BBGI GROUP Global Investments

Economic Research

WEEKLY ANALYSIS

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Real estate investments did not give in to panic in October

Most real estate markets internationally withstood the fall in equity markets. Interest rates do not yet constitute a real threat. Asia and Europe offer a higher potential for gains.

Key points

Securitised real estate weathers the uncertainty affecting financial assets in October

Real estate prices remain favourably oriented

Japanese real estate still the best performing

The increase in US rates was not enough to punish real estate investments

Risks of a slowdown remain slim

Real interest rates remain negative

Asian real estate is offering a new opportunity

Securitised real estate weathers the uncertainty affecting financial assets in October

The marked rise in uncertainty, which affected financial markets and equities in particular, did not have as much of an impact on most securitised real estate investments. While the US equity market fell by -7.4% in dollars in October and over the first two weeks of November, the Epra Nareit USA Total Return index actually grew by +0.84%. In Asia, reactions also remained muted (-0.84% in USD), and in Europe, Swiss real estate (-1.42%) held up better that the corresponding index for the Eurozone, down -3.22%, and for the UK, down -2.22%.

The increase in volatility in equity markets in October thus does not seem to have spread to real estate investments. The latter may in fact be benefitting indirectly from a certain lull on the interest rate front. Indeed, while one of the factors in the consolidation of equity markets involved the increase in long-term rates at the beginning of October, interest rates in the US have been stabilising over the past ten days or so. Indeed, US Treasury yields fell back from 3.25% to 3.05%, a retreat also observed with regard to German government bonds, whose regression from 0.55% to 0.35% was relatively similar. Given the somewhat more uncertain investment climate at the beginning of Q3 2018, we believe the macroeconomic environment remains relatively unchanged and favourable to real estate markets in general.

Real estate prices remain favourably oriented

In the United States, the pace of growth in real estate prices slowed again in August, sending overall growth of real estate assets to +5.7% year on year. It was the 5th consecutive month of slowing prices, suggesting waning buyer interest in a context of mortgage rate rises and high prices. However, demand remains robust thanks to a strong jobs market and high confidence.

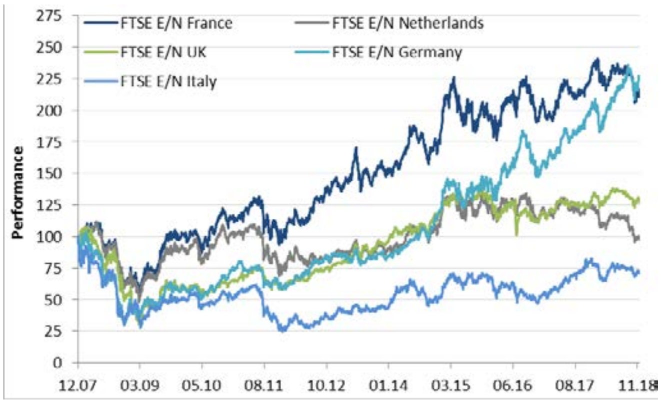
The US economic trend will remain strong, and will prop up continuing price rises, though at a much slower pace. The market is showing signs of running out of steam, but will once again benefit from rather weak inventories. In this context, investors are clearly justified in maintaining their exposure to the US real estate sector, though with smaller allocations. In Europe, real estate prices are not wavering, and continue with the upward trend that started in 2014. According to the Eurostat Index, house prices increased

+4.3% year on year in the Eurozone and in the European Union as a whole in the 2nd quarter. The quarterly rise stands at +1.4% and shows no sign of any recent dip. The greatest year on year rises were seen in Slovenia (+13.4%), Ireland (+12.6%), and Portugal (+11.2%).

Only Italy (-0.2%) and Sweden (-1.7%) did not benefit from this. We have yet to see the trend weaken, potentially helped on its way by an improvement in economic conditions and in the labour market. Financing for mortgages in the EU and the Eurozone remains particularly attractive, and ECB monetary policy carries little risk of affecting conditions relating to access to the real estate market in the short-term. We are still prioritising this region in our allocation of real estate assets.

In the United Kingdom, Brexit continues to weigh heavily on investor sentiment and real estate prices. In July, London real estate prices posted their starkest drop since 2009. Across the country as a whole, growth still stands at +3.1% year on year, but this is the weakest growth since August 2013. The British market is still haunted by the spectre of Brexit, and has yet to present any opportunities to reposition.

European Real Estate Markets FTSE E/N



Sources : Bloomberg, BBGI Group SA

We recommend avoiding this market for now, at a time when the Bank of England has said that real estate prices may plunge 25% in the pessimistic scenario of Brexit with no agreement.

In China, real estate prices started to rise again over summer; price growth year on year rose from +5.7% in June to +8.6% at the end of October in the seventy largest Chinese cities. This is the largest year-on-year increase since July 2017. However, the market situation is far from uniform. There is great variation between large urban centres and cities in the provinces. Understandably, concern in the country is rising, and starting to affect the balance of some real estate market segments. The real estate sector is particularly important for Chinese households, as it represents the main form of saving and investment.

