RICS Global Real Estate Weekly

29th April 2011

Indian interest rates set to move higher once again

"The leap in manufacturing prices is looking to be increasingly broadly based "

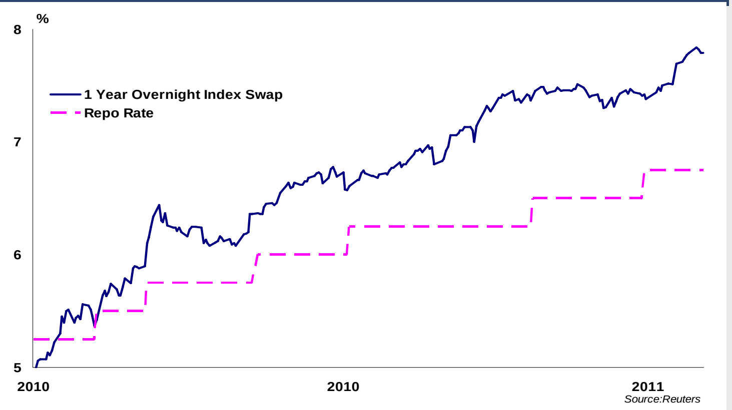
The Reserve Bank of India (RBI) meets again on Tuesday 3rd against a backdrop of increasing concern about the inflation outlook. March inflation rebounded to 9% fuelled by a sharp rise in non-food manufacturing prices as well as a further big jump in energy prices. Significantly, the leap in manufacturing prices is looking to be increasingly broadly based with every subcategory showing a material rise compared with February. In the wake of this release, money markets have begun to prepare themselves for more action from the central bank. One of the best guides to sentiment, the one year overnight index swap, has climbed to 7.8% leaping thirty basis points in the past fortnight.

Our best guess is that another quarter point hike in the repo rate will be sanctioned by the monetary authority next week but we would not at this stage rule out a more aggressive move. Even if the RBI does, indeed, choose to go along with the consensus view at the forthcoming meeting, further increases in rates are highly likely over the course of the year; it is certainty not unreasonable to project the repo rate standing at 7.5% by December (from 6.75% presently). The tighter monetary stance is already being reflected, to some extent, in activity data. Industrial production is still growing strongly but this is being primarily driven by exports. Meanwhile, the private sector investment cycle excluding infrastructure continues to disappoint.

The impact on the real estate sector has been mixed with some reports from brokers of disappointing sales in Mumbai offset by a stronger picture in Gurgaon and Bangalore. Significantly, real estate equities appear to, once again, have lost momentum slipping by 10% over the past three weeks compared with a much more modest decline in the wider market. Critically, we still retain a generally positive macro picture for India with GDP growth on course to exceed 8% this year despite the concerns noted earlier. This should continue to provide an important layer of support for the real estate market in the face of higher borrowing costs as the RBI attempts to fight inflation.

"Growth in excess of 8% should provide an important layer of support for the real estate sector"

Markets suggest Indian repo rate is heading to at least 7.5%



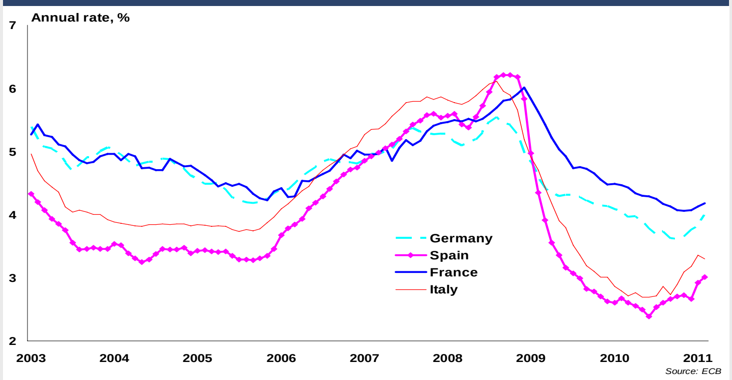
ECB rate hikes to have a varying impact across euro area mortgage markets

"Mortgage rates in Spain and Italy are tied more closely to money market rates..."

The next ECB interest rate announcement is due Thursday 5th. The main policy rate currently stands at 1.25%, having been raised in a widely expected move by 25 basis points at the last meeting. Although no change is expected next week, financial markets are still anticipating another 50 basis points of tightening by the end of the year.

Given recent developments on the policy rate front, it is worth reviewing the latest trends in national mortgage rates. Here we contrast Germany and France with Italy and Spain. In the former pair, mortgage lending is predominantly financed via the bond market (long term lending) whereas in the latter two, funding predominantly takes place via the money markets (short term lending). Compared with mid-2010, two notable features are apparent; the change in rates has been smaller in Germany and France, but the level is actually higher. Indeed, German mortgage rates have only increased by 21 basis points and in France they have actually fallen by 11 basis points; in contrast, Italian and Spanish mortgage rates have both increased by just over 60 basis points. However, in Germany and France, mortgage rates currently stand at 3.99% and 4.18%, whereas in Italy and Spain, they stand at 3.3% and 3.1% respectively.

Mortgage lending rates are higher in Germany and France



Given the probable direction of ECB monetary policy and the funding characteristics of national mortgage markets, two outcomes over the course of the year are likely; mortgage lending rates will rise more sharply in Italy and Spain compared to Germany and France, but they will remain lower overall. One obvious risk to this scenario is oil prices; if they continue to increase, this might exert pressure on the ECB to tighten policy more aggressively. However, at the same time, continued increases in oil prices are likely to harm growth prospects, not just in the euro area but globally. This would be reflected in lower bond yields and therefore, lower mortgage lending rates in Germany and France.

