



## SOVEREIGN DEBT, GLOBAL MARKET VOLATILITY AND COMMERCIAL REAL ESTATE

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### Q1: WHAT ARE THE PRIME DRIVERS OF RECENT GLOBAL MARKET VOLATILITY?

**A.** We have seen extreme volatility in the equity and capital markets in recent weeks, as economic news has been mixed and investors have perceived increased downside risks to global growth. This was accentuated by Standard & Poor’s’ downgrading of U.S. government sovereign debt from AAA to AA+. The downgrade itself served more as a catalyst, unleashing negative sentiment, which has built up over recent months, rather than the fundamental cause. The immediate impact of the downgrade has been to encourage a “flight to quality and safety,” paradoxically encouraging investors to buy/hold rather than sell U.S. Treasury bonds. The very asset which was downgraded has gone up in price rather than down, with yields trending below 2.5%.

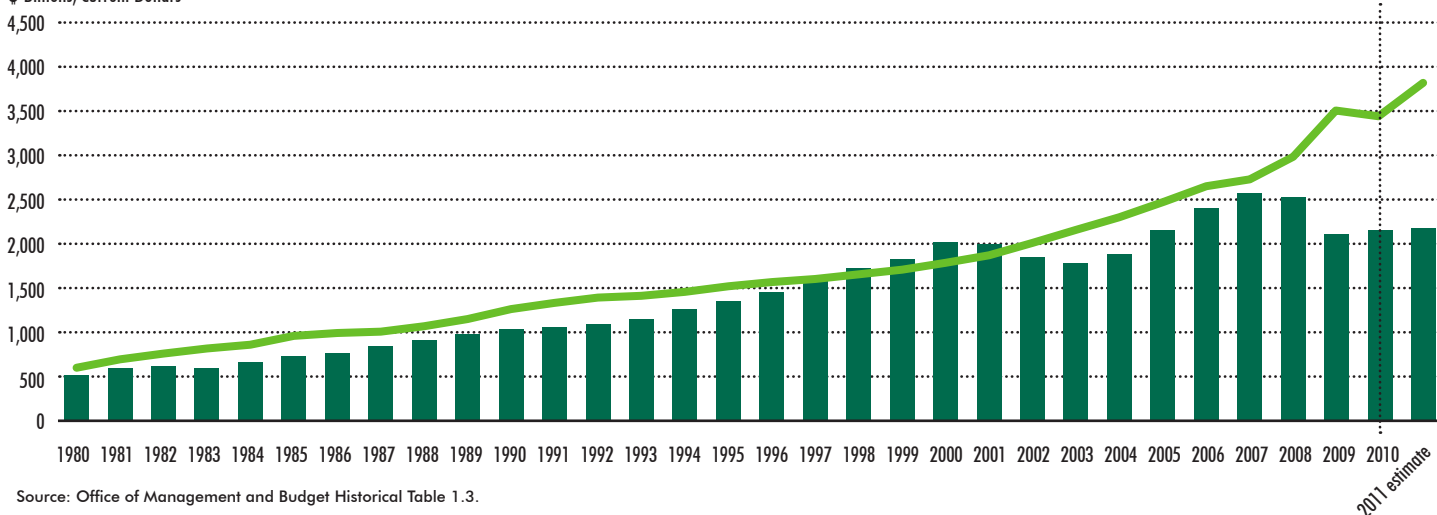
### Q2: WHAT ARE THE MAIN ISSUES ON WHICH INVESTORS SHOULD FOCUS?

- A.** Investors face multiple global concerns. These include:
- Unsustainable U.S. Debt Trajectory:** The level of U.S. debt and annual deficit, and the likelihood of ongoing uncertainty over how this will be resolved given the conflicts seen over the recent raising of the U.S. debt ceiling. Chart 1 reflects the growing fiscal imbalance that cannot be meaningfully addressed given policy gridlock in Washington. The Committee of 12 Congressmen charged with specifying ways to reduce the deficit is required to identify at least \$1.5 trillion of spending cuts and/or revenue increases. Most observers—including S&P—believe the Committee must identify more than \$1.5 trillion to satisfy the financial markets. If the committee cannot agree on the \$1.5 trillion—or Congress fails to vote to enact the Committee’s recommendations—then a so-called

**Chart 1: US Deficit: Only Four Years of Surplus**

Historical Government Receipts and Outlays

\$ Billions, Current Dollars



Source: Office of Management and Budget Historical Table 1.3.

trigger mechanism will kick in, requiring \$1.2 trillion of across the board spending cuts on about one-third of the total federal budget.

