

# ECONOMIC PULSE

A REPORT ON THE EUROPEAN ECONOMY AND  
ITS IMPACT ON COMMERCIAL REAL ESTATE

## EUROPE'S POLARISING MARKET: WHERE IS THE GROWTH IN 2010/11?

**N**ew data releases from governments and statistical offices around Europe are steadily completing the picture on 2009 – showing us both how bad was the early part of the year and how volatile and uncertain the recovery of the last few quarters.

Nonetheless, the nascent European recovery has in fact largely progressed as expected. Unfortunately, what was “expected” included a general belief that we would not see a sustained acceleration in growth but would more likely bounce along the bottom for some while, and that prospects would be increasingly divergent country by country.

Indeed, rates of growth have now fallen back in a number of countries as temporary stimulus measures have ended and as the cyclical boost from an end to inventory liquidations has faded. However, the lack of a strong engine to power an accelerating rate of growth does not mean a return to recession or even economic stagnation is around the corner.

In fact, growth expectations are quite likely to improve as evidence of the real level of current activity emerges. Ongoing export demand is keeping some positive momentum in the overall economy for example and a fall in the Euro over recent months should aid this further. Moreover, re-stocking is yet to take place in many areas of industry and this will follow the recovery in sentiment still underway.

In terms of domestic demand meanwhile, while fiscal policy may start to tighten this year, stimulus measures will be phased out only gradually and in many cases their effects will continue to be felt through this year and into next.

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The same is true of monetary policy and today's low interest rates may yet spur stronger growth over the next 12-18 months if past lags are anything to go by.

Elsewhere, consumers will remain under pressure as real wage growth eases and labour markets are slow to improve, but there are a number of positives which could boost the sector over 2010 including a fall in inflation helping support real incomes and reducing the pace at which central banks need to raise interest rates.

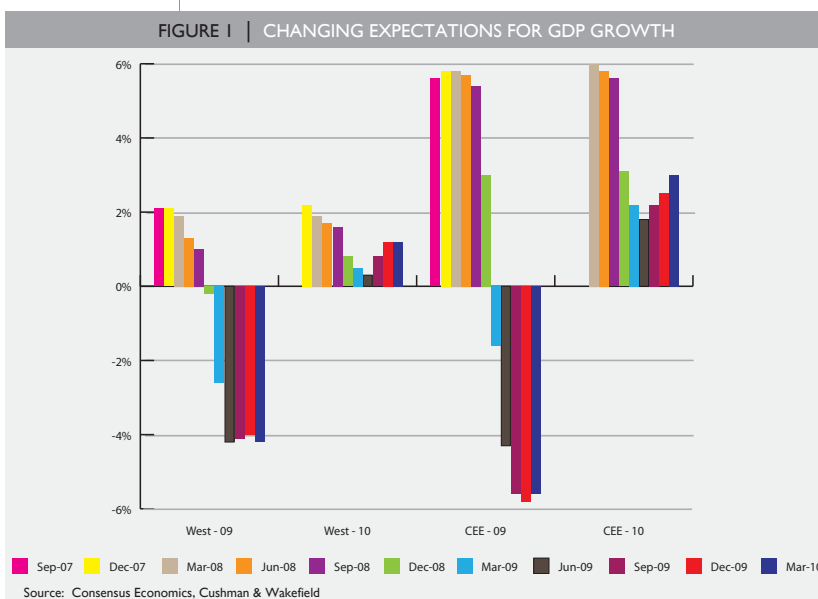
Market by market meanwhile, 2010 will see an increasingly pronounced divide between economies in terms of growth and, most especially perhaps, risk.

Moreover, the traditional East/West classification has become less relevant as top performing economies are drawn from different regions of Europe. Indeed, whilst in the short-term economies such as France, Germany and Switzerland stand out for offering potential out-performance at below average levels of risk, over a 2-3 year period, the Czech Republic, Poland and Slovakia should also be included, alongside Nordic markets such as Sweden and Norway.

