

Solid if unspectacular Russian economic recovery underpins real estate market

“The economy should grow by around 4.5% over the coming year”

The release on Wednesday 17th of October industrial production data will provide a timely update on the current state of the Russian economy. The September month on month gain of 0.7% was the first increase after three months of stagnation and was driven both by a rise in manufacturing output as well as the extraction of raw

materials. Newsflow generally has been pretty patchy with the latest retail sales figures disappointing but the service sector PMI picking up after a summer lull. Core inflation continues to hover around the 5% area although the headline number in October was somewhat higher at 7.5%. Pulling all this together, our suspicion is that the Russian central bank will be inclined to sit on its hands for the time being with interest rates likely to remain on hold well into 2011.

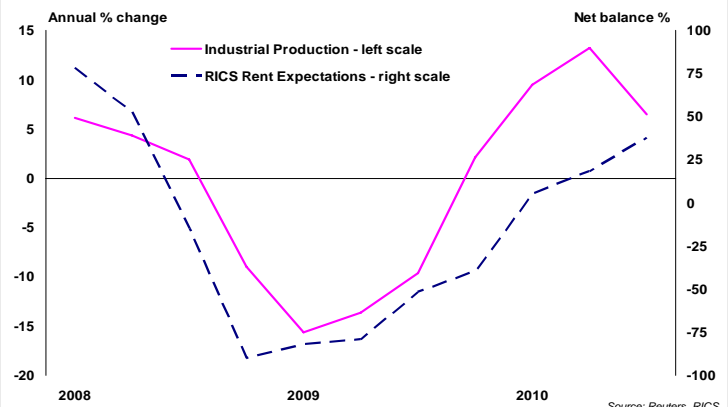
A backdrop of solid if unspectacular growth (we expect the economy to expand by 4.5% over the coming year) coupled with a broadly stable monetary stance should not be a bad one for the real estate sector. This is borne out by the generally positive results reported for the Russian commercial market in the latest RICS Global Property Survey. Tenant demand increased strongly in the third quarter fuelling a further acceleration in rental expectations. Meanwhile, investment demand appears to be holding up leading property professionals to take a generally upbeat stance on the prospects for capital values.

These sentiments are broadly consistent with other anecdotal reports of developments in the Russian real estate market. Jones Lang

LaSalle, for example, estimate that capital values in Moscow have increased by around 60% over the past year and see the market remaining in the spotlight. The RICS report, meanwhile, suggests that the number of investment bidders per property, a key guide to market activity, is continuing to rise; the net balance of respondents seeing an increase rather than a decrease in the number of investment bidders rose to 24% in the third quarter.

“Both capital value and rental expectations are firmer”

Economic recovery underpins rebound in rents



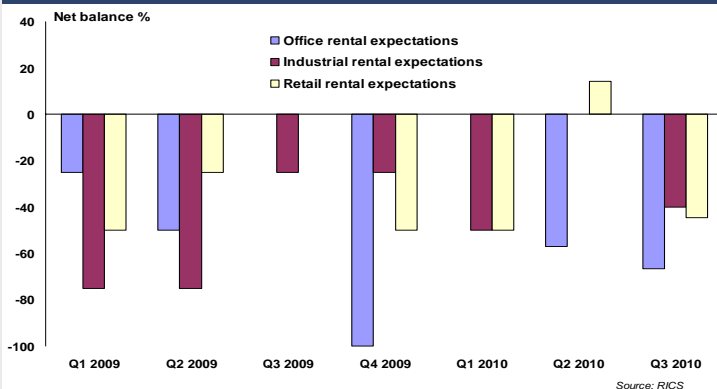
Sentiment in Korean commercial property market worsens

“The RICS survey showed that sentiment in Korea was more downbeat”

The Bank of Korea (BoK) will announce the latest interest rate decision on Tuesday 16th. All indications are that they will raise the 7-day repurchase rate by 25 basis points to 2.5%. Recently, CPI inflation has risen above the BoK’s target range of 2-4% with it spiking to a two year high of 4.1% in October, after reaching 3.6% in September.

While the minutes of the last BoK meeting showed a renewed effort to ensure price stability, the latest decision may also be influenced by

Rental expectations have long been depressed in Korea



recent interest rate meetings in other Asian countries (such as India and Australia), as a round of ‘quantitative tightening’ takes place in emerging markets to counter the highly contentious monetary stimulus programme from the Fed. Open economies in Asia are particularly wary of increasing capital inflows and the effects of a depreciating dollar driving down US export prices. Amongst other things, a rise in interest rates will impact on activity in the commercial property market. The results of the Q3 RICS Global Commercial Property Survey showed that sentiment amongst property professionals in Korea was downbeat, as the net balance for most indicators declined. On the occupier side tenant demand fell to -35, while available space increased. This is feeding through to rents, where expectations for next quarter dropped to -44. On the investment side, development starts dipped to -59 from +10 last quarter, while investment demand slumped to -60. Capital value expectations fell for the first time in a year as the net balance deteriorated to -20 from +5.

Looking ahead, the outlook for rents deteriorated across all three sectors, with the most severe decline in office property where the net balance dropped to -67. This was the lowest reading since Q4 2009. Meanwhile the pace of decline also accelerated for industrial and retail property. Moreover, the outlook for capital values appears most bleak for retail property, while the net balance for offices actually improved.

