

REO

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Real Estate Outlook – Global



Headwinds across market.



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“Sharp rises in interest rates around the world are feeding through to real estate yields and cap rates. Buyers and sellers are adjusting price expectations accordingly. Real estate returns have slowed, and transaction activity has fallen as some deals agreed at prices prior to the slowdown have been aborted.”

Returns slowing as rate rises feed through

Central banks around the world continued with aggressive monetary tightening in the third quarter. Large and consecutive rises in policy rates have taken them to levels unthinkable just a year ago and not seen since before the Global Financial Crisis (GFC). Central banks and economists underestimated the intense inflationary pressures that pent-up demand and bottlenecks in the economy would generate emerging from the pandemic. In addition, inflation has been given a significant boost by sharply higher food and energy prices due to the war in Ukraine.

Central banks have indicated that they are not done yet with rate rises. Financial markets expect further increases to come and rates to peak in 2023. Monetary policy typically takes 18-24 months to fully feed through to the economy, making it likely for central banks to face an uncomfortable period when inflation remains high, but they must refrain from further rate rises. This creates the risk that central banks will overtighten policy in an effort to burnish their inflation-fighting credentials, which could push the economy into a deeper recession as a result. Growth prospects have already weakened, and Oxford Economics expects the advanced economies to experience a shallow recession over 4Q22 and 1H23, focused on North America and Europe.

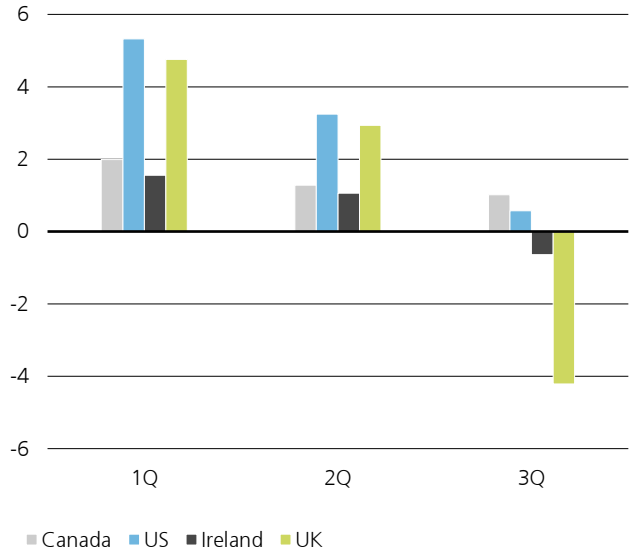
In real estate, occupier markets have held up well so far and in general, rents continued to increase in the third quarter. According to MSCI data, all-property rents in Canada, Ireland and the UK rose by around 1% QoQ. Office and retail rents were flat while industrial rents were stronger, up 2.2% QoQ in the UK for example. The slowdown in the economy is set to feed through to weaker occupier demand from businesses, which will weigh on rental growth. Moreover, it is likely to result in declines in rents in some markets and increases in vacancy rates. Within leases, rents linked to inflation will provide significant uplifts for landlords to counter the current high levels of inflation.

Interest rate rises are feeding through to the real estate market. Of the more than 300 city-sector markets we monitor globally, yields and cap rates rose in 56% of them in 3Q22, the first time they have risen in the majority of markets covered since the GFC. The increases were widespread and yields rose in the majority of markets across the main sectors of office, retail and industrial. In nearly all the remainder markets yields were flat. At the global level, the all-property cap rate was stable at 4.9% in 3Q22 according to data from MSCI. We expect further rises in yields and cap rates as buyers and sellers adjust their price expectations.

The rises in yields resulted in capital value declines and weakening returns in the third quarter. NCREIF data for the US and MSCI data for Canada, Ireland and the UK showed office and retail capital values falling 1-4% QoQ. Capital value growth for industrial in Canada, Ireland and the US slowed, but remained positive. In the UK it was negative, with values dropping a sizeable 8% QoQ. Income offset capital value declines in some markets to leave total returns positive. At the all-property level, total returns remained positive in the US and Canada while they were negative in Ireland and the UK (see Figure 1). UK total returns were -4.2% QoQ. We expect further capital value declines in 4Q22 and moving into 2023.

Real estate market transaction activity slowed for the third consecutive quarter in 3Q22, weighed down by some deals with prices agreed prior to the slowdown being aborted. Buyers and sellers are adjusting price expectations to higher interest rates. According to data from MSCI, global investment volumes fell 22% QoQ in 3Q22 in USD terms after adjusting for seasonal effects. Weaker market activity was focused on the EMEA and Asia Pacific regions, where volumes fell 25% and 26% QoQ respectively in USD terms after adjusting for seasonal effects. The Americas, driven by the US, was slightly more resilient, with volumes down 22% QoQ. Activity was weaker across sectors globally, with volumes down most for retail at 38% QoQ, while office, industrial and residential volumes fell by 21-23%.

Figure 1: 2022 all-property total returns (QoQ %)



Source: MSCI; NCREIF, November 2022. Note: Past performance is not a guarantee for future results.



