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Perspectives: The impact of QE on European property markets

M&G REAL ESTATE

The European Central Bank (ECB) plans to inject €1.1 trillion into the eurozone economy through its new quantitative easing (QE) programme from March 2015 to September 2016. This quadruples the total assets purchased since the global financial crisis (GFC) and is widely expected to kick-start the economy. In this paper, we look at what QE is likely to mean for the region's real estate market.

Executive summary

- Eurozone GDP growth forecasts for 2015 raised by 30bps to 1.4% post-QE.
- QE should support European real estate prices, mirroring US, UK and Japan experience.
- Strong investment inflows expected to continue.
- Potential for property yields in core markets to reach new record lows.
- Even greater scope for compression in peripheral yields.
- Rental growth to follow economic recovery.
- Structural reforms key to maintaining positive momentum in the region.

Fuel for the economy

QE enables the ECB to inject money into the economy, easing credit conditions even with short-term interest rates close to zero. Since the GFC, this method has been extensively used in the UK, the US and Japan, and studying their experience gives us some insight into the kind of impact that QE is likely to have on the European economy, government bond yields and the real estate market.

Fig 1: Global central banks' total asset purchases, 2009-2014

Central bank	Programmes	Assets purchased	Total purchases (€bn)*	Share of GDP**
Fed	QE1, QE2, Maturity Extension Program, QE3	GSE agency debt, MBS, Treasuries	3,500	32%
BoE	APF	Gilts, commercial paper, corporate bonds	450	25%
ECB	CBPP, SMP, CBPP2, ABSPP, CBPP3	Covered bonds, eurozone sovereign debt, ABS	375	4%
BoJ	Outright purchases, APP	JGBs, commercial paper, corporate bonds, Treasury discount bills, ETFs, J-REITs	2,200***	54%

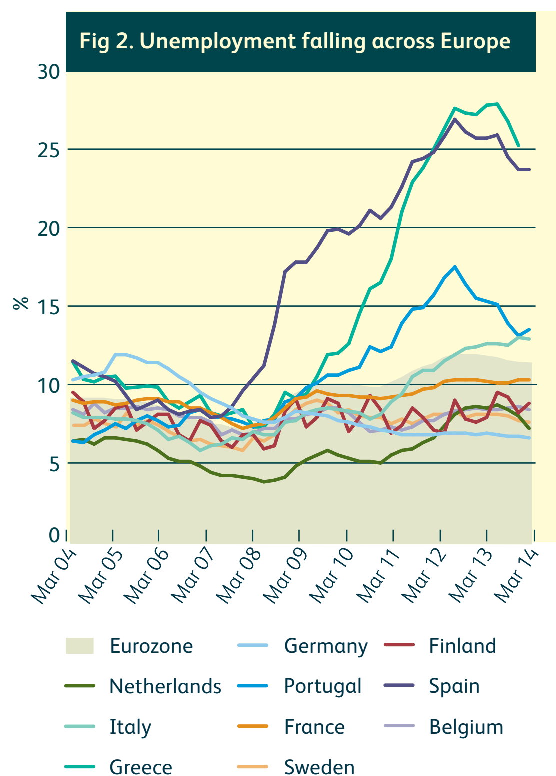
*Rounded. Exchange rates based on average of year of injection.
**2008 GDP at current prices
***Total estimate as at end 2014 although latest QE injection announced in April 2013 is envisaged to carry on indefinitely.

Source: BoE, FED, ECB, BoJ, World Bank, M&G Real Estate

Up until the end of last year, total assets purchased were greatest in the US (at c. €3.5 trillion) and lowest in Europe (c. €375m) in absolute terms. As a percentage of GDP, asset purchases were the most significant in Japan (c. 54%) and lowest in Europe (c. 4%).

Six years after monetary easing programmes were first introduced, both the US and the UK have benefitted from positive growth indicators including output, employment growth and private consumption.

In continental Europe, the latest stimulus plan marks by far the largest injection in the region – quadrupling the total assets purchased to €1.5 trillion over just 18 months. There are, therefore, strong grounds to believe that the eurozone will manifest marked improvements in output and inflation indicators.



Source: Bloomberg

Indeed, the consensus forecast for 2015 economic growth has already been revised up to 1.4% from 1.1% three months ago[1]. Private sector confidence is increasing with the composite PMI indicator rising to 54.1 in March, up from 51.4 before the QE announcement and the highest level in four years.

