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Real assets could see a lift

Reviewing real asset demand and income growth expectations | UBS Asset Management

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How should investors respond to the renewed widening in real asset risk premia as interest rates head back down? All in all, we believe that the weight of capital looking to invest will spur further price increases.

What's the outlook for real assets in 2020?

Recent months have seen a profound change in the monetary policy outlook globally that has important implications for the demand, pricing and performance of real assets in general in 2020 and for real estate in particular.

In a relatively short space of time, the policy stance of central banks including the US Federal Reserve (Fed) has gone from neutral or modestly tight to slight easing. This policy shift includes the re-introduction of quantitative easing (QE) in Europe and in the US, despite the Fed's protestations that its repo purchases should not be considered as QE.

Deteriorating economics trigger real assets reassessment
This precautionary easing is seen as necessary in light of a deteriorating economic outlook. Political uncertainty looks set to continue dampening business investment and job creation. If anything, we see this intensifying in 2020. With the issues separating the US and China deeply embedded in domestic political interests, the trade disputes between the two countries are likely to rumble on. The US has other trade disputes on its agenda, not the least over automobiles with trading partners including the EU and Japan. In addition, the US Congress is bitterly divided. Elsewhere, Brexit and the Japan/South Korea trade war both pose additional risks.

Our view is that if the growth outlook has deteriorated sufficiently to warrant a reversal in central bank policy, then it should also trigger a review of real asset demand and income growth expectations.

Political risk does not directly influence real assets in the short-term. However, the longer business investment is depressed, the worse it is for an economy over the longer-term, and that will inevitably impact demand for real assets.

Our view is that if the growth outlook has deteriorated sufficiently to warrant a reversal in central bank policy, then it should also trigger a review of real asset demand and income growth expectations. The weaker trade and capital investment outlook is therefore likely to constrain real estate, most immediately for smaller and more open economies.

The deteriorating economic outlook will also likely have a negative impact on valuations for GDP-linked infrastructure assets such as roads, airports and other transportation assets. In a normal market cycle, this could be mitigated by lower interest rates and the material benefits of refinancing highly leveraged infrastructure assets at the project level. However, many asset owners have already refinanced their debt facilities in the expectation of higher rates, thereby limiting the potential refinancing upside from the most recent cuts.

On the positive side, labor markets in major developed economies remain very healthy. By the end of 2018, the jobless rate of high income countries was near a record low of 5.3%, according to the International Labour Organization.

Consumer and capital strength will boost real assets
In our view, investors should be a little more conservative about the demand side of the real asset equation, but not markedly more pessimistic. Central banks are attempting to sustain the same rates of growth, but they now believe that

slightly easier policy is needed in order to achieve it. In September, the US, the world's largest economy, completed its 123rd consecutive month of growth, the longest expansion since records began in 1854[1]. Long expansions are good for real assets, particularly when new supply remains broadly in line with demand and vacancy rates are comparatively low. In most cases, this will remain true heading towards 2020.

Looking ahead, how should investors respond to the renewed widening in real asset risk premia as long-term interest rates head back down? In our view, the relative attractiveness of real assets has been given a further boost. This is particularly the case in negative-to-low interest rate markets like Continental Europe, where we believe further yield compression is possible, notwithstanding that yields of high quality assets in key markets are already exceptionally low in absolute terms in an historical context. According to a number of recent surveys[2], there is an abundance of uninvested capital in the hands of the real asset funds, while investor intentions generally indicate a desire to increase allocations to the asset class. In the absence of a more marked deterioration in economic fundamentals, we believe that the weight of capital looking to invest in real assets will spur further price increases. However, any above-inflation rise in capital values would likely come from yield compression rather than income growth, particularly in real estate.

The impact of ageing developed world populations on key economic and investment metrics is, in our view, significant and structural. Lower yields, lower interest rates, lower inflation, lower growth, and lower returns quite possibly represent the brave new world of investment. This has been posited for some time in academia but has yet to seep properly into investment planning for major institutions like pension funds and insurance funds. The downward pressure on real asset yields will likely increase in ultra-low interest rate markets such as the Eurozone, Japan, and Switzerland. But the gains come with some increase in risk due to thinner occupier markets and less liquidity in times of market stress. For long-horizon buyers such as pension and insurance institutions, we believe these risks are manageable.

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We expect flat to positive capital value growth
Another area that deserves investors' attention is the outlook for leverage in the real asset space. Borrowing costs have been low throughout this cycle. But a mix of risk aversion in the wake of the most recent financial crisis, increased regulation of banks, and the expectation of rising long-term interest rates kept loan-to-value (LTV) ratios historically low. Now that long-term interest rates have fallen anew, it would be natural for an increased number of investors to look to leverage to boost their returns.

There is never enough information to make definitive calls for the truly long term. But we believe that the 'lower forever' paradigm is one worth embracing. We are therefore revising our two- to three-year forecasts from an outlook of modest erosion in capital values due to narrowing risk premia to one of flat to positive capital value growth, driven by a further downward adjustment in structural interest rates.

This article is part of our *Panorama: Investing in 2020* publication. For further insights, go to ubs.com/panorama.

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[1] The National Bureau of Economic Research, US Business Cycle Expansions and Contractions.
[2] 2019 Institutional Real Estate Allocations Monitor, Cornell University's Baker Program in Real Estate and Hodes Weill & Associates, LP, October 2019; ANREV / INREV / PREA Investment Intentions Survey 2019, January 2019; 2019 Preqin Global Real Estate Report, February 2019.

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AMMA-3383 12/19
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