

A person with blonde hair is seen from the back, looking through a pair of binoculars. The background is a blurred city skyline, likely New York City, with various skyscrapers visible under a clear sky. The scene is set outdoors, possibly on a waterfront.

REO

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– Global

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UBS

Debt looking attractive

“Real estate capital values continue to edge lower, with the US lagging Europe, and APAC little impacted as Japanese interest rates remain on hold. Transaction activity remains muted while lending conditions have tightened. This is creating attractive opportunities for real estate-backed debt, such as bridging loans.”

Fergus Hicks

Real Estate Strategist



Ongoing challenges for real estate markets

Initial estimates from statistical agencies painted a mixed picture of economic activity in 3Q23. US growth accelerated to a blistering 4.9% Quarter on Quarter (QoQ) annualized while, after a lull in 2Q23, the Chinese economy picked up to show growth of 1.4% QoQ. However, China remains mired by a housing market downturn, house developer defaults and weak consumer confidence. The eurozone economy was lackluster and shrank 0.1% QoQ, having grown 0.2% QoQ in 2Q23. Ireland, which propped up the eurozone in 2Q23, was a significant drag in 3Q23 as its volatile economy shrank by 1.8% QoQ.

A key question is the US's ability to remain resilient and defy recession. The US jobs market finally showed some signs of softening in October as employment growth slowed to 150,000 jobs Month-on-Month (MoM). Given the very strong economy in 3Q23, a decline in GDP in 4Q23 looks increasingly unlikely. However, we do expect a slowdown of some sort in the first half of 2024 as the very rapid rise in interest rates over the past 18 months continues to feed through. Moreover, a slowdown is likely needed to keep a lid on inflation and stop it from rising again. The narrative on interest rates has shifted to higher-for-longer, particularly for the US, and the 10-year Treasury bond yield touched 5% briefly in October.

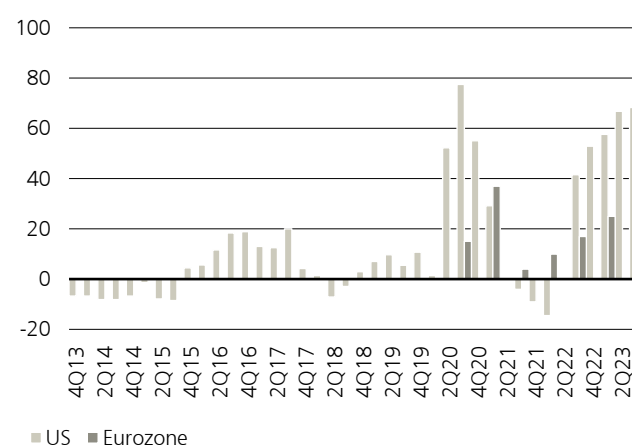
War in the Middle East creates a new risk and uncertainty for the global economy and real estate markets. Following the attacks against Israel on 7 October, the benchmark West Texas Intermediate (WTI) oil price rose 8% above its pre-conflict level. However, by the end of October it had fallen back and was actually slightly below its pre-conflict level. Any widening of the war beyond Israel and the occupied Palestinian territories could lead to an interruption in oil supply and exert upward pressure on oil prices. This could presage a supply-side shock to the global economy and simultaneously generate renewed inflation pressures and bear down on growth.

According to MSCI data, investment activity in real estate markets remained subdued in 3Q23 as sharp interest rate rises continued to feed through and a wedge remained between the price expectations of buyers and sellers. After allowing for seasonal effects, global real estate investment volumes fell 13% QoQ in 3Q23 in USD terms, leaving them down 59% from 2Q22. All geographies and sectors have been affected by the downturn. Asia Pacific residential has been more resilient, with volumes down just 11% since 2Q22, supported by the large Japanese market, which has not suffered from interest rate rises.

Real estate capital values remained under downward pressure in 3Q23. Data from the National Council of Real Estate Investment Fiduciaries (NCREIF) showed that US capital values dropped a further 2.4% QoQ, leaving them 12.4% below their peak in 2Q22. MSCI reported that UK capital values fell 1.7% QoQ, to leave them 20.2% below their 2Q22 peak. At the global level, latest forecasts from Oxford Economics are for a drop in capital values of around 9% in 2023. Japan has continued to be a resilient market, with latest data from MSCI showing capital values flat in 1H23, marking a significant relative outperformance.

Banking sector stress has eased since the first half of the year, though further rises in interest rates and downward pressure on bond values may create additional constraints on lending. Surveys of bank lending standards against commercial real estate have shown a continued tightening since mid-2022 in both the US and eurozone. Indeed, in 3Q23, a net 68% of large and mid-sized US banks reported a tightening in credit standards, as did a net 30% of eurozone banks (see Figure 1). Tighter credit markets make it more difficult to refinance existing debt secured against real estate and also to take on debt for new real estate investments.

Figure 1: Bank lending standards on commercial real estate (net balance of survey respondents reporting a tightening, %)



Source: ECB; Refinitiv Datastream; UBS Asset Management, Real Estate & Private Markets (REPM), November 2023. Note: ECB survey is bi-annual from 3Q20. **Past performance is not a guarantee for future results.**

Although tighter credit markets are invariably leading to pain for some real estate investors as they struggle to refinance debt, they are also creating opportunities for others. Debt backed against real estate assets for bridging loans or loans to finance real estate development can achieve double-digit returns in some cases. Moreover, such opportunities should remain as lending markets remain tight.

