

ECONOMIC PULSE

A REPORT ON THE ECONOMY AND ITS
IMPACT ON COMMERCIAL REAL ESTATE

MANAGING CHANGE

FINANCIAL INDUSTRY CRISIS: AN END IN SIGHT?

Despite the US Administration's rescue plan aimed at stabilizing US financial services markets passed on October 3, countries and institutions around the world are feeling the impact of this unprecedented crisis, and are scrambling to apply solutions.

Recent events have amounted to the greatest financial crisis that world economies have experienced since the 1929-30 period that triggered the Great Depression. The financial landscape has been remade, with governments in the US and many other countries now more directly involved in the financial system than at any time since the depression. Eventually new policies and the consolidation of the financial sector will lead to economic recovery. But that is not likely before the first half of 2009.

Until then, expect the current recession to worsen, more jobs to be lost and the real estate market to weaken. Cities and regions that have a high concentration of financial firms will feel greater downward pressure than those with broader industry concentrations, but no region is likely to emerge from the current downturn unscathed.

As 2008 has unfolded, the economic stress has been spreading around the globe. In a bid to stem the financial crisis, European governments are introducing emergency measures to guarantee personal bank deposits and rescue large insitutions. In Asia, a combination of financial uncertainty, declining demand

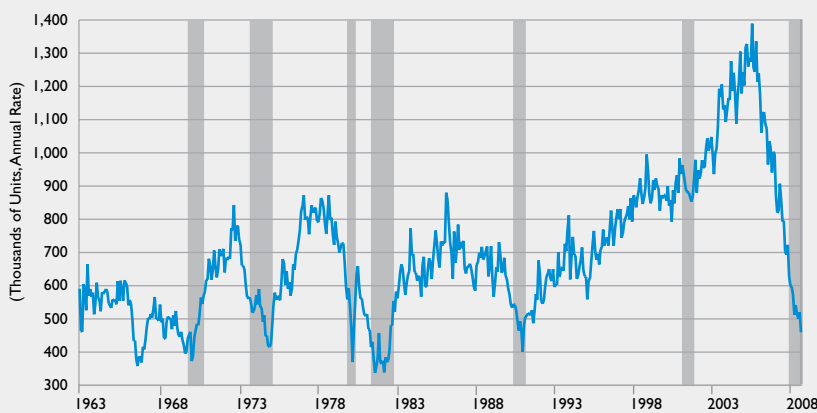
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from the US and the end of spending for the Olympic Games is causing growth to slow from super strong to merely strong. While the impacts vary, no region is completely immune from the effects of financial stress and the US recession.

Economic Backdrop

How did we get here? Why did the financial system suddenly collapse? The short answer is, financial firms assumed values would continue going up and they made loans on that basis. When the reversal started to happen, eventually it caused loans to default, security prices to fall and balance sheets to erode.

Chart 1 | NEW SINGLE FAMILY HOME SALES



Shaded areas are recessions
 Source: US Bureau of the Census, Moody's Economy.com

- **Behind all of the trouble was the housing sector.** The US housing sector experienced an unprecedented era of growth from 1992 to 2005 that saw prices climb and the number of home sales increase to break one record after another. Lenders acted as if home prices would rise forever and high levels of sales would be the norm. They began to offer mortgages to less creditworthy borrowers because the market looked secure and because they could rapidly sell the mortgages to investors who seemed to have an endless appetite for these instruments.

- **In 2005 conditions began to change as home sales peaked and began to decline.** This led to greater and greater risk taking by lenders whose numbers had grown dramatically and who sought to maintain their income flow. Mortgages were offered to borrowers of questionable credit worthiness. By mid 2007 the whole process came unglued as defaults on those loans soared and the securities that were issued using the loans as backing declined in value. Lenders became reluctant to part with their capital and the credit markets began to freeze up, as investors began to question the integrity of the entire securitization process. These events triggered a recession that many believe began in late 2007 and continues today. Employment, income, sales and production are all declining and the second half of 2008 is likely to be worse than the first half.

- **Nonfarm payrolls in the US have fallen by 760,000 jobs since the end of 2007 and the pace of decline is likely to accelerate in the months ahead.** New claims for unemployment benefits, a key leading indicator of total employment, have been climbing this year and now stand at 474,000 (on a four-week moving average basis), the highest level since the end of 2001, at the end of the last recession. The high level of claims indicates that labor markets are weak and the pace of job loss will accelerate from the roughly 84,000 per month recorded in the first nine months of the year.

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Chart 2 | INITIAL UNEMPLOYMENT CLAIMS



Shaded areas are recessions

Source: Department of Labor, Employment and Training Administration, Moody's Economy.com

• **Consumers are stressed.** High oil prices have led to high gas prices and could lead to a substantial increase in heating bills this winter. The amount consumers spend on energy is currently at an all time high and, relative to income, it is at the highest level since 1984. At the same time the values of their homes are falling and employment is declining. It's no surprise in this environment that consumer spending is declining. After an increase stimulated by tax rebate checks, consumer spending fell in June and July, and was flat in August. Further declines are likely. One key indicator of consumer spending, motor vehicle sales, are currently at the lowest level since 1991.

