CBRE Baltics
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VIEWPOINT | Baltic Yields

# Increased Cost of Capital and Interest Rates Impact Baltic Prime Yields

REPRICING SENTIMENT IN THE BALTICS

November 2022

Macroeconomic headwinds are raising fears of a downturn as central banks address persistently high inflation. Monetary tightening has started to impact on real estate pricing across the markets, including the Baltics. Rising financing costs are currently weighing on market sentiment and leading to repricing or expectations of repricing for almost all asset classes.

## ECB RAISED INTEREST RATES

Although high global energy, commodity and durable-goods' prices are the primary inflation drivers, central banks are adjusting interest rates noticeably to avoid the scenario where higher wages feed growing prices even more. In the Euro area, interest rates have already been increased three times (Jul'22 – 0.5 bp, Sep'22 – 0.75 bp, Nov'22 – 0.75 bp) and are currently reaching the 2% fixed rate level for the main refinancing operations. However, the currently set ECB's interest rate is still below that of the Bank of England and the US Federal Reserve.

The current ECB main financing rate is also lower than the rate set over the financial crisis in 2008. Yet, the current market widely expects that ECB may stretch interest rates upwards during the next meeting, implying further monetary tightening. Increasing interest rates are subject to the ECB's medium-term target to stabilize the inflation rate at around 2%.

Given the tight macroeconomic environment, the forward-looking indicators have deteriorated in the Baltics. As of Oct'22, consumer confidence has dropped to -37.5 in Estonia, -27.0 in Latvia, and -15.4 in Lithuania.

A modest economic downturn is expected throughout Europe, including the Baltics. Based on the current forecast, inflation will remain high in 2023. Yet, the forecasts are very sensible and are subject to the uncertainty over energy prices.

### MACROECONOMIC KPIs, (EE | LV | LT)

GDP Growth 2022 (%, yoy)

-0.1 | 1.9 | 2.5

Inflation 2022 (%, yoy)

19 | 17 | 19

Gross Public Debt (% of GDP)

19 | 42 | 38

Source: Autumn 2022 Economic Forecast (11/11/2022) by the European Commission


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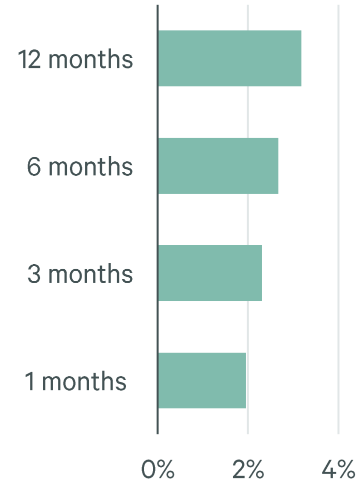
## BOND YIELDS HAVE STARTED ADJUSTING

The ECB's main financing rate has already reached 2% and is likely to increase in the coming periods with the aim of mitigating still rising inflation. Therefore, as there tends to be a positive relationship between interest rates and bond yields, the matured European markets' government bonds have already started adjusting.

The 10 year German bond yield (which is commonly referenced as a risk-free rate in the European markets) has risen by 2.26 pp YTD, while the average Euro Area bond yield shifted by 2.3 pp YTD. As real estate yields tend to correlate with the 10 year bond yield direction, especially in a volatile market, bond pricing can guide on the direction of where property yields could go.

The real estate yield shift has not yet been that large compared to the interest rate increases. Therefore, property yields are likely to keep rising in line with higher borrowing costs.

