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Finding Opportunity Amidst Uncertainty – European Real Estate Outlook

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Finding Opportunity Amidst Uncertainty

European Real Estate Outlook, April 2025

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Key Takeaways

- The world today is characterised by volatility. The U.S. administrations imposition of global **tariffs** poses clear inflationary and recessionary risk. At the same time, we are seeing decisive action by European governments to support growth through new **fiscal measures**.
- Despite heightened geopolitical and economic uncertainty, **the real estate market today is stronger than it has been in the past three years**. Easing inflation and looser monetary policy are lifting capital markets and sentiment.
- **To protect against volatility**, investors need to build a greater degree of protection into their real estate portfolios. We believe this can be achieved by alignment with the megaforces, creating exit optionality, and investment into high conviction markets / sectors.

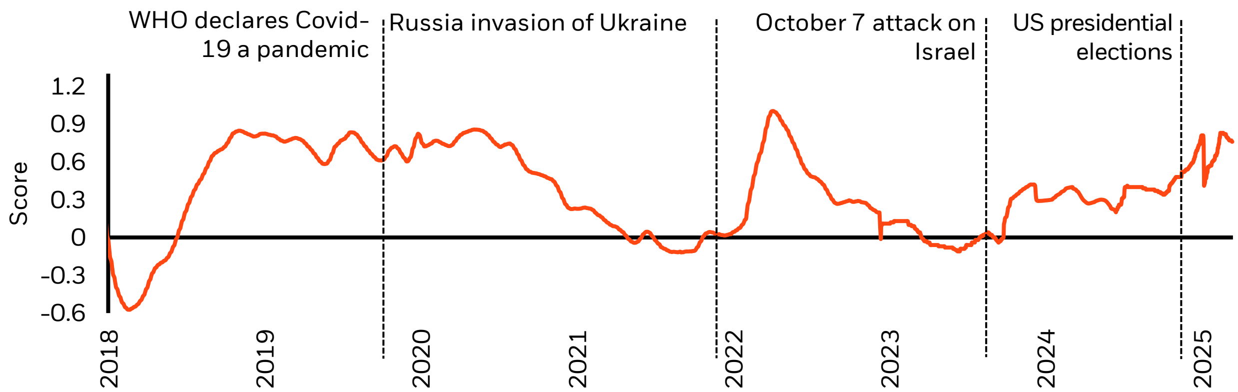
The European real estate market began 2025 with a renewed sense of optimism. Easing inflation and falling interest rates fostered a more attractive backdrop for market entry. However, we have subsequently experienced a fundamental shift in macroeconomic and foreign policy, which is driving a greater level of market uncertainty. Whilst the cyclical recovery has undoubtedly slowed in the short term, focusing on the enduring drivers of performance, or, mega forces, in our view remains a winning strategy.

The BlackRock geopolitical risk dashboard identifies key geopolitical risks and analyzes their potential market impact. According to the index, the world we are in today remains characterised by higher volatility (Figure 1).

Uncertainty arising from the U.S. administration's global tariffs has impacted today's delicate macroeconomic ecosystem. A 10% minimum tariff on imports from all countries is set to take effect from July. The European Union faces even steeper penalties, with tariffs rising to 20%, while the UK is set to be hit with a 10% levy. A key concern today is that real estate is sensitive to economic downturns, and elevated inflation combined with stagnant growth due to tariffs will push Europe closer to recession.

Whilst we recognize the uncertainty posed by these new tariffs, the transmission mechanism to economic growth and commercial real estate, remains uncertain.

Figure 1: BII Geopolitical Risk Indicator



Source: BII The BlackRock Geopolitical Risk Indicator (BGRI) tracks the relative frequency of brokerage reports (via Refinitiv) and financial news stories (Dow Jones News) associated with specific geopolitical risks. The score is adjusted for whether the sentiment in the text of articles is positive or negative and then assign a score. This score reflects the level of market attention to each risk versus a five-year history, as at 03 April 2025.

