

Japan Insights

Real estate markets

Navigating any rate rises – a balancing act

Macro in
perspective

Impact on cap
rates

Where is the
upside?



A watershed year in the making



Japan is at the critical juncture of breaking out from its three decades of stagnation. Nominal growth is returning. The outlook is not set in stone but the current wage-price dynamics look promising and supportive. We expect any policy adjustments during this transition period to be slow and steady. We seek to position in real estate sectors that can ride this new wave of growth.

Japan's macro in perspective

Globally, inflation spikes over the last 12-18 months have triggered aggressive policy reactions and a record pace of interest rate hikes. Investors fear the same for Japan. The sense of caution in the real estate market is escalating with every new tweak to the Bank of Japan's (BoJ) yield curve control (YCC) and as we approach a potential exit from the negative interest rate policy (NIRP) in 2024.

However, we think the policy outlook needs to be put in context. We are entering a "mild nominal growth" era after three decades of "stagnation" led by an improving inflationary outlook (see Figure 1). This is a good thing and should be cheered. The premise of any potential policy normalization should be to stabilize this transition and not to jeopardize it.

Nonetheless, the risks of a premature tightening have seemingly increased in this "higher-for-longer" interest rate environment, which is driving JPY weakness and 'bad' inflation. The BoJ is currently faced with an almost impossible task of fighting both deflation and inflation at the same time. So far, it has skillfully adapted the YCC to ensure continuity. Intervention by the Ministry of Finance has also helped to buy time.

The key questions real estate investors often seek answers to are the timing, pace and extent of any interest rate hikes. For timing, most economists expect a rate hike in 1H24 (most expect April or before), according to a Bloomberg survey¹. For the pace of hikes, our base case is "slow and steady" due to both structural and cyclical reasons:

Inflation is not running wild

Core inflation (ex-fresh foods) peaked at 4.2% in Jan 2023 and fell to 2.7% in Sept 2023. Inflation has largely been imported with limited domestic pressure. There is still some slack in the labor market with the unemployment rate at 2.6% in Sep 2023 vs 2.2% in Dec 2019. Japan's late reopening could be a driver, but the risk of overheating will likely be mitigated by the cyclical slowdown in the external environment.

Deep-rooted deflationary mindset

Japan has suffered near-three decades of deflation, with entrenched behavior. Demographic headwinds are partly to blame. The labor market is also rigid, with a culture of lifetime employment. It is the only country in the world where companies feel the need to make a public apology for raising prices. Changes are underway but will most likely be gradual due to structural and cultural barriers.

The Bank of Japan is wary

We can all agree that the BoJ is inching closer to a policy normalization. However, the governor's tone is still tilted towards a dove with an uncertain price outlook. There are initial signs of a virtuous price-wage cycle, but they are inconclusive. Another year of strong Rengo wages is likely needed. The central bank is also painfully aware of its past policy mistakes; it has tried hard for a long time to manufacture a healthy inflation rate. Delivering a shock tightening and causing another deflationary period is probably the last thing they want.

Fiscal considerations

Japan has the highest public debt-to-GDP ratio in the world at around 260%, significantly more than the US's 120%, the EU's 95% and the APAC (ex-Japan) average of 38%. Refinancing at higher interest rates will weigh on the fiscal accounts over time. The risk of credit rating downgrades may also hinge on the speed at which the interest burden builds up.

What about the extent? The consensus is mixed on the neutral interest rate² for Japan, with a wide range of 0.5-2%. UBS Investment Bank expects a gradual hike in the short-term policy rate to reach 1.0% by end-2025 and 1.5% by end-2026. Meanwhile, 10-year government bond yields could reach 1.5-2%. This assumes the successful formation of a virtuous wage-price cycle and a 2% medium-term inflation.

