

Strong Economic Data disguise increasing problems

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The German economy has recently been sending some positive signals despite the weak economy in Southern Europe. The ifo Business Climate Index has improved continuously from October 2014 to April – and remained more or less stable in May 2015. In particular, the business situation was positively assessed by respondent companies. Even the companies' outlook for the near future has improved irrespective of the continued uncertainties surrounding Greece. In May this year, the Federal Government as well as the EU Commission set their growth forecast at almost 2% for 2015 and 2016. The German Council of Economic Experts, sometimes referred to as the “five wise men” – together with leading economic research institutes - have produced similar estimates for the current year and part of next year. Real estate demand is of course dependent on the performance of the economy overall and it could be concluded that the upswing in the German real estate market will continue for at least two years. Critics may point out that caution is advised when there is consensus among economic researchers, as forecasting cycles exist in addition to economic cycles. These critics could also argue that demand for real estate boomed, particularly on the investment side and in the years of great uncertainty, as risk-averse investors sought a safe haven in real estate. Considering this positive perception of the economic climate, shouldn't investment be moving towards more opportunistic vehicles?

Firstly, the question arises: what exactly is a more opportunistic type of investment? Stocks soared from one historical peak to the next. The DAX still stands at 50% above its highest value in 2006, despite a decline of 1,000 points. This certainly promises a more opportunistic style of investment, even when one considers that the increasing dividends partly explain this rally. Simultaneously, debate surrounding a possible real estate bubble in Germany continues.

Indeed, the decline in yields on German apartments is considerable: since 2009 rental yields for new-build apartments in German cities fell by almost 50 basis points (0.5% points), in some cities such as Munich or Mainz by even more than 80 basis points. During the same period, however, German 10-year government bond yields fell temporarily by 400 basis points to almost zero per cent. Even if bond yields have recently recovered slightly, long-term German government bond yields remain only marginally above zero per cent. This makes prime yields for Munich apartments appear a very reasonable deal, doesn't it? In short: share prices have lost substantial ground, but remain at almost 50% of their peak value during the last cycle. The yields for long-term government bonds saw gains of almost 40 basis points in a few days and are now reaching an implicit multiple of 200. For short-term government

bonds investors still accept negative yields. And yet, we are primarily concerned about a real estate bubble, which seems a little strange.

To avoid any misunderstanding: the pricing for many real estate investments is alarmingly aggressive. Sooner or later there will be losers. In the end real estate cycles always follow the same pattern: demand increases and as a consequence so do rents and prices, which prompts developers into action and then due to the time-lag supply reaches the markets too late, namely when demand has passed its cyclical peak. Then rents and prices begin to sink again. This can be expected for the near future again and absolutely no bubble needs to burst; it would be a 'very normal' real estate cycle. Rising interest rates could accelerate this process. However, the most concerning fact is that many conservative real estate investors are not driven by a desire to gamble, but rather a lack of investment alternatives. The search for a satisfying yield is leading more investors towards increasingly opportunistic real estate investments (including developments), which, according to the real estate cycle model outlined above, is not favourable in the mid-term. What is more, as the government has restricted residential rent increases, the options for conservative investors have been eroded further and unnecessarily.

Following the positive growth forecasts, two further challenges need to be digested this year, which have so far not been sufficiently considered in the real estate sector:

- 1) On the one hand, the yields for Greek government bonds have recently doubled. They previously were at the level of a secondary residential location in a prime city and are now again two-digit. Whoever believed that in 2014 the investment risk for Greek bonds was similar to a residential investment in Frankfurt, would have been seriously disappointed. We have now become accustomed to the fluctuations of Greek government bonds. It is truly remarkable that negative financial news from Greece exerted almost no impact on Spanish, Italian and Portuguese bonds, as had occurred two or three years previously. Portuguese government bonds were most recently listed at 2.4% i.e. around half the level of German 10-year bonds in 2008. The capital markets evidently regard the contagion risk factor as negligible. This is exactly what makes a Grexit or a Graccident far more likely today than in 2012 as the Minimax strategy – the minimisation of maximum risk – in Europe might now lie in the management of a Grexit. Previously, this had been almost impossible due to the contagion risk factor. Then, the upward pressure on the euro would increase (indeed the euro did appreciate again moderately) and this would reduce the growth momentum as well as the scope for rising commercial real estate rents. However, this development is less a result of an expected Grexit than the second, additional risk factor.
- 2) On the other hand, the latest economic news for China and the US does not suggest sustained growth. A delay in the interest rate turnaround is being discussed again in the US although this matter was previously considered to be settled. At the same time, the Chinese government has relaxed the laws for acquiring second and third homes, evidently as a measure to stimulate the construction and real estate sector. A

measure that was unlikely to have been taken as a result of strong domestic economic sentiment. When the locomotives of the two most important global economies are not moving full steam ahead, this is not good news for Germany, a train wagon dependent on exports.

In conclusion, three aspects are important for the next 18 months: firstly, the benign economic growth forecast for Germany is far from a guarantee. Significant uncertainties remain, bad news for those that have based their purchase considerations on aggressive rental growth in the future. Secondly, a Grexit is more likely today than two years ago; a 'Grapocalypse' has certainly become less likely than in 2012 as other Southern European countries are currently considered less of a contagion risk than three years previously. At second glance, this good news is not necessarily positive for real estate investors as the argument for secure investment has been somewhat eroded compared to other asset classes. Moreover, the question arises whether the investment risk in Portugal or Italy really is as small as government bond prices suggest. Thirdly, there are arguably excesses in European real estate markets, however, compared to the excess in bond markets this is a 'lesser evil' for investors. At present, real estate investors must give careful consideration and certainly need to be more patient than three or four years previously. Still, subsequent quarters should prove positive for real estate markets. However, the better they perform, the stronger the downward correction could later prove to be.

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