March 2016

Asia Pacific Quarterly Outlook.

1Q16

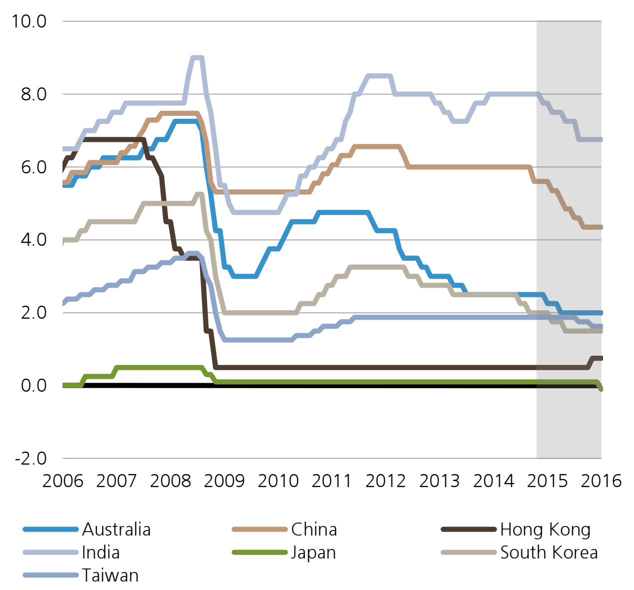
Asia Pacific real estate

Near-term macro conditions are set to remain challenging in the Asia Pacific (APAC) region relative to historical growth rates. Headline GDP growth is expected to average 4.2% per annum (p.a.) this year compared to 5.0% p.a. achieved over the past decade. The hit to global trade and accompanying pullback in manufacturing output are constraining economic growth in the region. Macro uncertainty, financial market volatility and limited credit availability mean that the corporate sector has been reluctant to commit to large spending projects, thereby constraining private capital expenditure.

Despite subdued growth conditions, household spending and the broader services sector have been resilient, supported by healthy jobs growth and monetary easing measures from central banks (Chart 1). The reflation of asset prices has helped consumer spending via the wealth channel, especially in those markets that have seen a sharp run-up in house prices over recent years. Lower oil prices have also supported the purchasing power of households and offset some of the hit to headline corporate revenues from slower regional GDP growth, particularly in the industrial sector where energy costs represent a large percentage of total operating expenses.

Chart 1: Policy rates

(% p.a.)



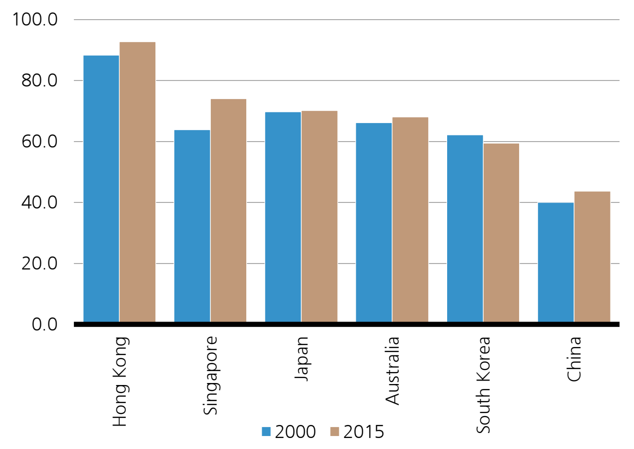
Source: Datastream, as at January 2016
NB: The Major Loan Rate for General Circulating Funds – 1 Year is used to proxy as China's policy ratesrce: Oxford economics, February 2016

Importantly, in Developed Markets (DMs) the services sector represents a large share of output ranging from 70-80% (or even larger for small and open markets such as Hong Kong) compared to 15-20% for industrial production (Chart 2).

Higher exposure to services has underpinned the recovery of DMs in recent years. In Emerging Markets (EMs), such as China, the services sector represents a relatively low but growing share of output and employment. China's services output represents 50% of the economy in current prices and just under 45% in real terms, after accounting for falling prices in the industrial sector, where deflationary pressures have been the norm in recent years owing to overcapacity issues and declining energy prices. Policymakers in EMs have been attempting to orchestrate a gradual shift towards sustainable growth models where the key drivers are focused on household spending and services sector employment rather than credit, investment and/or commodities. Investment and credit can only support growth for so long in an environment of deficient demand from end consumers (either domestic or external). As such, the share of services sector output in EMs should continue to move towards DM levels over time.

Chart 2: Services sector exposure

(gross value added in services, real, share of GDP)



Source: Oxford Economics, as at 15 January 2016

Across the APAC region, activity in financial and business services, professional services, tourism and education sectors continues to be supported by low interest rates and weaker currencies. Alongside the technology sector – which is benefitting from increasing demand from corporates and end users – these industries have been key drivers of leasing markets and are supporting office sector fundamentals in key APAC cities (Chart 3 and 4). The obvious exceptions to this include markets that are exposed to weak demand and/or elevated levels of supply which includes:

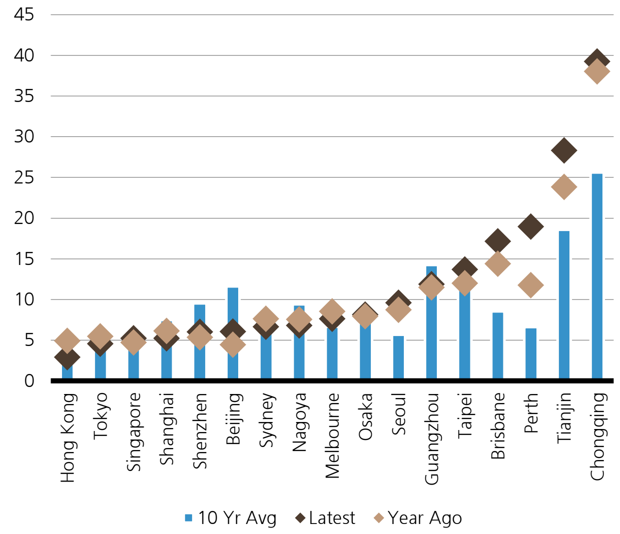
– Markets that are heavily exposed to the downturn in commodity prices and mining investment such as Brisbane and Perth;
– China's lower-tier cities, which continue to be hampered by supply issues and decentralization trends as occupiers move

to good quality buildings in submarkets with cheaper rents and access to public transport; and

– Singapore, which is undergoing a cyclical downturn on the back of a short-term supply spike and sluggish demand, particularly from corporates exposed to increasing regulatory pressures in the financial sector, market volatility and slower regional growth. Over the medium term we are optimistic on Singapore's prospects in the commercial real estate space.

