

# Inflation is good for European property

### Key Highlights

- Most Continental European property leases are inflation-linked.
- Inflation may pick up more quickly than economic growth over the next 12 months.
- Inflation could push up property income returns from late 2011.

## The benefits of inflation

In past editions of this publication we have noted that over the long-term in Continental European property, income returns have been the most important driver of overall investment performance<sup>1</sup>. In this edition we focus on the defensive index-linked characteristics of property income.

Figure 1 shows that since the inception of the Eurozone in 1999, property income returns have performed well compared to government bonds and equities, with the margin between them widening since the global recession of 2008-09. It also illustrates the relative stability of property income returns, which we believe has been particularly attractive for investors seeking defensive investment returns underpinned by stable yields.

Recognising the positive risk-adjusted contribution of property income returns within multi-asset portfolios over the longer term, we think it is timely to explore a key reason for this relative outperformance: the inflation-linked indexation provisions which exist in most Continental European property leases.

Most leases require rental payments to be indexed with reference to domestic Consumer Price Indices, often on an annual basis or subject to cumulative upward-only triggers<sup>2</sup>. For many countries, indexation rates over the past ten years have ranged between 1.5% and 2.0% per annum, with the highest growth in

southern Europe and France (refer to Figure 2).

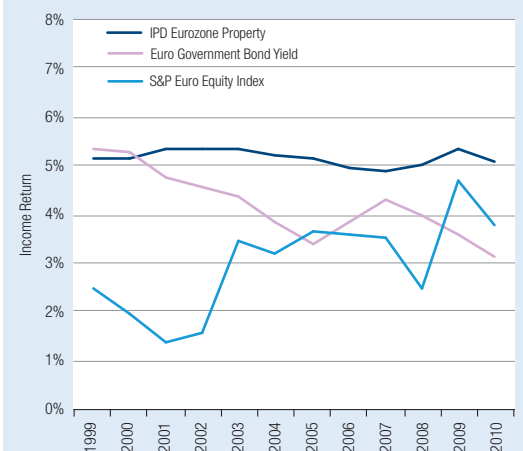
Over the next ten years inflation is forecast to rise in most Continental European countries, which we regard as being positive for property income growth. The main exception to this is southern Europe, where inflation is expected to decelerate and be lower than in Scandinavia and the Eurozone 'Core'.

Taking into account different lease structures and expected rates of inflation across Europe, we believe indexation will be a more positive contributor to total returns in markets such as France, Belgium, Netherlands and Scandinavia than in Austria, Germany, Switzerland and southern Europe.

Although the strength of the linkages between Eurozone economic growth and inflation is less clear since the ECB (European Central Bank) adopted its policy of targeting inflation, we believe that both will be important drivers of future property investment performance. However, predicting the direction of either remains extremely challenging.

Figure 1

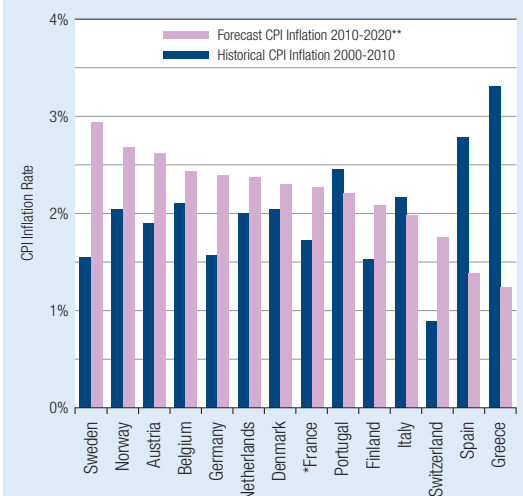
Property income returns have held up well in recent years, compared to bonds and equities



Source: Investment Property Databank, Datastream.  
\*Note: IPD data at 30 September 2010 (October property data estimated by Invista).

Figure 2

Inflation is forecast to rise in most countries, though southern Europe is an exception



Source: Economist Intelligence Unit.  
\*Note: Most commercial property leases in France are indexed with reference to the Cost of Construction Index (CCI), which is highly correlated with the broader French CPI, but exhibits greater volatility. Over the period 2000-2010 CCI averaged 3.4% pa compared to CPI at 1.7%. No forecasts are available for CCI.  
\*\*Forecasts are indicative only.

<sup>1</sup> See "European Market Perspective July 2010", Invista.

<sup>2</sup> For example, Belgian and French commercial property leases are typically nine years in duration with tenant break options after years 3 and 6, and provisions to index rents annually. In Austria and Germany, leases tend to be for five or ten years in duration with a tenant break option after year 5, and provision to index rents by a proportion of a stated cumulative increase in the reference index, for example 70% of a ten percentage point increase in the CPI.

## The ECB's inflation headache

The Eurozone's recovery from recession is proceeding at two different speeds (see Figure 3). Country performance has diverged markedly, broadly in favour of the Eurozone's 'Core' of Benelux, France and Germany, while growth has been negligible in countries on the periphery which continue to struggle with structural issues and debt.