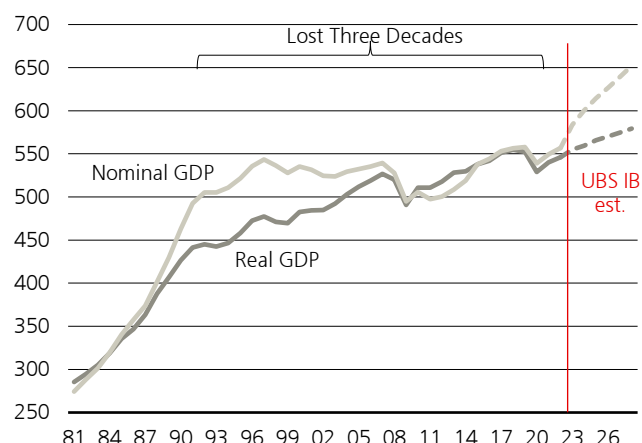
¹ As of 25 October 2023

² Theoretical interest rate that neither stimulates nor restricts the economy

Oxford Economics, in contrast, is more pessimistic about the inflation outlook at <2%. It forecasts the short-term policy rate to increase from -0.1% to 0% in 2024 and remain there indefinitely. They predict 10-year yields will stabilize between 0.6-0.8% in the long run. Long-term inflation will be the key determinant.

Understandably, this normalization journey will not happen in a straight line and could be fraught with unforeseen risks as the country has operated under an extended period of low interest rates. We think a premature tightening without accompanying growth could be detrimental. Alternatively, an overheating scenario, albeit low probability, could also result in an undesirable outcome.

Figure 1: Japan's lost three decades



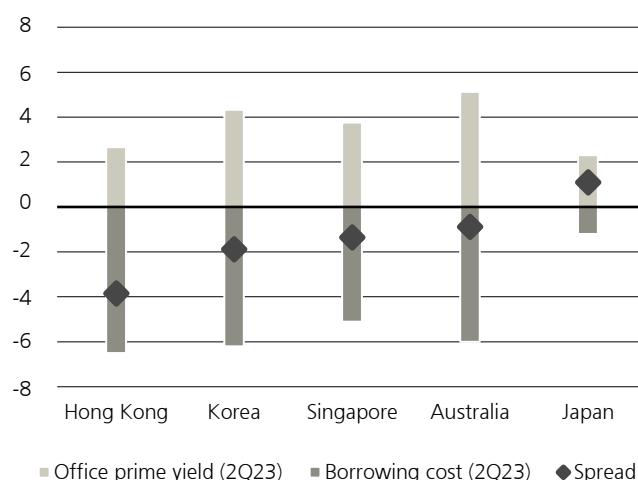
Source: Havers, UBS Investment Bank, November 2023.

How will cap rates react?

The outlook for higher interest rates has negative implications for real estate investment in two major ways. First, higher finance costs diminish income returns. Second, it increases the cost of capital and the required rate of returns. The latter transpires in the form of cap rate expansion in the property world and could be exacerbated by a deterioration in sentiment or fundamentals.

The immediate implications for Japanese real estate are difficult to quantify not least because of a lack of sufficient historical data. Its current wide yield spread also enhances its relative attractiveness versus other countries. We think this would act as a buffer until a more meaningful correction plays out elsewhere to narrow the gap. In 2Q23, the yield spread for most APAC countries was in negative territory except Japan (see Figure 2). In other words, Japan is the only country where debt funding is still considered accretive to returns.

Figure 2: APAC yield-funding spread (2Q23, %)

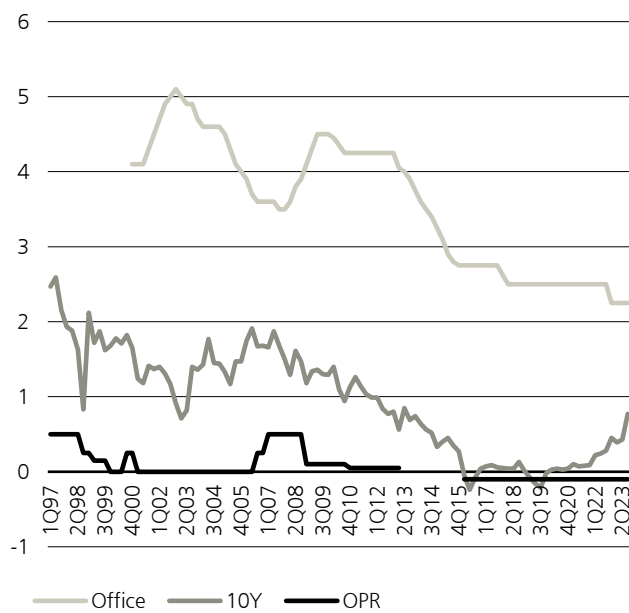


Source: CBRE, PMA, CEIC, Reuters, UBS Asset Management, Real Estate & Private Markets (REPM), November 2023.