Chart 3: Office vacancy rates in key cities

(% of existing stock)

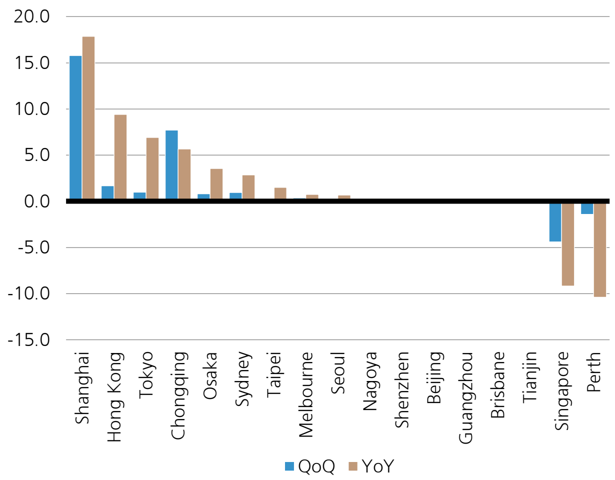


Source: CBRE Erix 4Q15, PMA, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

Segments within retail and industrial sectors that have been able to adopt to the new consumer environment should continue to benefit from the growing demand for faster delivery of goods and increasing share of income that households spend on services. Growth of e-commerce and third-party logistics (3PL) which are related to these shifting preferences should also support ongoing demand for modern logistics facilities.

Chart 4: Office rental growth

(% change)



Source: CBRE Erix 4Q15, PMA, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

Looking ahead, central banks in the region are likely to continue cutting interest rates in the near term to offset weakness in exports and capital spending. In Japan, the adoption of negative interest setting signals a shift in policy for the Bank of Japan (BoJ). Up to this point, the BoJ's monetary easing has focused on the quantity of its asset purchases (quantitative easing), as opposed the level of interest rates.

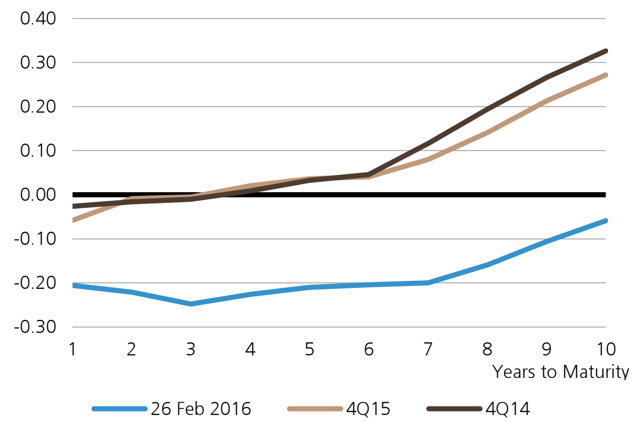
Although the BoJ will continue to engage in quantitative easing in 2016 (to the tune of JPY 80 trillion worth of asset purchases each month) the purpose of this policy shift is two fold. Firstly, to lower the returns for the banking sector's excess reserves held at the BoJ. This may incentivize financial institutions and banks to lend more to corporates and households rather than hoarding cash. Alternatively, financial institutions could seek higher returns by investing in longer duration government bonds, risk assets (such as equities, credit and real estate) and (eventually) overseas markets. The latter isn't guaranteed given domestic investors have been in a position to access higher yielding overseas markets for an extended period now. The accompanying increase in asset pricing and/or credit growth may help to boost domestic activity at the margin via a wealth channel or higher consumption and investment given the increased liquidity available to households and corporates.

Secondly, in so far as the adoption of negative interest rate policy reflects the BoJ's commitment to achieve its inflationary target of 2% (headline and core inflation excluding fresh food were both close to zero percent in January 2016), it may help to raise household and corporate inflationary expectations, which would have knock on impacts to wages and consumer spending. In turn, this may help to stimulate the economy as household and corporates bring forward their spending plans ahead of any expected price rises.

In fact, the BoJ's actions have already impacted domestic asset pricing with government bond maturities of up to 10 years now trading with negative yields (Chart 5). Moreover, longer-dated JGBs (Japanese Government Bonds) have seen a sharper downward movement in yields which has flattened the yield curve, as domestic and foreign investors searching for income returns are forced to take on more risk by moving into the longer duration space.

Chart 5: Downward shift in Japanese Government Bond yields

(% p.a.)



Source: Datastream, UBS Asset Management, Global Real Estate Research & Strategy, as at February 26, 2016

The BoJ's move has broader implications for central bank policy across the rest of the APAC region. With recent strength of the Japanese Yen (JPY) likely to be slowed (or reversed) by the negative interest rate setting, the upshot is that of the BoJ's actions will force the hand of other APAC central banks. In particular, economies that directly compete with Japanese exports, such as South Korea, Taiwan and (increasingly) China as it moves into the higher value-add manufacturing space will be forced to cut interest rates and engage in other easing measures to remain competitive. Monetary easing should help to mitigate the negative impact of tightening US interest rates on local financial and borrowing conditions.

For the time being, activity and jobs growth in the services sector should support further improvements of fundamentals in CBD office markets and the prime retail and logistics segments, particularly in markets where there is a shortage of good quality space and the supply pipeline is tempered by limited availability of development finance. Of course, there is the risk that the slowdown in the manufacturing sector eventually hits hiring intentions and activity levels in the services sector. This would be the case if the slowdown in industrial production translates into a sudden spike in unemployment and deterioration of consumer and business confidence in the broader economy. However, under such a scenario, we would expect even more policy action from central banks and even the return of stimulative fiscal measures from governments should they be warranted.

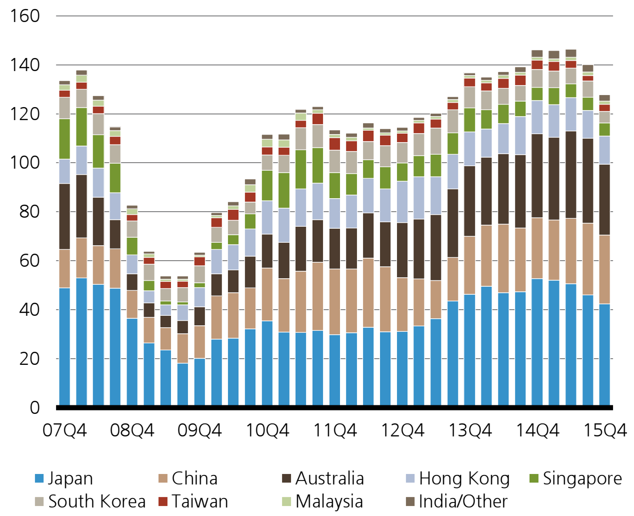
Real estate capital markets

APAC commercial real estate liquidity (excluding land sales) remained relatively healthy in 4Q15 with volumes higher over the quarter although there was a pullback over the year relative to 4Q14 levels. Overall, transactional volumes over the course of 2015 were down 12% on 2014 reflecting the impact of elevated financial market volatility, regional growth concerns and tighter financing conditions for risk assets, including commercial real estate. Japan and Australia were two key exceptions where commercial real estate lending conditions loosened in 2015 with domestic lenders keen to increase their exposure to the sector on account of the improving fundamentals and collateral quality. To some extent, the transactional figures in 2015 were distorted by weaker currencies, with the strengthening of the USD underplaying actual volumes in local currency terms. The largest declines against the USD have been seen in Australia (-10.9%), Korea (-7.0%), India (-4.8%) and China (-4.4%) over the course of 2015.

