

Real Estate Outlook

Global overview – Edition 2, 2021



Inflation protection desirable.



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Global overview

Strong performance in first quarter.



Economic performance varied by country in the first quarter, affected by different paces of progress against the virus. Real estate investment activity slipped slightly, but remained significantly above its nadir in 2020. Real estate markets showed a strong performance, led by further strong capital value growth for industrial real estate.

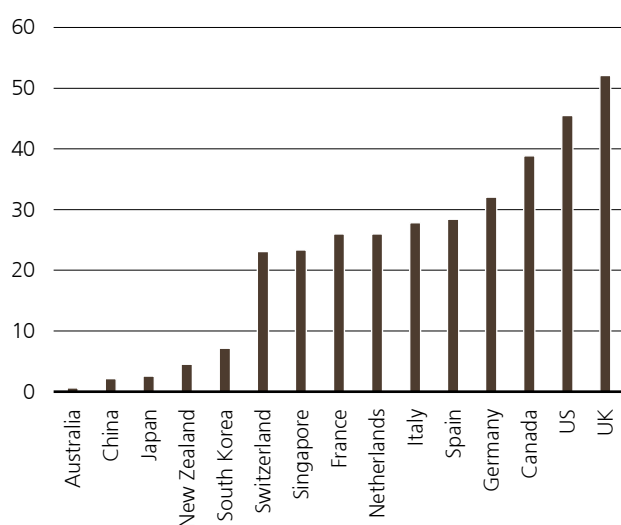
Macroeconomic overview

Uneven recovery, driven by virus progress.

According to the World Health Organization, the number of COVID-19 cases reached 150 million globally in April 2021 and the death toll passed three million. India, ravaged by a second wave of the virus, has been a significant contributor to the increase in cases, with its total number rising from 12 million to 19 million in April alone. However, good progress has been made on the vaccine rollout in some countries, fueling expectations that the economic recovery will gather pace as the year progresses. This will be very much dependent on whether new, vaccine-resistant forms of the virus emerge though, which could trigger further waves of lockdowns.

The rollout of vaccines has varied by country, with the US and UK now well-advanced. Indeed, in early May 52% of the UK population had received at least one dose of a vaccine and 45% in the US (see Figure 1). By contrast, the vaccine rollout in the rest of Europe has been more problematic, due to a lack of vaccines from manufacturers and more vaccine hesitancy in the population. By early May vaccination rates in France, Italy, Germany and Spain were in the range of 26-32%, though European governments are confident they can catch up over the summer. Vaccination rates in Asia Pacific remain low, generally less than 10%, and leave the region exposed to further outbreaks of the virus.

Figure 1: Share of population vaccinated at least once
(% of total, 10 May 2021)



Source: Our World in Data; UBS Asset Management, Real Estate & Private Markets (REPM), May 2021

The varied progress in combatting the virus was reflected in most recent GDP data. The US economy showed strong growth in 1Q21 of 1.6% QoQ while eurozone GDP fell 0.6% QoQ, reflecting the impact of widespread winter lockdowns there. Oxford Economics estimates that in China, the economy contracted 0.7% QoQ as caution held back Chinese New Year celebrations. The US economy is now within a whisker of its pre-pandemic level of output, just 0.9% below it, while bigger shortfalls persist in Europe.

The US, Canada and the main Asia Pacific economies are expected to regain their pre-crisis levels of output by the end of the year, with strong fiscal support driving the US. By contrast, Europe is lagging, with smaller and less timely fiscal stimulus in place. The Next Generation EU package, worth EUR 750 billion over five years, is still being finalized. The eurozone as a whole is not expected to regain its pre-pandemic level of output until 1Q22, with recovery in Italy and Spain delayed until the second half of 2022.

In line with the wider economy, the consumer sector is improving too. The rotation to online shopping supported retail spending during lockdown periods, though pent-up demand will likely fuel an initial bout of consumption as restrictions ease. Moreover, according to Oxford Economics consumers have built up excess savings worth USD 4.7 trillion globally. Whether consumers view these extra savings as wealth or income will be key in determining how they treat them. If viewed as wealth, the base case assumption, around 5% of these savings should be spent annually according to Oxford Economics, while if these savings are treated as income a much higher share, of around 45%, may be spent, creating an upside risk.

The recovery in demand is filtering through to rising inflation, also pushed higher by base effects as prices rebound from the lows hit last year. We expect that the rise in inflation will be transitory rather than sustained, which is also the view of the central banks. However, we cannot rule out the possibility that the sharp pick-up in inflation will push up price expectations and cause higher inflation to be sustained. Moreover, with elevated public debt levels, now above 100% in more countries than pre-crisis, higher inflation would be a convenient way for governments to reduce their debt burdens. We also cannot rule out a policy error by central banks as they navigate the uncertain path out of the pandemic. Hence investors need to be vigilant and ready to successfully navigate these factors as they evolve.

Capital markets

Strong performance in the first quarter.

