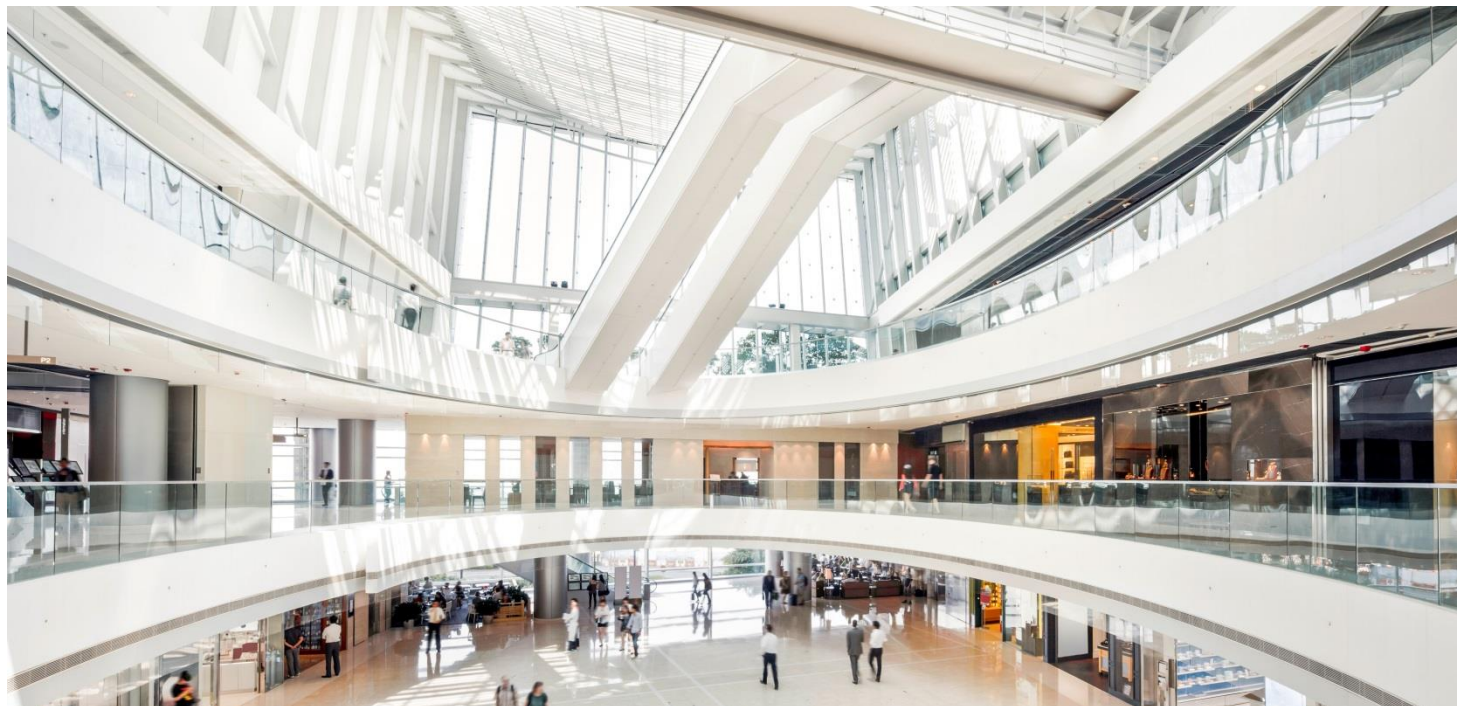


Real Estate Summary

Edition 3, 2019



Rate cuts support real estate values.
Economy is a risk to tenant demand.

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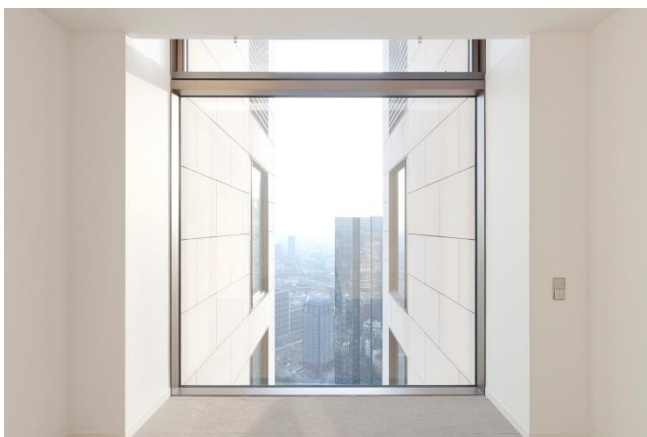
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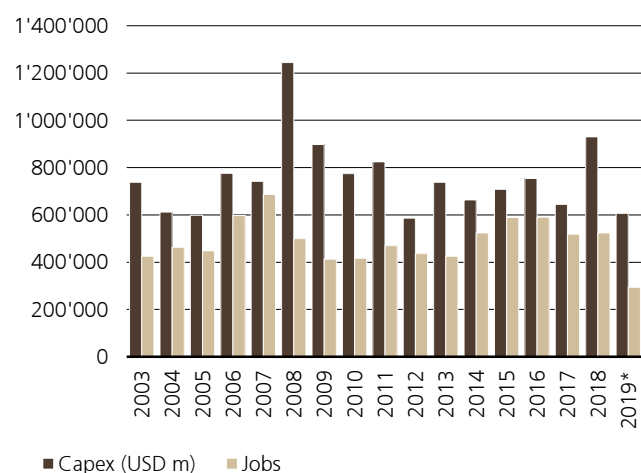
Global overview

The world has changed. Markets have reversed their expectations vis-à-vis central banks, from tightening to loosening. The growth outlook, meanwhile, is modestly weaker on the back of trade and political uncertainty. Both are significant for real estate but the monetary shift will have more lasting consequences.

Macroeconomic overview

The past few months have bred a profound change in the monetary policy outlook. The consensus rallied behind a 'precautionary' rate cut from the US Federal Reserve (the Fed), which it duly delivered in July. Meanwhile, the debates at the European Central Bank (ECB) and the Bank of Japan (BoJ) have now shifted from a cautious curtailing of Quantitative Easing (QE) towards discussions about how to expand asset purchases and cut interest rates further. In the space of just seven months, the view of the Fed has gone from a further, modest rate hike to a slight easing cycle. Other central banks had already eased before the Fed acted, including in South Korea and Australia, and most forecasters now expect rate cuts from the ECB and the Swiss National Bank before the end of the year. Amongst high income economies, only Norway is rowing the other way, hiking rates in response to domestic inflation.

Figure 1: Global greenfield foreign direct investment (FDI)

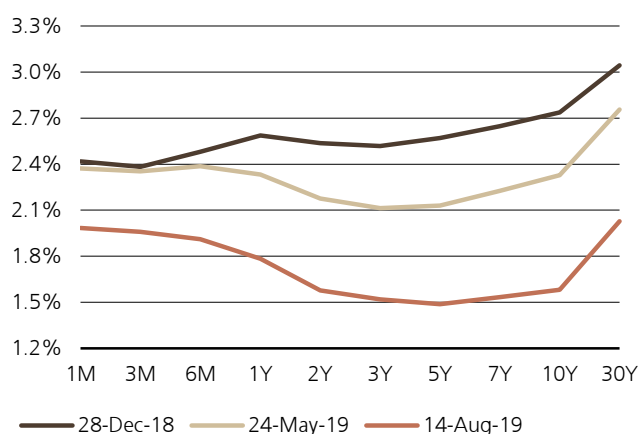


Note: * 2019 data has been annualized from end-June
Source: fDi Intelligence, as of June 2019

Political uncertainty, meanwhile, is dampening business investment and, if anything, this has intensified (see Figure 1). The G20 tariff ceasefire between China and the US was abruptly shattered in August when the US and China announced additional reciprocal tariffs on a further range of goods, effective September though some US increases will be delayed until December to minimise impact on the holidays. The issues separating the two are deeply embedded in domestic political interests. The US has other trade disputes on its agenda, not least over automobiles with, amongst others, the EU and Japan. In addition, the US Congress is bitterly divided, the UK is paralyzed by Brexit and a trade war has erupted between Japan and South Korea.

Moreover, a new front has emerged in the form of a possible currency war, with the US declaring China a currency manipulator, and may start to actively intervene in FX markets¹. Political risk does not directly influence commercial real estate markets in the short-term. However, the longer business investment is depressed, the worse it is for the economy... and that will impact on real estate demand.