Over recent years, concerns around growth in the German economy have clouded the long-term European outlook, as a structural slowing of manufacturing combined with a weakening labour force deliver weak relative growth prospects. In the face of a new reality whereby international tariffs may weaken growth further, we have seen a decisive fiscal response from the German government. A €500bn Infrastructure Investment fund has been established to modernize infrastructure, 20% of which being allocated to climate and economic transformation initiatives. They have also amended the constitution to exempt defence expenditures exceeding 1% of GDP from the debt brake. This is hugely significant.

These fiscal measures represent a major shift, as the government aims to revitalize the economy, addressing both domestic and international challenges. The announcement went some way to mitigate growth concerns, and was welcomed by the markets, which viewed this more through a growth than an inflation lens.

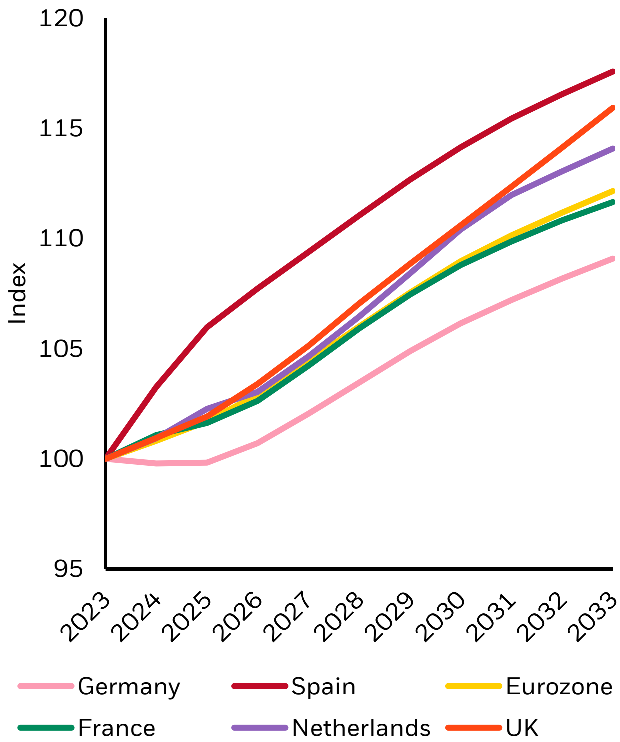
The changing Transatlantic security relationship has spurred material changes to defense spending in many European countries. This should be a catalyst for growth over the medium term, across a range of industries from manufacturing to warehousing and logistics. The UK has committed to increase spending from 2.3% to 2.5% of GDP[1], and France aims to increase its defence spending from 2.1% to 3-3.5% of GDP[2] . Higher defense spending is stimulative to economic growth, creating jobs, and promoting innovation, whilst also having spillover effects to other sectors, such as infrastructure and cybersecurity. In our opinion this should strengthen European economic activity.

At the time of writing, the EU is expected to see 1.3% GDP growth this year according to Oxford Economics, before picking up gradually to 1.6% by 2028[3] . This demonstrates that although uncertainty has increased in the global economy, and we remain cognisant of the downside risks, European economies do remain on the path of recovery, albeit slower than previously forecast (Figure 2), .

A key downside risk we are focused on today is that tariffs and fiscal support reignite inflation and increase the risk of recession. The tariffs on Europe will increase costs for manufacturers, making goods less competitive abroad and raising prices.

Additionally, retaliatory tariffs will cause the costs of imported goods to rise, which would increase overall prices. A consequence of higher inflation is that central banks are unable to cut rates as quickly as they previously anticipated. Our thesis remains that rates will remain higher for longer in this new cycle, and over the course of the last year, we have seen markets play catch up with this narrative.

Figure 2: GDP Growth Index



Source: Oxford Economics Forecasting, Index Base 100 = 2023 forecasts last updated 27 March, as at 31 March 2025.

Note: 1. Commons Library Parliament, UK, as at 1st April 2025; 2. Politico, as at 1st April 2025; 3. Oxford Economics Forecasting, as at 31 March 2025.

