

THE EURO-ZONE COMMERCIAL PROPERTY CHART BOOK

Aug. 2011



Euro-zone property investment market set to weaken

- **Q2's sharp slowdown in GDP growth in the euro-zone's so-called "core" economies is a worrying sign that investor sentiment across the region as a whole could fall sharply in the near term. If that is the case, then we think it is unlikely that euro-zone commercial property investment volumes will increase much further, if at all, in the second half of 2011.**
- **Euro-zone economic indicators** show that the quarterly rate of GDP growth slowed sharply from 0.8% in the first quarter of 2011 to just 0.2% in the second. While no breakdown is available at this stage, monthly data suggest that the slowdown has been broad-based across sectors. (Page 2.)
- **Country-level economic indicators** clearly demonstrate that the weakness observed over the past year or so in the region's peripheral economies is now spreading into the core. Indeed, the French economy stagnated, while the German and Dutch economies barely expanded either. (Page 3.)
- **Commercial property investment market indicators** suggest that the trend for European investment volumes has levelled off. Now that it is clear that even the euro-zone's core economies are suffering, this may dent investor sentiment and prevent investment volumes across the region as whole from recovering to pre-recession levels any time soon. (Page 4.)
- Prime commercial property yields were either stable or fell only slightly in Q2 in the majority of euro-zone markets. But yields in Greece, Ireland and Portugal are still rising, meaning that the yield gap between the euro-zone's core and peripheral sub-regions is still widening. (Page 5.)
- **Commercial property occupier market indicators** show that office take-up in Q2 was at least a little higher than in Q1 in most markets. As a result, office vacancy rates typically decreased in the second quarter. Even so, there was typically very little movement in office rental values. (Page 6.)
- For the first time since Q4 2007, no euro-zone retail market saw a quarterly decline in prime rental values. Indeed, retail rents held firm in most markets, while some, such as the major German cities, recorded relatively decent rates of growth. There was practically no quarterly movement among euro-zone industrial markets in Q2, meaning that, taking the region as a whole, euro-zone industrial rents are still lagging the office and retail rental recoveries. (Page 7.)

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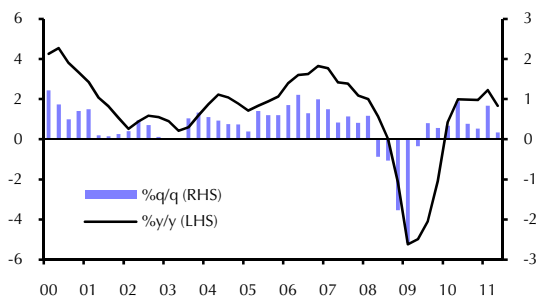
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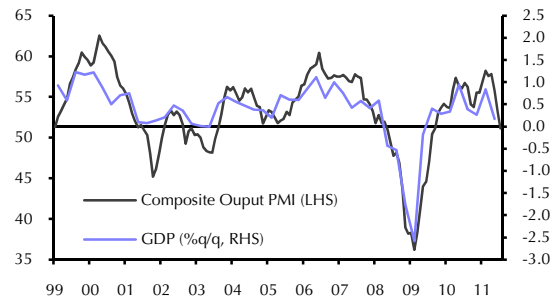
Economic Indicators (Euro-zone as a Whole)

- Taking the euro-zone region as a whole, the quarterly rate of GDP growth slowed sharply, from 0.8% in the first quarter of 2011 to just 0.2% in the second. This lowered the annual growth rate to 1.7% from 2.5% (1). What's more, the recent message from business surveys such as the euro-zone composite output PMI is that GDP growth is likely to slow even further in Q3 (2).
- The euro-zone manufacturing PMI has fallen quite sharply over the past few months, from 59 in February to 50.4 in July, suggesting that the annual rate of industrial production growth could slow to a halt in Q3 (3). Meanwhile, there is little sign that domestic demand will be strong enough to take over as the main driver of euro-zone economic growth. Indeed, the recovery in consumer confidence seen since near the start of 2009 has tailed off in recent months. Admittedly, consumer confidence is still pointing to fairly decent consumer spending growth (4). But the index has recently tended to over-predict spending, while fresh rises in unemployment in the last couple of months also argue against a pick-up in spending growth (5).
- Overall, with the euro-zone fiscal crisis set to deepen, we see growth in the region as a whole slowing to just 0.5%/y/y in 2012, and about zero in 2013 (6). However, there is a clear risk of a much weaker path if the debt crisis comes to a head sooner rather than later.

