

# ECONOMIC PULSE

A REPORT ON THE EUROPEAN ECONOMY AND  
ITS IMPACT ON COMMERCIAL REAL ESTATE

## EUROPE BRACED EVERY COUNTRY HAS ITS STORY AS THE DOWNTURN INTENSIFIES

**T**he full force of the economic downturn is now being felt in Europe, and it is clear there is further bad news to come as corporate de-stocking and weakening exports add to the problems caused by consumer stress, credit shortages and uncertainty in the financial markets.

While consumer confidence has already fallen in most countries, the reality of higher unemployment will impact as we move through this year. At the same time, corporate de-stocking has further to go as businesses up and down the supply chain react to changes in demand and the shortage of short-term finance by cutting expenditure and hoarding cash where possible.

Hence, while the concerted actions taken globally to stave off a financial market collapse have provided greater security and may soon start to bear fruit, it is clear that further action is required. The banking sector in particular will remain under pressure as markets wait to see how it reacts to increasing bad debts, rebuilds its balance sheets, and meets future refinancing needs.

For now, it is the lack of short-term credit that needs to be addressed and, while there has been progress in reducing debt costs, attention is now turning to increasing its supply.

Governments are gaining a better understanding of the scale of the problem and, while some may not be moving fast enough, fiscal stimulus plans are being laid out. This is undoubtedly good news for short-term economic prospects, albeit for most, it will come too late to stave off recession.

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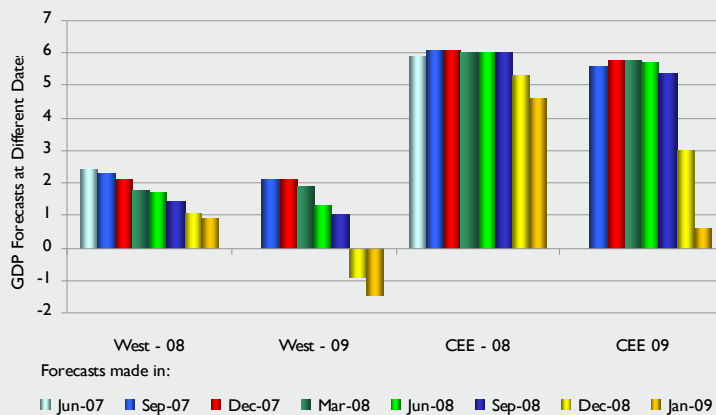
## European Overview

Expectations for GDP growth have fallen across the region (figure 1), with a contraction of 1.5% now forecast for the West, varying from a 2% to 2.5% drop in Ireland and the UK, to a more restrained fall of less than 0.5% in Finland and Norway. A further downgrade in growth expectations seems likely – possibly to around -2%. In Central & Eastern Europe, growth expectations have been cut to just 0.6%, and with exports and FDI falling, there is clear potential for a number of countries in the region to see an outright fall.

At the same time, rapid falls in inflation will be at least mildly positive for spending power and sentiment – reversing some of the damage done last year from the inflation spike. Western European inflation is expected to drop from an average of 3.3% last year to just 1% to 1.5%. Central & Eastern Europe will also see a sharp fall – more rapidly than many anticipated. As a result, interest rates have further to fall across the region, with Euro-zone rates likely to be cut further by mid-year despite the ECB's reluctant stance.

While this may help to stabilise the economy, it will take time to impact on domestic demand. At the same time, the decline in global demand will continue to bear down, particularly in the Euro-zone due to the strength of the currency. A number of markets will in fact need time to rebuild their competitiveness, with wages and employment taking much of the strain for this. Falls in other European currencies may benefit their economies and the Euro itself may start to see some respite as falling growth and interest

FIGURE 1 | CHANGING VIEWS ON GDP GROWTH POTENTIAL (% per annum)



Note: West is Western Europe, CEE is Central & Eastern Europe  
 Source: Consensus Economics Inc/Cushman & Wakefield Jan 09

rate differentials support at least a stabilisation if not a fall in the currency at some point.

Despite this, the Euro-zone faces increased tensions as some of its members struggle to adjust to market conditions in the strait jacket of a one-size-fits-all monetary policy. Some countries are looking enviously at the UK in particular due to the benefits that a significant fall in the Pound brings to its competitiveness. The prospect of a country leaving the Euro zone still look remote however – at least for now – but higher spreads on bond yields should continue, to reflect underlying country risks more fully than in the past.

