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ECONOMIC PULSE

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

OUTLOOK 2011

THE TIPPING POINT

WHY COMMERCIAL REAL ESTATE MARKETS STAND TO HAVE A GOOD YEAR

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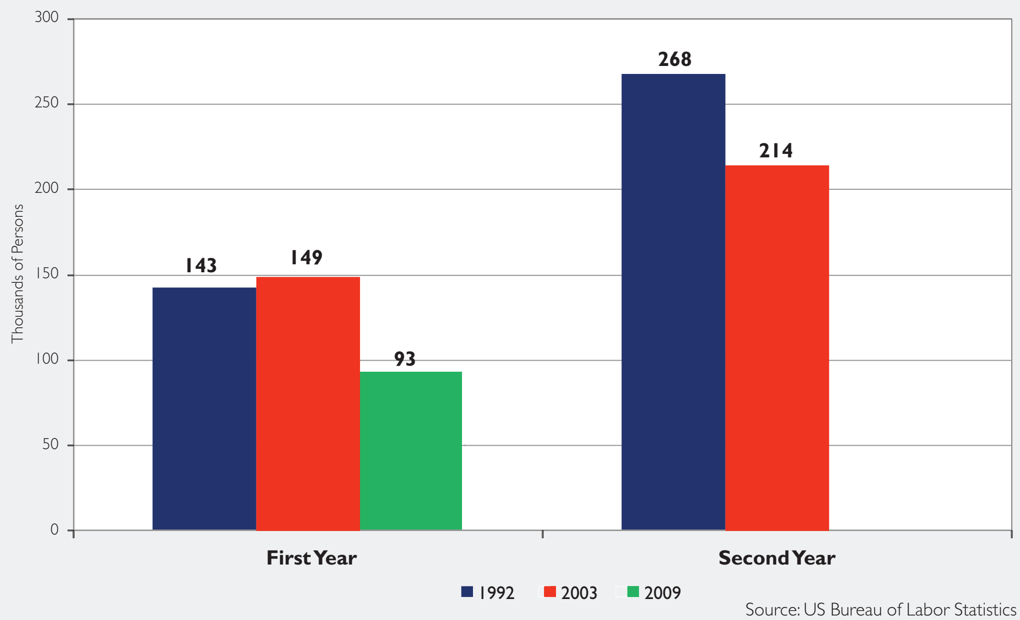
US Labor Markets Approaching a Tipping Point. In his popular book about how trends and fads emerge in a society, Malcolm Gladwell points out that there is an important psychological component to the emergence of trends. When certain key individuals or trendsetters adopt a behavior like a mode of dress, others follow suit and demand for a product can suddenly explode as it rises in popularity. The point at which the trend shifts from being a curiosity to a full-fledged fad is called the tipping point.

Something similar happens in an economic recovery. Employment growth, specifically, often shifts from weak to strong within a short period of time. Business behavior, which is understandably cautious during a recession and in the early stages of a recovery, tends to shift rapidly. At some point, businesses begin to hire because they go from being worried about losses or weak demand to being worried about the possibility of losing sales and missing out on potential profits. The shift, when it occurs, does tend to come suddenly. The result is a rapid acceleration in employment growth, which then generates higher income growth and leads to a sharp acceleration in economic activity.

TABLE 1: EMPLOYMENT GROWTH IN RECOVERIES (Monthly average)



