

North American Real Estate Market Report

March 2009



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Real estate market review

Recent market movement

- The performance of the US property market deteriorated through 2008 as the economic outlook darkened. Across all sectors, low levels of transaction activity and falling capital values were key features. Capitalisation rates were moving out at an increasing pace by the end of 2008 as the re-pricing of risk continued and the consequences of rapidly deteriorating space markets were felt.

All sectors in both the investment and space markets had a poor 2008

Offices

- With the financial services sector contracting, the demand for office space is falling. Vacancy rates are increasing, rents are heading downwards and landlords are offering higher incentives. Total returns were negative as capital values fell. Transaction levels are very low making it hard to judge how far the market has moved. Debt-laden distressed sellers and rapidly falling financial sector employment appear to be pulling prices down.

A weakening space market and prevalent distressed sales mean office values are falling

Retail

- With the retail sector hit particularly hard by the current economic climate and the poor standing of the US consumer, conditions in the occupational market are weakening rapidly with vacancy rates increasing sharply. Rents are falling and incentives increasing, lowering income growth. Capital values started depreciating in the middle of 2008 and fell rapidly in the last quarter. Total returns for the year are negative.

Retail sector has been hit hard by the reduction in consumer spending

Industrial

- With production levels down and the prospects for trade dimming, the industrial sector is being severely impacted on by the economic downturn. Rental declines have occurred in most markets and capital values are falling.

Declining industrial rents and capital values as industrial output falls

Residential

- With house prices down by almost a fifth in 2008 according to the Case-Shiller index, the residential market has continued to weaken. For landlords, high job losses are reducing tenants' ability to pay and rents are heading downwards.

No stabilisation in the housing market as values continue to fall

Economic overview

- The US economy shrank rapidly in the fourth quarter against the backdrop of a sharply deteriorating global outlook. Output has now been trending downwards for over a year, with the rate of contraction increasing quickly towards the end of last year. According to data from the Bureau of Economic Affairs (BEA), the economy is estimated to have shrunk at an annualised rate of 6.2% in the fourth quarter. Employment has also been decreasing rapidly. In January 2009, the US economy lost more than half a million jobs for the third consecutive month, according to the Bureau of Labour Statistics (BLS). In total, 2.6 million jobs were lost in 2008, more than in any other year since 1945. Nearly two million of these jobs were lost between September and December.

The US economy is shrinking and unemployment is rising
- Federal Reserve figures show that production and sales figures declined at a rapid pace during late-2008. Non-financial corporates were hit by a sharp retrenchment of consumer spending and an unexpected increase in input costs over the year as commodity and oil prices soared to a peak in mid-2008. Oil prices have since tumbled to around \$40 per barrel. As cost pressures eased, real incomes increased, but consumer demand remains very weak.

Producers hit by weakening demand and spike in input costs
- During the last two quarters of 2008, it is our view that government intervention both in the US and other major countries maintained the integrity of the formal banking system when, in September, there was a realistic prospect of its collapse. In the US like Europe, we judge additional bank capitalisation by the state is likely to be necessary. Credit conditions remain very tight. Inter-bank lending rates are down from the extreme highs seen in September following the collapse of Lehman Brothers, but remain at elevated levels by historic standards. We expect this to result in high levels of foreclosures and bankruptcies.

Credit conditions remain very tight
- Interest rates were cut to 0-0.25% in December, the lowest ever Federal rate. Policy makers are expressing a strong likelihood that rates will stay at this level for the foreseeable future. Whilst the limits to interest rate policy have been reached, the Fed has expressed a strong willingness to boost the money supply through quantitative easing to avoid deflation.

Extremely low interest rates and quantitative easing deployed to combat the risk of deflation
- Further declines in US GDP are expected. The consensus forecast suggests that growth will be -2.1% this year. Aviva Investors forecasts negative growth in 2009 and slow growth in 2010. In our opinion, there is a big onus on fiscal policy to stimulate the economy over the near term. The new Obama administration's fiscal stimulus package, worth around \$790bn in public spending and tax cuts, is very nearly finalised.

Further declines in GDP are expected
- In common with its southern neighbour, the Canadian economy has been slowing since late-2007 and, in fact, its growth performance in 2008 was worse than in the US. According to Statcan, respectable growth of 1.3% was achieved in the third quarter, but we view this as result of a jump in oil and gas output in the West Coast and Atlantic regions, areas of the economy that have now cooled. Initial resilience due to the strength of commodity markets is now less evident as global demand wanes. In November, the economy shrank by 0.7%. It appears to us that the Canadian manufacturing sector is clearly at risk of a prolonged US downturn. The growing threat of US protectionism is a concern. Lack of external demand is not the only source of weakness, however. Falling housing and stock markets combined with worsening employment prospects have weakened consumer demand. Job losses in Canada totalled 34,000 in December following a fall of 71,000 in November. In January, the pace picked up with 129,000 job losses, according to Statcan. This is the largest monthly fall in over 30 years.

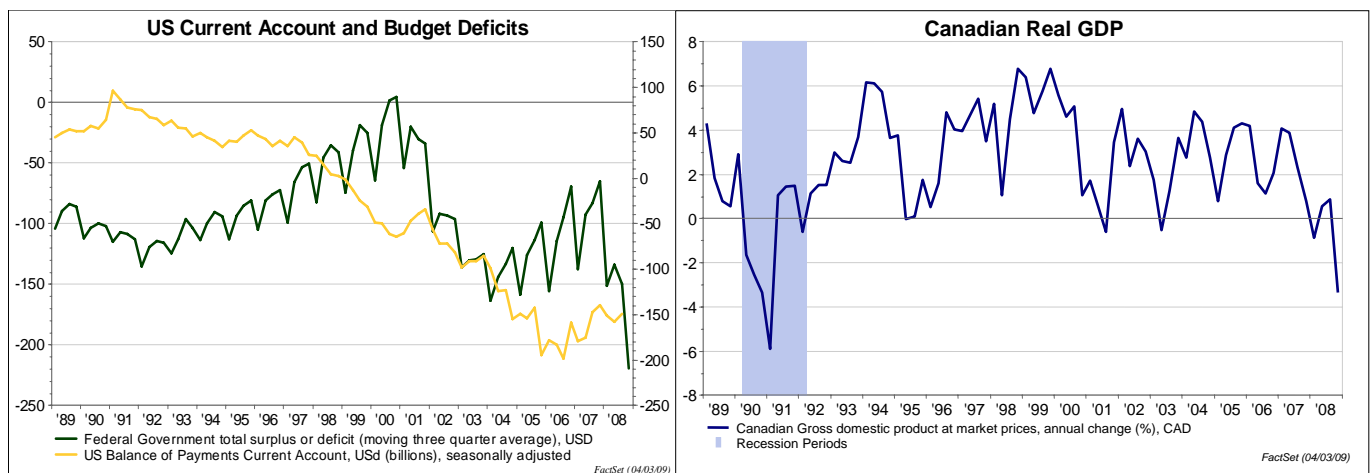
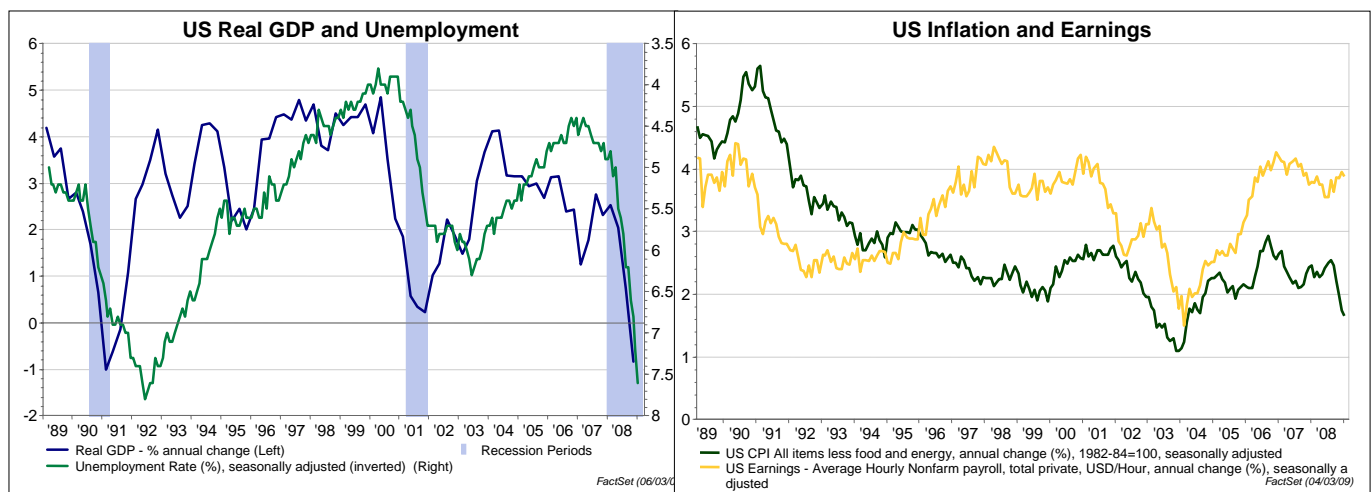
Weak external and internal demand reducing output and employment in Canada
- The February consensus forecast suggests that the Canadian economy will shrink by 1.1% in 2009. However, a sound banking system offers some protection from the financial crisis and a relatively rapid recovery in 2010 is expected. The Bank of Canada cut interest rates by 50bps to a new historic low of 1.00% in January. Furthermore, a fiscal stimulus package worth CAD40bn (around 2% of GDP) to be spent over the next two years was announced by the Finance Minister in late January. According to HSBC, Canada is in the best position of any G7 country to afford a stimulus package given relatively low levels of debt to GDP.

Monetary and fiscal policy to aid speedy recovery

¹ Revisiting a Canadian Recession, HSBC Global Research, 21 January 2009

	2007	2008	2009 (Forecast)
US Real GDP Growth	2.0	1.2	-2.9
US CPI Inflation	2.9	4.1	-0.3
US Short Rates	4.25	0.13	0.13
US Current Account (%GDP)	-5.3	-4.7	-3.8

Source: Factset, Aviva Investors 19.2.2009

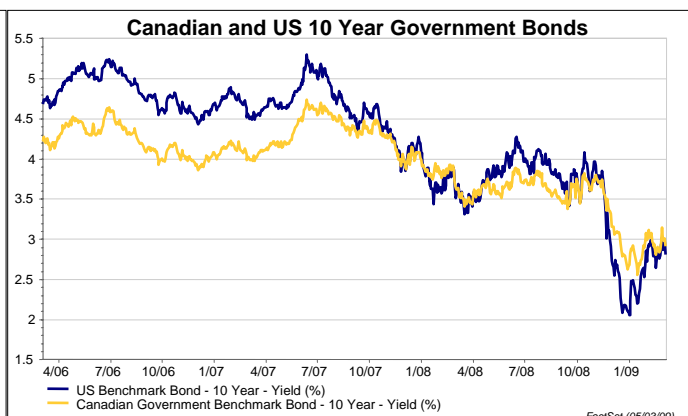
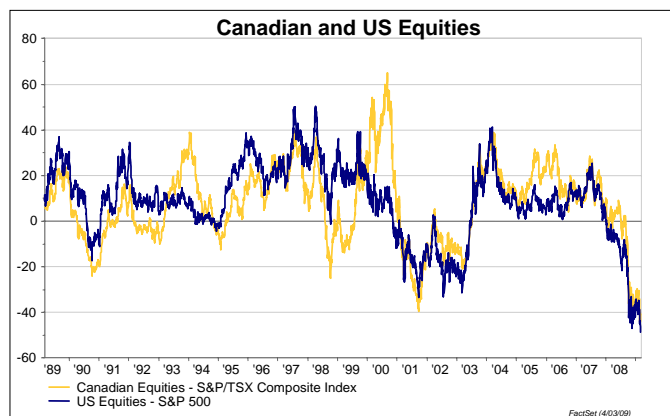


Bond and equity markets

	Latest – 16/02/09	12 Month Change
S&P 500 Composite – Price Index	826.8	-39.5%
Dow Jones Industrial	7,850.4	-37.5%
NASDAQ	1,534.4	-35.4%
3 Month US T-Bill	0.30	-197bp
10 Year US Treasury Yield	2.79	-94bp
S&P/TSX Composite (Canada) – Price Index	8,678.1	-34.7%
10 Year Canadian Bond Yield	2.95	-93bp

Source: Factset 16/02/09

- Equity markets across the world suffered an extremely bad year in 2008 and North American markets were no exception. The Dow Jones Index fell by 33.8%, the largest annual fall since 1931. The S&P 500 companies lost \$5.02 trillion in value (-38.5%) and the NASDAQ had its worst ever year since its foundation in the 1970s, dropping by 40.5%. In Canada, the S&P/TSX index fell by 33.0% in 2008. Around two thirds of this decline occurred during the fourth quarter when the index returned -22.7%. 2008 was a dismal year for North American equities
- The market experienced significant volatility throughout the year with particularly sharp downward movements seen in September in the wake of the collapse of Lehman Brothers and associated financial sector turmoil. Daily volatility declined noticeably towards the end of the year but remained high by historic standards. Markets have shown persistent volatility
- In our opinion, the investment case for US equities has improved considerably. However, continued volatility means short-term risks remain elevated and the weak economic outlook represents a significant impediment to a meaningful recovery. There is potential for good returns in the long term but poor performance in the near term is probable. Potential for good returns in the long term but poor performance in near term probable
- Government bond yields have declined to very low levels in response to investors' extreme risk aversion and lowered inflationary expectations. In fact, current yields reflect the pricing in of a deflationary outlook for the near term. However, the Fed has shown a willingness to employ extreme measures to prevent a downward price spiral gathering force. At current pricing, it appears difficult to make a long-run investment case for bonds. However, low bond yields increase the attractiveness of real estate in our view. Bond yields very low, boosting attractiveness of real estate



Real estate investment markets

- Investment levels in direct real estate have fallen very sharply, down by around 68% in 2008 in the US according to Commercial Real Estate Direct (CRED). Whereas over \$170 billion was invested in 2007, only \$55 billion was invested last year. Investment activity slowed sharply in the fourth quarter with just \$7.28 billion worth of deals done, 46% less than in the third quarter. The fall in investment volumes was less rapid in Canada, according to CBRE.

Investment in direct real estate has collapsed in the US and fallen more slowly in Canada
- In early 2008, foreign capitalised deals for landmark buildings such as the GM and Chrysler buildings lent some support to the market. However, such deals had dried up by the second half of the year. Foreign investment fell broadly in line with total investment with only German and Middle Eastern investors being particularly active, according to Real Capital Analytics (RCA).

Foreign investment faded as 2008 progressed
- The US property market is more debt reliant than other countries' markets. At the end of 2007, debt accounted for 62% of capital stock in the US, compared to 60% in the UK, 54% in Europe and 49% in Asia, according to RREEF. However, access to credit became increasingly difficult and costly in 2008. Banks have become reluctant to lend to commercial property. In the Senior Loan Survey for the first quarter of 2009, 79% of banks reported a continued tightening of lending standards to commercial property during January. Furthermore, opportunities for US investors to borrow through the issuance of Commercial Mortgage-Backed Securities (CMBS) all but dried up in 2008. Only \$12.1 billion of CMBS was issued, down 95% on 2007 levels, according to CRED reports. With credit default swap (CDS) spreads at very elevated levels, the market now appears highly concerned about the financing outlook for the real estate sector, even compared to just a few months ago. Concern over default is prevalent.

High cost and lack of access to finance is shrinking the market
- Distressed properties are weighing on pricing. In December, RCA identified over \$105 billion of commercial property that was either in distress or potentially troubled. This includes nearly \$26 billion of distressed properties (which generally means mortgage default has occurred) and over \$80 billion worth of potentially troubled properties (which include properties with mortgages that mature next year or are owned by companies in financial distress). It is our view that the ability of borrowers to refinance debt in the next 12 months will be a crucial determinant of the trajectory of the market. The retail sector is also showing high levels of distress as consumer sales fall and stores close. RCA estimates that there are 6,261 loans with a value of \$57.2 billion backed by retail properties that have service coverage levels of just 125% or less. One potential scenario is that distressed sales increase the amount of investment activity in 2009 while bringing prices down.

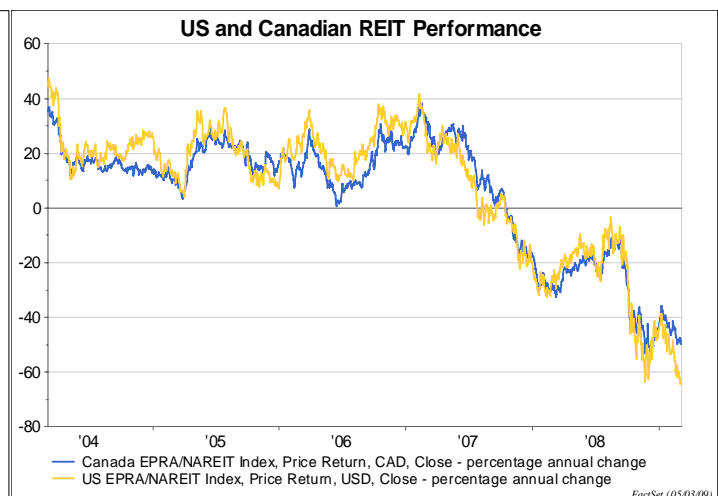
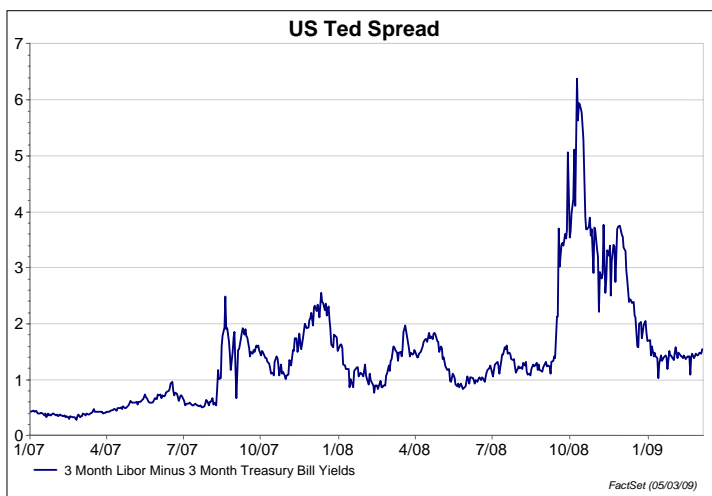
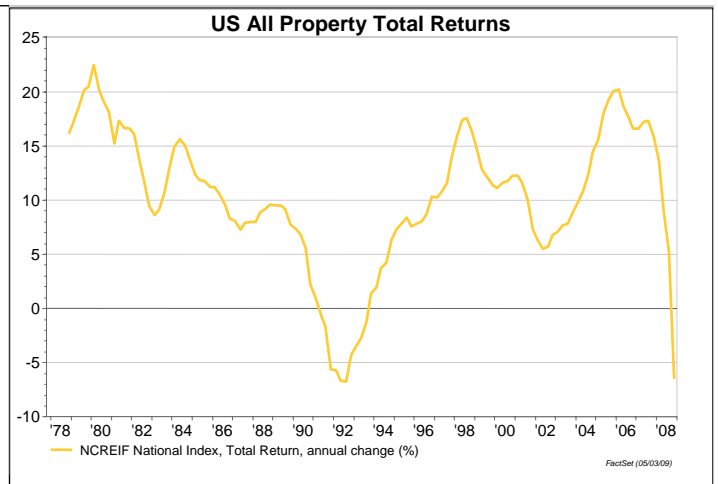
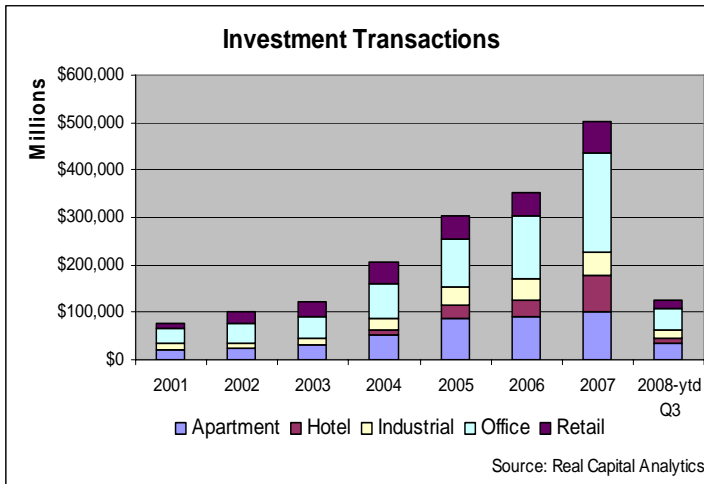
Distressed properties are now weighing on pricing
- According to Moody's/Real Commercial Property Price Index (CPPI), commercial real estate values fell 3.4% in November and by 14.3% in the preceding 12 months. At the end of November 2008, cap rates on all core property stood at 6.8% according to RCA. This represents an adjustment of 0.4% since cap rates bottomed out at 6.4% in June 2007. Given the rapid appreciation in 10-year Treasury bills, the adjustment of the spread over the risk-free rate has been more significant, moving from 130bp in June 2007 to 329bp in November 2008. The rate of adjustment has been most significant in CBD offices where the spread over the risk-free rate reached a low of just 78bp in June 2007 and now stands at 370bp. For the first time since 1993, total returns turned negative in the third quarter of 2008 according to the National Council of Real Estate Fiduciaries (NCREIF) index. Over 2008 as a whole, total returns declined by 6.5%. This compares very unfavourably with total returns of 15.9% achieved in 2007.

Transaction prices now significantly below peak, cap rates are moving out and total returns are falling
- During the year to September 2008, capital values in Canada grew by 6.4% according to the Institute of Canadian Real Estate Investment Managers (ICREIM)/Investment Property Databank (IPD) Canadian Annual Property Index. Infrequent valuations mean that the index lags the market, so while the slowing of the market is discernible, the degree of correction is less clear. In our opinion, the Canadian market should be less prone to a downturn. Firstly, highly leveraged deals are a far less common feature of the market. Secondly, major pension funds dominate the market for core real estate meaning buying and flipping is relatively rare. Values are generally less volatile as a result.

Less volatile movement in Canadian values

- From an international perspective, the rate of adjustment in the North American market appears slow. It is important to understand that, although markets such as the UK and the US are both at similar stages of the economic cycle and have deep, liquid and transparent property markets, there are some key differences. Firstly, the UK market is relatively small. Around half of the UK's invested property market is in the South East. By contrast, the US market is geographically diversified over a very large area. It seems that the small size of the UK market also enables a handful of appraisal firms to dominate the market allowing consensus on the direction of market sentiment to be achieved more quickly. The fact that the UK is a more concentrated and highly researched market appears to compound this effect. Secondly, UK values are based on annual external valuations to open market value in accordance with the Royal Institute of Chartered Surveyors' standards. In contrast, properties in NCREIF are only required to be externally valued once every three years. Thirdly, a higher proportion of retail funds are open-ended in the UK, which appears to lead to faster movements in values.

Pace of repricing appears slow from an international perspective



Real estate equities

Total Return Performance of Real Estate Equities					
% Total return in stated currency (as at 30/01/09)					
Index	Currency	Div yield	1 month %	3 months %	1 year %
Global	EUR	7.67	-5.5	-19.2	-45.0
• North America	EUR	9.22	-9.7	-26.9	-42.1
USA	USD	9.15	-17.6	-26.7	-49.7
Canada	CAD	10.00	-5.4	-17.4	-40.6
• Europe	EUR	7.93	-5.2	-20.5	-51.4
• Asia	EUR	6.04	-1.0	-8.9	-44.7

Source: Factset 17/02/09

Having fallen rapidly from the start of 2007, REIT performance was respectable in the first three quarters of 2008. Until September, equity REITs significantly outperformed the broader stock market. In September, they fell very sharply, as did share prices across all equity markets. The sell off of REITs since the beginning of September reflects heightened aversion to risk generally and the intensification of fears that the REIT earnings would slow as the economy weakens. By the end of 2008, REITs had suffered their worst ever year, down 38% according to Merrill Lynch. What is more, the end year figure reflects a marked recovery during a period of high volatility. The REIT index was down more than 50% at some points in the fourth quarter. REITs have continued to decline in 2009. US non-REIT property equity performance has been even worse. According to the European Public Real Estate Association, the index of United States non-REITs property equities fell by 62% in 2008. Canadian REITs, as measured by the S&P/TSX Capped REIT Index declined by 39.3% in 2008, broadly in line with the US experience. This represents an underperformance relative to all equities as measured by the S&P/TSX index.

Across the globe real estate equities fell by 45% in 2008, down further than all global equities (down 38.7%). Global REITs fell 41.7%, Asian REITs declined 51.2% and European REITs were down 44.2% according to the European Public Real Estate Association. Real estate equities performed better in the US than in Germany, Italy, Hong Kong and Australia.

In our view, the decline in US REITs reflects weakening fundamentals and a deteriorating credit market. According to Citigroup, overall occupancy of REIT properties fell to 93.0% from a peak of 94.3% at the end of 2007. However, REITs have suffered greatly due to their association with financial companies and concerns about liquidity. Generally, the worst performers are those with significant debts requiring refinancing in the near term. Those that have leveraged aggressively are potentially becoming candidates to be taken over. Such assessments have led to an apparent disconnect between the pricing of real estate equities and real estate valuations, even allowing for the relatively slow rate at which valuations appear to adjust to changing market conditions. We judge this disconnect to be more significant in Canada where REIT fundamentals in terms of vacancy rates and supply levels remain relatively robust.

As well as the lows touched by REITs, another distinguishing feature has been their volatility. Generally, stable yields based on long-term leases and relatively high dividend payout ratios mean REITs offer stability compared to other stocks. But in 2008, REITs were highly volatile – both the 20 biggest one-day gains and 20 biggest one-day losses in the 13-year history of the Morgan Stanley REIT index occurred in 2008.

Average dividend yields for US REITs increased slightly in 2008 to end the year at 7.8% (2nd January 2009) up from 7.6% a year ago and 4.9% two years ago, according to Citibank. They estimate that at the end of 2008, REIT pricing implied a 8.3% cap rate for their property portfolios. At present, REIT preferred stock is trading out of line with historical relationships with its debt and equity. Having incurred huge losses at the start of the year, REIT debt is currently yielding significantly more than preferred stock for the first time ever. This can be explained by the low level of selling pressures from existing investors and the presence of traditional equity investors that are largely income focused. Meanwhile, the spread of preferred yields over common yields has fallen to near zero, a very rare occurrence. The rapidly falling price of common yields has resulted from the growing expectation that a significant number of REITs will suspend their common dividends. Indeed, 35 US REITs have already cut their dividends.

Office markets

- Total employment in the US fell by 2.4% in 2008, according to BLS. BEA data shows unemployment reached 7.6% at the end of January. Employment in financial services, which had been falling since late 2007, fell by 1.8% over the year while the number of professional and business services jobs dropped by 3.8%.

Service sector employment falling rapidly
- In the US space market, there has been a pause in leasing activity. Absorption fell by 19.9m sq ft in the fourth quarter, the largest fall since early 2002. An increasing amount of space is available for sub-lease as occupiers look to minimise occupancy costs. The national vacancy rate reached 14.4% in the fourth quarter, the highest level for three years, according to Reis Inc. A steady increase in the vacancy rate has put downward pressure on rents and encouraged landlords to offer more generous incentives. According to Grubb & Ellis, annual rents for Class A office space dropped from \$36.38 per sq ft at the end of 2007 to \$35.80 at the end of 2008. We believe rents will continue on a downward trajectory as falling demand meets increasing supply; there is 85 million sq ft of office space currently under construction (Grubb & Ellis). However, the supply overhang is less threatening than at this point in previous cycles.

Vacancy rate increasing and rents falling as demand for office space wanes
- The Canadian space market held up better than the US market in 2008. With the financial sector in Canada seemingly on a far more stable footing than in the US, the impact on demand for office space has been less significant so far. In the fourth quarter, according to Colliers, net absorption remained positive although it was down significantly on levels achieved in the third quarter. CBRE reports negative net absorption in the fourth quarter but positive net absorption for 2008 as a whole. CBRE states that the national overall vacancy rate increased by 40bps in the fourth quarter to 6.7%. There was also a significant increase in space available for sub-let, especially from oil and engineering companies seeking to save costs. Rents were virtually unchanged in the fourth quarter according to CBRE.

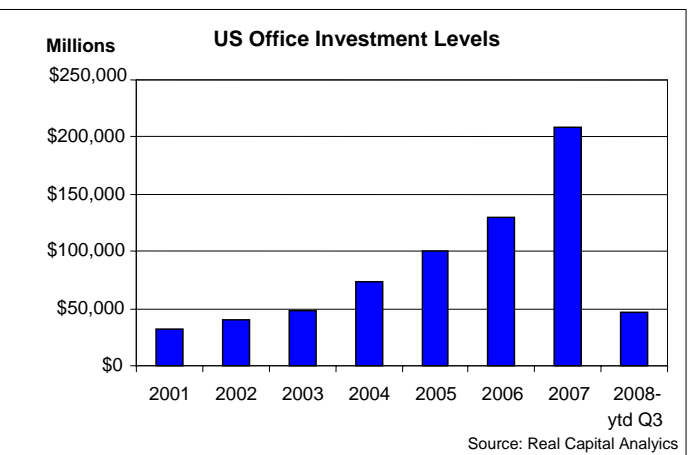
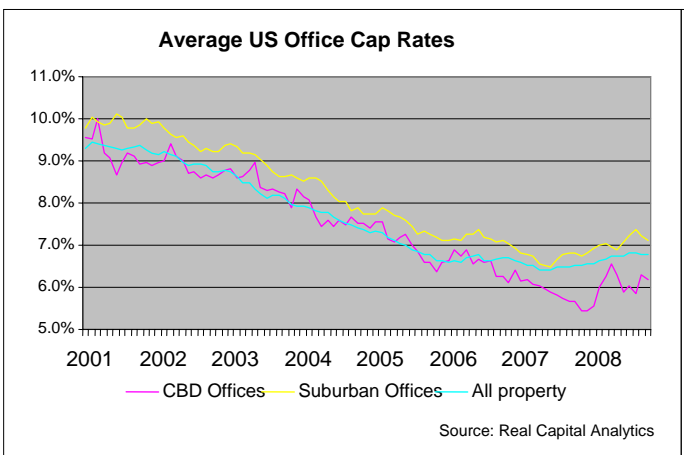
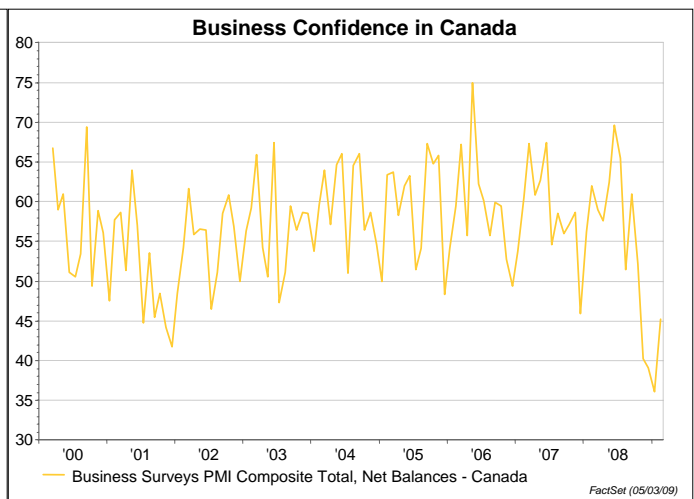
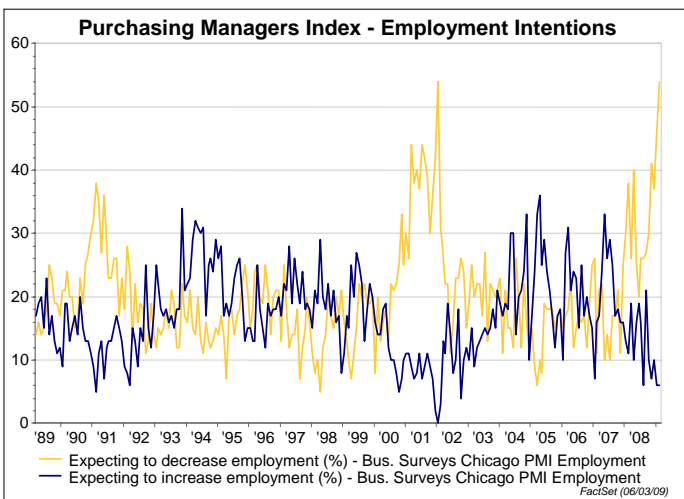
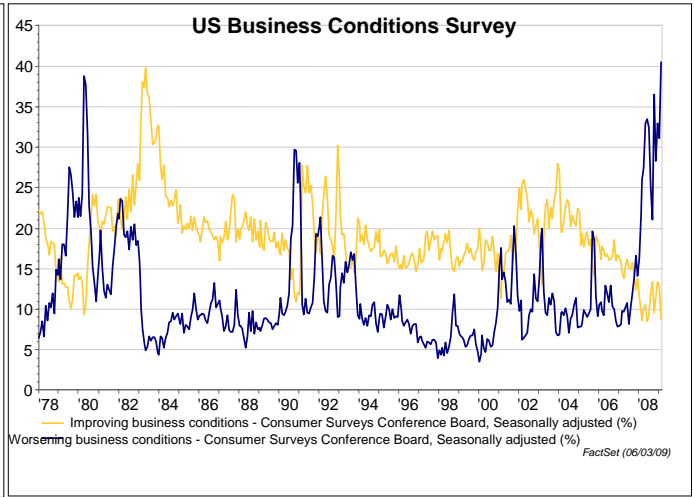
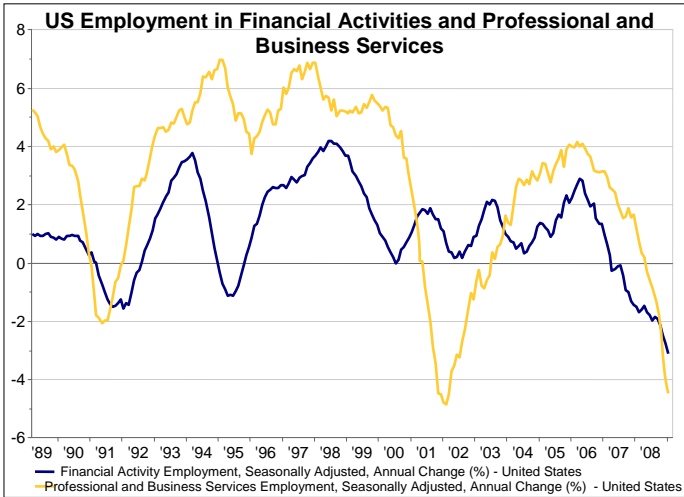
Canadian office sector showed greater resilience
- Cap rates are increasing. As would be expected, transaction based measures of cap rates are moving faster than valuation based. A lack of deal activity is making pricing very difficult. According to RCA, sales are down 70% on last year and the bid-ask gap remains very significant at 15%. Purchases by non-leveraged buyers fell the furthest suggesting that the market trajectory is being determined by economic uncertainty and not just the inability to finance.

Very low levels of transaction activity
- According to RCA's September issue of Capital Trends Monthly, the capital values of top assets have held up far better than secondary stock, reflecting the sharp fall in the appetite for risk and the increasing consideration buyers are giving to the certainty of selling. This has resulted in cap rates on suburban offices moving out twice as much as CBD offices. Furthermore, pricing dropped significantly on value-add properties, while it has increased for core/stabilised assets. The gap between the two continues to widen and trends in cap rates reflect this. Further evidence of the preference for prime, liquid assets can be seen in the type of deals that are being made. Sales of large portfolios have fallen faster than offices overall - down by 85% - and there have been hardly any "mega deals".

Buyers avoiding illiquid and risky assets
- Office total returns turned negative at -0.31% in the third quarter, according to NCREIF. A much more rapid decline occurred in the fourth quarter as returns fell by -9.26%. For the year as a whole, total returns were -7.3%. Even with the quickening pace of adjustment captured in fourth quarter figures, these may represent an underestimate of the fall in returns. This decline is consistent with a fall in capital values of 11.8%, which appears conservative.

Total returns negative for 2008
- In Canada, ICREIM/IPD reported that annual total returns for the office sector were 16.1% over the 12 months to the end of the third quarter, better than all other sectors except the mixed-use sector. Canadian office performance was boosted by annual capital growth of 9.1%. This is evidence of resilience in the market but we expect a significant deterioration in fourth quarter data.

Canadian investment performance held up into third quarter



Retail markets

- Compared to a year earlier, total US retail sales in the last month of 2008 were down nearly 11% according to US Census Bureau statistics. To some degree, this was due to rapidly falling gasoline prices, but it also represents further evidence of rapidly weakening consumer demand. Motor vehicles and parts have been hit particularly hard, falling 22.4%.

Retail sales heading downwards quickly
- Consumer confidence has been falling since the middle of 2007 and was lower than at any point in the previous ten years by the end of 2008. Clearly, falling house prices combined with deteriorating earnings prospects and decreased job security are hitting consumers hard. A changing attitude to credit is also evident with most consumers no longer appearing willing to sustain their expenditure by taking on more debt. In our view, 2008 will represent the peak in the debt mountain accumulated by customers during recent years.

Consumers are tightening their belts
- According to Reis, vacancy rates in regional malls increased at the fastest rate in the fourth quarter since they began tracking the sector in 2000. The vacancy rate is currently at a record high of 7.1%, up from 6.6% in the third quarter. In neighbourhood and community shopping centres, vacancy rates are also at their highest level since 2000. Reis reported that rents were falling in both malls and shopping centres, with landlords aggressively increasing incentives too.

Vacancy rates at record highs
- According to NCREIF, retail total returns turned negative in the fourth quarter, falling 6.3%. Continued income growth of 1.45% was outweighed by capital declines of -7.8%. For 2008 as a whole, total returns were -4.1%. US retail investment volumes were down two-thirds in the year to November 2008 according to RCA.

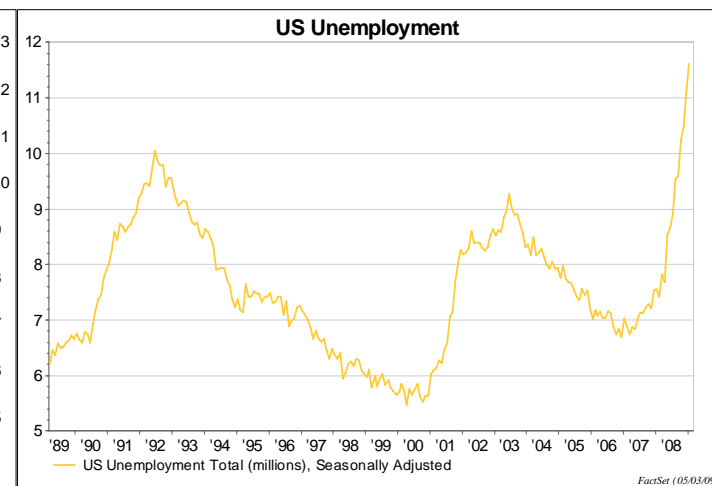
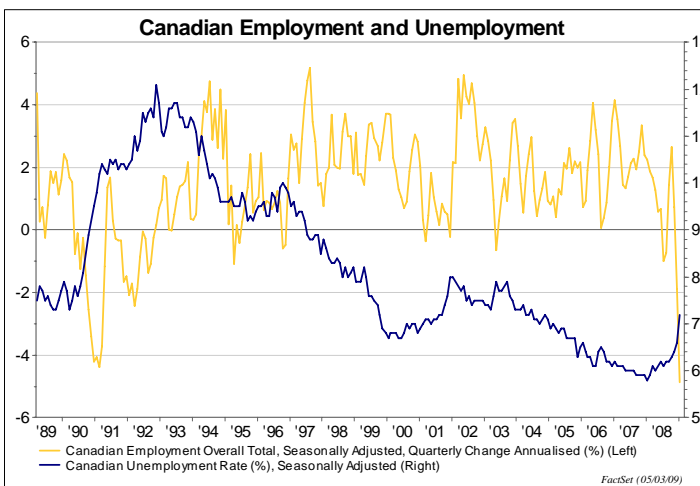
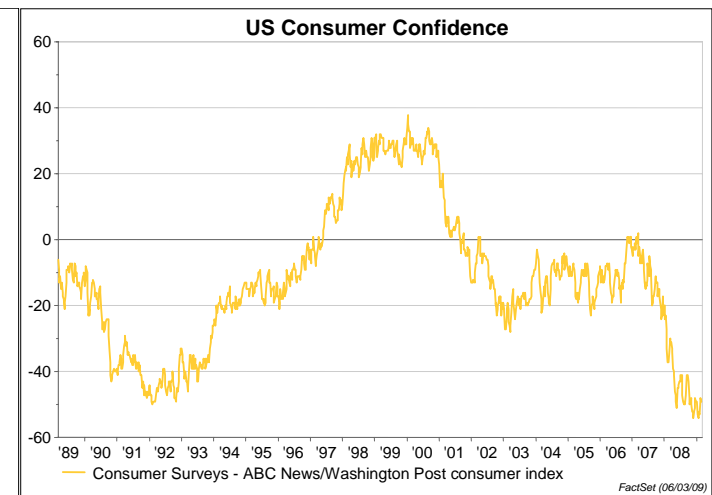
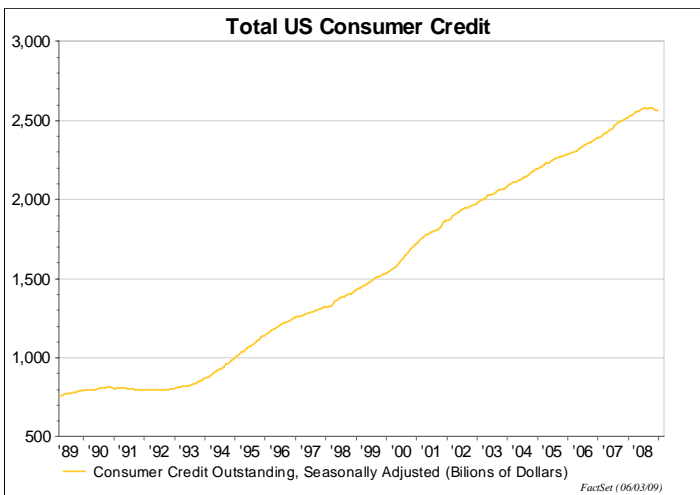
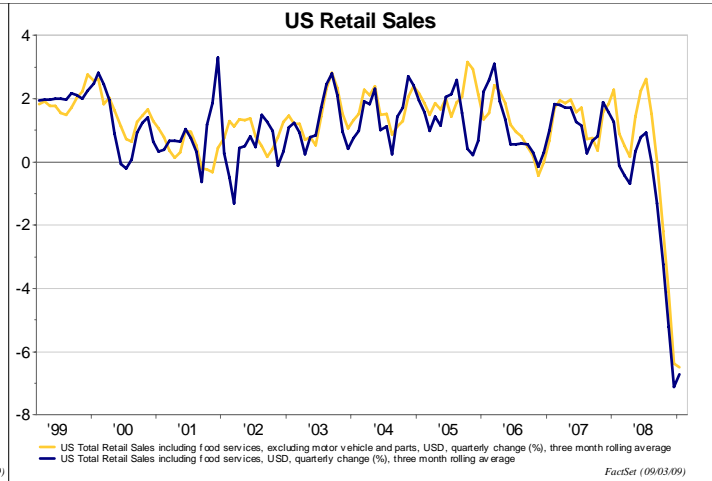
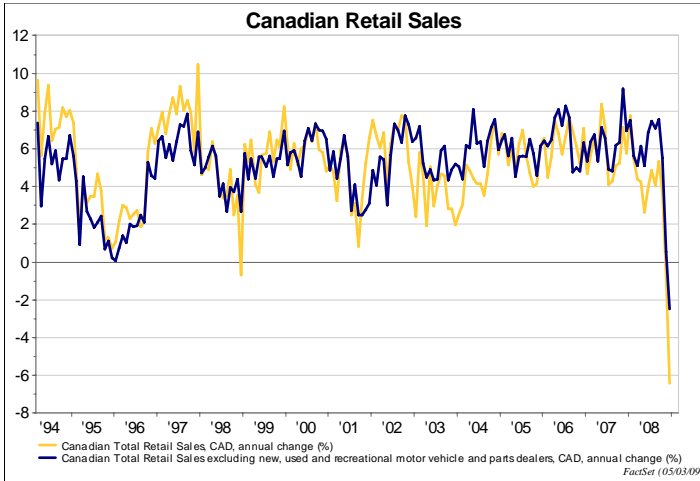
Total returns in negative territory
- Judging by Real Capital Analytics data, average cap rates have adjusted relatively quickly, moving out by 0.66% since the property market peaked in mid-2007. All core property average cap rates have moved by just 0.42%. In our view this reflects the fact that the retail sector is particularly exposed to the current downturn with low levels of consumer spending expected even as falling fuel prices boost real incomes and the government launches its stimulus package.

Adjustment in retail sharper than most other sectors
- Supply side risks are also prevalent although not as high as at this point in previous downturns and far lower than in the 1980s. Based on forecasts undertaken at the end of the third quarter, Reis expects around 85m sq ft of retail space to be added to the market over the next four years.

Supply side risks prevalent.
- In Canada, retail trade activity fell during 2008, reflecting the economic downturn. Retail sales declined by 2.4% in November, with much of this decline due to falling gasoline prices. Retail volumes were down only 0.6%. Heavy discounting is increasingly prevalent in Canadian stores and retailers' expansion plans are being put on ice.

Retail activity falling
- According to the ICREIM/IPD property index, total returns to Canadian retail property are falling more quickly than all other sectors except industrial. Although sharply down, total returns in the third quarter remained at 11.5% with both income and capital growth remaining robust. After recently experiencing tight supply conditions and rapid rental growth, a large development pipeline has built up. In mid-2008, CBRE reported that there is 25 million sq ft of retail space under construction with another 10 million sq ft planned. Increased supply is now set to coincide with falling demand.

Total returns down sharply but still relatively high



Industrial markets

- In the US, Industrial production fell very quickly during 2008. According to Federal Reserve figures, December's industrial production was 7.8% lower than a year earlier having fallen during five of the last six months of the year. Manufacturing production was down much faster (-10.0%) than the mining sector (-1.0%). Within the manufacturing sector, output of business equipment (-6.4%) fell faster than consumer goods (-5.2%), but it was the production of construction supplies (-14.0%) that fell the most. Capacity utilisation fell steadily across the year. Employment in the goods producing sectors has also fallen at a rate of over 6%, according to BLS data. BEA figures show that imports at the end of November were down 10.6% on a year ago and export levels had fallen by 1.7%.

Industrial output and employment are shrinking
- In Canada, the exposure to the US downturn is impacting on the industrial sector. Industrial production fell by 6.9% over the year to the end of November 2008 according to Statcan. In the same month, manufacturing new orders were down 12.9% on an annualised basis. The PMI business survey shows that producers have become increasingly pessimistic about output levels since September 2008, reaching in January 2009 the lowest point since the index's inception in 2000.

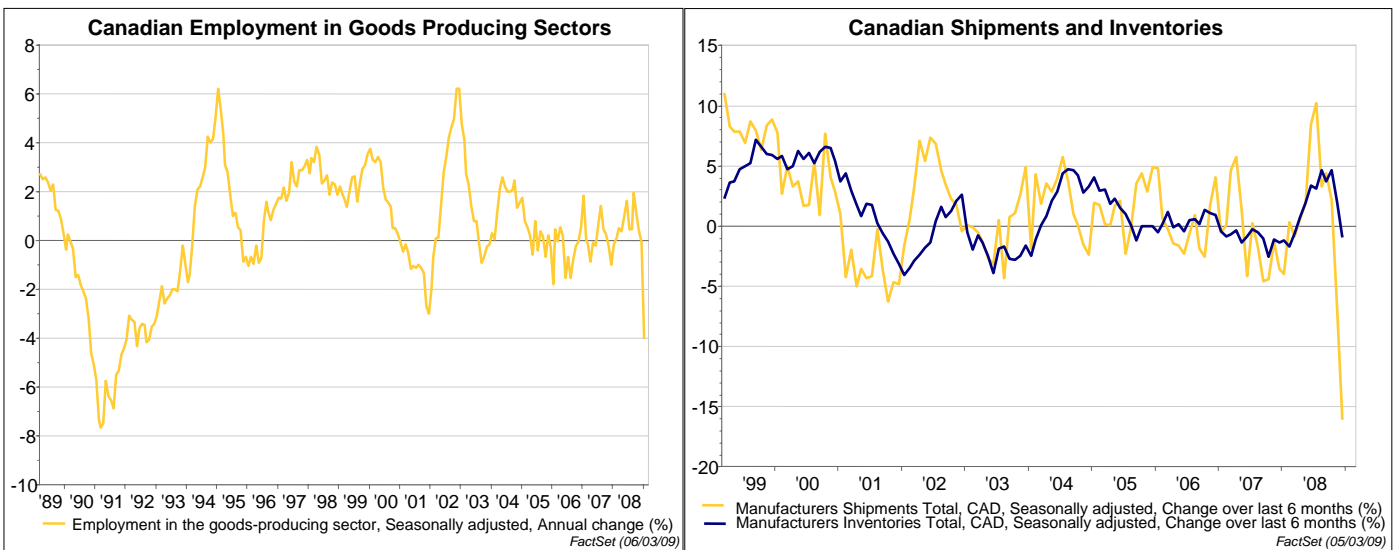
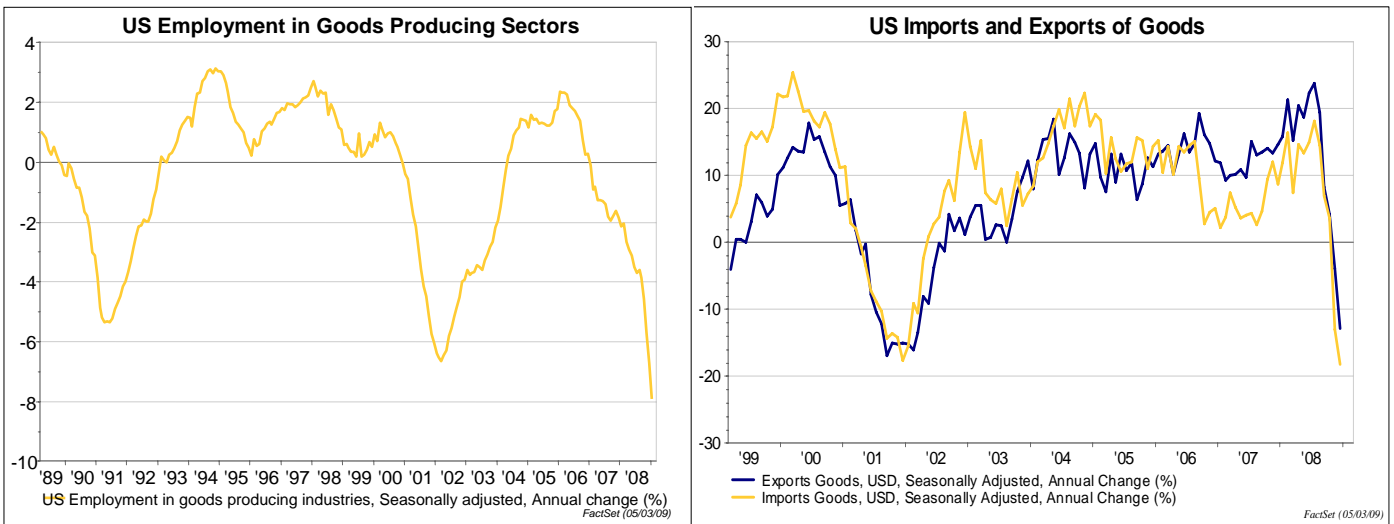
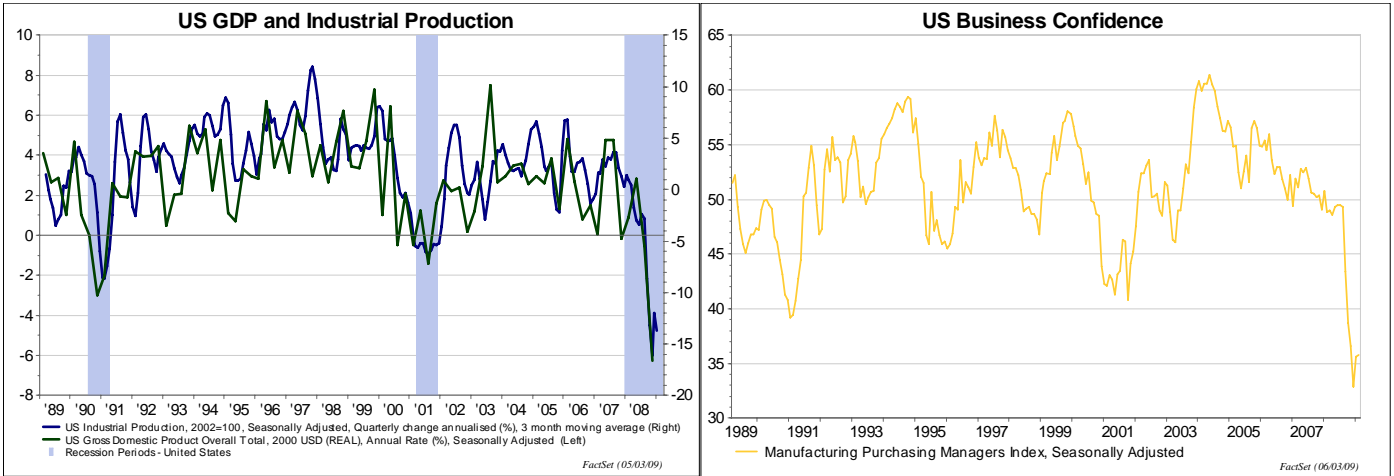
Sharp deterioration in Canadian manufacturing sector in late 2008
- PMA data shows that after rental growth of 6.1% in 2007, rents declined in the US by 1.6% in the first three quarters of 2008 when measured using an unweighted average of nine major centres. However, there is considerable local variation. In New York, rents fell by around 16% while in Philadelphia they grew by about 14%. In Canada, rents are stable but remain amongst the highest in North America in Calgary. Canadian rents were supported by robust demand in the first half of 2008. In the years ahead, we believe low availability will provide some cushioning. In the fourth quarter net absorption was negative, falling by 3.8m sq ft according to CBRE. This is the first quarterly fall since 2003. For the year as a whole, net absorption was positive at 13.2m sq ft, partly due to an exceptionally strong first quarter.

Rents heading downwards
- In the US supply side risks are subdued although far from negligible. Torto Wheaton Research suggest that around 650,000 sq ft of industrial space could be delivered over the next five years. In Canada, availability is low but rising.

Supply side risks low but not negligible
- The lowest industrial cap rates across the nine major centres monitored by PMA increased from 4.8% to 5.4% during 2008. However, an unweighted average across all nine centres suggests cap rates at the end of 2008 were more or less unchanged relative to 2007 levels. There is significant variation between centres. Cap rates moved out a full percentage point in New York but tightened in most centres.

Little change in cap rates
- US total returns fell quickly in the fourth quarter, down 8.0% after falling 1.5% in the third quarter according to NCREIF. For the year as a whole, total returns were down 11.1%. Slower international trade and falling consumer spending is hitting the manufacturing sector and industrial property will suffer. Cheaper imports due to the strengthening dollar would stimulate demand for warehouse space but overall the outlook for the sector is dim. In Canada, the ICREIM/IPD Canadian Annual Property Index shows that total returns at the end of the third quarter were 8.4%, significantly lower than all other property classes with capital growth easing quickly.

Flat total returns in US, slowing returns in Canada



Residential markets

- The US economy's boom and bust has been driven in large part by the housing market, which in turn has been propelled by debt, and in particular, sub-prime lending. US households' debt increased from around 60% of GDP in the early-1990s to nearly 100% by the second quarter of 2008, according to Federal Reserve figures. Household debt levels were supercharged by the development of securitisation and the associated leap in sub-prime lending. Mortgage-backed securities rose from \$492.6bn in 1996 to over \$3,071 billion in 2003, according to the Securities Industry and Financial Markets Association. By the second quarter of 2008, the total stock of mortgage backed securities totalled around \$6,500bn. Securitisation gave rise to the originate-and-distribute model which, when combined with light regulation, incentivised mortgage sellers to target loan quantity rather than loan quality. This encouraged a rapid increase in sub-prime lending. In 2003, sub-prime and Alt-A mortgages made up 8% of new mortgages. By 2004, this had increased to 18% and by 2006 it was 22%. By mid-2008, nearly 20% of all mortgages held by households were not prime. As interest rates started rising from mid-2004, house price growth moderated and lending conditions tightened. By mid-2007, some sub-prime borrowers began to default and foreclosures started, bursting the housing bubble.

Debt drove the housing bubble
- The Case-Shiller home price index fell 2.2% in November. Prices are now 18.2% lower than they were a year earlier. The largest declines have occurred in those areas where sub-prime lending was most pervasive. For example, from their peak home prices are down 42.6% in Phoenix, 41.2% in Las Vegas and 39.6% in Miami. Derivatives pricing in Radar Logic's Residential Price Index suggests prices in major cities will level off in 2010 at levels around 40% below the market peak.

Distressed sales pulling prices down
- House sales continued to fall in late-2008. According to the US Census Bureau Sales, sales fell a further 7.8% in 2008 following a 24.6% fall in 2007. Although constructors have curtailed development levels, completions levels in 2008 of just over one million units far exceeds new unit sales (331,000) and there is a large oversupply of housing.

House sales and prices have been falling since mid-2006
- The weakening economy is impacting on the fundamentals for landlords. According to the National Multi Housing Council, leasing conditions have now declined for six consecutive quarters as the worsening job market weakens tenant demand leading to lower rents.

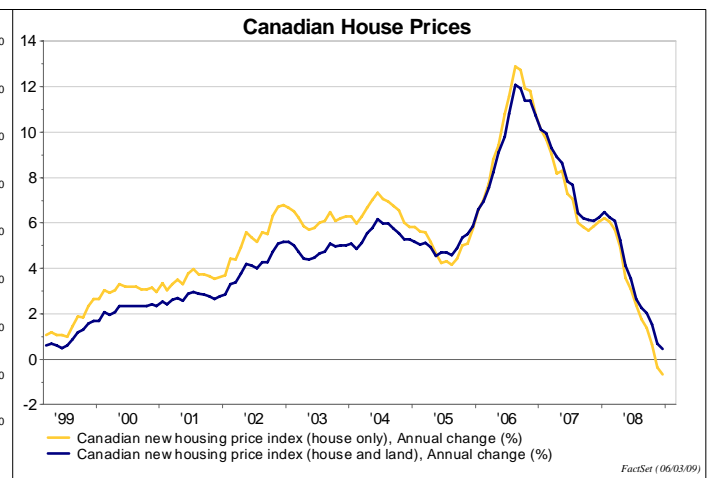
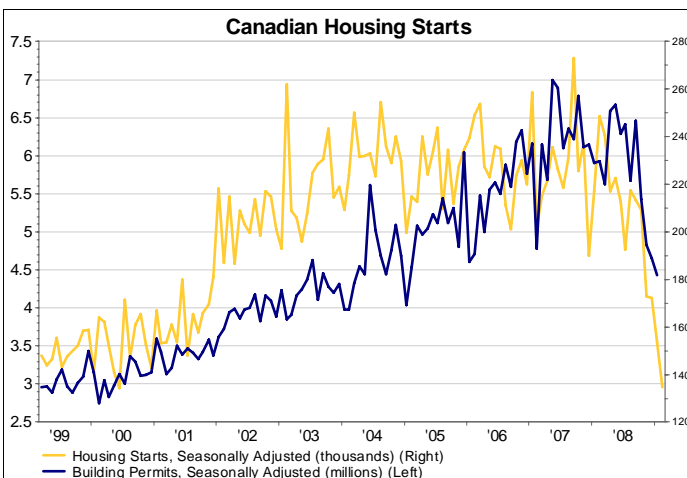
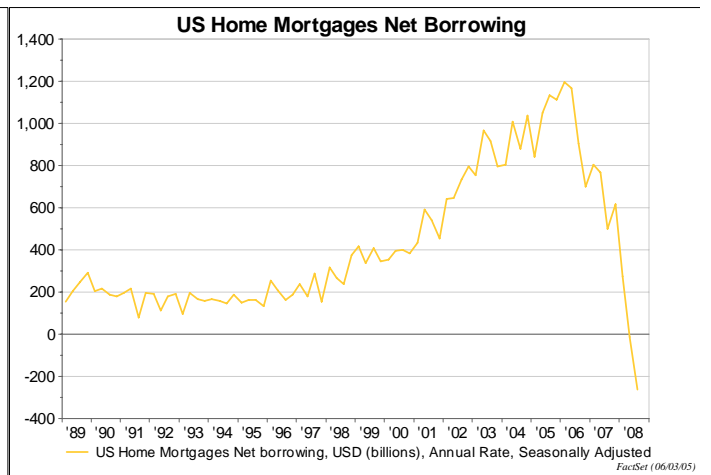
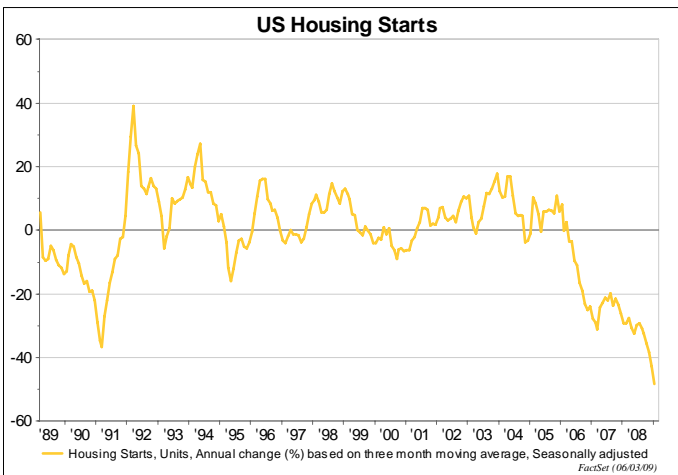
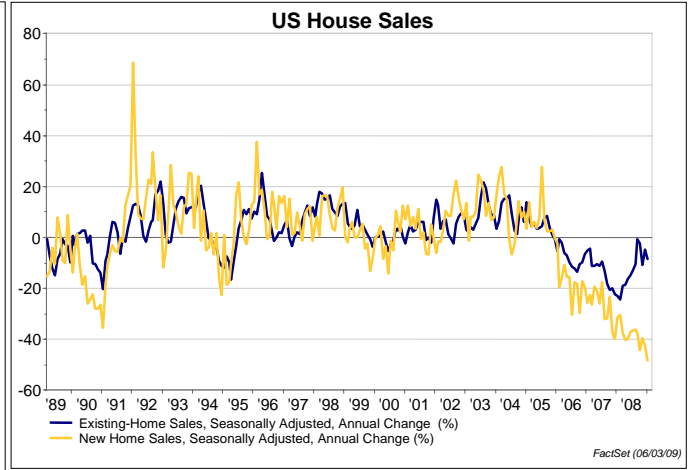
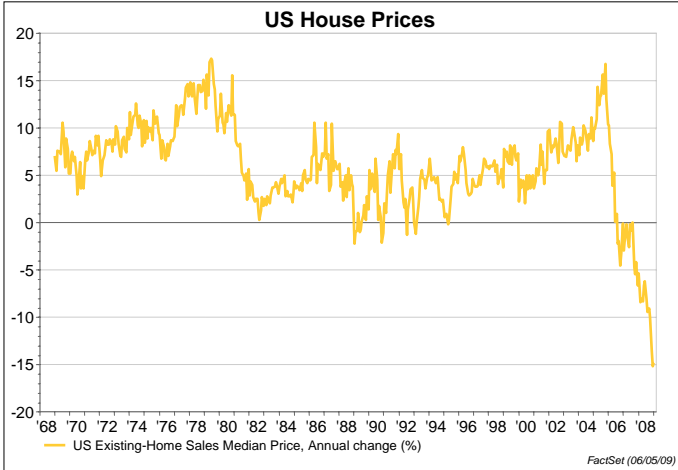
Rents are falling
- According to RCA, total investment in the US apartment sector was \$34.2 billion in the first eleven months of 2008. This represents a dramatic fall in investment volumes since 2007 when nearly \$100bn was traded. Trading levels in November were at highly abnormal lows. NCREIF data shows that in the fourth quarter, a fall in capital values of 9.50% dragged total returns down to -8.39% on the quarter. RCA data suggests that at the end of November 2008, cap rates on apartments were 6.3%. Since the commercial property market peaked, cap rates have moved out by 0.4%, a very slow rate of adjustment.

Investment in the apartment sector down markedly
- In Canada, new house price growth has been slowing since reaching a peak of 10.8% in 2006, according to the Canadian Real Estate Association (CREA). Prices increased by 6.1% in 2007 before falling by 11% in 2008. Unit sales of existing homes plunged by 22.2% per cent in the fourth quarter of 2008, as the downturn in activity accelerated. This fall in activity accounted for over half the fall in transactions since the peak in 2007. Housing starts are also down.

Canadian residential sales and prices are falling
- CBRE reported in mid 2008 that Canadian landlords were yet to be severely impacted on by the downturn. The vacancy rate was steady and modest rental increases were being achieved. However, the market is deteriorating at an increasing pace. Transaction levels were down markedly with just \$1.3 billion invested in the first half of 2008 compared to \$2.3 billion in the first six months of 2007.

Investment transactions down but space market indicators yet to be severely hit

² Wallison and Calomiris, "The Last Trillion Dollar Commitment", American Enterprise Institute for Public Policy Research, September 2008



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