In terms of geography, investor activity remains focused on the three key markets of Australia, Japan and China (Chart 6). Together these markets represent close to 80% of transactions in the region. The CBD office sector continues to be the preferred strategy for new capital, representing around 50% of transactions over the past 12 months, followed by retail (26.3%) and logistics (9.3%) sectors. The hotel and multi-family apartments sectors make up the residual components.

Chart 6: APAC real estate transactions

(USD bn, 12-month rolling sum)

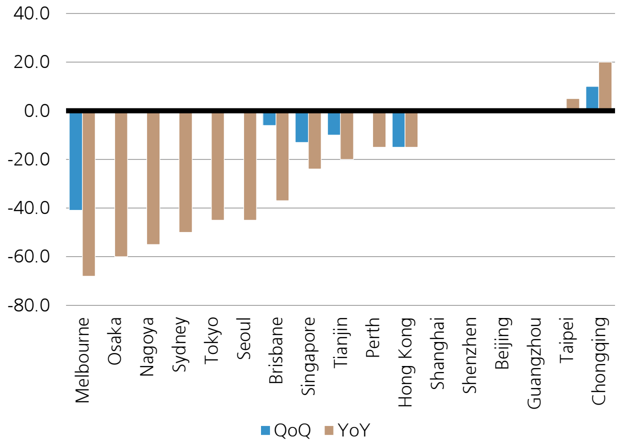


Source: RCA, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

In an environment of lower interest rates and increased volatility in other asset classes such as equities, commodities and credit, commercial real estate yields have compressed further in most markets across the region (Chart 7). Although the rate of yield compression has slowed we expect that as regional central banks ease further this year in the wake of the BoJ's actions, core property yields are likely to continue grinding lower in 2016. Alongside gradually improving fundamentals, further yield compression should support higher valuations and pricing this year. However, given prime yields are close to or already at historical lows in most markets there is clearly a limit to the extent to which further yield compression can support capital values (Chart 8). As such, we would warn against investors underwriting too much yield compression in the near term.

Chart 7: Prime CBD office yield movements for 4Q15

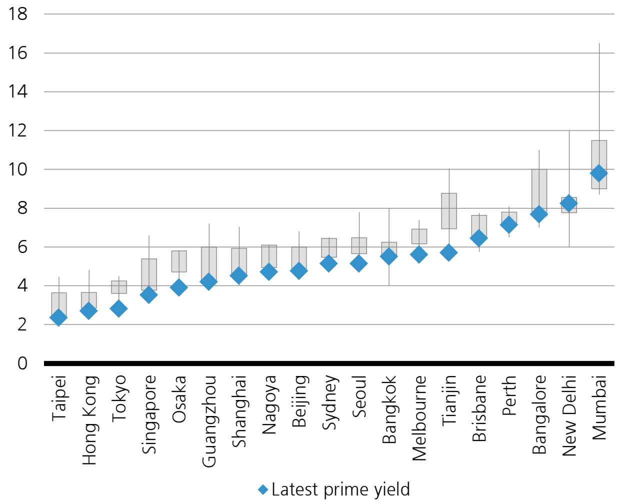
(basis points, quarter on quarter and year on year)



Source: CBRE Erix 4Q15, PMA, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

Chart 8: Distribution of prime CBD office yields over the last 10 years

(maximum, interquartile range, minimum and latest, % p.a.)



Source: CBRE Erix 4Q15, PMA, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

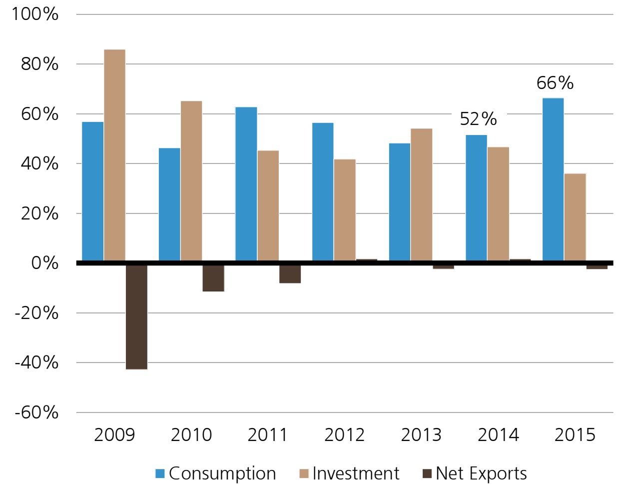
China

The rebalancing of China's economy continues to gather momentum, with around two-thirds of economic growth coming from household spending in 2015, up from just over 50% in the previous year (Chart 9). This is, to some extent, a mirror image of waning investment and decline in net exports, as China's overall GDP growth slowed from 7.3% (revised) in 2014 to 6.9% in 2015, the lowest figure recorded in the last 25 years.

To be sure, consumption is unlikely to become the immediate lynchpin of China's economy, and bring it back to the era of double-digit growth that investors have been accustomed to in the last decade. Ideally, the new normal will be reflected in slower growth, albeit on a greater base, but driven primarily by consumption and the services sector. The role of investments should remain significant as key reforms such as urbanization still call for substantial resources to be put to productive investment activities.

Chart 9: Contribution to China's GDP growth

(share of GDP, % p.a.)



Source: CEIC, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

Household disposable income growth has been robust in 2015, growing by 8.9% year on year (YOY). On the back of solid job creation (13 million new urban jobs were filled in 2015) despite the weakening broader economy, retail sales grew at 10.7% on an annual basis, notably outpacing that of GDP growth. The leaning of the economy towards the labor intensive services sector appears to be supporting consumption through wage growth and employment, although some frictional displacement arising from the mismatch of skillsets is inadvertent going forward. This implies that the immediate beneficiaries of this shift towards a services-led economy will be the Tier-1[1] and gateway cities in China, where skilled labor is in relative abundance. In these markets, we expect to see the office and retail sector outperforming other Chinese markets in the next few years.