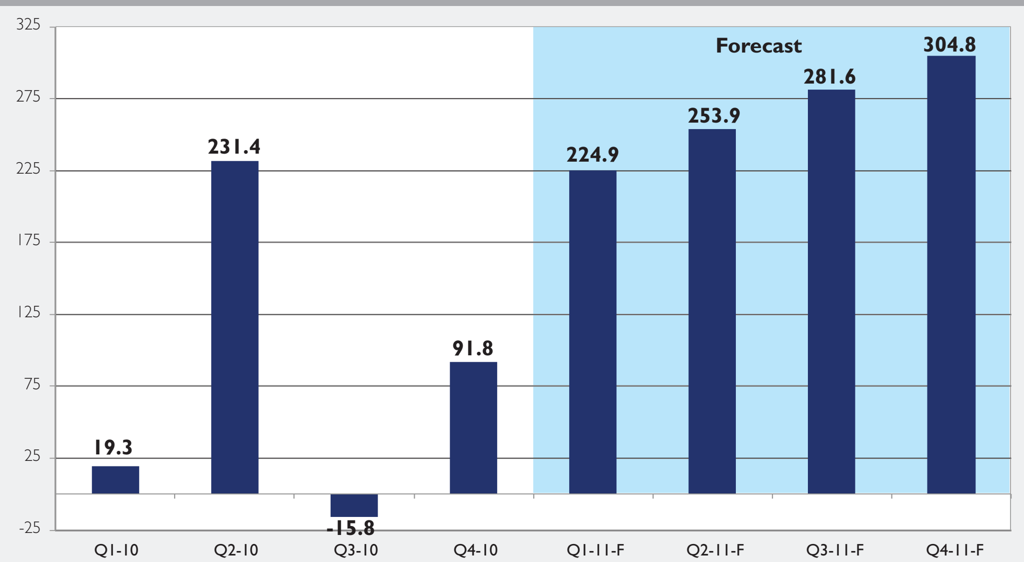
Source: US Bureau of Labor Statistics

In both the 1991 and 2001 recoveries, employment growth, when it did finally begin, started off slowly. But in both recoveries there came a tipping point when employment growth suddenly surged.

In the economic recoveries of the 1970s and 1980s, the shift to expanding employment began almost exactly at the same time that the overall recovery reached a bottom. But in the recessions of the last 20 years: –1990-91, 200 and 2007-09 – the economy turned around long before labor markets did. In 1991, the recession ended in March 1991, but employment did not bottom-out until February 1992, almost a year later. In 2001, the lag was even longer: 21 months with jobs finally beginning to increase in August 2003 even though the recession officially ended in November 2001. In the current recovery, payrolls bottomed in December 2009, six months after the official end of the recession in June 2009.

In both the 1991 and 2001 recoveries, employment growth, when it did finally begin, started off slowly. But in both recoveries there came a tipping point when employment growth suddenly surged. To illustrate this we examined employment growth in the 12 months after payrolls reached a bottom and compared that to the growth in the subsequent 12 months. In each of the last two recoveries, employment growth reached a tipping point and accelerated sharply in the second year after the bottom. We believe this is likely to happen again in the US in 2011. Payroll employment reached a bottom in December 2009. In the subsequent 12 months the economy added slightly more than one million jobs, or roughly 93,000 jobs per month. But the economy appears poised for a major acceleration in employment growth in the coming year.

TABLE 2: MONTHLY AVERAGE EMPLOYMENT GROWTH: 2010-2011 (Thousands of Persons)



Source: US Bureau of Labor Statistics, Moody's Analytics

The precursors for growth are falling into place, as indicated by:

- **Layoffs are decreasing.** The number of people filing for unemployment each week fell sharply just before employment growth took off. Between July and December 1992, the four-week moving average of the number of people filing for unemployment dropped from 446,000 to 350,000. In 2003, the number of filers for unemployment fell from 435,000 in April to 360,000 in December. Today, the number of claims filings is also plunging, from 490,000 in August to 410,000 in December. Generally, a drop below 400,000 is consistent with acceleration in employment growth, and the economy is just about there.

- **Consumer spending is accelerating.** In the 2002-03 recovery, retail sales, adjusted for inflation, increased 2.9% in 2002, 3.9% in 2003 and 4.2% in 2004. In 2010, real retail sales increased by 4.2% after falling 4.5% in 2009, and in the final six months of 2010 sales climbed at a 7.5% annual rate. This is critical because employers need to see growth in demand and have confidence that it will continue before they commit to more hiring.

- **Temp hiring is booming.** Temporary help services tend to experience employment growth sooner and faster than the rest of the economy. Businesses tend to be cautious early in a recovery and will hire temps until they are confident in the outlook. Temp hiring is currently the strongest it has ever been. In the 15 months since September 2009, temp help employment has increased nearly 500,000 jobs, by far the strongest 15 month period in the past 20 years. With demand rising we expect businesses will shift from hiring temps to hiring permanent employees in the coming year. That shift is likely to happen in 2011. In each of the last two recoveries, temp hiring peaked just before total job growth accelerated.

Businesses tend to be cautious early in a recovery and will hire temps until they are confident in the outlook. Temp hiring is currently the strongest it has ever been.

