



## MARKET FUNDAMENTALS CONTINUE TO WEAKEN ACROSS AMERICAS REGION

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A global recession appears to have arrived as the world's largest economies—the European Union, Japan and the United States—all contracting. Most developed nations are offering up fiscal stimuli, lower lending rates and economic recovery packages—and macro economic public policy is being coordinated across borders on an unprecedented scale—all in an effort to head off a prolonged worldwide downturn. Despite the best efforts of policy makers, the consensus view is that recovery from the financial crisis and resulting economic downturn will take longer than initially anticipated.

By some measures, the frozen credit markets began to thaw in October and early November. Inter-bank lending has revived after being nearly comatose earlier this fall. The three-month London Interbank Offered Rate (LIBOR)—the lending rate banks charge each other—recently fell to 2.1%. This is still a historically high number, but well below the peak of 4.8% reached on October 10, 2008. Funds are also flowing through the commercial paper market as well. However, the U.S. Treasury Department's decision not to use TARP funds to purchase mortgage securities caused parts of the credit markets to enter a new freeze and dealt another serious setback to the commercial real estate credit market. A new liquidity crisis at Citigroup prompted the Federal government to unveil a US\$20 billion rescue package—on top of the US\$25

**SUMMARY** A global recession appears to have arrived as the world's largest economies are all contracting. In the U.S., overall real estate market fundamentals continue to weaken, with companies that were initially reluctant to put excess space on the market now making increasing amounts of space available for sublease. In Canada, market fundamentals are generally stable, but with new office supply coming on stream and decreased employment in the financial sector, we may see softening over the next year. Meanwhile, the once-robust Latin America economy is starting to fade.

billion Citi has already received from TARP—and to guarantee more than US\$300 billion of toxic mortgage assets on Citi's books. The action appeared to calm investors, at least for now, and 10-year Treasury yields fell below 3.0% as investors sought the safety of government guarantee. However, commercial real estate lending standards remain extremely tight as financial institutions lack both capital and confidence. It is only after this crisis of confidence is resolved that we can expect the recovery to begin.

### UNITED STATES

The financial crisis and economic downturn continue to exact a heavy toll in the U.S. Gross Domestic Product contracted by 0.5% in the third quarter and employment dropped for the tenth straight month in October. The 240,000 jobs shed in the month pushed the unemployment rate to 6.5%, the highest in 14 years. September job losses were revised sharply higher as well, bringing two-month job losses to 520,000. Most troubling is the fact that while earlier job losses were confined to sectors most directly related to the housing downturn, recent losses spread into other sectors. Service companies, which were previously a source of labor market stability, are now reducing employment rolls as well. Two sectors that already showed weakness—retail and financial services, which reported

job losses from September to October of 49,000 and 33,000, respectively—will likely come under increased pressure due to the continuing fallout from the financial crisis and growing consumer apprehension. Reflecting just how frugal consumers have become, October saw retail sales decline by 4.1% from its year-ago level, the largest decline since the Census Bureau began tracking retail spending in 1992.

One bright spot in an otherwise dreary economic picture is the significant retreat of inflationary pressures, led by food and energy prices. For example, consumer prices dropped 1.0% from September to October—the largest one-month decline since World War II. With oil tumbling to under US\$50 per barrel and gasoline prices at less than half of what they were just a few months ago, consumers have, in effect, received a sizable tax cut—one they are thus far reluctant to spend due to the gloomy jobs outlook and falling value of homes, stock portfolios and most other assets. Auto sales, in particular, are hurting badly, tumbling by 32% in October. The housing market continues to shed listing inventory with home sales down slightly from 5.1 million in September to 5 million in October. Overall home buying is stable, but most of the activity is opportunistic, with 40% of the sales from short sales, where sale proceeds fall short of the loan balance, and foreclosures, according to the National Association of Realtors.

### **Market Overview**

Overall market fundamentals continue to weaken. Companies that were initially reluctant to put excess space on the market—even in the face of staff downsizings—are now making increasing amounts of space available for sublease. Office shadow space is becoming more prevalent as well, especially in markets with large financial sector tenancy. New construction projects have slowed markedly—and in some cases stopped altogether—due to a paucity of both tenants

and available financing. Weak industrial production and a continued loss of manufacturing jobs have adversely affected warehouse and distribution markets. The retail sector took another casualty with the Chapter 11 filing of Circuit City, and all eyes are on General Motors, Chrysler and Ford—icons of the U.S. automotive industry—which are confronting a liquidity crisis.

