# Sick men of Europe turn to outperformers of the euro area recovery

- Spain and Ireland now lead the euro area economic recovery, while Portugal makes steady progress
- Commercial real estate set to deliver strong returns with further growth in capital values and rents
- Portuguese housing market stages a turnaround with activity consistently improving

## Introduction

Previously dubbed the “sick men of Europe”, the three economies of Spain, Portugal and Ireland have seen a marked turnaround in fortunes of late. Following an extended period of adjustment, the economic progress made in these nations has become a bright spot in the comparably weak overall euro area recovery, with the relative outperformance fuelling a revival in their real estate markets. With the help of data gathered in the RICS Global Commercial Property Monitor and RICS/Ci Portuguese Housing Market Survey, this report explores the recent improvement in conditions and what lies ahead for these markets.

## Severe impact of the global financial crisis

Amongst the worst affected worldwide by the global financial crisis and the ensuing Euro sovereign debt crisis, the economies of Portugal, Spain and Ireland were plunged into deep, lengthy and damaging recessions. From peak to trough, GDP fell to the tune of nearly 10% across all three nations, albeit the low point was hit much sooner in Ireland (chart 1). This drop in output was accompanied by a steep rise in the rate of unemployment, with the sharpest increase experienced in Spain (9.6% to 27%), while the uptick in joblessness was also considerable in Portugal (8.6% to 17.3%) and Ireland (5.2% to 15%).

During the run up to 2008, booming property markets fuelled speculative development/construction, risky lending and over investment into the real estate sector. The subsequent corrections were the main catalysts behind the economic crash and fiscal crisis in each nation. Indeed, official indices suggest house prices collapsed by around 50% in Ireland, 40% in Spain and 20% in Portugal. This led to enormous losses being suffered by national banks and left the financial system in a fragile state, cutting off credit needed to drive and sustain economic activity.

In addition, the crash exposed the underlying weakness of seemingly healthy public finances in Spain and Ireland as a large portion of state revenue was in fact drawn from the soaring property markets (stamp duties and income tax from individuals working in the construction sector for instance). OECD data show revenue raised directly through taxing property increased by over 130% and 160% in Spain and Ireland, respectively, between 2000 and 2006. Subsequently, property tax receipts rose from around 6% of total tax intake

Chart 1: GDP levels following onset of global financial crisis

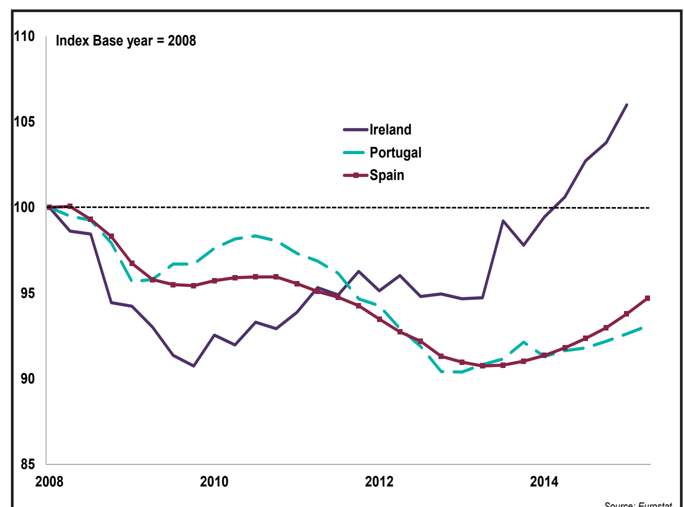
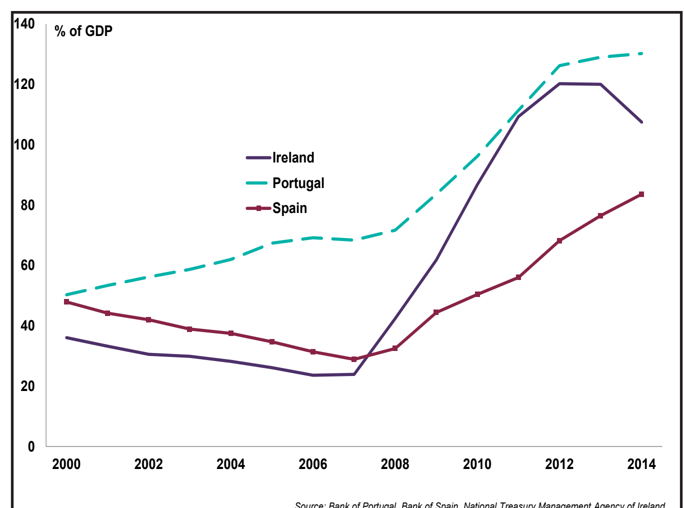



