Real Estate House View

Europe

Swiss Life Asset Managers

First half-year 2024

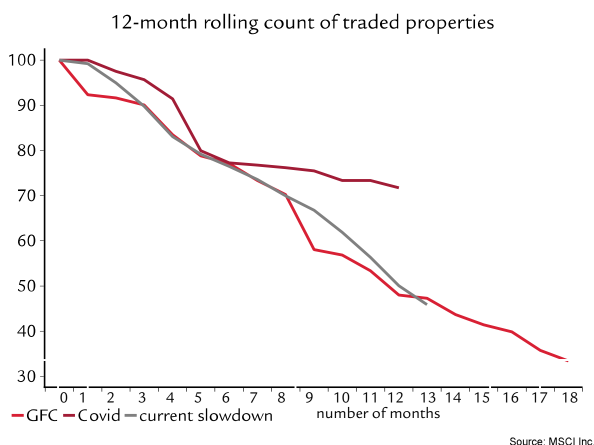
Key takeaways

- **Improving market certainty:** The consensus view is that monetary policy has peaked, as inflation rates across Europe retreat closer towards central bank targets. This will provide well-needed stability across financial markets and thus clarity on asset pricing.
- **Timing the trough:** Identifying the bottom of a cycle is much easier once it has passed, however, investors should be ready to target distressed opportunities, where seller's price aspirations will align most quickly with buyer expectations.
- **Creating value through active management:** In 2023, the asset class delivered on its promise to provide a hedge against inflation. Having entered a higher government bond yield environment, real estate performance will be increasingly driven by income return and income growth. Employing active management strategies will be necessary to deliver outperformance.
- **Limited access to the right product:** Troubles in the construction sector will limit new supply, and whilst investors and occupiers remain focused on high-quality space, this will provide a lifeline to rental growth performance over the short-term, despite muted economic growth.
- **Secular trends shaping demand:** To proof against recession and disruption, real estate investors should pay attention to the secular trends shaping the way users interact and experience the built environment.

When is the right time to re-enter the market?

Fears of investing whilst values are falling has put significant downwards pressure on investment volumes. Instead, real estate investors have been monitoring government bond yields, seeking stability in the so called 'risk free rate' as an indication that property yields have also stabilised. Into 2024, we expect investment activity to pick back up, supporting price discovery. Although the first half-year may only show tentative signs of improvement, by the second we believe activity will regain momentum.

Chart in focus



To attempt to answer the question: When is the right time to re-enter the market, real estate analytics platform RCA, had the idea to compare the current slowdown to others. They tracked the 12-month rolling count of traded properties, indexed to the peak month. As at September 2023, European commercial property investment was 13-months into its decline, broadly in line with the same position during the Global Financial Crisis (GFC). Although each slowdown is highly nuanced and not easily comparable, if following a similar trajectory to the GFC, the current slowdown may bottom out by month 18, sometime within the first quarter of 2024.

Five themes will shape the economic landscape in 2024: For the first time since 2021, real wages are on the rise, indicating that the economic trough is likely to be passed by mid-year. Secondly, the previous tightening of monetary policy brings the inflation targets of central banks within reach. Thirdly, there is a shift in both monetary and fiscal policies. After fiscal measures supported economic growth since the pandemic, in 2024, stimuli are more likely to take the form of lower financing costs and lower interest rates. Next, 2024 is set to be a record year for democracy: Never before have so many people around the globe been called to elections in a single year. Apart from any interim volatility in financial markets, and particularly in the foreign exchange, political events are unlikely to have a short-term impact on the economic outlook of European economies. However, the fifth major theme will weigh more heavily on the global economy: Growth impulses from China are expected remain absent. Europe's goods exports to China are recovering slowly, and the number of Chinese tourists remain below pre-pandemic levels.

