



# Cycles are inevitable – How can real estate investors make the most of them?

## *A closer look at leasing and interest rate cycles and their combined effects*

In economies and markets, one thing is clear: their natures are cyclical. Technological development, deregulation and re-regulation phases, credit cycles and investors' psychological natures are just some of the factors responsible for this phenomenon. The equilibrium of economies and markets is everchanging. Like the weather, economies and markets comprise a complex system, constantly shifting and never fully reaching equilibrium. The saying, "Nothing is constant but change" aptly applies.

Commercial real estate is a prime example of a market that follows this cyclical nature. The term commercial real estate, however, hides the details of what is going on within the complex nature of different sectors, countries, cities, climates and geopolitical realities. And when we invest in commercial real estate markets, there are three fundamental steps to take.

### **Step 1: Look at the leasing cycle**

Investors must be cautious and selective when it comes to commercial real estate, particularly in the context of commodified office spaces. For instance, think of large office towers in dense business districts such as London's Canary Wharf. Built to accommodate the surge of office workers from the 1980s onwards, these spaces are now facing a significant drop in demand due to technological advancements and the societal acceptance of flexible working arrangements. While the shock is certainly not of the same nature or similar degree as when the combustion engine wiped out the leasing market for stables approximately 100 years ago, the oversupply of such offices in many concentrated areas around the world is undeniable. Some pundits love to point this out and write real estate off as an asset class. Pessimism drives clicks.

But the devil is in the details. Prime offices, for example, are thriving. High-quality space in areas such as the Paris CBD saw rents rise by 20 percent in the year ending third quarter 2024. Similarly, another sector with a substantial potential is the life sciences real estate sector. As the global population ages and wealth increases, it forces and allows us to spend more on pharmaceuticals and other products the life sciences sector produces, which enable us to improve our lives. Geopolitical shifts are also driving the need to face the new realities, where regionalization of the supply chain is favored over outsourcing it to potential geopolitical adversaries. The real estate assets needed to sufficiently regionalize the supply chains do not currently exist, however. They need to be built. Again, the demand for such units – both labs and manufacturing sites

– compared with existing supply is strong and likely to drive returns in the sector in the years to come.

Furthermore, there is a huge need for investments in residential real estate in Europe and around the globe. In Germany alone, the goal is to build approximately 400,000 residential units per year, but only around 250,000 are being constructed. The investment volume we lack is astounding! Assuming a construction cost of €3,500 per square meter [\$3,577 per square meter], and an average unit size of 90 square meters [969 square feet], Germany needs more than €47 billion [\$48 billion] in additional annual investments, or more than 1 percent of its GDP, for residential construction. There are other European countries looking at similar shortages of residential construction, such as the United Kingdom, Netherlands and Spain, to name just a few. The boost to those economies in the form of increased output and lower price pressures on housing costs thanks to increased housing supply would be substantial. But often, local regulation and NIMBYism (not in my backyard) stops the necessary investments from taking place. While regulation is essential, overregulation is a drag.

Last but not least, the cycle in retail leasing market has turned. Rental growth has returned on the back of low supply (CBRE reports the United States had the lowest amount of quarterly construction completions in third quarter 2024 for the past 10 years at least); stabilizing demand after COVID-19; and ecommerce shocks. According to MSCI, annual rental growth in European retail assets hit 2.0 percent in third quarter 2024, steadily rising each quarter since hitting its lowest point of -8.9 percent in December 2020.

### **Step 2: Look at the interest rate cycle**

Interest rates are a fundamental economic factor that heavily influence how prices, especially for assets, form. Higher interest rates mean higher discount rates for the cash flows assets generate. Therefore, asset prices have the tendency to fall when interest rates rise and the other way around.

Central banks play a critical role in shaping short- and long-term interest rates through their policy decisions, which aim to meet specific monetary policy goals. For the world's key commercial real estate markets, that target is an inflation target, usually around 2.0 percent on an annual basis.

When inflation picked up in 2021 and 2022, central banks naturally responded by raising policy rates. This increased interest rates and forced through a painful repricing of

commercial real estate assets. As inflation has now declined, however, and often approaches central bank targets, many central banks have started cutting rates. Of the 39 central banks for which the Bank of International Settlements has data, only three – Japan, Brazil, Russia – have increased rates during the past six months, while 29 central banks have reduced rates, and many of them are expected to continue doing so.

Consequently, long-term interest rates have generally leveled off, and the risk premium between property yields and interest rates has stabilized. This stabilization has led to yields starting to decline, particularly in areas with strong leasing fundamentals. According to CBRE, in December, more than one-fifth of all commercial real estate property markets in Europe saw yields drop in the preceding three months, marking the most significant yield compression since early 2022. At the same time, fewer than 5 percent of markets saw rising yields during the same period – the lowest ratio since spring 2022. The interest rate cycle is turning and, with it, the property-yield cycle.

### Step 3: Put it together

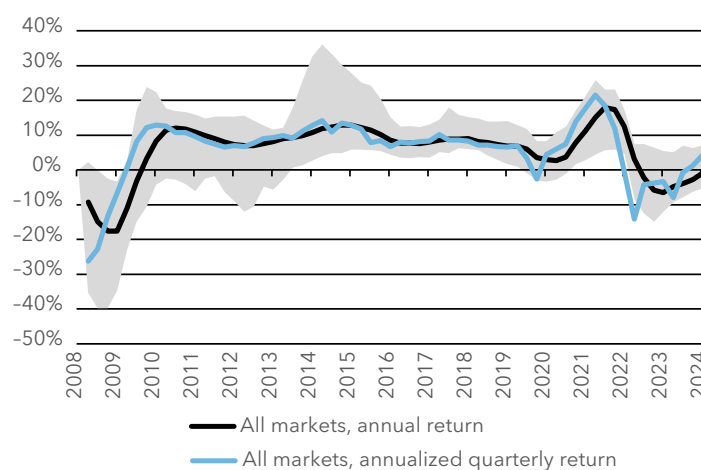
It is only so often we have the opportunity to benefit from both the leasing and the interest rate cycles at the same time, as they do not always align. Every so often, however, we hit a phase in the combined cycle when both the leasing cycle and the interest rate cycle are at a similar stage – and that is when investments get a lift thanks to both favorable leasing and interest rates cycles.

Figure 1 depicts how total returns in global real estate markets have developed since 2008. The gray area shows the max/min difference between countries in terms of annual total returns, while the overall total returns are displayed on both annual and annualized quarterly bases.

### So, is real estate due for a rebound in 2025?

Given where we are in the leasing and interest rate cycles: Yes, I think so! In fact, the rebound has already started, judging

**Figure 1: Global commercial real estate markets, total returns and max/min spread between markets**



Source: MSCI

Past performance is not a guarantee for future results.

from how the annualized quarterly data currently lead the trailing annual data, a tell-tale sign that momentum in returns is recovering.

The data also tells us, however, we must be selective. The performance between markets – and this includes countries and sectors – is set to be notable. Keep a firm eye on where the market in which you are interested stands in the leasing cycle. Understand how inflation and interest rates are developing in your area and what their key drivers are. Are they developing in the right direction? Then chances are interest rates will as well, as monetary policy makers adjust their stance.

And when in doubt, speak to a professional who can help you in allocating capital. The real estate cycle has turned, but a rising tide does not lift all boats equally.



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\* Assets under management stated on gross asset values basis, reflecting values as of Sept. 30, 2024, where available.

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