Chart 2: Public debt to GDP ratios



to 9% in both countries. After the market collapsed, huge losses in tax returns were incurred, resulting in current spending commitments vastly overshooting government income. For example, the Irish government went from running a budget surplus in 2007 to running a deficit equivalent to 32% of GDP in 2010 (the biggest in euro area history). For Portugal, in contrast, the main issue was over indebtedness prior to the crisis, both private and public, rather than overbuilding in the residential sector.

In each case, public finances were left in a worrying state, with a surge in welfare support exacerbating the imbalance caused by a steep fall in tax receipts. As such, government debt spiralled well above 100% of GDP in both Portugal and Ireland, while climbing to 82% in the case of Spain (chart 2). This caused long term government borrowing costs to spike in all three countries. Eventually, Ireland and Portugal had to request a bailout from the IMF and EU, and Spain received considerable financial assistance of around €100bn from the Eurogroup in 2012.

**Brighter outlook following painful adjustments**

Despite all the difficulties in the aftermath of the great recession, over the past year or so, these three financially troubled European nations have emerged as the leaders of the eurozone economic recovery. This is especially true for Spain and Ireland, but all three have shown a remarkable turnaround following often painful implementation of structural reforms and fiscal adjustment. Indeed, the Spanish economy is set to expand over 3% in 2015, Portugal is now seeing the most consistent period of output growth since 2006-7. Meanwhile GDP in Ireland has surpassed its pre-crisis level after average annual growth of 5.2% in 2014; a similar performance is widely forecast in 2015. As such, growth momentum comfortably exceeds that of the euro area's three biggest economies at present. The IMF's latest forecasts point to GDP increasing by a modest 0.8% and 1.2% in Italy and France respectively during 2015, and to rise at a steady 1.5% in Germany. Furthermore, growth is projected to accelerate only marginally in 2016 across these larger eurozone economies (chart 3).

The reversal in fortunes throughout Portugal, Ireland and Spain has in part been driven by material improvements in competitiveness. In the five years running up to the crisis, unit labour costs in each of these countries rose significantly, with Portugal seeing the greatest increase of over 26%. However, over the five years since 2009, unit labour costs have fallen markedly, led by an 18% decrease in Ireland (chart 4). At the same time, unit labour costs continued to rise in the euro area's two largest economies and are now 6% higher in France and 10% higher in Germany, compared to 2009. The OECD largely attributes the improvement in competitiveness to labour market reforms introduced in the aftermath of the crisis. Such measures include; reducing severance pay, enhancing flexibility in setting wages and allowing firms more adaptable approaches to limit job destruction (i.e. changing working hours). Over this period of falling unit labour costs, export volumes have grown by 62% in Spain, 50% in Portugal and 42% in Ireland. In each instance, growth in total exports has comfortably outstripped that of the euro area in aggregate during this time (25%).

