2009 OUTLOOK

January 2009

Living with de-leveraging

KEY INVESTMENT THEMES FOR 2009

Favour corporate bonds over both government bonds and equities. For investors who wish to benefit from lower yields but also want to ease back into riskier assets, high-grade corporate bonds look attractively priced, after the forced sales of recent months. Though a major narrowing of spreads seems unlikely in a recession, the yields on some corporate bonds with strong cash flows merit serious attention.

Be long government bond duration. Yields don't appear to have bottomed yet. That's because of the unusual depth of this recession relative to others since 1945, deflationary pressures, and the possibility that central banks will buy government bonds once conventional forms of monetary policy have been exhausted.

Equity weakness in 2009 should be used as a chance to add to equity exposure. Amid continued poor earnings and macro data, equities are set to stay volatile and could retest their lows. The flipside of this near-term uncertainty is attractive valuations that could vanish early in a fundamental equity rally.

Investors focused on capital preservation should wait for evidence that the environment for risk assets has picked up. Those who are unwilling or unable to accept volatility may wish to wait for signs that the macro-economic environment is improving.

Within equities, favour large-cap developed markets. Even in a standard economic cycle, it would be too early to expect high-beta trades such as emerging markets, high-yield corporate bonds and small caps to outperform. One in which de-leveraging is a defining feature is likely to be particularly tough for small caps.

Creditworthiness should be a key driver of relative returns from equity markets. With global recession conditions persisting in 2009 and de-leveraging a major force, the currencies, capital markets and economies of countries where external financing needs are set to rise are likely to remain under pressure.

Commodities are likely to perform poorly, as their recent bubble continues to deflate.

Bricks and mortar commercial property is likely to come under further pressure, and REITs, despite looking good value, are set to suffer from continued de-leveraging, limiting their upside.

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1. Macro-economic outlook - bad but how bad?

- US growth is not expected to turn positive until the third quarter of 2009 at the earliest, and the risks to this view remain to the downside. Other developed countries are likely to lag this timescale by three to six months.

- The path of growth will be determined by the rate of increase in household savings – the real economy equivalent of the de-leveraging seen in financial markets. The downside risk to growth is that this rises much faster than currently expected and may also limit trend growth in the medium term.

- A deeper-than-average recession and prolonged period of sub-trend growth are set to exaggerate deflation fears during the first half of 2009.

The financial crisis that started in 2007 has become a real economy recession.

Over the past 12 months, the liquidity crisis in financial markets – which began in the opaque markets for commercial paper and asset-backed securities in the summer of 2007 – began to hit the real economy hard. The US, the eurozone, Japan and the UK all experienced negative economic growth during the second half of 2008. Emerging markets, some of which were touted as largely immune from the slowdown in developed economies, started seriously faltering towards the end of the year.

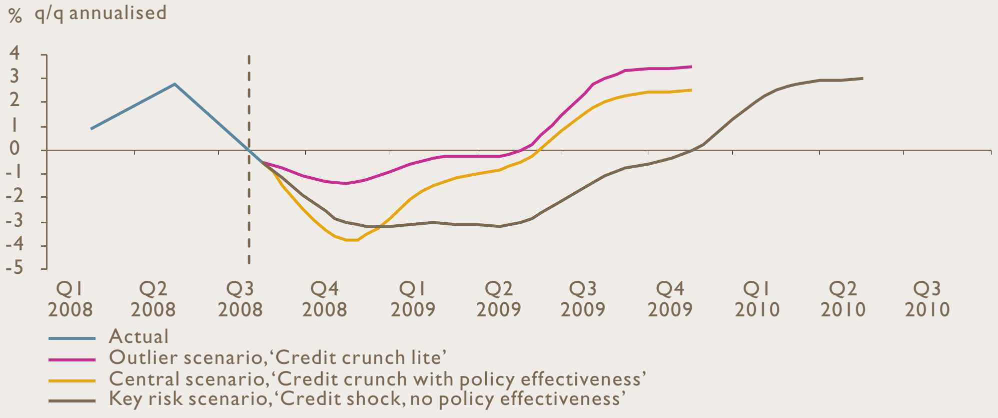
The main question facing investors in 2009 is how far this feed-through from financial markets will continue and, in particular, whether the asset price deflation seen during 2008 will become embedded in the real economy as wider price deflation. So we are at a stage of the cycle when the pattern and effectiveness of public policy is especially relevant to the economic and market outlook (see next section).

De-leveraging in financial markets means increased savings in the real economy.

In the meantime, the principle mechanism by which the financial dislocation of recent weeks will affect the real economy is through an involuntary rise in the household net savings rate (i.e., gross savings minus borrowing). Our model of the US savings rate, using the net change in household wealth and interest rates, points to an increase in net savings during 2009 and is usually a very good fit. However, at times of financial stress, such as the mid-1970s and early 1990s, the rise in the savings rate generally overshoots the model significantly. The reason is that, as well as reduced demand for credit, households also experience restrictions on the volume of credit – less credit is available to them.

The success of policy will be critical in counteracting tighter credit conditions.

