EXECUTIVE SUMMARY

“The pillars of the Parthenon may be crumbling. But half a world away, the stone slabs of the Great Wall of China, the basalt arches of the Gateway of India, and even the Twin Towers of Petronas have rarely looked in better shape.”

–David Pilling, Financial Times, 13 May 2010

Risk Aversion Returns

GDP growth in the first quarter in the Asia ex-Japan (AXJ) region has continued to gain strength with stellar results (China: 11.9%, Singapore: 15.5%, Hong Kong: 8.2%, Malaysia: 10.1%, Taiwan: 9.2%, and South Korea: 7.8%). As a result, global institutions ranging from the World Bank, to the International Monetary Fund (IMF) and the Asian Development Bank have continued to revise their global growth forecasts upward with particularly bullish forecasts for a strong V-shape recovery in the AXJ region. Indeed, most economists are of the view that the economic recovery across the globe is sustainable and that a double-dip recession is increasingly unlikely, as shown in a recent IMF forecast summarized in Figure 1.

![IMF Economic Growth Forecast](image)

<table>
<thead>
<tr>
<th>Country</th>
<th>2008</th>
<th>2009</th>
<th>2010F</th>
<th>2011F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global</td>
<td>3.0%</td>
<td>(0.6%)</td>
<td>4.2%</td>
<td>4.3%</td>
</tr>
<tr>
<td>United States</td>
<td>0.5%</td>
<td>(3.2%)</td>
<td>3.1%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Euro States</td>
<td>0.6%</td>
<td>(4.1%)</td>
<td>1.0%</td>
<td>1.5%</td>
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<tr>
<td>Japan</td>
<td>(1.2%)</td>
<td>(5.2%)</td>
<td>1.3%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Australia</td>
<td>2.4%</td>
<td>1.3%</td>
<td>3.0%</td>
<td>3.5%</td>
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<tr>
<td>Developing Asia</td>
<td>7.9%</td>
<td>6.6%</td>
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<td>8.7%</td>
</tr>
<tr>
<td>China</td>
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<td>8.7%</td>
<td>10.0%</td>
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<tr>
<td>Singapore</td>
<td>1.4%</td>
<td>(2.0%)</td>
<td>5.7%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Hong Kong</td>
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<td>(2.7%)</td>
<td>5.0%</td>
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<tr>
<td>Malaysia</td>
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<td>4.7%</td>
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</tr>
<tr>
<td>Thailand</td>
<td>2.5%</td>
<td>(2.3%)</td>
<td>5.5%</td>
<td>5.5%</td>
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<tr>
<td>Vietnam</td>
<td>6.2%</td>
<td>5.3%</td>
<td>6.0%</td>
<td>6.5%</td>
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</tbody>
</table>

Source: IMF

As of April 2010

1IMF publication: World Economic Outlook April 2010: Rebalancing Growth, data extracted from Table 1.1, Table A2, and Table 2.3.
Unfortunately, fears of sovereign debt default among the PIIGS (Portugal, Ireland, Italy, Greece and Spain), most notably Greece, have caused some to become increasingly skeptical about the strength and sustainability of the global economic recovery. A default by Greece would have increased systematic risk to the global financial markets similar to the global credit crisis following the bankruptcy of Lehman Brothers. There would also be heightened risk that the other PIIGS countries could default as investors increasingly refuse to refinance maturing government debt. This potential chain reaction of defaults would in turn put a significant hole in the balance sheets of the European banks holding these assets. This situation has forced the Eurozone governments, the ECB, and the IMF to scramble to put together a 1 trillion Euro rescue package in an attempt to restore confidence in the Eurozone sovereign debt market. Nonetheless, this rescue package is seen by some analysts as only delaying the inevitable default as the cost of funding this rescue package is seen as politically unpalatable. As such, the Euro remains under severe selling pressure.

Financial markets in Asia ex-Japan have not been spared from the re-emergence of risk aversion despite the region's minimal exposure to sovereign debt from the PIIGS and fundamentally stronger sovereign balance sheets. Ironically, China's financial markets have been the most impacted by these developments, despite the country reporting GDP growth of 11.9% year-over-year and being hailed as the new engine of global growth. As of mid-May 2010, the Shanghai Composite Index (SCI) had declined 19% year to date, a decline in magnitude similar to Greece. Other Asian markets fared better although their underperformance is not as significant as PIIGS, this is probably due in part to their supposed defensiveness and stronger economic growth prospects as shown in Figure 2. Figure 2 also includes a 2010 GDP forecast by Decision Economics (May 2010) that is more representative of growth forecasts by most private sector economists.

<table>
<thead>
<tr>
<th>Stock Market Performance in Local Currency</th>
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<tbody>
<tr>
<td>Stock Market Performance Year to Date (31 Dec 2009 to 12 May 2010) in local currency</td>
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<tr>
<td>--------------------------------------------</td>
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<tr>
<td>United States</td>
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<tr>
<td>Portugal</td>
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<td>Italy</td>
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<td>Malaysia</td>
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<td>Thailand</td>
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</table>

Source: IMF\(^1\) and Decision Economics

\(^1\)The Vanguard Group defines a Bear Market as a decline in prices of 20% or more over at least a two-month period.