In recent quarters, household consumption has also proved an engine of economic growth (chart 5). This has been fuelled by rising employment with consumer confidence hitting post-crisis highs and credit availability improving (helped by the ECB's quantitative easing programme). At the same time, falling energy costs are helping to boost the purchasing power of households' disposable income. Altogether, our suspicion

Chart 3: IMF forecasts for real GDP growth

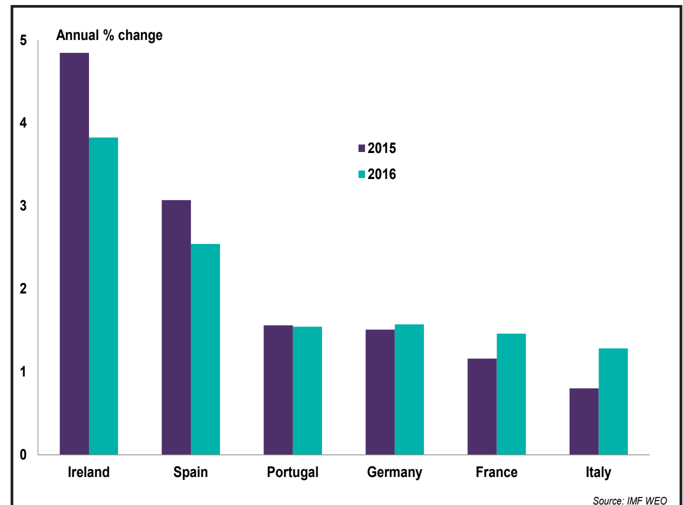



Chart 4: Change in unit labour costs before and after crisis

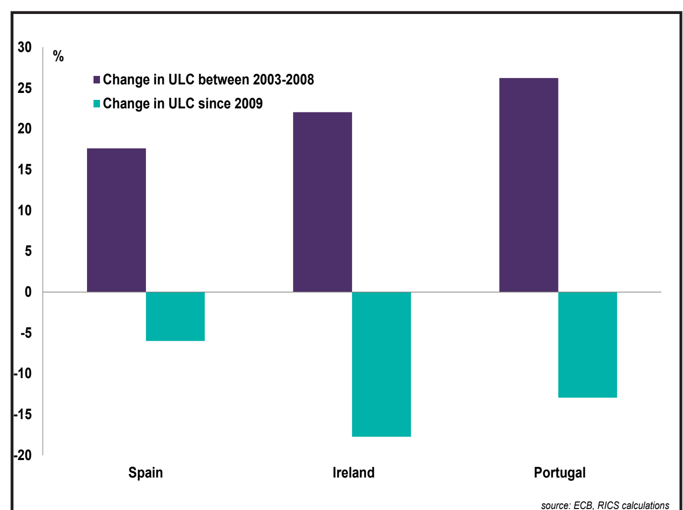
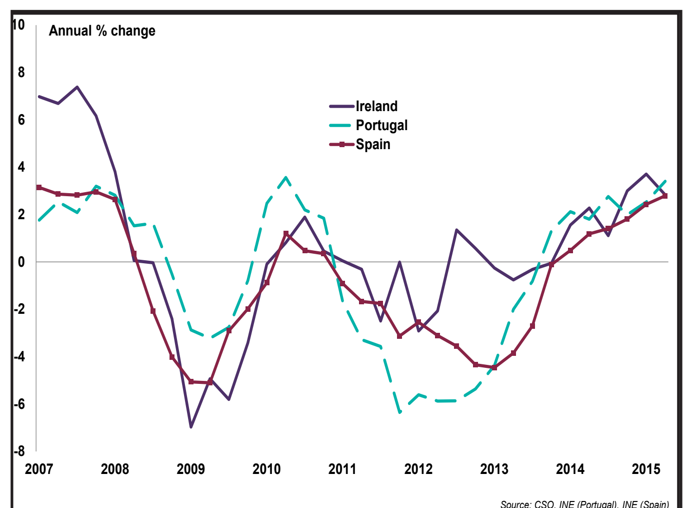



Chart 5: Change in private consumption expenditure





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is that these trends should continue to drive consumption higher over the next couple of years at least.