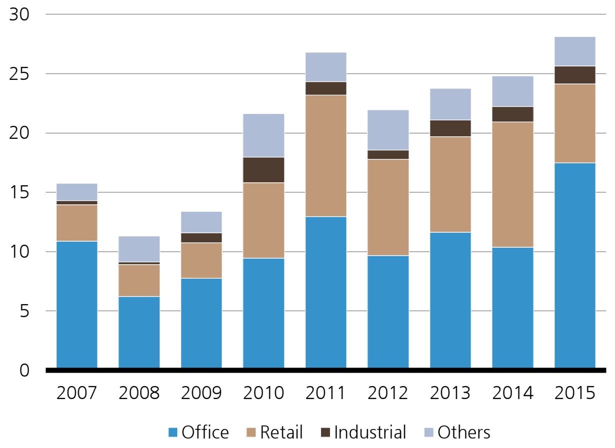
On the policy front, China has clearly moving to a more accommodative monetary stance. To date, there have been five policy rate cuts, the most recent being in October 2015. The required reserve ratio has been gradually reduced (more than two percentage points in 2015, to 17%) by the People's Bank of China (PBoC) to ensure that sufficient credit continues to feed into the real economy, albeit in a managed manner. The likelihood of further rate cuts is highly likely in the next 12 months which should be complemented by supply side fiscal support.

Many investors questioned the motivation for the recent RMB devaluation, after the PBoC weakened the daily fixing rate by 1.9% in August 2015, the biggest single day move since 2005. On January 7, 2016, China again lowered its daily fixing rate by 0.5%, sparking concerns that this was the beginning of a one-way weakening path. These events have contributed to the volatility of financial markets in recent months, further entrenching the view from certain investors that China's economy was slowing more rapidly than the official numbers suggest. We expect the RMB to maintain a steady path of modest depreciation against the USD in 2016, on the back of weak sentiment and ongoing capital outflows. Over the month of December 2015, foreign reserves fell by approximately USD 108 billion, and hit a three-year low of USD 3.3 trillion at year end, as China defended the RMB against pent up pressure of capital flight. Expectations of further RMB weakening is likely to further define the dichotomy in real estate pricing between domestic investors and foreign institutional capital.

Based on RCA data, total transacted value (excluding land sales) in real estate amounted to USD 28.1 billion in 2015, up by 13.4% from the previous year (Chart 10). Falling onshore interest rates continue to spur demand for real estate exposure by domestic capital, in particular property funds and insurance companies, putting a squeeze on yields. However, foreign capital remains cautious due to the uncertainties in the currency and economic outlook, and there is a general lack of confidence in the policy environment, resulting in a pursuit of higher risk premiums. To that end, retail and industrial property yields grinded sideways in 2015, while office sector yields compressed only slightly despite representing 62% of total transaction value and registering a 68% jump in transaction value YOY. Investment interest focused on office properties is likely continue into 2016, as operator experience starts to feature more heavily in extracting returns from retail and logistics assets.

[1] Tier-1 cities refer to Beijing, Guangzhou, Shanghai and Shenzhen

Chart 10: China real estate investment volumes
(USD bn)



Source: For transactions above USD 10 million, and excludes land transactions
Source: RCA, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

A clear divergence in performance among Chinese office markets is underway. Beijing and Shanghai continue to attract significant leasing interest from the financial and technology sectors, particularly domestic companies. Despite the growth of emerging office submarkets, core office rents in Beijing and Shanghai (eg. Financial Street in Beijing, and Little Lujiazui in Shanghai) are likely to hold steady in 4Q15, with average vacancy rates below 6%. Shenzhen's office sector benefited from favorable Chinese policies such as the Closer Economic Partnership Arrangement (CEPA) Service Trade Agreement between Mainland China and Hong Kong, and the office vacancy rate tightened to below 6% in 2015, although a looming supply influx in on the horizon for 2016. At the other end of the spectrum, lower-tier cities, in general, reported vacancy rates in excess of 18%. These include cities such as Chengdu (37.7%), Chongqing (39.2%), Tianjin (28.3%), Wuhan (24%) and Hangzhou (18.2%). The dire situation of oversupply will further exacerbate the softness in occupancy and rents in 2016.

The upgrading of consumer markets across China is almost a certainty, as middle class aspirations and higher wages provide a long-term impetus for retail spending growth. However, the short-term fundamentals of the retail sector point to an interim period of adjustment as the outlook for retail rents and performance remains uncertain. The wave of retail supply is running ahead of leasing demand in most new districts of Chinese cities; major international retailer are increasingly looking to just Beijing and Shanghai as gateways for expansion. The retail vacancy rate in Beijing tightened to 4.8% in 4Q15 on the back of limited supply, down from 7% in 4Q14. Correspondingly, prime rents moved up by 10.8% YOY. We expect retail performance in Beijing and Shanghai to remain flat in 2016, with a narrow probability of gains in rental growth and occupancy. In lower tier cities, rental growth moved sideways in 2015, even as vacancy rates displayed clear signs of leasing stress. This is likely due to most landlords offering rental incentives and sacrificing returns to maintain headline rents, especially in the face of retail supply intensifying the competition for tenants.

The logistics sector is emerging as an alternative proxy for the consumption theme in China. Despite policy encouragement by the government to develop the logistics backbone of China, there is limited availability of industrial land supply in primary logistics hubs such as Beijing, Shanghai, Guangzhou and Tianjin. Tier-1 cities, where e-commerce penetration is deeper, led rental growth (1.5% in Beijing to 7.8% in Shenzhen) in 2015, and the trend is likely to persist into 2016. In other cities where supply of industrial spaces is more abundant, asset quality and location selection will be key to driving investment performance. Across China, building to match demand in locations near to ports and transport links will likely offer better total returns in the next few years.

