

# REO

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Real Estate Outlook – APAC



Buckle up.

**Wai-Fai Kok**

Head of Real Estate Research &amp; Strategy – Asia Pacific

“APAC economic growth eased due to an export slump. Inflation seems to be under control and paves the way for rate pauses in 1H23. Yield spread is still tight and further cap rate expansions are expected in 2023. Japan’s policy risk has increased but the country still offers relative value.”

## Clearer signs of a slowdown

APAC GDP growth slowed to 3.2% YoY in 4Q22, largely driven by an export slump. Asian exports fell ca. 10% YoY during the quarter in the steepest decline since early-2020. External trade was on a tear during the pandemic period, as consumers channeled spending into goods amidst restriction on services. This trend turned on its head in mid-2022. While still elevated relative to 2019 levels, Asian exports reversed almost half of their gains in 2H22. We believe this weakness will likely continue driven by a continued normalization of face-to-face services spending, a turn in the semiconductor cycle, and moderation in global demand.

On a sequential basis, the pent-up demand from reopening seems to have faded in the fourth quarter though most countries still recorded positive QoQ GDP growth underpinned by a resilient private consumption. South Korea and Taiwan were among the countries to have contracted, by 0.4% and 1.1% QoQ respectively, as they were dealt an external blow from a downturn in the semiconductor cycle. In South Korea, the tighter financial conditions have also started to hit consumers as private consumptions shrunk. China’s growth was lackluster due to a COVID-19 outbreak but should show a more meaningful recovery, albeit bumpy, in the coming quarters with the lifting of its *zero-COVID-19 policy*.

Inflation has finally peaked and eased 0.3 percentage points QoQ to 5.3% in 4Q22. The softening should continue given the plunging energy prices – Brent crude oil now hovers at around USD 80/bbl while coal prices almost halved YTD. That said, the key risk would be a persistent strength in consumption and labor markets, which contributed to the stalling of disinflation in the US. The good news is that this has been less evident in APAC save for Australia and New Zealand (ANZ).

Correspondingly, we believe the interest rate upcycle is also coming to an end in 1H23. In ASEAN, Bank Negara Malaysia paused its hiking in January while Bank Indonesia signaled an end to its tightening. Consensus thinks Bank of Korea’s 25bps increase in January could be its last, while UBS Investment Bank expects Singapore to stay on hold through 2023. ANZ is on the opposite end of the spectrum with the Reserve Bank of Australia (RBA) keeping its hawkish stance despite the two straight months of increases in unemployment rates to 3.7% in January.

## A pricing stand-off

APAC leasing activity in 4Q22 moderated further on the back of mounting macro uncertainties. According to CBRE, office net absorption softened 4% QoQ, while logistics demand also fell as major e-commerce operators scaled back expansion plans. Retail fared better with leasing activity improving amid signs of tourist recovery. 4Q22 retail sales were robust and trended at >10% above pre-pandemic levels. We expect the overall leasing sentiment to weaken further in 1H23 as the economy enters a period of slower growth.

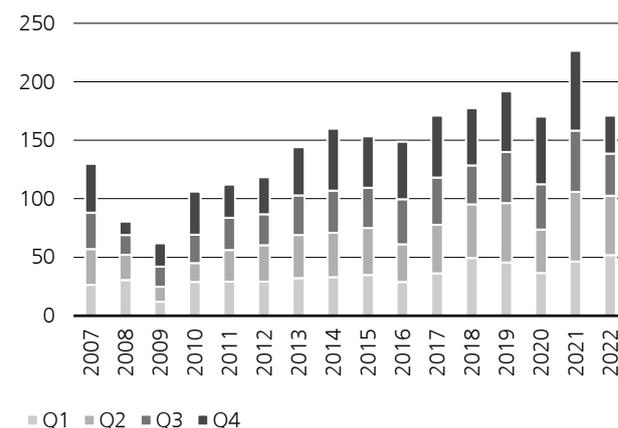
The transactional market remained sluggish in 4Q22. Cap rates have started to move out but at a considerably slow pace relative to the rise in funding costs. Bid-ask spread stayed wide and impeded deal closings. Equities and bond prices have rebounded but insufficient to alleviate the allocation cap on real estate given the slow valuation adjustments.

According to MSCI, APAC real estate transactions fell 52% YoY to USD 33 billion, the lowest since 2Q16 (see Figure 1). For the full year, 2022 transaction volume fell 24% YoY to USD 171 billion, similar to 2020 level but 11% below 2019. The decline was sharp across all sectors particularly in retail (-70%) and hotel (-60%). Japan was the most resilient market thanks to its continued positive yield spread not seen in most other markets. The country's transaction volume fell only 23% YoY in 4Q22 and -19% YoY for the whole of 2022.

In APAC, cap rates have expanded the most in South Korea and Australia, not surprising as their central banks have been among the most aggressive in rate hikes. Australia logistics witnessed the largest increase (+75bps) as it was perhaps an easier revaluation exercise with its strong rental growth

offering offset. Indeed, logistics valuations were still written up in Australia despite the rising cap rates. Elsewhere, Singapore's valuations stayed firm with limited notable office transactions. Two large retail transactions were concluded with mixed results, Jurong Point (6% below 2021 valuation) and Nex Mall (6% above), and will likely provide support to current cap rates. In the listed space, Singapore REITs mostly reported stable cap rates in the December quarter and higher valuations driven by rental growth. Australia REITs, meanwhile, lifted cap rates by up to 25bps for retail and office and up to 50bps for industrial assets.