This is not to suggest that the economic frailties within these countries have been totally resolved. Unemployment, although falling, remains stubbornly elevated. This is especially true in Spain, where over one in five labour market participants are still without a job. What is more, youth unemployment remains a real problem, with the rate of joblessness amongst under 25's stuck at 46% in Spain, 31% in Portugal and around 20% in Ireland.

Another concern is that private sector debt is still exceptionally high. In Ireland, debt held by the private sector is equivalent to a staggering 263% of GDP, while in Portugal it stands at 190% and in Spain it is 165%. This would suggest the process of deleveraging still has a long way to go and could potentially act as a constraint on future spending power.

Nevertheless, the strength of the recovery is encouraging, particularly during a time of widespread doubt surrounding the health of the global economy. The relative outperformance of these countries has started to attract the attention of international investors - a trend especially visible in the real estate sector.

### Commercial Real Estate Markets

Around the turn of 2013, commercial real estate in Spain, Ireland and Portugal began to catch the eye of investors. The substantial correction seen in each market, following the global financial crisis, left commercial property values significantly reduced relative to their pre-downturn peak. According to IPD data, between 2007 and 2013, prices fell 66% in Ireland, 22% in Portugal and 32% in Spain. The extent of this drop in prices, coupled with the green shoots of economic recovery being seen at the time, suggested there was scope for commercial property to deliver strong returns for investors.

Since then, data from the RICS Global Commercial Property Monitor indicate growth in investor demand has gone from strength to strength across each nation. As such, the RICS investment enquiries gauge captures a sharp upswing in buyer demand from 2013 onwards. Moreover, the growth rates being reported across each market during this period were (in net balance terms) among the quickest on a global comparison. This survey feedback chimes with investment volumes reported by Real Capital Analytics (RCA) which show a rapid pick up from early 2013 through to the start of 2015 (chart 6). As such, investment volumes grew by around five times in each market over the two year period. However, it is noteworthy that when looking at a twelve month rolling sum, only Ireland has recorded levels of commercial property investment which surpass those found in 2008.

On the back of sustained investment demand, the supply of property for sale has since started to decline in both Ireland and Portugal (indicated by RICS data). In Spain, supply of property for investment purposes has meanwhile stopped rising and stabilised at the headline level. These dynamics have triggered a rebound in capital values. Indeed, research conducted by Capital Economics estimates that, at the prime end of the market, commercial property prices in Q3 2015 were up (on a year on year basis) over 30% in both Ireland and Portugal, while Spain registered an increase of around 20%. Furthermore, recent conditions have underpinned strengthening expectations for firm growth in capital values over the next twelve months (chart 7). Office values are anticipated to outperform across the board, although expectations within the retail sector are only modestly weaker. In terms of a cross-country comparison, contributors in

Chart 6: Commercial real estate investment volumes

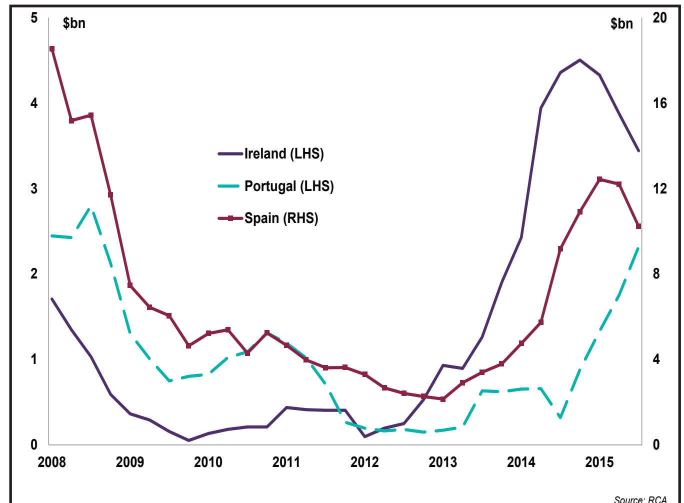
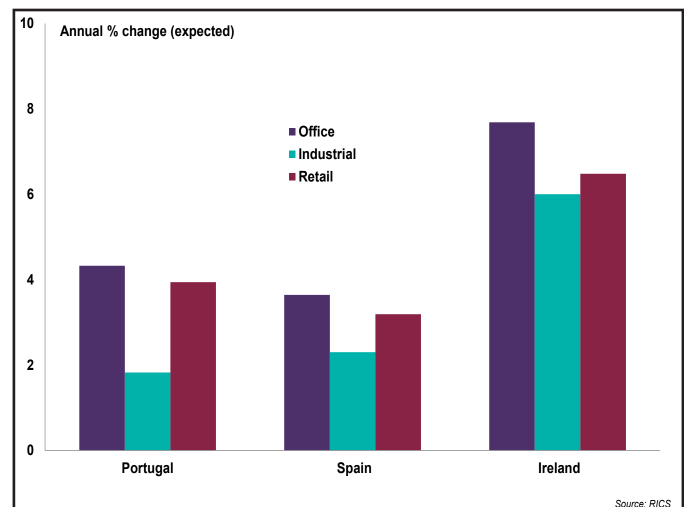



