USAA Real Estate

Could politics divert real estate markets?

The number of political risks that promise to test the nerve of investors is on the rise, and yet real estate continues to attract capital, demonstrating its enduring appeal. One index, which attempts to measure political uncertainty, is running at near historical levels, after rising to just below an all-time high in August 2019.[1] In the United States, geopolitical provocations in the form of contentious elections and escalating trade tensions have the potential to disrupt the economy. In Europe, political uncertainties stemming from Brexit, rising Catalan nationalism, and an upsurge in populism have attracted significant attention. It seems logical that these considerations might persuade investors to adopt a wait-and-see approach, but investors from all over the world remain attracted to real estate. Capital available for deployment into real estate is near an all-time high, and investors continue to target the sector. However, the persistence of uncertainty raises questions about the extent to which political shocks impact real estate markets.

Naturally, rising political uncertainty has investors wondering how real estate will respond, but this is only one of the factors that can influence markets. Others include macroeconomic drivers, technological transformation, and climate change, in addition to global capital ebbs and flows. Many of these factors are interrelated, making it impossible to separate fears of economic slowdown and trade tensions from rising political risks. In spite of these outside forces, real estate markets have remained remarkably stable, with allocations continuing to increase. This also reflects historically low returns in bond markets and uncertainty in equity markets, which contrasts with the stability of real assets.

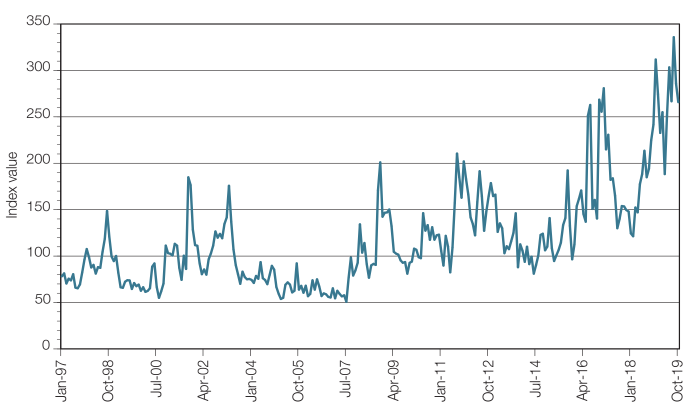
Capital flows

Markets continue to be influenced by several factors; however, a look back at recent political events suggests that real estate markets do tend to react. Concern over Brexit weighed heavily on investment volumes in the lead up to the UK referendum in June 2016. UK investment had moved broadly in sync with the global total, but there was a notable divergence in the lead up to the vote. UK real estate investment declined 50 percent year-on-year in second quarter 2016; for the first six months of the year, the total invested dropped 37 percent year-on-year. Investment fell sharply, and then fell further after the referendum. As with British politics, it has been a bit up and down since. Investor confidence has improved on several occasions, as expectations of a smooth transition have risen. Liquidity has notably declined in UK shopping centers, whereas logistics and alternative sectors have continued to attract significant interest. Reticence towards UK retail is probably more to do with the ongoing structural change across the sector. However, this highlights the range of factors that can impact liquidity.

While it may come as no surprise that Central London was particularly affected (volumes were down 57 percent year-on-year in the first half of 2016), data suggests the investment cycle had probably already peaked in second quarter 2015 and before the vote was announced. Since the vote, London has fallen down on various investment rankings, and yet it has continued to attract capital from outside Europe. For new entrants to Europe's commercial real estate market, London is often the preferred destination. With time and experience and the choice of market changes, however, there appears to be a link between the number of years non-European players have been active in Europe and their target markets. New entrants tend to favor London initially, but players with more years of experience often target Europe's other markets. This has less to do with politics and perhaps more to do with experience and long-term investment strategy.

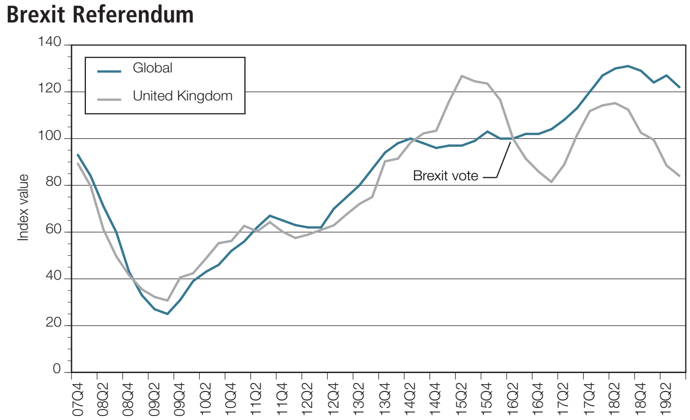
Elsewhere in Europe, there have been similar reactions to political events in other major real estate markets. We saw a similar situation in the run up to the French presidential elections in the first half of 2017. Liquidity was already impacted in first quarter 2017 with volumes down 38 percent year-on-year, but activity resumed within three months after the election. In Spain, tensions between Madrid and Barcelona escalated in the run up to the Catalan independence referendum held 1 October 2017. Liquidity notably decreased in Barcelona in the first half of 2018. This is in stark contrast to Madrid, which recorded its strongest first half on record. Investors' attitudes regarding Catalonia in the immediate aftermath were varied, with some buyers pushing ahead and closing deals, and others opting to put any decision-making on hold. On the sell-side, some vendors also decided to take their product off the market in order to wait for more favourable circumstances.

