EUROPEAN ECONOMIC & CRE OUTLOOK

Q3 2022

SHIFTING SANDS

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FOREWORD

The European economy has faced a number of challenges this year - high inflation, monetary policy normalisation, and energy continue to shift the outlook.

With growth slowing considerably, Europe will enter a recession in the final quarter of 2022 and the first quarter of 2023 under our baseline assumption.

KEY TAKEAWAYS:

- Since our previous forecasts, the economic sentiment has waned, with business and consumer confidence levels plunging to new lows.
- Although a recession is inevitable, we expect the contraction to be relatively mild compared to previous downturns. The underlying fundamentals of the euro area economy going into this recession are sound.
- The 10-year government bond yield forecasts have seen large upward adjustments throughout the forecast period with average 10-year Euro area bond yields reaching 3.1% from 2023-2025, a 570bps cumulative upward revision since March 2022.
- With a meaningful adjustment to the 10-year government bond yield (risk-free rate), there has been a significant revision in our real estate outlook.
- Real Estate valuations are under increasing pressure as interest rates continue to trend upwards.
- Due to the rising cost of debt and with prime yields across some markets at historically low levels, we have significantly revised our yield outlook- variations remain by property type and location
- The UK logistics sector leads the re-pricing with the sector expected to witness outward movement in yields proportional to the compression witnessed over 2017-2021.
- Prime office yields are expected to move out, second to the outward movement expected in the logistics sector.
- The retail adjustment during the pandemic has meant the sector has already been through the adjustment and therefore will face re-adjustment to a lesser extent in relative terms.

ECONOMIC OUTLOOK

The Euro area economy is slowing rapidly amid disruptions to gas supplies and European Central Bank's (ECB) response to rising inflation.

GDP is set to grow 2.9% and 0.5% in 2022 and 2023, respectively - a 2.6% cumulative downward revision from 3.4% and 2.6% since the March forecasts. Risks to growth remain skewed to the downside.

	2021	2022	2023	2023	2025
Real GDP (Y/Y % chg)	5.3 (5.2)	2.9 (3.4)	0.5 (2.6)	2.4 (2.2)	2.2 (1.8)
Employment Growth (Y/Y % chg)	1.2 (1.1)	1.9 (1.6)	0.4 (0.7)	0.3 (0.3)	0.2 (0.2)
Unemployment Rate (%)	7.7 (7.7)	6.9 (7.2)	7.2 (7.1)	7.2 (7.0)	7.1 (7.0)
Inflation (Y/Y % chg)	2.6 (2.6)	8.2 (6.5)	4.7 (1.5)	1.8 (1.6)	1.9 (1.9)
10-year Gov Bond Yield (%)	0.1 (0.1)	1.8 (0.6)	3.1 (0.8)	3.1 (1.2)	3.1 (1.6)

Source: Moody's Analytics September vintage (March vintage)

ECONOMIC OUTLOOK
RECESSION FEARS

All key European economies will face two consecutive quarters of negative growth. The UK forecasts are expected to be revised, reflecting a longer-lasting recession for the UK as higher inflation and tighter financial conditions weigh on consumer spending.

The euro area will enter a mild technical recession commencing in Q4 2022, albeit the key exception is France, where it narrowly escapes a technical recession largely due to the expansionary fiscal policy supporting consumer spending.

Although recession is inevitable, we expect the contraction to be relatively mild compared to previous downturns. The underlying fundamentals of the euro area economy going into this recession are sound, in particular the strength of the consumer, which underpins 50% of GDP. In addition, healthy corporate and bank balance sheets will help mitigate job losses therefore the Euro area will not suffer a deep hit to activity and employment.