Chart 7: 12-Month capital value projections



Ireland are pencilling in the largest increase in capital values of between 6-8% in each sector.

The surge in investment is being supported by a genuine revival in occupier demand, induced by the need for businesses to expand given strengthening economic fundamentals. In fact, over the past year and a half, overall occupier market conditions have consistently improved at a pace amongst the fastest across all 28 nations covered by the RICS monitor. Indeed, demand for leasable space has increased smartly in each market segment, while availability has now begun to fall materially. Against this backdrop, surveyors' near term rental expectations have been pushed sharply into positive territory following nearly five years of negative projections. Over the longer term, the rental outlook is even stronger, with all-sector rents expected to rise by an average of nearly 5% in Portugal, 8% in Spain and just under 9% in Ireland, per annum, over the next three years.

Even after the recent period of rising investment activity and recovery in capital values, commercial real estate is still perceived by those working in the sector to be attractively priced at present. Indeed, chart 8 shows the vast majority of RICS commercial property monitor contributors sensing current valuations to be either at or below fair value (92% Portugal, 80% Ireland, 82% Spain). At the same time, a considerable majority of respondents believe their market is either in the early upturn or mid-upturn stage of the property cycle (85% took this view in both Portugal and Spain while 75% were of this opinion in Ireland). These views appear in keeping with the current level of property yields. In Ireland for instance, cap rates, despite the recent decline, are still 2 percentage points higher than in 2009 at 6.1% (reported by RCA). Moreover, with government bond yields set to remain near historic lows for sometime to come, the wide difference between the two adds makes commercial property more attractive as an asset class.

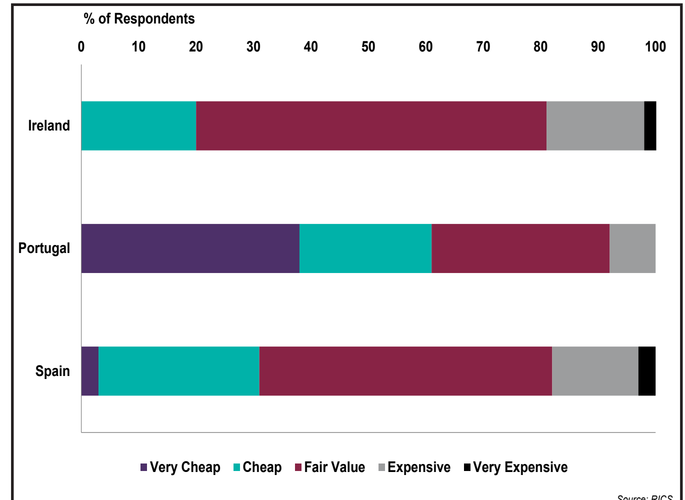
This would suggest that conditions in the commercial real estate market will continue to strengthen over the medium term. Supporting this view, RICS members are forecasting the upturn in capital values to retain significant momentum over the next three years, with both prime and secondary assets anticipated to post capital value gains. Within this, prime offices and well located retail units are expected to chalk up the strongest growth across Portugal and Spain. In Ireland, it is the prime office and industrial segments which exhibit the greatest three year projections (albeit all subcategories are anticipated to see robust growth).

