

# ECONOMIC PULSE

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

## THE DESCENT SLOWS

THE SITUATION IS STILL VERY TENSE THROUGHOUT  
THE AMERICAS BUT THERE ARE EARLY SIGNS OF STABILITY

### INTRODUCTION: REGIONAL WEAKNESS WITH BRIGHTER SPOTS

The economic collapse of late 2008 and early 2009 was the most severe downturn the US economy has experienced since the 1930s. The cumulative decline in US GDP of 3.2% since the recession began has had an impact on the entire Americas' region. Since the US is the largest export market in the region, the loss of demand is having an impact on all the major countries in the Americas.

However, not all countries are experiencing the same impact. First, not all countries have experienced the same level of financial stress. In Canada, the financial system did not get as over-leveraged as in the US, putting the banks in much better condition to weather the storm. In South America, weakness in exports to the US has been offset by healthy domestic demand leading to more moderate declines. And in Mexico, the vagaries of oil prices have caused that economy to rise then fall in 2008 then improve again in 2009.

No country is escaping unscathed, but it appears that the US and its property markets are being most severely impacted by this recession followed by Mexico and South America, with Canada faring best.

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**The Decline Slows:** In April 2009, the US economy lost 539,000 jobs and this was considered good news. Prior to October 2008, the US lost more than 500,000 jobs only four times in the preceding 60 years. Then in the five months from November 2008 to March 2009 the economy lost an average of 680,000 jobs per month. The economic environment changed so dramatically that a job loss of “only” 539,000 was looked on as a positive sign because it means the worst of the recession is now in the past. The blasted landscape left by the housing collapse, the financial crisis and consumer spending cutbacks has begun to ever so modestly improve.

Let’s be clear. The US economy is not in recovery and an upturn is not likely to take place until late this year or early in 2010. Until then, the economy will continue to shrink, fewer people will have jobs and more will become unemployed. However, the moderation in job loss shows that the speed of the collapse is now showing the first signs of slowing.

One way to track how the economy is performing and likely to perform is to review a large number of indicators that tend to coincide with and lead the business cycle. Keep in mind that the National Bureau of Economic Research defines a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators.” So the movement of a broad range of indicators gives a sense of direction. Table #1 simply shows the direction of month-to-month change in a set of six coincident indicators and five leading indicators since August 2008.

TABLE 1: DIRECTION OF CHANGE IN COINCIDENT AND LEADING INDICATORS

	Aug-08	Sep-08	Oct-08	Nov-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09
<b>Coincident Indicators</b>									
Non Farm Payroll Employment <sup>1</sup>	–	–	–	–	–	–	–	–	–
Real Retail Sales <sup>2</sup>	–	–	–	–	–	+	+	–	–
Real Personal Income Excluding Transfer Payments <sup>3</sup>	+	+	+	+	+	–	–	–	–
Manufacturing Production <sup>4</sup>	–	–	+	–	–	–	–	–	–
Motor Vehicle Sales <sup>3</sup>	+	–	–	–	+	–	–	+	–
Truck Tonnage Index <sup>5</sup>	–	–	–	+	–	+	+	–	–
<b>Leading Indicators</b>									
Consumer Confidence <sup>6</sup>	+	+	–	–	+	+	–	+	+
S&P 500 <sup>7</sup>	+	–	–	–	–	–	–	–	+
Single Family Building Permits <sup>2</sup>	–	–	–	–	–	–	+	–	+
Unemployment Claims <sup>1</sup>	+	–	–	–	–	–	+	+	+
Vendor Performance <sup>8</sup>	–	–	–	–	–	–	+	+	+

Sources: 1. US Bureau of Labor Statistics; 2. US Census Department; 3. US Bureau of Economic Analysis; 4. Federal Reserve Board; 5. American Trucking Association; 6. University of Michigan; 7. Standard and Poor's Corporation; 8. Institute for Supply Management.

