

A Turning Point for European Interest Rates

This analysis includes a breakdown of how prime Dublin yields across sectors compare to other European cities as we reach this inflection point.



Introduction

The European Central Bank (ECB) has today implemented its **first interest rate cut of a new cycle**. The 25-basis point decrease has been well-telegraphed and moves the main refinancing rate (the main lending rate that banks can borrow from the ECB over the medium term) to 4.25%, and the deposit rate (the interest rate on overnight deposits placed by banks with the ECB) to 3.75%.

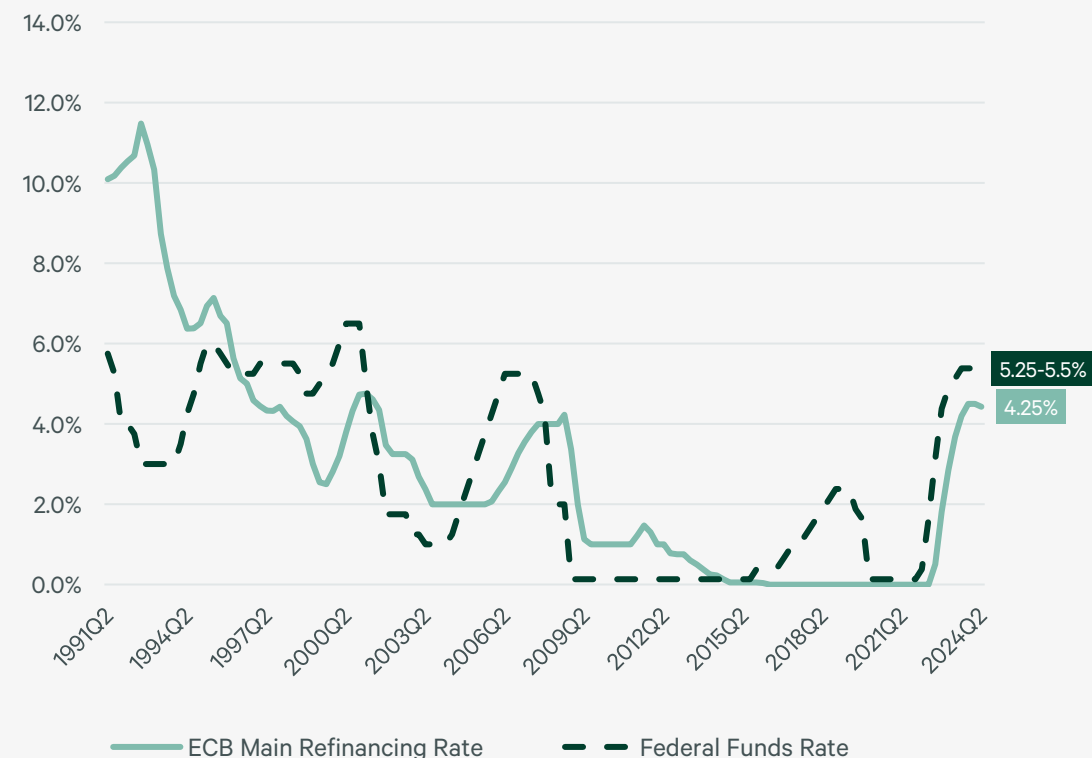
The ECB's move to decrease interest rates ahead of the US Federal Reserve is a **break away from the norms of recent history**. Since the late 1990's, when lowering rates, ECB interest rate policy direction has typically followed the Federal Reserve. The next FOMC meeting is being held over June 11th and 12th, and the Federal Reserve is likely to keep its key interest rate steady at 5.25%-5.50%.

The ECB's decision has come despite the latest flash estimate for Euro area inflation showing that the **12-month rate actually increased** from +2.4% to +2.6% in May. Wage growth, which has been prompted by general price inflation, continued to rise during the month. However, the ECB feel that the bigger picture for Euro area pricing is one of disinflation, and the target rate of +2% remains in range, albeit it might take slightly longer to reach than previously anticipated - potentially into early 2025.

