

GLOBAL OUTLOOK

Grosvenor's research perspective on world real estate markets



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Germany and the future of the euro zone

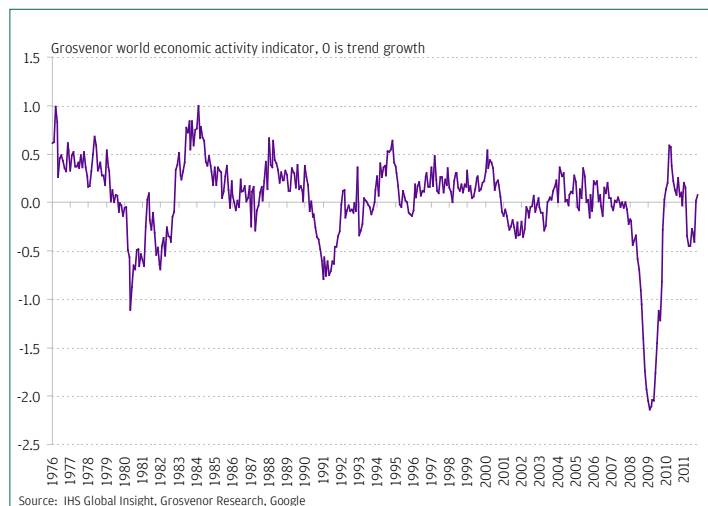
The 'headwinds' of fiscal contraction, monetary tightening in the emerging markets and the problems of the euro zone, are likely to prove too much for global growth next year. So we expect another recession despite the fact that economic conditions going into Q4 are surprising on the upside. The Grosvenor global activity indicator (see Chart) which has been updated to the end of October shows that the Q3 pick up in growth in the US and Japan has continued into Q4. Moreover inflation in China has begun to ease, down from 6.5% in September to 5.5% in October, without too great a hit to growth. The Chinese monetary authorities will not want to ease policy until the CPI rate drops below 4% but the recent data certainly brings the current tightening cycle to an end. It is too early to say whether China will be able to loosen policy sufficiently to offset the developed world contraction in 2012 but at least there is a possibility that it can.

So, if there is a chink of light in the economic landscape from emerging markets it would be a disaster if it was stymied by policy blunders in the euro zone. Here, the

actions of Germany are key. The current turmoil in the euro zone is not due to a generalised lack of political leadership but rather the pursuit, by Germany, of a very sensible medium term political objective. Germany's aim is to maintain the euro zone whilst engineering substantive economic reform within Greece, Portugal, Spain and Italy. The political changes that have recently taken place in southern Europe represent substantive progress towards this goal.

However, if the objective is sound then Germany's strategy to achieve it is highly risky. First, it places an intolerable burden of adjustment on the southern European countries. Real wages need to fall by up to 30%, or productivity to grow by a similar amount, in Greece, Spain and Portugal to bring unit labour costs into line with those of Germany. Italy is more competitive but still requires a fall in real wages. If the global economy was growing strongly and Germany was boosting domestic demand in the euro zone by eliminating its current account surplus, the strategy might work. As it is, the current policy settings are not sustainable. Second, markets are sceptical of the strategy and are pricing in a large risk premium on Greek, Spanish, Portuguese and Italian bonds. Not only does this compound the funding problem but there is a profound 'knock-on' effect on the euro zone banking system. The strategy, in this respect, is self defeating. By one mechanism or another (direct transfer; bank bail outs, the EFSF, the IMF or even via the ECB) the liquid and solvent northern European nations, Germany in particular, will have to stump up more cash. The Chinese are around to provide some additional support, but they will want to be assured that the system is not about to fail and, more to the point, will also require greater access to euro zone markets. Germany urgently needs to leaven its austere reform strategy with some meaningful and generous fiscal diplomacy. The future of the euro zone depends on it.

Grosvenor global economic activity indicator



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Real estate investment prospects in the US

The United States experienced an unusually deep, finance-centered recession in 2008-09. To date, the recovery has been tepid and inconsistent vis a vis previous economic recoveries. Real estate participated fully in the downturn. Fundamentals broadly stabilised during 2010, and registered consistent improvement through mid-2011. In this article, we discuss recent trends and expected performance for both the US economy and the core real estate sectors.

