30 April 2019

International securitized real estate remains an attractive opportunity

More moderate increase in direct real estate prices. Economic growth boosts real estate investments. Interest rates not threatening valuations yet. Stay invested

Key points

- Exceptional 1st quarter for international securitised real estate
- Logical loss of momentum in April
- The decline in interest rates supported the recovery of prices
- Risk premiums are still favorable
- More moderate increase in direct real estate prices in the United States
- Interest rates not threatening valuations yet
- Real estates profits from low real interest rates and remains an attractive opportunity
- Reduce tactical allocation in US

Exceptional quarter for international securitised real estate

At the end of last year we described the situation in various securitized real estate markets as a major boon and a genuine investment opportunity in view of the sell-off by panicked investors alarmed by the emergence of an extreme scenario involving a US recession combinedwith a collapse of global growth in 2019.

The drop in listed real estate exceeded -6% in 2018, most of which (-5%) occurred in December.

We noted then that this correction was irrationaland would be temporary, likely due to the wave of panic that overtook financial markets rather than to a real change in conditions inglobal real estate markets.

Our recommendation at the time was to take advantage of this opportunity to reposition on the cheap, focusingon Asian markets while also taking larger stakes in the US and Europeanmarkets. This strategy proved effective in Q1 2019, as listed real estate rose, in some cases significantly.

<u>Securized real estate markets in local currencies (2019)</u>

Sources : Bloomberg, BBGI Group SA

From a global point of view, international securitised real estate progressed by an impressive +14.7% in just three months, more than compensating for the -5% correction in December.

The performance of international real estate indices thus exceeded that of equity indices (+12.5%), which is particularly significant given the still uncertain – albeit more serene – context prevailing so far this year. All the large securitized real estate markets rose sharply. Emerging markets (+18%) and Asia (+14.4%) posted the best results, but the US (+15.5%), Europe (+13.1%) and the UK (+11.3%) also bounced back significantly.

Following impressive gains in the first three months of the year, the month of April ended on a mixed note. Over the past several weeks share prices in most regions consolidated somewhat, as expected, in a context of relatively low volatility. Regional real estate indices fluctuated only slightly (between -1% and +1%) except for Asian real estate, down -3%.

The decline in interest rates supported the recovery of prices

The first significant decrease in long-term rates, in some cases to below zero, which occurred in December, did not have a positive impact on listed real estate, quite the contrary. However, over the past few months, in a more optimistic stock market climate, this factor certainly contributed to the increase in real estate share prices.

Nevertheless, we don't think it will reprise this positive role over the next few months because of the trend reversal we are anticipating in rate markets given the improving economic environment that should be established in the coming quarters.

Risk premiums are still favorable

With regard to investment policy, we expect that securitised real estate investments will continue to offer much more attractive returns than bonds. International securitised real estate thus remains an attractive form of diversification for investors.

Expected returns over the next quarters will inevitably be lower than those achieved thus far this year, but in most geographic regions we anticipate yields much higher than those on bonds as well as additional capital gains. Risk premiums are high enough to motivate being overweight this asset class.

More moderate increase in direct real estate prices in the United States

The US real estate market has been stabilising for several months already. While the residential segment was still decelerating at the beginning of the year, yoy real estate price growth remains positive in February (+3%), but lower compared to January's comparable measure (+3.6%), significantly less than the previous year's increase over the same period.

Intermediate results seem to suggest a slight recovery in prices in recent weeks. The residential market should be bolstered by the recent decrease in mortgage rates and the visibility provided by the Fed Chair's shift in attitude with regard to monetary policy. This situation will likely boost demand and cause prices to rise by approximately +5% by 2020. Demand will also likely strengthen due to an increasingly robust job market, a high level of confidence, and growing disposable income, which means households are increasingly able to purchase residential property. There is no doubt regarding US economic momentum, which will drive further price growth, albeit at a much slower pace.

UK market remains very uncertain

The uncertainty surrounding the unresolved issue of what shape Brexit will take continues to weigh on real estate prices in the UK, which are increasingly volatile this year. The recent publication of residential property prices for March (-1.6%) stands in contrast to the February upswing (+6%), which had been preceded by a -2.6% drop. Housing prices fell more sharply in London than in the rest of the country. Brexit continues to cast a shadow over the British market, which still does not offer any repositioning opportunity.

We recommend staying away from this market for now, as the Bank of England is suggesting that real estate prices may plunge -25% in the case of a pessimistic no-deal Brexit scenario. While a hard or no-deal Brexit would likely cause UK real estate prices to fall, the outcome for European markets could be positive. A significant number of workers returning to their countries could boost demand and prices.

Real estate in China

In China, real estate prices progressed by +11.1% yoy in January 2019, while prices continued to rise by a decent +0.53% in February and +0.61% in March. Prices in nearly all cities across the country have been trending upwards, with the National Bureau of Statistics noting that prices rose in 57 out of 70 cities month on month.
In Hong Kong, real estate prices finally declined after rising steadily for two years. The slide started in summer 2018 and has continued until now, resulting from trade tensions, rising interest rates, and the volatility of the Hang Seng index. The situation seems to have improved in Q1, as prices stabilised and could now benefit from a more positive environment. However, from a relative point of view, Hong Kong real estate remains unaffordable for the large majority of residents.

