

## Global markets contract as rates, jobs and forecasts are cut

Since the beginning of November, further shared economic strain has weighed on worldwide property markets. Only a month after the International Monetary Fund (IMF) published its October World Economic Outlook, the group slashed its forecasts for global growth. Its November update cut the 2009 gross domestic product (GDP) growth forecast by 0.8 percent to just 2.2 percent. Advanced economies are forecast to contract in aggregate by 0.3 percent in 2009. Specifically, the United States is forecast to contract by 0.7 percent, the UK by 1.3 percent and the Euro-zone by 0.5 percent. Developing Asian economies are expecting a reduced growth rate of 7 percent.

Emerging economies once thought to be insulated also have been battered recently due to combinations of credit, currency and demand issues. Particularly in China, recent economic readings are weakening. Forecasters still are not predicting a technical global

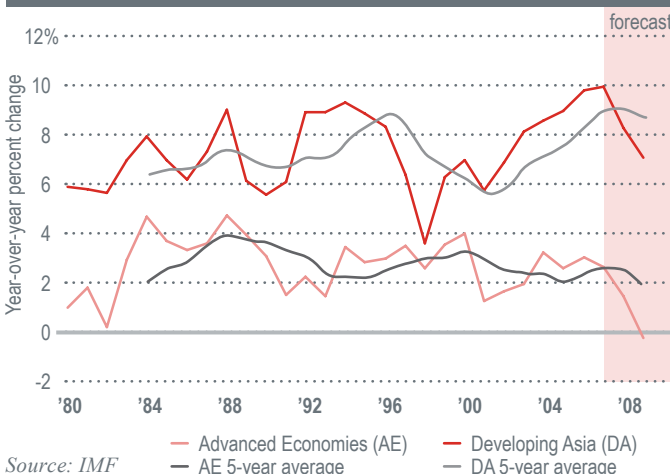
recession, but the question remains: With the developed world in recession and growth in the emerging world slumping more than previously thought, what will prevent the global economy from contracting now?

While it may seem like the same song keeps playing over and over in a lower key each week, there is a high note. Interest rates across the globe—with the exception of the Euro-zone—are beginning to reach relatively stimulatory levels. “Real” short-term interest rates, meaning the nominal rate minus inflation, which commonly represents investment purchasing power, turned negative in the United States and Japan, and approached zero in the UK. The rates are trending downward, indicating a true shift into a stimulated monetary environment worldwide. Yet, some concern lingers about the central banks’ ability to stimulate the economy further through monetary policy, given that there is little room left to lower discount rates that are now approaching zero.

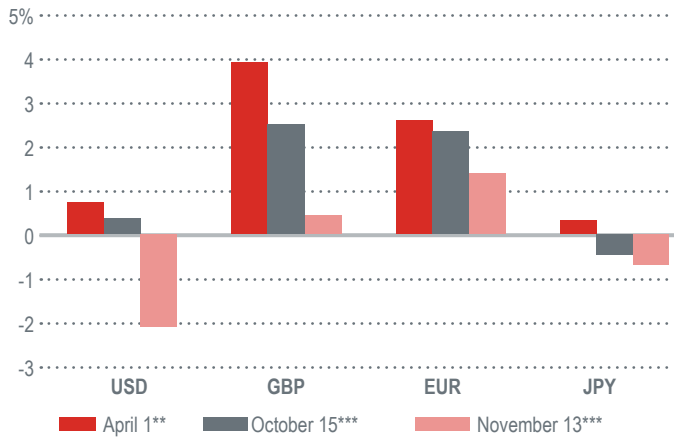
### The G-20 “talk-fest”

