

Euro crisis heightens challenge for real estate sector

“Debt funding gap has increased in Europe”

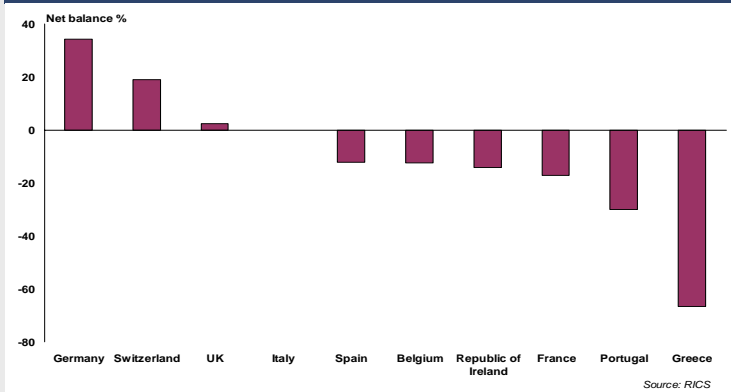
The euro crisis continues to deepen as doubts grow over the ability of the European Financial Stability Facility (EFSF) to leverage up sufficiently to meet the potential refinancing needs of the countries most in the firing line. This week, the EFSF struggled to attract demand for a Euro 3bn offering paying 1.8% over the cost of German debt; its first deal in June resulted in a spread of just 0.5%. Meanwhile, concerns in the real estate space are turning to the impact of write downs on banks balance sheets. Recent analysis from DTZ estimates that the global debt funding gap has been reduced by around one quarter over the last six months. However, within Europe it has actually increased with the UK, Spain and Ireland all seeing a worsening picture. By way of contrast, the funding gap has pretty much evaporated in North America.

DTZ estimate that equity finance has the potential to cover no more than one-third of the shortfall in funding in Europe. However the ongoing uncertainty about the future of the euro and the related economic consequences of this perilous state of affairs suggests that even this may prove a challenge. The Q3 RICS Global Commercial Property Survey provides some justification for such a grim assessment by painting a generally downbeat picture of the emerging trend in investment transactions across Europe. Expectations either turned negative or were broadly flat in all countries monitored with the notable exception of Germany and Switzerland. And of course, the news flow has deteriorated since the survey was completed at the end of September.

Last week we noted that prime real estate, particularly in the larger European markets is a potential beneficiary of safe haven flows and defensive property investment strategies. The performance of such prime assets could also be bolstered by the reduction in new commercial development given current elevated levels of uncertainty combined with a likely tightening in credit conditions across the region. The latter point is something that was highlighted in the latest ECB bank lending survey.

“RICS survey points to flatter investment picture across much of Europe”

Expected investment demand in Europe



Brazil loosening monetary policy in face of global slowdown

“Brazilian central bank likely to continue cutting interest rates”

A few months ago, the Banco Central do Brazil (BCB) unexpectedly cut base rates and began a more accommodating phase of monetary policy. This was seen as a bold move by many, especially in the face of rising and above target inflation at the time. The main reasons given by the monetary policy committee (COPOM) were the weakening domestic and external

markets. The BCB cut rates by a further 50bp (to 11.5%) in October, and now with the latest macro data numbers showing a major slowdown domestically, and the eurozone crises not yet resolved, the

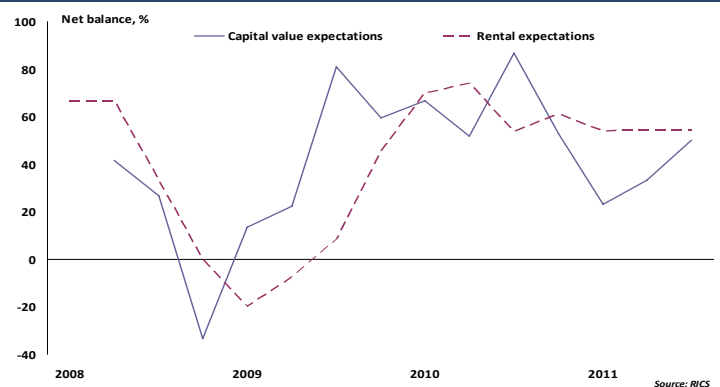
central bank will see their loosening of monetary policy as justified. Indeed, industrial production fell 2% in September; the largest monthly fall since April. Additionally, the central bank will view favourably the fact that real wages declined in September by 2%, reducing the upward pressure the tight labour market has had on inflation, which is currently running at 7.3%, above the central bank's target of 4.5%.

The 100bp cuts in interest rates since August will support already strong investment demand in the commercial property sector. Indeed, the Q3 2011 RICS Global Commercial Property Survey showed investment demand increasing in Q3 and investment expectations positive for the next quarter. Brazilian respondents were very upbeat about rental and capital value growth in the coming quarter. On the occupier side, demand while still positive in Q3, increased at a slower pace than the previous quarter and availability of property increased for the first time in two years.

Looking ahead, the markets have priced in a 60% chance of further cuts at the COPOM meeting at the start of December. Weakening global growth remains a major concern for Brazilian policy makers, with the Finance Minister stating that the government is ready to implement new tools to prevent a global crisis impacting the domestic outlook. Indeed, the government is considering reversing some of the earlier restrictions put in place on bank lending and taxes on stock trading to protect the economy from a potential seizure of global credit markets.