US GDP growth – our central and two risk scenarios



Source: Coutts

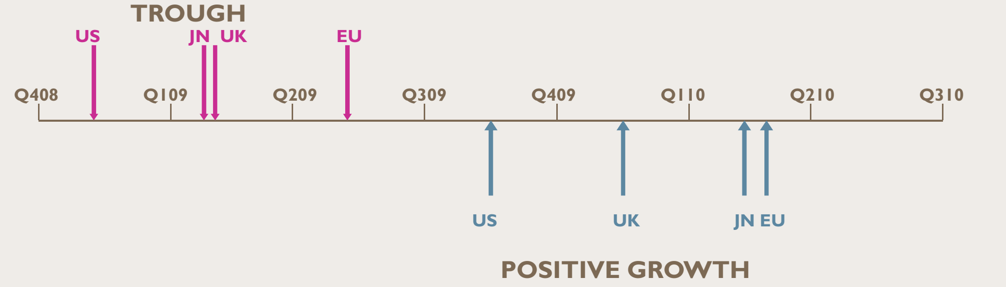
The yellow line in the first chart shows our central scenario for US GDP growth, assuming that credit is constrained but that monetary and fiscal policy ultimately proves successful. The pink line shows our 'outlier' scenario, where households face no new credit constraints. The brown line is the key risk scenario and is the outcome of a vector auto regression (VAR) model which assumes that the only driver of GDP growth is credit constraints (i.e., policy is completely ineffective).

This critical dynamic of increasing household savings rates is not unique to the US; indeed, it can be seen in most developed economies. Those that had previously enjoyed growth funded by a rapid expansion of credit – such as Spain and Ireland or, to a lesser extent, the US and the UK – are especially directly exposed, but tighter credit conditions and higher unemployment will raise savings rates everywhere.

The recession phase should continue during 2009…

In our central scenario, growth in most developed economies will remain negative until mid-2009 and below the trend rate until the end of the year. In terms of gauging the likely lags between economies, we would expect Europe and Japan to be around six months behind the US, with the UK somewhere in between.

Forecast recession timeline by region



Source: Coutts

…with a deeper-than-average recession affecting the usual pattern of asset performance.

In this phase of the cycle, equities begin to outperform bonds during the later stages, as the economy heads into recovery. We also find that traditionally high-beta trades, such as emerging market equities or high-yield bonds, perform best during the recovery phase of the cycle. The precise nature of the current financial crisis will nuance these outcomes – no two economic cycles are identical – but this broad pattern should remain intact.

The broad-brush read through from our economic forecast to asset allocation is therefore one in which long-term investors should begin to add defensive equity and high-grade credit risk but steer clear of higher-risk assets throughout 2009. Because of the unusual depth of the recession relative to others since 1945 and associated deflationary pressure, government bonds should remain an attractive alternative to risk assets for longer than during a normal recession.

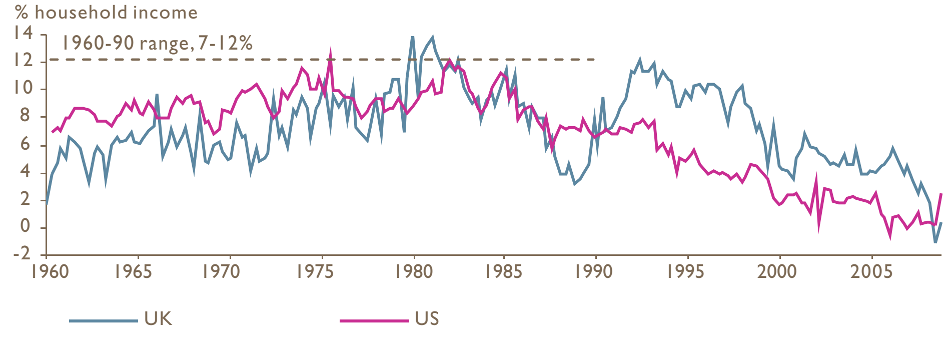
THE HOUSEHOLD NET SAVINGS RATE – THE MACRO-ECONOMIC ELEPHANT IN THE ROOM

Increased unemployment and tighter credit conditions are likely to drive a rise in the household net savings ratio in most economies around the world. Within this global trend, countries that have seen especially steep declines in saving over recent years are most exposed. The UK and the US are the two most prominent examples of this. The path of the recession, recovery and future trend growth will depend on how far and how fast this running down of the savings rate is reversed.

Our central scenario assumes that the pace of increase in developed countries' savings rates begins to slow during the second half of 2009 as lending conditions loosen in response to various policies implemented to repair banks' balance sheets and reopen credit markets. Our key risk scenario quantifies the danger that these policies do not work.

An 'inconvenient truth' is that the savings rates in the US and the UK are at historically low levels. One possible outcome of the current crisis in credit markets is that the mechanism which enabled this decline – notably the mortgage securitisation market – will not return to peak volume levels for many years, if ever. Consequently, although the rate of increase in savings may slow later in 2009, thus enabling a return to positive growth, it may continue on an upward trend over a period of many years or even decades.

UK and US household net savings rate, 1960-2008



Source: Datastream

In that case, the current financial crisis would be more a turning point than a typical recession from which a full, 'back to normal' recovery is made. As a guide to the possible impact on the US economy, a return to the average household net savings rate seen during 1960-90, taking as long as the two-decade decline to around zero, would reduce trend growth by around 0.5% a year. The effect would be felt elsewhere, as countries – such as China – that rely on imports to the US were directly affected. The history of the past two decades, when investors have been persistently surprised by the resilience of the US, would be reversed, with investors potentially overestimating the strength of the US economy. The effect need not be dramatic to have a draining quality on investors' confidence.

The table below shows forecast GDP growth over the coming years and our estimate of trend growth for the next decade by region. The last full economic cycle during which there was no persistent run-down in developed economy savings rates was 1982-93, so average annual growth during this period and the following 13 years of declining net household savings is also shown to facilitate comparison.

Growth (GDP)	2007	2008(F)	2009(F)	2010(F)	Average	Average	Trend Growth
					82-92	93-06	Estimate 2009-18
US	2.0	1.3	-1.2	2.5	3.5	3.1	3.0
China	11.9	9.2	8.0	9.0	10.2	10.0	9.0
UK	3.0	0.7	-2.0	1.0	2.5	3.0	2.1
Eurozone	2.6	0.9	-1.6	0.8	2.7	2.0	1.8
Japan	2.1	0.2	-2.5	1.7	3.8	1.2	1.0
ASEAN 5	6.3	5.5	4.9	5.8	5.6	4.7	4.2

Source: Coutts, Datastream

2. Policy reaction - budgeting for growth

- Policy-makers are pulling out all the stops. They are deploying emergency monetary and fiscal policy, with interest rates close to zero, a huge expansion of government deficit spending and additional policy measures, such as quantitative easing.

- A wide range of monetary and fiscal policy measures are needed to deal with the inter-linked problems of a banking crisis, liquidity crisis and associated recession.

- The policy response is anti-deflationary, not inflationary. We expect policy measures to boost nominal GDP, but the existence of spare capacity, as illustrated by rising unemployment and falling commodity prices, means that the result will be to support output rather than bid up prices.

A longer-than-average recession means infrastructure spending has a role to play.

The first policy reaction to a downturn is to cut interest rates. With monetary policy now approaching emergency levels as rates near zero, the emphasis moves to measures to stimulate demand directly, such as fiscal policy or even unconventional monetary policy. This bypasses the problems in the banking industry and the transmission of monetary policy and thus forestalls the deterioration into a debt-deflation cycle.

A fiscal boost to the economy is a key part of the policy response to the current crisis. A combination of measures is required to address the inter-linked problems of the banking crisis, the liquidity crunch and the associated recession, so bank bail-outs, monetary policy and fiscal policy will all feature. Just as with monetary policy, the US administration and, increasingly, governments worldwide have grasped the need for emergency fiscal policy measures to tackle the crisis.

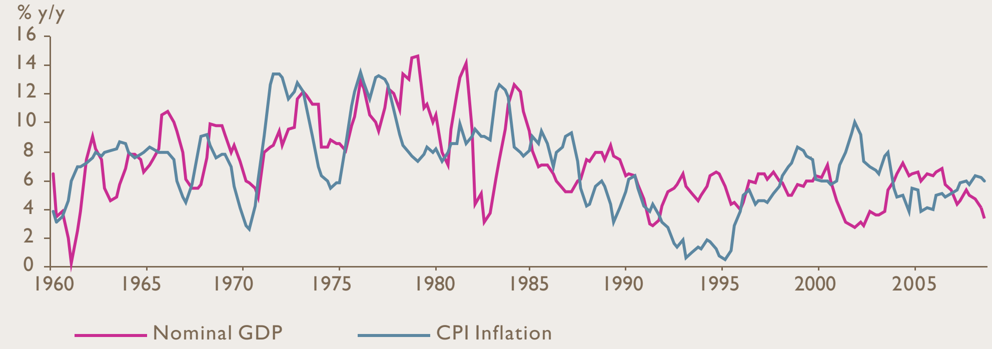
We expect a series of initiatives from the newly elected Congress and president Obama. The scale of the fiscal boost is likely to be huge, conceivably more than $800 billion, though it may be spread over a series of bills and extend into 2010.

The US has greater need for a fiscal stimulus package, because its automatic stabilisers are smaller.

The US fiscal boost appears large because federal spending does not have the same scale of automatic stabilisers as in countries with higher social security spending. For example, the UK deficit will also rise by over 5% of GDP in 2009, even though less than £20 billion of new measures was announced in the Pre-Budget Report. Normally, capital projects are seen as unhelpful, not arriving until after the economy is growing strongly. Yet we forecast an exceptional, extended period of sub-trend growth, so infrastructure could form a key part of fiscal plans. We see the scale of the fiscal boost, in coordination with other measures, as driving economic growth from the second half of 2009. The implications of the funding of such large-scale fiscal stimulus on bond issuance and yields are addressed later, on page 7.

The scale of the measures to boost activity at a time of low interest rates and money supply growth has inevitably led to concerns over inflation. In the current circumstances, however, the measures should prove anti-deflationary, not inflationary. Inflation will result only if the measures work, so it would be a problem of success and also an issue for the future, taking effect in 2010 at the earliest. The measures forecast will indeed boost nominal GDP growth rates, but surplus capacity across the global economy – as represented by falling commodity prices and rising unemployment – clearly indicates that this will translate into growth in activity rather than inflation, with pricing pressures remaining negative. The key factor is that the measures are merely offsetting part of the decline in activity and the huge destruction of wealth that has occurred over the past year.

