

# ECONOMIC PULSE

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

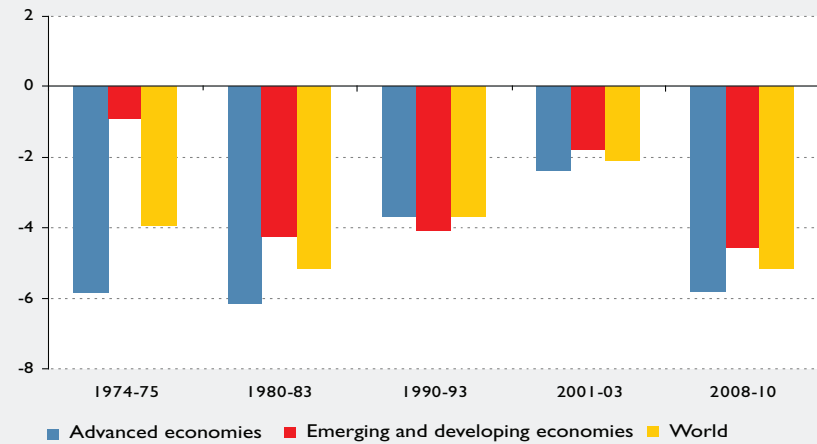
## DIRECTION, DEPTH, DURATION GETTING A HANDLE ON THE DOWNTURN'S IMPACT IN THE AMERICAS

**I**n 2008, a struggling US housing market became the catalyst for a world-wide recession. In what is now a painfully familiar story, US sub-prime mortgage defaults were transmitted with the speed of the internet throughout the world by the securitization model. What began as a housing/financial-driven downturn rippled through the rest of the US economy, as employment fell, confidence plunged and consumer spending collapsed. According to World Bank estimates, the US accounts for roughly 27% of global GDP and consumers for 70% of US GDP. This means US consumers account for roughly 19% of global demand. So, when they started holding on to their wallets after the events of September 2008, the whole world suffered the consequences.

But clearly the recession is not being felt in the same way or magnitude in every country. This report focuses on the impact of this challenging period in the Americas specifically, and how it compares to past downturns and what is being done to combat the decline.

A CUSHMAN & WAKEFIELD RESEARCH REPORT

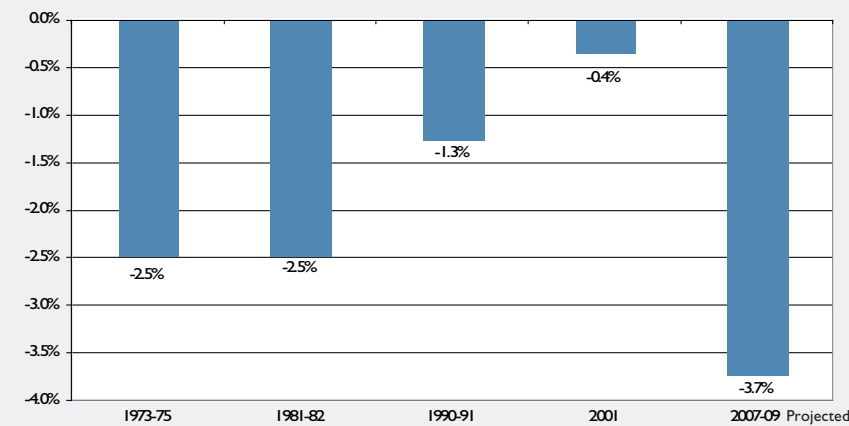
Chart 1 | CUMULATIVE OUTPUT LOSS RELATIVE TO POTENTIAL DURING GLOBAL DOWNTURNS (PERCENT)



Source: International Monetary Fund, World Economic Outlook, January 29, 2009.

by growth in the developing nations. However, developing world growth is expected to experience a sharp slowdown to 3.25% compared with 6.25% in 2008. This is, by far, the most negative outlook the IMF has ever published.

Chart 2 | US GDP DECLINE BY RECESSION (CHANGE FROM PEAK TO TROUGH)



Sources: US Department of Commerce, Moody's Economy.com

**RECESSION PARAMETERS**

There are three aspects of economic performance that are important: direction (is the economy expanding or contracting?); magnitude (how much is it expected to expand or contract?); and; duration (how long will it last?). To get a sense of where the US economy is today in a global context, we consulted the latest *World Economic Outlook* of the International Monetary Fund (IMF). The outlook, published in late January, revised its 2009 global growth projection downward by 1.75% points to a weak expansion of 0.5%. If correct, it makes 2009 the weakest year for the global economy since World War II. The IMF anticipates that an outright contraction of 2.0% in the advanced economies will be offset

For the global economy, the loss of output can be shown by comparing current- and projected growth with potential output growth. Chart 1 shows the loss of output relative to potential for advanced and developing nations in each of the last four recessions compared with the current projection. In this perspective, the loss of output expected for the advanced economies is the worst since the early 1980s; for the developing world, it is the worst in more than three decades. Keep in mind this is relative to the potential growth rate, which is much higher in developing nations. Overall, developing nations are projected to expand, but weakly.

