BARINGS

REAL ESTATE

No "Strait" Answer for Europe's Real Estate Recovery

Key macro risks from the last few years remain in focus, including U.S. policy volatility, energy prices, the ongoing impacts of higher long-term borrowing costs and the risk Europe's labour market strength reverses. With risk-off sentiment continuing to dominate, investor uncertainty continues to heavily polarise the outlook for individual real estate assets.

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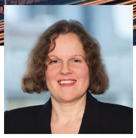

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Executive Summary

MARKET OUTLOOK

- Despite the external climate, internal property market risks remain low.
- A new property cycle is beginning, supported by stable interest rates and capital values.
- Rents are expected to continue rising for high quality space, with weak development economics limiting new supply.

INVESTMENT IMPLICATIONS

- Renewed volatility reinforces the value of investing in locations and sectors with strong structural fundamentals.
- Limited development activity and bifurcated tenant demand make office asset selection increasingly important.
- Grocery remains our favoured retail format, supported by food's high delivery costs and low margins, which underpin its long-term resilience to online competition.
- Positive logistics rental growth and a more generous yield spread create greater scope for yield compression to boost mid-term returns.
- Despite investor concerns around regulation, residential rent controls can, in practice, increase tenant retention, improve income certainty and reduce investment performance volatility.

Economic Outlook

The Eurozone Composite PMI rose to 49.5[1] in June and Germany's Ifo Index to 85.6.[2] However, lagging hard data, including GDP and industrial production, suggest growth will remain subdued this year. Even if a peace deal eventually holds, oil prices remain the key near-term macro variable to monitor.

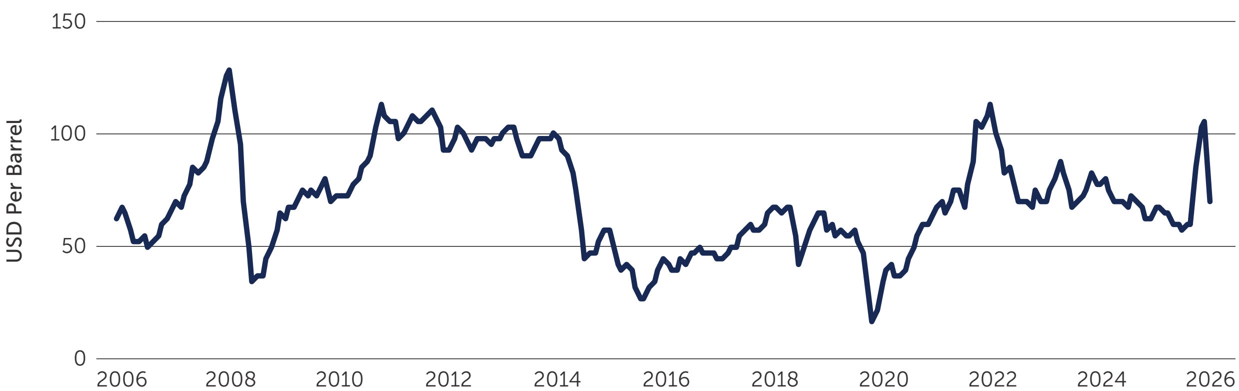
Despite signs of slowing economic activity, labour market conditions remain relatively resilient. According to Indeed, Eurozone job postings remain elevated, but growth has slowed and become less broad-based. Spain and Italy show the strongest trends, while labour market softening is more evident in France and Germany. For office investors, declining remote-work postings and strong growth in AI-related roles are supportive of innovative cities and prime CBD locations.

At the same time, wages are still rising but are no longer materially outpacing inflation, weighing on household purchasing power and consumer demand. Further labour market weakness is a downside risk to an already fragile growth outlook.

Against this backdrop, Eurozone inflation eased to 2.8% pa[3] in June 2026 but remains above the ECB's 2.0% target. The ECB delivered an expected 25 bps hike in June, treating the energy shock as a greater inflationary than growth risk. While we don't anticipate aggressive tightening, energy prices, and their pass-through to inflation, will determine whether additional rate hikes are needed in the quarters ahead.

Investor Implications: Key macro risks of the last few years remain in focus, including U.S. policy volatility, energy prices, the ongoing impacts of higher long-term borrowing costs and the potential for a reversal in Europe's labour market strength. With risk-off dominating, investor uncertainty continues to drive a heavily polarised outlook for individual real estate assets.