All this of course was happening before the crisis was ratcheted up several notches with the dramatic mergers, bailouts, buyouts and bankruptcies of September. Now, credit in the economy has been severely curtailed and activity is likely to slow even further.

However, while the immediate situation will be difficult, the financial supports set in motion by the US Federal Reserve, Treasury and Congress are expected to help get the worst of the problem debts out of the system, and permit lenders to begin lending again. Cushman & Wakefield is confident that credit availability will improve in the months ahead, especially in 2009.

Moving Forward

With the programs in place and the financial sector beginning to address their problems, the question is not if there will be a return to growth, but when. As has been the case throughout this cycle, the key will be the housing sector. One way to look at housing affordability is the price of a new home relative to per capita income. Currently, that ratio has fallen substantially and is below its 30-year average. When the ratio is below average, it is generally consistent with a bottom in the market, although there is always the possibility of further declines. A factor working against recovery however is demand. With a glut of housing stock on the market, there will simply not be enough buyers to restore balance to the sector for some time, especially with more rigorous mortgage qualification standards, declining employment and reduced spending in general.

Employment also needs to stabilize, which is not expected to happen until the first half of 2009. The decline in activity will eventually be halted as consumers begin to increase spending, gradually leading to greater demand and ultimately the creation of jobs.

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The combination of a housing bottom and higher employment will eventually create conditions for a return to more normal financial markets. As housing stabilizes, financial institutions will have a greater understanding of the value of many of the securities written against home mortgages. That will further assist in the clean up of balance sheets, made possible to a great extent by the government financial aid. If prices increase, the government may actually make a profit on these investments, as it did in the 1980s when a safety net was thrown to Chrysler Corporation. Of course, the hope is that the economy will get back on track and credit will become more readily available.

Real Estate Implications

The real estate industry will be negatively impacted by the combination of declining employment and tight credit. Already, many cities are experiencing vacancy rate increases and rents are coming under pressure. As employment falls, these trends are likely to continue in the coming year. Nationally CBD rents increased 43% in the 2005-2008 period. Over the next two or more years, we are likely to see rents decline in most CBDs. In the last real estate downturn, which lasted from 2001-2004 national average Class-A CBD rents fell 19%. Another decline in the 15% to 25% range nationally is quite possible. Vacancy rates are likely to increase substantially. The national CBD vacancy rate bottomed at 9.7% at the end of 2007 and has increased slightly this year. As employment falls, sublease space will come back to the market and vacancies will inevitably increase. We would not be surprised to see the national CBD vacancy rate top 15% before the current cycle ends.

Of course, not all cities will be affected the same. Cities with a high concentration of financial services firms will likely suffer greater job loss, along with related vacancy rate increases and rental declines. Cities that have a high concentration of energy-related employment such as Houston and Denver will likely feel less pressure.

But no city or product type is likely to emerge unscathed. With the recession worsening and consumer spending falling, a wide range of industries will be impacted, from business services to retail to manufacturing and distribution. It follows that these classes of real estate will also come under pressure in the coming year.

As rental rates decline and vacancies increase, during a period of tightening credit, investment markets will also come under pressure. Already sales have fallen 70% in volume from a year ago and prices have declined. While it is difficult to get an accurate reading on the investment market because of the small number of transactions, prices are down and cap rates are up, and real estate capital and risk have been fundamentally repriced for the foreseeable future. What impact this will have on long-term allocation to the sector remains to be seen, but in the meantime we expect to see further price adjustment and cap rate increases.

The effects are spreading rapidly to other major financial centers around the world. London has already experienced serious upward pressure on vacancy and downward pressure on rents. While it is too soon to quantify the full effects in Europe, EU countries are trending negatively as well. And markets in Asia are likely to feel more stress than they have in years, although this region is best positioned to offset a portion of the weakness from the US with locally-driven demand.

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There is one important silver lining for US real estate markets. With credit availability limited, speculative construction will be sharply curtailed. Since most markets did not go through a major building boom prior to the economy's weakening, the supply of new office space will not increase materially in the coming year or two, which will help support recovery.

The global economy is going through one of the most difficult periods in its history. The financial stresses of the past month will inevitably make an already difficult economic environment worse, and the next six months or so are likely to be extremely challenging. No industry or sector will be unaffected. The good news is that recent measures have started the necessary process of cleaning up the financial system that will permit the economy to move forward. In that sense this is the beginning of the end of the financial crisis.

Of course, in the current dynamic environment conditions can change rapidly depending on unfolding events. Cushman & Wakefield will be constantly monitoring events and updating you on the real estate implications on an ongoing basis.

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