“Looking ahead, the outlook for rents deteriorated across all three sectors”



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Sweden housing bubble risks likely to prompt further action from authorities

“Riksbank openly worried about the state of the housing market...”

Official Swedish house price data for Q3 are due Wednesday 17th. The housing market is booming at present; in Q2, prices rose by 2.3% (marking the fifth successive increase) and they are now 7.6% above their pre-crisis peak.

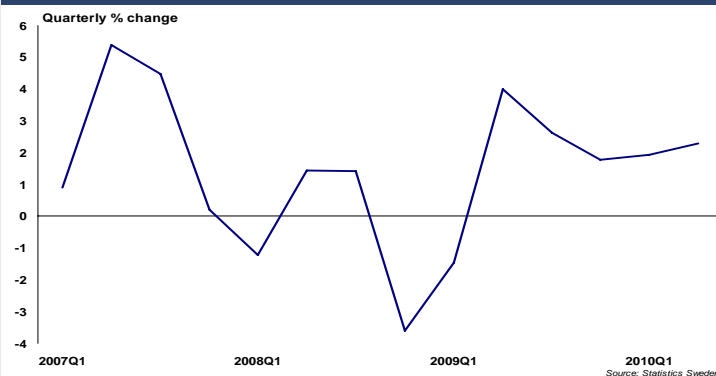
So far, the authorities have embarked on a dual strategy to cool the housing market; the Swedish Financial Supervisory Authority (SFSA) imposed an 85% cap on LTVs on October 1st and the Riksbank has heightened its rhetoric about the sustainability of price rises in a bid to manage household expectations. The 75 basis point tightening in policy rates since July will inevitably have some cooling effect on prices, but it was not delivered specifically for this purpose. Meanwhile, the October minutes of the Riksbank's monetary policy meeting reveal considerable unease about whether the risks are being sufficiently managed and there is open disagreement between board members on the best policy response going forward. Some on the board are arguing that interest rates are an ineffective policy tool in this regard but others, including Governor Ingves, are taking a more constructive view. Indeed, the Governor ended his speech given only today (Thursday) with a section entitled “Household debts still cause concern”, which outlines plans for an inquiry into the state of the Swedish housing market and the role of monetary policy.

Whether there will be a soft or hard landing in the Swedish housing market is difficult to judge at this stage. Clearly the authorities are alert to the risks and if the current boom continues for much longer, it is

likely that a more aggressive policy response will be delivered. Whether this comes from the SFSA in the form of tougher lending criteria or the Riksbank in the form of even tighter monetary policy, or both, is an open question, but they are unlikely to sit idle. Therefore, although the current pace of momentum in house prices still has further to run, in all likelihood, by the middle of next year, the risks to house prices will be skewed to the downside.

“...more measures, either from the SFSA or Riksbank are likely”

Swedish house prices are growing strongly



US residential construction stabilises

“Housing starts edged up in September”

The Census Bureau publishes housing starts for October on Wednesday 17th. The last couple of months have seen housing starts stabilise after sharply falling due to the homebuyer tax credit expiring. Indeed, after an 11% rise in August, housing starts edged up in September (0.5%) to an annualised rate of 610,000 (compared to the long run average of 1.5m). Although ground

breaking activity is still at depressed levels, other house building indicators seem to suggest that a gradual recovery in the home

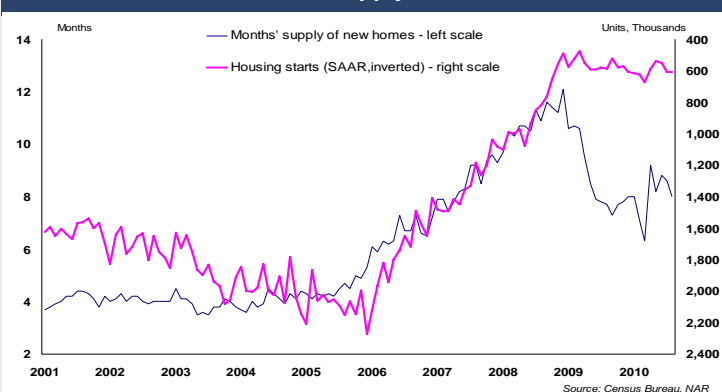
building industry could take shape. October's National Association of homebuilders (NAHB) index showed a rise in builders' confidence, with the index rising from 13 to 16, the highest the sentiment indicator has recorded since June. Additionally, the month's supply of new homes has been falling and after reaching a year high of 9.2 in May, has dropped to 8 in September.

Turning to commercial property construction, the latest RICS Global Commercial Property Survey (GCPS) shows that new development starts continue to fall in Q3 across all the 3 sectors of industrial, office and retail; this is not surprising given that the latest Moody's Commercial Property Price Index showed a negative return for all properties in August (-3.3%), and -7.5% on the year. Sectorally, the availability of commercial properties although still increasing, slowed in pace for the office and retail arenas, reducing downward pressure on returns. Indeed, results from the GPS seem to suggest a resurgence in investment demand for commercial real estate in all sectors with an emphasis on the office sector, where investment demand has reached a 4 year high.

Looking ahead, the QE2 by the Federal Reserve should drive more investors away from government debt and into other asset classes such as commercial real estate. This should support capital values.

“Commercial property returns slow pace of decline”

Month's supply declines



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