Research Update

Global real estate through a Japanese lens

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Japanese interest rates on hold while they rise elsewhere means that hedging costs have risen for Japanese investors.

Going global in real estate continues to bring benefits in terms of reducing concentration risk and tactically benefiting from markets in different phases.

A large global real estate market offers Japanese investors opportunities which are not available at home, such as life sciences real estate.

Japanese investors still hungry for global real estate, but appetite might ease slightly

The Bank of Japan has bucked the trend of all the other major central banks around the world and kept interest rates on hold. Moreover, markets and economists generally expect Japanese rates to remain on hold. This means that Japanese investors can expect higher hedging costs on their investments into global real estate, making domestic real estate look more attractive. Although diminished, there are still compelling reasons for Japanese investors to go global with their real estate investments. Moreover, a disorderly unwind of the zero-interest rate policy poses a risk to the domestic market.

During the COVID-19 pandemic central banks around the world slashed interest rates to zero and below, and aggressively expanded their balance sheets to support their economies. For a brief period, they mirrored the policies which the Bank of Japan had been pursuing since 2001, when it first introduced QE to try to stimulate the economy and generate inflation. However, the global surge in inflation on exiting the pandemic prompted other central banks to tighten policy aggressively, leaving the Bank of Japan as the outlier again as it continued with its zero-interest rate policy and commitment to large scale asset purchases. The abrupt policy changes pushed the yen to a 32-year low against the US dollar.

Moreover, the Bank of Japan, supported by the Japanese government, has dispelled the notion that it will raise rates anytime soon and in general the market and economists have accepted this guidance so far. Indeed, the Bank of Japan and Japanese government have intervened in currency markets several times to try and prop up the yen. This has had some success and by mid-November the yen had pulled back from its October low of JPY 150 against the US dollar.

Towards the end of December though, to improve market function, the Bank of Japan raised its target trading range for 10-year government bond yields from +/-25bps around zero to +/-50bps around zero. This led to speculation that the change may be a precursor to the Bank of Japan ending its zero-interest rate policy. There is uncertainty over Bank of Japan policy, particularly given it is scheduled to get a new governor in April.

Rising global interest rates are having a significant impact on hedging costs for Japanese investors, who typically prefer to hedge currency exposure on global real estate investments to smooth out returns. The cost of hedging a global real estate portfolio, which is determined by interest rate differentials between Japan and other countries, has risen from effectively zero in mid-2021 to over 300bps by mid-November 2022 and, based on current forward rates, will average 400bps over the three years 2023-25.

For global real estate to deliver the same returns to Japanese investors as the domestic market, it must deliver returns that are, on average, 400bps p.a. higher. Although latest real estate forecasts do show the global market outperforming Japan over the next three years, the margin is by only 100bps p.a., which is not enough to offset the hedging drag.

Despite the increased hedging cost, going global in real estate investments can still bring significant benefits to Japanese investors and complement any existing domestic holdings they may have. For a start, private markets real estate offers investors much less volatility compared to J-REITs, which are heavily influenced by wider equity market trends. For example, the standard deviation of annual total returns in the J-REIT market was 25% p.a. over the 15 years to 2021, compared to just 6% p.a. for global unlisted real estate hedged to JPY and 4% p.a. for unlisted domestic real estate[1].

Going global can also be prudent for Japanese investors in terms of risk management. History shows that any market can be hit by an unexpected shock which predominantly affects it alone. For example, Brexit in the UK, "zero-covid" policy in China and any number of natural disasters which have befallen different countries over time. For Japanese investors, going global minimizes the risk of being disproportionately impacted, should an isolated shock occur in their market. And by their nature, such shocks are inherently unpredictable, low probability events, but often with an oversized impact. A disorderly unwinding of the Bank of Japan zero interest rate policy is currently a risk for the domestic market.

As well as reducing concentration risk, going global can also provide diversification benefits to Japanese investors. Global real estate markets move at different speeds and in different directions. For example, between 2004 and 2021 the average correlation of total returns between the Japanese real estate market and other key global real estate markets was 0.65, creating scope for significant diversification benefits from a global portfolio (see Figure 1).

Going global allows investors to take advantage of these differences in market cycles and tactically allocate capital to those markets which present the most attractive opportunities at any point in time. A global portfolio can be adjusted to tilt towards those markets and sectors which are expected to outperform and offer the best opportunities. Ultimately this should lead to higher returns for investors and an improved risk-return trade-off.

To appreciate the size of the global real estate investment market that is available to Japanese investors, it is worth considering that although Japan is the second largest real estate market in the world, worth USD 947 billion at the end of 2021 according to MSCI data, it still accounts for just 8% of the global market[2]. The largest market is the US, accounting for 36% of the global total. This large, global market can present niche and emerging investment opportunities to Japanese investors which are unavailable or inaccessible at home, or not at the same scale as in other global markets.

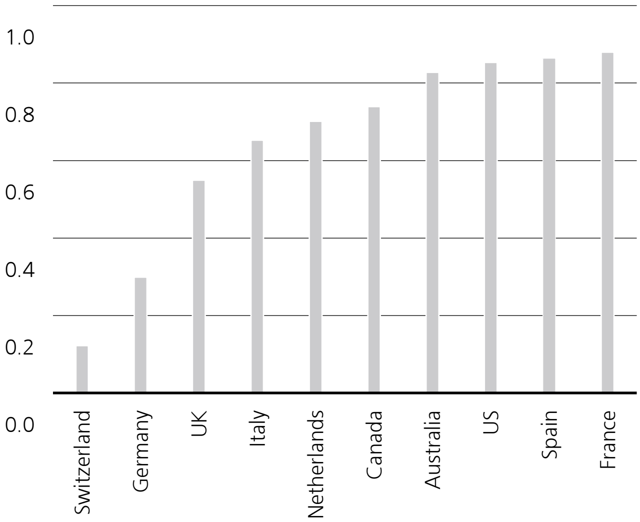
[1] Based on the TSE JREIT index and MSCI and NCREIF direct real estate market data, December 2021

[2] Including professionally managed listed and unlisted real estate.

Life sciences and lab space real estate is a good example of a niche and growing real estate sector, driven by growth in pharmaceuticals and medical research. It evolved in the US, where it is focused on Boston, San Diego and San Francisco, with local universities supplying talent to the sector. The UK is also seeing a growing institutional real estate market for lab space, again driven by leading universities which spawn start-ups and growth in the pharmaceuticals and medical research sector.

By contrast, in Japan, life sciences real estate does not exist in any significant scale and hence Japanese investors must go abroad if they want to access the sector. This is the case also for other sectors which will emerge outside of the domestic Japanese market.

Figure 1: Correlations of direct market real estate returns with Japanese market (selected markets, 2004-2021)



Sources: NCREIF; MSCI; UBS Asset Management, Real Estate & Private Markets (REPM), November 2022. Note: All-property country total returns de-smoothed by UBS. Past / expected performance is not a guarantee for future results.

Although Japanese interest rates are expected to remain on hold, those in other markets are expected to peak in 2023 before falling back as economies slow and inflation eases. By 2025 global interest rates are forecast to be trending towards long-term neutral levels which, on the basis of Oxford Economics forecasts, mean that hedging costs for Japanese investors should ease back below 200bps p.a..

Finally, for investors who expect Japanese interest rates to defy market expectations and rise, we recommend hedging currency exposure. This is because an unexpected rise in Japanese rates could prompt a strengthening of the yen, which would be a drag on returns in global markets as currencies lose value against the yen. Such a policy move could be driven by the current weak yen driving up import prices and causing domestic inflation to take hold and be higher than anticipated.

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