Real Estate Outlook

Global overview – Edition 1, 2020

Virus impact short-term if contained.

UBS Asset Management

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Rate cuts leading to yield falls.
Attractive pricing and capital targeting sector.

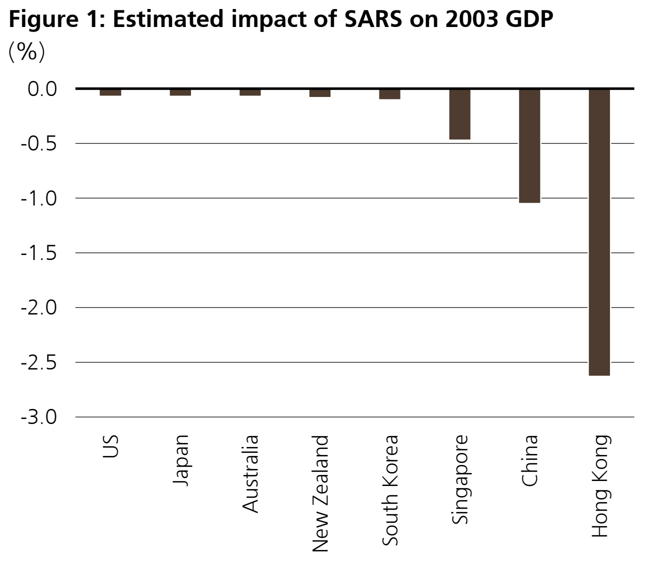
Coronavirus is a risk to economies and real estate markets, particularly in Asia Pacific, but any impact will be short-term if it is contained. Dip in investment activity and share of international capital flows. Interest rate cuts leading to yield falls in some markets, with real estate pricing around average versus index-linked bonds. We do not see a big inflation risk and our analysis suggests that real estate offers suitable inflation protection.

Macroeconomic overview

By mid-January sentiment over the global economy had improved. The malaise in the manufacturing sector appeared to be bottoming out while the US and China agreed a "Phase-One" trade deal that will stop threatened tariff increases and prevent new ones being added. As part of the deal China has agreed to purchase an additional USD 200 billion per year of US goods, improve enforcement of intellectual property rights, end forced technology transfers from US companies and further open its financial sector. The two sides have also agreed a dispute settlement framework allowing for tariffs to be applied if no agreement is reached. Most recently the outbreak of the coronavirus has prompted both the US and China to pledge to half tariffs on some imports. The US has also ratified the US-Mexico-Canada Agreement (USMCA), leaving Canada as the only country yet to formally sign.

The China deal embodies a rotation in trade policy away from the rules-based approach of the World Trade Organization (WTO) to an outcome-based approach. Indeed the US's refusal to nominate officials to the WTO's appellate dispute resolution body has brought it to a standstill. The efficacy of the US-China deal will not be known until 2021 when trade data for 2020 become available. The increased tariffs applied so far may merely result in trade diversion and leave the US trade deficit overall the same as the deficit with China shifts to other trading partners. However, data for 2019 show that the US goods deficit with China did fall by 18% to USD 346 billion.

Figure 1: Estimated impact of SARS on 2003 GDP



Source: "Estimating the Global Economic Costs of SARS", Jong-Wha Lee and Warwick J. McKibbin; 2004

The improved sentiment at the start of the year was called into question almost immediately. The coronavirus (COVID-19) outbreak in China presents a clear downside risk to the global economy, the extent of which will depend upon how much the virus spreads and how deadly it is. The SARS outbreak in 2003 provides some indication of the possible impact. According to one academic study SARS knocked 2.6% off Hong Kong GDP in 2003, 1.1% off China and 0.5% off Singapore. For the US, Japan and Australia the impact was much more muted, with these economies suffering mere 0.1% hits (see Figure 1).

Increased trade between countries and more international travel lead us to think that the impact of the virus outside of Asia will likely be higher than for SARS. Also, China now accounts for 16% of world GDP compared to just 4% in 2003. The SARS virus infected around 8,100 people globally and resulted in 774 deaths, a 10% mortality rate. The number of infections of the coronavirus so far has reached 60,000 at time of writing, though indications are that the mortality rate is much lower at around 2%. Oxford Economics has cut its global, US and eurozone GDP forecasts for 2020 by 0.2% pts and made a larger cut to China of 0.6% pts.