Unemployment rates are falling across the region, particularly in peripheral countries, albeit from higher levels. An improving jobs market suggests that office property sector performance will be stronger in core countries in the short term, with peripheral countries lagging the cycle. (We review the potential impact of QE on office property markets later in more detail.)

Risks to the upbeat growth forecast include concerns about the extent to which QE money will flow into the real economy through bank lending. With the majority of major banks passing the 2014 European Banking Authority stress tests however, we believe lending conditions should start to improve. Indeed, the ECB reported a modest improvement in bank lending to all loan categories including non-financial corporations in the fourth quarter of 2014 – even before the start of QE[2].

Another issue is that the money will not be spread evenly across the whole bloc. The bulk of the planned purchases will be linked to the various national central banks' shares in the ECB capital (the so-called capital key). This means that a significant portion of QE capital injection will flow to Germany and France, and therefore those countries are likely to enjoy the biggest economic boosts in the near term.

Implications for real estate

Firstly, having looked cheap relative to other asset classes, European property now offers even better value to investors thanks to QE. With 10-year government bonds reaching record lows following the first QE installment, we believe investment will continue strongly over the coming months. Even before QE was announced, flows into European real estate were expected to increase by 14% in 2015 compared to a year earlier[3].

Secondly, QE has already resulted in a weaker euro, which fell to a 12-year trough versus the dollar and a 7-year low against sterling. The cheaper currency is expected to be a major boost for Europe's export orientated economies, particularly Germany. For the industrial sector especially, the effects of a weaker euro coupled with ongoing positive structural changes is expected to boost rental growth, largely driven by e-commerce related businesses.

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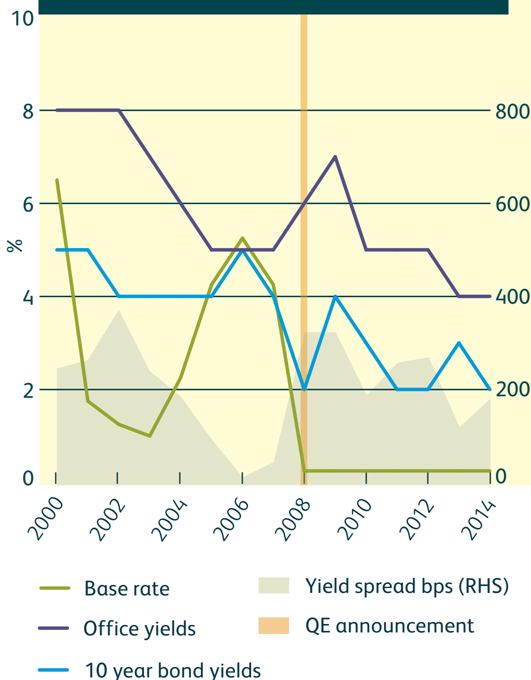
[1]Consensus forecasts, March 2015
[2]January 2015 Bank Lending Survey
[3]INREV 2015 Investor Intentions survey.

Drawing from our review of the performance of real estate markets in the US, UK and Japan, we have evaluated the corresponding potential impact in the eurozone. We reviewed office market performance as a proxy for real estate as a whole, given the relatively more liquid characteristics of the sector. Although drivers other than QE were clearly also at play, the research points to some similarities in market reactions.

The US and UK both benefited from a two-pronged stimulus approach, with the first injections of QE accompanied by cuts in central bank base rates, representing an additional monetary measure to further boost economic growth. In both cases, prime yields had been on an upward trajectory at the time of the QE announcements (November 2008 and March 2009 respectively).