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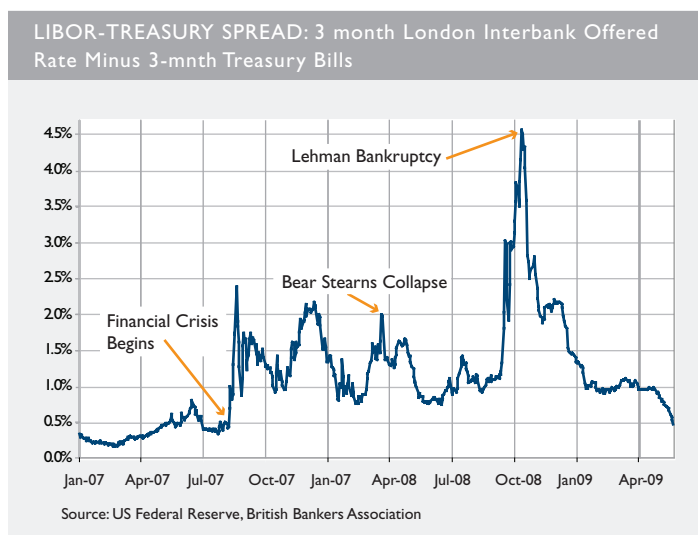
From September through January, no month saw more than three of the 11 indicators increase. Then in February and March, the number of indicators recording an increase jumped to five and four respectively with the leading indicators turning up most often. For April, five increased and they are all leading indicators. This modest shift from almost everything declining to some indicators increasing has been the cause of recent cautious optimism. These are still very preliminary indications, but when we start to see an increasing number of economic indicators turn up, it will be an important sign that a bottom is near.

**PRECURSORS**

What has to happen for recovery to truly take hold? There are three sets of conditions that will be necessary for a bottom to occur in the US economy and recovery to take shape.

While the bank lending spreads have narrowed, indicating greater confidence on the part of institutions and creating an environment in which lending can resume, interest rates in other segments of the credit market have not responded as well.

I. **Financial stability.** This recession started with a major financial crisis and financial stability is needed before it can end. Investors have to be willing to take risk for capital to flow through the economy. Currently we are moving in that direction, but there are still some significant areas of weakness. One measure of credit availability is the spread between risk free and risky investments. For banks, this is the spread between loans to other banks and loans to the government, or the interbank rate (LIBOR)



compared to rates on Treasury securities. In June 2007, before the credit crisis hit, the spread between the three-month LIBOR rate and three-month Treasury bills averaged 0.54%. At the height of the credit crisis in October 2008, that spread rose to 4.57%, as banks were so concerned about the viability of other banks that they were almost unwilling to lend. Since then, this spread has gradually closed, as the Federal Reserve has intervened in the workings of financial markets, taking on the role of guarantor of risk in order to get lenders lending. Today, it is 0.48%, the lowest level since August 2007.

While the bank lending spreads have narrowed, indicating greater confidence on the part of institutions and creating an environment in which lending can resume, interest rates in other segments of the credit market have not responded as well. For example, the spread between lower quality (BAA) corporate debt and 10-year Treasury notes was 1.61% in mid 2007. It rose to 6.16% at the height of the financial crisis and today it is only down to 4.86%. So the credit markets are improving but in the higher risk segments of the economy there is still a reluctance to lend. In order for the economy to enter a full recovery, those higher risk sectors will need more ready access to credit.

