

“Brace for Impact...”

Captain Chesley Sullenberger of USAirways flight 1549 preparing cabin and crew for a water landing in New York City’s Hudson River – January 15, 2009

Landing an Airbus A320 in the icy waters of New York’s Hudson River with no forward power is no easy task. In fact, there is no record of a successful commercial aircraft landing on water. And yet, despite a flock of geese intercepting this flight’s trajectory, all 155 cabin and crew members of USAirways flight 1549 made it home safely. How was this possible? Contingency planning.

Pilots routinely go through check lists to ensure that all standard safety precautions have been taken. However, knowing that safety precaution checklists are virtually useless during the course of an emergency, the airline industry has crafted emergency procedure guidelines that even apply to previously unencountered circumstances. Put another way, a risk management group in the airline industry was tasked with conjuring up all the horrifying “what-if” scenarios and drafting a responsive plan of action that was effective despite being broadly applicable.

For too many in the investment industry, contingency planning was either ignored or not even conjured. Now that it’s abundantly clear to even the most optimistic among us that base case assumptions were wildly inaccurate, we must consider next steps in an alternate world.

This quarter we review the intensity of the global economic hard landing and consider where we are. We also look forward on to the global economy and to the commercial real estate markets – with a focus on the global cities. Ultimately, this storm will pass, and we must remember that our primary business task was, is and always will be to look forward. Accordingly, we now consider the ways in which the truly global cities integrate with the rest of the world. An understanding of these processes may help real estate practitioners better position investment portfolios, particularly in an increasingly multi-polar and urbanized world.

The Global Economy – Floating on Thin Ice

As anticipated in last quarter’s *Our View*, year end 2008 financial figures worldwide were dismal. For investment portfolios across the globe, past performance has been horrific for anything but a U.S. government bond fund – leading some to quip that “down 20% is the new par...” It’s not so amusing to some however, particularly retirees who will not have the time to benefit from eventual market recovery.

In our view, the next six months will continue to be replete with negative and perhaps even shocking news as the global slowdown gets progressively worse before it gets better. Despite massive intervention, the current financial crisis has deeply frightened consumers and businesses. It is evident to us that this recession, in effect the collapse-phase of unsustainable global imbalances, will be the deepest since the 1930s and the modern economy’s first truly global recession – lead by plummeting world GDP, increasing unemployment, decreasing world trade, and declining consumer net worth. Of note, global loss of wealth now exceeds \$50 trillion, nearly half of world annual GDP – the last time this happened was also in the 1930s¹.

World Economic Growth²

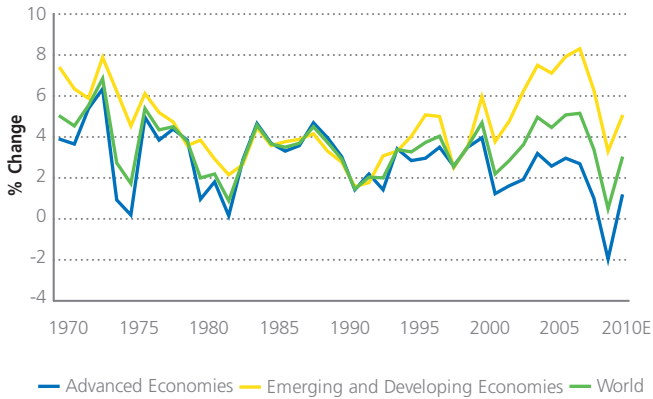
The world economy grew 3.3% in 2008, according to the International Monetary Fund (IMF) – its worst showing in six years, but still above the approximately 2% growth troughs of recessions in the early 1980s, 1990s and 2000s. Advanced economies grew 1% in 2008, their slowest pace since 1980. As in past years, emerging and developing economies proved to be the fuel providers for the global growth engine, but even they suffered; the 6% growth in emerging and developing economies was the weakest posting in five years.

We have little doubt that 2009 will be economically tumultuous. The IMF now predicts world economic growth of 0.5% in 2009, with advanced economies contracting 1.9%. Both figures represent lows not seen since World War II. Emerging and developing economies are also projected to grow at 10 year low rates of 3.3% in 2009. Although the IMF forecasts global growth picking up to 3% in 2010, its most recent Global Outlook notes that this estimate is highly uncertain.