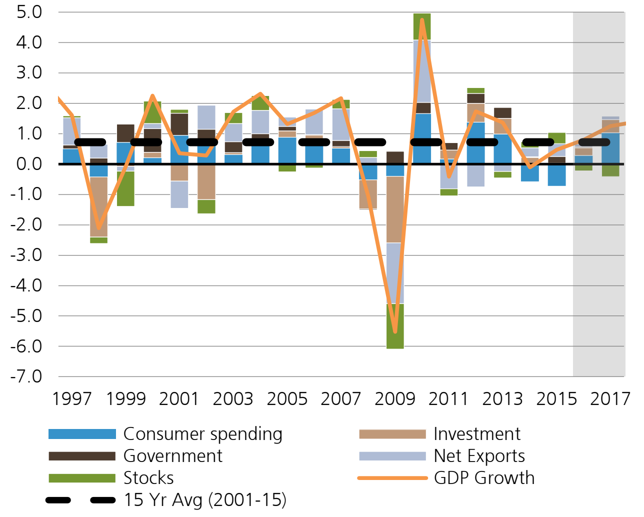
Japan

Notwithstanding the distortions to economic activity triggered as a result of the consumption tax rise in April 2014, Japan's post-financial crisis economic recovery remains broadly on track with growth set to be around 0.75% in 2016 which is in line with the historical growth achieved over the past 15 years (Chart 11). Household spending is likely to be the main driver of growth on the back of ongoing wage rises, relatively healthy jobs growth (albeit at a slower pace going forward) and lower oil prices which are boosting the purchasing power of households (Chart 10). If the government's planned consumption tax rise does go ahead in April 2017 some household spending is likely to be brought forward into 4Q16 and 1Q17 although this will be largely reversed thereafter. Unsurprisingly, given current global growth headwinds, there is growing pressure to delay the tax hike until the macro environment is in a stronger position to offset the negative impact of tighter fiscal policy. Any delay in the tax rise would eliminate the pre-emptive rush to spend and near term distortions in consumer spending.

At the margin, the negative interest rate environment, healthy cash balances and earnings of large corporates support a gradual pickup in capital expenditure although this isn't guaranteed if the Japanese Yen strengthens sharply during a sustained period of heightened risk aversion. Moreover, the focus of any capital spending and investment will largely be as a result of new product development, R&D and efficiency saving measures rather than the traditional drivers of increasing capacity, market share and headline revenues. There is some upside for capital spending in the services sector over the medium term as result of structural shifts from the aging population and accompanying labor shortages, adoption of technology and inbound consumption related to rising tourist numbers, and the Olympic Games.

Chart 11: Percentage contributions to Japan's GDP growth

(% p.a., forecasts for 2016 onwards)



Source: Oxford Economics, UBS Asset Management, Global Real Estate Research & Strategy, as at February 23, 2016

Fundamentals continue to improve in Japan's key office markets on the back of limited new supply and steady demand particularly from large corporates that have benefited as a result of the BoJ's asset purchases, lower borrowing costs and weaker currency which have helped to boost earnings and profitability levels. In contrast, small to medium sized enterprises (SMEs) that are exposed to domestic demand conditions have not seen the pickup in earnings as large corporates.

In Tokyo, the lack of near-term supply and demolition of existing stock for new development purposes should help push the CBD vacancy rate lower in 2016 and 2017. In turn, tighter vacancy rates should underpin higher rents in the near to medium term, albeit the pace of growth is likely to be slower than the last couple of years. Prime and better quality office buildings in core locations close to main rail or metro line stations should continue to outperform in the near term given the preference of employees to be close to public transport. Over the medium to longer term affordability constraints and rising levels of supply from 2018 onwards as current developments are delivered to the market should temper rental growth.

Osaka's prime office fundamentals will continue to be aided by a lack of new developments which should support further improvements in occupancy levels and effective rents. Overall, the CBD office vacancy rate has fallen to 7.5% in 4Q15 from 7.9% in 4Q14 according to data from PMA. However, the recovery is likely to remain focused at the upper end of the market, and in particular around Umeda which is regarded as the prime sub-market of the city. Overall, with a large proportion of leasing demand focused on occupiers relocating towards the Umeda sub-market and the city suffering from structural weakness over the longer term and exposure to a few major employers, the Grade A segment is likely to continuing outperforming.

In the logistics sector, leasing demand remains healthy with net absorption at 75,000 tsubo[2] in 4Q15 more than 50% above the five-year average for the Greater Tokyo area. However, around 150,000 tsubo of new space was added to the market in 4Q15 which pushed the overall vacancy rate to 6.9% compared to an average of 4.6% over the past five years. The majority of this stock was delivered in the outer areas of Route 16 and Ken-O-do Area. Reflecting the ongoing strength of the market though, occupancy levels for existing facilities remain tight with the vacancy rate for assets that are more than one year old falling to 1.2% in 4Q15. Looking ahead, although the leasing market is likely to remain robust on the back of increasing demand for same day deliveries from end users and growth of online shopping, new developments are likely to constrain overall rent growth.

Australia

Australia's growth model continues to shift away from the mining sector and resource-rich states, albeit at a gradual pace, supported by low interest rates, a weaker currency and national house price inflation. The mining sector represents around 9% of Gross Value Added (GDP adjusted for taxes and subsides) and 2% of employment. The sharp reversal of commodity pricing is clearly hitting nominal GDP growth via lower terms of trade (ratio of price of exports to the price of imports) and weaker corporate profitability and wage growth although the real economy continues to be supported by services sector activity and export volumes.

Consumer spending has shown some resilience in recent quarters, supported by durable goods spending related to the strong housing market and the wealth effect from improved household balance sheets. Residential construction will also contribute to growth again this year, although activity is close to peaking during this cycle given investor activity and pricing appear to be cooling. Any pullback in capital from China would also hamper transactions and pricing in the residential market. Overall, we continue to expect the consumer, housing and exports sectors to offset near term headwinds from falling commodity prices, capital spending cuts and restrictive fiscal stance.

[2] One tsubo is equivalent to approximately 3.305 square meters

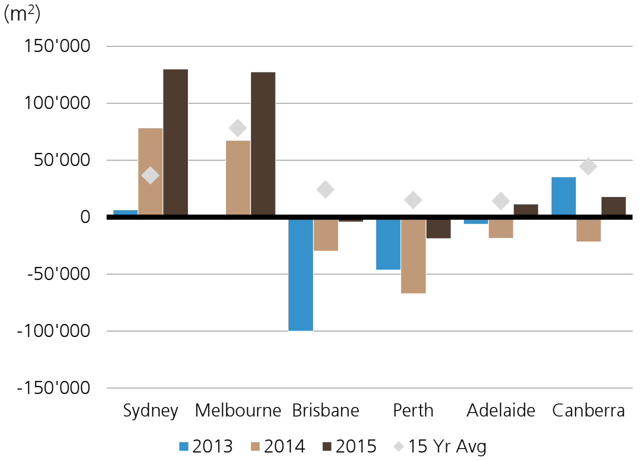
With activity levels lifting and growth shifting towards services sector employment and output, the key challenge for the domestic central bank is to ensure inflation moves from the lower end of its target band of 2-3% without stoking further sharp rises in house prices (relative to subdued income and wage growth). However, with monetary stimulus already having provided significant support for asset prices (particularly housing), and interest rates at record lows, further cuts in policy rates could threaten the stability of the financial system. As such, in the absence of a marked slowdown in China or a sharp reversal of house prices which triggers a sudden deterioration in business and consumer confidence, the RBA is likely to keep interest rates unchanged in the near term before beginning to tighten towards the end of 2017.

