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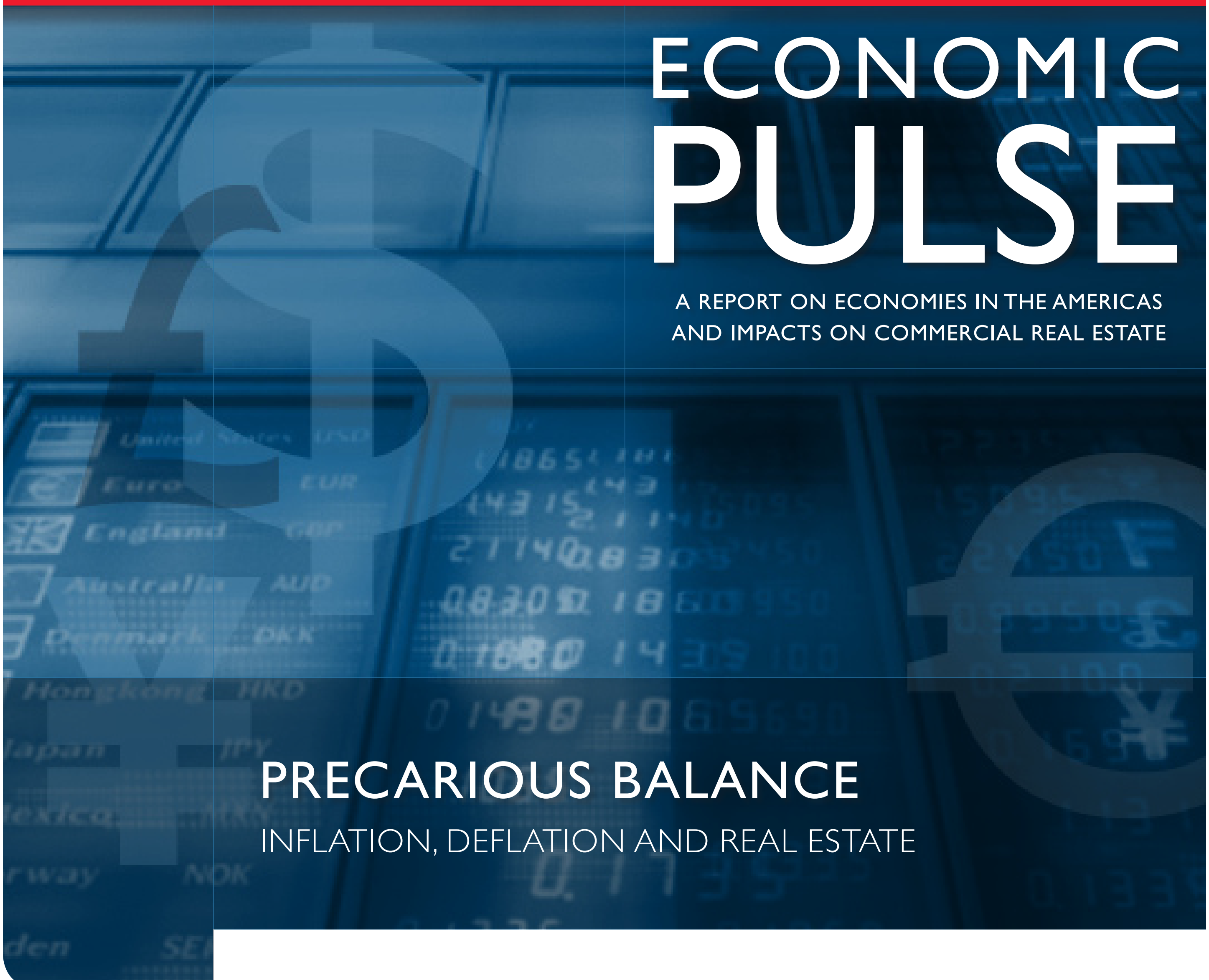

ECONOMIC PULSE

A REPORT ON ECONOMIES IN THE AMERICAS AND IMPACTS ON COMMERCIAL REAL ESTATE

PRECARIOUS BALANCE

INFLATION, DEFLATION AND REAL ESTATE

INFLATION OR DEFLATION, WHICH IS IT?