However, while macro national-level risk factors are very much in focus as the tragedy of Greek finances unravels, the growth outlook can differ quite significantly between cities located within the same area, suggesting a need to focus on regions and not just countries.

Some of the top performing city regions for the next 1-2 years are expected to be in Central Europe, notably Warsaw and Prague, but Budapest and Bratislava are also expected to fair relatively well. Further west, the top performing city regions for 2010/11 are forecast to be led by Stockholm, Luxembourg, Zurich and Oslo.

**Where we are now?**



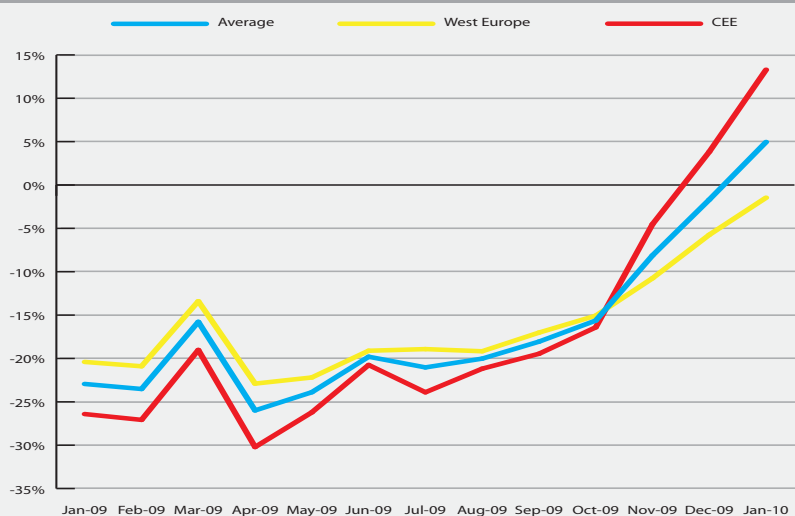
The path of economic recovery is proving to be a bumpy one for much of Europe, with the Euro zone as a whole slipping back to zero growth in q4 for example and a number of markets seeing negative growth return after just 1 or 2 quarters of positive increases in q2 and q3.

Data and sentiment indicators in the first quarter of 2010 nonetheless suggest that growth has restarted for the region overall and almost all major European economies are set to see positive growth by the end of 2010, if not for the year overall in some cases.

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Western Europe is currently expected to see growth of 1.2% this year improving to 1.7% next after a 4.2% drop in 2009. In Central & Eastern Europe, last year's under-performance of the West is expected to reverse in 2010/11 with sentiment towards the region improving further over the last 1-2 months and growth of 3.3% forecast for 2010, increasing to 4% in 2011.

FIGURE 2 | YEAR ON YEAR EXPORT GROWTH IN EUROPE



Source: Baltic Exchange, Cushman & Wakefield

**Industrial activity drives the recovery**

Helped significantly by stronger automobile demand, industrial activity and exports have played a key role in the revival to date and this should continue if sentiment and output surveys are to be believed and the Euro continues to gain competitiveness.

The process of re-stocking also has further to go, with inventories cut in the recession to such a large extent that even

the smallest increase in demand has to be met by increased production.

Crucially however, while many European economies are understandably focused on exports as a driver for recovery, external demand within Europe is only improving at a slow rate. Outside Europe, growth in much of Asia and Latin America continues apace, but demand from these countries is still a relatively smaller share of total European exports.

As a result, while the rebound in export demand and industrial production will continue, with car demand to fall as scrappage schemes are exhausted, the sector's contribution to growth can't increase unless regional and local demand is boosted from other sources.