1. Board of Governors of the Federal Reserve. www.federalreserve.gov.

2. Information in this section is attributed to the International Monetary Fund, www.imf.org.

World GDP

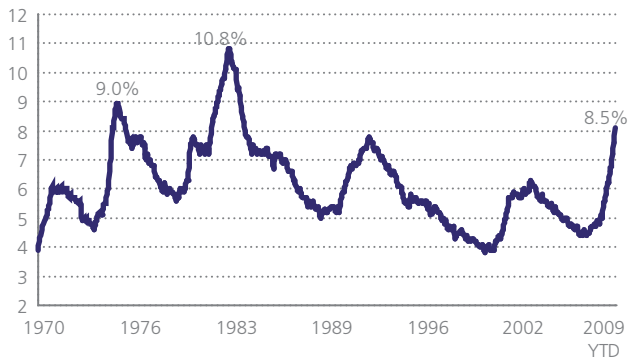


Source: IMF

Unemployment³

The U.S. economy shed 663,000 jobs in March causing unemployment to spike to 8.5%, a level not seen in 25 years and a phenomenon almost certain to put downward pricing pressure on real estate of all product types. In fact, in the past 40 years, unemployment has only reached higher levels between 1981-1984 and in 1975. Ominously, 3.3 million jobs were lost in the five months starting November 2008 and ending March 2009, a figure equal to aggregate 2008 job losses. Going forward, unemployment looks set to follow a path similar to that seen in the deep recessions of the 1970s and 1980s, rather than the relatively shallow recessions of the 1990s and 2000s. At its current 8.5%, it is now possible that unemployment may exceed the previous post World War II peak of 10.8%, reached in the early 1980s.

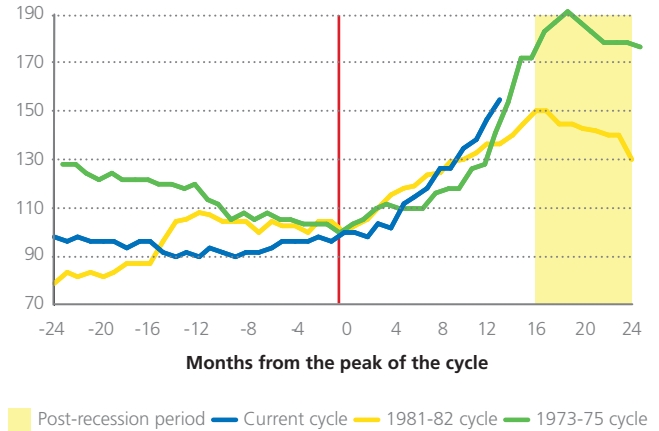
US Unemployment rate



Source: US Bureau of Labor Statistics

In total, 5 million jobs have now been lost since employment peaked in 2007, which does not bode well for real estate valuations in the near term. Healthy labor markets are a foundation for real estate values, as businesses require office space, produce output that often requires warehousing and provide salaries that fuel employee disposable income. Conversely, unhealthy labor markets result in a demand drain across all real estate sectors.

US Unemployment - rebased to the peak of the cycle

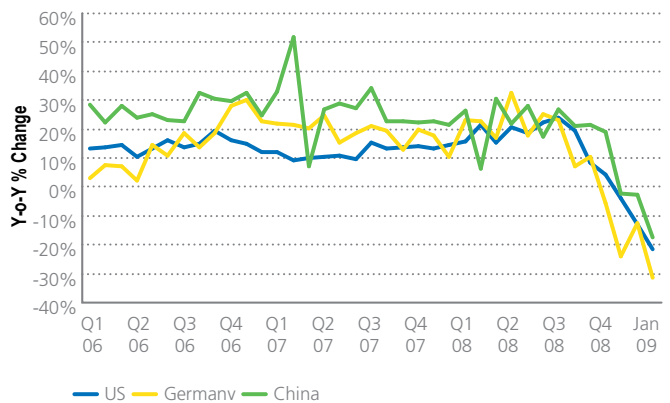


Source: Thomson Financial and Aviva Investors

World Exports

Following a bleak fourth quarter, world goods exports plunged in January of 2009, which, in particular will hurt warehouse and flex space valuations globally. The world's three largest exporters, China, Germany and the U.S. respectively, all experienced double digit year-over-year losses in January in total goods exported. Germany's 31% year-over-year decline, which was the most severe of the big three, puts German exports back at 2006 levels after having peaked at \$141 billion in April of 2008. At \$82 billion of goods exported in January, U.S. exports are now at 2006 levels, having peaked at \$120 billion in July of 2008. January's 21% decline goods exports decline in the U.S. is the first export contraction since 2003.

