

World Overview

Growth: Most developed economies had a dismal Q2, except the US which posted a remarkable but unsustainable bounce. In the Euro zone activity contracted by 0.2% (q/q), in Japan the fall was a larger 0.6% (q/q), a marginal decline of 0.09% (q/q) in Canada and the UK neither grew nor contracted. In most places consumers are losing confidence, the exception is China where consumers are spending strongly driving high retail sales growth. In Australia, in part muted consumer activity has been responsible for weakened Q2 growth at 0.3% (q/q). Labour markets are now confirming reduced activity and investment, with job losses continuing in the US, UK, Euro zone, Japan and Canada. Globally, there is little economic joy, with even Asian Pacific activity looking a little tarnished.

Inflation: In most countries inflationary pressure has come from energy and food prices, which are removed from the core rate used by policy makers. However, core rates have also been high, 4.4% in the UK and 3.8% in the Euro zone. In China, where the inflation rate has eased due to weakening food prices, there are still some concerns as non-food prices are now beginning to accelerate. Significantly reduced economic activity in the OECD countries should see price rises easing by early 2009.

Policy: Monetary policy makers are trying to steer a course carefully through the current economic quagmire: sudden, surprise or too large moves could bring problems in the future. Australian rates were cut by 25 basis points this month with more to come over the next year. In China policy tinkering continues with tightening regulations on lending to real estate. The UK is likely to cut when forecast inflation eases below target. The ECB with their extreme hawkishness are unlikely to move until next year. The Fed is likely to sit tight for a while.

Region by Region (changes in bold)

	Growth	Inflation Rate	Short Int Rate
USA	Weakening	Peaking	Stable
Euro zone	Weakening	Peaking	Stable
UK	Weakening	Peaking	Stable
Japan	Weakening	Rising	Stable
Canada	Weakening	Rising	Stable
China	Moderating	Rising	Stable
Australia	Moderating	Easing	Falling

Urban planning and commercial real estate values in the US

This month we examine the correlation between urban planning initiatives and commercial real estate values in metropolitan regions in the US. There is little research investigating this relationship, with most research focusing on the connection between zoning and building restrictions and residential real estate values. It has been shown that planning restrictions have significantly increased home values in metros by reducing the supply of new housing and effectively creating a "regulatory tax". As a result, New York and San Francisco, through a preponderance of exclusionary zoning techniques, have reduced supply to a trickle, whereas Houston and Dallas, with little to no zoning, have an abundance of affordable housing.

Commercial real estate in the US is generally preferred by municipalities, as they are able to enjoy the plentiful tax revenue that commercial real estate provides with a corresponding relative lack of demand on services. As a result, commercial real estate is seen to be more desirable among competing municipalities and less restricted by urban planning initiatives. In short, the "regulatory tax" imposed upon commercial real estate by urban planning is much less than residential real estate in the US.

However, this "regulatory tax" imposed by urban planning initiatives varies widely among metropolitan areas in the US. More rigorous planning constraints can be found primarily along the

coasts, with fewer restrictions found within the interior of the country. Specifically, New York, San Francisco, and Boston have in place more established zoning and approval requirements than Houston or Dallas. Although these guidelines can restrict supply, making commercial real estate more valuable in supply-constrained metros, the converse is that this same tax stymies economic growth. The increased regulatory environment not only discourages and even prohibits existing tenants from expanding and growing, but also confines the ability to provide affordable housing for employees. Ultimately, it is in the hands of metropolitan areas with their inherent ability to enact land use regulation, to decide if their regulatory tax is too high and is inhibiting economic growth or too low and reducing property values. The same decision faces us as investors and developers: which of these types of metros will provide us with the best risk-adjusted returns? Should we seek opportunities in those metros with supply constraints that restrict commercial real estate supply but at the same time inhibit strong economic growth? Or is it better to be positioned in metros with a less stringent regulatory environment but more abundant growth?

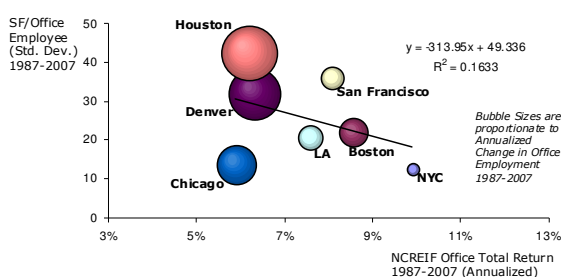
There are several constraints to deal with, mainly a lack of historical data and numerous external factors which we are unable to quantify and in this piece we can only begin to investigate such a complicated issue. Nevertheless, we have been able to choose seven metropolitan areas based upon data availability and their anecdotal reputation for building regulations. These include New York City, Boston, San Francisco, Los Angeles, Denver, Houston, and Chicago. Using data over a twenty year period between 1987 and 2007 for investment performance, economic growth, and building supply. For investment performance, we used the NCREIF Office Total Return Index. For economic growth and the demand for office space, we used the change in office employment. Finally, in order to quantify each metro's level of restriction to new building supply, we calculated the standard deviation of the square feet per office employee from 1987 to 2007. A larger standard deviations implying a more volatile office market and a greater ease in which significant amounts of office space can be supplied. The results are shown in the table above.

1987 - 2007	NCREIF Office Total Return (Annualized)	Sq. Ft. per Office Employee Standard Deviation	Change in Office Employment (Annualized)
New York	9.9%	12.7	0.11%
Boston	8.5%	22.2	0.74%
San Francisco	8.1%	36.0	0.45%
LA	7.6%	20.9	0.50%
Denver	6.3%	32.1	2.36%
Houston	6.2%	42.7	2.76%
Chicago	5.9%	13.9	1.37%

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The data and chart 1 reveal a modest correlation between a property's return and the urban planning "environment." As expected, New York and Boston have the highest returns among our seven metros, and also have the smallest deviation from their average square foot per employee over the

Chart 1: Planning, growth and values



Source: NCREIF, Reis

last twenty years. In addition, they are both relatively slow growth cities. San Francisco's square foot per employee standard deviation was unexpectedly high, but the San Francisco area has been uniquely positioned in the technology revolution over the past twenty years as well. As expected, the less regulated metropolitan areas of Denver and Houston were not only high growth metros in terms of employment, but also in significant deviation in the past twenty years to their average square foot per employee. In general, these "boom or bust" metros are quick to meet demand when it arises and interestingly, their NCREIF returns are also towards the lower end of the spectrum.

As for Chicago, this modest growth metro, though not experiencing particularly high supply volatility per employee, has a strong labour union movement and presence of old city politics that not only inhibit growth, but that can also be mobilized to meet demand when necessary, ultimately affecting long-term investment performance.

Our limited examination suggests that there appears to be a correlation at a macro level between higher office investment returns and metropolitan areas with more stringent building regulations.