EUROPE INSIGHTS

Key Themes

- Have Higher Government Bond Yields Changed the Real Estate Outlook?
- What Does an Analysis of Affordability Mean for Office Rental Growth Forecasts?

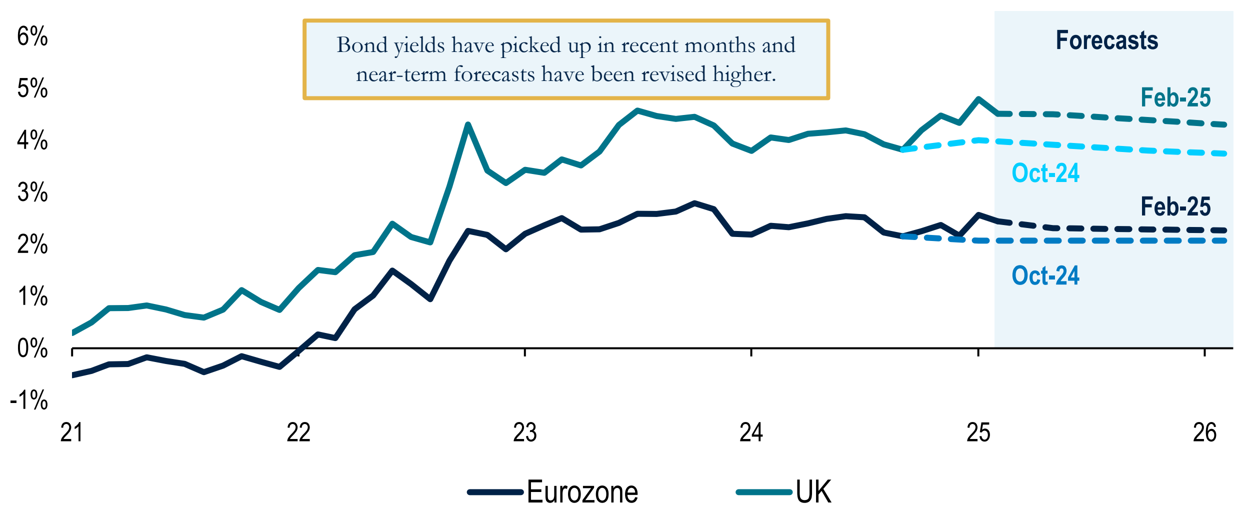
Have Higher Government Bond Yields Changed the Real Estate Outlook?

Real estate is a capital-intensive industry and the recent headline-grabbing rise in 10-year government bond yields and upward shift in near-term forecasts has understandably caused concern among investors (**Exhibit 1**). Higher risk-free rates matter, but the question is has the outlook really changed that much?

In aggregate, our answer is not very much – real estate yields in Europe tend to move closely with expectations about where bond yields will be in years to come (**Exhibit 2**, next page), rather than with often volatile movements in short-term market pricing. Yields have already risen a lot to reflect the transition to a higher interest rate environment than during the last cycle.

Exhibit 1: Government Bond Yields and Near-Term Forecasts Have Risen

10-Year Government Bond Yields (%)



Sources: Bloomberg, Consensus Economics, PGIM Real Estate. As of March 2025.

Forecasts are not guaranteed and may not be a reliable indicator of future results.

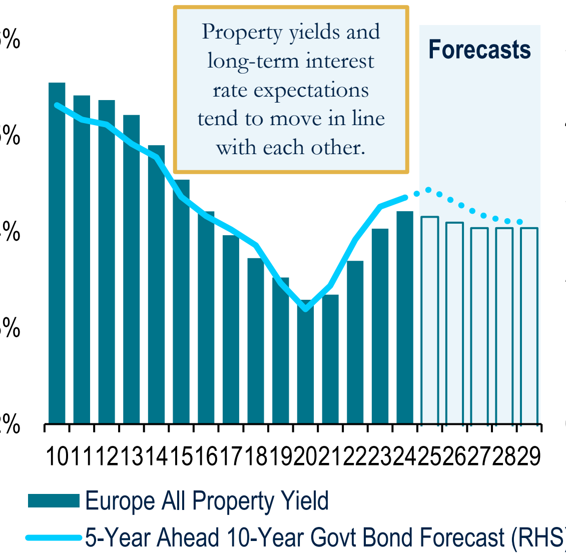
Our view of where bond yields will settle in the longer term across Europe – driven by factors such as demographics and productivity that affect potential rates of economic growth across the region – hasn't really changed. We see the recent pick-up in bond yields as temporary and don't see a need for any major adjustment to our forecasts for yields or real estate pricing as a result.