What many hoped would be an event that produced global economic change, the first G-20 emergency summit held November 15 in Washington, DC, was dubbed a “talk-fest.” Instead of emerging with clear, coordinated policy action to stem the crisis, leaders achieved only general agreement on the importance of strengthening economic growth, the need for cooperation in dealing with the financial crisis, and the goal of establishing the foundation for financial reform to avoid similar crises in the future. It also was noted that the governance of global financial institutions must improve. One suggestion was to broaden the membership of the Financial Stability Forum, the group of financial regulators and central bankers charged with the technicalities of financial supervision. Better accountability and transparency in the financial system and a clear regulatory framework may help avoid a repeat of the current crisis in the future. However, these changes will not do as much as coordinated monetary and fiscal policy action to help ailing economies in the present. While details on many of the announcements were light, the summit did mark an important change in global economic

**Figure 1** Global economic growth slowing



Source: IMF

**Figure 2** 3-month swap rate shows negative trend

\* 3-month swap rates less Consumer Price Index (CPI)

\*\* Uses April 2008 IMF forecast for year-end CPI growth

\*\*\* Uses October 2008 IMF forecast for year-end CPI growth

Source: Jones Lang LaSalle, IMF, National Australia Bank

management in that it involved a larger group of nations than the typical G-8 economic powerhouses. The G-20 agreed to meet again in London on April 30, 2009, allowing time for the new U.S. presidential administration to get situated.

### Ailing economies spur more global government monetary policy action

Easing of monetary policy in the Asia Pacific region kicked off on November 4, when the Reserve Bank of Australia cut rates by 75 basis points to 5.25 percent. Just a few days later, the Bank of Korea cut key rates by 25 basis points to 4 percent, the third cut in only a month.

It is clear that many central banks are running out of room in terms of providing monetary stimulus. This is becoming especially acute in the United States, where the Federal funds target rate now stands at 1 percent. Therefore, governments will be looking to fiscal stimulus—spending, that is—to jump-start their economies.

On November 9, the Chinese government unveiled the king of all stimulus packages, a 4,000 billion yuan (US\$586 billion) package designed to bolster the economy. That is equal to 16 percent of the country's GDP and will be spent by the end of 2010. However bold this sounds, there is some doubt regarding how much of this is intended for new spending. An estimated 75 percent of the package is thought to be earmarked for projects already in the pipeline. Additional expected rate cuts and tax relief are aimed at keeping growth chugging along above 8 percent—still a reduction for China but a level necessary to create enough jobs for the tens of millions

entering the workforce each year. Beijing also said that it would loosen credit and encourage lending, and establish a more “proactive fiscal policy” to strengthen its economy. One area of particular interest to watch is the Chinese government's new program to begin deeding land to farmers and other citizens to provide further growth incentives.

China's retail sales remain strong, but are likely to slow down as the production sector slows. Industrial production figures were much weaker than expected. Basic materials suffered the most with production of crude steel down by 17 percent in October, pig iron production down more than 16 percent and steel product production down more than 12 percent. The external sector still remains surprisingly sturdy. However, October export data showed a 19 percent year-over-year increase, only slightly lower than the 21.5 percent rate recorded in September. China's GDP is now expected to be in the 8.0 to 8.5 percent range for 2009, down from 11.4 percent in 2007. China still will be the largest contributor to global GDP growth in 2009.

**Figure 3** News on the economic front

#### NOVEMBER 2008

- 15 G-20 Emergency Summit: Leaders agreed to tighten regulations, clarify accounting rules and increase the transparency of the financial markets, but how to go about it remains unclear
- 14 November Euro-zone GDP (Q3) contracted 0.2% with growth over the year down to 0.7% from 1.4%
- 13 German GDP (Q3) recorded a recession, down 0.5% quarter over quarter (+0.8% year over year) after a fall of 0.4% in Q2
- 12 U.S. Treasury updated \$700 billion TARP strategy
- 10 China unveiled US\$586 billion stimulus package (16% of GDP)
- 7 U.S. non-farm payrolls (Q4) fell 240,000 in October; unemployment rate jumped to 6.5% from 6.1%  
Bank of Korea cut key rate by 0.25% to 4%, third cut in a month
- 6 Bank of England cut key base rate by a massive 150 basis points to 3.0%, the lowest level since May 1954  
European Central Bank (ECB) and Swiss National Bank (SNB) both cut rates by 50 basis points; ECB rate to 3.25% and SNB rate to 2.0%
- 4 Barack Obama elected U.S. President  
Reserve Bank of Australia cut rate 75 basis points to 5.25%