Based on available data since 2000, the Japan real estate market has gone through two cycles of BoJ rate hikes. The first in 2000 (+25bps) and the second in 2006-07 (+50bps). 10-year bond yields rose from 0.71% in 1Q03 to 1.91% in 2Q06. Based on our observations, cap rates did not react negatively to the higher 10-year bond yield and instead compressed further. In relation to the BoJ rate hikes, office cap rates expanded with a significant lag by 3-4 quarters. The causal relationship is weak. In fact, cap rates only started to inch up after or close to the subsequent rate cuts (see Figure 3).

In our view, the expansions were driven more by the economic crises during these periods – Dotcom bubble and the Global Financial Crisis. This also explained the disproportionate cap rate movements, rising 100bps in both periods over 7-8 quarters in 2001-03 and 2007-09. A similar trend was observed in other APAC countries. Hence, we must keep in mind that interest rates are just one factor which determines real estate cap rates, along with what’s happening in the economy. To be clear, we do expect upward movements in bond yields to lift cap rates. However, it is difficult to quantify the sensitivity based on available historical data.

Figure 3: Japan cap rates vs interest rates (%)



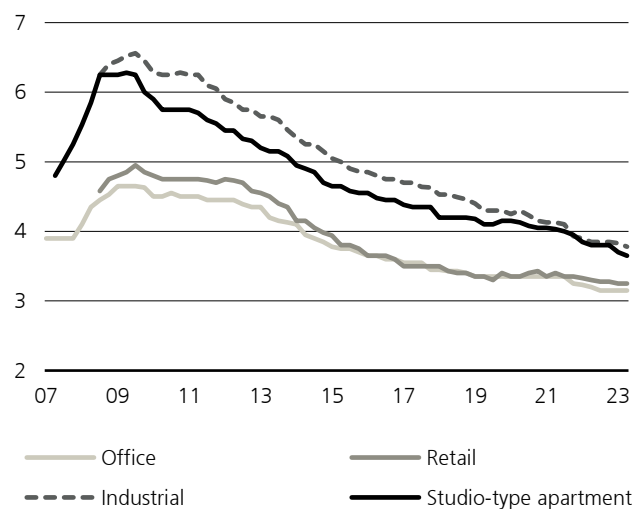
Source: CEIC, PMA, Oxford Economics, UBS Asset Management, Real Estate & Private Markets (REPM), November 2023. **Past performance is not a guarantee for future results.**

Fast forward to the present and 10-year JGB yields have jumped from 0.1% in 2021 to 0.5% by end-2022 and 0.9% in October 2023. Cap rates have held steady throughout and yield spreads have stayed attractive at around 150bps for prime office and 250bps for multifamily. The stable performance could also be partly driven by the unchanged 3-month TIBOR against which lenders price their loans. In either case, we do not think the transmission would be 1-for-1.

In the US, real estate cap rates have increased 120-360bps since December 2021 on the back of a 530bps increase in Fed fund rates and 325bps increase in 10Y treasury yields. However, the upper end of the range was driven by exceptional weakness in office fundamentals. Excluding the office sector, cap rate expansion was more modest at 120-200bps for the traditional sectors. In Australia, cap rates rose 80-150bps on the back of 425bps and 315bps increase in RBA cash rates and 10-year government bond yields. While we expect cap rates (outside Japan) to move out further in 2024, we think the bulk of expansions have already occurred.

Looking ahead, we think the outlook for Japan cap rate movements will hinge on the BoJ’s policy direction. The potential hawkishness in its tone or the lack thereof matters. In our base case of a slow-and-steady policy normalization, we expect a small impact on cap rates. This also assumes 10-year JGB yields do not overshoot on the upside. The effect would also likely differ by sector. The multifamily sector is better positioned given its stronger rental outlook and higher cap rates (see Figure 4). The office sector could be more vulnerable.

Figure 4: CBRE cap rates survey by sector (%)



Source: CBRE, UBS Asset Management, Real Estate & Private Markets (REPM), November 2023.