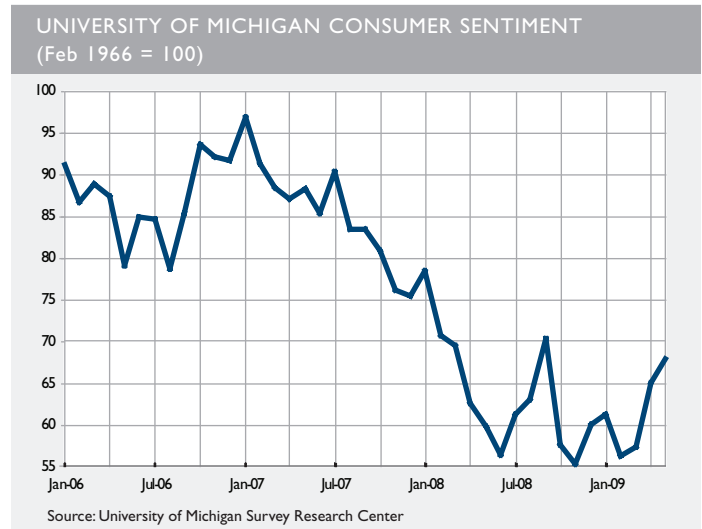
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- Housing bottom.** The epicenter of the financial crisis was the housing sector. Easy credit caused home sales to skyrocket and a huge speculative bubble to form. We are still working through the hangover from the bursting of that bubble. Sales and new construction have fallen to the lowest levels ever recorded as credit dried up and employment plunged. Prices peaked in 2006 and have fallen by about 25% since then. The decline in housing and increase in mortgage delinquencies in the past few years created stress in the financial system, with lenders forced to write down the value of non-performing loans (had anyone heard the phrase “subprime mortgage” prior to 2007?). When home prices stabilize and sales bottom, the main cause of the financial crisis will have run its course and lenders will stop having to write down asset values. This will be a critical factor in creating more liquidity in the economy, enabling lending to increase and the Fed to begin easing its way out of the economy.

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Thus far housing has not reached a bottom although there are some positive signs, particularly in the critical single family home segment. Sales of new single-family homes have increased modestly since January and by April stood about 7.0% above the January level. It’s a similar story for single family housing starts. They appear to be reaching a bottom since the end of 2008, but the upswing so far has been modest and far from definitive. Starts in April were up for the third consecutive month and stood 3.1% above the January level. Mortgage applications also appear to have stabilized, albeit at a low level. Finally, the inventory of unsold homes is falling rapidly. After soaring to a record in mid-2006, the inventory of unsold homes dropped by 48%, its lowest level since the end of 2001. So sales have stabilized, at very low levels, inventories are down and construction appears to be bottoming. It’s not much, but if the current trends continue, it would be an important signal that the economy is moving away from decline toward recovery some time late this year or in 2010.

- Rising Confidence – Consumer and Business.** Rising confidence on the part of both consumers and business is an important prerequisite for economic recovery. Businesses have to be convinced that their revenues and profits will increase before they begin to increase spending, and consumers need to have some confidence in their economic future before they commit to increasing spending any more than absolutely necessary.



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The confidence of consumers and business plunged last fall and continued to decline into the first quarter of 2009. However, recently, as we saw with the housing sector, there are signs that confidence is climbing out to the abyss. In May, the University of Michigan's Index of Consumer Sentiment increased for the third-consecutive month and now stands at its highest level since September 2008, when the financial crisis became an economic collapse. Sentiment is still low and by no means at a level that suggests consumers are about to go on a spending binge. In general, an index reading of 90 or higher is consistent with healthy consumer spending growth.

