EMPIRA

Economy & Real Estate

Research Quarterly View

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Dear Readers,

Stable rates shaping market expectations at the start of 2024

Following a period of very high inflation rates, the focus has now shifted to indicators of recession. Further key interest rate hikes are looking unlikely at present; it is more probable that rates will plateau over the next few months.

The forecasts also show that a return to the zero interest rates of the 2010s is unlikely. The most probable scenario is a return to a level of between 2% and 3%, in line with the long-term average.

The property markets regularly reflect economic developments with a time lag. With interest rates having risen sharply, real estate financing has collapsed. If interest rates remain at these high levels (or continue to rise) in the medium term, this will create potential problems for many follow-on financing arrangements. Banks will have to step up the realisation of collateral, which will delay a recovery in new business.

At Empira, we see striking differences in terms of region and type of use. In our current research, we analyse the conditions and put the performance in the context of other asset classes. In the current environment, real estate as an asset class can deliver the benefits that institutional investors have always valued, namely cash flow generation and the prospect of rising rents in most of the regions we cover.

Contact us to discuss which opportunities the office investment market offers in the current environment.

Regards,

Lahcen Knapp
Founder and Chairman, Empira Group

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Overview

Following a period of very high inflation rates, the focus has now shifted to indicators of recession. Further key interest rate hikes are looking unlikely at present; it is more probable that rates will plateau over the next few months.

Economic climate

Many European economies will report economic stagnation for 2023. In Germany and Austria, recessionary trends show no signs of abating. Growth prospects are limited by the continuing geopolitical tensions.

DACH region

German economic output fell by 0.3% in 2023, which means that Germany is in a recession. This was mainly attributable to weak consumption at both private and public level, and to lower value creation in the manufacturing sector. By contrast, the service sector and investment were robust. Fourth-quarter data is not yet available for Austria or Switzerland. The Austrian economy shrank by 1.8% in the third quarter. This was the second successive quarter of economic contraction, putting Austria in a recession. Although the Swiss economy grew 0.3% year on year in the third quarter, it lost considerable momentum compared with the prior quarters. The forecast range for 2024 and 2025 is wide: the German government is optimistically anticipating growth rates of 1.3% and 1.5%, respectively, whereas the German Economic Institute (IW Köln) is predicting that the economy will shrink by a further 0.5%.

DACH economic growth	2022	2023p	2024p
Economic growth – Germany	+1.8%	-0.3%	+1.3%
Economic growth – Austria	+4.8%	-0.8%	+0.9%
Economic growth – Switzerland	+2.5%	+1.3%	+1.1%
Inflation – Germany	+6.9%	+6.1%	+2.6%
Unemployment rate – Germany	5.3%	5.6%	5.6%

Source: German government – autumn projection 2023, DESTATIS, Austrian Institute of Economic Research (WIFO) economic outlook (4/2023), SECO economic trends (winter 2023/2024).

The period of very high inflation rates appears to be over for now. The industrial producer price index, which is a leading indicator for the consumer price index, has been falling year on year since July, with declines of over 10% between August and October. This indicator was down 14.7% year on year in September 2023, in the steepest drop since measurements began.

The price falls in some areas are also reflected in the broad consumer price index (CPI). Inflation was under 4% in the fourth quarter and therefore significantly below levels in its peak phase in 2022. A further fall in consumer price inflation to around 2.6% is forecast for the coming year. However, these levels are still above the Maastricht inflation criterion of 2%, which suggests it is unlikely that all central bank action will be dropped.

Austrian inflation remained high in the fourth quarter, at over 5%. Although the country is also seeing a downward trend, less progress has been made than in other European economies. Conversely, inflation has been less of a focus for some time now in Switzerland, as it has been within the target range for several quarters.

However, political measures such as the increase in the carbon price, the discontinuation of some subsidies, and additional taxes in the agriculture, e-mobility, and catering sectors are generally counteracting the trend towards lower inflation and may trigger price hikes across the wider economy.

