Real Estate Outlook

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Challenging times.

UBS

UBS Asset Management

Content

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Global overview

Reaching new altitudes.

The economic recovery continues, albeit interrupted by Omicron, and the war in Ukraine poses a new risk. Global real estate volumes reached a record high, driven by domestic buyers. Falls in office and retail yields were more widespread. We think that any headwinds from interest rate rises will be offset by growth in the economy.

Market overview and outlook

Strong domestic markets spur record volumes.

The global economy continues its recovery from the pandemic. However, the rebound has been uneven and interrupted, most recently by the Delta and Omicron variants of COVID-19. Omicron saw the re-introduction of some restrictions which impacted economic activity around the new year and in early 2022. Nevertheless, restrictions look set to ease, which should allow economic recovery to continue. The war in Ukraine poses a new risk and has hit confidence, financial markets and energy prices. It also looks set to have a knock-on effect on energy supplies to Europe. The exact medium-term impact will depend on how far relations between western countries and Russia deteriorate.

A year ago, the consensus expectation and our view at the time, was that inflation would temporarily rise but then subside. This narrative has proved wrong as inflation has accelerated to multi-decade highs around the world, with readings of 7.0% in the US and 5.0% in the eurozone in December. Again, we expect inflation to slow over the coming year as price pressures ease, but think risks lie firmly on the upside. There is some evidence that wage growth is also accelerating, which could sustain high inflation.

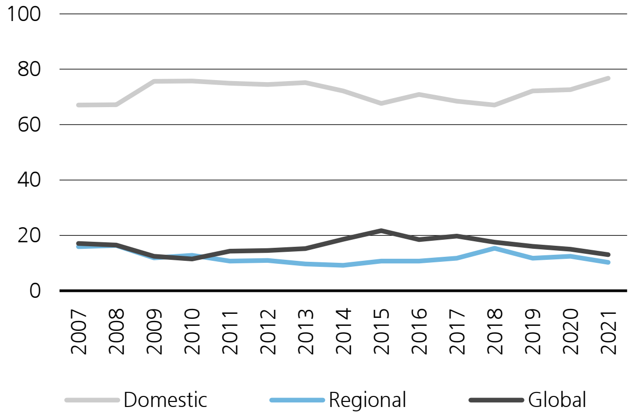
In the medium-term, we still expect inflation to return to target. The key question is whether this will be achieved by a soft landing or whether central banks, intentionally or otherwise, will push the economy into a sharper slowdown or even recession. Central banks are behind the curve and have become much more hawkish, with four or more rate hikes now expected by the Fed in 2022, along with a balance sheet reduction. Even the ECB seems to be opening the door for a rate hike, with markets expecting it to succumb by year-end.

The global real estate investment market had a strong year in 2021. According to Real Capital Analytics, global investment volumes reached a record USD 1.25 trillion, up 58% from 2020 and 22% from 2019. However, office and hotel volumes remained at or below 2019 levels, while retail volumes were little changed. It was industrial and residential which drove growth, with both at record shares of the total, and combined accounting for 57%. Strong underlying activity and price growth relative to offices and retail boosted their shares.

Travel restrictions continue to weigh on cross-border transaction activity as they prevent purchasers from conducting the necessary due diligence and visiting assets. This pushed domestic capital to account for a record 77% of global investment volume in 2021 (see Figure 1).

By contrast, regional capital accounted for just 10% of volumes, the lowest share since 2014. While global capital sources, coming from outside the region where the assets are located, accounted for just 13% of activity, the lowest since 2010. Once travel restrictions eventually ease on a sustained basis, we expect the cross-border share to pick up again.

Figure 1: Share of global investment volumes by source of capital (%)



Source: Real Capital Analytics, February 2022. Past performance is not a guarantee for future results.

Declines in real estate cap rates and yields were more widespread in 4Q21 and reported across more office and retail markets. Yields fell in 35% of the office markets we monitor and 25% of retail markets, while strong downward momentum continued in industrial, with yields falling in 63% of markets. Rises in yields and cap rates were few and far between, with increases recorded in just 4% of retail markets and even lower shares for offices and industrial. With the interest rate environment changing, we think impetus for further falls will fade.

Investment performance was strong in 4Q21, with the US and UK markets recording particularly strong returns. According to NCREIF, US total returns were 18% in 2021, while according to MSCI UK total returns were 16%. In both markets, it was outsized performances from industrial which powered the all property result, with US industrial recording a massive 43% total return for the year and 36% for UK industrial. Office and retail returns were around 5%, apart from UK retail, which recorded a 10% total return as the market bounced back.