## A CUSHMAN &amp; WAKEFIELD RESEARCH REPORT

We are in the worst point of a national recession that will last for another six to nine months, leading to further reductions in occupancy and increases in vacancy across all product types.

In the US, the current downturn is by some measures the worst since the Great Depression, but by others, it has yet to surpass the recessions of the 1980s and 1970s. To get a sense of where we stand in a historical context, we focused on three measures of output: manufacturing production, gross domestic product (GDP), and payroll employment, and compared them to previous US recessions since 1970. By all three of these measures, the current downturn is the worst since at least the 1981-82 contraction and stands to surpass those parameters. It is likely that by the time this recession is over, the loss of output will be the greatest since the 1930s by almost any measure.

- **GDP:** US gross domestic product (GDP) declined in both the third- and- fourth quarters of 2008 and was still falling during the first quarter of 2009 (That data will not be published until late April). To compare the current downturn to past declines, we took the forecast of Moody's Economy.com for the balance of 2009. The projection calls for GDP to contract for the first three quarters of 2009 with the current quarter being the worst for the year. The result will be a total contraction of 3.7% in GDP, far surpassing the 2.5% declines recorded in both the 1973-75 and 1981-82 recessions.
- **Manufacturing Production:** US manufacturers have cut output sharply in response to the steep decline in demand that emerged in summer 2008. Manufacturing output peaked in mid-2007 and was basically flat until the middle of 2008. The sharp decline began in August 2008. Overall, manufacturing production is down 13.8% from the peak and likely to decline further in the months ahead. The total drop will easily surpass the previous record of 14.3% set in the 1973-75 downturn.
- **Employment and Unemployment:** While job loss already exceeds the magnitude in any post-war recession on both an absolute and percentage basis, the unemployment rate is still far below its early 1980s' peak. The US economy has already lost 4.4 million jobs and will likely lose many more before the recession ends. But the unemployment rate at 8.1% currently is well below the 10.8% peak reached in 1982. While unemployment may approach that level, it appears unlikely that it will be breached this time around. Moody's Economy.com projects a peak of 9.8%.

Thus, the magnitude of the economic decline in the US is very likely to surpass the worst recessions of the post war era in just about every major measure of performance. The duration of this recession will also be longer than any previous recession since the 1930s. Both the 1973-75 and the 1981-82 downturns lasted 16 months. Since the current recession began in December 2007, it is already 14 months old and likely to last well into the second half of 2009. Federal Reserve Chairman Ben Bernanke most recently stated in CBS *60 Minutes* interview: "We'll see the recession coming to an end probably this year. We'll see recovery beginning next year." That would make this by far the longest recession since the 1930s.

By any measure – direction, depth, duration – the current downturn has already or will soon surpass every previous recession since the 1930s.

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For the real estate industry, this means demand for space of all kinds – office, industrial, retail will be affected negatively. We are in the worst point of a national recession that will last for another six-to-nine months leading to further reductions in occupancy and increases in vacancy across all product types. The resulting downward pressure on rents will last well into 2010. While it will differ depending on the market, there is no area of the economy or the country that will be unaffected.

**MEXICO**

Mexico's economic situation has been affected by the global recession in several ways. With direct ties to the US economy, the drop in US consumption has taken a toll on exports to the US. On the other hand, the Mexican peso has been devaluated 50% in the last five months, which brings good and bad effects: on the positive side, goods and services are less expensive, encouraging export and tourism; on the negative side, Mexico is braced for rising inflation, exacerbated by the high volume of commodities imported from foreign countries.

**MEXICO'S REAL ESTATE OUTLOOK**

The country's commercial real estate market has stood up well to the stormy economic weather. Generally, it helps that, entering the downturn, properties were not overvalued and therefore more balanced in loan-to-value ratios than those in the US. However, with the economy struggling, activity has been affected. In the retail sector, for instance, rents are going down and vacancy rate is going up. Thanks in part to the country's devaluated currency, which has enhanced manufacturing's global competitiveness, industrial real estate vacancy rates have remained low and the sector is expected to continue performing fairly well. On the office front, Mexico is dealing with a spike in sub-leasing and reduction in rent values as a result of the slowdown in many industries. The hospitality sector has remained fairly healthy but foreign investment levels, healthy for the last five years, are starting to ease off. Occupancy has maintained above 65%, which is considered very healthy; however, hospitality growth is expected to be much slower than in past years.