\(^{2}\)IMF publication: World Economic Outlook April 2010: Rebalancing Growth, data extracted from Table 1.1, Table A2, and Table 2.3.
The disconnect between the economic projections for the AJX region and the region's recent financial market performance is unsettling. Over the last two years, China's stock market (as measured by the SCI) has evolved into a good leading indicator for the state of the global economy, much like the proverbial canary in a coal mine. The SCI peaked at the end of September 2007 and by mid-January 2008 entered into a bear market period (losses of 20% in a two-month period), almost eight months ahead of the Lehman bankruptcy. This sharp decline was despite the extremely strong economic growth and the general prevailing view at that time that China and Asia would not be severely impacted by the U.S. sub-prime problems. Similarly, the SCI bottomed toward the end of October 2008 despite the panic-driven assessments at that time that the world was headed for next great global depression. Although these two turning points in the SCI are by no means statistical validation, they should not be ignored either as the general consensus economic view has been quite poor in determining the turning points in the economic cycle.

**China's Main Problem is Not Greece, But Housing Prices**

"China has plenty of demand right now, so this is no bubble in my definition… A bubble to me, if you want to be more precise, is the huge rise in market prices in the absence of demand. I think the buying opportunities are ahead of us, not behind us."

–Ronnie Chan, Chairman of Hang Lung Properties Ltd, 10 May 2010

"Speculators lost their fear, while the fear of inflation seized savers. No one believed the government would let property prices fall. As a result, people have been withdrawing their saving and borrowing as much as possible to buy property, regardless of the price."

–Andy Xie, ex-Morgan Stanley Asia economist, South China Morning Post, 20 April 2010

Although it is too early to tell whether the PIIGS’ sovereign crisis will have a significant impact on capital availability and trade flow, the recent behavior of the financial markets actually makes perfect sense. Investors have been lured into complacency as economic growth and financial markets have recovered much faster than anticipated. What many are forgetting is that this early recovery is the result of unprecedented global fiscal spending and monetary easing by governments, which was required to avert a global depression. These policies (deficit spending and zero interest rate policies) lessen the severity of the global recession by offsetting the lack of private demand with an increase in public demand. However, in economics there is no free lunch and there is always some form of payback.

This payback will be a period of slower global economic growth relative to the pre-crisis levels. Indeed, Greece's problems may be an omen of what lies ahead for many of the developed economies. Due to the need to deleverage, economic growth will have to slow as a result of higher taxes in combination
with lower government and consumer spending in Europe, the United Kingdom, Japan, the U.S., and even some countries in Asia. Although, the Asia decoupling theory is now back in vogue, globalization cuts both ways with shocks and adjustments in demand being transmitted through trade and financial markets (cost of capital). As such, even for Asian countries that have been financially prudent (low debt levels for both households and the government) the process of global deleveraging will mean lower growth rates. Even China with its structural growth advantages, such as urbanization, economic reform, and improving education levels (that has resulted in a growing consumer class), will not be immune.

Although China was extremely resilient in the recent global recession, its economy did not escape collateral damage arising from its policy responses. China's stimulus package of RMB4 trillion and the decision to flood the market with RMB9.6 trillion in new bank lending in 2009, has created problems that are now starting to surface. In particular, China is realizing that the quality of the growth in 2009 was extremely poor and unsustainable. Strong GDP numbers were due to local government spending on white elephant infrastructure projects, investments in industries with excess capacities, and real estate projects. This wasteful spending was facilitated by Chinese banks (that remain government-owned) that were anxious to lend to the local government and/or state-owned, quasi-private enterprise (SOQPE). SOQPE's that had easy access to credit emerged as aggressive bidders in the acquisition of land development sites across China, and contributed to the emergence of a residential asset bubble.

China’s strong economic growth and structural growth drivers have always been a seductive siren call to global investors, particularly in a global environment of increasingly lackluster growth. The investment case for the Chinese residential sector in particular has been compelling. China’s urban population increased from 173 million in 1978 (17.9% of the population) to 607 million in 2008 (45.7% of the population). Despite this rapid urbanization in China, the numbers pale in comparison to the developed economies and even regions such as Central and South America, where according to World Bank statistics urbanization levels currently exceed 70%. Current estimates suggest that urban migration will result in some 210 million rural persons moving to urban areas over the next decade (equivalent to Japan’s entire population), creating a seemingly huge demand for new housing. This is also evident in the sales projections by many analysts covering the listed Chinese residential developers. In addition, given the poor availability of household income data in China, many investors have become increasingly dependent on the anecdotal stories of wealthy Chinese households with suitcases full of cash that have been snapping up multiple properties, not only in major cities in China, but also in Hong Kong, Singapore, London, and even Australia.
Not surprisingly, China’s housing prices have continued to defy gravity. As of end April 2010, national housing prices increased by an average of 12.8% year-over-year, with prices for new projects up 15.4% year-over-year. Although some of the larger cities such as Beijing, Tianjin, and Shanghai registered gains of between 12-18%, the real star has been one of China’s less developed provinces, Hainan Island. Two metro areas (Haikou and Sanya) on Hainan Island reported price increases of more than 50% year-over-year, with some recently built luxury properties achieving prices that are even higher than those in Beijing and Shanghai. Prices are spiking despite the Chinese government’s efforts since the beginning of 2010 to slow the housing market. Not surprisingly in April, the Chinese government introduced more anti-speculation measures, including: banning mortgages for third homes, limiting mortgages to 40% loan-to-value for second homes, proof of residency requirements for purchases requiring mortgages, and also the possibility of annual residential property taxes.