**Figure 4** Federal funds target interest rate has declined

Source: Federal Reserve Bank

In Japan, industrial production showed a minor bounce in September, though the latest consensus economics forecasts of November predict negative GDP growth of 0.1 percent for 2009. Japan officially slipped into a recession for the first time since 2001, as Japanese companies cut spending amid weak exports and consumer demand.

While growth in developing markets in Asia is certain to slow, the region is in a much better state than during the crisis of 1997-98. At that time, massive foreign debt and high current account deficits prompted a currency crisis, and a spike in interest rates caused growth to collapse. While Asian countries are now in a much better position, developing nations in Central Europe and Latin America are faring much worse. Central and Eastern Europe and Latin America are in vulnerable positions due to high levels of external debt that could lead to the next phase of the credit crisis. Those countries with elevated current account deficits and weakening currencies are most exposed in today's scenario.

In Europe, Germany had the dubious distinction of being the first major economy to go into a technical recession, as defined by two consecutive quarters of negative GDP growth. The relatively slow response of the European Central Bank to cut interest rates suggests that there likely remains significant room for further monetary stimulus. The reversal in growth is the first for the Euro-zone—the 15 countries that now use the euro—since the shared currency was launched in late 1999. The combined economy of the countries, which rivals that of the United States in size, shrank 0.2 percent in the third quarter for its second straight quarter of decline. In the UK, the central bank's most recent forecasts suggest a sharp decline in

GDP in 2009, underscoring the urgency of its 1.5 percent interest rate cut earlier this month.

In the UK, the Bank of England cut its key interest rates by a massive 150 basis points to 3.0 percent, the lowest level since May 1954. This marks the first time since the euro's inception that UK rates have been lower than those on the continent, reinforcing sterling's steady decline against both the euro and the U.S. dollar. On the same day, the European Central Bank and Swiss National Bank each cut short-term rates by 50 basis points to 3.25 percent and 2.0 percent, respectively. The weakness of the continental economies implies that their central banks might be behind the curve, and further cuts are anticipated.

In the United States, extreme volatility in the financial markets persisted over the past two weeks. Although the stock market initially rallied on the election of Barack Obama as President, much of the gain was reversed the next day. High expectations have been placed on Obama's administration given that he has outlined several actions to get the economy back on track. Those actions include a new fiscal stimulus package, more active government intervention to prevent home foreclosures, and increased bank lending and tax cuts focused on low and middle income earners. However, it won't be clear which programs will take priority until after the late January inauguration. Another large stock market decline occurred after the Treasury announced it would not be purchasing troubled mortgaged-backed assets with the Troubled Asset Recovery Plan (TARP). TARP plans to continue investing the remaining funds as capital infusions directly into financial institutions and into other suffering areas related to consumer lending, such as credit cards, car loans and student loans.

A regular flow of disappointing economic data hasn't helped investor, business or consumer sentiment either. During October, the consumer price index (CPI) was expected to drop 0.8 percent while core inflation was expected to grow 0.1 percent. Instead, consumer prices fell 1.0 percent, and core inflation fell 0.1 percent. The drop in CPI was the largest on record since 1947. The last time core inflation dropped month over month was in December 1982 during the early 1980s recession. The categories that saw the largest drop in inflation this month were transportation, apparel and energy. Even without further declines in oil prices, inflation will continue to dip as previous declines in commodity prices work through the system and demand continues to slump. The combination of falling consumer prices and declining income levels increases the chance of deflation in the later stages of this recession. Deflation could worsen recovery

prospects by making debts harder to pay off and countering the impact of Fed rate cuts.

