CAPITAL VIEWS
RISK VERSUS OPPORTUNITY

CUSHMAN & WAKEFIELD®

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POLITICS TO THE FORE

This year has started well for the property investment market with strong momentum maintained from 2014 and improving occupational sector news also registering in an increasing number of markets.

However, we are also seeing a growing range of risk factors and while most are not necessarily new, they are providing investors with food for thought as they refine their strategies for the year ahead.

Our December "**Capital Views**" report identified political risk as one of the key areas of concern for 2015 and this is materializing all too quickly.

In a sweep across Europe, we have seen the unimaginable horror of events in Paris, heightened conflict in Ukraine, unexpected policy decisions in Switzerland, strains among the EU partners over monetary policy, a new party taking power in Greece and rising pressure from extreme political parties in a range of countries over issues including austerity, immigration and jobs,

The implications of all of these trends is far from clear – and in reality the fates they will bring are of course not yet written; they will only be formed over the coming weeks and months as decisions are made.

What is more, with elections to come in the UK, Spain, Portugal, Poland, Denmark, Finland and Turkey among others, politics are clearly going to remain front and center and investors need to develop appropriate strategies to both minimize risk and position themselves for the opportunities that will emerge.

The simple message is that performance will remain volatile and divergent market by market. At the same time however, performance drivers will be more compelling, with interest rates low, liquidity high and occupational market growth improving as a result of lower oil and commodity prices, a lower euro and stronger real spending power.

A nuanced market therefore lies ahead, with real growth potential but also with a range of risks that have to be understood at both a macro and a local level.

Political instability dominates

an increasingly complex risk landscape but at the same time performance drivers are growing more compelling.

Königstadt-Carrée, Berlin, Germany

This election

shouldn't spell the beginning of a new crisis for the eurozone although this risk can't be entirely discounted.

The election could however prove to be a high watermark for austerity.

GREECE

After fading from the headlines in the past year, Greece is back with a bang as a hastily called election has brought to power a party seen as radical and anti-establishment, with apparent plans to rip up bail-out agreements, scrap spending cuts and write-off debt. With little sign that other members of the eurozone will accept this, fears of a crisis and of Greece leaving the club have increased once more.

The reality of course is likely to be different to the hype and a Greek exit from the euro still looks unlikely. It could be disastrous for the country economically and politically but would also still be damaging for Europe as a whole, whatever some may like to think. Both sides therefore will be working to stop this happening.

It is no surprise that the majority of Greeks do not favour leaving the euro and hence that the rhetoric of the far-left Syriza party moderated as they moved closer to power. Nonetheless, while current brinkmanship will hopefully give way to careful negotiation now the election is past, the need for Greece's position to be reviewed is clear. Despite the reforms and progress that have been made, the economy has only now started to stabilise, the debt burden is more crippling and the need for deeper reform and debt relief is obvious.

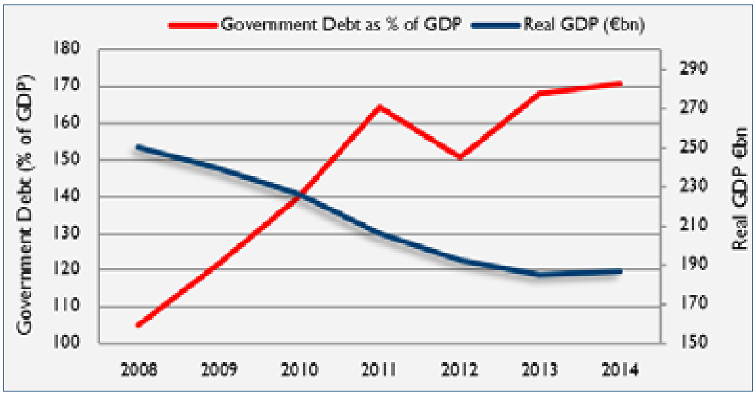
Action needs to be taken quickly, with a deadline for the Greek bailout deal due to expire at the end of February. Around the negotiating table, the best that the Syriza-led coalition may hope for in the short term is to extend debt maturities and take measures to hold down debt servicing costs. Actually writing-off more debt is likely to be difficult but if the debt burden can be extended, that will make life a lot easier for Greece.

The markets have already signalled their concerns over the stance taken by Greece but within the wider eurozone, the threat of a Greek exit now lacks the ability to panic the markets in the way it did in the past. Nonetheless, the view that a potential exit could be isolated this time around could be wishful thinking.

Firewalls exist and Greece may be allowed to leave, despite there being no precedent or mechanism to actually permit that, but political contagion risk is perhaps higher than ever with more extreme, anti-austerity parties emerging in many areas.