The recovery of Australia's leasing market is gradually taking place with the Sydney and Melbourne markets the main beneficiaries of shifting macro and sectoral drivers. For CBD offices, Sydney and Melbourne represent around 60% of the Australian market by space and 70% by value. Net absorption, which measures the change in occupied stock from one period to the next by adjusting for the existing space that becomes vacant when occupiers relocate, exceeded the long-term average for Sydney and Melbourne in 2015. The key sectors that are driving demand for office space in these markets include finance and insurance, professional services and the TMT sectors.

In terms of office fundamentals, alongside the uptick in services sector jobs, CBD leasing activity has been supported by an increasing number of corporates requiring office space near good public transport links and food and beverage offerings. The gradual erosion of the rental premium between CBD and suburban offices in recent years has also supported this centralization theme (although this is likely to be reversed going forward).

On the back of improving demand and limited new supply (adjusted for space that has been withdrawn for change of use including residential stock and mixed use schemes) vacancy rates in 4Q15 have fallen to 6.6% in Sydney and 7.6% in Melbourne, from 7.4% and 9.1% in 4Q14, respectively. Vacancy rates are expected to continue to remain low and stable over the medium term which should help to support above inflation rental growth, particularly if incentives tighten from current levels. Over the longer term, rental growth is likely to be limited by affordability constraints in Sydney and low-cost alternative submarkets in Melbourne.

Chart 12: Net absorption



Source: CBRE Erix 4Q15, PMA, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

Net absorption levels in the resource-rich states of Queensland and Western Australia continue to lag but even here demand stabilizing in Brisbane and becoming less negative in Perth (Chart 12). In Brisbane, stabilizing demand from the state government and rising demand from the education and tourism sectors are offsetting the contraction from the mining sector and related services. Although net absorption is becoming less negative we believe it will be a couple of years before Perth's fundamentals stabilize. Elevated levels of near-term supply will continue to pressurize vacancy levels this year. Vacancies are expected to remain high in Perth and improve in Brisbane (albeit from elevated levels) over the medium term. Rents are expected to rise from floor in Brisbane and Perth although substantial over-renting remains.

In the retail sector, the housing market has been a key driver of recent sales and performance, particularly in CBD markets and dominant shopping centers segments which are seeing healthy leasing activity and rent growth. Robust leasing demand from international retailers looking to gain exposure to the Australian market is also supporting higher rents and improving vacancies, particularly in prime pitches. In contrast, secondary retail is expected to continue to underperform in an environment of subdued wage growth and increasing penetration from the online sector, albeit at a slowing pace. Overall, as households allocate an increasing share of their incomes to services such as healthcare and education which continue to see higher levels of price inflation, we expect near-term rental growth to remain below historical averages.

Despite the subdued rental growth environment driven by elevated levels of supply and subdued occupier conditions – particularly from the manufacturing sector – investment demand for industrial assets remains strong. Foreign capital continues to be attracted to the attractive yields available relative to other asset classes and compared to other APAC markets. Looking ahead, the weaker currency is expected to provide some support for manufacturing although headwinds to global trade will continue to constrain any recovery in this sector. Ongoing growth of the transport and logistics operators and accompanying increase in warehousing space will remain the key drivers of the industrial sector.

South Korea
Weak export performance continues to weigh on Korea’s manufacturing sector and broader macro outlook. Capital expenditure has been sluggish on account of weak external demand conditions, both from regional APAC importers and further afield. Importantly, however, domestic demand remains in a better position supported by household spending, rising consumer credit and a rebound in services sector activity. Fiscal stimulus has also supported demand, and is likely to continue doing so with budget spending expected to be front-loaded, accompanied by plans for higher capex from state-owned enterprises. But fiscal measures will not be enough to pull growth back towards long term averages.

Looser monetary conditions should also help support growth in the near term as the Bank of Korea (BoK) attempts to tackle deflationary pressures, weaken the Korean Won further – particularly on account of the BoJ's recent actions – and help to offset the negative impact of tighter US rates on domestic borrowing costs. However, there are limits to further monetary easing with rising household leverage relative to disposable incomes potentially threatening financial stability. Additional risks include a further deterioration in global mining capital spending given Korea remains highly exposed to this sector. A sharper than expected slowdown in China’s economy would hit Korea's economy hard, being the largest market for Korean exports and corporate profitability. The concern now is that a sustained slowdown in exports and manufacturing hits domestic household spending via a weaker labor market and corporate profitability.

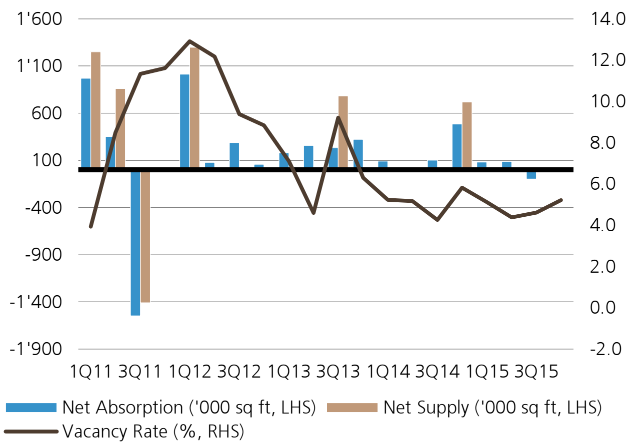
Office fundamentals remain sluggish in Seoul's CBD office market with vacancy rates remaining elevated relative to historical averages of between 4-5% and headline rents moving sideways. Across the three core sub-markets (CBD, Gangnam Business District (GBD), and Yeouido Business District (YBD)) the weighted average vacancy rate remains close to 8.0% at 4Q15 and effective Grade A rents have remained flat since 2009 as incentives have widened (in nominal terms, rents are 15% below pre-crisis levels). With net supply remaining in check in recent years it is the demand side of the equation that has seen limited growth with net absorption averaging less than 1% of stock between 2012 15. This compares to historical net absorption of 1.7% of stock over the past decade. Looking ahead, with net supply remaining constrained over the next couple of years demand will remain the key driver of fundamentals. The good news here is that, with the exception of the financial services industry, jobs growth has picked up in the key sectors that typically occupy office space including business services, public services and real estate. The employment levels of the finance and insurance sectors are still down from a year ago, but even here job numbers appear to have stabilized in 2H15. Healthy jobs growth in the services sectors should eventually translate into a recovery in net demand for office space which should eventually support occupancy and rental levels over the medium term.

