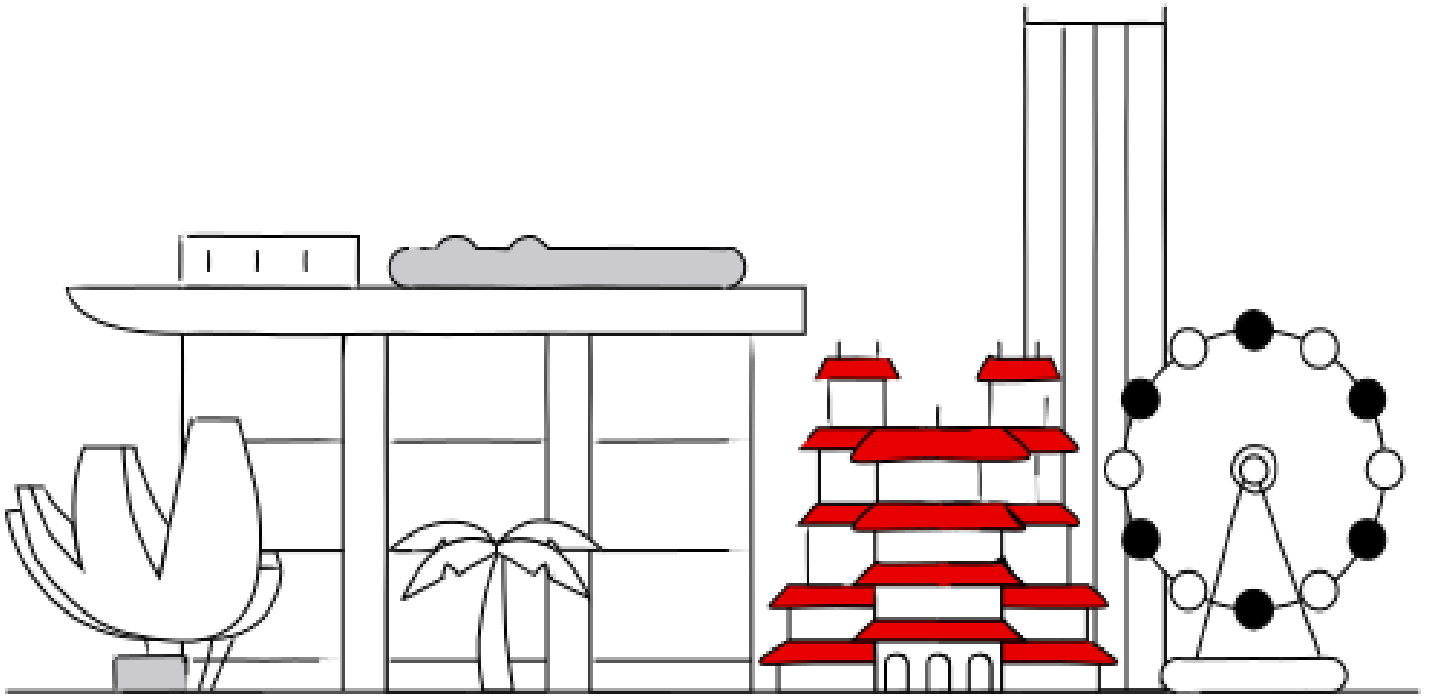


REO

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Real Estate Outlook – APAC



Look for the rising sun.



Wai-Fai Kok

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“APAC economic growth outpaced other regions in 2Q22. Inflation is rising but still modest and central banks’ reaction is not as aggressive as their western peers. Cap rates stayed firm but could rise in the next 1-2 quarters. We still see bright spots in the region that offer good investment opportunities.”

Leading growth but not overheating

In 2Q22, APAC (excluding Japan) was the fastest growing region in the world. GDP grew 4.7% YoY versus 1.7% in the US and 3.9% in Europe. Notwithstanding, APAC is generally not overheating. The region’s average inflation rate of 4.5% is the highest it’s been in more than a decade, but still way below the high-single digits being experienced in western countries. This is a function of the region’s more measured re-opening approach and supply chain proximity to China, which is still largely trapped in the COVID-19 era. The pace of monetary tightening differs across the region.

