Real Estate Outlook

Global overview – Edition 3, 2020

Things will never be the same again.

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The only certainty is the real estate landscape has changed, forever.

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Economies have seen the sharpest contractions on record while massive central bank and government intervention has supported asset prices. In real estate the crisis has turbo-charged trends we were already seeing prior to the crisis, boosting logistics and hurting retail. We are now in the social-distancing phase, but investors need to think long-term and position themselves for once the pandemic has passed.

Macroeconomic overview – Rise in infections casts doubt on recovery

Compared to one quarter ago the number of people impacted by COVID-19 around the world has increased sharply. As of 12 August 2020 the global death toll stood at 737,417 and the number of confirmed cases was 20.2 million. However, a number of localized outbreaks have occurred recently, such as in Melbourne in Australia, Catalonia in Spain and several US states, including Florida. The uptick in cases is not unexpected and demonstrates the contagiousness of the virus. Opening up the economy entails a tricky balance between limiting economic damage and an increase in cases and mortality.

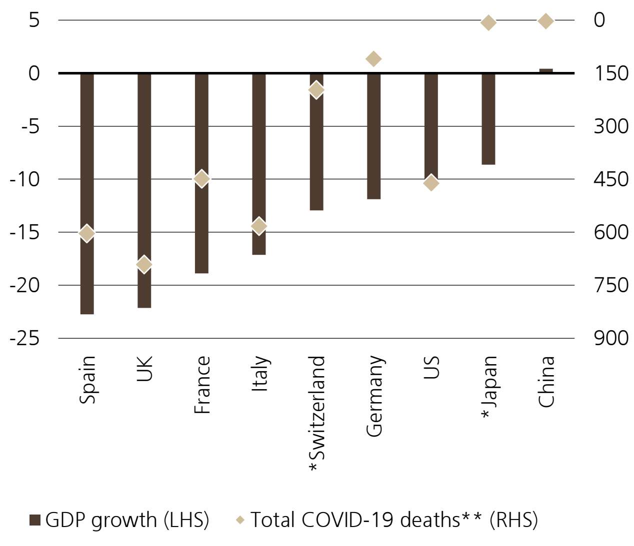
A vaccine would be the most certain way to bring the virus under control. The World Health Organization (WHO) has reported that 165 vaccines are in development globally, with 26 of those having reached clinical trials. Ultimately it seems likely that several vaccines will be produced, coming from several companies, with differing degrees of effectiveness and reliability. Overall, it seems likely that vaccination against COVID-19 will become available in 1H21. A key issue for governments will be the willingness of the population to use a vaccine that has been developed and approved rapidly.

Following much discussion and conjecture, we are finally receiving some factual economic growth figures for 2Q20. In general they were in line with expectations and showed large, double-digit declines in GDP. China fared better and reported a strong bounce-back, with the economy estimated to have grown by 12% QoQ. The overall contraction in economic activity in the first half of the year ranges from an estimated 23% in Spain to 9% in Japan, while China grew 0.4%. The figures wipe off several years of growth for most countries. In general economies which have been hit hardest by COVID-19, in terms of death rates, have seen the biggest economic slumps, though Germany and Switzerland have held up better than their mortality rates alone would suggest (see Figure 1).

A key risk is that schemes to support workers are not extended which results in large scale layoffs and unemployment. For example, enhanced unemployment benefits in the US expired at the end of July as Congress failed to reach a deal to allow for a rollover or replacement scheme. The news in Europe was more positive as the EU confounded expectations and heads of state agreed a EUR 750 billion recovery fund, including EUR 390 billion of grants. This is a sea change for the EU and marks the first time in the bloc's history that the European Commission will borrow on behalf of member states collectively as they pool debt and explicitly share liability.

The monetary policy outlook remains very much accommodative, with central banks holding interest rates near zero, continuing with asset purchase programmes and supplying loans to businesses of all sizes. In reality, even before the pandemic the Fed had returned to easing mode and interest rates now look likely to remain near zero for the foreseeable future. Indeed, central banks are weighing up options for additional measures like yield curve control, further forward rate guidance and altering mandates towards some type of inflation catch-up mechanism via price targeting.