Real estate market participants are looking through recent bond market volatility too. Since October 2024, lending margins have fallen and, for the first time in several years, there has been some compression of prime yields (**Exhibit 3**). What we are seeing though are differences emerge between the eurozone and the UK.

Short-term reference lending rates i.e. 5-year swaps, have been falling in the eurozone, so all-in real estate debt costs have moved lower and are more clearly accretive to returns in leveraged transactions. We expect this to support a recovery in liquidity and investment volume from low levels through 2025.

Exhibit 2: Long-Term Bond Yield Expectations are What Matter for Real Estate Pricing

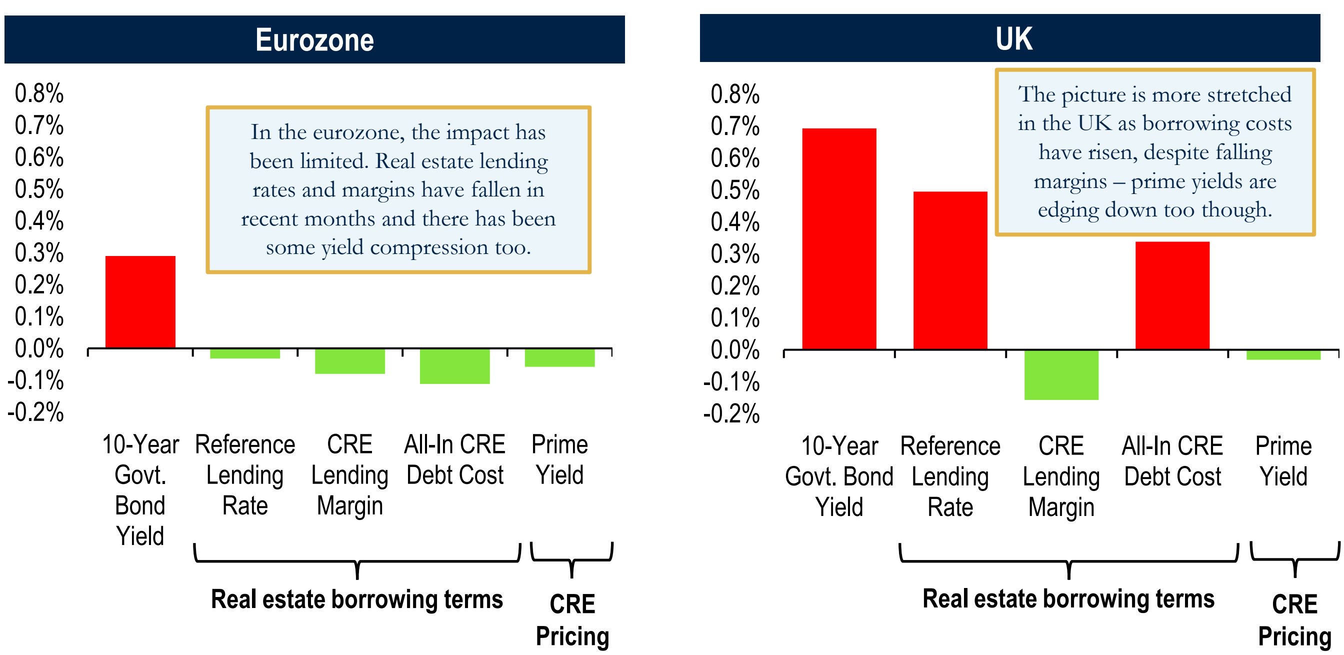
Five-Year Ahead Consensus Bond Yield Forecasts and Property Yields – Europe (%)



Forecasts are not guaranteed and may not be a reliable indicator of future results.
Sources: Consensus Economics, Oxford Economics, PMA, Cushman & Wakefield, PGIM Real Estate. As of March 2025.

