

Signs of spring, but economic cold spell lingers

It has been a long economic winter, but a new sense of optimism seems to have taken hold with the arrival of spring in the Northern Hemisphere. Two years have passed since the global financial crisis began with the bankruptcy of U.S. subprime mortgage issuer New Century Financial. Since then, glimmers of hope have been difficult to spot. Now, there are signs of improving credit markets, and the world's largest banks are reporting surprisingly strong, yet potentially fleeting, results.

While economic data remain very weak and more negative economic news lies ahead, the number of reports highlighting “green shoots of recovery” has increased in recent weeks. Rising optimism is a necessary precursor to recovery. As John Maynard Keynes noted in the 1930s, “Markets are moved by animal spirits and not by reason.” If we are indeed near the bottom of the “Great Recession,” the recovery will take time, and the lagging property markets likely will be one of the last sectors to benefit from an upturn.

Global economic overview

Governments and central banks around the globe have created an unprecedented range of measures to limit the depth and duration of the global recession. While there are signs that these measures are helping to “thaw” frozen credit markets, economic and property market data continue to indicate further declines in asset values.

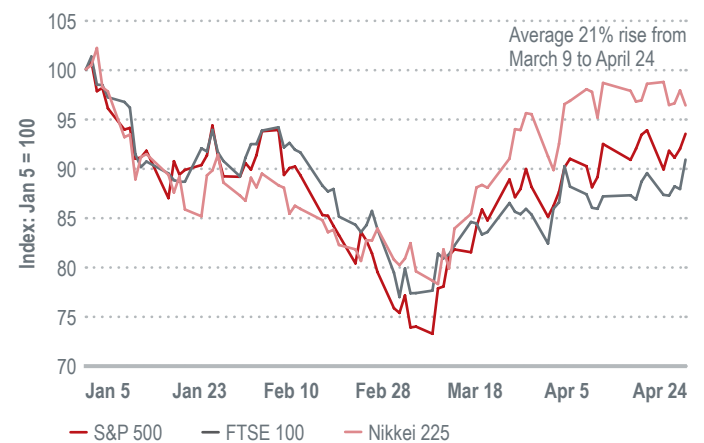
A recent report by the International Monetary fund (IMF)¹ suggests that recessions associated with financial crises or involving a synchronized slowdown between two or more economies tend to be longer and deeper than other recessions. The current recession, which was precipitated by the global credit crunch and is affecting virtually all nations, is likely to be unusually long and severe. Economic data released in March and April highlighted continued

weakness, with most industrial production, trade volumes, retail sales and employment figures down in both advanced and developing economies. These all point to a further contraction in global gross domestic product (GDP) over the first half of 2009.

Less pessimistic signs have emerged, however. Global equity markets have rallied substantially from March lows, spurred largely by positive reactions to the many government stimulus packages around the world. There has been improved earnings news from major banks including Barclays, Citigroup, JP Morgan, Credit Suisse and Goldman Sachs, all of which beat market expectations. Granted, these results may prove to be a combination of recent trading profits, interest income and ongoing management adjustments to loan reserves.

Green shoots, in terms of sentiment surveys, are slowly becoming visible—though there are too few to declare a new spring of hopeful optimism. In Australia, the Westpac Melbourne Institute Survey of Consumer Sentiment rose 8.3 percent. The Confederation of British Industry recently noted Britain was through the worst of the recession and would return to modest growth in the second half of 2010, as the expected pace of economic decline slows. The German ZEW Survey rose to a two-year high of +13 in April from -3.5 in March.

Figure 1 Stock markets bounce back from March lows



Source: Yahoo!, Jones Lang LaSalle

In the United States, the University of Michigan's preliminary consumer sentiment index for April increased from 57.3 to 61.9, with rises in both the current conditions and expectations components for the month. The expectations component was at its highest level since September, while the present conditions component was at its highest since December.

G-20 takes financial action

The major outcome of the Group of Twenty (G-20) Summit in London was an agreement to provide US\$1.1 trillion to the IMF to stimulate the global economy. The total includes up to US\$750 billion in additional loan resources to help countries whose finances have been devastated by the world financial crunch, with another US\$350 billion made available to restart trade and help the world's poorest countries. These funds primarily will benefit smaller nations through loans to support their currencies and financial systems, but also may help to prevent 1998 Asian Crisis-type meltdowns and the associated problems that flow to these nations' creditors.