- **Anemic U.S. and global economic growth:** We think a more important issue is the recent weak economic data suggesting that the U.S. economy is struggling to recover and may even be at risk of falling into another recession. The U.S. economy grew by a paltry 0.9% annualized rate during the first half of this year. Growth estimates for the balance of 2011 have also been downwardly revised. The softer economic numbers are one reason behind enhanced market volatility and negative investor reaction on a global scale. Economic weakness is also evident across other major economies including Europe, and there are some concerns over some aspects of recent data from parts of Asia Pacific, including Hong Kong and Singapore.
- **European Sovereign Debt Crisis:** The ongoing sovereign debt crisis in Europe, which forced the European Central Bank (ECB) to intervene in the market by buying Spanish and Italian bonds, is also weighing on consumer sentiment. The critical state of European finances and the need for governments to cut expenditures means that they cannot use fiscal policy to boost their economies, which will impede the recovery of many countries and reduce overall growth across the region.

### Q3: ARE ECONOMIC CONDITIONS IN EUROPE AS FRAGILE AS THOSE IN THE U.S.?

- A.** In Europe, concerns over financial stability and economic growth were evident and mounting before the August storms broke, reflecting the ongoing debt crisis in the Euro-area and the associated wide disparities in economic performance across the region. Robust expansion in Germany and Sweden, for example, largely driven by exports, has contrasted sharply with further contraction in Greece, Portugal and Ireland in 2011 and very weak activity in Spain and Italy.

Concern over sovereign debt has translated into perceived risks to financial stability stemming from the exposure of the European banking system, including the strongest countries, to peripheral Eurozone country debt, public and private. The result is funding stress and tighter credit conditions. The ECB's early move to raise Euro interest rates looks unhelpful in this context.

As has been well-rehearsed, the Eurozone economic difficulties are linked to the single currency itself. Over-indebted countries have been forced into fiscal austerity, hampering their growth prospects, but have no scope for exchange rate adjustment to boost their competitiveness. On one view, the only logical route to resolution of the crisis is a form of fiscal union to accompany monetary union, but such a course faces major political obstacles, at least for the present. That said, the proposals put forward in July by Eurozone political leaders to address the debt crisis could be regarded as moving in the direction of fiscal integration, particularly in the plan for an expanded European Financial Stability Facility (EFSF) able to operate more widely and proactively in European bond markets. While these proposals await ratification by Eurozone governments, the ECB has stepped into the breach with purchases of Spanish and Italian bonds.

As in the U.S., policy uncertainty hangs heavily over the European outlook with markets seeking credibility from European policy-makers that they will act collectively and effectively to manage the sovereign debt problem. There will be both need and opportunity for Europe's leaders to deliver that credibility in the coming months.

**Q4: IT APPEARS THAT MUCH OF THE CONCERNS ARE RELATED TO GROWTH PROSPECTS AND SOVEREIGN DEBT ISSUES IN THE DEVELOPED ECONOMIES. HOW ARE THE EMERGING MARKETS FARING IN THIS ENVIRONMENT?**

- A.** Many of the emerging markets are still seeing healthy levels of economic expansion. In part this is because the linkages between their economies, and particularly with China, have strengthened in recent years. This has somewhat reduced their direct dependence on the fortunes of the Western economies, and it was notable that most were far less affected by the global financial crisis than were Europe or the U.S. However, they face challenges of their own and reduced dependency is not the same as "decoupling"; the emerging economies will still be affected by any change in sentiment regarding economic growth elsewhere.

Across the Asia Pacific markets, growth ex-Japan continues to outpace that in the developed world. This is leading, however, to some concerns that economies may be overheating and at risk of accelerating inflation pressures. In Asia, the rising threat of inflation is coming at a time when governments may be unwilling to raise interest rates in light of recent market volatility and the slowdown in economic growth in the West. Higher interest rates in Asia will drive capital costs up and strengthen their local currencies, which in turn could hurt economic growth through declining exports, particularly given already weakened economies in the west.

