M&G Real Estate Perspectives

Italian elections: How big a threat is the outcome on real estate markets?

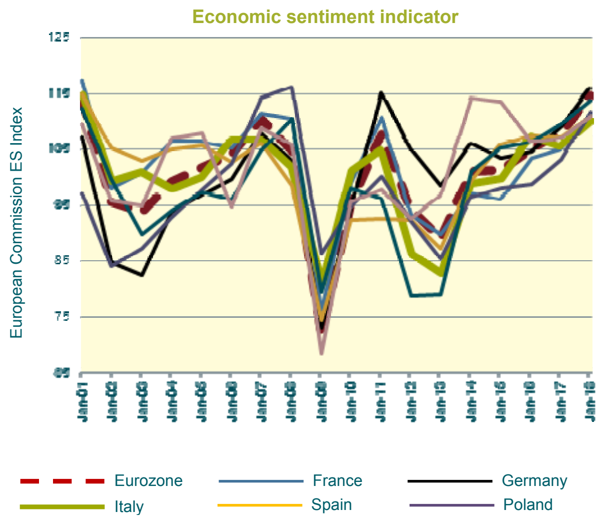
Yesterday's Italian election contest was the first to use the new electoral system where a third of parliamentary seats were assigned on a first-past-the-post basis, while two-thirds were allocated proportionally from lists drawn up at party level. Therefore, the outcome was always going to be difficult to predict.

In the end, the elections produced a deadlock where no one party can form a government leaving the president, Sergio Mattarella, to pick a compromise candidate to stitch together a new government. With 64 governments and 28 prime ministers in office since World War II, 18 of which have served for less than two years, Italy is no stranger to the process.

Economic growth beating analysts' expectations

The Eurozone economic recovery continues to gather pace despite political uncertainties brought about by major elections, including those in France and Germany last year. Italy is no exception. Eurozone GDP growth reached 1.6% in 2017, well above the consensus forecast expectation of 0.7%, at the start of the year[1].

Fig. 1 Economic sentiment rose to a 16-year high in 2017



Strength in the Italian economy was recently underlined by several leading indicators. The manufacturing and composite PMI's, which measure domestic demand, export and services growth, both registered new peaks in January. Italy's sentiment indicator, as measured by the European Commission, also reached 112 in December 2017, the strongest result since 2001. In 2018, GDP growth is projected to be 1.4%, still in excess of the 1.2% average over the last 35 years.

Meanwhile at the end of 2017, 10-year government bond yields in Portugal fell below those in Italy for the first time since 2009, reflecting uncertainties ahead of the Italian election. At the time of writing, Italian bond yields have settled to around 2%. Even if yields were to increase to 2.75% by year end, as forecast by Capital Economics, the rate would still be the lowest since mid-2014 and the spread versus the forecast 10-year German bond would remain stable around c.150bps.

On a more positive note, Banca Monte dei Paschi di Siena, a major Italian bank, took another recuperative step in January as it sold 95% of a tranche of bad loans, equating to €25 billion, to Quaestio, a boutique fund.

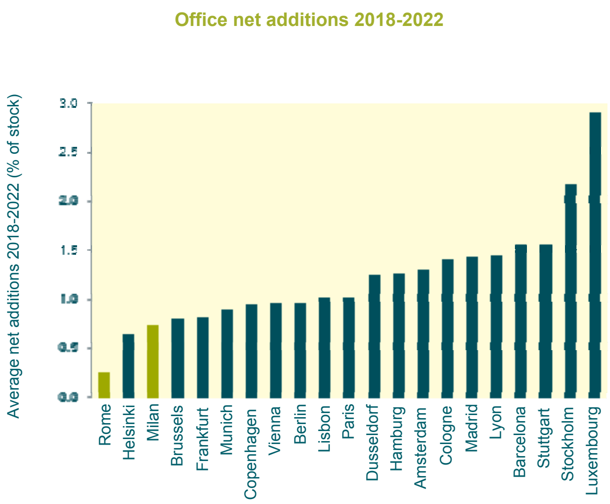
Impact on occupier real estate markets

Supported by monetary policy, the **retail** sector was the first to recover in the current European property cycle and is therefore most likely to stabilise ahead of other sectors. Thus, in 2015, prime retail shop rental growth in Milan reached a high of 25% y-o-y. We believe the importance of tourism, especially high spending visitors from emerging markets, will continue to be an increasingly important driver of retail rents, irrespective of the election outcome. This view is supported by tourism flow projections suggesting arrivals will increase by c.25% by 2025 in both Rome and Milan.[2] Overall, we expect an average rental growth of 2% p.a. across Italy over the next three years for the combined retail shop, retail warehouse and shopping centre sectors.

[1] Source: ISTAT

[2] Source: Euromonitor International 2017

Fig 2. Supply pipeline in Italy among lowest in Europe



Across Europe, the recovery in economic sentiment continues to filter through to **office** occupier markets. Aided by a muted supply response, y-o-y rental growth in Milan reached 6.8% in 2017, representing an outperformance relative to the 4% average growth seen in 23 cities across Europe. Over the next five years however, office-based employment in Italy is projected to fall short of 1% p.a., below the European average of 1.6% according to PMA. Under Matteo Renzi, who resigned as prime minister in 2017, a labour reform was passed that has since helped to create around one million jobs. A potential political deadlock following the election, therefore, could mean a failure to introduce further reforms to capitalise on the current job growth momentum.

Lastly, rental growth is now coming through in the **industrial** sector quite strongly, but only within select markets in Europe. According to JLL, of the six cities to see rises in prime rents in 2017, all saw 6% p.a. or more, including Milan and Rome. While manufacturing confidence is high and online consumption becomes more widespread in Italy, structural changes in the industrial market will continue to positively impact rental growth, regardless of the outcome of the elections.

Top 10 most favoured investment destination in 2018

Investment volumes in Italy reached a record high of €10.8 billion in 2017, up 17% y-o-y.[3] Capital flow prospects appear similarly positive this year, boosted by the pick-up in economic growth while the property cycle lags the rest of Europe. Coupled with attractive pricing relative to government bonds, we believe investors are likely to continue to drive capital growth and strong total returns in the medium term. This view is supported by INREV's Investor Intention Survey ranking Italy 6th most favoured European investment destination in 2018.

Summary

Despite the uncertain political backdrop in the lead-up to the Italian general election, both leading economic indicators and property fundamentals indicate positive growth. We expect good quality retail to continue to deliver healthy returns, particularly in established tourist destinations. In the office sector, Milan and Rome are among the tightest markets in terms of supply in Europe, with Milan in particular generating healthy rental growth. A deadlock in forming a new government following the elections represents a risk however, which may put a brake on the job creation momentum first implemented through Matteo Renzi's structural reforms before he resigned last year. Lastly, the industrial sector is likely to be impacted the least by political uncertainties due to ongoing structural changes driven by growing online sales, which are likely to generate further demand for both regional and last-mile logistics assets. In summary, the election result is unlikely to reverse the current strength of the property market – Italian real estate is likely to continue to perform well this year.

[3] Source: CBRE Q4 2017

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