**Portuguese Housing Market**

Unlike developments in Spain and Ireland where house prices collapsed immediately after 2008 (37% and 50% respectively), the Portuguese market experienced a more gradual, albeit equally persistent, drop in residential property prices. As reported by the Bank for International Settlements, house prices in Portugal declined 20% from their 2008 peak to the trough in Q2 2013. The RICS/Ci Portuguese Housing Market Survey captured this protracted downturn and subsequent period of muted activity.

According to the survey, new buyer demand fell continuously between the end of 2010 (survey's inception) and February 2013. In addition, transactions slipped unrelentingly until September 2013. Against this backdrop, the RICS price balance remained negative until June 2014, and even then returned to negative territory in the following three months. In keeping with the broader economic turnaround, demand for housing began to tentatively recover around the middle of 2013. A combination of factors contributed to this change in mood music which included: the aforementioned recovery in the labour market boosting disposable incomes, consumer

Chart 8: Perceptions of commercial property values



confidence recuperating as a result of the brightening macro news flow, and credit conditions easing - as looser ECB monetary policy began to feed through into lower mortgage rates. Chart 9 illustrates how improved confidence amongst real estate professionals mirrors the uptick seen in the European Commission gauge of consumer confidence toward making a major purchase.

Since then, the outlook has strengthened significantly, with both sales and prices expected to grow at a steady rate over the near term and beyond. Chart 10 tracks the RICS/Ci three month price expectations series alongside the house price index produced by the BIS. To demonstrate the lead indicator qualities of the RICS data, the price expectations series has been pushed forward by three months. From this, we can infer that the annual pace of house price inflation is likely to hover around the 2% in the near term. When asked for their projections of future price changes, survey respondents forecast prices will rise by around 2% on average nationally over the next 12 months. Over the next five years, price growth is anticipated to accelerate and contributors are pencilling roughly a 4% rise in national house prices, on average, per annum over the next five years.

Improvement in housing market activity has yet to spark a revival in house building, with recent figures showing the sector continuing to dwindle. Both housing starts and completions were already on a downward trend prior to the financial crisis, although the rate of decline accelerated materially following 2008. In 2006, housing starts were running at around 10,000 homes per quarter. By 2014, this figure had fallen to as low as 2000 per quarter, representing an 80% fall. The number of permits for construction has failed to see any meaningful pick up but now appears to have stabilised (chart 11). This would suggest the modest price gains and brighter sales outlook posted recently are not yet enough to convince housebuilders to ramp up production.

To give this some context, in Spain, the housing market recovery appears to be in a similar stage to that of Portugal. Indeed, the official house price index shows national prices have started to recover modestly over the past twelve months, with the latest reading showing year on year gains of around 4%. This followed a sustained rise in mortgage approvals which took hold around the turn of 2014, accompanied by a pick up in transaction volumes shortly after. That said, these improvements are from a low base and prices remain 34% below the high watermark set in 2007. Likewise, quarterly transaction levels are still less than half of those recorded in the run-up to the crisis. By way of contrast, the residential market in Ireland has raced ahead, stoking fears amongst some that it is becoming overheated once more. According to the Ireland Central Statistics Office, house prices have increased by 33% since the start of 2013. Nevertheless, the annual rate of house price inflation has eased over the past two quarters and is currently running at 9%. Going forward, forecasts (estimated by Oxford Economics), point to house price inflation accelerating in Spain during 2016 and foresee a slight moderation in Ireland. As such, both are projected to see house price growth of around 6%.