What is the capital market saying?

Real estate transactions in Japan stayed remarkably resilient this year. In 9M23, volumes grew 1% YoY in local currency terms, significantly outperforming other APAC countries, which fell 38% according to MSCI data (see Figure 5). This is unsurprising given the country's favorable and stable funding environment.

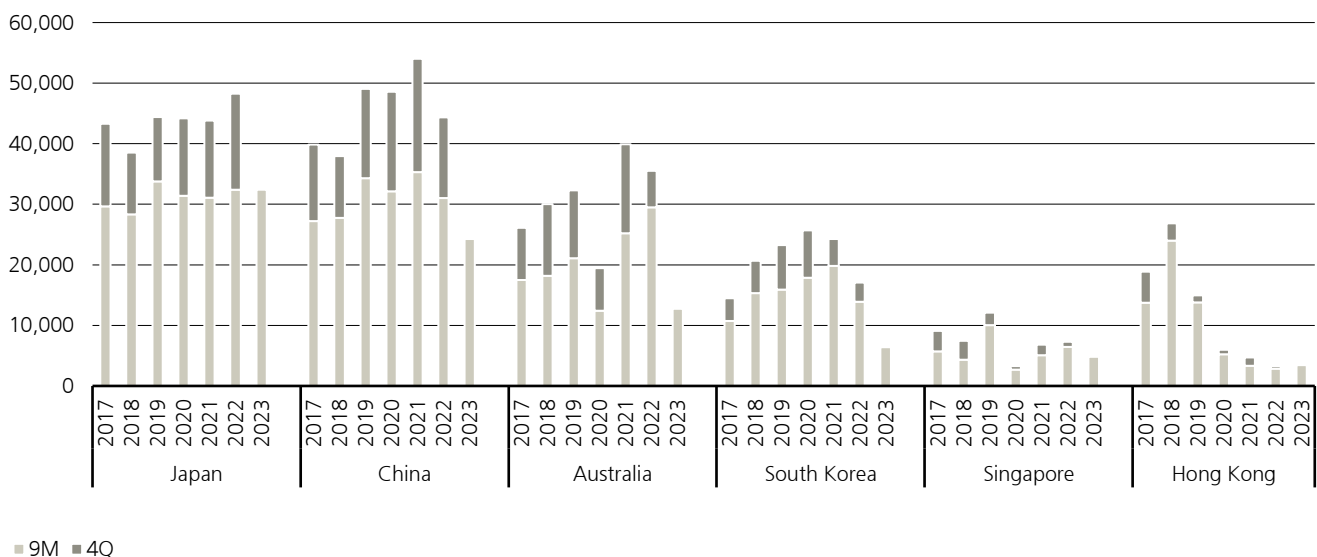
By sector, logistics (+106%) was the main driver offsetting weakness in office (-29%). The multifamily sector activity slowed YoY but continued to trend above the pre-pandemic average. Cap rates have largely remained stable based on data from various brokers. Transaction wise, some deals are still changing hands at tighter yields.

Japan has always been a popular market for investors from the United States, which dominates the bulk of foreign capital inflow. More recently, Singapore has also started pouring more money into the country.

In 2023, Mapletree Industrial Trust acquired its first Japan data center in Osaka, GIC bought more logistics facilities across the nation while City Developments and CapitalLand also made their entry into the multifamily scene. Other Singapore REITs have also articulated interests.

Turning to the listed market, Japan REITs have corrected for two consecutive years despite a stronger overall stock market. This is likely factoring in the outlook of potentially rising interest rates. However, their share price decline is mild when compared to REITs in other APAC countries. JREITs fell 12% since 2021 compared to -27% and -30% in Singapore and Australia. This de-rating lowered P/NAV multiple from 1.05x to 0.93x. This could be interpreted that JREIT prices were initially pricing in an outlook of "further cap rate compression" but that has now changed to an outlook of "a mild cap rate expansion". We estimate that the current JREIT valuations imply a 15-20bps cap rate expansion on average.