Strategy viewpoint

Growing economy to offset higher rates.

The outlook for real estate is closely linked to that for the broader economy. We have discussed the interlinkages previously on many occasions. Overall, we see what's happening in the economy, interest rates, use of leverage and the level of development activity as the key drivers of real estate performance. With regard to inflation, we think that real estate provides good, albeit imperfect, inflation protection for investors. Thus, at the current juncture, with inflation at multi-decade highs and heightened uncertainty over where it's headed, we think real estate is attractive for investors.

A key question now is how this mix of performance drivers will evolve over the next 12-24 months and what impact they will have on real estate performance. At the global all property level, we estimate that a one percentage point rise in 10-year government bond yields knocks 5% off real estate capital values after three years. Hence, interest rate and bond yield rises only affect real estate values with a lag. Additionally, we estimate that 1% growth in the economy in any given year pushes global real estate capital values up by 2% in that year.

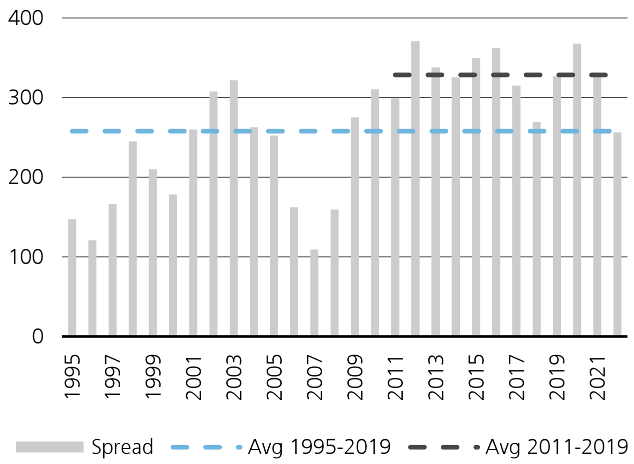
Oxford Economics forecasts that global bond yields, on an annual average basis, will rise by around 50bps each year over 2022 and 2023. This implies a downward drag on real estate values of around 2% p.a. in 2025 and 2026. Provided the economy is growing by 1% each year, the cooling impact on real estate capital values should be offset by economic growth, supporting higher occupier demand and rental levels.

Moreover, across the 23 global markets in our analysis, Oxford Economics forecasts that the economy will be growing by around 1.5% in both 2025 and 2026, more than enough to offset the drag from higher bond yields. Overall, it implies growth in real estate capital values of around 1-2% p.a. over 2025 and 2026, assuming that development activity remains balanced. We expect this to be the case given developers are much more cautious now than prior to the Global Financial Crisis (GFC), when large amounts of speculative development activity contributed to a real estate downturn.

Another factor that is positive for real estate investors is spreads with bond yields that are slightly above their long-term average. We estimate that in 2021, the spread between the income return on global real estate and the annual average of the 10-year government bond yield was 330bps. This is 70bps above the average of 260bps between 1995 and 2019.

Our latest forecasts are for the spread to fall to the long-term average in 2022 (see Figure 2). Spreads in 2021 were around the post-GFC average over the period 2011-19 of 330bps. In 2022, we expect the spread to fall slightly below the post-GFC average.

Figure 2: Spread between global all property income return and 10-year government bond yield (bps)



Note: Includes 23 countries globally; 2021 and 2022 are forecasts.
Source: MSCI; NCREIF; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), February 2022. Past performance is not a guarantee of future results.

In the decade following the GFC, interest rates were at record lows and spreads were higher than before. The real estate sector also matured, becoming more global and accessible for investors as new ways and vehicles to enter the market became available. Allocations to real estate rose as investors' need for higher returns saw them switch from low risk and lower – even negative – yielding government bonds, to slightly higher risk but also higher returning real estate.

Now that interest rates are set to rise, it is fair to ask whether this process will reverse. We think that moving from higher returning real estate back into lower risk government bonds is a different proposition from the initial switch. Indeed, we expect there to be an asymmetry and that capital that has flowed into real estate will be sticky. Moreover, investors report that they want to increase their allocations to real estate and Preqin reported that as of February 2022, a record USD 400 billion of equity capital was targeting global real estate.