Goods Exports



Source: EIU

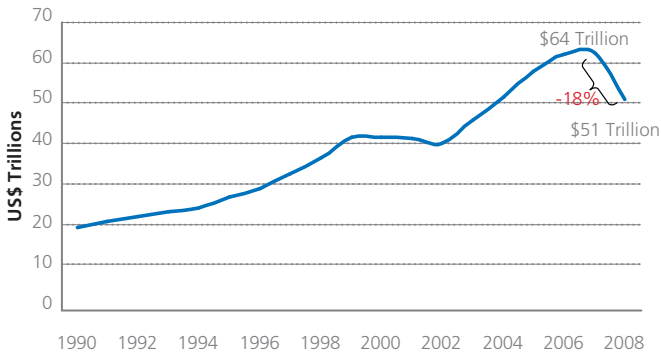
In total, the Economist Intelligence Unit projects high single digit to low double digit declines for goods exports in China, the U.S. and Germany respectively in 2009. The severe contraction in world trade may have a disproportionately negative affect on coastal and port markets in the near term, as these markets experienced the greatest appreciation in recent years.

3. Information in this section is attributed to the United States Bureau of Labor Statistics, www.bls.gov.

U.S. Households' Net Worth⁴

U.S. Households' net worth plummeted 18% in 2008 and 9% alone in the fourth quarter of 2008, the largest decline in more than half a century of record keeping by the Federal Reserve. The decline was this sixth straight quarterly decline, underscoring the challenges U.S. families are facing and the reality that retail real estate is likely to suffer until net worth begins expanding once more. Family net worth hit an all-time high of \$63 trillion in the second quarter of 2007 and has since fallen 20% to \$51 trillion or 2005 levels. In 2008 alone, household net worth fell by \$11.2 trillion. Household borrowing also contracted at a 2% annual rate in the fourth quarter, the first quarterly decline on record.

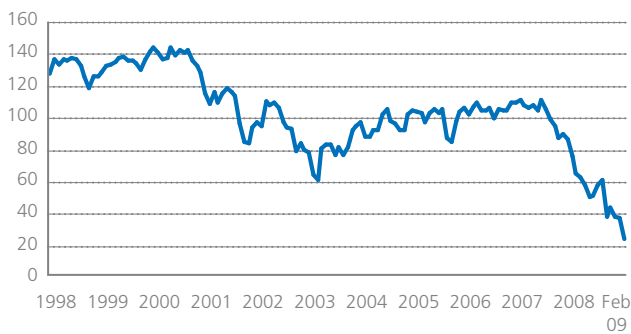
US Households net worth 1990-2008



Source: US Federal Reserve

Declines in consumer and business confidence suggest that sales will continue to shrink rapidly adversely impacting retail real estate. The Conference Board's Consumer Confidence Index fell to 25 in February, its lowest level since its 1967 inception. The index's new low is a sign that spending will continue to be tight. "Increasing concerns about business conditions, employment and earnings have further sapped confidence and driven expectations to their lowest level ever," said Lynn Franco, Director of the Conference Board's Research Center⁵.

Consumer confidence index



Source: Conference Board

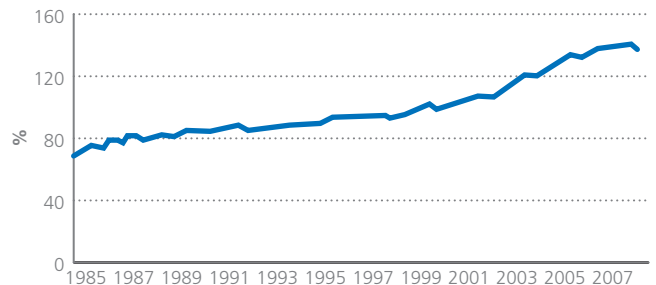
Not Your Typical Recovery

We believe investors should continue to position their investment portfolios defensively, by emphasizing acquisition value and cash flow over appreciation potential. This is because we expect a tepid and protracted recovery in the U.S. and the nations that depend on the U.S. for trade (notably Japan and Mexico – but also including Europe and much of Asia). We do not see an aggressive "V-Shaped" recovery as we believe there is no other country that can pick up the consumption effort the way the U.S. did for such a long time, and the U.S. consumer (largely manifested in the Baby Boom cohort) has come to realize that retirement is at risk and is going to start a significant savings effort.

Our outlook is driven by a view that this recession is not a typical post-war recession (of which there have been nine)⁶ whereby rising inflationary pressures result in monetary tightening and an economic slow-down in response to higher interest rates. Richard Koo of Nomura Securities believes that the current recession is balance sheet driven, much like the Japanese recession of the 1990s, whereby deleveraging of the consumer and the financial sector is resulting in a massive demand drain throughout the economy⁷. We're inclined to agree.