**Public sector help or hindrance?**

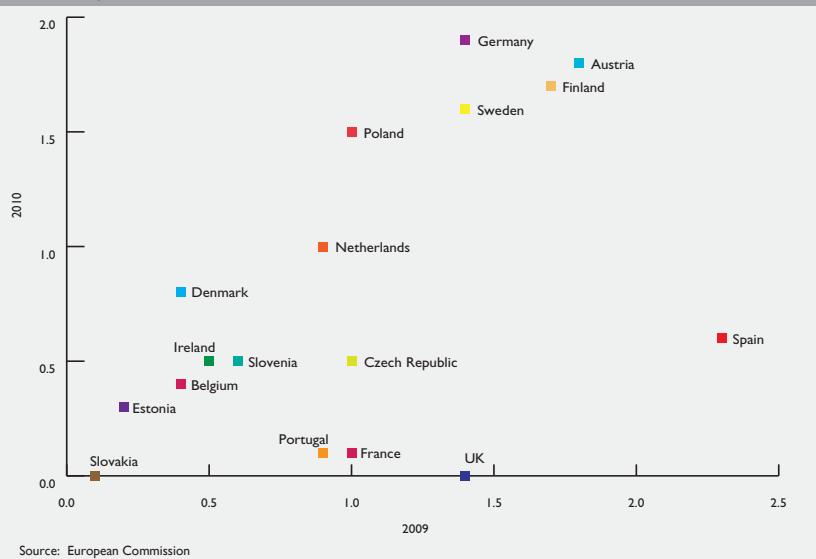
Increased government spending via automatic stabilisers and targeted stimulus measures is widely regarded as having been key to securing the recovery but clearly the majority of this extra spending was always intended to be temporary and recent attention has turned to the likely pace at which it will be removed and the damage this will do.

However, while the impact of stimulus measures may have peaked, many countries are still planning to pump significant amounts of new money into their economies this year (figure 3).

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It is also vital to distinguish between stimulus measures in a fiscal sense and their implementation and effect on the economy, which may continue long after the original measure is announced. For example, new infrastructure investment could take some years to be spent and should go on boosting output once complete.

FIGURE 3 | GOVERNMENT SPENDING KEEPS ON ROLLING - STIMULUS AS A % OF GDP BY YEAR



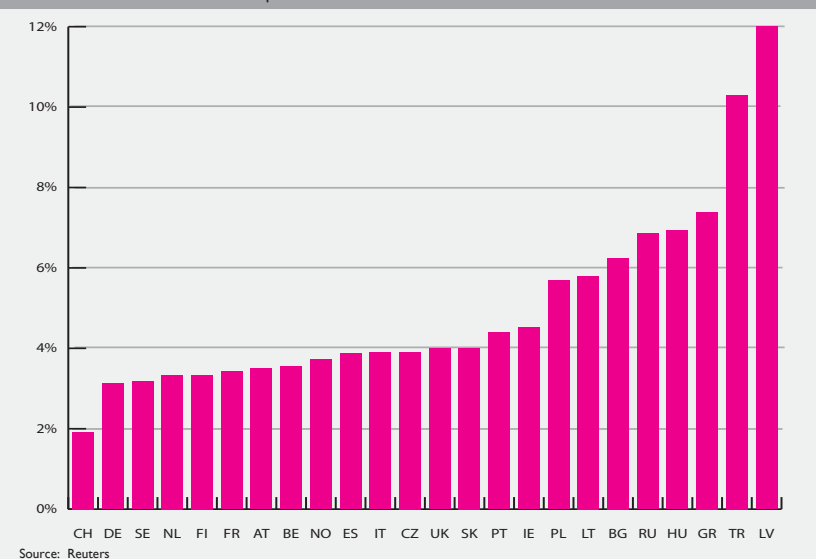
Nonetheless, pressure is clearly mounting on countries to show that at the very least they have a plan in place to stabilise spending and deficit levels. As shown by the difference between Irish and Greek bond yields (both Euro zone members), financial markets have been much more forgiving of high debt countries that have at least set out credible plans for debt reduction.

Financial markets have of course been casting a watchful eye over government finances ever since the scale of borrowing became apparent but the Greek situation has added further uncertainty, throwing doubt on the validity of some governments' data on the one hand but also on the likely

support and rescue mechanisms that exist – even for a Euro zone member.