Exhibit 3: Real Estate Lending Margins and Yields Moving Lower

Change in Borrowing Costs and Real Estate Yields Since October 2024 (%)



Sources: Bloomberg, Consensus Economics, Chatham Financial, CBRE, PGIM Real Estate. As of March 2025.
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The story is more stretched in the UK where inflation is stickier and swap rates have moved higher in recent months. All-in debt costs are both rising and at levels that are not clearly accretive to returns as they are above prime yield levels. The absence of a positive leverage effect means we see bigger risks around the liquidity story – and the therefore pricing outlook – in the UK in the coming months.

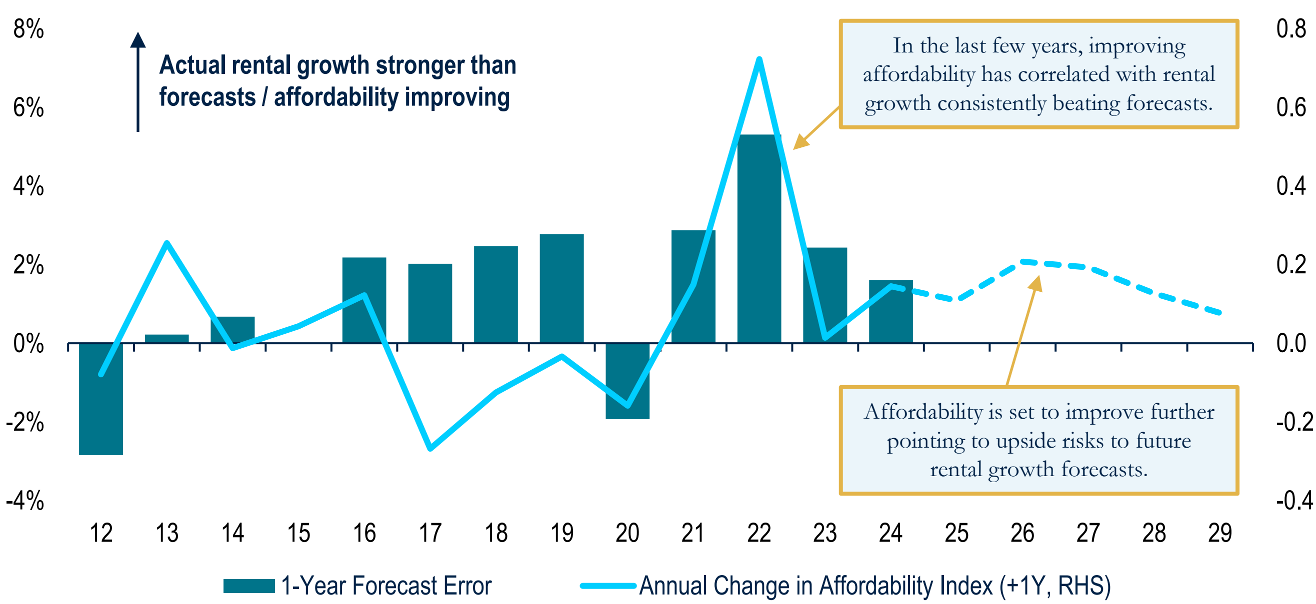
What Does an Analysis of Affordability Mean for Office Rental Growth Forecasts?

Offices have been out of favor with investors due to occupier headwinds from hybrid working but affordability has improved and points to upside risks to rental growth forecasts in the coming years.

Through the last cycle, office rental growth was repeatedly underpredicted, in part reflecting lower supply and higher employment growth outcomes than expected. In recent years improvements in our measure of tenant affordability – which compares economic activity per unit of occupied real estate space to headline rents – have started to play a role in explaining forecast errors too (**Exhibit 4**).

