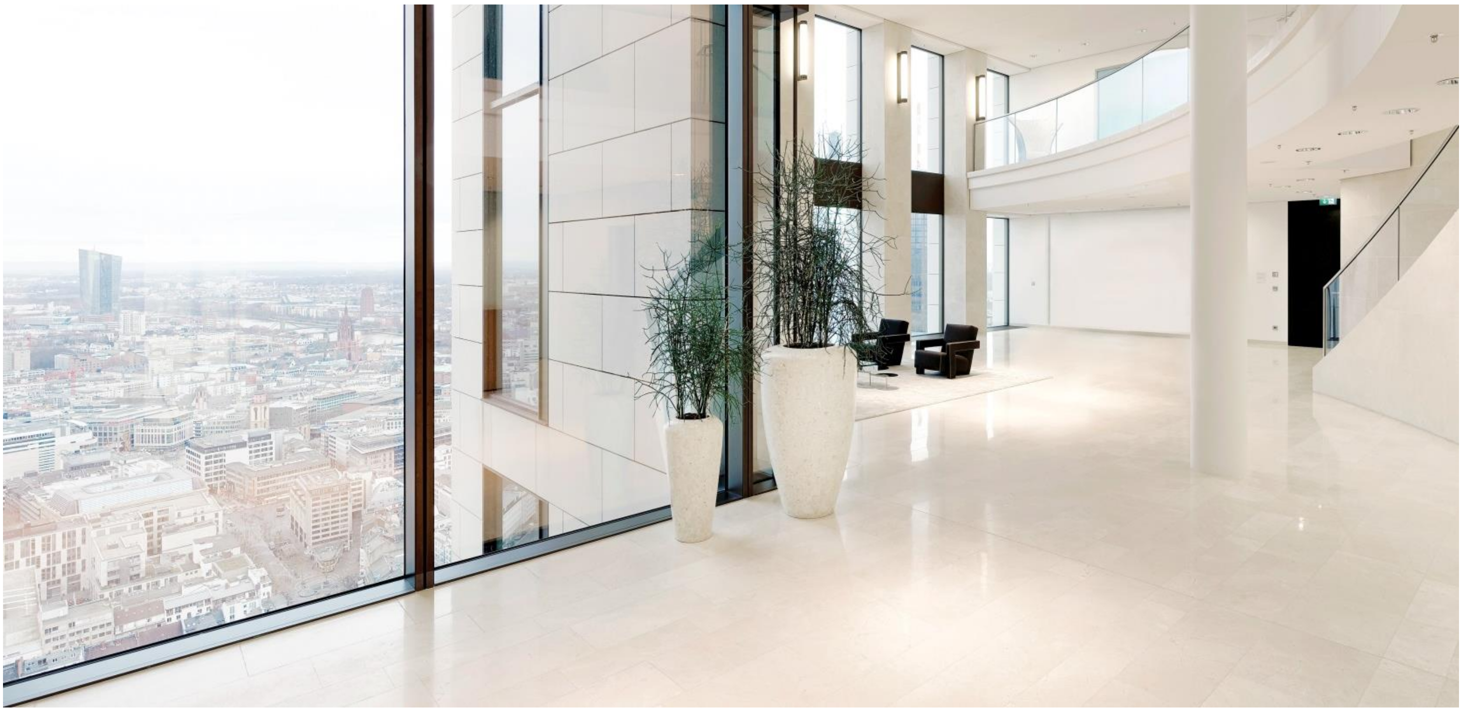
Real Estate Outlook

Global overview – Edition 2, 2020



Central bank liquidity supportive.

