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Algarve Property Market Outlook 2015 and review of 2014

Every year in December we reflect on the past year and provide an outlook for the property market in the year ahead, 2015. Twelve months ago we predicted that trading conditions for real estate would improve which proved to be an accurate assumption. The increase in transaction volume which started in 2013 continued in 2014 at even a higher pace. Also property prices are somewhat improving which is good news for vendors. These are positive signs in light of a lacklustre economic recovery in Europe with unemployment staying at stubbornly high levels versus previous economic recoveries. Moreover there has been little help from banks as new mortgage origination has been low and expensive with spreads of around 4% over Euribor. To put this in perspective, during the years before the financial crisis the spread was between 0.5 and 0.9% over Euribor.

The Algarve has always attracted buyers from all over the world, therefore it is important to watch how other economies are performing when analyzing trends in property prices. The big themes for 2015 that could have a negative impact on the property market are the possibility of economic stagnation in Europe, the possibly of deflation, and the need for further strengthening of banks balance sheets. To start with the first, Europe needs higher economic growth in order to bring unemployment down and to be able to lower budget deficits. Unfortunately, there are signs that the eurozone economy is slowing to a halt, with a key indicator of manufacturing activity, the PMI index (purchasing managers index) falling to 51.4 in the month of November 2014, just above the important 50 level marking an expansion. There is some positive tailwind from lower energy prices and a weak Euro, but this is not enough for a real economic recovery. Structural reform will also play a big role, not only in Portugal but also in France which is Europes second largest economy after Germany. For Europe it is important that the economy of both France and Germany are performing well. The ECB will do everything in its power to avoid deflation, however, it may well be that inflation will remain low and well below historical levels not just for a couple of years but for the coming decades. There have been long periods of very low inflation before in the past two centuries. The current low inflation environment is due to technological and energy innovation, the deleveraging by corporations, government and households all at the same time as well as an aging European population.

The year 2014 was also the year that Portugal exited the 3 year bailout program. During this period of austerity some progress was made with structural reform and the reduction of the budget deficit. However, progress has been slow and too little and makes you wonder what the future beholds now that Portugal is no longer required to negotiate with its lenders. Economic growth is forecasted at 0.8% for 2014, moving to 1.2 and 1.3 percent in 2015 and 2016 respectively. Furthermore, the government expects the budget deficit over 2015 to come in at 2.7 percent, which is already above the agreed target of 2.5 percent agreed with its international lenders. However, the troika (ECB/IMF/European Commission) thinks the government forecast is overly optimistic and expects the deficit not to drop below 3.3 percent of GDP in 2015 from a projected 4.8 percent in 2014. Moreover, the outlook from bank analysts is more in line with the numbers of the troika which will put pressure on the government to hit their targets during the 2015 election year. Issues hampering economic growth are a slow judicial system, inefficient public administration (e.g. hidden unemployment), restrictive labour regulations and a lack of competition in some sectors.

On a positive note, we believe that programs like the Golden Visa and the NHR (Non-Habitual Resident) will continue to be successful in attracting foreign buyers in 2015. Especially the latter as more and more people from Northern Europe will learn about this program and the benefits. The NHR program is a scheme for individuals who have not been a resident in Portugal during the past 5 years. Once an individual has been granted the NHR status, he or she will be exempt from income tax (work, royalties, pension, interest and dividend) for a period of 10 years. This program in combination with an undervalued property market is an attractive proposition for many foreigners who like to capitalize on a recovery in property prices while having a 10 year tax holiday. The market benefits more from this type of buyer versus flippers, as they have a strong incentive to hold on to their property during this 10 year period.

Recent changes to local lodging legislation make investment in real estate more attractive, especially in a low interest rate environment. The new legislation requires owners who rent out their property on a short term basis to holidaymakers to register at the local tax department as a business activity. The advantage of this so called simplified regime, is 85% of rental income is automatically considered as expenses. In other words, you are only taxed on 15% of your invoiced rental income. There is a flat tax rate of 25% percent, which results in a final rate of 3.75% of total rental income. This compares favourably with the tax rate on savings. Moreover, the rental returns also compare favourably with gross yields varying between 5 to 8 percent depending on the type of property, location and marketing.

To summarize, despite of political and economical challenges we expect 2015 to be a good year for real estate with both transaction volume and prices to increase during the year especially if economic growth in the eurozone picks up. As there is not much new construction coming to the market in 2015, we also expect supply and demand to be more balanced which also will contribute to the recovery in property prices. In addition, we believe banks will continue to strengthen their balance sheets in 2015 something we always considered to be a process and not an event which in the future will lead to a more liberal approach towards the issuance of new mortgages and a reduction in the spread.

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