



## Solid euro area growth supports favourable backdrop for commercial property

- Euro area economy to expand by 2% in both 2017 and 2018
- Interest rates unlikely to rise before 2019 although bond purchases could be tapered after December
- Strong commercial property investment set to drive capital value growth of 5% in the euro area this year

### Introduction

Amidst the drama of recent political events, it is perhaps unsurprising that the strengthening of the euro area's economic recovery has partly slipped under the radar. But, having lagged most advanced economies significantly throughout much of the post-financial crisis era, growth does appear to have gathered solid momentum over the last two years. The positive tone to the economic data has been accompanied by a smart improvement in confidence across the commercial real estate sector, a point evidenced through the findings of the RICS Global Commercial Property Monitor. Indeed, since 2015, European markets have consistently returned some of the most positive results worldwide, leading the way on both occupier and investment sentiment.

Notwithstanding this, the recovery across the single currency area still has plenty of catching up to do. For one, the overall size of the economy is only 3% larger than it was in 2008. Although, on the same basis, this is broadly similar to Japan, it is significantly below 14% expansion in Canada, 12% in the US, and 8% in the UK. In addition, the rate of unemployment has only fallen below 10% during the last twelve months, compared to a pre-crisis rate of 7.3%. Meanwhile, unemployment remains significantly higher in some member states (18% in Spain and 23% in Greece), with youth unemployment still a major concern in some parts. By way of contrast, the rate of unemployment across the three largest G7 economies - excluding euro area nations - is sub 5% and below that found in 2008.

Nevertheless, recent improvements appear to be built on increasingly stable foundations, boding well for growth over the next two years. What's more, survey data points to an acceleration in near term economic growth, which is already running above trend. At present, the ECB remains committed to conducting €60bn worth of bond purchases per month until December 2017 at the earliest. Given the recent upswing however, debate surrounding the appropriate course for monetary policy thereafter is becoming more finely balanced.

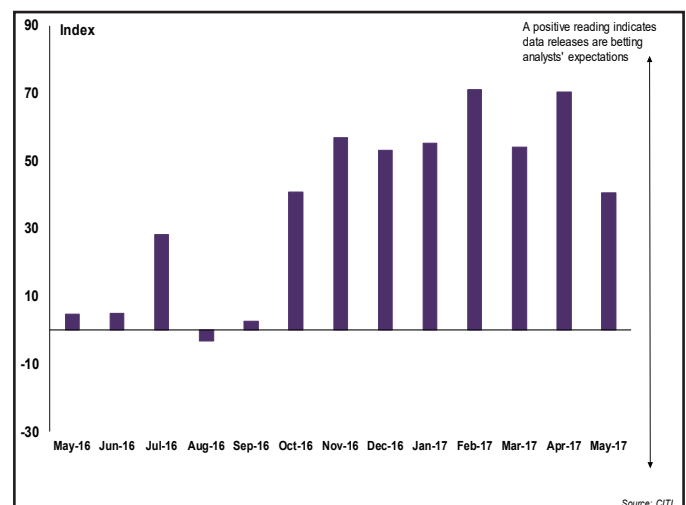
### Macroeconomic overview

Economic developments across the Eurozone have, by and large, surprised to the upside over the past two years. This has brought welcome news to an economy hit by a double dip recession during a troublesome period between 2008 and 2014 in which GDP contracted in twelve separate quarters.

Last year, euro area GDP increased at an annual rate of 1.7%, as growth outpaced the US for the first time since 2008 in the process. This momentum has been carried through into the early part of 2017, with the economy expanding by 0.6% during Q1. Furthermore, survey evidence is consistent with growth accelerating in Q2.