Cyclical opportunity still exists

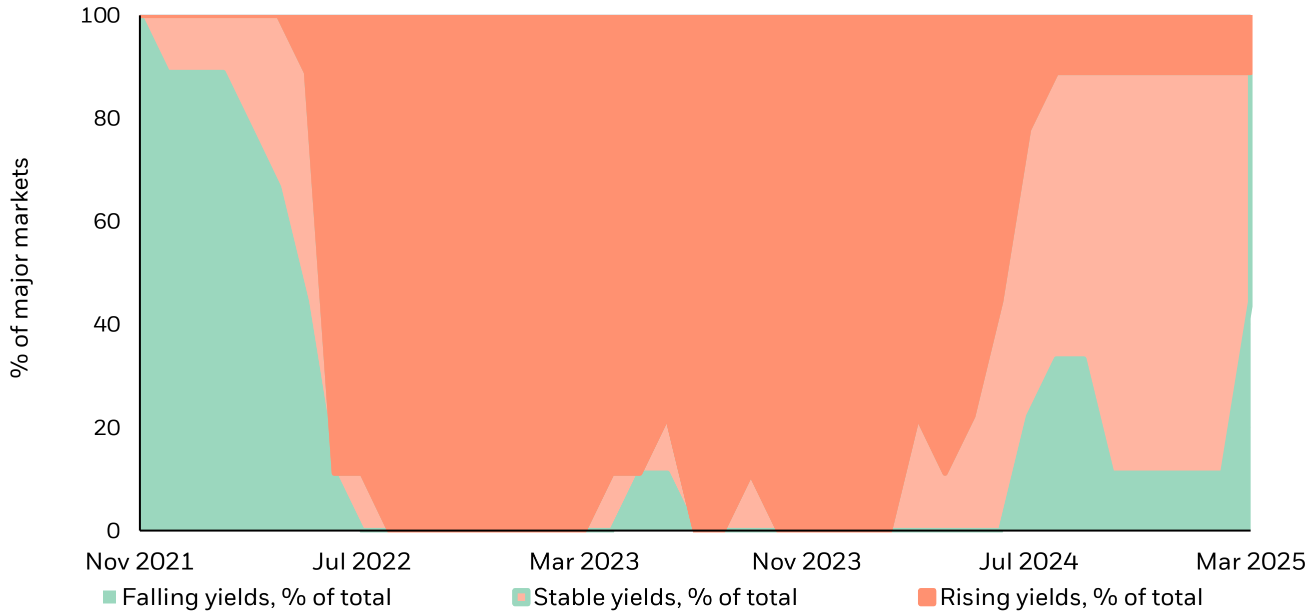
Even though the world today is more volatile, conditions for real estate investment have improved. We have seen correction of almost 20% in Eurozone, and 25% in the UK, meaning that although prices are stabilising today, there is still an attractive cyclical entry point to the real estate market[4]. Investors are still able to capitalise on distress and will be able to ride the cyclical upturn as markets correct.

Unlike in previous downturns, we know rates will likely remain higher than in the post GFC cycle, meaning investors cannot rely on yield compression alone to drive returns. Rental growth will be key, hence focusing on what occupiers want and alignment with megaforces remains important.

Following a period of falling valuations, there is growing confidence that the bottom of the real estate market has been reached. Capital is returning to the market, with transaction volumes picking up by 13% in 2024 versus 2023[5]. As highlighted in Figure 3, pricing has started to stabilise. This has meant buyer and seller expectations have moved closer together enabling liquidity to improve.

The more volatile and less predictable world order today means investors need to focus on building resilience into their portfolios, whilst positioning for optimum capital value uptick. This can be achieved through ensuring strong tenant covenants, investing into markets and sectors that benefit from structural tailwinds, focusing on exit optionality, and implementing asset management initiatives that create value from the onset of acquisition.

