

A SLOW-GO ECONOMY: IS CALLING A "RECESSION" NECESSARY?

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In early February, three indicators fully confirmed economic slowness, and one of these indicated that several months of chatter may have talked us "over the cliff" into recession. Each is a coincident indicator—reflecting today's economy, not the future:

- GDP growth for 4Q07 was 0.6%;
- January employment reported a loss of 17,000 jobs; and
- The Institute for Supply Management (ISM) Services sector indicator came in below a reading of 50, which indicates contraction sentiment among the service firms in the survey.

The financial markets reacted strongly as the ISM indicator is a reflection of business confidence and the drop in the index was precipitous. As can be seen in Figure 1, the index has fallen below 50 in other time periods, most recently in the 2001 recession.

SUMMARY Based on the expectation that the monetary and fiscal stimuli being implemented will be sufficient and that the capital markets will recover gradually, we expect that 2008 will be a year where the commercial real estate market will take some lumps in pricing and leasing, and some investors will be caught in the liquidity trap. But long-term real estate investors will view the year as one where opportunities will arise from others' mis-pricing or misfortune.

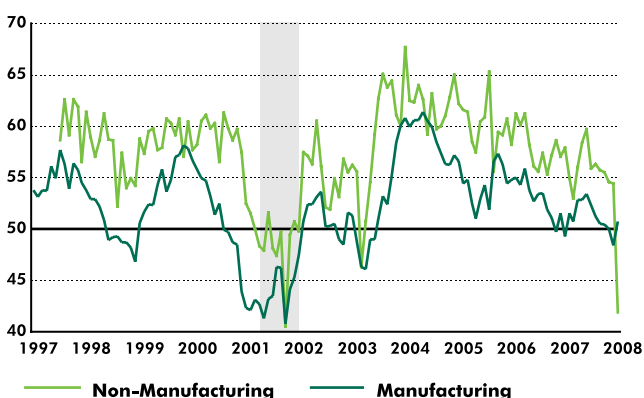
Those who follow the numbers closely remember that the initial December employment report was equally concerning: +18,000 jobs. However, December was revised upward to +82,000 jobs with the January report.

A monthly growth of 82,000 as opposed to 18,000 in December gives a totally different picture of the economy. And there are several good reasons to believe that the January employment report—along with the 4Q GDP and ISM indicator—will be revised upward next month¹. But no matter the revisions, however, the numbers will continue to signal slow growth—slower than normal and slower than last year.

We expect to see slowness persist through the first quarter and into the second quarter. The CBRE Torto Wheaton Research (TWR) models indicate an uptick will start in the third quarter of this year. However, this is based on the assumption that monetary policy remains loose.

There is much debate in the media as to whether we are already in or heading into a recession. From this debate one would think that economic observers are at great odds. However, there is not much difference between the U.S. economy growing a positive (+0.2%) or a negative (-0.2%). Compared to 4% in recent years, both outcomes are decided slowdowns. Also, most

Figure 1: ISM Manufacturing and Service Sector Indicators



¹ Economists face the same peril in forecasting the economy as weather people face forecasting the weather. Forecasting does help us plan and have informed expectations for the future, but it is not a perfect science. One advantage that weather people have over economists, however, is that the weather, unlike the economic data, is not revised.

economists agree that the first two quarters of 2008 will be slow growth or mild recession, leading to recovery in the second half of the year. Whether we are already in or heading into a recession is not the right question. Rather, the question is whether the financial and credit markets can settle down by mid-year so the economy can get back on track.

What could upset the consensus scenario of a slowdown followed by recovery in the second half of the year? A major financial market meltdown. While we expect further write-downs in the value of financial and real estate assets and some forced selling of such, we do not expect the failure of a large financial institution, or a further downgrading of the monoline insurers. Rather, we expect the Fed to keep the financial system intact, although banks will need to raise capital for their own balance sheets, thereby leading to selective lending and credit extension. The Fed's lowering of interest rates has only partially offset the widening of spreads, and it will be difficult to secure a high loan-to-value ratio on most any type of debt.

Commercial real estate is affected in two ways. The slowing economy reduces leasing activity and new development, and pricing uncertainty and less credit reduce sales transactions and sale prices.