Figure 5: Real estate transaction volume (USD million constant currency)

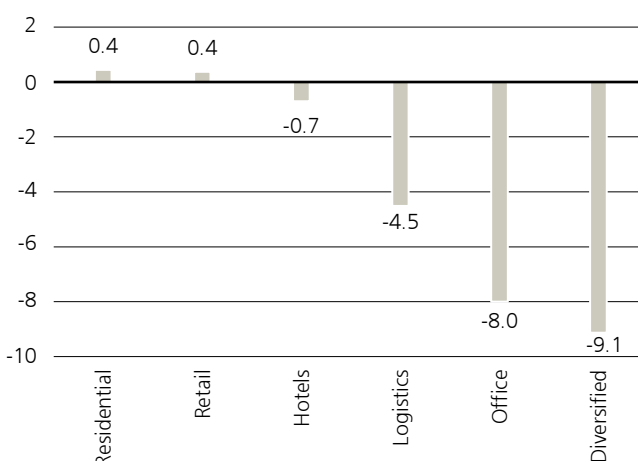


Source: MSCI Real Capital Analytics, UBS Asset Management, Real Estate & Private Markets (REPM), November 2023. Note: based on fixed exchange rate as of end-2019. **Past performance is not a guarantee for future results.**

Taking a step further, we analyze what this means at a sector level. The different P/NAV multiples suggest different expectations for sector outlooks. Listed investors seem to be most concerned about the office market, having ascribed an 8% discount to NAV (see Figure 6). Meanwhile, the expectations for multifamily are much more sanguine. The sector is still trading close to book value, which is in line with our assessment of the sector in the private space.

Relative to the region, JREITs' valuation discount is modest compared to other APAC countries. REITs in Australia and Singapore trade at close to 20% below NAV, with the office sector heavily penalized at a wide 45-50% discount.

Figure 6: Japan REIT share price to NAV (%)



Source: Reuters, UBS Asset Management, Real Estate & Private Markets (REPM), October 2023.

Where is the potential upside?

The “nominal renaissance”

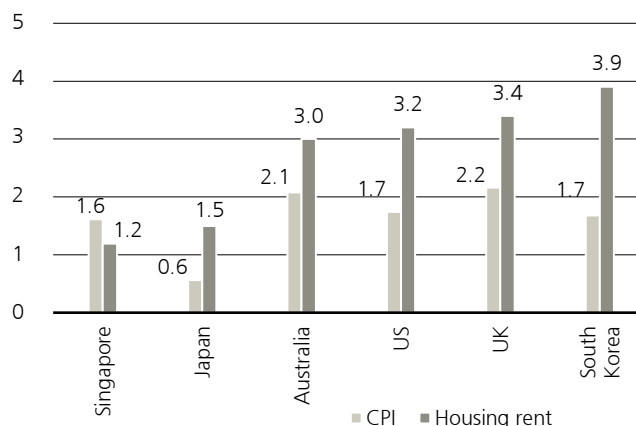
As discussed earlier, the outlook of higher interest rates should be accompanied by higher nominal growth. Nominal GDP has been almost stagnant for 30 years, growing at a rate of 0.4% p.a. With inflation inching closer to the BoJ's 2% target, long-term nominal growth should average around 2.5-3% p.a. based on real GDP growth of 0.5-1%. This acceleration has positive implications for the overall economy. It implies stronger revenue growth for businesses and wage growth for individuals. UBS IB economists named this economic phase as “nominal renaissance”.

The real estate sector should benefit from stronger rental growth outlook. However, as this nominal growth is driven more by inflation as opposed to aggregate demand, we do not expect the rising tide to lift all boats. A strong supply-demand dynamic would still be key. Landlords in a tight or balanced market will have a better chance to pass on inflation to tenants.

We think the multifamily sector is the best positioned in this environment. The residential sector has proven to be a good inflation hedge globally over the last two years. Even if we were to exclude this exceptional period, the historical comparison painted a similar picture. Over 2009-19, rents in key global cities grew at an average of 100bps above their respective national inflation rate (see Figure 7).

In the case of Japan, Tokyo rents grew 1.5% p.a. over this period compared to the inflation rate of 0.6%. If this relationship holds, a 2% inflation in Japan could lead to an acceleration of rental growth to 3% over the medium- to long-term. This should be viewed as an average run-rate and will be subject to cyclical factors. For other sectors, logistics has positive structural tailwinds, but in the near-term elevated supply could cap rental growth. Office is likely to be more disadvantaged.

