



GROSVENOR

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NORTH AMERICAN QUARTERLY REPORT

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Highlights

U.S. Economic Highlights

The recession is dead! Long live the recession! Preliminary estimates confirm that output rose by 3.5% in the third quarter led by increased consumer demand (up 3.4%). That's the good news, a more detailed analysis shows that much of the growth was fostered by government stimulus such as the "cash for clunkers" program. Auto sales represented almost half of the third quarter uptick (1.7%). Grosvenor Research as well as many others are concerned that third quarter growth is not sustainable, especially as massive government spending and subsidies wind down.

Canadian Economic Highlights

Canada's economic performance has been disappointing of late and it is looking more likely that third quarter real GDP growth may barely make it into positive territory. Early hints of this came when August's estimates showed negative growth. While moderate growth will return in 2010, it will not be until 2011 when employment growth and consumer spending show significant improvement.

Property Market Highlights

U.S.: Grosvenor Research is forecasting difficulties for commercial real estate borrowers during the coming quarters as a wave of refinancing swamps the capital markets. As expected, there is little good news to report on the pricing front. Both published as well as unpublished data show that cap rates are still migrating north and property cash flows are subject to further downward pressure as vacancy rises and effective rents erode in the face of falling demand.

Canada: As an economic recovery begins to slowly unfold, a clearer picture has emerged as to which land uses have been most affected by the downturn. Canada's multifamily market has escaped the recession relatively unscathed, while the office and industrial sectors continue to underperform. Retail properties and returns have remained surprisingly resilient, largely because retail sales have not contracted as much as first feared.

1.0 United States.

1.1 U.S.: Executive Summary

- The recession is dead! Long live the recession! Preliminary estimates confirm that output rose by 3.5% in the third quarter led by increased consumer demand (up 3.4%). That's the good news, a more detailed analysis shows that much of the growth was fostered by government stimulus such as the "cash for clunkers" program. Auto sales represented almost half of the third quarter uptick (1.7%). Grosvenor Research as well as many others are concerned that third quarter growth is not sustainable, especially as massive government spending and subsidies wind down.
 - Consensus economic forecasts suggest that unemployment will not fall to 6% before 2013 at the earliest and a weak U.S. dollar can only lead to increased inflation and interest rate pressures which will restrict lending and spending and in turn result in below average growth.
- Whether we like it or not, the U.S. economy is consumption, not export-based. This creates an interesting conundrum for both policymakers and investors.
 - Artificially bolstering demand via government stimulus programs creates the impression that the economy is on the rebound. However, without some solid evidence that household balance sheets have been repaired or employment is trending upwards, positive GDP gains may be creating a false sense of relief for investors.
 - Grosvenor Research believes that, to date, investors are overly optimistic with respect to the economy's long-term growth path. We believe that the current spate of "good" news has created a veneer that many investors will find disappointing. Massive government spending and aggressive expansion of the money supply are not the foundation for sustainable growth. Furthermore, they have not produced any measurable improvement in household wealth or domestic sales.
- The Federal Government is running out of options and while a second stimulus package is being talked about, it is likely to take the form of extending unemployment benefits and COBRA, as well as providing tax breaks to small businesses to expand their payrolls.
- Corporate earnings have largely beaten the low bar set by analysts, however, they have done so by drastically reducing costs and inventories, not increasing domestic sales.
 - On average, sales have dropped 12% for companies in the S&P 500. With foreign sales representing approximately half of all top-line revenue, a weak dollar helps revenue.
- With job losses approaching 8 million and unemployment at its highest level since 1983 (10.2%), sentiment is pivoting on a slow downward trend in initial unemployment claims, a small upward movement in home prices, and relatively upbeat pronouncements by the Fed that economic conditions have stabilized and that inflationary forces are for the moment being held at bay.

- With excess manufacturing capacity and weak labor markets keeping prices in check, the Fed will be able to hold rates down until mid-2010.
- Upward pricing pressure may eventually arrive in the form of import prices which are subject to the recent run-up in commodity prices and a weaker dollar.
- Bottom line is that we can look forward to a largely jobless recovery. In fact, Global Insight does not expect employment to return to its pre-recessionary levels until late 2012.
 - Along with disappointing employment growth will be limited wage and income growth. In the short-run, households will be reluctant to accumulate more debt on their balance sheets. Moreover, with the capital markets still constrained, consumer debt is both difficult to secure and expensive, making it doubtful whether households could get loans or expand their credit limits even if they so desired.
 - Federal Government deficits are also forecast to remain at record levels for some time to come making it difficult to make a case for a second stimulus package which is not revenue neutral.
 - The Fed is also entering a critical period as it considers the optimal way to unwind its positions. Moving either too slowly or too quickly could adversely affect the fragile recovery. However, with the Fed Funds rate at 0.0-0.25%, the Fed must continue to manipulate its balance sheet to maintain the economy's current momentum since lowering rates is no longer a viable policy option. In fact, the Fed Funds rate has nowhere to go but up, something which many investors expect sometime early next year.
- While it appears that some of the green shoots spotted earlier this year have begun to take root, it is not clear whether we should expect them to bloom anytime soon. While the U.S. economy may be technically out of recession, this does not mean that an accounting-based recovery will lead to a spontaneous celebration by businesses and consumers.

U.S. Macroeconomic Outlook (Source: IHS Global Insight)

	2006	2007	2008	Forecast begins 2009 →				
	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP Growth	2.7%	2.1%	0.4%	-2.5%	2.2%	2.9%	3.7%	2.9%
Employment Growth	1.8%	1.1%	-0.4%	-3.8%	-0.9%	1.7%	2.6%	2.0%
Housing Starts (Millions)	1.8	1.3	0.9	0.6	0.9	1.3	1.6	1.7
10-Year Treasury	4.8%	4.6%	3.7%	3.2%	3.5%	3.9%	4.5%	4.8%
Crude Oil (per barrel)	\$66	\$72	\$100	\$62	\$68	\$77	\$83	\$87
Consumer Prices (%Chg)								
Total	3.2%	2.9%	3.8%	-0.3%	1.5%	2.0%	2.0%	1.8%
Core	2.5%	2.3%	2.3%	1.7%	1.5%	1.6%	1.7%	1.7%

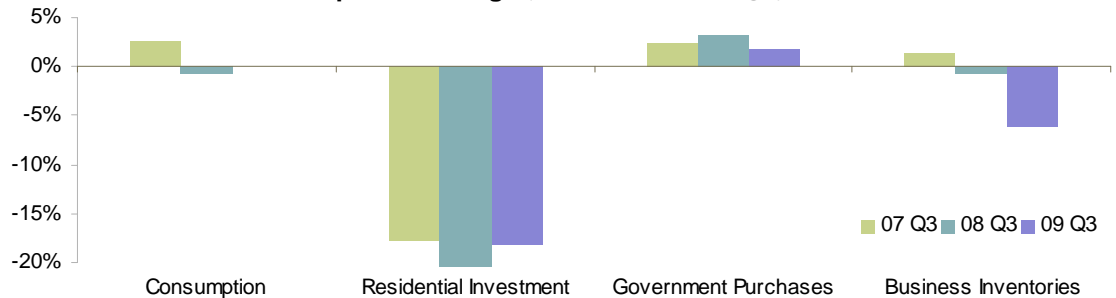
1.2 U.S.: Policy Initiatives

- All hail the Federal budget deficit. Without aggressive government spending and subsidies through the TALF, TARP, and a host of other programs, the economic landscape would still be littered with the remains of large and small companies, depression-like unemployment, and a global economic crisis. A second salutation should go the Federal Reserve whose aggressive expansion of the money supply has provided the needed liquidity to complement Government spending.
 - Of course, we still have a long way to go before the economy is out of the woods, and a second stimulus package may be needed to ensure success. However, this time around any package will likely be more targeted
- Assuming that the economy does start trending back to normalcy, the next hurdle is for the Obama Administration and the Fed to successfully unwind their supportive positions without creating an inflationary and interest rate spiral.
- Current spending levels will generate deficits in excess of \$1.5 trillion a year for the foreseeable future, limiting the Administration's stimulus options.
 - There is a growing sense that additional help may come in the form of non-spending initiatives such as tax credits for new hires or plant and equipment.
 - Given the growing backlash against unchecked government spending, it is also likely that any new proposal will have to be deficit neutral. For example, plans to extend unemployment benefits will most likely be paid for by extending the add-on tax paid by employers.
 - There is still a significant percentage of the original stimulus package wending its way through the economy which will help stabilize the recovery.
- Several more banks are requesting to return their TARP monies at the same time bank failures continue to grow.
 - Year-to-date, the FDIC has shut down 120 banks. The pace of bank closings is expected to accelerate over the next two years given the number of smaller regional and local banks that have large real estate exposures. It is estimated that up to one thousand banks by 2012 will be shut down and sold by the FDIC.
- Financial regulation is the Administration's next target. This initiative will be wide ranging and attempt to deal with everything from under-regulation of hedge funds to streamlining and strengthening the number of government regulatory agencies to the overriding issue of executive compensation.
- While TARP may have prevented a financial Armageddon, banks' lending policies still remain extremely conservative especially considering the host of consumer fees that are being piled on for late credit card or consumer debt repayments. It appears that they are making their profits not the old fashioned way, but by acting like Ebenezer Scrooge. Not surprisingly, legislation is emerging to limit bank credit card fees and the Administration's desire to create a consumer Czar to prevent further predatory actions.
- What is uncertain is how successful the various mortgage modification programs will be.
 - While many banks are participating in the program, many distressed homeowners still cannot qualify because they have no equity left in the homes or have run out of unemployment benefits and have no basis for paying for any mortgage, regardless of the level of forgiveness.

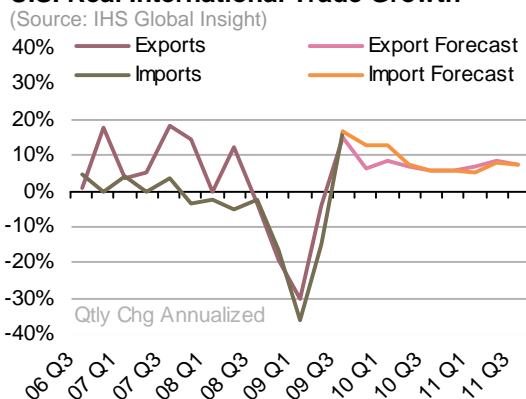
1.3 U.S.: GDP, Trade, and Productivity

- Third quarter GDP numbers showed that consumption, not business activity, was the main driver in the 3.5% gain in real output. Government spending came in above expectations, although state and local government spending was a drag on the numbers.
 - The trade gap widened as the American appetite for foreign energy and manufactured goods continued unabated.
 - Inventory accumulation also contributed almost 1% to GDP growth, which was expected given the recession-induced decline in the sales-to-inventory ratio.
 - The good news/bad news story regarding government stimulus spending is that less than half of the original stimulus package has been put to work which should help provide some additional impetus to the recovery. The bad news is that after having spent half the money, it is still not clear that who will replace the government once the stimulus monies have been exhausted.
- The Administration seems to be a bit bipolar with respect to the dollar. In public it remains committed to a strong Greenback, but in private it is doing little to stem the dollar's freefall.
- Commodity prices are on the move again. Prices are off their bottoms. For example, oil and natural gas prices were up approximately 25% in October.
- Business fixed investment has been disappointing. This might change soon as machinery and infrastructure age, forcing companies to reinvest.
 - Firms have learned to become more efficient. This could be bad news for workers who may not be rehired as rapidly as they have in past recoveries. Since businesses hold onto their most productive employees, productivity gains have been unsustainable. Typically, productivity ebbs during a recovery, but this time around there is a sea of experienced workers waiting to be hired.