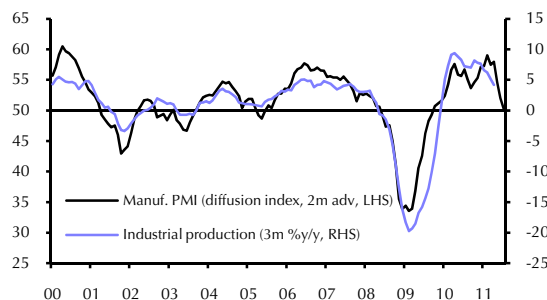
1. Euro-zone GDP Growth



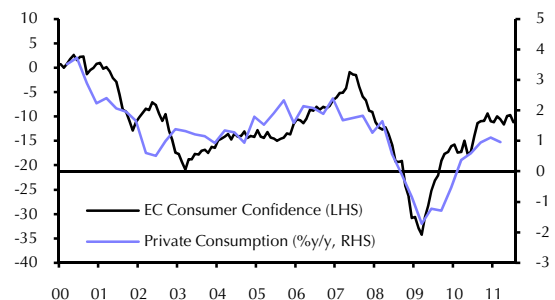
2. Euro-zone GDP and Composite Output PMI



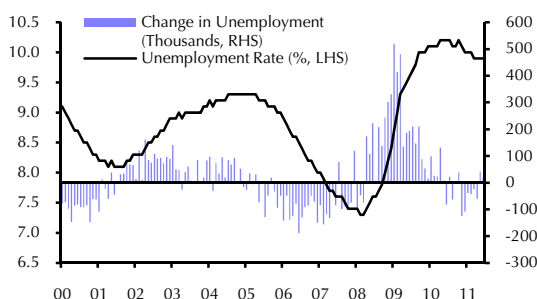
3. Euro-zone Manufacturing PMI and Industrial Production



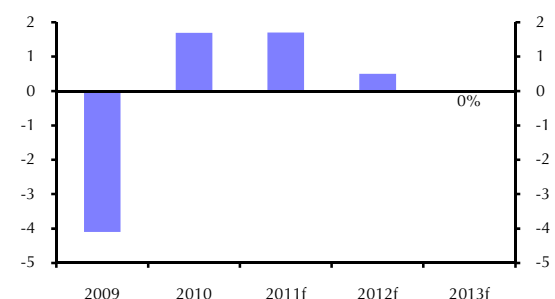
4. Euro-zone Consumer Spending and Consumer Confidence



5. Euro-zone Unemployment



6. Euro-zone GDP Growth Forecast (%y/y)

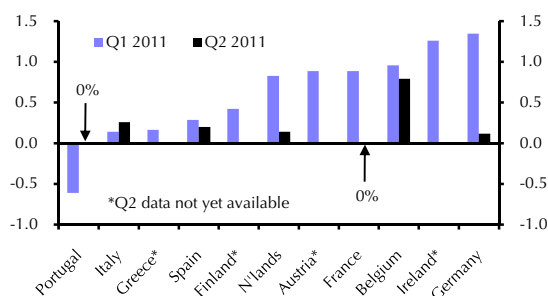


Sources – Thomson Datastream, Capital Economics

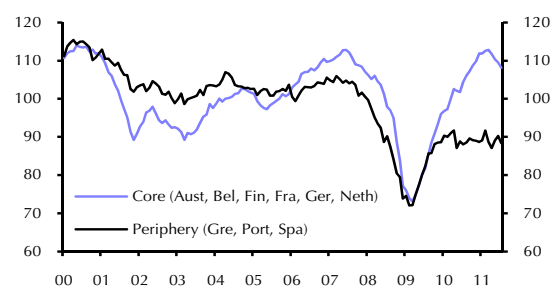
Economic Indicators (Country by Country)

- The slowdown in euro-zone GDP growth in the second quarter was primarily seen in the region's so-called "core" economies (1). Indeed, France stagnated, while Germany and the Netherlands barely expanded either. This confirms that the economic weakness observed in the euro-zone's peripheral economies over the past year or so is spreading to the region's core. The EC's economic sentiment indicator suggests that this trend will continue (2).
- Over the past 6 months, industrial confidence has fallen everywhere (3). Even in Germany, where the manufacturing sector has seen a remarkable bounce-back in activity since the recession, sentiment among industrial firms is showing clear signs of weakening. Meanwhile, consumer confidence remains at or below long-run average levels in most euro-zone countries (4). Unsurprisingly, it is still weakest in the region's periphery. After all, unemployment is highest in Portugal, Ireland, Greece and Spain, and, on an annual comparison, still rising (5).
- Fears that the euro-zone debt crisis was spreading from Greece, Ireland and Portugal to Spain and Italy, caused 10-year national government bond yields in both countries to surge in June and July (6). At their highest points, bond yields in both economies breached 6%, a level widely regarded as unsustainable. Note that the recent fall in Spanish and Italian bond yields is due to the ECB's bond-buying intervention in the markets rather than a shift in sentiment. Clearly, unsustainable borrowing costs in the euro-zone's third and fourth largest economies represent a huge risk to the future of the single currency region.