Economic Growth by Region
(Q/Q % chg)

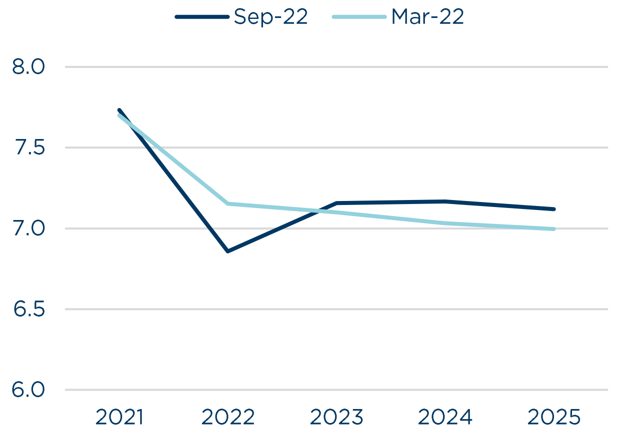
GDP growth (% Q/Q)	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3	2023 Q4
BENELUX	0.5	1.7	-0.1	-0.5	0.2	03	0.6	0.5
CEE	1.3	-0.2	0.1	-0.1	0.2	07	0.8	1.1
France	-0.2	0.5	0.1	-0.4	0.1	0.4	0.6	0.6
Germany	0.8	0.1	0.0	-0.6	-0.3	0.1	0.4	0.6
Nordics	-0.4	0.8	0.5	-0.4	0.0	0.4	1.1	0.6
Semi-Core	1.0	1.2	0.1	-0.5	-0.2	0.6	1.0	0.7
UK	0.8	-0.1	0.4	-0.8	-0.2	0.4	0.6	0.6
Euro area	0.5	0.6	0.1	-0.5	-0.1	0.4	0.7	0.6

Source: Moody's Analytics September vintage (March vintage)

ECONOMIC OUTLOOK
LABOUR MARKET

Rapid policy responses during the pandemic cushioned labour markets and prevented significant increases in unemployment. Euro area unemployment rate for 2022 is expected to better March estimations, improving 0.3% from 7.2% to 6.9%.

Euro area Unemployment Rate Forecast (%)

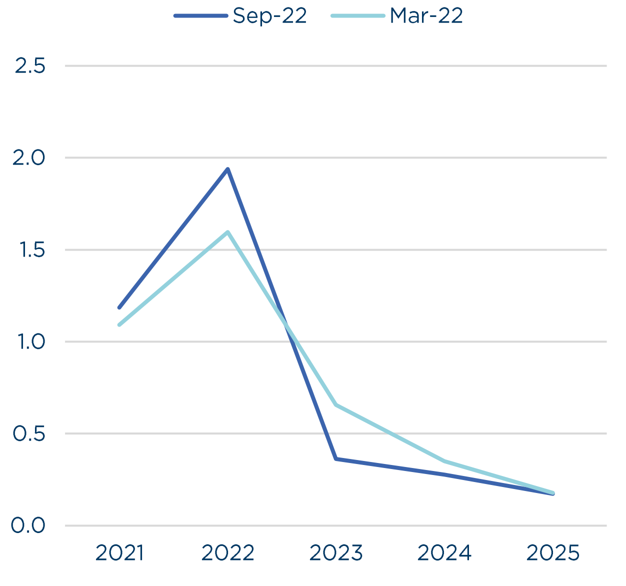


Source: Moody's Analytics September vintage (March vintage)

As economic activity recovered, labour market conditions have remained resilient and continue to outperform expectations. Employment growth is expected to average 1.9% in 2022.

However, mounting headwinds, particularly in the slowdown of economic growth will adversely impact labour markets . Medium to longer-term employment growth expectations are on the downside as corporate profits are expected to weaken and companies look to reduce costs.
Compared to March forecasts, Euro area employment growth is expected to slow in 2023, from 0.7% to 0.4%.