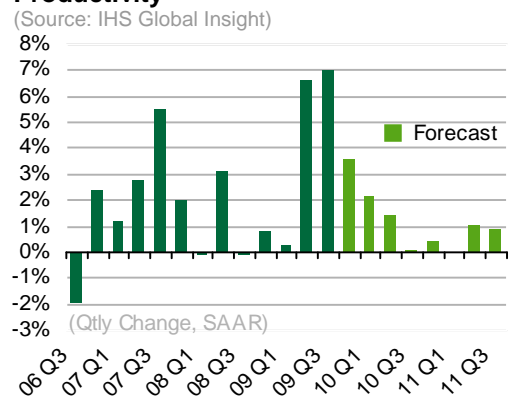
Selected GDP Sectors: 4-quarter Change (Source: IHS Global Insight)



U.S. Real International Trade Growth



Productivity

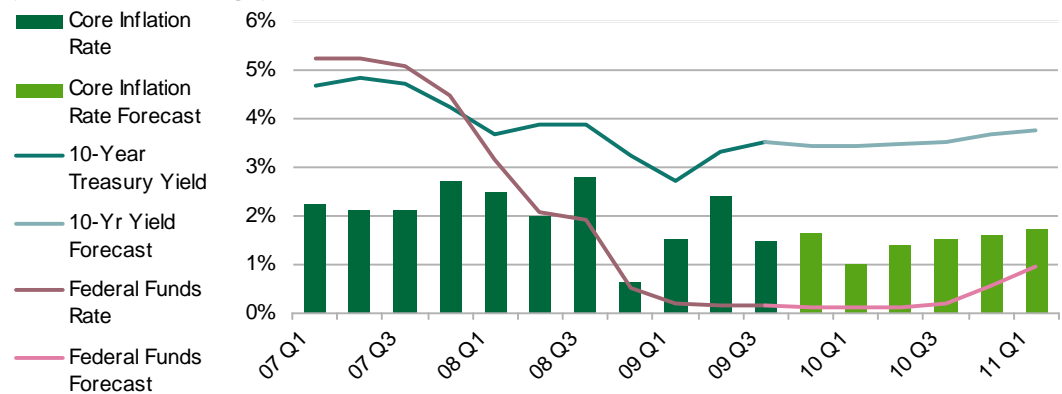


1.4 U.S.: Interest Rates & Inflation

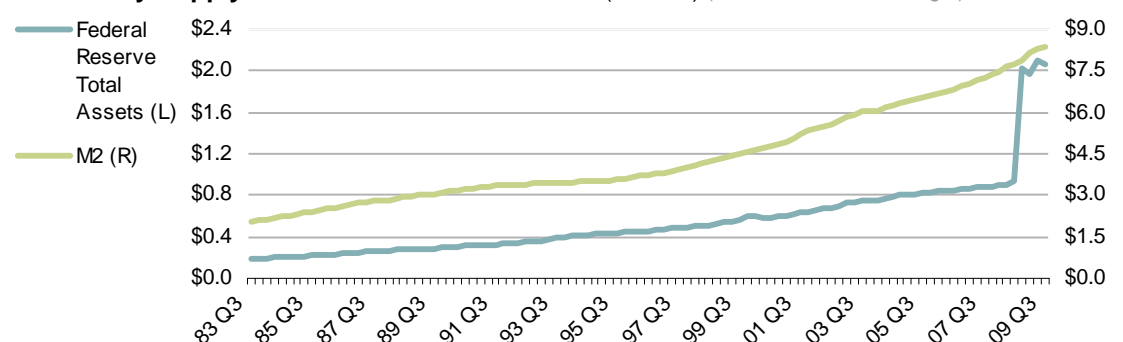
- The Federal Reserve's accommodation policy remains in full effect and there is little reason to expect it to change anytime soon. It is hoped that a near zero Federal Funds Rate will encourage lending activity, but to date the capital markets are showing few signs of improvement.
- Weak labor markets are keeping wages and inflation in check, thereby giving the Fed breathing room for the moment; however, commodity prices have increased significantly in recent weeks which along with a depreciating dollar, is likely to put significant upward pressure on import prices. Whether this will force the Fed to reexamine its inflation view will unfold in the coming quarters.
 - Oil is now trading slightly near \$80/barrel and gold has reached record highs in part because they are dollar denominated commodities.
- We remain in a slightly deflationary environment, although core inflation has been hovering between 1 and 2 percent for some time.
 - Timing is everything. If the Fed begins to tighten too soon, it will face the possibility of throwing the economy back into recession. If it waits too long then inflation is likely to return. The Fed is certainly walking a very fine line.
- A necessary evil in the short-run, the Federal deficit will exceed \$1.5 trillion for some time to come. Eventually, this will have to be paid back either in the form of a combination of lower spending, higher inflation, and/or higher taxes. None of which are very palatable.

Ten-Year Treasury Yields and Federal Funds Rate versus Core Inflation

(Source: IHS Global Insight)



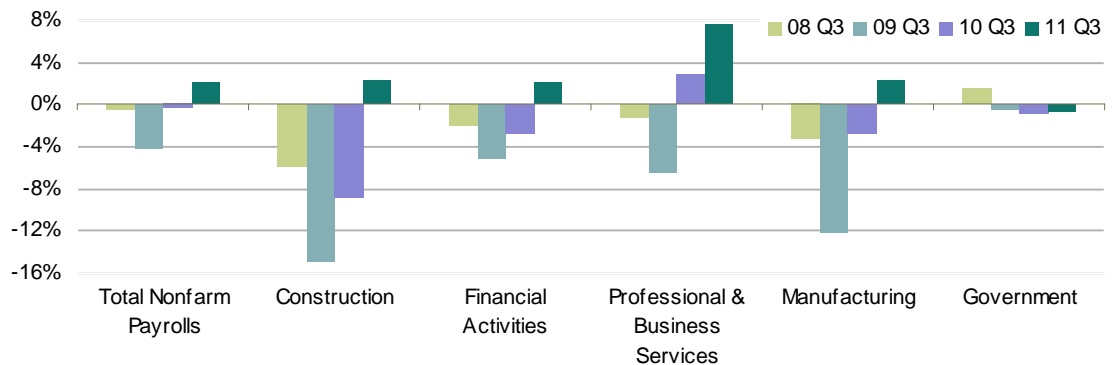
U.S. Money Supply and Federal Reserve Assets (Trillions) (Source: IHS Global Insight)



1.5 U.S.: Employment

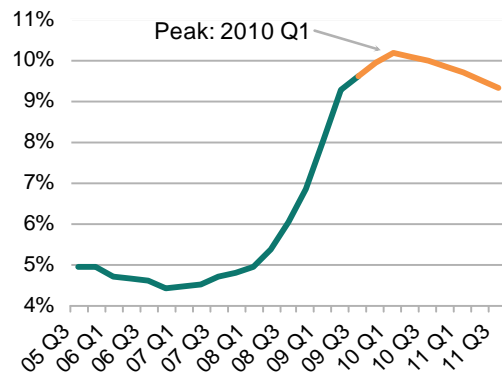
- Except for bankruptcy attorneys and workout specialists, few if any industries have stopped shedding jobs. Even the ever reliable government sector is losing workers in light of the rapid and steep erosion of tax revenues at the state and local levels.
 - The good news is that job losses are slowing and first-time unemployment claims appear to have peaked; however, the national unemployment rate has now reached 10.2%. Employment growth will be a lagging economic indicator and Global Insight does not expect employment levels to return to their pre-recession peak until late 2012.
 - In many instances, Federal bailout monies have saved, not created, jobs. But many consider that a major victory given what the economy would have looked like otherwise.
 - Extremely disappointing was business fixed investment. Even after accounting for the expected decline in nonresidential construction, it showed only minimal improvement.
- Unfortunately, a largely jobless recovery will have a profound impact on the economy as companies continue to make profits by cutting costs and improving overseas sales. While they will eventually be forced to reinvest in factories and plants, growing their payrolls will only begin when they are convinced the recovery is real.
- Since the U.S. is a consumer-driven economy, consumer spending and housing are critical to the timing and strength of future employment trends. This means job losses will continue until early 2010 before a slow upward march to recovery begins.

Employment Changes in Select Categories (4-quarter changes) (Source: IHS Global Insight)



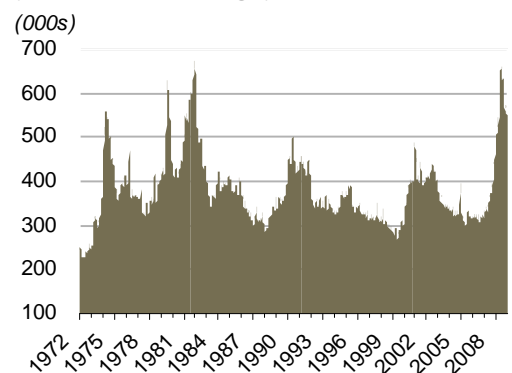
Unemployment Rate

(Source: IHS Global Insight)



Initial Claims for Unemployment Insurance

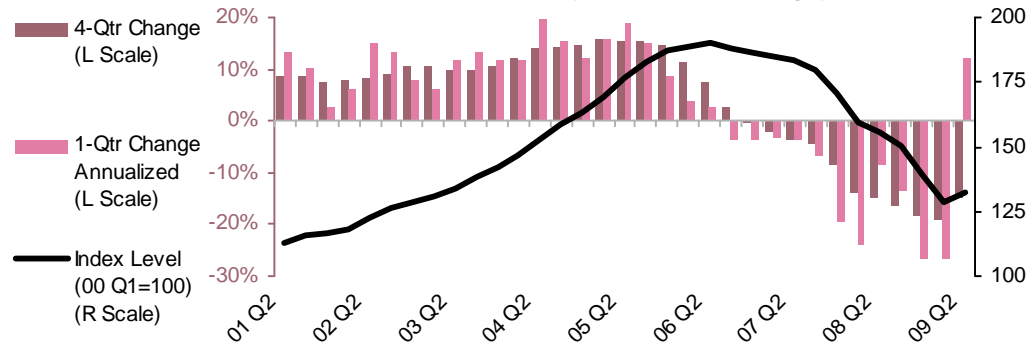
(Source: IHS Global Insight)



1.6 U.S.: Housing – National View

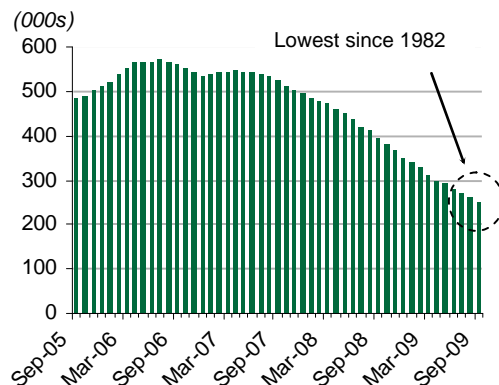
- It appears that housing prices may be stabilizing or slowing in many markets. The Case-Shiller Index showed positive month-over-month price changes in a number of markets over the past several months.
 - Home sales are skewed towards the lower end of the price range because of the \$8,000 first-time home buyer's tax credit. More expensive homes, especially those that require jumbo mortgages, are still not moving.
 - Congress extended and expanded the first-time homebuyer's tax credit beyond its November 30 expiration date to include higher income and home price caps.
- Apartment owners are not faring much better. Near record vacancy and falling effective rents are the by-product of weak employment and household growth and competition from condos and single family home rentals.
- Housing starts are being held back by record foreclosure levels but have bounced back from their recessionary nadir. Until foreclosure levels abate, it will be difficult for builders to significantly increase new home construction. A welcome by-product of depressed housing starts, the inventory of new homes is at its lowest level since 1982.
- The Federal Government is pressuring banks and mortgage companies to accelerate their loan modification programs. However, with total unemployment including discouraged and part-time workers running at 17.5%, many homeowners cannot afford even the most generous modification.

