BTG Global Advisory
EUROPEAN INSIGHT

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Age of uncertainty

In the third of a series of updates on the capital markets sector, BTG Global Advisory discusses the outlook for the global economy and how the European Central Bank's measures affect European CRE markets.

Renewed turbulence in financial markets in the early part of this year has given rise to a weakening outlook for the global economy, complicated further by diverging global central bank monetary policies.

Instead of normalising this year as expected, monetary policy continues to loosen as the Bank of Japan joins the European Central Bank (ECB), as well as Sweden, Denmark and Switzerland, in implementing unprecedented negative interest rates.

By contrast, in the US, inflation has flickered back into life, allowing the US Federal Reserve to initiate its first rate rise for nine years in December.

But the overarching material weakening in the global outlook – driven by slower growth in emerging economies, like China, as well as weak growth across the developed world – looms large over investor sentiment.

The ECB has revised down its growth projections for the eurozone and now expects GDP to grow 1.4% in 2016 and 1.7% in 2017. There is also a considerable decline in the ECB's inflation outlook since December, driven by the decline in energy prices.

The ECB now expects headline inflation to remain in negative territory over the next few months before picking up later in the year. For 2016 the ECB expects 0.1% inflation on average, followed by 1.3% in 2017 and 1.6% in 2018.

In addition to low inflation and economic growth, these downgrades in the eurozone are the result of financial market volatility and slow implementation of economic reforms as well as costs associated with the EU immigration crisis.

The net effect of all these variables has, perhaps, led Mario Draghi, ECB President, to prioritise stimulating lending to the economy in the central bank's latest unconventional tactics.

The tactics include:

- an expansion of quantitative easing (QE), ratcheting up the monthly bond buying programme by €20bn to €80bn, while expanding the range of assets the ECB will buy to include high-quality corporate bonds; and
- offering short- and long-term loans to banks, through auctions, at minus 0.4% interest rate, effectively paying banks to lend companies and households.

The implications for banks of negative interest rates are mixed. Negative interest rates have unintended consequences for banks as such a policy logically leads to falls in bank lending rates and, in turn, interest income generated from bank lending.

To counter these risks for banks, the ECB's new targeted longer-term refinancing operations (TLTRO) will provide liquidity through four quarterly auctions of its cash, offering short- and long-term loans with an interest rate of minus 0.4% – in effect paying banks to lend.

The effect could be to stimulate lending in the eurozone, but there remains the danger that the market response, as well as the response of households, is overly cautious over what is likely to be perceived as an experiment based on a counter-intuitive idea that banks must be paid to lend.

This, potentially, could damage business confidence and companies could shelve, or limit, their investment ambitions until the impact of the plan is visible in the market and the likelihood of further policy interventions is better understood.

So, in short, the strategy is bold, but it may also create uncertainty.

How the ECB's Measures Affect European CRE Markets

Mr Draghi's latest strategy to stimulate the eurozone has likely positive implications for European commercial real estate markets, although there are risks.

QE enables the ECB to inject money into the economy, easing credit conditions. So far, in the UK and the eurozone, QE has proved to be generally positive for CRE investment, as it lowers the risk-free rate (government yield) which impacts the capitalisation rate for commercial properties.

The ECB's auctions – which will be used by banks to purchase investment grade, highly liquid sovereign and corporate bonds – will drive down yields on such instruments, including government-linked bonds, covered bonds and highly rated corporates.

This will trigger a 'displacement effect' in which investors, typically pension funds and insurance companies, will be forced to redeploy their capital into higher yielding asset classes which should lead to a move up the risk curve.

At the same time the cost of money for governments and highly rated corporates will reduce, which could stimulate investment.

This redeployment of capital across higher yielding asset classes could, in part, be redistributed into higher yielding commercial real estate – across debt and equity.

Increased capital flows into debt and equity markets would see credit spreads compress and asset prices rise. The extent to which this happens would be relative to the capital flows, mitigated of course by counterbalancing property fundamental drivers.

By providing increasing liquidity in the market, the central bank is assuming that this will be transferred into the real economy and improving lending to companies, enhancing investment and growth in the economies and in the medium term impacting the real estate occupational market.

That is the theory, at least. Certainly it is hard to see how cheap money flowing into banks would have a negative impact on European property.

As Walter Boettcher, Director of Research and Forecasting at Colliers International, argues: “Low or negative interest rates would support lower yielding property across the risk spectrum, but would also make the pricing of very low yielding core assets look sustainable … at least until this stimulus were taken away.”

Bank lending has been substantially impacted by QE and negative interest rates, leading to the first-ever covered bond issued at a negative yield. In March, Berlin Hyp issued a €500m Pfandbrief bond, rated at AAA and AA+ by Moody’s and Fitch Ratings, at a yield of minus 0.162%.

This is counter-intuitive to say the least.

Berlin Hyp’s Pfandbrief bond, which was three times oversubscribed from 39 different investors, effectively allows the bank to charge subscribers to the deal for lending the bank money. Berlin Hyp can then use this capital to fund loans to its customers, which includes providing commercial real estate senior loans.

At the time of issuance, Gero Bergmann, Berlin Hyp board member with responsibility for the bank’s capital market business, said the issue of this bizarre first-of-its-kind bond was “only a matter of time” given the macroconditions – i.e. eurozone negative interest rates – and is indicative of the unusual times which we are in.

More broadly, with the ECB now targeting non-financial investment grade corporate bonds, investment grade property companies and European REITs can expect an even further reduction in credit margin in their corporate bonds, particularly for the largest companies, such as Unibail-Rodamco and Vonovia.

The ECB’s measure are likely to provide liquidity in the European financial system, which should be net positive for the performance of equity and credit markets. However, this positive outlook must be balanced with concern given the uncertainty over how the eventual reversal of QE will impact on property value and yields.

For banks in the European sector, the problem much of the time is the restraint of capital rather than cost of funds. When banks extend loans to companies and investors, these must be backed by a mix of equity capital relative to the perceived riskiness of the lending.

On the one hand, reducing the cost of debt should reduce loan rates to the real economy, but while capital is constrained it is uncertain whether this will translate into a real uptick in lending rates to corporates and investors in commercial real estate alike.

This is because there is only so far pushing down banks’ cost of funds will have in stimulating lending before the law of diminishing returns renders the strategy inefficient.

Injecting money into the system through QE increases asset prices and depresses interest rates even further, which can cause investors to buy assets at prices that look suspiciously like they may be inflated.

There is no better evidence for this than in the London office market where big ticket stabilised assets have been trading at sub 4% yields. In this stage of the real estate cycle, it is likely to see a further move back into development, helped by recent falls in commodity prices softening build costs.

Returning to the ECB’s stimulus measures, the underlying problem is that there is no real demand in Europe. The ECB’s measures should support the economic recovery of the eurozone and at least mitigate some risks.

It will, however, become harder for the ECB to add stimulus in the future. Further stimulus over the coming months would need to see at least a renewed sharp decline in oil prices or a renewed intensification of market volatility.