Sponsor Report
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Institutional Real Estate Americas

Morgan Stanley Real Estate Investing (MSREI)

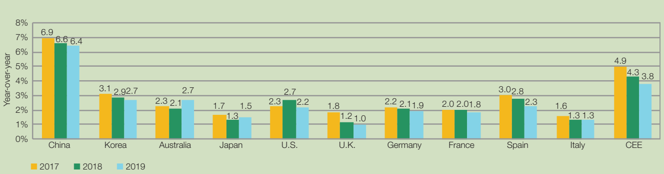
2018 Summer Global Real Estate Outlook

The global macro picture continues to look quite healthy, with 2018 likely to be the peak year for global growth, as most regions move upward together. On the back of stronger global growth, inflation is increasing and long-term rates have risen (most notably in the United States). Geopolitical tensions, as well as ongoing global trade issues, continue to threaten global growth and create heightened volatility and investor uncertainty. Despite this market turbulence, capital flows into real estate remain strong and returns are at or above historical-average levels. Morgan Stanley Real Estate Investing (MSREI) believes that the combination of strong economic growth, divergent interest rate policies and volatile currency movements will continue to create a favorable investing environment for commercial real estate, albeit one that requires increased levels of caution and prudence given the abundance of available capital and cycle maturity.

Global macroeconomic environment

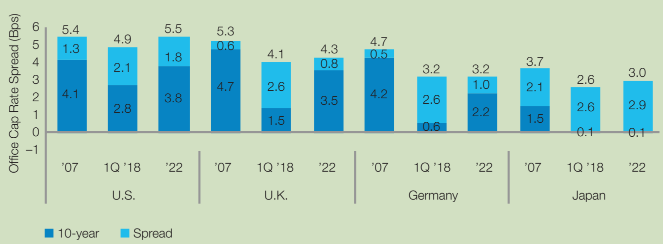
The global growth cycle is expected to moderate but remain at an above-trend pace over the forecast horizon, averaging an estimated 3.9 percent in 2018 and 3.8 percent in 2019, as compared with 3.7 percent in 2017 and 3.4 percent per year over the period 2012 to 2016.[1] Growth is being sustained by strong capex investment in developed markets and improving productivity growth. While there is ongoing discussion about the length of the global macro cycle (that we believe is likely to enter its 10th year in 2019), the recovery was preceded by a very deep recession and has been interrupted by a number of temporary crises. Additionally, although the global cycle is undoubtedly maturing, there are important regional differences. The current cycle is clearly more advanced in developed markets, with the United States being furthest along, followed by Japan and the euro area. The majority of emerging markets, excluding China, are still in the early- or mid-cycle stages of the business cycle.

Steady Real GDP Growth



Source: Morgan Stanley Research, as of June 2018
** Indicated 2019 numbers are forecasts.*

Healthy Cap Rate Spreads[4] Should Help Absorb Most of the Rate Increase



Sources: Bloomberg, NCREIF, PMA, MSREI Strategy, as of February 2018.
** Indicated 2022 numbers are forecasts.*

While inflation is set to rise, it is projected to remain close to central banks' targets. In developed markets, inflationary pressure will likely arise from a further tightening of labor markets and a rise in capacity utilization. However, more moderate wage growth at this stage of the current cycle and structural factors, such as technology diffusion and globalization, should continue to keep upward pressures in check.

As a result of higher inflation, central banks in developed markets are expected to reduce monetary accommodation. Following the 25 basis point rate hike on June 13, Morgan Stanley Research expects, as of this writing, the Federal Reserve to raise rates in September and December, 2018, followed by two hikes in 2019. They expect the European Central Bank (ECB) to begin tapering asset purchases in October this year and raise deposit rates in June 2019. Further, they expect the Bank of England (BoE) to raise rates in 3Q 2018, followed by two hikes in 2019. Lastly, they expect the Bank of Japan (BoJ) to adjust the 10-year JGB yield to around 0.15 percent in first quarter 2019.[2] In the United States, most of the increase in interest rates to date has been absorbed by spread compression; however, it is anticipated that cap rates will rise (see chart below). There will likely be a two- to three-year lag before this occurs in Europe and Asia, given the expected timing of monetary policy tightening. Fiscal policy, unlike monetary policy, is expected to become more expansionary, particularly in the United States, where the fiscal deficit is expected to increase from 3.4 percent in 2017 to 4.1 percent in 2018 and 4.5 percent in 2019.[3]

