



DEBT ADVISORY MARKET INSIGHTS

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The (current) status of the financing markets

The reason for waiting until the end of the summer holidays to publish an up-to-date market commentary is to provide property investors after a quieter time in the calendar with useful information as guidance for their year-end activities. However, events and capital market data are currently coming in so thick and fast that it is difficult to chart an adequate half-year point.

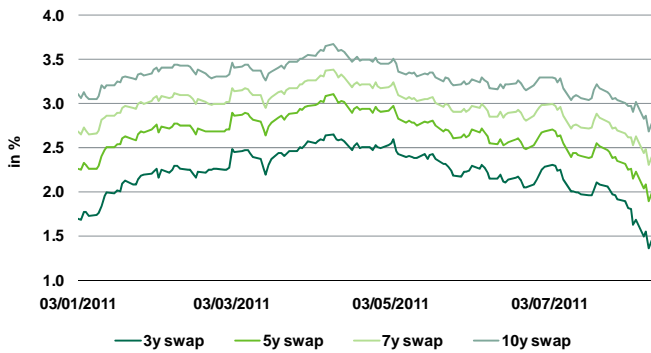
It is best we begin with our perception of the current status of the property lending market. European foreign banks appear to have anchored their interest in the German property lending market and are establishing a niche in more corporate-orientated loans with slightly higher lending rates and property packages which contain a value-added component. In contrast, German mortgage lending banks are holding fast to their moderately conservative business strategy but, for the first time since the onset of the financial crisis, are individually beginning to internalize the regulatory effects of the 'risk weighted assets'. This means that many banks, in their pursuit of safety, are now prepared to provide above-average credit volumes for loans which are of a particularly low risk and therefore potentially suitable for use as covered bonds collateral.

In the second quarter, we have seen loan commitments and offers from several institutes which lie above the €100m mark. This shows that the financing market is now willing to provide loans for high volume investment transactions of properties with stable cashflows and purchasers with good equity capital backing.

Unfortunately we are unable as yet to forecast the effects that the current market uncertainty will have on financing behaviour. The good news is that interest rates have fallen significantly since the beginning of April. Ten-year interest rate swaps are now 80 basis points lower, settling at around 2.75%. The same applies to the main refinancing sources for property financiers: the ten-year mortgage bond now lies at almost 3.1%, which is a very inexpensive source for the refinancing of property loans in the real estate lending field, of approx. 50% of the market value.

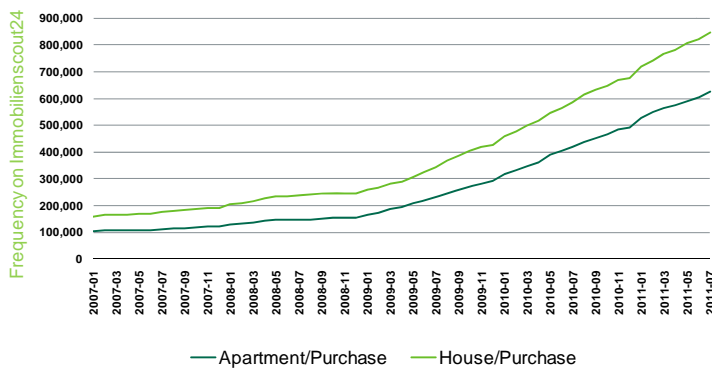
The not-so-good news is that current credit default swaps (CDS), i.e. the risk premium for senior unsecured bank bonds, are being traded at record-breaking levels, despite direct default risks in the banking market appearing to be lower today than two to three years ago. In our opinion, the increased risk premium is likely to be an indirect consequence of the turmoil in the prices of European government bonds and the extreme fall in share prices of the respective banks. It is therefore possible that some banks will resume a more cautious approach to their lending and that there will be a more significant widening of lending margins between low lending rates for loans which are suitable for use as covered bonds collateral and subordinated risks. This, in conjunction with a fall in the basic interest rates since the beginning of the year, should mean that lending interest rates will remain low despite the rising risk margins (fig. 1).

Figure 1 – Interest rates since the beginning of the year



Source: Bloomberg

Figure 2 – Property searches via Internet



Source: ImmobilienScout 24

Figure 3 – Private investors – internet searches



Source: Google Trends

Is there proof of a run on tangible assets?

Whilst the chaos in the stock markets is increasingly pushing risk-averse private investors towards securities, there are clear signs of a parallel run on tangible assets; as it was on the day of the major share losses (8 August), when the term 'gold price' became the sixth most searched term on the US Google page and the only financial sector term in the Top 20. In Germany, the term 'Goldpreis' [gold price] is always presumed to be a secure alternative when there is uncertainty in security markets, such as after the insolvency of Lehman Brothers and in the current uncertainties surrounding the refinancing of Greece and other European countries. This effect is not limited to gold and other commodities, but has also been recently observed in housing.