While this June rate cut has been widely anticipated by markets and largely priced into reference rates over recent weeks, it is a positive **first small step** on the path back to an interest rate environment that is more supportive of economic growth and commercial real estate markets in Europe.

FIGURE 1

Main Interest Rates: ECB & Federal Reserve



Source: Oxford Economics

The Neutral Rate

At the beginning of the year, our forecasts outlined that 50- to 75-basis points of ECB interest rate cuts were likely in 2024, and this continues to be a possibility – there are four further monetary policy meetings to come this calendar year. However, the bigger and more important question for market participants is, **at what point do interest rates stabilise?**

The so called ‘neutral rate’ is the policy rate that keeps inflation constant and supports an economy at full employment and maximum output. This rate is what real estate investors and lenders should focus on, as it will **set the tone for market activity** in the early years of the next cycle.

The ECB carries out a quarterly survey that can help give some guidance as to when and at what level interest rates will stabilise. The Q2 2024 Survey of Professional Forecasters (SPF) surveyed 61 parties. The results of the survey show that professional forecasters expect the **main refinancing rate to decline to 3.0% in 2025 and to 2.5% in 2026.**

When compared to long-term historical averages, it shows that a rate between 2.5%-3.0% would be marginally lower than the average rate over the period 1990-2022H1 (3.2%) and indeed lower than both the period 1990-1999 (7%) and 2000-2008 (3.1%).

The ultra-low interest rate environment of 2010-2022H1 is a period that should be considered a relative anomaly in the history of interest rate cycles, and a return to these levels is not expected. However, 2025 and 2026 should see conditions that are **generally more supportive of economic growth and indeed commercial real estate markets.**

FIGURE 2

ECB Main Refinancing Rate: Forecasts* vs. Long-Term Historical Averages



Source: Oxford Economics/ECB;

*Forecasts are the results of the Q2 2024 ECB Survey of Professional Forecasters

Implications for Yields

Commercial real estate investment yields and valuations are influenced by multiple factors. These include **cyclical, fundamental and structural factors**, with the **specification** of an individual building also a primary contributing factor.

Interest rates play a **cyclical** role in influencing yields across all sectors. This has never been clearer than over the last two years, as swift changes in interest rates led to yield expansion across real estate.

Conversely this oncoming cycle of interest rate declines should have a stabilising effect on European real estate yields and valuations, asset and sector dependent. As the cost of capital gradually lowers, it should also lead to more transactional activity, while a decrease in the yield on alternative risk-free investments should prompt somewhat of a rebound in capital allocations to the real estate sector.

Interest rates are only one cyclical factor. Ultimately the **fundamentals** of a given market and specific sector are just as important when analysing potential valuation changes, i.e. the demand, supply and rental income characteristics associated with the individual building.

Structural factors are now, more than ever, a huge consideration when analysing potential valuation changes, i.e. are there underlying structural changes to how society uses a given class of real estate, and how can this impact value regardless of any changes in interest rates. Lastly, the **specification** of any building will clearly be a driving factor in influencing its value.

Considering all of these factors, as interest rates start to decline, **what is the outlook for prime Dublin yields**, and where do these yields sit on a comparative basis versus other European cities?

FIGURE 3

The Risk-Free Rate: Irish 10 Year Government Bond Yield



Source: Trading Economics

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Office Yields

Prime Dublin office yields have expanded by 100-basis points (bps) since Q2 2022, now standing at 5.0%. There has been very few prime Dublin office transactions over the last two years, but the sale price of a recent transaction, the sale of 40 Molesworth Street in Dublin 2, supports holding prime Dublin office yields at 5%.

At this level, despite structural and fundamental challenges in the secondary Dublin office market, prime, sustainable buildings in the core city centre offer both **value and a fair risk premium** when compared to some other European cities.