Real estate investment performance outlook

2021 forecast and 2022-24 outlook are measured against the country-sector's long-term average total return, with the average +/- 100bps described as "in line with long-term average." The long-term average refers to the period 2002-20. The red underperformance quadrant refers to negative absolute total returns, either in 2021 forecast or the 2022-24 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multifamily
North America	Canada	8.9		8.7		10.2		n/a	
	US	7.5		8.9		10.0		7.9	
Europe	France	7.7		9.3		9.3		n/a	
	Germany	4.7		5.3		7.7		n/a	
	Switzerland	5.6		6.2		n/a		6.3	
	UK	7.0		4.8		9.5		n/a	
Asia Pacific	Australia	10.0		8.9		11.0		n/a	
	Japan	5.2		5.4		6.0		5.6	

: Forecast 2021

: Outlook 2022-24

: Underperformance (negative absolute returns)

: Underperformance vs. long-term average

: In line with long-term average

: Outperformance vs. long-term average

Source: UBS Asset Management, Real Estate & Private Markets (REPM), February 2022. Note: Abbreviation LTA: long-term average. Expected / past performance is not a guarantee for future results.

Fergus Hicks
Real Estate Strategist

APAC outlook

The hardest climbs look challenging until conquered.

The economic recovery has been choppy, while inflation has risen across the region. Central banks have moved to tighten policy, but we don’t think this will significantly impair real estate performance. APAC investment activity hit a new record in 2021 and cap rates were flat or fell in the last quarter. Occupier markets were generally healthy and should be buoyed by economic growth in 2022.

Market overview and outlook

APAC investment activity reaches new peak.

APAC economies continue to experience a choppy recovery from the pandemic. Just as the impact of the Delta variant of COVID-19 was subsiding, the Omicron variant emerged to hit activity in the run-up to year-end. Growth is expected to have been curbed in 1Q22 as well, before resuming the recovery phase. Despite Omicron, the main APAC economies are thought to have regained their pre-pandemic levels of output during 2021. The only exception is Japan, where Oxford Economics thinks GDP remained slightly below its pre-pandemic level in 4Q21 and is not expected to recover it until 2Q22.

Mirroring the global trend, inflation has accelerated across the region, although not to the same extent as in the US. New Zealand has the highest inflation rate of the main APAC economies, at 5.9% in December. The policy picture is varied. The People's Bank of China has cut some interest rates and reduced bank reserve requirements to cushion the economy from the housing market downturn. While the Chinese government is expected to provide support by increasing infrastructure spending as it focuses on the quality of growth.

In Australia, the central bank moved to tighten policy by ending its asset purchase program, but interest rate rises are not expected until towards the end of 2022. The Monetary Authority of Singapore has also tightened policy while interest rates in Hong Kong are dependent on the US given its currency peg, and thus expected to rise over the course of 2022. Meanwhile, South Korea led global policy tightening, with two rate hikes in 2021, and more expected in 2022. We do not think that higher rates will be significantly detrimental to real estate performance provided economies keep growing.

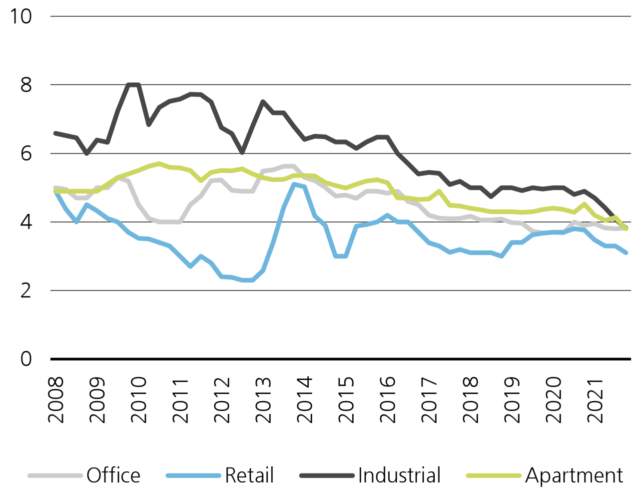
In the office sector, occupiers are looking to position their estates for the new and emerging hybrid working environment. Office net absorption across APAC recovered strongly in 2021, up 40% YoY according to CBRE, but remained slightly below 2019 levels. In addition, grade A office rents were mixed in 2021. In 2022, any rental declines are expected to be limited, like in Tokyo, while office rents are forecast to rise in some markets, including Singapore, Auckland, Melbourne and Sydney. The facilities and locations of offices will be of particular importance in driving rental growth and for occupiers in their quest to attract talent.

The retail market continues to be affected by COVID-19 restrictions as well as restricted or banned international travel. China and Hong Kong stand apart as keeping strict zero-COVID-19 polices. Some retail markets are turning the corner though. According to CBRE, Hong Kong prime high street retail rents showed modest growth of 4% in 2021. While in Australia prime shopping center rents were flat. The emphasis is on experience, brands and blending online and physical channels.