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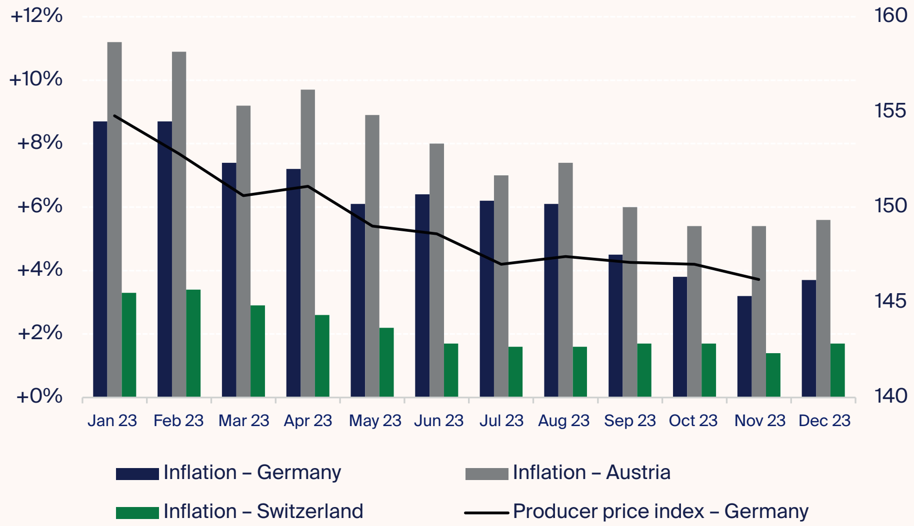
Inflation and producer prices



Source: OECD data, German Federal Statistical Office.

US

As the world's biggest economic power, the US is often a forerunner for economic trends elsewhere in the western world, meaning it is widely watched for nascent developments and leading indicators. The US, too, seems to have emerged from the period of high inflation. Inflation came in at just 3.7% in 2023, and rates of just 2.2% and 2.0% are expected for 2024 and 2025, respectively. 2023 also seems to have ended on a positive note for the US economy, based on stable economic growth of 2.5% and low unemployment. Real incomes have grown by 4.2%, as a result of which strong domestic economic activity is expected.

Forecasts for 2024, including weak growth of 1.2% and a rise in unemployment, point to a deterioration in the economic situation. In addition, disposable income is set to virtually stagnate, which will have a negative impact on domestic economic activity in particular, and also on international demand for consumer goods. The upcoming presidential elections could give the economy a boost to : economic programs are often launched in election years with a view to presenting robust economic data to voters. However, this is purely speculation and cannot be used for forecasting purposes.

US GDP	2023	2024p	2025p
Economic growth	+2.5%	+1.2%	+0.8%
Inflation	+3.7%	+2.2%	+2.0%
Unemployment rate	3.6%	4.0%	4.0%
Disposable income	+4.2%	+1.0%	+1.3%

Source: The Conference Board Economic Forecast for the US Economy (January 2024).

Global development

The geopolitical situation remains fraught. The wars in Ukraine and Gaza are continuing to hurt politico-economic stability. In particular, disrupted supply chains, reduced availability of raw materials, and sanctions are threatening the stability of the global economy.

Despite the ongoing conflicts, a new global economic equilibrium appears to be establishing itself, with commodities settling at a new price level and global supply chains stabilizing.

However, this equilibrium is fragile. There is currently a very high risk that these conflicts will further intensify or that new conflicts will emerge. This could trigger further price hikes and supply bottlenecks, which would present fresh challenges to the global economy.

Real estate markets

The real estate markets regularly follow economic trends, sometimes with a certain time lag and in widely divergent ways, depending on the region and usage type.

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DACH region

Extensive new regulations are being introduced in the DACH real estate market, which – with the exception of Switzerland – is also subject to EU law. Under the Buildings Energy Act (Gebäudeenergiegesetz, GEG) passed by the German government, all newly installed heating systems must be at least 65% fueled by renewable energy from the start of this year. This will require high levels of investment for some property owners.

The planned EU Energy Performance of Buildings Directive has stalled in its current form. It is at present unclear what a renegotiated and probably significantly watered-down version of the directive would look like. This uncertainty represents a further obstacle for investors, because it considerably restricts medium-term planning security.

Building permits – Germany	Residential buildings		Residential units	
	2023/Q3	2022/Q3	2023/Q3	2022/Q3
Total	22,077	34,400	50,434	75,045
Of which 3 or more residential units	3,074	4,436	32,897	45,436

Source: German Federal Statistical Office (Destatis).

There has been a strikingly sharp year-on-year decline in the number of approved residential units. In the third quarter of 2023, the number of residential units and residential buildings granted permits fell by around 33% and around 36%, respectively, year on year. The excess demand for residential space is therefore likely to increase even further.

