

Our View Aftershocks and Imbalances

3Q 2010



"We learn geology the morning after the earthquake."

Ralph Waldo Emerson

Introduction

While the tone of the real estate investment industry has improved globally, the events of 2010 have been thus far as complex and interrelated as any in our careers. Certainly, global growth is rebounding from the depths of the Global Financial Crisis (hereafter, the "GFC"), however, uncertainty regarding the medium-term direction of the global economy is significant, as the fiscal imbalances – which were at the heart of the causes of the GFC – remain unresolved.

Opinions differ profoundly regarding appropriate courses of action with regard to fiscal and monetary policy within each country. In most of the OECD¹ countries, a recent push for fiscal austerity seems to fly in the face of the lessons of the 1930's America and, more recently, late-1990s Japan, and yet is being pursued aggressively. As a result, investors are unsure whether to fear inflation, deflation, default, financial shocks, or all of the above.

In this quarter's *Our View* we cover a broad range of interrelated and intriguing topics. It is presented in the three sections, and in particular covers recent sovereign risk issues in Europe:

A Reviving Global Economy: Economic performance in the first quarter of 2010 showed general improvement across the globe with GDP improving and world trade rebounding. Asia (ex-Japan) is exhibiting the strongest rebound growth while southern Europe suffers from sovereign debt issues. In the Americas, U.S. growth is muted and job formation stagnant, while Brazil and Mexico show relative strength. Unfortunately, capital market indicators generally declined, perhaps due to fiscal issues in Southern Europe, but more likely as a result of uncertainty regarding sustainability of a very fragile recovery.

Aftershocks of the GFC: Thus far, the repercussions of the GFC have differed by country, sometimes greatly. Aftershocks of the GFC are likely to go on for years, with fiscal worries undermining confidence in the financial sector and back again. The countries of southern Europe generally find themselves in difficult positions, while all of Europe prepares for austerity. Further, financial repression will likely result as governments attempt to coerce market demand for their excessive supply of debt. In all, there is

a costly lesson to be learned regarding second order effects and contingent liabilities.

Global Imbalances: Macroeconomic events will affect virtually every driver to real estate returns, often significantly. In particular, imbalances and affects of policy decisions will continue to affect each nation's economic growth, job formation, currency rates and cost of capital. Specifically, can the U.S. continue to be the primary purchaser of the world's goods, financed by the global exporting countries, primarily led by China and the oil exporters? While China may be embarking on a drive to further develop internal demand and thereby alleviate imbalance pressures, sovereign issues and devaluation of the Euro may result in increasing imbalances. And the U.S. dependence on imported oil may make it difficult to exit this pernicious cycle.

Long term investors in real estate benefit by positioning capital away from risk and in the flow of potentially favorable events. For global investors: choose your country allocations wisely! For domestic-only investors: be prepared to have world events continue to affect your domestic returns as second order effects are dangerous and real.

A reviving global economy

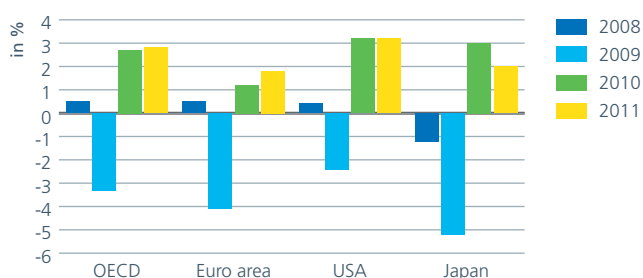
The global economy has undoubtedly been improving. The IMF recently reported in an update to its World Economic Outlook that the world economy expanded at an annualized rate of over 5% during the first quarter of 2010. This was better than expected in the April 2010 WEO, mostly due to robust growth in Asia.

In its latest economic outlook, the OECD has said that the world economy is forecast to grow 4.6% in 2010, after a 0.9% decline in 2009. Gross domestic product (GDP) across OECD countries is projected to rise by 2.7% this year and by 2.8% in 2011. These are upward revisions from the previous, November 2009, forecasts of OECD-wide GDP growth of 1.9% in 2010 and 2.5% in 2011 and are better than almost anybody expected even half a year ago. Unconventional policy has stopped the crisis from becoming a depression, so far.

Economic activity in OECD countries is picking up faster than expected but volatile sovereign debt markets and overheating in emerging-market economies are presenting increasing risks to the recovery.

1. Organisation for Economic Co-operation and Development

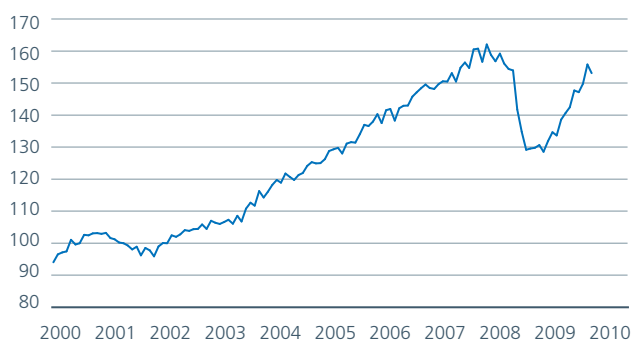
GDP projections (% change from previous year)



Source: OECD, Economic Outlook

Trade flows are rising again as strong growth in China (fueled by massive fiscal stimulus) and other emerging markets is helping to pull other countries out of recession. But at the same time, the risk of overheating and inflation is growing in emerging markets.