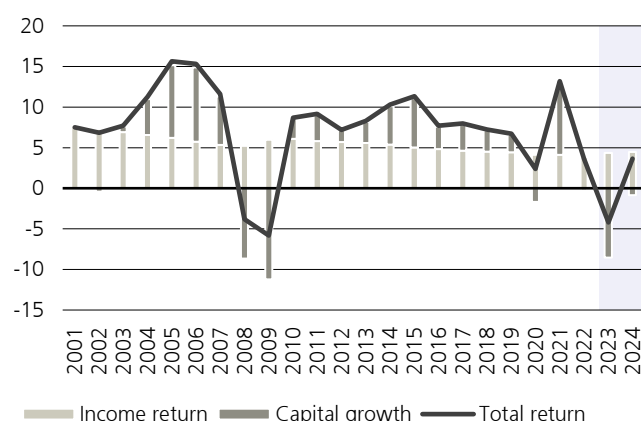
Income-driven returns expected in 2024

2023 has been a tough year for real estate markets around the world as they have digested sharp and rapid rises in interest rates. The result has been a marked contraction in investment activity and significant declines in capital values. Japan has been an exception regarding capital values, which have held steady as Japanese interest rates have remained on hold. The difference in performance between Japan and other markets serves as a reminder of just how important interest rates are for real estate markets. Investors have also had to cope with political uncertainty, ongoing war in Ukraine and the outbreak of a new conflict in the Middle East.

We think that in 2024 real estate markets will stabilize and that the re-pricing will come to an end. We expect the UK market to bottom out first, followed by the rest of Europe, while the lagged response in US valuations means that we expect these to bottom out last. We also expect some further modest declines in capital values in Asia Pacific markets as higher interest rates feed through.

At the global level, the latest forecasts are for income-driven returns in 2024 of just below 5%, following a negative total return of -4% expected for 2023, dragged down by a 9% fall in capital values (see Figure 2). From 2025 onwards, as economies resume growth and interest rates have started to fall, we expect capital growth to resume and that real estate returns will show some acceleration.

Figure 2: Global real estate returns (unleveraged, local currency, % YoY)



Source: MSCI; NCREIF; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), November 2023. **Past performance is not a guarantee for future results.**

This outlook is consistent with global listed markets, which showed renewed weakness in 4Q23 as conflict broke out in the Middle East and as interest rate expectations moved to higher-for-longer.

The FTSE EPRA Nareit Developed Index of global listed market prices touched a new low in October, following its high at the end of 2021. This implies that market conditions for private real estate will remain challenging in the near term at least, though we think that the bulk of the adjustment in capital values will have taken place by the end of 2023.

We continue to expect offices to be the weakest performing sector due to the ongoing impact of the adjustment to hybrid working and capex needed to make older offices energy efficient. We do expect prime, well-located offices with good sustainability credentials to be more resilient and perform better. We think that the retail, industrial and residential sectors will show broadly similar performances at the market level. Overall, we favor the industrial and residential sectors though and believe that they have good fundamental occupier market drivers.

We think that the retail sector, having faced a hard period of structural adjustment prior to the pandemic as retail shifted online, and then challenging conditions during pandemic lockdowns, should perform more in line with the market overall. Within retail we favor convenience and neighborhood retail, which is supported by consumer demand, and prime grade retail in the best locations, which also benefits from tourist spend. By contrast, secondary grade retail and malls are likely to continue to underperform, with some of these properties still likely to need re-purposing.

Having strongly boosted returns during the post-Global Financial Crisis decade and over the pandemic period, debt is often no longer enhancing to returns in a higher interest rate environment. Once interest rates eventually start to fall, we expect debt to be able to contribute to performance again. In the meantime, real estate fund managers will not be able to rely on debt to boost returns. Rather, they will need to focus on strong property selection, good asset management initiatives and taking advantage of distressed and discounted opportunities to drive performance.

How real estate markets fare in 2024 will critically depend on interest rates, over which there is significant uncertainty. At best, we expect some modest declines in policy rates next year. A higher-for-longer path would likely curb property market performance, while if inflation prints allowed central banks to cut interest rates faster than expected, a stronger recovery in real estate markets could result. Hence investors should carefully monitor the interest rate outlook as it evolves and consider its implications for real estate markets. In the higher rate environment, property-backed debt investments are a good opportunity for investors, particularly if bank lending is constrained.

Unlisted real estate sector performance outlook

	Negative		Neutral		Positive
US	Office		Residential, hotel		Retail, industrial
Canada			Office, retail, industrial, residential, hotel		
France			Office, residential		Retail, industrial, hotel
Germany	Office		Retail, residential, hotel		Industrial
Switzerland			Office		Retail, residential, hotel, Industrial
UK	Hotel	Office	Residential		Retail, industrial
Australia	Office		Retail		Industrial, residential, hotel
Japan					Office, Retail, industrial, residential, hotel
Singapore			Office, retail		Industrial, hotel

Source: Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), November 2023.

Note: Classifications refer to expected total returns after currency hedging over the period 2024-26 versus global all property. **Classifications are not a guarantee for future results.**

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