

# EUROPEAN COMMERCIAL PROPERTY UPDATE

20<sup>th</sup> Apr. 2009

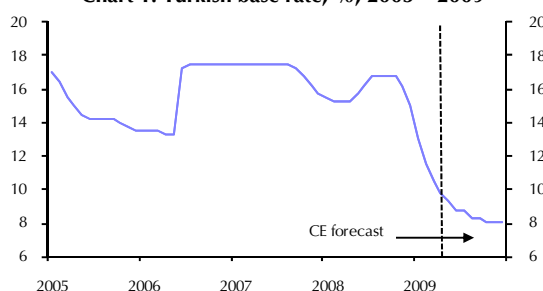


## Sharp interest rate cuts won't help Turkish commercial property

- The Central Bank of Turkey's most recent interest rate cut was the second in a row to surprise markets in its scale (75bps, to 9.75% on 16<sup>th</sup> April). However, unexpectedly sharp rate cuts do not mean that the outlook for Turkish commercial property has improved. Crucially, prospects for the real economy and, hence, property rents are poor and getting weaker. Even if Turkey does strike a new deal with the IMF, substantially negative property returns remain likely this year and next.
- At the start of the year, official interest rates in Turkey were close to 15%, and the consensus view was that they wouldn't drop much below that level. Our forecast, that they could fall to 10%, looked a bold call. But with rates now at 9.75%, clearly even we were not aggressive enough. We now think that official interest rates will end the year at 8%. (See Chart 1.)
- Financial markets have reacted positively and, thanks also to a pick-up in risk appetite, yields on Turkish 10-year dollar denominated bonds (though they remain high relative to elsewhere in Emerging Europe) have fallen by around 300bps recently. **On the face of it, this all suggests that we might have overestimated the extent to which Turkish property yields are likely to rise** and, as such, that our existing forecasts for returns are too pessimistic. In addition, Turkey now looks odds on to negotiate a new deal with the IMF, which could calm fears over a surge in debt defaults. That would point to lower risk premiums across all asset classes, moderating the upward pressure on property yields.
- **However, things may not be that simple. For a start, the recent increase in global risk appetite could easily yet be reversed** and Turkish markets would not be immune to the adverse effects of that. Indeed, if a decline in risk appetite brought about a sharp financial market sell-off, it is not inconceivable that the Central Bank could yet be forced to *raise* rates.
- Admittedly, the outright weakness of the real economy will cause a large degree of spare capacity to open up, suggesting that rate increases would be a last resort. But this is the very crux of the matter – **it is precisely because the real economy is weakening, undermining occupier demand and rents, that interest rates are falling so sharply and why the outlook for Turkish property has not got any brighter.**
- GDP contracted by a whopping 6%/y/y in 2008Q4 and things have got worse since then – for example, industrial output in Turkey has fallen by more than 20%/y/y in the past few months. **Turkish GDP could plausibly shrink by 10% in 2009 and, beyond that, the outlook remains soft.** Indeed, any IMF deal will come with strings attached, which would tend to stifle the speed and size of any recovery.
- The bottom line is that even though Turkish interest rates have fallen very quickly, the beneficial effects for commercial property could still easily be swamped by a renewed decline in investor risk appetite. And, at the same time, the outlook for the real economy remains poor, and is arguably getting worse. **In this environment, we continue to believe that Turkish commercial property will be a relatively poor performer over the next few years.** (See Chart 2.)

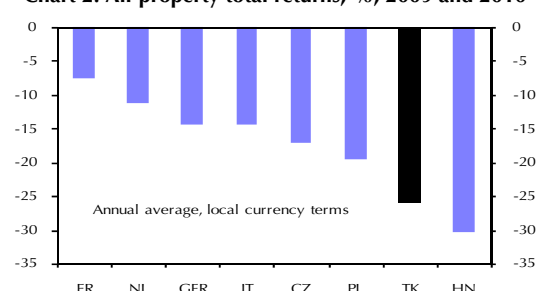
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Chart 1: Turkish base rate, %, 2005 – 2009



Sources – Bloomberg, Capital Economics

Chart 2: All-property total returns, %, 2009 and 2010



Source – Capital Economics