



## GROWING RECESSION FEARS IMPACT AMERICAS REAL ESTATE MARKETS

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The rising threat of a global recession and spreading investor fears in the face of extreme economic turmoil have caused financial markets around the world to swing wildly over the past few weeks. In the U.S., October has seen one of the sharpest declines in the Dow Jones Industrial Average since 1938. Governments have taken equity stakes in the largest banks and adopted extraordinary measures to foster inter-bank lending and loosen up paralyzed credit markets. Central banks around the world have even worked in conjunction with one another to reduce prime interest rates. This has resulted in an easing of the London Interbank Offered Rate (LIBOR), the overnight interest rate in which banks borrow from each other, which serves as a benchmark measure in the U.S. and Canada. The 3-month LIBOR, for instance, recently fell to 2.51%—its lowest level in four years and down from a peak of 4.8% on October 10—and the commercial paper market has revived as well. However, the credit market recovery is very tenuous and is unlikely to stave off a recession in most parts of the world; only the severity of the downturn remains in question.

### UNITED STATES

The U.S. is most likely already in a recession, as reflected in a 0.3% contraction in economic activity during the third

**SUMMARY** Overall market fundamentals in the U.S. continued to weaken as office vacancy and industrial availability rates increased during the third quarter. Overall investment transaction activity was down significantly, reflecting the highly dysfunctional capital markets. In Canada, market fundamentals remained strong, with office vacancy levels falling to record lows and industrial availability rates up only slightly, despite a weakened manufacturing sector. Latin America market fundamentals have also been relatively strong, but cracks are starting to appear in a couple of markets.

quarter. In September, the U.S. lost another 159,000 jobs—the largest single monthly payroll decline since January—and job losses for the year ballooned to 760,000. Perhaps the most troublesome aspect of the September report was the pervasiveness of job losses as both goods- and services-producing industries posted sharp declines. On the services side, retail (40,000) and financial activities (17,000) posted sharp declines. Conditions in these two sectors will likely deteriorate further in the coming months due

to continuing fallout from the financial crisis and growing consumer apprehension. The highly restricted credit flow is basically choking the U.S. economy; businesses are finding it difficult to borrow to meet payroll and operating needs. This accounts for the government's focus on unfreezing credit markets.

U.S. manufacturing showed further weakness. The Kansas City Fed survey index registered a -9 reading from August to September—the first negative reading since June—due to a decrease in new orders. The Industrial Supply Management index suffered another setback, reflecting weakness in new manufacturing orders, production and employment levels. Conditions are not likely to improve, as already slowing growth and the likelihood of a global recession suppress international trade.

Retail sales took another plunge in September, and fell to (-1.2%) compared to the month of August. The precipitous drop was due to declines in home furnishing sales (-2.3%) and motor vehicles/parts (-3.8%). These decreases are in line with employment losses and a continued decrease in consumer confidence, which the government reported fell in the third quarter by its largest percentage since 1980. In October, U.S. auto sales fell by 32%.

### Market Overview

Overall market fundamentals continued to weaken, as office vacancy and industrial availability rates increased during the third quarter to 14.1% and 11.4% respectively. Overall investment transaction activity compared to a year ago was down by 55%, according to Real Capital Analytics, reflecting the highly dysfunctional capital markets as the financial crisis deepened in late summer and early fall. Overall pricing remains weak as cap rates continue to increase, but many sellers have been reluctant to accept market realities. Yet, recent activity suggests the gap between bid and ask has lessened. The drag on properties clearing the market is the lack of credit, not the cost of the credit or the amount of equity. The retail sector remains weak, as tenants continue to struggle with rapidly diminishing consumer spending habits and brace for what is shaping up to be a bleak holiday shopping season.

### Capital Markets

Overall investment activity continues to be heavily impacted by the global credit crunch and faltering economic activity around the world. The Federal government's Troubled Asset Relief Program (TARP) has had relatively limited impact thus far on the distressed mortgage market, as the Treasury quickly shifted its initial focus to backstopping the nation's largest banks and breaking the freeze in the credit markets. Those efforts—in combination with similar moves by

governments around the world—have shown signs of easing the credit market paralysis, as seen in the aforementioned drop in LIBOR rates and revived commercial paper market. In addition, inter-bank lending, reflected by the "TED Spread," has dropped below 300 basis points. Government intervention, however, is not a panacea, and property prices will remain under pressure as the de-leveraging process plays out.

