

Impact of the storm will continue for a long time

If last week's near collapse of Citigroup marked the latest major storm in the global credit crisis, the fiscal and monetary policy events of the past two weeks—coupled with the U.S. government's rescue of Citi—may have stopped subsequent waves from causing further destruction. That said, it is clear the global markets will need a great deal of storm clean-up for at least the next year. Over the past two weeks, the global economy continued to exhibit signs of further weakness, and it is not expected to recover anytime soon.

In the United States, signals went from bad to worse as new homes sales and personal spending declined and first-time jobless claims remained high. Not that many needed confirmation, but the U.S. recession became official according to the independent Business Cycle Dating Committee of the National Bureau of Economic Research (NBER). The panel—recognized as the official arbiter of business cycles—stated it had made the determination that the recession began in December 2007, making the official contraction already a year old. Fortunately, there was more evidence that the inflation genie was back in the bottle as the consumer price index (CPI) registered a record 1.0 percent drop in October. However, this outcome is now stoking deflationary fears. The U.S. Federal Reserve Board's decision to buy \$600 billion of residential mortgage debt proved to be another positive development as it triggered a significant drop in residential mortgage rates. However, this has not yet had a positive impact on the availability or pricing of commercial real estate capital. There is a massive fiscal stimulus program in development

by the new federal administration and recently announced economic team that could include upwards of \$1 trillion in spending. Expect that package to be announced prior to the January 20, 2009 inauguration of President-elect Barack Obama.

These conditions were echoed in the United Kingdom, where declines in home prices, business investment and retail services muted inflation pressures. Survey data in continental Europe showed the unemployment rate rose to a level not seen in 15 years and the Economic Confidence index crashed to its lowest level since 1993. In a major development in the Middle East, Dubai was forced to merge four banks into one. Japan, already in a technical recession, saw further growth contraction and a significant decline in industrial production. There are further signs that China is now seeing a rapid slowdown, with manufacturing in November declining by the highest amount on record. India reported its economic growth slowed to 7.6 percent from 7.9 percent, but that was before the deplorable terrorist attack that killed an estimated 170 people in Mumbai. The terrorist attacks in India are a sober reality that the world is operating in a heightened state of geopolitical risk. Additionally, the potential for social unrest typically increases during this part of the business cycle in growing economies that can't seem to curtail the tide of rising unemployment. The tragedy in Mumbai may have given additional pause to investors, reminding them of the inherent risks associated with investing in emerging markets. This increase in perceived (and real) risk could quickly spread to other emerging markets.

A billion here, a trillion there

During the past two weeks, governments and central banks from across the globe continued their efforts to curb the credit crisis and stabilize their economies. The U.S. Federal Reserve Board announced a new \$200 billion Term Asset-

Backed Securities Loan Facility (TALF), a plan in which the central bank would directly purchase mortgage-backed securities and corporate debt of some of its government-sponsored enterprises, namely Fannie Mae and Freddie Mac.

Financial markets also cheered the U.S. government's rescue of Citigroup, although they turned negative again soon after.

Figure 1 2008 S&P 500



Source: Yahoo!

Across the pond, the UK government unveiled a new £34 billion stimulus package at 5 percent of gross domestic product (GDP), while the European Commission proposed a €200 billion fiscal stimulus package at 1.5 percent of GDP. The Bank of England and the European Central Bank are set to meet later this week and further interest rate cuts are anticipated in the face of weakening outputs, slumping business confidence and rapidly slowing inflation. Left with few bullets in its monetary arsenal, the Bank of Japan left interest rates unchanged. Meanwhile, China cut its key lending rate by 108 basis points to 5.58 percent, while deposit rates fell by the same amount to 2.52 percent, measuring the biggest cuts since the 1997 Asian financial crisis. Even Saudi Arabia's central bank lowered its key interest rate for the second time in a month.

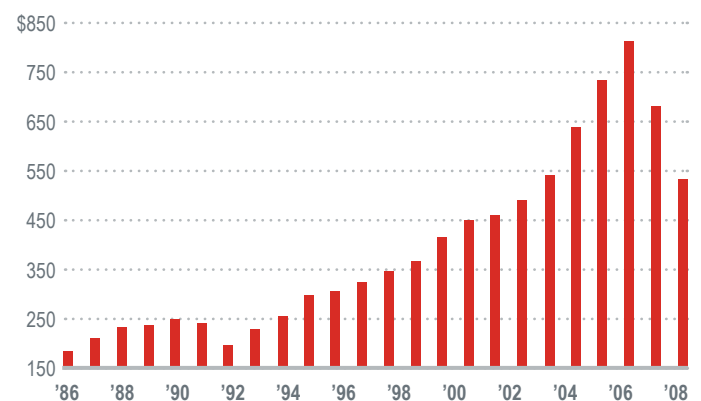
Global property market fundamentals

The global property market continues to be plagued by the dual challenges of tight credit and the rapidly weakening economy. The United States needs the housing and consumer spending markets to stabilize because both

prevent economic growth as banks continue to set aside reserves for potential losses from those sectors. A future wave to consider is the potential losses banks face from their commercial loan portfolios. As maturities come due, some borrowers will be unable to refinance and will default on current loans.

