30 January 2018

Better real estate fundamentals in the Eurozone and Asia

Global growth speeds up. Rent and prices rise. Rates no longer represent a threat. Favourable risk premium. The Eurozone and Asia outperform.

Key Points

- Upward real estate trend continues in 2017 and 2018
- Global growth picks up to +4%
- Interest rates still do not constitute a threat in 2018
- Inflation will keep real-terms rates historically low
- The US real estate cycle is losing momentum
- The Eurozone is still benefiting from better forecasts
- Asian real estate is enjoying more dynamic growth

Upward real estate trend continues in 2017 and 2018

In the last quarter, international real estate benefited from the improvement in overall investor sentiment and improved global growth prospects for 2018. The global real estate index (Epra Nareit Global Index TR in USD) posted further growth in the 4th quarter, and as such rounds off 2017 with an excellent performance of +15% in dollars (+10% in CHF). This is its best annual growth since 2012.

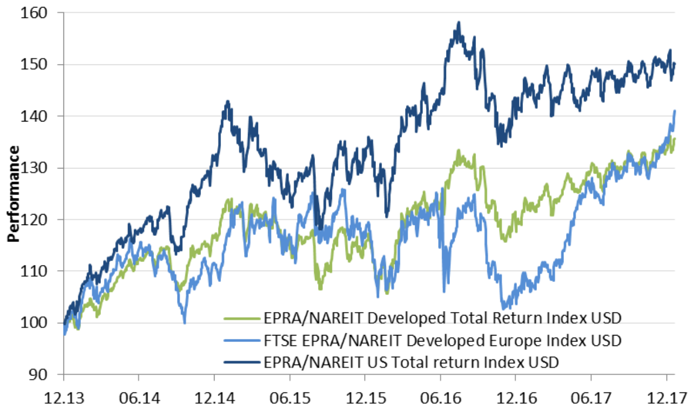
Since the start of the year, our strategy had prioritised the Eurozone in terms of regional allocation, which contributed considerably to the success of our investment policy.

Indeed, the Eurozone made a particularly positive contribution in 2017 (best overall market), with a +17.8% rise in euros, or +29.1% in USD (best performance since 2009).

This market segment gave a considerable helping hand to the global index in moving up to its highest levels.

In local currencies, the Eurozone grew considerably more than the United Kingdom (+8.6%, and +4.4% in euro), dealing itself a rather nice hand in the still very uncertain context of Brexit. Developed Asian markets moved up +12.2% in US dollars, and those of the Asia-Pacific region rose +22.6%. As such, Asian markets also outperformed United States real estate (+2.3%), which very much lagged behind securitised real estate growth in 2017.

EPRA/NAREIT USA Europe World Indices



Sources : Bloomberg, BBGI Group SA

The normalisation of key rates in the United States and higher dollar yields have made it less attractive to diversify in US real estate assets. In the Eurozone, Italy has benefited significantly from the fall in political uncertainty, posting the highest growth levels (+45.8%). Germany grew +28.7% over the year, and the French market particularly stands out for catching up very well in the 4th quarter +9.9%. The stability seen in the United

Kingdom might come as a surprise; listed real estate assets are not undergoing de-commitments and are putting in a laudable performance considering the Brexit context.

The overall performance of securitised international real estate was therefore particularly pleasing in 2017 and should continue to be positive in 2018. We believe that macro-economic factors are still working in favour of positive developments, and risks, mainly linked to new paradigms in the liquidity cycle and interest rates, should not have a negative impact until at least 2019.

Global growth accelerating to +4% is a positive factor

In 2018, global growth will certainly hit its highest level since 2011 and will benefit from regional economic cycles synchronising. According to OECD experts, global growth should exceed +4% in 2018. Developed and emerging countries will all help bolster activity. Upward revisions of forecasts will also benefit long-term investments in real estate. These investments will also be helped by the improvement in economic factors, and the likely increase in demand for commercial and residential real estate. We still believe that this rise in global demand will have a relatively noticeable effect, both on occupation rates and rents, in an environment shaped by less dynamic supply. As such, the macro-economic environment should prop up real estate investment thanks to a positive combination of several factors.