“Investment demand for commercial property is strong in Brazil”

Bright outlook for commercial property



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Q3 GDP should confirm Japanese recovery

“Output is likely to rebound following the dour growth seen in the first half of the year”

The first estimate of Q3 GDP is released on Monday 14th and is likely to show a rebound following the dour growth numbers seen in the first six months of the year. Demand in the third quarter has been generated domestically by a combination of improving consumer confidence, rising housing investment and the continuing reconstruction effort following the earthquake in March. More

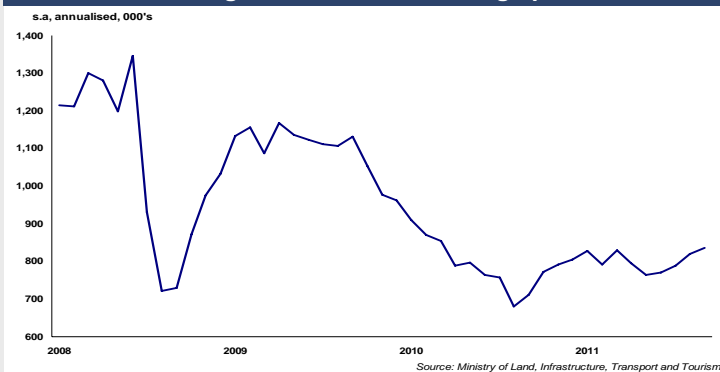
recently, business surveys for the manufacturing sector showed an uptick in sentiment; the PMI rose modestly to 50.6 from 49.3 in September. However, recent developments in Europe and the volatility in global financial markets seen in August are likely to mean growth is lower than we previously forecast.

Released the same day are the latest industrial production (IP) figures for September, and on Thursday 17th construction spending numbers are published for the same period. Industrial activity has improved moderately since March, rising steadily month on month. Production in the first two months of the quarter was 7.7% better than the first two months of Q2 and, while the first estimate of September IP shows a monthly decline, it still suggests a smart rebound in GDP. Construction orders collapsed in April, but have crept up as rebuilding has taken place in the disaster stricken regions. A 25% fall in orders in the second three months of the year was reversed by a 32% rise in the three months to September. Investment into the property sector has also picked up as a result of growing demand for restoring the damaged/destroyed stock increased.

Indeed, year on year housing starts increased for 5 straight months to September, before falling 10.8%. However, the September fall was mainly in reaction to the sharp increase in July and August, which was due to last minute demand ahead of the expiration of the housing Eco-points scheme (government initiative to incentivise the building of eco friendly dwellings). For the whole of the third quarter, starts improved 13%, following the 5.6% gain in Q2 and we expect them to continue rising in the near term.

“Investment into the property sector has also picked up”

Housing starts are now trending upwards



European construction recovery likely to run out of steam

“Construction output data has risen in 4 of the last 5 months”

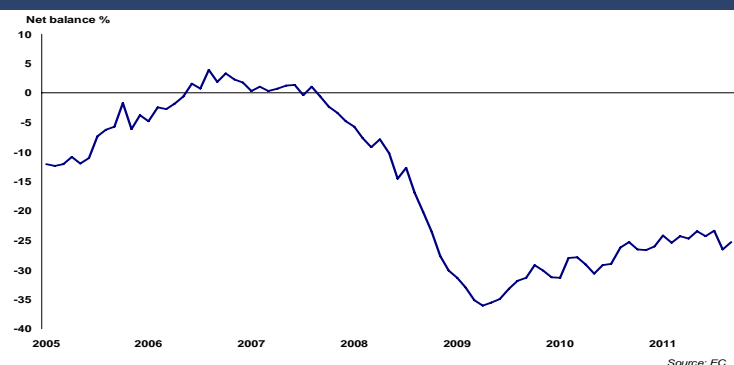
Construction output data for September in the euro area is released on Thursday 17th. The August numbers recorded a small gain and it has now risen in four of the last five months. As a result, construction output is currently running around 2% above its level of a year ago. Predictably, there is considerable variation in performance at a country level with arguably the most

interesting developments emerging in Germany which from a macro perspective has until now been an area of relative strength. Although by its nature a volatile series, construction output in Germany is according to the latest data almost 5% down on its March level with the annual gain

slipping over the same period from 15.4% to 5.2%.

Meanwhile the monthly business sentiment survey compiled by the European Commission suggests that if anything there has been deterioration in confidence in the sector across the euro area over the past few months which is not altogether surprising given the grim run of news. The main factor inhibiting output is subdued demand with orders books weak and little prospect of a turnaround in the employment picture. At a country level, the German readings (confidence -9) while worse than they were previously are still holding up better than those across much of the rest of euro area; this is broadly consistent with the hard data. The contrast to Germany is provided by Spain which recorded a less negative confidence indicator in October but that was still a net balance of -49.

EC construction confidence indicator set to head lower



The worsening economic picture has already prompted the new ECB president, Mario Draghi, to cut interest rates at his first meeting at the helm and our suspicion is that a further reduction is likely to be sanctioned in December. However, this is only likely to provide a measure of support for activity in the face of the widespread fiscal austerity programme. As a result, it will in all probability be insufficient to prevent the euro area slipping back into recession. This is likely to increase the pressure on the construction sector, in the process reversing the tentative signs of recovery in the official data.

“A further cut in interest rates is likely to be sanctioned in December”

RICS UK T +44 (0) 20 7695 1682 pressoffice@rics.org	RICS Europe T +32 2 733 1019 ricseurope@rics.org	RICS Americas T +1 212 847 7400 ricsamericas@rics.org	RICS Oceania T +61 2 92162333 ricsoceania@rics.org	RICS India T +91 124 459 5400 ricsindia@rics.org	RICS Middle East T +971 4 375 3074 ricsmiddleeast@rics.org	RICS Asia T +852 2537 7117 ricsasia@rics.org
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