

Real Estate Outlook

Edition 4, 2019



Returns slowing but
rate cuts supportive of sector

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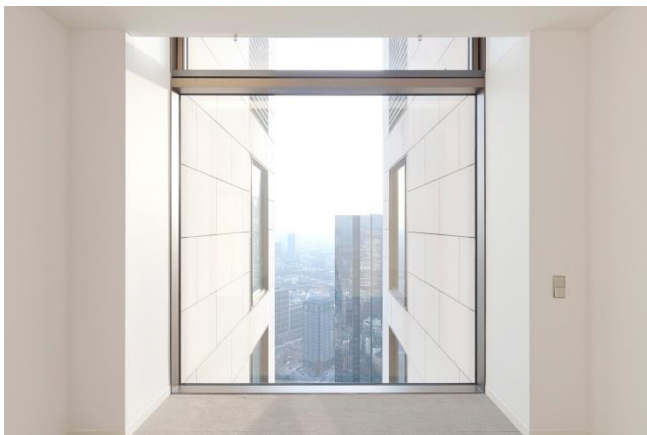
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Global overview

Economies around the world are slowing, with some on the brink of technical recession. However, the US consumer remains resilient and our base case is for a slowdown rather than a recession. The rotation in monetary policy towards easing is supportive of real estate and is expected to continue to attract capital to the sector.

Macroeconomic overview

Over the course of 2019 economic forecasts have been revised lower, and interest rate and bond yield projections cut. Concerns abound over prospects for the global economy and whether it will enter recession in 2020. Indeed, some economies, such as Singapore and Germany, are already approaching technical recessions, while Hong Kong is already there as protests take their toll on economic activity. That said, the main economies of the world continue to show growth, albeit weakening. The US, for example, recorded growth of 2.0% YoY in 3Q19 while the eurozone managed a better-than-expected 1.1% YoY. China grew 6.0% YoY, but growth is expected to slip below 6% in 2020, which would mark the slowest pace since the early 1990s.

The trade war between the US and China has escalated as the year has progressed, with the two superpowers retaliating to each other's tariffs with more of their own. However, the two sides reached a ceasefire in October, with the US agreeing to suspend a specific set of December tariffs, and China in turn agreeing to increase its purchase of US agricultural products. Their leaders are expected to meet in November, though an enduring truce seems a long way off. The pending US election in 2020 could provide some impetus on the American side, though it is not that clear cut since playing hard against China resonates with President Donald Trump's core electoral base.

Figure 1: World trade volume and world industrial production volume (3mma, % YoY)



Source: CPB World Trade Monitor, November 2019

At the global level, world trade volumes have reversed, and in the three months to August were down 1.5% compared to a year earlier. The impact has mainly been felt in industry where, over the same period, world industrial production growth slowed to 0.7% (see Figure 1). The weakness is a long way off those levels seen during the GFC, when trade and production volumes both plummeted; however, it is the most pronounced since. China has been hit particularly hard, with goods exports down 3.2% YoY in September in USD terms. Central and Eastern European economies are also feeling the chill, exposed to the German car industry through tightly integrated supply chains.

A key question is whether the service sector can remain resilient, having held up reasonably well. In the US, consumer spending remains robust, buoyed by a solid labor market and unemployment rate at a 50-year low. However, it is quite possible that weakness in trade and manufacturing will eventually spill over to services as well. The likelihood of recession has risen and is increasingly discussed. For example, Oxford Economics puts the probability of recession in the US over the next 12 months at 40%, up from below 30% at the start of the year.

The key global recession indicators flashing red at the moment are the US yield curve and world industrial production, though unconventional monetary policies mean the predictive power of the yield curve might be diminished. The term premium on long-dated bonds has fallen, making an inversion easier to achieve than in the past. Other recession indicators include US corporate earnings and commodity prices, which are currently flashing amber, and global stocks, corporate bond spreads and US credit standards, which remain green.

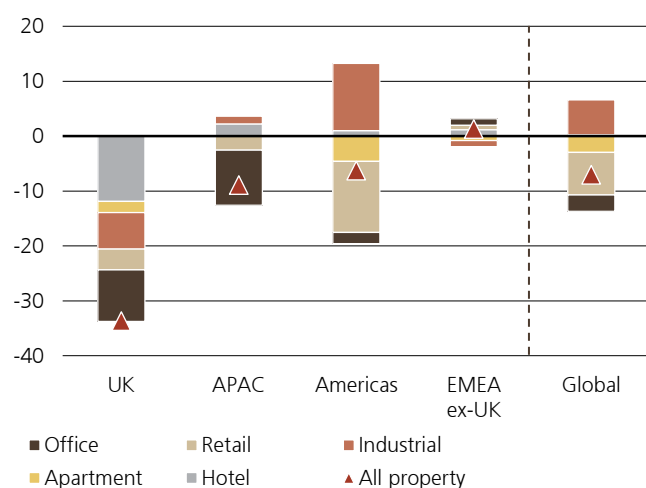
The escalation of the trade war and cooling growth has spurred central banks around the world to action and seen a U-turn in monetary policy this year. The Federal Reserve has cut US rates three times, largely reversing the four increases of 2018. However, it is unclear whether the Fed has been driving markets or responding to them; what Ben Bernanke called a "hall of mirrors". The ECB has also acted and in September cut its deposit rate to -0.5%, extended its forward guidance and restarted its asset purchase program at EUR 20 billion a month.

The ECB's decision created an increasingly bitter public division on its governing council. The German, French, Dutch and Austrian central bank chiefs all oppose the new easing measures, along with a host of former senior ECB officials. This will make the start of Christine Lagarde's tenure as ECB President harder. Mario Draghi voiced a parting call for eurozone governments to establish a joint budget for the single currency bloc, which could help stabilize it in times of crisis. Indeed, in Germany, opinion does seem to be softening on the law which prohibits structural budget deficits, and could yet result in some fiscal support for the economy as it slows. A eurozone program is much further off.

Capital markets

Global real estate investment volumes are lower than they were a year ago. According to Real Capital Analytics (RCA), global investment activity was down 7% in USD terms in 3Q19 from a year earlier (see Figure 2). Americas volumes were down 6%, with a particularly sharp drop recorded in the retail sector although partially offset by a strong industrial market. In the UK, volumes were down 34% in USD terms and lower across all property types. However, even excluding currency effects the underlying UK market was weak, with volumes still down 30% YoY in GBP. The rest of EMEA fared better, with little change in activity in most sectors and overall volumes up 1% in USD. In APAC, the office sector fared the worst, dragging all property volumes down 9%.

Figure 2: Investment volumes
(contribution to all property 3Q19 % YoY, USD)



Source: RCA; November 2019

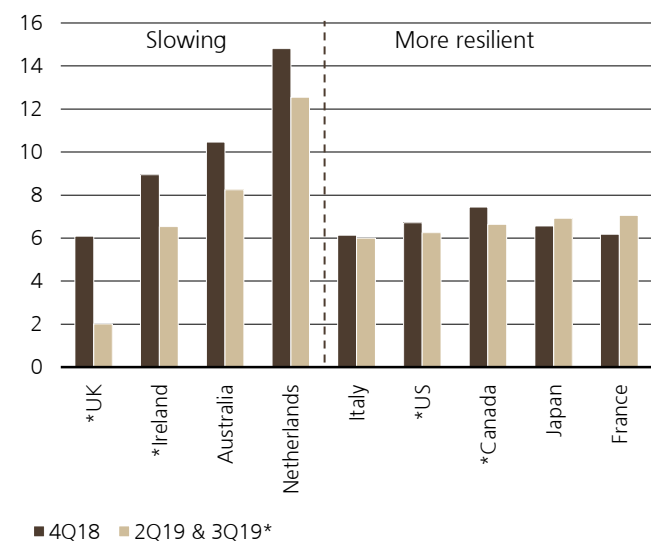
Yields and cap rates were broadly flat in 3Q19. In our quarterly survey of over 330 city-sector markets globally we found yields were unchanged in the vast majority (68%). A small number saw falls in cap rates and yields (17%) while a similar number saw increases (14%). Overall we think the interest rate cuts we have seen this year will likely provide some renewed downwards impetus on yields in some markets. At the very least, outside of the retail sector, they should prevent yields from rising. Retail is the only sector where we think yield rises are likely in the near term, particularly in lagging markets, as retailers battle with structural change. In the medium term we do not expect any sharp rises in yields and cap rates following the extended period of falls in the wake of the GFC. Moreover, investor interest in real estate remains firm, which is supporting current pricing.