Euro area Employment Forecast (Y/Y % chg)



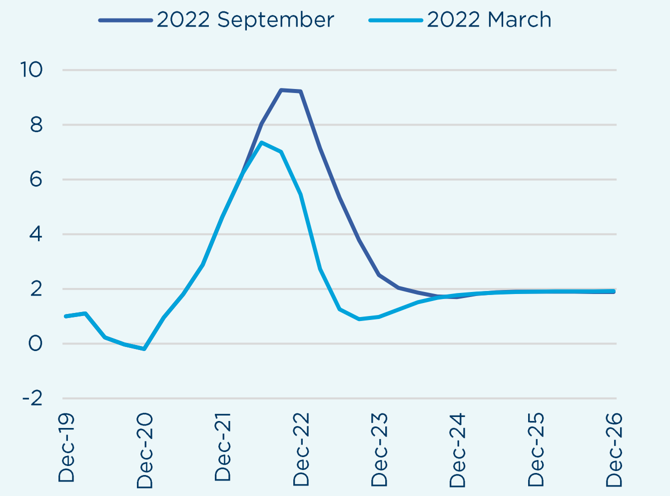
Source: Moody's Analytics September vintage (March vintage)

ECONOMIC OUTLOOK
HIGH INFLATION

European governments are introducing varying measures to combat sustained energy prices over the uncertainty of gas supplies in Europe, but inflation is to remain elevated throughout this winter and persist into next year.

The rapidly changing geopolitical landscape and concerns over Europe's gas supplies have led to actual inflation to continue to overshoot forecasts – Euro area HICP grew 10.7% in October compared to a year ago.

Euro area HICP Forecast
(Y/Y % chg)

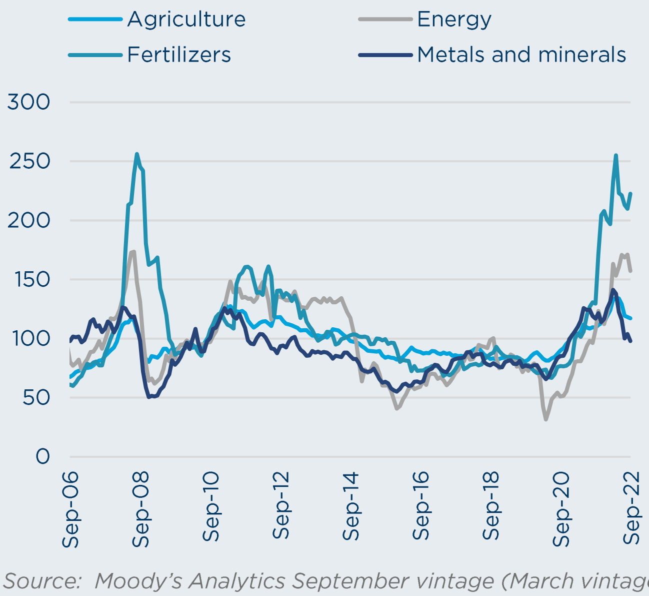


Source: Moody's Analytics September vintage (March vintage)

Despite commodity pressures including oil and gas prices easing in recent weeks, costs from earlier price hikes have found their way onto general goods and services, and are likely to remain sticky in the short-medium term.

The inflation outlook for 2022 and 2023 has upgraded, Moody's Analytics expects inflation to average 8.2% (from 6.5%) in 2022 and 4.7% (from 1.5%) in 2023.

Commodity Price Index
(Index, 2010=100)



Source: Moody's Analytics September vintage (March vintage)

ECONOMIC OUTLOOK
MONETARY POLICY

Interest rates have risen sharply, in order to tackle high levels of inflation.

The ECB initially lagged behind the Federal Reserve and Bank of England in policy normalisation cycle given the bloc's fragility to fragmentation risks.

However, since the introduction of the Transmission Protection Instrument (TPI) and the increased flexibility over the use of QE, it has picked up the pace with rate increases, the marginal lending facility rate stands at 2.25%, the main refinancing rate at 2% and the depo rate at 1.5% (the last time interest rates were seen at similar levels was back in Jan 2009 after the GFC).