S&P/ Case-Shiller National Home Price Index (Source: IHS Global Insight)



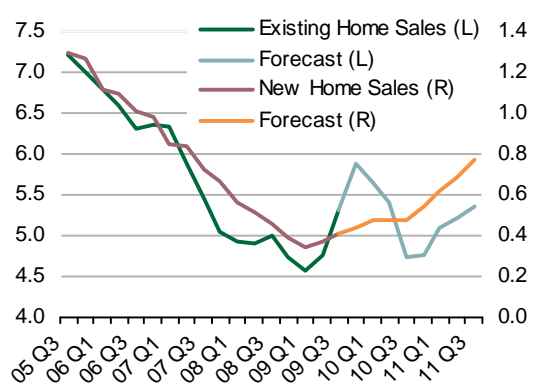
Inventory of New Homes

(Source: IHS Global Insight)



Home Sales (Millions; SAAR)

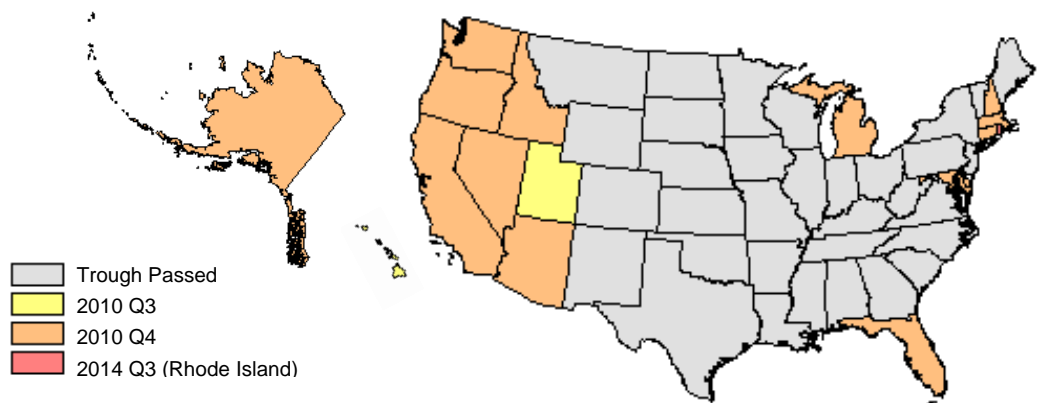
(Source: IHS Global Insight)



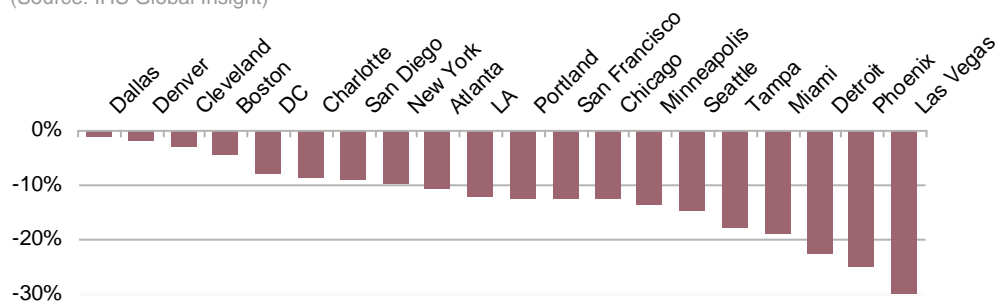
1.7 U.S.: Housing – Regional View

- As pointed out in past Quarterly Reports, not all U.S. housing markets are on the verge of collapse. However, there is little evidence to suggest that those markets which have weathered the storm are in any position to take off and those that are under siege are likely to experience further price declines in 2010.
- The least affected markets tend to be those that did not participate in the price wars earlier this decade. On the other hand, they also tended to be secondary and tertiary Midwestern and Mountain State markets of limited size and impact on the larger economy. Energy and commodity-centric markets are likely to show greater resiliency now that oil is above \$75/barrel and commodity prices are well off their bottoms. For example, while Des Moines may be an important insurance hub, the positive effects of its relatively healthy housing market are overwhelmed by the problems plaguing Southern California.
- The debt of the housing downturn has not been limited to “for sale” housing. According to Reis, national vacancy rates are approaching their highest levels in almost 30 years and effective rents are retreating, depressing net operating income. With little evidence of a robust job recovery in sight, a turnaround in rental fundamentals is some time away.
 - Refinancing risk will be an issue for a significant number of apartment owners and could create additional downward pressure on transaction prices. Many owners in Florida, Arizona, Nevada, and Southern California are likely to have negative equity positions and may be forced to return the keys to their lenders if they cannot inject additional equity into their projects.

Forecasted Trough of State Median New Home Prices (Source: IHS Global Insight)



S&P/Case-Shiller Metropolitan Home Price Indices (12-month Change through August 2009)
(Source: IHS Global Insight)

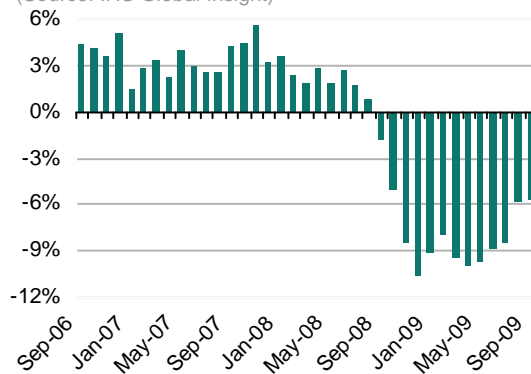


1.8 U.S.: Consumer Activity

- Nothing like a “cash for clunkers” program to bring out the best and worst effects of government intervention. While the program temporarily boosted auto sales and production, the party is now over and sales have dropped as expected. This pattern may be an early warning to government policymakers that Milton Friedman was right and that consumers are quick to distinguish between “permanent” and “transitory” changes, thereby limiting the impacts of the current stimulus package
- Grosvenor Research also wants to know if the Administration wants families to deleverage or spend their way out of the recession. The latter seems unlikely in light of a hemorrhaging job market, while continued saving would delay the recovery even further. It is an interesting policy dilemma which has no easy answer.
- Non-auto consumer spending has begun to slowly climb in recent months. While a positive sign, it is difficult to imagine that there is much momentum behind this trend given the state of the nation’s employment and housing markets.
 - Grosvenor Research is concerned that if oil prices were to remain above \$80/barrel, it could affect the recovery as consumers are effectively paying an “oil” tax and will have to reduce their discretionary spending to compensate.
- While some high-end retail sales are stabilizing, consumers remain price sensitive. WalMart is expanding its product line to include higher-end electronics as well as mobile phone services.
- Higher taxes and fees will put additional pressure on retail sales again hitting discretionary spending harder than basic necessities.

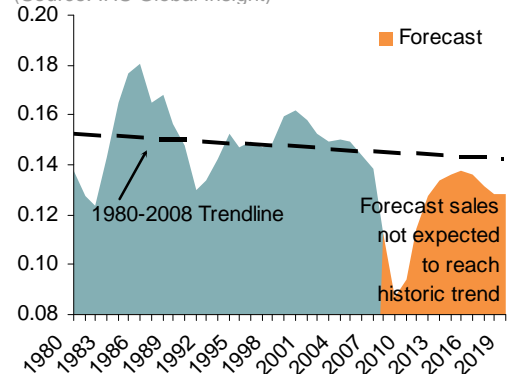
Retail Sales (12-month Changes)

(Source: IHS Global Insight)



New Light Vehicle Sales per Household

(Source: IHS Global Insight)



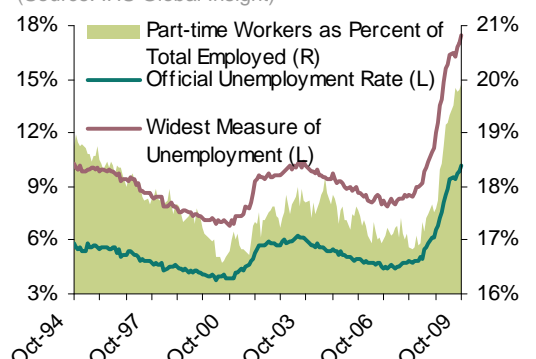
Savings Rate

(Source: IHS Global Insight)



Employment Indicators

(Source: IHS Global Insight)

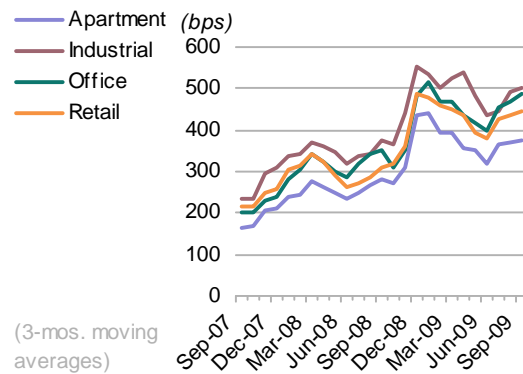


1.9 U.S.: Real Estate Capital Market Overview

- Capital market conditions have shown little improvement in recent months. In fact, the Fed is now concerned that banks are significantly under reserved for the expected wave of commercial real estate loan defaults. At greatest risk are smaller regional and local banks who have a higher exposure to real estate than larger national banks.
 - CapMark, one of the nation's largest commercial real estate lenders, declared bankruptcy in October and several well known mega-deals are also expected to collapse in the near-term. At the end of June, CapMark had approximately \$290 billion in loans.
- Grosvenor Research is forecasting difficulties for commercial real estate borrowers during the coming quarters as a wave of refinancing swamps the capital markets.
 - Many borrowers will need two new layers of capital: equity injections to meet lending covenants and a lender who has the capital base and willingness to lend. Neither of these conditions will be easy to meet for a significant number of property owners.
 - This will clearly increase the asset class's risk profile as will continued erosion in effective rents and occupancy.
 - With real estate prices already down 30-40%, on average, many owners are effectively underwater without any additional price declines. Add to that restrictions on gearing and it is clear that they have a tough decision to make: inject more equity capital into the deal or hand back the keys.
- TALF has had only a marginal effect on creating liquidity in the securitized markets and with the program ending next Spring, it is unlikely to have a major impact on market liquidity.

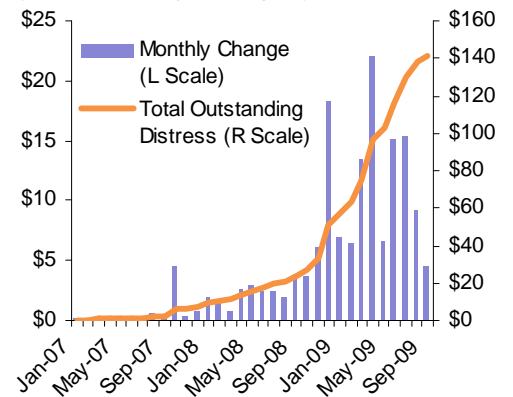
Cap Rate Spreads to Ten-Year U.S. Treasuries

(Source: Real Capital Analytics; IHS Global Insight)

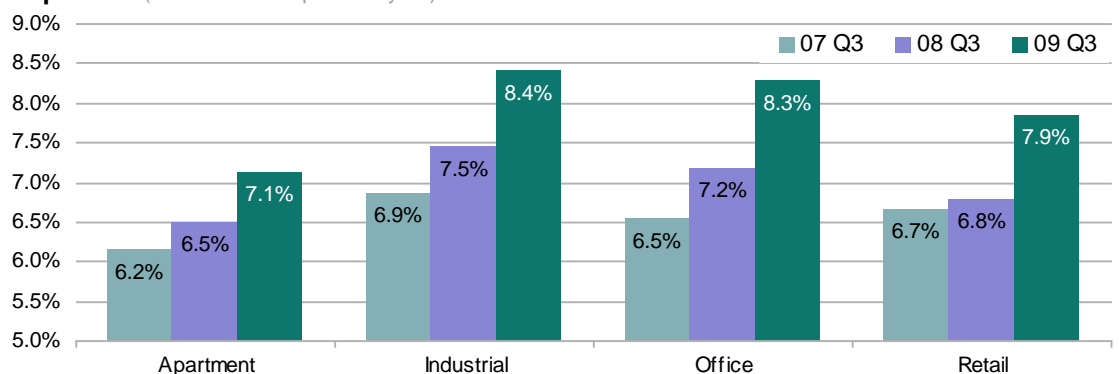


Distressed Assets

(Source: Real Capital Analytics)