Real estate continues to provide positive returns, with performance varying by market. Our expectation for some time has been that returns will slow and this is being borne out in markets which report performance at a higher frequency. Compared to 4Q18 most of these markets have shown some slowing in returns this year, with only two markets recording a mild acceleration. In 2Q19 annual returns were slightly higher in France and Japan compared to 4Q18. All other markets showed a slowdown, modest in the cases of Italy, the US and Canada, and sharper in the UK, Netherlands, Ireland and Australia (see Figure 3).

Returns in the UK slipped to 2% YoY in 3Q19 from 6% in 4Q18. The retail sector is the key driver of softness in the UK market, while industrial and offices have held up much better. With an election looming on 12 December and Brexit still unresolved, uncertainty hangs over the UK. However, foreign investors are waiting in the wings, looking for a possible currency play and ready to act if the Brexit fog clears. Moreover, office yields in the UK look high versus some other core European markets.

Ireland historically has been a more volatile market, and annual returns slowed to 7% in 3Q19 from 9% in 4Q18. In Australia, a market which has been outperforming its global peers recently, returns fell from 10% in 4Q18 to 8% in 2Q19. Finally, in the Netherlands, which has also been one of the strongest performing markets, with its buoyant office sector, returns slowed from 15% in 4Q18 to 13% in 2Q19. With returns slowing in most markets, we think they will converge to around the 5% p.a. level over the next three years, with little significant differentiation between markets.

Figure 3: All property total returns
(% YoY)



Source: MSCI; NCREIF; November 2019

Strategy viewpoint

A key consideration for global real estate investors is hedging costs and currency exposure. Given the changes in interest rates that we have seen this year, we believe it is worth reviewing them. Ultimately, hedging costs are determined by interest rate differentials. The decision to hedge or not to hedge is down to the individual investor and their risk appetite and objectives. Hedging will remove the increased volatility that currency exposure injects into returns, while going unhedged will see currency shifts impact the returns an investor receives. In extreme cases, currency swings can overpower real estate returns or turbo-charge them.

In the end, the cumulative foreign exchange impact for an investment will be realized at the time of sale, when proceeds are repatriated back to the investor in their own currency. However, the reported market values through the life of the investment will reflect currency impact, be it hedged or unhedged, and hedging on a rolling basis will likely result in cash flows along the way as contracts get settled and rolled over. Over the longer time horizon though we would expect the impact on total returns of going unhedged to be little different from going fully hedged since, on average, we would expect currencies to move in line with forward rates.

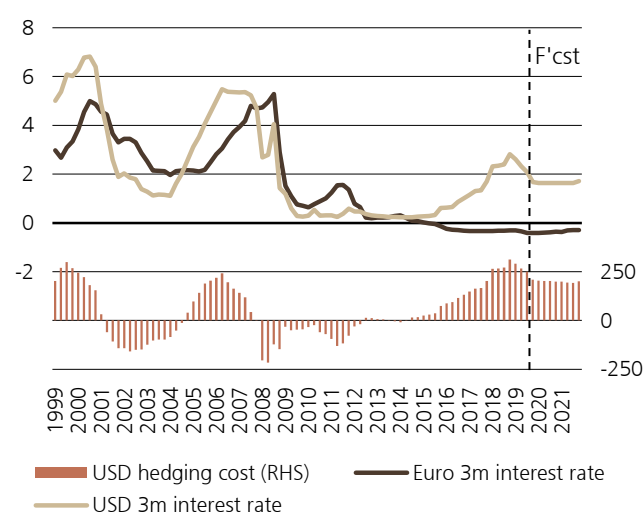
Indeed, our analysis shows that direct global real estate returns were 9.1% p.a. over the period 1994 to 2018 in USD terms at market exchange rates, little different from the 8.7% p.a. achieved on a fully hedged basis. Therefore over the period as a whole, market exchange rates moved broadly in line with forward rates. However, there were significant short term deviations, which show up in the volatility of returns. The standard deviation of annual returns at market exchange rates was 6.0% p.a., while it was 4.8% p.a. for fully hedged returns. Hence hedging does reduce return volatility.

The launch of the euro is a good case study of when currencies do not move in line with forward rates and when a substantial deviation exists. When the euro launched in 1999, US short-term interest rates were above eurozone rates and hence there was a cost for euro-denominated investors to hedge their investments in US assets. However, in reality, rather than depreciating as the forward rates predicted, the dollar actually surged 17% against the euro in the single currency's first year.

In 2019 US interest rate cuts have seen hedging costs for euro-denominated investors fall, from just above 300 basis points at the start of the year to 250 basis points by the end of 3Q. This means that in euro terms hedging knocks 2.5% off the annual returns on US investments.

A key question for investors now is how hedging costs will evolve going forward. Interest rate forecasts for the next couple of years imply that hedging costs will remain around the 250 basis points level (see Figure 4). However, a US recession which saw the Fed slash rates would likely see hedging costs fall sharply. Over the next decade, interest rate predictions from Oxford Economics suggest the hedging cost will gradually narrow to around 50 basis points.

Figure 4: US and eurozone three-month interbank rates and USD to EUR hedging cost (% and bps)



Source: Oxford Economics; November 2019

What does this mean for investment strategy? At face value it implies that US investments need to deliver an additional 2.5% p.a. of returns for euro-denominated investors over the next couple of years at least to compensate for the hedging drag. However, this is an overly simplified view. One of the main reasons for an investor of going global is the diversification it brings them from gaining exposure to different markets and economies. Moreover, in addition the US has the advantages of being the largest and most liquid real estate market in the world.

With return expectations for core real estate similar in both the US and eurozone, the current hedging drag suggests it would be appropriate to slightly underweight the US relative to its neutral allocation. Another way of taking into account the hedging cost would be to access real estate, which has higher return expectations. Indeed, the alternative sectors such as student accommodation, medical office and retirement housing are more developed in the US than most eurozone markets, and the multi-family sector is also bigger. With some of these more niche markets offering higher return expectations, exposure to them can provide a way of mitigating the hedging drag.

Real estate investment performance outlook

2019 performance and 2020-22 outlook are measured against the sector's long-term average 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 2019 or the 2020-22 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multi-family
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	4.0		5.5		6.9			
	Switzerland	5.6		6.4				6.3	
	UK	8.3		7.4		10.2			
Asia Pacific	Australia	10.4		10.7		11.0			
	Japan	5.3		5.6		6.0		5.1	

Forecast
Performance 2019

Outlook
2020-2022

: 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), November 2019. Note: Abbreviation LTA: long-term average

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APAC outlook

The APAC economy continues to rely more on domestic demand as fiscal policy response kicks in. A downbeat mood is starting to affect office demand although markets are still supported by tight vacancies. The performance of industrial real estate is boosted by restrictions on land use. While sales volumes are falling, investment interest is likely to remain strong as yield spreads increase.

APAC outlook

Real estate fundamentals

Bracing for a long winter

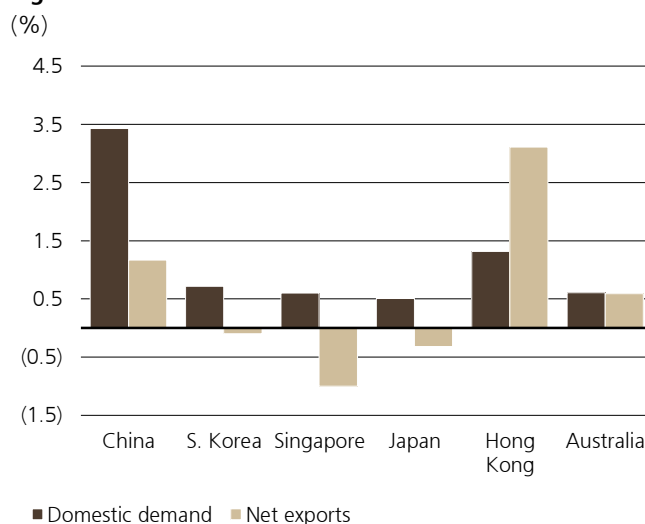
As we head into the last quarter of 2019, it has become more evident that the APAC economy is slowing down. While the situation is far from crisis proportions, there is a growing acceptance that economies in the region should brace for a long winter, heralded not just by the US-China trade conflict, but also the electronics down-cycle, Japan-Korea dispute and growing political tensions throughout the globe. GDP in China and Australia softened to the slowest pace of growth in a decade in 2Q19, while Hong Kong has entered into a technical recession as its GDP contracted on a quarter-on-quarter (QoQ) basis for two straight quarters. Unsurprisingly, weakness is mostly led by the external sector with exports contracting in most markets in 8M2019, with the exception of Australia where exports benefited from an increase in commodity prices. In contrast, domestic demand has emerged as a resilient pillar of support (Figure 5).