Much of the concerns in the Asia Pacific region centers on the Chinese economy. Inflation has been rising at a 6.5% pace and strenuous efforts are being made to curtail asset price appreciation (particularly residential property). The Chinese government has raised interest rates and bank reserve requirement ratios in the hope of engineering a "soft-landing" (a managed gradual decline in the pace of economic growth). The potential of a "hard-landing" (a sharp and uncontrolled slowdown in economic growth) for the Chinese economy is perilous not only for global economic growth but also raises the risk of social unrest.

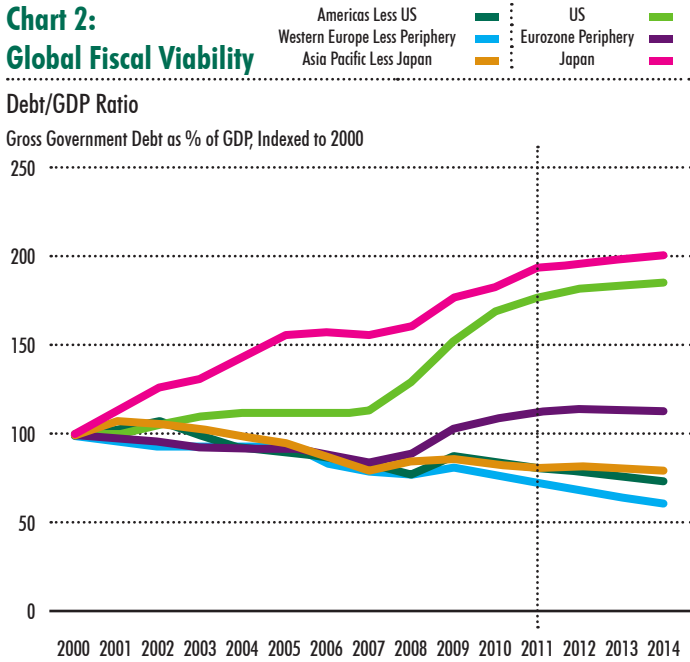
In addition to China, other export-dependent economies in Asia with large exposures to the U.S. and/or Europe should be impacted by a slowdown. Specifically, Thailand, Taiwan, Korea, Malaysia, the Philippines, Japan, Australia and New Zealand are likely to experience export-driven slowdowns either through weaker demand or lower export prices, or both.

Across Latin America, with the exception of Mexico, overheating of some of the key regional economies is an emerging concern. The global recovery and China's appetite for commodities has fueled both economic growth and inflation in Brazil, Peru, Chile and Columbia. Brazil, the bellwether of Latin American economies, is being impacted by recent market volatility in the developed economies. The higher interest rate differentials and still relatively low government deficits continue to attract global capital flows. This has raised the value of the Brazilian Real, which is hurting local manufacturers. The government announced just this week that it will be providing tax relief to negate the impact of the appreciating currency on Brazil's net export position.

**Q5: GIVEN THAT SOVEREIGN DEBT IS AT THE CENTER OF THE STORM, WHAT IS THE RELATIVE DEBT TO GDP POSITIONS OF THE DIFFERING ECONOMIES GLOBALLY?**

**A.** The ratio of a country’s debt to GDP is a reasonable measure of its fiscal vitality. It reflects the ability of the country to repay its debt. As Chart 2 shows, this ratio has been rising in Japan and the U.S. since 2000, and in the U.S. it has spiked dramatically since 2007. The countries on the periphery of the Eurozone, e.g., Greece, Italy and Portugal, have seen similar debt trajectories. Note that, except for Japan and the U.S., the debt ratio is falling for countries in Asia and the Americas, as well as most major economies in Europe outside the periphery. The emerging markets are generally reaping the rewards of the reforms that were made to their economic and financial systems following their own financial crisis in 1997/8.

**Chart 2:**  
**Global Fiscal Viability**



Source: CBRE Econometric Advisors, Oxford Economics as of Q2 2011.

**Q6: IN VIEW OF THE CURRENT MARKET TURMOIL, WHAT ARE YOUR EXPECTATIONS FOR GLOBAL GROWTH GOING FORWARD?**

**A.** Downside risks facing global economic growth have increased. The fragile recovery in the U.S. and Europe, relatively high levels of government debt in the developed world and mounting uncertainties will surely weigh on global growth. Both business and consumer confidence will take a hit, leading corporations and consumers to delay any discretionary expenditures until market volatility subsides. This should lower global growth through its impact on spending at the same time that governments, facing budgetary woes, are unable to increase outlays to head off any slowdown. This will be magnified by attempts by the monetary authorities to contain inflationary pressures through the slowing of their respective economies.