**Figure 1: Asia Pacific transaction volume (USD billion)**



Source: MSCI, February 2023.



## A new guard at the last bastion

APAC real estate valuations turned out to be relatively resilient in 2022. Potential sellers have been able to hold out with little to no distressed selling. However, this could be a function of timing according to debt and fund maturities. Balance sheet stresses have so far been minimal but could change upon refinancing and repricing. In the listed space, Asian REITs are starting to undertake pre-emptive equity raising to beef up their financial positions. Link REIT's HKD 18.8 billion rights issue and ESR-Logos REIT's SGD 300 million raising are cases in point. Australian REITs opted a less direct route through convertible bonds, such as Dexus and Centuria Industrial REIT.

With bond yields staying elevated, yield spread remained razor thin / negative. We think this will need to be adjusted and expect cap rate expansions to accelerate in 2023. By country, we think South Korea and Australia could see faster repricing due to their steeper yield-funding mismatch. For example, South Korea's debt cost of ca. 7% eclipses the asset yield of 4-5% (prime office and logistics) while Australia's debt cost of ca. 5% is also higher than its asset yield of 4-5%.

Being the last bastion of low interest rates, Japan has been an outlier with a highly accretive yield spread. However, the surprise move by the Bank of Japan (BoJ) in December has thrown a spanner in the works. What to expect for 2023?

### Japan – will 2023 be a watershed year?

In December 2022, the BoJ widened the band of its Yield Curve Control (YCC) for 10-year yield target from +/-25bps to +/-50bps. This was not intended as a monetary tightening move but rather as a measure to improve the functioning of bond markets. Nonetheless, this came as a negative surprise. Since then, bond markets have deteriorated further with a distorted yield curve driven by market speculations of further YCC relaxation ahead.

From a real estate perspective, the 25bps increase in 10-year bond yield could potentially have negative implications for cap rates. However, it needs to be put in context. Even after a 25bps increase, Japan's yield spread remains among the highest in the world. We think this relative attractiveness should continue to draw investment capital. Assuming no further policy tweaks, cap rates should remain stable. This is in contrast to some investor surveys prior to the policy tweak suggesting potential for continued compression.

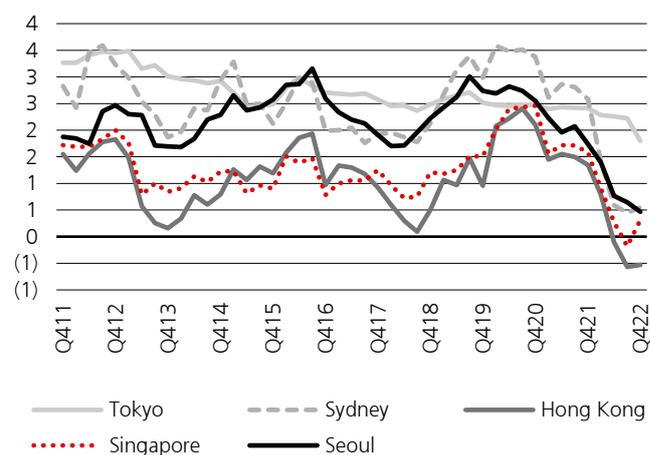
Nevertheless, market expectations have shifted. The likelihood of further YCC tweaks is no longer viewed as a matter of *if*, but *when*. The current dysfunctional bond market is one key reason. Inflation is another. We believe the outcome will be dependent on the upcoming macro data. The key metrics to watch will include inflation, spring wage negotiation and

macro momentum in the US. The wage outcome would be pivotal in determining the sustainability of the current inflation after decades of near-zero price movements. Meanwhile, a slowdown in the US would weigh on bond yields and in turn alleviate pressure on Japan's yield curve.

For real estate, we think the impact of an inflation-led YCC adjustment would be more manageable as it would likely be accompanied by a pick-up in rental growth. Nonetheless, the pace and extent of this tweak would be crucial. Much of this may hinge on the ideology of the next BoJ governor (and the incumbent administration) due to take over the driver's seat in April 2023. Kazuo Ueda was nominated for the role and most economists consider him a pragmatist with a neutral stance as opposed to a clear dove. Under his helm, we think any policy changes are likely to be gradual. That said, market conviction is currently low after the bombshell in December. A change in the short-term policy rate is still deemed unlikely in 2023 given the current state of the economy. 4Q22 macro print signaled continued recovery but uninspiring at best.

Using prime office as a proxy, Japan's yield spread has narrowed from 230bps in 3Q22 to 180bps in 4Q22 due to cap rate compression (-25bps) and higher bond yields (+25bps). This is still significantly higher than other APAC markets of between -50bps and +50bps (see Figure 2). In the event of a total abolishment of YCC, the current 10-year swap rate provides an indication of the potential 10-year JGB yield without control. Following the December tweak, the swap rate shot up to a high of 1.1% and averaged ca. 0.9% YTD. This implies an upside of 40-60bps from the current 10-year JGB yield of 0.5%. This looks manageable to Japan's current spread buffer. Still, the pace matters.

Figure 2: APAC office yield spreads (%)



Source: PMA; Reuters, February 2023.

For more information, please contact:

**UBS Asset Management**

Real Estate & Private Markets (REPM)  
Research & Strategy

Wai-Fai Kok  
+65-6495 5912  
wai-fai.kok@ubs.com



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