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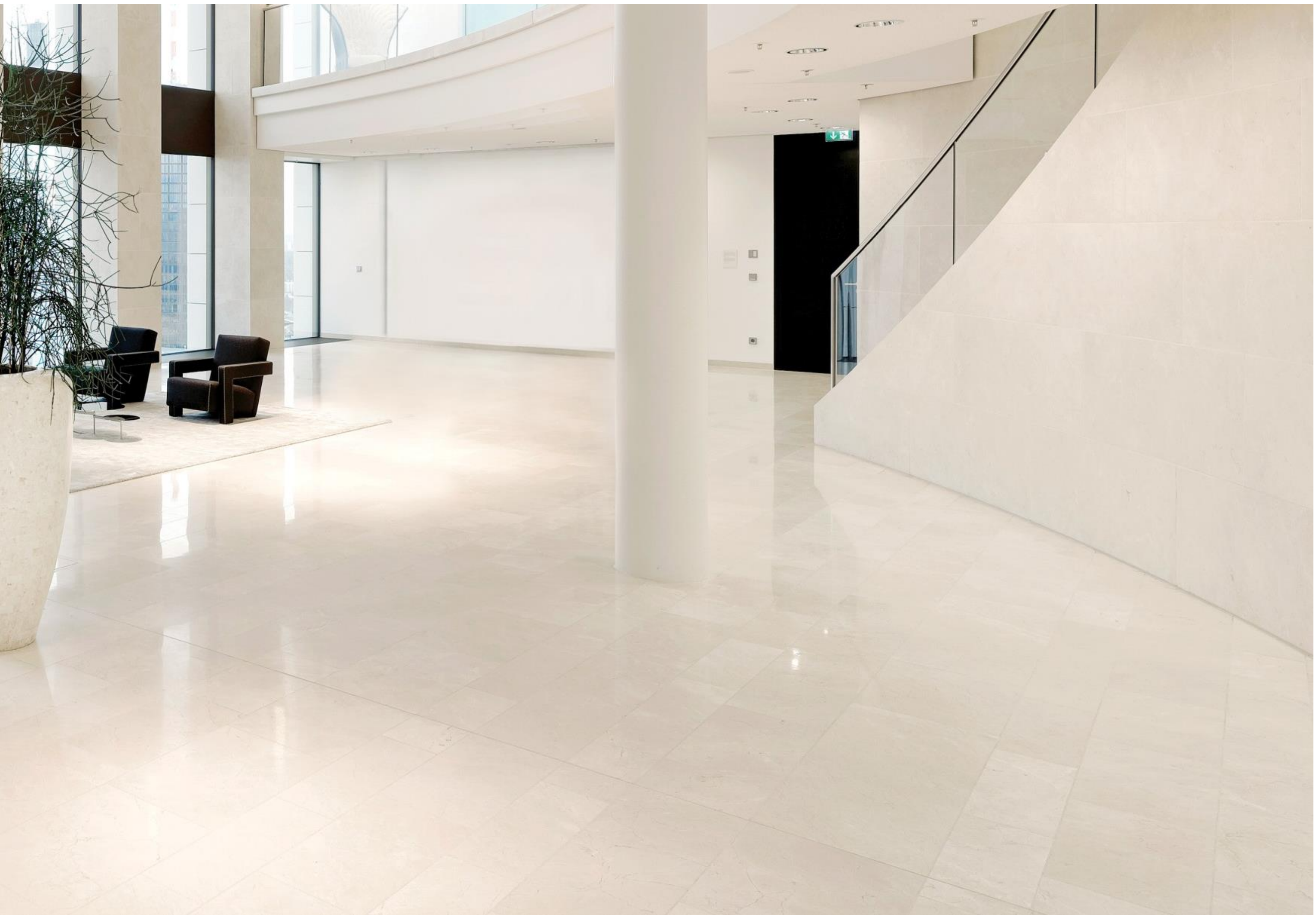
Rents under pressure, but central bank liquidity to cushion real estate values.



COVID-19 is affecting all real estate markets globally. Recession will hit occupier demand, with the retail sector being worst affected and logistics most resilient. Central bank easing and liquidity should support real estate values, though we still expect some declines this year. Ultimately, recovery will depend upon how quickly the health crisis is brought under control, with a vaccine likely needed for a full exit.