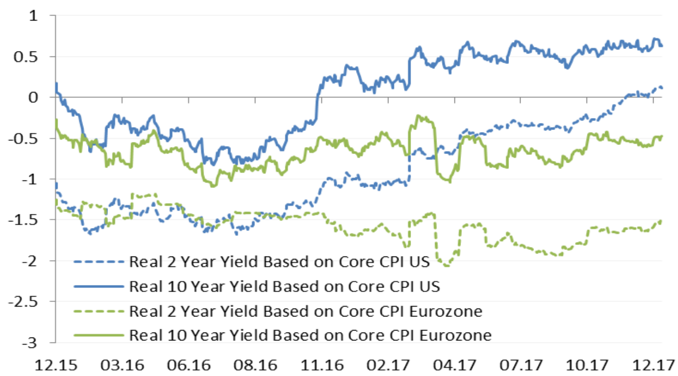
Interest rates still do not constitute a threat in 2018

2018 will certainly be the year of a global paradigm shift on monetary policy. The Federal Reserve has already embarked upon the normalisation process, leading it to both gradually increase its key rates and very slowly withdraw some of the liquidity injected into the economy over the last decade. The ECB and BoJ will follow the Fed down this path, which will mark an important change in international monetary policy. Long-term interest rates will also follow an upward trend in 2018, but we do not believe that this recovery in long rates will be enough to affect the valuation of real estate assets or even compete with this asset class in investment diversification strategies.

Yield differentials (or risk premia) between long-term interest rates and indirect real estate investment yields have shrunk slightly, but still remain attractive in past comparison, particularly in the Eurozone.

Normalisation of interest rates has hardly begun in various economic areas (Eurozone and Japan). It is therefore premature to fear the negative impact on rates of capitalisation for real estate investments in 2018 in general. At the current point of the global economic cycle, this phenomenon should not have a lasting effect on real estate fundamentals, except in the US market, which has already clearly headed into a revaluation cycle.

Real Interest Rates – USA and Eurozone



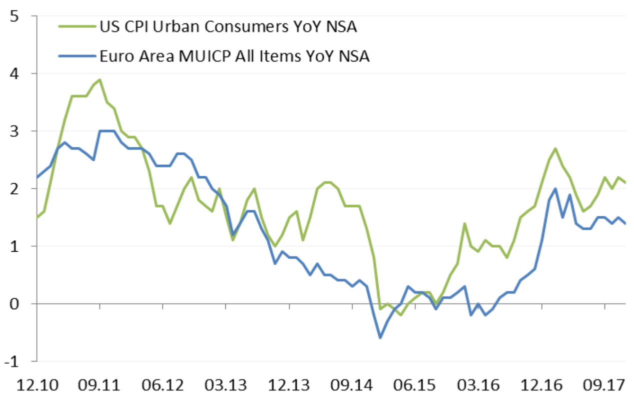
Sources: Bloomberg, BBGI Group SA

Inflation will keep real-terms rates historically low

The pleasant surprise of 2018 could well be the more positive development of prices indices. This trend could strengthen and affect real-terms interest rates a little more still. Despite monetary policy normalisation, currently underway in the United States and further down the road in the Eurozone, we believe that inflation will rise more quickly than long rates. We should therefore still see a downward trend in real-terms interest rates over the next few quarters, which will favour real estate markets, especially in the USA, the Eurozone, and Japan. Regular increases in inflation will only bolster this trend, which we believe will be positive for the sector.

The performances of real estate markets should be better when real-terms interest rates are low, and when growth forecasts are equal to or higher than their historic average.

Inflation – USA and Eurozone



Sources: Bloomberg, BBGI Group SA

The improvement in the global economic trend will go hand in hand with forecasts of greater rent growth, which works in favour of real estate asset valuations.

The US real estate cycle is losing momentum

The US real estate cycle is ahead of most other regional cycles. Real estate prices (S&P CoreLogic Case-Shiller Index) rose again in 2017 by +5.9%, which is the sixth consecutive year. It is now posting overall growth of +45%, and has surpassed the level it had hit before the real estate bubble burst in 2007 by an average of +6%. In the United States, short-term interest rates will head above +2% in 2018, and could head north of +3% for ten-year maturities. Mortgage rates are already above 4% (10 years) and could also hit 4.5% by the end of the year. Overall, the increase in financing costs could hold back demand and slow down the price rise. In parallel, the tax reform will have a rather negative impact on the real estate sector due to fewer opportunities for mortgages to be tax exempt. In the commercial sector, rent growth should also slow. The supply that should come onto the market could prevent strong rent rises. The rates of rent and price growth will therefore be much lower than in other regions, particularly the Eurozone. The below-par performance of listed US assets reflects the slowdown in the real estate cycle. Despite good economic prospects, US securitised real estate is certainly ahead on the revaluation cycle.

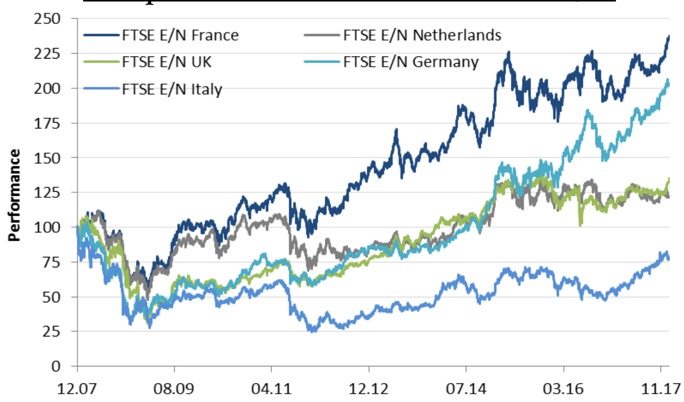
Despite its growth potential, the US market should under-perform other developed and emerging markets over the coming quarters. We recommend under-exposure to the US market within an internationally diversified investment strategy.