The industrial and logistics sector continued to perform strongly. According to CBRE data, rents rose across most APAC markets in 2021 and are expected to show further growth in 2022. However, rental growth is expected to slow in some markets, such as Greater Seoul as more new supply comes online. Prime assets near major consumer markets or transportation hubs are expected to perform best.

Yields and cap rates were typically flat or fell in 4Q21, with further sharp declines reported in the industrial and logistics sector where cap rates fell to record lows (see Figure 3). Real Capital Analytics reported that APAC investment volumes topped USD 200 billion for the first time in 2021, up 22% on 2020 and 10% from the previous record set in 2019. The industrial and retail sectors saw the strongest rises in activity compared to 2020, of 48% and 41% respectively.

Figure 3: Asia Pacific top quartile cap rates
(12-month average, %)



Source: Real Capital Analytics, February 2022

Strategy viewpoint

Investors target industrial for 2022.

At the start of the new year, investors often re-evaluate their portfolios and positioning for both the short and long-term. The new year also brings investor surveys which give insights into investor thinking and strategy. 2021 saw a strong but polarized performance in APAC real estate markets as investors had to navigate through the ongoing pandemic, with uncertainty prevailing over the mainstream office and retail markets. This made for a crowded logistics market and investors increasingly looked to residential, specialist and niche sectors. Moving into 2022, portfolio positioning will increase in importance, as investors grapple with the outlook for interest rates and inflation.

Encouragingly, this year's surveys show that investors are placing increased importance on ESG matters. ANREV's *Investment Intentions Survey 2022* reported that prior to investing in non-listed funds, 100% of APAC institutional investors considered whether the fund promotes ESG investments. 88% of respondents considered whether the fund has a commitment to net zero carbon, and 81% considered whether the fund had an established diversity, equity and inclusion (DEI) program. Indeed, from all the global investors surveyed and averaging across the three areas, those based in APAC placed the highest importance on ESG matters. This was boosted by the dominance of Australian investors in the survey and their long experience of focusing on ESG factors.

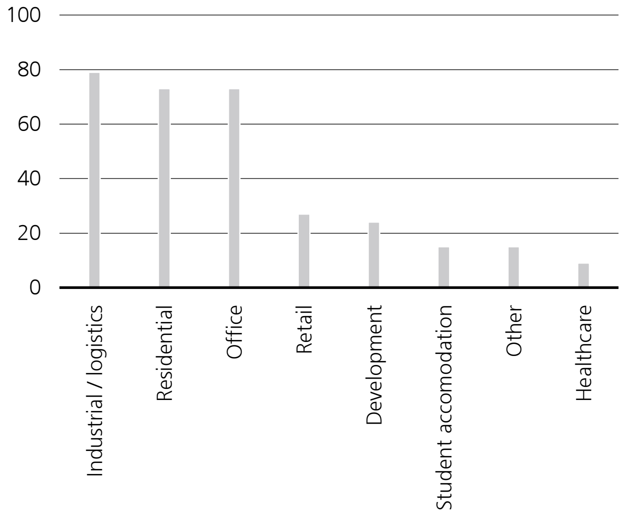
CBRE's *2022 Asia Pacific Investor Intentions Survey* also reported that investors are increasing their emphasis on ESG. More than 40% have already adopted ESG criteria, just above 10% said they will adopt ESG criteria over the next three to five years and just over 30% are considering adopting ESG criteria within an unspecified time frame. This leaves just over 10% of investors saying that they are unlikely to adopt ESG criteria. However, with ESG credentials becoming ever more important, it seems likely that these holdouts will also eventually embrace ESG.

Investors can target sustainability credentials by purchasing green buildings or retrofitting old buildings to enhance energy efficiency, water usage and wellness. The retrofitting of older buildings is particularly important for improving sustainability and reducing the carbon footprint of real estate, but also a big challenge. The CBRE survey reported that the three main priorities of APAC companies' ESG strategies are enhancing brand image and gaining certifications (such as GRESB), protecting the future value of real estate assets and the environment.

As well as highlighting the growing importance of ESG for investors, the investment intentions surveys also provide an insight into investors' views on the market. The ANREV survey reported that APAC was the favored region for investors from around the world, with 70% expecting to increase their allocations to the region and core being the preferred investment style. By contrast, CBRE reported value-added as being slightly preferred to core. The ANREV survey cited the top three cities for investment into APAC remaining as Tokyo, Sydney and Melbourne, while CBRE reported the top three as Tokyo, Shanghai and Singapore. Hence, Tokyo stands out as featuring in the top three of both surveys.

