

Real Estate Outlook

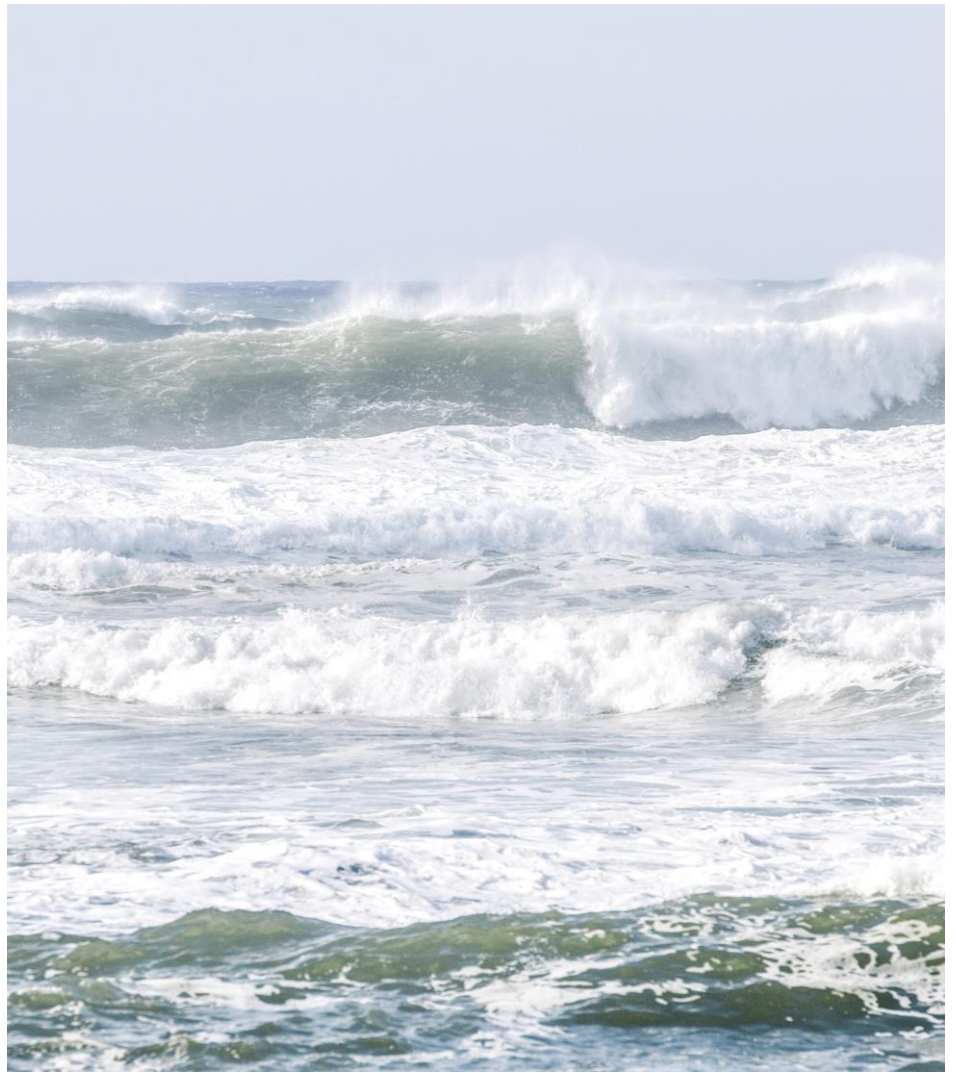
Global overview – Edition 3, 2021



Industrial rides the wave.



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Global overview

Finding direction in the waves of change.

Recovery in the economy and real estate investment markets gathered pace in the second quarter, though the new Delta variant of the virus poses a threat. Real estate showed strong returns in the first half of the year, driven by a stellar performance by the industrial sector. Investors should start to think about how to rebalance portfolios away from strong overweights to industrial.

Market overview and outlook

Rising tides from industrial in first half.

The economic bounce back gained traction in the second quarter of the year. Vaccines were rolled out to the wider population and virus case numbers fell, allowing economies to re-open. However, the newly emerged Delta variant of the virus has seen a renewed rise in cases and poses a threat to the recovery, particularly for northern hemisphere countries when they enter winter. The evidence to date is that virus infection remains possible for those that are vaccinated, but is much less likely and the effects a lot less severe, with much lower chances of hospitalization or fatalities.