Figure 1: 1H20 GDP growth and COVID-19 deaths
(% and per 1 million of population)



Note: *2Q20 based on forecasts, **as at 2 August 2020
Source: Oxford Economics; BEA; Eurostat; ONS; WHO, August 2020

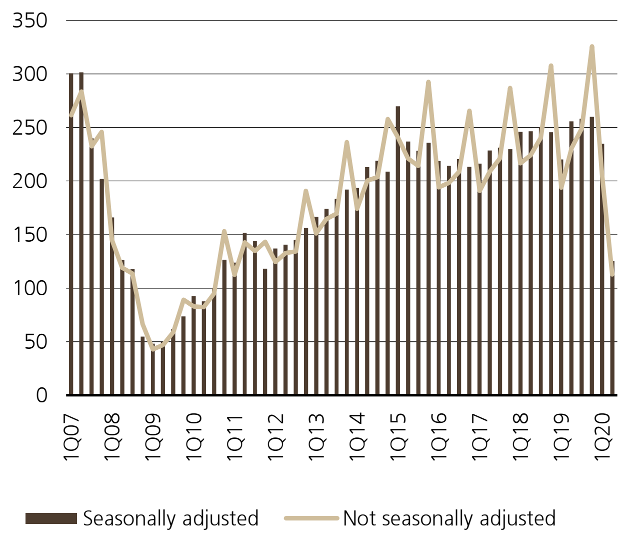
On the political front, things will likely get choppier in 2H20. The US presidential election looms in November and President Trump has suggested that high numbers of postal votes could invalidate the result. The Democratic candidate Joe Biden has shown a double-digit lead in opinion polls and victory would likely see changes in US policy. At the same time, Sino-Western tensions have risen following China's introduction of a security law in Hong Kong, the exclusion of Huawei from the UK's telephone network and disagreements in the tech space.

Following the pick-up in virus numbers the question now is whether the advanced economies will follow China's path of a strong bounce-back or whether further lockdowns will be needed, which in turn will see a renewed down-leg in growth in 2H20. Some choppiness in the economy seems highly likely, but our base case is that growth will recover moving into 2021 as the virus is brought under control and as some form of vaccine becomes available. Any sustained uptick in infections could stall the recovery though and see the economy remain in contraction as it moves into 2021.

Capital markets – Sharp drop in activity and rises in yields

Global real estate investment activity fell sharply in the first half of the year as COVID-19 created both uncertainty over real estate pricing and hindered the physical part of the transaction process as lockdowns and travel restrictions prohibited property inspections. After adjusting for seasonal effects, global investment volumes fell 10% in 1Q20 in USD terms and a further 47% in 2Q20. This left them down 52% in total in the first half of the year (see Figure 2). However, the size of decline has been less than that during the Global Financial Crisis, when volumes showed a peak to trough drop of 84%.

Figure 2: Global real estate investment volumes
(USD billion)



Note: Income producing properties for deals of USD 10 million and above
Source: Real Capital Analytics, August 2020

There were significant differences by region, with Asia Pacific volumes falling 28% in 1H20 in USD terms after adjusting for seasonal effects, EMEA dropping 36% and the Americas 70%. At the global level office volumes fell 56%, retail volumes 62%, industrial volumes 44% and apartment volumes 33%, while hotels showed the sharpest drop, of 80%. Following the easing of lockdowns over the summer and some clarity beginning to emerge on real estate pricing, we expect some recovery in transaction activity in the second half of the year. International travel restrictions remain widespread though technology, such as virtual building tours, is helping to overcome this. A second wave of the virus which necessitated further lockdowns and saw renewed uncertainty would put the brakes on a recovery in transaction activity.

Following an assessment of the shock due to COVID-19, real estate pricing has begun to adjust. Of the 332 markets we monitor globally 30% reported a rise in yields in 2Q20, similar to the 31% which reported a rise in 1Q20. A handful of markets (10%) reported a fall in yields while 60% reported no change. Just 16% of office markets reported an increase in yields, including New York, Paris and Shanghai. There were widespread increases in retail yields, with around half of markets (51%) reporting a rise. The picture was more mixed for industrial and logistics, with the bulk of markets (81%) reporting yields as flat, while 14% reported a fall, outweighing the 4% which reported a rise. For example, industrial yields fell in Dallas, Auckland and Copenhagen, reflecting investor perception and the general belief that industrial is the most resilient sector.

Based on results from the markets which report first, Canada, Ireland, UK and US, valuations fell across office and retail markets in 2Q20, while the picture was mixed for industrial. According to MSCI and NCREIF data falls in office values ranged from 1-2% QoQ, while retail saw larger declines of 5-9% and industrial ranged from a 1% fall to flat values. At the all property level values were down 2% in 1H20 in the US, 5% in the UK, 4% in Canada and 4% in Ireland. We expect further significant declines in retail values, smaller declines for offices while we expect industrial to remain more resilient as capital continues to target the sector.

Mirroring the broader stock market listed real estate values have recovered from their lows in March. However, there has been much more difference between sectors than between countries. For example, by the start of August REIT prices were down 20-25% year-to-date for the main countries. However, globally at the sector level, the worst performer was hotels, down 55% in USD terms and retail down 43%, while offices were down 27% and residential 10%. Industrial, on the other hand, bucked the trend and posted a 13% increase in prices year-to-August. These trends mirror sentiment in private markets.

