

ECONOMIC PULSE

A REPORT ON THE EUROPEAN ECONOMY AND
ITS IMPACT ON COMMERCIAL REAL ESTATE

HISTORY REVISITED

PAST EXPERIENCE OFFERS FEW CLUES AS TO WHEN
THIS RECESSION WILL END. THE TRICK IS TO SEIZE
OPPORTUNITIES THAT EXIST NOW.

The right historic perspective is a great tool to help understand current-day situations and is certainly now in demand as commentators run out of adjectives to describe exactly how bad things are and look instead to find historic comparisons: the worst, the deepest the longest.....since when?

In terms of scale, this slowdown is in fact clearly amongst the most serious at least since the oil shock of the 1970s, and for some countries in Europe we have to look further back to the late 1940s to find a larger fall. That does not mean, however, that this slowdown is comparable to the major crises that followed the two World Wars or the Great Depression - even the more pessimistic forecasters point to a smaller and briefer decline.

So what useful insights can we take from the historic record in Europe?

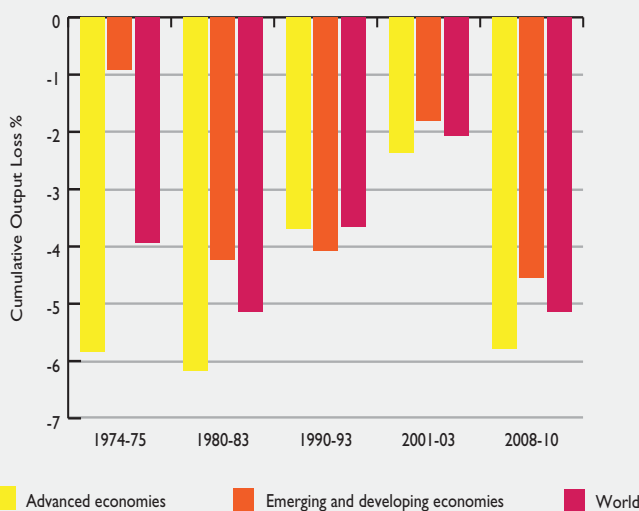
- Firstly, recoveries tend to go unnoticed at first - a rise in confidence is critical but this tends to happen after the event as pricing and supply adjust to a point where activity can again pick-up.
- Secondly, initial recoveries are often weak - at least in the first six to nine months.
- The current slowdown is unusually synchronised but country performance trends tend to polarise at the trough and during recovery. The same is likely to happen in the months ahead.
- Recoveries do not have one single driver - consumers, businesses and government spending can all be important to varying degrees in different markets. Those reliant on exports may be the last to recover in this cycle.
- Recessions offer some good news for occupiers as they hold more power than

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landlords. Their window of opportunity can be quite long since availability tends to rise further after recessions are over. However the best opportunities may lie in the depths of the recession when accelerating availability, falling rents and weak financing options combine to provide maximum leverage.

- Finally, history reminds us that recessions don't last for ever! Neither do the threats and opportunities they bring. While the recovery may be slow when it arrives, prime space availability for occupiers or investors could dry up more rapidly than usual based on the profile of supply.

FIGURE I | CUMULATIVE OUTPUT LOSS RELATIVE TO POTENTIAL DURING GLOBAL DOWNTURNS



Source: IMF, January 2009

A GLOBAL PERSPECTIVE

In January, the IMF predict that 2009 would be the weakest year of global growth since World War II, with output weighted by purchasing power rising just 0.5%. A return to better growth is forecast for 2010, at 3%, but it notes that this is highly uncertain and recovery depends on the policy reactions of the global authorities.

For advanced economies, the IMF forecast a 2% fall in 2009 and a cumulative fall through the downturn relative to potential of nearly 6%, roughly on a par with the losses seen in the recessions of the 1970s and 1980s. Emerging markets are expected to fair better - with positive growth of 3% in 2009 - but the cumulative loss relative to potential is

still severe at 4.5% and, in fact, more notable than in past downturns.

