

Indian Q1 GDP to show resilience in the face of recent interest rate hikes

“The real estate component of the BSE 100 index has fallen by more than 40% since early November”

The coming week sees the release of a number of important macro indicators in India. Most notably on Tuesday 31st, Q1 GDP will be published alongside April infrastructure output numbers. This will be followed on Wednesday 1st by the May PMI and the April trade numbers. The headline figure for economic growth will be most closely watched in the wake of the

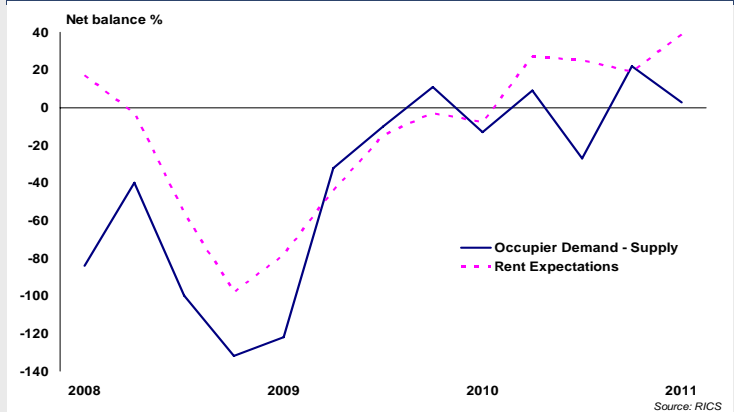
tightening in monetary policy that has been sanctioned over the past year; the repo rate has climbed from 4.75% last March to its current level of 7.25%. Our suspicion is that, in all probability, it will not be too far away from the 8.2% chalked up in the final three months of 2010. However, whether this pace of activity can be sustained through the course of this year and into 2012 is more open to question. Just under a month ago, the governor of the Reserve Bank of India (RBI) went as far as to suggest that “current elevated rates of inflation pose significant risks to future economic growth”. The tone of these comments has fuelled expectations that interest rates are likely to climb to at least 8% by the end of 2011.

The persistence of inflation well in excess of the RBI comfort zone of 5-5.5% and the impact this is having on the stance of monetary policy is clearly visible in the performance of financial assets with the Sensex index slipping from a high of just over 21,000 in early November to less than 18,000. Significantly the real estate component of the BSE 100 index is continuing to underperform, a trend that has been in place since the tail end of 2009; over the past seven months, it has dropped by more than 40%.

The Q1 RICS Global Commercial Property Survey continues, in contrast, to paint a rather more upbeat picture of sentiment in the real estate market. As the chart below shows, occupier demand is keeping pace with the increasing level of supply which is helping to support rising rental expectations; this is particularly marked in the office sector. The net balance reading for development starts also remains firm. Meanwhile, the report shows that capital values are projected to continue moving upwards on the back of firm investor appetite for stock.

“But the RICS Global Commercial Property Survey is continuing to indicate a more positive tone to sentiment”

Occupier demand continues to underpin rental expectations



Tougher policy beginning to slow Chinese economy

“The tougher policy environment is showing signs of slowing the property market”

A snapshot of business sentiment is available next week with the release of Chinese PMI data for May from HSBC/Markit on Wednesday 1st. The flash PMI, released on Monday 23rd, showed the index fell to a 10-month low of 51.1 in May, from April's final reading of 51.8 (where a reading above 50 indicates an expansion and one below shows a contraction). The softer tone to recent

newsflow provides food for thought to policy makers, who have recently drawn criticism about the aggressive tightening cycle undertaken.

Indeed, concerns about a ‘hard landing’ are being fuelled by the underwhelming raft of April data; industrial production slowed more than expected to 13.4%, while retail sales growth also moderated, suggesting that interest rate hikes are beginning to bite. Significantly, inflation scaled back to 5.3% from the near 3-year high of 5.4% seen in March, giving hope to the authorities who are aiming for it to average 4% through 2011. The tougher policy environment in China has also shown signs of slowing the effervescent property market. Tighter lending criteria, higher borrowing rates and an unprecedented property tax all helped to bring residential price growth down a touch, and the April reading showed annual growth now stands at 4.3% (down from the peak of 12.8% a year ago). Despite this, the commercial property sector is continuing to boom.

Price expectations continue to increase for retail space



The Q1 RICS Global Commercial Property Survey showed that property professionals in the region remain optimistic despite the best efforts of Beijing officials. The balance of respondents expecting rents to increase in Q2 rose to a survey high of +76, while values are also expected to increase next quarter, with the net balance standing at +79. In both instances, the retail and office sectors are the biggest drivers of this positive sentiment; capital value expectations for property in the retail sector improved to +100, indicating that all respondents think values will rise from the level recorded in the first quarter of the year.

“Despite this, the commercial sector is continuing to boom”



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H2 likely to be tough for Spanish property sector

“Risks to economic growth are shifting to downside”

The Spanish May manufacturing PMI survey is due Wednesday 1st with the services PMI on Friday 3rd. A reading of 50 marks the dividing line between expansion and contraction. The previous month's readings suggest, overall, a relatively flat growth picture but set against depressed levels of output. Indeed, the manufacturing number came in at 50.6 and the services reading was

50.4. But the official data shows industrial production and domestic demand still 30% and 10% below their respective peaks.