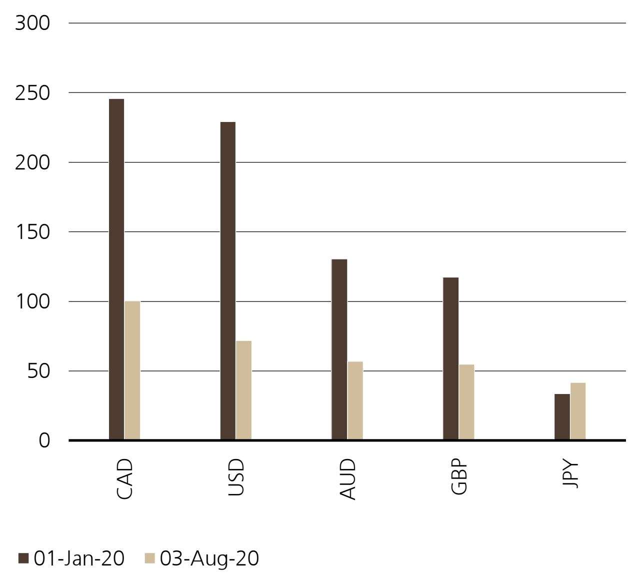
Investor interest in real estate remains strong, aided by healthy spreads between real estate yields and bond yields as near-zero interest rates have presaged falls in bond yields. Preqin reported that as of August USD 337 billion of capital was targeting real estate globally, down from USD 371 billion at the end of 2019. Adding on even modest leverage means there is a significant amount of capital looking to be deployed into real estate. On the supply-side, as of July Preqin reported that there were 903 closed-end funds looking to raise an aggregate of USD 273 billion. Open-end funds provide further opportunities for investors.

Strategy viewpoint – focus on sector allocations

The COVID-19 pandemic has resulted in the sharpest economic contraction on record. However, asset markets have held up surprisingly well and better than might be expected given the size of the downturn. The swift and big intervention by central banks and governments has supported risk assets and put a floor under their prices, including real estate.
As such, rather than the 20% decline we saw in global real estate values during the Global Financial Crisis we think they will drop by around 7% this year, and may prove more resilient.

The pandemic has turbo-charged the pre-crisis trends we were already seeing in the real estate market and has been much more about sectors than geographies. At the current juncture we think a broadly neutral allocation between the different regions seems appropriate, particularly given that the move to near-zero interest rates by the world's central banks has flattened hedging costs globally. For example, at the start of the year euro-denominated investors investing into the US faced annualized hedging cost of 230 bps, while by early August they had fallen to just 70 bps (see Figure 3). Moreover, hedging costs do not look set to rise anytime soon given that interest rates are expected to remain on hold.

Figure 3: 3-month hedging costs by currency for euro (bps, p.a.)



Source: Thomson Datastream, August 2020

With regard to sectors we think investment strategy should broadly mirror our advice before the pandemic broke out. This includes an overweight allocation to the industrial and logistics sector, and a broadly neutral allocation to offices and underweight to retail. There is uncertainty over the office market and the extent to which a permanent rise in homeworking will reduce office footprints once the pandemic has passed. Meanwhile, retail, the sector which was already out of favor with investors, is suffering even more due to the crisis, while industrial is benefiting. We expect further significant declines in retail values, with purchases only viable if at a significant discount to pre-crisis values.

Certain parts of retail will likely prove more resilient, such as convenience retail and grocery retail. However, even grocery retail and supermarkets are being encroached on by the rapid rise in online sales, which accelerated during the lockdown. Online grocery is a challenging area for operators though and has proved less profitable than they would like. Although supermarkets have seen sharp increases in online sales during the pandemic, they have also struggled to meet volume demands and seen sharp increases in costs too.