EFFECTS FROM THE CAPITAL MARKETS

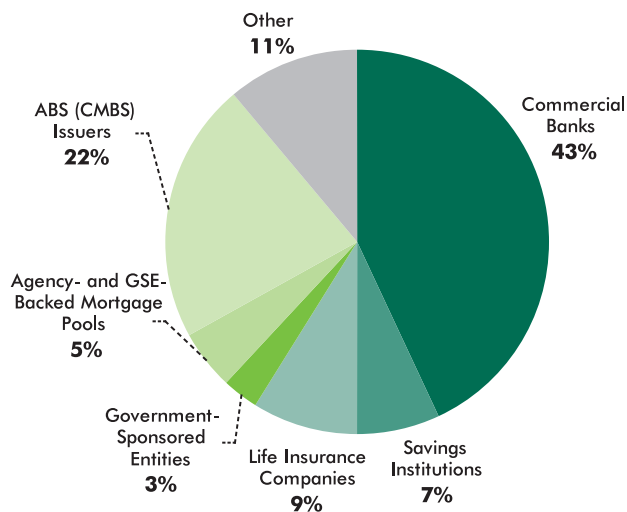
Investment sales of commercial real estate have been driven, in part, by abundant and inexpensive debt made available by the structured-finance revolution. In 2007, CMBS had a record volume of \$230 billion, or approximately \$18 billion per month. For the first month of 2008, not a single new CMBS deal was priced in the market.

How significant is this for commercial real estate (CRE)? As of mid-year 2007, about 22% of the \$3 trillion of CRE debt was provided by CMBS and it was the growth of the CMBS market over the first part of this decade that spurred the year-over-year rise in overall transaction volume. Moreover, data from Real Capital

Analytics (RCA) indicates that more than one-third of all commercial real estate sales transactions up to October 2007 were financed via CMBS. The etymology of the word credit means "trust" and it is a simple fact of life that once trust is broken, it takes a good while for it to return.

Figure 2: U.S. Commercial and Multi-family Mortgages²

Shares of \$3.00 Trillion Outstanding Debt By Type of Lender



Today, the structured finance revolution is on hold until investors become trusting again with the underwriting and ratings of debt obligations. Given what we have learned about how some subprime and other residential loans were underwritten, with loose criteria and in some cases fraud, it is no wonder that all securitized loans, or structured finance, are in question.

It is clear that some financial institutions, particularly the insurance companies, are stepping up to fill part of the current void in lending. However, as Figure 2 shows, the single largest source of CRE debt (as opposed to the fastest-growing) is the commercial banking sector, and these institutions are burdened with their own capital needs. No one really knows what the volume of CRE debt will be in 2008 versus 2007. Estimates are all over the map, but clearly it will be lower by some significant dollar volume. Figure 3 shows the correlation of

² Source: Federal Reserve Flow of Funds

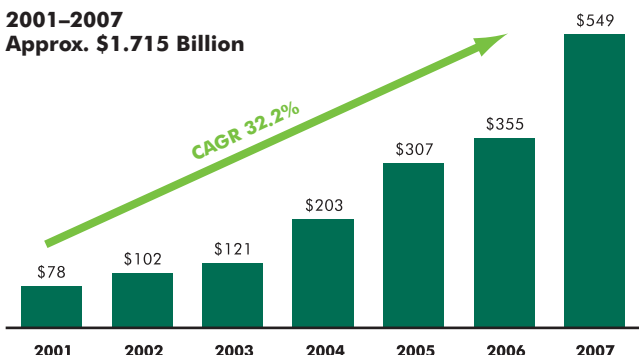
sales volume with CMBS volume, and the conclusion is unmistakable.

Figure 3: Strong Correlation of CMBS Debt to Investment Volume

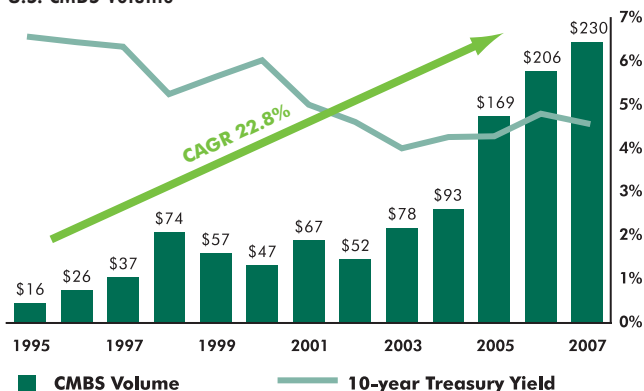
U.S. Investment Sales Volume (\$ Billion)³

2001–2007

Approx. \$1.715 Billion



U.S. CMBS Volume⁴



Of course, all cash buyers are gleeful at the reduction of competitive bidders for quality assets as high leverage bidders are now out of the market. But with reduced volumes, what has happened to prices? Pricing of CRE assets is hard to decipher. Data from RCA show little change in cap rates, but the reduced volume of transactions has analysts questioning the data.