Australia, South Korea and Singapore are among the more hawkish countries. Australia is riding a commodity boom with GDP growth tracking above potential and July’s 3.4% unemployment rate at a 48-year low. The Reserve Bank of Australia (RBA) now expects inflation to peak at 7.75% in 4Q22. Rate hike decisions have been accelerated and are moving much faster than initially expected – 25bps in May and 50bps in June, July, August and September. Consensus expects further increases in the benchmark rate from 2.35% to around 3% or more by year-end. Risks are on the upside but RBA will try its best to avoid a hard-landing.

South Korea bears a resemblance despite being one of the earliest economies to tighten monetary policies. The pace of rate hikes accelerated in July and the new Bank of Korea’s (BoK) governor hinted at a 2.75-3% policy rate by end-2022

from the current 2.5%. Along the spectrum, rate hikes in emerging ASEAN countries are lagging due to modest inflation, partly thanks to administered energy prices in some economies. Japan is a unique case, partly structural, with interest rates firmly on hold. The economy has yet to fully reopen with GDP barely returning to pre-pandemic levels. After decades of fighting deflation, a modest level of inflation also seems to be welcomed by the Bank of Japan (BoJ). With peaking interest rate expectations globally, we think there is even less urgency to review policy unless inflation gets out of control, which we see as low a probability.

China is at the opposite end of the spectrum, with monetary easing as the economy slows on the back of its zero COVID-19 policy. Inflation has stayed benign as GDP growth has slowed sharply to 0.4% YoY in 2Q22. Nevertheless, there is little doubt at this point that China will recover when the economy reopens. UBS Investment Bank forecasts the economy will grow 3.0% in 2022 and 5.4% in 2023.

Looking ahead, we expect the rebound in APAC GDP to slow as tailwinds from re-opening ease. China’s eventual re-opening will likely offer a growth cushion against global weakness as uncertainties loom. Interest rates are rising in APAC but, in our view, the pace is not aggressive enough to cripple spending. We expect APAC economic growth to continue its outperformance versus other regions.

Reluctance to budge

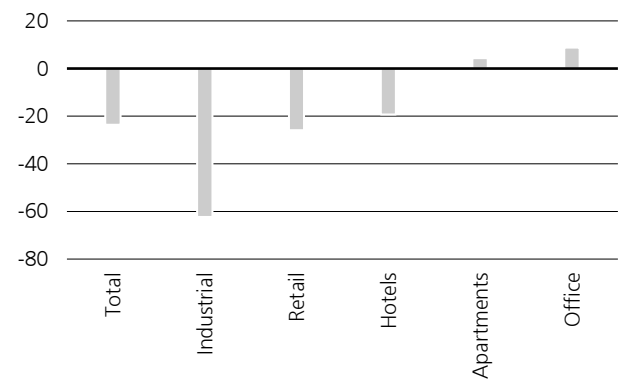
While the APAC occupier market remained largely healthy in 2Q22, investment volumes have taken a hit from gyrations in financial markets. Rising interest rates has been the bugbear and the market is currently in price discovery mode. The bid-ask spread has widened, as buyers seek to price in yield expansions while sellers have no urgency to budge. From a pricing perspective, stability in market indicators is crucial and volatile bond yields do not help. From a funding perspective, rapidly rising debt costs have made deals at current cap rates hardly accretive for investors.

The upshot is a slowdown in deal activity, as investors take a wait-and-see approach. In 2Q22, commercial real estate transaction volume in APAC fell 24% YoY and was 11% below 2Q19 levels, according MSCI. By country, China (-42%), Hong Kong (-50%) and Australia (-26%) were among the worst hit, partially offset by Singapore (+74%) which is being viewed as a safe haven. In other core markets, Japan and South Korea fell 19% YoY.