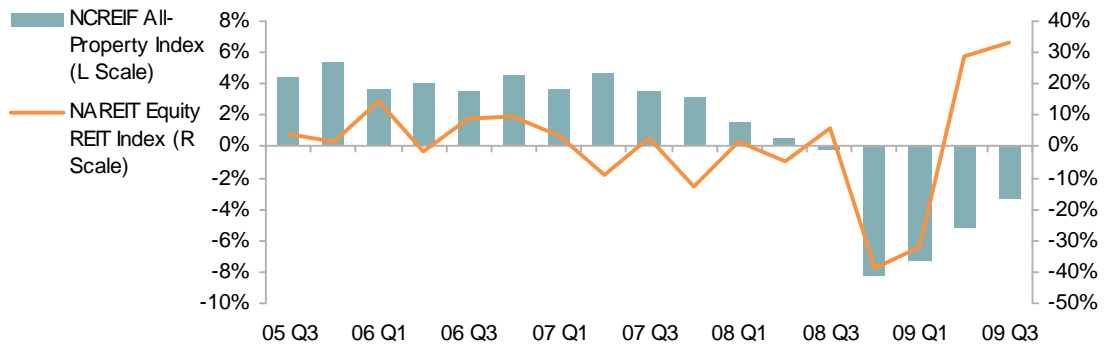
Cap Rates (Source: Real Capital Analytics)



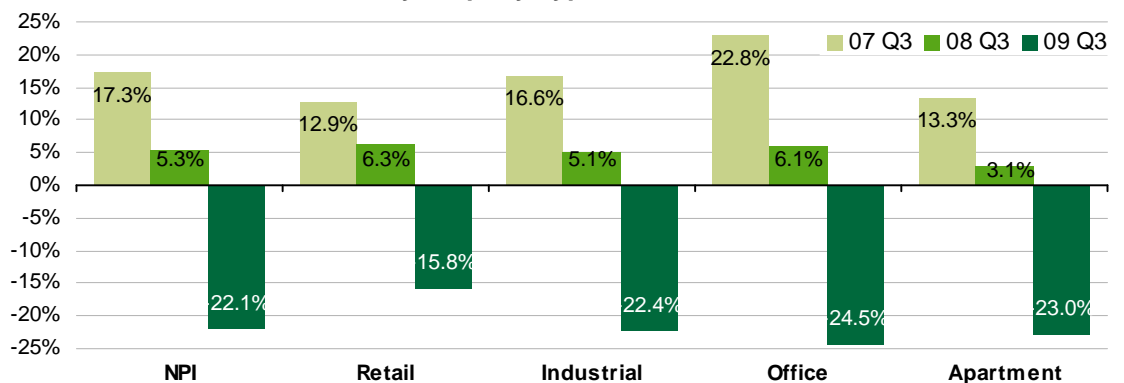
1.10 U.S.: Property Market Returns

- As expected, there is little good news to report on the pricing front. Both published as well as unpublished data show that cap rates are still migrating north and property cash flows are subject to further downward pressure as vacancy rises and effective rents erode in the face of falling demand.
 - The latest economic forecasts suggest that while a recovery is in the works, commercial real estate returns will lag considerably. Employment growth will not return until 2010 and consumer spending will likely remain constrained until labor markets improve.
- Year-over-year NCREIF returns are down 22.1% while equity REIT returns are down 28.4%, but REIT returns have begun to make up some of their losses in recent months.
 - REIT returns tend to lead private sector returns by upwards of 18 months. REITs continue to have an advantage over private equity with their ability to raise debt, helping them with their refinancings and giving some a war chest for future acquisitions.
- Grosvenor Research believes that cap rate compression is likely to be minimal and limited to a select group of markets and subsectors over the next several years and be concentrated in investments favored by foreign investors.
 - While risk spreads are likely to narrow over time they will be offset by rising Treasury yields. The net effect will be to keep cap rates near their historic averages somewhere between 8 and 9 percent by 2014.
- Private equity property returns will not see a bounce for some time to come. Growing mortgage defaults, deteriorating market fundamentals, and expensive and restricted capital will keep prices from rebounding soon.

Total Returns by Quarter



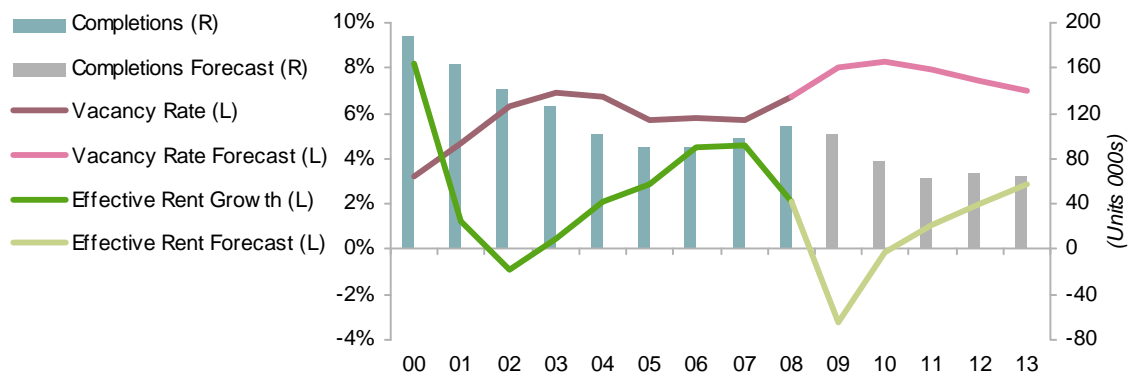
NCREIF Annual Total Returns by Property Type



1.11 U.S.: Multi-Family Market

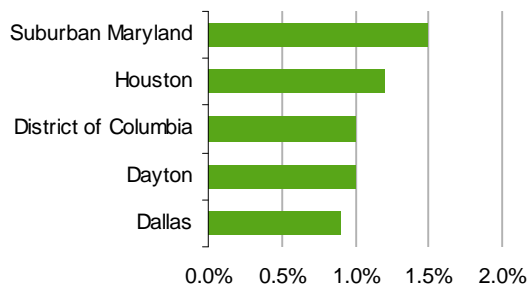
- What separates this real estate cycle from the typical cycle is how problems have spread to the apartment sector. Typically when the economy softens, multi-family properties are affected but also benefit from the shift away from homeownership. However, this recession has been so pervasive that rental properties have also been unable to escape unharmed.
 - The massive oversupply of single family homes and condos are now competing with institutional properties for tenants.
 - Vacancy rates are now approaching record levels according to Reis and effective rents are still shrinking.
 - This trend is likely to continue well into next year and there are few signs that a turnaround is in the making.
- In most markets, overbuilding is not the culprit, unlike previous cycles. This time around it is a massive inward shift in demand. This will remain the case until we see significant job growth as well as a reduction in the available supply of “for rent” single family homes and condos.
 - While Fannie and Freddie are still offering advantageous financing, demand fundamentals are making it difficult for borrowers to refinance or non-cash buyers to secure financing. The capital markets offer multi-family owners and investors one advantage over other land uses. The question is how long this window will remain open.

Apartment Market Indicators (Source: Reis)



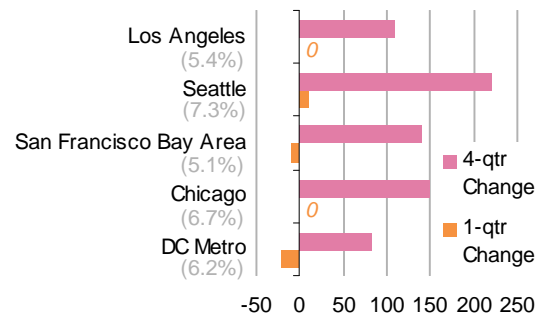
Top 5 Rent Growth Markets

(08 Q3 – 09 Q3) (Source: Reis)



Selected Vacancy Rates

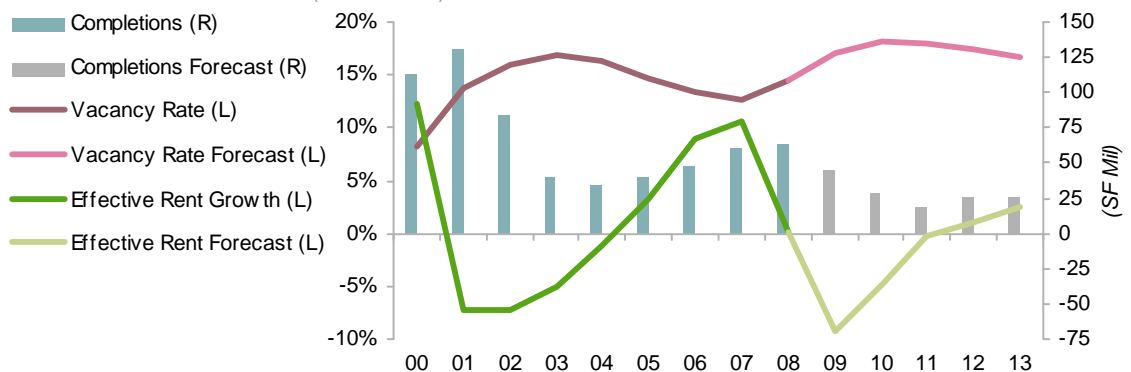
(09 Q3) (Source: Reis)



1.12 U.S.: Office Market

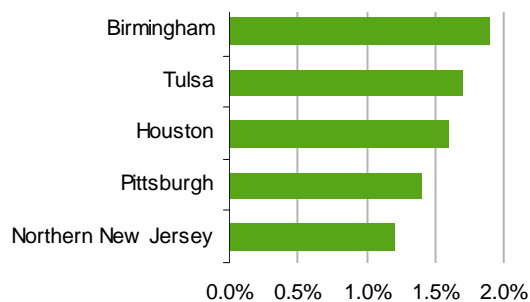
- It should come as no surprise that office vacancy rates continue to climb. Now standing at 16.5%, vacancy rates rose in 67 of 79 markets followed by Reis.
 - While some large leases have been signed as firms take advantage of plummeting rents, these mega-transactions are not enough to shift market fundamentals.
 - Effective rents are marching in lockstep with occupancy. That is, they continue to decline as owners compete for a limited number of available tenants.
 - In turn, tenant concessions continue to grow. This puts additional pressure on the average owner who must find the capital for TIs and other expenditures even as cash flow shrinks.
 - Foreign capital seems to have some increased interest in select CBD office purchases.
 - But their interests are limited and are insufficient to support the general market.
 - In many markets, no new demand driver is emerging. Banks and financial institutions are not expanding, small and mid-sized businesses, even if they could expand, are living in a capital constrained world. At this time, Grosvenor Research is unable to identify who the next White Knight might be.
- Office cap rates are climbing and values could be adversely affected by the coming wave of CMBS and mortgage defaults.
 - This will act to depress transaction prices and delay a bottom from being formed.
- Grosvenor Research believes that patience will be a virtue and that it is still too early to aggressively jump back into the market except when a unique opportunity presents itself.