Figure 1: Global Oil Prices



Source: EIA Short-Term Energy Outlook. As of Q2 2026.

1. Source: Eurostat. As of July 2026.
2. Source: Ifo Institute. As of July 2026.
3. Source: Eurostat. As of July 2026.

Capital Markets

European property experienced another false start in early 2026, with first quarter investment volumes declining 10% year over year[4] as investor sentiment was once again shaken by unpredictable U.S. policy. The sharpest declines were seen in Germany and France, where volumes fell 25% to 30%, while Italy was down over -40%. Spain remained a relative bright spot, with investment activity rising 25% toward normal capital market activity.

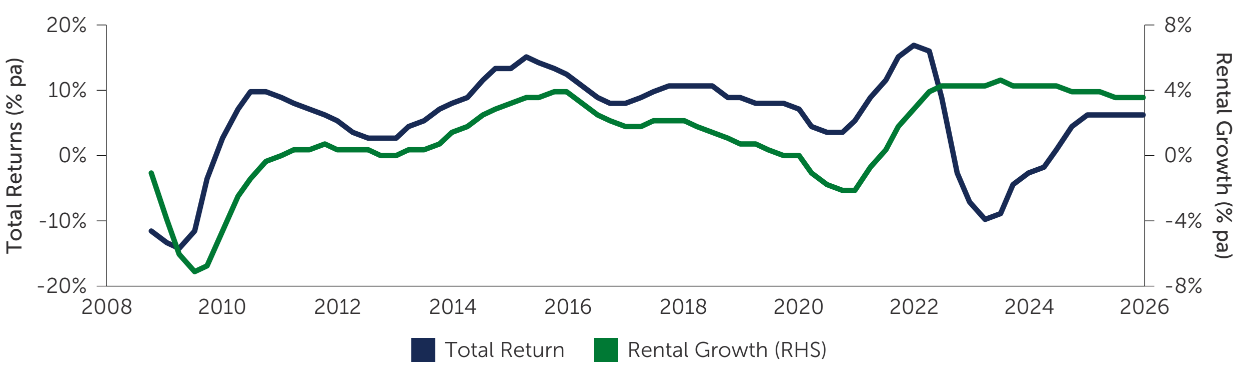
The MSCI Europe Quarterly Property Index total returns eased slightly to 5.7% pa through to March 2026, down modestly from 6% a year ago. As is often the case, the path to recovery is seldom smooth. Capital growth has slowed to just under 1% pa, with income the key driver at 4.7% pa. Returns were highest in the retail sector (7.5% pa), underpinned by a higher income return of nearly 6% pa, while office returns still lag at 3.3% pa.

Despite softer capital market activity, underlying property fundamentals remain supportive. Investment returns continue to be constrained by energy prices, inflation anxieties and ultimately uncertainty around the future path of interest rates. However, limited supply is helping sustain the rental growth outlook, with rents up 3% pa based on MSCI average values, and over 5% pa according to prime data.[5] As a result, future return prospects are well supported by robust yields and positive income growth potential, but oil prices remain key near-term variable to monitor.

Despite greater caution among both lenders and borrowers, debt appetite continues to exceed investment transaction volumes and origination opportunities. Consequently, property debt margins remained stable in the second quarter. Chatham Financial estimates current margins are in the range of 125–200 bps, depending on sector and country.

Investor Implications: Despite the challenging external climate, property market risk remains low as a new cycle begins, with interest rates and capital values stable. Prime rents should keep rising as poor development viability constrains new supply delivery. At the same time, renewed volatility reinforces the value of investing in locations and sectors supported by strong structural fundamentals.

Figure 2: European CRE Returns & Rental Growth



Source: MSCI Europe Quarterly Property Index. As of July 2026.

4. Source: RCA. As of Q1 2026.
5. Source: Cushman & Wakefield. As of Q1 2026.

Occupier Markets

OFFICE SECTOR

Occupier demand remains subdued, with leasing activity below both pre-COVID levels and the long-term average. According to Cushman & Wakefield, annual take-up is currently around 3.5% of stock, versus roughly 5% before the pandemic.