Key global risks worth noting include financial stability risks in the United States, given that there has been a meaningful pickup in leverage in parts of the private sector, particularly among corporates; trade protectionism, predominately between the United States and China; other geopolitical risks, including but not limited to midterm elections in the United States, Brexit, and political uncertainty in Spain and Italy; and, lastly, the adverse impact that rising U.S. yields and an appreciating U.S. dollar might have on emerging market economies, which recently have been significantly challenged.

Implications for commercial real estate

The strong macroeconomic backdrop and relatively low interest rate environment continue to attract significant capital flows into commercial real estate. Despite many markets being late cycle and relatively fully priced, MSREI believes the current cycle still has room to grow. Real estate fundamentals remain sound, with record-low vacancy rates supporting rent growth in most markets. Returns are at historical-average levels, supported by durable income yields of 4 percent to 5 percent,[5] which are attractive versus alternatives, and the spread between cap rates and interest rates provides a cushion to absorb some of the expected rate increases.

Rising interest rates have led to asset value correction fears across various asset classes. With real estate, however, investors may be able to mitigate these risks by shifting to investments that can participate and benefit from economic growth, with a measure of downside protection offered by current income.

While macroeconomic growth continues to be synchronous, different growth drivers underpin major economies around the world. Capital markets are also divergent, resulting in real estate markets that are at different cycle points (per the market cycle chart this page). It is anticipated that more attractive investing opportunities might be found in Europe and Asia relative to the United States. As discussed above, the United States is further along in the cycle from a macro and CRE standpoint. Interest rates are going up faster, pricing is "more" full, returns are decelerating, and we will likely see cap rate expansion over the next several years. In Europe, on the other hand, it is expected that growth over the next five years will be stronger than the last five years and interest rates will remain lower for longer. As a result, real estate returns in the region have been accelerating. In Asia, the rate of economic growth is two times that of the West, and interest rates also remain low, keeping cap rate spreads wider than in most parts of the world. The majority of Asia's markets recovered later than markets in the United States and Europe, so rents and values are still below prior peak levels.

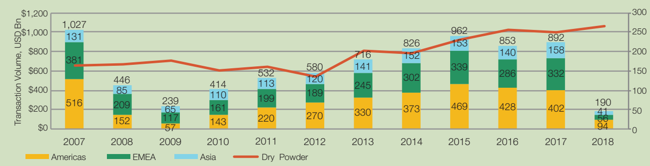
Europe

GDP growth in Europe is expected to remain relatively robust and above trend, averaging around 2 percent over the next two years, moderating 50 basis points from 2017 due to weaker consumer spending and exports (given the stronger euro), somewhat offset by stronger capex.[7] Rising wages and oil prices are expected to push inflation up during the second half of 2018, which should position the ECB to begin to reduce monetary accommodation. The United Kingdom is expected to slow further due to uncertainty around Brexit, with the most likely outcome anticipated by Morgan Stanley Research to be a soft, slow Brexit, likely involving the United Kingdom staying in a customs union with the European Union. A softer Brexit will likely lead to less economic disruption and may lead to improved investor sentiment, bringing it more in line with current fundamentals, which remain relatively strong.