All eyes on GDP

Despite a brief reprieve at mid-year, fears of recession are mounting once again according to market polls, especially in the Eurozone (65% chance) driven by Germany and Italy, where polls suggest a 75% and 60% chance of recession, respectively, and the UK (60% chance). The onset of a recession would carry significant challenges to both consumers and businesses and result in the current slowdown reaching the occupier market, which so far have shown great resilience to tough economic conditions. That said, there is perhaps one silver lining we can draw out in the event of a recession: If economic growth grounds to a halt as the market expects, it is likely this will be enough evidence to allow central banks to pivot from hiking base rates to cutting them. In our base case, we expect the first rate cut from the ECB in April, followed by the US Federal Reserve in July and Bank of England in August. This development will have favourable implications to local government bond yields, which in turn will have a favourable impact on property yields and investment activity. At this point, we expect real estate investors to be able to find opportunities at great value, as the entire real estate investment universe has endured a period of complete re-pricing, where capital values have been scrutinised and re-assessed, and which now stand at the fairest price.

We expect higher long-term rates

While we forecast central bank rate cuts over the course of 2024, we do not expect key interest rates to return to their pre-pandemic lows. Inflation will fall, but not by much below central banks' target, so rates will need to remain sufficiently restrictive. As such, we believe we have entered a new macroeconomic environment of higher long-term rates. Regardless, at its core, real estate is an effective hedge against inflation, given commercial leases which usually include index-linked reviews. Consequently, we expect property to remain in favour with investors, yet performance will be increasingly driven by income growth.

Waiting in the wings

Owing to the developments in the wider financial markets, transaction activity has been in decline since Q4 2021. Across Europe, market activity has been declining each quarter for the past seven, and Q3 data shows just €34.6bn transacted over the quarter (-%59 y-o-y), the lowest level since the period that followed the GFC well over 10 years ago. This slowdown has been broad-based across regional and property segmentations, as there remains a significant gap between buyer's price aspirations and seller's expectations. Southern European markets fared slightly better in Q3, where the slowdown seems to be moderating at a faster pace: Activity in Spain for example reflected an 8% increase from Q2. Looking ahead, we expect the price expectations gap to close over the short-term, provided inflation rates continue to decline and central banks turn to cutting base rates. Not only will this provide the market with greater price-certainty but should also ease refinancing pressures and allow market sentiment to recover. Transactions are therefore expected to improve over the first half of 2024, with preliminary Q4 data already suggesting greater levels of activity, supported by healthy levels of capital commitments from global investors, which show a significant amount of dry powder waiting in the wings for investment into European real estate.

Residential remains robust

Given the tenant base of residential segments, which relies on private individuals as opposed to businesses, the residential sector is less exposed to economic slowdowns than other commercial real estate sectors.

Our conviction for residential therefore remains highly pronounced, especially given the chronic undersupply across European markets. Moreover, recent hikes in interest rates have had a knock-on effect to mortgage rates, leading to a decrease in purchasing power and thus exacerbating the already severe supply-demand imbalance. Over the longer-term, demand for rented housing (whether that be multi or single family, student or co-living) will be supported by favourable demographic shifts including migration and population growth. Investors should be careful, though, as strong rental growth over the past 12-months has caused affordability concerns, and as ESG climbs ever-higher on the agenda, selecting sustainable buildings should be a top consideration.

Bright spot for performance

Despite a slowdown of activity over 2023, both in the investment and occupier markets, we remain focused on industrial and logistics as a bright spot for performance. Geopolitical events have exposed weaknesses in supply chains. Consequently, businesses will demand more industrial space for storage and distribution to protect against further disruption and to service ever-increasing consumer expectations of quick delivery services. Over the longer-term, e-commerce growth of between 6-10% by 2028 in key European markets (PMA) will support demand, particularly for urban logistics and larger units located along transport routes. Our conviction for the sector has also been reflected in our rental growth forecasts (figure 1.), where we expect growth to comfortably outpace inflation over the forecast period.