Index of world trade, 2000 = 100

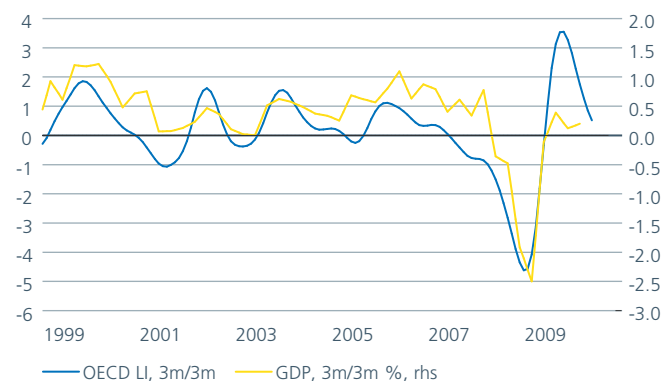


Source: FactSet, CPB Netherlands

Uneasy indicators

Despite a return to economic growth throughout the majority of the world, financial markets in the second quarter of 2010 were particularly weak, perhaps understandably so given recent world events. The Greek sovereign crisis, BP oil spill, potential effects of U.S. regulatory reform, potential overheating in China, burn-off of stimulus worldwide, and the latest North Korean aggression have been notable issues. Further, disappointing economic data have led to market anxiety over a potential soft patch in U.S. growth following a very strong first half of the year. Globally, European fears have now spread to risk assets in general as in many ways European contagion has become a predominant driving force of asset markets.

OECD Eurozone lead indicator and GDP



Source: FactSet

As we have written in the past, we have believed and continue to structure investment portfolios with the underlying assumption that the developed world economies will “bump along the bottom” as deleveraging pressures in both the private and government sectors create strong headwinds against relatively strong business financial conditions. In these “developed world” and current account deficit markets, relatively conservative investment strategies are warranted. And while the emerging world current account surplus countries have shown very strong recoveries over the first half of 2010, caution remains the hallmark due to a strong dependency on China economic policy (which is becoming less expansive), potential contagion effects from financial issues in the Eurozone, and a real question about the long-term sustainability of running surpluses.

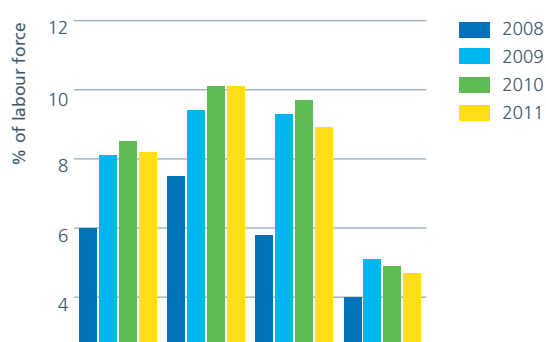
The following chart highlights capital market response to uncertainties, despite recovering economic performance. While some may argue that weak capital market performance in the first half of 2010 results from the difficulties in Southern Europe, we are inclined to believe that the markets are indicating concern regarding the sustainability of a very fragile economic recovery.

Capital Market Index	First half 2010
Performance	
S&P 500	(7.6)%
FTSE 100	(9.2)%
Euro Stoxx 50	(13.2)%
Shanghai Composite	(26.8)%
Nikkei 225	(11.0)%
MSCI World	(9.7)%
MSCE Emerging Mkts	(6.7)%
Euro vs USD	(14.6)%
S&P GSCI Commodities Index	(5.6)%
Crude Oil	(6.0)%
Gold	13.5%
US Dollar Index	6.6%

Sources: Datastream, Bloomberg

In another bearish signal for real estate, the OECD reports that the growth in jobs is not keeping pace with economic recovery. The number of unemployed has risen by 16 million in OECD countries in the past two years. The Outlook says the unemployment rate may now be peaking at an average 8.5% across OECD economies and is likely to fall only slowly in the near term. This does not bode well for a demand-led real estate recovery – again a signal to remain cautious and selective.

Unemployment rate (% of labor force)



There is a long way to go until economic recovery is entrenched and robust. World growth is projected at about 4½% in 2010 and 4¼% in 2011.

Relative to the April 2010 World Economic Outlook (WEO), this represents an upward revision of about ½ percentage point in 2010, reflecting stronger activity during the first half of the year.

Latest IMF projections

The world economy is recovering better than expected, but at varying speeds for different regions.

Percentage	Projections				Difference from April 2010 WEO projections	
	2008	2009	2010	2011	2010	2011
World Output	3.0	-0.6	4.6	4.3	0.4	0.0
Advanced economies	0.5	-3.2	2.6	2.4	0.3	0.0
United States	0.4	-2.4	3.3	2.9	0.2	0.3
Euro Area	0.6	-4.1	1.0	1.3	0.0	-0.2
Germany	1.2	-4.9	1.4	1.6	0.2	-0.1
France	0.1	-2.5	1.4	1.6	-0.1	-0.2
Italy	-1.3	-5.0	0.9	1.1	0.1	-0.1
Spain	0.9	-3.6	-0.4	0.6	0.0	-0.3
Japan	-1.2	-5.2	2.4	1.8	0.5	-0.2
United Kingdom	0.5	-4.9	1.2	2.1	-0.1	-0.4
Canada	0.5	-2.5	3.6	2.8	0.5	-0.4
Other Advanced Economies	1.7	-1.2	4.6	3.7	0.9	-0.2
Newly Industrialized Asian Economies	1.8	-0.9	6.7	4.7	1.5	-0.2
Emerging and Developing Economies	6.1	2.5	6.8	6.4	0.5	-0.1
Central and Eastern Europe	3.1	-3.6	3.2	3.4	0.4	0.0
Commonwealth of Independent States	5.5	-6.6	4.3	4.3	0.3	0.7
Russia	5.6	-7.9	4.3	4.1	0.3	0.8
Excluding Russia	5.3	-3.4	4.4	4.7	0.5	0.2
Developing Asia	7.7	6.9	9.2	8.5	0.5	-0.2
China	9.6	9.1	10.5	9.6	0.5	-0.3
India	6.4	5.7	9.4	8.4	0.6	0.0
ASEAN-5*	4.7	1.7	6.4	5.5	1.0	-0.1
Middle East and North Africa	5.3	2.4	4.5	4.9	0.0	0.1
Sub-Saharan Africa	5.6	2.2	5.0	5.9	0.3	0.0
Western Hemisphere	4.2	-1.8	4.8	4.0	0.8	0.0
Brazil	5.1	-0.2	7.1	4.2	1.6	0.1
Mexico	1.5	-6.5	4.5	4.4	0.3	-0.1

Source: IMF, *World Economic Outlook, July 2010*

* Indonesia, Malaysia, Phillipines, Thailand and Vietnam

The WEO forecast for 2011 is unchanged. At the same time, downside risks have risen sharply amid renewed financial turbulence. In this context, the new forecasts hinge on implementation of policies to rebuild confidence and stability, particularly in southern Europe.

