July 2010

Asian Quarterly

Market Perspective

Executive Summary

- Asian economies continued their upward momentum in the second quarter. Nonetheless, the sovereign debt crisis in the eurozone area and questions about the sustainability of growth in China following recent policy measures may affect Asia's performance in the next six months.
- Notwithstanding the slight increase in the region's credit market risk in the quarter, the region's IPO market was strong, accounting for 56% of global activity.
- The region's REIT market returns were diminished by the weaker sentiment in the broader equity market in the second quarter. Japan's REIT market dropped by 7%, while the markets in Hong Kong, Singapore and Malaysia made slight gains.
- Rents of class-A office space in the region appear to have bottomed, as demand for space is on the rise. The market was bolstered by the improvement in business confidence.
- Asia's retail market is stable due to the strong economy. High occupancies and robust tenant demand have created a favorable environment for landlords that will persist in the near term.

Asia's economy, which has been driven by brisk exports, is widely perceived to have led the global economic recovery. China registered a nearly 50% year-over-year rise in exports in May, following a 30% increase in April. Domestic demand in China also flourished, as imports climbed nearly 50% year-over-year in both April and May. There appears to be a growing possibility that the Chinese government will implement a managed float of the yuan, which would bolster domestic production at the expense of imports. However, there are concerns about Asia's growth prospects caused by the debt crisis in Europe, coupled with questions China's ability to sustain its growth following recent policy measures.

Asian nations have signaled the start of tighter monetary policy in the region in recent months, as policymakers in some nations have raised rates. Australia raised rates twice and Malaysia once in the second quarter, and Malaysia, South Korea and Thailand all have raised rates in July. These actions signal concerns that the strong economic growth will prompt inflation to grow to unpalatable levels.

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REIT Markets

The overall market capitalization of Asian REITs (excluding Australia) increased 3.5%, to $65.4 billion, during the second quarter, while the average dividend yield rose 12 bps, to 6.19%. The rise in the market cap in U.S. dollar terms was mainly due to the appreciation of the Asian currencies against the dollar, despite the subdued performance of REIT prices in the quarter. Share prices of Asian REITs largely fell in line with the weakness of the broader equity markets in the region. The number of Asian REITs remained at 79 during the quarter. Two REITs merged in Japan while one new REIT was formed in Singapore. Meanwhile, two new REITs filed registrations for IPOs in Malaysia. Both firms – the Sunway REIT and CapitaMalls Malaysia Trust – focus on the retail sector. If successful, they will be the first REITs to be formed in Malaysia since 2007.

Market Capitalization and Dividend Yields of Asian REITs

	No. of REITs	Market Cap (US$ bil.)	Average Dividend Yield	Risk-free Rate*	Risk Premium (bps)
Japan	37	31.80	5.84%	1.09%	475
Singapore	22	21.75	6.66%	2.37%	429
Hong Kong	7	10.07	5.90%	2.29%	361
Malaysia	11	1.73	8.80%	3.96%	484
Korea	2	0.10	9.90%	4.44%	546
Total	**79**	**$65.45**	**6.19%**	**(weighted average based on market cap)**	

* Risk-free rate refers to long-term government bond yields

Various Stock Exchanges; CEIC; Pramerica Real Estate Investors Research (as of 2Q10)

Total Returns, REITs vs. Property Equities

	2Q10	1Q10	2009	2008	2007
REITs					
Hong Kong	3.2%	1.6%	67.3%	-28.9%	10.4%
Japan	-6.7%	8.6%	6.1%	-49.0%	-2.3%
Malaysia	0.4%*	7.8%*	30.7%	-14.8%	17.8%
Singapore	2.4%	-1.2%	82.2%	-56.1%	2.8%
Property					
Hong Kong	-6.2%	0.7%	73.2%	-53.9%	57.1%
Japan	-13.7%	5.7%	5.6%	-46.6%	-13.2%
Malaysia	-1.4%	2.9%	37.5%	-38.5%	41.3%
Singapore	-0.8%	-3.4%	85.9%	-57.3%	8.9%

