

China's property market flying in face of 'cooling' measures

"The NBS PMI declined in June, but crucially remained above the dividing mark of 50"

Despite initial signs of a real slowdown in growth, Chinese GDP expanded by a robust 9.2% in Q2 to assuage some concerns that the world's second biggest economy may be heading for a 'hard landing'. Next week we get the first tentative signs of performance in Q3, as manufacturing PMI surveys are released on Monday 1st by the National Bureau of Statistics (NBS) and Markit/

HSBC. The HSBC flash PMI, released on July 21st showed the first reading below 50 in a year. However, we suspect that seasonal factors are the principal cause of this, as industrial activity tends to slow in the summer; the NBS PMI has typically shown declining readings during the summer months.

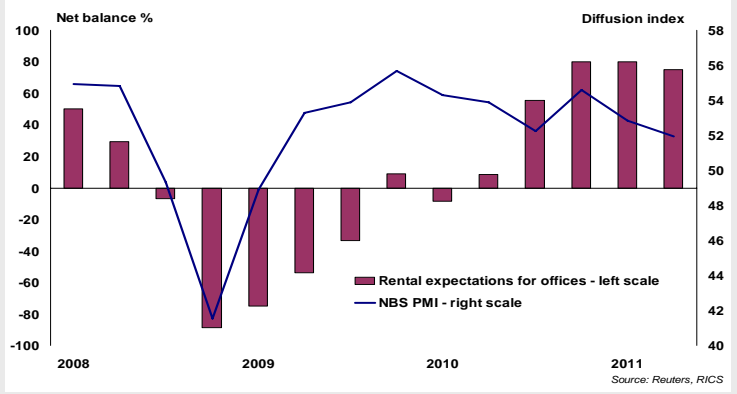
The semi-official NBS PMI declined to 50.9 in June from 52 in May, sinking to a 28 month low. Crucially, it remained above the expansion/contraction dividing mark of 50, albeit only just but the forthcoming reading is likely to follow the lead of the flash HSBC survey. In contrast to the generally softer tone of economic news flow, and despite prudent measures aimed specifically at cooling the economy, recent reports suggest the property market continues to perform strongly.

The RICS Global Commercial Property Survey for Q2 highlights the Chinese market as one where conditions are continuing to pick up at a greater rate than in Q1. At the all property level, occupier demand showed a pick-up from Q1, most notably for office and retail space, while rental expectations for Q3 were also buoyant; interestingly, a Q2 report by Cushman and Wakefield highlighting the Shanghai office

market showed similar results, even saying "rental rates will enjoy a continuous boom in the long term". Furthermore, the DTZ Q2 Chongqing report indicated rents were on the up. Respondents to the RICS survey indicated that demand from investors also improved over the quarter, with the office sector once again proving to be a particularly appealing investment. Capital value expectations are also forecast to continue rising into the second half of 2011, again most prominently in the office and retail sector.

"In contrast, the property market continues to perform strongly"

Office rents are expected to continue rising



Australian house prices to rebound as interest rates remain on hold for now

"The rebuilding in Queensland should be reflected in an increase in building approvals"

Tuesday 2nd will see a number of interesting data releases in Australia, most notably building approvals for June and the Q2 house price index, as well as the latest meeting of the central bank. The building approvals figure effectively measures the number of new dwelling units that have been given the go-ahead over the month; the recent picture has been quite disappointing

with the Australian Bureau of Statistics estimating that the underlying trend has been declining for the past seven months. One factor contributing to this, as we have noted in the past, was the flooding in

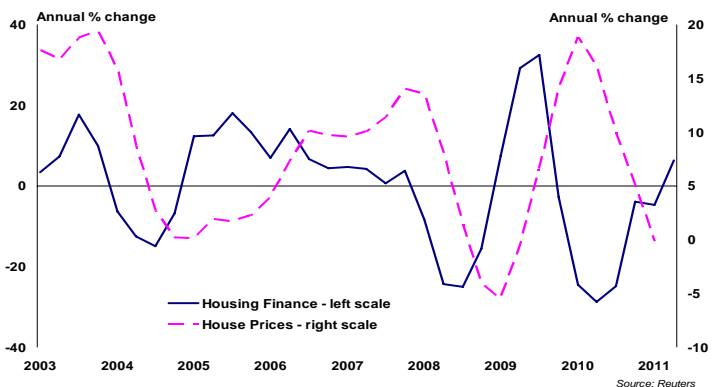
Queensland; as the rebuilding process gets under way, this should be reflected in an increase in building approvals.

Meanwhile, it is quite conceivable that the drop in house prices recorded in the first three months of the year will be at least partially reversed in the official data release for the second quarter. Significantly, the housing finance numbers rebounded strongly during the spring which in parts reflects the generally firm employment picture and the more stable trend in the cost of mortgage finance. It is also noteworthy that a significant contribution to the negative first quarter figure was the understandably weak reading from Brisbane.

Turning to the interest rate decision, the Reserve Bank of Australia (RBA) is likely to be particularly concerned by the latest inflation data. Both the headline and core measures rose by 0.9% on the quarter; the annual increase in the former now stands at 3.6%, comfortably above the 2-3% target band. Despite this, the likelihood is that the RBA will hold fire for the time being. The minutes of the last policy making meeting highlighted the importance of overseas developments in influencing the recent actions of the central bank and those same issues are likely to prove most persuasive in the forthcoming discussions. The RBA may also point to the importance of food and energy prices in driving inflation higher in the second quarter. Nevertheless, it is hard not to conclude that monetary policy will be tightened again at some point during the second half of the year unless the inflation picture begins to soften.

