REO

Edition September 2022

Real Estate Outlook – Global

Adjusting to higher interest rates.

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"Global real estate performance was strong in the first half of the year, though investment activity eased from a record high in 2021. We expect some rises in yields in the second half as they adjust to higher interest rates and a weaker economic outlook."

Some capital value declines ahead

Concerns over the economy and outlook intensified in June as the Federal Reserve (the Fed) opted for its first 75bps rise in US interest rates in 28 years, following it with another 75bps rise in July. With inflation near double-digits in many countries, other central banks around the world also implemented super-sized rate hikes beyond the standard 25bps of recent times. The Bank of Canada even opted for a 100bps rise in July. The monetary authorities are scrambling to bring inflation back under control and more interest rate rises are expected, along with a reduction in central bank balance sheets.

The higher interest rates and rapid policy tightening are expected to take a toll on the economy, though how heavy it will be is uncertain. Our base case is that the advanced economies as a whole will experience a soft landing, with some faring better than others. However, a more protracted slowdown or recession remain distinctly possible. The US has already met an often used definition of recession since GDP fell in both of the first two quarters. However, the labor market has held up well, with the unemployment rate falling back to its pre-pandemic record low, which may prevent an official recession from being declared.

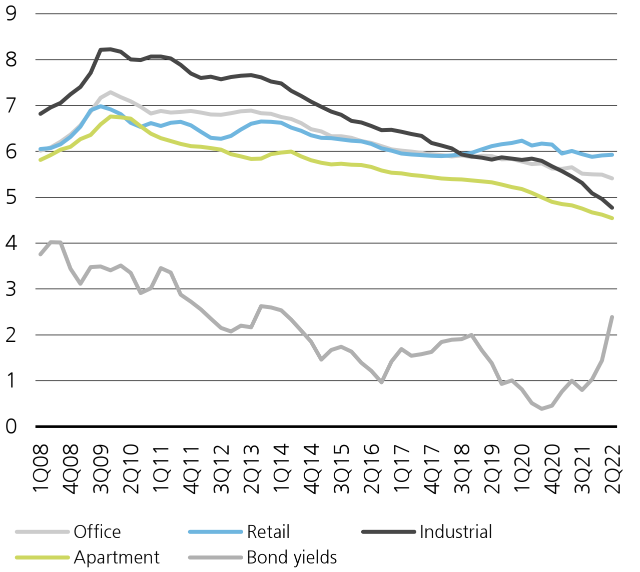
The deteriorating economic backdrop has created uncertainty in real estate markets. Global real estate investment volumes reached a record high at the end of 2021, focused on a recovery in the US market and driven by a surge in activity as the pandemic eased. However, though investment activity remained robust in the first half of 2022 it did slip back. After allowing for seasonal effects, global investment volumes fell 14% QoQ in 1Q22 in USD terms and a further 13% QoQ in 2Q22, according to data from MSCI. We expect uncertainty over the market outlook to continue to crimp activity in the second half of the year.

According to our analysis of over 300 markets globally, cap rates and yields increased in more markets than they fell in 2Q22, having trended lower since the start of 2021. The office and industrial sectors saw the most widespread rise in yields, up in 33% of markets covered for both sectors. By contrast, retail yields increased in just 10% of markets covered. At the global level, office and retail cap rates were broadly flat while industrial and apartment cap rates fell (see Figure 1). However, the sharp rise in government bond yields saw the spread with cap rates fall to 250bps by mid-year from 400bps at the end of 2021.

In the first half of the year, performance data remained strong. According to data from NCREIF, US total returns for all property were 9% over the first half of the year and, according to MSCI data, total returns were 8% in the UK, while in Canada and Ireland they were weaker at 3%. Though total returns did slow across markets in 2Q22 versus 1Q22. Industrial continued to outperform, with returns of 9-18% for 1H22, followed by retail with returns of 1-8%. Office was the weakest sector, with returns of 0-3% over the first half of the year. Listed real estate has pulled back sharply, mirroring the wider stock market and following large price gains in 2021. The FTSE EPRA NAREIT Global Developed price index fell 22% in 1H22 in USD terms, with the strong dollar accentuating the fall. In EUR terms the index fell 15%.

In the second half of the year, we expect a further correction in pricing across sectors to result in some capital value declines. However, following on from the strong first half this should still leave capital values up and total returns positive for the year as a whole. By the end of the year, we expect to get some clarity on the path of inflation and the economy. In 2023, central banks may look to reverse some of the interest rate rises they are implementing this year, which would be supportive for the market. However, a sharper economic downturn and recession which feeds through to the occupier market and rents remains a significant risk.