Figure 2: US forward yield curve (%)



Source: Datastream, as of 15 August 2019

If the growth outlook has deteriorated enough to warrant a reversal in central bank policy, it should also trigger a review of demand and rent growth expectations. A weaker trade and investment outlook will constrain real estate, most immediately for smaller, more open economies. The recent downgrade to Singapore's forecasts is notable. But there are relatively few examples where the facts are markedly worse than they were seven months ago. In addition, labor markets remain very healthy: the high income country aggregate of the International Labour Organization's jobless rate is at a record low of 5.1%, although the data only go back to 1991. The US, the UK, Germany, and others have comparable figures at generational lows.

All told, investors should be a little more conservative about the demand side of the equation, but not markedly more pessimistic. Central banks are attempting to sustain the same rates of growth, but they believe now that slightly easier policy is needed. In July, the US, the world's largest economy completed its 121st consecutive month of expansion, the longest since records began in 1854². Long expansions are good for real estate, particularly when new supply remains broadly in line with demand and vacancy rates are comparatively low. In most cases, this is true today.

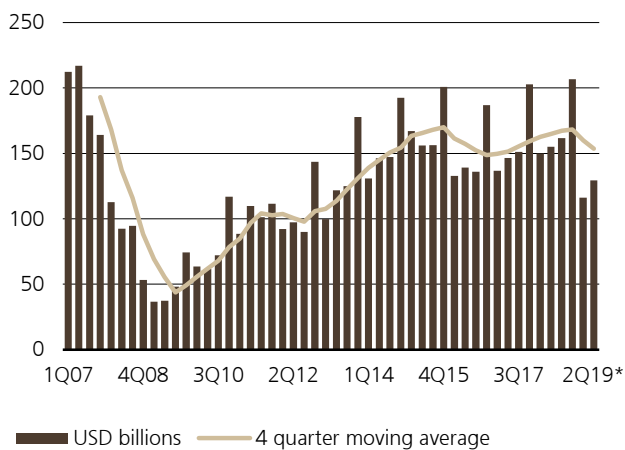
¹ UBS Investment Bank, "FX intervention: Can Trump intervene in the dollar?", 18 July 2019

² <https://www.nber.org/cycles.html>, accessed August 2019

Capital markets

The shift in interest rate expectations could also have a meaningful impact on real estate pricing. The past few quarters have been dominated by a concurrent slowdown in price growth and transaction volumes, albeit proceeding at different speeds across markets and sectors. In the first half of 2019, yield compression outside of the logistics sector effectively came to a halt while the pace of value erosion in retail accelerated. Meanwhile, transaction volumes in income-generating real estate plunged in 1Q, with only a small pickup evident in 2Q (Figure 3).

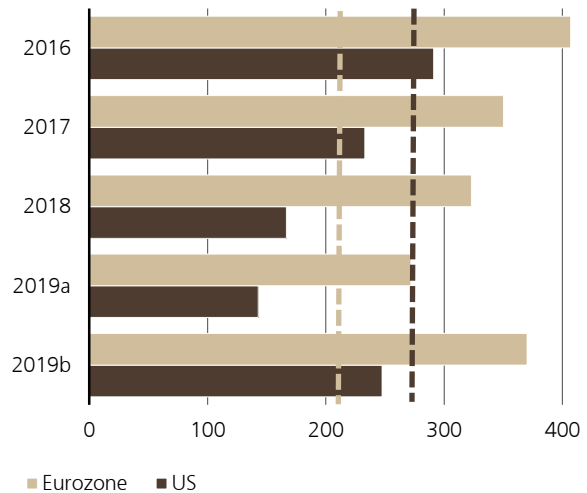
Figure 3: Commercial real estate transaction volume



Source: Real Capital Analytics, July 2019

We ascribe this 'pause' to several factors: a shortage of product for sale, increased uncertainty regarding both politics and the economy, as detailed above, and a recognition amongst buyers that prices were historically elevated. This can be illustrated by the risk premium: the spread between the risk free rate and property yields, proxied in Figure 4 by the all property income return from MSCI. The 2019 scenarios illustrate the swing in benchmark rates: 2019a is the risk premium based on 10-year bond forecasts as at December 2018, while 2019b is the same forecast income return spread over today's bond forecasts. The US has gone from being historically expensive to roughly fair value. To misquote Dinah Washington's 1959 cover song: "*What a difference a [few months] makes...*"

Figure 4: Real estate risk premium, basis points



Note: Dotted lines indicate historic averages, 2001-18
Sources: Oxford Economics; MSCI; UBS Real Estate & Private Markets (REPM), July 2019

Before considering how investors should respond to this change in outlook, it is worth a glance at the troubled retail sector. It has been hit by a double-whammy of major structural change and depressed investor sentiment. As a share of transaction volumes globally, retail has averaged nearly 21% per quarter since 2007 (Figure 3). This fell to 13.8% by the end of 2018 and just 11.4% in 2Q. The lack of activity is providing valuers with very limited transactional evidence.

Better located and quality stock will be more successful at maintaining rents and at re-letting or converting vacant space. The worst located, most over-supplied, least able to adapt stock will ultimately be redeveloped into other uses. Historically, retail has been the best performing asset class, with the highest risk-adjusted return and the lowest volatility over the cycle, particularly in markets with long performance indices like the US and the UK. It will be a challenging time for all retail, but not all retail will perform poorly. We will explore this in more detail in the subsequent regional sections.

Strategy viewpoint

How should investors respond to the renewed widening in risk premia? With long-term interest rates headed back down, the relative attractiveness of real estate has been given a further boost. Particularly in negative-to-low interest rate markets like continental Europe, further yield compression is possible, notwithstanding the fact that yields, particularly prime yields are already exceptionally low in key markets. According to surveys and data providers like Preqin, there is an abundance of dry powder in the hands of the real estate funds, while investor intentions generally indicate a desire to increase allocations to real estate. This means that, provided fundamentals hold up, capital is available to spur further price increases. However, as rent growth is broadly slowing down, any above inflation rise in capital values would likely entail a further round of yield compression.

Given the demographic outlook, this is quite possibly the brave new world: lower yields, lower interest rates, lower inflation, lower growth, and lower returns. This has been posited for some time but has yet to seep properly into investment planning for major institutions like pension and insurance funds. What is more likely, at least in the short-term, is further pressure on so-called 'alternative' sectors like self-storage, student housing, many of which carry operational risk. There will be increasing creativity in what is qualified as niche real estate. We have written elsewhere about [data centers](#)³, and where real estate stops and infrastructure starts. But other small universe assets will be posited as 'institutional', e.g. camp grounds, trailer parks, movie studio lots. Be wary of pricing.

We also expect further yield compression in tier 2 and 3 markets, or sub-markets in the larger cities. This is particularly true in the ultra-low interest rate markets, like the eurozone, Japan, and Switzerland. This too comes with some increase in risk, due to thinner occupier markets and less liquidity in times of market stress. This, however, is manageable for certain types of long-horizon buyers, with pension and insurance institutions falling into this category.






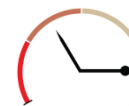





















Another area that deserves attention is leverage. Borrowing costs have been low throughout this cycle, but a mix of risk aversion following the last crisis, increased regulation of banks, and the expectation of rising long-term interest rates kept loan-to-value (LTV) ratios historically low. Now that 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 for the purposes of a 10-year underwriting, the 'lower for ever' paradigm is one worth embracing. We are hesitantly 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.

³ Innovation – An opinion about change – Technology – Paper 4, September 2018

Real estate investment performance outlook

2018 performance and 2019-21 outlook are measured against the sector's long-term average (LTA) total return, with a margin of 100bps 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 2018 or the 2019-21 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	3.9		5.4		6.8			
	Switzerland	5.5		6.4		6.9		6.3	
	UK	8.3		7.4		10.2			
	Asia Pacific	Australia	10.4		10.7		11.0		
	Japan	5.4		5.6		6.0		5.0	



Source: UBS Asset Management, Real Estate & Private Markets (REPM), July 2019. Note: Actual returns may vary materially from forecast returns. Abbreviation LTA: Long-term average

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APAC summary

The trade row effects continue to permeate through the APAC economy. Domestic demand is still holding up, but the public sector is coming to the fore to support growth. Industrial real estate is the best performing segment this quarter, while sentiment shift in office becomes more notable. Prime retail rents are still supported by tight vacancy, while investment volumes slipped in 1H19, in part due to a high base effect.

