



## 2008 Correction Unlikely to Match Depths of 1990 or 2001 Downturns

by Raymond G. Torto, PhD, CRE  
Global Chief Economist, CB Richard Ellis

When financial icons stumble, asset prices retreat and the cost of living and doing business escalates, the “animal spirits”, as John Maynard Keynes called them, dominate the markets. The fundamentals are beside the point.

The unwinding of the U.S. housing and mortgage market euphoria has produced tremors that, at mid-year 2008, have reached seismic proportions. Whereas a year ago risk was priced very low and investors could not get enough of it, today the market is fearful of almost any credit risk, and financial institutions and markets across the globe are reflecting that fear.

It is our view that U.S. policy makers have aggressively and successfully addressed the problems of systemic risk in the U.S. economy. However, we expect more bad news during the next six to 9 months from the economy as job cuts continue, and from real estate markets as occupancy, rents and prices fall. That said, we feel the headlines do not accurately reflect U.S. or global real estate fundamentals.

No one can predict when the trepidation will ease. But companies and investors, who prepare for more bad news with a strategy in mind in the short run and a plan for recovery in the long term, will emerge stronger in the end. Since I am not a psychologist, but an economist, I can only bring to the discussion an analysis of the fundamentals.

**SUMMARY** Investors can expect more bad news from the economy during the next six to nine months as job cuts continue, and from commercial real estate markets as occupancy, rents and prices fall. Despite painful market adjustments, commercial real estate should fare dramatically better in this downcycle than during the sharp correction of 2001 or the prolonged slump of the early 1990s.

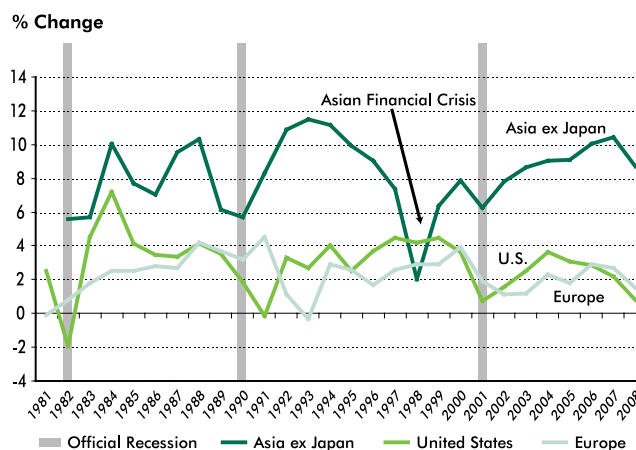
### ECONOMIC FUNDAMENTALS

Economic growth has slowed dramatically in the U.S., Europe and Asia ex-Japan, as shown in Figure 1. However, Asia ex-Japan is still growing above 8%. Unfortunately, the U.S. and Europe combined

make up about 50% of global GDP (57% if we include Japan). What is growing fast is small and what is slowing is the majority of world output.

#### Every Region is Slowing: GDP Growth By Region

Real GDP Growth<sup>1</sup>



Europe’s economy has been hampered by concerns about consumer spending, which is being impacted by a combination of rising inflation, higher interest rates and falling housing prices. As a consequence, most European

<sup>1</sup> Source: CBRE Global Research, EIU, June 2008

economies are expected to produce sub-trend growth for 2008.

In Asia, the slowing global macro economy and unsettled international capital markets have impacted consumer expectations, as has the inflation in food costs. Banks are taking a cautious stance in granting loans, and, coupled with the need to raise interest rates to curb inflation, the impact is that the pace of growth of all economies has slowed. That said, the pace is still quite strong in Asia, compared to Europe and the U.S.

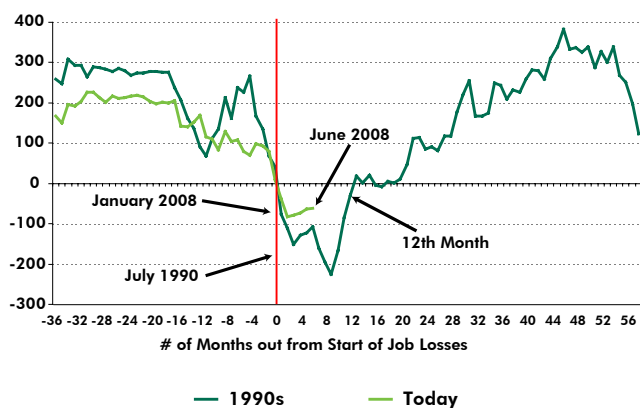
Asia's resilience is positive for the U.S. because the U.S. trade balance is narrowing as imports fall and exports accelerate. The continued growth in Asia, plus the weak dollar, make it possible for U.S. exports to increase significantly, and some economists are estimating that trade alone will add about one percentage point to GDP growth in the second quarter.

