



ECONOMIC SLOWDOWN DRIVES FURTHER WEAKENING OF MARKET FUNDAMENTALS

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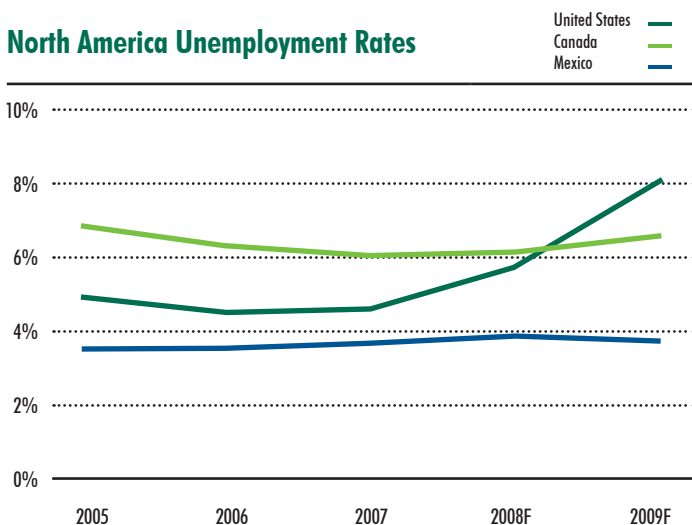
In a market wracked by unknowns and high anxiety, there is one thing we can be sure of: 2008 could not have ended soon enough for owners and occupiers of commercial real estate. It was a year marked by wrenching changes, heightened volatility and scores of unwelcomed surprises—a severe global recession, the collapse of energy and commodity prices, credit market disruptions and numerous financial failures, including that of several revered brand names. These events sparked unprecedented fiscal and monetary policy moves by governments and central banks around the world.

SUMMARY Two thousand eight was marked largely by wrenching changes in the economy and heightened volatility in the financial services sector, both of which contributed to a global recession, the collapse of energy prices, credit market disruptions and numerous financial failures. These events—which sparked unprecedented policy moves by governments and central banks around the world—will cause market fundamentals across the Americas to continue to weaken in 2009.

The U.S.—the epicenter of the global financial crisis—has been among the countries hit hardest by deteriorating economic conditions. In November alone, U.S. employers pared more than a half-million jobs, pushing the unemployment rate to 6.7%. In response, the U.S. Federal Reserve lowered its primary interest rate to nearly zero in December, and expanded its efforts to inject massive quantities of liquidity to jump-start stalled credit markets and restore economic

growth. Unfortunately, it will take time for these measures to re-ignite the world’s largest economy. As a consequence, the first half of 2009 may shape up to be the most difficult stretch of the long and painful downturn.

North America Unemployment Rates



Source: Economy.com

UNITED STATES

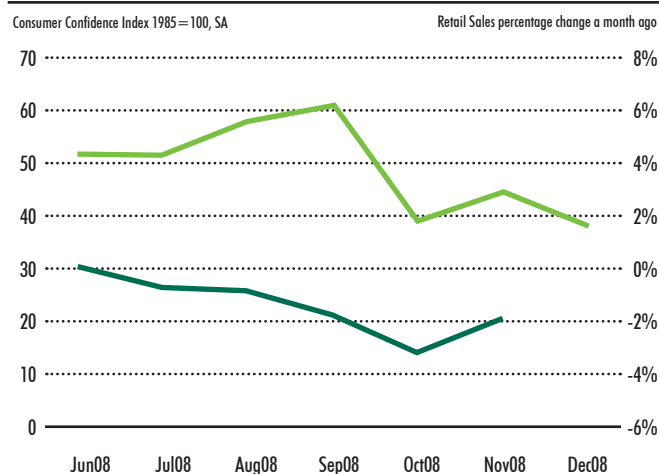
The National Bureau of Economic Research—arbiter of business cycles—declared that the U.S. has been in a recession for the past 12 months. This is already the longest downturn since the 16-month recession in 1982. In the third quarter of 2008, economic activity contracted by 0.5%, and economists expect the current slump to deepen before a recovery begins.

The deeply troubled U.S. auto industry captured center stage in December, as General Motors and Chrysler faced imminent threat of failure. The Bush Administration staved off this

gloomy prospect with a US\$13.4 billion bridge loan to the two automakers. The bridge loan, however, merely buys General Motors and Chrysler additional months to negotiate with their creditors and labor unions and reposition their businesses. The underlying risks to these automakers—and to the larger economy—remain high. According to Moody's Economy.com, a near-term failure of General Motors, Chrysler and their slightly better capitalized competitor Ford could drive the unemployment rate to as high as 11% in 2010.