Investment sales activity remains far below the levels of 2007. Real Capital Analytics reports approximately \$123 billion of total sales through the first nine months of 2008, a decrease of 55% from \$273 billion for the same period a year ago. With the exception of a few large portfolio and trophy sales, average transaction prices were smaller, dropping from an average consideration of \$27,052,089 in 2007 to \$19,904,758 in 2008, a 26% drop. Moreover, the number of portfolio sales declined, with mostly one-off investment sales so far in 2008. The combination of restrictive credit, growing investor apprehension and the polarization of buyer and seller expectations has stalled investment activity. Cap rates for all types of properties were impacted, with the increases ranging from 100 to 200 basis points depending on the property and the location.

Investor confidence is at a very low ebb across all asset classes. Yet, even with occupancy and rent levels diminishing, underlying commercial property market fundamentals remain solid, and property owners, with a few highly leveraged exceptions, enjoy good cash flow. Delinquencies remain at low levels: 1.18% for banks, 0.57% for CMBS, and 0.03% for life insurance companies. Despite this, the credit crisis continues to cull the field of players—both equity and debt. For example, some pension funds have been forced to become net sellers of commercial property, due to the "denominator effect." The steep value destruction in pension fund stock portfolios has caused real estate holdings—which are marked to market on an annual basis—to exceed

overall asset allocation thresholds. These pension funds have had to bring properties to market in order to return their real estate allocations to required levels. There has also been some pressure to sell assets to meet redemption demands by fund investors.

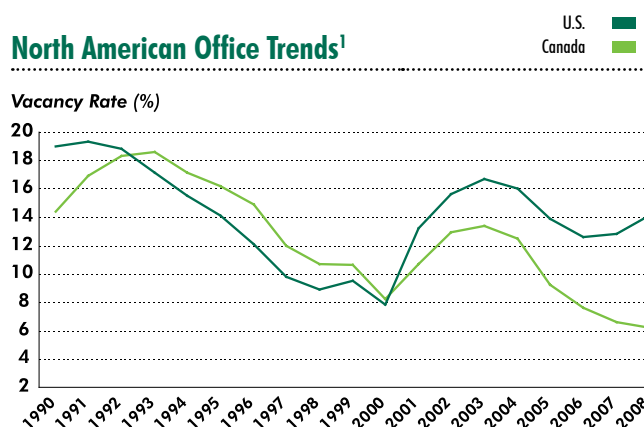
## Office

The national overall office vacancy rate increased to 14.1%, a 50-basis-point increase over the previous quarter, resulting in nearly 4 million sq. ft. of negative net absorption. New office completions fell to 13.1 million sq. ft. compared to 29.2 million sq. ft. in the second quarter. Sublet space still remains low at 11.2% of total vacancy, but is expected to grow. The highest office vacancy rates remain in Detroit, Dallas/Fort Worth and Phoenix—all over 19%. The lowest vacancy rates remain in Manhattan, Honolulu and Miami—all under 10%. The fallout from the financial market crisis on space requirements and overall occupancy levels remains to be seen. Rents have shown signs of weakening, especially in markets with high vacancy rates, but new construction deliveries have been kept in check. Most projects previously slated for construction, if not yet started, will be delayed until debt markets clear and the economy shows signs of recovery.

Office demand is definitely slowing as tenants adopt a wait and see attitude. Companies have focused 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. Labor Department. It is expected that most real estate occupancy decisions that can be deferred will be. On the other side, with the increase in vacancy rates, there will be opportunities to lock up space at advantageous rents. Previously noted gaps between owner and tenant rent expectations have begun to diminish, as landlords focus on property occupancy rates as opposed to holding fast

on asking rents. Concessions for relocations are rising, and renewals are more prevalent than relocations as capital expenditures resources are closely guarded. CBRE Torto Wheaton Research (TWR) expects further vacancy rate increase with national rents beginning to flatten in 2009.