The government has always been aware of the inherent risk of weakness in this sector and still has the means at its disposal to provide support. For the time being, we do not foresee any significant price correction, despite changes in forecasts linked to the trade tensions between China and the United States. It is, however, likely that prices will consolidate. In this context, we continue to prioritise the Chinese real estate market, mainly due to the valuation of securitised real estate, which is still very much affected by the risks set out above.

Japanese real estate still the best performing

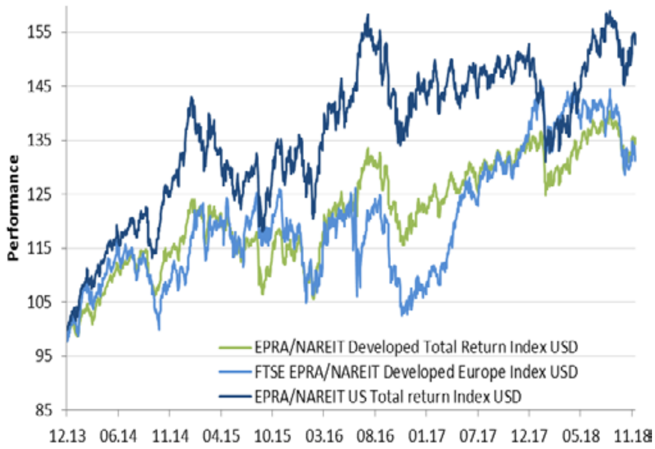
The US securitised real estate market could well have been the first affected by the interest rate rise in 2018, but that has clearly not been the case for now. It was the first market affected by the economic weakness in the 1st quarter, and recovered particularly well thereafter during the period of economic recovery and interest rate rises.

In local currency, US securitised real estate posted a satisfactory performance of +3.1% since the beginning of the year. The 1st quarter was very much favourable for the Asian market; thanks to a positive result, it clearly outperformed the Eurozone and the United States by nearly +20%, the latter two having remained negative in local currency.

In June, the 2nd quarter bounce back in the US market enabled it to achieve similar performance to other regions, thanks to the -20% drop in Chinese assets. In the end, the 3rd quarter saw convergence of the Eurozone results (+2.35%) over nine months, and slight under-performance in Asia (-0.67%), due to uncertainty weighing heavily on emerging markets. We believe that the Australian securitised market has benefited from investors repositioning so as to reduce their risk linked to emerging markets and China in the Asia-Pacific zone. This helped Australia to achieve a relatively steady +5.65% rise in context of price contractions on residential real estate (-0.6%).

Chinese securitised real estate still managed to rise +2.3%, but this positive result masks the nearly -20% plunge in prices during the second half of June, and the subsequent stabilisation of the market in the 3rd quarter. Japan is propping up the performance of the whole Asia-Pacific zone thanks to its excellent +6.9% result in yen over nine months. Japanese securitised real estate is benefiting from investors repositioning in Asia onto a developed market, while land prices saw their first modest rise in 27 years in July, at +0.1%.

EPRA/NAREIT USA Europe World Indices



Sources : Bloomberg, BBGI Group SA

The increase in US rates was not enough to punish real estate investments

Over the first nine months of the year, rises in interest rates came first and foremost in the United States, while the Eurozone and Japan saw more minor movements. The Fed's normalisation of key interest rates went hand in hand with an acceleration in long-term yields in US dollars, and more generally speaking, the whole of the interest rate curve saw an adjustment.

For several quarters, we had been saying that the pace of normalisation would step up, and that ten-year Treasury rates would head north of 3% and then hit 3.5% once inflation figures exceeded the central bank's target. The 3rd quarter drew to a close in a context of recovery on long rates, which should push long-term yield towards 3.5% at the start of 2019. Nonetheless, the US securitised real estate market remains relatively calm in this context, posting +2.7% growth over nine months, which is slightly lower than dividend yield.

Risks of a slowdown remain slim

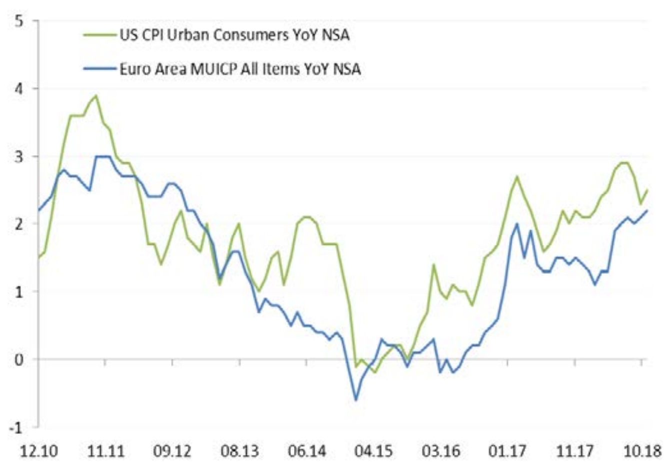
The international economy has stuck to a robust trend, despite trade tensions pointing to the risk of a slowdown in the not-too-distant future. Warnings from the IMF and other experts speaking of a likely slowdown in 2019 if the United States and China follow through on their clash about customs issues are probably overstated, and will specifically depend on what the governments will do with these duties.