Overall growth drives inflation, not public policy alone

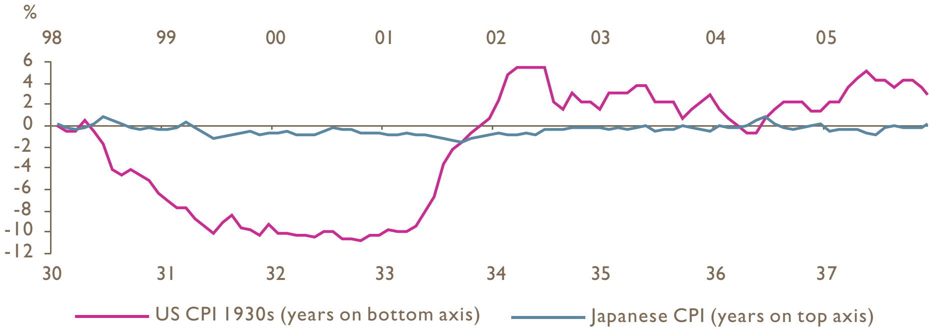


Source: Datastream

WHY DE-LEVERAGING AND DISINFLATION SHOULD NOT LEAD TO DEFLATION AND DEPRESSION

To work effectively, monetary policy requires positive inflation. Otherwise, falling prices can mean that the value of savings or the cost of debt continues to rise in real terms, even with interest rates at zero. This debt-deflation spiral was a key characteristic of the Great Depression and, in a less severe but more pervasive form, the 'lost decade' of the Japanese economy.

Debt-deflation in the US and Japan



Source: Bloomberg, BEA

To tackle it, the policy-makers' playbook reads as follows. First, cut interest rates to around zero as fast as possible, to give the maximum opportunity for monetary policy to work. Next, inject demand into the economy through fiscal policy (government deficit spending) and also quantitative monetary policy (printing money) to support output and so stop overcapacity forcing down prices. Finally, be sure not to confuse falling headline prices (a temporary phenomenon caused by declining commodity prices) with deflation (falling wages).

In other words, deflation is a necessary but not a sufficient condition for a debtdeflation spiral. Failing to recognise this difference could be a critical factor in any potential market overreaction to negative inflation numbers during 2009.

3. Bonds - bubbling?

- Lower policy rates and quantitative easing will probably show up first in lower bond yields.
- Deflation fears will provide a rationale for lower yields, and investors may overreact.
- This provides a positive risk-free rate backdrop for relatively attractively priced high-grade credit.

Fiscal policy easing will be paid for by record government bond issuance.

A fiscal boost to the economy is a key part of the policy response to the current crisis. Yet fiscal stimulus needs to be paid for, and the flip side of government largesse is dramatically higher issuance of bonds.

Estimates of government issuance for 2009 depend on expectations of the depth and length of the recession and the size of additional stimulus packages. In the US, however, it is reasonable to expect total Treasury issuance of around $1.3 trillion. This scale of issuance causes investors understandable concern that yields may rise as the government bond market becomes saturated with new bonds. For some countries, especially those with a high external financing requirement (see page 10), this will certainly be the case. Yet the supply and demand dynamics for developed economy bonds during 2009 look, perhaps counter-intuitively, rather attractive.

Could bonds be the next bubble?

Any bubble requires three elements: a fundamental long-term rationale (the 'this time it's different' part); a perception that the balance of risks has changed (such as a decline in volatility); and, most importantly, cheap money by the bucketful.

That we will see the last of these conditions in most developed economies during 2009 is something we can safely take for granted. So the more pertinent question is where this cheap money will show up. In this regard, the fact that government bonds also fulfil the first two of these criteria makes them a prime candidate.

Deflation provides a rationale for holding bonds…

…and investors may overreact.

The rapid decline in energy prices during the second half of 2008 is enough in itself to produce headline CPI deflation in most developed economies. An unusually deep recession would add to dis-inflationary forces in the real economy. Investors who appeared to forget that inflation in early 2008 was due to the lagged effect of above trend growth in 2007 may well make the same mistake on the way down and assume that the price declines that continue once growth has troughed are an indication of a long-term deflation problem – 'this time it's different'.

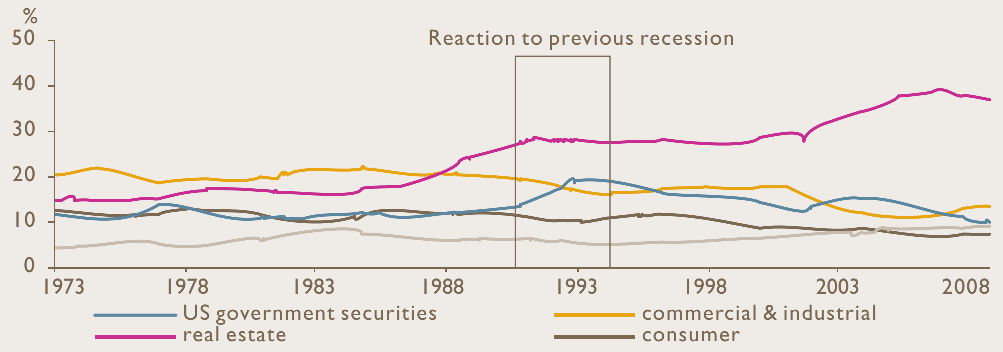
A 'Bernanke put' has limited the downside.

As well as this fundamental underpinning, Federal Reserve (Fed) Chairman Ben Bernanke has altered the rules of the game by suggesting that the Fed could directly buy Treasuries in 2009. This suggests that there is a 'Bernanke put' protecting bond investors from higher yields, just as the 'Greenspan put' of the last era was seen as protecting investors from a sharp fall in equity prices.

With credit conditions tightening at a rapid clip and demand for credit also likely to suffer as growth slows, commercial banks will have large amounts of cash to plough into government bonds. During the early-1990s recession, the proportion of their balance sheets that banks held in Treasuries increased by 10% (see chart on next page). The current value of US commercial bank assets is $12 trillion, and 10% of that is $1.2 trillion. So bank buyers are likely to consume something like 100% of all net Treasury issuance during 2009, leaving non-bank buyers to fight over any remainder.