It should be noted that the reasons for insufficient construction activity have shifted from the supply to the demand side. Whereas supply and construction capacity bottlenecks were the main reason for residential building targets not being met during the pandemic, this has now shifted to a lack of demand. The situation in the construction sector is particularly critical, as a report from the ifo Institute for Economic Research shows. The business climate index in this industry is at its lowest point since 2009, the peak of the financial crisis, and business expectations are in fact considerably worse. By far the most frequently cited reason for the poor business situation is the lack of orders, followed by order cancellations. By contrast, shortages of materials have largely ceased to be a problem. Despite expectations, financing difficulties also play a lesser – albeit growing – role. Incoming orders are currently around 25% below the peak recorded in 2021, which is approximately equal to the level of 2017/2018.

The volume of investment in residential portfolios with 30 or more residential units fell further last year. Following the peak in 2021, with a total volume of approximately EUR 51.0 billion, and the sharp fall of around 74% in 2022, transactions dropped by a further 60%, with a mere EUR 5.2 billion or so recorded in 2023.

A heterogeneous picture of the real estate market in the DACH region emerges from the price statistics. Firstly, we can see that rents are increasing across all locations. For example, the average net basic rent (exclusive of heating) in Germany was up 2.1% year on year in October 2023. Purchase prices tell a different story, however. These rose only in Cologne, falling in all the other top seven cities. Demand fell sharply in the latter group of cities, due in particular to higher interest rates and building costs. This also led prices in many sub-markets to edge lower. In the cities where prices rose, these effects were counteracted by new arrivals.

The fall in property prices is a Europe-wide phenomenon that is also reflected in the EPX index, which has been declining for some time. The broad index was down 4.2% year on year in October 2023. However, there is a clear divergence between trends for new builds and existing properties. While the existing buildings index fell by 7.7%, prices of new builds rose by a further 1.6%.

Change in prices	Purchase prices in EUR/m²		Rents for new-build properties in EUR/m²	
	2023/Q3	2022/Q3	2023/Q3	2022/Q3
Berlin	-5.4%	+8.0%	+9.1%	+4.8%
Hamburg	-5.4%	+3.5%	+5.6%	+3.2%
Munich	-2.4%	+4.1%	+2.9%	+1.0%
Cologne	+4.5%	+3.9%	+12.9%	+4.3%
Frankfurt	-5.5%	0.0%	+2.3%	+1.2%
Stuttgart	-2.5%	+8.1%	+1.2%	+1.8%
Düsseldorf	-5.4%	+5.7%	+6.4%	+1.4%
Vienna	+0.3%	+22.9%	+6.7%	+1.5%
Zurich	-3.0%	+8.1%	0.0%	+4.5%
European peers				
Brussels	0.0%	+4.3%	+7.1%	+3.7%
Prague	-0.5%	+9.7%	+8.4%	+7.4%
Copenhagen	-8.1%	+3.0%	+12.9%	+7.1%
Paris	-3.6%	-1.9%	+5.9%	+0.7%
Luxembourg	-4.2%	+9.1%	+1.7%	+3.4%
Warsaw	+13.0%	+18.5%	+26.8%	+9.2%
Madrid	+11.3%	+7.8%	+11.3%	+12.4%
Stockholm	-5.6%	+3.2%	+3.1%	+15.3%
London	+0.9%	-10.9%	+5.4%	+24.5%

Source: RIWIS, Catella residential market overview, 2023.

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However, the vdp index also showed that the top seven cities are less affected by the price falls than Germany as a whole, and that the uptrend in rents is significantly steeper in the major cities, with growth of 5.8% year on year.

US

Since the real estate market in the US is far less regulated than in Europe, rental and purchase prices in the US provide a relatively undistorted picture of the relationship between supply and demand in the housing market. Consequently, there are locations in the US where not only purchase prices but also rents are falling.

Overall, the situation in the US market looks critical. The total purchase volume of real estate fell by about two-thirds year on year over the past 12 months (USD 85 billion vs. USD 230 billion).Another example is the decline in the average purchase price of a residential unit by around USD 20,700 or 8.3%.

The various metro areas in the US are heterogeneous, and levels of momentum in their property markets vary considerably. Performances range from Odessa in Texas, where asking rents have risen 11% year on year, to Punta Gorda in Florida, the weakest location, where they are 9% below the prior year.

Two Sun Belt locations (Odessa and Goldsboro) are among the five fastest-growing metro areas.