Private sector consumption has held up¹ well in 2019 (see Figure 5). This is partly due to a still-tight labor market where employment remains at high levels. In theory, this is supposed to result in rising wages which should then have trickle-down effects on consumption. However, structural changes in the labor market (such as the rise of temporary workers, masked underemployment, etc.) are turning this theory on its head. Furthermore, the muted macro outlook is leading to weakening business sentiment which curtails the willingness and ability of corporations to raise wages. In addition to other idiosyncratic factors, such as the newly implemented sales tax hike in Japan and the protests in Hong Kong, consumer sentiment has taken a hit and households could be holding back on spending in anticipation of tougher times ahead.

In the absence of any strong demand drivers from the private sector, the buck passes to the public sector to stimulate, or at the very least, provide a backstop to economic performance in the region. Central banks have already taken the lead in this aspect. Early in October, the Reserve Bank of Australia cut its cash rate to an historic low of 0.75% – its third reduction this year. Amid the disruption from the anti-government protests, the Hong Kong Monetary Authority also lowered interest rates for the first time since the GFC, while the Monetary Authority of Singapore reduced the slope of the trading band of the Singapore Dollar Nominal Effective Exchange Rate for the first

time in three years. The People's Bank of China has also loosened monetary policy through a raft of measures including cutting banks' reserve requirement ratios and lowering lending rates, but given the simultaneous need to ensure that credit growth does not get out of hand, Beijing has turned to fiscal measures such as cutting value-added and personal income taxes to spur demand. Indeed, credit concerns are not just confined to China. Market watchers are increasingly warning of rising corporate debt levels throughout Asia, precipitated by a decade of low interest rates and made worse by a waning profit environment. Further monetary policy easing will have its limitations and expectations are increasingly on policymakers to up the ante on fiscal support, which has thus far remained relatively subdued as lawmakers wait to see how the trade tensions play out.

Figure 5: Contribution to GDP Growth



Source: Oxford Economics, CEIC, 2Q19

Retail

Retail sales in Singapore and Hong Kong have been contracting every month since February 2019, with the latter being particularly hard-hit by the anti-government protests. In comparison, retail sales in China, Australia and Japan held up relatively well, although consumers in each of these economies are also grappling with their respective challenges such as muted wage growth and the recent fall in home prices in Australia, and the dampening effect of the tax hike in Japan.

Performance of retail property in APAC in 3Q19 was muted at best and while risks remain tilted to the downside for most cities, arguably none is as badly hit as Hong Kong. Not only are domestic consumers cutting back on discretionary spending as the intensity and ferocity of the unrest is maintained, but visitor arrivals have also started to drop much more significantly, falling close to 40% YoY in August. Prime retail areas – where the main protests have been taking place – have been more affected than suburban areas, although some of the malls there have not been spared.

¹ Contribution of net exports to GDP growth for Hong Kong is positive because contributions from imports fell to a greater extent than that of exports

Average rents in Hong Kong as measured by CBRE dropped 10.5% QoQ in 3Q19, and anecdotal evidence suggests that there are instances of more drastic rent reductions. Retailers are unlikely to undertake significant expansion plans until the situation improves and landlords begin to offer monthly leases as a way of coping with the circumstances.

Elsewhere in the region, leasing demand for prime retail areas is still relatively robust. In Tokyo, luxury brands, jewelry stores, cosmetic brands and F&B operators continue to show interest in the prime Ginza and Omotesando shopping stretches. In Sydney and Melbourne, leasing demand for CBD retail is coming from F&B brands, personal services such as retail banking, as well as health and fitness operators. But despite the leasing interest, softness in the economy still merits caution by retailers, which limits the ability of landlords to raise rents. Rents in these three cities were largely flat in 3Q19.

In China, policymakers sought to offset the effects of the trade war by introducing tax cuts to shore up consumer confidence, but it remains to be seen just how effective the measures have been against the broader backdrop of a weakening economy. The biggest challenge facing the retail market is likely to be the high levels of new supply that is due to be completed.

Industrial

Despite the worsening manufacturing and export momentum in 3Q19, the industrial sector's performance continues to hold up, supported by demand from e-commerce and third party logistics (3PL) companies and a lack of available space in some markets. In some cities, demand is also coming from food manufacturers amid a rising trend of food delivery services, and the need for the sector to centralize and automate due to high labor costs and retail rents.

In certain cities, competing uses of land have also reduced the amount of space available for the industrial sector, thereby providing an impetus for rent growth in places where stock has been tightened rapidly. One such city is Hong Kong, where the government relaunched the Industrial Revitalization scheme, prompted by the decline of the city as a manufacturing hub. Incentives such as an increase in the plot ratio have attracted investors to acquire ageing industrial buildings, driving down vacancy rates. Warehouse vacancy fell to a five-year low of 1.7% in 3Q19, with prime rents managing to rise 2.1% QoQ. Tier 1 cities in China also face similar changes in land usage, where there are growing restrictions on industrial land supply as the country transitions from manufacturing to services-led growth.

Australia, on the other hand, has seen industrial developments ramp up amid population growth and a government push for infrastructure development. Many of these new industrial buildings are speculative projects, but with pre-commitment leasing activity still strong, there has yet to be a situation of runaway oversupply. Rents in Sydney and Melbourne rose 0.4% and 0.8% QoQ, respectively.

In Tokyo, demand continues to be robust and despite a record quarterly increase in completions, rents in the prime Tokyo Bay area rose 0.9% QoQ. Pressure on occupier performance is higher in the outer regions of Greater Tokyo, where tenants have ample choices and are inclined towards sites which provide better accessibility and proximity to workers.

Office

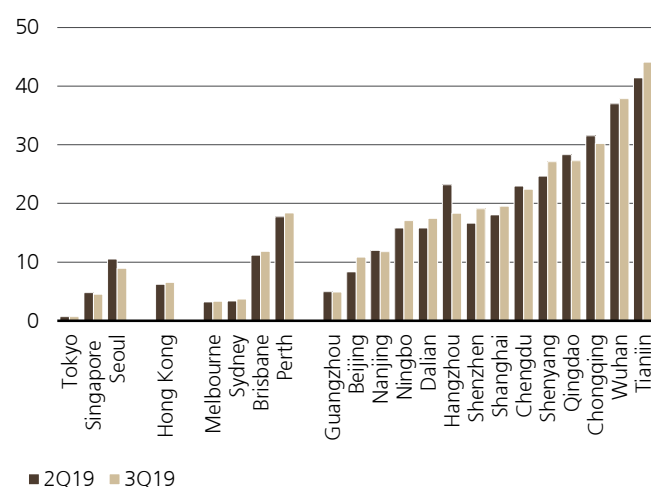
A wave of caution is sweeping across most of the APAC office markets, and as has been the case in the other sectors this quarter, Hong Kong has been especially hard hit as the social unrest adds another layer of uncertainty to corporate real estate decision making. Demand from Chinese firms has slowed, partly due to the ongoing slowdown in China, and more recently a reluctance to further commit to real estate in Hong Kong, at least not until the near-term uncertainty clears up. Other occupiers have also taken a wait-and-see approach with their expansion plans, although this had already been the case due to surging office occupancy costs in the last few years. The saving grace is that total net absorption has not yet swung into contractionary territory. Nevertheless, there is a fear that more companies will give up space in time to come, leading to a rise in shadow space. Overall prime rents fell 1.5% QoQ, the strongest quarterly decline since 1Q13.