"...whereas in Germany and France, they are tied more closely to bond market rates"

US homebuilding stalls as foreclosures continue to undermine house prices

> **"Residential construction spending is 8% below year ago levels"**

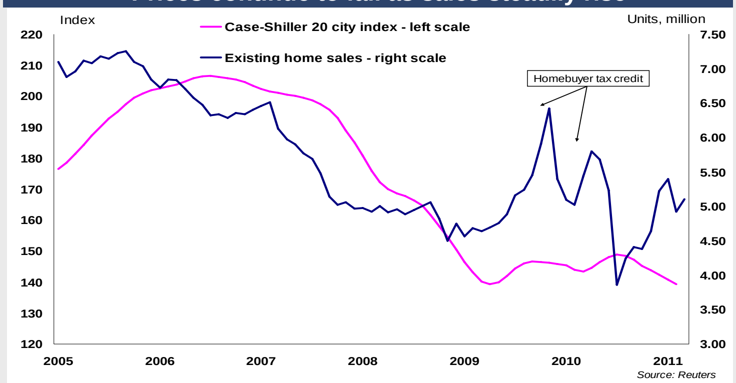
The coming week sees the release of both construction spending (March) and the Federal Reserve's Senior Loan Officer Survey (Q2) on Monday 2nd. Construction spending fell in February by 1.4% compared with the preceding month to an annualised rate of $760 billion. The decline in spending was led by residential construction, which now stands almost 8% below year ago levels, underscoring the weakness of the housing market recovery. Indeed, the latest Case-Shiller house price index showed house prices slipped for the 8th consecutive month (3.3% down on the year) and the index now stands precariously close to the trough reached at the height of the recession.

The massive supply overhang currently in the housing market and the continuing pipeline of foreclosures coming onto the market is continuing to undermine house prices, with distressed sales now making up 40% of all existing home sales (compared to a long run average of 20%). That said, there have been some green shoots in the housing market, with existing home sales increasing 3.7% in March, indicating an improving underlying trend in home sales. Indeed, with the labour market strengthening on the back of solid job gains in February and March, we look for demand to gradually recover in the housing market. A major factor that will continue to weigh on it is housing finance, or the lack thereof, be it to potential homebuyers or homebuilders. The latest NAHB housing market index (a good indicator of house builders' sentiment) shows that lack of finance continues to be leading factor in limiting home building. The Q1 Senior Loan Officers Survey paints a similar picture for residential mortgages, with banks, on balance, reporting no change in the tight standards of lending in prime mortgages, although standards on non traditional mortgage loans were tightened by 15% of banks surveyed in the last report.

> **"House prices fell for the 8th consecutive month in February"**

Looking ahead, the improving job market bodes well for housing demand. That said, excess supply in the market will take time to clear, with prices likely to fall further as the year progresses.

Prices continue to fall as sales steadily rise

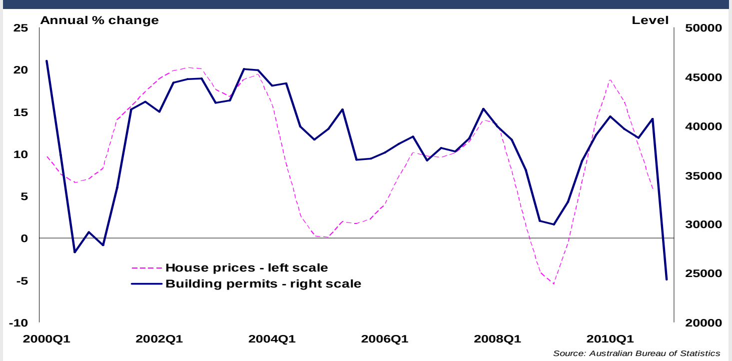


Past rate hikes are still feeding through to the Australian housing market

> **"The RBA has raised rates by 175 basis points since September 2009"**

Australian housing market data is due next week; Q1 house price data on Monday 2nd and March building permits data on Thursday 5th. The underlying picture is one of a strong market but one that is already coming off the boil. Indeed, February private sector approvals came in at 11,708; down 7.2% on the month and 10.4% on the year. Meanwhile, house prices were 5.8% above year ago levels in Q4, but this is almost half of Q3's annual growth rate and well off the 19% figure recorded in Q1.

Australian housing market is slowing



The proximate cause of falling building activity and slowing house price growth is tighter monetary policy. Indeed, the Reserve Bank of Australia (RBA) has hiked its official policy rate up from 3% in September 2009 to 4.75% presently. Unlike most of the developed world, Australia only suffered a very modest downturn in the wake of the global financial crisis, whilst inflation moved sharply above the RBA's target rate (1-3%) peaking at 5% in Q3 2008. The RBA chose not to tighten policy in the immediate aftermath of the crises because of the uncertainty still rippling through financial markets, but as this receded, it embarked on a policy of rate normalisation.

Although the RBA's last hike was in November, the full impact of the 175 basis points of tightening it has delivered is unlikely to have fed through to the housing market. As a result, even though the RBA seems content with its current policy stance for the time being, house price growth and building activity is likely to slow further over the course of the year in a lagged response to past rate hikes. However, we see this as a reversion to a more normal set of circumstances rather than the beginning of a severe housing downturn. Moreover, the risks are still skewed to the upside given the economy is experiencing a major investment boom, spurred by soaring commodity prices.

> **"The housing market will slow further, but a severe downturn is not on the cards"**

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