History prior to World War II opens up a range of more severe economic events for comparison meanwhile. A study by Robert Barro and José Ursúa (Harvard University, 2008), identified 152 separate economic crises (defined as a 10% or more cumulative decline in output), since 1870 in the countries covered. These averaged -21.5% and lasted an average of 3.5 years with the three most significant global events, in order, being the Second World War, the First World War and the Great Depression.

Even in disasters of this magnitude, however, there are marked differences in terms of

their extent and reach (Table I). During and after WWII, 25 of the 39 countries studied saw an economic crisis. In WWI the figure was similar while in the Great Depression, 22 of the 39 saw such a reverse.

TABLE I | CRISES IN THE GLOBAL ECONOMY SINCE 1870

	GDP (sample of 39 countries)		Consumer Spending (35 countries)	
	No. of Crises	Average Loss	No. of Crises	Average Loss
Pre 1914	45	16%	21	16%
WWI	27	21%	20	24%
1920's	15	18%	11	18%
Great Depression	22	22%	18	21%

Source: Richard J Barro and José F Ursúa, "Macroeconomic Crises Since 1870", Harvard University, May 2008

Aside from during war events, consumer spending and GDP have tended to fall similar amounts. However, while prior to WWII, "output" events outnumbered consumer falls, since 1950 crises in consumer spending have been the more numerous.

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THE PICTURE IN EUROPE

Current predictions point to a peak-to-trough GDP loss in Europe of 4-5% over five to seven quarters. While many Eastern markets suffered worse crises in the 1990s, for many in the West the expected losses would be the greatest of the post-war period. Moreover, while the downturn does not match the definition above of a crisis, its sheer synchronicity makes it near-unique. By comparison, across 16 Western markets which have negative

growth forecast for 2009, only 10 saw a recession in 1975, 11 in 1993 and just 6 in 1981. Even in earlier crises, a similar pattern holds, with 10 in recession after WWII and 13 during the Great Depression.

In part this is unsurprising since a notable feature of the post-war period has been a steady harmonisation in country performances - brought about by increasing industrialisation and urbanisation but also by advancing technology and communication and the growth of global trade.

Even in Central & Eastern Europe, which followed quite a different performance pattern to the West in recent years, markets are now falling in line - with an increasing number succumbing to recession. The

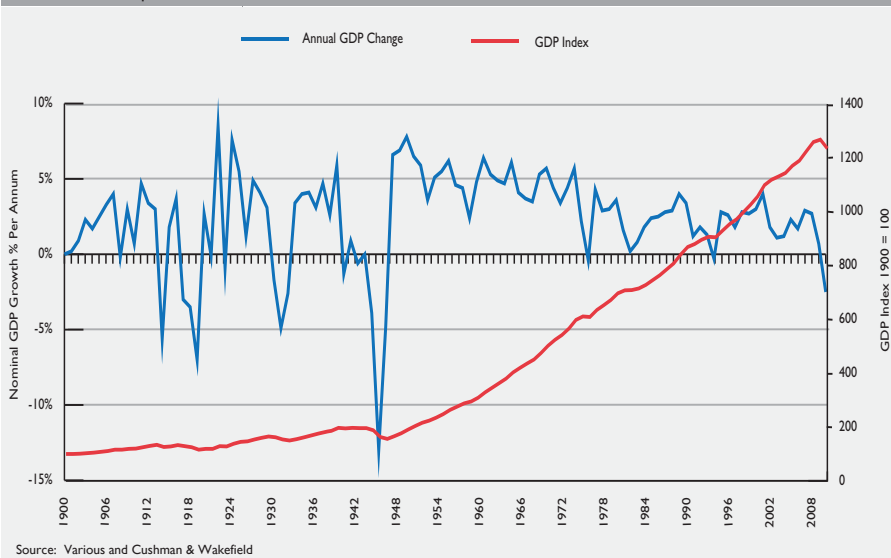
correlation in growth between East and West steadily increased after 1950 as the dislocations of the post-war period settled down. They temporarily moved apart in the late 1980's after the collapse of the Soviet Union and the crises that rocked the region in the early 1990's. However it was the emergence of economic out-performance in the late 1990's which really led to a differing performance track. Correlations in growth have in fact been negative over recent years, with the two areas providing strong diversification potential for each other.

