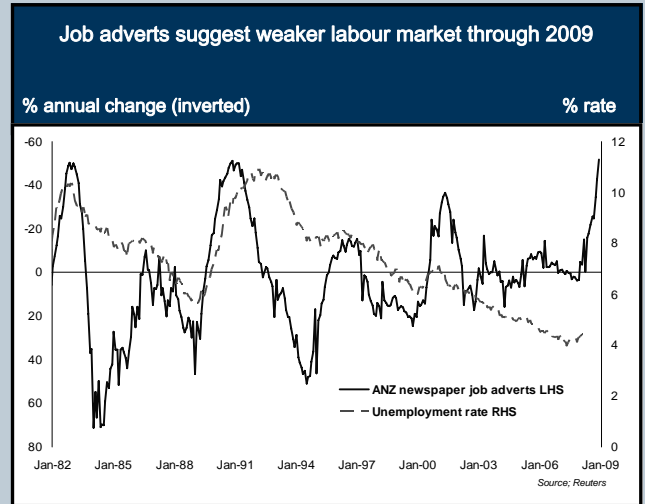


“ Rising unemployment will weigh on housing demand through 2009 ”

Australian house price declines to accelerate in 2009

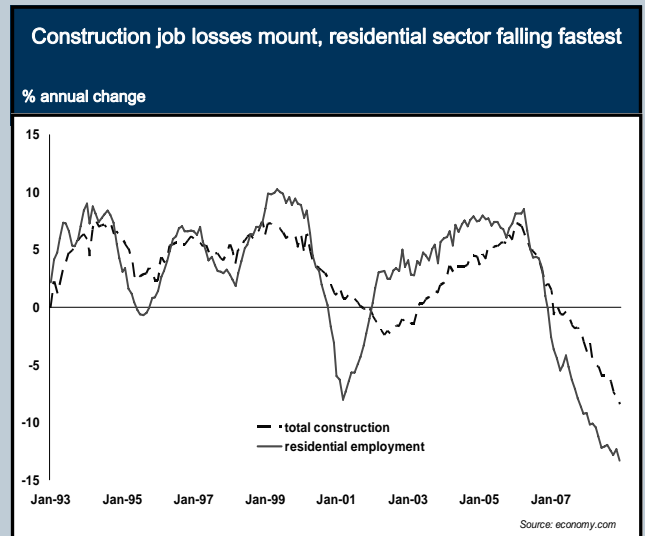
- The Reserve Bank of Australia is due to meet on Tuesday 3rd in a week which sees the release of several pieces of economic data key to the housing market. On Monday 2nd the Q4 2008 quarterly house price index will be released whilst building approvals are due out on Wednesday 4th. The degree of consumer retrenchment will be evident in retail sales data due on Wednesday 4th. Further, the pace at which external support for the economy is waning will be gauged in the latest trade data, also due on Tuesday 3rd.
- National statistics figures show house prices fell by a modest 2% in Australia between March and September 2008. Monday's release is likely to show that the pace of decline accelerated in Q4. Of the eight cities captured in the index, declines to date have been most pronounced in Perth where prices have fallen 5% from their peak. However, Q3 also saw accelerating declines across Sydney, Melbourne and Canberra with the first falls also registered in Brisbane.
- House price declines have been modest to date when compared to the US and UK, although the labour market has been in better shape with only moderate rises in unemployment. The tide is turning however, with leading indicators of the labour market plummeting in recent months indicating a sharp rise in the unemployment rate through 2009. The collapse in commodity prices and rapid loss of momentum in some of Australia's major trading partners will weigh on economic activity and open the door for further aggressive interest rate cuts of 100 basis points next week.



“...despite further aggressive interest rate cuts to come”

Outlook remains bleak for US Construction sector

- The US labour market has deteriorated dramatically with non-farm payrolls showing that over a million jobs were lost in the last two months of 2008. Not surprisingly, consumer confidence surveys have reported that jobs are still hard to find while jobless claims have climbed higher. The Employment Situation report for January, released on Friday 6th, will provide a more detailed look at the job market.
- In particular, it's likely to show that job losses in the construction sector continue to mount. Employment in the sector has been falling for 18 consecutive months. Over 100,000 jobs were lost in December 2008 alone, taking the number of jobs in the sector down by 8.5% y/y. Residential construction employment has been hit particularly hard, with the number of jobs falling by 13% over 2008. Continued weakness in the sector means further falls lie in the pipeline. To date, non-residential construction has held up better as the decline in activity has been less severe. Even so, the number of jobs in that sub-sector still fell by 6.5% last year.
- Construction spending data, released on Monday 2nd, are unlikely to show any improvement in employment prospects. Residential construction spending has continued to fall sharply in recent months and is unlikely to pick-up soon. After all, housing starts and permits fell by 15% and 10% respectively between November and December 2008 and builders' sentiment continues to plumb new lows. By contrast, spending on private non-residential construction actually edged up slightly in December. But with no sign of pause in the wider economic downturn, it is unlikely that this resilience will last.