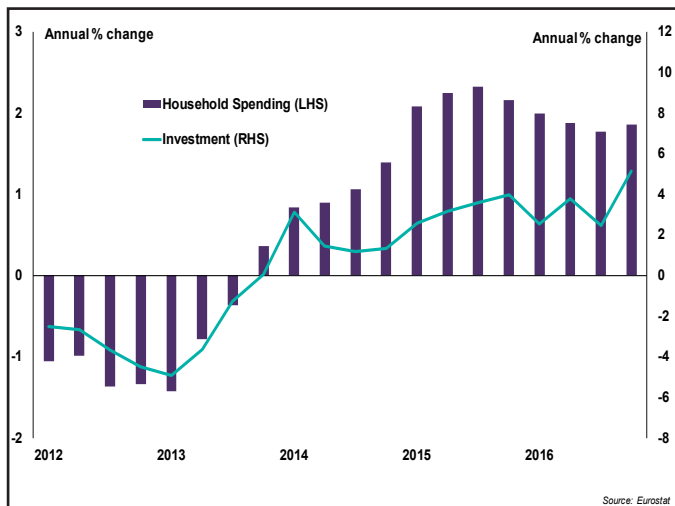
Consensus forecasts had anticipated a noticeable slowdown in the euro area economy through the end of 2016 and into this year, owing much to political uncertainty emanating from Brexit as well as elections in the Netherlands and France. This failed to materialise. Instead, downbeat projections turned out to be well wide of the mark, leading the euro area CITI Surprise Index (which measures variations between expectations for high frequency economic data and the actual outcomes) to exceed +40 in every single month since October last year (chart 1). This better-than-expected performance has since prompted upward revisions to growth forecasts from commentators and policymakers. However, in order to determine how justifiable these stronger projections are, it is important to assess the sustainability of the drivers behind the current pick-up.

Chart 1: Euro area CITI Surprise Index



Momentum behind the upturn really started to build in 2015, powered by a strengthening in domestic demand. Indeed, both household expenditure and investment have posted healthy gains in each quarter since then (chart 2). Alongside this, the positive contribution from net trade has actually diminished recently, with imports rising faster than exports in each of the last four quarters.

**Chart 2: Euro area investment and household spending**



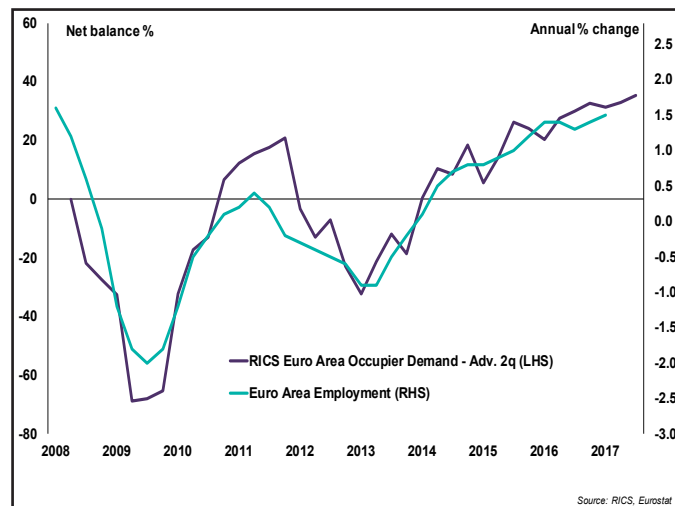
In part, the pick-up in consumer spending can be linked to the low inflationary environment over the past two years. With prices either falling or rising only marginally over much of this period, real (inflation adjusted) incomes rose by an average 2.7% and 2.5% year over year in 2015 and 2016, respectively. To put this into context, real income growth averaged 1.8% annually in the decade running up to the financial crisis, even though nominal growth averaged 3.8%.

Even though the tailwind from low inflation looks set to fade going forward, favourable developments within the labour market should continue to support consumption growth. Indeed, while still elevated relative to pre-crisis trends, the rate of unemployment has fallen from 10.2% to 9.3% over the past twelve months, with the pace of improvement gathering some speed recently.

Furthermore, the strength of the RICS Euro Area Occupier Demand indicator over the past few quarters is consistent with employment growth gaining momentum through 2017. Chart 3 plots the RICS series alongside the annual growth rate in total employment across the euro area. As occupier demand captures firms' interest to acquire new space before recruiting additional employees, this indicator has tended to lead employment figures by around 2 quarters. The resulting chart is signalling employment growth could accelerate from 1.5% currently to something approaching the 2% mark through the first half of 2017.