Recent events have brought this to a halt however and after turning positive last year, the correlation between East and West is set to hit its highest for at least 50 years. The hopes of those who felt emerging

markets would cope well with the global downturn have clearly faltered.

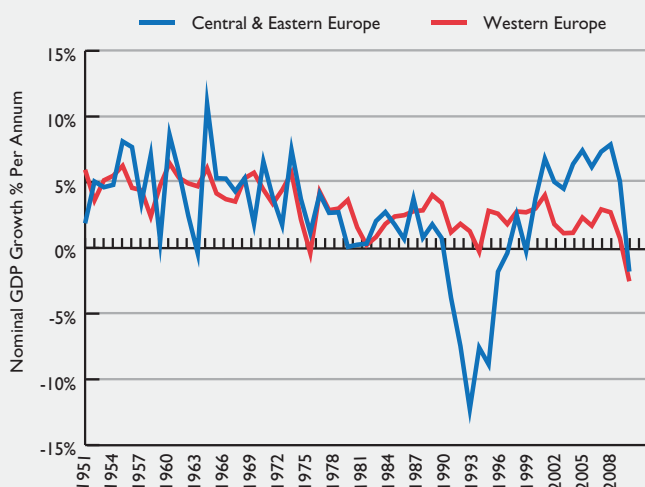
But how long will this pattern continue? Each of the last major downturns has been

FIGURE 2 | THE LONG TERM CYCLE OF ECONOMIC GROWTH IN WESTERN EUROPE



Source: Various and Cushman & Wakefield

FIGURE 3 | CYCLES OF GROWTH IN EASTERN & WESTERN EUROPE



Source: Various and Cushman & Wakefield

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accompanied by a marked breakout from the trend of increased harmonisation (figure 4) and, in our view, an increased polarisation in individual country performances can be expected in the months ahead.

There are two main reasons for this: Firstly, we are now moving past the common driver of a global financial crisis into the economic phase of the downturn and each country's

fundamental economic strength and ability to generate demand will be key to how quickly it can stabilise. Secondly the lessons of the downturn will remain with us for some time and areas of higher risk will continue to be penalised in the form of lower investment flows and higher required returns.

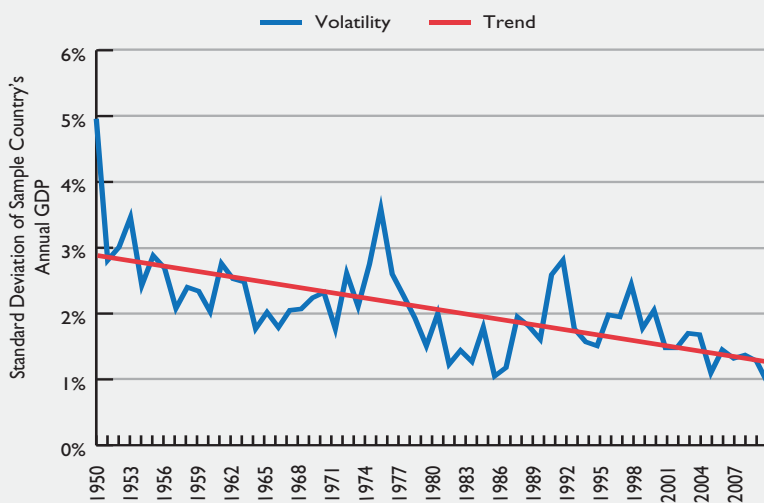
WHERE ARE WE TODAY?

The shocking scale of the declines in activity in late 2008 have continued in 2009, leading to forecasts for all Western markets being cut to show falls in GDP typically ranging between 2 and 3.5% this year.

