

Real Estate Summary

Edition 2, 2019



Tenant demand healthy
while investment activity slips.

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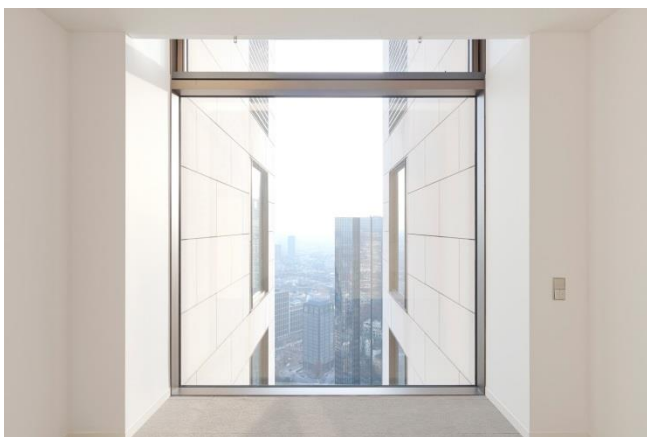
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Global overview

The economy held up better than expected in the first quarter of 2019, while some major central banks have turned dovish. Delayed policy tightening is supportive of real estate and investment activity was weaker across all regions with cap rates levelling off. We think occupier and investor markets look more resilient to any shock from the economy than they were prior to the global financial crisis.

Macroeconomic overview

At the start of the year sentiment over the economic outlook was weak. Stock markets had pulled back significantly in the second half of 2018, the US-Sino trade war had intensified and central banks looked set to tighten policy. Moving into spring the mood has lightened and sentiment has become less negative. By early May equity markets had pushed back towards their record highs. Progress was reportedly being made between the US and China on reaching a trade agreement. However, this was abruptly thrown into jeopardy when Donald Trump announced talks were faltering and that the US would increase its tariffs to 25% on USD 200bn of Chinese imports. China retaliated by announcing it would increase tariffs on USD 60bn of US imports. With the US presidential election looming in 2020, a conclusion to the trade dispute seems important for President Donald Trump's chances of re-election.

Of the countries reporting first quarter growth figures so far, results have been better than expected. The eurozone recorded growth of 0.4% QoQ, rebounding from a lackluster 0.2% in 4Q18 and 0.1% in 3Q18. Italy, which endured a technical recession in the second half of 2018, returned to growth of 0.2%. Domestic activity seems to have been the main driver of growth in Europe. Meanwhile US growth bounced back to 3.2% annualized in 1Q19 from 2.2% in 4Q18, though the headline figures were overly flattering and accumulation of inventories boosted US growth by 0.7% pts. Finally, China dispelled fears of a slowdown and maintained its 4Q18 growth rate of 6.4% YoY.

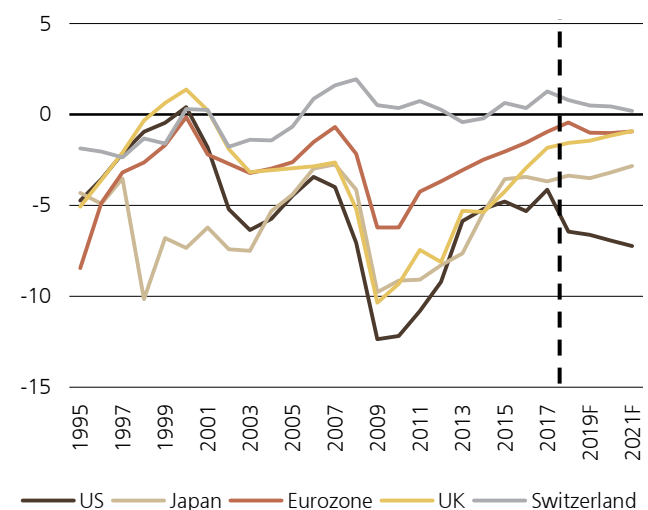
Following the dip in sentiment at the start of the year central banks turned dovish. In January, the Federal Reserve (the Fed) reined in expectations for several rate rises this year and said it would be "patient". Indeed, it is now unclear as to whether the next move in US rates will be up or down, with core personal consumption deflator inflation subdued at 1.6% in March and the unemployment rate at a 50-year low of 3.6% in April. Other major central banks have dropped into line behind the Fed, with the ECB announcing it will restart its targeted longer-term refinancing operations bank lending scheme in September and that it intends to keep rates on hold, while the BoJ has also said it will maintain easy policy.

Our base case scenario remains one under which economies continue to grow over the next 18 months, albeit at a slower pace than in 2018. There is of course uncertainty over this. A key question is what policy space exists should a downturn bite. The Fed has raised rates nine times from their low and hence has some room for conventional monetary support in

the form of interest rate cuts. However, this may not be enough. Moreover, the European Central Bank (ECB), Bank of England, and Bank of Japan (BoJ) have no room for conventional policy support given their rates remain around zero. Hence any new downturn might require new monetary measures to be introduced, in addition to those brought in after the financial crisis.

Given the limited room for monetary easing, support might be needed from fiscal policy. However, governments typically tend to move only slowly and fiscal policy takes time to feed through. Moreover, views on the desirability and efficacy of fiscal policy can vary. For example, Donald Trump has embarked on a fiscal stimulus of USD 1.5tn of tax cuts in the US over the next decade, while much of Europe is bound by eurozone budget deficit rules which foster austerity (see Figure 1). Germany is even more austere and limits its structural deficit to just 0.35% of GDP. However, calls for a greater role for fiscal policy are growing, with the Modern Monetary Theory proposed by some academics arguing for borrowing-financed spending, irrespective of debt levels.

Figure 1: Government budget balance (% of GDP)



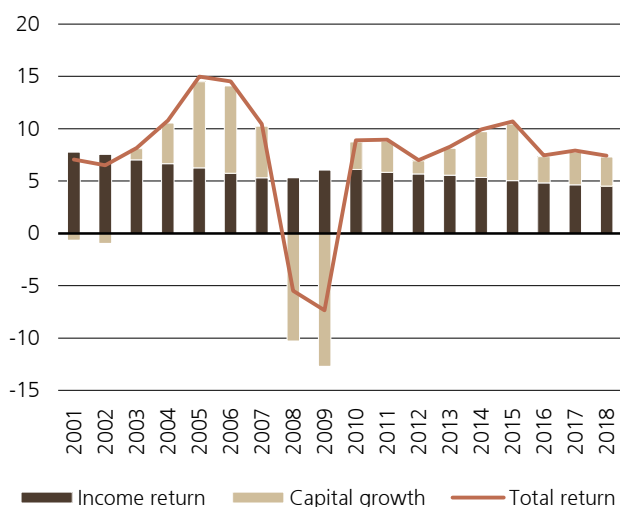
Source: Oxford Economics, May 2019

Another factor to be taken into account is central bank independence, which a decade ago was taken as a given. However this is not now the case. Indeed, the central banks of the US, India, and Turkey have all recently received calls, in varying forms and degrees, from politicians to take measures to support their economies, calling their independence into question. The backdrop of rising populism may foster a backpeddling in support of independent central banks, which could see a shake-up of the existing framework with unpredictable consequences. In such a scenario, real estate's inflation protection characteristics should provide some reassurance.

Capital markets

For some time, our house view has been that real estate returns will slow gradually and become driven mainly by income. MSCI data for 2018 corroborates this. Global all property returns slowed to 7.4% from 7.9% in 2017, with an income return of 4.5% and capital value growth of 2.8% (see Figure 2). This compares to peak value growth of 5.4% in 2015. First quarter data for 2019 from National Council of Real Estate Investment Fiduciaries (NCREIF) showed annual US all property returns of 6.8% YoY, virtually unchanged from the 6.7% YoY in 4Q18. MSCI reported UK all property returns slipping to 4.4% YoY from 6.0% in 4Q18, driven by retail weakness.

Figure 2: Global all property returns (local currency, unleveraged, % p.a.)



