BREXIT: IMPACT ON EUROPEAN REAL ESTATE

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Key points

Our central view is that the impact of "Brexit" on the European economy and property markets will be limited.

Brexit highlights that geopolitical risks are noticeable and can be badly mispriced by financial markets.

Given the rise of populist politics and anti-European Union (EU) sentiment, upcoming elections in major European states will be closely watched and may spark more volatility.

We see upside potential in continental European residential markets, student housing, and offices in smaller financial centers. The weaker euro may also boost some luxury retail markets.

In the longer term, prospects for some logistics markets could worsen due to the likelihood of protracted trade negotiations between the UK and the EU.

Monika Sujkowska*

Analyst, Real Estate Investment Strategy and Research, London

Monika joined Aviva Investors in June 2016. She is responsible for developing market views, forecasts and strategic advice with a primary focus on Europe. Prior to joining Aviva Investors, Monika was a Senior Analyst in the Investment Strategy team at Cushman and Wakefield. She holds an MA in Economics from University College London and a BA in International Relations from Warsaw University.

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European real estate prospects remain encouraging, despite heightened political risk and more uncertainty, says Monika Sujkowska.

The UK is now expected to enter a shallow economic recession by the end of 2016, though we believe it is unlikely to trigger a recession in the rest of the European Union (EU). Uncertainty around Brexit and its effect on financial markets and business investment may nevertheless shave 0.2% - 0.4% off overall Eurozone growth over the next 12 months. The impact of a slowdown would vary across the market, with Ireland and Benelux countries likely to take more of a hit than others.

Increased uncertainty to breed more volatility

The main change in our thinking on prospects for European real estate is a greater focus on potential geopolitical shocks. Populist parties in the Netherlands, Italy, and France may gain more parliamentary seats in upcoming elections by mid-2017. We nevertheless assume no further disintegration of the EU and maintain our forecast property returns for most markets in the region. Irish real estate would be an exception, due to the country's close trade and financial links with the UK. Benelux real estate is also expected to be affected, but to a lesser extent.

We believe uncertainty over the outcome of the UK-EU negotiations will breed further volatility, as will votes across Europe this year and next. We anticipate lower-for-longer interest rates and possibly an extension of the European Central Bank's asset-purchase program, both of which should be supportive for high-quality continental European real estate. Relative pricing for property is likely to improve further in "core" markets, especially Germany, Switzerland, and the Nordics where government bond yields may break fresh record lows in the coming weeks.

Activity levels to be more affected than asset values

On balance, we expect continental European transaction volumes to fall modestly in the second half of 2016. Many investors will delay acquisitions as they adjust their risk premiums following recent corrections in more liquid asset classes. Nevertheless, sentiment will be supported by favorable underlying fundamentals, with subdued development activity and steadily rising occupier demand resulting in shortages of space in a number of markets. We believe the outlook for rental growth is broadly positive. In addition, very accommodative monetary policy in the area may underpin property pricing, with yields expected to be unchanged in most parts of market and likely to compress for the best quality assets.

Mass exodus from London unlikely

There is much speculation about companies based in London relocating their staff to continental Europe. We believe this is premature and London may defend its position as a global financial hub due to its unique strengths, such as a low corporate tax rate, a diverse talent pool, and relatively low regulation. Companies may be more likely to favor continuity and maintain headquarters in London, although some functions such as euro-denominated trading, may be moved. There may be a modest uptick in demand for office space in smaller EU financial centers. This is unlikely to be focused on two or three cities and instead spread across more locations where city institutions operate. The UK's shocking decision to leave the EU is clearly a source of uncertainty. This will affect activity more than asset values, with the latter aided by a more entrenched economic recovery and even looser monetary policy. Top-quality assets in core markets are likely to prosper from the increasingly uncertain environment. While we maintain our forecasts of 5.6% average annual total returns for European real estate between 2016 and 2020, we assign a higher probability to future geopolitical risks, be it further EU disintegration, political impasse, or otherwise.

Key polling dates

- Autumn 2016: Hungarian referendum on rejecting EU mandatory refugee quotas
- October 2016: Italian constitutional referendum
- March 2017: Dutch general election
- April-May 2017: French presidential election
- June 2017: French parliamentary election
- September 2017: German parliamentary election