Office Market Indicators (Source: Reis)

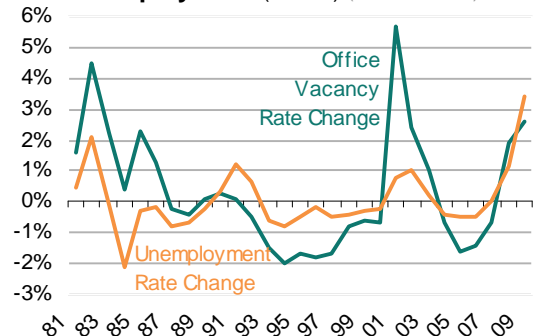


Top 5 Rent Growth Markets

(08 Q3 – 09 Q3) (Source: Reis)



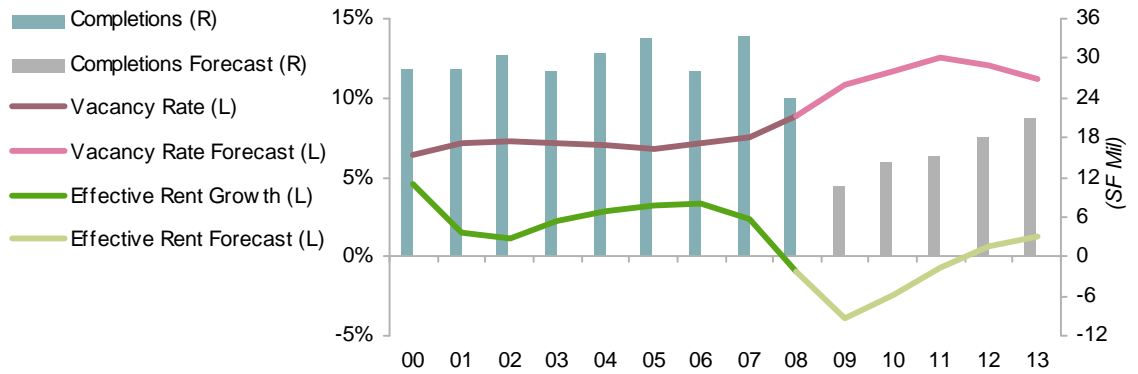
Absolute Changes in Office Vacancy and Unemployment (09 Q3) (Source: Reis)



1.13 U.S.: Retail Market

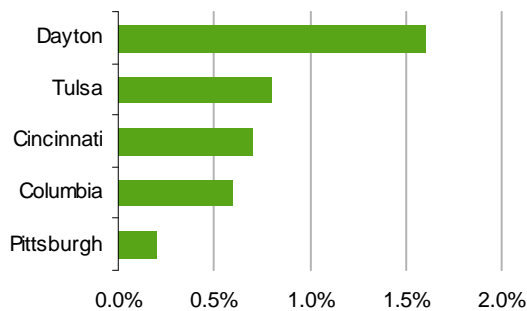
- While it is true that retail sales have been growing ever so slowly in recent months, it is difficult to get too excited given the employment and wage picture. Winners remain largely value retailers such as WalMart, TJMaxx, and Dollar Stores as consumers remain more concerned about labels at the same time these retailers have improved their product lines.
- NCREIF retail appreciation returns have outperformed other major land uses, which comes as some surprise given the depth and duration of the recession as well as the amount of new retail construction that hit the markets over the past 24 months. Appraisal lags may still be influencing returns but it is clear that centers in secondary and tertiary markets and locations are being most affected.
 - Until household incomes rebound and employment growth returns, most consumers will not be eager to purchase large discretionary items. Evidence of this behavior comes from the government's "cash for clunkers" program which temporarily boosted car sales and largely borrowed from future sales.
 - Given the employment and wage forecast, it is unlikely that U.S. retailers will see significant improvements in retail sales until sometime in late 2010 or 2011.
- Over the next several years, a number of malls and regional and strip centers will go dark and could resurrect themselves as mixed-use centers. Unfortunately, many will remain shuttered indefinitely.

Retail Market Indicators (Source: Reis)



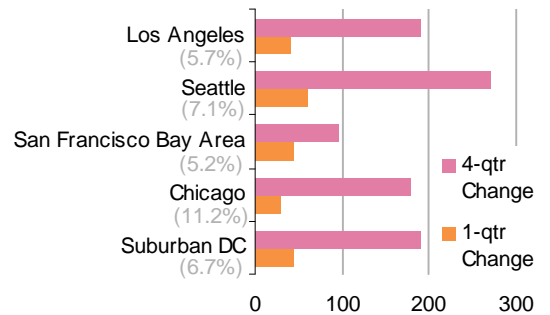
Top 5 Rent Growth Markets

(08 Q3 – 09 Q3) (Source: Reis)



Selected Vacancy Rates

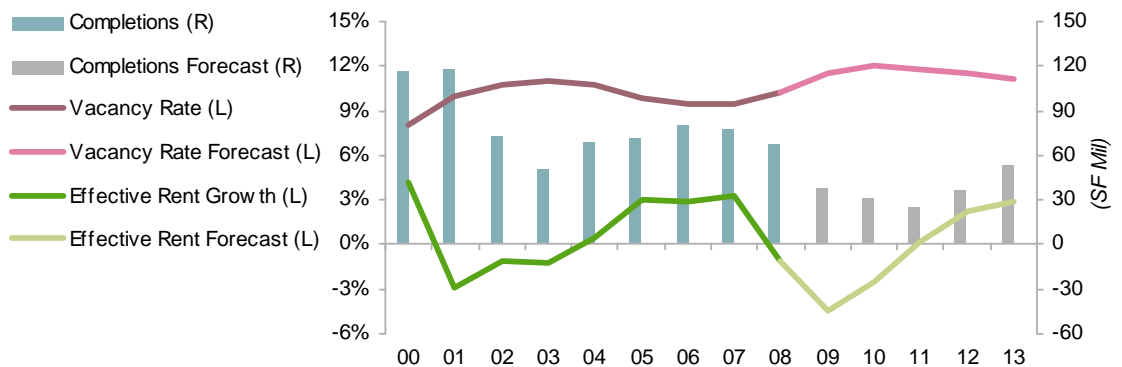
(09 Q3) (Source: Reis)



1.14 U.S.: Industrial Market

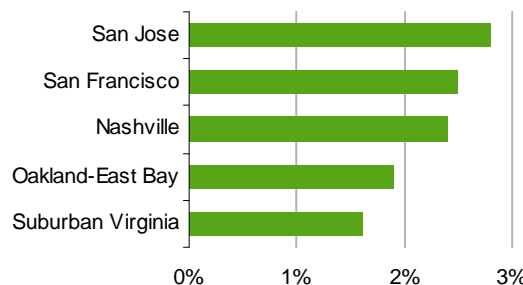
- The industrial property sector remains largely unchanged. With a beta that is closely related to the overall economy, it will likely be one of the first property uses to see some relief as the economy improves.
 - With inventory ratios now at near historic lows, they are beginning to trend upwards and should benefit industrial demand or at least stabilize it in many markets.
 - A weak dollar should also bolster exports which in turn should be another small bit of good news for warehouse owners in manufacturing nodes. Owners in transshipment locations are likely to see little change since higher exports are likely to be offset by lower imports if the dollar remains weak.
- Over the past 12 months, NCREIF Industrial property values have fallen 27.5% similar to that of office and retail properties but because industrial construction activity is the first to react to a downturn, overbuilding is of minimal concern. Therefore, any increase in demand should bring down vacancy rates in all but a handful of markets.
 - Product differentiation will be critical since “bread and butter” industrial space will likely become less popular as generic demand for industrial space diminishes over time. While we will still need generic space, the better performing assets need to be capable of handling specialized equipment, extra heavy loads, and be flexible enough to meet the requirements of a variety of potential users.

Industrial Market Indicators (Source: Reis)



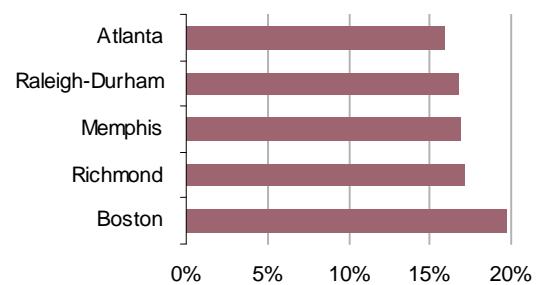
Top 5 Rent Growth Markets (2007-2008)

(Source: Reis)



Top 5 Highest Vacancy Markets (2008)

(Source: Reis)



2.0 Canada

2.1 Canada: Executive Summary

- Canada's economic performance has been disappointing of late and it is looking more likely that third quarter real GDP growth may barely make it into positive territory. Early hints of this came when August's estimates showed negative growth.
- Commodity exports remain Canada's primary economic driver. With oil prices hovering around \$80, the Canadian dollar is once again appreciating against the Greenback. This puts a governor on growth by boosting imports and dampening other exports such as tourism.
 - Canada's resource dependency increases the country's risk profile and makes it vulnerable to future commodity bubbles.
- While moderate growth will return in 2010, it will not be until 2011 when employment growth and consumer spending show significant improvement.
 - Canadian employment fell by over 43,000 workers between September and October signaling that the economy is not yet out of the woods. The best that can be said is that at 8.6%, Canada's unemployment rate is well below that of the U.S. However, at the same time, with approximately 80% of its exports going to the U.S., employment still remains highly dependent on the health of the U.S. economy.
 - The Canadian housing market which was never on life support seems to be holding its own and is beginning to show signs of life.
 - Consumer spending has languished in recent months, but appears to be bottoming out and should gain strength as the economy improves next year.
 - One significant advantage relative to the U.S. is the health of the Canadian commercial banking system. While capital flows are significantly down from their peak, at least Canadian banks are not burdened by the problems facing their U.S. counterparts.
 - Higher oil prices are spurring capital spending by oil companies and should continue to enhance Western Canada's long-term growth prospects. However, the level of new investment will pale in comparison when oil peaked at \$140 barrel. In fact, projects undertaken on the assumption that prices would remain at those elevated levels will show disappointing returns.
- The Bank of Canada is expected to maintain its current policy of keeping rates low well into next year following Washington's footsteps. This is not usual given the high correlation between U.S. and Canadian monetary policy.
 - Canadians are now deficit spending, something which they have not done in a number of years. While as a percentage of GDP it is much lower than many other developed countries, it is a growing point of contention.
 - As part of its stimulus spending, the Canadian Government is providing cash injections into the country's auto sector, in a similar fashion as the Obama Administration. Strong

Federal transfers to Provincial Government will continue and help with infrastructure spending. Tax cuts are also being employed as a stimulus tool.

- Regional growth disparities remain and can be largely explained by natural resources. Ontario's outlook will be hampered by the strong Loonie and its concentration in auto production, while Western Canada and Nova Scotia will benefit from recovering oil and other commodity prices. Eventually, even the lumber industry should see higher exports when U.S. housing starts begin to accelerate in 2011 and 2012.
- Business fixed investment remains disappointing. The strong Canadian dollar hurts what's left of the country's manufacturing base and more specifically, depressed auto sales will do little to encourage major reinvestment in plant and equipment.
- The Winter Olympics will distort short-term growth figures especially in British Columbia which will enjoy an unsustainable boost in activity during 2010 first quarter.

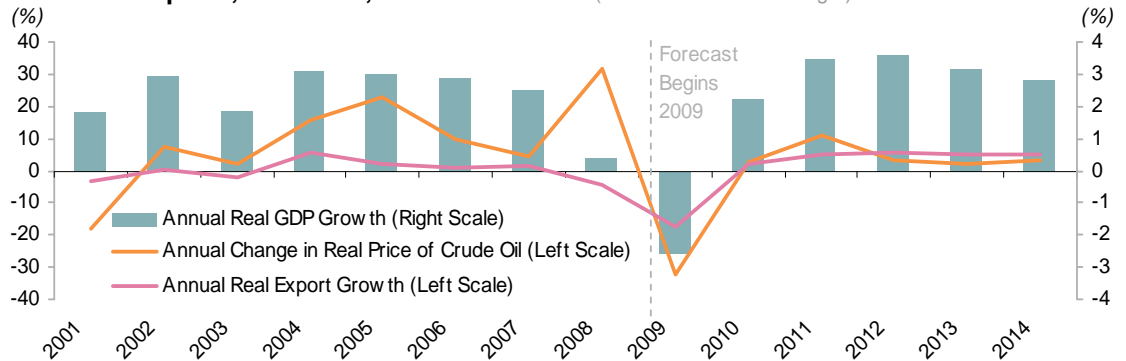
Canada Macroeconomic Outlook (Source: IHS Global Insight)

	2006	2007	2008	<i>Forecast begins 2009</i>				
				2009	2010	2011	2012	2013
Real GDP Growth	2.9%	2.5%	0.4%	-2.5%	2.2%	3.5%	3.6%	3.2%
Employment Growth	1.9%	2.3%	1.5%	-1.8%	0.5%	1.9%	1.5%	1.8%
Unemployment Rate	6.3%	6.0%	6.2%	8.3%	8.8%	8.4%	7.9%	7.6%
Housing Starts (Millions)	0.23	0.23	0.21	0.14	0.17	0.17	0.18	0.18
Long-Term Interest Rates	4.2%	4.3%	3.6%	3.4%	3.9%	4.0%	4.6%	5.0%
\$C per \$US	1.13	1.07	1.07	1.15	1.12	1.10	1.07	1.07
Crude Oil (US\$ per barrel)	\$66	\$72	\$100	\$62	\$68	\$77	\$83	\$87
Consumer Prices (%Chg)								
Total	2.0%	2.1%	2.4%	0.5%	1.8%	1.9%	2.0%	2.0%
Core	1.5%	2.0%	1.2%	1.2%	1.2%	1.5%	2.0%	2.3%