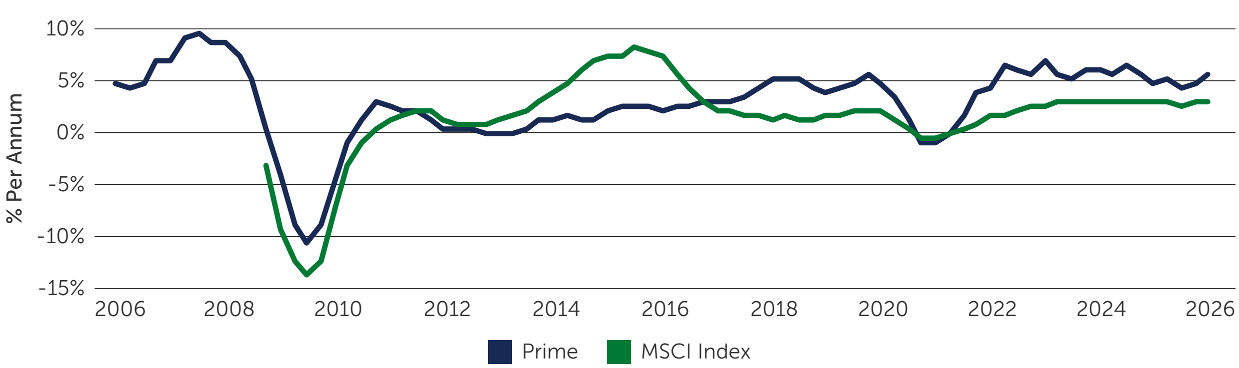
Demand has softened across most major European cities as elevated uncertainty continues to delay leasing decisions. The notable exceptions are Madrid and Barcelona, where Spain's stronger economic performance has supported more normal lettings conditions. Demand also remains increasingly concentrated in higher-quality space, with Grade A and CBD lettings significantly outperforming the remainder of the market.

Divergence is also evident in vacancy trends. European office vacancy continues to edge up toward 10%, above the long-run average of 8%.[6] Vacancy is tightest in Madrid and Manchester and loosest in Stockholm and Berlin, while average European CBD vacancy remains lower at around 4–5%. Looking ahead, the supply of top-end, Grade A, ESG-compliant space is likely to tighten further as higher construction and financing costs push the development pipeline toward multi-decade lows.

These supply constraints continue to support rental performance. Prime rents are up 5% pa[7] (3.1% pa on MSCI), led by London, Paris and Milan where top rental growth is circa 10% pa. While previous technological shifts boosted GDP by improving productivity, lowering costs and ultimately creating jobs, current AI-related concerns are already weighing on office jobs and investor sentiment. In this environment, centrally located prime assets are best placed to mitigate these risks.

Investor Implications: Prime office markets benefit from limited supply and increasingly bifurcated demand, making asset selection critical. Secondary assets face a growing risk of becoming value traps with heavy capex required. Brown-to-green repositioning strategies may offer value-add opportunities, but only on a highly selective basis.

Figure 3: European Office Rental Growth



Sources: Cushman & Wakefield; MSCI. As of July 2026.

6. Source: Cushman & Wakefield. As of Q1 2026
7. Source: Cushman & Wakefield. As of Q1 2026

RETAIL SECTOR

Wage growth has moderated and is now falling back in line with price inflation at just over 3% pa.[8] Consumer confidence has improved to -17.7 in June,[9] largely linked to the easing tensions in the Middle East at the time, although it's still low.

Consumer spending, however, has remained reasonably supportive. Retail sales values are up approximately 3% pa,[10] while sales volumes increased 1.8% during the first quarter. Even so, the cyclical economic backdrop remains challenging for physical retail profitability. Cash through the tills continues to outpace physical sales growth, while non-rent operational costs are also rising.

