Real Estate Outlook

Global overview – Edition 1, 2021

Recovery expected in second half.

UBS Asset Management

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Global overview

Changing mainstream spurs specialist sectors.

The rollout of vaccines gives rise to cautious optimism that the economy will improve in the second half of the year as lockdowns can be lifted. Real estate investment activity has shown some pick-up but remains below pre-pandemic levels. Logistics property remains the focus for the main commercial sectors, with interest in niche and specialist real estate types being driven higher.

Macroeconomic overview

Cautious optimism for strengthening economy.

The COVID-19 pandemic continues to grip the world and weigh on activity. According to the World Health Organization, the total number of virus cases globally passed 100 million in January and the death toll exceeded two million. Extended lockdowns have been enforced across most European countries during the winter months and restrictions are also in place in the US. Asia Pacific is further ahead in the recovery and returning to more normal life in many parts, although some localized lockdowns have been needed to combat the virus, such as in Sydney, Australia.

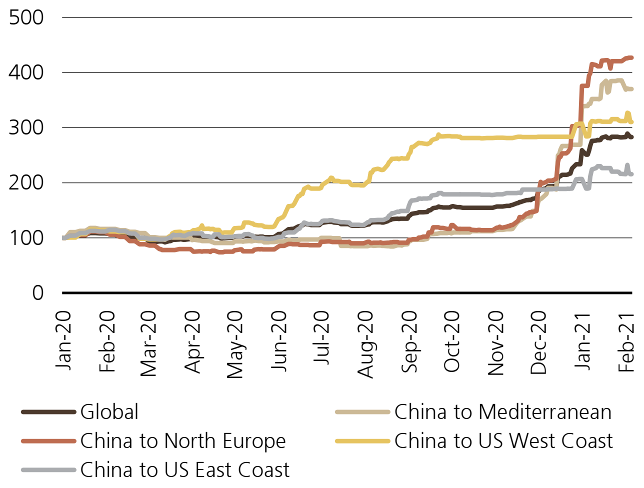
The rollout of vaccines began in late 2020, with three vaccines being used for the initial immunizations in western countries. The pace of the rollout has varied, with the UK and Israel leading the way, followed by the US. Other European countries have lagged due to delays in placing orders for vaccines last summer. There have also been some supply bottlenecks in the vaccine production chain, such as facilities being re-configured to ramp up production. These delays are not unexpected, but have stoked political tensions around the vaccine rollout.

Economies weakened in 4Q20 as new lockdowns hit activity and business surveys show many remained weak moving into 2021. Government statistics agencies reported that US GDP expanded 1.0% QoQ in 4Q20, eurozone GDP fell 0.7% QoQ while, according to estimates by Oxford Economics, Chinese GDP rose 2.9% QoQ. Arguably, the position of economies versus their pre-pandemic levels of activity is a better gauge of their underlying health. On this basis, US GDP was down 2.5% in 4Q20 from 4Q19, eurozone GDP was 5.1% lower while the Chinese economy was 6.5% larger. For the advanced economies, Oxford Economics estimates that GDP was 3.4% lower.

Weak economies and the precipitous drop in demand saw inflation tumble in 2020. Indeed, it turned negative in Australia and the eurozone, with a strong euro compounding downward pressure on prices in the single currency bloc. More recently though, some pockets of price pressure have been evident in the world economy. For example, global shipping costs have surged. According to media reports, shipping agents have said that the cost of transporting a 40-foot container unit from Asia to northern Europe has risen from around USD 2,000 in November to USD 9,000 in January. This has been mirrored in shipping cost indices (see Figure 1).

The sharp increases in shipping costs are due to stronger demand and a shortage of capacity on routes from Asia to Europe and North America. Empty containers were not returned to Asia once the pandemic struck and are scarce there now. Ports and shipping lines have also had their operations impacted by workers being unable to work due to the virus. The surge in prices looks unlikely to recede until later in the year when the industry has had a chance to normalize and clear the backlog. Prior to the crisis, shipping lines reported excess capacity in the industry.

Figure 1: Freightos Baltic index of shipping costs
(1 Jan 2020 = 100, USD)



Source: Thomson Reuters Datastream; UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

The rise in shipping costs serves as a reminder of potential inflationary pressures. Energy and commodity price inflation will also likely move higher as prices rebound from crisis lows. However, inflation prints remain below target. Statistical agencies report that eurozone inflation rose to 0.9% in January, ending five months of deflation, and US inflation was 1.4%. Japan remained mired in a mild deflation of -1.2% in December. If the economy improves as expected, rising demand will likely exert some upward pressure on prices. Hence some increase in inflation is likely, but not the kind of spike or sustained rise which might prompt central banks to unwind their QE programs and raise interest rates aggressively. Such a scenario is a risk for real estate investors.

