Europe

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The series of shocks and 'Black Swan'-type events that have hit financial markets and economies over the past few years have not been unique to Europe. Yet for a variety of reasons their effects have been stronger here than in other global regions[1]. For example, Russia's invasion of Ukraine hit close to home (directly impacting vital supply chains), while Europe's dependence on Russian gas left it exposed to the spike in global energy prices. The global monetary policy response to high inflation has also impacted Europe more than elsewhere, as higher rates and quantitative tightening have sent shockwaves through the money supply and credit flows[1]. Combined, these events have dealt a sustained blow to investor sentiment, economic growth, and overall risk appetite. Given this backdrop, it is not surprising (in our opinion) that of the three global regions covered by Hines Research, Europe is perhaps closest to falling into a mild recession. It may already be there – according to Eurostat, Euro Area real Gross Domestic Product (GDP) contracted by 0.1%[2] in the third quarter.

However, there are some silver linings to these relatively dark clouds. Inflation is slowing faster in Europe than in other developed regions, with the headline rate now tantalizingly close to the European Central Bank's (ECB) 2% target. Growth was weak, but sentiment was not far off average levels. And fixed-income traders are increasingly betting on rate cuts coming sooner and deeper in Europe than was thought possible just a couple of months ago[3] – after all, with inflation under control, the ECB will be less encumbered than other central banks and better able to support growth with lower rates. Although the economic backdrop to such a policy move would unlikely be a strong one, falling interest rates (and a cheaper cost of debt) may breathe life into real estate valuations. This is one area where Europe stands out – this market appears further along in its pricing correction than other regions. Aided by a muted supply cycle leading into this downturn, we anticipate any further price weakness should be limited moving forward. While it is not possible to "call the bottom" of the market with precision, we think the next year or two may prove to be strong vintages for European real estate investment.

[1] globalEDGE, Recession in Europe: How the Continent's Top 3 Economies are Faring, Cameron Levis, September 28, 2023
[2] Eurostat, EuroIndicators, November 14, 2023
[3] Bloomberg, Traders Bet on ECB Rate Cuts Next Year, Alice Gledhill, November 17, 2023

INVESTMENT IMPACTS

From a real estate investment perspective, what has really changed in the past year? European markets are still working through a major cyclical reset on par with those of the Global Financial Crisis (GFC) and the early 1990s recession. Hines Research expects the number of distressed sales to accelerate in 2024 and remain elevated through 2026. Yet vacancies remain low by historical standards, in part because Europe did not participate in the post-GFC building boom.[4] Permits for residential and commercial builds fell between 2007 and 2009 and have remained at those below-trend levels ever since.[4] Further support to real estate is likely provided by the historical growth of knowledge-intensive employment (particularly in larger cities like Paris, Berlin, London, and Madrid[5]), combined with a low level of construction employment that has never rebounded from the GFC and Eurozone debt crisis.

While pricing remains in flux, there are signs of an impending recovery. Liquidity may soon show signs of improvement as bid-ask spreads narrow, and the number of banks tightening lending standards to corporate enterprises, the drivers of real estate demand, continues to fall.[6] Hines Research has calculated the relative health of the European leasing environment by sector – warehouse and multifamily are strong (although off the 2022 highs), and retail is on the upswing. Only office seems to be in a new downturn, and of course, this varies by class. Looking at pricing, the amount of "very overvalued" property has fallen by about half, with "undervalued" now making up about 30% of the total.[7]

This valuation data supports the Hines belief that Europe has adjusted much more quickly than the U.S., and to a lesser degree, Asia. Comparing public versus private real estate price growth as of November, year-over-year public prices have stabilized over the past 12 months, while the private market continues to decline, but at a slower rate.[8] Public markets generally lead private markets by four to six months, so this would likely bode well for selective investments in the near to medium term. Other factors favoring the region also include the design of lease terms – in Europe it is very common for lease terms to be indexed to inflation. This contributes to a strong correlation between the two (R^2 of 0.69, the highest of the three major regions[9]). With the likelihood of inflation staying higher for longer, European assets would then likely experience stronger rent growth. Correlation also supports Europe as a diversification play against the U.S. – Hines Research found the average correlation between total returns of the top ten cities in each region was just 8% in U.S. dollar terms[10]. Using these same cities, Hines also found a 30% allocation to European real estate improved risk-adjusted return by 14.6%[10] over a U.S.-only portfolio, and for this hypothetical 70% U.S./30% Europe asset blend, downside risk was reduced by more than 25%.[10]

[4] Hines Research, Eurostat as of Q223
[5] Hines Research, Oxford Economics as of Q123
[6] European Central Bank, U.S. Federal Reserve as of Q323
[7] CBRE, Hines Research as of June 2023. The Composite Capital Market Score ("CCMS") is an aggregate score (0-100) derived from the following metrics: Price to Trend, Cap Rate Spreads, Growth-Adjusted Spreads, Trailing Price Growth, and Trailing Total returns. The CCMS is calculated as a percentile relative to each market's own history. Higher scores indicate that the market is expensive relative to its history. Very Overvalued -- 85-100th percentile; Overvalued -- 70-85th percentile; Fairly valued-- 30-70th percentile; Undervalued -- 15-30th percentile; and Very Undervalued -- 0-15th percentile.
[8] Refinitiv, CBRE, Hines Research as of October 2023
[9] CoStar, Hines Research as of Q422. The R^2 represents the percentage of the response variation reflected by the model – the higher the percentage, the higher the correlation.
[10] MSCI, Hines Research as of December 2022 – measured by weighted average of the ten cities over the past five years. The top ten European cities referenced were Amsterdam, Berlin, Dublin, Frankfurt, Hamburg, London, Madrid, Munich, Paris, and Vienna. The top ten U.S. cities were Atlanta, Boston, Dallas, Houston, Los Angeles, Miami, New York, Phoenix, San Francisco, and Washington, D.C.

CONCLUSION

Europe is further along in its cyclical reset than other regions, with public real estate prices stabilizing over the past 12 months. It is generally acknowledged that the ECB tightening campaign is over, and that fewer and fewer banks are tightening lending standards. Adding support to the case for the region – the adjustment has been tempered by relatively low vacancies against a supply pipeline that never rebounded from the GFC or debt troubles of 2007 through about 2014. Combined with a depleted construction workforce, continued growth of knowledge-intensive employment, and the benefits (on risk and return) of diversification, Hines believes quality opportunities in Europe will continue to grow.

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