Demand for quality buildings remains strong in Korea although transactional activity fell over the course of 2015 will overall volumes 35% lower than 2012 14 levels. The pullback in liquidity highlights the limited prime product available for sale but also the impact of elevated financial market volatility and tightening US interest rates. Nonetheless, despite the sluggish real estate fundamentals and pullback in transaction volumes, prime yields remained unchanged in 4Q15 according to data from PMA. Given the ongoing monetary easing of APAC central banks this year, prime yields may see some further marginal yield compression in 2016, which may support further uplifts in valuations in 2016.

Singapore
Full year GDP growth came in at 2.0%, down from 3.3% in 2014. Despite support from public sector construction and the finance sector, external and domestic economic engines appear to be stalling. Domestically, growth prospects continue to be dampened by the ongoing correction in the housing market, as macro-prudential measures targeting the property sector constrain real estate investment growth. In addition, labor productivity gains are looking elusive, as the clampdown on foreign labor supply casts a shadow over business costs and corporate investment, especially small enterprises. On the external front, softness in the manufacturing sector should persist into 2016 given the headwinds to global trade.

The outlook for the Singapore office leasing market remains challenging. We expect overall office sector performance to remain depressed in the next two years. In the last quarter of 2015, Grade A office rents declined by 7.1% relative to the same quarter in 2014 despite vacancy rates edging down slightly from 5.8% in 4Q14 to 5.2% in 4Q15 although they have edged up in recent months (Chart 13). This reflects the priority placed by landlords on tenant retention and the focus on occupancy rather than rents, given the looming supply influx in 2016 on the back of weak corporate sentiment. The completion of Marina One is likely to raise the overall vacancy rate in the Grade A office segment in 2016, and Guoco Tower and Duo are also likely to substitute leasing demand away from the core CBD area. In the investment market, only 19 transactions above USD 10 million were recorded in 2015 and total transacted volumes declined almost 30% YOY, with average yields widening by approximately 100bps.

Chart 13: Singapore office – Grade A supply and demand dynamics



Source: CBRE Erix 4Q15, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

In the retail sector, expansionary plans of retailers are largely being put on hold, despite the leasing market moving towards a tenant's market. The key drag on retailers is the limited availability of labor supply which is eroding profit margins for many tenants, not less in an environment of weakening retail sentiment. Prime retail rents fell by 4.3% YOY in 4Q15, the fourth consecutive quarter of decline. In contrast, suburban retail rents were more resilient throughout 2015, falling away only slightly in 4Q15, in which average rents recorded a 1.3% decrease YOY. Looking ahead, retail rents (both prime and suburban) are likely to register flat to marginal declines over the next 12 months.

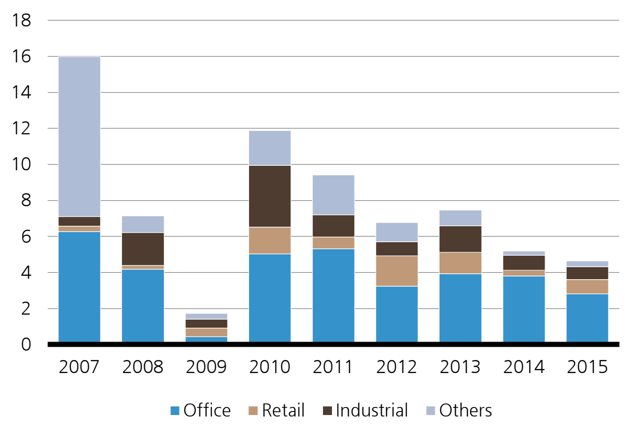
Weak manufacturing outlook is clouding overall prospects for the industrial property sector. E-commerce driven demand for industrial space is increasing, but there is a natural limit on Singapore's market size, which caps occupier expansion in this sub-segment. The impending supply pipeline will not help the near-term balance between supply and demand. According to CBRE estimates, more than 7 million square feet of space is expected to be delivered to the market in 2016 and 2017, exceeding the average annual absorption of 2.9 million square feet. Given the weak occupier market and sustained impact of government policies to curb speculative investments such as the Total Debt Servicing Ratio (TDSR) and Seller's Stamp Duty (SSD) we expect some moderate outward yield movement, which is likely to push down capital values.

On a related note, demand-side measures implemented by the Singapore government to curb speculative housing purchases have also constrained demand in the residential market. Administrative and financial measures such as Additional Buyer's Stamp Duty (ABSD), the TDSR and the SSD have dampened the investment appetite of local and foreign investors in the last two years, which is directly hitting the prime residential segment. In 2015, CBRE estimates that sales of prime residential homes fell by almost 54% YOY to approximately 400 units, and were only a quarter of the annual average between 2012 2014. Well-capitalized investors appear to be waiting on the sidelines for valuations to hit cyclical lows before (re)entering the market. We believe that expectations of interest rate hikes will continue to exert downward pressure on pricing and the government is unlikely to fully relax the existing property sector measures in 2016. However, the prime segment may present a near-term opportunity for long-term investors to take advantage of the convergence of pricing between prime and fringe-located residential property and extract significant value when the market turns.

According to RCA data, outbound capital from Singapore invested approximately USD 28.7 billion into overseas real estate, almost 49% higher than the USD 19.3 billion in 2014 (Chart 14). Interestingly however, total inbound capital into real estate also outperformed at USD 3.4 billion in 2015, up by 157% from USD 1.34 billion in 2014. While local capital is moving overseas in view of the weak domestic outlook and higher expected returns, to some extent, there appears to be some awareness of relative safety in the Singapore market, as evidenced by a sharp increase in inbound foreign capital. Overall, the capital outflow situation is unlikely to reverse in 2016, as further US monetary tightening lifts domestic borrowing costs, exerting upward pressure on yields. To that end, overall investment volumes are likely to remain subdued, further exacerbated by weak occupier markets as investment decisions are deferred.

Chart 14: Singapore real estate investment volumes

(USD bn)



Note: For transactions above USD 10 million, and excludes land transactions
Source: RCA, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

Hong Kong

Macro headwinds facing Hong Kong's economy are unlikely to abate anytime soon. Softness in the Chinese economy is hampering export growth and retail sales, while the currency peg is pushing up borrowing costs and undermining domestic competitiveness. On the domestic front, leveraged households are most exposed to higher interest rates and falling prices. Oxford Economics estimates that average house prices are more than 15 times median household incomes. Domestic household spending remains the one bright spot for the economy, supported by healthy labor market conditions with the unemployment rate hovering around 3%. In terms of industry performance, the finance and professional services sectors are likely to see ongoing expansion over the next 12 months, offset by job losses in the travel-related industries.