Banks will be large buyers of government bonds, especially in the US and the UK.

US commercial bank assets as % of total assets



Source: Federal Reserve

At low yield levels, small changes in yield produce large price moves.

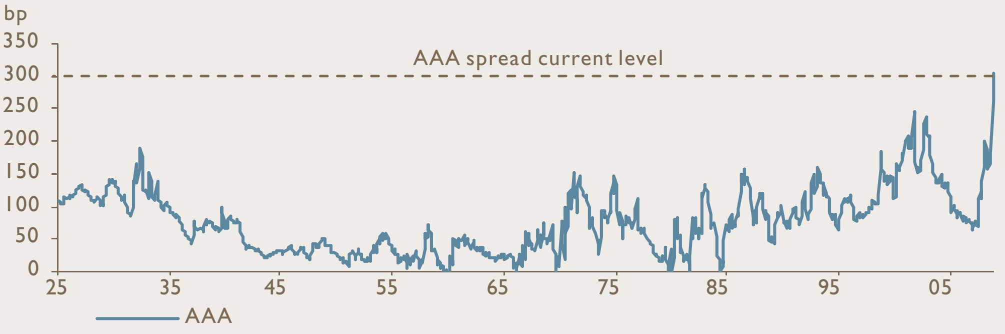
Nor is this trend likely to be confined to the US. In the UK, the Financial Services Authority is urging banks to hold a greater proportion of assets as government bonds. It suggests 6-10% of total assets, versus the current 5%. Reaching the mid-point of this range (8%) would involve banks buying around £220 billion of UK government debt – more than absorbing net gilt issuance during FY 2009-10, which is likely to be around £100 billion.

Hence, we see government bonds as a safe place to hide for short-term investors who cannot stand the near-term volatility of equity markets, and there remains the potential for significant capital return. For example, if Treasury yields were to reach 1% by mid-2009, that would give a total return of around 16% over the period.

For investors who wish to benefit from lower yields but also want to dip a toe back into riskier assets, high-grade corporate bonds are attractively priced, reflecting the forced sales of recent months. Although a dramatic narrowing of spreads seems unlikely during a recession, the yields currently offered by some corporate bonds with strong cash flows deserve serious attention.

A benign government bond backdrop and very attractive valuations make us positive on high-grade credit.

AAA spreads over Treasuries, 1925-2008



Source: Shiller, Federal Reserve

Legendary investor Benjamin Graham wrote that 'bonds should be bought on their ability to withstand depression'. That is probably truer today than at any time since it was written in 1934. Government bonds best fulfil this maxim, so we expect them to stay rich during 2009 and potentially get even richer. In addition, current valuations mean that moving carefully up the credit curve offers investors just the sort of attractive risk-return trade-off Benjamin Graham spent his life searching out.

4. Equities - valuations meet de-leveraging

- In an environment of extreme volatility, the decision to buy equities is highly dependent on the investment time horizon.

- Long-term investors should start building exposure to equities, to benefit from the risk premium discounted by supportive valuations.

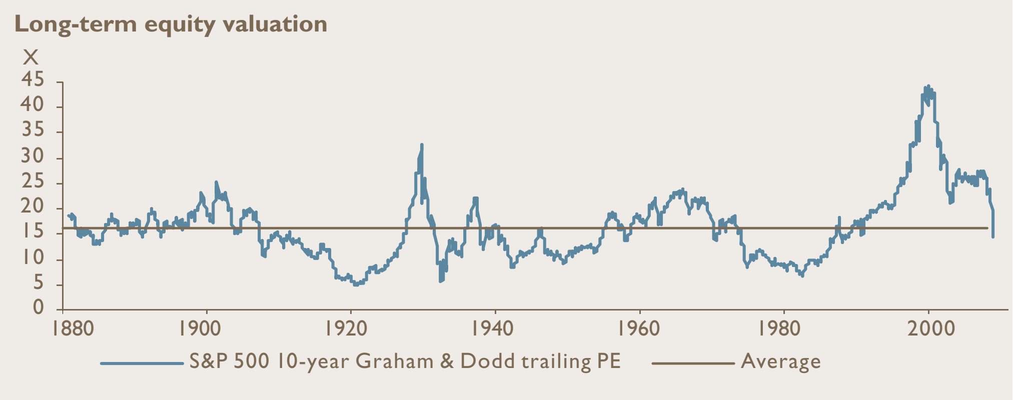
- Those with a low risk tolerance, who typically have a shorter investment horizon, should remain cautious about the risk of further de-leveraging in the coming months. Confirmation of market improvements is a prerequisite for entering stock markets, and countries with the lowest financing requirements should be favoured.

Companies' future earnings drive equity valuations...

The sharp fall in equity markets in 2008 led to significant improvements in valuations. According to our macro-economic scenario, profits for 2009 could be downgraded further. But buying into equities is a claim on long-term future profits, not just on next year's earnings. The rule of thumb is that the first three years of profits accounts for 10% of the value of a stock, the next five years for 15%, and the remainder for 75%.

...which look quite attractive in the US over the long term...

The Graham & Dodd price-earnings (PE) ratio, which uses ten-year average trailing earnings, is a good way to capture valuations for long-term equity investors. The S&P 500, with a reading of 14.4 times, recently moved below its 130-year average for the first time since May 1989. Looking at performance since 1890, such valuations offer little guidance in either direction for equity performance in 2009. Yet, for investors with an investment horizon of three years or greater, current valuations should offer long-term support, as long as we don't expect government policy failures and economic collapse along the lines of the early 1930s (which could drive PEs down further).