Many residential developers (both domestic and foreign) remain sanguine despite the on-going clamp down on the residential sector. They believe that the correction will be minor and temporary for a few reasons: one, that Chinese buyers are cash rich (China households have high cash holdings); second, that they are largely end users; and finally that political unrest will result if housing prices fall significantly. However, we believe these developers may be deluded. Although China’s rapid economic growth and structural reforms have indeed created a new affluent class, these cash-rich investors do not represent the majority of buyers nor should they be the benchmark for determining affordability. Mortgage financing does matter in China. Residential prices bottomed in Q3 2009 and subsequently surged in the following quarters helped largely by a 40% year-over-year increase in lending during the year. Similarly, the continued buoyancy in residential prices in the first four months of 2010 has been supported by the 53.4% year-over-year increase in mortgage financing. Despite the urbanization trends, not all buyers are end users as many developers claim. China’s Central Bank (PBOC) estimates that 23.1% of all home purchases in Q1 2010 were for investment, although no breakdowns were provided at the city level. Finally, the argument that falling housing prices will cause makes little sense. A rich speculator holding multiple properties is less likely to riot than a homeless immigrant with little to lose.

In short, we believe China will deflate its housing bubble. Although a 20%+ correction in housing prices in China sounds alarming, it will not lead to the type of financial meltdown we saw with the U.S. sub-prime debacle. First, in China there tends to be a higher level of owner equity in housing. Second, Chinese banks have very little inclination to enforce equity top ups (e.g., put in new equity if the loan-to-value ratio falls due to a decline in prices) for residential and commercial loans that breach their loan-to-value.

*Previous the LTV ratio for second homes was 60%.
*Note mortgage lending grew faster than the 32% increase in total lending in 2009.
ratios. Third, legal liability and the culture make it more difficult to default. Finally, bursting the housing bubble will be necessary if China wants to promote domestic consumption. Currently, high housing costs contributes to the excessively high saving rates in China and much of Asia, resulting in significantly lower consumption relative to income levels.

OUTLOOK AND STRATEGY

“The market is telling you that something is not quite right... The Chinese economy is going to slow down regardless. It is more likely that we will even have a crash sometime in the next nine to 12 months.”

—Marc Faber, Fund manager of Leopard Capital, and author of monthly investment newsletter *The Gloom Boom and Doom Report*, 3 May 2010

“Global debt mechanics are looking increasingly like a Ponzi scheme.”

—Nouriel Roubini, Chairman of Roubini Global Economics, 18 May 2010

Although we do not subscribe to a Goldilocks scenario of a sustained V-shape recovery in the AXJ region, we are also not in the camp of the bears who believe that the region is headed for a hard landing due to over-aggressive monetary tightening that could lead to a collapse in asset prices and consumer demand. Rather, we believe that the AXJ region will see a peak in growth toward the end of the first half of 2010 with growth slowing to a more moderate pace (but still relative healthy growth) in the second half of year. This growth will be driven primarily by the inventory restocking cycle that is coming to an end and a higher comparison base. Continued deflation in Europe, Japan, and to a lesser extent the U.S., will also result in Asian monetary authorities adopting a still fairly loose monetary policy despite signs of inflation re-emerging.6

Overall economic growth across the AXJ region in 2010 and 2011 will average about 100 to 200 basis points per annum below the pre-crisis levels. This growth, in context of the aftermath of a global recession and below-average global growth, remains exceptional, especially when compared to the continued weakness in Europe, Japan, and the U.S. This “Asia ex-Japan growth premium” will continue to generate demand from investors in search of growth and will support the longer-term growth in asset prices including equities, bonds, and commercial real estate. Indeed this is gradually happening with listed REITs and even the shell-shocked foreign private funds, which have been largely in retreat over the last 18 months, back in the acquisition mode.

With the exception of residential sector, where prices have significantly run ahead of fundamentals, rental growth for logistics, retail, and office, will continue to recover helped by firmer demand in the medium-term.

*Although in theory only Hong Kong has to adopt U.S. monetary policy because of a direct currency peg, most of the other Asian countries inclusive of Singapore, China, and Malaysia are essentially pseudo U.S. dollar peg currencies. The existence of direct or pseudo-peg results in Asian policy rates very similar to the U.S. policy rates.*
Nonetheless, rental growth will vary widely as fundamentals, particularly in terms of current vacancy levels and future supply vary significantly from country to country. Similarly, investment sentiment in the region has turned positive with most investors anticipating limited downside. Most real estate brokers have significantly revised their outlook for the Asian markets. Gone are the bearish forecasts of capital values in the region testing their Asian crisis lows; instead most are now projecting fairly high returns in the medium-term. This will also be facilitated by the region’s functional banking system and the increased willingness of banks to lend.