Over the past two years the economies of the Americas have experienced the most severe stress in seven decades. The collapse of the residential real estate sector in the US in 2007 triggered the financial crisis that led to the worst recession since the Great Depression. The government response to this crisis was massive. There was an unprecedented increase in liquidity and government spending to stimulate growth. Between the Federal Reserve and Treasury, an estimated $16 *trillion* in programs was authorized to put the financial system back together and to stimulate the economy.

To get a sense of the magnitude of these policies, the US Federal budget deficit in the fiscal year that ended on September 30, 2009 topped $1.3 trillion. In fiscal 2008, the deficit was a record $454 billion. So this year, the deficit was more than tripled to fight the recession.

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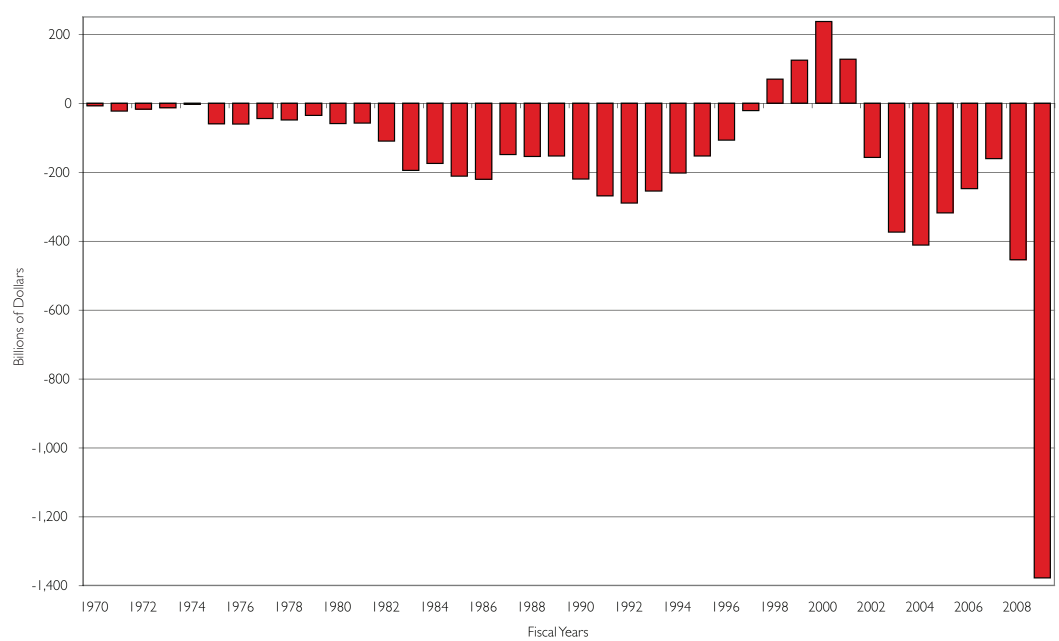
TABLE 1: US FEDERAL BUDGET DEFICIT (Billions of Dollars)