Expectations in Central & Eastern Europe have also been cut severely, with an overall fall of 1.8% now predicted as the collapse in

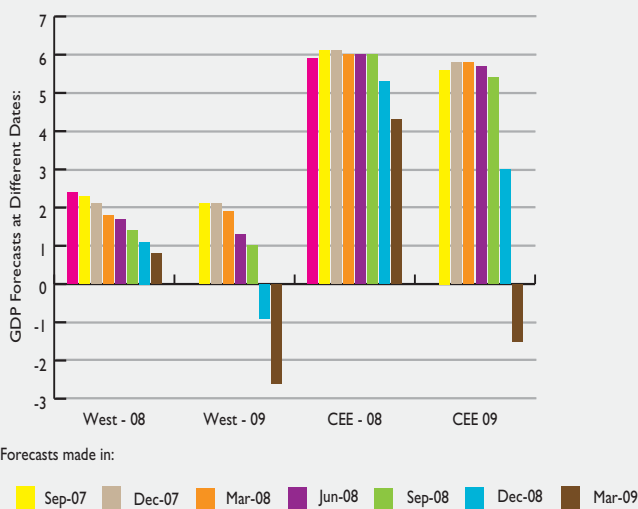
world exports has impacted together with fears over refinancing needs. Nonetheless, this reaction may be overdone - with a number of markets in the region facing less stress in term of financing needs and having a greater ability to support activity based on domestic demand.

FIGURE 4 | THE DIVERSITY OF PERFORMANCE IN WESTERN EUROPE



Source: Cushman & Wakefield

FIGURE 5 | CHANGING EXPECTATIONS FOR GDP GROWTH



Source: Consensus Economics and Cushman & Wakefield

Looking across the current drivers of activity, financial market stability shows tentative signs of improving, with some modest gains in credit availability and a narrowing in credit spreads. Uncertainty is still high however and this will continue as the economic crisis causes more disruption. Nonetheless, with the continuing commitment of the authorities globally, ongoing risk will be more focussed on specific companies and countries rather than the finance industry as a whole.

In the real economy meanwhile, it has been industrial and construction output which has borne the brunt of the contraction to date, with overall production falling back to 2004 levels. De-stocking is having a very negative impact in some areas as businesses cut back

and reduce inventories but with this process in its early stages in some economies, it is clear there is further bad news to come.

Elsewhere in the economy, results so far have been less negative. Recent service sector

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growth has exceeded the average since 2000 and while retail trading has declined, competitive pricing has supported demand. Recent data on German car sales shows the positive potential of government policy, with a cash-back plan encouraging the trading in of older cars.

TABLE 2 | MARKET FORECASTS (March 2009)