Overall, the WEO forecast continues to be consistent with a modest recovery in advanced economies, and still-robust growth overall in emerging and developing economies, but with considerable diversity among them. For 2011, growth in advanced economies remains broadly unchanged from the April 2010 WEO, at 2½ percent. Somewhat stronger projected growth in the United States (owing to gathering momentum in private demand) is offset by slightly weaker projected growth in Euro Area (due to the turbulence). Challenging the recovery in these economies are high levels of public debt, unemployment, and in some cases, constrained bank lending.

Output growth in emerging and developing economies is expected to edge down to 6½ percent on an annual basis in 2011. This forecast is broadly unchanged from the April 2010 WEO, with key emerging economies in Asia and in Latin America continuing to lead the recovery.

We have been consistent in expecting emerging market growth to outperform that of the developed world as their world economy emerges from the cyclical trough. Accordingly, we have believed that real estate investing activity in the developed world should remain tilted toward defensive strategies (e.g., debt, preferred equity, stabilized properties) rather than aggressive growth oriented objectives (e.g., leveraged equity, development). Even within emerging markets, growth expectations must be undertaken only with a rigorous value exercise in order to avoid disappointing investment results due to premium pricing driven by excessive weight of capital overwhelming thin investment markets.

Aftershocks of the GFC

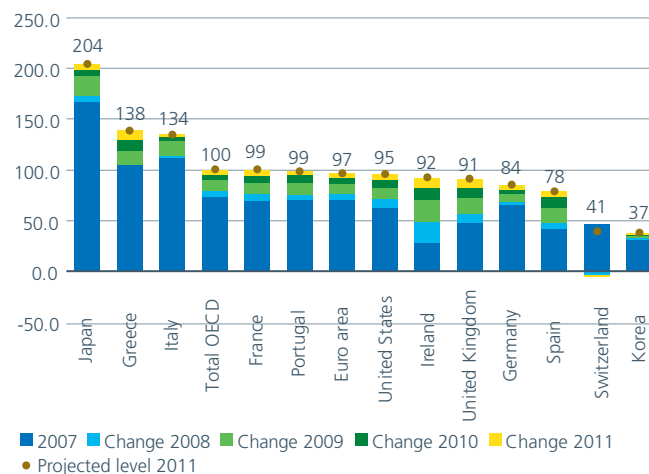
Last quarter we presented sovereign risk as one of six areas of uncertainty that we are monitoring carefully. This quarter, events in Greece have gone as far as to call the European project into question. This is perhaps the second stage of the GFC, during which we continue to expect a series of continued aftershocks – the first of these was the Euro debt crisis, which began when Greece revealed greater financial obligations than were “on the books”. As 2010 continues to prove, it is unreasonable to expect a simple global recovery given the unprecedented financial crisis and the unprecedented response to it.

While extraordinary fiscal and monetary action on the part of the world’s central banks prevented a global depression, they did not address many of the factors affecting imbalances that continue to pose risk to the financial system. Significantly, fiscal crises can be the aftershocks of financial crises, which can in turn cause further financial aftershocks.

There is no doubt that there is a huge debt burden weighing on many OECD countries as a result of additional public sector debt taken on, in some cases on top of already high obligations. The chart below highlights the debt for a number of countries before and after the global financial crisis.

Public debt before and after the crisis

Government debt as a % of GDP



Source: OECD, Economic Outlook

There are no easy solutions. In the long run, as national economies strengthen, emergency fiscal measures must be removed and even reversed – but there is little evidence that many mature economies are currently strengthening sufficiently. In fact, whether emergency fiscal measures need to be removed right now is extremely contentious, in similar fashion to the U.S. in the 1930s. In many countries, fiscal austerity is underway, we can only hope that spending cuts and tax increases should focus on areas that are the least harmful to growth – it will not be easy.

It’s also a reality that during complex periods, trade liberalization is difficult to promote. While reforming trade, product and labor market to enhance transparency, flexibility and competition should be part of globally coordinated strategies to increase global growth, trade reform in the economic environment of the next decade seems unlikely.

As the second quarter ended, the developed countries of the world were implementing a dangerous experiment – repeating an economic policy out of the 1930s, starting to cut spending and raise taxes before economic recovery is firmly assured. The hope is that the overall situation is different enough from the past to assure a better outcome than the economic decline which ensued in the past. If the private sector makes up for the slack, governments will have taken a strong step to improve fiscal positions. If not, (most likely because the private sector continues to pursue deleveraging), economies will decline, tax receipts will diminish, and fiscal positions could actually deteriorate.

What does this mean to a real estate investor? Everything. That “100%-location” building you own hasn’t performed so well if it’s

in downtown Reykjavik or Athens. On the other hand, a class-B, off center property in Sao Paolo or Sydney held up relatively well during the storm. For investors thinking globally, investment strategy has to start with a thorough long-term look forward view of macro economic forces.

The PIIGS are grounded²

Prior to the GFC, financial and property markets, fueled by leverage, increased in value, complexity and risk tolerance worldwide. Government tax receipts increased but spending in the developed world exceeded receipts so borrowing increased at a faster pace. In the new Eurozone, all governments found they could borrow as if they were Germany, despite lower productivity. Accordingly, wages soared and households and businesses borrowed aggressively to buy and build both productive and marginally-productive assets. In many cases, fiscal deficits exploded to levels never before seen in peacetime, particularly in countries affected by the bubbles – so the threat of a fiscal crisis emerged.

Greece's financial crisis is perhaps an extreme example of a broader European problem – the growth in the size and power of the European Union has fed a dangerous sense of complacency. Everybody could aspire to the relatively comfortable, stable lives of the French and the Germans without the same level of productivity. For many years, it appeared to be working beautifully – as living standards improved in countries such as Spain, Greece and Poland. Unfortunately, in the long run Europe's existence as a "lifestyle superpower" is dependent on an ample supply of credit – and debt markets became nervous about some countries ability to service their debt.