**CANADA**

Even though it has an enviable reputation for being one of the most fiscally-stable countries in the G7, the strain of the global recession is showing in Canada. Steep decreases in trade between the Canada and the US – the world's largest trading partners – stand behind many recent job losses: in February, 82,600 jobs disappeared, driving the national unemployment rate to 7.7%, the highest it has been since September, 2003 (7.9%). Hard-hit sectors include automotive in Ontario, oil and gas in Alberta, and wood products in British Columbia, with housing and retail also showing losses.

## A CUSHMAN &amp; WAKEFIELD RESEARCH REPORT

Canada's banking system has been lauded worldwide for its stability in the face of the global credit crisis, due in part to conservative lending practices and strict regulatory controls that helped shield it from over-exposure to sub-prime securities. However, given Canada's inextricable ties to the US (the US accounts for 80% of Canadian exports) and also world markets, the country's economic growth is expected to contract by 0.5-2.0% in 2009, compared to the 0.6% growth in 2008. Canada is waiting to see what effect stimulus programs on both sides of the border will have on the economy. Meanwhile credit remains tight and falling housing prices, fear of further job loss, and low consumer confidence have deepened the recession to lows not seen since the early 1980s. While Canada is expected to see recovery in 2010, with predicted growth swinging between 1.3-3.6%, it is clear that the future remains a guessing game.

**CANADA'S REAL ESTATE OUTLOOK**

All major Canadian office markets entered the downturn with historically tight vacancy rates, however rapidly weakening market conditions and demand are now the story in Vancouver, Calgary, Edmonton and Toronto. Vancouver and Calgary, faced with weak demand for natural resources and low oil and gas prices, are shedding office-using jobs, pushing vacancy rates higher. Calgary's vacancy jumped to 8.4% in the first quarter. While still low, this is significantly higher than the low of 1.0% posted at the end of 2006.

The struggling auto industry and general weakness in manufacturing, along with job losses in the financial services sector are beginning to take a toll in Greater Toronto Area (GTA) on both office and industrial markets. The GTA, with an industrial inventory of about 825 million square feet and an office inventory of 160 million square feet, saw its office vacancy rate begin to climb, rising to 6.0 percent in the first quarter of 2009, up from a recent low of 5.1% in the third quarter of 2008. While rental rates have begun to soften in the major markets, Calgary has experienced the most significant drop in recent quarters, with CBD Class-A asking rates dropping from a high of more than \$42 CDN to around \$30 CDN.

**SOUTH AMERICA**

For the most part, South American countries are expected to weather the global recession quite well; the exception being those with GDPs linked to a limited number of commodities and lacking sound fiscal and monetary policies (particularly Bolivia, Ecuador and Venezuela). Countries best positioned to manage current conditions are Brazil, Colombia, Chile and Peru and, to a lesser extent, Argentina. In spite of the downturn, the region is expected to grow in 2009, with GDP expectations as follows: Brazil, 1-3%; Colombia, 1.5-3%; Chile, 1.5-2.5%; Peru, 4-6%; and, Argentina, -2-0%. Brazil, Chile, Colombia and Peru are working to provide liquidity to their internal markets and sustain foreign direct investment flows.

**SOUTH AMERICA'S REAL ESTATE OUTLOOK**

The downturn is expected to have a much softer impact on the region's real estate markets compared to that in 2002, which took a strong toll on Brazil and Argentina. At that time, the vacancy rate reached 23% in Brazil because the crises caught the market with a huge oversupply of new inventory. Rent values plunged by 30%.

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**CONCLUSION: PRUDENCE PAYS OFF**

By any measure, this is the most difficult economic environment in more than 60 years. The developed world will experience the worst downturn since World War II and developing countries will see a substantial slowdown in growth. In the Americas, as the epicenter of the decline, the US will be hardest hit, although Canada and Mexico will continue to suffer the consequences. The good news, however, is that many countries in South America are expected to escape with slowdowns, not downturns.

It's certainly not all bad. Our economies are vastly different than they were 60 years ago. Even with further layoffs expected in the industrial sector (automobiles, aircraft, and commodities-related industries), most US markets are not over supplied. As well, from the new stock scheduled to enter the market in 2009, 70% is pre-leased, so even with an anticipated slowdown in absorption, we expect that the US overall office vacancy rate will stay below 15%, and rent values will remain flat or will increase slightly with inflation, particularly for Class A properties.

It is important to highlight that 2008 was the best year ever for office market, reaching its peak in the third quarter. Developers, envisioning the global recession, decided to postpone most of the projects due, seeking to start construction in 2009 and avoid potential higher vacancy in 2010. Industrial real estate is still mainly owned by family and individual investors that historically have managed to maintain lease prices, regardless of high vacancies or other market conditions.

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