Source: MSCI, May 2019

Weaker sentiment over the global economy at the start of the year seems to have impacted real estate investment activity. The first quarter is normally quieter following the rush to get deals across the line by the end of the year. However, even after allowing for the seasonal lull, the market was softer and volumes were down in 1Q across all regions. At the global level Real Capital Analytics (RCA) reported transactions worth USD 167bn on income-producing properties in the first quarter, down 23% on the same period in 2018.

APAC was the weakest market, with volumes down 36%, while in Europe they fell 32% and in the US 11%. At the sector level, all types of standard commercial property saw significant falls, along with hotels. The residential sector bucked the trend and showed more resilience, with volumes falling just 5% YoY.

Overall, we think slower investment activity reflects a number of factors, including weaker sentiment over the economy through the first quarter, political uncertainty and real estate prices which have reached high levels in some markets. A lack of stock for investors to buy is also likely to be holding back volumes, while a mismatch in price expectations between buyers and sellers has prevented some deals. If sellers are unable to achieve the prices they want they are happy to continue to hold on to the real estate rather than sell it at a perceived discount. We think that transaction activity for 2019 as a whole is likely to be healthy, but below 2018 levels.

At the same time as transaction activity slowed, cap rates and yields levelled off in the majority of markets. Of the sample of over 300 markets we monitor across the world, a net balance of just 7% reported a fall in cap rates and yields in 1Q, down from a net 10% reporting a drop in 4Q18. The markets reporting declines were focused on the industrial sector, including logistics markets in Germany, while some office markets also reported falls, including Frankfurt and Melbourne. A significant number of retail markets reported rises, such as shopping centers in France, Germany and the UK.

In the retail sector valuations are now beginning to move to reflect the severe structural challenges that traditional retailers are facing. This is ultimately impacting their profits and ability to pay rents. The UK is one of the markets most advanced in its correction and its retail valuations began to move downwards around mid-2018, with MSCI reporting retail values down 6% for 2018 as a whole. In the US, NCREIF reported retail values down 2% for the year. Value falls were also recorded in some other markets, including Finland, where KTI reported values down 3% and in France where MSCI reported values down 1%. Given ongoing stress in the retail sector and a steady flow of company bankruptcies announced in markets such as the UK, we expect further value decline. Investors are wary of the sector, though some higher risk capital and opportunity funds are circling for selective assets which can be repurposed for other uses.

Strategy viewpoint

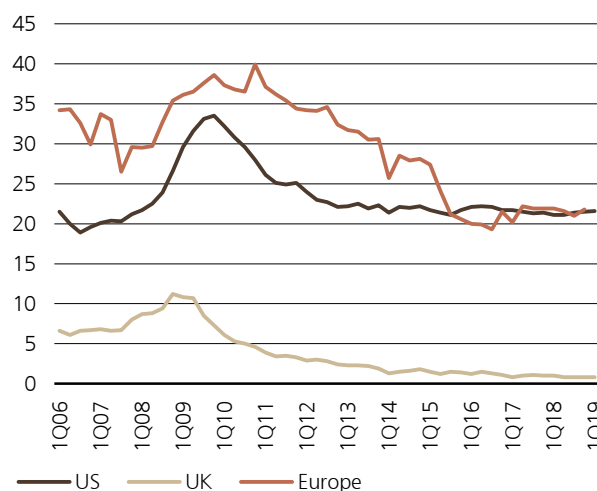
One of the things that investors have learnt from the financial crisis is that easy policy from central banks has been supportive of risk assets, including real estate. Sustained low interest rates on fixed income investments has attracted investors to real estate as an alternative and seen them increase their allocations to it. The new delay in policy tightening by the major central banks continues the trend of recent years which has seen expected rises in bond yields fail to materialize. Provided the economy keeps growing there seems no reason to believe why the new delay should not be positive for real estate.

In line with the economy, we think real estate markets are later in the cycle, but more resilient than they were prior to the financial crisis. For example, on the occupier side we estimate that tracked global office stock rose by around 1.5% in 2018, compared to growth of 2.5% in 2008. This makes a supply induced downturn in rents less likely and also provides a cushion should occupier demand weaken. Lower development activity has been driven by more cautious developers, who now tend to require pre-lets, and reduced availability of financing for development projects from banks. Any financing secured is also typically on stricter terms.

Investors and lenders have also been more cautious on lending for existing properties and in general leverage is below the levels reached prior to the financial crisis. For example, the Cass Lending Survey reported that 74% of the loan-book on UK commercial property in 2018 had a loan to value (LTV) ratio below 60%. Restrained leverage is also reflected in data on property funds (see Figure 3). In the financial crisis falling values saw many borrowers breach their loan covenants, which forced them to sell assets and caused further stress in the market.

In those pockets of the market which are currently weaker, such as secondary shopping centers, borrowers are being encouraged to inject equity. This should steer the market towards resilience in the face of any value falls and make forced sales less likely. One area which may prove trickier though is the refinancing of loans made by closed-ended debt funds. Indeed, where values have fallen such borrowers may need to inject equity in order to secure new financing. Overall though we think both occupier and investor markets are well placed should any shock filter through from the economy. The current environment of ongoing low interest rates accompanied by reasonable levels of economic growth is supportive of real estate. The main danger would come from any pullback in the economy, particularly if it was prompted a sharp rise in interest rates to control inflation, which would erode real estate's relative pricing appeal. For the moment though inflation seems contained.

Figure 3: Core fund leverage as percentage of gross asset value (%)



Note: US refers to NCREIF ODCE; UK refers to MSCI/AREF UK All Balanced Property Fund Index; Europe refers to MSCI Balanced Pan-European Property Fund Index. Sources: NCREIF; MSCI, May 2019

Real estate investment performance outlook

2018 performance and 2019-21 outlook are measured against the sector's long-term average performance, with a margin of 100bps around the average described as "on trend" or "stable".

		Office	Retail	Industrial	Multifamily
Asia Pacific	Australia				
	Japan				
Europe	France				
	Germany				
	Switzerland				
	UK				
North America	Canada				
	United States				

Icon color: 2018 performance

Icon style: Outlook (2019-2021)

Above trend



Positive

On trend



Stable

Below trend



Negative

Source: UBS Asset Management, Real Estate & Private Markets (REPM), May 2019

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APAC summary

Monetary policy is turning more accommodative in Asia. Most of developed Asia continues to see stable job growth underpinning demand for office and retail. The investment market continued the slowdown in momentum observed towards the end of 2018. Prime yields are showing signs of hitting resistance levels.

APAC summary

Demand and supply

For the times they are a-changin'

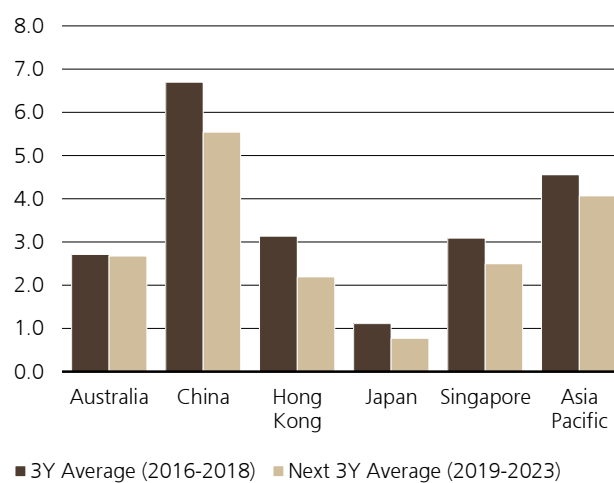
The strange and surreal world we live in today has increasingly made the once unfathomable seem commonplace. As Bob Dylan mentioned in his lyrics, "Don't speak too soon, for the wheel's still in spin." This could sum up how market observers feel about the erratic pulse of the regional economic and geopolitical landscape. At the point of this writing, the US and China trade negotiations are still underway although the talks are hanging much more delicately in the balance now, after the US abruptly raised tariffs on USD 200bn worth of Chinese imports on 10 May 2019. The uncertainties arising from this US-China trade impasse, coupled with expectations of the maturing global business cycle, have led to several multilateral agencies such as the International Monetary Fund (IMF), the Organization for Economic Co-operation and Development (OECD) and the Asian Development Bank (ADB) downgrading growth forecasts for most Asian economies. It seemed not too long ago when the APAC economic machine was humming along to a more melodious tune.