That aside, while a default on government debt in Europe is still considered unlikely, it will be very difficult for most governments to avoid a combination of a reduction in spending and an increase in taxation. As a result, public sector demand cannot be relied upon to be a significant driver of growth in Europe over the next year or two.

FIGURE 4 | YIELDS ON 10 YEAR GOVERNMENT BONDS



**Consumers to the rescue?**

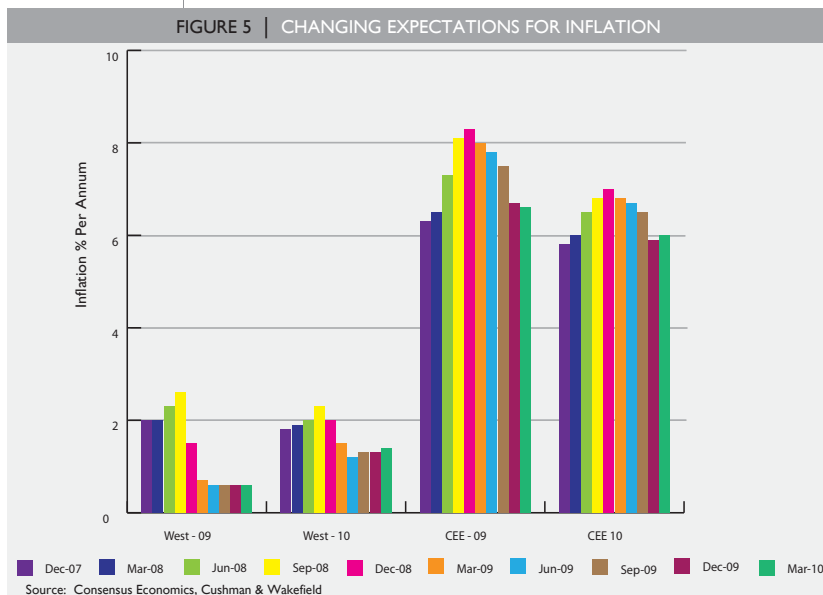
Looking at a comparison with GDP forecasts, which have improved over the past few months, the outlook for private consumption is less impressive. In the Euro zone, for example, while overall GDP is expected to grow by 1.1% in 2010, private consumption is set to grow by a much more modest 0.2%. It is not difficult to see that with governments tightening the purse-

strings, access to credit still difficult for some, and wage growth slowing, consumers have enjoyed more accommodating circumstances. All the same however, there are a number of clear supports to the consumer over the coming year such as better overall sentiment, low interest rates, lower inflation and a shift and stabilisation in labour market conditions.

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Moreover, if we look back at 2009, the fall in private consumption was much less than that in overall GDP, indicating that households were largely able to maintain spending levels despite the adverse economic backdrop. Indeed, while average consumption growth in 2010 may be modest, it may hold up better and recover more rapidly than some expect, and certain countries will see stronger growth, highlighting again the likely polarisation of performance around Europe.

FIGURE 5 | CHANGING EXPECTATIONS FOR INFLATION



**Inflation**

Current forecasts still see a general pick up in inflation from 2009 levels, but as the volatility in commodity prices at the end of 2008 and early 2009 fade from the calculations, inflation expectations will begin to recede. Indeed, a risk of deflation is clearly still present and with low inflation being brought on by a combination of subdued consumer demand and spare capacity, countries with the weakest economies are most at risk, at least in Western Europe.

This risk aside, a more benign inflationary environment than expected should provide a number of benefits such as supporting real spending power. With inflation set to fall below target, central banks will be under little pressure to raise interest rates in the short term, lending support to economic activity in general. Furthermore, a period of low inflation could help Europe's exporters to regain some competitiveness vis-à-vis other regions.

**National outlook**

One by-product of the downturn has been the re-evaluation of the accepted country hierarchy within Europe. Where once a simple East/West classification appeared to suffice for many, the large differences in performance and stability between European countries over the past few years have called this into question. For example, there are economies within Central Europe that have proved both more stable and have stronger growth prospects than some in the south.