In terms of sector allocation, both surveys reported industrial and logistics as the preferred sector for investors, who are expecting that the sector's strong performance in 2021 has further to run (see Figure 4). Offices and residential were in the second and third spots. In the alternatives space, CBRE reported that data centers, cold storage and healthcare were investors' preferred sectors. A smaller share of investors were interested in real estate debt, which was lower than in 2021. Though, sentiment is likely cooling due to debt defaults in the Chinese residential sector. Overall, the appetite for real estate looks set to remain strong, with investors globally currently being a percentage point below their 10% allocation target.

Figure 4: Preferred sectors for 2022 investments in APAC
(% of respondents)



Source: ANREV, January 2022

Zachary Gauge
Head of Real Estate Research
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European outlook

Uncertain months ahead.

Just as the COVID-19 pandemic appeared to be behind us, a war has started as Ukraine was invaded by Russia. We are not anticipating significant direct impacts on the European property market outside of CEE. However, the indirect impacts of higher energy costs and weakened business confidence may slow the economic recovery. Historic evidence suggests property pricing usually remains stable during crisis events unless accompanied by a major economic downturn.

Market overview and outlook

Moving from one crisis to a war.

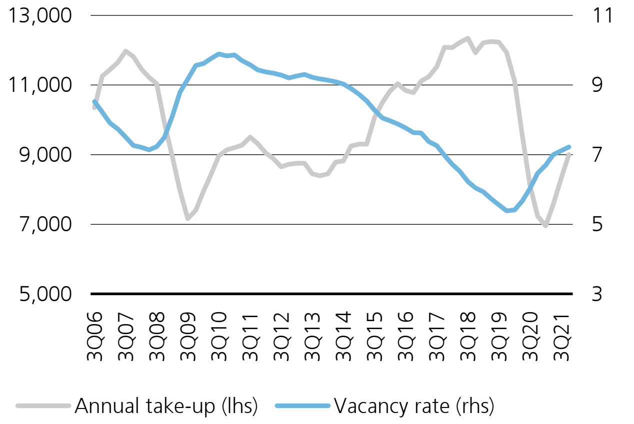
Economy

Europe was already grappling with inflation at the highest level in decades before Ukraine was invaded by Russia, and with energy prices set to continue to rise during the course of 2022 this will place further pressure on consumer confidence and spending power. Business investment may also be eased back in-light of the heightened uncertainty and geopolitical risks, and energy intensive industries will suffer disproportionately. New conflict zones will disrupt supply chains further and the cost of shipping will rise in-line with higher oil costs.

European growth was forecast to be significantly above trend in 2022 as markets are still catching-up the lost ground from the COVID-19 pandemic, and whilst we don't anticipate growth reversing as a result of the war the pace of growth is likely to fall back, particularly if the war is protracted over the course of the year. Central banks may look past the higher inflation and reduce expectations for future rate rises to avoid placing further pressure the cost of living, which would provide some support for both private and public asset pricing.

Despite the escalation, we expect the direct impacts of the war in Ukraine on commercial real estate to be limited. Investors may show increased hesitancy on Baltic markets and Central and Eastern European markets closer to the Russian sphere as higher risk is priced into valuations. More broadly, there may be some impact at the super-prime end of the residential market in key cities where wealthy Russian individuals have acquired assets which could be frozen, but this is not going to impact the wider residential market.

Figure 5: European office take-up and vacancy rate
('000 sqm, %)



Source: JLL, 4Q21

Occupier markets

The fourth quarter of 2021 showed some further positive signs of recovery in European office markets, with take-up recording its strongest quarter since the pandemic and the pace of increase in vacancy rates continuing to slow (see Figure 5). We still expect occupiers to take a more active approach to future space requirements in 2022, as new working patterns become more consistent.

This will only benefit the buildings in the market which are compatible for post-COVID-19 occupation. For example, in Central London 90% of take-up in 2021 was for Grade A space. The remaining part of the market will need to see significant capex, and for assets in weak locations obsolescence rates are set to accelerate.

The prime retail occupier markets continued to show signs of stabilization, with just the UK seeing rental declines in 4Q21. Amsterdam even recorded a marginal (2% QoQ) recovery according to JLL data. However, weakness persists in secondary pitches and shopping centers remain challenged across the continent. Logistics markets are more buoyant with a handful of markets recording prime rental growth in 4Q21. Though, it is questionable whether the rental growth levels will justify the ultra-low entry yields. With inflationary cost pressures coming from all angles, the willingness or ability of logistics operators to pay ever high rents will be tested in the coming quarters.

