

European construction to stabilise during second half of the year

“Ignoring the year end weather effects, large country divergences in construction output remain”

Euro area construction output data for January is due on Thursday 17th from Eurostat. Output is 11% below year ago levels and 27% below its December 2006 peak. These figures, however, mask considerable country variation, although timely indications of the scale of the divergence have been complicated by the unusually harsh weather during December that

impacted some markets, Germany in particular. Setting aside December's data, on year ago levels output is down by 16% in Spain (45% from its peak), 4% in France (16% from its peak) and is up by 6% in Germany (though down 5% from its peak).

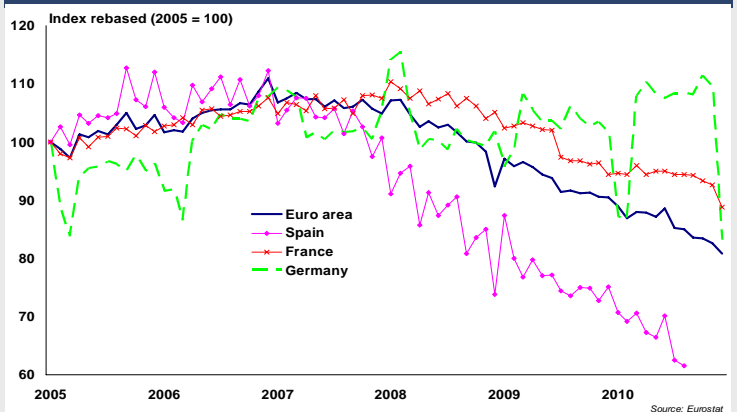
A large part of this divergence can be explained by differences in key macroeconomic drivers such as the labour market, but other factors that have played a role include lending conditions and the scale of overbuilding. Lower employment not only means less demand for new housing; it also means that less people will be occupying office or industrial space, or visiting retail stores. In Germany, the unemployment rate is at an all time low of 6.5%, having hardly deteriorated during the recession. Meanwhile, in France, the unemployment rate increased from a low of 7.6% (May 2008) to 9.6%, but in Spain, it has risen from 8% (May 2007) to 20.4%.

Looking forward, it is unclear what impact the end of year weather conditions will have on January's headline construction output data; the large fall in German output was barely discernable at the Euro area level in December, which is somewhat surprising given

Germany's weight in the region. Beyond any lingering uncertainty caused by the end of 2010 weather conditions, we expect construction output to stabilise during the second half of this year. This is broadly consistent with continued economic growth in the region and a steadier labour market. However, there are risks even to this cautious view; the ECB has signalled its intention to raise interest rates, as early as April. To the extent that tighter monetary policy slows growth, it is also likely to have some impact on the construction sector.

“At the Euro area level, we expect construction output to gradually stabilise during the second half of this year”

The weather had an impact on construction output



Higher Indian interest rates to hit residential trading volumes but not prices

“The repo rate is likely to be lifted by a further 25 basis points next week”

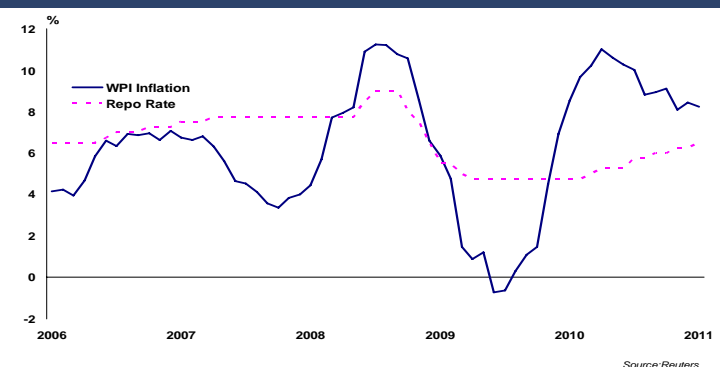
The Reserve Bank of India (RBI) meets again on Thursday 17th against a backdrop of continuing concerns over the inflation picture. Three days prior to this meeting, the February WPI inflation number is due for release and the indications are that this will not be very different from the January reading of 8.23%. The breakdown of the figure is likely to show that some moderation in

food price inflation will have been offset by higher fuel prices. Unease over the issue of food supply (and what this means for prices) was evident in the recent budget statement which allocated extra funding to lift output of lentils, vegetables, milk and edible oil. Nevertheless, the

odds still favour the RBI taking further steps to try and rein in the headline inflation number with the repo rate being lifted by a further 25 basis points to take it to 6.75%.

While the persistence of inflation pressures continues to pose significant challenges for the authorities, there have also been some disappointments to contend with on the growth front. The moderation in the pace of activity in Q4 was a little more pronounced than anticipated reflecting, in particular, a flatter picture on investment spending. Corporate confidence has been hit not just by concerns over inflation but also by the rising cost of capital and the corruption-related investigations. In the face of this, growth projections for 2011 have been scaled back although our suspicion is that a figure close to 8% for the coming financial year is still a reasonable estimate.

The repo rate remains below WPI inflation



Higher mortgage rates are beginning to have an impact on sentiment in the residential property market and this is likely to be reflected in lower trading volumes over the coming months. As yet, there is little evidence of developers lowering prices but with banks a little more cautious about lending to the sector, it is conceivable that some of the smaller operators will come under pressure. Even so, the combination of a lack of stock in cities like Mumbai, high land prices, and the generally healthy state of developers' balance sheets should prevent a re-run of the sharp cuts in residential prices witnessed in 2008.