Federal Reserve Chairman Ben Bernanke has recounted the "numerous difficulties" facing the U.S. economy and the "ongoing strains in financial markets, declining house prices, a softening labor market, and rising prices of oil, food, and some other commodities." We expect more bad news in all of these areas for the remainder of 2008 and into 2009 during what we see as a slow recovery.

Job growth is an important bellwether of demand for commercial real estate. In Figure 2, we contrast the current path of job losses with the levels during the last financial-driven downturn in the early 1990s.

### Job Losses Not as Sharp as 1990s<sup>2</sup>

Net # of Jobs Created per Month x1000



Clearly the pace of job losses in 2008 is less alarming than it was back then. In the 1990s there were 12 months of job losses of greater magnitude than we've seen today, followed by 9 months of essentially flat growth. In 2008, we have thus far seen six months of job losses and can certainly expect the next three to six months to be similar, but we don't expect the size of the losses to reach the levels of the early 1990s.

The U.S. economy is adjusting from an unsustainable over-allocation of resources into housing and mortgage production, and from auto and airline industry restructuring due to long-term implications of oil prices. In light of this, it is surprising that the job losses to date have not been greater. Fortunately, there are sectors of the economy that are growing, such as export industries, oil, health care and life sciences. Unfortunately, this growth—which we believe will continue into next year—is not enough to offset the negative drag from construction, financial and auto and airline-related declines.

<sup>2</sup> Source: CBRE Torto Wheaton Research, BLS, July 2008

While we think that overall job growth will be modestly positive in 2009, it will not be strong enough to match the growth of the labor force. Hence, unemployment rates will continue to rise into 2009, even as job change numbers eventually turn positive.

If we were to trace a line going forward from today in Figure 2, we would show modest job losses for the next six months, followed by stabilization and a slight recovery. The job contraction will be shallower than in the 1990s, but nevertheless painful.

### COMMERCIAL REAL ESTATE FUNDAMENTALS

The slowing global economy has impacted commercial real estate fundamentals as net absorption, or take-up, has slowed most everywhere and both occupancy and rents have fallen a bit. For example, in the U.S., second quarter vacancy rates are up by 50 to 100 basis points over the previous year's levels, which is shown in Figure 3.

#### Fundamentals Well Aligned, So Far<sup>3</sup>

##### Vacancy Rates for Markets Tracked (%)

	Q2 2008	Q2 2007	Natural Rate <sup>4</sup>
Office	13.2	12.5	13 to 15
Industrial	10.3	9.3	9 to 10
Retail	10.3	9.9	9 to 10
Multifamily	5.6	4.8	5 to 6

The current level of vacancy is in the range of the natural rate, which is the rate at which rents will neither rise nor fall. However, vacancy is expected to rise into 2009 while absorption turns slightly negative. Hence, upcoming quarters will bring more bad news for commercial real estate—higher vacancy, lower rents and weak absorption—but will not approach the acute pain we saw in the early 1990s downturn, or even in the 2001 technology recession. The expectation for commercial real estate is

<sup>3</sup> Source: CBRE Torto Wheaton Research, July 2008

<sup>4</sup> The Natural Rate is the vacancy rate where rents are in equilibrium, i.e. they are neither likely to rise or fall.

much like what we described for job growth: a shallow weakening but stretching through 2009.

While we expect overall market fundamentals to soften, many commercial properties with tenants in place will not see their cash flows threatened. In fact, strong market rental growth in recent years is boosting NOI and cash flow as tenants roll from four-year or longer leases into today's marketplace. The good cash flows are one reason that CMBS delinquency rates continue to be at historic lows—just 0.44% across all property types. Properties that are on the cusp of trouble are those with marginal tenants or no tenants because of competitive disadvantages or speculative development risk.

Because there are few distressed owners, the investment market is seeing a wide spread between bid and ask pricing, and investment transaction velocity is down considerably.

### COMPARISONS TO HISTORY

Let's put today's real estate market travails into context by comparing the economic and real estate performance in 2008 to earlier recessionary periods, especially the early 1990s and 2001.

The rate of negative change for GDP and Job Growth during this cycle is expected to be relatively mild. As already indicated, negative job growth will not be as severe as earlier periods, and GDP is expected to stay positive during this slowdown.