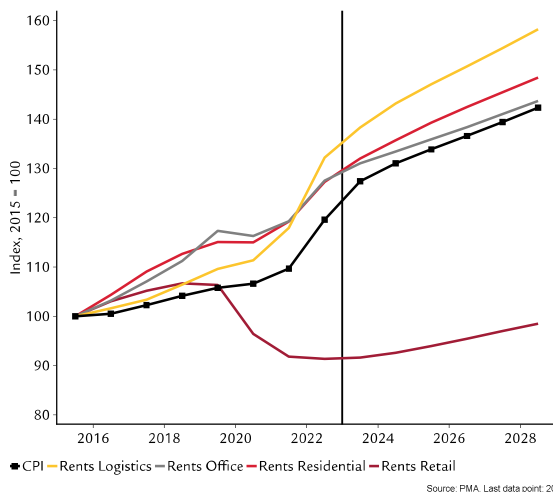
Concerns mounting for offices

The office sector was once considered a safe bet when it came to performance. However, digital autonomy continues to threaten the sector, which now no longer has a clear long-term demand driver. Now, portfolio managers with large office exposures will be required to allocate substantial capital expenditure to avoid vacancy and obsolescence, or to execute repositioning strategies. Given these challenges, it is critical to target resilient cities, particularly those where office-based employment forecasts and GDP growth are strongest. As such, prime rental growth over the next five years is expected to be strongest in Paris CBD (averaging 3.50% p.a.), Madrid (3.00% p.a.), and London West End (2.00% p.a.), although a highly selective investment approach is recommended as the proportion of 'prime' stock diminishes.

Consumer driven sectors at risk

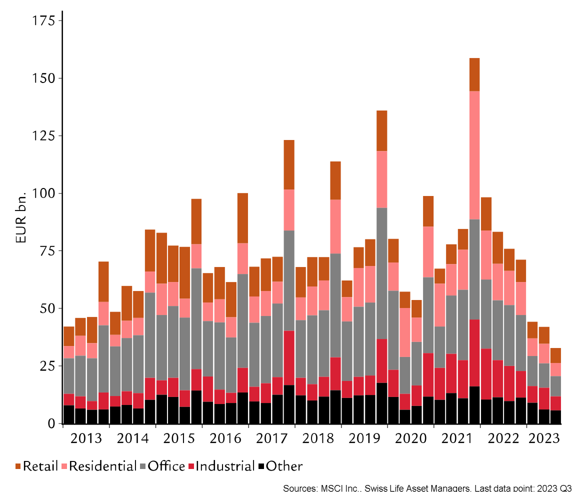
Although inflation has been retreating from peak levels, consumer sentiment remains in negative territory as European households face significant cost pressures. Elevated vacancy rates among high street retail markets will restrict performance, and so we do not foresee a recovery for retail over the reporting period. Meanwhile, the hotel sector has recovered well as tourism rates reach close to pre-pandemic levels for the first time since. Yet, for the most part, travel is considered a non-essential spend item and so we only have investment conviction for the key business and tourism markets including London, Paris, Madrid, and Berlin.

Figure 1: Rental and CPI Forecast



Source: PMA. Last data point: 2022

Figure 2: European transaction volume



Sources: MSCI Inc., Swiss Life Asset Managers. Last data point: 2023 Q3

Authors

Swiss Life Asset Managers
Francesca Boucard
Head Real Estate Research & Strategy
francesca.boucard@swisslife-am.com

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife-am.com

Robert Kuert
Real Estate Research Analyst Switzerland
robert.kuert@swisslife-am.com

Swiss Life Asset Managers, France
Béatrice Guedj
Head Research & Innovation
beatrice.guedj@swisslife-am.com

Swiss Life Asset Managers, Germany
Andri Eglitis
Head Research AM DE
andri.eglitis@swisslife-am.com

Gudrun Rolle
Research Analyst Real Estate
gudrun.rolle@swisslife-am.com

Swiss Life Asset Managers, UK
Frances Spence
Head UK Research, Strategy & Risk
frances.spence@swisslife-am.com

Rachel Singleton
Analyst Research, Strategy & Risk
rachel.singleton@swisslife-am.com

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