US Economy - An unusually large number of factors pressured the nation's economic expansion in early 2011; as a result, real GDP growth for the first half was only 0.9% (annualised). By mid-year, the primary constraints on growth were political in nature. They included the impact of the euro zone's sovereign debt crisis on the financial markets, and on the domestic front; August's plunge in confidence after Congressional brinksmanship over the federal debt ceiling and the subsequent downgrade of the US credit rating. In response, data for July and early August presented downside surprises, and together depicted an economy that was almost at a standstill.

Despite signs that the US recovery regained some impetus in the late third and early fourth quarter, the global economy is slowing and confidence remains extremely fragile. The euro zone is now expected to slip into a short and shallow recession early in 2012, with <50% odds that the US will follow suit. The most recent forecast calls for US real GDP to strengthen during the latter half of 2012. It will then expand at about its trend rate (3.0% - 3.5% per annum) through 2015. Growth will be strongest late in the forecast period. This view assumes (1) satisfactory resolution of the euro zone sovereign debt and banking issues; and (2) timely passage by the US Congress of limited fiscal support to offset the tightening that would otherwise occur as an array of stimulus measures expire at year-end 2011, coupled with (3) a credible longer-term plan to reduce the structural federal deficit.

Real Estate Fundamentals - After suffering a sudden and substantial demand shock in 2008-09, the four primary real estate sectors have stabilised and are now beginning to improve. The near-term prospects for each sector will be largely dictated by demand-side fundamentals, as new supply is in all cases at an historic low.

Apartments were first to turn and continue to hold a considerable lead over the other sectors. By Q3 2011, strong rental demand and minimal new construction had combined to reduce vacancy to a low 5.0%. Effective rents have risen for six consecutive quarters, and are trending well above the rate of inflation. Apartments should continue to lead the recovery, supported by both favorable demographics and, in

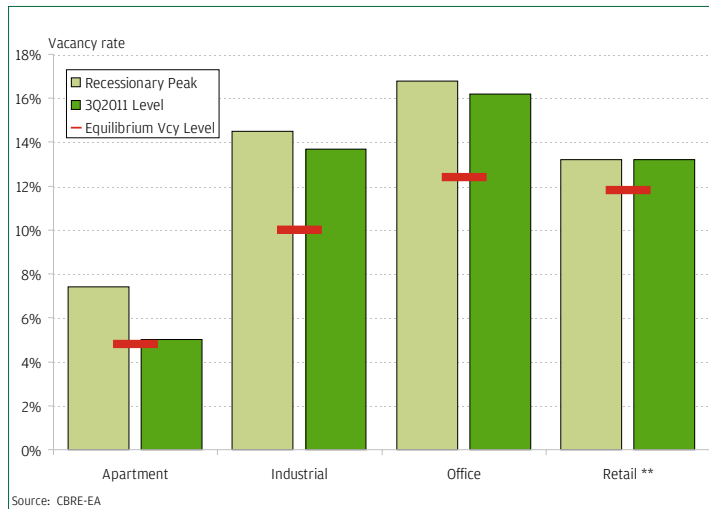
the short term, a shift by many households from the troubled ownership market into rental housing. A wild card on the supply side is the potential for distressed stock to enter the rental market. It is difficult to predict the timing and extent; but markets with high levels of ownership distress are vulnerable to this potential competition over the next few years.

Office, the most cyclical sector; usually lags at the outset of a recovery. In this cycle, however, office-using employment sectors benefitted considerably from government support, effectively cushioning the recession's impact. As a result, office was first to follow the apartment sector out of the downturn. As of Q2 2011, office space had enjoyed seven consecutive quarters of positive net absorption. Vacancy declined 60 bps from its Q2 2010 peak (to 16.2%), and effective rents had begun to turn upward. Unlike the apartment sector; however, activity in the US office market was impacted by this summer's financial market turmoil and economic slowdown; vacancy was unchanged and rental growth cooled to only 1.2% (annualised). Although job cuts among financial firms may reduce demand in the near term, office is slated to outperform over the five year forecast horizon, as the economy's major office-using sectors are expected to dominate US employment growth.