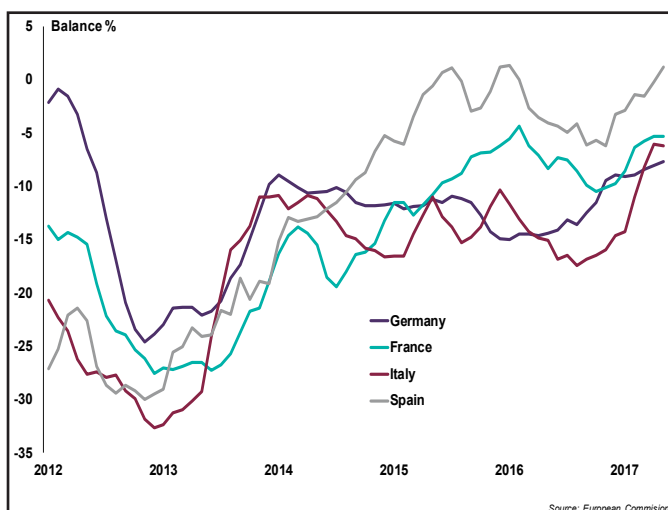
Aside from boosting aggregate income across the economy, greater levels of employment should further support consumer confidence, another key driver of household spending. In fact, consumer confidence (as captured by the European Commission's survey) is now more elevated than at any point over the past ten years. Going forward, the degree of slack still present in the labour market suggests there is ample room for employment to rise before the economy reaches full capacity. Consumption growth is therefore likely to remain strong over the next couple of years, despite the less advantageous inflationary environment.

**Chart 3: Euro area RICS Occupier Demand and employment growth**



Alongside solid domestic demand, recent months have seen something of a revival in global trade. On a year over year basis, growth in world trade volumes accelerated to 5.6% during March, the fastest rate of increase since 2011. Being a large net exporter of goods and services, a sustained pick-up in global growth should benefit the euro area as a whole. In particular, Germany, Europe's largest economy, should gain significantly from an upswing in world trade. Indeed, Germany's manufacturing sector accounts for 23% of overall output across the economy (which compares with 12% for the US and only 10% in the UK) while the country recorded a trade surplus of €253bn in 2016. In keeping with the improving external environment, monthly assessments of export order books have strengthened significantly since the end of 2016. Furthermore, each of the four largest euro area economies has seen an improvement (chart 4).

**Chart 4: Monthly assessment of export order books**



Corroborating the upbeat prospects for near term growth, the IFO business climate index (a widely followed early indicator of economic developments) has hit a record high in Germany, dating back to 1991. Meanwhile, the equivalent gauge covering the euro area as a whole reached its highest level since 2007.

**Monetary Policy**

Against a backdrop of accelerating growth, the upgrading of forecasts, and headline inflation moving nearer to the ECB’s target of ‘close to but below 2%’, attention has now turned to the appropriate path for monetary policy normalisation.

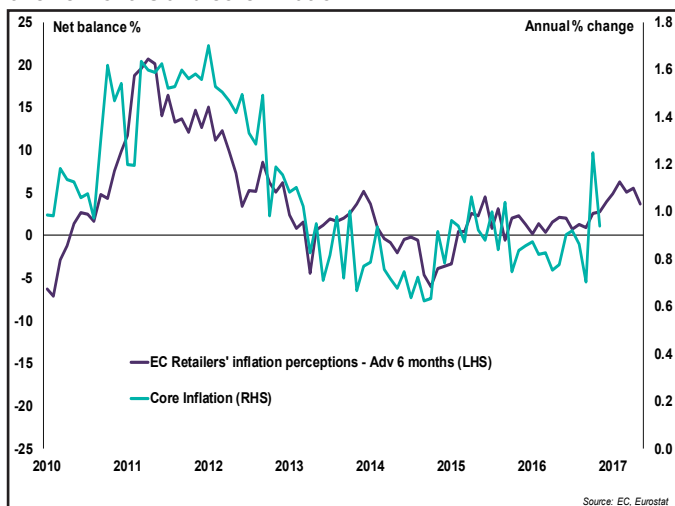
Up until recently, the central bank had maintained a strong bias towards easing in order to stave off the threat of deflation. However, this risk has now, in the words of ECB president Mario Draghi, ‘virtually disappeared’. Following the Governing Council’s July meeting, the Bank altered its forward guidance to state that interest rates are now expected “to remain at present levels for an extended period”, rather than “at present levels or lower”.