Credit markets face steep challenges

The sheer scale of the global financial crisis means that the challenges of getting credit flowing again are immense. The IMF recently reported that banks and other financial institutions could face write-downs, actual and potential, of US\$2.7 trillion in the value of their U.S. asset holdings, while write-downs that included other mature economies could be as much as US\$4 trillion.

Jones Lang LaSalle's Global Real Estate Health Monitor analyzes the leading health indicators of global commercial property market activity. In April's reading, most indicators continued to point down, and significant challenges remained (see Figure 2).

Lack of debt stymies property markets

There are signs of thawing in global credit markets, at least for larger, higher-quality borrowers and among financial institutions. If this trend continues, it should lead to stabilization and eventual improvement in economic performance. While the broader credit markets appear to

Figure 2 Global Real Estate Health Monitor

	U.S.	UK	Germany	France	Japan	China	Australia	General trend
Official interest rate	0.13%	0.50%	1.25%	1.25%	0.10%	5.31%	3.00%	▲ Down, slowing
GDP QOQ	Q4 2008 -1.6%	Q1 2009 -1.9%	Q4 2008 -2.1%	Q4 2008 -1.3%	Q4 2008 -3.2%	Q1 2009 +6.1%*	Q4 2008 -0.5%	▼ Recessionary trend
CPI YOY	Feb 2009 +0.2%	Mar 2009 +2.9%	Mar 2009 +0.6%	Mar 2009 +0.3%	Feb 2009 -0.4%	Feb 2009 -1.6%	Q1 2009 +2.5%	► Slowing
Consumer sentiment MOM	Mar 2009 +2.6%	Mar 2009 -4.7%	Apr 2009 -4.0%	Mar 2009 0.0%	NA	Mar 2009 -0.6%	Apr 2009 -8.3%	► Mixed
Employment YOY	Mar 2009 -3.5%	Dec-Feb -0.6%	Feb 2009 +0.1%	Q4 2008 -0.7%	Feb 2009 +0.0%	Dec 2008 +0.6%	Mar 2009 +0.2%	▲ Weaker trend
Retail trade MOM	Mar 2009 -1.1%	Feb 2009 -1.0%	Feb 2009 +0.2%	Dec 2008 -0.2%	Feb 2009 -0.3%	Mar 2009 +0.6%	Feb 2009 -2.0%	▲ Weaker trend
Housing starts YOY	Mar 2009 -48.4%	Q4 2008 -26.6%	NA	Feb 2009 -3.1%	Feb 2009 -24.9%	2008 +1.4%	Q4 2008 -19.5%	▼ Very steep falls
Stock market, MOM to Mar 31	+8.5%	+2.5%	+6.3%	+3.9%	+7.1%	+13.9%	+7.1%	▲ Strong gains
REIT market, MOM to Mar 31	+4.1%	-1.7%	+13.6%	-2.7%	+10.0%	NA	-0.5%	▼ Generally stronger
General trend	▼ Recession	▼ Recession	▼ Recession	▼ Recession	▼ Recession	► Slowing growth	▲ Near recession	▼ Synchronized global recession

QOQ = Quarter-over-quarter, YOY = Year-over-year, MOM = Month-over-month

* Chinese GDP equals YOY

Source: Global Insight, Global Property Research; FRB; BOE; ECB; BOJ; PBC; RBA, Yahoo Finance, Jones Lang LaSalle

be improving, commercial mortgage-backed securities (CMBS) spreads remain at extremely high levels, and there are few signs that lending to the real estate sector is improving. The lack of debt continues to impact transaction activity, though equity investors are beginning to become more active. This is mainly in markets such as London that already have been significantly re-priced. Around the globe, deteriorating fundamentals in commercial property markets are reducing underlying asset values and increasing expectations of borrower delinquency and default risk.

Occupiers consolidate space, step up due diligence

As the effects of the financial crisis flow through to the real estate economy, tenant demand is contracting in office, industrial and retail sectors. Vacancy rates in office markets around the globe are rising (see Figure 3), and leasing volumes are slowing, resulting in declining rents. While initially affecting financial centers, employment is now contracting in most markets. A significant amount of demand for industrial property over the past 10 years had been driven by logistics, transport and storage, but the retail slump is now pushing down demand for both retail and industrial space. The slowdown initially impacted more advanced economies, but developing economies are increasingly affected as exports wane.