Capital markets

A significant amount of capital has already been earmarked for deployment into European real estate this year and we think the majority of that capital will still be deployed, although there may be some more caution in the coming months and deals could take longer to complete. At this stage, we would not anticipate significant movements on the pricing side. Looking at historic crisis events, there is very little evidence to suggest there is a direct impact on property yields where the event has not been accompanied by major economic challenges. There is, in fact, some evidence that core property is seen as a safe haven asset during times of crisis and yields have moved in. Whilst pricing may prove to be resilient, lenders are likely to require higher spreads to reflect the heightened risk premia and general negative sentiment in financial markets.

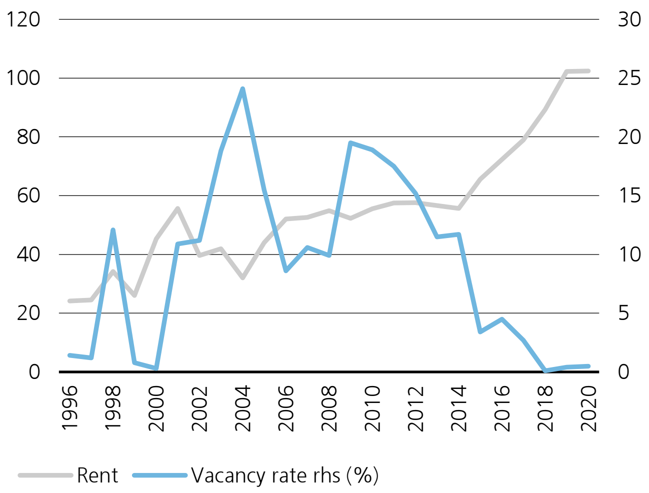
European life sciences poised for growth.

Fad or long-term growth opportunity?
It is no coincidence that the surge in interest in life sciences real estate in Europe emerged during the first major global pandemic in over a century. But as the pandemic (hopefully) fades away, will this emerging sector also run out of steam?

To enter into a relatively niche and extremely competitive real estate market, it is essential that the underlying occupier fundamentals will repay the risk with consistently high-income growth during the holding period. Essentially, the supply and demand balance need to be completely optimal to either justify development risk, or ultra-low yields for existing assets. Life sciences real estate demand is relatively unique as it has a clear correlation with VC funding coming into the sector.

After companies receive the funding, they have a relatively short window (on average less than a year) to take on new space to facilitate additional R&D or manufacturing of treatments. This is net demand for new space, rather than churn which predominantly drives the traditional office market.

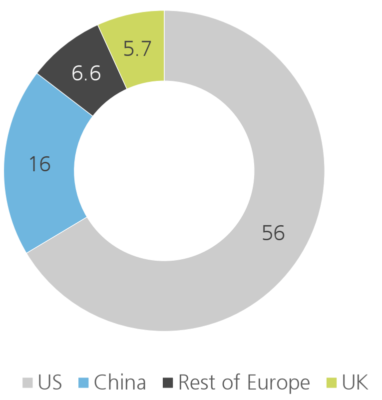
Figure 6: Lab space rent and vacancy rate in East Cambridge, US (USD/sqft, %)



Source: JLL Lab Market Overview, August 2020

The consequence of the weight of funding going into the sector is that companies generally do not release space back onto the market. They grow rather than relocate. And as life sciences companies' real estate requirements are very specific in terms of location and design, the supply of space in any life sciences cluster can run down very quickly. Even in mature markets such a Boston where there are specialist developers, they cannot keep pace with demand, keeping availability near 0%. (see Figure 6). With so few options for expanding companies, double digit rental growth (% y/y) has been achieved.

Figure 7: 1Q-3Q21 VC life sciences investment (%)



Source : JLL, September 2021

Europe is still a very different market to the US. Even with an increase in interest, the VC capital going into European companies in 1Q-3Q21 was just 22% of the US total (see Figure 7). But there is a clear trajectory of more funding targeting companies based around the top R&D universities in Europe. Whilst the sector is high on everyone's agenda, there are few specialist players with the track-record to deliver the right space for occupiers under a strict timeline.

This creates a window of opportunity to pre-emptively follow the funding capital, and target markets in Europe where there is a particular hub of excellence in one area of bioscience research. These are not necessarily in the largest traditional office markets, and we foresee better opportunities emerging outside of the crowded core markets where even traditional office yields are at record low levels.

Better long-term returns can be achieved by focusing on the growth trajectory of the underlying companies which, for bioscience research, are often outside of the core cities. In these locations, there is a more attractive entry yield and long-term prospects to work with key occupiers in the market to deliver the much-needed real estate to support their innovative health research.