The global easing bias in monetary policy from 2019 remains. According to the IMF 49 central banks cut interest rates in 2019 a combined total of 71 times. The Fed and ECB are conducting reviews of their policy frameworks. This may see the ECB's asymmetric inflation target brought into line with the symmetrical targets of other central banks. The new president of the ECB, Christine Lagarde, is also keen for environmental considerations to be incorporated. At the Fed price level targeting will likely be discussed, along with new measures to prop up the economy should a downturn strike.

Inflation remains low in most countries, with central banks more focused on boosting than containing it. However, with ultra-low unemployment we believe we should still be aware of inflation risk. Markets expect inflation to remain low. Five-year on five-year inflation swaps – measuring market expectations for inflation over five years, five years from now – remain low and have fallen since the start of 2015. As of mid-February they were below inflation targets for the eurozone (1.2%) and Japan (0.1%). Only in the US are they on target at 2.0%.

Latest GDP data has been mixed, with the US economy expanding 0.5% QoQ in 4Q19 (the same as 3Q19) though business investment was weak and dropped 0.4% QoQ. The eurozone was weaker than expected and managed growth of just 0.1% QoQ, down from 0.3% in 3Q19. Economies look set to continue grow this year, but at an unspectacular pace. The IMF predicts global growth of 3.3% YoY, up from 2.9% in 2019. However, the coronavirus means the expected acceleration now looks unlikely and growth may not top 3%.

Capital markets

Real estate investment activity slowed in 2019, with global volumes falling 5% from 2018 to USD 941 billion, according to Real Capital Analytics. Asia Pacific saw the biggest drop in volumes, down 10% in USD terms, while in EMEA volumes fell 7% in USD terms. In the Americas activity was little changed, dipping just 1%. A variety of factors are likely to have caused the slowdown. Decelerating economic growth in many countries will have cooled sentiment, along with uncertainty generated by the US-China trade war. At the same time, a lack of product in many markets has curbed sales as investors choose to hold on to their real estate assets.

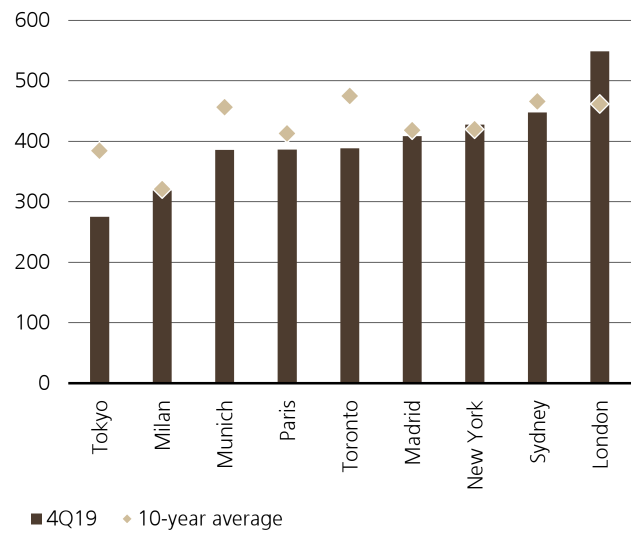
However, there were marked differences by sectors. Office volumes were down 3% globally in 2019 and hotel volumes 6% lower. In the challenging retail sector weak demand and falling prices compounded to see global investment volumes drop 25%. By contrast, industrial volumes rose 3% and residential volumes were up 4%. There was also a slight pullback in international capital flows and at the global level the share of transaction value accounted for by international buyers fell to 27%, from 33% in 2018. The share fell in both the Americas and Europe, while in Asia Pacific it rose to 35% from 31%. South Koreans were the most active buyers outside of their home region.