Hence, whilst in the short-term economies such as France, Germany and Switzerland stand out for offering potential out-performance at below average levels of risk, over a 2-3 year period, the Czech Republic, Poland and Slovakia should also be included, alongside Nordic markets such as Sweden and Norway.

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TABLE I | MARKET FORECASTS (March 2010)

	GDP % pa		Inflation % pa		Comment
	2010	2011	2010	2011	
Austria	1.3	1.7	1.3	1.6	The outlook is for a moderate recovery, as industrial output and consumer spending are expected to see gradual growth.
Belgium	1.2	1.8	1.1	1.6	The main driver is still expected to be rising exports but consumer spending is set to grow slowly in 2010 as well.
Bulgaria	0.1	2.6	2.6	3.1	Tight government finances and high unemployment will limit domestic demand so sustained investment will be key.
Czech Republic	1.5	2.7	1.5	2.3	Output may receive further support from exports, but a return to stronger domestic demand could take some time.
Denmark	1.2	1.9	1.4	1.8	The Danish economy is recovering, albeit slowly, with consumers still cautious as the housing market approaches trough.
Estonia	-0.4	3.5	0	1.6	Second year of recession looms as government spending offers little support to domestic demand.
Finland	1.1	2.1	1.1	1.6	Recovery has begun, but the initial stages will be slow, with high unemployment and sluggish exports growth.
France	1.4	1.6	1.2	1.5	Investment growth will not return until H2 10, in the short run it will be down to consumers to support growth.
Germany	1.7	1.6	0.8	1.2	Much of the recent growth has been cyclical, domestic demand must resume growth to support the economy.
Greece	-1.3	0.3	1.6	1.5	Government finances have taken centre stage and the resultant fiscal tightening has blunted short run growth prospects.
Hungary	-0.2	2.4	4.3	3	The impetus for growth must come from abroad, as domestic demand has been weakened by tough IMF measures.
Ireland	-1.2	2	-0.5	1.2	After a period of readjustment, the Irish economy may again become one of the stronger performers in Europe in 2011.
Italy	0.8	1.2	1.5	1.8	Italy has benefited from a pick up in global trade, but it will need to see a rise in domestic demand to maintain growth.
Latvia	-3	3	-2.9	0.6	The Euro currency-peg is proving difficult to maintain, while output has also been hit by weak external demand.
Lithuania	-2.3	2.7	0.2	1.1	A further year of decline forecast as domestic demand is hit by fiscal tightening and exports struggle to compensate.
Netherlands	1.3	1.6	1	1.2	There has been a marked improvement in the outlook in recent quarters and prospects now look comparatively good.
Norway	2.4	2.6	2.1	1.8	Output growth is expected to exceed other Western European economies, aided by loose monetary and fiscal policies.
Poland	2.7	3.4	2.4	2.6	Poland did not see outright recession in 2009, and is forecast to see one of the strongest recoveries in the region.
Portugal	0.7	1.4	0.9	1.4	Rising investment and improved demand from abroad will support a modest recovery in 2010.
Romania	1.1	3.1	4.3	3.6	With inflation and unemployment set to fall, rising consumer demand later in 2010 may offset weak government spending.
Russia	4.5	4.6	7	6.9	The cyclical industrial rebound will fade during 2010, but consumer demand could benefit from government policy.
Slovakia	2.5	3.4	1.4	2.8	Strong exports performance has aided the outlook for 2010, but uncertainty over strength of domestic demand remains.
Spain	-0.4	1.1	1.4	1.7	The downturn is expected to last longer than for much of the Eurozone, with domestic demand particularly weak.
Sweden	2.1	2.6	1.1	2	Exports have been weaker than expected, setting the economy back slightly, and unemployment will remain a concern.
Switzerland	1.5	1.8	0.8	1.1	On track for a relatively solid recovery, although the investment outlook is weak and unemployment is still elevated.
Turkey	4.5	4.3	9	6.2	Developments in recent months have done little to alter the view that Turkey is set for a strong recovery in 2010.
UK	1.4	2.3	2.6	1.7	Recent data have been more in line with expectations that the UK will perform relatively well in 2010 and 2011.
Ukraine	3.1	4.7	11.9	10.7	In the short run, momentum will depend significantly on developments in the region, as well as the political situation.
Western Europe	1	1.7	1.2	1.5	The outlook has stabilised, with a reasonable recovery still expected, albeit held back by weak consumer demand.
Eastern Europe	1.2	3.4	3.5	3.7	Outlook varied but slowdown now generally easing, with prospects improving as the western markets stabilise.