Through September, U.S. home prices declined 20 to 25 percent from peak levels, and 10 percent further declines are likely before the market bottoms. Prices need to fall further to be more in line with historic averages relative to incomes, and the inventory of homes for sale needs to shrink to allow for market stabilization. The period of time required to achieve housing stability will most certainly be affected by the length and depth of the recession. In October, single family housing permits hit the lowest level per capita in the modern era, and new construction levels have shown steady declines. Additionally, overall residential investment has declined by 40 percent since the peak in 2006 and most certainly has further to fall. Home construction and sales also will remain at historically low levels in 2009. The last piece needed for housing stabilization is available mortgage debt. Public and private efforts to modify existing mortgages will likely prevent an even larger number of foreclosures. That should lessen the impact on values from foreclosure sales and help slow the rate of price decline. The Fed's announcement that it would purchase direct obligations of the government-sponsored enterprises (Fannie Mae, Freddie Mac and Ginnie Mae) and residential mortgage-backed securities had an

Figure 2 U.S. housing investment



Source: Bureau of Economic Analysis

immediate positive effect. The rate on a 30-year mortgage dropped 88 basis points to 5.5 percent. This decline, coupled with the drop in housing prices, has improved overall affordability. According to the following index, which shows mortgage payments as a percentage of income, the average U.S. home is at its most affordable level since 1973.

Figure 3 Mortgage payment as percentage of income



Source: Jones Lang LaSalle, National Association of Realtors, Federal Reserve Bank of St. Louis

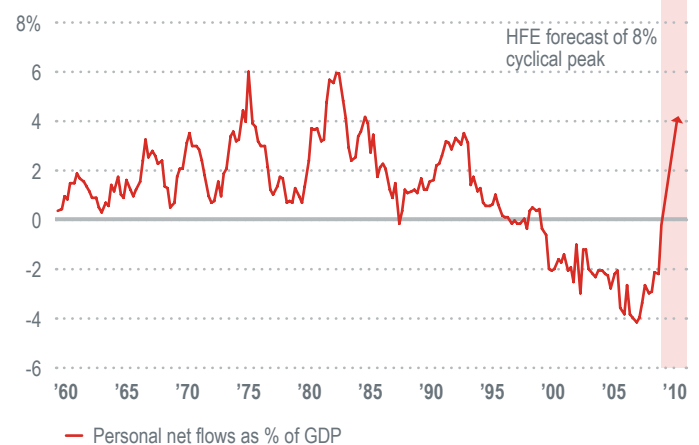
From a pricing perspective, the U.S. housing market should stabilize approximately a year from now and begin to show sustained, though very slow, positive growth again by the end of 2010.

Meanwhile, U.S. consumer spending continues to drop as consumers retrench, de-leverage and fundamentally change their behavior to match the new economic realities. While the previously tireless U.S. consumer is out of breath and out of credit, the most recent consumer confidence reading showed a moderate improvement in expectations. However, consumer sentiment remains near all-time lows. There is a sea change occurring in the relationship between consumption and savings for U.S. citizens, with a marked increase in the savings rate as consumers de-leverage and conserve capital for a potential long recession. That move is needed as illustrated by the extreme negative consumer cash flows driven by excessive amounts of spending and capital investment witnessed in the past decade. High Frequency Economics (HFE) expects net financial flows to finally migrate back into positive territory in the fourth quarter of 2008, an important step in the right direction

after a 4 percent deficit during 2006. However, to improve consumer balance sheets given current debt commitments, net financial flows may need to rise as high as 8 percent of GDP for a sustained period, even above the cyclical peaks of 6 percent in 1975 and 1982. Consumers will have no choice but to save more. The adjustment will be painful, but the forced trend of consumers getting back into the black must progress to set the stage for U.S., and likely global, economic stabilization in 2009. In the short term, this likely will be detrimental to property markets by further starving the demand side of the equation. Real estate fundamentals across property types and markets in the United States will show further weakness in 2009. Over the long term, more consumer savings will have a positive economic effect on the U.S. economy.