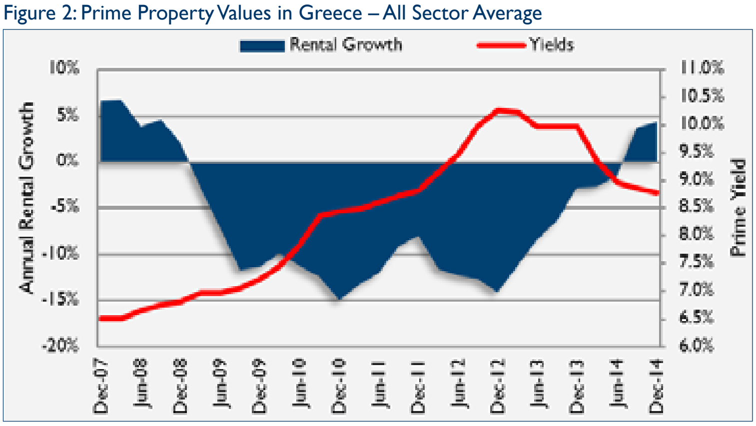
What is more, it should be on people's minds that if Greece left, the next "**domino**" is not a small country like Ireland or Portugal, but the EZ's third largest economy, Italy.

Figure 1: Greek Debt and The Economy



Overall therefore, while this change of government shouldn't spell the beginning of a new crisis for the eurozone, the risk can't be entirely discounted and a move to leave the eurozone, with subsequent devaluation and debt write-offs, would be an example carefully and perhaps jealously watched by some in Europe. In particular though, the election could prove to be a high water mark for austerity within Europe and could signal a more concerted effort to get growth and job creation higher up the agenda.

Figure 2: Prime Property Values in Greece – All Sector Average



Source: Cushman & Wakefield, OEF

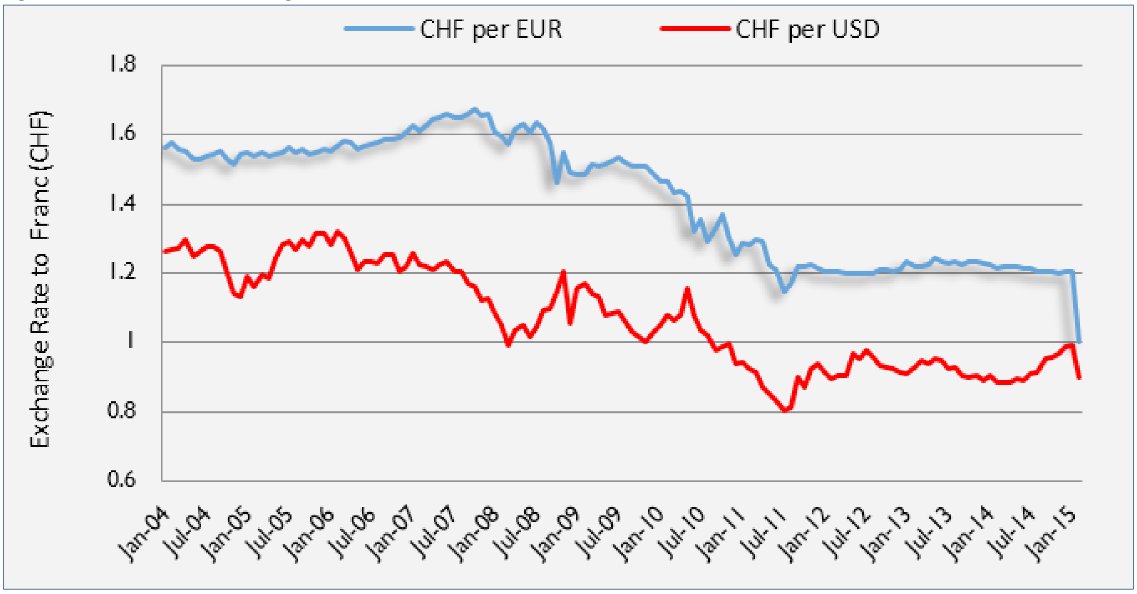
Either way, it is unlikely to signal a rapid bounce in Greece's property market, which had until recently shown some signs of balance returning. Syriza's economic plans may cause concerns, pushing back reforms that have started to cut the public sector and improve business efficiency. This will hold back occupational demand and any marked resumption of investment into Greece, particularly while the market waits to assess the new government's attitudes towards privatization and nationalization.

SWITZERLAND

It is not just the "**usual suspects**" such as Greece who have ramped up market uncertainty meanwhile. Switzerland, usually a bastion of stability, has also rocked the investment market, with the Swiss National Bank ending the cap on the Franc versus the Euro, in place since 2011 to maintain the currency at a competitive level during the euro crisis.