Despite this general optimism about Asia’s real estate markets, it won’t be smooth sailing for investors looking for a bargain. Unlike the Asian Crisis a decade ago, this cycle thus far has resulted in very few distressed sales. Banks have not been aggressive in forcing the liquidation of assets which have run into problems in terms of servicing or due to breaches in the loan-to-value ratios. Also the revival of foreign interest in Asia will eventually result in additional pressures on markets that have never been very liquid. These factors have resulted in yields compressing at an alarming pace across Asia. Even in overbuilt markets such as Beijing’s office market, where vacancy levels are currently above 25%, yields have fallen by 130 basis points over the last twelve months.

Given the low yield environment, we prefer markets that have the potential for significant rental growth driven by the combination of strong demand and a benign supply outlook. As such, we favor the Hong Kong office and retail sectors, with the latter being driven by the emergence of the Chinese consumer. We also like the recovery story for the office sector in Sydney and, to a lesser extent, Melbourne as supply remains very limited in the near term and yields are still fairly high. The Singapore office market also remains favorable despite the significant amount of future supply, primarily because of the excessive correction in values. Ironically, China’s broader property markets may not generate significant returns in the near term despite having strong economic growth. There is excess supply for most sectors in Beijing, and to a lesser extent, Shanghai. The focus in China will be at the more micro-level. This emphasis on the micro rather than the macro acknowledges that much of the existing and future supply in Beijing and Shanghai (especially for retail) is of poor quality in terms of design and/or management. This provides a niche opportunity for investors that have the operating expertise to reposition these underperforming assets.

**MARKET FUNDAMENTALS**

**Hong Kong**

In Q1 2010, economic growth in Hong Kong improved to 8.2% year-over-year as compared to 2.5% year-over-year growth in the prior quarter. Part of the reason behind the impressive growth was the low comparison base, as in Q1 2009 Hong Kong’s economy contracted by 7.7% year-over-year. Nonetheless, economic growth seems to be expanding with private consump-
Despite the sanguine outlook for growth in Hong Kong, there are some significant problems facing the Hong Kong economy. In particular asset prices will remain very volatile given China’s currency peg to the US$. Since Hong Kong’s economy is recovering at a much faster pace than the U.S., real interest rates have become too low. Indeed, these pressures are already quite evident as three-month interbank rates are currently in the region of 30 basis points relative to inflation levels of 2%. Negative short-term real rates, a fast rebound in the economy, and cheap mortgage financing have contributed to the spike in residential prices as shown in Figure 5. The residential indices do not always capture the record prices being set by uncompleted residential units that have been sold off plan in recent months, including the infamous HK$71,280 psf (US$9,138) sales price for 39 Conduit Road by one of the listed Hong Kong developer.

As a result of the rapid increase in housing prices and the perception that developers in Hong Kong were artificially boosting prices, new policies were introduced in May 2009 in an effort to dampen speculative pressures on new home sales. These policies mainly center around timely reporting of actual prices, insider sales, and sales that may had been manipulated by some of the residential developers in the past. At the same time, Hong Kong politicians who are perceived to be closely aligned to the Beijing government have been extremely vocal in pressuring the government to resume the sale of “subsidized” housing. The continued introduction of anti-speculation measures and the increased risk aversion in the global financial markets has resulted in a slowdown in sales for some new projects and also more tepid bidding for residential sites offered by the government.

Hong Kong’s office market continued to improve aided by a faster than anticipated recovery in the financial service sector. Although total employment declined by 0.3%, the finance and insurance sectors registered gains of 5.1% and 8.2%, respectively. This growth has translated to a pick-up in leasing activity with Jones Lang LaSalle estimating net demand for prime office space of 906,250 square feet in Q1 2010 and a decline in the vacancy rate by 5.1% and 8.2%, respectively. This growth has translated to a pick-up in leasing activity with Jones Lang LaSalle estimating net demand for prime office space of 906,250 square feet in Q1 2010 and a decline in the vacancy rate by 80 basis point to 6.2% quarter-over-quarter. Central (Hong Kong’s primary financial district) was the key beneficiary of this recovery with rents increas-
ing by 7.5% quarter-over-quarter. Although prime office rents in Central have now increased a cumulative 11% from their Q2 2009 trough, rents are still 37% lower than the Q3 2008 peak. However, the recovery in the broader office market has been more mild with rents up 4.8% quarter-over-quarter, but this more moderate recovery should be taken in the context of less of a decline in rents relative to the Central sub-market. Overall the outlook for Hong Kong’s core office market\(^8\) looks very favorable with total supply expected to increase by only 3.2% over the next three years. The combination of a low supply and healthy economic growth should facilitate a continued recovery in office rents in Hong Kong, with current forecasts ranging from 5% to 20%+ rental growth for 2010.