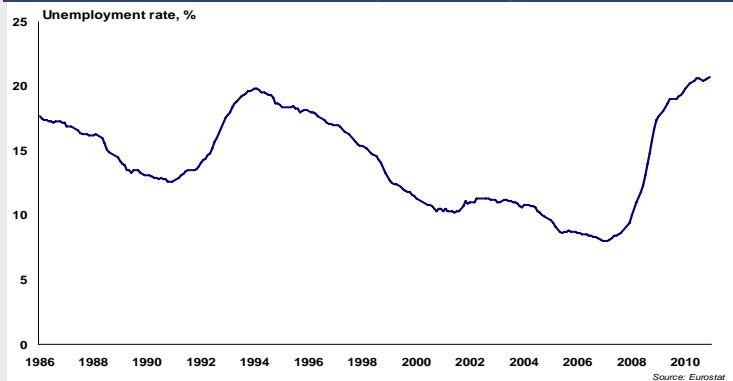
Although April's manufacturing PMI reading was nothing to write home about, the sector has nonetheless provided the main impetus behind growth in recent quarters, reflecting the strength of the external climate. However, this has yet to feed through to the industrial occupier market, which continues to weaken according to the latest RICS Global Commercial Property Survey. This is not altogether surprising given the current level of industrial output relative to its peak (mentioned above). In terms of the service sector, this continues to be weighed down by the sharp deterioration in the labour market, which has seen the unemployment rate surge from 8% in Q2 2007 to 21% presently. Unsurprisingly, a weaker labour market coupled with overbuilding in some regions has put downward on house prices; the Bank of Spain ask price index is currently 23% below its June 2007 peak, which is the lowest reading yet.

Looking forward, although the economy is likely to grow, such growth will be sluggish and the risks to the outlook are increasingly skewed

towards the downside. The ECB remains intent on tightening monetary policy (the main policy rate is 1.25%) and the government is determined to drive through its ambitious fiscal tightening plans (equivalent to a cumulative 5.3% of GDP from 2009-2012). Under these circumstances, and coupled with emerging fears that Spain could go the way of Portugal, it is difficult to envisage where the property sector (commercial or residential) will find support from.

“Difficult to see where property sector will find support from”

Spanish labour market is key to property market outlook



Canadian economy turning to business investment and trade as drivers of growth

“Bank of Canada unlikely to raise interest rates till later this year”

The coming week sees the release of GDP data for March and Q1 2011 on Monday 30th preceded by the Bank of Canada's (BoC) policy rate announcement the following day. GDP in February surprised on the downside, showing the economy contracting 0.2%. However, the dataflow suggests a solid rebound in March, with manufacturing sales up 1.9% on the month (4% quarter

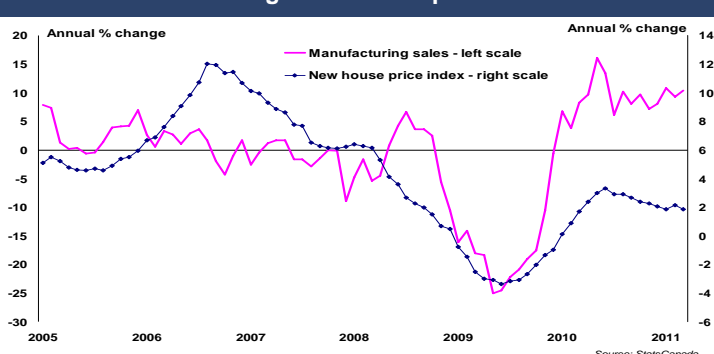
on quarter). Significantly, manufacturing shipments were up 19% when measured on an annualised quarter on quarter comparison (the largest rise since Q3 2009), pointing to a robust Q1 GDP figure.

Turning to the interest rate outlook, after March's shock rise of 1.1% in consumer prices, inflation in April remained unchanged (3.3% year on year). This will be welcome news to the BoC, as it has been reluctant to normalise interest rates too quickly. Indeed, the governor of the central bank reiterated last week that any reduction in monetary stimulus would need to be carefully considered. Although inflation is running above the BoC's target rate of 2%, this is mainly due to high energy and food prices, in addition to one-off factors such as rises in indirect taxes, with core CPI below the target rate (1.7%). Hence, we see a rate hike unlikely at the next meeting, and the overnight money rate (a good indicator of market expectations of interest rates) suggests nothing more than 25bp rise by year end.

The authorities have been keen to encourage a shift in the primary drivers of the recovery away from rising house values and consumer spending towards business investment and trade. There are encouraging signs, with exports rising 3.5% in March (14% on the year) and a recent survey of businesses showing that 66% are planning increased capital investment in the coming year. By contrast, the housing sector has slowed of late; new house price growth being flat in April, for only the second time since August 2010, and property sales declining 4% on the month. Indeed, tighter mortgage lending rules implemented in April this year will likely dampen price gains further in the coming months.

“New house prices remained flat in April”

Manufacturing sales rise to pre-crisis levels



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