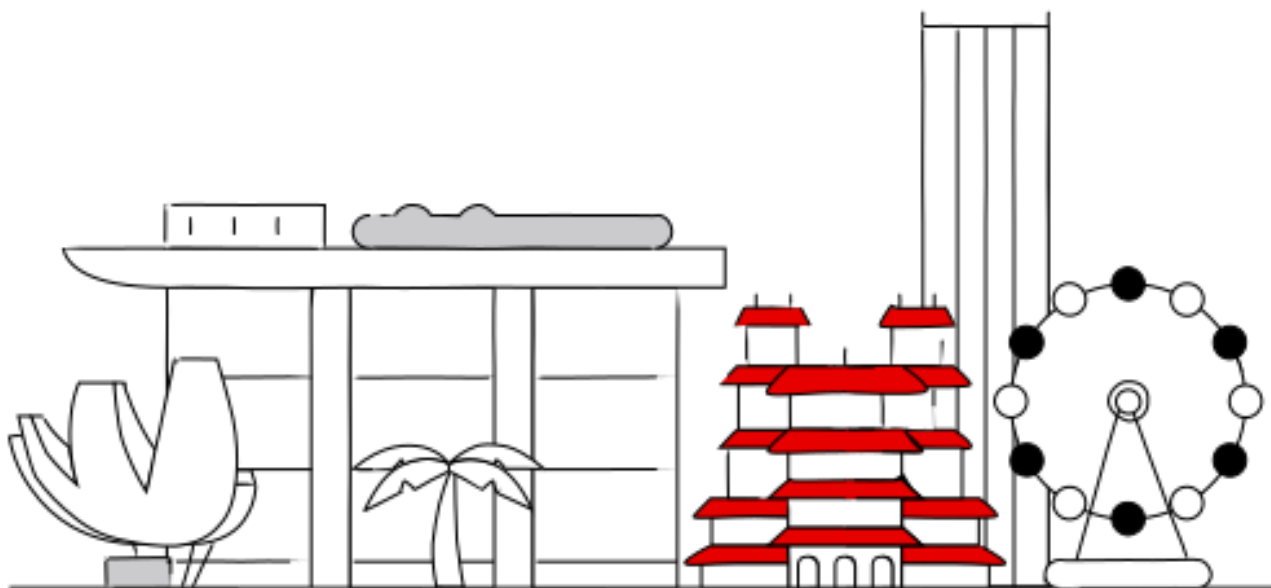
By sector, industrial experienced the largest pullback (-62%) following its bull run in 2020-21 (see Figure 1). Its structural growth story remains intact, but the rich pricing prompted a pause especially on the back of the rising cost of capital. With the APAC population leading the global return to work premises, investors are taking comfort with fund rotation back into the office sector (+9%). Singapore and South Korea offices performed the best given their positive fundamentals.

With few deals struck at a discount, there is still little evidence of yield expansion in APAC. In fact, in the 2Q22 reporting season, listed REITs largely reported higher valuations on stable cap rates and growing rents. Management commentary turned cautious on acquisitive growth due to a dearth of palatable yield spread. Cap rate guidance is mixed with Singapore REITs, and generally more optimistic than Australia REITs. Most property consultants are starting to project an increase in cap rates. We are in the same camp and expect yields to rise in certain markets, though it could take another 1-2 quarters to play out.

Figure 1: Asia Pacific transaction volume YoY change (2Q22)



Source: MSCI, August 2022.



Bright spots offer opportunities

We are living in a period of elevated volatility, which has characterized financial markets since 2019. The rebound in stock markets since June 2022 proved short-lived and has turned its head again in recent weeks given hawkish Fed comments. 10-year bond yields rose. We think a stabilization of market indicators is pivotal to ease negotiation stalemates in the property market.

US 10-year bond yields, as a proxy, are 130bps higher vs end-2019. Unlike the US and Europe, APAC cap rates have yet to let up and are perceived to be lagging, which is among the key hurdles for would-be buyers. That said, context is needed. Industrial asset valuations have surged 48% and 38% in the US and UK since 2019 and have far outpaced APAC's -1% to 35%. The run-up in APAC was more modest and any future reversal would also likely be milder, in our view. To be clear, we think that the higher risk-free rate will need to be factored in. But that it may not lead to a major valuation write-down, partly thanks to strong rental growth in certain markets.