The peg had clearly become too expensive to maintain – or at least prospectively so in light of quantitative easing in the eurozone. The fact that the Franc appreciated by as much as 38% after the cap was lifted shows the degree to which it was being maintained at an artificially low level. However, even though it has since settled at just less than 20% up, and a new unofficial peg is being rumoured,this will obviously have serious ramifications for the competitive standing of some Swiss businesses and growth expectations are likely to be cut back.

Figure 3: The Swiss Franc Exchange Rate



Source: Cushman & Wakefield, Macroband

While creating a lot of headlines, the direct impact of the Swiss move is likely to be limited within Europe aside from in those areas where foreign exchange borrowing in Swiss Francs may have been prevalent. It is perhaps more notably a signal of the pressure the euro itself is under. Within Switzerland however, the significant increase in the Franc will have conflicting implications for the market, probably boosting investment demand and bringing yields down further but at the same time, acting as a negative for the already slow occupier market.

The impact of the SNB's move is likely to be limited within Europe but does underline the pressures on the Euro.


Fashion Season, Moscow, Russia

The economic impact

of the conflict is severe and the instability being created within the region and beyond is more damaging still. Nonetheless, opportunities for risk takers are set to emerge in the months ahead.

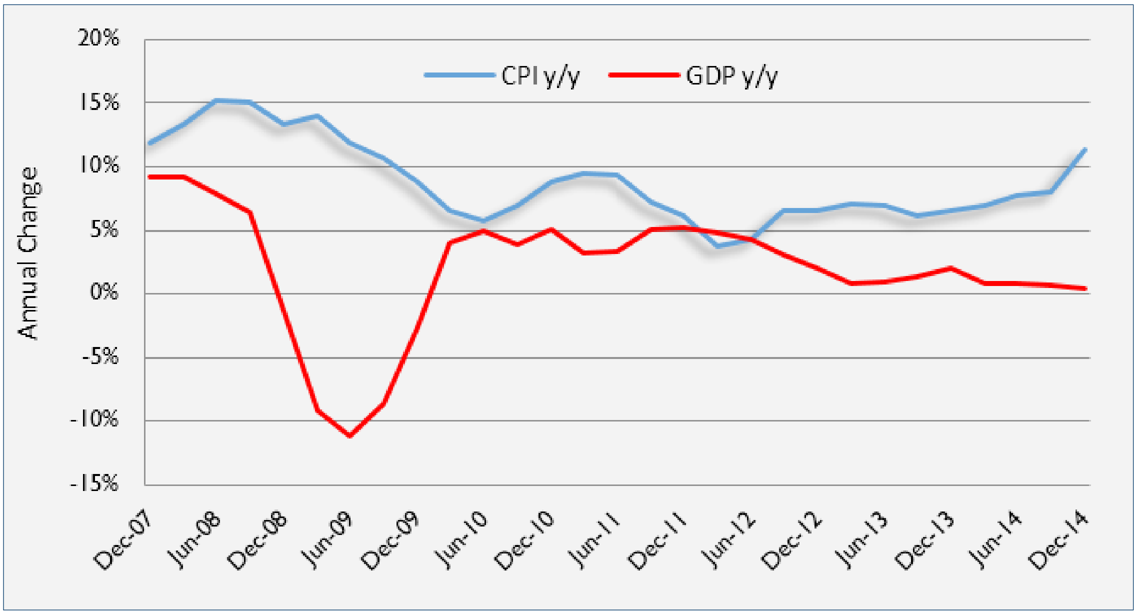
RUSSIA & UKRAINE

The situation in Ukraine clearly remains very unstable, particularly for those caught in what seems to be a still deteriorating cycle of violence. Implications are also being felt by all sides outside the country however, with economic and credibility issues impacting on Russia, neighbouring countries and the West as a whole.

Ukraine is now in the midst of a recession expected to cut national output by at least 10% over 2014 and 2015 while Russia has seen growth expectations plummet as weaker oil prices have magnified the problems imposed by sanctions. A marked recession is now expected in Russia in 2015, with the consensus moving towards a GDP fall of between 4% and 5% this year.

While Russia has ample foreign reserves, it has seen its investment rating downgraded. At the same time, the Rouble has fallen sharply and inflation expectations have increased, limiting the authorities' freedom to act. Property markets have followed suit, with yields rising around 100 basis points in Russia and by more in Ukraine – although evidence is limited in the latter - while prime rents are down 10-15%. Additionally, weaker economic demand in Russia is an added headwind for the rest of Europe, hitting some exporters, reinforcing deflationary pressures and posing a risk for Western banks and investors exposed to the market.

