

German construction sector may find traction, but risks remain

“So far there has been little feed through from the economy to the construction sector”

Data on German manufacturing orders and industrial production for May is due on Wednesday 6th and Thursday 7th respectively. Amongst all the talk that German industry is booming – and it is in terms of growth rates– it is still important not to lose sight of the fact that it has yet to recover back to pre-crisis levels. Indeed, manufacturing orders have recovered 45% from their

February 2009 low, but are still 10% below their December 2007 peak. Meanwhile, industrial production has recovered 27% from its January 2009 low, but is still 4% below its February 2008 peak. However, by means of comparison, the latest GDP data showed the German economy as a whole has now fully recovered, with the level of output exceeding its previous Q1 2008 peak.

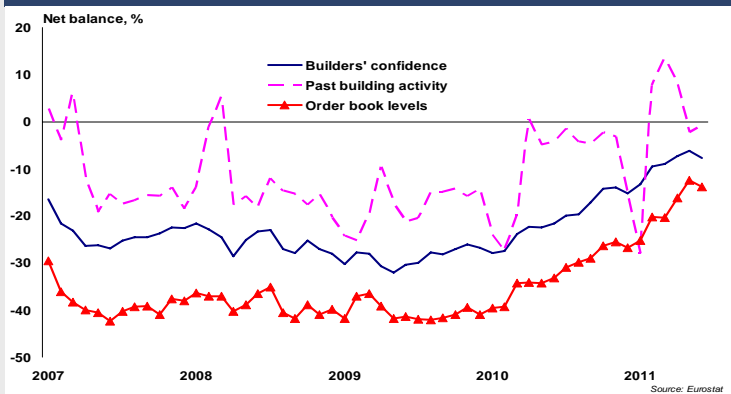
In spite of the rebound in the industrial sector and broader recovery in the economy, there still has not been much positive feed through to the construction sector. Indeed, the EC construction sentiment data shows that output is flat at best, while builders' confidence remains negative and order books are still shrinking. Discerning the underlying trend from the hard data produced by Eurostat is not easy given its volatile nature. On balance, the trend painted by the output and new orders data looks moderately stronger, but the levels are still much closer to the low end of past readings.

Looking forward, we still expect activity in the German construction sector to gradually pickup during the course of the next 12 months in response to strong macroeconomic fundamentals. However, the near

term risks to this view are admittedly shifting to the downside, as signalled by the recent deterioration in the forward looking components of leading German business sentiment indicators (such as the IFO and ZEW). This is mainly because of a weakening global backdrop combined with the prospect of further monetary tightening at home. Provided, the slowdown in the global economy is temporary and the ECB doesn't hike too aggressively, the German construction sector is still well positioned for an uplift.

“However, macroeconomic conditions remain supportive”

Conditions are less bad, but not good for German builders



US commercial property recovery dependent on job growth

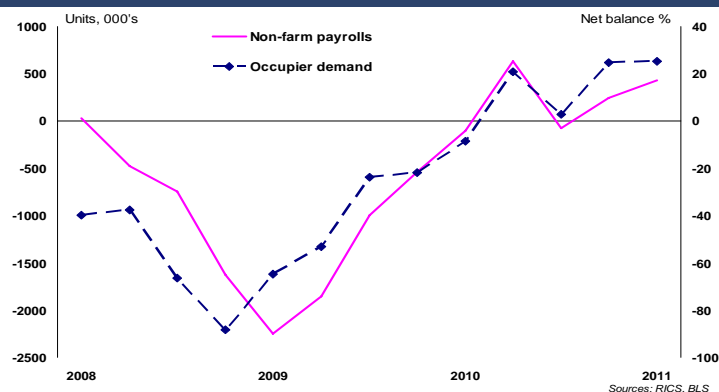
“Non-farm payrolls in May increased by 54,000”

The coming week sees the release of employment data from the Bureau of Labour Statistics (BLS) on Friday 8th. Non-farm payroll growth in particular has been lacklustre of late, with only 54,000 jobs created in May down from an average of 220,000 in the previous three months. If the slowdown in job creation proves to be permanent this would prevent the recovery from being

self-sustaining.

Turning to employment in the non-residential construction sector, the

Occupier demand reliant on job growth



job picture is much more worrying, with employment being broadly flat from the start of the year (after having fallen 22% from a pre-recession peak). This not surprising, given the lack of finance available to developers and potential investors (commercial mortgage lending declined by \$60 billion in Q1 2011) as well as fragile commercial property prices. Indeed, the latest Moody's/REAL Commercial Property Price Index (CPPI) showed prices hit an all time low at the all property level in May (falling from 101.71 to 98). Ominously, job growth in the economy is highly correlated with occupier demand in the commercial sector; hence without the robust job growth seen in the first quarter of 2011 continuing, a recovery in the commercial real estate market will be harder to come by. That said, record corporate profits in the US point to increased hiring, with previous cycles indicating that high corporate profits lead to increased job creation.

Looking ahead, the Federal Reserve, at the close of a two-day policy meeting recently, acknowledged the slowdown in the economy, but said it should be temporary. Indeed, the decision to release 60 million barrels of oil from stockpiles held by industrialized oil-consuming nations, which brought oil prices down sharply, is aimed at easing the pressure on consumers and bolstering the recovery. That said, job claims for the period covering the upcoming employment report increased by 9,000 to 429,000, dampening market expectations of job growth in June.