10-year Greece bond/bund spread, daily



Source: FactSet

Subsequent to the GFC the situation is vastly different, particularly for a group of countries known as the PIIGS (Portugal, Ireland, Italy, Greece and Spain). Even after unprecedented support for Greece, in mid June Greece's credit rating was cut to non-investment grade, or "junk", by Moody's Investors Service, threatening to further undermine demand for the debt-strapped nation's assets as it struggles to rein in its budget deficit. In making the four-step

downgrade to Ba1 from A3, Moody's cited "substantial" risks to economic growth from the austerity measures tied to a 110 billion-euro aid package from the European Union and the International Monetary Fund. The lower rating "incorporates a greater, albeit, low risk of default," Moody's said. In June, Moody's Investors Service placed Spain's Aaa credit ranking on review for a possible downgrade, citing deteriorating growth prospects and challenges in meeting fiscal targets.

Amid concerns about sovereign risk in Greece (and Ireland, Italy, Portugal, Spain and Hungary) the Euro declined by 15% through the end of June reflecting investor investor anxiety about increases in debt in Greece and elsewhere, and that other countries in peripheral Europe will find it difficult to grow out of their difficult situations. Without floating rate national currencies, which would allow realignment and facilitate exports growth in problem countries, structural reform alone will likely result in severe recessionary and deflationary domestic pressures, which will affect the northern European countries that export to the south, as well as the banks through the region who have been heavy lenders in the region.

Unfortunately, a decline in the Euro will also worsen prospects elsewhere – in the UK and U.S., for example, both countries with huge fiscal difficulties as well who will find their exports to be less competitive. While the markets don't seem to mind now, this view could change.

It is possible that the momentum gained by the U.S. and the big emerging markets, especially China, will let the world ride through the shocks – however, even in aggregate, the emerging countries are too small and weak to be locomotives for the entire world. And while the OECD calls the outlook 'moderately encouraging', one could argue that the massive fiscal deficits are unsustainable and that attempts to rein them in, in the Eurozone and UK, are going to cause renewed recession and political strife.

Preparing for Eurozone Austerity

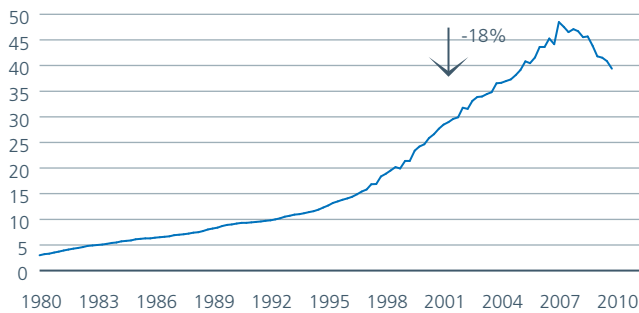
While Europe has bought itself time with the establishment of a €750bn bail-out fund, a long-term problem remains – many parts of the European Union are living beyond their means, with government deficits at worrisome levels and public-sector debt rising. If certain European governments, particularly Spain and Greece, do not use their new breathing space to control spending, it is quite possible that financial markets will get dangerously restless again. At the same time, the push for increased austerity among the stronger of the European countries will put the nascent economic recovery at risk.

Greece has cut spending, raised taxes and trimmed wages to tackle the deficit, which swelled to 13.6% of gross domestic product last year, more than four times the EU limit. As a Moody's representative noted: "It's rare for a country to implement so much structural reform in a very short time".³ To secure the EU-IMF aid,

2. Apologies to Bruce Lansky author of "If Pigs Could Fly, and other deep thoughts"... and to the good people of Portugal, Italy, Ireland, Greece and Spain.
3. Bloomberg.com, June 15, 2010

the government pledged to trim the shortfall to 8.1% of GDP this year and bring it back under the 3% EU ceiling in 2014.

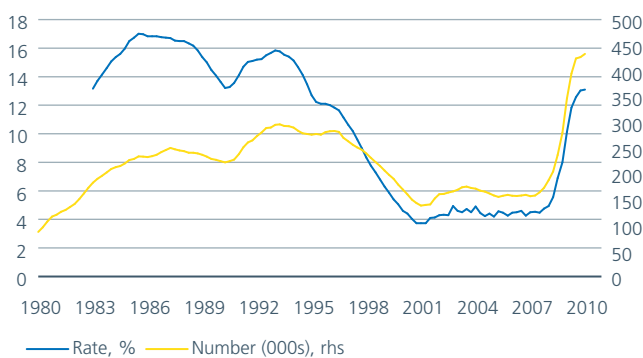
Ireland: nominal GDP Euro bn



Source: FactSet

Ireland has also implemented severe austerity plans. For several years Ireland was held up as the shining example of success within the Eurozone, with rapid GDP and jobs growth, modest inflation, low taxation, and a seemingly vibrant economy. But Irish the boom ended in a severe bust. The combination of fiscal hardship and, more importantly the bursting of the domestic bubble, has meant a huge decline in nominal GDP – the Irish economy has shrunk by 13%, house prices are falling and unemployment is soaring. Inflation has turned significantly negative and nominal GDP continues to plunge.

Ireland: unemployment



Source: FactSet

Aviva Investors' analysis of Spain in particular leads us to expect European contagion to remain a predominant driving force of asset markets with broad implications – particularly because the size of Spain's GDP is significantly greater than that of Greece (\$1.36 trillion vs. \$341 billion in 2009)⁴. Further, Spain, like Greece, exhibits little political cohesion and thus is also a difficult place to implement reforms. For example in May Spanish Prime Minister, Jose Luis Rodriguez Zapatero, won approval for a new austerity

package by a single vote. However, the emergency austerity package is not nearly as severe as that of Greece or Ireland as it is worth \$15bn or 1.5% of GDP of which 0.5% will be used in 2010 and 1% in 2011.