In Europe, the picture is not uniform, although all markets are unquestionably slowing toward—if not already in—reverse. Leasing volumes are still up in some markets, but these are becoming few and far between. A persistent gap remains in the investment markets between the expectations of buyers and sellers, with the former justifiably waiting in anticipation of further declines in capital values in the coming months. The continuing erosion of economic conditions and the likelihood of a pickup in distressed sales support the wait-and-see approach. In the UK, where the market has corrected most rapidly and aggressively, opportunistic buyers are investigating the London market as well as some retail assets. Following a substantial

Figure 4 U.S. consumer net cash flows



Source: US Census, High Frequency Economics

correction in yields across the market and given the currency benefits for foreign investors, the level of interest in the UK will continue to grow. Nevertheless, across Europe, financing rates have been very slow to come down. Furthermore, only puddles of liquidity are available to those with strong banking relationships and a substantial equity input, meaning that the workout in the debt markets will be slow.

China is now seeing a raft of negative indicators including a slump in manufacturing and mounting job losses.

In the Middle East, real estate market fundamentals differ from those in other regions given the amount of new supply being offered to the market (especially in Dubai and Abu Dhabi). With demand from both speculators and end-users negatively impacted by the global economic slowdown, sentiment toward real estate markets has turned down sharply in recent weeks, with this sea change being most dramatically exhibited in respect to Dubai. Another key differentiator of many Middle Eastern markets is the level of government control of the real estate sector. Government-controlled entities are responsible for up to 70 percent of future supply in Dubai. The government has acted quickly to reduce the supply pipeline, with a number of projects being placed on “indefinite hold.” This could result in a reduction of 40 to 60 percent in the level of potential supply entering the Dubai market between 2009 and 2012. Steps also are being taken to encourage developers to merge into fewer, stronger entities. In addition, efforts are being made to increase financial transparency and provide more clarity on debt levels across the region. In Dubai, the government has announced that total debt from sovereign and government-controlled entities amounts to around \$80 billion, against assets valued at around \$350 billion.

In Asia Pacific, the past two weeks have seen further signs of economic deterioration, both in mature and emerging economies. Arguably the most worrying trends relate to China, which until recently was expected to hold up relatively well, but is now seeing a raft of negative

indicators including a slump in manufacturing and mounting job losses. The economy in Australia—another country in the region that has notched up healthy rates of economic growth for many years—is now slowing rapidly. Australia’s central bank slashed interest rates by another 100 basis points on December 2, bringing the total rate cut to 300 basis points since September.

Fourth quarter 2008 property market indicators are expected to reflect a significant slowdown across many markets in Asia Pacific. In the office sector, occupational demand and rentals are likely to contract further in key financial centers, where downsizing by banks and other financial institutions is accelerating. The retail sector has held up relatively well to date, but it also is set to see a major slowdown in many markets as consumer spending wanes and unemployment rises. Residential markets, both mass and high-end, also are seeing weaker conditions generally, with some major price corrections in markets that had seen big run-ups in recent years.

Regional investment insights

Europe: Against the backdrop of continued economic deterioration, property market sentiment continued to worsen. The past two weeks were marked by a sense that Continental Europe would be unable to escape the woes currently plaguing the UK. Even a spate of cheery headlines touting news that German open-ended funds were buying in Tokyo belied what was really occurring. The funds had made these purchase commitments many months ago. While a handful of German funds indicate that they’ll have €2 to €4 billion to invest globally over the coming year, none seem committed to any transactions in the first calendar quarter at least. This month, transactions in the UK should accelerate as forced sellers come to market. A growing chorus of rumors about the possible demise of big property funds that include a number of very large portfolios that span property types—as well as media speculation that the property holdings of collapsed investment banks have little value—also weighed heavily on the investment markets. Property fund redemptions likely will continue as long as sentiment remains negative, and these conditions will extend into early 2009. Some prominent retail property funds find themselves substantially underwater and their

management debt is 10 times the value of their companies. A recent example of this trend was a decision by New Star Asset Management Group, which focuses primarily on individual investors, to suspend redemptions from its International Property Fund and other funds. The UK listing authority later refused New Star's request to temporarily halt trading of ordinary shares.

