

German economy strong, but risks shifting to downside

“Business surveys indicate strong conditions, but weakening expectations”

The May ZEW Survey – based on around 350 financial analysts and institutional investors – is due Tuesday 17th. The survey has two components; current conditions and forward expectations. The former hit a post-crises peak of 87.1 in April, well above the long run average of -27.9 while the latter indicator fell for a second consecutive month to 7.6, well below

the long run average of 26.6. This contrast between the present and the future is also reflected in another major German business survey, the IFO; the current component rose to 116.3 in April, the highest reading since January 1991, while the expectations component fell for the second consecutive month to 104.7.

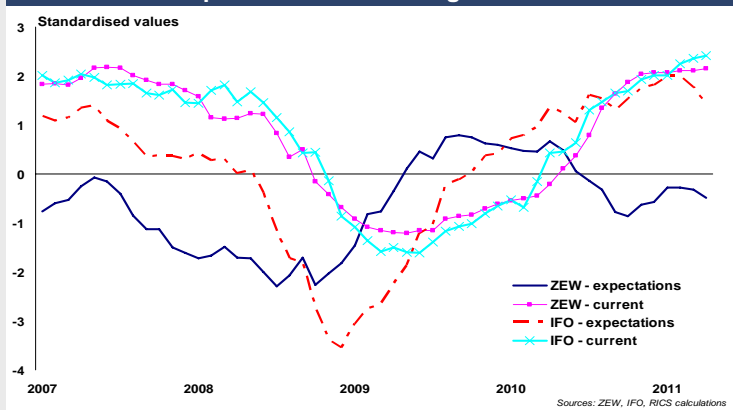
The divergence between current economic conditions and business expectations likely reflects two factors. On the one hand, there is clearly a lot of momentum in the German economy. Indeed, the manufacturing sector is booming on the back of a strong global backdrop, which in turn is increasingly feeding through to the labour market and domestic sphere. On the other hand, however, the balance of risks surrounding the outlook is gradually shifting to the downside, something not lost on IFO and ZEW survey respondents. Several factors are depressing the economic outlook; the tighter monetary policy (the ECB hiked rates by 25 basis points in April) and accelerating inflation (currently 2.3%, the highest since October 2008).

The current strength of the Germany economy is also reflected in developments in its commercial property market. This is highlighted by

the Q1 2011 RICS Global Commercial Property Survey, released last week. Indeed, occupier demand for commercial space accelerated further during Q1, as did rental expectations, which were additionally bolstered by a fall in availability. Capital value expectations abated somewhat, possibly reflecting the higher degree of uncertainty surrounding the outlook, but overall, they still remain elevated. From a sectoral perspective, rental and capital value expectations are strongest in the retail sphere.

“The commercial property market is still performing well”

Business expectations are starting to shift downwards



Russian real estate sector to continue to perform strongly despite interest rate hikes

“Recent revisions to official data suggests that the growth picture remains firm”

A further update on the underlying strength of the Russian economy will be provided by the clutch of data due for release on Thursday 19th and Friday 20th. First will come the industrial production figure for April and this will be followed by retail sales, unemployment and investment numbers. Recent revisions to official data suggests that the growth picture

remains firm. Most significantly, Rosstat upgraded its earlier estimate of retail sales in 2010 by close to 2% and added around 2.5% to provisional figures for this year; as a result, the March year on year

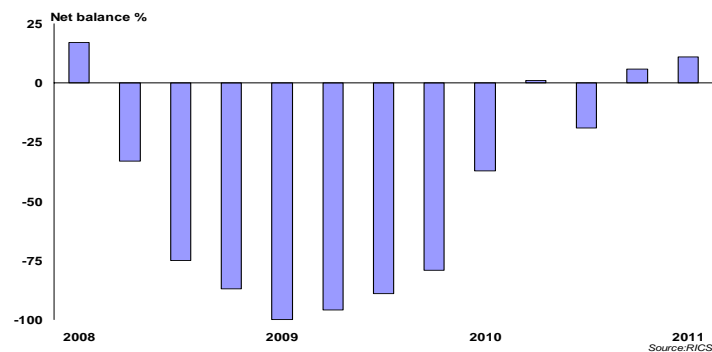
gain in household spending climbed to 4.8%.

The latest RICS Global Commercial Property Survey suggests that the real estate market in Russia is still very firm with strong readings for the forward looking questions on both rents and capital values. This chimes with estimates from Jones Lang LaSalle that Moscow office rents leapt more than 17% in the quarter and capital values almost 25% (on a year on year basis, the latter have risen by not far short of 50%). Significantly, the RICS report also indicates that the construction sector is beginning to respond to this more positive environment with the net balance for new development starts remaining in positive territory for the second consecutive quarter. Disaggregating these numbers a little further points to more of this activity being concentrated in the retail space.

The central bank surprised financial markets by raising the refinancing rate in late April. The latest reading on inflation provides some justification for a tightening in policy with the headline rate now standing at 9.7%. However, much of this can be explained by a jump in food prices off the back of last summer's drought. Even so, the likelihood is that interest rates will continue to be nudged up over the course of the year. This will inevitably have some impact on the economy but our judgement is that growth will still reach 4.5% this year, which should provide a reasonably favourable backdrop for the real estate sector.