Indeed, it is possible that they might not be all that negative for growth in the end if they are pumped back into the economy in the form of budgetary spending. Whatever the case may be, a slowdown would not have the same impact on the construction and real estate sector as a recession. As such, we believe that the global economic expansionary phase will continue and will be beneficial for real estate.

Real interest rates remain negative

Recent developments in the United States have confirmed our forecast of a steady rise in inflation, which should remain above the Federal Reserve's target in the long-term. We still believe that the already-visible impact on the jobs market foreshadows an improvement in salaries and household income, which will in turn affect demand and prices. Changes in energy and commodity prices will continue to put pressure on prices, as will the rise in customs duties potentially.

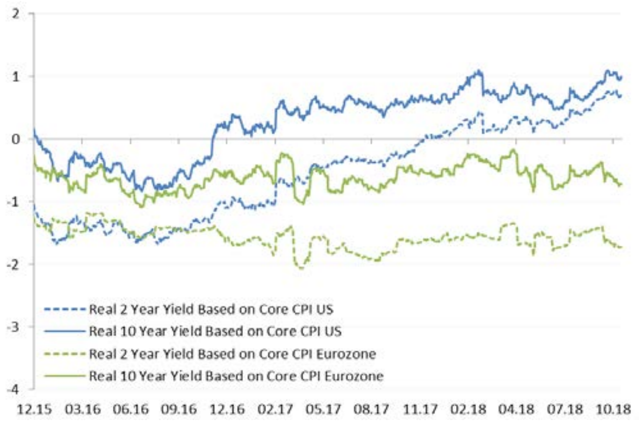
Inflation – USA and Eurozone



Sources : Bloomberg, BBGI Group SA

In the United States, inflation still stood at +2.7% in August, then +2.5% in October, which is slightly under the twelve-month rates (3.1%) and ten-year rates (3.05%). Real-terms rates in the United States have therefore crossed a threshold and are once again just in the black. Nevertheless, we do not think it enough to punish the real estate market. In the Eurozone, twelve-month yields are still negative, and, at 0.35%, the ten-year yield of the German Bund is far off the +2.5% inflation seen in October. Real-terms yields are therefore clearly negative in the Eurozone; this is also the case, among others, in Japan. Regular rises in inflation will only strengthen this trend, which we believe will be beneficial for the sector. Real estate market performances should therefore be higher when real-terms interest rates are low and growth prospects are equal to or higher than their past average. As the global economic trend shores up, so too will rent growth forecasts rise, which will be positive for the valuation of real estate assets.

Real Interest Rates – USA and Eurozone



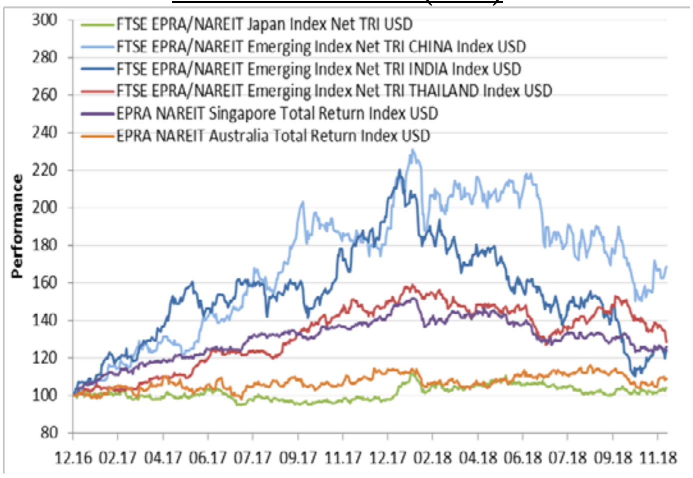
Sources : Bloomberg, BBGI Group SA

Asian real estate is offering a new opportunity

In the end, Asian real estate stood quite strong in the face of pressure and threats from the US president which had rather worried Asian and emerging equity markets. A trade war would have an impact on the various regional economic trends, and Asia would undoubtedly also be affected. However, Asian real estate can count above all on robust domestic investment demand, which would only be slightly affected by trade tensions.

The Chinese market could see an increase in relocation activity in some industries, particularly towards Viet Nam. This has already been happening for a few years. Most segments, however, should not be affected. The Chinese authorities have taken measures to relax foreign investment restrictions, not without some success, and hope that this will compensate for any potential negative impact of relocation outside of China. The appetite of domestic investors remains high in China and in South-East Asia. We believe that securitised Asian real estate should benefit from a change in regional risk analysis over the coming months, which should foster demand and price changes. The -20% fall in Chinese real estate assets has perhaps not yet finished, but it seems to have already sufficiently incorporated the increase in risk. Asian real estate is prioritised in our allocation.

Real estate markets (USD)



Sources : Bloomberg, BBGI Group SA

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