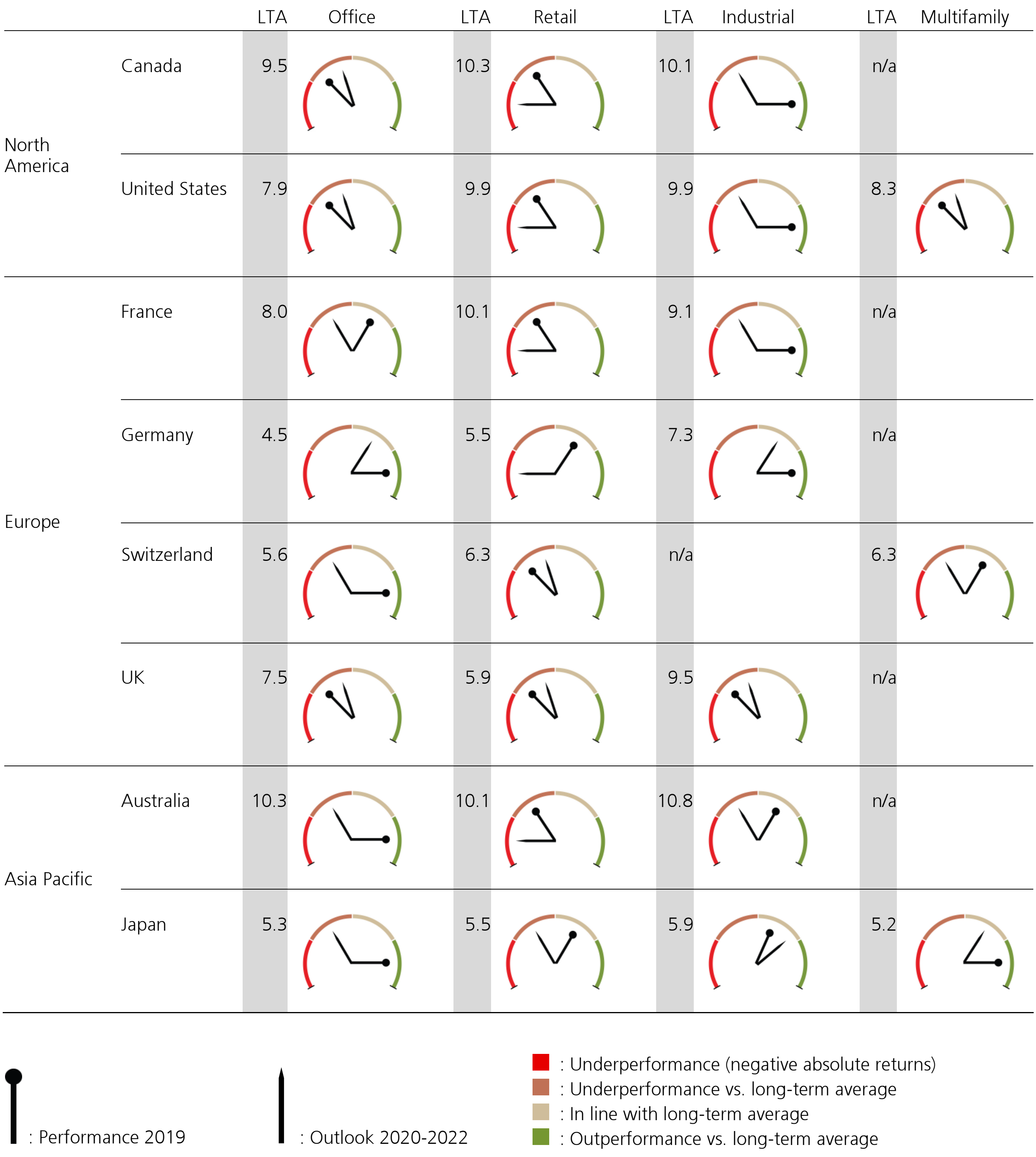
Since the current crisis is a health crisis rather than stemming from the economy and imbalances within it, we have seen less stress in real estate markets and few forced sales of assets. However, some dislocations will exist and present opportunities for investors who manage to find them.
For example, retail assets which have viable alternative uses in the form of residential or logistics space are an option for higher risk investors.

With economies mostly out of full lockdown we are now in the social-distancing phase of the crisis. How long this will last is unclear and will depend upon how quickly the virus can be contained. Businesses will have to continue to operate with social distancing measures in place for some time.
For example, the de-densification of offices and continued home working, retail outlets limiting the numbers of people allowed in shops and operating procedures being amended in factories and warehouses. A full return to normal seems unlikely until 2022 at the earliest and could take longer, with permanent changes in consumer attitudes and behavior likely as well.

Ultimately, investors need to position themselves for the long-term and what the world will look like once the pandemic has passed. Two key themes look set to be dominant. The first is an increasing reliance on and pervasiveness of tech and the digital space; the second is an increased value and importance placed on ESG factors by investors, governments and society at large. Property investments which take trends such as these into account will likely perform better than those which do not. Within ESG de-carbonization was already reducing the propensity for air travel prior to the crisis and we may see tourism rotate more towards domestic destinations in the future. This would be a problem for hotels in small economies where tourism is their main industry.

Real estate investment performance outlook

2019 performance and 2020-22 outlook are measured against the country-sector's long-term average total return, with a margin of 100bps around the average described as "in line with long-term average". The long-term average refers to the period 2002-19. The red underperformance quadrant refers to negative absolute total returns, either in 2019 or the 2020-22 outlook.



Source: UBS Asset Management, Real Estate & Private Markets (REPM), August 2020. Note: Abbreviation LTA: long-term average

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