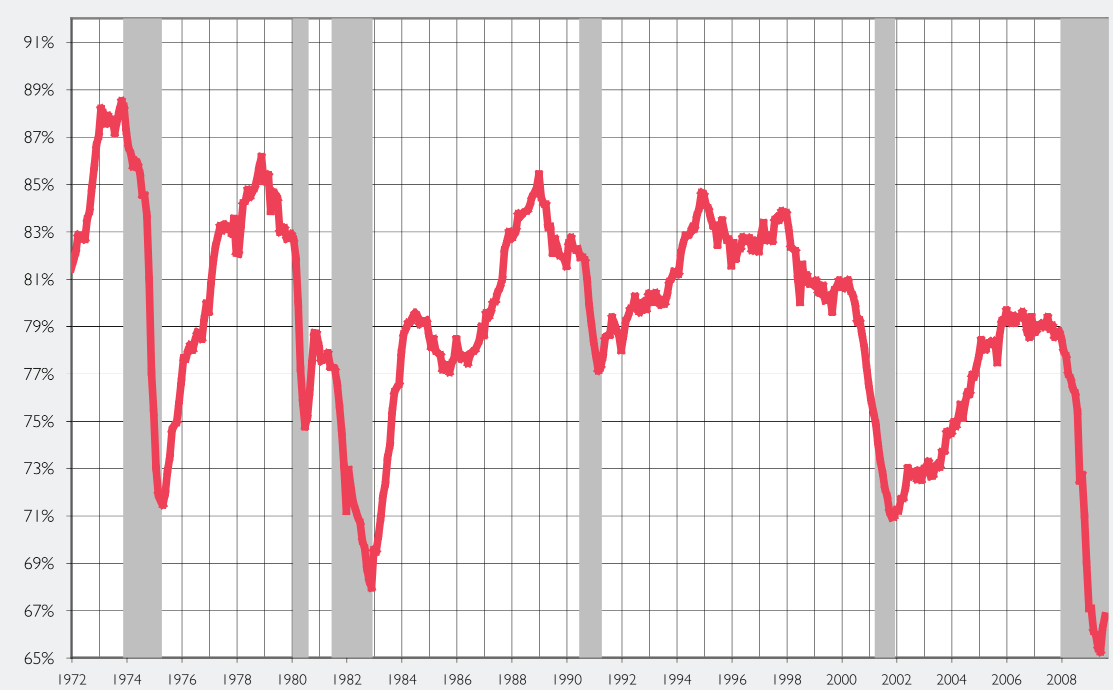
The US economy is not in recovery and an upturn is not likely to take place until late this year or early in 2010.

This massive bailout has raised concerns about potential inflation. As the government has increased spending, it has injected an enormous amount of demand into the economy. In the simplest of terms, US gross domestic product (GDP) is $14.1 trillion. If the government increases its excess spending from $450 billion to $1.3 trillion, that's a net increase of $850 billion, or 6.0% of GDP. Of course, it's not that simple: lower tax revenues have also contributed to the deficit, not just direct spending. However, the lion's share of the increased deficit is directly related to the extraordinary efforts used to boost the economy by creating a surge in demand in the form of spending programs and tax relief.

Let's be clear: the US economy is not in recovery and an upturn is not likely to take place until late this year or early in 2010. Until then, the economy will continue to shrink, fewer people will have jobs and more will become unemployed. However, the moderation in job loss indicates that the speed of the collapse is beginning to slow.

Inflation is defined as the rate of increase in prices. And price levels are a consequence of supply and demand. When demand substantially increases, higher prices usually follow unless there is a large supply of goods and services available to meet that demand. That is exactly the case today. Even though government programs stimulated a massive increase in demand, the available supply can easily handle the demand increase.

TABLE 2: MANUFACTURING CAPACITY UTILIZATION RATE



In the current environment, inflation is not a near-term threat because there is ample spare capacity in the economy. Deflation is also not a threat because prices continue to rise at a subdued pace.