As demand for space decreases, the global financial crisis also has caused new construction in major commercial markets around the globe to slow. The lack of new construction is perhaps a lone mitigating factor in deteriorating occupier markets. However, many

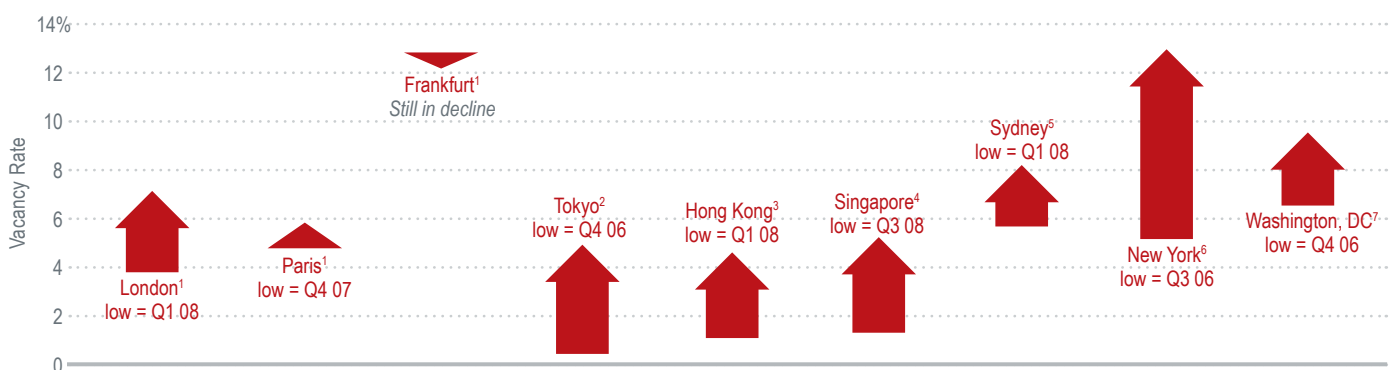
markets still are experiencing the cyclical impacts of an emptying supply pipeline. This is the case in Europe, where more than 2 million square meters of office completions recorded in the first quarter of 2009 were among the highest on record.

Given the difficult operating environment, businesses around the globe are beginning to consolidate their space requirements. Tenants are conducting more careful due diligence of landlords' terms before signing new leases or renewing current ones. That includes greater scrutiny of the capital or sponsor behind the landlord to ascertain if the building itself has the capital to underwrite the terms of the lease. Tenants now are asking brand-new questions about sponsorship and questioning the landlord's ability to pay down debt or commit liquidity to planned or required maintenance. Owners can differentiate their properties based on their ability to address these tenant concerns.

Hotel transaction volume may have hit bottom

During the first quarter of 2009, global hotel transaction volume fell to nearly \$2 billion, representing the lowest level of trading seen since the first quarter of 2002. During 2008, global hotel transaction volume fell drastically from quarter to quarter, but the first quarter 2009 level is only 2.6 percent lower than volumes recorded during the fourth quarter 2008, suggesting that transaction volumes may be hitting a bottom and may start increasing gradually in the second half of 2009 as distressed sales pick up.

Figure 3 Vacancy rates rising: recent lows to Q1 2009



¹ Total office market for London, Paris and Frankfurt

² Tokyo equals CBD 3-kus Prime (Premium/A Grade) office market

³ Hong Kong equals Central Prime (Premium/A Grade) office market

⁴ Singapore equals Raffles Prime (Premium/A Grade) office market

⁵ Sydney total CBD market

⁶ Total Midtown Manhattan market

⁷ Total DC City market

Regional real estate implications

Asia

The Asian banking sector was not as exposed to subprime debt as U.S. and European banks, though debt markets also have slowed considerably. Where many owners are having difficulty refinancing loans, the Asian banks do not seem to be taking possession of assets, preferring to discuss refinancing options with borrowers. Alternatively, some funds are finding equity to refinance from the sponsor or manager, like Fraser S-REIT (Singapore REIT), which renewed its loan from the REIT sponsor (Fraser and Neave Ltd).

The region's office markets suffered accelerated rental declines as vacancy rates rose and demand cooled in the first quarter of 2009. Net leasing in major first-tier office markets fell to just 30,000 square meters compared with almost 650,000 square meters in the previous quarter. Emerging markets in the region are exposed to excess supply that is putting pressure on the price of existing space available for lease.

The largest declines in net effective rents in the first quarter were in Hong Kong, down 25 percent from the previous quarter; in Singapore, down 30 percent; and in Mumbai, down 25 percent. In the retail and industrial sectors, rental declines were generally lower than in the office sector. Delhi recorded the largest fall in retail rents (17 percent), and Singapore recorded the largest decline in industrial rents (16 percent).