Average change in metro area	Rents Multifamily YoY
Top five by rent growth	
Odessa, TX	+11.0%
Casper, WY	+8.7%
Goldsboro, NC	+8.6%
Grand Island, NE	+8.5%
Danville, IL	+8.3%
Others	
Miami, FL	+1.2%
Dallas-Fort Worth, TX	-1.0%
Phoenix, AZ	-2.7%
US average	+0.9%

Source: CoStar.

Capital market and finance

Following a low-interest decade in the 2010s, central banks started to increase their key interest rates from mid-2022, in response to high inflation. The rise in key rates pushed credit market interest rates and bond yields higher.

Key interest rates

To counter the high inflation rates, many western central banks began hiking key interest rates in mid-2022, with the Fed, for example, reaching 5.5% and the ECB 4.5%. The major western central banks opted against further tightening in the fourth quarter of 2023, because inflation is heading back down towards the desired level and the economic situation is deteriorating. However, since inflation is still above the target level, they have not yet started cutting rates again; instead levels have plateaued over the past few months.
Depending on how inflation progresses, modest interest rate cuts can be expected in 2024. The Fed has forecast median key interest rates of 4.6% for 2024, and 3.6% and 2.9% for 2025 and 2026, respectively – on the assumption that there are no further economic shocks or crises. Commerzbank is expecting the first interest rate reductions in the third and fourth quarters of 2024 in the US and eurozone, respectively.

The forecasts also show that a return to the zero interest rates of the 2010s is unlikely. The most probable scenario is a return to a level of between 2% and 3%, in line with the long-term average.

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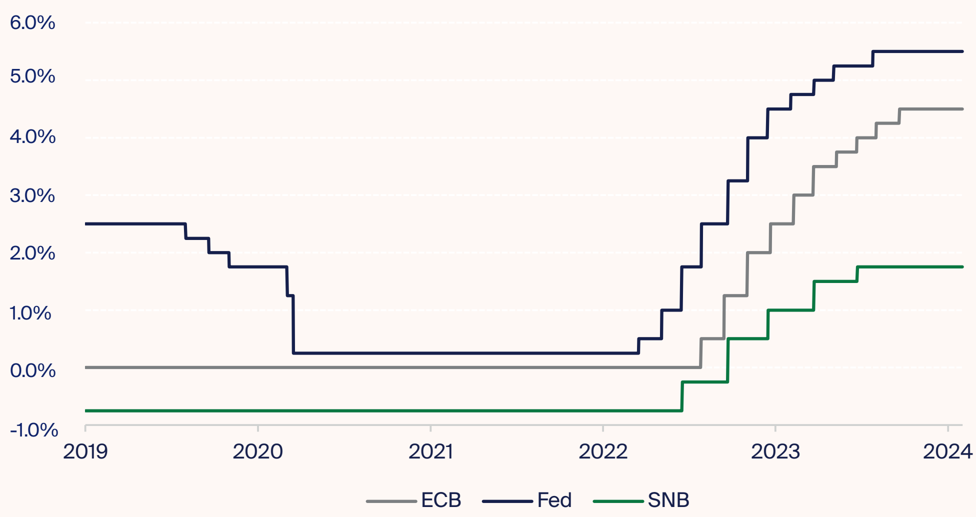
Key interest rates – ECB, Fed and SNB



Source: ECB, Fed, SNB.

Other asset classes

All asset classes are in competition for potential investors. The decisive criterion for evaluation and selection is their performance, which encompasses return, volatility and qualitative risks (e.g. legal certainty). For example, cryptocurrencies have been among the asset classes with the highest returns in recent years, although high volatility and the absence of statutory regulation on transparency and supervision limit their investment quality. By contrast, government bonds have very little volatility and decent security, but only offer low returns. Returns on equities and real estate lie somewhere in between.

Performance of various asset classes	2023/Q1	2023/Q2	2023/Q3	2023/Q4
DAX	13,924	15,629	15,387	16,752
DowJones	33,147	33,274	33,508	37,697
Interest rate – German government bond (10-year)	2.14%	2.34%	2.59%	2.53%
Interest rate – US government bond (10-year)	3.82%	3.65%	4.14%	4.43%
Bitcoin	15,426	26,201	25,475	38,149

Source: finanzen.net, closing prices on 31/03, 30/06, 30/09, 31/12; Banque centrale du Luxembourg.