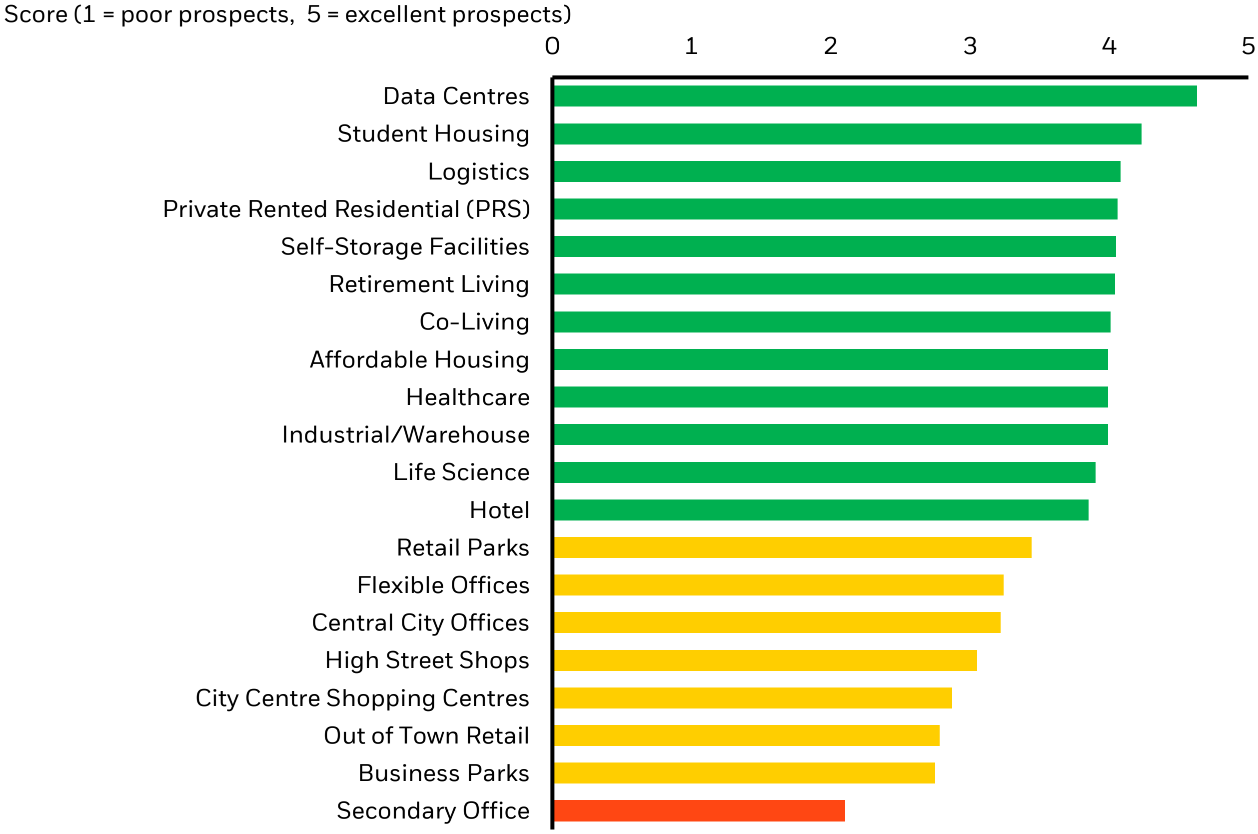
Figure 3: European Real Estate Pricing – Yield Movement



Source: CBRE Monthly Yields, Key Markets Include Denmark, Germany, the United Kingdom, Spain, France, the Netherlands, Italy, Finland, and Sweden covering Office, Industrial, Retail and Residential, as at 31 March 2025.

Note: 4. MSCI Capital Value Decline; 5. Source: RCA, European Transaction Volumes (Office, Industrial, Retail and Residential), as at 31 March 2025.

Figure 4: Investor Intentions (Prospects Ranking)



Source: PWC Emerging Trends in Europe view on Prospective European Real Estate, Respondents scored sectors prospects on a scale of 1=very poor to 5=excellent, and the scores for each sector are averages, as at 31 March 2025.