As we highlighted in the previous edition, the outlook for APAC is muted, but definitely not dire (see Figure 4). The increased regionalization of APAC over the years aligns the region's fortunes ever so closely with that of China. Every year in March, we look towards the annual National People's Congress in China and attempt to make sense of the signals that could guide our macro views for APAC. In terms of growth targets for 2019, China has put forth a range of 6.0% to 6.5%, which is somewhat a reflection of the uncertain and yet possible permutations of economic scenarios which could unfold this year. In 2018, the same GDP forecast was worded as "around 6.5%", which definitely allowed for less room to navigate. And indeed China grew at 6.6% in 2018 and 6.4% in 1Q19. All that said, numbers are just numbers, and what we are focused on is really the decreasing trend of growth guidance coming out of China, which provides a reliable inference for what we could be expecting in APAC later this year.

Across Asia, however, monetary stance is generally turning more accommodative, tax cuts and expansionary fiscal policies seem par for the course, and that will be highly supportive of economic growth. China aims to deliver RMB 2tn (around USD 300bn) worth of tax and fee cuts to the real economy this year, higher than the RMB 1.3tn in 2018. In Australia, ahead of a Federal election in May, the federal budget proposed

significant tax reductions for low and middle-income households. Obviously election results could alter the budget but we are not expecting a major shift in the fiscal stance regardless. Over in the land of the rising sun, the impact of the planned sales tax hike this year is expected to be negated in part by changes in the Japanese tax code which will feature tax breaks in excess of JPY 167bn.

Figure 4: Real GDP growth (% YoY)



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

Industrial

In the APAC region, modern industrial real estate continues to be supported by secular trends such as increasing e-commerce penetration, supply chain efficiency and labor shortages. As online retailing gains traction, we observe a growing inclination towards smaller infill space in markets where there is a high and rising proportion of online sales from businesses to consumers. In Australia and Japan, land values of industrial real estate located near the city centers have seen exponential growth over the last few years. Increasingly, we are starting to see the prevalence of vertical warehousing which has traditionally not been a major feature in these markets.

With the growth of e-commerce picking up pace in Asia, there are clear winners and less obvious losers. In Australia, the entry of major online retailers has created solid demand for industrial property. The headroom for e-commerce penetration will continue to allow online retailers to gain market share in the Japanese industrial space. On the other hand, we also see the displacement of large retailers such as Big W, Toys R Us, and Topshop, to name a few. These are having a counteractive negative impact on the demand for modern industrial space instead. On a net basis, we are not banking on e-commerce alone to drive the sustainability of the industrial real estate story in Asia with manufacturing also a key growth driver.

In Tokyo, the limited availability of supply in Tokyo Bay is underlying strong rent uplifts, while submarkets such as Ken-o-do continue to struggle with high vacancies. Industrial rent growth has remained strong in Sydney due to the ongoing infrastructure construction boosting demand for industrial space. Growth in business parks' rents in Singapore took a pause in 1Q19 after five consecutive quarters of rental growth but the outlook remains positive amid limited new supply.

Retail

Sobriety has been the leading theme in the APAC retail sector for a few years now. The growth of online retailing has clearly taken away significant market share from physical retail, and that trend is not expected to reverse anytime.

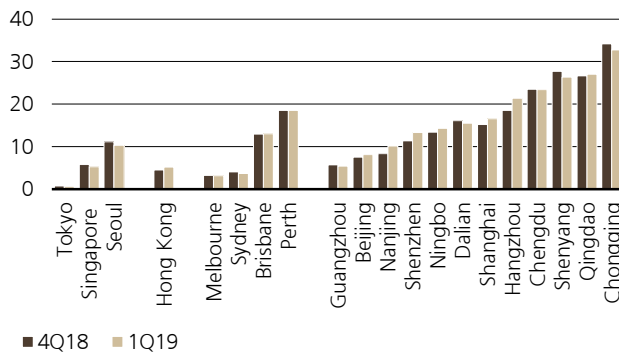
The opportunity set in the retail sector is increasingly a 'barbell' model, with some of the best options residing in the prime retail and suburban retail segments. In Hong Kong, growth in tourist arrivals helped support demand from retailers selling personal care products. Yet high street rents were flat in 1Q19 as the recent correction in home prices affected domestic retail sentiments. Domestic suburban retail assets with strong catchments can however play to the non-discretionary nature of neighborhood malls. We observe the same in the key cities of Australia, as prime retail rents slipped in 1Q19 as housing prices continue to correct and similarly dampen consumer sentiment.

The retail market in Japan is enjoying some positive spillover effects from the improving labor market and inbound tourism which is expected to continue expanding. This has been supported by a weak yen and events such as the Rugby World Cup 2019 and the 2020 Tokyo Olympics. In Singapore, the sophistication of suburban shopping centers will continue to apply pressure on prime retail. Island-wide prime retail rents rose 0.8% YoY in 1Q19. At the same time, the long-term prospects for retail in China's tier 1 cities is positive, whilst operating in the lower tier cities remains challenging as vacancy rates of the retail segment in certain cities hover at around 10% and above as at 1Q19. This is already supported by high rent-free and fit-out periods.

Office

Most of developed Asia continues to see stable job growth which is translating directly into positive net absorption by office tenants in traditional industries such as finance, and professional services, as well as in new-economy industries. Following on from 2018, vacancy rates continued to tighten in most APAC markets in 1Q19 (see Figure 5). Tokyo's office market has proven to be particularly resilient in spite of the high levels of supply. Demand has been supported by upbeat business sentiment and robust corporate profits, and as at 1Q19, prime office rents increased by 5.0% YoY.

Figure 5: APAC CBD office vacancy rates (% of existing stock)

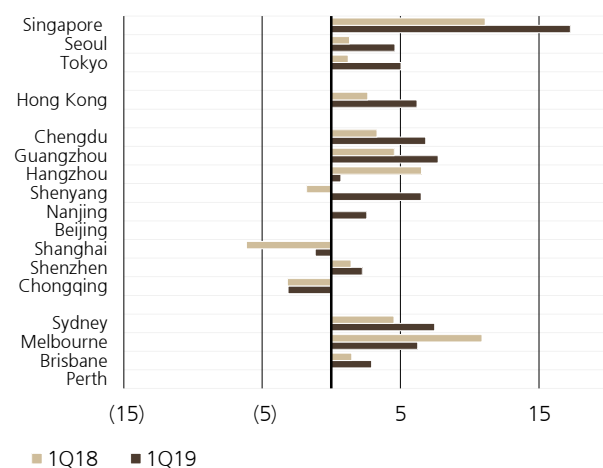


Source: CBRE, 1Q19

Vacancy rates are at 10-year lows in the Sydney and Melbourne office markets, translating to YoY prime rental growth of 6.2% and 7.5% respectively in 1Q19. In the Hong Kong office sector, against the backdrop of a cautious global macro environment, banking sector cost optimization, as well as concerns regarding Hong Kong's future competitiveness, office demand from multinational firms will continue to soften. That slack is however picked up by firms from China.

Prime rents in Singapore rose around 17% YoY in 1Q19 and is likely to see continued gains given a tapering off of completions (see Figure 6). In the tier 1 cities of China, domestic demand is still the main source of office occupancy, as finance, insurance and telecommunication, media and technology (TMT) sectors stepped up their leasing activities. In lower tier cities, we expect the dire situation of oversupply and weak absorption to further exacerbate the softness in occupancy and rents.

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



Source: CBRE, 1Q19

Capital markets

APAC commercial property investment performance was a mixed bag in 1Q19, with some markets holding steady while others saw steeper declines. According to preliminary data from RCA, total volumes in 1Q19 were down by almost 35% from the same quarter in 2018. This was likely an extension of the slowdown in investment momentum we observed towards the end of 2018, a result of the stalemate between buyers and sellers as well as tighter financing conditions (see Figure 7).

