Real Estate Outlook

Global overview – Edition 4, 2019

Returns slowing but rate cuts supportive of sector

UBS

UBS Asset Management

Economies around the world are slowing, with some on the brink of technical recession. However, the US consumer remains resilient and our base case is for a slowdown rather than a recession. The rotation in monetary policy towards easing is supportive of real estate and is expected to continue to attract capital to the sector.

Macroeconomic overview

Over the course of 2019 economic forecasts have been revised lower, and interest rate and bond yield projections cut. Concerns abound over prospects for the global economy and whether it will enter recession in 2020. Indeed, some economies, such as Singapore and Germany, are already approaching technical recessions, while Hong Kong is already there as protests take their toll on economic activity. That said, the main economies of the world continue to show growth, albeit weakening. The US, for example, recorded growth of 2.0% YoY in 3Q19 while the eurozone managed a better-than-expected 1.1% YoY. China grew 6.0% YoY, but growth is expected to slip below 6% in 2020, which would mark the slowest pace since the early 1990s.

The trade war between the US and China has escalated as the year has progressed, with the two superpowers retaliating to each other's tariffs with more of their own. However, the two sides reached a ceasefire in October, with the US agreeing to suspend a specific set of December tariffs, and China in turn agreeing to increase its purchase of US agricultural products. Their leaders are expected to meet in November, though an enduring truce seems a long way off. The pending US election in 2020 could provide some impetus on the American side, though it is not that clear cut since playing hard against China resonates with President Donald Trump's core electoral base.

Figure 1: World trade volume and world industrial production volume (3mma, % YoY)

Source: CPB World Trade Monitor, November 2019

At the global level, world trade volumes have reversed, and in the three months to August were down 1.5% compared to a year earlier. The impact has mainly been felt in industry where, over the same period, world industrial production growth slowed to 0.7% (see Figure 1). The weakness is a long way off those levels seen during the GFC, when trade and production volumes both plummeted; however, it is the most pronounced since. China has been hit particularly hard, with goods exports down 3.2% YoY in September in USD terms. Central and Eastern European economies are also feeling the chill, exposed to the German car industry through tightly integrated supply chains.

A key question is whether the service sector can remain resilient, having held up reasonably well. In the US, consumer spending remains robust, buoyed by a solid labor market and unemployment rate at a 50-year low. However, it is quite possible that weakness in trade and manufacturing will eventually spill over to services as well. The likelihood of recession has risen and is increasingly discussed. For example, Oxford Economics puts the probability of recession in the US over the next 12 months at 40%, up from below 30% at the start of the year.

The key global recession indicators flashing red at the moment are the US yield curve and world industrial production, though unconventional monetary policies mean the predictive power of the yield curve might be diminished. The term premium on long-dated bonds has fallen, making an inversion easier to achieve than in the past. Other recession indicators include US corporate earnings and commodity prices, which are currently flashing amber, and global stocks, corporate bond spreads and US credit standards, which remain green.

The escalation of the trade war and cooling growth has spurred central banks around the world to action and seen a U-turn in monetary policy this year. The Federal Reserve has cut US rates three times, largely reversing the four increases of 2018. However, it is unclear whether the Fed has been driving markets or responding to them; what Ben Bernanke called a "hall of mirrors". The ECB has also acted and in September cut its deposit rate to -0.5%, extended its forward guidance and restarted its asset purchase program at EUR 20 billion a month.

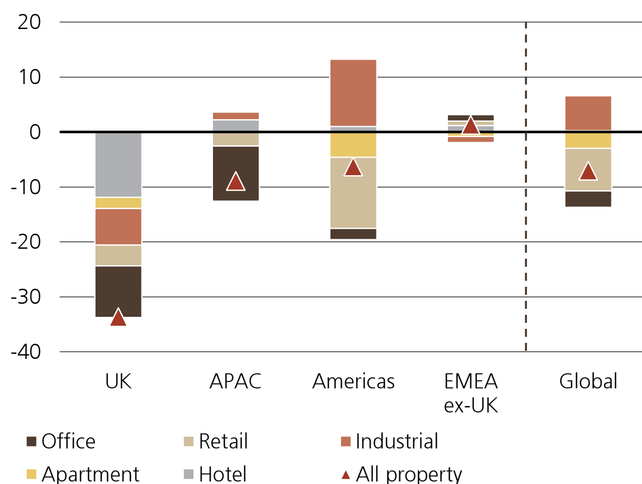
The ECB's decision created an increasingly bitter public division on its governing council. The German, French, Dutch and Austrian central bank chiefs all oppose the new easing measures, along with a host of former senior ECB officials. This will make the start of Christine Lagarde's tenure as ECB President harder. Mario Draghi voiced a parting call for eurozone governments to establish a joint budget for the single currency bloc, which could help stabilize it in times of crisis. Indeed, in Germany, opinion does seem to be softening on the law which prohibits structural budget deficits, and could yet result in some fiscal support for the economy as it slows. A eurozone program is much further off.