Macroeconomic overview – Big and fast policy response

Following the first cases being reported in Wuhan in December 2019, COVID-19 spread across Asia Pacific and then to Europe and the Americas to become a global pandemic by March. The number of cases reported globally has now surpassed four million and the number of deaths is above 300,000, although these numbers almost certainly underestimate the full impact of the virus. For example, not all deaths that have occurred outside of hospitals show up in the statistics. Sufferers who have only experienced mild symptoms or suffered short illnesses not requiring medical intervention are also absent from the figures.

In early May some countries started to ease the heavy restrictions they had placed on their citizens through much of March and April, with schools and shops beginning to re-open. However, a return to the pre-crisis norm is a long way off. Even once restrictions are lifted people may not want to visit shops or go out of their own volition for fear of catching the virus. Moreover, there is a risk of a second round of infections as restrictions are lifted. Indeed, new cases have already surfaced in Harbin in China and in migrant dormitories in Singapore. Hence the rolling back of the lockdown will likely be gradual and fraught with uncertainty.

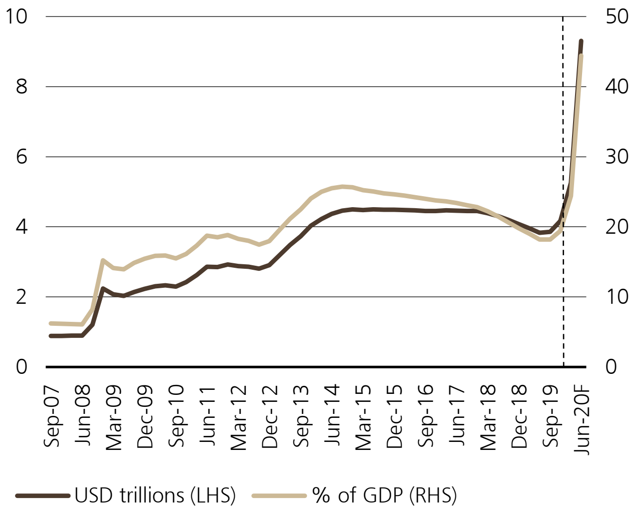
Going into this crisis economies were in better shape and more balanced than on entering the Global Financial Crisis (GFC), with lower debt burdens. However, central banks had less ammunition. The response from policymakers has been big and fast. The US Federal Reserve swiftly cut US interest rates in March by 150 bps to a target range of 0 to 0.25% and announced an initial USD 700 billion of new quantitative easing, with a subsequent commitment to unlimited asset purchases. Other central banks around the world also announced easing policies, including rate cuts, quantitative easing and other measures. However, monetary policy can only really help with a lack of demand in the economy when spending is too low, not a supply-side shock.

Supply is being suppressed as government lockdowns force factories, shops and other businesses to close. Governments and central banks have launched a multitude of loan programs to help ailing businesses of all sizes. However, loans risk saddling businesses with debt that could make them insolvent once the crisis has passed. Hence the importance of other government schemes such as furloughing workers and paying their wages, and grants to cover other fixed costs. Indeed, expectations are that many countries will see double-digit budget deficits this year.

Fiscal packages from some of the larger economies such as the US, Japan and Germany are estimated to be in the region of 10-20% of GDP and more. Although this will sharply push up public debt levels, most governments are unconcerned at this stage and see the increased debt burden as something to be addressed once the crisis has passed. Moreover, in the decade since the GFC central banks have struggled to generate inflation, with Japan-style deflation the bigger threat.

