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European Market Commentary: Q3 2021

October 2021

The eurozone has made a rapid recovery since most restrictions were lifted in April/May. The economy is on track to return to its pre-virus level by the end of this year and Schroders forecasts that it will grow by 5% in 2022 and 2% in 2023. The main driver will be consumer spending, as households spend some of the excess savings built up during lockdown.

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In addition, investment is expected to grow strongly, thanks to the rebound in exports and the EU Recovery Fund, which is focused on digital infrastructure and cutting carbon emissions. There are two main downside risks. First, there could be a new variant of Covid-19 which is more resistant to vaccines. Second, it is possible that the jump in inflation to over 3% sparks a wage-price spiral and forces the ECB to hike interest rates. While possible, we think it more likely that inflation will drop to 2% by the end of 2022, as supply chains normalise and the spike in energy prices falls out of the annual comparison. We expect the ECB to cut quantitative easing, but to leave the refi rate at zero until the end of 2023.

Although non-food shops have re-opened across Europe, the outlook for the sector is still difficult. Mid-market fashion brands (e.g. H&M, Zara) are closing stores as they shift more of their business on-line and the slow recovery in international travel is hurting luxury retailers who rely on Asian and American tourists. While some discounters are expanding (e.g. Action, Deichmann) they cannot afford to pay the same rent as mid-market brands and prefer fringe locations, or retail parks. Overall, we expect that prime shopping centre rents in continental Europe will fall by 10% over the next two years, while retail park rents will be broadly flat. By contrast, food stores will probably see rental growth of 1.5-2% p.a. through 2022-2023. On-line accounts for less than 5% of food sales in most European countries and there is good demand for mid-sized units in town centres.

In the office market there are signs that demand is stabilising, after a sharp fall in 2020. Take-up across Europe in the first half of 2021 was similar to 2009, the low point during the Global Financial Crisis. However, whereas prime office rents fell on average by 10% in the GFC, prime office rents in most cities have been stable over the last 18 months. The difference reflects two factors. First, the last couple of years have seen less office construction than in the run up to the GFC, so vacancy rates are lower, particularly in cities located in Germany, the Nordics, and the Netherlands. Second, occupier demand is polarising further and while secondary space is struggling, there is good demand for high quality offices in city centres close to amenities and which provide plenty of space for people to meet and collaborate. At the aggregate level, we expect that office demand will start to recover from 2022 onwards, but remain below pre-Covid levels, because of the growth in remote working. Looking across different cities, we think that Brussels, Dusseldorf, Rome and Stuttgart are likely to see the weakest recoveries due to a combination of slower office employment growth in the medium term, longer commutes (Brussels, Rome) and older offices with poorer facilities. Conversely, using the same variables, we expect that Luxembourg, Lyon and Madrid will see the strongest recovery in demand over the next few years.

Warehouse take-up in continental Europe is on course to hit a new record in 2021. The main driver is the growth in on-line retail as both internet retailers and traditional retailers add more capacity and shorten delivery times. In addition, although the immediate impact is limited, we think that the current disruption of supply chains and the risk of growing geopolitical tensions will encourage companies to hold slightly higher levels of stocks and re-shore some manufacturing to Europe. However, development is also on course to hit a new record this year. While two thirds of the space under construction is pre-let, the high level of new building means that rental growth in the logistics sector is likely to continue running at 2-3% through 2022-2023, rather than move up a gear. Multi-let industrial estates will probably see slightly faster rental growth, due to less new supply.

The investment market in the eurozone is now almost back to normal, after very subdued trading in Q2 and Q3 of last year. The value of investment transactions this year is likely to be only 10-20% below the average for 2015-2019 and despite travel restrictions both American and Asian investors are active in the market, alongside domestic investors. The divergence in industrial and shopping centre yields which began in 2018 has also continued with the average yield on prime logistics in the eurozone falling to 3.6% in September, while the average yield

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on prime shopping centres rose to 5.8%. Although it is difficult to predict sentiment amongst investors and lenders, our view is that this re-pricing is almost over and that most of the good news on logistic rents and bad news on shopping centre rents is now priced in. The average yield on prime offices in the eurozone stood at 3.3% in September, almost unchanged since the start of 2021.

In terms of a core investment strategy, we currently favour Grade A offices in city centres (e.g. Berlin, Lyon, Luxembourg, Madrid, Paris Stockholm), last mile distribution warehouses, food stores and residential schemes in affluent parts of Germany, the Netherlands and Sweden. Our preferred targets for a value add strategy are office refurbishments in major cities, the conversion of vacant retail buildings to mixed commercial and residential schemes, multi-let industrial estates, big box stores let to discount, or DIY retailers and hotels with management agreements.

A key question is how might higher inflation impact European real estate? While the tighter fiscal policies of eurozone governments mean that the risk of inflation becoming stuck at 3-5% is lower than in the USA, it cannot be ruled out. On a positive note, most rents in continental Europe are index-linked, so faster inflation should feed through to rental income, albeit with a short lag on those leases which specify a cumulative percentage increase in prices before rents can be reset.

On the downside, persistently higher inflation would inevitably lead to higher interest rates, with potential consequences for real estate yields. A lot would depend on the size of the increase in bond yields. If German 10 year bond yields stayed below 1% then the impact might be minimal. This is because real estate yields are only loosely correlated with bond yields in the short-term and the bigger influence is investors' rental growth expectations. However, if German 10 year bond yields rose above 1% then there probably would be a knock-on effect on real estate yields and capital values could fall. In these circumstances, history suggests it would take a few years for real estate yields to find a new higher equilibrium. Once this adjustment was complete, capital values would stabilise and real estate total returns would be higher in nominal terms. ESG concerns continue to run in parallel with economic risks with most institutional managers reviewing asset carbon pathways, capital investment and hold strategies.

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