Where to play?

Investors need to tactically allocate and rebalance towards those sectors that will support changing societal demands from the built environment. We favour looking at the investment landscape through the lens of megaforces alignment. These are the drivers of long-term performance that are impacting pricing today. These structural shifts are digitalisation, positioning against ongoing geopolitical uncertainty, the energy transition and demographic shifts. However, today, there should be more emphasis than ever on this strategic positioning, as it will be critical for building a resilient and liquid portfolio in the face of uncertainty.

We believe the more traditional sectors of the real estate market should continue to be the foundation of portfolio allocations. Offices, retail, logistics, and residential will always play a role in society. However, in some cases, that role is changing. As investors we therefore must be agile in our approach.

For example, following the pandemic, utilisation of office spaces has shifted. Although offices remain important as a hub for collaboration, the pandemic has proved they are not always essential. This has created a polarisation in demand, where offices within mixed-use developments, located in dynamic and vibrant city centers, will likely outperform. Uncertainty remains around the structural oversupply of stock, especially in secondary locations where stock requires significant capital injections to meet sustainability standards. However, this challenge also creates an opportunity, where more obsolete office assets are being repurposed for alternative uses, with growing examples of successful conversions into residential and hospitality.

Megaforces are reshaping demand and reinforcing the need for traditional real estate sectors, namely logistics. Digitalization, particularly e-commerce growth, has elevated logistics demand, this will behave as a long-term tailwind.

Global uncertainty has exposed supply chain fragility, accelerating nearshoring trends. Changes to global trade due to tariffs and European fiscal support for manufacturing will further drive demand for logistics space, push up rents, and limit vacancy in supply constrained markets.

Growing demand in the residential real estate sector is underpinned by shifting demographics. Urbanization, aging populations, and smaller household sizes are driving demand for rental housing. Affordability challenges alongside a preference for flexibility have meant renting is becoming preferable for younger generations. Given today's uncertainty, investors remain attracted to the residential sector as it provides stability of income, alongside the ability to reset rental levels more quickly which can act as a hedge to inflation. Recent macroeconomic volatility may discourage people from house purchase, making the PRS more attractive.

On a risk adjusted basis, investment into retail may be challenging. Opportunities exist, but success is highly dependent on location and tenant-mix. Retail parks, including grocery-anchored centers, are set to outperform, as they benefit from convenience, accessibility, and the rise of omnichannel shopping. Over the longer term, as e-commerce penetration continues to grow, tenants that fail to adopt an integrated online approach are likely to be challenged. Investors therefore need to have high conviction at the asset level that there will be exit liquidity.

The alternative parts of the market make up a growing and increasingly important part of the investment universe. According to investor intentions surveys, upwards of 60% of investors are looking to target investment in alternative sectors[6]. This includes, but is not limited to, life sciences, data centres, childcare, hospitality, and self-storage.

Strong investor interest in data centers represent the shift in how the built environment is being utilized. Digitalization, namely the scale up of AI is anticipated to drive high levels of demand, creating an exciting opportunity for investors with the expertise required to enter the market. Data centers share similar fundamentals with traditional real estate, namely due to the typical hold period as well as the ability for value generation. However, there are additional complexities that investors should not be naïve to, the availability of power is vital, along with proximity to urban hubs and transport routes.

Conclusion

- The European real estate market started 2025 characterised by cautious optimism due to easing inflation and falling interest rates. However, macroeconomic and foreign policy shifts have increased market uncertainty.
- The U.S. administration's introduction tariffs on imports could result in the development of a stagflationary scenario.
- The German government's €500bn Infrastructure Investment fund, along with increased defense spending in the UK and France, should help to support growth in the medium term.
- The real estate market is evolving, with traditional sectors like offices, retail, logistics, and residential remaining foundational. But the key is adapting to new demands and opportunities. Investors must be agile, recognizing the growing importance of alternative sectors such as life sciences, data centers, and hospitality.

6. CBRE Investor Intentions Survey January 2025, as at 31 March 2025.

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