BGO

1Q2024 European Economic and CRE Outlook

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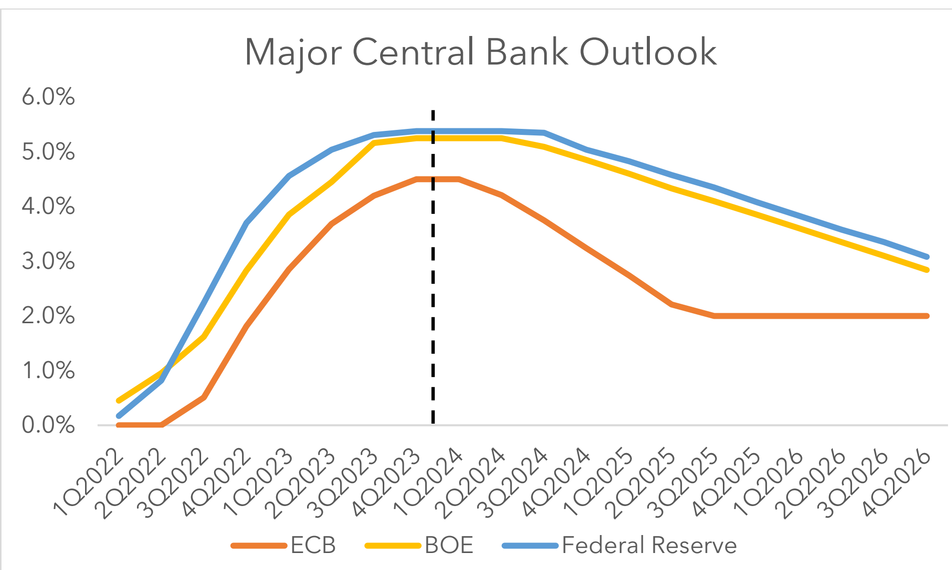
Highlights

- Growth slowing, not collapsing
- Monetary tightening ending
- Market fundamentals stabilizing
- Capital markets recovering
- Investment outlook improving

2023 presented a challenging year for the European economy and commercial real estate (CRE) market. Economic growth slowed, property market fundamentals faced some associated headwinds, and the interest rate increase disrupted capital markets. Yet, in many ways 2023 represented a year of stabilization, not implosion, as ongoing post-pandemic adjustments continued. With the major regional central banks poised to cut rates in 2024, the outlook for both the economy and the CRE market looks brighter. We remain cautiously optimistic about the outlook for 2024 and more so for 2025.

Economic Overview And Outlook

Broadly, the European economy concluded 2023 with weak growth and a loss of momentum. This occurred across a broad swath of the region, with the largest national economies – Germany, the UK, France, and Italy – stalling or contracting. For 2023, growth in the Eurozone and the UK finished slightly positive, but the quarterly data shows that while the Eurozone avoided a recession, the UK technically slipped into a very shallow one. Yet, despite recent challenges, the underlying dynamics are improving. Inflation continues to decelerate, and in the Eurozone, it is falling faster than many had expected. Of note, the decline in energy prices during 2023 benefitted Europe, which previously struggled under the weight of elevated energy prices in the wake of the war in Ukraine. As inflation has cooled, the region's major central banks, the European Central Bank (ECB) and the Bank of England (BOE), slowed the pace of rate hikes during the year and appear to have concluded their tightening for this cycle.



Sources: Oxford Economics, BGO Research

The major European economies should stabilize and begin a recovery in 2024. Inflation should continue to slow throughout the year as the impact from the war in Ukraine continues to fade, supply chains further improve, and demand steadies. Consequently, both the ECB and BOE should have sufficient cover to begin cutting rates this year. Of the major global central banks, the ECB should likely start cutting earliest due to more rapid inflation in the Eurozone, potentially as early as the second quarter. While the BOE should follow suit, it probably would not occur sooner than mid-year. Initially monetary policy will become less restrictive, but not easy or stimulative. That should remove a major headwind to economic growth and create a bit of a tailwind in the latter half of the year. We expect a modest acceleration in real GDP growth in 2024 for both the Eurozone and the UK, with acceleration as the year progresses. That sets the region up for stronger growth in 2025.

Property Market Overview And Outlook

With the major regional central banks set to cut rates, this development should remove the major impediment to better CRE market performance. But prospects across the region differ by property type. Generally, we expect the broad contours of the last few years to persist: logistics and residential remain robust, niche sectors increasingly justify a place in institutional portfolios, and the office sector will continue to face some challenges, but still present opportunities for investment. Against that backdrop, the outlook for the real estate market looks more optimistic over the medium term, powered by a combination of an improving economic environment, recovering capital markets, and attractive space market fundamentals.

Logistics

While demand during 2023 slowed relative to the breakneck pace of 2021 and 2022, it remains roughly on par with 2020, an unambiguously healthy year for the European logistics market. Moreover, demand for space strengthened in the latter half of the year, particularly for new, advanced spaces that can handle the demands of the modern global supply chain and distribution networks. 3PL firms continued to represent the largest share of demand for space, although manufacturers' take up of space increased as the year unfolded. Meanwhile, strong performance during 2021 and 2022 encouraged speculative new development. Additions to inventory are exceeding demand in many markets, putting upward pressure on vacancy rates. But that is enabling many tenants to move to newer space at the expense of older, often obsolete space. Although rental growth is slowing, it remains elevated. New supply is commanding above-average rents because it offers users advantages that they cannot obtain in older space. Over the next few years, demand should rebound while new construction slows, which should stabilize and ultimately reaccelerate rent growth.