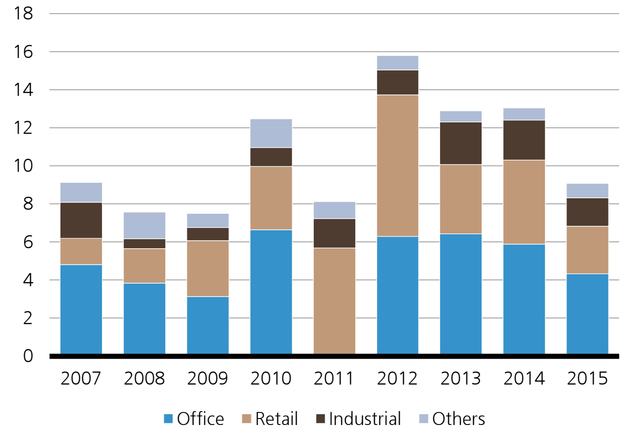
Despite the challenging macro environment, prime office rents strengthened in 2015, gaining 9.4% YOY. Net absorption of Grade A office space in 2015 was more than double the combined leasing activity of the previous two years, boosted by healthy demand from the banking and insurance sectors, particularly from Mainland Chinese companies. Average Grade A office vacancy rates have fallen to 3.2% in 4Q15, down from 4.1% in 4Q14. Vacancies rates across various sub-markets should continue tightening on the back of limited supply over the next 12 months. Rental growth is expected to be flat to marginally positive, coming off a high base.

In the retail sector, total sales remain under significant pressure, driven by the strengthening currency and travel restrictions on visitors from China. To that end, average retail rents fell by 17.3% YOY. Near-term prospects for the Hong Kong retail market are muted as retailers cut back on their expansionary plans, despite weakening rents across the board. In the investment market, total transacted volumes declined almost 44% YOY, with transactions limited to non-core retail segments supported by non-discretionary spending (Chart 15).

Leasing demand for industrial space is likely to remain subdued over the next 12 months. However, under the industrial revitalization scheme which ends on March 2016, landlords have rushed to submit planning applications for change of use, which is likely to constrain the amount of stock available for occupation. As such, rents and vacancies are set to move sideways in 2016, despite subdued occupier demand and increased focus on costs.

Chart 15: Hong Kong real estate investment volumes

(USD bn)



Note: For transactions above USD 10 million, and excludes land transactions
Source: RCA, UBS Asset Management, Global Real Estate Research & Strategy, as at December 31, 2015

Strategic views

As core yields compress below pre-crisis levels, the performance dynamic of real estate is shifting away from cap rate compression – which has underpinned strong capital growth since the financial crisis – towards income as the key driver of returns. In an environment of slowing capital growth, stock selection and asset management will be key to generating outperformance of individual buildings and portfolios. Moreover, in an absence of a material pickup in credit or growth prospects, for example, triggered as a result of a strong public infrastructure stimulus from China, the returns environment is set to be lower as the era of yield compression comes to an end.

Looking ahead, as we formulate our market and sector views, we continue to be guided by top-down macroeconomic drivers alongside pricing considerations and bottom-up evidence of cyclical and structural developments in individual real estate markets and sectors.

Our key views are

– Overall, with leasing markets sluggish in the region, on a risk adjusted basis we prefer core investments alongside value-add and 'build to core' strategies which are focused on CBD markets with healthy labor markets and demographics. Although core pricing is expensive on a historical basis, when comparing current yields with historical averages we believe these assets will provide investors with greater downside protection in the scenario where elevated financial market volatility hits the economic recovery of DMs.

– Over the next twelve months, we favor the region's DMs of Australia and Japan where the largest cities (Tokyo, Sydney and Melbourne) continue to be supported by relatively healthy leasing dynamics, jobs growth and credit availability. Public & private infrastructure investments – ahead of the 2020 Olympics in Tokyo and after years of underinvestment in Sydney's CBD – should also support core and value added strategies in these cities. To that end, we prefer office and mixed use residential or hotel anchored schemes that are close to major transport hubs and infrastructure projects. In other markets, we prefer exposure to stronger cities that are not plagued by oversupply concerns such as Tier-1 cities in China and Hong Kong offices.

- Despite the best efforts of central banks to pull down interest rates via lower policy rates, cuts to reserve ratios and other monetary easing measures, EMs will continue to be hampered by tighter financial conditions and limited credit availability on account of increased risk aversion, currency volatility and slower growth prospects. This is the case for both domestic lenders that have borrowed heavily in foreign currency (particularly, the USD) and foreign lenders where the loans are secured against cross border assets. In either case, lenders are demanded higher margins or higher quality collateral as compensation for increased uncertainty. Over the next few years we think there will be good opportunities for investors in the lending space, either to acquire whole portfolios of loans or provide credit to new investors.
- We maintain that the Hong Kong office sector offers a cyclical window of opportunity, although transactions are likely to remain limited. The lack of supply in the next year will tighten vacancy rates across various sub-markets, and there could be a market gap for a value-add office play. With economic linkages with mainland China remaining the most important catalyst for ongoing prosperity in Hong Kong we note that heightened political risks on the back of rising social tensions may increasingly become a key point of concern for investors.
- We recommend caution in any tactical allocation to Singapore's commercial real estate market over the next 12 months. However, we believe that Singapore still represents a safe haven for global liquidity and motivated sellers are few. As such, the expectations mismatch between buyers and sellers is likely to continue to limit transactions and support pricing. On aggregate, the Singapore real estate market is likely to remain subdued in the next year with yields broadly flat.
- We remain optimistic on China's long-term prospects. The bulls and bears are ostensibly split between domestic and foreign capital, and that will be a key defining theme for the Chinese real estate market in 2016. On a strategic (long-term hold) basis, we continue to recommend exposure to China. We expect that reforms will drive positive shifts in property sector dynamics. In terms of sector preference, commercial is preferred over residential, although residential development may have legs in selected markets if one is keen to move up the risk spectrum. As the services sector takes its place as a key driver of China's economy, property markets in cities with strong services sectors will be the initial beneficiaries, as higher wages, stronger employment and demand for commercial space boost overall real estate demand.

Real Estate Research & Strategy Team – APAC

David Roberts
Shaowei Toh

For more information please contact

UBS Asset Management
Global Real Estate Research
Shaowei Toh
Tel. +65-6495 3778
shaowei.toh@ubs.com

www.ubs.com/realestate