Figure 4: Growth and Inflation in Russia



Source: Cushman & Wakefield, Macroband

Of greater significance however is the impact on stability as geopolitical wrangles escalate, centered on Ukraine of course but extending within the Eurasian Union area promoted by Russia and beyond as destabilizing covert actions are said to be increasing from all sides and a new cold war is suggested by some. The role the oligarchs play in either supporting this or not could be crucial.

Amidst such uncertainty, investment patterns and occupier moves will continue to be impacted. However, Russia has been one of the region's most dynamic emerging property markets and is underpinned by vast wealth and resources. What is more, a firming in oil prices would provide quick relief to the Russian authorities and higher consumption over the winter may bring that about. At the same time, while apparently a remote possibility at present, positive noises on Ukraine could be quickly rewarded if the overtures of some European governments are to be believed.

Hence while the market and the region will remain off-bounds for many for some time, it will see increased interest from risk takers ready to take advantage of opportunities when they sense the market is close to bottoming out, with re-financing needs perhaps likely to trigger such opportunities in the near term. Local investors, Asian and Middle Eastern players, as corporate occupiers and investors already established in the market, may be in the vanguard of any such move.

The consequences of QE

are unknown but in the short term we should see a boost to sentiment, liquidity, exports and hopefully inflation as well as a "lower for longer" interest rate environment.

QUANTITATIVE EASING

Spurred by weak growth and falling prices, the ECB has signed up to what many have thought inevitable for some time: namely additional quantitative easing (QE).

Under this programme, they will buy government and covered bonds as well as asset backed securities, in an attempt to push up liquidity and inflation expectations while also holding down borrowing costs and improving the availability of finance for small to medium sized firms.

The package announced is larger than many expected – amounting to €60bn per month through to next September and beyond if inflation is not heading back to its 2% target rate.

This open-ended undertaking to hit the target shows that the bank is committed to inflation control and that the "whatever it takes" promise of 2012 is still alive and kicking.

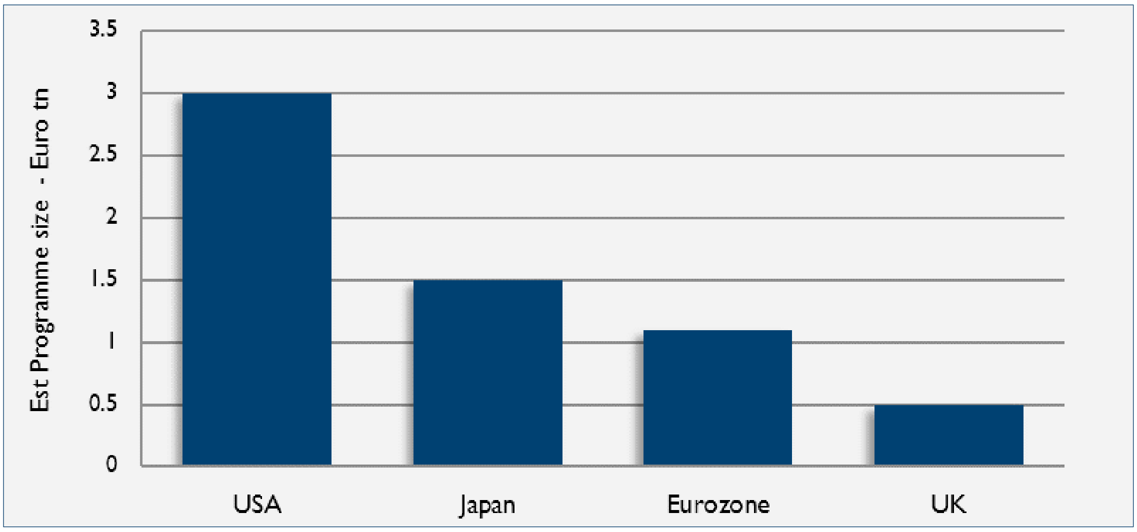
While smaller than the stimulus undertaken in the USA or Japan, particularly relative to GDP, it is nonetheless a very significant and sustained capital injection that will boost sentiment as well as credit markets.

Offsetting the news over scale however, a not unexpected compromise was reached on risk sharing whereby the first 20% of any losses will be shared across the eurozone but greater subsequent losses will be borne by the national bank of the country where the losses emerge.

This is believed to have been made to ensure governments make all efforts to reform and balance their books and so more frugal governments, led by Germany, are not seen to be bailing out more profligate regimes.

Of course in reality, as Mario Draghi the head of the European Central Bank has pointed out, the issue of shared responsibility is over-stated given that ultimately liability within the eurozone is mutual.