In terms of geography, activity in the first quarter of 2019 remains focused on the few commercial real estate markets of China, Japan and Hong Kong. Arguably, the changing patterns of investment activity across markets do not tell any real meaningful story as investors have become more cautious towards large ticket transactions and portfolio deals. This can be seen particularly in the cross-border space given the higher perceived risks of investing beyond domestic markets. Once every few months, a major transaction in Asia occurs after prolonged negotiations, and that inadvertently skews the entire distribution. In countries such as Japan and Australia, where regional sub-markets are more developed, investors have also started to switch their exposures towards these markets. In the case of Japan, domestic REITs continue to dominate activity in Japan and the easy credit environment has made the holding power of owners stronger.

In China, foreign investors stepped up buying activity in the first quarter of 2019 even as they limited their exposure to the tier 1 and key gateway cities in China. Several high profile transactions were big ticket purchases of retail and office assets. 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. Both factors combined to stabilize transaction volumes.

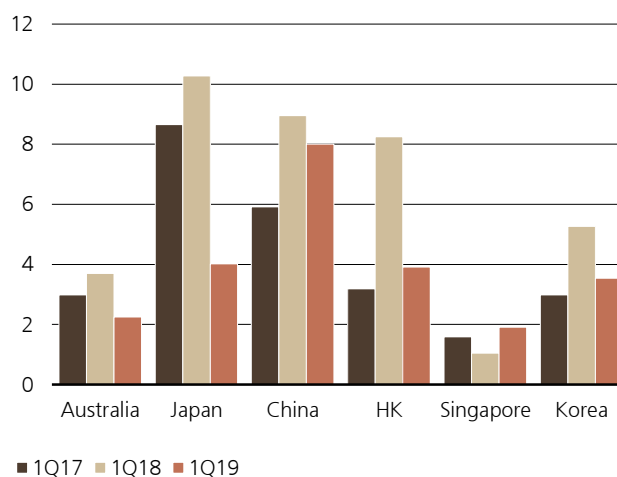
The story is different however in Japan and Hong Kong. This time last year, several large office transactions in Japan helped to support overall volumes, the deals of which have been sorely lacking so far in 2019.

In Hong Kong, the high base effect from the first quarter of 2018 was obvious, as volumes also settled down at typical first quarter levels.

In January 2019, the Fed made an about-turn and indicated that it would pause interest rate hikes on the back of softening global sentiments, and fears of policy overshooting. Despite signs pointing to the end of the yield compression cycle, it is hard to declare that with much certainty, particularly given the dovish comments creeping back into central bank rhetoric and with the weight of capital continually defying expectations. In some markets such as Australia, Japan and South Korea, the odds of monetary loosening have in fact moved higher than they were in the last year.

Overall, yields across most APAC markets are at their lowest in the last 10 years. That does not mean prime yields cannot tighten further, but it does imply we are almost reaching the floors of absolute yield levels. We remain skeptical as to how much further the lower boundaries of prime yields can be breached. To that end, yields are showing signs of hitting resistance levels and while they could remain low for some time, we still believe it is prudent not to underwrite significant capital gains given the already rich pricing levels.

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



Source: RCA, April 2019

Viewpoint

Urban regeneration in focus

Even as geopolitical and economic issues play out in the background, we continue to emphasize the importance for real asset investors to position themselves for the future. We are not referring to the imminence of flying cars and robot buildings with artificial intelligence, but rather the not too distant changes that we expect to alter the real estate landscape. Technological and structural trends will evolve at breakneck pace, speeding up the process of obsolescence in physical real estate and end-user demand. That in itself calls for significant foresight and action by all stakeholders to delay and prevent the process of urban decay.

In many developed markets in APAC, we are beginning to see a concerted effort by governments to either kick start or double down on urban regeneration. While arguably this is also an extension of the fiscal promotion policies, urban regeneration fills a real gap in most cities where dis-connectivity and urban deterioration has somewhat become prevalent. And as the way people work, live and play start to change and overlap, urban regeneration creates longevity in existing sub-markets and opportunities in new sub-markets.

As another illustration, urban renewal and infrastructure development in Asia will create new growth centers where new core real estate may be located. We see that the CBDs of Sydney and Melbourne are expanding with metro lines being built, and the urban regeneration projects taking place in Singapore and Hong Kong, are creating 'second CBDs' in these markets. These themes take a longer time to gain traction, and investors with a more patient investment horizon are better placed to ride through cycles and even enter earlier before secular trends are priced in by the general market.

Singapore is a prime example of urban renewal in action. The draft masterplan for Singapore was released in March 2019, and two key areas of focus, among others, were downtown rejuvenation and a continued focus on decentralization. Details aside, the rejuvenation of the downtown region in Singapore entails the provision of incentives to encourage the private sector to convert existing aging office buildings into mixed-used assets with a high component of residential and hotel use. The aim is to infuse life into the CBD area through the injection of residential use. And while that is in progress, greater resources will be directed towards nurturing the regional business districts. But what does this mean for investors? For one, the removal of aging office stock in the CBD for partial conversion into other uses is supportive of office rents and occupancy. We saw the same happen in the CBDs of Sydney and Melbourne. However, at the same time,

the sophistication and connectivity of the decentralized business districts provide alternatives for office end-users who may be priced out of the central business areas. In addition, retail space outside of the downtown area and within the regional districts may also get a boost from the increased footfall.

If one looks at the age profile of well-located commercial assets in Shanghai, more than half of these assets were constructed at least twenty years ago when China was embarking on the opening up of its economy. As another case in point, we estimate that approximately 80% of small and mid-sized office buildings in Tokyo were built more than two decades ago. With more than 90% of office tenants in Tokyo being small and medium companies employing less than 30 employees, the demand-supply certainly favors the value-add of existing class B office assets. Therein lies the long-term opportunity to capitalize on the aging profile of office assets in these markets.

In Hong Kong, the sequel to the 2009 industrial revitalization plan was announced by the government in late 2018. The renewed scheme allows for extra floor area in the conversion of entire industrial buildings built before 1987 into commercial purposes. The government ropes in the private sector in the renewal of old districts and aging industrial buildings, while allowing investors to take advantage of lower costs compared to acquiring new land. Obviously asset enhancement on existing industrial assets is not without challenges. The limitations on power loading and mechanical structures often mean that there may be additional costs related to such conversions, which may tilt the economics the other way. All that said, this is a window of opportunity for many asset owners and investors to identify areas where the greatest upside in conversion value may manifest. For sure, the decentralization theme in Hong Kong and the growth of the second CBD in Kowloon East is likely to create significant opportunities for commercial conversion. We continue to be believers in the long-term viability of office decentralization in Hong Kong, on the back of increasing affordability concerns in Central. Prospects for the logistics market in Hong Kong appear to be robust in spite of the trade war, although this is largely due to constraints on supply. According to CBRE, roughly 6 million sq ft of warehouse space could be removed from the market over the next five years which is expected to exacerbate an already tight warehouse market.

Clearly, what we have described above are but just a few examples of the key focus and gaps in urban regeneration, of which the wheels are already set in motion in key APAC markets. While we focus on the present, long-term investors can still find value in future-proofing their investment strategies, simply by keeping a watchful eye over the key urban priorities of governments in the region.





European summary

Europe entered the first quarter of 2019 following a year where the 'Euroboom' became 'Eurogloom' in just 12 months. The first three months offered slightly more encouragement in terms of fundamentals while leasing volumes returned to grow and prime rents continued to rise. Investment volumes declined firmly but prime yields remained stable or fell.

European summary

Demand

2018 has been a challenging period for the eurozone economy. Issues within the German automotive sector meant the 'engine' of the European economy saw far weaker growth than levels attained in recent years. Additionally, Italy slipped into recession following weakness in manufacturing against the backdrop of high political uncertainty. The first quarter of the year has offered some respite to this bleak picture, with survey data suggesting momentum is reviving somewhat, particularly in the services sector. Indeed, aggregate GDP is thought to have been slightly stronger than anticipated in 1Q19, at 0.4%. However, the outlook for the year remains muted at 1.3% GDP growth.