APAC summary

Real estate fundamentals

Pump-priming

The effects of the US-China trade row continued to permeate through the APAC economy in 2Q19, now more apparent than before given the end of the front-loading effect that we saw in late 2018. That might not be too damaging if the global economy had still been going strong, but the converse seems to be true in that the decade-long global expansion looks to be running out of steam. Export weakness was seen in China, Japan, Singapore and Hong Kong, with Australia spared due to the run-up in iron ore prices. At the time of writing, there is still no resolution to the US-China talks. With things on the external front set to remain challenging in the near-term, the hope that most are holding onto to bolster their respective economies is resilient domestic demand and the services sector.

Indeed, with the labor markets still generally tight across APAC, there is reason to believe that this might provide some support to domestic consumption. With the exception of Hong Kong, retail sales data across China, Japan, Australia and Singapore have been largely range-bound. But it might be prudent to remember that the domestic sectors are often not completely divorced from the external sectors, even in economies that are not primarily dependent on trade. There are indirect effects of the trade conflict on consumer sentiment, business investment decisions, job creation and the labor market, in addition to specific challenges facing each economy such as the housing market downturn in Australia and corporate resistance to raising wages in Japan.

In typical Keynesian economics style, the real hope of stimulating economic growth in APAC now lies with the public sector, be it through monetary or fiscal policy. In China, loosening of lending conditions has been instrumental in helping to revitalize credit growth in early 2019. In addition, increased spending on roads, railways and ports has helped to halt the decline in the growth of fixed asset investment. Subsidies and cuts in personal and company taxes further serve to stimulate domestic demand. Similarly Down Under, the Reserve Bank in Australia cut its benchmark cash rate two months in a row to a record low of 1.0% in July 2019 with the aim of shoring up confidence and employment growth. At the same time, the bank regulator, the Australian Prudential Regulation Authority, eased lending restrictions on mortgage loans to help rejuvenate a moribund housing market.

Government consumption expenditure was one of the outperformers in Hong Kong in 1Q19 with growth of 4.5% year-on-year (YoY) compared to a 0.5% expansion of the overall economy, supported by ongoing infrastructure projects. In Singapore, expectations of monetary policy easing have risen, with some foreseeing that the central bank would soon reduce the slope of the trading band of the Singapore dollar nominal effective exchange rate.

Even in Japan, where interest rates are already at ultra-low levels, the Bank of Japan has started to expand its monetary base again after almost a year. In addition, the government has prepared a stimulus package to support the economy after a planned tax hike. The question now is whether the government will even go ahead with the proposed consumption tax in October. While recent rhetoric indicates that there is no change to the current plan, it is not inconceivable that it might abort the increase given the recent patch of soft data.

Retail

In the previous section, we saw that retail sales have been resilient in China and Australia, but it is hard to escape the downbeat mood in other parts of APAC. Singapore and Hong Kong saw growth in retail sales turn negative from February onwards, perhaps unsurprisingly given how exposed their economies are to trade (and the resultant effect that would have on consumer sentiment). In Japan, the anticipated pre-emptive boost in retail sales ahead of the planned tax hike has not yet materialized, unlike the spike seen the last time the tax was raised in 2014.

Nevertheless, it is tricky to infer the performance of retail rents from that of the overall consumer market given the increasing importance of micro-location factors. While leasing activity softened in Singapore and Hong Kong in 2Q19, prime retail rents were still resilient due to low vacancy rates and continued demand for prime space. Similarly in Tokyo, the prime Ginza area has a vacancy rate of less than 5%, and with tourism inflows hovering around record high levels, there was support for rents, which were stable in 2Q19.

In Australia, much has been made about the struggles of the discount department stores which continue to consolidate but this has largely affected the sub-regional malls, with prime central business district (CBD) retail and neighborhood malls still relatively insulated. Tier 1 cities in China face a sustained wave of new completions in the pipeline. Most of the new stock will be in the suburban areas, which matches the expected population growth as these cities expand. While this presents near-term supply challenges, it also highlights the long-term prospects of retail in China given the shift towards consumption-driven growth.

Indeed, the opportunity set in the retail sector is increasingly a "barbell model", with the best options residing in the prime retail and suburban retail on the other end. The danger is in writing off retail altogether when well-located malls with stores and services that cater to consumers' needs are still a core part of the physical landscape. The hard part is figuring out what works in an ever-evolving retail scene. Even with e-commerce, it is not a one-way migration of consumers from offline to online – observations in Australia suggest that having a web presence also increases physical footfalls and in-store purchasing activity, a trend which is now deemed as Research Online, Purchase Offline (ROPO). E-tailing giants in China are also showing huge appetite for offline expansion as they create a "boundary-less" retail environment. Landlords of new malls in Singapore are hoping to captivate audiences with new concepts such as indoor waterfalls, rooftop gardens and farm-to-table restaurants. While placemaking is likely to succeed in retaining consumers, the challenge for landlords would be extracting value out of footfall, dwell time and the shift towards more services-based retailers.

Industrial

Despite the trade tensions, performance of industrial real estate in APAC was generally positive in 2Q19, thanks to the countervailing force of rising e-commerce which continued to spur demand from third party logistics (3PL) companies. In many APAC cities, tight vacancy rates and limited industrial land are also key factors in the positive performance of logistics rents. For example, Hong Kong, which would arguably be the most affected by the US-China trade war, has a vacancy rate of 2.1% for its prime warehouses. This is further supported by the government's industrial revitalization scheme, which seeks to make better use of industrial space given the society's changing needs. Similar policies can be found in the Chinese Tier 1 cities of Beijing and Shanghai, which have seen restrictions on industrial land supply in recent years, leading to a fall in vacancy rates to around 2-8%.

The only country in developed APAC where industrial stock seems to be moving in the opposite direction is Australia, which has seen an increase in speculative development particularly along the Eastern seaboard. But this has yet to become a problem given population growth and buoyant demand for warehousing and logistics facilities – vacancy rates are tight in Sydney and Melbourne, and the average time that new stock is on the market is reported to be one month for Sydney and two months for Melbourne.

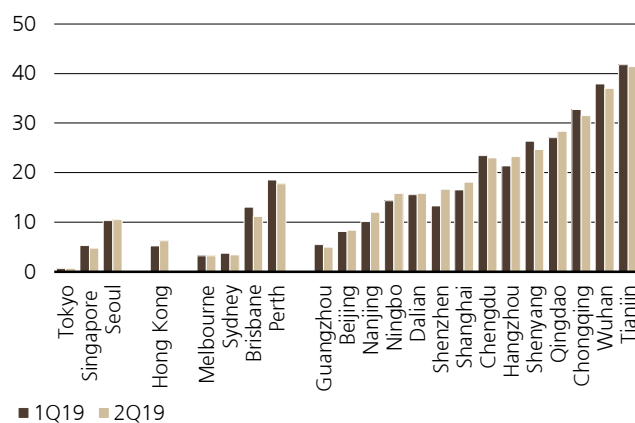
Across the large cities in Australia and Japan, there is a push towards more efficient supply chains amid increasing e-commerce penetration, consumer desire for shorter delivery times and labor shortages, which makes improving the last mile an increasing focus of the logistics sector. As a result, there will likely be a rise in demand for facilities in infill locations closer to both the consumers and employees.

Office

Although most of the office markets across developed APAC continued to remain tight in 2Q19, the shift in sentiment has become more notable. Indication of this downward tilt in sentiment is not widely reflected in the data as yet but instead manifests itself in more subtle ways.

Figure 5: APAC CBD office vacancy rates

(% of existing stock)



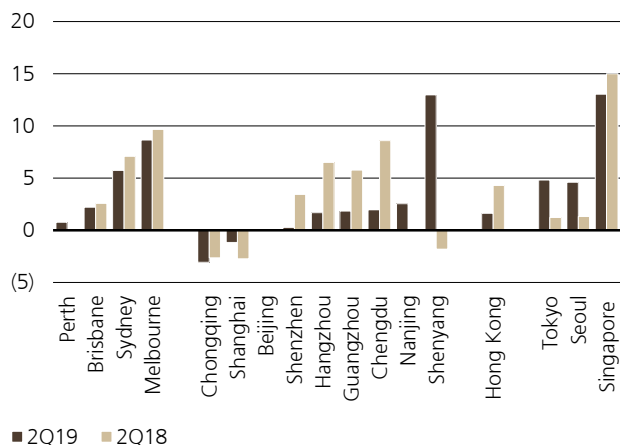
Source: CBRE, 2Q19

In Tokyo, for example, the prime vacancy rate still remains very tight at 0.7% (Figure 5), but amidst a weakening of corporate sentiment, brokers note that leasing negotiations are now taking longer to conclude. Rents continued their seven-year uptrend with a 4.8% YoY increase in 2Q19, but with high levels of supply expected to reach completion in the near-term, rents might too hit an inflection point soon.