Europe

The Bank of England decided to keep interest rates on hold at 0.50 percent in April, after cutting every month since October by a total of 450 basis points. The bank is pursuing other unorthodox measures to stimulate the economy and launched a quantitative easing scheme in March. It will purchase £75 billion in assets over the next three months, focusing on British government debt.

While the government attempts improvements, first quarter leasing volumes in the region fell by 40 percent compared with 2008, marking the largest annual declines on record. In addition, Europe marked the largest quarterly rental decline—8 percent—on record since 1980. Leasing in the Central and Eastern European markets dropped 41 percent in the first quarter compared with the fourth quarter of 2008.

In Western Europe, dramatic falls in occupier demand have been recorded in many markets, including London, Brussels, Madrid, Barcelona and Amsterdam. Only two major markets, Stockholm and Frankfurt, reported increased leasing in the first quarter. In both

cases, however, the increases were due to a solitary transaction by Vattenfall and Deutsche Bank that accounted for nearly half of Stockholm's lease-up in the quarter. Prime retail and logistic space rental rates are holding steadier. This may change as the effects of the deteriorating economy begin to be felt in those segments. Incentives such as free rent are increasing in all sectors.

United States

Debt remains scarce as market players hope that the counterbalancing forces of government support through the Term Asset-Backed Securities Loan Facility (TALF) and the Public-Private Investment Program (PPIP) will work to improve liquidity in the market and stem declining property values. CMBS spreads remain extremely high at 825 basis points for the most secure AAA rated bonds. However, corporate bonds across the rating spectrum are reporting a 10-year best in new volume with \$400 billion of U.S. corporate issuance in the first quarter of 2009. Pricing on high-yield bonds has reached six-month lows of 1,544 basis points compared with 2,182 basis points on December 15, 2008.²

Improved bank earnings opened a window of demand for companies to sell bonds and for some financial institutions, such as Goldman Sachs, to raise new equity. Nevertheless, more than \$300 billion in commercial mortgages are estimated to mature during each year from now through 2011. These maturities will continue to constrain the banking sector and property values as the markets seek new sources of refinancing capital.

The vast majority of U.S. metropolitan economies are now in recession, and demand for office space has declined. In the first three months of 2009, national leasing activity decreased 32 percent compared with the fourth quarter of 2008. Sublease space availability has jumped more than 33 percent over the past six months. While average U.S. office asking rents declined 4.6 percent in the first quarter of 2009, effective rents have been slashed anywhere between 10 percent and 30 percent across the vast majority of U.S. markets. The vacancy rate for U.S. investor-owned warehouse and distribution space has increased to 12 percent. Many struggling local and national retailers are filing for bankruptcy, while high-quality retailers are requesting rent relief from their landlords.

Apartments, which had benefited from some of the housing market's misery, will be challenged by rented condominium units and rising job losses throughout 2009 and 2010. However, given the size of many multifamily investment properties and the availability of debt financing from the government-sponsored enterprises (GSE) Fannie Mae and

Freddie Mac, this sector likely will show the first signs of asset value stabilization as property trades are occurring more frequently than in other asset classes.

More transactions are emerging

Transaction activity remains limited; however, cash-rich investors, typically smaller institutions or private investors, have begun to emerge as buyers in several regions.

Asia

In markets such as China, Taiwan and Japan, domestic investors have started purchasing, which has provided some support to the market and is assisting the price discovery process. The notable POSCO sale in Shanghai (Pudong) transacted at a cap rate of 7.3 percent (US\$253 million).

Europe

Direct investment into commercial real estate in Europe reached €12 billion in the first quarter of 2009. This is a further 30 percent drop compared with the previous quarter and 70 percent lower than the first quarter of 2008. In the UK, investment volumes reached €4.4 billion in the first quarter of 2009, a 4 percent upturn compared with the previous quarter, which was largely accounted for in Central London transactions.

Germany saw €1.6 billion of transactions during the quarter, down almost 50 percent over the previous quarter. Volumes are low principally because debt availability is highly restricted, especially for deals greater than €50 million. The only sellers are those forced to market by their own liquidity needs.

There was recent activity across the investor spectrum: Swiss pension funds, German funds, local institutions and private investors, both domestic and foreign. Transaction sizes remain relatively small, but activity has increased. For example, a private investor recently purchased Sheldon Shopping Centre, Birmingham for €9.2 million, reflecting an initial yield of 8.3 percent, while a Swiss pension fund purchased Garrard House, Gresham Street for €76.5 million, reflecting an initial yield of 7.5 percent. Investors are transacting large, long-term sale-leasebacks of supermarkets at 5 percent cap rates. Opportunistic funds continue to observe and investigate, but they generally are not committing at current prices.