There were signs that the negative sentiment may be seeping over into the occupier markets, however leasing volumes were strong in 1Q19 (see Figure 8), up 9% on the previous year and returning rolling annual office leasing levels to growth. The biggest driver of this was less core office markets. Stockholm saw rolling annual take-up surge by nearly 400%, while regional areas in the UK and Netherlands also posted strong results. Portugal has been a key focus recently and both Lisbon (+27%) and Porto (+22%) saw continued strong momentum over the last 12 months. Central London has seen reasonably buoyant demand considering the market's exposure to international services and uncertainty surrounding their post-Brexit status. Take-up in the aggregated submarkets was more or less comparable with the previous 12 months, showing just a -1% decline in volumes. However, much of this has been driven by take-up from serviced office providers (such as WeWork) as well as existing occupiers leasing space in newly completed schemes.

At the other end of the spectrum, Berlin saw a slight moderation, with leasing falling -6% when compared with the previous 12 months. Two of the mooted financial successors to London, Paris (-11%) and Frankfurt (-26%) had fairly weak years in terms of leasing, suggesting banks might not be rushing to abandon the UK capital just yet. Anecdotally, there are suggestions it is likely much of the demand from international finance will leave the continent altogether rather than operate from smaller financial centers within Europe.

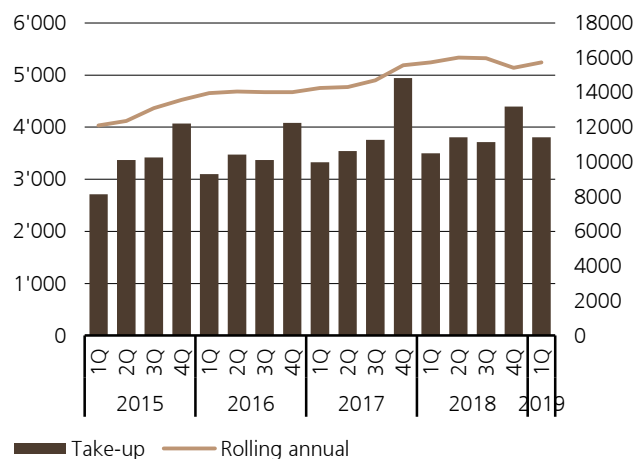
Prime office rents in EU-15 countries grew by 3.3% in the year to 1Q19. There were no recorded decreases in office rents in 1Q19, with all of the centers under coverage either seeing no

change or rising values. This indicates the strength of demand for prime office space remains very high in most centers. Portugal continued its impressive momentum; Porto saw the highest prime rental growth (+29%) while Lisbon (+12%) also performed very well. Berlin continued its transition to a tech center with rental values growing 11% YoY, while Madrid also saw rents increase by 10%. More established markets continued to see healthy growth with Munich and Dusseldorf both seeing rents climb by 4%. Central London saw rents edge up 2% for prime assets, although this potentially belies the weakness in demand for secondary space.

The retail sector continues to be challenged by changing consumer habits and retailers are struggling to adapt their business models to suit. This trend varies greatly by country, but as a general rule northern European countries face greater pressure than Southern Europe. By way of example, Eurostat 1Q19 data estimates 70-80% of German, British, Dutch and Danish consumers made a purchase online in 2018, whereas the propensity to spend online was much lower in Spain (43%), Portugal (27%) and Italy (26%). The UK has been further hit by the significant recent drop in consumer confidence, although retail sales have been fairly robust in the first quarter.

Unsurprisingly, areas seeing demand fall away and rents decline are in countries with high online penetration, with demand remaining fairly strong for less affected countries. Prime high street rents declined over the year in Bristol (-9.1%) and Edinburgh (-2.1%) as they did in Amsterdam (-3.2%) and Rotterdam (-2.8%). Conversely, rents grew by 5.9% in Rome, 7.7% in Milan and an impressive 25% in Lisbon. Overall, the picture was more negative than positive, with aggregate EU-15 prime rents declining by -0.7% to 1Q19.

Figure 8: Aggregate European office take-up volumes (000s sqm)¹



Source: JLL, 1Q19. Note: ¹ Select European centers

Supply

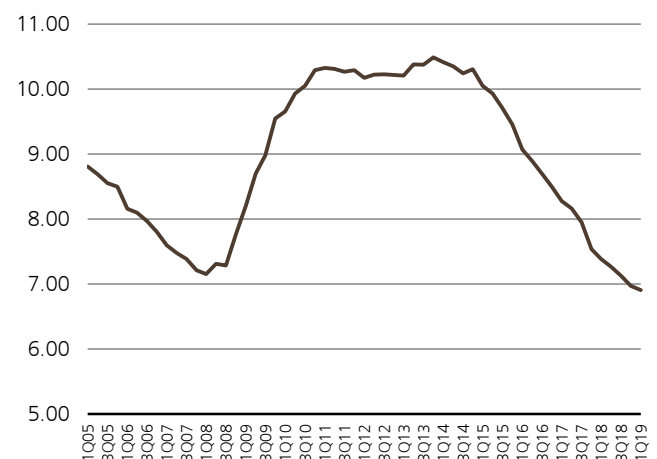
Prime vacancy fell further in 1Q19 (see Figure 9), standing at 6.9% in 1Q19. This reflects a combination of high demand but also very restricted availability of high-quality supply in most European cities. German cities have very low prime vacancy and several centers saw this come down further into the year. Berlin saw more space absorbed to stand at just 1.67% at 1Q19, while Hamburg dropped to 3.68%. Frankfurt by comparison is relatively high at 7.67%; however this has improved from a level of 11% as recently as 2017. Amsterdam continued to improve with vacancy now at just over 4% while surprisingly the City of London fell from 5.7% to 5.2% YoY. There were relatively few centers seeing an increase in vacancy, although Marseille saw vacant space tick-up by 1.5% over the year.

The main reason for this low vacancy story is the continued faltering development cycle in most European cities. While demand has been bullish over the past few years, construction has been relatively inelastic. There is very little speculative office development across European markets; by way of example, the City of London has 8% of new space under construction, but this drops to just 4.4% when pre-lets are stripped out. Warsaw still leads the pack with 9.7% of speculative stock under construction, while Paris (6.7%) and Lyon (6.1%) also had a sizable amount of space in the pipeline. However, cities with the most constrained space are generally seeing the lowest development. Amsterdam currently has just 1.9% of speculative space in the pipeline, while Berlin has just 2.0%. This means occupiers are generally faced with a lack of choice when looking for high-quality office space.

Retail continues to struggle with multiple headwinds, although as with the demand side the effects are unevenly distributed across different countries. The UK is the most severely affected, with town center and retail park vacancy rates increasing again in 1Q19 to stand at 13.3% and 12% respectively². Europe has relatively little supply data; however vacancy is thought to have declined due to less retail space per capita and generally lower online penetration. However, in terms of new space there are signs that most European cities are well if not over-supplied. According to 1Q19 PMA data, just 354,000 sqm of shopping center and unit shop space was added in 2017, which was around half the long-term average.

Industrial supply data is in similarly short supply, however there is general consensus that European-wide availability is falling due to higher demand and the prevalence of build to suit development in the market. Centers where we have data are invariably showing declining vacancy. Multiple cities now have vacancy levels at sub-5%, including Barcelona (2.6%), Venlo – Venray (1.1%) and Porto (3.3%). Madrid saw vacancy tick-up slightly to 6.65% while the UK has also seen vacancy increase in recent quarters. Both of these locations' increased supply levels have been largely due to high levels of development rather than tenants vacating units.

Figure 9: Vacancy rate (% of units)



Source: PMA, 1Q19

² PMA, 1Q19

Capital markets

Pan-European investment volumes fell for the sixth consecutive quarter (see Figure 10), with volumes declining -2.6% on the previous quarter and -14.7% when compared with the same quarter a year ago. That being said, the quarterly outturn of EUR 266bn was still below the long-term average and in terms of individual deals, 2018 was broadly comparable with the previous year. The main difference (in 1Q19 as well) has been the lack of portfolio deals, which reflects lower levels of overseas capital targeting Europe.