Looking at the profile of activity in Europe, a significant element of the rapid downturn in industrial output during the latter half of 2008 was not just falling demand, but also falling inventories, as firms became unable to finance existing stock levels out of existing cash flow. Many governments now appear to have grasped the need to boost credit availability and tackle bad debts head-on, but whilst the UK has announced a major additional bank support plan and France a smaller plan, other countries are still undecided on the need for additional support after the packages launched last autumn. It is to be hoped that more authorities come forward with genuine support schemes in the near term to ensure bank lending does not fall further.

On the monetary side, aggressive base-rate cuts have been the order of the day in most areas – although the ECB remains generally more reticent to deliver big cuts than other European Central Banks. As rates fall to historically low levels, more countries are coming to see an expansion of the money supply as the next logical step. Engaging in 'quantitative easing' is certainly a powerful policy tool, but the problems posed by the exit strategy - how to keep such measures temporary and under control - may limit its use in Europe.

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**Regional Economic Overview**

While there are, as ever, significant regional variations in the growth outlook around Europe, the past few months have seen something of a convergence, with few countries set to escape recession. The housing/ construction boom economies of the UK, Spain and Ireland have continued to lead the way down, but while it had been assumed that the lesser debt imbalances of some European economies would limit the scale of their

downturn, export dependant markets such as Germany are clearly now suffering. Moreover, while some avoided the immediate impact of the banking crisis, the availability of finance is now very limited and refinancing and bad debts will pose a major challenge in all areas going forward.

The outlook for Central and Eastern Europe has deteriorated quickly in recent weeks, but prospects differ significantly country to country. The slowdown in demand from Western Europe is keenly felt, as is the increasing aversion of banks to lend, but Hungary aside, Central Europe continues to fair reasonably well. More generally, those countries with higher deficits have seen prospects

downgraded as risk is re-priced in light of an outflow of capital. This makes deficit reduction a priority and points to slower growth at least in the short term.

The degree to which different countries are exposed to global trade varies significantly (fig 2), with countries such as Belgium, The Netherlands, Germany and Ireland having a greater than average reliance on exports together with a number of Central & Eastern European markets. At the same time, some of the countries most at risk due to their debt-imbalances, such as Spain and the UK, are less exposed.

**Investment Markets**

Bond markets were the star performer in 2008, at least in Western Europe, which saw implied capital growth of 23% as yields fell. Emerging markets by contrast suffered a re-rating of risk, resulting in an implied capital

loss of 18%, with more than half of this occurring in the last quarter. Equity markets also plunged in the final quarter despite fairing better in the final weeks of the year, and saw an average capital loss of 50% in Western Europe, and 56% in CEE markets in 2008. Property meanwhile fared better, albeit with growth deteriorating as the year progressed. The implied growth in prime property based on rent and yield movements was -12.1% for the West and -6.6% for CEE markets.

Investors want to see how far equity earnings will fall before they take a more positive view, but market volatility has

FIGURE 2 | EXPORTS RELATIVE TO TOTAL ECONOMIC OUTPUT

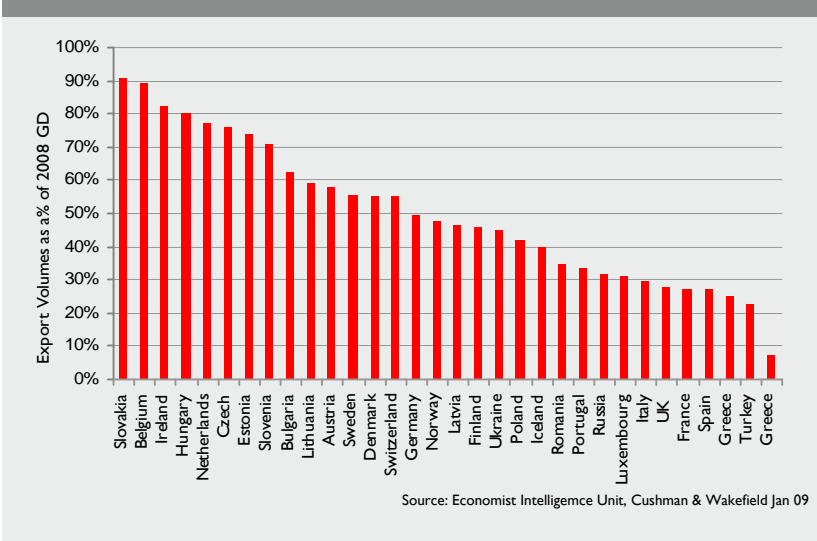
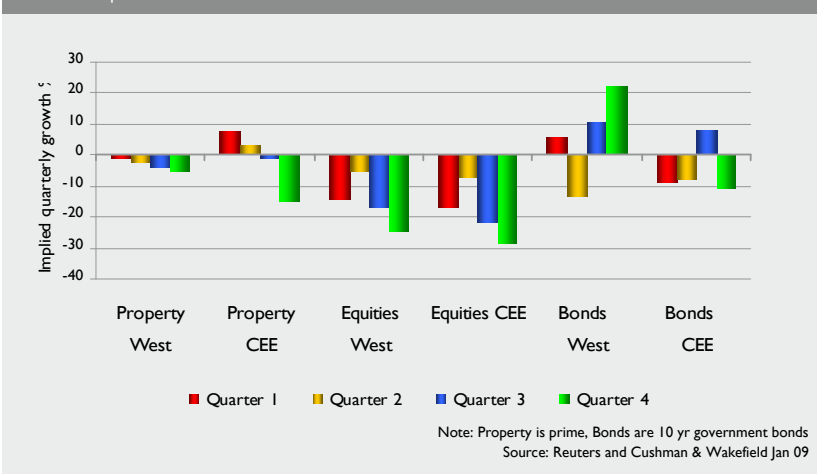


