Real estate

The outlook for real estate fundamentals is positive, but risks remain

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Key takeaways

- Risks today are crystallizing; many are more global in nature.
- Pricing remains attractive; however, yield/cap rate compression is largely behind us.
- Total returns in 2019 are likely to be driven by net operating income growth.

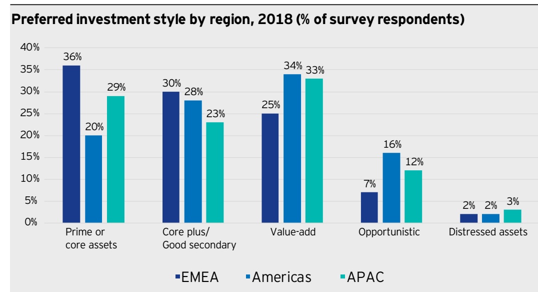
Strong growth in developed economies should continue to support favorable real estate fundamentals in the near term. The baseline scenario remains very positive, and global real estate securities earnings yields are providing a positive spread over local government bonds, a sign that real estate is still fairly priced. Yet macro risks to the outlook are perhaps now greater today than in prior years; many are increasingly global in nature. They include rising populism, an escalation of the US-China trade war, a monetary policy normalization misstep, a disorderly Brexit or a China debt crisis. Should any one of them materialize, it would have the potential to derail the global growth outlook to a measurable degree.

Global opportunities

Investor surveys in recent months reflect an increasing appetite for real estate, with allocations to the sector expanding to more than 10% of institutional portfolios. [1] While greater in the US and Asia Pacific than in Europe, many investors are seeking to leverage value-add platforms to enhance returns, likely in response to expectations of limited future cap rate compression (Figure 1). In Europe, there is a greater appetite for core strategies, given real estate's attractive pricing relative to long-term government bonds. We envisage the next few years will be marked by the emergence of new regionally focused offerings that can cater to these changing investor preferences.

Figure 1: Investment style appetite by region

Investors are increasingly interested in European core, Asian and US value-add.



Source: Invesco Real Estate using data from CBRE ResearchGlobal Investor Intentions Survey, 2018

Risks today are greater than they have been in prior years, and are increasingly global in nature.

Regional investment themes

Differences in the regional total return outlook are driven in large part by our expectations of growth, with various local and regional nuances:

- **Asia Pacific**
  Over the last few years, Asia Pacific returns have surprised to the upside. There have been strong market-level returns, and the region has been the strongest component of the MSCI IPD Global Property Fund Index. Going forward, our total return forecasts for the region are projected to maintain a stable growth profile, driven in part by greater net operating income potential. We favor market-sector combinations benefitting from either cyclical upswings, such as Singapore offices, or long-term secular trends (aging, e-commerce, and technology).

- **Europe**
  Prime rental growth is becoming increasingly broad-based amidst ongoing economic growth in Continental Europe. Despite Brexit uncertainty, UK real estate fundamentals and capital markets have thus far remained resilient, but peak uncertainty is likely still to come. Limited development pipelines and structural demand growth make logistics and hotels of particular interest. A nascent institutional-grade multi-family housing market presents additional opportunities to participate via forward-funded developments.

1 Source: Oxford Economics as of September 2018

- **United States**
  The US is probably furthest along in its real estate cycle relative to the other regions, although thus far it has maintained its robust pace of growth. The near-term outlook remains positive, although labor constraints could start to weigh on sustained growth. We anticipate a tapering in real estate returns in 2019-2021 after a strong 2018. Given it is in a later stage of the economic cycle, we intend to lean into markets and sectors that have historically offered enduring value and stable income, while supplementing with selective growth-oriented opportunities.

Two global risks
At present, the risk that seems most concrete is the continued disruption of the retail sector by e-commerce. While not a new trend, the potential for further e-commerce penetration worldwide may be greater and faster than previously anticipated. Changes in consumer behavior, led by increased spending power of the millennial and Generation Z cohorts, has accentuated the shift from offline to online, in turn creating greater divergence of retail asset performance. Once one of the best-performing real estate sectors in most countries, this convergence of technological and demographic influences is changing the profile of retail real estate. In our view, this divergence is creating a wider chasm between the best retail assets and the rest, and this warrants a direct strategic response going forward. Public markets have responded to the shift, pricing mall and strip center REITs at a sizable discount to gross asset value (GAV), particularly in the US, which is arguably the most impacted region given its outsized provision of retail space per capita.

A US-led trade war poses a key threat to the global outlook today. The US has thus far announced tariffs on Chinese imports totaling roughly half of the US's $506 billion total import volume from China in 2017.[1] China has reciprocated in kind, announcing tariffs on $110 billion of US goods, nearly 85% of Chinese imports from the US in 2017.[2] Of the two countries, only the US has much remaining capacity to impose greater tariffs, yet both countries could increase tariff rates, extend tariffs to services or impose broader capital control measures. Given that the US and China combined are expected to contribute 42% of global economic growth over the next several years,[2] a broad-based escalation of their trade war could impact both real estate fundamentals and capital markets.