Exhibit 4: Affordability Has Explained Forecast Errors in Recent Years

Annual Office Rental Growth Forecast Error (%) and Change in Affordability (Normalized)



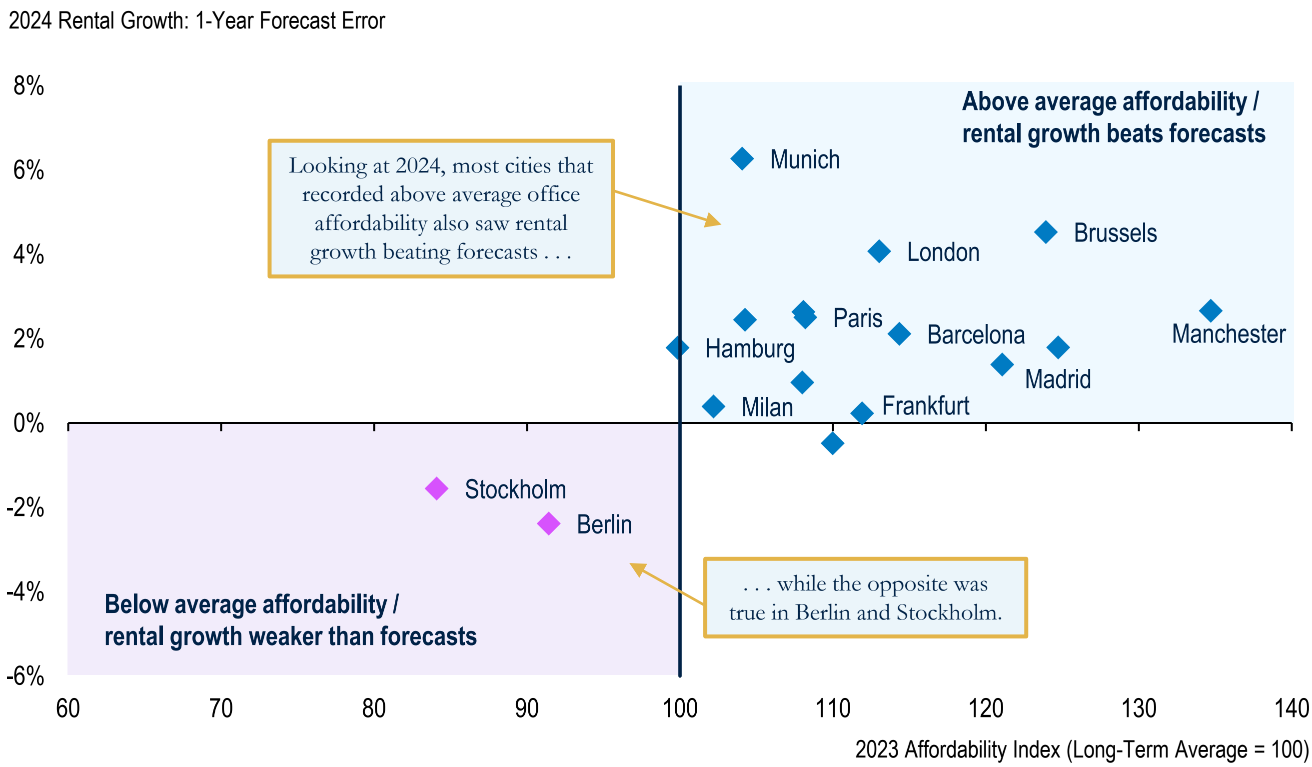
Sources: PMA, Oxford Economics, PGIM Real Estate. As of March 2025.

Forecasts are not guaranteed and may not be a reliable indicator of future results.

Our affordability index can be a helpful predicative tool when it comes to assessing city rental growth. Most cities that recorded an above average affordability score in 2023 went on to record stronger-than-expected rental growth in 2024 (**Exhibit 5**).

Exhibit 5: Affordability Can be A Helpful Predicative Tool For Cities

Office Rental Growth Forecast Error Versus Previous Year Affordability Index by Major City – 2024



Sources: PMA, Oxford Economics, PGIM Real Estate. As of March 2025.