Commercial real estate transaction volume in Europe reached $61 billion in first quarter 2018, down 17 percent from a year ago.[8] Industrial yields fell 20 basis points from year-ago levels to 6.3 percent in first quarter 2018, while office and retail yields were both 5.8 percent.[9] The United Kingdom and France were the most liquid markets in Europe over first quarter 2018, followed by the Netherlands. Dutch transaction volume increased 93 percent from first quarter 2017, and Spanish volume rose 40 percent.[10]

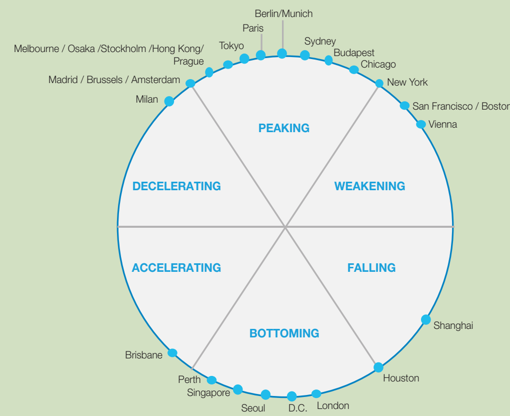
Europe's property fundamentals remain very healthy across all sectors. Office markets saw continuing improvements across core locations on the continent, with the average vacancy rate falling to 7.3 percent, 200 basis points below the 10-year average, helped by supply levels that are below the historical average. Berlin and Central Paris recorded vacancy rates of 3.0 percent and 2.6 percent in first quarter 2018, respectively, which were the lowest levels since 2000, while vacancy in the City of London recovered 50 basis points in first quarter 2018, and is now down to 8.4 percent.[11] Given uncertainties surrounding Brexit and future office demand in London, fully stabilized office buildings in London are trading at a significant premium to nonstabilized properties, suggesting an attractive spread for investors willing to take lease-up risk. Leasing velocity remains strong, helped by co-working, and investor interest for core London product continues to be robust, with liquidity over the past 12 months of $18 billion, which was higher than Manhattan ($17 billion), Paris ($10.5 million) and Frankfurt ($7 billion).[12]

Global Liquidity Robust



Sources: Real Capital Analytics, Prequin, MSREI Strategy, as of June 2018

Divergent Market Cycle[6]



Source: MSREI Strategy, as of June 2018

MSREI also believes that faster growth in Central and Eastern European countries could offer opportunities to reposition high-quality office assets in prime locations, taking advantage of the shift in middle- and back-office functions to markets such as Budapest, Warsaw and Bucharest, which is helping to drive the rental recovery in those markets. Additionally, institutional liquidity is growing, and yield spreads between primary and secondary cities remain attractive.[13]

In the industrial sector, demand continues to accelerate, supported by occupiers orienting their strategies toward efficient urban distribution and last-mile delivery capabilities. There is a shortage of modern industrial stock (2 square feet per capita in Europe vs. 13 square feet per capita in the United States)[14], suggesting development is required to meet modern logistics needs. While industrial rent growth has been relatively more muted versus in the United States, yield compression has been evident across most markets, contributing to outsized one-year returns averaging 13 percent across the region.[15] Outside of development, acquisition of regional distribution centers in key logistics hubs with supply constraints and last-mile logistics in dense urban areas where long-term rental growth is anticipated may provide attractive risk-adjusted return opportunities.

In the retail sector, steady growth in consumer spending and a relatively "under-retailed" environment is supporting low vacancies and accelerating rent growth in most major markets. Opportunities to reposition existing retail assets that are less susceptible to e-commerce trends in markets with barriers to new supply are potentially attractive.

Lastly, there may be attractive development opportunities in the housing sector in countries such as Spain, where pricing has just begun to recover. House prices increased 5 percent year on year in 2017 but remain 40 percent below 2006 peak levels.[16] Construction remains below 10 percent of prior peak levels,[17] while demand is robust due to strong household formation and growing income as unemployment levels drop.

Asia Pacific

Across Asia, Japan continues its late-cycle expansion (although the economy contracted in first quarater 2018), with the economy close to full employment and private consumption picking up on solid income growth, with front-loaded spending expected before the October 2019 consumption tax hike.