Table 1 shows that for some property types, such as office, the 4Q reduction in dollar volume was about 45% from 3Q levels. At the same time, cap rates for office properties have barely changed. On the other hand, industrial volume was also down significantly, but here

cap rates were up by about 60 basis points. Although RCA does a nice job of collecting transaction data, one needs to remember that the data samples are affected by what properties are selling in a given time period. For instance, many analysts believe that the lack of any big change in office cap rates is due to the composition of what sold in 4Q, i.e., trophy/core properties. Also, it is worth noting the data on apartments, where we see increased, not decreased volume. This reflects the role of the Government-Sponsored Entities in stepping up to finance multi-family properties.

Table 1: Low Volume Makes Cap Rates Inconclusive⁵

		4Q07	3Q07	4Q06
Apartment	Volume (\$)	35.8	22.6	27.2
	Cap Rate	6.46%	6.57%	6.48%
Industrial	Volume (\$)	8.2	13.3	11.4
	Cap Rate	7.35%	6.77%	7.15%
Office	Volume (\$)	26.5	47.3	45.6
	Cap Rate	6.49%	6.58%	6.81%
Retail	Volume (\$)	10.1	14.9	17.8
	Cap Rate	6.70%	6.62%	6.64%

In addition to databases, there is anecdotal evidence that indicates little change in pricing for trophy properties in core locations and up to 20% price change for secondary or tertiary properties. But how does one reconcile this view with the recent *Wall Street Journal* story on the Macklowe properties in New York potentially being returned to the primary lender?

EFFECT ON THE LEASING MARKET

A slowing economy will adversely affect the leasing market through reduced demand for new space and reductions in existing leasing plans. Even with a modest amount of new space entering the market, softer leasing demand will raise vacancy rates and also temper the forward momentum of rents. One performance measure that can reflect both of these factors is economic rent, which is the market average rent multiplied by the market occupancy rate. The measure reflects not only

3 Source: Real Capital Analytics. Includes deals greater than \$5 million for office, industrial, retail, multi-family and hotel properties (started tracking hotels in 2004).

4 Source: Commercial Mortgage Alert

5 Source: Real Capital Analytics, January 2008

the changes in rent but also the changes in occupancy. For the market it is equivalent to the change in gross income for occupied space.

Table 2 provides a summary of both the history and forecast for 2008 of the percentage change in economic rent for office and industrial markets. In 2006 and 2007, the office market nationally saw economic rent rise 9.8% and 9.9%, respectively. The industrial market had a more subdued growth in economic rent and showed some slowdown in 2007 from 2006's pace.

The biggest change is the forecast for 2008, in which the national economic slowdown will essentially keep economic rent flat. Behind the numbers are moderate increases in rent offset by slight decreases in occupancy. Also shown in the table is the change in economic rent for 2001, which was a recession year. The CBRE TWR outlook for the leasing market, while much slower than the last two years, is also certainly stronger than what occurred in 2001.

Table 2: Economic Rent Percent Change⁶

	2006	2007	2008F	History 2001
Office	9.8%	9.9%	-0.2%	-9.6%
Industrial	5.7%	3.6%	2.8%	-4.4%

Although CBRE TWR's national forecasts call for a rise in vacancy rates in 2008 and a small rise, on average, in rents, there are markets that will do quite well in 2008 compared with the nation. For example, Downtown Charlotte, NC, is a market with a vacancy rate under 2%. Of course, there is some concern in the marketplace about the persistence of this momentum, given the importance of banking institutions to the Downtown Charlotte market. Table 3 shows the top performers,

as measured by economic rent, for 2008 contrasted to their performance for 2007.

Table 3: Top Performers in Percent Change in Economic Rent

Office	2008F	2007
Charlotte	8.1%	7.7%
Raleigh	7.9	6.1
Pittsburgh	7.2	2.6
Dallas	7.0	6.5
Indianapolis	6.7	-0.2
Average All	-0.2	9.9

Industrial	2008F	2007
Indianapolis	10.7%	19.3%
San Jose	10.6	9.5
Akron	9.4	1.2
New York	8.3	4.2
Pittsburgh	7.9	9.0
Average All	2.8	3.6

CONCLUSION

Based on the expectation that the monetary and fiscal stimuli being implemented will be sufficient and that the capital markets will recover gradually, we expect that 2008 will be a year where the commercial real estate market will take some lumps in pricing and leasing, and some investors will be caught in the liquidity trap. The media will focus its lens on only those suffering in the market, but long-term real estate investors will view the year as one where opportunities will arise from others' mis-pricing or misfortune. Unlike the stock and bond markets, real estate is not a trader's market, but an investor's market. And all the evidence is that the major investors will continue to invest, albeit cautiously and with appropriate analysis and assumptions.

⁶ Source: TWR, Spring 2008 Outlook

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