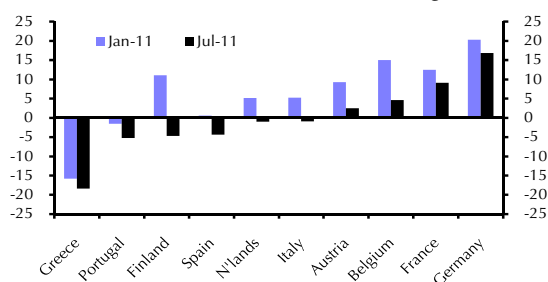
1. Euro-zone GDP Growth By Member State (%q/q)



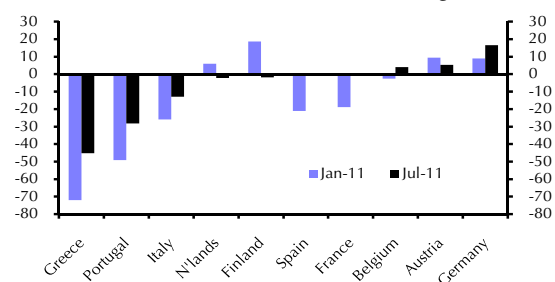
2. Euro-zone EC Economic Sentiment Indicator By Region



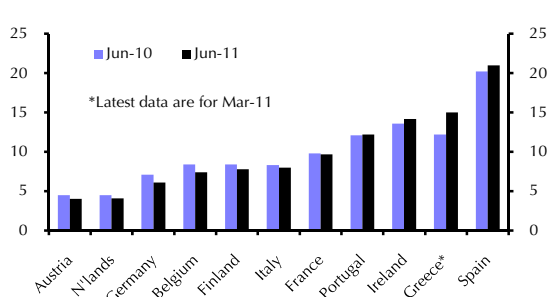
3. Industrial Confidence By Member State (Index Points Difference From Average)



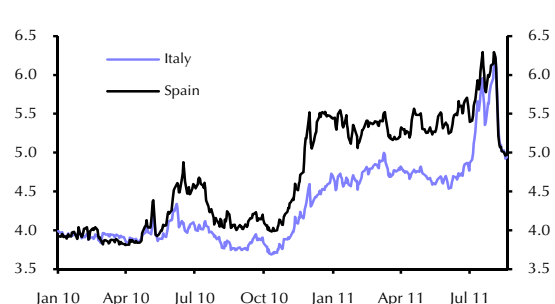
4. Consumer Confidence by Member State (Index Points Difference From Average)



5. Euro-zone Unemployment Rates By Member State (%)



6. Ten-Year Government Bond Yields (%)

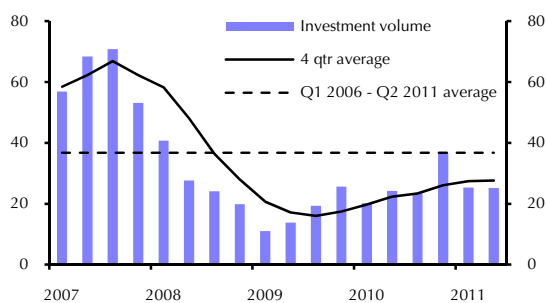


Sources – Thomson Datastream, Capital Economics

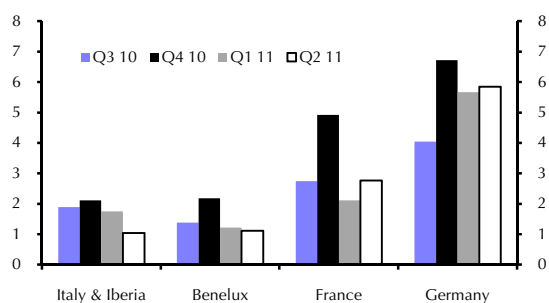
Investment Market Indicators

- European commercial property investment volumes remained at virtually the same level in the second quarter as in the first. As a result, the trend for investment volumes no longer appears to be upwards (1). By country, investors continued to target Germany and France more than anywhere else (2).
- According to the latest RICS survey, investment demand continued to rise in the euro-zone's core property markets, but weakened further in the periphery (3). Surveyors are becoming less downbeat about Greece, Ireland and Portugal. Even so, the survey suggests that the core/periphery gap may widen in Q3. But now that economic weakness is spreading to the core, we are not convinced that investment demand will rise in either sub-region.
- In Q2, the office market regained its position as the most traded of the three main commercial property sectors, attracting nearly 50% of all investment (4). But the retail sector's defensive characteristics remained in fairly strong demand. As perhaps a sign of declining sentiment, the proportion of cross-border investment declined back to less than one-third of the total (5). Bank lending conditions also remain tight in the euro-zone (6). This, together with slowing economic growth, adds more weight to our view that European investment volumes will fail to recover meaningfully any time soon.