Similarly, the vacancy rate continued to tighten to 4.8% in Singapore but there is more caution among occupiers, with some banks reportedly right-sizing. In Hong Kong, overall rents slipped 0.6% quarter-over-quarter (QoQ), the first decline since 2Q14. Rents in the core central sub-market saw the biggest drop (-0.8%), likely due to a combination of the softer economic environment as well as rents hitting resistance levels. On the other hand, the high rents and tight supply in Central appear to be hastening the decentralization trend with more firms across a range of sectors seen moving to non-core locations.

With the exception of Guangzhou, landlords in Tier 1 cities in China are largely feeling the effects of an influx of completions, with tenants increasingly gaining the upper hand in negotiations given the still substantial supply pipeline. Cities in Australia appear to be the only ones bucking the trend as demand remains strong and vacancy rates continue to tighten to historical lows. Rents in Melbourne and Sydney rose 8.7% and 5.8% YoY respectively (Figure 6), while those of Brisbane and Perth also appear to be at the start of a cyclical pick-up, with increases of 2.2% and 0.8% YoY respectively.

Figure 6: APAC CBD prime office rent growth (% p.a.)



Source: CBRE, 2Q19

Capital markets

According to preliminary data from Real Capital Analytics (RCA), transaction volumes of APAC commercial property in 1H19 were lower by almost 18% YoY. Most markets held steady while others experienced resistance in investment interest that had persisted since late 2018. Much of the decline this year was led by Japan and Hong Kong. To be fair, a high base effect had some distortionary impact, particularly as volumes in Hong Kong surged in the past two years. The momentum has clearly been stopped in its tracks due to ongoing sociopolitical developments, with commercial property volumes falling by more than 45% from 1H19.

This time last year, several large office transactions in Japan helped to support overall volumes but these deals were sorely lacking in 2019 so far. Domestic REITs continue to dominate activity in Japan and investors have also started to increase their exposure towards regional markets. Office transactions stayed focused on Greater Tokyo, but the distribution of retail and logistics transaction activity has clearly started to spread across Japan as the distribution of inbound tourists and the pervasiveness of e-commerce have led to more opportunities outside of core Tokyo and Osaka.

In Australia, transaction activity in the second quarter of 2019 was boosted by the sale of a portfolio of three Sydney office assets by Scentre Group. The buyer, Blackstone, reportedly paid in excess of AUD 1.5bn in total for one office building at Market Street and two more at Castlereagh Street. Again, we are aware that these highs and lows in transaction activity are often not as meaningful as the fact that transactions are indeed taking longer to close. Often, the nature of the extended negotiations and due diligence can lead to lumpy sales volumes, especially as pricing starts to look toppish.

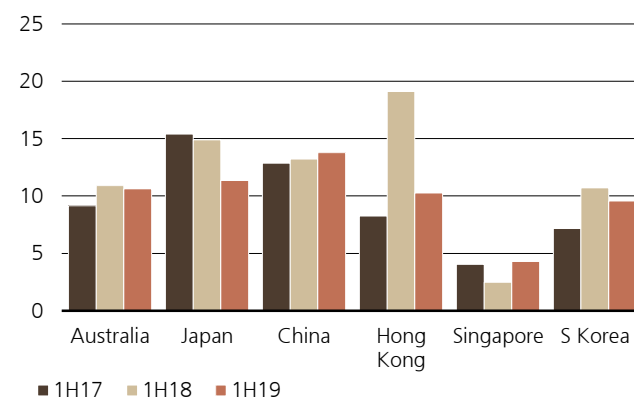
On the back of a potentially longer run in the office occupier market and still positive yield spreads, prime yields in most Australian markets are currently at the tightest in recent times.

In China, foreign investors started to hit the brakes on buying activity in the second quarter of 2019. Much of that was due to heightened uncertainty arising from trade tensions. On the domestic front in China, the tight yield environment has led to capital having very limited choice but to invest in lower tier cities and other asset classes in a bid to ensure deployment is met. These combined to ensure that transaction volumes stayed relatively stable compared to the same period last year.

Singapore did comparatively well in the first half of 2019, with transaction volumes surpassing those of 1H18. However, the chunky nature of the investment activity masks the fact that the number of transactions was actually not high. Notably, cross-border capital and funds continue to be keen in the Singapore commercial real estate space. After the sale of Chevron House to AEW Capital in March 2019, Frasers Tower was reportedly sold to Korea's NPS for more than SGD 1.9bn. At a quoted yield of 2.8% (according to RCA), this is most reflective of the situation in the Singapore capital markets – strong inflows chasing limited core assets. The stability of Singapore's economy has made it a magnet for both institutional and ultra-high-net-worth money, and that is unlikely to abate given the global economic uncertainty.

Recent macroeconomic developments have prompted the US Fed and other major central banks to reverse course and revert to dovish attitudes again. Bond yields have generally resumed their downtrend and yield spreads again inched up since late 2018. Unchanged from the last edition, we like to stress that property yields across most APAC markets are already at their lowest in the last decade. That does not mean prime yields cannot tighten further, especially with the relative appeal of real estate in a low yielding world. It does, however, imply we are almost reaching the floors of absolute yield levels.

Figure 7: Commercial real estate transaction volumes (USD billion)



Source: RCA, as at July 2019

Strategy viewpoint

Australia retail: Catching a falling knife?

We turn our attention towards the retail sector in Australia, which is probably a timely discussion given that much of the narrative has leaned towards the negative this year. Globally, the retail segment has been assailed by mounting pressures on retailer performance, particularly in the last few years. In the US and the UK, the pessimistic rhetoric has permeated across investment sentiment, amidst store closure woes and downsizing of retailer operations. The reasons behind the slump include muted consumer sentiment, the structural growth of e-commerce and changing shopping habits, amongst others.

As we engage with managers and principals in the Australian retail space, the mood is generally somber but sentiment is largely divided. Local groups and owners of retail assets are aware and cautious about the challenging operating environment, but they do not see severe fallout in the Australian retail sector. On the other hand, investors are looking towards the situation in the US, and some have extrapolated that towards their views on the retail market Down Under. To be fair, existing investors are not selling out in hordes yet, but new investments into the retail sector have turned indolent and guarded for sure. As recently as three years ago, foreign capital found it almost impossible to source for and acquire high-quality retail assets. Now, even if dominant and well-performing assets are on the market, the same investors are hesitating and less willing to bite the bullet.

The underlying concern here is value, or rather the perceived notion of value not being reflected in asset pricing yet. In our view, the price discovery process is mired in dilemma arising from mixed sentiments. In the market, we are not seeing much distressed selling in the retail sector. Of course there are liquidity windows for funds and if investors start to redeem on allocations, that might create a domino effect on re-pricing and increase the momentum to sell down. With that in mind, investors do not want to be caught catching a falling knife, which culminates in reduced transactional activity and offer prices. The sardonic flipside of this scenario is, should asset prices even start to correct, and probably southwards in search of equilibrium, will investors then be assured that prices are fairly adjusted already? Or will the outcome be the same such that no one makes a move in anticipation of further downward shifts in capital values?

Our house view on the retail sector across APAC has remained neutral and unchanged in the past year. We still favor prime retail and high street retail supported by tourism, as well as dominant suburban or regional retail centers.

In the case of Australia, occupier performance has been positive in the dominant and prime retail segments, and rent growth has been encouraging in general. In our view, geography is less important than asset specific sub-markets and attributes. A dominant super-regional center in Adelaide can arguably produce better investment outcomes than a sub-par Sydney CBD-fringe retail asset.

On the risk front, clearly, e-commerce is a dilutive and disruptive force on the physical retail outlook, but the impact is not even across the board. Super-regional centers, anchored by supermarkets, continue to see strong traffic footfall. The retail mix is evolving towards more experiential and lifestyle offerings, and positive rent reversion is not unachievable in well-managed centers which have been forward-looking in complementing structural changes in shopping habits. In terms of valuations, we see a potential risk stemming from overly cautious valuation metrics. Ground feedback has provided some anecdotal evidence that valuers are increasingly unwilling to work with rental growth assumptions that seem to be above trend, and are even more restrained in their approach for retail assets with already high occupancy costs.