Figure 5: Quantitative Easing Compared



Source: Cushman & Wakefield, FT


Skylight, Warsaw, Poland

A key early benefit from QE should come from maintaining market confidence in the authorities and their ability to act to stave off deflation and stagnation. The likely economic results beyond that are of course open to debate but it is clear that anticipation of the move had already brought eurozone bond yields down to fresh lows.

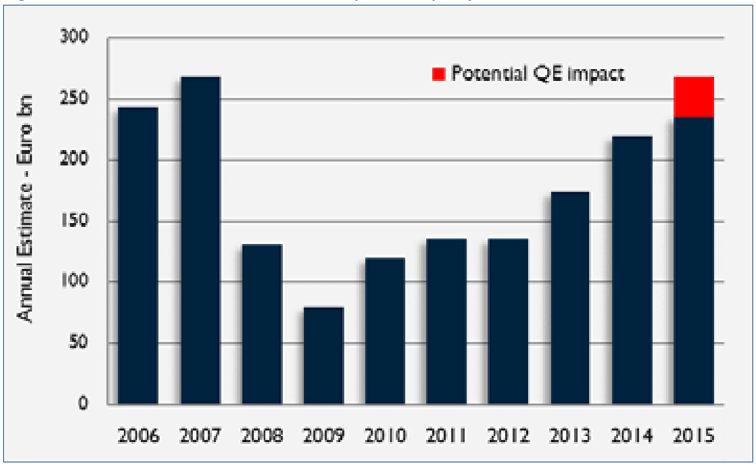
The area is now clearly in a "lower for longer" interest rate environment, with significant rate rises not likely to be on the agenda for some time.

To turn these short-term benefits into medium term gains, the QE programme needs to encourage and facilitate more business investment, partly perhaps by opening up Europe's securitisation market.

Some of the investment may also flow to the European Investment Bank, promoting infrastructure and other investments that will boost Europe's medium term capacity.

More notably perhaps, it must encourage governments to get on with deeper structural reforms and it will be committed reformers like Ireland, Spain and Portugal who gain most.

Figure 6: Commercial Investment in European Property



Source: Cushman & Wakefield Investment Strategy

If the QE programme is successful, the impact on property markets in general could be substantial, as even more demand will be diverted into the market. As a result, yields are set to fall more than expected and volumes will be pushed further back towards record levels.

Without QE, the market may have seen a 5-10% increase in investment volumes this year alongside a 20-30bp prime yield fall. With a successful QE package delivering lower for longer borrowing costs, more growth and some reform, that forecast is increased to a 40-70bp yield fall and a 20% plus jump in property trading.

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Ruhr Park, Bochum, Germany

DEFLATION

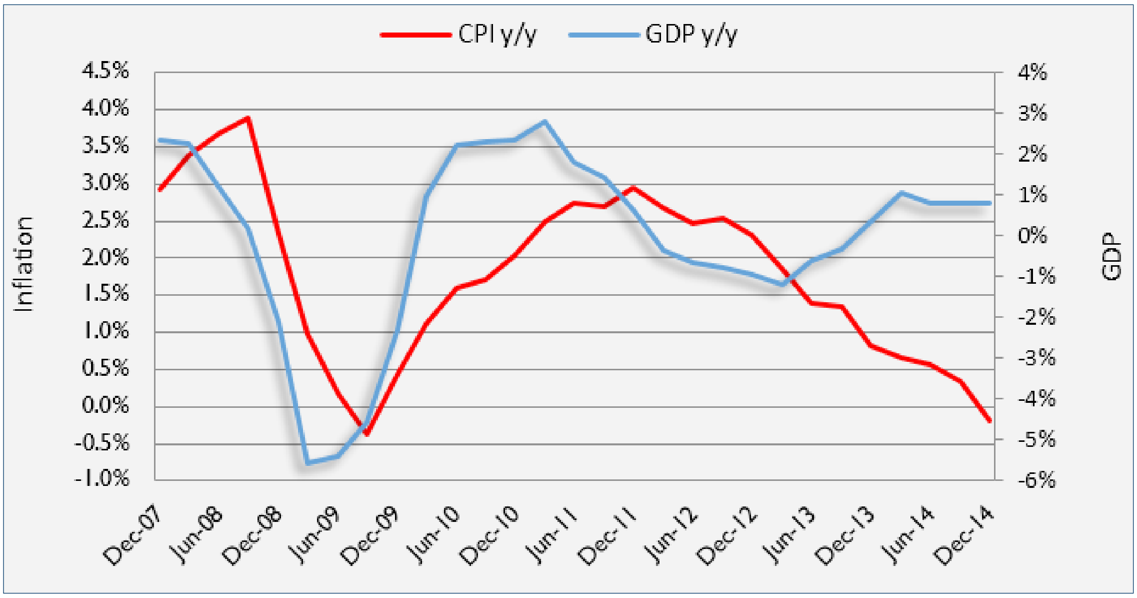
Europe's fall into deflation was a key event sparking the expansion of the QE programme. The price falls seen in January were the first since 2009 and will only increase in the months ahead as the full force of energy and commodity price drops come through. Even stripping volatile energy costs out of the measure however, core inflation rates are also falling. This is raising questions about the ability of the authorities to hold down inflation and with the public's faith in central bank control seen as key to underpinning macro-economic stability, it was no surprise that the ECB chose to act so robustly.