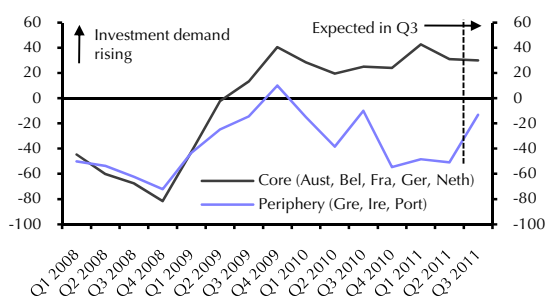
1. European Property Investment Volumes (Euro, Bn)



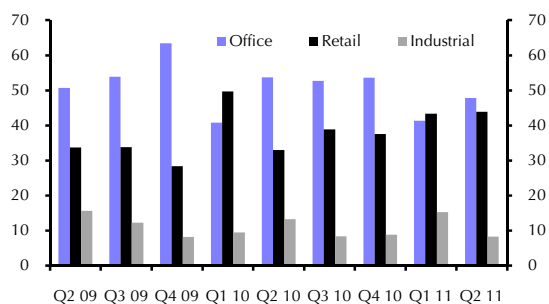
2. Investment Market Volumes By Country (Euro, Bn)



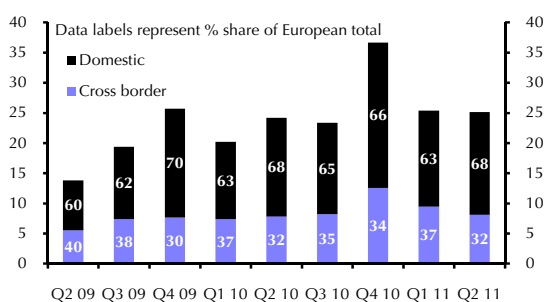
3. Surveyors Reporting a Rise in Investment Bidders Per Property (% Net Balances)



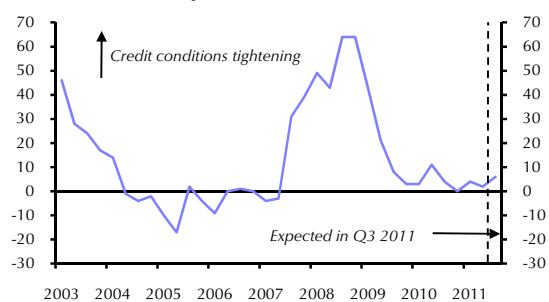
4. Investment Market Volumes By Sector (% of Total)



5. Domestic v Cross-border Investment Volumes (Euro, Bn)



6. Euro-zone Lenders Reducing the Supply of Credit to Enterprises (% Net Balance)

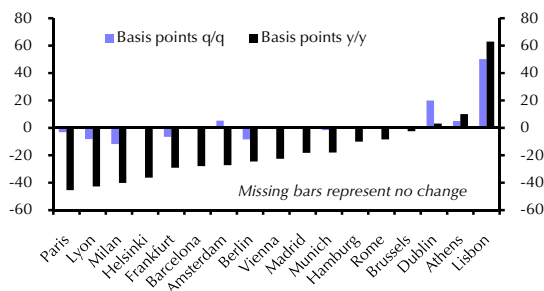


Sources – Thomson Datastream, Various Agents, RICS, Capital Economics

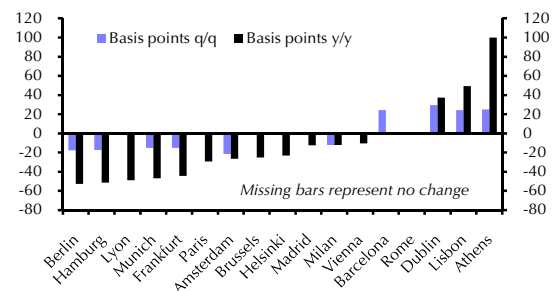
Investment Market Indicators (Continued)