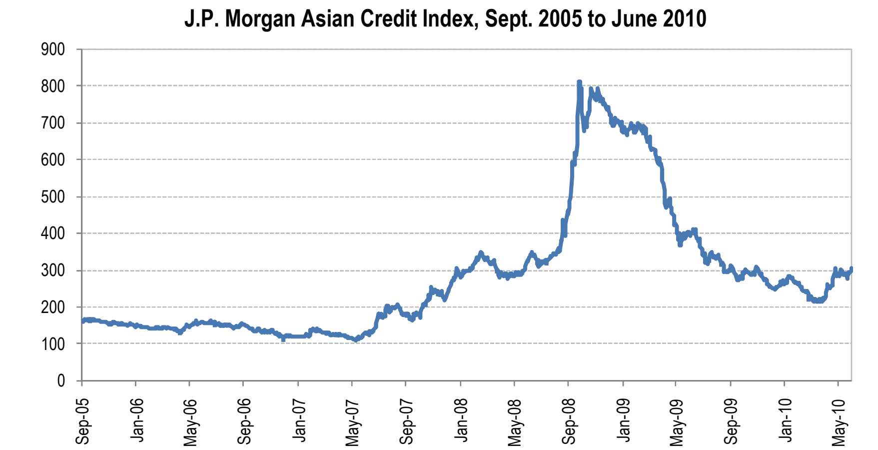
Standard & Poor's Index Services (local currency)
*Bloomberg

Capital Markets

Following a strong first quarter, Asia was not spared in the second quarter from the global volatility prompted by the financial crisis in Europe. Concerns about the possibility of a double-dip in the global economy jolted the region's equity markets, even though Asia's underlying fundamentals remained intact. Asia-Pacific stock markets fell by 10.7% in 2Q10, in contrast to the 5.3% gain in the first quarter, according to Standard & Poor's. Nevertheless, Asia garnered the lion's share of global IPOs in the second quarter. Companies in the region accounted for 159 IPOs encompassing US$25.7 billion of equity, or 56% of the US$46.1 billion of global activity in the second quarter.

Notwithstanding the region's stable economic environment, credit spreads rose in Asia during the second quarter as a symptom of the crisis in Europe. The J.P. Morgan Asian Credit Index (JACI) climbed 75 bps, to roughly 300 bps, during the quarter ending June 30. Not surprisingly, no CMBS was issued in Asia during the quarter, according to Commercial Mortgage Alert.

Credit Spreads Rose in Asia in the Second Quarter



J.P. Morgan

Sub-regional Markets

Japan: Triggered by the robust import demand for Japanese goods in emerging economies, including China, business sentiment among large manufacturers improved unexpectedly in June, according to the latest *tankan* survey by the Bank of Japan (BOJ). The rising confidence has prompted Japanese manufacturers to increase capital spending. The labor market also shows signs of improvement, as the jobless rate dropped 20 bps in May, to 5.2%, according to CEIC data. Corporate bankruptcy cases fell in the first half, a sign that the corporate sector is stabilizing. The sustainability of the economic growth in the longer term continues to be a challenge, as deflation risk remains a stumbling block. The appreciation of the Japanese yen is another potential risk that could impede the growth of exports.

According to brokerage firm Miki Shoji, Tokyo's office vacancy increased to a record 9.1% at the end of June, up from 8.8% in March. Vacancies of newly-constructed buildings (those less than 12 months old) rose to 40.6% in June, from 30.6% a quarter ago. For all other buildings, the average vacancy rose to 8.7% at the end of June, up from 8.3% in March, according to Miki Shoji. Class-A effective rents declined by 2.8% in the second quarter, after falling 5.1% in the first quarter, according to Jones Lang LaSalle (JLL). Vacancy levels are likely to remain at relatively high levels, which will force landlords to reduce rates and/or offer more attractive leasing incentives to fill space.

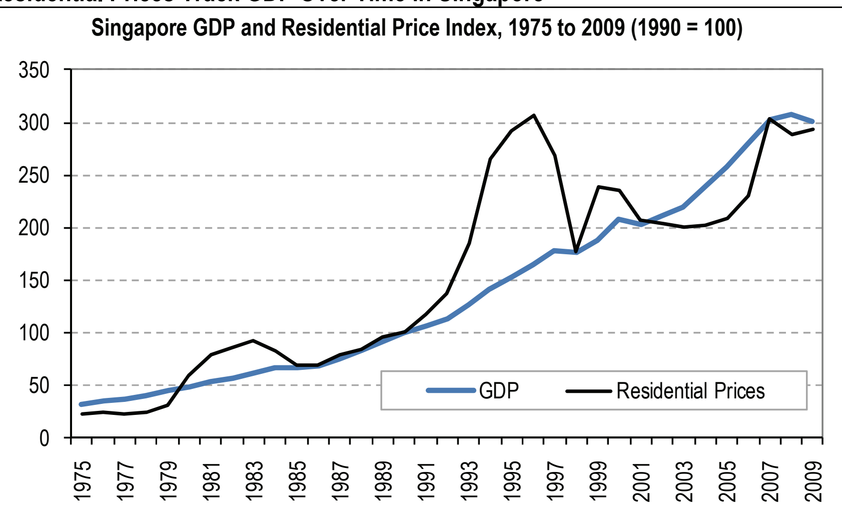
Sales activity of investment-grade retail assets in Japan totaled 209 billion yen (US$3.3 billion) in the first half, up from 45 billion yen (US$519 million), according to DTZ Rockwood. Demand is strong for core properties in select retail precincts such as Ginza and Omotesando. The initial yields for acquisitions in Ginza range between 4.5% and 5.2%, down from the 4.7% to 5.2% range in the first quarter, according to CB Richard Ellis Research Institute K.K. Yield-driven investors must look to the suburbs for retail properties.