U.S. consumers remain very guarded about their spending decisions, even with some macro-economic trends moving in their favor. They are benefiting, for example, from sharply lower gas prices tied to the burst of the energy bubble. Oil prices fell to around US\$40 per barrel in December—some 70% below their peak last July. Creditworthy consumers are also benefiting from plummeting interest rates. Ten-year Treasury yields fell to 2.2%, an historic low, and banks have shown more willingness to lend to each other. The 10-year LIBOR—the interest rate banks charge each other—reached a four-year low, at 1.4%, down from nearly 5% at the height of the financial crisis. Still, lenders have become much more stringent in their lending standards and qualifications, muting some of the benefit for consumers.

U.S. Consumer Confidence and Retail Spending



Source: Economy.com

Market Overview

Real estate market fundamentals will continue to weaken in 2009. The last region to slip into a recession was the Northeast, which has suffered from layoff activity in the financial services sector. As we begin the new year, retrenching companies will contribute to significant increases in sublease availability, which, combined with tepid office space demand, will push office vacancy rates upward. The challenges to industrial properties transcend the auto industry's woes, and reflect broader weakness in the manufacturing sector. The retail sector will suffer further, due to diminished consumer spending. Investment transaction volume, however, will likely rebound from the nearly dormant levels of late 2008, as distressed property sales take center stage in 2009.

Capital Markets

Investment activity remains in the doldrums. According to preliminary estimates from Real Capital Analytics, total activity fell by 74% in 2008 to an estimated US\$133 billion for that year. Property values continue to adjust downward—now 20% to 30% off their peak levels—in the face of a shrinking pool of buyers and sharply limited debt financing. It is expected that 2009 will see an increase in the number of available investment opportunities, as owners with high levels of loans coming due may have no other choice but to sell. However, only about US\$22 billion of fixed rate and US\$36.5 billion of floating rate CMBS debt is scheduled to come due in 2009, according to TREPP. Some lenders are extending the maturities on under-performing loans, as they prefer to limit the REO assets on their balance sheets.

CMBS markets began to settle down in December after going haywire in late November. Investors were heartened by signs that the Fed may use its balance sheet to buy troubled CMBS paper starting in February 2009, and as a result, AAA yields narrowed to 11.5% after widening to more than 18% a few weeks ago.

Still, investors are exhibiting trepidation over how much market fundamentals will deteriorate during the recession. Both consumer and business confidence are at all-time lows and will likely remain the same, if not worsen, in 2009.

Office

The Northeast was the last region to be impacted by rising office vacancy rates. The de-leveraging of the U.S. financial system and fundamental reordering of the financial sector will compel significant changes in the office landscape. There is a growing amount of shadow space, which will probably lead to increasing sublease availability over the coming months. Continued job losses across the board—and particularly within the office services sector—will further weaken market fundamentals in 2009. The once-safe office markets, such as Houston and Dallas, are starting to feel the effects of declining oil prices, which are now trading at around US\$40 per barrel.

Industrial

The industrial sector is getting the most attention, with the auto industry on the precipice. Chrysler and General Motors announced shutdowns in January 2009 to curb production and preserve cash flow. With the pervasive economic slowdown, this sector is expected to continue adding to the labor market's losses. The Institute for Supply Management's manufacturing index fell to 32.4 in December 2008. The index is at its lowest level since the early 1980s. New orders were down and most capital expenditures have been deferred. The industrial availability rate is expected to continue to rise, with rents softening.

Multi-Family

The multi-family sector continues to struggle in light of a slowing economy and specifically the weakness in the housing sector. Falling home prices have made it more attractive to own for those who can still qualify for financing and there still remains a sizeable inventory of

homes on the market. As a result of these headwinds, vacancy rates are rising and rent growth is slowing. Multi-housing completions remain elevated, but construction activity is expected to subside in 2009 and 2010, easing pressures on existing product.

Retail

The retail sector continues to be battered by consumers who remain largely on the sideline. Retail sales in November fell by 1.8%. The decrease was fueled mostly by lackluster sales in the auto sector, while the precipitous drop in gasoline prices also contributed to the year-over-year decline. Even with a boost from holiday-related purchases, the underlying trend in spending remains weak, as job losses mount and consumer confidence continues to hit record lows. Retail vacancy rates have continued to rise, with rents softening and new supply coming online virtually stopped. The markets with the largest job losses—including those in Michigan, California, Arizona, Florida, New York and Nevada—are at greatest risk of weakening in the retail sector.