Even though a potential further rate cut no longer looks necessary in the current climate, the statement is clear that policy tightening is not imminent. The ECB will be all too aware of the dangers of hiking rates prematurely. Indeed, with a healthy recovery seemingly underway in 2011, the main policy rate was increased in both April and July, only for the Bank to reverse course just four months later. This marked the start of an easing cycle that would eventually see the refinancing rate fall from 1.5% to zero, the deposit rate moved into negative territory (-0.4%), as well as the introduction of a quantitative easing programme now set to exceed €2.4trillion. This programme will run until the end of December 2017 at the earliest, or beyond, if required.

Given their error in tightening too early back in 2011, the Bank will want to wait for concrete evidence of a sustained rise in inflation. On this front, the headline rate currently stands at 1.4% for the Eurozone in aggregate. Earlier in the year, inflation reached 2% before falling back recently. The temporary rise in the headline rate can largely be attributed to higher energy prices and distortions created by the timing of Easter this year. There was also a brief spike in core inflation (which excludes some of these more volatile components), but this has since fallen back below 1%.

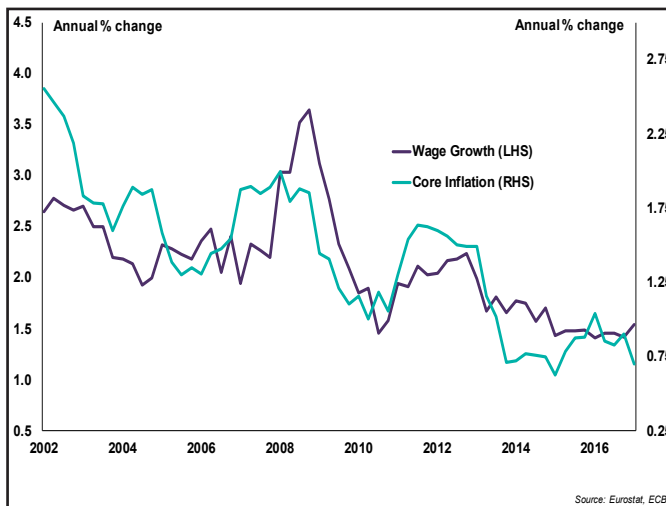
Looking ahead, it appears unlikely that core inflation will rise sharply from here. Indeed, data from the European Commission’s survey of retailers’ signals only a modest pick-up in the near term, and suggests core inflation will still be close to 1% in six months time (chart 5). Furthermore, the members of the Governing Council are yet to be convinced that underlying inflationary pressure are on a sustained upward path. The ECB’s latest forecasts project headline inflation to average 1.5% this year, but to soften to 1.3% next year before rising to 1.6% in 2019. Market based inflation expectations are lower still, pointing to inflation of just over 1% in 2019.

**Chart 5: Euro area Retailer’s inflation perceptions for the next twelve months and core inflation**



The main factor keeping a lid on price pressures appears to be subdued wage growth (chart 6). Within the labour market, there remains considerable slack and underutilisation of resources, and this will continue to weigh on the prospects for wages going forward. Given the still benign inflation outlook, the ECB has stated an exit strategy (from the various policy instruments currently in place) has not been discussed at this point.

**Chart 6: Euro area wage growth and core inflation**



Nevertheless, the quantitative easing programme that has been running since 2015 is scheduled to end in December. It is widely anticipated that rather than stopping asset purchases all at once, the pace will be reduced (tapered) beforehand. If the pace of asset purchases were to be tapered by €10bn a month from December, this would mean an end to quantitative easing during the middle of 2018. However, the ECB may refrain from announcing a predetermined rate of tapering to enable extra flexibility in case economic conditions warrant a change in approach. This was the stance taken by the US Federal reserve when concluding its QE programme in 2014. It is important to emphasise that tapering QE does not amount to a tightening in monetary policy, rather, it means policy is being loosened at a slower rate.

For this reason, the Bank has also made it clear that rates will not rise until quantitative easing has concluded. To loosen policy via one mechanism at the same time as tightening via another channel would be a counter-intuitive. The results of the Q2 2017 ECB survey of professional forecasters show the mean assumption is for the main policy rate to remain around 0% until the end of 2018, before increasing to 0.3% in 2019.