### **Capital Markets**

The U.S. Treasury's decision to abandon plans to purchase depressed mortgage securities and increased concerns about loan quality sent asset-backed credit markets reeling. CMBS spreads expanded to unheard of ranges before retreating last week, with AAA yields on the secondary market now being quoted at nearly 13%, down over 500 basis points from the prior week. BBB spreads, the lowest "investment grade" tranche of CMBS, are currently trading at yields over 35%, essentially building in an enormous default factor. Although delinquencies remain miniscule—only 0.63% of all CMBS loans as of the end of October, according to Realpoint—investors have become increasingly concerned about the quality of underlying mortgages. Major retailer bankruptcies are not helping matters. Additionally, reports that three loan packages are close to default fed investor wariness and reinforced the decision of many lenders to remain on the sidelines. The Mortgage Bankers Association reports a 53% decline in commercial lending during the third quarter, and a recent Fed Loan Officer Survey indicated that 84% have tightened lending standards for commercial and industrial loans.

Besides the virtually illiquid capital markets, investment sales activity is hamstrung by a deepening standoff between buyers and some well-capitalized sellers. Many landlords remain in good financial position; however, market fundamentals are trending away from them. For certain owners, higher vacancies and lower rents may

strain cash flows, and those with big loans maturing in the near term could be forced into distressed sales, as some institutional owners de-leverage to improve their balance sheets. Fortunately, only about US\$22 billion of fixed CMBS debt and US\$36.5 billion of floating rate debt are scheduled to mature next year, according to Realpoint. While buyers await bargains that may not emerge and sellers hold to pricing expectation levels, few transactions are being consummated. We do expect this logjam to release somewhat in the first two quarters of 2009. The widening of cap rates will continue, more so in B and C asset types than in high-quality core properties.

### **Office**

Nationally, there is a definite pause in the office leasing market as companies defer occupancy decisions in the face of growing economic turbulence. Tenant inducements have become more lucrative in most markets nationally, as landlords vie aggressively for tenants and try to protect cash flow. Tenant retention is an owner's primary objective. Companies across the economic spectrum have focused intensely on cost containment and rightsizing their workforces. U.S. employers conducted "mass" layoffs—defined as 50 positions or more—more than 2,200 times in September, according to the U.S. Department of Labor. Fewer office workers translates directly into less demand for office space and more sublease and shadow space availability, which puts downward pressure on rents. This has caused a distinct decrease in demand for space. By all accounts, shadow space is at the highest level since 2000. Further inhibiting leasing relocations is the limited availability of capital dollars required above landlord contributions to properly improve work spaces. This constraint of capital further encourages lease renewals as opposed to relocations.

### **Industrial**

The manufacturing sector continues to be impacted by the more cautious consumer and slowing international

trade. With new orders diminishing and inventory levels rising, the fallout on the industrial real estate market is already evident, and full-blown global recession will constrain demand for warehouse and distribution space. Although rental rates have remained largely stable, particularly for newer facilities, sale prices have moderated. Financial pressures on corporate owner-occupiers could spur an increase in sale/leaseback transactions, as companies seek to monetize their real estate assets and free up capital to re-invest in the business. October results from the Institute for Supply Management indicated a further slowdown in the manufacturing sector, with the Purchasing Managers Index (PMI) dropping to 36.2, the lowest level since May 1982. This was due to a decline in new orders, production and the loss in manufacturing jobs. While a strengthening dollar would ordinarily encourage increasing demand for warehouse space due to the relatively cheaper cost of imports, consumer demand negates this otherwise positive trend.

### **Multi-Family**

The multi-family sector continues to be affected by the housing crisis and an overbuilding of condominium projects in certain markets. So far, the sector has weathered the economic storm reasonably well, but mounting job losses and rising unemployment will cause occupancy levels to decrease and rental growth to flatten out next year. New completions are still adding to supply pressures in Florida and Texas. Once the existing projects move to completion, however, there will be little new construction starts in the multi-family sector. Many formerly for-sale units are now competition for rental properties.