Stock markets reacted negatively as the virus spread globally and posted some of the largest declines on record. The speed and strength of stimulus programs implemented by central banks and governments has however helped appease investors. Importantly, central banks are injecting large amounts of liquidity into the financial system which has supported prices. For example, the US Federal Reserve balance sheet rose by USD 2.2 trillion between the end of February and mid-April, equal to 10% of US GDP (see Figure 1). By the end of June Oxford Economics expects it to have risen by a total of USD 5.1 trillion, taking it to USD 9.3 trillion or 43% of US GDP.

Figure 1: US Federal Reserve balance sheet
(USD trillions and % of GDP)



Source: US Federal Reserve; Oxford Economics, May 2020

As the crisis worsened economists revised down their forecasts to numbers previously unimaginable, with latest projections pointing to a recession that will be the worst since the Great Depression. The IMF expects GDP in the Advanced Economies to shrink by 6.1% in 2020, before recovering 4.5% in 2021. Double-digit declines in output are predicted in 2Q20 followed by some recovery in 2H20. Ultimately, the timing and strength of the recovery will depend upon how the health crisis evolves and on how effective schemes to support firms have been. A vaccine will likely be needed for a full exit.

Capital markets – Value declines expected

Data on unlisted, private real estate markets is released only with a lag and is therefore less timely than high frequency financial market data. Real estate valuations tend to react to crises gradually as a lack of activity means that market transactions and comparable evidence needed are unavailable. So in times of uncertainty and crisis it can be useful to look to public real estate markets for a steer as to what might happen in private real estate markets.

Indeed many property valuations for 1Q20 have been subject to "material uncertainty clauses". How quickly property valuations change varies by country, but historically they have adjusted more rapidly in the US and UK than in continental European countries. However, even in times of severe stress transactions in the largest, most liquid real estate markets such as London, New York, Paris and Tokyo still take place (as was the case during the GFC). Social distancing measures will also impede the transaction process though by limiting travel and site visits.

We would expect the impact on investment activity in 1Q20 to have been greatest in the Asia Pacific region, while the full force of COVID-19 did not hit Europe and the Americas until mid-March. Real estate transaction activity typically slows in 1Q anyhow after a busy 4Q when deals are completed before year end. Data from Real Capital Analytics show that global real estate volumes fell 42% QoQ in 1Q20 but were down just 3% YoY. Statistically adjusting investment activity for seasonal variations gives a better indication of underlying market conditions. After removing seasonal effects, global volumes dropped 14% QoQ in 1Q20, with the largest fall, of 38%, in Asia Pacific, followed by a 12% decline in EMEA and a 5% drop in the Americas. Activity is likely to slip further in 2Q20.

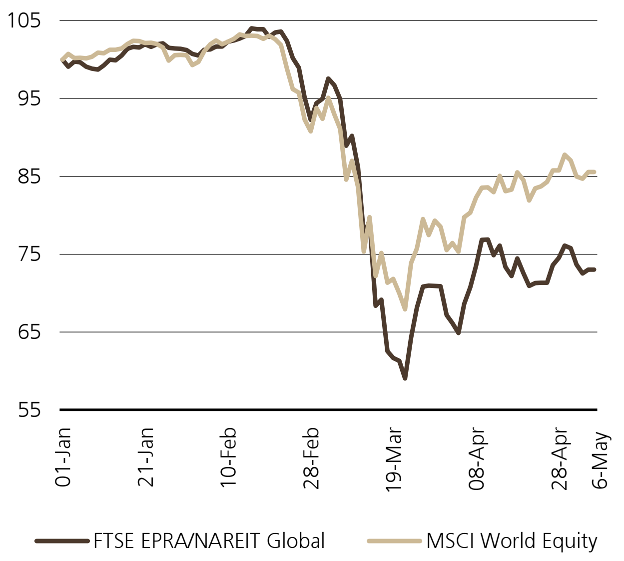
There was limited impact in 1Q20 on market level pricing data due to uncertainty over how COVID-19 will affect values. For example, JLL held its market yield series flat across Europe at 4Q19 levels, while CBRE did report data for 1Q20. At the global level, the largest share of markets reported a rise in yields since the GFC, with the rises focused on European retail markets which were already suffering. Of the 331 markets we track globally, 30% reported a rise in yields in 1Q20 while 6% reported a fall and 64% reported no change. We expect more clarity in yield and value movements in 2Q20 once price discovery has properly started.