Capital markets

Global real estate investment volumes are lower than they were a year ago. According to Real Capital Analytics (RCA), global investment activity was down 7% in USD terms in 3Q19 from a year earlier (see Figure 2). Americas volumes were down 6%, with a particularly sharp drop recorded in the retail sector although partially offset by a strong industrial market. In the UK, volumes were down 34% in USD terms and lower across all property types. However, even excluding currency effects the underlying UK market was weak, with volumes still down 30% YoY in GBP. The rest of EMEA fared better, with little change in activity in most sectors and overall volumes up 1% in USD. In APAC, the office sector fared the worst, dragging all property volumes down 9%.

Figure 2: Investment volumes

(contribution to all property 3Q19 % YoY, USD)



Source: RCA; November 2019

Yields and cap rates were broadly flat in 3Q19. In our quarterly survey of over 330 city-sector markets globally we found yields were unchanged in the vast majority (68%). A small number saw falls in cap rates and yields (17%) while a similar number saw increases (14%). Overall we think the interest rate cuts we have seen this year will likely provide some renewed downwards impetus on yields in some markets. At the very least, outside of the retail sector, they should prevent yields from rising. Retail is the only sector where we think yield rises are likely in the near term, particularly in lagging markets, as retailers battle with structural change. In the medium term we do not expect any sharp rises in yields and cap rates following the extended period of falls in the wake of the GFC. Moreover, investor interest in real estate remains firm, which is supporting current pricing.

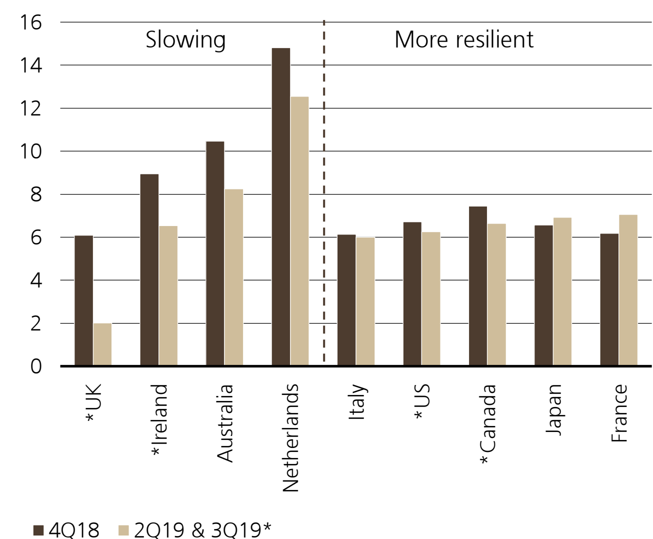
Real estate continues to provide positive returns, with performance varying by market. Our expectation for some time has been that returns will slow and this is being borne out in markets which report performance at a higher frequency. Compared to 4Q18 most of these markets have shown some slowing in returns this year, with only two markets recording a mild acceleration. In 2Q19 annual returns were slightly higher in France and Japan compared to 4Q18. All other markets showed a slowdown, modest in the cases of Italy, the US and Canada, and sharper in the UK, Netherlands, Ireland and Australia (see Figure 3).

Returns in the UK slipped to 2% YoY in 3Q19 from 6% in 4Q18. The retail sector is the key driver of softness in the UK market, while industrial and offices have held up much better. With an election looming on 12 December and Brexit still unresolved, uncertainty hangs over the UK. However, foreign investors are waiting in the wings, looking for a possible currency play and ready to act if the Brexit fog clears. Moreover, office yields in the UK look high versus some other core European markets.

Ireland historically has been a more volatile market, and annual returns slowed to 7% in 3Q19 from 9% in 4Q18. In Australia, a market which has been outperforming its global peers recently, returns fell from 10% in 4Q18 to 8% in 2Q19. Finally, in the Netherlands, which has also been one of the strongest performing markets, with its buoyant office sector, returns slowed from 15% in 4Q18 to 13% in 2Q19. With returns slowing in most markets, we think they will converge to around the 5% p.a. level over the next three years, with little significant differentiation between markets.

Figure 3: All property total returns

(% YoY)



Source: MSCI; NCREIF; November 2019

Strategy viewpoint

A key consideration for global real estate investors is hedging costs and currency exposure. Given the changes in interest rates that we have seen this year, we believe it is worth reviewing them. Ultimately, hedging costs are determined by interest rate differentials. The decision to hedge or not to hedge is down to the individual investor and their risk appetite and objectives. Hedging will remove the increased volatility that currency exposure injects into returns, while going unhedged will see currency shifts impact the returns an investor receives. In extreme cases, currency swings can overpower real estate returns or turbo-charge them.