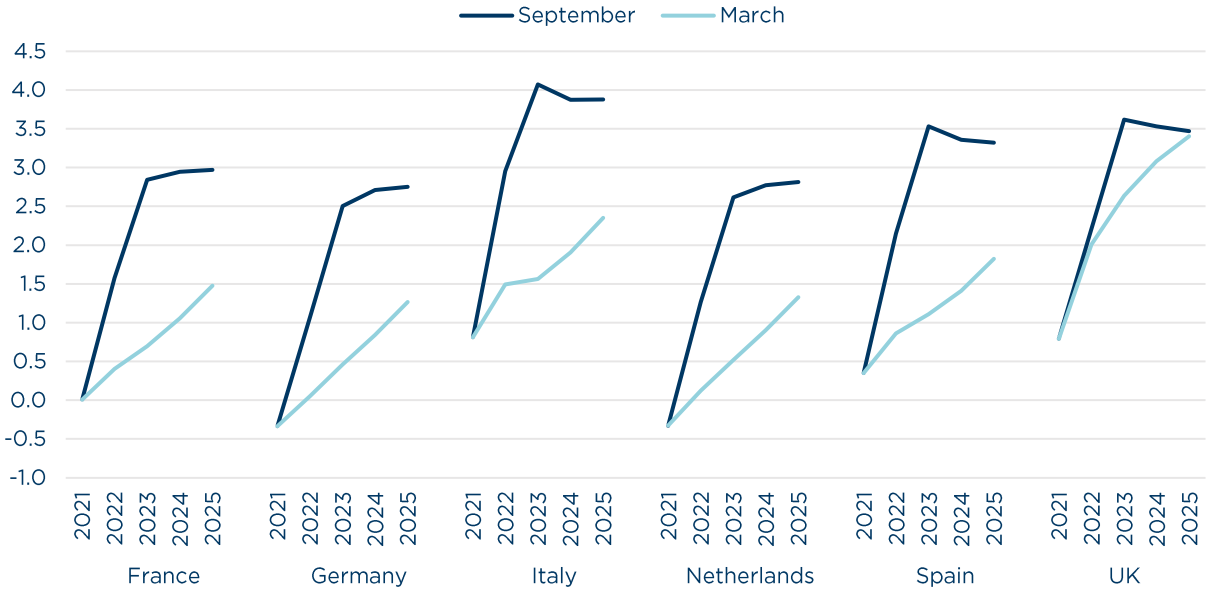
Rising interest rates and cost of debt

This 75bps increase in November follows the 75bps increase in September and 50bps increase in July, signalling the hawkish acceleration to rate hikes in attempts to bring inflation under control. The ECB is expected to raise rates further in December.

As a result, 10-year government bond yield forecasts have seen large upward adjustments throughout the forecast period with average 10-year Euro area bond yields reaching 3.1% from 2023-2025, a 570bps cumulative upward revision since March 2022. Higher fiscal deficit and raised risks of sovereign default will push the 10-year Italian bond yields past 4%.

Higher cost of capital will place upward pressure on yields.

Long-term Interest Rates:
10-year Government Bond Yield
(%)



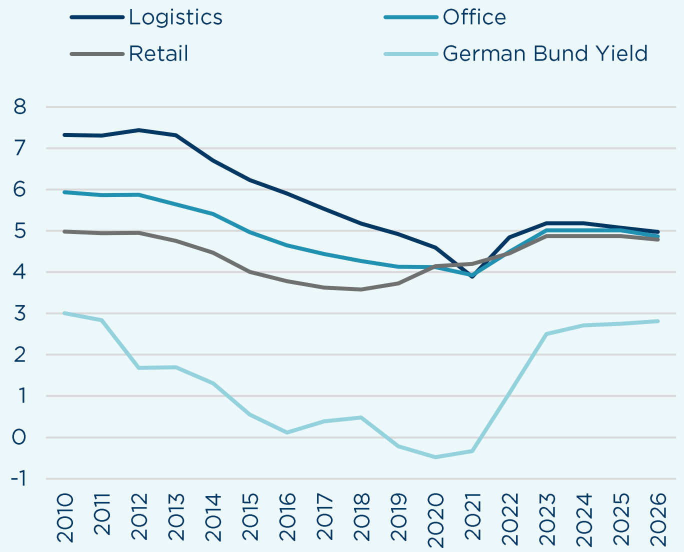
Source: Moody's Analytics September vintage (March vintage)