China's growth is expected to slow but remain sustainable and less reliant on credit amid improving private investment and productivity growth. Australia's mixed growth trajectory is expected to continue in 2018, as weak income growth and a credit squeeze weigh on consumption and housing, which is being partially offset by the weaker Australian dollar. Lastly, Korea's economy continues to grow at around 3 percent, supported by exports and improved wage growth. While denuclearization and the liberalization of the North Korean economy would reduce the South Korean risk premium and support growth, risks remain that an uneasy equilibrium may continue, which could be a headwind to growth.

Asia Pacific transaction activity increased to $40.6 billion in first quarter 2018, up 21 percent from a year ago. The office sector accounted for $18.1 billion in volume over first quarter 2018, while industrial activity rose 120 percent to $10.0 billion. Office transaction cap rates compressed 30 basis points from year-ago levels, to 5.2 percent in first quarter 2018, with 80 basis point and 30 basis point office yield compression in Sydney and Tokyo, respectively. Industrial cap rates compressed 60 basis points from a year ago to 5.9 percent, and retail cap rates declined 20 basis points to 4.9 percent.[18]

Asia Pacific office markets continued to exhibit broad-based growth. Across Japan, vacancy rates tightened over the year to first quarter 2018, dropping to 3.7 percent in Nagoya and 2.8 percent in Tokyo, and rents remain 30 percent below prior peak levels.[19] As a result, there continues to be opportunities to acquire assets at an attractive basis, with potential upside through asset management, re-tenanting and rolling rents to market, with exit to a J-REIT, once stabilized. Outside of Tokyo, regional Japanese markets offer a 100 basis point spread and equally tight fundamentals.[20]

Asia Pacific industrial rents continue to climb in most major markets, with the fastest growth in Melbourne, Hong Kong and Shanghai. Third-party logistics firms and online shopping fulfillment are driving the market, in addition to global trade and manufacturing. Developing core logistics facilities in major distribution hubs in the developing markets of China and India remains an attractive investment theme, given the growth in the consumer segment, e-commerce penetration and the undersupply of modern fulfilment stock (e.g., China has 17 percent Internet penetration and 0.2 square feet per capita of modern space).[21]

Tourism flows continue to support retail and hospitality fundamentals across Asia. In Japan, the government hit its inbound international visitor target of 20 million visitors four years ahead of its 2020 goal, and has doubled the target to 40 million, with 29.8 million visitors arriving over the last 12 months (March 2018), up 30 percent from the 12 months prior.[22] For China, the number of outbound tourist visits to Southeast Asia increased fivefold from 2006 to 2016, yet just around 10 percent of China's population has traveled abroad.[23] Consequently, hotel fundamentals are strong in the region, with occupancy increasing by 1.5 percent, ADR by 8.2 percent and RevPAR by 9.8 percent (year-over-year, through April 2018).[24]

United States

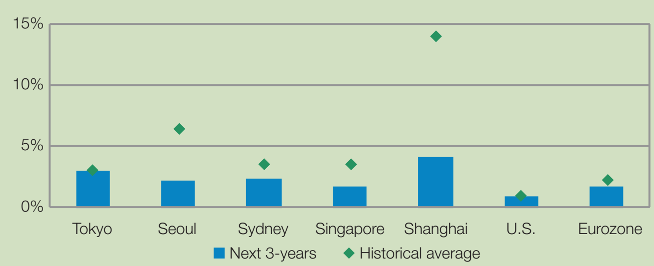
The U.S. economic expansion will shortly become the second longest on record. Rising gas prices, ongoing global trade tensions and interest rate increases may dampen (but are not enough to overcome) the tailwinds from fiscal stimulus and additional authorized government spending.