The best way to think of the supply side of the economy is in terms of the ability to produce. The amount of slack in the economy drives the supply. If demand surges and there is ample available capacity to meet it, prices will remain largely unaffected. But if demand jumps at a time of tight market conditions, significantly higher inflation will result. The good news is that there is plenty of capacity available to meet higher demand. This is demonstrated by the following:

- The unemployment rate was 9.8% in September, the highest since 1983, and there is every reason to expect it will increase into the early months of 2010. This alone will provide the capacity needed to meet rising demand without putting pressure on prices.
- Manufacturing capacity is even more ample. Currently, US manufacturers are using only 66.7% of their available capacity. That is up from 65.2% at the low point of the current cycle in June 2009, but it is still far below the previous all-time cyclical low of 67.9% reached in the 1981-82 recession. Clearly, US manufacturers have enough capacity to easily increase output without running into bottlenecks. In fact, when capacity utilization rates are declining and below 80%, inflation tends to decline. At current utilization rates there is little reason to anticipate any upward pressure on prices.

Currently, inflation is not an issue in the US economy. In August 2009, the consumer price index (CPI) stood 1.5% *below* the level of a year ago. That decline is partly a result of a steep drop in oil prices from the record high level reached in summer 2008. If energy is stripped out, the CPI was *up* 1.3% from a year ago.

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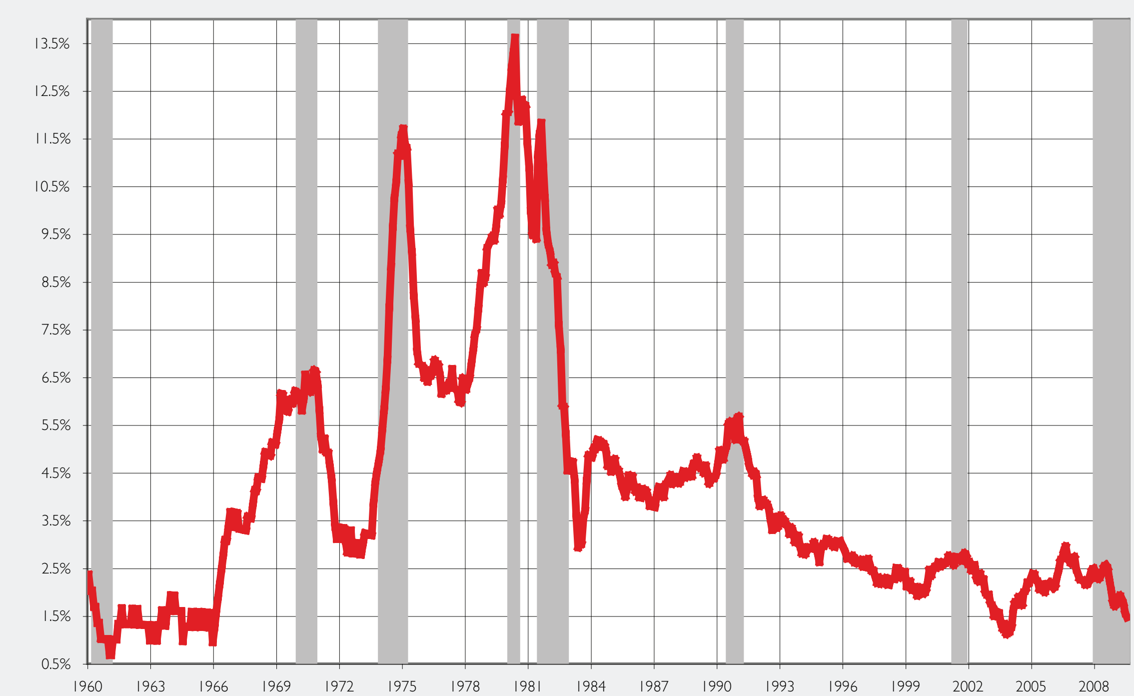
No matter how we look at it, the current environment in the US is not one in which there is any reason to be concerned about inflation. There is so much slack in the economy that the key issue for the next year is not inflation, but deflation. Deflation, a condition in which prices are declining is a great threat to economic growth. When there is deflation, prices of goods and services fall and producers must cut prices to meet competition. This generally means reducing costs or profits decline and companies are unable to grow. Deflation generally occurs in conditions that are consistent with economic decline.