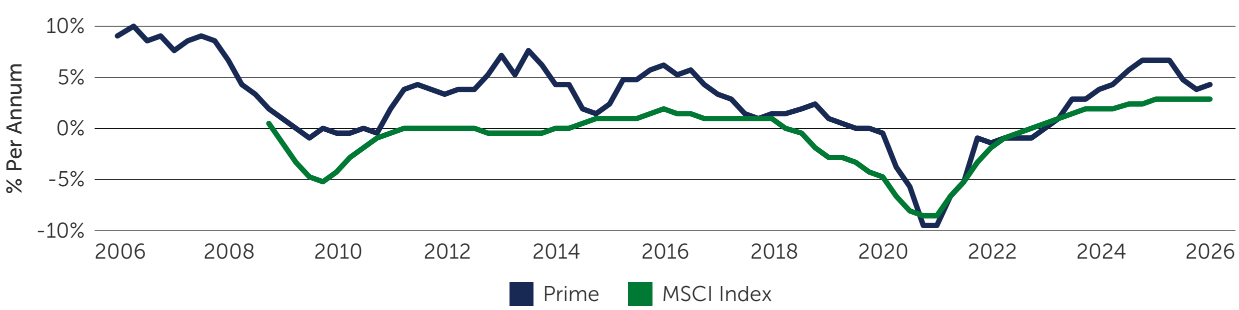
Letting agents report solid levels of new store openings and strong leasing demand, but only for prime locations. Demand is also being supported by a growing number of online retailers expanding into physical stores.[11] Given the lack of new retail development over the past two decades, availability across prime European pitches and best-in-class malls is tightening.

Retail effort rates have compressed as nominal sales growth has outpaced rents. This is more a function of inflation than retail strength, but it creates headroom for landlords to drive rental growth. Cushman & Wakefield reports prime rents are up nearly 4% pa,[12] while rental growth on the MSCI index reached 2.8% pa through Q1 2026.

The grocery market is polarised, with discount, value-oriented operators and premium grocery formats outperforming, while mid-market players face greater pressure. Big-box hypermarkets also continue to lose share as non-food spending shifts to better-suited channels, prompting operators to repurpose surplus space for online picking, last-mile logistics or subletting opportunities.

Investor Implications: Despite the recent rebound on prime high streets, grocery and convenience remain our favored retail formats. Their appeal is underpinned by the grocery sector's long-term e-commerce resilience, reflecting the high cost of food delivery and inherently low profit margins.

Figure 4: European Retail Rental Growth



Sources: Cushman & Wakefield; MSCI. As of July 2026.

8. Source: Eurostat. As of June 2026
9. Source: European Commission. As of July 2026.
10. Source: Oxford Economics. As of July 2026.
11. Source: CBRE. As of April 2026
12. Source: Cushman & Wakefield. As of Q1 2026.

INDUSTRIAL SECTOR

According to Savills, letting activity fell around 20% quarter over quarter in Q1 2026, although it was just over 5% above last year's level. Take-up in the Netherlands, U.K. and Belgium rebounded strongly, and Spain also improved. Even so, lettings activity across Europe remains below the long-term average, with France standing out as a notable underperformer as both domestic and global uncertainty weigh on supply chain location decision-making.

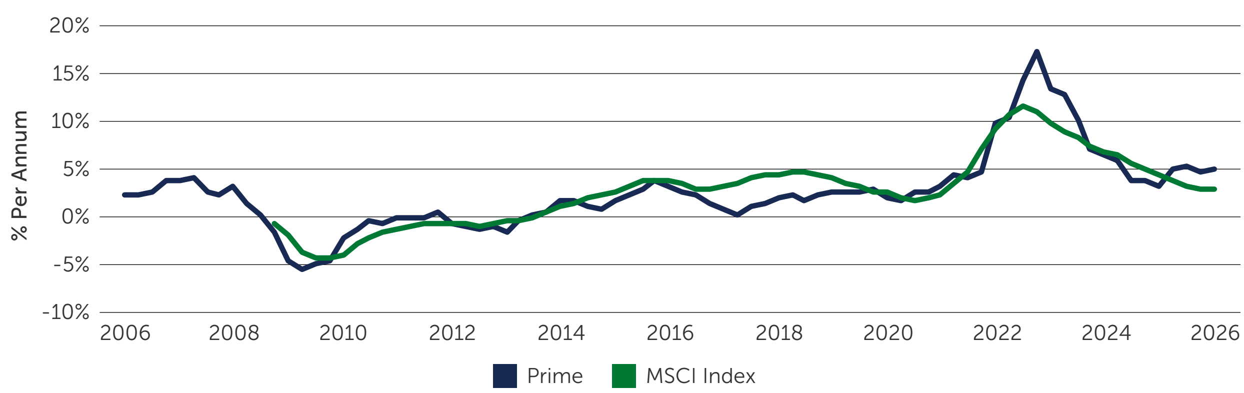
European vacancy rose to 7%, with marked polarisation across and within national markets.[13] For example, vacancy is over 9% in Madrid versus just 2% in Barcelona, while vacancy stands at 3% in Ireland compared to over 10% across London and South East of the U.K.