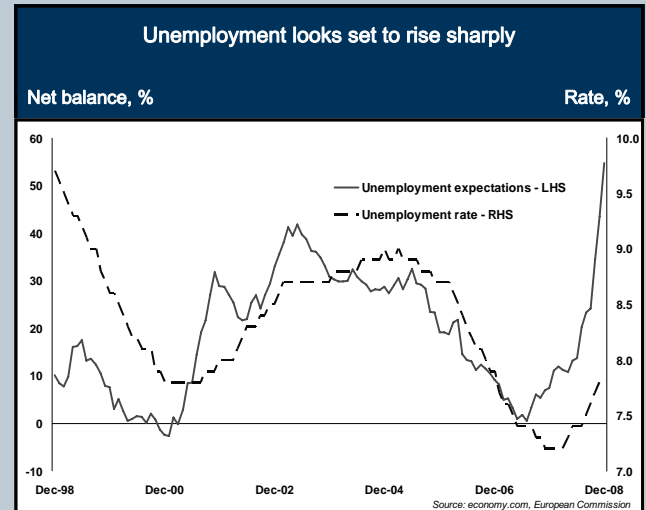
“ Weak construction spending to continue ”

“ Employment prospects remain limited ”

ECB on hold next week; will cut in March

- The ECB is due to announce its next interest rate decision on Thursday 5th. The key refinancing rate currently stands at 2%, following last month's 50 basis point cut. The primary reason that the ECB has been willing to aggressively ease monetary policy in recent months has been the reversal in headline inflation. Having peaked at 4% in July, inflation in the euro area is currently running at 1.6%, mainly on account of large energy price related base effects.
- Although the ECB envisages such base effects to fade by mid-year, its rhetoric remains dovish because of the sharp deterioration in the economic outlook. The euro area economy is now in recession, having contracted by another 0.2% in Q4 2008. As a result, capacity utilisation in the manufacturing sector is currently running at its lowest level since Q4 2005 according to the European Commission. As a result, companies are likely to shed more staff in the coming months. To date, the pick-up in unemployment has not been that dramatic. It's currently 7.8% compared to 7.2% last March. However, a sharp rise in unemployment would be consistent with the usual lags between economic activity and the labour market and also the fact that unemployment expectations have shot up to their highest level since December 1993.

- While this is likely to exert downward pressure on prices, a rate cut next week is unlikely. President Trichet has already in effect ruled this out, stating that the next important "rendezvous" will be at the March meeting. By this point the data flow on the real economy will have deteriorated further and we expect the ECB to cut rates by another 50 basis points.



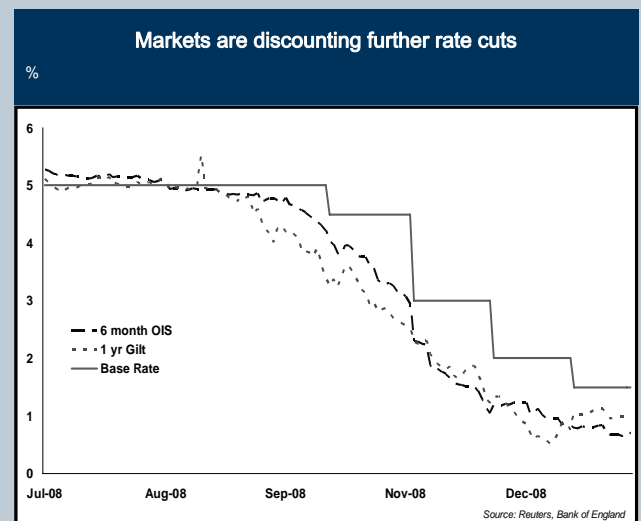
“The economic outlook in the euro area continues to deteriorate...”

“... RICS expect the ECB to next cut at the March meeting”

UK base rates heading for 1%

- The MPC regroup on Wednesday 4th with the outcome to its latest round of deliberations announced, as usual, the following day. The last four meetings have resulted in interest rate cuts, bringing the base lending rate down from 5% to just 1.5%. Given the continuing run of disappointing economic data, it is quite conceivable that the authorities may choose to sanction a further round of easing. Our suspicion, however, is that it will be a close call; a majority of members could support a pause this time around to fully assess the impact of previous moves.
- Lead indicators of activity remain firmly in negative territory with the recently released CBI Distributive Trades Survey showing only a very minor bounce from historic lows; indeed, expectations for February retail sales are the weakest since the survey began in 1983. Manufacturing and construction surveys have been equally gloomy with new orders in the latter sector falling particularly sharply.
- Significantly, financial markets are continuing to assume that the Bank of England has yet to reach the end of the rate cutting cycle. The one year gilt yield is currently bouncing around the one per cent area although it has edged upwards from the low of less than 0.6% at the tail end of 2008. Meanwhile, the rate on the 6 month overnight index swap currently stands at around 0.7%. Al-

though the MPC continues to express some concern about the efficacy of the monetary transmission mechanism, the minutes of the last meeting express its belief that interest rate reductions are boosting the 'income of many businesses and households'. Nevertheless, it appears increasingly likely that quantitative easing will soon be unleashed to help provide a further boost to liquidity.



“lead indicators of activity remain firmly in negative territory”

“quantitative easing likely to be unleashed”

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