Ordinarily, **industrial** is early to recover, following only the apartment sector out of a downturn. Unlike the office-using sectors, however, industrial space users did not receive support from the stimulus programs deployed after the financial crisis. The sector suffered the full extent of the Great Recession and was late to stabilise. Vacancy peaked at an all-time high of 14.5% in early 2010. Positive net absorption was registered in each of the last six quarters, supported by industrial production, strong international trade flows, and most recently renewed consumer spending. Unlike the office sector, industrial market conditions continued to improve. By September 2011, vacancy had declined to 13.7% and effective rents were stable. Extremely low construction volumes, coupled with healthy demand, will allow the very soft US industrial market to achieve balance over the next four to five years.

Retail, the laggard of this recovery, may now be stabilising. The industry over expanded during the 2000s, and has now rationalised operations by closing underperforming stores and/or business units to restore profitability. Vacancy appears to have stabilised at a 20-year high of 13.2%, although effective retail rents continue to deteriorate. Competition from internet sales is compounding the sector's cyclical adjustment to recession. Looking ahead, spending growth will be moderate due to high consumer debt levels. Effective retail rents are not expected to turn positive until 2013. Improvement for retail real estate

Chart 1: Vacancy by sector: recent statistics vs. equilibrium* vcy



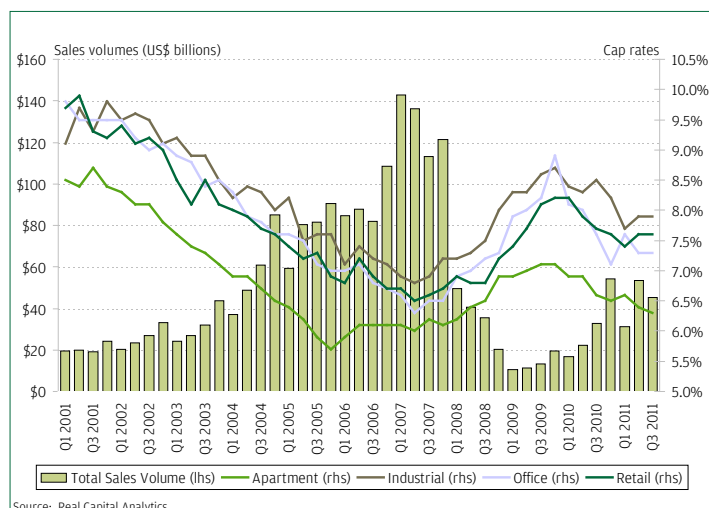
Source: CBRE-EA
 * Equilibrium vacancy is the vacancy level below which real effective rent accelerates until it justifies new rental supply
 ** Retail vacancy data based on community & neighborhood centers only

will be slow and uneven.

Real Estate Returns - Returns for real estate registered a severe and synchronised decline in 2008-09. In all, the NCREIF National Property Index (NPI) fell almost 23% during these two years. The strength of the index's subsequent recovery has also been remarkable; the NPI rose by 13.1% in 2010 and by an annualised 14.6% through September 2011.

We expect total returns to moderate from this bounce. Returns will trend lower in the near term for two reasons: (1) sectors with longer term leases will see NOI erosion as leases signed in the strong market of 2005-07 roll to lower current market rents; and (2) the expected normalisation of interest rates will in turn cause cap rates to adjust upward. The negative impacts of both factors will likely be mitigated by

Chart 2: Overall real estate sales volumes and cap rates by sector, Q1 2001 - Q3 2011



Source: Real Capital Analytics

the pressure of substantial capital seeking real estate investments, by improving market fundamentals, and by the reduction in spreads over Treasuries that cap rates typically exhibit as a market recovery unfolds. At the sector level, investment performance will mirror trends in fundamentals; i.e., apartment and office investments are expected to outperform, while industrial and retail returns will lag.

Investment Opportunities - The post-recession equity investment market continues to normalise. 2010 saw a return of capital but disconnect between buyers and sellers. The locations and asking prices of the few properties that were put on the market did not match buyer requirements, curtailing overall transaction activity and putting upward pressure on prices for the few "trophy" assets that did trade. With a marked improvement in both real estate fundamentals and returns, the volume of "for sale" properties is rising and buyers are increasingly interested in a range of geographies and investment risk. Sales volumes as of September 2011, although still at a low absolute level, were \$130 billion; 80% above their Jan-Sep 2010 level. Except for apartment transactions, post-recession cap rate compression appears to be tapering off.

