Research Blast

Asia Pacific Real Estate, April 2019

As monetary policy in most of Asia Pacific remains or turns more accommodative, real estate pricing and volumes are expected to dance sideways this year. In late cycle markets, the ignis fatuus of continued capital growth may prove to be misguided.

The ignis fatuus of monetary easing in Asia Pacific

Asia Pacific (APAC) central banks have long been passive participants at the table. Taking the cue from the US Federal Reserve (Fed), most APAC central banks adopted a tightening stance around 2017. Save for Japan, it seemed not long ago that policy normalization was marching along to the beat of the US.

We saw the Bank of Korea raise policy rates for the first time in more than six years in November 2017, the Hong Kong Monetary Authority increased lending rates in March 2018, and the Monetary Authority of Singapore made adjustments to the exchange rate in April 2018, also the first time in six years.

Things have changed somewhat recently, not drastically but still rather abruptly. In January 2019, the Fed made an about-turn and indicated that it would pause interest rate hikes, on the back of softening global sentiments and fears of policy overshooting. Alongside growing concerns about domestic conditions, it is not unfathomable that Asia central banks will stay on the sidelines this year, at the very least. For economies such as South Korea, Australia, China, and most emerging markets, the odds of monetary loosening, instead, have in fact moved higher.

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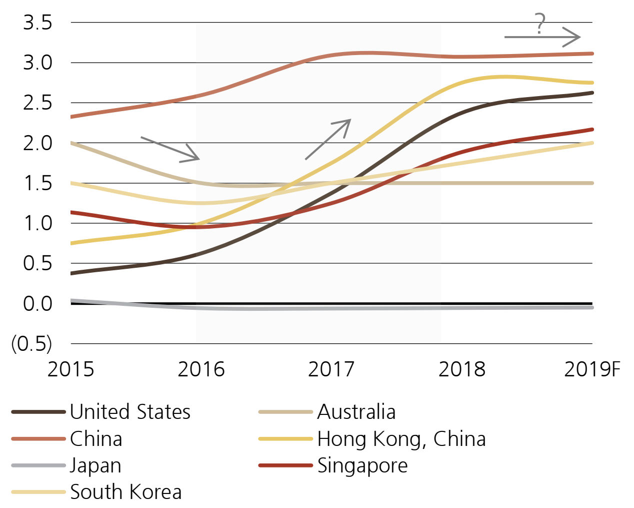
Looking at the more recent shifts in policy rates of major APAC economies (Figure 1), what is apparent is that policy rates generally moved in tandem with that of the US, commencing a general ascent in 2017. Japan has committed to an ultra-loose monetary policy divergent from the US, and that is probably the sole outlier, while Australia has strived to maintain status quo.

Figure 1: Policy rates of major economies (%)



Source: Oxford Economics, data as at 28 March 2019

Expect monetary conditions to remain accommodative
There is a world of difference between monetary tightening from a position of strength, and from a position of weakness. The US led global economic recovery for almost a decade, of which the positive knock-on effects on APAC economies were definitely felt, but were also still being fully realized. From a position of strength, the Fed embarked on its interest rate normalization cycle. Most APAC economies, to minimize currency and capital pressures, had to keep up with interest rate increases, but that cannot be said to be initiated from a comparable position of economic strength.

Fast forward to today, emerging economies in Asia, mostly with significant current account deficits, such as Indonesia and India, are more likely than not to wind back on the aggressive monetary tightening in the last two years. China has already committed to a more accommodative policy stance to support reforms and the economy, and this is now even more necessary with the uncertainties arising from the US-China trade dispute. Private sector debt in markets such as Hong Kong, South Korea and Australia are at their highest levels in recent history. Household leverage has burgeoned, and the ongoing slowdown in residential property prices after many years of boom does not work in favor of tighter monetary policies.

To that end, monetary conditions in most of Asia Pacific are likely to stay relatively loose for at least the next two years. In March 2019, Oxford Economics expects rate hikes in Asia to take a breather in 2019, interrupting the hawkish momentum that lasted less than 18 months. While partly directed by the Fed's policy reversal, limited growth prospects, subdued inflation expectations, and growing private sector leverage are also key considerations by APAC central banks.