Occupiers are increasingly hesitant to take up more space in Singapore and net absorption fell to the lowest in 10 quarters, but limited new stock still resulted in Grade A core CBD rents rising 1.3% QoQ. A tight vacancy rate of 0.7% is similarly supporting the office market in Tokyo, where Grade A rents rose 1.1% QoQ in 3Q19. But after almost eight years of growth, the market is likely nearing the tail end of its rental expansion cycle with substantial new supply expected in 2020.

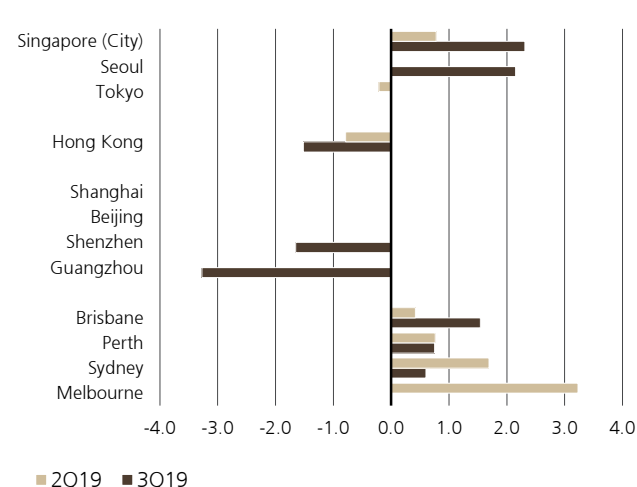
Cities in Australia are starting to approach their turning points as the rental growth momentum in Perth and Brisbane overtook that of Sydney and Melbourne in 3Q19. Rents in Melbourne were flat on the quarter, Sydney rose 0.6% QoQ, while Brisbane and Perth ticked up by 1.5% and 0.8% QoQ, respectively, amid a cyclical improvement in the secondary cities (which we wrote about earlier this year in our paper titled "*Approaching a turning point?*"). Although office vacancy rates remain at historical lows for the gateway cities of Sydney and Melbourne, rental growth is starting to stabilize after more than four years of growth. On a year-on-year basis, however, rental growth in Melbourne and Sydney still exceeded that of Brisbane and Perth. Melbourne and Sydney could start to see some pressure with the expected increase in new supply over the coming year, particularly Melbourne.

Figure 6: APAC CBD office vacancy rates

(% of existing stock)

**Figure 7: APAC CBD prime office rent growth**

(% QoQ)



Source: CBRE, 3Q19

Capital markets

According to RCA, total transaction volumes of APAC commercial property fell 9% YoY in 3Q19. This is reflective of several concurrent trends: (i) a weak macro environment, (ii) elevated pricing levels, and (iii) certain markets entering late cycle, all of which resulted in increased prudence from the buyers' perspective. Investment volumes fell in most markets except for Singapore and China but this is not a particular concern given that 2018 volumes were at record highs and overall transactions in 9M2019 are still in line with 10-year averages.

Although it has a small market share in APAC, Singapore volumes grew by nearly 70% YoY. This is perhaps not surprising given the level of uncertainty in the global environment which prompts capital to seek safety, and the stability seen in the Singapore market could be an attractive enough factor to offset the tight yields and rich pricing. Major deals in 3Q19 include the SGD 1.6 billion acquisition of mixed-use project Duo by Gaw Capital and Allianz Real Estate, the SGD 655 million sale of 71 Robinson Road, and the SGD 548 million sale of Bugis Junction Towers.

China makes up a large share of APAC commercial real estate transactions, with the biggest deal concluded this quarter belonging to the USD 1.5 billion acquisition by Brookfield Asset Management of mixed-use project the Huangpu Centre in Shanghai. While capital outflows have been curbed by authorities, cross border capital has been eager to get in, with investors from Singapore and the US propping up most of the buying activity in 3Q19.

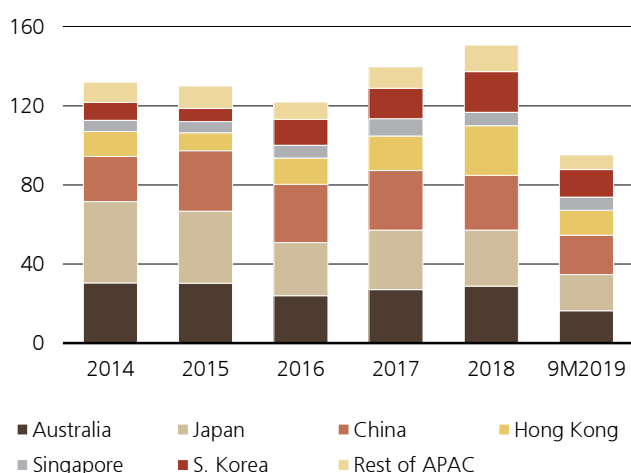
In Australia interest in the secondary cities of Brisbane and Perth has grown, although the lack of investable stock remains the limiting factor. 400 George Street in Brisbane managed to change hands for AUD 525 million, while most of the other major transactions in 3Q19 involved office assets in Sydney and Melbourne. Investor interest in Australia is likely to remain sustained given that cap rates there are still among the highest in APAC.

Several logistics properties changed hands in Japan, the most notable of which is Blackstone's USD 920 million acquisition from Mapletree of a portfolio of six logistics facilities in Greater Tokyo. Aside from this trade, Japan's investment market remains largely contained to domestic players, but rather than indicating a lack of interest, this is instead demonstrative of the difficulty of accessing stock in a market where assets are largely held by public and private J-REITs. There are growing signs of investors taking unconventional approaches such as strategic buyouts to acquire assets but these methods require a high level of sophistication and commitment and are unlikely to become commonplace.

Transaction volumes in Hong Kong fell over 40% YoY in 9M2019 but this is not alarming given that the volume in 2018 was at a record high and the total value of transactions in 9M2019 was in line with the 10-year average for full year investment volumes. Nevertheless, the full impact of the anti-government protests are likely to only be seen in the coming months given that the violence only started to escalate from July onwards. Mainland Chinese investors were noticeably absent from the investment market in 3Q19, marking the first quarter that they have not completed any acquisitions in Hong Kong in almost 10 years, according to CBRE.

With bond yields being driven down yet again by the accommodative stance adopted by global central banks, real estate yield spreads are once again looking attractive but we want to caution that property yields across most APAC markets are already at their lowest in 10 years. While the vast amounts of dry powder looking for limited assets to invest in could still result in cap rate compression, we recommend that investors remain prudent in underwriting capital gains in their investments.

Figure 8: Commercial real estate transaction volumes
(USD bn)



Source: RCA, as at October 2019

Strategy viewpoint

With the recent high profile withdrawal of WeWork's planned public listing, the spotlight is once again on the untested co-working business model and what the implications are for real estate in the mid-to-long term. Fears about the co-working sector were renewed and questions raised about the viability of a business model which pairs long-term lease liabilities with variable revenue from short-term occupants, with the latter particularly tenuous and exposed to uncertainty in a weakening macro environment.

In our recent interactions with investors, there was a sense of skepticism about co-working, but in our view the emperor has always been wearing his 'new' clothes; i.e. it was not a new fault line raised by a few, but often deliberately ignored by many more. Part of what feeds this renewed fear is the reliance that office markets in APAC have come to have on the co-working sector as a demand driver, where take-up by the sector accounted for as much as ~30-40% of total office net absorption in cities like Singapore and Hong Kong in 2018².

The issue is that co-working operators are not expanding as a result of organic growth but are doing so in order to gain market share, which results in a situation of obligations that are unbacked by earnings. Thus far, landlords have been willing to sign on such operators, partly driven by the belief that the way people work is changing and partly by the ability of operators to pay high rents, but in all likelihood it is also due to a lack of options as absorption from the traditional space guzzlers like banks, shipping and commodities companies dried up. The credit risk of co-working operators as tenants is high, especially for many that have relied on venture capital cash and have yet to turn a profit. And, on the more extreme end, there exists a real risk that co-working operators become 'too big to fail' even if they default on their lease obligations, as market exposure to such a business model holds landlords to ransom.