FIGURE 3 | INVESTMENT MARKET PERFORMANCE – CAPITAL GROWTH



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eased and recent improvements in the corporate-bond market suggest a slight increase in risk tolerance. Moreover, stock markets tend to react ahead of the economy; hence, if annual GDP growth is to improve later this year, equity markets may start to signal this in the next few months.

For now, nervousness about stock market performance helps to explain the continued strength of government bonds despite the plethora of fiscal stimulus measures planned. Investors are forcing a wider than usual yield spread however, while ratings agencies have weighed in with warnings that credit ratings may be reduced for a number of countries. Generally however, with the expectation of further base rates cuts, the strength of bond prices may be maintained for some time yet – at least in markets which sustain a solid investment credit rating.

### The Outlook

**FIGURE 4 | MARKET FORECASTS (January 2009)**

	GDP % pa		Inflation % pa		Comment
	2009	2010	2009	2010	
Austria	-0.6	0.9	1.2	1.8	Exports will suffer and exposure to CEE banking sector will not help
Belgium	-0.7	0.7	2.1	2.0	So far more resilient but business and consumer sentiment now falling rapidly
Bulgaria	1.9	3.0	6.5	5.0	Foreign capital falling and slowdown in industrial and consumer demand
Czech Republic	0.3	2.3	1.8	2.2	Impact from slowing in West despite stable bank sector and rate cuts
Denmark	-0.8	0.9	1.7	1.8	Growth hit by housing downturn, rising unemployment and falling exports
Estonia	-4.2	1.4	3.4	2.7	2nd year of recession looms as government spending offers little new support
Finland	-0.1	1.6	1.8	1.7	Struggling to show growth but downturn likely to be less severe than average
France	-1.0	0.9	1.0	1.7	Not yet in recession but outlook weak as investment and output fall
Germany	-2.0	0.8	0.8	1.5	Sharp fall due to world export decline and no response yet from consumers
Greece	-0.8	1.9	2.6	2.7	Broad fall in all GDP components, not helped by political unrest
Hungary	-2.4	0.7	2.6	2.7	IMF helped avert a meltdown but fiscal policy will weigh on growth prospects
Ireland	-2.5	1.0	1.2	2.0	Deep recession with banking and construction crisis and rising unemployment
Italy	-1.6	0.5	1.3	1.7	Slide into recession with broad based contraction and limited fiscal boost
Latvia	-7.4	-1.0	4.3	1.7	Recession deepening but government and IMF measures will help
Lithuania	-3.2	-0.3	4.5	3.6	Domestic demand suffering and banking sector bailout may be necessary
Luxembourg	-0.5	0.6	2.0	2.0	Strong fiscal position will support bank sector but inflation still relatively high
Netherlands	-1.1	0.6	1.3	1.3	Initial resilience fading as banking sector weakness feeds into consumer sector
Norway	-0.5	1.5	1.9	2.1	Falling oil output has triggered sharp interest rate cuts but recession still likely
Poland	1.9	2.9	2.7	2.4	Falling exports will be felt while slow wage growth will hit domestic spending
Portugal	-0.9	0.6	1.4	1.8	Weaker exports and corporate investment point to recession in 2009
Romania	0.8	3.2	5.5	4.6	Fastest growing EU market in 2008 but rapid slowdown in 2009
Russia	1.1	3.5	11.0	8.1	Inflation falling but unemployment is up and consumer spending is slowing
Slovakia	2.9	3.9	3.1	3.2	Euro adoption to aid stability but loss of exchange rate flexibility may hurt
Spain	-1.5	0.4	1.0	2.2	Weak outlook as industry and employment contract and confidence falls
Sweden	-0.8	1.3	0.6	1.1	Falling industrial output, rate cuts are yet to improve consumer confidence
Switzerland	-0.7	0.8	0.4	1.0	Relatively resilient so far but recession to begin despite interest rate cuts
Turkey	-0.5	3.2	7.9	6.6	Slowing as output and investment contract but inflation is starting to fall
UK	-2.2	0.6	1.0	1.9	Prospects down, with credit availability weak despite falls in interest rates
Ukraine	-4.5	2.0	17.1	11.6	Severe slowdown as industry contracts. Political tensions may delay recovery
Western	-1.5	0.8	1.2	1.7	Recession in most areas in 2009, with weak exports and a cautious consumer
Central & Eastern	0.6	3.1	7.8	6.2	Prospects vary but a sharp slowdown underway as exports and FDI fall