The Eurozone is still benefiting from better forecasts

In our previous forecasts, we predicted that the economic trend in Europe would pick up the pace. This did happen, and could be further bolstered in 2018 and 2019. Our positive forecasts for European economic growth, particularly for drivers of growth such as Germany, Spain, and even France, should have a positive impact on their respective real estate markets. Political risks have subsided, even though the German Chancellor Angela Merkel is still struggling to form a coalition government several months after the elections. The resumption of negotiations between the European Union and the British government has also eased political tensions, though without entirely erasing the uncertainty linked to Brexit. It is important to note that for the time being, the prospect of Brexit is not affecting analysis of future economic conditions for the Eurozone.

Eurozone inflation is still coming in under the targets that the ECB has set itself and, if 2018 unfolds as expected, it is likely that the only change the ECB will make to its monetary policy will be to alter its asset purchases, at least initially. The risk that key interest rates will rise, even slightly, in 2018 remains low.

European Real Estate Markets FTSE E/N



Sources: Bloomberg, BBGI Group SA

We forecast that long rates will rise, mainly due to the correlation that should exist between developed countries' rate markets. As such, although the Eurozone is very clearly not at the same point of its economic cycle as the United States, tensions on long rates in dollars will undoubtedly be passed onto long rates in euros. Equally, the faster pace of the European trend already provides grounds for long rate levels to be adjusted; this will probably be more abrupt than on the US market.

For the European real estate market, this economic context should stimulate demand for commercial real estate and gradually reduce the excess capacity in some large cities in 2018. Previous years' uncertainty had hampered development projects in a context already shaped by surplus supply. These changes will enable rents in Europe to continue to rise.

Risk premium favours European real estate

The change in trend on interest rates will certainly increase financing costs, but the real-terms cost (after inflation) and the lack of any alternative will once again enable the European real estate market to draw in new investors. We do not believe that the increase in financing costs will be enough to check real estate investments in 2018. The yield differential for real estate investments and government bond yield in euros is still at a twenty-year high at the start of 2018. In particular, the spread for top-location real estate investments stands at around 250 basis points, whilst in less central areas the yield differential is much higher and much more attractive in past comparison. We still believe that European real estate investments represent a very attractive alternative to bond yields.

As regards securitised real estate, we believe that the now-growing risks of capital losses on bonds will prop up reallocation of assets towards real estate in institutional portfolios to a greater degree in 2018. In terms of regional allocation, the Eurozone should still enjoy greater potential for rent revaluation and more sustained price growth.

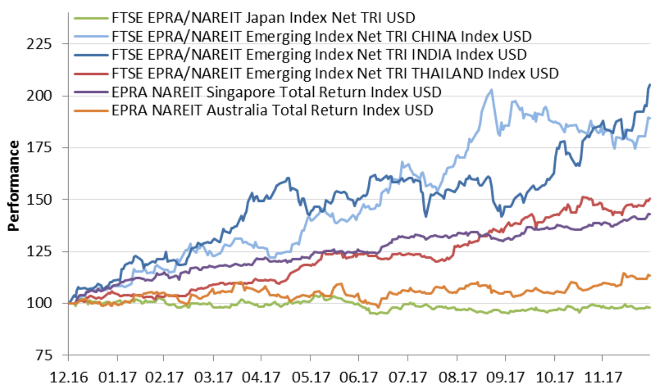
Asian real estate is enjoying more dynamic growth

Economic growth in Asia will still be robust in 2018, thanks to positive developments in the regional trend. It will still be much higher than in Europe and the United States, but it is unlikely that we will see considerable interest rate hikes. Prospects of rent increases are real, although partly held back by growth in real estate supply. Prospects of price increases are therefore also limited. Rises in rents in the office sector in Asia will benefit from the positive developments on the Australian and Indian markets. In China, rents seem to have dipped slightly due to new capacity coming onto the market.

In Singapore, demand for relocation has remained rather strong, though without any noticeable effect on rent. In Hong Kong and Tokyo, demand has flagged slightly. In India, demand for offices and sales premises will undoubtedly remain robust and will prop up rises in rent.

Asia is still enjoying a better trend and is still prioritised in our regional allocation.

Asian Real Estate Markets



Sources: Bloomberg, BBGI Group SA

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