Many economists believe the U.S. economy cannot truly begin to recover until the housing market stabilizes. That may be a tall order given that a further 10 to 15 percent decline in housing price is projected for next year, on top of the 20+ percent decline that already had hit the residential market. There is hope in the dramatic drop-off in new housing starts and the leveling of inventories. On November 19, the Commerce Department reported that housing starts and permits, key measurements of home construction, hit record lows in October. Housing starts also reached an annual rate of 791,000 last month, the lowest level since the department began tracking starts in 1959. At these levels, the stage could be set for a significant decline in inventories over the next six months—an important first step to a housing recovery.

The federal government and several of the country's largest banks have recently taken specific measures to help millions of homeowners with troubled mortgages avoid foreclosure. Residential foreclosures are up nearly 150 percent from two years ago, and mortgage delinquencies have tripled. The Mortgage Bankers Association reports that about 4 million borrowers are at least one payment behind. In addition to measures taken by Fannie and Freddie, major financial institutions that have established specific programs over the last month are IndyMac Bank, Bank of America and JPMorgan Chase among others. Citigroup recently stepped up to assist homeowners and indefinitely extended a moratorium program on resident foreclosures. This is the first program to target relief to homeowners who are not delinquent on payments. The program is focused on homeowners in states with plummeting home prices and high unemployment rates, including Arizona, California, Florida, Michigan, Ohio and Indiana.

Even with these actions, economists portend that with the massive deleveraging consumers face, the government needs to fill the void by being not only the lender of last resort, but also the spender of last resort. New fiscal stimulus is needed to help inject capital directly into the economy as quickly as possible. That may come after the new administration takes office given that a second US\$200 to \$500 billion fiscal stimulus bill was proposed that would provide direct aid to states, increased infrastructure spending and a temporary extension of unemployment benefits. Even if such a stimulus package is passed in early 2009, next year is shaping up to be a very challenging one for the United States. GDP is expected to contract further over the next three to four calendar quarters, with a modest

recovery in 2010. A return to annual growth above 2 percent is unlikely until 2011. However, many are predicting a bottom to the housing market in late 2009, which should signal the beginning of a return to stability in the financial markets.

### **Global property market fundamentals**

In Asia Pacific, the financial market turmoil is starting to significantly affect the occupancy market for major financial office centers. Net leasing activity has been negative, and vacancy rates have been on the rise for several quarters in Sydney, Tokyo, Singapore and Hong Kong. Rentals in Tokyo, Sydney and Hong Kong already have moved to the downward phase of the cycle, with Singapore expected to follow suit this quarter. The largest rental declines over the next one or two years are expected to be seen in the mature Asian markets following the demand contraction and the very strong rental increases observed in recent years. In the tier one cities in China and in some Indian suburban micro-markets, the next two years will see abundant new supply hitting the market as demand begins to fall. This will result in increased vacancy levels and thus the risk of a major correction in rentals in the short and medium term. In leasing markets where financial services companies contribute significantly to office occupancy and have driven rents to record levels, the increases now are beginning to reverse as the landlord-tenant power play shifts.

The economic impacts on real estate fundamentals are hitting more gradually in Europe than in the Middle East and North Africa or Asia Pacific. At the end of the third quarter, the overall European vacancy rate held at 7.2 percent. Aggregate leasing volumes have started to slide, down 7.4 percent year to date. London, Stockholm, Spain and Ireland have experienced greater declines. However, in Germany, Holland and Central and Eastern European, leasing volumes for the third quarter remained above 2007 levels. Rental rates vary regionally with rents down in London, Dublin and Barcelona but up in Prague, Berlin and Amsterdam. Aggregate European office rents are up 2.6 percent over 2007. Retail rental rates are up 2.4 percent quarter over quarter for the year but up just 0.3 percent for the year to date. Concessions also vary with free rent up from last year in the UK, France, Spain and Ireland, but rescinding in Germany, Italy and Central and Eastern Europe. While the realities are not manifesting in the data yet, negative outcomes from the occupier markets will no doubt change the European property markets quickly.