Generally, the drivers of retail in Australia are resilient and still pronounced. On the more macro level, different states and cities are at varied stages of economic expansion, but the overall economy is on its 27th consecutive year of growth. More recently, consumer sentiment was trending down on the back of declining home prices and the consequent negative wealth effect on domestic spending. The May 2019 federal election results saw the Liberal-National coalition secure a majority government, and that has immediately allayed original fears of sweeping changes to negative gearing and capital gains taxes. Further, the introduction of policies to support first time home buyers is also a massive tailwind for consumer sentiment. Population growth is also a major catalyst in the Australia retail context. The influx and growth of residents in some areas will create opportunities for dominance in regional centers which are able to capture the residential growth. Beyond that, we are also hopeful that the ongoing growth in employment can materialize into meaningful wage growth in Australia. The recent cash rate cut by the Reserve Bank of Australia is unlikely to feed directly into cap rates, but will have an indirect and constructive spillover impact on corporate and consumer sentiments.

Our recommendation is for existing investors to maintain a cautious watching brief and to be wary of knee-jerk reactions. New investors need to be conscious that buying into retail now means buying into a very different risk profile from a few years back. However, high-quality and dominant retail assets in Australia will continue to see value in the mid- to long-term.





European summary

The European economy is seeing a general period of weakness at present, although real estate demand remains strong in most locations and sectors. Supply continues to be largely restrained. Investment volumes are declining, however pricing remains at very high levels historically. The sustainability of this depends largely on the future direction of government bond yields, which we discuss in our viewpoint section.

European summary

Real estate fundamentals

Economic fundamentals weakening but real estate demand mostly solid

The short-lived "euroboom" seems a long time ago now as the Eurozone has seen challenging market conditions, which have continued into 2019. Following reasonably strong growth of 0.4% in 1Q, 2Q output is thought to have slowed to around 0.2%.

The key theme of the moment is divergence between services and a struggling manufacturing sector. This even applies to Germany, whose industrial economy is a key driver of eurozone growth. In fact, industrial activity has been very sluggish in 1H, with both the Purchasing Managers' Index (PMI) and IFO indicators coming in very weak. German industrial weakness has been driven by a poor outlook for global trade and structural challenges in the automotive sector.

2Q GDP numbers have been weak in almost all of the major European economies. However, the Spanish economy grew a further 0.5%, although this was its lowest quarterly outturn in five years. The positives are that inflation edged lower again to 1.1% which, combined with the underwhelming GDP numbers, likely indicates the ECB will loosen monetary policy again in September. Another bright spot was continuing employment growth across all countries bringing the eurozone unemployment rate down to 7.5%.

European office demand has been steadily rising since 2014, although the last four quarters have been somewhat skittish. Nonetheless, there still appears to be high demand for prime space in most of the major European office markets, especially as new supply coming on-stream is still highly restricted. None of the major markets saw prime rental decline, while many saw increases.

Portugal has been the in-vogue market of late, and justified this status somewhat with strong rental increases in Porto (16.1% YoY) and Lisbon (12.2% YoY). Spanish cities continue to perform well in-line with the fundamentals, as Barcelona and Madrid both saw prime rents rise by over 8% YoY. German cities continued to see high levels of demand, with all cities recording growth most notably in Berlin and Hamburg which both grew by just over 11% YoY.

This may seem surprising considering the waning demand, however this number makes sense when we consider the levels of availability. Berlin and Munich now have vacancy rates below 3% while Barcelona and Madrid have seen vacancy fall consistently over the past few years. London still has very low amounts of prime supply, with the City at just 5% and the West End at 3.5%. There is, however speculation that a secondary supply shock could be brewing as much of the take-up for new space coming on-stream has been driven by existing occupiers relocating to new premises.

The retail sector continues to be a source of weakness both in terms of low demand and structural over-supply. The former narrative used to be that the squeezed middle would suffer, while prime dominant assets and more local amenity-driven centers would outperform. However, Unibail-Rodamco-Westfield (URW) results this week stated that even in the two super-prime Westfield centers in London rents have been falling. The stress varies by segment and geography; it is thought that shopping centers are more affected than high street and retail warehouses, and the UK more affected than Europe. That being said, most major UK cities saw prime rents hold firm 2Q19, while Brussels (-10% YoY), Amsterdam (-3.4% YoY) and Barcelona all saw decreases. There were a few bright spots, however with Milan (7% YoY) and Naples (3% YoY) both seeing prime rents move up.

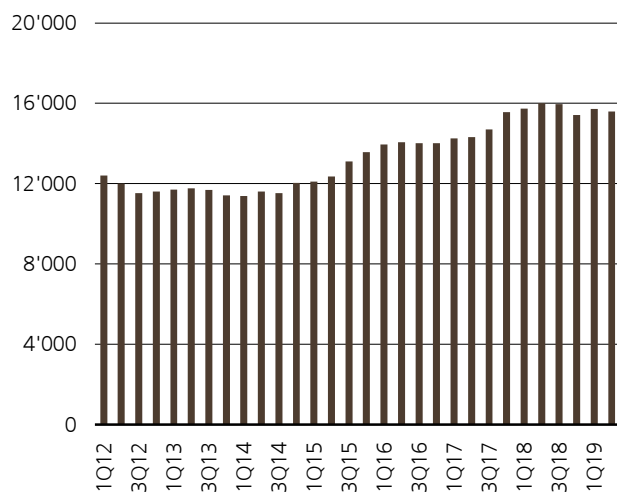
Vacancy continues to rise in most markets, particularly in the UK as well due to increasing amounts of company voluntary arrangements (CVA). In addition, there is heightened caution among retailers still trading, with anecdotal evidence of successful retailers seeking rent reductions from landlords. This is due to a combination of weak market conditions as well as the impact of e-commerce, which has radically reduced the number of stores required to achieve national coverage. While there is not much available data covering European supply, 1Q data from PMA showed that vacancy increased again in both high street and retail warehouses.

Interestingly, prime retail parks saw an uptick in vacancy while secondary parks remained stable. This reflects the greater exposure of prime parks to fashion tenants and comparatively higher rents. Overall, it is unlikely the rental and capital declines have ceased for now, as there is a significant amount of stock in most European countries which is in significant need of capital expenditure and repositioning.

The industrial sector continues to eat retail's lunch, with leasing volumes strong across most European countries and prime rental growth coming in at a healthy 3.8% YoY (Figure 9). The growth of e-commerce is the main driver of this, as retailers compete with 3PL to secure the best sites. Logistics in and around major cities is particularly sought after, with key sites in most Western European markets now leasing at premiums of 2-3 times the out of town market.

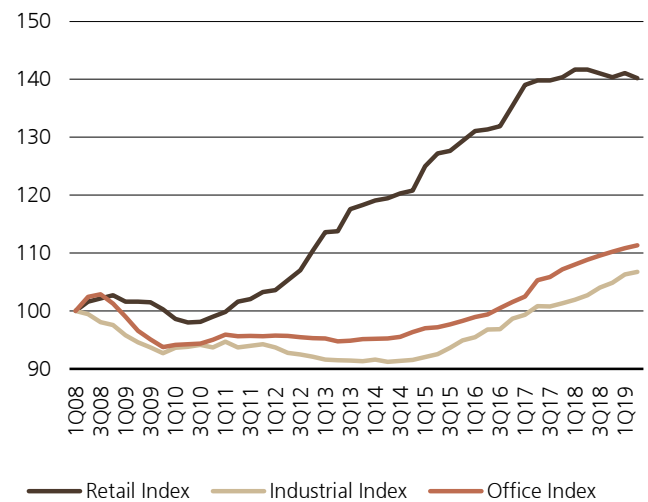
Supply remains fairly constrained in most countries, as speculative development has failed to recover due to the memory of the significant supply which ensued after the 2008 global financial crisis. This was something which hung over the market for a long time; indeed it was only in 2017 that rents overtook where they had been in 2008. As a result, developers have remained very disciplined and are opting to extend existing hubs rather than create new ones. The one possible exception to this is the UK, which has seen significant development, particularly in the big box segment, which has pushed up vacancy. Also, in the multi-let segment vacancy is increasing in Central London as occupiers appear to be feeling the pinch of high occupational costs.

Figure 8: European office take-up volumes
(000s sqm, rolling annual)



Source: JLL, 2Q19

Figure 9: European rental growth
(index, 100=1Q08)



Source: CBRE, 2Q19

Capital markets

Investment volumes were muted in the second quarter as a significant amount of political and economic uncertainty appears to have weighed on sentiment. A further issue is the relatively late-cycle nature of the European market, with prime yields at record lows in the majority of key investment markets. As a result, half-yearly volumes were down 15%, and 2Q19 volumes were 10% below the levels of 12 months prior (Figure 10).