Real estate investment activity slipped back in the first quarter as renewed lockdowns impinged on activity. After adjusting for seasonal effects, data from Real Capital Analytics showed global investment activity down 11% QoQ in USD terms. However, the market still showed a substantial improvement from its nadir in 2Q20, with volumes up 36% from their low. On a seasonally adjusted basis, global investment activity in 1Q21 remained 25% below its pre-pandemic level of 4Q19, with no significant differences between regions. We expect investment activity to mirror the economy, with a further easing of restrictions likely to boost investment volumes in the second half of the year. Moreover, a gradual return of international travel should aid cross-border purchase activity.

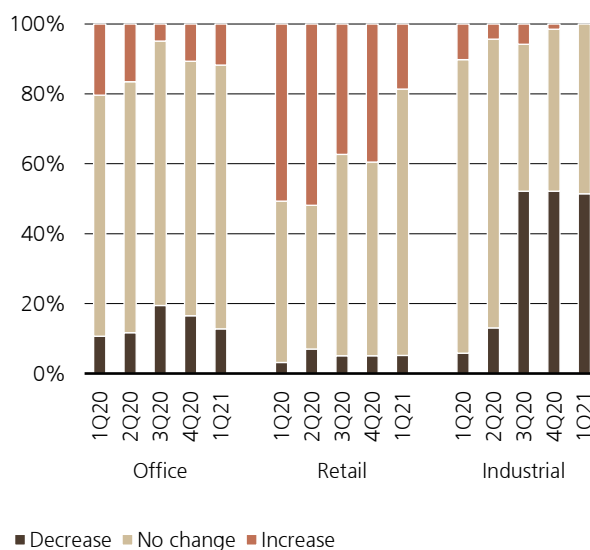
The sector trends which were already evident continue to play out. Global industrial investment volumes in 1Q21 were 3% above their pre-pandemic level, boosted by both strong investor demand for the sector and price rises across most industrial markets in 2020. By contrast office volumes were down 39%, while retail volumes were 49% below their pre-pandemic level, pushed down by both weak investor sentiment and widespread price falls in the sector. Residential activity was little-changed, 1% above pre-pandemic levels, while hotels remained down 52%, also impacted by falling prices as well as reduced transaction numbers.

MSCI reported a global all property return of 2.1% for 2020, with a capital value decline of 2.0%. Hence the market held up well compared to the Global Financial Crisis (GFC), when capital values fell 22% over two years. Unsurprisingly, the retail sector reported the weakest performance, with a global total return of -6.6% for 2020, driven lower by capital values falling 10.5%. Offices showed a single-digit positive return of 2.6% as income offset a modest capital value decline of 1.6%. Finally, industrial recorded a 10.4% total return, fueled by capital values rising by 5.5%. Income returns trended lower across sectors, to 4.1% at the all property level.

Initial results for 1Q21 suggest that the market showed a strong performance, driven by the prospect of economic recovery, and ongoing support from central banks and fiscal stimulus. Industrial capital values showed very sharp rises of 2-4% QoQ in Canada, Ireland, the UK and the US, according to data from MSCI and NCREIF. If sustained, this pace of increase would lead to double-digit growth for 2021 as a whole. By contrast, office capital values showed small falls of up to 1% QoQ across these four markets, while retail weakness continued, with capital values declining by up to 2% QoQ. In the US apartment sector capital values rose by 1%.

These trends in performance were mirrored in pricing and yield movements. According to CBRE and NCREIF data, office yields were generally flat. Within the office sector a bifurcation exists, with pricing for assets which have good location, accessibility and positive ESG credentials holding up better. Nearly 20% of retail markets monitored reported a rise in yields, down from 39% which reported an increase in 4Q20. In industrial, a majority of markets reported a fall in yields and cap rates for the third quarter in a row, with the remainder reporting them as flat (see Figure 2). Strength in the industrial sector looks set to continue, with further yield declines likely.

Figure 2: Global prime yield / cap rate movements
(QoQ, share of markets)



Note: From a sample of 103 office markets, 158 retail and 69 industrial
Source: CBRE, NCREIF; UBS Asset Management, Real Estate & Private Markets (REPM), May 2021. Past / expected performance is not a guarantee for future results.

In terms of fundraising, Preqin reported that globally there was USD 368 billion of capital targeting real estate as at May 2021, the same as at the end-2019. Capital targeting core and core plus real estate rose, while capital which was focused on opportunistic and value-added real estate fell slightly. Core is the dominant strategy in institutional portfolios and comprises 83% of the average portfolio, according to the ANREV/INREV/NCREIF 2021 Investment Intentions Survey, with value-added accounting for 11% and opportunistic 6%.

Strategy viewpoint

How to mitigate against inflation risk.

With inflation rising and a risk that price pressures may be prolonged rather than transitory, real estate investors must consider what this means for their strategy. How can they mitigate against inflation risk? In general, we think that real estate offers good inflation protection, but adjustments can be made to portfolios to maximize protection. Inflation affects real estate performance via two main channels. First, its impact on within-lease rental income and whether it keeps up with inflation; and second due to its impact on market rents and capital values via its influence on interest rates and the broader economy.