The retail sector in Hong Kong also continued to recover helped by the increase in visitor inflows from China and also by a recovery in domestic demand. Total retail sales in Q1 2010 increased by 18.8% year-over-year with luxury goods (jewelry, watches, and valuable gifts) posting a 37% increase. The strong growth in the luxury goods segment has been attributed to affluent mainland visitors. Not surprisingly, demand for retail space in recent months has been driven by jewelry/watch retailers and by restaurants. On average, rents increased 3% to 6% quarter-over-quarter. Given the fairly benign supply outlook (cumulative increase in prime stock of 6.1% over the next four years) relative to strong retail growth trends, many local retailers have been aggressive in buying high street shops in prominent locations at very high prices, causing yields for high street retail space to fall to a new low of 3.2%.

**Singapore**

Singapore’s economic recovery continues to surprise on the upside. In Q1 2010, GDP increased by 15.5% year-over-year and by 38.6% at an annualized rate over the previous quarter. Similar to Hong Kong, Singapore’s economy tends to be fairly volatile due to the fact that trade and finance are the key economic drivers. As such, due to the global credit crisis both city states experienced extreme contractions in Q1 2009. However, the current recovery in trade and finance is now being seen in recent growth figures. In Q1 2010, Singapore benefited from a 20% year-over-year increase in exports, although from a relatively low base\(^9\). This export-led recovery was also helped by an improvement in investments (primarily electronics and financial services) and government spending, which both expanded by 12.7% year-over-year. Currently, the Singapore government is forecasting GDP growth in the region of 7-9% in 2010, based on a continued recovery in the global economy, stronger tourism inflows due to the opening of the integrated resorts\(^10\) and strengthening domestic demand.

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\(^8\)Defined by the geographic areas of Central, Wanchai/Causeway Bay and Tsimshatsui.

\(^9\)Note in Q1 2009 exports fell by 17.6%, and total Q1 2010 export values are still about 4.6% below their Q3 2008 peak.

\(^10\)Singapore’s politically correct term for its two casinos.
Overall demand for office in Singapore has continued to recover. In Q1 2010, net absorption in the office sector increased by 258,000 square feet, marking the third quarter of positive absorption and vacancy levels increased marginally by 43 basis points to 13.7%. The situation in the CBD prime office sector was better. According to Jones Lang LaSalle data, aggregate vacancy levels in the Raffles/Shenton area declined by about 60 basis points in the quarter to 7.6%. This recovery is being led primarily by the finance sector, which is starting to show early signs of a strong recovery. In Q1 2010, the finance sector added 5,700 jobs, accounting for 16.8% of total jobs created. In conjunction with the recovery in the finance sector, prime office rents finally bottomed, following five consecutive quarters of sharp declines.

Although the supply of new office space remains high with an average of over 2 million square feet per annum expected to be completed over the next three years, most market analysts believe that most of the bad news has been reflected in prime office rents that have fallen by a cumulative 55% to 66% from their peaks. Prime office rents are now back to levels last seen in the 1990’s, which should improve affordability and support the continued recovery in the market. The increase in affordability may be one reason why many financial companies are upgrading and pre-committing to the newer office buildings scheduled for completion and also expanding their space requirements. The improved leasing sentiment also caused capital values to bottom. Based on information from the investment team, sellers that had been contemplating selling their office properties have been very aggressive in revising their selling prices upward as there are now multiple bidders for some of the higher quality buildings.

The Singapore retail sector has been resilient throughout the global credit crisis. Despite prime retail stock increasing by 11.8% in the 12-month period ending March 31, 2010, vacancy levels have increased by only 70 basis points to 2%. Retailers focused on luxury fashion brands, high-end restaurants, and watch and jewelry retailers were active in taking space in the new shopping centers in the Orchard area and in retail facilities near the integrated resorts despite the greater economic uncertainty. On average prime retail rents in Q1 2010 remained stable from the prior quarter, and have been very defensive vis-à-vis the office sector, having fallen only 10-15% from their pre-crisis peaks. Investor sentiment toward the retail sector is also improving. Colliers estimates that prime retail capital values in the Orchard area increased 6.8% quarter-over-quarter. Much of this buying interest is driven by expectations that the 8.7% year-over-year rebound in retail sales in Q1 2010 will continue, helped not only by improving domestic demand, but also by a significant increase in tourism as a result of the opening of the integrated resorts. Current government forecasts project that tourist arrivals will increase to between 11.5 million to 12.5 million in 2010, a significant increase from the previous high of 10.3 million tourist arrivals in 2007.
China
In Q1 2010, China’s economic growth accelerated to 11.9% year-over-year compared to 10.7% in the prior quarter. Despite this growth, the Chinese government has expressed little concern that the economy was overheating; attributing the strong growth to a low comparison base and the government stimulus package. Fixed investments continued to be the main driver of growth in China, with a 26.1% year-over-year increase in the four-month period ending April 30, 2010 relative to an 18.5% year-over-year increase in retail spending. Investment spending was dominated by local government, which increased 27.6%, in contrast to the central government and foreign enterprises which increased by 10.6% and 1.3%, respectively.