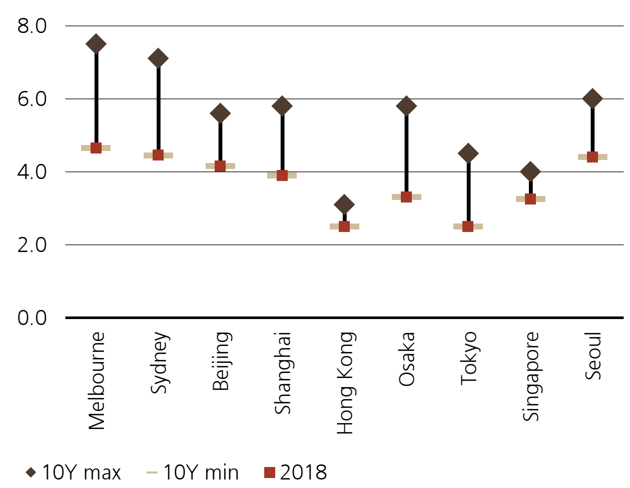
The impact on real estate
Some investors are already cheering the pullback in tightening momentum in Asia. The common view has always been that long term interest rates generally are positively correlated with property yields. This explains the dread in most commercial real estate investors when US Fed tightening picked up pace, as that also alluded to a possible reversal of yield compression. Clearly, we did not see that happening across the board. For sure, yield compression across some markets has slowed, but the turning point has certainly not arrived. As APAC reverts to an accommodative monetary stance, the same investors are probably hopeful that capital values continue to be protected.

We have been singing the yield decompression tune in APAC for the past few years. And each year as we look back at the investment market, that view was repeatedly proven wrong. The simple fact is interest rates are not the only drivers of property yield movements. In the case of APAC, the significant weight of capital largely distorted the dynamics between property yields and interest rates, and that has not been helped by the limited stock of investible property across Asia. According to Preqin, global private capital dry powder surpassed USD 2tn as at June 2018, of which close to 20% is focused on Asia Pacific.

Given that commercial real estate capital values continued to soar in spite of the rising rate expectations, it is definitely not inconceivable now to have capital values holding up should monetary conditions stay loose(r) in the near term. Should investors then be underwriting further yield compression?

Sanity check: Yields already at recent historical lows
Overall, yields across most APAC markets are at their lowest in the last 10 years (Figure 2).

Figure 2: Prime office yields (%)



Sources: PMA; UBS Asset Management, Real Estate & Private Markets (REPM), March 2019

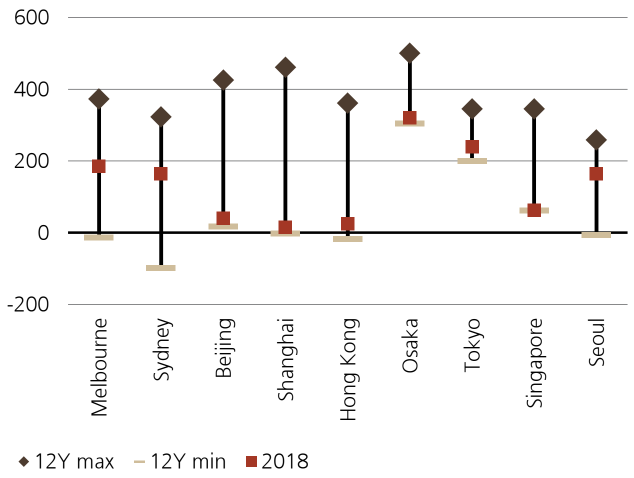
Obviously, that does not mean prime yields cannot tighten further, but it does imply we are almost reaching the floors of absolute yield levels. We remain skeptical as to how much further the lower boundaries of prime yields can be breached.