10-year Spain bond/bund spread, daily



Source: FactSet

The housing market continues to be a major issue in Spain. If the Spanish banks start taking write downs for all the residential real estate debt on their books it's possible that capitalization ratios fall dramatically and the chance of financial contagion grows. Accordingly, financial sector repair must be a key policy priority. Further, as noted below, the interest rate spread of Spanish bonds over that of German bonds has increased, making any reform even more difficult to implement, and raising the cost of capital even further for beleaguered Spanish real estate developers.

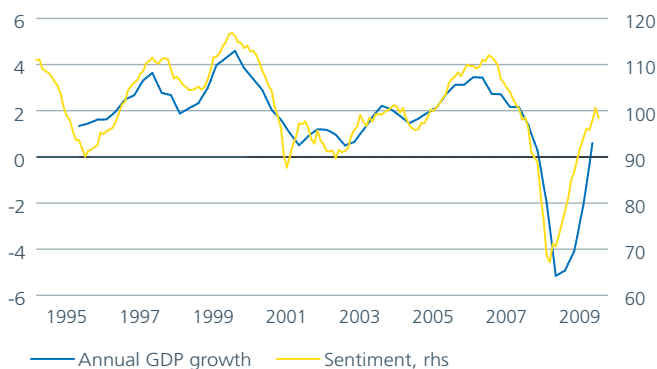
The main challenge for Spain remains seeking a balanced pattern of growth as the housing-fueled economic boom of the past ten years proved unsustainable. Securing a successful rebalancing would involve slowing the growth of domestic demand together with faster growth of exports, which represent 25% of GDP in Spain, compared to 40% in the Euro area. Because the decline of the Euro will not significantly benefit Spain (only 7.5% of its exports go outside the Euro area⁵), ultimately real wages will have to be reduced and productivity increased, particularly through labor market reforms, as well as product and service market liberalization. This will not bode well for real estate investment there.

While PIIGS debt-levels and budget deficits are large and of concern to the investment community, even Europe's big three – Britain, France and Germany – are hardly immune from concern, although investors are currently very willing holders of government debt despite very low returns offered. This likely results from legal and market transparency and trust in the financial indicators. In any event, austerity measures are being debated strongly in virtually every major market in Europe, with many even the strongest economies determined to reduce public spending.

4. Source: CIA World Factbook, 2009 Estimates in Purchasing Power Parity
5. Nomura Global Economics, Europe Special Report, Spain, July 5, 2010

Unfortunately, reduced government spending will result in lower growth within the region, and globally – affecting demand for real estate, particularly with Europe’s trading partners and in trade centers. Further, Germany’s determination to reduce public spending will likely exacerbate global imbalances. Moreover, continued uncertainties will likely reduce consumer discretionary spending, potentially increase the cost of capital, reduce economic growth and job growth and continue downward pressure on the Euro currency.

EC: Economic sentiment and growth



Source: FactSet

Sovereign debt issues in many southern European states have demonstrated the need for significant economic adjustment and urgent repair of government balance sheets. Given that this is yet to be fully reflected in relative pricing of real estate, our preference of the core markets of Germany, France, Benelux and Nordics has intensified. Despite headwinds, we expect the total return profile for these markets to improve. It is possible that in a risk-averse investor environment bond yields in these countries that are perceived to have secure government balance sheets could be very low for a long period. This may result in further yield compression in the for the highest quality properties. In southern Europe however, both income and investment risks are elevated.

Anticipating Financial Repression

According to Carmen Reinhart, co-author along with Ken Rogoff of *This Time is Different*, a study of financial crises, financial repression typically follows a sovereign debt crisis, which follows a financial crisis. Investors in cross-border real estate investment should take heed.

According to Reinhart, the potential for financial repression is supported by the history of both advanced and emerging countries. First, governments encourage credit expansion by the financial sector – resulting in a mountain of bad debt. At some following point a panic ensues and governments nationalize the liabilities of their financial sector. More importantly though, governments find their revenues collapsing, along with the economy - huge fiscal

deficits emerge and public debt starts to soar. (An alternate route is for governments to short-circuit this financial route and simply run huge and unsustainable fiscal deficits in good times). Either way, an unsustainable fiscal position leads, sooner or later, to a sovereign debt crisis, particularly if governments borrow in foreign currencies, short term, or both (as often happens, in such situations).

What do governments do when it becomes expensive to borrow? They promise to mend their ways, of course. But, by now, it is often too late: nobody believes them. So they tell the central bank to buy their bonds, which starts a run on the currency. Pegged exchange rates collapse and floating exchange rates fall. Inflation becomes an imminent threat.

At this point, desperate governments look for any way to force institutions to hold their bonds. This is the point at which financial repression begins: banks are forced to hold government bonds, for “liquidity”; pension funds are forced to hold government bonds, for “safety”; interest rate ceilings are imposed on private lending to prevent “usury”; and, if all else fails, exchange controls are imposed, to ensure nobody can easily escape from such regulations.

It is not clear how likely such measures are to be implemented in the advanced countries that are now in difficulty - but it is certainly worth watching, and as appropriate planning for risk mitigation strategies such as currency diversification and hedging.

The most plausible end-game scenario is some form of default for one or more countries, although political maneuvering and initiatives can keep things going almost indefinitely. At the very least, real estate investors should understand that government pressures might distort values in the debt capital markets, at least for the short term. Further, should the flight of capital to safety continue, secure-income real estate in relatively stable economies (e.g., Germany and the Nordics) may provide investors with attractive returns. In the extreme, investors should reposition portfolios away from countries in difficult financial straits.

Second order effects

Oil spills, global security and financial contagions may appear to have little in common, but they do. They all represent contingent liabilities that are by nature often unanticipated in valuation analyses. Balance sheets and asset valuations do not tell enough if one wishes to truly understand whether a business or property is viable or whether a government is overburdened with risk. This brings to mind the need for both broader thinking and a deeper dive into second order effects of potential global risks to better understand investment risk.