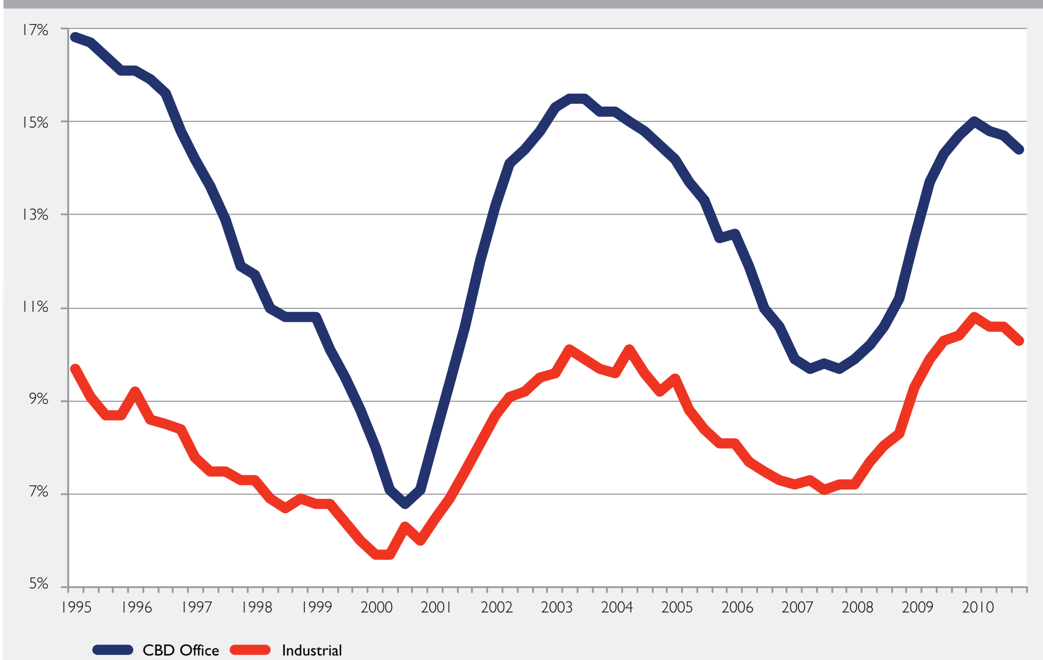
If we assume that the 3.2 million jobs projected to be added in the next 12 months are distributed among industries in the same proportion as current employment, the US will add approximately 660,000 jobs in office-using industries, 345,000 jobs in the manufacturing and distribution sectors and 350,000 in retail.

These trends suggest that US labor markets are at or near the tipping point. and will likely move from moderate growth to strong growth in 2011. As the chart on page 3 shows, monthly average employment growth is projected to increase from about 92,000 jobs per month in the final quarter of 2010 to slightly more than 300,000 per month in the fourth quarter of 2011. By the end of 2011 the US economy should be adding jobs at an annual rate of more than 3.5 million. That would be the strongest employment growth since the final quarter of 1997.

US Real Estate Market Implications. The projected acceleration in US employment growth in the coming year has major implications for the US commercial real estate market. All major sectors: office, industrial, retail and multi-family will benefit. If we assume that the 3.2 million jobs projected to be added in the next 12 months are distributed among industries in the same proportion as current employment, the US will add approximately 660,000 jobs in office-using industries, 345,000 jobs in the manufacturing and distribution sectors and 350,000 in retail.

Office markets are likely to improve substantially. In US central business districts (CBDs), the vacancy rate reached a peak of 15.0% in the first quarter of 2010 and declined moderately in the subsequent three quarters, ending the year at 14.4%. An additional 660,000 jobs in this sector will cause vacancy to drop sharply. The last year in which the US economy added that many office-using jobs was 2005. Then, the CBD vacancy rate dropped by 2.0 percentage points and the suburban vacancy rate fell 2.3 percentage points. Supply changes that year were roughly the same as in 2010, so that is not likely to have a material impact.

TABLE 3: NATIONAL VACANCY RATE: CBD OFFICE AND INDUSTRIAL



Source: Cushman & Wakefield Research

This suggests that CBD and suburban vacancy rates are likely to fall substantially if employment growth comes anywhere close to the current projection.

Industrial markets. Employment in the manufacturing and distribution sectors has not increased by 345,000 jobs since 1997 at the beginning of the Internet boom. That year also saw the start of a period of sharp increases in new construction, particularly in the warehouse sector. A total of 110 million square feet of space was completed in 1997. That is in stark contrast to the current market in which there was only 15 million square feet of new construction. Even with that tremendous new supply, the industrial sector as a whole saw the vacancy rate decline from 8.4% to 7.3% in 1997.

Overall, the industrial vacancy rate has declined 0.5 percentage points since the first quarter of 2010. Further substantial declines are very likely in the strong growth scenario we are projecting in 2011, especially in an environment with little new construction.