Source: R. Shiller

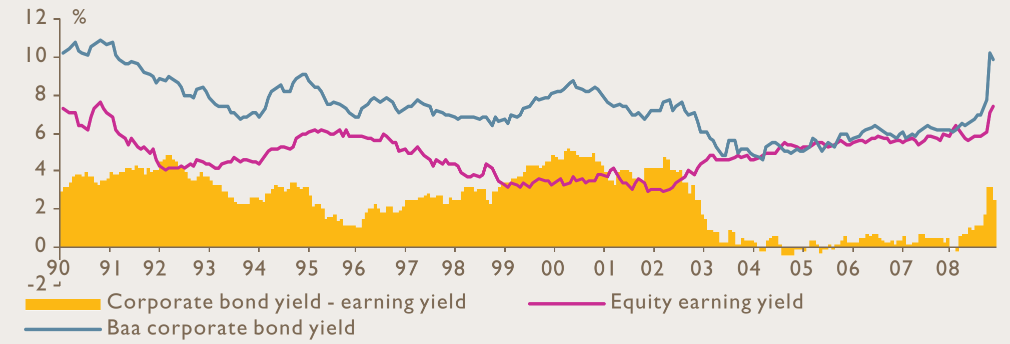
...and even more so in the UK.

Of course, the US isn't the only equity market in the world. Some other developed markets offer even better value. For instance, the UK market is trading on a Graham & Dodd PE of 12 times, thus offering greater valuation support. Emerging markets are trading on similar multiples (13.4 times), but we would argue that they should trade at a bigger discount, to compensate for the extra risk of investing in those markets.

The M&A and share buy-backs of recent years have faded...

In 2008, we saw the end of three years of de-equitisation, where companies and private equity buyers used cheap cash and debt to retire expensive equity financing. From 2005 to 2007, the yields on US BAA bonds were at the same level as the equity earnings yield. The de-rating of equities and re-rating of corporate debt offered a historic chance to make the switch. This process took two forms: mergers and acquisitions (M&A); and share buy-backs. Both are supportive for equity markets, as they represent extra demand for shares. Over that period, buy-backs for S&P 500 companies (at $1.32 trillion) surpassed capital expenditure ($1.28 trillion), R&D ($0.37 trillion) and common dividends ($0.60 trillion).

US bond and earning yields

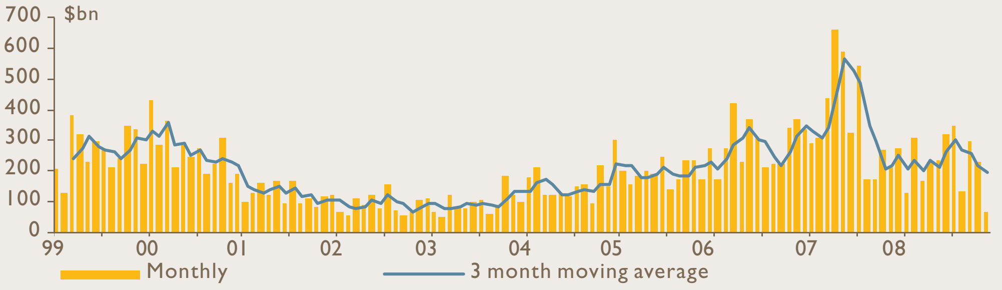


Source: Datastream

...removing one support from equity markets.

Since the middle of the year, however, corporate bond yields have widened sharply (from 6.5% to 10%), making the de-equitisation trade much less attractive, even though equities have de-rated further. Not surprisingly, volumes of M&A activity have plunged, to their lowest since 2003. M&A paid in stocks may still be an option for companies sensing an opportunity to buy weaker competitors at distressed prices, but acquisitions paid in cash will almost certainly disappear. Similarly, buy-back programmes have dried up recently. In the current environment where financing is scarce and expensive, we do not foresee this situation reversing any time soon, so equity markets are unlikely to benefit as much as recently from the support of M&A and buy-back activity in 2009.

Global M&A activity



Source: Bloomberg

FX volatility has risen amid global de-leveraging.

In markets dominated by de-leveraging, correlations tend towards unity as investors seek cash by liquidating their assets. However, foreign exchange (FX) markets are driven by where that money goes next. Are the sellers overseas investors withdrawing their cash or domestic owners paying off foreign currency borrowings? The FX markets have consistently been first to reveal the fault lines of globalisation (such as Iceland), as the US sub-prime collapse has reached out to pull the global economy into recession.

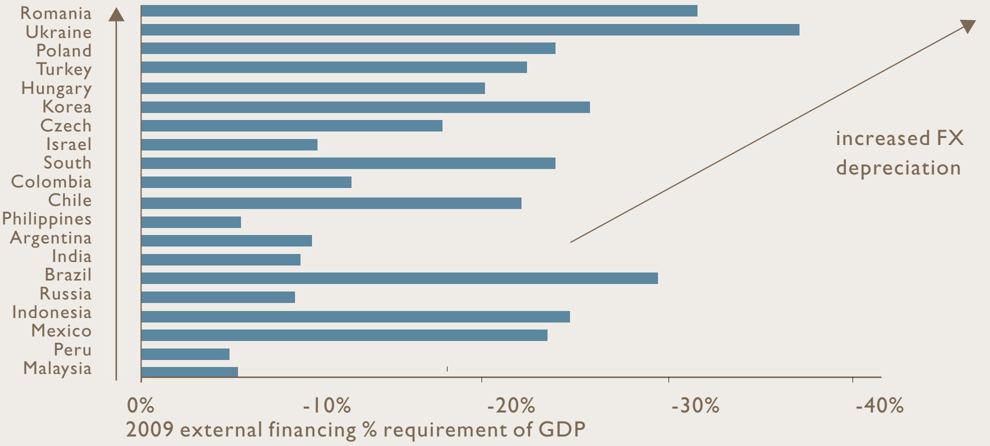
That is having a major impact on emerging markets...