Source: Consensus Economics Inc, EIU and Cushman & Wakefield

2009 is set to be a tougher year than hoped, particularly in the opening months. Nonetheless, nothing lasts for ever. Assuming that businesses begin to see an improvement in credit availability in the relatively near future, and are aided by the positive impact of low inflation and interest rates, the consensus view among economists is that we are close to the nadir of the current downturn in many countries in terms of quarter-on-quarter growth.

An improving, or at least less-negative trend in the second half would boost confidence. Two key questions will then emerge: What is the likely scale of recovery and what will be the outcome of the battle between the forces of inflation and deflation?

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On the former, a period of very low interest rates and stimulative policies could well clear the path to a bounce in growth – particularly in markets ready to take advantage of an upturn in world trade. However, it appears more likely that the recovery will be weak – with global imbalances taking some time to correct. Meanwhile, increased levels of government debt will need to be repaid, demanding higher taxes and/or lower spending, and long-term interest rates will increase. Additionally, the boost to activity over recent years coming from innovative financial solutions raising the availability of low-cost debt will clearly be reduced.

The inflation question is more finely balanced. Printing money is clearly inflationary and long-term growth in emerging markets and the need to change habits and develop new technologies to protect the environment can only add to future inflation. In the short term however, the deflationary forces in play are severe and a damaging deflationary spiral can not be ruled out, with export-reliant countries most at risk. The most likely scenario at present in fact appears a short, sharp negative price correction followed by modest inflationary growth, which will help to keep interest rates low for longer than some expect.

### The Implications for Property

The macro drivers for property performance are clearly still deteriorating and all market sectors are likely to suffer, with an increasing number of corporations looking to reduce head count – with a knock-on effect for both property supply and demand.

European prime rental growth actually turned negative in the final quarter of 2008 for the first time since 2003 and, with occupiers more cautious, the trend is likely to remain weak. We currently anticipate prime rents as an average across all sectors for Europe falling 5-7% this year and a further 2%-4% in 2010.

Nonetheless, many markets remain fundamentally undersupplied with modern, efficient property and, with development slowing quickly, the threat of over supply is less notable than in past downturns.

Retail markets will clearly face stress in those countries where consumers are under most pressure. For much of Europe however, there has been a limited build up in consumer debt and, hence, at least for prime stock, market values are more secure. Similar trends may be seen in the logistics market while light industrial property will be hit more than logistics by the slowing economy.

For offices, there are greater short term threats, starting with banking market consolidation, but with businesses reacting quickly to the need to de-leverage, they rather than consumers may be the first to recover in some areas. Moreover, we can expect a reorganization of many businesses, perhaps sparking demand for cost-effective space such as well-located decentralised offices and certain CEE markets.

For capital markets meanwhile, occupier distress has only added to the concerns of investors. A modest un-freezing in the debt market may be seen in the second quarter, but debt providers will remain in the driving seat and finance for real estate will remain constrained, with re-financing more of a problem than new lending.

Yields will continue to increase this year, notably in those markets that were slower to react in early 2008. Secondary stock, which is more dependant on the availability of finance, will suffer considerably more than prime, where yields look set to stabilise by the second to third quarter. Yield trends will however vary substantially to reflect the risk and growth outlook in individual countries, the degree to which each market was over-heated in 2007, and the nature of buyers and sellers and their willingness to accept the increasing illiquidity premia in property pricing as a true guide to value.

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Expectations for investment volumes in 2009 have weakened, with a lack of finance for major deals in particular expected to deflate the numbers. Additionally, the mountain of debt needing refinancing is likely to be an attractive route for some investors to gain exposure to the sector – diluting the potential pool of equity available for direct purchasing.