Much has been written about off-balance sheet structures and credit derivatives, particularly structured investment vehicles, or SIVs (see *Our View*, February and May 2008). And in many ways

off-balance sheet structures made risk assessment of Greece's bonds more difficult. Nonetheless, the problem has become more complicated than understanding the consequences of "innovation"-induced complexities.

While we may look back and feel vindicated that our investment analyses included consideration of a potential collapse of the U.S. housing markets on office tenant demand from the mortgage brokerage and finance industries, we failed to consider the implications of such a collapse on the entire global financial system. And while the expected probability of such a situation was perhaps low, the negative consequences if such an event did come to pass were obviously severe.

We must all better understand the contingent liabilities of entities indirectly linked to any particular credit risk. In the world of modern, interconnected markets, implied liabilities are everywhere that assets or countries or industries are seen as having a shared fate.

For example, David Rothkopf writing in the Financial Times⁶ notes that few investors when weighing the financial obligations of, say, Germany, prior to the Greece crisis would have listed "bailing out Greece" as a national liability for which Berlin was on the hook. There are many reasons Germany may feel an obligation to assist Greece, from noble European solidarity to the practical aspect that may be many German holders of Greek bonds. Nevertheless, most investors failed to understand that Greek profligacy was a problem for better managed economies to the north.

Similarly, AIG and General Motors were not carried on the books as U.S. government liabilities, but if they were too big to fail that likely meant that the government had an obligation to bail them out. While one could argue that this was a political choice, not an obligation, there are times when the political pressures are so great – when global financial cataclysm is the perceived alternative – that it becomes obligatory.

Investors, regulators and government financial officials must think more broadly about risk – even if this level of analysis invites the imagination of an almost endless supply of further risks to consider. We must recognize that contingent liabilities, particularly for government entities are here to stay and assess the obligations that federal treasuries may have to bear.

Events in southern Europe should remind all real estate investors to consider events outside our own borders and to appreciate that capital flows and governmental interrelationships often result in second order events, positive and negative. Aggressively developing markets that seem safe to local constituents (consider Dubai prior to the GFC) are subject to problems when their customers falter. And seemingly secure markets even without excessive development may be called upon to support the weak (consider Abu Dhabi's support of Dubai). For real estate investors in high-flying markets, diversification is often considered a costly risk mitigation strategy

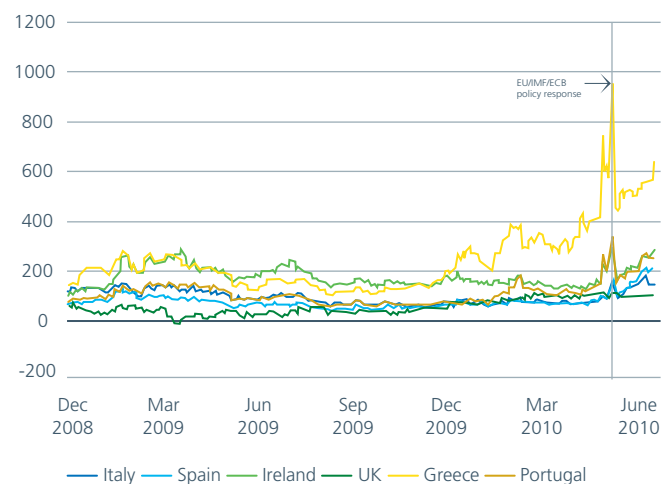
due to the natural reduction in expected return. Nevertheless, second order effects are under-appreciated and market diversification away from the seemingly "best" markets is often an under-appreciated performance saving strategy.

Global Imbalances

While it appeared for the past year that imbalances would be alleviated by reduced import demand in the U.S., it now looks as if imbalances are about to jump again – driven by the European situation. Fred Bergsten from the Peterson Institute for International Economics notes that new estimates from the OECD suggest that the sharp decline in the exchange rate of the euro, along with tepid European growth, will produce Eurozone surpluses of at least \$300bn (€251bn, £208bn) annually within the next few years.

European Bond Spreads

Basis points, 10-year bond spread to German bonds



Source: FactSet

The tightening of fiscal policies throughout Europe in response to the crisis, along with the new balanced budget amendment in Germany, will both depress domestic demand and require easier monetary policy that will weaken the euro further. These European developments will have effects similar to the overt steps taken by other major countries to enhance their trade competitiveness. The most extreme case is the sizable intervention by China and surrounding countries to keep their currencies undervalued. Other emerging markets are likewise seeking to expand further their war chests of foreign exchange by running large external surpluses.

The counterpart increases in deficits will again accumulate mainly in the U.S. as no other country could attract the requisite financing. Along with the large surpluses of China and other Asian countries, the new European surpluses will possibly double the American current account deficit beyond its previous record of \$800 billion in 2006.

6. *The all-too-real phantom balance sheet*, By David Rothkopf, *The Financial Times*, June 14, 2010

We note that while political rhetoric has focused on China as the main cause of the U.S. current account deficit, one could argue that the deficit was more closely tied to the price of oil than any other factor. Accordingly, when oil prices peaked in the first decade of the current century, the U.S. trade deficit was extremely high vis-à-vis the oil producing countries. With oil prices moderating over the past two years, considerable pressure has been reduced on the deficit. Nevertheless, with the euro currency depressed, the U.S. will find it difficult to maintain its recovery without continuing to run large budget deficits and again tolerating debt-financed consumer demand. This is the opposite of the rebalancing strategy agreed by the Group of 20 leading economies as critically important for sustaining global expansion.

Many regard this scenario as a desirable resolution of the current European crisis. Investor demand for U.S. Treasury securities and dollars could finance the American deficits for a while – and the U.S. would provide the global collective good, as in the past, by accepting increased dollar overvaluation and further increases in its external debt and deficits. However, Bergstrom sees three glaring problems with this vision, all centered on the U.S.

First: the sharp escalation of its own domestic and international imbalances would intensify the risk of future market attacks on the dollar and U.S. financial assets. As soon as Europe and other alternatives regain their acceptability to investors, the unsustainability of the U.S. situation would return to center stage at even more dangerous levels.