The housing and credit market collapse has caused enormous losses among households and banks, resulting in a steep drop in discretionary consumer spending and a halt to lending. A review of the damage to balance sheets provides indications of why recovery will be slow. Households net worth peaked in mid-2007 at \$64 trillion but fell to \$51.5 trillion by the end of 2008, a 20% fall. At the same time, household debt peaked at 130% of income in 2008⁸. This willingness to accumulate debt derived from Americans spending more than their income (which had been falling in real terms since 2000), reflecting a positive wealth effect – households felt wealthier despite pressure on incomes because home and financial asset values were rising.

Household debt as percentage of personal disposable income 1985-2008



Source: Federal Reserve

Now the wealth effect has reversed with a vengeance as falling asset values and unemployment risk have frightened households

4. Unless otherwise indicated, all information in this section is attributed to the Board of Governors of the Federal Reserve System. www.federalreserve.gov.

5. Consumer Confidence Survey Press Release. Conference Board. February 24, 2009. www.conference-board.org

6. National Bureau of Economic Research

7. The Holy Grail of Macro Economics, Lessons from Japan's Great Recession, Richard C. Koo

8. Financial Times, April 6th, 2009

into raising savings rates for the first time in years – from a stagnant 1-2% of income to nearly 5% now. A cut in personal consumption is the only way to increase savings if personal income is stagnant or declining. In our view home prices still have a way to fall, and there is no precedent for equity markets to snap back from a 45% decline, in particular with moderate economic demand. Therefore, it likely will take years before the consumer, which in recent history accounted for 70% of GDP, begins to drive the economy again.

The financial sector is in no better shape – probably worse. According to the International Monetary Fund, western financial institutions have realized \$1 trillion of losses since the crisis began – and are likely to suffer another \$1 trillion. The losses are eating into banks capital and shrinking ability to add assets by lending. Unfortunately, it is difficult to imagine that the scale of lending required to support economic recovery will materialize soon.

Dr. Koo argues that in order to repair their balance sheets the private sector moves away from profit maximization to debt minimization. With the private sector deleveraging newly created savings and debt repayments enter the banking system but cannot leave the system due to lack of borrowers. In this type of recession, the economy will not enter self-sustaining growth until private sector balance sheets are repaired. We believe global deleveraging will continue until the majority of debt issued in the bubble years is refinanced, or extinguished through bankruptcy. For a number of reasons, the U.S. will no longer be able to serve as the borrower and spender of last resort resulting in a major drag on global growth for years to come as the world adjusts to a new reality. Government stimulus may alleviate the pain, as Dr. Koo argues happened in Japan. In any event, our view is that a tempered expectation of future economic growth is reasonable.

Globalization and the Cities

By definition, prudent long-term investors look beyond current economic conditions to consider where future investment opportunities will manifest themselves. This is not to say that investors blindly adhere to any strategy labeled “long-term”; rather, they look long-term to make current decisions. This distinction is an important one. When real estate investors look long-term, they consider two primary drivers: demographics and economics. Where populations and economic activity are expanding demand for real estate of all kinds will surely follow. Looking globally, we anticipate that the leading edge of real estate activity, as a result of demographic and economic growth, will continue to play out in the major global cities.

Cities are engines of growth for countries and the gateways to the resources of their regions. Cities are where most global commercial real estate currently resides, a fact that is not likely to change in the foreseeable future. The world’s biggest and most interconnected cities help set global agendas and serve as the hubs for global integration. We focus at this time on the mega cities, because they have shown to be excellent long-term investment opportunities.

Global cities lead national commercial real estate development activity, exhibit extreme depth of human and institutional resources and have demonstrated resilience through recessions, depressions, famines, crime, scandal, as well as domestic and international conflict. As noted by Foreign Policy magazine, these global cities “host the biggest capital markets, elite universities, most diverse and well-educated populations, wealthiest multinationals, and most powerful international organizations are connected to the rest of the world like nowhere else⁹”. The cities that rise to the top are those that continue to forge global links, despite intensely complex economic environments.

A.T. Kearny and the Chicago Council on Global Affairs teamed up to produce a Global Cities Index, a comprehensive ranking of the ways in which cities are integrating with the rest of the world¹⁰. They analyzed a broad array of data and consulted with a number of renowned city experts and ranked metro areas according to 24 metrics across five dimensions. What’s interesting is that these dimensions are the same criteria you might use to analyze the attributes of any commercial real estate environment – but provide a little more framework than might be typically utilized. The five elements include:

Business activity: The value of its capital markets, the number of Fortune Global 500 firms headquartered there, and the volume of goods that passes through the city.