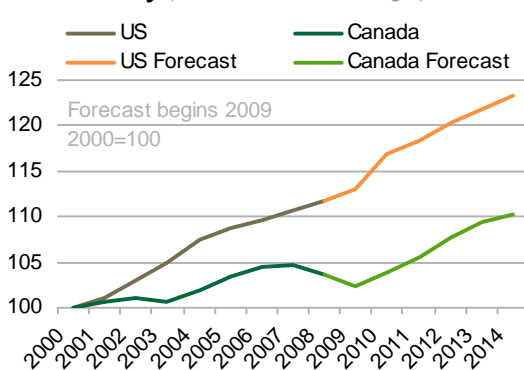
2.2 Canada: Trade and Productivity

- Trade for breakfast, trade for lunch, and trade for dinner. Given Canada's relatively small population and its vast wealth of natural resources, exports are its natural comparative advantage.
 - This is also true for the country's transportation industry. Canada's production of cars, planes, and trains far exceeds that which could be consumed domestically and with U.S. auto sales showing no early signs of improvement, this bellweather sector of the Canadian economy will continue to underperform.
 - Since the mid-1990s Canadian productivity growth has been lower than the U.S. This chronic disadvantage makes it harder for nonresource-based Canadian industries to successfully compete in the global economy.
 - Several factors have been cited for this trend including reduced higher education spending as a percentage of national output and disappointing capital spending on computers and technology by Canadian companies, ultimately resulting in higher capital costs.
 - Near parity with the U.S. dollar will hurt unit exports even when the U.S. economy recovers. A strong Canadian dollar makes non U.S. dollar denominated Canadian exports less competitive.
- Every quarter, Grosvenor Research harps on the poor performance of Canadian companies when it comes to investment spending. Without a massive injection of capital spending, Canadian manufacturing will become an endangered species. New roads and bridges help, but they will do little good if there is nothing to sell.

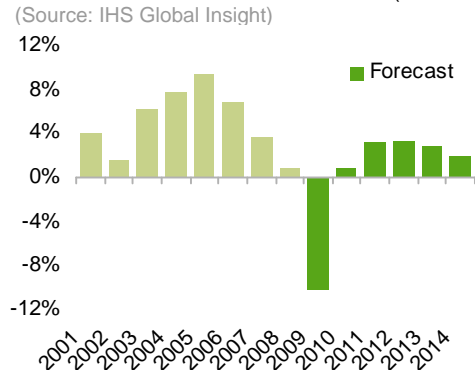
Canadian Exports, Oil Prices, and GDP Growth (Source: IHS Global Insight)



Productivity (Source: IHS Global Insight)



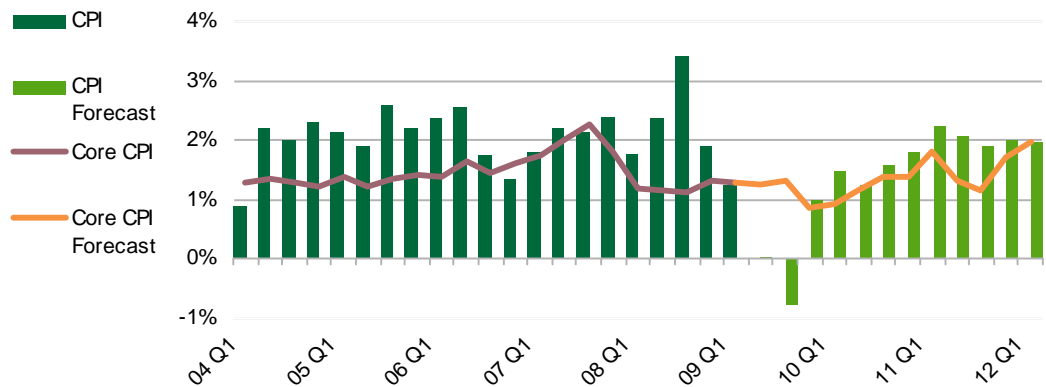
Real Fixed Investment Growth (12-mos Chg) (Source: IHS Global Insight)



2.3 Canada: Inflation and Exchange Rates

- Canadian core inflation remained under 2% for the year ending in October, consistent with expectations and within the Bank of Canada's target. This gives central bankers some breathing room to keep interest rates low for some time. However, they will remain hyper diligent and move quickly to reduce any inflationary pressures.
 - October's positive inflation contrasted with September's price decline. Ironically, higher gas prices were to blame.
 - With excess capacity, labor costs will not be a factor in driving up costs much like the U.S. This should also add to the downward pressure on prices, thereby helping to avoid an unexpected surge in consumer inflation.
- Rising commodity prices has bolstered the Canadian dollar, putting downward pressure on import prices. This is the mirror image of what is happening in the U.S.
 - While a strong Loonie may help consumers, it is a formidable barrier for many. Therefore, if the Loonie approaches or exceeds parity with the U.S. dollar, the Central bank may be forced to step in and make the currency less attractive.
- Exchange rate parity seems unlikely, but possible, if oil and other commodity prices accelerate. However, in the short-run, there seems to be some backing off of "risky" currencies because of a possible imbalance between supply and demand for many commodities.

Inflation (Source: IHS Global Insight)



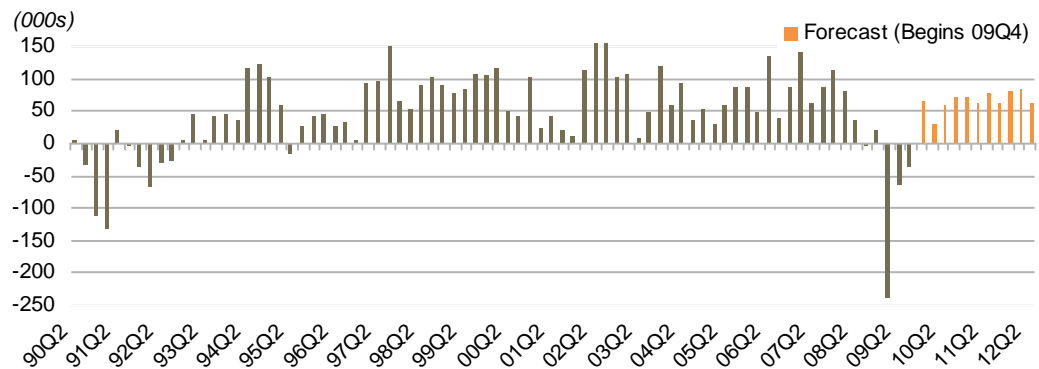
Canadian Dollars per U.S. Dollars (Monthly Average) (Source: IHS Global Insight)



2.4 Canada: Employment and Labor Force

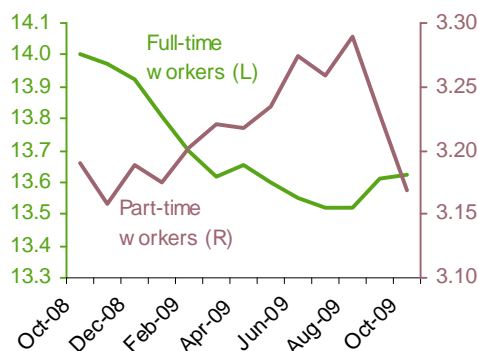
- August's negative GDP estimate does not give much hope for a quick turnaround in the job outlook and was probably a preview of the October job's report.
 - Canadian employment levels receded by over 43,000 workers between October and September and almost 340,000 in the last year. While auto industry employment has ticked up slightly because of the "cash for clunkers" program, other sectors are not running on all cylinders.
- Provincial and Federal budget deficits are growing, therefore making it less likely that public employment will continue to be a major job engine, although stimulus spending will continue. Even Alberta is expected to have a \$C7 billion dollar deficit this fiscal year. The projected record Federal budget deficit of over \$C55 billion is also uncomfortably high for most Canadians.
- British Columbia will experience a surge in temporary employment because of the Winter Olympics. This bubble will not last and by the second quarter, employment and retail sales will revert back to more sustainable levels.
- Significant employment gains will return in 2011 as growth returns. However, there is a risk that if the U.S recovery is delayed or the Canadian dollar becomes too strong, it will limit Canadian employment growth.

Quarterly Change in Canadian Employment (Source: IHS Global Insight)



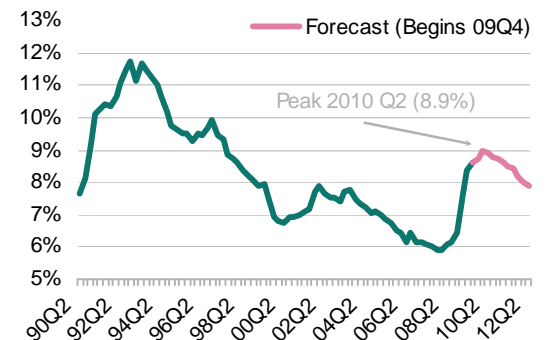
Composition of Workers (Thousands)

(Source: IHS Global Insight)



Unemployment Rate

(Source: IHS Global Insight)

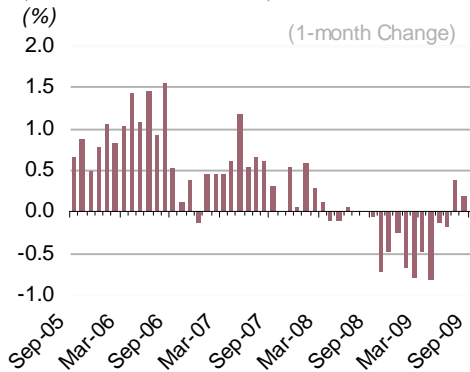


2.5 Canada: Housing

- While housing starts are well below their pre-recession peak, home prices have not seen a major correction. In fact, CMHC expects average resale home prices to climb modestly both in both 2009 and 2010.
 - With few “toxic” mortgages, the combination of low interest rates and unmet demand lend support to a slow march back to recovery. While, on average, pricing trends will be more moderate, they will also be more sustainable.
 - Housing starts are stabilizing and may actually be showing signs of a minor upward trend and, like the U.S., it will be some time before construction activity returns to pre-recessionary levels. Starts are expected to increase by almost 25,000 to approximately 165,000 units in 2010 and reach 187,000 by 2013, according to CMHC. However, that is still almost 50,000 fewer units than were started in 2004.
- Demand in Vancouver and Toronto continues to originate from foreign investors seeking capital protection and/or diversification. These investors provide a key underpinning to these markets.
- The jewel in the crown remains rental housing. Low vacancies and low turnover provide owners with consistent bond-like returns. Since apartment properties do not typically trade at prices that make them to attractive to institutional investors as rental properties, they are often viewed as potential condo conversions. For those who keep them as rental properties, they offer bond-like returns and relatively low volatility.