Figure 1: Global cap rates and 10-year government bond yields (%)



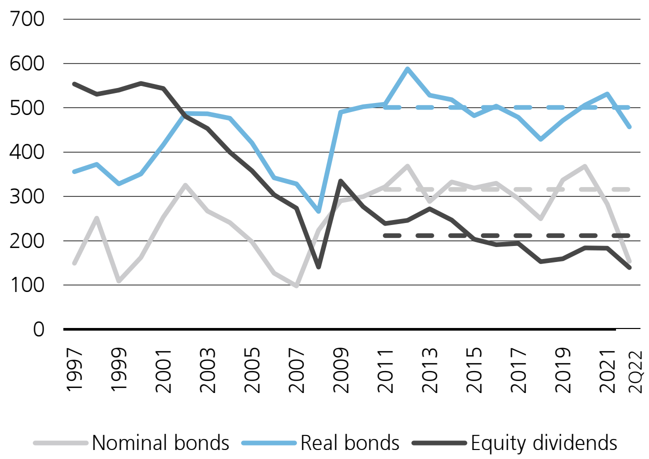
Source: Oxford Economics; MSCI, August 2022. Note: Cap rates refer to MSCI global all property and bond yields refer to the advanced economies.

Investment environment gets more challenging

The market backdrop has become more challenging for investors over the summer. Global interest rates have risen to levels not seen since the Global Financial Crisis (GFC), marking a significantly different environment for real estate investors. Cap rates and yields have already risen in some markets and we expect the pricing correction to broaden in the second half of the year. However, it is natural to see some upward pressure on yields given that spreads with bond and equity yields have been eroded. In some cases, debt costs are now above property yields, meaning that debt is no longer accretive to total returns.

In the wake of the GFC, central banks around the world cut interest rates to zero and below. However, real estate yields only followed them down with a lag, which resulted in some sizeable spreads and allowed leverage to give a significant boost to real estate returns. Central banks had just started to increase interest rates when COVID-19 struck. This saw them cut rates back to zero again (for those that had started to increase them) and aggressively expand their balance sheets to support the economy through the pandemic. Now, central banks are reversing this process, with interest rates rising back towards pre-GFC levels.

Figure 2: Global all property net operating income yield spreads (bps)



Source: MSCI; NCREIF; Oxford Economics; Thomson Refinitiv Datastream; UBS Asset Management, Real Estate & Private Markets (REPM), August 2022. Note: Global refers to 23 countries, dashed lines refer to average 2011-19. Past performance is not a guarantee for future results. Dashed lines refer to average 2011-19.

On the basis of estimated net operating income yields for 2Q22, the global all property spread with nominal bond yields was 150bps, close to the low of 100bps in 2007 immediately prior to the pre-GFC (see Figure 2). The spread with equity dividend yields also fell to 140bps in 2Q22. However, we would argue that real – index-linked – bond yields are the best comparator since real estate is a real asset and rents typically rise over the longer term to reflect inflation. The spread against real bond yields has also fallen, but remains close to the post-GFC average for 2011-19 and significantly above the low hit in 2008. For 2Q22, the spread was 460bps. Since inflation has risen more than nominal bond yields, real bond yields have risen by less than nominal bond yields and thus spreads against them have fallen by less. Utimately, we do expect the eroded spreads to be restored by some rises in real estate cap rates and yields.

In the current environment, we think that the best strategy for real estate investors is broad diversifation, both across countries and the different real estate sectors. In recent years, industrial and logistics property has shown a strong outperformance. Rapid growth in online retail has fueled demand for warehouse space and pushed rents and returns sharply higher. This rewarded those who overweighted the sector and boosted their portfolio returns. Going forward, we continue to expect industrial and logistics to outperform, but think it will do so by a smaller margin. Hence, we favor a marginal overweight to the sector.

The correction in pricing we expect over the coming months, will likely provide opportunities for investors as well. For example, access to assets at attractive pricing points. Although we do not expect large numbers of forced sellers and stress in the market, there will likely be some pockets of it and owners who are unable to refinance debt for example. Or those who choose to sell assets for other reasons. Some of these sellers may be willing to accept below market prices to facilitate a sale. Hence, for investors wanting to deploy capital now, holding off for a few months as pricing adjusts is probably the best strategy.

A focus on the security of income is very important for investors at the moment, as they try to maintain their returns. Hence, it is important to understand how much inflation protection portfolios contain. Short leases which allow for rents to be re-geared in line with higher inflation is one area, while within-lease rents being linked to some measure of inflation is another way of protecting income. The most exposed properties will be those with short leases where weakness in the occupier market means that rents cannot be increased when renewing the lease, and may even fall. Those on long leases, which do not have any mechanism to increase rents prior to the expiry of the lease, will also likely be less resilient.

Real estate investment performance outlook

2021 actual and 2022-24 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 2002-21. The red underperformance quadrant refers to negative absolute total returns, either in 2021 actual or the 2022-24 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Residential
North America	Canada	8.6		8.4		11.2		9.2	
	US	7.5		8.7		11.4		8.5	
Europe	France	7.6		9.0		9.9		7.8	
	Germany	5.0		5.2		8.5		7.4	
	Switzerland	5.7		6.1		6.6		6.4	
	UK	6.9		4.9		10.7		9.1	
Asia Pacific	Australia	9.9		8.8		11.9		n/a	
	Japan	5.2		5.3		6.1		5.7	

: Actual 2021

: Outlook 2022-24

: Underperformance (negative absolute returns)
: Underperformance vs. long-term average
: In line with long-term average
: Outperformance vs. long-term average

Source: Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), August 2022. Note: Abbreviation LTA: long-term average. Expected / past performance is not a guarantee for future results.

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