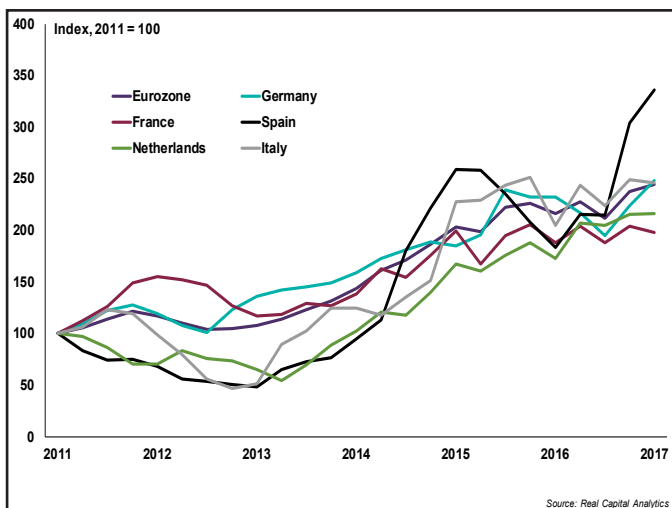
Consequently, monetary policy looks set to remain extremely accommodative for the foreseeable future. In such an environment, yields on government bonds are set to stay low, prompting investors to search for higher yielding assets. This should provide a still favourable backdrop for the commercial real estate market going forward, following an already sustained period of strong performance within the sector.

**Commercial Property Market**

Sentiment across European commercial real estate markets began to show noticeable improvement towards the tail end of 2013, perhaps slightly preceding the strengthening in the broader economic recovery. Indeed, the RICS euro area Investment Sentiment Index (a composite indicator capturing overall momentum behind the investment market) has been in positive territory since Q4 2013. Furthermore, the run of firmer readings over the past three years is consistent with significant impetus building across the sector.

Disaggregating the data shows the timing of the recovery has not been uniform across all member states. Indeed, according to figures produced by Real Capital Analytics, investment volumes in Germany began to pick-up near the back end of 2012 and have been rising consistently ever since. Across the next four largest markets (France, Spain, the Netherlands and Italy) the recovery took a little longer to emerge but, in each instance, investment activity has increased significantly over the past three years (chart 7).

**Chart 7: Commercial Property Investment Volumes**

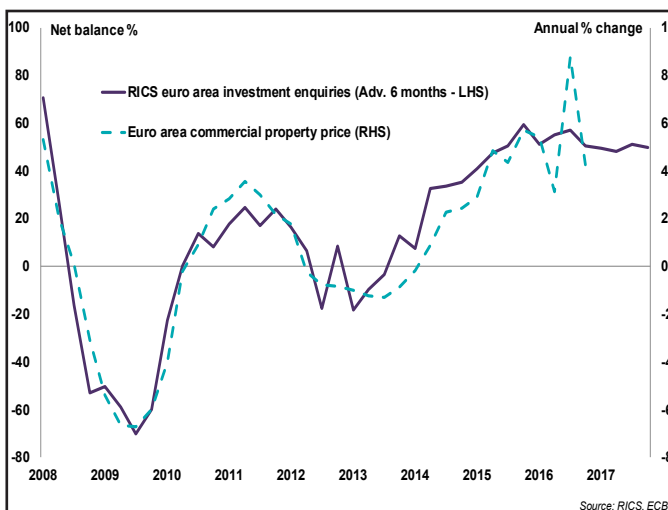


Moreover, solid activity has continued into 2017. During the first quarter of this year, commercial property investment inflows across the Eurozone as a whole (when taken as a twelve month rolling total) have now exceeded those found prior to the financial crisis. In Q1, investment volumes were the strongest seen within the German market for an opening three months of the year on record. Meanwhile, Spain has seen volumes surge 66% over the past year. Interestingly, 2016 saw the Germany overtake the UK to become Europe's most investment market, with the lead increasing in the latest period. This is reflective of both the strength of the market in Germany as well as the 44% dip in investment volumes within the UK over the past twelve months (RCA data).

Driven by the strength of demand, all-property capital values across the euro area have risen 12% since 2014 and are now 6% above their pre-crisis peak (ECB data). Going forward, the latest European results from the RICS Global Commercial Property Monitor (GCPM) are consistent with further material gains in capital values through 2017.