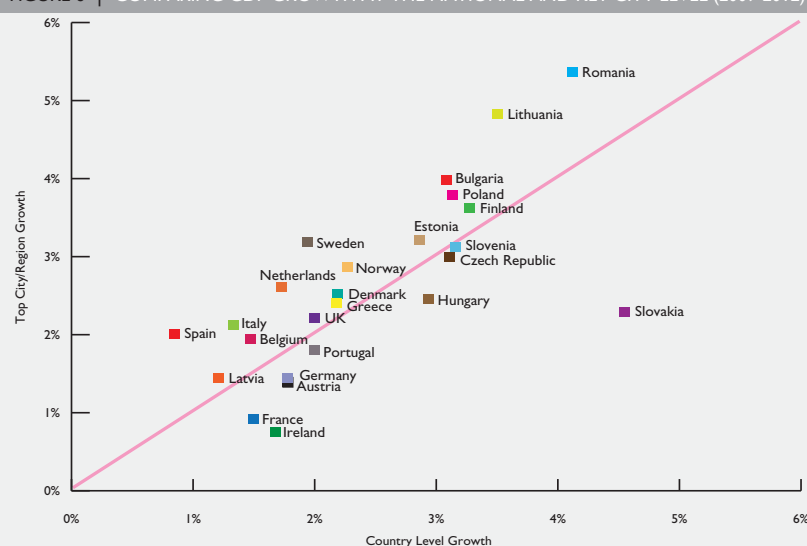
Source: Consensus Economics Inc, Oxford Economics and Cushman & Wakefield

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**Regional outlook**

Taking the analysis down to city level, forecasts suggest that in many parts of Europe, economic growth in the capital or main city will exceed that of the country as a whole by a significant margin over the next few years. In some cases this is due to the capital city rebounding more strongly than the country following a sharper fall during the downturn. In other cases the capital simply has a higher trend growth rate, regardless of the underlying economic environment.

FIGURE 6 | COMPARING GDP GROWTH AT THE NATIONAL AND KEY CITY LEVEL (2009-2012)



Overall looking at economic and labour market trends, some of the top performing city regions for the next 1-2 years are expected to be in Central Europe, notably Warsaw and Prague, but Budapest and Bratislava are also expected to fare relatively well as are eastern EU cities such as Sofia and Bucharest. Further west, the top performing regions for 2010/11 are forecast to be led by Stockholm, Luxembourg, Zurich and Oslo.

A more mixed but still positive performance is anticipated over the next 2 years in some key

cities such as Lisbon, Helsinki, Milan, Munich and Amsterdam, as well as in some regional cities such as Birmingham and Manchester in the UK and Lyon in France. Typically these are cities where stronger than average economic growth and recovery is forecast but perhaps without as strong a transmission into the labour market as is forecast for the top performing regions.

Under performers for 2010/11 from an economic perspective meanwhile include some which will suffer in line with their country, such as Athens and Dublin, some which are more dependant on the public sector, such as Berlin and Rome, as well as a range of others which may have the wrong industrial or cost base to succeed in the initial recovery, including some major cities such as Dusseldorf, Copenhagen, Vienna and Rotterdam.