Kurt Edwards
Head of Real Estate Research
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US outlook

Grab the skis: powder day!

Anticipated economic slowdown is driven by diminishing fiscal stimulus, the spread of the Omicron variant, and expected hikes in the Fed funds rate. Despite these headwinds, lessening supply chain disruptions, and continued recovery of employment are expected to support growth this year. At the market level, we anticipate strong industrial and apartments returns but modest performance for office and retail as we move further into 2022.

Market overview and outlook

Windblown clearings and drifts.

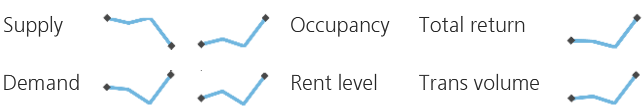
The NCREIF-ODCE Fund Index saw a positive total return of 7.97% for the quarter which was the highest quarterly total return on record. In addition, the index saw a 22.17% total return for the year ending 4Q21, which was the highest annual return since 1980. With the exception of hotels, all sectors experienced positive quarterly returns in 4Q21. This was largely driven by record setting industrial appreciation returns.

Multifamily and industrial continue to post outsized returns relative to the other sectors. However, fundamentals within the strip-center component of retail surprisingly showed modest improvements during the fourth quarter. In December 2021, Green Street reported no alterations to previously published positive year-end public strip-center REITs NOI/FFO guidance. Office demand continues to be focused on a flight-to-quality. Now two years in, remote and hybrid working feels like the norm, subsequently tenant firms may be assessing their culture and redesigning physical space requirements.

Transaction volume in 4Q21 alone stood at USD 313 billion (including entity transactions), equal to 79% of the full year 2020 volume, driven by apartment trades. The price per square foot/unit, in sectors except retail, is the highest since Real Capital Analytics records began in 2001. Investors are taking advantage of increased market liquidity to update portfolio positioning.

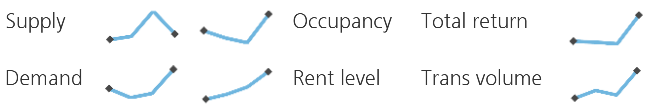
The primary property sectors all saw total returns on an annual basis accelerate over the quarter. Industrial returns accelerated to nearly four times that of one year ago. Office returns remain 100 bps below the pre-pandemic average. Retail returns were positive for the second consecutive quarter. Apartment returns accelerated to the highest level since 2011.

Apartments



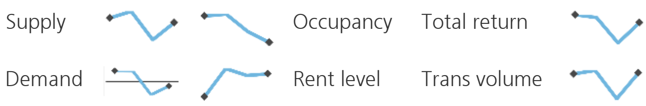
As the sparklines above indicate, the pace of apartment supply growth is well below that of 2018 and 2019, while the pace of demand has accelerated. As a consequence, occupancy and rent growth have gained strength. Apartment returns delivered an annual total return of 19.9% in 2021 – the highest since 2005. Additionally, the 2021 apartment transaction volume (including entity sales) reached a record high not only in dollar value, USD 335 billion, but also in number of properties transacted which was over 12,000.

Industrial



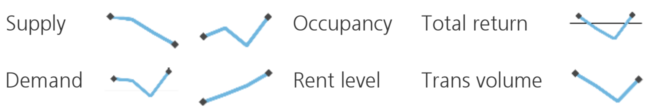
The industrial sector saw an unprecedented 43% annual total return. This proved out expectations that supply chain disruptions and logistics challenges would be no match for sustained customer demand. Persistent demand has been more than a match for near constant completions and occupancy continues to rise. The sparkline table above illustrates that 2020 ultimately had minimum impact on this rising sector. Growth trends established in 2018 and 2019 have sustained, and in some cases accelerated during 2021.

Office



Office sector fundamentals are struggling for consistent and sustainable strength. Although office rents have not experienced a substantial drop, the downward pressure is evident. The office sector is pushing hard for growth and recovery, but has only managed to match 2019 returns and transaction volumes. An accelerating price per square foot for CBD properties has suppressed overall subsector trades.

Retail



Demand experienced a rebound in 2021, while the pace of supply continued to diminish; driving a sharp rise in both occupancy and rent growth. The sparklines above show total return and transaction volume are little changed from 2018 and 2019. However, sector fundamentals have seen growth in line with pre-pandemic trends.

Sparklines: Data shown are year-end 2018 through 2021. Horizontal axis only shown if there are negative datapoints.
Supply, demand, occupancy, rent: CBRE-EA as of December 2021
Transaction volume: Real Capital Analytics as of December 2021
Total Return: NCREIF as of December 2021. Data show unlevered NCREIF Property Index total returns filtered for only ODCE managers. Past / expected performance is not indicative of future results.