Investors continue to want to deploy capital to real estate. According to Preqin there was USD 320 billion of capital targeting real estate as of January 2020, which at 40% leverage would equate to USD 533 billion of capital to be invested, 57% of the total investment volume for 2019. Preqin data also shows that closed-end real estate funds raised USD 151 billion in 2019, little changed from the amount raised in 2018. However the number of funds closed fell to 295 from 486. This means that the average fund size rose to USD 511 million from USD 304 million in 2018, and indicates some consolidation in the market. As of January 2020 there are 918 closed-end real estate funds looking to raise USD 281 billion.

The rotation to easier monetary policy and interest rate cuts in 2019 is filtering through to a renewed impetus for falls in yields. According to our analysis of over 300 markets globally, the share reporting falls in yields rose to 21% in 3Q19 from 18% in 2Q19, while the number reporting increases slipped to 12% from 15%. The declines were focused on the logistics sector, with some falls for offices too. The increases were predominantly in the retail sector. In Hong Kong yields rose across all sectors – office, retail and industrial – as protests continued. Property yields are now at levels not seen before in many markets. For example, the prime office yield in Zurich was 2.4% in Q4 according to CBRE, and 2.6% in Munich.

In a historical context yields at these levels look ultra-low. In mid-2007, prior to the global financial crisis, Zurich office yields were 4.5% and Munich office yields were 4.8%. However, interest rates are now much lower and negative in both these countries. Relative to government bonds real estate still looks attractively priced. Arguably index-linked bonds are the best comparator for property given expectations that inflation will push up rents. In many markets spreads between prime office yields and index-linked bond yields are around their average for the past decade, and slightly below them in some (see Figure 2). Indeed, in London, where Brexit uncertainty plagued the market in 2019, spreads remain above average, indicating potential value for investors.

Figure 2: Spreads between prime office yields and index-linked bond yields (bps)



Source: Thomson Datastream; CBRE; PMA; RCA; February 2020

Data is now becoming available on the full year performance of real estate for 2019. In the US NCREIF reported a total return of 6.4% at the property level, just below the 6.7% for 2018. In the UK MSCI reported a return of 1.2% on its quarterly property index, down from 6.0% in 2018. In general, our expectation is that returns will slow in most markets in 2020, cushioned by ongoing low interest rates. We expect more positive sentiment to see returns accelerate in the UK.

The coronavirus outbreak presents a clear threat to the real estate market if it becomes a pandemic, long-lived and causes a prolonged hit to global economic activity that drags down occupier demand. The sectors most at risk are retail and leisure in China and across Asia Pacific. However, the increased reach of Chinese tourists and consumers means that US and European retail and hotel markets are also at risk if these visitors are cut off for a longer period, along with exporters of consumer goods, such as German car makers.

Strategy viewpoint

As outlined in the economic overview section we do not expect a spike in inflation and it is not our base case. However, it remains a possibility and as such we think it is worth reviewing what impact inflation has on real estate investments. An often quoted maxim in the industry is that real estate provides a good "hedge against inflation". We broadly agree with this sentiment but prefer to use the term "inflation protection", since hedge implies a guaranteed outcome, which is not true in this case.

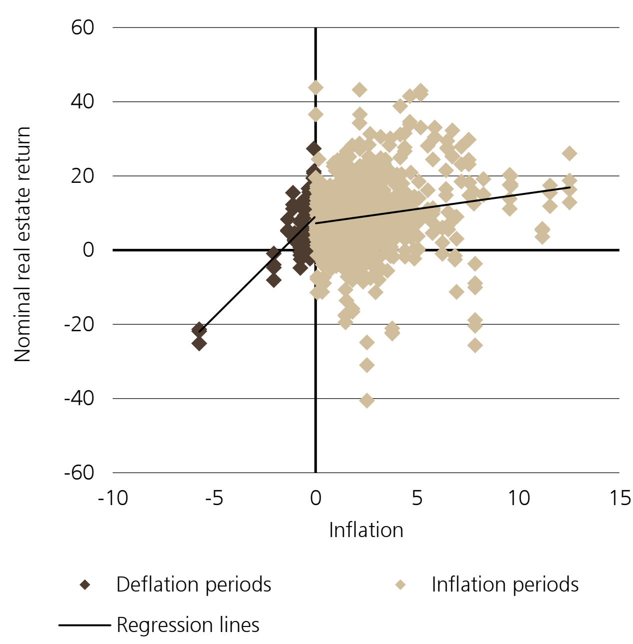
A key reason for thinking that real estate provides good inflation protection is that the rental income it generates is typically linked to some form of price index. Within a lease, this is indeed the case in many countries, with some also having provisions for upward-only rent reviews. However, at the end of the lease the property will need to be re-let, at which point the rent will revert to market value. If market rental values have kept up with inflation over the course of the lease then the inflation protection is good. If they have not, for example if the property needs to be re-let during a downturn, then the inflation protection is poor.