CANADA

The Bank of Canada lowered interest rates by an unprecedented 75 bps to 1.5%—the first time since the 1960s that the rate has been under 2.0%. This move acknowledges that the Canadian economy is slowing and lower interest rates are needed to stimulate business and consumer activity. The federal budget will now be in deficit over the next few years, rather than in small surpluses. Unemployment levels rose in October to 6.3%, with the majority of losses occurring in the manufacturing sector. The Canadian economy is finally catching up with the declining markets in the rest of the world. Oil prices, at less than US\$40 per barrel, may stall or delay certain oil sand projects in Alberta. The decline in commodity prices coupled with expected further weaknesses in the economy has caused the Canadian dollar to drop to the lowest level since 2005, at US\$0.82. Central Canada is still feeling the impact

of weakened U.S. consumer spending and will face further challenges in the auto sector. Canada is following the U.S.'s lead with regard to the auto industry, with a bailout for General Motors and Chrysler totaling approximately C\$3.3 billion.

Market Overview

Market fundamentals are starting to show weaknesses, underscored by a slight increase in sublease space. It is expected that this will rise with the amount of new supply entering the market and the continued global economic slowdown. The industrial and retail sectors continue to be hampered by the decrease in consumer spending in North America.

Capital Markets

Interest rates continue to fall, but borrowing has been constrained by tighter lending criteria. Most of the activity continues to be with smaller private investors in the range of C\$10 million or less. Cap rates continue to climb, due to diminished bidders, but the majority of owners are not distressed and do not have any urgency to sell. Investment activity was down significantly in 2008; news headlines were generated by transactions that did not take place, rather than those that did. Buyers were definitely more careful with bids, and vendors struggled to come to terms with lower values.

Office

National office vacancy continued to rise, partly due to the increase in sublease opportunities. Canada's unemployment rate increased modestly, but certain sectors such as financial services saw losses increase for the past year. Cost containment started at the beginning of 2008, especially with U.S.-based firms. Watch for increased office vacancy rates and continued softening in rents in 2009. New supply will be more of a factor over the next two years, especially in Calgary and Toronto. Tenants will definitely be able to take advantage of bargain rents in certain markets.

Industrial

The lack of consumer spending is starting to wreak havoc in this sector, with diminished demand for real estate and massive losses in the manufacturing sector. New supply has been tapering off slowly, with availability rates rising modestly. The bridge loans the Canadian government has extended to auto companies have provided some relief, but that sector will likely go through a major restructuring over the next few years.

LATIN AMERICA

Latin America, especially Mexico, is feeling the effects of the global economic slowdown, with diminished exports and lower commodity prices. Mexico's industrial production contracted by 2.7% year-over-year in October, continuing a three-month trend. The growth in the middle class over the last ten years will soften the blow of diminished foreign demand for goods. Similar to the U.S., credit availability has tightened and will further hamper local economic activity. The drop in commodity pricing has affected local currencies; it will make exports more competitive and help control the rate of inflation. The region is expected to skirt a recession based on its growing middle class and increased domestic demand for goods and services.

Market Overview

Market fundamentals remain stable, but a prolonged economic slowdown will impact the region, with vacancy rates rising to higher levels. The number of foreign companies seeking space has diminished temporarily. Investment activity continues to slow, as potential sellers and buyers reassess their opportunities.

Capital Markets

Latin America's investment activity continues to decline, with cap rates increasing slightly. Governments are reassuring the market with guarantees and possible bailouts; this will likely continue to stabilize the region. The challenge for the investment market is the diminished number of foreign purchasers and increased market

choices. Expect sales prices to continue to decline, with most of the activity generated by private investors.

Office

Office demand is starting to slow, especially from foreign-owned companies. Vacancy rates will likely rise, but for some tight markets, such as Lima, Sao Paulo and Mexico City, this will give tenants more choices and owners increased flexibility to meet the needs of exiting tenants.

Industrial

The industrial market has been most affected by the global economic slowdown, especially as it relates to auto production. Much of the recent expansion of assembly plants and dealerships in the region was mostly due to domestic demand and the growing middle class. The expansion of U.S. automakers in Mexico was designed to meet local demand, as well as supply automobiles to U.S. and Canada. Now, cutbacks in auto production will cause a loss of jobs in the manufacturing sector and other related industries. Lower currency levels have yet to translate into higher exports, and this will not likely recover until sometime in 2009.

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