Investors are likely to err on the side of caution in the short term though and stay selective for a stronger investment case. To that end, we highlight several bright spots in the region.

Japan – a world of its own

Japan is an outlier economy that has avoided the global phenomenon of worrying inflation and rising interest rates so far. That, by itself, enhances Japan's relative appeal versus other APAC countries which are facing tightening yield spreads, and as a result risks of cap rate expansion. The sustainability of this policy comes up regularly in our discussions and is a crucial investment consideration. We think that fundamentals suggest interest rates should stay low.

The BoJ has a rare chance to break out of the deflationary mindset that has bogged down the economy for decades and should not let this opportunity go to waste. It maintained its policy stance in July and showed its true mettle in fending off bond speculators' bet of rising interest rates. Foreign investors have turned net buyers of Japanese bonds, with a record USD 37 billion purchase in July, according to Bloomberg. Given the easing pressure from peaking fed rate expectations, we believe there is even less urgency to review its current stance.

Asset yields are attractive in the context of Japan's 0.2% 10-year bond yield. Tokyo prime office, for example, offers an outsized yield spread of 230bps vs 20-90bps in other APAC core markets (see Figure 2). Multifamily continues to see strong interest and is a sector we like for its resilient income profile. It is trading at a wider yield than office, while it is the

reverse in the US and UK. We think the current weak currency at JPY/USD 139 would also be a draw for foreign capital.

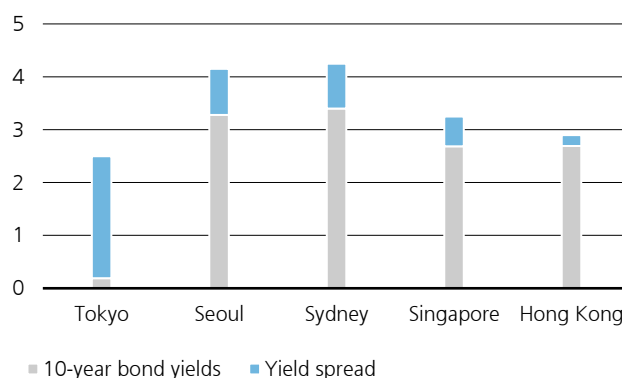
Defying gravity

Singapore was the only city in APAC to deliver growth in 2Q22 transaction activity; +74% YoY to a record high of USD 5.6 billion, according to MSCI, as investors were drawn to the office sector's tailwinds. Grade A rental growth accelerated to 3.2% QoQ and is on course to overshoot their last peak in 2019. Supply is limited and CBRE expects an 8.3% jump in rents for the full year. Hong Kong relocation is not apparent to landlords yet but anecdotal evidence suggests increasing headcount transfer. Transaction activity could stay elevated with NTUC marketing a huge SGD 4 billion retail portfolio.

Seoul is another sought-after market with strong fundamentals. 2Q22 office vacancy contracted 3 percentage points QoQ to 2.1%, the tightest since 2009. Grade A effective rents spiked 9.6% QoQ on the back of a 2.4% QoQ headline growth and lower incentives. Rents are likely to strengthen further, with no new supply in 2023 and 2024. We expect rental growth in the next two years to outstrip the 1-3% p.a. run-rate over the last decade.

We also highlight Australia logistics for its eye-watering rental growth. Thanks to its tight 0.3% vacancy, the lowest globally, super prime average rents in Sydney jumped 22.8% YoY. This could allay some concerns on capital values. Nevertheless, with cap rates at sub-4% and having compressed more than 100bps in the last two years, we think this sector is among the most exposed to yield expansion in APAC.

Figure 2: APAC office yield spreads in 2Q22 (%)



Source: PMA, Reuters. Note: bond yields as of 14 August 2022.

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