Although investment volume for 2023 came in well below levels from recent years, it showed signs of resurgence in the latter half of the year. Volume slowly increased as the year progressed, helped by the slowing pace of rate hikes from the ECB and BOE. But many investors remain cautious due to the economic challenges the region faces. Nonetheless, logistics continues to represent an increased share of the overall investment market relative to pre-pandemic levels. Yields have marginally increased throughout 2023 with investors repricing assets. Yields remained lower in Western Europe than Central Europe, but virtually all markets experienced a yield expansion. Yields should stabilize and recompress in the coming years as demand and supply recalibrate and interest rates decline.

Office

Office leasing volume across Europe held constant for the first three quarters of the year before accelerating during the fourth quarter, offering some hope heading into 2024. That proved insufficient to push net absorption into positive territory. Yet with supply growth remaining relatively limited, the vacancy rate for Europe increased only marginally during 2023 to roughly 8%. Although that represents an increase of roughly 300 basis points (bps) since reaching its cyclical low during the first quarter of 2020, the office market in Europe remains far tighter than that of the US and Asia, both of which sport a double-digit vacancy rate. Correspondingly, rent growth reflects this relative strength. During the fourth quarter, Europe boasted an outsized share of the top performing markets, led by London and Amsterdam which both generated quarterly rent growth of at least 7%. And of course, the flight to quality and newness remains entrenched, with newer, highly-amenitized properties performing strongly, well ahead of older, inferior buildings.

Transaction volume during 2023 continued to decline, reflecting not only the difficult office-market leasing environment, but also the challenging debt market environment. With interest rates remaining elevated, that kept the cost of debt capital high enough to provide a strong disincentive to invest in property. Both intra-regional and inter-regional investment in the property sector declined during the year. Yet, similar to the leasing market, some green shoots are slowly emerging in the capital markets. Volume appears to be stabilizing, if not increasing, across a number of markets. If European central banks begin cutting rates this year, as we anticipate, it should put downward pressure on debt costs and property yields and upward pressure on pricing and volumes. And ultimately, that should provide a fillip to sentiment in the office market which remains the main headwind for the sector. As sentiment shifts, it should combine with strong market fundamentals and improving capital markets to create a compelling investment environment.

Residential

The residential market remained tight across Europe in 2023. Limited supply growth amid ongoing demand continued to put upward pressure on rents and home prices. While the acute housing shortage remains well known, the outlook for pricing remains favorable for investors because of formidable barriers to developing new housing inventory. For example, the region's three largest economies – Germany, France, and the UK – are experiencing significant declines in construction volume due to the ongoing increases in the cost of building (including debt capital). Affordability will increasingly become a greater challenge across the region without much stronger incentives to develop.

With other major property sectors facing headwinds, residential investment reached its highest share of total real estate investment on record in the region during 2023 despite the challenging capital markets environment. While the absolute volume of transactions remains somewhat depressed, the favorable outlook for the property sector's fundamentals should serve as a tailwind for investment over the next few years.

Retail

Across Europe, demand for high-quality retail space remains robust, especially in major markets. Domestic consumption remains relatively healthy, with inflation slowing faster than wage growth, helping to boost demand. But Europe also boasts 8 of the top 10 international tourist destinations (including Turkey). That provides an additional driver of retail sales and demand for high-quality space. Somewhat ironically, the lack of available quality space could lead to a slowdown in leasing volumes this year. But that simply means that the market should remain tight and continue to offer attractive market fundamentals.

Increasingly, investment prospects for the sector look brighter. While many investors continue to overlook the retail market, strong fundamentals coupled with improving capital markets could make retail a surprise outperformer over the medium term. Property selection will remain important, but increasingly, investment opportunities should avail themselves.

Life Sciences

The life sciences sector across Europe is caught up in a universal slowdown that says more about the particulars of the broader environment than the state of the life sciences market itself. With a slowing fervor for the sector in a post-pandemic world, coupled with a challenging market environment for venture capital funding, demand for space continued to decline during 2023. Despite this, construction volumes remain relatively robust, due to the aforementioned fervor for the sector during the pandemic. Even the stalwart markets in the region, such as those near major research universities such as Cambridge, are experiencing shifting market conditions. Yet, the medium-term outlook remains bright. The sector has clearly proven its worth over the last four years and the frozen funding environment should thaw during 2024 as broader capital markets ease. That should occur against a more balanced backdrop of supply and demand for space, which portends better returns ahead over the next few years.

Data Centers

Demand for data centers continues to increase while supply simply cannot keep pace. Ongoing demand for storing and computing large data sets is putting immense pressure on availability across the region. Moreover, the “Balkanization” of data, due to both geopolitical considerations as well as regional and national differences in the legal and regulatory frameworks for data storage and privacy, generates regional and local demand that cannot easily transit across borders. While the primary markets of London and Frankfurt continue to see strong demand, some users of data centers are turning toward less-crowded secondary and tertiary markets such as Amsterdam, Paris, Dublin, Madrid, and Berlin. And centers built just a few years ago already struggle to compete with the newest centers which offer greater storage capacity, much faster computational capabilities, and the most advanced liquid-cooling systems to keep the centers operating safely. The future looks incredibly bright for data centers with excess demand expected to keep pushing up rents and returns over the medium term.

Summary And Risks

Despite the numerous challenges of the last few years, the CRE market in Europe has endured. And the outlook is certainly brightening. But notable risks persist. The geopolitical environment remains fraught. Central banks could leave rates too high for too long. And technology is evolving faster than ever. Yet, the economy and CRE market should improve as year unfolds and 2024 should present opportunities for investment not readily available during the last two years.

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