United States

Transaction volume reached a low watermark in the first quarter 2009, as preliminary data revealed that only US\$8 billion in

Middle East momentum

The Middle East remains one of few global regions where positive economic growth is forecast for 2009, with the IMF forecasting growth of 2.5 percent in its April Global Economic Update. After regional declines in the past six months, initial signs of stabilization have begun to emerge. Oil and gas prices have stabilized, although cuts in production levels have reduced revenue inflows. The banking sector has been refinanced, and there are early signs of increased liquidity flowing to the real estate sector. Additionally, plans for new office and residential supply in the Dubai market between 2009 and 2012 have been cut in half since mid-2008. Regulation and transparency have improved, and lower property prices have resulted in renewed investor interest.

Almost US\$520 million of mostly residential real estate sales were recorded in Dubai in February, more than double the previous month. Local and overseas opportunistic funds are showing more interest, which should translate into increased commercial real estate transactions in the fourth quarter of 2009. While the region's property markets have adjusted much more quickly than other regions, 2009 will be a year of correction. Markets will stabilize in 2010 ahead of a recovery in prices in 2011. Although more Middle Eastern capital is being redirected within the region, a net outflow of capital is expected to continue as both sovereign and private funds seek opportunities in overseas markets at both the strategic and asset level.

significant apartment, industrial, office and retail properties had traded. The quarter-over-quarter pace of decline in volume actually accelerated to 59 percent during the first three months of 2009 from the already very depressed level of transactions at year-end 2008. Deteriorating property market fundamentals will place further stress on values over the next two years.

In one transaction emblematic of the re-pricing that has taken hold, Boston's John Hancock Tower was sold in late March in a Uniform Commercial Code (UCC) foreclosure auction. It fetched only US\$660 million, half the price paid by the previous owner three years ago. On April 16, after struggling for many months to negotiate one-off extensions for a growing number of maturing loans, General Growth Properties finally filed for bankruptcy protection under Chapter 11. The largest real estate bankruptcy in U.S. history, it was largely seen as inevitable and likely caught few investors by surprise.

Will less pessimism give way to more optimism?

If it can be sustained, the recent rally in global equity prices provides hope that commercial property markets also will recover in time.

While stock market recoveries often precede an economic recovery, a key driver of property occupancy—employment—is often one of the last economic indicators to turn. This suggests that 2009 will remain a difficult year for commercial property globally.

Distressed asset sales are rising, with total known commercial distress estimated at US\$158 billion³ across the globe. On the whole, the banking sector remains reluctant to force sales. There is increasing evidence that banks are actively seeking equity and beginning to work through problem debt portfolios.

Asia

The decline in Asia Pacific property fundamentals is likely to continue during 2009, with office rentals expected to fall between 20 percent and 40 percent. The magnitude of that decline will depend on the extent of growth in the previous upturn and the supply/demand balance in each market. The largest decline is expected in Singapore, with a fall of almost 60 percent in Grade A rental rates. No office market is expected to post full-year positive rental movement this year, including those with large domestic market influences that previously have been defensive.

Weaker fundamentals are affecting future value expectations. This, along with continuing tight lending conditions, will keep capital markets activity subdued. In China, Taiwan and Japan, domestic investors have started purchasing, providing limited support to the market and assisting the price discovery process.

Europe

Relative pricing will be a key trend as markets and sectors continue to re-price at different speeds. A 40 percent decline in pricing and a weak currency have brought stronger interest from international investors in the Central London office markets. Secondary assets and the IPD index will continue to show rising yields, even if prime yields in the UK are much closer to levels that buyers will accept. This is the first requirement for the general market to stabilize and then recover across Europe.

United States

The country has seemed buoyed by the Federal Reserve's consideration of an expanded TALF program to buy commercial property debt and the modest ability of some REITs to place bond offerings and sell assets. Furthermore, the introduction of the PPIP should allow loans and real estate held by banks to begin to enter the market at market-clearing prices as 2009 progresses.

In lieu of securitization, funds with surplus cash likely will emerge as the key liquidity source. New funds are experiencing difficulty raising capital, but pockets of patient, fresh capital are quietly waiting for re-pricing to get more interesting before they begin to buy again.

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¹ "World Economic Outlook, April 2009", International Monetary Fund.

² Source: Merrill Lynch

³ Real Capital Analytics, Global Capital Trends, April 2009