



THE GLOBAL VIEW FOR 2012

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Across the economic landscape since the demise of Lehman Brothers in 2008, occasional signs of improvement in the global economies in recent years have contrasted with equally frequent setbacks and new challenges to market stability. With the hindsight of these last few years, the outlook for 2012 appears particularly cloudy, no matter the asset class or industry. Market volatility is pervasive across listed stock and equity markets, and it is macro events, rather than economic fundamentals, that are driving market sentiment. In fact, one pundit characterized the outlook for the forthcoming year as a “crapshoot.”

When the macro-economic and political landscape is so uncertain, it is inevitable that the outlook for real estate will in many ways be equally unclear. Yet that very uncertainty suggests that some features in the property market are likely to persist into 2012:

- Corporate occupiers will continue to exercise caution in their decisions, and demand will remain moderate. Investors in the West will therefore tend to adopt more defensive strategies, focusing on high-quality buildings in prime locations within the most liquid and transparent markets. Demand for such investments should remain healthy, and prime real estate should therefore perform well relative to other asset classes.
- Value-add strategies are more directly dependent on the economy’s growth or recovery, and are therefore

likely to be less popular in this environment. As a result, secondary property will continue to underperform.

- Previously, the stronger economic prospects for Asia meant that investors there have been more aggressive. But with growth starting to slow in China and concerns arising over the broader global impact of a Western slowdown, occupiers and investors are also becoming more cautious in many markets across Asia.

The Past Year

We began 2011 with renewed optimism that economies, and therefore real estate fundamentals, would continue to improve. But alas, challenges arose again.

In particular, the Japanese earthquake and tsunami impacted world manufacturing output and auto production. Clearly, the impact slowed growth in the first half of 2011 as the global economy stalled. Additionally, the Arab Spring and surge in commodity prices not only caused some market uncertainty but also fueled increases in oil and food prices. The gain in overall commodity prices did benefit commodity exporters such as Brazil and Canada, but at the same time hurt commodity importers, pushing up inflation. This became the principal policy concern in most emerging markets during the first nine months of the year. Central banks in many countries across Asia and Latin America began raising key benchmark rates, though by year’s end, policymakers had generally shifted their stance in the face of slowing global growth.

Rising commodity prices coupled with extreme weather patterns also impacted the consumer sector in the U.S. Consumer spending in the U.S. slowed significantly last spring, as demand for seasonal items dropped off. The large size of the consumer sector in the U.S. also renders

it an important driver of not only U.S. growth, but of global growth as well.

And, of course, the long-simmering financial crisis in the Eurozone flared up in 2011 and has been the foremost factor shaping the growth trajectory of the global economy. Concerns abound regarding the fiscal stability of certain Eurozone economies and the capitalization of banks. Many economies, including the U.S., need to address their gaping budget deficits and the fact that Standard & Poor's (S&P) downgraded the U.S. this past summer (and seven European nations, more recently). These factors did not help build confidence in the market for sustained economic growth.

As a result of these major challenges, the recovery in property market fundamentals in the West

was delayed. The slowdown resulted in weakened demand as occupiers re-evaluated their space requirements. The rental recovery that had begun in a range of Western markets was checked, though new supply remained muted and did not add to the disequilibrium in property market conditions. In Asia, the generally strong rental growth resulting from healthy occupier demand began to slow, as the impact of faltering global growth became evident in all but a few cities.

In the capital markets, the heightened risk aversion in 2011 drew investors to the safest real estate assets. Globally, investor demand was concentrated on prime properties in top locations. There was, of course, marked variation by region/city/market. Transaction volume for the year did top 2010's totals, and the nascent recovery in the CMBS market halted abruptly, underscoring the highly integrated quality of the global capital markets. Credit and debt remained available for only the best assets that offered high-quality, credit tenants.

2012 Outlook

While 2011 is in the past, many of the challenges of the last year continue to haunt the market in 2012—and failure to address these challenges renders the outlook less optimistic now than it was 12 months ago.

- The Western economies need to manage their government budgets and lower their debt profiles. Both the Eurozone and the U.S. have fiscal deficits and debt levels that require resolution in a constructive manner. Fiscal vitality is measured by the debt-to-GDP ratio, and policy actions are needed to address both the numerator and the denominator. Not only do deficits need to be reduced, but also policies are needed to stimulate private economic growth that will improve

the growth of the overall economy over time—i.e., raise the denominator. For example, the Eurozone countries with the biggest debt problems are caught in a cycle in which more austerity means less growth, therefore making deficit reduction more difficult.

- Unfortunately, in the West there is a wide difference of opinion regarding the appropriate actions that should be taken to address the solvency problem—and/or a lack of political willingness to do so. In the Eurozone, this threatens to intensify the sovereign debt crisis that has infected the banking system and could expand to become a global contagion. Some specific events in the Eurozone include:

- The December EU summit did not produce a credible solution to the Eurozone's short-term problem of the debt refinancing needs in Spain and Italy.

The resilience of prime European real estate, evident over the past turbulent year, will be supported in tougher economic conditions in 2012 by the widespread lack of new property supply.