London's West End yields remain tighter than European counterparts at 4.0%. In many instances offices in this location are targeted by equity-driven, high-net-worth investors, and hence are not always reflective of the current cost of capital. The fundamentals of the West End market are also much healthier than many markets across Europe. The office vacancy rate in the district is still below 5%.

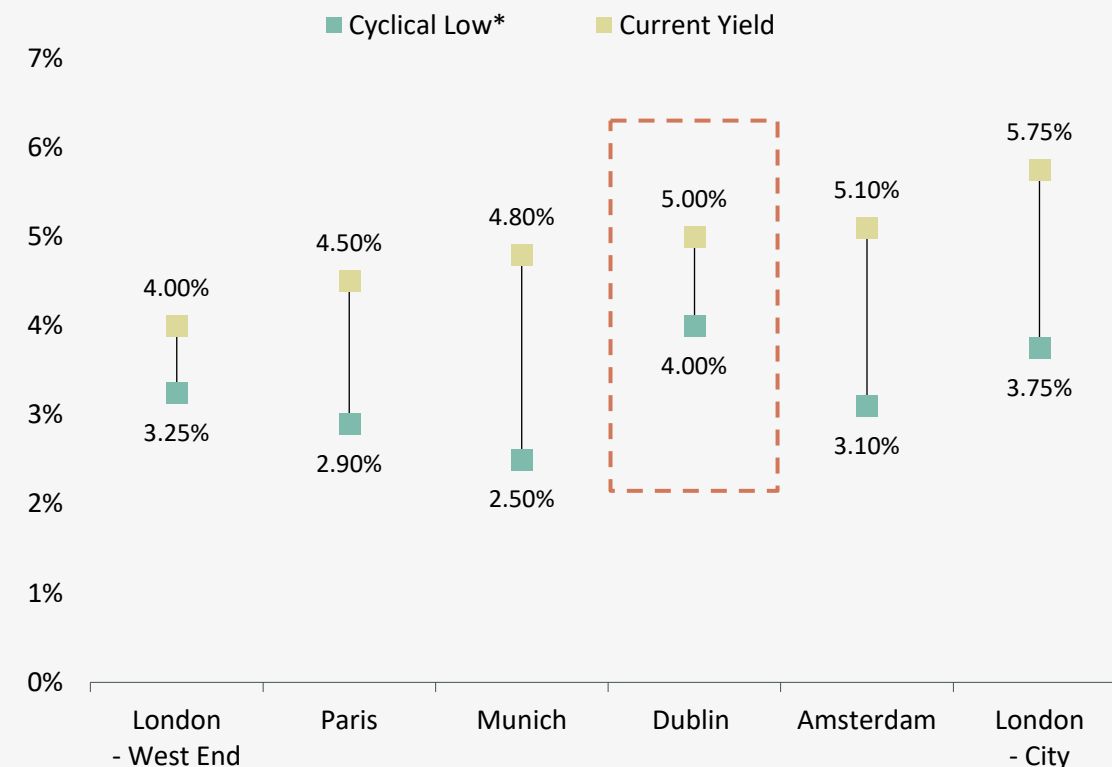
London City office valuations are more reflective of the current financing environment, with yields having expanded by 200-bps over the last two years to 5.75%. The occupational fundamentals of the market have also weakened, which has also contributed to these valuation declines. Many European investors are now seeing value in the London City market, on a selective basis.

Outside the UK&I, other core European cities including **Paris and Munich** have seen large prime yield expansion but are still offering a comparatively lower return than Dublin.

With interest rates now starting to decline, **prime office values are stabilising** across these jurisdictions, while secondary office valuations face continued challenges.

FIGURE 4

Prime Office Yields: Dublin vs. European Cities



Source: CBRE Research; *the lowest yield reached in the period prior to ECB interest rate increases in 2022

Industrial & Logistics Yields

Prime Dublin industrial & logistics (I&L) yields have been the most resilient across the main real estate sectors in Ireland, i.e. when compared to offices, high street retail, shopping centres, private rental apartments and hotels. Prime yields in the sector have expanded by 75-bps to 4.75% since Q2 2022.