The problem they face, however, is made that much harder by the diversity in performance shown across the eurozone. Only 5 countries in the EZ actually suffered deflation in the latest set of numbers for example, although only 2 had an inflation rate above 1%. At the same time, while German unemployment is at a fresh low of 6.5%, Italian unemployment hit a high of more than double that rate. House prices are up 15% in Ireland but are falling in France and Italy but retail sales are rising in 15 of the 19 members of the eurozone. The problem of applying one policy to fit the whole region is therefore as complex as ever.

The key question

is whether deflation becomes ingrained and with few signs of that currently, we can anticipate short-term gains, focused on Europe's retail sector.

Figure 7: Inflation and Economic growth (eurozone)



Source: Cushman & Wakefield, OEF

Nonetheless, the need to act is still clear. If sustained, deflation will encourage consumers to delay buying and also raise the real cost of debt, hitting consumer sentiment and potentially threatening a new financial crisis.

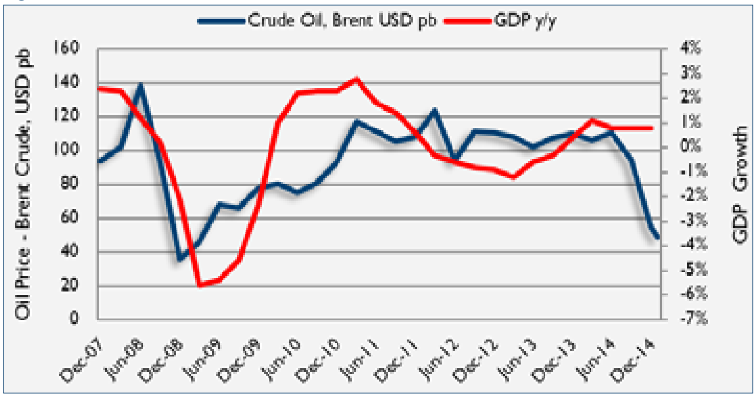
For now, the current burst of deflation can be thought of as benign, centered as it is on energy costs and with core prices still rising. Arguably therefore it will not make consumers delay purchasing but will boost their spending power. Indeed, a quick look at the recent trend of inflation and growth suggest the two have decoupled – with falling inflation not mirrored by falling growth as clearly as it has been in the past.

The key therefore is whether deflation becomes ingrained and with few signs of that currently, we can at least anticipate short-term gains, focused perhaps on Europe's retail sector.

OIL

Oil price falls have been dramatic and the explanations offered often controversial: from signalling the start of an economic meltdown to being part of a broad conspiracy aimed perhaps at high cost fracking production or at Russia. In reality, of course, the rollercoaster of the oil price is nothing new in a market very driven by the health of the US Dollar, production capacity, investment and geopolitical risk.

Figure 8: Oil Prices and Eurozone Economic Growth



Source: Cushman & Wakefield, Macroband

Some argue that the pace of decline demonstrates that the market did not have strong demand underpinnings and weakness in other commodity prices such as copper lend some support to this view.

However, while oil price falls are a product of demand as well as supply, most seem to agree that the more significant force does currently appear to be supply, aided by fracking and other investments in increased capacity. This is supported by recent data (see figure 8) showing GDP growth stable even though oil prices have been falling for some time.

This is a net positive

for the global economy – reducing costs, raising consumption and holding down inflation.

However, it does represent a transfer from exporters to importers and broadly speaking from savers to spenders.