This presents a monetary policy dilemma for the ECB, which is responsible for setting interest rates and controlling inflation in the Eurozone<sup>3</sup>. On one hand, there are calls for an immediate increase in interest rates to head off the risk of accelerating inflation in the medium-term. On the other hand, there are fears that deflation could set in without further monetary easing.

The problem for the ECB stems from the fact that inflation is subject to strong opposing forces: the deflationary after-effects of such a deep recession, and the inflationary impact of unprecedented stimulus measures to support the economy.

The ECB currently maintains its 'accommodative stance'<sup>4</sup> in relation to monetary policy, recognising the downside risks to inflation from another downturn in economic activity. Nevertheless, in its recent forecast it notes that upside risks from commodity price inflation have picked up since mid-2010, meaning that Eurozone inflation is likely to remain volatile in the short-term at least.

<sup>3</sup> European Central Bank Monetary Policy Strategy (<http://www.ecb.int/mopo/intro/html/index.en.html>) states an aim to "maintain inflation rates below, or close to, 2% over the medium-term."

<sup>4</sup> ECB Monthly Bulletin, September 2010.

## GDP and inflation are key to property performance

Taken at face value, the ECB's policy of "maintaining inflation rates below, or close to, 2% over the medium term" is supportive of future income performance from property investment in Europe. However, as Figure 4 shows GDP growth has also been a key driver of property investment performance, and it is therefore a concern that the consensus view is that growth will remain below-trend in the short-term.

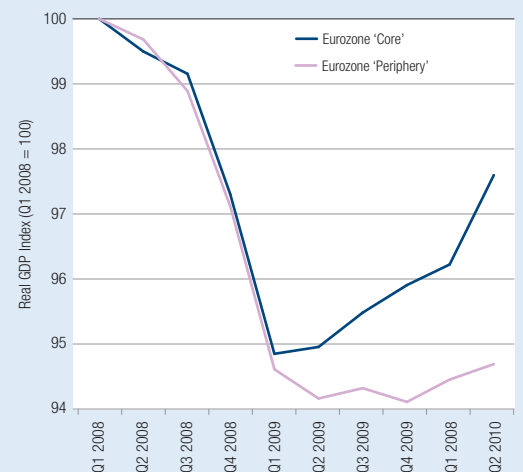
Taking into account the many variables that influence GDP growth and inflation, we believe the following scenarios have the highest probability of materialising:

- **Scenario A (50% probability): below-trend GDP growth, inflation picks up.**  
Economic activity remains weak and patchy for at least 12 months before gradually recovering. Inflation is volatile, but picks up from low levels in H1 2011 reflecting higher commodity prices and possible short-term Euro depreciation. Property leasing markets would remain challenging in 2011, though income returns could be boosted by inflation.
- **Scenario B (25% probability): short-term recession, falling inflation.**  
GDP growth is flat or negative in the short-term causing the Euro to depreciate. Core inflation falls, offsetting imported inflation, suppressing and potentially delaying the economic recovery. This outlook would exacerbate already weak leasing markets while low inflation would hamper income return growth.
- **Scenario C (15% probability): return to trend-level GDP growth and inflation.**  
The 'best-case' scenario which places a floor under the rental market in 2011, is one in which GDP growth and inflation continue to recover to trend levels, boosting investor confidence and allowing 'normal' liquidity to return to the property market.

**On balance, we believe the most likely outcome is that economic growth will remain weak until after 2011, presenting short-term challenges to leasing markets and favouring an active investment management philosophy. Property investment performance is therefore expected to be underpinned by income returns, which could benefit from a short-term build-up of inflation, before economic growth returns after 2011 to support the underlying leasing markets.**

Figure 3

Eurozone's 'two-speed' recovery highlights the ECB's difficulty in setting monetary policy

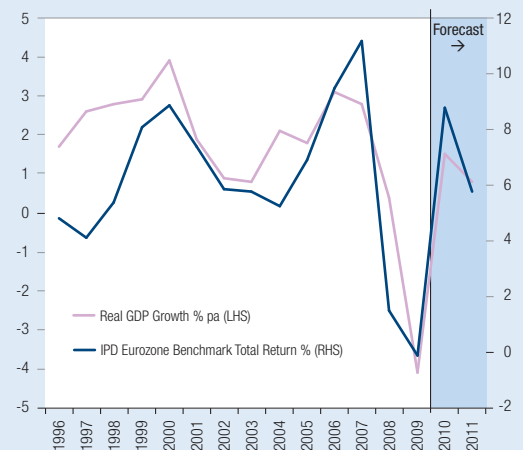


Source: Eurostat

Note: Eurozone Core = Austria, Belgium, France, Germany, Netherlands. Eurozone Periphery = Cyprus, Finland, Greece, Ireland, Italy, Malta, Portugal, Slovakia, Slovenia, Spain.

Figure 4

Investment performance in 2011 likely to be supported by income return



Source: Economist Intelligence Unit, IPD, Invista (forecast property performance as at mid-2010).

Note: Forecasts are indicative only.

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Published October 2010. Ref: inv-712.

  
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