptionally low in 2009 as the gap between prices buyers would “bid” and prices sellers would “ask” remained wide. Even cases where buyer/seller could agree, buyers had great difficulty obtaining reasonable loan terms as credit remained tight. The rising delinquency rate of commercial loans in the market has caused lenders to underwrite new loans on a very conservative loan-to-value (LTV) basis. Unless new lending and more reasonable underwriting standards prevail (unlikely in our near-term view), we anticipate more existing loans will either need to be restructured or foreclosed in 2010 which will likely cause new originations to be about \$50 billion or about 20% of what originations were in 2006-07.

The key to the real estate recovery is jobs. As jobs are created, the demand for space increases, leading to absorption of supply which ultimately leads to net operating income (NOI) growth. This will also result in more normal lending practices that recognize rent growth over time and a reasonable reversionary value in the 50-55% range. If job growth improves to a 250,000 annual rate, commercial real estate’s full recovery back to 2006-07 levels should take place in the 2015-2017 time frame. This is not to say that real estate will not be a good investment, in fact, over the course of the next several years, pricing should provide investors with opportunities to purchase properties at below equilibrium prices/cap rates and achieve good year-over-year current returns with the idea of selling into a stronger market/economy.

For 2009, the Northeast commercial office markets generally performed better than other regions of the country, still ending the year with decreasing rents and increasing vacancy. Several of the large brokerage companies are predicting that the worst may be behind us and that rents and vacancy should not deteriorate much from their current levels. In total, we expect rents will have decreased 40-50% from their peak and the amount of average vacant space in the N.E. markets will be about 20% of total space. Typically, a 10-12% vacancy rate is considered market equilibrium. There have been several large lease transactions in the markets we invest in that should lower the vacancy rate for 2010 which could provide for greater market rent stability absent another major tenant leaving the market. We expect that financial related firms will begin hiring again mid-2010 and slowly take more space over time.

Abbey Road Advisors is hopeful that 2010 will provide more opportunities to acquire quality-well-located real estate at attractive yields. Meanwhile, we continue to actively manage our portfolio of properties to keep them occupied and operating efficiently, while seeking opportunities to improve long-term value and current capital structures. Currently, our overall portfolio occupancy rate is 84%, and we are working toward a 2010 goal of 89% portfolio-wide occupancy.

All Abbey Road quarterly asset investment reports were mailed to investors earlier this month. The reports contain a more specific commentary to the asset itself and the local market. We will keep you updated on individual assets each quarter or sooner if a material event takes place. If you have any questions, please feel free to contact us anytime at 203-227-9798. We remain fully committed to the long term benefits of real estate ownership and being a leader in our markets.

Have a wonderful winter!

Mark Keeney Alan Bates Jim Digney
John McCarthy Steve Siegel