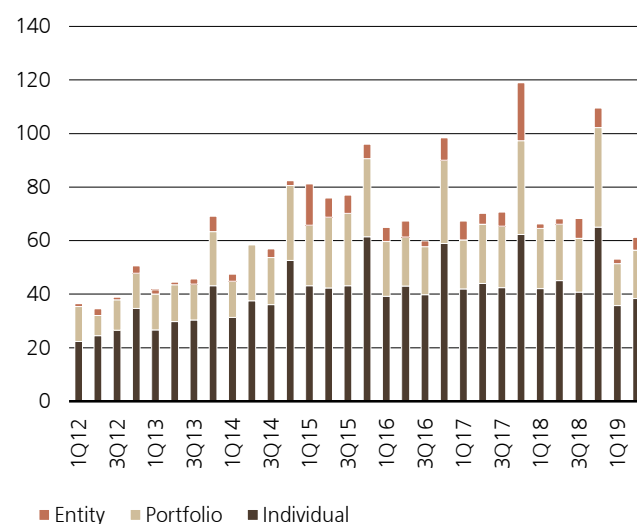
The decline largely maps the diverging fundamentals in the different sectors, most notably the troubled retail sector where investment dropped off by 51% YoY in 1H19. That being said, industrial also saw investment decrease by 16%, which is surprising considering offices only dropped off by 9%. One factor here is several large entities and deals in 1H18, but also a rising perception that industrial assets are possibly too keenly priced and therefore ever harder to underwrite. This is particularly pronounced in the UK where pricing is at very high levels and yields have already begun to move out. That being said, prime industrial yields in the eurozone compressed a further 46 bps YoY, suggesting that maybe continental Europe is slightly behind the UK.

In any case, the headline is that all traditional sectors saw volumes dipping over the last four quarters. Investors have turned instead to the so-called 'alternatives', i.e. more operationally-focused real-estate sectors. Hotels (+3% 1H19 versus 1H18), apartments (+6% 1H19 versus 1H18) and senior housing (+9% 1H19 versus 1H18) all saw increases in investment. There have been concerns about the liquidity and scalability of these sectors, however it does appear that they are becoming more established. For instance, approximately 30% of all UK assets bought in the first half of 2019 were in the "beds" category, hotels senior housing and private rented sector (PRS).

The regional split reflected geopolitical and economic concerns, with the UK seeing the largest decline and France and Germany seeing volumes fall by a slower amount. In terms of popular cities, London's mantle as Europe's most coveted investment market is now under threat from Paris, in the wake of a one-third decline in investment. One of the key drivers of this is that South Korean investors – the one major overseas investor in 1H – switched their focus from London to Paris, where they participated in several major syndicated deals. Indeed, South Korean investment increased 175% in the first half of 2019 compared to a year earlier, while other major overseas players have been far quieter. It is thought that lower hedging costs have provided a boon to investment from Asia, although that being said Chinese and Hong Kong investors did become net sellers as well.

While this was by all accounts a bad year for investment, it is unclear whether we are entering a downturn in capital markets as so much depends on the level of interest rates and intervention by the ECB. Previously markets were expecting hikes, whereas it is now looking likely the ECB will make further monetary accommodation in September, despite already having the lowest base rates compared with other major global markets. We have already seen prime yields in Munich drop below 3%, a level many thought was the absolute rock bottom for pricing. Should lower interest rates, persist for longer, we could see many other centers follow suit as investors become less concerned about rising bond yields depressing CRE pricing. This would have long-term implications for real estate investment, as is discussed in our viewpoint section below.

Figure 10: Investment volumes (EUR billion)



Source: RCA, 2Q19

Strategy viewpoint

Lower for longer or lower forever?

The future path of interest rates has long been a source of fascination (and concern!) for real estate investors. The low-rate environment of the last decade has been beneficial for investors in real estate, as there is a similar investor base for real estate and government bonds. The low-yielding bond environment has meant more money has been allocated to real estate pushing up prices. However, the conventional view is that rates will begin to rise, as soon as the loose monetary policy of central banks was reined in.

This view has been held for some years but – as the chart below shows – forecasted rises have been consistently wrong (Figure 11). Moreover, forward markets have recently changed to widespread expectations of rate cuts, particularly in the wake of the Fed cutting rates at its July meeting.

This is due to several reasons: firstly, central banks have been more tentative than many thought in reining in fiscal and monetary policy measures. Secondly, econometric models are inherently mean-reverting and as such will model data based purely on what has happened historically. Thus, these models will generally predict a 'snap-back' in rates based on where they are versus the long run average rather than material conditions. But thirdly, there is growing evidence of structural drivers which may depress interest rates over the long-term.

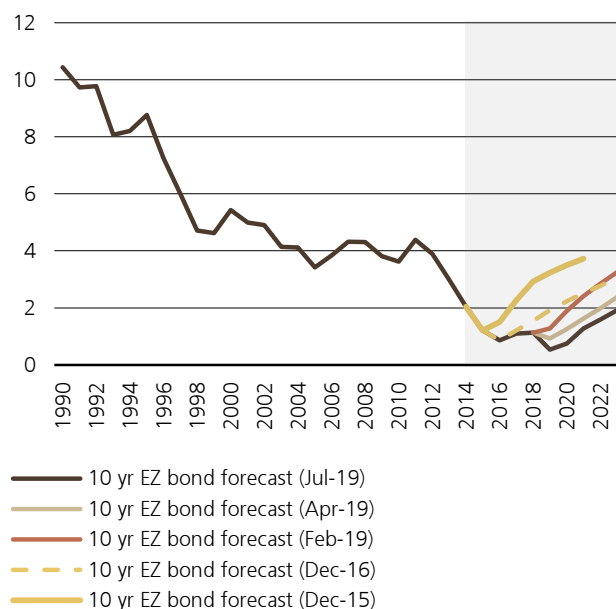
This third reason is what forecasters now have to worry about. There are many different viewpoints on what is driving bond yields so low. One interpretation emphasizes a structural increase in savings rates as the global population ages. Over the past 10 years, this has been further bolstered by the entry of China into the global financial market, with its large current account surplus. Others emphasize the relatively low capital intensity of the tech companies now driving the modern economy, when compared with their industrial predecessors.

There are, however cyclical explanations for this phenomenon, not least that bond yields tend to fall prior to an economic downturn. The economic recovery is very long in the tooth and should there be a spike in inflation it is likely yields will have to rise to compensate investors.

The answer to this question is unclear and vitally important. The 'secular stagnation' theory suggests that Europe is heading the way of Japan in having permanently low market interest rates, while others are less convinced and argue that eventually the forces that have held bond yields low will have to reverse. There are already potential clues as to where this could come from; China's savings glut is largely spent, while wider calls for heightened fiscal policy could absorb the rest. The baby boomers may also increase their spending once they reach retirement and will decline in number over the next 20 years.

While this is ostensibly positive for real estate, it provides a headache for forecasters as the yield on government bonds largely represents the risk free rate. Should the required return remain permanently low for real estate, investors will accept ever-lower yields and drive up prices further; there is already evidence of this with several key Western European office markets trading at sub-3%. However, bonds are liquid and can reprice overnight, whereas real estate cannot. Should the current low yield environment reverse, many real estate investors could be faced with significant capital loss. Smart investors will look to income as the main driver of returns in order to offset the risk of possible regime change in the public markets.

Figure 11: 10 Year government bond yields (%)



Sources: Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), July 2019





US summary

At mid-year 2019, US property sector performance diverged. Economic growth provides a sound backdrop for demand but is no longer accelerating.

Falling interest rates combined with little movement in the market cap rate mean the risk premium on US real estate increased.

US Summary

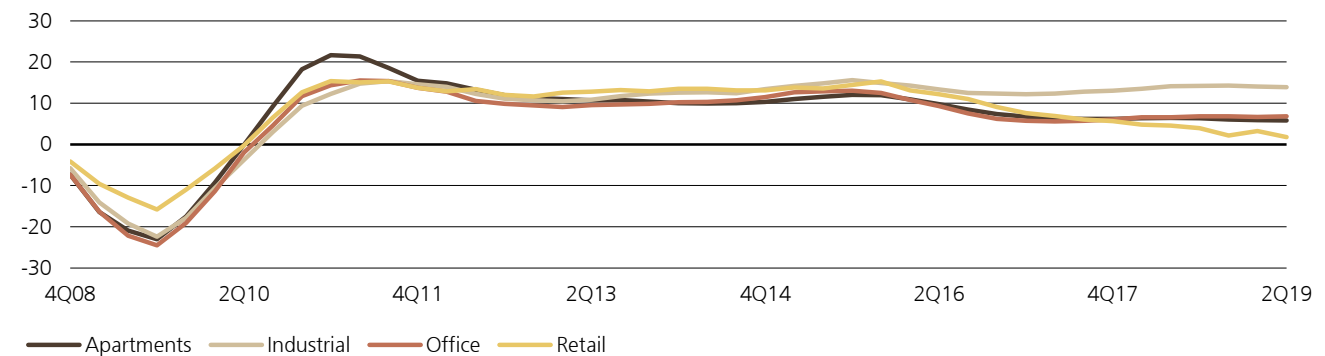
Real estate fundamentals

Private commercial real estate continues to produce steady returns, in-line with long-term expectations, even though there are big differences across property types (Figure 12). The income side of the equation is positive. Expectations are for continued growth, likely at a diminished rate. It's the valuations and capital expenditures that changed. Appreciation ranges from high in the industrial sector to negative in the retail sector.