In terms of growth, following a softer start to the year due to a pullback in consumption in first quarter 2018, a rebound in second quarter 2018 was apparent with 4.2 percent GDP growth, and full-year growth remains on track for 2.9 percent in 2018 and 2.4 percent in 2019. Morgan Stanley Research pegs longer term GDP growth (2020–2022) at 1.2 percent, which includes an implicit assumption that the United States is in recession at some point during that time frame.[25]

Supply in Check Relative to Historic Averages

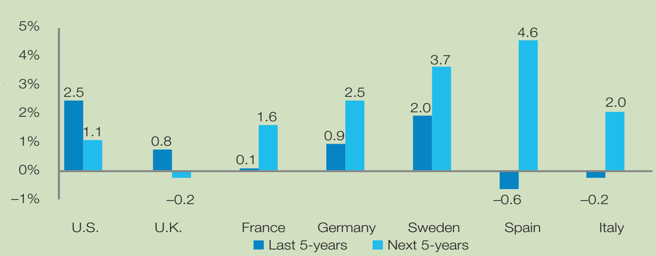
Sources: PMA, MSREI Strategy, as of April 2018

New Construction Below Historical Average



Sources: CoStar, PMA, MSREI Strategy, as of April 2018

Retail Rent Growth Accelerating in Europe

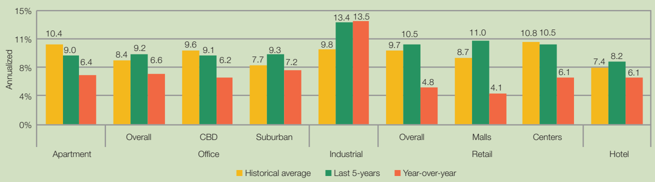


Sources: CoStar, PMA, MSREI Strategy, as of March 2018

Online Sales Penetration Increasing

Sources: Euromonitor, Quantium, ABS, ICSC, Morgan Stanley Research, as of April 2018

Performance by Property Type



Sources: NCREIF, MSREI Strategy, as of May 2018

U.S. investment activity totaled $111 billion in first quarter 2018, down 13 percent from fourth quarter 2017, but up 4 percent from first quarter 2017. Cap rates compressed 50 basis points from first quarter 2017 in the industrial sector. Office and retail sector cap rates were flat, and apartment and hotel sector cap rates rose 10 basis points and 50 basis points, respectively, from first quarter 2017. Trailing 12 -month industrial sector volume rose 29 percent year on year. Cross-border capital totaled $13.6 billion in first quarter 2018, down 1 percent year on year, and accounted for 12 percent of total transaction volume. China's share of cross-border investing rebounded to 31 percent with the first quarter 2018 privatization of Global Logistic Properties.[26]

In terms of property fundamentals, U.S. office markets improved further, as new supply has been constrained by rising construction cost, risk avoidance and banks' reluctance to back speculative developments. Vacancy fell 10 basis points year on year to 10 percent in first quarter 2018, improving most strongly in "Creative" and Class B office spaces. Asking rents have climbed 2.2 percent year on year to first quarter 2018,[27] with slower growth in East Coast core markets (where supply is more abundant) and the strongest growth in Seattle, Oakland and the Southeast. Late cycle/countercyclical markets potentially offer growth opportunities, either repositioning plays where physical product no longer meets market needs or lease-up plays in tighter markets.

U.S. industrial vacancy rates stayed close to their 30-year low, at 4.9 percent in first quarter 2018. Robust industrial absorption continued, at 242 million square feet over the year to first quarter 2018. Demand and annual rent growth of 5.6 percent is supported by increasing e-commerce penetration and associated warehouse requirements for last-mile delivery.[28] The average age of warehouse stock in the United States is 34 years and, in most cases, does not meet the needs of e-commerce tenants. As a result, there are attractive opportunities to build/convert either large regional distribution hubs and/or smaller warehouses serving the last mile and located in population-dense locations to meet robust demand needs. However, supply levels are increasing quite rapidly, which will likely lead to a slowdown in fundamentals in the medium term.