Across the Middle East, as with other emerging economies, the impact of the global economic crisis has spread and deepened over the past two weeks. The most obvious sign has been the decline of

regional stock markets. The Kuwait Stock Exchange (the region's second-largest) was closed for three days due to a court case brought by disgruntled investors. The Dubai market fell by more than 30 percent in one week to its lowest level in more than four years. While the equity markets are expected to recover some of these losses over the next few weeks, potentially more concerning are signs that employment growth is stabilizing with speculation of potential job losses, particularly in the real estate sector.

With the energy sector accounting for nearly 45 percent of the region's economy, the continued decline in oil prices is clearly having an impact. With global demand falling further, prices are threatening to decline below the US\$50 level for the first time since mid-2005. While oil forms the backbone of the region's energy sector, a number of countries derive significant revenues from the natural gas sector. Gas prices are trending down on the back of weaker global demand, but the long-term nature of the pricing structure means gas prices are far less volatile than prices for oil. This is providing an important source of secure revenue for Qatar, Iran, Saudi Arabia and the UAE, which between them account for more than 40 percent of the world's identified supply of natural gas.

The revised world economic outlook released by the IMF in November reflects the deepening impact of the global downturn on the Middle East. Projections for 2009 were reduced by 0.6 percent across the region. Despite this downgrade, the Middle East still is expected to experience growth of 5.3 percent in 2009, slightly ahead of all emerging and developing economies at 5.1 percent and far removed from the decline of 0.3 percent predicted for the advanced nations as a number of the world's largest economies slip into recession.

The United States now has lost nearly 1.2 million jobs as the job loss data originally reported for August and September were revised substantially downward. Nearly every major industry sector is now shedding jobs, with education, government and healthcare services being notable exceptions. The unemployment rate rose dramatically to 6.5 percent, up 200 basis points, making it the highest level seen since 1994. Unemployment is expected to rise to at least 7 percent by the summer of 2009. That rise would put unemployment at its highest level in 22 years. Worst-case scenarios put double-digit unemployment within the realm of possibility.

The initial stages of rising vacancy and declining rental rates have arrived, but this is only the beginning of the expected shift in underlying fundamentals. Neither the impact of the initial job losses, nor that of those expected through at least mid-2009, has reverberated through

overall occupancy. Most companies showed more constraint in taking on new space obligations during the recent economic expansion, and new supply stayed relatively in check. Tenants that have space requirements are delaying real estate decisions as they assess the impact of the slowing economy and try to secure the best deal in 2009. Given what now looks more like a slow recession and recovery, vacancy is unlikely to peak before 2010 and may eclipse the 17 to 18 percent levels of the last downturn. While the new pipeline is limited overall and the construction spigot has been shut off, new supply deliveries will accelerate near-term vacancy increases in several markets such as Miami, Charlotte, Sacramento, Silicon Valley, Washington, DC and Atlanta.

National rental rate growth flattened abruptly in early 2008. While substantial declines in asking rental rates have yet to statistically materialize in most markets, anecdotal evidence from lease negotiations and re-negotiations suggests that a rent correction is under way. Rents are down as much as 10 to 20 percent in the markets most affected by recent lease negotiations. Average asking rents should continue to decline throughout much of 2009 as tenants gain leverage and landlords are forced to compete to maintain building occupancy.

## Regional investment insights

### United States

U.S. government intervention in the financial markets again took center stage last week, with the surprise announcement by Henry Paulson that the U.S. Treasury Department is backing off its original plan to use the \$700 billion TARP to buy mortgage-related assets. TARP is a long way from even considering creating liquidity in the commercial mortgage market.