Structural changes in how consumers shop and an increasing preferences among businesses to de-risk supply chains by having storage facilities closer to customers, alongside an undersupply of modern facilities in the Dublin market, have ensured strong rental growth and helped to support prime asset values. This turning point in the interest rate cycle adds further support to holding prime Dublin I&L yields at this level.

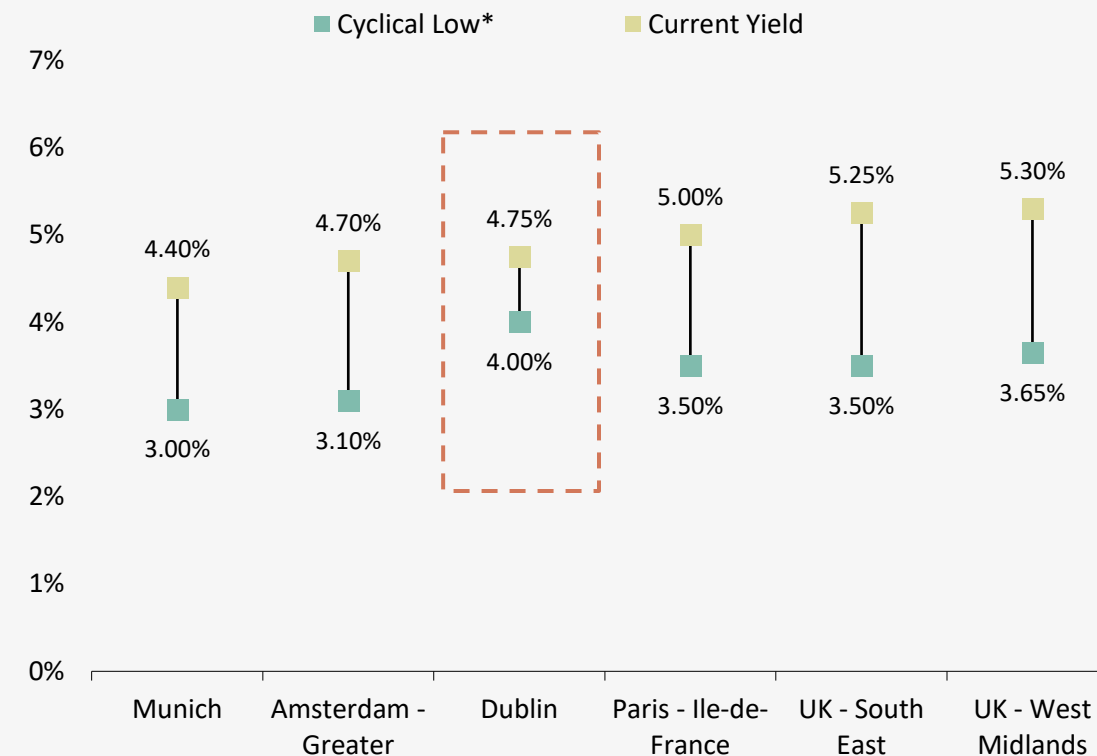
Yields for I&L buildings in the UK's South-East and West Midlands markets have experienced some of the most pronounced yield expansion of the countries covered in this analysis. Several factors have contributed to this, including the fact that yields went to cyclically low levels of 3.5% and 3.65%, respectively. Hence when interest rates and risk-free rates increased in H2 2022 and 2023, it left these lower yields more susceptible to expansion. Fundamentally, the occupational markets in both jurisdictions remain healthy, with vacancy rates of just 4.5% and 4.8%, respectively.

Greater Amsterdam (Schiphol) has also experienced significant yield expansion (+160-bps) since the onset of interest rate increases. In a market where prime yields reached 3.10% in June of 2022, they have now risen to 4.70%.

For those markets that have experienced significant yield expansion, this turning point for interest rates should help prime yields to stabilise.