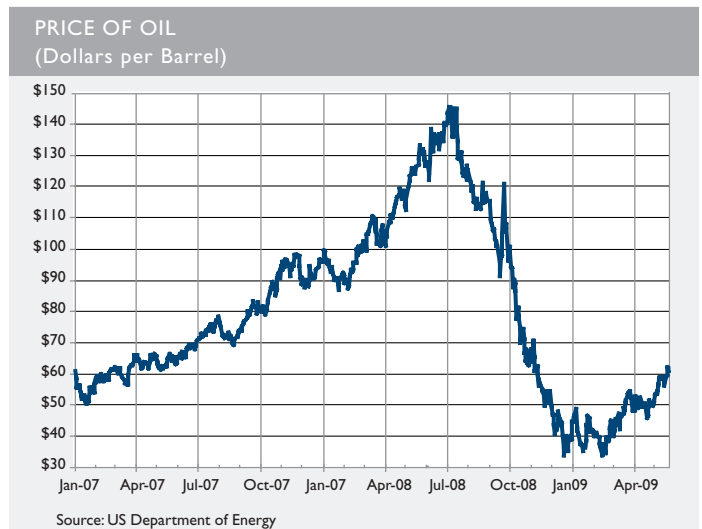
On the business front, pessimism is still the dominant sentiment. However, here too, the worst appears to be behind us. For example, several regional Federal Reserve Banks conduct monthly surveys of business sentiment in their regions: the Federal Reserve Banks of Richmond, Philadelphia, Kansas City, and New York. Each bank's survey, while still negative, has increased substantially since the beginning of 2009. A similar performance is evident in the weekly survey of Moody's Economy.com. The online survey, published weekly has increased from a reading of -30.4 in March 2009 to -18.0 in the latest week. While any reading below 10 indicates recession, the move up from the March bottom, suggests that there are some businesses that are seeing improvement.

**AREAS OF OPPORTUNITY**

**Oil and Government.** Throughout the America's the decline in US demand has been the dominant economic driver during the past year. However, it has been nearly rivaled by the rapid and unexpected shifts in energy prices. For oil exporters, like Mexico and Canada, the increase in oil prices in 2007 and the first half of 2008 was a windfall that was expected to help these countries weather the financial crisis. However the subsequent collapse of oil prices from an all-time high of \$145 per barrel in July 2008 to \$33 per barrel (a decline of 77%) in December – the lowest price since early 2004 – totally changed the outlook for these economies. Regions that had been booming, from Houston to Calgary to Mexico City, began to slow dramatically in the second half of 2008, just as the full impact of the financial meltdown of last September was being felt.

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The good news for oil producers is that prices have recovered dramatically since the winter. At the current price of about \$61 per barrel, oil prices are up 81% since February. This unexpected price surge, coming amidst bulging inventories and declining global demand has been a surprise, but it appears likely that oil prices fell too low in the reaction to last year's steep economic decline. It is always difficult to forecast the direction of oil prices, but it does appear likely that prices will stay above \$50 per barrel and even



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though demand is down, production cutbacks by OPEC are limiting supply enough to keep inventories from rising to levels that will put downward pressure on prices.

This is especially good news for Alberta in Canada, Mexico and Texas. These countries and regions are heavily dependent on production, export and processing of oil, and rising oil prices will lead to greater demand for space in these areas. Despite the decline in oil prices in 2008, the two main Texas office markets: Dallas and Houston both experienced positive absorption in their suburban markets of more than one-million square feet, only two other markets in the country experienced such a high absorption rate. In 2009, higher oil prices, if they are sustained will provide support for select economies and real estate markets throughout Mexico, Canada and the US.

On May 28 there was a job fair in New Jersey billed as the largest of the year. While the number of companies seeking employees was down substantially from a year earlier, there was one industry that has more recruiters this year: the federal government. There were 20 different departments represented at the job fair all looking for new employees. The effort to increase regulation and monitoring of the financial services industry, along with other expanded government programs, is causing government to become one of the most important growth sectors in the US. In the last 12 months, it has added 162,000 jobs, making it one of only two sectors in the economy to add jobs during the past year (the other was education and health services).

During the coming year, government employment is likely to continue to increase as the full impact of the economic stimulus package and other programs is felt. In addition, with the 2010 census just around the corner, more jobs will be created to help with the count. Of course, the main US city to benefit from higher federal spending will be Washington DC.

**AMERICAS REAL ESTATE MARKETS**

**Don't get too optimistic too quickly.** Although there have been some positive signs for the economy, there will be more pain to come, particularly in the second and third quarters of the year. As of late May 2009, the US was still experiencing near-record high levels of layoffs, with new claims for unemployment insurance at over 600,000 per week, well above the 350,000 or so that is consistent with rising employment. The US will still lose a substantial number of jobs in the next several months, a critical and negative factor for the US commercial real estate sector. Until we start to see some improvement in employment, real estate will remain under pressure in the US and throughout the Americas.