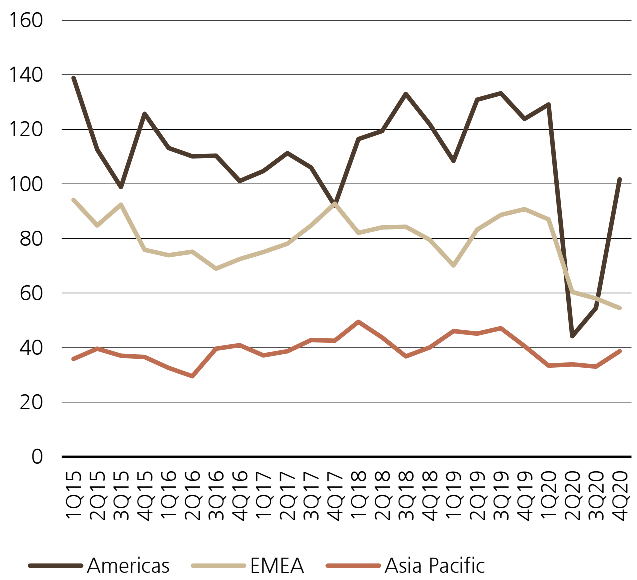
Capital markets

Some recovery in transaction activity.

Real estate investment activity varied by region in the second half of 2020. Having fallen sharply as the pandemic hit, transaction activity has started to recover in the Americas and Asia Pacific, while remaining weak in EMEA. This broadly reflects trends seen in the economies and the level of restrictions being imposed. According to Real Capital Analytics total global investment activity was USD 726 billion for 2020, down 28% from 2019. Despite the pandemic, all regions saw the usual sharp seasonal pick-up in activity in the last quarter of the year as investors completed deals before year-end.

After allowing for seasonal effects, the Americas showed a sharp pick-up in underlying activity in 4Q20 and Asia Pacific also rose, albeit by less. However, transactions in EMEA fell again, reflecting tougher lockdown restrictions in the region which impinged on activity (see Figure 2). Compared to 4Q19 pre-pandemic levels of activity, 4Q20 investment volumes were just 5% lower in Asia Pacific, 17% lower in the Americas, while EMEA lagged, where activity remained down by 40%.

Figure 2: Real estate transaction volumes (ex-land sales)
(USD billion, seasonally adjusted)



Source: Real Capital Analytics; UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

There were significant differences by sectors. Other than hotels, at the global level all the main sectors showed a rise in activity in 4Q20, after allowing for seasonal effects. Compared to 4Q19, office investment volumes were down 34%, retail volumes down 30% while industrial volumes were little changed with a 3% drop. The resilience of industrial reflects strong investor interest in the sector. Apartment volumes were 6% lower while hotels remained very subdued, down 76% from their pre-pandemic level. The fall will have been exacerbated by declines in asset values too.

On the basis of valuations data released so far by MSCI and NCREIF, for Canada, Ireland, the US and the UK, office capital values showed single-digit falls for 2020 overall. In addition, retail values showed larger, double-digit falls, while industrial capital values showed single-digit increases. At the global all property level, we estimate that real estate values fell 2-3% in 2020 on a valuation basis. This would give a small positive total return on global real estate for the year. Capital values have held up well in the context of the Global Financial Crisis (GFC) when, according to our series based on MSCI and NCREIF data, they dropped 9% in 2008, the first year of the downturn. We attribute the current resilience to the swift and sizeable support from governments and central banks in 2020.

Large sector differences remained in pricing in the last quarter of the year. According to cap rate and yield data from CBRE, NCREIF and PMA office yields were generally flat, with slightly more markets reporting falls than rises. Retail yields continued to increase, up in 42% of markets and flat in nearly all of the remainder, while industrial and logistics yields fell en-masse, dropping in 54% of markets, and remained flat in the bulk of the rest. Pricing adjustment to the pandemic will take time to feed through the market and further price adjustment is likely in 2021.