Today, the US is experiencing declining prices; however, the main reason for this decline as noted above is dropping energy prices. In order to understand inflation trends, we strip out the impact of changes in volatile goods: food and energy. The resulting inflation rate is referred to as the "core" inflation rate – consumer prices excluding food and energy. In August 2009, the core inflation rate was 1.4%, nowhere near the negative territory that would be called deflation. In fact, the core inflation rate today is not even as low as it was in 2003.

TABLE 3: CORE INFLATION RATE (CPI excluding food and energy, percent change from a year ago)



Source: US Department of Labor, Bureau of Labor Statistics, Economy.com, Shaded areas are recessi

The current environment is one in which inflation is not a near-term threat because there is ample spare capacity in the economy. Deflation is also not a threat because, overall, prices are still rising, just at a subdued pace. Therefore, in the longer term, we would characterize the greatest threat to the economy as inflation, not deflation, for two main reasons:

- Times of recovery are generally periods when inflation stabilizes and then begins to rise. A recovery in 2010 will likely lead to the first signs of inflation increases.
- The unprecedented volume of stimulus funds injected into the economy has the potential to boost demand much more rapidly than is currently anticipated. If the Federal Reserve and the Treasury do not act in a timely fashion to withdraw the stimulus from the economy, we could experience rising prices more quickly.

INFLATION AND REAL ESTATE

There is a view in the real estate industry that inflation is good for real estate. The idea seems to be that during periods of inflation, tenants are more willing to accept higher rents because the prices of all their other costs are rising. This leads to higher income from properties and tends to push up the prices of properties. However, it we look at the performance of real estate assets and rents over the past 30 years, the facts show a different story. Using the National Council of Real Estate Investment Fiduciaries (NCREIF) index of total real estate returns, and comparing the change in real estate returns to the change in consumer prices, there is little to suggest a strong correlation between inflation and returns. In the late 1970s and early 1980s, a period of high inflation, real estate returns were also high. However, in the early 1990s, real estate returns plunged while inflation increased, and in the late 1990s, real estate returns soared while inflation declined. Today, we have low inflation and plunging real estate values.

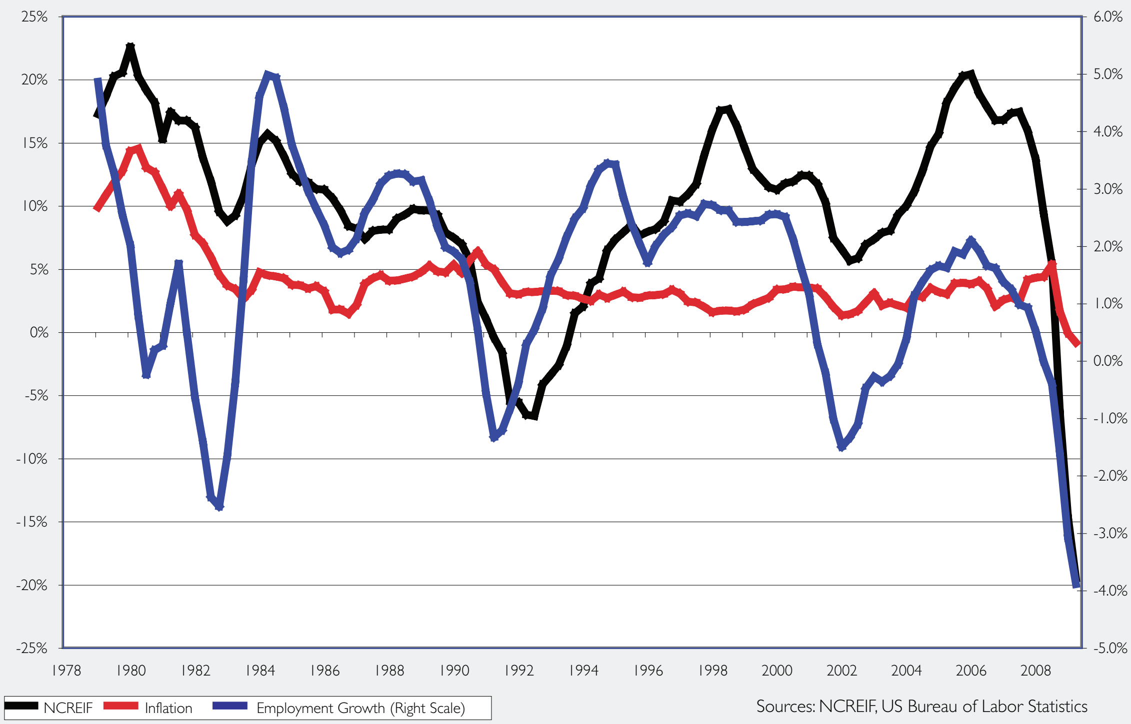
Because real estate leases tend to be long-term commitments at fixed prices, periods of inflation cause a profit squeeze as rental income is fixed while costs are increasing. Of course, the opposite can occur during periods declining inflation.