Despite higher vacancy in some markets, reduced speculative development is helping support prime rental growth in central hubs. Rental affordability remains supportive, with rents typically accounting for just 3–4% of supply-chain costs.[14] Prime rental growth has rebounded to 5% pa[15] and around 3% pa on MSCI in Q1 2026.

Growth in online retail sales, onshoring, higher European defence spending and ancillary demand linked to data centre storage continue to support the sector's future growth performance.

Investment Implications: Rental growth is inflecting back upwards, and logistics yield spreads are wide. This combination creates scope for potential yield compression, which could boost the sector's medium term return prospects.

Figure 5: European Industrial Rental Growth



Sources: Cushman & Wakefield; MSCI. As of July 2026.

13. Source: Savills. As of May 2026
14. Source: CBRE. As of April 2023.
15. Source: Cushman & Wakefield. As of Q1 2026.

LIVING SECTOR

MSCI data to Q1 2026 shows residential capital growth of 3.4% pa and rental growth of 5.4% pa. Values are recovering, but remain around 10% below the 2022 peak. Given long-term trends in wage growth and persistent supply-demand imbalances, annual rent growth of around 3% pa is a fairly conservative baseline expectation.

The outlook for housing supply remains challenging. Europe's chronic housing shortage is likely to worsen over the next several years, as higher build and funding costs, combined with sticky land prices, continue to slow housebuilding. A cumbersome planning process further constrains the delivery of new housing stock.

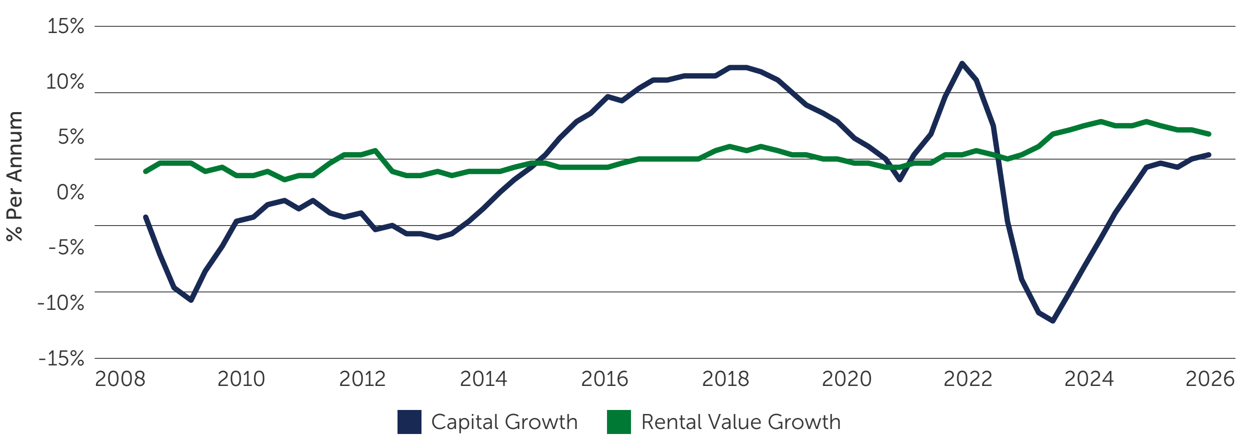
At the same time, evolving demographic trends are adding to structural demand pressures. The rise in single-person households, higher divorce rates and aging populations are reducing average household size and may lead to a growing mismatch between existing housing stock and occupier needs.

Soft underlying house prices, rising rent regulations and real wage growth have improved rental affordability in recent years. While wage growth is no longer expected to outpace inflation, housing shortages look likely to intensify. As a result, we anticipate sustained upward pressure on rents over the next two to three years, and likely beyond.

Sector risks are primarily political. More restrictive immigration policies could weaken long-term housing demand, while tighter rent regulation may constrain asset-level performance.

Investment Implications: Despite much investor anxiety around regulation, in practice, rent controls can increase tenant retention, improve income certainty and therefore reduce investment performance volatility.

Figure 6: European Residential Capital and Rental Growth



Source: MSCI. As of July 2026.

About the Team

Barings Real Estate's research team has a diverse background covering various industries, asset classes and countries, which is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.

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