Asia Pacific: Most investors remain sidelined, waiting for forced selling to begin in earnest and property prices to reflect distressed levels. In Australia, however, opportunity buyers are circling and sovereign wealth funds already have begun to scoop up bargains where yields on prime office markets have expanded from the low 6 percent range to the 7 to 8 percent range. That, coupled with currency devaluation of approximately 30 percent, has made the market much more attractive. Some participants are looking to enter the market by buying listed companies. Social and political issues combined with the Chinese government's admission that its economy faces problems have disillusioned some investors. Middle East investors have started to retreat from Asia and have cancelled development projects and joint venture development plans. In contrast, Australia is still a source of interest for investors, particularly those from Singapore. There's also compelling evidence to suggest that a number of large, global insurance firms that have entered the markets in the last 60 days are planning to enter the Tokyo, Singapore and Hong Kong markets in coming months.

United States: There is a wave of distress cascading through real estate investment trusts (REITs) facing billions of dollars of refinancing needs. While the fundamentals of the underlying investments are sound in most cases, there are few companies able to raise new capital or secure new financing. As a result, lenders will be forced to refinance and restructure these obligations or foreclose. Lenders are showing signs of forbearance signified by retail REIT General Growth Properties' recent announcement that it had secured an extended payment date for loans of about \$900 million. It successfully negotiated a two-week extension with its lenders while trying to raise capital through select asset sales. REIT pressure-selling could trigger additional sales activity in 2009. Other sources of potential transaction activity in the United States include

1031 tax deferral trades with private syndicated capital. Likewise, net lease assets with corporate occupancy will still be trading.

27 percent of Jones Lang LaSalle's major corporate clients experienced a drop in third quarter earnings.

On the debt market side, an increased level of loan sale transactions is occurring for banks and collateralized debt obligation (CDO) managers that have strategically decided to clear their balance sheets and/or exit the market entirely. The escalation in loan sales activity is a product of the bid-ask gap narrowing, as loan sellers have begun to lower their value expectations and capitulate to market pricing. However, the lack of commercial real estate debt availability will continue to create problems for owners and developers in 2009. The number of first mortgage and mezzanine loans that need to be refinanced in the coming year is expected to rise exponentially. New mortgage originations have become even more difficult as some prospective lenders are focused on pursuing distressed deals at a discount rather than facilitate re-financings or acquisitions. With this in mind, the government continues to strive to increase liquidity and stimulated lending. The expanded TALF program, along with the implementation of the FDIC's Temporary Liquidity Guarantee Program, may help strengthen lenders' impaired balance sheets and increase their willingness to lend on all asset types—including commercial real estate.

Global real estate implications

Corporate real estate occupiers: With pressure on headcount and earnings, 27 percent of Jones Lang LaSalle's major corporate clients experienced a drop in third quarter earnings with the greatest impact on banking, finance and computer/technology companies. Worsening conditions are producing a growing interest in business process outsourcing (BPO) which remains a steady source of demand in a number of Central and Eastern European markets such as Krakow.

Economic conditions are causing the corporate sector to pull back on near-term occupancy objectives and deferring

the otherwise attractive blend and extend deals in office, industrial and hotel sectors around the globe. In the United States, market fundamentals have been negatively impacted by the advent of new bank holding company regulations and an increasing number of financial sector layoffs. The wave of job cuts is expected to remain high through early 2009 as non-financial companies increasingly downsize. In Europe, transactions also are down, and already reduced leasing levels are predicted to slow further in the next 12 months across the 60 markets monitored in the region. Markets with diverse occupier bases, such as Hamburg, are proving more resilient than those with large exposure to financial services. Interestingly, a number of European markets also are being buoyed by activity from government departments, agencies and state-owned companies. Examples include Milan, Doha, Budapest and Moscow, which are experiencing new leasing activity.

Largely, occupiers across all sectors are taking a “wait and see” approach on leasing commitments out of strategic choice or financial necessity. However, many corporate occupiers seem to be willing to sell assets. This excludes banks, which been interested in offloading only secondary assets to date.

On a brighter note, some industry sectors continue to report increased capital spending, particularly healthcare and petrochemical. Sustainability also remains a focus for corporations, with many indicating continued interest in sustainable strategies, given the cost savings they ultimately deliver. In addition, a number of occupiers express ongoing support for expansion in emerging markets throughout Asia Pacific.

In this dynamic environment, corporations should continually evaluate their options and look to bring in tenants to absorb vacant space in sale/leaseback scenarios or evaluate lease versus own situations where capital is still available.