Exhibit 1: Global Economic Policy Uncertainty Index (GEPU)



Source: EPU

Exhibit 2: Real Estate Investment Volumes — Indexed to June 2016 Brexit Referendum



*Source: RCA. *Rolling four-quarter volumes*

The impact on liquidity in Catalonia was relatively short lived, with the data suggesting activity picked up again in 2018.

Pricing

Rising political uncertainty can also manifest itself on real estate pricing. But identifying the impact is far more complex, due to the fact that real estate yields tend to be influenced by a range of interconnected factors — including monetary policy, economic conditions, international capital flows, rental prospects, as well as bond and equity yields. Conventional wisdom suggests an increase in international capital flows, all else equal, produces a compression in property yields. However, it is probable that foreign investment and property yields are both influenced by a wide range of factors.

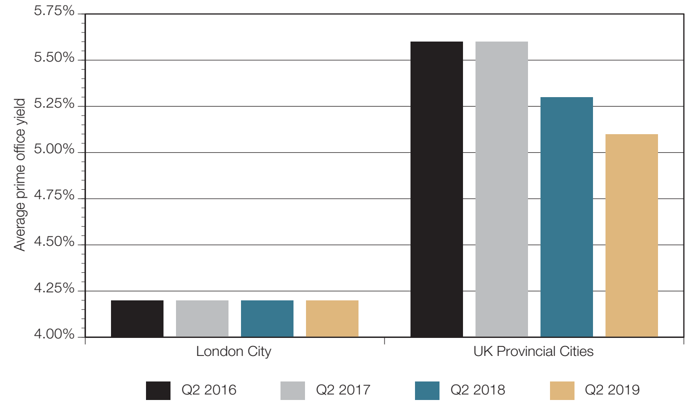
This could explain why, for example, UK property yields have experienced limited movement despite ongoing political uncertainty. Analysis of the UK office market demonstrates that property yields increased only moderately (20 basis points on average) after the EU referendum vote. After the initial shock, markets quickly regained composure. By 2017, office yields for both London City and the UK's key provincial cities had already returned to pre-referendum levels. Sterling's depreciation and talk of foreign capital flooding into the UK almost certainly influenced pricing.

Despite the political situation in Spain, pricing also remained surprisingly stable in the aftermath of the Catalan referendum. Prime office yields in Madrid and Barcelona remained on a par with each other throughout 2017 and 2018. It is only since early 2019 that we have seen the markets begin to diverge, with yields in Madrid compressing, while yields in Barcelona have remained firm. This latest development probably has more to do with increased investment momentum in Madrid, with investment volumes in the first nine months of 2019 reaching a record high. Paris office yields also appear to be less affected by recent political uncertainty. Prime CBD office yields have remained steadfastly low and stable since 2016. This is almost certainly due to the strength of investor appetite for Paris offices, as well as the continuation of low interest rates and growth in cross-border activity, which, as of third quarter 2019, had reached the highest level since 2007.

Conclusions

Widespread macroeconomic and political uncertainty has everyone guessing what cyclical changes we will see in real estate markets, and yet investors remain drawn to the sector. The continuing attraction of real estate over other investment asset classes justifies the enduring appeal. The stability of real estate, and greater

Exhibit 3: Post EU Referendum Prime Office Yields

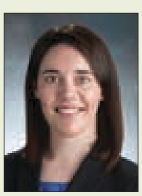


Source: CBRE

institutionalisation of the sector, has led to better access to information and more definable liquidity than ever before. Political uncertainty continues to rumble on and, although this is nothing new, perhaps the biggest challenge for investors is knowing that it will not disappear any time soon. It seems plausible that political events may generate an initial response, but over time, fatigue sets in and investors move on. Given the long cycle of a real estate investment, it is difficult to pinpoint the extent to which weekly headlines are truly impacting in the moment. Analysis of capital flows suggests political events do tend to impact liquidity, but predicting the duration and scale of the impact is difficult. Isolating the impact on pricing is also problematic. Although political concerns provide an uncertain backdrop for real estate investors, their effect on the market is imprecise. Some investors may look at politics and think the market is fraught with risk. But for every cautious investor, there is another investor who associates risk with opportunity. Long-term investors seeking stable income may be more concerned with political instability, versus those with a shorter investment horizon who may welcome the opportunities associated with increased volatility. The fact that markets are so global these days also complicates matters. The impact of something like a US/China trade war is not isolated to these two markets. It manifests itself in wider uncertainty globally. In this respect, the confluence of interconnected factors, rather than politics themselves, may be a better indicator for real estate investors to monitor.

Notes: [1] GEPU (Going back to 1997)

CONTRIBUTOR



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CORPORATE OVERVIEW

USAA Real Estate provides co-investment, acquisition, build-to-suit and development services for corporate and institutional investors, and arranges commercial mortgage loans on behalf of affiliates. The Amsterdam-based operation is actively engaged in developing, acquiring and managing institutional-quality real estate investments, primarily through its Pan-European logistics venture, Mountpark Logistics EU.