“Rent and capital value expectations remain upbeat”

New development starts are continuing to edge upwards



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Brazil property sector continues to soar

“Inflation slowed in April to 0.77% on the month”

The coming week sees the release of numerous price indices, most notably the May IPCA-15 index, on Friday 20th. Inflation in April unexpectedly slowed on a monthly basis, with the benchmark IPCA consumer price index coming in at 0.77%, down from 0.79% in March. Although the annual growth rate increased to 6.51% from 6.3%, the markets have focused on the monthly

slowdown, with market expectations for year end inflation declining to 6.23% from 6.41% a month ago. This clearly indicates that the government's fight against inflation, using the combined measures of fiscal retrenchment, higher interest rates and credit limiting legislation is slowly paying dividends.

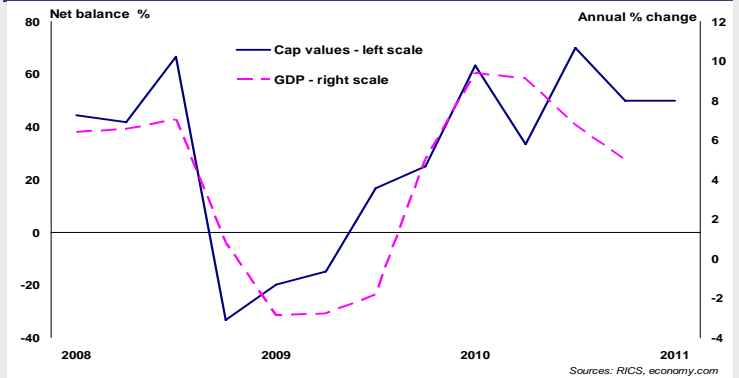
Indeed, with Brazil's growth rate in 2010 recorded at 7.5% (highest in 24 years) the government has repeatedly stated that keeping prices in check is their number one priority. The latest central bank minutes, covering the meeting in which they hiked rates by 25bp to 12%, emphasised a tougher stance on inflation, stating the need for a 'prolonged' cycle of monetary tightening. That said, we do not expect credit expansion to significantly slow in the coming months, especially in the housing sector, where lending to households in March increased 148% on the year; this led to certain metropolitan areas recording over 25% price growth in 2010.

Commercial property paints a similar picture, according to the Q1 2011 RICS Global Commercial Property Survey. Capital values at the all property level (offices, industrial and retail) continue to record

significant rises. Meanwhile, rising occupier demand combined with limited availability continues to support rising rental expectations. Investment demand also saw a rise, which is not surprising given that Brazil has seen a 110% rise in foreign commercial property investment over the past 12 months, according to the Real Capital Analytics. That said, there is a risk that the sharp appreciation in the Brazilian real could, if it continues, begin to at some point deter future foreign investment.

“Lending to households increased 148% year on year in March”

Capital values remain firm



Australian borrowers feeling the pinch

“Home loans stood at 45,393 in February, the lowest number since February 2001”

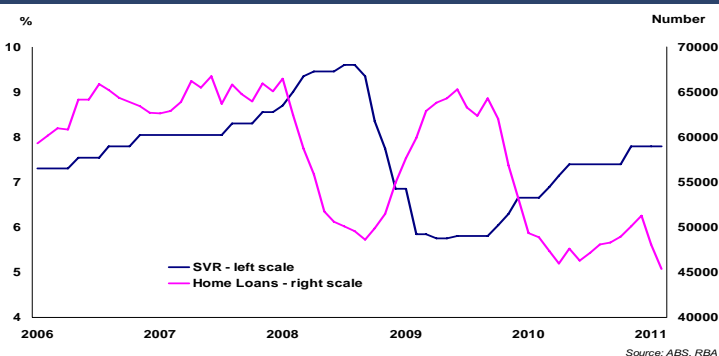
The Australian Bureau of Statistics will give the latest indication of demand for mortgages when they release housing finance commitments for March on Monday 16th. Commitments have been wilting recently and stood at 45,393 in February, the lowest number since February 2001. This is not altogether surprising; despite the recent 'time-out' from the monetary tightening cycle, the

RBA raised the cash rate aggressively throughout 2010, adding 100 basis points to the 7% that were sanctioned in the final 3 months of 2009. This drop in lending is evidence that households are being

squeezed by the increased cost of borrowing. Last week's house price index showed as much, as the Q1 index recorded the largest quarter on quarter fall since Q3 2008 (1.7%). Consequently, we are expecting the number of loans in March to be broadly flat.

Notwithstanding this, we believe the medium term outlook for both interest rates and, implicitly, mortgage demand remains in the balance. At the latest RBA meeting officials stepped up their rhetoric to take a more hawkish view, reflecting the unexpectedly high Q1 inflation figure of 3.3% (above the 2%-3% target). Furthermore, the RBA statement on monetary policy (released Friday 6th) showed the monetary authority lifting inflation forecasts for the 2 year period. One reason for this is the impending rebuilding activity needed in the flood hit Queensland area. The latest labour statistics (released Thursday 12th) show unemployment at 4.9%, so inflationary pressures are expected to arise due to the limited spare capacity in the economy. We expect the RBA to continue holding the policy rate at 4.75% in the near term, but add a further 25-50 basis points before the end of 2011.

Mortgage lending has fallen sharply in 2011



Indeed, the knock on effects of rate hikes to households are always likely to hit confidence. Coincidentally, the Westpac consumer confidence survey is released on Wednesday 18th, giving the results for the May survey. In April, the consumer confidence index increased modestly, but highlighted the near term risks, chief among them the increase in fuel costs.

“We expect 25-50 basis points to be added to the base rate before the end of 2011”

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