Figure 7: Resi rent growth vs inflation (09-19 CAGR, %)



Source: Athome, CBRE, REIA, CEIC, Asset Management, Real Estate & Private Markets (REPM), November 2023

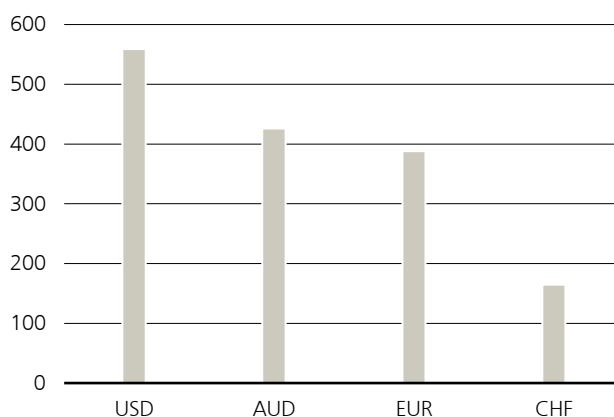
Foreign Exchange (FX) tailwinds

The foreign exchange rate (FX) is notoriously difficult to predict given the multitude of drivers. The consensus had expected a rebound in JPY this year on the assumption that a recessionary outlook in the US could lead to a Fed rate cut in the second half. As it turns out, the reverse has happened. Instead of narrowing, the interest rate differential between JPY and USD has widened further driven by the “higher-for-longer” outlook in the US and the BoJ standing pat on its accommodative policy. As a result, JPYUSD depreciated further from 133 in end-2022 to 150 in October 2023. The JPY currency has fallen 27% since the pre-pandemic levels of 109.

As the BoJ inches closer to a policy normalization in 2024, the currency outlook looks increasingly upbeat. Oxford Economics and UBS Investment Bank forecast an appreciation to 138 and 130, respectively, by end-2024. A hawkish outlook could lead to a fruitful gamble for investors. However, it seems unlikely to be a sure bet with the BoJ governor still sounding dovish and the US economy still resilient.

Nonetheless, foreign investors will still be able to reap gains through a more conservative route. Given the wide interest rate differential, hedging the JPY currency into USD / EUR / CHF would generate gains of ~550 / 390 / 160bps p.a. (see Figure 8). This is an attractive boost to the typical return for core and value-add strategies of mid-to-high-single digit.

Figure 8: JPY hedging gains implied by 3M interbank rates (bps, p.a.)



Source: Oxford Economics, UBS Asset Management, Real Estate & Private Markets (REPM), 30 September 2023.

Conclusion

Staying nimble

Expectations on inflation became increasingly ‘bullish’ since September, when the BoJ governor commented on potentially having sufficient data to determine the policy next-step. The market consensus took this as a hawkish signal and many economists have brought forward their forecasts of a rate hike to early-2024. 10-year bond yields rose from 65bps to a high of 96bps in end-Oct. Since then, it has fallen to around 70bps as of 21 November 2023, due to a dovish YCC tweak, weak macro print in Japan and weaker-than-expected inflation in the US.

Wading through the noise, we think the outlook of a sustained inflation is far from certain. Japan’s 3Q23 GDP missed expectations and fell 0.5% QoQ on the back of weak consumption and investment activity. This poses as a reminder that Japan’s economy is not overheating despite its loose monetary policy. If anything, this incremental datapoint supports an on-hold decision. Externally, the global macro performance would also be a wild card.

An outlook of rising interest rates may warrant caution in deal underwritings. However, given an uncertain outlook, we think investors should stay nimble in assessing new deals. We recommend sticking to sectors with strong fundamentals as opposed to a plain vanilla yield-spread play. The multifamily sector is favored given tightening vacancies and rising rents. It may also be a good hedge if inflation proves to be sustainable. Granted, the quirky Japan traditional leases favor tenants over landlords and could limit growth. We think a development strategy is likely better placed to access market growth. We still like the logistics sector for its medium-term story. We are selective on the office and retail sectors.

Finally, we think Japan’s cheap currency is appealing and should boost overall investment returns. For conservative investors, the expected hedging gains are attractive given its wide interest rate differential against other countries at the moment.

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