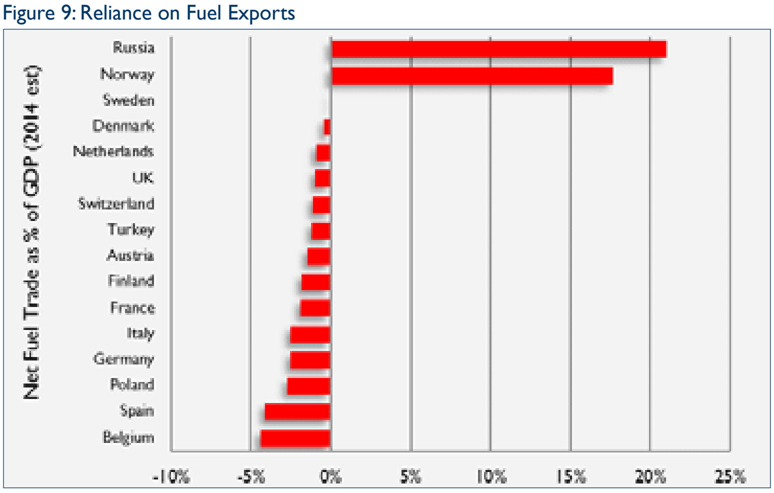
As low prices take some capacity off-line, it will take time before production can be raised back again and as a result while prices may stabilise in the months ahead, a return to the levels seen over recent years will take time to emerge. Current forecasts suggest pricing of €50 per barrel in Q2 and €60-70 in Q4.

Hence while there will be gains for some, there will be increased uncertainty in oil producing regions and this will hit property given that many of these "savers" are global real estate players. Indeed, at least a temporary cut in overseas investment will result in some cases, as we have already seen from some Malaysian funds for example.

Among the winners in Europe will be countries such as Belgium, Spain, Poland, Germany and Italy, followed by France, Finland, Austria and Turkey, who are most exposed to oil imports and will benefit more from falling prices. Differential implications will also be seen at a city level, with oil cities such as Aberdeen, Omsk and Stavanger seeing somewhat weaker conditions than they have become used to, in some cases just as supply is increasing.

Employment growth in non-oil sectors is likely to increase meanwhile as low prices support investment and this will benefit many other office markets in the region. More generally, better growth and consumer spending power argue in favour of a boost to European retail markets. However, if the oil price fall brings forward the prospect of rental growth, it may lead to some funds choosing to hold on to property rather than selling, despite the fact that rising bond yields next year may start to impact on property yields.

Figure 9: Reliance on Fuel Exports



Source: Cushman & Wakefield, Macroband

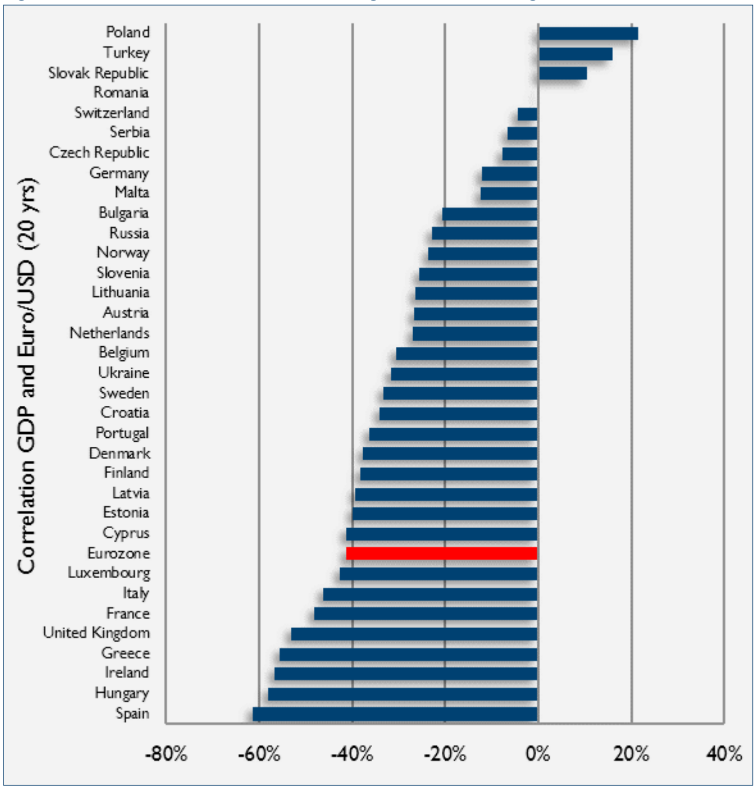
THE EURO

The euro has been on the slide for some time as the recovery has failed to ignite, the deflation threat has mounted and more latterly as quantitative easing has been launched. Of course, the strength of the dollar on the other side of the equation cannot be ignored and the fall in the euro is clearly a policy objective, not an accident or an unforeseen crisis.

The fall

in the euro is clearly a policy objective not an accident and will be a boost for the eurozone economically.

Figure 10: Correlation between Euro strength and economic growth



Source: Cushman & Wakefield, Macroband

A weaker currency will be a boost for the eurozone economically – particularly coming alongside lower oil prices, interest rates and inflation – and there may be further yet for it to fall.

Indeed, while the decline to date has been dramatic, the dollar's rally is not as marked as in some past recoveries.