AEW believes that the central government did not think that the underlying economy was overheating, but rather they thought that the excessive and unproductive investments by local governments were contributing to asset inflation in the residential sector. This view seems to remain valid as the central government has not significantly tightened monetary policy either through higher interest rates or by letting the Yuan appreciate as had been earlier anticipated by most analysts. The central government has focused on curbing local government involvement in real estate, restricting debt for speculative purchases by developers and individual buyers, and requiring banks to hold more reserves. In addition, Beijing has been explicit in explaining to local government officials that the benchmark for measuring performance will not be “high” GDP growth but their ability to control housing prices. These prudent measures by Beijing will engineer a soft landing for the Chinese economy, with full-year economic growth in the region of 7-8% for 2010.

Shanghai
The recovery in the Shanghai office market continued driven by the expansion of both foreign and local financial institutions. Average vacancy levels in Shanghai declined from 11.5% in Q4 2009 to 10.5% in Q1 2010 helped by the delays in some new projects and improved leasing sentiment. Pudong has benefitted as some companies have relocated from older office buildings in Puxi (old CBD) and fringe locations into Pudong. At the end of Q1 2010, vacancy in Pudong had fallen to 13.3%, as compared to a peak of 23.6% in Q1 2009. This resulted in rents increasing 4.9% over the previous quarter, although they remain 37% below peak levels set two years ago. Rental growth in Puxi continued to lag the recovery in Pudong with rents increasing by only 0.5% despite vacancy levels falling by 120 basis points during the quarter to 8.3%. Part of the reason for Puxi’s lagging performance has been the fact that rents in this submarket fell less during the downturn, with current rents 30% lower than their peak.

Although some property analysts are optimistic about the Shanghai office market, citing the improvement in rents and China’s accelerating economic growth, there are reasons to remain cautious due to the large amount of new
space scheduled to be completed. Approximately 1.33 million square meters of prime office space is scheduled to be completed from Q4 2009 to Q4 2011, representing a 38% increase in total office stock. This is very high relative to historical demand that has been in the region of 300,000 square meters per annum (2004 to 2008). As such, sustainable strong rental growth may remain difficult in the office sector in the near term, particularly for Pudong, where over 72% of the new supply is located. Despite concerns about future supply, investment demand in Shanghai has remained strong with five buildings totaling US$994.4 million traded in the five-month period ending May 2010. Foreign buyers were particularly active accounting for four of the five transactions.

The Shanghai retail sector continued to register strong growth in Q1 2010 with sales increasing by 16.6% year-over-year. Demand also remained firm with brokers reporting strong interest from foreign retailers either entering or expanding their presence in Shanghai, which is considered China’s most affluent and sophisticated retail market. In addition, both domestic and foreign retailers are excited about the World Fair which opened in May in Shanghai and is expected to attract some 70 million visitors (domestic and foreign). Despite this positive sentiment, average prime rents across Shanghai remained stable in Q1 2010 from the previous quarter, although they are up by about 5.6% year-over-year. Part of the reason for the lack of rental growth is the large amount of new supply expected in 2010 and 2011. By the end of 2011 we expect a cumulative increase of 34% in retail stock, although about 85% of this new supply will be in secondary and new suburban locations. Currently, most brokers do not expect that the new supply will cause a significant increase in prime vacancies in the core retail areas. As such, availability of prime retail in the traditional core retail areas will remain tight. Not surprisingly, Sun Hung Kai’s (SHK) new mega mall development IFC Mall (97,500 square meters for Phase 1) in Pudong has seen strong leasing prior to its completion in Q2 2010 with an estimated 75% of the space pre-committed. SHK estimates that 40% of the property’s international retail tenants are new entrants into the Shanghai retail market.

**Beijing**

Beijing’s prime office market continues to be surprisingly resilient. Demand in Q1 2010 was estimated by Jones Lang LaSalle (JLL) to be over 433,000 square meters, which is strong when compared to historical annual demand of about 440,000 square meters. According to JLL this high demand was due to several large owner-occupied buildings being completed in the quarter including the China Petrol Building (200,000 square meters) and BaoSteel Building (60,400 square meters). Excluding owner-occupied buildings, net absorption was in the region of 59,000 square meters with an almost even split between domestic and foreign companies. This high take up resulted in vacancy levels declining during the quarter by 230 basis points to 25.8%, despite a 9.2% increase in office stock.

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11Defined as Nanjing Road, Huaihai Road, Xujiahui, and Lujiazui
Although average rents increased by 3.6% quarter-on-quarter, the first increase following six consecutive quarter-over-quarter declines, the Beijing office market can hardly be considered healthy. Several very large office buildings that were completed over the last nine months currently have occupancy levels of under 10%, including PICC, China Overseas Plaza, and World Financial Centre. The stickiness in rents would suggest that Beijing's landlords are not cutting rents to draw in tenants, rather they may be quite content with an empty building as they are looking for an exit through en-bloc or strata sales.

