Introduction: Real estate prospects in a recovering European economy

As Europe battles with rising coronavirus cases, the Euro Area's economy will continue its recovery in 2022. Capital Economics forecast GDP growth will fall from 5.3% to 4.0% between 2021 and 2022, with all of Europe's major economies expected to have recovered above pre-pandemic levels of GDP by the end of 2022. CEE markets have recovered among the fastest of Europe's economies, led by Romania, Poland and Hungary, whilst southern Europe is recovering at a slower pace, due to lower levels of international tourism and higher levels of unemployment.

Supply chains will continue to adjust to both disruption to supply and a resurgence in demand. Port closures, labour scarcity and rising fuel costs have all impacted the price and availability of goods, particularly semiconductors, which have created shortages of new vehicles and smartphones. We have since seen some companies seek to near-shore their supply chains in order to mitigate future operational risks.

The main theme for investors will remain to what extent inflation will impact real estate returns. Eurozone inflation rose to 5.0% in December 2021, the highest reading since September 2008. However, looking more closely at the figures, the core level of Eurozone inflation remains at 2.6%, close to the ECB's target rate of 2.0%, and below other advanced economies, indicating that any policy change is unlikely for the forecast period. The 26% yoy increase in energy costs is expected to normalise, reducing the headline rate.

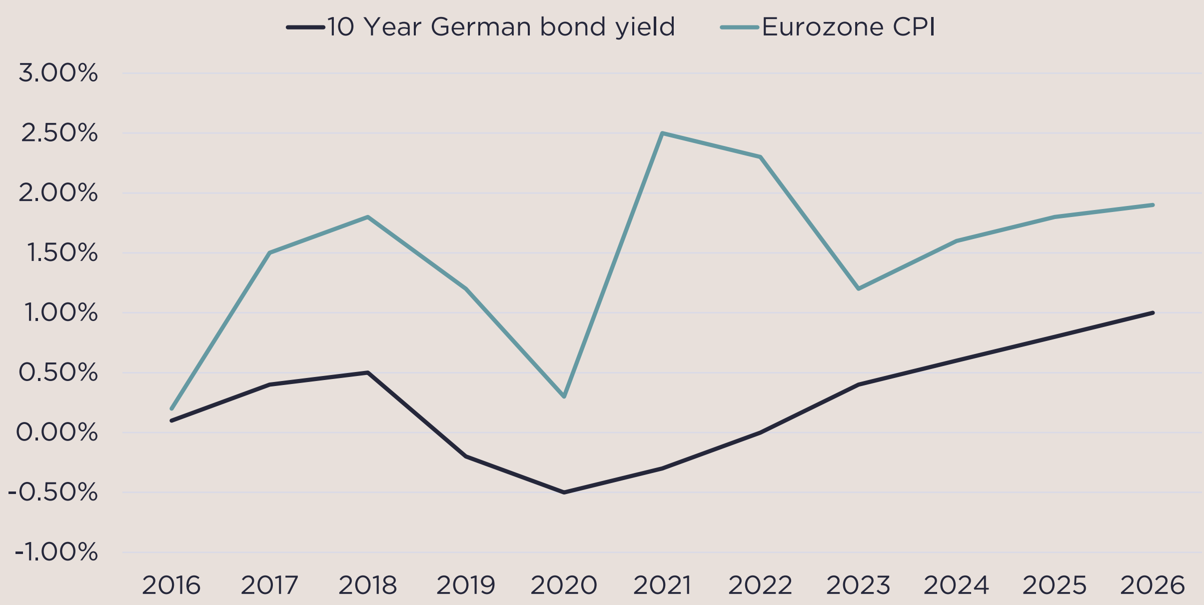
A scarcity of labour remains an additional price pressure in the Eurozone, although not as severe as those in the US, for example. Conversely, on the demand side, the Eurozone consumer bounceback has been weaker than other global markets, such as the US, which will reduce price pressures. As such, Capital Economics do not expect the Eurozone base rate to rise before 2024.

European real estate will remain an attractive asset class given the majority of leases are index linked, providing a hedge against inflation. The yield spread between prime CBD offices and government bonds also remains above the long term average.

The other consideration is the impact of rising construction input costs, increasing overall development costs, which may, in turn, support rental growth opportunities for existing stock.

One of the main downside risks for world economies in 2022 is the

Chart 1: German bond yield and Eurozone inflation forecasts



Source: Capital Economics