For emerging markets, the correlation between short-term financing requirements and the performance of the currency is strong. It doubled after the bankruptcy of Lehman Brothers triggered further de-leveraging in financial markets. With global recessionary conditions persisting in 2009 and de-leveraging still a major force, the currencies, capital markets and economies of countries where external financing pressures are set to rise – such as Russia, Poland and Romania – will probably remain under pressure.

...and all markets in countries with large external financing needs.

But the importance of FX extends beyond emerging markets. The flow of international capital seems to have reversed the previous relationship whereby a falling currency and increasing competitiveness boosted the domestic equity market. Currency markets have become more dynamic: although European equities have traded in a 20% band against the US stock market over the past three years, the euro has risen 35% against the US dollar, and fallen almost all the way back, over the same period. Globalisation and the flow of international capital mean that FX should play an increased role in determining and rewarding the relative performance of local capital markets.

EM FX depreciation since Lehman's failure vs 2009 financing requirement



Source: Datastream

SEEKING VALIDATION: WHEN SHOULD RISK-AVERSE INVESTORS RE-ENTER EQUITIES?

Looking at the eight US recessions of the past 50 years, macro-economic indicators such as the ISM and unemployment data have provided useful guidance for market bottoms. Equity markets have tended to hit their troughs when the economic climate has reached very depressed levels, as now seems to be the case. Of course, no recession is identical to any other, but this one seems particularly abnormal. Macro-economic conditions are as bad as most investors have ever seen, but the usual triggers for a market trough don't seem to be working.

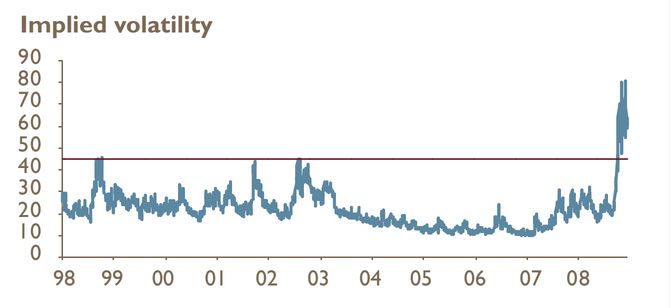
In such exceptional conditions, where markets are driven by fear, traditional fundamental triggers such as valuations and economic data offer little help for short-term market timing. Given the extreme volatility in the markets, it seems imprudent to try to anticipate rebounds. Instead, investors with a low risk tolerance should wait for indicators to suggest that we have returned to a more normal phase of the investment cycle where rational analysis works again. Admittedly, that means missing out on the first stage of the rebound, but it is sometimes better to wait for confirmation of an improvement, rather than trying to catch a falling knife. Below, we list three indicators which could signal such an improvement.

- Implied volatility: the VIX touched a 20-year high of 80.86 on 20 November. Over the past two decades, it averaged 19.6 and, even in the worst times of 2000-2003, never rose above 46. Hence, we would consider investor sentiment to be back to a normal level (though still very bearish) when the VIX falls below 45.

- November's drop in equity markets saw a flight to quality to government bonds (especially at the short end of the curve), as economic data deteriorated markedly, triggering a deflation scare. By early December, the US 2-year bond yield had fallen over 100 basis points (bps) since the start of October, to an all-time low of 0.85%. In the previous deflation scare in June 2003, it hit 1.07%. Hence, confirmation of an improvement would come when the 2-year bond yield moved back above 1.35% (retracing half its recent decline).

- De-leveraging has affected all risky assets, including corporate bonds. BAA spreads rose to 580 basis points (bps), their highest since the 1930s. The previous peak was reached in 2002, around 350 bps. Waiting for the current spread to return to this level may be too cautious, and the buy signal may arrive too late, but a level of 400 bps should indicate that the corporate bond market is starting to normalise.

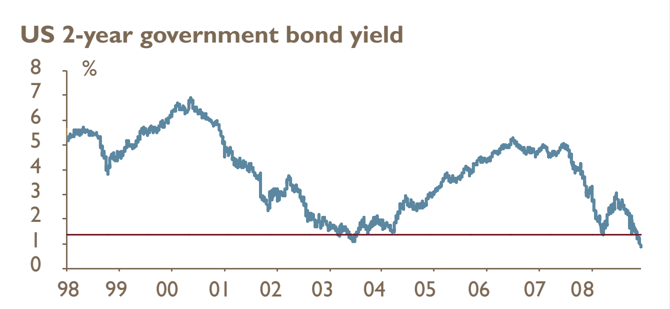
EQUITY MARKET RECOVERY CONFIRMATIONS FOR 2009



Source: Coutts, Datastream

1. VIX

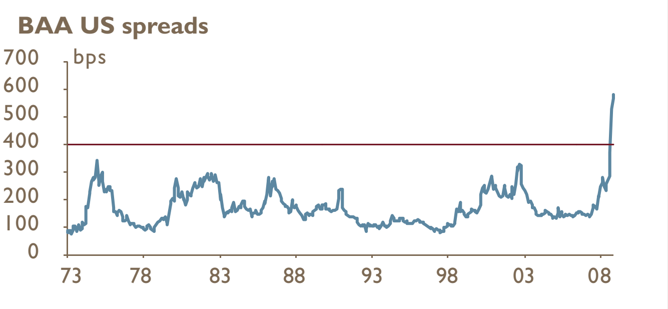
High volatility is a sign of disjointed, inefficient markets. A retreat to below 'normal' peak levels would be a good sign.



