Research Blast

European Real Estate, September 2018

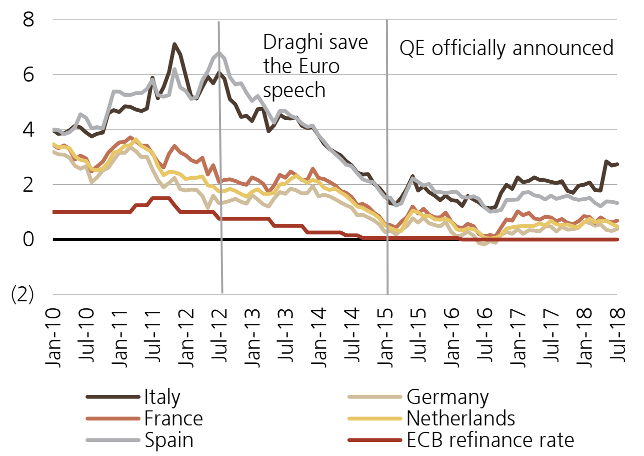
Quantitative easing has ultimately kept bond yields stable and the spreads narrow, but will a re-pricing of risk lead to spreads reopening?

As the biggest experiment in European Central Bank history draws to a close at the end of this year, we consider the implications for property pricing after six-years of ultra-loose monetary policy which has ultimately kept yields low and prices high.

The end of quantitative easing and a re-pricing of property risk

On the 14 June, Mario Draghi announced that the European Central Bank's (ECB) historic EUR 2.4 trillion bond-buying program would be wound down by the end of 2018, bringing to a close the biggest experiment in ECB monetary policy where absolute normalization is likely to be slow. In fact, the Euro actually fell sharply on the day of the announcement as Draghi indicated that the first rise in the ECB base rate is not likely to be until the second half of 2019, at the earliest. In spite of this, it would still mark a key turning point of ultra-loose monetary policy in the Eurozone after six years – one which would ultimately provide stability to the bond markets after the turmoil at the height of the debt crisis.

Chart 1: 10-year government bond yields, ECB interest rate (%)



Source: Datastream, August 2018

Since the implementation of quantitative easing (QE) in March 2015 government bond yields across the Eurozone, and the spreads between different countries, remained broadly stable despite the rise of various political uncertainties. Without the safety net of QE, it is likely these events would have risked sending bond yields spiking and contagion spreading. Real estate, as with every other income producing asset class, has undoubtedly benefited from the weight of capital compressing yields and maintaining a low and stable risk free rate. But how will property markets react as that stabilizer is removed and volatility is able to return to the market?

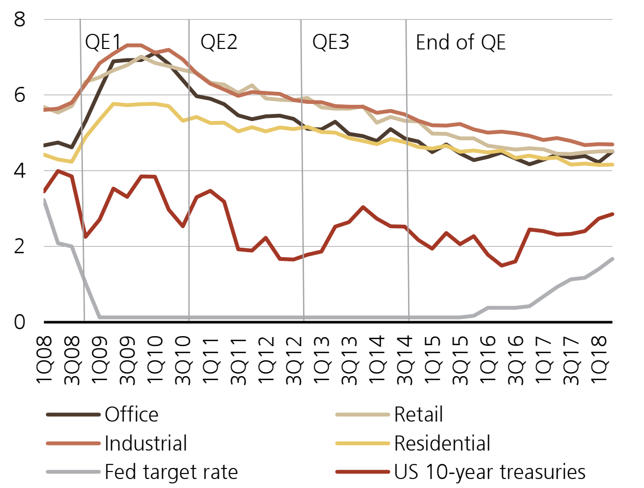
What has happened so far in the US?

With the US well ahead of both the UK and Eurozone in their monetary policy tightening, we can gather some indication of how property yields have reacted to the end of the QE program and gradual hiking up of interest rates.

The data from the US indicates that the gradual tightening of monetary policy from 2016 has not had a negative impact on property yields. In fact, for most sectors they have continued to edge in albeit at a more gradual pace than before. And despite the fact that 10-year treasuries exceeded 3% during 2Q18, most property sectors in the US have continued to see further yield compression. Core yields in the US stand at around 4.25% and it appears that the cushion of c.125 bps is still at a comfortable level for property investor. We do understand, however, that should the cushion erode further to around 100 bps, a turning point may be reached whereby a rebalancing of equity away from property and back into fixed income would lead to sustained outward pressure on property yields.

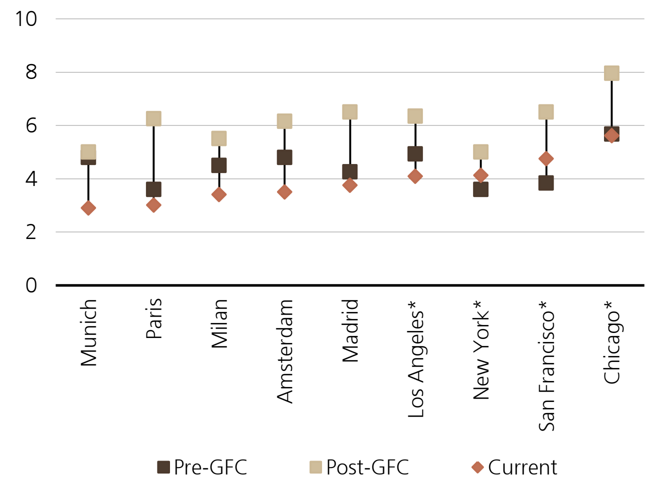
The situation in the US is also helped by the strength of occupational markets. The economy has performed well recently and although there is more development going ahead than in Europe, it hasn't yet had a negative impact on net occupancy rates. European occupational markets are also in relatively good health. And while economic growth is somewhat weaker than in the US, the level of new supply in most countries continues to be modest by historic norms. So it appears possible that with a solid outlook for income growth a "soft landing" scenario can take place with property yields remaining fairly steady in spite of the reversal in monetary policy. This seems to be the consensus view amongst European property forecasters. But with ultra-loose monetary policy continuing in Europe long after it was reversed in the US, the relative levels of yields [between the two regions] have become distorted. Furthermore, the weight of capital targeting US real estate has too eased off over the past two years with European transaction volumes staying at around or even above record levels, driving prime yields in core markets down to 3%.