Overall, the industrial vacancy rate has declined 0.5 percentage points since the first quarter of 2010. Further substantial declines are very likely in the strong growth scenario we are projecting in 2011, especially in an environment with little new construction.

Retail markets. The overall employment growth projected for 2011 comes in an environment of accelerating economic activity. GDP and consumer spending are both anticipated to accelerate from 2.8% and 2.7% (fourth quarter to fourth quarter) respectively in 2010 to 4.4% and 3.9% in 2011. This is likely to lead to significant improvement in retail markets. Lower vacancy rates are anticipated in the retail sector in the coming year largely because of strengthening consumer demand.

Rental rates. Average asking rents for available space continued to decline in 2010 in both office and industrial markets. But the rate slowed to almost nothing as the year progressed. By the end of 2010, CBD office asking rents were 0.2% below the level of a year earlier and industrial rents were down 6.0%. But fourth quarter rents were actually above the third quarter in industrial markets, on average across the country. In a climate of accelerated economic growth and declining vacancy rates, it is likely that rents will stabilize in 2011 and may begin to rise, particularly in markets that are tighter than the national average. Overall, 2011 is likely to mark a turning point for rents in the US commercial real estate market for the nation as a whole.

US Conclusions. The US economy is at or very near a tipping point in the growth cycle. Employment growth is projected to triple this year with more than 3 million jobs projected to be added to the workforce. Both GDP and consumer spending growth are projected to accelerate sharply.

In a commercial real estate environment characterized by limited construction, this sharp acceleration in demand is likely to have a healthy impact on vacancy and rents. Vacancy rates are expected to decline while rents will at the very least stop declining and in some markets turn up. Throughout the Americas, the outlook for the real estate market is expected to be one of improvement.

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CANADA

Businesses in Canada worked to find their footing in a challenging global economy in 2010. A healthy banking sector helped propel recovery in Canada, and push GDP growth to 6.1% in Q1 2010. The lion quickly turned into a lamb, however, and the recovery lost traction in the spring and summer of 2010, slowed by weakening global economic fundamentals. By yearend, with commodity and energy prices shifting upwards, Canada's economy once again started regaining steam. Overall, estimated GDP growth for 2010 will be about 3.1%.

In 2011, positive demand is projected for most markets, with central areas showing more strength than suburban markets.

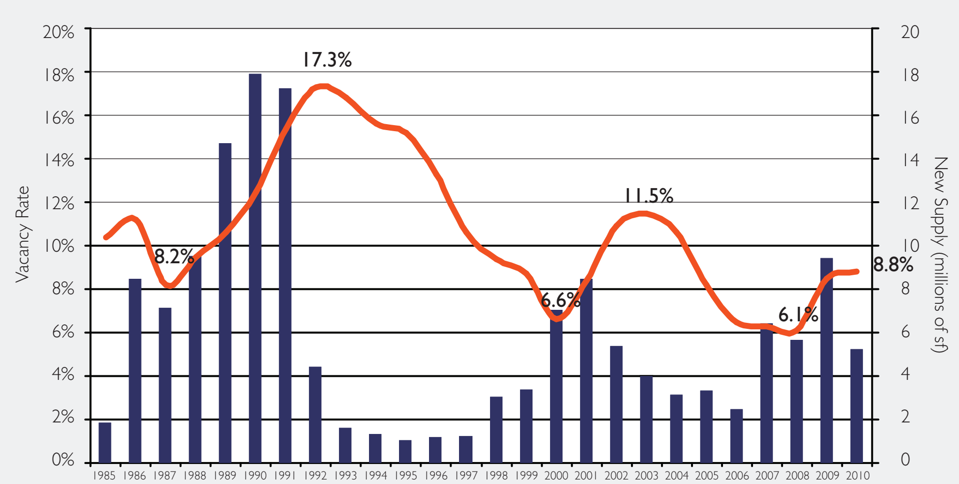
From a jobs perspective, Canada performed surprisingly well in 2010, recovering more jobs by the end of the year than had been lost during the recession. The unemployment rate stood at a respectable 7.6%.

Canada's economic performance varied widely across the country, and this is likely to be the case in 2011. GDP growth for Canada next year is projected to range from 2.4% to 3.0%. Higher growth will be experienced in resource-rich provinces located in Western Canada. Central Canada will also see improved strength, driven primarily by demand for goods and services from south of the border.