However, there are signs that investors are becoming somewhat spooked by late-cycle dynamics and high prices; greater political risk and a weaker economic outlook. This is further exacerbated by weakness in the retail sector which saw investment volumes decline by -62% compared with the previous quarter and -62% compared with the previous year. Industrial volumes also fell 26% over the year, however this is largely attributable to the 'Logicor effect' and an overall decline. More resilient, however were the so-called 'alternative' sectors; residential saw volumes increase by +10% while hotels (-1%) and senior housing (-3%) only saw very moderate declines.

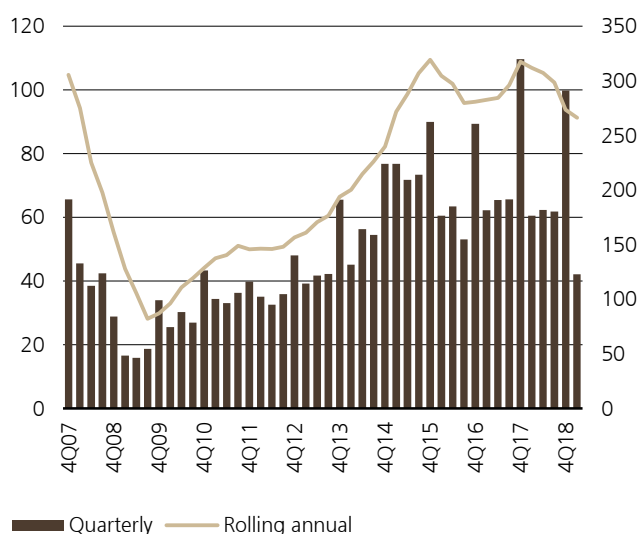
The consequence of this rotation out of retail and into the alternatives offers one perspective on why volumes have been declining. Considering the 'alternative' universe is incipient in most countries and retail is almost uniformly the largest and most liquid sector, the result of this strategy shift means the opportunity set is significantly reduced. This is further driven by regional shifts in focus, as investors pull back from the larger markets with the UK (-16%), Germany (-10%) and France (-11%) all seeing volumes drop in 1Q19 (YoY), while more peripheral markets such as Ireland (+45%), Sweden (+15%) and Norway (+12%) all saw volumes increase.

Besides this there is the very straightforward problem of high pricing combined with weak economic fundamentals. 1Q19 has seen slightly more positive data than was anticipated, however the GDP growth forecast for the Eurozone was still a very moderate 1.3% at the time of writing. When we consider the combined EU-15 prime yield is currently 3.74%, it is hardly surprising investors are struggling to underwrite transactions. Over the 12 months to 1Q19, the majority of European cities saw stable prime yields, although there was still compression. Munich compressed by a further 10 bps to reach 2.9%.

This represents the first time a European city (excluding Switzerland) has broken the 3% boundary. While Munich is the most expensive, all the other German cities are standing below 3-3.5%, a level significantly below the long-term average. The highest inward mover over the past 12 months was a 100 bps compression in Porto, however prime yields are still at 6% meaning there is certainly (prima facie) value compared with most other cities. No centers saw an outward yield shift in the 12 months to 1Q19, indicating an ongoing strength.

A big determinant of whether or not this pricing is sustainable will be the decision of the ECB regarding when and by how much to raise interest rates. The last meeting in April was more of a stepping stone to the June meeting, however there are indications it will likely err on the side of caution and delay interest rate hikes. The market implied interest rate hike has been trending up over the past few months and is now not factoring a 10 bps rise until 1H21. The decision of the Federal Reserve in May to delay further rate rises for the foreseeable future has given the ECB further breathing space in this regard. If interest rates are to remain and hence government yields at such low levels, we are less likely to see large outflows from core real estate. However, as a liquid asset class, government bonds can reprice overnight, and a sudden shock could push yields out and impact valuations. Therefore, we consider there to be a significant amount of capital risk to prime real estate in the current market and are reiterating the value of strong asset management and durable income returns.

Figure 10: European Investment Volumes (EUR billion)



Source: CBRE; RCA, 1Q19

Viewpoint

Has the capital cycle peaked?

There have been mixed indicators as to where we are in the capital cycle recently, giving real estate investors a lot to think about. Investment volumes do appear to be losing momentum. As described above, investment volumes are on a downward trajectory. Conversely, yields are showing no sign of moving out and there reportedly remains a record amount of dry powder targeting real estate.

If we look at the fundraising environment, the picture is fairly optimistic. As PERE reported in April, the first quarter of 2019 saw USD 39bn raised, a total representing the best outturn in a single quarter since the global financial crisis. This followed on from a full year in which 20% more capital targeting Europe was raised. The depth of this fundraising is also impressive, with unloved sectors and regions also in focus. Despite the general unpopularity of retail for instance, Asana Partner's second USD 800m retail value-add fund was oversubscribed, suggesting investors are even ready to take a view on value opportunities in the much-maligned sector. We have also heard anecdotally that numerous UK retail funds have seen inflows in the first quarter despite widespread uncertainty over the terms of the Brexit deal.

Despite this, the hard numbers indicate the money just isn't being spent. As discussed above in the capital markets section, the deal flow could be restricted by the availability of suitable assets. The 2019 ULI emerging trends report lends some support to this argument; the number one reason investors reported not investing more in real estate was a shortage of quality product and land. Moreover, RCA have reported a surge in forward sales suggesting investors are finding new means to achieve target returns. This is arguably borne out by the recent survey of investor intentions conducted by PMA

which suggested that – while the net balance of investor buying intentions fell away – the appetite for development rose. With investors looking to riskier deals in fewer geographies and sectors it is no surprise that the aggregate investment volume has reduced somewhat.

Also, while the USD 39bn raised was an impressive amount in value terms, much of this was explained by the launch of two mega funds. Brookfield raised USD 15bn for its Strategic Real Estate Partners III fund, while the Lone Star Fund XI raised USD 8bn. This accounts for over half of the monies raised, which if stripped out would mean 1Q19 was a comparatively weak quarter. This indicates that, while total fundraising has been resilient, it appears investors are being more selective about which managers they allocate capital to. This should have an impact of the dynamism of the market, as there will be fewer bidders on transactions.

Nonetheless, there is one other big tailwind for European real estate capital markets – the almost eternally low interest rate environment. With the market pricing in even more delayed rate hikes, European government bonds have fallen again with bunds hitting a 0% yields once more in 1Q19. Investors tend to substitute real estate and government bonds, and generally demand a 150-200 bps risk premium for holding real estate over government bonds. In the current environment, that criterion is satisfied even with real estate yields at rock-bottom levels. This environment also means North American and Asian Investors are able to hedge cheaply when investing into Europe.

The first quarter of the year can be a slightly odd one for investment markets. While there are signs investment is running out of steam, there are plenty of reasons investors will stay with the asset class, not least due to the unattractive returns elsewhere. The second quarter should provide more clarity, but those expecting a market collapse may be waiting for some time yet.





US summary

Returns on unlevered properties in the US behaved as expected in 2018 with a positive total return converging near a long term trend for apartments, office and non-mall shopping centers. American malls began to depreciate, resulting in a small positive return that was below the income return of the assets. Industrial remains the only major property sector with above-average return performance.

US Summary

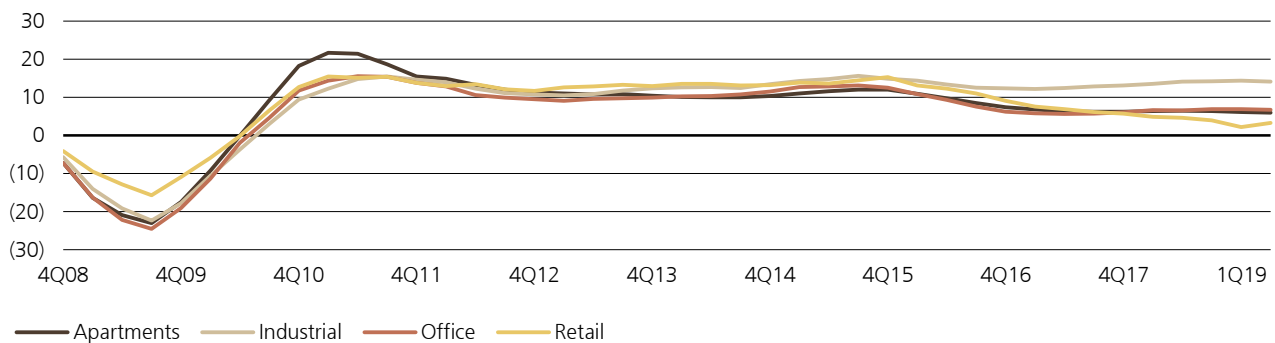
Real estate fundamentals

Private commercial real estate continues to produce steady returns, in-line with long-term expectations, even though there are some differences across major property types (see Figure 11). For long-term real estate investors, this outcome was expected. After all, rent growth is positive. With the current growth seen in the economy, expectations are for continued economic growth, at a diminished rate compared to recent performance.