Periods of inflation can also be periods in which costs rise faster than prices. Because real estate leases tend to be long-term commitments at fixed prices, periods of inflation cause a profit squeeze as rental income is fixed while costs are increasing. Of course, the opposite can occur during periods declining inflation.

Inflation and real estate can be linked peripherally in the sense that periods of rising inflation tend to be periods of strong demand growth in the economy and therefore periods when the demand for space rises. But the direct link between the price of real estate as an asset and general inflation seems tenuous at best.

What drives real estate values is largely the supply of property in the economy. This is among the most cyclical of industries because of the time needed to build new product. This is truer in major metropolitan areas than in suburban areas, but even in the suburbs, buildings take time to complete. As a result, at any given time, the supply of space is relatively fixed and the main drive of pricing is demand. In turn, the main driver of demand is employment. So the key influence on real estate values is not inflation, but employment. The change in employment correlates much more closely with the NCREIF total return index than the inflation rate.

TABLE 4: REAL ESTATE RETURNS VERSUS INFLATION AND EMPLOYMENT



Sources: NCREIF, US Bureau of Labor Statistics

CANADIAN PERSPECTIVE

Despite strong trade ties with the US, the recession has had less of an impact on Canada than most other major advanced economies. While some 390,000 jobs have been lost – pushing unemployment to 8.7%, over 90% of the losses took place in the first five months following October 2008. Since then, the rate of losses has slowed steadily, with only 31,000 jobs lost in the last five months.

Even though the GDP is expected to contract by 4.6% this year, the first signs of growth in ten months appeared in June when the economy posted a 1.2% growth rate. A major net exporter of commodities, Canada is particularly vulnerable to world commodity prices, and low gas prices, which have stalled projects and resulted in significant layoffs, have taken a toll.

Forecasters are predicting continued slow growth and lagging recovery in the labour force, with unemployment averaging 9.0% in 2010 and gradually easing to 6.5% by 2015. In this fragile environment, interest rates are expected to remain low until 2011, and then rise rapidly to about 4.0% by 2012.

Consumer prices fell by 0.8% in the 12 months ending August 2009, an improvement over the -0.9% in July. Excluding energy, the consumer price index rose 1.4% this year, a clear indication that Canada is not experiencing deflation.

Vacancy is rising slowly in most Canadian office markets, with the exception of Calgary and Toronto central markets where the combination of weakened demand and significant new supply is causing added strain. Across Canada, rental rates have softened, but most markets are now observing a slowing of annualized decline. The national office vacancy rate at the end of the second quarter increased to 7.6%, still exceptionally tight. While tenant activity stalled, a rekindling of demand is occurring in many markets, including Vancouver and Toronto. Demand in Ottawa, Canada's capital city, remains strong, driven by the appetite of the federal government.