Human Capital: How well the city acts as a magnet for diverse groups of people and talent – including the size of the immigrant population, number of international schools and the percentage of residents with university degrees.

Information Exchange: How well news and information is dispersed about the city and to the rest of the world, the number of international news bureaus, the amount of international news in leading local papers and the number of broadband subscribers.

Cultural Experience: The level of diverse attractions for international residents and travelers.

Political Engagement: The degree to which a city influences global policymaking and dialogue – an examination of the number of embassies, think tanks, international organizations, sister city relationships and political conferences hosted.

By pulling together a broad measures of cultural, social and policy indicators, as well as the more traditional economic and market measures, this index may provide a more complete picture of a city’s global standing – and importantly for us, resiliency.

The survey reviewed 60 cities, including the expected (London, Tokyo, New York) and the new surging metropolises (Chongqing, Dhaka, Lagos), which tell us a great deal about the direction of globalization. The following chart highlights the top cities as well as a number of rising stars.

9. A.T. Kearney. *The 2008 Global Cities Index*. Foreign Policy. Nov/Dec 2008. www.foreignpolicy.com.

10. See above.

2008 Global Cities Index - Selected Data

Overall Ranking	City	Dimension Ranking				
		Business Activity	Human Capital	International Exchange	Cultural Experience	Political Engagement
1	New York	1	1	4	3	2
2	London	4	2	3	1	5
3	Paris	3	11	1	2	4
4	Tokyo	2	6	7	7	6
5	Hong Kong	5	5	6	26	40
6	Los Angeles	15	4	11	5	17
7	Singapore	6	7	15	37	16
8	Chicago	12	3	24	20	20
9	Seoul	7	13	5	10	19
10	Toronto	26	10	18	4	24
11	Washington DC	35	17	10	14	1
12	Beijing	9	22	28	19	7
20	Shanghai	8	25	42	35	18
25	Mexico City	34	23	32	9	11
28	Istanbul	32	13	34	43	8
31	Sao Paolo	16	36	31	27	23
37	Atlanta	38	24	39	21	32
41	New Delhi	47	50	20	46	35
49	Mumbai	39	37	53	52	52
55	Ho Chi Minh City	55	52	58	53	58
59	Chongqing	60	60	56	47	57

Source: Foreign Policy - November/December 2008

The results show that no city dominated the index, although New York comes close. And as diverse as the cities are, the most successful have one thing in common – they excel across multiple dimensions. Further, there does not appear to be a single correct path to becoming global – but there are models, and understanding those models and their real estate implications can improve our investment acumen. The following paths are highlighted by Foreign Policy.

Global Pathways	Description	Examples (rank)
Open Cities	Large cities with a free press, open markets, easy access to information and technology, low barriers to foreign trade and investment and abundant cultural opportunities. They often rely on heavy service industry and are outward looking, rather than focused on domestic affairs.	New York (1) London (2) Paris (3)
National Leader	Large cities that shape the collective identity of their countries. They usually have homogenous populations, and their new urban policies tend to evoke a shared history. They do well in international business, but not because they are necessarily globally connected; in these places, foreign firms can find something no other city offers.	Tokyo (4) Seoul (9) Beijing (12)
Lifestyle Centers	Laid-back cities that enjoy a high quality of life and focus on having fun. They attract worldly people and offer cultural experiences to spare.	Los Angeles (6) Toronto (10)
Policy Hubs	Cities with outsized influence on national and international policy debates. Their think tanks, international organizations, and political institutions shape policies that affect all people, and they tend to be full of diplomats and journalists from somewhere else.	Washington (11) Brussels (13)
Regional Gateways	Efficient economic powerhouses with favorable incentives for businesses and easy access to the natural resources of their region. They attract smart, well-trained people from around the world, and they often must reinvent themselves to remain competitive.	Hong Kong (5) Singapore (7) Chicago (8)
Platform Cities	Large hubs in typically small countries that attract huge amounts of investment through their strategic locations and international connections. Firms don't set up shop in these cities to invest in the local economy; they move there so they can reach important foreign financial markets without dealing with the region's political headaches.	Amsterdam (23) Dubai (27) Copenhagen (36)

Source: Foreign Policy - November/December 2008

Building an investment portfolio of commercial real estate interests on a global basis requires a broad and penetrating analysis of demographics and economic activity, which lead to consumer-driven and business-driven demand as well as market access to understand current and future inventory. As Investors in a long-term asset class, we should set a course to benefit from the prevailing beneficial winds, and contingency plan for difficult scenarios. With globalization a currently immutable trend, a focus on the pinnacles of urbanization – the global mega-cities – may help understand why cities grow and how these important factors impact in investment decisions.

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