“the generally healthy state of developers' balance sheets should prevent a rerun of 2008”



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US housebuilding to remain subdued through 2011

“Housing starts bounce back up 14.6% during January”

The coming week sees data related to the US housing market released, beginning with the NAHB Housing Market Index (March) on Tuesday 15th and housing starts (February) the following day. Housing starts picked up in January to a four month high, to a seasonally adjusted annual rate of 596,000 (14.6% rise). However, this is

probably just a bounce back from the low December figure which was artificially depressed by the severe weather. Also, the surge during January in ground breaking activity was down to the volatile multi-family housing component, while single family units declined 1%.

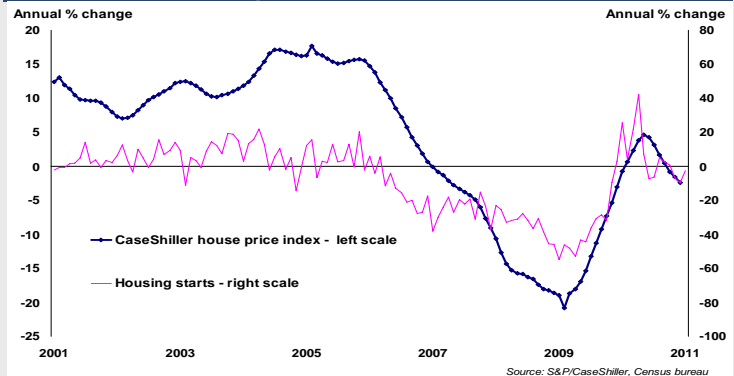
Turning to the NAHB index, a good indicator of house builders sentiment, it has remained unchanged at 16 for the fourth consecutive month (below 50 represents worsening market conditions). This is unsurprising given the continued fall in house prices, with the CaseShiller 20 city house price index dropping 2.3% over the course of 2010. We continue to anticipate a fall of around 5% in prices during 2011, due mainly to the supply overhang in the housing market and the continued flow of foreclosed properties coming onto the market. Indeed, despite improvements in the general economy, the housing market continues to remain weak. Recent sales data indicate that distressed property pushed existing home prices to a nine year low in January, even as they helped lift overall sales to a nine month high. Existing home sales increased by 2.7% in January, but foreclosed properties accounted for 37% of all existing home sales. The continued downward pressure exerted by distressed properties on

house prices is reflected in the median house price, which fell to \$158,800, the lowest level since April 2002.

Looking forward, the Federal Open Market Committee will meet next week to set the base interest rate, which continues to be held at 0.25%. We see little chance of a move, with rates set to stay on hold till the second half of 2012. This will keep mortgage rates close to historically low levels, which will aid demand in a stuttering housing market.

“House prices fell 2.3% over the course of 2010”

US housing sector continues to deteriorate



Bank of Korea’s rate decision to impact on commercial real estate

“Import prices rose at their fastest annual pace in nearly two years”

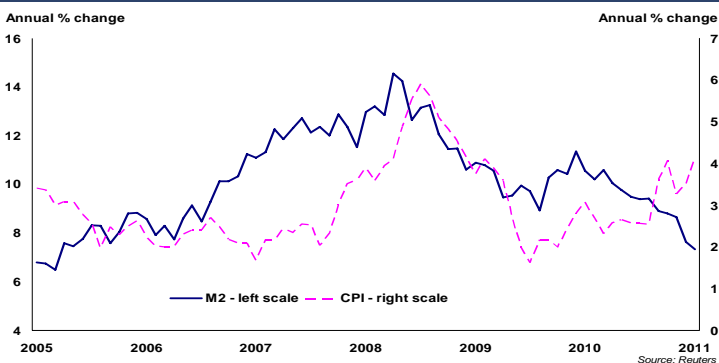
Economic news flow in Korea next week sees February data for both import and export prices, released by the Bank of Korea (BoK) on Tuesday 15th and is followed by unemployment numbers for the same period the next day. Employed persons rose by 331,000 in January from a year earlier after a gain of 455,000 in December, led by recruitment in the manufacturing sector

to meet rising demand for exports. This helped the unemployment rate hold steady in January at 3.6%, unchanged from December despite big job losses in the wholesale and retail sales sectors. Separately, the

BoK data showed import prices rose by their fastest annual pace in nearly two years in January, which helps to explain why inflation continues to accelerate in Asia’s fourth-largest economy.

Indeed, the annual growth of CPI has exceeded the BoK’s target range (of between 2 and 4%) for two consecutive months and this has prompted action; the BoK raised rates to 3% on Thursday 10th, after a brief pause in the policy tightening cycle in February. The hike was expected by the market as inflationary pressures, in the form of commodity and food prices, continue to blight the continent. Interestingly, CPI growth has historically followed robust growth in the money supply, but it now appears this trend is coming to a halt. The growth in M2 has been on a downward trend for six months straight and eased considerably from the peak of 14.6% in mid 2008. Annual growth in the money supply slipped to 7.3% on the year to January, the lowest growth rate since early 2005.

M2 has eased while inflation continues to rise



Growth in the wider economy is expected to slow from the pace seen in 2010, although the results of the Q4 RICS Global Commercial Property Survey are continuing to improve. Both capital value and rental expectations for Q1 picked up after registering negative net balances in the previous quarter. That said, if interest rates are forced significantly higher by the persistence of inflation the risk is that the upturn in sentiment in the commercial property market could wane.

“The BoK raised rates to 3% after two consecutive months of CPI broaching the bank’s target”

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