“The CPPI declined to an all time low in May”



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Australian building activity weak but getting better

“Building approvals in April edged down”

An update on house building activity is available next week when the Australian Bureau of Statistics release building approvals for May on Monday 4th. Approvals in April edged down to 13,377, which is 11.4% below year ago levels and compares to the long run average of 13505.

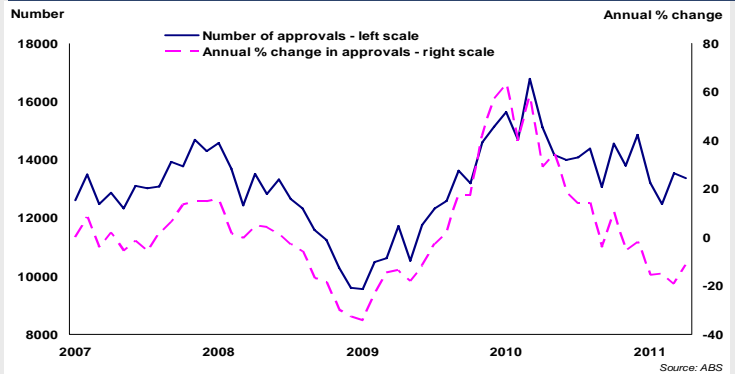
Notwithstanding this, the downward trend appears to be moderating; in the three months following the Queensland flooding, dwindling approvals fell at an average annual rate of 16.6%. This decline peaked in March when growth fell by 19.4%, the biggest fall since February 2009. However, it is worth noting that building approvals in the first half of 2010 picked up to near all time highs, owing to substantially lower borrowing costs and the prosperous performance of the domestic economy. The combination of flooding and base effects have weighed heavy on the rate of change, but as rebuilding activity picks up in the second half of the year, this trend may reverse. Indeed, bank lending to housing investors continues to increase and in April lending grew by 8.9% on a year ago.

One potential headwind for the market could be the resuming of the tightening cycle from the Reserve Bank of Australia, who are due to announce the latest cash rate decision on Tuesday 5th. In the June meeting, it was announced that the cash rate would be held at 4.75% for the eighth successive month, despite the hawkish tone suggested in the

minutes. Indeed, officials stated that further tightening will be required “at some point”, most likely after the release of the Q2 CPI figure, although developments in the euro area are being taken into consideration. CPI data for Q1 surprised on the upside, posting the highest rise in prices since 2008 Q4. Moreover, the RBA now forecast inflation 2 years ahead rising above target for the first time. As a result, RICS believe the RBA will resume rate hikes in August.

“..but as rebuilding activity picks up in the second half of the year, this trend may reverse”

Building approvals likely to edge up in H2 2011



UK construction sector to see a gradual recovery in workloads as year progresses

“The austerity package will have a significant impact on public sector construction”

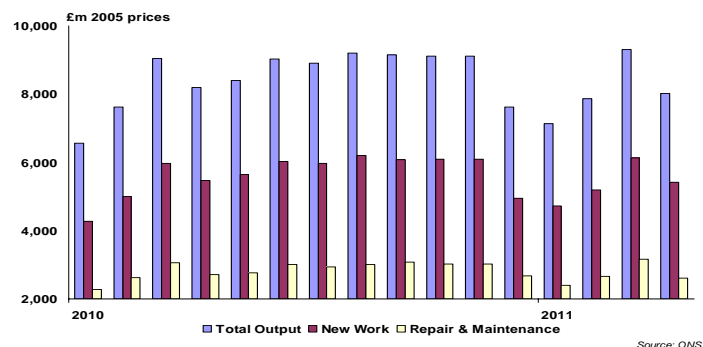
The current state of the UK construction sector will be back in focus next week with the release on Monday 4th of the June PMI report for the industry followed on Friday 8th by the official data for the month of May. A yawning chasm between the tone of recent measures of sentiment in the construction industry and the hard numbers compiled by the Office for National Statistics (ONS) led

the latter to hold an event for users of the data to demonstrate the robustness of its processes. However convincing the arguments, it is still striking that ONS figures remain quite so downbeat. As the chart

indicates, this appears to be the case for both new work and repairs and maintenance.

It is inevitable that the austerity package now being implemented by the government will have a significant impact on public sector construction. However, the latest RICS Construction Survey indicates that the private sector should be able to compensate for this loss; it suggests that workloads could actually edge upwards, albeit only modestly, over the next twelve months. That said, the on-going shortage of finance for development is likely to remain a drag on the magnitude of any recovery in the building industry. Indeed, the May lending figures from the British Bankers’ Association show another sharp fall in the total debt outstanding to the sector (£553m).

Official data suggests construction output remains flat



Aside from the attention focused on construction, Q1 numbers on housing equity withdrawal will also be published on Monday 4th by the Bank of England. They will indicate that homeowners are continuing to put equity back into property rather than withdrawing it as was the fashion in the run-up to the credit crunch. Finally on Thursday 7th, the Monetary Policy Committee (MPC) is set to leave interest rates on hold for another month. The likelihood of any tightening in policy has diminished in recent weeks and some comments from members of the MPC suggest that Adam Posen could at some point get company in his advocacy of further quantitative easing.

“But there are now some signs of a modest pick-up in private sector development”

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