For South America, the news has not been as bad as in the US. As a result, there are attractive investment opportunities in both relative and absolute terms. With sound economies and investment environments, Brazil, Peru and Colombia are the most attractive countries. Affordable housing targeting the low-income segments and infrastructure investments are still the most promising sectors in the three countries.

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The housing deficit in Brazil accounts for nine-million units being highly concentrated geographically in the most populous areas. In March 2009, the government announced house-building incentives targeting the low income segments. The incentive consists mainly of tax reductions and subsidies. With a lack of infrastructure and the 2014 World Soccer Cup in sight, there are many related opportunities in Brazil. In Colombia and Peru, infrastructure growth is limited mainly to their capital cities. With a large low-income population, affordable housing is also in demand in both countries.

In Canada, the federal government, like most governments around the world has pledged a substantial amount of money as a stimulus package. This includes \$12 billion (Canadian) in new infrastructure funding and provides a total stimulus of 1.9% of GDP. This measure is hoped to create and maintain up to 190,000 jobs for Canadians by the end of 2010.

Given rising oil prices, the oil and gas city Calgary is experiencing a slower decline in office-using demand. On the east coast, New Brunswick is also seen as a province of opportunity in 2009 and 2010. The energy sector dominates the province's international exports, which are expected to grow by 9% in 2009, in part based on the continued strength of US gasoline prices. Recently, the Government of Canada announced the need to lease an additional three-million square feet of office space in Ottawa in next few years. This will mean that an already very tight market will likely become one of the tightest markets in the world.

In Toronto, which houses 40% of Canada's office market, hot sectors include healthcare and, to an extent, the banking system. The Ontario government is undergoing radical change as it readdresses how services are provided to its population. Over \$42 billion is budgeted to be invested in healthcare in 2009/10, up from \$29 billion in 2003/04. The Canadian banking system, considered one of the most stable in the world, has continued to experience profitability. Canada's largest four banks, led by Royal Bank of Canada, are now ranked 7th to 10th among North America's top-10 banks, as measured by assets. Additional opportunities for growth in the banking sector are possible as we enter 2010.

Generally, Canadian office markets were extremely tight heading into the economic downturn, with an average central area vacancy of 4.1% at the low watermark in Q3 2008. Very conservative occupancy decisions in Central and Eastern Canada will mean less space returning to market due to reduced demand for Canadian goods and services.

Economic and real estate conditions in Mexico are similar to those in Canada. Higher oil prices are helping the Mexican economy offset some of the weakness in exports to the US. In addition, like Canada, the Mexican banking system did not become as highly leveraged as in the US, so the correction has not been as severe. Within the real estate investment sector, pricing is correcting, but not to the extent of the US. Values are down about 10% with cap rates up, although, as in the entire region, the number of transactions has been small, making it difficult to ascertain prices.

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One notable trend in Mexico has been developer land sales. As the market has softened and financing has become more difficult to obtain, developers who had purchased land for new construction have begun to sell the land rather than pay the cost of carrying it. In many cases, these sales are being made to high, net-worth private investors who can afford to hold the land for development in the future.

**CONCLUSION: THE WORST APPEARS TO BE OVER**

The best that can be said about the current environment is that it won't get any worse, and is more likely to show improvement sometime in late 2009. For the Americas' real estate markets, which tend to lag economic performance, this means a recovery is likely in 2010. While that seems like a long way off, if clients are looking at 2010 as the time to engage in a transaction, it is not too soon to start the process.

The end of 2008 and the first quarter of 2009 were the worst period in more than 70 years. They are behind us and the recovery is on the horizon. It may be only a dot in the distance right now, but we will continue to move in that direction in the months ahead.

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