The risk premium available in US real estate increased. After four short-term rate hikes in 2018, the Fed lowered rates for the first time in more than a decade during July 2019. For US commercial and multifamily real estate, lower interest rates mean the spread available in the sector widened a bit. Spreads had been low. Cap rates moved sideways or slightly downward in all but the retail sector, where cap rates increased.

Demand for space is supported by economic expansion and a strong labor market. Supply growth must be monitored closely. Supply eased in the office sector and is low in retail. For apartments and industrial, development is elevated, but currently, new construction levels are meeting strong demand, resulting in relatively stable occupancy rates and positive rent growth.

Figure 12: US real estate returns across property types. Annualized, rolling four-quarter total return (%)

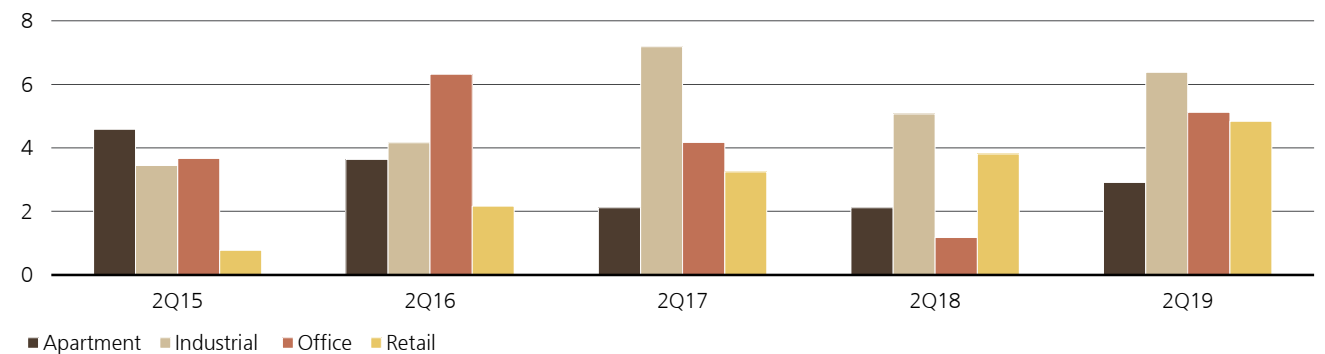


Source: NCREIF Property Index, 2Q19

We can further breakout real estate revenue into occupancy and rents. Occupancy rates are high relative to the past 10 years and occupancy faces a small degree of downward pressure with supply growth matching or exceeding demand.

As there is little room to increase occupancy, rent growth is the driving force behind income gains (Figure 13). Economic conditions create some optimism that growth will continue to reflect positive momentum for the US.

Figure 13: Property sector rent growth. Year-over-year change (%)



Source: CBRE-Econometric Advisors, 2Q19. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Apartments

Our expectation for the US apartment sector is "steady-as-she-goes". Supply and demand are balanced, resulting in positive but modest rent growth. Returns are income-driven with near-inflationary appreciation.

US homeownership was fairly flat near 64.1% in June 2019, representing an anticipated pause in a trend of increasing homeownership. Persistent labor market growth and consistent household formation help offset higher homeownership, supporting demand for multifamily rentals.

Apartment vacancy experienced a typical seasonal rise in first quarter 2019, but a surge in demand brought second quarter vacancy down by 60 bps to 4.0% (Figure 14). New construction is expected to increase through the middle of 2020. Year-over-year rent growth has remained near 3% of the last four quarters.

Industrial

Demand for industrial assets remains high, as this sector generates impressive double-digit returns. We expect 2019 to be another good year for industrial, but the low cap rate carries some future uncertainty. It is a good time to sell marginal assets, increasing the quality of portfolios, as increasing supply introduces more moderate expectations.

Growth in net rents remains strong. In the year ended 2Q19, industrial rents grew by 6.4%, notably above the five-year average of 5.2% per annum. Despite moderate easing during the first half of 2019, the pace of completions remains elevated, Figure 14. Forecasts expect rising completions over the coming year.

Industrial availability was 7.1% in second quarter 2019, unchanged from the previous quarter, nearly as low as it has been since 2000. Even as demand remains high, rising completions add increasing risk to the outlook.

Office

Office returns are in-line with apartments; however, capital expenditure requirements increased in the office sector, which results in thinner cash yields.

New office deliveries decelerated slightly over the past year, Figure 14. Exhibiting characteristic volatility, office rent gains outperformed inflation with Downtown's 8.3% annual growth; this unsustainable growth spurt far exceeding Suburban office's "steady as she goes" 2.7% rent growth.

Average office vacancy decreased 60 basis points from one year ago. The gap between Downtown office vacancy at 10.4% and Suburban vacancy at 13.2% remains wide. Downtown deliveries remain elevated, while Suburban completions have likely passed a peak period and remain steady over the year.

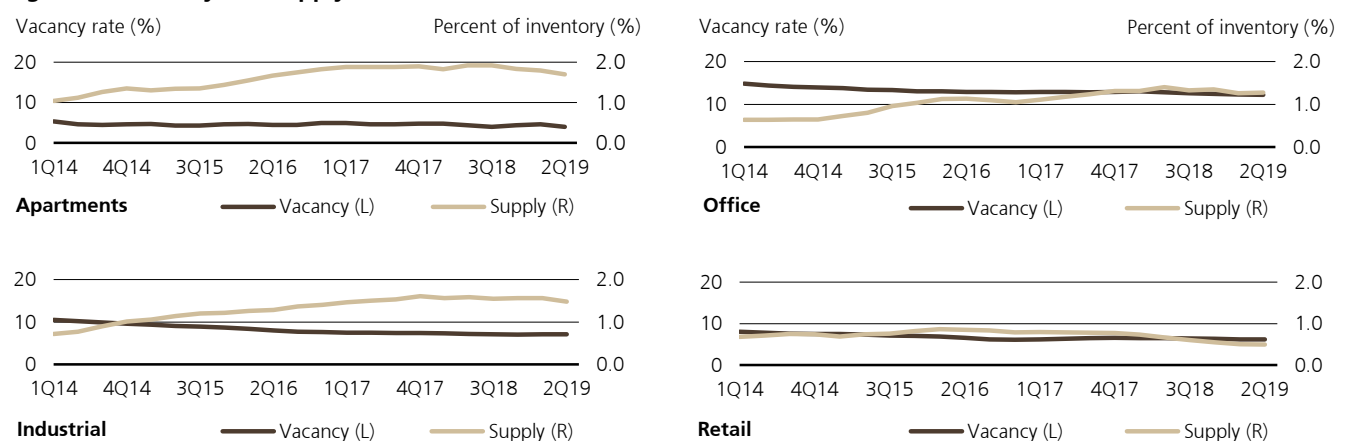
Retail

Capital requirements increased in the US retail sector, implying that the long-anticipated transition to mixed use centers is underway. Consumers are doing well; thus, increased disposable income and low unemployment should support retail sales in 2019. However, performance of the sector is likely to vary as the retail sector transitions to less apparel-based formats.

Mall/lifestyle center availability bounced between 4.8% and 5.6% over the past six quarters, while power center availability has been gradually increasing. Mall/lifestyle and power center asking rent growth are volatile, with little consistency from one quarter to the next.

At 8.8%, availability in Neighborhood, Community & Strip (NCS) retail is down 70 bps since the end of 2017, Figure 14. In the year ending second quarter 2019, NCS rents grew at a pace of 4.3%, more than double the pace of inflation.