### **CANADA**

The Canadian economy is still performing well compared to the U.S.; employment levels actually rose slightly in October. Current performance, however, does not reflect the challenges that lie ahead. The fall in commodity prices has benefited consumers, but it

has slowed economic activity in Western Canada. The sharp decline in oil prices to under US\$50 per barrel may stall or delay certain oil sand projects in Alberta. Central Canada is still feeling the impact of weakened U.S. consumer spending and will face further challenges in the auto sector. However, there is still a chance that the Canadian economy may skirt a recession. The fall in the Canadian dollar ("Loonie") (\$0.78 to USD today vs. \$1.01 a year ago) should benefit manufacturers, but a recessionary U.S. economy may partially offset the currency-related boost. Inflation is also another concern for the Canadian economy, as the recent decline in the Loonie has driven up prices for exported goods and services. Surprisingly, retail sales rose by 1% in September; this was due to the increase in auto sales as well as aggressive pricing by retailers to draw consumers.

### **Market Overview**

Market fundamentals are generally stable, but with new office supply coming on stream and decreased employment in the financial sector, we may see softening over the next year. The industrial market will face challenges not only in the manufacturing sector, but slower economic growth will also affect warehouse and distribution facilities. Overall investment activity has slowed significantly with cap rates increasing, and there is a growing disconnect between sellers and purchasers amid disagreement on pricing.

### **Capital Markets**

The Canadian government, through Canada Mortgage and Housing Corporation, bought up C\$25 billion in mortgages from the major banks to ensure credit liquidity in the market. The goal is to keep credit available for both businesses and consumers and maintain economic growth. Investment activity is expected to decrease by 40% in 2008, falling back to 2000/2001 levels. Cap rate changes are similar to the U.S., having increased over the past 12 months between 75 and 150 basis points, depending on the property and market.

Until credit becomes more readily available, investment activity is expected to remain slow.

### **Office**

Office vacancy rates in Canada remain near historic lows, but are poised to move higher due to new supply deliveries and the lower demand for office space. Concerns over the economy, pending new supply and tenant inducements are starting to become a factor in lease negotiations, as landlords try to renew existing tenants and attract new ones to ride out a potential economic downturn. The weakness in the capital markets has started to impact the financial services sector with a few announcements of layoffs, but nowhere near the same levels as in the U.S.

### **Industrial**

The industrial availability rate continued to increase, but still registered historically low levels. New construction is starting to slow, but has yet to impact rental rates. A slowdown in manufacturing is a growing concern, especially in light of the faltering economy in the U.S. The impact of the weaker Canadian dollar on the manufacturing sector is still uncertain, especially if the economy slows.

## **LATIN AMERICA**

The once-robust Latin America economy is starting to fade. Brazil and Mexico have been hit by rapidly falling currencies and declining oil prices, and the increasing value of the U.S. dollar has spread inflationary concerns throughout the region. Consumer lending rates are on the rise and will impact retail spending as banks tighten borrowing. Despite these new challenges, economic growth is expected to remain positive, albeit at more modest levels than in recent years.

### **Market Overview**

Latin America market fundamentals have been relatively strong, with office vacancy rates at all-time lows, with 0% in Lima and 6.6% in Mexico City, reflecting the

continued shortage of modern office buildings across much of the region. Similar to the office market, the industrial availability rate is low, at under 5%, while industrial and office rental rates for the most part remain stable. Similar to the rest of the Americas, investment activity has virtually stopped.

### Capital Markets

Foreign investor interest has waned. Investment activity has slowed appreciably since mid-year, mirroring the decrease in activity experienced across the rest of the world. There is evidence of increasing cap rates and a widening gulf between seller and purchaser expectations.

### Office

Office demand is starting to slow in some markets, but with low vacancy rates, the effect on rental rates should be only minimal. The amount of new office

projects being delivered, especially in São Paulo and Mexico City, could pose near-term challenges. But the new inventory is filling a marketplace need for more properties, with better HVAC, electrical and workplace efficiencies to meet the needs of 21st-century tenants.

### Industrial

Similar to the office market, there is a shortage of state-of-the-art industrial space in Latin America. New construction is slowly increasing, mostly driven by build-to-suit projects. Still, demand is outstripping new supply in some markets. Average rental rates continue to increase in some secondary emerging markets, while rents in regional key markets tend to be stable. The economic slowdown affected industrial productivity in September, especially in Mexico, where productivity was down 1.8%. This should have a marginal impact on availability rates.

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