With regard to rental income, investors can follow several strategies to protect against inflation. The first is to look to leases which have rents indexed to an inflation measure. Such leases tend to be more common in Europe than in Asia Pacific or the US. A lease with rents linked to inflation will provide protection, as rents get uplifted automatically should a bout of inflation occur. By contrast, rents under leases which are not indexed to inflation can get eroded over time in real terms if unexpected inflation occurs, and will likely be less than those underwritten. An alternative to indexation is focusing on shorter leases, which provide the opportunity to reset rents more quickly if inflation does take off.

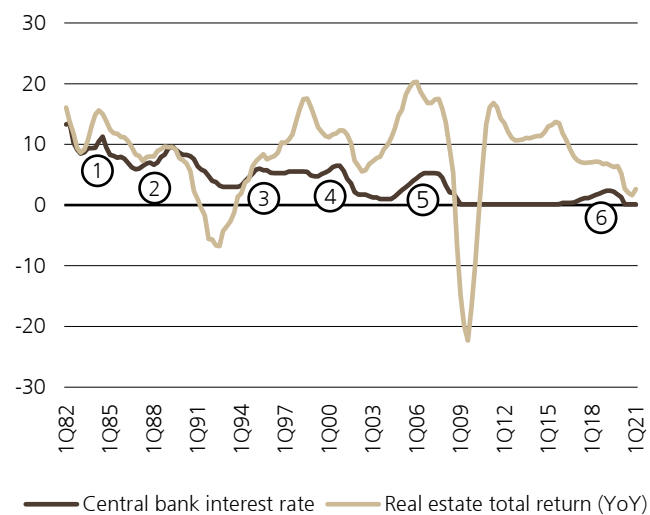
The impact of inflation on market rents, capital values and real estate investment performance is more complex. Ultimately, the impact depends upon what the inflation means for the broader macro economy and interest rates. Typically, we identify three variables as key in determining real estate performance. They are the level of development activity, what's happening in the broader economy and interest rates, with the latter two being particularly interlinked.

Excessive development can result in a glut of supply and put downward pressure on market rents. Economic growth normally coincides with rising occupier demand from businesses and pushes rents and capital values higher. Finally, across all asset classes falling interest rates push down discount rates which result in a given flow of expected income being valued more highly. Indeed, for real estate the adjustment to lower interest rates over the past decade has boosted returns via its impact on capital values.

Hence investors looking to protect against higher inflation must understand what impact inflation might have on the drivers of real estate performance. At the current juncture, central banks have said they will look through the temporary overshoot in inflation.

However, if there is a regime change and higher inflation turns out to be more permanent, it would likely jolt central banks into action, unwinding their QE programs and raising interest rates more aggressively than expected. Moreover, dealing with such a situation exposes the risk of policy error on the part of central banks.

Figure 3: US real estate total returns and interest rates (%)



Source: NCREIF; Oxford Economics, 1Q21. Past / expected performance is not a guarantee for future results.

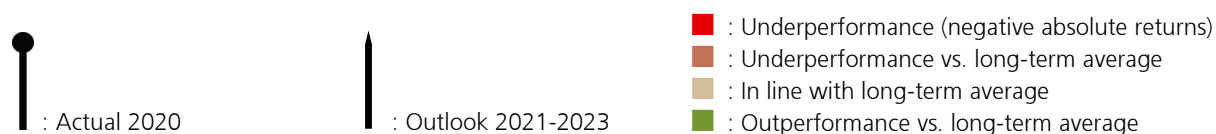
Historically, rising interest rate rises have not necessarily been bad for real estate returns. Indeed, in five out of six periods of interest rate rises in the US, real estate returns accelerated as interest rates were lifted (see Figure 3). On two of these occasions – the late 1980s and the GFC – real estate returns subsequently turned negative following the rate rises as the economy went into recession. Hence, if central banks are able to effectively manage a bout of higher inflation by cooling the economy without pushing it into recession, real estate performance is unlikely to see a significant hit.

The bigger risk for investors is that the economy overheats and central banks raise interest rates sharply to cool it, prompting a recession which then hits the wider economy and occupier demand. A diversified portfolio across countries should help protect against this risk since inflation dynamics vary by country. Investors should closely monitor how inflation evolves over the coming months and ensure that their portfolios are as resilient as possible to this emerging risk.

Real estate investment performance outlook

2020 actual and 2021-23 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 the 2020 actual or the 2021-23 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multifamily
North America	Canada	8.9		8.8		10.2		n/a	
	United States	7.5		8.9		10.0		7.9	
Europe	France	7.7		9.4		9.4		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		9.0		11.0		n/a	
	Japan	5.2		5.4		6.0		5.6	



Source: UBS Asset Management, Real Estate & Private Markets (REPM), May 2021. Note: Abbreviation LTA: long-term average. Past / expected performance is not a guarantee for future results.

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