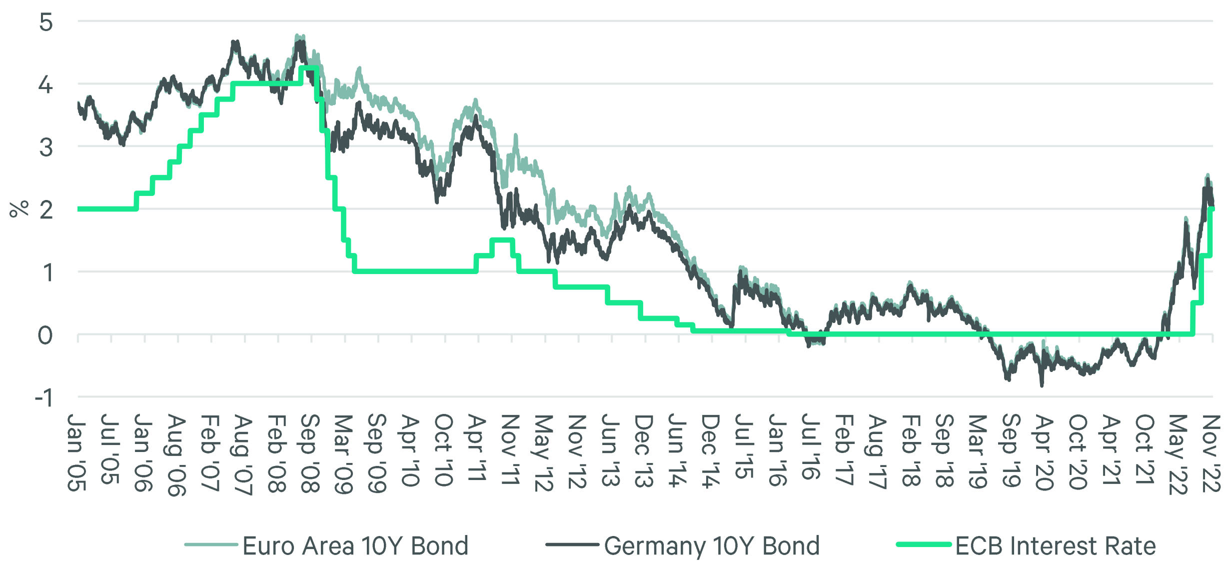
**FIGURE 1: Euribor Rate Change, Different Terms to Maturities, 01/01/2022 – 01/11/2022**




Source: CBRE Baltics Research, ECB

> Since government bonds and interest rates have started drifting up, property yields are expected to adjust, as well. As the Baltic real estate markets take time to adapt, Baltic property yields are expected to keep rising, following the sentiment across the core European markets.

**FIGURE 2: 10Y Bond Yields in Euro Area and Germany, ECB Main Financing Rate Development, 01/01/2005 - 18/11/2022**




Source: CBRE Baltics Research, ECB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## BALTIC REAL ESTATE YIELD SENTIMENT

The rising cost of debt has impacted on pricing expectations in the real estate market. Hence, the capital values are now shifting. However, among the prime assets, sustainability may help to generate a more buoyant outlook. Also, as the Baltic economies have a more resilient track record to the external factors that initiate an economic slowdown, it could be anticipated that both the economic contraction and capital values' correction may be softer in the Baltics than in other European markets, where the decline in values is already evident.

The economic realities happening in the core European markets tend to be more delayed in respect of the Baltics. As government bonds and interest rates have started drifting up, the property yield impact has been more observed. In the Baltics, yields are expected to keep rising in line with the higher borrowing costs. However, as the Baltic markets are smaller with lower prime assets supply, a less significant rise in yields is anticipated compared to the larger European markets.

### KPIs Q3 2022, (EE | LV | LT)

Economic Sentiment Indicator, Long-Term Average = 100

82 | 91 | 96

Source: Eurostat

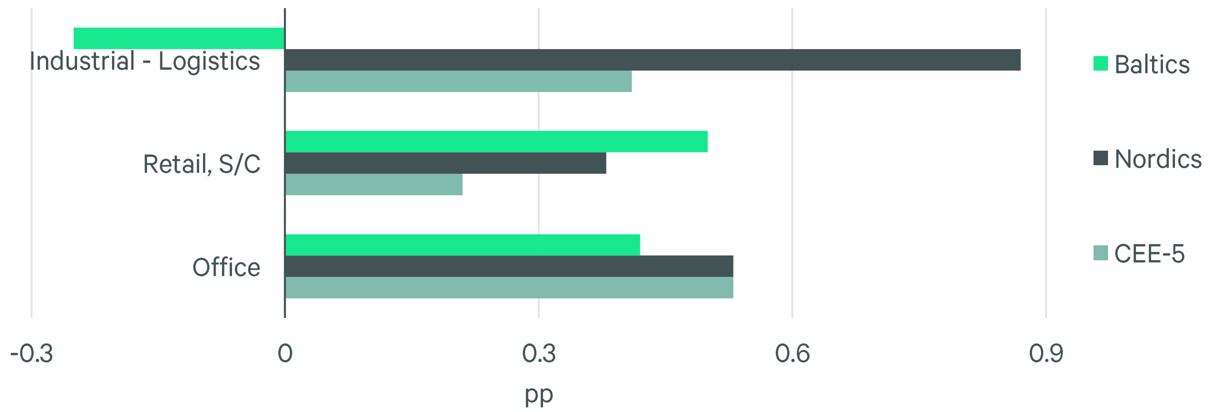
10Y Government Bond, %

4.1 | 4.6* | 3.8*

Source: ECB, World Government Bonds

** - The 10Y Bond Yield is not derived from the market. Its value is calculated according to the yields of other available durations.*

**FIGURE 3: Prime Yield Change in 2022, January-November 2022, pp**




Source: CBRE Baltics Research

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