Moreover, investors are not interested in just rental levels alone. Rather, they consider real estate returns in their totality, taking into account both the income and capital value components. To examine what impact inflation has on real estate total returns we have looked at data across 26 countries spanning the three main property sectors and also multi-family in three countries. The data go back to 1980 in the case of the US and the total sample is 1,591 data points.

We ran a simple regression analysis of nominal real estate returns against inflation across the sample of observations. We split the sample into periods of inflation and periods of deflation to assess whether these different regimes have a different impact on real estate returns. In times of inflation we find that, on average, real estate offers 78% inflation protection (see Figure 3). For example, inflation of 2% will, on average, see nominal real estate returns of 1.56% pts compared to the case of no inflation.

In reality many other factors also determine property returns, not least the level of real interest rates. Omitting them from our model may cause bias in the estimate of the level of inflation protection. However, provided these other factors are not correlated with inflation, which seems reasonable given they are real economic variables, then the estimate should not be biased. Indeed, when we run a richer model, which includes real interest rates and allows for the property risk premium to vary over time and between markets, we find that the inflation protection factor is little changed at 80%.

Figure 3: Nominal real estate returns versus inflation
(%)



Source: MSCI; NCREIF; Oxford Economics; UBS Asset Management; February 2020

We also ran the analysis for a globally diversified portfolio across countries and sectors using market weights. For this we found that inflation protection is 103%. Overall therefore we conclude that real estate offers investors good levels of inflation protection and that, in general, higher inflation presages higher nominal real estate returns. However, it may not fully offset the impact of a bout of rapid price increases.

Along with inflation, deflation is a risk which we think should also be considered. Indeed, in Europe there is discussion as to whether the economy could enter a lost decade like that experienced by Japan and see a prolonged deflationary episode. Cash gives the ultimate protection against deflation since its value actually rises in real terms as prices fall. However, as we have seen in recent years, investors have preferred to hold large volumes of negatively yielding government debt rather than incur the physical storage and security costs of holding cash.

How well does real estate protect against deflation? Our sample of periods with deflation is small, mainly relating to Japan and Switzerland, with some isolated instances in other countries. Moreover, the deflation periods have typically occurred during the financial crisis when capital values and returns were dragged disproportionately lower by recession. Therefore we do not draw any firm conclusions on what impact a mild deflation over a sustained period might have.

Real estate investment performance outlook

2019 performance and 2020-22 outlook are measured against the sectors' long-term average total return, with a margin of 100 bps around the average described as "in line with long-term average". The long-term average refers to the period 2002-18. The red underperformance quadrant refers to negative absolute total returns, either in 2019 or the 2020-22 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multifamily
North America	Canada	9.8		10.9		9.9			
	United States	8.4		10.7		10.1		8.9	
Europe	France	8.1		10.9		9.0			
	Germany	4.0		5.5		6.9			
	Switzerland	5.6		6.4				6.3	
	UK	8.3		7.4		10.2			
Asia Pacific	Australia	10.4		10.7		11.0			
	Japan	5.3		5.6		6.0		5.1	

Forecast Performance 2019

Outlook 2020-2022

: Underperformance (negative absolute returns)
: Underperformance vs. long-term average
: In line with long-term average
: Outperformance vs. long-term average

Source: UBS Asset Management, Real Estate & Private Markets (REPM), February 2020. Note: Abbreviation LTA: long-term average

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