Asia Tigers: Hong Kong's unemployment rate rose slightly to 4.6% in May, from 4.4% in April, according to the Census and Statistics Department. The increase was due to employers' caution on hiring in light of the volatile external environment. Nonetheless, we believe this should be temporary and not long term, as the SAR's economic outlook remains robust and job creation should surprise on the upside. The interest rate risk in Hong Kong is also relatively low, as rates typically follow the U.S. due to the fact that Hong Kong's currency is pegged to the U.S. dollar.

Fewer than 10,000 residential units were sold in Hong Kong in June, the lowest number in six months, according to the Land Registry. The gap between sellers and buyers widened, as sellers remained adamant about their asking prices, while potential buyers were concerned about overpaying in light of possible further government measures that might cool the residential market. Market sentiment was also dampened by the significant number of quick defaults by buyers of a new luxury residential project that set record prices just six months ago.

The Singapore government's residential price index gained 5.2% in the second quarter, reaching an all-time high, according to flash estimates. That is giving rise to fears that the market is in a bubble, but those concerns could be overblown. Historically, there is a strong underlying relationship between residential property prices and GDP growth. Despite significant price increases in the second half of 2009, however, residential prices are roughly in line with economic growth, which implies that the economic fundamentals are supportive of the current housing prices.

Residential Prices Track GDP Over Time in Singapore



CEIC, Pramerica Real Estate Investors Research Asia

Underpinned by strong demand for electronics, Singapore's economy grew by 19.3% in the second quarter, up from 16.9% in the first quarter. The robust performance prompted the government to revise up its 2010 GDP growth forecasts to 13-15%, although it also offered a cautionary outlook for the second half. In South Korea, the Bank of Korea raised the policy rate by 25 bps to 2.25% in early July – the first increase since August 2008 – citing growing inflationary pressure driven by domestic demand. The labor market is expected to improve, as the unemployment rate is forecast to decline from 3.8% at the end of June to 3.6% by year-end.

The class-A office market in the Asia Tiger countries saw improvements in market sentiment and fundamentals in the second quarter, as increased leasing activity was driven by corporate relocations and expansions. The flight-to-quality factor resulted in higher demand for class-A office space in central business districts (CBDs).

Effective rents for class-A office space in Hong Kong rose by 9.3% in 2Q10, up from the 7.5% growth in the previous quarter, according to JLL. Limited new supply in the Central submarket will support further rental growth, which should have a spillover effect on other submarkets.

After contracting for six consecutive quarters, effective rents for class-A office space in Singapore's Raffles Place market rose by 2.9% in the second quarter. Leasing activity is picking up, as the economic outlook improved and corporations finalized their relocation plans and upgraded to new buildings.

Effective rents for class-A office space in Seoul fell by 2.8% in the CBD, 1.1% in Gangnam and 0.2% in Yoido, according to JLL. The incoming new supply in the CBD has prompted landlords to be more realistic about their asking rents in the quarter. Prospects for rent increases in Gangnam appear to be slim. The limited availability of office space in the district may prompt tenants with expiring leases to consider moving to submarkets with more choices and competitive rents.

Retail sales in Hong Kong rose by nearly 20% year-over-year in May, higher than the 15.5% in April, according to the Census and Statistics Department. On the back of the positive sales performance, prime retail rents increased by 1.8% in the second quarter. In Singapore, both prime and suburban retail rents remained stable. Tourist arrivals rose by 30.3% in May, the sixth consecutive month of record visitor arrivals, based on the Singapore Tourism Board. The official opening of the Marina Bays Sands integrated resort in June will further enhance the republic's attraction as a tourist destination.

Australia: The Australian economy expanded by 0.5% in the first three months of the year, according to the Australian Bureau of Statistics (ABS). The moderate expansion is likely to sustain in the quarters ahead, given the high level of trade and expected increases in household income and demand. The Reserve Bank of Australia (RBA) raised the policy rate by 25 bps each in April and May but left it unchanged at 4.5% in June. RBA's view is that the inflation will be slightly more than 3% in the near term, due to the effects of increases in tobacco taxes and significant increases in utilities prices. The unemployment rate fell to 5.1% at the end of June, from 5.3% in March, according to the ABS.