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As a result of the commercial mortgage market's reaction to the TARP revamp and to an increased prospect of default on two large securitized mortgages originated by JPMorgan Chase, commercial mortgage-backed securities (CMBS) spreads on super-senior triple-A bonds skyrocketed to around 1150 to 1250 basis points over swaps this week—the highest levels ever. At the end of last week, spreads on super-senior bonds were in the 700 to 800 basis points range,

meaning that spreads jumped an incredible 450 to 500 basis points in just a couple of days. Spreads have come under additional pressure due to what is reported to be heavy liquidations by cash-strained financial institutions, as liquidity concerns continue to drive selling into an already oversold market.

On a positive note, some market players believe that TARP's decision to pursue equity stakes in place of asset purchases will spur financial institutions to finally unload assets at market-clearing prices. This could potentially unleash the log jam of equity capital that has been raised by more than 60 high-yield debt funds, most of which have deployed very little of the capital raised to date.

In Latin America, Mexican and Spanish banks continue to express their willingness to lend for real estate projects, albeit at spreads nearly double or triple past rates. That leaves wealthy families across the region—previously priced out by large institutional players—as buyers of last resort. They, however, will want much higher returns, which likely will put more pressure on property prices.

## Europe

Jitters about property markets in emerging economies increased during the past two weeks, with the ongoing retrenchment of German property funds being a key area of concern. Emerging Central Europe and, to some extent, Turkey are being viewed by some as accidents waiting to happen as the two major players in these markets—German and Austrian investors—are no longer buying. Against the backdrop of rapidly deteriorating economic fundamentals, Europe is leading a slow and gradual value realization that needs to spread to the other regions before global health returns. In some

European markets, property prices have corrected by much as 50 percent from the highs of 2007, though country-specific details vary considerably. Investors have swallowed these sober pills and are getting ready to move on.

Another factor weighing on price expectations is the fact that the North American banking community—particularly primary lenders and those active in the CMBS market—soon will need to rapidly clear their loan books to deleverage and strengthen their balance sheets. European life companies and balance sheet lenders seem to exhibit little strategic direction in their current actions. Rather than undertaking wholesale actions to appease their boards or shareholders, these lenders are attacking the problem of impairment bit by bit locally, ridding themselves of a property here and a property there. This has been frustrating for would-be buyers and the market as a whole. Over the next 12 months, European banks are expected to act much more quickly, starting with some brisk actions at the beginning of the year.

## Middle East

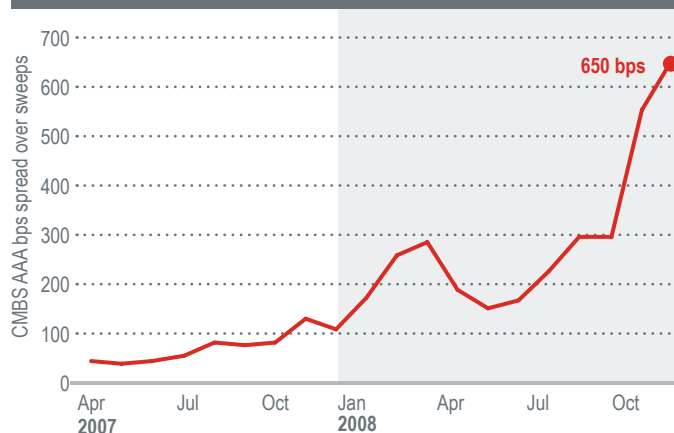
There has been a steep decline in sales activity across the region, limiting the level of recent transactional evidence. However, there is consensus that prices not only have stopped increasing, but also may have actually declined in a number of the region's key markets. According to an HSBC report, average asking prices in October fell across Dubai by 4 percent and Abu Dhabi by 5 percent. This fall has affected the villa sector over the apartment sector most, but some high-end apartment projects have been severely impacted. The decline in asking prices must be framed in light of the significant increases the region has experienced over the year to date. While the average asking price in the Dubai market increased 45 percent to its peak of \$6,180 per square meter in September, it fell back only by 4 percent in October.