Second: the higher imbalances themselves could sow the seeds of a new financial crisis just as they helped sow the seeds of the last crisis. Such huge inflows of foreign capital would keep U.S. financial markets excessively liquid, hold interest rates down, promote underpricing of risk and thus again generate irresponsible lending and borrowing.

Third: a renewed explosion of the U.S. trade deficit could well trigger the outbreak of protectionist trade policies that has been largely avoided to date. With unemployment remaining very high, job losses to the “new mercantilism” abroad are likely to incite strong political reactions. New import restrictions, especially aimed against “unfair exchange rates,” could readily prevail.

Bergstrom believes that the G20 must adapt its rebalancing strategy to prevent this new threat to continued recovery and lasting global stability. Surplus Germany, along with China and Japan, must stimulate domestic demand. Not an easy task as perhaps the most damaging aspect of the crisis is the global boost it has given to the arguments of those advocating fiscal austerity – a cure which will almost certainly cause deep recession that lowers tax revenues and aggravates budget difficulties, while also causing bankruptcies that threaten an already weakened banking sector.

Most importantly, Bergstrom believes the U.S. must convince the world it is unwilling again to become the consumer and borrower of last resort. Only then will other countries stop relying on rising trade surpluses and become serious about generating domestic demand. While we would generally agree with his premise, we again note that trade in oil and fuel has caused much of the imbalance. Taking this into consideration, one has to conclude that U.S. energy policy to reduce dependence on foreign oil would also have beneficial effect on global imbalances.

A note on surpluses and deficits

The current account balance is one of two major measures of the nature of a country's foreign trade (the other being the net capital outflow). A current account surplus increases a country's net foreign assets by the corresponding amount, and a current account deficit does the reverse. Both government and private payments are included in the calculation. It is called the current account because goods and services are generally consumed in the current period⁷. In general, exporters can build up sizable current account surpluses by selling goods to importers and in turn purchasing assets (either equity or debt – often sovereign debt) in the importing country.

The vendor finance problem: Perhaps the biggest single problem of the global economic system is the attempt by exporters to provide so much vendor finance to importers. Importers and exporters should be able to coexist in an economic system, with each side benefiting. This includes even the short runs during which exporters offer goods to importers now in return for repayment in the future. Unfortunately, as Martin Wolf of the Financial Times points out, large-scale net flows of debt finance from exporters to importers seem unlikely to do either side much good. While exporters do increase their productive capacity, they also often accumulate poor-quality assets and become dependent on what may well be unsustainable importer demand. The economies of importers, in turn, come to depend on unsustainable capital inflows and excessive consumption.

Further, Wolf notes, and Reinhart and Rogoff agree⁸ that typically, whenever countries run large (greater than approximately 5% of GDP) and sustained current account deficits, they tend to end up in financial crisis. Examples include Latin American countries in the debt crisis that erupted in 1982, in the 1997 Asian currency crisis, and the current financial crisis, whose epicenter has been in countries that ran large current account deficits, notably, the U.S., Spain, the UK and a number of countries in central and eastern Europe. Importantly, in each case surplus countries were affected indirectly, via losses of export markets and of the value of their assets held abroad.

(Note: Countries which borrow in their own currency (such as the U.S.) and control their money supply are unlikely to default because

7. Source: *Ecological Economics: Principles and Applications*; Herman E. Daly, Joshua Farley; Island Press, 2003.

8. *This Time is Different*, by Carmen Reinhart and Ken Rogoff.

they can always issue the money needed to repay their debts – in effect, another form of default given the decline in real value of repayments. Though such policy does increase the money supply, this may be desirable at a time of big demand shortage and excess capacity when inflation is a distant danger. Nevertheless, in the long run, governments cannot limitlessly increase debt and the money supply without creating currency devaluation and price inflation pressures once the economy recovers.).

The danger with imbalances: In the long run, current account deficits are dangerous because in the capital importing country you tend to create: unsustainable asset price bubbles; unsustainable accumulation of debt financing in both the private and public sectors; unsustainable expansion of the financial system, characterized by excessive leverage and excessive build-up of risky assets; and the development of currency mismatches within the economy, particularly in the financial system, which makes the economy extremely vulnerable to currency collapses.

Mindful of these risks many emerging market economies have tried to insulate themselves, by keeping exchange rates down and recycling current account surpluses. This is one of the reasons that the crisis erupted this time in developed countries, most of which have run large and sustained current account deficits.

Though the U.S. borrows in its own currency and hence has no problem of currency mismatches and little difficulty in financing external deficits, the financial system was damaged by the implosion of the bubble economy.

Current account imbalances matter even inside the common-currency Eurozone, because the surplus countries are unwilling to finance the deficit countries. In Greece, a huge primary fiscal deficit, huge debt levels, a huge current account deficit and real interest rates well above the long-term growth rate are simply an unimaginable combination. Therefore, within the Eurozone the surplus/deficit imbalance manifests itself through credit risk.

Countervailing pressures: Currently, the developed world is trying to push emerging economies into at least balance if not outright current account deficit, with the emerging economies resisting. While resisting currency appreciation, as China has done for example, emerging economies risk higher inflation. However, the imperative to create jobs for China's ambitious historically restless population has trumped all other objectives to date.

Under the pressure of the financial crisis itself, many erstwhile importers are being forced to become more like the exporters – and yet it's impossible for the entire trading world to be a net exporter. Either the emerging world as a whole starts to absorb these surpluses by creating internal demand for goods and reducing net savings, or the world will be stuck in a demand trap, with everybody seeking export surpluses.

This rebalancing is a difficult task, perhaps more easily achieved in the developed world than in the emerging markets, where it would be a difficult drawn out process. For emerging markets such as China and others to increase domestic demand by reducing savings would involve developing social security, introducing healthcare and building a personal banking infrastructure. Further, even in developed markets countervailing pressures dominate. For example, in developed surplus nations such as Japan and Germany, demographics make "excessive" savings difficult to reverse.

This is a major risk for real estate investors at the current point in time. A demand trap would result in a downward spiral of global GDP with unpredictable currency and political implications, and a potential for protectionist measures that could severely exacerbate the problem.