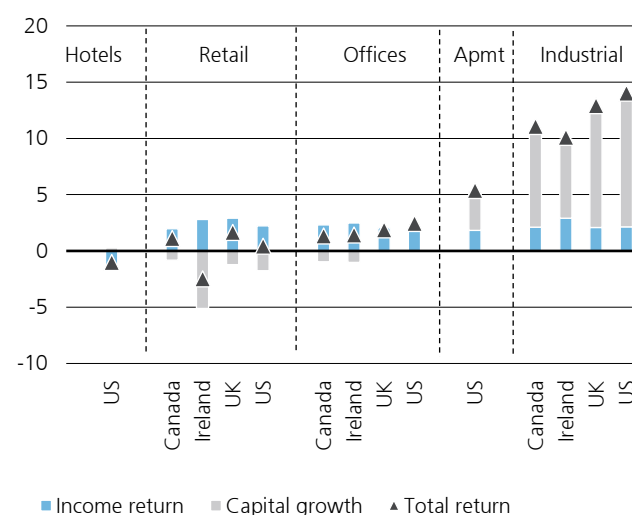
Inflation remains a key focus and has accelerated across most countries; to 5.4% in the US in June, which was significantly above the Fed's long-term target of 2%. Central banks continue to believe that price pressures will be transitory, allowing them to keep very easy monetary policy in place. However, central banks are increasingly acknowledging and flagging the risk that inflation might be more enduring, a scenario which investors should be prepared for. Indeed, if central banks did change their view and expected the pick-up in inflation to be more sustained it would imply that they should be taking steps to tighten policy to bring it back down and raising rates.

The inflationary pressures are being driven in part by turbulence and upheaval in the economy as it adjusts to its post-pandemic structure. For example, labor shortages are being reported in the hospitality and trucking sectors, with employers having to raise wages and offer sign-on bonuses to attract workers. Similarly, rising online fulfilment, of both consumer goods and meals, is creating new jobs in the warehouse and logistics sectors, while bricks and mortar retail suffers. It remains to be seen how labor markets will settle when job furlough schemes and enhanced benefits end.

Real estate markets saw a particularly strong first of the half of the year, driven by a stellar performance in the industrial sector. According to valuation indices from NCREIF and MSCI, industrial returns were in double-digits for the first half of the year, followed by residential at 5%, while retail and offices delivered small positive returns (see Figure 1). Overall, returns across sectors have been better than we expected. We attribute the strength of the market to the demonstrated recovery in the economy, the rollout of vaccines and their proven effectiveness giving a visible pathway out of the pandemic, and the large support from central banks and governments continuing to feed through to asset markets.

The total return performance figures were mirrored in pricing trends. The widespread appeal of industrial to investors drove demand and saw yields and cap rates fall for four consecutive quarters in a majority (55%) of the 69 industrial markets we monitor globally. The re-pricing in retail showed signs of easing, with yields rising in 15% of the markets we monitor, compared to 52% of them a year ago. The office market was pretty balanced, with falls occurring in slightly more markets than rises (17% versus 4%). We expect the pace of decline in industrial yields to gradually ease, while trends in retail will vary by country depending on the stage of pricing adjustment.

Figure 1: 1H21 total returns by sector and market (%)



Source: NCREIF; MSCI, August 2021. Past / expected performance is not an indication of future results.

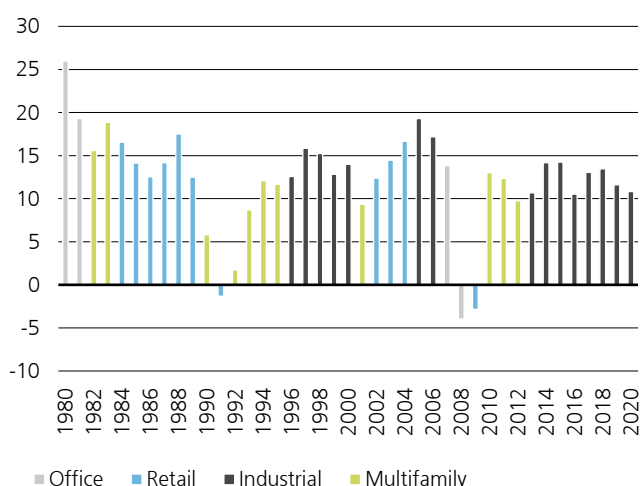
Real estate market activity mirrored the economy and, after a set-back in the first quarter due to new lockdowns, showed further recovery. According to data from Real Capital Analytics, after adjusting for seasonal effects global investment volumes rebounded strongly in 2Q, to within 3% of the high in 3Q19. Cross-border activity remains curtailed by ongoing travel restrictions, but has shown some recovery. Inter-regional deals accounted for 17% of global investment volumes prior to the pandemic in 4Q19, but slipped to 12% by 3Q20. In 2Q this year they had recovered to a 16% share. EMEA and Asia Pacific are the most driven by investors from outside the region, whose share of market activity is normally above 20%, compared to below 10% for the Americas.