During late-2018 and early-2019, investors experienced heightened uncertainty and volatility in equity and bond markets. After four short-term rate hikes in 2018, the US Federal Reserve indicated the December 2018 rate hike would likely be followed by a pause. Boosts to sentiment were short-lived as a partial government shutdown followed by volatile trade negotiations added uncertainty to investor outlooks. Federal budget negotiations and debt ceiling debates loom on the horizon. Yet, tight labor market conditions support consumers. Favorable credit conditions support economic growth, which most economists expect to be positive and at or slightly above-trend during 2019.

In real estate markets we turn to the fundamentals; demand for space is supported by economic expansion and a strong labor market. Supply growth must be monitored closely, but currently, new construction levels are meeting strong demand, resulting in relatively stable occupancy rates and positive rent growth.

Figure 11: US real estate returns across property types. Annualized, rolling four-quarter total return (%)

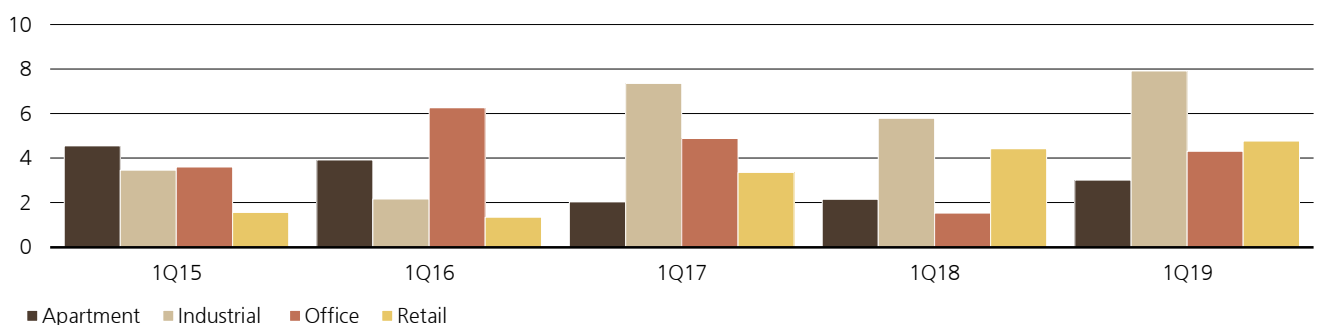


Source: NCREIF Property Index, 1Q19

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 (see Figure 12). Economic conditions create some optimism that growth will continue to reflect positive momentum for the US.

Figure 12: Property sector rent growth. Year-over-year change (%)



Source: CBRE-Econometric Advisors, 1Q19

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 64.2% in March 2019, unchanged from one year ago, 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.

After trending down through most of 2018, apartment vacancy rates rose modestly in the fourth quarter and again in first quarter 2019 (see Figure 13). Rent growth was above inflation at 3.0% in first quarter 2019. The pace of new construction is not anticipated to slow noticeably until 2020. At 4.6%, vacancy remains below the 20-year average of 5.4%.

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. 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 is strong. In the year-ended first quarter 2019, industrial net rent saw an up-tick of 7.9% growth, notably above the five-year average of 5.3% per annum. The pace of completions remains elevated (Figure 13), with further constructions forecast in 2019 and 2020.

Industrial availability was 7.1% in first quarter 2019, down 20 bps from one year ago, nearly as low as it has been since 2000. Even as demand remains high, rising completions add some increasing risk to the outlook.

Office

Office returns are in-line with apartments however, capital expenditure requirements increased in the office sector, pushing down cash yields.

New office deliveries decelerated slightly in first quarter 2019, exhibit R4. Exhibiting characteristic volatility, office rent gains outperformed inflation with downtown's 7.0% annual growth. This growth spurt appears to be unsustainable and far exceeds suburban office's 2.6% rent growth.

Average office vacancy decreased 50 basis points from one year ago. The gap between downtown office vacancy at 10.5% and suburban vacancy at 13.5% remains wide. downtown deliveries accelerated to 1.3% of inventory, while suburban completions slipped to 1.2%, possibly having passed a peak period.

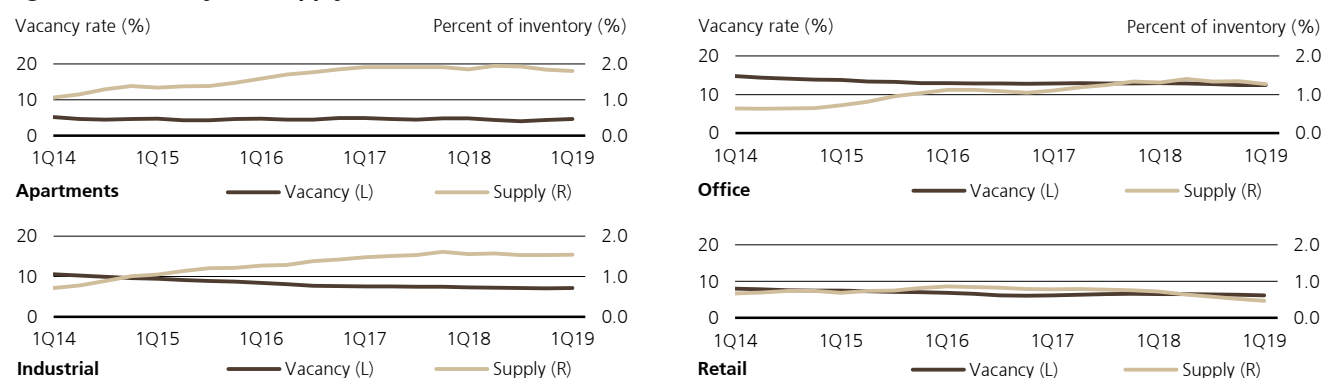
Retail

Consumers are doing well; thus, increased disposable income and low unemployment should support retail sales in 2019. However, we expect store closures to continue for weak and over-levered retailers. Capital requirements increased in the US retail sector, implying that the long-anticipated transition to mixed use centers is underway.

Mall/lifestyle center occupancy is flattening, while power center occupancy is increasing. Conversely, mall/lifestyle rent growth is volatile, while power center annual rents have seen modest growth in the last two annual periods.

At 8.8%, availability in Neighborhood, Community & Strip (NCS) retail is down 70 bps since the end of 2017 (see Figure 13). In the year ending first quarter 2019, NCS rents grew at a pace of 4.1%, more than double the pace of inflation.

Figure 13: Vacancy and supply trends



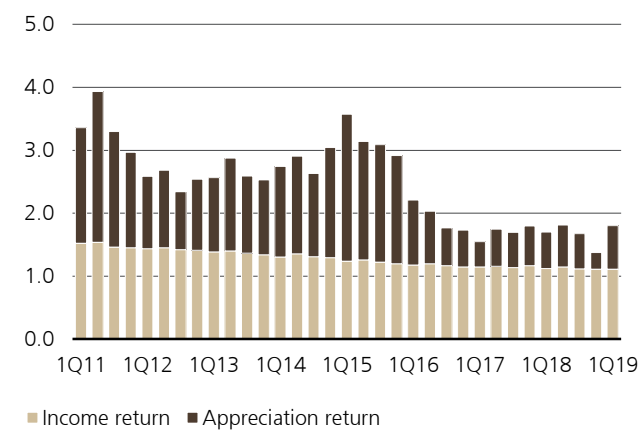
Source: CBRE Econometric Advisors, 1Q19. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory).