During Q4 2009, one listed Chinese developer, SOHO China, recently acquired en-bloc a largely empty office building (Nexus Center- 81,949 square meters) for US$343 million with the intention to strata sell to smaller local buyers. This may account for the 16% increase in capital values from Q2 2008 to Q1 2010 despite a cumulative 21% decline in rents, resulting in yields falling by 260 basis points to 6.3% (on a fully occupied building). Passing NOI yields for recent transactions in Beijing range from 5% to 5.5% after factoring in vacancy levels. Rents and occupancy levels will remain under pressure given that an additional 1.06 million square meters of new office space (20.6% net increase in stock) is scheduled to be completed by the end of Q4 2011. The low yields may also make it difficult for foreign institutional investors to acquire assets in Beijing. In addition, the recent efforts of the Chinese government to limit speculative buying by state-owned companies in the real estate sector have had an impact of buying sentiment. Transaction volume in Beijing has slowed significantly since the start of 2010 with only two building totaling US$453.3 million trading as compared to Q4 2009 that saw seven buildings totaling US$1.27 billion traded.

Malaysia

Malaysia has benefited from strong demand for natural resources from emerging markets such as China and India. In Q1 2010, Malaysia's economy expanded by 10.1% year-over-year compared to 4.4% in the prior quarter. The growth is primarily due to a 19.2% year-over-year increase in exports, primarily energy (oil and gas) and raw commodities (palm oil and rubber). The recovery in domestic demand was more moderate, but did show signs of strengthening with private consumption and investment spending expanding by 5.1% and 5.4%, respectively. Malaysia's government has indicated that following the release of Q1 2010 GDP numbers that they may be revising upwards their 2010 GDP forecast (current range is 4.5% to 6.5%). This improvement in economic confidence prompted Malaysia's monetary authorities to implement their second 25 basis point increase on policy rates in mid-May to a still accommodative 2.5%. This has helped the Malaysian currency appreciate by 3.2% relative to the U.S. dollar, despite increased risk aversion in the global markets.

Strata sales are the sale of individual whole floors or part floors within a given building. This creates a fragmented ownership structure and often results in the building becoming non-institutional due to poor maintenance. Empty floors are often easier to sell to owner-occupiers as these buyers are not looking for income.
Throughout the global credit crisis, Kuala Lumpur’s office market has been one of the least volatile markets in Asia. In Q1 2010 prime office rents remained unchanged from the prior quarter and have fallen by less than 7% from the peak. Overall, demand for prime CBD office space remained subdued during the quarter and was driven primarily by domestic companies, resulting in vacancy increasing by 130 basis points over the quarter to 11%. The outlook for the Kuala Lumpur office market remains challenging given the large number of speculative projects that will be completed over the next three years. Supply in Kuala Lumpur’s city center area will increase by a cumulative 25.9% (535,000 square meters) relative to average annual demand of less than 61,000 square meters per annum (2005 to 2009), so vacancy will increase. Despite the less than positive outlook facing the Kuala Lumpur office sector, investment demand picked up in Q1 2010. From December 2009 to May 2010, there were 15 transactions totaling US$498.6 million. Buyers were mainly Malaysian companies however there were also REITs and domestic institutional investors. Part of the attraction of the Kuala Lumpur office market may be the high yields, which are currently estimated at about 6.8% to 7.2% (on a fully occupied basis), relative to short-term borrowing cost of between 4.5% to 5.5%.

Thailand
Thailand registered stronger than anticipated economic growth in Q1 2010 with the economy expanding by 12% year-over-year compared to 5.9% in the prior year. This growth was primarily due to the rebound in exports and investment spending, which increased by 16.2% and 12.6%, respectively. However, this economic recovery will most likely be derailed by the recent political unrest, which deteriorated into a siege in Bangkok’s commercial district that required military action and resulted in loss of lives and damage to private property. Thailand tourism sector, which accounts for about 6% of GDP, could see a medium-term structural de-rating as foreign visitors no longer view the country as a safe place to visit. In addition, foreign direct investments and domestic investment spending are likely to be curtailed as underlying political issues have yet to be resolved. Already there are some indications that some foreign companies that have sourced products from Thailand are looking for more stable alternative locations. This includes not only electronic and auto parts, but also includes commodity goods including rice. As such, Thailand will likely be a laggard in the Asia region in terms of economic recovery. The country could also face a decade of lost growth similar to Indonesia and the Philippines as it struggles to resolve its political problems.

Although Bangkok prime office and retail sectors had shown signs of stabilizing in Q1 2010, overall demand recovery has been weak relative to other Asian markets. The recent unrest, including the torching of Central World, one of Asia largest modern prime retail shopping centers (100,000 square
meters\(^{13}\)) will do little to revive the already weak confidence from both foreign and domestic investors. The risk of holding physical assets in Bangkok has increased exponentially and it may be quite a few years before foreign investors put Bangkok back the investment list.

**Japan**

Economic conditions in Japan have finally shown some signs of a nascent recovery. In Q1 2010, real GDP increased by 4.6% year-over-year, the first positive year-over-year increase since Q1 2008. This recovery was mainly due to a 34.3% year-over-year increase in exports, as private consumption and investments remained weak at 2.9% and -3.9% respectively. Although most economists and the Japanese government are optimistic that the country may grow in excess of 2% in 2010, Japan's economy remains extremely vulnerable if global trade weakens. Japan currently has one of the highest government debt levels globally, with current estimates at around 180% to 200% of GDP. This high debt level will limit the government’s ability to allocate further stimulus spending if external demand starts to weaken.