#### Historic Comparisons: Economic Rent<sup>5</sup>

##### Office

	% Loss in Economic Rent	# Quarters Peak to Trough	Quarter Economic Rent Peaked
1990	-6.1	18	Q4 1990 (2Q after Recession Start)
2001	-23.4	12	Q2 2001 (1Q after Recession Start)
2008F	-1.2	6	Q3 2008 (3Q After Job Loss Start)

<sup>5</sup> Source: CBRE Torto Wheaton Research, July 2008

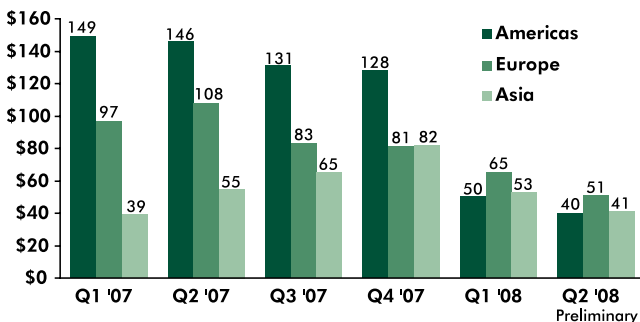
As shown in Figure 4, Economic Rent—which is a measure of the change in gross income of a property—is forecasted to decline just 1.2% on average across the country during this down cycle. This is dramatically better than the sharp reduction in 2001 and well below the decline of the early 1990s as well.

The relatively sanguine analysis does not mean that we don't expect some pain as the economy continues to move from froth to correction in 2008. Of course, most of the correction is expected in the pricing of real estate assets. With that, we turn to the capital markets.

### CAPITAL MARKETS

The capital markets globally have weakened materially. Investor sentiment is extremely cautious, credit availability is sharply limited, and buyer and seller expectations are highly polarized. These factors conspired to plunge global investment sales activity by approximately 50% during the first half of 2008, according to estimates from Real Capital Analytics.

Figure 5: Quarterly Sales Volume (\$ billions)<sup>6</sup>



<sup>6</sup> Source: Real Capital Analytics, July 2008

Overall market conditions remain extremely challenging. Focusing on the U.S., the CMBS market is dormant—only \$12 billion of originations during the first half of 2008 compared with \$137 billion in the first half of 2007—as Wall Street lenders focus on restoring their balance sheets and repairing their reputations.

Higher spreads, coupled with much tighter underwriting standards, have raised capital costs significantly and made property acquisitions less attractive for many buyers—particularly with sellers holding the line on pricing. The growing concerns about Freddie Mac and Fannie Mae have added to the negative market psychology, although the announced Treasury and Fed plans appear to have restored some level of confidence in the capital markets.

Most equity investors continue to take a wait-and-see attitude. The exceptions are Sovereign Wealth Funds and other well-capitalized offshore investors, for whom iconic trophy assets hold strong appeal. This can be seen in the significant role of Middle East capital in Boston Properties' purchase of the GM Building, and the recapitalization of the Chrysler Building. However, foreign fund activity is limited to a handful of major CBDs like New York, Washington, Houston and Los Angeles.

Still, a market standoff prevails. Sellers generally hold firm to "offer" pricing while buyers demur from raising "bids" appreciably. Interestingly, owners' confidence is being buoyed not only by their current cash flows, but the potential NOI and asset value implications of general price inflation. Construction costs are high, supply in the pipeline is very limited, and if there is a tight

tenant market in the near future, real estate could be a good inflation hedge.

Bridging the divide in expectations—and forging a “meeting of the minds” on valuation—will be essential to returning the investment market to more normalized activity levels. One thing is certain: There is plenty of capital looking to buy real estate at the “right” price.

Investors are only uncertain about when they should re-enter the market, not if they should.

We strongly believe that commercial real estate will hold up well relative to other asset classes. Property market fundamentals and capital market volumes and velocity will take time to recover, but in the long-term investors will continue to look to real estate for income, appreciation and diversification.

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*Raymond Torto, CRE, Ph.D., is CB Richard Ellis' Global Chief Economist. Dr. Torto, one of commercial real estate's most renowned economists and forecasters, directs CBRE's worldwide team of commercial real estate market analysts and serves as the firm's primary spokesperson on macro economic issues and the global commercial real estate market.*

#### **FOR MORE INFORMATION PLEASE CONTACT:**

Raymond Torto, CRE, Ph.D.  
Global Chief Economist  
Chair  
617 912 5225  
Raymond.Torto@cbre.com

Nick Axford, Ph.D.  
Head of Research and Consulting  
EMEA  
44 20 7182 3039  
Nick.Axford@cbre.com

Alan Dalgleish  
Executive Director, CBRE Consulting  
Asia  
65 6326 1237  
Alan.Dalgleish@cbre.com.sg

Andrew Ness  
Head of Research  
Asia  
852 2820 2845  
Andrew.Ness@cbre.com.hk

Kevin Stanley  
Executive Director, Research and Consulting  
Pacific Region  
61 2 9333 3490  
Kevin.Stanley@cbre.com.au

Raymond Wong  
Director of Research Operations  
Americas  
416 815 2353  
Raymond.Wong@cbre.com