## North American Office Trends<sup>1</sup>



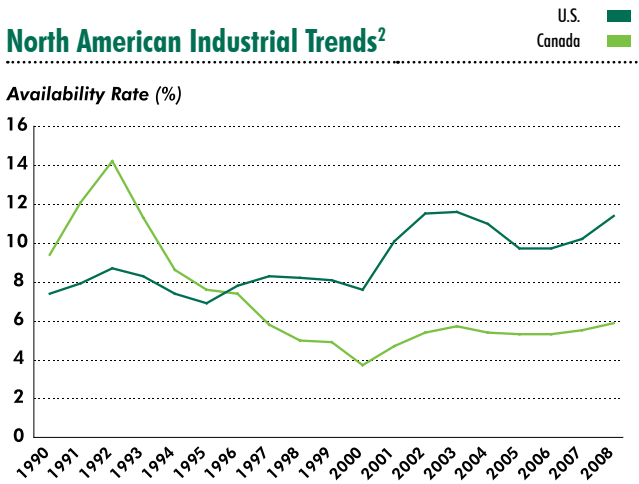
## Industrial

The national industrial availability rate has increased from 11.0% to 11.4%, a jump of 40 basis points during the third quarter. New supply slowed in the third quarter, with 32.1 million sq. ft. compared to 39.7 million sq. ft. in the second quarter. During the third quarter, there was 5 million sq. ft. of negative absorption. Manufacturing sectors continue to be impacted by the more frugal consumer and slowing international trade. With new orders diminishing and inventory levels rising, expect to see further fallout from this sector, especially if there is a global recession. Rental rates for the most part have remained stable, particularly for newer facilities. Sale prices will also moderate, but liquidity may increase in the form of sale/leasebacks if firms that own their own facilities need to raise their own capital to continue operating. The Institute for Supply Management October results indicated a further slowdown in the manufacturing sector, with the PMI dropping to 38.9, the lowest level

<sup>1</sup> Source: CBRE Research

since December 1982. This was due to a decline in new orders, production and the loss in manufacturing jobs.

## North American Industrial Trends<sup>2</sup>



### Retail

The national retail vacancy rate has increased, and this trend is likely to continue, especially with diminishing retail sales. Retail sales fell by 1.2% in September, paced by a 3.8% drop in the automotive sector. There was a continued decline in home furnishing sales, which is reflected in the continued challenges in the housing sector. Retail employment losses totaled 40,000 jobs in the previous month, further reflecting the weakening in the economy and the lack of credit. More cautious consumer spending over the next few months will focus on the necessities, with a significant decline in luxury items. Retailers such as Wal-Mart, Costco and supermarket chain ALDI are benefiting from this trend by picking up market share. Many retail projects will likely be mothballed due to concerns about the economy and, in some cases, the loss of construction funding.

### Multi-Family

The preliminary vacancy rate in the third quarter of 2008 stands at 5.7%—up 10 basis points from last quarter and 130 basis points from a year ago, according to CBRE Torto Wheaton Research. Apartment demand continues to suffer from declining employment (U.S. employment declined by 251,000 jobs in the third quarter) and loss

of residents to single-family homes and condominiums for rent and for sale. At the same time, completions of new rental apartments nationally remained elevated and put pressure on occupancy in existing properties. A rare bright spot in the capital markets is the continued lending by Freddie Mac and Fannie Mae in the multi-family sector. Constrained construction financing will eventually reduce new supply, but completions will run high through the first half of 2009, as projects already underway are delivered. Net absorption remains negative year to date, and it is expected that occupancies and revenue will continue to be challenged through 2009. Markets with steady job growth and a limited impact of “shadow” supply in terms of rentable single-family homes and condominiums will be in a better position to achieve above-average gains in occupancy and rents.

### Hotels

After several years of strong growth, operating fundamentals in the hotel sector are weakening. Occupancy rates have declined at an accelerating pace and should trend lower for the remainder of the year, especially with the global economy slowing. 2009 will see little or no growth for both supply and demand, as continued economic woes adversely affect the travel industry in general. The recent gains of the U.S. dollar against the Euro and British Pound will also negatively affect foreign tourism, particularly in major East Coast markets.

### CANADA

The Canadian economy has been impacted by the U.S. economic slowdown and the increasing threat of a global recession; this has resulted in reduced GDP growth expectations for the remainder of 2008 and into 2009. The Bank of Canada has continued to lower interest rates in an attempt to stimulate the economy.

The main impact has been on the manufacturing sector, with a high number of job losses and plant closures. The global slowdown is having an effect on commodity pricing, especially with oil prices plummeting to below

<sup>2</sup> Source: CBRE Research

\$65 per barrel. Retail spending has for the most part been resilient, increasing 4.9% compared to a year ago, but wholesale sales are off 4.9% from the previous month. The unemployment rate has remained steady at 6.1% with an increase of 106,000 new jobs, but only 10,000 of these were full-time positions. This is a reversal compared with a year ago, when most of the new employment was in full-time positions.