Strategy viewpoint

Start thinking about rebalancing.

In a historical context, the run of industrial property is unprecedented. At the global level, our analysis of market valuation indices from MSCI and NCREIF show that in 2020, industrial was the strongest performing sector for the eighth year in a row, delivering a total return of 10.8% (Figure 2). This marks the longest run of outperformance by a single sector since data started in 1980, and is followed only by a six-year outperformance by retail in the mid-1980s. Historically, industrial yields have been above those of other sectors, providing a greater income return. Hence their compression over recent years has been a strong tailwind for capital values.

Figure 2: Total returns of global highest performing sector by year (%) (local currency, unleveraged)



Source: MSCI; NCREIF; UBS Asset Management, Real Estate & Private Markets (REPM), August 2021. Past performance is not an indication of future results.

Transaction activity in the industrial sector has also been very strong. According to data from Real Capital Analytics, industrial's share of global investment volumes has doubled from 11% in 2016 to 22% in 2020 and reached 24% in the second quarter of 2021. The rising share has been boosted by both rising transaction numbers and keener prices. By contrast, retail's share stood at 19% in 2016, but slipped to 12% in 2020 and was 11% in 2Q21. These are significant shifts that reflect how the market has evolved, with the pandemic accelerating the changes.

We think it is a near certainty that industrial will be the strongest performing sector again this year and most likely in 2022 as well. Industrial looks set to continue to ride the wave of strong rental growth driven by booming occupier demand, along with strong investor interest in the sector. However, we think that caution is needed to ensure that investors do not pay excessive prices in some parts of the market and that rental growth assumptions are achievable. Industrial valuations are also catching up with strong price growth.

At the current juncture we consider well-positioned real estate portfolios to be significantly overweight to industrial and logistics, underweight to offices, minimal weight to retail, overweight to multifamily and growing an allocation to the emerging and niche sectors like lab space and data centers. We think that this strategy will continue to perform strongly, until at least the end of 2021 and into 2022. However, the backdrop of sustained outperformance by industrial should also make investors pause for thought.

In describing its policy meeting discussions in June 2020, Fed Chair Jerome Powell said "We're not even thinking about thinking about raising rates." Turning this maxim on its head, we believe that real estate investors should now be "starting to think about thinking about rebalancing their portfolios." Indeed, moving into 2022 we think that investors should be ready to scale back any overweights to industrial and the options for doing so.

Reducing industrial exposure may seem like an unnerving prospect and begs the question of where to deploy capital instead? Retail may become viable again as market repricing occurs more widely in this sector. Indeed, some parts of the market already look to have bottomed out, such as retail warehouses in the UK, while others, such as continental Europe, likely remain some way off. Uncertainty over offices may begin to ease, allowing for greater exposure to this sector. Finally, the growing multifamily sector, along with the alternatives and niche sectors, also present good opportunities for investors to flesh out their portfolios. Even once the adjustment has been made, industrial will make up a larger share of investors' portfolios than it did pre-pandemic and before its record-breaking run started. The rise in occupier demand for logistics property and increase in physical stock will drag the share of industrial higher.

Real estate investment performance outlook

2020 actual and 2021-23 outlook are measured against the country-sector's long-term average total return, with the average +/- 100bps described as "in line with long-term average." The long-term average refers to the period 2002-20. The red underperformance quadrant refers to negative absolute total returns, either in 2020 actual or the 2021-23 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multifamily
North America	Canada	8.9		8.7		10.2		n/a	
	US	7.5		8.9		10.0		7.9	
Europe	France	7.7		9.3		9.3		n/a	
	Germany	4.7		5.3		7.7		n/a	
	Switzerland	5.6		6.2		n/a		6.3	
	UK	7.0		4.8		9.5		n/a	
Asia Pacific	Australia	10.0		8.9		11.0		n/a	
	Japan	5.2		5.4		6.0		5.6	

: Actual 2020

: Outlook 2021-23

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

Source: UBS Asset Management, Real Estate & Private Markets (REPM), August 2021. Note: Abbreviation LTA: long-term average. Expected / past performance is not a guarantee for future results.

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