*Our expectations for global growth have been downwardly revised but we do not expect a recession. Moreover, central banks across the developed world remain committed to forestall any deeper economic decline than we are currently witnessing by shoring up global liquidity.*

**U.S.:** Growth prospects for the U.S. have deteriorated but we do not expect the economy to fall into another recession. Despite austerity measures that will rein in federal spending, business spending, consumers, and net exports should contribute to a moderate growth trajectory during the balance of this year and in 2012. Economic growth should average 2.5% in both 2011 and 2012. There are two factors shaping our sanguine view of economic growth. First, U.S. corporate earnings have been strong, beating consensus. U.S. corporations enjoy pristine balance sheets with roughly \$2 trillion of cash sitting on their balance sheets. Once uncertainty diminishes, they are expected to increase capital expenditures in order to remain competitive globally. Secondly, the lower value of the U.S. dollar has made U.S. goods more price competitive on a global scale. This will not only boost exports but will increase demand for U.S.-made import substitutes, further buoying

growth in the domestic manufacturing sector. The June drop in exports reflects slowing global growth, but exports remain above the levels seen in 2007. The U.S. Fed has also stated that it remains vigilant in the face of weakening growth and remains open to further policy that supports the U.S. economy. This includes their unprecedented move to keep interest rates near zero through mid-2013.

**EMEA:** The overall weakening in the global economy has been reflected in signs of slower momentum in many European economies, although still with wide disparities in performance. Expectations for growth in the UK for both 2011 and 2012 have been downgraded in light of recent weak GDP figures and the economic performance of other EU economies is likely to follow suit. Prospects for growth in Germany, although still among the most positive in Western Europe, have been dampened by likely weaker demand for its exports, while the peripheral Eurozone economies will remain stressed and will struggle to achieve any marked improvement in growth in 2012.

The latest consensus expectation for growth in the EU as a whole in 2012 shows expansion remaining below 2% with no acceleration from 2011. Forecasts for GDP growth in the major economies in the Union lie mainly in a range from around 1% to 2.5%. Eastern European economies, on the other hand, are expected to continue to sustain higher rates of expansion, reflecting their emerging markets characteristics.

**Asia Pacific:** It is important to recognize that Asia Pacific is far from a homogenous region. While China, India and much of Southeast Asia have seen relatively healthy growth, this has not been without its challenges. Japan's recovery saw a setback following the March earthquake, which had both positive and negative impacts on different countries as a result of supply chain readjustments. Australia and New Zealand faced natural disasters of their own, with significant economic ramifications. In Australia, there has been a growing dichotomy between the strong performance of resource-based sectors and the weakness seen in other areas of the economy. The Pacific region was expected to see something of a recovery into 2012, but this was in the context of a broadly supportive global improvement which is now in question.

Overall, most economies in the region are hostage to the fortunes of China and the developed Western economies. To the extent that the outlook has changed, this simply represents an accentuation of the concerns which already existed over the future prospects for these two key drivers. Short term, we must expect lower levels of activity in those countries most directly export-linked to the U.S. and Europe, but as the world's dominant import blocs, there are few countries in the region that are not likely to be affected to some degree. Those heavily dependent on tourist flows from these countries could also be affected by unattractive currency differentials and a weaker propensity for long-haul holidays. Asia is generally well placed to weather the current short-term volatility, but the future performance of the developed economies of the world remains the crucial medium-term issue.

#### Q7: HOW HAVE OTHER COUNTRIES FARED IN THE AFTERMATH OF A DOWNGRADE?

- A. A historical look at past downgrades and their impact on national equity markets may provide some insight into the likely trajectory for the U.S. and, indirectly, global markets. In nine of the past 11 downgrades of AAA-rated sovereign debt, the broader equity markets in those countries rallied significantly over the subsequent 12 months.