Valuations-based indices did show some impact in 1Q20. For example, in the US NCREIF reported an all property return of 0.7% QoQ, down from 1.5% in 4Q19. Property values fell 0.4%, marking the first decline since the GFC. Retail and hotels drove the fall as values slipped 3.2% and 4.8% over the quarter, respectively. Industrial and office values on the other hand rose, up by 1.5% and 0.2%, respectively. For the UK MSCI reported an all property total return of -1.4% QoQ for 1Q20, slowing from 0.0% in 4Q19; for Ireland a return of 0.6%, the same as in 4Q19; while in Canada returns slowed to -0.3% in 1Q20 from 2.0% in 4Q19.

Public markets moved quickly in March as the crisis unfolded and give a view into investor sentiment and the impact of the crisis on real estate pricing. Global listed real estate sold off along with the wider equity market. In late March, global developed market REIT prices were 43% below their late February high in US dollar terms, and marking a bigger drop than the wider equity global equity market, which troughed at 34% below its February high according to the MSCI World index (see Figure 2).

Massive government and central bank support saw markets rally and by the end of April global REIT prices had recovered ground to 27% below their peak. The wider equity market recovered to 16% below its peak. After allowing for leverage global REIT prices suggest a decline in global real estate values of around 10%. However, listed markets are affected by wider equity market sentiment and volatility, and hence only provide a rough guide as to prospects for direct real estate values. It is worth noting that listed markets have been much more positive on industrial, and negative on retail, which we would expect. Indeed the industrial sector has been trading at a small premium to net asset value, reflecting better prospects for online retail and logistics.

Figure 2: FTSE EPRA/NAREIT Global Developed Markets and MSCI World Equity price indices (31 Dec 2019 = 100)



Source: Thomson Datastream, May 2020

Strategy viewpoint – Accentuating existing trends

The COVID-19 pandemic and its pervasive impact is seeing investors reassess their portfolios and strategies. This will likely lead to some rebalancing following the decline in equity prices. For real estate several factors determine valuations. Lower rents and expected income streams will push capital values down, while falls in interest rates and bond yields will provide some support as they push discount rates lower. The final factor is the property risk premium, which typically has increased in times of crisis. However, with interest rates so low and investors seeking yield the risk premium may not rise significantly and could be unchanged. On entering the crisis spreads between property yields and bond yields were around the average for the past decade and significantly above those before the GFC. Overall, we expect to see some declines in real estate values this year.

The pandemic is affecting different real estate sectors in different ways. The office market entered the crisis in generally good shape. Vacancy rates were at record lows in many markets while development pipelines were relatively contained. This is unlike the GFC when new offices hit the market following a ramp-up in development activity prior to the crisis, fueled by easy lending. Constrained supply should cushion rents, though we do expect rents to come under pressure as some occupiers suffer. The office market is also at risk from stress in the flexible office sector as tenants and individuals hand back space. Indeed, the insolvency of any of the larger flexible office providers could see a large amount of space released back on to both the occupier and investment markets.