	GDP % pa		Inflation % pa		Comment
	2009	2010	2009	2010	
Austria	-1.6	0.3	0.6	1.3	Risk from CEE banking may be overdone but weak exports will hit growth
Belgium	-2.1	0.6	1.1	1.7	Sentiment falling rapidly as high export dependence hits growth
Bulgaria	0.1	1.7	5.3	4.4	Exports falling fast but higher government spending could soften the blow
Czech Republic	-2.1	1.4	1.4	2.2	Recession in 2009 as exports fall but stimulus package to aid 2010 recovery
Denmark	-1.8	0.7	1.3	1.6	Unemployment and falling exports adding to woes started by housing market
Estonia	-7.8	-1.0	1.4	2.0	Deepening recession with currency under pressure and public spending to fall
Finland	-2.0	1.1	1.5	1.8	Similar falls to rest of Europe but somewhat better recovery forecast
France	-2.0	0.6	0.4	1.4	Recession starting but still less affected than the UK or Germany
Germany	-3.2	0.7	0.5	1.2	Export decline hitting home but stimulus plans having an effect in auto sector
Greece	-0.1	1.2	2.0	2.4	Fall in all areas of activity including investment, not helped by political tensions
Hungary	-4.3	0.2	3.2	3.1	Recession underway, recovery to be slowed by fiscal policy and de-leveraging
Ireland	-4.3	-0.9	0.3	1.5	Decline deepens with banking and construction crisis and rising unemployment
Italy	-2.8	0.3	0.5	1.2	Very sharp slowdown in q4 08 continues, with manufacturing hard hit.
Latvia	-11.8	-3.3	3.5	-0.3	Domestic demand weak and growing calls for devaluation to aid competitiveness
Lithuania	-6.7	-2.9	4.6	3.2	Inflation still high despite falling output, with budget cuts to further hit demand
Luxembourg	-1.3	1.6	1.2	1.6	Strong fiscal position and higher government spending to aid recovery in 2010
Netherlands	-2.4	0.2	1.1	1.1	Increased weakness as exports fall and banking woes impact on consumption
Norway	-1.0	1.0	1.4	1.6	Export weakness but still less pronounced slowdown than in the rest of Europe
Poland	0.3	2.0	2.7	2.3	Large internal market will help offset weak exports despite slower pay growth
Portugal	-2.2	0.0	0.6	1.6	Sharp output fall in q4 08 continues to weigh on sentiment and activity
Romania	-1.0	1.5	5.9	4.7	Weaker financial market and export conditions leading to sharp slowdown
Russia	-1.5	2.5	12.6	9.8	Falling Rouble adding to lower oil revenues and rising unemployment
Slovakia	0.8	2.6	2.6	2.9	Euro adoption to aid stability but loss of exchange rate flexibility may hurt
Spain	-2.5	-0.1	0.6	1.9	Rapid rise in unemployment adding to concerns of the consumer sector
Sweden	-2.2	1.0	-0.4	1.0	Sharp fall in industrial output, but rate cuts may improve the outlook for 2010
Switzerland	-1.6	0.6	0.0	0.8	Weak short term picture but low interest rates may drive modest 2010 upturn
Turkey	-3.3	2.8	6.9	6.6	Weaker exports and consumer demand but relatively robust recovery in 2010
UK	-3.0	0.5	1.0	1.8	Ongoing sharp slowdown but policy more advanced and weak Sterling will help
Ukraine	-8.3	0.3	18.5	12.4	Capital flight and need to cut current account deficit results in sharp contraction
Western	-2.6	0.5	0.7	1.5	Severe falls in industrial output spreading recession to virtually all areas
Central & Eastern	-1.8	2.2	8.2	6.8	Banking crisis plus weak exports markedly changing the short term outlook

Source: Consensus Economics Inc, Oxford Economics and Cushman & Wakefield

Hence, while the downturn appears to be synchronised across countries, there are significant differences across sectors and some evidence of the positive impact of government action and falling inflation.

Falling exchange rates may be a boost to competitiveness for some countries but are also causing concern as speculators step in. While those in the Euro-zone can not devalue, some will be pleased with the security being part of a currency bloc can bring.

Nonetheless, the lack of freedom in terms of deficit financing and monetary policy is restricting their ability to react to the challenges they face and may leave some with little choice but to tackle structural imbalances by eroding real wages to improve competitiveness.

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DRIVERS FOR RECOVERY

It is often quoted (and even more frequently misquoted!) that those who do not learn from the mistakes of the past are doomed to repeat them. History rarely repeats in exactly the same form however - its drivers differ, as does the exact nature of any event and the subsequent repercussions. In economics there are clear cycles which many believe follow a set pattern but a quick look at long term cycles shows a highly volatile experience over time. Moreover, what drives each cycle is usually different - affecting different industries, sometimes global in nature, sometimes local.

There is therefore no "silver bullet" which will end the recession or an all-powerful indicator to watch for - a range of conditions must be in place and usually they impact before they're even noticed. The recession ends when supply and pricing adjust adequately to restart demand. For this to happen capacity levels have to be cut - as they now are - and changes in pricing need to be accepted.