Despite its detractors, we have to agree that the co-working sector has fundamentally changed the way that office users and owners are utilizing space. What used to be an old-school serviced office business has now created new, structural demand through the provision of supplementary offerings and clustering of networks, which are ever more important to new economy users. Furthermore, there are clearly companies who benefit from the flexible leases offered by co-working spaces, such as smaller enterprises and tech start-ups. As the economy slows, some traditional companies may also turn to co-working spaces as an interim solution while they wait and see how things turn out. To that end, we have even seen investors teaming up exclusively with co-working players in strategic partnerships to extract the premium from this structural change in how work space is being redefined.

The consolidation of co-working operators is something that will eventually happen across the industry, albeit gradually. That will allow for a few thriving and sustainable operators to stand out amid the currently fragmented landscape. Furthermore, many landlords have implemented measures to mitigate the risks while still getting exposure to the sector, such as by running a flexible office set-up on their own. And while WeWork might have been aggressive in spending, other operators which have been more disciplined in expenditure and diversified in revenue streams have shown that it is possible to be profitable.

The bigger implication, in our view, is that the pace of expansion by co-working operators is likely to slow from its breakneck speed. Office markets in APAC are likely to face a challenged demand picture, although this will be mitigated by tight vacancies in the region. More importantly, despite the rapid growth, co-working only accounts for about 2-5% of total office stock in the major cities in APAC; any fall out we see in the space will therefore likely be contained.

² Based on Colliers' estimates of 2018 take-up





European outlook

The eurozone is seeing a period of relatively low growth due to ongoing political tensions, slowing global trade and concern about the manufacturing sector. On the positive side, services remain buoyant and occupier demand for the office and logistics sectors is robust. International capital is also still entering the market despite a slowdown. Investors have rotated more into alternative sectors, which we explore in our viewpoint.

European outlook

Real estate fundamentals

The eurozone economy stabilized in the third quarter of 2019, but has not shown any sign of picking up after what has been a fairly lackluster year. Growth of 0.2% defied consensus forecast expectations; however, sentiment remains depressed and industrial production is in negative territory.

In fairness, there has been a general slowdown in the global economy which has weighed on the eurozone, particularly the external sector. The added political uncertainty has also been a drag, with the fallout from trade wars hitting manufacturing and the impasse over Brexit weighing on private investment. Germany has been hit particularly hard due to headwinds facing its dominant automotive industry. These will likely gather pace as ESG concerns establish themselves due to the country's reliance on diesel fuel.

Despite softening fundamentals, European office demand has been buoyant since 2014, with leasing volumes showing consistent increases (see Figure 9). Leasing momentum has been strong in cities such as Brussels (+60%), Berlin (+27%) and Liege (+123%), although there are signs of momentum tailing off in other locations. Paris (-14%), Frankfurt (-28%) and Amsterdam (-34%) all saw volumes fall away despite expectations they would benefit from a post-Brexit boom. This is most likely related to the fact that there has been a net job loss in these three cities since 2016, which suggests – in turn – that maybe structural headwinds facing the financial sector are more important drivers than Brexit.

But some of these slightly downbeat city numbers could simply be due to a lack of quality space. Vacancy rates have continued to trend down as completions of new space (particularly in the prime segment) have been limited. According to data from JLL, the vacancy rate for major European cities stood at just 5.5% of units in 3Q19. German cities continue to see exceptionally low availability, with vacancy rates in Berlin, Hamburg and Munich now south of 5%.

Against this backdrop, it is hardly surprising that we are still seeing prime rental increases across most markets. Aggregate prime office rents grew by 2.6% YoY, while most major city centers also saw prime rental growth (see Figure 10).

Liege capitalized on its very strong take-up to move rents on by 14%, while German cities Berlin, Cologne and Hamburg all saw double-digit growth. Rental growth was either positive or stable everywhere else, apart from Marseille in France where there was a slight 6% decline. Going forward we expect to see continued rental growth in the office sector, which will take over from yield compression as the main driver of returns.

The retail sector continues to struggle for reasons that are well documented. The UK is the most affected as capital values have fallen significantly for retail warehouse, shopping center and high street assets. While secondary/tertiary assets have been hit much harder, there is also evidence of stress in the prime segment of the market. Of the 46 prime locations monitored by CBRE, just 4 saw rents increase while 19 saw them decline. The impact varies by country and is closely linked to the level of ecommerce penetration in that location; Italian prime rents for instance have been quite resilient, with values rising by 5% in Milan. Such examples are, however, few and far between, with even successful retailers far more selective about where to open stores as they look to build a more 'asset-light' omnichannel presence.

Supply data is scarcer for the retail sector, but in the UK the high street vacancy rate is now thought to stand at around 13.8% of units, and retail parks have around 12.6% of units vacant. This does, however, mask a high degree of variation. Weak secondary shopping centers now have one in five units empty, while prime retail parks are around 9%. We consider the retail warehouse sector to be more resilient going forward, due to its high income returns, good accessibility and larger format units. In light of this, it is hardly surprising we are seeing such high rental decline which we are expecting to continue at least until 2020. We do, however, believe there will be selective buying opportunities once this process is complete.

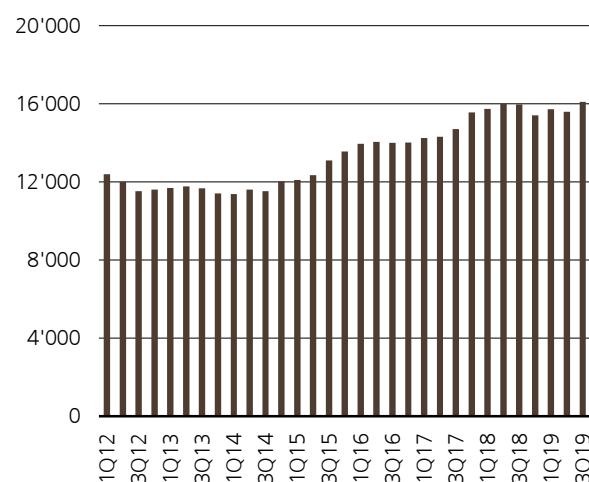
The industrial sector has continued to see strong demand for space with retailer, pureplay operators and 3PLs continuing to acquire warehouse space. Prime industrial rents in the eurozone increased by 3.1% YoY to 3Q19, illustrating high levels of demand (see Figure 10). While occupier demand continues to be robust, there are potential red flags for investors to be aware of. Firstly, the very low margin nature of the distribution business means there may be constraints on future rental growth. A recent UBS investment bank report commented that best-in-class omnichannel retailers were more attractive than pureplay online, due to the latter's lack of progress in growing their cash flows and profit margins. While this is only a single study, this will be of concern to real estate investors as ecommerce operators are currently driving the European logistics market, and a slowdown in that sector could have knock on effects for occupier demand.

On the supply side, there has been increased construction, with completion volumes exceeding take-up last year. However there continues to be a lack of speculative space in the pipeline and very low vacancy rates on a European-wide basis. As a result, we foresee modest rental growth over the next five years for logistics, with greater rates expected in assets located near to cities and large distribution hubs.

Going forward, we expect continued modest rental growth in the office sector, with rents increasing by 1-3% p.a. in the prime segment and 1% p.a. in the average segment. In the retail sector we are expecting some prime rental growth, albeit very selectively while the average retail stock is likely to see rental decline. Industrial is set to still see rental growth continue, but has historically not seen very high rates of expansion. In fact, prime European industrial rents are still only around 8% higher than they were in 2008, while retail rents are 44% above this level and office rents 15% higher. Thus, we are expecting fairly moderate performance, with average growth of around 1% and prime growth of around 2% p.a.