Commercial property sales totaled A$3.7 billion (US$3.2 billion) in the second quarter, slightly higher than the A$3.4 billion (US$2.95 billion) recorded in the preceding quarter, according to DTZ. Investors continue to favor the office market, which accounted for 65% of all transactions. Notable deals included the A$1.1

billion purchase of the Westpac Office Trust by Mirvac, and the sale of the 43-story CBD office development at 163 Castlereagh Street in Sydney for A$800 million, which translates into an initial yield of 6.7%. Development firm Grocon sold a 50% stake in 163 Castlereagh to GPT and 25% interest to LaSalle Investment Management, while retaining a 25% stake. Foreign investments accounted for just 16% of total sales activity in the second quarter, down from 41% in the previous quarter.

China

China's GDP grew by 10.3% in the second quarter, down from 11.9% in the first quarter. The economic prospects in the second half are somewhat clouded by the higher-than-expected drop in the official Purchasing Managers Index in June, which is designed to gauge business conditions in the manufacturing sector. The decline suggests that the broader economy may grow at a slower pace going forward, as demand for goods start to level off. Inflation stood at about 3% in June, compared to 2.4% in March and 1.9% at end of last year. If the CPI upward pressure persists in the second half, the central bank may have to adopt a tighter monetary policy. On the currency front, the float of the Chinese yuan became more probable in the quarter when the central bank noted that a more flexible exchange rate will reduce China's trade imbalance and over-reliance on exports.

Vacancies of class-A office space in Beijing CBD and Shanghai (Pudong) trended down in the second quarter, due to healthy demand from the financial sector, technology firms and state-owned enterprises. Against this background, effective rents in the Beijing CBD rose by 1.2% in the second quarter, while rents increased by 5.5% in Shanghai (Pudong), according to JLL. Expansion of the financial services sector could bolster demand for office space in Beijing and Shanghai. China is expected to become the world's biggest IPO market this year, in both the number of new listings and equity raised, according to PricewaterhouseCoopers.

Residential prices in China showed signs of leveling off in the second quarter, according to the National Bureau of Statistics of China. Prices in the 70 largest cities rose by 12.8% in April, 12.4% in May and 11.4% in June. The leveling came in response to a string of government measures aimed at keeping housing prices in check. In April, the government announced that second-home buyers cannot mortgage the property by more than 50%, and the mortgage rate must be not less than 1.1 times over the best lending rate (5.94% for more than five years). Moreover, apartment developers must have government approval to accept deposits from home buyers, and must also disclose to the public information about all available apartments and prices in the area. The measures are aimed at reducing demand and slowing the upward pressure on prices going forward.

Closing Thoughts

Asia sustained its upturn in the second quarter due to brisk exports and domestic consumption. Labor markets in the region saw continued improvement, which boosted consumer confidence and spending. China's economy continued to register double-digit growth, but the pace moderated in light of recent policy measures targeting the property market. Even though those measures should help mitigate the risk of a property market bubble, they could also slow the momentum of the broader economy in the quarters ahead.

The economies of Asia Tigers (Hong Kong, South Korea and Singapore) remained robust in the quarter, thanks to their diversified economic structure, from manufacturing to financial and business services. Intra-regional trade, especially with China, has boosted demand for labor in these markets. Household income in these countries should grow as the economies advance. In Japan, the *tankan* survey in June showed that large Japanese manufacturers have become more confident for the fifth consecutive quarter. On the other hand, retail sales growth slowed in May in Japan, according to CEIC data, as the benefit from the government's fiscal stimulus began to fade. Japan's prospects will be driven by capital investments by corporations and consumers' willingness to spend more.

Consumer confidence in the region remains strong, supported by the improving labor market. Against this background, household income should increase this year, leading to more spending and an improved retail market. International retailers have targeted resources to cater to the increasingly affluent mainland Chinese, especially when they are traveling overseas.

Leasing demand in the region's office market in the second quarter was generally unaffected by the volatility of global financial markets. In fact, the region's growing workforces and the flight to quality have increased demand for class-A office buildings. The rise in leasing enquiries has encouraged landlords to be firmer about their rental expectations, especially for prospective new office buildings. The market turnaround will likely expedite a review of expansion plans by tenants, who must decide if it makes more sense to relocate or expand in existing buildings. In some markets, such as Hong Kong and Seoul, reduced new supply in key submarkets could lead to upside in rents.

Commitment rates for future office supply in Singapore are improving meaningfully, while class-A office rents have started to rise. In Beijing and Shanghai, class-A office rents increased in the quarter, supported by expansions of financial institutions and multi-national corporations.

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