China peg policy

On June 19, the Chinese government announced that it would effectively abandon its currency peg⁹ with the U.S. dollar, in an indication that it will resume a policy of gradual appreciation of the yuan against the dollar after nearly two years when the rate has remained unchanged. The move that appeared to be an attempt to defuse mounting international criticism of its exchange rate, especially in the U.S., but also importantly from other emerging market countries who are disadvantaged if the Chinese currency is artificially low. The announcement came one week before the G20 summit in Toronto where the level of the yuan was shaping to be one of the dominant issues.

The Chinese have been careful to keep their currency at a level that would maintain internal growth and a healthy pace of job formation. As a result, Chinese central-bank dollar buying has left the nation with \$2.4 trillion in currency reserves, the world's largest holding. There are a number of reasons why this announcement has finally come:

- It may be that the Chinese are increasingly confident that they can make the adjustment to a domestic-driven economy rather than one relying on exporting low-value-added goods to the rest of the world.
- The move may have also been influenced by inflation pressures. China's inflation rate jumped to a 19-month high of 3.1% in May, higher than the government's full-year target of 3%. A more flexible currency would give China more freedom to decide on monetary policy and reduce inflationary pressures by lowering import costs.

9. China operated a currency peg with the U.S. dollar until July 2005 when it introduced a managed float under which the renminbi appreciated around 21% per cent against the US dollar. However, since mid-2008 the currency has been effectively pegged to the dollar at around Rmb 6.83. Although the official policy since 2005 has been that the exchange rate tracks a basket of currencies – an approach reaffirmed in June – the principal point of reference has been the U.S. dollar. The Chinese central bank sets a daily rate for the currency against the dollar, which can trade within a band of 0.5%, up or down. (source: Financial Times)

- The depreciation of the Euro (and in effect appreciation of the yuan against the euro – even as the yuan was pegged to the euro) may have created a window of opportunity to announce flexibility – Europe is China’s second largest export market behind the U.S. If the Euro remains weak, there could actually be pressure for the Yuan to depreciate against the dollar.

We believe that while this announcement is a beneficial step toward reducing imbalances, this shift is not a panacea for the global economy as any currency adjustment is likely to come at a very slow pace and its real significance is unclear. Further, all surplus saver countries such as China will still need to take additional actions to stimulate private consumption and reduce corporate savings. Importantly, China’s rebalancing will depend on measures to control excessive industrial capacity creation by adjusting relative costs (including, crucially, the renminbi exchange rate), promoting lending discipline and sending a higher share of corporate profits to state and private shareholders. All of which, incidentally, involve slower trend growth compared to the overheated trend of the past five years.

From a real estate standpoint, increased flexibility in the Chinese currency is one of many policy adjustments we have seen, and would like to continue to see, in order to invest capital in China on behalf of our less risk tolerant clients. We note that, political rhetoric notwithstanding, there are real questions whether the Yuan is meaningfully undervalued relative to the dollar so don’t bet the farm on an expectation of massive new exports from the U.S. to the world. Further, an accumulation of wealth within China may obviate the need for the country to continue to relax investment restrictions, and complexities. Nevertheless, we believe that this long-expected move is an important positive signal that China’s evolution into the global economy is on pace.

Conclusion

It’s difficult to recall any time in our careers where so much depends on policy decisions – and there are so many seasoned voices calling for seemingly disparate solutions. The most profound debate revolves around the decision to implement severe austerity measures at this point in the economic recovery cycle.

Reverberations of the GFC, particularly sovereign risks and the repercussions of fiscal and monetary policy leave question marks throughout Europe, while fundamentals in Asia are relatively strong, albeit with meaningful policy risks. And while the U.S. is benefiting as a safe haven, policy errors at a time of massive debt refinancing requirements could quickly derail the recovery.

The real estate opportunity set remains quite mixed with an extraordinary amount depending on government policy. The aftershocks and imbalances discussed herein leave us with a number of observations:

- “Location, location, location” applies as much (or more) to country choice as to property-site choice. Investment strategy has to start with a thorough long-term forward view of macroeconomic forces.
- Overall, we believe real estate investment strategies in the developed world are best positioned defensively at this time, while emerging world strategies must be undertaken with a rigorous and objective value exercise.
- Fiscal issues in Europe continue to play out, with Spain a pivotal player. Aggressive austerity measures in the region will reduce regional growth potential and undermine real estate market recoveries, especially in peripheral countries. Within Europe, overweight Germany, France, Benelux and the Nordics, and focus on core product.
- Government repression, manipulation of capital markets through coercion, may temporarily distort fixed income markets which often serve as benchmarks for real estate pricing. Over the next 12 months or so, such factors are likely to exert downward pressure on government bond yields, potentially pulling the capitalization rates of prime real estate lower.
- Second order effects, effectively contingent liabilities, may present risks not readily appreciated by a typical real estate investor. Delving into the non-obvious implications of primary risks may assist in avoiding significant pitfalls within seemingly safe core property investments. Geographic and product diversification can be a powerful risk mitigant to unforeseen factors.
- Continued global imbalances have the potential to result in implementation of protectionist measures, potentially hampering the value of properties dependent on global trade. However, China’s recent flexibility regarding its currency exchange rate is an important positive signal.
- The real estate universe is vast and includes many assets with income-producing characteristics that reduce risk. Real estate investment should appeal strongly to investors during a prolonged period of uncertainty and risk-aversion – in particular because investment strategies can be devised to capitalize on many of real estate’s innate defensive qualities.

Our investing strategy reflects this multi-speed view of the world, with a defensive bias. While in all markets value investing predominates (as it always should), in the developed markets we continue to avoid development risk and strategies dependent on a robust consumer discretionary spending, and continue to participate in recapitalizations of real estate ownership vehicles. In the emerging world, growth strategies can be tolerated, particularly those that address continued urbanization and growth of middle class wealth. Nevertheless, it is imperative to remain cautious and vigilant regarding valuation bubbles in formation.

As always, we look forward to your comments.

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