The 'market share' of German on-line property platforms, such as ImmobilienScout, Immonet and Immowelt, has grown by 30% to 40% according to Alexa.com, which suggests that the interest of Germany's population is rapidly increasing. Concrete figures from ImmobilienScout suggest that enquiries for apartments have increased six-fold and that there has been a similar rise in the number of enquiries for houses. Because the interest in purchasing property has risen steadily and is not necessarily proof of an intention to purchase, it is revealing to compare searches for the term 'Goldpreis' [gold price] with 'Immobilienkredit' [property loans], since private investors are only dealing with the financing of a property if they are definitely looking to buy.

As there have been similar patterns in curve progressions following the financial crash, the need for information on property financing arises much later, but has remained stable at a high level since the beginning of this year. This may suggest a heating up of the housing market.

Inflation and monetary policies

Considering this run on tangible assets and the frequent and intensive discussion on the threat of inflation, we would again like to make reference to some elementary counter-arguments:

- Derivative markets are trading inflation hedge in Germany at an average of 2% p.a. for the next ten years;
- Growth in the European money supply is currently very low at around 2% p.a., compared to the around 8.5% in the ten years before the financial crisis;
- Central banks' money supply makes up only around a fifth of the broad monetary aggregate, money supply M3. At the same time, all banks lack sufficient equity capital to be able to expand their businesses and/or to increase the money creation of the commercial banks;
- The current low interest policies are bringing about an undesired form of inflation.

Continued: Inflation und monetary policies

Current inflation is not being driven by the classic wage-price spiral, but mainly by a bubble of commodity prices. Commodity prices have once again risen strongly because the money market interest rates are very low, and below the level of inflation, and this has made it possible for speculators to borrow money almost free-of-charge to speculate on the price increases of commodities or the retention of the current upward trend.

However, this form of commodity price-induced upward inflation cannot be the desired strategic monetary policies of governments and central banks, as has been partly suggested: a general uplift in the price level, which will deflate nominal state debts or make them more affordable. On the other hand, a strong rise in commodity costs reduces the otherwise available income of private households and companies and therefore also the ability of the taxpayer to pay. Over the long-term, this also impacts on the solvency of the states. This downgrading also affects interest rates which the states will have to pay on their new loans over the medium to long term.

An attempt at an outlook

In view of the current, major volatility of the markets, the lack of European vision and monetary policies which seem to follow events, it is difficult to make clear forecasts on the further development of the market. Taking all factors into consideration, we believe it most likely that the property financing market will remain stable, interest rates will continue to lie below property yields and that we will see a quieter financial market environment over the next twelve months.

Below, we have summarised some arguments on which our assumptions are based:

- The mortgage bond remains a defensive and highly liquid security, which is closely aligned in its pricing to government bonds and therefore facilitates property financing at very favourable interest rates. Basic interest rates, which have fallen in Germany during the period of crisis, will largely offset the increasing margin requirements of banks;
- German and international banks are currently in a much better condition than they were at the peak of the crisis in 2008. Many banks have substantially improved their equity capital reserves and reduced their risks in terms of corporate financing. The private economy has a sufficient volume of liquidity and therefore a similar credit crunch is no longer to be feared. The current hedging costs of bank loans appear irrational and exaggerated;
- Euro crisis: over the medium-term the government should recognise that the fundamental problem of the current crisis is that the core structure of Europe is incomplete. The European economic and political union will ultimately have to be followed by a by a fiscal centralization although there may be different ways to achieve that and thereby complete the European project. In order to address German concerns and avoid a dramatic transfer of wealth from countries with relatively balanced households to countries with aggressive deficit spending, the European stability fund (EFSF) with its differentiated allocation of interest rates may serve as a blue print;
- Monetary policies: in addition to an appropriate interest rate policy, which will hold the balance between the stimulation of growth and the inexpensive refinancing of financial markets on one hand and a curb on price bubbles on the other, there is another as yet rarely discussed option of the central banks, that of the strategic revaluation of gold reserves or their disposal.

This would achieve several desired monetary political goals at the same time:

1. The discussion on returning the currency system to the gold standard would finally end and confidence would be reinforced in our paper money;
2. Profits realised from the gold reserves would offset the impending losses of central banks from diverse bond acquisitions since 2008;

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3. The sale of gold would absorb liquidity from the market, which is created by the current sustained acquisition of bonds;
4. The cumulative surplus in the supply of money and lack of perspective of a return to the gold standard would reverse the price trend in the market and put pressure on loan-based commodity speculators to dispose of further commodity investments to service their debts. This would give rise to the hope that the speculative element would be released from the commodity bubble and that prices would be orientated more towards actual demand for productive and consumption-based purposes and less towards stockpiling as a potential reserve currency or asset class.

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