Economic backdrop weighing on real estate

2022 has been a tumultuous year for the economy and real estate markets. At the start of the year, we expected the economy to build on its initial recovery in 2021 from the COVID-19 pandemic. Oxford Economics and others forecast that the advanced economies would grow by around 4%, before slowing to 2.5% growth in 2023. However, those forecasts have been steadily revised lower, with a knock-on impact on prospects for the real estate market. Latest forecasts from Oxford Economics show growth in the advanced economies of 2.4% in 2022, before slowing to a standstill in 2023, when GDP is expected to fall the first half of the year, before making a recovery in the second half.

The key driver behind the steady deterioration in the economic outlook has been interest rates rising much more rapidly and to levels higher than expected. Across the key global real estate markets, weighted by market size, policy interest rates are now expected to be above 3% by the end of 2023, compared to an expectation at the start of the year below 1%. The sharp upward revision to interest rate forecasts has been due to inflation consistently beating the expectations of most market participants and central banks.

Two factors have been behind the overshoot in inflation. First, a failure to assess the strong inflationary pressures that underlying demand and bottlenecks in the economy would create on emerging from the pandemic, with those pressures boosted by sizeable central bank balance sheet expansion during the pandemic. The second powerful and driving factor has been the exceptional rise in food and energy prices brought on by the war in Ukraine, which has destabilized these markets and turned them on end.

A weaker economy and rising interest rates weigh both on real estate market performance and across risk assets in general. Indeed, listed real estate markets have seen a sharp sell-off and price declines this year. Weaker economic growth ultimately feeds through to occupier demand from businesses for commercial premises, be they offices, retail or industrial and logistics properties. This in turn weighs on open-market rents, which will likely now decline in some markets. However, we do not expect the economy to deteriorate as much as it did during the GFC, rather that it will experience a mild downturn. Along with relatively constrained development activity and supply, this should support rents and cushion them from sharper falls.

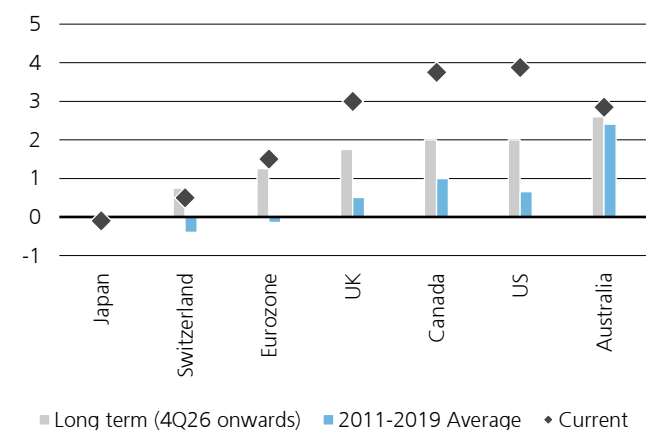
While a weaker economy weighs on occupier markets, higher interest rates are putting upward pressure on yields and cap rates and the market has started its adjustment to them. We are now seeing widespread increases in yields and cap rates across markets and sectors, a process which we expect to

continue into 2023. Against this backdrop we are seeing some falls in real estate market values, which we also expect to continue into 2023. The size of the eventual adjustment will depend upon the path of interest rates and the economy. If inflation were to surprise on the downside, it could allow central banks to cut interest rates sooner than expected, which would be supportive of real estate markets. While a deeper, longer downturn in the economy which saw interest rates remain higher for longer, would likely hit real estate values harder.

A key determinant of real estate market performance in the longer term will be where interest rates settle. Interest rates are notoriously hard to forecast, however, and depend on many factors. Indeed, widespread expectations that interest rates would rise around the middle of the 2010s proved unfounded. Latest forecasts for stabilized central bank policy rates show them at lower than current levels, but generally above those in the post-GFC period (see Figure 2). Some of the trends which presaged the ultra-low rates post-GFC, such as globalization, are now reversing.

For example, US interest rates are forecast to settle at 2%, compared to a post-GFC average of 0.7%. Eurozone interest rates are forecast at 1.5%, compared to -0.1% following the GFC. Australia is the only country where there is not a sizeable difference between the current longer-term rate forecast and those post-GFC. For real estate we expect this year's rate hikes to continue to feed through to some declines in capital values. If interest rates eventually trend back down as the current forecasts suggest, this could provide a boost to real estate.

Figure 2: Central bank policy rates (%)



Source: Oxford Economics; Refinitiv Datastream; UBS Asset Management, Real Estate & Private Markets (REPM), November 2022.

Real estate investment performance outlook

2022 forecast and 2023-25 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 2002-21. The red underperformance quadrant refers to negative absolute total returns, either in 2022 forecast or the 2023-25 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Residential
North America	Canada	8.6		8.4		11.2		9.2	
	US	7.5		8.7		11.4		8.5	
Europe	France	7.6		9.0		9.9		7.8	
	Germany	5.0		5.2		8.5		7.4	
	Switzerland	5.7		6.1		6.6		6.4	
	UK	6.9		4.9		10.7		9.1	
	Australia	9.9		8.8		11.9		n/a	
Asia Pacific	Japan	5.2		5.3		6.1		5.7	



: Forecast 2022



: Outlook 2023-25

- : Underperformance (negative absolute returns)
- : Underperformance vs. long-term average
- : In line with long-term average
- : Outperformance vs. long-term average

Source: Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), November 2022. Note: Abbreviation LTA: long-term average. Expected / past performance is not a guarantee for future results.

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