Peter Damesick, Ph.D.
EMEA Chief Economist

— France and Austria lost their AAA debt rating in January's wider S&P downgrade of sovereign debt in several Eurozone countries.

— The European Central Bank (ECB) has begun providing unlimited three-year loans to European banks in an attempt to improve liquidity. But will this liquidity find its way to the real economy through bank lending? Banks are holding onto cash or depositing it with the ECB due to concerns as to counter-party risks. If this persists there will be a serious credit crunch, affecting all parts of the European and global economies, as European banks have played a major role in lending to those in the global path of economic growth over the last decade.

— Eurozone banks are now required to raise their tier-one capital ratios to 9% by July 2012. The short timeframe and the difficulty of raising capital in this market may encourage banks to raise their capital ratios by reducing their balance sheets, resulting in less lending, with widespread impacts on the availability of credit.

- In the U.S., 2012 marks an election year, but political rhetoric is not supporting any comprehensive solution to compromise. However, the U.S. Fed has announced its intentions to maintain low interest rates through 2013, allowing more accommodative monetary policy to drive faster growth. A meaningful and comprehensive policy to curtail the growing debt burden, however, is far off. As a result, U.S.

growth this year is expected to be sub-par, as risks of premature fiscal tightening and policy error have escalated.

- The volume of public and private debt needs to be reduced via an orderly plan. Otherwise, a series of disorderly defaults will spur another financial crisis and further economic damage. Unless this is addressed, by the end of 2012 we will still be looking at very low or near-zero interest rates, as the monetary authorities provide the liquidity to keep

deferring the problem. The implications of inaction on the volume of debt are continued, below normal, economic growth for 2012 and into future years, with recurrent financial stress. The future will be "the new normal" —it will not be a return to economic growth-rate trends.

- While sub-normal, the growth outlook is also

disparate among and within regions. Growth in the U.S. may be slightly better in 2012 than in 2011, but will not show enough of an improvement to reduce unemployment significantly. The Eurozone will suffer at least a mild recession, as will the U.K. South America, the Middle East, northern Africa and Asia will all grow above the global average for the year, albeit at a slower pace than 2011, as the policies they have implemented to temper inflation begin to show their effects. For example, China, the third-largest economy in the world, ended 2011 with inflation above 5%, requiring continued monetary restrictions as we enter 2012.

- While the "slowdown" in China currently involves GDP growth dropping marginally below 9%, the combination of restrictive domestic policies (essential to slow the excessive growth in property prices,

In periods of market volatility, core real estate will continue to provide shelter to risk-averse institutional investors. As such, in 2012 the highly liquid U.S. commercial real estate market should easily attract the greatest share of both domestic and cross-border capital flows.

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Head of Research, Americas

particularly in the residential sector) and weakening global demand means that China will be a less-supportive factor in growth across Asia than in the past. The outlook for the region is clearly more positive than elsewhere, but Asia is clearly being affected by events in other global economies.

- With the unknowns around the policy issues of debts and deficits, and the uncertainty that is generated in such an environment, the slowdown in global growth should further increase investor risk aversion in 2012. That said, the more aggressive among us will test the risk frontiers.

Implications for Commercial Real Estate

The global economy has endured three years of below-trend growth, making the task of investment managers particularly perilous. There have been myriad headlines about the dissolution of private equity firms and hedge funds, and we are all aware of the many stories of distressed capital structures and real estate. Still, we know of numerous successes where returns are counted in double and even triple digits.

In an environment of such extremes, commercial real estate has compared favorably to other asset classes over the last several years. In 2011, commercial real estate showed solid returns globally as capital sought yield and capital preservation and flocked to risk-adverse, quality assets with tenant and leasing protections. Commercial real estate met these needs and also provided diversification for multi-asset portfolios.

Core real estate in prime locations in the best markets were every investor's darling in 2011, and prices for such assets became elevated, leading many to ask if they were overpriced as the year ended. The answer depends greatly on one's view of how 2012 will

proceed. In our view for the coming year, we expect the following:

- A continued slowdown in growth will impede the recovery of real estate fundamentals well into 2012, even though there is a lack of new supply in many markets. At the beginning of 2011, there was more optimism for fundamentals, specifically in certain Asian markets. As we enter 2012, Asian office rents have stabilized (and have started to fall in some markets), and expectations for 2012 have been downgraded from rent growth to rent stabilization in all regions and markets. There are few office markets where occupier demand is greater than supply, creating upward pressure on rents; exceptions are generally restricted to the emerging markets, such as parts of Brazil, China and India, or to particular submarkets where top-

quality space may be in short supply. Almost all the data and anecdotes we come across suggest that corporate occupiers will continue to face a challenging operating environment in 2012 and

will be cautious in their expansion/renewal plans.

- As five- to seven-year leases signed in the U.S. at peak rent levels are renewed, in-place rents, and therefore net operating income, are declining due to years of sub-normal economic growth and slow recovery in fundamentals. It is not clear how widespread this issue is, as it depends on the lease-term length customary in a given local market, but it does have implications for the level of cash flow to cover debt. However, the saving grace for some owners is the low level of interest rates. Further, our on-the-ground professionals advise that many clients circumvented this issue with proactive leasing and debt-restructuring strategies.