In some countries increased government spending will be critical. In others, the corporate sector may lead as de-stocking ends and businesses focus on markets where demand has been held up or on import substitution. In other cases, the consumer may lead as lower interest rates and inflation make purchasing still more attractive.

Markets that can generate their own demand or that are most competitive on the world stage will be first to recover, potentially favouring countries like the UK and Norway where exchange rates are down, as well as the Netherlands and possibly Germany if more initiatives are seen to boost domestic demand. At the same time, risk and economic stability need to be considered - which markets have the right business and institutional framework to allow a rapid readjustment to take place? Flexible markets such as the UK and the Netherlands may innovate quicker while secure, transparent markets such as the Nordics may also be favoured. To the East, a sifting of the good, the bad and the ugly quickly identifies markets such as the Czech Republic, Slovakia and Poland as offering better than average growth potential and stability.

OUTLOOK

While the short term outlook is clearly very poor, to get a proper perspective it is necessary to consider the cycle in stages: namely the down-cycle, the eventual recovery and the medium-term trend beyond that.

In the here and now, it is clear that no country will escape the slowdown and more pain from corporate failures and unemployment is unfortunately inevitable. More positively, stabilisation could be here sooner than many think, with the first markets possibly posting positive growth as early as the third quarter of 2009 as de-stocking ends. Unemployment will continue rising however and subsequent quarters will still be weak, but at least the recession will be over and that will start to release pent up demand and replacement spending.

Beyond the stabilisation phase, there is little to suggest a return to growth can be expected until the second half of 2010 in most countries, when monetary and fiscal easing, together with the increased affordability of goods and assets, should encourage more activity. An upswing in growth could then follow in 2011 - the pace of which will vary, and most markets will face a headwind from rising interest rates and inflation.

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Finally, the trend growth rate we return to will be less than in recent years since the driver of cheap finance will not be there and government spending will be cut and/or taxes raised. At the same time, unbalanced markets such as Spain and Ireland will take time to regain competitiveness.

Nonetheless, some markets may buck this trend. Resource-rich markets such as Norway and Russia will benefit from higher energy prices while lower-cost markets will be in demand for outsourcing. Poland and some other CEE markets could see improved demographics as migrant workers return, while the Nordics may benefit from ongoing risk aversion and innovation. The impact on markets such as Germany, which have been less reliant on debt, will be less than in highly-leveraged countries. Indeed, if the German authorities actively stimulate domestic demand, it could even emerge with faster trend growth.

THE IMPACT FOR PROPERTY OCCUPIERS

The current environment offers some good news for occupiers in that they have more negotiating power and more options. They will also be able to secure new space at a lower cost, with prime office rents in Europe expected to fall by an average of around 15% by the middle of 2010 for example and high yields relative to interest rates making property purchases potentially attractive for some well-financed occupiers. At the same time, for sensibly priced and sized lots, owner-occupiers may see an improvement in investment demand, offering an efficient route to raise cash from their property.

With cash flow king, landlords are already proving more flexible and not just in negotiating new leases but also in renegotiating existing contracts - although there is rarely such a thing as a free lunch and owners will tend to seek a longer lease term in exchange for any concessions.

The downside is that for those looking to downsize, they face a very competitive market in which to sub-let space - and second-hand space unless very well-located and fitted-out will suffer most. This argues in favour of occupiers trying to pass surplus space back to landlords as part of any renegotiation - which will clearly be easier in those markets with shorter leases or tenant-friendly break options.

An additional consideration will be how long this situation lasts. With development falling and the market not entering the downturn with a marked over supply, the demand balance for prime space should tighten quickly once the economy picks up. Moreover, with a growing disparity in performance likely between economies through 2009 to 2011, occupiers should review space needs on an international basis where possible to take advantage of those areas where better deals can be struck.