Figure 9: European office take-up

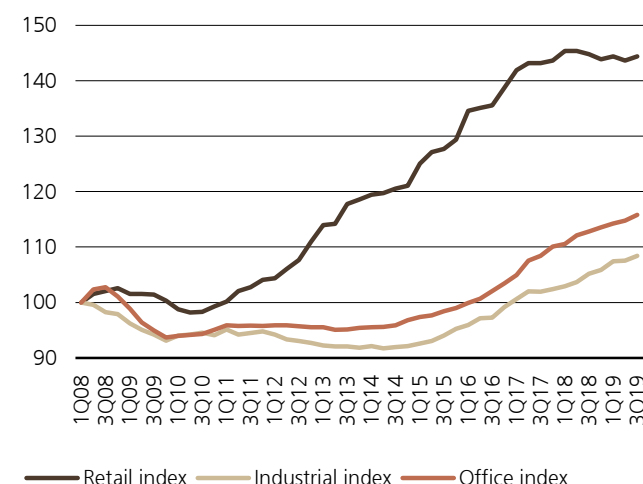
(000s sqm, rolling annual)



Source: JLL, 3Q19

Figure 10: European rental growth

(index, 1Q08 = 100)



Source: CBRE, 3Q19

Capital markets

Year-on-year (YoY) investment volumes have continued to decline for the seventh consecutive quarter, albeit with a degree of stabilization. Volumes were down 5% on the previous year, as weakness in Germany and the UK was offset by France where volumes increased by 16% (see Figure 11). Spain and the Netherlands saw volumes drop off by around 10%, while – surprisingly – Italian volumes jumped 52%, although from quite a low level.

The outperformance of France can largely be explained by Paris overtaking London as the city attracting the most investment in 3Q19. The UK capital has long been the unrivalled location for investment, but political uncertainty in the UK, as well as a strong influx of South Korean money into mostly Parisian offices, has swung the balance the other way. Nonetheless, the UK remains the first port of call for foreign capital entering Europe for the first time, with 70% of first-time buyers making their first acquisition here. Additionally, cross-border investors are still net buyers of the UK, signifying it has perhaps not yet lost its international appeal.

In any case, there is a strange logic to European investment markets at present. While volumes are not growing, they are also not falling substantially either, which with yields at record lows one would expect to happen at some stage. However, with government bond yields now negative in many locations, there is downward pressure on yields as institutional investors are forced to increase allocations to achieve a positive real return. As a result, prime yields continued to compress over 3Q19, with the combined prime yield coming in a further 15 basis points to stand at a record low of 3.6%. This indicates pricing is moving away from any absolute return target, rather relying on the spread over government bonds.

In terms of the individual sectors, industrial (-36 bps) was the best performer followed by offices (-20 bps) but the big surprise was that even retail managed to largely hold the level it was at one year ago. Prime retail deals are very few and far between, but the sale of the Nike store on the Champs Élysées at 2.7% is a reminder that there is still appetite for genuine best-in-class assets. Recent reported declines of 25% on Fifth Avenue in New York should, however, remind investors that no location is immune from the pressures facing the sector.

In fact, all of the traditional sectors have become somewhat unloved of late. As expected, retail investment was at a record low with annual volumes 32% below where they were in 2018.

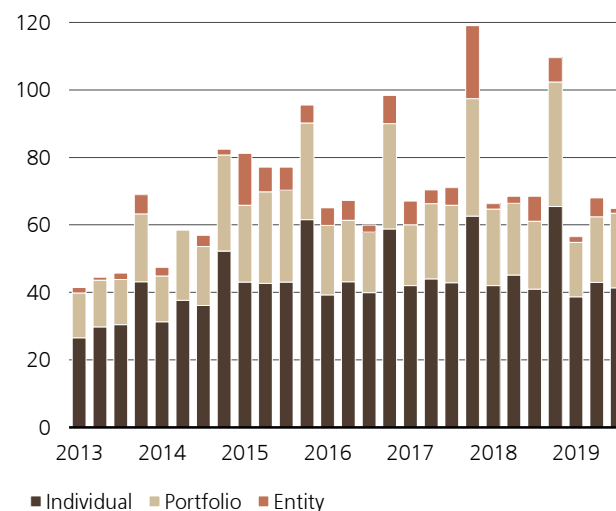
However, industrial and offices volumes were also down by 11% and 4%, respectively. In the office sector, there have been concerns about the increasing market share of serviced office providers, which have really come to the fore following the failed IPO of market leader WeWork. This could lead to an increased risk premium on assets with serviced offices as tenants, especially those that are single-let.

In terms of the industrial sector, while there are still some like-for-like effects of previous large portfolio deals, it is also true to say that investor sentiment has been somewhat varied. We are undoubtedly coming to the end of a long bull run, which has almost entirely been driven by yield impact (with the exception of the UK). As a result, pricing is currently at a level which would require rents to rise to meet return targets. Notwithstanding the structural drivers, many are wondering about the ability of a typically low rental growth sector to generate a strong and sustained increase in NOI.

As a result, investors have turned to alternatives, which have the added benefit of being less cyclical than the core sectors. Investments in senior housing rose 14% on the year, while hotels rose 2%. Apartments remain in vogue and saw YoY investment jump by 7%, while the rate of home ownership continues to decline in most European countries. This particular sector is subject to operating and regulatory risk, however, which we explore further in our viewpoint below.

Overall, our forward-looking expectations for European capital markets are defined by the continued 'lower for longer' interest rate environment. Therefore in spite of high pricing, we do not foresee a significant reversal over the next 12 months.

Figure 11: Investment volumes
(EUR bn)



Source: RCA, 3Q19

Strategy viewpoint

Regulatory uncertainties in European residential increasingly on investors' agenda

Since the Global Financial Crisis (GFC) the residential sector has developed from the least favored real estate sector to the second ranked after offices. In 1H19 investments in European residential accounted for more than 22% of total investment volume. Over the last decade institutional and in particular cross-border investors have increased their allocation in to residential.

However, while the downward yield shift in offices and industrial coincided with the cut in central banks' interest rates from 2011, the path of downward yield shift in residential seems to be more timed to the introduction of central banks' unconventional monetary policies in 2015. The yield shift in residential looks drastic but the spread of residential yields to office yields has just returned to its long-term average of 130 bps which was only 80 bps just before the introduction of the ECB's Quantitative Easing program.

The sector's main attractiveness for institutional investors has been the compelling macro story of increasing urbanization, privatization, deregulation and the emergence of an institutional multi-family sector (in Ireland and the UK). Investors have been recognizing residential as a real estate sector offering long-term rental growth prospects at inflation levels (at least). Tight supply in many urban areas has enabled investors to achieve rental growth well above inflation in recent history. After many years of rental growth, affordability of residential rents is now on the political agenda in many European countries. Even though the definition of what constitutes "affordability" is subject to discussion, politicians appear to be focusing on policies limiting rental growth on the landlord side while not tackling the more structural (under) supply side factors.

Economically successful cities are attracting inward migration, but managing residential supply is mainly the responsibility of the local authority regulating the planning and building laws. This can only be managed in the medium-to-long term as highlighted below:

- In 2001 the city of Hamburg introduced an overall regional development initiative. Since then Hamburg has put policies in place supporting growth including how to provide residential supply to support inward migration. The imbalance between supply and demand appears to be less severe in Hamburg as rental growth has been lower compared to other majorly undersupplied but economic successful German cities.

- The city of Helsinki has also followed a long-term supply-led policy approach. Even though there is still a shortage of supply, price increases in the Finnish capital have been less pronounced than for other Nordic peers.

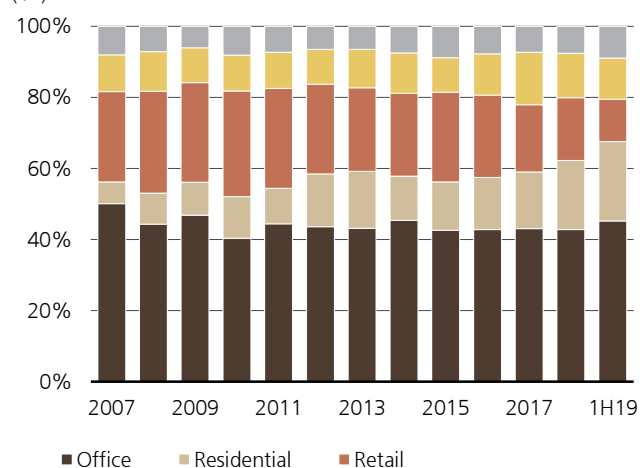
Investors have started to recognize that investing in residential exposes the invested capital increasingly to regulatory risk. While investment volumes in residential are still at very strong levels, cross-border net-acquisitions have slowed. This could be a sign of residential being a more sophisticated real estate sector but also of increasing investor cautiousness. An indication for investors' caution is listed German residential companies which are trading at an 8.7% discount to NAV.