Sanity check again: Pricing risk is elevated

The yield spread between property and government bonds is a more appropriate gauge of real estate pricing. Figure 3 shows where yield spreads were at the end of 2018, relative to the maximum and minimum yield spreads over the last 12 years. This will have included the period before and when the global financial crisis (GFC) erupted. In terms of pricing, it can be argued that only Sydney, Melbourne and Seoul look reasonably priced relative to recent history. In many other markets, prime yield spreads have already narrowed to pre-GFC levels, and are definitely looking toppish. These markets which are more exposed to tightening monetary conditions and rising bond yields are also the ones that we expect to benefit the most from this respite.

Should the Reserve Bank of Australia start slashing interest rates this August, we can certainly expect to see a consequential shift in property yields. The solid outlook for rent growth in Sydney and Melbourne might just ring-fence the extent of compression, but we are betting our money on capital pressures driving yields down more than the change in bond yields. In Korea, the dovish monetary sentiments are a reflection of the softening economy but yield spreads are likely to keep investment interest steady. We should still expect capital values to trend upwards. Again, the generous yield spread means there might be a disproportionate reaction in property yields relative to bond yields.

Figure 3: Pricing – Prime office yield spreads (bps)



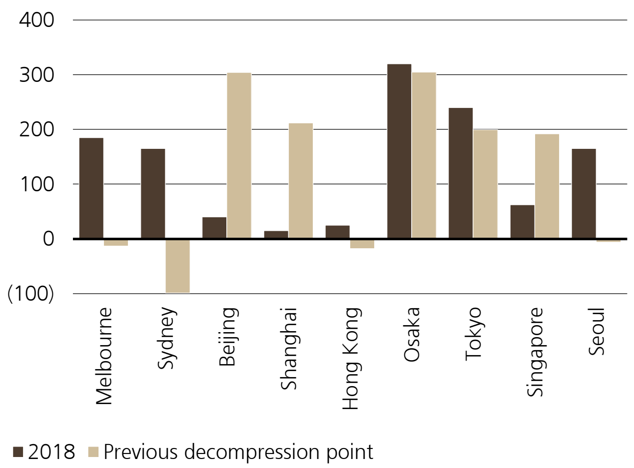
Sources: PMA; UBS Asset Management, Real Estate & Private Markets (REPM), March 2019

In markets where spreads are narrow and pricing is already walking on thin ice, such as in Singapore, Hong Kong and key cities in China, the pause in monetary tightening presents a much needed breather in terms of pricing risk.

With bond yields likely to stay relatively flat in the next two years, these markets will now have more time to adjust in terms of investor expectations and property yields. That may not be the silver bullet, but it probably helps to delay and smoothen the immediate risks of de-pricing in some markets. Transaction volumes are likely to stay flat in these markets as buyers and sellers work towards a middle point.

There is no scientific methodology and evidence to signal the turning point for property yields. As we examine the current yield gap levels versus the most recent yield decompression (in and around 2007 for most APAC markets), we can infer that some markets could be due for an adjustment already (Figure 4). In markets such as Beijing, Shanghai and Singapore, yield spreads are at levels below that of the last turning point for property yields. Even if monetary conditions become more conducive, the buffer in yield spreads is glaringly scant.

Figure 4: Yield spreads (2018 vs. last turning point)



Sources: PMA; UBS Asset Management, Real Estate & Private Markets (REPM), March 2019

Curb your enthusiasm

While looser monetary policies, prima facie, are probably good news to investors into APAC, there are a few points to note. Firstly, this is likely an interim scenario, and we may see monetary conditions normalizing in the longer term, especially if the US re-ignites its hawkish rhetoric. Secondly, property yields in most of APAC are already at historical lows, although we can argue that there is definitely some room to tighten further in absolute terms. Thirdly, pricing risk is much higher in some markets than others. In markets such as Sydney and Melbourne, we can expect continued support for capital values, especially with looser monetary conditions. In other markets, with yield spreads already treading dangerous grounds, the marginal benefit from an extended period of low interest rates is very limited. In these markets, investors should take this intermission and start to prepare for the eventual reversal of capital value appreciation, looking towards income growth to cushion against any possible hard landing.

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