Overall, following nearly four years of enduring difficulties, activity in the Portuguese housing market has seen a sustained period of improvement. This has been captured by the RICS/Ci Portuguese Housing Market Survey, with sentiment now suggesting sales and prices will continue to rise at a steady pace over the medium term. This turnaround is similar to that found in Spain, where prices have also started to post modest gains. As the recovery in each country remains in the early stages, further support will be needed from the labour market, as well as the upturn in the broader economy, if it is to become more firmly entrenched.

Chart 9: RICS/Ci and European Commision confidence indicators

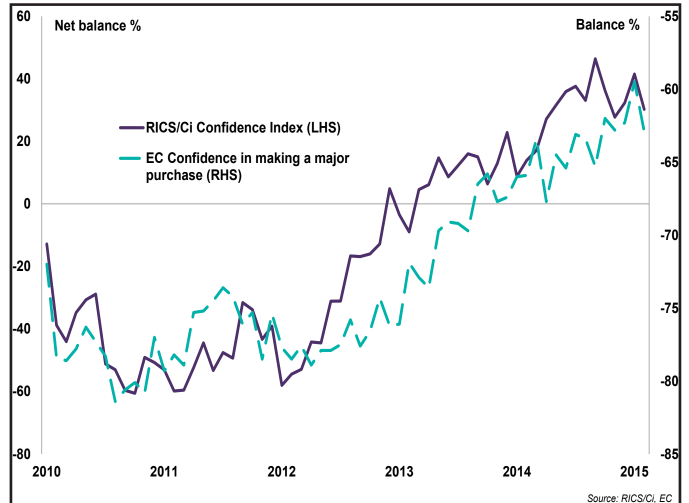



Chart 10: 3-month price expectations and BIS house price index

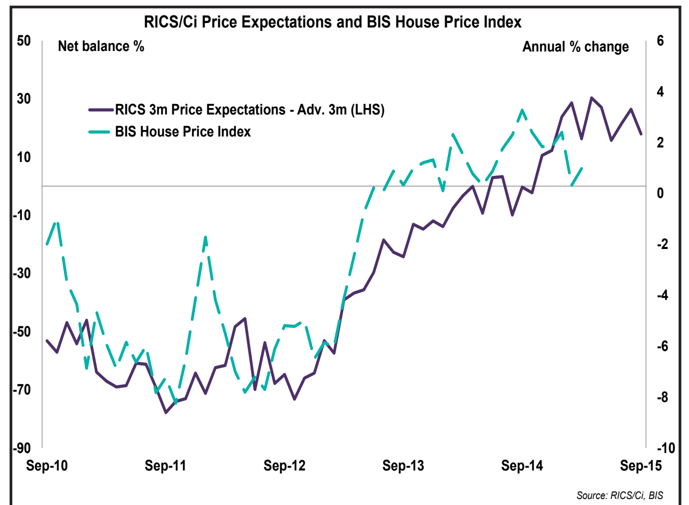
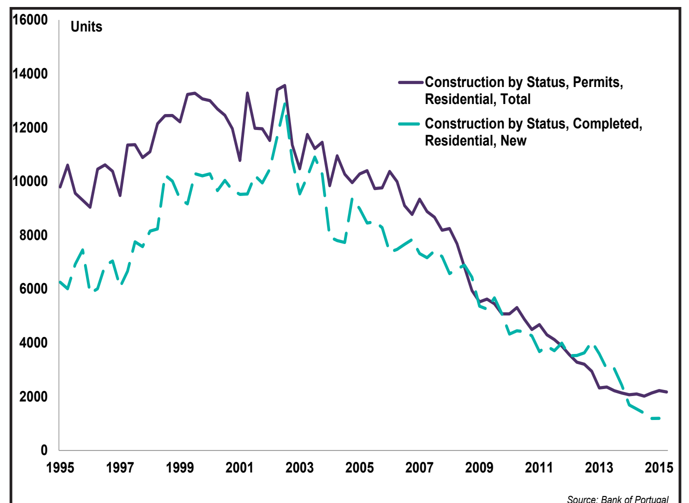



Chart 11: Housing starts and completions





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