**The Impact for Real Estate**

Business has to live with some degree of uncertainty and can't stand on the sidelines for ever and hence it is no surprise that we are now seeing signs of increasing activity from both occupiers and investors in the European property market. Of course there is less clarity on pricing than many would like - with overly ambitious negotiating positions seen in both investment and leasing discussions - and less competitively priced finance than the market needs. Nevertheless, confidence has improved in the first quarter and both occupiers and investors sense that for Grade A property, pricing is now around as good as it will get but for secondary stock, there is no urgency to invest or occupy property which should get cheaper yet.

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Activity meanwhile is not just about assets, it is also about companies. With most businesses expecting only modest organic growth during the early stages of this recovery, more are looking for expansion via other methods, including mergers or acquisitions, particularly as the difficulty of raising finance begins to recede for stronger firms. There will be plenty of weaker targets to pick through as banking support fades for the walking wounded.

#### **The Industrial Sector**

For much of the past 1-2 years, many industrial and warehouse occupiers have been too unsure of their future business to make decisions on relocation or even on renegotiating their existing leases. Short leases or breaks have been highly valued as a result and with availability in major distribution locations up 32% last year, landlords have been more than ready to oblige.

However industrial activity has a short lag time with the economy and signs are already emerging that demand for modern logistics and warehousing will slowly rise this year, with some mothballed relocation and expansion plans now being re-enacted and interest from smaller occupiers also improving in some areas.

Occupiers in general are still looking carefully at costs and efficiency of course and modern distribution property, and lower cost markets such as Poland, may benefit once users are ready to take action and implement a new property strategy.

Modern space to meet demand will however be increasingly hard to find, particularly given that the appetite for speculative development is expected to remain low. As a result, while rents may drop further in the short term— with a modest 2-3% decline forecast for 2010 – an increasing number of markets may start to see rents come under upward pressure by the end of the year.

Investor demand in up-and-let modern schemes is likely to rise further, with a focus on recently completed stock which is of better quality and relative to average stock, has a stronger lease and tenant line up. Interest in development and development funding will also start to increase as soon as investors see firmer signs that improving tenant demand will be sustained.

#### **The Office Market**

With corporate budgets still under pressure, office tenants remain reluctant to increase their outgoings or incur avoidable expenditure. Nonetheless, some are recognising that possible supply shortages will emerge in the next 1-2 years due to falls in development activity, which dropped 35% last year alone. As a result, an increase in active demand is starting, with a flight to quality as occupiers look for the best, modern space, with green credentials of growing importance. The market is therefore set to become increasingly polarised based on space and location quality.

An increase in merger and acquisitions and renewed international expansion are tipped by some to steadily reignite tenant demand but natural expansion will be slow to emerge, with no short-term recovery expected in employment and many businesses having spare capacity on hand. However, while a demand-push will be slow to materialise, a supply-led upturn should emerge more rapidly.

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Indeed, with limited new development and a peaking in grade A availability, the best deals for occupiers will start to fade in the second half of the year.

Prime rents overall are expected to fall 5-6% this year but effective rents may actually increase with incentives starting to tighten. The recovery will however be highly varied market by market as a result of its reliance on supply, with cities such as London already recovering and others such as Paris, Munich, Oslo and Warsaw set to do so in the months ahead.

Investment demand meanwhile has risen further in early 2010 and whilst not perhaps as popular at present as the retail market, a greater availability and familiarity with office product is sure to ensure the sector sees its fair share of activity. Volumes are likely to rise over 40% this year and yields will harden, ending the year perhaps 35-45bp lower than in late 2009.

#### **The Retail Sector**

Retail trends will be mixed in 2010, with better sentiment balanced by a cautious approach from shoppers and retailers alike. While the labour market has stopped falling at the rate seen early last year, limited wage growth and the threat of further job losses will subdue consumers. Lower inflation and low interest rates should support the release of some pent-up spending as the year progresses however and rents in the prime shopping centre market, which fell just over 7% last year, are set for a more modest fall of around 3-4% this year, before stabilising by year-end.