In addition, Japan also has to deal with on-going deflationary pressures that are in certain ways hidden by the reported real GDP growth numbers. Figure 6 shows the stark contrast between Japan’s real versus nominal GDP on an annual basis. Even prior to the global downturn Japan’s economy in nominal terms had not expanded much since 1997. The “real” GDP numbers suggest that growth from 1997 to 2007 (1.1% CAGR) was largely driven by deflationary trends rather than any increase in economic output.

Tokyo’s office market remained soft as a result of the continued weakness in the domestic economy. Based on data from local brokerage company Miki Shoji, in Q1 2010 average rents in the Tokyo CBD office (5-Inner Ward\(^{14}\)) declined 3.8% from the previous quarter, and have now fallen by a cumulative 17.7% from Q4 2008. Continued weak demand has led to a fall in rents and vacancy levels increasing by a further 66 basis points to 8.75% during the quarter. Miki Shoji further noted that vacancy levels for large recently completed buildings\(^{15}\) remains high at 30.6% and there is intense competition for anchor tenants. Most analysts believe that the Tokyo office market could be close to bottoming as demand is showing signs of bottoming. Nonetheless, rental growth will be difficult given Japan’s deflationary environment and also due to a fairly rich pipeline of new projects expected to be completed in 2011 and 2012.

Despite the less than sanguine outlook for the Tokyo office market, sales volume has continued to increase during the year. In the five month period ending May 31, 2010, total sales transacted reached US$11.4 billion compared to US$11.0 billion for all of 2009. Many of the recent transactions

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\(^{13}\)Defined as Minato-ku, Shibuya-ku, Chuo-ku, Shinjuku-ku, and Shibuya-ku.

\(^{14}\)Miki Shoji definition is for buildings with floor space of at least 330 sqm that had been completed within the last twelve months.

\(^{15}\)Miki Shoji definition is for buildings with floor space of at least 330 sqm that had been completed within the last twelve months.
have been very large, including the sale of the Tokyo Shiodome Building by Mori Trust Sogo REIT for US$2.36 billion. Some of the larger transactions are summarized in Figure 7.

Although buying activity in Tokyo has been driven largely by Japanese companies, particularly from companies affiliated with Japan’s larger conglomerates, foreign interest is expected to increase in the second half of the year. The main attraction of the Japanese investment market is due to the size and depth of the market, which can facilitate large transactions. The opportunity to deploy large amounts of capital will appeal to several of the larger multi-billion Pan-Asia funds that are now reaching the end of their commitment periods.

Australia

Surprisingly Australia has been one of the most resilient countries throughout this global economic downturn. In Q1 2010, the Australian economy grew by 2.7% year-over-year compared to 2.4% in the prior quarter. Unlike most of the other Asia-Pacific countries (with the exception of China), Australia did not register any year-over-year contractions even at the height of the global recession. This resilience may be partly due to strong commodity demand from China which has contributed indirectly to an investment spending boom. In addition, domestic household consumption in Australia has been very resilient. Figure 8 summarizes Australia’s resilient GDP growth, export trends, and private household consumption.

The general outlook for the Australian economy remains healthy, with current growth forecasts indicating that the country will be back to trend growth by as early as 2011. Indeed, the surprising strength of the Australian economy has allowed the Reserve Bank of Australia to be one of the first developed
countries to start to normalize interest rates. Since end September 2009, the Reserve Bank of Australia has steadily increased interest rates by 25 basis point increments from 3.0% to the current 4.5%. Despite this rapid increase in rates, domestic consumption and the housing market has remained resilient.

Australia’s office markets entered into the global economic crisis in a fairly strong position compared to previous cycles. Australia doesn’t really have significant oversupply with the exception of some of the smaller commodity-driven cities such as Perth and Brisbane. In Sydney total office stock increased by a cumulative 2.6% from end Q4 2004 to Q1 2010 (yes correct time frame), while in Melbourne total office stock increased by a cumulative 8.1% from Q4 2006 to Q1 2010. However despite weaker demand in Melbourne and negative absorption in Sydney over the past two years, vacancy levels did not significantly spike up. At end Q1 2010, vacancy levels continued to decline from the prior quarter on the back of stronger demand in both Sydney (8%, -20 bps) and Melbourne (6.3% -10 bps). The low vacancy level in Melbourne helped facilitate a 5.1% increase in rents over the prior quarter primarily as a result of lower rent free incentives. The recovery in the Sydney office market has been slower with rents remaining unchanged from the prior quarter. Nonetheless, there are signs that the financial industry, which is a key economic driver in Sydney, has started to expand again.

The general consensus is that both the Sydney and Melbourne will continue to see a recovery in rents primarily as the supply outlook for both markets will remain fairly moderate until after 2012. In addition, rents in Sydney may have fallen more than is justified by the underlying fundamentals. At the end of Q1 2010 prime office rents were 27% lower than their peak, a level of decline more associated with double-digit vacancy levels. This general expectation that the office markets in Sydney and Melbourne is bottoming has resulted in average yields stabilizing in the region of 7.0% to 7.9%. These yields are attractive vis-à-vis the 10-year Australian government bond rate of 5.3%. As such, there are some expectations of yield compression in the upcoming quarters.