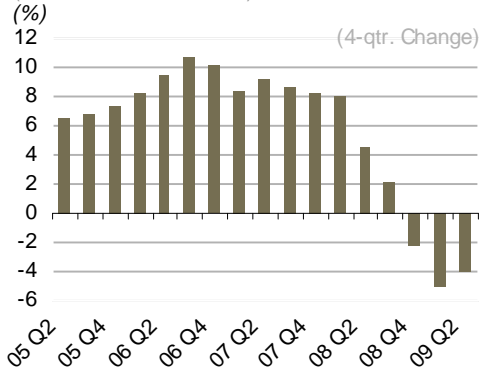
New Housing Price Growth

(Source: Statistics Canada)



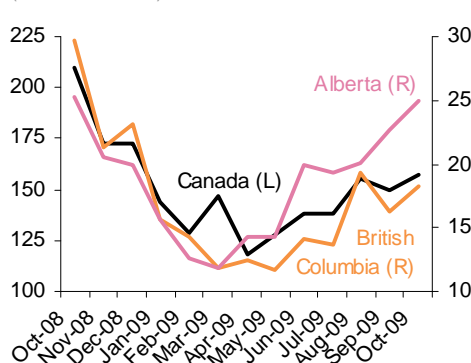
Existing Home Price Growth

(Source: Bank of Canada)



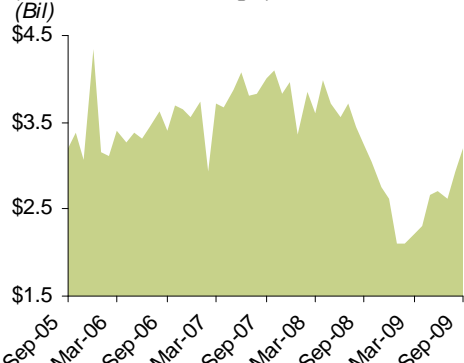
Housing Starts (000s; SAAR)

(Source: CMHC)



Residential Building Permits

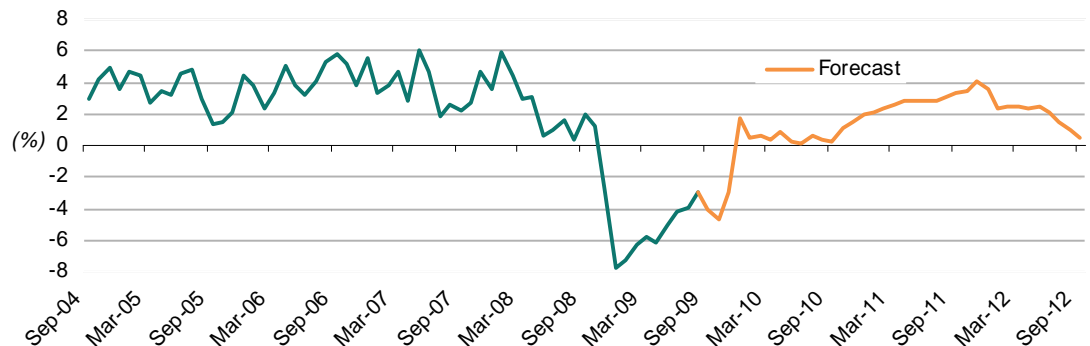
(Source: IHS Global Insight)



2.6 Canada: Consumer Activity

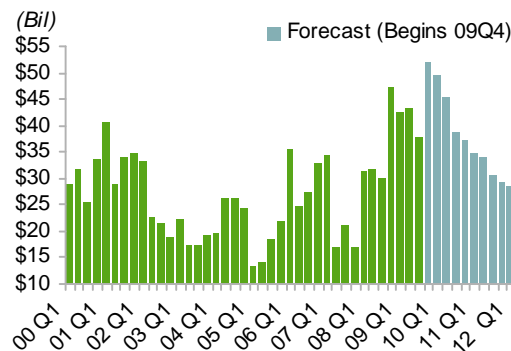
- The good news is that Canadian real retail sales have been on an inexorable slow climb since the beginning of the year. The bad news is that they are still below 2008 levels.
 - The latest retail sales numbers from August show broad-based improvement, although excluding gasoline sales, retail sales were flat.
 - Sales increases were registered in most Provinces, although sales did fall slightly in Alberta.
 - Expect to see a surge in Olympic-related retail sales in British Columbia in the first quarter, then followed by a drop off in the second quarter since the Games last less than a month. It will take several quarters for all the secondary and tertiary effects to dissipate. The Game's longest lasting benefits will be its public works projects including the Canada subway line.
- Until the U.S economy comes out of hibernation, it is unlikely that retail sales will register strong gains. Expect steady improvement in retail activity but tempered by above average unemployment.
 - The good news continues to be on the currency front where an appreciating Canadian dollar helps lower import prices. Of course a stronger Loonie also reduces tourism and hurts manufacturing.

Real Retail Sales Growth (12-month Change) (Source: IHS Global Insight)



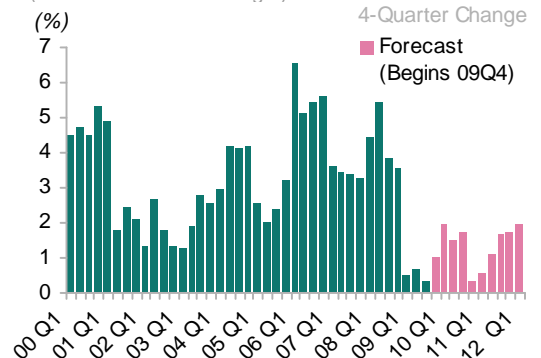
Household Savings

(Source: IHS Global Insight)



Real Disposable Income Growth

(Source: IHS Global Insight)



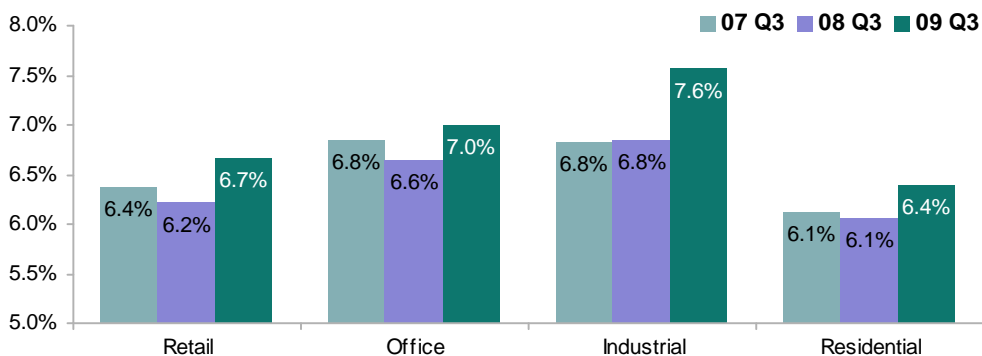
2.7 Canada: Real Estate Market Overview

- As an economic recovery begins to slowly unfold, a clearer picture has emerged as to which land uses have been most affected by the downturn.
 - Canada's multifamily market has escaped the recession relatively unscathed. This is not surprising given how supply-constrained the sector remains because of its comparatively low returns.
- The office and industrial sectors continue to underperform.
 - Most of the disruption to the office market is concentrated in Calgary and Toronto.
 - In contrast, difficulties in the industrial market are more broad-based, with the notable exception of Vancouver.
- Retail properties and returns have remained surprisingly resilient, largely because retail sales have not contracted as much as first feared.
- The fear that froze commercial real estate activity for several quarters has dissipated. Brokers indicate that sentiment has improved, inquiries have risen, and leasing activity has noticeably increased.
 - However, transaction volume remains weak despite some improvement in investor sentiment. A significant bid-ask spread exists as many owners are reluctant to sell unless necessary. Furthermore, although the debt market has thawed a bit, it stills remains an impediment.

Cap Rate Spreads to Long-Term Rates (Sources: IPD; IHS Global Insight)



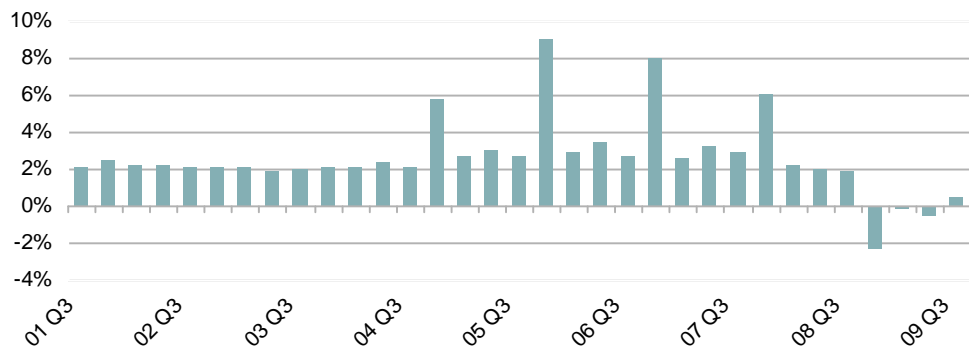
Cap Rates (Source: IPD)



2.8 Canada: Property Market Returns

- The IPD All-Property Index ventured back into positive territory in the third quarter, recording a .6% total return after three consecutive negative quarters. However, year-over-year returns are still negative (-2.4%) but well above U.S. returns.
 - Cap rates continued to increase across all major land uses. The IPD All-Property cap rate has increased every quarter since 2008Q1 and now stands at 6.9%. The All-Property vacancy rate continues to increase as well, climbing 110 basis points since 2008Q2. Offsetting this has been a 5% surge in rental growth over the past year.
 - The Canadian office market eked out a positive total return for the quarter, although this is unlikely to be a harbinger of things to come given below average employment growth and a spate of new property deliveries. Perhaps anticipating further erosion in market fundamentals, institutional office cap rates have climbed to 7% for the first time since the beginning of 2007.
 - Retail total returns grew 1.4% last quarter but returns still remained negative on a year-over-year basis.
 - The Industrial property sector continued to falter, registering its fourth consecutive negative quarterly total return. Cap rates have increased 80 basis points over the past year, while the national vacancy rate, according to IPD, has doubled since 2008Q2.
 - Multi-family properties are the only land use to have recorded positive total returns over the past year. However, this past quarter multi-family returns declined, largely due to Alberta's poor performance.

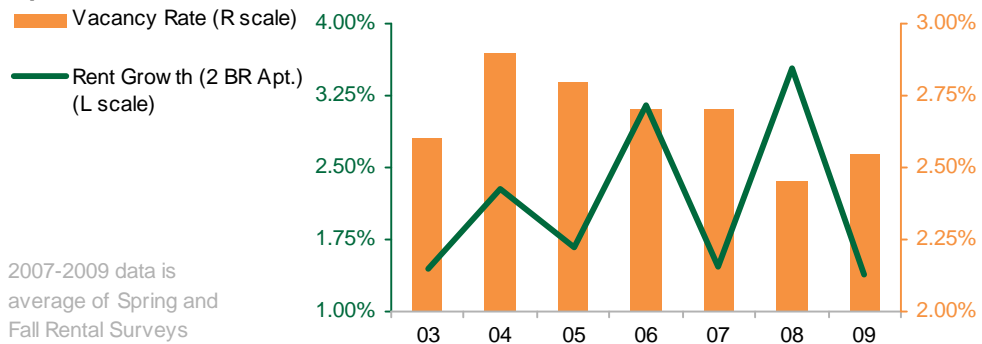
IPD Total Returns By Quarter – All Property, Standing Investments



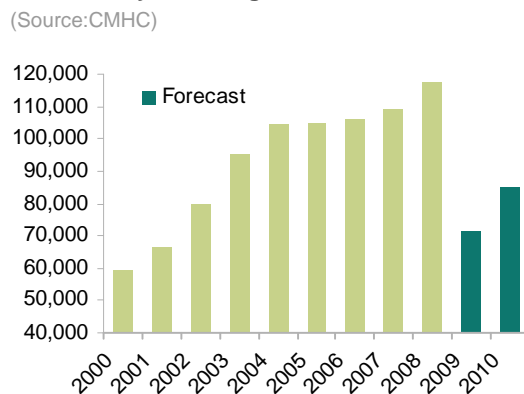
2.9 Canada: Rental Multi-Family Market

- Slow and steady is the best description for the Canadian multi-housing market. A growing immigrant population as well as a downward trend in average household size are providing the underpinnings for on-going demand. Furthermore, sub 4% debt financing from CMHC also buttresses the sector from volatility. As a result, cap rates for rental properties have barely moved during 2009.
 - As the housing market began to stumble during last winter, builders in British Columbia and Alberta quickly curtailed supply. Starts, however, are expected to increase in 2010, as available inventories of new homes and apartments stabilize.
- Though the sector has held up well, it has not been entirely immune to the recession. Softening rental growth and minor upticks in availability rates are becoming common in many markets.
 - According to IPD, institutional multi-family returns in Western Canada have lagged the rest of the country. British Columbia and Alberta have experienced four consecutive quarters of falling property values. Nova Scotia, with five consecutive quarters of value declines, however, leads the pack.
 - IPD reports cap rates for British Columbia have risen over 50 basis points since 2008Q3 to 5.4%, and 22 bps in Alberta during the same period.