"Monetary policy will be tightened at some point during the second half of the year"

A pick-up in housing finance points to a rebound in prices



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Real estate in Germany and France remain firm despite weaker business sentiment

“Latest set of euro area PMI reports are proving disappointing”

A raft of business sentiment data is due for release in the euro area over the coming week alongside the latest deliberations of the European Central Bank (ECB). Germany and France both release flash estimates of their PMI surveys at the back end of the relevant month; the July numbers were very disappointing suggesting that confidence in even the core economies of Europe is

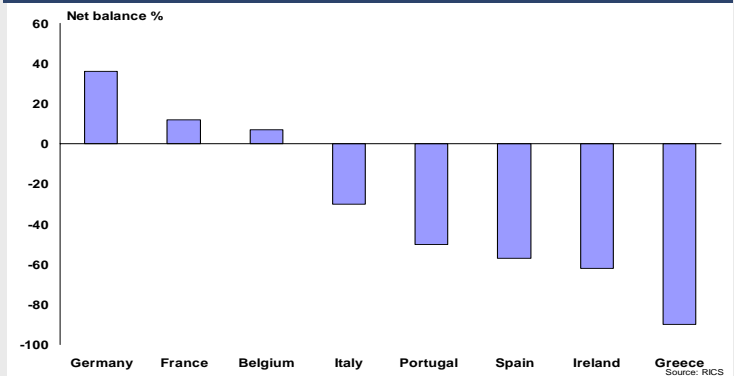
now beginning to flounder in the face of the financial turmoil surrounding the sovereign debt crisis. Final data for Germany and France as well as numbers for Italy and Spain will be published on Monday 1st (for manufacturing) and Wednesday 3rd (for services). Most interest will be centred on Italy as the June reports were already indicating that the economy could be contracting. The likelihood is that this will be confirmed by the forthcoming results.

That said, the recently agreed Greek bailout provides some encouragement that the faltering trend in economic activity, at least in the major European economies, will only prove a temporary hiccup. Indeed, the results from the Q2 RICS Global Commercial Property Survey suggests that the occupier market for real estate remains reasonably firm in both Germany and France; rent expectations are still in positive territory implying more respondents to the survey are anticipating further increases rather than declines on the back of solid demand to take-up space. By way of contrast, rents are projected to fall further in Italy and Spain as well as, predictably enough, Portugal, Ireland and Greece.

Having raised interest rates at the July meeting, August was always going to provide the ECB with the opportunity to contemplate the macro environment and ultimately do nothing more than sit on its collective hands. The gloomy tone to the flash PMI surveys will have merely served to strengthen this position. Indeed, it is quite conceivable that, unless there is a speedy rebound in the headline sentiment data for what may be loosely termed ‘core Europe’, the prospect of further rounds of monetary tightening during the second half of the year will continue to recede.

“But commercial rents are expected to continue rising in Germany and France”

RICS Global Commercial Property Survey - Rent Expectations



US construction sector still a drag on the recovery

“Construction spending in May fell 7% from year ago levels”

The coming week sees the release of construction spending (June) on Monday 1st. Total construction spending continued to fall in May, down 0.5% on the month; this is the sixth consecutive monthly decline, bringing the headline number to a decade low. Construction output now stands 7% below year ago levels (\$753 billion), with the current

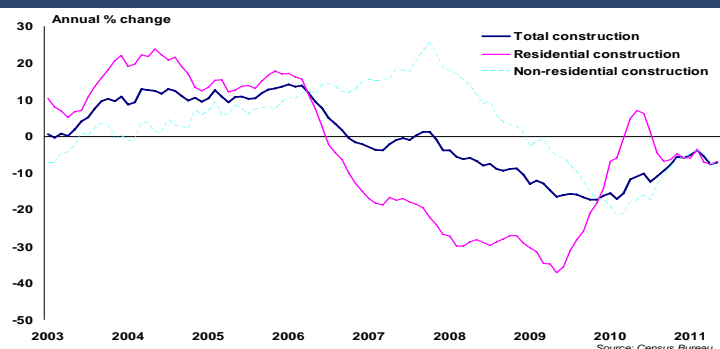
‘soft patch’ in the recovery weakening an already fragile sector. Residential construction has fallen 65% from its pre-recession peak, underlying the massive over-build in some parts of the country leading up to the downturn and the subsequent supply overhang in the sector.

Indeed, latest data from the Census Bureau showed that the gross vacancy rate increased in Q1 2011 to 14.4%, up from 14.1% in the previous quarter. To get an estimate of the excess housing in the market we estimate the equilibrium level of vacancies which we take to be the average rate between 1991-2001 (11%), we subtract household formation plus replacing old housing stock (around 1 million per year) from the total number of vacant homes above the equilibrium level (3%). This implies that the total excess inventory is currently around 3.4 million homes, a significant overhang in housing stock. Keeping constant the rate of housing starts and household formation, it would typically take 5 years to clear this backlog.

That said, stronger job growth could accelerate this process by increasing household formation. Employment numbers for July are coming out next Friday, and on the back of dismal job growth in June, we are looking for some sign of increased growth in the second half of 2011. On the upside, ISM manufacturing rose after 4 months of decline in June, and although non-manufacturing ISM dipped slightly, the employment component stayed unchanged at 60, this would be consistent with stronger hiring as the year wears on. Resolving the debt ceiling issue in the coming week should also provide some support for confidence in the economy.

“Housing overhang will take years to clear”

Construction spending continues to fall



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