- On a quarterly comparison, prime office yields in Q2 were broadly stable across the euro-zone (1). However, small falls, of between 5bps and 10bps, were recorded in Lyon, Milan, Frankfurt and Berlin, while yields continued to rise in Dublin and Lisbon. A similar pattern was evident among euro-zone industrial markets (2). But there was significantly less movement in euro-zone prime retail yields (3).
- Due to the small falls seen in prime office and retail yields in many core euro-zone markets, and the broad-based rises recorded in the region's peripheral markets, the core/periphery all-property yield spread widened further in Q2 (4). If, as we expect, investment demand softens in core markets, this suggests that yields in this sub-region are unlikely to fall much further. But we would not rule out the possibility that further economic shocks in Greece, Ireland or Portugal cause yields in this sub-region to increase further, causing the core/periphery spread to widen.
- 10-year Bund yields have fallen sharply over the past few months, from 3.35% in April 2011, to about 2.4% now. As a result, since Q1, property/bond yield spreads have increased substantially. Prime retail yields are currently at least 205bps higher than Bund yields, while such spreads are at least 220bps among euro-zone office markets (5). Industrial/Bund yield spreads are even higher, ranging between 415bps in Frankfurt and 710bps in Athens (6).

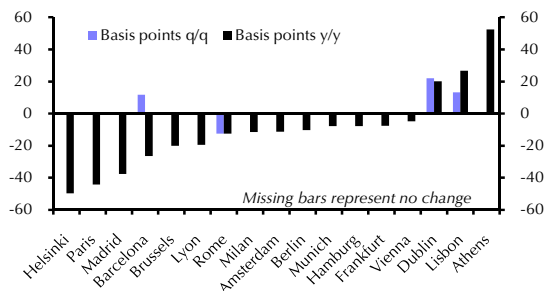
1. Change in Prime Euro-zone Office Yields (Q2 2011, Bps)



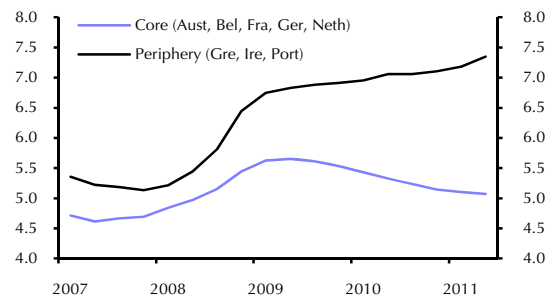
2. Change in Prime Euro-zone Industrial Yields (Q2 2011, Bps)



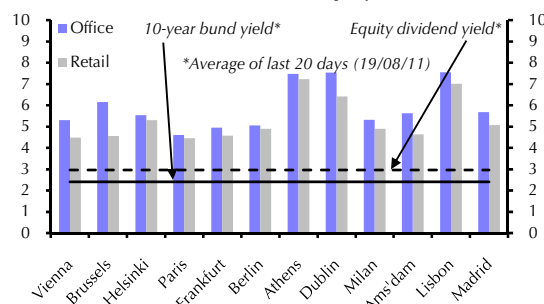
3. Change in Prime Euro-zone Retail Yields (Q2 2011, Bps)



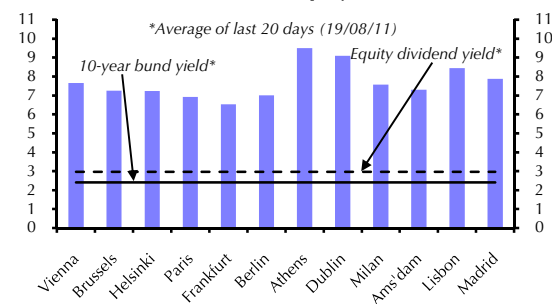
4. Prime All-Property Yields by Region (%)