Capital markets

In 2019, we expect positive unlevered property returns driven by growth in income with moderation in appreciation, relative to recent years. In first quarter 2019, appreciation return recovered somewhat from a dip the previous quarter, elevating the NCREIF Property Index gain to 1.8% (Figure 14).

Total US commercial real estate sales volume was USD 458bn in the year ending March 2019; up slightly compared to the prior two twelve month periods (see Figure 15). Sector trends remain consistent, with sales of retail and office properties decreasing and sales of apartment, industrial, and hotels increasing.

Figure 14: US property returns
(%)



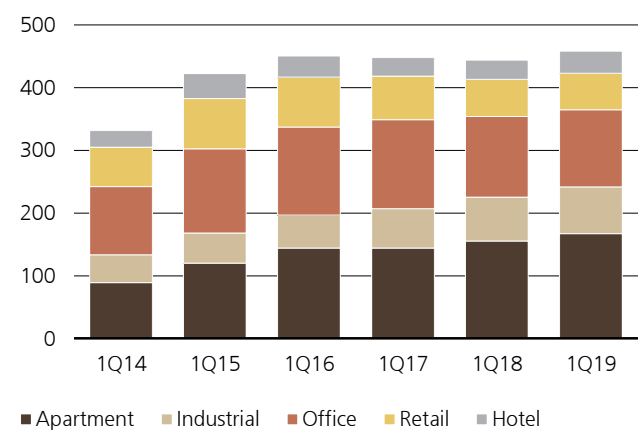
Source: NCREIF Property Index, 1Q19

One reason transaction volume is lower for retail and office properties is that lenders have a higher appetite to provide debt for industrial and apartment assets. Real estate debt capital is low cost and generally available but not free-flowing like it was during the lead-in to the last downturn. In 2018, increasing interest rates compressed spreads available to lenders in a competitive marketplace. The spread between property yields and the cost of debt decompressed slightly in early 2019. On the whole, US debt markets can be described as operational but not excessive, which encourages development but not an abundance of supply.

Long-term interest rates remain low relative to US history even as those rates moved higher in 2018. The 10-year US Treasury rate was 2.4% at the end of 2017 gaining 60 bps over 2018 to an average of 3% in the fourth quarter. A subsequent 50 bps drop in the 10-year Treasury in early 2019 eased much of the capital market pressure but did not fully reverse the increase in long-term interest rates over the prior year.

With little movement in cap rates, the downward move in Treasury rates slightly increased spreads available in US real estate, (see Figure 16). Yet, spreads offered by real estate investments are below long-term expectations, representing a change from the wide spreads that drew capital so quickly in

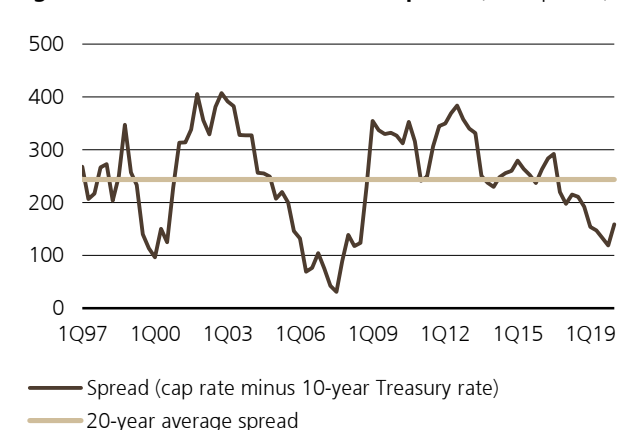
Figure 15: US transactions
Transaction volume (USD billions)



Source: Real Capital Analytics, 1Q19

the wake of the last recession. While the real estate spread is no longer compressing, it is low enough to support our expectation for slightly higher cap rates by the end of 2019. There is no noticeable 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 16: Commercial real estate spread (Basis points)



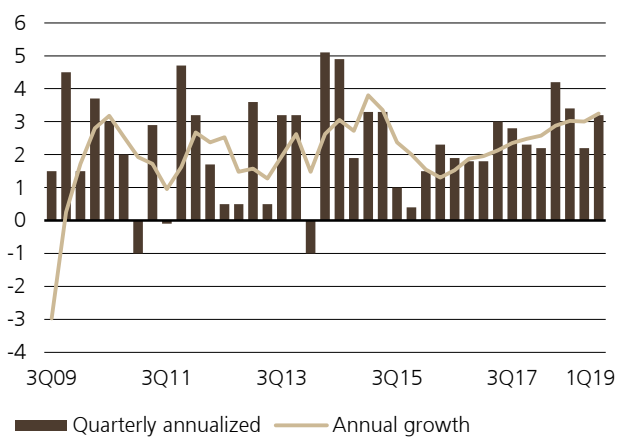
Sources: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 1Q19

A growing economy and tight labor market should continue to generate demand for real estate, with steady demand supporting income growth. Realized and expected growth in real estate income directly offsets upward pressure on real estate cap rates from the tight spread. Current economic expansion is considered to be self-sustaining at or above the long-term average, US GDP increased by 3.2% during first quarter 2019 (see Figure 17).

The tight labor market is one reason wage growth is expected to continue to accelerate in the US. US consumer price inflation was relatively contained at 1.9% in the year ending first quarter 2019. Expectations continue to be for a strong, but slowing, labor market and modest inflation in 2019.

In December 2018, the target range for the Fed fund rate rose for the fourth time in 2018 to 2.25% to 2.50%. The Fed has adopted a more patient perspective for 2019; the target range remains unchanged from year-end. While the labor market remains strong, national and global political hesitancy leads to the expectation for fewer changes to the Fed funds rate over the course of 2019.

Figure 17: US real GDP growth. Real GDP growth (%)



Source: Moody's Analytics, 1Q19

At 3.8% as of March 2019, the national unemployment rate is near its lowest point since 1969. A tight labor market generally makes it tougher to fill open positions and has put slow, upward pressure on wage inflation. Job growth has been lumpy but strong (see Figure 18). Over the past year, average monthly job gains approached 220,000 per month.

Strategy viewpoint

Even as capital markets face some pressure on spreads and the cost of debt, fundamental strength in the US economy acts as an offsetting 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.

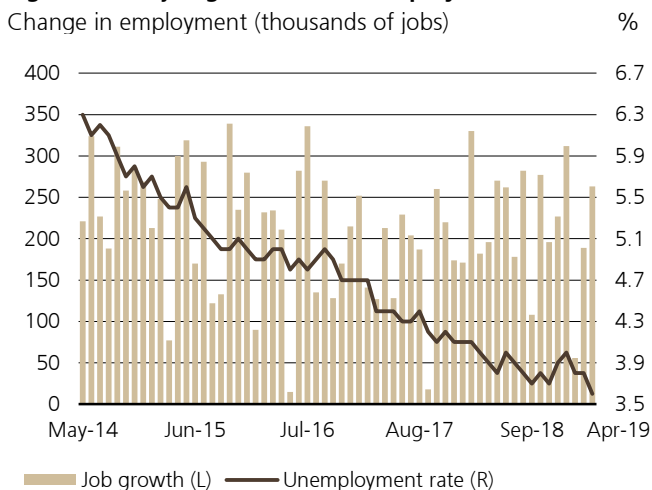
Beginning in early 2016, US real estate entered a widely-anticipated period of income-driven performance. US properties are appreciating at about the pace of inflation. Appreciation relates back to the positive rent growth generated by properties, as opposed to the out-sized influence of capital flows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

Looking more closely at the drivers of income, rent growth is the true powerhouse behind the gains. An expectation for continued positive economic growth reinforces our view that property-level income growth should outpace inflation even as the pace of growth moderated in recent years. Income-generated performance is consistent with a long-term expectation for private commercial real estate investments.

Even though 2018's rising interest rate environment reversed and long-term interest rates fell during early 2019, uncertainty remains. We expect a small upward movement in cap rates over the coming year.

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.

Figure 18: US job growth and unemployment rate



Source: Moody's Analytics, April 2019

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