ECONOMIC OUTLOOK
MONETARY POLICY

Shifting Era

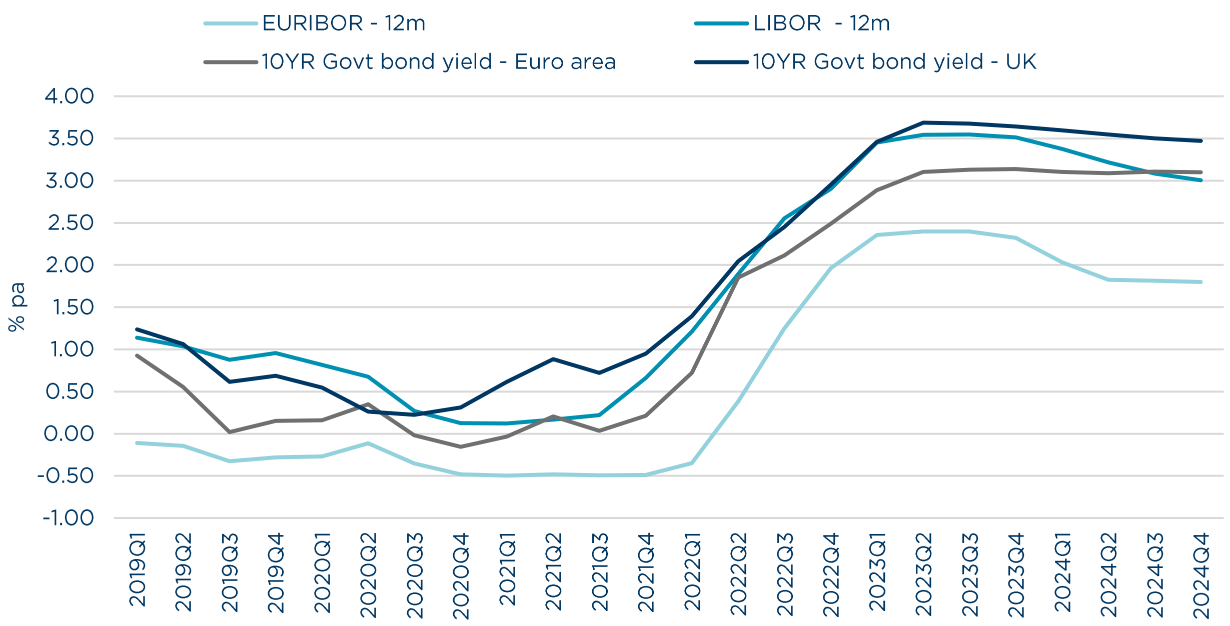
Property yields have historically tended a strong co-movement to government bond yields. Cheap credit has ensued post GFC, allowing for prolonged property yield compression. The end to cheap credit in the wake of rate normalisation to combat inflation will apply upward pressure on all property assets alike. Unlike the previous decade, rising construction and financing costs pose strong headwinds in the period ahead.

Property Yields vs 10-year Government Bond Yields (%)



Source: Moody's Analytics September vintage (March vintage)

Market Interest Rates (%)



Source: Moody's Analytics September vintage (March vintage)

IMPACT ON COMMERCIAL REAL ESTATE

The turn of events has become more evident in the real estate market in the third quarter. Typically there is a lag in the macroeconomic changes filtering through to the commercial real estate market. However, during this slowdown, many have been taken by surprise as to how quickly this has impacted the commercial real estate market.