THE IMPACT FOR PROPERTY INVESTORS

Investors are digesting the weaker news coming from the occupational market and views on risk are still being refined, notably in emerging markets, resulting in a further rise in yields. While this can be partially resisted for prime property in markets with a large and unstressed domestic investor base, in many cases the demands of international buyers will need to be met, with yields rising further in the months ahead.

Notwithstanding this weak short-term picture, there are some more hopeful signals for investors. A modest un-freezing in the debt market appears likely later this year from well-capitalised banks and markets which adjusted early may soon see prime yields stabilise.

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The supply of investment property may be an issue meanwhile. There has been only a modest increase in distressed sales to date and much of the stock that is available is not of the quality investors seek as the flight to quality continues, with more investors looking to access core-plus returns from core stock.

TABLE 3 | MARKET VALUES

	Rental Growth (yr to Q1 09)				Yield levels (March 2009)			
	Retail	Office	Industrial	Rental Trend - All Sector	Shop Units	Office	Industrial	Yield Trend - All Sector
Austria	5.0	2.0	0.0	→	4.60	5.25	6.75	↗
Belgium	1.9	5.1	1.0	↘	5.00	6.00	7.00	↗
Bulgaria	0.0	-1.8	8.3	↘	7.00	10.0	11.0	↗
Czech Rep	1.7	9.4	-1.8	↘	6.75	6.80	8.00	↗
Denmark	0.0	-5.1	0.0	↘	5.25	6.00	6.75	↗
Finland	-7.9	10.4	4.0	↘	6.10	6.25	7.50	↗
France	2.6	1.5	2.8	→	4.75	5.50	7.50	↗
Germany	6.0	1.7	0.0	→	4.15	5.05	6.85	↗
Greece	3.3	4.3	-4.3	↘	5.50	7.20	8.00	↗
Hungary	5.6	2.7	-4.7	↘	7.25	7.50	8.75	↗
Ireland	-11.6	-9.4	-1.6	↘	6.00	6.50	7.50	↗
Italy	6.3	4.1	4.9	→	5.25	5.75	7.25	↗
Luxembourg	0.0	8.6	Na	↘	5.50	6.00	Na	↗
Netherlands	6.1	1.2	-0.8	→	5.25	7.00	7.75	↗
Norway	0.0	5.2	5.3	→	6.15	7.00	8.25	↗
Poland	10.4	4.9	28.8	→	8.00	7.00	8.00	↗
Portugal	2.4	-1.9	-6.3	↘	6.75	7.25	8.25	↗
Romania	13.7	0.0	6.1	↘	9.00	8.75	9.50	↗
Russia	-1.1	-7.0	-2.0	↘	n/a	13.00	13.00	↗
Slovakia	6.7	0.0	0.0	→	7.75	7.75	8.25	↗
Spain	0.7	0.6	0.5	↘	5.50	6.25	7.75	↗
Sweden	-2.7	1.6	2.0	↘	5.75	5.75	7.75	↗
Switzerland	12.7	2.4	3.7	→	4.25	5.00	6.50	↗
Turkey	10.0	5.0	5.3	↘	9.00	8.50	9.00	↗
Ukraine	11.1	7.1	0.0	↘	15.00	15.00	18.00	↗

Note: Yields are headline levels for the prime market in each country and are quoted on their local market basis. Those shown in red are calculated net, to include transfer costs of tax and legal fees. The figures are a broad estimate and do not relate to any specific asset or transaction and assume a willing vendor, a securely financed purchaser and a lot size of up to €75mn. Rental growth reflects value movements in a sample of locations across each country. Source: Cushman & Wakefield

In terms of demand, there have been modest signs of improvement - notably in the UK - and with low interest rates and bond yields to fall as quantitative easing gets under way, property will be more attractive as an income play, particularly when other assets, such as corporate bonds, see returns start to normalise.

Prime yields for small to medium sized assets in less stressed economies may stabilise relatively quickly and the window of opportunity for investment in such stock may be shorter than expected. With the work-out process of refinancing and distressed sales proving slower than expected however, opportunistic buyers will see their window of opportunity lasting until at least 2011.

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