The table shows good gains for all the asset classes studied between the first quarter of 2023 and the fourth quarter of 2023. In particular, equities and cryptocurrencies again posted significant gains in the second half of the year, with Bitcoin, for example, more than doubling in value during 2023. The government bond yields also rose over the year before losing significant momentum in the final quarter in particular, which was attributable to lower interest rate expectations.

Property financing

The property lending volume has slumped with the sharp rise in interest rates. For private households, liquidity problems are a particularly significant factor, resulting in planned purchases and new-build projects being postponed. After a temporary peak in lending to private households for housing construction of around EUR 32 billion in March 2022, new loans collapsed in

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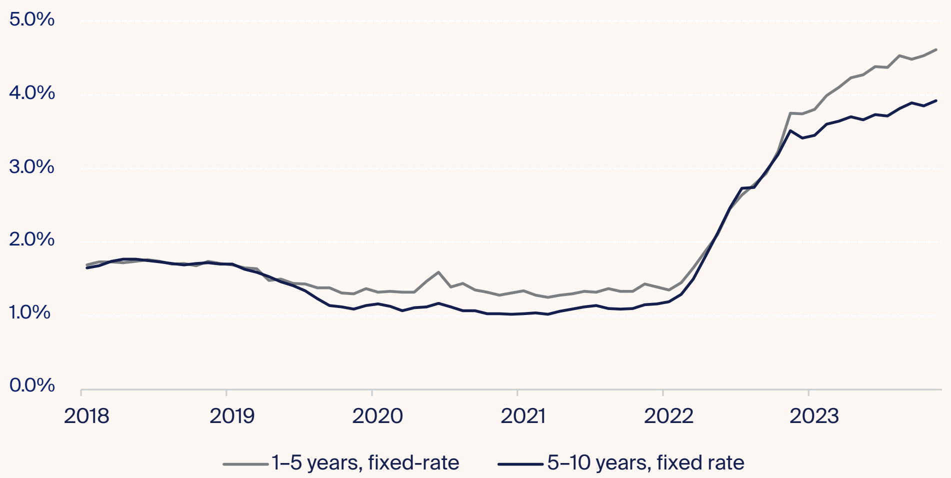
response to the rise in construction and interest costs. Since September 2022, the volume has been around just EUR 15 billion per month, roughly the same in nominal terms as in 2013.

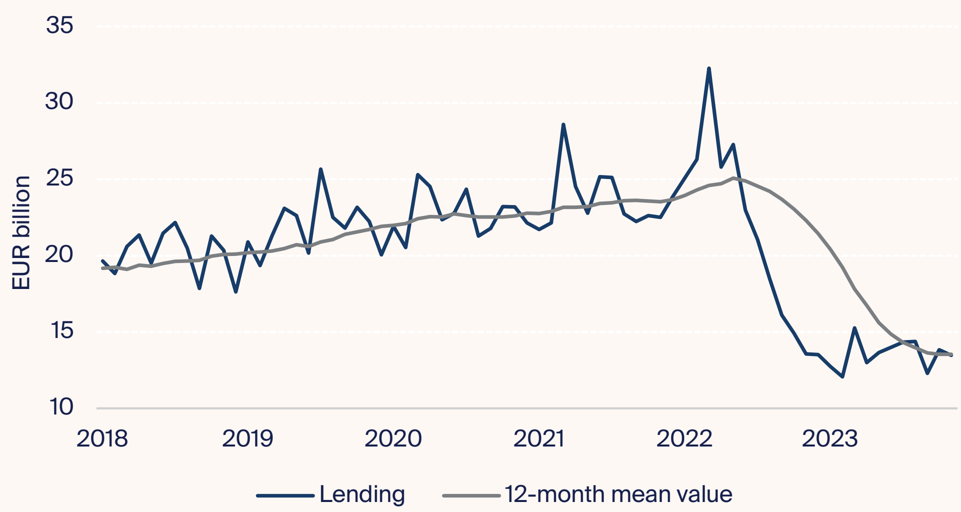
Effective interest rates for residential construction loans to private households – new business



Source: Deutsche Bundesbank.

If interest rates remain at this high level or continue to climb in the medium term, this will create potential problems for many refinancers. Loans that formerly had low interest arrangements will skyrocket in price, which will create liquidity problems for many borrowers. Loan defaults will become more likely. Banks will need to step up collateral realization, which will delay any pickup in new business.

Lending for housing construction to private households



Source: Deutsche Bundesbank.

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