There has been a noticeable slowdown in transactional activity with the Q3 volumes down by 37% in comparison to the levels seen a year ago. This slowdown has been felt across all sectors. According to RCA, the number of active buyers and sellers has fallen to a nine-year low. With a lack of transactional evidence, and the uncertainty surrounding the outlook, buyers and sellers are anticipating the market to adjust.

Public market pricing often leads private market pricing. REITS are down roughly 40% YTD, the decline in REITS does suggest that commercial property values are likely to follow a similar path downwards.

With a meaningful adjustment to the 10-year government bond yield (risk-free rate) there has been a significant revision in our real estate outlook.

IMPACT ON COMMERCIAL REAL ESTATE 2022 A TALE OF TWO HALVES

Generally, most property markets performed well in the first half of the year.

In Q3 2022, prime headline rents increased by 1.9% for offices and 4.2% for logistics, a slight acceleration from the prior quarter. Retail rents registered a moderate decline of -0.1%, a sign of the increasing impact of inflation on consumer sentiment being felt across most markets.

Increasing occupier focus on top-quality space to entice employees back into the office as well as the need for sustainable, energy-efficient buildings will place upward pressure on rents in the medium term.

Supply and demand imbalances continue to place upward pressure on rents for the logistics sector, as such, we continue to forecast positive rental growth in the short term although with rental growth easing.

Rental growth within retail is a mixed picture. Some markets are set to record their last year of rental decline in 2022, while a few continue to witness rental adjustment in 2023.

In a recession, (albeit mild) leasing fundamentals are expected to weaken as vacancy rises, limiting the upside for rental growth.

European Prime Rents
(Q/Q % chg)

	Q3-2021	Q4-2021	Q1-2022	Q2-2022	Q3-2022
Office	0.4%	0.7%	0.7%	1.6%	2.0%
Retail	-0.6%	0.1%	0.1%	0.1%	-0.1%
Logistics	0.4%	2.0%	1.4%	2.4%	4.0%

Source: Moody's Analytics September vintage (March vintage)

European Prime Yields
(%)

	Q3-2021	Q4-2021	Q1-2022	Q2-2022	Q3-2022
Office	4.0%	3.9%	3.9%	4.0%	4.2%
Retail	4.2%	4.2%	4.2%	4.2%	4.3%
Logistics	4.1%	3.9%	3.8%	3.9%	4.3%

Source: Moody's Analytics September vintage (March vintage)

IMPACT ON
COMMERCIAL REAL ESTATE

OFFICES

The strong rental momentum has resulted in upward revisions to prime rental growth, particularly for 2022.

Due to the rising cost of debt and with prime yields across some markets at historically low levels, we have significantly revised our yield outlook - variations remain by property type and location.

For offices, yields are expected to move out, second to the outward movement witnessed in logistics.

Towards the end of the forecast period as 10-year government bond yields begin to trend down and risk premia declining, prime office yields are also expected to compress.

INDUSTRIAL

The logistics sector has led the re-pricing adjustment with significant outward shifts in yields taking place in Q3 alone.

We expect the logistics sector to witness outward movement in yields proportional to the compression witnessed over 2017-2021, with re-pricing front-loaded in 2022 across most mature markets.

Strong fundamentals and investor interests will result in logistic yields compressing ahead of the retail and office sectors over the forecast period.

RETAIL

During the pandemic, retail underwent some sharp adjustments as the sector adapted to rapidly changing consumer behaviours.

This in effect eases the yield recalibration for retail relative to offices and logistics.

Nonetheless, retail rental growth will finish the year registering positive rental growth in 2022. 2023 will be tougher than 2022.

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  iii. Unless stated, one is assuming that the market will continue to operate in future as it has in the past, and that its stability will not be disrupted;

  iv. The forecasting is representative of only one moment in time;

  v. The reliability of forecasts for the property market are dependent on the accuracy of the input forecasts for the economy as a whole; and

  vi. The forecasts relate only to the type and quality of property indicated.

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