Chart 2: US yields (%)



Source: NCREIF; Oxford economics, August 2018

Chart 3: Prime office yields (%)

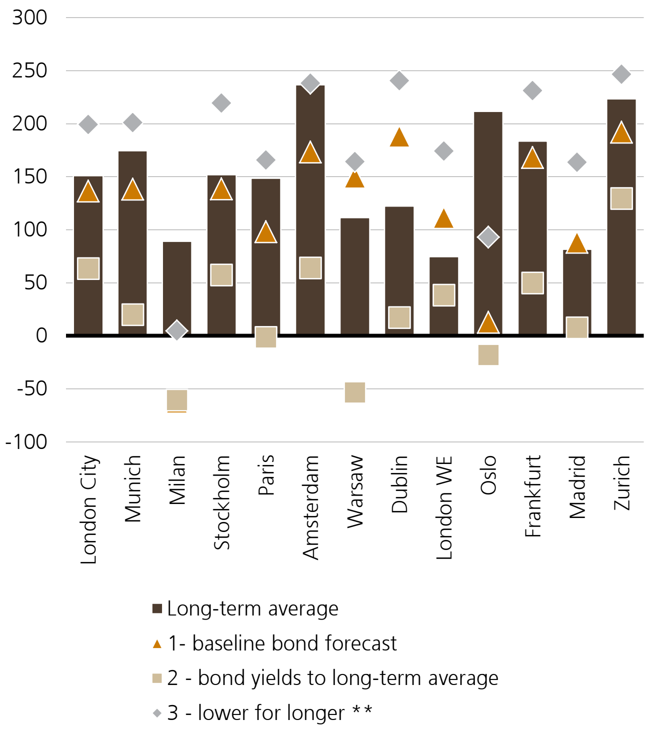


*US yields taken from RCA top quartile cap rates.
Source: CBRE; Real Capital Analytics, August 2018

With European yields at the current levels we need to start considering which markets might be more exposed to a gradual, or indeed a faster than expected increase in bond yields. To illustrate this in the below chart we have run three bond yield scenarios to compare the outcomes of the historic spread between prime office and government bond yields in the corresponding markets by end-2020, assuming no change in property yields.

Chart 4: Pricing risk

Yield spread (bps)



*nominal bond scenarios 1) OEF forecast; 2) long-term average (1998-2017); 3) lower for longer.
Source: CBRE; RCA; PMA; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), as at 2Q18 (property data); OEF forecasts, August 2018.
** Lower for longer calculated as mid-point between current level and OEF forecast

We are aware of the limitations of bond yield forecasts so we have run the different scenarios to demonstrate a range of possible outcomes. The least likely is the "bond yields to long-term average" which would mean a snap back to the typical levels of the past 20 years. This would only occur if there was a sudden unforeseen market shock to confidence, or a drastic change in the direction of monetary policy.

The baseline forecast is an external macro-forecast broadly in-line with the consensus. However, over the past few years the macro-forecasts for bond yields have been woefully inaccurate as most models operate on mean reversion. But as the "lower for longer" period has developed, those mean reversions have consistently been proven wrong. We have therefore included a third, and probably the most likely outcome, "baseline bond forecast" which is a more gradual easing of bond yields from where they are to sit between the current level and the macro-economic forecast.

It is clear, however, that if we do see a faster outward movement of government bond yields than the lower for longer scenario, pricing in some markets will start to look very stretched by 2020. The standout market is Milan, where Italian bond yields are forecast to get to 4% by 2020 (from 3% currently). This means property yields at the current level of 3.5% would have a negative premium. The spread would be eroded to near zero even under the lower for longer scenario. This is unless investors were to lose confidence in the government to such an extent that property is actually considered a safer asset to hold than an Italian government bond. Therefore property pricing may stand in need of significant adjustments.

Under the lower for longer scenario, most markets would remain above (and in some cases comfortably) their historic spreads – Amsterdam and Oslo being two exceptions where this would not be the case. The risks clearly accelerate if we move closer to the baseline scenario. It also has to be noted that the impact on underlying capital values of a 10-25 bps outward movement can be substantial, from the current levels. Paris for example, shows that if prime yields were to move out from 3% to 3.25% - assuming no change in the rental income - a EUR 100 million asset would lose EUR 8.2 million in value, equivalent to nearly three years rental income.

There is a risk that property pricing has become too reliant on inflated bond prices which have been relied on as the metric to show relative value in the property markets. And with pricing in the comparable asset class being inflated by the ultra-loose monetary policy of the past decade, investors should be aware of the markets and sectors which offer the most defensive returns against a backdrop of tightening monetary policy.

We have highlighted markets which may be at risk purely on the pricing side, whilst income growth and sector performance will likewise influence how resilient portfolios will be to a rising bond yield environment.

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