The period of cap rate compression appears to be in the rear-view mirror; as such, income growth is likely to become an even more important component of total returns going forward.

Pricing and timing
One concern over the next 12 months is the potential impact that interest rate normalization could have on real estate values. With the US Federal Reserve in the vanguard, more central banks around the world are starting to withdraw monetary policy stimulus. This winding down of quantitative easing (QE) and normalization of interest rates is an unprecedented and delicate process.

What might be the impact? As interest rates rise, there may be some upward pressure on real estate yields/cap rates as investors reassess relative pricing. Historically, however, the relationship has been far from one-to-one. Much depends on the outlook for real estate fundamentals. The period of yield/cap rate compression appears to be in the rearview mirror; as such, income growth is likely to become an even more important component of total returns going forward. Indeed, to some degree, growth in net operating income can offset changes in real estate yields/cap rates.

1 Source: Oxford Economics as of September 2018
2 Source: Oxford Economics as of September 2018

A useful mechanism for measuring price attractiveness in real estate is to compare real estate yield/cap rates spreads to long-term government bond yields. Two-thirds of the time, the yield/cap rate spread over long-term bonds is within plus or minus one standard deviation of the long-term average. Broadly speaking, when in this range, real estate may be considered to be fairly priced. Often, markets where strong growth is expected are found at or below minus one standard deviation.

As we see in Figure 2, yields/cap rates today broadly suggest that most markets are priced within the lower end of normal bounds. Europe is the main exception, as long-term government bond rates are very low, thus making real estate an attractively priced asset class; however, given the European Central Bank's anticipated wind-down of its QE program in the near term, these spreads may change.

Figure 2: Cap rate spreads over 10-year government bonds

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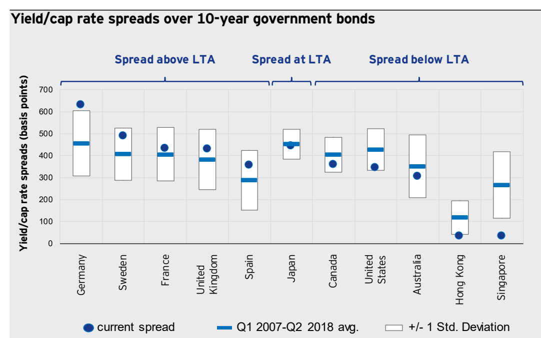


*Please note that data for Singapore is current as of Q1 2018.

Note: current spread is calculated as the spread between the Q2 2018 cap rate and the September 10, 2018 10-yr bond rate. Countries are ordered from left to right by current spread value after sorting by relative distance from Long Term Average (LTA). Spreads at LTA are within +/-25 bps of LTA.

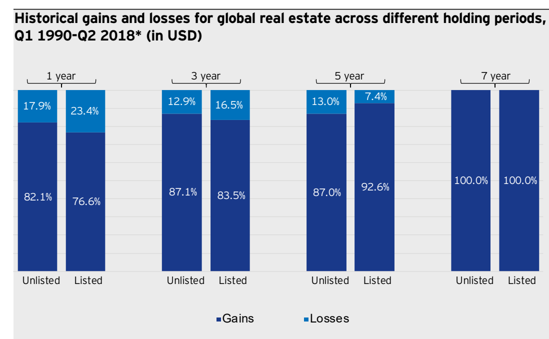
Source: Invesco Real Estate using data from Real Capital Analytics and Macrobond as of September 2018

Standard deviation is a statistic used to measure dispersion in a data set. It is calculated as the square root of the mean of the squares of the deviations from the arithmetic mean of the distribution. In a normal distribution, one would expect approximately two-thirds of data points to lie within +/- one standard deviation.

Given pricing pressures, investors may inquire whether now is a good time to be investing in listed and unlisted real estate. An exercise in comparing the asset class's tendency for gains and losses over different hold periods may yield one potential answer (Figure 3). Historically, there have been many more periods of gains than losses over the longest historical periods available – this suggests that regardless of entry point, the propensity for gains increases the longer the hold period. For many investors, time *in* the market may be more relevant than *timing* the market.

Figure 3: Historical frequency of gains and losses for listed and unlisted real estate

The longer the hold period, the greater the proportion of periods yielding gains.



Note: *Historic data series for global unlisted real estate represented by MSCI IPD GPFI and reflect the time period from 1Q2008 to 2Q2018, the longest time period available.
Global listed real estate is represented by the FTSE EPRA/NAREIT Developed Index reflects the period from 1Q1990 to 2Q2018, the longest time series available.
All returns shown in USD.

Source: Invesco Real Estate based on data from MSCI IPD, Bloomberg Barclays, and Macrobond as of September 2018

The MSCI IPD Global Property Fund Index is an index of unlisted, open-ended core funds that invest in a single country or cross-border. The index is used as a proxy for global core real estate performance.

Conclusion
Against the backdrop of global risk factors, the outlook for real estate fundamentals and returns remains broadly positive. In the more than 200 market-sector and 2,000 sub-sector combinations that Invesco Real Estate monitors globally, we expect rental growth in over 90% of these areas in 2019, with a slightly higher share in Asia Pacific and the US than in Europe.

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