Opportunities in distressed debt could become an increasingly important adjunct to traditional equity investment. Between 2009 and 2017, almost \$3 trillion of commercial real estate debt will mature. A sizable percentage of this is now "underwater", with distress on the part of the asset, the ownership, or both. There will be ample opportunity over the next six to seven years for investors to profitably participate in the refinancing of individual properties or portfolios.

Conclusions & Risks to the Outlook - Real estate markets are in the early stages of recovery. Although near-term slowing of economic growth will weaken demand for real estate product, historically low supply across all core sectors should allow for slower but continued improvement in market fundamentals. Firms that actively invest over the next few years will maximise their exposure to the improvement phase of the property cycle. Careful market selection will be key, with supply-constrained metro areas concentrated in the economy's high-growth sectors offering the greatest promise. However, this is dependant on the pre-conditions for sustained expansion, mentioned earlier, being met. Failing that, the US would likely tip back into recession and the real estate recovery would stall, to the detriment of both fundamentals and returns. Investment activity would likely decline overall and shift back to low-risk strategies, targeting the most resilient metros and property types.

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Questions & Answers with Harry Tan, Asia Pacific

Q: To what extent has Japan recovered from the earthquake?

A: For sure, economic activity has rebounded from the sharp retrenchment witnessed immediately post the March earthquake. Part of the rebound reflects pent up demand from improved business and consumer sentiment due to the easing of nuclear fears and also from the resumption of production. However, the recovery ran into a maelstrom during the summer. While electricity cutbacks did not disrupt factory output significantly due to efficient rationing, the escalating euro zone debt crisis, weaker than expected recovery in the US and slowing demand from China started to weaken the growth momentum in the last two months.

After four consecutive quarters of contraction, economic growth is expected to accelerate by more than 6% (annualised) in the third quarter. Weakening external demand is expected to hold growth back again in the current quarter, although reconstruction stimulus and very accommodative monetary conditions will help to buffer growth. On balance, the Japanese economy is recovering well if not as quickly as initially projected.

Q: What is the medium term growth outlook for Japan and Tokyo?

A: It is undeniable that there are fundamental and structural issues impeding Japan's long term growth. Due

to the aging and declining population, the full employment rate of growth after taking into account productivity gains is likely to average around 1.5% over the next five years. Weak nominal GDP growth and a deflationary environment will also suppress corporate profitability and impede business expansion and employment growth, resulting in a sub optimal domestic demand environment. That said however, Japan is increasingly profiting from the fast growing Asian economies, particularly China. China is now the biggest market for Japanese exports and mainland Chinese make up around 20% of total tourist arrivals in Japan. Japan is also one of the most technologically advanced economies and will benefit disproportionately from emerging market demand for high tech products. Japan can surprise on the upside.

The growth outlook for Tokyo is substantially brighter than Japan as a whole. Tokyo is the largest metropolitan city and most populous urban center in the world and is expected to stay so through to 2025. The 31% growth in Tokyo's population since 1975 also outpaces the 13% growth nationally. With GDP per capita of around US\$40,000 and projected to have the most number of households with income of over US\$20,000 in 2025, Tokyo will remain a wealthy and dominant world city. Being home to the most Fortune 500 companies, Tokyo is a big dominant business center and highly tied into the

world growth cycle. A turnaround in global growth in 2013 will lead to an outperformance of the Tokyo economy.

Q: What is the outlook for the Tokyo office and housing sectors?

A: Macro and event risks have acted to slow the recovery in the Tokyo real estate market post the financial crisis. Even though there were pockets of recovery driven mainly by domestic investors, broadly both residential and office rents and capital values remain at near cyclical lows due to an unstable recovery, weak domestic sentiment and refinancing issues. It is expected that the market in 2012 will remain at low levels, reflecting the severe and uncertain external environment. For the office market, substantial supply heading into the market next year is likely to suppress rental levels and hold vacancy up. Similarly housing rents have stabilised but remain 15% below the previous peak. However, the near bottom market presents a unique window of opportunity. An increasing number of foreign investors have started to show greater interest in the Tokyo market driven by the substantial yield spread to the risk free rate. Improving bank lending attitudes and renewed interest from foreign funds have also led to an improved debt and liquidity situation. The expected global economic recovery in 2013 will trigger a more robust and sustained cyclical pick up in both office and residential values.

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