

World Overview

Growth: PMI indicators for January show that global production has continued its slow and steady recovery from its deep depression in Q2 2009. The fortunes of manufacturing sector are often overlooked in the advanced economies but the sector remains an essential component of overall growth. There will not be a sustained recovery in GDP without growth in manufacturing output. In part, the current revival in production is due to the end of de-stocking and the beginning of inventory accumulation. However the strength of the gains in manufacturing also suggests the start of a revival in OECD domestic demand. The data support our view that a global recovery is underway.

Inflation: Although generally below target, the rate of inflation is increasing across the industrialised world apart from in Japan. This represents a success for policy and a substantive plus for the global recovery. Had deflation set in, as in Japan, the impetus to de-gear in the consumer and corporate sector would have been much higher and the recovery much slower. Although some commentators are fretting about the potential for runaway inflation, we are, due to excess capacity very far from that. For the time being inflation is to be welcomed.

Policy: Whether the current weak recovery gains ground in 2011 depends to a large extent on how policy makers withdraw the economic stimulus currently in place. Apart from in Asia, the fragility of the recovery suggests that the stimulus needs to remain in place for another three quarters at least. However, markets are already penalising the big deficit economies of Greece, Italy, Spain and the UK and, perhaps perversely, voters are reacting against big government in the US and the UK. On balance we think policy makers will hold their nerve by only planning for deficit reduction in 2011. This means small rate rises in Q4 2010 possibly earlier.

Region by Region (changes in bold)

	Growth	Inflation Rate	Short Int Rate
USA	Growing	Accelerating	Stable
Euro zone	Growing	Accelerating	Stable
UK	Growing	Accelerating	Stable
Japan	Growing	Falling	Stable
Canada	Growing	Rising	Stable
China	Accelerating	Accelerating	Stable
Australia	Growing	Rising	Increasing

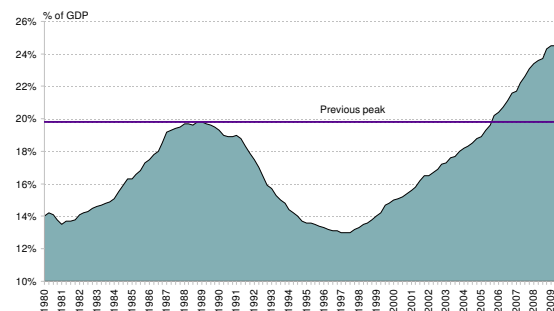
Global Headwinds: US Real Estate Debt

Whilst the US economy started to recover in Q3 2009, it is not clear when this be true of the property markets. First, employment is a lagging indicator. Employers are not willing to risk adding new employees until they are certain that the recovery is sustainable. Adding hours or temporary workers is the preferred path to increase output in the short-run and this does not require additional space. Second, as the economy recovers interest rates will start to rise putting some upward pressure on yields. However, the biggest real estate headwind is the looming wave of both traditional commercial real estate (CRE) loans and commercial mortgage-backed securities (CMBS) that need to be refinanced over the next several years.

Grosvenor North America Research estimates that approximately \$770 billion of the \$1.4 trillion CRE bank loans coming due in the next five years will be “underwater.” Losses from these loans will range from \$225 to \$300 billion and while it will be far less than the \$1.1 trillion residential loan debacle, it will force the closure of scores of smaller local and regional banks whose primary asset base is CRE loans. With commercial real estate prices down 30% to 50% or more depending on the market and/or

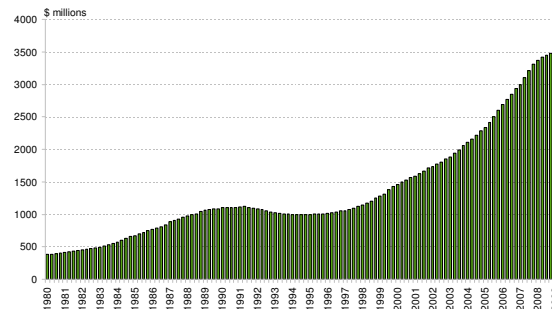
land use, the biggest surprise is that none of the nation's "super-banks" are on the Federal Deposit Insurance Corporation (FDIC) watch list. However, even these banks are now experiencing real estate delinquency rates approaching ten percent with more expected as the year progresses.

Chart 1: Commercial and multifamily loans



Source: IHS Global Insight

Chart 2: Commercial and multifamily loans outstanding

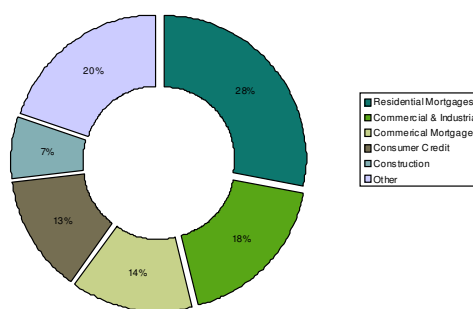


Source: Federal Reserve

Federal regulators in an attempt to avoid a crisis are allowing banks to extend loans that are in "technical" default but whose cash flows are sufficient to cover the building's debt obligations after taxes. Unfortunately, this 'extend and pretend' approach to problem loans only works if the market recovery period is shorter than the 'extend' period. Since job levels are not expected to return to pre-recession levels until 2013 carrying these loans for an extended period will hamper lending and increase costs on future activity. This will hurt profitability and create a vicious circle that will delay the market's recovery. In another sign that the FDIC is moving to quickly deal with the issue, there are moves to resurrect a Resolution Trust Corporation (RTC) style entity which would allow the government to quickly and efficiently sell off commercial real estate paper to interested investors.

In addition to foreclosed and "extended" CRE properties, the American property market must also deal with a rapidly worsening CMBS market. Virtually all CMBS pools securitised between 2007 and 2008 are underwater and delinquencies are quickly creeping into 2006 vintages as well. CMBS loans are much more complex than CRE loans since they are syndicated and once they default they are sent to a special servicer. Quite often, ownership rights become cloudy and alignment of interest issues quickly breakdown between the holders of various tranches. Like banks, special servicers can extend loans but at some point they must act in the best interest of the investors and this will eventually mean selling properties in a less than receptive market environment.

Chart 3: Banks' loan profile - June 30, 2009



Source: FDIC

CMBS maturities will not peak until 2017 and 2018, but CMBS pools represent over 20% of the \$3.5 trillion commercial real estate debt market and \$31 billion of it is expected to mature in 2010 alone. Fortunately, because of pay offs, liquidations, and defeasances, the actual 2010 refinancing needs are only approximately \$18 billion. Not surprisingly, defaults are becoming commonplace with the most notable being Stuyvesant Village in New York, an 11,000 unit apartment complex which was bought for \$5.4 billion in 2006 and is now thought to be worth only \$1.8 billion according to Fitch Ratings.

Whilst CRE and CMBS loan defaults will be a serious problem, they will not bring down the banking system. However, they will put additional downward pressure on commercial property prices. Whilst this will create opportunities for well financed investors, the broader impact, via bank balance sheets, is negative for the economy.