Source: Coutts, Datastream

2. TWO-YEAR YIELDS

A rising 2-year yield would indicate either declining deflation concerns or (related to this) an anticipated increase in nominal yields. Either of these would suggest deflation concerns had turned a corner.



Source: Coutts, Datastream

3. CREDIT SPREADS

Higher funding costs will be a drag on earnings growth in 2009, equity investors would be reassured by a return to normal credit market conditions and declining yields.

5. Commodities - that sagging feeling

- The commodity bubble of recent years continues to deflate.

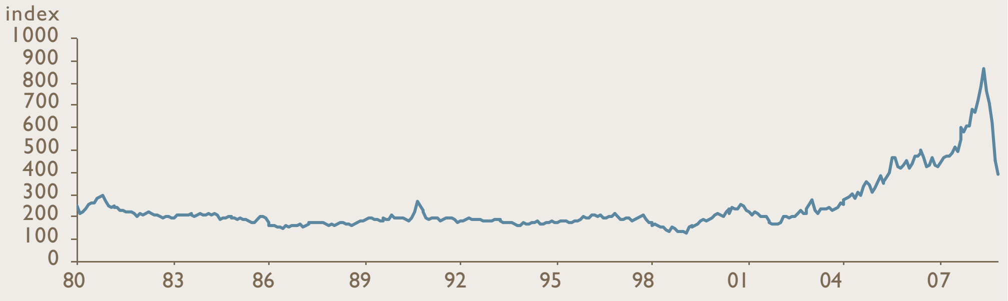
- Commodity returns tend to be negative in the recession phase of the cycle, and this recession is expected to be no exception.

- Even once the economy starts to grow again, the anaemic nature of that growth means that commodity performance is likely to be modest.

With the economy likely to remain in recession until the third quarter of 2009 at the earliest, and de-leveraging meaning that growth when it does return is likely to be weaker than we have been accustomed to in recent years, commodity returns are likely to be negative or, at best, flat in 2009. This will be particularly true of cyclical commodities, such as industrial metals and energy.

Agricultural commodities are better positioned, as demand is less sensitive to overall economic conditions. Double-digit commodity returns will not be seen again until growth is above trend and the economy is operating above potential – something that looks years rather than months away.

GSCI commodity prices – a bubble deflates



Source: Bloomberg

6. Commercial property - not out of the woods

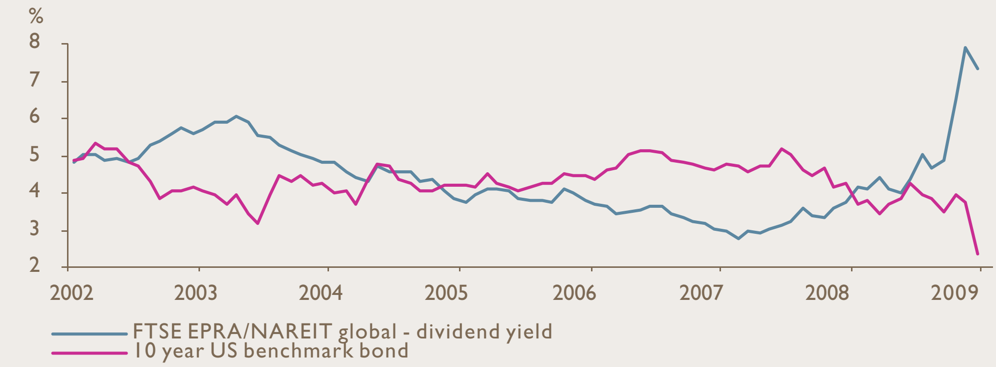
- Rents are set to fall, though the magnitude of the decline will depend on the extent of new capacity created during the preceding construction boom.

- Yields on commercial property have risen from the record lows reached on the back of plentiful cheap funding, driving down property values. This process has further to run, with prices set to fall beyond current levels.

- Investment strategies based on a return of leverage are unlikely to work well in 2009. That should limit the upside from REITs, despite the value they offer after their significant underperformance over the past year.

We expect that the property market will reach its bottom by the end of the year, as economic growth restarts. However, property is a late-cycle industry, so rental growth and asset price appreciation probably won't resume until the economy is growing strongly, which should not be before 2010.

Global REIT yields – not the bargain they appear



Source: Datastream

There is scope for a recovery in REITs ahead of this point, alongside the equity market. Commercial property yields – whether on direct property, REITs or bonds – have risen sharply as property prices have crashed. Yet these valuations are not as attractive as they appear relative to cash, the traditional benchmark for property investors.

The problem is that the commercial property market is based on debt. So higher yields also represent a higher cost of funding for most commercial property owners, which can erode their capital and increase the risk of foreclosure by banks or bondholders. As a result, we are only keen on selected commercial property securities, where leverage and other balance-sheet considerations can be taken into account.

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