Indeed, this is illustrated in chart 8, which maps the RICS Euro Area Investment Enquiries series alongside the annual growth rate in commercial real estate prices. The sentiment data taken from the survey has provided a strong guide to upcoming changes in capital values in the past, clearly demonstrated when advancing the series forward by two quarters. Consequently, the latest investment enquiries net

**Chart 8: RICS euro area investment enquiries and ECB indicator on commercial property prices**

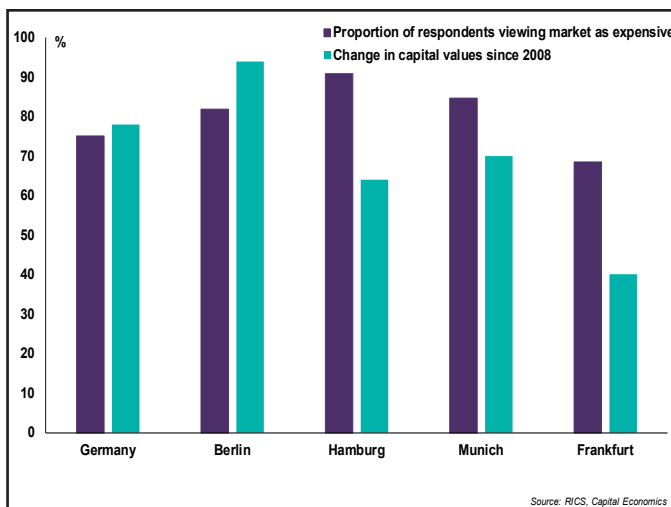


balance of +50% points to capital values posting annual gains of around 5% through the first three quarters of this year.

At a country level, Spain, Ireland and Germany exhibit the firmest twelve month capital value expectations (relative to all other euro area nations tracked by the RICS Monitor), with a net balance in excess of 60% of respondents anticipating capital values will be higher in a year's time.

That said, perceptions on valuations differ considerably in Germany compared to those in Spain and Ireland. Across Germany, a significant 76% of respondents sense valuations are becoming stretched relative to fundamentals. Furthermore, 65% of contributors feel conditions are reaching a peak, with the proportion taking this view even higher in Hamburg and Berlin, but fractionally less in Frankfurt. These perceptions may be explained by the trends seen in capital values since the global financial crisis. For instance, capital values across Germany as a whole are now 78% higher than prior to the onset of the crisis. Prices in Berlin are now 94% higher on the same basis, with the increase at standing at 64% in Hamburg and 40% in Frankfurt (shown in chart 9 below).

**Chart 9: Valuation perceptions across Germany and capital values relative to pre-crisis**



Nevertheless, over the year ahead, capital values are still expected to rise firmly across Germany. Looking further out, given some of the concern over valuations in the market at present, the performance of rents will have critical significance. From the results of the GCPM, rental growth prospects do appear solid, with the pace of increase anticipated to accelerate at the three year horizon, to broadly match that of capital values.

At the other end of the scale, 81% and 77% of contributors in Spain and Ireland respectively sense prices in the commercial property market are either at or below fair value currently. Despite significant gains in recent years, capital values are 5% below pre-crisis levels in Spain and some 36% lower in Ireland (Capital Economics).

Meanwhile, the vast majority of respondents in Dublin (67%) and Madrid (62%) feel market conditions are consistent with the middle stages of an upturn, suggesting growth has further to run. Alongside this, Spanish occupier market dynamics appear to be seeing the fastest rate of improvement across the euro area. In fact, the RICS Occupier Sentiment Index (OSI) climbed to +53 during Q1 in Spain, indicative of the strongest quarterly momentum since the survey was established in 2008. In terms of the Eurozone aggregate indicator, the OSI reading of +35 in Q1 was also the firmest since the survey's formation, with near term rental expectations positive to a greater or lesser degree across all markets.

Over the next three years, all-sector rents are projected to increase by around 3% per annum across the euro area. Within this, Madrid, Dublin and Berlin display the firmest expectations. Italy and France appear to be laggards, where only modest growth is anticipated. The more subdued rental outlook in these two markets is not entirely surprising given the pace of job creation has been somewhat softer than the average across the bloc over the past year. Recent trends have been more encouraging however and the brightening macro backdrop in Italy and France should boost occupier demand, lifting rental growth prospects further out.

Overall then, the euro area commercial real estate market should continue to deliver solid returns over the next couple of years. Both rents and capital values look set to rise at a firm pace through the remainder of 2017, with expectations further out also pointing to decent growth. In markets where concerns over valuations are present i.e. Germany, the outlook for rents will be all the more crucial in driving growth in investor activity beyond this year.



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