Despite relatively strong consumer fundamentals (U.S. retail spending rose by 4.1 percent over the year to first quarter 2018; consumer sentiment is at its highest point for 17 years; 125,000 new retail jobs created in the June Bureau of Labor Statistics report),[29] the retail sector outlook remains challenged due to e-commerce growth, market-specific demographic challenges and overall market saturation. Significant bifurcation exists between Class A malls, which continue to outperform, and Class B/C/D malls, which are struggling. Several planned Class A mall recapitalizations/sales suggest the best-quality malls in the United States can be valued at a 4.25 percent to 4.5 percent cap rate.[30]

Apartment absorption remained at strong levels relative to long-term trends at 213,000 units over the year to first quarter 2018, while vacancy was level at 6.2 percent.[31] Healthy demand persists, supported by household-formation trends, but new supply continues to be evident, and rent growth has slowed in select markets including Austin, Nashville, Washington, D.C., and New York. A housing shortage in the entry-level segment and distress in the high-end segment may create potential opportunities in the for-sale sector, while Class B multifamily rehab strategies in later recovery markets are also attractive due to affordability issues among renters.

Conclusion

In this cycle, 2018 is shaping up to be the strongest year of economic growth, with synchronicity evident across most major economies. Uncertainty and capital markets volatility have been ratcheted up due to multiple, ongoing geopolitical events across the United States, Europe and Asia. The next several years will likely see higher interest rates and cap rates; lower returns driven by income growth, pockets of illiquidity and distress; and a slowing of capital flows driven by fewer, more selective investment opportunities. Within this investing environment, MSREI believes there will be attractive opportunities to drive net operating income growth through repositioning, retenanting and lease-up strategies, as well as selective development opportunities in sectors aligned to structural trends, such as industrial (e-commerce) and residential (housing shortage). Additionally, acquiring prime quality, cashflowing assets in non-core markets continues to offer an attractive yield spread and growth forecast relative to core markets.

[1]Morgan Stanley Research, *Mid-year Outlook*, May 2018. [2]Ibid. [3]Ibid. [4]Cap Rate Spread is defined as the cap rate over the 10-year government bond yield. [5]Costar, PMA, MSREI Strategy and Research, April 2018. [6]The market cycle positioning framework is the outcome of the use of an internal tool being developed by MSREI based on a consistent set of real estate metrics available on a country-by-country basis. It is aimed to help identify drivers of market performance, market positioning relative to prior cyclical peaks and troughs, turning points and implications for investing strategies. It is updated on a quarterly basis in line with the release of macroeconomic and commercial real estate data. The tool uses a mix of real estate fundamentals and capital markets metrics that are generally available in applicable countries (including rent, occupancy, cap rates and spreads, and liquidity and values metrics). The majority of the metrics are based on "actuals," versus relying on forecast data. Note that other outcomes could result if different inputs or assumptions are made. The market cycle positioning constitutes a "forward-looking statement." Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statement. [7]Morgan Stanley Research, *Mid-year Outlook*, May 2018. [8]Real Capital Analytics, May 2018. [9]PMA, May, 2018. [10]Real Capital Analytics, May 2018. [11]PMA, May 2018. [12]Real Capital Analytics, June 2018. [13]Real Capital Analytics, NCREIF, PMA, MSREI Strategy, data as of June 2018. [14]CBRE, JLL, March 2018. [15]IPD, May 2018. [16]OECD, April 2018. [17]EuroStat, data as of June 2018. [18]Real Capital Analytics, May 2018. [19]PMA, data as of June 2018. [20]Property Market Analysis, May 2018, Real Capital Analytics, May 2018. [21]CBRE, JLL, data as of March 2018. [22]Japan National Tourism Organization data through March 2018. [23]ASEAN, *The Economist*, April 12, 2018. [24]*STR Global Hotel Review*, May 2018. [25]Morgan Stanley Research, *Mid-year Outlook*, May 2018. [26]Real Capital Analytics, May 2018. [27]Costar, May 2018. [28]Costar, May 2018. [29]Morgan Stanley Research, May 2018. [30] Green Street Advisors, June 2018. [31]Costar, May 2018.

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