MEXICAN PERSPECTIVE

The economy of Mexico has never experienced deflation and has had bouts of very high inflation in the past. However, the country has not experienced a significant change in inflation expectations since the crisis began. Currently inflation is 5.6% and it is expected to be about 6.0% for 2009 as a whole. The main source of inflationary pressure is the devaluation of the peso, which has declined relative to the dollar by about 20% over the latest 12 months. This decline is causing the prices of imported goods to increase and it will create more upward pressure on inflation in the months ahead.

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Inflation in the 5.5% to 6.5% range is expected in the coming year. The main source of upward pressure will be the devaluation of the peso. As import prices increase we are also starting to see wages increase at a faster pace as labor unions push for higher income.

The industry and real estate sector most negatively affected by the crisis and inflation has been retail. As has been the case in the US, consumers in Mexico are very uncertain about their employment situation and are limiting spending to all but necessities.

The office market in Mexico has not been as negatively affected by the global recession as many other regions because the market was not overbuilt. With little excess product, the vacancy rate has only increased modestly, from about 5% before the recession began to between 8% and 9% today. As the market is still in balance, there has been little decline in rents. They are down in dollar terms because of the decline in the peso, but peso rents have held steady.

Overall, inflation in Mexico is low by historical standards and, while it may increase, there is little reason to anticipate a sharp increase or for it to have a significant impact on the real estate market.

SOUTH AMERICAN PERSPECTIVE

For South American countries, such as Brazil, the risk of inflation is related strongly to rising foreign direct investment, which could generate a rapid increase in demand. Low interest rates may also spur demand, which may temporarily boost inflation. However, overall, inflation throughout South America is expected to remain low, compared to historical experience. By the end of September, Brazil's central bank kept its forecast for economic growth unchanged at 0.8% for 2009, but slightly increased its estimate for 2009 inflation from 3.9% to 4.4%. The target inflation rate for both 2009 and 2010 is a maximum of 4.5%.

In the real estate industry, the market has not been affected by inflation in the past five years and this trend is expected to continue in 2010. Rents have increased much higher than inflation in the past three years, and, for 2009/10, they are expected to remain in step with, or above, inflation rates (all rents are adjusted by inflation by law on an annual basis). The only factor that might depreciate rent value is a lack of demand and/or a high volume of new stock entering some markets, but any reduction will be short term only.

OUTLOOK

The US – and much of the global economy – is in the throes of the worst recession since the 1930s. The steep drops in demand have raised fears of a deflationary spiral similar to that which occurred during the Great Depression. Conversely, the massive government-led response to the slowdown around the world has raised fears of a new inflationary spiral in the years ahead.

The economic outcome will depend largely on the ability of monetary and fiscal authorities to revive the economy and then withdraw the stimulus before it creates too much demand. It's a fine line and it may not be accomplished. Currently, the stimulus appears to have headed off the threat of deflation, but we are not yet completely clear of that threat. Despite the increasingly positive sentiment about the economy in the US, there is no sign of growth, and if the stimulus wears off too soon, the US economy could slip back. We don't think this is likely, but it is too soon to completely rule this prospect out, particularly if stimulus programs are withdrawn too quickly.

The greater fear today is the potential for inflation down the road. However, with so much excess capacity in the economy, the likelihood of a significant pick up in inflation is remote in the near term. If the budget deficit remains ultra high for several years and the Fed continues to stimulate demand with ultra-low interest rates, there might be inflationary consequences in three to five years. But it is highly unlikely that the Fed will be so reckless.

Thus, in our view, the most likely course of events for the economy is for a modest recovery to take hold in 2010 leading to even higher growth in 2011. For the commercial real estate industry, the driver of value will be employment growth. The economic outlook we anticipate would suggest a return to rising values in the 2010/2011 time frame.

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A CUSHMAN & WAKEFIELD RESEARCH REPORT

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