In the end, the cumulative foreign exchange impact for an investment will be realized at the time of sale, when proceeds are repatriated back to the investor in their own currency. However, the reported market values through the life of the investment will reflect currency impact, be it hedged or unhedged, and hedging on a rolling basis will likely result in cash flows along the way as contracts get settled and rolled over. Over the longer time horizon though we would expect the impact on total returns of going unhedged to be little different from going fully hedged since, on average, we would expect currencies to move in line with forward rates.

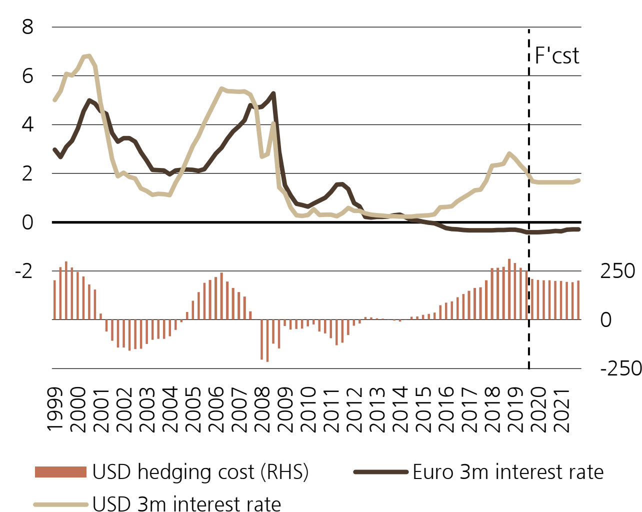
Indeed, our analysis shows that direct global real estate returns were 9.1% p.a. over the period 1994 to 2018 in USD terms at market exchange rates, little different from the 8.7% p.a. achieved on a fully hedged basis. Therefore over the period as a whole, market exchange rates moved broadly in line with forward rates. However, there were significant short term deviations, which show up in the volatility of returns. The standard deviation of annual returns at market exchange rates was 6.0% p.a., while it was 4.8% p.a. for fully hedged returns. Hence hedging does reduce return volatility.

The launch of the euro is a good case study of when currencies do not move in line with forward rates and when a substantial deviation exists. When the euro launched in 1999, US short-term interest rates were above eurozone rates and hence there was a cost for euro-denominated investors to hedge their investments in US assets. However, in reality, rather than depreciating as the forward rates predicted, the dollar actually surged 17% against the euro in the single currency's first year.

In 2019 US interest rate cuts have seen hedging costs for euro-denominated investors fall, from just above 300 basis points at the start of the year to 250 basis points by the end of 3Q. This means that in euro terms hedging knocks 2.5% off the annual returns on US investments.

A key question for investors now is how hedging costs will evolve going forward. Interest rate forecasts for the next couple of years imply that hedging costs will remain around the 250 basis points level (see Figure 4). However, a US recession which saw the Fed slash rates would likely see hedging costs fall sharply. Over the next decade, interest rate predictions from Oxford Economics suggest the hedging cost will gradually narrow to around 50 basis points.

Figure 4: US and eurozone three-month interbank rates and USD to EUR hedging cost (% and bps)



Source: Oxford Economics; November 2019

What does this mean for investment strategy? At face value it implies that US investments need to deliver an additional 2.5% p.a. of returns for euro-denominated investors over the next couple of years at least to compensate for the hedging drag. However, this is an overly simplified view. One of the main reasons for an investor of going global is the diversification it brings them from gaining exposure to different markets and economies. Moreover, in addition the US has the advantages of being the largest and most liquid real estate market in the world.

With return expectations for core real estate similar in both the US and eurozone, the current hedging drag suggests it would be appropriate to slightly underweight the US relative to its neutral allocation. Another way of taking into account the hedging cost would be to access real estate, which has higher return expectations. Indeed, the alternative sectors such as student accommodation, medical office and retirement housing are more developed in the US than most eurozone markets, and the multi-family sector is also bigger. With some of these more niche markets offering higher return expectations, exposure to them can provide a way of mitigating the hedging drag.

Real estate investment performance outlook

2019 performance and 2020-22 outlook are measured against the sector's 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 2002-18. 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	9.8		10.9		9.9			
	United States	8.4		10.7		10.1		8.9	
Europe	France	8.1		10.9		9.0			
	Germany	4.0		5.5		6.9			
	Switzerland	5.6		6.4				6.3	
	UK	8.3		7.4		10.2			
Asia Pacific	Australia	10.4		10.7		11.0			
	Japan	5.3		5.6		6.0		5.1	

Forecast 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), November 2019. Note: Abbreviation LTA: long-term average

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