5. Q2 2011 Euro-zone Office and Retail Yields Compared to Latest 10-Year Bund Yields and Equity Dividend Yields



6. Q2 2011 Euro-zone Industrial Yields Compared to Latest 10-Year Bund Yields and Equity Dividend Yields

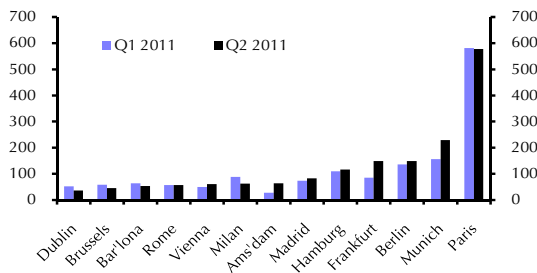


Sources – Thomson Datastream, Various Agents, Capital Economics

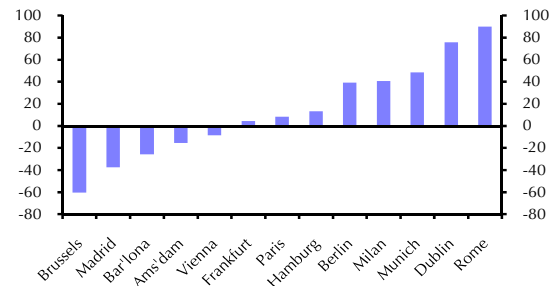
Occupier Market Indicators

- Compared to the first three months of the year, office take-up in Q2 in most euro-zone markets was at least a little higher (1). However, not all markets saw an improvement. Take-up was practically unchanged in Paris and Rome, while it fell in Dublin, Milan and the main Spanish cities. Even so, boosted by low base effects, comparing the first six months of 2011 to the same period in 2010, take-up in Dublin and Milan was substantially higher (2).
- Office vacancy rates fell in all of the major French and German markets in the second quarter, as well as in Rome and Barcelona (3). Despite take-up falling in Q2, office vacancy rates in Brussels and Milan were little changed. But vacancy rates in Dublin, Amsterdam, Vienna and Madrid all increased over the quarter. The latest rise in Dublin's vacancy rate has pushed it slightly above 23%, comfortably higher than anywhere else. But at between 13% and 15.6%, vacancy rates in Spain, Amsterdam and Frankfurt can hardly be described as low (4).
- There was very little movement in euro-zone prime office rental values in Q2 (5). However, some further quarterly declines were observed in the region's peripheral markets, particularly in Greece and Ireland. This means that, compared to the same period of last year, office rents in Spain, Greece and Ireland are currently at least 6% lower. That is disappointing given that, over the same period, office rents have increased in most other markets (6).

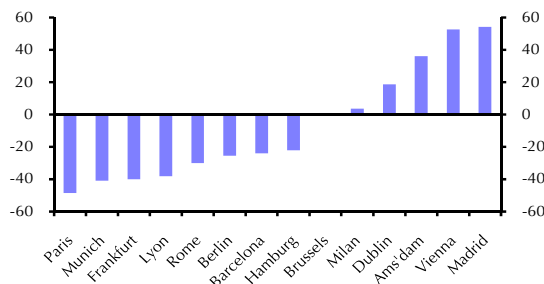
1. Euro-zone Quarterly Office Market Take-up (000s, Sqm)



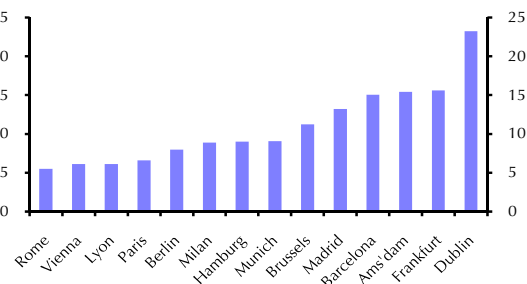
2. Change in Office Market Take-up (H1 2011 v H1 2010, %)



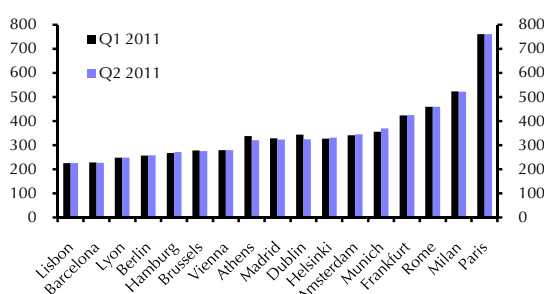
3. Change in Office Market Vacancy Rates (Q2 2011, Bps)



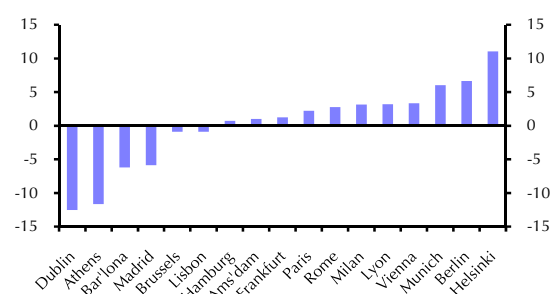
4. Euro-zone Office Market Vacancy Rates (Q2 2011, %)