Increasing rent control raises the question on rental and income growth assumptions. Today's yield levels might also be a reflection of the low interest and bond rate environment, which has been supported by a positive rental growth environment.

Increasing regulatory uncertainties on national but also more local levels raise the question of how to factor in a political/regulatory risk premium when acquiring a residential asset. Investors may also reallocate capital to other real estate sectors which are less exposed to regulatory risks. Political risks may not have an immediate impact on the tenants but on invested capex in the future. Considering that the investor's base in residential have been predominantly institutional investors (insurances and pension funds) lower property values tenants might be effected indirectly.

Managing the supply side of a real estate market is a medium to long-term process and requires foresight in policies, while restricting private ownership rights is a short-term (populist) policy but is unlikely to solve market imbalances. Nevertheless, the positive macro story for European residential is unchanged but investors may reconsider (political) risk-adjusted pricing.

Figure 12: Investment volumes split by sector (%)



Source: RCA, October 2019





US outlook

US property sector performance continues to diverge. 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 has increased.

US outlook

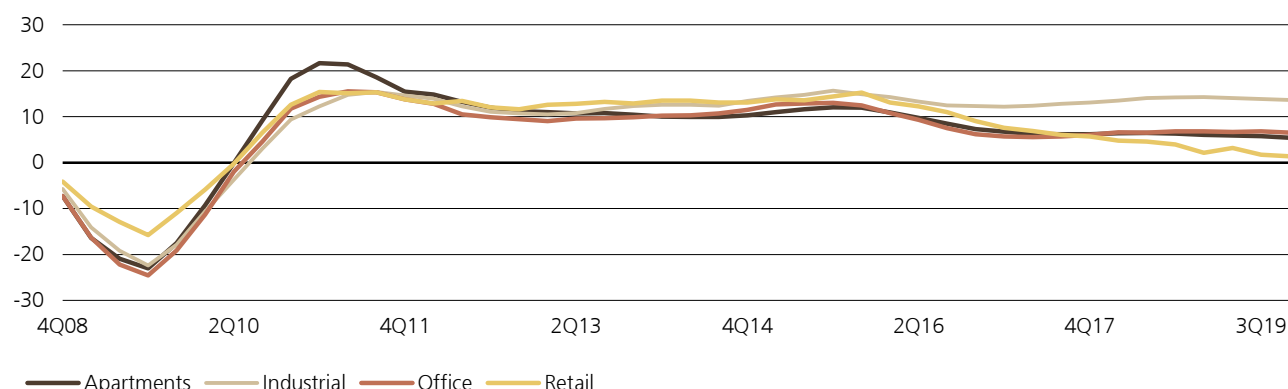
Real estate fundamentals

Private commercial real estate continues to produce steady returns, in line with long-term expectations, even though there are big differences across property types (see Figure 13). The income side of the equation is positive. Expectations are for continued growth, albeit at a diminished rate. It is the valuations and capital expenditures that have changed. Appreciation ranges from high in the industrial sector to negative in the retail sector.

The risk premium available in US real estate has increased. After four short-term rate hikes in 2018, the US Federal Reserve lowered rates for the first time in more than a decade in July, and then again in September and October. For US commercial and multi-family real estate, lower interest rates mean the spread available in the sector widened slightly. 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, although supply growth must be monitored closely. Supply eased in the office sector and is low in retail. Development is elevated for apartments and industrial, but currently, new construction levels are meeting strong demand, resulting in relatively stable occupancy rates and positive rent growth.

Figure 13: US real estate returns across property types (annualized, rolling four-quarter total return, %)

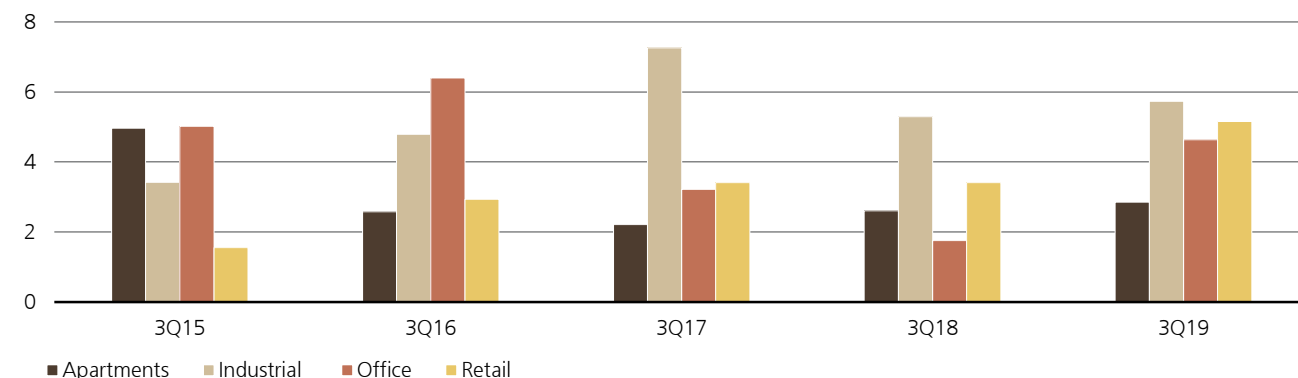


Source: NCREIF Property Index, 3Q19

We can further break out 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 14). Economic conditions create some optimism that growth will continue to reflect positive momentum for the US.

Figure 14: Property sector rent growth (year-over-year change %)



Source: CBRE-Econometric Advisors, 3Q19. 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 one of sustained performance. Supply and demand are balanced, resulting in positive and sustainable rent growth. Returns are income-driven with near-inflationary appreciation.

US homeownership was relatively flat near 64.8% in September 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 the first quarter of 2019, but a surge in demand brought third quarter vacancy down by 100 bps to 3.6% (see Figure 15). 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 3Q19, industrial rents grew by 5.7%, remaining above the five-year average of 5.3% per annum. Despite moderate easing during the first half of 2019, the pace of completions remains elevated (see Figure 15). Forecasts expect rising completions over the coming year.

Industrial availability was 7.2% in September 2019, and although nearly as low as it has been since 2000, 3Q19 availability has risen by 20 bps from 4Q18. 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 has resulted in thinner cash yields.

New office deliveries decelerated slightly over the past year (see Figure 15). Exhibiting characteristic volatility, office rent gains outperformed inflation with Downtown's 8.3% annual growth. This unsustainable growth spurt far exceeded Suburban office's "steady as she goes" 2.2% rent growth.

Average office vacancy decreased 50 basis points from one year ago. The gap between Downtown office vacancy at 10.2% and Suburban vacancy at 13.1% remains wide. Downtown deliveries were modest in the third quarter but are expected to pick up through 2020, while Suburban completions have remained steady over the year.