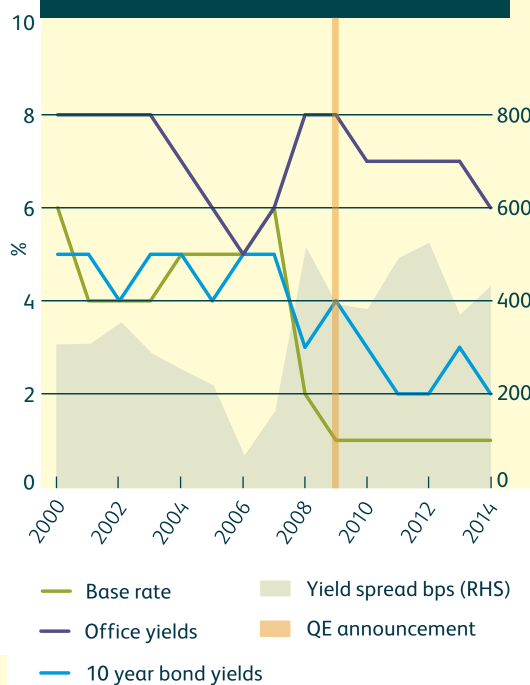
Fig 3. Effect of QE on US office market



Source: Bloomberg, PMA

As a result of the central bank stimulus, government bond yields reached new historic lows in both the US and UK. A similar trend followed within the property sector as investors searched for yield across the various asset classes. Over time, pressure on property yields augmented further with investors able to justify accepting lower returns in the face of a strengthening economic recovery and expected rental growth (which, indeed, is now being observed).

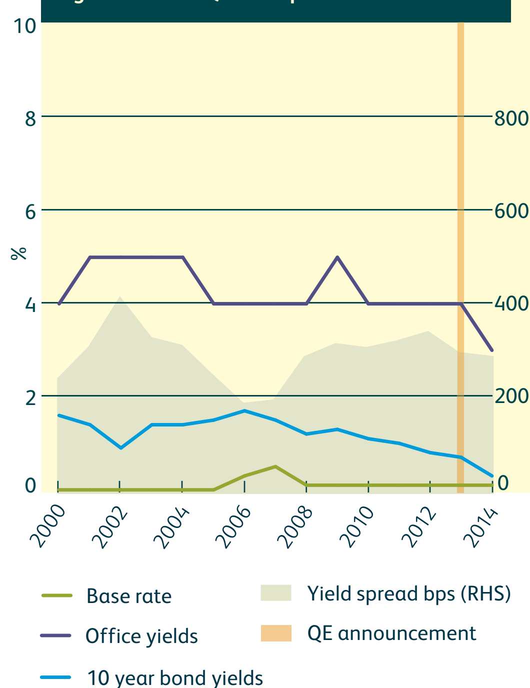
Fig 4. Effect of QE on UK office market



Source: Bloomberg, IPD

The pre-QE backdrop was slightly different in Japan, where bond yields have been historically lower than in the US or the UK, helping to sustain a healthy property-bond spread. Prime property yields had been stable for several years until the launch of 'Abenomics' (the economic programme advocated by the Japanese prime minister Shinzō Abe since 2012). Nonetheless, the response to QE was similar to that seen in the US and UK, with property and bond yields compressing to reach new record lows by the end of 2014.

Fig 5. Effect of QE on Japanese office market



Source: Bloomberg, PMA

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From a real estate perspective, meanwhile, property yields in core eurozone economies (such as Germany) have been keen for quite some time – partly in response to increasing investor interest in safe haven markets following the eurozone debt crisis as well as favourable base rates, which have been below 1% since 2012. However, the spread between prime office yields and government bond yields is at a record high (c. 400bps), which leaves plenty of room for compression.

Recovering markets such as Spain and Italy are further behind in the cycle both in terms of premium above bonds (c. 340bps) as well as property yields compared to historic lows. These markets were the ones most affected by the eurozone debt crisis and therefore have taken longer to recover. Consequently, there is scope for more significant yield compression compared to core countries in terms of basis points. However, we believe it is less likely that property yields in the likes of Spain or Italy will reach new record lows given that there is still some risk around the future of economic growth in these markets.