5. Euro-zone Prime Office Rental Values (EUR/Sqm/Annun)



6. Euro-zone Prime Office Rental Values (Q2 2011, % y/y)

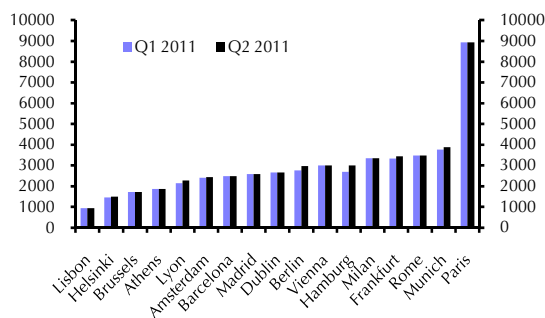


Sources – Various Agents, Capital Economics

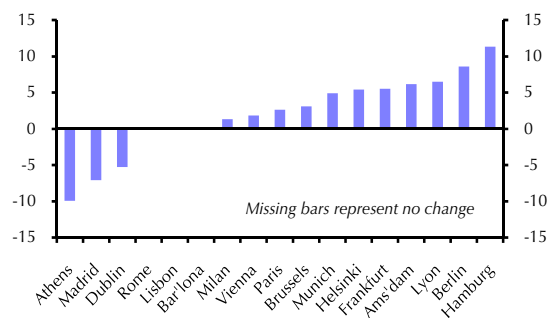
Occupier Market Indicators (Continued)

- For the first quarter since Q4 2007, no euro-zone retail market saw a quarterly decline in prime rental values (1). Indeed, rents were stable in the majority of markets, while they increased moderately in Amsterdam, Helsinki, Lyon and the major German cities. In year-on-year terms, retail rental growth in Hamburg is leading the way (2). In common with the office sector, retail rents in Athens, Madrid and Dublin are down compared to Q2 2010.
- There were even fewer cases of quarterly changes in euro-zone industrial rents than observed among office or retail markets. But industrial rents fell slightly in Munich and by more in Milan (3). In annual terms, most euro-zone industrial rental values are either the same or lower now. And in the isolated cases where rents have increased over this period, growth has not exceeded 2% (4).
- As a result, taking the euro-zone region as a whole, industrial rental values are still clearly lagging the recoveries currently underway among office and retail markets (5). On average, euro-zone retail rental values are now leading the recovery. Meanwhile, by sub-region, there is still no sign that declines in all-property rental values in the periphery are starting to slow. This has widened the divergence of performance with the region's core (6).

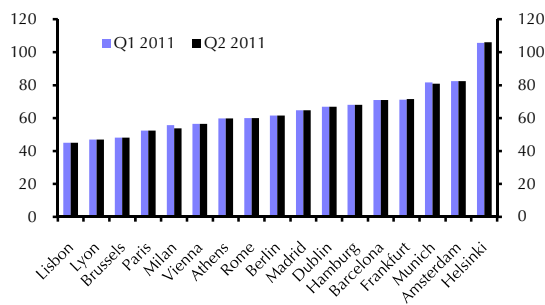
1. Euro-zone Prime Retail Rental Values (EUR/Sqm/Annum)



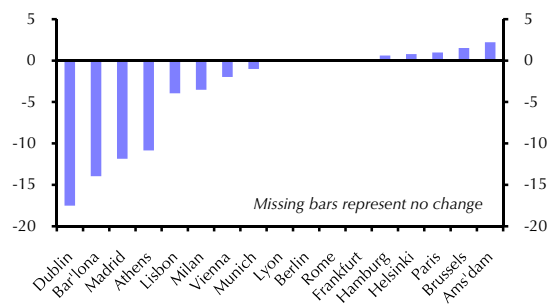
2. Euro-zone Prime Retail Rental Values (Q2 2011, %y/y)



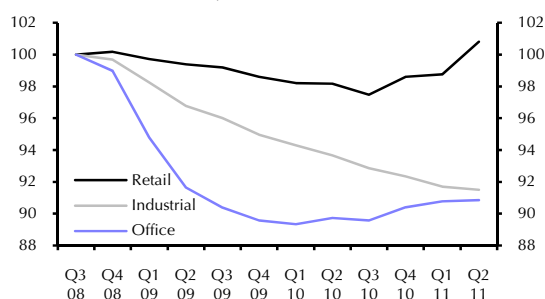
3. Euro-zone Prime Industrial Rental Values (EUR/Sqm/Annum)



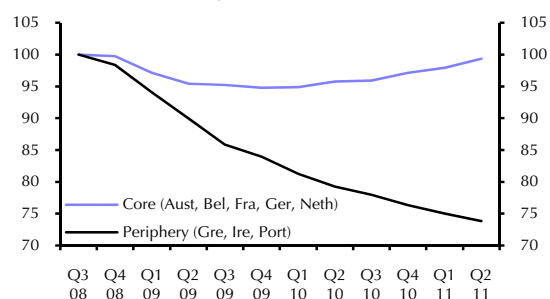
4. Euro-zone Prime Industrial Rental Values, (Q2 2011, % y/y)