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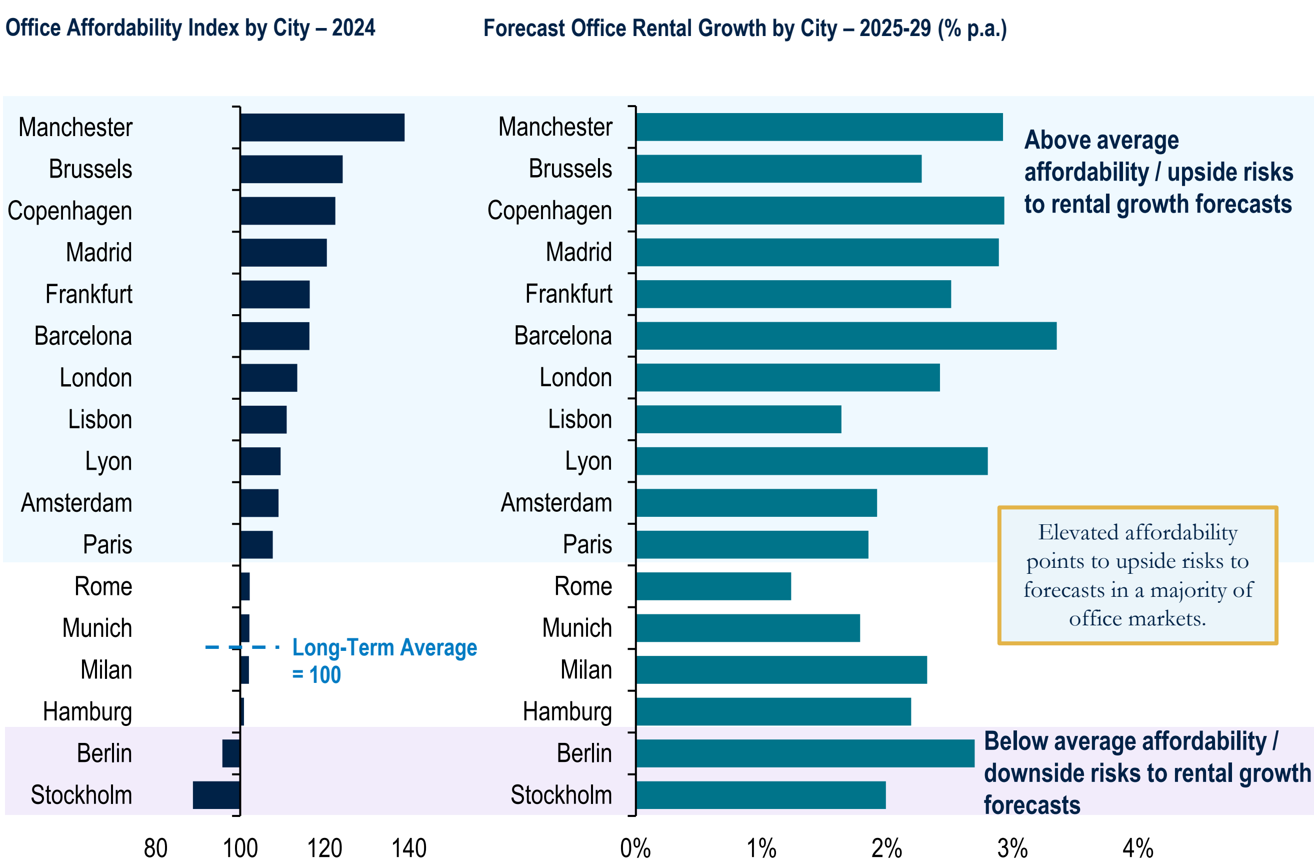
In turn, we can look at where there might be upside and downside risks to forecasts for rental growth in major markets in the coming years. Generally speaking, we are seeing elevated affordability and upside risks to the outlook in second-tier markets like Manchester, Brussels and Copenhagen, along with faster-growing Barcelona and Madrid in Spain, and major financial hubs like London, Paris and Frankfurt (**Exhibit 6**).

In contrast, affordability continues to look stretched in Berlin and Stockholm and points to a risk of rents underperforming expectations in the coming years.

Exhibit 6: There Are Upside Risks to Rental Growth in Many Office Markets



Sources: PMA, Oxford Economics, PGIM Real Estate. As of March 2025.
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Important information *(continued)*

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