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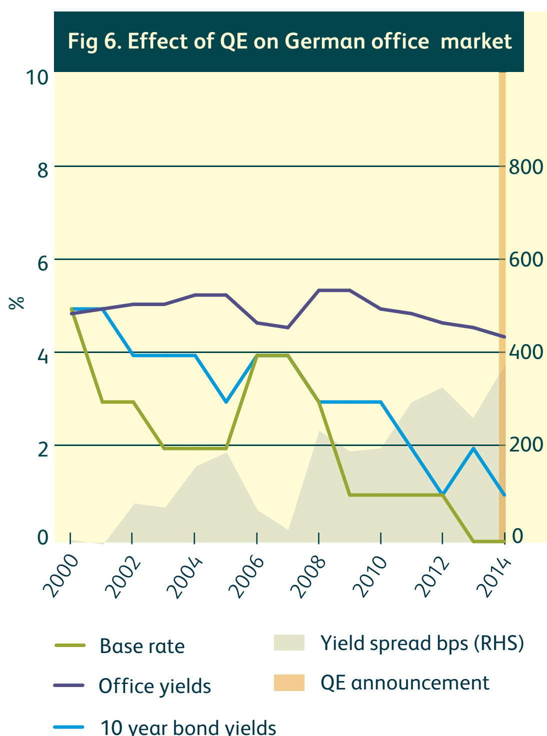
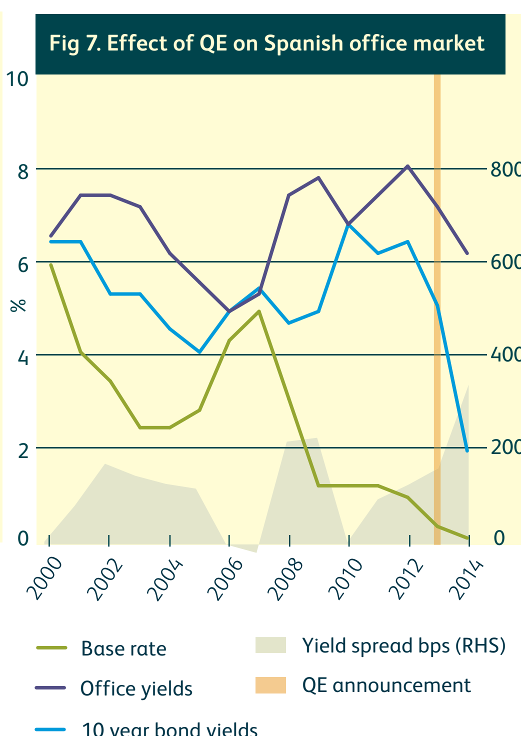


Source: Bloomberg, PMA



Source: Bloomberg, PMA

Going forward, we expect property yields in core countries to remain attractive compared to 10-year government bonds which are in many cases now trading at close to zero yields. Real estate in these markets is likely to be particularly appealing to risk-averse pension funds and insurance companies who are looking to reallocate capital from bonds to other asset classes including property. As a result, we expect property yields in core markets to continue to compress further, likely reaching new record low levels.

As mentioned earlier, part of the reason that investment momentum in the UK and US property markets took hold post-QE and property yields compressed, was the fact that expectations of economic growth were realised.

In Europe too, we believe that growth will be realised in the short-term. But, in order to secure the upwards economic momentum in the long run, it is key that QE stimulus is accompanied by effective structural reforms. This combined intervention will ensure that investors will continue to benefit from both sustained income returns and value preservation by investing in European real estate.

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Impact on occupier markets

The relationship between occupier markets and QE is less direct. The influx of money into the financial system will not in itself fuel rental growth. However, as that money translates into greater confidence, increased investment and an overall healthier economy, improvements in the occupier market are likely to follow.

The UK experience sheds some light on the potential trajectory of eurozone real estate returns post-QE. Yields in the UK are now compressing and approaching, or in some cases even falling below, their historic lows. With this in mind, there is an expectation that property returns going forward will likely be driven less by further yield compression and more by rental growth, which in the UK is now gradually coming through.

Provided the economic growth materialises in the eurozone, boosted by the QE effect, we could see medium to long-term rental growth exceed expectations – first in the core markets and then in the peripheral ones.

Currency risk

A cheaper euro highlights the relative appeal of European property to international investors. However, continued depreciation of the currency is likely to add to an investor's risk premium with respect to euro investments.

We feel that international investors with a short time horizon are likely to hedge their currency exposure, pay the market price and take advantage of falling yields amplified by the QE effect.

Those with a longer horizon, on the other hand, are less likely to hedge, since exchange rates tend to be mean-reverting over time. This group is likely to require a higher risk premium and, given that they are competing with short-term money as well as domestic investors, they could be at risk of getting outbid.

That said, European property yields still offer more attractive value than many other global markets, thus attracting investors from other regions without requiring additional risk premium.

Conclusion

The ECB's stimulus programme has cemented the attraction of real estate, both through the expected positive impact on economic growth and through the resulting record low bond yields.

With a premium of up to 400bps versus government bonds, European property remains an appealing asset class. Indeed, while yields on short maturity government bonds are close to zero and the spread versus property yields continues to widen, we see more capital targeting real estate in the region.

In the core markets, we believe yields could reach new record lows. This is further supported by the fact that a larger share of QE funds will be targeted towards France and Germany, in line with eurozone key capital contributions. Equally, we expect property yields in peripheral countries to continue to harden but to stay above historic lows until the economic recovery fully takes hold.

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