Governments are taking concerted actions to support the real estate sector. In Dubai, the government has instituted a review of the cash flows, borrowings and potential financial exposure of all the major development groups that it controls. As part of this review, developers are focusing on projects that are currently under way and other priority projects. The review is likely to result in more projects being delayed and some projects being placed on indefinite hold, if not officially cancelled.

## Asia Pacific

While transaction evidence is thin, there are strong indications that values in Singapore have fallen by 40 to 50 percent and in Hong

**Figure 5** CMBS spreads surged with financial crisis



Source: Jones Lang LaSalle, *Commercial Mortgage Alert*

Kong by 30 to 40 percent from market highs in fourth quarter 2007. Investors are pricing bids on expectations of future value, but that is not spurring the same value reality check by sellers that is taking place in Europe. While Asian owners at large tend not to have highly leveraged positions, both the equity and the mezzanine value positions of the highly leveraged players that entered the market late in the cycle have been wiped out. The erosion is creeping up to 60 or 70 percent of the senior investment position, and asset sales still have not been spurred. While investors aren't moving, there is a recent uptick in Japanese corporations tapping the lease-versus-own property dynamics. Three large German banks are set up to invest in sale-leasebacks to take advantage of Japanese corporations that are prepared to maximize the value of their real estate in order to access capital.

## Global real estate implications

### Corporate real estate occupiers

Corporate occupiers in developed countries are faced with a difficult decision. On the one hand, declining rents and stressed owners present unique opportunities to renegotiate longer lease terms at attractive levels. But given the heightened uncertainty over the economy and the financial crisis, a number of questions loom: How much space should be taken? For how long? It is time to focus on core operations space needs and structure a lease accordingly for as long is prudent. This runs counter to the more typical actions taken by corporations in a rising economy, in which they "go long" on obligations with very expensive real estate, while committing to the shortest periods during economically uncertain times—when space is at its most discounted. Given the existing economic downturn, now could be a good time to renegotiate obligations and secure long-term leases at low rents. Corporate occupiers should restructure leasing obligations to maximize the advantages that owner/investor stress may provide. It also may be the right time to consider using available capital to self-fund most tenant improvements, trading cash for more deeply discounted rents from troubled landlords. At the same time, occupiers in Latin America (particularly in Mexico) and the Middle East continue to face tight conditions and low vacancy rates. Low rates in those regions could persist longer than in most others due to current supply constraints.

### Owners and investors

The re-pricing of risk that touched all asset classes now may favor appropriately priced commercial real estate as an investment asset. Cash and cash alternatives around the world offer investors very little in the way of yield and, in some cases, offer negative real yields. At

the other end of the spectrum, corporate bond yields have widened significantly during the past year, reflecting their dramatically heightened level of credit risk, meaning default risk. In addition, these bonds also are susceptible to interest rate risk to the extent that other equity markets recover and yields on fixed income investments rise, led by U.S. treasuries. Attractively priced commercial real estate in this environment can deliver yields in between this range (perhaps in the 7.5 to 9.0 percent range) and provide a hedge against inflation, as rents can rise over time to improve the long-term yield. Fundamentals, while off peak, are basically solid. Cap rates are attractive, and real estate has a reputation of holding its value fairly well during inflation cycles. To the extent that investors seek out the relative values and protection from inflation offered by commercial property, the sector should benefit.

Many major institutional investors—particularly public and private pension funds—remain willing purchasers of commercial real estate. They are required to deploy the steady inflow of funds they receive from their plan participants and investments, and are comfortable taking on more real estate assets. However, institutions don't seem to believe that the market has reached equilibrium, so more downward price adjustments are likely in many regional markets, especially in most of Europe and the United States. Opportunities will begin to arise from sellers with assumable debt that may need to liquidate in order to redeploy capital and from sellers such as REITs who need to raise capital to pay down other debt. Later in 2009 and in 2010, there will be more forced selling as many properties acquired late in the economic expansion will have mature loans and be challenged to find adequate refinancing. Astute buyers today will attempt to preempt the foreclosure process and negotiate settlements with second lien holders and mezzanine lenders for these properties.

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