To date, equity investors have remained highly selective in what they will focus on, while the numerous opportunity funds are expecting more distress and see little reason to hurry into the market. Nonetheless, a growing yield gap over bonds and interest rates, greater acceptance of re-pricing, and an increasing flow of opportunities, should attract more buyers into the market as the year progresses, especially those private property companies, family offices and international funds, which have been conspicuously absent in the last few years because of their inability to find value at the top of the cycle.

Product supply is slowly increasing – and this will continue, with more corporate sales as well as disposals from leveraged investors, bank-controlled portfolios, and mutual funds contending with a falling property appetite among some of their investors. To date, product supply from the banks has been less than many expected and this may continue for stock where the loan is being serviced. Much of the supply emerging from all quarters meanwhile has been secondary in nature but this is slowly changing as vendors have to sell whatever will find a buyer – namely top-quality assets.

Greater disparity in performance should be seen in 2009 as economic recovery prospects and risks diverge. Maintaining high levels of occupation will dominate as the key theme for performance. Among investors, we can expect a further flight to quality and safety. Long-term, secure cash flow will be paramount, with a focus on covenant and guarantees. Some markets will remain under pressure as capital continues to move away from areas of risk such as high-deficit countries although some emerging markets are likely to be over-sold and will provide opportunities later this year. Currency trends are also likely to be keenly watched in 2009 for the opportunities they offer occupiers and investors.

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**Market Data**

Given the paucity of transactional data and fast moving pace of market sentiment, the yield figures below are a broad estimation only and do not relate to any one specific asset or transaction. The figures are based on prime assets let at today's market rent and assume a willing vendor and a securely financed purchaser. It should also be noted that, typically, these yields relate to lot sizes of up to €75mn. Larger lot sizes will see a discount in today's market.

Figure 5 PRIME RENTAL GROWTH AND YIELDS ACROSS EUROPE

	Rental Growth (Yr to Dec 08)				Prime Yields (January 2009)			
	Shops	Offices	Industrial	Trend	Shops	Offices	Industrial	Trend
Austria	15.0%	3.3%	0.0%	→	4.60%	5.25%	6.75%	↗
Belgium	1.9%	5.1%	1.0%	↘	5.00%	6.00%	7.00%	↗
Bulgaria	0.0%	-1.8%	8.3%	↘	6.75%	8.50%	9.50%	↑
Czech Republic	1.7%	9.4%	-1.8%	↘	6.25%	6.75%	7.50%	↑
Denmark	0.0%	-5.1%	0.0%	↘	5.00%	5.75%	6.75%	↗
Finland	-7.9%	10.4%	1.5%	↘	6.10%	6.10%	7.00%	↗
France	2.6%	1.5%	2.8%	→	4.75%	5.00%	7.25%	↗
Germany	6.0%	2.3%	0.0%	→	4.15%	5.05%	6.75%	↗
Greece	3.3%	4.3%	-4.3%	↘	5.50%	7.20%	7.70%	↗
Hungary	5.6%	2.7%	-4.7%	↘	6.50%	6.75%	8.00%	↗
Ireland	-11.6%	-9.4%	-1.6%	↘	5.50%	6.00%	7.00%	↑
Italy	6.3%	3.6%	3.7%	→	4.75%	5.75%	7.25%	↗
Luxembourg	0.0%	8.6%	Na	↘	5.50%	6.00%	Na	↗
Netherlands	6.1%	1.2%	-0.8%	→	5.00%	6.50%	7.25%	↑
Norway	-6.9%	-2.4%	15.8%	→	6.15%	7.00%	8.25%	↗
Poland	10.4%	1.2%	28.8%	↗	8.00%	7.00%	8.00%	↑
Portugal	2.4%	-1.1%	-6.3%	↘	6.50%	6.50%	8.00%	↗
Romania	13.7%	0.0%	6.1%	↘	7.75%	7.50%	8.50%	↑
Russia	8.3%	-4.8%	-1.9%	↘	Na	12.00%	13.00%	↑
Slovakia	6.7%	0.0%	-8.8%	→	7.25%	7.25%	8.00%	↗
Spain	0.7%	-2.8%	0.5%	↘	5.50%	6.00%	7.50%	↑
Sweden	-2.7%	1.6%	2.0%	↘	5.25%	5.50%	7.00%	↗
Switzerland	12.7%	2.4%	3.7%	→	4.25%	5.00%	6.50%	↗
Turkey	30.0%	17.6%	5.3%	↘	8.50%	8.50%	9.00%	↑
UK	0.2%	-9.4%	0.0%	↘	5.25%	6.50%	7.75%	↑
Ukraine	-16.7%	+14.3%	25.0%	↘	13.00%	14.00%	15.00%	↑

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