Figure 14: Vacancy and supply trends

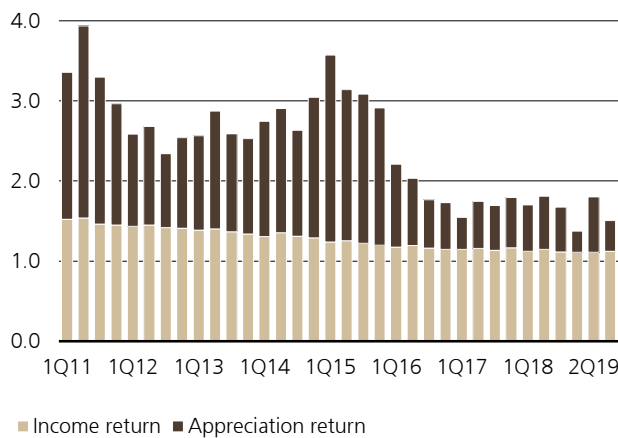


Source: CBRE Econometric Advisors, 2Q19. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory).

Capital markets

In 2019, we expect positive unlevered property returns driven by growth in income with moderation in appreciation, relative to recent years. In second quarter 2019, appreciation return slipped below that of the previous quarter, softening the NCREIF Property Index gain to 1.5% (Figure 15).

Figure 15: US property returns (%)



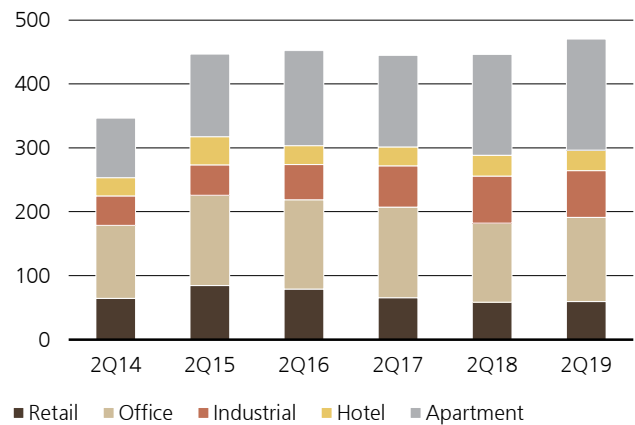
Source: NCREIF Property Index, 2Q19

In today's low interest rate, low cap rate environment, real estate debt capital is inexpensive and generally available. However, debt is not free-flowing like it was during the lead-in to the last downturn. The spread between property yields and the cost of debt decompressed somewhat in 2019. However, banks must contend with a flat yield curve. When both short and long-term rates are nearly the same, it becomes difficult to pay depositors a market rate while charging a competitive interest rate on loans. On the whole, US debt markets can be described as operational but not excessive, which encourages development but not an abundance of supply.

With little movement in cap rates, the downward move in Treasury rates widened the spread available on stabilized US real estate, (Figure 17). While the real estate spread is no longer compressing, the higher risk premium seems warranted as uncertainty around future economic growth also increased.

Total US commercial real estate sales volume was USD 470bn in the twelve months ended second quarter 2019, up slightly compared to the prior 12 month period. During the first half of 2019, sector trends remained consistent with recent annual performance. Sales of retail and office properties flattened after several years of decline, and sales of apartments increased, Figure 16. Industrial sales appear steady after tremendous growth in recent years.

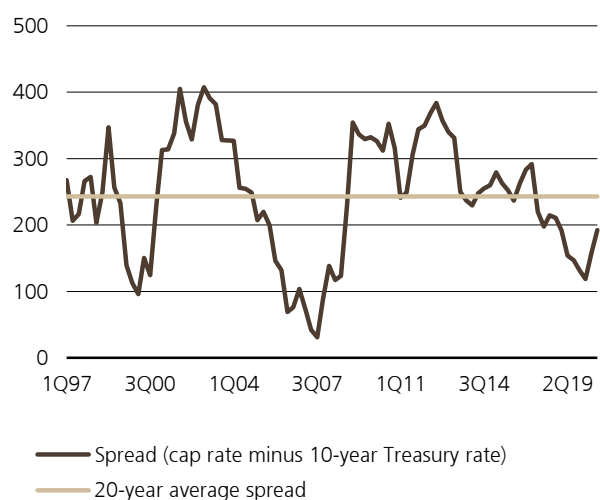
Figure 16: US transactions. Transaction volume (USD billions)



Source: Real Capital Analytics, 2Q19

That said, there is no obvious distress in the market that might put stronger upward pressure on cap rates. Income is growing; potential sellers can afford to be patient. In addition, debt is available, and capital expenditures are increasing.

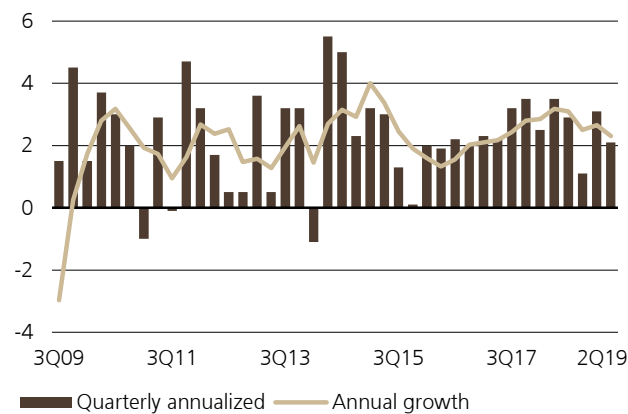
Figure 17: Commercial real estate spread (Basis points)



Sources: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 2Q19

Delving deeper into the fundamentals, a growing economy and tight labor market should continue to generate demand for real estate which supports income growth. After the first half of 2019, economic growth remains positive, although notably slower than during the first half of 2018. In 2Q19, GDP growth was 2.1%, which is near the long-term trend (Figure 18).

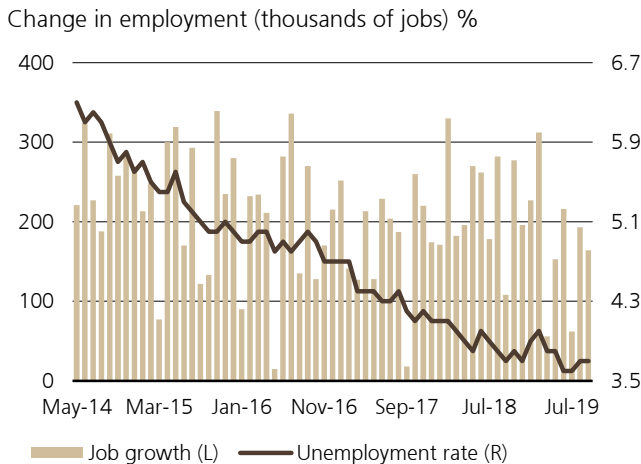
Figure 18: US real GDP growth (%)



Source: Moody's Analytics, 2Q19

Expectations continue to be for a strong, but slowing, labor market and modest inflation in 2019. US consumer price inflation slowed to 1.6% in the year ending second quarter 2019. At 3.7% as of June 2019, the national unemployment rate is near its lowest point since 1969. A tight labor market makes it tougher to fill open positions but bodes well for continued upward pressure on wage inflation. The tight labor market is one reason wage growth is expected to support consumer spending in the US. Average monthly job gains softened somewhat in the first half of 2019, to 192,000 per month. Monthly additions continue to be lumpy, Figure 19.

Figure 19: US job growth and unemployment rate



Source: Moody's Analytics, July 2019

Strategy viewpoint

Uncertainty increased around appreciation in US real estate. Falling interest rates eased upward pressure on cap rates, but the risk premium increased. Fundamental strength in the US economy acts as a stabilizing factor by supporting income growth at the property level. A tight labor market and optimistic confidence measures reinforce our expectations for relatively good occupancy rates and continued rent growth in the US real estate sector.

Beginning in early 2016, US real estate entered a widely-anticipated period of income-driven performance. On the whole, US properties are appreciating at about the pace of inflation. Appreciation relates back to the positive rent growth generated by properties, as opposed to the out-sized influence of capital flows the US experienced in 2014 and 2015.

Income-generated performance is consistent with a long-term expectation for private commercial real estate investments. Looking more closely at the drivers of income, rent growth is the true powerhouse behind the gains. Property-level income growth should outpace today's modest inflation even as the pace of growth moderated in recent years.

Even though 2018's rising interest rate environment reversed and long-term interest rates fell during 2019, uncertainty remains and the increased risk premium appears warranted.

Capital investment into stabilized assets is increasing, an expected outcome in a long expansion. Debt and equity capital is seeking growth strategies, and existing assets are under pressure to compete with new construction. Investors should pay careful attention to the risk-return expectations for incremental capital.

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