However, with China and Russia looking to reduce the hegemony of the USD in commodity and other trading, the typical pattern of flows of capital towards the USD may not be as strong as usual.

The implications meanwhile will vary market by market depending on trading patterns and competiveness, with recent history suggesting most of Europe has a negative correlation with the euro exchange rate to the Dollar: indicating that a weaker exchange rate is associated with higher typical GDP growth.

On average over the last 20 years, there has been a -41% correlation between EZ GDP and the euro:dollar rate: with an exchange rate less than 1.1 associated with GDP growth over 2.8%. Historically, those benefitting most have been Spain, Hungary, Ireland and Greece, followed by the UK, France, Italy and Luxembourg. Germany benefits, but to a much smaller degree according to these historic numbers. Conversely, meanwhile, Poland, Turkey and Slovakia have a positive correlation and tend to perform well in times of euro strength (see figure 10).

Looking at the property sector, the weakness of the euro may help to rebalance global capital flows and demand for real estate, with dollar assets attractive as the US economy and currency strengthen. However, with supply likely to increase in Europe, a lot of attention will stay on this region.

A notable rebalancing

in the market may result from recent trends, with occupier and investor cycles moving slightly closer together, savers and spenders transferring some market power and possibly growth moving up the agenda at the expense of a little less austerity.

SUMMARY: REBALANCING THE FLAVOUR OF THE MARKET

Recent events are reminding the market that there is no room for complacency and Europe generally, and the euro area specifically, face a critical time in the next few weeks in which events and decisions will shape the way the region evolves not just for the remainder of this year, but potentially for some time beyond.

Growth in the opening quarter clearly looks set to remain low and volatile but beyond that a modest improvement should be seen based on factors now in play. QE will ensure greater liquidity and low borrowing costs for example and, alongside measures taken to bolster the banking sector, should ensure a greater supply of finance to support investment and growth. Lower commodity prices and deflation will reduce operating costs and add to purchasing power, while exporters will benefit from the weaker euro.

Although the economic boost from these trends will be modest and far from universal, it will be real and may be added to by an easing in austerity and increased investment.

As far as real estate markets are concerned, it should help to deliver the start of a rebalancing between occupier and investor markets as employment and spending increase. All sectors stand to benefit but the turnaround from last year may be most marked for retail as increasing purchasing power boosts the consumer.

At the same time, while the Swiss situation will have only marginal ramifications in itself, alongside events such as the election in Greece, it will serve to remind investors not to take everything at face value: meaning the fundamentals in any target market need to be right but may be subject to change. Political linkages between markets may nonetheless grow in significance in driving some deals.

Property investment volumes will remain strong meanwhile and yields will continue to fall as bond benchmarks remain low. Interest rates are likely to remain low globally of course, boosting demand for real estate in a range of markets beyond Europe.

Demand for Dollar denominated assets should rise for example, spurred on by the outperformance of the US economy. The recovery in emerging market demand globally does however look further away than previously thought – with risk tolerances likely to stay more focused on developed economies. One possible exception to this could be Turkey, which is a big energy importer and of course the only true large scale emerging market in Europe other than Russia.

Finding stock to buy will remain an issue – but also a positive draw for Europe as bank sales and deleveraging as well as profit taking and stock recycling add to available supply. Interest will flow over to a range of other European markets and there will be a more noted move back into development, helped by recent falls in commodity prices which should reduce build costs. In addition, more corporate activity is likely - including asset sales by corporates, joint ventures and takeovers.

Overall therefore, current trends point to a gradual improvement in growth but in a volatile and still very divergent fashion market by market. The risk of an asset price bubble in Europe is clearly present as high liquidity and a chase for yield drives investors. However, at the same time there could be a notable rebalancing of growth that takes some risks out of the market. For example, occupier trends may start to catch up with investment in some markets and global capital flows between regions should become more balanced.

2015 therefore is shaping up to be a year for truly global real estate targets as well as global capital and for a focus on what occupiers want – with development and repositioning a key route to profit.

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CUSHMAN & WAKEFIELD

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The Capital Markets team provides trusted commercial advice and execution services to those engaged in buying, selling, investing in, financing or building real estate. We work closely with our clients in order to accurately advise them on maximising the value of their real estate. Our services include investment sales and acquisitions, sale and leasebacks, arranging senior debt and mezzanine finance, private placements, loan sales and indirect investment.

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A recognized leader in real estate research, the firm publishes its market information and studies online at www.cushmanwakefield.com/knowledge

THE REPORT

This report has been prepared by David Hutchings, head of the Investment Strategy team in Cushman & Wakefield's EMEA Capital Markets group, based on desk research together with input from Cushman & Wakefield professionals in the Capital Markets teams across Europe.

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