Strategically, global investors are positioned not for a normal outcome, but for a worst-case outcome.

Raymond Torto, Ph.D., CRE®
Global Chief Economist

- Availability of debt finance for real estate in Western markets looks set to remain tight, and appears to be getting tighter in Europe. Lending will remain selective. Banks seeking to reduce existing real estate exposure face a protracted workout of loan portfolios, although pressures to achieve disposals and recycle capital are increasing. Sales of loan portfolios are likely to be completed at prices below the peak but higher than a few years ago. Some new lenders will become more active in the market—notably, insurance companies in Europe.
- In the U.S., equity and debt finance is available for only the highest-quality product in the best market. Given the lack of new supply, more modern facilities continue to attract the bulk of domestic and cross-border capital flows. There is virtually no financing available for new development, outside of the multi-housing market in certain gateway U.S. markets. As 2011 progressed, the availability of debt finance became significantly more restricted across almost every market, and has become difficult to secure for all but the best-quality assets.
- However, it is also true that where top-quality assets are available, buyers are seeing the 2012 environment as an opportunity to finance purchases at low interest rates, with a wide yield spread. This accounts for much of the current interest in the Japanese market. Of course, investors are concerned about whether there is an exit strategy for when cap rates/yields fall below long-term averages, as they are today. Future economic growth and a more significant recovery in jobs will bring about both increased occupier demand and higher interest rates. The strategy is based on the expectation that demand for space will grow before

Asia Pacific has not decoupled, and events elsewhere are now clearly affecting occupiers and investors across the region.

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yields rise, due to the increases in interest rates that accompany more-normal economic growth. In the meantime, quality assets provide a good risk-adjusted yield depending on the tenant quality and lease structure. Real estate investment demand will be uneven in 2012. Investors will continue to target the best-quality, core assets. They will also be concerned with variable growth potential and sovereign debt risk in choosing which markets to invest in.

- With significant concerns about the pace of economic activity in 2012 and an extended view on the timing of improved property fundamentals, there is speculation that these factors may hit valuations in the near term. We think prime real estate should be relatively protected from any such declines given our knowledge of the demand for such assets and the abundance of capital that is waiting to be deployed into commercial real estate. The possible exception would be markets where yields had been driven down by expectations of significant rental growth that now appear unsustainable. There is a wide prime/secondary yield gap, but our expectation is that this gap will only narrow in the future when secondary yields fall, which will only happen when the economic outlook sufficiently improves. In the short term, secondary values will weaken, given the low liquidity in secondary markets and lack of available debt.
- Despite challenging economic times and operating conditions, quality commercial real estate will continue to attract investment capital for four main reasons:

- a. In the world of fiat money where central banks may end up monetizing sovereign debt, the perception of the inflation-hedging capabilities of core real estate offers considerable appeal to investors. The evidence is mixed on the inflation-hedging abilities of commercial real estate, but the question is posed in comparison to alternative options, and real estate is clearly a better hedge against inflation than fixed-income investments. In today's world and given today's opportunities, we can make a strong case for the inflation-hedging opportunities of commercial real estate for the long term.
- b. Current supply shortages, which remain in many of today's core markets, have positive long-term implications for supply/demand balance, even in sub-normal economic growth periods. History has shown that modest increases in occupied space over time lead to space shortages and rent spikes in the future. Demand is strong for modern facilities with some "sustainability" features.
- c. Commercial real estate will still offer competitive risk-adjusted returns relative to many other asset classes for 2012. We do not expect to see the performance to be as strong as it was in 2011, but commercial real estate has advantages in a low-yield world. In particular, it is a real asset enjoying a contractually underpinned rent, with even the best-quality property typically generating a higher income return than a good-quality bond. It is these top-quality, "bond-like" properties that are attracting the most investor interest.
- d. Finally, the debate as to whether commercial real estate can act as a diversifier in a multi-asset portfolio is over, and has been for about a decade in the professional literature. However, portfolio adjustment moves at a slower pace, and allocations are still being made in favor of commercial real estate.

Final Thoughts

In each of the past three years, some "unknown unknown" or "event risk" has challenged global economic growth. Today, some investors are suggesting that the current "fat-tailed" distribution is tending toward bimodal. For 2012, there are many possible challenges, and failure to address these could yield an outcome worse than what is generally expected. One issue that is receiving remarkably little attention as we publish this ViewPoint is the prospect of another spike in oil prices due to the sanctions imposed on, and even a possible war with, Iran. We saw the impact on oil prices in 2011, and while economic dependency on conventional fossil fuels is gradually declining, we know from history that the global economy remains highly susceptible to challenges from such disruptions and pricing changes.

While the consensus outlook remains heavily overshadowed by negative factors, the positive effects of a broad-based agreement on deficits, debt and economic growth could be substantial. With most businesses holding higher-than-normal cash balances, and with consumer and business confidence retarded by the current policy paralysis, policy agreements that yield a significant improvement in confidence could unleash strong economic growth globally. This, in turn, would have positive implications for both occupiers and owners of commercial real estate.

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