5. Euro-zone Prime Rental Value Indices by Sector (Q3 2008 = 100)



6. All-Property Rental Value Indices by Sub-Region (Q3 2008 = 100)



Sources – Various Agents, Capital Economics

Economic and Financial Market Data and Forecasts

LATEST EURO-ZONE ECONOMIC INDICATORS

Monthly Data %m/m(%y/y) unless stated		Apr	May	Jun	Jul
Consumer Prices	HICP	+0.6(+2.8)	0.0(+2.7)	0.0(+2.7)	-0.6(+2.5)
	Core	(+1.6)	(+1.5)	(+1.6)	(+1.2)
Producer Prices		+0.9(+6.8)	-0.2(+6.2)	0.0(+5.9)	-
M3		(+2.0)	(+2.5)	(+2.1)	-
Unemployment, monthly change thous.,(rate %)		-60(9.9)	+41(9.9)	+18(9.9)	-
Retail Sales		+0.7(+0.9)	-1.3(-2.3)	+0.9(-0.4)	-
Industrial Production		+0.2(+5.3)	+0.1(+4.0)	-0.7(2.9)	-
External Trade Balance €bn		-2.5	-0.8	-1.6	-
Current Account €bn		-5.4	-5.6	-7.4	-
Monthly Data %m/m(%y/y) unless stated		Apr	May	Jun	Jul
German ZEW		7.6	3.1	-9.0	-15.1
German Ifo		114.2	114.2	114.5	112.9
Euro-zone Composite PMI		57.8	55.8	53.3	51.1
EC Euro-zone Economic Sentiment Indicator		106.1	105.5	105.4	103.2
Quarterly Data %q/q(%y/y) unless stated		Q3 2010	Q4 2010	Q1 2011	Q2 2011
GDP		+0.4(+2.0)	+0.3(+1.9)	+0.8(+2.5)	+0.2(+1.7)
Household Spending		+0.2(+1.0)	+0.3(+1.1)	+0.3(+1.1)	-
Hourly Labour Costs		(+1.0)	(+1.5)	(+2.6)	-

LATEST MARKET DATA

Instrument/rate	1 mth ago	1 week ago	Latest*	Instrument/rate	1 mth ago	1 week ago	Latest*
Official Rates				Germany yield curve (20-2)	208	240	224
ECB refi	1.50	1.50	1.50	Global yields			
UK repo	0.50	0.50	0.50	US 10 year	2.96	2.25	2.07
US Fed funds	0-0.25	0-0.25	0-0.25	UK 10 year	3.11	2.53	2.32
Japan o'night	0.10	0.10	0.10	Japan 10 year	1.10	1.05	0.99
Market rates				Equity indices			
3mth Euribor	1.56	1.49	1.48	German DAX	7326	5998	5412
12mth Euribor	2.18	2.05	2.05	French CAC	3843	3214	2986
Bond yields				Italian MIB	19461	15889	14611
Germany 2 yr	1.39	0.69	0.59	Exchange rates			
Germany 10 yr	2.83	2.33	2.06	\$/euro	1.44	1.42	1.43
Germany 20 yr	3.47	3.09	2.83	£/euro	0.88	0.88	0.87
France 10 yr	3.41	2.98	2.74	¥/euro	112.8	109.3	109.2
Italy 10 yr	5.41	5.02	4.97	Brent crude oil price (\$ pb)	118.3	107.3	106.0

*Latest as at 09.30am on 19th Aug. 2011

MAIN ECONOMIC & MARKET FORECASTS

%q/q(%y/y) unless stated	Latest	Q3 2011	Q4 2011	Q1 2012	2011	2012	2013
GDP	+0.2(+1.7)	+0.2(+1.4)	+0.2(+1.4)	+0.1(+0.7)	+1.7	+0.5	0.0
Household Spending	+0.3(+1.1)	+0.1(+0.7)	+0.1(+0.7)	+0.2(+0.4)	+0.7	+0.5	0.0
HICP (%y/y)	+2.5	+2.7	+2.9	+2.3	+2.8	+1.5	+0.5
Unemployment Rate (%)	9.9	9.9	10.0	10.1	10.0	10.5	11.0
Repo Rate, end period (%)	1.50	1.50	1.50	1.50	1.50	1.50	1.50
10 yr. Ger. Bond Yield, end period (%)	2.06	2.25	2.25	2.25	2.50	2.25	2.75
\$/euro, end period	1.43	1.40	1.40	1.40	1.40	1.30	1.20
£/euro, end period	0.87	0.88	0.87	0.86	0.88	0.84	0.80