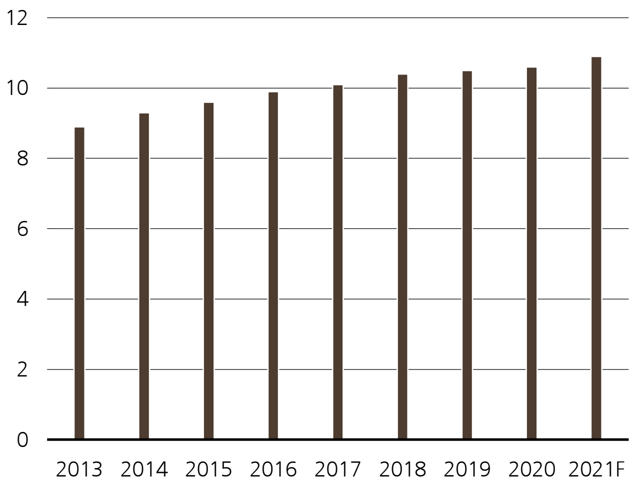
The listed market continues to reflect the sector differences seen in private real estate markets. According to FTSE EPRA NAREIT listed market data, by the end of January global industrial prices were 14% above end-2019 levels in USD terms, residential down 5%, offices down 20% and retail down 27%. At the country level there was less variation, with falls of around 15% in the markets of the US, Europe excluding the UK, Japan and Switzerland. Prices in the UK showed a slightly sharper fall, down 20% since end-2019, but having recovered from the lows hit when the pandemic struck last spring. The bigger fall in UK values reflects a relatively high exposure to the badly hit retail sector.

Strategy viewpoint

Focus on niche and specialist real estate.

The rotation to interest rates near zero around the world has been supportive of all risk assets. Indeed, investors also continue to be attracted to real estate because of its ability to generate income. For example, the 2021 ANREV/INREV/NCREIF Investment Intentions Survey reports that globally investors are targeting an allocation to real estate of 10.0% versus their current average allocation of 9.3%. Similarly, Hodes Weill & Associates's 2020 Institutional Real Estate Allocations Monitor report states that globally investors targeted a 10.6% allocation to real estate in 2020, which is expected to rise to 10.9% in 2021. The target has risen steadily from 8.9% in 2013 (see Figure 3). The rise reflects a gradual adjustment of investor portfolios to the low interest rate environment, and the improved accessibility of real estate as an asset class as new investment routes into it have become available.

Figure 3: Target allocations to real estate (%)



Source: Hodes Weill & Associates, December 2020

Investors looking to increase their real estate allocations must carefully consider their strategy. In the mainstream traditional sectors of office, retail and industrial very different trends are playing out now. There is significant uncertainty over offices. First, it is unknown how long the pandemic will last and keep large swathes of workers from using the offices that their employers are paying rent for.

Moreover, there is significant uncertainty over the impact that more flexible working arrangements will have on offices in the medium-term once the pandemic has passed. In retail, we expect further falls in capital values as structural change and the rotation to online drastically alter the retail landscape. Hence, for offices and retail the investment opportunities which exist will likely be asset specific. By contrast, at the market level we expect industrial and logistics to perform well, fueled by strong occupier demand pushing rents higher and heightened investor demand compressing yields. Multifamily also presents an option in markets where it is an institutional asset class.