Value for money is a key theme of the market while among retailers, the focus more than ever is on quality space in quality locations. The best dominant shopping centres have maintained occupancy better than most while an increasing focus is also being seen on the strongest high streets and outlet centres. More retailers are also recognising the opportunities now available to them, with rents down, incentives up and more choice of product than for some years. However, this will not last, with take-up focussed on the best space and the biggest centres and a falling level of development, with the shopping centre pipeline down 30% since 2007.

Investors will take further comfort from this and while their focus will remain on the best assets, an increasing number of buyers will be drawn into the market by its low risk attributes as much as its longer term growth potential. With signs of falling yields, likely to drop by 50bp or more this year for prime centres, a modest increase in investment supply should lead to further growth in activity and a slow increase in interest in development and development funding is also likely.

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TABLE 2 | MARKET VALUES

	Rental Growth (yr to March 2010)				Yield levels (March 2010)				
	Retail	Office	Industrial	Trend - All Sector	Shoping Centres	Shop Units	Office	Industrial	Trend - All Sector
Austria	4.4	2.2	0.0	→	6.25	4.60	5.50	7.50	↘
Belgium	0.0	-3.0	-5.0	↘	5.50	5.00	6.20	7.75	↘
Bulgaria	-43.8	-28.8	-25.0	↘	9.50	9.00	10.50	13.00	↘
Czech Republic	-6.7	-6.7	-5.6	↘	6.75	6.75	6.75	9.00	↘
Denmark	-8.9	-3.1	-5.5	→	6.00	5.00	5.25	7.50	→
Finland	0.0	-11.0	0.0	→	6.25	6.50	6.50	8.00	→
France	-1.4	-0.4	1.0	→	5.25	5.00	5.50	8.25	↘
Germany	1.5	-4.0	0.0	→	5.40	4.15	5.10	6.80	↘
Greece	-16.5	-5.1	-6.6	↘	7.00	6.80	7.60	8.10	↗
Hungary	-3.1	-2.6	-6.3	↘	7.50	7.50	7.50	9.50	→
Ireland	-27.6	-25.5	-20.7	↘	7.50	6.40	7.50	8.25	→
Italy	-2.0	-4.7	-3.5	↘	6.50	5.00	6.00	8.00	→
Luxembourg	2.9	-5.3	n/a	→	n/a	5.75	6.15	n/a	→
Netherlands	-2.2	-3.60	-0.8	→	6.90	4.80	6.50	7.80	↘
Norway	0.0	-4.7	0.0	→	6.50	5.75	6.00	7.50	↘
Poland	-1.2	-8.8	-1.7	→	7.00	9.00	7.00	8.50	↘
Portugal	-3.5	-2.0	0.0	→	6.25	6.25	7.00	8.25	↘
Romania	-15.3	-15.6	-4.5	↘	9.00	9.25	9.00	9.50	→
Russia	-6.6	-19.1	-4.8	→	12.00	n/a	12.00	13.00	↘
Slovakia	-40.0	-11.1	0.0	↘	7.50	7.50	7.75	9.00	↘
Spain	-1.0	-8.8	-9.2	↘	6.00	5.35	6.00	7.75	↘
Sweden	-0.6	-6.2	-7.0	→	5.50	5.50	5.50	7.00	↘
Switzerland	0.0	-2.4	-0.9	→	5.50	4.50	4.50	6.75	→
Turkey	6.6	5.1	-12.0	↗	8.75	7.00	8.50	9.25	↘
Ukraine	-3.9	-16.7	-2.4	→	14.00	16.00	16.00	16.00	↘
UK	-5.2	-2.9	0.0	↗	6.00	4.50	4.50	6.25	↘

Note: Yields are headline levels for the prime market in each country and are quoted on their local market basis. Those shown in red are calculated net, to include transfer costs of tax and legal fees. Rental growth reflects value movements in a sample of locations across each country.  
Source: Cushman & Wakefield

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