### **Market Overview**

Market fundamentals in Canada remain strong. Office vacancy levels have descended to record lows, and the industrial availability rates are up only slightly, despite the weakened manufacturing sector. Western Canada continues to exert strong economic growth, while Eastern Canada is starting to see the influence of the global economic chill. Atlantic Canada is still doing well, benefiting from the resource sector and defense spending. Overall investment activity has slowed due the fallout in the capital markets, with cap rates increasing and the disconnect between sellers and purchasers widening. Meanwhile, the U.S. dollar has advanced meaningfully against the Loonie.

### **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 concern is to keep credit available for both businesses and consumers and maintain economic growth. Investment transaction 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**

Canadian office vacancy rates decreased marginally to 6.3% in the third quarter from 6.4% in second quarter, with 5.9 million sq. ft. of absorption year to date. Office space under construction is at 19.5 million sq. ft., representing 5% of the Canadian inventory, with the majority of the activity in Calgary and Toronto. These new completions will be spread over the next five years. Office rental rates have for the most part stabilized and demand has slowly diminished, as companies try to grapple with the changing economy and the possible impact to their business.

### **Industrial**

The Canadian industrial availability rate increased modestly to 5.8% in the third quarter from 5.5% in the previous quarter. This was partially due to new supply and some weakening demand in Central Canada. Rental rates continued to increase for better class space, but for the most part have remained flat. It is expected that new construction, especially speculative building, will taper off in the coming months. Manufacturing is a growing concern, given the economic slowdown in the U.S. The impact of the lower Canadian dollar on the manufacturing sector is uncertain, especially if the economy slows.

### **Retail**

Retail spending for the month of August slowed by 0.3%. Lower sales in the automotive sector were the main drag on spending. Unlike the U.S., building and outdoor home supplies sales increased. Canadian consumer confidence continues to fall; this will likely impact retail spending for the remainder of the year. Retail vacancy rates are expected to increase slightly due to anticipated new construction and a softening economy.

## Hotel

The Canadian hotel market is facing a number of challenges. The strong Canadian dollar, high fuel costs and new border controls slowed the number of American visitors over the summer. However, visitation levels from Europe and Asia remain robust, especially in Vancouver, Calgary, Quebec City and Toronto. Overall, occupancy levels in Canada are expected to face continued pressures due to a decline in business and tourism travel with a weakened global economy.

## LATIN AMERICA

The Latin America economy is faring better than the U.S. and Canada, with GDP growth at mid-year at 4.0% compared to 1.2% for U.S. and Canada, according to Economy.com. But the expected growth for the remainder of the year will likely be adjusted downward, as weakening worldwide economic growth reaches developing economies. The credit crunch has started to impact access to capital by both business and consumers. Brazil and Mexico were hit by rapidly falling currencies due to drop in oil prices, the increasing value of the U.S. dollar and economic concerns for the region. Once concerned with competing internationally for their finished goods, now the region's governments have turned toward curbing inflation fueled by higher import costs.

## Market Overview

The Latin America market fundamentals have been relatively strong, with office vacancy rates at all time lows, between 0% in Lima and 6.6% in Mexico City. For Class A space the market is even tighter, 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. Investment activity for the first half of 2008, according to Real Capital Analytics, is slightly more than \$8 billion, not that far off the \$10.2 billion achieved a year ago. It is expected that cap rates will increase

over the next few months, to reflect diminished bids and purchaser expectations associated with the credit crisis and economic slowdown.

## Capital Markets

While investment activity has been driven by local buyers in 2008, there has also been a steady increase in foreign interest, especially from the major pension funds. Latin America offers higher returns with the risk premium slowly decreasing. Especially with the number of multi-national firms that have established operations in the region and better transparencies, investors have become more comfortable with real estate in Latin America. Investment activity in the second half of the year slowed, mirroring the decrease in activity experienced across the rest of the world. Especially with increasing cap rates on a global basis, it is expected that we will see increased cap rates for most property types in Latin America as well.

## Office

The main challenge for the office market is the shortage of modern office buildings. With the office vacancy rate in Mexico City at 6.6%, Sao Paulo at 5.8% and Buenos Aires at 4.7%, there is a shortage of space, especially Class A. There is new office space coming online within the next two to three years to alleviate the shortage, which will cause the office vacancy rate to increase. Rental rates have increased marginally, but for the most part have stabilized.

## Industrial

Similar to the office market, there is a shortage of modern industrial space in Latin America. New construction is slowly increasing, but demand is still outstripping new supply. Average rental rates continue to increase. The economic slowdown affected industrial productivity in August, especially in Mexico, where productivity is down by 1.6% compared to a year ago. This should have a marginal impact on availability rates.

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