Strategy viewpoint

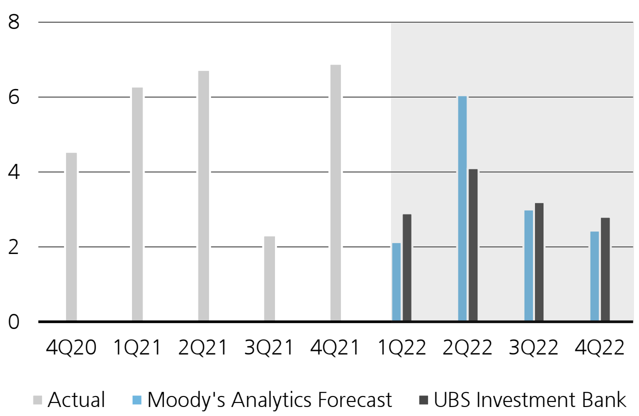
Avalanche threats recede.

The US economy ended the year on a strong note, fueled by consumer spending and business investment in inventory restocking. GDP expanded at a 6.9% annualized rate in 4Q21, following a moderate 2.3% pace in 3Q21 (see Figure 8).

Economic growth accelerated in the fourth quarter despite negative effects from the early stages of the Omicron variant. Over the full year of 2021, the US economy expanded 5.7%, marking its fastest pace since 1984.

With the US labor market on track to full recovery, the Fed has shifted its attention to combating inflation which continues to persist well above the 2% target. The Fed has signaled three 25 basis point interest rate hikes in 2022. However, the market is betting on more hikes this year. The impact of higher interest rates on commercial real estate will vary across sectors. All else equal, higher interest rates will impact values, as the cost of borrowing becomes more expensive. However, we believe that strong demand for space and higher rents will offset higher interest rates in certain sectors (i.e. industrial, multifamily).

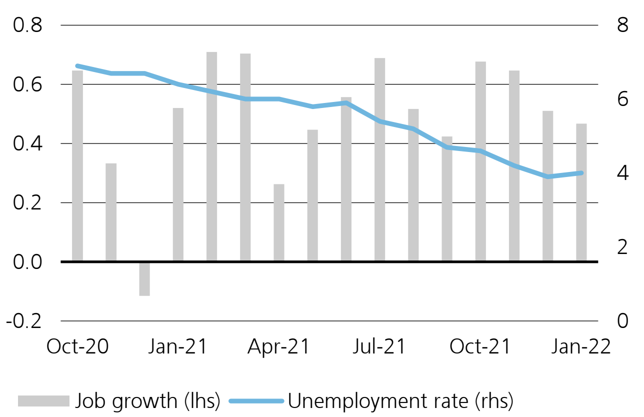
Figure 8: GDP quarterly annualized forecast (%)



Source: Actual Moody's Analytics, as of 27 January 2022; Moody's Analytics forecast, as of 10 January 2022; UBS Investment Bank forecast, as of 28 January 2022. Shaded area indicates forecast data.

Figure 9: Monthly job growth

Jobs (millions) Unemployment rate (%)



Source: Moody's Analytics, as of 4 February 2022

UBS Investment Bank forecast US GDP growth to deliver solid above-trend growth in 2022, albeit at a more moderate pace than in 2021. The expected slowdown is being driven by diminishing fiscal stimulus, the spread of the Omicron variant, and expected hikes in the Fed funds rate. Despite these headwinds, lessening supply chain disruptions, and continued recovery of employment are expected to support growth this year.

January's jobs report posted an increase of 467,000 employed and significant revisions for November and December by a combined 709,000 jobs to much higher levels of 647,000 and 510,000 respectively (see Figure 9). The monthly unemployment edged up 10bps to 4.0% in January, 40bps above the December 2019 rate. As of January 2022, the labor force participation rate remains 120bps below the February 2020 peak with nearly 2.2 million fewer jobs than at the end of 2019.

The abnormally high returns experienced in the industrial and apartment sectors may drive the bulls and bears further from each other. The confirmation of the structural changes in demand across the two sectors will continue to be tailwinds. But the question remains: *at what price?*

The contrarian views are now creeping into the market, as sectors that have long been out of favor are now showing signs of stability, with some green shoots showing relatively robust spreads in pricing. We expect marginal moves in capital seeking risk-adjusted total returns within the core sectors (e.g., tiers of metros and sub-property types) more than across sectors. However, the next two quarters will be an important barometer of the fundamental direction for the retail and office sectors.

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