FIGURE 5

Prime Industrial & Logistics Yields: Dublin vs. European Cities



Source: CBRE Research; *the lowest yield reached in the period prior to ECB interest rate increases in 2022

Residential (PRS) Yields

European residential markets have more complexity than other sectors. A structural undersupply of housing exists across many major European cities, including cities in this analysis such as Amsterdam, Barcelona, Berlin, London and Dublin. In many of these markets regulation adds further complexity, with rent caps one specific mechanism that impacts returns and valuations for private rental sector apartments (PRS). This makes direct comparable analysis of yields across countries different to other sectors

In an Irish context, a huge challenge remains with landlords and their inability to rebase rents to market rent for a two-year period when a tenancy ends. **Prime yields have expanded by 115-bps for prime, stabilised, Dublin PRS developments since H1 2022.** Such regulations on landlords, combined with higher financing costs and yield expansion, have challenged the viability of investment into the sector.

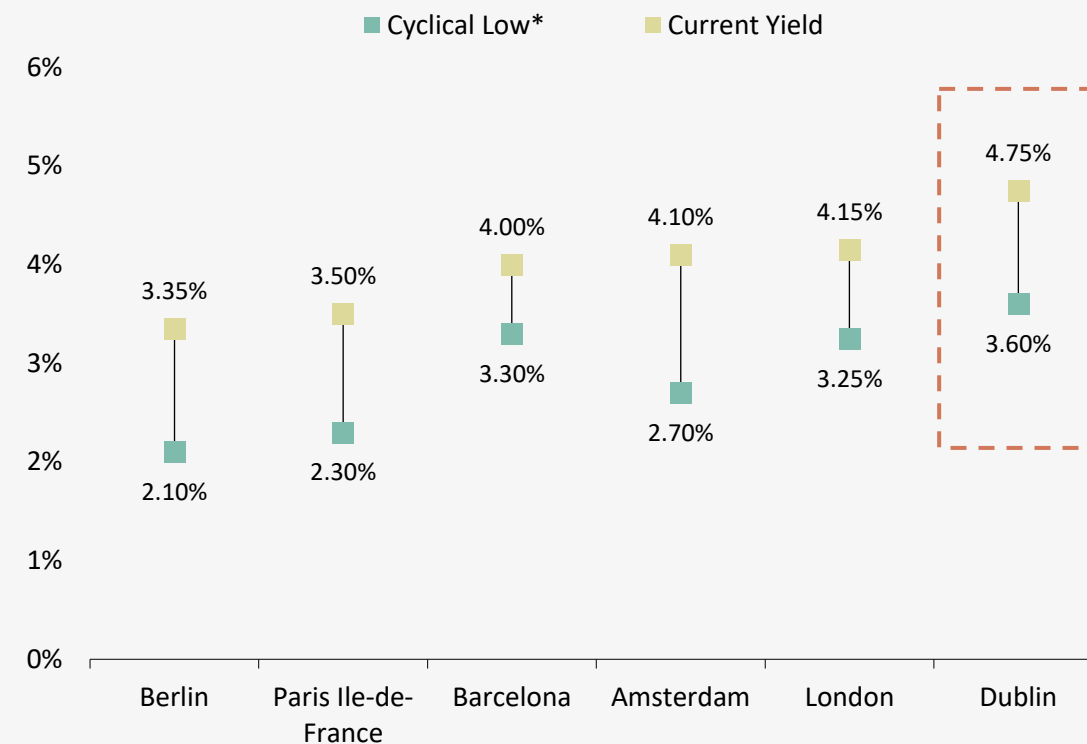
In **Berlin**, a 'rent freeze' for the city's housing market was initially passed in 2020 but was eventually defeated in a constitutional court. The market now has alternative regulation in place that limits rent increases over a 3-year period. Since 2022, prime yields in Berlin have expanded by over 100-bps. From as low as 2.1%, they are now 3.35%.

Rent controls are now also in place in **Amsterdam and Barcelona** where yields have expanded by 140-bps and 70-bps from cyclical lows, respectively.