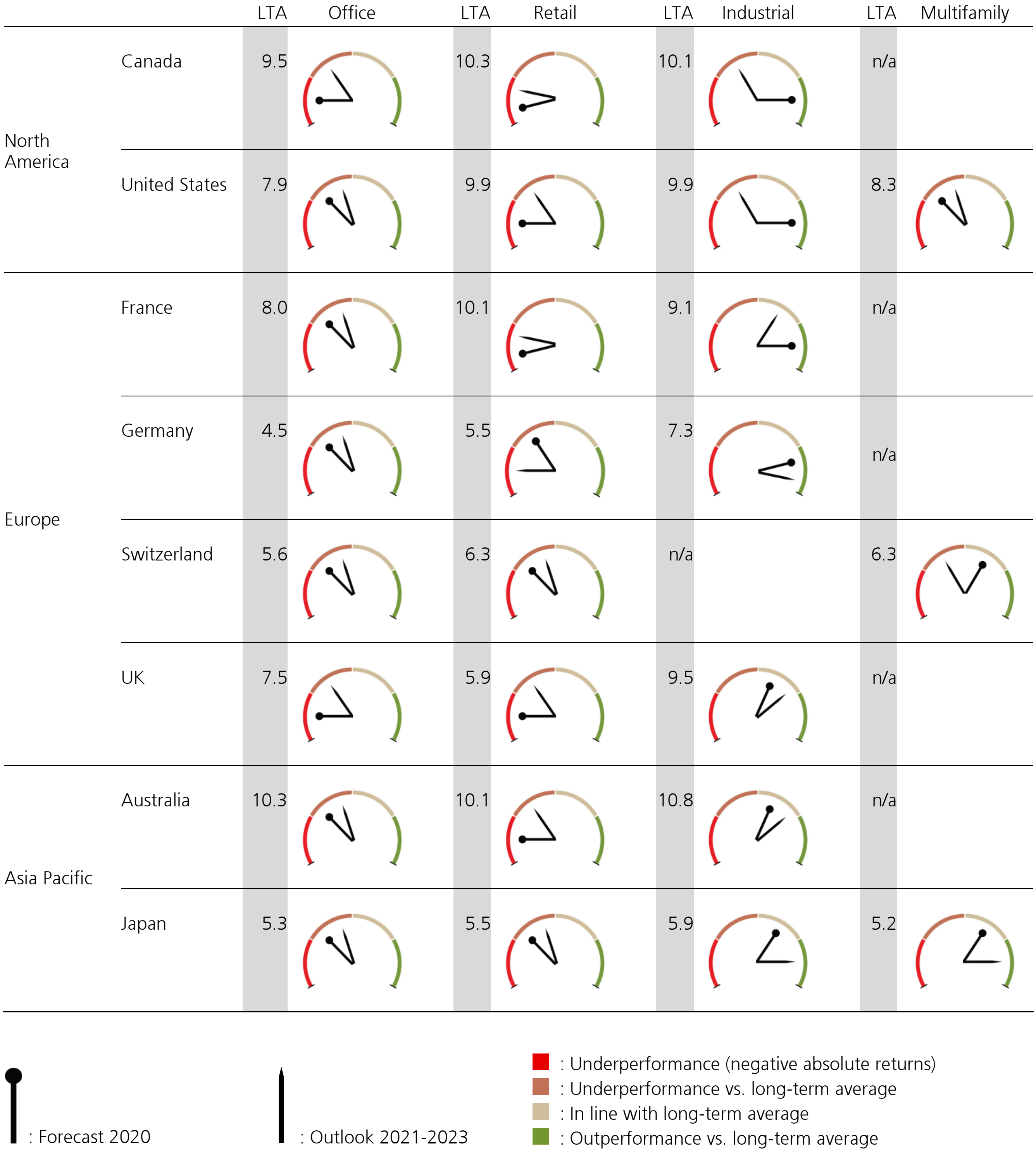
Outside of the mainstream, investors will need to focus on niche and specialist sectors which have the potential to grow and deliver good investment performance. This includes areas such as data centers, lab space, medical offices and affordable housing. When investing in these more specialist areas investors will need to carefully consider their entry route and ensure that they are partnering with an advisor or manager who has the specialist knowledge and skills required to be successful when operating in these sectors.

Another potential area for investors to look at is pockets of distress in the market which lead to properties becoming available at discounted prices. So far though, we have not seen high levels of distress in the market resulting from the pandemic. However, typically it can take two years or so for distressed assets to work their way through the system, and given that retail values only really started to decline in earnest in some markets last year, distressed opportunities may not appear until 2022. Distressed sales typically occur when loan covenants are breached or investors need to sell rapidly for liquidity reasons.

Along with deploying capital to increase their allocations to real estate, investors will also be mindful of what will happen if inflation does pick up. We believe that real estate offers a partial hedge against inflation since in many cases rents within leases are indexed to an inflation measure and in the longer-term open market rents have tended to keep pace with inflation. Hence on the income side real estate is attractive, particularly assets with long, inflation-linked leases. The other aspect of higher inflation is its potential to prompt central banks to reduce liquidity, scale back QE programs and increase interest rates. This would likely push discount rates higher and weigh on all risk assets, real estate included. However, for central banks to move they would need to see a sustained and enduring pick-up inflation rather than a transitory increase which is partly driven by base effects.

Real estate investment performance outlook

2020 forecast and 2021-23 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 2020 forecast or the 2021-23 outlook.



		LTA Office	LTA Retail	LTA Industrial	LTA Multifamily
North America	Canada	9.5	10.3	10.1	n/a
	United States	7.9	9.9	9.9	8.3
Europe	France	8.0	10.1	9.1	n/a
	Germany	4.5	5.5	7.3	n/a
	Switzerland	5.6	6.3	n/a	6.3
	UK	7.5	5.9	9.5	n/a
Asia Pacific	Australia	10.3	10.1	10.8	n/a
	Japan	5.3	5.5	5.9	5.2

Source: UBS Asset Management, Real Estate & Private Markets (REPM), February 2021. Note: Abbreviation LTA: long-term average. Past/Expected performance is not a guarantee for future results.

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