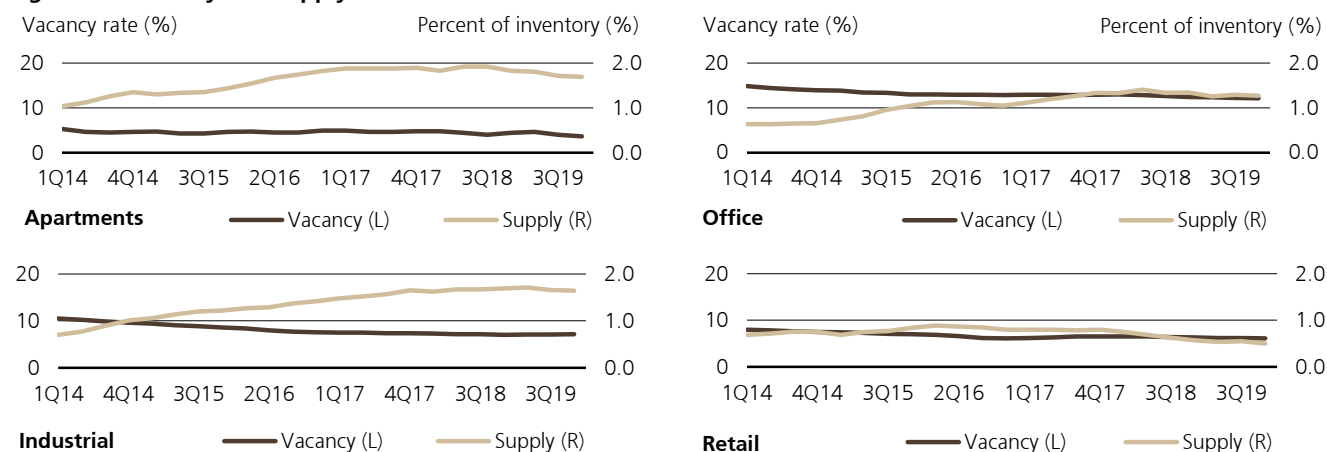
Retail

Capital requirements increased in the US retail sector, implying that the long-anticipated transition to mixed use centers is underway. Consumers are doing well; therefore, 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 4.9% and 5.7% over the past six quarters, while power center availability has been flat at 7.0% for three quarters. Mall/lifestyle and power center asking rent growth are volatile, with little consistency from one quarter to the next.

At 8.7%, availability in Neighborhood, Community & Strip (NCS) retail is down 80 bps since the end of 2017 (see Figure 15). In the year ending third quarter 2019, NCS rents grew at a pace of 4.1%, more than double the pace of inflation.

Figure 15: Vacancy and supply trends



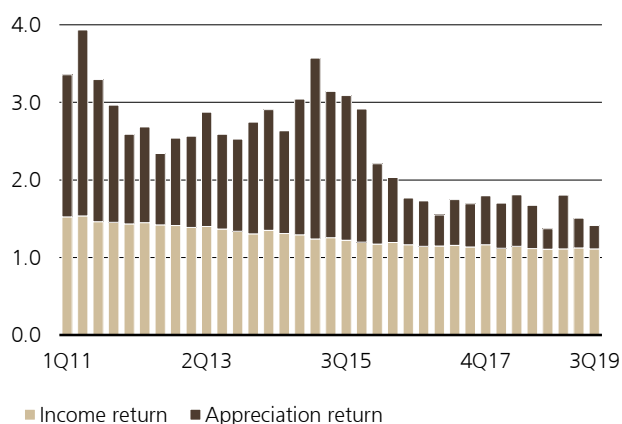
Source: CBRE Econometric Advisors, 3Q19. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory).

Capital markets

In 2019, we anticipate positive unlevered property returns driven by growth in income with moderation in appreciation, relative to recent years. In the third quarter of 2019, appreciation returns slipped below that of the previous two quarters, softening the NCREIF Property Index gain to 1.4% (see Figure 16).

Figure 16: US property returns

(%)



Source: NCREIF Property Index, 3Q19

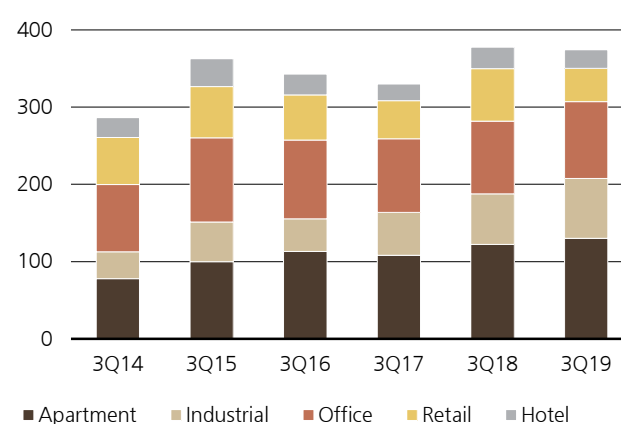
In today's low interest rate, low cap rate environment, real estate debt capital is inexpensive and generally available. However, debt is not as free-flowing as it was during the lead-in to the last downturn. The spread between property yields and the cost of debt decompressed somewhat in 2019. However, 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, (see Figure 18). 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 499 billion in the 12 months ended 30 September 2019, up slightly compared to the prior 12-month period. During the three quarters of 2019, the volume of hotel, office, and retail properties sales remained consistent with the previous two years. However, apartment sales volume has maintained a rising trend and industrial sales volume increased over the prior year (see Figure 17).

Figure 17: US transactions

(transaction volume, rolling 4Q, USD bn)

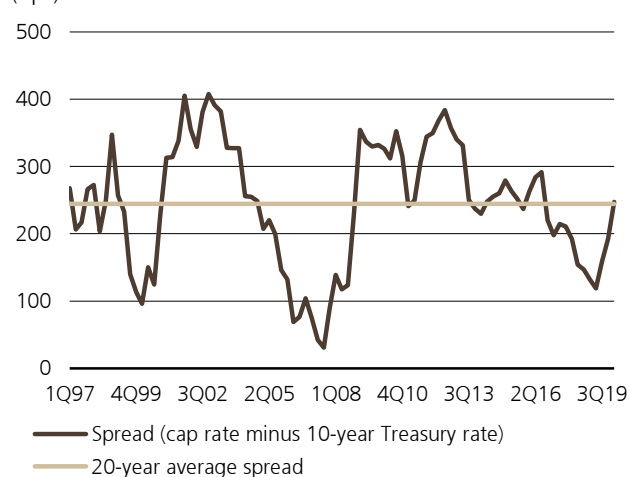


Source: Real Capital Analytics, 3Q19

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

Figure 18: Commercial real estate spread

(bps)

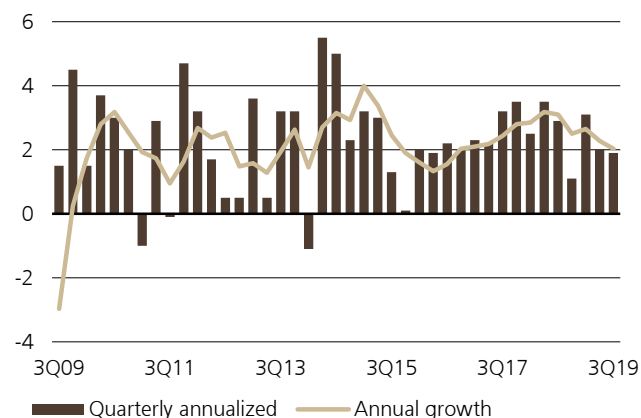


Sources: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 3Q19

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 three quarters of 2019, economic growth remains positive, although notably slower than during the first half of 2018. In 3Q19, GDP growth was 1.9%, which is near the long-term trend (see Figure 19).

Figure 19: US real GDP growth

(real GDP growth, %)

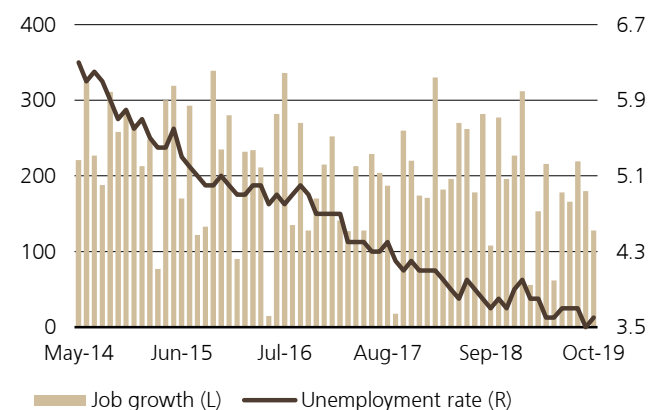


Source: Moody's Analytics, 3Q19

Expectations continue to be for a strong, but slowing, labor market and modest inflation in 2019. US consumer price inflation slowed to 1.7% in the year ending 30 June 2019. At 3.6% as of October 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 that wage growth is expected to support consumer spending in the US. Average monthly job gains softened further in the third quarter of 2019, averaging 167,000 per month since January. Monthly additions continue to be lumpy (see Figure 20).

Figure 20: US job growth and unemployment rate

(change in employment, thousands of jobs)



Source: Moody's Analytics, October 2019

Strategy viewpoint

Uncertainty has 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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