Interestingly, **prime, stabilised Dublin private rental apartments are offering a higher initial return than these other core cities.** Given that the fundamentals of the rental market in Dublin remain exceptionally strong, this turning point in the interest rate cycle could be the first small step towards a rebound in investment into the sector in Ireland.

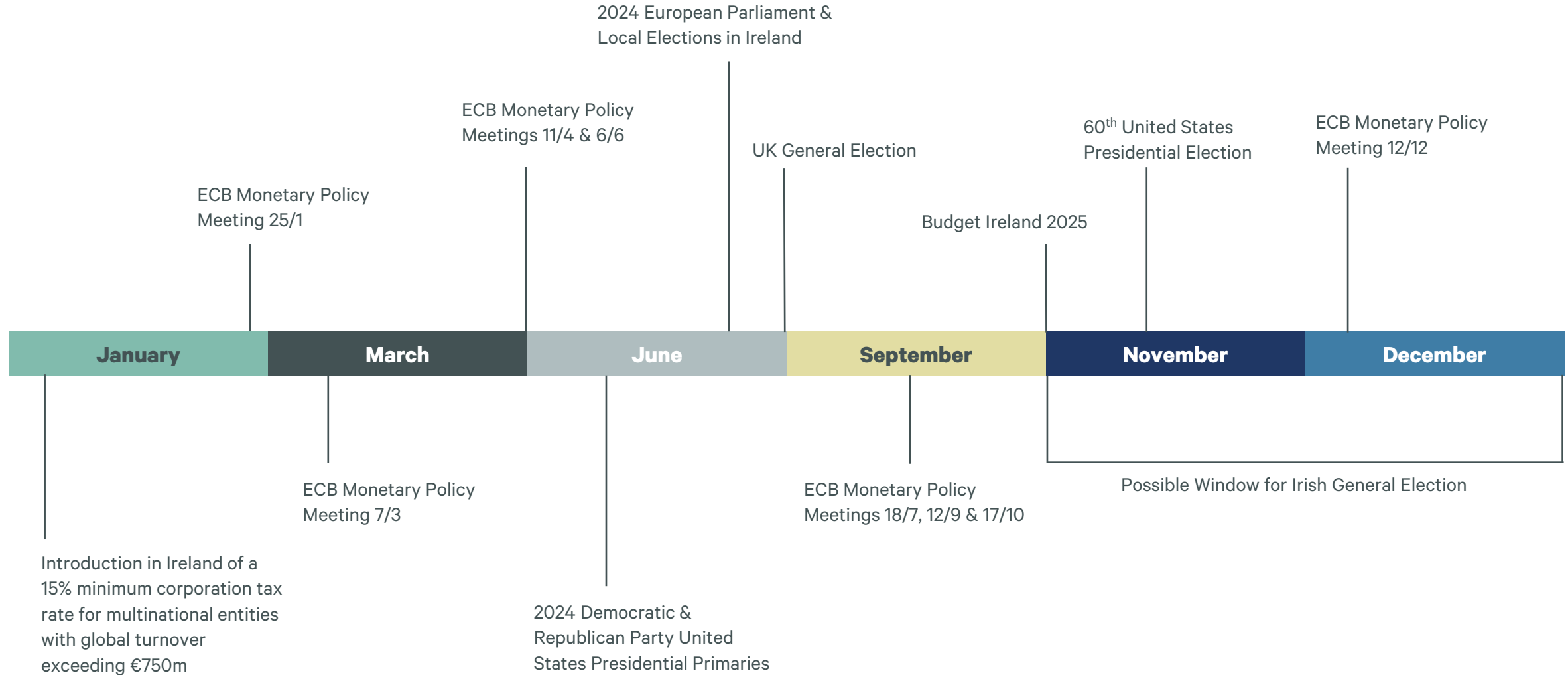
FIGURE 6

Prime Residential (PRS) Yields: Dublin vs. European Cities



Source: CBRE Research; *the lowest yield reached in the period prior to ECB interest rate increases in 2022

Economic & Political Calendar 2024



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