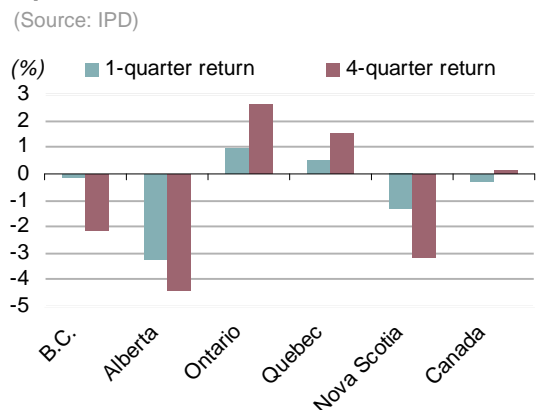
Apartment Market Indicators (Source: CMHC)



Multi-family Housing Starts (Source: CMHC)



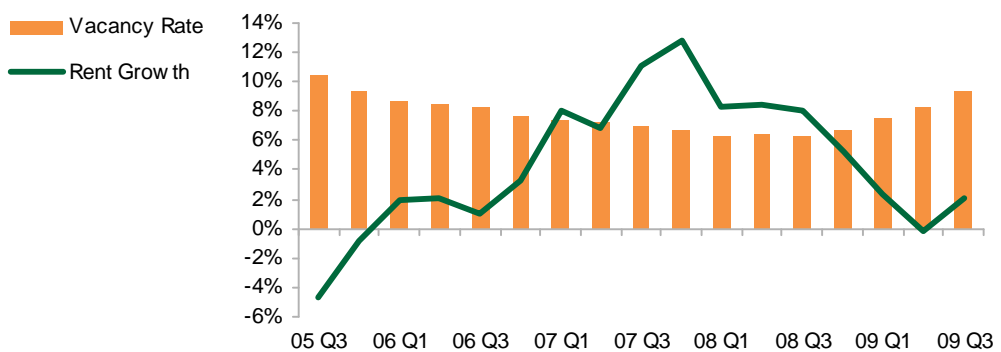
Apartment Total Returns (Source: IPD)



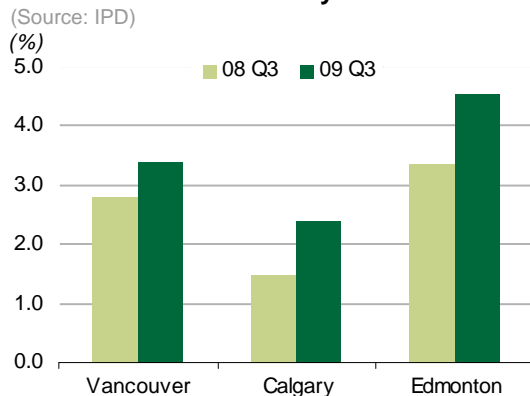
2.10 Canada: Office Market

- Canadian office markets appear to have experienced a temporary reprieve during the third quarter; however, it will not be enough to prevent the Canadian office market from registering its first year of negative absorption since 2003. Not surprisingly, effective rents have also declined. With some employment growth likely in 2010, most Canadian office markets should begin to stabilize in the coming months. The exceptions are likely to be Calgary and Toronto which are trying to cope with a surge in new supply.
- CBRE has reported positive absorption and an increase in national average net rent last quarter, and though this is welcome news, much of it was due to pre-leasing from contracts signed prior to the economic downturn. As a result, these headlines will likely not be repeated in the fourth quarter.
- The Calgary market continues to be a bearer of bad news. Sublet space continues to be a major problem, and now totals 2.2 million sq. ft or 51.3% of total vacant space. In turn, this has led to a 13% decline in average CBD rents. However, Class B buildings are in even worse shape since many of their primary tenants, oil and gas start-up firms, have gone out of business after the collapse in oil prices.
- Vancouver remains relatively stable, though rising vacancies in suburban markets and significant sublease space have impacted effective rents.
- 2009 is on schedule to be the first year in which Canadian developers will bring more CBD than suburban space to market.

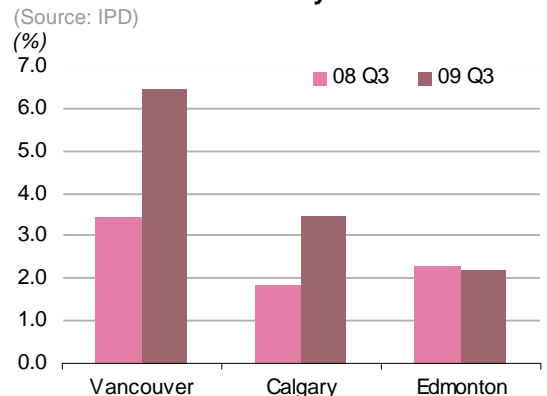
Office Market Indicators (Source: CBRE)



Downtown Office Vacancy Rates (Source: IPD)



Suburban Office Vacancy Rates (Source: IPD)



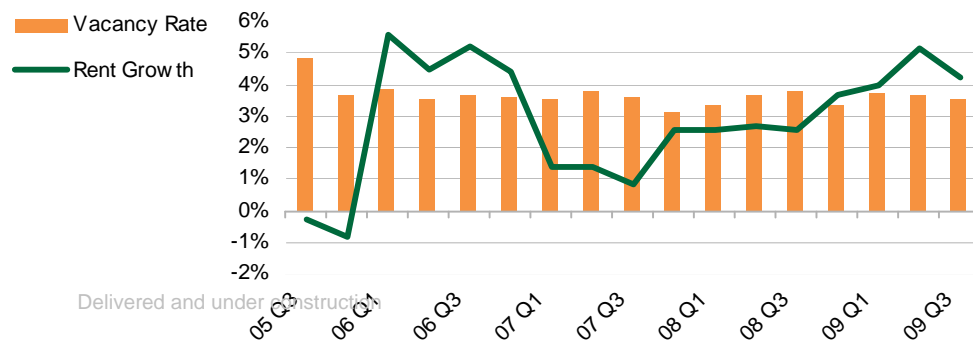
2.11 Canada: Retail Market

- Canadian retailers have been able to avoid much of the damage that has beset their neighbors to the south. Sales still remain below last year's levels, although they have climbed steadily in recent months. However, there is some concern that weak sales in September and October may be a precursor to a weaker 2010 than originally forecasted.
 - Vancouver will benefit from an Olympic-related retail sales boost in early 2010, and it is already seeing stronger retail sales and with it improved leasing activity.
 - Calgary retail has seen no improvement as vacancy rates have ticked up slightly and rents have contracted modestly. Alberta remains the "most stored" province in Canada with 17.8 square feet per capita compared to a national average of 13.5 square feet. This oversupply could delay Calgary's recovery.
 - Retailers focusing on personal necessities have fared the best. Retail sales from food and beverage stores are up 3.6% over the past year, while sales from pharmacies and personal care stores have increased 5.9%.

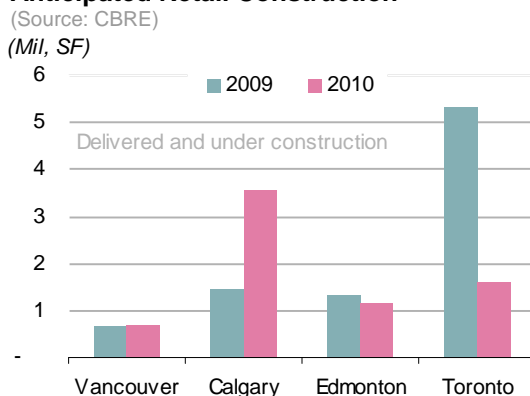
Total retail sales for Canada have fallen 3.3% year-over-year. Automotive retailers have been hit the hardest with sales 11% lower than last year. Furniture, home furnishings, and electronics retailers have performed almost as poorly, dropping 8% over the same period.

- Rebounding housing starts have helped stem any further slide in retail sales, particularly in Alberta. Historically, starts have acted as a stimulus for retail sales as homebuyers stock up on furnishings.

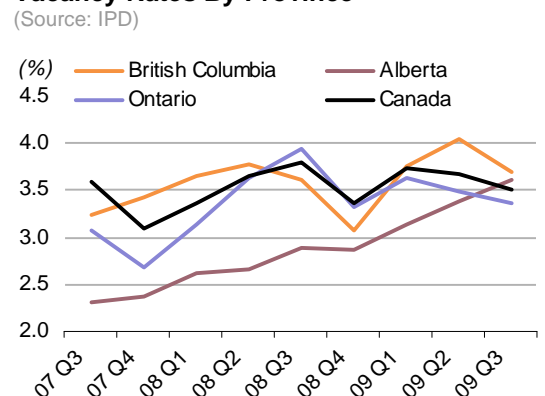
Retail Market Indicators (Source: IPD)



Anticipated Retail Construction (Source: CBRE)



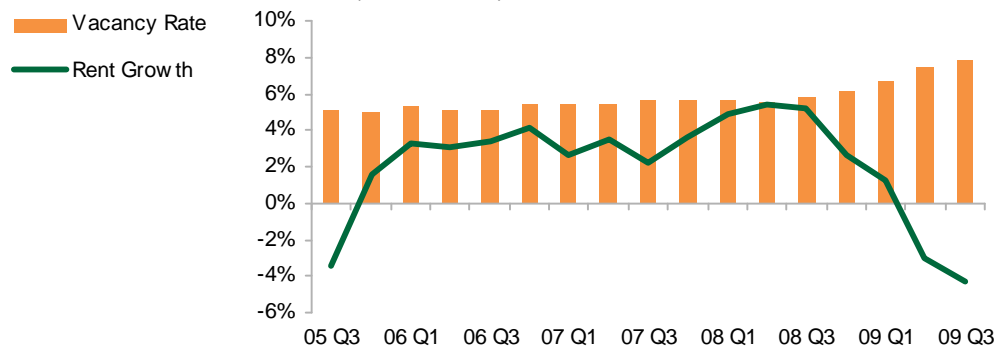
Vacancy Rates By Province (Source: IPD)



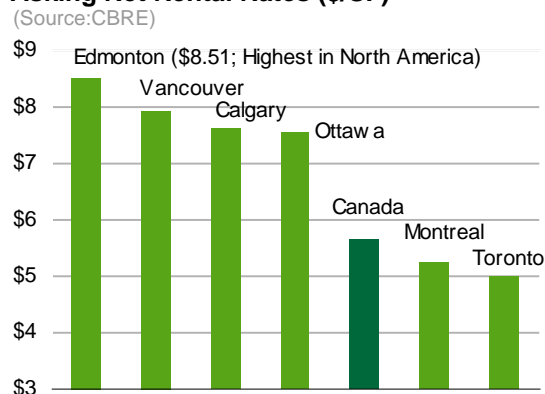
2.12 Canada: Industrial Market

- Just when it was expected that the Canadian industrial market might begin to gain some traction as global economic activity began to pick up, the Canadian dollar rallied. Although this has taken some steam out of Canadian exports, most of the damage has been done since the Canadian dollar is not expected to gain much more strength relative to the US dollar. The impact has been less in the West where Vancouver and Edmonton's industrial markets have already begun to stabilize because of their ties to Asia.
- The industrial sector's challenge is not oversupply, but a major contraction in demand. There is virtually no new speculative supply coming to market except some residual deliveries that were started before the recession began.
- CBRE forecasts vacancies to peak next year just below 10%. In addition, rents are close to hitting their nadir.
- Though investment volume is down 64% compared to this time last year, according to Avison Young, industrial properties have been the second most sought after property type trailing only offices by dollar value of sales.
- The Vancouver industrial market is improving after a disappointing first half of the year. Third quarter experienced positive absorption, positive net rental growth, and improved occupancy rates.
- In contrast, Calgary's industrial market is still lagging as sublease space continues to enter the market.

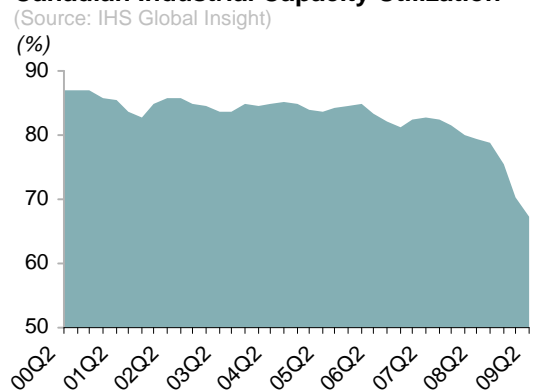
Industrial Market Indicators (Source: CBRE)



Asking Net Rental Rates (\$/SF)



Canadian Industrial Capacity Utilization



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