**Chart 3: Equity Market Performance in Response to Past Rating Cuts from AAA**

	Downgrade Date	Day of Downgrade	1 Month Later	3 Months Later	6 Months Later	12 Months Later
Ireland	5/6/1998	0.4%	-7.0%	-8.8%	-20.1%	4.8%
Ireland	3/30/2009	1.6%	17.6%	4.0%	18.3%	20.8%
Belgium	5/6/1998	0.6%	7.7%	17.0%	9.5%	13.5%
Finland	5/6/1998	-0.2%	-3.4%	3.9%	-0.8%	55.8%
Italy	5/6/1998	0.7%	3.2%	0.6%	-10.2%	5.2%
Portugal	5/6/1998	0.9%	-5.2%	-6.4%	-15.0%	-25.5%
Spain	5/6/1998	0.4%	3.2%	2.5%	-7.7%	0.7%
Spain	1/19/2009	1.7%	-7.7%	7.6%	20.6%	40.7%
Japan	2/22/2001	-0.5%	2.1%	9.9%	-6.2%	-19.9%
Canada	4/12/1995	-0.6%	-0.9%	9.7%	3.1%	18.2%
Australia	9/12/1986	-0.5%	8.5%	15.7%	32.2%	86.4%
Average		0.4%	1.6%	5.1%	2.2%	18.2%

Source: DB Private Wealth Management, FactSet, Price Returns reflected only, using MSCI indices.

### Q8: WHAT ARE THE SHORT-TERM IMPLICATIONS FOR REAL ESTATE INVESTORS?

- A.** In the short run there will be heightened volatility as investors readjust their growth expectations for the world's major economies, most particularly the U.S. Investors buy future cash flows, and these now face higher downside risks than they did a few weeks ago. Hence, asset prices will adjust downward to reflect the new, more conservative estimates of future cash flow.

Equity investors in real estate will react differently depending on their risk profile. Investors with a higher risk tolerance will look for opportunities in volatile markets. More risk-averse investors may delay any new outlays of capital.

While investors in companies must evaluate future cash flows against a backdrop of slowing economic growth, commercial real estate investments face more certainty of future cash flows, provided they are leased to credit-worthy tenants.

Early signs in the U.S. CMBS market indicate a withdrawal of capital, with spreads widening. Debt sources, however, lead us to believe that there is ample supply of capital available for core deals.

Lending rates should stay low but with more conservative underwriting standards and stricter covenants. While we believe global equity markets will be under pressure, commercial real estate should not fare as poorly because it remains a preferred asset class, within a well-diversified, multi-asset institutional portfolio. Increasingly risk-averse capital will look for core, income-producing assets in primary markets to satisfy demand.

In Europe, there has been less improvement in the supply of mainstream bank debt for property investment and new activity in the CMBS market has been limited. In the short term, lending is likely to remain constrained and may tighten in some parts of the market. At the same time, European markets have seen growth in potential sources of mezzanine finance and new debt funding through the insurance sector. Opportunities for these forms of finance are likely to increase.

In Asia, short-term implications are likely to be limited. Some investors may be tempted to stay on the sidelines while the current extreme volatility exists—but for many local investors (who are currently the dominant force in the market) this volatility is of less concern. Of greater import is whether there will be a more fundamental shift in investor confidence on the back of weaker confidence in global fundamentals. As yet there is no sign of this—but in truth it is too early to judge whether such a shift is now underway.

#### **Q9: WHAT ARE THE IMPLICATIONS FOR REAL ESTATE FUNDAMENTALS?**

- A.** Real estate fundamentals change more slowly than real estate values and debt availability. However, we might see a postponement in tenant expansion or relocation decisions. New development will have more difficulty getting off the ground.

If a decline in business and consumer confidence persists for a time, it may delay any meaningful recovery in the U.S. economy and adversely affect the nascent recovery in property market fundamentals. Leasing volumes are expected to slow and the recent improvement in key performance metrics (absorption, occupancy, rents) should lose the momentum that was evident in the first half of 2011.

Weaker economic forecasts imply weaker letting market prospects in European markets, but a notable feature of the supply/demand balance in many retail and office markets is the scarcity of readily available new space due to the protracted downturn in development activity. Vacancy rates in CBD offices, for example, have been moving down and pipelines for the short term are thin in most major cities. The supply-side foundations for cyclical recovery in rents, as and when letting demand does improve, look positive in a range of markets.