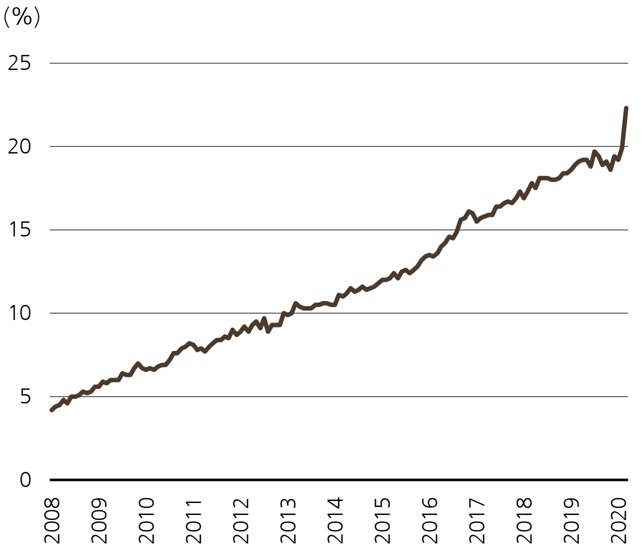
In the near term it will likely be difficult for all office-based employees to return to work at once as companies enforce social distancing rules to stop the spread of the virus and protect workers. This implies office space per employee will be higher until the virus eventually passes, with homeworking being used for the additional flex-space needed. In the medium term corporates will also likely re-evaluate their office footprints and conclude that they can reduce them following the success of mass home-working during the crisis.

Retail has been the sector hit hardest by government lockdowns and the forced store closures which retailers have had to endure. In the eurozone, for example, retail sales volumes fell 11% in March from February, while in the US the University of Michigan Index of consumer sentiment survey recorded its largest one month drop on record in April. Some retailers have already gone bankrupt and more are likely to follow. In the medium term the crisis looks like it will exacerbate the difficulties that the sector was already facing. Only the strongest retailers will survive while the weaker ones and those with high debt levels will not. The crisis is also accelerating the shift to online shopping and will push surplus retail space higher still.

The fortunes of the logistics sector are the inverse of retail. Government lockdowns, which have forced people to stay at home, are seeing them resort to online shopping. Some of these people have not done so before or only in small volumes. Indeed, the crisis looks likely to accelerate the shift to online sales which was already well underway. For example, in the UK a combination of falling physical store sales and rising online sales pushed the online retail share to 22% of the total in March from 20% in February (see Figure 3).

The online rise is accentuated by shop closures, but in the medium term demand for logistics facilities will likely be boosted. However, we think the sector will not be immune from falling consumer spending due job losses and recession. Online fashion retailers have been hit as people do not socialize or go out.

Figure 3: UK online retail sales as share of total

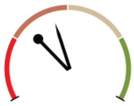
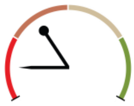
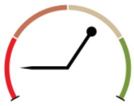
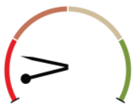
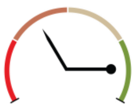
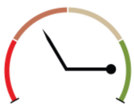


Source: UK Office for National Statistics, April 2020

The residential sector has historically been more defensive and resilient in times of crisis. However, it is unlikely to be fully immune to the recession. Rising unemployment and weaker incomes will affect the ability of tenants to pay rents. Large government schemes to furlough workers and pay part of their wages should provide some support. Senior housing has also been hit, with residents particularly at risk from the virus, and operating procedures will likely be amended following the crisis. In the longer term though the fundamental demographic driver of an aging population will remain and should support the sector.

Real estate investment performance outlook

2019 performance and 2020-22 outlook are measured against the country sectors' long-term average total return, with a margin of 100bps around the average described as "in line with long-term average". The long-term average refers to the period 2002-19. The red underperformance quadrant refers to negative absolute total returns, either in 2019 or the 2020-22 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multi-family
North America	Canada	9.5		10.3		10.1		n/a	
	United States	7.9		9.9		9.9		8.3	
Europe	France	8.0		10.1		9.1		n/a	
	Germany	4.5		5.5		7.3		n/a	
	Switzerland	5.6		6.3		n/a		6.3	
	UK	7.5		5.9		9.5		n/a	
Asia Pacific	Australia	10.3		10.1		10.8		n/a	
	Japan	5.3		5.5		5.9		5.2	

: Performance 2019

: Outlook 2020-2022

: 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), May 2020. Note: Abbreviation LTA: long-term average

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