Owners and investors: Even as property market fundamentals across the globe continued to decline, there remains a healthy dose of value denial among owners. Pricing has declined as much as 25 to 30 percent or more in many areas, yet most owners seem to crave evidence—as measured by a history of closed transactions—that the bottom has been reached. To maintain the value of their

Figure 5 News on the economic front

NOVEMBER 2008

- 28** Euro-zone corporate price index (CPI) fell from 3.2% to 2.1% (Q4)
India's GDP (Q3) fell from 7.9% to 7.6%
- 27** Mumbai terrorist attack, more than 170 killed
- 26** China cut its key lending rate by 108 basis points to 5.58%;
deposit rates fell by the same amount to 2.52%, the biggest cut
since the 1997 Asian crisis
- 25** The U.S. Fed announced a new \$800 billion Term Asset-Backed
Securities Loan Facility (TALF)
U.S. GDP (Q3) was revised from -0.3% to -0.5%
- 24** U.S. government initiated rescue plan for Citigroup
UK announced a fiscal package of approximately 34 billion
pounds, or 5% of GDP
- 19** U.S. CPI (Q4) fell by a record 1.0%, with the core down 0.1%
- 17** Japan's GDP (Q3) contracted by 0.1%

assets, owners have started to aggressively offer rental rate reductions and concessions aimed at retaining tenants, many of whom are likely to encounter pressure to downsize.

The key question among owners and investors is whether to sell now or wait. From the current vantage point, holding may not be the best strategy. Property fundamentals will almost certainly worsen two years from now as leasing rates are re-set and vacancies rise, which could have a negative impact on value. Additionally, because capital sources are starved for equity, some investors are asking investment managers to get their assets sold now, even though this does not appear to be a wise time to sell. Owners of vacant property should strongly consider selling now unless their time frames stretch beyond the next three to four years.

Owners and investors facing imminent loan maturities should meet with lenders as soon as possible to restructure. Additionally, given that traditional mortgage lenders are hamstrung in today's environment, non-traditional players are finding attractive opportunities as first mortgage lenders.

In the UK, fixed assets such as real estate are beginning to look very attractive compared with low-yield bonds and

riskier equity options. This is especially true for Japanese investors because the decline in the value of sterling relative to the yen has increased the buying power of the Yen by 40 percent in the last 60 days. This currency move, along with the re-pricing of British real estate, could bring Japanese money back into the UK sooner than some might expect. Parking capital in real estate could be a smart move.

An increasing number of U.S. banks are finding buyers emerging as they engage intermediaries to unload secondary loans.

Banks with real estate assets on their books are turning to principal-to-principal transactions to relieve balance sheet pressure. They are arranging transfers of loans with distressed borrowers to new equity sponsors, while agreeing to some loan modifications, along with new equity contributions. Most of these transactions are managed quietly and off-market, where the banks are opting for expediency and certainty rather than an open auction process, where there is greater risk of required write-downs in the event of a failed auction. However, an increasing number of U.S. banks are finding buyers emerging as they engage intermediaries to unload secondary loans. Banks should look to advisors to assist with thorough reviews of assets to determine which ones can be re-positioned to create liquidity. These reviews can accomplish three key things: first, to give greater transparency to the highly selective but growing number of debt buyers; second, to determine which assets can or should be sold immediately and which should be held for re-positioning; and third, to identify future problems that could be avoided early. Once the review is completed, these asset pools can be marketed to a pre-qualified global audience to recover the greatest value quickly.

Recovery signposts

While the forecast remains murky, there are several key signs that may signal a move further toward recovery.

The U.S. economic recovery cannot begin until the U.S. housing market recovers, but the timing is difficult to predict. If the Fed successfully boosts liquidity in the credit markets at a time when housing is becoming more affordable, the housing market may stabilize by the end of 2009, and forecasts of a return to economic growth in 2010 may be correct. In addition, massive fiscal stimulus plans in the form of government infrastructure investments will help reduce unemployment and potentially have a multiplier affect through the economy for each taxpayer dollar spent.

In Europe, watch for further reductions in central bank interest rates, as the Bank of England is likely to make a move again this week. The recovery also will require action on the part of banks, either willingly or forced by politicians, to ease up on borrowing provisions. This is acutely true in the UK residential lending market.

In the UK, opportunity and vulture funds will move into the market once they perceive value. Given the current level of yields and (for some) currency benefits, this value perception cannot be too far away. The property market turnaround could be fairly quick once this happens as there is equity sitting on the sidelines waiting for someone to call the bottom of the market. The first to do so will be the brave one.

In Asia, the re-emergence of the high-net-worth investor—who has been sitting on the sidelines for several years now—may provide the first boost of confidence to the marketplace.

Jones Lang LaSalle's global Value Recovery Service experts can help solve today's market challenges. Tap into our experts for a detailed analysis of your next move. Visit www.joneslanglasalle.com for more information.