In Asia, real estate fundamentals have been relatively strong and if anything the challenge has been the scale of the supply pipeline in some markets, as developers seek to take advantage of strengthening demand. To the extent that this demand is being driven by local or regional companies, little is likely to change in the short term unless fundamental global economies have in fact weakened markedly. However, multinational occupiers are in a different position. They recognize that Asia is—to some extent—different. It is noteworthy that amidst the announcement of recent headcount reductions in the banking sector, many are at the same time continuing to hire aggressively in Asia. That said, in most cases a high proportion of multinational corporation businesses lie in other parts of the world. The prospect of ongoing volatility and slower growth elsewhere will almost certainly impact on the scale and timing of their expansion plans in Asia, which could potentially have an impact on Asia's global hubs—those cities such as Tokyo, Hong Kong, Singapore and Shanghai which (as our recent Global Business Footprints report demonstrates) are most exposed to major global companies.

#### **Q10: WHAT ARE THE IMPLICATIONS FOR INVESTMENT TRANSACTIONS?**

- A.** With heightened uncertainty, transaction volume may slow. Through the second quarter of this year, we have seen greater U.S. transaction volume based on Real Capital Analytics data with a continued compression in cap rates. In light of recent events, both sellers and buyers may sit on the sidelines to assess the environment. There will also be less transparency of pricing and valuation metrics in this climate, making it increasingly challenging to accurately underwrite real estate values.

Multiple economic concerns will weigh on investor confidence, causing a further rotation toward the least-risky assets and increasing demand for core assets located in primary markets. Assets further out on the risk spectrum—including value-add “plays” and those properties in secondary markets or peripheral locations—may be less desirable until the economic uncertainty is reduced.

Across European markets, the uncertain and uneven outlook appears likely to give some reinforcement to investment trends already apparent during the first half of 2011. In summary, these have reflected the marked influence on investor demand and activity of geography, asset quality and local market liquidity. One dimension of this has been, as elsewhere, a focus on prime quality assets in core markets, which is likely to be sustained. An emergent trend for investors to move toward “good secondary” properties located in stronger markets and/or with improvement potential could be curtailed until uncertainty lessens, although investors with a higher risk appetite (and asset management capabilities) may see more opportunities in this environment.

Total investment flows in Europe showed signs of easing during the first half of 2011, although this was mainly due to lower volumes in the UK and subdued activity in the southern periphery. Rising activity was evident in Germany, the Nordic markets and parts of Central and Eastern Europe. Investors have been focusing more on markets perceived to have stronger economic fundamentals and where growth prospects are better. It seems likely that the divergent outlook across European economies will continue to shape the direction and level of investment activity. At the same time, heightened risk aversion, among some investors, will increase the relative attractiveness of major markets perceived to offer advantages of depth and liquidity—London and Paris, for example.

Preliminary analysis in the U.S. indicates that the multifamily sector will be the least affected fundamentally by a slowdown or even a new recession. The sector should benefit from increased investor risk aversion. However, one deal that we are aware of—a fractured condo sale—recently fell through. The investor was willing to buy at around a 5 cap in a high-end development but dropped out of the bidding. The deal structure was really the issue. Converting a fractured condo to rental apartments is a risky venture. Last week investors were willing to take that risk, while they are more hesitant this week.

In Asia Pacific, investment demand has largely been driven by local or regional capital rather than inflows of investment from elsewhere. With prices having reached aggressive levels in some markets—in certain cases exceeding their 2007/8 highs—there is clear vulnerability to a shift in investor sentiment due to lower growth prospects. However, there is a huge weight of investment capital looking to access the Asian markets and a shortage of sellers of better-quality assets. Asian investors remain, on the whole, in bullish mode. Some institutional investors have already started to look at selling into this demand and, dependent on the property concerned and pricing expectations, any shift toward disposals could see transaction volumes increase. If ever there was a time when people might take different views on the outlook, it is now—and that’s what makes a market! Given the prevailing climate of risk aversion, strong medium-term prospects for the region and the likelihood that global capital will continue to gravitate towards Asia, we would expect to see healthy demand for any good buildings offered for sale.

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This report was prepared by the Global Team, which forms part of CB Richard Ellis Global Research and Consulting—a network of preeminent researchers and consultants who collaborate to provide real estate market research, econometric forecasting and consulting solutions to real estate investors and occupiers around the globe.

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