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The patient has survived the crash but is still critically ill in intensive care. Recovery is expected to be frail and slow.

The billions upon billions of dollars, euros , pounds and so on that governments have spent so far seem to have averted the much feared financial meltdown and a ‘30s style depression. By general admission, the global economy is not in a freefall but the implications of the recession can by no means be shrugged off. Although Eastern Europe is now deeply in recession, there is talk in the US and Europe about a tentative recovery. Voices about ‘double dips’, and ‘Ws’ have not abated though: a relapse could be triggered by the rising unemployment, the end of the stimulus funds and the risk of rising interest rates (investors need be enticed with attractive interest rates, if they are to hold the huge supply of public debt raised).

Prime yields falling?

The reversal in psychology has resulted to a halt and in certain cases *reversal* in the yield decompression witnessed over the last few quarters. The latest reports indicate only a marginal rise of yields during the second quarter: CBRE for example points out that office yields in Europe have only risen by an average 5 bps. Notably, London and Paris have witnessed prime yield actually *decreasing*. Riskier markets are still fragile though: Kyiv is up 100bps to 15% and Moscow is up 50 bps to 12%. This is partially due to fundamentals (falling rents and the level of the correction that has already taken place) but the ‘flight to quality’ is certainly a critical factor. Investment volumes are still extremely low and primarily focussed on prime, core assets. As long as investors and bankers shun secondary and emerging markets, falling yields in the prime end hardly counts as a recovery. Besides, news on the rental front is still upsetting. Cushman & Wakefield report rents dropping in 26 out of the 32 European markets they track. By general consensus, property returns in Western Europe won’t buck the trend until well into 2010. And it seems Central & Eastern Europe will have to wait longer still.

Toxic

We all remember the trigger of the crisis – the subprime loans in the US Residential market. Ironically, there are increasing fears about the same thing happening again with *commercial* property. Alarming evidence is emerging around the world. Certain (not all) banks are being more verbal about their provisions: Commertzbank, RBS and Eurohypo are warning that losses will continue well into 2010. A bombshell dropped when Bafin, the German banking regulator recently warmed about the existence of €800 billion of toxic and non-core assets in the balance sheets of German banks. In the US, Wells Fargo and Morgan Stanley warned that potential losses on commercial property could be the ‘*next front of the financial crisis after the collapse of the housing market’*

Meanwhile, more evidence is surfacing that the situation is deteriorating. Real Capital Analytics estimates the volume of troubled assets globally at €145 bn, almost 30% up in 3 months. The Royal Institute of Chartered Surveyors (RICS) has recently reported that distressed commercial property sales are on the rise in *every* region in the world. The RICS further predicted that falling rents and rising corporate bankruptcies are likely to increase the incidence of distressed properties in the forthcoming quarters. As regards refinancing, in the UK, £47bn *per annum* will come up for refinancing every year until 2013. The number for the US is a mind-boggling $280 bn p.a. All this in a comatose CMBS market and a tarnished banking sector.

Crucially, banks are taking a pragmatic approach and tend not to fret too much about loan-to-value breaches (no one can accurately determine property values these days, they argue). They do, however get nasty when interest coverage ratios and more importantly, arrears in debt servicing are experienced. INREV (the European association of non-listed property vehicles), reports that over the last 12 months, a creeping 30% of funds / fund-of-funds were involved in a defaulting loan and a subsequent asset repossession. The banks have been composed and measured in their response. They proclaim that there won't be any fire sales this time. Indeed, some banks have been on top of their property collaterals, effecting changes in management, business plans and capital structures when necessary. For 'vultures', it's been drip-feeding rather than feast. The next few months however, will be more about corporate bankruptcies and tenant defaults. Unless banks ensure they are fully informed in *time* and keep the situation under control, things may well destabilise and get out of hand.

As we go into the 3rd quarter of the year, all eyes are on the big patient. Avoiding a relapse is absolutely essential, if the property market is to *start* recovering in 2010.

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