Central Canadian office markets performed very well in 2010, with demand in central Toronto leading the way. The primary driver in Downtown Toronto was the financial services sector. Vancouver and Montreal also experienced central area demand resilience. Calgary, fuelled by a mid-year royalty tax reduction and strengthening oil prices, saw a huge resurgence in demand.

At the national level, the Class A vacancy rate across central markets only rose to 7.1% in the first half of 2010 from a low of 3.2% at the end of the third quarter of 2008. This means that Canada is at its tightest point in history entering an expansionary cycle. Notably, central area developments are being discussed in four major markets due to both demand needs and underlying vacancy conditions.

TABLE 4: CANADIAN OFFICE MARKET: VACANCY RATE VS. NEW SUPPLY (All Classes)



Source: Cushman & Wakefield Research, Canada

Suburban office markets, which are much more closely connected to US business activity, did not fare nearly as well as central markets in 2010. In many, a significant amount of space was returned to market by downsizing or exiting US companies.

In 2011, positive demand is projected for most markets, with central areas showing more strength than suburban markets. However, the pace will be moderate, with the exception of Downtown Toronto, where demand will remain at or near expansionary levels. Suburban markets will see slower growth accelerate as the year progresses.

LATIN AMERICA

After contracting in 2009 in response to the US recession, this region accelerated sharply in 2010 as global demand increased. A slowdown to a more moderate, but still strong growth rate is projected for 2011. Latin American nations may benefit from the debt problems in Europe and the Middle East by attracting foreign investment that supports growth.

Brazil's commercial office market remained one of the best performers in the world in 2010 with strong demand, healthy absorption and rising rents across all major metropolitan areas. This trend is expected to continue in 2011, as economic growth remains healthy.

BRAZIL. Brazil's national development bank, BNDES, has provided funds to improve infrastructure and for small- and mid-sized companies to increase their production capacity. Easing of credit conditions has also stimulated growth in retail sales and consumer spending. These increases have also been triggered by an increase in consumer confidence due to reduced unemployment, which closed the year at a rate of 5.7%.

Brazil's GDP grew a strong 7.3% in 2010, buoyed by increasing foreign demand and rising domestic spending. A slowdown to 4.5% is projected for 2011 as domestic demand growth moderates while foreign demand remains strong.

Inflation is likely to increase, with commodity prices climbing. In 2010 inflation reached 5.9% and may accelerate further in 2011. This prompted the central bank to raise interest rates during 2010, which will contribute to the growth slowdown.

As interest rates increased, so did the exchange rate for the Brazilian Real. Since Brazil relies heavily on foreign markets, a stronger currency has reduced export prospects and raised domestic inflation. We expect the government to hold interest rates flat and permit the currency to gradually weaken in 2011.

Dilma Rousseff of the Partido dos Trabalhadores (PT) won the October 2010 presidential run-off election and took office in January. She will face several economic issues in 2011, particularly the exchange rate and inflation. Uncertainty about the policies of the new president have had an impact on financial markets, but thus far the transition has been smooth.

Brazil's commercial office market remained one of the best performers in the world in 2010 with strong demand, healthy absorption and rising rents across all major metropolitan areas. This trend is expected to continue in 2011, as economic growth remains healthy. With employment projected to increase 1.6%, demand for space will continue to climb in 2011 boosting absorption and keeping rents high.

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MEXICO

Mexico's economy recorded strong growth in 2010 with real GDP growing an estimated 5.0%. Much of the growth was driven by the recovery in the US with domestic demand remaining sluggish. Businesses are still cautious in the uncertain economic environment and less willing to take risks. This contributed to the unemployment rate remaining essentially flat at about 5.2% in 2010.

The economy is expected to continue to improve in 2011 with growth accelerating as the US economy improves. This should lead to higher business confidence and more investment and hiring. The result is expected to be a recovery in domestic demand as the year progresses and another year of solid economic expansion.

The Mexico City office market, the largest in the country, saw modest gains in 2010 with a slight decline in the vacancy rate, but rents still declining. In 2011, we anticipate that stronger employment growth will lead to an improvement in the vacancy rate and stabilization in rents. Overall, the market is expected to continue looking up in 2011.

Americas Conclusions. The recovery is here and is likely to get stronger as 2011 progresses. The entire region will benefit from stronger growth in the US, but all the major countries in the Americas will be in full-fledged economic expansions in 2011. That can only help conditions in real estate markets. Healthy employment growth will contribute to declining vacancy in most markets, on average and lead to an upturn in asking rents sometime in the next 12 to 18 months. We are already seeing higher rents in several markets. The tipping point, if it isn't here yet, is very close.

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