European real estate

In Europe, the Portuguese market is thus well positioned to be in high demand, although almost all countries that are benefiting from particularly advantageous borrowing conditions are in fact likely to see increases in real estate prices in 2019.

Economic growth boosts real estate investments

Fears of a recession were irrational and largely attributable to the unusual stock market climate at the end of the year. The risks of a slowdown are primarily related to the current quarter and seem to be already mostly factored into economic forecasts. Statements made by US and Chinese negotiators seem to imply that an agreement will be reached, even if it will take a few more weeks to iron out the details.

Meanwhile, economic fundamentals seem to be showing signs that confidence may be stabilising and even improving. The manufacturing sector may thus have reached the bottom of its short-term cycle. Our scenario assumes a limited global economic slowdown with no significant impact on construction and real estate. The global economy will continue to expand in 2019 with positive effects on international real estate.

Interest rates not threatening valuations yet

The beginning of the year was marked by a fairly radical shift in the strategies of the major central banks. The latter had previously been rather optimistic with regard to the vigour of the economy and the necessity of continuing to normalise monetary policy, as shown by the Fed's latest rate hike in December and the ECB's plan to terminate its government debt purchase programme as of 1 January 2019. Indeed, central banks, probably somewhat concerned with regards to developments in financial markets and the emergence of a negative economic scenario that caused a general market panic in Q4 2018, shifted gears.

The Fed stated that it would not change its rates in 2019 and would end its balance sheet reductions. In the Eurozone, the ECB is not plan-ning to raise rates and announced a further wave of TLTRO loans to inject liquidity into the banking system. The drop in long-term rates is no doubt excessive given the economic slowdown.

They are thus likely to start trending back up towards levels prevailing in September 2018. Fears of rising interest rates are often mentioned as one of the main risks with regard to the valuation of real estate assets, and rightly so. However, in the current context, it is unlikely that this factor will have a significant impact on real estate prices.

Persistently low real interest rates have positive impact on real estate

Real estate markets are typically expected to perform better when real interest rates are low and the growth outlook is equal to or exceeds its historical average. Excessive fears of a slowdown affected year-end expectations, but global economic momentum will likely turn out to be more resilient than anticipated in 2019, enabling global GDP growth of close to +3.5%. In this context, we continue to think the environment remains favourable to moderate growth in rents and in real estates prices more generally.

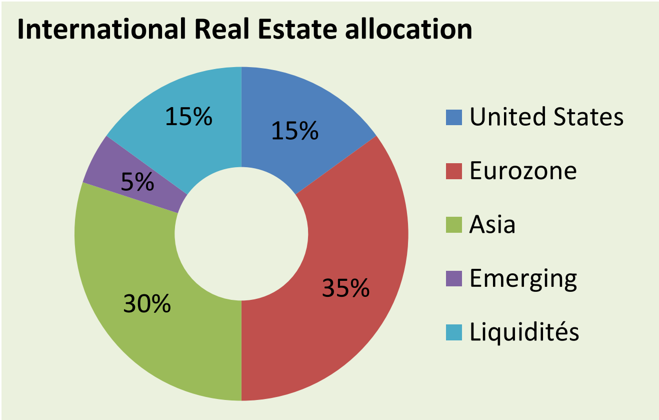
With regard to real interest rates, decelerating inflation, as indicated by consumer price indices in most developed countries, has been accom-panied by similar decreases in long-term yields. In the US, inflation slid from +2.2% to +1.5% in February, while 10-year US Treasury yields fell from 3.1% to 2.4%. Similar decreases occurred in the euro area, where inflation slid from 2% to 1.5% in February and 10-year German Bund yields fell from 0.55% to 0%. Barring an actual recession, inflation will likely be bolstered in 2019 by increasingly robust job markets, hourly wage increases, and rising commodity and energy prices.

Current real yields are negative not only in the Eurozone but in other developed countries such as Japan as well. In emerging markets, this factor will be less favourable due to positive real yields. This is the case in China in particular, where inflation (+1.5%) is lower than government bond yields (3.2%).

Reduce tactical allocation in US

Given the extremely rapid increase in securitised real estate in Q1, it has become more challenging to justify a continuation of this trend in the immediate future. The outlook remains positive overall, as we mentioned, but going forward growth is less likely to be linear and will impact various regional markets in different ways.

The correlation among markets was especially high over the past three months because real estate prices overall were in fact recalibrating after the December panic. Indeed, most markets increased by around +14%, except for emerging real estate, which rose by +16%. Over the next few months, the correlation among securitised real estate markets will likely diminish once again, and there will be a wider disparity in performance. With regard to investment policy, the most mature market seems to be the US market. At this stage we recommend a higher exposure to European and Asian markets, underweighting the US in our regional allocation grid.



BBGI Group is regulated by the Swiss Financial Market Supervisory Authority and offers the following services to Swiss and International clients:

- Institutional Asset Management
- Private Banking
- Fund Management
- Advisory Services for Institutional and Private Investors
- Currency Risk Management
- Real Estate

BBGI Group SA
Rue Sigismond Thalberg no 2
1201 Geneva – Switzerland
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch