

Real Estate Outlook

Global overview – Edition 1, 2022



Yields slide downwards.



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Global overview

Reaching new altitudes.

The economic recovery continues, albeit interrupted by Omicron, and the war in Ukraine poses a new risk. Global real estate volumes reached a record high, driven by domestic buyers. Falls in office and retail yields were more widespread. We think that any headwinds from interest rate rises will be offset by growth in the economy.

Market overview and outlook

Strong domestic markets spur record volumes.

The global economy continues its recovery from the pandemic. However, the rebound has been uneven and interrupted, most recently by the Delta and Omicron variants of COVID-19. Omicron saw the re-introduction of some restrictions which impacted economic activity around the new year and in early 2022. Nevertheless, restrictions look set to ease, which should allow economic recovery to continue. The war in Ukraine poses a new risk and has hit confidence, financial markets and energy prices. It also looks set to have a knock-on effect on energy supplies to Europe. The exact medium-term impact will depend on how far relations between western countries and Russia deteriorate.

A year ago, the consensus expectation and our view at the time, was that inflation would temporarily rise but then subside. This narrative has proved wrong as inflation has accelerated to multi-decade highs around the world, with readings of 7.0% in the US and 5.0% in the eurozone in December. Again, we expect inflation to slow over the coming year as price pressures ease, but think risks lie firmly on the upside. There is some evidence that wage growth is also accelerating, which could sustain high inflation.

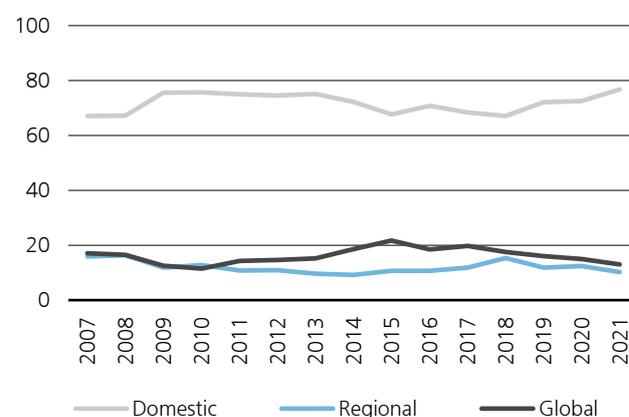
In the medium-term, we still expect inflation to return to target. The key question is whether this will be achieved by a soft landing or whether central banks, intentionally or otherwise, will push the economy into a sharper slowdown or even recession. Central banks are behind the curve and have become much more hawkish, with four or more rate hikes now expected by the Fed in 2022, along with a balance sheet reduction. Even the ECB seems to be opening the door for a rate hike, with markets expecting it to succumb by year-end.

The global real estate investment market had a strong year in 2021. According to Real Capital Analytics, global investment volumes reached a record USD 1.25 trillion, up 58% from 2020 and 22% from 2019. However, office and hotel volumes remained at or below 2019 levels, while retail volumes were little changed. It was industrial and residential which drove growth, with both at record shares of the total, and combined accounting for 57%. Strong underlying activity and price growth relative to offices and retail boosted their shares.

Travel restrictions continue to weigh on cross-border transaction activity as they prevent purchasers from conducting the necessary due diligence and visiting assets. This pushed domestic capital to account for a record 77% of global investment volume in 2021 (see Figure 1).

By contrast, regional capital accounted for just 10% of volumes, the lowest share since 2014. While global capital sources, coming from outside the region where the assets are located, accounted for just 13% of activity, the lowest since 2010. Once travel restrictions eventually ease on a sustained basis, we expect the cross-border share to pick up again.

Figure 1: Share of global investment volumes by source of capital (%)



Source: Real Capital Analytics, February 2022. Past performance is not a guarantee for future results.

Declines in real estate cap rates and yields were more widespread in 4Q21 and reported across more office and retail markets. Yields fell in 35% of the office markets we monitor and 25% of retail markets, while strong downward momentum continued in industrial, with yields falling in 63% of markets. Rises in yields and cap rates were few and far between, with increases recorded in just 4% of retail markets and even lower shares for offices and industrial. With the interest rate environment changing, we think impetus for further falls will fade.

Investment performance was strong in 4Q21, with the US and UK markets recording particularly strong returns. According to NCREIF, US total returns were 18% in 2021, while according to MSCI UK total returns were 16%. In both markets, it was outsized performances from industrial which powered the all property result, with US industrial recording a massive 43% total return for the year and 36% for UK industrial. Office and retail returns were around 5%, apart from UK retail, which recorded a 10% total return as the market bounced back.

Strategy viewpoint

Growing economy to offset higher rates.

The outlook for real estate is closely linked to that for the broader economy. We have discussed the interlinkages previously on many occasions. Overall, we see what's happening in the economy, interest rates, use of leverage and the level of development activity as the key drivers of real estate performance. With regard to inflation, we think that real estate provides good, albeit imperfect, inflation protection for investors. Thus, at the current juncture, with inflation at multi-decade highs and heightened uncertainty over where it's headed, we think real estate is attractive for investors.

A key question now is how this mix of performance drivers will evolve over the next 12-24 months and what impact they will have on real estate performance. At the global all property level, we estimate that a one percentage point rise in 10-year government bond yields knocks 5% off real estate capital values after three years. Hence, interest rate and bond yield rises only affect real estate values with a lag. Additionally, we estimate that 1% growth in the economy in any given year pushes global real estate capital values up by 2% in that year.

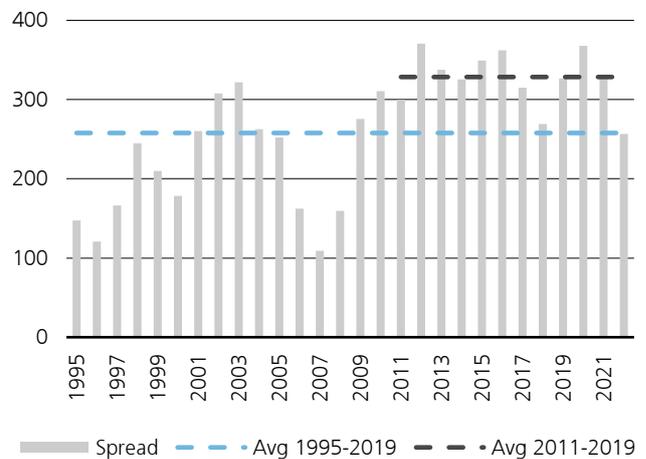
Oxford Economics forecasts that global bond yields, on an annual average basis, will rise by around 50bps each year over 2022 and 2023. This implies a downward drag on real estate values of around 2% p.a. in 2025 and 2026. Provided the economy is growing by 1% each year, the cooling impact on real estate capital values should be offset by economic growth, supporting higher occupier demand and rental levels.

Moreover, across the 23 global markets in our analysis, Oxford Economics forecasts that the economy will be growing by around 1.5% in both 2025 and 2026, more than enough to offset the drag from higher bond yields. Overall, it implies growth in real estate capital values of around 1-2% p.a. over 2025 and 2026, assuming that development activity remains balanced. We expect this to be the case given developers are much more cautious now than prior to the Global Financial Crisis (GFC), when large amounts of speculative development activity contributed to a real estate downturn.

Another factor that is positive for real estate investors is spreads with bond yields that are slightly above their long-term average. We estimate that in 2021, the spread between the income return on global real estate and the annual average of the 10-year government bond yield was 330bps. This is 70bps above the average of 260bps between 1995 and 2019.

Our latest forecasts are for the spread to fall to the long-term average in 2022 (see Figure 2). Spreads in 2021 were around the post-GFC average over the period 2011-19 of 330bps. In 2022, we expect the spread to fall slightly below the post-GFC average.

Figure 2: Spread between global all property income return and 10-year government bond yield (bps)



Note: Includes 23 countries globally; 2021 and 2022 are forecasts. Source: MSCI; NCREIF; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), February 2022. Past performance is not a guarantee of future results.

In the decade following the GFC, interest rates were at record lows and spreads were higher than before. The real estate sector also matured, becoming more global and accessible for investors as new ways and vehicles to enter the market became available. Allocations to real estate rose as investors' need for higher returns saw them switch from low risk and lower – even negative – yielding government bonds, to slightly higher risk but also higher returning real estate.

Now that interest rates are set to rise, it is fair to ask whether this process will reverse. We think that moving from higher returning real estate back into lower risk government bonds is a different proposition from the initial switch. Indeed, we expect there to be an asymmetry and that capital that has flowed into real estate will be sticky. Moreover, investors report that they want to increase their allocations to real estate and Preqin reported that as of February 2022, a record USD 400 billion of equity capital was targeting global real estate.

Real estate investment performance outlook

2021 forecast and 2022-24 outlook are measured against the country-sector's long-term average total return, with the average +/- 100bps described as "in line with long-term average." The long-term average refers to the period 2002-20. The red underperformance quadrant refers to negative absolute total returns, either in 2021 forecast or the 2022-24 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multifamily
North America	Canada	8.9		8.7		10.2		n/a	
	US	7.5		8.9		10.0		7.9	
Europe	France	7.7		9.3		9.3		n/a	
	Germany	4.7		5.3		7.7		n/a	
	Switzerland	5.6		6.2		n/a		6.3	
	UK	7.0		4.8		9.5		n/a	
Asia Pacific	Australia	10.0		8.9		11.0		n/a	
	Japan	5.2		5.4		6.0		5.6	

: Forecast 2021
 : Outlook 2022-24

: 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), February 2022. Note: Abbreviation LTA: long-term average. Expected / past performance is not a guarantee for future results.

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